Assessment of the Fiscal Forecasts

Draft Budgetary Plan 2018

A report prepared

by the Malta Fiscal Advisory Council

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Draft Budgetary Plan 2018

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Dear Minister

LETTER OF TRANSMITTAL

In terms of Article 13 of the Fiscal Responsibility Act, 2014 (Cap 534), I have the honour to transmit a report by the Malta Fiscal Advisory Council (MFAC) on the assessment of the fiscal projections outlined in the Draft Budgetary Plan for 2018. This assessment was carried out by the Malta Fiscal Advisory Council in line with the requirements prescribed in the Fiscal Responsibility Act, 2014 (Cap. 534).

The Council understands that the methodologies used by the Ministry for Finance to prepare the fiscal projections remained largely unchanged, compared to the previous forecast rounds. The attainment, and in some cases, the overachievement of the headline targets for the fiscal balance and public debt observed in recent years, suggest that the current forecasting framework used by the Ministry for Finance is conservative, whereas financial controls appear to be adequate.

The targeted fiscal surplus, amounting to 0.8% of GDP in 2017 and 0.5% of GDP in 2018, lie within the endorsable range of the Fiscal Council. The anticipated further reduction in the public debt-to-GDP ratio, to 54.9% in 2017, and to 50.8% in 2018, also appear to be feasible. These developments are compatible with the projections for the individual revenue and expenditure items within the Budget, as well as the anticipated stock-flow adjustments.

There is strong similarity in the fiscal projections prepared by the Central Bank of Malta and the European Commission to those presented by the Ministry for Finance. The forecasts presented by the three institutions show a small fiscal surplus for 2017 and 2018 and a further drop in the debt ratio. These similarities corroborate the assessment by the Fiscal Council about the plausibility of the fiscal projections contained in the Draft Budgetary Plan.

In 2017 and 2018 total revenue is projected to maintain an upward trend in absolute terms. However, the revenue-to-GDP ratio, which backtracked in 2016, is expected to fall further in each of the forecast years. This reflects the fact that the growth rate in total revenue is expected to be outpaced by the nominal GDP growth rate. This would bring the revenue ratio to 37.8% of GDP in 2018, which is the lowest level since Malta joined the EU.

Likewise, the upward trend in total expenditure in absolute terms, which was temporarily reversed in 2016, is expected to resume over the forecast horizon. Expenditure is projected to rise by 8.3% in 2017 and by 5.4% in 2018. Nevertheless, the expenditure-to-GDP ratio is expected to reach 37.3%, some 5.0 pp lower than the peak attained in 2012. The restraint in expenditure growth is particularly noticeable in relation to compensation of employees, social payments and interest payments, whose ratios to GDP have been declining at least since that year. This decline is again driven by the high growth rate of GDP, which has been outstripping expenditure growth.

The Council has scrutinised the various revenue and expenditure components within the budget, and the measures announced in the Budget Speech on 9 October 2017. Overall, the Council considers that that there are upside risks to total revenue and downside risks to total expenditure, both for 2017 and 2018. Their combined effect translates into an upside risk for the fiscal balance across the forecast horizon.

In 2017, it is possible that tax revenues and inflows from the Individual Investor Programme may exceed the targets, reflecting the prudent assumptions employed by the Ministry for Finance. On the other hand, the outturn for expenditure may be less than planned, particularly because spending on compensation of employees and on gross fixed capital formation could be less than budgeted for. Non-recourse to the Contingency Reserve would similarly contribute to expenditure savings.

The upside risks to the fiscal balance appear to be less strong in 2018. In this case, the upside revenue risks are related to the possibility of above-target revenues from the Individual Investor Programme, while the downside risks to expenditure are contingent on slower-than-planned progress in gross fixed capital formation, and again on the non-recourse to the Contingency Reserve.

Notwithstanding the benign macroeconomic conditions, with real GDP growth expected at 5.9% in 2017 and 5.6% in 2018, and the Council's favourable assessment of the fiscal projections, it is important that the Government remains very vigilant and adhere closely to the fiscal plans as outlined in the Draft Budgetary Plan. Any significant departure, resulting from possible initiatives undertaken post submission of the Draft Budgetary Plan, could pose risks to the attainment of the fiscal surplus and debt targets as outlined in this Report, unless

compensated for through other initiatives. At the same time, given the significant role played by the revenues derived from the Individual Investor Programme, it is important that developments are monitored closely, as their outturn can have a significant impact on the yearly outcome.

Finally, the Council expresses satisfaction at the ongoing constructive dialogue with the Ministry for Finance, across all levels. The Council appreciates the frank internal discussions and the adequate information provided to the Council to enable it to carry out its functions. The Council also views very positively the intention by the Ministry to institutionalise better the feedback to its recommendations. This would contribute to strengthen the ongoing dialogue between the two institutions and enhance further fiscal transparency.

Yours sincerely

Rene Saliba
Chairman

Table of Contents

Executive summary 5

1. Introduction 6
2. Overview of the fiscal projections for 2017 and 2018 7
3. Assessment of the methodologies used to prepare the fiscal projections 12
4. Assessment of the revenue projections for 2017 and 2018 14
5. Assessment of the expenditure projections for 2017 and 2018 22
6. Assessment of the trajectory for the fiscal balance and public debt for 2017 and 2018 34
7. Comparison with other forecasts for the fiscal balance and public debt 37
8. Conclusion 40

List of Tables

Table 1: Fiscal targets in absolute terms 8

Table 2: Main fiscal targets as per cent of nominal GDP 8

Table 3: Taxes on production and imports 16

Table 4: Current taxes on income and wealth 18

Table 5: Social contributions 19

Table 6: Property income 20

Table 7: Other revenue 21

Table 8: Summary of risks to the revenue projections 22

Table 9: Compensation of employees 26

Table 10: Intermediate consumption 27

Table 11: Social benefits 28

Table 12: Interest expenditure 29

Table 13: Subsidies 30

Table 14: Gross fixed capital formation 31

Table 15: Capital transfers payable 32

Table 16: Other expenditure 33

Table 17: Summary of risks to the expenditure projections 34

Table 18: Summary of risks to the fiscal projections 34

Table 19: Stock-flow adjustments 36

Table 20: Fiscal projections by organisation 38

List of Charts and Diagrams

Chart 1: Yearly changes in revenue components 9

Chart 2: Yearly changes in expenditure components 9

Chart 3: Vintages of revenue and expenditure targets 10

Chart 4: Vintages of fiscal balance targets 10

Chart 5: Main revenue and expenditure components across forecast vintages 11

Chart 6: MFIN's risk assessment of the budget balance forecast 13

Chart 7: MFIN's fan chart of GDP growth forecasts 13

Chart 8: Total government revenue 14

Chart 9: Revenue components 15

Chart 10: Total government expenditure 23

Chart 11: Expenditure components 24

Chart 12: Drivers of public debt 35

Diagram 1: Allocation of IIP revenues 37

ABBREVIATIONS

CBM	Central Bank of Malta
COLA	Cost of Living Adjustment
COM	European Commission
DBP	Draft Budgetary Plan
DCS	Depositor Compensation Scheme
EBU	Extra Budgetary Unit
ESA	European System of National and Regional Accounts
EU	European Union
FRA	Fiscal Responsibility Act
FTS	Foundation for Tomorrow Schools
GDP	Gross Domestic Product
HYR	Half-Yearly Report
IIP	Individual Investor Programme
MCAST	Malta College for Arts Sciences and Technology
MCST	Malta Council for Science and Technology
MFAC	Malta Fiscal Advisory Council
MFIN	Ministry for Finance
MFSA	Malta Financial Services Authority
MSE	Malta Stock Exchange
NDSF	National Development and Social Fund
NPISH	Non-Profit Institutions Serving Households
NSO	National Statistics Office
OPM	Office of the Prime Minister
pp	percentage point
PSO	Public Service Obligation
SGP	Stability and Growth Pact
SMEs	Small and Medium-Sized Enterprises
UoM	University of Malta
USP	Update of Stability Programme
VAT	Value-Added Tax

Executive summary

This Report reviews the updated fiscal projections for 2017 and 2018 prepared by the Ministry for Finance, as part of the Draft Budgetary Plan for 2018. The Government is targeting a fiscal surplus of 0.8% of GDP and a public debt-to-GDP ratio of 54.9% for 2017. In 2018, the fiscal surplus is then expected to narrow slightly, to 0.5% of GDP, and the public debt ratio to fall further, to 50.8% of GDP.

The methodologies used by the Ministry for Finance to prepare the fiscal projections remained largely unchanged, compared to the previous forecast rounds. The attainment, and in some cases, the overachievement of the headline targets for the fiscal balance and public debt observed in recent years, suggest that the current forecasting framework used by the Ministry for Finance is conservative, whereas financial controls appear to be adequate.

The assessment by the Malta Fiscal Advisory Council of the various revenue and expenditure components within the budget projections suggests that there are upside risks to total revenue and downside risks to total expenditure, both for 2017 and 2018. Their combined effect translates into an upside risk for the fiscal balance across the forecast horizon. The view of the Malta Fiscal Advisory Council is that in relation to 2017, it is possible that tax revenues and inflows from the Individual Investor Programme may exceed the targets, reflecting the prudent assumptions employed by the Ministry for Finance. The outturn for expenditure may also be less than planned because spending on compensation of employees could be less than budgeted for. The same applies to spending on gross fixed capital formation. Non-recourse to the Contingency Reserve would similarly contribute to expenditure being lower than budgeted for. The upside risks to the fiscal balance appear to be less strong in 2018. In this case, the upside revenue risks are related to the possibility of above-target revenues from the Individual Investor Programme, while the downside risks to expenditure are contingent on slower-than-planned progress in gross fixed capital formation and the non-recourse to the Contingency Reserve.

In turn, the robustness of the public debt projections for 2017 and 2018 depends on the extent to which the planned fiscal surpluses and the stock-flow adjustments for these years can be considered as plausible. The upside risks to the fiscal balance would normally pose downside risks to the outstanding level of debt. With regard to stock-flow adjustments, these are to a large extent policy-driven, and thus, if the plans which underpin the Draft Budgetary Plan projections are adhered to, the outcome should be reasonably in line with the projections.

The Fiscal Council notes that there is strong similarity in the fiscal projections prepared by the Central Bank of Malta and the European Commission to those presented by the Ministry for Finance. The forecasts presented by the three institutions show a small fiscal surplus for 2017 and 2018 and a further drop in the debt ratio. These similarities corroborate the assessment by the Fiscal Council about the plausibility of the fiscal projections contained in the Draft Budgetary Plan. At the same time, the Council invites the Government to adhere closely to the fiscal plans as outlined in the Draft Budgetary Plan, since any significant departure could pose risks to the attainment of the fiscal surplus and debt targets as outlined in this Report.

1. Introduction

Members of the European Union (EU) which have adopted the euro as their currency are required to submit to the European Commission (COM) a Draft Budgetary Plan (DBP) by 15 October of each year.[1] The latest DBP, prepared by the Ministry for Finance (MFIN), presents the Government's updated macroeconomic outlook and fiscal projections, covering 2017 and 2018.[2] The fiscal projections contained in the DBP are consistent with the Budget 2018 Speech and the Draft Financial Estimates 2018, which were tabled in Parliament on 9 October 2017.[3] The DBP classifies the various revenue and expenditure components within the budget in accordance with the European System of National and Regional Accounts (ESA 2010), rather than the nomenclatures and methodologies used to record transactions in the Consolidated Fund.[4] The measures announced in the Budget Speech also feature within the respective ESA revenue or expenditure categories.

To strengthen confidence in the plausibility of the fiscal projections, and add to fiscal transparency, Article 13 of the Fiscal Responsibility Act (FRA) prescribes that the Malta Fiscal Advisory Council (MFAC) shall endorse, as it considers appropriate, the fiscal forecasts contained in the DBP, and make such assessment public. This Report, whose cut-off date is 10 November 2017, complements the previous report by the MFAC published on 16 October 2017, wherein the Council had endorsed the macroeconomic forecasts for 2017 and 2018.[5] In relation to the endorsement of the macroeconomic forecasts, the practice since the setting up of the MFAC has been for the MFIN to forward to the MFAC, for its consideration, the preliminary and the final macroeconomic forecasts ahead of the submission of the DBP to the COM. On the other hand, the final fiscal projections are submitted to the MFAC after the delivery of the Budget Speech in Parliament, and the submission of the DBP to the COM.

This Report proceeds as follows. Section 2 presents an overview of the main fiscal aggregates outlined in the DBP for 2018 and identifies the revisions carried out in relation to the earlier forecast vintages. Section 3 evaluates the methodologies and processes adopted by the MFIN to prepare the latest vintage of fiscal forecasts and the associated risk assessment. Section 4 examines the extent to which, the forecasts for the main revenue components on an ESA basis can be considered as plausible, and whether there could be any upside or downside risks to the baseline forecasts. Section 5 carries out a similar assessment for the main expenditure projections. Section 6 examines the extent to which the projections for the fiscal balance and public debt for 2017 and 2018 lie within the endorsable range of the MFAC. Section 7 compares the MFIN's fiscal forecasts to those prepared by the Central Bank of Malta (CBM) and the COM. Section 9 concludes with some final remarks.

