MALTA FISCAL ADVISORY COUNCIL

An Overall Assessment of the Medium-Term Fiscal Strategy for Malta 2016 – 2019

A report prepared by the
Malta Fiscal Advisory Council

June 2016

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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) assessing the planned conduct of fiscal policy as outlined in the Government's Medium Term Fiscal Strategy for the period 2016 to 2019. This report also contains the Council's assessment on the extent to which the numerical fiscal rules prescribed in the Stability and Growth Pact, and referred to in the Fiscal Responsibility Act, are being complied with.

The Council welcomes that by 2019 a budget surplus of 0.1% of GDP is being targeted, which is more ambitious than the objective of achieving a balance of -0.5% of GDP indicated in the Fiscal Responsibility Act. The Council positively notes that there is a commitment for the general government balance to continue to improve in each of the forecast years, both in absolute terms and when expressed as percentage of GDP. It further notes that the Government's reliance on one-off measures is limited throughout the Programme's horizon, which is desirable from a prudential perspective.

The planned yearly improvement in the underlying fiscal balance is driven by policy measures affecting both the revenue and expenditure sides of the budget. On the revenue side, the main contributors to the additional budget revenues should remain taxes on production and imports as well as current taxes on income and wealth. In structural terms, the increase in revenues is expected to be generated mainly through structural improvements in the economy and their effects on revenue, the Individual Investor Programme as well as through new indirect tax measures in place as from 2016.

On the expenditure side, it is noted that consolidation will be driven primarily through the planned restraint embedded in a number of expenditure components, particularly compensation of employees, intermediate consumption and social payments. While welcoming the drive towards greater expenditure restraint underpinning the Government's fiscal strategy, the Council considers that this may be increasingly harder to maintain over the medium term, unless supported by permanent structural changes. The Council therefore considers important that expenditure savings of a permanent nature are sought and crystallised. This may be possible through decisive improvements in the efficiency of the public services and the undertaking of further structural reforms, on the basis of the findings emerging from the various Comprehensive Spending Reviews which are being undertaken across the major expenditure categories within the Government's budget.

The Council positively notes that the 2015 targets for the general government fiscal balance-to-GDP ratio and the public debt-to-GDP ratio were met and indeed exceeded. However, the Council also notes that, when evaluated in terms of the numerical rules of the EU Fiscal Framework, the conduct of fiscal policy in 2015 prima facie did not fulfil two of the three criteria that are normally taken into account to assess compliance with the requirements of the Stability and Growth Pact. In this respect, the Council acknowledges that the European Commission's overall assessment concluded that "there appears to have been some but close to a significant deviation from the adjustment path towards the Medium Term Objective in 2015". Moreover, the Council welcomes the increased effort on the side of Government to ensure closer compliance in the years 2016 and 2017.

The debt criterion was met in 2015, aided by the strong nominal GDP growth which was recorded in that year. The Council expects this rule to continue being met throughout the forecast horizon, and indeed to register a positive margin of over four percentage points in relation to the debt benchmark calculated according to the rules of the Stability and Growth Pact.

On the other hand, in 2015 the actual improvement in the structural budget balance fell short of the required 0.6 percentage points. To some extent this was due to factors beyond the direct control of the Government. However, while acknowledging that the evaluation of structural conditions could be rather challenging in view of ongoing revisions in the output gap estimates, the MFAC encourages the Ministry for Finance to give increased attention, to the extent possible, to the structural balance in its regular monitoring of public finance, as ultimately the European Commission evaluates progress towards the Medium Term Objective on the basis of developments in the structural balance rather than the general government balance. The Council also underscores the importance to stick to the planned fiscal effort for 2016 and 2017, also through the supplementary €15 million expenditure restraint for 2016, which was announced in the Government's Medium Term Fiscal Strategy. This is necessary to ensure that over a two-year period the projected structural balance pillar would be met.

Moreover, the Council notes that in 2015, the expenditure benchmark was exceeded. The MFAC acknowledges that the estimated excess in government expenditure was influenced by the spike in capital expenditure and the interplay of one-off measures. However, going forward, it is important that efforts are stepped up to ensure full compliance with the expenditure rule, with expenditure growth contained to within the permissible limits, in line with what is indicated in the latest expenditure projections for the period 2016 to 2017. In this context, further rationalisation measures to maximise efficiency and concerted expenditure restraint will be essential to ensure that no significant deviation takes place with respect to the expenditure rule established in the Stability and Growth Pact.

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The Council views positively the publication by the Ministry for Finance of long term expenditure projections. This should help direct attention to issues beyond the electoral cycle.

While acknowledging the uncertainty which surrounds such long-term projections, the Council's view is that although in the short and medium term, risks to fiscal sustainability appear to be low, expenditure challenges seem to exist in the long term due to the projected impact of an ageing population on outlays related to pensions, healthcare and long term care. These challenges point to potential risks to fiscal sustainability in the long term, which warrant timely action. The Government is therefore invited to utilise the current benign macroeconomic conditions to continue to address these expenditure challenges through further strategic choices, aimed at safeguarding public finances from undue future pressures.

The MFAC notes positively that the Government's Medium Term Fiscal Strategy document has taken on board some of the recommendations made earlier by the Council, particularly in the area of fiscal transparency. At the same time, the Council would like to re-iterate its other recommendations, such as the importance of a gradual building of fiscal buffers, the need for the establishment of more clear criteria regarding resort to the Contingency Reserve, and the desirability of new legislation to govern the issuance of Government guarantees.

Overall, the Council considers that the Medium Term Fiscal Strategy broadly complies with the requirements of the Fiscal Responsibility Act. As required by Article 13 of the Fiscal Responsibility Act, the Council also confirms that in its opinion, there are no exceptional circumstances which would allow for a departure from the fiscal plans as announced in the latest Fiscal Strategy document.

Finally, the MFAC would like to express satisfaction at the constructive dialogue between the parties involved, auguring also that where possible the Government expresses publicly its views on the recommendations published by the Council.

Yours sincerely

Rene Saliba
Chairman

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Abbreviations

AWG	Working Group on Ageing Populations and Sustainability
COM	European Commission
CSR	Comprehensive Spending Review
DBP	Draft Budgetary Plan
EC	European Council
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EMU	Economic and Monetary Union
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
ISA	Individual Savings Account
MFAC	Malta Fiscal Advisory Council
MFIN	Ministry for Finance
MTFS	Medium-Term Fiscal Strategy
MTO	Medium Term Budgetary Objective
pp	percentage points
PSG	Pensions Strategy Group
SGP	Stability and Growth Pact
USP	Update of Stability Programme

Executive summary

This Report provides an overall assessment by the Malta Fiscal Advisory Council on the planned conduct of fiscal policy outlined in the Government's Medium Term Fiscal Strategy for the period 2016 to 2019. It also assesses compliance to the numerical fiscal rules prescribed in the Stability and Growth Pact, and referred to in the Fiscal Responsibility Act, based on the separate calculations presented by the Ministry for Finance and the European Commission.

The Government's macroeconomic projections indicate that during this period, economic growth is expected to remain elevated but moderate gradually, against a background of low unemployment and low inflation. Malta's fiscal policy priority is currently the attainment of the Medium Term Budgetary Objective of a balanced budget in structural terms by 2019, whose lower limit is specified in the Fiscal Responsibility Act at -0.5% of GDP at market prices. The Malta Fiscal Advisory Council welcomes that a budget surplus of 0.1% of GDP is targeted by 2019. Specifically, the target is for the general government balance to improve in each of the forecast years, both in absolute terms and when expressed as percentage of GDP. The planned retrenchment of the headline fiscal deficit is however spread unequally over the Programme period, with the correction being more pronounced in 2016 whereas in the following years, the correction is expected to be more gradual. The Council notes positively that the Government's reliance on one-off measures is limited throughout the Programme's horizon, which is desirable from a prudential perspective.

The planned yearly improvement in the underlying fiscal balance is driven by policy measures affecting both the revenue and expenditure sides of the budget. On the revenue side, the main contributors to the headline additional budget revenues should be taxes on production and imports as well as current taxes on income and wealth, against a background of strong economic growth. In structural terms, the increase in revenues is expected to be generated mainly through structural improvements in the economy and their effects on revenue, the Individual Investor Programme as well as through new indirect tax measures in place as from 2016.

On the expenditure front, consolidation is driven primarily through the planned restraint embedded in a number of expenditure components, particularly compensation of employees, intermediate consumption and social payments. Should such consolidation measures materialise, total expenditure as a percentage of GDP would be scaled down from 43.3% in 2015 to 38.3% in 2019, which is a rather ambitious though plausible target. While welcoming such expenditure restraint, the Council considers that this may be increasingly harder to maintain over the medium term, unless supported by permanent structural changes. The Council therefore considers important that expenditure savings of a permanent nature are sought and crystallised, where possible, through decisive improvements in the efficiency of the public services and the undertaking of structural reforms, also on the basis of the findings emerging from the various Comprehensive Spending Reviews being undertaken.

The Council notes that prima facie the conduct of fiscal policy in 2015 did not fulfil two of the three criteria that are normally taken into account to assess compliance with the requirements of the Stability and Growth Pact. However it also acknowledges that the European Commission's overall assessment concluded that "there appears to have been some but close to a significant deviation from the adjustment path towards the Medium Term Objective in 2015". In this respect, the Council welcomes the increased effort on the side of Government to ensure closer compliance in the years 2016 and 2017.

On a positive note, the debt criterion, which establishes the path that the debt-to-GDP ratio has to follow in order to ensure convergence to the threshold of 60%, was met in 2015, aided by the strong nominal growth which was recorded in that year. This rule is likewise expected to continue being met in the following years as both the Ministry of Finance and the European Commission are projecting that the debt ratio should continue falling to a level which is over four percentage points below the required debt benchmark.

On the other hand, in 2015 the actual improvement in the structural budget balance fell short of the required 0.6 percentage points. In this case, the Council shares the European Commission's view that this lack of structural effort can be ascribed to the fact that the more than expected GDP growth does not appear to have been sufficiently tax-rich, besides the fact that the eventual outcome of the Individual Investor Programme was less than expected mainly due to processing delays. While acknowledging that the evaluation of structural conditions could be rather challenging in view of ongoing revisions in the output gap estimates, the Council encourages the Ministry for Finance to give increased attention to the structural balance, as ultimately the European Commission evaluates progress towards the Medium Term Objective on the basis of developments in the structural balance rather than the headline balance. The Council also underscores the importance to stick to the planned fiscal effort for 2016 and 2017 to ensure that over a two-year period the projected structural balance pillar would be met.

