An Assessment of the Main Fiscal Forecasts prepared by the Ministry for Finance and presented in the Update of the Stability Programme for Malta 2015-2018

An independent report prepared for the
Malta Fiscal Advisory Council

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Dear Minister

LETTER OF TRANSMITTAL

In terms of article 13 of the Fiscal Responsibility Act, 2014 (Cap 534), I have the honour to transmit a report prepared for the Malta Fiscal Advisory Council (MFAC) on an assessment of the fiscal forecasts as presented by the Ministry for Finance in its Update of the Stability Programme 2015-2018 published on 30 April 2015. The MFAC is in agreement with this report.

On the basis of this assessment, the MFAC considers the fiscal targets to be attainable. At an aggregate level, the assessment positively notes that the fiscal consolidation plan for 2015 presented in the Update of the Stability Programme 2015-2018 is not reliant on cyclical factors and one-off and other temporary measures to the same extent as that recorded in 2014. Moreover, the fiscal targets for the forecast period are quite similar to the forecasts presented by other institutions, namely the European Commission and the Central Bank of Malta although these two entities expect a more gradual pace of fiscal adjustment.

With regard to the methodologies and processes by which the fiscal forecasts are estimated, this assessment positively notes the detailed process undertaken by the relevant authorities to take into account all available information and the detailed internal discussions between experts to finalise the forecasts. Nevertheless, it has to be noted that the process remains subject to significant fragmentation particularly since different stages of the estimation of the fiscal projections are conducted by separate authorities. This fragmentation may possibly lead to inconsistencies and could increase the risk of forecast errors. Furthermore, this process necessitates various assumptions entailing a certain degree of uncertainty. This issue is accentuated by the fact that there is a lack of official documentation pertaining to the methodologies and processes behind the estimation of these fiscal projections. It would therefore be desirable to have formal methodological documentation in place in order to ensure a more robust procedure, which currently relies heavily on the personal experience and knowledge of a very limited number of experts. More streamlining and coordination between the different entities contributing to the fiscal forecasts would also be desirable to enhance the process and minimise the possibility of distortions or inconsistencies.

As already indicated on 30 April 2015 by the MFAC in its assessment of the macroeconomic forecasts, whereas the macroeconomic projections may be achievable they are subject to an element of risk given the high dependence on the planned strong growth in investment. This consideration is particularly relevant to this assessment of the fiscal forecasts since in the eventuality that the projected growth in investment does not materialize, it may affect other components of GDP and, in turn, impinge on various tax bases, spilling over to the fiscal forecasts.

On the revenue side, this assessment notes that no particular risks were identified for the main tax items notably taxes on production and imports and social contributions. Meanwhile, the projections for another principal item of taxation – current taxes on income and wealth – show some element of prudence. Moreover, some caution is also noted as any proceeds resulting from the revision in tax on rental income and in the property tax system are not taken into account in the fiscal projections. In addition, another upside risk involves the fact that the authorities stopped short of including the indirect impact on tax revenue of the structural reforms to increase labour market participation. On the other hand, the assessment notes some element of uncertainty surrounding the expected impact of the new measures to combat tax avoidance.

With regard to the expenditure side, this assessment notes some risks of possible slippages. In particular, there could be a risk that outlays on compensation of employees and intermediate consumption could be higher than projected. Furthermore, some element of uncertainty also surrounds the estimated impact of the deficit-reducing measures under the social payments category. On the other hand, on a positive note, savings in expenditure could result from the implementation of the spending review.

The above-mentioned risk factors also apply to the debt projections presented in the Stability Programme. Furthermore, the debt forecasts are subject to additional uncertainties reflecting a number of necessary assumptions which increase the risk of forecast error.

In conclusion, while the MFAC, as indicated, regards the fiscal targets as attainable, it would like to highlight that, given the risks and uncertainties noted above, close monitoring by the authorities is warranted to identify and correct any possible deviations from the projections included in the Stability Programme.

Finally, the MFAC would like to underline the full collaboration extended by all the Government entities involved during the course of this assessment exercise, in particular the Economic Policy Department, the Budget Affairs Division and the National Statistics Office, and would like to thank them for their frankness and disposition in providing the necessary information and clarifications.

