# An Assessment of the Annual Report 2015 published by the Ministry for Finance

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 present the overall assessment by the Malta Fiscal Advisory Council (MFAC) of the 2015 Annual Report 2015 published by the Ministry for Finance on 30 June 2016.

The Council notes that in 2015 both nominal and real GDP growth rates were significantly higher than originally anticipated in the Budget for 2015 and in the 2015 – 2018 Update of Stability Programme. Such buoyant economic conditions contributed to higher-than-anticipated tax revenues. On the other hand, since a substantial amount of EU funds which were due for 2015, were not yet received by the end of the year, non-tax revenues were below target. This delayed receipt of EU funds impacted significantly the Consolidated Fund which thus recorded a deficit which was €79.7 million, or 51%, larger than originally planned, when measured on a cash basis.

However, this delayed receipt of EU funds did not impact the general government balance measured according to the ESA, since according to this accrual-based statistical framework, such EU funds can be imputed, and thus included with the government revenues for 2015. As a result, the headline fiscal deficit-to-GDP ratio contracted from 2.0% in 2014 to 1.5% in 2015. The Council welcomes the fact that this was a slightly better turnout than the 1.6% deficit originally targeted. However, the Council notes that the headline improvement in public finances could have been even stronger, in the absence of expenditure slippages in certain areas. The Council acknowledges the current practice whereby the expenditure projections prepared by the Ministry for Finance serve as a cap on approved expenditure. However, the Council considers that the robustness of expenditure projections can be further enhanced through stronger monitoring and vigilance, and through an accelerated implementation of the findings of the Comprehensive Spending Review exercises, particularly in respect of ambitious expenditure restraint targets. Moreover, the possibility of revenue windfalls should not be viewed as an opportunity to extend further permanent expenditure initiatives.

When assessed in structural terms, according to the methodology used by the European Commission for the surveillance of Member States' public finances, the reduction in the headline deficit-to-GDP ratio was practically entirely due to cyclical factors reflecting the buoyant macroeconomic conditions which materialised during 2015. As a result, no structural fiscal effort appears to have been undertaken during 2015, with the structural fiscal balance remaining stable when compared to a year earlier, at 2.3% of potential GDP, thereby falling short of the 0.7 percentage point structural effort that had been initially planned and the 0.6 percentage point required in terms of the Stability and Growth Pact. The Council acknowledges that special circumstances, mostly beyond the direct control of the Government, played a role in the lack of realised structural adjustment in 2015. At the same time, the Council invites the Government to remain vigilant and ensure that in 2016 the planned structural adjustment, equivalent to 0.8 percentage points, is indeed attained.

On the other hand, the Council views positively the further scaling back of the debt-to-GDP ratio during 2015, noting favourably that such ratio actually declined from 67.1% in 2014 to 63.9%, significantly faster than the 66.8% originally targeted, on the back of the strong nominal GDP growth conditions.

Overall, the Council considers that the 2015 Annual Report published by the Ministry for Finance adequately meets the requirements prescribed in Article 41 of the Fiscal Responsibility Act. However, the Council would like to draw attention to the fact that whereas the structural balance pillar and the debt criterion are explicitly referred to in the Fiscal Responsibility Act, the Stability and Growth Pact specifies another principle, namely the expenditure benchmark, which must also be taken into account when assessing adjustment towards the Medium Term Objective. While acknowledging that the expenditure benchmark is only indirectly referred to in the Fiscal Responsibility Act, the Council considers the evaluation of compliance with the expenditure benchmark of importance within the context of the Stability and Growth Pact. In this respect, the Council would welcome the possibility that the Ministry for Finance also dedicates a specific section to the analysis of the expenditure benchmark in its Annual Report. This would ensure a more comprehensive ex-post assessment of the conduct of fiscal policy during the previous year, in the context of the Government's European commitments.

Finally, the Council would like to express satisfaction at the ongoing constructive dialogue with the parties involved within the Ministry for Finance. At the same time, the Council invites the Ministry to evaluate the merit of using its Annual Report to make public its views on the various recommendations made by the Council throughout the year, as this would strengthen further the institutional dialogue and add more fiscal transparency.

Yours sincerely

**Rene Saliba**
**Chairman**

## Table of Contents



## List of Tables



## List of Charts



## List of Diagrams

## Abbreviations

| | |
|---|---|
| **COM** | European Commission |
| **CSR** | Comprehensive Spending Review |
| **DAS** | Departmental Accounting System |
| **DBP** | Draft Budgetary Plan |
| **EBU** | Extra-Budgetary Unit |
| **EFSF** | European Financial Stability Facility |
| **EPD** | Economic Policy Department |
| **ESA** | European System of National and Regional Accounts |
| **ESM** | European Stability Mechanism |
| **EU** | European Union |
| **FRA** | Fiscal Responsibility Act |
| **GDP** | Gross Domestic Product |
| **MFAC** | Malta Fiscal Advisory Council |
| **MFIN** | Ministry for Finance |
| **MTFS** | Medium-Term Fiscal Strategy |
| **MTO** | Medium-Term budgetary Objective |
| **NSO** | National Statistics Office |
| **pp** | percentage point |
| **SGP** | Stability and Growth Pact |
| **USP** | Update of Stability Programme |
| **VAT** | Value Added Tax |

## Executive summary

This Report provides an overall assessment by the Malta Fiscal Advisory Council on the 2015 Annual Report published by the Ministry for Finance, in line with the requirements prescribed in the Fiscal Responsibility Act.

In 2015 growth in nominal GDP was significantly higher than originally anticipated in the Budget for 2015 and in the 2015 – 2018 Update for Stability Programme. In particular, when compared to the initial projections, the actual growth in operating surplus and in gross fixed capital formation was much higher than had been forecasted. This exceptional growth in in nominal GDP was also reflected into a better-than-expected turnout for real GDP growth.

Despite such favourable macroeconomic conditions, in 2015, the deficit on the Consolidated Fund measured on a cash basis was 51% higher than originally planned. While additional revenues stemmed from the buoyant economic conditions, non-tax revenues were below target. Indeed, a significant amount of EU grants which were due for 2015 were not yet received by the end of the year. At the same time, expenditure overruns took place across various expenditure categories, of which, larger outlays on capital expenditure were the most noticeable. These were necessary to be able to absorb the remaining European Union funds under the Programme Period 2007 – 2013, before their expiry at the end of 2015.

On the other hand, when computed according to the European System of National and Regional Accounts, the general government balance turned out marginally better than targeted in 2015. The fiscal deficit-to-GDP ratio contracted from 2.0% in 2014 to 1.5% in 2015, against the original projection of 1.6%. Both total revenue and total expenditure were higher than originally projected. The former was 3.7% more than targeted, due to higher current taxes on income and wealth and higher revenue streams from taxes on production and imports, on the back of higher-than-expected GDP growth. In this case, the delayed receipt of substantial EU funds did not impact the general government balance, since according to the accrual-based European System of National and Regional Accounts, such funds can be imputed, and thus included with the government revenues for 2015. In turn, total expenditure exceeded the target by 3.5% in 2015. This was mainly driven by larger outlays on gross fixed capital formation, most of which were however EU-funded. This fact thus limited the impact on the fiscal balance to the national co-financing element. Higher compensation of employees and intermediate consumption also contributed to the above-target expenditure recorded in 2015.

