MALTA:
ECONOMIC PARTNERSHIP PROGRAMME
October 2013

Contents

1 Introduction

It is now six months since the new Labour Government came to office. During this period the Government has made it its priority to stabilise and consolidate Malta's fiscal position, whilst at the same time address the long-standing issues included in the country's CSRs. The Government has committed itself to reducing the deficit to 2.7 per cent by year end 2013 in contrast to an end of year 2012 deficit of 3.3 per cent. It is further committing itself to further consolidation during 2014 ending the year with a deficit of 2.1 per cent.

For 2014, the Government is basing its projected revenues on an estimated real GDP growth rate of 1.7 per cent per annum (refer to Table 1). The European Commission, the Central Bank of Malta and the IMF are estimating a marginally higher growth rate.

The growth rate for this year's first two quarters stood at 1.8 per cent. A strong labour market performance continued to underline economic developments in Malta. During the second quarter Eurostat reported that employment increased year-on-year by 3.6 per cent, the highest rate in the EU and higher than Malta's previous four quarters. Female activity in April 2013 increased by 2.7 percentage points compared to a year earlier. Unemployment still stands at a relatively low rate of 6.3 per cent. Inflation has fallen below 1 per cent year-on-year.

On its part, the European Commission projected a much higher deficit of 3.7 per cent of GDP for 2013, despite very similar macroeconomic projections. The discrepancy between the two sets of forecasts was predominantly due to more conservative estimate of the impact of measures undertaken by the government to contain the public expenditure pressures and the active drive to collect more revenue, including past unpaid arrears.

As part of the drive to monitor closely the fiscal situation, the Ministry for Finance is now producing revenue and expenditure forecasts on a monthly basis for cash data and on a quarterly basis for accrual adjusted data. This enables a real time comparison of the actual outturn with the corresponding projections and identifies variances in time to allow Government to take the necessary action. This method is being run in parallel with risk assessment methods used in the past.

Recent cash data up till August 2013, which is presented in Table 2, suggests that whilst indirect tax revenue is slightly lower than projected, direct tax revenue is stronger than anticipated whilst expenditure is marginally less than that projected. Overall, there are no indications of any major deviations from the overall fiscal targets for 2013 suggesting that the target deficit of 2.7% of GDP remains attainable.

Table 1: Main Macroeconomic Indicators

Main Macroeconomic Indicators

	2012	2013(1)	2014
GDP growth at current market prices (%)	3.1	3.7	3.8
GDP growth at constant (2000) prices (%)	0.8	1.2	1.7
Expenditure Components of GDP at constant (2000) prices (% change)			
Private final consumption expenditure(2)	-0.2	1.2	1.3
General government final consumption expenditure	5.0	-0.4	1.3
Gross fixed capital formation	-3.9	0.7	3.5
Exports of goods and services	7.0	1.9	1.9
Imports of goods and services	5.5	1.5	1.8
Contribution to real GDP growth			
Final domestic demand	0.3	0.8	1.5
Change in inventories and net acquisition of valuables	-1.2	0.0	0.0
External balance of goods and services	1.7	0.4	0.2
Inflation rate (%)	3.2	1.7	2.3
Employment growth (%) (3)	2.4	1.8	1.8
Harmonised Unemployment rate (%)	6.5	6.3	6.3
Output Gap	-1.1	-1.2	-0.7
Potential Output	1.4	1.2	1.2

(1) Forecasts from 2013 onwards
(2) Includes NPISH final consumption expenditure
(3) Headcount, LFS

