An Assessment of the Medium Term Fiscal Strategy 2015-2018, Annual Report 2014 and Half Yearly Report 2015 published by the Ministry for Finance

A report prepared by the
Malta Fiscal Advisory Council

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30 September 2015

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Dear Minister

LETTER OF TRANSMITTAL

In terms of the Fiscal Responsibility Act, 2014 (Cap 534), I have the honour to transmit a report prepared by the Malta Fiscal Advisory Council (MFAC) which evaluates the Government's fiscal strategy and performance, as outlined in the Medium Term Fiscal Strategy 2015-2018, the Annual Report 2014 and the Half-Yearly Report 2015, published by the Ministry for Finance.

The MFAC positively notes the timely publication of these reports, which were prepared for the first time, in accordance with the Fiscal Responsibility Act. The MFAC considers that these reports provide useful information to evaluate the sustainability of public finances and compliance with the Act. The MFAC also positively notes that the Ministry for Finance has given due consideration in its publications to the issues raised by the Council in its previous communications regarding the macroeconomic and fiscal projections published in the Update of the Stability Programme 2015-2018 (USP). With regard to the **Medium Term Fiscal Strategy 2015-2018 (MTFS)**, the MFAC confirms its opinion that the macroeconomic projections and fiscal targets for 2015-2018 appear attainable albeit subject to a number of risks. It is important that the Government remains firmly committed to the planned reduction in the deficit and debt ratios and remains vigilant to ensure that any upside risks to these ratios, as a result of the possibility of a less favourable macroeconomic environment or less effective deficit reducing measures, are rapidly addressed.

The MFAC's opinion is that the planned structural adjustment envisaged for the period 2015-2018 appears to be appropriate on the basis of the projected economic developments and the current debt levels. In view of Malta's obligations under the Stability and Growth Pact, the MFAC encourages the Ministry for Finance that in the course of monitoring macroeconomic conditions, a closer assessment is carried out evaluating the extent to which the economy is operating below or above potential. Such an assessment is important given the direct impact it has on the measured structural balance and structural effort upon which the adherence to the underlying SGP requirements is assessed.

Due consideration should also be given to ensuring that accurate estimates of ageing related costs are maintained, following on the work of the Pensions Strategy Group, as this will contribute to focus constant awareness about this long term challenge such that timely action can be undertaken. The MFAC considers the reforms to foster rationalisation and efficiency in such age-related expenditure programmes as important, so as to ensure the long term sustainability of public finances.

The MFAC welcomes the inclusion in the MTFS of the main assumptions underpinning the fiscal projections, thereby contributing to greater transparency and to a better appraisal of the fiscal forecasts. The MFAC invites the Government to complement such information with additional explanations to further justify these assumptions, thus making it easier to judge the plausibility of such forecasts.

The MFAC also welcomes the inclusion in the MTFS of projected targets for contingent liabilities for the period 2015-2018. The report would benefit from greater transparency if additional explanations about the main drivers of these projected changes were also included. Moreover, the Council encourages the Government to consider the introduction of legislation providing for an appropriate framework governing the monitoring and issuance of Government guarantees, thereby facilitating control and introducing stronger governance.

With regard to the **Annual Report 2014**, the MFAC positively notes that the targets for the fiscal deficit- and public debt-to GDP ratios for 2014 have been met and this, alongside the favourable fiscal outlook for 2015-2016, has enabled Malta to exit from the EU's Excessive Deficit Procedure.

The variances between the projected and recorded revenues and expenditures for 2014 are well detailed in the Annual Report. The MFAC is of the opinion that, although not specified within Article 41 of the Act, explanations with respect to the potential interdependence between variances in the fiscal outturn and macroeconomic forecast errors would be beneficial to better evaluate and communicate about the determinants of the recorded variations.

Moreover, the MFAC notes that part of the variances between the actual and projected revenue and expenditure components, recorded in the report were attributable to the change in methodology used to compile such figures, from ESA95 to ESA 2010. In this respect, the MFAC recommends that when such major methodological changes are implemented, tables could be included to map and quantify the approximate impact of such changes on key indicators, in order to enhance the transparency of the report.

The MFAC also notes that the structural adjustment recorded in 2014 was marginally negative, -0.1% of GDP, against the original target of 0.5% of GDP published in the 2014 USP. Nevertheless, in view that the combined structural effort over the period 2013-2014 amounted to 1.0% of GDP, on the back of a stronger than projected fiscal adjustment in 2013, the view of the MFAC is that, overall, Malta remained on track to attain the Medium Term Objective by 2019 as specified by the calendar of convergence put forward by the Commission.

While the Council considers that the Annual Report 2014 fulfilled the main objectives and tasks stipulated by Article 41 of the Act, the MFAC would like to refer to Article 41(3) which requires that the Report includes a section showing the deviations from the fiscal strategy and the initial annual budget, and presenting justifications for such deviations. Although this form of assessment was undertaken throughout the individual sections of the Report, the MFAC feels that a separate section focusing exclusively on this issue could have benefited the report as a whole.

With regard to the **Half-Yearly Report 2015**, the MFAC notes that the document provides the required detailed comparison between the forecasts presented in the 2015-2018 USP and those contained in the 2015 Budget. On the basis of the macroeconomic outlook presented in the USP and the positive fiscal outturn recorded in the first six months of the year, the MFAC considers that the headline fiscal target ratios for 2015 can reasonably be met.

The MFAC notes that since the cut-off date when the macro projections were prepared for the USP, a new vintage of national accounts data, covering up to the first quarter of 2015, were published. The Report provides a commentary of the main economic developments based on this release but it does not take this information into account to revise the macroeconomic outlook as published in the USP. It is the opinion of the MFAC that the Report could have been more explicit as to the arguments to justify why the macroeconomic forecasts were not revised.

The MFAC appreciates that possible updated macroeconomic projections to incorporate new information based on the national accounts data for the first quarter of the year might not have materially impacted the deficit targets. Nevertheless, the MFAC invites the Government to be more explicit in how it views the latest economic developments in relation to the anticipated trends, in particular whether the latest available data suggests any new upside or downside risks to the macroeconomic and fiscal outlook for the year.

The MFAC welcomes the success in the collection of revenue arrears as indicated by the exceeded targets. Going forward it is important that this momentum is maintained and that all Ministries and entities submit the required information in a timely manner.

With regard to the **compliance with the Act**, the MFAC welcomes the Government's commitment to achieve further progress towards the Medium Term Objective (MTO) of structural balance by 2019, and to gradually lower the public debt ratio to 60% of GDP, in line with the prescribed timetable. In this respect, the MFAC considers that the current conduct of fiscal policy may be considered as conducive to prudent economic and budgetary management.

Initiatives aimed at incentivising work and building human capital are positively viewed by the MFAC as these contribute to raise Malta’s potential output, thereby sustaining rising standards of living. The MFAC also welcomes the Government’s intention to rationalise expenditure where this is feasible, as this would ensure that sufficient resources can be channelled into more productive activities and to support initiatives aimed at protecting the vulnerable segments within society, without endangering sustainability.

On the basis of the information presented by the Ministry for Finance, the MFAC considers that the budget rule is being satisfied. The MFAC's opinion is that the structural adjustment effort as planned by the Government is consistent with the minimum effort required indicated in the EU's Country Specific Recommendations. In this respect, it is important that the consolidation pace remains consistent with these plans. The MFAC also stresses on the importance that possible revenue windfalls are used to bring about fiscal consolidation and are not used to finance undue permanent expenditure commitments.

