Strengthening Malta’s Fiscal Framework
An Economic Assessment
The following symbols have been used throughout this document:

- . . . to indicate that data are not available;
- — to indicate that the figure is negligible;
- 0 to indicate that the figure is zero;
- - to indicate that data are not applicable or cannot be determined;
- n/c to indicate that there is no change in the data.

Figures may not add up due to rounding.
# Contents

1. **Strengthening Malta’s Fiscal Framework – an Economic Assessment** 3  
   1.1 Preamble 3  
   1.2 The current macro-economic environment 3  
   1.3 Objectives of this Report 3  

2. **Strengthening the National Fiscal Framework** 7  
   2.1 Evolving Budgetary Surveillance 8  
      2.1.1 The 2011 reform of the Stability and Growth Pact 9  
      2.1.2 The Directive on National Budgetary Frameworks 9  
      2.1.3 The Treaty on Stability, Coordination and Governance (TSCG) and the Fiscal Compact 11  
      2.1.4 Common Provisions for Monitoring and Assessing Draft Budgetary Plans 11  
      2.1.5 Beyond the EU Fiscal Governance Frameworks 13  

3. **Fiscal Developments in Malta** 17  
   3.1 The Sources of Fiscal Consolidation Efforts 19  
   3.2 Debt Dynamics 21  
   3.3 Macroeconomic Projections and the Deficit Bias 23  
   3.4 Conclusion 26  

4. **The Role of Economic Growth** 29  
   4.1 Debt Accumulation and Its Sources 29  
   4.2 The Impact of High Debt on Economic Growth 29  
   4.3 Fiscal Adjustment and Debt Reduction 30  
   4.4 Expansionary Austerity? 31  
   4.5 Fiscal Multipliers 32  
   4.6 Short-term vs Long-term Effects 32  
   4.7 Growth Friendly Fiscal Consolidation; Expenditure vs Revenue Based Consolidation 33  
   4.8 Conclusion 34  

5. **Strengthening the National Fiscal Framework** 37  
   5.1 Fiscal rules – anchoring expectations for sustainable public finances 37  
      5.1.1 Designing fiscal rules 37  
      5.1.2 Alternative Fiscal Rules 37  
      5.1.3 Desirable Characteristics of Fiscal Rules 38  
      5.1.4 The Appropriate Coverage of Fiscal Rules 42  
   5.2 Alternative Formulations of Fiscal Rules for Malta 43  
   5.3 Implementation and Enforcement 45  
      5.3.1 Desired level of Legislative Support 45  
      5.3.2 Escape clauses 46  
      5.3.3 Common Principles for National Fiscal Correction 46  
   5.4 Conclusion 48

6.1 Applying Fiscal Rules to Malta’s Recent Economic History
6.2 The responsiveness of changes in GDP, and debt and deficit ratios
6.3 Responsiveness Results
6.4 Implications of the Empirical Results
6.5 Compliance with the Debt Benchmark
6.6 Local policy considerations
6.7 Conclusion

7. Independent Fiscal Institutions

7.1 Functions of an Independent Fiscal Institution
7.2 The Deficit Bias in the Maltese Context
7.3 Fiscal Institutions and the Overall Fiscal Frameworks
7.4 Principles for an Independent Fiscal Institution
7.5 Possible Options Underpinning a Fiscal Institution
  7.5.1 Option 1: Minimalist Approach; Monitoring Only
  7.5.2 Option 2: Minimalist Approach; Monitoring + Evaluation
  7.5.3 Option 3: Monitoring, Forecasting and Evaluation Approach
  7.5.4 Option 4: Monitoring, Partial Forecasting and Evaluation Approach
  7.5.5 Option 5: Total Independence Option
7.6 The Political Process and the Role of the Ministry for Finance

8. The Medium-Term Budgetary Framework

8.1 Designing a Medium Term Budgetary Framework for Malta
  8.1.1 Cyclical Expenditure
  8.1.2 Debt Service Payments
  8.1.3 Statutory Expenditure
  8.1.4 Ministerial Allocation
  8.1.5 Capital Expenditure
8.2 The Contingency Reserve
  8.2.1 Introducing Contingency Reserves
  8.2.2 Potential Uses of the Contingency Reserve
  8.2.3 The Size of the Contingency Reserve
  8.2.4 Establishment of the Contingency Reserve
  8.2.5 Utilisation of the Contingency Reserve
  8.2.6 Minimising the Cost to the Taxpayer
  8.2.7 Transparency and Accountability

9. Conclusion

9.1 A Brief History of Recent Fiscal Consolidation Efforts
9.2 The Deficit Bias
9.3 Commitments under the EU Fiscal Framework
9.4 Fiscal Rules
9.5 Fiscal Institutions
9.6 The Medium Term Budgetary Framework
9.7 Further Considerations

Appendix A: International Budgetary Practices
A1: Irish Budgetary Practice
A2: Dutch Budgetary Practice

Tables
6.1 Responsiveness Ratio to Economic Conditions
6.2 Structural Effort Implied by the Different Budget Rules
8.1 Composition of Government Expenditure in 2011
8.2 Statutory Expenditure

Charts
3.1 Developments in Public Finances 1999-2011 (% of GDP)
3.2 Fiscal Policy and Cyclic Conditions
3.3 The Business Cycle and the Fiscal Stance (as % of GDP)
3.4 Fiscal Policy and Cyclic Conditions
3.5 Disaggregating the Changes in the Budget Balance Ratio
3.6 Fiscal Strategy ((+) fiscal contraction (-) fiscal expansion)
3.7 Deficit and Debt Developments
3.8 General Government Debt Dynamics 2000-2011
3.9 Sources of Fiscal Slippages
3.10 Forecast Error of Budgetary Targets after adjusting for Cyclical Effects
3.11 Forecast Error of Nominal GDP Growth
   (+ indicates optimistic forecasts / - indicates pessimistic forecasts)
4.1 Economic Growth and Public Indebtedness
5.1 The Output Gap and the Growth Gap
6.1 Impact of Fiscal Rules on Debt Dynamics
6.2 Structural Effort Implied by the Different Budget Rules
6.3 Structural Effort of a Hypothetical Scenario
8.1 Frequency Distribution of Ministerial Expenditure Deviations from Budget Targets between 2008 and 2011
8.2 General Government Gross Fixed Capital Formation

Boxes
5.1 Common principles for national fiscal correction
1. Strengthening Malta’s Fiscal Framework – an Economic Assessment
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1.1 Preamble

Whilst Malta has thus far displayed a relatively high degree of resilience to the international turmoil, the great recession and the numerous financial crises which have preceded it provide a clear case for the need to control dangerous debt dynamics. The need to ensure sustainable fiscal positions is even more desirable for countries which in the past have experienced unfavourable balance of payments conditions. If one looks at the sovereign debt crisis in Europe it is clear that financial markets have not responded very kindly to rising fiscal deficits and high public indebtedness particularly in countries which also run current account deficits. Current account deficits arise when countries borrow excessively from abroad and over time this increases the vulnerability to international financial markets. Furthermore excessive borrowing often fuels asset price bubbles whether it is in the form of construction overinvestment and high property prices, excessively leveraged financial systems or low-yielding sovereign debt of profligate Governments. Malta’s public debt to GDP ratio is not amongst the highest in the EU and the deficit is relatively controlled. Overall Malta enjoys a net asset position whilst the public debt is almost totally supported by domestic savings. However rising private and public indebtedness levels are increasing Malta’s vulnerability. It is thus opportune at this point in time to consider measures to control rising debt including public debt.

1.2 The current macro-economic environment

Since the onset of the global crisis, Government policies have played an important stabilising role as EU countries have taken significant measures to support economic activity and the financial sector, leading to upward pressures on Government deficits and in some countries also compounding on the dynamics of their structural deficits. Initially the downturn in economic activity stemming form the crisis led to an increase in Government deficits as automatic stabilisers cushioned the impact of the contraction in economic activity. Subsequently, the European Commission promoted fiscal stimulus measures to support the economy via the European Economic Recovery Plan. In addition, a number of Member States were forced to grant expensive support towards distressed systemically important financial institutions in order to preserve the functioning of their financial systems. As a result Government debt soared, in some cases also reaching unprecedented historical levels.

Despite the fact that Member States have started a path towards consolidation of Government finances on the back of major policy actions, dangerous adverse feedback loops between Government finances, macro-economic dynamics and the financial sector have developed. The current state of play shows that investor’s concerns regarding the sustainability of sovereign debt levels in the EU have triggered stress in financial markets which spurred the onset of the current sovereign debt crisis. This has led to tensions within the banking sector which ultimately holds a large share of sovereign debt. In turn, the strains within the banking sector weighed down on the perceived sovereign risk as investors view Member States as the ultimate guarantors for vulnerable financial institutions, particularly in the Euro Area where a banker of the last resort function vested in the ECB is not present and a move towards this direction is still strongly opposed. Adding to the adverse dynamics is the negative affect on growth stemming from the deleveraging process ongoing in both the private and public sector and which ultimately further undermines the debt sustainability. Lastly, the increased market tensions have also raised interest rates for Government borrowing, thus also further undermining the sustainability of public finances, aggravating the already difficult path towards consolidation.

1.3 Objectives of this Report

The aforementioned macroeconomic developments have led to an unprecedented call for strengthening of economic governance in the EU and Euro Area through the use of a number of initiatives and legislative
packages. This naturally means that Malta’s fiscal framework also needs to be strengthened. Due to the sensitivity and complexity of the subject at hand, this report aims to outline the evolution of the budgetary surveillance process and reforms enacted by the Commission and Member States while at the same time, also taking into consideration the wider macro-economic aspects of such developments with particular reference to Malta. In particular, the document assesses the performance of the legislative measures being pursued, their implications for deficit, debt and consolidation dynamics, as well as their unavoidable impact on economic activity and growth. Additionally, the analysis also takes into consideration the institutional framework highlighting the importance that this has on the success or otherwise of the chosen policy actions. These aspects are all taken into consideration when portraying the derived conclusions as well as when presenting the possible policy solutions in the final section of the document.
2. Strengthening the National Fiscal Framework
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Fiscal governance in the EU is regulated by the Stability and Growth Pact which sets targets for medium term budgetary objectives (MTO), the required structural adjustment path (known as the structural effort) needed to reach the MTO, defines “excessive deficits” and how such deficits can be eliminated. The SGP represents an important safeguard in the functioning of the economic and monetary union. However the great recession has proven to be too formidable a test of the SGP and the sovereign debt crisis in Europe has clearly brought to the fore two major weaknesses of the SGP.

First of all the absence of clear fiscal imbalances is not an insurance against fiscal crisis as the situation in Ireland and Spain has shown. Private sector imbalances can quickly lead to excessive fiscal imbalances as the Governments of the member states act as the ultimate guarantors of private debt borne especially by the systemic banks. This lead to the creation of the Macroeconomic Imbalance Procedure (MIP) in the EU which is an automatic mechanism which tries to identify macroeconomic imbalances such as excessive or rising indebtedness, asset price bubbles, persistent competitiveness losses, persistent unemployment and excessive inflationary pressures which over time could potentially lead to an economic crisis. If such imbalances are identified, especially those which are excessive and which could hamper the operation of the monetary union, the MIP exerts pressure on the respective member states to take corrective action. In the absence of effective action fines could be imposed. Whilst the MIP is not the subject of this paper it should be kept in mind as the operation of the MIP has important implications from an economic point of view on the success of the SGP.

The second major weakness of the SGP relates to the evaluation of fiscal imbalances in good times. EU member states such as Ireland and Spain (and to a certain extent Greece) which appeared to enjoy a strong and seemingly sustainable public finance position prior to the crisis ended up with huge fiscal imbalances as soon as the crisis erupted. There are a number of important factors (apart from the macroeconomic imbalances) which underlined such weakness.

The first weakness relates to the structural effort required by member states to reach their MTO. The SGP requires member states to reduce their structural deficit by a minimum of 0.5 per cent of GDP per annum to reach their MTO. Few member states ever reached their MTO which in itself should ensure ample safeguards so that in a recessionary environment (known as ‘bad times’ in Brussels speak) deficits do not rise above a 3 per cent benchmark due to automatic stabilisers and allow some room for counter cyclical fiscal policy without undermining fiscal sustainability.

A second weakness relates to the way the structural effort is defined and estimated. Ireland and Spain had reached a fiscal position prior to the crisis which was close to their MTO. And yet this proved to be insufficient. The common denominator in these two countries was the property market bubble. The exceptionally strong economic activity prior to the crisis in these two economies was largely supported by the bubble building up in their property market. As a result of this bubble the increase in Government revenue due to rising housing prices was significantly in excess of what the growth in economic activity was indicating. Unfortunately the way the ‘structural deficit’ is estimated for the purpose of the SGP tends to regard these exceptional revenue increases as structural rather than cyclical.

Here a definition of the terms ‘structural deficit’ and ‘structural effort’ is in order. The structural deficit is not the actual ‘accounting’ deficit we typically observe in public finances statistics. It is the deficit net of one off measures and net of cyclical components. In other words it is an estimate at any point in time of the deficit that would prevail if the economy is performing at its potential and excluding one-off deficit reducing items. The structural effort is the yearly change in the structural deficit. To estimate the structural deficit one needs to estimate the output gap defined as the difference between actual GPD we observe in the statistics and potential GDP (which we impute through economic models because we do not observe in the statistics). Once the output gap is estimated it is possible to eliminate from the budget balance that part which is attributable to normal cyclical conditions. When countries target a balanced budget as their MTO,
they are actually targeting this imputed cyclically adjusted balance and not the actual budget balance. This ensures that in ‘good times’ surpluses are required whilst in ‘bad times’ deficits are sanctioned thus allowing counter cyclical fiscal policy to take place in accordance with sound economic practices.

Unfortunately the output gap is not something we can easily measure and potential output is not something which we can observe directly in the statistics. It is like air which is there even though it can’t be seen. And like air we know it is there because when it moves it stirs everything in its path. In the same sense we measure potential output by its effects. We do not observe the output gap but when the economy has a positive output gap and GDP is above its potential, then inflationary pressures are often created and unemployment levels decline sufficiently below normal levels. On the other hand negative output gaps are associated with recessionary environments of above normal unemployment levels and often disinflation or at times deflation.

However even if we were to accept the ability of economic models to measure potential output and the output gap correctly as given, one has to acknowledge that such estimates often underestimate the impact of asset price bubbles. As a result revenue derived from asset price bubbles tends to be regarded as permanent and structural rather than temporary and cyclical. And because asset price bubbles can persist for years if not decades before they burst it is often difficult for economists to convince policymakers that the bursting of such bubbles may be just around the corner and that the revenue derived from such bubbles should be reserved for future need. The SGP itself did not correct for this flaw and gave countries such as Spain and Ireland a false sense of security when they reached their MTO on the back of these exceptional revenue streams. This however quickly evaporated when the property bubbles burst.

A third weakness of the SGP proved to be statistical. The failure of statistics to capture the actual value of debt, often hidden by complex instruments such as Special Purpose Vehicles (SPVs) proved to be Greece’s undoing as the misrepresentation of sovereign debt eventually emerged in the press triggering a crisis of confidence in the statistics and hence the underlying budgetary position. The weaknesses of the EU statistical framework have been identified as a major factor underpinning the loss of confidence of markets in the European sovereigns.

The fourth weakness relates to weak governance and institutional frameworks. The weaknesses in the statistics, the treatment of excessive revenue from asset bubbles as permanent rather than temporary and the enforcement of a proper adjustment path towards the EU were not discovered as the crisis erupted; they were well known deficiencies well before the crisis. And yet the institutional features were not strong enough to take corrective action to address these weaknesses. Institutional features such as the rules based framework of the SGP are insufficient in the absence of a strong governance framework which recognises the limits of a rules based framework and acts accordingly to ensure fiscal sustainability. By institutional features we refer to medium term budgetary frameworks, independent fiscal institutions, strong finance ministries and prudent macroeconomic forecasting platforms.

It is clear that the SGP is a necessary but not sufficient condition for stability in the EU particularly in the Euro Area. The further strengthening of economic governance for the EU and the Euro area, in particular the entry into force of the directive of the Council and the European Parliament on the requirements for budgetary frameworks of Member States, have important implications for the institutional features of public finances. Moreover, Malta’s commitment to the Euro Plus Pact, the EU economic governance legislative package, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and the significantly stronger coordination of economic policies in areas of common interest, including the common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of an excessive deficit, require that Malta’s fiscal framework is strengthened.

2.1 Evolving Budgetary Surveillance

The deepening of the sovereign debt crisis in 2011 and 2012 signalled the need for a stricter budgetary
and economic surveillance mechanism, with important implications for the institutional features of public finances. Government acknowledges the important role that the national budgetary framework may play in sustaining budgetary retrenchment. This is reflected in Malta’s commitment to the Euro Plus Pact, the EU economic governance legislative package, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and the significantly stronger coordination of economic policies in areas of common interest, including the common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of an excessive deficit.

The following section outlines the provisions introduced in the 2011 reform of the Stability and Growth Pact, the key requirements in five areas of budgetary policy-making outlined in the Directive on requirements for budgetary frameworks of the Member States, as well as the initiatives to strengthen budgetary discipline and economic policy coordination outlined in the Treaty on Stability, Coordination and Governance (TSCG).

2.1.1 The 2011 reform of the Stability and Growth Pact

As part of the EU response to the crisis, a reform of the European common fiscal framework – the Stability and Growth Pact (SGP) – entered into force on 13 December 2011. The new framework has two main components:

Stronger preventive action and deeper fiscal coordination: A new expenditure benchmark will now be used alongside the change in the structural budget balance to assess adjustments towards the country specific medium-term budgetary objective (MTO). It is worth noting that the expenditure benchmark represents an ingenious way to correct for the reliance of the SGP on the need to estimate the output gap to derive the structural effort and also corrects somewhat for the impact of asset price bubbles. By ensuring that expenditure growth does not exceed the rate of potential growth unless offset by discretionary revenue measures it ensures that exceptional revenue increases due to asset price bubbles are not employed to raise expenditure excessively. Inadequate action to correct significant deviations from the appropriate adjustment path towards the MTO can lead to an interest-bearing deposit (of 0.2 per cent of GDP as a rule) to be lodged on non-compliant Euro area countries.

Stronger corrective action through a reinforced SGP: The launch of an Excessive Deficit Procedure (EDP) can now result from Government debt developments as well as from Government deficit. Member States with debt in excess of 60 per cent of GDP should reduce it at an average rate of one twentieth per year as a benchmark, based on changes over the last three years for which the data is available. Furthermore, regardless of whether an EDP is launched on the basis of deficit or debt developments, progressive financial sanctions on Euro area Member States kick in at an earlier stage of the EDP. In cases of particularly serious noncompliance, including those evidenced by the existence of an interest bearing deposit, a noninterest bearing deposit (of 0.2 per cent of GDP as a rule) will be requested from a Euro area country when it is placed in EDP. Failure by a Euro area country to comply with a Council recommendation under Article 126(7) to correct its excessive deficit will result in a fine (of 0.2 per cent of GDP as a rule). The fine imposed can rise up to 0.5 per cent of GDP per year in the case of non-compliance with a notice to take measures for the deficit reduction in accordance with Article 126(9).

2.1.2 The Directive on National Budgetary Frameworks

The Directive on requirements for budgetary frameworks of the Member States was adopted as part of the Six-Pack economic governance package and will be transposed by end of December 2013. It sets out minimum requirements for Member States’ fiscal frameworks in five key areas outlined below, with a view to ensuring consistency between national fiscal governance and budgetary discipline provisions from the EU Treaties and the Stability and Growth Pact (SGP). The legal instrument chosen was a Directive, to ensure the most appropriate association of uniform EU-level requirements with the variety of Member States’ budgetary structures. Contrary to voluntary standards, a Directive is binding, but unlike a Regulation – through which most of the SGP rules are established – it leaves Member States the flexibility to choose the means they will
use to comply with its requirements. In particular, the Directive on budgetary frameworks allows Member States to adapt their existing frameworks to the new EU rules, and leaves open the possibility of enacting – or maintaining – more stringent provisions than its minimum requirements. This is crucial not only to respect existing institutional settings, but also to anchor national ownership of EU rules.

The Directive outlines key requirements in five areas of budgetary policy-making:

1. **Accounting and statistics:** Sound fiscal statistics are not only necessary to support national budgetary processes from budget preparation to execution, they are also crucial for a proper functioning of the EU fiscal surveillance framework. Building on the proven methodological framework provided by the European System of Accounts, the Directive requires accruals-based data compliant with ESA95 covering all the general Government subsectors, and also regular audits, both internal and external, of public accounts. Member States are required to publish cash-based fiscal data, at a monthly frequency for each of the central and regional Government and social security subsectors, while local Governments are required to report on a quarterly basis. Reconciliation tables explaining how ESA95 data is derived from primary sources should also be made publicly available.

2. **Forecasting:** Macroeconomic and budgetary forecasts are an essential component of the budget process, as fiscal planning based on biased or unrealistic forecasts may hamper budgetary discipline in a significant manner. The Directive mandates the publication of official macroeconomic and budgetary forecasts prepared for fiscal planning, and also of the methodologies, assumptions and parameters on which these forecasts are based; alternative scenarios (e.g. lower-than-expected growth) shall also be considered. Furthermore, the reliability of the forecasts can be improved through comparisons with forecasts from other institutions – such as the Commission – and independent economic institutes; other relevant stakeholders should contribute to strengthening the robustness of forecasts.

3. **Numerical fiscal rules:** Well-designed national rules-based frameworks are known to significantly enhance budgetary discipline; numerical fiscal rules can therefore provide effective domestic leverage for the SGP (itself a rule-based system defined on quantitative fiscal targets) through increased domestic ownership of fiscal goals. While discretion is left in the definition of the numerical fiscal rules – which may target not just the debt or deficit but also expenditure and/or revenues – basic features are mandated in the Directive. These features include the requirements that the targets and scope of the rules be well defined, that effective and timely independent monitoring be put in place, that strict compliance mechanisms must exist and that well-circumscribed escape clauses should be defined. This can be relevant not only at the general Government level, but also at the sub-national level.

4. **Medium-term budgetary frameworks (MTBFs):** Although the annual budget law is the pivotal element of fiscal policy in all Member States, most fiscal measures have budgetary implications beyond the yearly cycle; a multiannual perspective can greatly improve fiscal planning. While the Stability and Convergence Programmes are already presented from a multi-annual perspective, they could have a greater impact on domestic budgetary debates, notably given that annual budgets are supposed to be in line with SGP commitments. The Directive therefore sets out minimum requirements for domestic MTBFs which include a fiscal planning horizon of at least three years, the embedding of the MTBF into the EU fiscal framework (including reference to the achievement of the medium-term objective), revenue and expenditure projections on the basis of unchanged policy and an explicit link to annual budgets.

5. **Transparency:** Increasing fiscal decentralisation in most Member States strengthens the need for coordination between central Government (which, according to Protocol 12 of the Treaty, is the level at which compliance with Treaty provisions on fiscal matters is judged), and regional and local Governments, which manage an increasing share of public expenditure. The Directive promotes accountability by calling for national fiscal frameworks to appropriately cover all general Government tiers and requires that Member States establish coordination mechanisms across subsectors, including numerical fiscal rules. The Directive
also requires more clarity on specific items which may have an impact on budgets, namely extra-budgetary funds, tax expenditures and contingent liabilities.

### 2.1.3 The Treaty on Stability, Coordination and Governance (TSCG) and the Fiscal Compact

The Treaty on Stability, Coordination and Governance complements the new legislation on fiscal and macroeconomic surveillance (the Six-Pack), and further strengthens and fully implements the provisions of the revised Stability and Growth Pact (SGP) by incorporating key concepts of the SGP within national legislation. The 25 signatories of the TSCG (including Malta), concentrated their commitments to achieve greater budgetary and economic coordination on three main dimensions: (i) fiscal discipline, (ii) economic policy convergence and (iii) enhanced governance of the Euro area.

On the budgetary side, the Fiscal Compact (Articles 3 to 8 of the TSCG) follows the two-fold approach of the SGP, where a preventive arm is designed to maintain or guide Member States towards medium and long-term fiscal sustainability; while corrective mechanisms (the excessive deficit procedure) ensure the correction of gross policy errors. The Fiscal Compact intends to complement both stages of fiscal surveillance, through:

- at a preventive stage: **implementation of a balanced-budget rule into national law** and ex-ante reporting on debt issuance plans;
- ensuring the correction of gross policy errors: greater deterrence of the **corrective procedure**; new focus on structural reform necessary to accompany correction of fiscal imbalances.

Accordingly, and building directly on the concepts of the European Stability and Growth Pact, the Fiscal Compact sets the following rules:

- The general Government budget will have to reach a ‘balanced or in surplus’ position, deemed respected if the annual structural balance of the general Government is at the country-specific medium-term objective (MTO). For Euro Area member states the MTO should not exceed a deficit of 0.5 per cent of GDP as a minimum. A temporary deviation from the medium-term objective or the adjustment path towards it will only be possible in exceptional circumstances. In case of significant observed deviations from the MTO or the adjustment path towards it, also assessed in accordance with SGP concepts, **correction mechanisms will be triggered automatically** at the national level.
- To ensure compliance, these **rules have to be enshrined in national law** through provisions of binding force and permanent character. In addition, **functionally independent bodies will be in charge**, at the national level, of monitoring compliance with the balanced-budget rule.
- A new debt reduction benchmark in case the general Government debt exceeds 60 per cent of GDP, which requires Member States to reduce the difference between their debt-to-GDP ratio and the 60 per cent threshold at an average rate of one-twentieth per year as a benchmark.
- Member States are required to report ex ante on their debt issuance plans to the Council of the EU and to the European Commission.
- Contracting Parties subject to an EDP will have to present an **economic partnership programme** detailing the structural reforms that are deemed necessary to support an effective and durable correction of the excessive deficit.

