Foreword

The security of our collective future is the key objective of this year's Pre-Budget Document. My Government is proposing a programme of action that is meant to thrust our country into its next phase of socio-economic development while nurturing the significant achievements which we managed to achieve through our vision, our creativity, our determination and our hard work.

We are living in a dynamic world where the axis of economic and political power is changing and shifting rapidly. Many countries and their emerging economies have become or are fast becoming key players internationally. Their influence goes beyond their immediate geo-political region while their economic weight is a force to be reckoned with. The internationalisation of capital flows, the onset of cheaper and easier means of communication and the further erosion of trade barriers are proving to be major challenges to many countries worldwide. My Government believes that these challenges need to be met and turned into real opportunities for further economic growth and social development.

It is with this aim in mind that this year's Pre-Budget Document was drawn up. This time last year we carried out a serious evaluation of our collective situation and performance thus far and decided upon a vision and a strategy for the five-year period to 2010. Then we resolved that there is a distinct need to consolidate our people's achievements thus far and to safeguard our collective well-being by investing into our future. As a result we drew up a vision and a strategy for this country; a vision that is founded on a set of core values and a strategy that makes for improved competencies and capacities, higher productivity and a diffused culture of excellence all round.

"Government's vision for Malta is that of a dynamic, high-value-added economy founded on competence, skills and excellence and capable of sustaining a high standard of living for its entire people ..."

Pre Budget Document 2006
– A Better Quality of Life

We firmly believe that this vision can be translated into a programme of action that would assure our continued presence within the international marketplace and thereby assure a sustainable level of socio-economic well-being for ourselves.

Through this year's Pre-Budget Document, we are submitting for our collective consideration a programme of action that would consolidate our collective well-being and secure a better future for our people. We are proposing initiatives that would stimulate economic growth. Initiatives that would improve the business environment in the country and that would therefore facilitate enterprise and attract local and foreign direct investment in key sectors within our economy. We are promoting creativity and excellence in the strong belief that the resourcefulness of our people will once more grasp the significant opportunities being presented by an increasingly open and globalised world economy. We are outlining a programme for increased internal social and economic cohesion in the strong belief that the people of this country have a right to balanced development and equal access to its opportunities and benefits. Most importantly, we are submitting a programme of action that continues to hold people as the real focus of our attention. We are laying out a strategy that would translate into a society whereby each one of us would continue to have an opportunity for personal development and achievement; a society that encourages participation, growth and inclusion.

I would like to extend my appreciation for the commendable work of the Hon. Tonio Fenech, Parliamentary Secretary in the Ministry of Finance, and the pre-budget team, in consolidating and expressing Government's various policies and vision into this Pre-Budget Document for the consideration of the Maltese people.

Lawrence Gonzi
Prime Minister

5 August 2006

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August 2006

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1 Introduction

1.1 Building on our vision

In 2006, Government launched its first Pre-Budget Document *A Better Quality of Life*, that presented a five year vision and strategy for Malta and Gozo, based on our past achievements and the new realities that emanated from our membership into the European Union. The vision of providing a better quality of life for all of us; emphasised the need to further develop our islands' competitiveness and build an economy based on higher value added, founded on a culture of excellence.

The strategy to achieve this vision was based on the integration and sustainability of three important and inter-dependent pillars: strengthening the economy, promoting education and social progress, and sustaining the environment.

Government has sought to initiate last year a process of governance that is enhanced by greater civic participation, public dialogue and consultation. The participation as members of society has generated a wealth of important ideas, suggestions and opportunities for the advancement of our country ranging from suggestions regarding the reconciliation of family and work life to ideas for the transformation of natural energy to the development of our local research potential. While remarkable and encouraging, such feedback makes the diversity of opinions, ideas and desires all the more apparent. In this respect, it is essential to note that this Document does not present a cramming exercise that attempts to recklessly assemble a collage of everyone's pet idea. Rather it presents themes on which to secure the socio-economic environment which is necessary for the realisation of all the good ideas for advancement to become possible.

The outcome of this year's Pre-Budget Document intends providing a clear direction for 2007. Strategic focus will compliment the broader objectives and above all continue breeding a culture of efficiency, accountability and responsible action guided by the awareness of our country's realistic strengths and limitations.

Such culture is already being reflected in the emerging practices towards enhanced project management, implementation and monitoring. Strategic focus will also create an enabling environment for the development of initiatives such as the Better Regulations Unit and the recent development of centralised project monitoring. Developing these practices will continue to ensure that this Government is a Government that delivers.

1.1.1 Securing our future

This year's Pre-Budget Document *Securing Our Future*, seeks to open up for debate a number of specific themes within last year's set three pillars. The themes selected have been thoroughly studied over the past few months with the aim of not only sustaining the momentum and progress already achieved over the past years, but more so to launch new ideas and initiatives.

In order to secure our future we need to take new initiatives founded on the principle of sustainability; a sustainable taxation system to secure sound economic management and well-functioning of public systems; a sustainable environment and energy strategy to secure a cleaner and better environment; to create the right environment for industry to operate and to invest in innovation to secure the creative responses to competition and globalisation; and sustaining our society to secure higher competence and living standards for all of our people.

The following themes will be covered by this year's Document:

- towards a more inclusive and participatory society
- a socio-economic strategy for Gozo;
- incentivising work and growth - a review of the fiscal regime;
- sustaining industry;
- sustaining growth through research and innovation;
- towards sustainable development;
- mainstreaming the EU dimension to the 2007 budget.

1.2 Executive summary

The analysis of the Maltese economy outlines the challenges and achievements of our economy over the past year.

International oil prices remain the main cause for concern for a small open economy like ours, resulting in a higher import bill. However, the local economy still managed to grow by 2.4 per cent in real terms in 2005, a momentum that has been sustained also in the first quarter of this year, with the major sources of growth being investment and private consumption. Investment expenditure has been particularly encouraging over the past three years, increasing by 8.5 per cent in 2005, and almost 15 per cent in the first quarter of 2006. A positive performance has also been recorded with regard to the manufacturing sector mainly as a result of 'new' industries such as the pharmaceutical industry and the manufacture of transport equipment. In terms of exports while the pressures experienced by the semi-conductor industry in 2005 brought about a decline in the exports figure, particularly in the first six months, the pick up in the second half of last year has been sustained in the first quarter of 2006 with a 23 per cent recovery. Tourism outcomes on the other hand did not achieve the desired levels of growth. In 2005 the industry faced a number of challenges emanating from international political instability and increasing competition from emerging new markets.

Government consumption expenditure only increased marginally by 0.6 per cent in real terms in 2005, indicative of the Government's achievements to rain on the fiscal consolidation front. Government's programme of fiscal consolidation is well on track as is evidenced by the decreasing deficit-to-GDP ratio and also in the debt-to-GDP ratio which has started to reflect the declining deficit-to-GDP trend.

In 2006, the Maltese economy is expected to continue registering positive growth rates mainly spurred by further investment, with domestic demand conditions expected to remain buoyant and with exports expected to continue growing in 2006. Tourism trends for 2006 prove to be a major challenge for this year, with possibly declining earnings this year. With the economy is expected to grow once again beyond what was originally forecasted, international oil prices is the main downside risk.

- **Towards a more inclusive and participatory society**
  While economic growth and prosperity are fundamental to a country's general well being, a secure future for all can only be attained through social cohesion

with a society that is both inclusive and participative. Social cohesion is a wide ranging concept not limited to social welfare, but it also encompasses education, employment and the provision of health care. Through this Document Government seeks to propose measures that improve the distribution of social policy towards particular groups with greater needs. To achieve these aims, Government needs to strategically focus and invest in a qualitative and inclusive educational system; continue to address the issues of employability, modernise our welfare systems to ensure equity, adequacy and sustainability of benefits provided, promote gender equality and take active measures to prevent social exclusion. A secure future also requires a healthy population. This Document presents Government's vision and plans for this critical sector, beyond the opening of the Mater Dei Hospital.

- **A socio-economic strategy for Gozo**
  In this year's Pre-Budget Document Gozo has been placed at the heart of Government's priorities by presenting a socio-economic strategy for Gozo. Three fundamental factors namely small size, double insularity and also being on the periphery, are rendering Gozo more vulnerable than Malta to adverse economic events. A holistic view is taken of Gozo's culture, industry and environment as the Document presents the island's strengths and weaknesses, as well as the composition and characteristics of the island's demography and labour force. A sound policy framework for Gozo should be directed towards addressing the particular needs of the island and seek to transform challenges into opportunities. The policy in the Document presents Government's framework for the way forward for the Island. The cornerstones of this framework are the distinctiveness of Gozo, economic efficiency, education, social cohesion and the environment underpinned by sound regional governance with the Ministry for Gozo in the role of key regional coordinator.

- **Incentivising work and growth – a review of the fiscal regime**
  The workings of the Tax Reform Commission have been concluded and Government through this year's Pre-Budget Document is presenting the commissions major finding and recommendations. The Document presents extensively the review carried out, the comparison of our fiscal systems with those of other neighbouring and competing countries and the main findings and recommendations. Some important features emerge from the assessment that has been carried out. The assessment, as directed by Government, had to focus on changes that could instigate further job creation, work attractiveness, further economic growth and increase our competitivity. Any proposed changes have to be congruent with the over-riding objective of maintaining a sustainable deficit below the 3 per cent of GDP limit and not to create any inflationary pressures that could somewhat jeopardise Malta's prospects of adopting the euro in January 2008.

  Some of the more important conclusions that emerge from the assessment carried out include the fact that positively Malta already relies significantly on indirect taxation (45.1 per cent of total tax revenue), when compared to the EU-25 average of 38.2 per cent. It is today recognised that taxation on income inherently creates a disincentive to work. Moreover a shift from direct taxation to indirect taxation will encourage households to save and consequently the potential output of the economy to increase. Also, Malta's taxation on labour is amongst the lowest in the EU at 12.2 per cent of GDP when compared to the EU-25 at 18.5 per cent of GDP. In terms of social security contribution only yield 6.9 per cent of GDP, that is slightly less then half of the EU-25 average of 13 per cent of GDP.

Also a review of our present company taxation system determined that the fundamentals of Malta's company taxation system should be retained as our system profits are only taxed once at the hands of the shareholder, since the tax collected from the company is only provisional and refundable upon distribution of a dividend. However recent developments in the international tax arena and the need to sustain the growth prospects of the financial services industry require some changes to the mechanics of our system. These changes in principle will not affect local residents or businesses but are directed at maintaining our attractiveness as a foreign direct investment destination. A Supplementary Technical Paper is being annexed with this Document to describe in more detail the proposed changes.

Following the workings of the Commission, Government is actively considering a number of measures over the next two to three years, subject to the overall performance of the economy and the room of manoeuvrability that this would allow us to make such changes without jeopardising the medium term sustainability of fiscal consolidation. The measures being considered include a review of the income tax bands, replace the part-time minimum NI contribution with a pro-rata contribution, introduce an energy benefit to provide adequate compensation for low income families, introduce incentives to funded pension schemes, allow spouses to be employed in family self employed businesses, introduce tax rebates for family carers, and reduce airport tax.

However, it needs to be clearly stated that the measures presented cannot all be implemented in the forthcoming budget, but one competing against each other in terms of the priorities that the public consultation process will indicate within the established financial envelope.

- **Sustaining industry and tourism**
  This year's Pre-Budget Document also lays out Government's proposed vision for industry. A number of strategic principles support this vision. Salient among these are the inculcating of the entrepreneurial ethos into the collective Maltese mentality, the positioning of Government as a partner to industry and the strengthening of Malta's advantages when compared to other nations. A vision for Maltese industry must build on these comparative advantages which comprise: the intelligence, versatility and capacity for hard work of the Maltese labour force, the responsive agility to changing circumstances shown by Maltese organisational structures which is facilitated by the Island's compact size, and geopolitical and social stability. A strategy for industry must be conducted on two levels. First, it must address the existing industry base, reinforcing it, through restructuring and other methods, to orientate it towards the manufacture of quality, high value-added products. Second, new investment must be channelled in a consistent manner towards targeted areas. These include identified service sectors – education and health, financial management, back-office operations, maritime support and the creative industries; and various industrial sectors that are already proving their worth particularly the pharmaceutical and hi-tech manufacturing sectors. With regard to tourism, this has been and is an industry that has the potential to give Malta sustained economic growth and good employment opportunities. Planned efforts for this industry include maximising internet facilities for passenger booking, developing products that would enable Malta to be marketed as a high-quality destination and marketing Gozo as a unique-holiday experience.

- **Sustaining growth through research and innovation**
  To sustain high value added industry and thus promote further economic growth this Pre-Budget Document also presents a case for a substantial increase in national focus on R&I in order to establish and sustain the appropriate institutional framework to render

R&I a truly effective platform for Malta's economy. Government's strategy for R&I, is being published alongside this document, setting out a number of proposals which focus on identified platforms of strategic importance including Government's role as facilitator, the MCST role as key enabler of the strategy, as well as the role of educational institutions and government departments and entities. The importance of benchmarking the effectiveness of the strategy is also highlighted in a performance-indicator framework

- **Towards sustainable development**
  Government is committed to the formulation and gradual introduction of a number of action plans linked to environmental priority areas as identified in the *National Strategy for Sustainable Development.* These priorities include; air emissions, air quality, fresh water, sea water, waste, land use and transport. Practices pertaining to sustainable development should be embedded in every policy formulated by Government and not just those relating to the environment. Government intends that this should be so, especially with regard to its energy policy for Malta which straddles the economic, social and environmental spheres. The five areas sustaining this policy are: energy efficiency, reducing reliance on imported fuels, stability in energy supply, a sound distribution system and support of the energy sector in order to render it capable of delivering on its objectives. *A Draft Renewable Energy Policy for Malta* is also being published alongside this Pre-Budget document, to spur further discussion on this fundamental theme

- **Mainstreaming the EU dimension in the 2007 budget**
  The 2007 budget will be the first financial year that will be impact by the 805 million euro funds allocated to Malta under the European Union's Cohesion Policy for 2007 to 2013. The 2007 budget will also be the budget that prospects Malta into the adoption of the euro in 1 January 2008.

Four main national strategic objectives have been established following an extensive consultation process in the formulation and publication of the *National Strategic Reference Framework* document published earlier this year. These are, sustaining a growing knowledge-based economy; improving citizens' quality of life through environmental protection and urban regeneration; investing in human resources; and addressing the regional distinctiveness of Gozo. Funding, projects and initiatives being considered in this Pre-Budget Document compliment the strategic direction agreed upon and is now in the phase of being presented to the EU Commission. The operational programmes for both ERDF and Cohesion Funds and the European Social Fund have now also been published for consultation established priorities and proposed budgetary allocations to the various targeted interventions. Such interventions include investment in and aid to industry, education, research and innovation, tourism, transport, human resource development, access to employment, the environment, energy and urban regeneration.

The adoption of the euro, is not only the next logical step in our integration with the European Union but also and important development in the socio-economic sense. Upon joining the European single currency area, Malta can expect to realise economic gains through the elimination of exchange rate risk and the reduction of external transaction costs. There is a general agreement that the adoption of the euro will lead to considerable economic gains for Malta, and that it will have a permanent, positive impact on our country's economic growth prospects. Thus delaying further makes no sense, as this will only be perceived negatively by international operators who would perceive such a decision as a negative sign on the sustainability and investment attractiveness of our economy.

Conclusion

Together we can make our future! This is our firm belief even though we are working within an international context that has become increasingly volatile and unpredictable.

Our past achievements are a testimony to our resourcefulness and resilience even when faced with adversity. Despite our tendency to rightfully focus on current and future challenges, we should never forget that we have made a success of our small country. A success that is visible and that needs highlighting in order to encourage us to work harder and smarter in order to meet our challenges with courage and increased determination.

On its part Government will continue to do its utmost to prepare the country for a secure and prosperous future. The measures, reforms and projects carried out in the past years have served us well and are a good launching pad for this purpose. The work programme being presented in this Document is meant to take us further down this road and thereby make and secure that future.

Government will continue to do its part in steering the country forward. However, our future depends on our collective contribution and solidarity and not on Government action alone. Our future would also depend on our commitment to one another in creating a society that cares. It is only thus that we can truly shape a harmonious and secure future that would benefit each one of us without overlooking our collective well being.

The Pre-Budget Document is published for the scope of public consultation. The period for public consultation will close on the 30th September 2006; a time span which we trust will allow reasonable time for your evaluation of Government's recommendations and submission of feedback.

Through this consultation Government is inviting everyone, constituted bodies and citizens, to be active participants in securing our country's future. Feedback is to be sent to:

The Hon. Tonio Fenech
Chair
The Budget 2007 Planning Team
Office of the Prime Minister
Valletta CMR 02

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2 An analysis of the Maltese economy

2.1 General overview

The Maltese economy has been undergoing a restructuring process, in part inspired and motivated by an increasingly competitive international environment, brought by the integration of world markets as a result of globalisation. During this restructuring process, which is expected to translate into long-term benefits, the Maltese economy has been subject to external shocks, in particular negative supply shocks in the form of higher oil prices and severe price competition in several industries.

The changes stimulated by these restructuring efforts left their mark on the labour market, where job losses were registered in certain manufacturing industries whilst new job opportunities were created in other industries, especially in the services sector, but also in specific growth manufacturing industries. Moreover, foreign direct investment and capital transfers from abroad played an important part in providing the necessary funds in order to finance the necessary investment, including investment in infrastructure. Another development taking place in the Maltese economy has been the increasing orientation towards service activities and the declining dependence on the public sector.

Furthermore, in recent years, fiscal consolidation has been an important objective in the local economic policy agenda. Whilst this is a necessary condition to ensure a stable macroeconomic framework conducive to economic growth, fiscal consolidation has acted as a drag on short-term economic expansion.

2.2 The international scene

The high degree of openness renders the Maltese economy more vulnerable to economic developments in the international scene. Hence, a review of external economic developments provides an appropriate context for the local economic scene.

Despite higher oil prices, a sustained expansion in the global economy is expected to continue in the coming years, mainly underpinned by strong global industrial production. Indeed, after registering a growth of 4.6 per cent in 2005, economic growth is forecasted to maintain the same rate of growth in 2006 and to moderate slightly to 4.3 per cent in 2007. World trade growth is also expected to increase from 7.3 per cent recorded in 2005 to 8.0 per cent in 2006. In 2007, world trade is forecasted to slow down slightly to 7.5 per cent.

Economic growth in the US and in Asia, excluding Japan, is expected to contribute significantly to the positive outlook for the coming years. Indeed, the US economy which expanded by 3.5 per cent in 2005 is expected to continue growing with the same momentum in the first half of 2006, before cooling down afterwards in response to higher interest rates and a downturn in the property market. Growth in Asia is mainly underpinned by strong growth in China. In fact, for 2005 the Chinese economy is expected to register a growth of 9.9 per cent. Growth is expected to moderate slightly to 9.5 per cent and around 9.0 per cent in 2006 and 2007 respectively, mainly reflecting a decline in export in face of a slight slowdown in the US and a gradual appreciation of the currency. In Japan, growth increased slightly in 2005 to reach 2.7 per cent from the 2.3 per cent recorded in 2004. Growth was mainly driven by private domestic demand, including household consumption and business investment. Growth in Japan is expected to continue with an expansion of 2.8 per cent in 2006 and 2.4 per cent in 2007.

Growth in the EU is forecasted to be 2.3 per cent and 2.2 per cent in 2006 and 2007 respectively from 1.6 per cent registered in 2005. In the euro area, following a growth of 1.3 per cent registered in 2005, real GDP is expected to grow by 2.1 per cent in 2006 and 1.8 per cent in 2007. This expansion will continue to be dependent on strong external demand. On the other hand, household expansion is expected to remain subdued mainly as a result of sluggish performance in labour market and higher oil prices.

Overall, the outlook for the global economy appears balanced. However, uncertainties mainly in the form of rising oil prices could impinge negatively on the world economy. Table 2.1 shows an overview of the current projections in respect of the world economy for the period 2005-2007:

Table 2.1: Key economic indicators (summary projections)

		2005	2006	2007
Real GDP Growth	EU25	1.6	2.3	2.2
	Euro Area	1.3	2.1	1.8
	USA	3.5	3.2	2.7
	Japan	2.7	2.8	2.4
Inflation	EU25	2.2	2.1	2.2
	Euro Area	2.2	2.2	2.2
	USA	3.4	2.9	1.6
	Japan	-0.3	0.7	1.0
Unemployment	EU25	8.7	8.5	8.2
	Euro Area	8.6	8.4	8.2
	USA	5.1	4.8	5.1
	Japan	4.4	4.3	4.3
World Trade Growth		7.3	8.0	7.5

Source: IMF/European Commission, Spring Economic Forecasts, 2006

2.2.1 The cost of energy

- **Developments in international oil prices**
  Oil prices increased sharply in 2005, particularly since May, as a result of tight supply, growing demand (though slower than in 2004), geopolitical concerns, a series of disruptions to production and refining capacities caused by natural disasters and other incidents. After reaching a peak in August, oil prices declined, reflecting a deceleration of oil demand. Brent was priced at $55 per barrel in late November, down from $63 per barrel in late August, when hurricanes provoked serious disruptions in an already tight market.

  Prices bounced back, however, in January 2006 and have fluctuated mostly in the $60–66 range, owing to renewed geopolitical concerns in the Islamic Republic of Iran, Iraq, and Nigeria. These countries, together account for about 11 per cent of total world production, which is well above the current OPEC spare capacity of 2–3 per cent of world production.

  The decline in oil prices during the last quarter of 2005 largely reflects the response of the market to the deceleration in global demand growth. Yet, several factors indicate that prices are expected to remain well above a floor of $50 per barrel over the outlook period. Oil demand is still growing at a significant pace, in spite of the recent moderation, particularly in some developing countries, while existing supply constraints will only ease off gradually. As a result, Brent oil prices will remain robust and are anticipated to increase from an average of $54.1 per barrel estimated for 2005 to $68.9 per barrel in 2006 and $71 per barrel in 2007. This corresponds to an increase in the average annual price of 27.4 per cent in 2006 and of 3.1 per cent in 2007.

- **Economic impact of higher oil prices**
  Important effects of higher oil prices include the impact on inflation and the consequences for GDP growth in individual economies and for the world economy as a whole.

  To date, the impact of higher oil prices on the global economy has been more moderate than generally expected, in part because inflationary expectations have remained well anchored, and the shock has been driven by strong global demand. Looking forward, however, there are reasons for concern. In fact, the full effects of the recent shocks may not yet have been felt, especially if producers and consumers are still treating it as temporary, rather than largely permanent in nature. With excess capacity still very low, the market remains vulnerable to shocks.

  Negative welfare effects from higher costs for producers and consumers have been offset by the continued growth in income. Should the push no longer come from the demand side, but rather from restrictions on the supply side—as was the case with the oil shocks of the 1970s and early 1980s—world output growth could be hurt substantially.

  The Maltese economy is exclusively dependent on oil imports for its energy requirements. An increase in oil prices is associated with a negative impact on real GDP growth, higher inflation and deterioration in the current account deficit primarily as a result of a higher import bill.

Table 2.2: Petroleum Commodity Prices (percentage change on preceding year)

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Fuel products	23.2	47.5	-8.9	-0.3	12.7	30.1	41.6	25.0*	3.0*
of which:									
Crude Petroleum	41.1	59.1	-12.4	0.2	14.8	31.6	42.8	27.4*	3.1*
Crude Petroleum - price per barrel (US dollar)									
Brent	17.9	28.5	25	25	28.8	37.8	54.1	68.9*	71*

* forecasts

Source: European Commission, Spring Economic Forecasts, 2006

2.3 Aggregate demand conditions

The Maltese economy expanded by 2.4 per cent in 2005. Although still below Malta's economic potential as evidenced by a negative output gap, this growth rate represents a recovery following the negative growth rates recorded in 2003 and 2004. On a quarterly basis, following the negative growth registered in the second half of 2004, GDP growth recovered in the first and second quarter of 2005, gathered pace in the third quarter of the year and slowed slightly during the last quarter of 2005. The expansion in the economy continued during the first quarter of 2006, when real GDP growth reached 3.1 per cent.

Domestic demand conditions remained a major contributor to economic growth in the past three years. The major sources of growth were investment and private consumption expenditure. On the other hand, government expenditure reflected the fiscal consolidation process observed in recent years. During the first quarter of 2006, private consumption expenditure together with investment remained important contributors to GDP growth. A more detailed analysis of the sources of growth is shown in Table 2.3.

Table 2.3: Sources of real GDP growth

	2001 (%)	2002 (%)	2003 (%)	2004 (%)	2005 (%)
Growth					
Private Consumption	0.4	-2.2	3.2	0.8	2.2
Government Expenditure	0.6	3.8	3.0	2.3	0.6
Gross Fixed Capital Formation	-14.0	-18.9	28.8	-0.9	8.5
Exports of Goods and Services	-2.9	6.1	-2.4	0.3	-6.2
Imports of Goods and Services	-9.0	-1.6	6.2	2.2	-1.0
Contributors to GDP Growth					
Private Consumption	0.3	-1.4	2.0	0.5	1.5
Government Expenditure	0.1	0.7	0.6	0.5	0.1
Gross Fixed Capital Formation	-3.1	-3.6	4.3	-0.2	1.7
Stock Building	-4.3	-0.9	-1.7	0.6	3.9
Exports of Goods and Services	-2.6	5.4	-2.2	0.3	-5.8
Imports of Goods and Services	-9.2	-1.5	5.6	2.2	-1.0
GDP Growth (real)	-0.4	1.7	-2.6	-0.5	2.4

Source: National Statistics Office

2.3.1 Private consumption

Private consumption in 2005 increased by 2.2 per cent in real terms; underpinned mainly by strong growth rates in financial services, furnishings and household equipment. The growth rate in 2005 followed a growth rate of 3.2 per cent and 0.8 per cent in 2003 and 2004 respectively. These growth rates were recorded following a negative growth of 2.2 per cent in 2002. The fluctuations in private consumption recorded in the last years cannot be totally attributed to changes in prices, disposable income and interest rates. Indeed the positive growth rate in private consumption, recorded in the last two years, does not reflect developments in real compensation of employees per head in 2004 and 2005 and interest rates in 2005. This suggests that other factors may have affected consumption patterns in the last few years.

The availability of credit appears to be an increasingly important variable affecting consumption patterns. The increase in consumer credit, particularly in 2004, may have partly resulted in the higher consumer expenditure in financial intermediation, furnishings and household equipment. However, the major increase in credit was registered in loans for house purchases. Therefore, higher demand for housing investment could also have exerted an indirect effect on demand for household furnishings and appliances. Thus, one cannot exclude the possibility that in general improved credit facilities could partly explain the increase in private consumption expenditure in real terms. Wealth effects, primarily arising from higher prices in the stock market and in the housing sector, could also be influencing private consumption expenditure in the last few years.

2.3.2 Investment

A particularly positive development in the Maltese economy is that for the last three years most of the domestic demand was driven by investment expenditure. Chart 2.1 shows the ratio of Investment in real GDP. It is notable that the ratio has increased from 18.8 per cent of GDP in 2001 to 21.0 per cent of GDP in 2005, almost reaching the level registered in 2000. If one excludes 2002, which was characterized by one-off transactions related to the sale of aircraft, an increasing trend in investment can be discerned, particularly in the last three years.

In real terms, investment registered an increase of 8.5 per cent in 2005. In the first quarter of 2006, investment expenditure increased further by almost 15 per cent compared to the comparable quarter of 2005. In 2003 and 2004, the private sector was the main source of investment expenditure while in 2005 Government was the main source of growth in domestic demand. Gross fixed capital formation increased by 10.3 per cent in nominal terms during 2005, with Government contributing to around 57 per cent of this growth.

Cahrt 2.1: Share of investment in real GDP

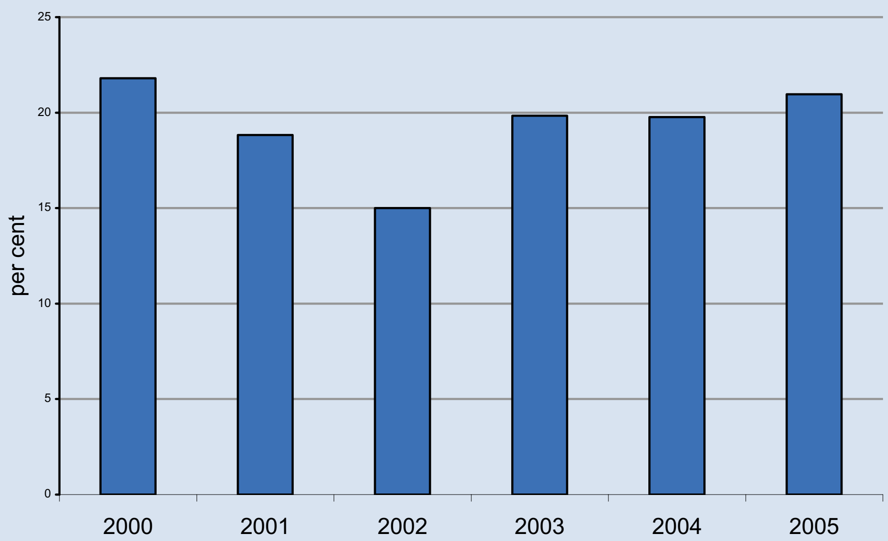


Chart 2.2: Sources of growth in Government Investment Expenditure during 2005

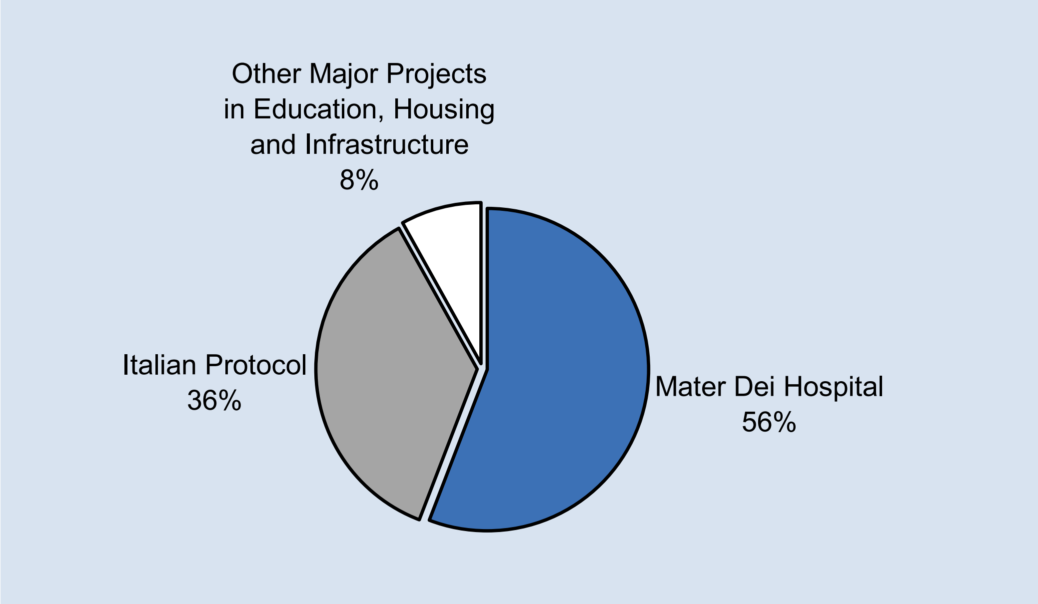


Table 2.4: Sources of growth in Nominal Investment Expenditure

	2001 (%)	2002 (%)	2003 (%)	2004 (%)	2005 (%)
Equipment	-19.9	-16.5	27.7	1.0	1.5
Housing Construction	4.4	1.6	2.0	0.8	1.6
Other Construction	3.5	-0.7	-0.2	0.1	6.4
Other	1.1	-0.1	0.0	-1.8	0.9
Total Nominal Investment Growth	-10.9	-15.8	29.5	0.0	10.3
Government	-1.5	4.7	4.9	-3.1	5.9
Private	-9.4	-20.5	24.5	3.2	4.4
Total Nominal Investment Growth	-10.9	-15.8	29.5	0.0	10.3

Source: National Statistics Office

Chart 2.2 provides a breakdown of the major sources of the increase in Government capital expenditure as recorded in 2005. The estimates, which do not correspond to national accounts data for Government Gross Fixed Capital Formation, were obtained from the Ministry of Finance. Expenditure on the Mater Dei Hospital which represented around one third of Government capital outlays in 2005, contributed to an estimated 56 per cent of the nominal growth in investment expenditure by Government. Projects financed from the 5th Italian Protocol on the roads infrastructure contributed to a further 36 per cent to nominal growth in capital expenditure by Government. The remaining growth was due to a number of projects in education, housing, roads and infrastructure. Included in the latter category are the EU Structural and Cohesion Funds which in 2005 represented around 8 per cent of total outlays by Government on Capital Expenditure.

Growth in private investment expenditure continued in 2005. The contribution to growth of investment in new equipment stood at 1.5 per cent, while investment in housing construction contributed to 1.6 per cent to the overall growth rate in investment expenditure. Table 2.4 provides a breakdown of the major sources of growth in nominal investment expenditure.

2.3.3 Government consumption expenditure

Nominally, government consumption expenditure for 2005 increased by 2.3 per cent. However, in real terms it increased marginally by 0.6 per cent. This indicates that most of the increase in government consumption was due to higher prices. Indeed, despite this increase in government consumption, the ratio of nominal government consumption declined from 22.5 per cent in 2004 to 22.0 per cent in 2005. This is indicative of Government's efforts at fiscal consolidation from the expenditure side.

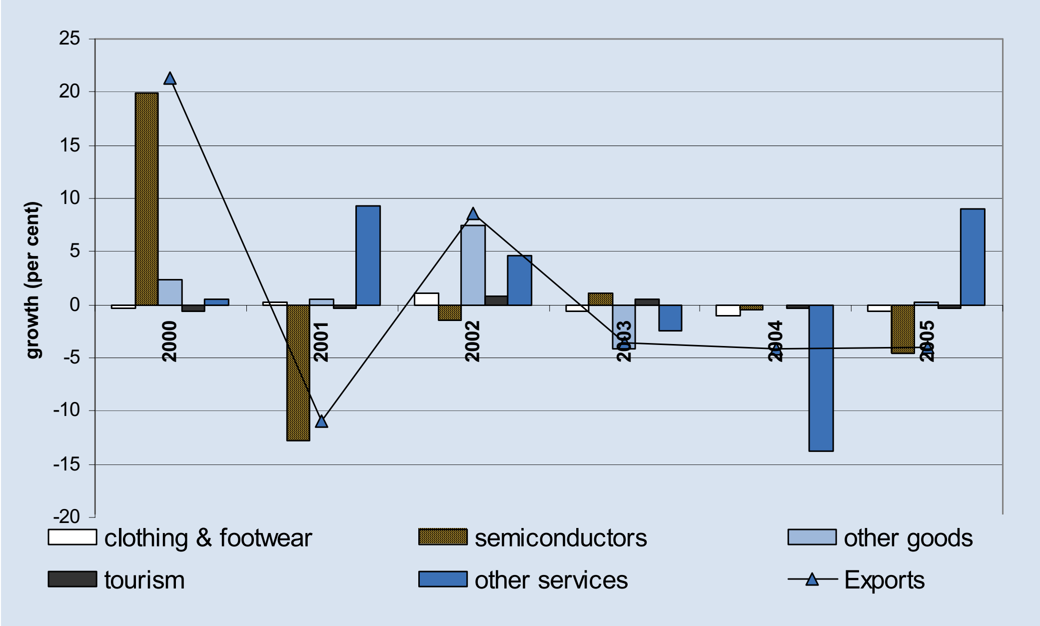
Table 2.5 gives a breakdown of recurrent expenditure. Lower costs on operations and maintenance and a lower contribution to government entities contributed to the decline in government expenditure. Meanwhile, personal emoluments increased marginally by Lm0.3 million. The ratio to GDP at market prices declined in all categories excluding programmes and initiatives. This implies that the marginal growth in personal emoluments did not exceed the rate of economic growth. Given the rate of inflation prevailing in 2005, personal emoluments have probably registered a decline in real terms. This is in line with reductions in the labour complement of government departments reflecting Government's policy to restrict employment in non-essential categories of employment. This confirms further that, when one excludes programmes and initiatives, fiscal consolidation in 2005 has partly occurred from the expenditure side.

Table 2.5: Breakdown of government recurrent expenditure

		2002	2003	2004	2005
Government Recurrent Expenditure (Lm million)	**Personal Emoluments**	196.5	196.0	201.0	201.3
	Operations and Maintenance	43.2	45.5	55.9	35.6
	Special Expenditure	0.6	0.6	0.7	0.6
	Programmes and Initiatives	336.6	359.8	396.5	451.5
	Contribution to Government Entities	69.1	75.8	78.7	76.4
	GDP at Current Market Prices	**1,821.2**	**1,845.1**	**1,847.4**	**1,933.2**
Ratio to GDP	Personal Emoluments	10.8	10.6	10.9	10.4
	Operations and Maintenance	2.4	2.5	3.0	1.8
	Special Expenditure	0.0	0.0	0.0	0.0
	Programmes and Initiatives	18.5	19.5	21.5	23.4
	Contribution to Government Entities	3.8	4.1	4.3	4.0

Source: Ministry of Finance

Chart 2.3: Contributors to growth in exports of goods and services



2.3.4 The external balance

The Maltese economy is characterised by a high degree of openness. The lack of available resources implies that significant leakages in the form of imports of goods and services are likely to occur. This means that while an increase in aggregate demand generally has a positive initial impact on GDP growth, its effect is generally mitigated by higher leakages in the form of imports, thus reducing the initial positive impact on GDP growth.

Exports

The slow growth in foreign demand and developments in the semiconductors industry, impinged negatively on the exporting sectors of the Maltese economy in the first six months of 2005. This was reflected in a decline in exports in 2005. As can be seen from Chart 2.3, the decline in exports was primarily the result of lower exports of semiconductors and lower exports of clothing and footwear.

Semiconductors

The importance of exports of machinery and transport equipment is confirmed by the fact that nearly 30 per cent of total exports of goods and services are machinery and transport equipment. Moreover, most of the exports of machinery and transport equipment are made up of semiconductors. Thus, the developments in this sector have strong ramifications on total exports. In view of this a major international company operating in this sector plays a determining part in the performance in exports. Indeed, the significant decline in exports registered in the first half of 2005 can be primarily attributed to the restructuring exercise undertaken in this firm as a result of changing international scenario and in view of internationally declining profitability levels. It is notable that this sector has recorded a drop in exports in every year since 2001 except in 2003. In 2005, exports of electrical machinery and equipment declined by around Lm65 million or 13 per cent. Nevertheless, it is notable that data for the second half of 2005 and the first quarter of 2006 indicate a recovery in this sector, with a registered growth of 23 per cent.

Tourism

Another important sector for the Maltese economy which contributes to around 20 per cent of total exports of goods and services is tourism. In 2005, the tourism industry faced a number of challenges originating mainly from geopolitical developments that characterised the international environment, as well an adverse situation in a number of major tourist markets. In addition, the Maltese tourist industry continued to face increasing competition both from traditional competitors and new emerging ones. Despite of this, total tourist departures in 2005 amounted to 1,170,610 representing an increase of 1.1 per cent over the previous year. On the other hand, data for the first quarter show a decline of 3.9 per cent in tourist departures.

Looking at the quarterly distribution of tourist departures in Table 2.6, the high seasonality prevailing in this industry is evident. This strong seasonal nature poses particular difficulties in the form of pressures on the infrastructure in peak seasons, hotel occupancy, as well as on the labour market.

In 2005, gross foreign exchange earnings amounted to Lm263.3 million, a decrease of 1.8 per cent over 2004. Per capita earnings declined to Lm224.9 from a previous level of Lm231.8, as presented in Table 2.7. Changes in the number of tourist and earnings cannot be duly explained by exchange rate movements. During this period, the Maltese lira remained relatively stable against the euro depreciated against the US dollar and appreciated against the Sterling in the second half of 2005.

Recent developments in the tourism industry reflect the increasingly popularity among tourists of short breaks which outpaced the growth in outbound travel. In fact, in the last years, growth rates in tourist departures on an international level have tended to outpace nights spent. As a result, total nights spent declined even though tourist departures increased, resulting in lower tourism earnings.

An important development in the tourism sector is the growing importance of cruise passengers. In 2005, cruise passenger arrivals increased by 9.7 per cent over the previous year, mainly attributable to an increase in the number of cruise ships.

Table 2.6: Quarterly distribution of tourist departures[2]

		2003	2004	2005	2006
	Q1	171,919	166,393	168,795	162,164
	Q2	306,602	312,447	314,769	-
	Q3	420,626	440,888	447,649	-
	Q4	219,087	237,956	239,399	-
	Total	**1,118,234**	**1,157,684**	**1,170,610**	**-**
Share (per cent)	Q1	15.4	14.4	14.4	
	Q2	27.4	27.0	26.9	
	Q3	37.6	38.1	38.2	
	Q4	19.6	20.6	20.5	

Source: National Statistics Office

[2] Until March 2004, data for sea arrivals taken from embarkation cards. Thereafter, data for sea departures taken from Inbound Tourism Survey

Table 2.7: Earnings from tourism

	2003	2004	2005
Gross Foreign Exchange Earnings (Lm million)	272.2	268.0	263.3
% change	3.3	-1.5	-1.8
Gross Tourism Earnings per capita	243.4	231.8	224.9

Source: National Statistics Office

The Maltese tourism industry is performing in a highly competitive market, with Asia, the Pacific and the Americas experiencing sustained growth on account of cheaper long-haul travel. Furthermore, mass-market destinations such as Turkey, Egypt, Tunisia and Morocco are gaining market share, in most cases because they are cheaper in price. New Eastern European destinations such as Croatia, Bulgaria, Romania, Montenegro, and Slovenia are also gaining popularity, again competing primarily on price. These destinations are putting pressure not only on Malta but also on other traditional Mediterranean destinations such as Cyprus, Greece and Spain as well as other European markets such Portugal, France and Austria. Moreover, recent market trends indicate a preference for shorter and more frequent trips.

Energy prices are another issue that is impacting upon tourism. Nevertheless, due to high competition in their sector, airlines have refrained over the last few months from passing on fuel energy price rises to consumers. In fact, notwithstanding the widespread application of airline fuel surcharges, aggressive competition has driven real-price reductions in air transport in 2005.

Imports

Imports of goods and services during the last five years were quite volatile, primarily reflecting developments in private consumption, investment expenditure and exports of goods and services. In 2005, imports of goods and services recorded an increase of 2.4 per cent in nominal terms. In real terms, imports declined suggesting that the higher import bill occurred because of higher prices, particularly oil prices. Indeed, as indicated in Chart 2.4, the growth in imports of goods and services in 2005 mainly reflected the higher fuel import bill related to the significant increase in international oil prices. Imports of consumer goods continued to grow, and increased further by 4 per cent in 2005. An increase of around 6 per cent in imports of services was also recorded during 2005. Meanwhile, imports of industrial supplies declined by around 5 per cent in 2005, reflecting subdued export activity. In addition, despite higher investment activity in 2005, imports of capital goods registered a decline of around 8 per cent.

Chart 2.4: Contributors to growth in imports of goods and services

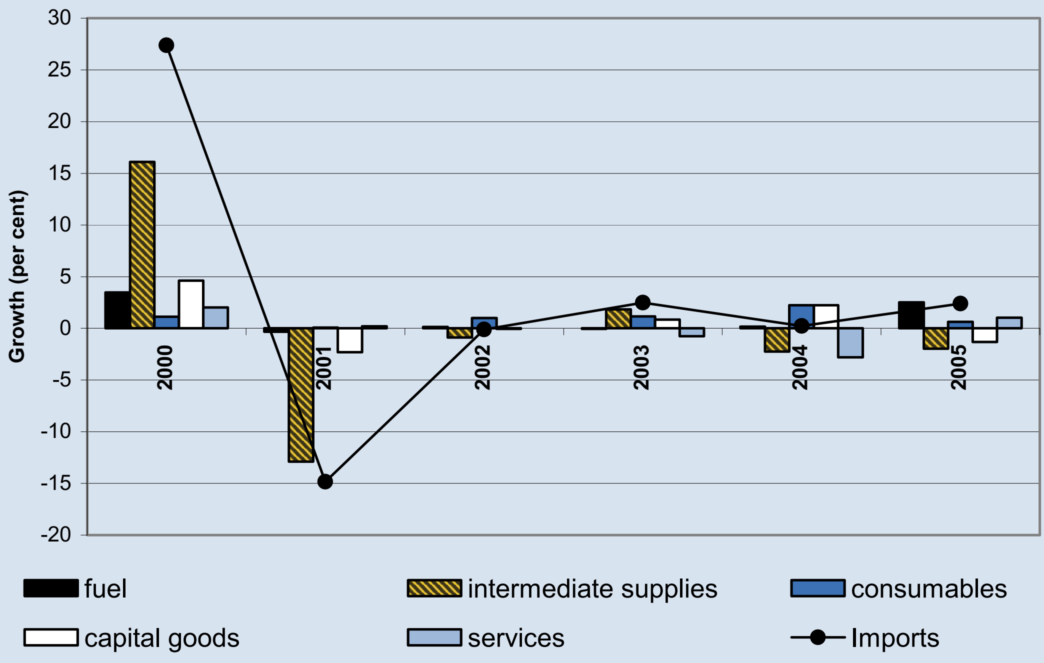
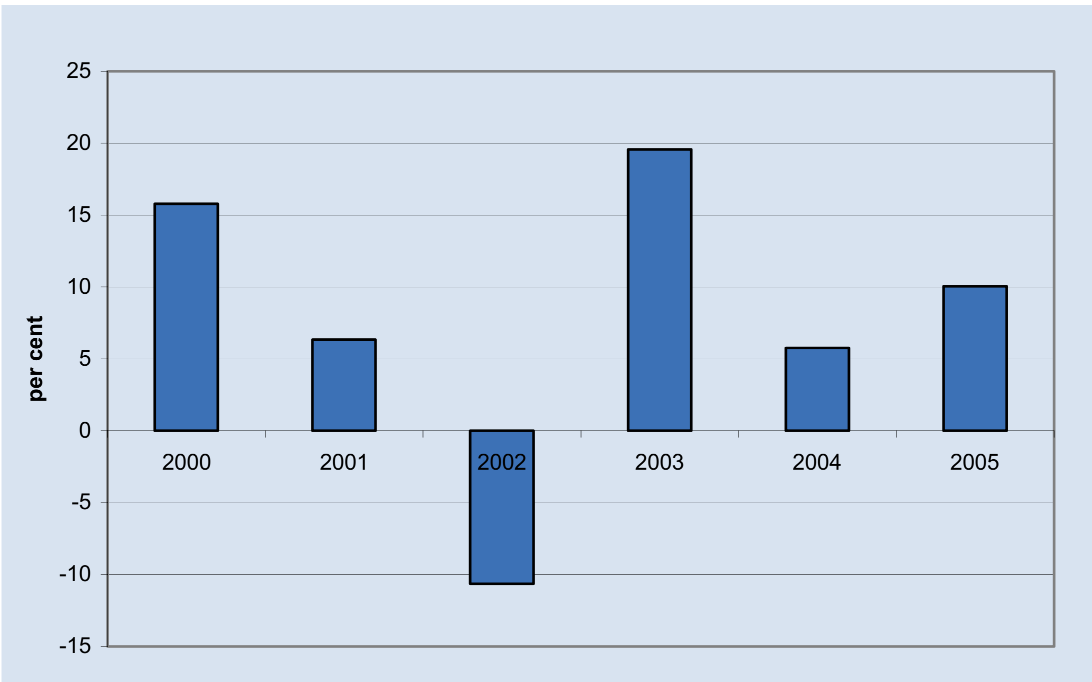


Chart 2.5: Current account deficit as a per cent of GDP

Chart 2.6: Ratio of FDI to nominal GDP



2.3.5 The current account

The current account balance deteriorated in 2005, as a result of a significant decline in exports of electrical machinery and an increase in imports of fuel. The services account also deteriorated primarily as a result of lower tourist earnings, even though this was partly compensated for by higher net receipts from transport and other services. In addition, a significant increase in earnings of foreign owned companies resulted in a significant outflow of funds abroad, representing around 15 per cent of the deterioration in the current account. It is notable that this increase in earnings was not re-invested in the Maltese economy in 2005 but distributed abroad to foreign investors. As a result, these funds were not used to finance the current account deficit. The deterioration in the income account was compensated by a significant net inflow of current transfers.

As illustrated in Chart 2.5, the current account has been in deficit in the recent years excluding 2002 on account of an exceptional export item of around Lm50 million. In addition, a notable deterioration in the last three years is evident, with the current account deficit reaching 11.0 per cent of GDP in 2005.

During the first quarter of 2006, the current account deficit stood at Lm69.5 million, from Lm61.4 million in the corresponding 2005 period. This marginal deterioration primarily reflects a higher deficit in the goods account. Although exports increased significantly imports rose by a larger margin, mainly reflecting imports of industrial supplies and capital goods.

2.3.6 Recent developments in the Balance of Payments

The positive balance on the services account improved marginally, owing to higher earnings from other services, particularly in financial services, computer services, other business services, and personal, cultural and recreational services. Higher exports of such services are not only indicative of the restructuring of the economy towards services but also of the ability of the economy to tap foreign markets. In spite of the decline of 2.5 per cent in tourism earnings, the net balance in the travel account improved marginally, primarily as a result of lower expenditure by Maltese tourists abroad. Meanwhile, the net receipts on transport services declined marginally.

The current account deficit of Lm69.5 million registered in the first quarter of 2006 was entirely financed by net foreign direct investment inflows of Lm65.8 million and capital inflows of Lm11.1 million. Foreign direct investment in Malta provides an important source of funds for investment in the Maltese economy, particularly in the context of declining national savings. It also allows technology transfer from abroad, thus improving Malta's overall competitiveness and long-term potential. In this regard, FDI is an important source of restructuring in the Maltese economy. Meanwhile, capital transfers are expected to become increasingly important in the future as the amount of structural funds from the EU materialises.

As shown in Chart 2.6, the ratio of FDI inflows to GDP has generally exceeded 5 per cent of GDP. In 2005, FDI inflows represented 10 per cent of GDP. The level of FDI in the Maltese economy compares favourably with levels in a number of EU member states, including the 10 newly acceded Member States.

Nevertheless, net portfolio investment outflows inclusive of errors and omissions were not entirely financed by net other investment inflows. Consequently, reserve assets declined by Lm55.8 million during the first quarter of 2006. Recent developments in the Balance of Payments are illustrated in Table 2.8.

