Overall Assessment

Ministry for Finance Annual Report 2016

A report prepared

by the Malta Fiscal Advisory Council

July 2017

MFAC
MALTA FISCAL ADVISORY COUNCIL

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Annual Report

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Dear Minister

LETTER OF TRANSMITTAL

In terms of Article 13 of the Fiscal Responsibility Act, 2014 (Cap 534), I have the honour to present the overall assessment by the Malta Fiscal Advisory Council (MFAC) of the 2016 Annual Report by the Ministry for Finance, which was tabled in Parliament on 27 June 2017.

The Council positively notes that the 2016 fiscal turnout was significantly better than originally targeted. Indeed, a fiscal surplus was achieved, in lieu of the anticipated deficit, both according to the Consolidated Fund transactions, as well as based on the European System of National and Regional Accounts (ESA) methodology.

This better-than-expected fiscal outturn was predominantly revenue driven, underpinned by a number of factors which included: the prudent assumptions used in the forecast round; a more tax-rich economic growth; a larger tax base than originally considered in the Ministry's forecasting model; and a higher-than-expected yield from the Individual Investor Programme. In relation to expenditure, the Council notes that overruns were reported across many current expenditure components, but their effect on total expenditure was fully offset by lower spending on gross fixed capital formation. As a result, in 2016, total expenditure was slightly below the budgeted amount.

The Council acknowledges that the Ministry's policy of willingly opting for conservative revenue projections appears sound from a risk management perspective. This practice safeguards against over-optimistic revenue targets which could lead to missing the fiscal balance targets. At the same time, it is important that expenditure targets strike the right balance between being ambitious, in terms of containment of expenditure growth, but at the same time guaranteeing that the budgets allocated do not need to be subsequently revised upwards to accommodate necessary expenditure for the proper functioning of Government and delivery of public services. The view of the Council in this respect is that it is important that fiscal plans, as outlined both in the Draft Budgetary Plan and the Update of Stability Programme, provide projections as close as possible to the actual realisations, leading to fewer revisions across forecast rounds, particularly for those expenditure components which are more within the direct control of the Government.

With regard to the format of the Ministry's analysis of the actual fiscal performance vis-à-vis the budgetary objectives and projections, the Council agrees with the practice of providing an analysis both on a cash basis and in ESA terms. The Council would like to suggest that in order to enable the public to better understand the conduct of fiscal policy, it would be useful for the Ministry to also include explanations in its Annual Report to reconcile the developments across the two methodologies. Moreover, the Council notes that the Ministry's evaluation in ESA terms of the attainment of the fiscal targets is conducted only in respect of the targets set in the Update of Stability Programme. The Council understands that the Update of Stability Programme targets are more updated compared to the Draft Budgetary Plan targets. However, the Council considers opportune for the Ministry to also evaluate the targets contained in the Draft Budgetary Plan, that is, the fiscal targets specified on an ESA basis apart from those of the Consolidated Fund. In this way, the Annual Report would be following more closely the provisions of article 41(2)(a) of the Fiscal Responsibility Act which specifies that the purpose of the Annual Report is "to provide information on the execution of the previous budget". Moreover, by doing so, the assessment of the fiscal forecasts would be similar to the assessment carried out in relation to the macroeconomic forecasts. This would also identify more clearly the instances when the official fiscal targets are changed from the Draft Budgetary Plan to the Update of Stability Programme.

As regards the macroeconomic aggregates, the Council notes positively that the differences between the actual and the forecast growth rates for the 2016 nominal GDP and most other macroeconomic variables were small, supporting the overall quality of the forecasting framework employed by the Ministry. The larger discrepancies stemmed from the slower-than-anticipated progress in the utilisation of EU funds, and the above-target revenues from the Individual Investor Programme. In the first case, this led to a gap in the spending on gross fixed capital formation by the Government, compared to what was indicated in last year's Stability Programme and Draft Budgetary Plan. In the second case, this resulted in an unexpected decline in Government consumption. The Council acknowledges the inherent difficulties in such a forecasting exercise, but considers that there could be scope for improvement, particularly in relation to the forecasting of the progress in public sector capital projects.

The Council notes positively the full compliance of the 2016 budgetary performance with the two fiscal rules directly mentioned in the Fiscal Responsibility Act, namely the budgetary rule and the debt rule. After netting out the impact of the economic cycle and temporary effects, the structural fiscal balance ended 2016 with a surplus of 0.2% of potential output, instead of the structural deficit of 1.5% of potential GDP indicated in the 2016 Draft Budgetary Plan. This meant that the country's Medium-Term Objective (MTO) was achieved in 2016, three years ahead of the plan agreed with the European Commission. In this respect, the Council invites the Ministry to remain vigilant in order to ensure that the country remains at its MTO. The target for the public debt-to-GDP ratio was likewise overachieved as the ratio declined below the required 60.0% of GDP threshold earlier than planned, also under the impact of the recent upward revision in the nominal GDP statistics undertaken by the National Statistics Office.

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The MFAC considers the Annual Report to meet the requirements prescribed in Article 41 of the Fiscal Responsibility Act. However, the Council would like to encourage the Ministry to explore more fully the reasons why certain fiscal targets have been missed or exceeded, in order to draw useful insight, thus improving the forecasting framework in future rounds. The Council also suggests that the Ministry's Annual Report could serve as a good medium through which the Ministry reacts publicly to the recommendations made by the Council, thereby contributing to enhance fiscal transparency further.

Finally, the Council would like to express its satisfaction at the ongoing constructive dialogue with the Ministry and its officials and the sustained support received to facilitate the Council's operations.

