An Assessment of the Fiscal Forecasts for Malta prepared by the Ministry for Finance in April 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 to transmit a report by the Malta Fiscal Advisory Council (MFAC) on the assessment of the fiscal forecasts presented by the Ministry for Finance in the Update of Stability Programme 2016 – 2019.

The MFAC welcomes the further fiscal consolidation achieved in 2015, more specifically the reduction in the deficit from 2.0% of GDP to 1.5% of GDP and of the debt-to-GDP ratio from 67.1% to 63.9%. The MFAC also views positively the fact that both the fiscal deficit and the debt ratio for 2015 were less than had been targeted, by 0.1 percentage points and 2.7 percentage points, respectively.

The targets published in the latest Update of Stability Programme are quite ambitious, aiming for a fiscal surplus equivalent to 0.1% of GDP and a debt-to-GDP ratio of 55.5%, by 2019. Overall, the MFAC considers the planned yearly trajectory for the fiscal balance and the debt ratios for the period 2016 to 2019 to be within its endorseable range.

The MFAC considers the revenue projections to be plausible, noting the possibility that a number of specific revenue forecasts could indeed surpass projections as these appear to be based on rather prudent assumptions. This seems to be particularly the case for taxes on production and imports and current taxes on income and wealth, given the past trends observed in these components and the macroeconomic conditions being forecasted. On the other hand, the MFAC does identify a number of downside risks in the other revenue category, mainly associated to an element of uncertainty related to the intake from market output, largely from the Individual Investor Programme, as well as the somewhat challenging targets set for the absorption of EU funds. On balance , however, the MFAC is of the view that there appear to be upside risks to the overall revenue projections.

As for the expenditure targets, the projected decline from 43.3% of GDP in 2015 to 38.3% of GDP in 2019 is rather ambitious. The MFAC has identified possible upside risks for a number of expenditure components, such as compensation of employees and intermediate consumption, as their projections appear rather challenging in terms of the assumed restraint. Very close monitoring and vigilance by the authorities will therefore be crucial to ensure that these targets are met. Moreover, the Government is invited to sustain the positive momentum regarding expenditure rationalisation, particularly the further implementation of the measures proposed following the Comprehensive Spending Review exercises.

Overall, the MFAC considers the risks to the attainment of the targets for the fiscal balance over the period 2016 to 2019 to be neutral on account of the opposing revenue and expenditure upside risks. Furthermore, the track record in meeting the targets for the headline fiscal balance suggests that there appears to be sufficient flexibility within the budget to cope with an element of unplanned revenue shortfalls or expenditure overruns, provided these are not excessive. The deficit projections for 2016 and 2017 are also within a close range to the latest forecasts published by the Central Bank of Malta and the European Commission, albeit slightly more ambitious.

With regard to the debt projections, these are also considered by the MFAC to lie within its endorseable range, as they are consistent with the forecasts for the fiscal balance and the level of nominal GDP, while factoring the amount of stock-flow adjustments assumed by the Ministry for Finance in its calculations. Indeed, both the Central Bank of Malta and the European Commission are projecting a slightly lower debt ratio for both 2016 and 2017, notwithstanding that their projections for the fiscal deficit are slightly higher.

As for the processes and methodologies used by the Ministry for Finance to prepare its fiscal projections, the MFAC positively notes that in this round there were increased efforts to co-ordinate the inputs from the various bodies involved, in order to ensure greater internal consistency between the fiscal and macroeconomic forecasts included in the Update of Stability Programme. The MFAC also views favourably that as from this round, estimates for previously announced measures were also updated on the basis of more recent information. The MFAC is also satisfied that this year’s Update of Stability Programme has boosted the level of fiscal transparency, and in this respect the MFAC invites the Ministry for Finance to consider adding even more details in its future publications, particularly by outlining better the full set of measures that are embedded in the Ministry’s projections.

The MFAC would also like to underscore the importance that, as much as possible, working practices should be better aligned to the timelines envisaged by the European Semester, possibly by anticipating some of the work involved with the preparation of the fiscal projections, as these are a crucial element in the preparation of the macroeconomic projections, on which there are strict timelines which need to be respected by the MFAC to issue its assessment.

Finally, the MFAC would like to express satisfaction at the constructive dialogue between the parties involved, and in particular the full support it received from the Economic Policy Department, the Budget Office and the National Statistics Office, in order to prepare its assessment of the latest set of published fiscal projections.

Yours sincerely

Rene Saliba
Chairman

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Abbreviations

AR	Annual Report
BO	Budget Office
CBM	Central Bank of Malta
COM	European Commission
COLA	Cost of Living Adjustment
CSR	Comprehensive Spending Review
DBP	Draft Budgetary Plan
EBUs	Extra-Budgetary Units
EDP	Excessive Deficit Procedure
EPD	Economic Policy Department
ESA	European System of National and Regional Accounts
EU	European Union
FRA	Fiscal Responsibility Act
FTS	Foundation for Tomorrow Schools
FWT	Final Withholding Tax
GDP	Gross Domestic Product
IIP	Individual Investor Programme
IRD	Inland Revenue Department
LHS	Left hand scale
MCAST	Malta College of Arts Science and Technology
MCST	Malta Council for Science and Technology
MFAC	Malta Fiscal Advisory Council
MFF	Multiannual Financial Framework
MFIN	Ministry for Finance
MFSA	Malta Financial Services Authority

MGS	Malta Government Stock
MSE	Malta Stock Exchange
MTO	Medium Term Budgetary Objective
NAO	National Audit Office
NPISH	Non-Profit Institutions Serving Households
NSO	National Statistics Office
OPM	Office of the Prime Minister
pp	percentage points
PSO	Public Service Obligation
RHS	Right hand scale
SGP	Stability and Growth Pact
UoM	University of Malta
USP	Update of the Stability Programme
VAT	Value Added Tax

Executive summary

This Report presents an assessment of the fiscal projections contained in the Update of Stability Programme 2016 – 2019 which was published by the Ministry for Finance on 29 April 2016. This assessment is carried out by the Malta Fiscal Advisory Council in line with the requirements prescribed in the Fiscal Responsibility Act, 2014 (Cap. 534).

In 2015, the deficit for general government amounted to €129 million, equivalent to 1.5% of GDP. This was 0.1 percentage points less than what had been targeted in previous vintages of the Stability Programme. The Government's aim is to progressively improve the state of public finances, with the deficit ratio projected to decline to 0.7% in 2016, 0.6% in 2017 and 0.2% in 2018. By 2019, the Government aims to attain a small surplus, equivalent to 0.1% of GDP. At the same time the Government is aiming to steadily lower the public debt-to-GDP ratio from 63.9% at the end of 2015 to 55.5% in 2019.

The methodologies used to prepare the fiscal projections remained similar to those adopted in previous years, with some improvements, particularly the increased efforts to ensure better internal consistency between the macroeconomic and fiscal projections. The Malta Fiscal Advisory Council is satisfied that the current process factors in reasonably well the micro-based knowledge and expertise about very specific features of the various tax and expenditure laws in Malta, while ensuring general consistency with the forecasts for GDP and its components.

The Malta Fiscal Advisory Council considers the revenue projections to be plausible, noting the possibility that some specific revenue items could indeed surpass projections, in view of prudent underlying assumptions, thereby leaving the possibility for upside risks. This appears to be the case particularly for taxes on production and imports and current taxes on income and wealth. This view is contingent on the materialisation of the rather buoyant macroeconomic outlook, which has been endorsed by the Malta Fiscal Advisory Council in its previous report.

On the other hand, the expenditure targets may be rather ambitious, leaving the possibility for an element of upside risk due to the fact that a number of projected expenditure components, especially compensation of employees and intermediate consumption, appear rather challenging in terms of the assumed restraint.

Overall, the Malta Fiscal Advisory Council considers the risks to the attainment of the targets for the fiscal balance over the period 2016 to 2019 to be broadly neutral, on account of the opposing revenue and expenditure upside risks. The track record in meeting the targets for the headline fiscal balance suggests that there appears to be sufficient flexibility within the budget to cope with an element of unplanned revenue shortfalls or expenditure overruns, provided these are not excessive. Furthermore, the deficit projections for 2016 and 2017 are within a close range, albeit slightly more ambitious, when compared to the latest forecasts published by the Central Bank of Malta and the European Commission. On the basis of its assessment, the Council therefore considers the deficit projections presented by the Ministry for Finance to be within its endorseable range.

With regard to the debt projections presented by the Ministry for Finance, these are deemed to be consistent with the forecasts for the fiscal balance and nominal GDP. They also reflect an element of prudence. Indeed, both the Central Bank of Malta and the European Commission are projecting a slightly lower debt ratio for both 2016 and 2017, notwithstanding that their projections for the fiscal deficit are slightly higher. The discrepancy is largely due to the assumed stock-flow adjustments.

1. Introduction

Every April, European Union (EU) Member States are required to lay out their fiscal plans for the next three years, which are outlined in their Update of Stability Programme (USP).[1] This ensures that the country's fiscal policy is conducted within a medium term framework, particularly by outlining how the country's commitments in the area of public finances are being addressed. Article 13 (3) of the Fiscal Responsibility Act (FRA) 2014 (Cap. 534), prescribes that the Malta Fiscal Advisory Council (MFAC) shall endorse, as it considers appropriate, the fiscal forecasts contained in Malta's USP. The assessment of Malta's fiscal forecasts started being carried out in 2014 by the National Audit Office (NAO), but since 2015, this task has been taken over by the MFAC.

This Report complements another report, published on 29 April 2016, wherein the MFAC had endorsed the macroeconomic forecasts contained in the USP 2016 – 2019, and proceeds as follows.[2] Section 2 presents the headline fiscal forecasts. Section 3 evaluates the methodologies and processes adopted by the Ministry for Finance (MFIN) to prepare the fiscal forecasts contained in the USP. Section 4 examines the extent to which, the forecasts for the main revenue components can be considered to be plausible, and whether there could be any upside or downside risks to the baseline forecasts. Section 5 carries out the same type of analysis, applied to the main expenditure forecasts. Section 6 examines the extent to which the projections for the fiscal balance for the period 2016 to 2019 can be considered to be within the endorseable range of the MFAC. Section 7 examines the extent to which the trajectory for public debt is plausible. Section 8 compares the MFIN's fiscal forecasts to those prepared by the European Commission (COM) and the Central Bank of Malta (CBM). Section 9 concludes with an overall assessment.

2. Overview of the main fiscal projections

The latest USP, which was published by the MFIN on 29 April 2016, provides an overview of the main factors which contributed to the fiscal outturn in 2015, in line with the notification of the General Government Debt and Deficit under the Maastricht Treaty issued by the National Statistics Office (NSO) through a press release published on 21 April 2016.[3] The USP presents the fiscal targets for the four-year period 2016 to 2019, expressed as a percentage of GDP (see Table 1). These targets are also converted and presented in absolute terms in order to facilitate the analysis (see Tables 2 and 3).[4]

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[1] The cut-off date for the information contained in this Report is 27 May 2016.
[2] The report presenting the endorsement of the macroeconomic forecasts contained in the USP 2016-2019 is available on the MFAC's website.
[3] Source: NSO News Release 065/2016 available on the NSO's website.
[4] These figures were provided by the MFIN. Throughout the Report there may be reference to figures not explicitly quoted in the USP 2016-2019 but which were made available by the MFIN and the NSO, to enable a more thorough analysis of the fiscal projections.

Table 1: Summary of fiscal developments expressed as per cent of GDP[5]

Fiscal Variable	**2015**	**2016**	**2017**	**2018**	**2019**
Revenue	41.9	39.4	39.3	38.8	38.4
Expenditure	43.3	40.1	39.9	39.0	38.3
General government balance	-1.5	-0.7	-0.6	-0.2	0.1
Structural balance*	-2.3	-1.5	-0.9	-0.3	0.2
Debt	63.9	62.6	60.4	57.5	55.5

**As per cent of potential GDP expressed in nominal terms*
Source: MFIN

Table 2: Summary of fiscal developments in EUR millions

Fiscal Variable	**2015**	**2016**	**2017**	**2018**	**2019**
Revenue	3,683.1	3,706.3	3,902.2	4,040.4	4,179.1
Expenditure	3,812.1	3,771.9	3,957.0	4,059.4	4,169.2
General government balance	-129.0	-65.6	-54.8	-19.0	10.0
Structural balance	-180.8	-124.6	-76.7	-27.0	14.3
Debt	5,620.7	5,878.4	6,000.0	5,986.1	6,031.0

Source: MFIN

In 2015, the deficit for general government amounted to €129 million, equivalent to 1.5% of GDP. This was 0.1 percentage points less than had been targeted in the previous three vintages of the USP. The process of fiscal consolidation is expected to continue throughout the entire forecast horizon. Indeed the general government fiscal deficit is expected to progressively narrow, albeit at an uneven pace. The MFIN also expects that by 2019, a small fiscal surplus, equivalent to 0.1% of GDP or just under €10 million, will be achieved. In absolute terms, the correction is expected to be frontloaded to 2016. Indeed, an improvement of just over €63 million is being targeted for 2016, also on account of the new measures which came into force.[6] In subsequent years, the correction, in absolute terms, is more contained, and no details about specific new measures are outlined in the USP.

