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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of Malta

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Malta

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1. Introduction

Malta submitted its Draft Budgetary Plan (DBP) for 2018 on 16 October 2017 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Malta is subject to the preventive arm of the Pact and should preserve a sound fiscal position which ensures compliance with the medium term budgetary objective (MTO) of 0% of GDP.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission 2017 autumn 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 2017 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 2017-2018 (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 the composition of public finances on fiscal-structural issues in response to the latest country-specific recommendations adopted by the Council in the spring of 2017, including reducing the tax wedge. Section 6 summarises the main conclusions of the present document.

2. Macroeconomic developments underlying the draft budgetary plan

The macroeconomic scenario underlying the DBP forecasts real GDP growth to pick up in 2017 to 5.9%, from 5.5% in 2016. More dynamic economic activity in 2017 reflects stronger household consumption and a lower import content of domestic demand, which have more than offset the contraction in investment and a slowdown in exports. Real GDP growth is forecast to moderate somewhat to 5.6% in 2018 as a recovery in imports offsets the projected rebound in investment. This scenario presents a significant upward revision of the projections underpinning the 2017 Stability Programme (SP), which projected a more moderate economic expansion in particular due to lower private consumption growth and stronger imports.

The labour market outlook is also more positive compared to the SP projections. The unemployment rate is forecast to be significantly lower, falling to 4.1% in 2017 and inching up to 4.2% in 2018. At the same time, employment growth is projected to be significantly higher, reaching 4% in 2017 and 3.8% in 2018. Wage growth is projected to moderate with respect to 2016, contrary to SP projections. HICP inflation is expected to rise gradually to 1.3% in 2017 and further to 1.5% in 2018. That inflation path has been revised down compared to the projections in the latest SP.

Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	5.5	4.3	5.9	5.6	3.7	5.6	4.9
Private consumption (% change)	3.0	3.6	4.2	4.2	3.1	4.1	4.1
Gross fixed capital formation (% change)	-0.4	-1.3	-12.1	-11.5	-3.1	7.8	5.6
Exports of goods and services (% change)	3.5	3.4	2.2	3.0	4.4	2.5	3.6
Imports of goods and services (% change)	0.8	3.2	-2.2	-0.8	2.7	1.7	4.0
Contributions to real GDP growth:							
- Final domestic demand	1.0	3.7	0.0	0.5	0.9	4.2	4.8
- Change in inventories	0.5	0.0	-0.1	0.0	0.0	0.0	0.0
- Net exports	4.0	0.6	6.0	5.2	2.8	1.4	0.1
Output gap[1]	1.0	0.9	0.8	1.1	0.3	0.5	0.8
Employment (% change)	3.7	3.2	4.0	4.7	2.9	3.8	3.0
Unemployment rate (%)	4.7	4.6	4.1	4.2	4.7	4.2	4.0
Labour productivity (% change)	1.8	1.1	1.9	0.9	0.8	1.8	1.8
HICP inflation (%)	0.9	1.5	1.3	1.3	1.8	1.5	1.5
GDP deflator (% change)	1.6	1.9	2.2	2.0	2.1	2.0	2.1
Comp. of employees (per head, % change)	2.7	3.6	2.0	2.0	3.6	2.6	3.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	7.8	7.3	13.6	10.3	9.8	15.9	10.1

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 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

The macroeconomic scenario underlying the DBP is more favourable than the Commission 2017 autumn forecast. The real GDP growth projections are higher in 2017 and particularly so in 2018. The main differences between the two scenarios are driven by net exports, which according to the authorities are expected to have a stronger positive contribution to growth. As a result, volatility in Malta's main export markets could pose a risk to the DBP's underlying macroeconomic scenario. Nevertheless, the (recalculated) output gap in 2018 declines at the same pace as in the Commission forecast.