Yours sincerely

Rene Saliba
Chairman

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Abbreviations

COM	European Commission
DBP	Draft Budgetary Plan
EBU	Extra-Budgetary Unit
ESA	European System of National and Regional Accounts
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
IIP	Individual Investor Programme
MFAC	Malta Fiscal Advisory Council
MFIN	Ministry for Finance
MTFS	Medium-Term Fiscal Strategy
MTO	Medium-Term Budgetary Objective
NSO	National Statistics Office
pp	percentage point
USP	Update of Stability Programme
wrt	with respect to

Executive summary

Macroeconomic forecasts are conditional on the information available at the time of their preparation. New information and unexpected developments contribute to forecast revisions from one round to the other. In this respect, the Ministry for Finance's Annual Report presents a commentary on developments in nominal GDP and its components, which are used in the Ministry's fiscal and macroeconomic forecasting models.

In 2016, nominal GDP growth, on the basis of the first vintage published by the National Statistics Office, was estimated at 6.7% which was close to the official forecasts, of 6.2% and 6.8%, prepared respectively in October 2015 and April 2016. The Fiscal Council notes positively that the forecast errors for nominal GDP and most other variables were small, with no particular pattern. It is only in the case of the forecasts for Government consumption and gross fixed capital formation that forecast errors were rather significant. While acknowledging the inherent difficulties, the Council considers that there could be scope for improvement in forecasting these two variables.

The Consolidated Fund recorded a surplus of €8.9 million in 2016, as opposed to the deficit of €196.0 million indicated in the approved Estimates published in October 2015. The significantly better fiscal turnout resulted mainly from stronger revenues, which were substantially above-target, while total expenditure was slightly lower than planned. Even under the ESA methodology, the outturn for the fiscal balance was better than targeted, achieving a surplus of 1.0% of GDP, instead of the 1.1% deficit targeted in the 2016 Draft Budgetary Plan.

The higher-than-expected intake from the Individual Investor Programme was the most important factor behind the revenue surplus. Current taxes on income and wealth were the other main contributor to the revenue surplus. The latter reflected prudent assumptions used in the forecast round, a more tax-rich growth, as well as a larger tax base than considered in the Ministry's forecasting model. On the other hand, despite the slightly lower than planned total expenditure for the year, overruns were reported across many current expenditure components. These were however fully offset by the lower-than-anticipated expenditure on gross fixed capital formation.

After netting out the impact of the economic cycle and temporary effects, the structural balance ended 2016 with a surplus of 0.2% of potential output, instead of the structural deficit of 1.5% of potential GDP projected in the 2016 Draft Budgetary Plan. This indicates that in structural terms, the magnitude of the adjustment was 2.8 percentage points compared to 2015, well in excess of the 0.6% requirement set by the European Commission. It also means that the country's MTO was achieved in 2016, three years ahead of the plan agreed with the Commission. In turn, the target for the public debt-to-GDP ratio, which was set at 62.6%, was overachieved as the ratio declined to 58.3% of GDP.

The Fiscal Council considers the Annual Report to meet the requirements prescribed in Article 41 of the Fiscal Responsibility Act. It also notes the full compliance with the two fiscal rules directly mentioned in the Fiscal Responsibility Act, namely the budgetary rule and the debt rule. While noting positively the better-than-expected fiscal outturn in 2016, the Council would like to encourage the Ministry to explore more fully the reasons why certain fiscal targets have been missed or exceeded, in order to draw useful insight, thus improving the forecasting framework in future rounds. It is also important that the Update of Stability Programme provides a reliable medium term anchor, whereby the published revenue and expenditure plans for the next three years are as close as possible to the actual realisations, rather than being consecutively revised. This will avoid the pattern observed in recent years, where the actual revenues and expenditures were higher than indicated in successive Draft Budgetary Plans and Stability Programmes.

1. Introduction

Article 41 of the Fiscal Responsibility Act (FRA), 2014 (Cap. 534), (reproduced below), requires that every year the Ministry for Finance (MFIN) publishes a report which explains the execution of the previous Budget and possible deviations from the fiscal targets as well as assessing the compliance with fiscal rules.[1] The purpose of this report is to increase transparency and accountability. This document was tabled in Parliament on 27 June 2017, complying with the end of June deadline indicated in Article 41(1) of the FRA.[2] The Malta Fiscal Advisory Council (MFAC) has assessed the MFIN's Annual Report in terms of article 13 (3) (e) of the FRA.

Article 41 of the Fiscal Responsibility Act (2014)

(1) The Minister for Finance shall prepare and make public before or at the end of June of each year, an annual report on the previous fiscal year.

(2) The purpose of the annual report is to:

(a) provide information on the execution of the previous budget and to compare its outcome with the strategic objectives and priorities in the fiscal strategy and the fiscal targets as announced in the previous annual budget;

(b) analyze how the Government has respected the principles and rules stipulated in this Act and to explain any deviations therefrom;

(c) assess if the fiscal and budgetary policies in the completed budget year and its results were in line with the medium-term objective stipulated in the fiscal strategy;

(d) explain any deviations from the Government's medium-term objectives and how these are to be addressed;

(e) explain the outcome of the budget in the context of the Government's European commitments, in particular the terms of the Stability and Growth Pact.

(3) The report on budget execution shall include the final execution data for the indicators provided in the fiscal strategy, and a section that shows deviations from the fiscal strategy and from the initial annual budget, with justification for such deviations.

[1] In Malta, fiscal targets are announced in the Budget Speech and included in the Draft Budgetary Plan (DBP), which must be published by 15 October of each year, and in the Update of Stability Programme (USP), which must be published by 30 April of each year. The latter document also serves as Malta's Medium-Term Fiscal Strategy (MTFS).

[2] The document is available on http://www.parlament.mt/paperslaiddetails?id=28278&legcat=14.

The Report proceeds as follows. Section 2 evaluates how the macroeconomic conditions have evolved since the publication of the 2016 DBP / Budget Speech (October 2015) and the publication of the 2016 – 2019 USP / MTFS (April 2016). Section 3 presents the outturn for the Consolidated Fund for 2016 and how this compared to the targets set by the MFIN in the Approved Estimates which were published in conjunction with the annual Budget Speech. Section 4 focuses on the general government balance, analysing developments using the revenue and expenditure nomenclatures specified in the European System of National and Regional Accounts (ESA). Section 5 assesses the extent of compliance with the two rules directly mentioned in the FRA, that is the budgetary rule and the debt rule.[3] Section 6 concludes with the MFAC's overall assessment and presents a number of final recommendations.