Table 2: Central Government Finance, 2012-2013

Central Government Finance, 2012-2013				
	Actual	Actual	Forecast	Variance
	Jan-Aug 2012	Jan-Aug 2013	Jan-Aug 2013	
Customs and Excise Tax	107,541	127,064	140,667	-13,603
Fees of Office	21,805	21,099	18,878	2,221
Licences, Taxes and Fines	156,174	144,108	170,209	-26,101
Social Security	363,394	389,519	381,360	8,159
VAT	370,335	376,858	390,877	-14,020
Income Tax	516,273	592,734	548,008	44,726
Tax Revenue	**1,535,522**	**1,651,382**	**1,649,999**	**1,382**
Reimbursements	18,065	13,843	16,301	-2,458
Public Corporations	0	0	0	0
Central Bank of Malta*	42,000	36,000	36,000	-
Rents*	17,293	17,115	17,115	-
Dividends on Investments*	11,939	9,962	9,962	-
Repayments of Interest on Loans	569	1,407	899	509
Grants**	26,111	93,590	93,590	-
Miscellaneous	53,445	14,516	15,556	-1,040
Non-Tax Revenue	**169,422**	**186,433**	**189,423**	**-2,989**
Recurrent Revenue	**1,704,944**	**1,837,815**	**1,839,422**	**-1,607**
Personal Emoluments	369,259	394,452	394,004	-448
Operations and Maintenance	83,411	81,961	83,920	1,959
Programmes and Initiatives	1,010,561	1,050,151	1,043,334	-6,817
Contributions to Government Entities	135,169	141,070	148,753	7,682
Recurrent Expenditure	**1,598,401**	**1,667,634**	**1,670,010**	**2,376**
Interest Payments*	**147,497**	**148,571**	**148,571**	**-**
Capital Expenditure**	**226,665**	**218,527**	**218,527**	**-**
Total Expenditure	**1,972,563**	**2,034,732**	**2,037,108**	**2,376**
Central Government Balance	**-267,619**	**-196,917**	**-197,686**	**769**
* Values not taken into account since values will be accrued at end-of-year				
** Since grants and capital tend to cancel each other, the variance is not taken into account.				
Source: NSO, EPD				

2 Government's Strategy and the Fiscal Framework

Key Policy Planks

The Government's economic and fiscal strategy rests on a number of key policy planks which are vital for the development of the economy and are included in the country's CSRs:

1. Ensuring public finance sustainability in the short to medium term, while also addressing the long term;
2. Raising potential output, in particular through productive capital investment, raising skill and education levels, promoting lifelong learning and increasing labour force participation;
3. Enhancing the competitiveness and transparency of the products and services markets whilst strengthening consumer protection;
4. Ensuring that the public service is not only efficient and cost-effective, but delivers a quality service;
5. Safeguarding the successes achieved by the Maltese financial sector as based on sound regulation and ensuring it continues to follow rigorous practices;
6. Prioritising the promotion of a diversified and balanced economy.

Fiscal Framework

To achieve the policy aims the government has outline a fiscal framework that ensures transparency in policy making for the future years. These reforms are outlined below and presented in more detail in Annex 1:

- Fiscal Rules that provide a medium term economic strategy. A Fiscal Responsibility Act will be presented to Parliament.

- The functions of an Independent Fiscal Council are envisaged to be undertaken by the Audit Office in Malta which is already backed by a legal framework to ensure its independence and adequacy of resources.

- Planning total for Public spending to be presented and endorsed by Cabinet and the setting up of a Star Chamber to adjudicate on public spending priorities,

- Multi-year budgets so that ministries have pathways for public spending as opposed to a stop start model of one year budgets. In addition proposals for the setting up of a contingency reserve fund and the regulation of supplementary estimates are being proposed

- A comprehensive spending review with zero budgets ad policy outputs to ensure that ministry spending reflects changing priorities.

- For the period 2013 to 2016, the gradual losses from the revision in the income tax regime affecting direct taxation will be offset by similar gradual revisions in indirect taxation planned in the context of the budgetary exercise for the upcoming year. Moreover, revisions to the VAT legislation are before Parliament. These will empower the Minister responsible for finance to revise as necessary the penalties and interest payable on taxation due in order to increase tax compliance and ease the recovery of amounts due.