Table 2.8: An analysis of recent developments in the balance of payments – Lm million

	2004	2005	2005 Q1	2006 Q1
Total Goods Imports	1,247.6	1,268.3	281.2	325.3
Imports of Goods (Trade Statistics)	1,315.4	1,316.3	292.0	326.1
Consumer Goods	341.5	355.2	76.1	82.9
Industrial Supplies	625.2	592.3	139.6	150.3
Capital Goods	241.6	226.0	50.5	63.9
Fuels and Lubricants	107.1	142.8	25.8	29.0
Other	-67.8	-48.0	-10.8	-0.8
Total Goods Exports	920.4	850.6	193.5	225.2
Exports of Goods (Trade Statistics)	905.4	820.7	186.5	216.7
Other	15.0	29.9	7.0	8.5
Imports of Services	281.8	297.7	65.5	65.8
Transport	99.6	100.2	22.5	19.9
Travel	88.0	92.9	19.9	17.7
Other	94.2	104.6	23.2	28.2
Exports of Services	480.8	495.2	84.9	89.1
Transport	120.7	125.8	29.6	23.8
Travel	268.0	263.3	33.4	32.6
Other	92.1	106.1	21.9	32.7
Net Balance on Goods	-327.2	-417.7	-87.6	-100.2
Net Balance on Services	198.9	197.5	19.3	23.3
Net Income	8.4	-2.8	11.9	-5.6
Net Transfers	-20.2	10.0	-5.0	13.0
Current Account Deficit	**-140.1**	**-213.0**	**-61.4**	**-69.5**
Financing of the Current Account				
Net Capital Transfers	28.8	62.4	16.8	11.1
Foreign Direct Investment Abroad	0.1	9.0	13.6	0.2
Foreign Direct Investment in Malta	106.3	194.2	21.4	65.5
Portfolio Investment Net Assets	-574.5	-1,023.0	-110.8	-140.7
Portfolio Investment Liabilities	-0.8	2.4	1.6	0.0
Financial Derivatives Assets	-253.7	-400.2	-24.4	-239.7
Financial Derivatives Liabilities	254.6	384.6	17.3	246.4
Other Investment Assets	-365.7	-1,086.1	-11.7	-499.3
Other Investment Liabilities	834.7	2,094.0	134.0	608.1
Errors and Omissions	40.9	56.3	-31.8	-38.0
Reserves	69.3	-80.6	35.4	55.8

Source: National Statistics Office

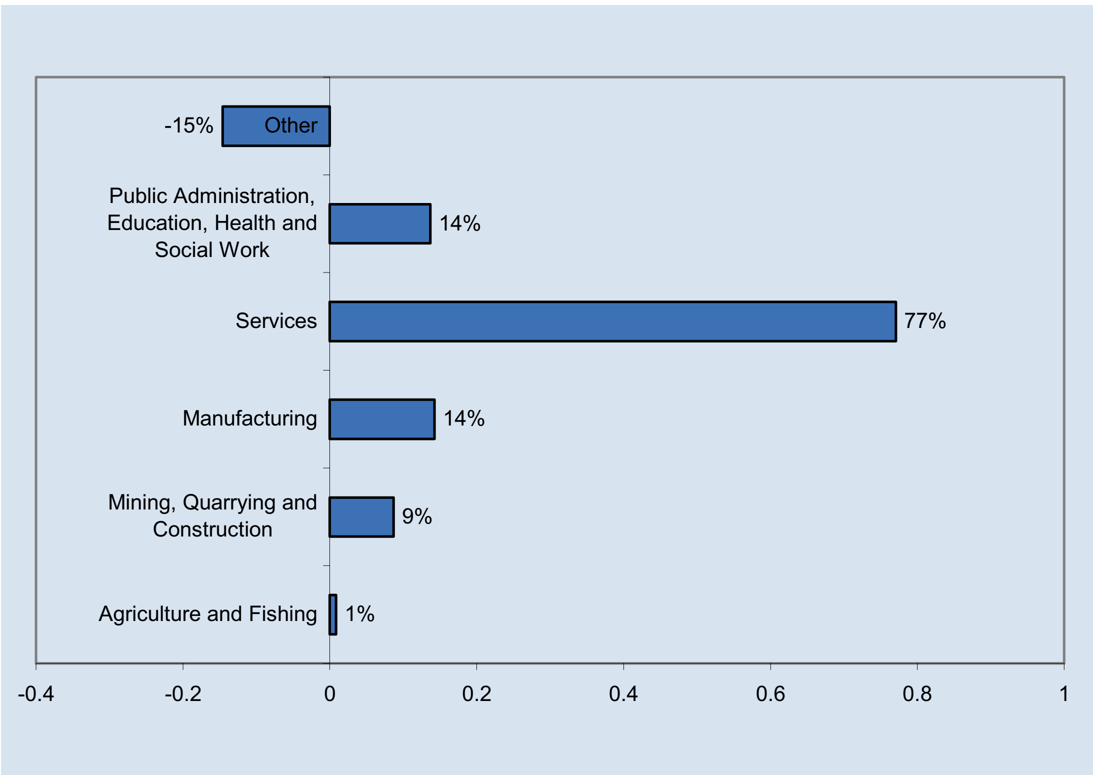
2.4 Analysis of gross value added by sector

From the production approach, the nominal rate of growth in GDP of 4.6 per cent recorded during 2005 is mainly attributable to an overall increase in activity, particularly in the services sector. Total gross value added increased by 3.8 per cent. As shown in Chart 2.7, services were the main contributor to growth in gross value added, followed remotely by manufacturing, and mining, quarrying and construction. This reflects the reorganization of the Maltese economy towards the services sector, the restructuring in the manufacturing sector, and the investment in housing and infrastructure that is translating into higher value added in construction.

Growth in the services sector was mainly underpinned by growth in the financial services sector inclusive of insurance, whilst increases were also registered by transport, storage and communications services. The wholesale and retail sector also remained buoyant in 2005, with gross value added increasing.

Value added in manufacturing is also showing positive signs of recovery, mainly on account of a positive performance in new-growth industries such as pharmaceuticals and the manufacturing of other transport equipment which includes manufacture of aircraft parts. These gains in gross value added were partly offset by declines in value added in the communications equipment sector (which includes semiconductors), and a similar decline in value added of the water, gas and electricity sector. Major declines were also recorded by the textiles and wearing apparel industry and the furniture and other manufacturing industry. Negative terms of trade shocks could be contributing to this performance.

Chart 2.7: Contributors to growth in gross value added in 2005



2.5 The labour market

Table 2.9: Labour Market Indicators

	December					
	2000	2001	2002	2003	2004	2005
Labour Supply	143,947	145,095	144,981	144,930	145,695	145,316
Employed	136,759	137,662	137,465	136,755	137,592	137,937
Direct Production	46,570	46,774	45,745	43,223	42,470	41,586
Market Services	88,983	89,712	90,646	92,552	94,196	95,783
Temporary Employed	1,206	1,176	1,074	980	926	568
Unemployed (part I & part II)	7,188	7,433	7,516	8,175	8,103	7,379
Unemployment Rate	5.0	5.1	5.2	5.6	5.6	5.1

Source: National Statistics Office, ETC

The Employment and Training Corporation (ETC) records for December 2005 indicate a decline of 0.3 per cent, or 379 persons, in labour supply over the same month of 2004. On the other hand, the number of gainfully occupied persons increased by 345 or 0.3 per cent. The decrease in the labour supply reflects a decrease in the number of persons registering for unemployment that exceeded the increase in the gainfully occupied population. Details are provided in Table 2.9.

Private sector employment (exclusive of temporary employment) increased by 1,486 over the twelve months to December 2005, underpinned by the expansion of employment and self employment of 2,010 in private market services. This increase mainly reflects the expansion recorded in other business activities, hotels and restaurants, other service activities, and wholesale trade and commission trade (except of motor vehicles and motorcycles). However, this positive development was partly offset by a contraction in employment in direct production which declined by 524 persons, reflecting in part reductions recorded in the manufacturing of wearing apparel and leather goods, manufacture of textiles, tanning and dressing of leather, manufacture of rubber and plastic products. Overall, developments in employment reflect the trend towards marker services activities.

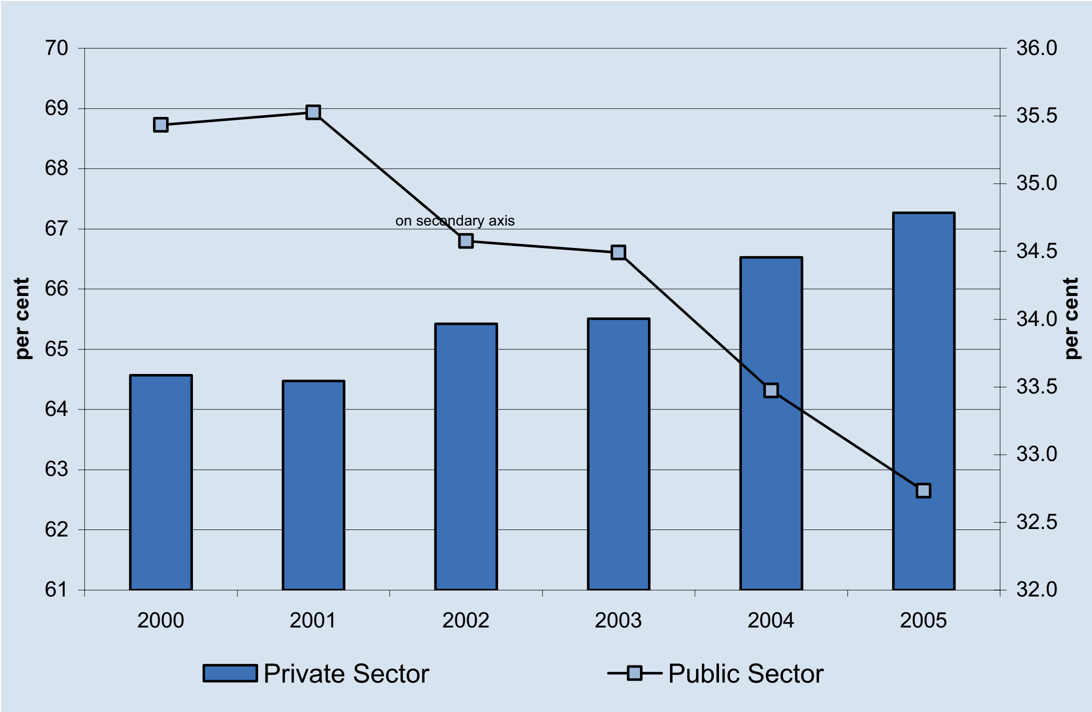
Public sector employment (exclusive of temporary employment) declined by 783 during the period under review. This decrease was driven mainly by reductions in the labour complement of government departments reflecting Government's policy to restrict employment in non-essential categories of employment.

Over the five-year period to December 2005, the labour supply rose by 1,369 or 1.0 per cent to 145,316. This rise reflects the developments in the gainfully occupied population and registered unemployed during the same period.

Another interesting feature is the relative shares of the private and public sector in the gainfully occupied population over the period December 2000-December 2005, illustrated in Chart 2.8. The share of the private sector in the gainfully occupied population was clearly on a rising trend, and stood at 67.3 per cent during the end of December 2005.

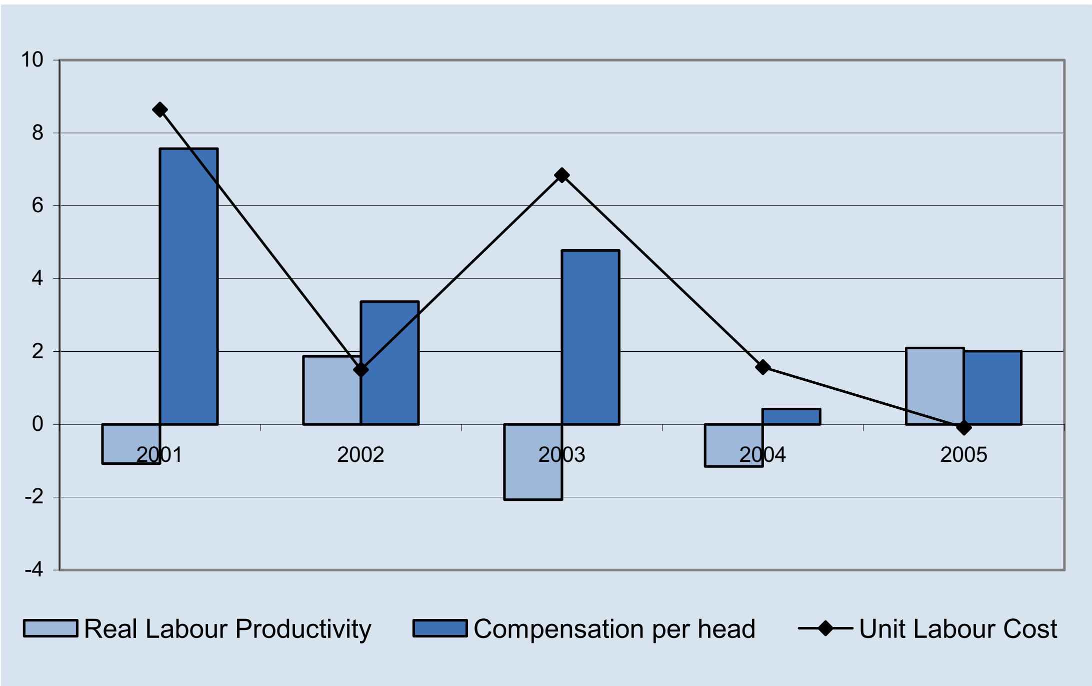
Thus, on the basis of the indicators outlined above one notes that the labour market in Malta displayed a degree of resilience during 2005 as evidenced by rate of increase in employment. The trends in employment are also in line with the restructuring of the Maltese economy which is today more service oriented and less dependent on the public sector.

Chart 2.8: Gainfully occupied (exclusive of temporary employment)



Source: National Statistics Office

Chart 2.9: Nominal unit labour costs



Source: National Statistics Office

The Employment and Training Corporation (ETC) and the Labour Force Survey (LFS) are both sources of labour market data yet they have different characteristics. The database held by the ETC is an administrative database, i.e. it holds records for all those persons who are registered as gainfully occupied and conversely, for all those persons who are registered as unemployed.

The LFS is, as its name shows, an enquiry-based exercise which is carried out among persons aged 15-65 years including those who may still be in education and those who may wish to work but are unable to for one reason or another.

The Labour Force Survey (LFS) data for the period October-December 2005 shows that the labour force stood at 159,986, of which 148,229 were employed and the remaining 11,757 were unemployed. Compared with the same quarter of 2004, the labour force increased marginally by 0.5 per cent or 848 persons, mainly due to an increase in the number of employed persons (+127) and an increase in those looking for work (+721). This increase in the number of persons looking for work resulted in a rise in the rate of unemployment.

Over the five-year period to October-December 2005, the labour supply rose by 4,812 or 3.1 per cent to 159,986. The increase in labour supply was more pronounced in the year to October-December 2002 as between 2002 and 2005 the labour supply was marked by a degree of stability with the main changes arising from the movement of persons into and out of employment.

The employment rate during October-December 2005 stood at 53.7 per cent, unchanged from the rate recorded a year earlier. The total employment rate was relatively stable in 2005. It stood 0.5 percentage points lower than the rate recorded in December 2000. The employment rate for males stood at 74.1 per cent during the fourth quarter of 2005, 1.0 percentage points lower than December 2000. Over the period 2000 to 2005 the female employment rate declined by 0.3 percentage points to 32.8 per cent till the fourth quarter of 2005.

The activity rate declined by 0.6 percentage points to 57.7 per cent during the 12 months to the fourth quarter of 2005. During the fourth quarter of 2005 the total activity rate decline by 0.3 percentage points when compared to December 2000. The male activity rate stood at 77.9 per cent during the last quarter of 2005. Over the five-year period till 2005, the male activity rate declined by 2.9 percentage points. On the other hand, the female activity rate stood at 37.0 per cent. During the five-year period till the fourth quarter of 2005, the female activity rate rose by 2.0 percentage points.

The trends recorded during recent years indicate that the rise in the activity rate for females compensated for a decline in the rate for males; however the employment rate for both males and females suffered decreases during the same period. This was translated into a higher total unemployment rate, especially for females. Increases in female employment are welcome in view of the Lisbon targets in this area. However, given that lower female employment levels in Malta are in part compensated by significantly higher male employment levels, higher female employment levels shall be sought whilst ensuring that the high levels of employment among males are maintained.

2.6 Unit labour costs

ULC give an indication of the extent to which growth in wages exceed or otherwise the developments in real labour productivity over a period of time. An increase in the unit labour costs represents a supply-side shock to the economy possibly with negative effects on competitiveness which may persist for a number of years.

As shown in Chart 2.9 growth in nominal unit labour costs remained positive over the period 2001-2004. ULC increased by around 9.0 per cent in 2001 and 6.8 per cent in 2003, reflecting strong increases in compensation per head that were exacerbated by declines in real labour productivity. One notes that the ULC performance tends to be sensitive to payroll increases in the public sector, as happened in 2001 and 2003 upon the signing of the then new collective agreement for the Civil Service. It is also sensitive to general macroeconomic developments that tend to be reflected in labour productivity.

In 2004, the decline in labour productivity remained the major contributor to the increase of 1.6 per cent in unit labour costs. In 2005, the economic recovery translated into productivity gains of around 2.1 per cent. These exceeded marginally the nominal increase in compensation per head. As a result, a marginal improvement in nominal unit labour costs was registered.

2.7 Prices

In the last few years, the percentage changes in the 12-month moving average for HICP index show that the inflation rate has been following a downward trend. Chart 2.10 illustrates developments since 1997, when the inflation rate stood at 3.9 per cent. By 2003, the HICP inflation rate stood at its lowest level in the last nine years, measuring 1.9 per cent. It is interesting to note that in the period 1999 to 2003, the HICP inflation rate was generally below trend. However, in 2004, HICP inflation edged up to 2.7 per cent. Last year, the corresponding inflation rate stood at 2.5 per cent.

Malta's 12-month moving inflation rate stood at 2.6 per cent in March 2006, practically unchanged from the previous two months, but marginally lower compared to the level recorded in the same period of last year. During the observed period, the HICP inflation rate was attributable to a general increase in all sub-indices in particular the housing, water, electricity, gas and other fuels sub-index (0.73 per cent), transport sub-index (0.58 per cent), food and non-alcoholic beverages sub-index (0.29 per cent) and furnishing, household equipment sub-index (0.23 per cent).

A deeper analysis at a more disaggregated level, indicates that nearly 70 per cent of total inflation registered in March 2006 originated from 9 products. In relation to the international increase in oil prices, higher prices for fuel and lubricants for personal transport equipment, electricity, water supply and gas contributed to around 38 per cent of HICP inflation. A significant contribution to the rise in prices was also attributed to higher prices related to the maintenance and repair of dwellings and to household appliances. These are probably related to excess demand, directly or indirectly related to the level of activity in the property market. Other products that increased in price were passenger transport by road (0.09 percentage points). Moreover, products classified under the various headings of meat, and vegetables, each contributed between 0.7 and 0.8 percentage points to total inflation in March 2006. The main products contributing to March 2006 inflation are shown in Table 2.10.

On the other hand products that registered a decrease in prices, thus exerted downward pressures on the HICP were purchase of vehicles (-0.08), garments (-0.04), information processing equipment (-0.02), fish and seafood (-0.02), equipment for the reception, recording and reproduction of sound and pictures (-0.02), passenger transport by air (-0.01), and gardens, plants and flowers (-0.01).

Chart 2.10: HICP inflation rate

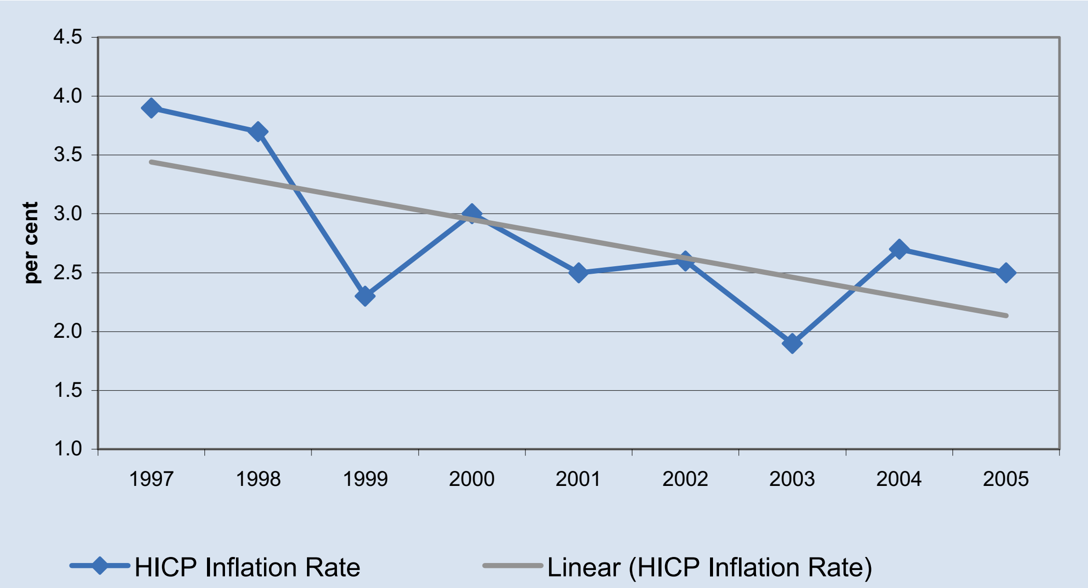


Table 2.10: Main items contributing to HICP inflation (March 06)

	Weight	12 Month Moving Average (%)	Contribution to Inflation (Percentage points)	Contribution to Inflation as % of Total Inflation
All Items	1,000	2.60		
Fuels and Lubricants for Personal Transport				
Equipment	34.21	15.28	0.52	23.54
Electricity	11.15	26.90	0.30	13.58
Services for the Maintenance and Repair of Dwelling	37.49	6.02	0.23	10.41
Water Supply	6.14	23.54	0.10	4.53
Passenger Transport by Road	4.10	14.07	0.09	4.07
Meat	18.94	2.40	0.08	3.62
Major Household Appliances	35.04	4.09	0.08	3.62
Vegetables	3.19	3.49	0.07	3.17
Gas	11.25	21.18	0.07	3.17
Total Contribution to Inflation			1.50	69.71

Source: National Statistics Office

2.8 Prospects for 2006

The Maltese economy is expected to continue registering positive growth rates in 2006, mainly spurred by investment activity. Public investment is expected to remain a major source of growth whilst private investment activity is expected to remain positive as the economy continues to restructure. Domestic demand conditions are expected to remain buoyant, with gains in real income affecting private consumption positively.

Data for the first quarter of 2006 indicate a recovery in exports, in particular a significant recovery in semiconductors. Furthermore, exports of a number of services industries are also likely to increase in line with the re-orientation of the Maltese economy towards services. These improvements are along the lines of improvements anticipated in the international economy over the short to medium term, which are expected to influence positively the external sector of the Maltese economy. Nonetheless, the trends in tourism towards shorter stays are expected to continue, with the result that earnings may register a decline.

Higher exports, private consumption expenditure and investment are likely to result in an increase in imports of consumer, industrial and capital goods. Coupled with higher international oil prices, which will further increase imports of fuel, these are expected to result in a still relatively high external negative balance of goods and services in 2006. In addition higher earnings by foreign owned companies are expected, even though this is expected to be neutralised by higher current transfers from abroad. Consequently, the current account deficit is expected to remain significant in 2006.

In line with the expected developments over the forecast horizon, employment growth is expected to improve slightly in 2006, while inflation is anticipated to remain relatively high in the absence of a drop in international oil prices.

The main downside risks to economic growth are related to the external sector, particularly the increase in international oil prices and the decline in international prices of manufacturing goods such as semiconductors. A progressive upsurge of oil prices would lower real household disposable income resulting in a negative effect on private consumption expenditure, as well as resulting in higher imports of fuel, thereby affecting GDP growth negatively both from domestic demand and from an increase in net imports.

Although indirect and second-round effects on prices have so far been contained to the electricity, water and transport services, further increases in international oil prices could result in an acceleration of inflation. As a consequence, higher inflation could spur higher unit labour costs, which unless sustained by increasing productivity levels, may have negative implications on Malta's competitiveness, particularly in sectors where international prices are declining, such as textiles and clothing manufacturing sectors and possibly the tourism sector.

Although the main downside risks to economic growth are related to the external sector, certain domestic factors could affect growth prospects, such as further increases in the interest rates. Nonetheless, partly related to the low sensitivity of domestic demand to interest rate changes, simulation studies have shown that a further rise of 25 basis points in the central intervention rate has a limited negative short-term effect on GDP growth.

In contrast, these downside risks could be compensated by a higher than expected increase in foreign demand, particularly from Malta's major trading partners, including France, Germany, Italy and the UK. In fact, in its Spring forecasts, the European Commission has already revised upwards its forecasts of real GDP growth in 2006 for Germany, but also for France and the UK.

2.9 Fiscal developments

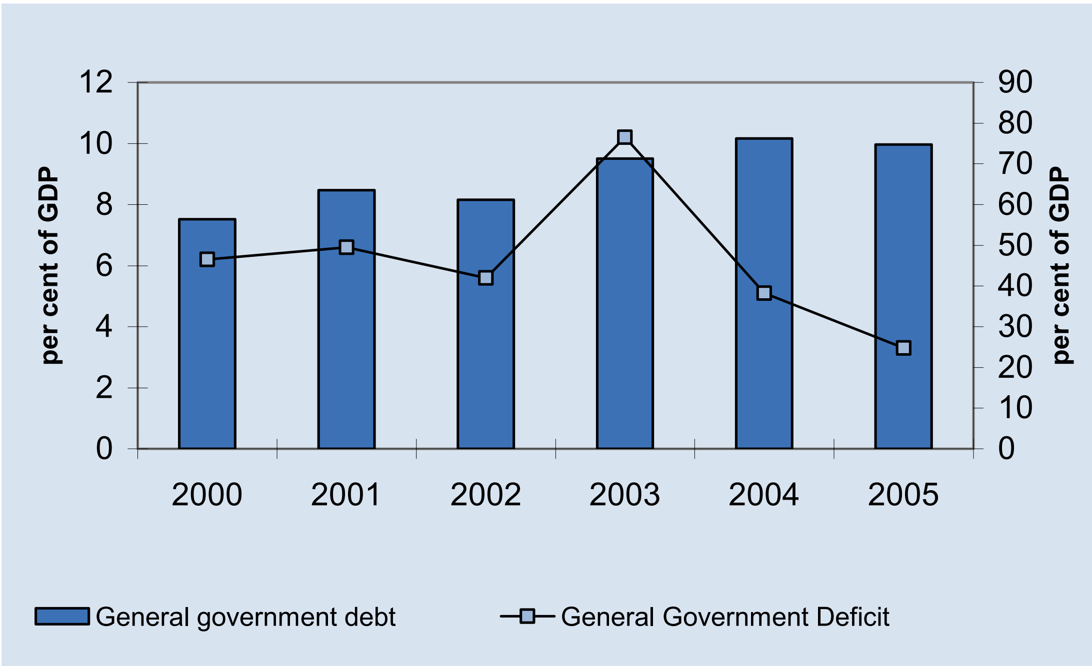
Addressing the imbalance in public finances has constituted a priority for the Maltese Government in recent years as a sustainable public finance position is a fundamental aspect of sound economic management. Chart 2.11 illustrates developments in public finances over the last five years. The deficit is shown to be on a declining trend during this period except in 2003. Meanwhile, debt levels have been increasing between 1999 and 2004.

Government's fiscal consolidation programme is proceeding on track. In fact, the deficit-to-GDP ratio followed a downward trend declining further from 5.1 per cent in 2004 to 3.3 per cent in 2005, thus below the deficit-to-GDP target set at 3.9 per cent in the December 2005 Convergence Programme. Moreover, updated fiscal projections confirm that the general government deficit as a per cent of GDP is expected to decline below the 3 per cent of GDP reference value in 2006 and to continue to decline thereafter.

Government is proceeding with the fiscal consolidation programme for 2006. During the first three months of 2006, the structural deficit declined slightly to Lm60.6 million from Lm61.2 million registered during the corresponding 2005 period. Despite the rather slow improvement in the fiscal position in the beginning of 2006, the planned consolidation foreseen for 2006 is expected to be attained over the remaining months of 2006.

Government's objective of restoring public finances to a sustainable path entails not only reducing the fiscal deficit but importance is also attached to reducing the debt to GDP ratio at a satisfactory pace. The recent increasing trend in the debt to GDP ratio has been halted and as at the end of 2005, the debt-to-GDP ratio was 74.5 per cent, down from 76.2 per cent at the end of 2004. The debt-to-GDP ratio is expected to decrease significantly in 2006 and thereafter to maintain a downward trend. The decline in the debt-to-GDP ratio expected for 2006 reflects the gradual reduction in the fiscal imbalance as well as significant privatization proceeds which have a contracting effect on the debt-to-GDP ratio.

Chart 2.11: Public finance developments



2.10 Monetary developments

The Central Bank of Malta increased the central intervention rate by 25 basis points to 3.25 per cent in April 2005. This increase followed a decline in the Central Bank's net foreign assets that reflected the liberalization of trade, a higher fuel import bill and increased capital outflows that were compounded by strong growth in credit to the personal sector. This decision prior to ERM II entry aimed to curb excessive credit growth, dampen resulting inflationary pressures and help to correct the existing imbalance between saving and spending. As a result of this increase, the interest rate differential in favour of the Maltese lira vis-à-vis the euro widened in the second and third quarter of 2005 though declined again in the fourth quarter of 2005 and beginning of 2006 as the European Central Bank increased the minimum bid rate. The progressive narrowing in recent months of the interest rate differential in favour of the Maltese lira, caused mainly by rising euro interest rates called for further tightening of the monetary policy stance by the Central Bank of Malta in May 2006. In fact, the Central Bank of Malta raised the central intervention rate by 25 basis points to 3.50 per cent in May 2006.

2.11 Conclusion

This chapter provides an overview of the Maltese economic scene, assessing the global and local factors at play in bringing about various shifts and challenges. These factors include: economic developments on an international plane including the rise in oil prices resulting in, amongst others, a higher local imports bill; growth in domestic demand mainly characterised by increased private consumption expenditure and investment growth; challenges in the form of those presented by developments in the geopolitical scene which impacted negatively on the tourist industry, slow growth in foreign demand and international developments in the semiconductor industry with both latter factors contributing to a decline in exports; the positive performance in the manufacturing sector mainly as a result of 'new' industries; and the programme of fiscal consolidation, conceived by Government as a fundamental aspect of good economic management, a demonstration of which is the decreasing deficit-to-GDP ratio.

3 Securing a more inclusive and participatory society

3.1 Background

Government plays an essential role in ensuring that everyone can participate in and contribute towards the vision of a competitive high value-added economy as well as enjoy its benefits. However, this essential role is not without limitations in what it can achieve if securing a more inclusive and participatory society is not a national project. While Government is determined to ensure that all Maltese people will have access to the life chances that will enable them to fulfil their potential, it is what Maltese Society does together that will secure a future of opportunity for one and all. An open constructive dialogue is necessary on social policy goals and developments required both for today and for the future. The extent to which economic progress contributes effectively to social cohesion will have a deep impact on competitiveness and sustainable growth in the long term. At the same time, social cohesion is fundamental for a strong economy.

Government considers education to be the key social, economic, and environmental policy for securing Maltese society's future. No effort will be spared to ensure that all children are supported to succeed and that second, third, fourth and more chances are provided through a lifelong vision of education. Health, social welfare, community care, equal opportunities and employment policies are an integral part of this support.

3.1.1 Definition

Social cohesion implies empowerment, enabling people towards effective participation, inclusion and well-being. It means allowing people to move from the extremes of dependence, isolation, lack of involvement and risk of poverty towards interdependence, participation and responsibility within a community. Social cohesion is a wide-ranging concept that encompasses the areas of education, social welfare, employment, and health care: programmes regarding employment, education, health, social welfare and benefits, including pensions, claim almost 60 per cent of total government expenditure. Government's proposals will aim to continue to develop these principles in policy, Maltese society and people's actions. In this way, the character of our society as a whole will continue to be defined as that of a caring society in a changing world.

Solidarity is a fundamental value in the development of social cohesion providing equal opportunities for everyone, ensuring a fair contribution to and a fair benefit from the gains of our economy.

3.1.2 Current trends influencing our social dimension

Various interdependent factors will have a deep impact on the future of our society and the attractiveness and sustainability of our economy.

The processes that are acting upon Malta's social context include:

- **Globalisation and economic restructuring**
  Globalisation, irrespective of national boundaries, is influencing international markets for goods, capital and labour, making them more competitive and demanding. Increased competition without relative increases in productivity, results in either lower earnings or a shift of productive capacity to other markets.

- **The impact of international prices on cost of living**
  World markets affect the price of essential imports, such as fuel and energy. It is clear that these prices are having an impact on the cost of living, a gradual inflationary effect, and an impact on the standard of living of low- and middle-income families in particular. Economic resilience, continuous competitiveness and flexible markets are the only way to counter these pressures in the longrun.

- **Changes in the labour market structure and the nature of work**
  For Malta to sustain and continue to afford current welfare programmes in the future, changes in the labour market must occur in consonance with an economic strategy that leads to an increase in employment opportunities.

  The nature of work demanded is also changing towards professional and highly skilled occupations and from labour-intensive to knowledge-intensive sectors. Training, retraining services, a life cycle approach to work, different forms of work organisation, shifts in occupational status, as well as active and preventive measures must continue to be developed and supported.

  An ageing population, shifts in family structure, and extended study periods into further and higher levels of education are together increasing the demand on social programmes and services.

- **Adjusting to changes in family structure**
  Family structures are changing in several ways, e.g. increase in births outside

Chart 3.1: Percentage of 20-24 year olds achieving upper secondary education level or more

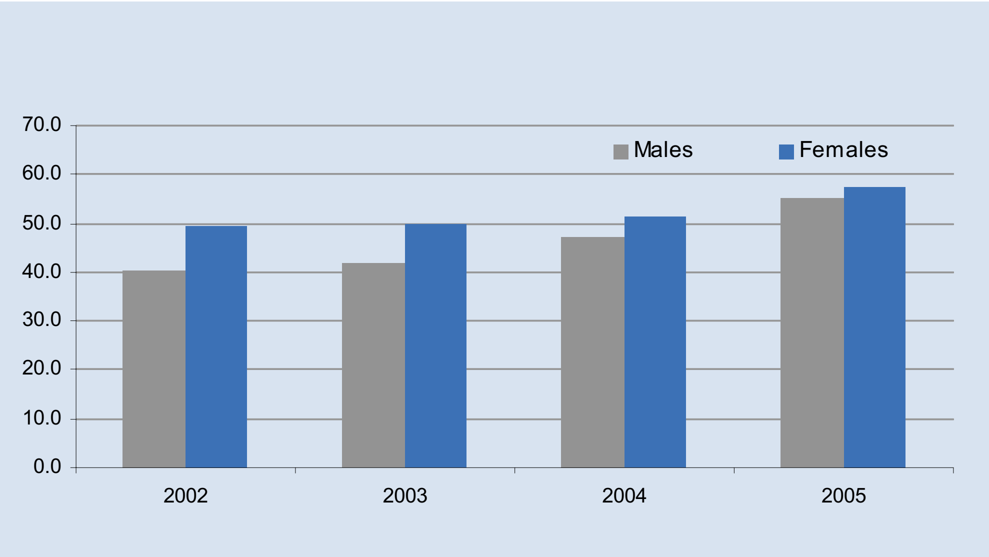
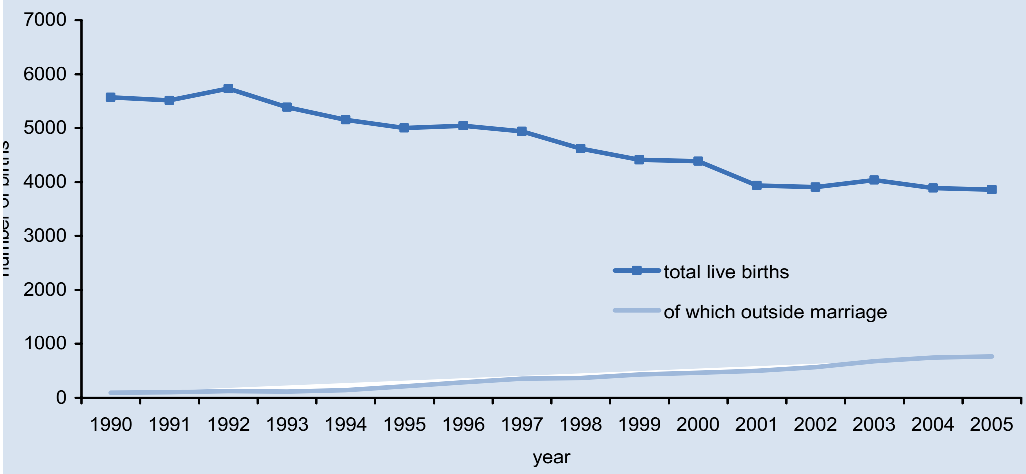


Table 3.1: Youth employment rate (15-24 years)

Year	Sex		Total
	Males (%)	Females (%)	
2002	51.2	48.7	50.0
2003	46.6	45.6	46.1
2004	49.8	42.9	46.4
2005	45.4	42.9	44.2

Source: National Statistics Office – Labour Force Survey, 2005

Chart 3.2: Total live births and births outside marriage: 1990-2005



Source: National Statistics Office – Demographic Statistics

Table 3.3: All births by age of mother

Age of Mother	1984			1994			2004		
	All births			All births			All births		
	Total	Live	Still*	Total	Live	Still*	Total	Live	Still*
Total	5,735	5,685	49	5,189	5,152	37	3,902	3,887	15
Under 20	184	181	3	201	199	2	223	223	-
20 - 24	1,261	1,257	4	1,068	1,060	8	735	734	1
25 - 29	2,121	2,108	13	1,752	1,746	6	1,438	1,435	3
30 - 34	1,334	1,315	19	1,422	1,406	16	1,049	1,044	5
35 - 39	696	688	8	616	613	3	367	362	5
40 - 44	121	119	2	119	117	2	86	85	1
45+	7	7	-	8	8	-	4	4	-
Unknown	-	-	-	-	-	-	-	-	-

Source: Department of Health Information marriage and in the number of marital breakdown.

These emerging trends indicate the changing relationship between parenthood and marriage with significant implications for social policy, particularly where child support and pension arrangements for women are concerned.

- **Continuous development of education and training outcomes**
  Changing demographics, growing competitive pressures, a structural change in the economy and shifts in the labour market towards highly skilled occupations, all necessitate a transformation of our education system. Compulsory education remains crucial to personal development, however demand for education at further and higher levels, and throughout life, will add pressure on the capacity of the entire education system and its resources.

  The type of education required is also changing. New fields of scientific research are continuously emerging, generally acting as precursors to entirely new products, services, and ways of life. If Malta is to adapt and embrace these changes, its education must develop at a rate that keeps up with, and contribute to this continuum of innovation and creativity.

  The challenge for students is to acquire the necessary information to navigate through larger and more varied education pathways and gain access to what could at times become an oversubscribed field of study. Education must therefore anticipate, lead and provide more responsive education systems, more education at further and higher levels, for more students, throughout their entire life.

  One crucial test for education is its capacity to ensure that our society can sustain itself through its ability to reach much higher levels of productivity and compete successfully in the near future. The importance of universal access to knowledge, to the highest level possible, is the key to success.

- **Managing demographic change**
  Today one pensioner depends on four persons of working age and two persons active in the labour force. By 2050 this will shift to one pensioner for every two persons of working age.

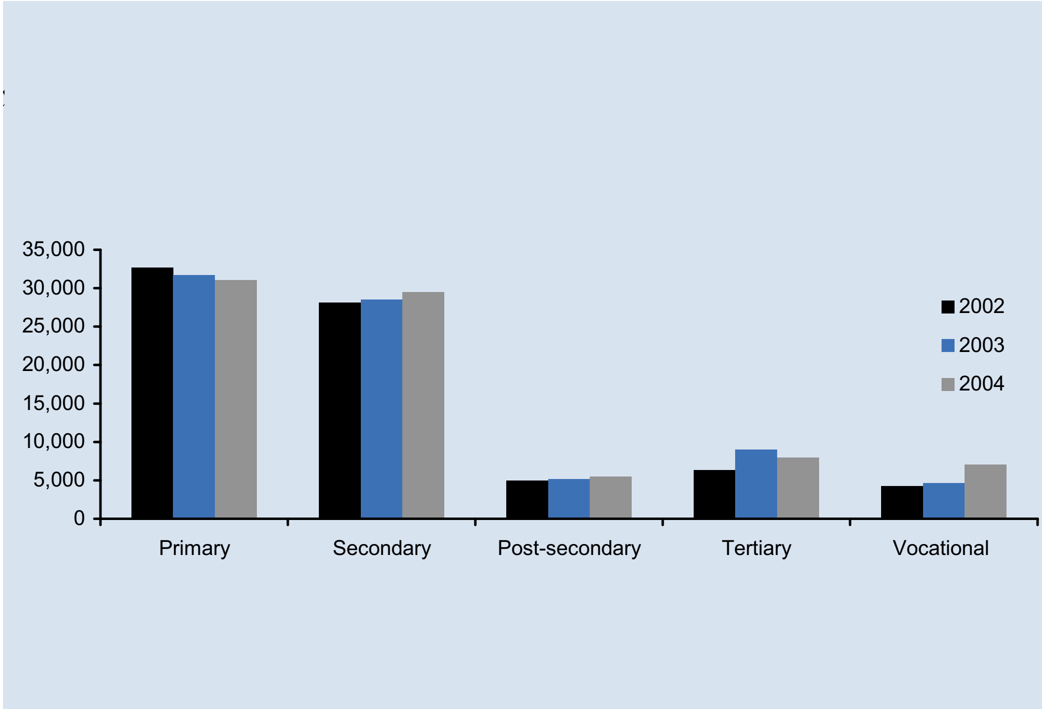
  Life expectancy has increased while birth rates have declined, increasing the number of older people and reducing the number of younger workers. Two major demographic processes are evident; longevity resulting in an aging population, and a gradual decline in total fertility rate (TFR) towards below replacement level (TFR 1.5 in 2002).

- **Reducing income disparity**
  A country may generate high levels of economic growth, increase constantly its expenditure programme and yet fail to prevent social exclusion. The distribution of income is affected by changes in tax and contributions, and subsequently is the result of re-distributional effects caused by Government spending on welfare services; employment, education, health, pensions, benefits, etc.

  Fairness, access, equity, sustainability and quality are all dimensions that must be addressed in an overarching context of incidence of burden and clearer definitions of intended distribution and redistribution outcomes. Distribution of income is the aggregate effect of numerous policies and an effective strategy must on the one hand have an overarching and co-ordinated analysis and portfolio of measures, but on the other must refine its programmes using a wider or different mix of policy instruments.

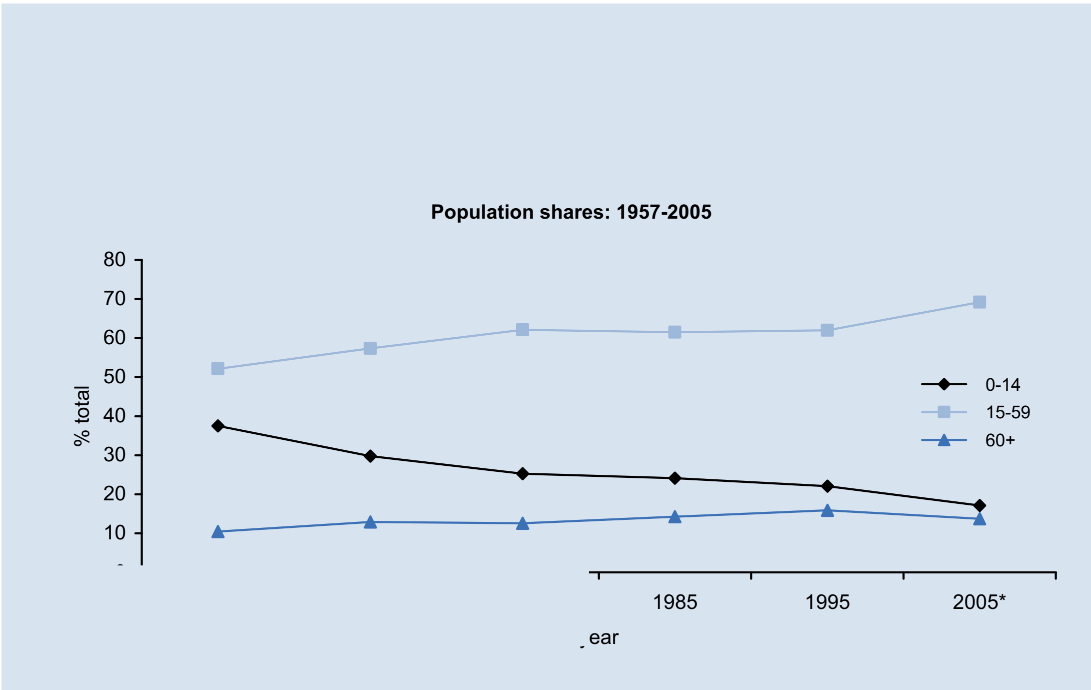
  More modern and separate policy instruments have been developed in recent years, and various effective models are available for Malta to consider. Such models provide interventions for specific distribution and redistribution objectives, which include: vertical distribution from higher to lower income brackets; horizontal distribution amongst people with the same conditions irrespective of income (e.g.

Chart 3.3: Enrolment at different levels of education: 2002-2004



Source: National Statistics Office – Education Statistics

Chart 3.4: Population shares: 1957-2005



Source: National Statistics Office – Demographic Statistics

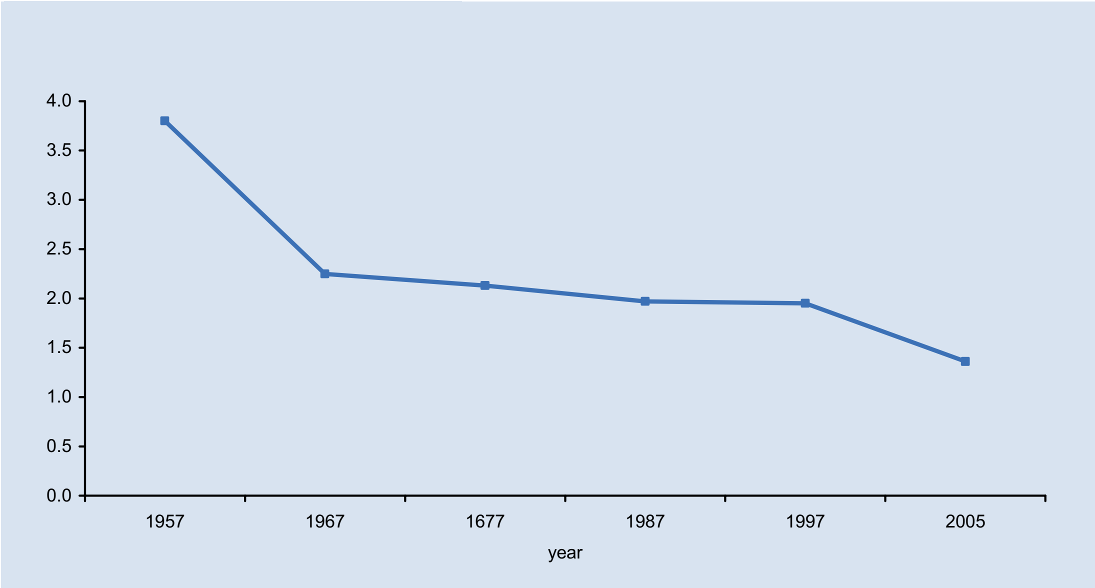
health); distribution to compensate for other disadvantaged groups other than on the basis of income; insurance against risk; life cycle smoothing; and influence or controls on merit or demerit good consumption.

The well-developed social welfare system in Malta substantially reduces, by 50 per cent, the incidence of persons at risk of poverty, affecting men and women in equal measure. However we still need to explore ways in which we can achieve more in targeted areas and sectors of need.

We have to ensure that social security systems are not a disincentive to work but actually create the right frameworks for people to actively participate in the labour market.

Our challenge is to use and further develop our policies to promote a more inclusive society. Can the tax system be used to strengthen

Chart 3.5: Total fertility rate: 1957-2004



Source: National Statistics Office – Demographic Statistics

families, support families with children, and protect children against poverty? How can we ensure that our social security benefit system does not encourage or contribute to family breakdown? How can our social security system and employment training system be used to pull people out of the risk of poverty?

- **Health care services**

The national Health Interview Survey, conducted in 2002, is a very reliable tool to assess health priorities. A relatively high proportion of respondents (73 per cent) stated they were in good or very good health.

The public health care system is funded through general taxation and provides a comprehensive basket of health services. The private sector acts as a complementary mechanism for health care coverage and is funded either from private insurance schemes or through out-of-pocket payments especially at the primary health level. Public health services are considered to be highly cost-effective and provide considerable value for money. It is estimated that around 7.44 per cent of GDP is spent on health care in the public sector. Total health expenditure (that is, also including expenditure in the private sector) amounts to 9.3 per cent of GDP.

Health services have competent and caring qualified human resources and there is a sharply increasing demand across Europe for such human resources. How will Malta manage to keep its competent and caring professionals in spite of the fact that we can start to compete with the salaries offered in many European countries?

The health care system has always offered a relatively large degree of patient choice. Patients can move without restrictions between the public and private sectors although much more can be done for the sharing of information between the National Health Services and Private Health Services. The public health centres and private general practitioners offer primary health care. St. Luke's Hospital provides all specialised, ambulatory, inpatient and intensive care services. Malta has become almost self-sufficient in terms of providing most tertiary care.

The demographic changes, highlighted earlier, are already producing a pressing impact on the provision of health care services. Increased demand for health services as a result of the ageing population is already the leading cause of overcrowding of hospital facilities besides waiting lists for acute services and also for long-term care.

The challenge ahead is to sustain our National Health Service to continue to progress with the latest developments in clinical practices, technology and innovation.

3.2 Objectives

Government's broad objectives for social cohesion are:

- to ensure that each and every person is equipped with the necessary competencies and skills to lead a decent life and reach his or her full potential;

- to improve the distribution and redistribution effects of social policy towards particular groups with greater needs;

- to continue providing insurance against life's risks;

- to prevent and relieve persons from risk of poverty.

Government will seek to ensure:

- adequate and sufficient provision of welfare services for the most vulnerable groups in society;
- fair entitlement and access to social benefits, while curbing abuse;
- to make work pay;
- financial sustainability to complement a fast growing market economy.

3.3 Strategic measures

Government's efforts to achieve these objectives will be implemented in terms of the following strategic measures:

3.3.1 Education

1. **Provide for quality education**
Ascertaining quality education at all levels necessitates a paradigm shift in the administration and regulation of the education sector. A move towards further autonomy for state schools and educational institutions together with a stronger regulatory framework for all levels focusing on quality education in each and every class and for each and every student is also required. A highly-skilled and competent workforce is the product of a lifelong education process starting from the first days of life, early childhood, going on to primary and secondary schooling, vocational, post-secondary and tertiary education, and continuing with professional, ongoing training and re-training.

Measures for quality provision include:

- The gradual implementation of the new Education law, just approved by Parliament, through the setting up of the Directorate for Quality and Standards in Education and Directorate for Educational Services;

- Quality childcare and early education services for our children to promote the development of the personality, creativity, talents and intellectual potential of each and every child;

- The networking of all state schools into autonomous colleges;

- The strengthening of the advanced and higher education provision supported by the newly set-up National Commission for Higher Education;

- The continuation of the state schools building and modernisation project, including the building of new schools in Cospicua, Mosta, Naxxar, Qormi and Pembroke;

- Sustained investment in resources to upgrade science and technology labs and facilities within all schools;

- The further implementation of the reports carried out on inclusive and special education, MATSEC, school attendance, early childhood education, career guidance and adult basic skills;

- Developing out-of-school-hours programmes with the aim of enhancing and increasing creativity and innovation.

2. Ensuring smooth education transitions

Assuring that all learners succeed in their educational voyage requires that they pass through various levels of the education system smoothly and seamlessly. Focusing on the early and compulsory school years, children face various hurdles at transition points and although the majority make it, the country cannot afford to lose one single student by the wayside as a result of faulty transition or a lack of planning and preparation. This strategic measure links to the aim of increasing participation rates in further and higher levels of education and beyond, in the context of a lifelong learning perspective.

Measures for transition:

- Improving and promoting best practices in establishments responsible for young children and implementing effective programmes to ensure better informed parents and public;

- Ease the transition between childcare and early education, kindergarten, primary and secondary education. The grouping of state schools in networks is intended to bring the various schools closer to one other and create a smooth and seamless educational pathway;

- Place a transition plan for students with a disability, so as to smooth their progress from one level to another – that is, from home to early education programmes, to kindergarten centres, to primary, secondary and post-secondary levels, and beyond into the adult world;

- Following the MATSEC review and the current 11+ exam review, develop a national benchmarking system separate from the schooling system for compulsory education level in state, Church and independent schools. This compulsory national benchmarking exercise will be taken at significant stages to test the educational development of all students in both primary and secondary schooling in the state and non-state sectors;

- Government is committed to extending the possibility of certification to meet today's aspirations, market trends and societal growth. MATSEC will aim to offer a number of vocational subjects for certification in the near future;

- Government is also committed to implementing an improved system of revision of paper in the SEC system;

- Whilst retaining examinations, appropriate continuous assessment modifications must be made to cover the whole range of performance-based abilities of all students;

- Improve guidance services to ensure better transition from one educational phase to another.

3. Inclusive education

With a declared policy of inclusive education, major changes have been made to date. The implementation of the Spiteri Report on Inclusive Education has started in earnest and a number of its recommendations have already been implemented and others are being phased in.

Training is of crucial importance in this sector and, while achievements have been registered, greater input needs to be placed so as to ensure continual upgrading and updating of professional development. Monitoring and supporting services are being given top priority. There is also an active review and discussion with regard to developing roles of personnel to be as effective and efficient as possible. Strategies are also being developed, especially with regard to students manifesting challenging behaviour.

These measures aim to develop further inclusive education:

- Extend and develop training programmes for professionals and personnel working with students with a disability;
- Continue to evolve special schools into resource centres;
- Reform the Statementing Process to ensure maximum efficiency of service for students with a disability who need classroom support and to facilitate the active participation and significant input of the disabled student and family in the process;
- Improve inclusive services in mainstream schools offering support to class teacher and class learning support assistants so as to design and deliver individual educational programmes;
- Develop support services in the post-secondary and higher education sector with regard to students with a disability.

4. Career pathways and guidance

For education and training pathways to become more attractive and flexible, research-based and effective career guidance services, research grants, and scholarships (locally and abroad) for those who wish to further their studies particularly in new fields of research activity are required.