Public finances are expected to be favourably impacted by the projected positive output gap conditions.[7] As a result, when the fiscal balance is expressed in structural terms, the structural balance is estimated at somewhat higher levels than the general government balance (see Tables 1 and 2). In this context, however, it is to be noted that whereas the general government balance shown in Table 1 is expressed as a percentage of GDP, the structural balance is expressed as a percentage of potential output. In absolute terms, the structural fiscal balance is expected to decline from €180.8 million in 2015 to €124.6 million in 2016,

[5] Figures for 2015 included in Tables 1, 2 and 3 are based on actual data while figures for 2016 – 2019 are forecasts. Figures may not add up due to rounding.
[6] Some of these measures are discussed in Section 4 in this Report.
[7] A positive output gap means that the actual level of economic activity exceeds the estimated level of potential output. This is an indication of buoyant economic conditions, which thus impact public finances positively, particularly by boosting tax revenues and by lowering spending on unemployment benefits. The opposite is true when the economy is said to be operating below potential or with a negative output gap.

and with further improvements being targeted in subsequent years.[8] The improvement in the structural balance is expected to amount to more than €40 million annually, with the stronger improvement (equivalent to €56.2 million) expected in 2016. The gap between the structural balance and the general government balance is expected to narrow in the outer forecast years, wholly because the level of economic activity is expected to eventually converge towards potential. The impact of one-off and temporary measures is meanwhile expected to remain stable at 0.1% of GDP annually. In 2019, the projected structural surplus is marginally higher than the general government surplus since the economy is expected to swing to below potential as from that year.[9]

Table 3: Detailed revenue and expenditure projections in EUR millions

	2015	2019	2016	2017	2018	2019	Total change
			year-on-year change				
Total revenue	**3683.1**	**4179.1**	**23.2**	**195.9**	**138.2**	**138.7**	**496.0**
Taxes on production and imports	1189.1	1428.3	88.3	64.2	43.8	42.9	239.2
Current taxes on income and wealth	1237.6	1508.9	68.0	61.8	68.8	72.8	271.3
Capital taxes	15.0	15.1	0.1	0.1	0.1	-0.2	0.1
Social contributions	596.3	693.5	29.5	23.0	21.7	23.0	97.2
Property income	99.8	97.5	-4.0	0.7	1.0	0.0	-2.3
Other revenue	545.3	435.8	-158.8	46.3	2.8	0.3	-109.5
Total expenditure	**3812.1**	**4169.2**	**-40.2**	**185.1**	**102.4**	**109.8**	**357.1**
Compensation of employees	1116.4	1302.3	57.2	45.2	39.1	44.3	185.9
Intermediate consumption	596.5	651.9	16.5	33.4	-1.9	7.4	55.4
Social payments	1033.2	1185.6	30.7	35.6	42.3	43.9	152.4
Interest expenditure	227.6	228.2	-10.1	3.2	4.4	3.2	0.6
Subsidies	110.6	118.1	-1.2	6.7	2.2	-0.2	7.5
Gross fixed capital formation	402.3	343.4	-86.7	30.5	1.2	-3.9	-58.9
Capital transfers payable	129.6	83.4	-69.4	20.3	1.2	1.7	-46.2
Other expenditure	195.9	256.3	22.8	10.3	13.9	13.4	60.4
Fiscal balance	**-129.0**	**9.9**	**63.3**	**10.9**	**35.8**	**28.9**	**138.9**
One-off and temporary effects	9.8	7.8	0.5	-0.6	-1.9	0.0	-2.0
Cyclical effects	42.0	-12.2	6.7	-36.4	-12.0	-12.4	-54.2
Structural balance	**-180.8**	**14.3**	**56.2**	**47.9**	**49.7**	**41.3**	**195.1**

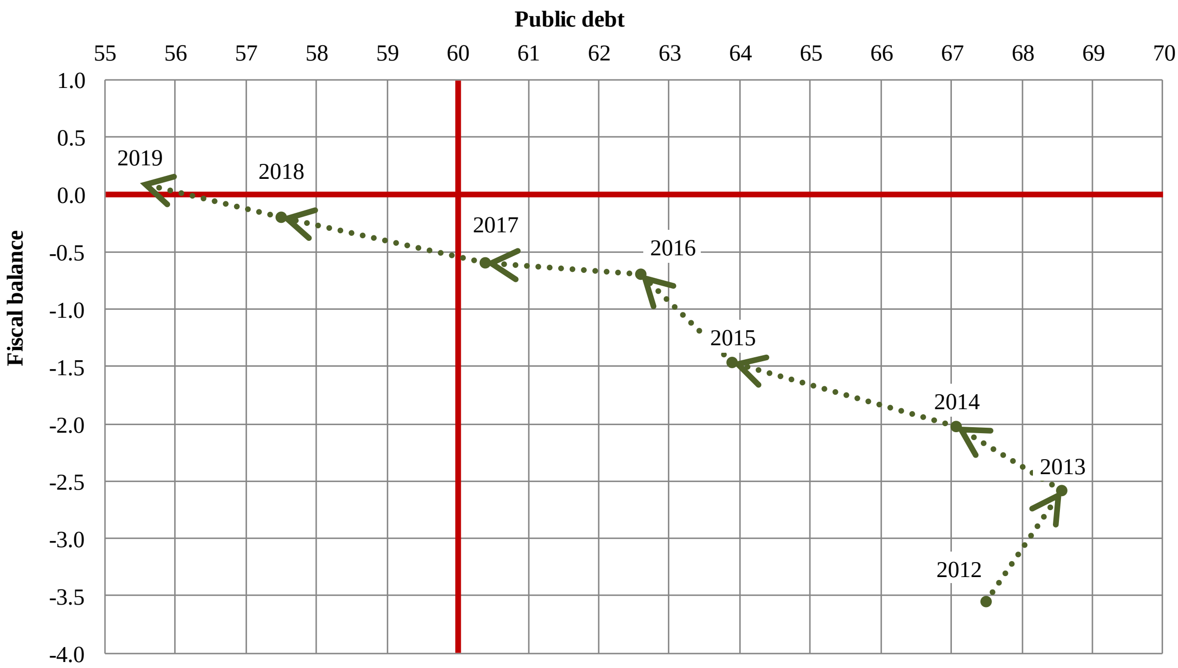
Source: MFIN

[8] The structural fiscal balance represents the actual budget balance net of one-off and temporary effects and net of cyclical effects. The structural balance thus provides a measure of the underlying trend in the budget balance..
[9] Economic theories suggest that economies pass through phases of activity above- and below- potential. When an economy is operating below potential, the headline fiscal figures are negatively affected.

As a result of the projected fiscal developments, the outstanding level of public debt is set to increase from just over €5.6 billion as at end 2015 to slightly above €6 billion by 2019.[10] When expressed as a percentage of GDP, the debt ratio is however estimated to fall from 63.9% as at end 2015 to 55.5% as at end 2019.

The envisaged yearly reductions in the fiscal deficit and the public debt ratios extend the consolidation pattern observed in recent years (see Chart 1). Indeed, should the projected fiscal consolidation materialise, 2019 would represent the year when a small fiscal surplus would be attained, since fiscal data compiled according to the European System of National and Regional Accounts (ESA) methodologies have been available for Malta.[11] At the same time, the debt ratio would stand comfortably below the 60% threshold, after having peaked at 72.0% in 2004, retrenching to the ratio which prevailed between 1998 and 1999.[12]

Chart 1: Fiscal balance and debt trajectories



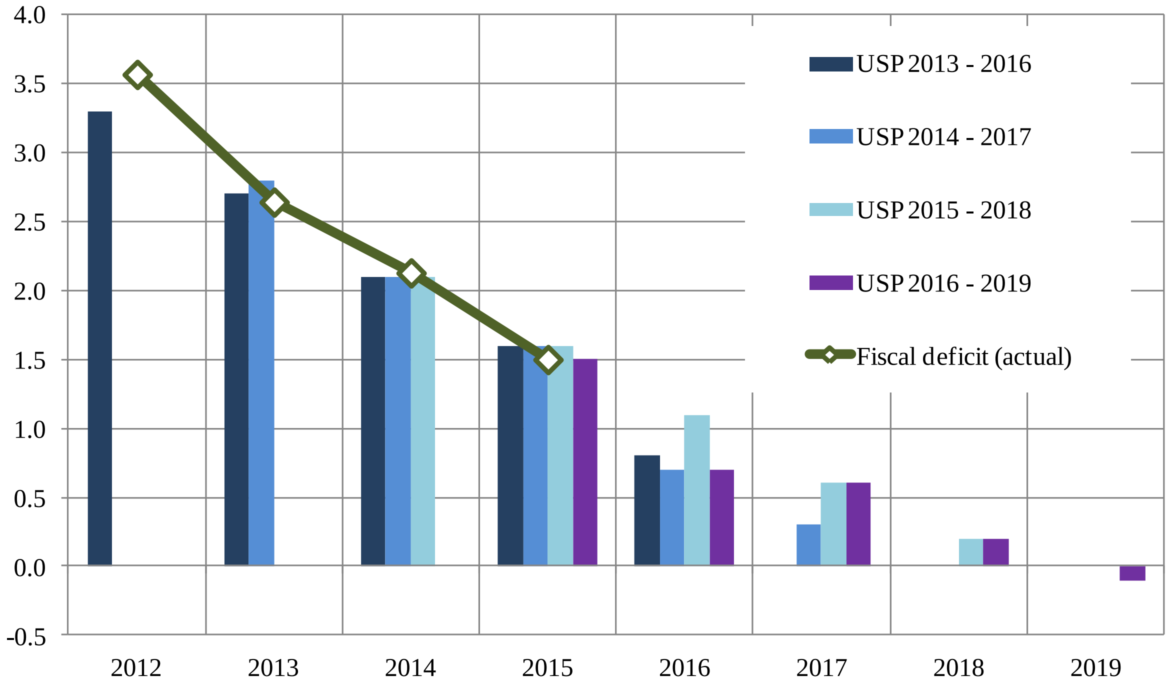
Source: Eurostat, MFIN

The official deficit targets for 2017 and 2018 were left unchanged when compared to last year's USP (see Chart 2). That for 2016 was however revised to indicate a more ambitious target. This follows the more favourable macroeconomic outlook when compared to those underpinning the previous years' USPs, and also in view of the country's obligations

[10] The factors contributing to the projected trajectory for the public debt are evaluated in Section 7 in this Report.
[11] In Europe, ESA methodologies are mandatory to ensure comparability of data across countries since statistics are compiled using standard guidelines.
[12] At the end of 1998 the debt-to-GDP ratio amounted to 51.2% and at the end of 1999 this ratio stood at 62.1%.

prescribed in the Stability and Growth Pact (SGP).[13] In the case of 2019, this was the first instant when this target has been formally announced. The small general government fiscal surplus being targeted is slightly more ambitious than the country's requirement to achieve its Medium Term Budgetary Objective (MTO) of a balanced budget, in structural terms by 2019.[14]

Chart 2: Fiscal deficit forecasts across vintages[15]



Source: Eurostat, MFIN

3. Assessment of the MFIN's methodologies used to prepare the fiscal projections

The preparation of the draft fiscal projections for the years 2016 to 2019 is carried out by the Budget Office (BO) in consultation with the Economic Policy Department (EPD) both within MFIN. Technical assistance is also provided by the NSO. The BO is the main liaison with the various ministries. Each government department prepares the initial revenue and expenditure projections on the basis of the specific expert knowledge and on the basis of the identified empirical patterns and regularities. The revenue and expenditure forecasts are prepared according to the classifications and methodologies adopted for the transactions which are recorded in the Consolidated Fund, and as published in the Financial Estimates.[16] Hence these forecasts differ from the ESA classifications and are essentially on a 'cash-basis', also

[13] Compliance with local and European fiscal rules will be assessed in a following report by the MFAC.
[14] According to the MFIN's calculations, the economy is expected to be operating slightly below potential in 2019, while one-off and temporary effects are projected to amount to 0.1% of GDP in that year.
[15] A negative figure indicates a fiscal surplus.
[16] According to the Financial Administration and Audit Act - "Financial estimates" means the estimates, presented to the House of Representatives in respect of any financial year, of the expenditure for the service of that financial year and includes any supplementary estimates of expenditure for which it may be necessary to provide after the estimates have been presented to the House of Representatives.

taking into account the expected receipts from debtors and the funds required for the payment of creditors.

The BO reviews the various departments' projections, particularly in the light of the requirements in terms of the intended target for the annual fiscal balance. In certain cases this entails a certain element of fine-tuning, to ensure that revenue and expenditure projections are on one hand attainable, but also address the annual consolidation efforts required. In practice, the BO revises certain revenue targets upwards in case where these are deemed to be insufficiently ambitious, while when the departments' estimates appear to be excessively ambitious, further discussions are held, and clarifications sought, in order to fine-tune such projections.

The various departments also prepare three-year business plans which are submitted annually around April. These contain an outline of their plans in terms of expected revenues, and recurrent and capital expenditures. They are subsequently negotiated with the MFIN to ensure that such plans are consistent with the targets specified in the USP particularly in terms of the resulting fiscal balance. However, the specific content of these business plans is normally only factored into the next DBP and the USP of the following year. Hence in practice the USP for 2016 – 2019 factors in the business plans submitted during 2015 and the latest identified trends. While the MFAC considers that an anticipated submission of such business plans would make it possible to embed more fully and in a timely manner such plans into the current year's USP, it understands that this might be difficult to implement in practice since some information might still be incomplete and the detailed assessment of the business plans tends to be a lengthy process.

