Chapter 5

Public finances in Malta and the euro area

5.1 Introduction

This chapter compares public finance developments in Malta with those in the 19 euro area countries (EA-19) over the period 2004 to 2015 based on ESA 2010 methodology.[28,29] These years cover the period since Malta joined the EU up to the latest available data for the full set of 19 countries. The high-level comparison identifies the similarities and differences relating to the conduct of fiscal policy. The analysis covers the yearly fiscal and outstanding debt balances, as well as the developments and composition of fiscal revenues and expenditures. This analysis helps identify areas where policy changes might be worth exploring and also areas of possible strengths and weaknesses in the conduct of fiscal policy in Malta. At the same time, the differences between Malta and the euro area may be entirely the result of historic developments and country preferences. Membership in the euro area does not imply harmonisation in the conduct of fiscal policy.

5.2 Macro-fiscal situation

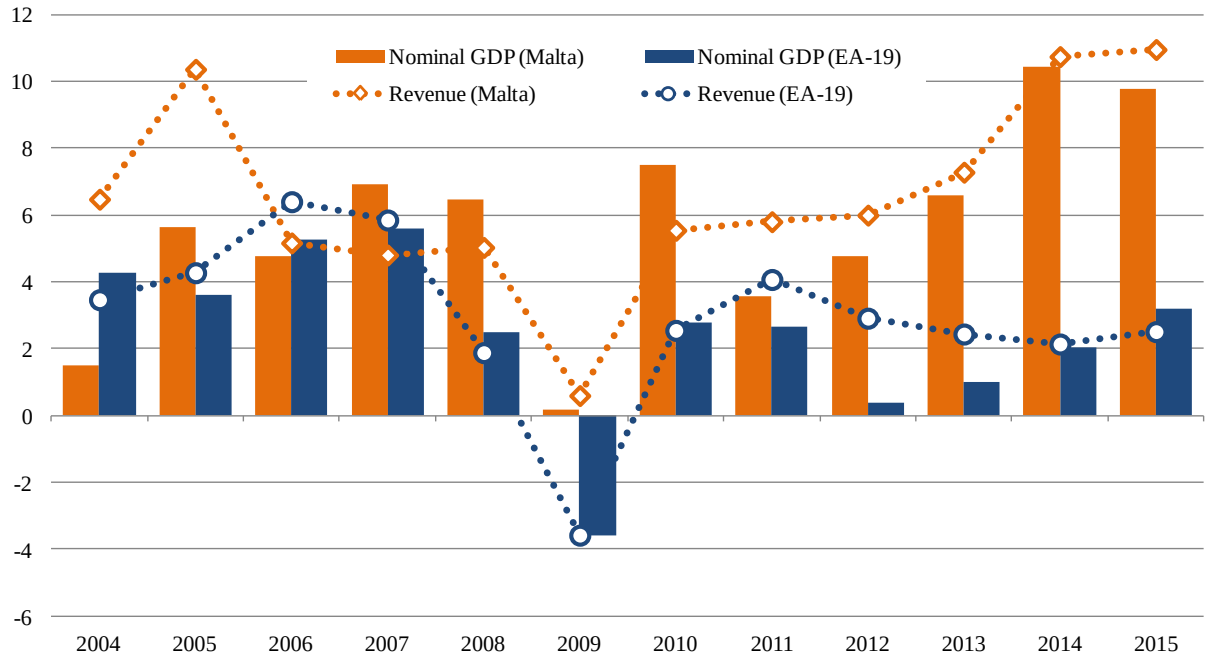
Nominal macroeconomic developments impact public finances as they drive tax bases, and hence tax revenues. The nominal macroeconomic developments underpinning the economy's business cycle implicitly also affect the economy's fiscal stance. They may also influence certain elements of government expenditure, particularly outlays on unemployment benefits. Therefore, macroeconomic developments provide useful background to help understand the observed fiscal outturn in a country. Indeed, standard economic theory suggests that fiscal policy should be counter-cyclical, that is, expansionary in times of recessions and contractionary in times of booms, thereby dampening business cycle fluctuations.

[28] Since the launch of the euro, the number of countries which adopted the euro as their currency increased to 19 [Austria; Belgium; Cyprus; Estonia; Finland; France; Germany; Greece; Ireland; Italy; Latvia; Lithuania; Luxembourg; Malta; The Netherlands; Portugal; Slovakia; Slovenia and Spain]. The euro area developments analysed in this chapter reflect 'unchanged composition', that is, the 19 countries are included for the whole period, even though some countries, including Malta joined after 2004.

[29] The ESA 2010 methodology ensures meaningful cross-country comparisons. For background information about ESA 2010 refer to http://ec.europa.eu/eurostat/web/esa-2010.

