Overall Assessment

Ministry for Finance Half Yearly Report 2017

A report prepared

by the Malta Fiscal Advisory Council

MFAC
MALTA FISCAL ADVISORY COUNCIL

August 2017

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Half-Yearly Report

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31 August 2017

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Minister for Finance
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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 2017 Half-Yearly Report prepared by the Ministry for Finance.

Compared to the latest Update of Stability Programme, the Half-Yearly Report maintained the official macroeconomic forecasts unchanged, while updating slightly the fiscal projections. The Council takes note of the reconfirmed official forecasts for 2017, of 6.3% nominal GDP growth and 4.3% real GDP growth, which it had already endorsed in the assessment report published on 2 May 2017. At the same time, the Council welcomes the updated fiscal targets for 2017, aiming towards a more ambitious fiscal surplus of 0.8% of GDP compared to the surplus of 0.5% of GDP targeted in the Update of Stability Programme and the deficit of 0.5% of GDP indicated in the 2017 Budget. More significantly, the structural fiscal balance is anticipated to end 2017 with a surplus of 0.5% of potential output, against the surplus of 0.2% of potential GDP indicated in the Update of Stability Programme and the deficit of 0.3% of potential GDP projected in the 2017 Budget. Similarly, the public debt-to-GDP ratio of 55.6% being targeted in the Half-Yearly Report is more positive than that indicated in the Update of Stability Programme and particularly so when compared to the 2017 Budget plans. Such a stance is in line with the Council's recommendation for fiscal prudence, facilitating the building up of fiscal buffers at a time when the economy operates above potential.

Provisional statistics published by the National Statistics Office show that, the actual first quarter year-on-year nominal and real GDP growth rates were very close to the latest official forecasts. Although at an expenditure component level there are differences, the Council feels that leaving the macroeconomic forecasts unchanged in the Half-Yearly Report appears justifiable for 2017. Having said this, the Council acknowledges that the information content of the first quarter provisional GDP statistics in relation to the eventual yearly outcome may be somewhat limited, as was the case in previous years, and may also be subject to revisions.

In the Council's view, the fiscal updates introduced in the Half-Yearly Report appear to lead to marginal inconsistencies with the official macroeconomic forecasts presented in the Update of Stability Programme, at a component level. This may apply in particular in the case of Government consumption and gross fixed capital formation. Nevertheless, these inconsistencies are not expected to influence to a relevant extent the macroeconomic outlook for the year. The Council therefore feels that the overall real and nominal GDP growth forecasts for 2017 are still plausible.

In relation to the fiscal projections, the Council considers that, on the basis of the information contained in the Half-Yearly Report, the new targets for both the fiscal balance and the public debt are within its endorsable range. The updated fiscal targets adequately factor the developments in the Consolidated Fund during the first six months of the year, as well as other relevant information, such as the imminent decision by Eurostat on the recording of transactions related to protection funds.

During the first half of the year, progress in the majority of revenue and expenditure components (on an ESA basis) are reasonably close to the 50% benchmark. The Council considers this benchmark to be a useful guidance as an indicative measure of the extent to which revenues and expenditures are moving in line with the annual targets, albeit acknowledging that specific factors might lead to fluctuations across quarters. At the same time, the Council notes that the Half-Yearly Report specifies that other adjustments may be carried out within various recurrent expenditure votes over the remaining months of the year, by which shortfalls would be covered by compensatory savings, aimed at conserving the fiscal balance. The Council is aware that this practice has over many years facilitated the attainment of the fiscal targets. However, the Council recommends that fiscal expenditure allocations safeguard the effective functioning of government and the attainment of the stated policy objectives, apart from attaining the numerical fiscal targets. Moreover, the Council considers important that the Ministry for Finance should remain vigilant to ensure that expenditure targets, which in absolute terms have in many instances been exceeded, are indeed met, allowing for the possibility that any revenues above target are channelled into a better fiscal balance.

The Council considers that the Half-Yearly Report contributes positively to fiscal transparency and accountability. In particular, the Council welcomes the broad and extensive coverage and details provided in the Report. The Council considers that the Report generally meets the requirements prescribed by the Fiscal Responsibility Act. Importantly, the attainment of the fiscal targets would again ensure full compliance with the fiscal rules (specifically those regarding the budget balance and the debt-to-GDP ratio) prescribed by the Fiscal Responsibility Act and the Stability and Growth Pact.

The Council would like to make reference to Article 39(7) of the Fiscal Responsibility Act which specifies that the Half-Yearly Report shall be tabled in Parliament by the end of July of each year. However, in 2017 the Half-Yearly Report was submitted to Parliament on 28 July 2017 but has not yet been tabled, in view of the Parliament's summer recess which started on 20 July. The Council acknowledges that for logistic reasons it may not always be possible for the Minister for Finance to compile and lay on the table of the Parliament this Report in July, depending on the timing of the commencement of the Parliament's summer recess. The Council would therefore like to recommend that consideration would be given to an amendment to Article 39(7) of the Act to take into account such logistic considerations.

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The Council would also like to draw attention to Article 39(8)(h) of the Act which prescribes that the Half-Yearly Report should contain “data on the absorption of European funds, indicating the approved program, the results achieved in the first six months and an updated forecast for the entire year”. While the Report makes some reference to the utilisation of EU funds, noting that the absorption could be less than originally planned in view of slower progress in capital projects, the Council feels that the information provided in this regard falls short of the more precise details being prescribed by the Act. The Ministry is therefore encouraged to provide a more detailed account in this respect in future reports.

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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DIAGRAMS AND BOXES

ABBREVIATIONS

CF	Consolidated Fund
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
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
HYR	Half-Yearly Report
IIP	Individual Investor Programme
IRD	Inland Revenue Department
MFAC	Malta Fiscal Advisory Council
MFIN	Ministry for Finance
MGS	Malta Government Stocks
NAO	National Audit Office
NSO	National Statistics Office
pp	percentage point
SGP	Stability and Growth Pact
USP	Update of Stability Programme

Executive summary

The Half-Yearly Report 2017, prepared by the Ministry for Finance, reviews the macroeconomic and fiscal developments since the presentation of the last Budget in Parliament (Autumn 2016 forecast round) and the submission of the latest Update of Stability Programme / Medium-Term Fiscal Strategy (Spring 2017 forecast round) to the European Commission. The main purpose of the Half-Yearly Report is to assess whether any significant new developments have occurred, which in turn, might necessitate some fine tuning in the announced targets for the fiscal balance and the public debt for the current year.

The forecasts for nominal and real GDP growth in 2017 were both revised slightly upwards in Spring 2017, compared to Autumn 2016, respectively to 6.3% and 4.3%. The revision in the real GDP growth forecast undertaken in Spring 2017 was driven by higher forecast growth for private consumption, government consumption and exports. The Spring 2017 forecast round, maintained domestic demand as the main contributor to growth, but its contribution was reduced. At the same time, the contribution to growth stemming from net exports was revised from negative to positive. This resulted from the reduction in the import growth forecasts, mainly as a result of the downward revision in the forecast for gross fixed capital formation.

The Spring 2017 macroeconomic forecasts were endorsed by the Malta Fiscal Advisory Council in its assessment report which was published on 2 May 2017. The justifications provided for the macroeconomic revisions were considered valid. Recent data, based on the provisional statistics published by the National Statistics Office show that the actual first quarter year-on-year nominal and real GDP growth rates were very close to those indicated in the Spring 2017 forecast round. Although at an expenditure component level there are differences, the Council feels that leaving the macroeconomic forecasts unchanged in the Half-Yearly Report appears justifiable. However, the Council acknowledges that the information content of the first quarter provisional GDP statistics in relation to the eventual yearly outcome may be limited, as was the case in previous years, and may also be subject to revisions.

The Spring macroeconomic forecasts contributed to the revision in the fiscal projections for 2017. Whereas in Autumn 2016, a fiscal deficit of €50.0 million was being targeted, this was converted into a surplus of €57.1 million, in Spring 2017, largely as a result of higher anticipated revenues which more than offset the additional planned expenditures. The Half-Yearly Report updated the targets further, aiming towards a fiscal surplus of €89.0 million for 2017, or 0.8% of GDP. The more ambitious target for the fiscal balance contributed to a comparable reduction in the target for the absolute value of gross debt. Revisions across the various revenue and expenditure forecasts, compared to what was indicated in the Budget are broadly in line with the upside risks which had been identified by the Fiscal Council in its assessment of the Budget forecasts.

On the revenue side, the most significant update presented in the Half-Yearly Report (compared to the information contained in the Update of Stability Programme) related to the increase in the target revenues expected to be generated through the Individual Investor Programme. This upward revision was based on actual developments during the first six months of 2017. On the expenditure front, the main updates related to the further reduction in outlays on gross fixed capital formation by government, on account of the progress in the capital projects underway, and higher capital transfers, on account of the anticipated decision by Eurostat on the statistical recording of transactions undertaken by financial protection schemes and any claims thereof.

The Fiscal Council considers that the fiscal targets contained in the Half-Yearly Report as within its endorsable range. The Council also positively notes that the updated fiscal projections aim towards a higher fiscal surplus than the forecast in the Update of Stability Programme. Such a stance is in line with the Council's recommendation for fiscal prudence at a time when the economy operates above potential. The provisional data for the first six months of the year support the attainment of the more ambitious target for the structural balance, equivalent to 0.5% of potential output. Likewise, the updated target for the debt ratio, at 55.6%, is plausible. The attainment of these targets would again ensure full compliance with the fiscal rules (specifically those regarding the budget balance and the debt-to-GDP ratio) prescribed by the Fiscal Responsibility Act and the Stability and Growth Pact.