In structural terms, the fiscal balance-to-GDP ratio remained stable between 2014 and 2015, at 2.3%, as the headline improvement was practically fully ascribed to cyclical conditions. Indeed, according to the methodologies used by the European Commission for the surveillance of Member States' public finances, the reduction in the headline deficit-to-GDP ratio was practically entirely due to the buoyant macroeconomic conditions which materialised during 2015, rather than specific structural fiscal effort undertaken during that year. As a result, in 2015, the budgetary rule, which is prescribed in the Fiscal Responsibility

Act, was not met. Indeed, no fiscal consolidation adjustment was realised in structural terms, thereby falling short of the 0.7pp structural effort that was initially planned and the 0.6pp that was required in terms of the Stability and Growth Pact. The Council acknowledges that this deviation from the planned structural effort is largely attributable to a series of inter-related factors, primarily beyond the direct control of the Government. These factors include the downward revision in the 2014 deficit figures by the National Statistics Office; the stronger than anticipated output gap for 2015; the higher than expected co-financing of EU funds which became necessary to ensure full absorption; and the fact that the higher than expected economic growth included components which were inherently less tax-rich.

Of particular relevance is the fact that macroeconomic conditions turned out more buoyant than previously anticipated. The Council welcomes the stepped up efforts by the Government to ensure that the budgetary rule is met in 2016.

As for the debt-to-GDP ratio, this was scaled down in 2015, by more than had been targeted, falling from 67.1% in 2014 to 63.9%, compared to the original target of 66.8%. This achievement was principally due to the faster-than-expected nominal GDP growth. This ensured that in 2015 the debt rule, which establishes the trajectory along which this ratio should embark towards the 60% threshold, and which is also prescribed in the Fiscal Responsibility Act, was met.

This Council's Report includes a series of recommendations addressed to the Ministry for Finance which aim to further enhance fiscal transparency and also to improve forecast accuracy, particularly on the expenditure side of the budget, which is more under the direct control of Government. Moreover, the Council encourages the Ministry for Finance to expand the coverage of its Annual Report to also focus on the expenditure rule requirements which are stated in the Stability and Growth Pact and indirectly referred to in the Fiscal Responsibility Act. At the same time, the Council invites the Ministry for Finance to evaluate the merit of using its Annual Report to make public its views on the various recommendations made by the Malta Fiscal Advisory Council throughout the year, as this would strengthen further the institutional dialogue and add more fiscal transparency.

Finally, the Council considers that the 2015 Annual Report adequately meets the requirements prescribed in Article 41 of the Fiscal Responsibility Act.

## 1. Introduction

On 30 June 2016, the Ministry for Finance (MFIN) published its second Annual Report, for 2015, in line with the requirements stipulated under Article 41 of the Fiscal Responsibility Act, 2014 (Cap. 534) (henceforth referred to as the FRA). The Annual Report presents the fiscal turnout compiled on the basis of two different methodologies; on a cash basis, and according to the statistical guidelines of the European Union (EU).[1] Any deviations from the previous estimates are identified and explained, thereby contributing to greater fiscal transparency. The MFIN's Annual Report also evaluates the extent of compliance with the principles and numerical fiscal rules stipulated in the FRA, which in turn are based on the requirements of the Stability and Growth Pact (SGP). Furthermore, it analyses whether the 2015 budgetary results were in line with the stipulated Medium Term Objective (MTO).

Article 13(3)(e) of the FRA prescribes that the Malta Fiscal Advisory Council (MFAC) shall "analyse and issue an opinion and any recommendations pursuant to the Government's publication of the half-yearly and the annual report on the execution of the budget". In this respect, this MFAC's Report proceeds as follows.[2] Section 2 summarises how the macroeconomic conditions have evolved since the publication of the Budget for 2015 and of the 2015 Update of Stability Programme (USP), respectively in November 2014 and in April 2015. Section 3 presents the outturn for the Consolidated Fund for 2015 and how this compared to the forecast estimates prepared by the MFIN. Section 4 focuses on the general government balance, analysing developments using the revenue and expenditure nomenclatures specified in the European System of National and Regional Accounts (ESA). Section 5 assesses the extent of compliance with the budgetary rule while Section 6 evaluates the compliance with respect to the debt rule. Section 7 concludes with the MFAC's overall assessment and presents a number of final recommendations.

## 2. Macroeconomic developments

Macroeconomic forecasts are conditional on the information available at the time of their preparation. In this respect, they are driven by the historical relationships across variables and the assumptions about exogenous variables embodied into the forecasting models.[3] The actual outturn would normally be different from the projections, with the deviation varying each time official macroeconomic statistics are released.[4] Macroeconomic forecasts are essential to help project future tax revenues, and to a more limited extent, future government expenditure.

[1] The fiscal data is compiled according to Eurostat's 'Manual on Government Deficit and Debt – Implementation of ESA 2010', which is available on: http://ec.europa.eu/eurostat/web/products-manuals-and-guidelines/-/KS-GQ-16-001.

[2] The cut-off date for the information contained in this Report is 25 July 2016 unless otherwise indicated. Some totals presented in the Tables may not add up due to rounding.

[3] Exogenous variables are those variables whose developments are taken as given and are not explained within the model.

[4] Macroeconomic statistics are normally revised in each subsequent release, as more and better information becomes available to the National Statistics Office (NSO).

They also present the conditions, favourable or unfavourable, against which fiscal policy is expected to be conducted and can thus be evaluated. Specifically in the case of tax revenues, nominal GDP developments play the more significant role, particularly since most tax bases are specified in nominal terms.[5] On the other hand, to evaluate the size of the actual structural fiscal effort, real GDP and potential GDP developments are more relevant, as they determine the economy's position along the business cycle, namely whether the economy is operating above or below potential.

In 2015, growth in nominal GDP (at current market prices) has been significantly higher than originally anticipated in the Budget for 2015 and the 2015 – 2018 USP. Nominal GDP growth for 2015 had been projected at 4.8% in the 2015 Budget document and subsequently revised slightly, to 4.7%, in the 2015 USP.[6] However, the first estimate published by the NSO on 8 March 2016, and which was included in the 2016 USP, the actual nominal GDP growth for 2015 was reported exceptionally high, at 8.8% (see Chart 1 and Table 1).[7]

The MFAC notes that the GDP statistics from the income side show that the higher-than-expected nominal GDP growth was largely the result of much faster growth in operating surplus and mixed income (referred to as 'profits' in short).[8] Indeed, while in the Budget for 2015, and in the 2015 USP, profits were projected to grow in the region of 6.0%, official statistics reported in the 2016 USP show a growth rate of 12.9%. The forecast growth for compensation of employees was likewise underestimated, due to more buoyant labour market conditions. Indeed, the yearly employment growth for 2015, which in November 2014 had been forecasted at 1.9%, was revised slightly, to 2.0% in the 2015 USP, and raised to 3.5%, in the 2016 USP.[9] In the case of compensation of employees, the forecast error was still more contained than in the case of gross operating surplus and mixed income, since official statistics indicated an annual rise of 5.3% compared to the original estimates of 4.2% in the Budget for 2015 and 4.7% in the 2015 USP.

The MFAC acknowledges that in the case of Malta, it may be rather difficult to prepare very accurate forecasts for the profits component within GDP, in view of its possible volatility,

[5] This applies to taxes that are specified on values. On the other hand, in the case of taxes which are specified on quantities, for example litres, kilograms, permits, or other units, developments in real GDP are more appropriate.

