

ASSESSMENT OF THE FISCAL FORECASTS
UPDATE OF STABILITY PROGRAMME 2017 – 2020

A REPORT PREPARED
BY THE MALTA FISCAL ADVISORY COUNCIL

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Assessment of the Fiscal Forecasts
Update of Stability Programme 2017 – 2020



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31 May 2017

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Dear Minister

LETTER OF TRANSMITTAL

In terms of Article 13 of the Fiscal Responsibility Act, 2014 (Cap 534), I have the honour to transmit a report by the Malta Fiscal Advisory Council (MFAC) on the assessment of the fiscal forecasts for the Maltese economy prepared by the Ministry for Finance in April 2017, as part of the Update of Stability Programme 2017 – 2020.

The Council notes that in 2016 a fiscal surplus equivalent to 1.0% of GDP was recorded. This outturn was significantly better than the 0.7% of GDP deficit target which was indicated in the Draft Budgetary Plan published in October 2016. When compared to the previous forecast round, notable deviations were observed between the actual data and the forecasts for 2016, particularly in relation to higher-than-projected revenues from current taxes on income and wealth, and from the Individual Investor Programme, whose positive impact on the fiscal balance was reinforced by lower-than-planned spending on gross fixed capital formation.

Nonetheless, the Council considers the process used by the Ministry to prepare its fiscal projections as rigorous, and based on sound methodological practices. The Council also notes the general level of prudence exercised by the Ministry within the forecasting framework, particularly in relation to the conservative approach embedded in the tax revenue projections. At the same time, the Council suggests that budget items which deviate by more than 0.5% of GDP from the forecasts could be areas where possible improvements could be explored by the Ministry, with the aim of avoiding such large differences in future.

The Council views positively that the latest Update of Stability Programme targets a stable annual fiscal surplus of 0.5% of GDP for the period 2017 to 2020. The Council also views positively the fact that the Update of Stability Programme projects further declines in the public debt-to-GDP ratio, from 58.3% of GDP in 2016 to 47.6% of GDP by 2020.

Over the forecast horizon, both the revenue-to-GDP ratio and the expenditure-to-GDP ratio are anticipated to be scaled back by 2.3 percentage points and by 1.8 percentage points respectively, when compared to 2016. This is largely driven by the projection that, in line with the pattern observed in 2016, nominal GDP is expected to grow faster than total revenue and total expenditure according to the latest forecast round.

After having scrutinised the various revenue and expenditure components within the budget, the Council considers that the projected annual fiscal surplus for the period 2017 to 2020 is within its endorsable range. The Council also considers as plausible the projected decline in the debt-to-GDP ratio over the forecast horizon. Indeed, the Ministry's projections for both the fiscal balance and the public debt ratios are within close range to the forecasts published by the European Commission in May 2017, which are based on broadly similar information.

In the Council's view, there may be upside risks to both total revenue and total expenditure throughout the forecast horizon, contingent on the close adherence to the Update of Stability Programme. The magnitude of these upside risks appears broadly similar, with the Council's assessment pointing to a neutral balance of risks with respect to the fiscal balance. On the revenue side, the Council notes, in particular, the prudent assumptions employed by the Ministry in the projections for current taxes on income and wealth as well as for taxes on production and imports. On the expenditure side, the upside risks are mainly driven by the fact that the projections for compensation of employees and for intermediate consumption embed a certain element of restraint, which may be rather challenging to achieve.

The Council therefore invites the Government to adhere closely to the fiscal plans as outlined in the latest Update of Stability Programme, since any significant departure could pose risks to the attainment of the fiscal surplus and debt targets. In particular, the Council underscores that the Ministry remains vigilant to quickly detect and address any departure from the anticipated revenue trends, should the macroeconomic performance be less positive than that underpinning the Update of Stability Programme's calculations, or else, be driven by completely different contributors which may be relatively less tax rich. At the same time, the Council acknowledges that since there is a material share of expenditure which is discretionary, and hence directly under the control of Government, it is essential for the Government to remain vigilant to ensure that the Programme's challenging expenditure targets are attained.

Since the macroeconomic and fiscal outlook for the period 2017 to 2020 have been deemed to be within the Councils' endorsable range, the estimated impacts on debt dynamics stemming from the primary balance, interest payments, real economic growth and inflation are consequently deemed to be also plausible. In the case of the stock flow adjustments, these are based on the plans by the Ministry, and the Council does not have any specific information to the contrary.

Finally, the Council expresses satisfaction at the ongoing constructive dialogue with the units within the Ministry responsible for the forecasting exercise.

Yours sincerely



Rene Saliba
Chairman

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Abbreviations

CBM	Central Bank of Malta
COM	European Commission
COLA	Cost of Living Adjustment
DBP	Draft Budgetary Plan
EBUs	Extra-Budgetary Units
ECB	European Central Bank
ESA	European System of National and Regional Accounts
EU	European Union
FRA	Fiscal Responsibility Act
FTS	Foundation for Tomorrow Schools
GDP	Gross Domestic Product
IIP	Individual Investor Programme
IMF	International Monetary Fund
MCAST	Malta College of Arts Science and Technology
MCST	Malta Council for Science and Technology
MFAC	Malta Fiscal Advisory Council
MFF	Multiannual Financial Framework
MFIN	Ministry for Finance
MFSA	Malta Financial Services Authority
MGS	Malta Government Stock
MSE	Malta Stock Exchange
NPISH	Non-Profit Institutions Serving Households
NSO	National Statistics Office
OECD	Organisation for Economic Co-operation and Development
PP	percentage points
SGP	Stability and Growth Pact
UoM	University of Malta
USP	Update of the Stability Programme
VAT	Value Added Tax

Executive summary

This Report assesses the fiscal projections covering the period 2017 to 2020 contained in Malta's latest Update of Stability Programme, which was published by the Ministry for Finance on 2 May 2017. This assessment was carried out by the Malta Fiscal Advisory Council in line with the requirements prescribed in the Fiscal Responsibility Act, 2014 (Cap. 534).

In 2016, a fiscal surplus equivalent to 1.0% of GDP was recorded. This outcome was significantly better than the 0.7% of GDP deficit target which was indicated in the Draft Budgetary Plan published in October 2016. When compared to the projections carried out by the Ministry for Finance in October 2016, notable deviations were observed in terms of higher-than-projected revenues from current taxes on income and wealth and in terms of the Individual Investor Programme, which coincided with lower-than-planned spending on gross fixed capital formation. Overall, the Ministry's fiscal forecasting approach and framework, founded on the expert input from the various line ministries and macroeconomic consistency checks, is deemed to be acceptable to the Council, while still leaving room for improvement.

The latest Update of Stability Programme targets a stable yearly fiscal surplus of 0.5% of GDP for the period 2017 to 2020. It is expected that over the forecast horizon, both the revenue-to-GDP ratio and the expenditure-to-GDP ratio will be scaled back, when compared to 2016. Indeed, nominal GDP is expected to grow faster than the projections for total revenue and total expenditure, extending the pattern observed in 2016. On the basis of these projections, the revenue-to-GDP ratio is envisaged to decline from 39.1% in 2016 to 36.8% in 2020. Over the same period, the expenditure-to-GDP ratio is projected to drop from 38.1% in 2016 to 36.3% in 2020. The Update of Stability Programme also projects further declines in the public debt-to-GDP ratio, from 58.3% of GDP in 2016 to 47.6% of GDP by 2020.

The Ministry's projections for both the fiscal balance and the public debt ratios are within close range to those published by the European Commission in May 2017. On the other hand there are some differences with respect to the fiscal forecasts prepared by the International Monetary Fund and the Central Bank of Malta. However, the Council acknowledges that the forecasts prepared by these two institutions are not directly comparable to those prepared by the Ministry for Finance, since they were based on earlier data, which did not capture the fiscal surplus recorded for 2016.

This Report evaluates the plausibility of each main revenue and expenditure component in the budget, based on the European System of Accounts framework. The separate assessment of each budget component permits a more robust analysis, since each component may be influenced by completely different factors. The Council's assessment is mainly based on the fiscal assumptions underpinning the Update of Stability Programme; Consolidated Fund developments in the first three months of 2017; existing tax and expenditure laws; announced fiscal measures; information obtained from public sources; as well as supplementary

information made available by the Ministry for Finance and the National Statistics Office through internal discussions and communications. The Council does not prepare its independent revenue forecasts but relies on expert judgment, based on historical trends and identified regular patterns in the actual fiscal data.

Overall, the Fiscal Council considers the projections for total revenue, total expenditure and the fiscal balance, for the period 2017 to 2020, to be within its endorsable range. In the Council's view, there may be upside risks to both total revenue and total expenditure throughout the forecast horizon. The Council believes that the magnitude of these upside risks is broadly similar, whereby the balance of risks with respect to the fiscal balance is neutral.

On the revenue side, the Council notes, in particular, the prudent assumptions employed by the Ministry in the case of current taxes on income and wealth as well as of taxes on production and imports. Turning to the expenditure side, the upside risks are mainly driven by the fact that the projections for compensation of employees and for intermediate consumption embed a certain element of restraint which may be rather challenging to achieve.

With regards to the public debt-to-GDP projections, these are also considered by the Council to be within its endorsable range. The plausibility of the trajectory for the public debt ratio is contingent on the anticipated growth in nominal GDP – which has already been endorsed by the Council in its previous report – as well as the forecasts for the fiscal balance, and the anticipated stock flow adjustments. In the latter case, the Council notes that these are based on the plans by the Ministry.

Finally, the MFAC invites the Government to adhere closely to the fiscal plans as outlined in the Update of Stability Programme 2017 – 2020, since any significant departure could pose risks to the attainment of the fiscal surplus and debt targets as outlined in this Report.

1. Introduction

Members of the European Union (EU) are required to submit to the European Commission (COM) an Update of Stability Programme (USP) by 30 April of each year.¹ Malta's latest USP, which is prepared by the Ministry for Finance (MFIN), presents the government's updated macroeconomic outlook and fiscal projections, covering the period from 2017 to 2020.^{2,3} To strengthen confidence in the reliability of the fiscal projections, Article 13, sub-article 3 (a), of the Fiscal Responsibility Act (FRA) prescribes that the Malta Fiscal Advisory Council (MFAC) "shall endorse, as it considers appropriate the macroeconomic and fiscal forecasts prepared by the Ministry for Finance". Article 13, sub-article 4, further requires that the MFAC makes public all its assessments.

The aim of this Report is to evaluate the fiscal projections contained in the latest USP. It complements the previous report recently published by the MFAC, wherein the MFAC had endorsed the macroeconomic forecasts for the period 2017 to 2020, which forecasts form the basis for these fiscal projections.⁴ The Report, whose cut-off date is 15 May 2017, proceeds as follows.⁵ Section 2 presents an overview of the main fiscal aggregates outlined in the USP. Section 3 analyses the methodologies adopted by the MFIN and the performance of the previous round of fiscal forecasts. Section 4 examines the extent to which, the forecasts for the main revenue components can be considered plausible, and whether there could be any upside or downside risks to the baseline forecasts. Section 5 carries out the same type of assessment for the main expenditure projections and also refers to developments in nominal government consumption, which is a component within nominal GDP. Section 6 examines the extent to which the projections for the fiscal balance for 2017 – 2020 can be considered to be within the endorsable range of the MFAC and also on the plausibility of the planned trajectory for public debt. Section 7 compares the MFIN's fiscal forecasts to those prepared by the COM, the Central Bank of Malta (CBM) and the International Monetary Fund (IMF). Section 8 concludes with an overall assessment.

2. Overview of the fiscal projections

Table 1 and Table 2 present the actual fiscal turnout in 2016, together with the updated fiscal targets for the period 2017 to 2020, expressed in absolute terms and as percentage of nominal GDP. In 2016, a fiscal surplus amounting to €101 million, equivalent to 1.0% of GDP, was

¹ In 2017 a number of Member States, including Malta, in agreement with the COM, submitted their USP a few days after 30 April, since this deadline fell on a Sunday and the following Monday was a public holiday.

² The latest USP is available on <https://ec.europa.eu/info/sites/info/files/2017-european-semester-stability-programme-malta-en.pdf>.

³ The fiscal projections are based on the revenue and expenditure categories compiled in accordance with the European System of National and Regional Accounts (ESA 2010). ESA methodologies are mandatory across EU Member States to ensure comparability of data across countries.

⁴ The MFAC's assessment of the latest Draft Budgetary Plan's (DBP) macroeconomic forecasts was published on 2 May 2017 and is available on www.mfac.org.mt.

⁵ The Report is based on the information contained in the USP. It does not cover revenue and expenditure proposals put forward by the major political parties in their electoral manifesto, in relation to the general election to be held on 3 June 2017.

recorded. The MFAC positively notes the attainment of the fiscal surplus and the Government's intention to maintain a stable fiscal surplus in each of the forecast years, equivalent to approximately 0.5% of GDP.

Table 1: Fiscal aggregates in EUR millions (2016 – 2020)

	2016	2017	2018	2019	2020
Total revenue	3,871.3	4,049.7	4,256.6	4,420.1	4,596.7
Taxes on production and imports	1,264.6	1,322.5	1,364.8	1,417.8	1,471.9
Current taxes on income and wealth	1,375.9	1,493.9	1,573.7	1,659.2	1,739.2
Capital taxes	15.9	18.3	17.6	17.6	17.6
Social contributions	639.3	678.5	707.5	738.4	777.1
Property income	92.0	109.8	103.6	104.6	105.6
Other revenue	483.5	426.7	489.3	482.5	485.2
Total expenditure	3,770.2	3,992.6	4,196.3	4,360.9	4,539.7
Compensation of employees	1,185.7	1,263.6	1,301.8	1,348.9	1,404.6
Intermediate consumption	635.9	716.0	708.2	756.7	786.8
Social payments	1,078.9	1,110.4	1,145.2	1,188.3	1,247.4
Interest expenditure	217.8	206.6	202.9	201.9	200.6
Subsidies	129.2	114.8	124.8	125.3	131.1
Gross fixed capital formation	251.9	293.1	343.2	336.9	345.0
Capital transfers payable	77.3	90.8	119.3	114.6	120.6
Other expenditure	193.5	197.3	250.9	288.3	303.5
Fiscal balance	101.0	57.1	60.3	59.2	57.0
One-off and temporary effects (net)	-7.3	-16.1	7.8	7.8	7.8
Cyclical effects	90.9	51.6	9.9	-8.2	-7.1
Structural balance	17.4	21.5	42.5	59.6	56.3
Gross debt	5,768.4	5,881.2	5,838.3	5,888.4	5,945.4
<i>Nominal GDP</i>	<i>9,898.0</i>	<i>10,520.0</i>	<i>11,127.6</i>	<i>11,787.3</i>	<i>12,497.0</i>
<i>Output gap (% of potential GDP)</i>	<i>2.0</i>	<i>1.0</i>	<i>0.0</i>	<i>-0.4</i>	<i>-0.4</i>

Source: MFIN

It is expected that over the forecast horizon, both the revenue-to-GDP ratio and the expenditure-to-GDP ratio will be scaled back, when compared to 2016. Indeed, nominal GDP is expected to grow faster than total revenue and total expenditure, similar to what happened in 2016. Over the forecast horizon, the revenue ratio is thus expected to drop by 2.3

percentage points (pp), from 39.1% of GDP in 2016 to 36.8% of GDP in 2020, while the expenditure ratio is expected to drop by 1.8 pp, from 38.1% of GDP to 36.3% GDP.