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[1] Since in 2017 this deadline fell on a Sunday, Member States were permitted to submit their DBP by 16 October, an option which was taken by Malta and other countries.
[2] Malta's DBP for 2018 is available on https://ec.europa.eu/info/sites/info/files/2018_dbp_mt.pdf.
[3] These documents are available on https://mfin.gov.mt/en/The-Budget/Pages/The-Budget-2018.aspx.
[4] ESA 2010 is mandatory across all EU Member States. This ensures cross country comparability and facilitates the assessment of compliance with fiscal rules.
[5] The MFAC's assessment report dealing with the macroeconomic forecasts contained in the DBP for 2018 is available on https://mfac.org.mt/en/publications/Pages/Publications.aspx.

2. Overview of the fiscal projections for 2017 and 2018

The latest official statistics published by the National Statistics Office (NSO) show that in 2016, a fiscal surplus of €112.9 million, equivalent to 1.1% of nominal GDP, was achieved (see Table 1 and Table 2).[6] The updated projections by the MFIN indicate that in 2017 the fiscal surplus is expected to amount to €88.0 million (0.8% of GDP), whereas for 2018, a fiscal surplus amounting to €54.0 million or 0.5% of GDP is being targeted. In structural terms, the surplus is expected to drop slightly, from 0.8% of potential output in 2016 to 0.6% in 2017, and in the following year, move to a balanced budget. These developments are expected to take place against a background of a stable small positive output gap, estimated at 0.8% of potential output throughout 2017 and 2018.

In absolute terms, total revenue and total expenditure are expected to increase in each of the forecast years. However, compared to 2016, both the revenue-to-GDP ratio and the expenditure-to-GDP ratio are projected to decline over the forecast horizon, respectively by 1.4 percentage points (pp), to 37.8%, and by 0.7 pp, to 37.3%. Meanwhile, gross debt is expected to increase by €177.5 million in 2017. In 2018, public debt is even projected to decline in absolute terms, down by €30.5 million. If such plans materialise, this would indicate a significant departure from the historical increases recorded over the past decades. Gross debt is projected to amount to just under €5.9 billion in 2018, thereby extending the downward trend in the debt-to-GDP ratio to 50.8%, from the peak of 70.1% which was reached in 2011.

The projected increases in the three main ESA revenue components (namely current taxes on income and wealth, taxes on production and imports, and social contributions) are slightly lower than the actual changes recorded in 2016 (see Chart 1). The volatility in the total revenue projections can be primarily ascribed to the swings from 'other revenue' sources, primarily the Individual Investor Programme (IIP) and EU funds. On the other hand, expenditure is expected to rebound in 2017, rising by €314.4 million, after having declined by €39.6 million in 2016 (see Chart 2). In 2017, compensation of employees, intermediate consumption and social benefits are expected to increase by a larger amount than in 2016. Furthermore, expenditure relating to gross fixed capital formation and to capital transfers is expected to be higher, in contrast with the drops registered in 2016. Then, in 2018, most expenditure categories are expected to increase by a lower amount than in 2017.

[6] Source: News Release 141/2017 for GDP statistics and NSO News Releases 169/2017 and 170/2017 for fiscal statistics.

Table 1: Fiscal targets in absolute terms (EUR millions)

	2016	2017	2018
Total revenue	**3,893.5**	**4,183.0**	**4,369.3**
Taxes on production and imports	1,276.1	1,344.9	1,424.1
Current taxes on income and wealth	1,383.9	1,492.4	1,626.4
Capital taxes	15.9	20.1	20.5
Social contributions	639.3	681.3	723.8
Property income	94.2	111.5	105.0
Other revenue	484.1	532.9	469.5
Total expenditure	**3,780.6**	**4,095.0**	**4,315.3**
Compensation of employees	1,182.1	1,267.9	1,314.3
Intermediate consumption	636.6	727.9	773.9
Social payments	1,086.0	1,138.5	1,188.2
Interest expenditure	217.9	203.1	199.6
Subsidies	129.2	125.3	130.8
Gross fixed capital formation	250.8	308.3	361.0
Capital transfers payable	79.3	114.8	113.1
Other expenditure	198.7	209.2	234.4
Fiscal balance	**112.9**	**88.0**	**54.0**
One-off and temporary effects (net)	-7.3	-16.1	7.8
Cyclical effects	51.3	47.2	42.6
Structural balance	**68.8**	**56.8**	**3.6**
Gross debt	**5,727.9**	**5,905.5**	**5,874.9**
Nominal GDP	*9,943.1*	*10,750.6*	*11,572.9*
Output gap (% of potential GDP)	*0.9*	*0.8*	*0.8*

Source: MFIN

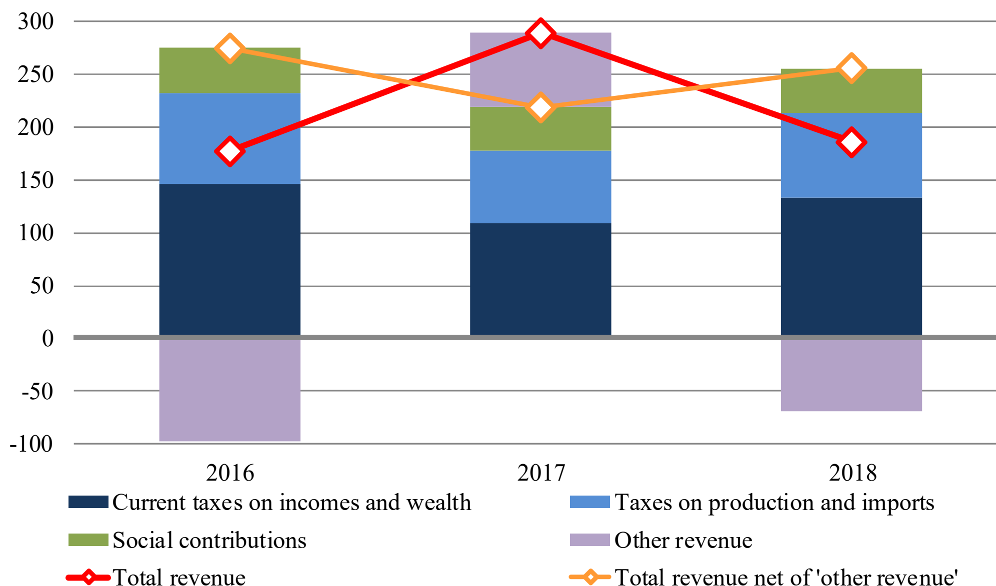
Table 2: Main fiscal targets as per cent of nominal GDP (%)

	Total revenue	Total expenditure	Fiscal balance	Structural Balance*	Gross debt
2016	39.2	38.0	1.1	0.8	57.6
2017	38.9	38.1	0.8	0.6	54.9
2018	37.8	37.3	0.5	0.0	50.8

* As per cent of potential GDP

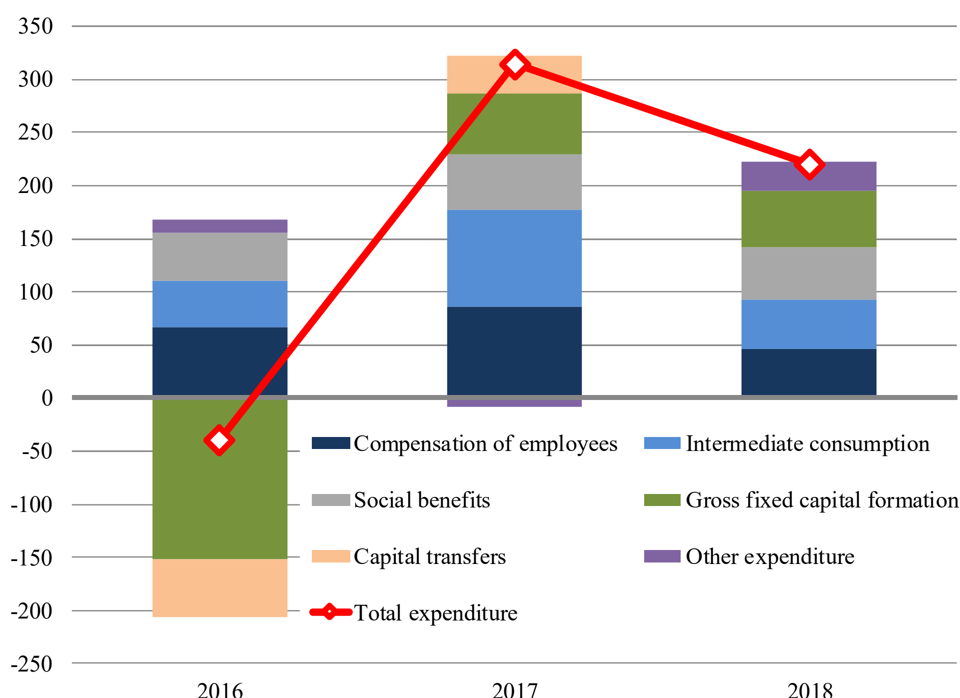
Source: MFIN

Chart 1: Yearly changes in revenue components (EUR millions)



Source: MFIN

Chart 2: Yearly changes in expenditure components (EUR millions)

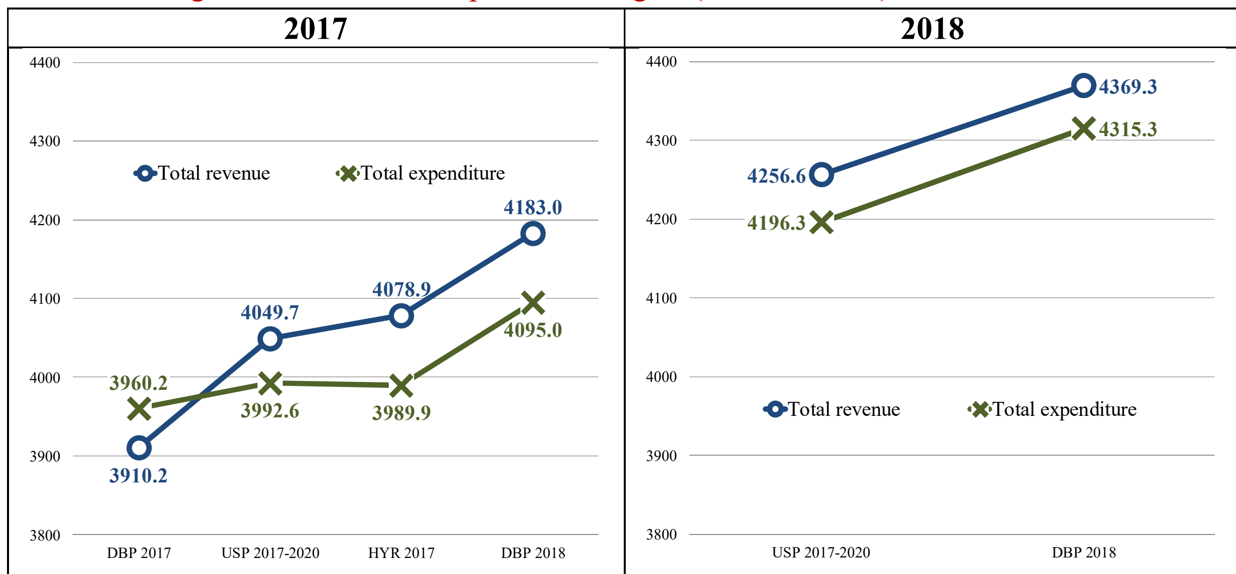


Source: MFIN

The latest DBP revised upwards the total revenue and expenditure projections both for 2017 and 2018, when compared to previous forecast vintages, namely those indicated in last year's DBP, and this year's Update of Stability Programme (USP) and Half-Yearly Report (HYR) (see Chart 3). As a result, the target for the 2017 fiscal balance was revised from the initial deficit of €50.0 million that had been indicated in last year's DBP, to a surplus of €88.0 million (see Chart 4). This is practically at the same level indicated in the HYR, which was published

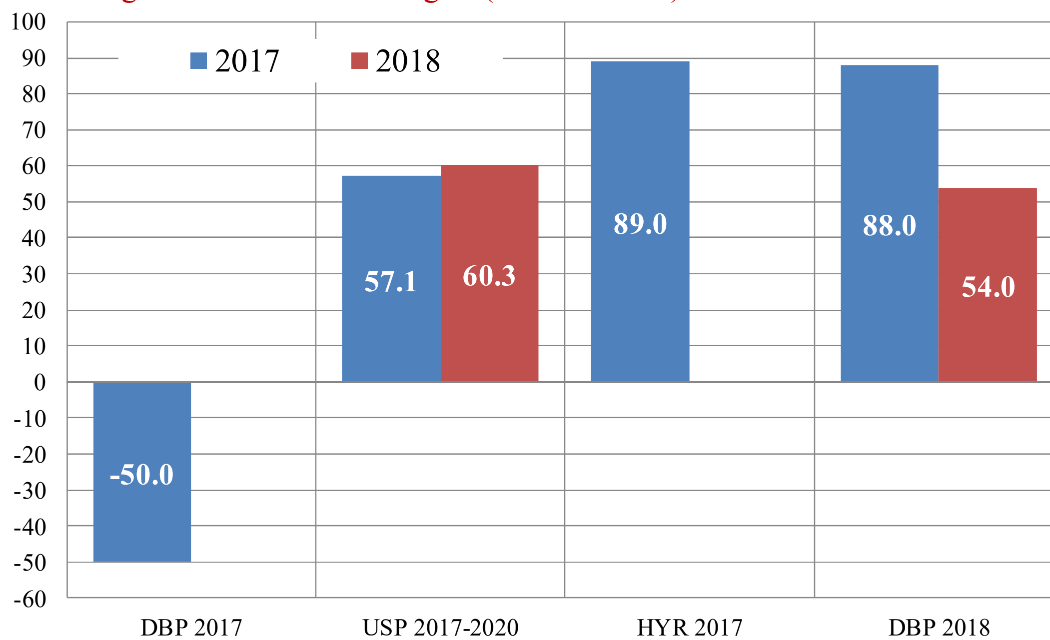
in July 2017. On the other hand, the original €60.3 million surplus target for 2018, which had been indicated in the USP, was reduced slightly, to €54.0 million.