Essentially, the budget process may be considered as a top-down approach supported by three-year business plans. A first set of estimates for the various ESA-based revenue and expenditure items are prepared by the EPD, on the basis of equations (identities) driven by the proxy tax or expenditure bases, quantified information about new measures, and empirically-based elasticities. The quantification of the measures is carried out either by the BO or EPD or else the specific departments concerned, depending on the nature of the measure. This is done in order to benefit from the use of granular data, where possible. In this respect the MFAC views favourably that the latest USP includes revised estimates for the effect of budgetary measures, based on actual data. The MFAC also notes that it is the intention of the MFIN to continue with this practice of re-estimating the effect of measures (both ex-post and ex-ante) when this is possible and feasible. This should ensure a more accurate analysis of the conduct of fiscal policy and its effects and better outline the consolidation efforts being undertaken.

With regard to the quantification of revenue measures, the MFIN maintained a generally static approach, whereby, any change in revenue is assumed to result from the change in taxation. Possible further revenue additions which are driven by the underlying change in the tax base (to which the tax measures relate) are generally not considered, thereby introducing an element of prudence in the revenue projections.[17] On the other hand, the spending on certain expenditure measures are sometimes capped in subsequent years, introducing an element of upside risks to the expenditure projections, particularly in the eventuality that costs increase because of inflationary pressures.

Since the classifications of the main revenue projections used by the BO's and the EPD differ, the former being primarily cash-based and include the transactions carried out through the Consolidated Fund and the latter being accrual-based and cover the activities of the general government, technical assistance is provided by the NSO in order for the EPD to map the ESA revenue data into the Consolidated Fund classifications. This is normally done by assuming the same type of patterns from the ESA data to the Consolidated Fund data, with allowance for expected fluctuations from normal patterns when these are known in advance. The MFAC notes positively that as from this round, the MFIN have also allocated resources to build up expertise in the compilation of fiscal data using ESA methodologies.

In the meantime BO produces its own preliminary cash estimates for revenues based on past trends and estimates carried out by the responsible departments. Discussions are subsequently held between the BO and the EPD in order to align the bottom-up and the top-down fiscal projections. Various rounds of discussions are held until a final revenue target is recommended for final endorsement by the MFIN which target is deemed to be consistent with macroeconomic projections and prudent when considered necessary. Once the revenue projections are finalised, including the estimated impact of discretionary revenue measures, the top-down approach establishes the spending ceiling consistent with the announced budgetary targets and the existing fiscal rules.

The methodologies used to prepare the projections contained in the latest USP remained largely similar to those used in previous years. Particular strengths of this process are the fact that micro-based knowledge and expertise about very specific features of the various tax and expenditure laws in Malta are embedded into the forecasts. This is ensured through the decentralised input by the various departments and the co-ordination and the horizontal assessment undertaken by the BO. On the other hand, the set of forecasts prepared by the EPD provide a useful envelope within which the plausibility of the BO's targets conditional on the macroeconomic forecasts can be judged. The MFAC's view is that this system appears to have worked well in terms of prudence of the projections particularly for the overall balance for general government.

The MFAC also considers positively the fact that in recent years there were increased efforts by the MFIN to ensure that the fiscal and macro projections are internally consistent. This is important since a number of expenditure items and one revenue item enter directly into the

[17] Increased revenue efficiency is not generally considered in the MFIN's fiscal forecasts unless backed by specific measures announced in the Budget. This adds a further element of prudence in the fiscal projections.

build-up of GDP as they make up government consumption.[18] The MFAC underscores the importance that as much as possible, working practices should be better aligned to the timelines envisaged by the European Semester. More specifically, while the MFAC notes that the formal deadline (30 April) for the submission of the USP to the Commission is being respected by the MFIN, the time allocated for the MFAC's assessment of the macroeconomic forecasts is being conditioned by the fact that these are being finalised very close to this deadline, in view of the fluidity of the fiscal projections (which serve as an important input for the preparation of such forecasts).

The MFAC also notes that since some fiscal revenues and expenditures were not fully outlined in the USP, their impact is not necessarily fully captured in the macroeconomic forecasts, though owing to their relatively small size, this is not thought to have created any material bias in the macroeconomic forecasts. As in previous years, the MFIN maintained their practice whereby certain revenues and/or expenditures are factored into the calculations for the projected fiscal balance but at a disaggregated level, any measures which remain unspecified are only allocated to the specific categories once the budgetary decision has been taken.[19]

The MFAC observes that the BO is concurrently responsible for the preparation of the Consolidated Fund projections, but must also ensure that revenue targets are met and overall expenditure ceilings respected (in terms of not exceeding the allocated funds, unless these are approved by the Permanent Secretary of the MFIN). Hence the final projections as agreed within the MFIN become targets, rather than the baseline forecasts, in the sense of representing the most likely outcome, based on the available information.

Overall, the MFAC considers that the current methodologies used by the MFIN to prepare the fiscal projections are acceptable, particularly when judged with respect to the past accuracy in projecting the fiscal balance. However, the systems used do not necessarily guarantee that the assumptions used are necessarily fully internally consistent.

The MFAC notes that the current projection methodologies may give rise to prudent revenue forecasts, which to some extent may be desirable, as a buffer against unexpected swings in macroeconomic conditions, which can easily occur in a small open economy subject to external shocks. However they may also possibly lead to overly ambitious expenditure restraint targets, which may thus underestimate the challenges to attaining the stated fiscal targets. The MFAC views positively that the USP document contains information about revenue elasticities underpinning the forecasts, but considers that transparency and estimates'

[18] Specifically, Government consumption consists of the following budget items: compensation of employees plus intermediate consumption plus social transfers in kind plus consumption of fixed capital less market output & output for own final use.

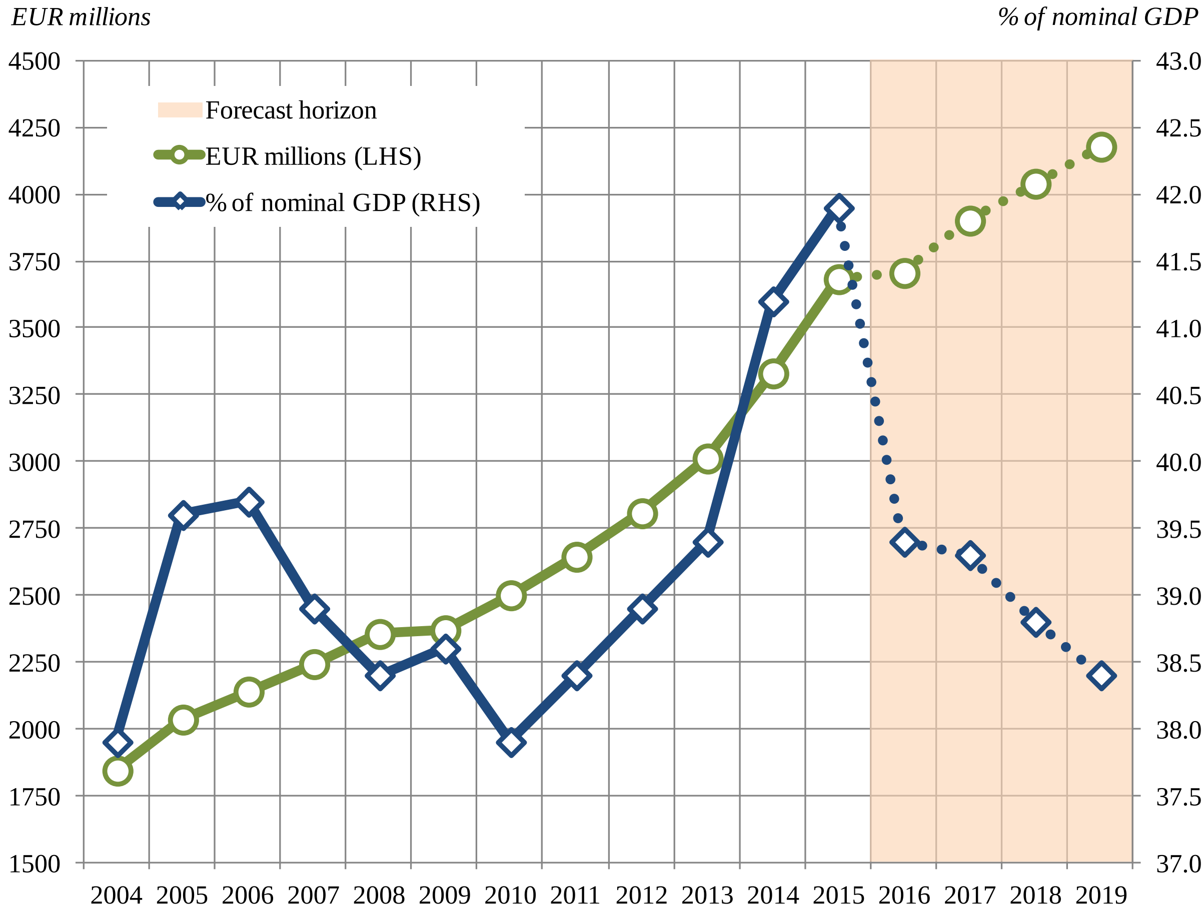
[19] This practice creates a permanent source of difference with respect to the fiscal projections prepared by other institutions such as the COM and the CBM, as these institutions only include measures which are fully specified in their forecasts.

robustness would be improved further if formal documentation outlining the way the fiscal projections are being carried out were to be published by the MFIN.

4. Assessment of the revenue projections for the period 2016 – 2019

According to the projections included in the USP, total revenue is expected to increase by close to €500 million, from around €3.7 billion in 2015 to almost €4.2 billion by 2019. These revenue projections extend the upward pattern observed over the past decade (see Chart 3).

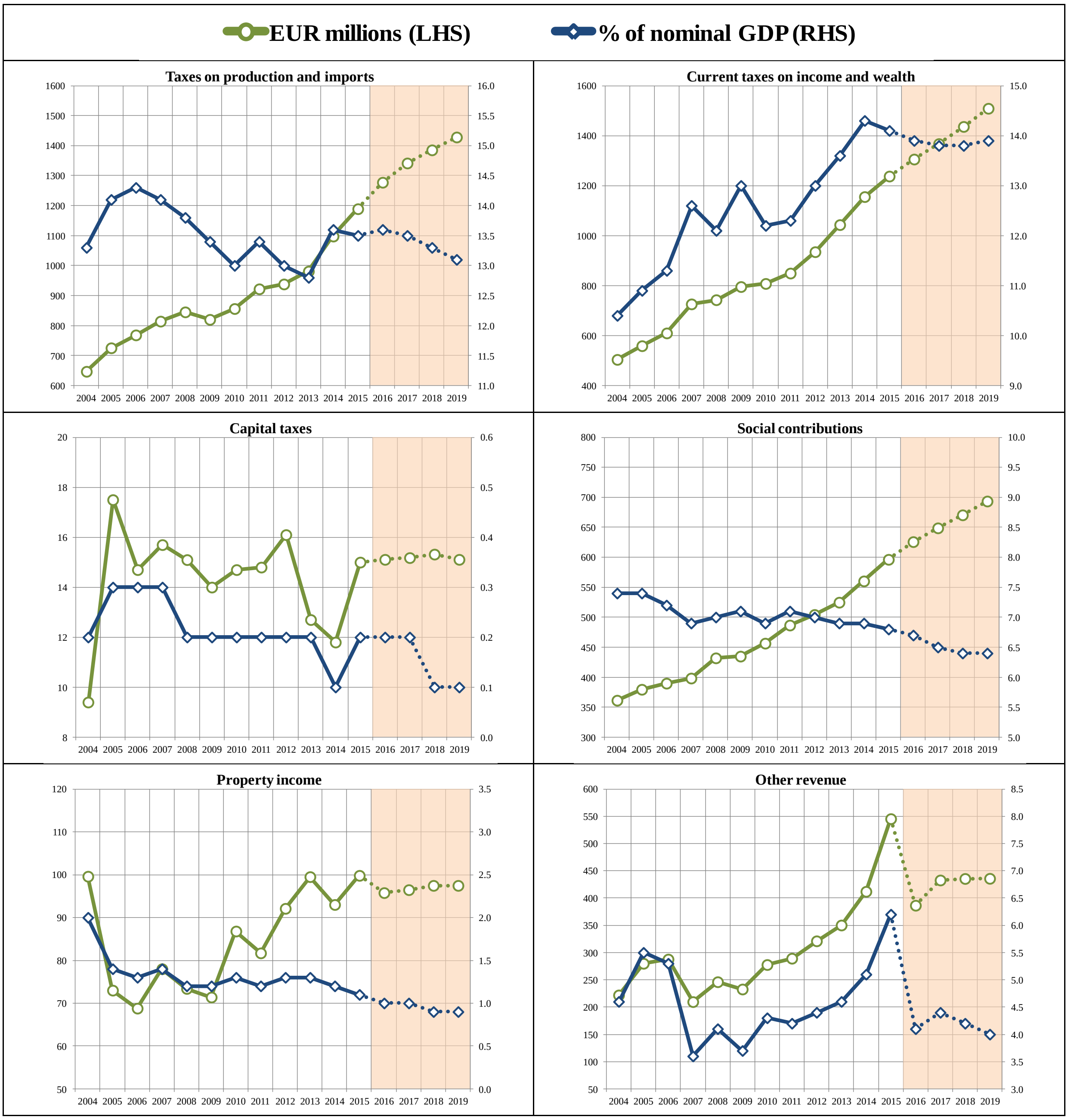
Chart 3: Total government revenue



Source: Eurostat, MFIN

However, the anticipated additional revenues vary across the years, with an increase of only €23.2 million being projected for 2016, followed by a €195.9 million rise in 2017. In both 2018 and 2019, total revenue is expected to increase less sharply, by €138 million. In terms of GDP, the revenue ratio is thus expected to slide back from 41.9% in 2015 to 38.4% in 2019, reversing the rise observed in previous years. The projected revenue growth is expected to be below nominal GDP growth throughout the forecast horizon, an indication of overall forecast conservativeness. In order to evaluate the plausibility of the trajectory envisaged for total revenue, each main component - based on the ESA breakdown utilised in the USP - is evaluated separately (see Chart 4). This permits a more robust analysis, since revenue components may be influenced by completely different factors.