In 2015, the expenditure benchmark, which establishes limits on growth in government expenditures, was also exceeded. This was to an extent related to the spike in capital expenditure and to the interplay of one-off measures. According to the projections by the Ministry for Finance, in 2016 growth in expenditure should be contained to below the reference rate but be slightly higher in 2017. The Ministry for Finance and the European Commission both anticipate that, over the period 2016 to 2017, the expenditure benchmark rule should be complied with.

The Medium Term Fiscal Strategy document also presents long-term projections which provide an indication of the demographic changes and fiscal impact that could result from an ageing population under a 'no-policy change' scenario. On the basis of the population and macroeconomic projections taking into account the pension reforms in place up to 2014, age-related public expenditure is expected to rise from 22.6% of GDP in 2013 to 29.2% in 2060. The Fiscal Strategy document also provides an update of these long-term expenditure calculations by including interim estimates on the projected impact resulting from the recently announced lengthening of the social security contributory period and the linking of the contributory period to retirement. On the basis of these interim estimates, there could be an improvement in the fiscal balance amounting to 0.5% of GDP by 2060 assuming no behavioural changes. The improvement could increase to 1.7% of GDP if one factors in possible changes in retirement patterns which lead to a later retirement.

While acknowledging the uncertainty which surrounds such long-term projections, the Council's view is that it appears clear that expenditure challenges exist in the long term, which would warrant timely action. This view is also in line with the assessment by the European Commission that while in the case of Malta short and medium term risks for fiscal sustainability are low, medium risks exist in the long run. It is however worth noting that the Commission's assessment does not include the impact of budget measures aimed at improving fiscal sustainability as documented in the MTFS document. The Government is invited to continue to utilise the current benign macroeconomic conditions to address these expenditure challenges through further strategic choices, aimed to safeguard public finances from undue future pressures, while keeping the tax burden at acceptable levels.

The Council notes positively that the Government's Medium Term Fiscal Strategy document has taken on board some of the recommendations made earlier by the Council, particularly in the area of fiscal transparency and increased co-ordination among government departments. At the same time, the Council would like to re-iterate its recommendation for the building of fiscal buffers and also for the establishment of more clear criteria regarding resort to the Contingency Reserve, as well as new legislation to govern the issuance of Government guarantees.

Finally, the Council considers that the Medium Term Fiscal Strategy broadly complies with the requirements of the Fiscal Responsibility Act. As required by Article 13 of the Fiscal Responsibility Act, the Council also confirms that in its opinion, there are no exceptional circumstances which would allow for a departure from the fiscal plans as announced in the latest Fiscal Strategy document.

1. Introduction

The Government's fiscal strategy for the years 2016 to 2019 was outlined in the annual Update of Stability Programme (USP), published by the Ministry for Finance (MFIN) on 30 April 2016, which is a document that European Union (EU) Member States are required to submit to the European Commission (COM) by the end of April of each year. This document identifies and quantifies the new fiscal measures to be implemented throughout the forecast period. It also presents the revenue and expenditure projections consistent with the anticipated macroeconomic conditions and based on the tax and expenditure policies in place. A chapter in the latest USP is also dedicated to the projections for long-term age related public expenditures.

On 13 June 2016, the Government tabled in Parliament a version of this document, entitled 'Malta Medium Term Fiscal Strategy 2016 2019 – Update of Stability Programme', in line with the requirements prescribed in Article 15 of the Fiscal Responsibility Act, 2014 (Cap. 534) (henceforth referred to as the FRA).[1] The Medium Term Fiscal Strategy (MTFS) supplements the USP with 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 the compliance with the general principles of fiscal responsibility. The MTFS also contains an appendix on the fiscal risk assessment which summarises the risks identified by the Malta Fiscal Advisory Council (MFAC) in its evaluation of the official projections.

Article 13 of the FRA prescribes that the MFAC shall endorse as it considers appropriate the macroeconomic and fiscal forecasts prepared by the MFIN; analyse and assess whether the Government's fiscal strategy is compliant with the provisions of the FRA; and provide an assessment of whether the proposed fiscal stance is conducive to prudent economic and budgetary management, including adherence to the provisions of the Stability and Growth Pact (SGP).[2]

The macroeconomic forecasts underpinning the latest MTFS, together with the fiscal projections contained therein, have already been considered by the MFAC to be within its endorseable range, with the assessments published in two earlier reports which were issued in April and May 2016.[3] This Report complements these two reports, and proceeds as follows.

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[1] The document was tabled in Parliament during sitting number 401 and can be downloaded from http://www.parlament.mt/paperslaiddetails?id=26738&legcat=13.

[2] The cut-off date for the GDP-related statistics contained in this Report is 6 June 2016. This is done to ensure that the MFAC's analysis uses the same statistics contained in the MTFS. According to News Release 091/2016, which was subsequently published by the NSO on 8 June 2016, nominal GDP for 2015 was revised upwards by 0.1% (from €8.796 billion to €8.806 billion) whereas real GDP for 2015 was revised upwards by slightly less than 0.1% (from €7.939 billion to €7.944 billion). On the other hand, nominal government consumption was revised downwards by 0.3% (from €1.709 billion to €1.704 billion), while real government consumption was revised upwards by 0.1% (from €1.597 billion to €1.599 billion). For the purposes of this analysis, these revisions are not taken into account.

[3] The reports 'An assessment of the macroeconomic forecasts for the Maltese economy prepared by the Ministry for Finance in April 2016' and 'An assessment of the fiscal forecasts for Malta prepared by the Ministry for Finance in April 2016' are available on the MFAC's website www.mfac.gov.mt.

Section 2 summarises the main observations which had been identified in the MFAC's assessment of the macroeconomic and fiscal projections. Section 3 presents a high-level assessment of the planned conduct of Malta's fiscal policy. Section 4 evaluates the extent to which the fiscal rules prescribed in the SGP, and referred to in the FRA, are expected to be respected, based on the projections prepared by the MFIN and by the COM. Section 5 focuses on the sustainability of public finances. Section 6 concludes with the MFAC's overall assessment of the MTFS and presents a number of final recommendations.

2. Macroeconomic and fiscal projections contained in the MTFS

According to the latest Government projections, economic growth, both in real and in nominal terms, is expected to remain strong, but moderate gradually between 2015 and 2019. Real GDP growth is expected to decelerate from the buoyant growth rate of 6.3% recorded in 2015, to 2.4% in 2019 (see Table 1). During this period, nominal GDP growth is likewise anticipated to moderate, from 8.8% to 4.5%. In turn, the unemployment rate is expected to remain low and stable, at around 5.4%, while the annual inflation rate is projected to increase slightly, but should remain below and close to 2% throughout the forecast horizon, in line with the target of the European Central Bank (ECB). Meanwhile potential output growth is estimated to decelerate from 4.5% in 2015 to 2.8% in 2019, while the output gap is expected to turn from positive to slightly negative.[4] As for, the headline fiscal balance-to-GDP ratio, this is targeted to swing from a deficit of 1.5% in 2015 to a 0.1% surplus in 2019.[5] As a result, the trajectory for the public debt ratio is expected to maintain a downward momentum, declining from 63.9% to 55.5%.

While the MFAC views the official macroeconomic baseline forecasts as achievable, it identified elements of downside risk to real economic growth, especially for the outer forecast years.[6] Risks are in particular related to the investment component within GDP, since the trajectory being forecasted is contingent on the extent to which materialisation of a number of private and public investment projects, will progress as envisaged. Another source of downside risk is associated with exports, as their projected annual growth is driven by the assumption that throughout the forecast horizon the exchange rate will remain competitive, and that Malta's main trading partners will experience steady growth, against a background of ever changing international economic conditions.

With regard to the official baseline fiscal projections, these are deemed by the MFAC to be plausible, with the risks to the general government balance considered to be neutral. Indeed, the MFAC sees the possibility that a number of major revenue items could exceed the

[4] The output gap represents the difference between the level of actual and potential output expressed as a percentage of potential output. A positive output gap means that actual output is above potential while a negative output gap means that actual output is below potential.
[5] Within this Report, 'headline fiscal balance' and 'general government fiscal balance' are used interchangeably.
[6] The COM, in its assessment of Malta's USP stated that 'overall, the macroeconomic scenario underpinning the Stability Programme is plausible for 2016 and cautious for 2017-2019'.

projections in view of the rather conservative assumptions when compared to recent trends, particularly in the case of taxes on production and imports, as well as taxes on income and wealth. On the other hand, there could be the risk of expenditure overshoots in view of the rather challenging restraint being factored into the forecasts, particularly in the areas of compensation of employees and intermediate consumption.[7]

Table 1: Key macroeconomic and fiscal developments[8]

	2015	2016	2017	2018	2019
			Per cent		
Real GDP growth	6.3	4.2	3.1	2.9	2.4
Nominal GDP growth	8.8	6.8	5.6	4.8	4.5
Unemployment rate	5.4	5.3	5.3	5.4	5.4
Inflation rate	1.2	1.6	1.9	1.8	1.9
Potential output growth	4.5	4.2	4.2	3.4	2.8
Output gap (% of potential output)	1.6	1.6	0.6	0.1	-0.3
Fiscal balance-to-GDP (headline)	-1.5	-0.7	-0.6	-0.2	0.1
Public debt-to-GDP	63.9	62.6	60.4	57.5	55.5

Source: MFIN

The MFAC considers the planned reduction in the debt ratio to be rather conservative with scope for downside risks should the stock-flow adjustments be less than anticipated in the MTFS.

The MFAC notes positively that the MTFS contains a chapter dedicated to sensitivity analysis. Sixteen alternative scenarios are assumed, and for each scenario the possible impact is estimated. Results are then summarised in two fan charts, which present the possible range of outcomes on real GDP growth and on the fiscal balance-to-GDP ratio. To enable a clearer valuation of the robustness of these results, it would however be important to include additional explanations as to how these scenarios have been chosen and identify the underlying critical technical assumptions which are driving such results.

[7] Similarly, the COM, in its assessment of Malta's USP stated that the overall 'risks related to the deficit targets seem balanced' noting that there may be risk 'related to slippages in current expenditure, especially in the public sector wage bill and intermediate consumption, given past experience' but acknowledging that as a result of conservative revenue elasticities there could be 'marginal upside risk to the revenue projections'.
[8] All figures for 2015 contained in this Report represent actual figures while for subsequent years they are forecasts.