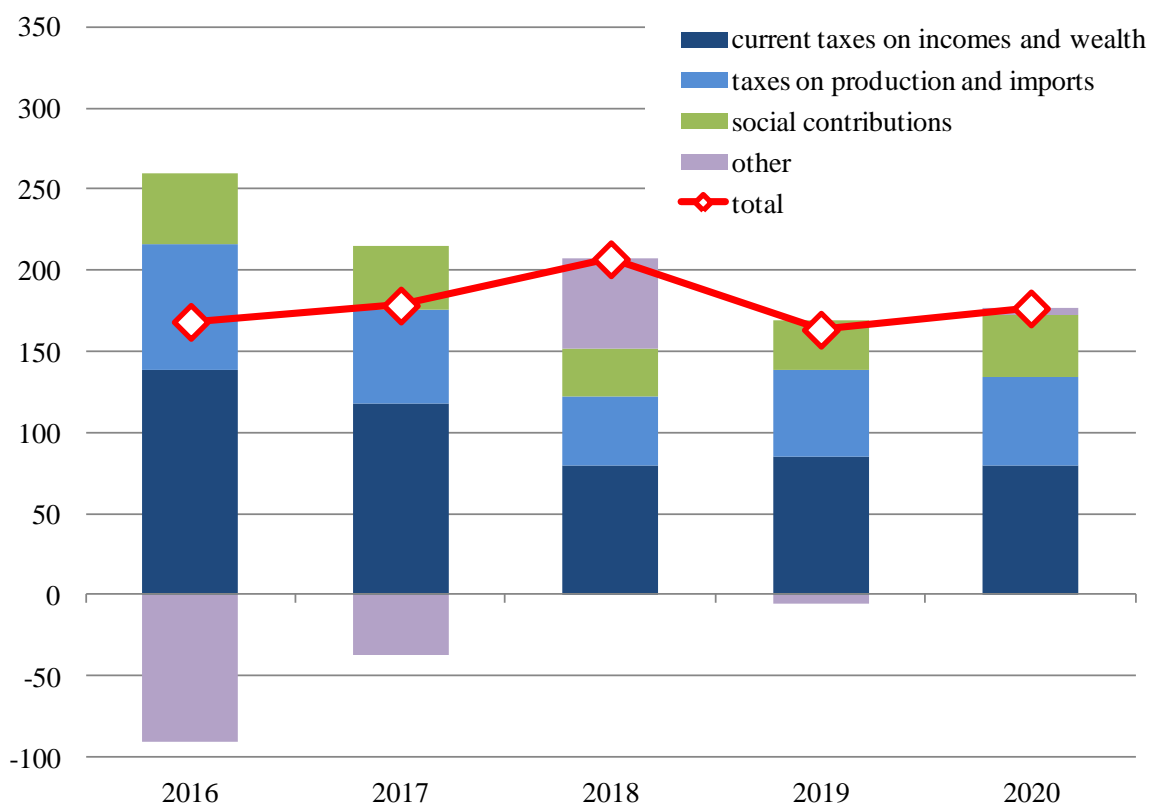
Table 2: Fiscal targets as percentage of nominal GDP

	Total revenue	Total expenditure	Fiscal balance	Structural balance	Gross debt
2016	39.1	38.1	1.0	0.2	58.3
2017	38.5	38.0	0.5	0.2	55.9
2018	38.3	37.7	0.5	0.5	52.5
2019	37.5	37.0	0.5	0.6	50.0
2020	36.8	36.3	0.5	0.6	47.6

Source: MFIN

The USP indicates that in absolute terms, the increases in revenue are rather stable, estimated at around €180 million each year (see Chart 1). Current taxes on income and wealth are again expected to be the main source of revenue growth throughout the forecast horizon, followed by taxes on production and imports. Stable year-on-year increases are also projected in the case of social contributions, as opposed to the other sources of revenue, whose pattern is more volatile across the forecast horizon.

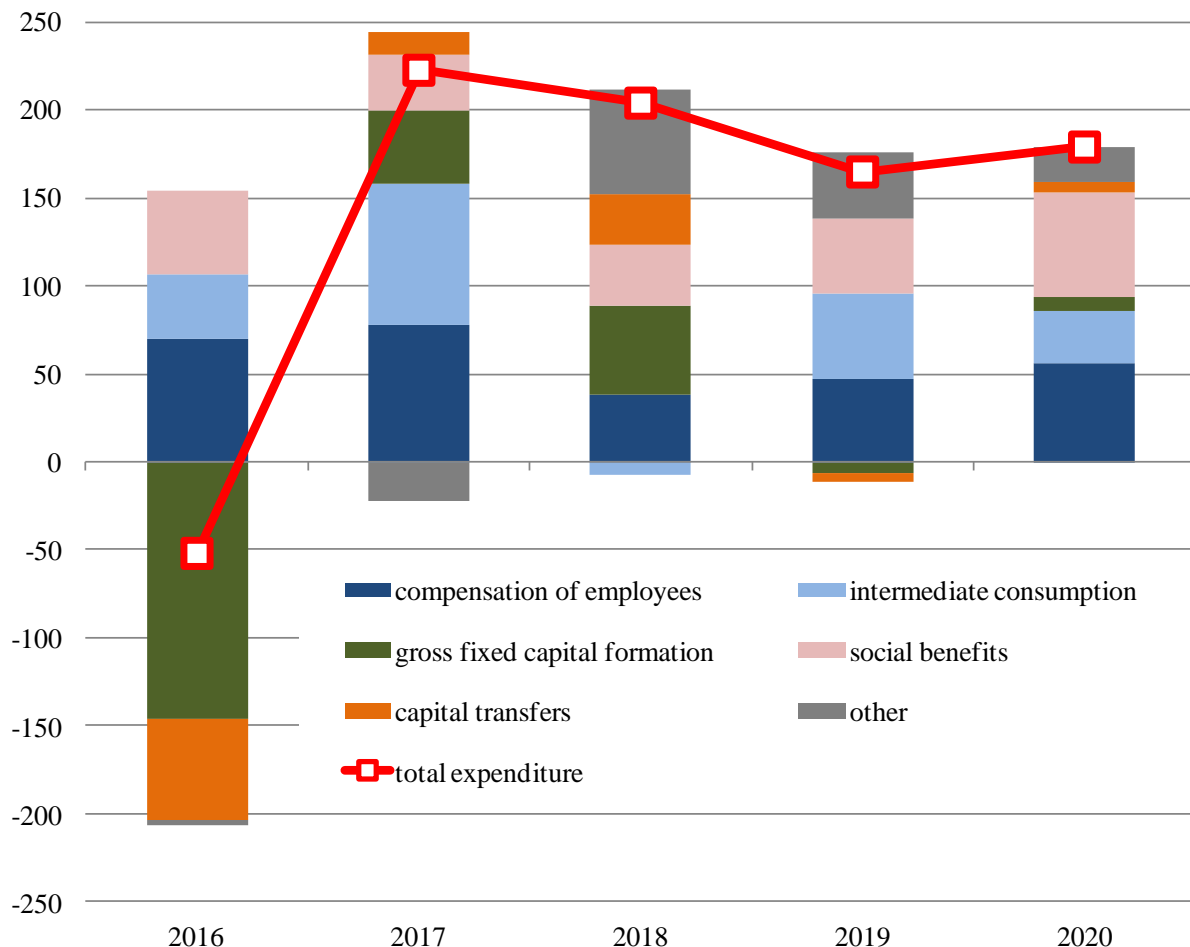
Chart 1: Yearly changes in the main revenue components (EUR millions)



Source: MFIN

In the case of expenditure, the projected average yearly increase between 2017 and 2020 amounts to €192 million (see Chart 2). Outlays on compensation of employees and social benefits are expected to contribute rather steady year-on-year increases. On the other hand, the dynamics for the remaining expenditure components, such as intermediate consumption, gross fixed capital formation, capital transfers and the ‘other’ category, vary more conspicuously from one year to the next. This volatility stems from the fact that special factors impact these items, such as the assumed rising profile for the absorption of EU funds (which in turn provides most of the funding of new investment), and the one-off expenditure related to Malta’s EU Presidency in 2017.

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



Source: MFIN

In 2017, the cyclical effects as measured by the MFIN are expected to be half as much as in 2016. Their impact is expected to diminish further, to below €10.0 million in each year, between 2018 and 2020. This is due to the closing off of the output gap, as being projected by the MFIN. Indeed, whereas in 2016 the output gap was measured at 2.0%, it is expected to close-off completely by 2018 and turn slightly negative in 2019 and 2020. The estimated magnitude of the one-off and temporary effects is also expected to be generally low, amounting to -€16.1 million in 2017, and €7.8 million in each of the subsequent forecast

years.⁶ As a result, the difference between the fiscal balance and the structural balance is only 0.3 pp for 2017, whereas in 2016 the gap was in the order of 0.8 pp.⁷ Nonetheless, the swing from 2017 to 2018 is rather significant since the effect on the budget balance changes from being slightly negative to being slightly positive.

A less positive structural balance than the headline balance in 2017 is due to the fact that the economy is expected to operate above potential in that year. This impact is however mitigated by the one-off net temporary expenditures for that year. In the outer years, the difference between the headline and the structural balance is limited to within 0.1 pp. This is also due to the fact that in 2019 and 2020, the positive impact of the projected net temporary revenues is estimated to practically match the negative cyclical effects over those two years.

With regards to the public debt-to-GDP ratio, the MFIN's projections extend the downward trend which has been observed in recent years. The target for public debt was thus set to shed 10.7 pp over the projected period, to reach 47.6% of GDP by 2020. However, in absolute terms the outstanding level of public debt is expected to continue rising, from €5.8 billion as at end 2016, to €5.9 billion by 2020. In this case, the impact of primary surpluses is more than offset by other debt-creating transactions in the form of positive stock-flow adjustments.⁸

3. Assessment of the MFIN's methodologies used to prepare the fiscal projections

The methodologies used by the MFIN to prepare the fiscal projections remained largely unchanged compared to the previous round. The process continued to be based on the expert input provided by the line ministries, working along the Consolidated Fund framework. This bottom-up approach ensures the tapping of expert knowledge and micro information which is available at ministry level. Top-down ESA-based forecasts are also produced, based on the estimated relationships between the fiscal variables and their respective proxy bases. The top-down projections act as an upper bound, to ensure prudence and the overall consistency of the fiscal forecasts with the official macroeconomic outlook as endorsed by the MFAC. The bottom-up and top-down fiscal projections are discussed among ministry senior officials and fine-tuned. The objective is to finalise the USP official projections which are compatible with the budgetary targets and which respect the fiscal rules established by the Stability and Growth Pact (SGP) and the FRA.^{9,10}

⁶ The negative figure for 2017 indicates that in net terms the downside impact on the budget balance exceeds the upside effect, while a positive figure for the subsequent years indicates that the positive impact on the budget balance is higher than the negative effect.

⁷ The structural balance removes the effect of cyclical and net temporary and one-off effects from the headline balance.

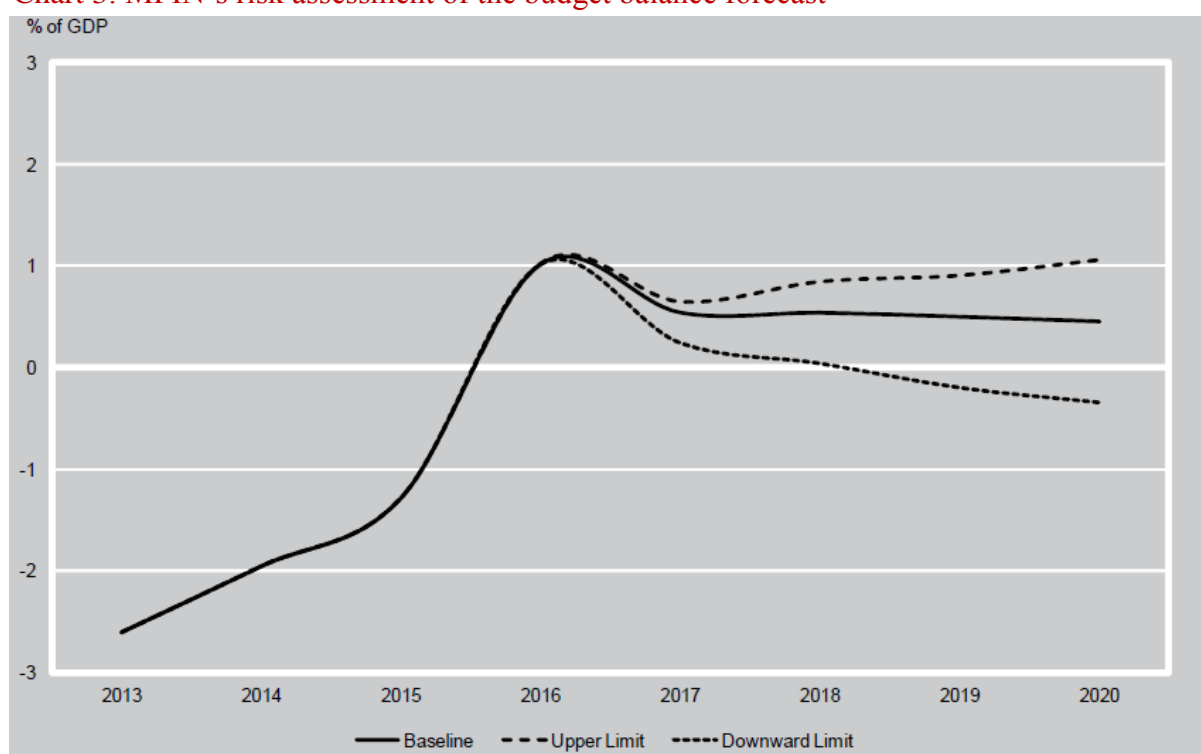
⁸ Refer to section 6 in this Report for further details.

⁹ The fiscal forecasts contained in the USP also serve as targets for the MFIN. To this effect, 'fiscal forecasts' and 'fiscal targets' are used interchangeably in this Report.

¹⁰ The assessment of compliance with the fiscal rules will be assessed by the MFAC in its next report.