During the period under review, nominal GDP growth in Malta was almost always higher than the average rate in the euro area (see Chart 5.1). The gap actually widened in the more recent years, as nominal GDP growth in Malta accelerated while that in the euro area tended to decelerate. Correspondingly, government revenue growth in Malta generally exceeded that in euro area. The positive correlation between nominal GDP growth and revenues is quite high for Malta, at 0.71, albeit not as high as that of 0.91 for the euro area. These figures confirm that GDP developments matter significantly for government revenues, though in the case of Malta the strength of the relationship is slightly less strong than in the euro area, suggesting that factors apart from GDP also play an important role for determining overall government revenue in Malta.[30]

Chart 5.1: GDP and revenue developments (year-on-year percentage growth rates)

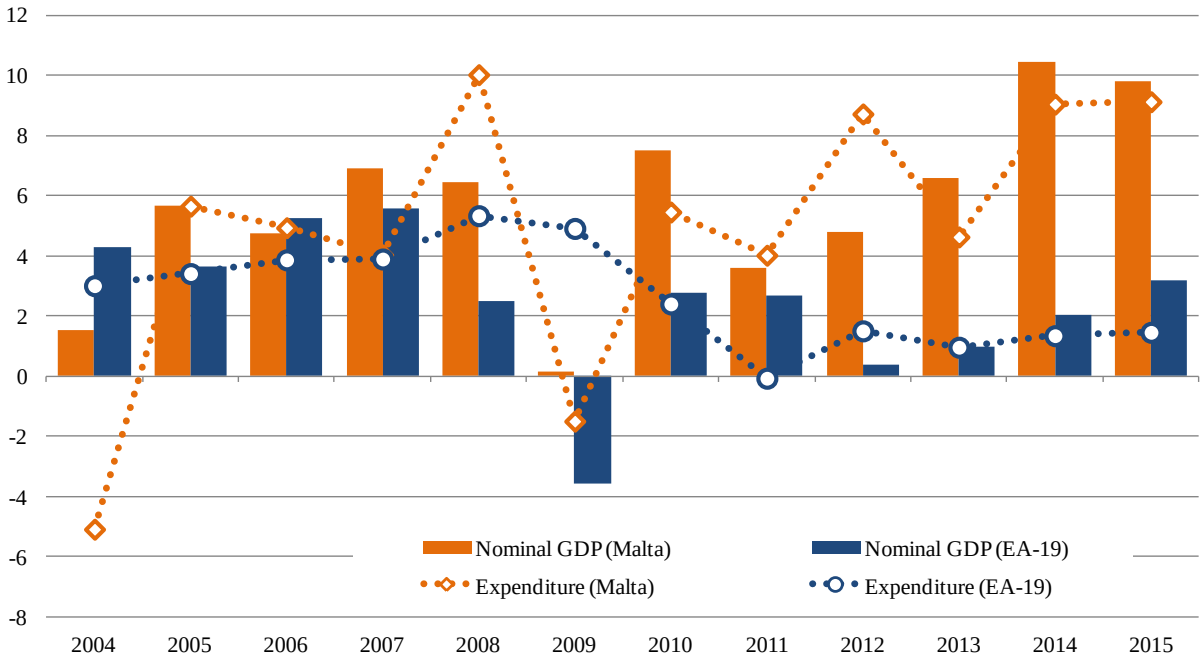


Source: Eurostat

Likewise, government expenditure growth in Malta was in most years faster than in the euro area (see Chart 5.2). It also exhibited more fluctuations, particularly when compared to the expenditure growth pattern for the euro area. Euro area expenditure growth was higher throughout the first half of the period and markedly slower in the second half. Conversely, expenditure growth in Malta tended to be faster in the second half of the period in relation to the first half. Another difference between Malta and the euro area relates to the fact that whereas the correlation between nominal GDP growth and expenditure growth in Malta was high, at 0.78, in the case of the euro area, this was marginally negative, at -0.02. This would suggest that in Malta, government expenditure has contributed positively to economic growth, as periods of higher government expenditure growth were generally associated with periods of higher nominal GDP growth.

[30] For example certain Special Purposes Entities (SPE) contribute to tax revenues but their profits are not included in the measurement of GDP. Varying tax collection efficiency across the years could also weaken the link between the year's GDP and tax revenue collected.

Chart 5.2: GDP and expenditure developments (year-on-year growth rates)



Source: Eurostat

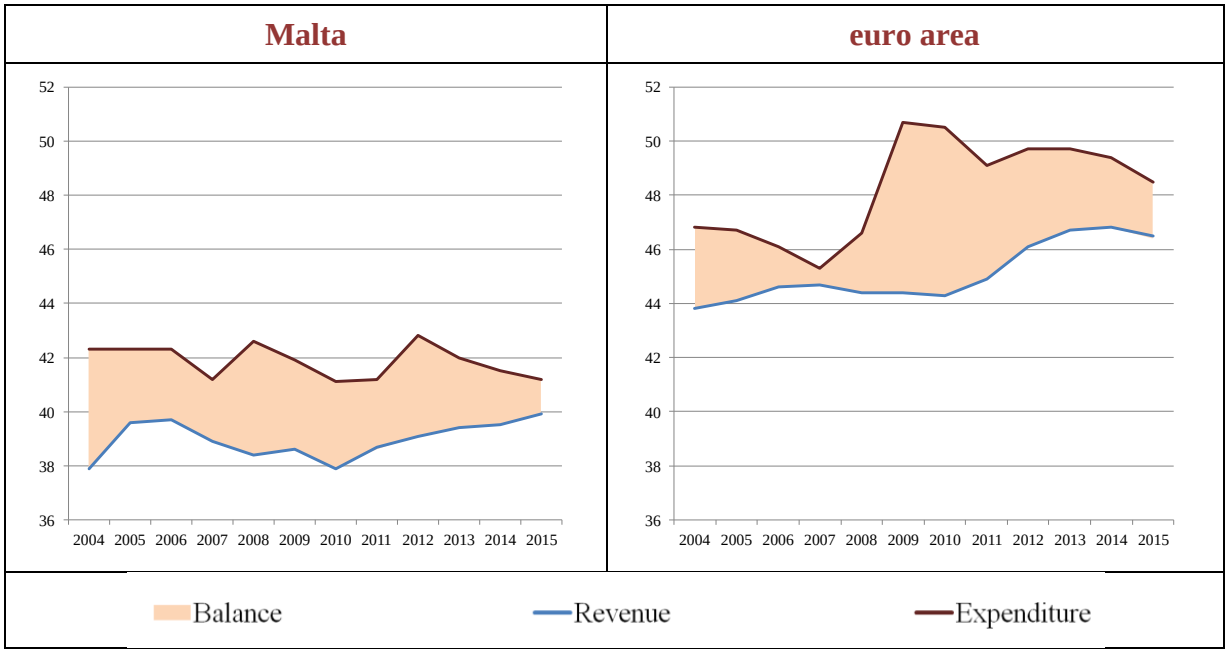
5.3 Revenue, expenditure and balance ratios

