An overall assessment of the

Draft Budgetary Plan for 2017

A report prepared by the
Malta Fiscal Advisory Council

December 2016

MALTA FISCAL ADVISORY COUNCIL

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Draft Budgetary Plan for 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) reviewing the conduct of fiscal policy as outlined in the Draft Budgetary Plan 2017. Following the Council's earlier endorsement of the Government's macroeconomic forecasts and fiscal projections, the third report in the series relating to the Draft Budgetary Plan focuses mainly on an evaluation of the extent of compliance with the fiscal rules which are specified in the Fiscal Responsibility Act and the Stability and Growth Pact.

The Council welcomes the Government's sustained commitment to pursue fiscal consolidation through the gradual lowering of the fiscal deficit. This is being facilitated through the strong economic growth recorded by the country in recent years. The Council notes that in 2016, further progress has been achieved in this respect. At the same time, it is important that the drive towards fiscal consolidation is maintained, to ensure that the Medium-Term Objective of structural balance can be attained by 2019. This would place Malta's public finances on a stronger footing, and be better able to cope with the longer term expenditure pressures.

The Council acknowledges that the slower accumulation of debt and the expansion in the nominal GDP denominator should enable the debt rule to be satisfied both in 2016 and 2017. Indeed, the Council notes that, following the cut-off date for the finalisation of this Report, the National Statistics Office published an upward revision in the nominal GDP figures for the period 2014 to mid-2016 which offers greater scope for the 60% debt-GDP target to be reached earlier than originally anticipated by the Government. The Council considers that this is an opportunity which should not be missed.

The Council is also of the view that, on the basis of the available information, the structural adjustment envisaged by the Government for 2016 should comfortably meet the 0.6% of GDP minimum requirement. However, with regard to 2017, there appears to be some risk of a small shortfall from this requirement. In this respect, the Council identifies some differences in the estimates published by the Ministry for Finance and by the European Commission which appear to be related mainly to the treatment of expenditure associated to Malta's European Union Presidency. The Council shares the Commission's view that expenditure on European Union Presidency should not be treated as a one-off expenditure item, if one interprets conservatively the published guidelines.

With regard to the expenditure rule, the Council notes that the annual expenditure growth (adjusted for certain components) is required not to exceed 1.3% in 2016. The Council's view is that the Government is on track to respect this limit this year. However there is a risk of some deviation for 2017, both according to the Ministry's calculations as well as those by the European Commission, as current fiscal plans translate into an adjusted expenditure growth which is somewhat higher than the 1.8% limit for 2017 set by the Commission.

Overall, the Council considers that the budgetary plan broadly complies with the requirements of the Fiscal Responsibility Act and the Stability and Growth Pact. The fiscal performance for 2016 appears to be fully compatible with the yearly requirements. However, the Government is invited to explore possible fine-tuning of expenditure plans for 2017, to better accommodate the requirements for the annual structural effort and the expenditure growth limit for next year. At the same time, the Council considers important that compliance with rules is done in a way which does not limit the efficacy and the meeting of fiscal policy objectives.

Finally, the Council expresses its satisfaction at the ongoing constructive dialogue with the Ministry. The Council remains committed to promote further awareness about the current fiscal framework in Malta and the role played by the fiscal rules which are enshrined in the Fiscal Responsibility Act and the Stability and Growth Pact. In this respect, the Ministry is likewise encouraged to give further importance to the numerical fiscal rules in its communications. This would allow for a more reasoned public dialogue in the areas covering public finance issues.

Yours sincerely

Rene Saliba
Chairman

Table of Contents

List of Tables

List of Charts

List of Boxes

Abbreviations

COM	European Commission
DBP	Draft Budgetary Plan
EU	European Union
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
IIP	Individual Investor Programme
MFAC	Malta Fiscal Advisory Council
MFIN	Ministry for Finance
MTO	Medium Term Objective
NSO	National Statistics Office
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union

Executive summary

This Report reviews the conduct of fiscal policy as outlined in the Draft Budgetary Plan 2017, focusing primarily on the extent of compliance with the fiscal rules outlined in the Fiscal Responsibility Act, 2014 (Cap. 534) and the Stability and Growth Pact of the European Union.

Headline public finances are expected to continue improving, with the fiscal deficit expected to narrow to 0.7% of GDP in 2016 and 0.5% of GDP in 2017, while the gross debt-to-GDP ratio is projected to decline to 63.3% in 2016 and 61.9% in 2017

The planned debt trajectory complies with the backward looking debt rule both for 2016 and 2017. Indeed, the slower accumulation of debt and the expansion in nominal GDP are enabling the debt to-GDP ratio to converge closer towards the 60% threshold, as confirmed by the calculations of both the Ministry for Finance and the European Commission.

Likewise, the undertaking of counter-cyclical fiscal tightening is facilitating the attainment of the Medium Term Objective of structural balance by 2019. Both the Ministry for Finance and the European Commission anticipate that the structural adjustment for 2016 will be comfortably higher than the 0.6% of GDP requirement. However, with regard to 2017, there is the risk of some divergence from this requirement, since according to the European Commission's estimate the structural adjustment may amount to 0.4 percentage points, which is half the magnitude indicated by the Ministry for Finance. This discrepancy mainly relates to the treatment of expenditure on Malta's European Union Presidency, which according to the European Commission's guidelines cannot be treated as a one-off expenditure.

Both institutions expect the expenditure rule, which requires annual expenditure growth (adjusted for certain components) not to exceed a country-specific lower rate, to be respected in 2016. Indeed, adjusted expenditure growth forecasts range around 0.5%-0.7%, which are lower than the benchmark rate of 1.3% set by the European Commission. However there is a risk of some deviation in 2017, as adjusted expenditure growth is estimated at 2.2% on the basis of the Commission's forecasts, and thus may exceed the 1.8% limit for the year.

The Malta Fiscal Advisory Council considers that the budgetary plan broadly complies with the requirements of the Fiscal Responsibility Act and the Stability and Growth Pact. Nevertheless, the Ministry is invited to explore possible fine-tuning of expenditure plans for 2017 to accommodate the requirements for both the annual structural effort as well as the yearly expenditure growth limits. It is however important that compliance with rules is done in a way which does not limit the efficacy and the meeting of fiscal policy objectives.

1. Introduction

The Draft Budgetary Plan (DBP) which outlines the government's fiscal plans for 2017 was published on 18 October 2016. This document contains the measures announced by the Minister for Finance during the budget speech which was delivered on 17 October 2016. The information which needs to feature in the DBP is specified in Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (see Box 1).

The European Commission (COM) evaluates each country's DBP to ensure that economic policy among the countries sharing the euro is coordinated and that they respect the European Union's (EU) economic governance rules. Thereafter, the COM grades each country's DBP as being either compliant, or broadly compliant, or at risk of non-compliance.

The fiscal plans outlined in the DBP, and associated fiscal outlook, are underpinned by the latest macroeconomic forecasts. Both the macroeconomic and fiscal baseline forecasts have been considered to be within the endorsable range of the Malta Fiscal Advisory Council (MFAC), on the basis of independent assessment reports which were respectively published in October and November 2016.[1] This third assessment report linked to the DBP 2017 evaluates whether the actual and planned conduct of fiscal policy for 2016 and 2017 complies with the fiscal rules prescribed by the Fiscal Responsibility Act (FRA) and the Stability and Growth Pact (SGP). Specifically, the FRA stipulates a debt rule and a structural adjustment rule, and makes indirect reference to the expenditure benchmark requirement. These three rules are based on the requirements of the SGP. The relevant text from the FRA and SGP are reproduced in the Appendix.