Measures for career pathways and guidance:

- Development of guidance and counselling services at the compulsory education level into two separate, yet complementary services;
- Provide research capacity for foresight activities;
- Better information and communication systems to provide guidance information to students;
- Develop a national career guidance policy within a lifelong learning context.

5. Further and higher education

In reaching targets for higher participation rates in further and higher education, Government will invest heavily in the expansion and quality of public further and higher education services.

Measures for further and higher education:

(a) National Commission for Higher Education

During 2006 Government established an interim National Commission for Higher Education (NCHE), and has enacted legislation for its permanent setup. The Commission has a consultative and advisory role on all aspects of further and higher education policy and the responsibility for developing the necessary strategic framework for future developments.

The NCHE will be developing the necessary basis for strategic planning and effective development of the further and higher education sectors in Malta. The Commission will engage key stakeholders in identifying the roadmap for an effective investment programme addressing the balancing act between capacity and quality improvement.

(b) Infrastructure for further and higher education

Investment in further and higher education infrastructure is required to increase the quality and capacity of education facilities for more and better education services. For this to occur, Government is committed to investing heavily in educational infrastructure needs aimed at expanding institutional capacity, improving quality through investment in modern equipment and other necessary facilities, and additional investment to secure inclusiveness.

In 2007 Government is committed to invest in infrastructural developments across all levels of further and higher education. These include expansion of the Junior College, heavy investment in the University of Malta faculties and student facilities, and sustained development and expansion of the Malta College for Arts, Science and Technology (MCAST).

Infrastructural requirements at the University of Malta will generally address the development of faculty, institute and library buildings, equipment, research facilities across those areas which the University of Malta identifies as priority areas for development. Whilst Government is committed to invest across all fields of education and research, ongoing policy debate indicates the need to focus on particular areas. These include health sciences, science, engineering, ICT, business and entrepreneurship. Additionally, further investment in general lecturing, research and general student facilities (including sports, recreational, residential and transportation considerations) will be required as more students attend University.

The MCAST and Institute of Tourism Studies will be undergoing a similar development investment programme to that of the University of Malta. Currently MCAST is undergoing the preparatory strategy which will identify the infrastructural developments required for a better and larger vocational college. ITS will be commencing this strategic evaluation during 2007.

Additional investment in equipment and information systems for improved administration and governance will be directed towards these institutions. Larger educational institutions will require more flexible funding systems, improvement of administrative and quality assurance systems, and adaptation for inclusiveness.

(c) Development of tertiary level courses at MCAST

The MCAST will be launching a pilot project during 2007 to develop a full first degree programme with vocational relevance. The top-up degree programme will be developed through a franchise and joint award framework with the aim of obtaining degree awarding status in the long term.

(d) **Government scholarships for Masters and Doctoral degrees**
To complement the strategy for research, development and innovation in Malta, the Ministry of Education, Youth and Employment launched the Malta Government Scholarship Scheme. This scheme will provide a financial package of incentives for increasing the R&D activity through Masters and Doctoral courses undertaken at the University of Malta and for financially assisting those who want to specialise further overseas, and will be extended in 2007.

In Malta, full-time Masters and Doctoral programmes are provided freely at the University of Malta. Funding is required to off-set opportunity costs to those who would otherwise seek employment immediately after obtaining their Bachelor Degree. Such incentives would be directed towards student maintenance but would be provided in the form of scholarships and based on merit and academic achievement. The scheme is designed to take into account the circumstances of the University of Malta which does not charge fees for full-time post graduate courses and thus requires incentives to accept more full-time research students.

(e) **Innovation and entrepreneurship**
Through the ESF Government intends promoting initiatives aimed to bridge the gap between artistic, scientific, and technological innovation and commercial exploitation; to bootstrap new business ventures; and to project existing businesses to international markets.

Developing Executive Training Programmes in market analysis, acquisition of venture financing, management of innovation, risk analysis, business internationalisation, decision support systems, branding, business and financial planning, intellectual property and copyright, the European single market, franchising, are indispensable for developing and promoting more professional innovative and entrepreneurial skills.

(f) **Improving science, engineering, ICT, medicine and health and environmental sciences programmes**
Intensive investment in specific sectoral traineeship programmes, training, postdoctoral fellowships, and popularisation programmes will be launched through various projects under ESF by various public and private agencies or institutions. Such intensive investment should address the priority of increasing the number of students in specific sectors where structural shortage is identified and long term growth opportunities perceived.

(g) **Quality assurance, funding and administrative systems**
More accountability is necessary in view of the ever increasing importance in the role of further and higher education outcomes for economic and social sustainability. Institution and programme evaluation and accreditation against local recognised standards are the precursor to adequate accountability and flexible funding frameworks. Government aims to initiate the process to pursue the following actions:

- further development of existing internal quality assurance systems in the major public further and higher education institutions in Malta;
- the training of staff for the implementation and running of the quality assurance programs (for both internal and external quality assurance programs);
- the financing of external evaluation and accreditation by selected quality

assurance agencies within the European Higher Education Area (EHEA).

The further development of an embedded quality assurance programme is necessary within MCAST, ITS and the University of Malta and requires further development of existing processes, systems, staff training, management and implementation of this function and the reporting of outcomes. Additionally external evaluations need to occur within a broader quality assurance and funding framework which will emerge as a result of future NCHE recommendations.

(h) Approval, evaluation and accreditation frameworks for private further and higher education institutions

The intention of Government to promote an expansion strategy of further and higher education services in Malta includes the development of a framework to encourage more private provision and consumption of further and higher education. Part of the remit of the NCHE is to make recommendations on a phased regulation framework for approval, external evaluation and accreditation of private institutions and programmes they provide. It is necessary for the Ministry of Education to appoint and train staff during 2007 in developing and executing these processes for institutions applying or operating under a licence in Malta.

(i) Providing alternative modes and tools for learning

- Virtual courses and distance learning systems;

- More efficient use of available technologies means that various institutions may benefit from platforms to distribute online courses and facilitate distance learning;

- Language proficiency and the need to develop the necessary programmes, facilities and resources, will be amongst the priority areas of education policy at further and higher levels of education;

- The importance of available information to guide students in their choices for further and higher education courses is a recognised priority. Apart from efforts to improve the career guidance function within the compulsory sector, and to provide an overarching strategy for sectoral development linked to the economic agenda of the country through the NCHE, more investment in systems to link research, guidance information and career and educational pathways, is necessary.

6. Adult education, continuous education and lifelong learning

An important way of facilitating access to continuous education and training is to strengthen the concept of schools as 'community learning centres'. Widening the opportunities for young people who have already left school to further their education and training requires the adoption and implementation of "extended policies" such as open, distance and e-learning strategies.

3.3.2 Employment

Employment policy is primarily a strategy which ensures that people have an incentive to work, have access to training programs and other opportunities which ensure that workers meet the necessary requirements in terms of levels of skill, productivity, adaptability and competitiveness.

Government remains committed to the strategy outlined in the *National Action Plan for Employment.*

The strategy is based on seven key areas of intervention, namely:

- Improve levels of education and certification with a view to raising productivity;

- Raise the national employment rate, and particularly that of women and workers aged 55 and over, through a package of measures that enable access to and retention of employment throughout the life course;

- Encourage more parents to take up paid employment and enable the retention of employees within the labour market after they have children by facilitating access to child care services;

- Enhance the business environment, identify and address labour market distortions that may serve as disincentives to the hiring of labour and/or the use of regular workers;

- Increase productivity in the public sector by implementing its privatisation programme and redeploying employees in more productive positions in the public and private sectors;

- Modernise public employment service, and equip it to meet the preventive and active measures required under the European Employment Guidelines;

- Improve its governance of labour market policy, strengthen competencies with a view to better strategic co-ordination and a fuller involvement of the social partners in the formulation, implementation and evaluation of labour market policy.

In the National Reform Programme (October 2005), Government restated its intention to raise the overall employment rates and provide employees with the necessary support for transitions in occupational status through the following policy responses:

- Raise the employment rate of the Maltese workforce to achieve the 2010 targets set in the National Action Plan for Employment presented by Malta in the 2004;

- Place particular emphasis on increasing the female and older workers employment rate in the labour market to achieve the overall employment targets;

- Ensure that employees are provided with the necessary support for transitions in occupational status between training, self-employment and business creation.

The Operational Programme, presenting the strategy on the use of structural funds between 2007 and 2013, which is currently undergoing public consultation and will be discussed formally with the European Commission later on this year, proposes an allocation of around 95 million euros to carry out projects in the areas of employment, education and training and related social inclusion interventions. This major investment in Malta's employment policy should ensure a long lasting positive impact resulting from the 2007-2013 Financial Perspectives.

3.3.3 Social Welfare

Government is committed to promote the well-being of individuals, families and communities, and to enhance social solidarity by implementing necessary reforms within its social welfare services through a multi-dimensional policy response. The strategy underpinning such reforms has the following objectives:

- To continue to modernise welfare systems through the restructuring of benefits to ensure equity, adequacy and sustainability, and to constantly improve the standards of social welfare services;

- To promote gender equality;

- To enhance social solidarity by addressing the risks of poverty and social exclusion and by building stronger community based services;

- To invest in a multi-dimensional and integrated policy approach, network the social welfare sector and strengthen the voluntary sector;

- To support the provision of affordable housing and social accommodation.

1. Continue modernising welfare systems through the restructuring of benefits to ensure equity, adequacy and sustainability, and to constantly improve the standards of social welfare services

Welfare benefits are designed to assist beneficiaries through vulnerable situations or difficult periods in their lifetime. Social benefits are designed to prevent the recipients from falling into social exclusion. Ultimately social benefits ensure a healthy society by promoting the potential and respecting the dignity of each individual. With changing social and economic realities, benefits must be tailor-made to facilitate the entry of beneficiaries into the labour market.

Government will continue with the current revision of the Social Security Act to ensure that social benefits support the wider social and economic programme. This review will ensure that social security benefits are continuously adjusted to respond to those most in need of financial support.

The Invalidity Pension reform represents the first step towards having a more consistent and comprehensive legislation for the provision of social security benefits. This reform is well underway with legislative changes enacted and administrative changes already in place.

(a) Government is working responsibly on a strategy to reform pensions, ensuring adequacy, financial sustainability, gender and occupational equity, and security for future generations. The new pensions system in Malta will address adequacy by providing:

- a basic safety net to prevent social exclusion in old age, through a fair mechanism to assure against the erosion of the purchasing power of the minimum pension;

- a flexible safety net to address relative income levels, primarily either through the mandatory second pension or the voluntary third pension;

- more flexibility to encourage savings outside the state pensions systems.

(b) In addition, Government will continue modernising the welfare systems based on the principles of fair access, adequate assistance and empowerment, through the:

- analysis of the incidence of taxes and benefits, vulnerability traps which emerge from the combination of tax, incentives, and free services and benefit schemes, and the incentive effect to make work pay;

- introduction of vulnerability lines with respect to different socio-economic groups of the population, for a unified and coherent single means-testing instrument to support the eligibility process to benefits that are currently means-tested;

- improvement of anti-fraud efforts, building upon increased networking, introducing a strong information and audit basis that will allow Government to determine legitimate qualification for the benefits or services being received.

(c) Furthermore, in the restructuring of welfare programmes to ensure quality, efficiency and sustainability and to improve standards of social welfare services, to:

- formulate, propose and review standards for welfare service provision. This will be done by involving stakeholders and consulting the public concerned;
- improve quality and standards in social welfare services to protect and enhance the dignity, safety and welfare of all service users through regulation and inspection. The setting up of a regulatory body for welfare services is to be supported through technical assistance;
- ensure that service provision maintains high standards by establishing a system for the registration of services (regulation and inspection structures and procedures).

2. Promoting gender equality

Malta has adopted a number of strategies including gender mainstreaming in social protection and social inclusion, and gender equality in employment to promote stable and quality employment for all women and men.

More innovative policies are being developed to promote reconciliation of work and family life including a wider provision of, and improved access to, childcare facilities. Notwithstanding the efforts, promoting and ensuring equality between men and women requires further practical and innovative approaches to bring about effective equality. The introduction of more flexible working methods, facilitated by technological advancement, is considered crucial to help women and men achieve a healthy work-life balance

3. Enhancing social solidarity through preventing the risks of poverty and social exclusion and the building of stronger community-based services

Social exclusion influences several life aspects including employment, education, health social welfare, housing and leisure. In turn, these aspects affect the level of social inclusion, and therefore need to be addressed effectively and efficiently. Due to our limited geographical size, policy-making and programme implementation was predisposed to developing social services on a national level. The development of community-based services is becoming a more acceptable form of intervention due to its advantages in building community strengths and integrating grassroots actors. Such initiatives are observed to provide a less bureaucratic and more intervention focused service through providing opportunities within or as close as possible to one's home environment. They also tend to offer an inclusive and holistic service for a cross category of persons, especially vulnerable groups, within various areas. As a result, the current local trend is that of investing in smaller locality-based entities based on decentralization models whilst expanding on the already existing successful programmes and services and maximising on the resources of non-government community resources.

(a) Community-based social services

Community-based social services offer an interdisciplinary approach, integrating health, employment, housing, social benefits, social work and education services. Centres provide a variety of services according to the needs of the community which may vary from family support, childcare facilities and day programmes for disabled persons. Furthermore, services at a community level reduce unnecessary institutionalization through supported living arrangements and outreach health provisions, in areas of mental health, disability and addictive behaviour.

- Additional and smaller locality-based entities are intended to be developed, based on decentralization models, whilst expanding those already in existence. Priority should be given to the opening of community residential homes for disabled persons and children requiring alternative care;

- The development of networking between social welfare services in the community will be further encouraged. Inclusive resource centres that build on the successful experience of Aċċess in the Cottonera area, will be set up in localities characterized by particular social challenges;

- More youth empowerment centres, run by professional youth and community workers, are also intended to be set up in other localities. Existing centres have provided insight into future measures for the inclusion of youths through prevention and early intervention measures on a community level;

- A review of the day programmes for disabled persons is underway with the aim of strengthening the service to support community access for disabled persons within a unified service agency (Aġenzija Sapport).

(b) Supporting Families and Children

One of the greatest challenges for our economy is that of reconciling the need for increased female participation in the labour market with women's role in family formation. The caring role, still attributed predominantly to women, remains a central issue - hence the importance of the encouragement of better distribution of roles related to family development and its caring role.

- Government is working to ensure that the child day care facilities provide good-quality educare services for young children. Moreover, Government is considering how best to assist parents to meet the costs of good-quality child day care services. This measure is intended to provide quality childcare and early education services for children, especially children from deprived environments. It will also encourage more parents to take up paid employment and enable the retention of employees within the labour market after they have children. Moreover, such a measure should also address the challenge of achieving a balance between work and family commitments;

- The implementation of a financial scheme which supports Child Care Centres to achieve the new standards set for these facilities;

Government also intends to continue supporting families through the ongoing development of other existing services which have had positive results in recent years.

Social exclusion has a direct impact on children and youth, particularly with regards to education, health, employment and their overall long-term level of participation in society. Challenging social background and low educational attainment may trigger a continuous chain of dependence on social welfare services. Government intends to continue:

- strengthening the legislative framework with regards to adoption, fostering and guardianship;

- investing further in the promotion of fostering through recruitment of core personnel to assess and support foster carers and the introduction of specialised schemes to meet the needs of children in foster care;

- strengthening the adoption services and integrate them with the current child and family services;

- expanding the monitoring service of children who spend weekends at home with their families. This pilot project has been very successful in supporting families of "looked after children", giving opportunity to children to spend more quality time with their families, and in helping to reintegrate more children with their families of origin rather than keeping them institutionalised;

- restructuring the High Support Service to better address the children's needs and to work in closer collaboration with the residential facilities;

- providing a mentoring service for troubled adolescents which would be helpful in creating more prevention and protection from harm for these young vulnerable people.

4. Invest in a multi-dimensional and integrated policy approach, network the social welfare sector and strengthen the voluntary sector

Persons on the margins of society often suffer from a number of interrelated issues and require a holistic response. Government's overarching goal is to restructure welfare programmes into an integrated and co-ordinated set of effective support services networks. Work in this area will call on entities dealing with employment, education, health, social benefits, tax systems, housing, as well as others, to provide a portfolio of measures together. For such a multi-policy approach to develop further, a number of cross-sectoral measures need to be implemented.

The Social Inclusion Office at the Ministry for the Family and Social Solidarity will continue to mobilize and streamline efforts to achieve common goals across agencies, projects and programme, which can then achieve greater sustainability by demonstrating their effectiveness in meeting large policy goals, primarily by maximising the use of their resources.

(a) Strengthening the voluntary sector by

- Continuing to support the sector through various measures including grants, fiscal exemptions, stronger coordination and consultation;

- Implementing a legal framework based on the draft legislation and ensuing consultations presented in the white paper Strengthening the Voluntary Sector;

- Setting up the Office of the Commissioner and the National Council for the Voluntary Sector which will extend support to voluntary organizations;

- Consolidating better partnerships between the state and civil society organisations in the implementation of policy.

  In this respect, Government is interested in receiving feedback on two key issues that have been identified as needing further thinking: What funding mechanisms could re-invigorate this sector? How can Government facilitate the spread of best practices within the voluntary sector?

(b) Prevention and Early Intervention

Prevention and early intervention programmes are highly linked to quality education and employment. Government intends to continue investing in this sector while closely monitoring outcome indicators as to the effectiveness of such programmes.

5. To support the provision of social and affordable housing

The results of the Census carried out by the National Statistics Office in 2005 indicate that around 74.8 per cent of householders own the dwellings they live in, whilst 21.7 per cent occupy rented properties. 2.7 per cent of all households live in free-of-charge premises.

The extent of home ownership in Malta compares favourably with that of other Member States. The acquisition of one's residence has always featured highly on the priority list of Maltese citizens.

Government, through the Housing Authority, already provides units for sale at subsidised prices on a regular basis. The Shared Ownership Scheme, whereby clients buy part of the premises for sale, is a proven success and the scheme is intended to be extended in the future.

The Right to Buy Scheme has also enabled a substantial number of tenants in Government-owned property to become owners of their residence, by allowing them to buy at significantly subsidised rates.

A significant share of the country's housing stock requires maintenance and a smaller share (typically concentrated in the core of urban centres) is in a dilapidated state. Several initiatives of urban regeneration are already underway to address the issue, primarily through the Housing Authority's schemes and projects:

- the demolition of substandard and dilapidated dwellings and the rebuilding of new units for rent or for sale achieve two goals: that of the provision of decent and affordable units as well as the regeneration of run down areas in our towns and villages;
- the Housing Authority has initiated a new scheme calling on private landlords to sell their vacant property to the Authority which will then renovate or rebuild to increase the provision of housing for those in need;
- the Care and Repair initiative will continue to provide grants for the repair and upgrading of residential units.

The client list on the Housing Register for rental housing remains a challenge. High rental prices, changing family structures and substandard housing all factor in the Department's client list.

The construction of new residential units through the Housing Authority for renting out to those in need, as well as subsidies on rents paid to private landowners, work towards addressing the issue.

The Authority has also embarked upon the initiative of renting from the private sector to provide units for the department's clients. With tax incentives indicated in section 5.6.3 of this document, this initiative should see more landlords subscribing to it.

Various schemes ensure that disabled persons benefit from grants which provide for accessibility and supported living within the community.

In spite of legislative changes in 1995, there is still an inordinate number of vacant properties on the Island. Government remains committed to carrying out the next phase in its programme of Rent Reform started in 1995. Work on this phase is in hand and a number of policy options are being evaluated. The results and analysis of the data collected in the *Census of Population and Housing 2005*, are essential in order to conclude the proposals for this highly sensitive area.

3.3.4 Health

Government's vision for the health sector is centred around the patient and founded on the principles of social solidarity and equity. Within the realities of our socio-economic environment, and taking into account current strengths and past accomplishments, Government will further enhance the policy objectives of accessibility, quality and sustainability in health and care of the elderly in the coming years. These objectives are aligned with the priorities identified in the wider EU context through the open method of coordination in health and long-term care that will also underpin future European health policy and strategy. The policies and strategies that will be pursued by Government may be grouped within three over-arching priorities, namely:

1. **Enhancing equity in access to care**
   The principles of equity and solidarity in the Maltese health care system will be consolidated by enhancing access that continue to place the patient at the centre of all initiatives. The opening of Mater Dei hospital and new rehabilitation facilities will strengthen service capacity. A legislative framework will be put in place to address patient rights and responsibilities. Service charters will promote sensible use of services, curtailing waiting times for specific interventions, ensuring affordability of new medicines and technology and developing community-based responses to care needs. The health needs of vulnerable groups as well as barriers that limit access to care will be researched. Government intends to embark on a programme to address accessibility issues in the following priority areas:

   - the new Health Services Act, expected to be enacted in Parliament over the coming months, will provide the legal framework for the re-organisation of the public health sector and for the application of uniform standards throughout the health system;

   - a system for better management of hospital waiting lists will be introduced in partnership with medical consultants and other professionals. Patient choice of consultant will continue to be guaranteed. An analysis of waiting lists and capacity for intervention will be re-assessed in an effort to set acceptable and feasible waiting times for non-urgent interventions;

   - Government has introduced a registration system of new medicines firmly guaranteeing high quality and safety of medicines. Government is also committed to implement efficient and competitive public procurement systems. In collaboration with stakeholders, systems that ensures availability of medicines with fair, just and transparent pricing mechanisms will be introduced;

   - primary health care needs to be refocused towards preventive care. Health promotion and disease prevention initiatives will further complement the extensive services offered by public health centres.

2. **Promoting quality and excellence**
   The Maltese public has repeatedly expressed high levels of satisfaction with the quality of clinical care offered by both the public and the private sector. Demographic and socio-cultural changes, including most notably the growth in the ageing population, are exerting considerable added pressure on health care systems worldwide.

   The opening of the new Mater Dei Hospital and new Oncology and Rehabilitation facilities will signify a quality leap in the environment within which care is delivered. Increasing bed numbers in step down facilities will address overcrowding in the acute care and thus ensure a more concerted approach to meeting patient needs and expectations on service delivery. Government will develop and implement new information technology systems and an e-health strategy to improve health care delivery. Government will promote the development and application of care protocols and promote research and development capabilities. Government is committed to continue to promote and advance the quality and excellence of Malta's health care services through a series of measures including:

- the opening of new "state-of-the-art" hospital/rehabilitation facilities;
- the development of new information technology systems to improve health care delivery;
- the assurance of quality health care.

3. **Improving governance to safeguard sustainability**
The sustainability of the Maltese health system envisages meaningful and effective responses leading to efficient utilisation of all resources, including human resources. Government's long-term approach to sustainability will include a permanent mechanism of consultation with a wide array of stakeholders to maintain an on-going public discussion on sustainability. The health response to sustainability will focus primarily on health promotion and healthy lifestyle initiatives aimed at improving quality of life besides increasing life expectancy. The constantly increasing demand for care is demonstrated by spiralling health care activity data and increasing expenditure on medicines and devices. In an attempt to enhance sustainability, the following priorities are proposed:

- promoting the shift of focus from institutional to community care taking place in the mental health sector across the entire health sector;
- drawing up a human resources strategy for health care professionals and supporting staff in the health care workforce;
- setting up a central system of financial management, monitoring and control.

Government recognises the major concern and difficulties experienced by people who have a medical condition not covered by Schedule V and who require very expensive medication. In this respect, Government is interested in receiving feedback from the general public and the medical professions on who best to address this issue without rendering such an important programme financially unsustainable.

3.3.5 Care of the elderly and long-term care

Government's vision for the elderly and long-term care is to support and sustain healthy and active living of our senior citizens in the community, supported by an array of services that are focused and tailored to specific individual needs, with the involvement and support of immediate carers. These basic principles will be sustained by better co-ordination of available services and the gradual development of new services. It is recognised that the elderly utilise health services very heavily and demographic trends indicate heavier utilisation in the coming years. The policies and strategies that will be pursued by Government may be grouped within three over-arching priorities, namely:

1. **Enhancing equity in access to care**
The infrastructure for institutional care of the elderly and long-term care is well developed, but more investment is required in order to widen patient/client choice. The continuous development of community-based services in the long-term care sector will remain a major priority area. Increasing accessibility to long-term care also necessitates an on-going review of service eligibility criteria. Improving equitable access to long-term care requires a coherent policy response supported by all stakeholders in the field (including the Church, private sector, local councils and NGOs) to enhance capacity, address service gaps and develop services that are more responsive to changing and emerging needs. Government intends to address the following priority areas:

    - **Bed capacity**
    Capacity in providing institutional long-term care needs to increase in order to match increasing demand. For this reason Government has decided to increase capacity within St Vincent de Paule Residence (SVPR) by a further 100 beds. The transitional beds developed at Mount Carmel Hospital were a success and the bed capacity will be further increased. Government is also studying the financial and human resource implication of transforming state community homes gradually into nursing homes that cater for the needs of dependant persons.

    - **Community-based services**
    Government is seeking to work with other partners in addressing demand for residential places in long-term care facilities. Capacity needs to meet current and future changing population trends. A strategy to increase and match capacity for residential long-term care will be developed together and in agreement with the private/NGO and church sectors. A Community home in Mellieha providing for varying needs and dependency levels including nursing care will be developed through a public private partnership project. This home is expected to be opened in 2008. An evaluation of community services for older persons will be effected while a plan for the enhancement of community services to support long-term care in the local community will be drawn up. The development of day care centres in the various towns and villages will continue. A day care centre focusing on elderly suffering from dementia will shortly be launched to provide specialist services that can cater for this client group that is sharply increasing in incidence as a result of the increasing numbers of older persons.

2. **Promoting quality and excellence**
Promotion of quality in long-term care will be further consolidated through the development of the appropriate legislative framework.

    Revised guidelines for establishments offering long-term care will replace the current framework. These will sustain and improve the administrative standards that have been formulated through experience and that are currently being applied.

3. **Improving governance to safeguard sustainability**
Government is currently working on a policy document for long-term care services that will seek to provide options for discussion on the future organisation and delivery in this sector.

    - **Prevention and health promotion**
    In respect of the long-term care sector, the elderly need to move away from

a culture of dependency to one of greater awareness and involvement in the decision-making processes involving their health and social needs. A health promotion and information strategy will be formulated to address the health needs of older persons and to empower them to look after their health needs, in collaboration with health care professionals. Older persons have an increased need for preventive interventions in order to maintain good health.

- **Human Resource Development**
  A human resources development plan for long-term care is required and will be developed with all stakeholders involved in the sector.

- **Sustainable financial management and control systems**
  The decision to expand residential long-term care for the elderly, the need to address service gaps in long-term care for other categories of beneficiaries and the need to strengthen the network of services in the community will place financial pressures on the long-term care sector. These pressures will be exacerbated by the steep rise in the numbers of older persons anticipated in the coming years and other socio-demographic changes including the anticipated increase of women taking up paid employment outside the home. It has to be ensured that quality long term care remains affordable and sustainable. Government recognises the need to assist further families who retain individuals that are eligible for residential care within the community setting.

Our society is still functioning within a mindset of looking at Malta's social development by waiting for what Government will plan and implement in the various related sectors. If Malta is to secure its future beyond the achievements of the welfare state, then, as a society, we need to continue recognising the limitations of the state in preventing and solving social problems while acknowledging what we can and should all be doing together to bring forth the society we want to be living in and in which we want to bring up our children. The state can provide good services but can never replace the care that families and communities can provide.

In the coming weeks of pre-budget consultations, Government would like to hear more from the general public and community groups on those areas of high importance and urgency that require additional funding and proposals on how such additional funding can be achieved without increasing public recurrent expenditure.

The public expenditure in education, health and social policy which exceeds 60 per cent of all public recurrent expenditure is a statement itself on the high importance that Government gives to the social cohesion of Maltese society. Government wants to use the pre-budget consultation process to engage in a constructive public dialogue on what measures are necessary to secure a more inclusive and participatory society.

4 A socio-economic strategy for Gozo

4.1 Background

Over the past five years Gozo has experienced considerable progress across various socio-economic areas. Extending beyond the visible infrastructural dimension, such progress has been strongly characterised by a number of measures that have enhanced and facilitated transport and communication, especially between the two islands. These investments have contributed to increased participation of Gozitans in the labour market, further education and human resource development initiatives.

In order to fulfil Gozo's full economic potential, policy objectives should be directed towards addressing three fundamental factors:

- small size;
- double insularity;
- being on the periphery.

These lead to vulnerability, making Gozo more susceptible than the Island of Malta to adverse economic events which are outside the control of national policy formulation, including lower of economic growth and lower consumption per capita. In fact, Gozo has a GDP per capita that is an estimated 69 per cent of the figure for the Island of Malta. This is due to a combination of causes: lower labour participation; non-directly productive sources of income such as pensions and money transfers; involvement in economic activities that offer low remuneration; and a high incidence of economic activity that is not directed towards the market, such as production for home consumption.

Other inherent factors also cause constraints on production possibilities and the ability to reap economies of scale; lack of diversification of products, especially for the export sector; high transport costs; less attractiveness for investment opportunities; a relatively large public-sector activity; and a marked lack of absorption of technological capacities. Small size and insularity may also lead to increased environmental vulnerability, especially when one considers that Gozo has a very limited land area and a relatively large coastline.

Tourism is a main contributor to income and employment in Gozo, as is agriculture. Rural development therefore has the prospective to complement tourism development which, in addition to the economic advantage of having the agricultural sector act as an important food supplier to the tourism one, would have the advantage of the aesthetic attraction and traditional features offered by areas under cultivation. The Island also possesses a very rich cultural heritage. A priority for Gozo should be actions for the preservation and promotion of this legacy.

4.1.1 Some demographic and labour market characteristics of Gozo

A preliminary estimate of the Gozitan population according to the *Census of Population and Housing 2005* puts this figure at 31,053 persons, a percentage increase of seven per cent over the 1995 Census. This means that the population of Gozo makes up around 7.7 per cent of the national total. The Gozitan population also exhibits a markedly higher dependency ratio than the one calculated for the Island of Malta. The dependency ratio is defined as the ratio of the sum of persons aged up to 16 years and those over 61 years to the working-age population. The relatively higher dependency is mainly due to a higher proportion of persons in retirement while another reason is that many Gozitan young people transfer to a residence in Malta either through marriage or because they are attracted by better economic prospects. Another factor to which the generally older population of Gozo in comparison to Malta's may be attributed is the net return migration flows. It should be noted that a substantial source of population growth in Gozo comprises returned migrants, naturalisations and registrations. By contrast, population growth in the Island of Malta is mainly sustained by natural increases.

Gozo is characterised by a considerably lower population density than the one prevalent in the larger Island. From a demographic perspective, the implication here is not that there is scope for an increase in the Gozitan population density, but, if anything, that the density in the Island of Malta is immeasurably higher than that in all EU Member States. Indeed, Gozo has the highest population density among all EU Island Regions. From an economic perspective however, Gozo's lower density implies a greater potential for sustainable development based on land resources than Malta's since, in the latter Island, natural resources are intensively utilised.

The lower employment rate characterising Gozo is a combination of two factors: an unemployment rate that is slightly higher than the one for the Island of Malta and a markedly lower labour market participation rate, especially with regard to women. Furthermore, it is not only the extent of the unemployment rate that is significant, but also some important features in its compositions. These features were identified in *The Special Needs Assessment Study (2002)* and are mainly attributed to the fact that, in a small economy such as Gozo's, employment mismatches are bound to occur. Thus, while most unemployed persons are in elementary occupations (labourers, agricultural workers, machine operators, and repair-related capacities), the bulk of job vacancies are recorded in the service industries. The seasonal nature of work in Gozo, such as that related to the tourism industry, should also not be discounted. For Gozo, seasonality translates into higher registered unemployment in winter when compared to summer and the shoulder months.

An important implication of the lower employment rate in Gozo is that the population here may be more dependent upon money transfers and unearned income for its livelihood. This does not augur well for several aspects of the socio-economic development of the Island and may in the long run jeopardise the sustainability of maintaining a stable body of working-age population.

Growth in part-time employment in Gozo has been much higher than its counterpart in the Island of Malta, although this in part reflects employment trends on a national level. Total part-time employment in 2005 stood at 3,316 persons, with nearly 1,800 persons holding a part-time job as a primary job. While this trend is an indicator of certain positive elements in the labour market which hold advantages for employee as well as employer, the possibility that, in the case of Gozo especially, part-time employment is a second-best alternative to a lack of full-time jobs available cannot be excluded. The statistics consistently show that part-time jobs as primary jobs in Gozo predominate in private services, tourism and government departments.

4.1.2 Strengths and weaknesses of the Gozitan economy

When compared to the Island of Malta, the Gozitan economy has a higher dependence on agriculture and fishing, construction, the public sector and, to some extent, property income. The contribution of the manufacturing sector to Gozo's economy is even smaller than that of Malta.

1. **Agriculture and fishing**
   Open-field cultivation of tomatoes for processing is Gozo's largest agricultural crop with an annual production of more than half a million Maltese Liri, representing 60 per cent of the national tomato crop and employing some five hundred farmers, mostly part-timers. Tomatoes are mainly grown on a contract basis for a major agro-industrial enterprise in Gozo. This means that agriculture in Gozo has contributed directly to an upsurge in the performance of food manufacturing. Overall, the agricultural

and fisheries sector is in decline on a national basis. However, there exists in Gozo the opportunity to build on the strong potential contribution the sector may make towards the development of high-value market niches such as specialist tourism and environmental management. As in the Island of Malta, there are opportunities in Gozo for the revival of specific crops, namely the cultivation of vineyards and olive groves. Gozitan farmers will also have opportunities to avail themselves of EU funds earmarked for rural development.

Although fishing is a small-scale national industry, it is possibly more significant in Gozo than in the Island of Malta since it is an important supplier of food both for local consumption and for the tourist industry.

2. Manufacturing

The manufacturing sector employs about 13 per cent of workers in Gozo which is lower than manufacturing employment in the Island of Malta by some 7 per cent. In Gozo, this sector comprises three components: one main industrial complex in Xewkija, smaller concerns scattered throughout the Island, and crafts and cottage industries. Two types of manufacturing activities – export-oriented, low-technology operations and domestic-oriented manufacturing utilising imported material – are in decline as a result of loss of competitiveness. Export-oriented, high-technology manufacturing and the agri-food industry are looking up, one reason for the good performance of the former being that it is not unduly handicapped by transport costs. Overall however, the success stories in Gozo's manufacturing sector are few and the high market concentration still leads to vulnerability in this type of employment.

Cottage industries are well established in the Island. Products include textile articles such as knitted garments, lace and woven carpets, artefacts such as glass, limestone objects and filigree work, and rural-food products such as 'ġbejniet', honey, olive oil and, sun-dried tomatoes. It should be noted that the majority of workers in the cottage industries operate in the informal economy. This implies that the contribution of manufacturing to the Gozitan GDP may in reality be quite higher than estimates of this statistic. There is definitely room for development in cottage-industry activities, especially in synergy with the agricultural, tourism and heritage sectors.

3. Construction

The construction industry has and still is a key sector of the national economy, however it is also facing a number of challenges. As in agriculture and fishing, there is an opportunity for construction activities to enter into a synergy with cultural heritage, wherein the skills of masons and stone-carvers could be utilised. Again, this would also be conducive towards niche tourism sectors. In an island where impacts may easily be amplified, there are also opportunities for improved self-regulation so that the social and environmental impact of the construction activity continues to lessen.

4. Services

The principal areas of economic activity contributing to the creation of jobs in Gozo during the past five years have been in the services sector, namely, financial services, business and community, and hotels. That said, the nature of this contribution, is not such that one would expect to be repeated in the short term since some of these areas have undergone a structural transformation. For example, the transfer to Gozo of back-office operations of a major bank and the deepening of financial intermediation in the wake of liberalisation has contributed to a significant surge in financial services. The business and community sector has expanded but, in view of the smallness of an economy such as Gozo, may now be reaching saturation point.

The Special Needs Assessment Report (2002) highlights a number of key facts in respect of the tourism industry in Gozo. It is clear that, from the supply side, Gozo possesses the potential to develop this industry, by way of 5-star and 4-star hotels, upper-class farmhouse accommodation, natural amenities and cultural heritage. From the demand side, it is equally clear that Gozo has niche areas with a strong tourist potential, but which are as yet undeveloped. These include business and conference tourism. The incidence of repeat tourism for Gozo is also higher than that for the Island of Malta. All these factors call for a strategic and coordinated approach to marketing with a view to attracting specialist tourism to Gozo as a destination in its own right. This type of tourism is normally of a higher spending nature than other types and is also less subject to seasonal fluctuations. Here too, Government is aware of the balance that needs to be achieved in preserving Gozo's natural heritage, itself a tourist niche area, and the provisions of services for a higher spending tourist as mentioned above.

5. **The public sector**
   The public sector in Gozo accounts for almost 45 per cent of total employment; higher than the counterpart statistic in the Island of Malta by about 11 per cent. A significant element of these employees is found in the lower-level industrial grades. Tangible steps in redeployment strategies have recently been taken with the transfer to Gozo of various back-office operations pertaining to the public sector. This has created new jobs especially for new entrants in the labour market but it has not solved under-employment in other categories.

4.1.3 An analysis of social cohesion in the Island

Gozo tends to be more vulnerable to problems afflicting the national economy than the Island of Malta. The GDP per capita for Gozo in 2003 was estimated at Lm 3,619. That said, the estimate of households at risk of poverty, is somewhat lower than in the larger Island. This indicates the dependence of the Gozitan population on sources of income that are not directly productive, such as pensions and money transfers. While this is an indicator of a higher non-market economy, in the form of more production for home consumption, it could result in greater vulnerability to economic, social and political change, thus compromising social cohesion.

In the past few years, Gozo has seen improvements in educational infrastructure and in opportunities for education. A private girls' secondary school was opened in Victoria and the Malta College for Arts, Science and Technology (MCAST) was made accessible in Xagħra and Xewkija. The Gozo Centre of the University of Malta has increased and diversified its selection of part-time courses leading to diploma and degrees at Bachelor's and Master's level. The Employment and Training Corporation, the Institute for Tourism Studies and the School for Arts and Crafts in Gozo have been offering various skill-enhancing courses. In 2005, Gozitan persons with a tertiary qualification accounted for 6.9 per cent of the national total, which stands very well when one considers the significant size of the elderly age cohort in Gozo. However, the specialisation range of Gozitan graduates is very narrow, mainly in Arts and Commerce, with markedly low numbers opting for studies in science and technology.

4.2 Objectives

Government's strategy for Gozo aims to:

- identify concrete measures by which budgetary allocations from Government and the European Union may be used most effectively towards maximising opportunities for the social and economic development of Gozo, taking into account the double-insularity factor and other permanent disadvantages specific to the Island;

- provide a coherent framework for the implementation of measures directed towards the medium- and long-term development of the Island Region, which framework may also serve as the foundation for future development plans;

- propose an approach for the effective realisation of the concept of social partnership, involving participation by the main stakeholders in the Gozitan economy and society;

- propose a framework for the strengthening of the Ministry for Gozo with a view to (i) consolidating its role in national and regional policy-making (ii) improving its focus on economic efficiency and business opportunities available to the Island.

Within these aims and objectives and, given Government's commitment to allocate at least 10 per cent of the available EU Cohesion Policy Funds to Gozo's development, three strategic priorities have been identified as shown in Table 4.1 below:

Table 4.1: Strategic priorities for EU Cohesion Policy Funds to Gozo

Priority I Addressing peripherality and double insularity	Addressing problems associated with the geography of the Island by promoting the use of Information and Communication Technologies as tools for productivity; by increasing sales to visitors; and by generally improving facilities on the Island.
Priority II Strengthening the Gozitan economy	Diversification of industry; bringing primary products to the forefront, specifically the crafts sector; promoting development in potential growth sectors, particularly the tourism and market services sectors; and promoting a culture of innovation across the board.
Priority III Strengthening the Gozitan community	Creating opportunities for further career training and development on a local basis; supporting retention and creation of jobs; and strengthening facilities aimed at community retention and building.

Source: National Strategic Reference Framework 2007-2013

4.3 Strategic measures

4.3.1 Measures targeted at specific population cohorts

The projected age distribution of the Gozitan population is expected to move along the lines outlined hereunder which provide components of a direction of policy appropriately tailored to the needs of specific population cohorts:

A drop in persons up to 16 years of age
This implies a possible reduction in quantitative services which should however be complemented by an increase in qualitative services, especially with regard to the educational system, preparation for the labour market and travelling arrangements.

An increase in the number of working-age persons
This implies increased services towards this age cohort with regard to job creation, retraining and, education for older workers.

A significantly larger elderly population
Services for the elderly would include active retirement programmes and measures intended to counteract the problems associated with social cohesion faced by this vulnerable group.

4.3.2 A typology of measures for socio-economic development

The measures towards the promotion of a socio-economic strategy for Gozo may be grouped under ten main headings:

- an economy based on Gozo's distinctive characteristics;
- enhanced economic efficiency in the context of small size, double insularity and being on the periphery;
- increasing demand for labour and encouragement of labour market participation;
- education and lifelong learning;
- health;
- culture and recreation;
- social cohesion;
- the environment;
- regional governance in the context of a small island economy.

1. **A distinctive economy**
The rationale underlying the proposals is that Gozo as an Island Region should pursue a path of economic development that is specific to it, and not replicate that of the Island of Malta. A distinctive economy is more likely to provide sustainable, long-term economic growth and would give Gozo the opportunity to under-play the effects of its inherent disadvantages while working to make up for them through enhanced efficiency. The measures proposed in this direction include:

    - rehabilitate culturally valuable sites such as Ċittadella and Ġgantija;
    - create and promote crafts cooperatives and centres within the greater view of an integrated strategy for the revival of the traditional crafts sector in Gozo;
    - valorise traditional, regional cuisine through research, publications and media events and implement support schemes for the grading and packaging of traditional gourmet products;
    - develop a niche for sport tourism and sport amenities such as training camps and facilities for cycling, climbing and walking;
    - provide access to research and training to workers in the areas required to develop distinctive Gozitan activities. The approach to training and research

should be integrated with the activities of the education providers currently operating in Gozo, namely, the University Gozo Centre, MCAST, ITS and ETC.

2. **Enhanced economic efficiency**
   Measures towards enhanced economic efficiency would include:
   - identification and promotion of innovative business lines in agriculture such as organic farming and horticulture;
   - re-defining of uses of space in existing industrial areas;
   - upgrade and maintenance of road network;
   - extension of port facilities to allow for the possibility for Gozo as a cruise liner distinctive destination;
   - upgrade and maintenance of ICT, electricity, water and sewerage networks;
   - improvement of water collection systems for agriculture and identify uses of second-class water;
   - encouragement of participation by foreign research organisations in innovative projects in Gozo, possibly in partnership with local entities.

3. **Increased labour demand and labour market participation**
   The measures proposed for sustaining the employment rate and increasing labour market participation in Gozo include:
   - marketing of Gozo as a centre for back-office operations. These would include the operations of the public sector;
   - development of facilities for the attraction of the high-spending tourist;
   - implementation of a package of instruments for SME development;
   - extension and improvement of arable land and better organization of the farm access road network.

4. **Education and lifelong learning**
   Some of the measures for the provision of a well-qualified resource base would be:
   - upgrade of the educational infrastructure with a view to improving educational facilities;
   - strengthening and further developing the Gozo University Centre;
   - improvement of access to educational services by Gozitan students;
   - strengthening of the role of education providers such as the Qala Tourism Training Facility, the Gozo Educational and Vocational Training Council and the Foundation for Human Resource Development.

5. **Culture and recreation**
   Measures for the enhancement of culture and recreation facilities would include:
   - improve and increase literary events and activities in the Gozo Reference Library;
   - upgrade of the horse racing complex and offering the facilities available in the complex to other sporting disciplines.

6. **Social cohesion in Gozo**
   Enhancing the strong community sentiment is an important value when considering the various aspects of social and economic development for the Island of Gozo. Extending solidarity through family and community support is the way forward in achieving further social cohesion. Awareness and education will remain important aspects in achieving a preventive approach when working with children, families and communities. Government intends to continue:
   - improving coordination between Government, the Church and NGOs for the provision of social welfare services to various target groups;
   - improving opportunities for disabled persons and their families;
   - increasing the provision of social housing;
   - continuing to support the care of the

elderly in the community and evaluate any developments to the infrastructure of homes for the elderly;
- developing further disaster response facilities in conjunction with various NGOs;
- improving training opportunities for carers, voluntary workers, and others in the caring profession.

7. **The environment**
The environment should not be viewed as solely essential for the quality of life of the population, but also as the crucial element for the way forward in the niche economic activities identified for Gozo. To date, Gozo maintains a reasonably wholesome environment; however a number of challenges are emerging with regards to the environment, in the form of issues related to waste management and water quality. For the two Islands, it is mandatory that the right balance be obtained between the environmental and economic dimensions, so that the two may complement each other and not act as rival forces that disrupt the country's projects in both spheres. The strategic vision for the environment in Gozo includes:
    - finalising the setting up of all necessary physical infrastructure for the treatment of solid and liquid waste as well as of improved systems for the management of these waste streams;
    - continuing with the implementation of measures for the elimination of effluent into areas with economic potential;
    - upgrading environmentally important sites such as Villa Rundle Gardens, Xlendi and Marsalforn Bays;
    - transforming Iż-Żewwieqa area at Mġarr Port into a waterfront promenade;
    - implementing the Master Plan for Dwejra aimed at environmental conservation and economic generation;
    - creating afforestation and valley regeneration programmes;
    - initiating a rubble-wall reconstruction programme aimed at presenting these rural characteristics as an environmental feature.

8. **Regional governance**
The Ministry for Gozo is the key enabler of a number of service areas and a coordinator of efforts and resources with other ministries and public service entities. The small size of Gozo is often the cause of certain inefficiencies in public governance that arise from indivisibilities. It is also the case that market failures show up more in small jurisdictions, calling for larger degrees of intervention by the public sector. All these factors call for strategies to improve the operations of public governance in Gozo. Within the context of the need to project Gozo as a distinctive economy, the following concrete measures should form the focus of the Ministry for Gozo:
    - strengthen the Ministry, in order to enable it to provide better service, to enhance its coordinating function with other ministries and public entities, and to gear it towards long-term strategic development objectives. This would include setting up one-stop shops for the provision of government services;
    - intensify re-training programmes for public service employees with a view to productive redeployment within the Ministry;
    - improve monitoring of socio-economic development in Gozo, inter alia, by ensuring regional-level reporting in national statistics and the representation of Gozo in official statistical surveys;
    - introduce more Quality Service Charters and monitor their implementation;
    - consolidate and strengthen the mainstreaming of the Gozitan dimension in national policy making and ensure its role of prime mover in their implementation.

4.4 Conclusion

In this strategy for Gozo, three fundamental factors namely small size, double insularity and being on the periphery, are identified as rendering Gozo more vulnerable than the Island of Malta to adverse economic events. For this reason, policy direction should address these factors. Gozo's strengths and weaknesses are enumerated and discussed, the make-up and characteristics of its labour force analysed, while a holistic view is taken of the island's culture, industry and environment with regard to one of Gozo's main economic pillars - the tourism industry. Government's framework for the way forward for the Island is outlined. The cornerstones are: the distinctiveness of Gozo as an economy, economic efficiency, education, social cohesion and the environment underpinned by sound regional governance with the Ministry for Gozo in the role of key regional coordinator.

5 Incentivising work and growth
– a review of the fiscal regime

5.1 Introduction

Taxation has always been a bone of contention. The debate on how much, on what, the methods used for collection and subsequently who gets access to the funds raised, has always caused intense debates both locally and internationally.

Nobody likes taxation, but everyone accepts that it is an indispensable tool for a modern nation to operate. However while many of us accept the principle of having to pay tax, the real issue is the rate of taxation paid and on what this should be paid, without being unfair, inequitable, distorting economic growth and a disincentive to work.

Taxation is the main instrument that generates the necessary revenues required by a country to sustain its development, social support structures, health and education systems and direct resources to the country's investment requirements. Theoretically taxation is defined as "the unrequited transfers of resources from the economy to Government, primarily on the basis of income, expenditure and wealth". It does not include payments made to Government and other public sector entities for services rendered.

Taxation is a core element of fiscal policy through which Government can implement is social and economic programmes. Taxation is a means of generating resources out of a broad economic base towards expenditure measures and initiatives. It can also serve as tool that encourages further economic growth, affecting the balance between consumption and saving and of redistributing wealth at a macro as well as micro levels. Taxation thus has a significant impact on economic efficiency as well as social equity. Finding an optimum approach towards taxation policy is therefore the key towards the achievement of the Government's objectives.

In the 2006 budget speech, the Prime Minister and Minister of Finance announced an initiative to establish a Commission to review Malta's taxation system and to report back its recommendations for change to Government by June 2006. The Tax Reform Commission, tasked to report on its findings and present its recommendations by June 2006, was headed by the Hon. Tonio Fenech, Parliamentary Secretary in the Ministry of Finance, and was composed of members with technical expertise and experience in specific areas of economic and social policy and legislation and in the field of business and commerce.

5.2 The work of the Tax Reform Commission

The terms of reference for the work of the Commission were, in synthesis, the following:

- to review the system of taxation in a coherent and comprehensive manner;
- to compare the current taxation framework with competing jurisdictions as well as EU member states in terms of their effects on job creation, work attractiveness, economic growth, competitiveness;
- to assess the implications of shifting taxation from direct to indirect taxation, to abet work effort, saving and the achievement of environmental goals;
- to review specific measures in relation to small enterprises and research and development;
- to review the legislative framework to seek to remove excessive administrative

burdens, and anomalies, as well as to simplify processes.

The Commission was to make recommendations that could be implemented over a three year plan starting from the Budget for 2007. In this respect, the Commission took into consideration existing government policies, such as the Convergence Programme and the National Reform Programme, as well as other initiatives such as last year's Pre-Budget Document.

From a short term perspective, the meeting of the criteria for euro adoption, which cover, inter alia, fiscal and inflation performance would be considered a priority for taxation policy in Malta. From the medium term perspective, considerations regarding the promotion of economic growth would be imperative. It is recognised that taxation could impinge on both demand-driven expansion in economic activity, which is bound to be of a short term nature, and supply-driven growth which is likely to be more sustainable in the long-term. Consequently, the work of the Tax Reform Commission placed significant emphasis on supply-side growth with due consideration to an adequate management of aggregate demand, in the context of sustaining an optimal growth path for the economy. Hence, the emphasis on the alleviation of the tax burden on work and entrepreneurship.

Taxation policy alone cannot be expected to achieve or approximate an optimal performance of an economy alone. However the Commission was asked to advice Government on the suitability of and need for reform to the taxation system in such a way as to:

- be conducive to the generation of revenue as envisaged in the Update of the Convergence Programme submitted to the European Commission in Spring 2006, which aims at enabling Malta it to adopt the euro by the target date of January 2008;

- provide incentives to the generation of employment and social cohesion by making work pay;

- encourage saving and investment;

- minimise the excess burden of taxation through administrative and bureaucratic simplification;

- enhance the acceptability of taxation through an equitable distribution of the tax burden involving adequate compliance by all categories of tax-payers;

- contribute to the country's performance in the various aspects of sustainable development including the economic, social and environmental dimensions.

The notions and options presented in this document emanate in good part out of the proceedings and recommendations of the Tax Reform Commission. Following the operating strategy of the Commission, this Document proceeds by stating the rationale for undertaking any reform to the tax system and by outlining the overall objectives for taxation policy as specified by Government . Subsequently, it described the taxation measures currently in force and presents a discussion on some of the major reform proposals considered as they emanate out of suggestions from the Tax Reform Commission, Government, the Social Partners and Civil Society. Strategic directions and options for taxation reform are finally being presented for public consultation prior to the final decision by Government.

5.3 Rationale underpinning reforms

It is considered that any reforms to be undertaken to the taxation system must be grounded into a solid rationale based on four tenets. These tenets are relevant to any reform that is contemplated and must be at present necessary, effective, implement able and time- and policy- consistent.

The term "necessary" indicates that a reform would be based on a genuine need, not merely to undertake change for change's sake. The term "effective" indicates that a recommendation is conducive towards achieving specific important goals. The term "implementable" means that the measures recommended can be actually designed, introduced and enforced within the context of the available information and administrative capacity. The term "time- and policy-consistent" means that the measures recommended must not conflict with other policy initiatives either in view of their nature or of their timing. It would be desirable that measures which are recommended are not only in themselves suitable but would also not risk introducing instability in markets because of excessively frequent interventions, or by giving conflicting signals in relation to other policy approaches.

It is to be stated that the options presented should not be construed to constitute a definitive policy approach towards taxation policy from a short term and much less from a medium term perspective. This is an area of on-going work and research, taking into account and anticipating the dynamic evolution of the local and international economic and social contexts. There also remain issues for consideration over the medium term, which, although relevant for taxation policy in Malta, were not considered to be of a priority nature at this juncture.