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 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.[1] According to the MFAC, the DBP's macroeconomic scenario is plausible. The balance of risks is judged to be neutral, since

[1] Publication available on https://mfac.org.mt/en/publications/Pages/Publications.aspx

possible downside risks are offset by the level of prudence in the projections, given also the strong potential output estimates. The MFAC expressed satisfaction with its cooperation with the Ministry of Finance. Similar to its opinion on the 2017 DBP, the MFAC recommended further streamlining of the forecast process and invited the Ministry to finalise its projections earlier to allow appropriate time for assessment by the Council.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The headline balance projections included in the DBP constitute an improvement compared to the targets set in the SP. The DBP projects the surplus for 2017 at 0.8% of GDP, against a surplus of 0.5% of GDP targeted in the SP. Part of the difference is explained by the higher proceeds related to the Individual Investor Programme (IIP). In the DBP, the IIP is expected to reach 1.9% of GDP against an estimate of 1.0% of GDP in the SP. In addition, the stronger-than-expected growth, in particular stronger growth in corporate profits and in the labour market, is expected to contribute to a more buoyant projection for current taxes.

At the same time, however, compared to the SP, current expenditure is expected to be more dynamic, despite lower than projected expenditure related to the Maltese presidency of the Council of the EU in the first semester of 2017 and lower interest expenditure. Conversely, government investment net of EU funds is projected to be less dynamic, reflecting the lower than expected absorption of these funds. In addition, capital transfers have been revised upward by 0.3 percentage point, to incorporate the forthcoming Eurostat decision on the statistical recording of financial protection schemes (depositor, investor and insurance) and any claim thereof.

The Commission 2017 autumn forecast projects the 2017 government surplus at 0.9% of GDP, which is 0.1 percentage point higher than the authorities' target. The Commission projects lower nationally financed public investment (mainly the projects financed with the IIP revenue) which is partly offset by lower total current revenue and a more dynamic growth of current expenditure.

For 2018, the DBP targets a reduction of the surplus to 0.5% of GDP. Compared to the SP, the general government target remains unchanged. In nominal terms, upward revisions to current expenditure (mainly compensation of employees and intermediate consumption and social spending) and net capital expenditure (especially for nationally financed public investment) are offset by higher current revenues, including the upward revision in the expected proceeds coming from the IIP (at 1% of GDP compared to the previous estimate of 0.3% of GDP). The revision is also explained by both the more favourable macroeconomic scenario and the measures included in the 2018 budget, presented on 9 October, which have an expansionary impact of 0.3% of GDP.

According to the DBP, in 2018, current revenues (in nominal terms) are projected to increase by 3.8% (less than nominal GDP growth) thus decreasing as a share of GDP (by 1.4 percentage point) as a result of the expected reduction the proceeds linked compared to the previous year. Current expenditure is projected to decelerate, increasing at a rate of 4.7% and to decrease by 1.0 percentage point relative to GDP, thanks to decreasing interest expenditure and a deceleration in spending linked to public wages and intermediate consumption. It should also be noted that intermediate consumption increased in 2017 on the back of one-off spending related to the Maltese presidency of the Council of the EU for around 0.25% of GDP. Net capital expenditure is expected to increase marginally, by 0.2 percentage point, thanks also to an expected increase in the absorption of EU funds. The current expenditure projection for 2018 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 the fiscal rules (while, if unused, it will be translated into additional savings).

The Commission 2017 autumn forecast projects the 2018 government surplus at 0.5% of GDP, in line with the authorities' target. However, there are some differences in the composition. Higher current taxes, mainly income taxes following also a higher base in 2017, and lower spending for investment from national funds are expected to be offset by higher current expenditure (mainly compensation of employees).