[6] Table 1 of the MFIN's Annual Report erroneously reported the 2015 USP nominal GDP growth forecast for 2015 of 5.4% instead of 4.7%. The MFAC's assessment is based on the correct figures for the nominal GDP growth forecast.

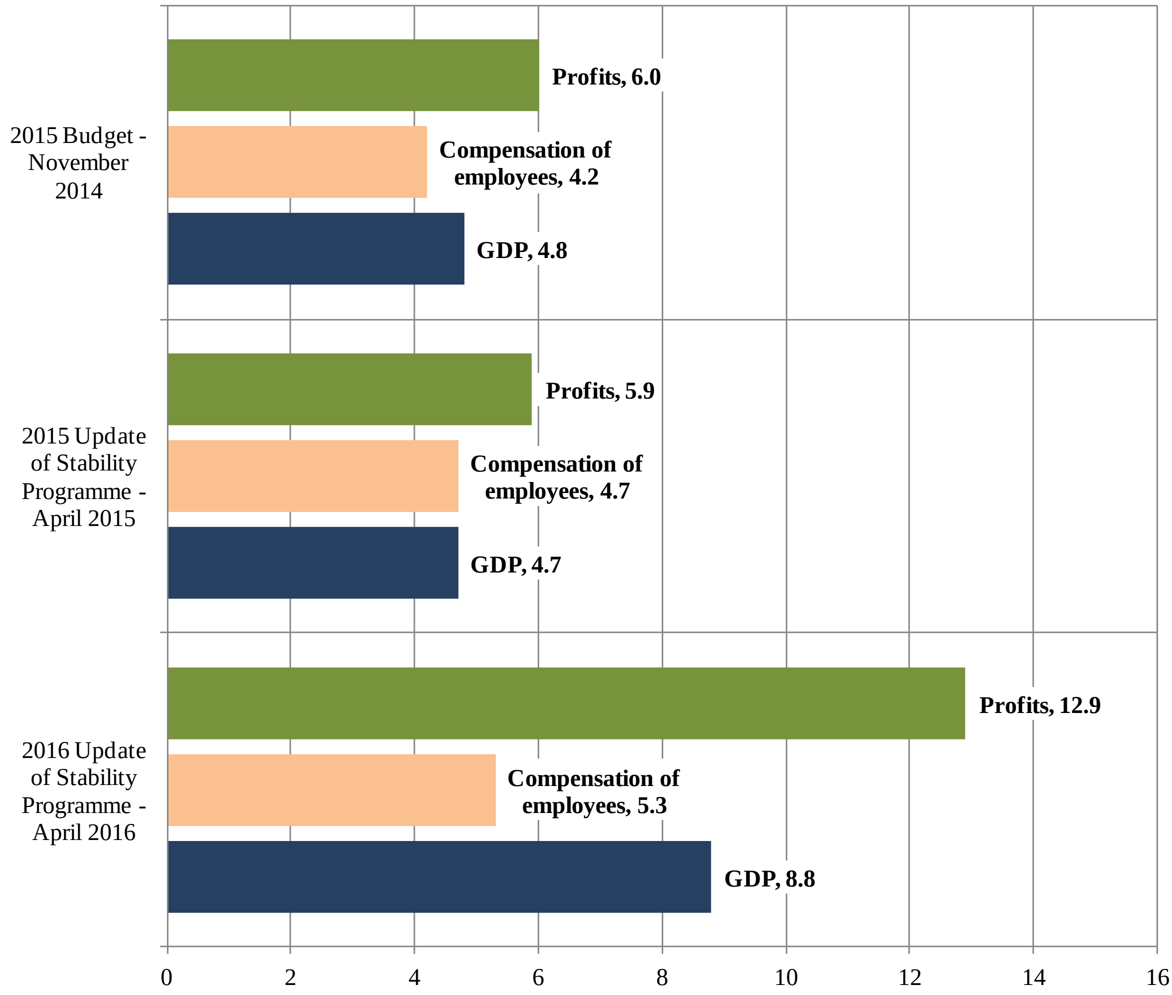
[7] In a more recent News Release, published by the NSO on 8 June 2016, the nominal GDP growth for 2015 was revised slightly upwards, to 8.9%. All figures included in the MFIN's Annual Report relate to the 8 March 2016 News Release, since these were the figures available at the time the USP and the Medium-Term Fiscal Strategy (MTFS) documents were prepared. Accordingly, the MFAC's analysis is based on the same data used by the MFIN.

[8] In some cases it is difficult to distinguish between income from labour and income from capital, such as in the case of self-employed. The generation of income account is thus 'mixed' by including both the remuneration of capital and labour. For further details about the compilation of gross operating surplus and mixed income refer to: http://ec.europa.eu/eurostat/statistics-explained/index.php/Glossary:Gross_operating_surplus_(GOS)_-_NA.

[9] Table 1 of the MFIN's Annual Report erroneously reported the 2015 USP employment growth forecast for 2015 of 4.7% instead of 2.0%. The MFAC's assessment is based on the correct figures for the employment growth forecast

particularly as it can be significantly influenced by one-off, special and international developments, as well as the timing of payments received, which may be difficult to anticipate. Frequent official revisions in the historical time series add further challenges.

Chart 1: Projected and actual economic developments in 2015 – income side of nominal GDP (year-on-year % change)




*Source: MFIN*

In order to boost transparency further, the MFAC encourages the MFIN to consider including in its Annual Report, explanations about the profit deviations for the key sectors of the Maltese economy. This may be useful since the eventual impact on public finances may be different depending which sectors experience growth or contraction. For instance, the tax yield across different economic sectors can vary and thus sector developments may be useful to understand better why economic growth may be more or less 'tax-rich' than in previous years.

Turning to the estimate of nominal GDP from the expenditure side, the largest percentage point difference between the initial growth forecasts and the actual turnout was related to gross fixed capital formation (referred to as 'investment' in short). Indeed, whereas in the

Budget for 2015, nominal investment was forecasted to grow by 3.6%, this was subsequently revised upwards to 25.5% in the 2015 USP (see Table 1). According to the official statistics, this item actually expanded by slightly more, up by 27.7% year-on-year.

Table 1: Projected and actual economic developments – expenditure side of nominal GDP (year-on-year % change)

| | Budget 2015 | USP 2015 | USP 2016 |
|---|---|---|---|
| Gross Domestic Product | 4.8 | 4.7 | 8.8 |
| Private final consumption expenditure | 4.2 | 4.3 | 6.1 |
| General government final consumption expenditure | 5.7 | 3.8 | 6.5 |
| Gross fixed capital formation | 3.6 | 25.5 | 27.7 |
| Exports of goods and services | 4.8 | 5.2 | 4.0 |
| Imports of goods and services | 4.7 | 8.1 | 4.4 |

*Source: MFIN*

Nominal growth in private consumption, which is the largest component within domestic demand, outpaced the original forecasts, growing by 6.1%, compared to the previous forecasts, which hovered slightly above 4%. In turn, nominal government consumption is estimated to have increased by 6.5%, which was reasonably close to the original forecast of 5.7%, but rather high, when compared to the 3.8% forecast presented in the interim, that is, in the 2015 USP. In this case, it would have been useful for the MFIN to provide further explanations in the Annual Report as to why the forecast for government consumption had been cut in the interim, particularly since the deceleration did not materialise.