Yours sincerely

Rene Saliba
Chairman

cc Mr Alfred Camilleri, Permanent Secretary, Ministry for Finance

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Abbreviations

BO	Budget Office
CBM	Central Bank of Malta
CION	European Commission
COLA	Cost of Living Adjustment
DBP	Draft Budgetary Plan
EBU	Extra-Budgetary Units
EDP	Excessive Deficit Procedure
EPD	Economic Policy Department
ESA	European System of Accounts
EU	European Union
EUROPOP	Eurostat's Population Projections
GDP	Gross Domestic Product
GNI	Gross National Income
IIP	International Investor Programme
IRS	Investment Registration Scheme
MFAC	Malta Advisory Fiscal Council
MFIN	Ministry for Finance
NAO	National Audit Office
NSO	National Statistics Office
SFA	Stock-Flow Adjustment
SP	Stability Programme
VAT	Value Added Tax

Executive Summary

This report presents an assessment of the main fiscal forecasts prepared by the Ministry for Finance and presented in the Update of the Stability Programme for Malta 2015-2018. This assessment is based on an examination of the methodologies, processes and the main assumptions used to generate these fiscal forecasts.

With regard to the methodologies and processes by which the fiscal forecasts are estimated, this report positively notes the detailed process undertaken by the relevant authorities to take into account all available information and the internal discussions between experts to finalise the forecasts. Nevertheless, the process remains subject to significant fragmentation particularly since different stages of the estimation of the projections are conducted by separate authorities. This fragmentation may lead to inconsistencies and increase the risk of forecast errors. Furthermore, this process necessitates various assumptions entailing a certain degree of uncertainty. This issue is accentuated by the fact that there is lack of official documentation pertaining to the methodologies and processes behind the estimation of these fiscal projections.

The report notes that, according to a separate assessment of the macroeconomic forecasts prepared by the MFAC , the macroeconomic projections may be achievable but are subject to an element of risk particularly given the high dependence on the planned strong growth in investment. This is particularly relevant to this assessment of the fiscal forecasts since in the eventuality that the projected growth in investment does not materialize, it may affect other components of GDP and, in turn, impinge on various tax bases, spilling over to the fiscal forecasts.

At an aggregate level, this assessment positively notes that the fiscal consolidation plan presented in the Update of the Stability Programme for Malta 2015-2018 for 2015 is not reliant on cyclical factors and one-off and other temporary measures to the same extent as that recorded in 2014. Moreover, the fiscal targets for the forecast period are quite similar to the forecasts presented by other institutions, namely the European Commission and the Central Bank of Malta although these two entities expect a more gradual pace of fiscal adjustment.

On the revenue side, no particular risks were identified for the main tax items notably taxes on production and imports and social contributions. Meanwhile, the projections for another principal item of taxation – current taxes on income and wealth – show some element of prudence. Moreover, some caution is also noted as any proceeds resulting from the revision in tax on rental income and in the property tax system are not taken into account in the fiscal projections. In addition, another upside risk involves the fact that the authorities stopped short of including the indirect impact on tax revenue of the structural reforms to increase labour market participation. On the other hand, some element of uncertainty surrounds the expected impact of the measure to combat tax avoidance.

With regard to the expenditure side, this assessment notes some risks of possible slippages. In particular, outlays on compensation of employees and intermediate consumption could be higher than projected. Furthermore, some element of uncertainty surrounds the estimated impact of the deficit-reducing measures under the social payments category. On the other hand, on a positive note, savings in expenditure could result from the implementation of the spending review.

The above mentioned risk factors also apply to the debt projections presented in the Stability Programme. Furthermore, the debt forecasts are subject to additional uncertainties reflecting a number of necessary assumptions which increase the risk of forecast error.

Overall, this assessment considers the fiscal targets to be attainable. However, given the risks and uncertainties highlighted above, close monitoring by the authorities is warranted to identify and correct any deviations from the projections included in the Stability Programme.