Chart 3: Vintages of revenue and expenditure targets (EUR millions)



Source: MFIN

Chart 4: Vintages of fiscal balance targets (EUR millions)

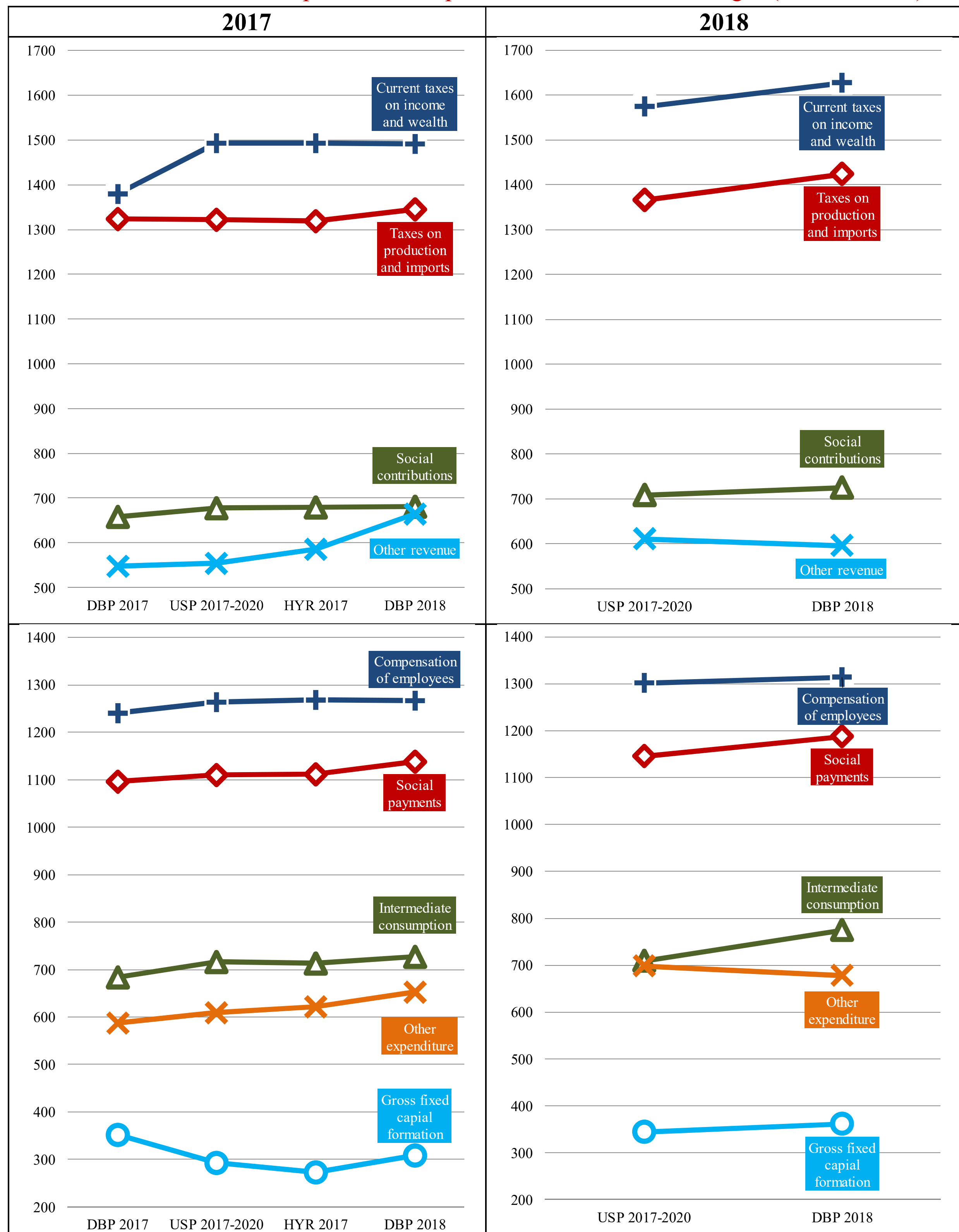


Source: MFIN

At a component level, the latest DBP presents several updates across different budget items (see Chart 5). Compared to the last year's DBP, the major revenue revisions for 2017 impacted current taxes on income and wealth and 'other revenue'. On the expenditure side, changes were rather evenly spread across categories. For 2018, changes mainly consisted of stronger revenues derived from the two largest tax categories (namely current taxes on income and

wealth and taxes on production and imports) and higher expenditure across most categories, particularly intermediate consumption and social payments.

Chart 5: Main revenue and expenditure components across forecast vintages (EUR millions)



Source: MFIN

3. Assessment of the methodologies used to prepare the fiscal projections

The methodologies used by the MFIN to prepare the fiscal projections remained largely unchanged compared to the previous forecast rounds. The framework continued to be based on the expert input provided by the line ministries, working along the Consolidated Fund line items. This bottom-up approach ensures the tapping of expert knowledge and micro information which is available at ministry level. Top-down ESA-based forecasts are also produced, based on the estimated relationships between the fiscal variables and their respective proxy bases. The top-down projections act as an envelope, to ensure prudence and the overall consistency between the fiscal forecasts and the official macroeconomic outlook, as endorsed by the MFAC. The bottom-up and top-down fiscal projections are discussed among senior ministry officials and fine-tuned. The objective is to ensure that the official projections contained in the DBP, are compatible with the budgetary targets, and respect the fiscal rules established by the Stability and Growth Pact (SGP) and the FRA.[7] The attainment, and in some cases, the overachievement of the headline targets for the fiscal balance and public debt, observed in recent years, suggest that the current forecasting framework used by the MFIN is conservative, whereas financial controls appear to be adequate.

The DBP provides a risk assessment of the baseline budget balance over the forecast horizon, by considering thirteen alternative scenarios. The ensuing fiscal balance under each scenario is then estimated. The specific scenarios considered in the latest DBP are [1] pure model driven forecasts, thus excluding the expert judgement which was factored into the baseline; [2] lower economic growth in Malta's main trading partners; [3] stronger economic growth in Malta's main trading partners; [4] forecasts produced by alternative models; [5] appreciation of the euro; [6] lower tourist average spending; [7] higher protectionism by the United States; [8] soft and hard BREXIT arrangements; [9] subdued wage growth; [10] lower import content of investment; [11] higher long-term interest rates; [12] stronger financial sector growth; and [13] postponement of investment expenditure. These scenarios were considered by the MFIN as among the most relevant to the Maltese economy at present. The MFAC understands that these scenarios were chosen after consultation with stakeholders, reviewing the economic literature, identification of emerging international economic risks and supplemented with the MFIN's own judgement.

The MFIN's calculations under the alternative scenarios show that the fiscal balance-to-GDP ratio could at one extreme worsen from a surplus of 0.5% in 2018, up to a deficit of 0.3% under the scenario with the most adverse effect on public finances, or else improve to a larger surplus of 0.8% under the most favourable scenario (see Chart 6). To increase transparency and enable a fuller evaluation of these calculations, the MFAC considers useful that the MFIN indicates in the DBP which specific scenarios have contributed to the estimated upper and lower bounds, and also provide information about the distribution of the results for the remaining scenarios. The MFAC also notes that the estimated impacts on the fiscal balance derived from these

[7] The fiscal forecasts contained in the DBP also serve as targets for the MFIN. To this effect, 'fiscal forecasts' and 'fiscal targets' are used interchangeably in this Report.

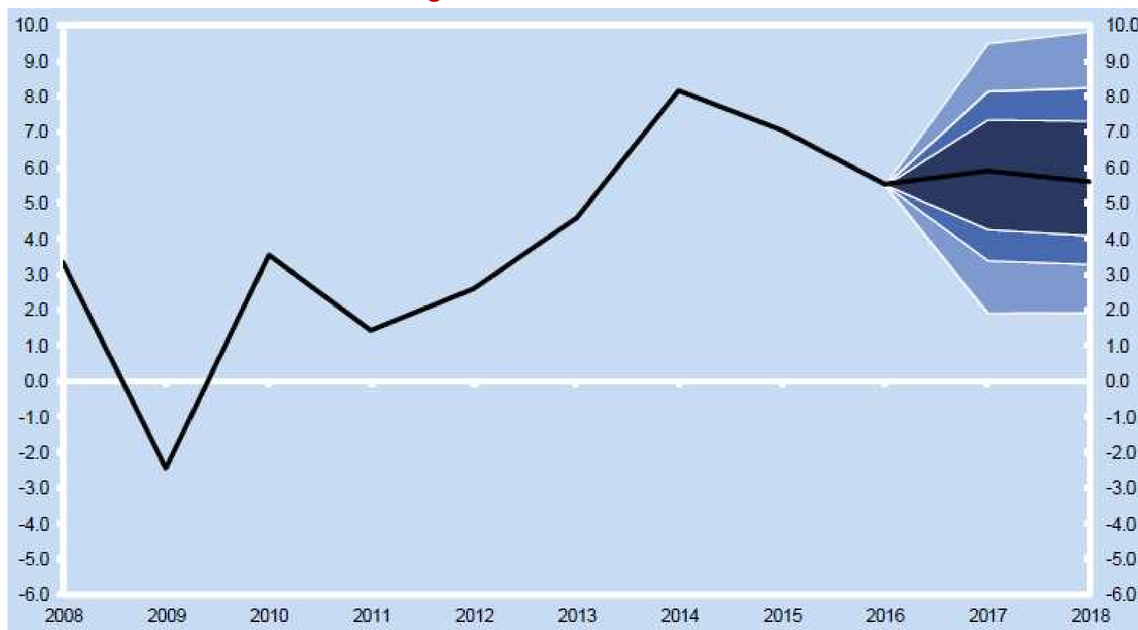
thirteen scenarios fall within a rather narrow range, of approximately 1.0 pp, whereas the MFIN's fan chart shows that the same shocks can lead to a variation range in real GDP growth of some 8.0 pp (see Chart 7). The MFAC understands that the macroeconomic and the fiscal risk assessments are carried out using different methodologies, and hence the results cannot be directly reconciled.

Chart 6: MFIN's risk assessment of the budget balance forecast

Note: The chart is reproduced from the DBP 2018 document.

Source: MFIN

Chart 7: MFIN's fan chart of GDP growth forecasts



Note: The chart is reproduced from the DBP 2018 document.