In conclusion, the MFAC's opinion is that the Government has broadly complied with the requirements of the Act.

Finally, the MFAC would like to express its gratitude for the full collaboration and assistance extended by the various departments during the course of this assessment, particularly the Economic Policy Department within the Ministry for Finance.

Yours sincerely

Rene Saliba
Chairman

c.c. Mr Alfred Camilleri, Permanent Secretary, Ministry for Finance

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Abbreviations

CBM	Central Bank of Malta
COM	European Commission
DG ECFIN	Directorate General for Economic and Financial Affairs
EDP	Excessive Deficit Procedure
EPC	Economic Policy Committee
ESA	European System of National and Regional Accounts
EU	European Union
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
IIP	Individual Investor Programme
MFAC	Malta Fiscal Advisory Council
MTFS	Medium Term Fiscal Strategy
MFIN	Ministry for Finance
MTO	Medium Term Objective
NSO	National Statistics Office
SGP	Stability and Growth Pact
USP	Update of Stability Programme
VAT	Value Added Tax

1. Introduction

The Fiscal Responsibility Act, 2014 (hereinafter referred to as the Act) assigns the responsibility to the Malta Fiscal Advisory Council (MFAC) to assess and offer recommendations on the fiscal strategy in Malta and to evaluate the adherence to fiscal rules. In this respect, the MFAC is presenting a report assessing the economic projections, fiscal developments and adherence to budgetary targets, as outlined in three separate documents published by the Ministry for Finance (MFIN) in recent months, namely, the Medium Term Fiscal Strategy 2015-2018 (June 2015), the Annual Report 2014 (June 2015) and the Half Yearly Report 2015 (July 2015).

The MFAC positively notes the timely publication of these reports which were prepared for the first time in accordance with the Act. These reports contribute to enhanced fiscal transparency, allow for closer public scrutiny of the Government's budgetary activities and help focus attention on sustainability issues. The MFAC also acknowledges the collaboration extended by the various departments and entities in the provision of additional information and explanations, to support the preparation of this report.

This report is structured in different sections focusing on each document separately. Each section introduces the document and provides the MFAC's high level assessment and respective recommendations. The MFAC's evaluation of compliance with the underlying fiscal requirements is presented in the conclusion.

2. The MFAC's opinion on the Medium Term Fiscal Strategy 2015–2018

2.1 Introduction

In April 2015 the Government submitted the Update of Stability Programme 2015–2018 (USP) in accordance with the relevant European Council Regulations, setting out the national medium term fiscal plan.[1] A slightly revised version of this document was also tabled in Parliament in June, titled Medium Term Fiscal Strategy 2015–2018 (MTFS), to comply with Article 15 of the Act.[2] These documents outline the Government's macroeconomic outlook, and how the Government intends to conduct fiscal policy, in particular to ensure that fiscal revenues, expenditures and public debt evolve consistently with fiscal targets and international obligations. The MTFS includes a statement by the Prime Minister and the Minister for Finance attesting to the reliability and completeness of the information in this document as well as compliance with the principles of fiscal responsibility. It also presents the Government's views and responses to the risks which had been identified by the MFAC with regard to the USP, as well as provides further details on contingent liabilities, specific fiscal assumptions and the public investment programme.

[1] The report is available on http://ec.europa.eu/europe2020/pdf/csr2015/sp2015_malta_en.pdf
[2] The report is available on http://www.parlament.mt/paperslaiddetails?id=24470&l=1

2.2 High level assessment

In terms of Article 13 of the Act, in April 2015 the MFAC published its assessment of the Government's macroeconomic forecasts for 2015-2018, stating that in its opinion the headline GDP forecasts (both in nominal and real terms) presented by the MFIN were indeed achievable (see Table 1).[3]

Table 1: Key indicators – Update of Stability Programme 2015 - 2018

	Actual	Forecast			
	2014	**2015**	**2016**	**2017**	**2018**
	Growth (%)				
Nominal GDP	5.2	4.7	5.2	5.2	5.4
Real GDP*	3.5	3.4	3.1	2.8	2.8
of which:					
Gross fixed capital formation	14	23.6	13.1	-2.8	0.2
Government consumption expenditure	7.3	0.6	1.2	0.5	0.5
	Percentages of GDP				
General Government fiscal balance	-2.1	-1.6	-1.1	-0.6	-0.2
Gross debt	68.0	66.8	65.6	63.8	61.2
Total revenue	41.7	42.6	40.6	39.9	39.4
Total expenditure	43.8	44.2	41.7	40.5	39.6
of which:					
Compensation of employees	13.2	13.0	12.8	12.6	12.3
Intermediate consumption	6.6	6.8	6.5	6.3	5.9
Social payments	12.7	12.5	12.1	11.9	11.7
Gross fixed capital formation	3.8	4.1	3.2	3.1	3.0
*At chain linked volumes by year (reference year 2010)					
Source: Update of Stability Programme 2015-2018					

The Council however had noted that while the projected economic growth for 2015 was in line with the forecasts presented by other institutions, particularly by the European Commission (COM) and by the Central Bank of Malta (CBM), the MFIN's growth forecast for 2016, at 3.1% was marginally more optimistic than the growth projected by the other two institutions (CBM: 2.8%; COM: 2.9%).[4]

[3] The report is available on http://mfac.gov.mt/en/publications/Pages/Publications.aspx

[4] Refer to the European Commission Winter 2015 Forecast and the Central Bank of Malta Annual Report 2014 available on the respective institutions' websites.

The Council had underlined that the economic outturn for 2015 and 2016 depended critically on the projected developments in final domestic demand, especially a scenario of buoyant gross fixed capital formation, driven by a number of large public and private investment projects, which the MFIN embedded in its forecasts. High investment was contingent on the assumed absorption of EU funds and rapid progress in energy-related projects, which factors the MFAC viewed as posing downside risks to the yearly growth forecast.

In May 2015 the MFAC then published its assessment of the fiscal forecasts for 2015-2018, stating that even in this case the targets appeared to be attainable.[5] It was positively noted that in 2015, fiscal consolidation was not relying on cyclical factors and one-off and other temporary measures to the same extent as in 2014. Though the fiscal projections were rather similar to the forecasts presented by the COM and the CBM, these two institutions anticipated a more gradual consolidation process.

On the revenue side, the MFAC concluded that there were no significant risks attached to the main tax items, noting a general element of prudence in certain instances. Residual uncertainty surrounded the expected impact of measures to combat tax evasion and avoidance.

The MFAC acknowledged that the Comprehensive Spending Review being carried out by the MFIN could result in expenditure savings (see Box 1). However when considering previous years' patterns, the Council identified risks of possible slippages, particularly on outlays relating to compensation of employees and intermediate consumption. An issue of further concern is the magnitude of the deficit-reducing measures within the social payments category which is factored into the forecasts.

The challenges pertaining to the attainment of the deficit target transposed onto similar upside risks to the debt projections. The MFAC's assessment had thus concluded that close monitoring by the authorities was warranted to identify and correct any deviations from the projections in a timely manner.

[5] The report is available on http://mfac.gov.mt/en/publications/Pages/Publications.aspx

Box 1: The Comprehensive Spending Review

The Comprehensive Spending Review (CSR) being carried out by the MFIN consists of a line-by-line analysis of each Ministry's expenditure inputs and outputs in order to determine the effective cost of government's activities. The objective is to prioritise expenditure and identify areas where savings can be attained. By establishing an output for each line of expenditure or input, the Government will be able to assess each expenditure item in terms of its contribution to the promotion of the public interest on a cost effective basis.