The actual turnout for growth in exports, at 4.0%, was close, but slightly lower than had been projected. Notwithstanding that overall, domestic demand expanded more robustly than originally expected, growth in imports was lower than forecasted, especially when compared to the forecasts presented in the 2015 USP. This suggests that the import content of GDP, primarily exports of services, appears to have been lower than would have normally been expected. Indeed, this appears to be an important factor which explains why in 2015 nominal GDP growth turned out much higher than expected.

The MFAC considers that in a situation where the economy is undergoing structural changes, it is important that ongoing research is carried out to better understand evolving economic phenomena and relationships, such as why in 2015 the import-content of services exports appears to have been lower than had been anticipated. At the same time, it is important that detailed dossiers continue to be maintained to support the assumed patterns for those variables which are more of an exogenous and possibly volatile nature, such as for investment. The MFAC notes positively that the increased efforts by the Economic Policy Department (EPD) at the time of preparation of the 2015 USP, aimed at collecting more granular information about investment projects, have enabled the MFIN to correctly anticipate the surge in gross fixed capital formation.

The higher-than-expected nominal GDP growth was similarly reflected into a better-than-expected turnout for real GDP growth in 2015. Indeed, real GDP growth was estimated at 6.3%, significantly higher than the 3.5% and the 3.4% which were projected respectively in the 2015 Budget and in the 2015 USP (see Table 2). This forecast error contributed to a wide discrepancy ex-post for the output gap conditions in 2015.[10]

Table 2: Projected and actual economic developments – real terms (%)

| | Budget 2015 | USP 2015 | USP 2016 |
|---|---|---|---|
| Gross Domestic Product | 3.5 | 3.4 | 6.3 |
| Output gap (% of potential output) | 0.3 | 0.5 | 1.6 |

*Source: MFIN*

While in November 2014 the output gap for 2015 had been estimated at 0.3% of potential output, it was revised slightly upwards, to 0.5% of potential output in April 2015. However, according to the 2016 USP, the output gap was revised significantly upwards, to 1.6% of potential output. This implies that the extent to which the economy was operating above potential during 2015 was significantly more pronounced than ex-ante thought. This fact plays an important role in the assessment of the conduct of fiscal policy for 2015, particularly with regards to the assessment of the actual structural effort undertaken for the year, or lack thereof, when compared to the requirements stipulated in the FRA.[11]

## 3. Developments in the Consolidated Fund

Despite the better-than-expected macroeconomic turnout, in 2015 the balance on the Consolidated Fund fell short of the target. Such situation is more likely when considering that the transactions in the Consolidated Fund are recorded on a cash basis, rather than on an accrual basis, whereas national accounts statistics are compiled on an accrual basis. Transactions in the Consolidated Fund are recorded on the basis of methodologies and classifications, which in certain areas are different from international methodologies such as ESA. Cash-based methodologies underlying consolidated fund estimates are not meant to

[10] The output gap compares the actual real GDP to the estimate of potential output. When actual real GDP is higher than potential output, the economy is said to be operating above potential, and the output gap is said to be positive. When actual real GDP is lower than potential output, the economy is said to be operating below potential, and the output gap is said to be negative.
[11] For further details refer to Section 5 in this Report.

guarantee close consistency with actual GDP developments which are based on accrual-based concepts.

In 2015, the deficit on the Consolidated Fund amounted to €235.8 million, which was €79.7 million (51%) above the Approved Estimates (see Table 3).[12] Both revenues and expenditures were higher than originally planned. Total recurrent revenue was €79.7 million (2.2%) more than projected, while total expenditure was €159.5 million (4.3%) above the target indicated in the 2015 Annual Report.

Table 3: Main developments in the Consolidated Fund (EUR million)

| | Approved Estimates | Actual | Difference |
|---|---|---|---|
| Total recurrent revenue | 3,555.0 | 3,634.8 | 79.7 |
| Total expenditure | 3,711.2 | 3,870.6 | 159.5 |
| Consolidated Fund balance | -156.1 | -235.8 | -79.7 |

*Source: MFIN*

The MFAC notes that the quoted deficit figure of €156.1 million differs from the deficit target of €148.6 million indicated in the Financial Estimates 2015 which were published in conjunction with the Budget Speech for 2015. Indeed, the Annual Report specified target expenditure for 2015 of €3,711.2 million, as against the €3,703.7 million which was published in the Financial Estimates for 2015.[13] While it is noted that the MFIN's Annual Report Table includes a footnote to qualify the expenditure figures, the MFAC considers that it would be preferable if official targets are not recalculated, since this would make the ex-post budgetary evaluation less transparent, unless such adjustment is considered to be strictly necessary, in which case appropriate justifications should be provided in the Annual Report.

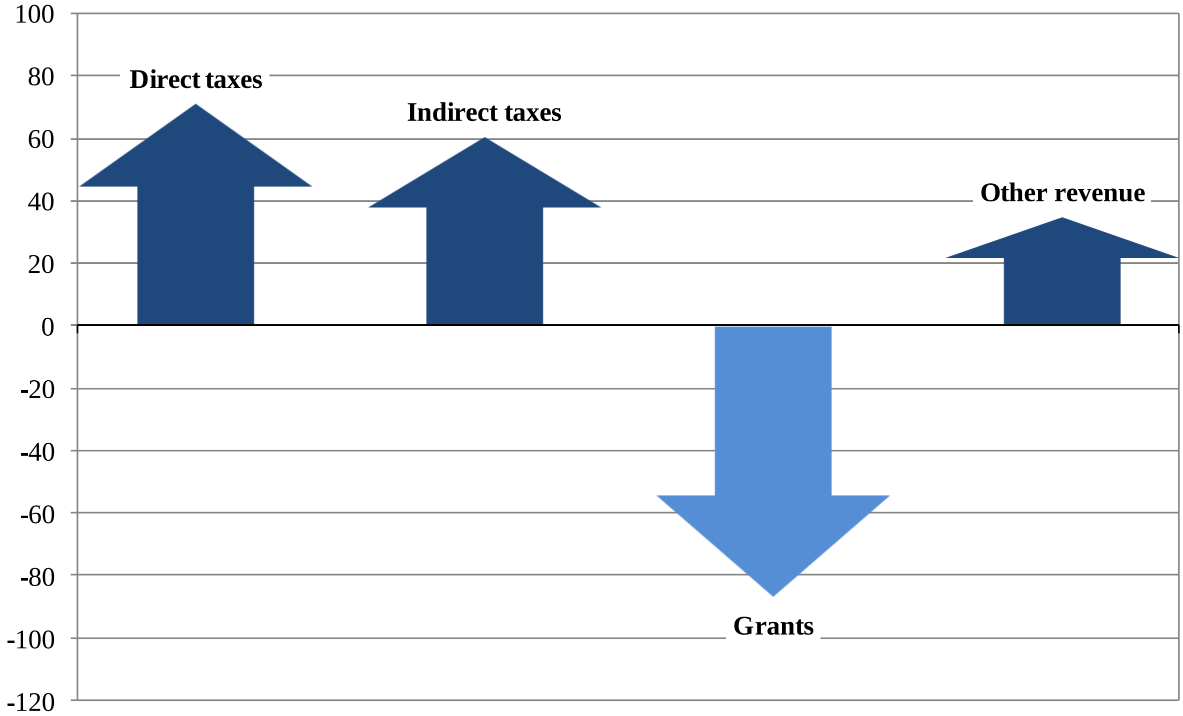
As indicated in the Approved Estimates, as recalculated in the Annual Report, the intake from both direct and indirect taxes exceeded the targets (see Chart 2). In the first case, this was entirely attributable to income tax, whereas revenue from social security was slightly below target. Developments in companies' profits, prevailing labour market conditions and enhanced efficiency in revenue collection, contributed to the better-than-expected turnout. At the same time, all three main indirect tax categories (customs and excise duties; VAT; and licenses taxes and fines) contributed to the overall higher-than-projected revenue. The

[12] The Approved Estimates 'form the basis of the accounts of the financial year to which they relate and the classification and subdivision of the revenue and expenditure must accord with the details of the estimates', Article 69 of the Subsidiary Legislation 174.01 General Financial Regulations (1966). The figures included in Table 3 are reproduced from the MFIN's Annual Report. These are slightly different from the figures which had been published in the original Financial Estimates presented at the time of the Budget, because they include some minor adjustments.