- Tackling tax evasion, avoidance and enhancing efficiency in revenue collection:
  The various Government revenue departments are being consolidated into one authority. Through this restructuring Government is aspiring to utilise the resources available in the Inland Revenue Department (IRD), the VAT Department and the Tax Compliance Unit (TCU) with maximum efficiency. Once the different departments are merged the new entity will be able to use the information at its disposal more effectively and will be in a more favourable position to prevent tax evasion. Other legal and administrative measures being undertaken will update and simplify tax legislation, improve tax audits, enhance risk analysis, raise penalties and sanctions on non-compliance, increase human resource complement and improve its quality through training, strengthen the link with foreign tax authorities, maintain double-tax agreements, strengthen the power of the Commissioner for Inland Revenue, strengthen the provision on transfer of shares, and strengthen the legal framework to combat tax evasion. Further details are provided in the Table of measures in Annex 2.

3 Fiscal and Economic Reforms under the Economic Partnership Programme

In addition to the rule-based approach on policy making, the government can report major progress on specific policy initiatives. Taken together these initiatives confirm the Government's commitment to sustainable public finances. These economic and fiscal reform initiatives include:

Diversifying Energy Source and Restructuring the Energy Corporation

The Government recently announced that it had signed a Memorandum of Understanding with the China Power Investments Corporation (CPIC), one of the five largest state-owned electricity producers in China. As part of the agreement, Shanghai Electric Power, a subsidiary of CPIC will become a minority shareholder in Enemalta, providing the Maltese utility company with a cash injection of about 200 million euro and provide an AAA strategic partner that will improve its financial position and therefore reduce the risks to Government public finances.

In 2012, Enemalta's total debt reached more than €830 million (12 per cent of GDP), of which 85% is guaranteed by the government. As of end-2012, guarantees to Enemalta represented about 50% of the government's total guarantees.

In the short run Enemalta is expected to generate €36 million in savings from the recently installed diesel-run power plant. This has cut the cost of electricity generation to 11 cents/unit, from 17-18 cents. Management sees further revenue boosting potential through an ongoing cost-reduction exercise, settling and resolving a number of locked and past-due accounts, greater billing efficiency, and the benefits derived from the PPPs, savings from the new generation engines, the interconnector and potential sale of non-strategic assets which could generate nearly €75 million. The 200MW 230kV HVAC sub-sea interconnector between Malta and Sicily is expected to be completed before the end of next year, when, Enemalta is expected to break-even.

Furthermore, Government is committed to switch Malta's energy generation facilities from Liquid Fuel Oils to Natural Gas through the construction of a new highly efficient generating plant and Liquefied Natural Gas (LNG) infrastructure. The gas plant is expected to be an LNG storage and re-gasification facility which will meet the total gas supply requirements of the new (circa 200MW) gas-fired baseload generating plant; and Enemalta's gas requirements to operate its 149MW Diesel Engine plant which will be converted to operate on Gas. The new gas fired **CCGT** generating plant shall be based on a proven, advanced CCGT design with a rating of approximately 200MW.

The gas plant project is currently on track, in fact three consortia out of nineteen bidders where recently short-listed including: ElectroGas Malta Consortium, Yildrim Tecnicas Power and Gas Consortium and Endeavor Energy, Exodus Crussing and BB Energy Consortium. The investment in a new gas fired generating plant will lead to considerable improvements in respect of efficiencies in the generation of electricity leading to reduction in overall costs. It will also achieve significant reductions in air pollution in the country.

In the meantime, **a** comprehensive study that includes a cost-benefit analysis to determine the commercial viability of **gas interconnection** as well as its effect on the Maltese economy is being prepared. The study will also look into other externalities of the project such as security of supply, competitiveness, sustainability, and shall identify those aspects that make it a potential Project of Common Interest (PCI) as defined by the proposed Regulation on guidelines for trans-European energy infrastructure (which repeals Decision 1364/2006/EC on TEN-E). The study may be used to support an application to the European Commission for financial assistance from the 'Connecting Europe Facility' funding instrument under the Commission's energy infrastructure package.