The CSR was launched in 2014 as part of the Government's medium term budget framework and was targeted on programmes and initiatives in all Ministries. The MFIN intends to conduct in-depth CSRs with respect to the various Ministries. To date, the MFIN has finalised the CSR for the Ministry for Family and Social Solidarity and is in the process of completing the CSR for the health sector.

The MFAC views such initiatives positively and invites the Government to act on the areas where potential expenditure savings are identified.

The MFAC positively notes that based on the assessment of Malta's 2015 USP, the COM issued a recommendation to the European Council to abrogate the decision on the existence of an excessive deficit in Malta.[6] On 19 June 2015 the European Council closed the Excessive Deficit Procedure (EDP) for Malta, confirming that the country had reduced the deficit below the 3% of GDP reference value.[7] Indeed in 2014 the deficit-to-GDP ratio was reported at 2.1%, well below the 2.7% target which had originally been set by the COM in its recommendation dated 21 June 2013.

The public debt ratio likewise embarked on a downward trend, falling from 69.2% of GDP in 2013 to 68.0% in 2014. This ratio was forecast to head further downwards to 65.6% by 2016, thereby complying with the forward looking "debt rule", which requires a steady convergence to the 60% debt-to-GDP threshold (see Box 2). Since the outstanding public debt ratio still exceeds this limit, Malta needs to maintain a downward trajectory to approach this ceiling at a satisfactory pace.

[6] For further details refer to http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-12_commission/2015-05-13_mt_126-12_commission_en.pdf

[7] For further details refer to http://www.consilium.europa.eu/en/press/press-releases/2015/06/19-malta-poland-deficits-back-below-three-percent-gdp/

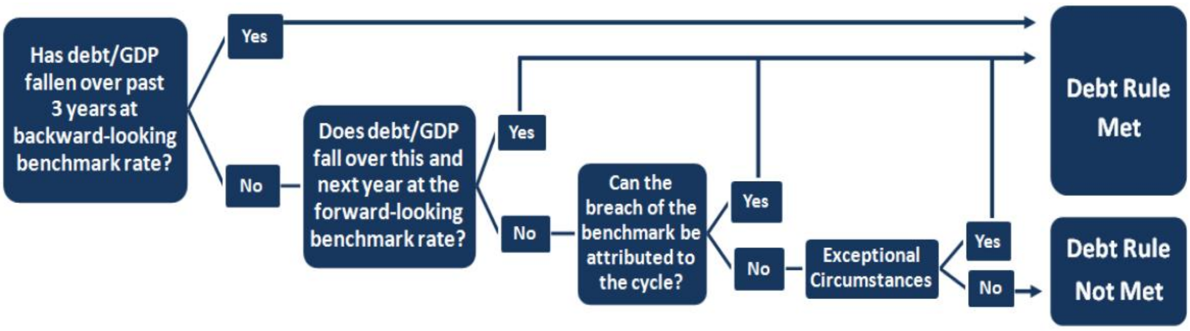
Box 2: The debt rule

The SGP debt criterion is part of the corrective arm of the SGP, alongside the 3 per cent of GDP deficit criterion. A country whose public debt-to-GDP ratio exceeds the 60% threshold must converge to this limit at a satisfactory pace. The definition of a 'satisfactory pace' was specified within the so-called 'six pack' regulations of the EU which entered into force in 2011. In the case of Malta, the debt rule is transposed into national legislation through Article 9 of the FRA.

A country can satisfy this debt rule if at least one of three different conditions, as outlined below, are met.

- The debt rule may be satisfied if the disparity between the actual debt-to-GDP ratio and the 60% benchmark has diminished at a minimum average rate of 5% (one-twentieth per year) over the past 3 years. This is referred to as the **backward looking benchmark**.
- Alternatively, convergence can be evaluated in terms of a forward looking assessment, termed the **forward-looking benchmark**, by looking at the debt-to-GDP trajectory over a 3 year period, covering years t+1, t and t-1.
- If neither criterion is satisfied, an assessment is carried out to determine whether this is due to **cyclical conditions** or **anomalistic circumstances**, in which case the country would also not be deemed to be in breach of the debt rule.

These conditions apply sequentially, implying that the requirement under the debt rule is based on the least demanding of the conditions at any point in time, as shown in the diagram below:



Source: The diagram is reproduced from http://www.fiscalcouncil.ie/wp-content/uploads/2014/06/AN-5.pdf

On the basis of the projections included in the USP, Malta has satisfied the forward looking debt rule in 2014 because the debt-to-GDP ratio is expected to decline further at a satisfactory pace in the period 2015-2016. Indeed both the MFIN and the COM expect the debt reduction benchmark to be met with a margin above 2 percentage points in both 2015 and 2016.

The MTO and the adjustment path necessary to achieve it constitute the 'budget rule' which is enshrined in Article 8 of the Act. Article 8 also contemplates exceptional circumstances as defined by the SGP which can justify a temporary suspension of this rule provided that it does not endanger fiscal sustainability in the medium term. Specifically, exceptional circumstances refer to unusual events beyond the control of the Member State concerned and that have a major financial impact on the government budget, or else to periods of severe economic downturn for the euro area or EU as a whole. According to the Country Specific Recommendations addressed to Malta by the COM, the structural adjustment, that is, the required improvement in the fiscal balance net of cyclical, temporary and one-off factors, must be at least 0.6% of GDP per year in 2015 and in 2016.[8] This is necessary to enable sufficient progress towards the country's Medium Term Objective (MTO) and depends on the fact that Malta's economy is deemed to have a positive output gap (see Box 3).[9] The MTO is a budgetary target assigned to each EU Member State in order to keep governments on track towards meeting their commitments to pursue sound fiscal policies and ensure a healthy underlying budgetary position over the economic cycle. In the case of Malta, the MTO is a balanced budgetary position in structural terms by 2019. The USP and the MTFS 2015-2018 envisage a structural adjustment of 0.7 percentage points (pp) and 0.8 pp of GDP for 2015 and 2016, respectively (recalculated as 0.8 pp and 0.9 pp by the COM).[10] For 2017 and 2018 the fiscal adjustment is forecast by the USP and MTFS at 0.7 pp and 0.4 pp, respectively, thereby anticipated to comply with the requirement of 0.6 pp average yearly adjustment for the whole period 2015–2018, albeit reporting a shortfall in 2018 (see Table 2).

Table 2: Structural adjustment according to Update of Stability Programme 2015-2018

	2014	2015	2016	2017	2018
	Percentage Points of GDP				
General Government balance	-2.1	-1.6	-1.1	-0.6	-0.2
One-off and other temporary measures	0.3	0.1	0.1	0.1	0.1
General Government balance net of One-offs	-2.4	-1.7	-1.1	-0.6	-0.3
Output Gap estimates	0.5	0.5	0.0	-0.3	-0.4
Cyclically-Adjusted Budget balance	-2.3	-1.8	-1.0	-0.4	0.0
Structural balance	-2.7	-2.0	-1.1	-0.5	-0.1
Structural adjustment	-0.1	0.7	0.8	0.7	0.4
Source: Update of Stability Programme 2015-2018					

[8] Source: http://ec.europa.eu/europe2020/pdf/csr2015/csr2015_council_malta_en.pdf
[9] A positive output gap represents situations when the actual growth exceeds potential growth, whereas a negative output gap is when actual growth is less than potential.
[10] The COM has recalculated the structural adjustment at 0.8pp and 0.9pp for 2015 and 2016 respectively.