3. High-level assessment of the planned conduct of Malta's fiscal policy

The MFAC notes that the current priority for Malta's fiscal policy is the attainment of the Medium Term Budgetary Objective (MTO) of a balanced budget, in structural terms, by 2019. The requirement to meet the MTO forms part of the SGP, which under the EU's fiscal framework serves to keep governments on track towards meeting their commitments to pursue sound fiscal policies, and to ensure a healthy underlying budgetary position over the economic cycle.

In order to meet Malta's MTO it is necessary that the fiscal consolidation momentum is maintained over the next few years. The consolidation phase followed the European Council's (EC) decision to place Malta under the Excessive Deficit Procedure (EDP), on the basis that, in 2012 the fiscal deficit-to-GDP ratio had exceeded the 3% reference value which is prescribed in the SGP. [9] In 2015, the EC abrogated the EDP for Malta, on the basis that in 2014, the fiscal deficit had fallen to below 3% of GDP, with public finances being expected to continue improving. In this respect, the MFAC invites the Government to remain vigilant and maintain its commitment to keep public finances under control, particularly through expenditure restraint and further expenditure rationalisation measures along the lines proposed through the Comprehensive Spending Reviews (CSRs).

The MFAC welcomes the Government's fiscal strategy for the period 2016 – 2019, which shows that the Government is targeting a small fiscal surplus. Specifically, the target is for the general government balance to improve in each of the forecast years, both in absolute terms and when expressed as percentage of GDP. The planned retrenchment of the fiscal deficit is however spread unequally over the programme period, with the correction being more pronounced in 2016 – the fiscal deficit-to-GDP ratio practically halving – whereas in the following years, the correction is expected to be more gradual (see Chart 1).

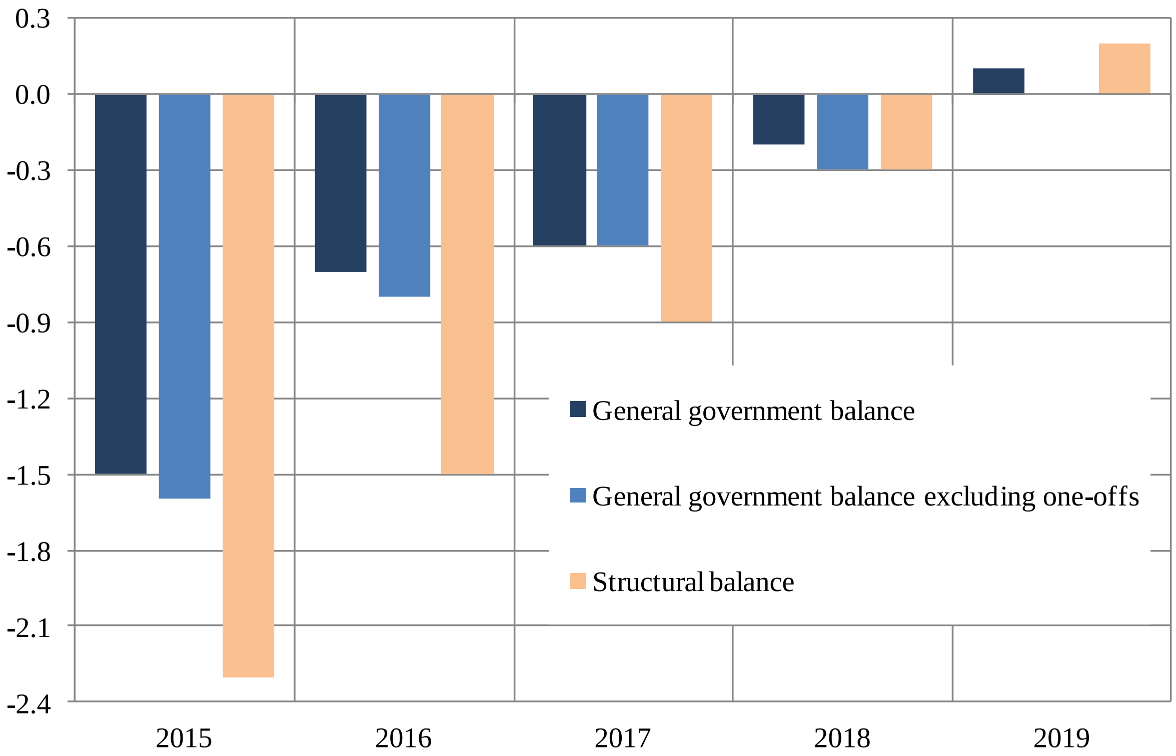
Should the fiscal and macroeconomic developments being projected by the Government materialise, over the forecast horizon the public debt-to-GDP ratio would be scaled to below the 60% threshold, with an annual positive margin of over four percentage points (pp) of GDP compared to the required debt benchmark in terms of the SGP.

Public finances are generally expected to be positively impacted by the anticipated favourable macroeconomic conditions. However, the latter's contribution to the improvements in public finances is expected to moderate in the outer forecast years. The planned yearly improvement in the underlying fiscal balance (structural effort) is driven by policy measures affecting both the revenue and expenditure sides of the budget. On the revenue side, additional revenues are expected to be generated through the Individual Investor Programme (IIP) and to a lesser extent through new indirect tax measures, in place as from 2016. On the expenditure front, consolidation is driven primarily through the expiry of a number of temporary deficit-

[9] Refer to http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/malta_en.htm for the specific details about the various occasions when Malta was placed under the EDP.

increasing expenditure outlays recorded in 2015 as well as the planned restraint embedded in a number of expenditure components, such as for compensation of employees, intermediate consumption and social payments, some of which announced in the latest USP.

Chart 1: Actual and planned fiscal balances (% of GDP)



Note: In the case of the structural balance ratio, this is expressed in per cent of potential GDP converted into nominal terms, rather than nominal GDP
Source: MFIN

The MFAC welcomes the fact that the planned fiscal consolidation is spread over a number of revenue and expenditure initiatives. This should be a safer strategy for the conduct of fiscal policy. Expenditure restraint, while considered by the MFAC to be desirable, may however be increasingly harder to maintain over the medium term, unless supported by permanent structural changes. In this respect the MFAC considers important that expenditure savings of a permanent nature are sought and crystallised, where possible, through decisive improvements in the efficiency of the public services and the undertaking of structural reforms, similar to those carried out in the area of social benefits.[10] This should mitigate the risk that short term savings are eventually offset through compensatory adjustments over the medium term. The Government is invited to take stock of the findings resulting from the CSRs which to date have been concluded in the areas on social benefits and health, and which is currently being undertaken in the area of education. The MFAC recommends that

[10] As indicated in the MTFS, the government continues to monitor and address the challenges outlined in the Country Report Malta 2016 prepared by the COM, particularly in the areas of taxation, quality of public finances and long-term fiscal sustainability, labour market, education and skills and social aspects, the business environment and competitiveness.

the findings of the various CSRs will continue to be followed up by appropriate decisions, to ensure that non-productive expenditures are phased out, and that inefficiencies are addressed.

This should also help to ensure that nominal government consumption, which in 2015 expanded by 6.5%, grows at a slower pace between 2016 and 2019, by an average of 4.4% annually, though the rate is expected to be quite volatile throughout this period. In fact, from 4.0% in 2016, the growth rate is projected to spike to 7.4% in 2017, before decelerating to 2.5% and 3.5% in the following two years. Should these projections materialise, growth in nominal government consumption would thus be contained to below that in nominal GDP in all but one year. This is in line with what happened in 2015 and evidences the planned expenditure restraint which underpins the MTFS, with the rather ambitious target to scale the ratio of total government expenditure to GDP from 43.3% in 2015 to 38.3% by 2019. The MFAC acknowledges that the apparent volatility in the projected nominal growth dynamics for government consumption, and in particular the elevated growth rate for 2017, is influenced by the statistical methodologies (in particular the treatment of market output) rather than a departure from the fiscal consolidation momentum (see Box 1).

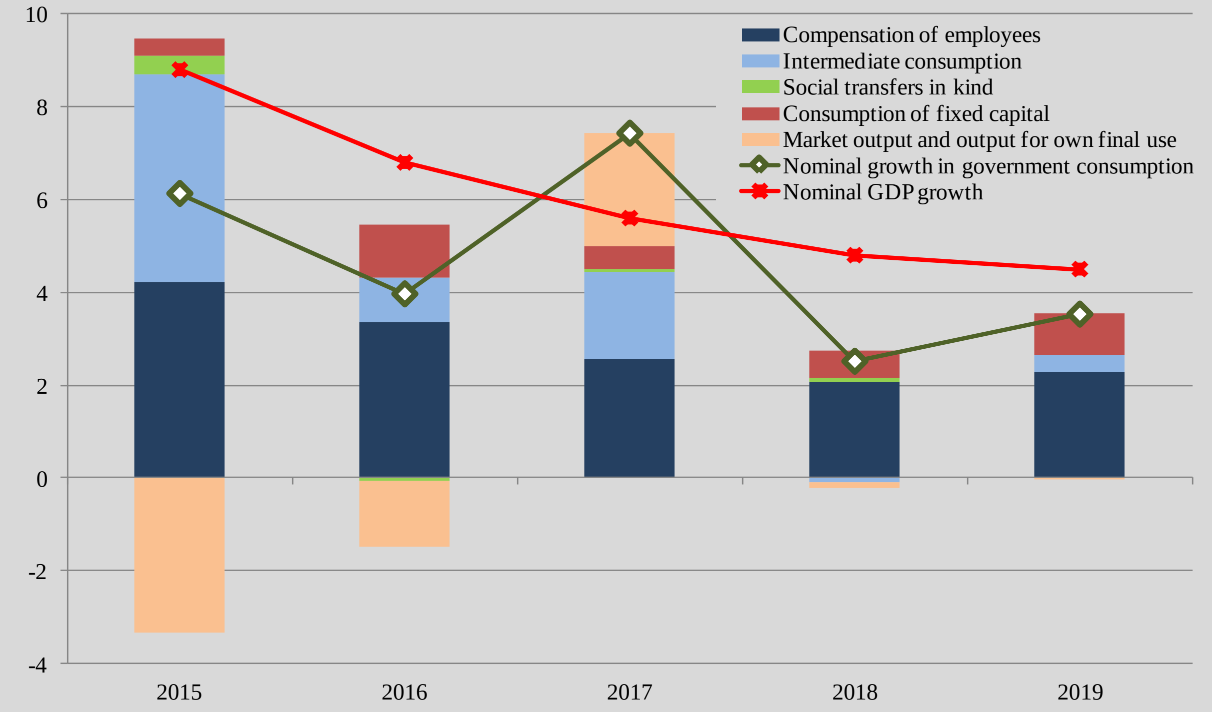
Box 1: Nominal government consumption growth

Nominal government consumption is driven by five different elements within the fiscal budget. The largest component is compensation of employees which in 2015 accounted for approximately two-thirds of the total government consumption. Intermediate consumption is another main component within this aggregate. The European System of National and Regional Accounts (ESA) methodology prescribes that market output, is netted out from the various expenditure items forming government consumption, as this represents a source of revenue for the Government,. Hence, statistically, an increase in market output lowers government consumption and vice versa.

