EUROPEAN
COMMISSION

Brussels, 16.11.2015
SWD(2015) 609

COMMISSION STAFF WORKING DOCUMENT

Analysis of the 2016 Draft Budgetary Plan of MALTA

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of MALTA

Analysis of the 2016 Draft Budgetary Plan of MALTA

1. INTRODUCTION

Malta has submitted its Draft Budgetary Plan (DBP) for 2016 on 15 October 2015 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Malta is subject to the preventive arm of the Pact and should achieve a fiscal adjustment of 0.6 % of GDP towards the medium-term budgetary objective (MTO) in 2015 and 2016. As the general government gross debt ratio was 68.3% of GDP in 2014 Malta also needs to comply with the debt reduction benchmark.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission forecast. The following section presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission 2015 autumn forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2015-2016 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact (SGP). Section 5 provides an analysis of implementation of reforms in the area of fiscal governance in response to the latest Country-specific Recommendations (CSRs) adopted by the Council on 14 July 2015, including those to reduce the tax wedge. Section 6 concludes.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underlying the DBP assumes an acceleration in real GDP growth from 3.5% in 2014 to 4.2% in 2015 reflecting buoyant domestic demand, which is partially offset by lower net exports due to the high import content of some domestic demand components, in particular equipment investment. GDP growth is projected to decelerate to 3.6% in 2016 as investment declines from a high base, which is partially offset by a rebound in net exports. Employment growth is set to decline from 4.5% in 2014 to 2.0% in 2015-16. However the unemployment rate is seen to continue gradually decreasing.

The real GDP growth projections underlying the DBP have been revised upwards compared to the projected 3.4% in 2015 and 3.1% in 2016 in the 2015 Stability Programme, due to a more favourable outlook for net exports, partly offset by a significant downward revision for investment in 2016. The growth projections for both 2015 and 2016 are fully in line with Commission forecast. HICP inflation is seen to accelerate gradually from 0.8% in 2014 to 1.8% in 2016, in line with the projections underlying the 2015 Stability Programme and with the Commission's views.

Assessed against currently available information, the DBP's macroeconomic scenario appears plausible for 2015 and 2016. Upside risks to these projections could come from higher investment related to the materialisation of additional infrastructure projects, while downside risks are linked to the uncertain external environment and its potential impact on external trade developments.

Box 1: The macro economic forecast underpinning the budget in Malta

The macroeconomic projections underlying the DBP have been endorsed by the Malta Fiscal Advisory Council (MFAC), an independent fiscal council established in accordance with the Fiscal Responsibility Act. The endorsement took the form of a letter addressed to the Minister of Finance and a report, published on the MFAC's website. The MFAC found the macroeconomic scenario for 2015 and 2016 plausible, albeit subject to downside risks related to external trade developments in 2016. The endorsement of the fiscal targets in the DBP was not finalised before the cut-off date for this document.

The Malta Fiscal Advisory Council is an independent body established in January 2015. The mandate of the MFAC includes endorsing the macroeconomic and fiscal projections of the government, assessing fiscal performance and assessing compliance of the fiscal stance with respect to the Fiscal Responsibility Act and the SGP. Existing legislation, however, does not lay down deadlines for action to the MFAC. Government is obliged to consider the MFAC's opinion and if it does not accept it, the Minister of Finance is to lay the reasons for not accepting it before parliament within two months of receiving the opinion.

Table 1. Comparison of macroeconomic developments and forecasts

	2014	2015			2016		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	3.5	3.4	4.2	4.3	3.1	3.6	3.6
Private consumption (% change)	2.9	3.4	3.5	3.2	2.7	2.9	2.9
Gross fixed capital formation (% change)	9.1	23.6	21.4	17.1	13.1	-8.0	-1.0
Exports of goods and services (% change)	-0.3	2.8	0.0	-1.1	2.4	3.9	3.9
Imports of goods and services (% change)	0.6	5.0	1.4	-0.3	3.5	1.7	3.0
Contributions to real GDP growth:							
- Final domestic demand	4.7	6.3	6.1	5.4	4.6	0.3	2.1
- Change in inventories	0.1	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-1.3	-2.9	-1.9	-1.1	-1.6	3.3	1.5
Output gap[1]	-0.1	0.6	0.6	0.6	0.0	1.1	0.8
Employment (% change)	4.5	2.0	1.9	2.4	1.8	2.0	2.0
Unemployment rate (%)	5.9	5.8	5.8	5.8	5.7	5.6	5.7
Labour productivity (% change)	-1.0	1.8	2.3	1.8	1.5	1.6	1.6
HICP inflation (%)	0.8	1.0	1.0	1.1	1.8	1.8	1.8
GDP deflator (% change)	1.8	1.3	2.3	2.3	2.1	2.5	2.5
Comp. of employees (per head, % change)	0.3	3.1	2.7	2.4	3.7	3.2	2.9
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	5.0	2.2	3.0	3.6	-0.7	8.7	5.3