1. Introduction: Aims, Methodology and Limitations of this Assessment

On 30th April 2015, the Ministry for Finance (MFIN) submitted the Update of Stability Programme for Malta 2015-2018, thereafter referred to as the Stability Programme (SP), to the European Commission (CION) and the European Council. The medium-term budget framework presented in the SP constitutes Malta's national medium-term fiscal plan which, according to Article 4 of Regulation (EU) 473/2013, should "be based on independent macroeconomic forecasts, and shall indicate whether the budgetary forecasts have been produced or endorsed by an independent body". Furthermore, at the national level, Article 13 of the Fiscal Responsibility Act, 2014 (Cap. 534) stipulates that the Malta Fiscal Advisory Council (MFAC) shall "endorse, as it considers appropriate, the macroeconomic and fiscal forecasts prepared by the Ministry for Finance, and provide an assessment of the official forecasts".

This report constitutes the first such assessment of MFIN's fiscal forecasts for the MFAC following its establishment in January 2015[1]. Prior to the setup of the MFAC, the National Audit Office (NAO), as an independent body, in 2014 had carried out assessments of the fiscal projections presented in the Update of Stability Programme 2014-2017 (May 2014 Assessment[2]) and in the Draft Budgetary Plan 2015 (November 2014 Assessment[3]).

The assessment of the fiscal projections presented in this report involved:

- an assessment of the methodologies and processes used to produce the budgetary forecasts;
- a comparison to the fiscal projections included in the Ministry's Draft Budgetary Plan (DBP) 2015 published in October 2014;
- an evaluation of the forecasts for the main revenue and expenditure budgetary components by applying tests of reasonableness in the context of the macroeconomic outlook, historical trends and other relevant available information, namely:

  i) an assessment of the projections for the main tax revenue categories on the basis of the implied elasticities for the forecast period, when compared to historical averages, taking into account the impact of discretionary measures and other relevant information;
  ii) an assessment of the forecasts for the main expenditure categories on the basis of projected growth rates compared to recent trends, and taking into account the impact of discretionary measures and other relevant information;

[1] The assessment of the macroeconomic forecasts is presented in a separate MFAC report: An assessment of the macroeconomic forecasts for the Maltese economy prepared by the Ministry for Finance in April 2015: A report prepared by the Malta Fiscal Advisory Council, 30th April 2015.

[2] An assessment of the main fiscal forecasts prepared by the Ministry for Finance and presented in the Update of the Stability Programme for Malta 2014-2017 of 5th May 2014.

[3] An assessment of the main fiscal forecasts prepared by the Ministry for Finance and presented in the Draft Budgetary Plan 2015 of 11th November 2014.

iii) an assessment of the impact of the main discretionary measures, based on the methodology used to estimate their budgetary impact, and other information available;

- an assessment of the macroeconomic risks surrounding the fiscal projections, based on the findings of the MFAC report of 30th April 2015;
- a comparison of the forecasts for the main fiscal aggregate indicators and budgetary components with the most recent forecasts of the CION and the Central Bank of Malta (CBM).

The provisional forecasts for the main budgetary components and fiscal aggregates for 2015-2018 were presented to the MFAC for review on 17th April 2015. When the fiscal forecasts were finalised, the revised projections were forwarded to the MFAC, and taken into account in this assessment. Detailed disaggregated data was provided by the MFIN and the National Statistics Office (NSO) for the main revenue and expenditure categories, which enabled a detailed analysis to be carried out for the main budgetary components. A detailed set of additional data and information was requested in writing, and a number of other supporting documents related to the key drivers of the main budgetary components were also consulted during the course of the assessment exercise. A meeting was held with officials from the MFIN, namely the Budget Office (BO), the Economic Policy Department (EPD) and the NSO, to discuss the additional information requested as well as areas of uncertainty or concern regarding the projections for the main fiscal aggregates and the impact of discretionary measures. Further clarification on issues which arose during the assessment exercise were obtained in writing (via email) or through contacts with the relevant officials over the telephone. The cut-off date for data and information included in this report was 5th May, 2015.

In the limited timeframe available to carry out this assessment, it was not possible to carry out an equivalent of a complete audit of the budget forecasts. Given these time constraints, the analysis largely focused on the fiscal projections for the general government sector in ESA 2010 terms, as presented in the SP rather than Consolidated Fund cash projections for central government. Furthermore, a comparison of the annual fiscal targets for 2015 with the actual available data for the current year was not carried out since such data only covered Consolidated Fund (cash) data for the first three months of the year, on which it is very difficult to derive reliable trends.