As in previous cases, the USP also provides a risk assessment of the baseline budget balance over the forecast horizon. Alternative macroeconomic shocks are considered by MFIN, which can be benign or adverse. The shock's impact on the fiscal balance is then estimated. The specific shocks considered in the latest USP are [1] more optimistic private consumption growth; [2] higher tourist inflows in 2017; [3] weaker than expected tourism growth in outer years; [4] improved global economic growth; [5] weaker global economic growth; [6] subdued wage growth; [7] stronger growth in remote gaming; [8] lower growth in manufacturing; [9] updated Consensus Forecasts available beyond the cut-off date; [10] tax cuts in the United States (US) amounting to 1.3% of GDP; [11] tax cuts in the US amounting to 2.0% of GDP; [12] stronger domestic investment; [13] investment in a new gas pipeline; [14] development of high rise buildings; [15] lower import content of investment; [16] higher short term interest rates; and [17] alternative economic growth scenarios derived from different models. These positive and negative economic shocks, which the MFIN considers as the most relevant to the Maltese economy, are chosen after consultation with stakeholders; on the basis of economic literature and relevant international economic risks; and also on the MFIN's own judgement. Results are then summarised in the form of a chart, which shows the upper and lower bounds of the MFIN's risk assessment on the budget balance (see Chart 3).

Chart 3: MFIN's risk assessment of the budget balance forecast



Note: The chart is reproduced from the USP 2017 - 2020 document.

Source: MFIN

On the basis of the specific economic shocks considered, the upper and lower limits for the fiscal balance are only slightly different from the baseline forecasts. Indeed, the widest gap, which is applicable to the more distant forecast (year 2020), shows a range which is only slightly more than 1.0% of GDP. In order to increase transparency it would be useful for the

MFIN to indicate in the USP which of the before-mentioned shocks have contributed to the upper and lower limits.¹¹ The MFAC notes that the number of alternative scenarios has been expanded in comparison to previous USPs, thereby contributing to broaden the coverage of the MFIN's sensitivity analysis exercise. At the same time, it is important to acknowledge that this framework presents the information about the impact of macroeconomic risks which happen in isolation. Shocks which materialise concurrently could thus exert larger effects if these reinforce each other in terms of the positive or negative impacts. The comprehensiveness of the sensitivity analysis would benefit from considering also the possibility of two or more of the seventeen risks outlined in the USP occurring simultaneously. Furthermore, the MFAC considers useful that the coverage of risks in the USP would be expanded to include the other types of risks which could impact public finances, apart from the macroeconomic risks, particularly if these could exert a larger impact on the fiscal balance.¹²

The quality of the forecasting framework can be further assessed on an ex-post basis by evaluating the extent to which the MFIN's forecasts differ from the actual turnout. In this case, the previous fiscal forecasts, which are compared to the actual turnout, were prepared on the basis of information available up to September 2016, as part of the DBP.

In 2016, the significant differences, that is, those instances where the absolute difference between the actual and the budgeted amounts was equal to at least 0.5% of GDP, were related to three specific components within the budget.¹³ Two of these related to revenue components, specifically 'current taxes on income and wealth' and 'other revenue' – reflecting the conscious level of prudence employed by the MFIN when preparing such projections – and one related to an expenditure component, namely 'gross fixed capital formation'. These three budget components are identified with red crosses in Chart 4. In the remaining cases, the deviations were more contained, and acceptable, being within the threshold for significance.

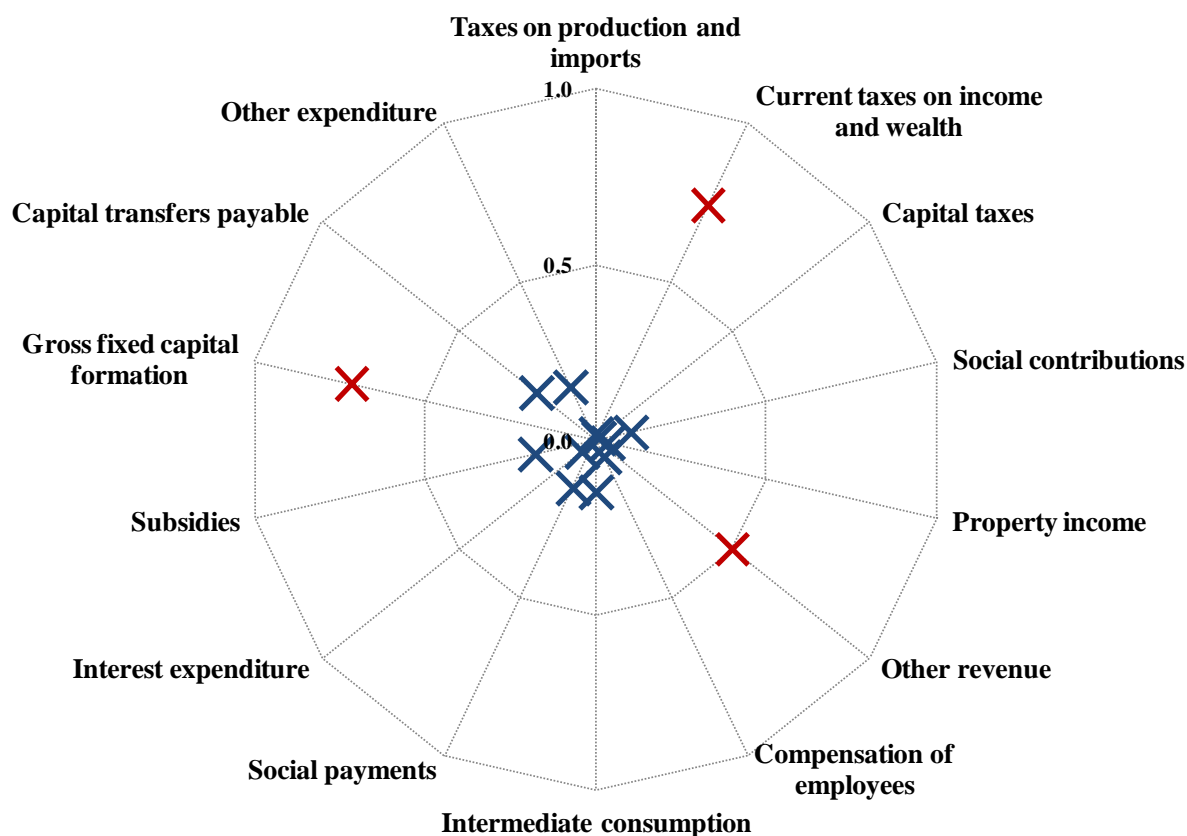
The budget items whose deviations were above 0.5% of GDP could be areas where possible improvements could be explored by the MFIN, with the aim of avoiding such large differences in future. At the same time, the MFAC acknowledges that revisions to past GDP statistics carried out by the NSO, which occasionally may be rather significant, make this task more challenging.

¹¹ The upper limit relates to the most favourable budget balance outcome resulting from one of the 17 risks which are considered, while the lower limit relates to the least favourable budget balance outcome resulting from another of the 17 risks considered. The impacts of the other 15 risks fall within the upper and lower limit.

¹² In this respect, the IMF refers to eight different sources of possible fiscal risks (see MFAC's Annual Report Table 6.1 on page 59 for a list of the additional risks which could be considered).

¹³ Deviations from targets are normal as most revenues and certain expenditure items are beyond the direct control of government. The threshold for significance was set by the MFAC at 0.5% of GDP, to focus attention to the larger deviations, which exert the more material impact on the fiscal balance. The choice of the 0.5% of GDP threshold is subjective, but consistent with the 0.5% of GDP threshold used by the COM to determine significant deviation in relation to its assessment of the Members' compliance with European fiscal rules.

Chart 4: Significant deviations in the 2016 budget components (% of GDP)



Source: MFIN

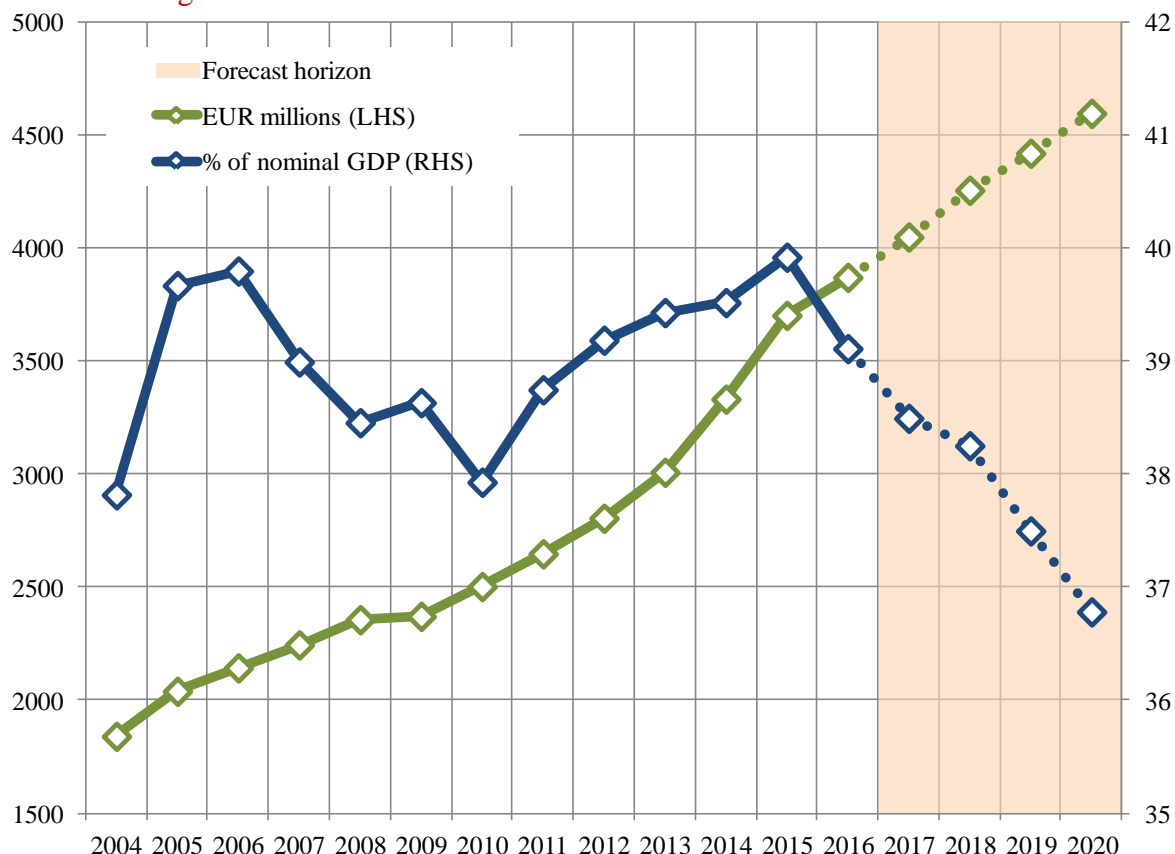
On balance, the surplus revenue, which amounted to 1.3% of GDP, combined with the shortfall in total expenditure, equivalent to 0.4% of GDP, shifted the outturn for 2016 from the projected deficit of 0.7% of GDP, to a surplus of 1.0% of GDP. While the attainment of a much better-than-expected budget balance is considered as a positive development, it leaves scope for deeper evaluation of the factors which contributed to such wide divergences between the plans and the actual turnout, also when considering that the fiscal forecasts were finalised towards the end of year, that is, in October 2016. The MFAC acknowledges that the revisions to the back data which were carried out by the NSO in December 2016, which in particular impacted gross operating surplus, explain some of the variance linked to the corporate income tax element.

Overall, the MFIN's fiscal forecasting approach and performance is deemed to be acceptable to the MFAC, while still allowing room for improvement. In particular, since certain expenditure elements within the budget could normally be more within the direct control of Government, the MFAC believes that it is possible to narrow the deviations in this case.

4. Assessment of the revenue projections for the period 2017 – 2020

In absolute terms, total revenue is projected to maintain an almost linear upward trend over the forecast horizon (see Chart 5). In terms of GDP, however, the revenue ratio is expected to extend the downward pattern observed in 2016, dropping in each of the forecast years. This pattern would place the revenue-to-GDP ratio at 36.8% of GDP by 2020, the lowest ratio recorded for over a decade.

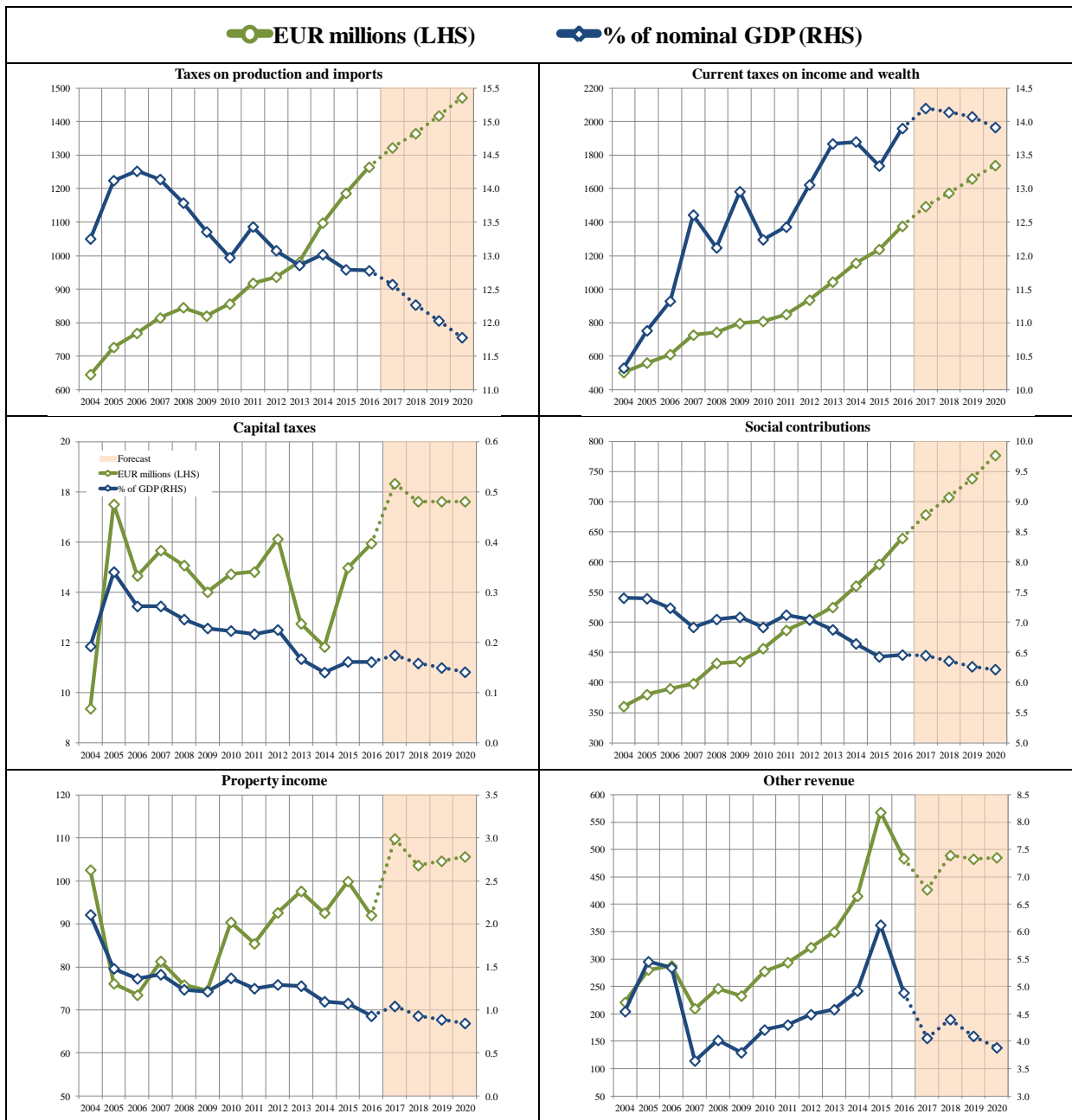
Chart 5: Total government revenue



Source: MFIN

In order to evaluate the plausibility of the trajectory envisaged for total revenue, each main component is evaluated separately (see Chart 6). The separate assessment of each revenue component permits a more robust analysis, since each component may be influenced by completely different factors. The MFAC’s assessment is mainly based on the fiscal assumptions underpinning the USP; developments in the first three months of the Consolidated Fund; existing tax and expenditure laws; announced fiscal measures; information obtained from public sources; as well as supplementary information made available by the MFIN and the NSO through internal discussions and communications. The MFAC does not prepare its independent revenue forecasts but relies on expert judgment, based on historical trends and identified regular patterns in the actual fiscal data.