This Report, whose cut-off date is 2 December 2016, proceeds as follows.[2] Section 2 presents an overview of the actual and planned conduct of fiscal policy in Malta. Section 3 examines the extent to which, the debt rule is being adhered to. Section 4 evaluates compliance to the structural adjustment rule. Section 5 examines whether the expenditure benchmark is being respected. Section 6 concludes with some final considerations.

[1] The MFAC's reports are available on www.mfac.gov.mt.

[2] On 7 December 2016, the National Statistics office (NSO) published updated GDP statistics which indicated significant revisions to the level of both nominal and real GDP, as well to the yearly growth rates, particularly from 2014 onwards. However, this GDP vintage is not considered further in this Report since this data was not available at the time the DBP 2017 had been prepared, and also became available beyond the cut-off date.

Box 1: Monitoring requirements specified in Article 6 of Regulation (EU) No 473/2013

1. Member States shall submit annually to the Commission and to the Eurogroup a draft budgetary plan for the forthcoming year by 15 October.[3] That draft budgetary plan shall be consistent with the recommendations issued in the context of the SGP and, where applicable, with recommendations issued in the context of the annual cycle of surveillance, including the macroeconomic imbalances procedure as established by Regulation (EU) No 1176/2011, and with opinions on the economic partnership programmes referred to in Article 9.

2. As soon as the draft budgetary plans referred to in paragraph 1 have been submitted to the Commission, they shall be made public.

3. The draft budgetary plan shall contain the following information for the forthcoming year:

(a) the targeted budget balance for the general government as a percentage of Gross Domestic Product (GDP), broken down by subsector of general government;

(b) the projections at unchanged policies for expenditure and revenue as a percentage of GDP for the general government and their main components, including gross fixed capital formation;

(c) the targeted expenditure and revenue as a percentage of GDP for the general government and their main components, taking into account the conditions and criteria to establish the growth path of government expenditure net of discretionary revenue measures under Article 5(1) of Regulation (EC) No 1466/97;

(d) relevant information on the general government expenditure by function, including on education, healthcare and employment, and, where possible, indications on the expected distributional impact of the main expenditure and revenue measures;

(e) a description and quantification of the expenditure and revenue measures to be included in the draft budget for the year to come at the level of each subsector in order to bridge the gap between the targets referred to in point (c) and the projections at unchanged policies provided in accordance with point (b);

(f) the main assumptions of the independent macroeconomic forecasts and important economic developments which are relevant to the achievement of the budgetary targets;

[3] Since in 2016 this date fell on a Saturday, countries were allowed to submit at a later date.

(g) an annex containing the methodology, economic models and assumptions, and any other relevant parameters underpinning the budgetary forecasts and the estimated impact of aggregated budgetary measures on economic growth;

(h) indications on how reforms and measures in the draft budgetary plan, including in particular public investment, address the current recommendations to the Member State concerned in accordance with Articles 121 and 148 TFEU and are instrumental to the achievement of the targets set by the Union's strategy for growth and jobs.

The description referred to in point (e) of the first subparagraph may be less detailed for measures with a budgetary impact estimated to be lower than 0.1 % of GDP. Particular and explicit attention shall be paid to major fiscal policy reform plans with potential spill-over effects for other Member States whose currency is the euro.

4. Where the budgetary targets reported in the draft budgetary plan in accordance with paragraph 3 or the projections at unchanged policies differ from those in the most recent stability programme, the differences shall be duly explained.

5. The specification of the content of the draft budgetary plan shall be set out in a harmonised framework established by the Commission in cooperation with the Member States.

2. Overview of the actual and planned conduct of fiscal policy

According to the latest DBP, the fiscal deficit-to GDP ratio is expected to decline from 1.4% in 2015, to 0.7% in 2016, and 0.5% in 2017 (see Table 1). In absolute terms, total revenue is expected to increase both in 2016 and 2017, but at a slower pace than nominal GDP. As a result, the revenue-to-GDP ratio is expected to decline from 42.0% in 2015 to 40.3% in 2016 and 39.8% in 2017. At the same time, the total expenditure-to-GDP ratio is expected to decline from 43.4% in 2015 to 41.0% in 2016, on account of lower expenditure in absolute terms. The expenditure-to-GDP ratio is expected to decline further in 2017, to 40.3%, on the basis of plans to restrain expenditure growth below that in nominal GDP.

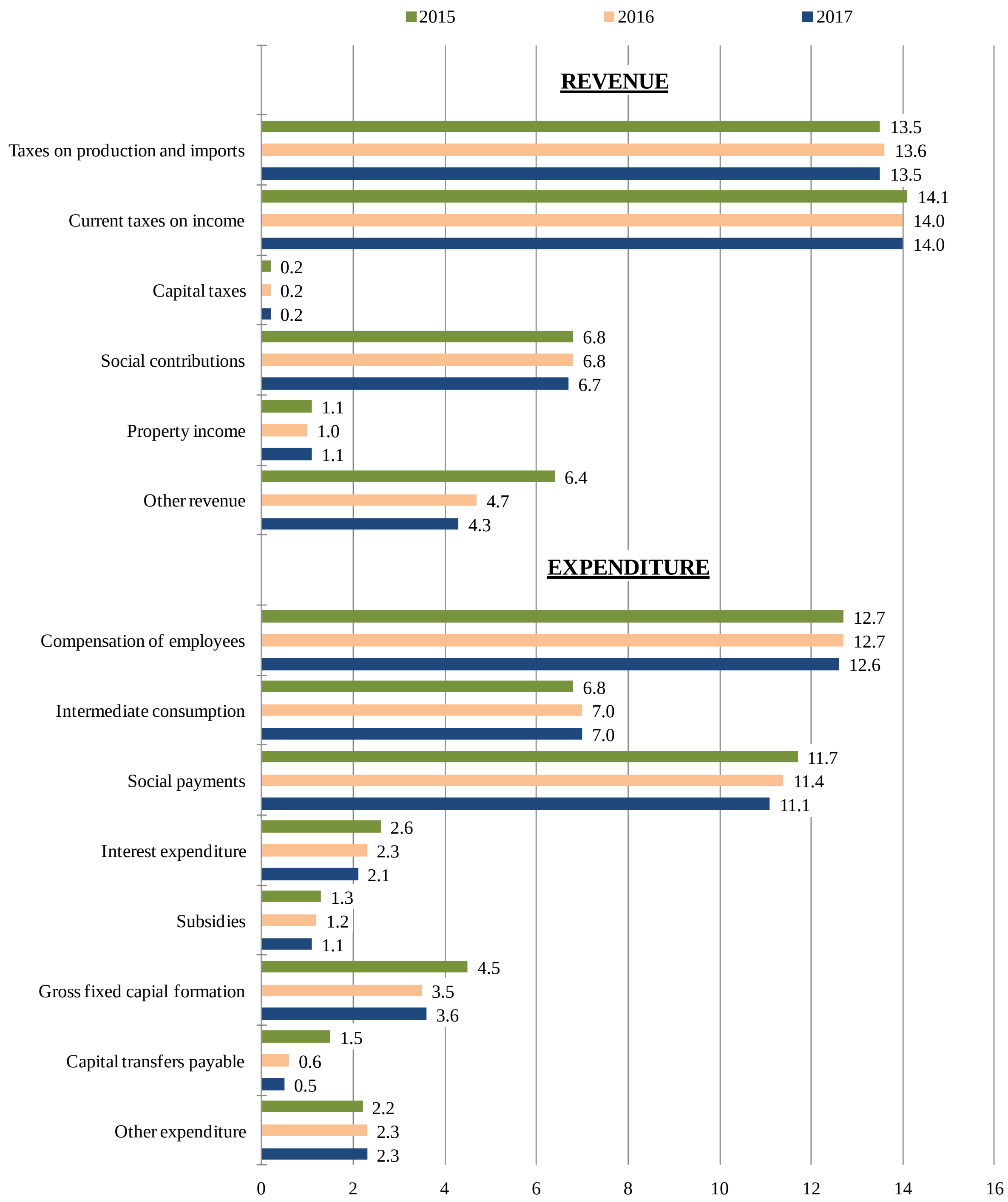
Table 1: Key fiscal aggregates (per cent of GDP)

