An overall assessment of
the Draft Budgetary Plan 2016

A report prepared by the
Malta Fiscal Advisory Council

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Dear Minister

LETTER OF TRANSMITTAL

In terms of article 13 of the Fiscal Responsibility Act, 2014 (Cap 534), I have the honour of transmitting a report by the Malta Fiscal Advisory Council (MFAC) with regard to an overall assessment of the Draft Budgetary Plan (DBP) 2016. This Report, which follows the earlier MFAC's opinion on the plausibility of the macroeconomic and fiscal projections contained in the DBP, focuses predominantly on the conduct of fiscal policy in high level terms, in particular on the extent to which the current and planned conduct of fiscal policy can be considered as sound, and in line with Malta's national and international obligations in the area of public finances.

The MFAC commends the Government for its full commitment to the announced fiscal targets within the context of a policy of growth friendly fiscal consolidation. The consecutive declines in the annual fiscal deficit being achieved and planned, suggest that the country is on the right path towards attaining its Medium Term Objective of a balanced budget in structural terms by 2019, which the MFAC considers as a cornerstone of prudent macroeconomic management.

The MFAC favourably notes that the fiscal and macro projections prepared by the EU Commission (COM), as part of its autumn forecast round, are broadly in line with those presented by the Government in the DBP. This offers further support to the robustness of the estimates underpinning the DBP for 2016. The view of the MFAC is that the Government's fiscal projections are attainable although in some instances, particularly on the expenditure side, they may be quite challenging.

However, the MFAC also notes that the fiscal deficit-to-GDP targets for 2015 and 2016 were left unchanged from the levels set in the Update of Stability Programme 2015–2018, notwithstanding an improved macroeconomic scenario. The MFAC considers that against such a generally enhanced macroeconomic situation, there is a good opportunity to accelerate the fiscal consolidation process. In particular, the MFAC strongly recommends that revenue windfalls, as distinguished from normal revenue forecast errors, should primarily be used to build fiscal buffers.

With respect to the announced fiscal measures for 2016, the MFAC considers positively the introduction of some measures contributing to a diversification of tax bases, as well as the ongoing shift from direct to indirect taxes. The latter has enabled the country to maintain the tax burden on labour at low levels, a factor which supports the recent successes in boosting overall employment. As regards the tax bases, while the new environmental contribution to be levied on the tourism sector as from April 2016 is unlikely to have major effects, it is a step towards broader tax bases which should contribute to ensure that tax sources are more diversified and more stable. Such initiatives to broaden and diversify the tax bases are instrumental in maintaining revenues more stable in the face of underlying upward expenditure pressures. This is also important so as to mitigate the risk of possible shortfalls from certain potentially volatile revenue sources, such as tax on profits on companies with limited presence in Malta as well as under the Individual Investor Programme (IIP).

With regard to the IIP, it is pertinent to note that whereas on a cash accounting basis, 70% of IIP revenues are being channelled to the National Development and Social Fund rather than used to finance the fiscal deficit, according to ESA standards the entire revenues collected through the IIP feature as part of government revenues, and hence are an important contributor to the reported decline in the fiscal deficit. The MFAC encourages the Government to evaluate how best to utilise such funds, particularly to ensure that such funds are used to finance the acquisition of financial assets, rather than to fund direct expenditure, as this could have implications for the future fiscal balances, when measured according to the ESA definitions.

As for the debt management policy, the strategy of opting for longer duration of public debt is fully supported by the MFAC. Indeed, there appears to be scope to extend the average maturity of public debt further, to enable the Government to benefit from the current exceptionally low interest rate environment and limit the impact of the eventual rise in interest rates as they revert back to normal, besides reducing roll-over risks.

It is noted that in the COM's assessment of the DBP, Malta's DBP was classified as 'broadly compliant' with the requirements of the Stability and Growth Pact (SGP), an opinion which is also shared by the MFAC. Indeed, while the current projections indicate that the debt criterion will be comfortably met, there remains a possibility that the actual structural effort undertaken may fall short of the 0.6 percentage point requirement indicated in the Country Specific Recommendation addressed to Malta, according to the calculations by the COM. Likewise, the overall expenditure growth, net of certain specific items, may overshoot the limits prescribed by the SGP, as computed by the COM. The MFAC therefore emphasises the importance of adding momentum to the expenditure rationalisation and reform processes, and the avoidance of situations where revenue windfalls could be channelled into additional permanent spending.

In this context, it is essential for the Authorities to continue to exercise constant vigilance to ensure adherence to the expenditure containment plans. In this respect, the MFAC fully supports the decision to implement a fiscal rule, through Directive Number 9 of 18 September 2015, aimed at ensuring that ministries respect the cap of the approved wage bill, which represents a significant part of the yearly fiscal expenditures. The ongoing Comprehensive Spending Review exercise is another important tool to seek further expenditure rationalisation opportunities and greater efficiencies.

With regard to the Contingency Reserve, the MFAC acknowledges that some expenditure undertaken in 2015 was not initially allotted for in the Budget Estimates, and as a result, the Government took the decision to drawdown fully the Contingency Reserve, on account of unforeseen circumstances. However, the MFAC invites the authorities to establish more rigorous policies of how this Reserve may be resorted to in future, while at the same time encouraging the authorities to maintain the required amount of funds in the Reserve, as stipulated in the Fiscal Responsibility Act.

In this Report, the MFAC lists areas of possible improvement in terms of added transparency in future DBP documents, with the aim of enhancing further the fiscal governance framework in Malta. In particular, the MFAC considers important that the differences between the balance on the Consolidated Fund, upon which the Budget Speech is based, and the fiscal balance calculated on the basis of the ESA guidelines, upon which the DBP is based, are clearly mapped and explained. This is useful in order to enhance the general public's understanding of important fiscal issues and developments. Likewise, it is desirable that the DBP makes public the key fiscal assumptions, such as the employment level within general government and details about large public investment projects, in order to boost transparency of the conduct of fiscal policy.

Finally, the MFAC would like to express once again its appreciation to the staff within the Ministry for Fin

ance and the National Statistics Office for their assistance and cooperation in providing the necessary information and support for the preparation of this assessment.

Yours sincerely

Rene Saliba
Chairman

c.c. Mr Alfred Camilleri, Permanent Secretary, Ministry for Finance

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Abbreviations

BO	Budget Office
CBM	Central Bank of Malta
COM	European Commission
CSR	Country-specific recommendations
DBP	Draft Budgetary Plan
DG ECFIN	Directorate General for Economic and Financial Affairs
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EPD	Economic Policy Department
ESA	European System of National and Regional Accounts
EU	European Union
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
IBP	International Budget Partnership
IIP	Individual Investor Programme
IMF	International Monetary Fund
MFAC	Malta Fiscal Advisory Council
MGS	Malta Government Stocks
MTO	Medium-Term Objective
MFIN	Ministry for Finance
NSO	National Statistics Office
pp	percentage points
SGP	Stability and Growth Pact
USP	Update of Stability Programme

Executive summary

This Report, which is to be viewed in conjunction with the latest reports on the plausibility of the macro and fiscal projections, presents a high level assessment of the Draft Budgetary Plan (DBP) for 2016. The Report focuses predominantly on the conduct of fiscal policy in high level terms, in particular on the extent to which the current and planned conduct of fiscal policy can be considered as sound, and in line with Malta's international obligations in the context of a prudent and sustainable administration of public finances.

The DBP reaffirms the Government's efforts to cut down the fiscal deficit further from 1.6% of GDP in 2015 to 1.1% of GDP in 2016, alongside a targeted decline in the debt-to-GDP ratio from 66.6% in 2015 to 65.2% in 2016. The Malta Fiscal Advisory Council (MFAC) commends the authorities' full commitment to the announced fiscal targets, which suggests that the country is on the right path towards attaining its Medium Term Objective (MTO) of a balanced budget, in structural terms, by 2019, which is a cornerstone of prudent macroeconomic management. However, the MFAC notes that the fiscal deficit-to-GDP targets for 2015 and 2016 were left unchanged from their levels as set in the Update of Stability Programme 2015-2018, notwithstanding an improved macroeconomic scenario. In this context there appears to be scope for the structural effort to be stepped up further, given the very favourable macroeconomic and financial conditions, particularly the elevated economic growth and the historically low interest rates.

While the MFAC acknowledges that the correction of fiscal imbalances needs to be gradual, in order to avoid adverse shocks which could undermine economic growth, the MFAC underscores that a period of high economic growth facilitates the implementation of reforms. The MFAC encourages the Government to take advantage of the current benign macroeconomic scenario in Malta, with real growth rate of 3.6% being projected for 2016, to add momentum to the expenditure rationalisation and reform processes. At the same time, it remains paramount that any revenue windfalls should not be channelled into additional permanent spending. Indeed, the MFAC strongly advises that revenues in excess of targets should be carefully analysed and any revenue windfalls, as distinguished from normal revenue forecast errors, should primarily be used to build fiscal buffers.

The MFAC favourably notes that the fiscal and macro projections prepared by the EU Commission (COM), as part of its autumn forecast round, are broadly in line with those presented by the Government in the DBP. This offers further support to the robustness of the estimates underpinning the DBP for 2016. Specifically, with respect to the fiscal projections, the planned expenditure restraint appears to be rather ambitious. Accordingly, the authorities are being encouraged to be vigilant in order to adhere fully to the announced plans to meet the stated targets and to ensure the effective implementation of Directive No. 9 aiming to keep the public sector wage bill under control.

The MFAC acknowledges that some expenditure undertaken in 2015 was not initially allocated for in the Budget Estimates, and as a result, the Government took the decision to drawdown fully the Contingency Fund, on account of unforeseen circumstances. However, the MFAC invites the authorities to establish more rigorous policies of how this reserve may be resorted to in future, while at the same time encouraging the authorities to replenish the Contingency Fund, as stipulated in the Fiscal Responsibility Act.

In terms of compliance with the requirements of the Stability and Growth Pact (SGP), the view of the MFAC, like that of the COM is that Malta's DBP is 'broadly compliant'. While the debt rule appears to be comfortably satisfied, as the downward pattern in the debt-to-GDP ratio is ahead of the set path to converge towards the 60% debt-to-GDP threshold, there is some risk that the other two criteria may only be partially met. Indeed, the structural effort, in terms of the fiscal consolidation undertaken over and above cyclically-driven improvements, may fall short of the 0.6 percentage points prescribed in the country-specific recommendations addressed to Malta. Likewise, expenditure growth may overshoot the limits prescribed by the SGP, though such expenditure benchmark limits may be considered to be somewhat restrictive since they are based on past estimates of Malta's potential growth, which may not fully reflect the recent surge in investment activity, and the ongoing rise in the female labour market activity rates.

With respect to the announced fiscal measures for 2016, the MFAC considers positively the diversification of tax bases through the addition of new sources of tax, as well as the ongoing shift from direct to indirect taxes. The latter has enabled the country to maintain the tax burden on labour at low levels, a factor which supports employment.

Finally, the MFAC has identified additional fiscal information which would be useful to be included in future DBP documents, in order to enhance transparency and contribute to better fiscal governance in Malta.

1. Introduction

On 15 October 2015 the Ministry for Finance presented the Draft Budgetary Plan (DBP) for 2016.[1] The DBP is an important document within Malta's fiscal cycle as it presents the Government's updated official macroeconomic outlook and the fiscal projections for 2015 and 2016, in line with the requirements of the Stability and Growth Pact (SGP).

This Report is being prepared by the Malta Fiscal Advisory Council (MFAC) in terms of article 13 of the Fiscal Responsibility Act, 2014 (Cap 534), henceforth referred to as FRA. The aim of this Report, which is to be viewed in conjunction with the MFAC's latest reports on the plausibility of the macro and fiscal projections, is to present the MFAC's high level assessment of the DBP for 2016. It focuses predominantly on the conduct of fiscal policy in high level terms and adherence to the international obligations in the area of public finances.

This Report continues as follows. Section 2 presents some background to the DBP framework. Section 3 presents an overview of the revenue and expenditure patterns observed in recent years and how these are expected to evolve in 2015 and 2016. Section 4 then evaluates the projected fiscal developments against the expected macroeconomic conditions and announced measures. Section 5 focuses on a comparison of the fiscal and macroeconomic projections presented in the DBP, with those of the COM. Section 6 evaluates the compliance with the SGP requirements, based on the MFAC's and COM's assessments. Section 7 evaluates the extent to which the current and planned conduct of fiscal policy can be considered as sound, as well as provides recommendations to improve the conduct of fiscal policy. Section 8 presents the overall conclusions and suggestions for further enhancing the transparency of the DBP document and process.

2. Background to the DBP framework

The DBP forms part of the formulation stage within the fiscal governance framework in Malta (see Table 1). This document is based on the Budget Speech 2016, which was presented in Parliament on 12 October 2015.[2] All the budget votes by ministry, which underpin the fiscal data contained in the DBP for 2016, were subsequently approved by Parliament on 9 December 2015 (sitting number 338 by means of motion number 268).[3]

[1] The cut-off date for data included in this MFAC Report is 1 December 2015. Other information is updated up until the publication date.
[2] The Table is based on the framework used by the International Budget Partnership (IBP) to categorise the various stages of the budget. The IBP is an organisation which collaborates with civil society around the world to use budget analysis and advocacy as a tool to improve effective governance and reduce poverty. For further details refer to Open Budget Survey 2015, available on http://internationalbudget.org/
[3] Refer to http://www.parlament.mt/sittingdetails?sid=5181&l=1&legcat=13&forcat=12 for the full details of the sitting.

Table1: The fiscal governance framework in Malta

Stage	Relevant documents
Formulation The Government presents the proposals for the new tax and expenditure measures	**Pre-Budget Document**: A high level document which identifies key fiscal issues and options
	Budget Speech: The official presentation in parliament of the Government's fiscal plans and measures for the following year
	Budget Estimates: Line by line expenditures votes by each ministry for the following year
	Draft Budgetary Plan: The publication of the fiscal plans and measures according to the requirements of the SGP and based on the ESA guidelines
Approval Legislative debates and approval of the budget proposals	**Budget Measures Implementation Act**: Legislation to implement the budget measures for the financial year
	Appropriation Act: Legislation to appropriate funds from the Consolidated Fund to meet expenditure during the next financial year under the specified votes indicated in the Budget Estimates
	Second Appropriation Act: Legislation to appropriate further funds from the Consolidated Fund to meet additional expenditure indicated in the revised votes for the same year
Execution Government implements the outlined policies	**Annual Report**: Commentary on the previous' year fiscal turnout
	Half Yearly Report: Update on the fiscal performance and implementation of the budget for the first half of the year
Oversight Independent assessment of fiscal performance	**MFAC and COM Assessments:** Evaluation of the plausibility of the macroeconomic and fiscal projections and compliance with existing fiscal rules, in terms of the FRA and the SGP

Source: International Budget Partnership

The DBP outlines the planned revenue and expenditure measures for the year ahead in order to meet the announced fiscal targets. The minimum content of the DBP is prescribed and must include specific information on the basis of Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (see Table 2).[4]

Euro area Member States are required by the European economic governance rules to submit their DBP for the forthcoming year to the European Commission (COM) and to the Eurogroup by 15 October of each year as part of the European Semester (see Diagram 1).[5] This requirement

[4] This Regulation can be accessed on http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0473
[5] The European Semester is a pre-defined timetable according to which the member states receive EU-level advice and then submit their policy plans to be assessed at EU level. For further details refer to http://www.consilium.europa.eu/en/policies/european-semester/how-european-semester-works/

is also established through Regulation (EU) No 473/2013. Importantly, the DBP must aim to be consistent with the fiscal country-specific recommendations (CSRs) issued by the COM (see Box 1). In the case of Malta, the DBP is also mandated through article 16 of the Fiscal Responsibility Act (FRA), which lays down the specific minimum content which must be included in this document.