Chart 6: Revenue components



Source: MFIN

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

*Definition: Compulsory, unrequited payments, in cash or in kind, which are levied by general government, or by the institutions of the European Union, in respect of the production and importation of goods and services, the employment of labour, the ownership or use of land, buildings or other assets used in production. Such taxes are payable irrespective of profits made.*¹⁴

Taxes on production and imports are projected to rise by 4.6% in 2017 and thereafter grow by slightly more than 3.0% yearly (see Table 3). These growth rates are slightly lower than the projected growth in nominal consumption, whose trajectory is slightly above 5% in 2017, and above 4% in subsequent years. The implied revenue elasticity for Value Added Tax (VAT) (which comprises some 60% of this revenue component) with respect to its proxy tax base was set at 1.3 in 2016, and unity throughout the rest of the forecast horizon.¹⁵ On the other hand, the MFIN used an implied elasticity for the remaining categories which is on aggregate negative. This explains how the implied elasticity for the whole component falls as low as 0.3 in 2017, 2018 and 2019 which is nonetheless similar to the average for the period 2015 to 2016.¹⁶

Table 3: Taxes on production and imports

	Yearly growth rate (%)	Yearly absolute change (EUR millions)	Implied elasticity for taxes on production and imports	Implied elasticity for Value Added Tax
2015	8.1	88.8	0.8	1.0
2016	6.6	78.1	-1.3	1.6
2017	4.6	57.9	0.3	1.3
2018	3.2	42.4	0.3	1.0
2019	3.9	52.9	0.3	1.0
2020	3.8	54.2	0.6	1.0

Source: MFIN

The estimates for the announced measures for 2017 relating to this component have not been changed relative to the DBP for 2017, while no information about measures beyond 2017

¹⁴ This revenue component is dominated by VAT (representing more than half of the total), with other important contributors being levies on petroleum; levies on cigarettes and tobacco; property taxes; gaming taxes; motor vehicle registration tax; taxes on spirits, alcohol and beverages; duties on insurance products and taxes on cement. The list of contributors in this revenue component is in descending order based on 2016 data.

¹⁵ An elasticity of 1.3 means that for every 1% rise in the proxy base (in this case household consumption expenditure) the revenue from VAT will increase by 1.3%.

¹⁶ The average for the period 2015 – 2016 was 0.25, since it was +0.8 in 2015 and -1.3 in 2016.

have been outlined. The only known factor is the expiry of the effect of a temporary boost amounting to €5.0 million in relation to concessions on stamp duty for business inheritance, applicable only to 2017.

While the implied elasticity for VAT is in line with normal practice, the low elasticity employed for the remaining indirect taxes, appears to be very conservative. Indeed, the implied elasticity for overall indirect taxes is significantly lower than normally adopted in the literature.¹⁷ Furthermore, the projected revenues from taxes on production and imports for 2018 and 2019 are slightly lower than had been projected in last year's USP, despite a generally more benign macroeconomic outlook and unchanged estimates for the impact of the measures. Consolidated Fund data also corroborate the view of rather conservative estimates for 2017. Indeed, during February and March 2017, VAT was up by 11.4% while during the first quarter of the year revenue from licenses taxes and fines was up by 21.7%.¹⁸

Overall, the MFAC considers the projections for taxes on production and imports to be plausible, with upside risks throughout the forecast horizon.

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

*Definition: Compulsory, unrequited payments levied periodically by general government on the income and wealth of institutional units.*¹⁹

Current taxes on income and wealth are projected to maintain a fairly stable ratio of around 14.0% of GDP. Apart from the budgetary measures reducing this revenue category by €3.6 million in 2017 (unchanged estimate compared to the DBP), the forecasts are driven by the implied elasticities. On the basis of Malta's progressive income tax system, one would generally expect the direct tax elasticity to be at least equal to unity. However, the MFIN's implied elasticity for personal income tax is slightly less, ranging between 0.8 and 0.9 for the period 2018 to 2020 (see Table 4). This is significantly lower than the levels recorded in 2016 and assumed for 2017. At the same time, according to the MFIN, the sources of economic growth will not be particularly tax rich, as suggested by the rather low elasticity for corporate

¹⁷ For example, a 2006 working paper by the European Central Bank (ECB) used the elasticity of unity for Belgium, Finland, The Netherlands and Portugal; and 0.9 in the case of Germany and Italy. Refer to Appendix 'A' in "A disaggregated framework for the analysis of structural developments in public finances", available on <https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp579.pdf?e95dd4f6b9dad8ff826b09588a697acc>.

¹⁸ In ESA basis, revenues from VAT, Income Tax and Social Security Contributions are recorded using the time-adjusted cash method in accordance with Council Regulation 2516/2000. Following a study undertaken by NSO in 2008, Eurostat approved a time adjustment of t+1 for VAT and t+2 for Income Tax and Social Security Contributions. This implies that in the case of VAT, the fiscal year starts from February of each year while for the other indirect taxes it starts from January. For further details refer to the metadata prepared by the NSO available on https://nso.gov.mt/metadata/reports/GOVDD_ESMS_A_MT_2014_0000.pdf.

¹⁹ This revenue component is driven to a large extent by taxes on employment income, on interest income and on profits. Another relevant contributor to this revenue item is the annual car circulation tax.

income tax.²⁰ This scenario is plausible, although still considered rather conservative, also when compared to the developments in recent years. The MFAC acknowledges that presenting accurate forecasts for this revenue item could be rather challenging. Furthermore, since the bulk of tax payments take place towards the end of year, the information available towards the beginning of the year is very limited.²¹ On balance, the MFAC considers that there may be upside risks for current taxes on income and wealth throughout the forecast horizon, also when taking into account the significant additional taxes which were collected in 2016, beyond what were initially forecasted.

Table 4: Current taxes on income and wealth

	Yearly growth rate (%)	Yearly absolute change (EUR millions)	Implied elasticity personal income tax	Implied elasticity for corporate income tax
2015	7.1	82.1	0.9	2.8
2016	11.2	138.4	2.0	0.9
2017	8.6	117.9	1.3	0.7
2018	5.3	79.9	0.8	0.5
2019	5.4	85.5	0.9	0.6
2020	4.8	80.0	0.8	0.8

Source: MFIN

4.3. Capital taxes (D.91)

Definition: Taxes levied at irregular and very infrequent intervals on the values of the assets or net worth owned by institutional units or on the values of assets transferred between institutional units as a result of legacies, gifts between persons, or other transfers.²²

Capital taxes represent only a small share of total revenue, merely amounting to around 0.2% of GDP. The MFIN's forecasts feature a small increase for 2017, from €15.9 million to €18.3 million, thereafter remaining practically stable around this level. In view of the observed historical stability of this revenue item, the MFAC considers reasonable the approach adopted by the MFIN and does not identify any upside or downside risks for this revenue category.

²⁰ The MFIN's corporate income tax projections are based on three-year average lags of gross operating surplus and this also contributes to the fact that the implied elasticity with the current year gross operating surplus can vary from unity.

²¹ Owing to the time adjustment method used for the compilation of current taxes on income and wealth, income tax proceeds during January and February are considered as part of the previous' year's revenues.

²² This revenue component consists mainly of taxes imposed on certain property transfers.

4.4. Social contributions (D.61)

*Definition: The actual or imputed contributions made by households to social insurance schemes to make provision for social benefits to be paid.*²³

The forecast growth rates projected for social contributions are lower than the growth rates recorded during 2015 and 2016 (see Table 5). As a result, the ratio of social contributions to GDP is expected to continue declining gently over the forecast horizon, extending the trend in evidence in recent years. The implied elasticity with respect to the tax base is less than unity, consistent with the cap on annual payments.²⁴ No new measures are applicable to social contributions. The MFAC notes the changes in the implied elasticity over the forecast horizon, in particular the drop to 0.7 in 2018 compared to 0.9 in 2017 and the increase to 0.9 in 2020 compared to 0.7 in 2019. In cases where no known identifiable factors can be traced, the MFAC considers that the forecasting framework would be more transparent if stable elasticities are assumed throughout the entire horizon.²⁵ On balance, the MFAC considers that the risks to social contributions are neutral across all years of the forecast horizon.

Table 5: Social contributions

	Yearly growth rate (%)	Yearly absolute change (EUR millions)	Implied elasticity
2015	6.4	36.0	0.9
2016	7.2	43.0	1.1
2017	6.1	39.3	0.9
2018	4.3	29.0	0.7
2019	4.4	30.9	0.7
2020	5.2	38.7	0.9

Source: MFIN

²³ This revenue component captures the national insurance contributions paid by employees, their employers and the self-employed.

²⁴ The cap implies that growth in incomes beyond a certain threshold do not entail higher social contributions.

²⁵ One factor which may contribute to fluctuations in the implied elasticity for social contributions relates to the payments made by the self-employed.

4.5. Property income (D.4)

Definition: Accrues when the owners of financial assets and natural resources put them at the disposal of other institutional units. The income payable for the use of financial assets is called investment income, while that payable for the use of a natural resource is called rent. Property income is the sum of investment income and rent.²⁶

According to the USP 2017 – 2020, in 2017 property income is projected to increase by €17.8 million, from €92.0 million to €109.8 million (see Table 6). It is then expected to decline slightly in 2018, and increase marginally over the following two years. The MFAC notes that the 2016 targets which had been indicated in the USP 2016 – 2019 and the DBP for 2017 were marginally missed. At the time of the assessment of the DBP, the MFAC had commented on the absence of “identifiable factors to justify the higher dividends anticipated from the MFSA” for 2017. There is no further justification provided why the 2017 estimate has been scaled further up in the USP 2017 – 2020. Likewise, the upward revisions for the 2018 and 2019 estimates, compared to those produced in the USP of the previous year, cannot be traced to specific factors. On this basis, the MFAC considers there are small downside risks to the forecasts for the revenue item throughout the full forecast horizon.

Table 6: Property income (EUR millions)

	USP 2016 – 2019	DBP 2017	USP 2017 - 2020
2016	95.8	95.3	92.0
2017	96.5	105.0	109.8
2018	97.5	NA	103.6
2019	97.5	NA	104.6
2020	NA	NA	105.6

Source: MFIN

²⁶ Property income represents mainly the dividends received in particular from the CBM, and to a lesser extent the companies listed on the Malta Stock Exchange (MSE) and the Malta Financial Services Authority (MFSA), together with rent earned from government properties and interest earned on holdings of bonds and other loans.

4.6. Other revenue

*Definition: Other revenues not elsewhere classified.*²⁷

Other revenue is projected to decline in 2017 but increase in 2018 and remain broadly stable thereafter (see Table 7). The two most relevant factors explaining these movements are the expected inflows from EU funds, and the revenue generated through the IIP.

Table 7: Other revenue

	Total	EU funds	IIP	Residual
2015	567.8	253.1	50.2	264.5
2016	483.5	39.4	171.5	272.6
2017	426.7	94.7	100.0	232.0
2018	489.3	155.8	100.0	233.5
2019	482.5	153.2	90.0	239.2
2020	485.2	150.0	90.0	245.3

Source: MFIN

The projections for EU funds are based on the assumption that after a slow start in 2016, the absorption rate will pick up in 2017. Further momentum is expected to be gained in 2018 and remain high, albeit slightly lower in 2019 and 2020. The assumption of higher absorption rate compared to 2016 is plausible, as this tends to increase as the new programming period advances. However the extent of the possible increase remains uncertain. The projected take up of EU funds is possible, as indicated by the very high level recorded in 2015, which was the last year for which funds allocated under the EU's Multiannual Financial Framework (MFF) 2007-2013 programming period could be used.

The target revenues from the IIP, at €100 million for 2017 and 2018 and €90 million for 2019 and 2020, are lower than the elevated amount collected in 2016, but still higher than what was collected in 2015. The target for 2017 remained unchanged compared to what was indicated in the latest DBP, but the new targets for 2018 and 2019, set out in the latest USP, are higher than the €37.6 million which had been indicated in last year's USP. This upward revision mirrors the higher-than-expected yield in 2016.

On the other hand, the estimates for the residual elements within the 'other revenue' category are projected to scale down in 2017 and to moderately increase thereafter.

²⁷ This budget item represents residual revenue components, mainly accounted for by market output and capital transfers. Market output consists primarily of revenues derived from permits and charges for the services offered by the public sector, and also of the revenues accruing from the IIP. Capital transfers receivable relate mainly to the absorption of EU funds.

By its nature, the trajectory for ‘other revenue’ remains uncertain, owing to the diverse components making up this revenue item. Under one scenario, downside risks may exist because the take up of EU funds may progress more slowly than envisaged, while the yield from the IIP may not be as high as anticipated. On the other hand, it is equally possible that such targets could be achieved and possibly surpassed, since the forecast amounts are within the levels which have been attained in the past. On balance, since the direction of specific identifiable risks cannot be detected by the MFAC with reasonable certainty, the risk assessment for this revenue item is treated as broadly neutral across the forecast horizon.

4.7. Total government revenue

The MFAC’s assessment identified upside risks in relation to taxes on production and imports, as well for current taxes on income and wealth (see Table 8). This follows the rather conservative assumptions employed by the MFIN in these two cases, as judged by the MFAC. On the other hand, the intake from property income may fall slightly short of expectations. In the case of the remaining revenue components, namely ‘capital taxes’, ‘social contributions’ and the ‘other revenue’ category, the MFAC’s risk assessment is neutral.