### 2.1.4 Common Provisions for Monitoring and Assessing Draft Budgetary Plans

In recent weeks agreement has been reached between the European Council, the European Parliament and the European Commission on a regulation stipulating common provisions for monitoring and assessing draft budgetary plans. This will complement the European Semester and lead to further coordination of the budgetary cycle among the euro area member states. Central to this regulation is the mandate to prepare draft national budgetary plans before the national budget is adopted and at the latest by the 15th of October.
each year. The draft budget shall contain the following elements:

1. Budget **targets** for the forthcoming year
2. Projections at **unchanged policy** for revenue and expenditure including their main components
3. **Targeted** revenue and expenditure including their main components, taking into account the **expenditure benchmark**
4. Relevant information of Government expenditure by function
5. A description and **quantification of the revenue and expenditure measures** which account for the difference between the budgetary projections under unchanged policies and the budgetary targets
6. The main **assumptions** underlying the macroeconomic forecasts and the estimated economic impact of budgetary measures
7. An account of how reforms and measures in the plan address country specific recommendations and the targets for growth and jobs of the EU

A harmonised framework will eventually be established by the Commission in cooperation with the member states. The **draft budgetary plan** will need to be published. It is also specified that the budgetary plans should be based on **independent macroeconomic forecasts**, thus going a step further from the 6-pack requirements. The draft budgetary plan has to be submitted to the European Commission and the European Council whilst the European Commission is bound to publish an opinion on the Draft Budgetary Plan. The European Commission may also ask for a revision of the Draft Budgetary Plan in exceptional circumstances.

The regulation also introduces the **National Medium-Term Fiscal Plan** to be published together with the NRP and the Stability Programme. The National Medium Term Fiscal Plan can be part of the Stability Programme but has to be based on independent macroeconomic forecasts. It is presumed that if the macroeconomic forecasts underlying the Stability Programme are not produced independently, then the Medium Term Fiscal Plan may need to be presented separately from the Stability Programme.

The regulation also defines more clearly than the 6-pack legislation what is meant by **independent bodies**. These can be “structurally independent” bodies or bodies endowed with “**functional autonomy**”. On functional autonomy the regulation states that such bodies should be:

1. ‘functionally autonomous’ from the budgetary authorities,
2. underpinned by national legal provisions,
3. free from interference, free to communicate publicly,
4. meritocratic nomination procedures
5. adequacy of resources
6. access to information to carry out its mandate

On the independence of macroeconomic forecasts, the regulation indicates that such forecasts can be either **produced** by independent bodies as defined above or **endorsed** by independent bodies.

Finally the regulation also introduces the concept of **“economic partnership programmes”** whereby countries under an excessive deficit procedure need to present to the Commission and the Council the policy measures and structural reforms needed to ensure an effective and durable correction of the excessive deficit. These would include growth enhancing structural policies which would be necessary to support any fiscal adjustment necessary to address the excessive deficit.

The following section will examine the developments in Government finances in Malta over the recent history in order to provide a view of Malta’s fiscal performance also pointing to the importance of the interaction
between the dynamics of Government finances and the dynamics of growth and the business cycle. By doing so, the following section will guide the discussion on the dynamics of fiscal developments as well as the extent of fiscal consolidation in Malta over the past, despite the absence of fiscal rules, thus putting into context the requirements set out by enhanced fiscal governance.

2.1.5 Beyond the EU Fiscal Governance Frameworks

The strengthening of the SGP presents a formidable step forwards by the EU towards a stronger fiscal framework which promotes more sustainable fiscal and economic policies in the long term whilst preserving the stabilisation role of fiscal policy in the short term. It is also expected to lead forward enhanced efforts by EU member states towards stronger fiscal governance. However it is important to emphasise that the new regulatory framework will be insufficient to ensure prudent fiscal policy. Indeed the success of the new fiscal governance framework will always depend on a stronger political will to abide by it and to comply with the spirit of the framework. For instance the setting up of a fiscal institution to oversee the compliance with fiscal rules will not safeguard the sustainability of public finances if the fiscal institution is not given the appropriate resources or its independence and credibility is undermined by the Government the first time such an institution criticises Government policy. It is thus important to emphasise that the application of rules governing the fiscal governance frameworks be consistent with certain basic principles to be considered in further detail in this paper.

Secondly it is also important to emphasise that whilst the EU fiscal governance framework provides a common platform for the necessary reforms in the EU, it is imperative that the fiscal governance framework in every member state addresses the country specificities and is tailored to its needs and characteristics. What applies to a country with a long history of fiscal discipline with specialised resources developed over a long time may not apply for a small open economy which is still developing its fiscal framework. What may apply for a country whose electorate has long been debating fiscal prudence may not necessarily apply for a country where fiscal prudence has rarely been an electoral issue. What applies for a country with a strong, independent and financially literate media watchdog may not apply for a another where the support of such media is still to be developed. The following chapter will address some of these specificities, starting from the analysis of presence or otherwise of deficit bias in Malta and its possible sources.
3. Fiscal Developments in Malta
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As indicated in Chart 3.1, over the period 2000-2005, general Government revenue was following an upward trend. The trend was reversed in 2007 as the revenue-to-GDP ratio declined between 2007 and 2010. Meanwhile, general Government expenditure peaked in 2003, and followed a declining trend thereafter, apart from the slippage recorded in 2008.

As a result of these developments, the general Government deficit ratio to GDP declined from 9.2 per cent of GDP in 2003 to 2.7 per cent in 2011. Over this time period it is clear that the deficit followed a declining trend and stabilised close to the SGP benchmark of 3 per cent. However notable reversals from this trend were clearly evident in 2003 and 2008 which incidentally coincided with election years.

Developments in public finances relative to cyclical economic developments are illustrated in Charts 3.2 and 3.3, which depict the output gap against the change in the primary balance. It is assumed here that the output gap is a relatively good measure of cyclical conditions. The measure of the output gap used in this chart is that measured by DG Ecfin as published in the AMECO database. The chart presents a clear indication that fiscal policy in Malta since 2000 has been pro-cyclical. It suggests that fiscal consolidation efforts tended to take place when the economy least could support them and fiscal expansions tended to take place in times when fiscal consolidation was necessary to prevent the build up of economic imbalances.

Whilst a-priori one cannot exclude the possibility of a deficit bias due to the electoral cycle this is not a sufficient and adequate representation of fiscal policy in Malta over the last decade. It is worth noting that this period was initially marked by relatively high debt ratios often exceeding 60 per cent of GDP (especially since 2003) and relatively high deficit ratios exceeding 6 per cent of GDP. Thus the pro-cyclical element could also be attributable to the need to revert to more sustainable fiscal positions irrespective of the business cycle. In effect one may convincingly argue that fiscal policy in Malta took into account the starting position and thus had to give more importance to the need for fiscal consolidation rather than short-term economic stabilisation objectives. Counter cyclical fiscal policy is desirable but only as long as one starts from a credible and sustainable position. In this context the chart below is presented as a matter of fact and should not be construed to be overly judgemental of the fiscal stance over the last decade.
Furthermore it is also worth noting that an alternative interpretation of cyclical conditions based on growth in excess of a historical average of 2 per cent (see Chart 3.4) suggests that overall fiscal policy in Malta was not always clearly pro cyclical.
3.1 The Sources of Fiscal Consolidation Efforts

In general, between 2000 and 2011, improvements in the primary balance were supported by a decline in the general Government expenditure ratio with 2001, 2003 and 2008 being exceptions to this general trend. These expenditure slippages coincided with the major fiscal slippages that took place over this period. However this also suggests that the expenditure slippages were often not permanent slippages and often reflected one-off factors such as the privatisation of the shipyards. The coincidence with the electoral cycle however suggests that a rules-based framework which limits the political discretion over exceptional expenditure growth and encourages long-term planning of major reforms may be appropriate for Malta.

As illustrated in Chart 3.5, the fiscal slippages noted in 2001, 2003 and 2008 were almost invariably...
caused by expenditure slippages with revenue acting as a partial shock absorber. Only in 2008 was the expenditure slippage exacerbated by revenue slippage. It is also worth noting that the **major sources of fiscal consolidation efforts in Malta particularly in the middle of the last decade and in the run-up to euro area membership occurred primarily on the basis of revenue increases supported by expenditure consolidation measures**. However this analysis fails to take into account whether the changes in revenue or expenditure were due to normal cyclical conditions or whether they were the product of structural fiscal consolidation measures.

In this context, it is also important to decompose the fiscal strategy (change in the deficit) to distinguish the effect of automatic stabilisers, such as changes in income taxes and welfare payments related to the economic cycle, from the structural fiscal effort resulting from fiscal policy measures such as the increase in VAT or pension reform initiatives and from the impact of changes in one-off and temporary measures. The structural effort is further decomposed into the changes related to public investment and in interest payments.

Whilst a structural effort typically represents a more permanent correction in the deficit it is opportune to distinguish between a reduction in public investment from other forms of structural consolidation efforts. Whilst both contribute towards the budgetary position, a reduction in public investment can have negative effects on the long-term growth potential of the economy and thus on the future sustainability of public finances. Furthermore, while changes in interest payments also affect the structural effort they are primarily reflecting past fiscal positions and market conditions and can at best only be altered materially through debt restructuring efforts. The decomposition of the fiscal strategy also allows one to identify the role of automatic stabilisers in acting both as a source of fiscal consolidation in good times and as a countercyclical economic stimulus in recessionary times.

The more recent period covered by Chart 3.6 can be divided between years of fiscal consolidation and fiscal expansion, the latter being represented solely by the fiscal developments in 2008. It is notable that this period was primarily characterised by fiscal consolidation efforts which underlined the trend reduction in the deficit. Can this fiscal consolidation effort be considered to have been permanent and sustainable? The type of fiscal consolidation effort is an important determinant of the sustainability of such an effort. Fiscal consolidation efforts are more sustainable if they are more reliant on structural fiscal measures and less reliant on one-off deficit reducing measures or on favourable cyclical conditions which are by definition temporary.
In the period leading to the adoption of the euro, fiscal consolidation was marked predominantly by structural measures although in 2006 and 2007 lower public investment partly or fully underlined the structural effort. Lower interest payments also contributed positively over this period. One-off deficit reducing measures only featured in 2005 as a major source of fiscal consolidation. Overall this suggests a relatively permanent and sustainable fiscal correction although the reliance on lower public investment over this period raises some concern over the long-term sustainability of fiscal consolidation.

The use of lower public investment as a source of fiscal consolidation has become less of a feature in the consolidation efforts post euro adoption. This partly reflects the impact of EU funds which are largely deficit neutral and subject to an expiry date. However with the exception of 2011 there is a higher reliance on one-off measures which raise some doubts on the permanent nature of the fiscal effort post euro adoption. On the other hand such one-off measures may in part be justified as a response to non-repeatable deficit increasing costs such as the shipyards privatisation.

Exceptional expenditure outlays towards the shipyards and utilities sector contributed towards an increase in the fiscal deficit ratio to GDP in 2008, which worsened by 2.2 percentage points, and was reflected in negative structural effort and one-offs. Nevertheless, a decline in public investment, in addition to the impact of automatic stabilisers, dampened the deterioration of public finances recorded in 2008.

Against the backdrop of the 2009 recession, Government continued to consolidate its public finance position by 0.8 percentage points. The fiscal stance remained restrictive primarily through a notable structural effort of 1.6 per cent of GDP. Half of this effort however reflected the phasing out of the impact of the privatisation of the shipyards undertaken in the previous year. Public investment was also reduced marginally by 0.2 per cent of GDP. The bulk of the adjustment, however, reflected a structural effort which included higher tax proceeds from the annual circulation tax and lower subsidies mainly reflecting the termination of financial support to the utilities sector. In addition higher revenue, in particular from a scheme providing for a reduction in interest and penalties due on outstanding tax balances contributed further to the fiscal consolidation efforts. At the same time the contractionary impact of the fiscal strategy in 2009 was partly offset by automatic stabilisers which almost totally offset the structural effort and thus provided an important stimulus to the Maltese economy.

Notwithstanding the partial reversal of the fiscal structural consolidation registered in the previous year, the overall Government fiscal position in 2010 remained relatively stable. Higher one-off revenue, together with the deficit-reducing effect of automatic stabilisers as the economy recovered from the previous year’s recession accounted for such stability in the fiscal position.

Fiscal consolidation in 2011 accelerated in line with the Council recommendations to end the excessive deficit through a significant structural effort. An overall improvement in the Government fiscal balance of 1.0 percentage point was achieved. This was mainly the result of a restrictive fiscal strategy which increased structural effort, although partially offset by a marginal increase in interest expenditure and an increase in public investment expenditure. The continued growth registered by the Maltese economy contributed further to the fiscal consolidation effort through the impact of automatic stabilisers.

3.2 Debt Dynamics

The developments in public debt reflect to an extent the developments in the primary balance recorded over the past years, as well its interaction with economic growth to interest rate differential and more recently stock-flow adjustments. In any particular year the change in debt can be decomposed according to the following formula:
The term on the left hand side of the equation gives the change in the debt to GDP ratio. The first term on the right gives the differential between the effective real interest rate on debt \( r_t \) and the real growth rate of GDP \( g_t \) multiplied by the lagged debt ratio. The second term is the primary balance \( \text{pbt} \) as a ratio of GDP. The last term is the stock flow adjustment \( \text{sfa} \) representing anything else apart from the other two determinants which explains the debt dynamics including valuation effects and below the line fiscal operations.

As illustrated in Charts 3.7 and 3.8, between 2000 and 2004, the ratio of general Government debt to GDP followed an upward trend, increasing from 54.9 per cent in 2000 to 71.7 per cent in 2004. This primarily resulted from persistent primary deficits and a negative growth to interest rate differential from 2001. Indeed the slowdown in economic growth registered over this period led to a negative growth to interest rate differential which was not supported by the commensurate primary surpluses.

Subsequently, the debt ratio registered significant declines, aided primarily by a positive growth to interest rate differential as well as resort to privatisation proceeds to reduce the public debt borrowing requirement. This was a period characterised by a strong economic recovery, improved credit rating and lower interest payments on public debt. In the run-up to euro adoption fiscal consolidation led to primary surpluses which further supported the reduction in the debt to GDP ratio.

In 2009 and in the subsequent years the trend was again reversed and general Government debt increased to 72.0 per cent of GDP in 2011. Economic activity was weak due to the recessionary environment and growth failed to offset the interest payments partly contributing to the rise in the debt to GDP ratio. Furthermore the fiscal position returned to a primary deficit further exacerbating the debt dynamics.

A notable feature during this period is however the positive estimated Stock Flow Adjustment (SFA) which

![Chart 3.7: Deficit and Debt Developments](chart.png)

*Chart 3.7: Deficit and Debt Developments*

*A positive sign represents a reduction in the debt to GDP ratio*
added further to the rise in the debt to GDP ratio. This partly reflects an increase in the size of Government debt related to Malta’s contribution in view of the agreement approved by the Euro Area Member States in pursuance of a decision of the Council of the European Union providing for the lending of money to the Hellenic Republic, the loan to Air Malta, and the EFSF debt re-routing procedure.

3.3 Macroeconomic Projections and the Deficit Bias

The fiscal strategy in any particular year often depends on an accurate prediction of the macroeconomic developments and their impact on public finances. An optimistic macroeconomic scenario could often lead to fiscal targets being missed altogether. If this occurs persistently a deficit bias could result. Deficit bias can also arise if expenditure developments are consistently underestimated due to socio-economic factors such as the cost of healthcare and the ageing population. It is thus important to determine whether fiscal planning is based on unbiased or realistic figures which may otherwise hamper budgetary discipline in a significant way.

As a result, the performance of macroeconomic forecasts is also an essential element in setting Government policy and in guiding Government in achieving its planned targets. An evaluation of the performance of fiscal and macroeconomic forecasts against actual data would therefore also be useful in assessing the fiscal developments in Malta in line with the enhanced fiscal governance structure being proposed.

Overall with the exclusion of 2008 and the recession of 2009, fiscal slippages were rather limited ranging from a slippage of 0.4 per cent of GDP in 2006 to better than expected fiscal position in 2011 of 0.1 per cent of GDP. This is illustrated in Chart 3.9. The fiscal slippage in 2008 was partly influenced by the shipyards privatisation. According to the 2010 Update of the Stability Programme the cost of the shipyards privatisation amounted to 1.9 per cent of GDP in 2008 and 0.3 per cent of GDP in 2009. However, even if one were to remove the cost of the shipyards privatisation the fiscal slippage in 2008 and 2009 remains significant. It is clear that the effect of automatic stabilisers explains the fiscal slippage in 2009 and therefore the deterioration was purely cyclical. **However the fiscal slippage in 2008 cannot be explained by such macroeconomic developments. The un-budgeted costs of various collective agreements signed in 2008 exerted a significant effect on Government’s ability to meet budgetary targets.**
Whilst such expenditure components can be considered as temporary and exceptional there is no reason to conclude that such extraordinary expanses cannot be planned well in advance within the budgetary process. **In this context it is important to stress that the fiscal slippage in 2008 is partly due to a weak medium term budgetary framework.**

For 2009 and 2010 the absence of any significant fiscal slippages masks an increasing tendency towards optimistic revenue projections which subsequently do not materialise. **These revenue slippages were typically offset by expenditure control, primarily public investment.** It is to a great extent clear that budgeted funds for public investment projects are acting as some sort of contingency reserve fund, cushioning the impact of revenue slippages. This practice can have serious consequences on the ability to forecast macroeconomic conditions and to have a clear understanding of important budgetary conditions. **It may also have created a dangerous practice of regarding public investment as a major source of fiscal consolidation** and could explain the low public investment to GDP ratio observed in Malta relative to other small EU member states with similar levels of development. This practice should be discontinued and should be replaced by tailor-made instruments designed specifically to absorb unexpected variations in underlying fiscal conditions.

A comparison of the budgetary targets presented in successive issues of the Stability and Convergence Programmes since 2005 is also provided in Chart 3.10. The chart distinguishes between successive forecasts for the year coinciding with the forecast exercise and successive forecasts of future years up to three-year-ahead forecasts. Obviously forecast errors for the current year are expected to be lower than the three-year-ahead forecasts as forecast uncertainty increases with time. The average forecast error should however be close to zero and persistent forecast errors in one direction are indicative of a deficit bias. Forecast errors do rise with time in line with a-priori expectations. However some further important conclusions can be drawn from the analysis presented. **First of all there is no clear indication of an improvement in forecast accuracy over the time period under consideration.** Secondly, with the exception of the forecasts for the current year, all other forecasts show a tendency to underestimate the deficit. This presents a clear case of a deficit bias for years t+1 to t+3. **Thirdly the deficit bias increases over the medium term framework** with t+2 forecast errors averaging 1.6 per cent of GDP and t+3 forecast errors averaging 3 per cent of GDP. **Forecasts errors for t+1 which, are of vital importance to the operation of the European Semester, average 0.64 per cent of GDP and almost invariably represent slippages from fiscal targets.**
Forecast errors can be attributable to errors in macroeconomic forecasts, errors in estimating the impact of fiscal measures or weaknesses in the ability to link fiscal projections with sound macroeconomic projections. In a paper published by the Economic Policy Department in the Economic Bulletin of June 2012 no clear evidence of a systemic bias in macroeconomic projections was found whilst some element of bias in nominal GDP growth forecast was identified.

Chart 3.11 confirms those findings. If one excludes the recession of 2009 which was not predicted by the Ministry’s forecasts, forecast errors range from -2.5 percentage points of GDP growth to +1.6 percentage points of GDP growth. A tendency to produce optimistic nominal growth forecasts for the current year is
evident. If one excludes the recession of 2009 the average forecast error is of 0.5 percentage points of GDP growth. However the relevance of current year (versus t+1) forecasts is diminishing with the strengthening of the European Semester which is primarily aimed at assessing the fiscal projections of year t+1 and beyond. For subsequent years, whilst the variance of forecast errors for any year tends to increase as expected the average forecast error excluding the 2009 recession is actually negative for t+1 and t+2 and marginally positive for t+3 (+0.1 % points of GDP growth). There is thus no indication of systemic bias in nominal GDP growth forecasts except for the current year and macroeconomic projections do not explain the fiscal slippages observed previously.

3.4 Conclusion
This evaluation suggests no systematic bias in nominal growth forecasts for years beyond the current year. This suggests that fiscal slippages for years t+1 are due to lack of consistency between the budgetary targets and the underlying macroeconomic projections. Economic models which underpin fiscal projections with macroeconomic projections should be used more extensively. Such models are available within the Economic Policy Department. Furthermore the ability to measure the impact of discretionary fiscal measures could be an additional source of forecast errors. The ability to quantify the impact of discretionary fiscal measures should also be strengthened. The analysis also suggests that a stronger fiscal governance framework supported by rules and independent fiscal institutions could be beneficial to ensure fiscal prudence. However, would such rules and frameworks risk undermining the stabilisation role of fiscal policy? To address this question the next chapter evaluates the link between fiscal policy and economic growth as developed in the economics literature.
4. The Role of Economic Growth
4. The Role of Economic Growth

As already argued above, the empirical evidence available for Malta shows that indeed, the evolution of national income and the implied cyclical developments have important implications for deficit and debt dynamics. There is widespread agreement in the economic literature that economic activity and fiscal developments are relatives. This does not mean that the economic literature on fiscal consolidation is not rife with conflicting theories and observations of the relationship between the two. In particular is fiscal indiscipline a cause of weak economic activity and soaring public debt or is it the other way round; weak economic activity leads to soaring debt levels and unsustainable public finances? Central to this debate is the conventional Keynesian hypothesis that fiscal austerity reduces aggregate demand and economic activity versus the notion of “expansionary austerity” where fiscal retrenchment is deemed to strengthen households and business confidence, lower interest rates and thereby raise aggregate demand. But even if one were to accept the Keynesian hypothesis that fiscal consolidation reduces aggregate demand, under what conditions would fiscal contractions lead to successful fiscal consolidation despite the negative impact on growth? This would depend on the sensitivity of economic growth to fiscal shocks; in other words it will depend on the size of fiscal multipliers. The following chapter provides a literature review of these important themes.

4.1 Debt Accumulation and Its Sources

Several papers in the economic literature explore the main sources of sharp debt accumulation in history. Most of these episodes were related to major military events or to financial crisis. Reinhart and Rogoff (2009) suggest that public debt could rise by almost 90 per cent in a space of three years following a banking crisis whilst Baldacci et al (2009) indicate a rise in the debt-to-GDP ratios of about 40 percentage points following banking crisis.

For advanced economies rising trends in the debt ratios are evident since the 1970s and a combination of positive interest-growth differential and deteriorating primary balance often underlines such trends (Abbas et al, 2011). Indeed Abbas et al show that whilst high and middle income growth countries (countries experiencing trend growth rates above 3 per cent) have managed to stabilise the rising trend in debt to GDP ratios since the mid 1980s, low growth economies continued to sustain the rising debt-to-GDP ratios experienced since the early 1970s.

This suggests that low economic growth has a central role in determining debt accumulation either through the relatively sudden impact of financial crisis or through a more protracted impact of weak economic activity. A selection of major advanced economies1 (including those with relatively high debt-to-GDP ratios above 100 per cent)2 further supports the hypothesis that economic growth has been a lagging indicator of debt accumulation since the 1980s. Chart 4.1 indicates that the average real growth of the preceding twelve years is negatively correlated with the debt to GDP ratio. The correlation is however not perfect suggesting that other economic factors such as inflation, interest rates, discretionary fiscal policy and stock-flow adjustments can influence public indebtedness.

4.2 The Impact of High Debt on Economic Growth

However it is also interesting to note in Chart 4.1 that 12 year forward growth rates are not as strong a leading indicator of public indebtedness. In other words high indebtedness is not necessarily as strong an indicator of weak economic activity at least over the subsequent twelve years. This does not mean that high debt cannot be associated with low growth. A simple correlation analysis does not control for other factors determining growth nor does it determine causation. There are various channels through which high public indebtedness could undermine long-term growth: high public debt could adversely affect capital accumulation, raise long-term interest rates, raise future distortionary taxes, and create financial instability and uncertainty about prospects and policies.
Reinhart and Rogoff (2010) find that the difference in median growth rates of GDP between low debt (below 30 percent of GDP) and high debt (above 90 percent of GDP) groups is 2.6 percentage points in advanced economies over the period under analysis. However these estimates are based on simple correlation analysis which again do not control for reverse causality; that low growth could be causing high indebtedness rather than the other way round. By contrast Kumar and Woo (2010) use a regression-based model which controls for other determinants of growth whilst avoiding the problem of reverse causality by using initial values of debt to determine subsequent levels of growth. **On average, a 10 percentage point increase in the initial debt-to-GDP ratio is associated with a slowdown in annual real per capita GDP growth of around 0.2 percentage points per year.** The impact is somewhat smaller in advanced economies where a 10 percentage point increase in initial debt-to-GDP ratio is associated with a growth slowdown around 0.15–0.2 per cent in advanced economies, compared to 0.3–0.4 per cent in emerging economies. IMF (2010) estimates based on a dynamic general equilibrium model similarly suggest that a 10 percentage point decrease in the debt ratio of the Euro area, US and Japan would raise GDP by 1.4 per cent over the long term.

### 4.3 Fiscal Adjustment and Debt Reduction

In the advent of the great recession, the significant increase in public indebtedness, particularly in many advanced economies, has brought to the fore the question of successful fiscal consolidation. On the interaction between growth and fiscal consolidation two alternative schools of thought are evident in the economic literature. According to the Keynesian view fiscal contractions reduce aggregate demand and growth in the short-term.

Does this mean that fiscal contractions do not necessarily lead to a reduction in public indebtedness? This depends on the size of the fiscal multipliers which in turn depends on the time period under analysis, the development stage and the openness of the economy, the exchange rate regime and the monetary policy reaction function, monetary conditions and the initial value of the debt coupled with the composition of the fiscal adjustment. **The higher the fiscal multiplier the more costly is the impact of fiscal consolidation on growth to the extent that if the economic impact is significant (often associated with high multipliers exceeding 0.9) fiscal consolidation could actually be self-defeating and lead to higher rather than lower debt.**
4.4 Expansionary Austerity?