[13] The 2015 Annual Report indicates that the expenditure target figures have been revised compared to the Financial Estimates, to include the credit line facility of €4.5 million granted to the European Financial Stability Facility (EFSF) and to the European Stability Mechanism (ESM) under recurrent expenditure, and to include outlays on equity acquisition of €3.0 million under capital expenditure. The MFAC's analysis is based on the re-calculated Approved Estimates figures presented in the Annual Report rather than the original estimates presented with the Budget.

MFIN's Annual Report attributes this surplus revenue to higher excise from petroleum, higher income from duty on documents, stronger growth in private consumption and positive performance among the tourism sector.

Chart 2: Variances in revenue components – Consolidated Fund (EUR millions)




Note: The arrows show the difference between the actual values and the projected values as reported in the MFIN's 2015 Annual Report.

*Source: MFIN*

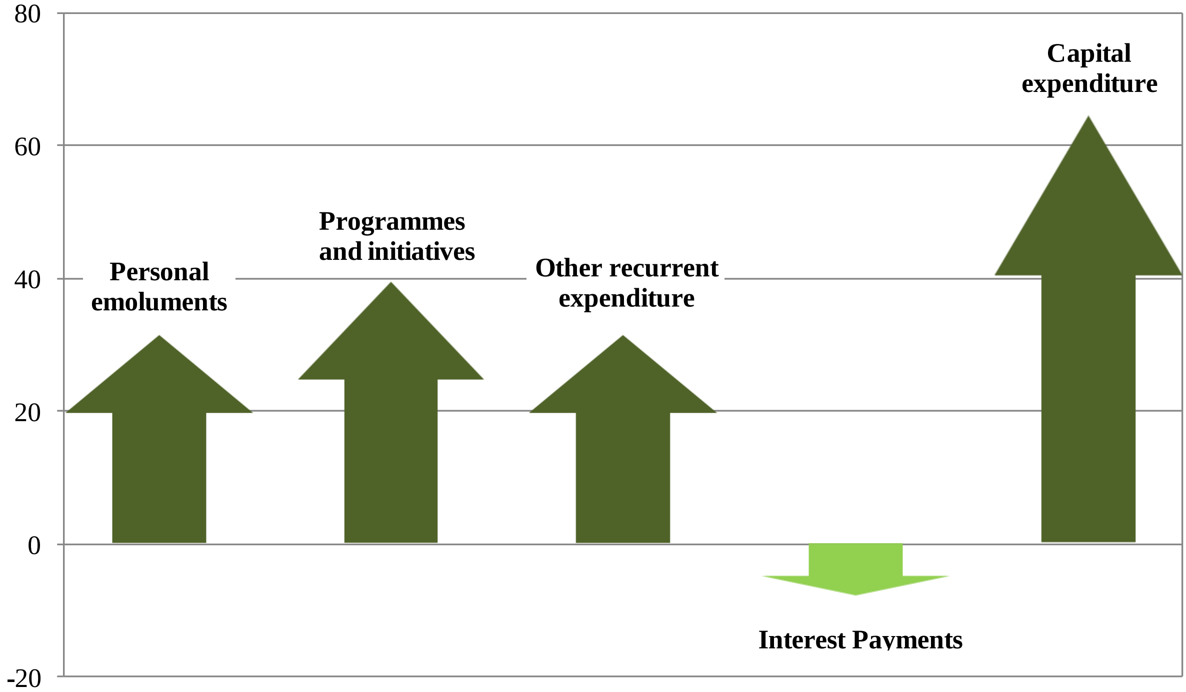
On the other hand, non-tax revenues were below target since a significant amount of grants (EU funds) which were due for 2015 were not yet received by the end of the year.[14] However, such revenues would be reflected in the Consolidated Fund balance for 2016, when they are received, since transactions are recorded on a cash-basis. The delayed receipt of EU funds, owing to the fact that the requests for refunds were made very close to the end-of-year, was partly cushioned through higher-than-projected intakes from fees of office and from other miscellaneous sources which are classified under the 'other revenue' category.

In turn, expenditure overruns were reflected across various components (see Chart 3). Around 40% of this overrun was attributable to larger outlays on capital expenditure. The latter reflected the drive by the Government to absorb the remaining EU funds under the Programme Period 2007-2013, before their expiry at the end of 2015. Higher-than-expected expenditures were in particular channelled into the health and education sectors, thus impacting the outlays on Programmes and Initiatives, and spending on Personal Emoluments. Other factors contributing to the higher-than-expected outlays on Programmes and Initiatives

[14] The revenue targets presented in the 2015 Annual Report where identical to those presented in the original Approved Estimates. No recalculation was carried out in the case of revenues.

included expenditures relating to the EU-Africa Summit and the Commonwealth Heads of Government which events were both unforeseen in the original estimates presented in the 2015 Budget. Furthermore, contributions to the company which absorbed workers from the previous state energy company were also more than projected, thus raising the overall Contributions to Government Entities. These higher expenditures were however partly offset through lower interest payments, which were €7.9 million less than budgeted for, reflecting the further rolling over of maturing debt at lower interest rates.

Chart 3: Variances in expenditure components – Consolidated Fund (EUR millions)




Note: The arrows show the difference between the actual values and the projected values as reported in the MFIN's 2015 Annual Report.
*Source: MFIN*

The MFAC welcomes the details provided by the MFIN in its 2015 Annual Report to explain why the deficit on the Consolidated Fund turned out to be higher than originally expected, consistent with the requirements imposed by the FRA. The MFAC considers that the higher than anticipated revenues reflect the better-than-expected nominal GDP growth recorded in 2015, as well as the tendency by MFIN to adopt prudent forecast estimates for revenues to mitigate downside risks to public finances as a result of possible unfavourable economic conditions, in a very open economy over which Government has no control. This practice makes it hard to disentangle the separate effects created by revenue windfalls and forecast errors. Nonetheless, the MFAC re-iterates the importance that any revenue windfalls, which can be distinguished from normal revenue forecast errors, should not be used to finance new recurrent expenditure. This would sustain the planned expenditure restraint embedded in the USP 2016 – 2019 and also contribute to build fiscal buffers.