Table 8: Summary of risks to the revenue projections

	2017	2018	2019	2020
Taxes on production and imports	↑↑	↑↑	↑↑	↑↑
Current taxes on income and wealth	↑↑	↑↑	↑↑	↑↑
Capital taxes	↔	↔	↔	↔
Social contributions	↔	↔	↔	↔
Property income	↓↓	↓↓	↓↓	↓↓
Other revenue	↔	↔	↔	↔
Total revenue	↑↑	↑↑	↑↑	↑↑

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

Source: MFAC

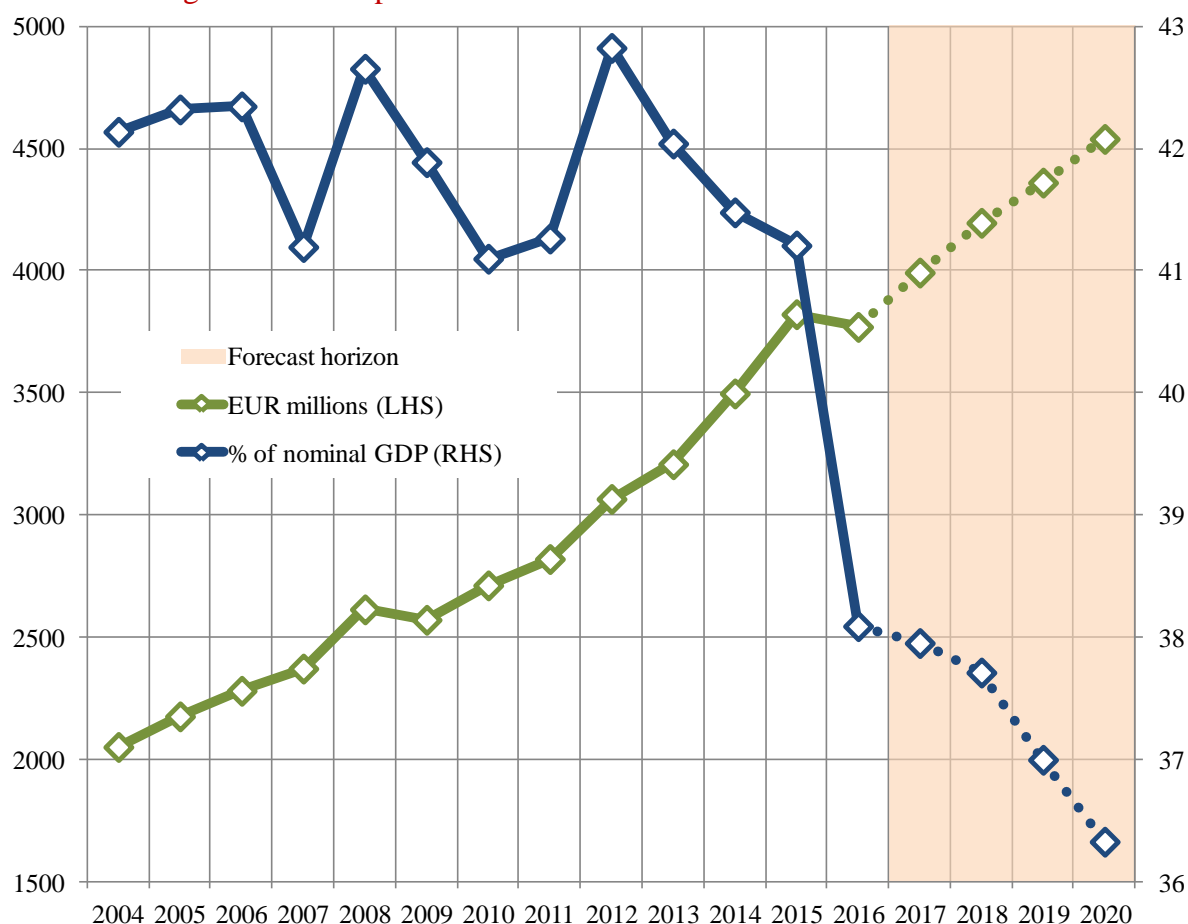
Overall, the MFAC thus considers the projections for total government revenue for the period 2017 – 2020 to be within its endorsable range, with on aggregate possible upside risks for total revenue. The analysis carried out on each major revenue component indicates

homogeneity as regards the risk assessment, in the sense that the identified risks apply for each forecast year.

5. Assessment of the expenditure projections for the period 2017 – 2020

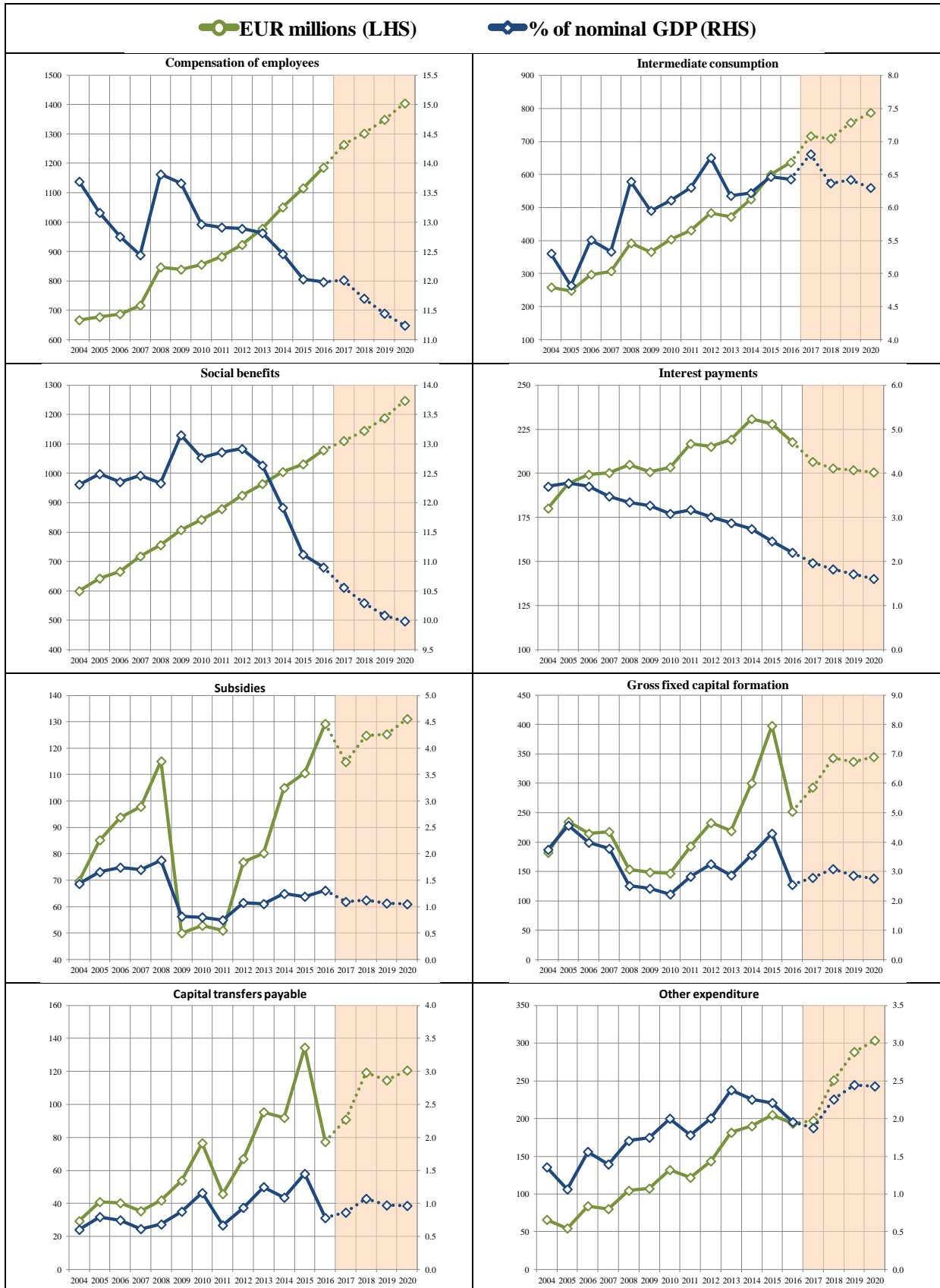
The projections included in the USP 2017 – 2020 show that total expenditure is expected to rise again in 2017, after the exceptional fall recorded in 2016. Between 2017 and 2020 expenditure is projected to increase by €769.5 million in total. Growth in each of these years is respectively estimated at 5.9%, 5.1%, 3.9% and 4.1%, consistently below the projected annual nominal GDP growth. This planned restraint in expenditure growth is spread across different components. If these projections materialise, the expenditure-to-GDP ratio will fall to 36.3% of GDP by 2020, which is the lowest for over a decade (see Chart 7). The assessment of these projections is carried out in a disaggregated manner, adopting the same approach used in the previous section (see Chart 8).

Chart 7: Total government expenditure



Source: MFIN

Chart 8: Expenditure components



Source: MFIN

5.1. Compensation of employees (D.1)

*Definition: The total remuneration, in cash or in kind, payable by an employer to an employee in return for work done by the latter during an accounting period.*²⁸

The drivers of spending on compensation of employees are the number of public sector employees and their average wage. Since employment within the government departments has been decentralised, the projections for compensation of employees effectively show the allocated spending on this budget item. Ministries are free to determine their employment levels, as long as the total budgeted amount is respected. On the other hand, the average wage over the forecast horizon is driven by the new collective agreement concluded in April 2017 which covers the eight-year period 2017 to 2024, and any wage drift which would occur when employees are promoted or receive bonuses.

The increases awarded to the civil servants under the new collective agreement are in the region of 3% per annum for the period 2017 to 2020.²⁹ These increases are inclusive of any cost of living adjustments (COLA) which the Government may award in respect of these years. However, the new collective agreement does not cover other elements of the Government's wage bill, such as those pertaining to certain sectors such as health and education, as well as those employees in public sector entities and the extra budgetary units, who are covered by different collective agreements or compensation packages.³⁰

The budgeted increase in compensation of employees for 2017 is comparable to the increases recorded in previous years (see Chart 9). On the other hand, the growth rates projected for the period 2018 to 2020 are significantly lower than the growth rates which were recorded in previous years. The projected amounts appear to allow almost exclusively for the increases in the average wage. Any additional employment or wage drift may thus increase the challenges to adhere to such restraint.

Compared to the previous forecasts, the allocations have been increased by €22.8 million for 2017 (compared to the latest DBP) and by €43.9 million and €46.7 million for 2018 and 2019 respectively (based on the USP figures of the previous year). The USP 2017 – 2020 stated that “autumn projections already factored in an estimate of the cost of the collective agreement. Whilst this was lower than the actual cost of the agreement, until such time as the planned recruitment for 2017 becomes effective, savings are known to have materialised in the first quarter of 2017. These savings should cover the additional cost which was not

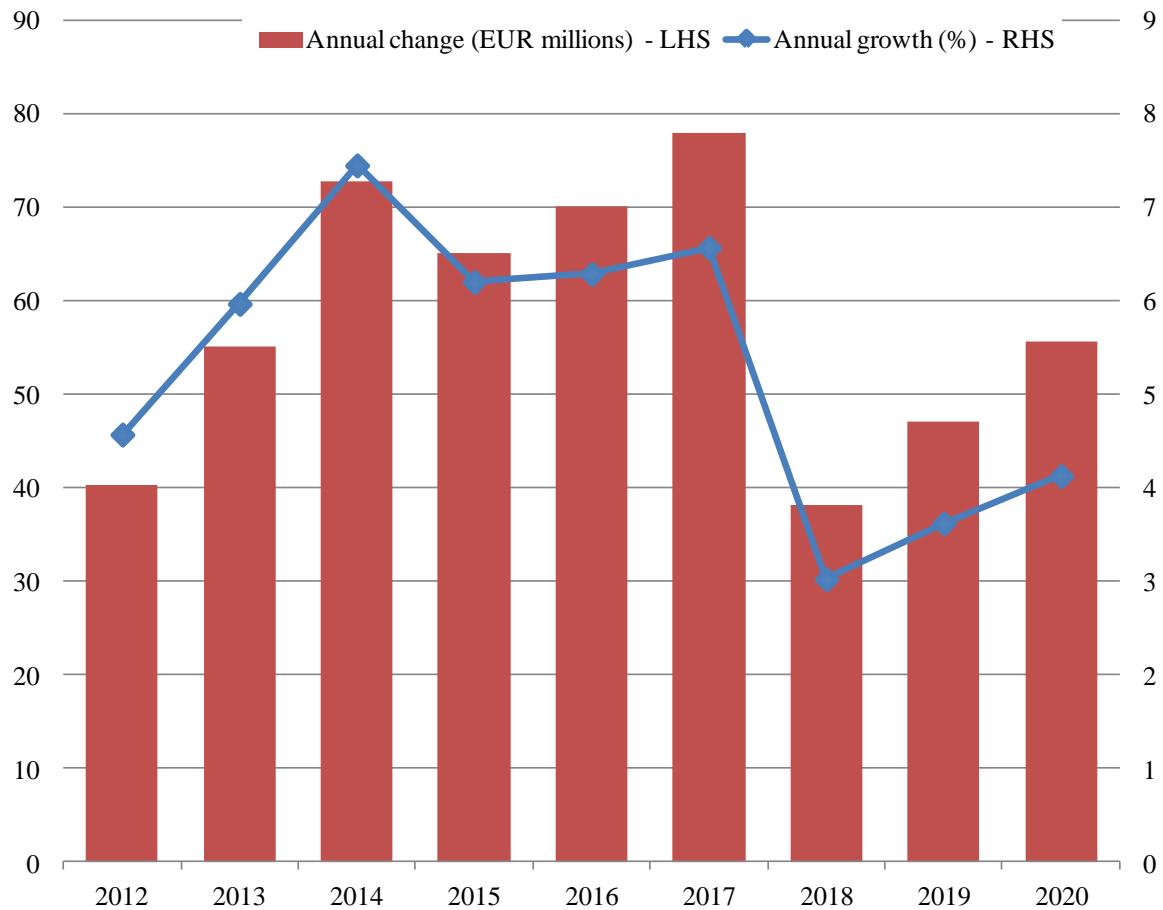
²⁸ This budget item consists of the wages and salaries of civil servants, and employees in local councils and government entities. These include Extra Budgetary Units (EBUs) that are funded fully or in large part by subventions from the Government and are therefore classified within the general government sector for ESA purposes.

²⁹ This figure is calculated on the basis of how the minimum salary for three representative scales, scale 5, scale 10 and scale 15 is changing in each respective year according to Appendix A of the Collective Agreement for Employees in the Public Service.

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

factored in the autumn projections.” Indeed, according to the Consolidated Fund data, personal emoluments only increased by €6.3 million during the first three months of the year. However, these increases do not yet incorporate the impact of the new collective agreement which is estimated to cost around €17 million for 2017.³¹

Chart 9: Compensation of employees



Source: MFIN

Thus, on balance the MFAC considers that the risks for the attainment of the target for compensation of employees to be neutral for 2017 but on the upside for the period 2018 – 2020.

³¹ The agreement came into effect from 1 January 2017.