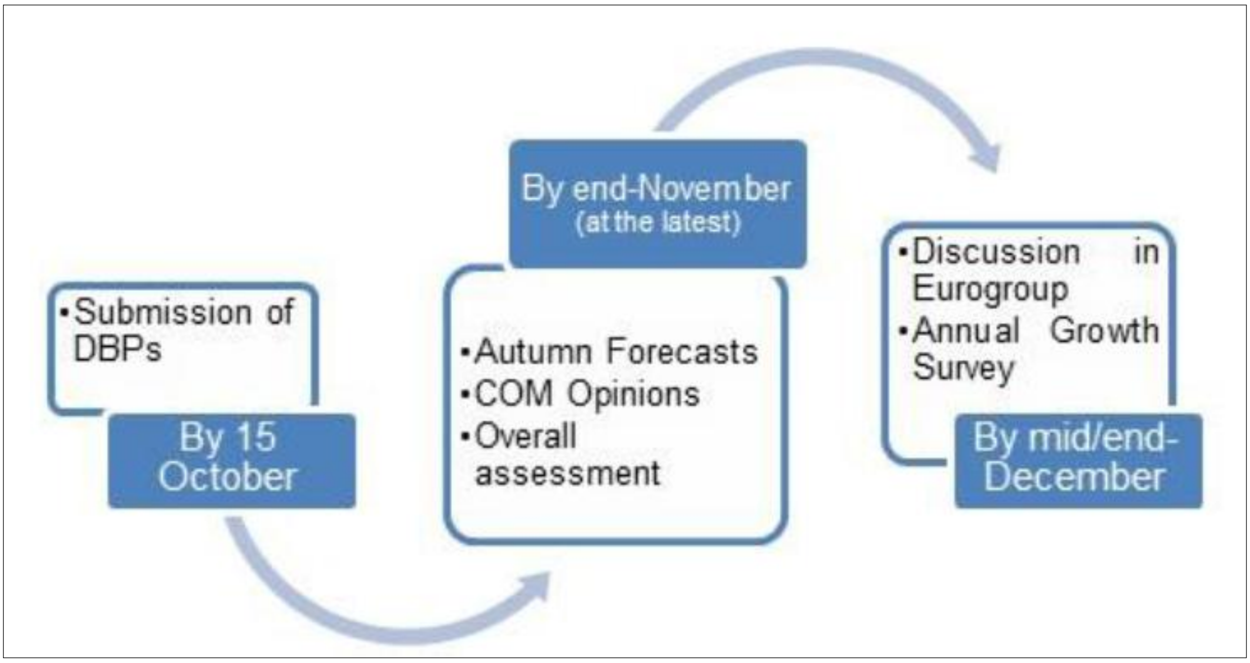
Table 2: The information required to feature in the DBP[6]

Targeted budget balance	The targeted budget balance for the general government as a percentage of Gross Domestic Product (GDP), broken down by sub-sector of general government
Unchanged policy projections	The projections at unchanged policies for expenditure and revenue as a percentage of GDP for the general government and their main components, including gross fixed capital formation.
Targeted expenditure and revenue path	The targeted expenditure and revenue as a percentage of GDP for the general government and their main components, taking into account the conditions and criteria to establish the growth path of government expenditure net of discretionary revenue measures under Article 5(1) of Regulation (EC) No 1466/97
Detail on expenditure plans	Relevant information on the general government expenditure by function, including on education, healthcare and employment, and, where possible, indications on the expected distributional impact of the main expenditure and revenue measures.
Detail on measures	A description and quantification of the expenditure and revenue measures to be included in the draft budget for the year to come at the level of each sub-sector in order to bridge the gap between the targets and the projections at unchanged policies; may be less detailed for measures with a budgetary impact estimated to be lower than 0.1% of GDP. Particular and explicit attention shall be paid to major fiscal policy reform plans with potential spill-over effects for other euro area Member States
Debt and implicit liabilities	Debt developments for the forthcoming year
Consistency with other economic policy recommendations	Indications on how reforms and measures in the draft budgetary plan, including in particular public investment, address the current recommendations to the Member State concerned in accordance with Articles 121 and 148 TFEU and are instrumental to the achievement of the targets set by the Union's Strategy for growth and jobs
Forecasts	The main assumptions of the independent macro-economic forecasts and important economic developments which are relevant to the achievement of the budgetary targets. An annex containing the methodology, economic models and assumptions, and any other relevant parameters underpinning the budgetary forecasts and the estimated impact of aggregated budgetary measures on economic growth

Source: European Commission

[6] The Table is reproduced from "Public Finances in EMU 2013", available on http://ec.europa.eu/economy_finance/publications/european_economy/public_finances_emu_en.htm

Diagram 1: Timeline for the autumn assessment of the fiscal stance[7]



Source: European Commission

Box 1: Country-specific recommendations

Country-specific recommendations (CSRs) provide tailored advice by the European Council following a proposal by the COM to Member States on how to boost jobs and growth, while maintaining sound public finances. The Commission publishes them every spring, as part of the European Semester, the EU's calendar for economic policy coordination. They focus on what can realistically be achieved in the next 12-18 months to promote economic growth which is more sustainable and more inclusive, in line with the EU's long-term jobs and growth plan, the Europe 2020 strategy.[8] These are later approved by the European Council, under agreed voting modalities, sometimes with amendments under a 'comply or explain' procedure.

The COM subsequently monitors the progress made in terms of meeting the CSRs and judges the progress according to the following benchmarks.

- *No progress*: The Member State has neither announced nor adopted any measures to address the relevant CSR.
- *Limited progress*: The Member State has announced some measures to address the relevant CSR, but these measures appear insufficient and/or their adoption/implementation is at risk.
- *Some progress*: The Member State has announced or adopted measures to address the relevant CSR. These measures are promising, but not all of them have been implemented yet and implementation is not certain in all cases.
- *Substantial progress*: The Member State has adopted measures, most of which have been implemented. These measures address to a significant extent the relevant CSR.

[7] The diagram is reproduced from "2013 Report on Public Finances in EMU" by the European Commission, available on http://ec.europa.eu/economy_finance/publications/european_economy/public_finances_emu_en.htm
[8] Source: http://europa.eu/rapid/press-release_MEMO-15-4968_en.htm

- *Fully addressed*: The Member State has adopted and implemented measures that address the relevant CSR appropriately.

In the case of Malta, the latest CSRs by the COM, published on 13 May 2015, were:

- Following correction of the excessive deficit, achieve a fiscal adjustment of 0.6% of GDP towards the Medium-Term Budgetary Objective in 2015 and 2016;
- Take measures to improve basic skills and further reduce early school-leaving by promoting the continuous professional development of teachers;
- To ensure the long-term sustainability of public finances continue ongoing pension reform, such as by accelerating the already enacted increase in the statutory retirement age and by consecutively linking it to changes in life expectancy; and
- Improve small and micro-enterprises' access to finance, in particular through non-bank instruments.

Two of the CSRs addressed to Malta relate directly to public finances, one of which of a short term nature and one of a longer term nature. Following the submission of Malta's DBP, which includes a section indicating the measures intended to address the CSRs, the COM has judged the country as having made *some progress* in addressing the CSRs. However, the COM was of the opinion, that no concrete measures have been announced towards ensuring long-term sustainability of public finances, particularly in terms of adjusting the statutory retirement age to developments in life expectancy. The COM has therefore recommended that further effort is required to address fully the CSRs.

In this respect, the MFAC takes note of the progress made in addressing the CSRs particularly in relation to pension reform and invites the authorities to advance further in the announced reforms. In the Budget Speech 2016, it was stated that the Government "believes there should be a fair and just balance between the number of years one spends paying contributions and the number of years one is expected to be on a pension, which principle should help in guaranteeing the sustainability of the pensions system."[9] To this effect, the number of years of required valid contributions was raised from 40 to 41 years for persons born after 1968. Other initiatives include the introduction of a regulatory framework for private pensions (Third Pillar) and of a tax credit in respect of contributions paid into personal retirement schemes; the setting up of a working group to estimate what are the fiscal benefits for employers who voluntarily take on private pension schemes for their employees; the increase in the minimum amount payable for pensioners with sufficient contributions to €7,280 per annum; National Insurance contributions 'lost' are to be credited for those who left work to take care for their offspring or for study reasons; and with respect to the private sector, those who choose to continue to work and do not apply for a pension even though they are entitled to it, would gain from a percentage increase in their rate of pension for every additional year in employment.

[9] In its report, "Strengthening the Pension System" (2015), the Pensions Strategy Group suggested the setting up of a special body which every 5 years would establish the parameters of the pension system architecture with a view of announcing changes necessary to maintain balance between contributions and benefits across generations.

The COM also carried out its own assessment of the DBP, based on the Autumn Economic Forecasts.[10] The COM's opinion and accompanying assessment were published on 16 November 2015 (see Table 3).[11]

Table 3: Process for the autumn assessment by the COM of the draft budgetary plans[12]

	By when?	Who?	What?
	15 October	Each Member State	Submits its draft budgetary plan
Individual assessment of DBPs	***Normal process***		
Individual assessment of DBPs	End-November at the latest	Commission	Adopts an Opinion on each DBP
Individual assessment of DBPs	***If Commission detects serious non-compliance with SGP obligations in a DBP***		
Individual assessment of DBPs	1 week of submission [indicative: 23 October]	Commission	Consults the Member State concerned
Individual assessment of DBPs	2 weeks of submission [indicative: 30 October]	Commission	Adopts an Opinion requesting a revised DBP to be submitted within 3 weeks
Individual assessment of DBPs	3 weeks of the date of Commission's Opinion at the latest [indicative: 21 November at the latest]	Member State concerned	Submits a revised DBP
Individual assessment of DBPs	3 weeks of submission of revised DBP at the latest [indicative: 12 December at the latest]	Commission	Adopts a new Opinion on revised DBP
	No fixed deadline (in principle end-November)	Commission	Overall assessment of the budgetary situation and prospects in the euro area as a whole, on the basis of national DBPs and their interaction

Source: European Commission

[10] DG ECFIN produces economic forecasts on behalf of the COM. They serve as a basis for various economic surveillance procedures, such as in the context of the European Semester. DG ECFIN's forecasts are published three times a year in sync with the EU's annual cycle of economic surveillance procedures. These are labelled as the 'Winter', 'Spring' and 'Autumn' forecasts, and are available on http://ec.europa.eu/economy_finance/eu/forecasts/index_en.htm

[11] These are available on http://ec.europa.eu/economy_finance/economic_governance/sgp/budgetary_plans/index_en.htm

[12] The table is reproduced from "2013 Report on Public Finances in EMU" by the European Commission, available on http://ec.europa.eu/economy_finance/publications/european_economy/public_finances_emu_en.htm

The COM's responsibility is to evaluate whether Malta, as a euro area Member State under the preventive arm of the Stability and Growth Pact (SGP), is making sufficient progress to achieve its Medium-Term Objective (MTO) of a balanced budget, in structural terms, by 2019. In the case of Malta, the assessment process was 'normal' in the sense that the COM did not detect any serious non-compliance with the SGP obligations, to the extent of requiring the country to re-submit its DBP. The COM's opinion was discussed at the Eurogroup meeting on 23 November 2015.[13]

Between October and December 2015, the Malta Fiscal Advisory Council (MFAC) published two separate reports evaluating the plausibility of the macroeconomic forecasts and the fiscal projections which were presented in the DBP for 2016 (see Table 4). Following an in-depth assessment, the MFAC endorsed the macroeconomic projections for the period 2015-2016 and confirmed that the fiscal projections for 2015-2016 also appeared realistic and within its endorsable range.[14]

Table 4: MFAC timeline in relation to the DBP for 2016

4 September	The NSO released the National Accounts estimates for the second quarter of 2015.
24 September	The MFAC received the preliminary macroeconomic projections by the MFIN.
29 September	The MFAC held a meeting with EPD staff to discuss the preliminary macroeconomic projections.
7 October	The MFAC received the revised macroeconomic forecasts prepared by the MFIN, which included adjustments reflecting the MFAC's opinion and concerns raised during the meeting on the 29 September.
15 October	The DBP for 2016 was formally submitted to the COM.
15 October	The MFAC endorsed the macroeconomic projections contained in the DBP for 2016 and published its assessment of the macroeconomic forecasts.
27 October	The MFAC held a meeting with MFIN and NSO to discuss the fiscal projections as presented in the DBP for 2016 and sought further explanations underpinning these projections.
3 December	The MFAC published its assessment of the fiscal projections for 2015 and 2016.
16 December	The MFAC transmitted a draft version of the Report containing the overall assessment for the DBP for 2016 and met with senior MFIN officials to discuss its content.
22 December	The MFIN submitted its initial feedback on the MFAC's overall assessment.
30 December	The MFIN submitted additional feedback on the MFAC's overall assessment.

Source: Malta Fiscal Advisory Council

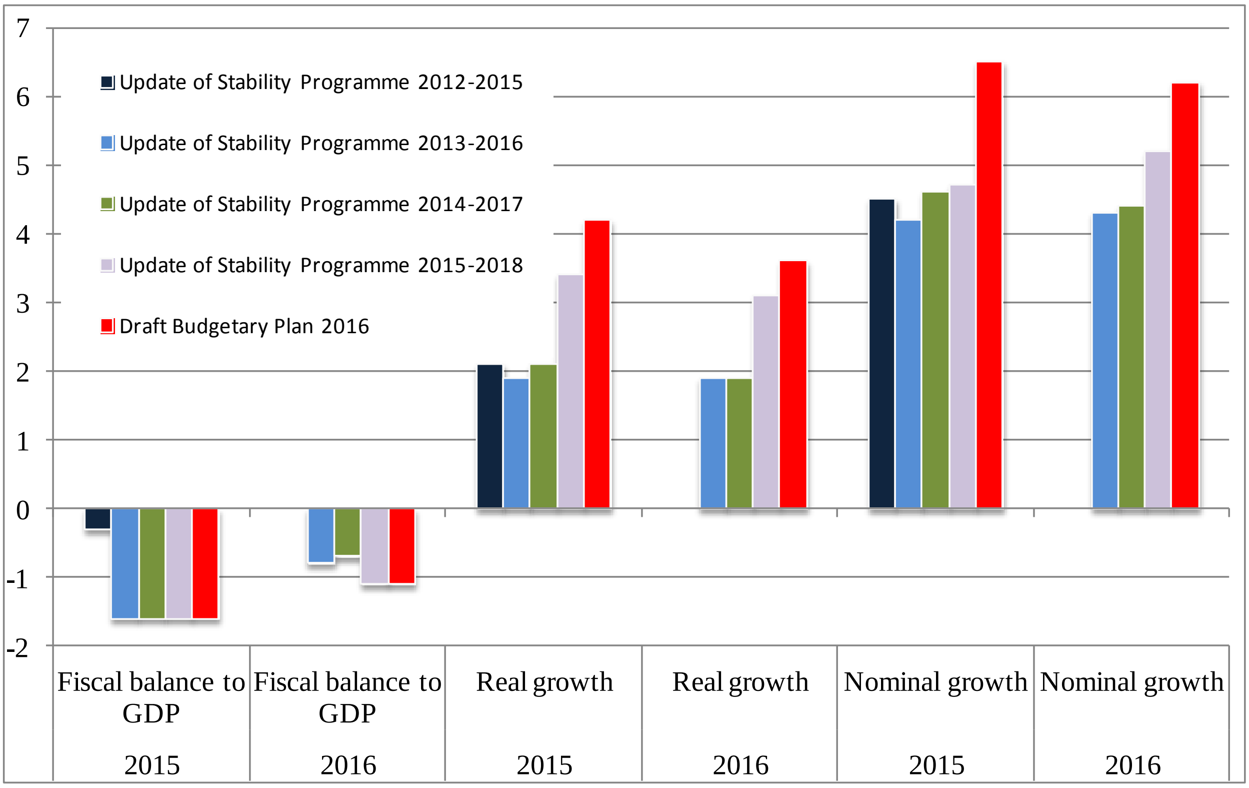
[13] For further details refer to http://www.consilium.europa.eu/en/press/press-releases/2015/11/23-eurogroup-jd-remarks/

[14] See the reports "An Assessment of the Macroeconomic Forecasts for the Maltese Economy prepared by the Ministry for Finance in October 2015" and "An Assessment of the Main Fiscal Forecasts prepared by the Ministry for Finance and presented in the Draft Budgetary Plan 2016", both available on http://mfac.gov.mt/en/publications/Pages/Publications.aspx

3. Projected fiscal developments in 2015 and 2016

The DBP for 2016 reaffirms the Government's efforts to curb the fiscal deficit further. Indeed, in 2016, a further reduction in the fiscal deficit, when expressed as a percentage of GDP, is planned. This follows the successful abrogation of the Excessive Deficit Procedure (EDP) in 2015, which enabled Malta to move from the 'Corrective Arm' to the 'Preventive Arm' of the SGP. The official deficit-to-GDP targets for 2015 and 2016 were respectively re-confirmed at 1.6% and 1.1%, unchanged when compared with those presented in the Update of Stability Programme (USP) 2015-2018 published in April 2015 (see Chart 1).

