

expenditure side.²⁷ Taking into account all these elements, the deviation is reduced to 0.4pp leading the COM to conclude that Malta has registered “some but close to significant deviation from the adjustment path towards the MTO in 2015”.

However, in 2016, according to the MFIN’s plans and the COM’s projections, expenditure growth will be contained to 0.2pp below the specified benchmark. This is also facilitated through the lower uptake of EU funds compared to a year earlier, hence requiring lower co-financing. On the contrary, in 2017 the projections indicate that the expenditure benchmark will again be exceeded, by 0.2pp in the case of the MFIN’s projections and by 0.6pp according to the COM’s projections, based on the no-policy-change assumption. Thus, for the period 2015 – 2016, both the MFIN and the COM expect an average deviation of 0.5pp. On the other hand, for the period 2016 – 2017, according to the MFIN’s forecasts there should be no deviation while the COM expects a small deviation equivalent to 0.2pp.

The MFAC acknowledges that in a situation where the economy is undergoing structural changes, estimates of potential output growth may be volatile and not necessarily robust. However, it invites the Government to exert further restraint in expenditure in order to address the risk of a significant deviation from the reference rate and thereby ensure full compliance with the expenditure growth benchmark. Indirectly this would also help to address the risk that revenue windfalls are channelled into higher expenditures.

5. Sustainability of public finances

As confirmed by COM’s periodic sustainability analysis, there do not appear to be risks to fiscal sustainability in the short term, on the basis of various fiscal and financial competitiveness indicators. The COM’s medium term outlook also suggests a resilient scenario, with low risks to fiscal sustainability. On the other hand, the COM’s projections for the long term point towards possible medium risks to fiscal sustainability (see Box 2).

Box 2: The COM’s fiscal sustainability analysis

Pressures on public finances may arise in the short term, medium term or in the long term. Since the time available for policy action differs, it is thus important to distinguish between the various horizons over which fiscal challenges may be posed. The more fiscal risks are identified in the short-term, the more urgent the need for corrective action, while when such risks relate mainly to the long-term, there will be more time available to design appropriate policy changes.

²⁷ In 2014, temporary measures and one-off effects included the Investment Registration Scheme, sale of land and the adjustment of the national contribution to the EU budget. In 2015, temporary and one-off measures amounted to less and were mainly related to the sale of land.

In this respect, the COM uses a methodology which aims to identify whether on the basis of a ‘no-policy change’ scenario, risks are likely to emerge, within a year, by 2030 or in the distant future.²⁸ The quantitative indicators are respectively referred to as S0, S1 and S2.²⁹

The S0 indicator incorporates 14 variables under the sub-component ‘fiscal index’ and another 14 variables under the sub-component ‘financial competitiveness index’ (see Table A). These two sub-indices mainly capture fiscal and macroeconomic conditions which empirical evidence has shown to be good predictors of fiscal stress.

Table A: Components of the S0 indicator

Fiscal index	Financial competitiveness index
1. Balance, % GDP	1. Net international investment position, % GDP
2. Primary balance, % GDP	2. Net savings of households, % GDP
3. Cyclically adjusted balance, % GDP	3. Private sector debt, % GDP
4. Stabilizing primary balance, % GDP	4. Private sector credit flow, % GDP
5. Gross debt, % GDP	5. Leverage, financial corporations
6. Change in gross debt, % GDP	6. Short-term debt, non-financial corporations, % GDP
7. Short-term debt, government, % GDP	7. Short-term debt, households, % GDP
8. Net debt, % GDP	8. Construction, % value added
9. Gross financing needs, % GDP	9. Current account, 3-year backward moving average, % GDP
10. Interest rate-growth rate differential	10. Change (3 years) of real effective exchange rate, based on exports deflator
11. Change in expenditure of general government, % GDP	11. Change (3 years) in nominal unit labour costs
12. Change in final consumption expenditure of general government, % GDP	12. Yield curve
13. Old-age dependency ratio 20 years ahead	13. Real GDP growth
14. Average yearly change in projected age-related public expenditure as % of GDP over next 5 years	14. GDP per capita in PPP, % of US level

Source: COM

According to the assessment carried out by the COM, in the case of Malta **the short term risks are low** as measured by the S0 indicator, with both the fiscal sub-index and the financial and competitiveness sub-index pointing towards low risks.³⁰ This is in line with Malta’s recent improvements in public finance conditions and the current benign macroeconomic conditions.

²⁸ A ‘no-policy change’ scenario means that the existing policies are assumed to remain in place throughout the full forecast horizon.

²⁹ For further details on the methodology and the results for the various EU Member States, refer to the ‘Fiscal Sustainability Report 2015’, available on: http://ec.europa.eu/economy_finance/publications/eeip/ip018_en.htm.

³⁰ In the case of Malta, the value of the S0 indicator was calculated at 0.1, which is significantly below the applicable threshold of 0.43. The figures for the various indicators have been updated by the COM in its assessment of Malta’s latest USP, when compared to the figures shown in the Fiscal Sustainability Report 2015.

On the other hand, the S1 and S2 indicators are based on the inter-temporal constraint facing governments, namely that the current public debt and the discounted value of future public expenditure is covered by the discounted value of future public revenues. However, whereas the S1 indicator measures the required fiscal adjustment to ensure that the 60% public-debt-to-GDP ratio can be attained by 2030, the S2 indicator measures the adjustment necessary to ensure that the debt-to-GDP ratio stabilises over the infinite horizon (see Table B). Thus, the S1 and S2 indicators are forward looking (as opposed to the S0 indicator which is mainly backward looking), and importantly, factor in those expenditures which may be slowly but steadily increasing over time, particularly as a result of ageing.

Table B: S1 and S2 sub-components

	<i>Required adjustment given initial budgetary position</i>		<i>Required adjustment to reach debt ratio of 60% in 2030</i>		<i>Required adjustment due to cost of ageing</i>
S1 =	Gap to debt stabilising primary balance	+	Additional adjustment to reach the 60% debt ratio in 2030	+	Additional adjustment required to finance the increase in public spending due to ageing up to 2030
S2 =	Gap to debt stabilising primary balance	+	0	+	Additional adjustment required to finance the increase in public spending over infinite horizon

Source: COM

In the case of Malta, **medium term risks**, based on the **S1 indicator**, are estimated to be **low**.³¹ Indeed, according to the COM's projections, the gross debt ratio will fall below 60% of GDP by 2017 and thereafter the costs of ageing are not expected to contribute to breach again this debt threshold, at least up until 2030. On the other hand, as regards the **long term**, the **S2 indicator places Malta in the medium risk** territory.³² This is entirely attributable to the fact that in the long term, the costs of ageing are expected to be significant, particularly as a result of the projected higher outlays driven by pensions, health care and long term care. These higher costs are expected to more than offset Malta's favourable initial budgetary position.

³¹ In the case of Malta, the value of the S1 indicator was calculated at -0.9pp of GDP. A negative value by definition classifies a country as low risk since it implies that a country may be able to undertake some fiscal loosening without breaching the debt threshold within the specified timeframe.

³² In the case of Malta, the value of the S2 indicator was calculated at 4.3% of GDP, which falls within the bracket of 2-6%, which is the category for medium risk. This means that an adjustment effort of 4.3% of GDP is required in order to ensure that the debt-to-GDP ratio does not embark on an upward path.