5.2. Intermediate consumption (P.2)

Definition: Goods and services consumed as inputs by a process of production, excluding fixed assets whose consumption is recorded as consumption of fixed capital. The goods and services are either transformed or used up by the production process.³²

Spending on intermediate consumption is projected to rise significantly in 2017, up by €80.1 million (see Table 9). The 2017 outlays on intermediate consumption have been revised upwards by €32.0 million when compared to the forecasts presented in the latest DBP. However, it may also reflect the fact that not all the budgeted amount was spent in 2016, which could have been the result of the postponement of certain activities.

A major factor contributing to the higher outlays on intermediate consumption compared to 2016 relates to the costs associated with the EU Presidency. In 2016 its effect was estimated at €10.8 million, while for 2017, €26.3 million is being budgeted for. However, the upward revision in the estimates for 2017 is not directly related to the EU Presidency, since the budgeted amount was unchanged from the time the DBP was published. Other factors boosting intermediate consumption in 2017 relate to the health concession agreements. The recent agreement to increase the national minimum wage will also probably have an upward impact on the yearly outlays on intermediate consumption. Further upward pressure could arise from the outlays relating to the holding of the general elections in 2017, to be held on 3 June.

Table 9: Intermediate consumption

	Yearly absolute change (EUR millions)	Yearly growth rate (%)
2015	75.1	14.3
2016	36.4	6.1
2017	80.1	12.6
2018	-7.8	-1.1
2019	48.4	6.8
2020	30.2	4.0

Source: MFIN

³² Intermediate consumption consists of a vast array of expenditures incurred as part of the activities carried out by the Government. A significant proportion is associated with the health sector, and includes other special expenditures such as the initiative of free child care, the organisation of international summits and other similar initiatives, and payments in relation to the provision of public services (such as lighting, transport and water services). This item also captures the activities of the Environmental Landscapes Consortium Ltd and Engineering Resources Ltd, which have assumed some of the employees previously employed in the ship repair and energy sectors, following the restructuring which has been undertaken in these sectors.

The planned reduction in outlays for 2018 reflects the base effect created by the exceptional expenditure linked to 2017. The expiry of related contracts is expected to contribute to the decline. Further growth, amounting to 6.8% and 4.0% is then projected for 2019 and 2020, respectively.

Intermediate consumption is historically a volatile component of government expenditure. Still, the general pattern is for the ratio of intermediate consumption to GDP to rise over time. Indeed, elements such as health related expenditure tend to grow faster than GDP.³³ Hence, the targeted slowdown in expenditure growth in 2020 may be rather challenging.

Thus, on balance, the MFAC considers that there are upside risks to spending on intermediate consumption throughout the forecast horizon.

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

Definition: Benefits payable in cash to households by social security funds and other benefits payable by employers in the context of other employment related social insurance schemes. In kind benefits refer to individual goods and services provided for free or at prices that are not economically significant to individual households by government units and Non-Profit Institutions Serving Households (NPISH), whether purchased on the market or produced as non-market output by government units or NPISHs. They are financed out of taxation, other government income or social security contributions, or out of donations and property income in the case of NPISHs.³⁴

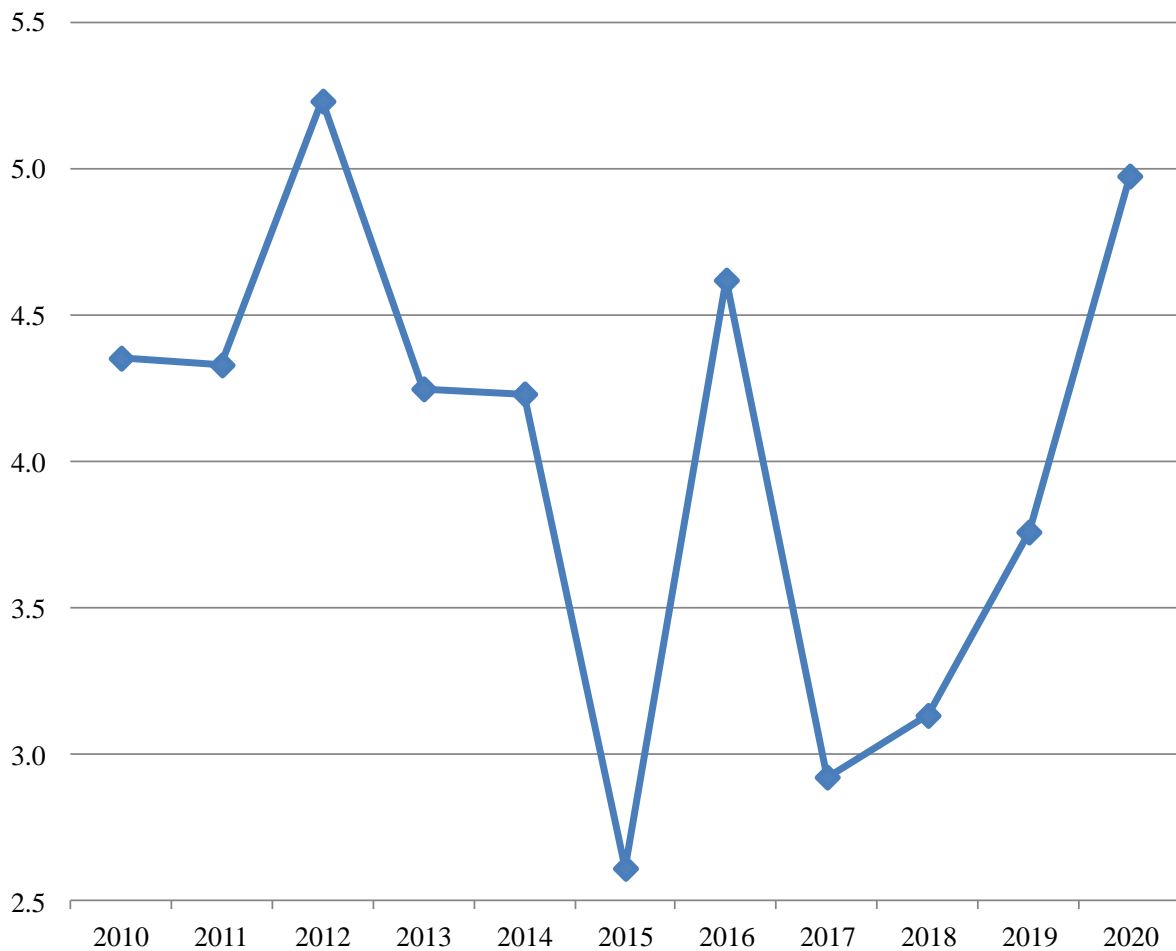
The projections extend the downward trajectory for the social benefits-to-GDP ratio observed in recent years. Between 2017 and 2019, social benefits are generally projected to increase at a slower rate than the average growth recorded during the seven-year period 2010 to 2016. Indeed, during these years social payments are expected to grow by 2.9%, 3.1% and 3.8% respectively, as opposed to the average growth of 4.2% observed in recent years (see Chart 10). The growth rate for 2020 is however expected to be higher, at 5.0%.

Specifically for 2017, the higher social payments arising from the 2017 Budget measures, which collectively are expected to increase expenditure by around €13.0 million, are in part offset by the other expenditure-reducing effects, in particular through the tapering of social benefits.

³³ For example in a 2011 statement by the Organisation for Economic Co-operation and Development (OECD), the institution remarked that “Health spending continues to rise faster than economic growth in most OECD countries, maintaining a trend observed since the 1970s”. Source: <http://www.oecd.org/newsroom/healthspendingcontinuestooutpaceeconomicgrowthinmostoecdcountries.htm>.

³⁴ This budget item consists of the various welfare programmes, both contributory and non-contributory, such as pensions, children allowances, social assistance and stipends. The direct provision of pharmaceutical products accounts for the bulk of social transfers in kind, with another element consisting of the provision of free school transport.

Chart 10: Growth in social benefits (%)

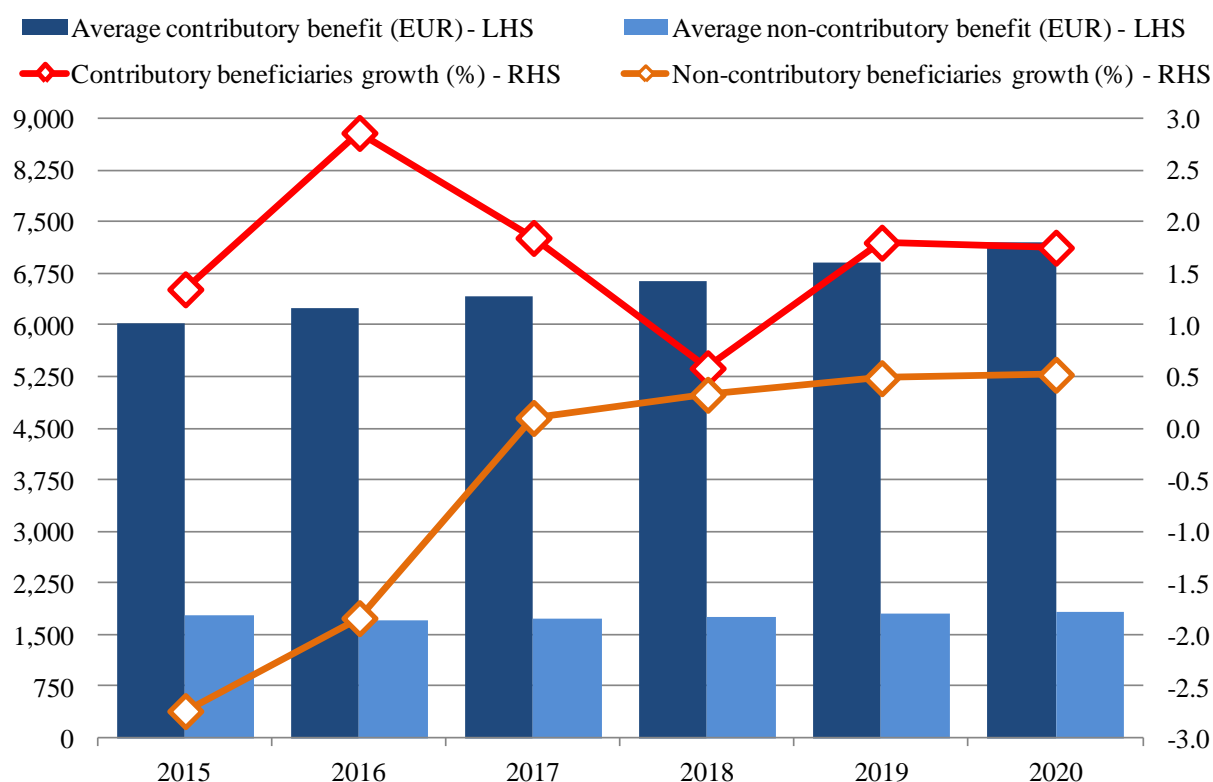


Source: MFIN

The average contributory benefit is expected to rise from €6,246 in 2016 to €7,198 by 2020, while the average non-contributory benefit is projected to rise from €1,710 to €1,837 during the same period (see Chart 11). The projections also embed a rising number of contributory and non-contributory beneficiaries. In the case of contributory beneficiaries, the assumed growth rates are within close range of the average growth rate recorded during 2015 and 2016. In the case of non-contributory benefits, small positive growth is being assumed, in contrast with the declines registered in 2015 and 2016.

On balance, the MFIN's calculations for outlays on social payments appear plausible. No specific upside or downside risks can be identified, supporting the MFAC's view of neutral risks for social benefits over the forecast horizon.

Chart 11: Contributory and non-contributory benefits



Source: MFIN

5.4. Interest expenditure (D.41)

*Definition: Property income receivable by the owners of a financial asset for putting it at the disposal of another institutional unit.*³⁵

Interest payments are projected to amount to €206.6 million in 2017, €11.2 million less than in 2016. This follows a similar decline amounting to €10.2 million which was recorded in 2016. The projections feature additional interest savings over the forecast horizon, albeit of a smaller magnitude, €3.7 million in 2018, €1.0 million in 2019 and €1.3 million in 2020.

The USP assumes that the short-term interest rate will remain stable at 0.0% while the long-term 10-year interest rate will average 0.8% throughout the forecast horizon (slightly less than the 0.9% recorded in 2016). Given that the implicit rate on government debt stood at 3.9% in 2016, roll-over savings on the maturing debt are likely. In 2017, the implicit interest rate is expected to decline by 0.3 pp, similar to the change observed in 2016. Throughout the period 2018 to 2020 the implied interest rate is projected to decline further and hover around 3.4-3.5%.

³⁵ This budget item consists of the interest payments made on public debt.

The roll-over savings are partially offset by the assumed higher level of debt, which by 2020 is expected to be €177.0 million higher when compared to end 2016, as a result of positive stock-flow adjustments.³⁶ However, the additional interest cost associated with the servicing of higher outstanding public debt is likely to be more than offset by the before-mentioned roll-over savings.

Overall, the MFAC considers the risk to the projections for interest payments to be neutral over the forecast horizon.

5.5. Subsidies (D.3)

*Definition: Current unrequited payments which general government or the institutions of the European Union make to resident producers.*³⁷

According to the USP 2017 – 2020, subsidies are expected to decline from €129.2 million in 2016 to €114.8 million and then rise again thereafter (see Table 10). In 2016, the outturn was higher than initially projected in both the USP 2016 – 2019 and the DBP 2017. This may suggest that the planned drop for 2017, indicated in the latest USP, could be more challenging to achieve, should the higher subsidies in 2016 create a permanent base effect. At the same time, the MFAC notes that the forecasts for 2018 and 2019 have been scaled slightly upwards when compared to what was indicated in last year’s USP. This makes the yearly target for subsidies more feasible. On this basis, the MFAC considers that there are upside risks to subsidies for 2017 but neutral risks for the outer forecast years.

Table 10: Subsidies (EUR millions)

	USP 2016 - 2019	DBP 2017	USP 2017 - 2019
2015	110.6	110.6	110.6
2016	109.4	111.6	129.2
2017	116.1	112.4	114.8
2018	118.3	NA	124.8
2019	118.1	NA	125.3
2020	NA	NA	131.1

Source: MFIN

³⁶ Refer to section 6 for further details.

³⁷ This budget item consists mainly of the subsidies paid to the transport, energy and agricultural sectors.

5.6. Gross fixed capital formation (P.51)

*Definition: Resident producers' acquisitions, less disposals, of fixed assets during a given period plus certain additions to the value of non-produced assets realised by the productive activity of producer or institutional units. Fixed assets are produced assets used in production for more than one year.*³⁸

Spending on gross fixed capital formation is planned to increase from €251.9 million to €293.1 million in 2017, and average €341.7 million between 2018 and 2020. The projections thus suggest that during the period 2018 to 2020 the outlays on gross fixed capital formation will be higher than recorded in previous years, excluding 2015, which was an exceptional year.³⁹

Gross fixed capital formation can be a rather volatile expenditure component. Elevated spending on gross fixed capital formation is indeed possible, but can be challenging. The fact that Consolidated Fund data for the first three months of 2017 indicates that capital expenditure declined from €52.1 million to €43.8 million, creates challenges for the attainment of the 2017 target. Still, these figures should only be considered as indicative since the compilation of gross fixed capital formation on an ESA basis varies from the measurement of capital expenditure in the Consolidated Fund. Investment spending also normally picks up gradually along the year. Indeed, in 2016, spending on capital expenditure during the first quarter of the year was 16.8% of the yearly total, while the comparable figure for 2015 was 15.2%. At the same time, the attainment of the higher level of spending on gross fixed capital formation for the outer forecast years relies on the assumption of higher absorption of EU funds in the earlier years of the EU's Programming Period, when compared to the previous period.