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The DBP confirms the 2015 deficit target of 1.6% of GDP set in the 2015 Stability Programme, despite a higher GDP growth in the macroeconomic scenario underpinning the DBP.

The nominal GDP has been revised up substantially in the DBP due to higher growth registered in the first half of the year. In nominal terms, both total revenue and expenditure have been revised up significantly, with the increase spread all over the items. On current expenditure, the increase is particularly substantial for compensation of employees and intermediate consumption, while subsidies and social transfers have been revised downwards. The increase in public wages follows the growth in employment in the public sector due to higher recruitments mainly in the health and the education sectors. On the revenue side, direct taxes have been revised upwards due to the positive performance of the labour market. In addition, higher expected proceeds related to the citizenship programme (from 0.6% of GDP in the 2015 Stability Programme to 0.9% of GDP in the DBP) have contributed to the upward revision of current taxes. In addition, the 0.1% of GDP contingency reserve included in the Stability Programme is expected to be spent in 2015. Overall, both revenue and expenditure are expected to contribute to deficit reduction in 2015.

The Commission 2015 autumn forecast projects the 2015 deficit at 1.7% of GDP. The 0.1 pp. of GDP difference with the authorities' target is explained by higher current expenditure, especially compensation of employees and intermediate consumption, although partly compensated by lower net capital expenditure. In line with the positive performance in the first nine month of the year and past experience, the Commission projects higher current revenue (despite a comparable projection regarding the citizenship programme) compared to the conservative forecast included in the DBP (especially for income taxes) matched by a more dynamic growth rate of current expenditure, which seems to be overly cautious in the DBP.

For 2016, the DBP targets a further reduction of the deficit to 1.1% of GDP, with the primary surplus reaching 1.3% of GDP. Compared to the 2015 Stability Programme, the target is unchanged, and the consolidation remains mainly expenditure-based. Indeed, in nominal terms, upward revisions to current expenditure (mainly compensation of employees and intermediate consumption) and net capital expenditure have been offset by higher current revenues, including the upward revision in the expected proceeds coming from the citizenship programme (at 0.9% of GDP compared to the previous estimate of 0.4% of GDP). The revision is also explained by the measures included in the 2016 Budget, presented on 12 October, which has a slightly expansionary impact (0.1 % of GDP). As a result of the favourable macroeconomic environment, the headline balance remains unchanged in 2016 compared to the 2015 Stability Programme. Current revenues (in nominal terms) are projected to increase by 5.4% (less than nominal GDP growth) thus decreasing as a share of GDP (by 0.3 pp. of GDP). Current expenditure is projected to increase at 3.5% while net capital expenditure is expected to increase substantially. In particular, despite the phasing out of the capital injection into Air Malta (which in 2015 amounted to 0.5 pp. of GDP), net capital expenditure would increase by 0.3 pp. of GDP due to a lower absorption of EU funds and a higher reliance on national funds. It should also be noted that the current expenditure projection for 2016 includes a contingency reserve of 0.1% of GDP (in line with the Fiscal Responsibility Act) that should be activated in case of unforeseen expenditure or revenue slippages in order to ensure compliance with fiscal rules (while, if unused, it will tranlate in additional savings).

The Commission 2015 autumn forecast projects the 2016 deficit at 1.2% of GDP. The 0.1 pp. of GDP difference with the authorities' target is due to the higher base in 2015. In addition, the Commission forecast includes a different composition of revenue and expenditure. Namely, the Commission envisages more dynamic current expenditure and a lower expenditure on public investment.