The Half-Yearly Report contributes positively to fiscal transparency and accountability. The Council considers that the Report generally meets the requirements prescribed by the Fiscal Responsibility Act. In particular, the Council welcomes the broad and extensive coverage and details provided in the Report. However, the Fiscal Council notes that the recent updates to the fiscal projections when compared to the forecasts contained in the Update of Stability Programme, could present some inconsistencies with the earlier forecasts for GDP at a component level, as the latter remained unchanged compared to what was indicated in the Update of Stability Programme. These inconsistencies should, however, not create a significant impact on the overall economic outlook for the year in terms of GDP growth and their second round impact on fiscal targets is expected to be marginal.

Moreover, the Council would like to make reference to Article 39(7) of the Act, which specifies that such Report shall be tabled in Parliament by the end of July of each year. In 2017, the Report was forwarded to Parliament on 28 July, but has not yet been tabled, in view of the Parliament's summer recess, which started on 20 July. The Council acknowledges that for logistic reasons it may not always be possible for the Minister for Finance to compile and lay on the table of the Parliament the Half-Yearly Report in July, and for this reason, would like to recommend that consideration be given to possible legislative amendments in this respect.

The Council also draws attention to the fact that the Act prescribes that the Report should contain "data on the absorption of European funds, indicating the approved program, the results achieved in the first six months and an updated forecast for the entire year". Whereas the Report makes some reference to the utilisation of European Union funds, noting that the absorption could be less than originally planned in view of slower progress in capital projects, the Council feels that the information provided in the Report in this regard appears to fall short of the more precise details being prescribed by the legislation.

1. Introduction

The Half-Yearly Report (HYR) 2017, prepared by the Ministry for Finance (MFIN), reviews the macroeconomic and fiscal developments since the presentation of the Budget in Parliament, on 17 October 2016, and the submission of the 2017 – 2020 Update of Stability Programme (USP) to the European Commission (COM), on 2 May 2017.[1] The main purpose of the HYR, which is mandated by the Fiscal Responsibility Act (FRA), is to assess whether any significant new developments have occurred, which in turn, might necessitate some corrective measures or fine tuning in the announced targets for the fiscal balance and the public debt for the year underway.[2]

In order to contribute towards greater fiscal transparency, the HYR also presents information to reconcile the Consolidated Fund (CF) balance and the fiscal balance compiled according to the guidelines of the European System of National and Regional Accounts (ESA 2010).[3] In addition, the HYR includes details about the outstanding payments facing the Government, progress in relation to the collection of revenue arrears and an overview of the debt developments.

2. Macroeconomic forecasts for 2017

The HYR 2017 maintained the macroeconomic forecasts unchanged compared to the USP. The USP forecasts are based on more recent information compared to the forecasts which were presented in the Draft Budgetary Plan (DBP).[4] The USP macroeconomic forecasts, which are again reproduced in the HYR, represent the latest available official macroeconomic forecasts for Malta.

The objective of the macroeconomic forecasters is to produce estimates which are as close as possible to the eventual outcome. The cut-off dates are very important since they clarify the vintage of official statistics which are available at the time the macroeconomic forecasts are produced. In this respect, Diagram 1 shows the relevant cut-off dates, and the available statistics published by the National Statistics Office (NSO), in relation to the Autumn 2016 forecasts (which underpinned the Budget 2017), in relation to the Spring 2017 forecasts (presented in the 2017 – 2020 USP), and in relation to the HYR 2017.

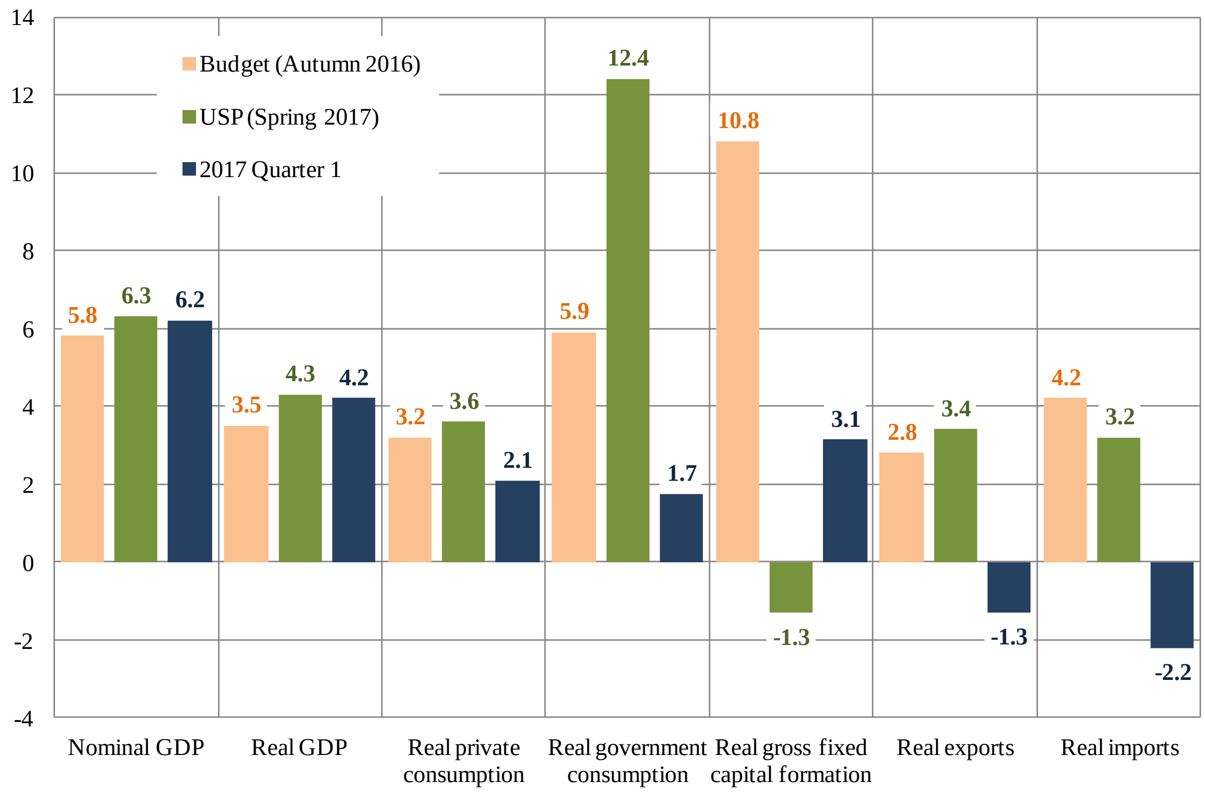
[1] The USP also serves as the Medium-Term Fiscal Strategy for Malta.
[2] The HYR 2017 is the third report since the enactment of the FRA.
[3] All allocations provided from the CF are either authorised by the House of Representatives under an Appropriation Act, or are permanently appropriated by the House under other relevant legislation. While the budget execution is mainly monitored by the MFIN in terms of the CF developments, compliance with fiscal rules is assessed on the basis of fiscal statistics compiled according to the ESA guidelines.
[4] Macroeconomic forecasts are contingent on the information available and the assumptions used at the time of their preparation. These may need to be updated when new information becomes available, or when previous assumptions are updated, or when historical data is revised significantly.

Diagram 1: Macroeconomic forecast vintages, cut-off dates and available statistics

Source: MFIN

The forecasts for nominal and real GDP growth in 2017 were both revised slightly upwards in Spring 2017, compared to Autumn 2016. Specifically, nominal GDP growth was lifted by 0.5 percentage point (pp), from 5.8% to 6.3%, while the real GDP growth rate was raised by 0.8 pp, from 3.5% to 4.3% (see Chart 1).

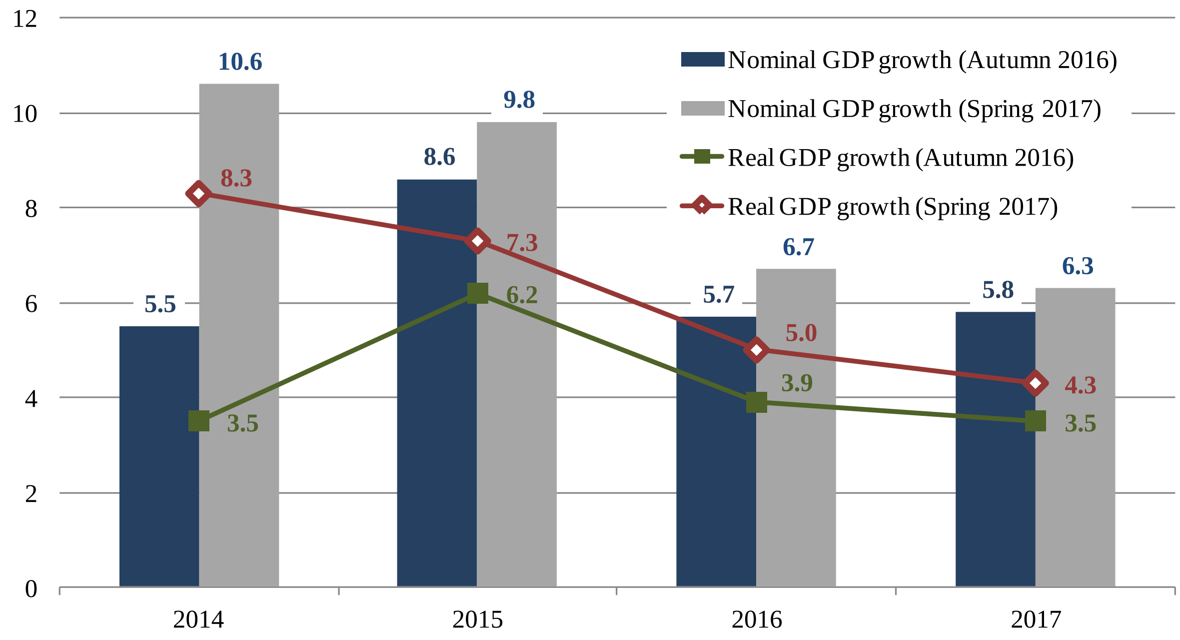
Chart 1: Growth in GDP and its components (y-o-y % change)



* The Budget and USP figures are forecasts while the figures for 2017 Quarter 1 represent actual data.
Source: MFIN, NSO

The upward adjustments which took place from one forecast round to the other follow the significant statistical revisions which were undertaken by the NSO in December 2016.[5] In particular, the NSO revised upwards the historical growth rates for both nominal and real GDP, suggesting that the economy was growing at a faster pace than was originally indicated (see Chart 2).