Malta is continuing to pursue the development of its internal **electricity distribution network**, both to meet increased consumer demand and to enable the connection of increased renewable energy installations. A new 132kV primary distribution centre (sub-station) in Kappara has been constructed and is intended to receive the electricity imported from the Interconnector and to distribute it to the network for distribution throughout Malta.

Restructuring of Air Malta

The Air Malta restructuring programme is focused on cost cutting measures and initiatives to boost revenue. In 2013, the company received an EU approved injection of 40 million euro. Measures to cut costs include in-flight catering costs, better fuel efficiency and improved deployment of resources. Contract negotiations with third parties should also result in a reduction in ground handling and landing costs.

Furthermore a number of ongoing measures are being implemented to optimise revenue potential. These include, amongst others, the Network planning and fleet deployment optimisation together with an effective pricing strategy supported by marketing tactics. The signing of new charter flight contracts will also contribute to increase Air Malta's revenue. Moreover, a better process control particularly in Outstations together with Initiatives to increase on-flight sales (meals and other products) shall also contribute to raise revenue. New Contracts were also signed in relation to Handling and Engineering Services offered to third parties.

The New Pension Reform Process

Following the election of the new administration in March 2013, Government has expressed its commitment for the continuation of the pension reform process in Malta. A Joint Pensions Working Group – the Pensions Strategy Group - between the Ministry for Finance and the Ministry for the Family and Social Solidarity was set up to review the work carried out by the Pensions Working Group, in particular the recommendations outlined in the Post-Consultation Report submitted to Government in August 2012. Furthermore, it has been tasked to draw up a holistic strategy aimed at addressing the adequacy and sustainability of pensions in Malta and develop a communications strategy directed towards raising the level of public awareness on pensions' issues. It will also emphasise the need to ensure that future pension incomes are adequate in order to sustain a high standard of living in retirement.

Third Pillar pensions

An Advisory Group on Third Pillar Pensions has been set up and has made a number of recommendations relative to the introduction of such voluntary schemes in Malta. The group also recommended the introduction of tax-favoured accounts, where interest earned on these accounts would be tax-free, with the option of converting such accounts into personal retirement schemes. Such tax-favoured accounts would supplement the introduction of voluntary third pillar pensions in Malta. Under a cautious scenario where take-up is partial and in line with current saving behaviour, the cost of tax relief could be in the range of €3.3 - €9.9 million, depending on the type of tax relief to be adopted by the Authorities.

Making Work Pay

The Government aims to reduce the current poverty trap by introducing incentives to ensure that being in work is always better than being dependent on social benefits. To achieve this objective, the Government is studying ways of introducing a tapering system so that those who are long-term unemployed and join the labour market do not loose their benefits at the rate of 100 per cent. The government is also seeking to introduce tax incentives so that household do not loose income if a second bread winner joins the labour market.

Health Reforms

The Government is introducing a series of health reforms that ensure better use of community care facilities to release pressure on the national public hospital including the continuation of the health reform of moving patients from social beds to residential homes utilising capacities in both the private and public sectors, reforming the medicine procurement process and centralising the storage of medicines.

At Mater Dei Hospital there are approximately 70 "social" beds occupied by elderly persons needing long-term care. These beds are costing the Ministry for Health approximately €200 per day. The aim is to move some of these occupants into community nursing homes to transfer the cost of long-term care in hospitals to a lower-cost community care.

Raising Economic Growth Potential through Investment in Human Capital

A series of policy initiatives have been introduced by the Ministry of Education to ensure high levels of education attainments of our student population and these include: improving literacy, providing better community access in deprived areas and providing incentives for students to stay in school longer. Further, the Government is introducing and widening childcare facilities to allow working mothers to enter the labour market. There are also initiatives to open schools earlier and provide support for longer hours to help working parents with childcare. There are also programmes being launched aimed at continuing retraining of the existing workforce, updating their skills and increasing labour force participation.