Chart 1: Fiscal targets and macroeconomic outlook (per cent)



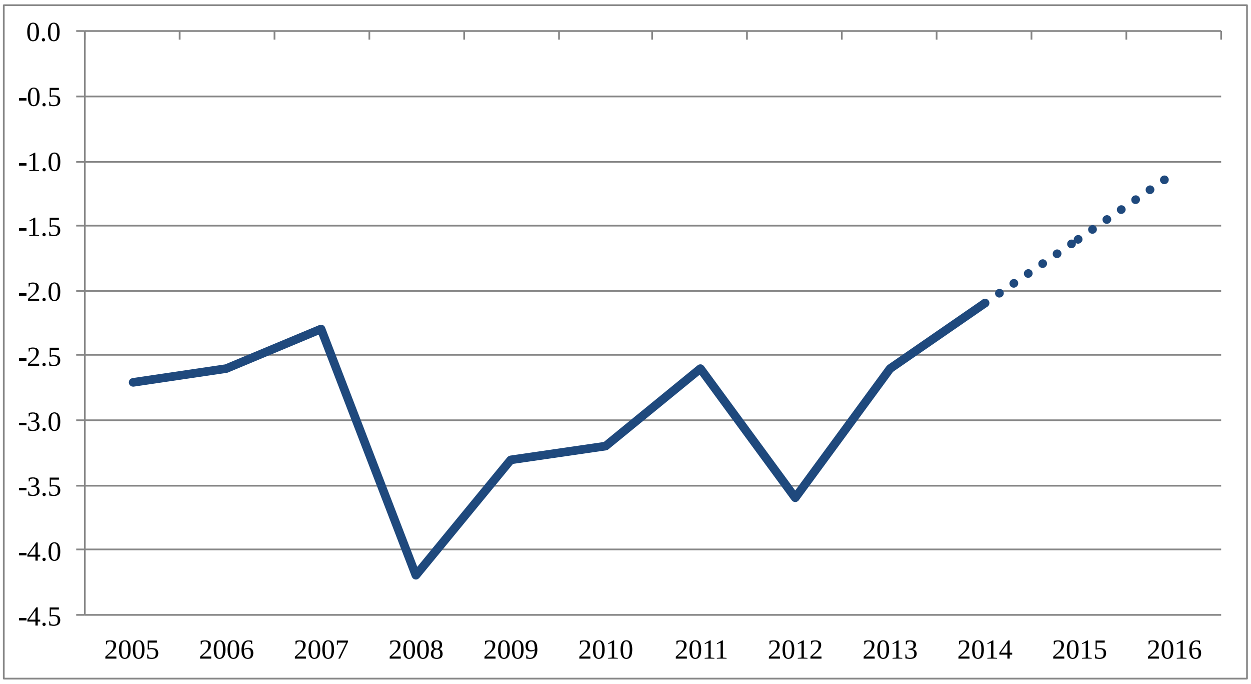
Source: Ministry for Finance

The latest economic forecasts indicate a more favourable macroeconomic scenario for 2015 and 2016 when compared to the previous forecasts, both with respect to real and nominal growth rates. This is due to a more favourable outlook for net exports, partly offset by a significant downward revision for investment in 2016. The higher growth rates have paralleled upward revisions in the estimates of potential output growth.

However this improved macroeconomic scenario was not transposed into more ambitious fiscal targets. In the case of the deficit target for 2015, this has remained fixed for a number of years (since the USP 2013-2016), despite the improvement in the macroeconomic scenario. Likewise, the deficit target for 2016 has remained relatively unchanged since the USP 2015-2018 (the latest USP) and is actually higher than had been targeted in previous USPs. This indicates that most of the higher revenues that were expected to be generated by the more favourable macroeconomic conditions have been matched by higher expenditures rather than in a larger decline in the fiscal deficit. The view of the MFAC is that the prevailing buoyant macroeconomic scenario is providing a good opportunity to accelerate fiscal consolidation.

According to the DBP, the reduction in the fiscal deficit ratio is expected to amount to 0.5 percentage points (pp) in 2015 and a further 0.5 pp in 2016. If attained, this would place the fiscal deficit ratio below what was recorded since the time when Malta joined the EU (see Chart 2). It would also represent the longest stream of consecutive fiscal corrections.

Chart 2: Fiscal balance as per cent of GDP (2005 – 2016)



Source: Eurostat, Ministry for Finance

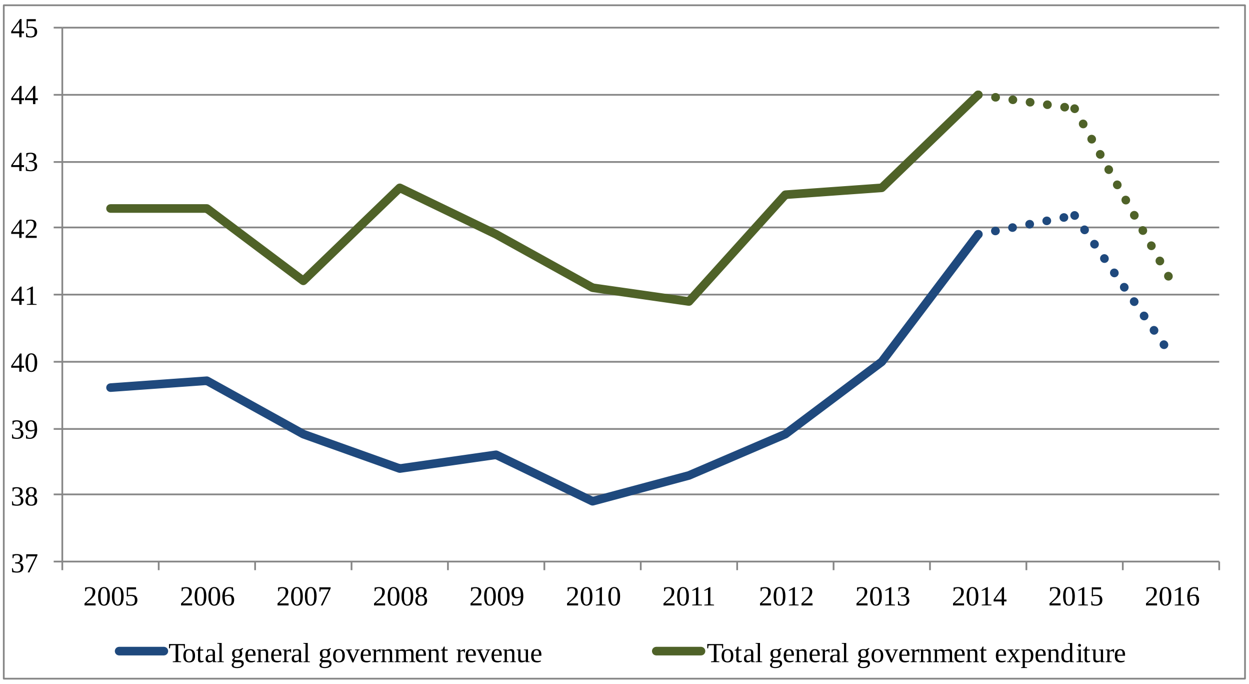
The anticipated improvement in public finances during 2015 was attributed to an increase in the revenue-to-GDP ratio from 41.9% to 42.2% and a decline in the expenditure ratio from 44.0% to 43.8%. The DBP indicates that fiscal revenues should outpace nominal GDP growth, maintaining the pattern observed in recent years (see Chart 3).

In particular, the edging up of the revenue ratio in 2015 is attributed to the strong inflow of EU funds, as well as revenues generated through the Individual Investor Programme (IIP).[15] On the contrary, the revenue ratio is expected to scale back in 2016, by 2.1 pp to 40.1% as a result of the

[15] The IIP allows for the grant of citizenship by a certificate of naturalization to foreign individuals and their families who contribute to the economic development of Malta, as provided in the regulations contained in Legal Notice 47 of 2014, available on http://iip.gov.mt/wp-content/uploads/2014/02/LN-47-2014.pdf

projected lower absorption of EU funds. Indeed, the inflow of EU funds recorded in 2015 were exceptionally high since this represented the final year for the absorption of funds allocated under the EU Financial Perspectives covering the period 2007-2013. On the other hand, as is normal, the take-up of EU funds under the new EU Financial Perspectives (covering the period 2014-2020), is assumed to be rather low during the initial years.

Chart 3: Fiscal revenues and expenditures as per cent of GDP (2005 – 2016)



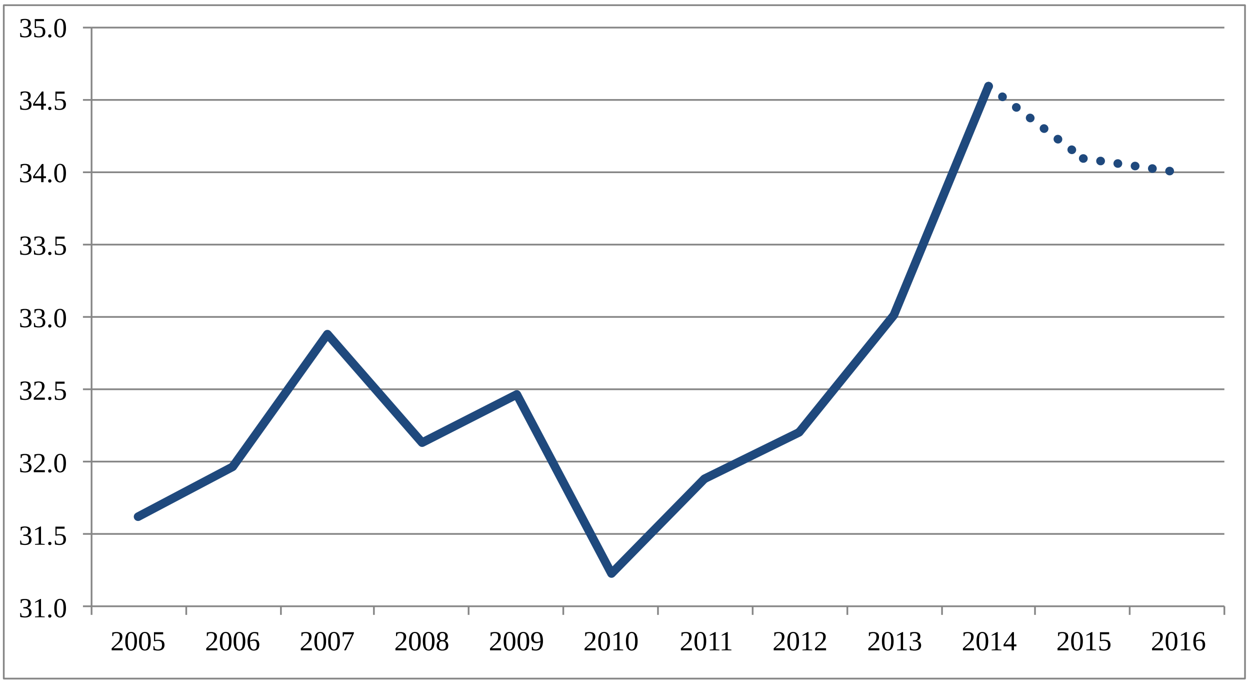
Source: Eurostat, Ministry for Finance

Meanwhile, according to the DBP the expenditure ratio is expected to decline slightly in 2015, to 43.8% of GDP and rather pronouncedly, to 41.2% of GDP in 2016. The scaling back of the expenditure ratio primarily reflects the lower planned EU-funded investment expenditure, as well as the higher level of nominal GDP. Further downward momentum reflects the envisaged slower growth in social payments, interest payments and intermediate consumption. The expiry of temporary expenditure outlays, expenditure rationalisation, and the favourable impact on debt servicing of lower interest rates contribute to the planned reduction in the expenditure ratio. In the latter case, the accommodative monetary policy in recent years, coupled with the quantitative easing programme embarked by the European Central Bank (ECB) have enabled the Government to continue to benefit from very favourable interest rates on its borrowings. Specifically, through this programme, the Central Bank of Malta (CBM) purchases government securities on the secondary market, thereby increasing the demand for Malta Government Stocks (MGS) and as a result, enables the Government to issue bonds at lower interest rates. The favourable impact on debt servicing costs is however partially being dampened through an increase in the average maturity of government debt.

This debt management strategy to opt for longer duration is fully supported by the MFAC as this enables the Government to benefit from the current exceptionally low interest rate environment and limits the impact of the eventual rise in interest rates as they revert back to normal, besides reducing roll-over risks. Indeed, the MFAC considers that there is scope to further extend the average maturity profile of the public debt in Malta. This policy, together with the fact that almost all public debt is held by residents, a large proportion of whom have a buy-to-hold tendency, should safeguard against any sudden changes in interest rates and international sentiment.

Apart from the before-mentioned fluctuations associated with the inflows of EU funds, the tax burden is expected to decline slightly in 2015, as a result of the fiscal relief measures, centred on the reduction in direct taxes[16]. The tax burden is then expected to remain stable in 2016, at around 34%, as reductions in some direct taxes are expected to be compensated for, through higher indirect taxes (see Chart 4).

Chart 4: Tax burden as per cent of GDP (2005 – 2016)



Source: Eurostat, Ministry for Finance

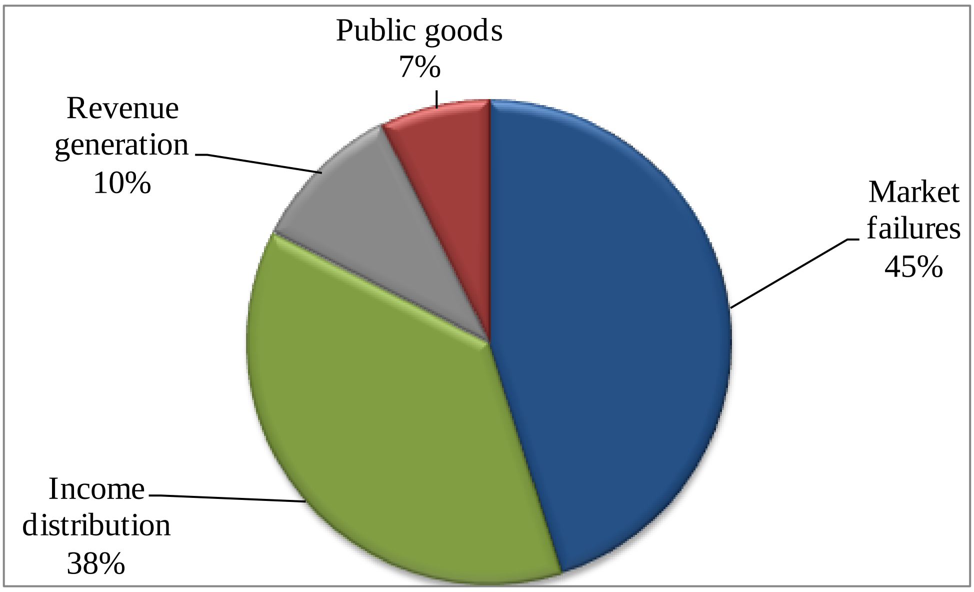
The permanent initiatives announced in the DBP for 2016 primarily address two objectives. On aggregate, 45% of the new permanent measures focus on the correction for market failures, through the imposition of higher indirect taxes on products creating negative externalities (see Chart 5).[17,18] Another 38% are related to income re-distribution, primarily by offering benefits

[16] The projected decline in the tax burden is also in part driven by the prudent elasticity assumptions underlying the MFIN's projections

[17] The MFAC's estimates are based on the aggregate absolute amount of the funds involved, irrespective of whether they exert a positive or negative budgetary impact. The main focus of the measures as described by the MFAC does not exclude that the same measures could serve other purposes too.

targeted to the lower income households. Other measures focus on the generation of additional revenues (10%), in the form of a new tax to be imposed on the tourism sector, and the allocation of funds for the expropriation of land (7%), classified under the public good motive.