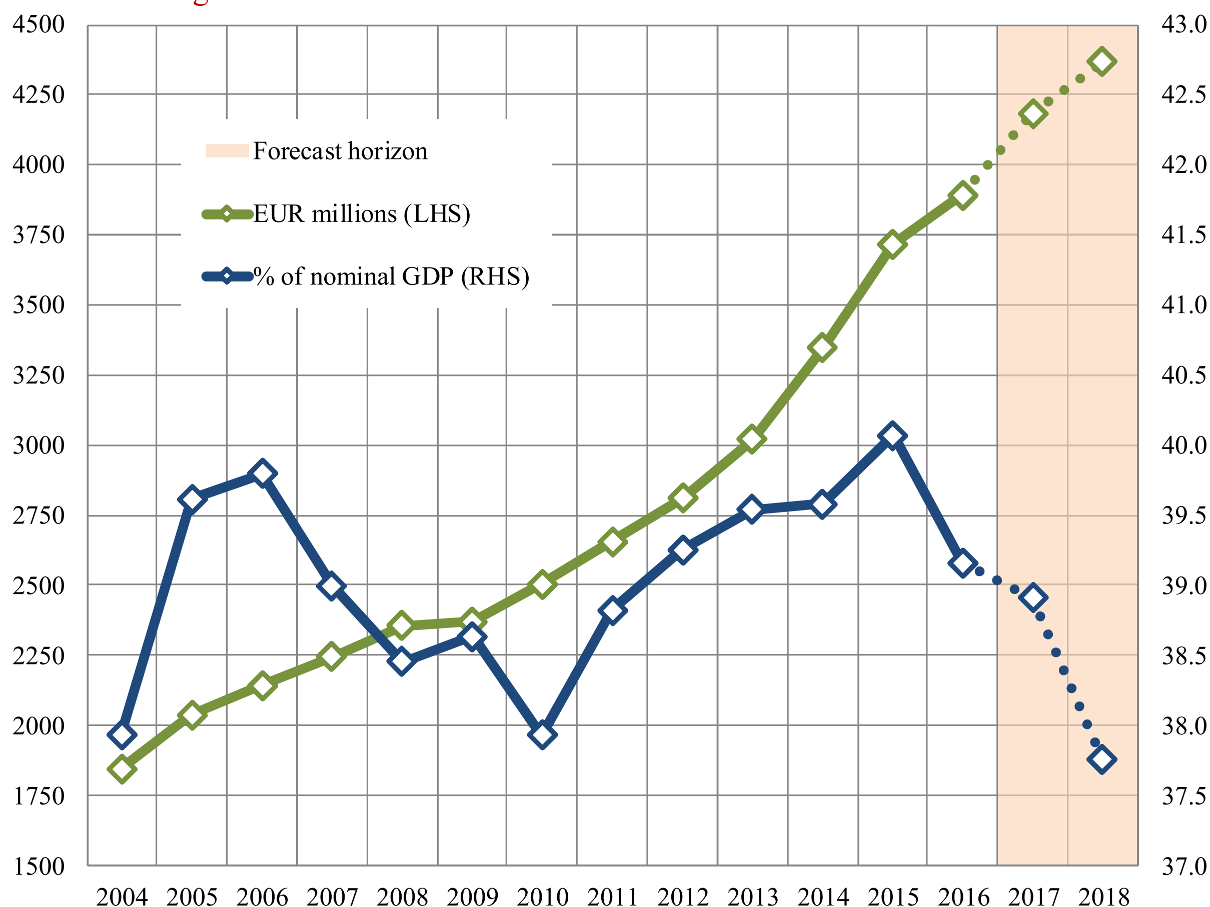
Source: MFIN

4. Assessment of the revenue projections for 2017 and 2018

In 2017 and 2018 total revenue is projected to maintain an upward trend in absolute terms (see Chart 8). However, the revenue-to-GDP ratio, which backtracked in 2016, is expected to fall further in each of the forecast years. The revenue-to-GDP ratio is forecast to decline to 38.9% in 2017, and experience a sharper drop, to 37.8%, in 2018, reflecting the fact that the growth rate in revenue is expected to be outpaced by the nominal GDP growth rate. This would bring the revenue ratio to its lowest level since Malta joined the EU.[8]

In this section, the MFAC assesses the plausibility of the trajectory for total revenue for 2017 and 2018 on a component by component basis (see Chart 9). The intake from the largest three categories (current taxes on income and wealth; taxes on production and imports; and social contributions) is expected to increase in each of the forecast years. On the other hand, the forecasts for the smaller revenue sources exhibit some fluctuations over the forecast years.

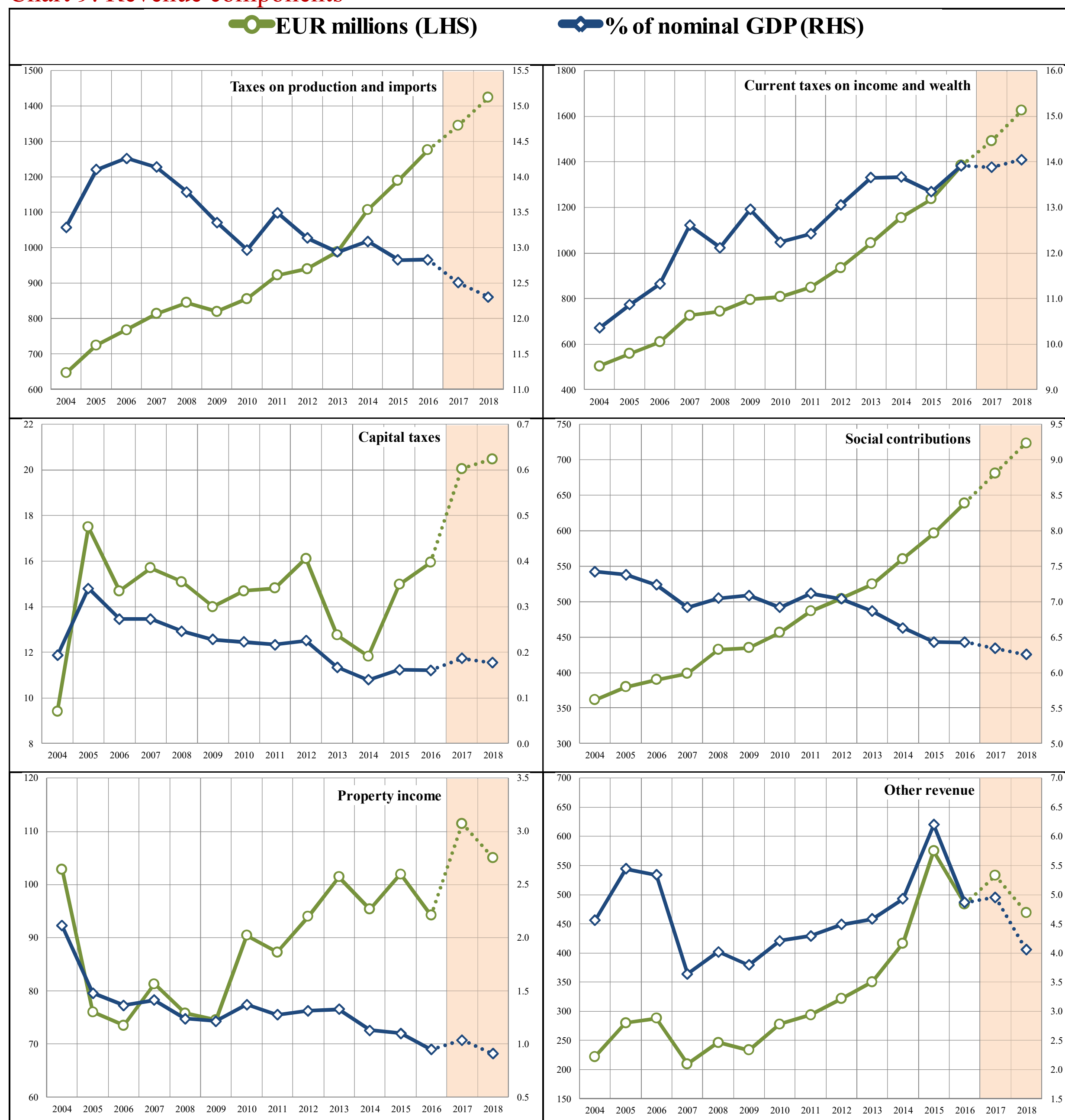
Chart 8: Total government revenue



Source: MFIN

[8] Malta joined the EU on 1 May 2004.

Chart 9: Revenue components



Source: MFIN

The disaggregated assessment is useful since the drivers of the various ESA revenue categories can be different. This also makes it easier to pin down factors impacting specific items. The MFAC does not prepare independent revenue forecasts, but relies on expert judgment for its assessment, based on historical trends and identified regular patterns in the actual fiscal data. More specifically, the MFAC's assessment builds upon a number of factors including the developments in the quarterly accounts of general government (up to June 2017); developments in the Consolidated Fund (up to September 2017), fiscal assumptions underpinning the DBP; existing tax and expenditure laws; the fiscal measures announced in the Budget Speech;

information obtained from public sources; as well as supplementary information made available by the MFIN and the NSO through internal discussions and communications.[9]

4.1. Taxes on production and imports (D.2)

Definition: Compulsory, unrequited payments, in cash or in kind, which are levied by general government, or by the institutions of the European Union, in respect of the production and importation of goods and services, the employment of labour, the ownership or use of land, buildings or other assets used in production. Such taxes are payable irrespective of profits made.[10]

Taxes on production and imports are expected to rise by 5.4% in 2017 and by 5.9% in 2018. The projected growth is thus lower than that recorded during the previous two years (see Table 3). Taxes on production and imports are forecast to grow in line with private nominal consumption, which is the proxy base most relevant for this revenue item.[11] The MFIN's projections maintain a stable ratio of 25.6% for this revenue item, when compared to private nominal consumption over the period 2016 to 2018.

Table 3: Taxes on production and imports

	Taxes on production and imports		Private consumption	
	Growth (%)	Change (EUR millions)	Nominal growth (%)	Real growth (%)
2015	7.5	83.2	6.6	5.9
2016	7.2	85.9	3.7	3.0
2017	5.4	68.9	5.6	4.2
2018	5.9	79.2	5.6	4.1

Source: MFIN

During the first half of the year, taxes on production and imports rose by 8.0% over the corresponding period of 2016. This is a higher rate of growth than the target projected for the whole of 2017. As a result, 46.7% of the amounted targeted for 2017 was collected as at June. This compares favourably to the outturn in 2016. During the first half of that year, 45.5% of

[9] NSO News Release 174/2017 makes available additional data up to September 2017, based on the cash transactions recorded in the Consolidated Fund, but classified under the ESA headings. This is in conformity with EU Council Directive 85/2011 which includes requirements on the collection, treatment and dissemination of fiscal data and statistics.
[10] This revenue component is dominated by VAT (representing more than half of the total), with other important contributors being levies on petroleum; levies on cigarettes and tobacco; property taxes; gaming taxes; motor vehicle registration tax; taxes on spirits, alcohol and beverages; duties on insurance products and taxes on cement. The list of contributors in this revenue component is in descending order based on 2016 data.
[11] Private nominal consumption is the closest proxy in the case of value driven taxes, such as VAT. On the other hand, private real consumption is more suitable in the case of volume driven taxes, (which account for a smaller share of indirect taxes).

the yearly revenue from this source was collected. However, ESA fiscal statistics are provisional, and hence, may be subject to change in subsequent releases by the NSO. This implies that such percentages may be subject to change.[12] More recent cash data, covering up to September, based on the Consolidated Fund, show that during the first nine-months of 2017, growth remained high, with taxes on production and imports rising by 13.5% year-on-year.[13,14]

The DBP does not indicate any new indirect taxes for 2018. Growth is thus expected to be fuelled entirely by the expansion in the relevant tax base. Three identifiable factors are however expected to impact this revenue item negatively, by around €12.3 million, in 2018. New concessions in relation to the taxation on property transactions, are estimated to cost €5.8 million, while a reduction in the VAT paid by Small and Medium Sized-Enterprises (SMEs), by raising the VAT-exempt threshold, is estimated to cost another €1.5 million. Furthermore, the temporary revenue boost, estimated at some €5.0 million, derived from the one-off concession granted in 2017, on stamp duty in relation to business inheritance, will not be repeated in 2018.

Overall, the MFAC considers the projections for taxes on production and imports to be plausible, with upside risks for 2017 and neutral risks for 2018.

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

Definition: *Compulsory, unrequited payments levied periodically by general government on the income and wealth of institutional units*.[15]

Current taxes on income and wealth are projected to rise by 7.8% in 2017 and by 9.0% in 2018, within the range recorded during the previous two years (see Table 4). The projected growth rates are higher than the expected growth in total compensation of employees. They are compatible with the general progressivity of the income tax system in Malta. They are also compatible with the forecast trajectory for the corporate tax base, which is expected to grow at a faster pace than employment income.[16] The MFIN's projections maintain the ratio of current taxes on income and wealth as per cent of GDP, rather stable at around 14.0% between 2016 and 2018.

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[12] This caveat also applies to the other provisional half-yearly outturns mentioned in the rest of the Report.
[13] Source: NSO News Release 174/2017.
[14] Developments in the Consolidated Fund are not directly comparable to official statistics based on ESA. The former is primarily cash-based, while ESA has broader coverage and includes accrual adjustments. However, developments in the Consolidated Fund, which are mapped onto ESA classifications, can still be useful for surveillance purposes, while acknowledging the possible caveats. These statistics are however not subject to change as they are cash-based.
[15] This revenue component is driven to a large extent by taxes on employment income, on interest income and on profits. Another relevant contributor to this revenue item is the annual car circulation tax.
[16] This can be deduced by the fact that growth in nominal GDP (consisting mainly of compensation of employees and gross operating surplus, which is the proxy for corporate profits) is higher than that in compensation of employees on its own.

Table 4: Current taxes on income and wealth

	Current taxes on income and wealth		Nominal growth in	
	Growth (%)	Change (EUR millions)	Compensation of employees (%)	GDP (%)
2015	7.1	82.1	7.4	9.7
2016	11.8	146.4	6.5	7.2
2017	7.8	108.4	6.0	8.1
2018	9.0	134.0	6.5	7.6

Source: MFIN

The DBP does not indicate any new direct taxes for 2018, and thus growth is also expected to be fuelled entirely by the expansion in the relevant tax base. The effect is however partially dampened by a number of budgetary measures for 2018 which envisage income tax rebates for students, employees, and pensioners, with an estimated impact of €14.2 million.[17]

During the first six months of 2017, current taxes on income and wealth expanded by 8.5% on a year earlier. Such revenues account for 47.2% of the target set for 2017. This compares slightly favourably to the outturn in 2016, when during the first half of the year, 46.9% of the yearly revenue was collected. More recent data, covering up to September, based on the Consolidated Fund, show that growth remained sustained, with such taxes expanding by 9.1% year-on-year. Both the six-month and the nine-month performance thus indicate annual growth rates exceeding the target growth for 2017.