Chart 4: Individual revenue components



Source: Eurostat, MFIN

The MFAC's analysis contained in this Report is based on the information available to the MFAC up to the cut-off date of 27 May 2016, which consists primarily of the detailed fiscal assumptions contained in the USP; figures for the Consolidated Fund for the first four months of 2016; existing tax and expenditure laws; implemented fiscal measures; information obtained from public sources; and supplementary information made available by the MFIN and NSO through internal discussions and communications. The MFAC does not prepare its independent revenue forecasts but relies on expert judgment, based on historical trends and known empirical regularities.

4.1. Taxes on production and imports (D.2)[20]

<u>Definition:</u> Compulsory, unrequited payments, in cash or in kind, which are levied by general government, or by the institutions of the European Union, in respect of the production and importation of goods and services, the employment of labour, the ownership or use of land, buildings or other assets used in production. Such taxes are payable irrespective of profits made.

In the case of Malta, this budget item is dominated by VAT (representing more than half of the total), with other important contributors being levies on petroleum; levies on cigarettes and tobacco; property taxes; gaming taxes; motor vehicle registration tax; duties on insurance products; taxes on spirits, alcohol and beverages; taxes on cement and the Eco-contribution.[21]

The projections by the MFIN indicate that throughout the period 2016 – 2019, taxes on production and imports are expected to grow at a decelerating pace, respectively by 7.4%, 5.0%, 3.3% and 3.1%. As a result, its share in GDP will rise marginally in 2016 but decline slightly thereafter, from 13.6% in 2016 to 13.1% in 2019.

In 2016, new measures are expected to boost the revenue intake from such source, primarily as a result of the revisions to excise duties on fuel, on cement as well as on cigarettes and tobacco, together with the introduction of a tourist environmental charge.[22] The overall impact is however partially dampened by the fact that the yield from the introduction of a new tax system to replace the Eco-contribution is expected to be lower.[23]

The USP reflects the latest quantitative effects of these measures. With regard to the new measures, there were some small upward revisions to the estimates (see Table 4). The earlier estimates for the various measures had been judged to be plausible in a previous report by the MFAC which dealt with the endorsement of the fiscal forecasts contained in the DBP for 2016.[24] These updated estimates are based on the latest micro information available to the MFIN.

[20] The ESA codes and summary descriptions of each variable are reproduced from the ESA 2010 manual.
[21] The list of revenue components is in descending order based on 2015 data.
[22] After 2017, the revenue intake from the tourist environmental charge is kept constant in absolute terms, reflecting the (conservative) assumption that the number of tourists remains constant and also to allow for the fact that there is a cap on the maximum tax payable per person.
[23] The Government is expecting to phase out completely the Eco-contribution by September 2016. However the current projections include some revenues from this source, in the form of arrears which are, included in the 2017 revenues.
[24] The report, 'An Assessment of the Fiscal Forecasts prepared by the Ministry for Finance and presented in the Draft Budgetary Plan 2016', is available on the MFAC's website.

Table 4: Revised estimates for fiscal measures (EUR millions)

	Budgetary impact	DBP 2016	USP 2016 - 2019	Difference
Revision in excise duty on fuel	Taxes on production and imports	7.0	7.5	0.5
Revision in excise duty on cigarettes and tobacco	Taxes on production and imports	5.8	7.3	1.5
Revision in excise duty on cement	Taxes on production and imports	1.5	2.5	1.0
Tourist environmental charge	Taxes on production and imports	6.3	4.4	-1.9
Eco-contribution	Taxes on production and imports	-5.8	-6.9	-1.1
Fee on Caging of bluefin tuna	Taxes on production and imports	0.0	1.1	1.1
VAT from the Revision in excise duty on fuel	Taxes on production and imports	1.3	1.4	0.1
VAT from the Revision in excise duty on cigarettes and	Taxes on production and imports	1.1	1.4	0.3
VAT from the Revision in excise duty on cement	Taxes on production and imports	0.3	0.5	0.2
Ex-Gratia Payment on Car Registration Tax	Taxes on production and imports	-4.3	-4.2	0.1
Hotel Energy Efficiency Scheme	Taxes on production and imports	-1.0	-0.8	0.2
Grant for Electric Vehicles	Taxes on production and imports	-0.1	-0.1	0.0
Additional Measures *		0.0	15.0	15.0
Restriction in recruitment growth	Compensation of employees	0.0	4.1	4.1
Lower expenditure towards intermediate consumption	Intermediate consumption	0.0	1.6	1.6
Lower expenditure in capital transfers	Capital transfers	0.0	8.8	8.8
A restriction in other current transfers	Other expenditure	0.0	0.5	0.5

* The ex-gratia payment on car registration tax, the hotel energy efficiency scheme and the grant for electric vehicles are part of the €15 million additional measures.

Source: MFIN

The major revision relates to the intake derived from the new environmental contribution by tourists. In this respect, the MFAC finds plausible the downward revision in the revenue expected from the new environmental charge on tourists, which has been lowered from €6.3 million to €4.4 million indicated in the USP, since this is consistent with the fact that the introduction of this tax, which was initially planned to be introduced in April, has been postponed by two months, and is scheduled to be effective as from June.

The Consolidated Fund data for the first four months of the year supports the projection for higher indirect tax revenues for 2016, since VAT advanced by 2.5% whereas customs and excise duties were up 19.1% year-on-year.[25]

The anticipated growth rates for taxes on production and imports for the period 2018 to 2019, for which there are no specific announced measures, are below the projected growth rates for household nominal consumption, but that for 2017 is slightly higher.[26] Overall, the implied elasticities adopted by the MFIN appear to be conservative, below unitary in the outer two years. This practice caters well for the fact that some of the taxes are levied on volume bases (such as for petroleum), and hence expected to move more in line with real consumption growth, which is still expected to grow at a sustained, albeit decelerating pace throughout the forecast horizon. At the same time, the projections adequately embody a certain element of prudence with respect to the dynamics for gaming and property related taxes, which may be more uncertain, although at the current juncture, both sectors face a positive outlook, and such scenario is embedded into the latest macroeconomic projections. The reason for the volatility in the implied yearly elasticity for this revenue item, stemming from the methodologies being used, as well as the assumptions adopted and expert judgement, could however be better explained in the USP.

Overall, the MFAC considers the projections for taxes on production and imports to be plausible, allowing for possible upside risks, on account of the rather prudent assumptions contributing to these projections.

4.2. Current taxes on income and wealth (D.5)

Definition: *Compulsory, unrequited payments levied periodically by general government on the income and wealth of institutional units.*

[25] In 2016 the pattern for the payment of VAT refunds to date was different than that recorded in 2015 during the same period, making the comparison between Consolidate Fund data and ESA data less direct.
[26] In the absence of sophisticated modelling techniques for various types of indirect taxes, the MFIN generally assume that consumption patterns remain unchanged throughout the forecast period such that no further changes in revenue attributable to the specific measures take place, particularly if the dynamic impacts are judged to be small.

In the case of Malta, this budget item is driven to a large extent by taxes on employment income, on interest income and on profits. Another relevant contributor to this revenue item is the annual car circulation tax.

The MFIN's projections indicate a stable growth rate throughout the forecast horizon, which is expected to hover around 5%, and contribute an average increase slightly below €70 million annually. This is in line with the nominal GDP growth rates projected for this period. Hence this revenue component is expected to maintain a stable share of GDP, after having fallen slightly in 2015. This follows an earlier period wherein its share had been increasing steadily.

The aggregate revenue from this source is practically equally split between individuals and companies. The dynamics from both sources may however be different, and hence, each element is analysed separately.

In the case of individuals, the revenue intake is expected to be partially dampened by the reduction in the effective tax rate paid by the lower income bracket households. The impact of this measure has been estimated by the MFIN to amount to €11.3 million. This estimate is based on detailed tax return data available to the Inland Revenue Department (IRD). The MFAC does not consider it to contribute materially to any downside risk to the projected turnout. Without this measure, revenue growth from taxes on income and wealth would have amounted to 6.4% in 2016. The MFAC is not aware of any material exceptional impact relating to current taxes on income and wealth in the 2015 figures which would need to be factored into the 2016 forecast. There are no known base effects which would warrant attention.

When considering that for 2016, growth in compensation per employee is projected at 2.8% and overall employment growth at 2.7%, as well as the fact that the legislative income tax elasticity for individuals is higher than one due to the inbuilt progressivity in the tax rates, the projected growth rate appears to be in line with the underlying macroeconomic trends.

Specifically for 2016, the Consolidated Fund data for the first four months of the year supports the projection for higher direct taxes, since revenues from income tax were up by 15% year-on-year.

Over the forecast horizon, the low interest rate environment, assumed in the USP, may impact negatively interest income and hence the Final Withholding Tax (FWT) component. The impact on public finances is, however, likely to be cushioned through the further build up of financial asset holdings. At the same time, the positive outlook for consumption suggests that the intake from the car circulation tax should maintain a positive upward momentum, also aided by the expected rise in the size of the population, because of net inward migration.

On the other hand, the intake from taxes on company profits may prove more volatile, and challenging to predict, particularly since in the case of Malta, a material contribution is made by companies which have limited links with the Maltese economy and whose performance is not dependent on local macroeconomic conditions.

In this respect, the MFAC considers good practice that the implied elasticities with respect to the corporate tax base (operating surplus in the national accounts) adopted by the MFIN, are kept at prudent levels, and below historical averages. Indeed, the implied elasticity is kept below unitary for the period 2016-2018, though rising slightly over the forecast horizon, to reach 1.1 in 2019, which is still significantly below the historical average.[27] While the MFAC does not find any evidence to challenge these assumptions, it finds merit in having more consistency as regards the assumptions for the implied elasticity during the forecast years, unless there are specific reasons to justify the changing sensitivity.[28]

Overall the MFAC considers the USP's forecast for current taxes on income and wealth to be plausible and consistent with the macroeconomic projections, allowing for the possibility of upside risks should taxes on company profits maintain patterns observed in recent years, also when considering that economic growth throughout the forecast horizon is generally stronger.

4.3. Capital taxes (D.91)

<u>Definition:</u> *Taxes levied at irregular and very infrequent intervals on the values of the assets or net worth owned by institutional units or on the values of assets transferred between institutional units as a result of legacies, gifts between persons, or other transfers.*

This budget item consists mainly of taxes imposed on certain property transfers. Historically the revenue intake from this source has been low and fluctuated along a narrow range, averaging around €14 million between 2004 and 2015. The projections assume that the same pattern will be repeated, with the projections practically constant at the 2015 level.

Owing to the fact that this revenue source accounts for only 0.4% of the total revenue throughout the forecast horizon, and in view of its observed historical stability, the MFAC does not identify particular upside or downside risks stemming from this revenue component.

[27] The changing elasticity is being driven by the methodology applied by the MFIN. In particular four-year averages are being used for the tax base and hence, the estimated yearly developments may be reflecting past trends rather than the current year's developments. The anticipated moderation in growth in operating surplus is leading to the slight increase in the implied annual elasticity for this revenue item.

[28] One instance how the elasticity might change from one period to the other is when the sectoral composition of operating surplus changes over time to shift in favour of sectors with a higher effective tax rate.

4.4. Social contributions (D.61)

<u>Definition:</u> *The actual or imputed contributions made by households to social insurance schemes to make provision for social benefits to be paid.*

This budget item captures the national insurance contributions paid by employees, their employers and the self-employed. Throughout the forecast horizon social contributions are expected to grow by 5.0%, 3.7%, 3.3% and 3.4% respectively. This compares with the forecast growth in total compensation of employees of around 5.6% in 2016, which is expected to decelerate smoothly to around 4.6% by 2019.

During the first four months of the year revenue from social security contributions, as recorded in the Consolidated Fund, were up by 12.8%, confirming the positive outlook for this revenue item.

Owing to the fact that social contributions are capped above a certain level of income, it is natural to expect the elasticity to be less than unitary. Indeed, the implied elasticities adopted by the MFIN, ranging between 0.7 and 0.8, are deemed to be realistic by the MFAC. The projected small decline in the social contributions to GDP ratio thus appears to be plausible and does not place any particular upside or downside risks to the revenue projections.

4.5. Property income (D.4)

<u>Definition:</u> *Accrues when the owners of financial assets and natural resources put them at the disposal of other institutional units. The income payable for the use of financial assets is called investment income, while that payable for the use of a natural resource is called rent. Property income is the sum of investment income and rent.*

Property income represents mainly the dividends received in particular from the CBM, and to a lesser extent the companies listed on the Malta Stock Exchange (MSE) and the Malta Financial Services Authority (MFSA), together with rent earned from government properties and interest earned on holdings of bonds and other loans.