Chart 2: Nominal and real GDP growth across vintages (y-o-y % change)



Source: MFIN

The upward revision in the real GDP growth forecast undertaken in Spring 2017 was driven by private consumption, government consumption and exports. Specifically, the Spring 2017 forecast round lifted the growth forecast for private consumption by 0.4pp, that for government consumption by 6.5pp, and that for exports by 0.6pp. On the other hand, in the case of gross fixed capital formation, the 10.8% positive real growth forecast indicated in the Autumn 2016 forecasts was revised to a 1.3% decline. The latter is the main factor why the forecast for real imports was also lowered from 4.2% to 3.2% (in Malta's case, gross fixed capital formation tends to have high import content). The main justifications offered by the MFIN in relation to the revisions in the various GDP expenditure components undertaken in the USP 2017 – 2020 are shown in Table 1.

The Autumn 2016 forecast round had anticipated growth in 2017 to be exclusively domestically-driven, with its contribution to growth estimated at 5.4pp. Net exports were seen as contributing negatively to growth, by some 2.0pp. On the other hand, the Spring 2017 round, while maintaining domestic demand as the main contributor to growth, has reduced its contribution to 3.7pp. However, the contribution to growth stemming from net exports was revised to a positive 0.6pp.

[5] Source: NSO News Release 199/2016.

Table 1: Explanations for the revisions in real GDP undertaken in the USP 2017 – 2020

GDP expenditure components	Reasons for the revisions
Private consumption	Better outlook for disposable income, in line with heightened expectations for the labour market and for wage developments
Government consumption	Upward revision in spending on intermediate consumption and compensation of employees, compounded with a base effect created by the elevated revenues derived from the IIP (which according to the ESA methodology is deducted from government consumption)
Gross fixed capital formation	Higher-than-expected private investment in 2016 which created a base effect
Exports	Stronger pick-up in external demand and stronger revenues expected from the IIP (which are recorded as an export of a service)
Imports	Changing composition of domestic demand resulting in lower import intensity on average

Source: MFIN

The macroeconomic forecasts included in the USP 2017 – 2020 were endorsed by the Malta Fiscal Advisory Council (MFAC) in its report published in May 2017.[6] The justifications provided by the MFIN for the macroeconomic revisions were considered valid. Furthermore, recent data, based on the provisional statistics published by the NSO on 8 June 2017, show that, if the pace of growth recorded during the first quarter was to be maintained across the remaining quarters of 2017, then the yearly growth would, under this assumption, be in line with that indicated in the Spring 2017 forecast round.[7] Specifically, during the first quarter of 2017, nominal GDP and real GDP expanded by 6.2% and 4.2% respectively, year-on-year, which growth rates were merely 0.1pp less than indicated in the Spring 2017 forecasts for the full year.

However, at a component level, there are some differences between the first quarter annual real growth rates estimated by the NSO and those indicated for the full year in the Spring 2017 forecast round. In particular, when compared to the Spring forecast round, the first quarter data shows lower growth in private consumption and government consumption, and declines in exports and imports. On the other hand, growth in gross fixed capital formation was higher. This may be a sign of possible downside risks in the former four GDP expenditure components and upside risks in the latter component.

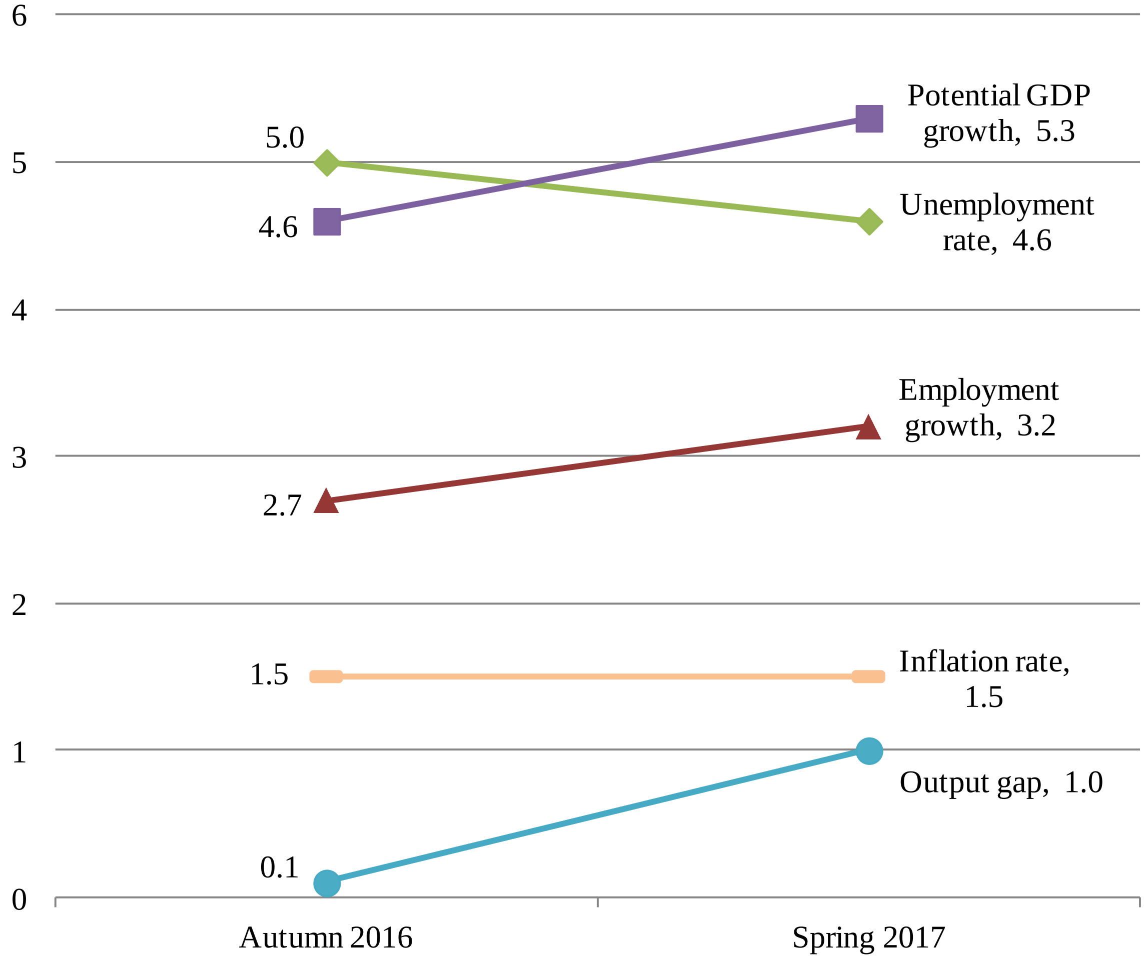
[6] Source: "Assessment of macroeconomic forecasts – Update of Stability Programme 2017 – 2020", available on www.mfac.org.mt.

[7] Source: NSO News Release 093/2017.

However, the MFAC acknowledges that the information content of the first quarter provisional GDP statistics in relation to the eventual yearly outcome may be limited, and may also be subject to revisions. Actual data for the first quarter shows that economy is still growing strongly and that supports the validity of the GDP growth forecast indicated in the USP. Given that the MFAC is not aware of major specific factors warranting an update in macroeconomic forecasts, the MFAC considers that the MFIN's approach of carrying out two macroeconomic forecast rounds to coincide with the Budget and the USP as reasonable. Leaving the macroeconomic forecasts unchanged between the USP and the HYR appears justifiable for 2017.

Apart from revisions to the 2017 forecasts for the various GDP expenditure components, updates were also carried out in the forecasts for other key macroeconomic variables in the Spring round compared to the Autumn round (see Chart 3).

Chart 3: Forecasts for other macroeconomic variables for 2017 (%)



Source: MFIN

Specifically, potential GDP growth was increased from 4.6% in the Autumn 2016 vintage to 5.3% in the Spring 2017 forecast. Nonetheless, the output gap was also increased, from 0.1%

to 1.0% of potential GDP.[8] In turn, the projected employment growth for 2017 was increased by 0.5pp, to 3.2%, while the unemployment rate declined from 5.0% to 4.6%. On the other hand, the inflation rate forecast remained stable at 1.5%. The buoyant labour market conditions and absence of major inflationary pressures corroborate this forecast scenario. Specifically, during the first quarter of 2017, employment increased by 2.8% over the corresponding period of 2016, while annual inflation rate measured according to the Harmonised Index of Consumer Prices (HICP), stood at 1.1% as at May 2017.

3. Fiscal projections for 2017

Although the macroeconomic forecasts remained consistent between SGP and HYR, the fiscal forecasts were re-estimated post USP, based on updated information available to the MFIN. The HYR thus presents updated fiscal targets for 2017. The fiscal updates contained in the HYR are driven by fiscal developments, since the macroeconomic forecasts were not revised post submission of the USP. When compared to the Autumn 2016 forecast round, the fiscal surplus targeted in the HYR reflects upward revisions to revenues, which more than compensated for the additional expenditures. On the basis of the information contained in the HYR, the MFAC considers that the new targets for both the fiscal balance and the public debt to be within its endorsable range.