Compensation of employees is expected to be the main driver of growth in nominal government consumption throughout the forecast horizon. Its contribution to growth is however expected to fall in the outer years (see Chart A). On the other hand, the contribution to growth from intermediate consumption is expected to fluctuate, particularly as this item is conditioned by opposing factors throughout the forecast horizon, such as efficiency gains and expenditure restraint in some areas, and one-off event-driven expenditures in other areas.

Developments in market output are the main factor explaining the instability in the forecast for nominal growth in government consumption, and in particular the spike anticipated for 2017. In 2015 higher market output was recorded and in 2016 this is projected to increase further (thereby reducing government consumption). On the other hand, it is expected to fall back in 2017 (which increases government consumption) and stabilise thereafter (which exerts a neutral effect on government consumption). The developments in market output mirror closely the assumed profile for the revenues derived from the IIP, which are expected to increase in 2016 compared to 2015 and then scale back in the outer forecast years.

Chart A: Contribution to growth in nominal government consumption (pp)



Source: MFIN

On the other hand, consumption of fixed capital (which reflects the decline in the value of fixed assets owned) and social transfers in kind (which reflects mostly the direct provision of pharmaceutical products, the provisions of free school transport and the running of homes for the elderly) are expected to exert only a small impact on the overall dynamics for nominal government consumption.

It is worth noting that owing to the general stability in the projected pattern for the government deflator, with its growth estimated at around 2% annually, the volatility in the nominal government consumption is mirrored into a similar pattern for real government consumption. Indeed, the MFIN's forecasts indicate that growth in real government consumption, which for 2016 is expected to be 2.2%, will similarly peak at 5.1% in 2017, and then decelerate to 0.1% and 1.1% respectively in the following two years. The stability in the deflator for government consumption is thus driving the similar pattern for growth in real government consumption.

The planned improvement in the fiscal balance relies only to a very limited extent on one-off and temporary effects, which in 2015 are estimated to have been 0.2pp lower than in 2014. In fact, the projected balance for general government changes only marginally when excluding one-off and temporary effects.[11] As can be seen from Chart 1, such effects are contained to around 0.1% of GDP annually throughout the period 2015 to 2019, and consist primarily of

[11] One-off measures are measures having only a transitory budgetary effect that does not lead to a sustained change in the budgetary position. For an overview of the classification principles for one off and temporary measures used for fiscal surveillance refer to 'Report on Public Finances in EMU – 2015', by the COM.

sale of land. The MFAC views positively that the Government's reliance on one-off measures is limited, since undue dependence on such measures would add uncertainty while not being consistent with a long-term approach to the management of public finances.

In assessing progress towards achieving the medium term budgetary objective in terms of the SGP, one needs to focus on fiscal developments in structural terms. In 2015 public finances are estimated to have benefitted from an upswing of around 0.8pp, mainly due to tax revenues edging higher, as a result of the favourable cyclical conditions.[12] In fact whereas the headline fiscal balance stood at -1.5% of GDP, the structural balance (which represents the headline balance adjusted by the cyclical component and net of one-off and temporary measures) was estimated at -2.3% of potential output.

Favourable cyclical conditions are again expected to ameliorate the general government balance by 0.8pp in 2016 (see Chart 1). Indeed, the MFIN estimates that the structural deficit will narrow to 1.5% of potential output in 2016, on the basis of the planned structural correction, against the projected headline fiscal balance of 0.7% of GDP.[13] From 2017 onwards, the difference between the general government balance and the structural balance is more contained, as the output gap is expected to shrink during these years, with the economy converging towards its potential.

In this respect it is pertinent to note that the COM's projections for the structural balance are slightly less optimistic than those produced by the MFIN, while the output gap conditions are also slightly different (see Chart 2).[14]

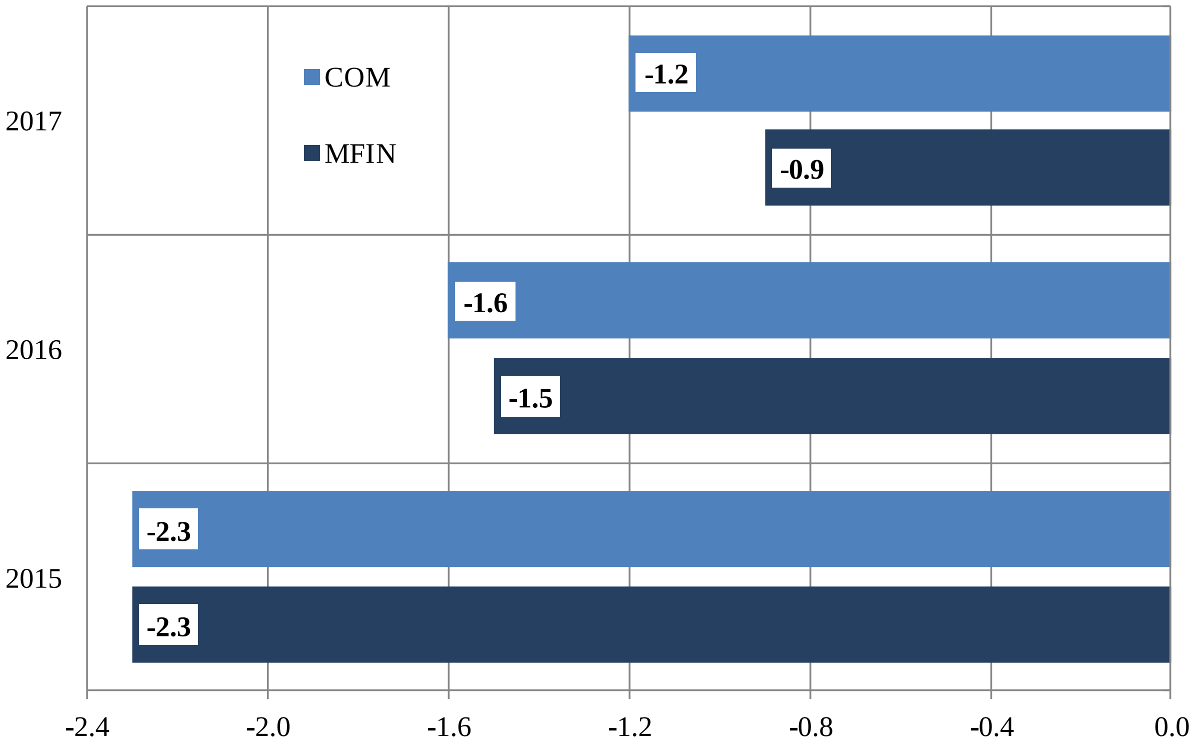
These forecasts would suggest that the projected developments in the headline fiscal balance offer a more positive outturn than the underlying fiscal position, on account of the positive output gap conditions. The MFAC therefore stresses the importance of remaining vigilant so as to ensure that the fiscal consolidation process is driven by a structural effort rather than by cyclical factors, The MFAC also re-iterates its recommendation that any revenue windfalls, as distinguished from normal revenue forecast errors, which could materialise over the forecast horizon, should be used to achieve a faster decline in the fiscal deficit, rather than finance additional permanent expenditures.

The MFAC notes that according to the MFIN's calculations, during 2015 the conduct of fiscal policy was prima facie marginally and temporarily pro-cyclical, as the structural balance remained stable at a time when the economy was operating above potential. On the other hand, for the period 2016 to 2018 the MFIN plans to undertake counter-cyclical fiscal tightening, partly supported by the expiry of temporary deficit increasing expenditure outlays observed in 2015. Indeed, the Government plans to improve the structural balance by 0.8pp

[12] This is an approximation since the headline balance is expressed as per cent of GDP while the structural balance is expressed as per cent of potential output.
[13] A structural correction measures the change in the fiscal balance which is not attributable to cyclical and temporary or one-off effects.
[14] The COM's estimates place the output gap at 1.5%, 1.3% and 0.6% respectively for the period 2015 – 2017.

in 2016 and by 0.6pp in 2017, while the economy's output gap remains positive, albeit closing off gradually (see Chart 3).

Chart 2: Structural balance (% of potential output)



Source: MFIN, COM

Whilst the MFIN projects that actual output will converge close to potential output in 2018, the planned annual structural consolidation will be maintained stable at 0.6pp. Fiscal consolidation will thus be undertaken against a background where the economy is operating above potential but cyclical conditions are tending to deteriorate. This is in line with the general consensus among economists that fiscal policy should try to dampen rather than amplify the economic cycle, by improving the fiscal balance when economic conditions are favourable and vice-versa.[15] The MFAC welcomes the Government's intention to undertake a fiscal contraction (as suggested by an improvement in the structural balance) at a time when an above-potential level of economic activity is expected to prevail.[16] This should help sustain a steady momentum towards the MTO.