	2015	2016	2017
Fiscal balance	-1.4	-0.7	-0.5
Total revenue	42.0	40.3	39.8
Total expenditure	43.4	41.0	40.3

Source: MFIN

At a revenue component level, the major changes are related to 'other revenue' which is expected to drop from 6.4% of GDP to 4.3% of GDP by 2017, primarily reflecting the absorption patterns of EU funds, which are included within this category. Otherwise, the major revenue items within the budget are expected to remain broadly stable, when compared to nominal GDP, with changes limited to around 0.1 percentage point (see Chart 1).

Chart 1: Main budget components (per cent of GDP)



Source: MFIN

On the other hand, the expenditure components are expected to undergo somewhat more pronounced changes as a percentage of nominal GDP during the forecast period. In particular, after having spiked in 2015, the ratio of spending on gross fixed capital formation is expected to drop, mirroring the projected lower take up of EU funds during this period. The latter also explains the planned contraction in capital transfers, as percentage of GDP. Other main changes relate to the scaling back of social payments when compared to GDP, from 11.7% in 2015, to 11.1% in 2017. This is primarily driven by the low inflationary environment which helps limit growth in social payments below that in nominal GDP. Interest expenditure is also expected to drop from 2.6% of GDP in 2015 to 2.1% of GDP in 2017, facilitated by the roll-over savings achieved as a result of the low interest rate environment.

Table 2 presents a longer term perspective of public finances, covering the actual and planned key fiscal ratios for 2013 – 2017. This five year period is characterised by a progressive improvement in the state of public finances, through consecutive reductions in the fiscal deficit ratio and in the structural deficit as percentage of potential GDP. The debt-to-GDP ratio is likewise on a downward trajectory. Should the 2017 targets be achieved, the fiscal balance would have improved by 2.1 percentage points compared to the 2013 level, to -0.5% of GDP. Meanwhile, the structural balance would have improved by slightly more (2.6 percentage points), to -0.3% of potential GDP. At the same time, the debt-to-GDP ratio would have been scaled back from 68.4% of GDP in 2013 to 61.9% of GDP in 2017. The MFAC welcomes the Government's actions to date which have succeeded in improving the state of public finances, and encourages the Government to ensure that, as indicated in the DBP, such momentum is also maintained in 2017.

Table 2: Fiscal performance (2013 – 2017) (per cent of GDP)

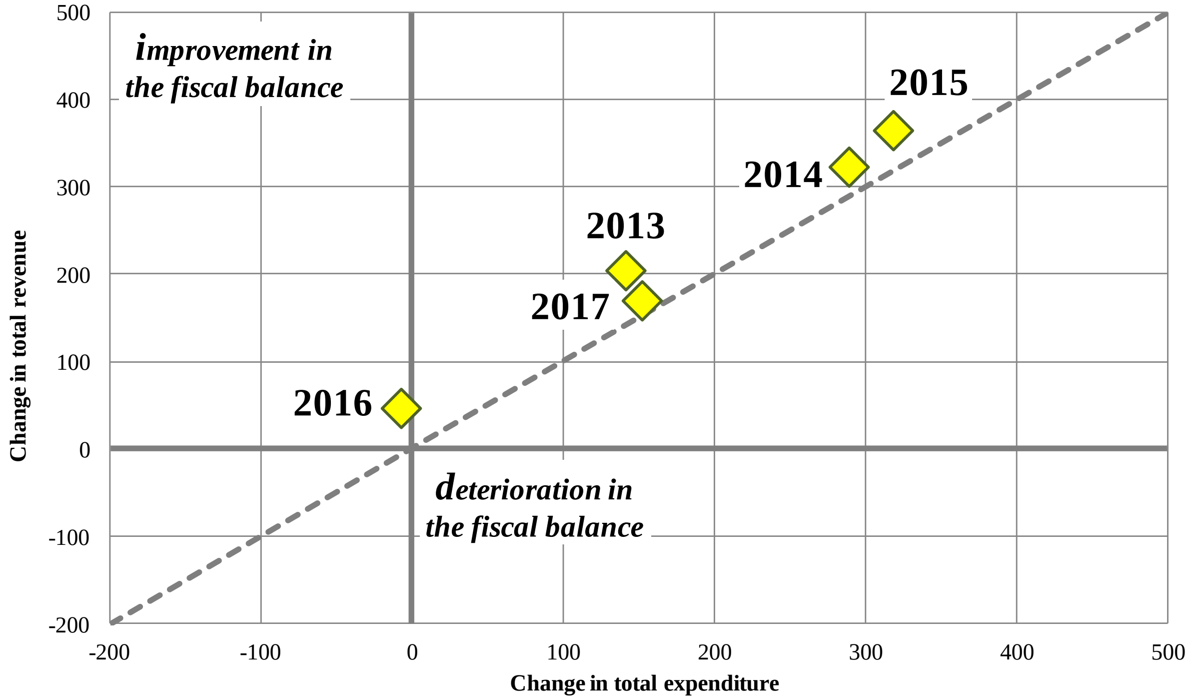
	2013	2014	2015	2016	2017
Fiscal balance	-2.6	-2.1	-1.4	-0.7	-0.5
Structural balance*	-2.9	-2.8	-2.2	-1.1	-0.3
Gross Debt	68.4	67.0	64.0	63.3	61.9

* The structural balance is expressed as percentage of potential GDP. The structural balance figures for years 2013, 2014 and 2015 are reproduced from the COM's autumn 2016 forecasts while those for 2016 and 2017 are derived from MFIN's DBP for 2017.

Source: COM, MFIN

Throughout the 2013 – 2015 period, revenues have expanded by more than expenditures and a similar pattern is expected for 2016 and 2017 (see Chart 2). This explains the consecutive narrowing of the fiscal deficit in absolute terms (see Chart 3). The rising level of nominal GDP is contributing to further reduce the fiscal deficit-to-GDP ratio. On the other hand, the fall in the debt ratio reflects the slower accumulation of debt and the expansion of nominal GDP (see Chart 4).