The MFAC acknowledges that the expenditure projections prepared by MFIN serve as a cap on approved expenditure. However, the MFAC considers that the robustness of expenditure projections can be further enhanced through stronger monitoring and vigilance, and through an accelerated implementation of the findings of the Comprehensive Spending Review (CSR) exercises, particularly in respect of ambitious expenditure restraint targets. This is important in order to avoid situations where expenditure projections would otherwise need to be subsequently revised upwards. Going forward, as the system of three-year budget plans undertaken by the various Government departments becomes more ingrained, this should contribute to establish more attainable expenditure targets, and thus improve expenditure forecast accuracy. The MFAC acknowledges the exceptional nature of part of the 2015 additional expenditure in view of the necessity to ensure higher absorption of EU funds before their expiry, as well as to organise international events which were not foreseen. The MFAC continues to emphasise the need for expenditure restraint and continuous vigilance to ensure that fiscal commitments are maintained. The possibility of revenue surpluses should not be viewed as an opportunity to extend further permanent expenditure initiatives.

## 4. Developments in the general government balance

Contrary to the pattern exhibited by the Consolidated Fund (on a cash basis), the fiscal turnout compiled according to the ESA accrual-based framework indicates that in 2015 the fiscal balance was marginally better than had been targeted. Indeed, the fiscal deficit was €4.1 million less than targeted in the 2015 USP (see Table 4).[15] As a result, in 2015, the fiscal deficit stood at 1.5% of GDP when compared to the target of 1.6% of GDP.

Both total revenue and total expenditure were higher than originally projected.[16] Total revenue was €131.5 million (3.7%) above the target. Better-than-expected nominal and real economic growth contributed to the additional revenues from current taxes on income and wealth and from taxes on production and imports. This mirrored the cash-based developments which were identified in the previous Section. Out of the additional total revenue, some three-fourths, €63.9 million and €34.0 million, were respectively derived from the before-mentioned two sources. An additional €14.8 million was in turn generated through higher market output by Extra-Budgetary Units (EBUs).[17]

As for total expenditure, this exceeded the target by €127.4 million (3.5%). Practically half of this slippage, €59.9 million was driven by the larger outlays on gross fixed capital formation. Most of the latter expenditures were however EU-funded. Thus, the impact on the fiscal

[15] The fiscal targets reproduced in the Table are based on the 2015 USP, which had been updated when compared to the Draft Budgetary Plan (DBP) for 2015 published in October 2014. While the fiscal deficit target remained unchanged at 1.6% of GDP, the revenue-to-GDP ratio was revised upwards from 41.8% to 42.6% and the expenditure-to-GDP ratio was revised upwards from 43.4% to 44.2%.

[16] The fiscal data compiled on the basis of the ESA framework relies on estimates and hence these are to be considered as provisional and subject to possible revisions in future.

[17] EBUs are entities forming part of general government but which are not accounted for within the Departmental Accounting System (DAS) of central government.

balance was limited to the national co-financing element. Although a significant portion of EU funds were not actually received in 2015, according to the ESA guidelines, these were imputed, since they are reasonably certain to be received.[18]

Table 4: Main developments in the general government balance – ESA basis (EUR millions)

| | 2015 USP | Actual | Difference |
|---|---|---|---|
| **Total revenue** | **3,551.5** | **3,683.1** | **131.5** |
| *of which:* | | | |
| Current taxes on income and wealth | 1,173.6 | 1,237.6 | 63.9 |
| Taxes on production and imports | 1,155.1 | 1,189.1 | 34.0 |
| Market output and output for own final use | 217.9 | 232.8 | 14.8 |
| **Total expenditure** | **3,684.6** | **3,812.1** | **127.4** |
| *of which:* | | | |
| Gross fixed capital formation | 342.5 | 402.3 | 59.9 |
| Compensation of employees | 1,082.4 | 1,116.4 | 34.0 |
| Intermediate consumption | 566.6 | 596.5 | 29.9 |
| **General government balance** | **-133.1** | **-129.0** | **4.1** |
| as % of GDP | **-1.6** | **-1.5** | **0.1** |

*Source: MFIN*

Spending on compensation of employees and on intermediate consumption likewise exceeded the targets, respectively by €34.0 million and €29.9 million. In the first case this probably reflected both a higher level of public sector employment as well as a faster average public sector wage increase. In the case of intermediate consumption, this was the result of higher-than-expected spending by EBUs, the EU-Africa migration summit and the 'Childcare for all' scheme, among others. On the other hand, the MFAC positively notes that expenditure related to social benefits and social transfers in kind, interest expenditure, subsidies and other expenditure were reasonably close to the target.

The MFIN is invited to ensure that going forward the actual spending on compensation of employees be closer to the targets. Forecast accuracy would increase through more precise information about the expected year-end headcount, seniority structures, overtime pay and bonuses.[19] Indeed, this expenditure element is largely discretionary and reasonably within

[18] On the other hand, no such imputation was made with respect to the Consolidated Fund.
[19] In this respect, it is pertinent to note that additional efforts should be made to establish the figure for employment within general government, in a more timely manner.

control of the Government.[20] The MFAC believes it is possible to improve the forecasting accuracy for this budget component, particularly when considering that the USP presents the in-year forecast, when data at least up till March should be available and the short term employment plans for the rest of the year should be rather clear. The MFAC is aware that under the new public service regulations that came into force in February 2016, certain departments have been given flexibility to utilise the allocation of funds for wages as deemed fit, thereby allowing for some flexibility in terms of employment levels provided that the overall expenditure envelope for compensation of employees is not exceeded. It is thus essential that appropriate budget controls are maintained to ensure that such expenditure envelope is fully respected.

## 5. Compliance with the budgetary rule

Article (8) of the FRA requires that 'the annual structural balance of the general government is converging towards the medium-term budgetary objective in line with the timeframe set in accordance with the 1997 Surveillance and Coordination Regulation'. This requires that the structural effort, that is, the change in the fiscal balance-to-potential-GDP ratio, net of cyclical and one-off effects, must amount to at least 0.5pp annually. In good times, that is, when economic conditions are considered to be rather buoyant, the structural effort must actually be higher.[21] Indeed, the European Commission's (COM) 2015 Country Specific Recommendations for Malta indicated that a fiscal adjustment of 0.6% of GDP was required for 2015.[22]

In this respect, in the USP published in April 2015 the Government had targeted a structural effort of 0.7pp, with the structural deficit targeted to decline from 2.7% of potential GDP in 2014 to 2.0% of potential GDP in 2015. However, as a result of some special developments and factors, the structural deficit for 2014 has been re-estimated to 2.3% of potential GDP in 2014 while that for 2015 was estimated at 2.3% of potential GDP. This meant that in practice no structural adjustment has been undertaken during 2015, falling short of the 0.6pp requirement. The MFAC takes note of the clear explanations provided in the MFIN's Annual Report as to the inter-related factors which have contributed to this deviation from the original plans (see Diagram 1 and Table 5).