A difficulty faced during the assessment exercise was that the SP was still being drafted when work on the assessment was already under way, so that data and information were forwarded to the MFAC in a staggered manner. One notes positively the full cooperation by the entities involved in the forecasting exercise and the detailed information which was made available to the MFAC. Nevertheless, work on the assessment exercise would be facilitated if the data and information are forwarded in a more coherent and streamlined manner.

2. Assessment of the Methodologies and Processes used to produce the Fiscal Forecasts

The following section presents an assessment of the methodologies and processes by which the fiscal forecasts are estimated. This process of producing the fiscal forecasts is carried out jointly by a number of entities namely the BO, the EPD, the NSO and the Treasury. One notes that the fiscal targets for 2015 presented in the SP are in line with those submitted in the Excessive

Deficit Procedure (EDP) Notification in March 2015 and which were published by the NSO in News Release 75/2015. Fiscal forecasts for 2015-2018 are based on the ESA 2010 methodology.

The authorities ascertained that most of the aspects of the process to formulate the fiscal projections remained largely similar to those described in the Fiscal Projections Assessments published by the NAO in May and November 2014.

The fiscal projections for 2015 (on cash basis and covering only central government) were revised on the basis of the fiscal outturn for 2014, the registered macroeconomic performance for the same year, the fiscal outturn for the first quarter of 2015, the revised macroeconomic projections and any other relevant information. These fiscal targets were also revised to take into account updated information concerning budgetary measures.

The process of forecasting revenue items for 2016-2018 was carried out on two fronts: the BO produced revenue projections on a cash basis and covering only central government after taking into account the financial plans provided by the respective departments, past trends, the revised estimates for 2015 and any relevant budgetary measures. In parallel, the EPD produced revenue forecasts in ESA 2010 terms conditional upon the macroeconomic projections and also taking into account estimates of revenue elasticities observed in past years. Subsequently, the two sets of projections were discussed by the two relevant entities – the EPD and the BO - and any necessary fine-tuning to the BO estimates was carried out to come up with a final set of revenue projections on a cash basis for central government.

With regards to expenditure, projections were estimated on the basis of lengthy discussions between the BO and each line Ministry on the basis of their financial plans. The EPD provided estimates for social benefits and compensation of employees which were used to fine tune the BO's projections based on micro data provided by the line Ministries. As described in further detail later on in this report, the forecasts for social benefits were based on demographic projections and average benefit rates. The forecasts for the government's wage bill were based on generated projections for public sector employment and average wage growth. Expenditure projections were finalised to reflect the overall expenditure targets which are set on the basis of the targets for the fiscal balance and the revenue projections.

Both the revenue and expenditure forecasts prepared by the BO on cash basis and covering only central government were transposed to ESA 2010 methodology by the NSO. The relevant entities confirmed that the process by which this transposition took place was left unchanged as that described in the May and November 2014 Assessments. This process highly hinges on a number of underlying assumptions, concerning the accruals adjustment, the time adjusted cash as well as the net borrowing/net lending of Extra Budgetary Units (EBUs). These assumptions concern items which are relatively volatile and thus increasing the risk of significant forecast error.

The possibility of distortions at an expenditure component level in terms of ESA 2010 noted in the two previous Fiscal Projections Assessments published by the NAO remained in this forecasting exercise. This emerges from a number of assumptions which were used to allocate expenditure forecasts in different items according to the ESA 2010 methodology. These assumptions were necessary since expenditure forecasts are still firstly compiled on a cash basis and later transposed into accrual basis and also since detailed information by vote and project item is lacking for the forecast period. In particular, the methodology by which the capital expenditure category was broken down into different types of expenditure items remained that of resorting to the use of ratios of the capital expenditure outturn for the preceding three years. However, although as noted earlier, there is a possibility that this process may result in distortions at a component level (in particular intermediate consumption, subsidies and gross fixed capital formation), this does not imply any risk of forecast error for aggregate expenditure.