Box 3: The required structural effort

Fiscal consolidation efforts have enabled Malta to exit from the Excessive Deficit Procedure (EDP) under the corrective arm of the Stability and Growth Pact (SGP) in June 2015. As part of the preventive arm of the SGP, Malta must now reach its Medium Term Objective (MTO). Article 5 of Regulation (EU) No 1175/2011 stipulates that a Member State following a fiscal adjustment path towards its MTO should achieve an annual improvement of its general government fiscal balance measured in structural terms (that is the cyclically-adjusted balance, net of one-off or other temporary measures). For Member States whose debt ratio is below 60% of GDP and are not facing sustainability risks, the annual structural effort in normal times has to be at least equivalent to 0.5% of GDP, which is the set benchmark rate. With respect to Member States that are not yet at their MTO and whose debt level is greater than 60% of GDP or which face sustainability risks, the European Council may consider whether the structural effort needed should be higher than the 0.5% benchmark. Indeed, the required structural adjustment is contingent upon the economic conditions of the Member State, based on output gap estimates, that is, the difference between the level of actual and potential output expressed in percentage points in terms of the potential output. The structural effort should be higher in 'good' economic times and lower in 'bad' economic times. This implies that the larger the positive (negative) output gap, the greater (lower) the required fiscal adjustment effort.

In this respect the European Council recommended that Malta should realise a structural adjustment of 0.6% of GDP in 2015 and 2016. The higher required effort is determined by the fact that Malta has a debt level higher than 60% of GDP and the country is considered to be in 'normal times' (the shaded cell in the Table below).

		Required annual fiscal adjustment*	
	Condition **(figures in pp of GDP**	Debt below 60 % and no sustainability risk	Debt above 60% or sustainability risk
Exceptionally bad times	Real Growth < 0 or output gap <-4	No adjustment needed	
Very bad times	- 4 ≤ output gap < - 3	0	0.25
Bad times	- 3 ≤ output gap < -1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1.5 ≤ output gap < 1.5	0.5	> 0.5
Good times	Output gap ≥ 1.5	> 0.5 if growth below potential, ≥ 0.75 if growth above potential	≥ 0.75 if growth below potential, ≥ 1 if growth above potential

The Table is reproduced from a document 'Making the best use of flexibility within the existing rules of the Stability and Growth Pact', available on http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf

The COM's calculations with regard to the structural adjustment are more conservative. The expected improvement in the structural balance in 2015 according to the COM amounts to 0.5% of GDP, falling marginally short of the 0.6% requirement while in 2016 the structural adjustment is expected to be equivalent to the required level of 0.6% (see Table 3).

Table 3: Estimates of COM and USP regarding compliance with the structural and expenditure benchmarks

	2015		2016	
	USP	**COM**	**USP**	**COM**
	% of GDP			
Structural balance (COM)	-2.1		-1.6	
Structural balance pillar:				
Required adjustment (COM)	0.6		0.6	
Change in structural balance compared to year t-1	0.8	0.5	0.9	0.6
One-year deviation from the required adjustment	0.2	-0.1	0.3	0.0
Expenditure benchmark pillar:				
Applicable reference rate (COM)	0.3		1.3	
One-year deviation	0.0	-1.5	-0.2	-0.1
Source: Assessment of the 2015 Stability Programme for Malta (DG ECFIN)				

The USP and MTFS anticipate that government expenditure, calculated as per relevant EU guidelines, will be contained to an annual average growth of 3% between 2015 and 2018. However it is worth noting that according to the COM's estimates, the growth rate of government expenditure (as per EU guidelines) may exceed the expenditure benchmark set by the COM during both 2015 and 2016 (see Table 3 and Box 4). In this context, however, it is relevant to note that in accordance with Article 5(1) of Regulation EC 1466/97, sufficient progress towards the MTO shall be evaluated on the basis of an overall assessment. In its assessment of the USP, the COM acknowledged that a series of assumptions, such as in relation to the future potential growth rate and the permanent or temporary nature of revenue measures, conditioned the applicable expenditure reference value. In particular, the COM considered, in this specific case, the structural adjustment measure to be superior to the expenditure benchmark as a yardstick to assess effective action since the latter is based on a potential growth rate of 1.8% whereas the former is based on more realistic higher potential output growth projections which reflect better the recent strengthening of economic activity in Malta. As a result, the COM concluded that no significant deviation has been identified for Malta but rather the country "is expected to be at risk of some deviation from the adjustment path towards the MTO in 2015" (see Box 5)

Box 4: The expenditure benchmark

The expenditure benchmark rule serves as a tool for governments to control their expenditure (appropriately defined) and sustain progress towards the MTO or maintain the MTO itself. Article 5 of Regulation (EU) No 1466/97 as amended in Regulation (EU) No 1175/2011 introduced the concept of expenditure caps by establishing a reference value for expenditure growth dependent on potential GDP growth, with the requirement that any excess is matched by discretionary revenue measures. Since Malta is on the path towards its MTO, the country is also subject to an additional convergence margin, which implies that expenditure growth must actually be restricted to below potential growth.

The reference expenditure growth rate is calculated by the COM and established on the basis of 10-year potential GDP growth rates, comprising both a backward element, ranging from years t-5 to t-1, and forward-looking element, covering years t, to t+4. The medium term rate is subsequently revised every 3 years by the COM.

The expenditure rule does not apply to total expenditure but rather should exclude cyclical unemployment spending, interest expenditure and expenditure on EU programmes that are fully-matched by EU funds revenue. Further adjustment relates to investment which is aggregated over a 4-year period, owing to the volatile nature of this expenditure component.

Box 5: '*Significant deviation*' from the Medium Term Objective (MTO)

For Member States that have not yet reached their MTO, Article 6(3) of Regulation EC 1466/97 defines a significant deviation as a departure of:

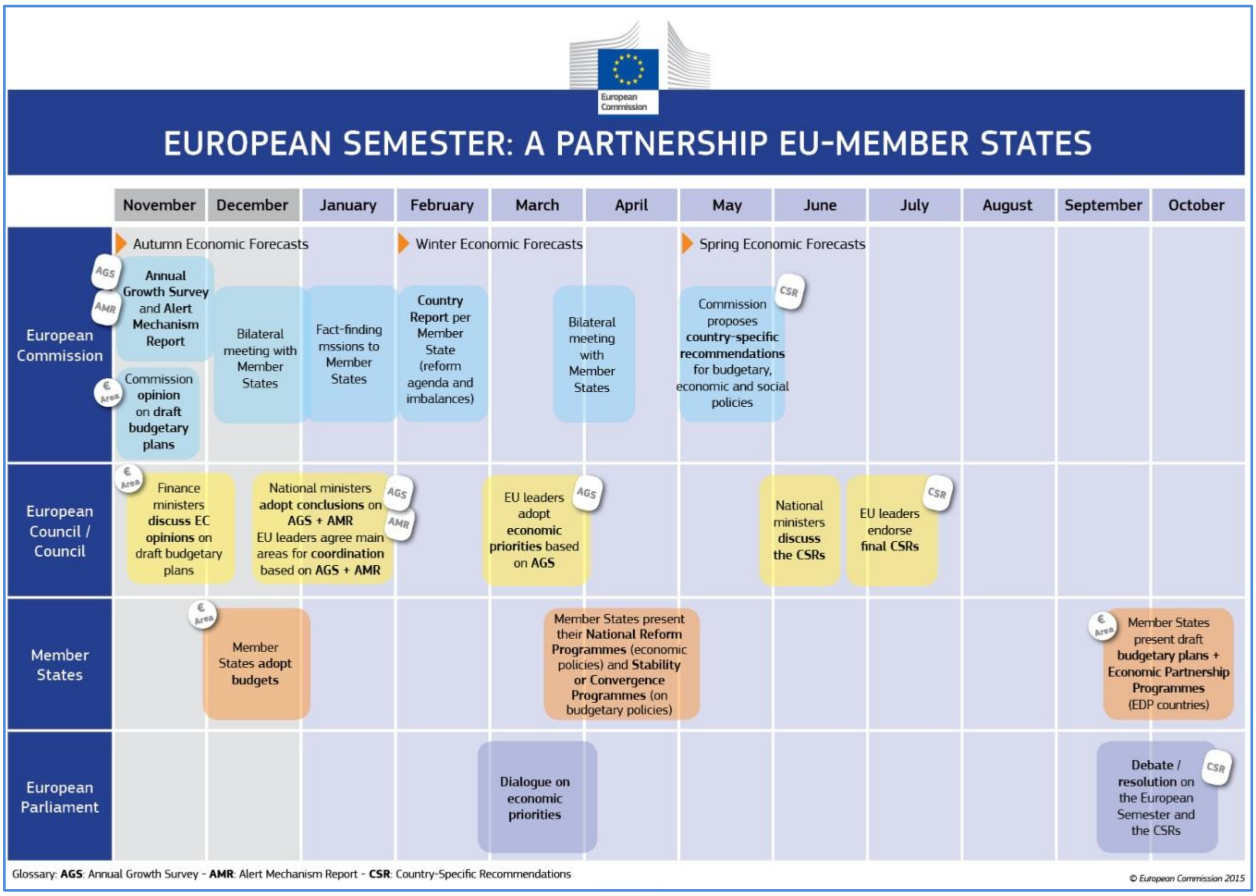
- at least 0.5 % of GDP in a single year or at least 0.25 % of GDP on average per year in 2 consecutive years from the medium-term budgetary objective or from the appropriate adjustment path towards it; and/or
- a deviation in expenditure developments net of discretionary revenue measures from the reference rate of potential growth of at least 0.5 % of GDP in a single year or cumulatively in 2 consecutive years.

If the deviation is ex-post judged to be significant, the COM addresses a warning to the Member State concerned by virtue of Article 6(2) of Regulation EC 1466/97. Such a warning would automatically trigger Article 11(1) of the Fiscal Responsibility Act which requires Government to present to Parliament a Corrective Action Plan. Article 11(1) of the Act also requires that such a Plan is consistent with 'any recommendations made to Malta under the Stability and Growth Pact (SGP) in relation to the period over which compliance with the budgetary rule is to be achieved and the size of the measures to be taken to secure such compliance'. This effectively means that both the size of the correction and the time-frames to achieve such a correction are determined by the European Institutions in line with the SGP requirements.

Besides differences in the assumptions behind the growth projections, another source of divergence between the MFIN and the COM's forecasts with respect to the structural effort shown in Table 3 may be attributed to projected additional revenue measures which are not sufficiently well documented or specified in the USP and thus not embedded in the COM's forecasts. This may also have impacted the COM's calculations with respect to the expenditure growth benchmark for Malta.

In this respect, the Council encourages the MFIN to better outline the relevant revenue and expenditure measures, particularly to support forecasts beyond the current year, in line with the three-year budgeting framework. This would also contribute to further align government budgetary practices to meet the European Semester requirements.[11] In this context, the Council positively notes that the Government in 2015 intends to align its budget schedule to the European Semester, which requires that the USP be submitted by end April of each year and the draft budgetary plan to be submitted by 15 October each year (see Diagram 1).

Diagram 1: The European Semester[12]



[11] The European semester is a yearly cycle of economic policy co-ordination.
[12] The diagram is reproduced from http://ec.europa.eu/europe2020/making-it-happen/index_en.htm

2.3 Conclusion

The MFAC welcomes Malta's exit from the EDP. The MFAC considers that the planned structural adjustment envisaged for the period 2015-2018 is appropriate on the basis of the projected economic developments and the current debt levels. Specifically, the planned structural adjustment is consistent with the scenario of above potential growth and a debt ratio which exceeds the 60% of GDP threshold.

In view of Malta's obligations under the SGP, the MFAC encourages the Authorities that in the course of monitoring of macroeconomic conditions, a closer assessment is carried out of the extent to which the economy is operating below or above potential as this has a direct impact on the measured structural balance upon which adherence to SGP requirements is assessed.

It is important that the Government remains firmly committed to the planned reduction in the deficit and debt ratios and remains vigilant to ensure that any upside risks to these ratios, as a result of the possibility of a less favourable macroeconomic environment or less effective deficit reducing measures are rapidly addressed. In this respect, the MFAC also considers that future deficit reducing measures could target an adjustment above the minimum requirements, in order to reduce the risk of missing the fiscal benchmarks. The MFAC invites the Government to be more explicit about how it intends to constrain expenditure growth.

Due consideration should also be given to ensuring that accurate estimates of ageing related costs are maintained, following on the work of the Pensions Strategy Group, as this will contribute to focus constant awareness about this long term challenge and timely action can be taken.[13] This is necessary to ensure that even long terms risks are well addressed in current budgets. In this context, it is pertinent to highlight that in its assessment of the USP, the COM noted that whereas Malta does not appear to face sustainability risks in the short term, risks in the medium and long term are likely to increase, primarily as a result of costs arising from population aging. Indeed, according to the projections by the Economic Policy Committee (EPC) Ageing Working Group (based on commonly agreed assumptions for the EU Member States), age-related spending (including pensions, health care, long-term care, education and unemployment benefits) in Malta is projected to increase by 6.6 pp of GDP over the period 2013-2060, one of the highest rates within the EU.[14] The MFAC therefore highlights the importance of continuous vigilance and adequate reforms to foster further rationalisation and efficiency in such age-related expenditure programmes so as to ensure the long term sustainability of public finances.

The MFAC welcomes the inclusion of a Table in the MTFS to indicate the main assumptions underpinning the fiscal projections. Such information contributes to greater transparency and to a better understanding of the forecasting framework. The Council notes that the implied elasticities of the main revenue sources in respect of the respective tax bases which are projected for the 2015–2018 period are significantly lower than the average level of recent years. This reflects a degree of prudence which will help to mitigate possible downside risks regarding revenue forecasts. However the MFAC would welcome that such data would be complemented by additional explanations that would further justify these assumptions. Further details about the main assumptions used to produce the fiscal forecasts would make it easier to judge the

[13] The latest forecasts presented by the Pensions Strategy Group are available on http://mfss.gov.mt/en/public-consultations/pensions/Documents/Pensions%20Report.pdf

[14] For further details refer to the Pre-Budget Document 2016 available on https://mfin.gov.mt/en/The-Budget/Documents/The_Budget_2016/PRE_BUDGET_2016_DOC.PDF

plausibility of such forecasts. Moreover, the inclusion of a commentary to clarify the impact of such assumptions on the overall fiscal balance would have enhanced further the transparency of the report.

The MFAC also welcomes the inclusion in the MTFS of projected targets for contingent liabilities for the period 2015–2018. It notes that the ratio of government guarantees to GDP is expected to gain almost 2 pp in 2015 to 18.6%, before declining to 13.9% by 2018. The report would benefit from greater transparency if additional information is included on the main drivers of these projected changes. Moreover, the Council encourages the Government to consider the introduction of legislation providing for an appropriate framework governing the monitoring and issuance of Government guarantees, thereby facilitating control and introducing stronger governance.