Notwithstanding that the output gap is expected to turn marginally negative in 2019, the Government plans to undertake further improvement in the structural balance, equivalent to 0.5pp. This implies that in 2019 there would be pro-cyclical fiscal tightening.[17] The MFAC

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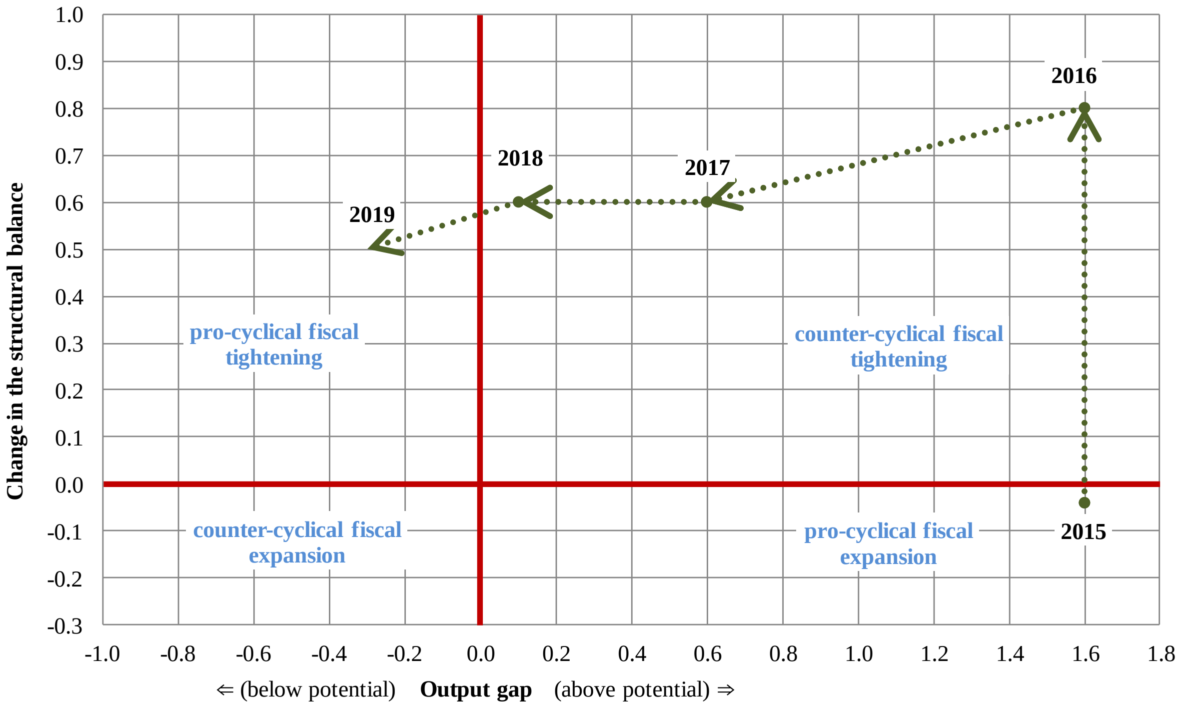
[15] Economic cycles basically refer to the tendency that economies experience periods of buoyant activity and periods when activity is more subdued.
[16] A change in the structural balance gives an indication of whether the Government is undertaking underlying fiscal tightening or loosening by excluding the effects generated by the economic cycle and temporary factors,.
[17] The 2019 pro-cyclicality refers to the fact that the fiscal tightening will be coinciding with a period when the economy will be operating below potential.

considers that this level of prudence should not create any undue negative economic effects, as indicated by the MFIN's forecast of 2.4% real economic growth for that year. However, it may prove somewhat more challenging to implement such tightening under conditions of below-potential level of activity.

Chart 3: Change in the structural balance and the output gap (% of potential GDP)



Source: MFIN

4. Compliance with fiscal rules

The SGP features two fiscal rules which Malta has to respect, as a euro area Member State which is subject to the preventive arm.[18] In particular, the country needs to respect:

- **the debt criterion**, which prescribes the required path for the scaling back of the debt-to-GDP ratio for those countries whose debt ratio exceeds the 60% of GDP threshold;

- **the structural balance pillar**, which prescribes the required underlying improvement in the fiscal balance in structural terms, conditional on the macroeconomic conditions. It is to be noted that when evaluating the structural effort, an overall assessment will

[18] For an overview of the various rules refer to Boxes 2, 3 and 4 contained in the report 'An assessment of the Medium-Term Fiscal Strategy 2015-2018, Annual Report 2014 and Half-Yearly Report 2015', available on the MFAC's website.

also include an evaluation of compliance with **the expenditure benchmark**, which prescribes the limit for the annual growth in 'adjusted' total expenditure.[19]

Whereas the structural balance pillar and the debt criterion are explicitly mentioned in the FRA, respectively through Articles 8 and 9, the expenditure benchmark is only indirectly referred to, specifically in the case that a warning of a significant deviation is issued by the Commission on the basis of the expenditure benchmark, in terms of Article 11. In this context the MFAC considers the evaluation of compliance with the expenditure benchmark equally important in evaluating the compliance with the obligations of the SGP, given that such evaluation is also within the MFAC's mandate.

4.1. Debt criterion

As at the end of 2015, Malta's debt-to-GDP ratio exceeded the 60% threshold, and therefore the country must ensure that the debt ratio is sufficiently diminishing and approaching the 60% requirement at a satisfactory pace.[20] The ensuing benchmark debt ratio for 2015 was calculated at 69.1% (see Chart 4).[21]

This requirement was respected in 2015 since Malta's gross debt ratio amounted to 63.9% of GDP, aided by the elevated nominal GDP growth rate, of 8.8%, which was recorded during that year. Overall, both according to the MFIN's calculations and the COM's forecast, the debt rule is estimated to have been respected in its forward-looking dimension. It is worth noting that the buffer between the benchmark debt ratio in 2015 and actual debt ratio was rather significant, at 5.2pp, as a result of a faster decline in this ratio when compared to the requirements.[22]

The debt criterion is expected to be met again in 2016 as the gross debt-to-GDP ratio is projected to decline to 62.6% according to the MFIN's plans and to 60.9% according to the COM's projections. In either case the debt projections are below the benchmark, estimated at 67.1% using the MFIN's inputs and 65.8% on the basis of the COM's figures. This is also the

[19] The expenditure benchmark is a reference value for the permissible expenditure growth which depends on estimates for potential GDP growth. Any excess expenditure must be matched by discretionary revenue measures. 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.

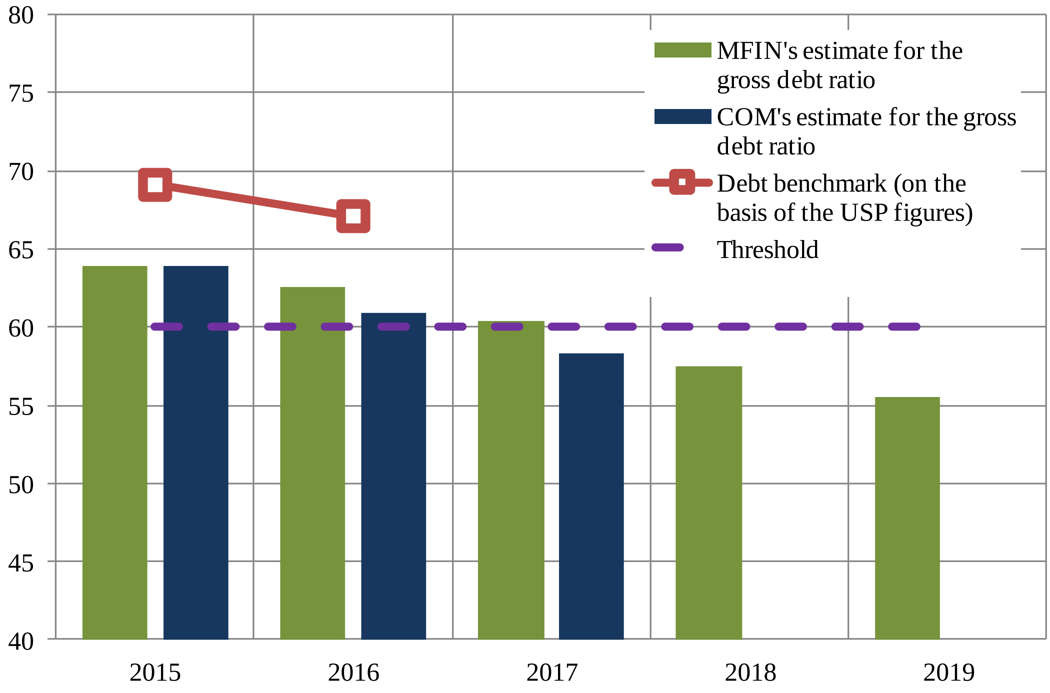
[20] 'Sufficiently diminishing' and 'satisfactory pace' are defined in Regulation (EC) 1467/97 as being fulfilled if "the differential [of the debt ratio] with respect to the reference value has decreased over the previous three years at an average rate of 1/20th per year as a benchmark". The Regulation then specifies that "the requirement under the debt criterion shall also be considered to be fulfilled if the budgetary forecasts of the Commission indicate that the required reduction in the differential will occur over the three-year period encompassing the two years following the final year for which data is available". Source: Vade Mecum on the Stability and Growth Pact, 2016 edition.

[21] The benchmark is arrived at by adding up the debt ratio and the gap to the debt benchmark published by the COM in its assessment of Malta's USP.

[22] The COM, in its assessment of Malta's USP notes that 'while a precise comparison of debt-to-GDP ratios from different programmes is not possible due to high GDP growth that occurred in 2015, it is worth noting that the debt is now projected to follow a faster pace of reduction compared to the previous programme'.

result of the favourable downward push to the debt ratio resulting from the 6.8% expansion in nominal GDP projected for 2016.

Chart 4: Developments in the debt ratio (% of GDP)[23]



Source: COM

According to the MFIN, the debt ratio is set to fall to 60.4% of GDP in 2017, and proceed along a downward trajectory, to below the 60% threshold, in the following two years. As a result, the debt criterion is expected to be met according to the MFIN's calculations. The COM's projections actually indicate that the debt ratio would fall to below the 60% of GDP threshold by 2017. Indeed, the MFAC identified possible downside risks to the MFIN's debt projections particularly should stock flow adjustments turn out less than anticipated within the USP.