When expressed as percentage of GDP, both revenue and expenditure ratios were lower in Malta than in the euro area, throughout the whole period (see Chart 5.3). In Malta, both the revenue and expenditure ratios moved along a rather narrow range. Between 2004 and 2015, the average revenue-to-GDP ratio in Malta was 39.0% while the average expenditure-to-GDP ratio stood at 41.9%. The corresponding average revenue and expenditure ratios for the euro area were respectively 45.1% and 48.3%. These figures portray a structural difference between Malta and the euro area in terms of the extent of state intervention in the economy. The amount of services and outlays by the state across the euro area are higher than in Malta (as indicated by the higher expenditure ratio), which in turn requires higher government revenues (as indicated by the higher revenue ratio).

Indeed, the tax burden in Malta was also lower than that in the euro area, despite having increased by 1.7 percentage points (pp) between 2005 and 2015.[31] Thus, the tax burden in Malta rose from 33.0% in 2005 to 34.7% in 2015 and a similar increase was recorded in the euro area, whose tax-to-GDP ratio rose from 39.5% in 2004 to 41.4% in 2015 (see Table 5.1). Tax-to-GDP ratios varied widely within the euro area, with the highest in 2015 being 47.9% in France and the lowest 24.4% in Ireland. Malta had the eighth lowest rate within the euro area.

[31] The tax (fiscal) burden covers the categories direct taxes (D.5), indirect taxes (D.2), social contributions (D.61) and capital taxes (D.91). ESA codes are in brackets.

Chart 5.3: Revenue, expenditure and balance ratios (% of GDP)



Source: Eurostat

Table 5.1: Tax-to-GDP ratios (%)

	2005	2010	2015
Malta	33.0	32.5	34.7
euro area	39.5	39.2	41.4

Source: Eurostat News Release 234/2016

Since 2012, Malta's fiscal deficit narrowed, driven by a gradual rise in the revenue-to-GDP ratio and a decline in the expenditure-to-GDP ratio. The euro area fiscal deficit also fell, particularly when compared to the substantial widening which took place in 2009 as a result of the international financial crisis. Indeed, the financial crisis had caused a spike in the euro area expenditure ratio of 4.1 pp, whilst the revenue ratio remained rather stable. At 1.3% of GDP, Malta's 2015 fiscal deficit was the sixth lowest when compared to the other euro area countries.[32]

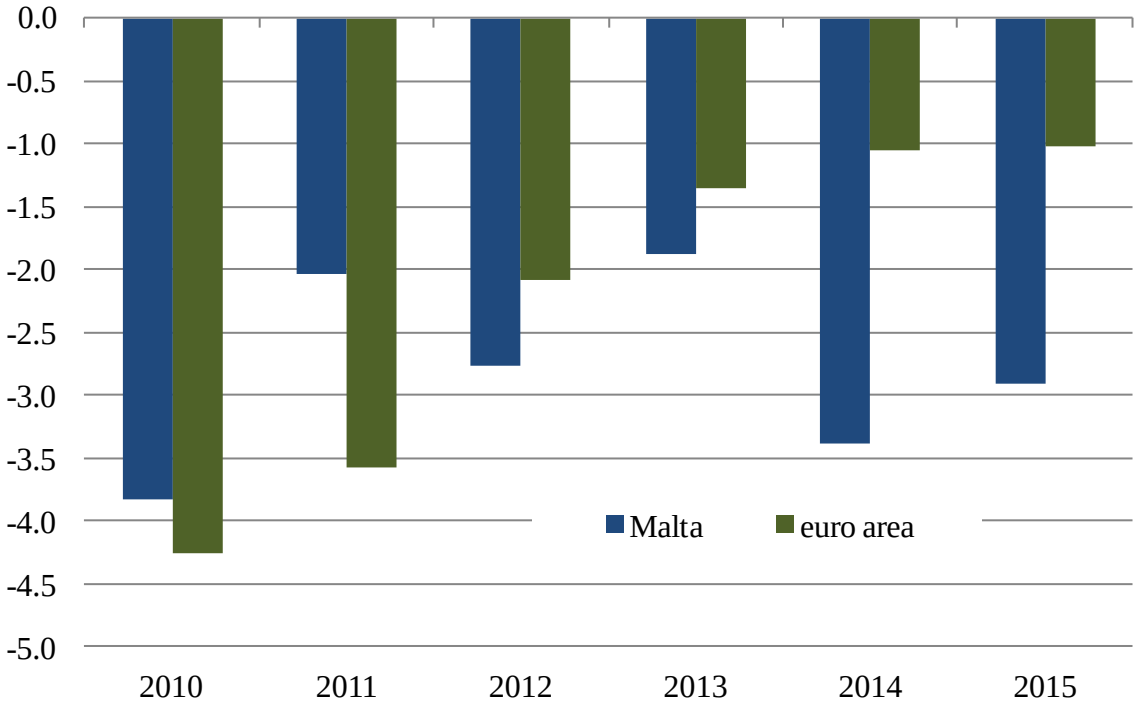
The analysis of the country's fiscal situation can also be assessed by focusing on the structural balance ratio.[33] The latter adjusts for cyclical and one-off and temporary measures, by following a standard methodology, thereby offering a potentially better gauge of the country's underlying fiscal position. This helps identify whether the reduction in the fiscal