2. Macroeconomic developments during 2016

Macroeconomic forecasts are conditional on the information available at the time of their preparation.[4] New information and unexpected developments contribute to forecast revisions from one round to the other. In the case of Malta, the country's official macroeconomic forecasts are produced twice a year, ahead of the submission of the DBP and the USP. It is to be expected that the actual macroeconomic outturn would still be somewhat different from the forecasts, since it is practically impossible to forecast with perfect accuracy.[5] What is important, however, is the fact that the macroeconomic forecasts do not present a systematic bias, in the sense of repeatedly, underestimating or overestimating the variable of interest.

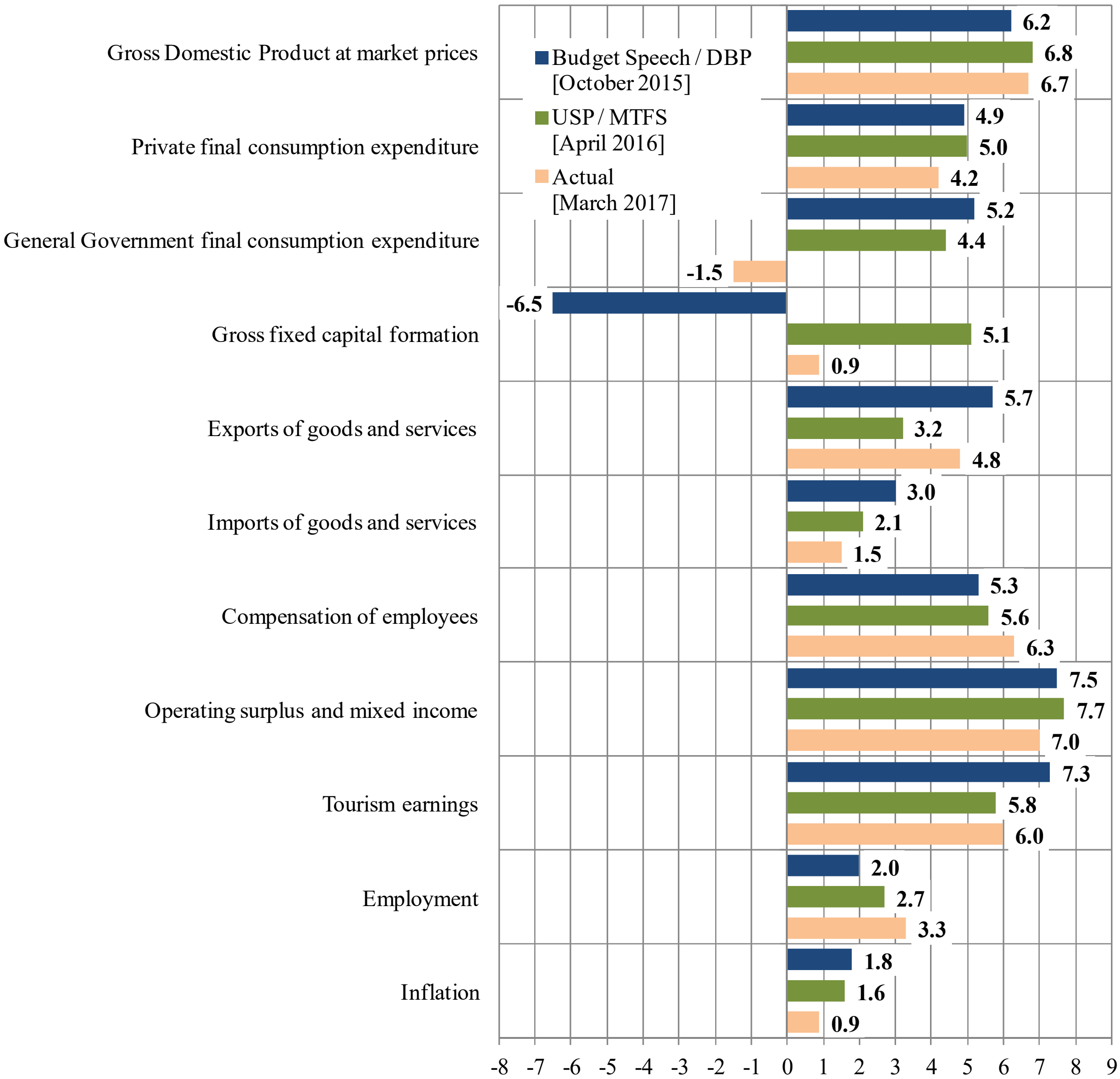
Macroeconomic forecast errors could impact the accuracy of the fiscal projections as they play an important, though not exclusive, role in their preparation. In this respect, the MFIN's Annual Report presents a commentary on developments in nominal GDP and its components, which are used in the MFIN's fiscal forecasting model. The Report contains information both with respect to the expenditure side, as well as the income side of GDP. Other supplementary information relates to tourism earnings, employment and inflation – based on the Harmonised Index of Consumer Prices (HICP).

In 2016, nominal GDP growth, on the basis of the first vintage published by the National Statistics Office (NSO) in March 2017, was estimated at 6.7% (see Chart 1).[6] This was close to the MFIN's forecasts, of 6.2% and 6.8%, prepared respectively in October 2015 for the DBP and in April 2016 for the USP. The forecasts for nominal GDP growth were among the closest to the actual turnout, compared to some other macroeconomic variables. Nominal

[3] The FRA also makes indirect reference to a third rule, the expenditure benchmark.
[4] The cut-off date is used to communicate to the users the information and statistical vintages that were available and could be used for the preparation of the forecasts.
[5] The estimates for the actual outturn as published by the National Statistics Office (NSO) may also change from one release to the next, on the basis of updated information. It is normal for macroeconomic statistics to be labelled as provisional.
[6] The second vintage, published by the NSO in June 2017, reconfirmed the 6.7% nominal GDP growth.