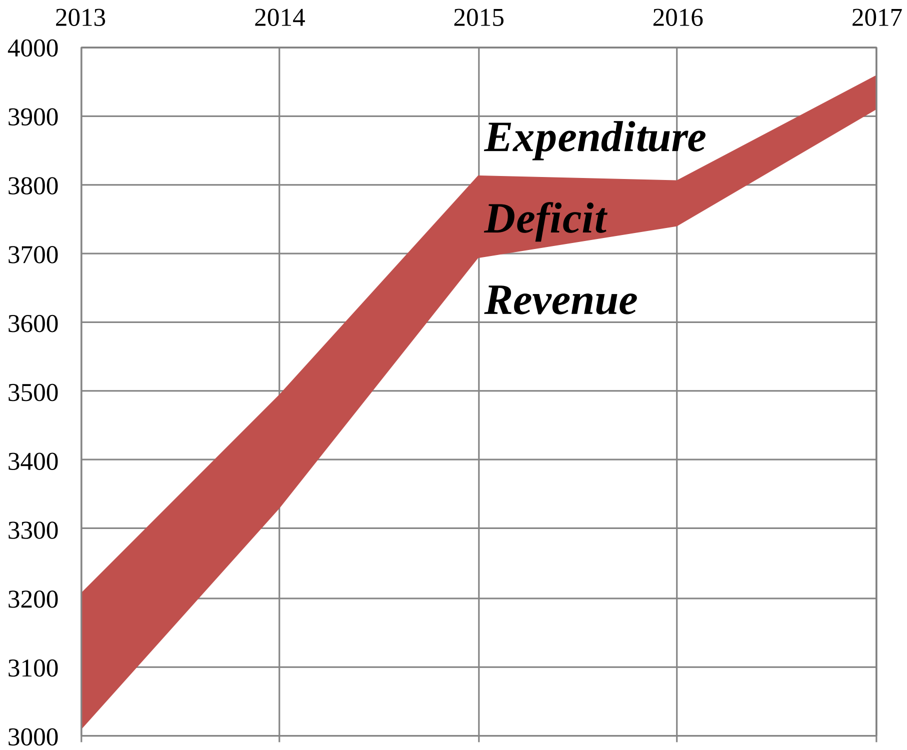
Chart 2: Yearly revenue and expenditure patterns (EUR millions)



Note: Anywhere above the dashed line indicates combinations of revenue and expenditure developments leading to an improvement in the fiscal balance, whereas anywhere below the dashed line indicates combinations which lead to a deterioration in the fiscal balance. For the period 2013 – 2017 all points in the Chart are above the dashed line, in line with the improvements recorded in each of these years.

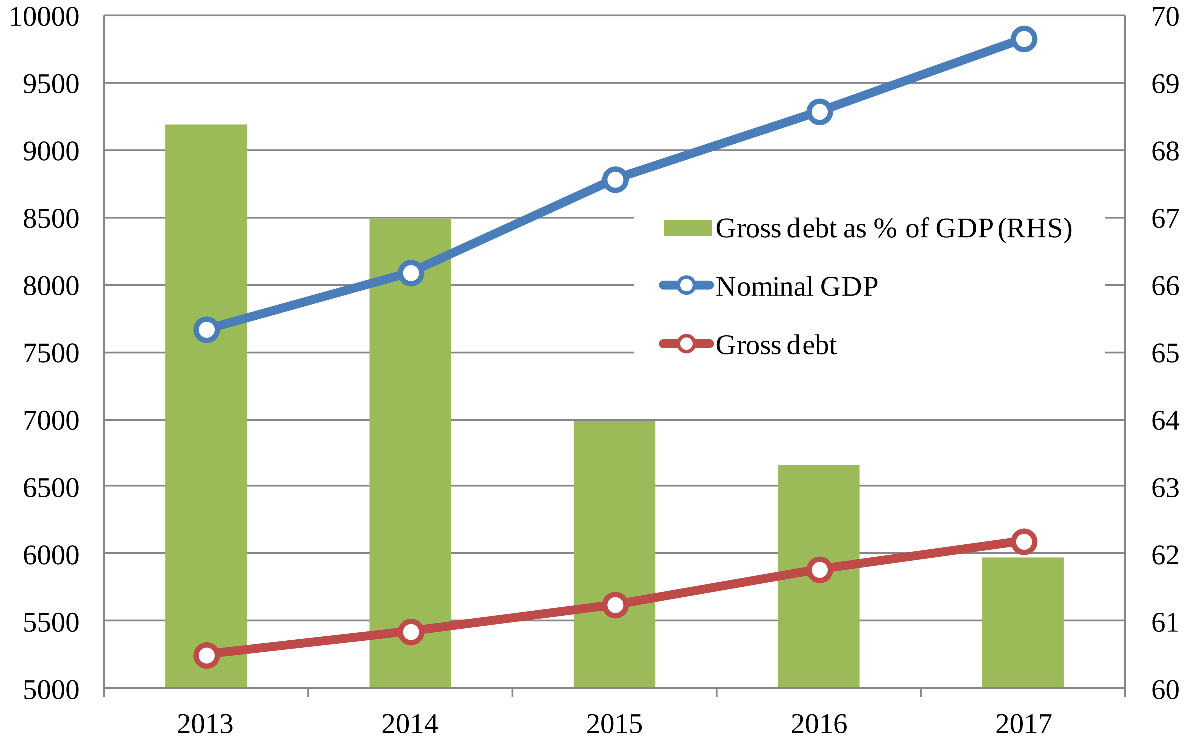
Source: MFIN

Chart 3: Fiscal deficit (EUR millions)



Source: MFIN

Chart 4: Gross debt and nominal GDP (EUR millions, per cent)