Overall, the MFAC considers the projections for current taxes on income and wealth to be plausible, with upside risks for 2017 and neutral risks for 2018.

4.3. Capital taxes (D.91)

<u>Definition:</u> *Taxes levied at irregular and very infrequent intervals on the values of the assets or net worth owned by institutional units or on the values of assets transferred between institutional units as a result of legacies, gifts between persons, or other transfers.*[18]

Capital taxes represent only a small share of total revenue, amounting to around 0.2% of GDP. The forecasts for capital taxes thus do not normally exert a material impact on the overall fiscal outturn for the year. The MFIN's forecasts show an increase from €15.9 million in 2016, to €20.1 million in 2017 and €20.5 million in 2018. This is compatible with the sustained activity

[17] The budgetary effect created by the income tax rebate for pensioners applicable for 2018, indicated at practically nil, may be somewhat understated given that this measure was distributed evenly across two years and for 2017 its effect was estimated at 0.03% of GDP.

[18] This revenue component consists mainly of taxes imposed on certain property transfers.

in the property market, in relation to which, capital taxes are mostly linked. The MFAC considers the projections for capital taxes to be plausible with neutral risks throughout the forecast horizon.

4.4. Social contributions (D.61)

Definition: The actual or imputed contributions made by households to social insurance schemes to make provision for social benefits to be paid.[19]

Social contributions are projected to grow by 6.6% in 2017 and 6.2% in 2018 (see Table 5). As a result, the ratio of social contributions to GDP is expected to continue declining gently over the forecast horizon, extending the observed trend derived from published data since 2011. The projected growth rates are in line with those recorded during 2015 and 2016. The implied elasticity with respect to compensation of employees (which is the proxy base for this revenue item) is practically unity. This is consistent with recent empirical developments, although the cap on annual payments should in theory produce an elasticity which is slightly less than one.[20]

Table 5: Social contributions

	Yearly growth rate (%)	Yearly absolute change (EUR millions)	Growth in compensation of employees (%)
2015	6.4	36.0	7.4
2016	7.2	43.0	6.5
2017	6.6	42.0	6.0
2018	6.2	42.5	6.5

Source: MFIN

During the first half of 2017, social contributions increased by 8.5% over the corresponding period of 2016, and amounted to 49.0% of the yearly target. This is slightly higher than in 2016, where the ratio stood at 48.2%. In turn, cash-based data shows this item growing by 13.5% during the first nine months of 2017.

No new measures are applicable to social contributions for 2018 and thus growth is driven entirely by the expansion in the tax base. At the same time, there are no specific known factors impacting positively or negatively this item.

Overall, the MFAC considers the projections for social contributions to be plausible, with upside risks for 2017 and neutral risks for 2018.

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[19] This revenue component captures the national insurance contributions paid by employees, their employers and the self-employed.
[20] The cap implies that income increases beyond a certain threshold do not entail higher social contributions.

4.5. Property income (D.4)

Definition: *Accrues when the owners of financial assets and natural resources put them at the disposal of other institutional units. The income payable for the use of financial assets is called investment income, while that payable for the use of a natural resource is called rent. Property income is the sum of investment income and rent.*[21]

In 2017 property income is projected to increase by €17.3 million, from €94.2 million to €111.5 million (see Table 6). In 2018, it is expected to decline slightly, to €105.0 million. However, during the first half of 2017 property income on an ESA basis increased by only €1.2 million. Moreover, cash figures up to September, show that property income declined by €0.8 million on a year earlier. These developments point towards some challenges towards the attainment of the annual target. Indeed, the MFAC is unable to identify specific factors to justify the higher dividends anticipated from the MFSA for 2017, which explain some one-third of the projected annual increase. On this basis, the MFAC considers there are small downside risks to the forecasts for property income for 2017 but neutral risks for 2018.

Table 6: Property income (EUR millions)

	2016	2017	2018
DBP 2018	94.2	111.5	105.0
ESA (January – June)	56.2	57.4	-
Cash (January – September)	63.0	62.2	-

Source: MFIN

4.6. Other revenue

Definition: *Other revenues not elsewhere classified.*[22]

Other revenue is projected to increase in 2017, but to decline in 2018 (see Table 7). The assumptions of higher absorption of EU funds and higher revenues from the IIP are the major drivers of the increase in the 'other revenue' category in 2017. Their combined impact is

[21] Property income represents mainly the dividends received from the CBM, and to a lesser extent the companies listed on the Malta Stock Exchange (MSE) and the Malta Financial Services Authority (MFSA), together with rent earned from government properties and interest earned on holdings of bonds and other loans.
[22] This budget item represents residual revenue components, mainly accounted for by market output and capital transfers. Market output consists primarily of revenues derived from permits and charges for the services offered by the public sector, and revenues accruing from the IIP. Capital transfers receivable relate mainly to the absorption of EU funds.

partially offset by lower revenue expected from reimbursements which is included in the residual.[23]

Table 7: Other revenue

	Total	EU funds	IIP	Residual
2015	575.2	300.5	50.2	224.5
2016	484.1	67.2	171.5	245.4
2017	532.9	88.1	200.0	244.8
2018	469.5	124.8	110.0	234.7

Source: MFIN

All revenues generated through the IIP are classified as revenues under the ESA framework, thus contributing to improve the fiscal balance. Of these, 6% of funds are retained by Identity Malta, to fund its activities, and 4% are paid as commission.

The projections for EU funds assume that after a slow start in 2016, the absorption rate will pick up in 2017 and gain further momentum in 2018. This scenario is plausible. However, the extent of the possible increase remains uncertain. In relation to the IIP, data for the first nine months of 2017 show that the annual target of €200.0 million, has already been exceeded.

In 2018, EU funds are expected to pick up further momentum, whereas a significantly lower intake from the IIP is assumed, as part of the MFIN's conservative approach. This leaves the possibility for IIP revenues to be higher and more in line with the previous' years outturn.

Overall, the MFAC considers the projections for 'other revenue' to be plausible, with upside risks both for 2017 and 2018, primarily due to the possibility that revenues from the IIP exceed the targets in both years.

4.7. Total government revenue

Overall, the view of the MFAC is that there are upside risks to total revenue both for 2017 and for 2018 (see Table 8). On the basis of the assessment outlined above, the MFAC identifies upside risks in relation to taxes on production and imports; current taxes on income and wealth; social contributions; and other revenue relevant for 2017. This reflects the rather conservative assumptions employed by the MFIN, in relation to the actual developments to date. On the other hand, downside risks exist in relation to property income and neutral risks exist in relation to capital taxes. For 2018, the only upside risk relates to 'other revenue' with all other revenue components facing neutral risks.

[23] Reimbursements represent mainly revenues accruing to the Government for providing a service.

Table 8: Summary of risks to the revenue projections

	2017	2018
Taxes on production and imports	⇑	⇔
Current taxes on income and wealth	⇑	⇔
Capital taxes	⇔	⇔
Social contributions	⇑	⇔
Property income	⇓	⇔
Other revenue	⇑	⇑
Total revenue	⇑	⇑

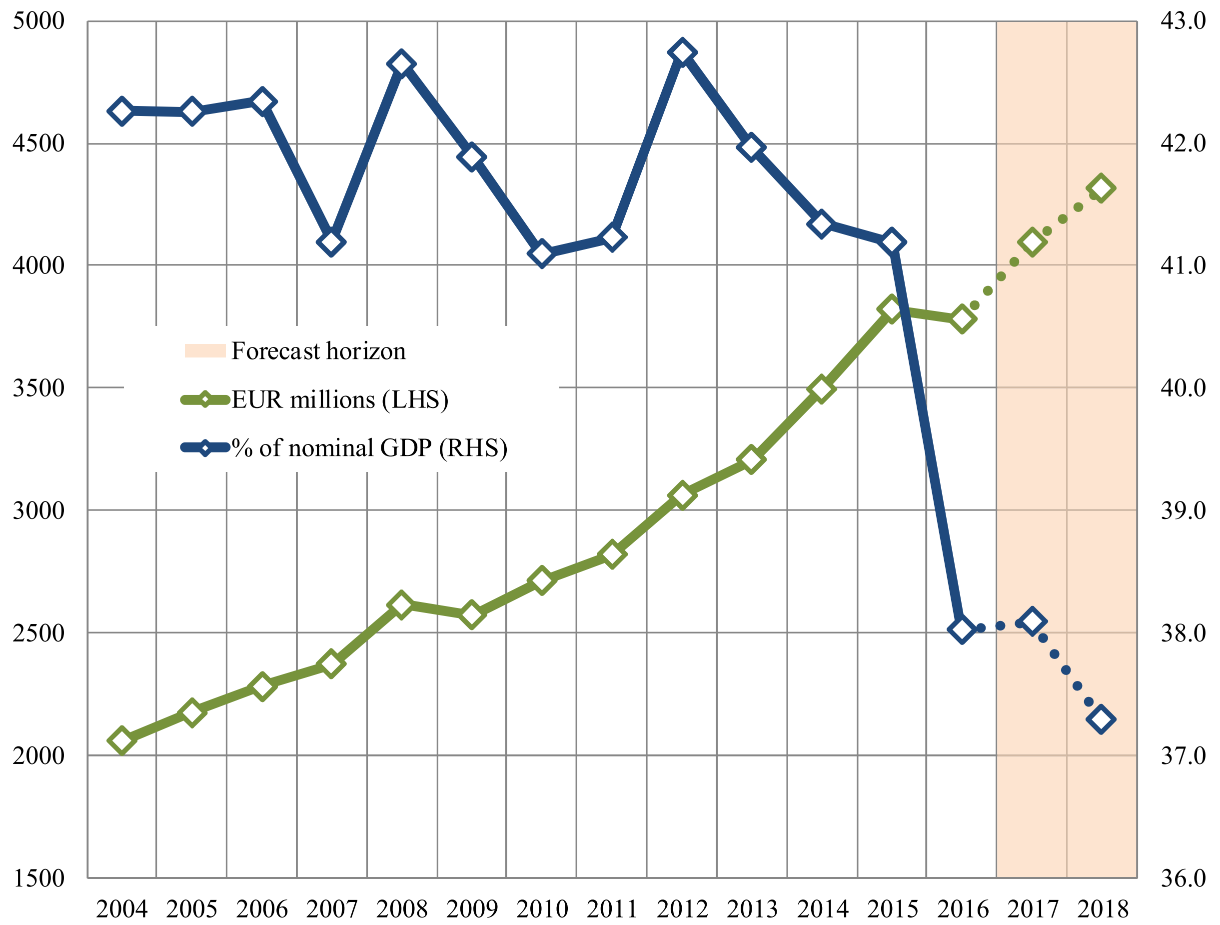
Note: ⇔ indicates neutral risks, ⇑ indicates upside risks and ⇓ indicates downside risks. All risks are assessed with respect to the specific revenue component and based on the information made available to the MFAC by the cut-off date. For the purposes of risk identification, the materiality principle is used, where any deviations (up or down) which are less than 0.1% of GDP are considered as stable, thus carrying a neutral risk assessment.
Source: MFAC

5. Assessment of the expenditure projections for 2017 and 2018

The upward trend in total expenditure in absolute terms, which was temporarily reversed in 2016, is expected to resume over the forecast horizon. It is projected to rise by 8.3% in 2017 and 5.4% in 2018 (see Chart 10). These projected developments follow the 1.0% drop which occurred in 2016. However, as per cent of GDP, total expenditure is expected to remain significantly lower than the average level witnessed over the past decade. While in 2017 it is expected to remain stable, at around 38.0% of GDP, the expenditure ratio is expected to decline further in 2018, to reach 37.3%. This would place total expenditure some 5.0 pp lower than the peak attained in 2012. The restraint in expenditure growth is particularly noticeable in relation to compensation of employees, social payments and interest payments, whose ratios to GDP have been declining at least since that year (see Chart 11). This decline is driven by the high growth rate of GDP, which has been outstripping expenditure growth.