The Spring macroeconomic forecasts contributed to the revision in the ESA fiscal projections for 2017 which were submitted in the 2017 – 2020 USP, compared to those presented in the Budget. Whereas in Autumn 2016 a fiscal deficit of €50.0 million was being targeted for 2017, the target was converted into a surplus of €57.1 million in Spring 2017 (see Table 2). This also followed the significantly better-than-expected outturn for 2016, where a surplus amounting to €101.0 million was achieved instead of the deficit that had been projected in the 2016 Budget (€102.0 million) and in the 2016-2019 USP (€65.6 million).

The fiscal projections presented in the HYR suggest that the amelioration in the budgetary position is expected to be even stronger than that anticipated in Spring 2017. Indeed, the HYR targets a surplus of €89.0 million for 2017, which is €31.9 million higher than indicated in the USP (see Chart 4). As a result, the fiscal balance-to-GDP target was set at 0.8% in the HYR, compared to the USP's projected surplus of 0.5% and the deficit of 0.5% that had been indicated in the 2017 Budget. The more ambitious target for the fiscal balance is fully reflected in a comparable reduction in the target for the absolute value of gross debt. Whereas in the 2017 Budget, the overall stock of General Government debt was projected to end 2017 at €6,093 million, this target was scaled down by €211.8 million in the USP and by a further €33.2 million in the HYR. In relation to GDP, the gross debt target has been reviewed

[8] A positive output gap indicates that actual GDP exceeds potential GDP whereas a negative output gap denotes that actual GDP falls short of potential. The output gap plays an important role in the assessment of compliance with fiscal rules, since it determines the size of the cyclical element within the budget, which is netted off in order to estimate the structural balance.

downwards from 61.9% in the Budget to 55.9% in the USP and to 55.6% in the HYR.[9] This improvement reflects the combined effect of an upward revision of the projected primary balance and of the expected GDP growth.

Table 2: Fiscal projections for 2017 (EUR millions)

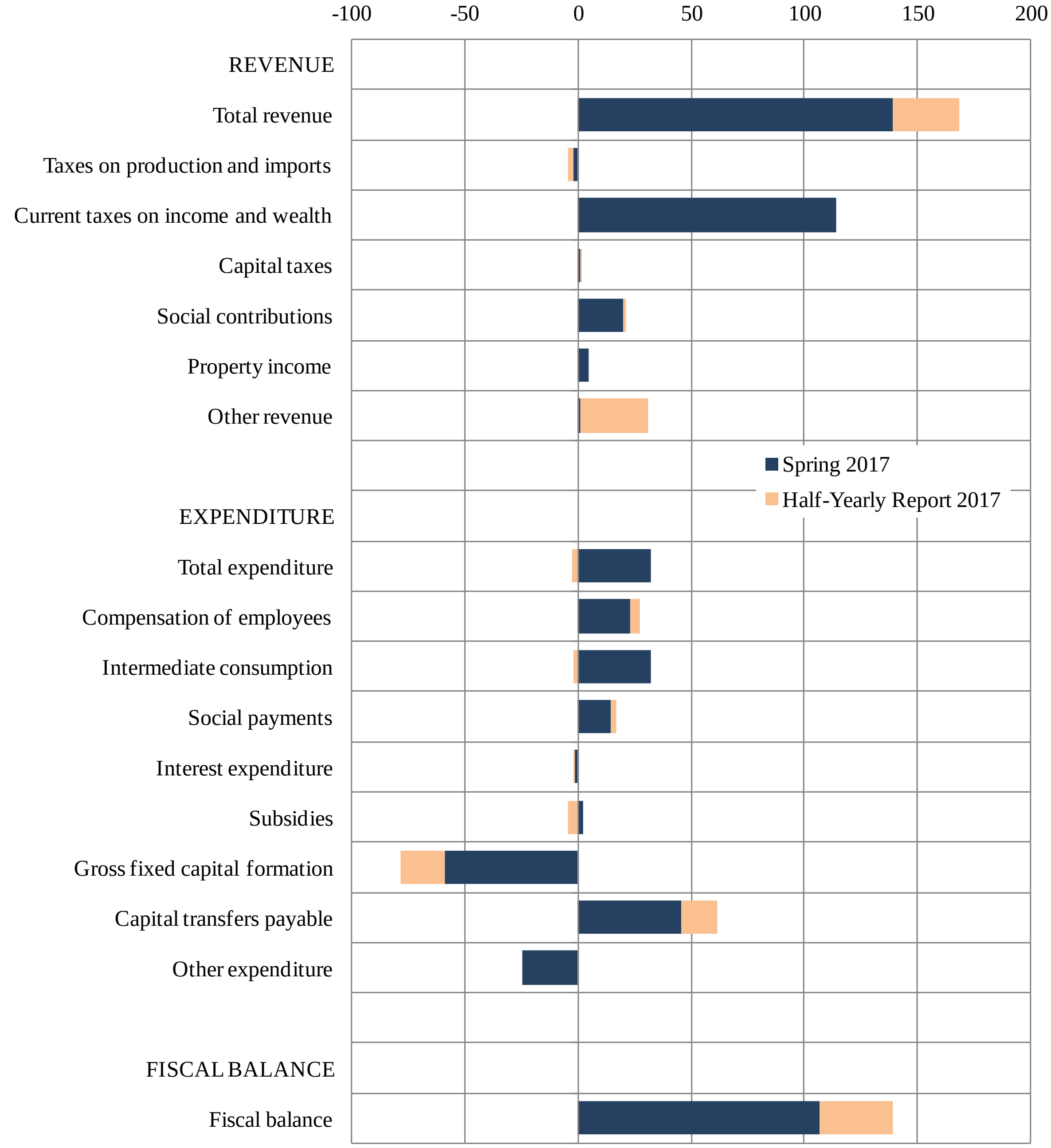
	Autumn 2016 (Budget)	Spring 2017 (USP)	HYR 2017
Total revenue	**3,910.2**	**4,049.7**	**4,078.9**
Taxes on production and imports	1,324.4	1,322.5	1,319.8
Current taxes on income and wealth	1,379.5	1,493.9	1,493.9
Capital taxes	17.2	18.3	18.9
Social contributions	658.5	678.5	679.9
Property income	105.0	109.8	109.8
Other revenue	425.6	426.7	456.7
Total expenditure	**3,960.2**	**3,992.6**	**3,989.9**
Compensation of employees	1,240.8	1,263.6	1,268.4
Intermediate consumption	684.0	716.0	714.0
Social payments	1,096.2	1,110.4	1,112.9
Interest expenditure	207.7	206.6	206.5
Subsidies	112.4	114.8	110.1
Gross fixed capital formation	352.1	293.1	273.4
Capital transfers payable	45.2	90.8	106.7
Other expenditure	221.9	197.3	197.7
Fiscal balance	**-50.0**	**57.1**	**89.0**
% of GDP*	**-0.5%**	**0.5%**	**0.8%**
Gross Debt	**6,093.0**	**5,881.2**	**5,848.0**
% of GDP*	**61.9%**	**55.9%**	**55.6%**

* The figure for nominal GDP is that specified in the respective forecast round. The forecast for nominal GDP in the HYR 2017 is identical to that indicated in Spring 2017.

Source: MFIN

[9] As at end June 2017, the weighted average maturity of Malta Government Stock (MGS), which constitutes the bulk of public debt, stood at 9.3 years, slightly lower than the 9.8 years as at end December 2016. The implicit interest rate on total debt, which in 2016 was around 3.9%, is expected to fall to 3.6% in 2017.

Chart 4: Updates to the Autumn 2016 fiscal projections for 2017 (EUR millions)



Source: MFIN

Changes to the revenue forecasts were mainly related to current taxes on income and wealth. These were increased by €114.4 million in the USP 2017 – 2020 and left unchanged in the HYR 2017. Social contributions were also raised by €20.0 million in the USP and by a further €1.4 million in the HYR. Both revisions are consistent with the upside risk which was identified by the MFAC in its assessment of the Autumn 2016 fiscal projections.[10] The major revenue revision introduced in the HYR related to the 'other' category, which was raised by a further €30.0 million, after having been raised by €1.1 million in the USP. This reflected

[10] Source: "Assessment of the fiscal forecasts for Malta prepared by the Ministry for Finance in October 2016", available on www.mfac.org.mt.

higher anticipated revenues from the Individual Investor Programme (IIP), based on actual developments during the first six months of 2017.

On the expenditure side, the HYR shows that the total change in the forecasts compared to those contained in the Budget amounted to €29.7 million. Even in this case, the bulk of the revisions were undertaken in the USP. Specifically, in the USP, total expenditure was increased by €32.4 million, but was subsequently scaled back by €2.7 million in the HYR. The additional expenditure factored in the USP related to compensation of employees, intermediate consumption and social payments. Even in these cases, these are consistent with the upside risks which the MFAC had identified in its assessment of the projections contained in the DBP.

On the other hand, spending on gross fixed capital formation was revised downwards by €59.0 million in the USP and by a further €19.7 million in the HYR. The total reduction compared to the Budget thus amounted to €78.7 million. These revisions were undertaken to better reflect the slower progress during the year of ongoing capital projects and anticipated disbursements by the end of the year. The lowering of the planned spending on gross fixed capital formation for 2017 follows a similar pattern to what happened in 2016, when investment spending was €72.2 million below the budgeted amount in the USP 2016 – 2019. The variance in capital spending between that indicated in the Budget and the HYR, covers projects which were funded by the EU 2014 – 2020 funding programme, but also includes elements that are not considered as being eligible for EU funding and need to be met out of national funds.