Risks to the deficit targets are mainly linked to the state owned enterprises, namely Enemalta and Air Malta, which could lead to additional subsidies. There is also a risk of slippages in the public sector wage bill and in intermediate consumption in case of higher than expected use of consultancies in the public sector. On the other hand, in line with past experience, net capital expenditure could be lower than planned if it continues to be used to compensate for slippages in budgetary execution. Finally, current revenue could turn out more buoyant than expected due to a more favourable economic environment and higher proceeds coming from the citizenship programme.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2014	2015			2016			Change: 2014-2016
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**41.9**	**42.6**	*42.2*	**42.3**	**40.6**	*40.1*	**40.4**	**-1.8**
of which:								
- Taxes on production and imports	13.8	13.9	*13.7*	13.8	13.7	*13.8*	13.9	0.0
- Current taxes on income, wealth, etc.	14.5	14.1	*14.1*	14.3	14.0	*14.1*	14.4	-0.4
- Capital taxes	0.1	0.2	*0.2*	0.1	0.2	*0.1*	0.1	0.0
- Social contributions	7.1	7.1	*7.0*	6.9	7.0	*6.9*	6.8	-0.2
- Other (residual)	6.3	7.3	*7.2*	7.0	5.7	*5.2*	5.1	-1.1
Expenditure	**44.0**	**44.2**	**43.8**	**44.0**	**41.7**	**41.2**	**41.6**	**-2.8**
of which:								
- Primary expenditure	41.1	41.5	41.2	41.3	39.1	38.8	39.2	-2.3
of which:								
Compensation of employees	13.3	13.0	13.1	13.3	12.8	13.0	13.3	-0.3
Intermediate consumption	6.6	6.8	6.8	6.8	6.5	6.5	6.8	-0.1
Social payments	12.6	12.5	12.3	12.3	12.1	11.9	12.1	-0.7
Subsidies	1.3	1.5	1.3	1.4	1.4	1.2	1.3	-0.1
Gross fixed capital formation	3.8	4.1	4.3	3.9	3.2	3.2	2.6	-0.6
Other (residual)	3.5	3.6	3.4	3.6	3.1	3.0	3.1	-0.5
- Interest expenditure	2.9	2.7	2.6	2.7	2.6	2.4	2.4	-0.5
General government balance (GGB)	**-2.1**	**-1.6**	**-1.6**	**-1.7**	**-1.1**	**-1.1**	**-1.2**	**1.0**
Primary balance	**0.8**	**1.1**	**1.1**	**1.0**	**1.5**	**1.3**	**1.2**	**0.5**
One-off and other temporary measures	0.3	0.1	0.2	0.1	0.1	0.1	0.1	-0.2
GGB excl. one-offs	**-2.4**	**-1.7**	**-1.8**	**-1.8**	**-1.1**	**-1.2**	**-1.3**	**1.3**
Output gap[1]	-0.1	0.6	0.6	0.6	0.0	1.1	0.8	1.1
Cyclically-adjusted balance[1]	-2.1	-1.9	-1.9	-2.0	-1.1	-1.6	-1.6	0.5
Structural balance (SB)[2]	**-2.4**	**-2.0**	**-2.1**	**-2.1**	**-1.1**	**-1.7**	**-1.7**	**0.8**
Structural primary balance[2]	0.5	0.7	0.5	0.6	1.4	0.7	0.8	0.3

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

In structural terms[1], the government plans imply an improvement in the balance in both years, amounting to ¼ pp. of GDP in 2015 and ½ pp. of GDP in 2016, in line with the improvement expected on the basis of the Commission Forecast. However, the improvement in the

[1] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the DBP, using the commonly agreed methodology.

structural effort expected in 2016 is much lower compared to what was expected in the 2015 Stability Programme due to a substantial upward revision in the output gap.

Box 2: Impact of the current low interest rate environment on compliance with the SGP

Identifying an interest rate windfall/shortfall for 2016

Sovereign bond yields have fallen sharply since end-2013 and reached historical lows in the first half of 2015, before increasing somewhat during the summer months. However, yields in Malta remain well below their long-term average of 5%, with 10-year rates standing at 1.6%. As a result of lower interest rates, total interest payments by the general government have also decreased over the last few years. Interest expenditure in Malta is expected to fall from 3.0% of GDP in 2012 to 2.6% in 2015, and is projected to decrease further next year, to 2.4% of GDP in 2016, based on the information provided in the DBP.