On balance, since the direction of specific identifiable risks cannot be identified by the MFAC with reasonable certainty, the risk assessment for this expenditure item is treated as broadly neutral across the forecast horizon.

³⁸ This budget item consists of the capital expenditure undertaken by the various ministries and EBUs.

³⁹ 2015 was an exceptional year since this was the last year when EU funds pertaining to the programming period 2007 – 2013 could be spent.

5.7. Capital transfers payable (D.9)

*Definition: capital transfers require the acquisition or disposal of an asset, or assets, by at least one of the parties to the transaction. Whether made in cash or in kind, they result in a commensurate change in the financial, or non-financial, assets shown in the balance sheets of one or both parties to the transaction.*⁴⁰

In 2016, capital transfers had been projected at €60.2 million in the USP 2016 – 2019 and €55.8 million in the last DBP. Specifically for 2016, consolidation measures amounting to €8.8 million, were announced but yet unspecified, in the USP and DBP. However, the outturn was significantly higher than projected, at €77.3 million, highlighting the challenges on expenditure restraint in this area.⁴¹

The projections indicate higher outlays for the period 2017 to 2020 compared to 2016. These are also influenced by the assumptions relating to the absorption of EU funds, some of which are channelled to public sector entities via capital transfers.

The MFAC acknowledges the extent of discretion available to the Government over this expenditure item. Overall, the MFAC considers the projections for capital transfers to be plausible with neutral risks throughout the forecast horizon.

5.8. Other expenditure

*Definition: Other expenditures not elsewhere classified.*⁴²

In absolute terms, ‘other expenditure’ is expected to increase slightly in 2017, and continue increasing in the outer forecast years. As a result, its ratio to GDP is expected to increase from 2.0% in 2016 to 2.4% in 2020, possibly reflecting the expansion of Government activities which impact this expenditure item. Owing to the heterogeneity of this expenditure item, it is hard to project such expenditure at an aggregate level.⁴³ Overall, the MFAC

⁴⁰ This budget item consists mainly of transfers to a number of public sector entities to cover their capital expenditure. These include Wasteserv, Foundation for Tomorrow Schools (FTS), Malta Enterprise, Malta College for Arts Science and Technology (MCAST), Malta Council for Science and Technology (MCST) and the University of Malta (UoM). Part of this expenditure is also matched by EU funds.

⁴¹ The actual consolidation measures, which were initially conceived in terms of the Consolidated Fund framework, rather than the ESA framework, could have been carried out in respect of expenditure components which impacted a different ESA expenditure component than capital transfers.

⁴² This budget item represents residual expenditure components, mainly accounted for by current transfers to the numerous government entities to fund their operations. Within this aggregate there is also included the annual budget allocation equivalent to 0.1% of GDP for the Contingency Reserve, if applicable. Sale of government land is treated as a negative value among these components.

⁴³ Owing to the fact that in 2016 a fiscal surplus was recorded, no expenditure allocation for the Contingency Reserve is embedded within the fiscal forecasts, in line with the FRA.

considers the allocation for expenditure in this category as prudent, with neutral risks throughout the forecast horizon.

5.9. Total government expenditure

According to the USP, total government expenditure will increase throughout the forecast horizon. However, in terms of GDP, total expenditure will be scaled down further. The item-by-item examination of risks to the expenditure forecasts outlined in the previous sections indicates that on aggregate there could be possible upside risks throughout the forecast horizon (see Table 11). With respect to 2017, upside risks have been identified in relation to intermediate consumption and subsidies, while in the case of the other expenditure components within the budget, the risks have been judged neutral by the MFAC. Over the remaining three-year forecast horizon, upside risks relate to compensation of employees and intermediate consumption.

Table 11: Summary of risks to the expenditure projections

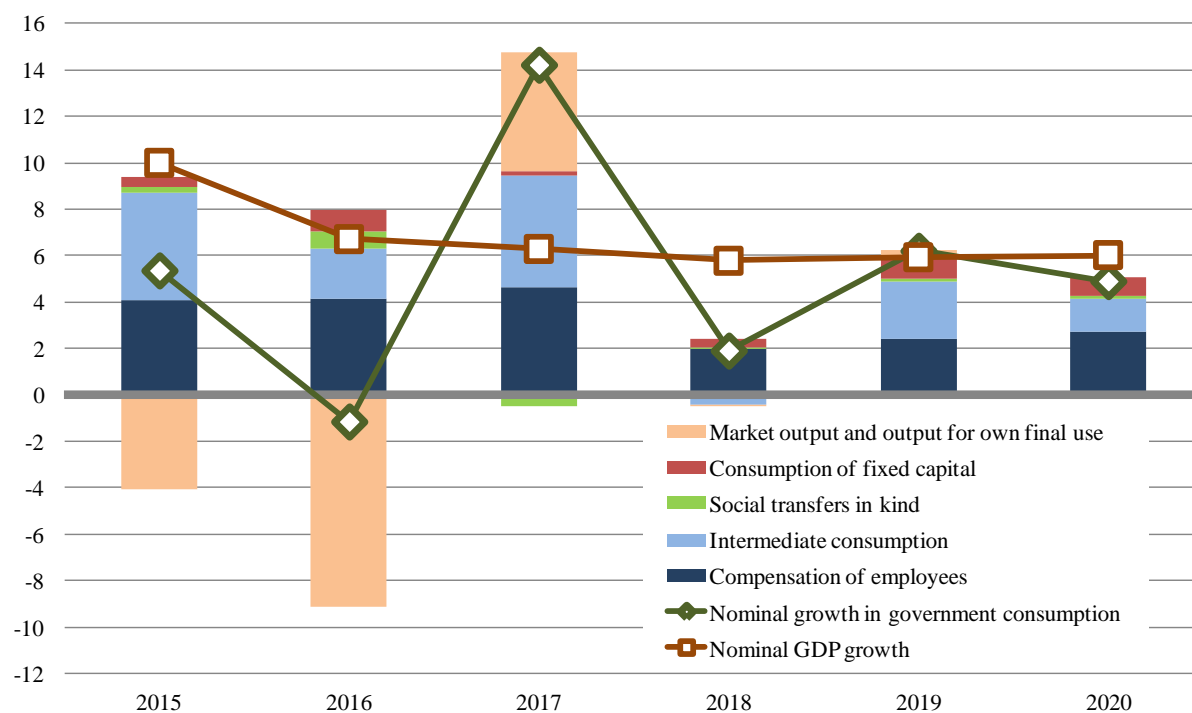
	2017	2018	2019	2020
Compensation of employees	↔	↑	↑	↑
Intermediate consumption	↑	↑	↑	↑
Social benefits	↔	↔	↔	↔
Interest expenditure	↔	↔	↔	↔
Subsidies	↑	↔	↔	↔
Gross fixed capital formation	↔	↔	↔	↔
Capital transfers payable	↔	↔	↔	↔
Other expenditure	↔	↔	↔	↔
Total expenditure	↑	↑	↑	↑

Source: MFAC

The projected expenditure developments, combined with the projections for market output, determine the forecast for nominal government consumption, as measured in the national accounts. Nominal government consumption is expected to grow unevenly throughout the forecast horizon. In particular, government consumption is expected to grow much faster than nominal GDP in 2017, up by 14.2%, and lower than GDP in 2018, up by 1.9% (see Chart 12). The surge in nominal government consumption in 2017 can be traced to two main factors, the swings in market output, as well as the one-off expenditure associated with the EU

Presidency (which features in intermediate consumption).⁴⁴ Otherwise, compensation of employees, which normally represents around half of government consumption, is expected to contribute steadily to nominal government consumption growth throughout the forecast horizon. In 2019 and 2020, nominal government consumption is projected to grow roughly in line with nominal GDP.

Chart 12: Drivers of nominal government consumption growth (% , pp)



Source: MFIN

6. Assessment of the trajectory for the fiscal balance and public debt for 2017 – 2020

On the basis of the MFAC’s assessment, there are upside risks to total revenue and total expenditure in each of the forecast years (see Table 12). However, the MFAC considers that both upside risks may compensate each other in terms of magnitudes. As a result, the risks to the attainment of the fiscal balance targets are judged to be neutral throughout the full forecast horizon.

Turning to public debt, in absolute terms it is projected to increase in each of the forecast years, apart from a small decline in 2018 (see Chart 13). Such a pattern is projected despite a yearly fiscal surplus of approximately €60 million being targeted between 2017 and 2020. Since nominal GDP is expected to expand at a faster pace, however, the ratio of public debt to GDP is expected to decline steadily, to well below the 60% requirement prescribed by the SGP.

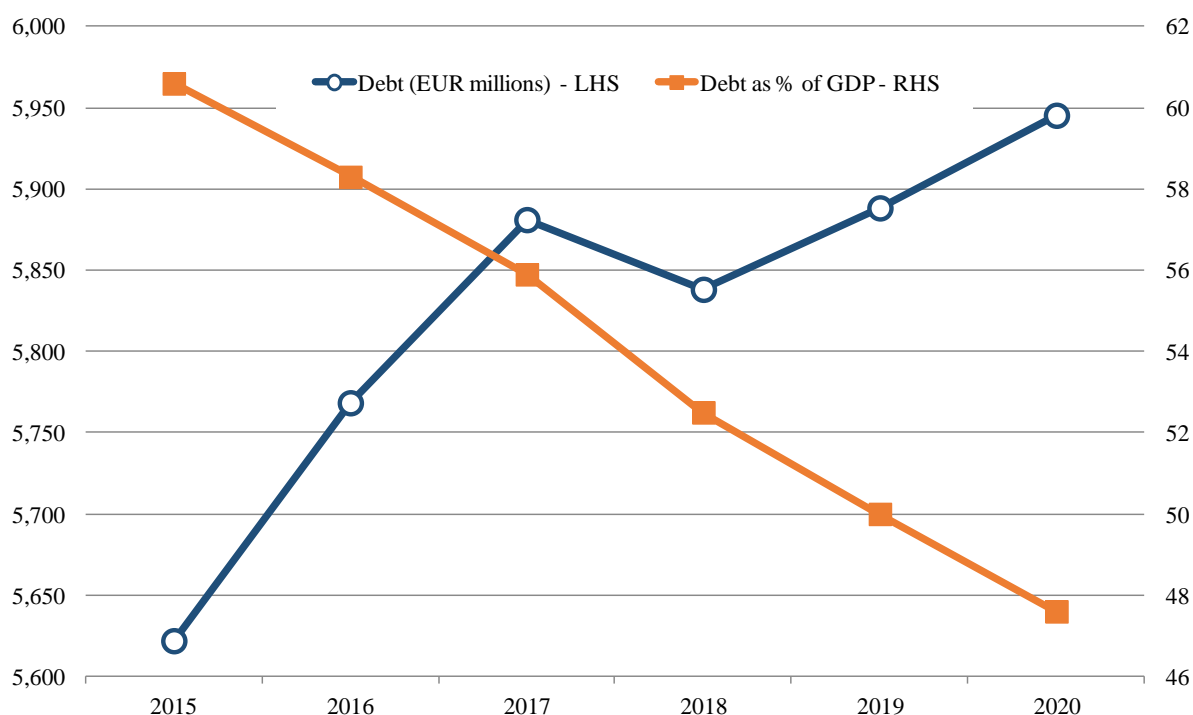
⁴⁴ The value of market output is deducted from the other components of Government consumption. Therefore, since market output (which includes the revenues from the IIP) is projected to be lower in 2017 than in 2016, this creates an upward effect.

Table 12: Summary of risks to the fiscal projections

	2017	2018	2019	2020
Total revenue	↑↑	↑↑	↑↑	↑↑
Total expenditure	↑↑	↑↑	↑↑	↑↑
Fiscal balance	↔	↔	↔	↔

Source: MFAC

Chart 13: Public debt dynamics

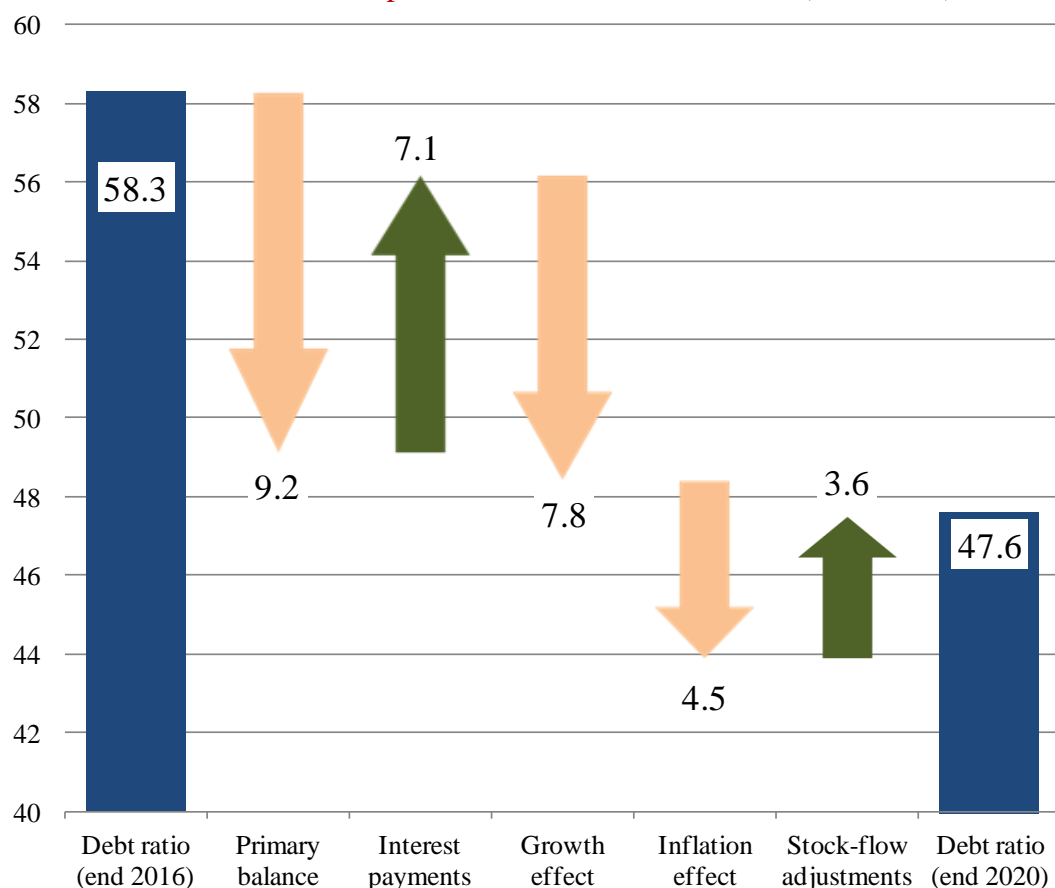


Source: MFIN

The plausibility of the trajectory for the public debt ratio depends on the extent to which the underlying drivers of the public debt ratio are considered to be plausible. On the basis of the MFIN's calculations, the drop in the debt ratio from 58.3% of GDP in 2016 to 47.6% of GDP, by 2020, stems from the positive downward impact of three factors, namely the primary surplus, real economic growth and inflation, which is partially offset by the upward push created by interest payments and the positive stock-flow adjustments (see Chart 14).