The economic literature however also indicates instances where fiscal expansion can be growth enhancing even in the short-term (Alesina and Perotti, 1995, 1996). Barry and Devereux (1995) show that when using a neo-Keynesian framework that embodies inter-temporal effects of the Ricardian Equivalence, a fiscal contraction conducted through a reduction in Government spending may support economic activity through an impact on expectations. In particular, the reduction in future tax burden associated with a fiscal contraction is hypothesised to generate an improvement in consumption and investment that leads to an increase in aggregate demand and to an improvement in output (and in some cases even employment). The extent of the aforementioned dynamic depends, however, on the magnitude and perceived permanence of the fiscal measures.

Nevertheless in a seminal paper in the World Economic Outlook (2010) the IMF clearly qualifies the conclusions of the “expansionary austerity” studies of the 1990s. In particular the IMF casts doubt on the identification of periods of fiscal adjustment through the use of changes in the cyclically adjusted budget balance since this is shown to bias the results in favour of showing expansionary effects of fiscal consolidation in the short-term whilst downplaying the contractionary effects of fiscal consolidation. The IMF paper draws out the following important conclusions on this matter:

1. **Fiscal consolidation exerts a contractionary effect on economic activity.** Typically a fiscal effort of 1 per cent of GDP reduces GDP by 0.5 per cent within two years and raises unemployment.

2. Monetary policy and flexible exchange rates can cushion somewhat the impact of fiscal contractions. **However if interest rates are close to the zero lower bound and exchange rates do not react** (for instance when exchange rates are fixed) **the effects of fiscal consolidation on economic activity can be at least twice as large in the short term.** In this case a one percentage point of GDP in fiscal consolidation is expected to reduce GDP by 1 per cent within two years.

3. Furthermore **if fiscal consolidation is coordinated among countries when monetary policy is constrained by the zero lower bound the impact on GDP of a small open economy can be twice as large as the fiscal shock due to international spillovers.** This is a particularly important finding for the conduct of fiscal coordination during a severe recession in a monetary union such as the Euro area. It is important to note that in the absence of escape clauses allowing for recessiory periods fiscal rules greatly enhance fiscal policy coordination when Euro Area economies face common shocks. If this occurs at a time when monetary policy has reached the limits of the zero lower bound, fiscal consolidation can become self defeating and propel a monetary union into a debt spiral. This is indeed a major concern surrounding the current fiscal governance framework. It could also be a valid explanation of the failure of programme countries in the Euro Area to meet deficit and debt targets despite the severe austerity measures. This finding clearly underlines the importance of the application of escape clauses in fiscal rules and the relevance of ensuring that the rules are as counter cyclical as possible. But even in the absence of such common shocks, the lack of monetary policy independence within a monetary union make it more difficult for fiscal consolidation to take place since the efficiency of fiscal consolidation is reduced if not supported by monetary stimulus.

4. Another important qualification of the IMF paper relates to the debate about the composition of fiscal consolidation. The results suggest that expenditure consolidation tends to be more growth friendly than tax-based consolidations. But part of this difference emanates from the reaction of the monetary authorities which tend to accommodate spending cuts which are typically less inflationary but tend to raise policy rates particularly when indirect taxes are raised because these raise inflation. In a monetary union, a member state facing unilateral shocks to its economy is unlikely to benefit from monetary support when carrying out expenditure based consolidation programmes. On the other hand it can take advantage of indirect tax measures which are unlikely to have an impact on the inflation rate of the whole monetary union particularly if the country is small. **As a result the presumed superiority of expenditure based versus revenue based fiscal consolidation with respect to their impact on economic growth is minimised in a monetary union.**
5. Fiscal consolidation in countries associated by financial markets with higher sovereign default risk can implement fiscal consolidation at a lower cost to growth as this reduces the perceived risk. Nevertheless there is no clear evidence of “expansionary austerity” even among such cases.

4.5 Fiscal Multipliers

A central theme to the economic impact of fiscal consolidation is the magnitude of fiscal multipliers. The smaller the multiplier the less taxing fiscal consolidation is on economic activity. A major hypothesis that has been explored in recent literature is the asymmetry of fiscal multipliers across the business cycle. In particular Auerbach and Gorodnichenko (2012) show that multipliers of Government purchases are larger in recessions typically twice as large as in normal times. The IMF suggests that in periods of recession constrained by the zero lower bound, fiscal multipliers can range from 0.9 to 1.7. This implies that fiscal stimulus is more effective and fiscal consolidation is more costly in recessions. This further attests to the importance of ensuring counter-cyclical fiscal policy.

Nevertheless Auerbach and Gorodnichenko (2012) make some other important qualifications to these findings which are of direct relevance to a country like Malta. First of all fiscal multipliers are inversely proportional to the debt-to-GDP ratio. Furthermore, the cyclical variation in the size of the output multiplier vanishes as the level of debt approaches 100 percent.

Secondly, rigid labor market actually increase the output response of fiscal stimulus in recession and the cyclical variation in the fiscal multiplier becomes more pronounced. This pattern is consistent with the view that more rigid labor markets can result in enhanced effectiveness of Government spending shocks to stimulate output during a downturn. It also suggests that fiscal consolidation can be more costly during a recession in the presence of labour market rigidities. This is an important consideration for Malta in view of the COLA mechanism.

Finally macroeconomic theory suggests that fiscal multipliers are likely to be smaller in open economies due to the significant leakages in the form of imports. Auerbach and Gorodnichenko (2012) do not find evidence supporting this conclusion although omitted variable bias is suspected. Indeed Ilzetzki et al. (2010) report that the Government spending multiplier is larger in closed economies than in open economies.

These findings suggest a limited role of fiscal stimulus in recessionary periods for a small open economy like Malta with a relatively high debt-to-GDP ratio in excess of 60 per cent. They also suggest that fiscal consolidation in a recession can be less costly to such an economy. Furthermore the European Commission (2012) estimate that the critical multiplier for Malta above which fiscal contractions can lead to a short-term increase in the debt-to-GDP ratios to be 0.9. This is a relatively high multiplier which reduces the probability that fiscal consolidation fails to reduce the debt-to-GDP ratio. Critical values range from as low as 0.5 for Greece and 0.6 for Italy to as high as 2.8 for Estonia. However an empirical analysis for Malta using an econometric model is provided later on.

4.6 Short-term vs Long-term Effects

Whilst high fiscal multipliers can undermine the success of fiscal consolidation efforts in the short term, in the long term successful fiscal consolidation efforts are primarily the result of primary surpluses. A study conducted by the IMF (2009) which involved debt decomposition concluded that the top ten largest reductions in debt ratios in advanced economies over the past three decades occurred largely by running primary surpluses. Nevertheless, the same study also found that it was much easier for Governments to run stronger primary balances when growth was higher. In fact, higher growth raises revenues and when this revenue is not spent, the effect on debt dynamics can be very strong.

The question is, how long does it take fiscal consolidation to reduce public indebtedness? The European
Commission (2012) (The Quarterly Report of the Euro Area) provides another very interesting analysis of fiscal multipliers complementing the work on fiscal multipliers by the IMF in the World Economic Outlook of October 2012. The analysis concedes that fiscal consolidation can lead to an increase (not decline) in the debt ratio at least in the first two years of the consolidation process. If confidence is restored immediately with fiscal consolidation (and assuming financial markets are not “myopic”) this period can be reduced slightly. But if confidence is not restored, the situation deteriorates even further.

It is however worth noting that the recent experience among the Program Countries experiencing sovereign bond market distress suggests that sovereign bond yields in programme countries can remain excessive even in the case of the more “credible” of the fiscal consolidation strategies. Furthermore, the high persistence scenario presented in the same paper is not to be discounted either as the Commission seems to do. This crisis has already been going on for 5 to 6 years after all and the persistence implied by the paper is really a reference to the high multipliers which typically prevail under recessionary conditions compared to normal times. This suggests that the increase in the debt ratio could remain above a baseline case where the primary balance is simply stabilised for a range of minimum four years to a maximum of infinity under a very worse case scenario. Judging by recent experience in the sovereign debt crisis in Europe one also has to keep in mind that consolidation often takes place over a number of years since it is difficult to implement drastic measures over one year when the fiscal adjustment required could be as high as 12 percentage points of GDP. Indeed, the scale of the necessary adjustment during the European sovereign debt crisis suggests that the consolidation process in countries could take as much as 4 to 5 years. So probably we are seeing a minimum of 6 years under very optimistic assumptions before debt to GDP turns to baseline and more years before the debt to GDP ratio actually starts to decline.

Another interesting point that emerges from this analysis is the pivotal role of the monetary authorities to make sure that excessive sovereign bond yields are addressed through central bank purchases. In the absence of such action and support from the central bank the confidence in sovereign markets is unlikely to be restored thus undermining completely the fiscal consolidation over an indefinite period!

4.7 Growth Friendly Fiscal Consolidation; Expenditure vs Revenue Based Consolidation

Milesi-Ferretti and Roubini (1998) show that a consumption tax affects the choice between time spent in productive activities such as labour and education and the time spend in leisure in favour of the latter, thus reducing the growth rate of the economy. At the same time, the same study also finds that income taxes also lead to a similar dynamic while concurrently also negatively affecting capital accumulation, therefore reinforcing the notion that a revenue based consolidation process would have negative implications for economic growth. An analysis conducted by the OECD (2010) supports the view that revenue based consolidation weighs down on economic growth. In particular, the OECD finds that corporate taxes are the most harmful type of taxes for economic growth, followed by personal income taxes and then consumption taxes.

Baldacci et al. (2011) take into account the current post-financial-crisis context, noting that the fiscal adjustment needed will have to take place in an environment of extended private sector deleveraging and economic uncertainty, thus also implying that fiscal consolidation might have to be achieved over a longer time span compared to past consolidations. In particular, while finding that successful debt consolidation is in general more likely when it is based on expenditure policy, they also find that with respect to consolidation following a banking crisis, a revenue based strategy may also increase future growth potential. However, akin to studies mentioned earlier, they also stress the importance of simplifying the tax system by reducing excessive tax rates and broadening the tax base, thus not harming tax efficiency. Additionally, Baldacci et al. also note that political fragmentation and the proximity of elections both make debt reduction more difficult and, as a result, they call for credible medium-term fiscal plans which are backed by strong and transparent fiscal institutions.
It is also intuitive that the extent of effort in one type of consolidation strategy or the other may depend on the initial degree of revenue and expenditure ratios of Government. In this regard, the IMF (2009) noted that many advanced economies already have a fairly high revenue-to-GDP ratio and that therefore a large part of the adjustment effort would need to take place on the spending side. The OECD (2012) also noted that the extent to which revenue or spending will have a bearing on consolidation will necessarily depend on whether spending is already high.

The IMF (2010) supports the view that expenditure based fiscal consolidation is more growth friendly than revenue based consolidation. However the IMF paper qualifies this result by showing the extent to which this result is due to the reaction of monetary policy. In the absence of accommodating monetary conditions the difference between the two is likely to be less significant. The study also suggests that the impact of expenditure based consolidation differs depending on the expenditure being reduced. Consolidation through lower public investment or Government consumption tends to be costly in terms of economic growth whilst lower transfer payments are relatively benign.

The IMF (2009) and OECD (2012) also propose structural reforms within the tax system. In particular, both suggest a broadening of tax bases by eliminating tax expenditures (such as tax credits and deductions), the reduction in tax rates, and the improvement of the extent to which taxes correct for externalities (for example tax support towards research and development and environmental taxes). Both the IMF and OECD also suggest improving the fight against tax evasion, as well as improved efficiency in public finances, particularly should a consolidation strategy based on freezing spending be pursued. In particular, it is argued that costs should be minimised by aiming to improve allocative efficiency (better use of resources) and technical efficiency (maximising output for a given input). In addition, the OECD (2012) also notes the importance of addressing drivers of future spending pressures, in particular in the case of spending related to pensions and population ageing. The OECD (2012) further suggests that when necessary increases in taxes or marginal tax rates are identified, measures should be oriented to those tax bases that have less distortionary effects as this can help make fiscal consolidation on the revenue side less costly to long-term output.

4.8 Conclusion

Deciding on the right policy mix for growth friendly fiscal consolidation therefore requires taking into account multiple factors. Both the short-term and the long-term need to be addressed as the results of both approaches will have important implications for the paths of economic growth and fiscal consolidation. Additionally, the context is also highly important as was shown in the case of a small open economy experiencing the effects of a coordinated fiscal consolidation in the context of constrained interest rates and exchange rates. Moreover, the importance of the political climate prevailing in a country is also a determining element which calls for appropriate fiscal institutions which can uphold the credibility of national fiscal plans.

Equipped with the knowledge of the important and far reaching elements of growth friendly fiscal consolidation, it is now possible to delve into the various possible courses of action in terms of the fiscal rules possible. The next section will therefore take an in-depth look at the various fiscal rules that could be adopted by Malta, taking into consideration the technical aspects affecting Government finances, as well as the pros and cons of the various rules conditional on their underlying features. This will be an important step before subsequently moving on to a more practical performance based assessment for the local policy context.

Footnote:

1 United Kingdom, France, Germany and Spain
2 United States, Japan, Italy, Belgium, Greece and Portugal
5. Strengthening the National Fiscal Framework
5. Strengthening the National Fiscal Framework

The economic analysis presented so far suggests that a deficit bias exists. There is also scope for fiscal policy to smoothen business cycles in Malta even though such a tool may have limitations in a small open economy. If anything a counter-cyclical fiscal policy should ensure more stability and long term sustainability in public finances and reduce the risk of loss of confidence in the sovereign debt markets. There is a need to preserve public investment which is essential for long-term growth and avoid using public investment as a pro-cyclical buffer for public finances. A need to strengthen the medium to long term budgetary planning has clearly emerged from the analysis. The budgetary process should be more closely linked with macroeconomic developments and forecasting and a clearer separation between the budgetary planning process and the political mandate should be established. Finally, the evolution of the European Semester and the strengthening of the fiscal governance framework in the EU needs to be respected in line with Malta’s commitments at an EU level.

In order to transpose the provisions introduced in the 2011 reform of the Stability and Growth Pact, the key requirements in five areas of budgetary policy-making outlined in the Directive on requirements for budgetary frameworks of the Member States, as well as the initiatives to strengthen budgetary discipline and economic policy coordination outlined in the Treaty on Stability, Coordination and Governance, Malta needs to strengthen its national fiscal framework. This section analyses the various possibilities in terms of fiscal rules and budgetary institutions that Malta could adopt in fulfilment of the requirements of the Stability and Growth Pact, the Directive on requirements for budgetary frameworks, and the Treaty on Stability, Coordination and Governance.

5.1 Fiscal rules – anchoring expectations for sustainable public finances

Fiscal rules may be defined as a permanent constraint on fiscal policy in terms of a summary indicator of fiscal performance such as Government budget deficit, debt or a component of the budget. They are indeed institutional mechanisms aimed at supporting fiscal credibility and discipline. The use of fiscal rules is often associated with improved fiscal performance (European Commission, 2006 and 2009; and IMF, 2009). However, the success of fiscal rules in ensuring fiscal prudence and fiscal sustainability is conditional on a number of other factors.

A rule has to be credible with regard to its ability to help deliver the required adjustment and put debt on a sustainable path. But it should also have adequate flexibility to respond to shocks. This section also discusses the issue of coverage of rules, the extent to which rules should respond to past deviations, and the importance of effective monitoring and enforcement procedures. Finally, rules need to be considered in their proper context; medium term budgetary framework. The strength of the fiscal institutions and an effective medium term budgetary framework contribute significantly to the success or failure of fiscal rules.

5.1.1 Designing fiscal rules

A fiscal rule is defined as a permanent constraint on fiscal policy through simple numerical limits on budgetary aggregates (Kopits and Symansky, 1998). A rule delineates a numerical target over a long-lasting time period with a view to guiding fiscal policy; it specifies a summary operational fiscal indicator to which it is applicable; and it is simple so that it can be readily operationalised, communicated to the public, and monitored.

5.1.2 Alternative Fiscal Rules

While constraining policymakers is a common target of different rules, the effectiveness of each type of rule varies. There are three main objectives against which each rule can be judged; (i) enhancing the macro stabilisation role of fiscal policy, that is, improving the effectiveness of counter-cyclical fiscal policy; (ii) restoring and maintaining the sustainability of public debt; and (iii) improving expenditure efficiency (i.e., ensuring, or at least not harming, allocative and productive efficiency of Government programmes).
Budget balance rules (BBR) typically set a target (limit) on the overall balance, the current balance, or the operating balance during a particular year or over the medium-term. BBRs that are set in nominal terms or as a share of GDP are simple to monitor and to explain to the public, but tend to impart pro-cyclical bias to fiscal policy by tying the hands of policymakers when unanticipated cyclical movements in the economy require offsetting measures to respect the target. By contrast, while less easily understood by the public, BBRs that target a cyclically adjusted or structural budget balance can theoretically allow automatic stabilizers to operate over the cycle if the duration and the shape of the cycle can be accurately forecasted. Constraining the overall balance can help to achieve convergence of the debt-GDP ratio to a desired level. A BBR can also target the primary balance and can be very effective in constraining fiscal policy particularly when public indebtedness is relatively low. However unexpected changes in interest spending (due to higher interest rates) can weaken the link. BBRs, especially those based on the non-cyclically-adjusted balance, can have adverse effects on expenditure efficiency, such as when otherwise desirable but lumpy investment outlays are reduced solely to achieve short-term budgetary target at the expense of longer term growth (Blanchard and Giavazzi, 2004).

Debt rules (DR) specify an explicit limit or target for the public debt as a per cent of GDP. Since the target is operationally reached via the budget balance, the rule has to be designed carefully to avoid pro-cyclicality. Stand-alone debt rules tend to be ineffective constraints at low levels of the debt-to-GDP ratio. At high debt ratios they can provide an important complement to BBRs.

Expenditure rules (ER) take many shapes, but all are designed to constrain the growth of public outlays, notably during cyclical upswings or asset price bubbles when the buoyancy of revenues can easily lead to pro-cyclical and structural increases in spending. With a ceiling on expenditures set in advance, both the budgeted level for the coming fiscal year and indicative levels for the subsequent years of a medium-term framework, cyclically sensitive revenues are allowed to play a stabilization role. A key issue in the design of an ER is the coverage. It is important to consider excluding some highly sensitive spending items such as unemployment benefits, but allowing too many carve-outs is an invitation to excessive reclassification. Expenditure rules can be weakened if tax expenditures are not constrained as well.

Revenue rules (RR) are relatively less prevalent than other types of rules. RRs set a ceiling (to limit the burden) or a floor, or specify ex ante the uses to which above-forecasted receipts can be utilised or saved for unexpected needs in the future. Caps can introduce pro-cyclicality if, in a boom, rates are lowered to respect the cap (and symmetrically for a floor during a downturn). Pre-specified constraints on the use of above-forecasted revenues can prevent pro-cyclicality by ensuring that they are not used to finance large discretionary spending initiatives or to raise structural spending. In a number of countries, the RR requires that excess revenues be used to reduce the deficit or be placed in a “rainy-day” fund for future use.

5.1.3 Desirable Characteristics of Fiscal Rules

Successful fiscal rules have a number of characteristics in common. They are well-defined, transparent, adequate, consistent, simple, flexible, enforceable, and efficient (Kopits and Symanksy, 1998). A well-designed fiscal rule, or set of fiscal rules, will reflect a careful balancing of the relative importance of each desirable characteristic to achieve the policy objective conditional on a country’s institutional and political context.

- The rule should be clear regarding the indicator (fiscal balance, debt, expenditure) on the basis of which performance is to be judged, including its institutional coverage and specific escape clauses.
- A rule will only be credible if it is implemented in a context of full transparency of Government operations (accounting, forecasting and institutional coverage and relationships). Scepticism about the statistical underpinnings and intra-Governmental relationships that can affect the veracity of the indicator will undermine the rule’s credibility.
- A well-designed rule is consistent with other macroeconomic policies or rules. For instance, in the absence of a monetary policy lever for counter-cyclical policies, a fiscal rule ought to ensure that fiscal
policy can play its stabilisation role insofar as possible.

- The **adequacy** of a rule relates to its relevance to the proximate goal of fiscal policy conditional on the source of deficit bias. Thus, if chronic expenditure growth is the root cause of ballooning deficits, a constraint on expenditure growth—accompanied or not by a budget balance rule—would be more promising than other rules.

- There is a trade-off between **simplicity** and some other desirable characteristics of rules. For instance, while a cyclically adjusted budget balance is better suited to avoiding the pro-cyclicality inherent in a headline deficit rule, it is also more complicated to calculate, can be subject to dispute even among experts, and is not easily understood by the general public.

- A **flexible** rule allows for the absorption of shocks that are beyond the control of the Government. The most obvious of these is an unpredictable cyclical downturn, which, at a minimum, would call for automatic stabilizers to operate.

- A rule needs to be **enforceable**. **Consequences** for the failure of authorities to respect the provisions of the rules-based framework need to be explicit. Whether the sanctions are financial, judicial, reputational, or, in the limit, political, holding officials **accountable** for non-adherence to the rule is essential for the rule’s credibility and eventual success, other things equal.

- Finally, a rule should be designed in a manner that protects or improves **efficiency**. For instance, it could be more harmful than helpful to rely on an expenditure rule that sets a ceiling on total Government spending while allowing the rule to be met solely through cuts in public investment otherwise favourable to growth.
### Properties of various numerical fiscal rules with respect to different economic objectives

<table>
<thead>
<tr>
<th>Properties</th>
<th>Budget balance rules</th>
<th>Expenditure rules</th>
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<tbody>
<tr>
<td><strong>Effects on the deficit bias</strong></td>
<td>Effectiveness in addressing the deficit bias depends on the degree of ambition of the numerical targets and on the design (time-horizon, definition of the objective, coverage) and characteristics of the rule (in particular monitoring and enforcement procedures).</td>
<td>Effectiveness in addressing the deficit bias depends on the degree of ambition of the numerical targets, on the design and characteristics of the rule, but also on tax developments.</td>
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<tr>
<td><strong>Budget balance rules</strong></td>
<td>Budget balance rules defined in nominal terms (in levels and as a per cent of GDP) introduce a procyclical bias in fiscal policy. The bias is reduced in case the rule has a multi-annual perspective. Budget balance rules targeting a cyclically adjusted balance, or that need to be respected over the cycle, do not have such a bias (subject to uncertainties on the quality of the cyclical adjustment).</td>
<td>Expenditure rules contribute to macroeconomic stabilisation if the aggregate targeted by the rule is defined in level or growth rate of expenditure. Counter-cyclical contribution is maximal when the rule is defined in nominal terms (larger-than-expected budgetary adjustment in case of demand-pull inflation) and when the coverage excludes cyclically sensitive items. Expenditure rules can, however, entail a pro-cyclical bias if they are defined in terms of an expenditure-to-GDP ratio.</td>
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<tr>
<td><strong>Effects on macroeconomic stabilisation</strong></td>
<td>Positive effect in case selected ‘productive’ items are subject to less strict constraints or excluded from the scope of the rule. This may, however, imply risks of inefficient allocation of public resources. Additionally, exclusion of selected items can raise monitoring difficulties and facilitate circumvention of the rule. A negative effect is possible in case no item is excluded from the coverage of the rule, due to the political temptation to cut expenditure categories that are less politically sensitive, including ‘productive’ expenditure (expenditure on R&amp;D, infrastructure and education).</td>
<td>Same as for budget balance rules.</td>
</tr>
<tr>
<td><strong>Effects on quality of government finances</strong></td>
<td>Positive effect in case selected ‘productive’ items are subject to less strict constraints or excluded from the scope of the rule. This may, however, imply risks of inefficient allocation of public resources. Additionally, exclusion of selected items can raise monitoring difficulties and facilitate circumvention of the rule. A negative effect is possible in case no item is excluded from the coverage of the rule, due to the political temptation to cut expenditure categories that are less politically sensitive, including ‘productive’ expenditure (expenditure on R&amp;D, infrastructure and education).</td>
<td>Such rules are relatively rare at local government level and frequent at central government level. They may help to contain the size of the public sector. High accountability of the government for respecting the rule since such rules directly target the part of the budget that the government controls most directly. Accountability is maximal if specific items not fully under the control of the government are excluded from the coverage of the rule (e.g. interest payments, unemployment benefits).</td>
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### Revenue rules

- **Effects on the deficit bias:** Rules imposing limits on revenues (e.g. aiming at stabilising or reducing the tax burden) may have a negative impact on the deficit bias if they are not coupled with other rules, e.g. budget balance or expenditure rules. Indeed, stringent tax limits may have a negative impact on borrowing costs (markets might consider that the risk of default becomes higher if constraints are imposed on the capacity of the authority to increase taxes). On the contrary, rules pre-defining the allocation of higher-than-expected revenues generally help lessen the deficit bias by avoiding a relaxation of the fiscal stance in good times (depends on the allocation rule).

- **Effects on macroeconomic stabilisation:** Such rules can be slightly pro-cyclical in case the rule targets a given revenue-to-GDP ratio (due to the progressivity of the tax systems). They can be strongly pro-cyclical if the rule targets a given amount of revenues in nominal terms (such rules are rare). Revenue rules pre-defining the allocation of higher-than-expected revenues may limit the conduct of pro-cyclical policies in good times (if all additional cyclical revenues are allocated to deficit reduction).

- **Effects on quality of government finances:** No evident influence on the quality of government finances. However, in case only some categories of taxes are covered by the rule, there can be an impact on the structure of the tax system.

- **Other properties:** Revenue rules pursue a wide variety of objectives. Rules imposing limits on revenues may contribute to contain the size of the public sector.

### Debt rules

- **Effectiveness in addressing the deficit bias:** Effectiveness depends on the degree of ambition of the numerical targets and on the design and characteristics of the rule (in particular monitoring and enforcement procedures).

- **Depends on the design and time-horizon considered by the rule (see budget balance rules).** In case the rule has to be respected over the business cycle, the stabilisation objective is not hampered.