GDP growth was 0.5 percentage points (pp) higher when compared to the October 2015 forecast, and 0.1pp lower when compared to the April 2016 forecast (see Chart 2).

Chart 1: Macroeconomic developments in 2016 (year-on-year % change)

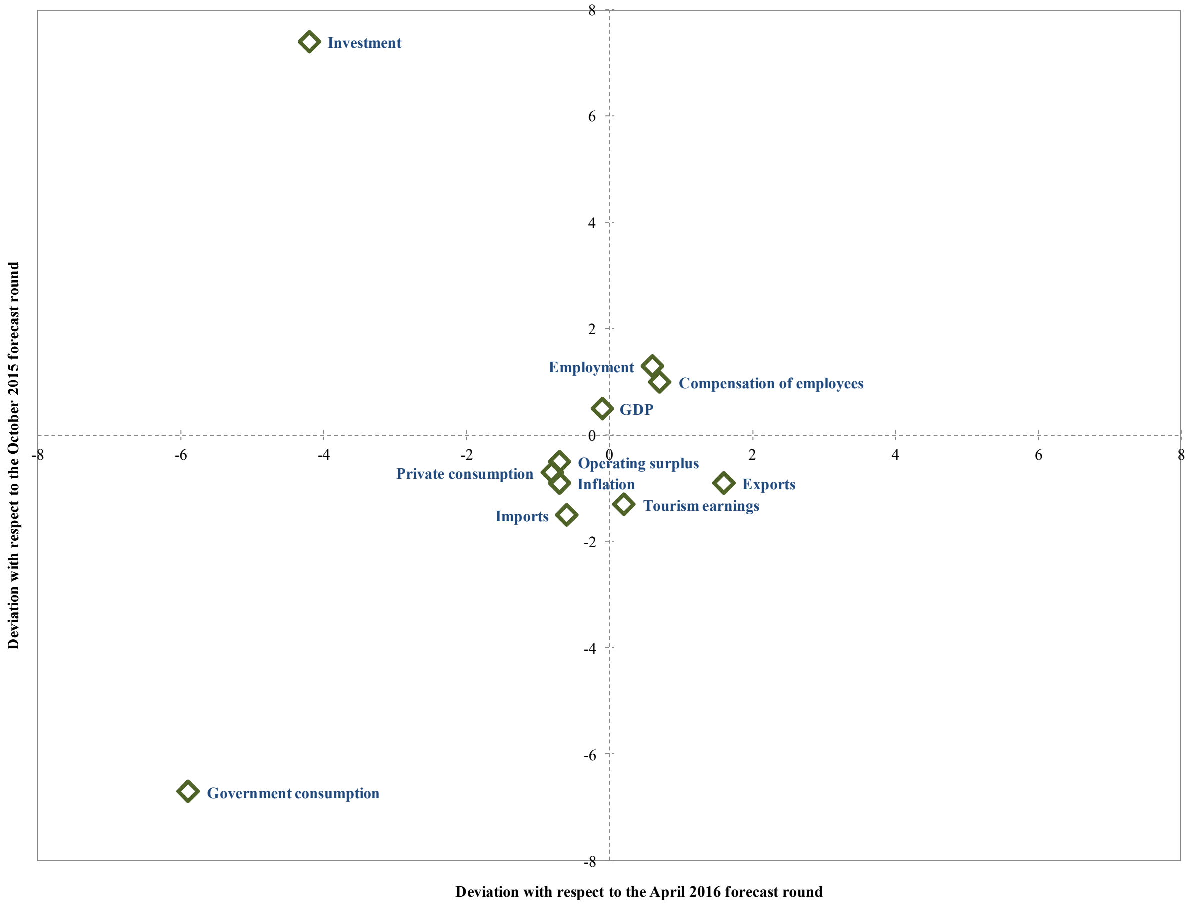


Source: MFIN

Even in the case of private final consumption expenditure, which is the largest component within GDP, the forecast errors were no more than 0.8pp. Private consumption grew by slightly less than was anticipated in both the MFIN's forecast rounds. Actual nominal growth in private consumption amounted to 4.2%, slightly lower than the 4.9% and 5.0%, forecasted by the MFIN.

On the other hand, the forecast error in the case of Government consumption was pronounced. Indeed, whereas the MFIN projected growth of 5.2% in October 2015 and 4.4% in April 2016, the NSO's data indicated that Government consumption actually declined by 1.5% compared to a year earlier. This large forecast error was mainly the result of higher than expected market output by the Government, which according to the ESA methodology is deducted from the other expenditure components of Government consumption. In turn, this reflected the yield from the Individual Investor Programme (IIP), which was above expectations. Its impact on the measurement of nominal GDP was however neutral, as this amount was added to exports, since according to the ESA guidelines, revenues from the IIP are considered as a sale of a service to non-residents by the Government. The MFAC acknowledges the challenges involved in preparing accurate forecasts for the IIP, particularly since the programme has only been in operation since 2014 and the duration of each application process may vary depending on its complexities.

Chart 2: Macroeconomic forecast errors in relation to the 2016 forecasts (pp)



Note: The top-left quadrant indicates instances when the actual turnout was higher than indicated in the October 2015 forecast round but lower than indicated in the April 2016 forecast round. The top-right quadrant indicates instances when the actual turnout was higher than indicated in both the October 2015 and the April 2016 forecast rounds. The bottom-left quadrant indicates instances when the actual turnout was lower than indicated in both the October 2015 and the April 2016 forecast rounds. The bottom-right quadrant indicates instances when the actual turnout was lower than indicated in the October 2015 forecast round but higher than indicated in the April 2016 forecast round.
Source: MFIN

Likewise, the forecast error for gross fixed capital formation (investment) was also significant. In the 2015 DBP, investment was expected to decline by 6.5%, whereas in the USP of April 2016 it was expected to grow by 5.1%. On the other hand, according to the

NSO's data, in 2016, investment actually expanded by 0.9%. The MFAC understands that achieving high accuracy in the case of private investment forecasts may be rather challenging, as this expenditure component can be rather volatile. On the other hand, there is scope to narrow the forecast errors in the case of public investment growth, since in this case projects are managed by the Government's departments or its entities.