[32] Germany and Estonia were the only two countries which recorded a fiscal surplus, equivalent to 0.7% and 0.1% of GDP respectively.
[33] In order to ensure comparability across countries the figures are reproduced from AMECO which is the statistical database of the COM.

deficit is due to genuine fiscal consolidation, or else mainly the result of one-off or cyclical factors. The structural balance is expressed as a percentage of potential output.

Malta's structural balance was rather volatile between 2010 and 2015 (see Chart 5.4).[34] Apart from 2010 and 2011, the structural deficit in Malta was higher than in the euro area. In the euro area, the fiscal consolidation was more sustained, with a consistent yearly decline in the structural deficit recorded throughout the whole period.

Chart 5.4: Structural balance (% of potential GDP)



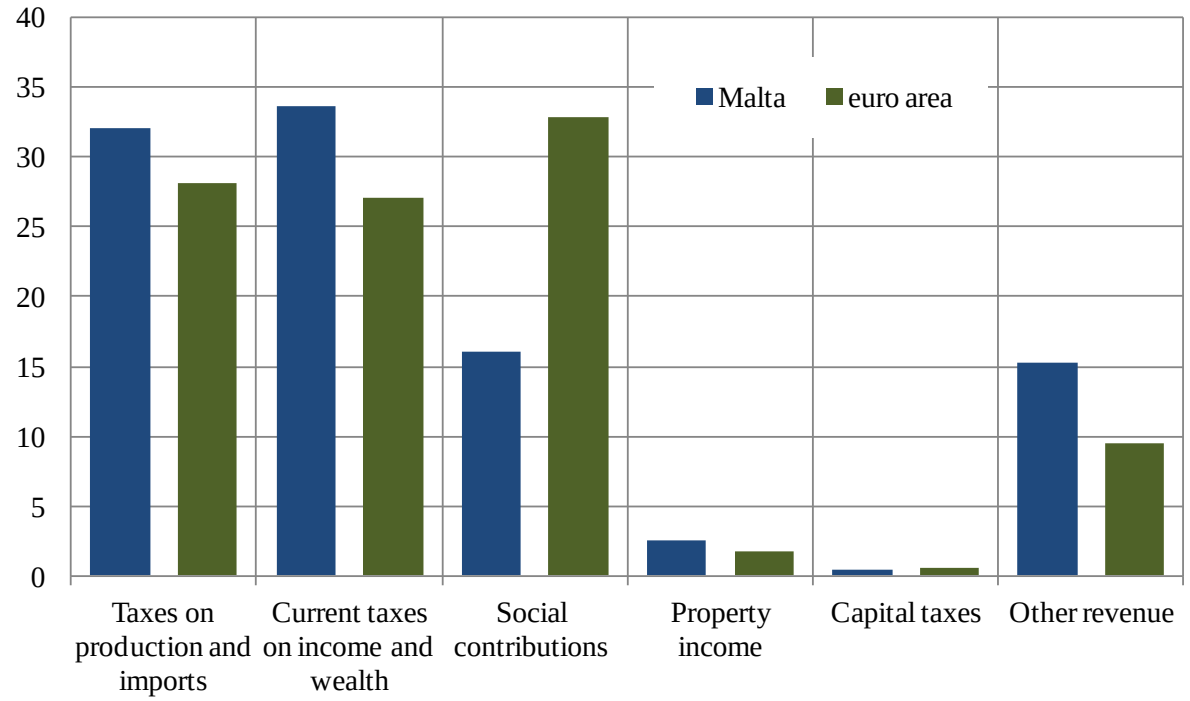
Source: AMECO

5.4 Revenue components

Government revenue patterns in Malta are slightly different when compared to those in the euro area (see Chart 5.5). The most notable difference relates to social contributions which accounted for only 16.0% of total revenues in 2015. Across the euro area, the share of social contributions in total revenue was twice as high. Indeed, when expressed as percent of GDP, social contributions in Malta, at 6.4% in 2015, were the second lowest among euro area countries where they accounted for 15.3%. This is in part attributable to the approach that has been adopted by Malta for the past years in respect of the Pay-As-You-GO (PAYG) system whereby the 10% employee and employer National Insurance (NI) contributions are capped in the case of the higher earning employees rather than applicable on the full salary.