- **Same as for budget balance rules.**

- **Borrowing constraints are generally applied at sub-central levels of government. However, in some countries, debt limits for the general government sector are enshrined in the law or constitution.**

5.1.4 The Appropriate Coverage of Fiscal Rules

Coverage of general Government (as opposed to local/regional) aggregates is more common in countries with supranational rules because of the higher status of the supranational legislation. In Malta, the general Government sector consists of the central Government and the local councils, but the latter is not responsible for fiscal policy. Rules covering general Government aggregates are thus considered more appropriate for the domestic context.

There are pros and cons of a more selective coverage of budgetary categories. Fiscal sustainability considerations argue in favour of a more comprehensive coverage as this is more likely to ensure effective control of total revenue and expenditure, and make the target more transparent and easier to monitor and enforce. However, including volatile items in the rule would lower the overall stability and predictability of fiscal aggregates and could require ad hoc adjustments in other budgetary items.

One item that has in practice been frequently excluded from targeted fiscal aggregates is capital expenditure (the ‘golden rule’). In the local context, excluding capital expenditure from the targeted fiscal aggregate could restrict the possibility of a lower utilisation of budgetary targets for capital expenditure to counter either higher recurrent expenditure or the failure of over-optimistic revenue projections to materialise in any particular year. Excluding capital expenditure from the coverage of fiscal rules is consistent with the need to preserve long-term growth. Absorbing fiscal slippages through lower public investment preserve short-term budgetary targets at the expense of long-term growth and possibly fiscal sustainability. The benefit of excluding capital expenditure however needs to be weighed against the risks of “creative” accounting that reclassifies spending items so as to weaken the strength of fiscal rules. Moreover, certain recurrent expenditure projects particularly in education and health could arguably be considered as “growth friendly” as any capital expenditure further diluting the argument in favour of a golden rule.

<table>
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<th>Pros and Cons of Selective Coverage</th>
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<tr>
<td>Exclude</td>
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<td><strong>Interest payments</strong></td>
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<td><strong>Cyclically-sensitive expenditure</strong></td>
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<td><strong>Capital expenditure</strong></td>
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Source: IMF (2009)
5.2 Alternative Formulations of Fiscal Rules for Malta

The structural balance rule (SBR) posits that the budget balance in any given year is equal to the medium-term balance target adjusted for changes in the output gap. Formally,

\[ b_t = b^* + a y^G_t, \quad a > 0 \]

where \( b_t \) is the overall balance in the current year, \( b^* \) is the medium-term balance target, \( a \) is the semi-elasticity of budget balance with respect to the output gap, and \( y^G_t \) is the output gap in the current year.

Targeting a cyclically adjusted or structural balance rather than the nominal balance provides a straightforward mechanism for allowing flexibility to respond to output shocks. The main feature of the structural balance rule is to provide an explicit allowance for the economic cycle’s impact through the operation of automatic stabilisers, both on the revenue and the expenditure side. The budget balance is allowed to decline (or rise) as necessary in response to changes in the output gap without prompting specific action. If the cycle is reasonably well defined, that is deficits during the downturn are offset by surpluses during the upturn, a target structural balance consistent with the debt objective can be attained.

A variant of this rule, the growth-based balance rule (GBR), replaces the output gap with the difference between actual and long-term growth: that is

\[ b_t = b^* + a (g_t - g^*) \quad a > 0 \]

where \( g_t \) is the GDP growth rate in the current year; and \( g^* \) is the average long-run GDP growth rate. Thus the overall balance reacts to changes in the growth rate rather than in the level of output.

This growth-based balance rule may be particularly useful in periods of uncertainty about the level of the output gap: in this rule, the nominal deficit is allowed to be higher when GDP growth in the current year is below its trend level, and vice versa. However, this approach does not invariably remove the risk of pro-cyclicality: for instance, during the early phase of economic recovery, actual growth may exceed trend growth even though the economy is still recovering from a recession and the rule may posit a pro-cyclical fiscal adjustment. Evaluating the average growth rate also involves an element of judgement over how long a period this will be estimated, how often it is to be revised and how to take into account prolonged periods of booms or recessions. On the other hand the technical constraints in estimating potential output and output gaps and the complexity of such estimations together with the difficulty in explaining the structural approach present a clear advantage of the growth based balance rule over the structural balance rule. From a political economy perspective the growth based rule may also be more closely correlated with electoral perceptions of the economic prospects than measures of the output gap.

One major drawback of both these two rules is that they fail to take into account the starting position. Thus if one starts to apply the rules immediately when the deficit ratio is still relatively high, the fiscal effort required in the following year may be unreasonably high thus undermining the credibility of the same rules.

In this context fiscal rules can be modified by taking into account past deviations from the target that can help deal with the speed of adjustment and/or pro-cyclicality issues. Indeed, the augmented growth-based balance rule (AGBR) includes a term that ‘smoothes’ the adjustment from any deviation in the deficit from its target in the previous year. The AGB rule mimics a structural balance rule without requiring estimation of the output gap while still allowing automatic stabilisers to operate. The rule requires policy to be geared toward achieving the Government’s medium-term budgetary objective including a balanced budget or some other reference target deemed desirable. The major advantage is that the rule can accommodate large budgetary shocks by anticipating a specific pace of adjustment in the event the budget deficit is moved off
track by an unexpectedly large margin. Formally,

\[ b_t = b^* + a (g_t - g^*) + e (b_{t-1} - b^*) , \quad a > 0 \text{,} \quad 0 < e < 1 \]

where \( e \) is the pace of adjustment when the overall balance in the previous year, \( b_{t-1} \), differs from the medium-term target \( b^* \). By delaying the adjustment of the balance back to target, this term reduces the pro-cyclicality of the rule.

The rule emphasizes that the required minimum change in the budget balance is a function of how far the overall balance is from the medium-term budget target, and of the relative strength of growth. The former promotes medium-term adjustment, while the latter ensures counter-cyclical fiscal policy. The rule allows for a larger adjustment than otherwise in years when the actual balance is further from the medium-term target. Once the medium term target is reached the rule effectively becomes equivalent to a growth based balance rule.

Alternatively, the Stability and Growth Pact requires Member States that have not yet reached their MTO to pursue an annual adjustment in cyclically adjusted terms, net of one-off and other temporary measures, of 0.5 of a percentage point of GDP as a benchmark. Formally, the SGP rule can be defined thus:

\[ b_t = 0.5 + a y^G_t + b_{t-1} - a y^G_{t-1} + \Delta \text{ one-offs} , \quad a > 0 \]

where \( b_t \) is the overall balance in the current year, \( b_{t-1} \) is the overall balance in the previous year, \( a \) is the semi-elasticity of budget balance with respect to the output gap, \( y^G_t \) and \( y^G_{t-1} \) is the output gap in the current year and the previous year respectively, and one-off and temporary measures are measures having a transitory budgetary effect that does not lead to a sustained change in the inter-temporal budgetary position.

The rules discussed require a well defined cycle which allows for deficits during an economic downturn to be adequately offset by surpluses during an upturn. In this context the output gap as a measure of the business cycle may raise some concerns. When looking at the data for Malta for the period 2004 to 2013, one notes a predominantly negative output gap. This contrasts with the economic growth experienced over the same period which is arguably closer to what economic operators observe in the published data and therefore what they perceive to be the business cycle. Chart 5.1 plots the output gap together with the growth gap (developments in growth in excess of 2.0 per cent) and the change in the output gap. In particular, it illustrates how the growth gap shows a movement which is more in line with the annual changes in the output gap rather than its level, thus showing a more balanced dynamic in relation to the position within the economic cycle. Output gap estimates completely miss the short-lived 2001 recession in Malta whilst it understates the 2009 recession relative to the growth gap estimate. On the other hand, the growth rule would have demanded fiscal consolidation efforts during periods of recovery from a recessionary environment such as the 2007/08 period and the 2010/11 and could thus destabilise growth prospects by requiring premature exit from the fiscal support measures.

An alternative variable to target through a rules based framework is the level of expenditures. The latter is directly under the control of the policymakers, provides operational guidance, and is easy to monitor. Combining budget balance with expenditure rules appears to have been effective, particularly among large adjusters (IMF, 2009). Since the entry into force of the reform of the Stability and Growth Pact (SGP) in December 2011, the appropriateness of the adjustment path of Member States towards their medium-term budgetary objective (MTO) under the preventive arm is now also assessed on the basis of the evolution of Government primary expenditure, net of discretionary revenue measures, to a reference rate, based on the medium-term potential GDP growth\(^1\). An expenditure benchmark reflecting the SGP is thus also considered.
Strengthening Malta’s Fiscal Framework

\[ b_t = r_t - i(D_{t-1}) - e_{unt} - e_{u}(1+g^* - pm), \]
\[ e_{s-1} = e_{t-1} - i(D_{t-1}) - e_{unt} - e_{eu} \]

where: \( g^* \) is the potential growth of the economy plus the average growth in the GDP deflator; \( r_t \) and \( e_t \) represent the total revenue and total expenditure respectively; \( i(D_{t-1}) \) represents expenditure on debt servicing; \( e_{unt} \) represents the change in expenditure on unemployment benefits, \( e_{eu} \) represents expenditure fully financed from EU funds. The term \( pm \) represents a prudent margin of expenditure growth below potential growth for high debt countries. For Malta this is estimated by the European Commission at 1.3 percentage points of growth.

Considering a potential growth of 1.9 per cent, a GDP deflator of around 2.6 per cent and a prudent margin of 1.3 percentage points the allowed growth in expenditure (net of interest payments and expenditure fully funded from EU funds) for Malta roughly equals 3.2 per cent. The expenditure benchmark used by the European Commission as part of its budgetary surveillance under the SGP also smoothens the public investment to GDP ratio to remove any extraordinary annual fluctuations. The usefulness of expenditure rules in the context of asset price bubbles have already been amply highlighted in Chapter 2 of this paper.

5.3 Implementation and Enforcement

5.3.1 Desired level of Legislative Support

The Maltese Government has already indicated that the new fiscal rule will be embedded in the Constitution. Rules enshrined in higher-level legislation are likely to be more difficult to reverse or abandon. Fiscal rule frameworks embedded in constitutional laws need parliamentary ‘super-majorities’ to be established and changed. This confers more stability to the rule framework, although it does not necessarily make it more effective if accountability procedures and enforcement mechanisms are weak.

In order for the rule to be binding on the Government, the parameters of the fiscal rule would be set in...
legislation. For example, in the case of the augmented growth-based balance rule, the parameters \(a, e, \) and \(g^*\), and the budgetary objective \(b^*\) would be given a legal foundation. The value of \(b^*\) could target the MTO of a balanced budget. Unlike potential growth, trend growth can be determined in a fairly straightforward manner from actual historical GDP data. Periodic but infrequent changes to trend growth can be made as structural reforms or endogenous structural changes (e.g., those arising from population ageing) take hold, or productivity shocks impact underlying growth. The parameter \(a\), which is an estimate of the cyclical sensitivity of the budget balance to the cycle, is currently computed as the weighted average of individual revenue and expenditure elasticities estimated by the OECD. The current parameter value for Malta is 0.36. The value of \(e\) sets the pace of adjustment to the medium-term objective. The weight given to the adjustment to past deviations from the balance target relative to the cyclical parameter will determine the speed at which the overall balance returns to target and the degree of counter-cyclicality envisaged by the rule. With a low weight on past deviations, adjustment will be slow and the countercyclical component may outweigh the pull from the convergence factor, allowing for stronger overall counter-cyclicality. But if convergence is required to occur rapidly and the weight placed on correcting past deviations is large, fiscal deficit may have to shrink while the output gap is still widening. For instance, a parameter value of 0.75 in the first year of the correction period would require the deficit to return to a balanced budget over a four year period.

### 5.3.2 Escape clauses

The common principles for national fiscal correction mechanisms as expressed in the Communication from the Commission posit that the definition of possible escape clauses shall adhere to the notion of ‘exceptional circumstances’ as agreed in the Stability and Growth Pact. This would include an unusual event outside the control of the Maltese Government with a major impact on the financial position of the general Government, or periods of severe economic downturn as defined in the Stability and Growth Pact, including at the level of the Euro Area. An independent fiscal institution should monitor compliance with the rule and the application of escape clauses as will be detailed later on. The suspension of the correction mechanism in the event of an escape clause shall be on a temporary basis. When exiting the escape clause, the Maltese Government shall adopt a corrective plan that shall be binding over the budgets covered by the correction period.

### 5.3.3 Common Principles for National Fiscal Correction

In order to ensure compliance with the new rules implementing MTOs at the national level, the fiscal compact foresees that a correction mechanism will be triggered automatically in the event of a significant deviation from the medium-term objective or the adjustment path towards it. According to the TSCG, this national mechanism is to be put in place on the basis of common principles to be proposed by the Commission on the nature, size and timeframe of the corrective action to be undertaken, as well as on the role and independence of the national institutions responsible for monitoring compliance with the rule. A Communication putting forward common principles underlying the national correction mechanisms was issued by the Commission on 20 June 2012.
Box 5.1

Common principles for national fiscal correction

The common principles for national fiscal correction mechanisms as expressed in the Communication from the Commission COM (2012) 342 of 20 June 2012 are the following:

1. [Legal status] The correction mechanism shall be enshrined in national law through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes. The mechanism shall fully respect the prerogatives of national Parliaments.

2. [Consistency with EU framework] National correction mechanisms shall rely closely on the concepts and rules of the European fiscal framework. This applies in particular to the notion of a 'significant deviation' and the definition of possible escape clauses. The correction, in terms of size and timeline, shall be made consistent with possible recommendations addressed to the concerned Member State under the Stability and Growth Pact.

3. [Activation] The activation of the correction mechanism shall occur in well-defined circumstances characterising a significant deviation from the medium-term objective (MTO) or the adjustment path towards it. The activation triggers may comprise EU-driven or country-specific criteria, to the extent that they meet the above condition. Subject to the same condition, both ex ante mechanisms that set budgetary objectives preventing the materialisation of deviations and ex post mechanisms that trigger corrections in reaction to prior deviations, may fulfil the requirements.

4. [Nature of the correction] The size and timeline of the correction shall be framed by pre-determined rules. Larger deviations from the medium-term objective or the adjustment path towards it shall lead to larger corrections. Restoring the structural balance at or above the MTO within the planned deadline, and maintaining it there afterwards, shall provide the reference point for the correction mechanism. The correction mechanism shall ensure adherence to critical fiscal targets as set before the occurrence of the significant deviation, thereby preventing any lasting departure from overall fiscal objectives as planned before the occurrence of the significant deviation. At the onset of the correction Member States shall adopt a corrective plan that shall be binding over the budgets covered by the correction period.

5. [Operational instruments] The correction mechanism may give a prominent operational role to rules on public expenditure and discretionary tax measures, including in activating the mechanism and implementing the correction, to the extent that these rules are consistent with attainment of the MTO and the adjustment path towards it. The design of the correction mechanism shall consider provisions as regards, in the event of activation, the coordination of fiscal adjustments across some or all sub-sectors of general Government.

6. [Escape clauses] The definition of possible escape clauses shall adhere to the notion of 'exceptional circumstances' as agreed in the Stability and Growth Pact. This would include an unusual event outside the control of the concerned Member State with a major impact on the financial position of the general Government, or periods of severe economic downturn as defined in the Stability and Growth Pact, including at the level of the Euro area. The suspension of the correction mechanism in the event of an escape clause shall be on a temporary basis. The correction mechanism shall foresee a minimum pace of structural adjustment once out of the escape clause, with the requirement from the Stability and Growth Pact a lower limit. When exiting the escape clause, Member States shall adopt a corrective plan that shall be binding over the budgets covered by the correction period.

7. [Role and independence of monitoring institutions] Independent bodies or bodies with functional autonomy acting as monitoring institutions shall support the credibility and transparency of the correction mechanism. These institutions would provide public assessments over: the occurrence of circumstances warranting the activation of the correction mechanism; of whether the correction is proceeding in accordance with national rules and plans; and over the occurrence of circumstances for triggering, extending and exiting escape clauses. The concerned Member State shall be obliged to comply with, or alternatively explain publicly why they are not following the assessments of these bodies. The design of the above bodies shall take into account the already existing institutional setting and the country-specific administrative
5.4 Conclusion

The application of fiscal rules is a necessary but not sufficient safeguard against the shortcomings discussed earlier in terms of the effects that fiscal consolidation may have on economic growth. In particular the conduct of fiscal policy as a stabilisation tool may not follow precisely from a pure rules-based framework depending on the design of such rules. The next chapter will evaluate empirically characteristics of alternative fiscal rules in terms of their ability to ensure fiscal prudence whilst preserving the economic stabilisation role of fiscal policy. This will yield a better understanding of the responsiveness of deficit and debt in the application of alternative fiscal rules and how each rule acts vis-à-vis the growth component which as discussed earlier represents an important component in formulating policy advice.

Footnote:

1 Countries that are at their MTO have a reference rate equal to their medium-term potential GDP growth rate, while those not yet at their MTO have a reference rate that is lower.

2 Individual elasticities currently used in the CAB framework are considered as time-invariant and were computed in 2004 on the basis of the methodology developed by the OECD and agreed by the EPC OGWG. The methodology is currently under review.


6.1 Applying Fiscal Rules to Malta’s Recent Economic History

In order to assess the implications of the above proposed rules on the pace of debt reduction, this section attempts to simulate the hypothetical debt trajectory over the period between 2005 and 2011 had each rule been in place since 2005. To this effect, Chart 6.1 illustrates the impact of applying each respective fiscal rule over the period 2005-2011 on the debt ratio to GDP. This will then allow us to look deeper into the results obtained in order to ascertain which rules perform in the most desirable outcome from an empirical standpoint.

Conditional on the growth dynamics of the Maltese economy since 2005, the growth-based balance rule, followed closely by the structural balance rule, would have been the most stringent of all the proposed rules, resulting in the lowest debt-to-GDP ratio by the end of the period. The SGP rule would have been the least stringent of all the rules considered and would have resulted in debt dynamics which would have been very close (though still more stringent) to what was actually observed over the period under analysis. The AGB rule would have resulted in a marginally stronger fiscal consolidation effort compared to the SGP rule. Finally the expenditure benchmark would have mimicked the GBR and the SBR but would have allowed a less stringent fiscal consolidation effort than these two rules but still resulted in a lower debt to GDP ratio than the SGP rule or the AGB rule.

It is however important to note that the analysis carried out in terms of the simulated deficit, debt and growth developments is static in nature. The simulations, in fact, do not take into account the second round effects of fiscal consolidation on economic growth in the short term which, in turn depends on the nature of fiscal consolidation and the fiscal multipliers related to the fiscal component being altered. In other words they do not take into account the effect on the denominator and thus overstate the differences between the rules in terms of fiscal efforts. This limitation will be addressed later on in this paper. However a more counter cyclical fiscal consolidation is likely to have a weaker impact in bad times and a stronger impact in good times. The more countercyclical a rule is the less would be the expected impact of fiscal consolidation on economic activity. The degree of counter-cyclicality of the alternative rules is thus important to assess. The counter-cyclical properties of the alternative rules considered will first be evaluated over the historical

![Chart 6.1: Impact of Fiscal Rules on Debt Dynamics](chart)

Strengthening Malta’s Fiscal Framework
developments of the Maltese economy since 2005. The chart above already gives some indications on the
cyclical properties of the alternative rules considered.

The period 2004/06 was marked by anaemic growth with the economy registering a negative output gap. During this period one would have desired a weaker fiscal consolidation effort from an economic stabilisation perspective. In this context the SGP, AGBR and the ER rule would have allowed a less pro-cyclical fiscal policy compared to the SBR and GBR and also compared to actual fiscal policy developments.

The strong recovery of 2007 which led to a positive output gap in 2008 suggests that economic stabilisation would have mandated a strong fiscal consolidation effort during this period. All rules acted in a counter-cyclical manner and compared favourably with the relatively pro-cyclical fiscal policy actually experienced at the time. Interestingly during this period the ER would have resulted in the highest correction in the debt ratio and would have thus been the more counter-cyclical of all the rules considered.

In 2009 Malta experienced a recession. Macroeconomic stabilisation would have mandated a fiscal expansion. All rules would have allowed a measure of counter-cyclicality. But the most counter-cyclical of these rules would have been the SGP rule and the AGBR. On the other hand the ER tended to be less counter-cyclical.

The years 2010/11 can be considered as a period of weak recovery from the notable recession of 2009. Whilst growth picked up uncertainty still prevailed and the output gap was still in negative territory. Macroeconomic stabilisation would have mandated stable fiscal policy at best or a weak fiscal consolidation effort. Again the SGP and AGBR closely fit this pattern. The other rules would have demanded a strong fiscal contraction which could have destabilised the economy.

These results suggest that based on very recent historical conditions the SGP and the AGBR are good candidates for good fiscal policy making in Malta particularly in periods of slow growth, recessions and periods of weak recovery. However in periods of strong economic activity, the GBR, SBR and the ER tend to be more stringent and counter-cyclical. This analysis indicates that a combination of rules switched on and off depending on cyclical conditions could be optimal for Malta. The analysis suggests that operating the SGP or the AGBR coupled with a stronger fiscal effort especially in good times as mandated by the ER would have been the optimal policy rule for Malta over the period under consideration.

6.2 The responsiveness of changes in GDP, and debt and deficit ratios

As already seen, the application of each particular fiscal rule will result in different levels of deficit and debt with respect to the developments in GDP. Since the outcomes vary for each rule, the ratios relating the changes in the deficit and debt together with the changes in GDP vary from year to year. This gives rise to varying sensitivities of the debt and deficit components to growth developments for each rule. What follows is a more formal evaluation of the counter cyclical properties of the rules considered and their strength in terms of desirable debt reduction.

The observed results span all the possible outcomes which include:

- an improvement or worsening in economic conditions accompanied by either an improvement or a worsening in the debt ratio, as well as
- an improvement or worsening in economic conditions accompanied by either an improvement or a worsening in the deficit ratio

As already discussed the growth component is an important element in ascertaining the desirability of a
rule with respect to another. In particular one would need to account for debt, deficit, as well as concurrent developments in economic conditions and subsequently assess the observed sensitivity of their relative movements in combination.

One might consider that for any given scenario it would be preferable to observe a high improvement in debt or a lower deterioration in the debt for each unit of improvement in economic conditions such that the rule which results in the highest ratio would be the most efficient and desirable in good times. In bad times the opposite should hold and the debt ratio should be allowed to deteriorate or improve at a slower pace for every unit worsening in economic conditions. The table below portrays the possible combinations of outcomes for debt and economic output while also indicating the desired sensitivities/responsiveness of the developments for each case.

<table>
<thead>
<tr>
<th>Debt scenarios</th>
<th>Worsening in economic conditions</th>
<th>Desired responsiveness</th>
<th>Improvement in economic conditions</th>
<th>Desired responsiveness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Worsening in debt ratio</td>
<td>Low</td>
<td>Improvement in debt ratio</td>
<td>High</td>
<td></td>
</tr>
<tr>
<td>Improvement in debt ratio</td>
<td>High</td>
<td>Worsing in debt ratio</td>
<td>Low</td>
<td></td>
</tr>
</tbody>
</table>

Similarly, the table below portrays the possible combinations of outcomes for deficit and economic conditions while also indicating the desired sensitivities/responsiveness of the developments for each case.

<table>
<thead>
<tr>
<th>Deficit scenarios</th>
<th>Worsening in economic conditions</th>
<th>Desired responsiveness</th>
<th>Improvement in economic conditions</th>
<th>Desired responsiveness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Worsening in deficit ratio</td>
<td>High</td>
<td>Improvement in deficit ratio</td>
<td>High</td>
<td></td>
</tr>
<tr>
<td>Improvement in deficit ratio</td>
<td>Low</td>
<td>Worsing in deficit ratio</td>
<td>Low</td>
<td></td>
</tr>
</tbody>
</table>

The above scenarios represent symmetric preferences such that the degree of fiscal adjustment in proportion to economic conditions in good times is the same as that proportion in bad times. However one may wish to follow a rule which gives the highest fiscal consolidation in good times relative to economic conditions but minimise the fiscal expansion relative to economic conditions in bad times so as to give some more weight to fiscal consolidation without excluding an element of counter-cyclicality. This may be a more appropriate strategy for high debt countries. The table below is consistent with such an asymmetrical approach. As can be seen, in this case, the desired responsiveness results are reversed when considering a worsening in economic output thus accounting for a lower desired deficit.

<table>
<thead>
<tr>
<th>Deficit scenarios – highest possible deficit: possible developments in economic output and deficit ratio</th>
<th>Worsening in economic conditions</th>
<th>Desired responsiveness</th>
<th>Improvement in economic conditions</th>
<th>Desired responsiveness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Worsening in deficit ratio</td>
<td>Low</td>
<td>Improvement in deficit ratio</td>
<td>High</td>
<td></td>
</tr>
<tr>
<td>Improvement in deficit ratio</td>
<td>High</td>
<td>Worsing in deficit ratio</td>
<td>Low</td>
<td></td>
</tr>
</tbody>
</table>
Knowing beforehand the desirable outcomes one can ascertain the desired responsiveness of the debt and deficit with respect to economic conditions. Basing on the outcomes implied by each fiscal rule over the selected time-frame, the best performing rule/s (in terms of the desired outcomes) can then be identified.

In order to complete this analysis one has to define an indicator which best captures economic conditions. Three possible candidates can be considered: the output gap, the change in the output gap and the growth in excess of a period average (referred to as the growth gap). The relative merits of the three have already been considered briefly in Chart 5.1. The change in the output gap and the growth gap show very similar dynamics for Malta. Compared to these two, the output gap tends to respond to economic growth with a lag. Periods of recovery from a slump require a time lag for the output gap to consider them as ‘good times’. This was clearly a weakness of the output gap estimate in the 2007/08 period. Moreover the output gap tends to underestimate the magnitude of recessions if these are preceded by a period of high growth. This was clearly evident in 2001 where the output gap estimates recognise a recessionary period with a lag of almost three years. The major drawback of the change in the output gap and the growth gap is that it tends to overstate the good times in periods of economic recovery. This was a case in 2010. In this context the growth gap performed better than the change in the output gap and was closer to the output gap. **Whilst an element of judgement is here unavoidable, overall one could consider the growth gap as the most intuitive measure of economic conditions.**

More formally, the results of the responsiveness ratios are derived according to the following representations:

$$R_d = \frac{\delta d}{g-g^*}$$

and

$$R_D = \frac{\delta D}{g-g^*}$$

Where $R_d$ and $R_D$ are the responsiveness ratios for deficit and debt respectively, $\delta d$ is the change in the deficit-to-nominal GDP ratio, $\delta D$ is the change in the debt-to-nominal GDP ratio $g$ represents real economic growth and $g^*$ represents Malta’s 10-year average growth rate between 2000 and 2010 which is equal to 2 per cent.