Since the macroeconomic and fiscal outlook for the period 2017 to 2020 have been deemed to be within the endorsable range of the MFAC, the estimated impacts derived from the primary balance, interest payments, real economic growth and inflation are consequently deemed to be plausible.

Chart 14: Forecast debt developments between 2016 and 2020 (% of GDP)



Source: MFIN

The additional item which impacts the outstanding level of debt relates to stock-flow adjustments, which are assumed to be positive in each of the forecast years, thereby exerting an upward push on the debt. The USP indicates the full list of stock flow adjustments, which include contributions to special Malta Government Stock (MGS) Sinking Funds (€50 million annually), equity acquisitions (in particular €32.6 million in 2017) and currency issue (an average of €7.5 million yearly).⁴⁵ These are based on the plans by the MFIN, and the MFAC does not have any specific information to the contrary.

Thus, overall, the MFAC considers the MFIN's projections for the public debt-to-GDP ratio as within its endorsable range.

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

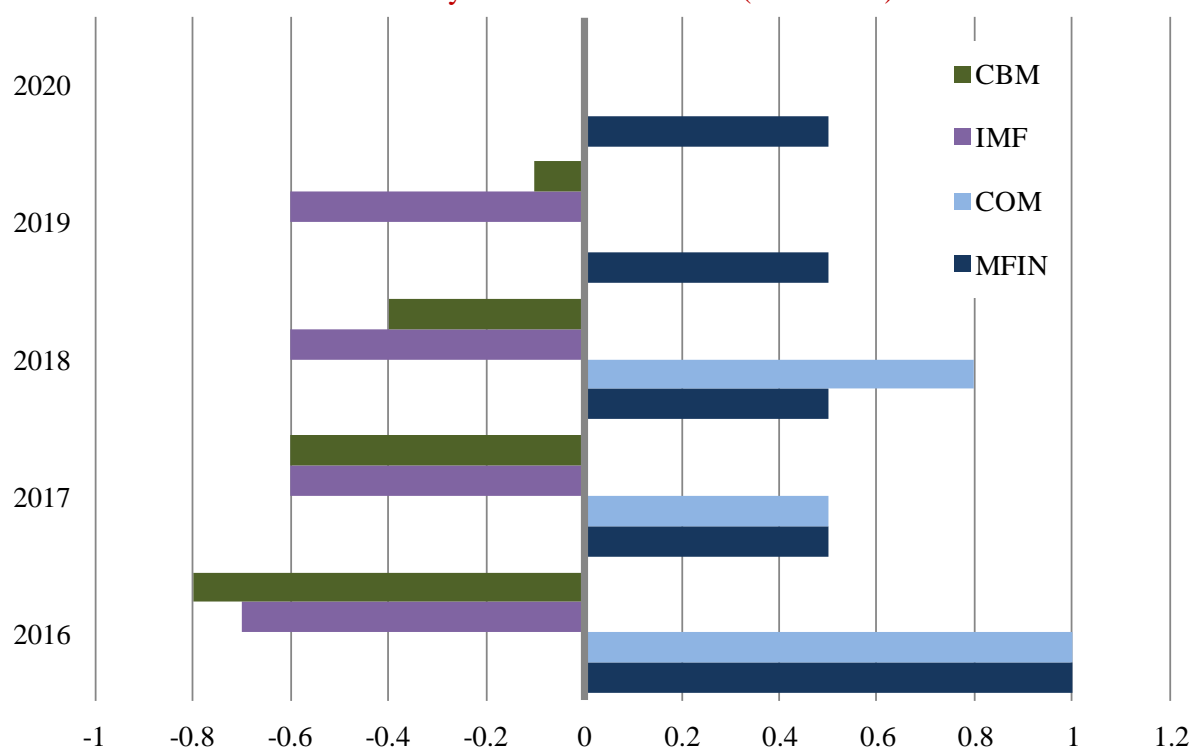
The plausibility of the MFIN's projections contained in the latest USP can also be evaluated by comparing them to the forecasts which are prepared by other institutions, namely the COM, the IMF and the CBM. A caveat of this analysis is however the fact that these forecasts were prepared in different periods. In particular, among the other institutions, only

⁴⁵ The issue of currency relates to currency coins issued by the CBM on behalf of the Government.

the COM's forecasts factor in the latest official outturn for fiscal and macroeconomic developments for 2016, as published by the NSO on 24 April 2017.⁴⁶

The COM's forecasts are very close to the MFIN's projections, both for the fiscal balance and for the public debt ratios for 2017 and 2018 (see Chart 15, Chart 16 and Table 13). Both institutions are projecting the fiscal balance to amount to 0.5% of GDP in 2017. However, in absolute terms, the COM's projected fiscal balance is €7.1 million lower than the MFIN's forecast, with slightly lower forecasts for both total revenue and total expenditure (see Table 14).

Chart 15: Fiscal balance forecasts by different institutions (% of GDP)



Note: The COM's forecasts extend till 2018, while those by the CBM and the IMF extend till 2019.

Source: CBM, COM, MFIN

Although for 2017 the COM's projections for taxes on production and imports are slightly higher than indicated in the USP, the other revenue components are expected to generate slightly less. Meanwhile, the COM's lower projections for total expenditure mainly reflect lower outlays on intermediate consumption, gross fixed capital formation and the 'other expenditures' category, which are partially offset by higher spending on subsidies, compensation of employees, interest payments and social payments.

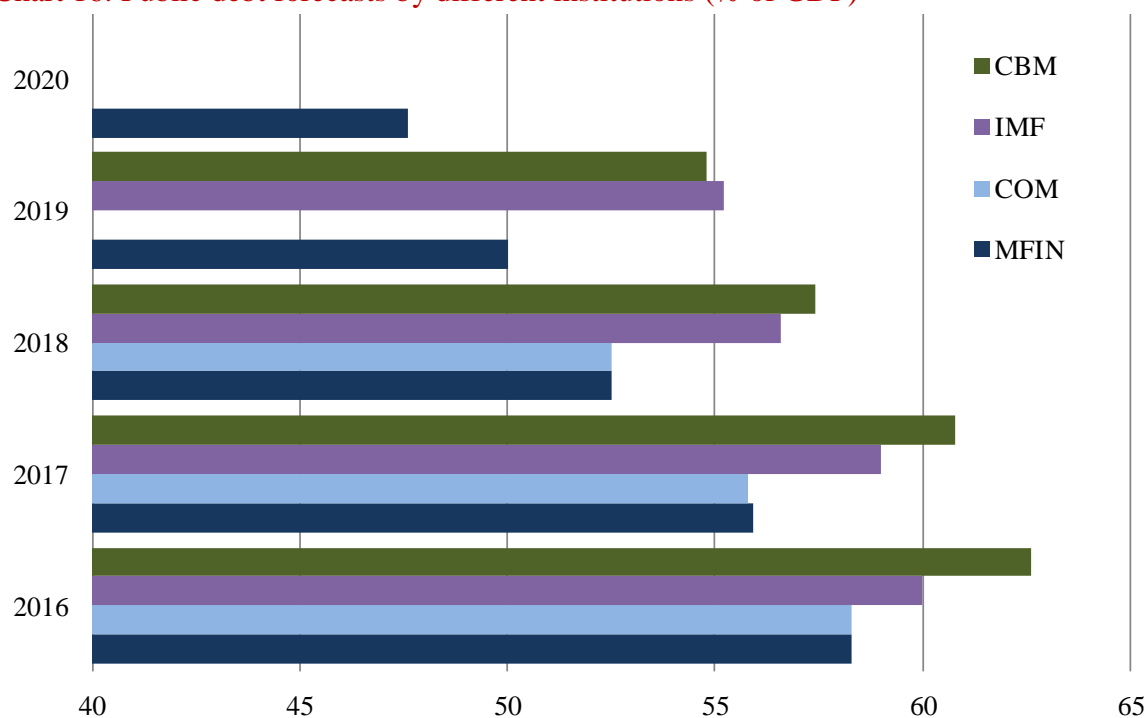
For 2018, the COM's projections point towards a fiscal surplus equivalent to 0.8% of GDP, which is slightly higher than the 0.5% of GDP being targeted by the MFIN. In absolute terms,

⁴⁶ Indeed, the COM's forecasts were published after the MFIN's forecasts while those by the IMF and CBM had been published before. The cut-off for the data used by the CBM was 23 November 2016, while in the case of the IMF, its report was finalised in February 2017.

the difference amounts to €30.7 million. The COM's forecast for total revenue is merely €3.4 million higher than that produced by the MFIN, with however some differences in terms of developments in the various components. In particular, the three main tax sources are expected to be yield more than indicated in the USP, but the impact is practically offset by lower projections from the other sources (which include EU funds and the intake from the IIP). On the other hand, the COM's forecast for total expenditure in 2018 is €26.3 million lower than indicated by the MFIN. Lower outlays on gross fixed capital formation and 'other expenditure' categories are expected to make up for the higher projections for compensation of employees, intermediate consumption, social payments, interest payments and subsidies.

A main difference between the COM's and the MFIN's forecasts, relates to the assumption about the yearly absorption of EU funds. Furthermore, the COM's more positive revenue projections compensate for the lesser degree of current expenditure restraint embodied in the COM's forecasts.

Chart 16: Public debt forecasts by different institutions (% of GDP)



Note: The COM's forecasts extend till 2018, while those by the CBM and the IMF extend till 2019.

Source: CBM, COM, MFIN

With regards to the public debt projections, both the COM and the MFIN indicate a progressive fall in the debt ratio, with the trajectory being practically identical, in both cases the debt ratio falling to 52.5% of GDP by 2018.

The MFAC acknowledges that the forecasts by the IMF and the CBM are not directly comparable to the MFIN's latest forecasts. Indeed, both the IMF and the CBM based their forecasts on the 2016 estimated data, which indicated a fiscal deficit-to-GDP ratio of 0.7%

and 0.8% respectively, as opposed to the actual 1.0% fiscal surplus embedded in the MFIN's database. This factor has created a base effect.

Table 13: Differences between the forecasts prepared by the COM and the MFIN

	2017			2018		
	EUR millions			EUR millions		
	COM	MFIN	Diff*	COM	MFIN	Diff*
Total revenue	4,032.0	4,049.7	-17.7	4,260.0	4,256.0	3.4
Taxes on production and imports	1,333.0	1,322.5	10.5	1,396.0	1,364.8	31.2
Current taxes on income & wealth	1,487.0	1,493.9	-6.9	1,600.0	1,573.7	26.3
Social contributions	675.0	678.5	-3.5	712.0	707.5	4.5
Other revenues**	537.0	554.8	-17.8	552.0	610.6	-58.6
Total expenditure	3,982.0	3,992.6	-10.6	4,170.0	4,196.3	-26.3
Compensation of employees	1,275.0	1,263.6	11.4	1,345.0	1,301.8	43.2
Intermediate consumption	687.0	716.0	-29.0	718.0	708.2	9.8
Social payments	1,117.0	1,110.4	6.6	1,156.0	1,145.2	10.8
Interest expenditure	215.0	206.6	8.4	211.0	202.9	8.1
Subsidies	132.0	114.8	17.2	134.0	124.8	9.2
Gross fixed capital formation	275.0	293.1	-18.1	307.0	343.2	-36.2
Other expenditures**	281.0	288.1	-7.1	299.0	370.2	-71.2
Fiscal balance	50.0	57.1	-7.1	91.0	60.3	30.7

* Figures represent the absolute differences between the COM's forecasts when compared to the MFIN's projections. A positive figure indicates a higher forecast by the COM while a negative figure indicates a lower forecast by the COM. Figures may not add up due to rounding.

** The values for other revenues and other expenditures do not correspond to the same values described in the other sections in this Report since they include revenue and expenditure items which are not separately identified in the COM's projections.

Source: COM, MFIN

The CBM's forecasts indicate a gradual yearly narrowing of the fiscal deficit-to-GDP ratio, to 0.6% in 2017, 0.4% in 2018 and 0.1% in 2019. On the other hand, the IMF's projections indicate a stable deficit ratio of 0.6% of GDP throughout the period 2017 to 2019. Owing to the less positive projections for the fiscal balance by both the IMF and the CBM, the forecast for the public debt ratio by these two institutions are also slightly higher. Both institutions see the ratio of public debt-to-GDP ratio on a declining path, but to around 55.0% of GDP by 2019, some 5 pp higher than indicated by the MFIN.

8. Conclusion

The MFAC acknowledges that the process used by the MFIN to prepare its fiscal projections is rigorous and based on sound methodological practices, despite the fact that for 2016 the MFIN had projected a small deficit and in actual fact a surplus was recorded.

The MFAC considers that the MFIN's revenue projections lie within its endorsable range, leaving the possibility for upside risks throughout the forecast horizon. This view is contingent on the materialisation of the macroeconomic outlook, as envisaged in the USP 2017 – 2020. Should the macroeconomic performance be less positive than that underpinning the DBP's calculations, or else, be driven by completely different contributors (which may be relatively more or less tax rich), the fiscal turnout could however be impacted, since most revenues are endogenous in nature. It is thus important that the MFIN remains vigilant to quickly detect and address any departure from current revenue trends.

The planned expenditures are also within the MFAC's endorsable range throughout the forecast horizon. However, the MFAC considers that expenditure may exceed its yearly target if some of the increases recorded in previous years are repeated. Nevertheless, the MFAC acknowledges that since there is a material share of expenditure which is discretionary, and hence directly under the control of Government, expenditure targets can thus still be attained.

On the basis of this assessment and the information available up to the cut-off date, the MFAC concludes that the risks to the fiscal balance appear to be neutral for the period 2017 to 2020, as the upside risks to revenue and expenditure compensate for each other. On this basis, even the planned downward trajectory for the public debt ratio appears achievable. The MFAC also notes that the COM's latest fiscal forecasts, which form part of the COM's Spring 2017 forecast round, and which are prepared independently of the MFIN, portray a similar outlook to that presented by the MFIN the USP 2017 – 2020.

Finally, the MFAC invites the Government to adhere closely to the fiscal plans as outlined in the USP 2017 - 2020, since any significant departure could pose risks to the attainment of the fiscal surplus and debt targets as outlined in this Report.

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