Above all, it is recognised that taxation policy is an area where the utilisation of an effective social dialogue is paramount. This Document is indeed an instrument towards the promotion of such dialogue.

5.4 Government's objectives for the tax system

The key objectives of economic and social policy are at present clearly delineated by the priorities for Malta as they are influenced and congruent with Malta's accession to the EU. From a short term perspective, the principal objective is to adopt the euro in January 2008, requiring, inter alia, the fiscal deficit to be sustainably maintained within the 3 per cent of GDP limit, the inflation rate not to exceed 1.5 percentage points over the average inflation rate of the three EU Member States with the lowest rates of inflation as well as a wide analysis of the fiscal situation. Malta's efforts to abrogate the EU Excessive Deficit Procedure can also be viewed to be an integral part of the euro adoption programme. From a longer term perspective, Malta is endeavouring to meet the targets established by the Lisbon Agenda for competitiveness and growth.

These objectives are expressed in a number of documents issued by the Government, the principal ones of which are:

- the 2006 Pre-Budget Document which sets the vision for fiscal policy over a five-year time frame;

- the Updated Convergence Programme (2005-8) which sets Malta's strategy to abrogate the EU excessive deficit procedure;

- the *National Reform Programme* which sets out a comprehensive three-year strategy to implement the integrated guidelines to deliver growth and jobs;

- the *National Strategic Reference Framework*, outlining the strategic priorities for Objective 1 structural funds from the EU for the period 2007-2013;

- the Council Recommendations and Council Opinions on Malta's excessive deficit and the Convergence Programme.

5.4.1 A better quality of life: Pre-Budget Document 2006-2010

In the 2006-2010 Pre-Budget Document: *A Better Quality of Life*, Government stated that the budgetary thrusts are to attain a balanced position for public finances in the medium term. However,

> "the balancing of these accounts should not be sought through an increase in the tax burden but primarily through an increase in economic growth".

In addition, Government argued that the emphasis of its fiscal review in this regards must be directed towards measures which discourage work and undermine productivity.

In the 2006 Pre-Budget Document, Government highlighted four key issues which merit further consideration in the context of taxation policy:

1. The use of tax policy to stimulate economic growth with particular emphasis on tax on small and medium enterprises, tax bands affecting individuals, the rate of corporate tax as well as the capital gains tax regime.

2. A shift from direct taxation to environmental related taxation which would leave government revenue neutral but would introduce concepts based on the polluter pay principle.

3. The introduction of tax incentives to stimulate the rental market.

4. Simplification of tax reporting requirements and finding the appropriate balance between regulation and compliance with special reference to small and micro businesses.

5.4.2 The updated Convergence Programme

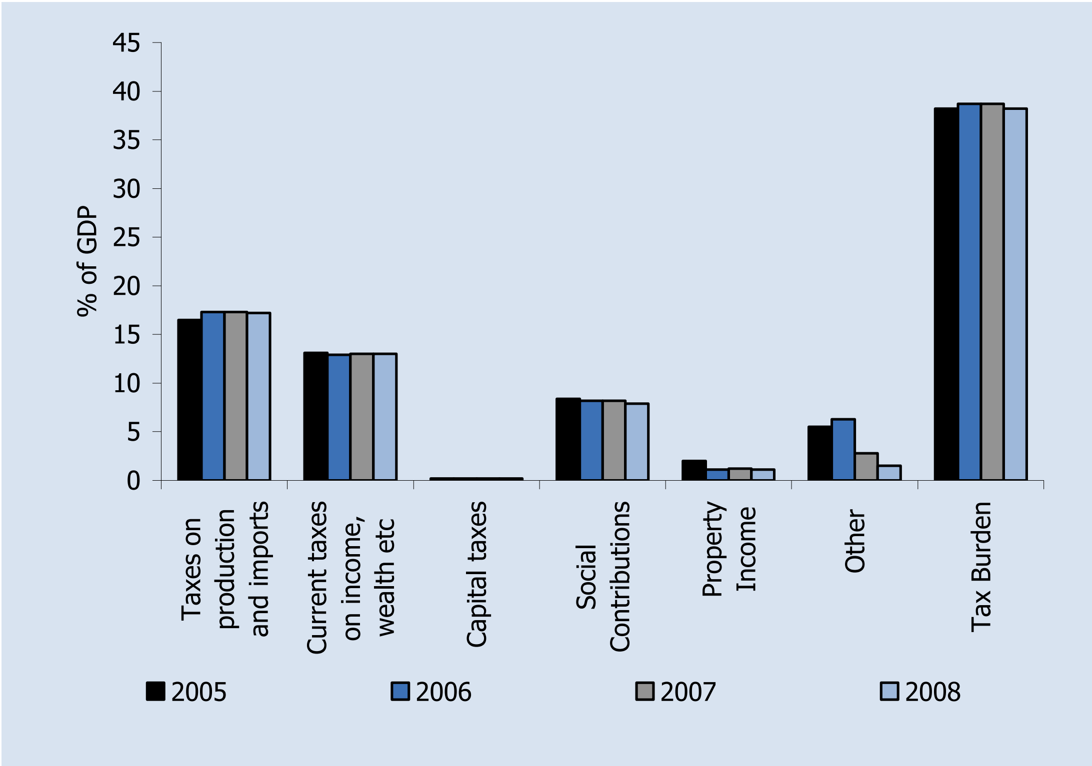
According to the updated Convergence Programme (2005-2008), starting from a ratio of 43.6 per cent in 2004, government total revenue as a proportion of GDP is expected to increase in 2006 followed by a declining trend to 2008. The increase in the ratio of total receipts to GDP in 2005 and 2006 mainly reflect a higher tax to GDP ratio as well as higher ratio from the 'Other' component of revenue. The declining total revenue to GDP ratio in 2007 and 2008 is mainly due to lower revenue from the 'Other' component of receipts on account of lower non-tax revenue.

According to the Convergence Programme, the increase in government revenue for 2005 and 2006 reflects higher revenue from income tax and VAT receipts due to stricter enforcement as well as higher revenue from the measures announced in the 2005 Budget. Sustained efforts to curb tax evasion are anticipated to contribute to an increase in the absolute level of revenue from taxation.

The ratio of the 'Other' component of revenue is also expected to advance further in 2006 on account of privatisation proceeds. However the ratio is expected to decline in 2007 and 2008 on account of lower revenue from one-off items as well lower inflows from EU funds over the period.

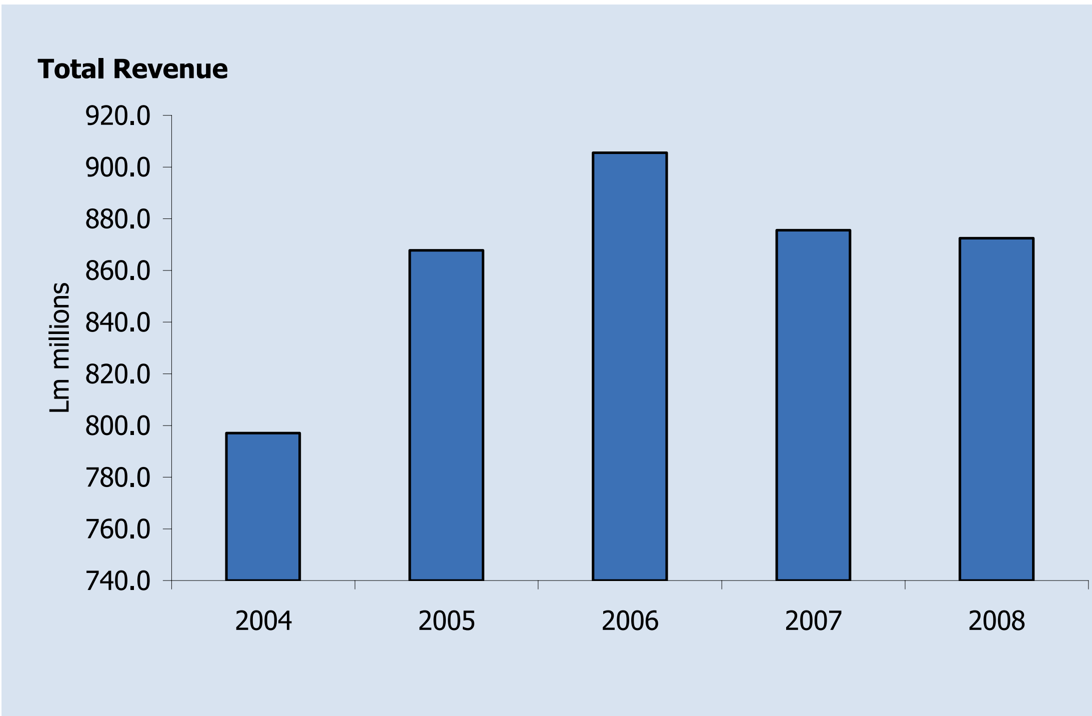
Social security contributions are estimated to follow a downward trend over the period declining from 8.5 per cent of GDP in 2004 to 7.9 per cent of GDP in 2008. In absolute terms higher proceeds are expected, due to strict enforcement, but the growth in social security contributions is expected to be outpaced by the nominal growth in GDP. Details of these projections are given in the charts below.

Chart 5.1: Revenue projections



Source: Update of Convergence

Chart 5.2: Projected Revenue



Source: Update of Convergence

5.4.3 The National Reform Programme

In the *National Reform Programme* (NRP), which is the blueprint for the next three years in terms of meeting the Lisbon Agenda targets, Government reiterated its objectives to meet the deficit targets and reduce debt/GDP ratio at a satisfactory pace. Furthermore, among the priorities identified in the NRP for the sustainability of public finances are using taxation policy to encourage work and productivity to stimulate economic growth, and improving tax compliance and reducing benefit fraud.

A number of guidelines listed in the NRP identify taxation as a necessary tool to reach goals related to economic activity and competitiveness. Guideline 3 deals with promoting growth and employment through an efficient allocation of resources. One of the measures adopted to attain this goal is to review the taxation framework in a manner that encourages work and productivity. Guideline 14 deals with creating a more attractive business environment and encouraging private initiative through better regulation. Two of the measures deal specifically with reducing paperwork and streamlining tax compliance procedures by SMEs as well as establishing regular formal dialogue with business operators and simplifying tax systems at VAT, Inland Revenue and Customs and Excise departments. Measure 17 deals with implementing employment polices which aim at achieving full employment, improving quality and productivity at work and strengthening social and territorial cohesion. One of the policies deals specifically with a review of the tax system to encourage, in particular, a higher female participation rate.

In this respect, it is noted that Government has already offered a number of tax incentives conducive towards these objectives.

5.4.4 National Strategic Reference Framework

The *National Strategic Reference Framework* is another crucial policy document behind the delineation of economic policy approaches in Malta over the coming years, as it outlines the priorities for the use of EU Structural Funds during the current budgeting period. While the *National Strategic Reference Framework* does not directly deal with government finances, it does state that a competitive and knowledge based economy is clearly based on the realisation of public finances sustainability as well as employment generation, two goals which are clearly influenced by taxation.

5.5 An inventory of taxes in Malta

This section presents a synthesised description of the principal elements of the entire system of taxation measures in Malta. An assessment of the on-going shift from direct towards indirect taxation as a medium term tendency is presented. This is followed by a high level comparison between taxation measures in Malta and those of other EU Member States.

5.5.1 Direct taxes

1. **Income Tax**

   Income tax is regulated by the Income Tax Act Chapter 123 and Income Tax Management Act. Prior to 1990, the highest income tax rates in Malta were significantly high at 65 per cent. In 1990, these were slashed by slightly less than half, from 65 per cent to 35 per cent. The corporate tax rate was also cut to 35 per cent from 65 per cent. In the Budget Speech delivered in 2002, Government amended tax on income for married couples with a joint declaration of income. In fact, the taxable income bands were increased whereby non-taxable income increased by Lm100, the second band by Lm300 and the third band by Lm500. Those who benefited from these tax amendments saved up to Lm145. In the following year, Government decided to increase income tax bands from three to five and to increase the non-taxable income for those declaring married and separate declaration. As a result, married couples with a joint declaration could save up to Lm187 in tax annually while those with a separate declaration could save up to Lm108 in tax annually.

At present, income tax brackets in Malta for Maltese residents are as follows:

Table 5.1: Current tax bands for residents in Malta

Married		Single	
Income	Tax Rate %	Income	Tax Rate %
0-4,300	0	0-3,100	0
4,301-6,000	15	3,101-4,100	15
6,001-7,250	20	4,101-5,000	20
7,251-8,500	25	5,001-6,000	25
8,501-10,000	30	6,001-6,750	30
Over 10,000	35	Over 6,750	35

Source: Ministry of Finance

Table 5.2: Current tax bands for non-residents in Malta

Income	Tax Rate %
0-300	0
301-1,300	20
1,301-3,300	30
Over 3,300	35

Source: Ministry of Finance

Individuals who are domiciled and who are ordinary residents in Malta must pay income tax on their world wide income. On the other hand, individuals who are domiciled elsewhere and who are resident in Malta but not ordinary residents in Malta, must pay tax on their income arising in Malta, or remitted here. Non-resident individuals in Malta pay tax on their Malta source income only, but local interest and royalty income are exempt from tax, as are capital gains on holdings in collective schemes or on securities. Basically any asset, as long as it is not Maltese immovable property is exempt. Returned migrants to Malta are also offered a special tax regime so that a person born in Malta who returns can elect to pay 15 per cent income tax on local income only. In addition, holders of permanent residence permits can pay tax at a reduced rate of income arising in Malta plus remittances of foreign income.

In January 1998, a scheme was launched under which foreigners could choose to take up permanent residence in Malta under certain conditions. These were obliged to transfer to Malta a minimum of Lm6,000 annually in their respect and another Lm1,000 annually for every dependent person. Those who opted for this scheme paid tax at 15 per cent on these amounts subject to a minimum of Lm1,000 annually. In the budget speech for 2003, this measure was revised and the minimum amount upon which tax is payable was hiked to Lm12,000 without any deductions and which covers all members of the family. The minimum amount was retained at Lm6,000.

Recently, in 2005, in order to increase the female participation rate in Malta which is significantly low at 33.7 per cent (2005), Government announced that women who have been absent from the labour market for more than five years could now be exempt from tax in their first year of re-employment.

2. Social Security Contributions

Social Security Contributions are governed by the Social Security Act 1987 which was recently amended in 2005. Employers and employees pay social security contributions in Malta on a graduated scale. The minimum National Insurance Contribution payable is Lm5.79 per week, or 10 per cent of the minimum wage (except for workers under 18, where the rate is fixed at Lm2.84 per week). When earnings exceed minimum wage, national insurance contributions are levied at 10 per cent of the employees wage and this 10 per cent is payable by both employee and employer. The State then matches the joint contribution. National Insurance Contributions are also capped at Lm13.38 per week for those earning at, or above, Lm133.81 per week. These contributions change every year to reflect cost of living adjustments.

The minimum Social Security Contribution which must be paid by employees at Lm2.84 for persons under the age of 18 and Lm5.79 for persons over the age of 18 tends to disincentivise workers to work, particularly on a part-time basis. In fact, the current system tends to work against the principle of ‘making work pay' since anyone earning a minimum age whether on full time or part-time basis must pay a significant proportion of their income in social security contributions. Consequently, a number of individuals, in particular women tend to be discouraged in finding employment. In fact, this is perceived as one of the reasons why the female participation rate in Malta is so low. Indeed, females constitute only 30 per cent of the fulltime gainfully occupied population and 45 per cent of employees working on a part time basis.

Table 5.3: Current Social Security Contribution rates

Category	Basic Weekly Wage		Weekly Rates		Total
	From	Up to	Employee	Employer	
A: Persons under 18 years of age earning not more than the amount indicated	0	57.88	2.84	2.84	5.68
B: Persons aged 18 and over, earning not more than the amount indicated	0	57.88	5.79	5.79	11.58
C: All persons whose basic weekly wage falls between the amounts indicated	57.89	133.80	10%	10%	NA
D: All persons whose basic weekly wage is equal to or exceed the amount indicated	133.81	NA	13.38	13.38	26.76
E: Students under 18 years of age	NA	NA	10% Max 1.88	10% Max 1.88	NA
F: Students 18 years and over	NA	NA	10% Max 3.41	10% Max 3.41	NA

Source: Ministry of Finance

Making work pay has been identified as one of the priority areas in the National Action Plan for Employment. The guideline calls upon Member States to make work pay. The Guideline specifically states that policies should aim at achieving by 2010 a significant reduction in high marginal effective tax rates and where appropriate in the tax burden on low paid work workers.

National Insurance Contributions also vary depending on whether an individual is classified as self-occupied or self-employed Rates for Class 2 Social Security Contributions are based on the annual net profit or income for the year preceding the contribution payment year. The category 'Self-Employed' refers to persons who receive income from rents, investments, capital gain or any other income. This refers to category code SP where the rate applies to self employed persons only and when the total net income in the previous year exceeds Lm430 (Single person) or Lm630 (Married). On the other hand category SA, SB and SC refer to self-

Table 5.4: Current Social Security Contribution rates (Self-Employed)

Category Code	Annual Net Income From (Lm)	Weekly Rate Up to (Lm	(Lm)
SA	0	3,535	10.2
SB	3,536	6,957	15%
SC	6,958	n/a	20.07
SP	431	2,908	8.39

Source: Ministry of Finance

Profession, Vocation or any other economic activity that exceeds Lm390.

Recently, Government in an attempt to increase the participation rate of older workers which is also significantly low in Malta compared to other EU Member States introduced a scheme to assist employers employing any person over the age of forty and who in the previous year would have been registering unemployed under Part 1. Under this scheme an employer will be entitled to retrieve from ETC a sum equivalent to 25 per cent of the rate of contribution paid by employers.

3. Part-time employment

Income earned from part-time employment is taxed at 15 per cent. However if the part-time employer is the same as the full-time employer, individuals are taxed at 20 per cent. The preferred rate on part-time employment has presented somewhat of a problem for some employers, particularly in the hotel and restaurants industry, as employees prefer to opt for a part-time job rather than work overtime and be taxed at the highest marginal income tax rate under which their income falls. Consequently, employers find themselves in a position having to employ part-time workers to satisfy the excess demand which exists particularly during the summer months. As from 1 January 2005, couples who opt for joint tax computation could start to benefit from a fixed income tax rate of 15 per cent on secondary employment, up to a maximum of Lm3,000. Prior to 2005, only full-time employees or self-employed persons were eligible for this preferred income tax rate.

4. Corporation tax

Malta operates a full imputation system of taxation. There is a company rate of tax but not actually a Corporation Tax. A limited liability company is liable to national income tax on its income from all sources. However, under this imputation system, once profits are distributed as dividends to the shareholders, the latter are taxed on their personal rates and their share of company tax originally paid on the profits distributed fully credited to them. The company rate of taxation is 35 per cent which is the same as the maximum rate of tax on personal income. The Maltese tax system provides comprehensive double tax relief to taxes incurred in territories outside Malta, both under double taxation treaties and under unilateral relief provision of Maltese law.

Prior to 1996, Maltese law admitted two basic forms of corporate structure which were available to non-residents who wished to register a Maltese company for commercial or asset holding purposes. These were (i) the onshore company with an issued share capital of Lm10,000 and (ii) the low-tax (5 per cent) offshore trading or zero-tax non-trading company. In 1996, in view of the closure of the offshore regime, a new form of company structure was introduced to cater for the growing demands of non-residents who wished to establish their business or holding interests in Malta. The International Trading Company (ITC) is a normal onshore Maltese company with no distinction from other local companies. It is a company incorporated or resident in Malta but which is engaged solely in trading activities outside Malta with non-residents. An ITC is subject at the normal rate of 35 per cent but when a dividend is paid by an ITC to non-resident shareholders, they become entitled to a refund of two-thirds of the tax paid by the company on the distributed profits. The shareholders also qualify for a credit for the company tax under the full imputation system.

5. **Capital Gains tax**

Up to 2005, a capital gains tax of 35 per cent was applied on the capital gained from the sale of property. The gain allowed for an allowance for inflation, a maintenance allowance, ground rent paid on the property and any improvements and expense that would have increased the value of the property. However, that regime was incentivising people to under declare the selling price of the property. Consequently in the Budget Speech for 2006, Government declared that the capital gains tax would be replaced by a 12 per cent Final Withholding Tax on the value of the property sold without allowing for expenses and other related exemptions that used to apply under the Capital Gains Tax System.

The Final With-holding tax on property at 12 per cent applies on both those selling property that has been inherited as well as those selling property that has been acquired through purchase and other means.

Two scenarios apply in relation to that property that has been inherited. The first related to an individual who would have inherited property before 1992. In such case the heir who sells the inherited property is subject to a Final Withholding Tax of 7 per cent on the full transfer price, that is, the price declared on contract of sale. The second scenario relates to an individual who would have inherited property after 1992. In this case the heir, up to 2005, would have paid up to a maximum of 35 per cent tax on total profit made, that is, on the difference between the sale price and the value shown on the deed of transfer ‘cause mortis’. However in 2005, the rate in this case was also reduced to 12 per cent.

Property that is exempted from taxation includes the transfer of property resulting from separations and sale by court order.

6. **Withholding tax and taxes at source**

A Withholding tax of 15 per cent is paid on interest that is earned from bank deposits deposited in deposit monetary banks located in Malta. When the Investment Registration Scheme was introduced, individuals were offered the possibility to pay 15 per cent withholding tax on repatriated assets invested in banks or else to declare such income in the annual tax return and be taxed at the applicable rate.

The November 2000 budget introduced Withholding tax on Collective Investment

Schemes. With regard to foreign funds (with primary or secondary listing on the Malta Stock Exchange), the fund manager or representative must register with the Inland Revenue Department which means that income to the investors in the fund will be subject to a 15 per cent withholding tax. In the case of investment income which does not constitute bank interest and which is payable to a collective investment scheme in relation to a prescribed fund, tax is withheld at the rate of 10 per cent.

The taxation of dividends is governed by the full imputation system that entitles shareholders to claim a credit for the tax paid by the company and ensures that distributions out of taxed company profits are not subject to further tax in the hands of the shareholders. In certain cases the distribution of a dividend entitles the shareholder to a tax refund.

5.5.2 Revenue collected from direct taxation

The majority of revenue generated from direct taxes in Malta originates from personal income tax and corporate income tax as can be seen from the chart. Capital taxes and other income tax generated the least amount of direct taxation during the time frame 2000 to 2004.

As can be seen from the chart below, revenue received from personal income tax increased consistently from 2000 to 2005, growing at an average annual rate of 8 per cent per annum. Revenue received from company income tax also increased significantly up to 2003, after which it dropped to Lm77.7 million from Lm83.6 million a year earlier. Combined, revenue from personal income tax and company tax represent over 90 per cent of total revenue received from direct taxation. Capital taxes which only represent a small proportion of total revenue generated from direct taxation have also increased throughout the time frame reaching Lm4.1 million in 2004. It is also pertinent to note that increase in income tax revenue was not the result of an increase in income tax rates. It should be emphasised that such increases have be spurred only through growth in economic activity and better tax enforcement measures. There where no rate increases in the years under review.

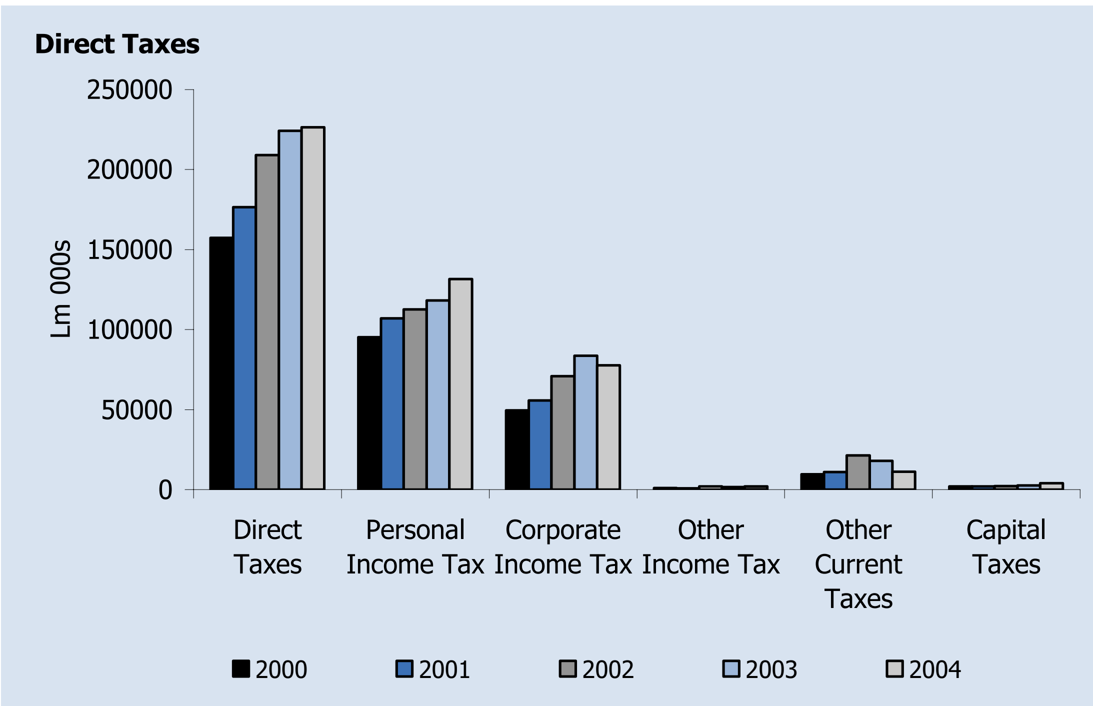
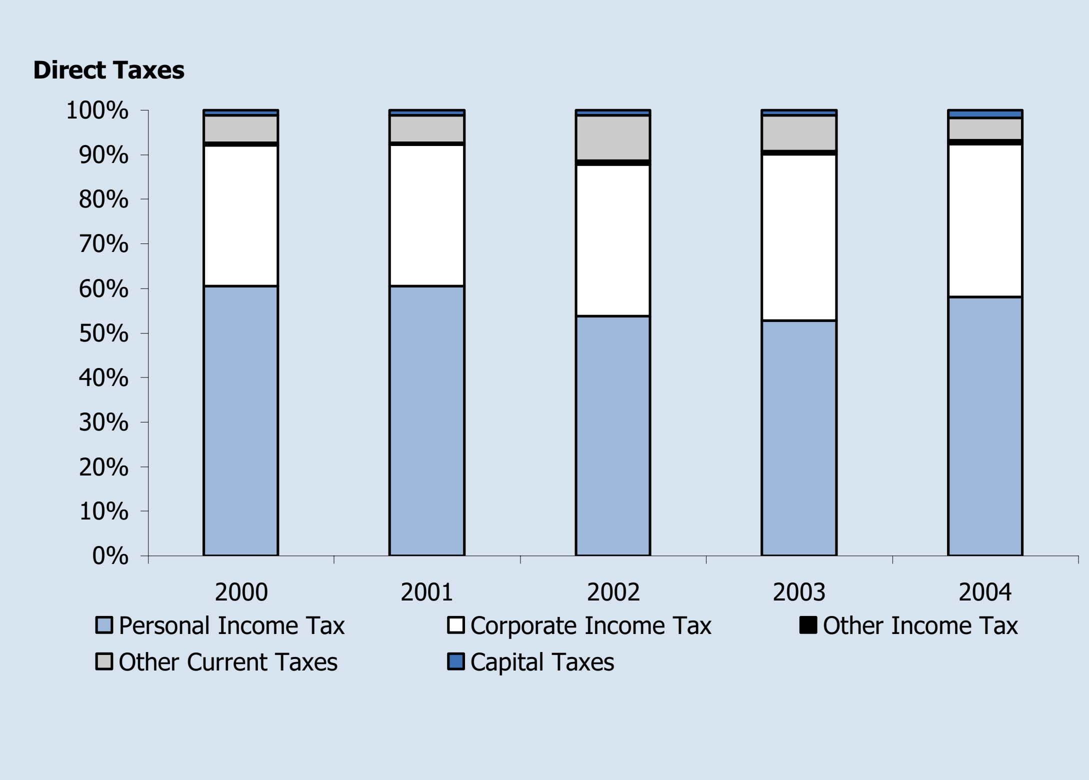


Table 5.3: Revenue from direct taxes

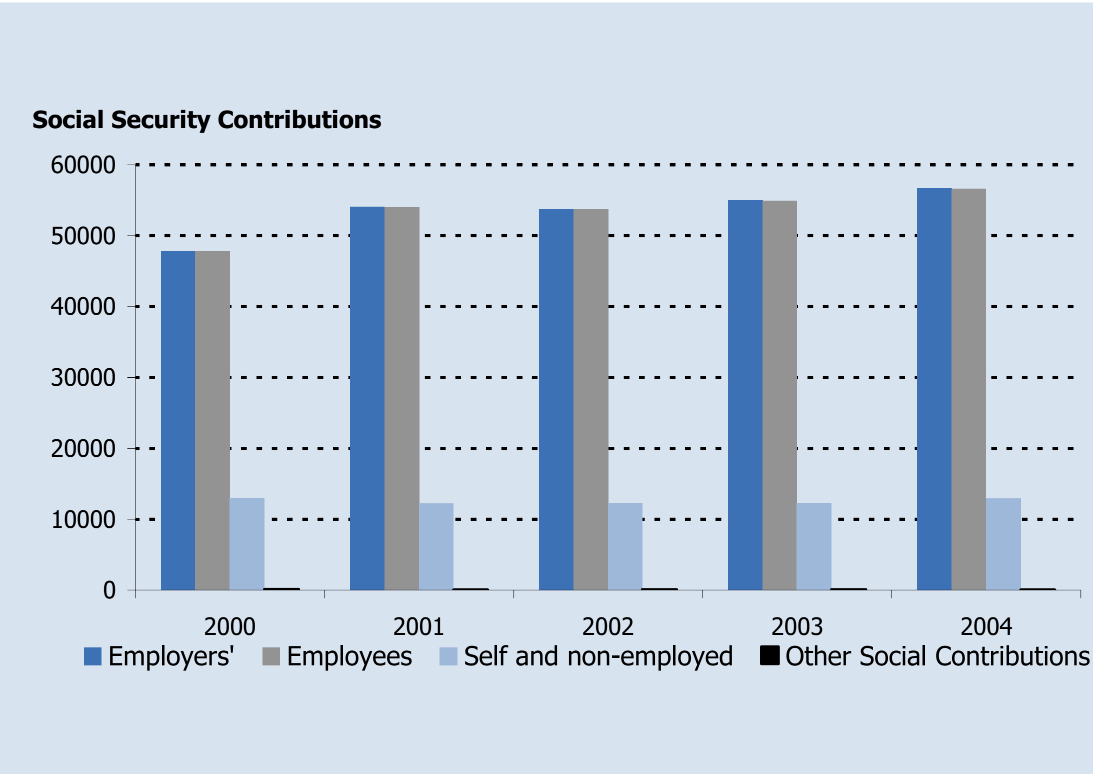
Source: NSO Press Release 218/2005

Chart 5.4: Direct tax revenue



Source: NSO Press Release 218/2005

Chart 5.5: Revenue from Social Security Contributions



Source: NSO Press Release 218/2005

Social Security Contributions have also increased steadily from 2000 to 2004 reaching over Lm126 million in 2004. As can be seen from Chart 5.5 above, the increase in social security contributions is derived from employers and employees' contributions implying that the number of registered self-employed personnel has remained relatively stable over the time period.

5.5.3 Indirect taxes

1. **Value Added Tax**

   Value Added Tax (VAT) is nowadays the principal element on indirect taxation in Malta and indeed a cornerstone of taxation policy as a whole. It practical advantages in terms of revenue management and collection and its benefits for economic activity are nowadays recognised internationally and are indeed an integral part of economic policy within the EU. Indeed, in the light of its advantages, the EU constrains Member States in terms of the minimum amount of VAT rates which they may impose.

   VAT was first introduced in Malta in 1995 only to be replaced by CET in 1996. In 1999 VAT was reintroduced at a rate of 15 per cent, with a reduced rate of 5 per cent applicable to tourist accommodation. The budget for 2004 included an increase in the VAT rate to 18 per cent. Confectionary and similar items, Medical Accessories, goods intended for the use of disabled and printed matter which are defined in the Eight Schedule to the VAT Act attract a reduced rate of 5 per cent. Food and Pharmaceutical Products as defined in Part Five of the Fifth Schedule to the VAT Act are exempt without credit from VAT, as is local transport. A number of these provisions represent exemptions from EU regulations regarding the spread and minimum rates of VAT applicable in Member States.

2. **Customs and Excise tax**

   Excise taxes are imposed on goods such as alcohol, cigarettes and petrol in an attempt to discourage their use. The rates vary according to the different goods with excise duty on alcohol varying from Lm0.10 per percentage volume per litre on ethyl alcohol to Lm0.32 per hectolitre per degree Plato on beer. The rate of excise duty on wine is nil. The excise duty on tobacco products varies according to the nature of the product. In 2004, there was the latest re-adjustment of 5 cents in excise duty on every packet of cigarettes of 20.

   In terms of fuel (energy) products, the excise duty on LRP and unleaded is 16.6 cents/litre, excise tax on gas oil is 10.54 cents/litre while that on heavy fuel oil is LM6 /1000kg. Excise tax on LRP and unleaded were recently adjusted towards the end of 2005.

   Gas oil used for bunkering purposes is subject to a reduced rate of excise duty. Operators pay an excise duty of Lm154/1000 litres and are subsequently entitled to a refund (once all the necessary documentation is submitted to Customs Department) of Lm93/1000 litre, which effectively reduces the excise tax on gas oil used for bunkering purposes to Lm61/1000 litres.

   In the 2005 Budget Speech Government stated that 'in an effort to reduce the ratio of direct taxation to total income and to provide more for indirect taxation when taxation is required' an excise duty of 3 per cent on all expenditure, including that for rentals, related to the use of mobile telephony was to be introduced with immediate effect.

3. **Import duties**

   Import duties vary according to different products and according to what country they are originating from. As from 1 January 1995, duties on imported goods of EU origin were removed. As from 1 May 2004, no customs charges are levied on goods which are in free circulation within the EU irrespective of origin. As for goods that are imported from non-EU countries, there is a Common External Tariff (CET) which is imposed by the EU which depends on the type of goods.

Permanent residents in Malta may import used household goods and furniture goods duty free within six months from the issue of the residence permit or from taking up residence in Malta, whichever is the later.

4. **Eco-contribution**

The eco-contribution was introduced through the Eco-Contribution Act No 12 of 2004 and which came into force on 1 September 2004. This measure recognised the important role that can be potentially played by taxation in environmental management, which is attested by a number of international experiences, particularly in the more advanced countries of the EU.

The eco-contribution imposed on a particular product is meant to reflect the cost of treatment when the product reaches its end of life. Consequently, the amount of eco-contribution varies according to different products depending on the extent to which these products are harmful to the environment. Products on which an eco-contribution must be paid include beverage containers which are made from glass, plastic or metal. The eco-contribution applied on these products ranges from Lm0.01 to Lm0.05. An eco-contribution of Lm0.05 is also applied on perfumes and toiletries. Eco-contribution also applies on tyres at Lm2.00 per unit while the rate on petroleum products is Lm0.10 per litre. In relation to white goods such as air-conditioners, fridges and freezers, washing machines, cookers and ovens the eco-contribution ranges from Lm2.50 to Lm30.00. Moreover, eco-contribution on batteries is Lm0.025.

In 2005, Eco-Contribution was extended on additional products such as plastic bags, plastic containers for toiletries, mattresses, shotgun cartridges and ammunition, plastic items for kitchen use, chewing gum and some more electronic products.

While the Eco-Contribution Act envisages a scenario whereby both exemptions from paying the Eco-Contribution and refunds of the latter, could be operated, the Eco-Contribution Commission, which was established to advise Government on the matter in 2004, recommended a framework focused mostly on refunds. In its report the Eco-Contribution Commission concluded that a framework based on refunds as opposed to exemptions would be more appropriate and this change should result in a better audit trail for the whole chain. The Eco-Contribution Commission considered that such a system would reward those companies with higher percentages of recovered material from waste.

As such, while the exemptions scenario is not excluded, Government published a consultation document focusing on the design of a refund mechanism, particularly a partial refund system, ideally in the form of a credit to be offset against future payments and not refund paid out.

Following public consultation, Government is awaiting MEPA's final recommendation prior to implementing the refund mechanism on condition that the producer/importer provides or participates in a scheme, approved as provided in the regulations, for the recovery of waste for products falling within the Eco Contribution Act.

5. **Motor vehicle licences**

Government imposes a motor vehicles annual road license fee. Users of private vehicles pay between Lm30 per annum to Lm150 depending on the size of the engine. An additional Lm20 has to be paid for those requiring a licence into Valletta.

Government also imposes a registration tax on motor vehicles. The Motor Vehicles Registration Tax Act (Cap 368) provides the Malta Transport Authority with the responsibility to register every vehicle imported or manufactured in Malta, and to impose an excise tax on its registration in accordance with the rates prescribed in the Schedule to the Act. The tax is charged ad valorem on the registration value of the vehicle. The tax ranges between 6 per cent and 75 per cent, depending on the engine capacity, motor vehicle type and purpose of use, with some special purpose vehicles (such as breakdown lorries, crane lorries and fire-fighting vehicles) being zero rated. Vehicles that run only on an electrically driven system are also exempt from paying this tax, which is another form of economic instrument for environmental management.

6. **Air Transport Tax**
Travel from Malta whether it is by sea or air travel is subject to a passenger departure tax as well as a passenger service charge. In 1998 Government increased airport tax from Lm4 to Lm 10 and in 2005, Government decided to double the departure tax on all air travel starting from Malta from Lm10 to Lm20.

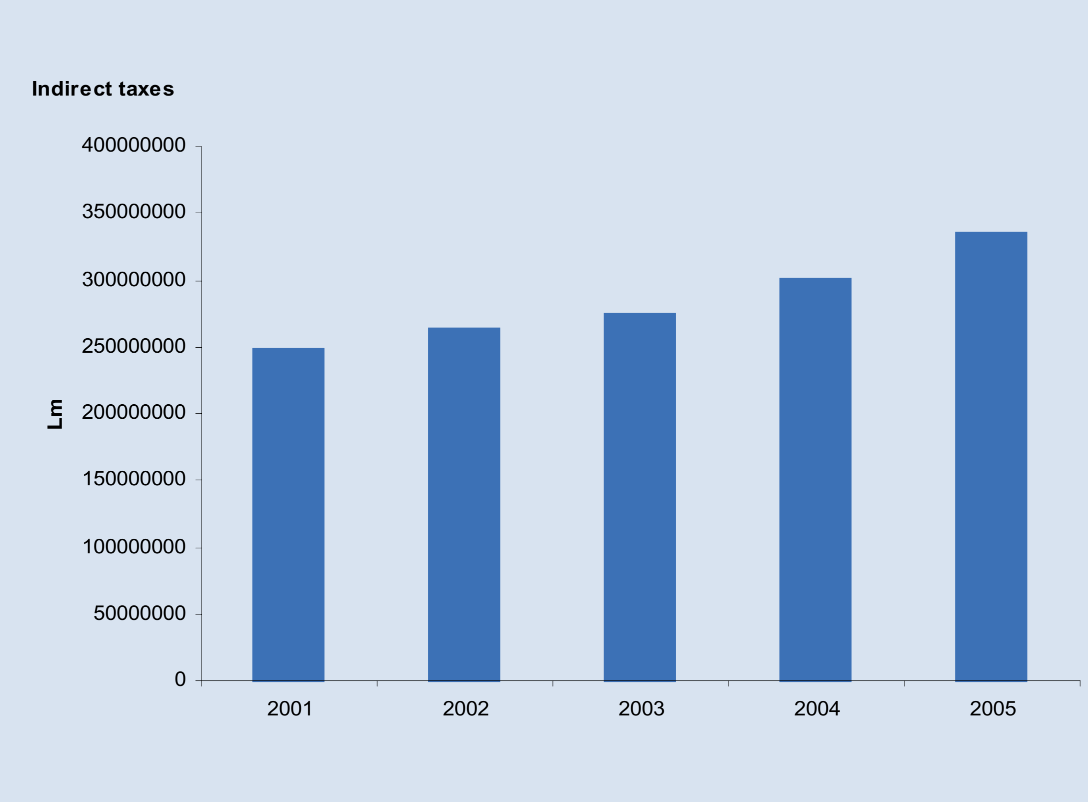
7. **Stamp duties**
Stamp duties in Malta are paid on transfers of immovable property and shares in Maltese companies, unless the respective companies are quoted on the Malta Stock Exchange or are otherwise exempted from such stamp duty.

In terms of immovable property, the current rate of stamp duty is 3.5 per cent for the first Lm30,000 and 5 per cent on the rest of the balance. 1 per cent of this total is due on signing of Preliminary Agreement while the remainder is due on signing for final deed or contract. The purchase of a second property is entitled to a stamp duty of 5 per cent. Stamp Duties are also levied on share transfers at the rate of 2 per cent of the consideration and share issues at 0.4 per cent of the nominal value. Companies licensed under the Investment Services Act 1994 (i.e. Investment Funds) are exempt from stamp duty on share transfers and issues. Maltese companies with predominantly foreign income can also obtain some exemption.

8. **Death duties**
There is no succession tax in Malta, but the transfer of inheritance of immovable property situated in Malta and shares in Maltese companies is subject to stamp duty. Duty is due at the rate of 5 per cent in the case of immovable property. If the property is jointly owned and one of the spouses passes away, the 5 per cent is levied on half the value of the property. A rate of 2 per cent applies in the case of shares.

9. **Gaming taxes**
Gaming taxes differ in accordance to the type of activity/license. In general casino type games must pay Lm2,000/month during the first six months after issue of the licence and Lm3,000 month thereafter for the entire duration of the licence period. Betting operation must pay 0.5 per cent on the gross amount of bets accepted, 0.5 per cent on the sum of all net winnings calculated per player per betting market and 0.5 per cent on the aggregate of stakes paid. 5 per cent of net income must be paid on betting exchanges and poker operations.

Chart 5.6: Revenue from indirect taxation



Source: Financial Estimates

5.5.4 Revenue collected from indirect taxation

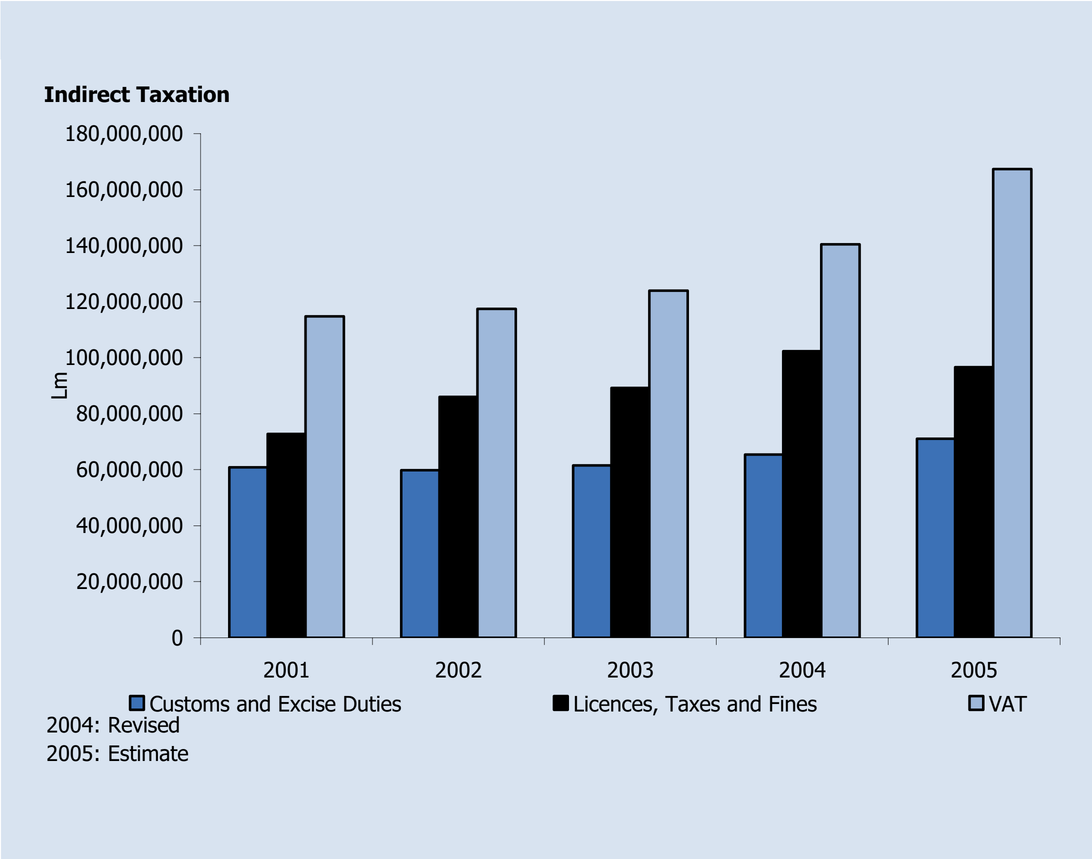
As can be seen from the chart below, revenue collected from indirect taxation has increased during the time period 2000-2005, picking up significantly by 12 per cent in 2004 and by 8 per cent in 2005.

The majority of revenue generated from indirect taxes in Malta originates from VAT, licences, taxes and fines and excise duties. A further breakdown of customs and excise duties indicates that the majority of the revenue collected from customs duties is derived from miscellaneous goods followed by customs duties from motor vehicles and clothing.

In terms of excise duties, the majority of the revenue collected has originated from machine made cigarettes and petroleum products. However while excise duties from cigarettes have increased persistently from 2001 to 2005, excise duties on petroleum products dropped to 2004 but is expected to pick up in 2005 on account of an increase in the excise tax on unleaded petrol and LRP.

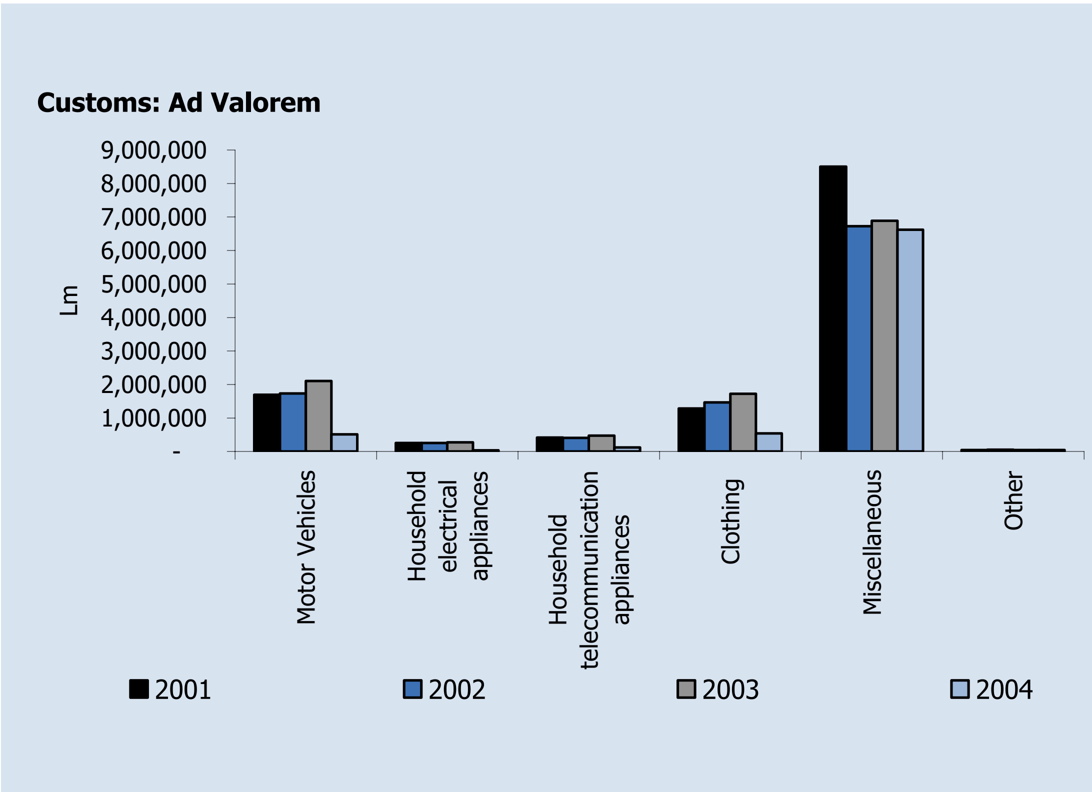
Licences, taxes and fines constitute another important category of revenue. Within this category, airport taxes increased significantly in 2005 on account of the hike in transport tax towards the end of 2004. Duty on documents has also increased significantly with an average annual growth rate of 22.5 per cent. The spike in revenue collected from gaming taxes reflects the privations of lotteries in 2004. On the other hand, levy on imported goods has diminished mainly due to the low rates of duty applicable to products and as a result of the numerous preferential agreements which the EU has with scores of countries throughout the world. In some cases, apart from import duties, other charges are levied such as anti-dumping duties and agricultural charges.