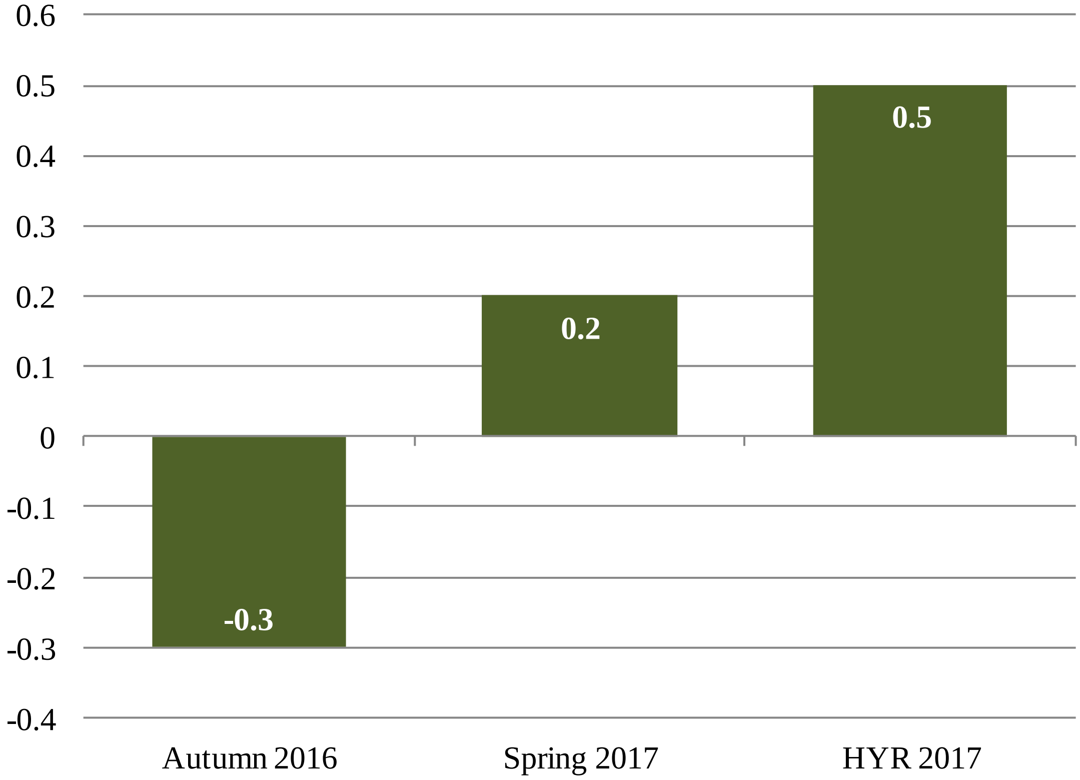
Capital transfers have been adjusted upwards by €45.6 million in the USP and by a further €15.9 million in the HYR. The latter adjustment factors in the anticipated decision by Eurostat, on the statistical recording of transactions undertaken by financial protection schemes (depositor, investor and insurance compensation schemes), and any claims thereof. The statistical impact created by the activities of the Depositor Compensation Scheme (DCS) on general government was estimated at €35 million for 2017. Other expenditure items within capital transfers were however reduced by €19.1 million in the HYR compared to the USP.[11]

The HYR also specifies that other adjustments may be carried out within various recurrent expenditure votes over the remaining months of the year, by which shortfalls would be covered by compensatory savings, aimed at conserving the fiscal balance. This practice has over many years facilitated the attainment of the fiscal targets. However the MFAC recommends that fiscal expenditure allocations safeguard the effective functioning of government and the attainment of the stated policy objectives, apart from attaining the numerical fiscal targets.

[11] This reduction is consistent with the assumption of slower progress of capital projects since some capital transfers represent EU funds transferred to State entities for their capital projects.

Compared to the Autumn 2016 forecasts, the HYR's updated fiscal projections, in conjunction with unchanged USP's macroeconomic forecasts show that the 2017 target for the structural balance has improved progressively. Thus, while the Autumn projections indicated a structural deficit target of 0.3% of potential GDP, this shifted to a structural surplus of 0.2% of potential GDP in Spring 2017 and to a surplus of 0.5% of potential GDP according to the HYR (see Chart 5). The changes to the structural balance target are primarily influenced by the changes to the targets set for the IIP revenues, and some other elements within the budget (not attributed to cyclical developments according to the EU common methodology) rather than any deliberate change in the conduct of fiscal policy.[12]

Chart 5: Targets for the 2017 structural balance (% of potential output)



Source: MFIN

The view of the MFAC is that the updates introduced in the HYR appear to lead to marginal inconsistencies with the macroeconomic forecasts presented in the USP, as the macroeconomic forecasts were not updated. The inconsistencies stem from two main sources. Revenues accruing from the IIP feature as market output by government in the compilation of GDP statistics, which revenues are deducted from the expenditure items making up government consumption, with an equal amount being added to exports. However, the updated IIP revenue target is not accounted for in the macroeconomic forecasts. Furthermore, the latest revisions to gross fixed capital formation and capital transfers indicated in the HYR, suggest that even in this case there could be some marginal inconsistency between the fiscal projections outlined in the HYR and the macroeconomic forecasts presented in the USP, as

[12] Revenues from the IIP are considered as structural in nature since they are not cyclically-adjusted and they are treated as permanent measures.

the latter are based on the previous targets for these two expenditure components. Nevertheless, these small inconsistencies are not expected to influence to a relevant extent the macroeconomic outlook for the year. Their second round effect on the fiscal targets beyond the initial effect as presented in the HYR is consequently also deemed marginal. Growth is still expected to be driven by domestic demand, with small contribution also from net exports, and the overall real and nominal GDP growth forecast for 2017 is still plausible.

4. Fiscal outturn during the first half of 2017

The purpose of the mid-year review is to assess the extent to which the fiscal projections contained in the Budget and in the USP can be fine-tuned on the basis of updated fiscal information. However, while the first quarter of 2017 is based on NSO News Release 109/2017 published on 7 July 2017, data for the second quarter is only provisionally estimated by the MFIN, with the assistance of the NSO. Thus, the assessment of the fiscal outturn for the first half of 2017 should be considered as preliminary, as data might be subject to change. A particular limitation is that accruals data for general government was not fully available by the time the HYR was finalised. As a result, developments in the cash-based CF play a critical role in shaping the MFIN's revised outlook (see Box 1).

Box 1: Consolidated Fund and ESA balances

Monthly fiscal statistics are published by the NSO based on the CF transactions. However, European Union (EU) Council Directive 85/2011, which deals with the requirements on the collection, treatment and dissemination of fiscal data and statistics, prescribes that fiscal data must also be presented in ESA codes.

During the first half of 2017, the ratio of revenues recorded through the CF amounted to 87% of its ESA counterpart, slightly lower than a year earlier, where it stood at 90% (see Table A). In the case of expenditure, the ratios were slightly higher, 94% in 2016 and 95% in 2017. However, at a component level the representativeness of the CF transactions is somewhat limited in relation to subsidies, gross fixed capital formation and capital transfers, where the coverage amounted to 54%, 58% and 30% respectively.

Both the CF and the fiscal figures in accordance with the ESA standards showed an improvement in the fiscal balance during the first half of 2017 compared to a year earlier. However, whereas the CF recorded a reduction in the deficit from €110.6 million in the first half of 2016 to €92.0 million during the first six months of 2017, in ESA terms the outturn was significantly more positive, with an estimated surplus of €66.6 million in the first half of 2017 against a deficit of €41.9 million in the same period of 2016. Indeed, on a net basis, the revenues and expenditures outside the CF framework contributed very positively to the fiscal balance (see Table B). This mainly reflected the operations of Extra-Budgetary Units (EBUs) and the impact of timing adjustments which more than compensated for the effect of amounts owed by the Government.

Table A: Consolidated Fund and ESA balances for January – June (EUR millions)

	2016		2017		2016	2017
	CF	ESA	CF	ESA	% CF/ESA*	
Total revenue	**1,573.3**	**1,753.0**	**1,736.8**	**1,985.1**	**90**	**87**
Taxes on production and imports	573.2	575.2	630.0	613.2	100	103
Current taxes on income and wealth	550.8	649.3	565.3	690.1	85	82
Social contributions	282.5	307.9	317.4	327.7	92	97
Property income	50.0	54.9	50.5	56.7	91	89
Other	116.8	165.7	173.7	297.3	70	58
Total expenditure	**1683.9**	**1,794.8**	**1,828.9**	**1,918.5**	**94**	**95**
Compensation of employees	424.4	590.7	445.7	624.5	72	71
Intermediate consumption	201.6	287.8	203.3	323.6	70	63
Social payments	505.4	540.1	561.6	571.8	94	98
Interest expenditure	108.5	107.6	102.9	102.5	101	100
Subsidies	38.2	56.4	35.2	64.9	68	54
Gross fixed capital formation	48.3	102.3	61.2	105.0	47	58
Capital transfers payable	6.1	38.5	6.2	20.8	16	30
Other	351.4	71.5	412.8	105.5	491	391
Fiscal balance	**-110.6**	**-41.9**	**-92.0**	**66.6**		

*A percentage higher (lower) than 100% indicates that the CF transactions overstate (understate) the amount when compared to the ESA methodology.