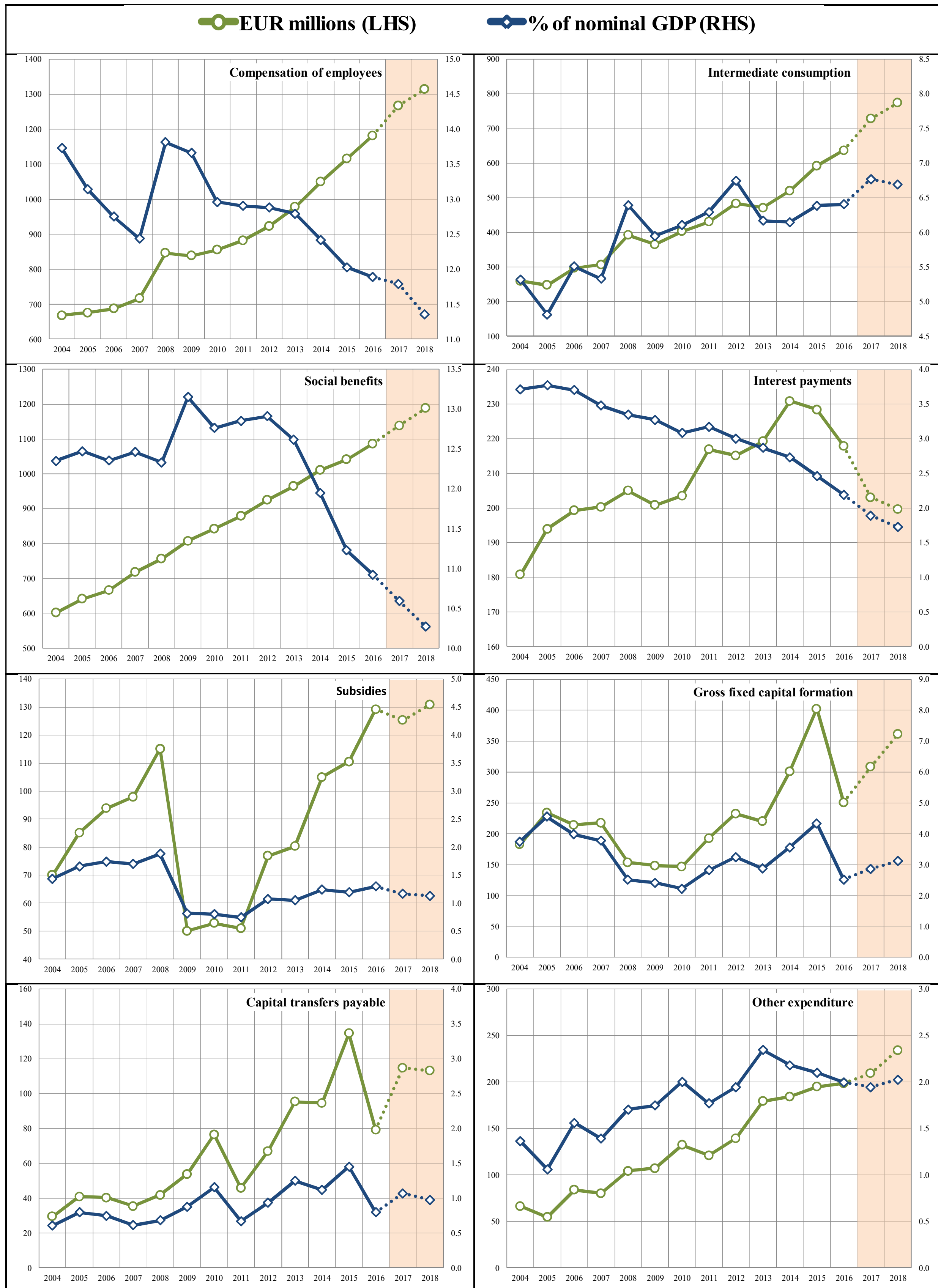
The assessment of the expenditure projections in this Report is carried out by the MFAC in a disaggregated manner, adopting the same approach used in the case of revenue projections. This is necessary to better capture the specificities of the various expenditure components.

Chart 10: Total government expenditure



Source: MFIN

Chart 11: Expenditure components



Source: MFIN

5.1. Compensation of employees (D.1)

Definition: *The total remuneration, in cash or in kind, payable by an employer to an employee in return for work done by the latter during an accounting period.*[24]

Spending on compensation of employees is driven by the number of public sector employees and their average wage. Since recruitment within government departments has been decentralised, the projections for compensation of employees effectively show the allocated spending on this budget item, within headcount limits established by the MFIN and the Office of the Prime Minister (OPM). In turn, the average wage over the forecast horizon is driven by the new collective agreement for public service employees which was concluded in April 2017, and any wage drift which would occur when employees are promoted or receive bonuses.[25]

The increases awarded to civil servants under the new collective agreement are in the region of 3% per annum for 2017 and 2018.[26] These increases are inclusive of any cost of living adjustments (COLA) which the Government may award in respect of these years. However, this collective agreement does not cover the full Government's wage bill, as other sectors such as health and education are covered by a different collective agreement.[27] In fact, a financial package was agreed with the teachers' union in November 2017, as part of a new collective agreement which is expected to be finalised in the near term.

Employees in public sector entities and EBUs are also covered by different collective agreements or compensation packages. However, it is worth highlighting that Article 72 of the Financial Administration and Audit Act (1962) allows for the Minister for Finance to issue directives on the recruitment and remuneration of employees "to any authority, board, foundation, corporation, institute, agency, commission, company or any other entity, 51 per cent or more of which, is held in ownership by the Government, or over which, the Government has effective control, or where 51 per cent of its income comes from public monies, or from monies it receives by virtue of any law". Effectively, this enables the MFIN to have the final say on any collective agreement within the public sector.

In 2017, spending on compensation of employees is expected to increase by €85.8 million, or 7.3%, which is a faster rate of growth than in the previous two years (see Table 9). This can be ascribed to the fact that during the first six months of 2017, Malta held the rotating Presidency of the EU, which added workload upon the administration. Thus, the slower growth anticipated

[24] This budget item consists of the wages and salaries of civil servants, and employees in local councils and government entities. These include Extra Budgetary Units (EBUs) that are funded fully or in large part by subventions from the Government and are therefore classified within the general government sector for ESA purposes.

[25] The collective agreement covers the eight-year period 2017 – 2024.

[26] This figure is based on how the minimum salary for three representative scales, scale 5, scale 10 and scale 15 is changing in each respective year according to Appendix A of the Collective Agreement for Employees in the Public Service.

[27] The collective agreement covers around 30,000 employees from a total of around 45,000 employees in the public sector.

for 2018, primarily reflects the base effect created by the EU Presidency in 2017. The planned 3.7% additional spending on wages for 2018 broadly covers two possible scenarios. On one hand, it is compatible with public sector employment and overtime remaining stable compared to end-2017, and average wage growth broadly limited to that indicated in the collective agreement for civil servants. Another compatible scenario is that whereby employment and/or overtime is less than in 2017, but average wage growth is faster.

Table 9: Compensation of employees

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2015	6.3	65.8
2016	5.9	66.3
2017	7.3	85.8
2018	3.7	46.4

Source: MFIN

During the first six months of 2017, spending on compensation of employees was €38.0 million higher than a year ago.[28] The upward push should probably be more muted over the second half of the year, since the EU Presidency impacted the first half of 2017, unless some related wage payments spilled over into the second half of the year. Furthermore, Consolidated Fund data for the first nine months shows that the increase in compensation of employees was €40.0 million compared to a year earlier.

These considerations would suggest possible downside risks to the Government's wage bill, vis-à-vis the annual target for 2017, as they are both less than half the €85.8 planned increase for the year. In turn, a lower spending outturn for 2017 would permit a larger increase in spending for 2018, such as due to the signing of the collective agreement with teachers (after the submission of the DBP), while still respecting the envisaged expenditure envelope.

Overall, the MFAC considers the projections for compensation of employees to be plausible, with downside risks for 2017 and neutral risks for 2018.

[28] During the first six months of 2016, spending on compensation of employees had covered 49.9% of the annual outturn, indicating a general level of stability in the outlays between the first half and the second half of the year.

5.2. Intermediate consumption (P.2)

<u>Definition:</u> *Goods and services consumed as inputs by a process of production, excluding fixed assets whose consumption is recorded as consumption of fixed capital. The goods and services are either transformed or used up by the production process.*[29]

Spending on intermediate consumption is projected to rise significantly in 2017, up by €91.3 million (see Table 10). An important factor contributing to the higher outlays on intermediate consumption compared to 2016 relates to the costs associated with the EU Presidency. In 2016 its one-off effect was estimated at €10.8 million, while for 2017, €26.3 million was being budgeted for. Other factors boosting the planned higher expenditure on intermediate consumption in 2017 relate to health concession agreements and the €3.5 million allocation for the Tourism Environment Trust.

Table 10: Intermediate consumption

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2015	14.0	72.6
2016	7.5	44.3
2017	14.3	91.3
2018	6.3	46.0

Source: MFIN

On the other hand, intermediate consumption is planned to rise by €46.0 million in 2018. To an extent this reflects the base effect created by the exceptional expenditure in 2017, which also includes €5.5 million in relation to the holding of the general elections in 2017. The expiry of related contracts is expected to contribute to the slowdown in expenditure growth from 14.3% in 2017 to 6.3% in 2018.

ESA data shows that intermediate consumption was €72.7 million higher than a year ago during the first half of the year. This has absorbed a significant share of the total planned yearly rise for the year which amounts to €91.3 million. This suggests that the largest increase took place during the first half of the year. On the other hand, Consolidated Fund data shows that intermediate consumption only increased by €37.8 million during the first nine months,

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

suggesting that developments outside the Consolidated Fund could be playing a material role in explaining the developments to date.

Intermediate consumption is historically a volatile component of government expenditure, in view of a significant discretionary element. This factor makes possible significant swings in expenditure from one year to the other. On balance, the MFAC considers that there are upside risks to spending on intermediate consumption for 2017 and neutral risks for 2018.

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

Definition: *Benefits payable in cash to households by social security funds and other benefits payable by employers in the context of other employment related social insurance schemes. In kind benefits refer to individual goods and services provided for free or at prices that are not economically significant to individual households by government units and Non-Profit Institutions Serving Households (NPISH), whether purchased on the market or produced as non-market output by government units or NPISHs. They are financed out of taxation, other government income or social security contributions, or out of donations and property income in the case of NPISHs.*[30]

Outlays on social payments are expected to increase by €52.5 million in 2017 and a further €49.7 million in 2018 (see Table 11). Despite slightly faster growth rates compared to the previous two years, the downward trajectory for the social benefits-to-GDP ratio observed in recent years, is set to continue.

Table 11: Social benefits

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2015	3.1	30.9
2016	4.3	44.8
2017	4.8	52.5
2018	4.4	49.7

Source: MFIN

The higher social payments arising from the 2017 Budget measures, which collectively are expected to increase expenditure by around €13.0 million, are partially offset by the lower recourse to social benefits due to the tapering of social benefits (the difference of its impact between 2017 and 2016 is estimated at €3.6 million). The Budget for 2018 envisages new

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

measures amounting to €10.3 million spending on social benefits, of which €8.5 million in the form of higher pensions.

In relation to the Government's statement in the 2018 Budget Speech that as from academic year 2018 – 2019 students attending both Church and private schools would be provided with free transport, in 2018, only €70,000 were allocated in relation to the carrying out of preliminary studies.[31] Thus, if this planned initiative translates into expenditure commitments starting in 2018, this could create upside risks to spending on social benefits for that year.

During the first half of 2017, social benefits increased by 3.6% or €19.6 million, rather subdued compared to the 4.8% yearly growth forecast. However, cash data for the first nine months shows a 5.0% increase, which is in line with the yearly expected outturn.

Overall, the MFAC considers the projections for social benefits to be plausible, with neutral risks for 2017, but upside risks for 2018.

5.4. Interest expenditure (D.41)

Definition: Property income receivable by the owners of a financial asset for putting it at the disposal of another institutional unit.[32]

Interest payments are expected to amount to €203.1 million in 2017, €14.8 million less than in 2016 (see Table 12). This follows a similar decline amounting to €10.6 million, which was recorded in 2016, and reflects the rolling over of maturing bonds at lower coupon rates. The projections feature additional interest savings in 2018, albeit of a smaller magnitude, amounting to €3.4 million.

Table 12: Interest expenditure

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2015	-1.1	-2.4
2016	-4.6	-10.6
2017	-6.8	-14.8
2018	-1.7	-3.4

Source: MFIN

[31] The provision of transport services falls under social assistance benefits in kind under the ESA framework.
[32] This budget item consists of the interest payments made on public debt.

During the first half of 2017, savings on interest payments were around €5.1 million on an ESA basis. In turn, Consolidate Fund data shows a decline of €7.2 million for the first nine months of the year.

For 2018, the short and long-term interest rates are assumed to remain unchanged compared to 2017, respectively at 0.0% and 1.4%. This should ensure further roll over savings. Indeed, the MFIN has estimated that the implicit interest rate should drop from 3.5% to 3.4%. The projected decline of €30.5 million in public debt in 2018, would contribute to lower interest payments further.

Overall, the MFAC considers the risk to the projections for interest payments to be neutral both for 2017 and for 2018.

5.5. Subsidies (D.3)

Definition: Current unrequited payments which general government or the institutions of the European Union make to resident producers.[33]

Subsidies are expected to amount to €125.3 million in 2017, a drop of €3.9 million on the previous year (see Table 13). Nonetheless, this represents an upward revision compared to the previous targets. Indeed, 2017 subsidies were targeted at €112.4 million in the DBP for 2017, €114.8 million in the USP 2017 – 2020, and €110.1 million in the HYR 2017.[34] A significant share of subsidies is of a contractual nature such as in relation to Public Service Obligations (PSOs), thereby contributing to stability in the outlays, in the absence of renegotiations or new subsidies. During the first half of 2017, subsidies were €2.0 million higher than over the corresponding period of 2016. However, on a cash basis, subsidies were €9.2 million lower during the first nine months. Overall, the MFAC considers the risk to the projections for subsidies to be neutral, both for 2017 and for 2018.