For Malta to catch-up with its European peers in relation to the skill level of its working-age population and the number of persons in the working-age population that opt to enter the labour force, reforms are under way with respect to the National Curriculum Framework, Early School Leaving Strategy and the National Literacy Strategy.

In addition, Government remains committed towards raising the number of persons in tertiary education through the development of new scholarship schemes that complement ongoing programmes. Government will be also launching a Lifelong Learning Strategy, which coupled with the ongoing and new training programmes, shall contribute to raise the skills and competences in the labour market.

With regards to raising the **labour force participation rate**, especially amongst females, Government is planning to complement its support to working parents through the introduction of free childcare centres. Government is also introducing changes in the tax-benefit system intended to make work pay, alongside labour activation programmes, notably through the launch of the Active Ageing Strategy.

Enterprise and Competitiveness

The Government has introduced a series of legislative frameworks to improve competitiveness cut red tape and reduce the costs of regulation on enterprise. The reforms in the judicial system are aimed at increasing transparency and reducing the invisible costs of bureaucracy.

Transport policy also plays a key role in raising competitiveness in Malta. In this regard, Government is presenting initiatives focused on raising energy efficiency alongside the on-going public transport reform. Some of the energy efficiency measures in the transport sector include: the tax reform to further incentivise a newer, smaller and less polluting fleet of vehicles; an increase in the share of sustainable biofuel as a percentage of the total energy content of petrol and diesel imposed on importers/wholesalers of fuel for the transport sector; and a scrapping scheme with the aim of encouraging owners of old passenger cars and old light commercial vehicles to scrap their old vehicles and buy new vehicles in the same category as their scrapped vehicles. With regards to the on-going public transport reform, further improvements to the system are being proposed aimed at increasing passengers and hence increasing the use of public transport.

In fact, the Government has entered into discussions with the operator in order to try and find areas where the service can be improved.

Finally, the holistic **justice reform** is also expected to contribute to competitiveness in Malta by enhancing the quality of the business environment by containing administrative burdens and hence reducing administrative costs. It will also help to reduce pending cases and the average time it takes for Judiciary personnel to decide on the court case. This will lead to significant cost-savings as currently the system is imposing on the Citizens to spend a cumulative 3.5 million hours each year to attend Court sittings. The justice reform will involve, amongst other measures, the investment in ICT Technology and capacity building including training of personnel, the refurbishment of the Malta Courts Building and the building of a new Court in Gozo, will have to be financed through National funds.

Government is also keen to **reduce bureaucracy** in an effective manner. In this regard, Government has appointed a **junior minister** tasked with the simplification of administrative processes that set the objective of a reduction of 25% in existing bureaucratic procedures. Initiatives are at present underway to reduce the length of **public procurement procedures**. A report was commissioned and an inter-ministerial committee is formulating recommendations.

Work on a **maritime strategy** is underway, supported by a number of capital projects, notably the development of a Maritime Hub. An expression of interest which was recently launched has had a very good response. International business in Malta is also being supported through the launching of Global Residence Programme designed to attract high net-worth individuals to Malta.

Further details on Government's economic and financial reforms are outlined in the Annex 2 accompanying this document.

Annex 1: Reform of Malta's Fiscal Framework

1. Introduction

The Malta Government has welcomed the initiatives contained in the Fiscal Compact as well as the six-pack and two-pack legislative packages in view that they are aimed to strengthen the economic and fiscal governance. In fact it has embarked on a programme of reforms to update the national fiscal framework with a view to bringing Malta's fiscal architecture in line with the new legal obligations. The reform of Malta's fiscal framework is based on three main pillars: fiscal rules, fiscal institutions, and a medium-term budgetary framework.