Counter cyclicality is represented by a negative sign on $R_d$ as one would posit an increase in the debt ratio in bad times and a reduction in good times. On the other hand counter-cyclicality is represented by a positive sign on $R_D$ as one would posit a deterioration in the budget balance in bad times and an improvement in good times. The absolute value of $R$ is an indication of the degree of counter-cyclicality. The following results are presented in the case where the growth gap is used as a measure of economic conditions. As a robustness check of these results the alternative formulations of economic conditions were also tested and are available on request.

### 6.3 Responsiveness Results

Table 6.1 shows the aggregate results (‘scores’) for the desired responsiveness/sensitivity in each scenario discussed – a higher score indicates a higher desirability from a macroeconomic stabilisation perspective. A separation between good times and bad times based on the growth gap is carried out. In good times the SBR and GBR followed closely by the ER appear to be the most pro-cyclical of all the rules. Thus whilst in good times the GBR is the best rule the SBR and ER are almost as efficient from a macroeconomic stabilisation perspective.

In bad times, the SGP and the AGBR rules are clearly the most efficient from a macroeconomic stabilisation perspective. However if one wants to minimise the fiscal expansion in bad times to give more weight to debt
6.4 Implications of the Empirical Results

In formulating a fiscal rule one may include additional elements. In fact, the empirical analysis suggests that moving away from a single rule concept could solve the inefficiencies of such a frame-set. This concept is also similar in nature to the fiscal rule being pursued by Germany whereby in addition to securing the long-term viability of public finances, the new budget rule is intended to enable the pursuit of fiscal policy that is responsive to the cyclical conditions of the economy.

As seen in the previous section, each fiscal rule entails a different path in the dynamics of deficit and debt such that the developments also show varying levels of fiscal consolidation effort. In this regard, it is pertinent to put such fiscal effort into an appropriate context. In this sense, while it may be true that the highest level of fiscal consolidation effort would naturally lead to the best results in terms of consolidation, it is to be kept in mind that such a performance may prove to be excessively stringent and possibly undermine the credibility of the rules based approach. Chart 6.2 shows the level of fiscal consolidation effort that would have been required by each of the rules discussed. As can be observed, some rules would have required a structural effort in excess of 4.0 per cent which might be deemed as excessive. It is therefore important to put any proposed policy recommendation into context by looking at the possible implied structural effort.

Another important issue to consider when looking at the empirical results of the fiscal rules simulations is whether they abide with any policy constraints which may be applicable. In this regard, it is imperative to note that Malta is required to abide with the requirements of the SGP and therefore the effort required by the SGP should always be safeguarded lest the condition of a minimum structural effort of 0.5 per cent be breached. It is therefore necessary to ascertain whether the application of any of the rules considered is in compliance with the constraint laid out in the SGP. In this regard a number of hypothetical scenarios in terms of GDP developments are being laid out to consider a wider possibility of developments for the fiscal rules.
As can be seen in Chart 6.3, the dynamics indicate that the required minimum structural effort required by the SGP is not always guaranteed by every rule at any point in time should certain underlying conditions prevail. This could lead to a potential conflict with the SGP requirements. This has important implication for the current analysis and in formulating policy recommendations since empirically it can effectively be shown that irrespective of their characteristics and possible desirability, the rules considered in isolation (except for the SGP rule) do not represent an adequate strategy for fiscal consolidation in terms of the binding requirement of the SGP.

Furthermore, in line with the principle of prudent fiscal policy-making, the Commission is also recommending supplementing the SGP requirements with an expenditure rule which would require

* The hypothetical scenario is based on an initial deficit of 3% of GDP in 2004 which evolves completely with the given rules. The deficit is cyclically adjusted (based on actual growth and cyclical conditions prevailing in Malta at the time) in order to derive the implied structural effort.

** The expenditure rule scenario is not completely hypothetical since it is based on actual revenue figures for Malta with expenditure scaled down in 2004 so as to generate a hypothetical initial deficit of 3% of GDP in 2004.
Government expenditure to not exceed a prudent medium-term rate of economic growth. Ideally, therefore, one would maintain the SGP rule since this is a necessary constraint, whilst also introducing the expenditure rule which allows for counter-cyclicality as well as debt reduction. Such a combination would allow for a more efficient and growth friendly consolidation strategy.

### 6.5 Compliance with the Debt Benchmark

As part of the strengthening of the Stability and Growth Pact a **debt rule** is now clearly defined with debt increases beyond a benchmark over a prolonged period of time constituting a basis for initiating an excessive deficit procedure. Specifically, the rule defines a debt-to-GDP ratio above 60 per cent as being considered sufficiently diminishing if its distance with respect to the reference value has been reduced over the previous three years at a rate of the order of 1/20th per year or is expected to be reduced over the next two years starting from the current year. Thus, the process will involve both a backward-looking and a forward-looking assessment. More specifically, the proposed benchmark debt level, is given as:

\[
\begin{align*}
 bb & = 60\% + \frac{0.95}{3} (b_{t-1} - 60\%) + \frac{0.95^2}{3} (b_{t-2} - 60\%) + \frac{0.95^3}{3} (b_{t-3} - 60\%) \\
\end{align*}
\]

It is a weighted average that considers the outcomes in the debt-to-GDP ratio in each of the 3 years preceding the year under consideration, and requires a 5% decrease per annum from each of these three outcomes.

The formulation of the criterion implies asymptotic convergence towards the 60% of GDP threshold with the debt reduction needed to reach the 60 per cent reference target increasing with high initial debt ratios. As debt approaches 60% of GDP from above, the fiscal effort required diminishes. Assuming a nominal growth rate of 5 per cent, the 1/20th yearly rate of reduction is the one that ensures consistency between the 3 per cent of GDP and the 60 per cent of GDP deficit and debt limits respectively. However, if growth in nominal terms is less than 5 per cent and in the presence of stock flow adjustments, the debt rule becomes more binding than the deficit rule of 3 per cent contained in the SGP.

The respect of the debt reduction benchmark would effectively be checked over six years (from t-3 to t+2) with such relatively long horizon aimed to mitigate the impact of the cycle. However if cyclical conditions are such that the debt benchmark demands significant fiscal consolidation efforts in bad times cannot be excluded entirely. In this context before putting a Member State under an EDP because of the breach of the debt benchmark the Commission will take into account cyclical conditions. The debt benchmark is conceptually similar to considering the MTO positions of the countries and the debt criterion is less demanding than a sustained MTO criterion; in other words for countries that respect the MTO, the debt benchmark is too some extent superfluous (European Commission, 2010). A further implication is that countries that do not run counter-cyclical fiscal policy in good times run the risk of breaching the debt benchmark both in nominal and cyclically adjusted terms as soon as growth diminishes (European Commission, 2010).

To what extent is the debt benchmark consistent with the alternative fiscal rules being considered for Malta? Figure 6.1 simulates the debt benchmark on the basis of the debt trajectory consistent with each alternative fiscal rule for Malta since 2002. In the majority of cases the fiscal rules considered are more stringent than the debt benchmark. The exceptions relate to the Augmented Growth Balance Rule and the SGP Rule in 2009. But in this case the deviation from the benchmark would have probably been due to unfavourable cyclical conditions and would not necessarily have led to the initiation of an excessive deficit procedure against Malta. Interestingly, during this period, compliance with the expenditure benchmark would have reduced the debt ratio within the debt benchmark. Thus a combination of the SGP rule and the expenditure benchmark would have ensured that Malta did not breach the debt rule in the SGP. **In this context the incorporation of the debt rule in Malta’s fiscal framework should not be inconsistent with a combination of the SGP rule and an expenditure rule and would be totally in line with the SGP requirements.**
6.6 Local policy considerations

Despite the vast economic literature on the subject matter there is very little pertaining directly to the effects of fiscal consolidation on growth in Malta. Work relating to the short-term effects of tax policy on economic output stems from analysis carried out by the Economic Policy Department involving the Structural Annualised Econometric Model for Malta (SAMM). This analysis shows that the effects of fiscal policy on economic output depend heavily on the type of fiscal consolidation measure being considered. As already discussed in a previous section, the success of consolidation in reducing the debt ratio depends heavily on the value of the fiscal multiplier which measures the impact of consolidation on growth. The aforementioned short-term analysis conducted using the SAMM provides insight into the short-term multipliers. The results are portrayed in Table 6.1. The fiscal multiplier shows the extent by which GDP reacts to a change in a fiscal variable – thus a low income multiplier would be most desirable for fiscal consolidation but less desirable for counter cyclical fiscal policy in a recession.

As displayed in the table below, the least damaging measure in terms of multipliers would be an increase in VAT as shown under Scenario 4. The downside of an increase in VAT is a concurrent increase in inflation, albeit this contributes to lower the debt to nominal GDP ratio in the short term. Multipliers typically range from 0.4 to 0.6 thus below the critical value estimated by the European Commission beyond which austerity undermines growth to the extent that it leads to a rise rather than a fall in the debt-to-GDP ratio.
The only exception is the scenario with the reduction in Government employment. This scenario assumes that none of these redundant/retired public employees are absorbed by the private sector. As a result the estimated multiplier is biased upwards. However such a multiplier is very plausible under a recessionary scenario where the absorption of public employees by the private sector in a recessionary environment is unlikely. In this sense the value of this multiplier presents an example of how multipliers can be higher in a recessionary environment. Indeed under this scenario public debt-to-GDP ratio increases rather than declines at least in the year the fiscal consolidation takes place.

Scenario 3 portraying a reduction in public sector wages of around 5 per cent is also interesting. Whilst the fiscal multiplier is shown to be 0.5 this measure still leads to a rise in the debt-to-GDP ratio in the first year. The reason for this is primarily statistical. The fall in public sector wages reduces the deflator for public expenditure such that public expenditure actually rises rather than falls in real terms. As a result the impact on real GDP is much less than the impact on nominal GDP. Since the debt-to-GDP ratio is based on nominal GDP the debt ratio still rises.

Overall, the results portrayed show that in the short-term, a revenue based consolidation is at worst as growth friendly as an expenditure based consolidation while at best, it would be more growth friendly than an expenditure led consolidation. It is however worth noting that expectations are not modelled in SAMM and a Keynesian consumption function is used with no elements of Ricardian equivalence embedded in such a function. This is not necessarily a constraint in the very short term. However over time this could become an element which limits the comparability of the multipliers derived from SAMM to those found in the literature. It is also important to note that monetary policy and exchange rate policy are assumed to be exogenous in SAMM. This is a realistic assumption given that Malta does not enjoy monetary independence being part of the Euro Area. However this further limits the comparability of these multipliers with those of other countries often found in the literature.

The results also suggest that despite the openness of the Maltese economy fiscal multipliers are not insignificant as the literature review may have indicated. Another limitation of the SAMM multipliers is the notion of investor confidence. SAMM does not model the reaction of financial markets to fiscal consolidation efforts and does not distinguish between the levels of indebtedness. It is worth remembering that the literature suggests that multipliers tend to decline as debt-to-GDP ratios tend to 100 per cent. Such effects are not captured by SAMM. The scenarios presented would thus be consistent with the hypothesis that home country bias in sovereign debt markets allows Malta to benefit from higher fiscal multipliers despite the level of public indebtedness. As long as this hypothesis holds the SAMM multipliers can be assumed to be realistic.

SAMM also fails to capture long-term supply side effects. Additional work in this area which involves a longer-term perspective has been carried out by Mifsud (2004). In this case, the effects of fiscal policy on output in Malta is analysed using a structural vector error correction approach. The main results suggest that tax shocks (in the form of higher taxation) have a persistent negative effect on output while expenditure shocks (in the form of increased Government expenditure) have a temporary expansionary effect.

The results of the structural VAR approach is consistent with the Keynesian view that fiscal consolidation is contractionary in the short term and is thus consistent with SAMM results in the short term. However the structural VAR approach adds that tax reforms tend to have persistent effects which are not captured by SAMM whilst expenditure reforms tend to have only temporary effects on economic activity. Unfortunately the model does not distinguish between the effects of various tax and expenditure measures. The structural VAR approach supports the OECD and IMF policy recommendations that fiscal consolidation is less damaging to economic activity in the long term if it is expenditure driven and that longer term growth should be fostered through appropriate tax reforms.

A limitation of the model adopted by Mifsud is that it does not discern which type of expenditure would
be most appropriate to stimulate growth in the short-term. While this is just one side of the consolidation approach, more insight can be gathered in terms of the revenue side.

Malta also enjoys a relatively low tax burden and the ratio of public expenditure to GDP is also amongst the lowest in the EU. This suggests that space for fiscal consolidation efforts exist for both expenditure based and/or revenue based measures. Recently the Commission has drafted the 2012 report on tax reforms in EU Member States, outlining tax policy challenges for economic growth and fiscal sustainability and which also contains an analysis of the decompositions of Government tax revenue. This analysis sheds light on the areas within tax revenue which may be most effectively used, thus providing important information on which tax measures may be tapped for better revenue. In particular the Commission analysis found that, besides the necessary measures on the expenditure side, almost a quarter of EU MS could make use of revenue side measures (albeit with varying degrees) in order to consolidate their public finances and to make them more sustainable. The country assessments are based on the Lisbon Assessment Framework (LAF) in which MS are considered to face a challenge in a particular area of tax policy if the indicator value is significantly worse than the GDP-weighted average of the EU27.

With respect to Malta, the CION study concluded that while facing a consolidation challenge, Malta also had tax space available and could therefore consider using measures on the revenue side of the budget (in addition to expenditure side measures) in order to consolidate public finances and to make them more sustainable. When looking at the more disaggregated data, the CION study found that when compared to the EU27, Malta had a low tax burden on consumption taxes and property taxes. Additionally, Malta also had potential to improve tax revenue through higher effort in the perusal of meeting greenhouse gas emissions, and through increasing tax compliance. In terms of consumption taxes, the CION (2012) estimates that there is potential to increase revenue from consumption taxation by more than one percentage point in Malta. The CION argues that the broadening of the tax base through the removal of reduced rates would improve revenue as well as efficiency by reducing the distortions resulting from differential treatment. In particular, the CION also noted Malta’s reduced rate of VAT on energy. While at present MS have the possibility of levying lower VAT rates on electricity for instance, this was nonetheless in conflict with the overall ambitions of energy and climate policy. Additionally, the CION also argues that it is possible to provide more efficient targeted support to vulnerable households via general welfare payments as opposed to reduced rates.

The CION also estimates that tax revenue from property (albeit comprising a smaller portion than consumption tax revenue) could also be increased by around 0.4 per cent of GDP by bringing the revenue from this source in line with the EU27 average. Moreover, the CION argues that this source of taxation is less harmful to growth than consumption taxes. The CION also suggests shifting from transaction based taxes to recurrent taxes on real estate (which are currently absent in Malta) in order to reduce the distortions introduced by taxation and to improve economic efficiency.

<table>
<thead>
<tr>
<th>Alternative Fiscal Consolidation Measures and Related Multipliers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scenario 1</strong></td>
</tr>
<tr>
<td>Reduction in Public Investment of 0.7% of GDP</td>
</tr>
<tr>
<td>Magnitude of shock (in % of GDP)</td>
</tr>
<tr>
<td>Impact on NOMINAL GDP</td>
</tr>
<tr>
<td>Impact on real GDP growth</td>
</tr>
<tr>
<td>Impact on Unemployment</td>
</tr>
<tr>
<td>Impact on RPI inflation rate</td>
</tr>
<tr>
<td>Impact on Budget Balance (in % of GDP)</td>
</tr>
<tr>
<td>Impact on Debt to GDP Ratio</td>
</tr>
<tr>
<td>Fiscal Multiplier</td>
</tr>
</tbody>
</table>

Strengthening Malta’s Fiscal Framework
Additional effort is also needed for Malta to meet greenhouse gas emissions targets which risk not being met by 2020. As a result, this aim should be pursued through further policy action through market based measures via taxation, charges, or emission quotas. In particular, however, taxation has the advantage of providing additional revenue while at the same time also allowing for cost efficient abatement.

Moreover, the CION also identified a particular challenge for Malta with respect to the high level of undeclared work and size of the shadow economy which both undermine potential tax revenue. In particular, undeclared work in estimated at 25 per cent for the period 1995-2006 while the shadow economy stood at around 25 per cent in 2012 (slightly down from 26 per cent in 2010). The CION notes that the purpose of a compliance strategy is to identify and respond to the most significant risks in the tax collection system and achieve the widest possible impact on voluntary compliance. A set of selected measures to improve tax compliance and promote efficient tax administration based on Jensen and Wohlbier (2012) can be found in Box 5.4 in the CION report.

### 6.7 Conclusion

Following the analysis carried out it is clear that when considering fiscal rules, several factors need to be taken into account. This has become evident not only in terms of the operational features of each rule, but also in terms of wider policy implications which must take into account the overall macroeconomic impact. The analysis has in fact shown the importance of economic growth for a successful consolidation strategy and that in turn the chosen fiscal consolidation strategy will also impact the dynamics of growth thus giving rise to important inter-lineages which cannot be overlooked. As a result, apart from the objective of fiscal prudence, the need for counter-cyclical policy action has also been identified.

It is also noteworthy that the analysis carried out by the IMF demonstrates that when countries cannot rely on the exchange rate to stimulate exports and cannot alter their interest rate (or are close to a zero-interest-rate-floor) in order to stimulate domestic demand, the output costs of a fiscal consolidation are much greater. Additionally, the IMF simulations also show additional negative effects on a small and open economy from a multi-country coordinated consolidation process which also has additional output costs for the small and open economy. Because these simulations reflect Malta’s situation they should not be taken lightly. As a result, considering the impending and evolving output costs for the local economy which are dictated by the external environment, the need for a counter-cyclical policy which allows Government to support the economy in bad times should be further stressed.

In addition however the IMF suggests further that though desirable, the counter-cyclical effects of fiscal policy in a small open economy are also more limited. In other words a relatively stronger fiscal effort would be required in an open economy to achieve the same stimulus in bad times compared to the fiscal stimulus necessary in a more closed economy. This suggests that fiscal consolidation efforts should be stronger in good times and Government should aim for a primary surplus over the cycle. In this way, small open economies like Malta would have the necessary fiscal space to undertake the much needed counter cyclical fiscal expansion in bad times. This lends further support to the conclusion of this analysis in favour of the application of a combination of the expenditure rule and the debt rule to encourage fiscal prudence and the SGP rule to preserve counter cyclical fiscal policy in bad times.

Indeed, the empirical analysis of each of the rules assessed has shown that there is no one best rule which leads to quick debt reduction, that also ranks best in terms of counter-cyclical policy and which also yields a credible structural effort. In fact, taken separately from each other, the aforementioned desired features seem to be in conflict with each other. Indeed what may be the best policy for debt reduction also results to be the least counter-cyclical policy. Additionally, and intuitively, the rules which provide for the largest debt reduction also result in the greatest structural effort; a situation which in turn may not be tenable given too high of an effort. Moreover, allowing for too much slack when accounting for counter-cyclicity would negatively affect the debt trajectory. Consequently, a balance is required in order to allow for consistent and
credible debt reduction while also allowing leeway for fiscal policy to support the economy when needed. Indeed, a credible fiscal consolidation strategy which when required allows the Government to consolidate in good times and to support economic growth during bad times is needed.

The analysis has also put into perspective the consistency of the alternative rules assessed with the requirements of the Stability and Growth Pact. This has shown that compliance with the 0.5 per cent fiscal effort is not guaranteed by the rules taken into consideration, except, of course, by the SGP rule itself. As a result, despite any possible desirability of any other rule, such a fact effectively limits the choice of rules considered to the SGP rules. Nevertheless, the application of an expenditure rule consistent with the expenditure benchmark of the SGP together with the application of the SGP rule appears to be a favourable economic option for Malta irrespective of the requirements of the SGP.

Whilst the expenditure rule would encourage fiscal prudence in good times escape clauses could allow the suspension of the expenditure rule in bad times so that the overarching SGP rule and the debt rule allow counter-cyclical fiscal policy to be undertaken without jeopardising fiscal sustainability. Such a strategy should help to safeguard Malta against persistent structural deficits and unsustainable indebtedness levels thus lowering the risk of a sovereign crisis.

A rules based framework however has its limitations. First of all it does not tell you how best to consolidate public finances without jeopardising growth prospects unnecessarily. It may tell you to raise revenue or limit expenditure growth but says nothing about which revenue component should be raised and how or which expenditure measure should be preserved in the fiscal consolidation process when this is deemed necessary. Secondly due to the necessity of introducing escape clauses to preserve counter cyclicality, a level of policy discretion may be necessary even if this could undermine the effectiveness of such a rules-based framework. In other words, rules need to be supported by a stronger institutional framework. This will be the subject of the second part of this report.
7. Independent Fiscal Institutions
7. Independent Fiscal Institutions

Independent fiscal institutions are defined by the European Commission as non-partisan public bodies, other than the central bank, Government or parliament that prepare macroeconomic forecasts for the budget, monitor fiscal performance and/or advise the Government on fiscal policy matters. These institutions are primarily financed by public funds and are functionally independent vis-a-vis fiscal authorities. Fiscal institutions play an important economic function.

Fiscal policy is best undertaken by democratically elected Governments and in this context independent fiscal institutions should not interfere unduly with this political process. Nevertheless fiscal policy carries with it economic repercussions and the misuse of fiscal policy for short-term partisan gains is often to the detriment of the democratic process itself, particularly if this is undertaken in the absence structures which ensure accountability towards society in the conduct of fiscal policy. The loss of sovereignty suffered by countries which are currently in a fiscal crisis is sufficient testimony to this. In this context independent fiscal institutions can act as a watchdog on fiscal policy thus strengthening the democratic process rather than limiting it.

Ultimately the financial markets also act as the ultimate watchdog of fiscal policy, presumably denying profligate Governments from access to funds to finance the budgetary execution so central to the operations of Government. However financial markets are known to react rather late when fiscal conditions have already been aggravated. And when they act, financial markets tend to overreact, causing havoc to public policy often to the detriment of the democratic process itself. This has been evident in many a financial crisis including those following fiscal crisis. In this context the operation of independent fiscal institution is meant to prevent the fiscal position of a country from deteriorating to this extent. Moreover the presence of a strong and independent fiscal institution supported by an effective rules-based fiscal framework enhances the credibility of Governments in the eyes of financial markets and thus allows Governments to borrow, when necessary, at a minimum cost.

Independent fiscal institutions also enhance the democratic process by improving the flow of information between the Government and its electorate. They act to explain the otherwise complicated budgetary process in more simple terms to the wider public. In this way a more informed public makes electoral decisions based on reliable non-partisan information knowing in advance the likely economic repercussions of alternative choices. Their evaluation of the budgetary process is the ultimate guardian of society’s interests in ensuring a sustainable public finance position which can stabilise the economy in times of need. In many countries the role of independent fiscal institutions in strengthening the democratic process is recognised to the extent that they are often enshrined in the constitution and their actions are answerable to parliament rather than the executive with mandates which include the provision of information to the general electorate. In some countries (notably the Netherlands) they are even required to evaluate electoral manifestos and the full-term programme of an elected Government.

7.1 Functions of an Independent Fiscal Institution

The functions of an independent fiscal institution vary from country to country. Their mandate often includes the following:

1. monitoring **compliance** with numerical fiscal rules
2. assess fiscal and macroeconomic **projections**
3. **impact assessment** of major fiscal policy measures
4. verify the activation of **escape clauses** embedded in fiscal rules
5. verify the activation of **corrective mechanisms** when rules are not adhered to
Due to its complexity, the budgetary process is often fraught with information asymmetries, with most of the information underlying the budget remaining hidden from the general public including Parliament. In this context functionally independent fiscal institutions also have an important communication role. Their evaluation of the budgetary process is made public and serves to explain the otherwise complex budgetary process and its expected outcome to the general public and especially to Parliament. In this way they increase transparency and reduce the gains from opportunistic behaviour.

Most independent fiscal institutions are tasked with evaluating macroeconomic and fiscal projections. However, independent fiscal institutions sometimes produce their own macroeconomic and fiscal projections and in even rarer instances fiscal authorities completely delegate this function to independent fiscal institutions. In some cases fiscal institutions are also entrusted with the function of evaluating fiscal policy measures including those contained in electoral programmes or the medium term budgetary plan of newly elected Governments.

Some fiscal institutions also produce policy relevant forecasts. The economic literature suggests that forecasts produced by independent fiscal institutions are often less biased than those prepared by the fiscal authorities. However as any macroeconomic and fiscal projections they are not necessarily accurate. The inevitable inaccuracy of forecasts can lead to a potential loss of reputation to the fiscal institution publishing its own forecast. Indeed many economists suggest that independent fiscal institutions should not publish their forecasts and should limit themselves to the evaluation of forecasts. Alternatively forecasts should be presented as a range of probabilistic outcomes (e.g. the use of fan charts by the Irish Fiscal Advisory Council) and fiscal institutions should encourage Governments to adopt more prudent growth forecasts than the most likely growth prospect. In the Netherlands such a practice was openly adopted by the Government although it was eventually abandoned in more recent years. Whilst monitoring and forecasting are often viewed as two separate functions of fiscal institutions, our experience suggests that forecasting, even if internal, greatly enhances the effectiveness of the monitoring process.