Source: MFIN

Table B: Reconciliation between Consolidate Fund and ESA balances (EUR millions)

Consolidated Fund balance as at June 2017	**-92.0**
Surplus of Extra-Budgetary Units (EBUs) including revenues from the IIP not recorded through the Consolidated Fund	107.0
Net effect of time and quarterly adjustments (to allow for the fact that some taxes are not necessarily collected in the same calendar year, and some items may be re-apportioned to alternative quarters over the year)	87.5
Additional net revenues in relations to transactions in the Treasury Clearance Fund	32.2
Surplus in the balances of local	4.4
Net amounts owed by government	-71.7
Other	-0.8
ESA balance as at June 2017	**66.6**

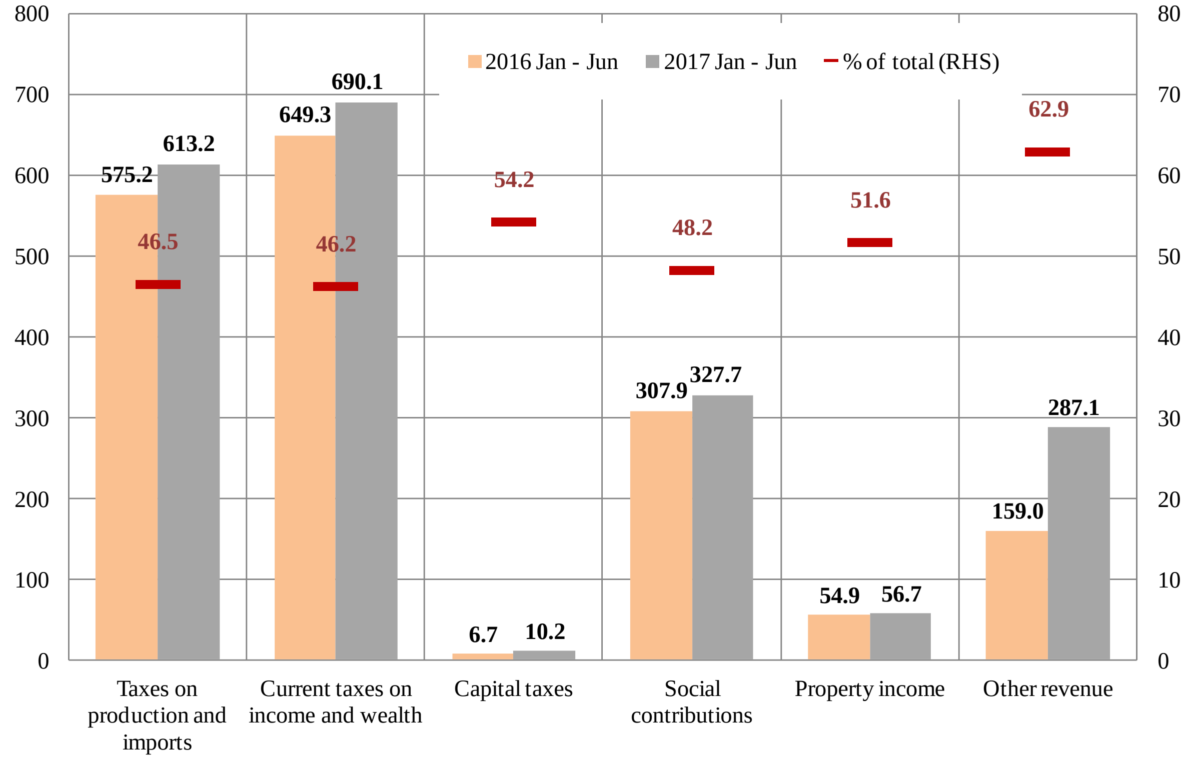
Source: MFIN

The estimated revenue for the first half of 2017, amounting to €1,985.1 million, represents 48.7% of the HYR target for the entire year. Developments across the broad revenue components show that the estimated amounts for the first half of the year are rather close to the 50% benchmark. The MFAC considers this benchmark as useful guidance for both revenues and expenditures, albeit acknowledging that specific factors might lead to fluctuations across quarters.

In the case of taxes on production and imports, current taxes on income and wealth, and social contributions (the three main revenue items), the ratio to the HYR targets stands at

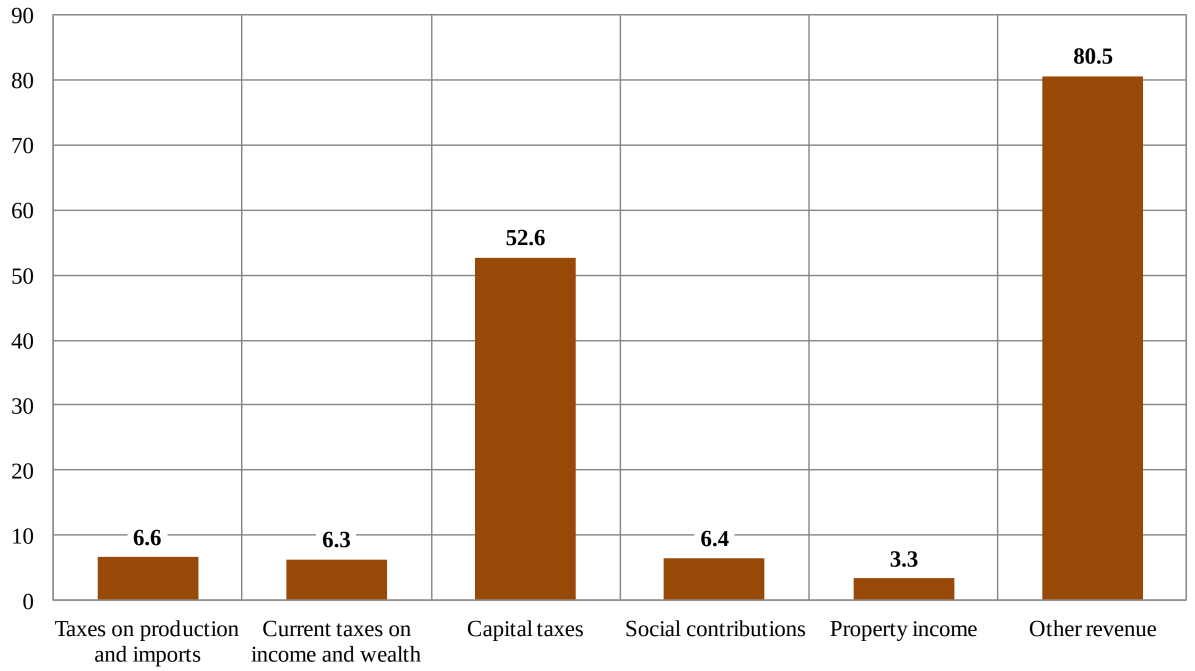
46.5%, 46.2% and 48.2% respectively (see Chart 6). All three components recorded growth rates slightly above 6.0% during the first half of the year (see Chart 7).

Chart 6: Half-yearly revenue developments (EUR millions)



Source: MFIN

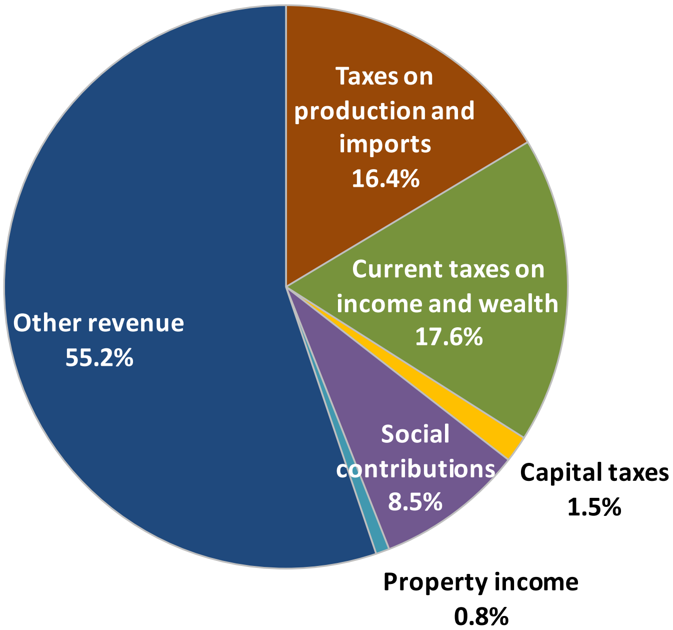
Chart 7: Revenue developments during the first half of 2017 (y-o-y % growth)



Source: MFIN

In the case of the 'other revenue' category, this ratio is higher, at 62.9% of the HYR target. Indeed, this category grew by 80.5% on a year earlier and contributed 55.2% of the entire increase during the first half of 2017, compared to the same period of 2016 (see Chart 8). This mainly reflects the elevated proceeds generated by the IIP.

Chart 8: Contribution to total revenue growth during the first half of 2017 (%)