3. The MFAC's opinion on the Annual Report 2014

3.1 Introduction

In June 2015 the MFIN published the Annual Report 2014 in accordance with Article 41 of the Act.[15] The main objective of this report is to provide an ex-post assessment of the execution of the budget, and in particular to evaluate the attainment of fiscal targets. In the report the Government is also obliged to state whether the principles and rules stipulated in the Act were respected and explain any deviations there from. The report should also contain an assessment whether the fiscal turnout in the completed year is in line with the country's MTO, and explain any deviations and how these are to be addressed.

3.2 High level assessment

The MFAC notes that the deficit recorded on the Consolidated Fund for 2014 stood at €136.3 million or €126.9 million (48.2%) lower than in 2013 (see Table 4). This was also €15.0 million below the €151.3 million indicated as the budget target in the Annual Report 2014.[16] The underlying better-than-expected deficit turnout (when comparing the projected estimate indicated in the Annual Report 2014 with the actual outturn) was largely the result of buoyant tax revenues, driven by favourable macroeconomic conditions, which more than offset higher expenditures in certain areas. Although capital expenditure outlays were less than originally anticipated, the impact was largely deficit neutral as this reflected lower absorption of EU funds (classified under grants).

[15] The report is available on https://mfin.gov.mt/en/Library/Documents/Annual%20Reports/Annual_Report_2014.pdf

[16] The recalculated approved deficit estimate for 2014 as published in the Annual Report 2014, is inclusive of the equity injection in Airmalta whereas the target figure reported in the Financial Estimates 2014 of €136.3 million was exclusive of this equity injection which was treated as an accrual adjustment.

Table 4: Variances between the actual and projected fiscal revenues and expenditures

	January - December 2014		
	Approved Estimate	Actual	Variance
	(Millions of Euro)		
Recurrent revenue	3272.9	3387.2	114.3
Tax revenue	2806.5	2953.7	147.2
of which:			
Indirect tax revenue	1142.5	1186.4	43.9
Direct tax revenue	1664.0	1767.3	103.3
Non-tax revenue	466.4	433.5	-32.9
Total Expenditure	3424.2	3523.5	99.3
Recurrent expenditure	2721.7	2857.0	135.4
Interest payments	234.7	231.1	-3.6
Capital expenditure*	467.8	435.3	-32.5
Government Consolidated Fund balance	-151.3	-136.3	15.0
* Includes equity injection in Airmalta			
Source: Malta Annual Report 2014			

The report contains a detailed assessment of the variances between the projected and recorded revenues and expenditures for 2014. Revenues from both direct and indirect sources were higher, and this more than compensated for higher expenditures, particularly on health and education. At the same time, the shortfall in non-tax revenue (mainly as a result of lower absorption of EU funds) basically had a neutral effect on the deficit, since EU-funded capital expenditure was likewise below target.

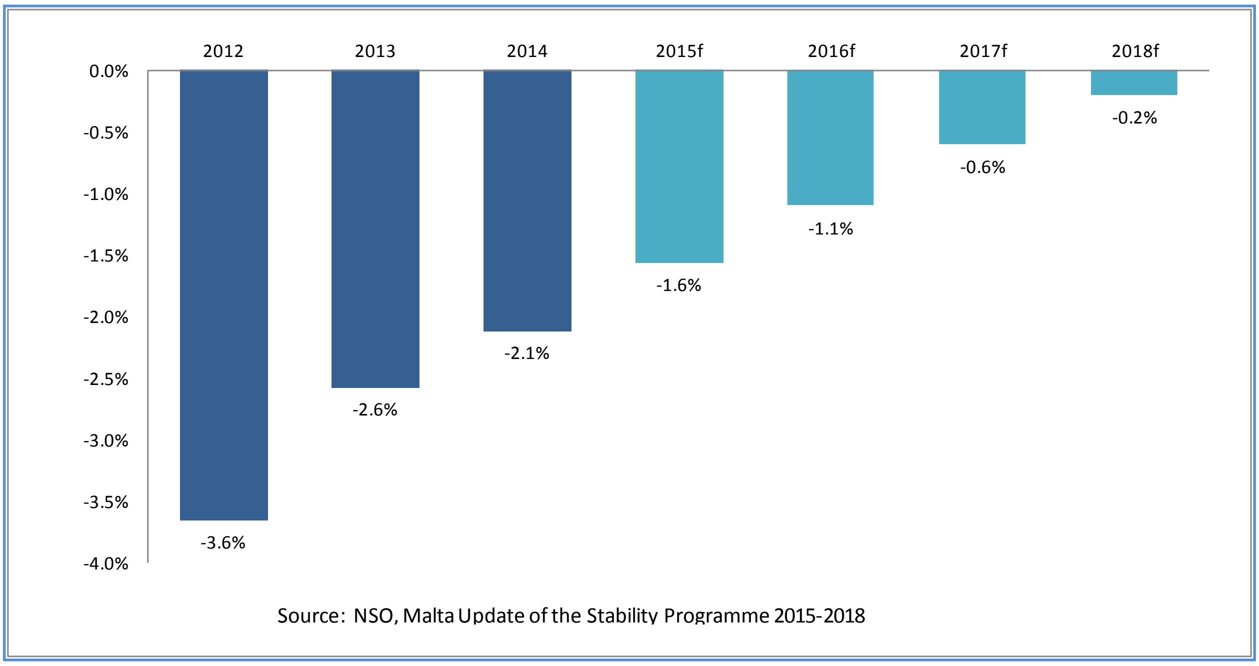
The MFAC is of the opinion that, although not specified within Article 41 of the Act, explanations with respect to the potential interdependence between variances in the fiscal outturn and macroeconomic forecast errors would be beneficial to better evaluate and communicate about the determinants of the recorded variations.

Turning to public finance figures compiled on the basis of the European System of National and Regional Accounts (ESA) upon which Malta's obligations are assessed by the COM, the MFAC notes that the Government attained the 2.1% deficit to GDP target published in the 2014 USP (see Chart 1).[17] This was 0.6pp lower than the deficit target of 2.7% that had been recommended by the COM as part of the adjustment path to enable Malta to exit the EDP. While a number of items both within the revenue and expenditure categories diverged from the targets included in the previous year's USP, differences were in part attributable to the change in methodology used to compile such figures, from ESA 1995 to ESA 2010.[18] In this respect, the MFAC recommends

[17] In practice the main differences between cash based Consolidated Fund figures and ESA figures relate to the accrual adjustments and the use of harmonised definitions.
[18] In particular, items such as market output and gross fixed capital formation were impacted by this statistical change.

that when such major methodological changes are implemented, tables could be included to map and quantify the approximate impact of such changes on key indicators, in order to enhance the transparency of the report.