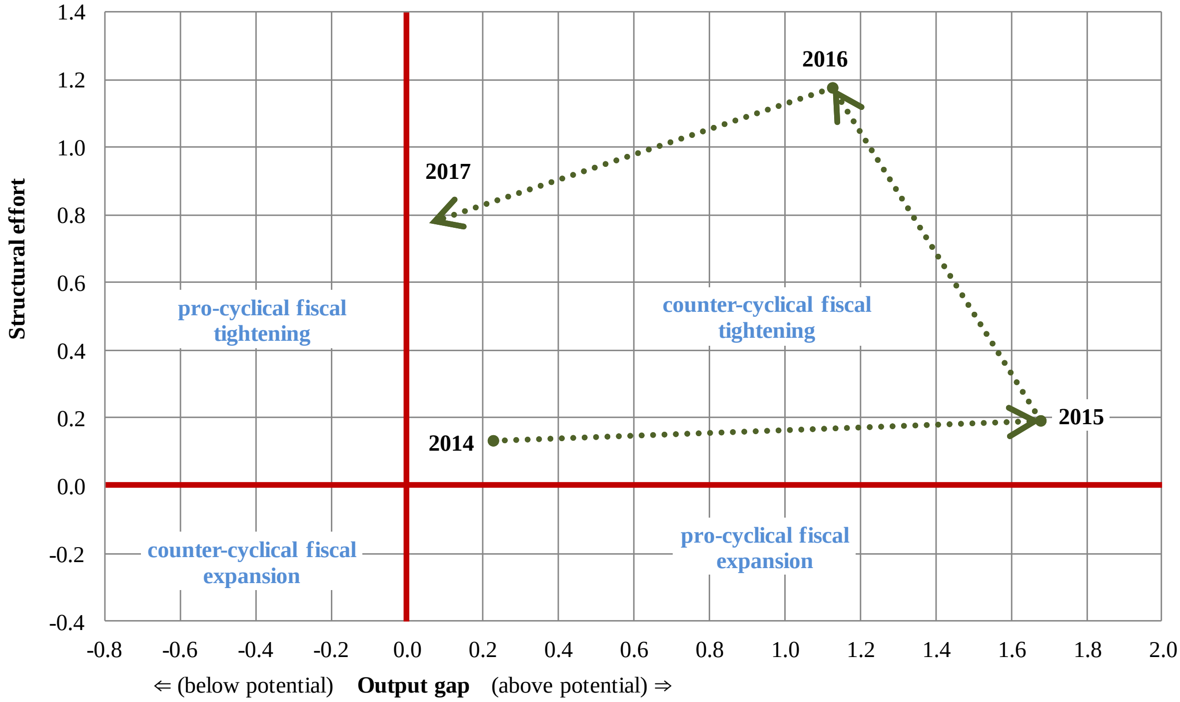
Source: MFIN

With regard to the improvement in the structural balance, this was the result of counter-cyclical fiscal tightening. Indeed, positive, albeit uneven, structural adjustment is being undertaken at the time when the economy is operating above potential (see Chart 5). While the structural adjustment undertaken in 2014 and 2015 was contained, on the basis of the calculations by the Ministry for Finance (MFIN), 2016 will see the strongest adjustment in structural terms, equivalent to 1.2 percentage points. A further significant adjustment equivalent to 0.8 percentage points is planned for 2017.

The DBP 2017 includes revenue and expenditure measures which in total amount to €80.7 million.[4] The largest portion of initiatives, representing approximately 41.7% of the total, relate to additional spending on the provision of public goods (see Chart 6).[5] A further 24.9% of measures are related to various redistribution initiatives, primarily targeted towards the lower income households. Some 14.4% represent measures which address market failures, particularly negative externalities. A significant share, amounting to 12.7% is accounted for by spending in relation to the EU Presidency, which Malta will hold during the first six months of 2017. As for the new measures which are explicitly intended to generate revenue, these are limited, and equivalent to 6.2% of the measures identified in the DBP 2017.

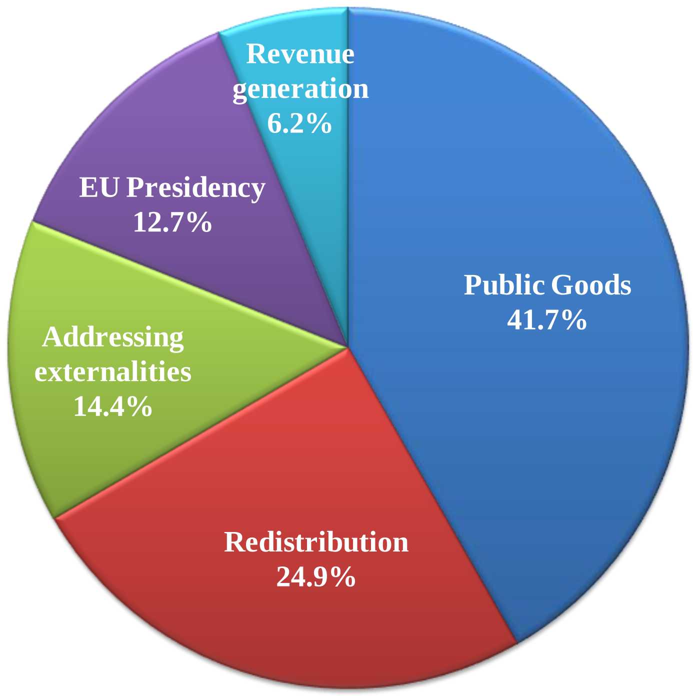
[4] The estimate of measures is based on the magnitude of the measures, irrespective of whether they are of a revenue or expenditure nature. Hence this figure is different from the impact estimated at -0.651% of GDP quoted in Table 5a of the DBP, as the latter represents the net incremental budgetary impact.
[5] This spending is mainly financed through the revenues raised from the Individual Investor Programme (IIP).

Chart 5: Cyclical conditions and structural effort (percentage points of GDP)



Source: MFIN

Chart 6: Budget 2017 measures (per cent)



Source: MFAC calculations

3. Compliance with the debt criterion

At the end of 2015, Malta's ratio of gross government debt to GDP exceeded the 60% threshold. As a result compliance with the debt criterion requires that the country progressively lowers its debt ratio to converge to this limit. The pace of convergence must also be sustained. This criterion can be met in its most stringent version, termed the backward looking approach, if the debt ratio falls below or is equal to the appropriately calculated benchmark rate.[6] The latter, which is meant to sustain gradual progress towards the threshold, is calculated on the basis of the differential between the actual values for debt ratio of the preceding three years and the 60% threshold.

The applicable debt ceiling for 2016, which considers 2015 as period (t) is thus based on the actual debt ratios recorded over the three year period 2012 to 2014 (see Table 3). In turn, that for 2017 is based on the debt ratios for the three year period 2013 to 2015 (see Table 4). The formula to establish the annual benchmark rate assigns progressively declining weights to the gap (for each of the three years) with respect to the threshold.[7] Thus, greater importance (higher weights) is assigned to the more recent debt statistics.

Table 3: Calculation of the backward looking debt ratio benchmark rate for 2016

$$DD_t = 60\% + \frac{0.95}{3}(D_{t-1} - 60\%) + \frac{0.95^2}{3}(D_{t-2} - 60\%) + \frac{0.95^3}{3}(D_{t-3} - 60\%)$$

	a	b d*f	c	d	e	f
			Differential		**Weight**	
	Formula	***Result***	***Formula***	***Result***	***Formula***	***Result***
A	Threshold	60.0				
B	Debt $_{(t-1)}$	2.2	$D_{(t-1)} - 60$	7.0	(0.95)/3	0.3167
C	Debt $_{(t-2)}$	2.5	$D_{(t-2)} - 60$	8.4	$(0.95^2)/3$	0.3008
D	Debt $_{(t-3)}$	2.2	$D_{(t-3)} - 60$	7.6	$(0.95^3)/3$	0.2858
A+B+C+D	**Benchmark rate (DD_t)**	**66.9**				

Note: D_{t-1} is the debt ratio for 2014, D_{t-2} is the debt ratio for 2013 and D_{t-3} is the debt ratio for 2012. The capital and small letters of the alphabet indicate the rows and columns of the Table and are included to clarify the computations involved.

Source: MFAC calculations

[6] The SGP also allows for some flexibility when the backward rule in not satisfied. For further details refer to 'Box 2 – The debt rule' published by the MFAC on 30 September 2015 in 'An Assessment of the Medium-Term Fiscal Strategy 2015-2018, Annual Report 2014 and Half Yearly Report 2015 published by the Ministry for Finance', available on the MFAC's website.