This revenue item represented only 2.7% of total government revenue in 2015, and the projections are very much in line with observed patterns. Indeed, the USP shows that this revenue item is expected to decline marginally in 2016 and remain practically unchanged throughout the forecast horizon. As a result, its share in GDP is expected to decline slightly. The MFAC considers this estimate to be plausible. Although dividends from listed companies may be negatively affected by the low interest rate environment and more conservative distribution policies, this impact may be neutralised by the CBM's level of profits. Hence in this case the risks to the projected revenues from this source are considered by the MFAC to be balanced.

4.6. Other revenue

This budget item represents residual revenue components, mainly accounted for by market output and capital transfers. Market output consists primarily of revenues derived from permits and charges for the services offered by the public sector, and also of the revenues accruing from the Individual Investor Programme (IIP).

In 2016, the aggregate for other revenue is expected to decline by almost €159 million notwithstanding that market output is expected to yield an additional €25 million during the same year. The latter is entirely based on the assumption of higher revenues from the IIP compared to a year ago. However, in 2017 revenues from the market output are expected to scale back by around €43 million, reflecting the expected intake from the IIP. Owing to the special nature of this Programme, it is hard to project its success with certainty. In 2015, revenues from the IIP amounted to €50.2 million, below the original €75 million which was being targeted as the procedures appeared to take longer than originally anticipated. The USP assumes that the revenues from the IIP will amount to €80 million in 2016 and thereafter stabilise at €37.6 million annually for the period 2017 to 2019. Since the revenues collected through the IIP amounted to €16.4 million during the first four months of 2016, achieving the annual target may be challenging, thereby contributing to possible downside revenue risks, but attainable given that there are still a significant number of pending applications.[29]

Around 90% of the decline in the 'other revenue' category is attributable to the assumption of a lower absorption rate of EU funds, when compared to 2015. Indeed, the intake of EU funds during 2015 was exceptionally high (equivalent to 2.9% of GDP) as that year represented the final take up of funds before the expiry of the programmes pertaining to the EU's Multiannual Financial Framework (MFF) 2007 – 2013.[30] As is normal, the take up of funds at the start of a new EU's MFF period, covering 2014 to 2020, is expected to be low and accordingly is assumed to amount to only 1.2% of GDP. However, the intake of EU funds is projected to increase, to an average of 2.0% of GDP annually, between 2017 and 2019. Such a rapid pick up in the absorption of EU funds may prove challenging and allow for downside risk, but nevertheless feasible. In this case, although any shortfall would impact on the overall revenue projections, it would not have any adverse impact on the fiscal balance, as this revenue is matched by eligible expenditure, primarily on gross fixed capital formation.[31]

While noting the inherent uncertainty associated with forecasts for this revenue item, the MFAC is of the opinion that the MFIN's forecasts were prepared in line with acceptable practice. Uncertainty with regard to the forecast for this revenue component is however

[29] As of end April, 667 individuals had applied under the IIP since the launch of this Programme. Of these, 143 applications were approved while 84 applications were refused.
[30] For further details refer to http://ec.europa.eu/budget/biblio/documents/fin_fwk0713/fin_fwk0713_en.cfm#aii
[31] The impact on the fiscal balance could actually be positive because of savings on the co-financing element by the Government.

present in view of its historic volatility. In this case, downside risks could exist should the uptake of EU funds turn out less than targeted, though the impact on the budget balance would be largely neutral.

4.7. Total government revenue

The assessment for the individual revenue categories has identified possible upside risks specific to taxes on imports and products and current taxes on income and wealth, while possible downside risks relate to the revenue intake from the IIP and the absorption of EU funds included under the 'other revenue' category. As a result, the overall projection for total government revenue for the period 2016 – 2019 is on balance considered by the MFAC to be within its endorseable range.

5. Assessment of the expenditure projections for the period 2016 – 2019

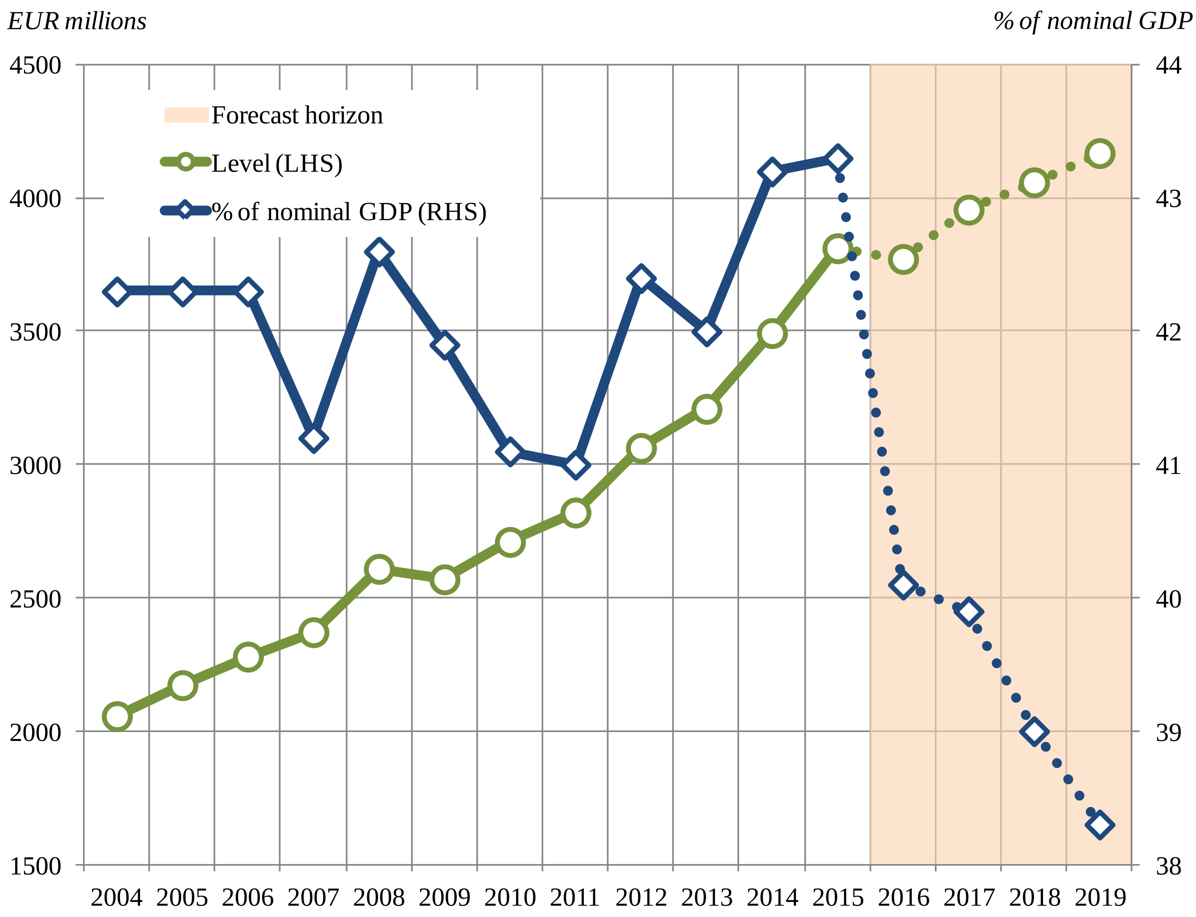
The evaluation of the projected trajectory for general government expenditure for the period 2016 – 2019 is carried out in a disaggregated manner, adopting the same approach used in the case of revenues. According to the projections included in the USP, total expenditure is expected to increase by €357.1 million, from around €3.8 billion in 2015 to slightly under €4.2 billion by 2019.[32] These projections indicate that total expenditure will decline in 2016, mainly due to lower assumed expenditure financed through EU funds, and thereafter grow at a slower pace than what was observed over the previous decade (see Chart 5).

Whereas between 2005 and 2015 average annual growth amounted to 5.8%, expenditure is projected to contract by 1.1% in 2016 and register growth rates of 4.9%, 2.6% and 2.7% respectively for the following three years.[33] These growth rates suggest an element of restraint across the main expenditure categories (see Chart 6). As a result, the expenditure-to-GDP ratio is projected to retrench significantly over the forecast horizon. This contrasts with the pattern observed during the four-year period 2011-2015, wherein the expenditure ratio had generally trended upwards, rising from 41.0% of GDP to 43.3% of GDP.

Should the expenditure projections materialise, the total government expenditure ratio would fall to 38.3% by 2019, significantly below what was observed over the past decade. This achievement is contingent on the scaling back of a number of expenditure components, when expressed as per cent of GDP, in view of expenditure restraint and the projected developments in nominal GDP.

[32] Refer to Table 2 included in Section 2 in this Report.
[33] During this period, negative expenditure growth was only recorded in 2009.

Chart 5: Total government expenditure



Source: Eurostat, MFIN

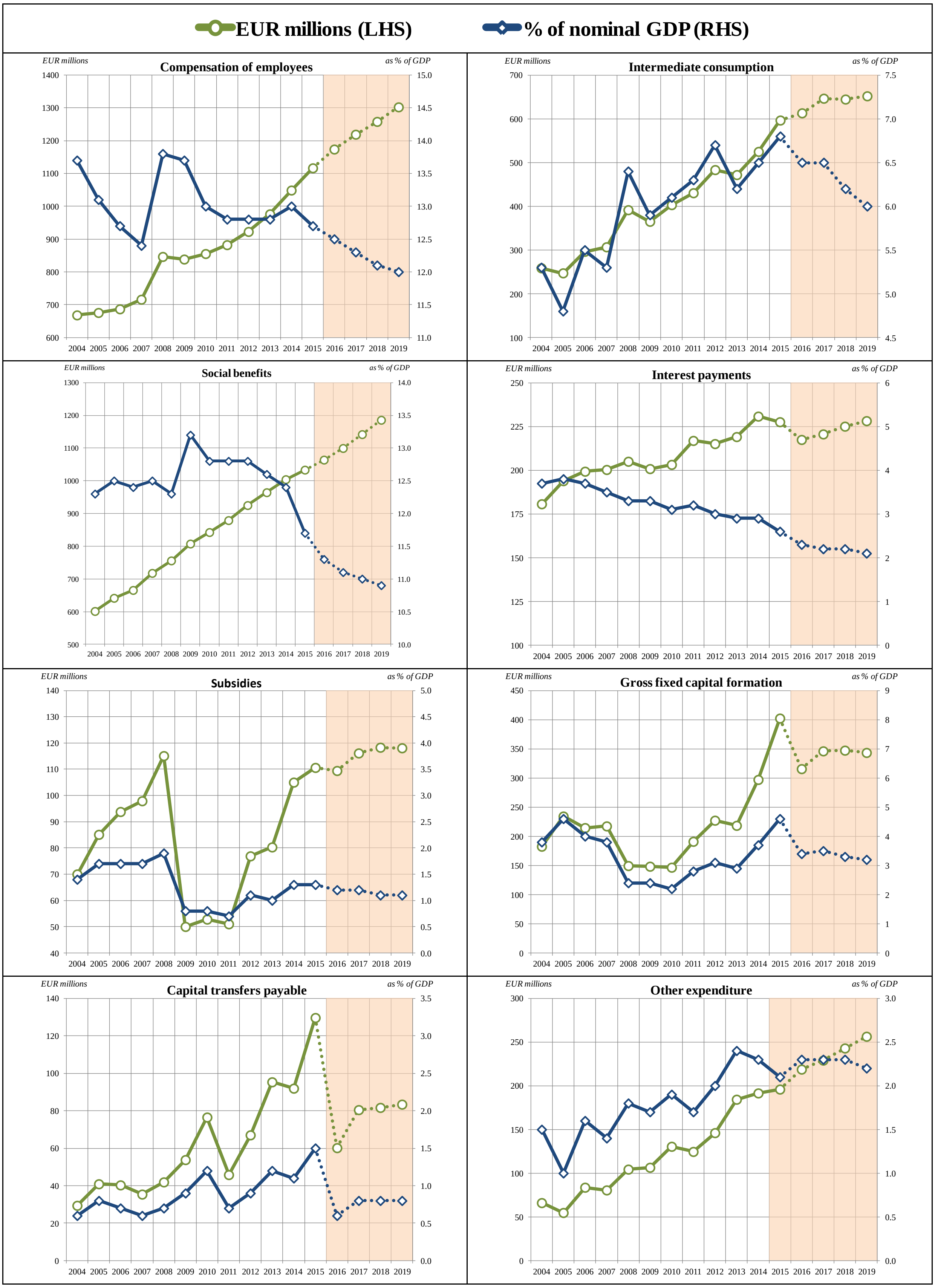
5.1. Compensation of employees (D.1)

Definition: The total remuneration, in cash or in kind, payable by an employer to an employee in return for work done by the latter during an accounting period.

This budget item consists of the wages and salaries of civil servants, and employees in local councils and government entities.[34] The main determinants for spending on compensation of employees are the number of public sector employees and their average wage. The latter depends on their level of seniority, bonuses, over-time pay and other allowances. Every year, a number of public sector employees retire and hence the dynamics in the overall employment level depends on whether the number of new recruits is higher or lower than those retiring.

[34] These include public sector entities, mainly Extra Budgetary Units (EBUs) that are funded fully or in large part by subventions from the Government and are therefore classified within the general government sector for ESA purposes.