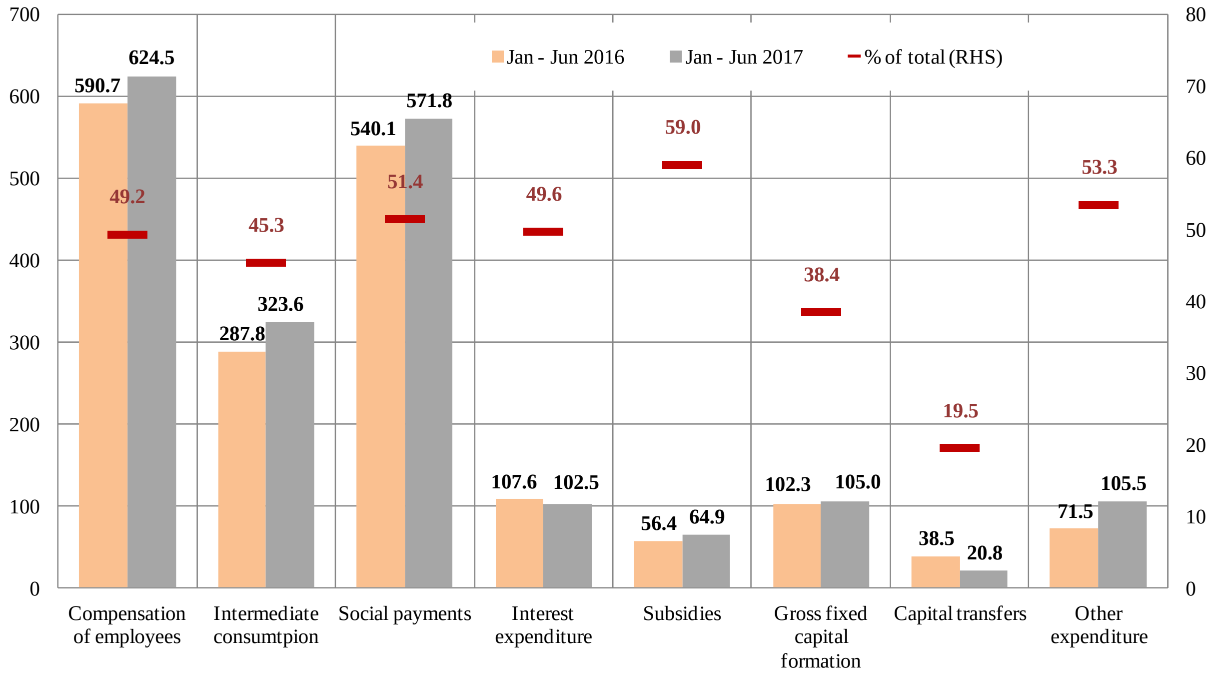


Source: MFIN

Expenditure undertaken during the first half of 2017 represents 48.1% of the HYR target for the full year. Spending is somewhat close to the 50% benchmark across most categories (see Chart 9). The main gap relates to gross fixed capital formation and capital transfers, where expenditure during the first half of 2017 only represented 38.4% and 19.5% respectively of that indicated in the HYR for the entire year. In the case of capital transfers, this is explained by the fact that the HYR factors in an amount equivalent to €35.0 million in anticipation of the before-mentioned Eurostat decision on the statistical recording of financial protection schemes and any claims thereof, which are classified as capital transfers. This adjustment does not feature in the estimated fiscal data for the first half of 2017. Furthermore, the actual drop recorded in the first half of the year stems from the non-repetition of a capital transfer to the national airline which was undertaken in 2016.

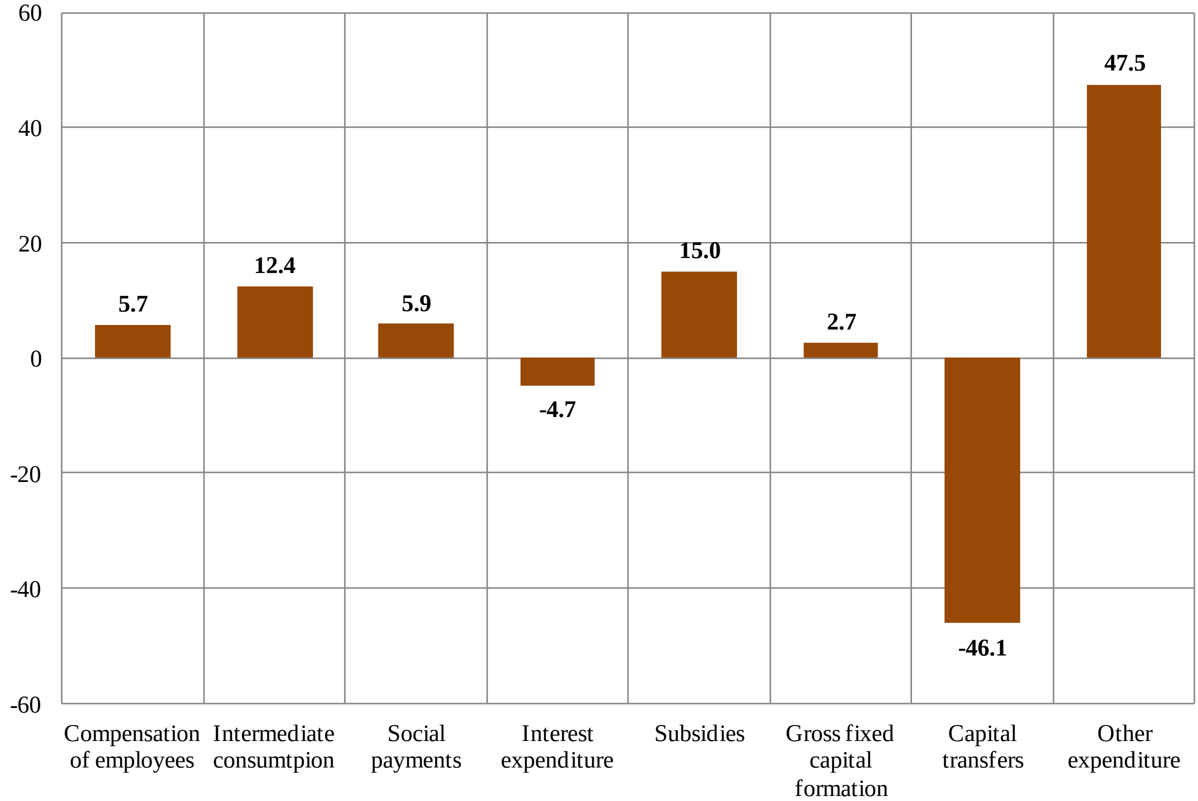
On the other hand, in the case of gross fixed capital formation, despite being 2.7% above that undertaken during the first half of 2016, there appear to be challenges to the utilisation of the full budget indicated in the HYR, notwithstanding that this has been lowered (see Chart 10). Indeed, only 38.4% of the budgeted amounts have been utilised during the first half of the year.

Chart 9: Half-yearly expenditure developments (EUR millions)



Source: MFIN

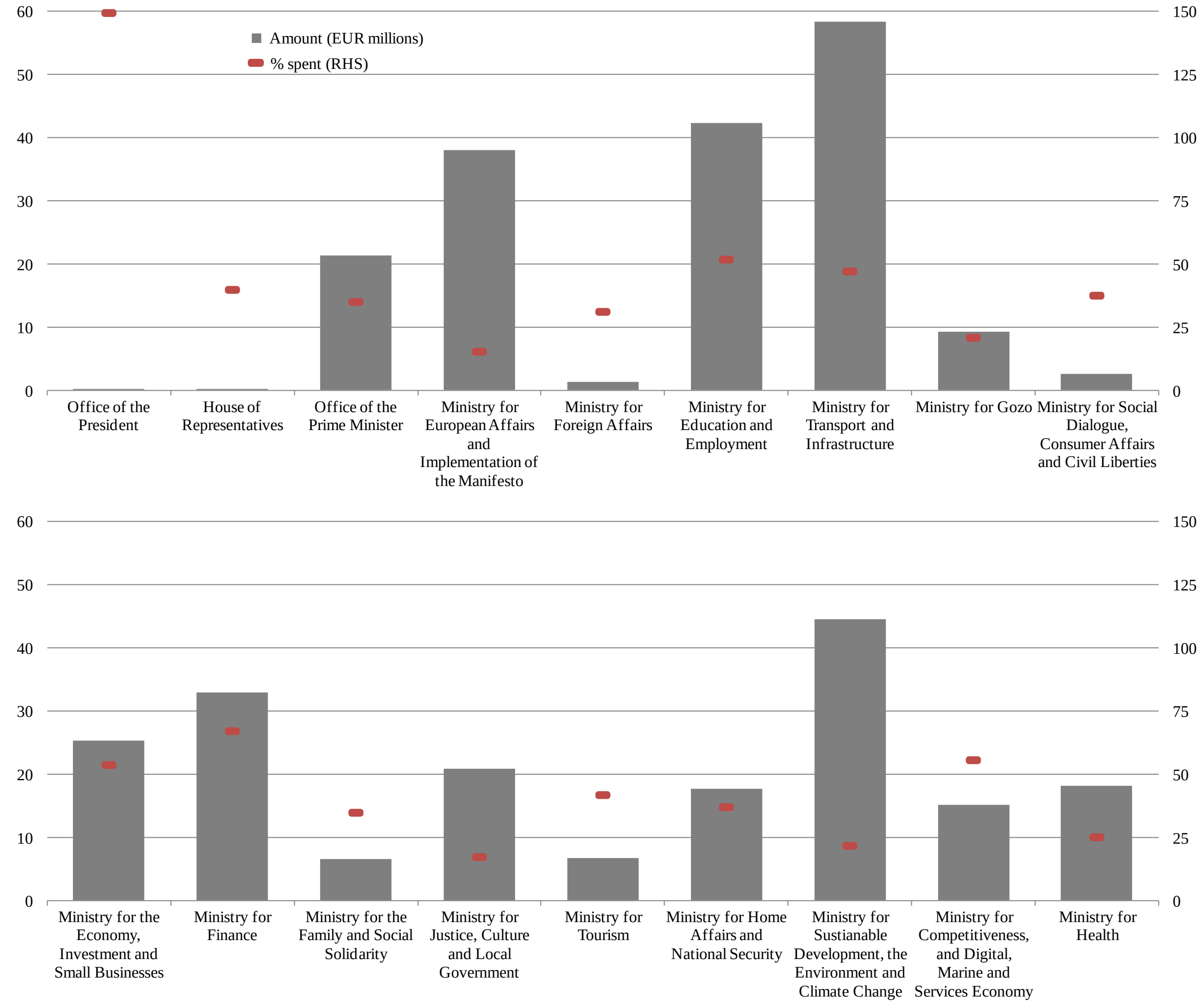
Chart 10: Expenditure developments during the first half of 2017 (y-o-y % growth)



Source: MFIN

CF data shows that across a number of ministries, spending on capital expenditure is progressing rather slower than originally envisaged (see Chart 11). From among the larger capital vote allocations, this applies in particular to the Ministry for European Affairs and Implementation of the Manifesto, the Ministry for Sustainable Development, the Environment and Climate change, and the Ministry for Health, whose capital spending during the first half of 2017 amounted to 15.3%, 21.7% and 25.1% of their end of year target, respectively. On the other hand, from a functional perspective, the various components of recurrent expenditure, as recorded in the CF, are all close to the 50% benchmark (see Chart 12).