Chart 5: Breakdown of permanent fiscal initiatives for 2016



Source: Ministry for Finance

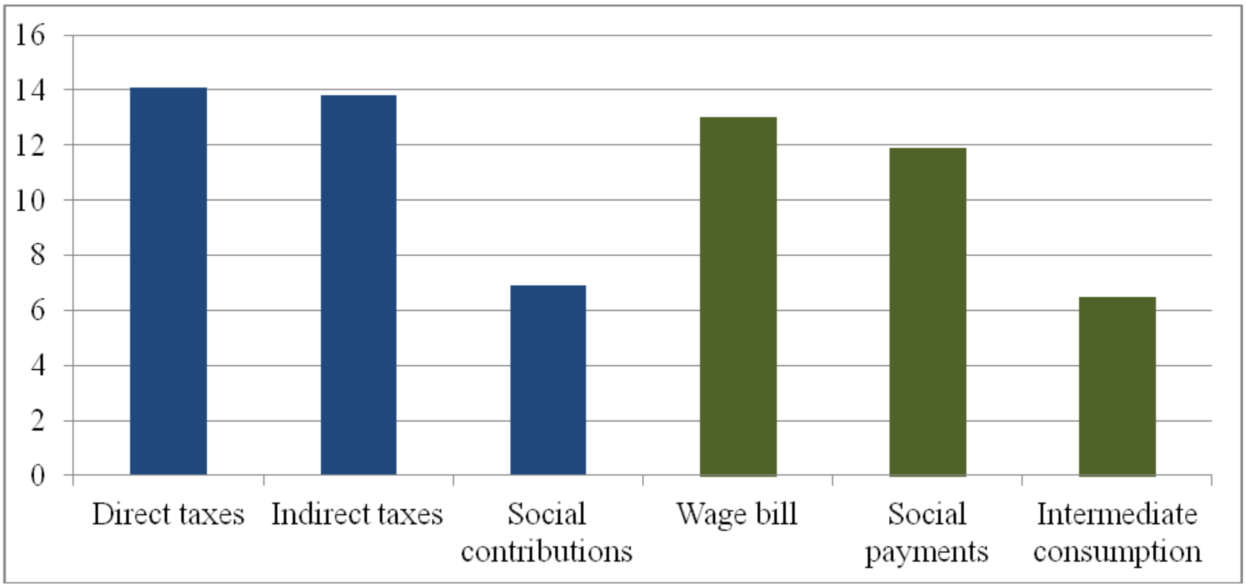
The fiscal measures announced in the DBP for 2016 are not expected to alter the revenue and expenditure components within the budget structure significantly. In the case of the three largest budget revenue and expenditure components (direct taxes, indirect taxes, social contributions; and wage bill, social payments and intermediate consumption), the changes only amount to 0.1 pp of GDP, with the exception of expenditure on intermediate consumption, which is projected to decline from 6.8% of GDP in 2015 to 6.5% in 2016. To some extent this is conditioned by the non-repetition of some special national events which took place in 2015 such as the organisation of the Valletta summit on migration and the meeting of the Commonwealth Heads of Government. Overall, the main budget components are thus expected to remain practically unchanged as a percentage of GDP (see Chart 6).

Changes in the fiscal balance between 2014 and 2016 are to a significant extent impacted by the interplay of temporary measures and other special factors (see Chart 7).[19] Temporary factors had an overall positive impact on the budget balance in 2014 as temporary revenues more than outweighed the revenue-decreasing effects and the expenditure-increasing effects.[20] On the contrary, in 2015, temporary factors are expected to have worsened the fiscal balance in view of

[18] Market failures refer to situations where the market equilibrium may not be optimal from a welfare perspective, thus giving scope for government intervention, such as through the imposition of taxes on activities related to pollution (negative externalities).
[19] Temporary factors include both temporary measures as well as one-off factors. These are budget items whose impact is constrained to specific year(s). During this period there were no temporary expenditure reducing measures.
[20] The temporary factors included capital injection in the national airline.

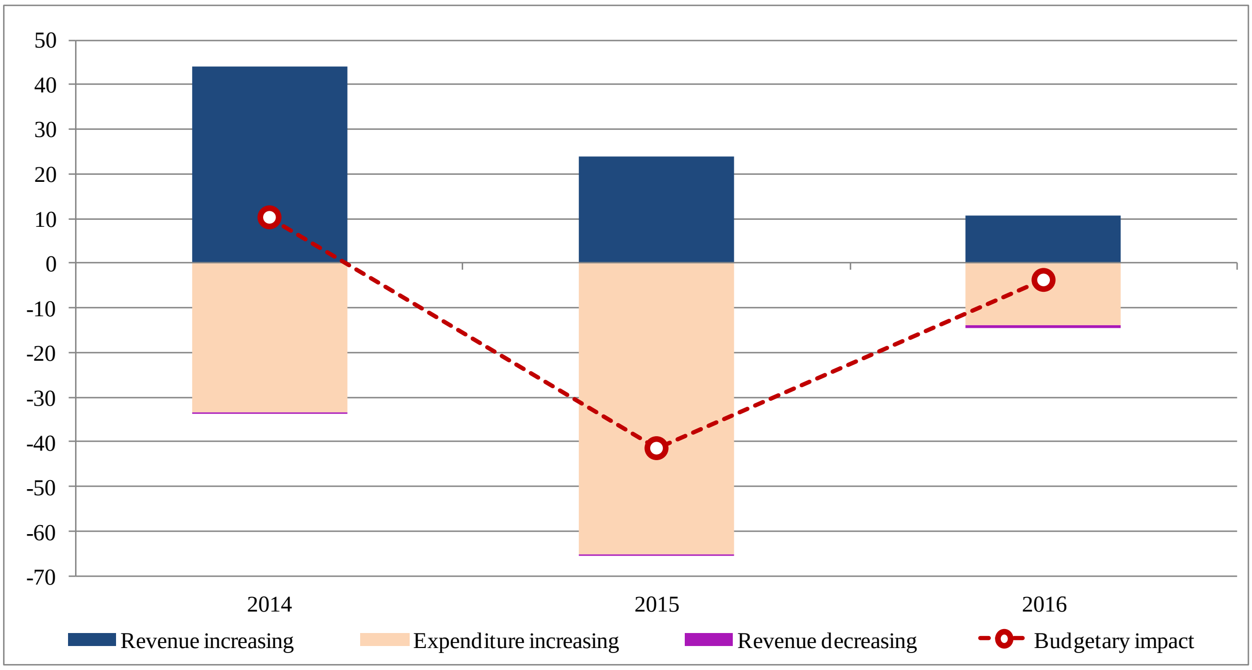
significant temporary expenditures which are expected to have exceeded the amount of temporary revenues. In turn, in 2016, the temporary effects on the budget are expected to be minimal. The lower recourse to temporary measures is positively viewed by the MFAC, since excessive reliance on one-off measures (impacting either revenues or expenditures) could create uncertainty with respect to the future direction of fiscal policy.

Chart 6: Main budget components, as per cent of GDP (2016)



Source: Ministry for Finance

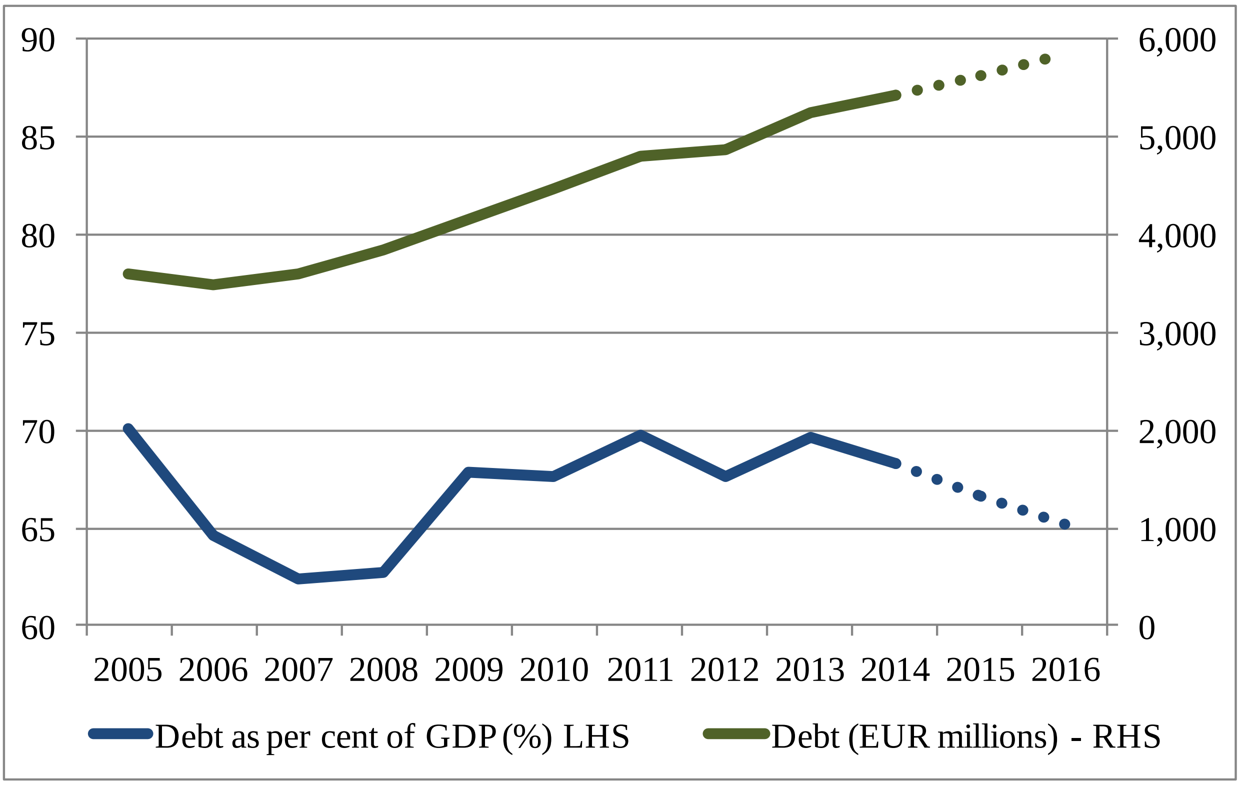
Chart 7: Budgetary impact of temporary revenue and expenditure factors (EUR millions)



Source: Ministry for Finance

As a result of the yearly fiscal deficit, the outstanding gross Government debt is expected to maintain its upward trend in absolute terms, to reach almost EUR 6 billion in 2016. However, when expressed as a percentage of GDP, the public debt ratio is expected to decline further, to 65.2% (see Chart 8).

Chart 8: Public debt (2005-2016)



Source: Eurostat, Ministry for Finance

This follows the slower accumulation of debt envisaged for 2016, as a result of the lower fiscal deficit, with additional downward push stemming from the expanding nominal GDP base. The overall impact on the debt-to-GDP trajectory is however partially offset by positive stock flow adjustments. Stock flow adjustments relate to certain type of transactions which have an impact on public debt but no impact on the fiscal balance, and as a result create a difference between the annual change in gross debt and the budget deficit (see Box 2). In this case, since stock flow adjustments are positive, the change in gross public debt exceeds the fiscal deficit for the year.

Box 2: Snow-ball effects and stock flow adjustments

The outstanding level of public debt evolves from one year to the next depending on the yearly fiscal turnout, according to the simplest fiscal accounting framework. When a country runs a fiscal deficit (that is when government's total expenditure is higher than its total revenue), the outstanding level of public debt increases, and when the country runs a fiscal surplus (that is when government's total revenue is higher than its total expenditure) the outstanding level of public debt diminishes. This relationship can be expressed in alternative ways, as in equations [1] to [5], with subscript (t) indicating the current time period, subscript (t-1) indicating the previous year, and (r) referring to the interest rate (assumed to be constant for simplicity). In particular, equation [5] evidences that in order to maintain the outstanding level of public debt constant the country would need to run a primary surplus (a positive primary balance) sufficient to match the yearly debt interest payments.

[1] $\text{Debt}_t - \text{Debt}_{t-1} = -\text{Fiscal Balance}_t$

[2] $\text{Debt}_t - \text{Debt}_{t-1} = \text{Total Expenditure}_t - \text{Revenue}_t$

[3] $\text{Debt}_t - \text{Debt}_{t-1} = (\text{Primary Expenditure}_t + \text{Interest Payments}_t) - \text{Revenue}_t$

[4] $\text{Debt}_t - \text{Debt}_{t-1} = (\text{Primary Expenditure}_t - \text{Revenue}_t) + (r * \text{Debt}_{t-1})$

[5] $\text{Debt}_t - \text{Debt}_{t-1} = -\text{Primary Balance}_t + (r * \text{Debt}_{t-1})$

To allow cross-country comparability, as well as to better evaluate the outstanding level of debt in relation to the country's repayment capabilities (particularly in the case of a growing economy) it is helpful to express fiscal variables in terms of ratios to GDP. Dividing each of the fiscal variables in equation [5] by nominal GDP (labelled as Y), yields the following equation:

[6] $(\text{Debt}_t / Y_t) - (\text{Debt}_{t-1} / Y_t) = (-\text{Primary Balance}_t / Y_t) + [(r * \text{Debt}_{t-1}) / Y_t]$

To better identify the implications of equation [6] it is also useful to multiply and divide the variables related to period (t-1) with Y_{t-1} (that is the previous year's nominal GDP level), as this transformation allows for a richer analysis of the public debt dynamics. Lower case letters in equation [7] indicate the variables expressed as a ratio to the same period GDP, with (d) and (pb) representing respectively the debt-to-GDP ratio and the primary balance-to GDP ratio, while (g) represents the growth rate of nominal GDP from period (t-1) to period (t), also assumed to be constant for simplicity.

[7] $d_t - [d_{t-1} / (1+g)] = [-pb_t] + [(r * d_{t-1}) / (1+g)]$

Re-arranging the terms in equation [7] yields equation [8].

[8] $d_t - [d_{t-1} (1+r) / (1+g)] = -pb_t$

For small value for (r) and (g), equation [8] can also be approximated as follows:

[9] $d_t - [d_{t-1} (1 + r - g)] = -pb_t$

The so called '**snow-ball effect**' is defined as the interaction term between the public debt-to-GDP ratio for the previous year and the difference between the interest rate on public debt and the nominal GDP growth rate, referred to as the 'interest-growth differential'. Expressed differently, the so called "snow-ball effect" consists of the upward push on the outstanding debt as a result of the debt servicing costs, net of the downward effect on the debt ratio generated as a result of real economic growth and inflation (which push up the GDP denominator). The 'snow-ball effect can thus be positive when the interest rate is higher than the GDP growth rate and negative when the interest rate is lower than the GDP growth rate.

Therefore, whenever the interest rate is higher than the nominal GDP growth rate (which is the more common type of situation under normal economic conditions) there is need for a primary fiscal surplus, to maintain the debt-to-GDP ratio stable. On the other hand, when the nominal GDP growth rate is higher than the interest rate on public debt, the debt ratio would fall when there is a primary balance (when total revenue matches the primary expenditure, which is equivalent to total expenditure net of interest payments).

In this respect, it is pertinent to note that nominal growth reflects the combined effect of real growth and inflationary pressure, and as a result, within this framework, both real GDP growth and inflation help contain the trajectory in the debt ratio. Consequently, against a background of rather subdued inflation, it is important the real economic growth remains vibrant, to maintain nominal GDP growth elevated.