[34] Figures for the structural balance are only available from 2010 onwards. Figures for Malta are reproduced from the COM's database and may be different from figures reported by the MFIN in its publications.

Chart 5.5: Revenue by category in 2015 (% of total revenue)



Source: Eurostat

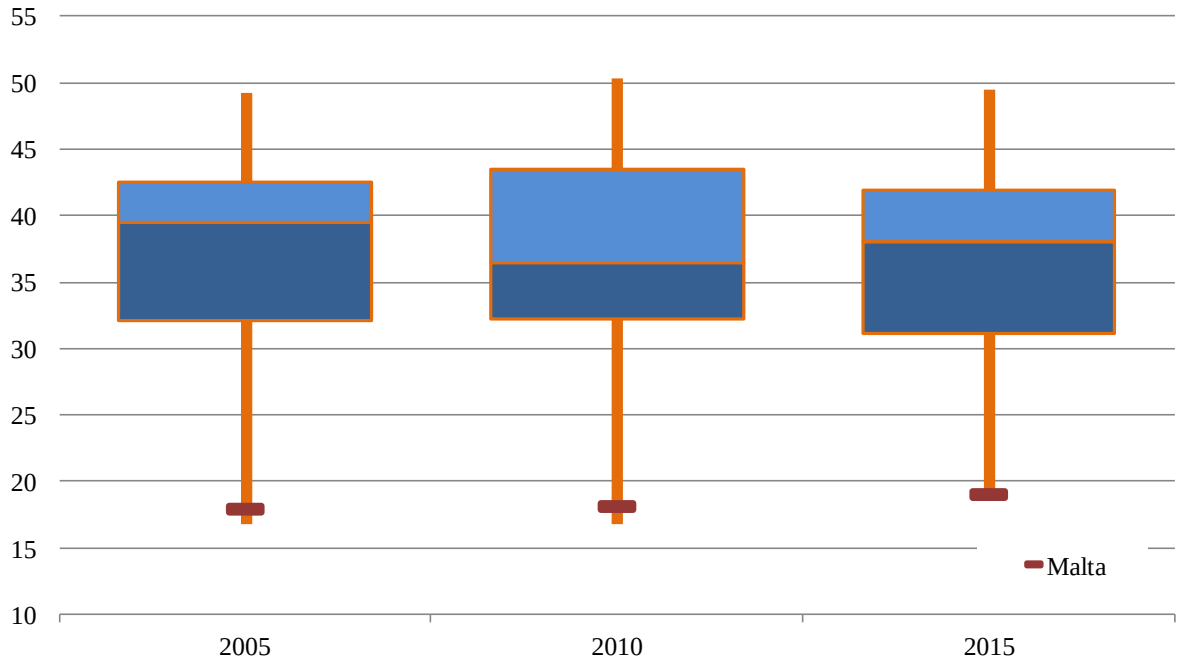
The relatively low social contributions in Malta have thus kept the tax wedge on labour among the lowest across the euro area despite the divergent trends registered by Malta and the euro area since 2005[35]. In fact, notwithstanding that Malta's tax wedge on labour costs increased from 17.9% in 2005 to 19.0% in 2015, Malta registered the lowest tax wedge amongst the euro area in 2015 (see Chart 5.6). Such low tax wedge acts as an incentive for employment generation in Malta. The tax wedge in the euro area on average declined from 42.6% to 41.4% over the same period. The highest tax wedge registered in 2015 was that of Belgium at 49.5%, followed by Germany, at 45.3%.

On the other hand, taxes on production and imports (indirect taxes) and current taxes on income and wealth (direct taxes) both accounted for a larger proportion of total revenue in Malta, respectively 3.9 pp and 6.5 pp higher than in the euro area in 2015. As a percentage of GDP, taxes on production and imports in Malta stood at 12.8% in 2015, slightly lower than the euro area average of 13.1%. The share of taxes on income and wealth was marginally higher in Malta, at 13.4% of GDP in 2015 compared to 12.6% in the euro area. This was entirely due to the higher tax-to-GDP ratio for corporates, at 6.6% for Malta against 2.5% for the euro area. In contrast, taxes on household income represented 6.7% of GDP for Malta

[35] The tax wedge on labour costs is defined as income tax on gross wage earnings plus the employee's and the employer's social security contributions, expressed as a percentage of the total labour costs of the earner. The total labour costs of the earner are defined as gross earnings plus the employer's social security contributions plus payroll taxes (where applicable). A low tax wedge boosts employment and pushes towards a more growth-friendly composition of public finances. On the other hand, when labour taxes are high, this may weigh on economic activity and employment.

compared to 9.3% for the euro area. Indeed, the reliance on corporate taxation in Malta is higher than across the euro area.

Chart 5.6: Tax wedge box plots[36] (% of total labour costs)



Source: Eurostat

Environmental taxes (largely included under taxes on production and imports) represented 2.9% of GDP in 2014 in Malta, slightly higher than in the euro area, which stood at 2.4% of GDP.[37,38] Likewise, other revenues were 5.8 pp higher in Malta, reflecting the utilisation of EU funds as well as revenues from the IIP included within this category. Revenue shares for property income and capital taxes, which are much smaller than other categories, were broadly similar in Malta and the euro area. Reliance on these sources of revenue is low both in Malta and across the euro area.[39]

[36] Box plots split the data set into quarters. The dark blue box represents the second quarter, while the light blue box represents the third quarter, showing the range of values of those countries which rank in the second lowest quarter and the second highest quarter of the dataset, respectively. The orange line in between the blue boxes represents the median. The two vertical lines (whiskers), extending from the top and bottom of the box reflect the divergence of values within the range, with the lower whisker going from quartile 1 to the lowest value while the upper whisker goes from quartile 3 to the highest value. A quartile value represents the 'cut-off' between each group. Therefore, the value of quartile 1 represents the value of the country that ranks at a quarter from the lowest value within the dataset, the value of quartile 2 represents the median, while quartile 3 represents the value of the country that ranks at a quarter from the highest value within the dataset.