Chart 1: General Government deficit as per cent of GDP



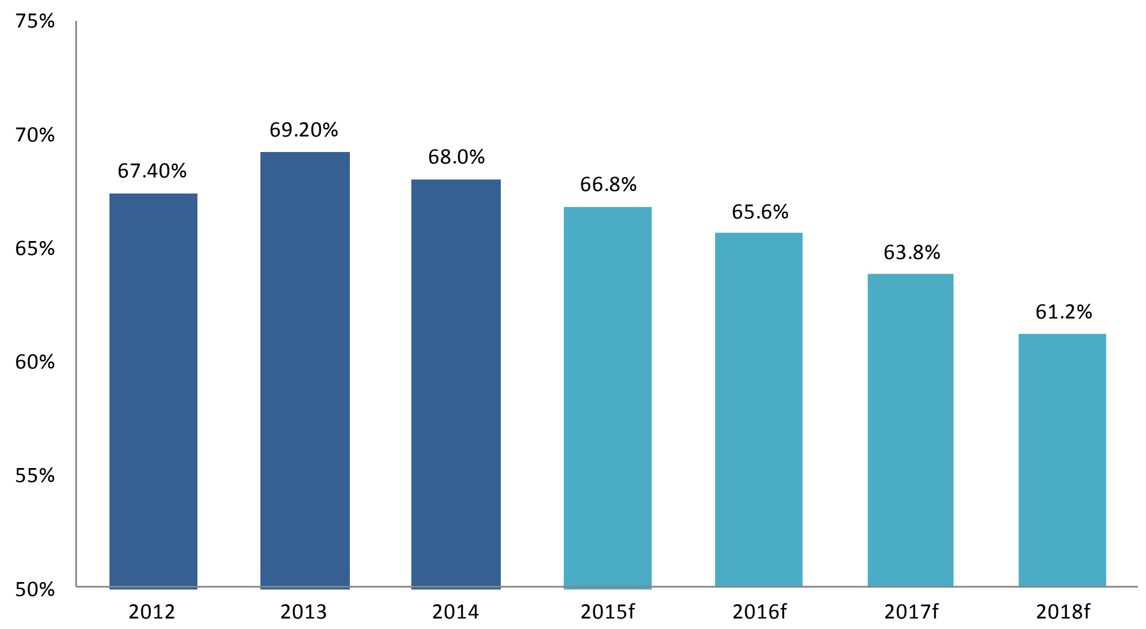
With regard to the structural fiscal balance, the MFAC notes that the structural budget deficit, at 2.7% of GDP in 2014, fell short of the 2.3% target published in the 2014 USP, and was 0.2 pp higher than that recorded in 2013. The MFAC also notes that the structural adjustment recorded in 2014 was marginally negative, -0.1% of GDP, against the original target of 0.5% of GDP published in the 2014 USP (see Table 4).

Nevertheless, the combined structural effort over the period of 2013-2014 amounted to 1.0 pp of GDP, on the back of strong fiscal adjustment, in the order of 1.1pp of GDP actually undertaken during 2013, against the original target of 0.7% of GDP which had been published in the 2014 USP. Therefore, notwithstanding the shortfall in the structural effort reported in 2014, the view of the MFAC is that, overall, Malta remained on track to attain the MTO by 2019 as specified by the calendar of convergence put forward by the COM.

The MFAC notes that the public debt ratio for Malta between 2013 and 2014 declined by 1.2 pp of GDP to 68.0%, effectively fulfilling the forward looking debt reduction criterion (see Chart 2). This was also 1.4 pp lower than targeted in the 2014 USP. This decline primarily reflected higher-than-expected economic growth, but was also influenced by the methodological update in the compilation of GDP from ESA 95 to ESA 2010.[19]

[19] The statistical transition makes it hard to disentangle the two effects and thus to be able to quantify the specific contribution by each factor.

Chart 2: General Government debt as per cent of GDP



Source: NSO, Malta Update of the Stability Programme 2015-2018

In absolute terms, the general government debt reached €5.4 billion as at end 2014, €78.8 million above the original projections, mainly as a result of higher-than-anticipated issues of Malta Government Stocks (MGS). This appears to be in line with the Government's stated intention to front load its borrowing requirements, in view of favourable interest rate conditions, as well as to lengthen the average maturity of the debt. The MFAC is of the opinion that the report could have expanded more on the underlying factors which have contributed to the deviation rather than just apportioning the variances across the different components of aggregate public debt.

3.3 Conclusion

It is the view of the Council that the Annual Report for 2014, which was the first of its kind, has fulfilled the main objectives and tasks stipulated by Article 41 of the Act. However, it should also be pointed out that Article 41(3) requires that the report includes a section which is focused solely on explaining the deviations from the fiscal strategy and initial annual budget, and presenting justifications for such deviations. Although this form of assessment was undertaken throughout the individual sections of the report, the MFAC feels that a separate section focusing exclusively on this issue could have benefited the report as a whole.

4. The MFAC's opinion on the Half Yearly Report 2015

4.1 Introduction

In July 2015 the MFIN published the Half-Yearly Report 2015, in accordance with the requirements of Article 39(7) of the Act. The main objective of this document is to identify any significant changes in the macroeconomic outlook since the finalisation of the annual budget; to provide information on the fiscal turnout for the first half of the year; and to assess how these may impinge on the attainment of fiscal targets.

4.2 High level assessment

The report compares the forecasts presented in the USP 2015-2018 to those contained in the 2015 Budget. The macroeconomic forecasts upon which the Budget 2015 forecasts were based had a cut-off date of 15 September 2014 while the forecasts contained in the USP 2015-2018 had a cut-off date of 18 March 2015. The overall outlook for economic growth remained broadly unchanged between that contained in the Budget 2015 and the SP 2015, with real GDP expected to grow by around 3.5%. However the outlook for the individual GDP components was revised. The latest forecasts published in April 2015 indicated significantly faster growth in investment and higher private consumption, with correspondingly higher growth in imports.

On the other hand, growth in government consumption was revised downwards. In this respect the MFAC notes that whereas developments in government consumption are a key variable in interpreting fiscal policy, the document provides few explanations as to the reason behind the downward revision. While the latest USP made reference to the statistical treatment of revenues from the Individual Investor Programme (IIP) as impacting this GDP component, the document could have been clearer in terms of apportioning between the 'statistical effect' and the 'real restraint' effect, in order to better evaluate the plausibility of this forecast.

The change in potential output growth, which was revised upwards by 0.7 pp, was attributed to strong investment for the current year. While the increase in potential output growth is certainly plausible, such a rapid pass-through from same-year investment into same-year output growth potential would have warranted further explanations. Whereas the MFAC appreciates that currently not all assumptions made by the COM are communicated to Member States, it will be desirable to explore ways that would enable the MFIN to better assess the possible implications that such revisions could have on fiscal requirements and in particular on how this could influence the expenditure growth reference rate calculated by the COM.

Since the cut-off date when the macro projections were prepared, a new vintage of national accounts data, covering up to the first quarter of 2015 were published by the NSO. The MFIN provides a commentary of the main economic developments based on this release but it does not take this information into account to revise the macroeconomic outlook as published within the USP 2015-2018. It is the opinion of the MFAC that the MFIN could have been more explicit as to the arguments to justify why the macroeconomic forecasts were not revised.

The MFAC acknowledges that latest published data is by definition the most prone to revisions, and also appreciates that in this particular instance the impact of revised macroeconomic projections might not have had a material effect on the deficit targets. Nevertheless, the MFAC would like to invite the MFIN to be more explicit in how it views the latest economic developments in relation to the anticipated trends.

The MFAC understands that resource constraints may limit the possibility to carry out new forecast rounds. A reasonable solution would be to at least clearly articulate whether the latest available data suggests any upside or downside risks to the macroeconomic and fiscal outlook for the year, while confirming whether on the basis of available information, fiscal and macro forecasts are still deemed to be fully consistent with each other.

The report also presented a detailed explanation of how on the basis of the half-yearly fiscal performance, the annual figures were revised. In this respect it is pertinent to note that the Consolidated Fund deficit narrowed significantly during the first six months of 2015 compared to the same period of last year (see Table 5).