Moving away from the simplest accounting framework, it is possible to identify other factors which impact the evolution of the debt-to-GDP ratio, beyond the primary balance and the 'snow-ball effect'. These other factors are collectively referred to as '**stock-flow adjustments**' and give rise to a situation wherein, the annual change in gross debt does not equal the annual fiscal deficit. These factors include:

- Valuation effects, through the impact of say exchange rate changes on foreign currency denominated debt;
- Time of recording effects, since deficits are often measured in accrual terms while debt is a cash concept; and
- Below the-line operations, such as privatisation revenues and transactions in financial assets, such as the acquisition or disposal of shares.

Equation [9] can thus be expanded in order to incorporate the stock-flow adjustments as per cent of GDP, represented as (sf) in equation [10], which can push up or down the debt-to-GDP ratio.

[10] $d_t - [d_{t-1}(1 + r - g)] = -pb_t + sf_t$

As can be seen from equation [10] positive stock-flow adjustments push up the debt ratio whereas negative stock-flow adjustments lower the debt ratio.

While the existence of rather sizable stock flow adjustments is not exceptional, the MFAC encourages the Government to be more transparent in its off-budget activities and better document the factors contributing to the stock flow adjustments, to enable analysts to better evaluate the likelihood of such stock flow adjustments. This is also necessary to instil confidence that such positive stock flow adjustments are not tantamount to future risks to the budget balance.[21]

The accumulation of debt exceeds the fiscal deficit for 2015 and 2016, particularly as a result of the MFIN's assumption that some funds will be kept in the form of buffers (cash) rather than used to repay the outstanding debt. This follows the timing profile of receipt of EU funds being assumed, as well as to allow for the fact that 70% of the revenues from the IIP will be contributed to the National Development and Social Fund rather than used to finance the fiscal deficit.

However, under the European System of national and regional accounts (ESA) guidelines, the National Development and Social Fund is classified as part of general government and hence its activities are combined to that of the central government. In practice this implies that the entire revenues collected through the IIP are featuring as part of government revenues when measured in terms of ESA definitions. The MFAC encourages the Government to evaluate how best to utilise such funds, particularly to ensure that such funds are used to finance the acquisition of financial assets, rather than to fund direct expenditure, as this could have implications for the future fiscal balances, when measured according to the ESA definitions.

4. An assessment of the fiscal projections based on the expected macroeconomic conditions

To better evaluate revenue projections and expenditure plans, it is useful to disentangle between the separate factors which drive the planned changes. Yearly revenue and expenditure dynamics can be attributed to (a) changes in the proxy base; (b) the elasticity of the budget item with respect to the proxy base; (c) new permanent initiatives; and (d) temporary measures or other special factors.[22,23] Any remaining 'unexplained' contributor to the yearly change in the revenue

[21] Weber (2012) has documented a general trend among many countries to display positive stock flow adjustments stating that "This finding is consistent with the view that government might engage in off-budget operations in order to hide the impact on the deficit of transactions that increase debt, while they are quite willing to let debt reducing measures pass through the budget. Reputational concerns associated with missing numerical budget balance targets, which historically have received more attention than public debt targets, might be one factor underlying this behaviour." Source: 'Stock-Flow Adjustments and Fiscal Transparency: A Cross-Country Comparison', IMF Working Paper 12/39.

[22] Each revenue and expenditure component in the fiscal budget is influenced by the specific legislation. For example income tax is levied on employment income and profits according to specific rules, with different types of deductions. At the macro level it is impossible to fine tune the analysis to capture these specific effects. Hence the use of a 'proxy base', say for income tax, that is a base which is an approximate estimate of the 'precise yet unknown' economy-wide tax base.

or expenditure item is classified as a residual.[24] This framework permits a better assessment of the links between macroeconomic developments and the fiscal turnout.[25]

This approach has been applied by the MFAC to: (i) taxes on production and imports; (ii) current taxes on income and wealth; and (iii) social contributions, on the revenue side. On the expenditure side, it has been applied to: (iv) intermediate consumption; and (v) compensation of employees. A number of proxy bases were used to analyse the projected absolute changes in the fiscal revenues and expenditures (see Table 5).[26] The proxy bases were based on the macroeconomic forecasts prepared by the MFIN and contained in the DBP for 2016. In turn, the elasticities being assumed in the analysis are based on theoretical considerations and expert judgement.

Table 5: Fiscal budget components and proxy bases

Fiscal budget components	**Proxy base**
Taxes on production and imports	Nominal private consumption
Current taxes on income and wealth	Nominal gross operating surplus plus nominal compensation of employees
Social contributions	Nominal compensation of employees
Intermediate consumption	Nominal GDP
Compensation of employees	General government employment

Source: Eurostat, Ministry for Finance

Caveats to this type of analysis include the fact that the use of proxies and elasticity estimates necessarily entails some imprecision as to the precise importance of each specific driver. A further source of error could stem from the inaccurate measurement of temporary and permanent budgetary effects. Notwithstanding its limitations, the MFAC considers this framework as a

[23] Elasticity refers to the impact of a one percent change in the proxy base on the specific budget component. For example, an elasticity equal to one would imply that a one percent change in the revenue base would generate a one percent change in the revenue collected.

[24] The residual represents a change in revenue or expenditure budget component which has not specifically been attributed to the factors identified in the analysis. A positive residual indicates that the expected turnout in the budget item exceeds what can be specifically pinned down to the economic contributors, while a negative residual indicates that the expected turnout in the budget item is lower than would be explained by the economic contributors.

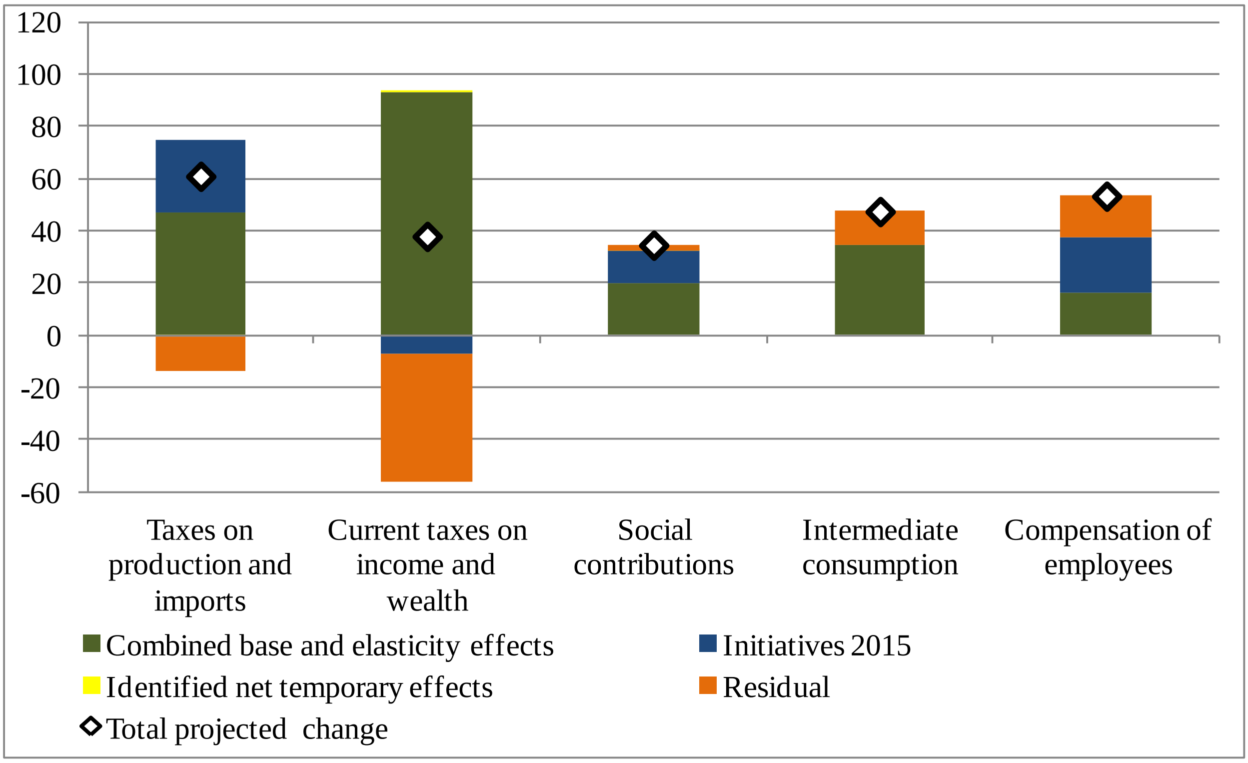
[25] This approach is a simplified version of the approach, termed the 'disaggregated approach' used by the ECB for the analysis of public finances. For further details refer to Kremer et al (2006) "A Disaggregated Framework for the Analysis of Structural Developments in Public Finances", ECB Working Paper Series No. 579, available on https://www.ecb.europa.eu/pub/research/working-papers/html/index.en.html

[26] For example, if the yearly projected increase in the macroeconomic base amounts to €100 million, and the effective tax rate is 5% and the elasticity is 2, the overall change in the tax revenue would amount to €10 million [100 x 0.05 x 2].

useful tool which can be used to identify areas of possible fiscal risks, in terms of ambitious revenue or expenditure projections.[27]

In 2015, the favourable interplay of developments in the proxy bases and elasticity conditions contributed to boost the three types of tax revenues considered (see Chart 9).[28] New initiatives further boosted taxes on production and imports and social contributions, but lowered taxes on income and wealth. It is pertinent to note that in the case of social contributions, the projected developments are perfectly in line with what one would have expected on the basis of economic developments, elasticity conditions and the estimated impact of announced measures. With regards to the other two revenue components considered, there is however a negative residual. This may suggest on one hand a possible decoupling of the actual tax base from the assumed proxy, or on the other hand, rather conservative revenue projections. On the basis of the actual turnout for the first half of 2015, the MFAC considers the second hypothesis as more likely, suggesting that the taxes on income may actually outperform the yearly target indicated in the DBP (see Box 3).

Chart 9: Fiscal developments in 2015 (year-on-year change) – EUR millions



Source: Eurostat, Ministry for Finance

[27] Other fiscal councils use analytical frameworks based on similar approaches. For example, a working paper by the Irish Fiscal Advisory Council appraises tax forecasting errors, by decomposing the total error into a 'macro error', a 'starting point error' and 'other error'(Source: An Analysis of Tax Forecasting Errors in Ireland, Working Paper No.3, September 2015). The Office for Budget Responsibility (UK), evaluates public finance forecasts by identifying the source of the change in the change in different revenue items to GDP ratios by splitting the total change into that part due to a change in the 'tax base', that part due to a change in the 'effective tax rate' and 'other' change which is not decomposed (Source: Forecast Evaluation Report, October 2015).
[28] The estimates are based on the MFAC's calculations.

On the expenditure front, the estimated residuals indicate that intermediate consumption expanded at a faster pace than GDP, partly as a result of the number of special events which were organised during the year.[29] Similarly, in the case of compensation of employees, there appears to have been an element of wage drift, as this budget item expanded faster than the estimated impact of the higher employment level and the negotiated wage increases for the year, as per current collective agreement for civil servants.[30] The wage drift may generally be caused by promotions, over-time pay or bonuses.

Box 3: Half-yearly fiscal performance – actual and required

On the basis of the actual fiscal turnout for the first half of 2015, it is possible to compute the required fiscal developments, compared to the same period of 2014, which are necessary to achieve the targets indicated in the DBP.[31] The analysis naturally assumes that the published figures are not subsequently revised significantly. Important caveats to the analysis include the fact that unstable seasonable fluctuations in certain budget items may constrain the quality of the signals which can be detected from intra-year data. Indeed, the usefulness of using mid-year developments to uncover possible issues pertaining to the yearly assessment of certain expenditure and revenue components diminishes when there are volatile patterns. This may be particularly pertinent in the case of certain non-tax revenues and capital expenditure.[32]

The required revenue growth over the second half of the year (H2) appears to be consistent with the developments recorded in the first half (H1) of 2015 (see Chart A).

Should taxes on income and wealth be at least as high as recorded during the same period of 2014 (rather than lower as inferred from the DBP), there is a possibility that revenues exceed the target indicated in the DBP. This effect may however be offset should the developments in other minor revenue components not match the required growth rates. On the other hand, in the case of a number of expenditure items, there is an implied restraint for the second half of the year compared to the actual turnout during the first half of 2015. This is suggested by the slower (or even negative) rate of growth in the case of certain expenditure components. Should the restraint underpinning the DBP not materialise, there is a risk that the overall expenditure target would be missed.

[29] While fiscal revenues are reasonably driven by economic determinants (best considered as endogenous), expenditures tend to be driven more by policy decisions (the discretionary element is significant and hence can be interpreted as rather exogenous). The relationship between expenditure and macroeconomic developments is less direct and can be interpreted more as a way to benchmark expenditure developments with respect to general economic trends,

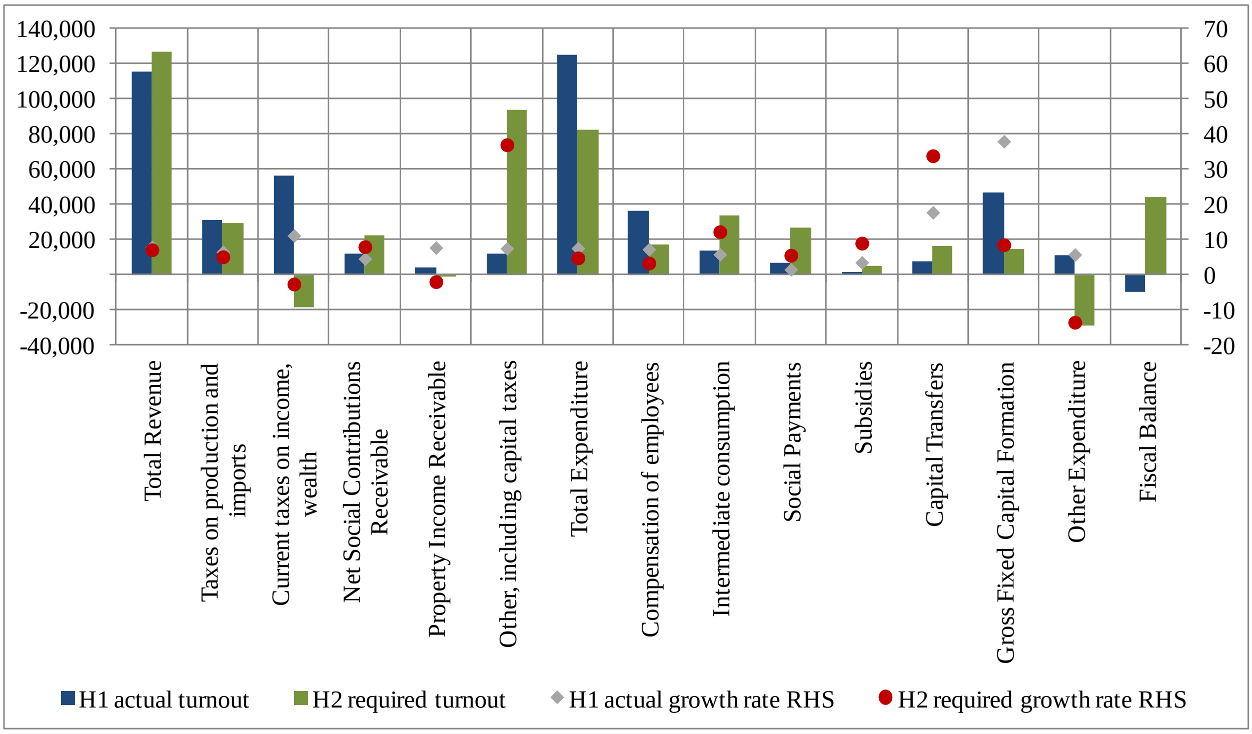
[30] The yearly salaries for public officials can be accessed on http://www.mut.org.mt/files/Public%20Service%20CA%202011-16.0001.pdf

[31] On 21 October 2015, the National Statistics Office (NSO) published the quarterly accounts up to the second quarter of 2015 for General Government. Source: NSO news release 191/2015.