Chart 5.7: Indirect taxation



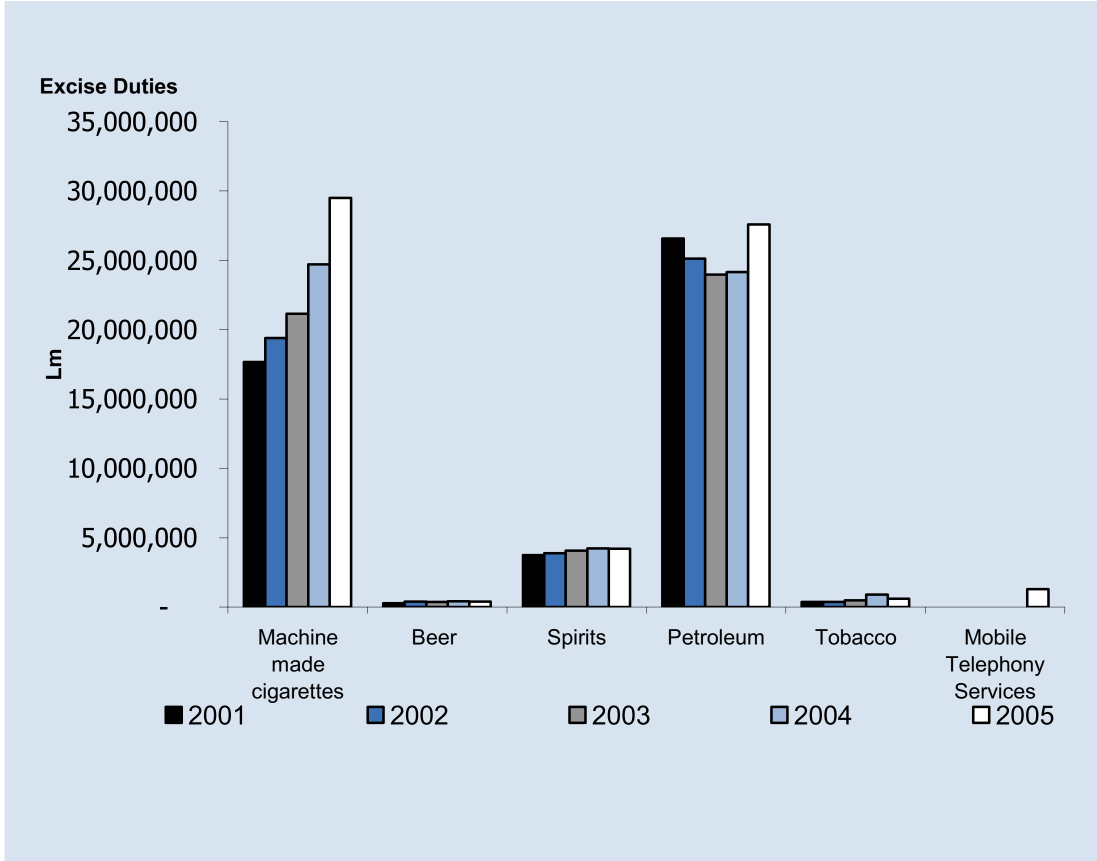
Source: Financial Estimates

Chart 5.8: Customs revenue



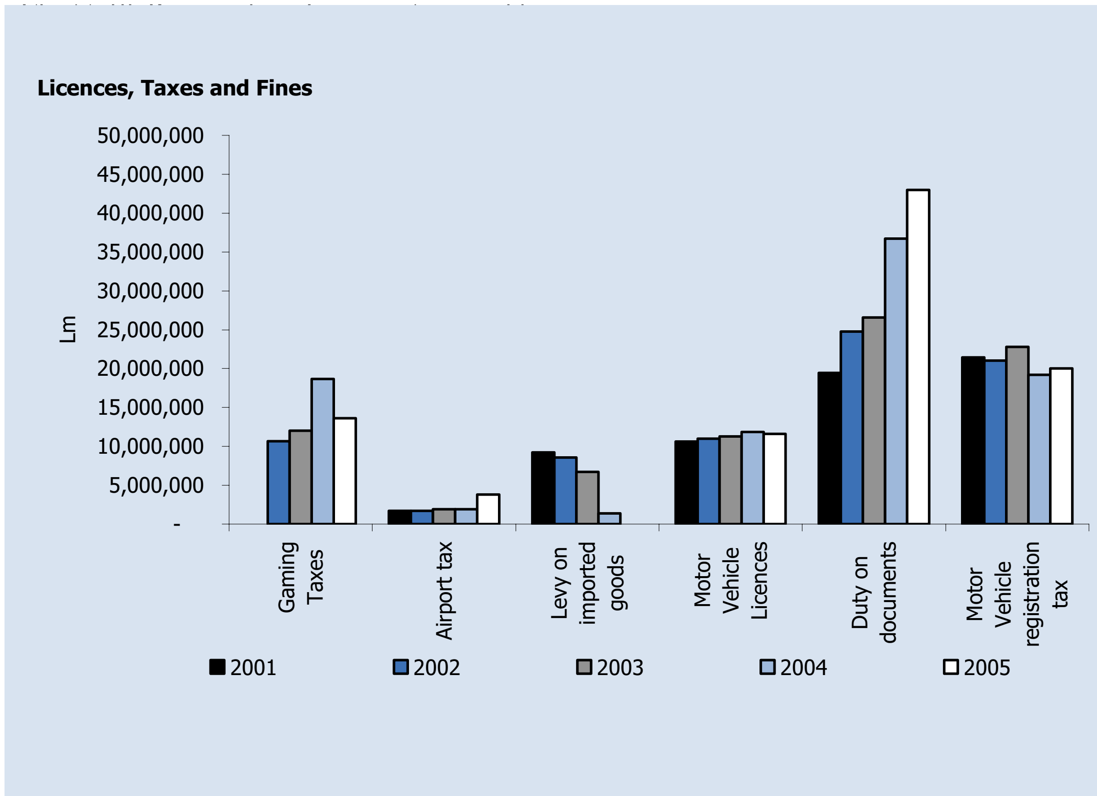
Source: Financial Estimates

Chart 5.9: Revenue from excise duties



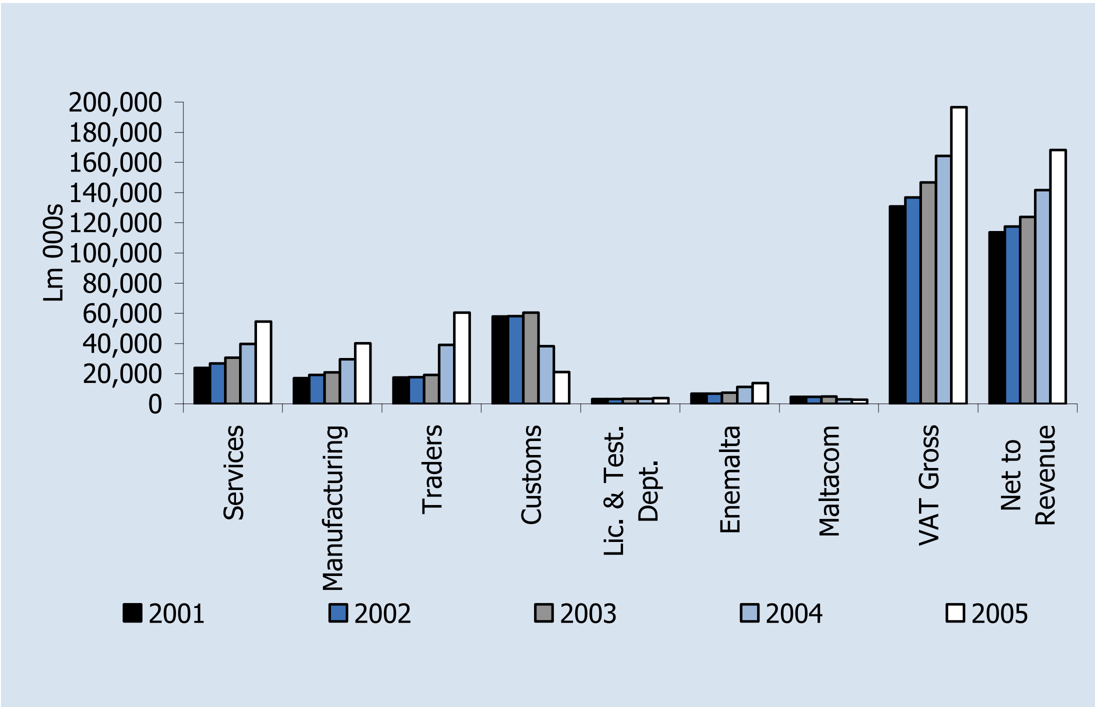
Source: Financial Estimates

Chart 5.10: Revenue from licenses, taxes and fines



Source: Financial Estimates

Chart 5.11: Revenue from VAT



Source: Ministry of Finance

As can be seen from the chart above, VAT receipts have increased persistently during 2000 to 2005, picking up by 14 per cent in 2004 and by 19 per cent in 2005. Majority of VAT receipts are collected from services, manufacturing, traders and customs. VAT collected from Customs has dropped due to a change in the methodology for the collection of VAT following EU accession.

5.5.5 Trend shift from direct taxation to indirect taxation

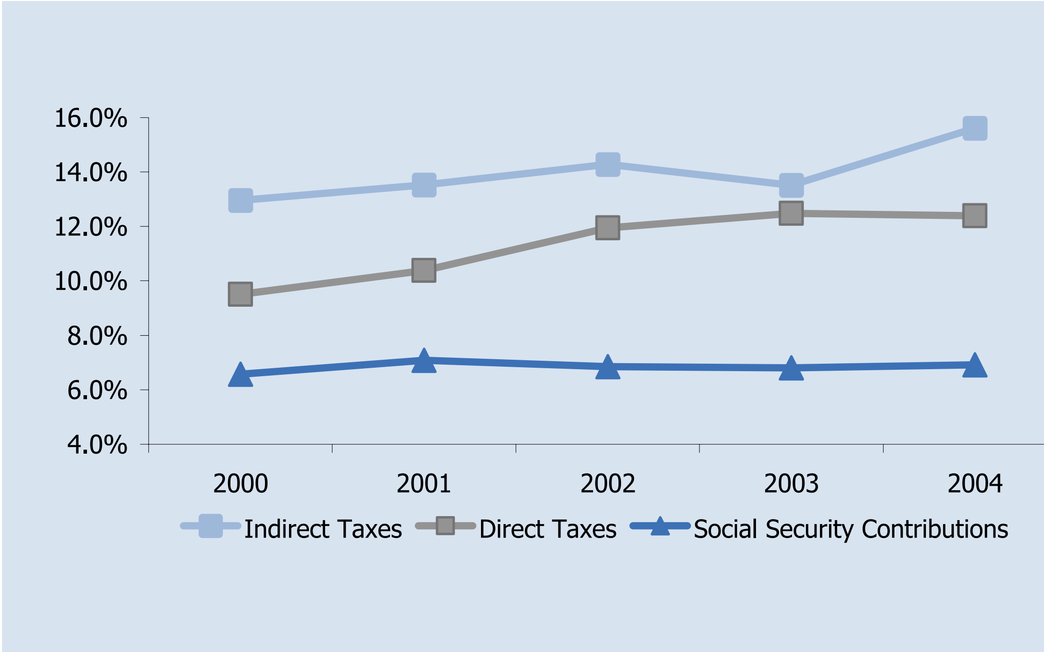
An important emphasis of Government's fiscal policy is directed towards measures that encourage work and enhance productivity. In fact as can be seen from the chart above, Government has already embarked on shifting the taxation towards indirect taxes rather than direct taxation, a trend which is currently being adopted by a number of countries.

Increased indirect taxation has allowed governments to reduce the overall tax burden on income and capital. This is one of the fundamental principles of supply side economics which focuses on long-term economic growth rather than demand driven growth which tends to be more of a short-term nature.

It is believed that direct taxation on income creates a disincentive to work. The argument runs that workers will respond to lower marginal tax rates by expanding the hours they work and raising productivity. Moreover a shift from direct taxation to indirect taxation will encourage households to save. Consequently the potential output of the economy increases.

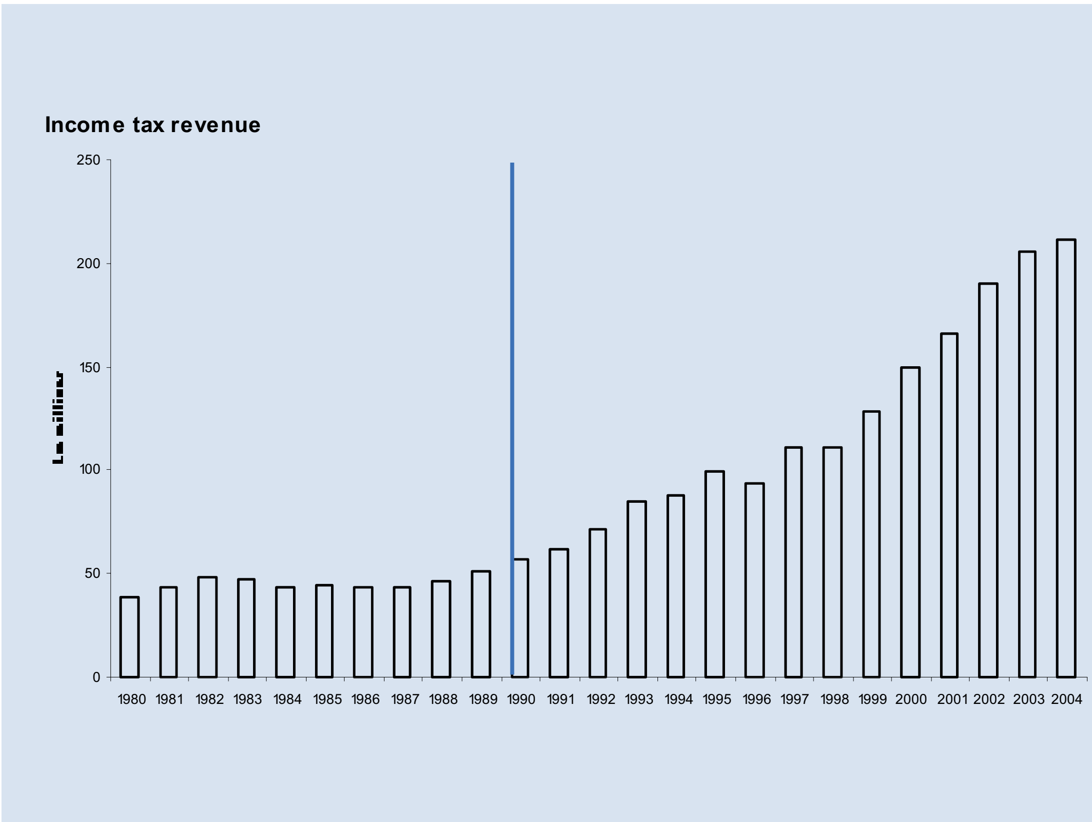
As stated above, prior to 1990, the highest income tax rates in Malta were significantly high at 65 per cent. When they were slashed to 35 per cent in 1990, government revenue collected from taxation started to increase. In fact, between 1990 and 2004, government revenue more than quadrupled. Previously, on account of the high marginal income tax, government revenue between 1980 and 1986 dropped by Lm5 million to Lm27 million as more people opted to evade taxation.

Chart 5.12: Tax burden as a percentage of gross domestic product



Source: National Statistics Office

Chart 5.13: History of income tax revenue

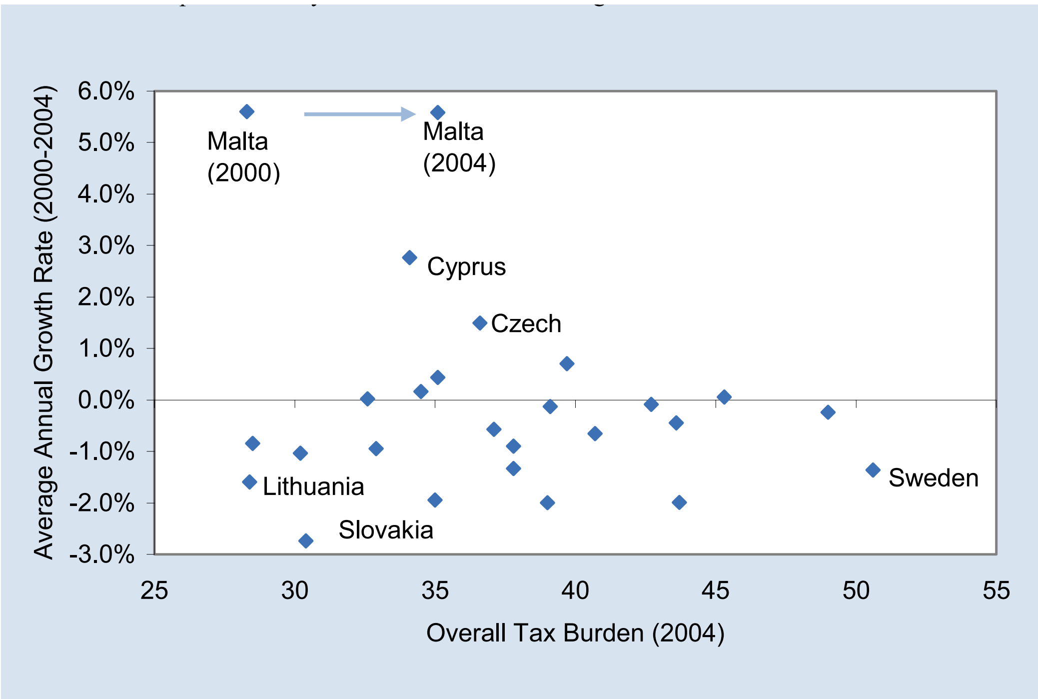


Source: Ministry of Finance

5.5.6 Comparison of tax system with EU practices

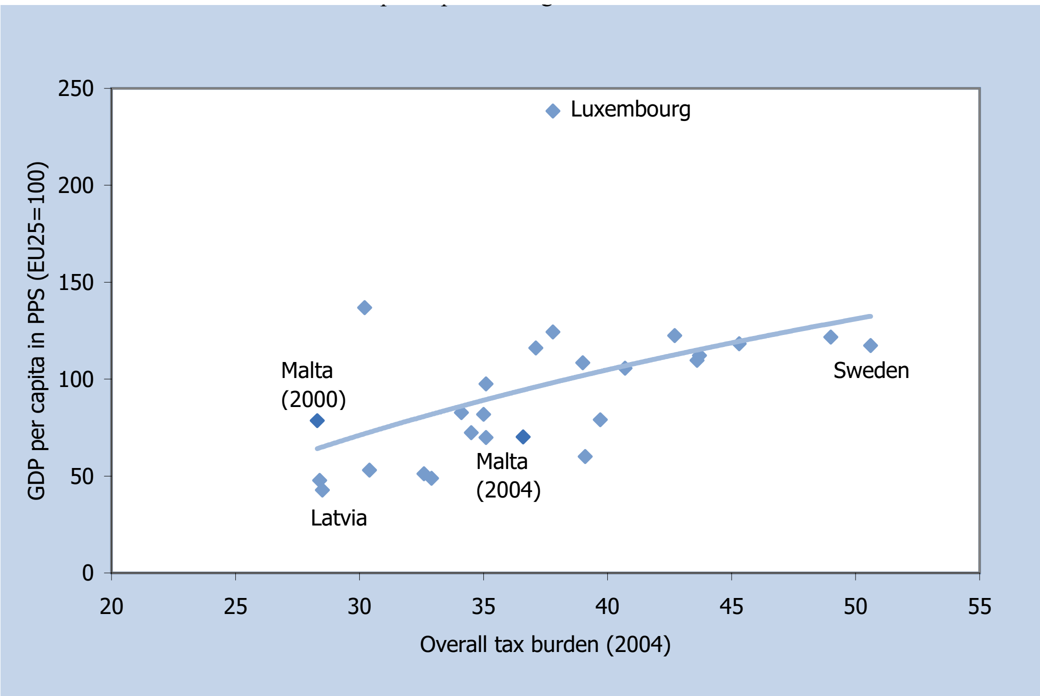
Total tax receipts (including social security contributions) as a percentage of GDP, an indicator more commonly known as the overall tax burden, was quite low in Malta in 2000 at 28.3 per cent, ranking Malta as the country with the lowest tax burden compared to other EU Member States. However, over time the tax burden in Malta crept up to the extent that in 2004 Malta had the 11th highest tax burden at 35.1 per cent, compared to the other EU 24 countries. It is noteworthy that while Malta's overall tax burden is comparable to other New Member States, it is substantially lower than the EU average which is 37.6 per cent.

Chart 5.14: A comparative analysis of the tax burden among selected EU countries



Source: Eurostat

Chart 5.14: A comparative analysis of the tax burden among selected EU countries



Source: Eurostat

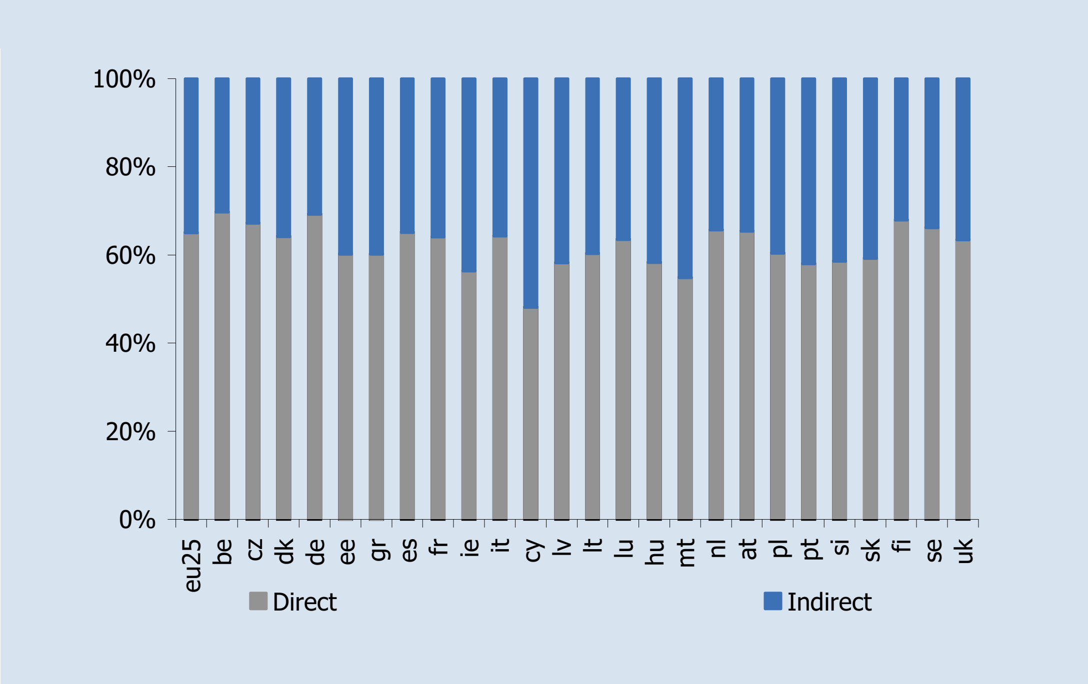
In fact as can be seen from the chart above, Malta has recorded the highest average growth rate in the tax burden between 2000 and 2004. This significant increase in the tax burden is partly due to higher tax revenue collected by Government as well as weak GDP growth during the same time frame.

In terms of government revenue, higher revenue partly reflects increased efforts to improve efficiency in collection, enforcement and compliance factors such as the individual assessment system as well as the wider tax bands in 2003 and 2004 which may have encouraged people to work more.

- **Distribution of tax burden by economic function**

Malta mainly relies on indirect taxes, the share of indirect taxes total tax in Malta at 45.1 per cent lies well above the EU-25 average of 38.2 per cent. The ratio of the overall taxation

Chart 5.16: Direct and indirect taxation in the EU



Source: Eurostat

structure – indirect taxes, direct taxes and social contributions is roughly 2:2:1 which is similar to the UK structure.

Indirect taxes absorb a proportion of GDP (15.9 per cent) which is higher than the EU average (13.7 per c ent). Direct taxes however take in a proportion in line with the EU average (12.4 per cent) but significantly higher than other New Member States (NMS) where 7.7 per cent is absorbed in taxes on income as a proportion of GDP.

In Malta, social security contributions yield comparatively little revenue at 6.9 per cent of GDP, slightly less than half of the EU average which is 13 per cent. Although this is somewhat surprising particularly since Malta has one of the widest social security nets, one should also take into account the deficit in the system. Within social security contributions, employees contribute somewhat below the European average (Malta 3.1 per cent, EU-25 3.5 per cent) while employers contribute less than half the EU-25 average (Malta 3.1 per cent, EU-25 6.8 per cent).

Taxes on consumption take in 13 per cent of GDP which is a higher than that recorded in EU-25 at 11 per cent in 2004. In fact as can be seen from Chart 5.17, Malta has one of the highest ratios of consumption to GDP compared to other EU member states. This ratio has also increased progressively from 1998 when the consumption taxes as a proportion of GDP were recorded at 9.4 per cent. The increase in the ratio is mainly due to the widening of the VAT base and the raising of excise duties to bring them in line with EU minimum rates.

Table 5.5: Taxation as a percentage of GDP

	Taxation/GDP		
	Indirect	Direct	SSC
Malta	15.9	12.4	6.9
NMS	13.7	7.7	13.2
EU-15	13.7	13.1	13
EU-25	13.7	12.5	13

Source: Ministry of Finance and Eurostat

Chart 5.17: Taxes on Consumption as a percentage of GDP (2004)

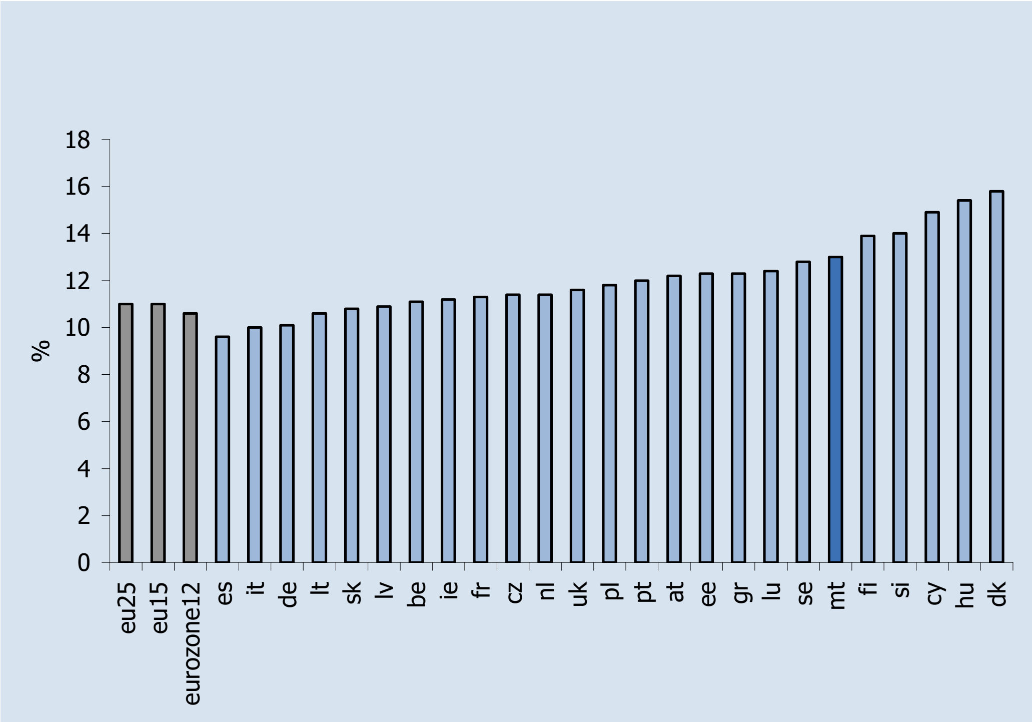
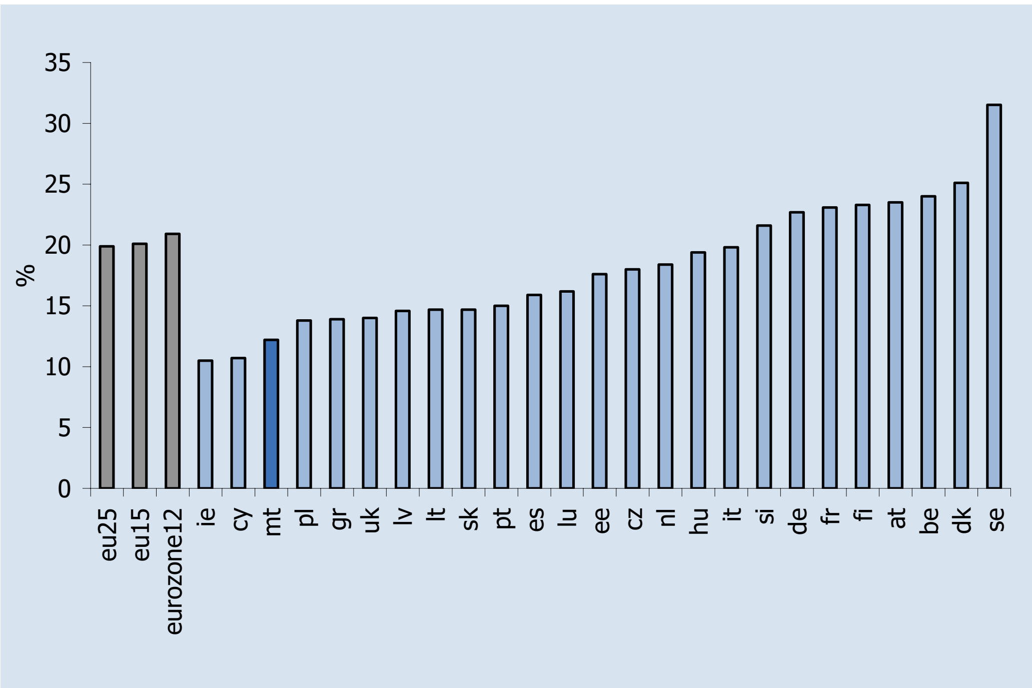


Chart 5.18: Taxes on labour as a percentage of GDP (2004)

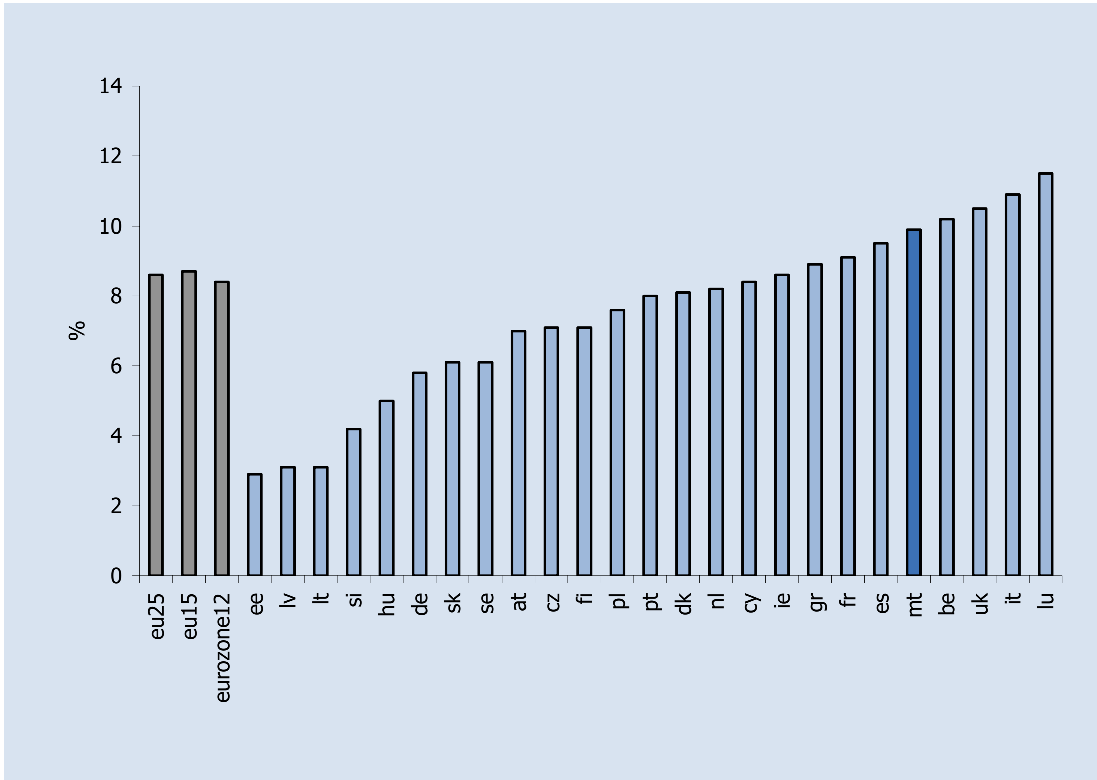


Source: Eurostat

Maltese taxation of labour (National Income contribution and income taxes on employment income). is among the lowest in the Union at 12.2 per cent of GDP compared to an EU-25 level of 18.5 per cent. The figure is comparable to that for Cyprus and Ireland with a ratio of 10.5 per cent and 10.7 per cent respectively.

In 1998 taxes on capital in Malta absorbed 6.7 per cent of GDP but the ratio has risen progressively reaching 9.9 per cent in 2003. Malta ranks as one of the countries with the highest ratios followed by Belgium, UK, Italy and Luxembourg. The ratio is also higher than the EU-25 ratio where capital taxes constitute 11 per cent of GDP.

Chart 5.19: Taxes on capital as a percentage of GDP (2004)



Source: Eurostat

5.6 Taxation reform: strategic directions and options

On the basis of the objectives set, the foregoing analysis and the inventory of taxation measures in Malta, together with an assessment of the input and feedback received from constituted bodies on the matter, this section provides a number of strategic directions and options for taxation reform that are considered that may be implementable within the short-term. Within the medium term Government believes that the process of shifting the burden of taxation from income to consumption and environment-harming activities (Poluter Pays Principle) should be the strategic focus for any future changes. Government also believes that further expenditure control and reduction through the continuation of the necessary structural reforms within public sector spending are the more desirable tools for fiscal sustainability and longer term economic growth prospects as the burden of taxation is not increased beyond what is required.

5.6.1 A discussion on the main strategic directions for reform

Subject to the overall performance of the elements of the fiscal budget and to the continuation of economic growth performance along the expected path, it can be construed that a reform involving a manageable net revenue loss in 2007 can be contemplated without undermining the fiscal consolidation targets and medium term sustainability of fiscal consolidation, also allowing Malta to still achieving the desired target of adopting the euro on 1 January 2008. In order to maximise the benefits of such a reform, it would be desirable not to concentrate on a single measure but rather on those measures with complementary economic and social effects that would satisfy this budgetary criterion and achieve the economic growth objectives the reform seeks to achieve.

The work of the Tax Reform Commission as well as inputs, obtained in different fora, from the social partners and other constituted bodies indicated that the current income tax bands should be reviewed to encourage work, productivity and therefore stimulate economic growth. Some constituted bodies and civil society members advocated for the introduction of a lump sum tax system, particularly for the self-employed, a system that is however alien to the Maltese tax structure. In effect, while this type of system may encourage work effort, the Tax Reform Commission showed concern on the potential resultant loss of audit trail which has been instrumental in moderating the level of tax evasion. Government has also its own concerns in terms of how much such a system is socially just.

The possibility of introducing tax credits for SMEs as mentioned in the Pre-Budget Document was favoured by some bodies. However the Commission noted that the possibility of introducing measures in favour of SMEs such as tax credits may encourage firms to remain small. In fact, the Commission agreed that in general, differential tax regimes and discriminatory rates would introduce distortions and inefficiencies in the system.

In this context, it was suggested that the taxation of part-time employment income at a rate of 15 per cent could be inducing distortions when considered that overtime income may potentially be taxed at higher rates. However, it was also considered that the removal of the concession on part-time income with a potential reduction of income tax rates across the board would have unpredictable effects on different individuals earning different income levels, and this option was not pursued.
In terms of corporate tax, some bodies suggested the possibility of taxing non-productive activities rather than productive ones. Moreover it was also suggested that the corporate tax rate should be lowered. The assessment carried out by the Commission however noted that the rate of corporate tax in Malta is highly competitive, because of the absence of double taxation of dividends and while changes are being proposed, changing the rate itself would not at this stage achieve the desired rate of the reform as this would only alleviate large companies that are already presently making abnormal profits. The introduction of tax incentives to stimulate the rental market raised different views from constituted bodies, civil society and other interested parties. In fact, some suggested reducing the level of tax on rental income. The Commission noted that there are limitations as to what can be suggested for the rental market at this point in time particularly since there is a pending outcome on the reform of rental law. However, Government is proposing measures associated with properties that are rented within the social market.

Similar feedback was obtained with respect to the taxation of wealth in general and real estate in particular. The taxation of wealth in terms of inheritance taxes was not identified as a priority issue for policy. Changes in the taxation on real estate were also considered to be inappropriate at this stage in view of the idiosyncratic nature of the property market in Malta, the need to avoid excessive volatility in prices, and the consideration that an intervention was already affected in the 2006 Budget. Furthermore, interventions on wealth taxation could create conflicts with the review of the corporate tax system currently under way. It was however not excluded that in the medium term, taxation on wealth could be an efficient and effective method of generating revenue in Malta.

The need to find the appropriate balance between regulation and compliance was stressed by some of the bodies and civil society. The possibility of introducing a tax ombudsman and a tax payer's charter was highlighted in the feedback by these parties. In addition it was also stated that there is a need to review the penalties structure and appeals system. In fact the Commission recognised the fact that while a lot has been done in terms of compliance, the system is still rigid and requires tuning.

While constituted bodies in general favour a shift of taxation to favour the supply side of the economy, such as VAT, Government feels that an increase in indirect taxation at this juncture would adversely impact on competitiveness.

On the other hand, constituted bodies tend to agree with Government's objectives in the field of employment. In particular, one of the objectives established to address labour market distortions, is the need to address labour market mismatches and ensuring that work pays. This particular point has also been emphasised by the Commission as tax measures can be used towards attaining these objectives, particularly where they impact upon the cost of labour and the extent to which work pays, in areas such as Social Security Contributions. In fact, while the Commission has not assessed the social security contributions in terms of pension reform the Commission has analysed thoroughly the minimum NI contributions which are considered a fundamental component in making work pay.

Another important issue is the taxation of the acquisition and use of automobiles. Malta has relatively high registration taxes upon car imports (which are waived, in part of in full in the case of environmentally friendly cars and vehicles for public transport), keeping the price of cars in Malta relatively high. This notwithstanding, car traffic is a serious environmental concern in Malta, from the perspectives of congestion and air quality. A suggestion to shift taxation away from car purchase to car use was considered, but at this point was found to be not implementable. This is mainly due to the fact that the high price of cars is in itself restricting the total volume of cars on the island. Implementing a tax regime based on emissions is not practicable because of the lack of sufficient information on a substantial part of the fleet circulating on the island. This is however an area which can be considered in the longer term, where reforms would be introduced gradually so as to not unduly destabilise the market.

5.6.2 Strategic options for taxation reform

On the basis of the foregoing analysis of the objectives set and the inventory of taxation measures in Malta, together with an assessment of the input and feedback received from constituted bodies on the matter, this section provides a number of strategic directions.

Within the medium term Government believes that the process of shifting the burden of taxation from income to consumption and the environment, based on the Poluter Pays Principle, should be the strategic focus for any future changes.

Following the Commission finding and proposals, Government is actively considering a number of measures that can be implemented over the next two to three years.

Subject to the overall performance of the elements of the fiscal budget and to the continuation of economic growth performance along the present and expected path, it can be construed that measures involving a revenue loss exposure of circa Lm 8 million in 2007 can be contemplated without undermining the fiscal consolidation targets and medium term sustainability of fiscal consolidation, thus allowing Malta to still achieve the desired target of adopting the euro on 1 January 2008.

In order to maximise the benefits of such a reform, it would be desirable not to concentrate on a single measure but rather on a package of measures with complementary economic and social effects that would satisfy the budgetary criterion and achieve the economic growth objectives the reform seeks to achieve, thus providing sufficient elbow for future measures, within the parameters of financial sustainability.

However, it needs to be clearly stated that the measures presented cannot all be implemented in the forthcoming budget, but one competing against each other in terms of the priorities that the public consultation process will indicate within the established financial envelope.

Government also believes that further expenditure control and reduction through the continuation of the necessary structural reforms within public sector spending are the more desirable tools for fiscal sustainability and longer term economic growth prospects, thus ensuring that the burden of taxation is not increased beyond what is required.

The measures being proposed are the following:

- streamline the present company taxation system to ensure long term international acceptance and improve on present competitive advantages;
- review income bands applicable to personal income taxation, in order to extend the band of income which is taxed at a zero rate and to retard the onset of highest rate of tax;
- replace the minimum NI Contributions with a pro-rata contribution on income earned at the statutory rates;
- introduce an energy benefit to provide adequate compensation for the surcharge on the consumption of electricity;
- introduce incentives for Funded Pension Scheme contributions;
- allow spouses to work within a family self-employed business;
- introduce a tax rebate for family carers;
- reduce the airport departure tax.

These measures reflect attempts to achieve a number of aims. First and foremost, there is a trust towards enhancing economic activity by making; maintaining and enhancing the competitive edge of our tax structure to continue attract foreign business in good measure. These measures also seek to make work pay whilst emphasising a more equitable distribution of income, through the introduction of family incentives.

1. Streamlining company taxation

A review of the present company taxation system necessarily involves a comparison with those of other countries. As we had pointed in last year's Pre Budget Document the criticism often levied that our company rate of tax is too high compared to that obtaining in other countries is not justified. Malta's tax system is a full imputation tax system which avoids the double taxation of company profits. The tax paid by the company is essentially only a prepayment of the tax, which is ultimately borne at the shareholder level depending on each shareholder's tax status and position. It should be recognised that our imputation system is a complete imputation system – company income, tax incentives, tax credits and tax borne are all imputed to the shareholder, at which level the tax burden is finally determined. Once distributed the company income may be taxed in the shareholder's hands and if his personal tax on that income is less than the tax the company paid on the income, the excess is refunded to the individual. Most imputation tax systems in other countries do not achieve this level of integration.

Most countries today have moved to classical tax systems where tax is levied on company profits as separate taxable persons and dividends or part thereof are again taxed in the hands of the shareholders. The Commission findings demonstrate that Malta has an effective tax on company profits which is significantly lower than that applicable in most other countries.

The Commission finding therefore strongly recommend that the fundamentals of Malta's full imputation tax system are as good as any tax system and should be retained.

However, recent developments in the international tax arena, and the impact these could have on the growth prospects of our financial services industry need to be addressed. Thirteen years ago when we had transformed our tax laws the international tax landscape was significantly different to what it is today. Then one could simply direct and model the tax system as one wished without any international repercussions by simply giving direct tax incentives to businesses which provide employment and training to our work force but which do not partake in our domestic market or do so to a very limited extent. Since those changes, international developments have not made this any more possible.

These developments as well as the way in which countries viewed and implemented imputation tax systems only domestically i.e. only up to their borders, has caused the disadvantage that also a tax credit in respect of the Malta tax paid may not always be available to the foreign investor leading in certain cases to double taxation of company profits upon distribution. We have remedied these disadvantages by the introduction of the exemption method or giving a credit for foreign underlying taxes within our own system.
As was announced in March, we have reached agreement with the EU Commission as regards our current tax rules as they apply to international trading companies and companies having foreign income. While Malta was not in agreement with the Commission that these elements in our tax system constituted state aid, in the interests of stability and certainty Malta sought to reach agreement with the Commission on a revised tax system with appropriate transitional arrangements. The supplementary paper attached with this Pre Budget Document seeks to provide sufficient technical information on the background, economic rational and changes contemplated.

From the outset, the Government is not proposing to change the tax landscape in a significant way and this for a number of reasons, including the possible impact on international tax considerations and that business taxation must necessarily remain profit based. However the proposed changes that will be implemented over a period of time should ensure a smooth transition.

Government is therefore proposing:

- retaining the present imputation tax system whereby the tax paid by companies will essentially remain a prepaid tax on behalf of the shareholders at which level the tax is finally determined;

- introducing the notion of an economic rent within our system, as well a enhancing the distinction as to how profits are derived, directly or indirectly, whereby profits from immovable property will be excluded from the tax refund system agreed to with the EU Commission;

- for this purpose such profits will, for tax purposes, be allocated to an immovable property account and treated in the same manner as they have been treated to date;

- as is also currently the case, company profits will be allocated to tax accounts in order that the tax treatment when such profits are distributed to shareholders as dividends can be determined;

- within the above economic conceptual framework company profits will be divided between those profits the tax on which will not be available for refund since they are deemed to be the company's contribution towards the country's provision of public goods, and allocated to the respective tax accounts;

- the remaining profits, as happens today, will be allocated to the taxed accounts called the Maltese taxed account and the foreign income account;

- upon the payment of a dividend from such profits shareholders, resident or non-resident, may claim a refund of part or the whole of the tax paid on the distributed profits. The refund will generally be equal to 6/7ths of the Malta tax paid on the distributed profits. When the distributing company claims double taxation relief (these provisions remain unchanged) on the distributed profits the tax refund will remain at the current level of 2/3rds of the Malta tax paid;

- in principle these changes will not affect local residents or businesses but are directed towards maintaining our attractiveness as foreign direct investment destination.

However as the case in other EU members states certain anti-abuse provisions will be introduced aimed at distributions received from companies having mainly passive income where such income would not have been taxed at more than 5 per cent.

2. Review of income tax bands

The taxation of personal income in Malta is operated on a progressive system with an initial band of income which is tax free and maximum rate of 35 per cent, with the bands being differentiated between persons subject to a computation as a married couple or as a single person. The table below shows the average amount of personal income tax paid by taxpayers falling under different income and computation categories, on the basis of 2004 data.

Table 5.6: Average amount of personal income tax paid by taxpayers **(2004)**

Separate Computation			Joint Computation		
Income Band	Number of Tax-Payers	Average Tax Bill (Lm)	Income Band	Number of Tax-Payers	Average Tax Bill (Lm)
0-3100 (0%)	55,620	-	0-4300 (0%)	23,232	-
3101-4100 (15%)	21,556	75	4301-6000 (15%)	18,576	128
4101-5000 (20%)	17,448	225	6001-7250 (20%)	8,306	253
5001-6000 (25%)	15,396	350	7251-8000 (25%)	5,771	416
6001-6750 (30%)	8,341	463	8501-10000 (30%)	4,377	641
6751+ (35%)	26,372	813	10001+ (35%)	7,501	991

Source: Ministry of Finance

Around 37 per cent of tax payers in Malta are not subject to income tax because they declare an income within the zero tax bands. On the other hand, more than a fifth of tax-payers are subject to a tax bill in excess of Lm400 per annum. The marginal rate of tax progresses quite steeply, such that it may serve as a disincentive to work for people in the lower income brackets deciding between work and dependence on social services, as well as for higher income people deciding between leisure and providing further work effort.

The present system of personal income taxation may be reformed in a number of possibly complementary manners:

- extending the zero band of income tax;
- retarding the onset of the maximum rate of tax by adjusted subsequent income tax brackets;
- lowering average tax rates, including the maximum rate.

Of these, the first two options are considered to be preferable. They would potentially extend over a wide section of the population and the labour market, facilitating work and productivity and stimulating consumption and saving. They can also be devised in a manner which ensures that benefits accrue to all taxpayers in an equitable manner, although in a progressive tax system, it is inevitable that a reduction in the tax burden would, at least in absolute terms, benefit the higher income earners to a larger extent. The lowering of average tax rates, including the maximum rate, would have repercussions on the corporate tax rate, thereby resulting in a drop in government revenue whose effects would not be widespread across the labour market. Furthermore, it is considered that the corporate tax system is already competitive in Malta as more amply analysed in a specific section in this Document.

It goes without saying that such a reform can only be contemplated within the constraints of the developments in the overall budget and the undertaking of other measures which would keep fiscal performance along the projected path.

However, Government feels that the considering the present cost of living realities and the added burden that had been placed on the population due to the higher energy prices, the compensation to be considered should be sufficiently meaningful and effective to have in itself a deflationary impact and lowers wage pressures that may further harm the countries competitively. Government is also considering a further measure to alleviate the burden of families whose income would not benefit for tax relief and thus would have to be supported through a supplementary benefit.

To do so effectively, the potential loss in net revenue in 2007, beyond the earmarked Lm 8 million would have to be made good by other measures, such as further expenditure reductions or by shifting the burden of taxation through additional revenue sources that might be identified during the consultation process. To this effect, Government is proposing the containment of total expenditure except that earmarked for pension benefits within this year's parameters.

3. Minimum National Insurance contributions.

It appears that the current minimum NI contribution, which at present is Lm11.58, half of which is paid by the employer and half of which is paid by the employee, is keeping a number of people working in the undeclared economy. Moreover, a number of individuals, in particular women returnees who opt for part time employment, end up paying a very high effective tax rate on employment to the extent that they either prefer to remain out of the labour force or else to engage in undeclared activity.

This is essentially due to the nature of the minimum NI contribution which is fixed irrespective of the level of income under the minimum wage. Consequently anyone with an income level under the minimum wage must pay a proportionately higher rate of NI contributions to income. In fact as can be seen from the chart below, the effective rate is significantly higher at lower income levels. Indeed the effective tax rate is over 100 per cent for individuals over the age of 18 who earn an income of Lm500 per annum.

It can thus be proposed to change the current minimum NI contributions to a proportional system such that the current system is changed and linking the contribution paid to the income being earned.

The proposal is to maintain the present system, however giving part-timers the option to apply for a proportionate system should their income be at a level lower then the minimum contribution rates established. Since the contribution that would be paid would be less then that required by the Social Security Act for the purpose of qualifying for the minimum pension, should the contribution paid be more then 50 per cent of the established minimum contribution the individual would be entitled to a pension proportionate to the contribution paid. However should the contribution be less then 50 per cent of the minimum contribution rate the individual would lose any pension entitlement and any contributions paid are deemed as a contribution towards health and other benefits.

This proposal could result in a maximum potential loss in government revenue of Lm 1.5 million. However, it is important to note that this assessment is based only on the present situation and does not include individuals who may actually be encouraged to seek employment, implying that the potential loss in government revenue could be lower than what might appear.

4. Energy benefit

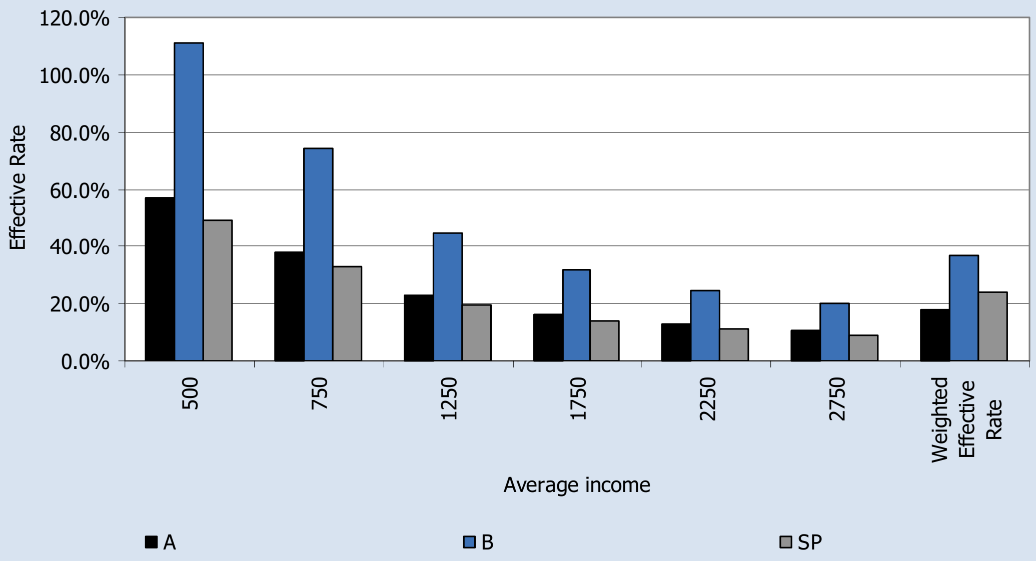
As highlighted in section 2.2.1 of this document, oil prices are leaving a serious impact on most world economies, including ours. As a result, Government had to take remedial action in order to counterbalance the hefty increases in the international price of oil and, thereby, mitigate its negative impact on the national energy provider and the various economic operators.

In spite of the above, circumstances have arisen whereby a group of families and persons with limited means would require assistance on the payment of their water and electricity bills in order to prevent their standard of living from deteriorating. Government is fully committed to its declared policy of social solidarity and social inclusion. Therefore, given the new realities arising from the constant increase in the international price of oil and within the context of its declared social welfare policies, Government proposes the introduction of a new social benefit - the Energy Benefit.

The objective of the proposed Energy Benefit is to provide adequate compensation for the surcharge on the consumption of electricity. It is proposed that this benefit be based on the following criteria:

- household income;
- household size;
- household consumption of water and electricity.

Chart 5.20: Average income



Source: National Statistics Office

In addition to the grant of this benefit to the qualifying households and persons, it is Government's intention to extend this benefit to those households and persons who might be suffering from certain medical conditions that would warrant an extraordinary level of consumption of either water or electricity, or both.

It is estimated that the above-mentioned schemes would benefit around 17,000 households.

5. Incentives for Funded Pension Scheme contributions

The Government of Malta is currently in the process of enacting a reform of the pension system. Complementing this initiative could be a reinforcement of the incentives currently available to individuals who opt for a voluntary funded pension scheme. This would also contribute to overall macroeconomic stability by inducing an overall higher rate of saving.

The Malta Financial Services Authority commissioned a report on the potential fiscal incentives that could support Second and Third Pillar pension schemes. The main objectives of the report were to provide an overview of fiscal incentives options that can be introduced taking into account, amongst other issues, the potential impact on persons in low and middle income groups; the impact on encouraging savings across all income groups; the impact on cost of administration of incentive options and the impact on the Final Settlement Scheme. The assessment has to also provide an assessment of the annual and total (up to 2050) impact on the financial revenues of Government both in terms of revenue foregone and deferred taxation.

The report assesses four different incentive structures as shown in Table 5.7. Macro-economic projections are mapped out for each year over the period 2006 to 2050. The macroeconomic cost of the contribution incentive differs according to the incentives. Incentive structures 1 and 5, which offer a tax relief on contributions, could potentially cost Lm9 million in 2006 and increase progressively to Lm82 million in 2050. On the other hand, incentive structures 2 and 3 which are based on a Lm1 for Lm4 subsidy offered by Government could potentially cost Lm10 million in 2006 and up to Lm97 million in 2050.

Table 5.7:

Structure	Voluntary SPPS Contributions	Investment Returns	Retirement Lump Sum	Annuity payments
Base	Taxed as income	Exempt from income capital gains tax	None	None
1	Exempt from income tax	Exempt from income capital gains tax	Taxed as income (Limit to 20% of fund at retirement)	Taxed as income
2	Taxed as income but government subsidy of Lm 1 paid for every Lm 4 of contributions	Exempt from income capital gains tax	No tax applied (Limited to 20% of fund at retirement)	Taxed as income
3	Taxed as income but government subsidy of Lm 1 paid for every Lm 4 of contributions	Exempt from income capital gains tax	Taxed as income (Limit to 20% of fund at retirement)	Taxed as income
4	Exempt from income tax	Exempt from income capital gains tax	No tax applied (Limited to 20% of fund at retirement)	Taxed as income

The report also presents an assessment on the possible cost of the incentive for the first year of projections, based on a level of take-up for people at different ages. In this first year of projection, the take up rate is expected to be low among young age groups. However a high take up is expected for higher age groups, in particular individuals within the age-cohort 41-45. The actual cost of providing the incentive is expected to range between Lm1.6 million and Lm3.2 million. On the other hand, since there are no incentive structures for the voluntary third pillar pension scheme, there are also no potential costs.

The following are the main recommendations of the report:

- **Second Pillar Pension**
  For the Mandatory Second Pillar Pension, which Government is considering its introduction at a later stage of the reform, the report recommends that no tax exemption or government subsidy is applied to any mandatory contributions that would have carved out from the present social security benefits. However full tax exemption is given on investment income and capital gains on the pensions assets accumulated by investing additional mandatory carve out contributions. Both pension benefits and any lump sum benefits arising from mandatory carve out contributions are taxed as earned income.