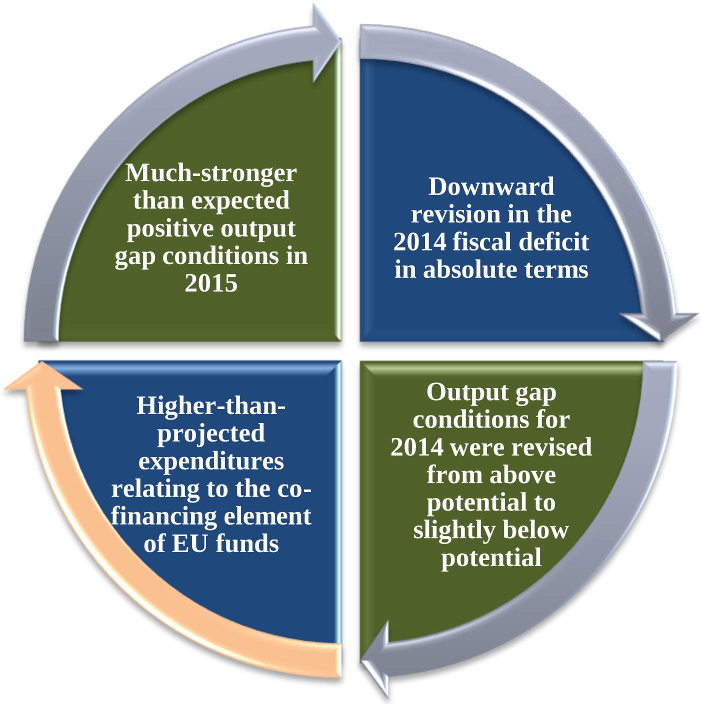
Two factors behind the observed deviation are directly related to fiscal developments (shaded in blue in Diagram 1), while the other two factors are related to macroeconomic conditions (shaded in green in Diagram 1). Viewed differently, three factors could be considered to be beyond the direct control of the Government (indicated with grey arrows), with the other factor (indicated with a light brown arrow), was the result of a policy decision, in respect of

[20] In this sense, compensation of employees is largely deterministic.
[21] For further details, refer to Box 3 in the MFAC's Report "An Assessment of the Medium-Term Fiscal Strategy 2015 – 2018, Annual report 2014 and Half-Yearly Report 2015 published by the Ministry for Finance", available on the MFAC's website.
[22] For further details refer to http://ec.europa.eu/malta/news/2015-country-specific-recommendations-malta_en.

the co-financing element related to EU-funded projects which in the Budget were under-estimated.

The downward revision in the headline fiscal deficit for 2014, from 2.1% of GDP to 2.0% of GDP, meant that the starting point for fiscal consolidation was slightly more advanced. Hence, this required a slightly more ambitious headline fiscal target for 2015, in order to carry forward the better starting point for public finances at the beginning of the year, while undertaking the envisaged improvement in percentage points compared to the previous year.

Diagram 1: Main determinants of the lack of structural effort undertaken during 2015




*Source: MFIN*

Table 5: Structural adjustment

| | 2015 USP | Actual | Difference |
|---|---|---|---|
| | % | % | pp |
| General government balance | -1.6 | -1.5 | 0.1 |
| One-off and other temporary measures | 0.1 | 0.1 | 0.0 |
| Output gap | 0.5 | 1.6 | 1.1 |
| Cyclically-adjusted budget balance | -1.8 | -2.2 | -0.4 |
| Structural balance | -2.0 | -2.3 | -0.3 |
| Structural adjustment | 0.7 | 0.0 | -0.7 |

*Source: MFIN*

At the same time, the macroeconomic conditions against which fiscal policy was assessed were significantly different than had been anticipated. Indeed, while the ex-ante conduct of fiscal policy was planned on the basis of an assumed stability in output gap conditions between 2014 and 2015, constant at 0.5% of potential output, the latest estimates placed the output gap at -0.1% in 2014 and 1.6% of potential output in 2015. Thus, whereas the MFIN was anticipating that cyclical conditions would not play an important contributory role to the improvement in the headline fiscal balance for 2015, on the basis of the latest estimates undertaken four months after the end of 2015, the realised improvement was practically fully ascribed to the cyclical developments, which resulted in a significant swing in output gap conditions.

Moreover, owing to the fact that certain amounts of EU funds under the Programme Period 2007-2013 were going to expire by the end of 2015, the Government took a conscious decision to boost its effort to try to tap in the remaining EU funds, which thus necessitated higher expenditures as part of the co-financing element.

The MFAC acknowledges that the simultaneous materialisation of these four factors derailed the Government's plans for the 2015 consolidation in structural terms. Owing to the frequent revisions and volatility in the past data, particularly the macroeconomic data, and to a much lesser extent also in the fiscal data, it is challenging to meet precisely the structural consolidation requirement on an annual basis, in real time. Indeed, as was the case in 2015, there were significant differences between ex-ante and ex-post conditions. The MFAC also acknowledges that these developments were rather exceptional and could not have been anticipated precisely. At the same time, the high expenditure necessary for the co-financing element of EU funds created only a temporary impact in 2015 which will be reversed in 2016. Moreover, in its assessment of Malta's 2016 – 2019 USP, the COM had concluded that in view of the before-mentioned factors, 'it seems difficult to conclude on a significant deviation' as a result of the lack of actual structural effort undertaken during 2015, and that without the exceptional developments 'the structural balance pillar would have pointed to compliance with the required adjustment towards the MTO'.

Indeed, the non-repetition of certain expenditures should contribute towards the attainment of the required structural effort for 2016. In this respect, the MFAC welcomes the Government's plans to meet the 0.6pp structural adjustment requirement in 2016, also by means of an additional €15 million cut in expenditure. Indeed, the 2016 USP indicates that in 2016, structural adjustment could amount to 0.8pp, or 0.2pp in excess of the requirement in terms of the SGP. The €15 million additional measures were announced following the ex-post realisation of the lack of structural adjustment undertaken in 2015. This is important to ensure that no 'significant deviation' over a two-year period takes place from the recommended structural adjustment towards the MTO, when combining fiscal years 2015 and 2016.[23] In this respect, it is pertinent to note that, should the COM, in due course, establish that a

[23] Except in the year following the correction of an excessive deficit, the COM generally considers the existence of 'significant deviation' on the basis of two-year averages rather than focusing on a single year.

‘significant deviation’ has taken place and issue a warning pursuant to Article 6(2) of Council Regulation (EC) No. 1466/97, Article 11 of the FRA contemplates that a corrective plan must be formulated and submitted to Parliament within two months.

The MFAC encourages the MFIN to continue to strengthen its assessment of macroeconomic conditions, to be able to suggest and undertake possible corrective action in the timeliest way possible. Indeed, the very high quarterly economic growth rates that were being registered in 2015 would have suggested that there was the concrete possibility that output gap conditions could have turned out more buoyant than originally expected. In turn, this would have raised the issue that a more ambitious reduction in the fiscal deficit, in absolute terms, would have been necessary to comply with the annual structural effort requirement. In this respect, the MFAC re-iterates its recommendation that the MFIN should pay increasing attention to the structural balance, similar to the focus on the headline balance. This is necessary so as to correctly identify possible revenue windfalls, as a result of better-than-expected macroeconomic conditions, and endeavour that these are not channelled into new current expenditure.