Risks related to the fiscal targets appear balanced. Current expenditure could be higher due to implementation risks in view of possible slippages in the budgetary execution. On the other hand, given that a precise estimate of the expected revenue from the IIP has so far proven difficult to obtain, upside risks to the revenue projections exist.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Malta currently standing at 1.26[2]. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the DBP, interest expenditure in Malta is expected to fall from 2.2% of GDP in 2016 to 1.9% in 2017 and is projected to decrease further next year, to 1.7% of GDP, well below the 3.0% recorded back in 2012 at the peak of the euro area sovereign debt crisis. The picture stemming from Member States' plans is broadly confirmed by the Commission forecast.

In structural terms[3], the government plans imply a decrease in the surplus in both years, which is expected to reach 0.6% and 0.2% of GDP respectively in 2017 and 2018. Based on the Commission forecast, the trend in the structural balance is the same, but with a higher base of 0.1 percentage point in 2017.

Against the background of falling interest expenditure, the projected deterioration in the structural balance in 2017-18 (0.2 percentage point and 0.4 percentage point, respectively) is accompanied by a more pronounced deterioration in the structural primary balance (0.5 percentage point and 0.6 percentage point, respectively).

[2] 10-year bond yields, average in September 2017. Source: Eurostat.

[3] Cyclically adjusted balance net of one-off and temporary measures, as recalculated by the Commission using the commonly agreed methodology.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**39.2**	**38.5**	***38.9***	**39.0**	**38.3**	***37.8***	**38.1**	**-1.4**
of which:								
- Taxes on production and imports	12.8	12.6	*12.5*	12.6	12.3	*12.3*	12.3	-0.5
- Current taxes on income, wealth, etc.	13.9	14.2	*13.9*	14.1	14.1	*14.1*	14.4	0.1
- Capital taxes	0.2	0.2	*0.2*	0.1	0.2	*0.2*	0.1	0.0
- Social contributions	6.4	6.5	*6.3*	6.4	6.4	*6.3*	6.3	-0.2
- Other (residual)	5.8	5.0	*6.0*	5.9	5.3	*4.9*	4.9	-0.9
Expenditure	**38.0**	**38.0**	**38.1**	**38.1**	**37.7**	**37.3**	**37.6**	**-0.7**
of which:								
- Primary expenditure	35.8	36.0	36.2	36.2	35.9	35.6	35.8	-0.3
of which:								
Compensation of employees	11.9	12.0	11.8	11.8	11.7	11.4	11.7	-0.5
Intermediate consumption	6.4	6.8	6.8	6.8	6.4	6.7	6.8	0.3
Social payments	10.9	10.6	10.6	10.6	10.3	10.3	10.4	-0.7
Subsidies	1.3	1.1	1.2	1.2	1.1	1.1	1.1	-0.2
Gross fixed capital formation	2.5	2.8	2.9	2.6	3.1	3.1	2.8	0.6
Other (residual)	2.8	2.7	2.9	3.1	3.3	3.0	3.0	0.2
- Interest expenditure	2.2	2.0	1.9	1.9	1.8	1.7	1.7	-0.5
General government balance (GGB)	**1.1**	**0.5**	**0.8**	**0.9**	**0.5**	**0.5**	**0.5**	**-0.7**
Primary balance	**3.3**	**2.5**	**2.7**	**2.8**	**2.4**	**2.2**	**2.3**	**-1.1**
One-off and other temporary measures	-0.1	-0.2	-0.1	-0.2	0.1	0.1	0.0	0.2
GGB excl. one-offs	**1.2**	**0.7**	**1.0**	**1.1**	**0.5**	**0.4**	**0.5**	**-0.9**
Output gap[1]	1.0	0.9	0.8	1.1	0.3	0.5	0.8	-0.3
Cyclically-adjusted balance[1]	0.7	0.1	0.5	0.4	0.4	0.2	0.2	-0.5
Structural balance (SB)[2]	**0.8**	**0.3**	**0.6**	**0.6**	**0.3**	**0.2**	**0.1**	**-0.7**
Structural primary balance[2]	3.0	2.2	2.5	2.5	2.2	1.9	1.9	-1.2

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/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 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3.2. Debt developments

The general government debt-to-GDP ratio declined from 60.3% of GDP in 2015 to 57.6% of GDP in 2016 thanks to favourable fiscal and macroeconomic developments and despite the debt-increasing stock-flow adjustment (amounting to 2.5% of GDP). The latter was related, among others, to the IIP revenues and cash buffer. In the DBP, the general government gross debt ratio is expected to decrease to 54.9% in 2017 and to decrease further by 4.2 percentage points of GDP in 2018, reaching 50.8% of GDP.