  For the Voluntary Second Pillar Pension Contributions, a Government subsidy of

Lm1 is added to every Lm4 of voluntary contributions paid, subject to a maximum subsidy – reviewed annually – on the contributions paid in each year. The maximum subsidy is expressed as a fixed amount. Under such a proposal no tax exemption is applied to voluntary contributions and any voluntary employer contributions are automatically treated as part of the employees' taxable earned income. On the other hand full tax exemption is given on investment income and capital gains on the pension assets accumulated by investing voluntary contributions i.e. the accumulation of the fund as these are re-invested. However pension benefits and/or lump sum arising from voluntary contributions would be taxed as earned income.

- **Voluntary Third Pillar Pension Scheme**
  No tax exemption or government subsidy is applied to the voluntary Third Pillar Pension Scheme (TPPS) contributions, however full tax exemption is given on investment income and capital gains earned on the TPPS savings. Benefits whether paid in the form of lump sum withdrawals or on a flexible basis and paid tax free. A maximum limit is reviewed each year is applied to the amount which can be saved as TPPS contributions in each year. For administrative simplicity, this limit is expressed as a fixed amount.

- **Considerations**
  If Government were to consider setting aside 1 per cent from the employees' and employers' contribution respectively (i.e. 2 per cent) towards the introduction of the Mandatory Second Pension and introduce the Voluntary Second Pillar Pension scheme, the financial implication on Government is estimates to be around Lm 18 million. This would in effect jeopardise the possibility of Government allowing for any sort of tax relief on personal income without having to shift significantly the burden of taxation elsewhere through other taxation forms, without altering in any way the present financial state of affairs of Maltese families.

  Government's preference is towards lifting the burden of taxation on income and allowing for choice in the way that extra money available is invested or spent, introducing the incentives related to the Third Pillar Pension to encourage such savings.

  As in the case of the reform of personal income taxation, this measure would have to be undertaken within the context of the existing constraints to budgetary performance.

6. Recognition of married women working in family self-employed businesses

Self-employed persons cannot declare their spouse as working within their business so as to stop them from benefiting from a wider non-taxable income when both individuals declare their income separately. However, this constraint may be by-passed and could be introducing more inefficiencies than is warranted in terms of the gains to government revenue it may be procuring. By relaxing this requirement, although a minor tax leakage can take place, it is expected that family businesses are significantly encouraged, while, the valuable contribution that the spouse, generally woman, contribute to the growth and profitability of the business itself is recognised.

It is pertinent to note that this measure will also increase the NI contributions as self-employed individuals employing their spouse will have to contribute for NI contributions. This measure could also encourage part time and full time activity by women in the labour market. This would imply potential second round benefits on economic activity and government revenue.

7. Family tax incentives

There are suggestions to make the taxation system in Malta more family-friendly. At the same time, any reform in the income tax brackets would have to be rendered more equitable for the lower income earners. It is proposed that these objectives be targeted through the introduction of Family Benefits. This can be done in a number of ways, but it is important that the system selected is manageable, understandable and simple to operate. It is thus proposed that a flat rate non-taxable benefit for every child under care is introduced, which would be independent of the level of income earned. This would be in addition to the current system of children's allowance, which is means-tested.

This measure can be viewed to partly address the demographic problem in Malta, whereby the birth rate has recently fallen dramatically with adverse consequences to the sustainability of pensions.

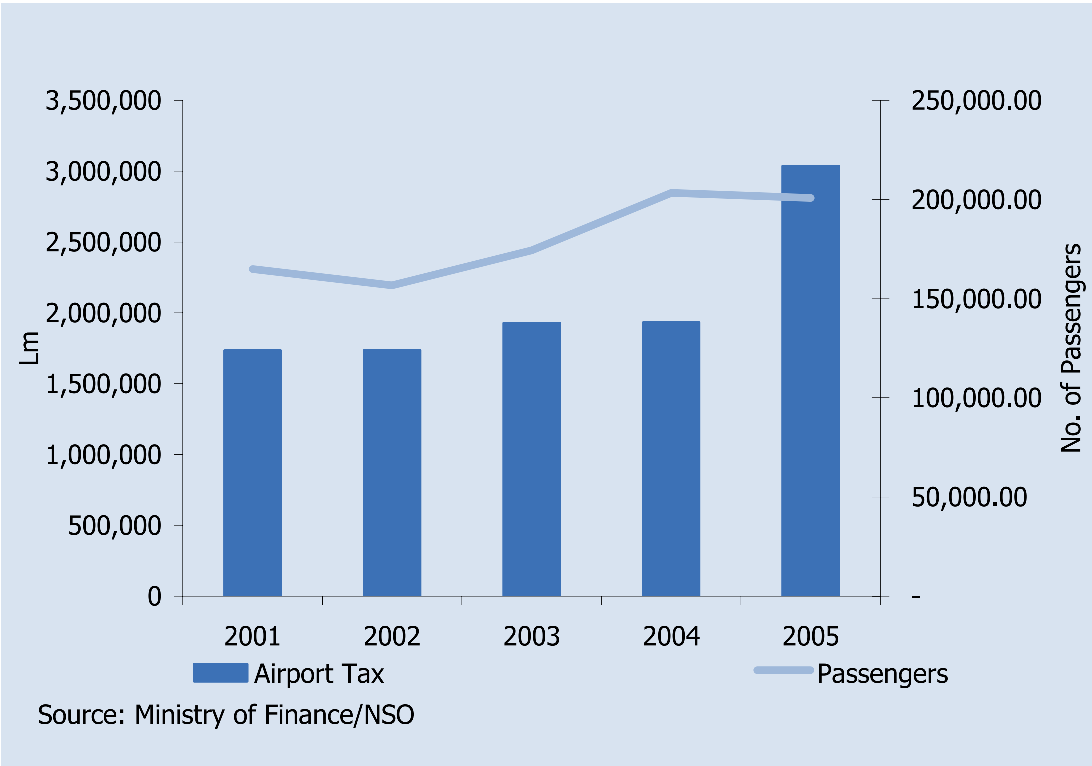
8. Airport taxes

Travel from Malta, whether by sea or air, is subject to a passenger departure tax. In the case of sea travel the charge is Lm10 but in 2005 Government increased the passenger tax for travellers travelling by air from Lm10 to Lm20.

The air departure tax is payable in respect of each departing passenger whose travel commences from Malta for a destination outside Malta, other than a military aircraft, and who does not return to Malta on the same day of departure.

During 2005, Government raised Lm3 million in air departure taxes. The chart below provides an overview of the income generated from the air transport departure taxes over the last 5 years. Income from the air transport tax increased considerably in 2005 following the increase in the departure tax in August 2005. This is set to increase to Lm 4 million by the end of 2006 as the tax would have been in effect for a full year.

Chart 5.21: Revenue from airport tax



Source: Ministry of Finance/NSO

It is proposed reducing the departure tax but retain it at a sufficient level so as to enable the attainment of overall fiscal objectives. The implications of this proposal are that there may be an increase in outbound tourism to the extent that the surplus on the services component of the current account may deteriorate on account of an increase in expenditure by Maltese travellers.

Furthermore, total elimination may not be a priority for economic and fiscal policy, as other tax alleviation measures proposed in this document could at this point in time be more preferable within the budgetary constraints being experienced.

5.6.3 Other initiatives

- **A proposal for the integration of revenue departments**

An important aspect of better regulation across Government concerns the tax reform process in that Government is exploring the possibility of establishing a closer working relationship between the revenue earning departments. The opportunities for improved synergies between the three main revenue-earning departments, namely the Inland Revenue Department, the Value-Added Tax Department and the Customs Department are also being assessed.

In furtherance of this objective, the Ministry of Finance has set up an inter-departmental working group with a view to:

(a) evaluate Government's stated policy objective, research best practices in this area and identify an operational model that would cater for local needs and circumstances;

(b) make concrete proposals for a closer working relationship and/or amalgamation of the three revenue-earning departments under consideration;

(c) propose any required new and/or amended organizational structures for each of these departments in furtherance of the stated objective;

(d) propose ways on the integration of the Tax Compliance Unit within the new structure/s;

(e) identify and quantify any resources requirements that may be required for the proper implementation of this proposal;

(f) propose and draft amendments to current legislation and/or new legislation with a view to implementing the Group's recommendations.

The Working Group, which will meet over a period of six months, is expected to submit its final report by the end of October 2006.

The thrust of this initiative should result in increased efficiencies in resource use and improved results on an operational level. In addition, it should provide a better institutional framework for the introduction of certain business practices like a system of set-offs for businesses of tax claims and liabilities.

- **Taxpayer free filing initiative**

Last year the Inland Revenue Department had introduced the concept of tax return free filing for a restricted number of taxpayers as a pilot project. Last year 29,175 taxpayers, mostly pensioners and students, benefited from this initiative and were relieved from the requirement of filing the tax return or the declaration. The department had also benefited as no manual processing was necessary and the respective officers could be deployed on other duties.

Table 5.8: Analysis of taxpayer

Type of Taxpayer	Count of Taxpayers
Pensioner	28,622
Employed with a Private Employer	20,449
Students	11,209
Employed with Government or Parastatal entity	13,316

Source: Ministry of Finance

Considering the positive feedback received from taxpayers who were included in this initiative together with the potential increase in the internal operational efficiency and related reduction in costs, the Inland Revenue Department plans to extend this initiative for this year to general employees irrespective of the tax liability incurred by the taxpayer.

For this purpose, further risk analysis was made to ensure that the selected taxpayers are low risk taxpayers with respect to revenue. A total of 73,501 taxpayers have been identified in respect of whom the department feels that there would be no need for the respective taxpayers to file any return or declaration. These taxpayers are categorized as follows:

It should be noted that in the case of private sector employees, the information available to the department matches with ETC data, and the respective FSS documents for 2005 have already been received from the employer. Moreover students form part of the government payroll.

The declared income by these taxpayers for Year of Assessment 2005 is classified as follows:

Table 5.9: Analysis of the declared income by taxpayers (2005)

Previous Year Income Range in Lm	Declared by Taxpayer	Count of Taxpayers
Greater than 3000	Yes	44,051
Between 1001 and 3000	Yes	17,399
Income not yet determined	Yes (Return not yet captured)	95
No income	No (new registrations and students)	3,966
Between 1 and 1000	Yes (mostly students)	8,085

Source: Ministry of Finance

Government is therefore confident that the department can widen the selection parameters adopted last year by including a greater number of employees as free filers, bringing the total to about 73,500 taxpayers, without any potential risks to revenue.

- **Government debt conversion or release through the use of securitisation**

While on a statistical level, Government is considered to be in debt levels beyond those deemed to be sustainable, with debts particularly that had accumulated along the years and accumulated upon the expropriation of land, little value has been given to date to the large land resources available to Government but which to date neither been appropriate valorised and reflected in the government books. Eurostat regulations on Government Financial Reporting do no allow for the deduction from National Accounts payables assets in property.

Government recently passed through parliament an act dealing with securitisations which can assist Government in addressing past injustices without impinging on the fiscal conversation targets and necessarily disposing of government property at hand, which property may be desirable for Government to retain in the future.

Government can gain access to capital in the short term and settle debts that had accumulated over a long number of years that either have a higher cost in delay further settlement as is the case of properties that had been expropriated, or as is the case in a number of loans and advances to reduce financing costs in interest payments, thus reducing the long term burden of financing on annual budgets.

In doing so Government can also allow people to participate in capital growth and income that can be derived from the public wealth, with Government not losing the property transferred to the securitisation vehicles or funds through possibly "buy back options" or other structures which can be created to leave equity with Government while releasing the relative economic activity to the capital markets and involving the private sector in valorising further these assets.

There are also broader benefits that should be considered by pursuing these new methods of dealing with financing and Government property:

(a) the structured process of giving value to "dead" assets and placing them in a securitisation vehicle or fund that transforms these properties into income producing assets, or converting "unsellable" properties in the ordinary sense into saleable structured products on the capital market, will definitely have a direct impact on economic growth, particularly through the wider investment opportunities that can be offered to investors in the capital market and even more directly in the economy as these asset are specifically managed and transformed to effective economic use and thus increasing the long term value of the said assets;

(b) certain properties can be placed onto the market in a managed manner and allow access to this "wealth" to the public at large. Securitisation can also focus direction of development example in Valletta, by raising the necessary capital to inject in restoration of derelict properties which can be leased, and thus while upgrading Valletta itself generating further economic growth;

(c) these kind of projects can also generate funds for development raised through the capitalisation of future rental flows, releasing funding towards projects that the private sector would not have entered into because of the low capital yields or not sufficiently high to justify the investment. It also allows Government to move forward in the absence of identified capital funds as

Government acts very much like a promoter or intermediary between the capital markets and the end product developers, avoiding the dynamics of the speculative or profit-making orientation of current promoters while still ensuring a good yield on money.

This also ensures that rental values on property released can then be kept to reasonable levels rather than pushed to levels which are unachievable by most tenants;

(d) these instruments can also give rise to good investment of monies held by life insurance companies and pension funds as they are highly rated and with institutional investors of this type a managed growth and income yield will be very acceptable;

(e) give opportunity to smaller investors that lack the financial strength to enter the property market on a large scale and thus not benefiting from the higher returns experienced in the past years;

(f) these initiatives will also give more depth and diversity to the capital markets and will help thus help Malta prove itself up for a more sophisticated financial centre. This would also give opportunities to professional in the local industry build their expertise and thus place them in a position to attract international projects that would structure through Malta and possibly our local stock exchange.

Whilst Government can be instrumental in generating the necessary securitisation obligations, Government looks favourably also at co-operating with a manufacturer/issuer of a securitised assets through established financial institutions. In such arrangements the institutions would assume the risks of the securities that are being managed by mutual co-operation, avoiding risk of intervening disputes in the payment of the debts.

Any government debt, ranging from debts due for procurement to debts for rent or expropriated property allow themselves for securitisation. This could be done through the setting up of a Special Purpose Vehicle (SPV), with Government acknowledging the debt and agreeing the interest rate on such debts. The SPV would raise the money through issue of bonds, and administer the debt and pays investors capital and interest due. When Government pays the SPV the capital and interest, the SPV pays the bond holders so the credit rating of that security is equal to the government debt.

In the case of debt by Government to owners of expropriated properties and that have been pending for many years, this can be addressed through the issue of securities which can be traded on the stock exchange as an alternative to a direct payment of cash. This enables the creditors of the expropriated properties to receive value, readily realizable, without Government having to pay the value in cash immediately. The SPV becomes a sort of conduit for Government to pay its various creditors in the future, while allowing the creditor to crystallize his claim immediately and to use his claim as cash (if he/she decides to sell) as an investment (if he/she holds and gets interest) or as security for his/her own business or personal interests (if he/she pledges it to banks etc.) and can even use it to pay outstanding debts if a creditor is willing to receive it in exchange of payment.

- **Incentive proposals to landlords of properties rented to Housing Authority for social housing.**

There are about 3,000 persons in the waiting list of Department for Social Housing for rental of premises. The Housing Authority every year provides a number of new housing units, which together with other units which are vacated periodically will be offered for rent. In order to increase the stock of residences which can be offered for rent, the Housing Authority has issued a scheme in March 2005 by which owners of Housing blocks were invited to rent their properties to the Housing Authority for a period of between five to ten years. The Housing Authority has made it clear to the owners that their properties will be returned to them after the lapse of the agreed period.

Unfortunately the owners have not participated in this scheme. In fact the Housing Authority has received only one application. In order to reactivate this scheme Government is considering a tax incentives to make this scheme more attractive to potential landlords.

The proposal is to apply a low rate of tax on income generated from such rents of 5 per cent, provided that the contractual arrangements meet a number of criteria that need to be established, to ensure that such properties are rented for social housing purposes. Government is also considering granting to owners refund of VAT on expenses incurred on alterations or improvements, to bring the said properties up to standard before being rented to Housing Authority.

Đ Regulating existing amusement and gaming machines

Locations with a wine and spirit licence are presently automatically permitted a licence for three amusement machines. These include social clubs such as band clubs, football clubs and other similar facilities. There are also a number of dedicated arcade halls, operating within an insufficiently controlled environment.

Government is concerned with the social implications of the current situation where presently:

(a) No regulations or systems are in place to ensure that locations where such machines are present can adequately ensure that under-age persons are precluded from using gaming machines;

(b) Players who have gambling problems do not have recourse to self barring and player protection measures that are applicable to licenced operations.

(c) Also, players who have gambling problems are discouraged from seeking assistance as present state of legislation would treat them as criminals rather then persons in need of help.

(d) A number of locations today can be found in the vicinity of schools and other recreational facilities, hence attracting the interest of under-aged persons.

(e) Loopholes in legislation not easily addressable due to technical ambiguities as to whether an amusement machines can also be used as a gaming machine, give operators sufficient liberty to 'design' their own systems abusively.

Government is proposing a number of measures to address the present state of being, and to address the social implications of this unregulated sector:

(a) to increase the present gaming limit to 18 years from the present 16 years for all gaming activities;

(b) to introduce a licensing regime for the machines, imposing conditions, control measures and limitations on the locations in which they will be placed.

(c) introduce a centralised surveillance system which is installed in locations that have such machines to ensure that under-age individuals are not being allowed access to these machines.

(d) to introduce and enforce responsible gaming procedures to protect vulnerable players and establish problem gambling programmes;

(e) to establish new regulations that prohibit amusement and gaming machines from being installed in locations which are close to socially sensitive locations.

5.7 Tax reform, proposals and priorities

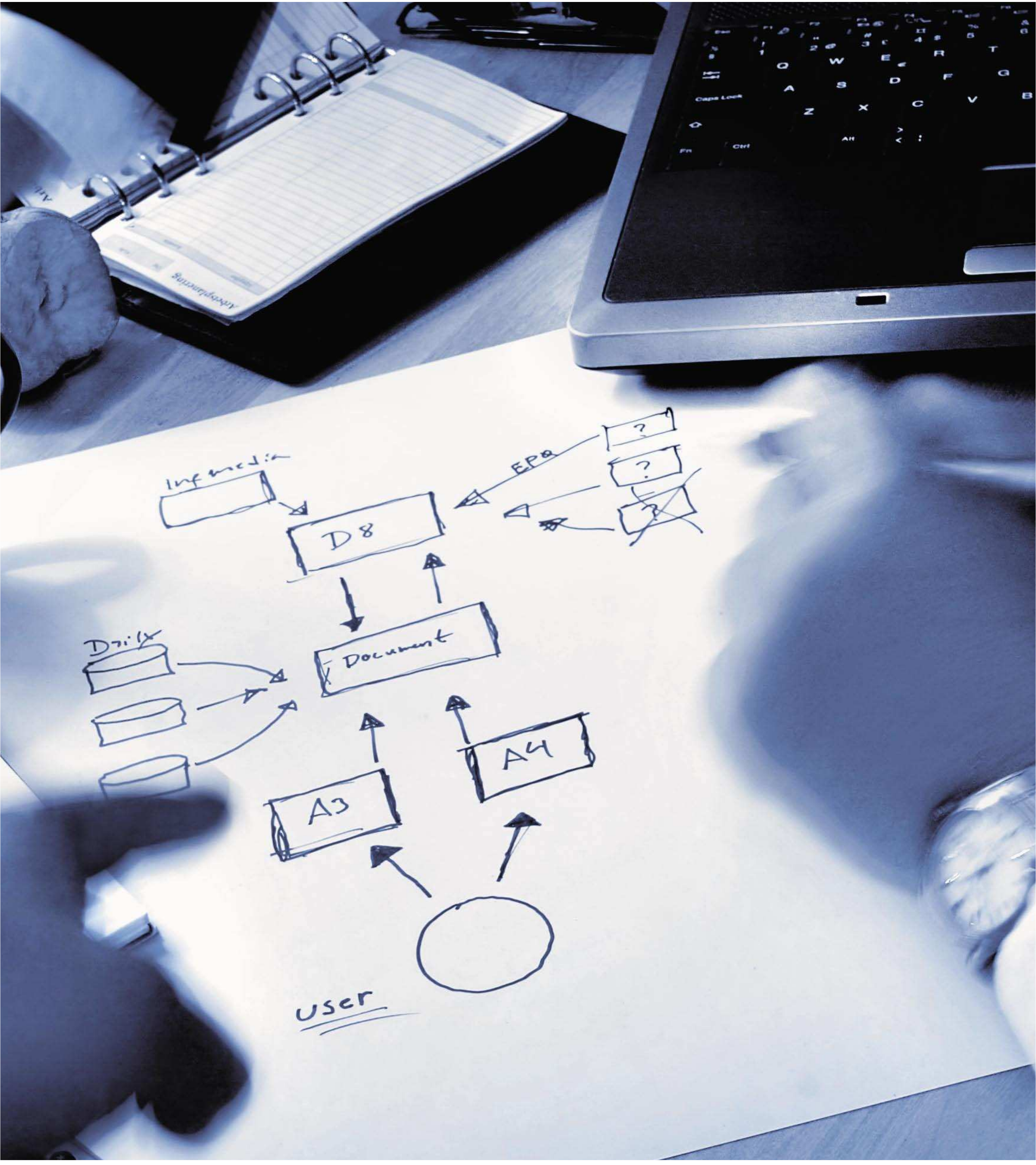
A reform of the taxation system in Malta presents a number of opportunities to be reaped in the context of fostering employment and social cohesion by making work pay, encouraging saving and investment, minimise the excess burden of taxation, enhance equitability and compliance by all categories of tax-payers and contributing to the country's performance in the various aspects of sustainable development including the economic, social and environmental dimensions. Any such reforms would however to be undertaken within the parameters of the need to meet the fiscal performance objectives as envisaged in the Convergence Programme submitted to the European Commission in Spring 2006.

It is considered that these opportunities can be reaped through reforms that are at present necessary, effective, implementable and time- and policy- consistent. This document proposes a number of measures for consideration, to which there may be added others as a result of the pre-budget consultation process. The principal emphasis of the measures proposed are intended to give a further spur to economic growth by maintaining and enhancing the competitive edge of our tax structure to continue attract foreign investment make work pay whilst emphasising a more equitable distribution of income, through the introduction of family incentives and preserving equitability.

Finally, it is to be reiterated that the area of tax reform perforce involves the undertaking of difficult choices in the face of limited resources. Therefore, while all proposals may seem desirable, there would have to be a process of prioritisation and sequencing of measures in order to ensure the achievement of all fiscal objectives in a balanced manner.

5.8 Conclusion

The above combined review and proposals go into the rationale underpinning tax reform, Government's objectives for a reformed tax system and the work of the Tax Reform Commission in this regard. Taxation policy is contextualised within the *National Reform Programme*, wherein it is identified as an important tool for the encouragement of productivity in order to: further economic growth, improve tax compliance and reduce social benefit fraud. An account of the different types of taxation measures in Malta is also provided in addition to a background of the legal instruments underpinning income tax. A detailed description of direct and indirect taxation is given, followed by an outline of the shift in emphasis of Government's fiscal policy from tax on income to tax on consumption. Malta's tax burden is compared to that prevalent in other EU Member States. The main strategic options that are being considered by Government in the context of the tax reform process are listed and analysed.



6 Sustaining industry and tourism

6.1 A vision upheld by strategic principles

A review of economies that are currently prospering shows that an important factor in their success is a vision that is supported across the political spectrum. This enables industry to mobilise resources and investment in a strategic direction, in the sure knowledge that changes in administration will not jeopardize the continuity of strategies and policies. Such vision needs to be forward looking, to be understood by all sectors of the population and, most importantly, to ensure that all members of society emerge as winners. In this regard, Government proposes the following vision for in view of the current efforts aimed at renewing the country's industrial policy:

> **"Enabling industry to achieve quality value-added and productivity growth to engender prosperity and wealth."**

A number of strategic principles uphold this vision. These are:

- inculcating the entrepreneurial spirit in Malta;
- reinforcing Malta's comparative advantage with regard to its human resources;
- achieving quality value-added and growth in productivity in industry;
- clustering and networking industry and Government;
- incentivising the research and innovation (R&I) capacity;
- enabling access to finance;
- re-vitalising existing conditions and the infrastructure in order to render them conducive to competitiveness;
- orientating Government as a partner to industry;
- enabling Government and industry to work together in facing and resolving emerging challenges.

6.2 Malta's comparative advantages

Malta has successfully managed its transition from a colony to an Independent Nation. We must continue to build on Malta's competitive advantages, including:

- **Human resource capital**
  This is Malta's main resource. Maltese workers are acknowledged to be hard-working, flexible, intelligent, adaptable, trainable and diligent. This competitive advantage must be sustained and upgraded on a continuous basis.
- **English and the multi-lingual skills base**
  Malta, together with England and Ireland, has English as an official language. This gives Malta an added edge on mainstream Europe and North Africa as English is both the business language and the ICT language. Safeguarding our ability to write and speak good English is critical.
- **Innovative legislation design**
  Through innovative legislative design

Malta has, in the past decade, created two vibrant micro-economic sectors in the knowledge and services enterprises and one high-tech manufacturing industry. In terms of the former, forward looking legislative frameworks with regard to the financial services and e-commerce have acted as fundamental spurs to these two service sectors. With regard to the latter, innovative patent legislation design created a niche market that has attracted the generic pharmaceutical industry to Malta.

- **Smallness provides agility**
  While smallness generates diseconomies of scale, it can also translate into a comparative advantage as it should facilitate immediate action in response to changing circumstances. Representatives of Government and industry can meet face-to-face without undue delay to find solutions and agree on actions. Primarily in view of the fact that Government is to be a partner to industry, this responsive agility should present a considerable advantage in facilitating the growth of this sector.

- **Stability**
  Malta is well recognised as an international stable haven free from geo-political and social international threats. From this perspective, Malta assumes an importance far greater than its size, particularly in terms of acting as an honest broker between Europe and the Mediterranean. Greater long-term stability can be institutionalised if political parties and social as well as civic partners manage to find consensus and common ground on the key issues, including the Industrial Policy.

6.3 Targeting growth in industry

A strategy for industry must provide a focus built on Malta's comparative advantages. It must identify the areas to be targeted. A scatter-gun approach would result in a diffusion of resources which Malta, in a fast changing, globalised environment, can ill afford. To this end Government is renewing its industry policy and strategy. A lot of work has already been carried out including a number of meetings with the stakeholders. Malta Enterprise and the Federation of Industry are playing a key role in these efforts and Government is grateful for the contribution, feedback and support of all those consulted.

In this Pre-Budget Document Government is stating the key points emerging during the consultation phase with a view to engage in the widest consultation possible. It is expected that the Industry and Enterprise Policy will be published by the next budget.

A two-tiered approach is being considered. The first relates to the existing industry base. Existing industry must be supported to restructure and to strengthen their capacities in order that they meet the set vision quality, high value-added, and productivity growth. This argument is based on the success stories that have come about in cases where industry have restructured and up-graded their quality, high value-added, and productivity growth both in order to make successful ventures into the international market and also to safeguard their domestic market segment against competition from imports.

The second relates to new investment, be it from foreign or local sources. Without diminishing the importance of the existing industry base, Government believes that targeted new investment should be focused primarily on the service sectors and on hi-tech manufacturing – these are the sectors that meet Malta's comparative advantages and that minimise the impact of other countries' comparative advantages that impact adversely on Malta's ability to compete.

It is pertinent to add that the *National Strategy for Research and Innovation (NSRI)* identifies the upgrading of the manufacturing industry as a platform of strategic importance.

6.3.1 Targeted service sectors

The following service sectors are being considered as ones that Malta should target:

- **Education services**
  Malta has an active and vibrant education industry with significant growth potential. The education sector offers a good combination of well-established public and private institutions, local facilities and expertise. Potential benefits would include a larger education sector that would offer a wider range of professional and vocational training, as well as tertiary education and the development of a larger diversified education sector that would serve the needs of both foreign and domestic students.

- **Health care services**
  Global health 'tourism' is estimated to be worth US$ 40 billion. Malta has much of the necessary physical and human capital in place and is well served, with good air links with mainland Europe and North Africa, to provide a high level of health care to patients. Potential benefits would include the evolution of a deeper health-care sector that would also benefit Maltese citizens, a larger health-care sector, and an attractive living environment that is capable of attracting high net worth retirees.

- **Back-Office Processing Outsourcing (BPO)**
  To date, this is a fledgling industry in Malta. While Malta's location works against its ability to become a major BPO provider, it can act as an extension to SMEs, call centres and firms dealing with knowledge process outsourcing.

- **Financial management services**
  In the past decade, financial services have evolved as one of the fastest growing economic sectors in Malta, with major financial institutions and firms coming to the country in order to operate within our legislative and regulatory framework. The achievements gained to date provide an excellent platform for further growth.

- **Professional services**
  Local representation of the 'big five' international consultancy groups, as well as others, have shown that these can compete internationally both in terms of pricing and quality. This service sector is a veritable frontrunner in offering scope for enlargement.

- **Creative services**
  Malta has established itself as a vibrant site for film and other productions. The converging of supporting services – studios, set-design and construction, ICT film graphics design, heritage sites and others – would strengthen Malta's attractiveness in this regard.

- **Maritime industry**
  China and India are fast growing economies with trade as a key prong – their goods enter Europe primarily through the Suez Canal. Malta could utilise its strategic geographic position to act as a 'Comfort Zone' for their respective fleets, providing trans-shipment services, ship maintenance servicing and supply replenishment.

- **Maritime leisure**
  Malta has established itself as a quality leisure zone. Its strategic geographic position could further provide it with a vantage 'servicing and maintenance' zone for yachters who are increasingly making use of low-cost land berthing facilities in North Africa.

- **Aviation**
  Malta has demonstrated its competitive ability in the provision of hi-tech services, with success also achieved in terms of research and development in this area. Scope definitely exists to broaden this service sector.

6.3.2 Targeted high-value industry sectors

- **Pharmaceutical manufacturing and services**
  Malta has managed to build a successful pharmaceutical industry through certain patent legal provisions. The challenge is to transform this industry into a permanent feature of our industrial and entrepreneurial landscape. The evolution of excellent centres for bio-equivalence testing, as well as clinical trials would constitute an anchor that could successfully generate further growth in this regard, particularly when coupled with favourable costs and skills of Maltese labour.

- **ICT sector**
  Malta is acknowledged as a leading information economy and society. Government's forward looking vision and action in this regard have led to the establishment of a state-of-the-art ICT infrastructure, enabling e-commerce legislation that has induced e-billing and e-gaming companies to set up shop in Malta. The Maltese ICT skills base is nowadays internationally acknowledged for its competence and value-added. Furthermore, ICT employment provides higher valued-added output and higher paid employment. It is pertinent to add that the NSRI also identifies ICT as a platform of strategic importance.

- **Biotechnology and Bio-informatics**
  Malta has a comparative advantage in the bio-technology and bio-informatics areas. This lies in the particular characteristics of Malta's genetic pool. This provides a 'founding' effect where genetics 'errors' can be identified by the use of smaller clusters of population sample, resulting in a higher identification of genetic 'errors' than in other societies. This constitutes a potential enabler of better 'quick-to-market' transition from genetic error identification to the development of new medication.

- **Hi-tech manufacturing**
  This relates to engineering and other hi-tech manufacturing in which Malta has shown a good ability to compete.

6.4 Proposed actions for achieving the vision and its underlying strategic principles

6.4.1 Inculcating entrepreneurship

1. **Instilling entrepreneurship**
   The educational curriculum, across all its tiers, as proposed in the National Strategy for Research and Innovation should be such that it instils in Maltese children the creativity, innovation and risk-taking which are so essential for inculcating an entrepreneurial culture.

2. **Encouraging the entrepreneurial spirit in young people**
   In complement to the recommendation in the *National Strategy for Research and Innovation*, Malta Enterprise should evaluate the possibility of establishing small incubation services centres at the University of Malta and MCAST to provide students and youths in higher education institutions to start-up their entrepreneurial ideas.

3. **Removing the stigma of entrepreneurial failure**
   There should be a review of legal provisions relating to insolvency in order to reduce barriers for honest entrepreneurs to make a fresh start without unduly harming creditors' interests.

4. **Rewarding entrepreneurship**
   An environment that is attractive to persons who risk generating economic well-being is to be fostered.

6.4.2 Reinforcing Malta's human resource capital comparative advantage

1. **Anticipating and embracing change to improve our comparative advantage**
   Industry, employers' associations and Government are to work together to introduce new methods of job design as and where appropriate – ranging from flexible working, tele-working, job-sharing, etc. – as well as to increase the labour participation rate.

2. **Institutionalising lifelong learning**
   Industry and higher education institutions are to work together to establish the appropriate facilitative framework that will institutionalise lifelong learning.

3. **Introducing a National Vocational Qualification (NVQ) as the foundation for skills upgrading**
   The introduction of a NVQ framework is critical to the maintenance of Malta's comparative advantage in the human capital base, and its introduction in the immediate term is seen as a matter of national importance.

4. **Apprenticeships and place schemes are the life-blood to industry**
   The National Commission for Higher Education together with the Employment and Training Corporation are to review the existing apprenticeship and placement frameworks in order to strengthen them to provide increased value.

5. **Complementing long-term building of a high-skilled and research human capital base with inward mobility of such skills and research**
   Obstacles to the mobility of high-skilled workers and researchers to Malta should be identified and removed in order to provide industry with the human capital capacity so essential for growth whilst long-term efforts to achieve a quality indigenous high-skilled and research human capital base takes root.

6. **Supporting export orientation with first-class marketing and skills competency**
Specialised sales and marketing diploma, degree and post-graduate studies that integrate work placements so that work experience is garnered during the term of study are necessary. Sales and marketing modules may be made available on an optional basis to SET disciplines.

7. **Safeguarding and strengthening Malta's comparative advantage**
A high level task force is to be constituted to review the concerns raised in the consultation process in relation to the need to improve the command of English, our multi-lingual ability, and work ethic and to propose policy instruments to safeguard Malta's comparative advantage in this regard.

6.4.3 Achieving quality high added-value and productivity growth in both the industry up-grading in terms of quality and standards

Assistance is to be provided to industry with respect to the identification of appropriate standards to be adopted and in the training of staff to up-grade their skills appropriately. Assistance in terms of transformation management assistance is to be provided to SMEs that are committed to undergo a process of transition to increase their quality and achieve high value-added. Government will demonstrate that achieving quality and high value-added as well as a successful track record pays and to facilitate this process will introduce a Preferred Goods and Services Suppliers framework.

1. **Securing productivity growth**
Whilst the high correlation between productivity growth and ICT and technology investment raises where a focused National ICT and Technology Strategy is required, Government will continue to promulgate the importance of ICT and technology on productivity and will partially assist specialised consultancy on the basis of business plans directed to up-grade to quality high value-added and productivity growth.

6.4.4 Clustering and networking industry and Government

1. **Supply Chain Vendors Clusters Initiative (SCVCI)**
An assistance scheme directed to establish Supply Chain Vendor Clusters in the 'traditional industries' with assistance directed to facilitate the transformation of suppliers into preferred vendors and in managing the transformation process may be considered.

2. **Industry and Enterprise Grouping Clusters Initiative (IEGCI)**
The Industry and Enterprise Grouping Clusters Initiatives (IEGCI) may be activated by supporting the engagement from industry of Cluster Co-ordinators, with the IEGC being established on the basis of open invitation subject to demonstration of the quality high value-added and productivity growth.

3. **Targeted National Clusters Initiatives (TNCI)**
Targeted National Clusters Initiatives and the national consultation and discussion process should act as a platform to firm-up the first wave of the target areas. Clusters will successfully work if industries perceive each other as allies and the establishment of trust is a key goal that their constituted bodies are to facilitate.

6.4.5 Incentivising the Research and Innovation (R&I) capacity

1. **Re-defining research to incorporate skills, processes and services**
EU Commission definitions will apply for R&I following the completion of its communication process so that industry benefit from State Aid for R&I purposes to the broadest extent made possible by the new EU rules on State Aid.

2. **Intensifying aid to industry that cluster with SMEs and higher education institutions**
The criterion for eligibility for fiscal aid for R&I should provide for a higher intensification of such aid for firms that cluster with SMEs and higher education institutions.

3. **Influencing the EU Commission review of state aid for R&D&I**
Malta should closely follow the articulation of this Community Framework for State Aid for R&D and Innovation and it should adopt to the maximum of the Aid intensities all of the measures permissible under this Framework.

4. **Incentivising the uptake of popularisation of science and technology as a corporate responsibility by industry**
Donations by enterprises for S&T education and popularisation measures will be incentivised by various measures.

5. **Government and industry partnering to finance horizontal business driven R&I Initiatives**
Government may work with industry to establish a fund directed to strengthen the national infrastructural capacity for R&I where in Government will complement contributions made by industry in any one year up to a set maximum.

6.4.6 Enabling access to finance

1. **Accessibility to guarantees**
New guarantee instruments that can be introduced to increase the lending volume available to SMEs are to be studied.

2. **Institutionalising a Business Angels Network**
Public entities and the private sector, should study why the Business Angels scheme failed and re-launch on the basis of lessons learnt so that Business Angels become an active part of the environment necessary to foster entrepreneurship, innovation and growth.

3. **Activating venture capital**
The setting up of Venture Capital Funds may increase the amount of private investment capital available in the seed or early stages of business development.

4. **Facilitating credit insurance**
Industry needs to be more aware of the benefits of utilising credit insurance firms. Credit insurance may prove to be a very good instrument to manage short-term liquidity risks in business-to-business activities.

5. **Promulgating knowledge on sources of finance**
SMEs and start-ups need support through building knowledge and awareness by means of coaching tools, hands-on coaching schemes, access to best practices etc in terms of financing options.

6. **Micro-credit for SMEs**
The degree of the presence of a micro-credit friendly environment needs to be assessed and, if necessary, improved.

7. **Monitoring review of state aid rules for risk capital**
Appropriate conditions may be necessary to balance intrinsic difficulties in Malta due to its inherent comparative disadvantages.

6.4.7 Fostering the essential conditions and infrastructure to secure competitiveness

1. **The management of inflation**
Government will continuously strive to manage inflation so this, to the extent possible, is not allowed to exceed the

rate of inflation in the EU25 threshold as well as that of competing nations. Whilst industry has an obligation not to unnecessarily create inflation, it is Government's obligation to rigorously survey the market and to intervene with rigour where artificial inflation is induced.

2. **Reforming the transportation and logistics service chain**
   Industry and Government should continuously seek to improve the transportation and logistics networks on a sustained basis given the vulnerability to Malta's industry stemming directly from Malta's comparative disadvantage of insularity

3. **Upgrading laboratory, testing and quality assurance services**
   A case exists for Government to invest in clustering and accrediting its public laboratories and quality assurance functions to provide certification and testing services to industry as proposed in the *National Strategy for Research and Innovation.*

4. **Upgrading industrial parks**
   The tempo adopted in the up-grading of Malta's industrial parks is to be maintained and sustained, for excellent industrial parks reflect the image of quality and excellence which is at the heart of the national vision set for Malta.

5. **Setting-up of technology and commercial centres**
   Technology and Commercial Centres may assume the lead role in assisting industry to achieve quality high value-added and secure productivity growth. Such centres would act as business intelligence centres and be the lead government partner and support arm to the Supply Chain Vendor Cluster Initiative, the Industry and Enterprise Group Cluster Initiative, and the Targeted National Cluster Initiative.

6.4.8 Orientating Government as a partner to industry

1. **Introducing an industry portal as the flagship of business-to-Government e-commerce**
   An industry portal, which will act as the flagship for business-to-Government e-commerce, is to be set up.

2. **Reducing the regulatory administrative burden to industry**
   The work of the Better Regulations Unit to achieve a streamlined and simpler regulatory framework for industry should be placed in the public domain and industry invited to submit their feedback and review. The application of a sound regulatory impact assessment methodology will provide a powerful tool for Malta to strive to establish innovative regulatory instruments design as a comparative advantage.

   Review of the regulatory authorities to achieve increased streamlining, consolidation, remove overlap, duplication, secure good practice et al to reduce the cost of regulation both to Government itself as well as the economy at large should be established as a continuous goal.

3. **Rewarding good governance industry**
   A scaling regulatory regime that awards and rewards good governance whereby the degree of enforcement lightens is applied successfully in select areas of public administration and should be established as a policy direction for all regulatory authorities.

4. **Facilitating the achievement of good governance**
   Work should thus ensue to achieve good administration in the regulatory environment wherein the regulatory authorities are instructed to back regulatory instruments,

within definitive time-frames, with formal guidelines, formal documentation and best practice guidelines.

Education, support in working out a compliance programme that is realistic, sharing of good practice et al should precede sanctioned enforcement; with sanctioned enforcement assuming an escalatory regime where industry displays dishonesty in its commitment to meet the regulatory requirements.

5. **Aligning Government business hours with the productivity chain**
   Senior executives in public administration should be held accountable to adopt a pro-active role to apply the agreement reached in the Collective Agreement with Unions expected to respond positively so that the productive chain of industry is enhanced.

6. **Management of public works maintenance**
   Whilst public management is to be held accountable to introduce appropriate work schedules and work planning to carry out such works in such a manner that refrain from creating unnecessary productive losses. An assessment of the cost to the economy in terms of productivity lost is to be carried out.

7. **Refining the institutional framework to provide increased value-added to industry**
   Policy design and implementation is upgraded to the extent possible so that focus, agility and responsiveness is attained in the face of a changing global and local environment so Industrial Policy reflects the dynamics of international competition. Public administration should seek innovative ways to induce innovative public management and administration in relation to industry.

   A principled based legislation within the framework of the Malta Enterprise legislation would secure a dynamic legislative instrument as the definitive enabling legislation as it provide for agility in response to as changes in the local and international environment.

   Public administration must, with agility and smartness, establish mechanisms, if so necessary the introduction of fast track mechanisms, that will allow industry to successfully utilise EU funding instruments to upgrade their quality high value-added and productive growth.

   Shared ownership of the vision and its implementation would be facilitated in the event that an expert group on industry, potentially stewarded and owned politically, is set-up to act as a formal mechanism to secure the commitment of all involved, to attain collaboration as and where possible, to instil the urgency of agility and smartness in response to changing circumstances.

6.4.9 Government and industry must work together to resolve new challenges

Stakeholders need to address arising existing and arising 'new' challenges in the most cost effective manner.

Knowledge on EU funds established to assist industry in addressing such new challenges should be acquired and disseminated to industry on an on-going basis.

6.5 Tourism

The tourism industry has dominated the national agenda over the past twelve months. The restructuring of the Malta Tourism Authority, the effects towards the introduction of low cost carriers and the overall performance of the industry featured highly on the agenda of internal government meetings and in frequent meetings between Government and industry stakeholders. The priority afforded to tourism is more than justified. Tourism has the potential to give the Maltese islands sustained economic growth and better employment opportunities.

These principles will be reflected in the National Policy for Tourism which Government will be formulating and in the Malta Tourism Authority's Strategic Plan. The National Policy for Tourism will recognise the issues and challenges facing our destination within the international and local scenario within which we operate and compete. It will present a number of policy responses together with a number of tasks which Government will be committed to deliver by the next five years. MTA's Strategic Plan will identify what MTA will be doing to implement the National Tourism Policy and achieve its objectives. Both documents will be available for consultation.

Unfortunately, the targets we set for ourselves over these past two years were not achieved. Although the volume of travel in Europe is growing, the market has changed from a seller's market to a buyer's market. The internet continues to increase its power as a major selling force in this industry as travellers warmed up to the idea of planning and booking their holidays through their personal computer.

The level of accessibility of a destination has in the past years become a prime factor influencing the competitiveness of that destination. Competing on accessibility calls for being physically accessible through some mode of transport whilst also being more affordable. This is one reason for the growth in the performance of low cost carriers. Low cost carriers are set to continue out-performing other players in the industry. On a global scale, competition from new developing destinations and facilities continues to increase. These destinations, because of their economies of scale, can afford more visible and intense marketing and promotion campaigns. These new destinations, especially destinations in North Africa and East Mediterranean, are highly competitive on price; giving tour operators which are still an essential component of our tourism mix, economies of scale and higher yields that we cannot offer. We can however compete with success in terms of value for money. These developments present us with a number of challenges which we are addressing.

A web portal will offer prospective travellers increased opportunities for on-line booking. This portal will initially offer travellers to Malta the opportunity to book their flights, accommodation, holiday package and car hire on-line. It is our intention to expand this portal in the future to include other services. The success of this portal depends partially on the industry operators' ability to offer their services on the internet. One of the schemes Government is considering is precisely aimed at building the know-how amongst tourism operators. The Malta Tourism Authority will promote this web portal extensively in its media campaigns. This web portal should be built into a strong selling machine for Malta's tourism.

The call for proposals we have issued for Low Cost Carriers to develop air routes to Malta offers the opportunity for major low cost carriers to start operating to and from Malta. The call issued in July is the first step in adding major low cost carriers to our tourism mix. Their introduction cannot be at the expense of existing business. They can and should be a channel for new business and a means of minimising the seasonal nature of our tourism industry. To this end we will be identifying new and under-served routes to add into our scheme.

Through the branding exercise we will ensure that our marketing budgets are spent in the most cost effective manner. These campaigns will be based on the three core values that distinguish us most from our competitors, our heritage, diversity and hospitality. In the coming weeks the Malta Tourism Authority will be carrying out an intensive exercise to promote these values amongst the Maltese. An international company is being recruited to assist in developing an international advertising campaign for the islands of Malta.

A number of efforts to promote Malta as a quality destination need to also be sustained through product development. However, such projects being undertaken are intended to enrich the visitor experience. It is Government's intention to continue the programme of creating new beaches that can better serve our tourist expectations both in Malta and Gozo. Together with the St George's Bay and BuĐibba perched project, these beaches will add value to the visitors who are attracted to our islands for leisure purposes. These beaches will continue to be maintained. A number of specific initiatives are being contemplated in conceiving our Heritage, thus giving our visitors a distinct exposure. Heritage Malta will continue works on the ĐaĐar Qim and Mnajdra and, on the Đgantija projects. Improvement works are contemplated to be carried out in the Museum of Archaeology and in the Museum of Fine Arts. Preparatory work is being carried out next year on the garden city project, a project that is intended to link and upgrade all the public gardens in Floriana and Valletta. The Malta Tourism Authority will draw up an inventory of all the facilities and infrastructure in the six tourism zones. This list will be the basis for ongoing monitoring by the Authority's zone coordinators and maintenance works to be carried out by government entities, local councils and the private sector in tourism zones. The Inter-Ministerial Committee on Tourism will continue to deal expediently with issues affecting tourism.

The Malta Tourism Authority will also carry out improvement works on the coastal shores of important dive sites. Following the approval of MEPA, the Malta Tourism Authority will proceed with the scuttling of the ex-AFM patrol boats. These will create new attractions for the divers that now represent around 5 per cent of our tourist arrivals.

Gozo will be marketed internationally as a destination offering a unique experience where visitors can get in touch with unspoilt nature while having the possibility to engage in a number of healthy or relaxing activities. The potential of domestic tourism for Gozo will also be tapped in order to ensure a steady flow of Maltese visitors to the islands not only during the peak season but especially in the lean and shoulder months when activity on the islands diminishes. The Ministry for Tourism and Culture will continue supporting cultural activities of a high standard on the Island of Gozo in order to increase the number of activities during the winter months.

The tourism industry is all about the quality of the service we offer and particular attention is being given in order to ensure that visitors to our islands get treated with the best service possible. The changes in the tourism industry world-wide and the initiatives we are undertaking create a need for thorough assessment of the human resources in the tourism industry. A human resources needs assessment will be carried out next year.

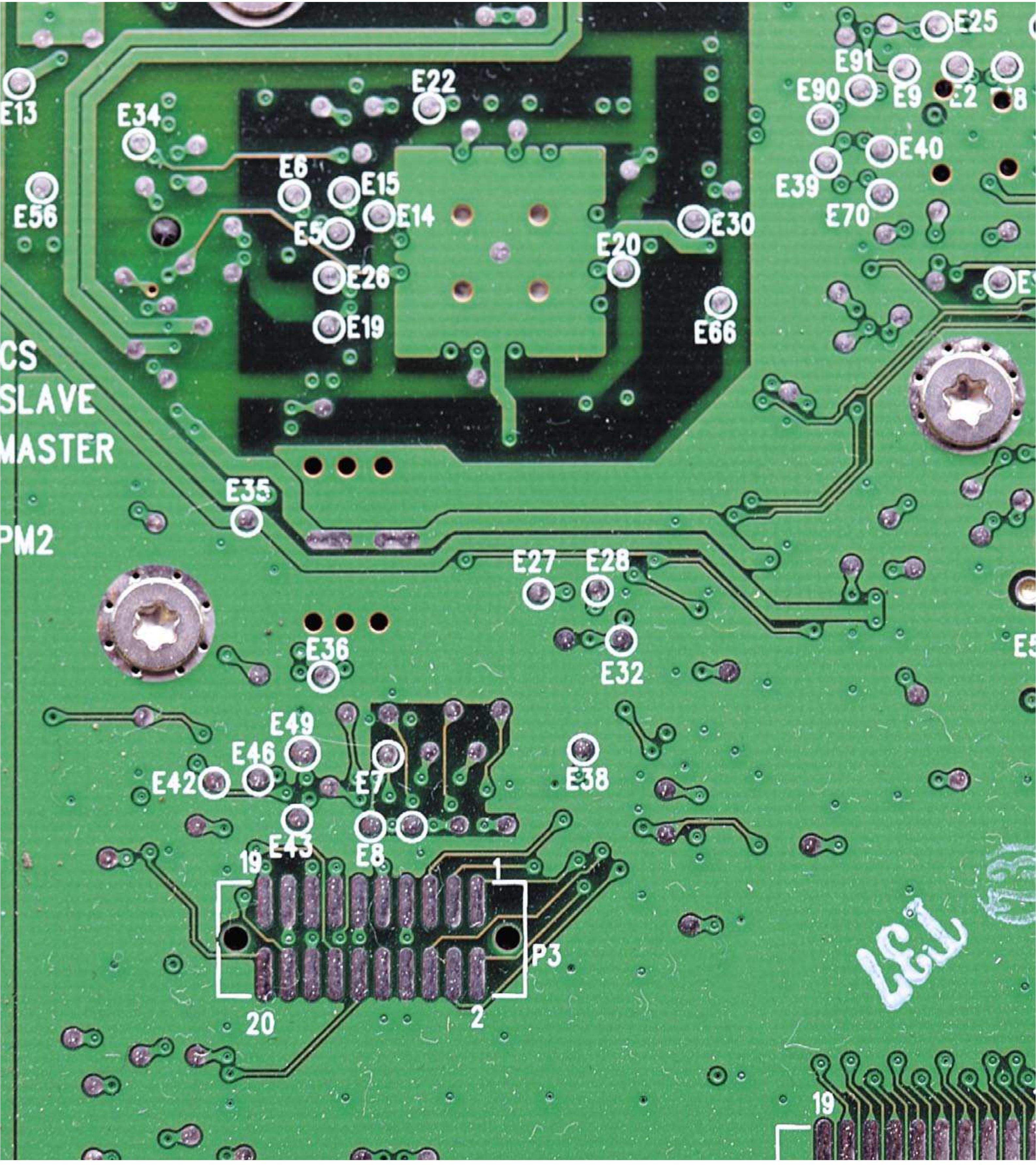
Government wants to reduce unemployment by training and retraining personnel in the industry in order to fit in the new working scenario, help improve the industry in increasing the quality of service delivery and meeting the demands that the industry will be facing as a result of the changes underway.

These efforts will be complemented by a strong regulatory arm responsible for ensuring that standards are continuously adhered to by the private tourism service providers who will be encouraged to move into quality assurance. We will continue to actively participate in the decision-making process at a European level within the EU structures, contributing to the development of the European tourism industry and ensuring that Malta's interests are safeguarded.

As indicated in the Operational Programme documents we intend to allocate a proportion of structural funds to tourism both for government-led projects of direct benefit to tourism and for a scheme aimed at supporting tourism and cultural projects undertaken by private enterprise and non-profit making organizations. A proportion of these structural funds will also be dedicated to training and employment creation.

6.6 Conclusion

Government believes that a vibrant private sector creates prosperity and wealth across society. It is thus in the interest of all stakeholders to see our industry base expand to the largest extent possible. Government hopes that all contribute towards the renewed industry policy for Malta and that it will eventually enjoy the broadest consensus. This vision should guide this sector in the coming years, with shared principles that underpin the vision, the fostering of the comparative advantages forming the basis of the strategy and the vigorous development of the targeted growth sectors.



7 Sustaining growth through research and innovation

7.1 Background

A country's dominant source of competitive advantage and growth potential is its ability to create, transfer and exploit knowledge and its technological and innovative capabilities to create new products and services. There is strong evidence that increased public spending in R&I acts as a driver of economic growth, generating not only good returns on investment but also positive spill-over effects in the economy as a whole.