Table 13: Subsidies

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2015	5.3	5.6
2016	16.9	18.7
2017	-3.1	-3.9
2018	4.4	5.5

Source: MFIN

[33] This budget item consists mainly of the subsidies paid to the transport, energy and agricultural sectors.
[34] To an extent the upward revisions in subsidies also reflect the approach taken by MFIN where the projections for subsidies are linked to spending on gross fixed capital formation. Hence, upward adjustments to the latter also translate into higher projections for subsidies.

5.6. Gross fixed capital formation (P.51)

Definition: Resident producers' acquisitions, less disposals, of fixed assets during a given period plus certain additions to the value of non-produced assets realised by the productive activity of producer or institutional units. Fixed assets are produced assets used in production for more than one year.[35]

Spending on gross fixed capital formation is planned to increase from €250.8 million in 2016, to €308.3 million in 2017, and €361.0 million in 2018. During 2015 and 2016, major fluctuations were reported, with a significant increase followed by a significant decline.[36] The projections point towards a more stable trajectory, with investment spending rising by €57.5 million in 2017 and €52.6 million in 2018 (see Table 14). The DBP states that the "increase in capital expenditure will be devoted to roads, environment, health and education and include higher infrastructure expenditure financed from both the European Union and local funds".

Table 14: Gross fixed capital formation

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2015	33.8	101.6
2016	-37.7	-151.5
2017	22.9	57.5
2018	17.1	52.6

Source: MFIN

During the first half of the year, the spending increase was limited to €12.9 million.[37] Likewise, cash data indicates that the increase for the first nine months of the year was limited to €15.9 million. Both factors make it challenging for the target on planned yearly outlays to be met by the end of 2017. Lower than anticipated spending could create a base effect, making the attainment of the 2018 also challenging. An accelerated take up of EU funds, compared to the previous seven-year programming period, has proved rather challenging.

Overall, the MFAC considers the risk to the projections for gross fixed capital formation to be on the downside both for 2017 and for 2018, though acknowledging that as has happened in 2015, elevated investment spending is feasible.

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[35] This budget item consists of the capital expenditure undertaken by the various ministries and EBUs.
[36] 2015 was an exceptional year since this was the last year when EU funds pertaining to the programming period 2007 – 2013 could be spent, leading to an acceleration of investment spending to ensure the fullest possible utilisation of available EU funds. On the other hand, 2016 was the first year of the following programming period, which is typically characterised by a relatively slow start in the utilisation rate.
[37] The figure is based on gross capital formation which represents almost exclusively gross fixed capital formation. The minor difference relates to the value of acquisitions less disposals of non-produced assets.

5.7. Capital transfers payable (D.9)

Definition: capital transfers require the acquisition or disposal of an asset, or assets, by at least one of the parties to the transaction. Whether made in cash or in kind, they result in a commensurate change in the financial, or non-financial, assets shown in the balance sheets of one or both parties to the transaction.[38]

According to the latest DBP, capital transfers in 2017 are projected at €114.8 million. This amount has been scaled up across the various forecast vintages. In October 2016 (DBP 2017) the target was €45.2 million; in April 2017 (USP 2017 – 2020) the target was doubled to €90.8 million; while in July 2017 (HYR 2017) the target was raised further to €106.7 million. Capital transfers are expected to rise by €35.5 million in 2017 (see Table 15). Of this, €35.0 million is due to the payments made by the Depositor Compensation Scheme (DCS). Another identifiable factor impacting 2017 compared to a year earlier relates to the non-repetition of the equity investment in the national airline, which amounted to €12.0 million in 2016.

Table 15: Capital transfers payable

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2015	42.4	40.1
2016	-41.1	-55.4
2017	44.8	35.5
2018	-1.5	-1.7

Source: MFIN

In ESA terms, during the first half of 2017 capital transfers were up by €25.3 million, justifying the upward revisions undertaken across forecast vintages. In the case of capital transfers, Consolidated Fund data is not very informative, as the coverage is very limited. Indeed, the total capital transfers for the first nine months recorded through the Consolidated Fund only amounted to €8.2 million, lower than the €23.0 million recorded in 2016. With regard to 2018, the projected €1.7 million decline reflects the non-repetition of certain expenditure items. This is expected to fully offset the assumption of higher take up of EU funds in that year, some of which are channelled to public sector entities via capital transfers.

The MFAC acknowledges the extent of discretion available to the Government over this expenditure item. Overall, the MFAC considers the risk to the projections for capital transfers to be neutral for 2017 and for 2018.

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

5.8. Other expenditure

Definition: Other expenditures not elsewhere classified.[39]

In 2017 'other expenditure' is expected to increase by €10.5 million, to €209.2 million (see Table 16). A further €25.1 million rise is anticipated for 2018. Its ratio to GDP is expected to remain rather stable at around 2.0% of GDP. This is a prudent approach. Within this figure, €9.8 million and €11.6 million were allocated to the Contingency Reserve respectively in 2017 and 2018.[40] This would translate into an automatic saving, of the same amount, should there be no recourse to the Contingency Reserve during these two years. As a result, the MFAC considers the risk to the projections for 'other expenditure' to be downside both for 2017 and for 2018.

Table 16: Other expenditure

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2015	5.7	10.6
2016	1.9	3.8
2017	5.3	10.5
2018	12.0	25.1

Source: MFIN

5.9. Total government expenditure

The item-by-item examination of risks to the expenditure forecasts suggests that on aggregate there could be possible downside risks to total expenditure in 2017 (see Table 17). Possibly lower-than-budgeted spending on compensation of employees, gross fixed capital formation and 'other expenditure' could more than compensate for the risk of slippage in the case of intermediate consumption. With respect to 2018, downside risks have been identified in relation to gross fixed capital formation and 'other expenditure' whose impact could be larger

[39] This budget item represents residual expenditure components, mainly accounted for by current transfers to the numerous government entities to fund their operations. Within this aggregate there is also included the annual budget allocation equivalent to 0.1% of GDP for the Contingency Reserve, if applicable. Sale of government land is treated as a negative value among these components.

[40] Article 32 of the FRA specifies that "As long as the budget is not balanced, the contingency reserve is to be established as an expenditure vote to be appropriated in the event of temporary and unforeseen circumstances." Article 2 of the FRA further clarifies that the balance refers to the balance of the Consolidated Fund rather than the balance on an ESA basis. Article 2 of the FRA states "Budget means the budgetary estimates, presented to the House of Representatives in respect of any financial year, of the expenditure and revenue for the service of that financial year and includes any supplementary estimates of expenditure for which it may be necessary to provide after the estimates have been presented to the House of Representatives".

than the upside risks in relation to social transfers. As a result, there also appear to be possible downside risks to total expenditure in 2018.

Table 17: Summary of risks to the expenditure projections

	2017	2018
Compensation of employees	⇓	⇔
Intermediate consumption	⇑	⇔
Social benefits	⇔	⇑
Interest expenditure	⇔	⇔
Subsidies	⇔	⇔
Gross fixed capital formation	⇓	⇓
Capital transfers payable	⇔	⇔
Other expenditure	⇓	⇓
Total expenditure	⇓	⇓

Source: MFAC

6. Assessment of the trajectory for the fiscal balance and public debt for 2017 and 2018

The MFAC's assessment of the various revenue and expenditure components within the 2018 Budget suggests that there are upside risks to total revenue and downside risks to total expenditure, both for 2017 and 2018 (see Table 18). Their combined effect translates into an upside risk for the fiscal balance across the forecast horizon.

Table 18: Summary of risks to the fiscal projections

	2017	2018
Total revenue	⇑	⇑
Total expenditure	⇓	⇓
Fiscal balance	⇑	⇑

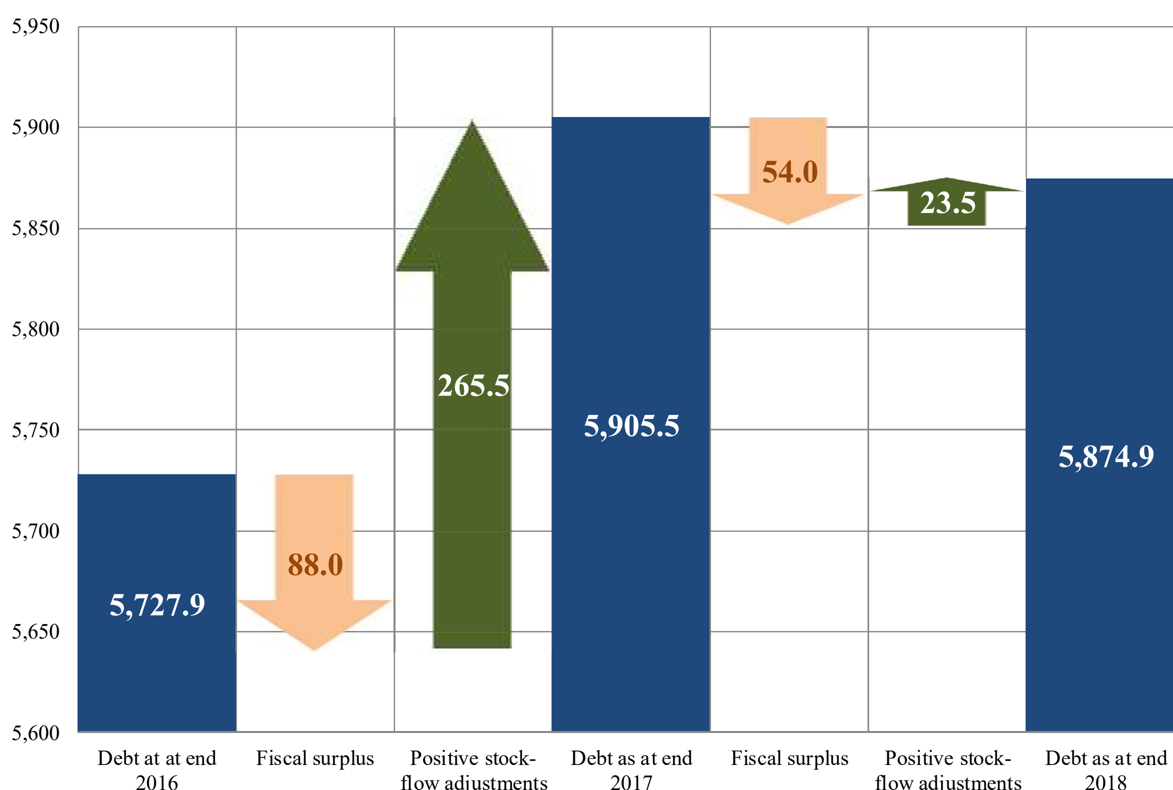
Source: MFAC

In relation to 2017, it is possible that tax revenues and inflows from the IIP may exceed the targets, reflecting the prudent assumptions employed by the MFIN. The outturn for expenditure may also be less than planned because of spending shortfalls on compensation of employees,

and on gross fixed capital formation, and the non-recourse to the Contingency Reserve.[41] The upside risks to the fiscal balance appear to be less strong in 2018. In this case, the upside revenue risks hinge exclusively on the possibility of above-target revenues from the IIP, while the downside risks to expenditure are contingent on slower-than-planned progress in gross fixed capital formation and the non-recourse to the Contingency Reserve.

Despite the €88.0 million surplus targeted for 2017, the MFIN's projections show that the outstanding public debt would increase by €177.5 million in 2017, up from €5.7 billion to €5.9 billion (see Chart 12). This is the result of positive stock-flow adjustments, which are estimated at €265.5 million.[42] On the other hand, public debt is expected to decline by €30.5 million in 2018. This drop is slightly less than the planned fiscal surplus for the year, as stock-flow adjustments are again expected to be positive, albeit having a much smaller effect than in 2017.

Chart 12: Drivers of public debt (EUR millions)



Source: MFIN

The robustness of the public debt projections for 2017 and 2018 depends on the extent to which the planned fiscal surpluses and the stock-flow adjustments for these years can be considered as plausible. The upside risks to the fiscal balance would normally pose downside risks to the outstanding level of debt. A higher fiscal surplus would enable larger debt repayment on a net basis. With regards to stock-flow adjustments, these are to a large extent policy-driven, and

[41] The impact on the fiscal balance resulting from shortfalls in gross fixed capital formation which is funded by EU funds, is limited to the use of local funds for the project.
[42] Stock-flow adjustments are transactions which impact the debt but not the fiscal balance, thus resulting in situations where the change in the outstanding debt does not equal to the fiscal balance.

thus, if the plans which underpin the DBP projections are adhered to, the outcome should be reasonably in line with the projections. The information provided in the DBP suggests that the anticipated stock-flow adjustments for 2017 and 2018 are strongly influenced by transactions related to the funds generated by the IIP, which feature under the activities of the National Development and Social Fund (NDSF) (see Table 19).