## 6. Compliance with the debt rule

Article 9 of the FRA requires that ‘when the ratio of general government debt to gross domestic product at market prices exceeds 60 per cent, the ratio shall be reduced in accordance with the 1997 Excessive Deficit Regulation until the ratio reaches 60 per cent’. This requires that public debt, when expressed as percentage of GDP embarks on a continuous downward trajectory, to gradually reach the threshold of 60%.[24]

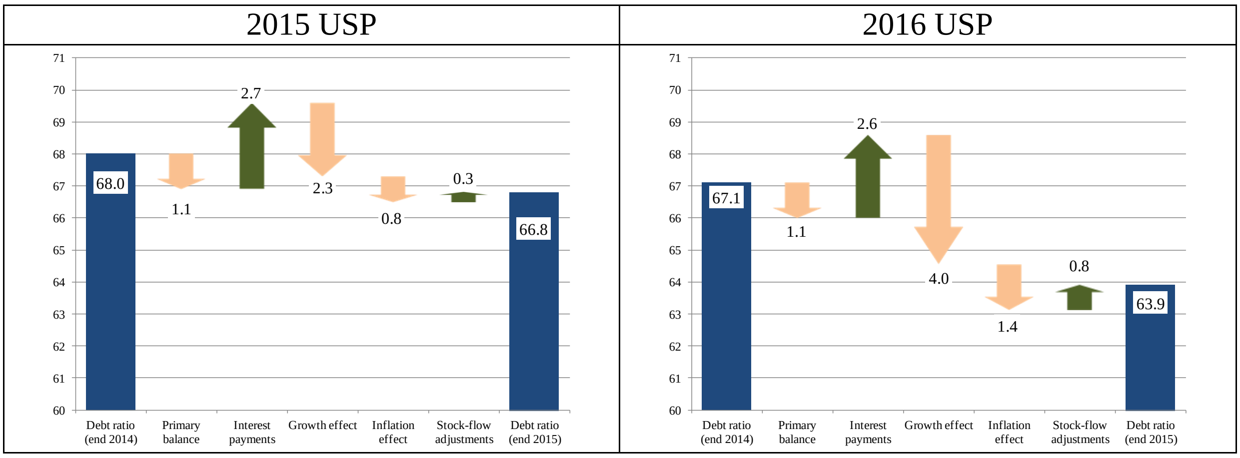
As the MFIN had anticipated, the debt-to-GDP ratio was scaled down during 2015. Indeed, the 2016 USP indicated that public debt ratio declined faster than originally targeted in the 2015 USP, settling at 63.9% of GDP against the previous projection of 66.8% of GDP (see Chart 4).

When focusing on the contributors to the observed debt dynamics, the main discrepancy between the projections shown in the 2015 USP and the calculations included in the 2016 USP relate to the GDP growth and inflation effects, which contributed to an actual downward push of around 4pp and 1.4pp respectively over 2014, or 2.3pp more than had been envisaged in the 2015 USP.[25] This mirrors the exceptionally high nominal GDP growth which was recorded in 2015. This more than compensated for the upward push created by stock-flow adjustments which were slightly higher than planned. The MFAC welcomes that in the USP 2016 – 2019, the MFIN increased the amount of details about stock-flow adjustments when compared to the same report published the year before. In the same spirit, the MFAC

[24] The debt rule requires that the debt-to-GDP ratio should fall by an average of one-twentieth of the excess between the actual debt ratio and the threshold of 60% of GDP.
[25] Inflation contributes to lower the debt ratio, as it raises nominal GDP.

encourages the MFIN to expand further the coverage of the Annual Report, to provide details whenever the actual stock-flow adjustments deviate from the projections, as was the case in 2015.

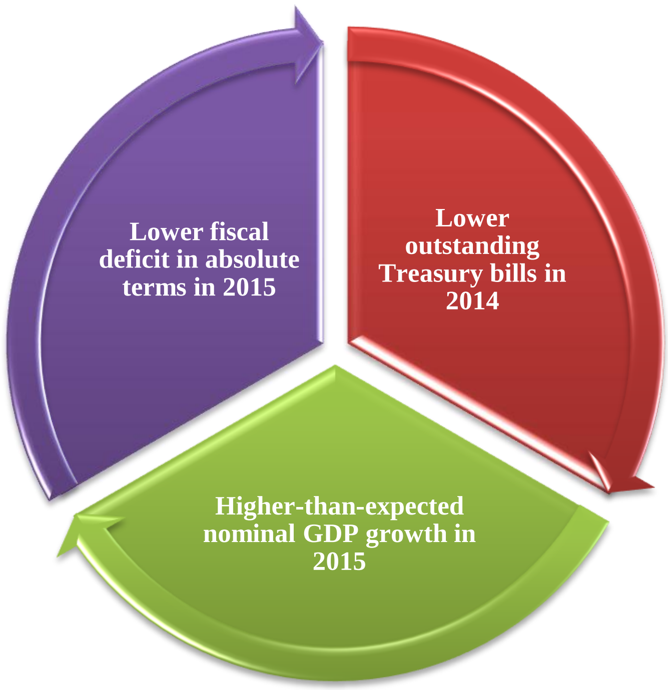
Chart 4: Government debt dynamics




*Source: MFIN*

Besides the nominal GDP growth factor, other two factors contributed to the downward push in the public debt ratio in 2015 (see Diagram 2). The ratio for public debt as at end 2014 was slightly lower than originally estimated, reflecting a lower outstanding level of Treasury bills. This created a favourable base effect which was carried forward onto 2015.

Diagram 2: Main contributors to the lower public debt ratio at the end of 2015




*Source: MFIN*

The MFAC welcomes the reduction in the public debt ratio achieved in 2015. The MFAC also encourages the Government to maintain the momentum towards the MTO of a balanced budget by 2019, which will also help to bring public debt within the 60% threshold within the next few years.[26]

## 7. Conclusion and final recommendations

The MFIN's Annual Report 2015, which was published for the second time, is a useful exercise in promoting greater fiscal transparency and accountability. It provides adequate details and explanations to enable a valid ex-post assessment of the fiscal turnout for the previous year. The MFAC considers the report to meet the requirements prescribed in Article 41 of the FRA.

The MFAC would like to draw attention to the fact that whereas the structural balance pillar and the debt criterion are explicitly referred to in the FRA, through the budgetary rule (Article 8) and the debt rule (Article 9), the SGP specifies another principle, namely the expenditure benchmark, which must be taken into account when assessing adjustment towards the MTO. The MFAC acknowledges that the expenditure benchmark is only indirectly referred to in the FRA (Article 11), specifically in the case that a warning of a significant deviation is issued by the COM on the basis of the expenditure benchmark in terms of Article 6 of Council Regulation (EC) No. 1466/97. Nevertheless, the MFAC considers the evaluation of compliance with the expenditure benchmark of importance and in this respect would welcome the possibility that the MFIN also dedicates a specific section to the analysis of the expenditure benchmark in its Annual Report. This would ensure a more comprehensive ex-post assessment of the conduct of fiscal policy during the previous year in the context of the Government's European commitments, in particular the terms of the SGP.

The MFAC also notes that in the Annual Report the MFIN stated that it "... has taken note of many of the MFAC proposals" and that the " Ministry has also held preliminary discussions with the MFAC to exchange views on these observations and further meetings are envisaged to ensure continued progress".[27] The MFAC looks forward to such meetings which should be very instrumental in enhancing further the open and positive dialogue with the MFIN.

At the same time, the Council invites the MFIN to evaluate the merit of using its Annual Report to make public its views on the various recommendations made by the MFAC throughout the year, also summarised in the MFAC's first Annual Report, as this would strengthen further the institutional dialogue and add more fiscal transparency.[28]

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[26] Article 10(1) of the FRA states that 'the lower limit of the medium-term budgetary objective shall be an annual structural balance of the general government of minus 0.5 per cent of gross domestic product at market prices'.

[27] Source: Malta: Annual Report 2015, page 7.

[28] The recommendations made between January 2015 and January 2016 are explained in Chapter 3 of the MFAC's First Annual Report and Statement of Accounts 2015.

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