[32] The revenues from the IIP as well as the spending on EU-funded projects have an impact on the intra-year patterns, which make it more difficult to establish strong conclusions from the fiscal turnout for the first half of the year.

On balance, the MFAC considers the risks to the fiscal balance as somewhat neutral for 2015, as there is a possibility that both revenues and expenditures overshoot, to a similar magnitude.

Chart A: Actual and required fiscal developments (EUR thousands, per cent)



Source: Ministry for Finance

With respect to the projected fiscal developments in 2016, one can identify that the projected changes in both revenue and expenditure items are to a significant extent influenced by the changes in the proxy bases (see Chart 10). Indeed, this is an element of consistency and robustness which supports the fiscal forecasting framework used by the MFIN. With respect to the projections for indirect taxes and social contributions, there appears to be an element of prudence, as indicated by the negative residuals. On the other hand the projection for taxes on income mirrors closely the expected developments in the macro proxy base.

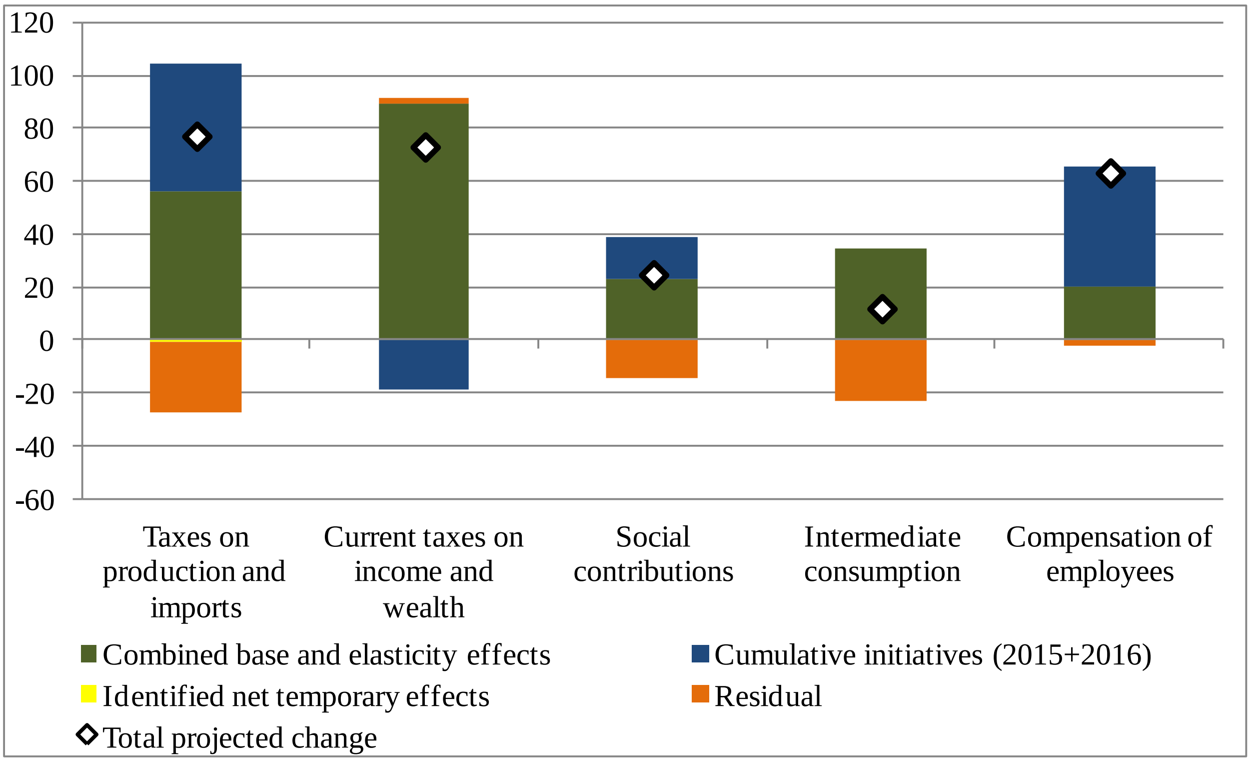
The expenditure projections contained in the DBP for 2016 embed a certain element of restraint. This is evidenced by the negative residual for intermediate consumption (corresponding to the scaling back of such expenditure without a specific identifiable measure).[33] Similarly, the forecasts for compensation of employees do not embed any form of wage drift for 2016, in contrast with the pattern estimated for 2015.[34] An alternative interpretation could be that the

[33] The proxy base used for intermediate consumption, namely nominal GDP, may be a weak proxy, but it is meant to capture the idea that the government's scale of operations tend to keep up with economic activity in general. Furthermore, the scaling back of intermediate consumption may prove challenging when considering the high investment levels undertaken by the government and which necessitate maintenance expenditure.

[34] Wage drift consists of increases in the average wage beyond the negotiated wage as per existing collective agreement, which may be due to for example promotions and bonuses.

employment levels embedded in the forecasts may be difficult to attain in the presence of wage drift. In both cases, this could indicate a certain element of upside risk to the expenditure projections. In the case of compensation of employees, the Government intends to implement a new fiscal rule through Directive No. 9 to ensure that ministries respect the cap on the approved wage bill.[35] However, there still remains the risk that possible slippage feeds into intermediate consumption, such as in the form of outsourced activities, instead. In this respect, the MFAC highlights the importance that as suggested by Kopits (2001), any new expenditure rule 'must be implemented in a transparent manner, with the support of an appropriate institutional infrastructure especially as regards the budgetary process and surveillance mechanism'.[36]

Chart 10: Fiscal developments in 2016 (year-on-year change) – EUR millions



Source: Eurostat, Ministry for Finance

[35] This will come in place through Directive 9 "Delegation of Authority to conduct selection processes and make appointments in the Malta Public Service", issued by the Principal Permanent Secretary in terms of the Public Administration Act and in consultation with the Public Service Commission, available on https://opm.gov.mt/en/PAHRO/Pages/directives/Directive-9.aspx

[36] Source: Kopits (2001) "Fiscal Rules: Useful Policy Framework or Unnecessary Ornament?", paper presented at the Workshop on Public Finance organised by the Banca D'Italia, available on https://www.bancaditalia.it/pubblicazioni/altri-atti-convegni/2001-fiscal-rules/index.html?com.dotmarketing.htmlpage.language=1

5. Comparison between the fiscal and macroeconomic projections contained in the DBP and the COM's autumn forecasts

The fiscal projections prepared by the COM, are broadly in line with those presented in the DBP (see Table 6).[37] However, the COM expects the fiscal deficit to GDP to be slightly higher, by 0.1 pp, both in 2015 and 2016.[38] For both years, the COM indicates higher expenditures, which are to a large extent offset by stronger revenue projections. Of note is the fact that the COM's estimates suggest that when compared to the DBP forecasts, there is the risk that compensation of employees could be understated by some 0.2 pp in 2015 and 0.3 pp in 2016. Moreover, outlays on intermediate consumption could overshoot by some 0.3 pp in 2016. These calculations evidence the rather ambitious expenditure restraint targets for these two budget components, and consequent risk of slippages, in the absence of properly defined measures.[39]

Table 6: Fiscal projections (per cent of GDP)[40]

	2015			2016		
	DBP	**COM**	**DBP - COM**	**DBP**	**COM**	**DBP - COM**
Taxes on production and imports	13.7	13.8	-0.1	13.8	13.9	-0.1
Current taxes on income and wealth	14.1	14.3	-0.2	14.1	14.4	-0.3
Capital taxes	0.2	0.1	0.1	0.1	0.1	0.0
Social contributions	7.0	6.9	0.1	6.9	6.8	0.1
Other	7.2	7.0	0.2	5.2	5.1	0.1
Total Revenue	**42.2**	**42.3**	**-0.1**	**40.1**	**40.4**	**-0.3**
Compensation of employees	13.1	13.3	-0.2	13.0	13.3	-0.3
Intermediate consumption	6.8	6.8	0.0	6.5	6.8	-0.3
Social payments	12.3	12.3	0.0	11.9	12.1	-0.2
Subsidies	1.3	1.4	-0.1	1.2	1.3	-0.1
Gross fixed capital formation	4.3	3.9	0.4	3.2	2.6	0.6
Interest expenditure	2.6	2.7	-0.1	2.4	2.4	0.0
Other	3.4	3.6	-0.2	3.0	3.1	-0.1
Total Expenditure	**43.8**	**44.0**	**-0.2**	**41.2**	**41.6**	**-0.4**
General government balance	**-1.6**	**-1.7**	**0.1**	**-1.1**	**-1.2**	**0.1**

Source: Ministry for Finance, European Commission

[37] The COM's projections are based on the information contained in the Malta's DBP and the macroeconomic forecasts prepared by DG ECFIN, and published as the autumn 2015 European Economic Forecast on 5 November 2015. The cut-off date for taking new information into account in this European Economic Forecast was 22 October. The forecast incorporates validated public finance data as published in Eurostat's News Release 186/2015 of 21 October 2015.

[38] In the case of 2016, the discrepancy between the fiscal deficit contained in the DBP and that in the COM's forecasts is mainly attributable to the higher COM's estimated deficit base in 2015.

[39] This risk has also been identified in the MFAC's own analysis carried out in the previous section.

[40] Figures may not add up due to rounding.

While estimates for subsidies are also marginally lower in the DBP compared to the COM's projections, it is pertinent to note that under both sets of forecasts, possible risks associated with underperformance in state owned enterprises in the transport and energy sectors, are not factored into the baseline projections. On the other hand, the DBP's projections for gross fixed capital formation are higher than in the COM's forecasts, though the impact on the deficit is expected to be limited as the MFIN's projections assume that the higher investment related predominantly to EU co-financed projects.

The COM is more optimistic with regards to the revenue projections, both in the case of indirect and direct taxes. The COM explicitly states that "current revenue could turn out more buoyant than expected due to a more favourable economic environment and higher proceeds from the citizenship programme".[41] This suggests that the MFIN's revenue projects could be rather conservative.

The macroeconomic projections underpinning the DBP are fully in line with the COM's forecasts. Indeed, the COM's real GDP growth forecast for 2015 is 0.1 pp higher, while the real growth forecast for 2016 is identical (see Table 7).[42] However, there is some divergence with respect to the sources of growth. For 2015, the DBP envisages a stronger positive contribution from domestic demand, offset by a larger downside impact from next exports. On the other hand, in the case of the DBP, growth is projected to be driven almost entirely by net exports in 2016, with a limited contribution from domestic demand, but the COM's projections indicate a more evenly distributed growth, with higher contribution coming from final domestic demand and a positive contribution from net exports.

Table 7: Macroeconomic projections (percentage points, per cent)

	2015			2016		
	DBP	**COM**	**DBP - COM**	**DBP**	**COM**	**DBP - COM**
Final domestic demand	6.1	5.4	0.7	0.3	2.1	-1.8
Net exports	-1.9	-1.1	-0.8	3.3	1.5	1.8
Real GDP	4.2	4.3	-0.1	3.6	3.6	0.0
Output gap	0.6	0.6	0.0	1.1	0.8	0.3

Source: Ministry for Finance, European Commission

The main source of discrepancy between the projections contained in the DBP and the COM's forecasts relates to the assumed trajectory for gross fixed capital formation, which by its nature tends to be volatile and thus rather hard to forecast, particularly in the case of a small economy.

[41] This mirrors the MFAC's observation that the DBP revenue estimates may be rather conservative, judged by recent trends.

[42] In its assessment the COM confirmed that on the basis of currently available information, the DBP's macroeconomic scenario appeared plausible for 2015 and 2016. The COM identified possible upside risks as a result of the materialisation of additional infrastructure projects and downside risks related to the uncertain external environment with potential impact on trade developments.

However, the divergence between the COM's and MFIN's views with regards to the investment trajectory is not thought to have material macroeconomic implications, particularly since the type of investment being considered in the forecasts for 2015 and 2016 has a very high import content. Nonetheless, the MFAC considers that MFIN should allocate more resources to enhance the robustness of the forecasts for EU-funded investment projects. Although the impact on public finances may be limited to the co-financing element and any expenditure outlay which is not eligible for EU funding, while the impact on the overall outlook for economic growth limited due to the high import content of imports, the individual forecasts for investment and imports could be significantly impacted. Furthermore, investment forecasts play a critical role in the estimates for future potential output.

Another discrepancy between the MFIN and the COM's estimates relates to the output gap for 2016. Indeed, while both institutions estimate the output gap to amount to 0.6 pp in 2015 and be higher in 2016, the magnitude is slightly different. Specifically the MFIN expects a higher output gap for 2016 than the COM.

Notwithstanding the higher deficit projections than those contained in the DBP, the COM envisages lower debt ratios both for 2015 and 2016 when compared to the MFIN's forecasts (see Table 8).[43] This is almost entirely attributable to differences in the assumed positive stock flow adjustments for 2015 and 2016.[44] Whereas the MFIN is factoring in rather sizable positive stock flow adjustments in both years, the COM has assumed a positive but limited stock flow adjustment in 2015 and none in 2016. Indeed the DBP implicitly assumes the maintenance of high cash buffers by the government, as opposed to the COM's projections.[45] This is the main factor which explains the reported higher debt ratio target contained in the DBP when compared to the COM's forecasts. Otherwise, the projections for the primary balance as well as the estimates for the "snow-ball effect" are very similar across the sets of forecasts.

Table 8: Debt developments (per cent, percentage points)

	2015			**2016**		
	DBP	**COM**	**DBP - COM**	**DBP**	**COM**	**DBP - COM**
Gross debt ratio	**66.6**	**65.9**	**0.7**	**65.2**	**63.2**	**2.0**
Primary balance	-1.1	-1.0	-0.1	-1.3	-1.2	-0.1
"Snow-ball effect"	-1.4	-1.5	0.1	-1.4	-1.4	0.0
Stock-flow adjustment	0.9	0.2	0.7	1.4	0.0	1.4

Source: Ministry for Finance, European Commission

[43] However, the COM identified the elevated level of government-guaranteed debt (which remains high compared to other Member States), as an upside risk to the debt ratio projections.
[44] A positive stock-flow adjustment exerts an upward push on the debt ratio whereas a negative stock-flow adjustment exerts a downward push on the debt ratio.
[45] In particular the Government is assuming that as a result of the late timing of certain revenues, these would be received towards the end of the year and thus be maintained in the form of cash rather than used to lower the outstanding debt. The COM is not assuming such scenario.

6. Compliance with the SGP requirements

Compliance with the SGP requirements is assessed on the basis of three specific criteria, referred to as 'the debt criterion', 'the structural balance pillar' and 'the expenditure benchmark pillar'.[46] While the MFAC does not prepare its own independent fiscal projections, on the basis of its assessment of the current and near term baseline economic conditions and fiscal developments, it considers the debt rule to be met both for 2015 and 2016. To a large extent this criterion is being satisfied on the back of a lower outstanding starting public debt-to-GDP as at end 2014, implying that the reduction in the debt ratio was proceeding ahead of the prescribed timetable. Both the projections by the MFIN and the COM likewise indicate that the debt rule is expected to be met in both 2015 and 2016 since both sets of forecasts suggest that the debt ratio will be lower than the set benchmarks for both years (see Table 9).[47,48]

Table 9: Compliance with the SGP requirements – Malta

	2015			2016		
	Benchmark	**DBP**	**COM**	**Benchmark**	**DBP**	**COM**
Gross debt ratio	70.1	66.6	65.9	67.1	65.2	63.2
Change in structural balance (MFIN)	0.6	0.5	0.3	0.6	0.6	0.4
Change in structural balance (COM)		0.3			0.4	
Expenditure benchmark pillar	0.3	0.3	1.2	1.3	2.5	2.8

Source: Ministry for Finance, European Commission

On the other hand, the MFAC identifies possible challenges in order to meet the structural effort criterion of 0.6 pp for 2015 and another 0.6 pp for 2016, when considering that the official fiscal balance targets for 2015 and 2016 were unchanged by the authorities, despite the more favourable macroeconomic conditions. Consequently in the COM's calculations, a larger share of the consolidation effort planned for these years is being ascribed to the better cyclical conditions, rather than to structural effort. Indeed, while the MFIN's calculations suggest that the structural effort criterion could be marginally missed in 2015 and met in 2016, the COM's calculations indicate a lower structural effort in both years.