2. Fiscal Rules

Although the EU budgetary framework directive does not prescribe any specific rules at the national level, however, the Malta Government is putting in place clearly defined numerical fiscal rules which promote effective compliance with the Stability and Growth Pact (SGP). It is its intention to ensure that the fiscal rules are monitored effectively in a manner such that non-compliance would only be permitted temporarily under clearly defined escape clauses. These fiscal rules would be reflected in Maltese legislation.

Attention would be given to finding a balance between the known trade-offs which exists between, on the one hand, the simplicity of the selected rules making them more likely to be understood by the public, and on the other hand, rules that are better suited to avoid pro-cyclicality but which, at the same time, involve complex calculations.

The Ministry for Finance has evaluated alternative fiscal rules which could be applicable for Malta. Even though no single rule was found to be optimal under all scenarios, a combination of the SGP rule stipulating a cyclically-adjusted fiscal consolidation effort of 0.5 percentage points per annum coupled with the application of an expenditure benchmark and the application of escape clauses in 'exceptional circumstances', as defined under the SGP, was found to be a sufficiently good rule to be followed by Malta.

According to the simulations, such rules would have ensured lower indebtedness and would have preserved better counter-cyclical conditions during the period under consideration. On the basis of this evaluation Government is proposing to incorporate these specific rules enshrined in the Stability and Growth Pact in national legislation.

The Malta Government is currently in the process of implementing a Fiscal Responsibility Act. Among the features of this law will be the introduction of fiscal rules, and in particular the SGP rule which will bind national fiscal authorities with numerical targets to achieve a balanced budget or in the absence of a balanced budget, to converge towards the medium-term objective in line with the timeframes derived from Regulation 1466/97[1].

[1] Regulation 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies

The introduction of the Fiscal Responsibility Act is also in line with the requirements prescribed in Council Directive 2011/85/EU[2].

3. Fiscal Institutions

The Malta Government is committed within the coming year to set up an independent fiscal institution to oversee compliance with fiscal rules. The institution will be primarily financed by public funds. This will ensure that fiscal authorities safeguard the sustainability of public finances. The Government believes that this institution will enhance its credibility in the eyes of financial markets and thus allows borrowing, when necessary, at minimum cost. The institution will be given a mandate to prepare macroeconomic forecasts which may be its own or of other independent institutions for the budget, monitor fiscal performance and advise the Government on fiscal policy matters. The institution will serve as the ultimate guardian of society's interests in ensuring a sustainable public finance position which can stabilise the economy in times of need.

Of course the fiscal institution would have to reflect the country specificities. In this context, it is imperative that the scope and role of a Malta fiscal institutional framework would have to reflect Malta's economic, political and cultural contexts. In designing the institutional fiscal framework the following characteristics will be kept in mind:

- an open economy on foreign investment which is more vulnerable to outside shocks such that a rules-based framework needs to be supported by appropriately designed escape clauses
- an ageing population
- forecast accuracy limited by the vulnerability to outside shocks
- a small administrative set-up coupled with a wide-ranging fiscal policy coverage and a fully developed, often complicated tax/benefit structure
- a mature and extensive welfare system and a relatively egalitarian society
- a centralised political system with limited devolution to local councils
- limited access to international financial markets with public sector borrowing predominantly from domestic savings
- limited financial literacy coupled with a limited journalistic review of financial, economic and budgetary conditions
- a common pool problem, where small groups lobby for their interests with insufficient regard to the full budgetary costs now and in the future

The size and mandate of the fiscal institution will need to be consistent with the size and scope of the Government administrative apparatus. Human resource limitations in a small administration suggest that a lean, well-focused institutional apparatus will be more appropriate to ensure minimum resource duplication.

[2] Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States.