4.2. Structural balance pillar

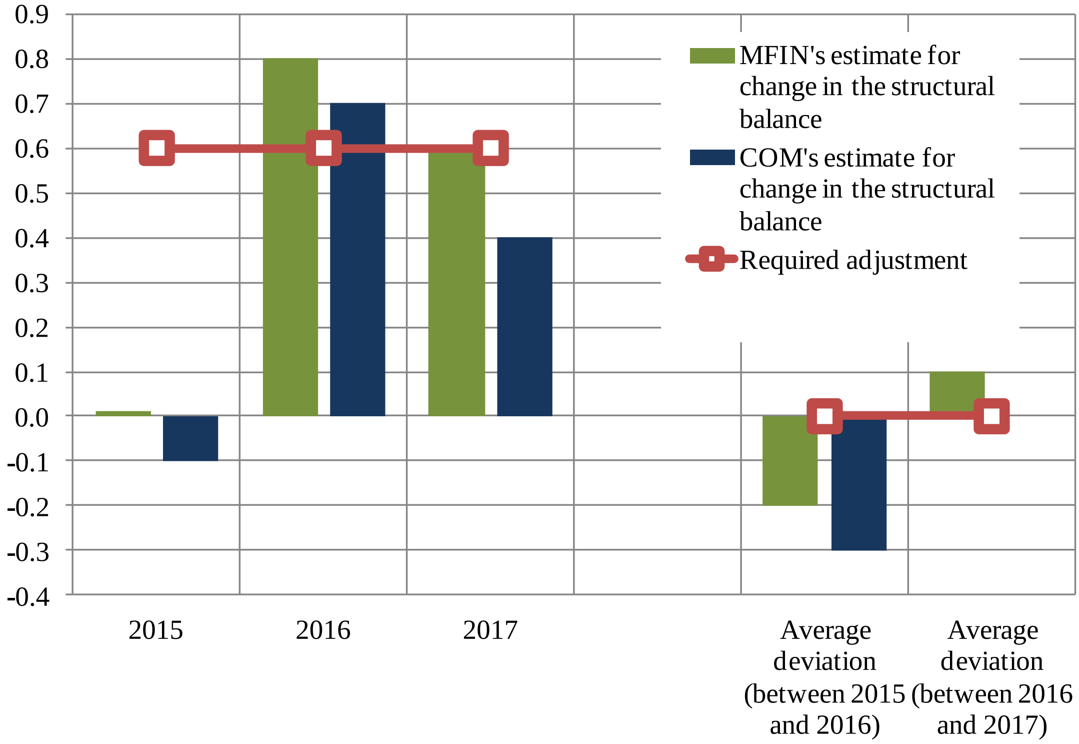
Fiscal consolidation requires that the improvement in public finances is the result of structural efforts, as distinguished from cyclical, temporary and other one-off effects. In this respect, in 2015, the EC recommended to Malta to achieve a fiscal adjustment in 2015 and in 2016 of at least 0.6% of GDP annually. The 2016 EC's country-specific recommendations re-stated that Malta should achieve an annual fiscal adjustment of 0.6% of GDP in 2016 and extended this requirement also for 2017. The required size of the fiscal correction follows the

[23] The COM does not publish debt forecasts for 2018 and 2019 in its assessment of the USP.

assessment by the COM that economic conditions in Malta reflect 'good times', as suggested by the positive output gap.[24]

On the basis of the 2015 fiscal turnout in absolute terms, as well as the macroeconomic statistics available at the time of the USP assessment carried out by the COM, the structural balance was estimated by the MFIN to have been stable while by the COM to have deteriorated by 0.1pp of GDP, compared to 2014 (see Chart 5). Hence the actual structural effort undertaken during 2015 fell significantly short of the consolidation requirement for the year. However, the MFAC considers that there are valid reasons and circumstances as identified in the COM's assessment of the USP which would suggest that this indicator may need to be considered with caution.

Chart 5: Structural effort (pp of GDP)



Source: MFIN, COM

On the basis of the commonly agreed methodology regarding the structural balance, the 2015 improvement in public finances (in absolute terms) was fully ascribed to cyclical developments, which are thus not part of the 'structural effort'. The MFAC acknowledges that revisions to the 2014 figures have played a part and the common methodology adopted may not always adequately capture all the peculiarities of the Maltese economy and public finance developments.

[24] The required structural effort depends not only on the size of the output gap but also whether the actual growth rate is below or above the potential growth rate. In 2015 the actual growth rate exceeded the potential growth rate by 1.6pp and therefore a structural effort exceeding 0.5% was required in terms of the SGP.

The MFAC shares the same view of the COM that the main reasons for the lack of structural effort recorded in 2015 can be ascribed to a number of factors, one of which being the fact that the more than expected GDP growth does not appear to have been sufficiently tax-rich, besides the fact that the eventual proceeds from the IIP turned lower than expected in view of processing delays. These factors were estimated to lead to revenue shortfalls equivalent to some 0.7% points of GDP which diminished the recorded structural effort. The additional expenditure necessary to co-finance the 2015 upsurge in projects financed through the EU funds also had an impact on the structural effort of 0.4% points against what was originally targeted. Furthermore, the COM notes that the ‘sizable revision in the output gap’, which is something rather extraordinary, has played an important role in the difference between the planned and the actual structural effort for the year.[25] Indeed, while in the Draft Budgetary Plan (DBP) for 2016, the output gap was estimated by the MFIN to be 0.42% of potential output, according to the USP 2016 – 2019 this was revised upwards to 1.6% of potential output. In this context, it is pertinent to note that the COM, in its assessment of the USP states that ‘correcting for these factors, the structural balance pillar would have pointed to compliance with the required adjustment towards the MTO’.

The MFIN’s planned fiscal effort for 2016 and 2017 is estimated at 0.8pp and 0.6pp respectively. As recalculated by the COM on the basis of the information in the USP, and according to the commonly agreed methodology, the change in the structural balance is estimated at 0.7pp annually for these two years.[26] As a result, the requirement for the annual structural effort for both 2016 and 2017 should be met if such projections materialise. Nonetheless, owing to the deviation from the required adjustment in 2015, the average adjustment for the two year period 2015 to 2016 would still fall some 0.3pp short of the requirement for this period. In this respect, it is pertinent to note that in the latest USP the Government has included a number of additional measures aiming to reduce expenditures by €15 million, mainly related to compensation of employees, capital transfers and intermediate consumption. These measures should reduce the deviation from the required adjustment level for the period 2015 – 2016 by an amount equivalent to 0.2% of GDP. On the other hand, over the two-year period 2016 to 2017, the consolidation effort is expected to exceed the minimum requirement by some 0.1pp.

An analysis of the COM’s own projections for the structural balance, would lead to a similar assessment for the 2016 annual structural effort, which at 0.7pp is expected to be 0.1pp higher than the required level. On the other hand, the structural effort for 2017 based on a no-policy-change scenario is calculated by the COM at 0.4pp, which would be 0.2pp below the requirement. As a result, the COM’s calculations for the two-year average deviation for the

[25] The change in the output gap conditions was mainly the result of a much higher than anticipated growth in 2015 and a downward revision to growth in 2014.
[26] Recalculations by the COM may occur when the estimates produced by a country may not be fully in line with the methods specified by the COM. The small difference between the MFIN’s calculations and the COM’s recalculations may also be due to rounding.

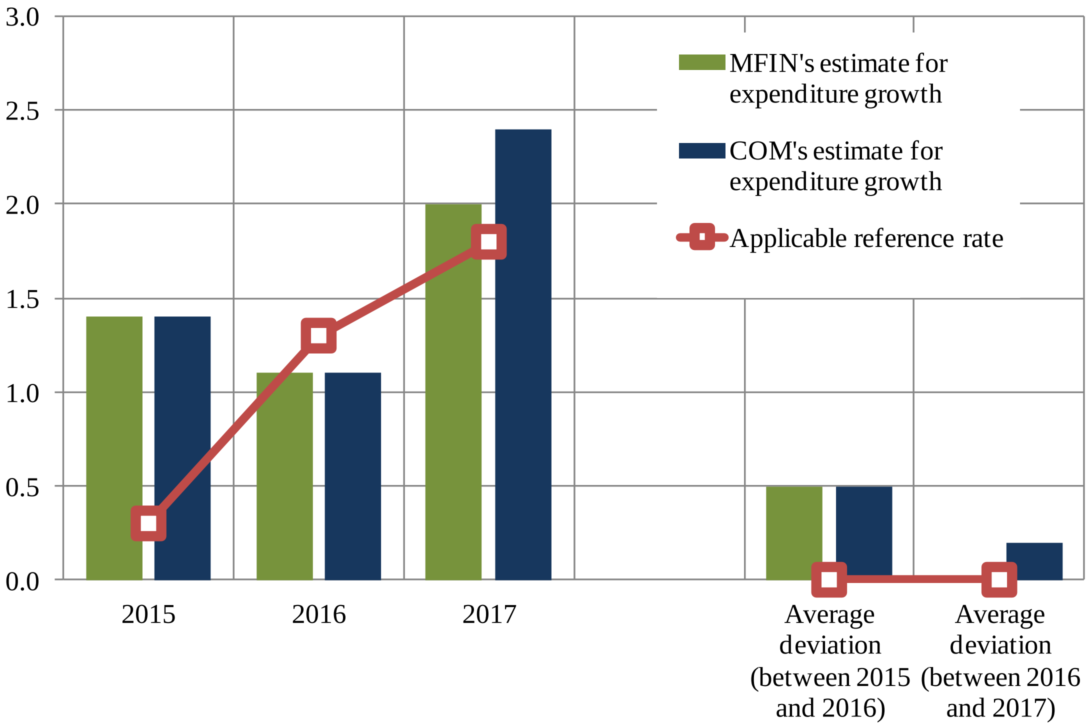
period 2015 – 2016 is identical to the MFIN's estimated shortfall of 0.3pp, while for the 2016 – 2017 period the COM's calculations indicate no deviation from the requirement.

While acknowledging that the evaluation of structural conditions could be rather challenging in view of ongoing revisions in the output gap estimates, the MFAC would like to recommend that increased attention should be given by the MFIN to the structural balance, as ultimately the COM evaluates progress towards the MTO on the basis of developments in the structural balance rather than the headline balance.

4.3. Expenditure benchmark pillar

Fiscal consolidation requires that expenditure growth is contained, entailing that overall government expenditure, netted out of certain items, is less that the preset benchmark rate. Specifically for Malta, the applicable reference rates for the expenditure benchmark for the years 2015, 2016 and 2017 were respectively estimated by the COM at 0.3%, 1.3% and 1.8% (see Chart 6). These rates are primarily determined on the basis of ten-year potential GDP growth rates, comprising both a backward element and forward-looking element.

Chart 6: Expenditure growth (%)



Source: MFIN, COM

In 2015, the applicable reference rate was exceeded by 1.1pp. Around half of this gap, or 0.5pp, is attributed to the spike in capital expenditure, in turn driven by the hike in the co-financing element related to projects financed under EU programmes, in order to boost the take-up of EU Funds under the Programme Period 2007 – 2013, before their expiry in 2015. Another 0.2pp was due to the interplay of one-off measures, both on the revenue and on the expenditure side.[27] Taking into account all these elements, the deviation is reduced to 0.4pp leading the COM to conclude that Malta has registered "some but close to significant deviation from the adjustment path towards the MTO in 2015".