7.2 The Deficit Bias in the Maltese Context

The economic literature suggests that fiscal institutions should reflect country specificities. The underlying diversity in the scope and role of a fiscal institutional framework should reflect the economic, political and cultural contexts, these being the three factors influencing policy. In the Maltese context these characteristics should be kept in mind:

- an open economy which is more vulnerable to outside shocks such that a rules based framework needs to be supported by appropriately designed escape clauses
- a small open economy dependent on foreign investment which needs to preserve its economic credibility including through sustainable public finances and competitive and growth-friendly taxation
- a domestic banking system which is heavily exposed to the Maltese sovereign debt and therefore whose credibility is strongly tied with that of the Government
- an ageing population which makes it even more important to ensure long-term sustainability of public finances in view of rising health care and pension related costs
- a deficit bias has been identified, with a tendency towards optimistic revenue forecasts
- no noticeable bias in economic forecasts supported by a maturing tradition of independent macroeconomic forecasts based on well maintained and frequently updated macroeconomic models within the Economic Policy Department
- forecast accuracy limited by the vulnerability to outside shocks suggesting the need for rainy day funds
- a rather polarised political process with electoral competition often leading to impatience in the short term and fiscal slippages often materialising before an election
- a tendency for fiscal policy to act pro-cyclically
- a **small administrative set-up** coupled with a wide-ranging fiscal policy coverage and a fully developed, often complicated tax/benefit structure
- a mature and **extensive welfare system** and a relatively egalitarian society
- a centralised political system with **limited devolution to local councils** which do not yet enjoy financial autonomy from central Government
- **limited access to international financial markets** with public sector borrowing predominantly from domestic savings
- **limited financial literacy** coupled with a limited journalistic review of financial, economic and budgetary conditions

Malta also suffers from a **common pool problem**. This is the case when small groups lobby for their interests with insufficient regard to the full budgetary costs now and in the future. Common pool theories focus on the fact that decision makers, including spending ministers, fail to internalise the overall costs of higher spending and debt. In this context, an independent fiscal institution could strengthen the authority of a finance minister with regards to common pool problems, while making clear the future consequences of current deficits through fiscal sustainability calculations.

**In this context, an independent fiscal institution supported by a rules-based fiscal framework represents a desirable institutional development in Malta to address the deficit bias.** It can act as a fiscal watchdog for the benefit of Maltese citizens, safeguard long term sustainability of Government finances, preserve fiscal space for fiscal policy to act counter-cyclically when required, inform the electorate of the all-important budgetary process and promote confidence in the Maltese economy and the financial system. The size and mandate of the fiscal institution should also be consistent with the size and scope of the Government administrative apparatus. Human resource limitations suggest that a lean, well-focused institutional apparatus may be more appropriate ensuring minimum resource duplication.

### 7.3 Fiscal Institutions and the Overall Fiscal Frameworks

Whilst fiscal institutions can act independently of the rules-based fiscal framework, rules are most often an important tool for the operation of fiscal institutions. To safeguard the credibility and impartiality of a fiscal institution, especially in view of the polarised political system in Malta, **fiscal rules are deemed to provide a vital support to the operation of a fiscal institution.** Judging fiscal performance often involves a measure of economic judgement which can easily undermine the credibility of a fiscal institution particularly in a polarised political context. Fiscal rules can reduce considerably the element of judgement and therefore preserve the integrity of the institutional framework.

The economic literature suggests that fiscal institutions should preferably be **advisory rather than decision making, whilst allowing rules-based fiscal policy to be more flexible.** Specific country experiences further outline that fiscal institutions should complement fiscal rules. In the United Kingdom, for example, the introduction of fiscal rules in 1997 did not prevent slippages after 2002, disproving the idea that a public commitment with no enforcement mechanism would work. This has led the newly elected British Government to pass in 2011 the Budget Responsibility and National Audit Act, which act combines a set of rules and an independent fiscal policy committee. In this context the enhanced fiscal governance framework through the operation of a fiscal council supports and to a certain extent strengthens the operation of fiscal rules.

It is interesting to take note of the discussion in the Maltese Parliament regarding the Fiscal Compact where a prominent and experience member of Parliament expressed a reasonable concern on the ability of operating macroeconomic and fiscal policy completely through a rules-based framework. **In a sense a fiscal council which applies the rules according to the spirit of the rules, avoiding a purely mechanical interpretation whilst allowing a certain degree of manoeuvre in the application of rules subject to the economic conditions ensures that fiscal policy is not reduced to an overly mechanical process of a solely rules-based fiscal framework.** This is especially relevant when more than one rule is in operation as is being
recommended in this report. Different rules may occasionally conflict at which point a fiscal institution could provide a form of arbitration between conflicting rules.

Independent fiscal institutions are also required to sanction deviations from fiscal rules when appropriate thus allowing the necessary flexibility in economic and fiscal policy making. The operation of countercyclical fiscal rules is often based on an imperfect statistical quantification of cyclical conditions which may not always reflect entirely and in a timely manner the reality on the ground. This is especially so in the local context where for instance the relocation of one or two companies may lead to a significant rise in unemployment. If such instances are preceded by a booming period, alternative statistical evaluations of the output gap may not necessarily capture entirely the scale of such output contractions below potential or possibly capture it belatedly to the extent that Government support in such instances may be delayed unnecessarily. This presents a clear example where economic judgment may be opportune and a Fiscal Institution should have the mandate to deviate from a purely mechanistic interpretation of the rules. In the local context therefore it is imperative that a Fiscal Institution possesses the capacity and wisdom to make good economic policy judgement.

Independent fiscal institutions and fiscal rules should also be complemented by fully independent statistical offices, a strengthening of the roles of audit mechanisms and parliamentary technical services, disclosure requirements for all fiscal authorities and a medium term budgetary framework.

### 7.4 Principles for an Independent Fiscal Institution

Although fiscal institutions should be tailored to the specific needs of a country, a number of minimum conditions or principles should be respected irrespective of the context. Outlined as principle seven of the communication from the Commission on common principles for national fiscal correction mechanisms is the requirement of credible and transparent independent bodies. Also supported by academics and evident from historical experience is the necessary political will which should be present so as to safeguard credibility and transparency, while ensuring commitment to such an initiative. These three pillars, namely credibility, transparency and political will are key building blocks of a functionally independent fiscal institution.

In light of addressing these basic requirements of a functional fiscal institution, the OECD is proposing a number of principles for independent fiscal institutions, which principles Malta is advised to follow in the setting up its fiscal institution. Whilst fiscal councils vary from one country to the next, the following basic principles should be followed:

- **Local Ownership**: To be effective and enduring, an independent fiscal institution requires broad national ownership, commitment, and consensus across the political spectrum. The local needs and the local institutional environment should determine options for the role and structure of the institution and the basic characteristics will be consistent with the country’s legal framework, political system and culture. The institution’s functions should be determined by the country’s fiscal framework and the specific issues that need to be addressed.

- **Clear and achievable mandate**: The mandate of the independent institution should be clearly defined in legislation, including the types of reports and analysis that are to be produced. Typical tasks carried out by independent fiscal institutions might include (but are not limited to): economic and fiscal projections (with a short- to medium-term horizon, or long-term scenarios); baseline projections (assuming unchanged policies); monitoring compliance with fiscal rules or official targets; verification and activation of escape clauses embedded in fiscal rules; verification the activation of corrective mechanisms when rules are not adhered to; costing of major legislative proposals; and analytical studies on selected issues. The mandate should be tailored to the circumstance of the country concerned. Relevant deadlines for submitting reports should also be established.
• **Statutory or Functional Independence:** A non-partisan institution does not present its analysis from a political perspective and always strives to demonstrate objectivity and professional excellence. The leadership and membership of an independent institution should be selected on the basis of merit and technical competence, without reference to political affiliation. More specifically, this should involve proven competence in economics and public finances, and familiarity with the budget process. The membership term should be independent of the electoral cycle, while the position of head of the institution should be remunerated and preferably in full-time position. The agency should have full autonomy in carrying out the tasks necessary to fulfil its mandate including those relating to staffing. Dismissals should be carried out only through a parliamentary resolution. Independence should preferably be enshrined in law, and may also take place through proper administrative arrangements of legal binding value which allow the entity to perform its functions independently from Government without any interference. Security of tenure should further enhance the independence of the council.

• **Access to relevant information:** No matter how well an independent institution is resourced, there is often asymmetry of information between the Government and the fiscal institution. This creates a special duty to guarantee the independent institution full access to all relevant information – including methodology and assumptions underlying the budget and other fiscal proposals in a timely manner. Any restrictions on access to Government information should also be clearly defined, while appropriate safeguards may be put in place as regards protection of privacy and of sensitive information.

• **Resource support:** The fiscal institution should be adequately resourced with the necessary expertise to carry out its function and preserve its independence. Members should be qualified professionals with expertise in the areas of international and local macroeconomics and fiscal policy. Remuneration should be adequate to attract competent and specialised human resources. Resources allocated should commensurate with the institution’s mandate in order for them to fulfil it in a credible manner. In particular if the fiscal institution is to be given the mandate of producing macroeconomic and fiscal projections as well as that of evaluating policy proposals its resources will have to be greater than those of an alternative fiscal institution required to simply monitor the compliance with fiscal rules. In many countries fiscal councils are lean organisations employing less than ten members. However where the mandate of the institution is rather wide (as in the case of Netherlands and the USA) and includes responsibilities such as the evaluation of legislative measures and macroeconomic and fiscal projections, the size of a fiscal institution could exceed a hundred members. In this case the fiscal council would be undertaking a large share of the role of the central budgetary authorities. There is no indication in the literature that one model is superior to the other.

• **Transparency, Communication, and Evaluation:** One primary goal of a fiscal institution is to promote transparency in public finances, thus full transparency in the institution’s work and operations is critical, as is effective communication, especially through proper media coverage. Independent fiscal institutions’ reports and analysis (including a full account of the underlying data and methodology) should be published and made freely available to all, and ideally, a newly created independent fiscal institution must identify itself and start operating according to its terms of reference as soon as possible. Communication should not take place too frequently since this can undermine its effectiveness. Typically communication should take place twice a year; once following the publication of the budget and secondly following the publication of the Stability and Convergence programme in line with the European Semester. Every effort should be made to avoid biased and partisan communication and recommendations should be backed by evidence whilst normative economic judgement should be avoided. Direct communication with respected, unbiased and financially literate journalists and media houses is advised. In view of known limitations in Malta in this respect the Fiscal Institution should possibly organise information workshops to the media in order to improve such financial literacy. Alternatively in the Maltese context it is important that the fiscal institution develops its own Public Relations function. Experience from other countries suggests that communication is a vital function of a fiscal institution.
• **Accountability**: An independent fiscal institution therefore shifts responsibility from political authorities, to the new apolitical institution, where influence of political pressure on policy is diminished. At the same time accountability to the political institutions, primarily to Parliament and ultimately to the Constitution would ensure that the political aspirations of the nation and the democratic process is not jeopardised. Mechanisms should be put in place to encourage appropriate accountability to the legislature. These may include (but are not limited to): all reports sent to parliament for scrutiny; appearance of institution’s leadership before the budget committee to provide responses to parliamentary questions; and role for parliament’s budget committee in leadership appointments and dismissals. Elected representatives must be able, on behalf of voters, to conduct ex post evaluations to ensure that the delegated powers are in fact being used in pursuit of the agency’s mission.

Whilst a clear political support for a functionally independent fiscal institution is now evident in Malta, it is important to define clearly what is meant by “functionally independent” possibly through a code of conduct which should accompany the role and function of the institution. As highlighted in section 2.1.4 of this Report the regulation soon to be enacted at EU level on minimum provisions for monitoring and assessing draft budgetary plans, provides a more formal definition of what constitutes functionally independent bodies.

### 7.5 Possible Options Underpinning a Fiscal Institution

Fiscal institutions can take various forms. Before considering the options it is worth highlighting the administrative apparatus currently in operation in Malta. At present macroeconomic projections are carried out by the Ministry of Finance through the Economic Policy Department. Whilst the Department is part of the Ministry it has a strong tradition of professional autonomy from the Ministry. In recent years the Department has also invested heavily in the forecasting of fiscal aggregates. However the Department lacks the experience and knowhow of the Budget Office when it comes to the more detailed projections of fiscal variables at departmental level. Indeed fiscal projections are the responsibility of the Budget Office and the Treasury also within the Ministry of Finance, with the assistance of the National Statistics Office which is involved in the conversion of cash-based fiscal projections into accruals-adjusted projections. Since EU membership, the degree of collaboration between the Economic Policy Department and the Budget Office has increased considerably and the former now gives technical assistance to the latter in order to ensure greater consistency with the macroeconomic projections. In this context, five different types of independent fiscal institutions could be considered for Malta.

#### 7.5.1 Option 1: Minimalist Approach; Monitoring Only

A minimal approach for an independent fiscal institution would simply require the institution to be **responsible at national level for monitoring compliance with the fiscal rules** with no responsibility whatsoever of forecasting macroeconomic aggregates or fiscal variables. This is the minimum requirement for an independent institution as outlined by Paragraph Two in Article Three of the Treaty on Stability, Coordination and Convergence as referred to in the section on Budgetary Surveillance. Such an option could be well suited to a country which does not display a deficit bias or a tendency towards optimistic macroeconomic growth projections.

#### 7.5.2 Option 2: Minimalist Approach; Monitoring + Evaluation

A second option for an independent fiscal institution is to **monitor and analyse forecasts which are presented by the Ministry for Finance**, alongside monitoring the compliance with fiscal rules. Whilst the fiscal institution would not be required to produce its own forecasts it would be able to **evaluate the forecasts presented by the Ministry for Finance and present its finding to parliament and publish its assessment**. This is the option being implemented by Ireland through the establishment of the Fiscal Advisory Council. **It is suitable for small administrations particularly if there is no clear forecast bias in the macroeconomic and fiscal projections.** In order to evaluate these forecasts it would have to compare these forecasts with alternative forecasts. It would need to be given the faculty to probe deeper into these forecasts and request the necessary information from the ministry, including access to confidential information. In
this context the fiscal institution would need to be given access to the assumptions underlying the Ministry’s forecasts together with a clear evaluation of the impact of discretionary policies and the projections under a no policy change scenario. It could also request sensitivity analysis. Most of this information would be required anyway by the new SGP.

7.5.3 Option 3: Monitoring, Forecasting and Evaluation Approach

The ability of a fiscal institution to produce its own set of forecasts strengthens the institution’s oversight function. All international bodies which oversee fiscal forecasts, whether it is the IMF, the European Commission or the credit rating agencies carry their function by producing their own forecasts. Therefore a third option would allow the fiscal institution to produce its own macroeconomic and fiscal projections, independently of the Government. The independent institution would therefore be required to prepare macroeconomic and fiscal forecasts for advisory purposes, so as to analyse the Ministry’s forecasts, and then to present analysis.

Under this setup, the Ministry for Finance shall be obliged to explain publicly why forecasts differ. Under this set-up the Budget Office and the Economic Policy Department would remain within the Ministry for Finance whilst a new independent institution would have to be created, carrying out similar functions to the two departments within the Ministry for Finance. The third option involves a degree of overlap of functions with the Ministry for Finance and a significant element of resource duplication since there will be at least two sets of macroeconomic and fiscal projections.

7.5.4 Option 4: Monitoring, Partial Forecasting and Evaluation Approach

Given resource limitations in terms of the size of the administrative apparatus and limited specialised human resources, duplication of resources when reforming the fiscal institutional framework should be minimised in the case of Malta. Thus, a hybrid of the third option for an independent fiscal institution could be considered whereby the institution would be required to solely prepare fiscal projections, while using the macroeconomic forecasts of the Ministry for Finance as a baseline. In this way the function of the fiscal institution would be to evaluate the consistency of the fiscal projections with the macroeconomic forecasts. Whilst the Fiscal Institution would not be responsible to replicate the macroeconomic forecasts of the Ministry it would still be able to evaluate them as in option 2. Under this option duplication of resources is not eliminated completely (since two sets of fiscal projections will be made) but minimised (in the case of macroeconomic projections). The fiscal projections carried out by the Fiscal Institution could however be carried out at an aggregate level with the more detailed departmental expenditure projections remaining under the responsibility of the Budget Office within the Ministry for Finance. Under this option the Economic Policy Department would remain within the Ministry for Finance and produce the macroeconomic forecasts. However part of the Department currently responsible for fiscal affairs would have to be given its own functional autonomy or complete independence from the Ministry for Finance.

This setup would be effective in a country where a deficit bias is evident but where this deficit bias cannot be attributable in whole or to a large extent to any bias in macroeconomic projections. This is specifically the case of Malta judging by recent forecasting performance. However since past performance in macroeconomic projections is not necessarily a guarantee of future performance and the evidence produced in this Report has not eliminated completely the presence of some bias in the current year macroeconomic forecasts another variant of this option could be considered.

The Ministry for Finance may alternatively farm out the macroeconomic projections completely to the Independent Fiscal Institution. The aggregate fiscal projections would also be carried out by the Fiscal Institution but the Budget Office within the Ministry for Finance would continue to carry out its fiscal projections at a departmental level on the basis of the macroeconomic forecasts and aggregate fiscal projections of the Independent Fiscal Institution. This option could be easily implemented by Malta through the granting of functional autonomy to the Economic Policy Department whilst keeping the
Strengthening Malta’s Fiscal Framework

This would ensure complete independence from the ministry of finance and still minimise resource duplication at least in the formulation of macroeconomic projections. From a resource perspective, this option could be ideal in a small administration such as Malta’s. **However it still involves an element of resource duplication in the fiscal projections.**

### 7.5.5 Option 5: Total Independence Option

The final alternative would be for the Ministry for Finance to completely farm-out the macroeconomic and fiscal projections to the mandate of an independent institution. This means that the fiscal institution will be responsible to produce independently the macroeconomic projections to be used in the budget together with the fiscal variables driven by the economic cycle. Austria, Belgium, the Netherlands and recently the UK apply this model. The independent institution performing the forecast function is typically enshrined in legislation except in Austria where this function is performed administratively by an agency. In the UK the Office of Budgetary Responsibility is expected to be based on a statutory footing (Ireland Department of Finance, 2011). This option would completely eliminate the unnecessary duplication of resources which may be very costly for a small administration. It would also ensure almost complete independence.

This approach is very similar to that applied in the Netherlands and would represent a brave step politically. However the administrative apparatus of such institutions is typically larger than that necessary for the other options and may have to be adjusted to be applicable in Malta’s case. **However a variant of this model adapted for Malta’s circumstances would simply amount to the granting of functional autonomy to both the Economic Policy Department and the Budget Office.**

### 7.6 The Political Process and the Role of the Ministry for Finance

In the context of a small administration Options 4 and 5 allow the necessary balance to be achieved between the need for independence and the need to minimise or eliminate resource duplication. Even though resource duplication is minimised under these two options, this should not mean that no additional resources would be required. As already indicated in this Report, the functions of a Fiscal Institutions go beyond forecasting and evaluation but should also include evaluating compliance with fiscal rules, verifying the activation of escape clauses embedded in fiscal rules, verifying the activation of corrective mechanisms when rules are not adhered to and communicating with the public. Such functions are not currently performed by any department within the Ministry for Finance and therefore additional resources may still be needed.

Does independence mean that the functions of the Ministry for Finance will be completely contracted out to another institution? **This is not necessarily the case and the Ministry can/should still play an important role in the budgetary process, a role which need not/should not be divorced from the political process. Budget measures and policies should remain the prerogative of democratically elected Governments.**

The fiscal institution’s function should remain a separate technical function and not a political function and therefore it would be beyond its remit to judge the political choices of the Government. The priorities set by the Government over the expenditure components or the type of taxes and the breadth of the tax bases should remain in the hands of the Government. In this context **the Ministry for Finance remains a vital organ of the Government and indeed should be strengthened further as part of the reform of fiscal institutions.** It is important that the fiscal institution works closely with the Ministry even if independently. This will be dealt with in the next chapter on the medium term budgetary framework.
8. The Medium-Term Budgetary Framework
8. The Medium-Term Budgetary Framework

Academic research suggests that the design of budget processes has considerable influence on the fiscal performance of Governments. There are two mechanisms to strengthen fiscal discipline – centralisation of the budget process, which enhances authority, and a contract on the budget targets. The budget process, in the broadest sense, is a system of rules, both formal and informal, governing the decision-making process that leads to the formulation of a budget by the executive, its passage through the legislature, and its implementation.

The International Monetary Fund 2012 Article IV Report suggests that, “a key weakness of Malta’s framework is the non-binding nature of the multi-annual targets, which implies a relatively short fiscal planning horizon… other weaknesses relate to the lack of expenditure ceilings and corrective measures in the event of deviations from the target… also characterised by the absence of an independent budgetary institution to provide independent macroeconomic and fiscal forecasts and to assess fiscal sustainability and compliance with the fiscal mandate”. Currently in Malta, plans arising from the medium-term budgetary framework do not have a binding effect on the actual budget. The multi-annual dimension of expenditure planning in Malta is often seen as indicative, non-binding and subject to future budgetary processes. The existing budgetary process focuses attention on the year ahead, whereas expenditure trends and pressures that fall outside this annual frame of reference do not receive the same attention or control; and by the time these future years are reached, earlier projections will invariably have been superseded. Moreover, supplementary budgets weaken further the discipline of fiscal targets even for the year ahead.

Producing estimates has been an annual event and limits were set from the centre regarding the totality of funds available for expenditure, and these are then countered by demands and bids from the spending Ministries. After extended and confidential discussions, the eventual outcome would be made known in the Financial Estimates document, usually on Budget Day. Soon afterwards, the whole annual cycle would start afresh, with little regard to medium-term plans or constraints upon overall allocations.

8.1 Designing a Medium Term Budgetary Framework for Malta

A credible and effective medium term budgetary framework needs to create the right balance between control and discipline on the one hand and flexibility on the other hand. Whilst certain expenditure overruns are inevitable lack of proper planning and foresight often leads to sizeable overruns whilst the lack of a multi-annual budgetary framework leads to persistent overruns. Expenditure rules at ministry/department level should complement the fiscal rules on the overall budget and should ensure a measure of discipline in the use of public funds.

The risk with any medium-term expenditure framework is that it could become a mechanistic exercise, which is not responsive enough to the needs and priorities of the Government, or to the challenges encountered by Ministers and Departments in managing a complex and diverse range of programmes. Frequent violations of expenditure rules undermine the credibility of a rules-based medium term budgetary framework when the rules:

1. are not well designed to take into account the diverse nature of fiscal policy
2. are frequently changed
3. are not periodically reviewed to identify clear and persistent failures
4. fail to support political commitments such as social contracts
5. are not supported by clear political commitments
6. fail to take into account a certain the degree of uncertainty and
7. are not supported by a strong centralised budgetary planning framework,
8. when the performance of the rules is not monitored regularly
9. when a proper accounting, reporting and auditing framework is not present
In order to take into account (i) the diverse nature of fiscal policy in Malta (including the economic stabilisation, sustainable growth, and income redistribution function), (ii) the degree of uncertainty in projecting expenditure components, and (iii) the statutory political commitments which have shaped the social contract between the State and Maltese citizens over time it is being proposed that a rolling three to five year medium term budgetary framework for expenditure commitments is set up which clearly distinguishes the following four types of expenditure:

1. Cyclical expenditure commitments (namely unemployment benefits)
2. Statutory Expenditure (namely pensions and social benefits)
3. Debt Service Payments
4. Ministerial Allocation
5. Capital Expenditure

Table 8.1 gives an indicative breakdown of 2011 general Government expenditure in accordance with the above five expenditure categories. It is worth noting that in 2011 general Government total expenditure amounted to €2,752 million. Different rules will apply to the above expenditure categories.

### 8.1.1 Cyclical Expenditure

This is basically equivalent to unemployment benefits. Expenditure on unemployment benefits represents only 1.2% per cent of total expenditure. Given the sensitivity of this type of demand-led expenditure to the economic cycle and its role as an automatic stabiliser it is proposed that unemployment benefits should be funded and managed on an annual basis and catered for separately within the overall budgetary planning process. Savings in any given year will automatically lead to fiscal consolidation whilst overruns in any particular year will allow the budget to deteriorate. In this way the automatic stabilisation role of cyclical expenditure is preserved. Such a treatment would also be consistent with the overall expenditure rule and the requirements of the SGP.

### 8.1.2 Debt Service Payments

Legal commitments require that debt service commitments are paid such that the solvency of Government is not undermined posing risks on the overall fiscal framework and the overarching credibility of Government. Whilst debt service payments can be projected with a high degree of accuracy it is not advisable to limit such payments through explicit expenditure ceilings. However this does not preclude the Government from strengthening further the role of the Treasury in performing its debt management function to minimise the cost of debt servicing whilst at the same time ensuring enough liquidity and preserving the solvency of Government debt. Excluding debt servicing from expenditure ceilings is also consistent with the expenditure rule and the SGP.
8.1.3 Statutory Expenditure

Statutory expenditure, including social security benefits and pensions-related expenditure, represents almost 1/3rd of the annual budget. Social benefits and pensions define the social contract between the state and its citizens. Thus legal requirements and political commitments underlying the social contract have to be respected. However this should not preclude multi annual expenditure commitments. The absence of such commitments could greatly reduce the incentive on the part of Government to undertake structural reforms in a timely and efficient manner when the sustainability of the same social contract is under question. In the context of an ageing population it is necessary to design a medium term budgetary framework which does not unduly diminish the incentives for necessary structural reforms in pensions, child benefits, health or long-term care.

At the same time it should be recognised that the implementation of structural reforms on statutory expenditure commitments can take a number of years often beyond the medium term budgetary framework envisaged here. This means that the strengthening of the budgetary function is not enough on its own to ensure that medium term budgetary projections are undertaken in the context of longer term budgetary projections. In this case the institutional set up governing statutory expenditure should be strengthened to ensure closer coordination between the Budget Office, the ministry responsible for social policy, the National Statistics Office and the Economic Policy Department which produces long term budgetary projections. This would ensure continuity between the medium term expenditure ceilings, the long term budgetary commitments and the structural reforms that may occasionally be required.