In the published version of the DBP document (Appendix Table 6.A), it was stated that "in structural terms, the deficit is expected to register an improvement of 0.5 percentage points of GDP in both 2015 and 2016" indicating that the structural effort was estimated by the MFIN at

[46] For a non-technical explanation of these criteria, refer to Box 2, Box 3 and Box 4 in the MFAC report "An Assessment of the Medium Term Fiscal Strategy 2015-2018, Annual Report 2014 and Half Yearly Report 2015 published by the Ministry for Finance", available on http://mfac.gov.mt/en/publications/Pages/Publications.aspx

[47] The COM however stated that it was unable to evaluate the ex-ante compliance with the debt criterion as this requires extended data series covering up to t+4, which were not published in the DBP. However, the provision of such information is only on a voluntary basis, as agreed by the EFC-A on 22 September 2014.

[48] The benchmark is calculated on the basis of a formula which establishes a linear reduction in the debt-to-GDP ratio to converge towards the 60% threshold.

0.5 pp in each year. On 23 October 2015, the MFIN informed the MFAC that while the structural effort for 2015 was confirmed at 0.5 pp, that for 2016 was revised upwards to 0.6 pp. The discrepancy between the MFIN's and the COM's calculations may be attributed to different inputs used in such calculations, such as the estimates for potential output and the estimates for temporary effects. The MFIN also advised the MFAC that in its initial transmission to the COM there was a mistake amounting to some €7 million, relating to a one-off deficit-increasing measure in connection with the retroactive impact of extra payments in relation to the implementation of the 2014 Own Resources Decision. Consequently, according to the MFIN, the DBP had underestimated the structural effort by 0.1pp in 2016. This was subsequently communicated to the COM on 23 October 2015.

With respect to the expenditure benchmark, the MFAC is of the view that there is a certain element of uncertainty with respect to the 'correct' benchmark to be used since on the basis of Malta's most recent economic performance the allowed expenditure growth could be higher than originally estimated. Indeed, while Malta's medium term growth rate used in the calculation for the expenditure benchmark is based on the frozen COM's calculations at the time of the 2013 winter forecasts, recent and projected economic developments, particularly the elevated levels of investment and the growth in the labour supply would suggest that Malta's potential growth rate has increased since then. This observation would tend to diminish the reliability of the expenditure benchmark criterion to assess the quality of public finance management in Malta. It also suggests that the structural balance appears to be a better indicator of the underlying budgetary performance than the expenditure benchmark.

On balance the MFAC considers possible that the expenditure benchmark could be missed at least in one of the two years over the 2015-2016 period. The MFAC's view is that planned expenditure growth, as calculated by the MFIN, could exceed the applicable reference rate, in 2016.

The MFAC notes that the COM's estimates are more cautious in terms of possible expenditure restraint and as a result, the COM expects this criterion to be missed in both years. Overall, the COM's opinion is that the DBP of Malta is *broadly compliant* with the provisions of the SGP, similar to the opinion expressed on six other euro area countries (see Box 4 and Table 10).[49] This means that the national authorities need to take the necessary measures within the national budgetary process to ensure that the DBP would be compliant with the SGP. This is based on the reasoning that the DBP may result in *some* deviation from the MTO or the adjustment path towards it, but nevertheless this would not represent a *significant* deviation from the required adjustment. Furthermore, the COM's opinion is that Malta is expected to comply with the debt reduction benchmark. Thus on the basis of the criteria set for Member States under the preventive arm of the SGP, Malta's budgetary plan is considered to be broadly compliant with the SGP rules.

[49] The COM's staff working document and its opinion on Malta's DBPs is found on: http://ec.europa.eu/economy_finance/economic_governance/sgp/budgetary_plans/index_en.htm

The MFAC welcomes the improved compliance with the SGP requirements when considering that the DBP for 2015 had been judged by the COM as ‘at risk of non-compliance’ with the SGP. Indeed, at that time the COM had anticipated a significant deviation from the adjustment path towards the MTO in 2015, whilst highlighting that according to their forecast, the structural effort for 2014 was far from that recommended (by the COM), and a slight risk of compliance with the debt rule was also the case.

Box 4: The COM’s opinion on the overall compliance of the DBP with the SGP

The COM’s assessment of a country’s DBP generally concludes with three possible statements:

Compliant: there is no need to amend the budgetary plans within the national budgetary procedure to ensure compliance with the SGP rules;

Broadly Compliant: authorities need to take the necessary measures within the national budgetary process to ensure compliance with the SGP. Specifically: *for Member States in the EDP*: the headline deficit target is projected to be achieved but the projected fiscal effort falls short of that recommended by the COM; *for Member States under the preventive arm of the SGP*: the respective DBP may result in some deviation from the MTO or the adjustment path towards it and is in compliance with the debt reduction benchmark, if applicable.

Risk of non-compliance: the respective DBP would not be expected to comply with the SGP requirements. The COM would thus require the authorities to take the necessary measures within the national budgetary process to make sure that the 2016 budget would comply with the SGP. Specifically: f*or Member States in EDP*: the COM's forecast for 2016, if confirmed ex post, could lead to the stepping up of the EDP as neither the recommended fiscal effort nor the recommended headline deficit target is forecast to be achieved; f*or Member States under the preventive arm of the SGP:* the COM's forecast projects a significant deviation from the MTO or the required adjustment path towards the MTO in 2016 and/or non-compliance with the debt reduction benchmark, if applicable.

The COM has not judged any of the Member States to be in a situation of serious non-compliance with the SGP. Malta, together with a number of other countries was judged to be ‘broadly compliant’. [50]

[50] Source: ‘2016 Draft Budgetary Plans: Overall Assessment’, available on: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2015/communication_to_euro_area_member_states_2015_dbp_en.pdf

Table 10: Compliance with the SGP requirements – euro area countries[51]

Commission Opinion on compliance of 2016 DBPs with SGP	Member State in preventive or corrective arm
Compliant	
Germany	Preventive arm
Estonia	Preventive arm
Luxembourg	Preventive arm
Netherlands	Preventive arm
Slovakia	Preventive arm
Broadly Compliant	
Belgium	Preventive arm
Latvia	Preventive arm
Malta	Preventive arm
Finland	Preventive arm
Ireland	Corrective arm
France	Corrective arm
Slovenia	Corrective arm
At risk of non-compliance	
Italy	Preventive arm
Lithuania	Preventive arm
Austria	Preventive arm
Spain	Corrective arm

Source: European Commission

7. The MFAC's evaluation of the budgetary stance

A sound budgetary policy requires that the conduct of fiscal policy satisfies three criteria: being counter-cyclical; being sustainable and being stable. Fiscal policy is meant to 'lean against the wind', boosting aggregate demand (being expansionary) when the economy is operating below potential and vice versa. However, the effectiveness of such policy presupposes that the trajectory for the public debt, when expressed as a percentage of GDP remains within sustainable levels.[52] Such considerations underpin the SGP limits for the fiscal deficit and debt ratios within the European context. However, apart from limiting fiscal imbalances, economic theory suggests that it is beneficial for a country to maintain stable tax rates over time as this reduces the economic distortions (excess burden) associated with frequent changes in taxation.[53]

[51] Cyprus and Greece do not need to submit draft budgetary plans because they are currently subject to macroeconomic adjustment programmes, while Portugal did not submit its DBP by the stipulated date.
[52] GDP serves as a proxy for the repayment capabilities of the Government.
[53] For an early exposition of this idea see Barro (1979), "On the determination of the public debt", The Journal of Political Economy, Volume 87, Number 5.

The MFAC positively views the Government's full commitment to the announced fiscal targets, which has resulted in years of consecutive fiscal consolidation, which is being projected to continue both for 2016 and the years ahead. This suggests that the country is on the right path towards achieving its MTO of a balanced budget, in structural terms, by 2019. Apart from meeting the country's international obligations, this is seen by the MFAC as the cornerstone of prudent macroeconomic management.

The MFAC also considers positively the creation of additional tax bases, such as through the new environmental contribution to be levied on the tourism sector as from 1 April 2016.[54] While this measure is unlikely to have major downside effects on the otherwise buoyant tourism activity, broader tax bases can ensure that tax sources are more diversified and more stable. This could help maintain taxes on income and profits stable in the face of underlying upward expenditure pressures. Indeed, recent measures to reduce the tax burden on labour are positively viewed by the MFAC as this pushes towards more growth-friendly composition of public finances. The increase in labour force participation observed in recent years, which impact positively long term pension sustainability, can to some extent be ascribed to such tax reforms.

At the same time, the MFAC notes positively that a recent benchmarking exercise carried out by the COM (on the basis of 2014 data) and published in the overall assessment of the latest countries' DBPs, revealed that the tax wedge in Malta, that is the tax burden on labour (consisting of income tax payments and social contributions by the employee and employer), is the lowest among euro area countries (see Chart 11).[55] This indicator is positively viewed by the MFAC, as high labour taxes may weigh on economic activity and employment. The MFAC commends the authorities for embarking on an across-the-board lowering of income taxes over the years, shifting the composition of tax revenues towards from direct to indirect taxes.

On the other hand, while the MFAC acknowledges that the correction of fiscal imbalances needs to be gradual, in order to avoid adverse shocks which could undermine economic growth, the MFAC underscores that a period of high economic growth facilitates the implementation of reforms. In this respect, it is a matter of concern that the planned structural effort (the change in the structural balance) may fall short of the SGP requirements. The MFAC encourages the Government to take advantage of the current benign macroeconomic scenario in Malta, with real growth rate of 3.6% being projected for 2016, to add momentum to the expenditure rationalisation and reform processes. This applies with respect to the necessary changes to rationalise expenditure and increase effectiveness, such as in the areas of health and education.[56,57] This is particularly relevant since planned fiscal expenditures are not consistent with the expenditure limits imposed by the SGP, as estimated by the COM.

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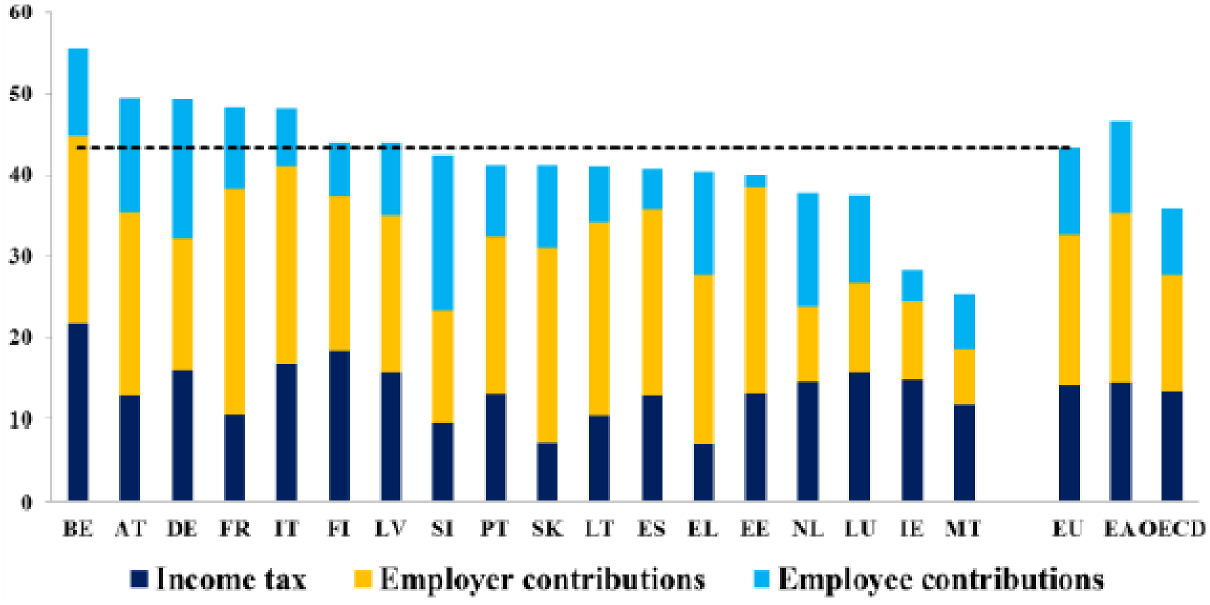
[54] Tax bases are the bases upon which taxes are levied.

[55] In the case of Malta, Latvia and Lithuania the date related to 2013.

[56] In the case of Malta, the public expenditure on education, as a percentage of GDP and as a share of total public expenditure exceeded the EU average, but the education attainment levels were less positive with a higher proportion of early leavers and lower levels of tertiary education attainment. Source: Education and Training Monitor 2015 – Malta, available on http://ec.europa.eu/education/tools/et-monitor_en.htm

[57] In the case of health, the Comprehensive Spending Review could provide useful insights to enable better rationalisation of expenditure in this sector.

Chart 11: The tax burden on the average wage in 2014 (as a percentage of GDP)[58]



Source: European Commission

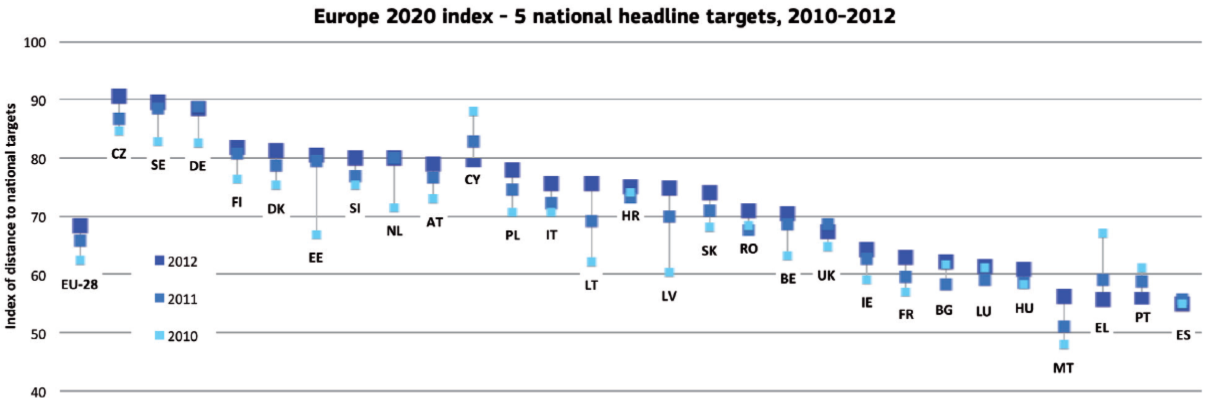
While financial sustainability considerations remain a priority, it is important that the desired outcomes, in terms of improved health care services, and higher nation-wide educational attainment are actively sought. These reforms are deemed important not only for welfare purposes but also because they contribute to sustain the country's future potential output. The same applies with respect to the necessary initiatives to implement transport reform and boost labour market activity further.[59] The MFAC highlights the importance to implement the necessary changes, ahead of a possible change in business cycle conditions, which according to the latest DBP could take place over the medium term.[60]

The MFAC also draws the attention to the fact that according to the latest assessment by the COM (based on data up to 2012), Malta lags behind in the achievement of the Europe 2020 targets, though acknowledging that some progress is being made (see Chart 12).[61] The MFAC acknowledges that progress has been made since the publication of the COM's report. The initiatives undertaken in the fields of the environment and labour market, including those contained in the latest DBP, are a step in the right direction, but there appears to be the need and

[58] Reproduced from "2016 Draft Budgetary Plans: Overall Assessment", Communication from the Commission.
[59] A recent study has found that the external costs of transport for 2012 amounted to €274 million (of which €117.9 million attributable to congestion) and under a no policy change these costs would increase to €317 million by 2020. Source: The External Costs of Passenger and Commercial Vehicles Use in Malta, prepared by the Institute for Climate Change and Sustainable Development and funded by the European Commission, available on https://ec.europa.eu/malta/sites/malta/files/docs/body/study_on_traffic_online.pdf
[60] The output gap is expected to remain positive between 2015 and 2017 (implying that actual output will exceed potential output) but is expected to turn slightly negative as from 2018 (implying actual output will fall short of potential).
[61] These targets deal with employment, R&D, emissions levels, renewable energy use, energy efficiency, early school leaving, tertiary education and population at risk of poverty. For further details about Malta's progress with respect to each target is available on http://ec.europa.eu/europe2020/europe-2020-in-your-country/malta/progress-towards-2020-targets/index_en.htm

scope for further initiatives in order to attain such targets. This may also necessitate additional public spending and fiscal measures, which need to be considered in the conduct of future fiscal policy.