Interest expenditure in the DBP entails an implicit debt-servicing cost of 2.7% in nominal terms in 2015 and 2.6% in 2016 (from 2.9% in 2014). The Commission forecast projects a similar level of interest expenditure.

Prospects and vulnerability

Over the 2016-18 period, around 22% of the Maltese outstanding government bond debt is due to be refinanced. On average, the share of outstanding debt to be renewed in that period is lower compared to what is expected to be renewed in 2015. This offers scope for potential interest savings in case of bond rollovers at lower yields.

In the past, spreads on Maltese sovereign bonds have not been significantly affected by the tensions generated by the sovereign-debt crisis. The maturity structure of government debt has been significantly lengthened since Malta's accession to the EU, with an increase in the proportion of debt with long-term maturity and a reduction in the short-term debt. This is expected to further reduce the impact of fluctuations in the interest rate on government in case of changes in market sentiment. In addition, government debt is almost entirely held by residents, with non-residents accounting for just 3% of the outstanding debt stock. This has further protected sovereign debt against the tensions on international markets.

Consequences for public finances

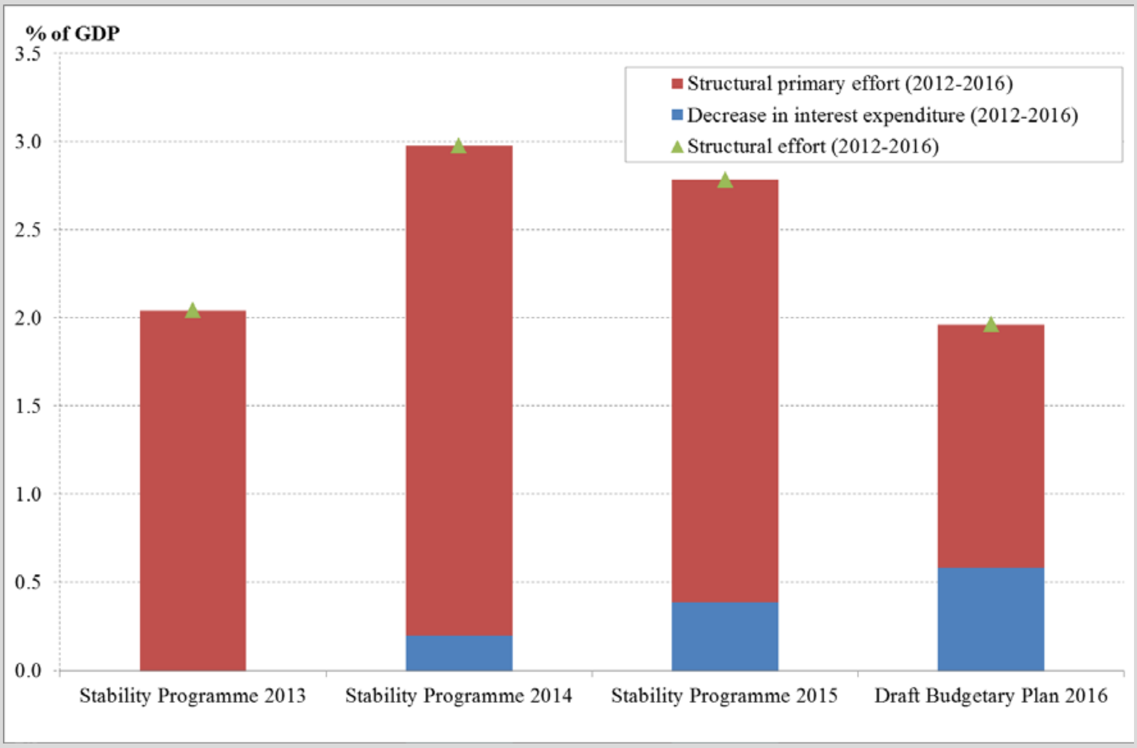
Comparing the interest expenditure projections across different vintages of Stability and Convergence Programmes and the DBP sheds more light on the (unexpected) interest windfall since the fall in interest rates (see Chart)[2].