Table 5: Key indicators – The Consolidated Fund

	January-June		
	2014	**2015**	**Variance**
	€ 000	€ 000	€ 000
Revenue	1,414,347	1,607,398	193,051
of which:			
Tax Revenue	1,214,279	1,337,154	122,875
Non-Tax Revenue	200,068	270,244	70,176
Total Expenditure	1,664,573	1,762,373	97,800
of which:			
Recurrent Expenditure	1,376,798	1,443,163	66,365
Interest Payments	111,215	116,164	4,949
Capital Expenditure	176,560	203,046	26,486
Consolidated Fund Balance	-250,226	-154,975	95,251
General Government Debt	5,759,203	5,659,946	-99,257
Source: Malta Half Yearly Report 2015			

While both total revenue and total expenditure have been revised upwards, the deficit target remained unchanged at 1.6% of GDP. On the other hand, the public debt-to-GDP ratio has been revised downwards by 1.7 pp to 67.3%.

The MFAC notes that while revenues depend to a large extent on macroeconomic conditions, government expenditure in the area of health and education is more deterministic. Further explanations as to the factors which contributed to the upward revision in personal emoluments would have been advisable to better distinguish between policy initiatives, such as changes to employment levels and other contributors to expenditure growth such as wage drift. Likewise, the document could have outlined which specific expenditures are being referred to when stating 'corresponding downward expenditure trends are also envisaged under nationally funded capital expenditure items'. It is unclear whether such projects have been cancelled or simply postponed. Such information would be necessary to evaluate the fiscal projections beyond the current year.

On the revenue front, the document notes that VAT revenue for the first half of the year was lower than expected as a result of some amendments in the regulations which came in effect as from 1 January 2015. These refer to EU VAT changes to the place of supply of telecommunications, broadcasting and electronic services as per Regulation (EU) No 1042/2013.[20] The MFAC notes that the change in the legislation was known before the cut-off date for the preparation of the fiscal forecasts. The Council notes the increased co-operation across departments to improve the forecasting process, but believes that there is still scope for further synergy, as suggested by this specific instance.

The document presents an updated position for general government based on actual estimates published by the NSO for the first quarter and NSO provisional calculations for the second quarter. While the NSO's statistical obligations allow for a longer period to provide official figures for the second quarter of the year, the MFAC invites the authorities to consider whether more timely official data can be made available to enable more meaningful analysis and risk assessment. This would contribute to a more robust analysis of the fiscal turnout for the first half of the year, upon which the SGP requirements are evaluated.

The 2015 fiscal deficit in absolute terms has been revised upwards from €130.0 million to €135.5 million. This change, combined with a higher (recalculated) level of nominal GDP, corresponded to less than 0.1% of GDP and had no impact on the 1.6% deficit ratio target.

The MFAC welcomes the success in the collection of revenue arrears as indicated by the exceeded targets. This is a positive development and going forward it is important that this momentum is maintained and that all Ministries and entities submit the required information in a timely manner.

4.3 Conclusion

The main purpose of a mid-year report is to ensure timely action and communication whenever the progress differs from what was originally envisaged. A mechanical review of line by line items for revenues and expenditures is important in order to assess whether targets are likely to be met or whether policy changes are necessary. However the MFAC encourages the MFIN to better explain the extent to which revisions are due to macro developments, policy changes, one-offs or judgement. This will foster higher transparency and enable a more robust assessment of fiscal risks. A main objective of the report is to ensure that the assessment of fiscal risks is based on latest available macroeconomic information. The opinion of the MFAC is that the MFIN should have clearly outlined policies to document and justify when the latest macroeconomic data would warrant a revision of official forecasts or when such developments are considered to be neutral or insufficiently informative.

[20] For further information see Regulation EU No 1042/2013 available on http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:284:0001:0009:EN:PDF

The half yearly document could also directly address the issues raised by the COM in its assessment of the USP. This is not directly stated in the Act, but the MFAC is of the opinion that this would better contribute to enhance transparency and foster public dialogue on issues of fiscal sustainability.

5. Compliance with the Fiscal Responsibility Act (2014)

According to article 43(2) of the Fiscal Responsibility Act, 'The Fiscal Council shall review and assess the extent to which the fiscal and economic policy objectives proposed by the Government are being achieved and thus contribute to more transparency and clarity about the aims and effectiveness of economic policy.' Sound conduct of fiscal policy requires that the Government continues on its consolidation process while sustaining the economic growth momentum, with the aim of achieving the MTO of structural balance by 2019.

The MFAC notes that the deficit and debt targets for 2014 have been attained and this contributed to the abrogation of the EDP for Malta. The MFAC is of the opinion that the published fiscal data and the benign macroeconomic outlook make the attainment of the fiscal deficit and debt targets for 2015 feasible. Caution is however warranted with regards to fiscal expenditure to ensure that growth is contained to within the country's growth potential.

The information contained in the annual and half-yearly reports published by the MFIN adds to fiscal policy transparency. Developments in the various revenue and expenditure components, variations compared to budgets, and revisions are reasonably explained. However, more detailed explanations about the future conduct of fiscal policy would be desirable to enable a better assessment of the pace of correction and possible fiscal risks. This will also help the general public to better understand and evaluate the conduct of fiscal policy.

The MFAC considers that the current main priority for fiscal policy in Malta is to achieve further progress towards the MTO in line with the prescribed timetable. In this respect, the MFAC positively views the Government's commitment to the announced deficit and debt reducing targets. The MFAC considers that to the extent that the conduct of fiscal policy is geared towards attaining these priorities, without acting as a drag on economic activity, it may be considered as conducive to prudent economic and budgetary management. It is important that the Government maintains the consolidation pace in line with the announced plans. This will enable the Government to have sufficient flexibility to act in the event that economic conditions were to become not as positive. Initiatives aimed at incentivising work and building human capital are positively viewed by the MFAC as these contribute to raise Malta's potential output thereby sustaining rising standards of living. The MFAC also welcomes the Government's intention to rationalise expenditure where this is feasible, as this would ensure that sufficient resources can be channelled into more productive activities and to support initiatives aimed at protecting the vulnerable segments within society, without endangering sustainability. Expenditure rationalisation would also enable a higher degree of predictability regarding the level and stability of future tax rates which is important for private sector planning and decision making.

Overall, the MFAC is of the opinion that the Government is broadly complying with the announced fiscal strategy aimed at maintaining public finances on a sustainable track. On the basis of the information presented by the MFIN, the MFAC's opinion is that the budget rule is being satisfied. In particular, in view of the benign macroeconomic conditions, the MFAC considers that the planned structural adjustment effort as outlined by the Government is consistent with the minimum effort required under the SGP. The MFAC stresses on the importance that possible revenue windfalls are used to bring about fiscal consolidation and do not create undue long term expenditure commitments.

In conclusion, based on the documents published by the MFIN this year, the MFAC's opinion is that:

- the Government's fiscal strategy appears to be broadly compliant with the provisions of the Act as requested by article 13(3)(b) of Act;
- the fiscal stance appears to be broadly compliant with the prudent economic and budgetary management requirements specified in article 13(3)(c) of the Act;
- the year-to-date and projected budgetary performance appears to meet the fiscal targets and policies specified in the fiscal strategy, as requested by article 13(3)(d);
- the Government has effectively considered the opinions and recommendations of the MFAC as specified in article 13(6) of the Act; and
- the Government is expected to comply fully with the European Semester requirements as from 2015.