Chart 12: EU 2020 progress[62]



Source: European Commission

The MFAC further notes that the budgetary performance in recent years has benefitted from tax revenues levied on potentially volatile tax bases, such as profits of international companies based in Malta. This pattern has extended further, since the revenues generated from the IIP can also be considered to be to some extent volatile in nature, as these depend on the yearly applications received and the speed of processing of such requests. While the MFAC acknowledges that to date the actual performance of these specific revenue components has been very positive, such revenues may in future become unstable and could scale back suddenly.[63]

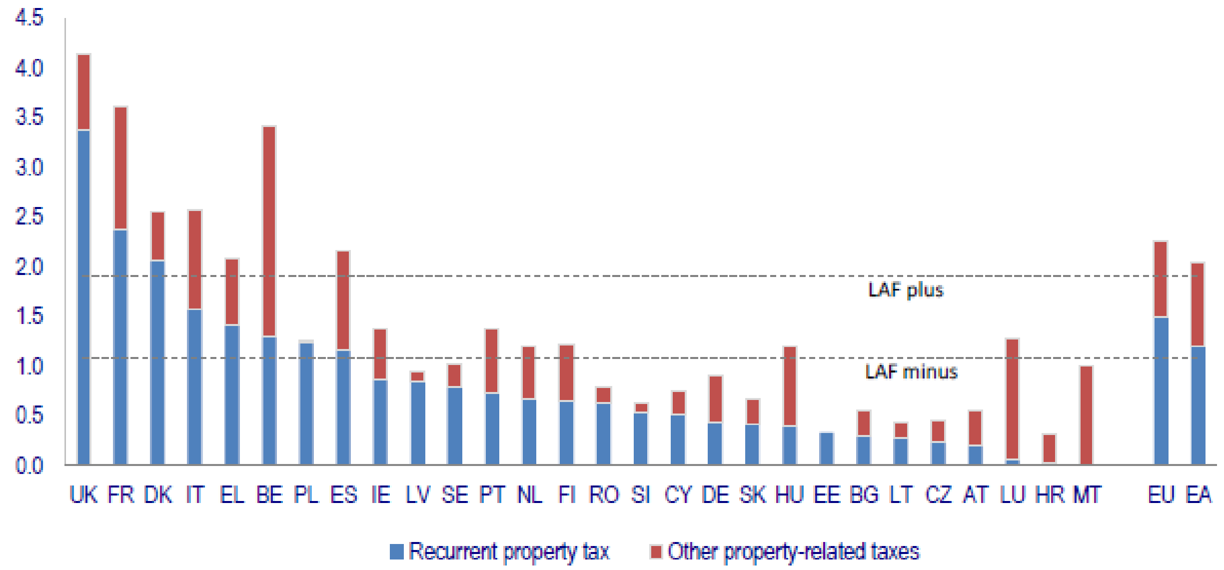
The MFAC also invites the Government to consider whether the current system of property-related taxes is indeed the most efficient and equitable or whether one could consider alternatives. Indeed, Malta stands out as one of the few EU countries which do not levy recurrent taxes on property (see Chart 13).[64] Indeed, property taxes in Malta are mainly levied at the time of property transfers (purchases and sales). In this context it is relevant to note the COM's view that 'the case for increasing revenue generated by recurrent taxes on immovable property rests upon the relatively limited negative effect they have on growth, compared to other taxes, notably taxes on income'.

[62] The chart is reproduced from "The Europe 2020 Index: The Progress of EU Countries, Regions and Cities to the 2020 Targets" by the European Commission, May 2015, available on http://ec.europa.eu/regional_policy/sources/docgener/focus/2015_01_europe2020_index.pdf

[63] For example, the drive by some countries in the EU towards some element of tax harmonisation as well as the implications of the OECD initiatives aiming to fight the phenomenon of Base Erosion and Profit Shifting (BEPS) could be an element of risk in the distant future affecting Malta's tax attractiveness for the domicile of business. For further details refer to http://www.oecd.org/ctp/beps.htm

[64] Source for the chart and quote: Tax Reforms in EU Member States 2015, European Commission, available on http://ec.europa.eu/economy_finance/publications/eeip/ip008_en.htm

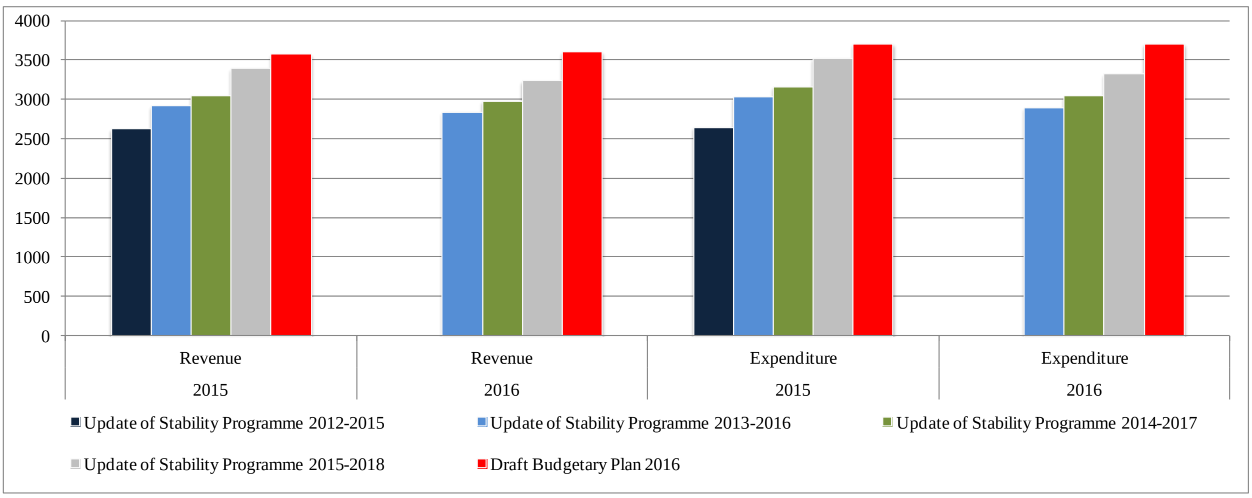
Chart 13: Revenue from property taxation in 2012 (as a percentage of GDP)



Source: European Commission

The MFAC also notes that while the actual and projected macroeconomic outlook appears to be more benign than that envisaged in last year's DBP and this year's USP, the pace of fiscal consolidation has remained unchanged. The MFAC considers that the more benign macroeconomic conditions, which translate into higher tax revenues, should be channelled into a faster decline in the fiscal deficit rather than to finance additional expenditures. Indeed, whereas the commitment to the yearly deficit targets appears ingrained, consecutive revenue and expenditure forecasts as presented in the yearly Updates to the Stability Programme and in the latest DBP have exhibited a persistent upward adjustment for 2015 and 2016 (see Chart 14). The MFAC's view is that strong revenue growth provides an effective opportunity to address more forcefully the structural deficit problems and thereby prepare on a sounder basis for future demographic trends.

Chart 14: Fiscal projections across vintages (EUR millions)



Source: European Commission

8. Conclusion

The DBP confirms the target to reduce the headline fiscal deficit further. At the same time, the DBP confirms the strategy of the Maltese authorities to continue the shift from direct to indirect taxation. These are in line with the country's international obligations and in line with the Eurogroup's expressed commitment to reduce the tax burden on labour across the euro area countries.

The MFAC positively notes the sustained pace of fiscal consolidation and encourages the authorities to remain vigilant in this regard. In this context there appears to be scope for the structural effort to be stepped up further in the form of fiscal consolidation over and above cyclically-driven improvements. This is particularly warranted on account of the very favourable macroeconomic and financial conditions, characterised by elevated economic growth and the historically low interest rates. It is also important that any revenue windfalls are not channelled into additional permanent spending.

The MFAC strongly advises that revenues in excess of targets should be carefully analysed and any revenue windfalls as distinguished from normal revenue forecast errors, should primarily be used to build fiscal buffers. In this respect, the MFAC notes the decision by the Government to pass motion number 289 on 9 December 2015, to enable the drawdown from the Contingency Reserve of the full balance (equivalent to €8.272 million). This decision was taken on the grounds that urgent unforeseen events had occurred, which had not been provided for in the 2015 Budget Estimates. Specifically, the Contingency Reserve was used to finance part of Malta's Own Resources Contributions to the EU Budget, which were higher than originally budgeted for.[65] While the MFAC acknowledges that some expenditure undertaken in 2015 was not initially earmarked for in the Budget Estimates, it invites the authorities to establish more rigorous policies of how this reserve may be resorted to in future. The MFAC considers that such Contingency Reserve should only be utilised in rare circumstances and when all other options have been exhausted. The MFAC also encourages the MFIN to replenish the Contingency Reserve, as stipulated in the FRA, by ensuring that the required amount is allocated for in the budget estimates.

At the same time, while the current expenditure restraint, embedded in the MFIN's projections is to be supported, the MFAC shares the concern by the COM that net capital expenditure could be lower than planned should it need to compensate for slippages in the budgetary execution. In particular, the MFAC notes that in its assessment the COM invited "the authorities to take the necessary measures within the national budgetary process to ensure that the 2016 budget will be compliant with the SGP". This follows similar remarks contained in the IMF Staff Concluding Statement of the 2015 Article IV Mission which stated that "the fast growth of sticky current expenditures makes the planned consolidation difficult. To ensure that the proposed fiscal targets

[65] Late payment of such funds would have incurred interest payments.

are met, additional expenditure measures should be considered."[66] The MFAC also encourages the authorities to remain vigilant with respect to the age-related expenditure while at the same time ensure that long term sustainability issues are also addressed in a timely manner.

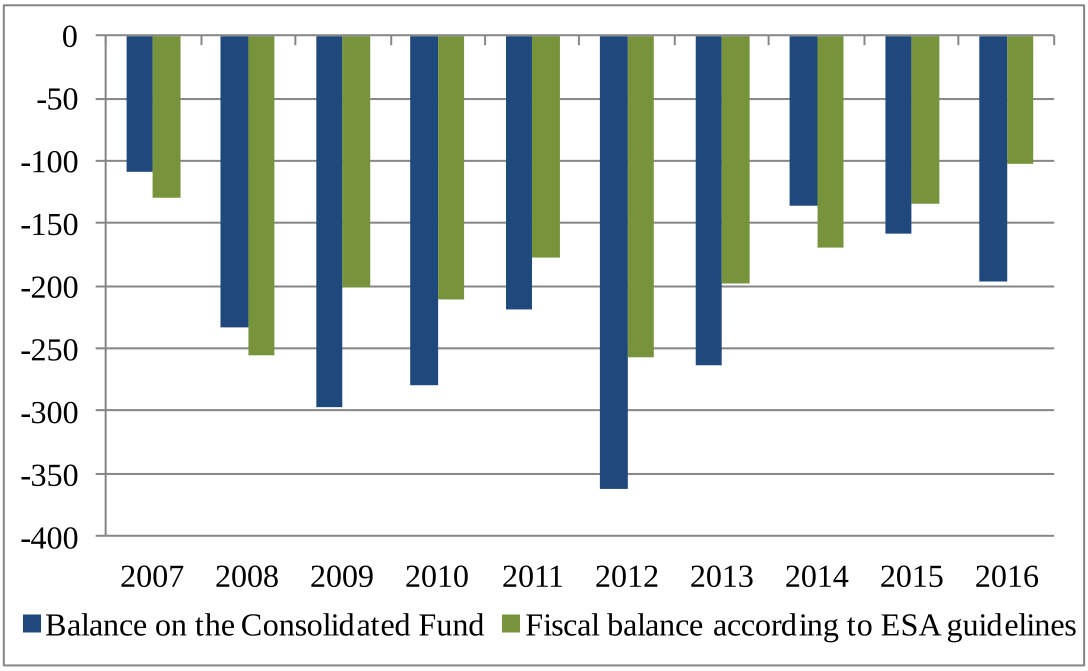
In order to enhance the transparency of fiscal policy, the MFAC also considers important that the differences between the balance on the Consolidated Fund, upon which the Budget Speech is based, and the fiscal balance calculated on the basis of the ESA guidelines, upon which the DBP is based, are clearly mapped and explained (see Box 5).

Box 5: The Consolidated Fund and the ESA balances

In Malta fiscal data has traditionally been compiled on the basis of methodologies devised by the Budget Office (BO) within MFIN. According to this methodology, revenues and expenditures are broken down by ministry. The definitions used by the BO are outlined in the yearly Financial Estimates document published by the MFIN. The MFAC considers that there is scope for these definitions to be enhanced in order to make them more exhaustive, less subjective, and closer to defintions used by Eurostat. For example, the definitions used to classify certain types of expenditures are rather arbitrary, such as the distinction between capital and current expenditure.

The MFAC notes that the trend in the Consolidated Fund balance diverged from the fiscal balance measured as per ESA guidelines, making the communication of fiscal developments to the general public more challenging (see Chart B).

Chart B: Consolidated Fund and ESA balances (EUR millions)



Source: Ministry for Finance

[66] Source: http://www.imf.org/external/np/ms/2015/111615.htm

In particular, when compared to 2014, the Consolidated Fund deficit is expected to widen in 2015 and in 2016 but to decline in ESA terms. While this is due to many different factors, the primary factor appears to be related to the current method of recording of IIP revenues, where in the case of the Consolidated Fund only 30% of such revenues feature, while in the case of the ESA balance, the full 100% is considered.

The MFAC acknowledges that the current framework has to date served the country well in the sense that it enabled the BO to maintain a firm grip of the fiscal revenues and expenditures to ensure adherence to local legislation. However, another apparent weakness of the current BO framework is the possibility of undertaking 'below-the-line' transactions, that is transactions which entail fiscal revenues and expenditures but which do not feature among the Consolidated Fund transactions.[67] The MFAC considers important that information about these types of transactions be more easily available publicly, in order to contribute to more informed public opinion about the conduct of fiscal policy.

The MFAC acknowledges the work being carried out internally by the Budget Office (BO) in terms of analysis of the quarterly accruals returns presented by the various ministries, and the other entities forming part of general government as per ESA guidelines but a longer term approach is warranted to steer the current BO methodologies to approximate better the ESA guidelines. This is advisable both to ensure that the MFIN's analysis of fiscal developments is more focused on the internationally recognised definitions but also to enable the general public to better understand and participate in the debate on fiscal issues as applicable within the general EU fiscal governance framework.

Finally, the MFAC has identified areas of possible improvement in terms of added transparency in the contents of the DBP document as well as in the process. In particular the MFAC suggests that the DBP should include a table to identify the following key fiscal assumptions: the projected employment level within general government and the projected change in the average government wage. Furthermore, the MFAC deems necessary that MFIN publishes greater details on intermediate consumption and expenditure on gross fixed capital formation (on projects above a certain threshold), particularly since the latter two expenditure categories can prove rather volatile and where micro evidence is necessary to support the stated targets. This is particularly relevant whenever the planned budgetary improvement relies on developments in these two categories.

[67] The transactions in the 'below-the-line' accounts are reflected in the Treasury Clearance Fund which is established in terms of the Financial Administration and Audit Act. The opening of such accounts requires prior approval from the MFIN and is subject to conditions laid down in those cases when approval is granted, which approval is only issued after having ensured that the requests are justified. The 'below-the-line' accounts are included in the Annual Financial Report of the Treasury, are assigned an ESA code in the system and their performance forms part of the bi-annual 'Notification of Debt and Deficit' reported to the COM.