The stock-flow adjustment is projected to be sizeable also in 2017. More than half is linked to the positive balance in the National Development and Social Fund[4] related to the IIP which does not feature in the general government deficit. Other factors contributing to the high stock-flow adjustment are the contribution towards a special Malta Government Stocks sinking fund, and the equity acquisition of the Malta Development Bank. In 2018, the stock stock-flow adjustment is expected to be minor, due to lower expected IIP revenues and a negative balance in the sinking fund used to manage the debt.

[4] The Individual Investment Programme was established by LN 47/2014. This scheme grants naturalization to foreign individuals and their dependants following substantial investment and a due diligence process. By virtue of LN 2/2015, which amends the Public Administration Act, a legal framework was provided for the funds received through the IIP applications, and managed by the National Development and Social Fund Agency as a separate legal entity. The National Development and Social Fund was established in 2015 and it is expected to receive 70% of the contributions paid by the applicants. According to the establishing act, the funds received by the National Development and Social Fund shall be used in the public interest inter alia for the advancement of education, research, innovation, social purposes, justice and the rule of law, employment initiatives, the environment and public health.

Table 3. Debt developments

(% of GDP)	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**57.6**	**55.9**	**54.9**	**54.9**	**52.5**	**50.8**	**51.6**
Change in the ratio	-2.7	-1.7	-2.7	-2.7	-3.4	-4.2	-3.3
Contributions[2] :							
1. Primary balance	**-3.3**	**-2.5**	**-2.7**	**-2.8**	**-2.4**	**-2.2**	**-2.3**
2. "Snow-ball" effect	**-1.8**	**-1.4**	**-2.4**	**-2.2**	**-1.2**	**-2.1**	**-1.8**
Of which:							
Interest expenditure	2.2	2.0	1.9	1.9	1.8	1.7	1.7
Growth effect	-3.1	-2.3	-3.1	-3.0	-2.0	-2.9	-2.5
Inflation effect	-0.9	-1.0	-1.1	-1.1	-1.1	-1.0	-1.1
3. Stock-flow adjustment	**2.5**	**2.2**	**2.5**	**2.3**	**0.3**	**0.2**	**0.9**
Of which:							
Cash/accruals difference							
Net accumulation of financial							
of which privatisation proceeds							
Valuation effect & residual							

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

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

Compared to the SP, the DBP projects a faster reduction in the debt ratio, especially in 2017, due to both a higher primary surplus and nominal growth, which more than compensate for the higher stock-flow adjustment. In 2018, compared to the SP, the faster debt reduction is mainly explained by the higher nominal growth.

According to the Commission forecast, the debt ratio is projected to decrease to 54.9% in 2017 and to decrease further to 51.6% of GDP in 2018. The difference compared to the DBP targets, is mainly explained by the higher stock-flow adjustment in the Commission forecast in 2018, which is in line with past values. The Commission also forecasts a slightly lower primary surplus and a lower impact of inflation on the debt-to-GDP ratio.

The risks highlighted for the deficit targets also apply to the debt projections of the DBP. Moreover, compared to other Member States, the government guarantees provided by central government on debt of non-government units remains high in Malta. After having reached 15.8% of GDP in 2014, they have decreased to 15.1% of GDP in 2015 and further to 14.1% of GDP in 2016.