The Government of Malta plans to embed the role of an independent fiscal institution within the National Audit Office, itself an independent institution tasked with the auditing of Government finances, and is a body established by the Constitution of the Republic of Malta. The latter enjoys bi-partisan support and country wide credibility and therefore administrative costs are contained. The reputational and legal standing of the National Audit Office will enable a newly conceived fiscal body to develop into an effective and crucial part of Malta's fiscal framework. Amendments to the Auditor General and National Audit Office Act are being contemplated to include the new functions consistent with the Fiscal Responsibility Act.

In the interim, for the 2014 Budget, the Government has appointed the National Audit office to undertake the endorsement of the Ministry for Finance macroeconomic forecasts underlying the 2014 Budget. The report was completed and presented to the Government at the beginning of September.

The fiscal body will perform a vital task in the democratic process and will remain accountable for its actions to Parliament and the Maltese Constitution. The fiscal body will report to Parliament regularly and will play a vital role in communicating the rather complicated budgetary process to the general public. Furthermore this institution should establish a direct link with the press, promote financial literacy and also provide scope for training in financial journalism. Government will be obliged to comply with recommendations presented by the fiscal body or explain the differences in line with the requirements of the EU fiscal framework.

Ultimately fiscal policy however remains a political process and thus the role of the Ministry for Finance remains crucial in the budgetary process. In particular, the Ministry for Finance retains an important role in the operation of a multi-annual medium-term budgetary framework; the third pillar of this new fiscal framework.

In this context, an independent fiscal institution strengthens the authority of the finance minister with regards to common pool problems, whereby spending ministries, can fail to internalise the overall costs of higher spending and debt, while making clear the future consequences of current deficits through fiscal sustainability calculations.

4. Medium-Term Budgetary Framework

While the medium-term budgetary targets are already presented in Malta's annual Stability Programme, such targets are presently non-binding, and subject to future annual budgetary processes. It is worth noting that budget forecasts accuracy inevitably deteriorates in the medium-term, stipulating the clear need to establish more formal rules-based medium-term budgetary frameworks.

A credible and effective medium-term budgetary framework needs to create the right balance between control and discipline on the one hand and flexibility on the other hand. Whilst certain expenditure overruns are inevitable, lack of proper planning and foresight often leads to sizeable overruns whilst the lack of a multiannual budgetary framework leads to persistent overruns.

4.1. Multi-Annual Budget

For this reason the Government of Malta will introduce a rolling three-year medium-term budgetary framework for expenditure commitments. Once this framework is in place, during each budgetary period, the annual budget prepared in line with the requirements of the European Semester will be presented together with the projected three-year medium-term budget.

4.2. Expenditure Ceiling

The medium-term budgetary allocation will be prepared by the Ministry for Finance and will be based on the macroeconomic projections for revenue and will be consistent with the fiscal rules in place, the provisions of the SGP, and on the basis of prudent macroeconomic and fiscal projections.

This practice shall be fine-tuned in line with policy developments in order to take into account (i) the diverse nature of fiscal policy in Malta (including the economic stabilisation, sustainable growth, and income redistribution function), (ii) the degree of uncertainty in projecting expenditure components, and (iii) the statutory political commitments which have shaped the social contract between the State and Maltese citizens over time. The Stability Programme will determine the overall budgetary allocation for the three-year period.

Specific provisions are to be put in place in order to ensure that the medium-term budget will be preserved and overruns prevented. These rules will determine a priori spending priorities and will govern the planning process, delineate the scope for reallocation of expenditure over time or across headings and functions, establish specific ceilings or floors, establish limits to overspending or under-spending, and also rules which preserve automatic stabilisers when these apply.

Through this top-down budgeting approach, a spending total target is set in compliance with the operative fiscal rules. From this total budget envelope, the budgetary allocation excluding unemployment benefits, statutory expenditure commitments, debt service payments, unemployment benefits and capital expenditure can then be established.

4.3. The Establishment of a Funding Gap

The top-down approach will also be complemented by the Comprehensive Spending Review which is being conducted at each line Ministry level, to serve as a platform for medium-term public finance forecasts. The practice of zero budgets, line by line analysis and output by expenditure lines should ensure that spending is under continuous scrutiny and reflects changing priorities and changing needs.