However, in 2016, according to the MFIN's plans and the COM's projections, expenditure growth will be contained to 0.2pp below the specified benchmark. This is also facilitated through the lower uptake of EU funds compared to a year earlier, hence requiring lower co-financing. On the contrary, in 2017 the projections indicate that the expenditure benchmark will again be exceeded, by 0.2pp in the case of the MFIN's projections and by 0.6pp according to the COM's projections, based on the no-policy-change assumption. Thus, for the period 2015 – 2016, both the MFIN and the COM expect an average deviation of 0.5pp. On the other hand, for the period 2016 – 2017, according to the MFIN's forecasts there should be no deviation while the COM expects a small deviation equivalent to 0.2pp.

The MFAC acknowledges that in a situation where the economy is undergoing structural changes, estimates of potential output growth may be volatile and not necessarily robust. However, it invites the Government to exert further restraint in expenditure in order to address the risk of a significant deviation from the reference rate and thereby ensure full compliance with the expenditure growth benchmark. Indirectly this would also help to address the risk that revenue windfalls are channelled into higher expenditures.

5. Sustainability of public finances

As confirmed by COM's periodic sustainability analysis, there do not appear to be risks to fiscal sustainability in the short term, on the basis of various fiscal and financial competitiveness indicators. The COM's medium term outlook also suggests a resilient scenario, with low risks to fiscal sustainability. On the other hand, the COM's projections for the long term point towards possible medium risks to fiscal sustainability (see Box 2).

Box 2: The COM's fiscal sustainability analysis

Pressures on public finances may arise in the short term, medium term or in the long term. Since the time available for policy action differs, it is thus important to distinguish between the various horizons over which fiscal challenges may be posed. The more fiscal risks are identified in the short-term, the more urgent the need for corrective action, while when such risks relate mainly to the long-term, there will be more time available to design appropriate policy changes.

[27] In 2014, temporary measures and one-off effects included the Investment Registration Scheme, sale of land and the adjustment of the national contribution to the EU budget. In 2015, temporary and one-off measures amounted to less and were mainly related to the sale of land.

In this respect, the COM uses a methodology which aims to identify whether on the basis of a 'no-policy change' scenario, risks are likely to emerge, within a year, by 2030 or in the distant future.[28] The quantitative indicators are respectively referred to as S0, S1 and S2.[29]

The S0 indicator incorporates 14 variables under the sub-component 'fiscal index' and another 14 variables under the sub-component 'financial competitiveness index' (see Table A). These two sub-indices mainly capture fiscal and macroeconomic conditions which empirical evidence has shown to be good predictors of fiscal stress.

Table A: Components of the S0 indicator

Fiscal index	**Financial competitiveness index**
1. Balance, % GDP	1. Net international investment position, % GDP
2. Primary balance, % GDP	2. Net savings of households, % GDP
3. Cyclically adjusted balance, % GDP	3. Private sector debt, % GDP
4. Stabilizing primary balance, % GDP	4. Private sector credit flow, % GDP
5. Gross debt, % GDP	5. Leverage, financial corporations
6. Change in gross debt, % GDP	6. Short-term debt, non-financial corporations, % GDP
7. Short-term debt, government, % GDP	7. Short-term debt, households, % GDP
8. Net debt, % GDP	8. Construction, % value added
9. Gross financing needs, % GDP	9. Current account, 3-year backward moving average, % GDP
10. Interest rate-growth rate differential	10. Change (3 years) of real effective exchange rate, based on exports deflator
11. Change in expenditure of general government, % GDP	11. Change (3 years) in nominal unit labour costs
12. Change in final consumption expenditure of general government, % GDP	12. Yield curve
13. Old-age dependency ratio 20 years ahead	13. Real GDP growth
14. Average yearly change in projected age-related public expenditure as % of GDP over next 5 years	14. GDP per capita in PPP, % of US level

Source: COM

According to the assessment carried out by the COM, in the case of Malta **the short term risks are low** as measured by the S0 indicator, with both the fiscal sub-index and the financial and competitiveness sub-index pointing towards low risks.[30] This is in line with Malta's recent improvements in public finance conditions and the current benign macroeconomic conditions.

[28] A 'no-policy change' scenario means that the existing policies are assumed to remain in place throughout the full forecast horizon.

[29] For further details on the methodology and the results for the various EU Member States, refer to the 'Fiscal Sustainability Report 2015', available on: http://ec.europa.eu/economy_finance/publications/eeip/ip018_en.htm.

[30] In the case of Malta, the value of the S0 indicator was calculated at 0.1, which is significantly below the applicable threshold of 0.43. The figures for the various indicators have been updated by the COM in its assessment of Malta's latest USP, when compared to the figures shown in the Fiscal Sustainability Report 2015.

On the other hand, the S1 and S2 indicators are based on the inter-temporal constraint facing governments, namely that the current public debt and the discounted value of future public expenditure is covered by the discounted value of future public revenues. However, whereas the S1 indicator measures the required fiscal adjustment to ensure that the 60% public-debt-to-GDP ratio can be attained by 2030, the S2 indicator measures the adjustment necessary to ensure that the debt-to-GDP ratio stabilises over the infinite horizon (see Table B). Thus, the S1 and S2 indicators are forward looking (as opposed to the S0 indicator which is mainly backward looking), and importantly, factor in those expenditures which may be slowly but steadily increasing over time, particularly as a result of ageing.

Table B: S1 and S2 sub-components

		Required adjustment given initial budgetary position		*Required adjustment to reach debt ratio of 60% in 2030*		*Required adjustment due to cost of ageing*
S1	=	Gap to debt stabilising primary balance	+	Additional adjustment to reach the 60% debt ratio in 2030	+	Additional adjustment required to finance the increase in public spending due to ageing up to 2030
S2	=	Gap to debt stabilising primary balance	+	0	+	Additional adjustment required to finance the increase in public spending over infinite horizon

Source: COM

In the case of Malta, **medium term risks**, based on the **S1 indicator,** are estimated to be **low**.[31] Indeed, according to the COM's projections, the gross debt ratio will fall below 60% of GDP by 2017 and thereafter the costs of ageing are not expected to contribute to breach again this debt threshold, at least up until 2030. On the other hand, as regards the **long term**, the **S2 indicator places Malta in the medium risk** territory.[32] This is entirely attributable to the fact that in the long term, the costs of ageing are expected to be significant, particularly as a result of the projected higher outlays driven by pensions, health care and long term care. These higher costs are expected to more than offset Malta's favourable initial budgetary position.

[31] In the case of Malta, the value of the S1 indicator was calculated at -0.9pp of GDP. A negative value by definition classifies a country as low risk since it implies that a country may be able to undertake some fiscal loosening without breaching the debt threshold within the specified timeframe.
[32] In the case of Malta, the value of the S2 indicator was calculated at 4.3% of GDP, which falls within the bracket of 2-6%, which is the category for medium risk. This means that an adjustment effort of 4.3% of GDP is required in order to ensure that the debt-to-GDP ratio does not embark on an upward path.

The long-term challenges facing Malta's public finances depend to a large extent on the anticipated developments in the population and the macroeconomic outlook. Indeed, a country's population dynamics determine expenditure pressures, not only as a result of the increase in the size of the population but also in view of changes in its composition, particularly the balance between the working and non-working population. Among the developed countries, an ageing population is a prime determinant of upward expenditure pressures, driven in particular by higher outlays on pensions and on health.

The MTFS presents long term expenditure estimates by the MFIN, based on methodologies applied at an EU level on age-related expenditures.[33] These long-term projections provide an indication of the timing and scale of economic changes that would result from an ageing population under a 'no-policy change' scenario. The aim of such projections is to show where, when, and to what extent, ageing pressures will accelerate as a generation retires and the average life span increases. Hence, the projections are helpful in highlighting the immediate and future policy challenges posed for governments by demographic trends.

Such estimates are however particularly dependent on the assumed long-term macroeconomic outlook, and in particular the assumed population growth rate, the assumed migration patterns and the long term potential growth rate. Owing to the greater uncertainty associated with long term predictions, these forecasts should thus be interpreted with caution and should serve mainly to indicate a general pattern, rather than a definite path.

According to the MFIN's projections (based on the EUROPOP 2013 dataset), Malta's population is expected to increase from 422,556 in 2013 to 476,383 by 2060 (see Table 2).[34] Life expectancy at birth is expected to increase by slightly more than 6 years for both males and females. The fertility rate is also expected to increase slightly, from 1.4 births per woman in 2013 to 1.8 in 2060. Net migration inflows are expected to remain positive throughout the entire forecast horizon, but decline slightly from 1,600 to 1,146 annually.

As a result of the assumptions used, the youth dependency ratio is expected to increase slightly, from 21.3% to 27.5% whereas the old-age dependency ratio will rise significantly, to practically double, from 25.8% in 2013 to 50.9% in 2060. Consequently, the total dependency ratio is expected to rise sharply from 47.1% to 78.4% over the forecast horizon.

Meanwhile, the potential growth rate is assumed to remain rather stable, but decline slightly, from 1.7% in 2013 to 1.4% in 2060. On the other hand, participation rates are expected to increase, both for males and females. Further convergence in participation rates is expected

[33] Specifically, the expenditures which are considered are: pension expenditure, health and long-term care expenditure, spending on education and on unemployment benefits.

[34] EUROPOP 2013 is the name of the population dataset produced by Eurostat with base year 2013. It takes into account the likely future size and structure of the population and is prepared every three years. For further details refer to http://ec.europa.eu/eurostat/web/population-demography-migration-projections/population-projections-data. It is worth highlighting that in the case of Malta, there was a significant revision between EUROPOP 2010 and 2013 in terms of the overall size of the population. Indeed, according to the EUROPOP 2010, the size of Malta's population had been projected to decline from 412,637 in 2013 to 386,935 by 2060.

as the female participation rate is expected to increase from 50.2% in 2013 to 66.9% in 2060, thereby narrowing the gap with respect to the male participation rate, which is projected to rise from 79.7% to 83.4%. As for the unemployment rate, this is expected to remain stable.