[37] An environmental tax is a tax whose tax base is a physical unit (or a proxy of it) of something that has a proven, specific negative impact on the environment. Total revenues for environmental taxes include taxes on transport, energy, pollution and resources.

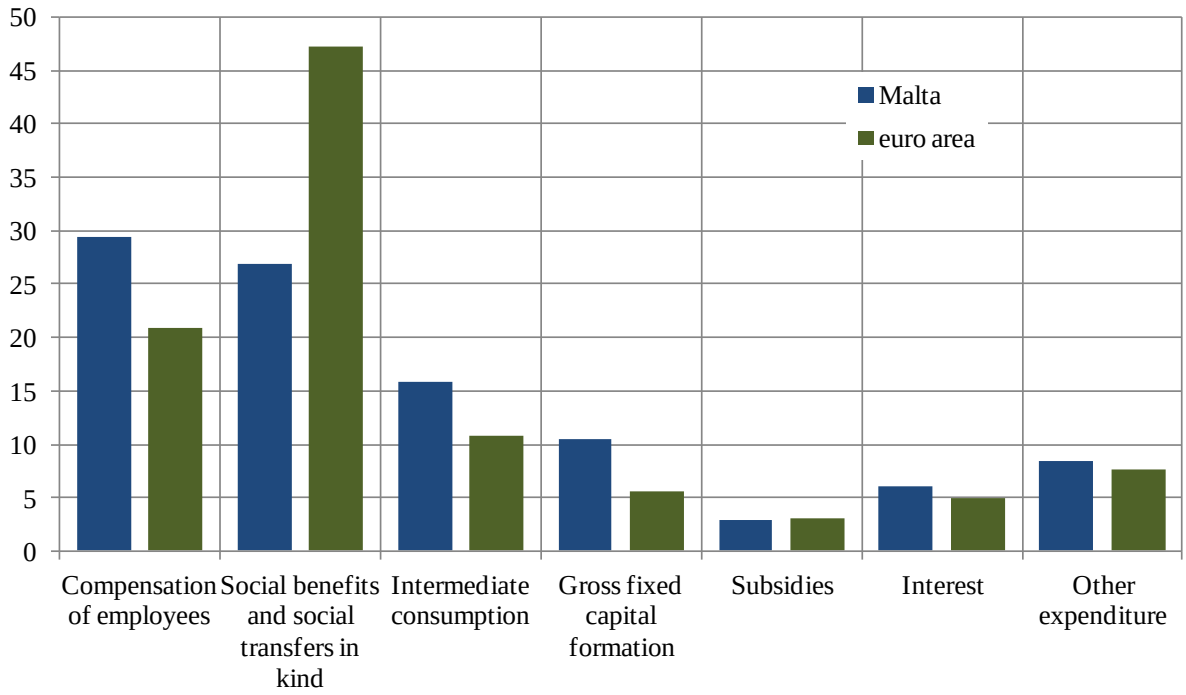
[38] Source: Environmental Trends in the European Union, 2016 edition.

[39] In the case of Malta capital taxes are mainly imposed on certain property transfers while property income mainly consists of dividends and rental earnings.

5.5 Government expenditure

The substantial difference in social contributions referred to above is also reflected in a comparable gap in social payments (see Chart 5.7). While in the euro area social benefits accounted for close to half of total expenditure, in Malta their share was lower, at 26.9%. On the other hand, Malta's spending on compensation of employees and intermediate consumption was higher than in the euro area, when expressed as percent of total expenditure. Spending on gross fixed capital formation was also relatively higher in Malta, reflecting the strong contribution of EU-funded capital projects, particularly since the absorption of EU funds was very elevated in that year as it was the last period when certain funds could be utilised. Interest payments and the 'other' expenditure categories were also marginally higher in Malta, while subsidies broadly accounted for a similar proportion in terms of percent of total expenditure.

Chart 5.7: Expenditure by category in 2015 (% of total expenditure)