In the case of exports of goods and services, the actual turnout, estimated at 4.8%, was within the MFIN's forecasts presented in the DBP and the USP, being lower than the 5.7% anticipated in October 2015, but higher than the 3.2% indicated in April 2016. Imports growth was lower than expected, indicating a lower import content of domestic expenditure. Indeed, imports of goods and services grew by only 1.5%, as opposed to the 3.0% and 2.1% which were forecasted in October 2015 and April 2016, respectively.

Turning to the income side of GDP, growth in compensation of employees was slightly above that indicated in both forecast rounds. This mirrored the actual employment growth, which, at 3.3% exceeded the forecasts. This effect was however largely offset by the slower-than-expected growth in operating surplus and mixed income.[7] Thus, while the nominal GDP growth forecast was very close to the outturn, its composition from the income side was slightly different than anticipated.

In the case of tourism earnings, these expanded by 6.0% on a year earlier, reasonably close to the 7.3% and 5.8% which were forecasted. With regard to the actual inflation rate, at 0.9%, this was below expectations of 1.8% and 1.6% forecasted in October 2015 and in April 2016, respectively.

Overall, the MFAC notes positively that the forecast errors for nominal GDP and most other variables were small, with no particular pattern. It is only in the case of the forecasts for Government consumption and investment that forecast errors were rather significant, and for which the MFAC considers that there could be scope for improvement, while acknowledging the inherent difficulties.

3. Developments in the Consolidated Fund during 2016

In 2016, the Consolidated Fund recorded a surplus of €8.9 million, as opposed to the deficit of €196.0 million indicated in the approved Estimates (see Table 1).[8] The better fiscal turnout resulted mainly from stronger revenues, which were €193.7 million above-target. In addition, total expenditure was €11.2 million lower than planned.

[7] The gross operating surplus of the total economy is the sum of the gross operating surpluses of the various industries or the various institutional sectors while mixed income represents the income from the self-employed of the household sector.

[8] The Consolidated Fund reflects the Government's cash-based position although certain financial transactions are excluded. Allocations are authorised either by the House of Representatives under an Appropriation Act, or else are permanently appropriated by the House under specific legislation. The Consolidated Fund does not take into account accruals, and the recording of revenues and expenditures also differs from the ESA guidelines.

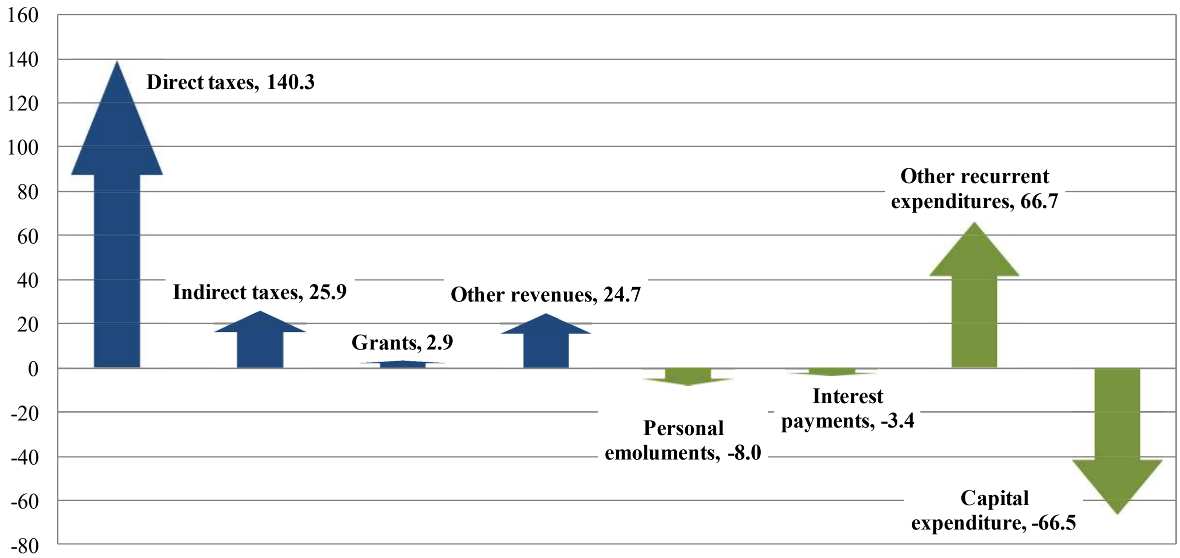
Table 1: Main developments in the Consolidated Fund in 2016 (EUR million)

	Approved Estimates	Actual	Difference
Total recurrent revenue	3,613.2	3,807.0	193.7
Total expenditure	3,809.2	3,798.1	-11.2
Consolidated Fund balance	-196.0	8.9	204.9

Source: MFIN

Surplus revenues were recorded across all main components, but were mainly driven by direct taxes, which exceeded the target by €140.3 million (see Chart 3). This was attributable to the prudent forecast assumptions employed, and the more tax-rich composition of nominal GDP growth than anticipated. Another contributor to the underestimation of revenue was the fact that the historic levels of nominal GDP used to produce the fiscal projection vintages of October 2015 and April 2016 were significantly lower in absolute terms than indicated in the subsequent revisions by the NSO. In particular, these revisions suggested that the actual corporate tax base for 2016, using gross operating surplus as a proxy, was substantially larger than that factored into the MFIN's forecasting model.

Chart 3: Variances in the Consolidated Fund components, actual compared to the Approved Estimates 2016 (EUR millions)



Source: MFIN

Indirect taxes were likewise €25.9 million above target, mainly on account of higher-than expected revenues collected from duty on documents, which are to a large extent driven by property transactions. Grants recorded in the Consolidated Fund were also €2.9 million higher than shown in the Estimates. Other revenues were €24.7 million above target, primarily as a result of the higher revenues from the IIP, 30% of which are directly channelled into the Consolidated Fund.