<u>Chart 6: Individual expenditure components</u>



Source: Eurostat, MFIN

According to the projections contained in the USP, in 2016 this expenditure item will grow by some 5.1% or €57.2 million. In the subsequent 3 years, the growth rate is expected to be stable around 3.5% per annum, thereby adding an approximate €43 million annually to the Government's wage bill. The annual growth rate in compensation of employees is below that projected for nominal GDP, as a result of intended restraint on recruitment in the public sector. As a result, the share of this category is projected to contract consistently, from 12.7% of GDP in 2015 to 12.0% of GDP in 2019. This pattern protracts that in evidence in 2015, where the ratio declined slightly after having been roughly stable since 2010.

Specifically for 2016, the USP identifies a €4.1 million saving attributed to restrictions on employment growth, although the implicit stated public sector employment level for 2016, at 40,671 employees, is higher than the 39,839 in employment reported for 2015.[35]

When considering the implicit Government employment levels, the projected growth in the average compensation per employee in the public sector appears rather volatile. Whereas the general government average compensation per employee is expected to have increased by 5.3% in 2015 (which may be attributed to the changing composition of government employment, possible over-time payments, and wage increases based on the civil service collective agreement), over the forecast horizon, growth projections for the average compensation per employee are generally lower, at 3.0%, 4.3%, 1.9% and 4.5% respectively. The volatility in the average public sector wage rate projection contrasts with the rather stable projected inflation rate of around 1.8%.

The volatility in the forecasts for public employment may be another source of uncertainty conditioning the outlook for this expenditure item. Indeed, employment within general government is expected to rise by 832 on a net basis, in 2016, but decline by 160 in 2017, increase again in 2018, by 523 and fall by 364 in 2019. In particular, the projected decline in public sector employment in 2017 may be challenging given that in that year Malta would be assuming the EU's presidency.

To some extent, the uncertainty relating to the plausibility of the USP's estimates for the average yearly wage growth and the level of employment may be attributed to the fact that under the current framework, government departments primarily follow an expenditure cap driven by the yearly budget allocations, allowing for some flexibility in terms of their actual headcount.

The item 'personal emoluments' in the Consolidated Fund captures approximately two-thirds of the overall category. Between January and April 2016, this expenditure item has increased by approximately €3 million per month, compared to the same period in 2015,

[35] This element of inconsistency is attributed to the fact that under the current methodologies adopted by the MFIN, the projections focus on the overall spending on compensation for general government employees whereas the employment levels are only implicitly derived subsequently on the basis of a consistency exercise using as input average salary projections.

registering a 5.5% rise. The historical monthly pattern is quite stable, instilling a certain degree of confidence in the information content of this figure. As a result, the projected annual increase in compensation of employees for 2016 appears to be within reach.

The MFAC acknowledges that through a number of directives issued by the Office of the Prime Minister (OPM), the recruitment process by government departments is decentralised and recruitment by ministries can only be made as long as the wage bill is covered by the allocated funds.[36] However, there remains an element of upside risk to this expenditure forecast particularly since the civil service collective agreement expires in 2016.[37]

5.2. Intermediate consumption (P.2)

<u>Definition:</u> Goods and services consumed as inputs by a process of production, excluding fixed assets whose consumption is recorded as consumption of fixed capital. The goods and services are either transformed or used up by the production process.

Intermediate consumption consists of a vast array of expenditures incurred as part of the activities carried out by the Government. A significant proportion is associated with the health sector, and includes other special expenditures such as the initiative of free child care, the organisation of international summits and other similar initiatives, and payments in relation to the provision of public services (such as lighting, transport and water services). This item also captures the activities of the Environmental Landscapes Consortium Ltd and Engineering Resources Ltd, which have assumed some of the employees previously employed in the ship repair and energy sectors, following the restructuring which has been undertaken in these sectors.

Owing to the heterogeneity of the various components forming part of intermediate consumption, the fact that there are numerous elements, and the rather frequent occurrence of one-off and special factors, this item's trajectory has been very volatile historically. Given that this item's share in GDP is the third highest expenditure component, it can play a decisive role in the consolidation process.

According to the USP, the growth in this expenditure item is projected to be contained to below that in GDP, whereby its share will be scaled down from 6.8% of GDP in 2015 to 6.0% in 2019, reversing the generally upward trend of previous years. In absolute terms, this category is expected to rise by an annual average of €13.9 million during the forecast

[36] Directive Number 9 'Delegation of authority to conduct selection processes and make appointments in the Malta public service' and Directive Number 10 'The submission and approval of business and HR plans'.
[37] The historical tendency to underestimate growth in compensation of employees has been documented in a recent working paper published by the MFIN available on:
https://mfin.gov.mt/en/epd/Documents/Working_Papers/Working_Paper_Full.pdf

period, well below the €41.6 million average increase recorded in the preceding four years. The USP assumes a certain element of restraint resulting from improved efficiency in government operations following the implementation of proposals following the Comprehensive Spending Reviews (CSRs).

The non-repetition of a number of expenditure items, particularly the two summits which were held in Malta during 2015 explains part of the target growth slowdown. However, during the forecast horizon, Malta will be assuming the EU Presidency in 2017, while Valletta will be the European Capital of Culture in 2018. One-off events tend to recur on a yearly basis and hence it may not always be easy to scale back some expenditure items.

The MFAC acknowledges that the micro data available at the MFIN and the commitment towards the announced fiscal targets can justify some restraint. Indeed, owing to the special nature of intermediate consumption, in general, the Government may have more leeway to adjust this expenditure item, albeit, in either direction. Furthermore, some payments may be of a contractual nature and hence fixed for a certain period of time, allowing for stability over time.[38] However, upward pressures from health-related expenditures tend to persist, particularly because of ageing and demand for more and better services. At the same time, the eventual renegotiation of existing contracts may entail some upward financial adjustments, particularly in the eventuality that costs of production would have increased.

Overall there appears to be an element of upside risk to the projection for intermediate consumption, particularly since the stated targets may be conditional on the successful implementation of further reforms, particularly in the health sector and further on, in the education sector, by building upon the possible savings identified through the CSRs.[39]

5.3. Social benefits and social transfers in kind (D.62, D.632)

Definition: *Benefits payable in cash to households by social security funds and other benefits payable by employers in the context of other employment related social insurance schemes. In kind benefits refer to individual goods and services provided for free or at prices that are not economically significant to individual households by government units and Non-Profit Institutions Serving Households (NPISH), whether purchased on the market or produced as non-market output by government units or NPISHs. They are financed out of taxation, other government income or social security contributions, or out of donations and property income in the case of NPISHs.*

[38] For example, the cost of free child care amounted to €5.3 million in 2014 and €11.5 million in 2015. For the period 2016 – 2019, the annual cost has been estimated by the MFIN at €11 million, on the assumption that the amount of children will stabilise and the cost per child remains fixed.
[39] Further caution is warranted since the historical tendency to underestimate growth in intermediate consumption has also been documented in a working paper published by the MFIN available on: https://mfin.gov.mt/en/epd/Documents/Working_Papers/Working_Paper_Full.pdf

This budget item consists of the various welfare programmes, both contributory and non-contributory, such as pensions, children allowances, social assistance and stipends. The direct provision of pharmaceutical products accounts for the bulk of social transfers in kind, with another element consisting of the provision of free school transport.

This expenditure category peaked at 13.2% of GDP in 2009 but since then, this ratio has embarked on a downward trend, with the most pronounced fall being recorded in 2015 following a number of reforms. The projections assume that the same pattern of below GDP growth will persist throughout the forecast horizon, partly under the impact of the measures introduced following the CSR, and also the expected population size and resulting pension outlays. Consequently, the ratio is projected to fall below 11% of GDP by 2019. If such projections materialise, this ratio would be at its lowest over the past decade.

In terms of growth rates, social benefits are expected to grow in the region of 3-4% annually, which is in line with what was recorded in 2015 but lower than the average growth rate of 5.3% recorded between 2005 and 2014. The projections assume that the number of beneficiaries, both for contributory as well as non contributory benefits will decline in 2018 compared to 2017.[40] Specifically for 2018 this is influenced by the slowdown in the increase in the number of beneficiaries for retirement pensions owing to the fact that the retirement age will be increasing from 62 to 63 in that year. In 2019, the number of contributory beneficiaries is expected to increase whereas that for non-contributory beneficiaries will decline marginally.

Average per capita contributory benefits (which represent the bulk of social benefits) are recorded to have risen by 2.1% in 2015. In 2016, the average per capita contributory benefit is projected to rise by 1.8%, while for the following three years the annual growth rate is projected at 2.2%, 5.1% and 4.7% respectively. These estimates are influenced by the changing composition of the type of benefits as well as the expected annual Cost of Living Adjustment (COLA) throughout the forecast years, consistent with the gradual increase in inflationary pressures.

With regard to the restraint on spending on social transfers in kind, developments, particularly in relation to the direct provision of health related services, remain contingent on the successful implementation of the CSR findings.[41]

The overall assessment for this expenditure item is mainly conditioned by the possible upside risks should the assumed decline indicated in the USP not materialise, particularly since the projections assume that between 2015 and 2019 the number of beneficiaries for

[40] Additional data provided to the MFAC indicates that the patterns across the various categories diverge, with some maintaining an upward trend while others declining.
[41] For example, the forecasts for the costs of assistance to elderly follows a step-wise change, estimated as €9.5 million in 2016 and 2017, and €10 million in 2018 and 2019.

invalidity pensions and 'other benefits' (within the contributory benefits category), and for medical assistance (within the non-contributory benefits category) will decline.

5.4. Interest expenditure (D.41)

Definition: Property income receivable by the owners of a financial asset for putting it at the disposal of another institutional unit.

This budget item consists of the interest payments made on public debt. The projected trajectory for the interest payments to GDP ratio is expected to prolong its downward trend from the peak of 3.8% in 2005 and expected to fall to 2.1% by 2019. The projections for interest payments are contingent on the anticipated outstanding level of public debt and the effective interest rate paid on public debt. In the first case, the debt projections are consistent with the gradually narrowing fiscal deficit, but also factor in the upward impact as a result of stock flow adjustments.

When considering that the weighted average coupon rates on the Malta Government Stock (MGS) which will be maturing between 2016 and 2019 stands at 4.7%, and the latest issue of MGS, in April 2016, had coupon rates of 1.5% (for the shorter maturity) and 2.5% (for the longer maturity), the assumption of a constant effective interest rate on public debt of 3.8% throughout 2017 – 2019 appears to be rather conservative. This is particular so when judged against the constant long term interest rate of 1.8% assumed in the USP. Indeed, throughout the period 2016 - 2019, just under €1.4 billion worth of MGS will be maturing and hence roll over savings should be achieved, thereby lowering further the average effective interest rate on public debt.

Hence there is the possibility that higher savings in debt servicing costs could be achieved as a result of the low interest rate scenario. On the other hand, any slippage from the announced fiscal balance targets would exert upward pressure on interest payments. Should the assumed positive stock flow adjustments be less than projected, the opposite would be true. Overall, the MFAC considers that the projections for interest payments are plausible, noting possible downside risks, in the eventuality that the weighted average interest rate on public debt is less than what is being assumed.

5.5. Subsidies (D.3)

Definition: Current unrequited payments which general government or the institutions of the European Union make to resident producers.

This budget item consists mainly of the subsidies paid to the transport, energy and agricultural sectors. In 2016 this item is expected to remain practically constant compared to the previous year and increase by some €7 million in 2017, before stabilising at this level for the following two years. As a result, the ratio of subsidies to GDP is expected to decline slightly to 1.1% by 2019. Some of these subsidies represent contractual agreements, in the form of public service obligations (PSOs), and hence they can be projected with a degree of certainty by the MFIN. Upward risks would however exist when such agreements expire and are renegotiated or else if new subsidy initiatives are undertaken, although the latter possibility is constrained by the requirements to be in conformity with the EU's State Aid Rules.

On balance, the MFAC considers the forecasts for subsidies to be plausible, on the basis of available information.

5.6. Gross fixed capital formation (P.51)

Definition: Resident producers' acquisitions, less disposals, of fixed assets during a given period plus certain additions to the value of non-produced assets realised by the productive activity of producer or institutional units. Fixed assets are produced assets used in production for more than one year.

This budget item consists of the capital expenditure undertaken by the various ministries and the extra-budgetary units (EBUs). In 2015, gross fixed capital formation spiked to just over €402.3 million, the highest level in absolute terms, as a result of strong investment, largely financed through EU funds. According to the projections, in 2016 investment spending is expected to drop by 21.6% but still remain higher in absolute terms when compared to 2014. It is expected to rise again in 2017, by 9.7%, and stabilise at just under €350 million throughout the outer forecast years. Consequently, the public investment ratio to GDP is expected to partly reverse the previous uptrend, dropping from 4.6% in 2015 to 3.2% by 2019.

The anticipated trajectory for gross fixed capital formation is rather elevated in absolute terms compared to the past decade. This assumes that the absorption of funds out of the EU's Multiannual Financial Framework 2014 – 2020, follows a more even path compared to what was the case for the previous seven-year EU's Financial Framework. The Government's track record in securing the take up of EU funds in 2015, suggests that high take up of EU funds is indeed attainable.

Some of the projects underpinning gross fixed capital formation can be traced to ongoing projects related to road infrastructure, health, education and the environment, which supports the general plausibility of the projections reported in the USP. At the same time, since such estimates are matched by the assumed absorption of EU funds, the risks to the fiscal balance generated from this expenditure item are limited. There remains the possibility that the actual progress in such projects is slower than planned throughout the forecast horizon.