Table 19: Stock-flow adjustments (EUR millions)

	2017	2018
Change in NDSF's financial balances	108.0	42.0
Changes in Sinking Fund balances and MGS holdings	74.7	-58.3
Equity acquisitions	32.6	2.6
Net impact of EBU-related transactions	-28.9	-9.5
Changes in cash balances	12.3	-11.2
Euro currency issue	8.1	7.2
Other adjustments	58.7	50.7
Total stock-flow adjustments	**265.5**	**23.5**

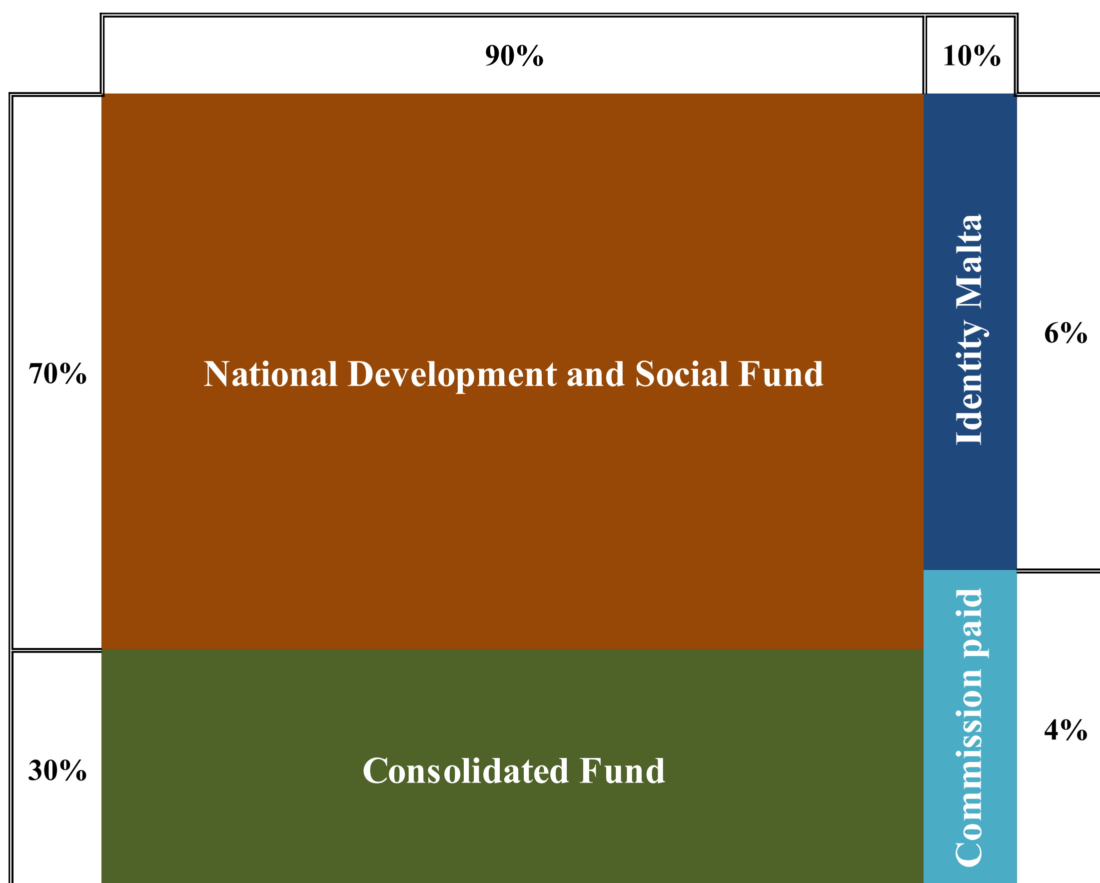
Source: MFIN

All revenues generated through the IIP are classified as revenues under the ESA framework, thus contributing to improve the fiscal balance. Of these, 6% of funds are retained by Identity Malta, to fund its activities, and 4% are paid as commission. Accordingly, they are both classified as expenditure, in ESA terms. Out of the remaining 90%, 30% are transferred to the Consolidated Fund, while 70% are transferred to the NDSF (see Diagram 1). The financial assets held by the NDSF (rather than used to fund the redemption of debt) are the main reason why despite the fiscal surplus, gross debt is still expected to increase in 2017.

Other important factors contributing to the expected mismatch between debt developments during the year and the fiscal balance relate to movements in the Sinking Fund, equity acquisitions and the operations of EBUs. The accumulation of financial assets in 2017 and the drawdown of such assets in 2018 are another factor explaining the variation in the size of the stock-flow adjustments between those two years. A similar effect is created by the planned build-up in cash balances in 2017 and their draw-down in 2018.

The MFAC considers that the planned stock-flow adjustments for 2017 and 2018 are plausible. They are based on information available to the MFIN. Hence the trajectory for the public debt, in absolute terms, is also plausible. Likewise, the planned trajectory for the gross debt-to-GDP ratio, is plausible. The nominal GDP growth rates of 8.1% for 2017 and 7.6% for 2018, which determine the absolute value of nominal GDP for those years, which in turn acts as the denominator to the ratio, have already been endorsed by the MFAC in its previous Report.

Diagram 1: Allocation of IIP revenues



Source: MFAC

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

The plausibility of the MFIN's projections contained in the DBP can also be evaluated by comparing them to the forecasts by other institutions, namely the CBM and the COM.[43] However, a caveat of this type of analysis is that these forecasts were prepared in different periods, and hence based on different information sets.[44] The latest available forecasts by the CBM were published on 9 June 2017, whereas the most recent forecasts by the COM were published on 9 November 2017. As a result, the CBM's forecasts do not factor the information contained in the latest DBP. They are also based on older statistical vintages for GDP and fiscal statistics, compared to those by the MFIN and the COM. On the other hand, the forecasts by the MFIN and the COM are more comparable as they include broadly similar information, with the differences arising mainly from different assumptions and the estimated economic relationships underpinning such forecasts.

[43] The latest available CBM and COM forecasts can be downloaded respectively from https://www.centralbankmalta.org/economic-projections and https://ec.europa.eu/info/sites/info/files/economy-finance/ggd_i_autumn2017_en.pdf.
[44] The cut-off date for the CBM's forecasts was 23 May 2017, while the cut-off date for the COM's forecasts was 23 October 2017.

The CBM's forecasts for the fiscal balance and the public debt ratios for 2017 and 2018 are both very close to those prepared by the MFIN (see Table 20). The CBM is projecting a fiscal surplus of 0.5% of GDP in 2017, which rises to 0.7% of GDP in 2018. The CBM also expects the debt-to-GDP ratio to extend its downward trajectory over the forecast horizon. However, the CBM' is projecting a slightly higher debt ratio, with the difference amounting to 0.8 pp in 2017 and by 1.2 pp in 2018.

Table 20: Fiscal projections by organisation (% of GDP)

	2017			2018		
	MFIN	CBM	COM	MFIN	CBM	COM
Total revenue	**38.9**	**38.8**	**39.0**	**37.8**	**39.0**	**38.1**
Taxes on production and imports	12.5	12.8	12.6	12.3	12.7	12.3
Current taxes on income & wealth	13.9	14.0	14.1	14.1	14.1	14.4
Social contributions	6.3	6.4	6.4	6.3	6.3	6.3
Other*	6.2	5.6	5.9	5.2	5.9	5.1
Total expenditure	**38.1**	**38.3**	**38.1**	**37.3**	**38.3**	**37.6**
Compensation of employees	11.8	11.9	11.8	11.4	11.9	11.7
Intermediate consumption	6.8	6.7	6.8	6.7	6.4	6.8
Social payments	10.6	10.8	10.0	10.3	10.7	9.7
Interest expenditure	1.9	2.0	1.9	1.7	1.9	1.7
Subsidies	1.2	1.3	1.2	1.1	1.3	1.1
Gross fixed capital formation	2.9	2.8	2.6	3.1	3.2	2.8
Other**	3.0	2.8	3.8	3.0	2.9	3.8
Fiscal balance	**0.8**	**0.5**	**0.9**	**0.5**	**0.7**	**0.5**
Gross debt	**54.9**	**55.7**	**54.9**	**50.8**	**52.0**	**51.6**

* Consist of capital taxes and 'other revenue'.
** Consist of capital transfers payable and 'other expenditure'.
Source: MFIN, CBM, COM

The projections by the COM are closer to the MFIN's projections. The COM anticipates the fiscal surplus for 2017 to amount to 0.9% of GDP (+0.1 pp compared to the MFIN), and 0.5% of GDP in 2018 (identical forecast to the MFIN). In turn, the COM's debt-to-GDP forecast for 2017 is identical to the MFIN's, at 54.9%. For 2018 the COM expects a smaller decline in the debt ratio than the MFIN, with the debt-to-GDP ratio settling at 51.6% compared to the DBP's target of 50.8%.

The CBM's tax revenue component ratios for 2017 are more positive that those of the MFIN. This effect is however fully offset by more cautious assumptions in relation to other revenues. As a result, the CBM is projecting a total revenue ratio which is 0.1 pp lower than that targeted by the MFIN. On the other hand, the CBM's forecast for the total expenditure ratio is 0.2 pp higher than that indicated by the MFIN, suggesting a lower degree of expenditure restraint. Nevertheless, the differences across the various expenditure categories lie within a narrow range of 0.2 pp. With regards to 2018, the total revenue forecast by the CBM is higher than that indicated in the DBP. Indeed, the CBM is projecting a revenue-to-GDP ratio of 39.0%, which exceeds that indicated by the MFIN by 1.2 pp. Specifically, the CBM's forecasts for taxes on production and imports and 'other' revenues are respectively 0.4 pp and 0.7 pp higher. Likewise, the CBM's expenditure-to-GDP ratio for 2018 is 1.0 pp higher than that targeted in the DBP. The largest discrepancies relate to compensation of employees (+0.5 pp) and social payments (+0.4 pp). These differences are also driven by the variations in the forecasts for nominal GDP by the different institutions.

The COM's tax revenue projections for 2017 are also slightly more positive that those of the MFIN. This applies to the three main revenue components. On the contrary, the COM's forecast for 'other revenues' is lower on the back of a more conservative absorption rate for EU funds. Overall, the COM's 2017 forecast for the total revenue-to-GDP ratio, at 39.0%, is only 0.1 pp higher than that of the MFIN. For 2018, the gap is slightly larger. The COM's revenue-to-GDP forecast is 38.1%, as opposed to the MFIN's forecast of 37.8%. This is due to the COM's higher anticipated current taxes on income and wealth compared to the MFIN. On the expenditure side, there are more differences at a components level in both years. At an aggregate level, however, there is limited variation or none. For 2017, the COM expects much lower social payments (-0.6 pp) and lower gross fixed capital formation (-0.3 pp) but higher 'other expenditure' (+0.8 pp). For 2018, the main difference relates again to social payments (-0.6 pp). Other relevant differences relate to compensation of employees and gross fixed capital formation. In the first case, the COM expects expenditure to be 0.3 pp higher than that indicated by the MFIN, while in the second case, the COM expects expenditure to be 0.3 pp lower.

Turning to the risk assessment of such projections, the CBM concludes that "risks to the public finances tilt on the upside, with contingency risks from public corporations more than offset by the possibility of higher than projected revenues from the IIP and growth in tax revenue". On the other hand, the COM states that over the forecast horizon, "risks to the fiscal outlook are balanced as higher current expenditure and related slippages in budgetary execution could be compensated by higher proceeds from the citizenship programme".

8. Conclusion

The MFAC acknowledges that the process used by the MFIN to prepare its fiscal projections is rigorous and based on sound methodological practices. The consistent attainment, or in certain cases over-achievement of the headline budget balance and public debt targets over the years, suggests that the framework is sufficiently robust and controls are adequate to address slippages. The MFAC also notes the strong similarity in the fiscal projections prepared by the CBM and the COM. Importantly, the outlook presented by the three institutions, is very similar. All are projecting a small fiscal surplus for 2017 and 2018 and a further drop in the debt ratio. This fact corroborates further the assessment by the MFAC about the plausibility of the fiscal projections contained in the DBP.

The MFAC considers that the MFIN's revenue projections for 2017 and 2018 lie within its endorsable range, leaving the possibility for upside risks throughout the forecast horizon. This view is contingent on the materialisation of the macroeconomic outlook, as envisaged in the DBP. Should the macroeconomic performance be less positive than that underpinning the DBP's calculations, or else, be driven by completely different contributors (which may be relatively more or less tax rich), the fiscal turnout could however be impacted, since most revenues are endogenous in nature. It is thus important that the MFIN remains vigilant to quickly detect and address any departure from current revenue trends. The planned expenditures are also within the MFAC's endorsable range throughout the forecast horizon. The downside risks to total expenditure identified by MFAC are mainly the result of possibly slower progress in certain capital projects. The MFAC concludes that the risks to the fiscal balance appear to be on the upside for 2017 and 2018. Even the trajectory for the public debt ratio appears achievable. In this case the downside risks mirror the before-mentioned upside risks to the fiscal balance.

Finally, the MFAC invites the Government to adhere closely to the fiscal plans as outlined in the DBP, since any significant departure could pose risks to the attainment of the fiscal surplus and debt targets as outlined in this Report.

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