3.3. Measures underpinning the draft budgetary plan

The Maltese authorities presented the 2018 budget to the Parliament on 9 October 2017. On the revenue side, the measures are expected to decrease the headline surplus by 0.2% of GDP. These include, among other measures, the exemption and reduction of duty on documents for first time and second time buyers, for the acquisition of a property in Gozo; the introduction of VAT grouping for the financial services and gaming sectors (implying that supplies between members of the same VAT group will not trigger a VAT charge); the increase in the VAT exemption threshold for small and medium enterprises; a VAT refund on car registration tax to those who registered their vehicle in 2017; a reduced VAT (7%) on hiring of bicycles and the exemption from registration tax for electric and hybrid vehicles; a one-time income tax refund for employees earning less than EUR 60,000 per annum; an increase in the pension income tax not subject to tax; and a tax credit for persons attending a postgraduate course, allowing them not to pay any income tax for up to two years following the finalization of the course.

On the expenditure side, altogether, the budget measures are estimated to decrease the surplus by nearly 0.1% of GDP. The budget includes an increase in pensions by EUR 2 per week and several social measures i.e. an increase in the in-work benefit and in the community work scheme, an increase in service pensions by EUR 200 per year, an annual grant of €300 for persons over the age of 75 who still reside in their personal home, the reckoning of social security contributions paid after the payment of pensions, the extension of the disability allowance, an increase in the foster care allowance, and a grant for expenses incurred for adopting foreign children. In the area of property, the budget foresees a widening of the thresholds for subsidies to persons living in rented property (including special thresholds for persons who are 65 years and over) and the launching of a scheme by the Housing Authority to offer financial assistance for the restoration of properties to be used as social housing.

Overall, the measures included in the 2018 budget are estimated to have a net deficit-increasing impact of around 0.3% of GDP, which is plausible.

In addition, the DBP projects expenditure financed by the National Development Social Fund to 0.3% of GDP which is split between public investments (¾) and other current expenditure (¼).

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	
	2017	**2018**
Taxes on production and	0.2	-0.1
Current taxes on income,	0	-0.1
Capital taxes		
Social contributions		
Property Income		
Other	0.3	-0.8
Total	0.4	-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

Source: Draft Budgetary Plan for 2018

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the	
	2017	**2018**
Compensation of employees		
Intermediate consumption	-0.2	0.2
Social payments	-0.1	0.0
Interest Expenditure		
Subsidies		
Gross fixed capital formation	-0.2	0.0
Capital transfers	0.1	0.0
Other	-0.1	-0.1
Total	-0.5	0.2

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

Source: Draft Budgetary Plan for 2018

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

Malta is subject to the preventive arm of the Stability and Growth Pact and should preserve a sound fiscal position which ensures compliance with its MTO.

4.1. Compliance with the MTO

Malta is subject to the preventive arm of the Stability and Growth Pact. The general government balance posted a surplus of 1.1% of GDP in 2016 and it is expected to remain in surplus throughout the DBP period. This is confirmed by the Commission forecast for the years 2017 and 2018.

Malta's structural balance reached a surplus of 0.8% of GDP in 2016, above its medium-term objective of a balanced budgetary position in structural terms. It should be noted that the improvement in the fiscal position has largely benefitted from the revenue related to a particular budget measure, namely the IIP. In the 2014-16 period, revenue increased by 2.4% of GDP thanks to the IIP proceeds. According to the information provided in the DBP, Malta is expected to remain above its medium-term objective also in 2017 and 2018. This is also confirmed in the Commission forecast, albeit with a slightly lower structural surplus.

According to the information provided in the DBP, in 2017, the (recalculated) structural balance is expected to stand at 0.6% of GDP, thus above the MTO. This is in line with the Commission forecast. Therefore, this points to compliance with the provisions of the SGP in 2017, which is also confirmed by the Commission forecast.