[7] For further details refer to the Vade Mecum on the Stability and Growth Pact – 2016 edition, by the COM, available on http://ec.europa.eu/economy_finance/publications/eeip/ip021_en.htm.

Table 4: Calculation of the backward looking debt ratio benchmark rate for 2017

	a	b d*f	c	d	e	f
			Differential		**Weight**	
	Formula	***Result***	***Formula***	***Result***	***Formula***	***Result***
A	Threshold	60.0				
B	Debt $_{(t-1)}$	1.3	$D_{(t-1)} - 60$	4.0	(0.95)/3	0.3167
C	Debt $_{(t-2)}$	2.1	$D_{(t-2)} - 60$	7.0	$(0.95^2)/3$	0.3008
D	Debt $_{(t-3)}$	2.4	$D_{(t-3)} - 60$	8.4	$(0.95^3)/3$	0.2858
A+B+C+D	**Benchmark rate (DD_t)**	**65.8**				

Note: D_{t-1} is the debt ratio for 2015, D_{t-2} is the debt ratio for 2014 and D_{t-3} is the debt ratio for 2013. The capital and small letters of the alphabet indicate the rows and columns of the Table and are included to clarify the computations involved.

Source: MFAC calculations

The MFIN is projecting the debt-to GDP ratio to reach 63.3% in 2016 and 61.9% in 2017 (see Table 5). In both cases the debt projections are below the applicable benchmark rates which, as can be seen from Table 3 and Table 4, are estimated respectively at 66.9% and 65.8%. As a result, the debt criterion is satisfied according to the backward looking method. Compliance to this rule is also confirmed when using the COM's debt forecasts which, at 62.1% of GDP for 2016, and 59.9% of GDP for 2017, are actually more optimistic than the MFIN's forecasts. Indeed, the COM anticipates that by 2017, the 60% debt threshold would be fully met, in which case, going forward, the requirement would be to maintain the debt ratio below this ceiling.

Table 5: Compliance with the debt rule (per cent of GDP)

	2016			2017		
	Benchmark	**DBP**	**COM**	**Benchmark**	**DBP**	**COM**
Gross debt ratio	66.9	63.3	62.1	65.8	61.9	59.9

Source: COM, MFAC, MFIN

4. Compliance with the structural adjustment rule

In order to progress toward the Medium Term Objective (MTO) of a balanced budget in structural terms by 2019, the government must undertake a minimum annual improvement in the structural budget balance, that is, in the fiscal balance net of cyclical and temporary effects and of one-off measures. The size of the required structural effort varies depending on two factors: whether the country's debt-to-GDP ratio is below or above the 60% threshold; and the prevailing output gap conditions.[8]

In Malta's case, the size of the required fiscal adjustment is determined by the fact that Malta's debt-to-GDP ratio will remain above the 60% threshold in both 2016 and 2017 while cyclical conditions are considered to be in 'normal times' (see Table 6).[9] Projections for the output gap are rather similar for the MFIN and the COM, narrowing from 1.1% of potential output in 2016 to 0.1% in 2017 according to the MFIN's forecasts, and narrowing from 0.9% to 0.1% according to the COM's forecasts.

Table 6: Debt and output gap projections (per cent of GDP, per cent of potential output)

		2016	2017
Debt	MFIN (DBP)	63.3	61.9
	COM (Autumn forecasts)	62.1	59.9
Output gap	MFIN (DBP)	1.1	0.1
	MFIN (recalculated by COM)*	1.1	0.0
	COM (Autumn forecasts)	0.9	0.1

* Note: The figures provided by a country may be recalculated by the COM. Figures relating to debt are expressed as percentage of GDP while those relating to the output gap are expressed as percentage of potential output.

Source: COM, MFIN

The applicable fiscal adjustment requested for Malta for 2016 and 2017 was set by the COM at 0.6% of potential GDP. This requirement was included in the recommendation issued by the European Council on 12 July 2016, which encouraged the country 'to achieve an annual fiscal adjustment of 0.6 % of GDP towards the medium-term budgetary objective in 2016 and in 2017, by taking the necessary structural measures'.[10]

For 2016, both the structural effort envisaged by the MFIN and that projected by the COM, respectively at 1.2% and 1.1% of GDP, suggest that the criterion for the year should be met (see Table 7) with an element of frontloading. This is in line with the MFAC's recommendation to use windfalls for a stronger fiscal consolidation effort and is also meant to ensure broad compliance with the expenditure benchmark referred to in the following section. On the other hand, for 2017, whereas the MFIN anticipates a structural effort

[8] For further details refer to 'Box 3 – The required structural effort published in 'An Assessment of the Medium-Term Fiscal Strategy 2015-2018, Annual Report 2014 and Half Yearly Report 2015 published by the Ministry for Finance', available on the MFAC's website.

[9] In the case of debt the COM expected the debt ratio to fall below 60% of GDP by 2017, while cyclical conditions fall within the range to be considered as in normal conditions according to both the MFIN's and the COM's projections.

[10] Source: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32016H0818(25)&from=EN.

equivalent to 0.8% of GDP, the estimates by the COM indicate a structural effort which is half the size, at 0.4% of GDP.

Table 7: Estimates of the structural effort (per cent of GDP)

	2016	2017
Required structural effort	0.6	0.6
MFIN (DBP)	1.2	0.8
COM (Autumn forecasts)	1.1	0.4

Source: COM, MFIN

Thus, whereas according to the MFIN the annual 0.6% of GDP adjustment will also be met in 2017, according to the COM's projections there is a risk of some deviation in 2017. The factors explaining why the COM's estimates differ to some extent from the MFIN's calculations can be various and relate both to fiscal and macroeconomic factors (see Table 8 and Table 9).

Table 8: Fiscal factors contributing to the differences between the structural effort computed by the MFIN and that calculated by the COM

Theoretical factor	**Specific factor**	**Applicable for Year**	**Identifiable effect on structural effort***
Differences in the forecasts for the headline fiscal balance	While for 2016 the COM is forecasting an identical fiscal deficit to the MFIN, the COM is projecting a slightly higher fiscal deficit for 2017 (of 0.6% of GDP compared to MFIN's forecast of 0.5% of GDP)..	2016 2017	Nil – €12.0 million – 0.1% of GDP
Differences in the list of one-off and temporary effects	The COM did not consider the expenditure related to the EU Presidency as fitting the definition of one-off events according to the SGP guidelines. On the other hand, the MFIN considered the EU presidency costs as one-off expenditures, which can be netted off from the budget balance.	2016 2017	– €16.0 million – 0.2% of GDP – €26.3 million – 0.3% of GDP
Differences in the quantification of the magnitude of one-off and temporary effects	The COM's estimates for temporary measures are in line with those of the MFIN (apart from the exclusion of EU presidency costs mentioned above).	2016 2017	Nil Nil

* A negative value contributes towards a smaller structural effort estimated by the COM when compared to the MFIN.