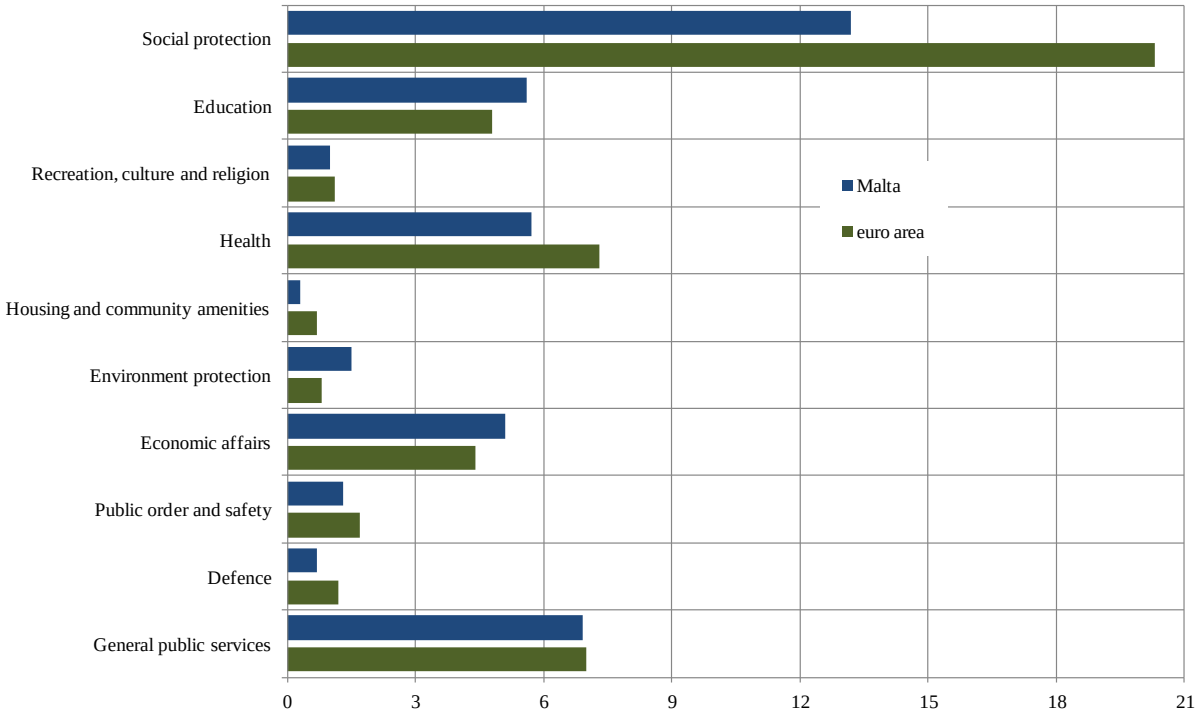


Source: Eurostat

To facilitate the analysis of expenditure patterns, government expenditure can also be assessed in terms of the Classification of the Functions of Government (COFOG). In 2014, spending on social protection and on health in Malta as a percentage of GDP was below that in the euro area (see Chart 5.8).[40] On the other hand, Malta's spending on education and on economic affairs in proportion to GDP was higher than in the euro area. Spending on other major categories was broadly in line with that in the euro area.

[40] 2014 was the last year for full country data.

Chart 5.8: Expenditure by COFOG category in 2014 (% of GDP)



Source: Eurostat

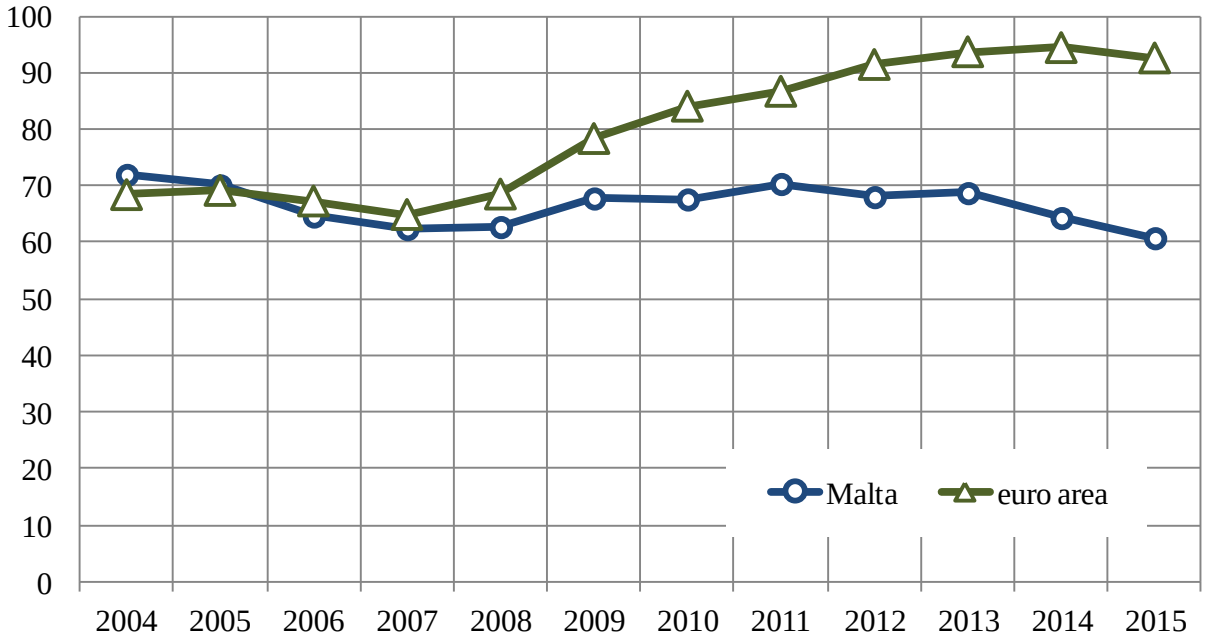
5.6 Public debt

Yearly fiscal deficits contribute to the accumulation of public debt. As a result, public debt has risen in absolute terms both in Malta and in the euro area. From an economic perspective, however, it is better to evaluate debt dynamics, when compared to nominal GDP, since the latter acts as a gauge on the extent to which there could be threats to sustainability, or otherwise. Furthermore, the SGP debt rule is specified in terms of nominal GDP. In 2004, debt-to-GDP ratios in Malta and the euro area were rather similar, close to 70.0% and remained rather close up to 2008 (see Chart 5.9). However, patterns departed with the onset of the global financial crisis after 2009 which impacted very adversely a number of euro area countries. Malta's debt ratio subsequently continued to hover around 70.0% for some years, before embarking on a downward trend, converging towards the 60.0% SGP threshold, by 2015.