In 2018, according to the DBP, at face value, the (recalculated) structural balance is set to deteriorate by 0.4 percentage point, due mainly to the impact of the 2018 budget measures, and to reach a surplus of 0.2% of GDP, thus remaining above the MTO. This points to compliance with the requirements of the SGP.

In the Commission forecast for 2018, the structural balance is set to deteriorate by 0.5 percentage point, and to reach a surplus of 0.1% of GDP, thus remaining above the MTO at face value. The structural balance points to compliance, while the growth rate of government expenditure net of discretionary revenue measures of 10.4% (in nominal terms) is projected to exceed the applicable expenditure benchmark rate[5] (8.4%) by 0.6% of GDP, thus pointing to a risk of a significant deviation. An overall assessment suggests that the structural balance is positively impacted by revenue windfalls (0.2% of GDP), by the decrease in interest outlays (0.2%) and the lower public investment compared to the average (0.1%). The expenditure benchmark is thus considered to appropriately reflect the underlying fiscal effort of Malta. However, given that the contribution of revenue windfalls in 2018 to the surplus above the MTO is not considered to be significant (0.2%)[6], the expenditure developments shall not be considered as significantly deviating from the requirement. Taking into account these factors, the overall assessment points to a risk of some deviation in 2018 based on the Commission forecast. At the same time, expenditure developments should be monitored carefully in the

[5] As part of the agreement on the EFC Opinion on "Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm", which was adopted by the EFC on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

[6] According to Article 6(3) of Regulation No 1466/97 of 7 July 1997, "The deviation of expenditure developments shall not be considered significant if the Member State concerned has overachieved the medium-term budgetary objective, taking into account the possibility of significant revenue windfalls and the budgetary plans laid out in the stability programme do not jeopardise that objective over the programme period."

short and the medium term, especially in light of possible risks to the resilience of revenues going forward.

According to the DBP, as well as the Commission forecast, the debt-to-GDP ratio, which in 2016 was below the 60%-of-GDP threshold, is expected to remain below that threshold and to decrease further over the programme horizon.

Following an overall assessment based on the DBP, the compliance with the MTO seems to be in line with the requirements of the preventive arm of the Pact in both 2017 and 2018. The Commission 2017 autumn forecast confirms the assessment of compliance in 2017, while it points to some deviation from the compliance with the requirements of the preventive arm of the Pact in 2018.

Table 5: Compliance with the requirements of the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	0.0	0.0		0.0	
Structural balance[2] (COM)	0.8	0.6		0.1	
Structural balance based on freezing (COM)	0.7	0.6		-	
Position vis-a -vis the MTO[3]	Not at MTO	At or above the MTO		At or above the MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.6			0.0	
Required adjustment corrected[5]	0.6			-0.6	
Change in structural balance[6]	3.0			-0.4	-0.5
One-year deviation from the required adjustment [7]	2.4			0.2	0.2
Two-year average deviation from the required adjustment [7]	0.9			0.3	0.4
Expenditure benchmark pillar		Compliance			
Applicable reference rate[8]	1.3			8.4	
One-year deviation adjusted for one-offs [9]	1.3			-0.20	-0.63
Two-year average deviation adjusted for one-offs [9]	0.2			0.0	-0.2
PER MEMORIAM: One-year deviation [10]	1.1			0.0	-0.4
PER MEMORIAM: Two-year average deviation [10]	1.1			0.1	-0.2
Conclusion					
Conclusion over one year	Compliance	Compliance	Compliance	Overall assessment	Overall assessment
Conclusion over two years	Compliance	Compliance	Compliance	Compliance	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 38.).

[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 2016) was carried out on the basis of Commission 2017 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, revenue increases mandated by law and one-offs 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.

[10] 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 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations.