The planned improvement in the headline and in the structural balance in 2012-16 did not change between the 2013 Stability Programme and the latest DBP. The contribution of interest rate expenditure to the structural effort has been increasingly positive since the 2014 Stability Programme. Using data from the 2016 DBP, interest rate savings are estimated to contribute 0.6% of GDP to the overall planned structural effort over 2012-16. The decline in interest expenditure was generally offset by a decline in structural primary effort, or in other words the interest windfalls have been used to reduce the primary fiscal effort, rather than to accelerate the fiscal adjustment. However, the unexpected interest windfall is less than what would be suggested by the change in the sovereign bond yields as the maturity structure of government debt was lengthened during this period.

[2] Note that, while it is likely that revisions in the interest expenditure projections across different vintages primarily reflect changes in interest rates, other factors such as debt dynamics, the maturity profile of debt and statistical reclassifications (e.g. the switchover to the ESA 2010 standard of national accounts) may also have played a role.

It should also be taken into account that around half of this windfall results from higher nominal GDP projections, affected also by a level shift due to the transition to ESA 2010. As a result, the projection for the level of nominal GDP in 2016 is over 13% higher in the DBP compared to the 2013 Stability Programme. Moreover, the recalculated output gap for 2016 according to the DBP is 1.1%, i.e. 0.5pp higher than according to the 2013 Stability Programme.

Structural effort and decrease in interest expenditures between 2012 and 2016 based on government plans



Source: Stability programmes, Draft Budgetary Plan 2016 and AMECO

3.2. Debt developments

The general government debt-to-GDP ratio declined from the peak of 69.6% of GDP in 2013 to 68.3% of GDP in 2014 also on account of the reduction of the stock-flow adjustment related to tax arrears from Enemalta (the public energy utility corporation). In the DBP, the general government gross debt ratio is expected to decrease to 66.6% of GDP in 2015. It is then expected to decrease further by 1.4 pps. of GDP in 2016, reaching 65.2% of GDP.

Despite the expected repayment in 2015 of some tax arrears (by around 0.4% of GDP) from Enemalta, the stock-flow adjustment is projected to be sizeable over the two years 2015-2016 due to a high cash buffer. It is also expected to increase in 2016 due to the contribution to the Malta Government Stock sinking fund. Despite this, the projected increasing primary surplus, the acceleration of inflation and the positive (even if moderating) impact of real growth as well as the planned decrease in interest expenditure are sufficient to keep the debt ratio on a declining path.

According to the Commission forecast, the debt ratio is projected to reach 65.9% of GDP in 2015 and to decrease further in 2016 to 63.2% of GDP. The difference compared to the DBP targets, is mainly explained by the lower stock-flow adjustment in the Commission forecast.

The Commission also forecasts a slightly lower primary surplus and a lower impact of inflation on the debt-to-GDP ratio.

The same risks highlighted for the deficit targets apply to the debt projections of the DBP. Moreover, despite a decrease in 2013 (to 15.9% of GDP from 16.5% of GDP in 2012), the government-guaranteed debt in Malta has increased again in 2014 to 16.8% of GDP and remains high compared to other Member States.

Table 3. Debt developments

(% of GDP)	2014	2015			2016		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**68.3**	**66.8**	**66.6**	**65.9**	**65.6**	**65.2**	**63.2**
Change in the ratio	-1.4	-1.5	-1.7	-2.4	-1.2	-1.4	-2.7
Contributions[2] *:*							
1. Primary balance	**-0.8**	**-1.1**	**-1.1**	**-1.0**	**-1.5**	**-1.3**	**-1.2**
2. "Snow-ball" effect	**-0.6**	**-0.4**	**-1.4**	**-1.5**	**-0.7**	**-1.4**	**-1.4**
Of which:							
Interest expenditure	2.9	2.7	2.7	2.7	2.6	2.4	2.4
Growth effect	-2.3	-2.2	-2.7	-2.7	-2.0	-2.3	-2.2
Inflation effect	-1.2	-0.8	-1.4	-1.4	-1.3	-1.6	-1.6
3. Stock-flow adjustment	**0.1**	**0.0**	**0.9**	**0.2**	**1.1**	**1.4**	**0.0**