Table 2: Long-term macroeconomic projections

	2013	2060
Total population (number of persons)	422,556	476,383
Life expectancy at birth – male (years)	78.7	85.1
Life expectancy at birth – female (years)	82.8	89.1
Fertility rate (number of births per woman)	1.4	1.8
Net inward migration (number of persons)	1,600	1,146
Working-age population (15-64 yrs / total) (%)	68.0	56.1
Youth dependency ratio (0-14yrs / 15-64yrs) (%)	21.3	27.5
Old-age dependency ratio (65+yrs / 15-64yrs) (%)	25.8	50.9
Total dependency ratio (%)	47.1	78.4
Potential growth rate (%)	1.7	1.4
Male participation rate (%)	79.7	83.4
Female participation rate (%)	50.2	66.9
Unemployment rate (%)	6.5	6.7

Source: Ageing Working Group, Annual Report 2015

On the basis of the before-mentioned population and macroeconomic projections, age-related public expenditure is expected to rise from 22.6% of GDP in 2013 to 29.2% in 2060 (see Table 3). A main contributor to the 6.6pp overall rise in the expenditure-to-GDP ratio is pension expenditure which is expected to increase by 3.2pp from 9.6% of GDP in 2013 to 12.8% of GDP in 2060. It is however worth noting that these projections cover only reforms introduced up to 2014. A number of subsequent pension reforms which are not incorporated in these projections include the launching of the Third Pillar pension scheme, referred to as the Personal Retirement Scheme, and which is being supplemented by another scheme, the Individual Savings Account (ISA), as well as the pension reforms introduced in the 2016 Budget.

The other main drivers of public expenditure growth relate to the spending on healthcare and on long-term care, which respectively are expected to edge up by 2.1pp and 1.2pp throughout the forecast horizon. On the other hand, both spending on education and unemployment benefits are projected to maintain a generally stable share of GDP respectively at around 6% and 0.3%.

The MTFS document provides an update of these long-term expenditure calculations by including interim estimates presented by the Pensions Strategy Group (PSG) about the possible impact resulting from the recently announced lengthening of the social security contributory period and the linking of the contributory period to retirement. These interim estimates project that, on the assumption of no behavioural changes, there may be an improvement in the fiscal balance amounting to 0.5% of GDP by 2060. The improvement would increase to 1.7% of GDP if one were to factor in possible changes in retirement patterns (namely later retirement).[35]

Table 3: Age-related public expenditures

	2013	2060	change
	Per cent of GDP		*pp*
Total age-related public expenditure	22.6	29.2	6.6
Pension expenditure	9.6	12.8	3.2
Healthcare	5.7	7.8	2.1
Long-term care	1.1	2.3	1.2
Education expenditure	5.9	6.0	0.1
Unemployment benefits	0.3	0.3	0.0

Source: Ageing Working Group, Annual Report 2015

On the basis of a high level assessment by the MFAC, it appears that according to these projections, it clear that expenditure challenges exist in the long term, which would warrant timely action. These challenges appear evident, notwithstanding that the overall assumptions used in this exercise might possibly be rather optimistic. Indeed, the macroeconomic background, characterised by the rising participation rates (predominantly for females but also to some extent for males) together with the regular yearly inflow of foreign workers appear to be alleviating pressures on the working-age population (as a result of ageing). While the increase in the female participation rate appears to be in line with the recent trends, the increase in the male participation rate may be challenging. Although participation rates are modelled to increase, creating a positive effect on potential output, the share of working age population is set to decline, thereby creating a negative effect on potential output. Moreover, it may be unclear to what extent one can safely assume that the phenomenon of worker inflows, particularly from other EU countries will continue at the projected rate, once macroeconomic conditions in Europe eventually improve. At the same time, the assumption of a rising fertility rate contrasts with the downward trend observed in the recent past. On the other hand, the assumption of a slight fall in the potential GDP growth rate over the medium

[35] It should be noted that whereas the PSG had proposed that the increase in the contributory period from 40 to 41 years would be applied to persons born after 1962, the 2016 budgetary measure was applied to persons born after 1968.

term appears to be justifiable, owing to the fact that by that time, Malta's standard of living would have likely converged to the EU's average.

Apart from the long-term macroeconomic forecasts, which impact on the expected level of nominal GDP, uncertainties also relate to the expenditure projections, particularly in view of the expenditure slippages which have generally tended to occur, particularly with regard to spending on health.

The MFAC notes that the Government intends to present an updated set of budgetary projections to the EU's Economic Policy Committee's (EPC) Working Group on Ageing Populations and Sustainability (AWG).[36]The Government is invited to utilise the current benign macroeconomic conditions to continue to address the age-related expenditure challenges through further strategic choices, aimed to safeguard public finances from undue future pressures, while keeping the tax burden at acceptable levels.

6. Conclusion and final recommendations

The MFAC notes that the MTFS takes on board some of the recommendations made by the MFAC which are listed in its first Annual Report.[37] In particular, the MFAC views positively the increased transparency with regard to the conduct of fiscal policy through the provision of more detailed information about the assumptions underpinning such plans. The MFAC also welcomes the increased efforts spearheaded by the MFIN which aim to ensure fuller consistency between the macro and fiscal forecasts. This helps to boost the robustness of both sets of projections, thereby enhancing their plausibility and credibility. The provision of long term forecasts also helps focus attention on issues which extend well beyond the electoral cycle.

At the same time the MFAC notes that some progress was made with regard to increased collaboration across government departments and entities. The MFAC invites the MFIN to push further ahead in this respect, particularly to ensure that the processes are consistent with the timelines envisaged by the European Semesters, allowing sufficient time for the exchange of views and assessment by the MFAC, particularly with respect to the endorsement of the macroeconomic projections which needs to be submitted twice-yearly, concurrently with the USP and with the Draft Budgetary Plan (DBP).

The MFAC views positively that the Government's plans appear to be in line with the requirements imposed by the SGP and the FRA. The consolidation efforts are mainly expenditure based, but supported with some measures related in particular to indirect taxes, which however are only fully specified for 2016. In this respect, the MFAC invites the Government to explore ways how measures for the outer years, which are embodied into the

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[36] Background information about the AWG is available on http://europa.eu/epc/working_groups/ageing_en.htm.
[37] For the full list of recommendations and explanations refer to Chapter 3 and Appendix A of the Annual Report which is available on the MFAC's website.

MFIN's projections, can be better delineated. This should help introduce more clarity with regard to the future conduct of fiscal policy, which is a cornerstone of a medium term strategy. At the same time the MFAC invites the Government to ensure that when new taxes are introduced, such as in the case of the environmental contribution to be paid by tourists, all operational and legal aspects are pro-actively dealt with to avoid the derailing from the initial plans.

The MFAC underscores that the assumed expenditure restraint, which is necessary to ensure compliance with fiscal rules as well as to reinforce the rationalisation of expenditure to the extent possible, may prove increasingly challenging, particularly in the outer years. It is thus important that expenditure restraint takes place through efficiency gains and cuts in unproductive expenditures, so as to ensure that the rest of the budget allocations remain consistent with an acceptable quality in the delivery of government services. This should be facilitated if the findings emerging from the various CSRs translate into effective remedial action, in order to mitigate long term pressures on public finances. This is also important to ensure sufficient resources are allocated to enable the country to attain the Europe 2020 targets. Further progress in pension reform, which aims to improve sustainability while addressing poverty considerations, on the basis of the suggestions put forward by the Pensions Strategy Group, is also encouraged, in order to strike a good balance between financial sustainability and equitable growth and development.

The MFAC notes that according to the projections, an annual allocation of 0.1% of GDP for the Contingency Reserve was factored in for each of the years between 2016 and 2019. Should the Contingency Reserve not be resorted to during these years, the actual fiscal balance could thus cumulatively improve by an additional 0.4pp by the end of 2019 compared to the announced targets.[38] The MFAC recommends such a prudent approach, which would generate a buffer over the minimum annual structural effort required.[39] This in turn would enable the Government to be in a better position to address any unforeseen deterioration in economic or fiscal conditions. At the same time, the MFAC reiterates the need to establish clear and objective criteria which specify more thoroughly when recourse to the Contingency Reserve may be resorted to. The MFAC welcomes the replenishment of the Contingency Reserve, after having been utilised in 2015, but would recommend that the Contingency Reserve should not be seen as a readily available buffer to finance expenditure slippages.

Should cyclical macroeconomic conditions be better than expected, or else translate into a more tax-rich growth than currently being forecasted, it is important that resulting revenue windfalls be considered as further buffers rather than used to ease the envisaged expenditure restraint.

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[38] The annual allocation to the Contingency Fund, at 0.1% of GDP is recorded as a yearly expenditure item in the fiscal projections prepared by the MFIN. In cumulative terms, this expenditure would thus amount to 0.4% of GDP between 2016 and 2019. This is also in line with Article 34 of the FRA which specifies that in any one particular year the Contingency Reserve shall amount to between 0.1 per cent and 0.5 per cent of GDP.

[39] The structural effort is measured as the change in the structural balance.

Over the short-term forecast horizon, public finances are expected to benefit significantly from the projected revenues generated through the IIP. The MFAC's view is that it is important that the 70% share of the IIP proceeds which is allocated to the National Development and Social Fund is used in a way which does not jeopardise the attainment of budget targets outlined in the MTFS. In this sense, the MFAC suggests that revenues from the IIP are not channelled into additional spending of a recurrent nature but are rather used to finance one off initiatives consistent with the expenditures budgeted in the MTFS. The MFAC also encourages the Government to study whether certain elements of the current tax framework, such as in the case of immovable property, can be improved upon.

The MFAC draws attention to the need to monitor more closely the country's output gap conditions. The MFAC acknowledges the fact that the variability in the official macroeconomic statistics across vintages makes the assessment in real time of output gap conditions quite challenging.[40] However, since the output gap is a crucial determinant of the structural balance, which in turn determines whether a country has satisfied the annual required structural effort in terms of the SGP, it is important that to the extent possible this aspect is better factored into the budgetary practices.

The MFAC re-iterates that there is scope to extend further the average maturity of public debt in order to spread savings resulting from the exceptionally low interest rate environment over many years. Similarly, the MFAC invites again the Government to consider new legislation on the issuing of government guarantees, particularly since these remain rather high when compared to other EU Member States, despite being projected to decline from 16% of GDP in 2015 to 11.8% by 2019.[41] This would also enhance the level of transparency in the way government guarantees are awarded, besides providing for a more robust fiscal governance framework.

Overall, the MFAC considers that the MTFS broadly complies with the requirement of the FRA. As prescribed by Article 13 of the FRA, the MFAC also confirms that in its opinion, there are no exceptional circumstances which would allow for a departure from the fiscal plans as announced in the latest MTFS.

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[40] This can also give rise to significant differences between the output gap as estimated by the MFIN and that estimated by the COM.

[41] The COM, in its assessment of the USP likewise remarks that 'the government-guaranteed debt in Malta remains high compared to other Member States'. For further details about the level of government guarantees across EU Member States refer to Eurostat news release 20/2016 available on http://ec.europa.eu/eurostat/documents/2995521/7143457/2-27012016-AP-EN.pdf/60f17285-93bb-4813-9bd8-bb5263703408.

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