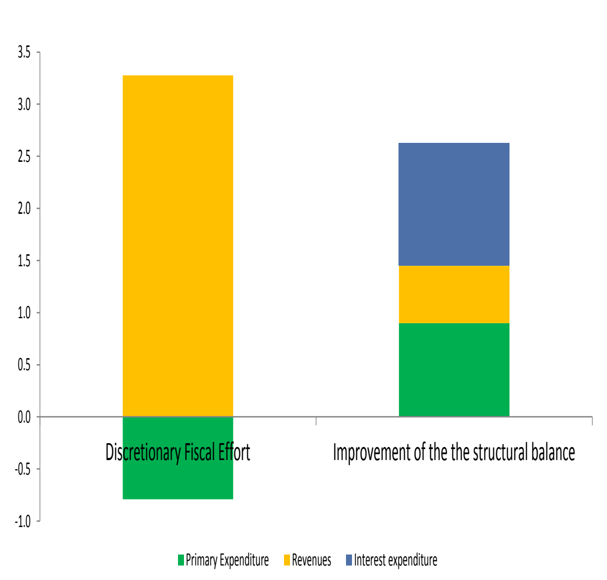
5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The total discretionary fiscal effort between 2011 and 2017 amounts to 2.5% of GDP. The increase in primary expenditure by 0.8% of GDP is more than compensated by adjustment on the revenue side (which is expected to be higher at 3.3% of GDP).

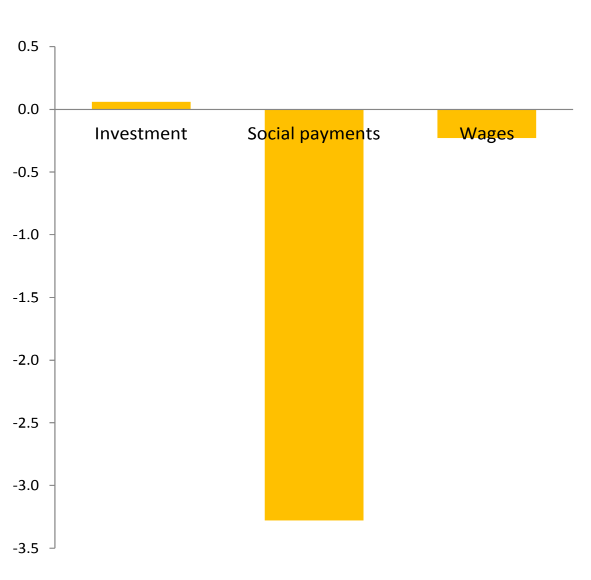
The increase in revenue is linked to the improvement in the macroeconomic conditions since 2014, but also to the introduction of budget measures, and in particular the IIP. The proceeds related to the IIP are estimated to have reached 4.3% of GDP cumulatively over the period 2014-17.

On the expenditure side, all the expenditure components, except social transfers, increased at a fast pace. Primary current expenditure will increase on average by above 6% in the period 2011-18. As a result, the share of social transfers in total expenditure is expected to decrease. The increase in capital expenditure exceeds 12%, due to capital transfers to Air Malta and the acceleration of public investments, especially in 2015, linked to the high absorption of EU funds. In 2016 investment decreased substantially following a decline in the absorption of EU funds as a result of the start of a new programming period. It is expected to recover in 2017 and 2018 averaging around 3.0% of GDP due to both a pick up in the absorption of EU funds and an increase in investment financed by national resources.

Graph 1: Composition of the fiscal effort (2011-2017), Malta (% GDP)



Graph 2: Change in the share in total expenditure of selected expenditure items (2011-2017), Malta (% change)



Source: Draft Budgetary Plans 2018, European Commission 2017 autumn forecast. Graph 1 shows the Discretionary Fiscal Effort (DFE) which combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. In a nutshell, the DFE consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013): Measuring the fiscal effort, Report on Public Finances in EMU, part 3 http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf

The Maltese authorities started an expenditure review in 2014. It covers three areas of public expenditure: social security (Department for Social Security in 2014), health (Mater Dei Hospital in 2015 and other services within the Ministry for Health, including the Ministry itself, Primary Care Services, POYC and the Contracts Procurement Services Unit) and education (Ministry for Education and Employment in 2016). Each review ended with the publication of a report which included recommendations, some of them have been already implemented (especially for the first two reviews) and others are being implemented.