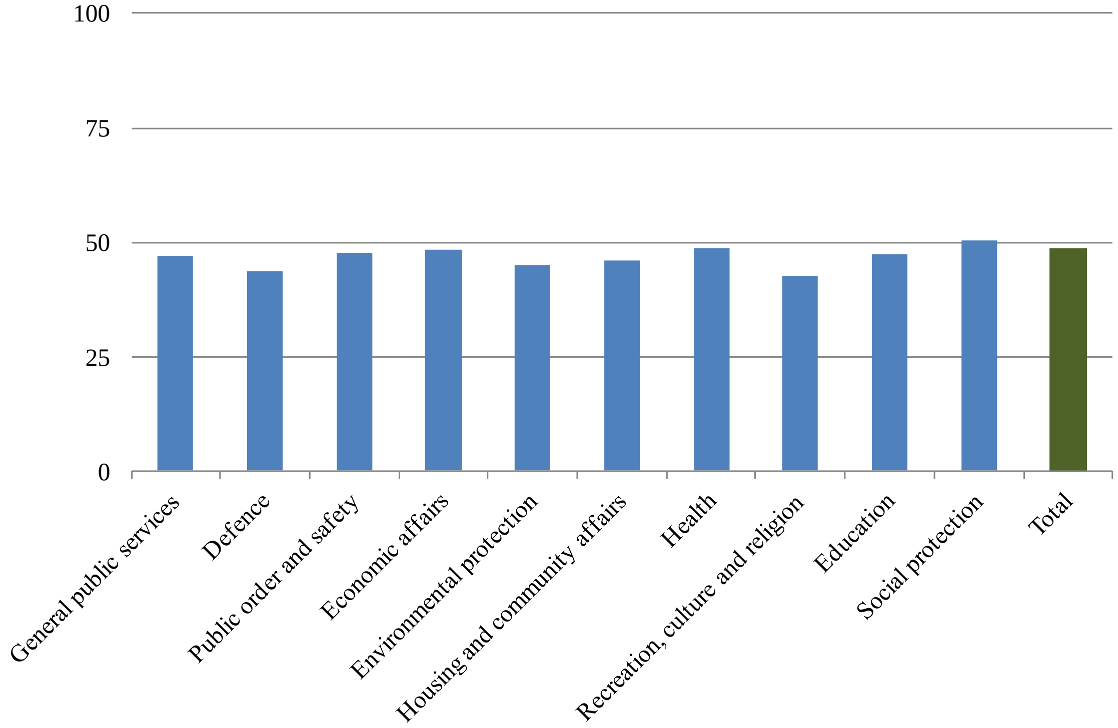
Chart 11: Capital expenditure by Ministry



Source: MFIN

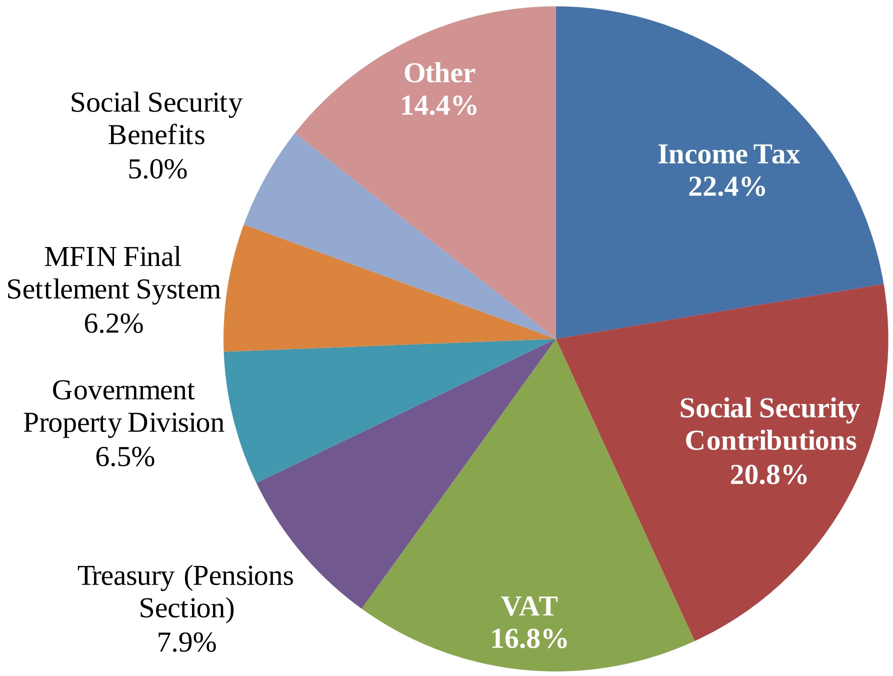
As regards the collection of revenue arrears, this amounted to €35.7 million during the first half of 2017, thus exceeding the target for this period which was set at €21.7 million. The amount collected represented 8.2% of the net collectable amount outstanding as at end 2015. This positive performance was driven by the Inland Revenue Department (IRD), as the arrears collected by the IRD, at €28.6 million, were more than double the target of €11.1 million. This development is positive, particularly when noting that arrears in relation to income tax dominate the outstanding net collectable revenue arrears, with a share of 22.4% of the total (see Chart 13).

Chart 12: Half-yearly recurrent expenditure as % of Approved Estimates



Source: MFIN

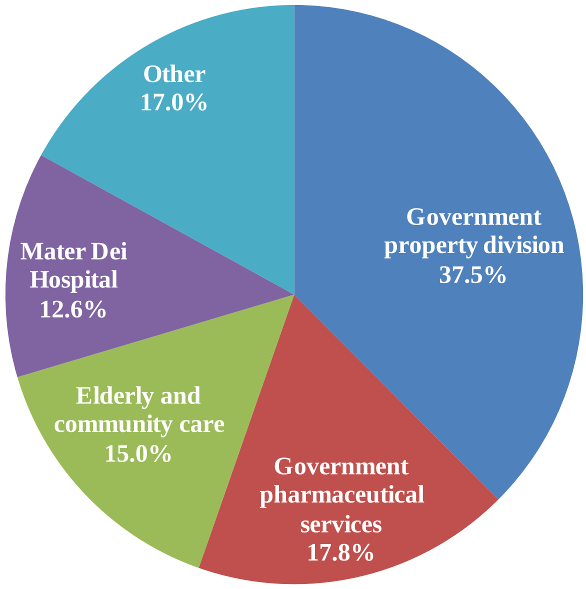
Chart 13: Share of net collectable revenue arrears as at end 2015 (%)



Source: NAO

However, even the amounts owed by the Government to suppliers have also increased between the end of 2016 and the first half of 2017, by €5.8 million. The outstanding dues thus amounted to €120.4 million as at June 2017. Of these, the largest share, 37.5%, related to the Government property division (see Chart 14). Other important areas where payments are still due are mainly related to health, in relation to the Government pharmaceutical services, elderly and community care and the Mater Dei Hospital which respectively accounted for 17.8%, 15.0% and 12.6% of the amounted owed. The MFAC considers important that both revenue arrears and payments due are kept under close control, on one hand to avoid the possibility of non-recoverability, and on the other, not to create cash flow problems particularly for suppliers.

Chart 14: Share of outstanding creditors as at end June 2017 (%)



Source: MFIN

5. Conclusion and final recommendations

The MFAC considers that the HYR broadly meets the requirements of the HYR in terms of its contents.

The MFAC welcomes the broad and extensive coverage and the details provided in the Report. The MFAC also welcomes the fact that the updated fiscal projections aim towards a higher fiscal surplus than indicated in the USP. This is in line with the MFAC recommendation for fiscal prudence at a time when the economy operates above potential. In the opinion of the MFAC, the provisional data for the first six months of the year appears to support the attainment of the more ambitious fiscal targets for 2017, more specifically a fiscal balance of 0.8% of GDP and a positive structural balance amounting to 0.5% of potential output. Likewise, the updated target for the debt ratio, at 55.6%, is plausible. The attainment of these targets would again ensure full compliance with the fiscal rules (budget balance and debt) prescribed by the FRA and the Stability and Growth Pact (SGP).

On the basis of the information contained in the HYR, the MFAC considers that the macroeconomic forecasts (unchanged compared to the USP) and the slightly revised fiscal targets presented in the HYR (compared to those contained in the USP) are within the endorsable range of the MFAC. The MFAC considers important that the MFIN should remain vigilant, to ensure that expenditure targets, which in absolute terms have in many instances been exceeded, are indeed met, allowing for the possibility that any revenues above target are channelled into a better fiscal balance.

However, the MFAC noted that the revised fiscal projections presented in the HYR could present some inconsistencies with the earlier forecasts for GDP at a component level, which remained unchanged compared to what was indicated in the USP. This may apply in particular in the case of Government consumption and gross fixed capital formation. These inconsistencies should however not create a significant impact on the overall economic outlook for the year in terms of GDP growth and second round effects on fiscal targets are expected to be marginal.

Moreover, the MFAC would like to make reference to Article 39(7) of the FRA which specifies that the HYR shall be tabled in Parliament by the end of July of each year. However, in 2017 the HYR was submitted to Parliament on 28 July 2017 but has not yet been tabled, in view of the Parliament's summer recess which started on 20 July. The MFAC acknowledges that for logistic reasons it may not always be possible for the Minister for Finance to compile and lay on the table of the Parliament the HYR in July, depending on the timing of the commencement of the Parliament's summer recess. The MFAC would therefore like to recommend that consideration would be given to an amendment to Article 39(7) of the FRA to take into account such logistic considerations.

Finally, the MFAC would like to draw attention to Article 39(8)(h) of the FRA which prescribes that the HYR should contain "data on the absorption of European funds, indicating the approved program, the results achieved in the first six months and an updated forecast for the entire year". While the HYR makes some reference to the utilisation of EU funds, noting that the absorption could be less than originally planned in view of slower progress in capital projects, the MFAC feels that the information provided in the HYR in this regard falls short of the more precise details being prescribed by the FRA. The MFIN is therefore encouraged to provide a more detailed account in this respect in future reports.

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