This initiative will however be updated to include a multi-annual framework. By following the bottom-up and top-down approaches, a funding gap will be identified, which will be the difference between the expenditure target in compliance with the fiscal rules and the ministerial allocation proposed by each ministry. An inter-ministerial approach will then follow, where ministries and departments are invited to re-submit their spending plans in order to bridge the funding gap and re-allocate resources inter-temporally over the 3-year period.

4.4. Creation of a Star Chamber at Cabinet Level

However to resolve any pending disagreements which may persist, such that the ministerial allocation is deemed to be insufficient to comply with political commitments and responsibilities, a Star Chamber at Cabinet level composed of the Prime Minister, the Deputy Prime Minister and the Minister for Finance will be established. It will be tasked with finalising a compromise between the line ministries or to entrust the Ministry for Finance to come up with appropriate revenue measures to address the funding gap. Once a final ministerial allocation is agreed to and distributed to the various line ministries, each ministry will be responsible to design a medium-term budgetary plan containing the allocation by department and function.

4.5. The Contingency Reserve Fund

In addition, a Contingency Reserve Fund (CRF) is to be phased in, by making an annual contribution to build up this reserve over a period of three years. The CRF will be established at a prudent proportion of GDP (not exceeding 0.8 per cent of GDP). The purpose of this reserve is to cover unplanned fiscal slippages and resort to the CRF is to be made only under special circumstances with the direct approval of the Prime Minister and on recommendation of the Minister for Finance. Resort to funds from the contingency reserve would not undermine compliance with fiscal rules.

The reserve should be established for the entire medium-term budgetary period and the available balance can be carried forward from one year to the next. When draw-downs from the contingency reserve occur, these are to be recovered gradually over a maximum period of three years. However at the beginning of each three-year medium-term budgetary plan the contingency reserve is to be replenished again to its minimum reserve ratio.

4.6. Rules Governing the Reallocation of Funds

Ministries and departments will be responsible to manage within their plan. Slippages in the ministerial expenditure by function or department would first have to be offset against the allocation of the following year subject to the three-year ceiling. Reallocations from one year to the next will however be capped to 3 per cent of allocated expenditure. On the other hand, fiscal savings within any ministerial allocation in a given year can be carried forward to the next up to a maximum of 3 per cent of planned expenditure. Additional savings will be used to offset slippages elsewhere within a ministry or used for fiscal consolidation.

Statutory expenditure will also be planned over a three-year budgetary period. Medium-term budgets should provide an incentive for structural reforms where necessary. However, deviations from the plan can immediately be recovered from the contingency reserve. The same would apply for debt service payments.

4.7. Regulating Supplementary Estimates

Resort to supplementary estimates as foreseen in the Financial Administration and Audit Act will need to be regulated to ensure consistency between the fiscal rules and escape clauses. The link between the Contingency Reserve Fund and Supplementary Estimates currently established by the Financial Administration and Audit Act will be severed completely. Supplementary Estimates are to be resorted to following a recommendation from the Audit Office acting as the Fiscal Council in Malta and as long as such additional provisions do not compromise the fiscal rules in place and provided that "exceptional circumstances" as defined in the Fiscal Responsibility Act demand the application of escape clauses. A report by the Auditor General is to be drawn up and presented to Parliament before Parliament approves such supplementary estimates.

5. Conclusion

It is expected that the reform of Malta's fiscal framework including, the adoption of fiscal rules, the establishment of a fiscal institution and the implementation of a medium-term budgetary framework, will not only bring Malta's fiscal framework in line with the new fiscal obligation but will also contribute positively towards the Government's priority of achieving fiscal consolidation with the aim of strengthening Malta's fiscal position.

Annex 2: Table of Reforms under the Economic Partnership Programme October 2013

Annex 3: Pre-Budget Document 2014