A pension reserve fund could also be considered. Some countries have opted to create an Ageing (Pension) Reserve in the Budget. Particularly in Ireland, the National Pensions Reserve Fund was established with the objective of meeting as much as possible the costs of social welfare and public service pensions from 2025 onwards when these costs are projected to rise significantly due to population ageing. Discussions with the Pension Reform Working Group should be initiated if such a fund were to be created, possibly as a substitute or as a precursor to a second pillar pension scheme.

Table 8.2 suggests that over the last six years deviations from expenditure commitments on social security benefits amount to an annual average of 0.8 per cent of budgetary allocations. The deviations from budget estimates ranges from -0.1 per cent of GDP to 0.3 per cent of GDP. Over this period the total deviation from expenditure commitments amounted to €31 million. This does not appear to be a significant amount, suggesting that the budgetary allocations and the underlying budgetary planning when it comes to social expenditure is already quite robust.

From the information available in the financial estimates it is not possible to evaluate the deviations from

<table>
<thead>
<tr>
<th>Table 8.2 Statutory Expenditure (€ millions)</th>
</tr>
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<tbody>
<tr>
<td>2006</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>Estimated</td>
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<tr>
<td>Actual</td>
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<tr>
<td>Deviation</td>
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<tr>
<td>Annual/Average Deviation (%)</td>
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</tbody>
</table>

Note: Deviations exclude pensions under Malta Dry Docks of a total actual expenditure of €73.9 million over the years 2008-2011 and Pensions under MDD/MSCL/MSY Voluntary Retirement Schemes/Early Retirement Schemes
budgetary targets for the years beyond the annual budget allocation (i.e. the forecast errors for years t+2 and t+3). An internal exercise could however be carried out within the Ministry to determine further the medium term forecast errors in this area of expenditure. However, a-priori one would expect that a multiannual framework may exert further challenges on the ability to project statutory expenditure commitments in the medium term. Nevertheless the strengthening of the institutional framework as suggested above should ensure that the budgetary projections for statutory expenditure remain realistic whilst providing the necessary incentives for longer-term planning and structural reforms.

Deviations from medium term budgetary targets could be covered from a contingency reserve established for the medium term budgetary period. Further details on the operation of a contingency fund will be explored further on in this document. However at this point it is suggested that statutory expenditure should be given priority over other forms of expenditure when use is made of the contingency fund. In view of its priority, the need to project future expenditure commitments as accurately as possible is crucial in order to preserve the sustainability of the medium term budgetary process.

8.1.4 Ministerial Allocation

The annual allocation towards ministerial portfolios, excluding cyclical, statutory and debt service payments exceeds ½ of total Government expenditure. At the beginning of each medium term budget, the projected three to five year budgetary allocation excluding unemployment benefits, statutory expenditure, debt servicing and capital expenditure by ministerial portfolio will have to be determined. At the beginning of each period, the Ministry for Finance will determine the total expenditure ceiling consistent with the fiscal rules in place, given the prudent revenue projections and macroeconomic projections. After deducting the yearly contribution to the contingency fund, the expected annual allocation for the statutory expenditure, the allocation for capital expenditure, the expected debt service payments and the expected expenditure on unemployment benefits, the overall Ministerial Allocation will be determined by the Ministry for Finance.

An inter-ministerial process will then have to be set up so that this overall ministerial allocation can be allocated to the various ministries and departments based on the political considerations and political commitments. In no way should the total Ministerial Allocation be altered at this stage.

However if disagreements persist limited resort to reallocations from capital expenditure may be considered as a last resort. It is proposed that reallocations from capital expenditure allocations to ministerial allocations are limited so as to ensure that growth friendly expenditure is not jeopardised. A minimum commitment for capital expenditure as a percentage of GDP should be established. This minimum should be established on the basis of economic considerations, after taking into account the commitments made by Malta in its National Reform Programme and the partnership agreement with the EU on the use of EU Budget. This ensures that the absorption of EU funds is safeguarded whilst structural reform commitments with the EU as part of the EU2020 strategy or any similar framework in the future is preserved. Any further commitments for capital expenditure could then be the subject of reallocation between the Ministerial Allocation and the Capital Expenditure allocation, depending on the political commitments and administrative constraints. Capital expenditure is considered later in this Chapter.

In addition in the run-up to negotiations at a ministerial level, the Ministry for Finance may also wish to set up a performance reserve. The International Monetary Fund (1999) suggests that within the aggregate total expenditure, and separate from the allocations to ministries, a planning reserve (usually 1 or 2 percent of total expenditure) can be used to assign extra resources later during budget negotiations for the most urgent priorities, without breaching the macroeconomic constraint.

Once the ministerial allocations are determined, each ministry will be responsible to produce a detailed plan of how their expenditure allocation will be established by department, programme and type of expenditure. As a general principle, Ministers and their Departments are responsible for managing strictly within the envelope allocation; policy proposals and structural reforms should be drawn up on an ongoing
Strengthening Malta’s Fiscal Framework

basis, as necessary to keep within this constraint. No additional funds will be available if any scheme exhausts its allocation – and this will require an enhanced managerial focus within all Departments. The setting up of such multi-annual plans would create a good basis for the introduction of performance budgeting if this were to be considered in the future.

Ministerial allocations should be given a lower priority compared to the other expenditure categories when considering the use of the contingency reserve. To establish this level of prioritisation it is proposed that once determined the ministerial allocation for the entire medium term programming period represents a ceiling. Any deviations from the departmental allocations in any given year will have to be offset against the allocations of the rest of the programming period subject to a ceiling. Reallocations from one year to the next within the medium term budgetary allocation should nevertheless be capped. Excessive annual reallocations could undermine the dynamic consistency of multi annual plans by postponing the necessary adjustments to the end of the multi-annual period to such an extent as to jeopardise the credibility of the medium term commitment at a late stage of the budgetary process.

It is worth noting that actual ministerial expenditure for the period 2008/2011 deviated by an average of around 5 per cent per annum from the budgetary allocation. There is a clear tendency to exceed budgetary allocations. Cumulatively, during this period, actual ministerial expenditure exceeded budgetary allocations by €300 million or an annual average of €75 million per annum. This is equivalent to 2.4% of total Government Expenditure or slightly more than 1 per cent of 2011 GDP per annum. Note that this is significantly above the average annual budgetary slippage of around €4 million noted for statutory expenditure.

Almost 65 per cent of the slippages in ministerial allocations occurred due to programme and initiative allocations. However this includes €44 million slippage in 2008 under MIIT primarily due to energy support measures followed by another €17 million slippage under MFEI related to higher EU own resource payments and finally €40 million slippage in 2009 under MFEI primarily due to the winding up of shipyards. These account for more than half of the slippages recorded under programmes and initiatives over the entire four year period. Another €80 million slippage over 2010 and 2011 under Treasury are mainly due to loan facility agreements with the Hellenic Republic and Air Malta.

Another 21 per cent of the total slippages under ministerial expenditure represent higher spending on wages, primarily by Health and Education ministries. These could reflect the impact of various collective agreements signed. Total slippages under contributions to Government entities between 2008 and 2011 amounted to €29 million primarily made up of higher expenditure allocated to the University of Malta (€14 million) and MEPA (€19 million). Actual expenditure on operations exceeded the budgetary allocation over the four year period by €16 million, €9 million of which represent higher expenditures on contractual services in health.

Chart 8.1 below suggests that expenditure deviations from target of between +/- 3 per cent are common, with 29 per cent of all ministerial allocations deviating from their budget allocations within this range. This is also supported by a frequency distribution of deviations from budgetary targets by type of ministerial expenditure. This suggests that limiting annual reallocations to 3 per cent of the overall budget of any ministry should be feasible. Moreover the line ministries would still have the option of reallocating expenditure within their ministerial portfolio and amongst the various departments.

To ensure greater budgetary discipline whilst creating good incentives for proper budgetary planning it is proposed that ministries achieving expenditure savings from budget allocation would be allowed to retain part of their savings for the years within the medium term programming period. This should promote good resource management and remove any incentives to use up allocations by end-year, even though such expenditure might not be optimal in value-for-money terms. It is proposed that a maximum carryover amount should be considered. In Ireland this has been limited to between 1 per cent to a maximum of 3 per cent. Savings in excess of 3 per cent should be used first to offset overruns in other departments, with
additional savings (if any) used to achieve further fiscal consolidation.

If such measures are deemed to be insufficient to finance major expenditure overruns, reallocations between different ministerial portfolios (virement) could be envisaged at a second stage. This will require re-prioritising political commitments and should be decided at Cabinet level. If a compromise is not found, draw-downs from the contingency reserve should be considered as a last option. [However the Prime Minister and/or the Minister for Finance should have a veto in the decision to draw down funds from the contingency reserve.]

To underpin the effectiveness and credibility of the Ministerial Expenditure Envelopes, the Government should provide a full reconciliation each year of any deviations from the prior envelope allocation. In line with best practice in other countries, these reconciliations would identify the impact of changes in (a) macroeconomic variables such as GDP growth, wage and price inflation, (b) volumes of programme beneficiaries, (c) discretionary policy including reallocations, (d) drawdown of carryovers and contingency reserve, and (e) other factors for each Envelope, together with a summary report for overall expenditure.

8.1.5 Capital Expenditure

Government invests around 6 per cent of total expenditure (or roughly 2.5 per cent of GDP) in capital expenditure. Most Government capital expenditure constitutes an essential element in the productive capacity of any economy and changes in public investment have implications on both short-term and long-term economic growth. Nevertheless, most of the benefits of public investment take time to materialise and are not always immediately obvious to the taxpayers. As a result they are often the first to be sacrificed when fiscal consolidation is underway. The Government investment multiplier is also often underestimated particularly in recessionary environments such that the immediate negative effects on economic growth are often underestimated by Governments and policy advisors often with negative consequences on the success of fiscal consolidation efforts. It is worth noting that actual capital expenditure for the period 2008/2011 deviated by an average of around a negative 28 per cent per annum from the budgetary allocation, indicating a tendency to over-predict and/or under-utilise public investment by as much as 2 per cent of GDP.

As shown in Chart 8.2 below fiscal consolidation efforts in many European states preserved their public investment during the crisis. The major exceptions were Greece, Malta, Portugal, Hungary, Iceland and
Ireland. Most other European states either preserved their public investment or even increased it during the recession. Average public investment in the EU and the EA amounted to around 2.5 per cent of GDP. However, countries which are at a similar stage of development to Malta often invest between 3.5 per cent of GDP to 4 per cent of GDP through public funds. At 3.7 per cent of GDP, Malta’s public investment prior to the recession compares well with these shares. However immediately following the recession, Malta’s public investment was reduced to 2.3 per cent of GDP representing the most significant decline in public investment activity during the crisis among the EU member states.

It is evident that public investment in Malta proved to be a source of fiscal consolidation. The openness of the Maltese economy, the lack of natural resources and the high import content of expenditure suggest that fiscal multipliers in Malta could be low even in public investment such that the immediate negative impact of fiscal consolidation on economic growth through lower public investment could be lower in Malta compared to other member states. This provides a partial justification for the reaction of Maltese authorities.

Nevertheless one should not neglect the negative effects of lower public investment on the long-term economic growth potential of the Maltese economy. The reduction in public investment after the recession was all the more of concern when considering that the use of EU funds should have helped Malta to devote more public funds for investment without major negative consequences on deficit levels. In this context it would be opportune to try to limit the extent to which public investment is used as a potential source of fiscal consolidation. It is thus recommended that public investment should not be allowed to go below 3 per cent of GDP. This is still at the low end of the distribution of small EU member states at a similar stage of economic development to Malta. Indeed Malta should aim to invest at least 4 per cent of GDP per annum on public investment at least until it converges to EU per capita income levels.

### 8.2 The Contingency Reserve

#### 8.2.1 Introducing Contingency Reserves

A look at the literature on contingent reserves indicates that these are to be limited for the sole use of unforeseeable claims on the budget, such as floods and future policy considerations. Nevertheless, no specifications exist as to (1) how contingency reserves are to be funded, (2) how balances resulting from
contingency reserves should be used, and (3) the size of the reserve. The use of contingency reserves should be consistent with principles of good governance. A comprehensive policy addressing reserve funds should exist. This helps to openly communicate with the taxpayer and educate citizens about why public funds have been set aside. Furthermore, for the purpose of a contingent reserve to be accomplished, its operations should be understood well by all and political support should be present throughout. It is important to make sure that the scope of the reserve is made clear, as an illusion of safety might be created, this as opposed to the actual scope, being a commitment to fiscal stability.

8.2.2 Potential Uses of the Contingency Reserve

The use of the contingency reserve is primarily aimed at creating a buffer between the overall expenditure ceiling consistent with the fiscal rules and the actual expenditure. The contingency reserve is meant to allow a degree of flexibility in budgetary allocations without jeopardising the medium term fiscal targets. Indeed the contingency reserve should be within the total expenditure allocation consistent with the fiscal rules in place and conditional on the prudent revenue forecasts. The reserve should be established for the entire medium term budgetary period and the available balance should be carried forward from one year to the next.

A second priority of the contingency reserve should be to cover revenue slippages unrelated to cyclical macroeconomic developments. The distinction between structural, cyclical and one-off revenue should be established both ex-ante and ex-post in line with the SGP requirements. The contingency reserve should be used (only) to cover unexpected structural variations from budget targets. Structural revenue slippages to be covered from the contingency reserve should be given priority over ministerial expenditure slippages. Use of the contingency reserve for structural revenue slippages would reduce the extent to which the contingency reserve could cover ministerial expenditure slippages, making it more difficult to draw down of the contingency reserve. This in itself would strengthen the incentive to ensure against systematic bias in revenue projections.

[Government could also consider the use of the contingency reserve for cyclical deviations from revenue targets as well, specifically for when unfavourable macroeconomic conditions are more pronounced than anticipated. This would preserve the automatic stabilisation function whilst ensuring strong incentives for fiscal discipline even in bad times. During a recessionary period part of the contingency reserve will be used to cover the foregone cyclically sensitive revenue and thus allowing less room for expenditure slippages at ministerial level. However, if this option were to be considered, the contingency reserve should be of a higher order of magnitude than otherwise so as to ensure that the credibility of the medium term budgetary framework is not undermined by being too taxing. In good times the use of the contingency reserve to cover cyclical deviations from revenue targets would not arise giving more scope for the use of the reserve for expenditure slippages. This could reduce the incentive for prudence in ministerial expenditure in good times. In order to minimise this one should consider the size of the contingency reserve to be determined as a ratio of GDP rather than as a ratio of budgeted expenditure.]

The contingency reserve has the potential to smoothen one-off variations in deficit due to unexpected (not necessarily cyclical) changes in revenue or expenditure. However, the contingency reserve remains a finite pool of resources and is therefore not meant to address persistent biases in the deficit projections against targets. For instance consider the impact of the ageing problem on health, long term care and pension expenditure. If the cost of aging on public finances is persistently underestimated and age-related expenditure is not controlled, expenditure slippages would quickly undermine the contingency reserve. Indeed it is to be noted that a contingency reserve can exacerbate the volatility of deficit dynamics if misused to cover persistent slippages such as underestimated ageing related costs. Therefore extreme caution should be exerted in the use of the contingency reserve.
8.2.3 The Size of the Contingency Reserve

Contingency reserves do not follow a one size fits all, but factors influencing the size of the reserves could include the budget size, the country’s economic well-being, and the underlying policy decisions. In theory, finding a reserve’s optimal size involves placing a value on the costs and benefits that a reserve gives rise to, and then finding the particular reserve balance for which the net benefits of the reserve are maximised (Vasche and Williams, 1987). However, this is not a practical approach, and an alternative would be to quantitatively analyse the fiscal forecasting error with an additional subjective qualitative judgement regarding the degree to which a reserve should be funded to protect against this forecasting error margin. Under this approach, the deviations are measured, and the resulting deviation is assumed to represent the shortfall that a contingent reserve could be expected to offset.

Contingency reserves are used in various countries and are typically set at between 0.25 per cent of expenditure to 5 per cent of expenditure. In Canada, a contingency reserve of about 0.15 per cent of GDP is used to compensate for forecasting errors and unpredictable events. At 0.25 per cent of total general Government sector expenses (equivalent to around 0.1 per cent of GDP), the contingency reserve in Australia is used to reflect anticipated events that cannot be assigned to individual programmes in the preparation of the Budget estimates. In Greece, a compulsory contingency reserve of 5 percent of the total appropriations of Government departments other than wages, pensions and interest (equivalent to around 0.9 per cent of GDP) has been introduced and is under the control of the Ministry of Finance. In Spain, a similar mechanism known as the Contingency Fund exists, this amounting to 3 per cent of the non-financial expenditure (or around 1.3 per cent of GDP). This fund is included in the Budget Law and allows for the financing of any unforeseen and non-discretionary expenditure, thus contributing to reduce the risk of slippage. In the case of Ireland, overruns on an envelope allocation are treated as advances from the next year’s allocation, meaning that reprioritisation of resources within an envelope is required, with the drawing up from the contingency reserve reserved for exceptional circumstances. The budget margin in Sweden is 2 per cent of the total expenditure (or approximately 1 per cent of GDP), requires approval by Parliament, and can be used only to offset expenses attributable to economic forecasting errors. Besides the margin, some ministries hold their own contingency reserves as a separate appropriation against natural disasters (Kim and Park, 2006).

There is clearly a wide variation between countries. In some countries the contingency reserve is set as a proportion of GDP whilst in others it is set as a share of expenditure or in rare cases revenue. The IMF recommends that contingency reserves should not exceed 2 per cent to 3 per cent of total expenditure. In Malta’s case this would be equivalent to around 0.75 per cent to 1.15 per cent of GDP. Contingency reserves are typically utilised in exceptional cases such as natural disasters, called guarantees and sometimes due to major changes in budgetary assumptions such as oil prices.

An evaluation of fiscal slippages over the last four years, excluding extraordinary events which could however have been planned in advance (e.g. enterprise restructuring, collective agreements or biased revenue forecasts) suggests that the contingency reserve could be set up to cover around 0.5 per cent of GDP for possible unforeseen expenditure overruns and an additional 0.3 per cent of GDP for unforeseen revenue slippages. Thus a contingency fund of around 0.8 per cent of GDP (roughly equivalent to 2 per cent of expenditure) appears to be a plausible reserve for Malta to cover unforeseen deviations in the deficit from targets. This is well within the acceptable range recommended by the IMF.

This level of reserve accumulation is not meant to cover foreseen structural reforms including reforms to state-owned companies. The use of the contingency reserve for such circumstances could delay the cost of such restructuring efforts beyond the medium term budgetary targets particularly if such reforms are of a significant magnitude and if they occur at the end of a medium term budgetary plan. Under such circumstances this could completely eliminating the closing balance at the end of the medium term budget requiring a significant top-up in the next medium term programming period. This could coincide with the end of a legislature such that the consequences could be postponed to a new legislature. This in itself provides a further justification for limiting the size of the contingency reserve despite its clear attributes for smoothing unpredictable shocks to the budgetary cycle.
8.2.4 Establishment of the Contingency Reserve

The Reserve could be established either at a suitably prudent proportion of GDP or a proportion of expenditure each year. The build up of a contingency reserve represents a cost to the taxpayer and temporarily increases the deficit. As a result, the full accumulation of such a reserve may need to take place over a number of years. The build up of the reserve in Malta could easily take place over a period of three years, possibly leading to the target to achieve Malta’s Medium Term Budgetary Objective of a structural surplus.

Should the contingency reserve be set as a prudent proportion of GDP or as a prudent proportion of expenditure? Setting the contingency reserve as a share of expenditure when expenditure is growing faster than economic growth means that the contingency fund will grow automatically as a share of GDP. In itself this acts as a tax on expenditure since the contingency reserve represents funds which cannot be used except in exceptional circumstances. However in this circumstance, when the economy is going through a recessionary period where Government expenditure is/should be increasing whilst income is declining, the contingency reserve would act pro-cyclically rising significantly as a share of GDP and thus limiting the stimulus provided by the automatic stabilisers in-built in cyclical expenditure. On the other hand, if the contingency reserve is set as a proportion of GDP then the contingency fund will grow faster in good times than in bad times. The advantage here is that it can act as a counter cyclical tool. The choice again depends on the desired balance between fiscal discipline and economic stabilisation. However if an expenditure rule which ensures that expenditure does not rise faster than potential GDP is in place, the need for the contingency reserve to move with GDP is less of a constraint and one should consider going for the counter cyclical approach.

8.2.5 Utilisation of the Contingency Reserve

Any draw-downs from the reserve should be formally reconciled in the budgetary documentation from one year to the next. As a result the use of the contingency reserve can overlap more than one medium term budgetary period. At any point in time a number of requests for draw-downs from the contingency reserve may arise. Under such circumstances statutory expenditure should be given priority over ministerial expenditure. To promote sound and realistic budgetary planning structural revenue slippages should also be offset against the contingency reserve prior to any drawdown from ministerial expenditure. The Irish system also proposes that cyclical expenditure overruns can benefit from the contingency reserve. However given the small size of cyclical expenditure, the need to preserve automatic stabilisers and the consistency with expenditure rules, this is deemed unnecessary in the case of Malta.

Draw-downs from the contingency reserve should be recovered in the following periods. It is proposed that the use of the contingency reserve is recovered gradually over a three-year rolling period. Effectively this means that any extraordinary expenditure overruns covered by the reserve will not immediately affect the deficit of that year whilst the negative impact can be spread over a period of three years starting from the following year. This smoothenes the fiscal effect and allows the budgetary authorities to revise their medium term budgetary targets starting from the following year in order to neutralise where possible the negative budgetary impact.

At the beginning of each three-year medium term plan, the balance on the contingency reserve has to be replenished again in accordance with the reserve ratio. In the best case scenario where the contingency reserve has not been utilised there will be no need to replenish the reserve. By ensuring that 1/3rd of the draw-downs from the reserve are replenished in the following year lowers the probability that the balance as at 1st January each year in the reserve is equal to zero. As a result replenishing the reserve at the start of each medium term period should not create significant pressure on the deficit figures.

A worst case scenario could be envisaged whereby a significant slippage occurs at the end of a medium term plan, the magnitude of such a shock being such as to completely absorb the resources of the contingency
reserve. In this case the complete replenishment of the contingency reserve at the beginning of the following medium term plan will result in a significant increase in the deficit level. However, even in this extreme scenario, the outcome is still better than a baseline scenario in the absence of a contingency reserve. This is because at least the contingency reserve allows the budgetary deterioration to be postponed to the following year allowing some time for the budgetary authorities to plan for the necessary adjustments in the following year.

The table in the next page shows a hypothetical scenario of how the contingency reserve could be designed to absorb the impact of an unexpected one-off surge in expenditure in the first year of the medium term budgetary framework. In this scenario a contingency fund equal to 3 per cent of GDP is established prior to year 1. The shock to expenditure is equal to €100 million or 1.4 per cent of GDP.

The contingency reserve absorbs completely the impact on the deficit in year 1 and gradually offsets this in the following years. In this scenario the budgetary authorities do not make any additional adjustments such that the deficit in years 2 and onwards is slightly higher. In reality, the Medium Term Budgetary Framework is revised every year such that additional expenditure savings can be considered to absorb further the impact. In this scenario, the contingency reserve is topped up again by €83 million in year 6 that is the first year of the second Medium Term Budgetary Framework (MTBF). However because the cost of the initial shock in year 1 and its effect on the difference between the actual deficit and the projected deficit, €21 million is still drawn down from the contingency reserve in Year 4.

8.2.6 Minimising the Cost to the Taxpayer
The build-up of a contingency reserve implies an opportunity cost on funds which could have been invested elsewhere to generate a return. To minimise the opportunity cost Government could consider investing the reserve in short-term liquid and high rated Government paper.

8.2.7 Transparency and Accountability
To increase transparency and accountability the use of the contingency reserve should always be notified to Parliament. [Given the degree of political responsibility deemed necessary in the use of the contingency reserve, the Prime Minister and/or the Minister for Finance should be given a veto at cabinet level on the use of the contingency reserve.]

The contingency reserve should be determined and approved by Parliament. Moreover any expenditure overruns or revenue slippages which cannot be covered entirely by the contingency reserve (and after all options for reallocation are considered) should be decided by Parliament. Exceeding the contingency reserve would amount to a violation of fiscal rules to be enshrined in the Constitution unless it is matched by offsetting structural fiscal measures. In this context it is proposed that, in line with the expenditure benchmark established by the SGP, any additional expenditure which is not covered by the contingency reserve should be allowed only in the event of offsetting revenue measures. In such circumstances a simple majority in parliament should be deemed enough. The violation of fiscal rules resulting from fiscal slippages not covered by the contingency reserve and additional revenue measures will require the sanctioning of an independent fiscal institution subject to clearly defined escape clauses. Legal consequences are to be defined in such a scenario but their nature goes beyond the remit of this report.
The Contingency Reserve Account

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<tr>
<th>Year</th>
<th>MTBF YR 1 to YR 3</th>
<th>MTBF YR 4 to YR 6</th>
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ACTUAL

- Balance as at Jan: 202.5, 105.8, 130.7, 153.3, 215.0, 202.4
- Contribution to reserve: 202.5, 8.1, 34.9, 38.3, 83.6, 15.9, 22.0
- Draw Down from reserve: 0.0, -104.8, -10.0, -15.7, -21.8, -28.5, -35.7
- Balance as at Dec: 202.5, 105.8, 130.7, 153.3, 215.0, 202.4, 188.7
- as % of GDP: 3.0, 1.5, 1.8, 2.0, 2.7, 2.5, 2.2

Hypothetical Deficit Scenario Following an Unexpected 1.4% of GDP Shock to Expenditure in YR1

<table>
<thead>
<tr>
<th>Year</th>
<th>MTBF YR 1 to YR 3</th>
<th>MTBF YR 4 to YR 6</th>
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<tr>
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<td>Deficit before contingency</td>
<td>Deficit after Contingency</td>
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</table>

- Deficit before contingency: 1.5, 2.9, 3.5, 4.1, 4.7, 5.3, 5.9
- as % of GDP: 1.5, 1.5, 1.5, 1.5, 1.5, 1.5, 1.5

- Deficit after Contingency: -1.5, -1.5, -1.4, -1.3, -1.3, -1.2, -1.1
- as % of GDP: -1.5, -1.5, -1.4, -1.3, -1.3, -1.2, -1.1

Graph: Hypothetical Deficit Scenario Following an Unexpected 1.4% of GDP Shock to Expenditure in YR1

- Graph shows the deficit before and after contingency over years 0 to 6.
9. Conclusion
9. Conclusion

The financial crisis of late 2007 and the ensuing recession followed by the euro crisis exerted a heavy toll on public finances particularly in Europe. It brought to the fore the weaknesses of Governments even of those presumed to be highly solvent before the crisis. Financial markets quickly wrought havoc on the peripheral economies of Europe starting from Iceland and the Eastern block to be followed by Greece, Ireland and Portugal. Italy and Spain followed, with Cyprus being the latest casualty. Whilst prima-face financial markets seem to have targeted indiscriminately, in hindsight these were all economies (except for Italy) which experienced massive inflows of capital from abroad which were excessive relative to the size of their economies and which fuelled the build up of asset bubbles ranging from inflated housing markets, excessively leveraged banking sectors or overvalued sovereign debt instruments.