Overall risks to this budget item are considered by the MFAC to be balanced. However, the MFAC notes that by its nature, gross fixed capital formation may be harder to project, owing to its inherent volatility and the fact that it largely reflects discretionary expenditure.

5.7. Capital transfers payable (D.9)

Definition: capital transfers require the acquisition or disposal of an asset, or assets, by at least one of the parties to the transaction. Whether made in cash or in kind, they result in a commensurate change in the financial, or non-financial, assets shown in the balance sheets of one or both parties to the transaction.

This budget item consists mainly of transfers to a number of public sector entities to cover their capital expenditure. These include Wasteserv, Foundation for Tomorrow Schools (FTS), Malta Enetrprise, Malta College for Arts Science and Technology (MCAST), Malta Council for Science and Technology (MCST) and the University of Malta (UoM). Part of this expenditure is also matched by EU funds.

In 2015, the item had peaked at €129.6 million under the impact of the last equity injection in the national airline (around €40 million) as part of the restructuring process. In 2016, capital transfers are expected to decline sharply, by €69.4 million, mainly due to the non-repetition of this extraordinary outlay, which will be reinforced by further cuts in capital transfers of some €30 million. In 2017, this category is forecasted to rise to just over €80 million and then level off. As a result, the share in GDP of this item is expected to contract from 1.5% in 2015 to 0.6% in 2016 before stabilising at around 0.8% throughout 2017 – 2019. These developments are generally in line with the assumptions for the intake of EU funds which support some of this expenditure. The MFAC takes note that for 2016 the USP indicates that €8.4 million less will be spent when compared to what was stated in the DBP, without however specifying which institutions could be impacted.

The MFAC acknowledges the inherent challenges in projecting with certainty this item, given that this expenditure component is rather discretionary. When considering that the underlying projected outlays are higher than in previous years (after excluding the one-off transaction related to the national airline), a pattern which one would expect as a result of the generally higher prices, the MFAC does not identify any specific upside or downside risks related to this expenditure item.

5.8. Other expenditure

This budget item represents residual expenditure components, mainly accounted for by current transfers to the numerous government entities to fund their operations. In statistical terms, sale of government land is treated as a negative value among these components.

In absolute terms, ‘other expenditure’ is expected to maintain an upward path similar to that observed in recent years. Owing to the heterogeneity of its components, it has exhibited volatile patterns, with a generally upward trend up to 2013 followed by two consecutive declines in 2014 and 2015. Specifically for 2015, this was influenced by lower current transfers and higher revenues from sale of land. Throughout 2016 – 2019, its ratio is expected to remain relatively stable at just above its 2015 level, in line with the Government’s aim to restrain expenditure growth to or below nominal GDP growth.

Owing to the heterogeneity of this expenditure item, it is hard to project at an aggregate level. The MFAC notes positively that the assumption of a roughly stable ratio ensures that the envisaged restraint should be reasonably attained.

5.9. Total government expenditure

The assessment for the individual expenditure categories has identified possible upside risks which are specific to spending on compensation of employees and intermediate consumption while downside risks may exist in the case of interest payments. On this basis, the overall projection for total government expenditure for the period 2016 – 2019 is considered by the MFAC to be within its endorseable range.

6. An assessment of the trajectory for the fiscal balance for the period 2016 - 2019

As indicated in the previous two sections, both the projections for total revenue and for total expenditure are deemed to be within the endorseable range of the MFAC, although in both instances generally there appears to be some upside risk. However, such risks tend to offset each other, in terms of their possible impact on the fiscal balance. Both overall revenue and expenditure would be impacted in case the actual absorption of EU funds is different than that envisaged in the USP.

In 2015, both revenues and expenditure overshot the initial projections, but resulted in a general government fiscal balance which was marginally below the target. Indeed, judging by the MFIN’s past track record in meeting the general government fiscal balance targets, there appears to be sufficient responsiveness in the Government’s budget to address along the year the realisation of forecast errors or make up for unexpected outlays or shortfalls. This process is also facilitated through the existence of a Contingency Fund equivalent to 0.1% of GDP.[42]

On this basis, the MFAC considers that the projected fiscal balance for the years 2016 to 2019 is within its endorseable range. However, it must be noted that according to the NSO’s

[42] In 2015 the MFIN made recourse to the Contingency Fund.

Excessive Deficit Procedure (EDP) notification, the estimated turnout for the fiscal balance in 2015 included a significant accrual adjustment to allow for the fact that EU funds utilised towards the end of 2015 would be reimbursed in 2016. Should any such reimbursements not take place because of non-compliance with EU regulations, this would place an upside risk to the fiscal balance for 2015.

The USP includes an analysis of possible positive and negative shocks to the baseline macroeconomic forecasts, whose impact on real GDP is summarised in a fan chart. The consequent impact on the fiscal balance is then shown in another fan chart. Under the worst case considered, the fiscal deficit would amount to around 1.5% of GDP in 2019 and under more optimistic assumptions the fiscal surplus would be attained as early as 2018. However, the USP does not specify the exact impact on each revenue and expenditure item, resulting from each specific shock. Hence the MFAC is not in a position to comment on the plausibility of the MFIN's fiscal fan chart calculations.

7. An assessment of the trajectory for the public debt for the period 2016 - 2019

The outstanding level of public debt and its trajectory is impacted by the following factors: the yearly fiscal primary balance, interest payments, and stock flow adjustments.[43, 44] In turn, the debt ratio (public debt expressed as a percentage of GDP), is further influenced by real GDP growth and inflation.[45] Chart 7 shows the cumulated effects of these various factors throughout the forecast horizon.[46]

According to the USP, the debt ratio is projected to decline steadily from 63.9% of GDP in 2015 to 55.5% of GDP by 2019. Consecutive primary surpluses are almost sufficient to offset the upward push as a result of interest payments. Moreover, the positive impact exerted by the expansion of the nominal GDP denominator, as a result of real GDP growth and inflation, is expected to amply compensate for the upward impact of stock flow adjustments.

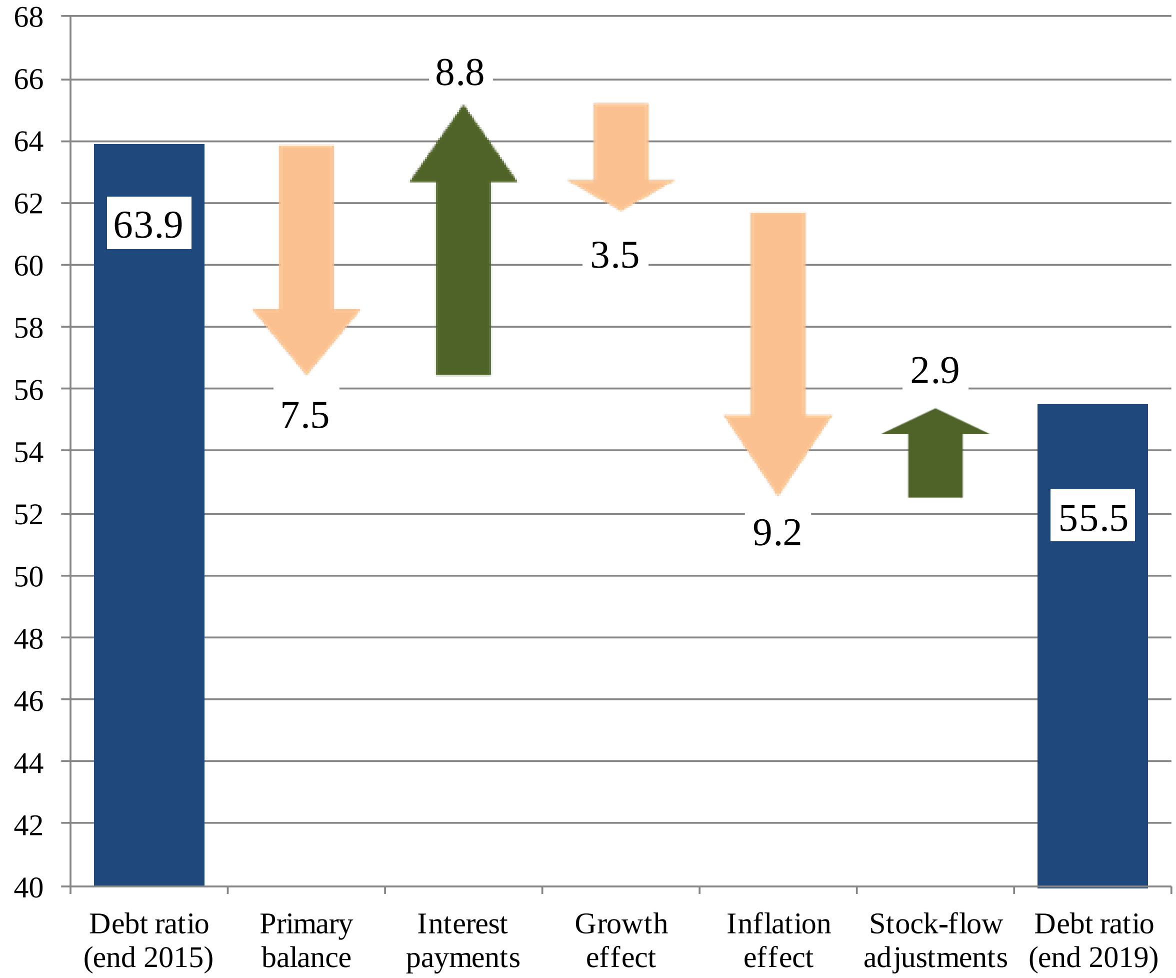
As indicated in previous sections of this assessment, the series of primary surpluses and the expenditure on interest payments are considered to be plausible. Likewise, the real GDP growth effect and the inflation effect are plausible since these are the direct arithmetic result

[43] The primary balance nets out interest payments from the General Government balance.
[44] Stock flow adjustments result from transactions which impact the level of debt but do not impact the fiscal balance or vice versa. This may happen due to, for instance, differences in timing of recording certain transactions, the acquisition or disposal of shares, the issue of loans by the government or repayment thereof, contributions to special below-the-line funds such as the National Development and Social Fund and the Special Malta Government Stock Sinking Fund.
[45] The combined effect resulting from the impact of interest expenditure, real GDP growth and inflation is referred to as the 'snowball effect'.
[46] For a technical exposition on debt dynamics, please refer to Box 2 contained in the MFAC's report "An Overall Assessment of the Draft Budgetary Plan 2016", available on the MFAC's website.

of the macroeconomic projections which have already been endorsed by the MFAC in an earlier report.[47]

When focusing on the absolute changes in the projected level of debt, one notices significant departures from the yearly requirements to finance the fiscal deficit (see Chart 8). This indicates a significant role assumed by stock flow adjustments which over the forecast horizon are expected to amount to 2.9 pp on a net basis over the forecast horizon. Indeed, in absolute terms changes in the public debt are expected to exceed the financing of the yearly deficit by a material amount, particularly in 2016 and to a lesser extent in 2017. In this context, the MFAC welcomes the additional details provided in the USP regarding the disaggregated compounds of the stock flow adjustment for the period 2015 – 2019.

<u>Chart 7: Accumulated factors contributing to the projected debt ratio dynamics (per cent of GDP, percentage points)</u>[48]

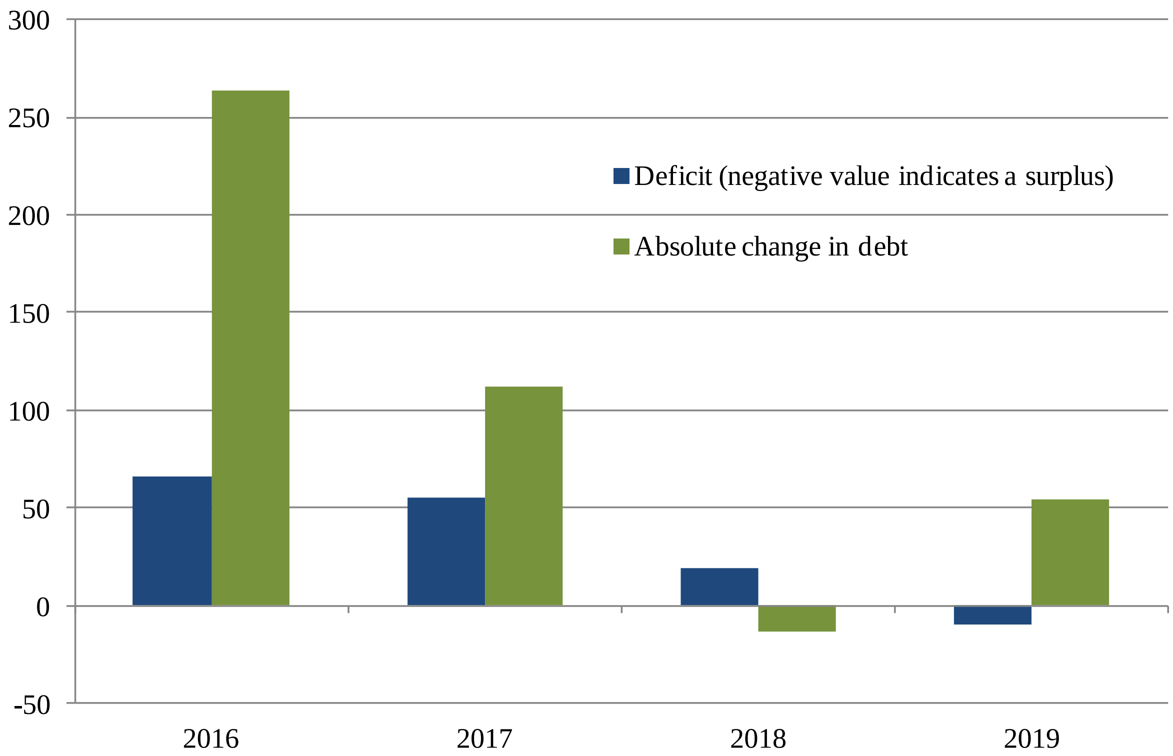


Source: MFIN

[47] The report 'An assessment of the macroeconomic forecasts for the Maltese economy prepared by the Ministry for Finance in April 2016' is available on the website of the MFAC.
[48] The size of the arrows indicates the actual magnitude in percentage points. The direction of the arrows indicates whether the factor is pushing the debt ratio higher or lower.