> "Firstly, it has a direct impact on innovation that shows up as growth in industrial productivity. Secondly, as noted by David, Hall and Toole (2000), public funding of R&D can contribute indirectly, by complementing and stimulating private R&D investment... Thirdly, besides providing the foundation for successful innovation resulting in the creation of new products and markets – and ultimately, enhancement of consumer welfare – publicly funded R&D also benefits the private sector through the improvement of production processes and existing products".

Two success stories that stand out in Malta's experience of R&I are the Information, Communication and Technology (ICT) and financial services sectors. Both were 'green field' site less than 15 years ago – with no vision, no enabling legislation, no resource capacity, and no infrastructure. Today they stand amongst the most vibrant of the micro-economic sectors of our economy. They are established as excellent centres of repute by international players. Both continue to enjoy excellent prospects for growth.

Moreover, Malta managed to secure 3 million euro and 9 million euro in funding from the EU Fifth and Sixth Framework Programmes respectively. This is a remarkable performance; particularly so given the limited investment made.

7.1.1 Continuing strategy

In the 2005 Budget, the Prime Minister, in his capacity as Minister of Finance, underlined the importance of R&I as a critical component towards the attainment of competitiveness.

In summer 2005, Government launched the NRP document for public consultation setting out the activities and initiatives to be embarked upon in order to meet the goals of the EU's Lisbon Agenda. In terms of the proposed policy response under Theme 02 entitled 'Competitiveness', Government proposed that:

> "As part of the single market economy, Maltese businesses need to ensure that the products/services offered are creative and innovative. This would enable the Maltese product to gain a competitive edge in an enlarged market. In order to achieve this competitive edge, Malta needs to invest in research and development both within the public and private sector. Such investment will contribute towards increasing Malta's competitiveness. The widespread use of ICT also contributes to a more competitive industrial base."

The NSRF document launched recently for public consultation states that:

> "The development of research, technical development and innovation (RTDI) is a goal that Malta will actively seek to address. Malta's objective in promoting RTDI is to develop a focused sector bearing in mind the country's realities that do not support the development of a broad-based research sector or the pursuit of pure research for its own sake. The specific targeting of focused, business-oriented RTDI is envisaged to be driven by operators of repute. Though a macro and a micro perspective, Malta is taking a two pronged approach towards the

development of a thriving RTDI sector. The macro approach envisages the delineation of a strategic framework in which actors in the system of innovation can interact and engage. A micro approach will look closely at the actions of specific sectors both in the firm and non-firm sector."

In the 2006 Budget the Prime Minister, announced that in 2006 the Malta Council for Science and Technology (MCST) would:

> "draw up a strategy setting out priorities for State funded financing in the areas of research and development for technology"

The Board of MCST tasked, in November 2005, the Director of Science and Technology (S&T) Policy to draw up a 2017- 2010 National Strategic Plan for Research and Innovation. The specific terms of reference provided were to:

- identify barriers and weaknesses in the national system of R&I and to promote remedial measures to transform and strengthen infrastructure, institutions and capacities;

- recognise and address through targeted actions our inherent strengths and weaknesses as the means for tapping emerging opportunities in priority sectors and niche areas;

- identify priority areas towards which State investment and resources are to be channelled;

- establish performance targets and specific goals to be attained during the life of this strategy;

- define a coherent, well structured set of direct and indirect measures to promote R&I capacity, competencies and activity, to be implemented in a phased approach over the next four years;

- secure and garner the scale of resources required in term of public sector R&I investments in order to achieve Government's set targets for the phased increase of GERD (Gross Expenditure on R&D) by 2010;

- define and set up appropriate policy coordination mechanisms to activate and strengthen the R&I element of Ministries' sectoral policies and ensure the development of joined-up policies and actions;

- improve Malta's position in the European Union (EU) Lisbon rankings and the European Innovation Scoreboard (EIS) by ensuring appropriate focusing and coherence of R&I measures and actions within the Lisbon National Reform Programme (NRP) and the National Strategic Reference Framework (NSRF).

7.1.2 Challenges

The constraints being faced by Malta in the area of R&I are acknowledged by Government who deliberately entitled The National Strategy for Research and Innovation (2007-2010): *Building and Sustaining the Research and Innovation (R&I) Enabling Framework*. This document has outlined a number of specific measures aimed towards such a framework.

The strategy envisaged for the Budget thrusts in 2007-2010 for R&I is based on the realisation that, time and again, economic theory and reality have shown that states have progressed and declined in tandem with their ability to innovate and to render economic growth spin-offs from such innovation.

There is no doubt that Malta's current investment level in R&I, public and private sector is minimal, both in absolute amounts and as a percentage of GDP, that this is constraining national efforts to attract and retain high-tech FDI and to move up the technological ladder.

Factors of increased competition in a more liberal trade environment and the impact of the rise in the international price of oil highlight the need for strong action by all stakeholders to improve the country's competitiveness through increased public and private sector investments in R&I. In 2005, Malta slipped down from 33rd to 35th place in the global competitiveness rankings and up from 48th to 46th place in terms of the business competitiveness rankings, receiving however a particularly low score on company operations and strategy. In terms of FDI intensity, Malta has registered a major improvement from -5.3 per cent in 2002 to 3.3 per cent in 2003 and compares well with new Member States; though behind Cyprus and Estonia both at 5.8 per cent. It must be remarked that Malta has the highest FDI/GDP ratio among this group of countries.

In order to continue to attract FDI in the face of competition from emerging markets in Eastern Europe, the Maghreb and Asia offering lower costs for doing business, Malta must be in a position to offer distinct advantages, by "constantly moving up the knowledge ladder (through) schemes to incentivise research and development". In moving up the knowledge ladder, Malta has to contend with a different set of agile, high-tech countries, regions and cities. The more advanced of these players offer a "critical mass of advanced knowledge institutions (universities, public research institutes and corporate laboratories), venture capital, entrepreneurial talents, knowledge workers, sophisticated corporate end-users, well-developed financial markets". Increasingly, competition for FDI is less at the country level and focused more on high-tech regions or cities – this has important implications for a small country. For Malta the challenge may thus be less related to size, and more to the level of networking, inter-connection with EU mainland, high-tech centres and the knowledge resources it can latch onto there and provide access to.

Malta's Innovation Scoreboard indicates a highly mixed record of performance with poor rankings on the input indicators in terms of number of S&T graduates, R&D expenditures, and SMEs innovating in-house, but generally high rankings on innovation and ICT expenditures and certain output indicators such as exports of high-tech products and employment in medium- to high-tech manufacturing. Thus Malta is positioned above the EU average for the output-input composite indicator, i.e., it generates a higher than average output in proportion to the inputs.

7.2 Objectives

The strategy is underpinned by the following objectives:

- **Addressing national issues**
  The Government must leverage State R&I funding to address pressing national priorities relating to water, energy and the environment.

- **Focusing on selected areas of economic performance**
  Government must focus its resources, energies and abilities towards a select number of value-added economic sectors in order to obtain value-added R&I.

- **Enabling SMEs to innovate**
  The appropriate supporting framework must be put into place at the earliest to enable SMEs to innovate and flourish.

- **Exporting locally generated R&I**
  Government should facilitate the establishment of an enabling platform that will allow Maltese enterprises in partnership with overseas institutions and business to enhance imported know-how and technology for exportation in the Southern Mediterranean region.

- **Expanding Malta's science, engineering and technology human capital base**
  Government's mainstream strategic objective is to establish the appropriate platforms bringing together parents, knowledge institutions and professions, and students to expand the science, engineering and technology human capital base.

- **Establishing the nexus between the knowledge institutions and business**
  The appropriate mechanisms for a business-to-academia nexus are paramount in order for R&I to flourish.

- **Developing a national pro-innovation culture supportive of invention, risk-taking and entrepreneurship**
  Government, together with key stakeholders, should assume a leading role in inculcating a culture that is supportive of invention, risk-taking and entrepreneurship.

7.3 Strategic measures

The proposed strategy is encompassed within the following parameters:

- all local activities that qualify as R&I. These include application of existing technology to the geophysical characteristics of the Maltese and Mediterranean region. Therefore, activity and initiatives involving the application of scientific or technical knowledge but with no clear element of innovation fall outside the scope of this document;
- the national framework of competencies and responsibilities for R&I policy;
- the set of measures, direct and indirect, to implement the strategy.

In the design of the strategy an open consultative approach (involving mainly experts but also open to non-experts) was adopted and a review of literature was carried out. A stakeholder mapping drawing on MCST's existing database of sectoral experts in academia and Government, policy coordinators in Ministries and senior executives in companies was drawn up.

This strategy presents a vision for R&I in Malta as well as a set of underpinning strategic principles. The R&I vision that it proposes for 2007-2010 is:

> "Research and Innovation at the heart of the Maltese economy to support value-added growth and wealth."

In essence, this vision places R&I as a fundamental driver of our economy. It recognises that if Malta aspires to be a knowledge economy it can only do so if it truly grafts R&I within its economic and supporting institutional fabric. It also establishes that R&I are not end goals in themselves – that is, motivated by blue-sky research. Rather, within the constraints of resources, R&I are critical catalysts upon which growth and wealth are highly dependent. This, in turn, demands a primary focus towards business driven and applied R&I.

This strategy strongly argues that, for R&I to flourish, fundamental and critical enabling frameworks must be put into place. The strategy sets out the following proposals which, with a view to coherent presentation, have been grouped under a set of headings:

7.3.1 Identified strategic platforms

1. Government financing and state intervention over the period of this strategy should focus on the following areas, designated as platforms of strategic importance:

Environment and energy resources	with focus on solar, wind, and bio energy together with energy efficiency technologies, as well as water, desalination, waste rehabilitation technologies, soil and marine management.
ICT	with focus on software development related to bridging technologies in security, hardware, telecommunications, health, marine and specialised applications.
Value-Added Manufacturing and Services	with focus on building SMEs as cluster elements in value-added manufacturing and services provision.
Health-Biotech	with focus on human genetics, bio-informatics for support of clinical trials including pharmacogenetic ones and bio-technology for transition of generic pharma.

2. A Platform of Strategic Importance (PSI) Financing Fund is established to ensure that a critical mass of sustained R&I in the designated platforms is secured.

3. In order to secure the appropriate progress in the designated platforms of strategic importance MCST, together with experts from industry and academia, is to develop a strategic plan for each of the identified platforms.

4. While focus of state financing and intervention should not be diluted from the designated platforms of strategic importance, flexibility should be retained in both planning and in responding to arising opportunities.

5. In order to spur and sustain R&I in areas emerging outside the designated platforms of strategic importance it is proposed that a Fund for research in emerging technologies be set up.

6. An Access to Financing of Seed Ideas Fund should be established to underwrite collateral for SME start-ups in the designated platforms of strategic importance.

7.3.2 The facilitating role of Government

1. MCST, Malta Enterprise and the Ministry for Competitiveness and Communications are to be accountable for, within their respective portfolios, meeting the objectives of this strategy and the application of flexibility must be consistent with the vision and strategic principles established.

2. Government is to increase its investment in the setting up of the enabling R&I framework to 0.75 per cent of GDP by 2010.

3. In conjunction with the local financial institutions and the European Investment Bank, Government sets up venture capital funds in the designated platforms of strategic importance.

4. Government should encourage entrepreneurs to diversify their investment portfolio into venture capital funds and Business Angels schemes by providing R&I tax incentives.

5. By May 2007, MCST, Malta Enterprise and the Ministry for Competitiveness and Communications should work together to evaluate current incentive schemes for their effectiveness and to propose to Government a suite of financial and other incentives to promote R&I in the private sector.

6. By June 2007, Government should explore the possibility of converting the Plant Biotechnology Centre and the Malta Centre for Fisheries Sciences into ‘public private’ business and research centres with private sector management behaviour.

7. A strategy is designed and implemented whereby public laboratories are clustered to the National Laboratory, with the aggregate research function being aggressively marketed to the private sector. To this end, it is imperative that the National Laboratory and a substantial proportion of public laboratories attain international accreditation by 2010.

7.3.3 MCST: key enabler of the R&I strategy

1. The MCST, in consultation with the appropriate stakeholders, is to carry out a science and technology horizon scanning exercise every three years, with a minimum ten-year time horizon.

2. MCST is to present to Government a business plan for the setting-up of an institutional framework to take the European-Mediterranean R&I concept forward.

3. In order to boost its resources and funds, MCST is to issue a tender for local experts and professional resources, as well as adopt a policy of paying a percentage award fee for private sector firms that secure funding from international programmes.

4. In order to build the critical mass required to manage the implementation of this strategy, it is proposed that MCST's operating capital be increased by Lm72,000 in the 2007 Budget, by Lm172,000 in the 2008 Budget, by Lm192,000 in the 2009 Budget and by Lm212,000 in the 2010 Budget.

5. MCST is to assist and advise various departments and entities in drawing up R&I strategies; post-2008 it should undertake a rolling programme of external scrutiny.

6. MCST and the Department of Contracts should by end 2007 introduce transparent mechanisms to reward R&I through public procurement.

7. MCST should, with the relevant owners, draw up and maintain an inventory of equipment held in public laboratories (including those of the University of Malta) and adopt a consolidated procurement and negotiation process to capitalise on the increased economies of scale.

8. MCST is to work with relevant institutions, in particular with the University of Malta, to introduce a programme for science and technology management which, as a first step, is to build the appropriate capacity in designated government entities and departments.

9. MCST, in conjunction with Malta Enterprise should in 2006 initiate the establishment of a vibrant network that brings together local industry, academia, Government and international players in the designated platforms of strategic importance for participation in EU and in other international R&I funding programmes.

10. MCST should, by the first quarter of 2007, launch an R&I Co-Sharing Fund designed to provide the necessary financial support for joint local industry-academia-government research in the designated platforms of strategic importance, which will benefit from R&I funding emanating from the EU and other international programmes.

11. MCST is to take an active role in tirelessly and courageously influencing the shape and focus of the educational system across all its tiers so that a spirit of creativity, innovation and risk-taking is instilled in Maltese children and young people. This role would include being an official sponsor of science-promoting events such as the Young Scientists Competition and launching national awards of competence to schools and students.

7.3.4 Educational institutions

1. The pedigree of the University of Malta is strongly dependent on its research abilities and competencies. Therefore, the headship of the University should seek to ensure that its Research Fund becomes an aggressive feature of its financial management structure, with financing to be sought from business, international programmes, and its own revenue streams.

2. The University of Malta should seek to rationalise, consolidate as well as re-orientate departments and institutes to become research institutes of excellence in the designated platforms of strategic importance.

3. A University of Malta Research and Innovation Excellence Fund is established to reward those academic departments and institutes that secure international as well as local industry/ business funding for their research activities.

4. The University of Malta should initiate a process by which to introduce science, engineering and technology conversion courses on both a full and part-time basis by 2008. These courses should be at post-graduate Diploma and Masters Level.

5.. The University of Malta should seek to reach a level of excellence in the designated platforms of strategic importance that will allow it to attract Masters, MPhil and PhD foreign students from both the Mediterranean region and elsewhere.

6. The University of Malta should seek to establish an Alumni Network in science, engineering and technology related disciplines in order to strengthen its international and local networking capabilities.

7. The University of Malta should, by 2008, seek to establish an effective Technology Transfer Office to provide advice and assistance to university staff and students interested in setting up spin-offs, and to act as a broker bringing together financiers, business incubation centres, and others relevant to the establishment of such spin-offs.

8. The National Commission for Higher Education should establish an institutional and permanent mechanism that will ensure the provision by knowledge suppliers of the knowledge needs that industry requires at the right time, to the right levels, and with the right skills-set.

9. The Ministry for Education, Youth and Employment should launch a twenty-year science popularisation strategy in 2008. This should be a joint venture with the Office of the Prime Minister as the ministry responsible for R&I.

10. The Ministry for Education, Youth and Employment is to invest in the necessary resources to build up an infrastructure and critical mass that would enable it to own and champion science popularisation.

7.3.5 Government departments and entities

1. By financial year 2007, the Malta Transport Authority, the Department of Building and Construction, the Department of Agriculture, the Department of Fisheries, the Department of Health, Water Services Corporation, Enemalta Corporation and MITTS Ltd. are to introduce an R&I strategy as part of their Business and Financial Plan and to allocate a minimum of 0.25 per cent of their turnover or budget (whichever is the greater) to R&I.

2. National Statistics Office should, by end of 2008, introduce online facilities for the submission of R&I data by the relevant stakeholders.

3. The R&I statistical framework should be set up by 2008, with investment by 2010 to consist of:

    - Lm100,000 for the setting up of the ICT infrastructure for online collation and data management;

    - Lm38,000 to build the necessary R&I analysis base within the National Statistics Office.

7.4 Benchmarking the success of the R&I strategy

The R&I strategy demands visible and direct commitment and should be conducted with firm, across-the board aspirations towards delivery. Therefore, a set of performance indicators relating to (a) the science, engineering and technology human capital base, (b) future R&I capacity, (c) R&I progress and performance, (d) industry-academia collaboration, (e) current R&I capacity, (f) imported know-how, (g) growth and wealth creation, and (h) funding sources for R&I in business, higher education and Government, should be introduced in order to allow for effective health checking of the R&I landscape in Malta. These are depicted as follows:

Performance Indicators	Performance Goals			
	2007	2008	2009	2010
Science, Engineering and Technology Human Capital Base				
Researchers per 1,000 worker	0	0	0	+2% of S&T researchers population
Number of PhD enrolments in S&T	+5 persons	+10 persons	+15 persons	+20 persons
Number of Masters / MPhil enrolments in S&T	+5 persons	+8 persons	+8 persons	+8 persons
Future RTDI Capacity				
University enrolments in S&T	0	+5% of 2007 of S&T student population	+5% of 2008 of S&T student population	+5% of 2009 S&T student population
MCAST enrolments in S&T	0	0	+1% of S&T student population	+2% of S&T student population
Private Sector enrolments in S&T	0	+4 new local firms	+6 new local firms	+8 new local firms
R&I Progress and Performance				
Expenditure of Government on R&I	0.3%	0.45%	0.6%	0.75%
Hi-Tech Start-Ups	0	+4 new local firms	+6 new local firms	+8 new local firms
Firms successfully migrating from Incubation Centres	0	+4 new local firms	+6 new local firms	+8 new local firms
European Mediterranean exportation of enhanced innovation	+ 4 enhanced innovation projects	+ 8 enhanced innovation projects	+ 16 enhanced innovation projects	+ 20 enhanced innovation projects
Industry-Academia Collaboration				
Number of Collaborative initiatives	+4 initiatives	+8 initiatives	+12 initiatives	+16 initiatives
Current R&I Capacity				
Number of internationally accredited laboratories	0	15% of Public Labs	35% of Public Labs	60% of Public Labs
Growth and Wealth Creation				
Employment in S&T	0	0	+100 new positions	+150 new positions
Funding Sources for R&I in Business, higher education and Government				
Venture Capital	+100% on 2006 target	+100% on 2007 target	+100% on 2008 target	+100% on 2009 target
EU	+5% on 2005 EU financing of S&T student population	+20 of S&T student population	+40% of S&T student population	+60% of S&T student population

7.5 Conclusion

Government is presenting a case for a substantial increase in its focus on R&I in order to establish and sustain the appropriate institutional and enabling framework towards rendering R&I a truly effective platform for Malta's economy.

This is not to imply that the road towards establishing Malta as an R&I centre of excellence is easy, or that short-cuts that attempt to make up for the decisions not taken in the past will yield instant results. The road to success is hard and long. It requires consensus from the stakeholders, including the political ones. It requires culture shifts not only on the part of parents, teachers and children in their attitude to S&T as a career choice, but also on the part of the financial planners on a national and an enterprise level, in that they will have to recognise R&I not as a cost, but as an investment.

Investment in R&I must, however, not be sporadic. An authentic approach to R&I investment requires that it be focused and made in a consistent manner against realistic performance goals. This, in turn, would establish the basis for further investment.

8 Ensuring a sustainable environmental future

8.1 Introduction

The National Reform Programme identifies a number of activities that generate pollution which are currently not bearing the full environmental costs. These include waste generation, development and energy generation. With regard to the latter, the rise in the price of fossil fuels on the international market caused by political events and natural calamities, as well as the effects of accelerated climate change, has moved energy issues to the fore on most countries' agendas.

Environmental investment must be complemented by public confidence and understanding if success is to be ensured. In this regard, Government is committed to continue with its policy of open dialogue with all stakeholders in this crucial area in order to ensure an efficient and timely implementation of the various initiatives that are being undertaken.

8.2 Key issues and challenges

Two main areas, currently being focused upon by Government include biodiversity and climate change. In the case of biodiversity there are a number of pressures arising from ongoing development. Biodiversity both on land and in the marine environment is under constant pressure and risk of degradation. The main contributors with respect to climate change are greenhouse gas emissions arising from electricity generation and transport.

- **Halting biodiversity loss**
  Malta is currently preparing a National Biodiversity Strategy as part of its commitments as a contracting party to the Convention of Biological Diversity. Furthermore Malta is implementing the Flora, Fauna and Habitats Protection Regulations which covers among other aspects the setting up of the National Ecological Network and the selection of the candidate Natura 2000 sites.

  Government is in the process of building three sewage treatment plants, two in Malta and one in Gozo. This should help alleviate problems associated with the loss of marine biodiversity.

- **Internalisation of environmental externalities**
  Each Member State is expected to develop an Environmental Technologies Action Plan (ETAP), with the aim of setting 3-year targets by the end of 2006. Green Public Procurement (GPP) is one of the key actions emerging from ETAP. Malta is currently preparing a local plan for both the ETAP and GPP.

- **Fight against Climate Change**
  At the moment, Malta does not have any binding green house gas emissions targets given that Malta has a non-Annex I status. Following Malta's membership in the European Union, Malta has assumed various obligations to fight climate change. The reduction of greenhouse gas emissions based on measures and initiatives that target various sectors (especially energy production, transport

and waste), could lead to decoupling of greenhouse gas emissions from economic development. Various measures are being undertaken to address climate change, amongst which are appropriate treatment/ disposal of waste and the better utilisation of energy sources.

- **Policy Response**
  Government is committed to upgrade the nation's environment in order to ensure an improved quality of life. There is no doubt that the quality of life of our citizens and visiting population is intertwined with the quality of our environment. Environment has been this administration's priority, as declared in the 2006 Budget, to step up, through financing and other resources, the necessary programmes across the whole spectrum of environmental policy in order to attain the desired goals. The following priorities will continue to receive Government's commitment to:

- promote the use of non-conventional sources of water;
- promote biological diversity;
- promote the development of means of internalisation of external environmental costs and decoupling of economic growth from environmental degradations in line with existing Community legislation and the Environmental Technologies Action Plan (ETAP);
- fight against climate change.

8.3 An overview of the achievements this year

In the course of this year, work continued on various environmental projects while new initiatives were launched. In particular, substantial work was carried out in respect of the:

- waste recycling plant at Sant Antnin;
- gradual rehabilitation of disused dumps;
- development of engineered waste disposal sites;
- relocation of the aquaculture zone;
- authorisation/registration of schemes for refunds of the eco-contribution;
- littering regulations;
- drafting of the construction site regulations;
- reform within MEPA;
- the limited adjustment of development boundaries as an end to the process initiated in 1988 with the Temporary Planning Schemes.

In the course of this year and, during the debate on the apportioning of funds for the funding programme *LIFE +*, Malta secured an agreement from the EU Environment Council to the effect that population density should also feature as a criteria on how much member states should receive under this programme. As a result of this position being met favourably by the Commission and, under the *LIFE +* programme, Malta benefited from an additional 1 million euro per year.

The link between agriculture and environment is nowadays being strengthened with one safeguarding the existence of the other. During this past year, Government has gradually shifted the focus on the quality of production as opposed to quantity. As a result, niche activities are gradually sprouting and today the discussion is extending on how such niche markets, may supplement our tourist industry by providing new tourist markets.

Another marked success during the past year was the strengthening of the afforestation project, most notably through the *Tree 4 U Campaign*. The target of 10,000 trees to be planted during 2006 is well on the way of being achieved. This campaign has taken off successfully with over 7,500 trees being planted during the first half of this year.

During the past year, consumer information on their impact on the environment has continued to increase through the dissemination of information. Waste management during 2005 experienced interesting developments with trainers visiting households to disseminate good practice. Urban areas have also received considerable attention through the very valid contribution that the Environment Landscape Consortium is making. The soft areas that are gradually being rehabilitated should leave a lasting impression on us and the people we host.

8.4 Sustainable development

Government is committed to see the formulation and gradual introduction of action plans to attain the priority areas identified in the *Draft National Strategy for Sustainable Development*. This Strategy is currently being concluded by the National Commission for Sustainable Development, chaired by the Prime Minister. It is Government's intention to ascertain that sustainable development is embedded in each and every policy formulated across Government and not merely on those related to the environment.

This strategy identifies a number of priority areas for the attainment of sustainable development goals in Malta. They are considered to have direct positive effect on society as a whole, in that they improve the quality of life of the population and are in line with sustainable development goals. The priority strategic directions directly linked to the environment include:

- **Emissions**
  Take steps to reduce greenhouse gas emissions through an energy policy which has clear targets and which considers internalisation of energy costs, and as a result decouple the rate of growth of GHG emissions from economic growth.

- **Air Quality**
  Take remedial action to control emissions of air pollutants (ambient levels of particulate matter, sulphur dioxide, carbon monoxide, benzene, lead, ozone, heavy metals and nitrogen oxides) and achieve compliance with European standards.

- **Freshwater**
  Adopt a policy that safeguards the quality of fresh water resources so as to protect human health, and satisfy the requirements for human use (including agricultural and industrial usage) and utilise the Water Exploitation Index to achieve good quantitative status by 2015 in line with the Water Framework Directive (LN 194 of 2004).

- **Seawater**
  Improve seawater quality standards in order to achieve compliance with Bathing Water Directive (LN 380 of 2003).

- **Waste**
  Prevent and minimize waste by achieving EU waste-related targets, reviewing Malta's Waste Management Strategy by 2007, and deviating at least 50% of Municipal Solid Waste from final disposal by 2020.

- **Land use**
  Protect, maintain and improve the urban and rural environment and through the planning system protect the open countryside from uses, particularly residences, which can be more appropriately located in urban areas.

- **Transport**
  Reduce car ownership rates to the EU average by 2014. Attain 1995 bus patronage levels by 2014 (40 million passengers).

8.5 Environment protection

It is proposed that in the coming year, Government will continue to bring to the fore opportunities for environmental success. Government will continue to facilitate the uptake of new technologies and new industrial activity that will also safeguard our social and economic perspectives.

During the consultation meetings held with the public leading to the preparation of the *National Strategic Reference Framework*, the strategic document outlining the prioritization of funds secured under the forthcoming financing programme, Government understood the desire to continue to invest in the environment. To this end, a series of environmental projects will be proposed to augment the total capital environmental investment of these past years.

The transport sector is being revamped through the development of new infrastructure as well as long-term strategies for the gradual introduction of modes of transport running on renewable sources of energy. The energy sector too is on the way of being liberalised allowing a level playing field even for biofuels. Budget measures for PV and wind installations at a domestic and commercial level must continue to provide opportunities for investment in green technology, not merely to benefit the environment but also to reap economic sense.

In the year ahead, Government will continue to engender increased awareness on the need of safeguarding our environment. Environment protection can no longer be perceived as a cost but as a profit. The appreciation of this may be slow and at times painful but the end result ensures compliance, improved markets, job creation and, last but not least, a healthier environment for our collective well-being.

Government will continue to transpose European directives in line with the environment acquis communautaire. Consultation on the implementation of these obligations will continue with all interested parties. The decoupling from Government intervention in areas where a clear economic benefit results if private sector involvement is cultivated will continue to be nurtured. Incentives for the private sector to understand this more rapidly will continue to be provided most notably by the implementation of the refund mechanism for eco-contribution.

Infrastructural projects necessary to provide a service to industry will continue to be developed. There is increasing awareness of the problems that some manufacturing concerns face when it comes to managing their waste in an environmentally acceptable manner. As a result, Government will continue to set up the necessary infrastructure to provide this service. This Government involvement will occur in areas where private intervention is not forthcoming. Even in these cases, every effort will be made to involve the private sector through PPP arrangements so that the risks and benefits are shared.

The setting up of the facilities for municipal waste, facilities for the treatment of hazardous waste, the facility for the treatment of clinical and other related waste as well as facilities for the separate collection of household and semi-commercial waste will be set up. The transport of waste from Gozo to Malta will also be made more cost effective. For this, funding through the European Union will continue to be targeted.

Work on the Gozo and North sewage treatment facilities will progress so that the amount of liquid emissions into our marine surroundings will be reduced. Work will also continue on the clearing of waterways so that the management of floods will be facilitated. The restoration of our cultural heritage will be continued as this too is seen as an important aspect in preserving our identity as a nation, even internationally.

The restoration of disused uncontrolled landfills will gradually continue. The formulation of long term strategies for the benefit after use of these sites will also initiate during this current year.

Government will continue to work towards improving the implementation of the littering regulations so that an improved culture of care within citizens is nurtured so that the common good is preserved. When it comes to regulation, the workings of the Better Regulation Unit, aimed at facilitating economic activity by doing away with unnecessary bureaucracy, shall also highlight the importance of self-regulation, a principle that until today may be perceived by some as a means of evading responsibility. On this premise, Government will continue to work towards attaining a situation where regulation is applied on the basis of risk.

The construction industry is a case in point. Government must eradicate the existing culture within this industrial sector so as to instil good practice at construction sites that respect neighbours. A common understanding on the new construction site regulations will soon be sought. Some of these regulations may be contentious given the current practises that have gone unchecked for many years.

Government will also continue to lead by example when it comes to environment practices. The sterling work currently being undertaken by the Green Leaders in the adoption of new procedures on waste management, energy and water conservation and transport will continue to be developed and strengthened.

During the coming year, Government will also launch an action plan on Green Public Procurement. The ripple effect this is likely to have, especially due to the supply chain, will benefit both the economy and environment alike.

8.6 Energy policy

Recently Government has published a formal statement of its energy policy and put it up for public consultation to encourage participation and finally ownership of this policy. This will be followed by several other detailed policies and action plans focusing on specific segments of the sector. One such policy is *A Draft Renewable Energy Policy for Malta* being published for public consultation with this Pre-Budget Document.

Government's energy policy for Malta is directed towards three main principles:

- security of supply;
- environmental responsibility;
- competitiveness including the social dimension. To achieve these principles, Government is focusing on five policy areas:

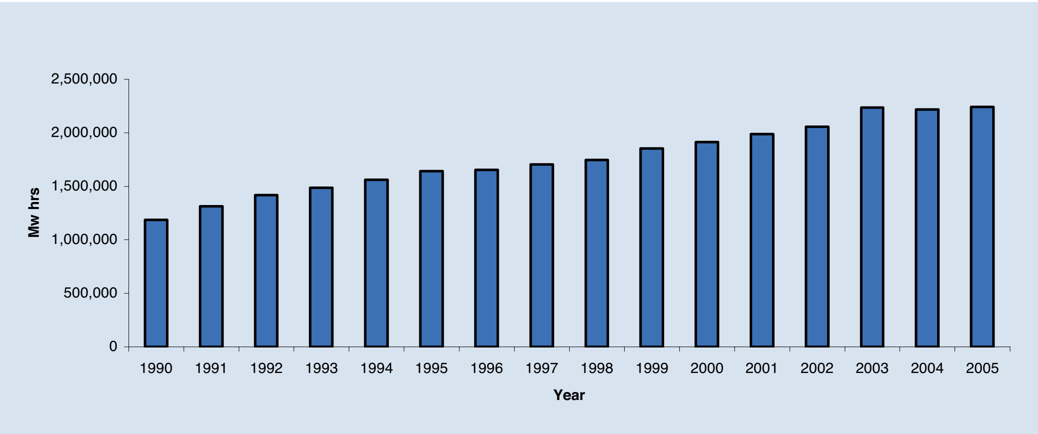
1. **Energy efficiency**
Government will encourage and facilitate the achievement of increased energy efficiency in electricity generation and distribution, and in energy end-use, and will lead by example.

2. **Reducing reliance on imported fuels**
Government will continue to provide opportunities in oil exploration, and support the reasonable development of sources of renewable energy.

3. **Stability in energy supply**
Government will seek to diversify the current reliance on oil products while ensuring that contingency plans are in place to cater for short-term disruption in oil supply. Malta will interconnect with the European electricity system.

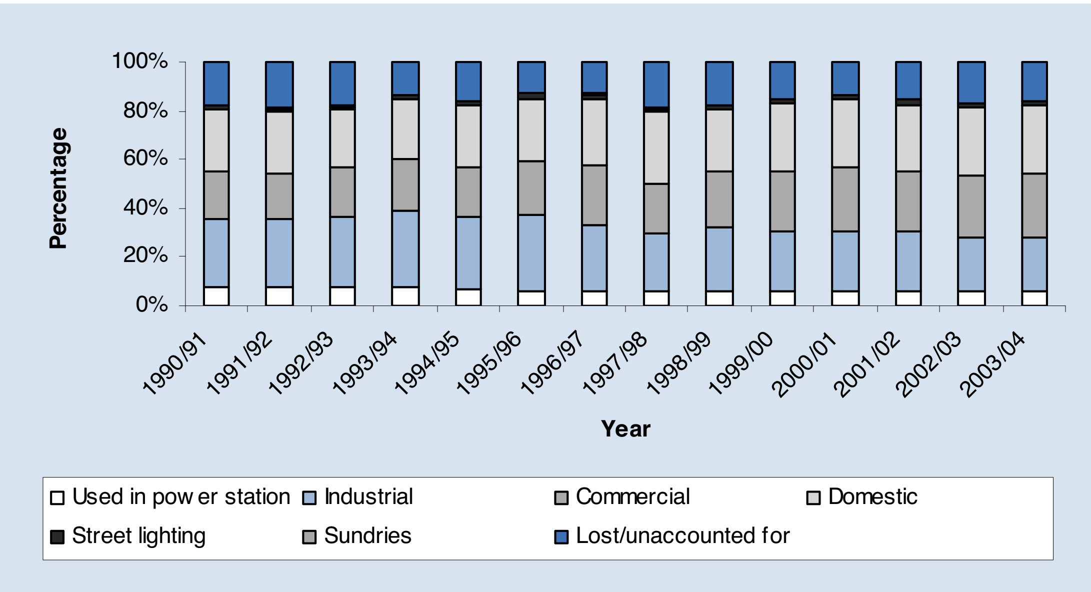
4. **Delivering energy efficiently and effectively**
Government will reform the energy sector to ensure maximum competition possible within the limits imposed by the market, while ensuring that operators deliver the best quality of service at the cheapest possible prices through market forces complemented by robust regulation.

Chart 8.1: Electrical power generated in Malta



Source: National Statistics Office

Chart 8.2: Electrical consumption by sector



Source: National Statistics Office

5. **Ensuring that the energy sector can deliver**
   Government will ensure that fiscal policy and policy in education and research support the general objectives of ensuring security of supply, environmental protection and competitiveness.

8.6.1 Energy efficiency

Energy efficiency is a key objective in the Government's energy policy. It can assist the economy, as well as help to achieve social and environmental objectives. It is widely perceived that the potential for improving energy efficiency in Malta exists.

The contribution of efficiency in the use of energy towards improving energy security and reducing carbon emissions arguably comes at the lowest cost of all options. It is even more rewarding than the introduction of renewables in the achievement of environmental objectives, and hence deserves priority.

In fact, energy efficiency is now a high international priority. The European Commission has launched a green paper on the subject followed by a green paper on a European strategy for sustainable, competitive and secure energy.

Government will endeavour to utilise Community programmes, such as the *Sixth Research Technology Development Framework Programme (2002-2006) and Intelligent Energy – Europe (2003-2006)* to further its efforts to attain energy efficiency.

- **Efficiency in electricity generation and distribution**
  Government has opened the electricity generation sector to competition, and the construction of any new plant is subject to the granting of an authorisation permit issued by the Malta Resources Authority and an integrated pollution prevention permit issued by the Malta Environment and Planning Authority. Government has established energy efficiency as an important criterion to be considered prior to the issue of any such permit or authorisation to construct new plant.

  It is also ensuring, through the budget approval process, that Enemalta Corporation strives continually to improve its efficiency of operations by investing in newer more efficient plant, by improving the efficiency of the distribution network and by implementing demand management measures.

  Government will also promote new more efficient technologies for the generation of electricity such as the use of high-efficiency cogeneration plant in industry that uses heat and power in its manufacturing process.

- **Efficiency in end-use**
  There are many initiatives currently taking place in the country to attain greater energy use efficiency, ranging from subsidies and support schemes by Government, initiatives by Government authorities and corporations, such as in water production and construction of housing schemes, and by the private sector.

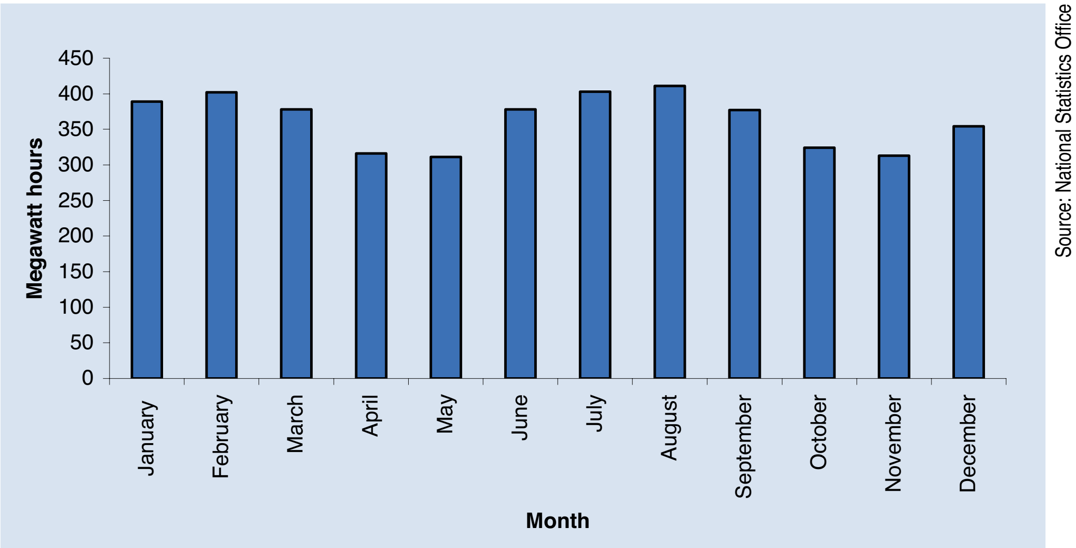
  Government will now bring all current initiatives, including targets for energy efficiency up to 2015, within a more holistic coordinated framework through a national energy efficiency action plan.

  In particular, a major energy efficiency programme is being put up to create awareness of efficiency in all energy applications and to provide access to the right information to the user at the right time, i.e. the crucial time when decisions that effect energy consumption are made.

  Government will continue to lead by example through the adoption of energy efficient practices in the public sector.

  In addition, it will be adopting legislative and administrative instruments to achieve energy efficient and environmentally friendly buildings and services.

Chart 8.3: Electricity maximum demand for the year 2005



- **Efficiency in transport.**
  Government is implementing a number of measures that should lead to an increase in the use of the public transport service, a consequent reduction in the use of private transport and hence will generate efficiency in the use of fuels for transport.

  Government will also be promoting and continue to provide fiscal incentives for the use of more efficient or environmentally friendly alternative fuels for transport and/or modes of transportation. It will also be supporting initiatives at EU level to promote the manufacture and marketing of more efficient vehicles and components.

8.6.2 Reducing reliance on imported fuels

Malta is today totally dependant on imported refined fossil fuel. It is clearly desirable to reduce this dependency.

This can be done if efforts to find indigenous oil or gas are successful and if renewable energy sources can be exploited to a significant degree. The latter is the long term option of choice.

Chart 8.4: Percentage share of fuel consumption

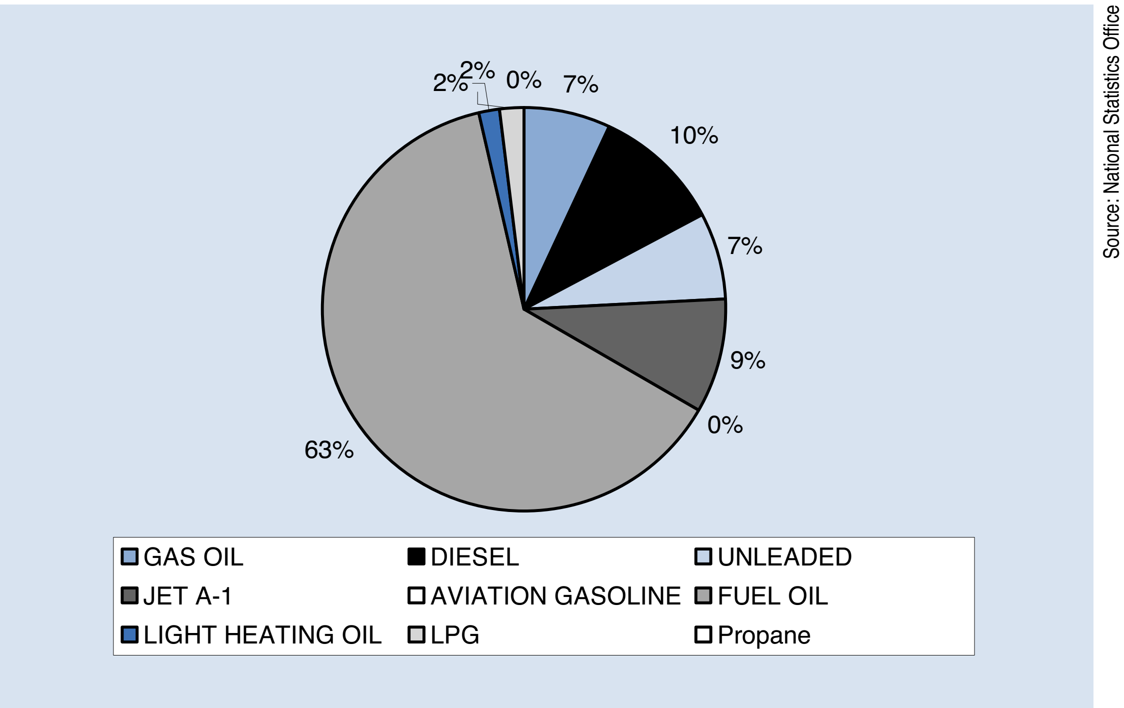
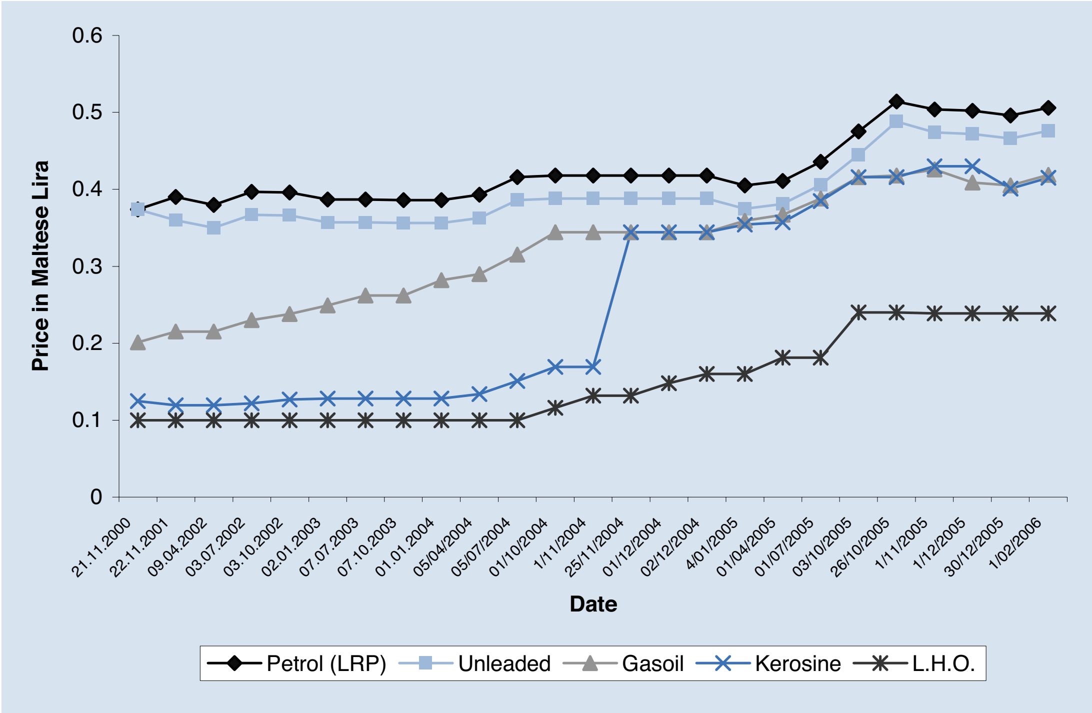


Chart 8.5: Fuel prices in the Maltese Islands



Source: National Statistics Office

- **Exploitation of renewable energy sources**
  Over the last year, Government has devoted significant attention to the introduction of renewable energy sources into Malta. Crucial decisions had to be taken given the innovative issues involved. A separate policy document, focusing on RES has been drawn up, demonstrating the importance Government is attaching to these sources of energy. This will be discussed separately in the second part of this chapter.

- **Oil exploration**
  Government will seek to intensify exploration for oil and gas by oil companies. Exploration and production of petroleum in Malta will continue to benefit from a favourable legal and fiscal regime. Under the current legislation, the process of granting exploration and production permits is short and of a duration compatible with the decision-making process of oil and gas companies. Specific incentives exist for exploration and exploitation in water depths greater than 250m. The sharing of revenue derived from petroleum also encourages the exploitation of marginal discoveries.

  Government will also seek to negotiate with neighbouring countries where disputed boundaries exist, with a view to enabling oil exploration to take place in currently disputed areas.

8.6.3 Stability in energy supply

Stability in energy supply is a major challenge facing all governments today, and will be tackled on several fronts.

- **Actions at an EU level**
  At an EU level, Government will continue to take an active part in the formulation of the EU external energy policy that aims to foster stability through dialogue with producing countries and follow heavy-consuming economics.

- **Energy interconnections with Europe**
  Government deems an electricity interconnection with Sicily, as the nearest point in mainland Europe, as desirable to ensure energy supply stability.

  Other options are also available, such as a gas pipeline to Sicily and/or an LNG terminal. The Malta Resources Authority, in its role as advisor to Government, is undertaking a study to determine the feasibility of such options and the commercial, regulatory and legal aspects of all interconnection options.

- **Planning for disruption**
  Despite the best efforts, the possibility of disruption in fuel supply cannot be excluded. It would be wise to plan ahead to manage such situation so as to minimise the social and economic impacts.

  Government has prepared an outline disruption response plan which will be detailed further during 2007. The plan is intended to identify the risks and incidents leading to oil supply disruption and the responsibilities, procedures and measures to respond to oil supply shortages.

  Through this plan, Government will ensure that institutions, information, hardware and infrastructure are available, ready, and coordinated so as to perform efficiently and expeditiously in any emergency, while leaving the freedom and flexibility to respond to any circumstance as it arises and as best thought fit.

  Malta is also holding security stocks of fuel in terms of the applicable EU directive. Government will soon be examining whether a reform of the relevant policies is necessary to reach the EU-wide objective at the least possible cost.

8.6.4 Delivering energy efficiently

EU law requires the liberalisation of the fuel market and of electricity generation.

The previous market arrangements in Malta therefore need to change drastically to comply with the relevant directives and obligations.

Government believes in the ability of private enterprise to perform up to the required standards. Yet it is mindful of the importance of these energy sectors to the economy and of the as yet limited experience in the operation and regulation of such liberalised markets, which in Malta are not conducive to economies of scale or scope. It is therefore proceeding with changes and reform in a spirit of prudent innovation, allowing stockholders time to consolidate their activities, whether commercial or regulatory.

- **Regulation**
  Government has already put the regulatory structures to deal with a liberalised energy market. The most directly relevant are the Office of Fair Competition and the Malta Resources Authority.

  Through these institutions, and others, Government will ensure that the sector is regulated through policies that are coherent, impose minimum bureaucratic obligations, that are least intrusive, while aiming towards affordability of fuels and customer and environmental protection, and where possible fostering competition.

- **Opening up the fuel sector to competition**
  While the bunkering and aviation sectors are already liberalised, the rest of the market will soon follow after Government takes the final decisions following the public consultation exercise on the proposals for reform of the fuel sector.

  Government will soon adopt the necessary legal, administrative, fiscal, economic measures consistent with its social considerations, its obligations and strategic concerns.

- **An effective electricity sector**
  The legal basis for a liberalised electricity sector – the *Electricity Supply Regulations (LN511 of 2004)* issued under the MRA Act have been in place since 2004.

  The objective behind this liberalisation, besides obligations arising out of EU Directives, is the introduction of competition in electricity generation, leading to greater efficiency and reduced costs in the sector.

Government will ensure that there is free entry into the competitive generation market. It will give special attention to ensure security (including security of supply), regularity, quality and price of supplies, environmental protection, (including energy efficiency and climate protection) social and economic cohesion and customer protection.

8.6.5 Ensuring that the energy sector can deliver

Government will ensure that the energy sector is supported through other policies to deliver on its objectives. Examples are fiscal policy, education and research and employment policies.

- **Fiscal policy**
  Used judiciously, taxation can be used to achieve certain objectives by placing a value to costs or benefits that are not valued by the market or to discriminate positively in favour of certain aspects, such as renewable energy.

  Government will continue to implement the transitory arrangements for energy taxation as agreed with the EU and use fiscal policy to promote environmental and other Government priorities in the energy sector. It will allocate funding from the Cohesion Policy 2007-2013 to the energy sector, including funding for new generation infrastructure and alternative sources of electric energy.

- **Education and research**
  It has been demonstrated in other sectors that the introduction of the latest technology and its innovative and enterprising application guarantees development to the highest international standards. Government will promote and encourage such technology transfer and research that is of direct benefit to Malta.

  The achievement of this level of excellence requires the availability of a skilled workforce, which Government will provide.

8.7 Focusing on Renewable Energy Sources (RES) in the context of an overall energy policy

Consistent with the three principles of its energy policy, Government is now focusing on renewable energy as a concept and a practice in energy sector operations. This focus, aspects of which are treated in this chapter, is described in detail in *A Draft Renewable Energy Policy for Malta*.

Renewable energy is recognised as an effective contributor to security of supply, is regarded as a sound policy option towards promoting environment-friendly energy production, contributes to a reduction of greenhouse gas emissions that are associated with climate change and, is credited with having long-term potential to contribute towards meeting the energy challenges that we are facing. It is an energy source that is not affected by volatility in prices; and it can create jobs. Owing to certain natural characteristics and circumstances, not all countries reap these benefits to the same degree. For example, Malta cannot benefit from the cultivation of energy crops – a complementary activity associated with bio fuels – because of the scarcity of land and water. Having said this, Malta is fully cognizant of the opportunities which RES offers to national development as well as of a moral commitment to participation in international efforts.

Education over time and a heightened awareness of the facts are bound to contribute to a shift in public opinion towards acceptance of the renewable energy concept. Coupled with the fact that the process of research and implementation directed towards increasing energy efficiency and construction of large RES infrastructure takes time, the deploying of those measures that are deemed feasible and appropriate to Maltese circumstances should not unnecessarily be delayed.

8.7.1 Renewable energy: a definition

Renewable Energy Sources are energy sources that are rapidly replaced by a natural process, and are defined in the EU Directive 2001/77/EC. Those sources that have the potential to contribute to Malta's energy economy are solar, wind, biomass, landfill gas, sewage treatment plant gas and biogases.

8.7.2 Security of supply

As things stand, Malta is close to 100 per cent reliant on fossil fuels for its energy. Over and above the general increase in global market energy prices related to supply-and-demand, oil prices are subject to very significant spikes that occur as a result of political developments and threats, and natural calamities. The international scenario does not offer a reason for a discontinuation of this trend; as such, fossil fuels could exercise a very considerable burden on the economy, becoming unaffordable in extreme cases. Were Malta's oil exploration ventures to yield a successful outcome, Malta would still have to rely on foreign refineries for the finished product.

Renewable energy is unaffected by this state of affairs, a fact which justifies a conceptual shift in energy policy in order to obtain at least partial relief from volatility in prices and scarcity of products. Of course, renewable energy does not come cheap but investment in it should be regarded and promoted as investment for the future. At the same time, we should be enterprising enough to take full advantage of those renewable energy sources that lie within our reach.

8.7.3 Environmental responsibility

All countries are becoming more conscious of the benefits that can be obtained from a cleaner environment and the environmental responsibility which current generations have towards future ones. This translates into rising pressure on governments to adopt environmental policies. While cleaner fuels contribute to less pollution, most renewable energy sources clearly have the potential to provide a quantitative jump in the reduction of pollution from energy generation and other operations.