In Italy’s case the opposite may be true and lack of inflows of capital coupled with structural weaknesses and consequently anaemic growth led to the build up of a massive public debt. But Italy’s situation is not much different from that of Japan. And yet financial markets have targeted the former and not the latter, presumably because Italy’s policy options are constrained by its membership in a monetary union whereas Japan is not. The relevance of the euro in encouraging excess capital inflows before the crisis and capital fight in the aftermath cannot be underestimated. There is not much difference between Spain and the UK. And yet whilst the former was severely attacked by the financial markets the latter still enjoys low sovereign bond yields. The main difference is that the UK has its own monetary policy and has the benefit of its own currency whereas Spain doesn’t.

The performance of the Maltese economy prior to the recession and in its aftermath provides a seemingly stark contrast with what happened to other peripheral economies. Although Malta was a beneficiary of massive capital inflows most of these were not absorbed by the economy and were redirected abroad through the same international banks which brought them here. The trend correction in the current account deficit as the Maltese economy restructured in the run up to EU membership continued and today Malta enjoys a current account surplus. Unlike what can be observed in some European states this was not the result of a recession but the result of the restructuring toward higher value added production particularly in services sector. Economic growth in the second half of the last decade was close to potential and despite low investment levels, employment growth was significant even in the aftermath of the brief 2009 recession. Economic activity allowed the absorption of new entrants in the labour market as female participation rates soared. The labour market remained competitive on the back of wage moderation. Whilst signs of a housing bubble were evident in the run-up to the euro, this was largely financed by domestic savings including the repatriated past savings of Maltese residents. Domestic banks were highly solvent and liquid also allowing them to continue to finance public debt at reasonable sovereign bond yields. Public sector borrowing was entirely financed domestically providing some cushion from what was happening in international financial markets.

Despite this rather benign economic environment, this should not distract Malta from the necessary structural reforms. The fragility of the international situation particularly in view of the concern of international investors in the peripheral economies of the Euro Area continues to present a formidable challenge for Malta. Though public finances in Malta contrast favourably with the situation observed in many peripheral economies of the Euro Area, Malta’s public indebtedness is still far from the Maastricht targets. Worrying developments in the deficit level are emerging as this concluding chapter of this year long evaluation of public finances is being written, with the deficit exceeding again the 3 per cent target and Malta risking again an excessive deficit procedure. The timing of such deterioration in public finances could not be worse as the international spotlight following the Cyprus debacle is now on peripheral islands like Malta deemed to have attracted large inflows of capital through tax incentives. Malta must thread with extreme caution in these difficult times. Now is definitely the time for the needed structural reforms to be launched. This report highlights the various challenges in public finances which need to be addressed.
9.1 A Brief History of Recent Fiscal Consolidation Efforts

The trend decline in the deficit levels of recent years suggests that Malta has gone through a period of fiscal consolidation. To what extent was this consolidation effort successful? The success of fiscal consolidation can be measured on three fronts:

1. Permanence – Fiscal corrections which rely excessively on one-off measures, cyclical conditions or asset price bubbles will not be sustainable over time. In the run-up to the euro adoption Malta’s fiscal consolidation efforts were mainly sustained by structural measures. Unfortunately such a structural fiscal consolidation effort was mainly in the form of lower public investment. Reliance on favourable cyclical conditions prior to the international crisis was also evident. Fiscal consolidation efforts since the 2009 recession were initially more reliant on temporary measures. However these were partly aimed at mitigating temporary deficit increasing measures (such as the shipyards privatisation and the Air-Malta restructuring) and could thus be considered as appropriate. Planning in preparation for such restructuring efforts would however have been more appropriate. Structural measures including indirect tax measures, reforms to the national insurance contribution system as part of the pension reform, limits on public sector recruitment and measures aimed at reducing the stock of arrears sustained the fiscal consolidation efforts until the excessive deficit was eliminated in 2011. These are also indicative of a permanent correction in the absence of temporary slippages. Indeed the analysis presented in this report suggests that Malta’s fiscal position deteriorated not as a result of lack of structural fiscal consolidation measures but often as a result of temporary yet frequent deteriorations in the fiscal stance. The coincidence of major fiscal (predominantly expenditure) slippages close to election years (2003, 2008 and 2012) indicate strongly that fiscal policy in Malta is synchronised more with the electoral cycle than with the economic cycle.

2. Growth Friendly – Fiscal corrections are best undertaken during boom periods whilst in recessions a weaker, possibly expansionary stance should be pursued thus providing a degree of stabilisation in the economy. Moreover fiscal consolidation should preferably preserve growth-friendly expenditure primarily public investment. The fiscal consolidation efforts of the last decade were at best unrelated to the economic cycle and at worse pro-cyclical, thus tending to exacerbate the effects of the business cycle. Public investment has been a source of major fiscal consolidation at least since 2006. A significant decline in pubic investment was registered immediately prior to the 2009 recession and declined further as a percentage of GDP until 2010. It was only in 2011 that public investment activity started to recover. Thus the fiscal stance was not only pro-cyclical but also detrimental to long-term growth prospects.

3. Debt Reducing – If fiscal consolidation efforts undermine growth it may not necessarily lead to debt reductions, particularly if fiscal multipliers are stronger than anticipated. Due to the lack of material resources and the high import content, fiscal multipliers in Malta may be lower than those observed in more closed economies. Under such conditions fiscal consolidation efforts are likely to be associated with declining debt-to-GDP ratios. However the experience of the first five years of the last decade point to the detrimental effect of lack of economic growth on rising debt ratios coupled with the lack of offsetting primary surpluses. This contrasts with the period leading to the adoption of the Euro; a period characterised by strong economic growth sustained further by primary surpluses. The tide turned again following the recession. Primary deficits coupled with slow growth again led to a deterioration in the debt ratio. However stock-flow adjustments primarily relate to the shipyards privatisation, the restructuring of Air Malta and the financial assistance to Euro Area member states in distress.

9.2 The Deficit Bias

To what extent can fiscal slippages be attributable to inadequate forecasts? The analysis presented in this report points to major slippages which could have been planned ahead and therefore to a certain extent avoided. Most of these fiscal slippages relate to major restructuring operations in large enterprises with public sector majority holdings. Moreover the minor fiscal slippages in recent years also mask significant revenue slippages which were mitigated by forced expenditure reduction measures, often involving public investment. The report indicates that fiscal projections are not only inaccurate but also biased. Whilst the
accuracy of macroeconomic projections published with the fiscal projections are also inaccurate no significant bias beyond the current year in which the forecasts are published was found. This suggests that optimistic fiscal projections cannot be attributable to optimistic macroeconomic forecasts.

**Recommendation 1:** Whilst further efforts towards greater forecast accuracy in the macroeconomic forecasts produced by the Economic Policy Department should continue to be pursued, it is crucial that the link between the macroeconomic forecasts and the fiscal projections is improved. There is a clear need to enhance the forecasting capability of the Budget Office and ensure greater coordination with the forecasting capability of the Economic Policy Department within the Ministry for Finance.

### 9.3 Commitments under the EU Fiscal Framework

The analysis presented in this report points to the need to strengthen further the fiscal frameworks. This report suggests that the newly reformed EU fiscal framework provides a good guideline for reforming the Maltese fiscal framework.

The revised fiscal framework includes the enhanced Stability and Growth Pact which places greater emphasis on the correction of debt dynamics and the introduction of an expenditure benchmark aimed at ensuring that Government revenue emanating from unsustainable asset price bubbles is used for deficit reduction rather than to finance expenditure measures.

It also includes the directive on national budgetary frameworks which foresees stronger and more independent accounting and statistics, the strengthening of forecasting processes, the application of numerical fiscal rules and the institution of medium term budgetary frameworks with multi-annual fiscal targets.

The fiscal compact further provides for the institution of a rules-based fiscal framework in national legislation with a balanced budget rule to be enshrined in the constitution and fiscal rules to be monitored by independent bodies or bodies endowed with functional autonomy.

As part of the two-pack, the common provisions for monitoring and assessing budgetary plans of Euro Area member states ensures further fiscal policy coordination with the presentation of draft national budgets prior to the annual budget legislation and the publication of the national medium term budgetary plan together or as part of the Stability Programme. The regulation further defines how macroeconomic forecasts should as a minimum be endorsed by independent institutions and also defines clearly the conditions defining functional autonomy of the fiscal institutions to be responsible for monitoring the application of national fiscal rules.

This report has focused on three major elements of reform, fiscal rules, fiscal institutions and a medium term budgetary framework. All the three elements should work together to address the deficiencies highlighted so far in Malta’s fiscal framework and resulting fiscal performance.

### 9.4 Fiscal Rules

The report has evaluated the performance of alternative fiscal rules under the different economic conditions that have prevailed in Malta since 2004. The optimum fiscal rule or combination of rules should ensure the strongest possible fiscal consolidation effort when the medium term fiscal target is yet to be achieved without however jeopardising unnecessarily the economic growth prospects of the Maltese economy. Thus in the evaluation of fiscal rules a balance between the fiscal consolidation effort and counter-cyclical fiscal policy is to be ensured.

**Recommendation 2:** No single rule was found to be optimal under the two sometimes conflicting conditions. However a combination of the SGP rule stipulating a cyclically-adjusted fiscal consolidation
effort of 0.5 percentage points per annum coupled with the application of an expenditure benchmark and the application of escape clauses in ‘exceptional circumstances’ as defined under the SGP has been found to be a sufficiently good rule to be followed by Malta. Were such a framework operational in Malta it would have ensured lower indebtedness and would have preserved better counter-cyclical fiscal conditions.

Naturally a rules-based framework is a desirable but not sufficient condition for fiscal sustainability. A rules-based framework has clear limitations particularly in a small open economy vulnerable to significant exogenous shocks. Whilst the size of fiscal multipliers in Malta are limited the exposure to external shocks can be exacerbated in a monetary union where monetary policy cannot accommodate the idiosyncratic economic conditions in a recession and especially when fiscal policy is excessively coordinated among the euro area member states. Under such conditions fiscal policy is less effective yet more desirable for a small open economy. To achieve the same level of economic stabilisation through fiscal policy, a higher fiscal stimulus is needed in an open economy than in a closed economy.

Recommendation 3: To do this it is imperative to have the necessary fiscal space accumulated in good times to then be used in bad times. It is therefore imperative that fiscal rules target a surplus budgetary position more so than in other closed and resource endowed economies. In this way a stronger fiscal stimulus in bad times can be employed without undermining fiscal sustainability. In this context there is a need to apply fiscal rules in an intelligent manner in order to take into account such country specificities.

9.5 Fiscal Institutions

Recommendation 4: The need to apply fiscal rules in an intelligent manner, complying with the spirit of the rules but avoiding an overly mechanical application and interpretation of fiscal rules means that the monitoring of fiscal rules should be entrusted to a competent fiscal institution which has the capacity to evaluate the economic conditions and not just the accounting conditions underlying fiscal developments.

Independent fiscal institutions are often entrusted with the monitoring of compliance with fiscal rules, the evaluation of macroeconomic and fiscal projections, the evaluation of fiscal policy measures, the verification and application of escape clauses and the verification and application of corrective mechanisms.

It is also worth noting that the evaluation of the fiscal stance inevitably involves an element of economic judgement. In the context of a relatively polarised society such economic judgement can easily become politically controversial and could undermine the credibility of a Fiscal Institution. In this context fiscal rules limit (but do not eliminate) the scope for economic judgement thus helping to support the credibility of fiscal institutions. Thus fiscal rules and fiscal institutions are mutually reinforcing.

The report has also identified a number of other country-specific conditions which need to be considered when establishing a Fiscal Institution for Malta. Some of these conditions have already been highlighted before and include the biases in fiscal projections, the lack of consistency with macroeconomic projections, and the polarised political process. Moreover due to the size of the country, a common pool problem is also evident whereby special interest groups (which could be either outside Government or within the same ministerial apparatus) tend to lobby for their interests without recognising the full budgetary costs to society in general.

Recommendation 5: Such conditions point towards the need of a functionally independent fiscal institution. Functional independence is defined in accordance with the planned directive on Common Provisions for Monitoring and Assessing Draft Budgetary Plans which will soon form part of the SGP.
Another important characteristic which could influence the set-up of a fiscal institution includes the small size of the administrative apparatus and consequently the need to avoid resource duplication. Therefore ‘functional independence’ may be more appropriate to the size of the administrative apparatus in Malta whereby an existing institution/institutions could be given the necessary functional autonomy from central fiscal authorities under the conditions defined in the 2-pack.

The openness of the Maltese economy and consequently its vulnerability to outside shocks can significantly hamper macroeconomic forecast accuracy. This feature should be recognised when designing the function of a fiscal institution particularly the extent to which such an institution should be given the ability to produce its own independent macroeconomic and fiscal projections. It should be noted that forecast errors while unavoidable in this context can undermine the credibility of a fiscal institution. Requiring a fiscal institution to produce its own forecasts requires a greater administrative set-up and can also increase resource duplication in a small economy with a small administrative set up. On the other hand the ability of a fiscal institution to produce its own forecasts greatly enhances its ability to evaluate fiscal policy and enhances its independence from the fiscal authorities.

Finally it should also be recognised that a fiscal institution has an important communication role, ensuring greater transparency and accountability of fiscal policy action towards the democratic process. A fiscal institution should be capable of communicating with the general public and explain complicated fiscal decisions in a clear manner, understandable to the general public. At the same time clarity should not be at the expense of comprehensiveness and accuracy.

Recommendation 6: In the absence of advanced level of financial literacy and the limits of financial journalism in Malta it is suggested that the Independent fiscal institution should also assume its own public relations role and should also provide support towards the development of financial journalism in Malta.

Recommendation 7: Apart from these country specific conditions, fiscal institutions should also satisfy a number of minimum conditions. Political processes should take ownership and support the role of fiscal institutions. Fiscal institutions should have a clear and achievable mandate consistent with the resources under their disposal. Access to relevant information consistent with the functions and mandate of the fiscal institution should be ensured. Fiscal institutions should be competent and adequately supported by resources necessary to perform their function. Fiscal institutions also perform a vital task in the democratic process and therefore should be accountable for their actions to Parliament and the Maltese Constitution with sufficient though not necessarily too frequent reporting.

In view of these country-specific conditions and minimum requirements for an effective fiscal institution for Malta five alternative policy recommendations are considered in the report. These options balance the need for autonomy of a fiscal institution with the need to give the necessary apparatus for a proper fiscal policy evaluation possibly through forecasting processes and finally the need to avoid resource duplication as much as possible.

Recommendation 8: These five alternative options should be considered and an institutional set-up be agreed by a two-thirds majority in Parliament.

Whatever the option chosen for Malta, the role of the Ministry for Finance remains crucial in the budgetary process. Indeed the report highlights the need to ensure a clear separation between the technocratic role of the Fiscal Institution and the more political role of the Ministry for Finance. Fiscal policy is part of the democratic function of Government and cannot be completely relegated to a technical exercise.

Recommendation 9: Therefore Fiscal Institutions should avoid political judgements and should limit their responsibilities towards economic and financial evaluation of fiscal policy. In turn the role of
the Ministry for Finance should be strengthened further in order to ensure that the advice of fiscal institutions can be applied within the whole Government apparatus. In particular, the Ministry for Finance has an important role in the operation of a multi-annual medium term budgetary framework; the third pillar of this evaluation of fiscal frameworks in Malta.

9.6 The Medium Term Budgetary Framework

Whilst medium term budgetary targets are presented in Malta’s annual Stability Programme, such targets are often considered indicative, non-binding and subject to future annual budgetary processes. It is worth noting that budget forecast accuracy deteriorates significantly in the medium term framework and forecast biases are also identified in this report. There is a clear need to establish more formal rules-based medium term budgetary frameworks. Their effectiveness depends on the strengthened role of the Ministry for Finance.

Recommendation 10: Establishing a Medium Term Budgetary Plan

A rolling three-year medium term budgetary framework for expenditure commitments should be established.

1. At the beginning of each medium term budget the projected three year total budget allocation consistent with the macroeconomic projections for revenue and the fiscal rules should be established by the Ministry of Finance.
2. From the total available budget envelope, the budgetary allocation excluding unemployment benefits, statutory expenditure commitments, debt service payments, unemployment benefits and capital expenditure should be established.
3. A Contingency Reserve Fund as a proportion of GDP would also be established with annual contributions made to the contingency reserve in line with pre-determined rules. The contingency reserve is meant to cover unplanned fiscal slippages in exceptional circumstances. Resort to the contingency reserve under special circumstances would require approval from the Prime Minister following a recommendation by the Ministry for Finance. Resort to funds from the contingency reserve would not undermine compliance with fiscal rules.
4. The Contingency reserve would also be deducted from the total budgetary allocation. The remaining budgetary allocation will constitute the maximum ministerial allocation and will be determined by the Ministry for Finance.
5. An inter-ministerial process will then be set up so that the overall ministerial allocation can be distributed among the various ministries and departments based on political considerations and political commitments. At this stage no alterations to the ministerial envelope established by the Ministry of Finance will be allowed.
6. If disagreements persist such that the ministerial allocation is deemed to be insufficient in order to comply with political commitments and responsibilities, resort to a re-allocation from capital expenditure should be considered. However a minimum commitment for capital expenditure as a share of GDP should be established. It is advised that this should not be less than 3 per cent of GDP. Alternatively the Ministry for Finance may also consider the setting up of a planning reserve allowing some flexibility in the negotiations with the line ministries. Such a reserve could be utilised instead of or before the utilisation of capital expenditure.
7. Once a final ministerial allocation is agreed to and distributed to the various line ministries, each ministry will be responsible to design a medium term budgetary plan containing the allocation by department and function.

Recommendation 11: Implementation of the Medium Term Plan

As a rule ministries and departments are responsible to manage within their plan.
1. Slippages in the ministerial expenditure by function or department would first have to be offset against the allocation of the following year subject to the three-year ceiling. Reallocations from one year to the next should however be capped to 3 per cent of allocated expenditure.

2. Fiscal savings within any ministerial allocation in a given year can be carried forward to the next up to a maximum of 3 per cent of planned expenditure. Additional savings will be used to offset slippages elsewhere within a ministry or used for fiscal consolidation.

3. If such measures are deemed to be insufficient to finance major expenditure overruns, reallocations between different ministerial portfolios (virement) could be envisaged at a second stage. Such re-prioritisation of political commitments should be decided at a cabinet level but would continue to preserve the overall ministerial allocation.

4. Statutory expenditure should also be planned over a three-year budgetary period. Medium term budgets should provide an incentive for structural reforms where necessary. However deviations from the plan can immediately be recovered from the contingency reserve. The same would apply for debt service payments.

5. To ensure minimum deviations from plan the institutional set up governing statutory expenditure should be strengthened to ensure closer coordination between the Budget Office, the ministry responsible for social policy, the National Statistics Office and the Economic Policy Department and such a set-up should ensure consistency with long-term budgetary projections. Likewise the operations of the Treasury should also be strengthened further.

6. Cyclic expenditure commitments, namely unemployment benefits should be allowed to vary from annual allocations thus ensuring that the automatic stabilisation function of such expenditure is preserved.

**Recommendation 12: Operate a Contingency Reserve Fund**

1. A Contingency Reserve Fund should be established at a prudent proportion of GDP (not exceeding 0.8 per cent of GDP). Parliament should determine and establish the Contingency Reserve.

2. It should be established within the total expenditure allocation consistent with the fiscal rules in place and conditional on prudent revenue forecasts.

3. Establishing a contingency reserve represents a cost to the taxpayer and temporarily increases the deficit. It is recommended to build up the reserve over a period of three years.

4. The reserve should be established for the entire medium term budgetary period and the available balance can be carried forward from one year to the next.

5. The contingency reserve should be used only in exceptional and unforeseen circumstances. It could also cover revenue slippages unrelated to the economic cycle. It should not cover persistent biases in fiscal projections against targets.

6. Statutory expenditure and structural revenue slippages should be given priority over ministerial expenditure when use is to be made of the contingency reserve.

7. Draw-downs from the contingency reserve are to be recovered gradually over a maximum period of three years. However at the beginning of each three-year medium term budgetary plan the contingency reserve is to be replenished again to its minimum reserve ratio.

8. The annual balance in the contingency reserve could be invested in short-term liquid and high rated Government paper to minimise the opportunity cost of the reserve.

9. Draw-down from the contingency reserve should be approved by the Prime Minister following a recommendation from the Ministry for Finance. Use of the contingency reserve is to be reported to Parliament.

**9.7 Further Considerations**

The analysis contained in this report and the recommendations should help in a considerable way in improving fiscal frameworks and fiscal outcomes. It is however important to stress that the success of any reform of the fiscal framework will always ultimately depend on the political will to implement reform commitments. It
is also important to achieve a sufficiently high level of political consensus on the necessary reforms. Whilst a number of minimum requirements and options have been highlighted in this report some elements need to be negotiated at a political level. This is indeed desirable in order to ensure the widest possible political ownership of the process. It is however also worth pointing out that despite the comprehensiveness of this report there are still some further elements which are necessary in order to improve fiscal sustainability. These include the following:

• Transparent and independent accounting practices
• Establishment of an accrual accounting framework
• Establishment of a performance budgeting framework
• Disclosure of implicit liabilities, Government guarantees and securitisation of certain Government operations
• Orderly restructuring of state-owned entities particularly where Government guarantees are involved.

These present further challenges to the development of fiscal frameworks in Malta. Although they go beyond the scope of this report they should nonetheless not be considered as less important. Failure to consider these additional elements could well undermine the operation of the recommendations contained in this report.
Appendix A: International Budgetary Practices
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A1: Irish Budgetary Practice

For the past years, Ireland has been focusing only on the first year’s spending plan, often considering as indicative the multi-annual dimension of expenditure planning. The attention of the budgetary process was on the coming year, whereas future expenditure trends and pressures beyond the year ahead did not receive the same attention or control, and by the time these future years were being reached, earlier projections would have invariably been superseded.

A new medium-term expenditure framework (MTEF) for Ireland was outlined in the National Recovery Plan 2011-2014, which framework was based both on best practice in other EU countries and also by taking into account the preparatory work that has been undertaken within the Irish public service for some time.

The starting point for an MTEF is a Government decision on an overall, top down upper limit for aggregated voted current spending for the multi-year period ahead, consistent with the broader fiscal targets as set out in the Stability Programme and in line with the fiscal rules set up.

A second feature includes Governmental Expenditure Assessments (GEA), which involves a comprehensive review of all areas of Government spending which should be conducted every 2 to 3 years. The scope of such review is to assess the relative contribution of each area towards meeting Government commitments, and to evaluate its relative priority in terms of resource allocation policy.

Once the aggregate expenditure level has been decided, and in light of the outcome of the GEA exercise, the Government should apply nominal cash ceiling for current expenditure within each Ministerial Vote Group, so that programmes can be managed and prioritised within a fixed, determinate envelope of spending over the multi-annual period.

Continuity is stressed in another key feature of the proposed MTEF. The expenditure ceilings should be seen as effective operational limits over the three-year period, thus the ceilings, including the Ministerial envelopes, should be set out each year in the Stability Programme. As a rule, the following year’s Stability Programme should not vary the previously-set expenditure allocations for years 1 and 2, and should roll on the fiscal frame of reference to include a new year 3. However, setting sensible ‘envelopes’, and providing the right balance between firmness and flexibility, is important from the outset.

Another multi-annual expenditure management mechanism currently in use, the Employment Control Framework, which is used for controlling staff numbers, and the Administrative Budget Agreements, would be subsumed into the overall multi-annual framework. Capital spending, which is already subject to multi-annual provisions of its own, would continue to be handled in parallel under the existing arrangements.

A2: Dutch Budgetary Practice

Following a dramatic increase in deficits in the early 1980s in Netherlands, the Government embarked on a new policy to bring deficits down. However, between 1989 and 1994, budget projections were frequently overtaken by downward revisions in economic activity, forcing the Government to introduce new fiscal packages with greater budget savings than the original budgets. It was recognised that this system of continuous budgeting had to be reformed. It was recommended that budget formulation focuses on the level of expenditures (rather than the level of the deficit), and on cautious economic assumptions. Thus, any extra revenue would not automatically translate into extra expenditures while the cautious economic assumptions would help compensate for uncertainty.
Separate caps on expenditures were established for each of the three sectors of the Dutch budget: the “core” budget sector; the health care sector; and the social security and the labour market sector. Transfers were to be permitted between sectors and between sub-caps established within the “core” budget sector. Surpluses in one area, however, could used only to fund existing policies that are experiencing higher costs than projected. Budget over-runs must be offset in the area of the over-run. In exceptional cases, the cabinet may decided that more than one ministry should contribute to financing an over-run, making the use of virement almost impossible unless approved by the cabinet.