On the other hand, the euro area debt ratio increased significantly during this period, and peaked to 94.4% of GDP in 2014, before declining slightly, to 92.6% in 2015. Contributing factors to this deterioration included the sharp increase in expenditure in relation to GDP in various euro area countries under the impact of substantial bail-out programmes which coincided with a deceleration in economic activity. As a result, whereas in 2005 Malta's debt ratio featured among the fourth (highest) quartile, by 2010 it retracted close to the median,

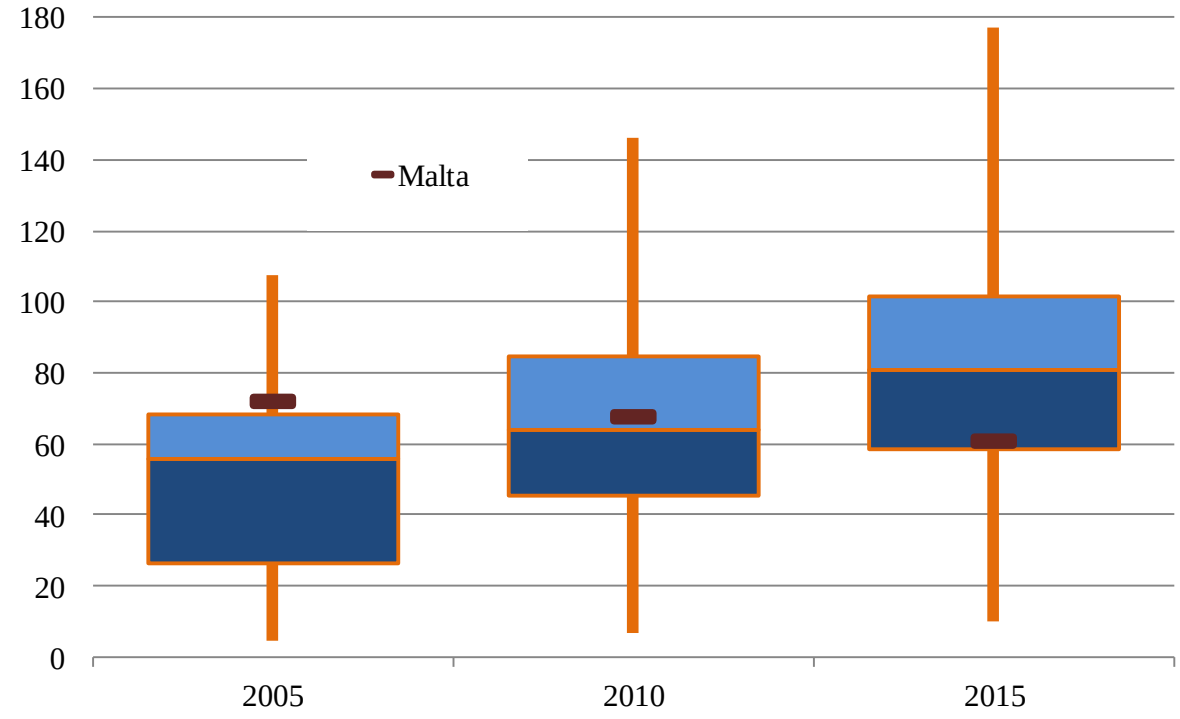
and in 2015 stood at the lower end of the second quartile (see Chart 5.10).[41] This is largely explained by the very elevated nominal GDP growth rates which were recorded in recent years when compared to the other euro area countries.

Chart 5.9: Debt levels (% of GDP)



Source: AMECO

Chart 5.10: Government debt box plots (% of GDP)



Source: AMECO

[41] In 2015 Greece had the highest debt-to-GDP ratio, at 177.4%, while Estonia had the lowest ratio, at 10.1%.

5.7 Conclusion

Malta's headline fiscal situation has tended to improve during the period surveyed. Buoyant economic growth has contributed positively to this improvement. This was facilitated by the strong economic resilience demonstrated by the Maltese economy when faced with both the international financial crises as well as the EU sovereign debt crisis which negatively impacted several EU countries. This was reinforced by a process of fiscal consolidation measures and expenditure rationalisation initiatives, in part reflecting the impact of the CSR exercises.

The fiscal trends observed during the period surveyed also highlighted a number of structural differences between Malta and the euro area countries in terms of revenue sources and expenditure allocations as witnessed by the lower revenue and expenditure ratios in Malta compared to the euro area. To a large extent these mirror the policy response in respect of the range and extent of services offered by the government and the tax framework which has prevailed in Malta for many years. At the same time, by comparing the fiscal outturn for Malta and the euro area, one can re-assess whether the current conduct of fiscal policy is deemed to be the most suitable for Malta, or else whether possible fine-tuning of revenue and expenditure policies could be considered.