When considering the before-mentioned significant accrual adjustment in relation to EU funds, in cash terms, the substantial EU funds expected to be received during 2016 would result in lower financing needs for the Government during 2016. On the other hand, since 70% of the revenues emanating from the IIP are not featuring in the Consolidated Fund, despite being treated as normal revenues for ESA purposes, such funds are not being used to lower the debt issuance needs for the year. The assumption embedded in the USP is that such funds are kept as financial assets rather than used to lower the public debt.

Chart 8: Fiscal deficit and changes in public debt (EUR million)



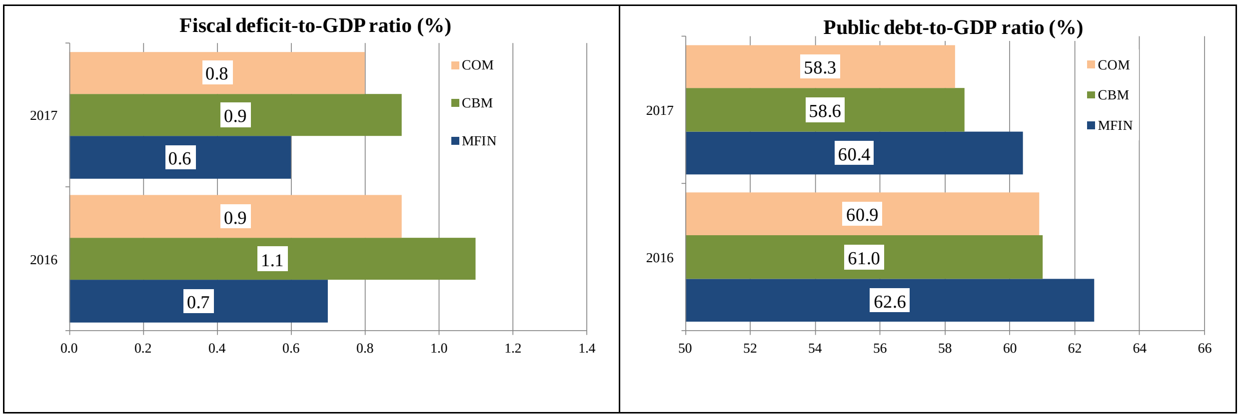
Source: MFIN

Overall, the MFAC considers the debt projections contained in the USP to be rather conservative, with scope for downside risks, should the stock flow adjustments be less than envisaged in the USP.

8. Comparison with other forecasts for the fiscal balance and public debt

The plausibility of the MFIN's projections contained in the latest USP can also be evaluated by comparing them to the forecasts which are prepared by other institutions, namely the CBM and the COM. In its latest Annual Report (AR), the CBM is projecting the deficit to narrow to 1.1% in 2016 and 0.9% in 2017 respectively 0.4 pp and 0.3 pp higher than the MFIN's forecasts (see Chart 9). The MFAC notes that the forecasts by the CBM are within a close range to those prepared by the MFIN. However, since the CBM does not publish the forecasts for the underlying revenue and expenditure components, no further comparisons can be made in this case. On the other hand, the set of forecasts published by the COM is very detailed, thus allowing for a fuller analysis.

Chart 9: Fiscal forecasts by different institutions



Source: CBM, COM, MFIN

In terms of the key fiscal ratios, the COM's spring projections present a rather similar pattern as that indicated in the USP. Indeed, according to the COM's projections, both the fiscal deficit and the public debt ratios are expected to decline further in 2016 and 2017. However, the COM's deficit projections indicate a slightly lower pace of consolidation, placing the deficit 0.2 pp higher than indicated in the USP, both for 2016 and for 2017, equivalent to a difference of €20.3 million and €27.2 million respectively (see Table 5). It is however worth noting that in line with its normal practices, the COM does not take into account measures which are not fully specified, when preparing its forecasts. On the other hand, the COM's debt projections for 2016 and 2017 are more positive, with this ratio standing at 1.7 pp and 2.1 pp below that envisaged in the USP.

For 2016, the MFIN's overall forecast for total revenue is just below that produced by the COM, with a slightly larger gap for 2017. However, in terms of the drivers, the outlook diverges to some extent. In particular the MFIN's projected revenues from current taxes on income and wealth are below that envisaged by the COM. Particularly for the outer forecast year, the gap between the MFIN's and the COM's estimates amounts to €20.6 million. The MFIN's projections for taxes on productions and imports are also below those projected by the COM both for 2016 and 2017, though in this case the gap between the two sets of forecasts is smaller in absolute terms. In both cases, the fact that the COM's forecast revenues from these two sources are higher corroborates the MFAC's view that such estimates could be rather conservative, leaving the possibility for beneficial upside risks.

In the case of social contributions, the two sets of projections are rather close, with the MFIN's slightly higher than the COM's for 2016 but slightly lower for 2017. The overall projected increases by the MFIN are however again more conservative, albeit slightly, when compared to the COM's estimates.

With regard to the other two revenue items 'capital transfers receivable' and 'other revenue', the overall intake over the two-year period targeted by the MFIN from these two sources is above that anticipated by the COM. While both the MFIN and the COM expect capital transfers receivable to scale back, compared to the 2015 level, mainly as a result of lower absorption of EU funds, the MFIN is projecting larger swings, characterised by a greater fall during 2016 and a bigger acceleration in 2017, with a higher estimate overall. This discrepancy is in the main driven by the assumed yearly profile for the absorption of EU funds. The MFIN also expects the 'other revenue' category for 2016 and 2017 to be more elevated when compared to the projections by the COM. The difference is probably the result of more optimistic assumptions used by the MFIN with regard to the expected intake from the IIP.

Table 5: Breakdown of fiscal projections

	2015	2016	2017	2016	2017	2016	2017
	Actual	MFIN USP April 2016		COM Spring 2016		Difference USP - COM	
	% of GDP					percentage points	
General Government balance	**-1.5**	**-0.7**	**-0.6**	**-0.9**	**-0.8**	**0.2**	**0.2**
General Government debt	**63.9**	**62.6**	**60.4**	**60.9**	**58.3**	**1.7**	**2.1**
	EUR Millions						
Taxes on production and imports	1,189.1	1,277.4	1,341.6	1,279.0	1,353.0	-1.6	-11.4
Current taxes on income and wealth	1,237.6	1,305.6	1,367.4	1,315.0	1,388.0	-9.4	-20.6
Social contributions	596.3	625.8	648.8	623.0	654.0	2.8	-5.2
Capital transfers receivable	300.6	100.2	196.2	109.0	178.0	-8.8	18.2
Other revenue*	359.5	397.2	348.2	384.0	340.0	13.2	8.2
Total Revenue	**3,683.1**	**3,706.3**	**3,902.2**	**3,710.0**	**3,913.0**	**-3.7**	**-10.8**
Compensation of employees	1,116.4	1,173.6	1,218.8	1,189.0	1,260.0	-15.4	-41.2
Intermediate consumption	596.5	613.0	646.4	638.0	680.0	-25.0	-33.6
Social payments in cash and in kind	1,033.2	1,063.9	1,099.4	1,070.0	1,106.0	-6.1	-6.6
Interest expenditure	227.6	217.5	220.6	223.0	225.0	-5.5	-4.4
Subsidies	110.6	109.4	116.1	113.0	116.0	-3.6	0.1
Gross fixed capital formation	402.3	315.6	346.1	270.0	297.0	45.6	49.1
Other expenditure*	325.5	278.9	309.5	293.0	311.0	-14.1	-1.5
Total Expenditure	**3,812.1**	**3,771.9**	**3,957.0**	**3,796.0**	**3,995.0**	**-24.1**	**-38.0**
General Government balance	**-129.0**	**-65.7**	**-54.8**	**-86.0**	**-82.0**	**20.3**	**27.2**

*The values for other revenues and other expenditures do not correspond to the same values described in the other sections in this Report since they include revenue and expenditure items which are not separately identified in the COM's projections.
Source*: MFIN, COM*

On the other hand, the COM's expenditure projections highlight the extent to which the MFIN's targets could be challenging. Indeed the COM's projections for the government current expenditure items are all higher than those by the MFIN, apart from outlays on subsidies, where the two sets of forecasts nearly match. The gap is amplified further for 2017, with significantly higher current expenditures being projected by the COM. Specifically the COM expects compensation of employees to be €15.4 million higher in 2016 and €41.2 million higher in 2017. The COM also expects intermediate consumption to be €25.0 million and €33.6 million higher, respectively, in 2016 and 2017. In this case the COM's projections mirror the MFAC's views that upside risks could exist to the attainment of the stated targets for these two categories.

In contrast, in the case of gross fixed capital formation, the projection by the MFIN is higher than that by the COM, respectively by €45.6 million and €49.1 million in 2016 and 2017. This mirrors the Government's intention to maintain a rather buoyant investment activity, financed through the take-up of EU funds and from national funds for the co-financing element.

When comparing the two sets of forecasts, it appears that the COM's projections factor in a more positive outlook with respect to the tax revenue performance, consistent with the positive macroeconomic outlook. This effect is, however, more than offset by the COM's more cautious approach with respect to the expenditure projections. It is, however, worth noting that the MFIN's projections embed an equivalent of €15 million in expenditure restraint which were announced in the USP, but which could not be factored into the COM's spring forecasts.[49] Likewise, the USP indicates an equivalent of €29 million in consolidation measures for 2017, which are not factored into the COM's forecasts since no further details were presented.[50]

The mismatch in the outlook by the MFIN and the COM with regard to expenditure on gross fixed capital formation, and the associated uptake of EU funds, has generally a limited effect on the overall projections for the fiscal balance, as this is limited to the Government's co-financing element.[51]

Notwithstanding that the MFIN projects a lower fiscal deficit when compared to the COM, the latter institution projects a slightly lower level of outstanding debt over the forecast horizon, at 60.9% of GDP in 2016 and 58.3% in 2017. This is attributable to the fact that whereas the MFIN is assuming an element of positive stock-flow adjustments throughout 2016 and 2017, equivalent cumulatively to 2.7% of GDP, the COM is assuming that no such transactions take place. Similar to the COM, the CBM's forecasts place the debt ratio lower than indicated in the USP, at 61.0% of GDP and 58.6% of GDP, respectively for 2016 and 2017.

[49] The cut-off date for the COM's spring forecasts was 22 April 2016 while the USP was published on 29 April 2016.
[50] The USP states that these consolidation measures are still to be specified in the respective budget, including the decision whether to resort to revenue and or expenditure or a mix of both.
[51] In 2015, the co-financing element was temporarily rather high, estimated at 0.4% of GDP, since this represented the last year for the take up of EU funds for the expiring Programme.

9. Conclusion

The MFAC acknowledges that the process used by the MFIN to prepare the fiscal projections is rigorous and has a good track record with regard to the accuracy of the forecasts for the fiscal balance. The increased transparency in terms of greater availability of information is also viewed positively.

The MFAC considers the MFIN's revenue projections to be plausible and prudent, leaving the possibility for upside risks. This view is contingent on the materialisation of the rather buoyant macroeconomic outlook which has been endorsed by the MFAC in its previous report. Should the macroeconomic performance be less positive than underpinning the USP calculations, or else, be driven by completely different contributors (which may be relatively more or less tax rich), the fiscal turnout could naturally be impacted, since most revenues are endogenous.

On the other hand, the expenditure targets may be rather ambitious, leaving the possibility for upside risks. However, the MFAC acknowledges that there is a material share of expenditure which is discretionary, and hence directly under the control of Government, which can thus be adjusted to make it consistent with the attainment of the fiscal targets, in the eventuality that expenditure overruns in certain areas occur. The customary practice of allowing for veering of expenditures across votes, or slowing down expenditure commitments over the years, tends to supports this view.

The risks to the attainment of the targets for the fiscal balance are thus neutral, on account of the opposing revenue and expenditure upside risks. The track record in meeting or even exceeding the fiscal balance targets suggests that there appears to be sufficient flexibility within the budget to cope with an element of unplanned revenue shortfalls or expenditure overruns, provided these are not excessive. The MFAC also notes that the latest forecasts for the fiscal balance prepared by the COM and the CBM are within close range to those of the MFIN. At the same time, the MFIN's debt projections appear rather conservative when considered against the gradually improving fiscal balance. Indeed, both the COM and the CBM are forecasting a lower debt ratio when compared to the MFIN, with the difference large attributable to the stock-flow adjustment factor.

Overall, the MFAC considers that the fiscal projections contained in the USP are within its endorseable range as they were prepared using the best available knowledge and methodologies that adequately capture the salient features of the Maltese economy, tax systems and government expenditure programmes.

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