Source: COM, MFAC, MFIN

Table 9: Macroeconomic factors contributing to the differences between the structural effort computed by the MFIN and that calculated by the COM

Theoretical factor	Specific factor	Effect on structural effort
Differences in the output gap	For 2016 the COM has higher forecasts for real GDP growth and potential output growth when compared to the MFIN. Nevertheless, the two effects are practically cancelling off yielding a similar output gap estimate as the MFIN. For 2017, the differences between the COM and the MFIN are likewise small, and despite different real GDP and potential output growth forecasts, the estimates for the output gap range closely, between 0.0% and 0.1% of potential GDP.	The differences in the output gap estimates produce differences in the cyclical element of the budget balance. In particular, a higher output gap produces a larger estimate for the cyclical effect and vice versa. As a result, the changes in the structural balance from one year to the other will be impacted. This effect is however small since the differences in the output gap estimates are only marginal.
Items impacting the output gap		
Differences in the forecasts for real GDP*	The COM is forecasting higher real GDP growth both for 2016 and 2017, respectively at 4.1% and 3.7%, compared to the 3.9% and 3.5% real GDP forecasts by the MFIN.	
Differences in the forecast for potential output*	The COM is forecasting higher growth in potential output for 2016 (4.7% as compared to 4.5% estimated by the MFIN) but lower potential growth in 2017 (4.5% compared to the MFIN's 4.6%). These differences can be partly ascribed to the fact that when compared to the MFIN's forecasts, the COM has higher forecast growth for gross fixed capital formation in 2016 but lower in 2017.	

* The combined impact of differences in the forecast for real GDP and for potential output results in differences for the estimates of the output gap.

Source: COM, MFAC, MFIN

It appears that the main factor explaining the divergence between the MFIN's and the COM's estimate of the structural effort relates to the fiscal domain, and in particular is related to the classification of costs associated with Malta's EU Presidency, and to a lesser extent the higher fiscal deficit forecast by the COM for 2017. The main issue is whether costs related to the EU Presidency fall within the definition of a one-off event or not according to the SGP.

In this respect, the COM has issued five guiding principles for the definition of one-off measures (see Table 10).[11] These principles are used by the COM when it issues its opinion

[11] Source: Report on Public Finances in EMU 2015, Institutional Paper 014, December 2015 available on http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip014_en.pdf.

regarding the extent of compliance with respect to the SGP. On balance, while acknowledging the special nature of this type of expenditure, the MFAC shares the opinion of the COM that EU Presidency costs should not be treated as one-off costs, because not all five principles are satisfied. The main argument relates to the fact that EU membership is an integral part of the country's obligations and hence, despite the EU Presidency's disproportionate impact in terms of costs in the case of a small economy, this by itself cannot be considered as a one-off event.

Table 10: Principles for the identification of one-off measures

Number	Principle	MFAC Comments
1	One-off measures are intrinsically non-recurrent.	The EU Presidency is held by each country for six months on a rotation basis. Although this event is voluntary and not frequent, it forms part of the EU membership general duties of a country and hence is normally expected to repeat itself again in future.
2	The one-off nature of a measure cannot be decreed by law or by an autonomous government decision.	The definition of what constitutes a one-off measure cannot be unilaterally decided by the country itself.
3	Volatile components of revenue or expenditure should not be considered one-off.	Not applicable.
4	Deliberate policy actions that increase the deficit do not, as a rule, qualify as one-offs.	Not applicable.
5	Only measures having a significant impact on the general government balance should be considered one-offs.	For a small country like Malta, spending on the EU Presidency can be disproportionately high when compared to GDP.

Source: COM

On the other hand, when one takes 2016 and 2017 together, both Commission's estimates and the MFIN's targets indicate that the projected change in the structural balance over these two years will exceed the structural effort needed to converge to the MTO and thus there is no risk of deviation from the required adjustment based on the annual average structural effort criteria for this two-year period.

5. Compliance with the expenditure benchmark

Whereas the SGP envisages an expenditure benchmark, the FRA only makes indirect reference to it in the eventuality that the country receives a warning from the COM as a result of a significant deviation in its budgetary policy.

According to the rule, the annual ceiling for expenditure growth in real terms is based on the medium-term rate of potential GDP growth. The latter is calculated using the 10-year average of potential GDP, which comprises five years of historical data, the current year and four year forecasts.[12] In the case of countries which are not at their MTO, which includes Malta, a country-specific convergence margin is then subtracted from the medium-term rate of potential GDP growth, to establish the annual reference growth rate for expenditure. This additional restraint acts as a safeguard in favour of fiscal consolidation. The permissible expenditure growth is thus assessed in terms of a 'modified expenditure' aggregate, which nets out specific items (see Table 11). Nominal growth in the modified expenditure is then converted into real growth by deducting the percentage change in the GDP deflator. This is necessary to make this aggregate comparable to the ceiling which is also expressed in real terms.

Table 11: Methodology for the calculation of modified expenditure

+	Government expenditure aggregate in period t
-	Interest expenditure in period t
-	Government expenditure on EU programmes which is fully matched by EU funds revenue in period t
-	Gross fixed capital formation in period t
+	Gross fixed capital formation averaged over periods t-3 to t
-	Cyclical unemployment benefit expenditure in period t
=	**Modified expenditure aggregate in period t**

Source: Vade Mecum on the Stability and Growth Pact (2016 edition) published by the COM.

The expenditure benchmark is respected whenever the real modified expenditure growth is within the estimate for potential output growth netted off the convergence margin. Differences between the MFIN's and the COM's expenditure component forecasts, as well as the macroeconomic outlook (in terms of cyclical conditions, the GDP deflator and the medium term potential GDP), may give rise to divergences in the assessment of compliance or otherwise with respect to the expenditure benchmark.

[12] The calculations follow the commonly agreed methodology set out by the COM's Output Gap Working Group.

The MFIN's forecasts, as reworked by the COM, place the modified real expenditure growth for 2016 at 0.5% while the COM estimates a slightly higher growth rate of 0.7% (see Table 12). On the other hand, both the MFIN's figures as reworked by the COM and the COM's own forecasts estimate the modified real expenditure growth for 2017 at 2.2%.

Table 12: Modified expenditure growth forecasts and the reference rate (per cent)

	2016	2017
MFIN (DBP)*	0.5	2.2
COM (Autumn forecasts)	0.7	2.2
Reference rate (COM)	1.3	1.8

* The COM reports the MFIN's recalculated growth figure at 2.2% for 2017, whereas the MFIN's calculations place the growth rate at 2.0%. This may be attributable to the use of different data sources.

Source: COM, MFAC

The estimates by the COM and the MFIN are thus close for 2016 and identical for 2017, notwithstanding differences across the variables used within the framework. The identifiable differences which exert a material impact on the necessary calculations are outlined in Table 13.

Table 13: Factors contributing to the differences in the modified expenditure aggregate

Differences in the Government expenditure aggregate	The COM's estimate for total expenditure in 2016 is €13.6 million lower than the MFIN's estimate but €8.8 million higher for 2017.
Differences in the interest expenditure	The COM's estimate for interest payments is €0.3 million and €2.3 million higher than the MFIN's estimate respectively for 2016 and 2017.
Differences in EU-funded expenditure	The COM is estimating higher absorption of EU funds.
Differences in investment expenditure	The COM's forecast for investment is €26.9 million below the four year average both for 2016 and for 2017. On the other hand, the MFIN is forecasting investment to be €12.5 million above average for 2016 and €8.8 million above average for 2017.
Differences in cyclical unemployment expenditure	Both the COM and the MFIN are estimating negligible spending on cyclical unemployment
Differences in discretionary revenue measures	Both the COM's and the MFIN's estimates for discretionary revenues are similar.