In the case of expenditure, overruns in some components were more than compensated for through reductions in other areas. €8.0 million less were spent on personal emoluments compared to the amounted budgeted in the Consolidated Fund. Lower than-planned spending on personal emoluments took place across most votes, with the most notable gap being recorded by the Ministry for Foreign Affairs. In turn, €3.4 million lower interest payments reflected the low interest rate environment. In contrast, other recurrent expenditure (which includes various items such as programmes and initiatives, operations and maintenance expenditure and contributions to Government entities) exceeded the target by €66.7 million. In particular, overruns were noted in relation to health, tourism and education. However, this effect was fully offset by lower capital expenditure, as slower implementation of projects resulted in €66.5 million of the budgeted amount remaining unspent by the end of the year.[9]

4. Developments in the General Government balance during 2016

While the Consolidated Fund provides useful information about the developments in public finances, the assessment of fiscal policy, in relation to the FRA requirements, is based on revenues and expenditure compiled according to the ESA methodology.[10] In 2016, even under the ESA methodology, the outturn for the fiscal balance was better than targeted in April 2016.[11] Similarly, this result was predominantly revenue driven, since revenue exceeded the target by €165.0 million (see Table 2 and Chart 4). At the same time, total expenditure was €1.7 million lower than the budgeted amount. As a result, a fiscal surplus of €101.0 million was recorded, in contrast with the originally planned deficit of €65.7 million.

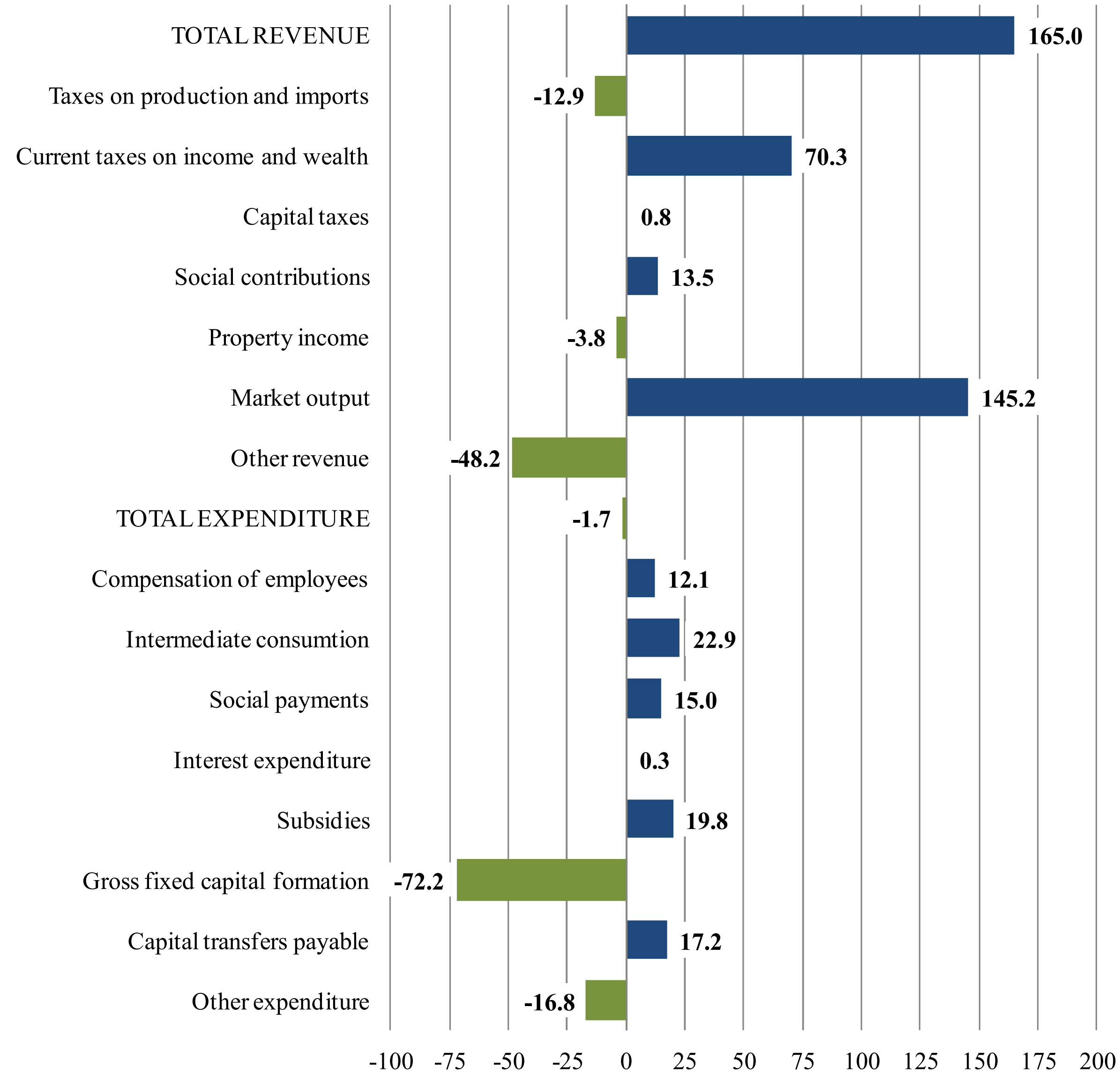
Table 2: Main fiscal developments on an ESA basis in 2016 (EUR million)

	DBP	USP	Actual	Difference wrt DBP	Difference wrt USP
Total revenue	3,602.8	3,706.3	3,871.3	268.5	165.0
Total expenditure	3,704.8	3,771.9	3,770.2	65.4	-1.7
General Government balance	-102.0	-65.7	101.0	203.0	166.7

Source: MFIN

[9] Since the shortfall in capital expenditure related to EU funded projects, the impact on the fiscal balance was limited to the co-financing element.
[10] Among other things the ESA methodology is based on accrual accounting, rather than cash based, and has wider coverage for General Government, including also the activities of Extra-Budgetary Units (EBUs).
[11] The targets for 2016 as prepared in April 2016 were different from those underlying the Budget presented in October 2015, due to updated fiscal information and revised macroeconomic assumptions.