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the Draft Budgetary Plan

The Maltese authorities presented the 2016 budget to Parliament on 12 October 2015. The government's 2016 budget includes some revenue-increasing measures, such as increases in indirect taxation and the introduction of an environmental contribution to be paid by tourists, partly compensated by the lowering in income tax for low income earners and the phasing out of the eco contribution (which will be substituted by excise taxes by 1st September 2016), with a net impact on revenues of about 0.1% of GDP. On the expenditure side, the budget envisages several deficit-increasing social measures for 0.2% of GDP, among which, the upward adjustment of the minimum contributory pension and the partial funding of the cost of home care for elderly and an expropriation compensation (to address property locked in inheritance disputes). Overall, the budget measures are estimated to have a net deficit-increasing impact amounting to 0.1% of GDP.

Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2015	**2016**
Taxes on production and imports	0.3	0.2
Current taxes on income, wealth, etc.	-0.5	-0.1
Capital taxes		
Social contributions	0.1	0.0
Property Income		
Other	0.8	0.0
Total	0.7	0.1

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2016

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2015	**2016**
Compensation of employees		
Intermediate consumption		
Social payments	-0.3	0.1
Interest Expenditure		
Subsidies	0	0.0
Gross fixed capital formation		
Capital transfers	-0.3	0.5
Other		
Total	-0.6	0.6

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2016

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Malta is subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO. Box 2 reports the latest country specific recommendations in the area of public finances.

Box 3. Council recommendations addressed to Malta

On 14 July 2015, the Council addressed recommendations to Malta in the context of the European Semester. In particular, in the area of public finances the Council recommended to Malta to, following correction of the excessive deficit, achieve a fiscal adjustment of 0.6 % of GDP towards the MTO in 2015 and 2016.

4.1. Compliance with the debt criterion

As the debt ratio was 68.3% of GDP in 2014, Malta needs to comply with the debt reduction benchmark.

The DBP does not include sufficient information to assess compliance with the debt rule. Based on the 2015 autumn forecast, the debt rule is expected to be met in the period 2015-2016, with an average margin of 4 pps.

Table 5. Compliance with the debt criterion*

	2015			2016		
	SP	**DBP**	**COM**	**SP**	**DBP**	**COM**
Gross debt ratio	66.8	66.6	65.9	65.6	65.2	63.2
Gap to the debt benchmark [1,2]	-2.3	n.a.	-4.2	-3.9	n.a.	-3.9

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

* An ex-ante assessment of planned compliance with the debt criterion can be based on the DBP only for the concerned countries providing extended data series (i.e. covering years up to t+4) in the DPB on a voluntary basis, as agreed at the EFC-A on 22 September 2014 and reflected in the updated Code of Conduct of the two-pack..

4.2. Adjustment towards the MTO

According to the DBP, in 2015, the annual change in the (recalculated) structural balance of 0.3% of GDP is below the required adjustment, pointing to a risk of some deviation from the required 0.6% of GDP adjustment towards the MTO, while the growth rate of government expenditure, net of discretionary revenue measures, is in line with the applicable expenditure benchmark rate. Therefore, an overall assessment needs to be carried out. On the one hand, the medium-term reference rate of potential growth underpinning the expenditure benchmark does not fully reflect the recent improvement in the macroeconomic economic outlook, leading to an underestimation of the allowed expenditure growth. In particular, the annual potential GDP growth rate used in the computation of the structural balance (3.6%) is significantly higher than the medium term rate (1.8%) used in the calculation of the expenditure benchmark (frozen based on Commission 2013 winter forecast, while the macroeconomic outlook in Malta turned out much better than expected at that time). On the other hand, subdued growth rates of public current expenditure in the national plans would lead to overestimate the fiscal effort based on the expenditure benchmark. Thus, the structural balance is a better indicator of the underlying budgetary position. Therefore, the overall assessment points to some deviation from the adjustment path towards the MTO in 2015 based on the DBP.

Based on the Commission 2015 autumn forecast, in 2015 the projected 0.3% of GDP improvement in the structural balance would lead to some deviation from the required 0.6% of GDP adjustment towards the MTO. The growth rate of government expenditure net of discretionary revenue measures is expected to exceed the benchmark by 0.9% of GDP in 2015, thereby breaching the threshold for significance pointing to a significant deviation as a result of more dynamic current expenditure in the Commission forecast compared to the Draft Budgetary Plan .As mentioned above, the structural balance pillar is found to be based on a more appropriate estimate of potential growth. In addition, one-off transactions have had a negative impact on the expenditure benchmark (partly due to the higher-than-expected revenues in 2014 coming from the Investment Registration Scheme). Considering these factors, the structural balance seems to be a better indicator of the fiscal effort. Therefore, the overall assessment points to a risk of some deviation from the adjustment path towards the MTO in 2015 based on the Commission Forecast.