Source: MFAC

On balance, it appears that the main differences between the COM's and the MFIN's estimates relate to the total expenditure aggregate for the year, as well as to the amount of investment expenditure. The two effects are however working in the opposite direction, since higher total expenditure pushes the modified expenditure upwards but the interplay of investment expenditure below average pushes the modified expenditure downwards. This explains why the estimates for the modified expenditure by the COM and the MFIN are similar, notwithstanding the different projections.

According to the MFIN's and the COM's estimates, the expenditure benchmark is expected to be met in 2016, as the adjusted expenditure growth (of 0.5% and 0.7% respectively) is below the reference rate. On the other hand, the expenditure benchmark may be exceeded in 2017 according to the estimates of both the COM and the MFIN, as reworked by the COM. The MFAC acknowledges that the expenditure benchmark requirement is only referred to indirectly by the FRA in case where ex-post the deviation is deemed to be 'significant', that is when the deviation is of at least 0.5% of GDP over one year or cumulatively over two consecutive years. The Commission's assessment does not point to any deviation in 2016 and also does not indicate a risk of a 'significant deviation' in 2017.

6. Conclusion

The MFAC notes the progress in public finances achieved over recent years and acknowledges that the budgetary plan broadly complies with the requirements of the FRA and the SGP (see Table 14). The MFAC shares the COM's overall assessment of 'broad compliance' with respect to the requirements of the SGP. In particular, the fact that the debt-to-GDP ratio has fallen rapidly in recent years has facilitated the meeting of this criterion over the forecast horizon.

Table 14: Compliance with the fiscal rules (per cent of GDP)

	2016			2017		
	Benchmark	**DBP**	**COM**	**Benchmark**	**DBP**	**COM**
Gross debt ratio	66.9	**63.3**	**62.1**	65.8	**61.9**	**59.9**
Change in structural balance	0.6	**1.2**	**1.1**	0.6	**0.8**	**0.4**
Expenditure benchmark	1.3	**0.5**	**0.7**	1.8	**2.2**	**2.2**

Note: Green cells indicate full compliance and yellow cells indicate deviation which is less than the threshold for significant deviation (amounting to 0.5% of GDP).
Source: COM, MFIN

At the same time, the MFAC notes that the large structural effort planned to be undertaken in 2016 is expected to compensate for the limited structural effort which had been undertaken in the previous two years. On the other hand, the MFAC acknowledges that the treatment of EU Presidency costs may be a borderline case which is impacting the structural effort envisaged for 2017. To this effect, the MFIN is invited to explore whether fine-tuning of expenditure plans for 2017 could be possible so as to at least aim towards the annual 0.6 percent of GDP requirement in the improvement of the structural balance, if one were to exclude the effect of the costs relating to the EU Presidency from the calculations.

Likewise, while noting that in 2016, expenditure dynamics are on track to satisfy the expenditure benchmark, for 2017 this is expected to be exceeded slightly. Full compliance with the SGP requires that expenditure growth be closely monitored and actions are taken to keep expenditure growth under check.

The MFAC re-iterates the importance that fiscal rules be respected at all times. It is also important that corrective action be taken whenever new information suggests that there could be risks to the compliance with such rules. At the same time it is important that compliance with such rules is done in a way which does not limit the efficacy and the meeting of fiscal policy objectives. In this respect it is important that the sustainability of public finances is maintained, while safeguarding the high value added expenditure which contributes to the regular functioning of public services, while sustaining economic efficiency and economy-wide productivity.

Appendix: Fiscal Rules

i) The debt criterion

Extract from the Vade Mecum on the Stability and Growth Pact (2016 edition) published by the COM

A Member State is non-compliant with the debt requirement if its general government debt is greater than 60% of GDP and is not sufficiently diminishing and approaching 60% of GDP at a satisfactory pace. The concept of “sufficiently diminishing” and the “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”.

Article 9 of the FRA

When the ratio of general government debt to gross domestic product at market prices exceeds 60 per cent, the ratio shall be reduced in accordance with the 1997 Excessive Deficit Regulation until the ratio reaches 60 per cent.

ii) The structural adjustment rule

Extract from the Vade Mecum on the Stability and Growth Pact (2016 edition) published by the COM

In normal times, interpreted as an output gap between -1.5% and +1.5% of potential GDP, all Member States with a debt-to-GDP ratio below 60% would be required to make an effort of 0.5% of GDP, whereas the Member States with debt levels above 60% would need to make an adjustment greater than 0.5% of GDP. This is conventionally understood to be 0.6% of GDP at least. In bad times, interpreted as an output gap between -3% and -1.5% of potential GDP, the required adjustment would be lower. All EU Member States with the debt-to-GDP ratio below 60% would be required to ensure a budgetary effort of 0.25% of GDP when their economies grow above potential, and a fiscal adjustment of zero would be temporarily allowed when their economies grow below the potential. In the same cyclical conditions, these requirements become 0.5% of GDP and 0.25% of GDP respectively for Member States with debt levels above 60%. In very bad times, interpreted as an output gap between -4% and -3% of potential GDP, all Member States with the debt-to-GDP ratio below 60% would be temporarily allowed zero adjustment, meaning that no fiscal effort would be required, whereas Member States with debt-ratios exceeding 60% would need to provide an annual adjustment of 0.25% of GDP. In exceptionally bad times, interpreted as an output gap below 4% of potential GDP or when real GDP contracts, all Member States, irrespective of their debt levels, would be temporarily exempted from making any fiscal effort.

Article 8 sub-article 4(a) of the FRA

The annual structural balance of the general government is converging towards the medium-term budgetary objective in line with the timeframe set in accordance with the 1997 Surveillance and Coordination Regulation

iii) The expenditure benchmark

Extract from the Vade Mecum on the Stability and Growth Pact (2016 edition) published by the COM

For Member States that have not attained their MTO: Annual expenditure growth should not exceed a specific lower rate, which is set below the reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures. The difference between the appropriate growth rate for net expenditure and the reference medium-term rate of potential GDP growth is referred to as the convergence margin and is set so as to ensure the appropriate adjustment towards the MTO (i.e. in line with the required change in the structural balance). As a default the convergence margin is calculated to be consistent with a tightening of the structural balance of 0.5% of GDP. In cases where a higher or lower tightening of the structural balance is required, the convergence margin is recalibrated to reflect the tighter or looser adjustment path. Any discretionary reductions of government revenue items must be matched by either expenditure reductions or by discretionary increases in other revenue items or both. In addition, whether at the MTO or not, excess expenditure growth over the medium-term reference is not counted as a breach of the benchmark if it is fully offset by revenue increases mandated by law.

Article 11(1) of the FRA

If the European Commission addresses a warning to the Malta under Article 6(2) of the 1997 Surveillance and Coordination Regulation or if the Government considers that there is a failure to comply with the budgetary rule which constitutes a significant deviation for the purposes of Article 6(3) of that Regulation, the Government shall, within two months, prepare and lay before House of Representatives a plan specifying what is required to be done for securing compliance with the budgetary rule.[13]

[13] Note: Article 6 (2) refers to the identification of significant divergence of the budgetary position from the MTO or the adjustment path towards it, while Article 6 (3) refers to the circumstance when such divergence is persisting or worsening.

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