Chart 4: Variances on an ESA basis, actual compared to the Stability Programme 2016 (EUR millions)



Source: MFIN

The higher-than-expected intake from the IIP (which forms part of market output) was the most important factor behind the revenue surplus.[12] In fact, the IIP accounted for almost two-thirds of the €145.2 million additional revenues generated through market output. Specifically, revenue from the IIP was €91.5 million above target. Current taxes on income and wealth, which exceeded the target by €70.3 million, were the other main contributor to the revenue surplus. This reflected prudent projections, a more tax-rich growth, as well as a

[12] Whereas in the case of the Consolidated Fund, only 30% of revenues from the IIP are included, according to the ESA guidelines, the full 100% of IIP revenues are considered as revenue after the finalisation of the application process.

larger tax base than considered in the MFIN's forecasting model at the time of preparing the USP forecasts.[13]

Social contributions also exceeded their target, by €13.5 million. This mirrors the faster growth in compensation of employees when compared to the MFIN's forecasts. Moreover, the intake from 'other revenue' missed its target by €48.2 million, as the absorption of EU funds was slower than anticipated.[14]

On the other hand, total expenditure for the year was practically on target, only €1.7 million short of the amount budgeted for in the USP. There were overruns across many current expenditure components, which were however fully offset by the lower-than-anticipated expenditure on gross fixed capital formation. Indeed, gross fixed capital formation was €72.2 million below target.[15] On the other hand, spending on compensation of employees, intermediate consumption, social payments, interest expenditure and capital transfers payable were all above target.[16]

The broad-based overruns in current expenditure suggest that the targets presented in the USP were rather challenging to achieve. At the same time, some of the surplus revenues generated in 2016 appear to have been channelled into fresh expenditure initiatives. This follows a similar pattern which was observed in previous years. Indeed, over consecutive years, revenues above target appear to coincide with higher-than-planned expenditures, without however missing the target for the fiscal balance (see Chart 5).

The MFAC acknowledges that the MFIN's policy of willingly opting for conservative revenue projections appears sound from a risk management perspective. This practice safeguards against over-optimistic revenue targets which could lead to missing the fiscal balance targets and limits the repercussions in the event of an unanticipated economic downturn in an economy vulnerable to external shocks. At the same time, it is important that expenditure targets strike the right balance between being ambitious, in terms of containment of expenditure growth, but at the same time guaranteeing that the budgets allocated do not need to be subsequently revised upwards to accommodate necessary expenditure for the proper functioning of Government and delivery of public services.

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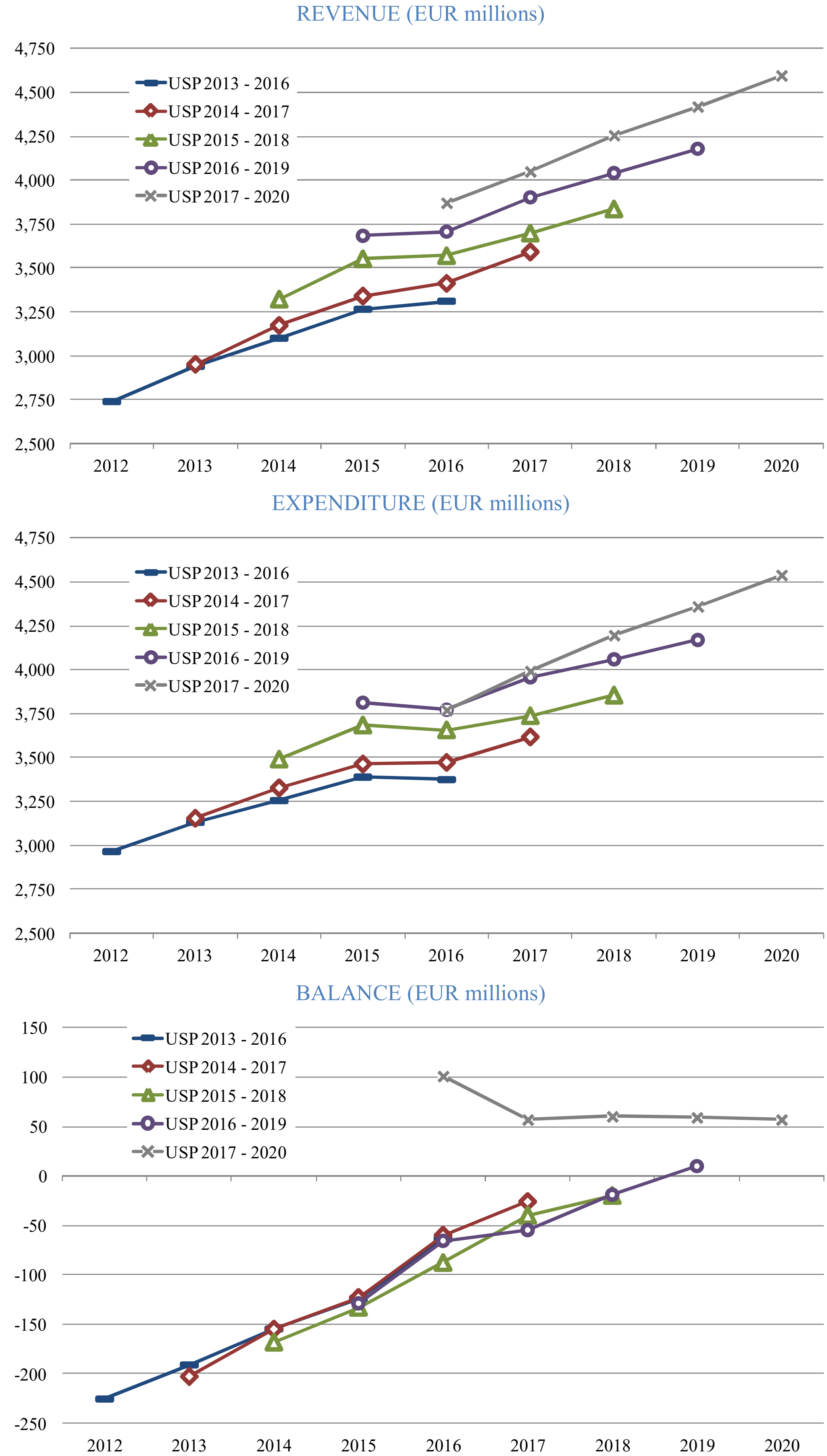
[13] Fiscal forecasting models employ fiscal elasticities applied as a proxy for the tax base which in the case of corporate income tax could include time lags spanning a number of years. Hence, if the tax base is underestimated, this will translate into underestimated forecast tax revenues. In particular, more recent NSO data has shown that previous estimates for gross operating surplus, which is the proxy used for the corporate tax base, was larger than originally indicated in the official statistics.