In 2016, based on the DBP, the projected 0.4% of GDP improvement in the structural balance would lead to some deviation from the required 0.6% of GDP adjustment towards the MTO. In addition, the growth rate of government expenditure net of discretionary revenue measures is expected to exceed the benchmark by 1.3% of GDP in 2016, thereby breaching the threshold for significance. As in 2015, the structural balance is based on a more appropriate estimate of potential growth (3.4% and 2.7% in the computation of the structural balance and the expenditure benchmark respectively). However, the main reason for the difference between the structural balance and the expenditure benchmark pillar is related to the projected (significant drop in EU-funded investments, which negatively impacts the assessment based on the expenditure benchmark by overestimating the net expenditure growth. Therefore, the structural balance seems to be a better indicator of the fiscal effort at the current juncture and the overall assessment points to a risk of some deviation from the adjustment path towards the MTO based on the government plans.

The Commission forecast for 2016 also points to a risk of some deviation from the required 0.6% of GDP adjustment towards the MTO since the structural balance is projected to improve by 0.4% of GDP. The growth rate of government expenditure net of discretionary revenue measures is expected to point to a risk of significant deviation as it is expected to exceed the benchmark by 1.5% of GDP. Therefore, an overall assessment needs to be carried out. The arguments used to explain the higher reliability of the structural balance pillar in the national plans for 2016 remain valid for the Commission forecast. The overall assessment points to a risk of some deviation from the adjustment path towards the MTO based on both the government plans and the Commission forecast in 2016.

Table 6: Compliance with the requirements of the preventive arm

(% of GDP)	2015		2016	
Initial position[1]				
Medium-term objective (MTO)	0.0		0.0	
Structural balance[2] (COM)	-2.1		-1.7	
Structural balance based on freezing (COM)	-2.1		-	
Position vis-a -vis the MTO[3]	Not at MTO		Not at MTO	
(% of GDP)	**2015**		**2016**	
	DBP	**COM**	**DBP**	**COM**
Structural balance pillar				
Required adjustment[4]	0.6		0.6	
Required adjustment corrected[5]	0.6		0.6	
Change in structural balance[6]	0.3	0.3	0.4	0.4
One-year deviation from the required adjustment [7]	-0.3	-0.3	-0.2	-0.2
Two-year average deviation from the required adjustment [7]	n.a. in EDP in 2014		-0.2	-0.2
Expenditure benchmark pillar				
Applicable reference rate[8]	0.3		1.3	
One-year deviation [9]	0.0	-0.9	-1.2	-1.5
Two-year average deviation [9]	n.a. in EDP in 2014		-0.6	-1.2
Conclusion				
Conclusion over one year	Overall assessment	Overall assessment	Overall assessment	Overall assessment
Conclusion over two years	n.a. in EDP in 2014		Overall assessment	Overall assessment

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 27.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2014) was carried out on the basis of Commission 2015 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations.

Following an overall assessment of the DBP of Malta, the planned structural adjustment points to some deviation from the required adjustment path towards the MTO in both 2015 and 2016. The risk of some deviation from the adjustment path towards the MTO is confirmed following an overall assessment based on Commission 2015 autumn forecast both in 2015 and 2016.

5. IMPLEMENTATION OF REFORMS IN THE AREA OF FISCAL GOVERNANCE

The DBP includes information on progress made in addressing the CSRs related to fiscal governance.

As concerns the recommendation to continue the ongoing pension reform, so far no concrete measures to ensure the sustainability of the pension system have been put in place. In particular, no proposals have yet been discussed by the government to accelerate the increase in the statutory retirement age and consequently linking it to changes in life expectancy. At the same time, last June the Pensions Strategy Group (which was set up by the Ministry for the Family and Social Solidarity and the Ministry of Finance in June 2013 and tasked to submit recommendations with regard to the strengthening of the pension system) published 27 recommendations on the way forward to reform the pension system. Those recommendations were subject to public consultation and the 2016 budget introduced some measures that seem to address some of the recommendations published by the Pensions Strategy Group, although their impact on long-term sustainability remains to be assessed.