8.7.4 The social and economic dimension

Government will also be considering the aspects of affordability and competitiveness. To date, the market has been biased against renewable energy sources, due to long-term, often hidden, subsidies for conventional energy and the lack of systems for the incorporation of external costs related to renewable energy infrastructure. Thus, the benefits accruing from renewable energy are not easily accounted. The cost factor is not uniform across all renewable energy sources. For example, large-scale wind farms produce energy at prices that are competitive with today's fossil-fuel prices even when one excludes external costs. On the other hand, electricity generation by means of technologies such as photovoltaics (PV) is still expensive and must be bolstered by support and incentive schemes in order to enable such technologies to penetrate the market to any significant extent.

A prospective industry in renewable energy sources offers a good potential for job creation. Installation of small-scale RES is labour-intensive, while large-scale RES requires skilled and qualified personnel for the manufacture, erection and maintenance of the infrastructure and for the potential offering of related services to neighbouring countries.

8.8 Renewable energy policy

Within the objectives of its overall energy policy, Government has identified three key objectives related to renewable energy sources. These are:

1. **Promotion of RES**
   Government will promote renewable energy sources in recognition of their short- and long-term benefits. This will be achieved by setting goals targeted at the penetration of the market by these energy sources and by introducing support schemes and regulatory measures in order to encourage public investment and participation.

2. **Quality of life**
   While appreciating the benefits of RES, Government is mindful of their impact upon the quality of life of citizens. In promoting RES, Government will ensure that quality of life for all will not be adversely affected by the measures adopted.

3. **Support facilities and services**
   A robust adoption of RES implies the availability and accessibility to all citizens of support services and development facilities. These services and facilities include dissemination of information, encouragement of public participation and acceptance of RES projects, and human resource development. Government will adopt this holistic approach in order to ensure a successful uptake of RES. This approach also entails getting all stakeholders on board: these include business and social partners, civil society organisations and consumers.

8.8.1 Objectives - setting targets that are ambitious but feasible

Government has, directly or through its agencies, conducted several studies in connection with specific renewable energy technologies both up to and post-2010. The following is the outlook on sources that are exploitable in Malta.

1. **Solar energy**
   Large, land-based solar farms are not considered attractive mainly because of their footprint and the impact of their hardware on the local landscape. More cost-effective uses of solar energy are perceived to lie in water heating and in the medium term in cooling.

   Solar water heaters were slow to be introduced into Malta. A recent survey by the Institute for Energy Technology within the University of Malta found that, due to faulty installation, many solar units came across as ineffective. Ever since Government offered an incentive related to solar water heating, there has been an upturn in the penetration of this type of technology. Solar energy for cooling purposes is particularly attractive to Malta. However, while large units are not difficult to come by, domestic-sized units are more rarely found on the market. There are a number of international initiatives currently in progress for dealing with this problem, which are also being monitored on a local level.

Noting the cost of PV-generated energy, and benchmarking with other countries, it is clear that the penetration rate in Malta is likely to be too small to be significant in terms of its contribution to the national energy balance.

However, Government will continue to support PV installation in the interest of a diversified energy mix and as a gesture towards fostering environmentally favourable technologies.

2. **Wind energy**
   Wind energy is the most attractive technology under consideration, in that it is perceived as having the potential to contribute significantly to the generation of electricity in the medium term (within the next decade). Owing to the impact of land-based wind farms on a densely populated land area the size of Malta, on-shore wind farms have been considered unsuitable. Locations where wind farms may be set up are also constrained by the need to provide facilities indispensable in an island state, such as buffer zones for an international airport, harbour approaches and other unavoidable commercial activities. Government is currently examining the possibility of installing large-scale offshore wind farms. These are attractive because their environmental visual and acoustic impacts are somewhat mitigated by distance.

   An expression of interest for consortia willing to develop such wind farm projects on a public private partnership basis has been published. Government will offer the site on a concessionary basis; the network operator will buy the energy produced under agreed terms, while the developers will finance build and operate the plant. If built, an offshore wind farm with a capacity of about 100MW may generate around 270GWh per year of electricity (about 10 per cent of the national demand of electric energy in 2010). Some aspects of these sea-based farms involve new technology that is still being tested. As such, no targets have been set as yet.

3. **Energy from solid waste**
   Malta is in the process of revising its national solid waste management strategy. This will highlight measures for the reduction of the land filling of biodegradable waste. In so doing, this revision will also take on board recommendations contemplated by a technical committee on waste to energy established by Government to explore new waste treatment technologies on the market. The revised strategy as well as the waste-to-energy document will be published shortly. A new plant for the processing of 35,000 tons of the biological fraction in municipal waste is planned for 2008. It is estimated that electricity produced from this facility may range from 7 to 10 GWh/per year. The waste treatment capacity will be tripled by the introduction of additional treatment facilities. All in all, it is expected that the plants will yield around 54 GWh of waste-generated electricity by 2013. The recovery of energy from landfills is envisaged through the gas potential of the Ta’ Żwejra and at Għallies facilities. In 2006, this has been estimated at 200m3/h and may rise to between 600m3/h and 800m3/h by 2010.

4. **Energy from sewage and animal waste**
   The potential of energy generation from sewage sludge and waste emanating from animal husbandry has not yet been assessed; nevertheless, this may prove to be significant. Government has commissioned an Agricultural Waste

Management Plan to examine and propose cost-effective strategies for the management and use of animal waste. This project involves the construction of anaerobic digestion plants that are capable of providing an on-site energy source.

The Water Services Corporation is currently working towards setting up three new sewage treatment plants, two in Malta and one in Gozo. The two smaller plants – the Gozo plant and the Northern Malta plant – will be operational by the third quarter of 2007. The largest plant – in Southern Malta – will be equipped to generate 80 per cent of its electrical power requirements and is expected to start operations in 2010.

3. Energy from biofuels

In line with EU Directive 2003/30/EC promoting the use of biofuels in road transport, Government has set a target of a 0.03 per cent use of biofuels as a share of total fuel sold for road transport in 2005. In this year, biodiesel accounted for 0.5 per cent of total fuel used for road transport, a significant improvement on the 0.1 per cent achieved in 2004. A more ambitious target for the use of biofuels up to 2010 will be set in 2007. Following the interest raised by the use of biodiesel, production of biofuels – from waste cooking oil, abattoir waste and imported virgin oil – has increased.

8.9 Strategic measures

1. Photovoltaic and solar thermal energy

In the interest of promoting such a mix, Government has already introduced various measures of support with a view to increasing photovoltaic-generated electricity. These include:

- capital grants for solar installations, including solar thermal water heaters, in private households;
- the establishment of a net metering arrangement whereby excess electricity generated by photovoltaic domestic units is purchased by Enemalta Corporation with the meter charges for the consumers in question being wavered.

2. Energy from biofuels

Government has already put into effect an exemption from excise duty on the biomass content in biodiesel. Such measures will come up for review, following an assessment of the results achieved.

3. Energy from waste

The Eco-contribution introduced by Government already provides an incentive towards the recovery and recycling of waste fractions. A potential support scheme for waste-generated energy could be a differentiated tax on waste destined for land filling in order to re-channel appropriate waste away from landfills and towards recycling and energy recovery plants.

4. Externalities

In line with its policy of acting on the basis of knowledge-based decisions, Government plans to commission studies on the external costs of electricity generation from renewable sources in

Malta. Where appropriate, it will seek to internalise these costs.

5. **Incentives to private enterprise**
   Malta Enterprise will prioritise renewable energy industries, especially the solar thermal and photovoltaic industries by establishing a series of incentives specifically targeted at business units. The incentives include advantageous tax rates, special loans, loan guarantees, training grants and subsidised property rates.

6. **Financial support mechanisms**
   The high costs of renewable energy technology generally rise from high initial capital outlays and finance-related risks. Government will work with banks and other financing institutions in order to establish low-interest and guaranteed loans, as well as flexible repayment schemes, for renewable energy projects.

   Government will continue with the implementation of support schemes to promote the adoption of a mix of appropriate technologies at all levels – large, medium and micro – while considering the costs of implementation and maintenance of these technologies and related financing aspects. These schemes will be improved where possible.

8.10 Assessment of environmental benefits of renewable energy sources

In promoting and managing the introduction of Renewable Energy Sources, Government will seek to ensure that the quality of life of citizens is not compromised. The different renewable energy technologies all have different impacts on the environment and on quality of life and, as such, they need to be assessed individually. Small-scale systems such as photovoltaics, micro-wind and solar thermal panels, should not be unduly intrusive if building regulations are adhered to. With regard to large-scale wind farms, every effort will be made to locate them offshore where their impact on the environment and on various economy sectors will be much mitigated. Electrical energy generated from organic waste is CO_2 neutral. Separation at source of organic waste fractions from the waste streams deposited at the landfills will minimise risks of escaping methane gas, which is a potent greenhouse gas. With regard to subsidy schemes for specific renewable technology projects, all such proposals will be subjected to a rigorous, environmental impact analysis. In this respect, Government intends to ensure that appropriate methodologies for the carrying out of these assessments are employed.

8.10.1 Human resource development

Government will continue to strengthen institutional capacities in education and information particularly through participation in the Mediterranean Renewable Energy Programme. The University of Malta and its institutes, national institutions such as the Malta College of Arts, Science and Technology (MCAST) and the Employment and Training Corporation (ETC), all have an important role in human resource development as well as in educating and training an adequate, knowledgeable and skilled workforce which is a prerequisite for the effective adoption of renewable energy sources and for maximising the benefits to be had.

8.11 Getting the public on board

Education and information are two elements that are crucial to the success of policies and strategies promoting and implementing renewable energy projects and programmes. Environmental awareness is definitely on the increase, a fact which is largely attributable to the priority which Government is according environmental issues. As noted in the *State of the Environment Report* of 2005, in the past 10 years investment in the protection of the environment increased from 0.5 per cent to 1.4 per cent of the GDP. This itself evidences the significant commitment of this Government in ensuring that investment in environmental protection will continue to improve in order to ensure sustainable development now and in the future.

NGOs and public awareness have also continued to push our own personal understanding that the resources at our disposal today are not everlasting and every effort must be made to protect these for generations to come.

The role of the mass media in communicating the benefits of renewable energy and in raising awareness among the public is essential. Media channels will be utilised to the full by entities such as the Malta Resources Authority (MRA) which will continue to conduct in full strength the national educational campaign soon to be underway. MEPA will promote greater public participation at the local level by addressing local communities. It will seek to foster local communities' sense of ownership of RES projects and will work in partnership with them in order to showcase best-practice projects in the field of renewable energy.

Government will continue to invest intensively in environmental education. This will be done through a number of initiatives, namely *Eko Skola*, waste prevention campaigns and the *Xummiemu* campaign. A number of popular educational campaigns have also been initiated and will be sustained. These include the Climate Change Awareness Campaign and the *EcoFest* held annually to commemorate Environment Day.

Finally, Government believes in leading by example. In this vein, Government will promote installation of solar and micro-wind systems on public buildings. Specifically, plans are in hand for a number of projects.

8.12 Conclusion

Government is committed to the formulation and gradual introduction of action plans in priority areas directly linked to the environment identified in the *National Strategy for Sustainable Development*. Priorities include; air emissions, air quality, fresh water, sea water, waste, land use and transport. Practices pertaining to sustainable development should be embedded in every policy formulated by Government and not just those relating to the environment. Government intends that this should be so, especially with regard to its energy policy for Malta which straddles the economic, social and environmental spheres. The five areas sustaining this policy are: energy efficiency, reducing reliance on imported fuels, stability in energy supply, a sound distribution system and support of the energy sector in order to render it capable of delivering on its objectives. With regard to the second mentioned principle, a framework for the use of renewable energy sources is elaborated on.

9 Mainstreaming the EU dimension to the 2007 budget

9.1 EU Funding

Malta is currently benefiting from Cohesion Policy 2004-2006. The road has been long and the learning curve has been steep, however the effects of the funds can now be seen all over the country with upgrading of roads, improvements in the environment (the main sectors include air quality, waste management and water quality), and the procurement of vocational training equipment, investments in tourism, enterprise, human resources, agriculture and fisheries.

Malta's lion share from the Community Budget comes under the heading of Cohesion Policy. In December 2005 the European Council agreed on the Financial Perspectives and Malta has been allocated a budget of over 805 million euro for the next seven years. In effect this means more than four times as much on annual basis than the 2004-2006 period. These sums exclude money coming to Malta under the agricultural and fisheries funds, other Community Programmes and Initiatives, primarily the specific programmes targeting particular sectors such as education, training, R+D, environment, border control, and public health. A number of other headings under the Financial Perspectives 2007-2013, such as the direct subsidies to farmers, are also excluded from this calculation.

With a GDP of less than 75 per cent of Community average, Malta is a convergence objective country and thereby considered to be a Member State qualifying for support to converge to the more prosperous European economies. The mobilisation of these funds will be critical to the country in achieving its targets in terms of employment and productivity growth. Moreover, these funds will also impact considerably on the citizens' overall quality of life, particularly through investments in the environment sector.

The 2007-2013 strategy and programmes aim to build upon the results achieved in the current financial period with significant new additions such as Research and Development, innovation, e-society and urban regeneration. One of the principles of Cohesion Policy is the concentration of resources – that is not focus the intervention of the Funds in those areas and sectors where they can achieve maximum results both in terms of impact and absorption.

Cohesion Policy funding has to be programmed in a structured manner. Programmes proposed by the Member States have to be negotiated with and agreed upon by the European Commission. In this regard Malta is on track and now has good drafts of all three documents, namely the National Strategic Reference Framework launched in March 2006 and, Operational Programmes I and II released for public consultation in June and July of this year respectively. Following this consultation, these documents will be finalised in the coming months and will mobilise the use of the Funds. Once the European Commission approves these documents, projects are selected and implementation is started. Technical, financial and administrative capacity is crucial to the successful absorption of the Funds and in this regard Government is working in parallel to the programming process to ensure sufficient capacity in key organisations, a good pipe-line of projects and also the required co-financing.

Cohesion Policy is an essential adjunct to boost and sustain economic growth. During the period 2007-2013 Cohesion Policy in Malta will be critical to the country realising its full potential as an EU Member State. Structural Funds are mainly deployed to reduce the disparities and/or deficiencies in infrastructure and human capital endowment between the convergence countries/regions and the more prosperous parts of the European Union. While it is yet too early to analyse the effect of Cohesion Policy 2004-2006 on the Maltese economy, empirical analysis (from other Member States) has shown that growth of GDP, employment and productivity in the poorer regions of the Union (and therefore also recipient of the Funds) has exceeded that in the rest of the EU. Moreover, convergence has been most pronounced in the least prosperous areas of these poor regions. Structural interventions have boosted growth in the countries/regions both by adding to demand and strengthening the supply side of the economy and by encouraging a growth of trade between cohesion countries and other parts of the Union.

The policy mix for funding being proposed by Malta, based on a thorough analysis of the objectives and needs of the country, taking into account the specific characteristics of our country, the structure of its economic activity, the nature and extent of its structural deficits and its potential areas of comparative advantage.

Malta's four main strategic objectives are:

- sustaining a growing and knowledge based, competitive economy;
- improving the quality of life of citizens through environment protection and urban regeneration;
- investing in human capital;
- addressing Gozo's regional distinctiveness.

These four strategic objectives are consistent with the strategic thrust being outlined in this document and will result in investments in enterprise (including aid to enterprises), research and innovation, education reform, access to employment, tourism (including cultural heritage), transport infrastructure, information society, environment, water, energy, urban regeneration and human resource development. These investments will complement the efforts being co-funded by the national budget and other sources and aim at improving both Malta's competitiveness as well as the quality of life of our citizens.

Apart from the investments in national infrastructure and services, the Funds will also support the modernisation and re-structuring of the productive capacity by providing services to enterprises, particularly SMEs. These services include promotion of RTDI, developing human resources, improving access to finance, and the promotion of ICT.

Moreover, the investments in human resources and skills, social inclusion and improved governance together with the potential of the funds to mobilise additional resources and instigate change and reform are guarantees that investments are not aimed at merely improvements in infrastructure and short-term growth but are laying the foundations for sustained growth and long term prosperity as outlined under the Lisbon Agenda for Growth and Jobs. In parallel to external cohesion, Government recognises the importance of increased cohesion within the country and this is reflected in one of the four strategic objectives mentioned above. Government is committed to continue to direct specific support to address the special needs of Gozo. A minimum of 10 per cent of the Funds will be allocated for measures aimed at Gozo's continued development.

Despite the visibility of the Funds through promotion and publicity campaigns, very few citizens are aware of their impact on their daily life. Perhaps some examples will help in illustrating the magnitude of the interventions. In the past two years over 12.5 million euro have been committed to human resource development projects which have supported projects aimed at increasing the number and variety of courses at MCAST; projects that have assisted people from disadvantaged groups (the unemployed, the disabled etc.) into employment; and, promoted lifelong learning through courses in ICT, professional development and others. Over 50 million euro have been committed to environment projects targeting primarily waste management, water and air quality. Over 15 million euro are being invested in transport infrastructure, primarily in upgrading roads. Over 12 million euro have been committed towards the development of enterprise and tourism, including 3 million euro in direct aid to industry.

One must add that apart from the two large mainstream programmes mentioned above, Malta is also eligible under the territorial objective of Cohesion Policy. The aim of this co-operation is to promote a stronger integration of the territory of the Union as a whole in all its dimensions. Malta currently participates in four Interreg Programmes with fifty five projects in all with a variety of different stakeholders ranging from Government departments and public agencies to local councils and NGOs. The territorial co-operation programmes are based on shared strategies of the territories and aim to reduce the barrier-effects through cross-border co-operation, networking of the key stakeholders and exchange of good practices.

9.2 The euro

With Malta's process of deeper integration with the EU well under way; Government's next objective is to join the European single currency area. Monetary union is a logical complement to economic union. While the adoption of the euro is an obligatory next step for the new Member States, an expeditious entry is doubly important for small and open economies like ours. It is hardly surprising that the other new Member States are similarly eager to secure, as soon as possible, the protection and benefits afforded by the world's second most important currency.

Since independence in 1964, Malta's economic development strategy has been driven by the need to compensate for the country's lack of natural resources and its small size. The chosen path of diversification into manufacturing and services, particularly tourism and, more recently, financial services, has consequently had to depend heavily on inflows of foreign direct investment and on securing access to larger overseas markets. Economic openness and small size also entail exposure to external shocks, a characteristic shared by other small economies.

In different parts of the world, regional integration has proved a successful strategy as a means of building up resilience to such shocks, while at the same time providing exporters with new markets. This has been Malta's experience too. For while Malta's close economic ties to Europe owe much to geography and history, they are to a large extent also the product of a conscious policy that recognises the importance of closer integration with major trading partners.

Two years after accession to the single market, it is possible to begin to assess the impact of the wide-ranging changes and reforms that membership has entailed, and also to evaluate the role that the Economic and Monetary Union (EMU) plays in the process of economic integration.

Malta's economy is today highly diversified. Until recently, export-oriented industries coexisted with import-substituting and mostly labour-intensive enterprises, which sold their product in the protected domestic market. Faced with foreign competition in the aftermath of EU accession, domestically-oriented manufacturing and agricultural enterprises were among the first to make the necessary adjustments to survive in the new, liberalised environment. The impact was also felt in the public sector, where the privatisation of a number of state-owned enterprises has attracted considerable foreign direct investment. This adjustment was made with no real disruptions in the economy, with the level of unemployment remaining comparatively low.

The export-oriented sectors of the Maltese economy have also adapted to the new realities in an external environment that has not been particularly favourable. Exporters of manufactured products have been facing intensified market competition, particularly from Asia. There have lately been signs of a rebound in the electronics sector, which is an important source of employment and foreign exchange earnings, while rapid expansion in the pharmaceuticals sector is filling the void left by the shrinkage in labour-intensive export activities such as clothing and textiles. While the tourist industry appears to be recovering slowly from the post-9/11 slowdown, other service activities, including financial services, are growing steadily and have emerged as an important source of employment creation.

Upon adoption of the euro we expect to reap gains from the elimination of exchange rate risk and reduced transaction costs across most of our external transactions. If the experience of Austria – another small and open economy – is anything to go by, such cost savings could amount to as much as 0.8 per cent of GDP annually. Indeed, given that Malta's combined imports and exports are almost twice as large as its GDP, the cost savings could be even greater. In the product and resource markets, monetary union is also likely to generate greater price transparency and increased competition. Furthermore, the experience of other countries points to the prospect of substantial output growth arising from increased external trade. It is estimated that the additional annual GDP growth resulting from participation in the euro area could range between one and two per cent over the next twenty years in the new Member States. As importantly, the policy discipline that is synonymous with membership of a monetary union will reduce the risk premium on interest rates, to the benefit of both corporate and personal borrowers.

These benefits, of course, do not accrue automatically. They are premised on our ability to make progress in achieving nominal and real convergence. In this regard, Malta's EU membership and the prospect of euro adoption already serve as catalysts for a series of reforms designed to raise productivity and enhance the country's attractiveness as a location for foreign direct investment.

Malta's candidacy for membership of the euro area is based on the grounds that it satisfies to a significant extent the conditions which a country aspiring to join a single currency area must fulfil. The Maltese economy is already closely integrated with its major trading partner. It also has close similarities with the euro area in the sectoral composition of employment and GDP and in financial sector integration. This would suggest a low probability of shocks that would affect only Malta, which are shocks that could be more effectively addressed by a separate monetary policy. A similar conclusion is reached from a comparison of the degree of business cycle synchronisation in the Maltese and euro area economies. The case for joining a monetary union is further supported by the degree of nominal wage and price flexibility in Malta. Such flexibility, too, reduces the likelihood that the European Central Bank's (ECB) monetary policy would not be appropriate for Malta.

Economic theory suggests, and the experience of other countries has shown that, given these characteristics, Malta should derive substantial gains by becoming a full member of the European Monetary Union. The loss of monetary policy autonomy that such membership entails should not prove costly either. Indeed, by operating a fixed exchange rate regime in the context of a liberalised capital account and in practice, therefore, we would be exchanging an already limited degree of autonomy for the greater credibility of the European Central Bank's monetary policy.

Apart from exchange rate stability, the nominal convergence criteria that have to be met as a condition for adopting the euro relate to fiscal discipline, inflation and long-term interest rates. Until recently, the fiscal criteria, which specify maximum deficit-GDP and debt-GDP ratios, represented a major challenge. Government's determined efforts to correct the existing imbalances, however, have begun to show results, and the fiscal turnaround in the last three years has been quite remarkable. The budget deficit has been reduced significantly during this time, so that its ratio to GDP is scheduled to decline to below the 3 per cent benchmark this year from 10.2 per cent in 2003. The debt ratio has meanwhile started to reflect the declining deficit trend, and should also this year fall to around 71 per cent, a change of no less than six percentage points since 2004.

The inflation criterion is likely to prove more challenging to satisfy in the light of unfavourable external developments. The criterion compares the national inflation rate with the three lowest inflation rates in the EU. At present, however, the rising price of oil is affecting Member States differently, depending on their reliance on imports of fossil fuels and on the availability of alternative energy sources. The three countries with the lowest inflation rates at present, Sweden, Finland and Poland, have a relatively low dependence in this respect compared to countries like Malta. Although the second-round or ripple effects of higher oil prices have not been substantial so far, world fuel and energy price increases may, therefore, present a challenge for Malta's convergence. Our total dependence on oil imports is accentuated by the lack of alternative energy sources, and by the major use of electricity for the purpose of transforming sea water into drinking water.

Another challenge is current account deficit. While such deficits are typical of open, developing economies, the imbalance in Malta's case was accentuated last year by the large increase in the import bill due to the sharp rise in oil prices.

The reforms related to EU accession have also contributed to the deficit. For example, following the removal of the remaining trade barriers upon accession, a marked shift was experienced in consumption patterns towards imported goods. Additionally, while the injection of foreign expertise and capital has contributed to productivity growth, it has also been followed in the course of time by an increased outflow of dividend payments to foreign shareholders. The current account has also been burdened of late by the implementation of a number of public sector capital projects, largely financed by EU funds, which contain substantial import content.

There have been some calls for delaying euro adoption until the economy is growing at a faster rate. These calls are inspired by the prospect of relaxing the fiscal consolidation timetable. Apart from sending the wrong signals to foreign investors, calls for such a policy reversal ignore a fundamental truth: in an open economy like Malta's, not only does higher public expenditure not give rise to a permanent boost to growth, but a large part of the stimulus will extinguish itself through import leakages. It is no coincidence that fiscal imbalances tend, in our experience, to be mirrored by imbalances in external trade. Therefore, Government considers that in the long run the price to pay for fiscal laxity and for the failure to correct structural imbalances by far exceeds any possible gains for the economy.

9.3 Towards the adoption of the euro

The process of euro adoption started when Malta joined the Exchange Rate Mechanism II (ERM II) of the European Monetary System together with Latvia and Cyprus on 2nd May 2005. This mechanism provides the framework for exchange rate policy co-operation between the EU member states forming part of the euro area and those that have still not joined it. The target date for the adoption of the euro is 1 January 2008. The euro adoption process is made up of three key phases:

1. **ERM II period**

   This period commenced when Malta entered into the ERM II mechanism of the European Monetary System together with Latvia and

Cyprus on 2 May 2005. The period of time between Malta's entry into the ERM II on this date up to the decision by the ECOFIN on whether Malta can join the euro area cannot be less than two years. The decision of the ECOFIN follows a convergence assessment by the European Commission and a discussion of such assessment by the Heads of State in the European Council and a discussion by the European Parliament on whether Malta has fulfilled the (Maastricht) convergence criteria.

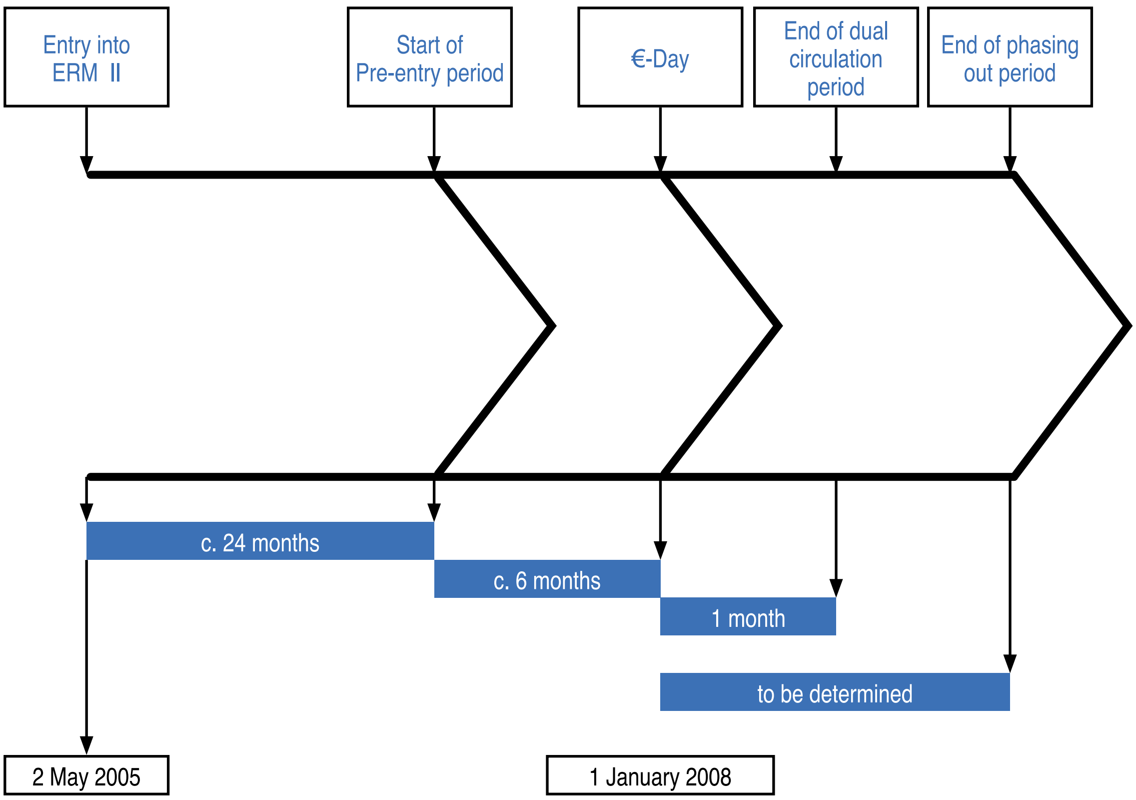
2. **Pre-entry period**

This is a relatively short period of time during which Malta is still part of ERM II. It covers the period from the date of a favourable decision by the ECOFIN for Malta to join the euro area till the day of adoption of the euro (€-day). Government's target date for €-day is 1 January 2008. Government's €-day is targeted to coincide with ECOFIN's decision for the date when Malta adopts the euro.

3. **Post-entry period**

€-day is marked by the simultaneous commencement of two key processes, namely – the dual circulation period and the kick-off for the phasing out period. The dual circulation period is a period during which Maltese Lira notes and coins circulate alongside euro notes and coins. The duration of such a period is planned to span four weeks, that is, until 31 January 2008. The phasing out period is an integral part of Government's preferred legal framework for the adoption of the euro i.e. that of a 'Big Bang' with a 'phasing out' period. 'Big bang' is an approach by which the adoption of the euro as the legacy currency and the introduction of euro cash (changeover) coincide on a single date (i.e. €-day). The phasing out period conceptually allows for the possibility of carrying out certain operations, except those related to cash payments, exchange or transaction instruments, in Maltese Lira. The parameters and duration governing the 'phasing out' period are still to be determined.

Chart 9.1: The euro adoption process



9.4 Conclusion

The four main strategic objectives in the policy proposals for EU funding being made by Malta are: sustaining a growing knowledge-based economy; improving citizen's quality of life through environmental protection and urban regeneration; investing in human resources; and addressing the regional distinctiveness of Gozo. These objectives are all in line with the strategic direction outlined in this document in that they will result in amongst others, investment in and aid to enterprises, education, research and innovation, tourism, transport, human resource development, access to employment, the environment, energy and urban regeneration. Malta's next objective, the adoption of the euro, is a logical next step since economic union should be followed by monetary union. Upon joining the European single currency area, Malta can expect to realise economic gains through the elimination of exchange rate risk and the reduction of external transaction costs. Malta's status as an EU Member State and the prospect of joining the euro area are already important platforms for reforms designed to increase productivity and to enhance the country's attractiveness as a foreign direct investment destination.

Supplementary Paper - **Streamlining company taxation**

A review of the present company taxation system necessarily involves a comparison with those of other countries. As we had pointed in last year's Pre Budget Document the criticism often levied that our company rate of tax is too high compared to that obtaining in other countries is not justified. Malta's tax system is a full imputation tax system which avoids the double taxation of company profits. The tax paid by the company is essentially only a prepayment of the tax, which is ultimately borne at the shareholder level depending on each shareholder's tax status and position. It should be recognised that our imputation system is a complete imputation system – company income, tax incentives, tax credits and tax borne are all imputed to the shareholder, at which level the tax burden is finally determined. Once distributed the company income may be taxed in the shareholder's hands and if his personal tax on that income is less than the tax the company paid on the income, the excess is refunded to the individual. Most imputation tax systems in other countries do not achieve this level of integration.

In other countries where tax systems are no so fully integrated, tax is levied on company profits as separate taxable persons and dividends or part thereof are again taxed in the hands of the shareholders. These are referred to as classical tax systems. Table A1 below shows the effective tax in EU countries on distributed corporate profits. From this table it will be noted that only a few EU countries have an effective tax on company profits which is significantly lower than that applicable in Malta. Moreover certain countries with a low corporate rate of tax result in a very high maximum effective tax at the shareholder level – e.g. Ireland. Some of these countries have adopted a specific policy of keeping corporate tax rates low in order to attract foreign direct investment in both the industrial and services sectors but at the same time retaining a relatively high tax at the resident shareholder level. This can be seen by reference to the difference between the effective tax suffered by residents and non-residents on distributed corporate profits.

Malta has always held the view that the imputation system as a tax system is one which reduces the tax induced economic distortions often complained of by economists. This is supported by many analysts and economists. Even in the United States, with a classical tax system, there is much discussion of changing the system into an integrated tax system that will tax business profits once and abandon the double taxation of corporate profits in view of the economic distortions the latter system produces resulting also in the uncompetitiveness of the US economy internationally. Clearly if such arguments are relevant to an economic super power like the US, the arguments in favour of an integrated tax system are even more relevant to an open economy like ours which is heavily dependent on foreign direct investment and its ability to create and capitalise on its competitive advantages.

A classical tax system taxes corporate profit distributed to shareholders at least twice- once at the shareholder level and once at the corporate level. If the distribution is made through multiple unrelated corporations, profits may be taxed more than twice – to the extent that dividends between companies are not wholly exempt.

Classical tax systems are said to have at least three inherent distortions and which are not generated in an integrated tax system such as Malta's.

Country	Type of Tax system	Profit tax rate including business municipality taxes and surcharges	Maximum* Effective Tax on residents	Effective Tax on non-residents	Difference
Denmark	0	28.00%	58.96	28.00	30.96
France Old Imputation -2004	Imputation	34.33%	56.90	16.27	40.63
Ireland – 25%	Imputation	25.00%	56.50	25.00	31.50
France Classical 2005	Imputation	34.43%	56.49	34.43	22.06
France Classical 2006	Imputation	34.43%	56.47	34.43	22.04
Germany	Classical	40.86%	53.97	40.86	13.10
Belgium	Classical	33.99%	51.73	33.99	17.74
Spain	Imputation	35.00%	49.95	35.00	14.95
Sweden	Classical	28.00%	49.60	28.00	21.60
Slovenia 2005	Classical	25.00%	49.38	25.00	24.38
Ireland - 12.5%	Classical	12.50%	49.25	12.50	36.75
Italy	Classical	37.25%	48.04	37.25	10.79
Hungary - 2005	Classical	16.00%	47.92	16.00	31.92
Hungary - 2006	Classical	16.00%	45.40	16.00	29.40
Netherlands	Classical	30.50%	47.88	30.50	17.38
UK - 30% Tax Rate	Classical	30.00%	47.50	30.00	17.50
Luxembourg	Classical	29.63%	43.33	29.63	13.70
Austria	Classical	25.00%	43.75	25.00	18.75
Portugal	Classical	27.50%	42.00	27.50	14.50
Slovenia - 2006	Classical	25.00%	40.00	25.00	15.00
UK - 19% Tax Rate	Classical	19.00%	39.25	19.00	20.25
Finland	Classical	26.00%	37.81	26.00	11.81
Czech Republic	Classical	26.00%	37.10	26.00	11.10
Poland	Classical	19.00%	34.39	19.00	15.39
Greece	Dividend Exemption	32.00%	32.00	32.00	0.00
Lithuania	Classical	15.00%	27.75	15.00	12.75
Estonia	Distribution Tax	24.00%	24.00	24.00	0.00
Cyprus	Classical	10.00%	23.50	10.00	13.50
Slovakia	Dividend Exemption	19.00%	19.00	19.00	0.00
Latvia	Classical	15.00%	15.00	15.00	0.00

* It is assumed that the dividend will be taxed at the highest marginal tax rate

These distortions may be summarized as follows:

- The incentive to invest in non-corporate rather than corporate businesses. The double tax on corporations in classical tax systems creates a higher effective tax rate on corporate equity than on non-corporate equity. The additional tax burden encourages "self-help" integration through dis-incorporation;

- The incentive to finance corporate investments with debt rather than by equity since interest would normally be deductible for the paying company and only taxed once in the lender's hands. In the USA, for example, a substantial increase in debt financing has been noted;

- The incentive to retain earnings or to structure distributions of corporate profits in a manner to avoid the double tax. In the US, for example this led to substantial increases in the repurchase of own shares by corporations leading to further increased financing by debt as this replaced equity financing.

These distortions in effect raise the cost of capital for corporate investments while an integrated tax system should be expected to reduce it. To the extent that an integrated system reduces incentives for highly-leveraged corporate capital structures, it would provide important non-tax benefits by encouraging the adoption of capital structures less vulnerable to instability in times of economic downturn. As far as possible, fundamental economic considerations, rather than tax considerations, should guide business investment, organization, and financial decisions.

In addition to the above our imputation tax system can be said to be one which is in its purest form. Other imputation tax systems as those which existed in France, Germany, Italy, the UK and other countries were not pure imputation tax systems especially when it came to granting non-residents a tax credit for the tax prepaid at the company level. Such a tax credit was only given by some countries in terms of some double taxation agreements and not as a general domestic rule of law and therefore theses imputation tax systems became classical systems where cross-border investment and dividend flows were involved.

This difference of treatment by such systems was held to infringe EU law by the European Court of Justice (ECJ) and as a consequence of a number of ECJ decisions holding imputation systems to be discriminatory; many EU countries have now changed their tax systems to classical systems or modifications of it. Malta's full imputation tax system however always treated residents and non-residents in exactly the same way and is therefore in this non-discriminatory and does not fall foul of EU law on this count. The only feature in Malta's imputation system which requires amendment for it to be fully compliant with ECJ decisions on imputation systems is to allow a credit for foreign underlying corporate tax to individuals in addition to companies where such a credit is already available. Such an amendment can easily be made and would in fact the harmony of our tax system by not discriminating in favour of the corporate form.

In conclusion therefore it will be apparent that the fundamentals of Malta's full imputation tax system are as good as any tax system can be. It reduces the tax induced economic distortions caused by classical tax systems which may result in the misallocation of economic resources.

- **Recent developments in the international tax arena**

  The foregoing analysis does not mean that we cannot seek to improve our tax system. Rather we should be proactive and not reactive in this regard. Globalisation, the increased mobility of capital and industry, competition for the location industrial activities all point to the fact that change, and at a relatively fast pace, is unavoidable. As we have seen over the last two decades the shape of what manufacturing industry can be in Malta has changed and will change even more in the future. Our niche is high value added activities and services requiring skilled workers working on research and development and innovation projects and ICT are becoming increasingly important.

Particular emphasis must be made also on financial services industry which as has already been emphasised last year is increasing in importance and now accounts for approximately 12 per cent of our GDP.

Recent trends in this sector are highly encouraging and we must realise this sector has the potential of becoming one of Malta's main economic pillars. Our insular and peripheral position to Europe, clearly indicate that we must direct our energies and efforts to this sector which could have further positive spillovers onto other sectors of the economy, including the hospitality industry.

As we had stated in 1988 and reconfirmed in 1994, our aim is to continue developing Malta as a highly regulated but open and efficient financial centre of repute to the highest levels.

Thirteen years ago when we had made transformed our tax laws the international tax landscape was significantly different to what it is today. Then one could simply direct and model the tax system as one wished without any international repercussions by simply giving direct tax incentives to businesses which provide employment and training to our work force but which do not partake in our domestic market or do so to a very limited extent. Since those changes, international developments have not made this any more possible.

More specifically since November 1994 the WTO Agreement on Subsidies and Countervailing Measures, to which Malta is a signatory prohibited any export subsidies which included the granting of tax incentives conditional on exports. Under that agreement Malta, which was then regarded as a developing country had a transitional period of eight years. In addition, a significant number of initiatives were taken at international and national levels to curb what was regarded as harmful tax practices.

The first initiative was that of the OECD and this was followed closely by an EU initiative called the Code of Conduct for Business Taxation. Under these initiatives the OECD at an international level and the EU with EU member states have sought to eliminate or reduce harmful tax practices. Harmful tax regimes are those which provide for zero or very low tax rates that are ring fenced from their domestic market and which are not transparent and/or do not provide effective exchange of information.

Most countries have cooperated with the OECD initiative, which focused primarily on transparency and exchange of information. Only six countries have not cooperated. At the EU level these initiatives were also supplemented by state aid initiatives of the EU Commission, whereby the Commission declared certain tax regimes which were regarded as harmful as illegal state aid. As a consequence of these initiatives even tax regimes such as the Irish 10 per cent tax rate of manufacturing activities, was regarded as no longer being compatible with EU state aid rules. While the foregoing initiatives brought certain tax regimes into the limelight, certain countries continued to tighten up their domestic anti-avoidance provisions.

This change in the international landscape meant that countries could no longer adopt so called "beggar thy neighbour" policies which provide tax incentives for export oriented industries thus luring investment at the expense of neighbouring countries.

These developments as well as the way in which countries viewed and implemented imputation tax systems only domestically i.e. only up to their borders, has caused the disadvantage that also a tax credit in respect of the Malta tax paid may not always be available to the foreign investor leading in certain cases to double taxation of company profits upon distribution. We have remedied these disadvantages by the introduction of the exemption method or giving a credit for foreign underlying taxes within our own system.

Malta has and is participating in these initiatives. At the OECD Malta satisfied the necessary requirements and even took an active role by co-chairing the working group on effective exchange of information. Before accession we transformed the Industrial Development Act into the Business Promotion Act to transform the export linked incentives into schemes compatible with EU law and our WTO commitments.

More recently, as was announced in March, we have reached agreement with the EU Commission as regards our current tax rules as they apply to international trading companies and companies having foreign income. While Malta was not in agreement with the Commission that these elements in our tax system constituted state aid, in the interests of stability and certainty Malta sought to reach agreement with the Commission on a revised tax system with appropriate transitional arrangements. The Commission agreed with the Maltese proposal on a revised tax system and in its decision the Commission invites Malta to implement this with effect form 1 January 2007. In principle, as explained in more detail below, this proposal extends the refundable tax credit system to dividend payments made by all Maltese companies to all their shareholders.

Under the agreement the proposals will take effect from 1 January, 2007, and the existing tax refunds will be retained for up to 2010 for beneficiaries existing as at 31 December, 2006. The tax refunds under the extended system will not be materially different from those currently applicable. This is an important agreement for Malta and helps ensure its future ability to continue to be an attractive and competitive environment for business and investment.

- **Ensuring that the right changes are made**

Though such international developments in the tax arena are clearly relevant to Malta a small open economy highly dependent on foreign investment, we must also seek to improve our tax system in more ways than one to improve economic efficiency.

Taxation, all taxes not just income tax, is nothing more than the raising of funds to finance the services Government provides ultimately for the benefit all individuals living in Malta. Businesses also benefit from those services but such benefit ultimately inures to individuals and the incidence of all forms of taxation is also ultimately borne by individuals. Businesses should however pay their fair share of the tax relative to the benefit they receive from the general tangible and intangible infrastructure Government provides to the extent that the cost of such benefit is not offset by specific user charges. The cost of all other benefits provided through Government services must then be borne by individuals at whom level taxation is progressive to achieve the social redistribution objectives.

If we wish to create economic wealth we need to produce goods and services and export a substantial part of that production to pay for the goods and services we necessarily have to import. An important and vital factor in that simple formula has been and remains the creation of an environment which is conducive to foreign direct investment. This means that a tax system must be of the correct ingredients not to tax the foreign investor more and neither less than is required. This tax should equate to the benefit the foreign investor derives from the general infrastructure provided by Government. If we overtax, the investor will be paying for benefits we enjoy and he will simply take his investment somewhere else which, in today's highly mobile world, is relatively easy. If we under-tax, we give him too much of a good deal and we would end up paying for the benefit he derived.

Profitability is not a good measure of the claim that a business makes on the country's resources and it is possible that taxing profits may result in overtaxing to under-taxing the foreign investor. Overtaxing may especially be the case where the foreign investment's demands on Malta's resources are relatively small compared to the profits generated. Furthermore foreign investment provides good employment and transfers new skills to Malta. In determining the amount foreign investors are expected to pay in taxes therefore we should also take into consideration the reciprocal benefits they provide to the country.

From an economic efficiency point of view it is generally agreed that the taxation of business profits, as it is today, creates economic distortions in that the factors of production are not treated equally. However it is also accepted that in view of the fact that businesses should first pay for services provided by Government by means of specific user charges and should also pay tax based on the benefit that they derive from the provision of general public goods.

Furthermore business taxation should not be mingled with wealth redistribution. Income redistribution cannot be a free or subsidized tie-in of business development; it must be evaluated and provided by households in their role as citizens. Therefore a distinction should be made between what businesses (whether incorporated or not) should contribute towards government expenditure and personal income tax at which level wealth redistribution and social considerations come into play.

From any country's point of view, a tax paid a foreigner would be a very good tax indeed in the sense of providing additional revenue for public purposes without reducing domestic resources available for public use. This will only be the case however if it can be done without offsetting effects on investment flows and/or trade patterns. Given Malta's highly open economy it is unlikely that this is possible and the over taxing argument made previously becomes relevant.

Finally economists also argue that taxing economic rent or pure profit (the profit above opportunity cost) does not disturb private economic decisions provides additional revenue that can be used either to finance public goods or achieve distributional goals. The difficultly perhaps in applying this principle is ascertaining what the economic rent element is.

- **Implementation and Practicalities**

It is not possible to measure at the micro level the extent to which businesses benefit from Government's provision of public goods such as law and order, stable political, economic and social environment, developed legal and commercial system, education, health and social welfare, the general physical infrastructure etc.

From the outset, Government is not proposing to change the tax landscape in a significant way and this for a number of reasons, including the possible impact on international tax considerations and that business taxation must necessarily remain profit based. However if we must improve the tax system we must understand the underlying economic rationale and implement the required changes, if necessary over a period of time in order to ensure a smooth transition. In essence, all that is needed is to ensure that all businesses pay their fair share of taxes based on the benefit they derive from country's provision of public goods. Detailed work is well under way in establishing a fair way by which to ensure that this is achieved, taking into consideration Malta's specific circumstances as a very small open economy, thus establishing an even level playing field for all. This may be achieved by possibly using the current system of allocating profits to different tax accounts for the purpose of determining the tax ramifications at the shareholder level.

- **The proposed tax system**

Government is therefore proposing to retain the present imputation tax system whereby the tax paid by companies will essentially remain a prepaid tax on behalf of the shareholders at which level the tax is finally determined.

Within our system we are proposing to introduce the notion of an economic rent, as well a enhancing the distinction as to how profits are derived, directly or indirectly, whereby profits from immovable property will be excluded from the tax refund system agreed to with the EU Commission.

These profits need to be treated differently since land is not a mobile factor and such profits do not only arise as a result of the inputs of capital and labour, but because land has an inherent value relative to its location. For this purpose such profits will, for tax purposes, be allocated to an immovable property account and treated in the same manner as they have been treated to date.

As is also currently the case, company profits will be allocated to tax accounts in order that the tax treatment when such profits are distributed to shareholders as dividends can be determined. Within the above economic conceptual framework company profits will be divided between those profits the tax on which will not be available for refund since they are deemed to be the company's contribution towards the country's provision of public goods, and allocated to the respective tax accounts.

The remaining profits, as happens today, will be allocated to the taxed accounts called the Maltese taxed account and the foreign income account. Upon the payment of a dividend from such profits shareholders, resident or non-resident, may claim a refund of part or the whole of the tax paid on the distributed profits. The refund will generally be equal to 6/7ths of the Malta tax paid on the distributed profits. When the distributing company claims double taxation relief (these provisions remain unchanged) on the distributed profits the tax refund will remain at the current level of 2/3rds of the Malta tax paid. These changes will not affect local residents.

The tax refund however is increased to 100 per cent when the profits distributed were derived by the distributing company from a participating holding. The definition of a participating holding will essentially remain as it is today. However as the case in other EU members states certain anti-abuse provisions will be introduced aimed at distributions received from companies having mainly passive income where such income would not have been taxed at more than 5 per cent. Currently a shareholding in a non-resident company will qualify as a 'participating holding' of a Maltese company:

(a) if the latter holds equity shares in a non-resident company and it:
   (i) has at least 10 per cent of the equity shares in the non-resident company; or

   (ii) is an equity shareholder in the non-resident company and is entitled to purchase the balance of the equity shares of the non-resident company, or it has the right of first refusal to purchase such shares; or

   (iii) is an equity shareholder in the non-resident company and is entitled to either sit on the Board or appoint a person on the Board of that subsidiary as a director; or

   (iv) is an equity shareholder which invests a minimum in the non-resident company of Lm 500,000 (or the equivalent sum in a foreign currency); or

   (v) holds the shares in the non-resident company for the furtherance of its own business.

(b) the holding is not held as trading stock for the purpose of a trade.

It should be noted that the rules in (a) will remain applicable for participating holdings existing at 31 December 2006 until the end of 2010.

With regards to acquisitions of participating holdings made on or after 1 January 2007, where the non resident company, having mainly passive income, is not resident or incorporated in a tax treaty, EU or EEA jurisdiction or a country which levies a tax on corporate profits at a rate which is at least 50 per cent of the Maltese corporate income tax rate, the following additional conditions must be satisfied:

(a) the shares in the non-resident company must not be held as a portfolio investment. In any event a participation of at least 25 per cent in the capital of a non-resident company 90 per cent of the assets of which consist of portfolio investments and non-trading financial assets shall be deemed to be a portfolio investment; and

(b) the non-resident company or its passive income must have been subject to tax at a rate which is not less than 5 per cent.

In addition, to the above as from 1 January 2007 Malta will also introduce a participation exemption which will exempt from tax dividends and capital gains derived from participating holdings.

- **Conclusion**

Malta is a small open economy which is heavily influenced by international developments and is also heavily reliant on foreign direct investment. Global trends dictate that the future economic development is only sustainable from the further development of the services sector including financial services, research and innovation and information and communication technology. Empirical evidence of the growth of small economies in these sectors such as Luxembourg, Ireland and Cyprus clearly indicate that this is the way forward.

A tax system which is conducive to economic growth in these sectors and which reduces tax induced economic distortions is one of the corner stones of this economic strategy. The tax system must ensure that there is no costly tax exportation and that businesses carry their fair share of the cost of provision of public goods. The real tax and income redistribution is then borne and provided by households in their role as citizens.

Glossary

AFM	Armed Forces of Malta
BMI	Body Mass Index
BPO	Back-Office Processing Outsourcing
CET	Common External Tariff
CET	Customs and Excise Tax
CO2	Carbon dioxide molecules - symbol
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council Meeting
EHEA	European Higher Education Area
EIS	European Innovation Scoreboard
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM II	Exchange Rate Mechanism II of the European Monetary System
ESF	European Social Fund
ETAP	Environmental Technologies Action Plan
ETC	Employment and Training Corporation
EU-25	A collective designation for the twenty-five Member States forming the European Union
EUROSTAT	Statistical Office of the European Commission
FDI	Foreign Direct Investment
FSS	Final Settlement Scheme
GDP	Gross Domestic Product
GDP per capita	The Gross Domestic Product engendered by a country's resources calculated over every member of the population
GERD	Gross Expenditure on Research and Development
GFCF	Gross Fixed Capital Formation
GHG	Greenhouse Gas(es)
GPP	Green Public Procurement
GWh	gigawatt hour(s) - unit of measure
HICP	Harmonised Index of Consumer Prices
ICT	Information and Communication Technology/Technologies
IEGCI	Industry and Enterprise Group Cluster Initiative
ITC	International Trading Company
ITS	Institute for Tourism Studies
kWp	kilowatt-peak - a measure of the peak output of a photovoltaic system, for example
LFS	Labour Force Survey
LNG	Liquefied Natural Gas, or natural gas in its liquid form

LRP	Lead Replacement Petrol
MATSEC	Matriculation and Secondary Education Certificate
MCAST	Malta College for Arts, Science and Technology
MCST	Malta Council for Science and Technology
MEPA	Malta Environment and Planning Authority
MITTS	Malta Information Technology and Training Services
MRA	Malta Resources Authority
NAPE	National Action Plan for Employment
NCHE	National Commission for Higher Education
NGOs	Non-Governmental Organisations
NI	National Insurance
NMS	New Member States
NRP	National Reform Programme
NSO	National Statistics Office
NSRF	National Strategic Reference Framework
NSRI	National Strategy for Research and Innovation
NVQ	National Vocational Qualification
OPEC	Organisation of the Petroleum Exporting Countries
PPP	Polluter Pays Principle
PPP	Public-Private Partnership
PSI	Platform of Strategic Importance
PV	Photovoltaic [energy generation]
R&D	Research and Development
R&D&I	Research and Development and Innovation
R&I	Research and Innovation
RES	Renewable Energy Sources
RTDI	Research, Technical Development and Innovation
S&T	Science and Technology
SCVCI	Supply Chain Vendor Cluster Initiative
SET	Science, Engineering and Technology
SMEs	Small and Medium-sized Enterprises
SPPS	Second Pillar Pension Scheme
SPV	Special Purpose Vehicle
TFR	Total Fertility Rate
TNCI	Targeted National Cluster Initiative
TPPS	Third Pillar Pension Scheme
ULC	Unit Labour Costs
UOM	University of Malta
VAT	Value-Added Tax
WHO	World Health Organisation