The Council Recommendation addressed to Malta under the European Semester on 11 July 2017[7] recommended Malta to expand the scope of the ongoing spending reviews to the broader public sector and to introduce performance-based public spending.

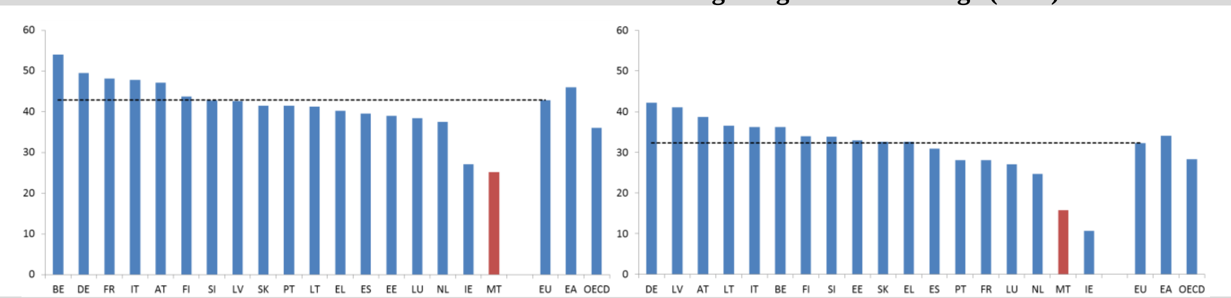
The DBP reports on the latest developments regarding the country-specific recommendation on the spending review. The authorities envisage that a review will be undertaken at the Management Efficiency Unit and the Malta College for the Arts, Sciences and Technology. They are also planning to institutionalise the spending review function under a directorate within the Ministry for Finance which is tasked with public sector performance and evaluation. This directorate will be also in charge of the monitoring of the recommendations issued in the past years in the three areas concerned by the spending review and coordinate in the future. These initiatives seem promising and should contribute towards increased effectiveness in public spending, provided those are properly implemented.

Box 2 – 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 benchmark euro area Member States' tax burdens 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.

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: 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.

[7] Council Recommendation of 11 July 2017 on the 2017 National Reform Programme of Malta and delivering a Council opinion on the 2017 Stability Programme of Malta (OJ C 261, 9.8.2017, p. 75–78).

Benchmarking 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 Draft Budgetary Plan does not include any measures affecting the tax wedge on labour. Malta's Draft Budgetary Plan contains two measures that affect (marginally) the tax wedge on labour. These measures target low and medium income earners. The first one is a one-time income tax refund, ranging between EUR 40 and EUR 68 depending on the level of income, for part-time and full-time employees earning less than EUR 60,000 per annum. The second measure is a tax credit granted to persons following a post-graduate course leading to a Masters or Ph.D. (equivalent to MQF 7 and MQF 8) with an income earned up to EUR 60,000.

These measures are included in the 2018 budget, which includes also several social measures. Their aim it to redistribute wealth and reduce income inequality. Their budgetary impact is estimated at around 0.1% of GDP, fully financed with a reduction of the fiscal surplus. According to the simulation illustrated in the DBP, the first measure is likely to have a positive effect on income inequality, with a reduction on the Gini coefficient by 0.04 percentage point when incomes after tax are considered.

6. Overall conclusion

Following an overall assessment of the DBP for 2018, the planned structural adjustment is in line with the compliance with the MTO in both 2017 and 2018. The Commission 2017 autumn forecast confirms the assessment of compliance in 2017 while, based on an overall assessment, there appears to be a risk of some deviation from the compliance towards the MTO in 2018.