[14] EU funds are recorded on an accrual basis under the ESA framework whereas grants are recorded on a cash basis in the Consolidated Fund. This explains the divergence between the pattern shown under the Consolidated Fund and that shown under the ESA framework.

[15] This also explains why the MFIN's investment growth forecast in the USP was significantly over-estimated.

[16] This means that the below-target spending on personal emoluments recorded in the Consolidated Fund was offset by higher than expected expenditure by EBUs. The same applies in the case of interest payments.

Chart 5: Revenue, expenditure and balance targets indicated in successive USPs



Source: MFIN

5. Compliance with the budget balance rule and the debt rule

The FRA requires that the Government aims towards the Medium-Term Objective (MTO) – a balanced budget in structural terms by 2019 – and lowers the public debt ratio below the 60% of GDP threshold. To ensure sufficient progress towards the MTO, particularly at a time when the economy was operating above potential, the annual structural adjustment needed to be at least equal to 0.6% of GDP.[17,18] In this respect, the Government targeted a structural adjustment of 0.8% of GDP, in order to reduce the structural deficit to 1.5% of potential GDP (see Table 3).

Table 3: Compliance with the budgetary rule in 2016

	DBP	USP	Actual	Difference wrt DBP	Difference wrt USP
General Government balance (% of GDP)	-1.1	-0.7	1.0	2.1	1.7
Structural balance (% of potential GDP)	-1.5	-1.5	0.2	1.7	1.7
Structural adjustment (pp)	0.5	0.8	2.8	2.3	2.0

Source: MFIN

The fiscal turnout in 2016 was significantly better than targeted, with a surplus equivalent to 1.0% of GDP. After netting out the impact of the cycle and temporary effects, the structural surplus was estimated at 0.2% of GDP.[19] This indicates that in structural terms, the magnitude of the adjustment was 2.8pp compared to 2015, well in excess of the 0.6% requirement. It also means that the country's MTO was achieved in 2016, three years ahead of the plan agreed with the European Commission (COM).[20] Accordingly, the budgetary rule was fully respected.

In turn, the target for the public debt-to-GDP ratio for 2016 was set at 62.6%. However, the actual turnout was 4.3pp lower, that is, 58.3% of GDP (see Table 4). In absolute terms, public debt was €117.5 million lower than projected, almost entirely because of a lower outstanding value of Treasury bills than originally projected. This coincided with the fiscal balance being more positive than originally targeted. The outstanding amount of Malta Government Stocks (MGS) was in line with targets. Furthermore, nominal GDP was €500.2 million higher than forecasted, mainly on account of the revisions in past data. This upward shift in the denominator contributed to lower the debt ratio further, and be within the 60.0% of GDP

[17] Structural adjustment refers to changes in the budget balance net of temporary and cyclical factors.
[18] This formed part of the Country Specific Recommendations addressed to Malta by the European Council on 14 July 2015 and on 13 June 2016.
[19] In 2016, the output gap was expected to be 1.6% but according to the latest estimates by the MFIN this was slightly larger, 2.0%, indicating that the economy operated slightly more above potential than originally expected.
[20] Even according to the COM's forecasts, Malta is expected to maintain its MTO, on the basis of current fiscal plans.

threshold earlier than anticipated. The planned fiscal surpluses over the period 2017 to 2020 are expected to maintain the trajectory for the debt ratio on a downward trend.

Table 4: Developments in the public debt ratio in 2016

	DBP	USP	Actual	Difference wrt DBP	Difference wrt USP
Public debt (EUR millions)	5,857.2	5,884.0	5,766.5	-90.7	-117.5
Nominal GDP (EUR millions)	8,983.4	9,397.8	9,898.0	914.6	500.2
Public debt-to-GDP ratio (%)	65.2	62.6	58.3	-6.9	-4.3

Source: MFIN

6. Conclusion and final recommendations

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

The MFAC notes that the attainment of the fiscal targets is evaluated in ESA terms only with respect to the targets set in the USP. The MFAC understands that the USP targets are more updated compared to the DBP targets. However, the MFAC considers opportune for the MFIN to also evaluate the targets contained in the DBP, that is, the fiscal targets specified on an ESA basis, apart from those of the Consolidated Fund. In this way, the Annual Report would be following more closely the provisions of article 41(2)(a) of the FRA which specifies that the purpose of the Annual Report is "to provide information on the execution of the previous budget". Moreover, the assessment of the fiscal forecasts would be similar to the assessment carried out in relation to the macroeconomic forecasts. This would also identify more clearly the instances when the official fiscal targets are changed from the DBP to the USP.

The MFAC also encourages the MFIN to explore more fully the reasons why certain fiscal targets have been missed or exceeded, in order to draw useful insight, thus improving the forecasting framework in future rounds.

It is also important that the USP provides a reliable medium term anchor, whereby the published revenue and expenditure plans for the next three years are as close as possible to the actual realisations, rather than being consecutively revised.

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