The DBP also reports on the latest progress concerning the operationalization of the Malta Advisory Fiscal Council.

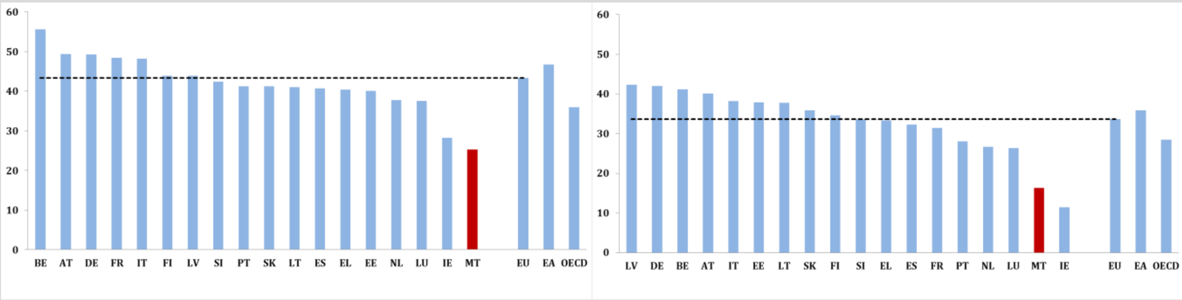
A comprehensive assessment of progress made with the implementation of the CSRs will be made in the 2016 Country Reports and in the context of the CSRs adopted by the Commission in May.

Box 4: Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to screen euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability. Furthermore, the Eurogroup expressed its intention to take stock of the state of play in the reduction of the tax burden on labour when discussing the DBPs of euro area Member States.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker’s net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Malta for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Malta at the average wage and a low wage (2014)



Notes: Data for Latvia, Lithuania and Malta is for 2013. No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

This screening is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

Malta's DBP contains one measure that affect the tax wedge on labour, the lowering in income tax for low income earners. In particular, no income tax will be paid by employees who annually earn less than €9,100 or €10,500, respectively and couples that earn less than €12,700; lower income tax will be paid by those with an income below €19,500, €28,700 and €21,200. This measure is fully financed by the revision in excise duties on several products.

This measure follows a number of reforms introduced in the previous years, such as the introduction of a separate tax regime for parents which had benefitted primarily those on low to middle incomes. In addition, the 2013 budget introduced a tax reform aimed at gradually reducing the overall income tax levels. Namely, the 2013 budget established that the highest income tax rate of 35% would only start to apply on those earning more than €60,000, and introduced a new transitory tax bracket on income up to €60,000 per annum, the tax on which was gradually reduced over the following three years from 32% to 29% to 25% in 2015. Also the 2014 budget raised the minimum tax threshold by €500 for those opting for the parent-rate computation. These measures are part of the strategy of the Maltese authorities to continue the shift from direct to indirect taxation.

The Central Bank of Malta[3] has estimated the possible macroeconomic impact of the tax reduction introduced in 2013. The reform is estimated to have a positive effect on economic activity, with its impact on GDP peaking at 0.35% in 2016. Subsequently, the impact stabilises at 0.28% in the medium term, as the initial boost to consumption from disposable income is eroded by a decline in net exports due to higher domestic prices. Finally, both employment and investment are expected to grow significantly, with an improvement in the medium term of 0.33% and 0.49% respectively.

While there are no simulations available concerning the impact of the newly introduced measure, a positive macroeconomic impact can be expected based on the above mentioned simulation.

[3] *Quarterly Review*, 2015:2, Central Bank of Malta, pp. 41-47.

6. OVERALL CONCLUSION

According to the Commission 2015 autumn forecast, Malta is expected to comply with the debt rule in both 2015 and 2016.

Following an overall assessment of the DBP, the planned structural adjustment points to some deviation from the required adjustment path towards the MTO in both 2015 and 2016. The risk of some deviation from the adjustment path towards the MTO is confirmed following an overall assessment based on Commission 2015 autumn forecast both in 2015 and 2016.