The synergy between the EPD and the BO noted in the NAO's previous 2014 Fiscal Projections Assessments in respect of the production of the fiscal forecasts has been sustained. One positively notes the detailed process undertaken by BO to ensure that all available information at departmental level is taken into account in the forecasts. One also acknowledges the detailed internal discussions between experts from BO and EPD in finalizing the forecasts. Nevertheless, the process remains subject to significant fragmentation since firstly forecasts are finalised on a cash basis and only subsequently transposed to ESA 2010 methodology. Such fragmentation is accentuated by the fact that such transposition of data is the responsibility of an entity – namely the NSO – which is separate from the two other entities responsible for the estimation of the projections – namely the BO and the EPD. Moreover, the fact that there is no official documentation of the methodology by which data is transposed to ESA 2010 methodology is resulting in a situation whereby a very limited number of experts have knowledge of the underlying methodology. This could lead to inconsistencies in the updates of the databases used by the different entities involved with the possibility that users could make use of misleading data. Moreover, the disaggregation in the process of formulating the projections also increases the risk of forecast errors and possible discrepancies between figures for the same item of expenditure taken from different databases. It would therefore be desirable to have formal methodological documentation in place in this regard.

3. Overview of Fiscal Targets presented in the Update of the Stability Programme 2015-2018

In 2014, the budget deficit narrowed further by 0.5 percentage points of GDP, to reach 2.1 per cent of GDP, thus remaining, for the second consecutive year, below the 3 per cent of GDP benchmark. According to the SP, the budget deficit will continue to decline over the forecast period to reach a close to balance position in 2018. The SP presents an annual fiscal adjustment of 0.5 percentage points of GDP, except in 2018, where the adjustment is slightly lower at 0.4 percentage points. According to the SP, "the envisaged fiscal consolidation will be primarily supported by stronger and more sustainable growth" (MFIN, 2015, p.6), as various supply-side policies are implemented to increase potential output growth, including raising labour market participation[4]. In the medium-term, increased efficiency both in public spending and in tax revenue collection, as well as efforts to combat tax abuse, will contribute to narrow the fiscal imbalance.

One-off and other temporary measures amounted to 0.3 per cent of GDP in 2014. This included proceeds from sale of land and revenue generated by the Investment Registration Scheme (IRS) fee, with the latter amounting to 0.4 per cent of GDP. On the other hand, in 2014, there was also a deficit-increasing one-off measure relating to the adjustment of the national contribution to the EU budget (0.2 per cent of GDP), resulting from the recalculation of EU member states' historical Gross National Income (GNI) data. In the forecast period, one-off measures are projected to consist only of proceeds from sale of land, and are expected at a lower 0.1 per cent of GDP in 2015 and to decline further to around 0.06 per cent of GDP by 2018. In 2015, revenue

[4] Malta's National Reform Programme 2015 presents a detailed discussion of the government's structural reform agenda.

generated from the sale of Government property is expected to be relatively high and the authorities explained that this is underpinned by two specific transactions and proceeds from one of them have already been received.

The fiscal adjustment in 2014 was largely revenue-based, reflecting one-off revenue from the IRS fee, other discretionary measures as well as around 1 percentage point of GDP in tax revenue buoyancy. On the expenditure side, whilst discretionary measures had a deficit-increasing impact of 0.1 per cent of GDP, the lower equity injection in the national airline contributed to improve the budget balance by 0.3 per cent of GDP. Thus, the fiscal consolidation achieved in 2014 largely reflected cyclical conditions and one-off measures or other non-permanent factors, as reflected in the marginal deterioration (0.1 per cent of GDP) in the structural balance (cyclically adjusted balance net of one-off measures). Whilst this could carry over some risk to the fiscal projections, it is positively noted that over the forecast period, the fiscal consolidation is expected to be much less reliant on one-off measures and on tax revenue buoyancy.

Similarly to 2014, the fiscal consolidation in 2015 is revenue-based, with an increase of 0.9 percentage points of GDP in the total revenue ratio, offsetting a minor increase of 0.3 percentage points in the total expenditure ratio. The overall impact of discretionary revenue measures is deficit-reducing and amounts to 0.5 per cent of GDP. On the other hand, on the expenditure side, discretionary measures and the incremental impact of the equity injection in the national airline increase the deficit by 0.2 and 0.3 per cent of GDP, respectively.

Table 3.1. Analysis of the Fiscal Adjustment

	2014	2015	2016	2017	2018
			per cent of GDP		
Fiscal Balance	-2.1	-1.6	-1.1	-0.6	-0.2
One-off and other temporary measures[1]	0.3	0.1	0.1	0.1	0.1
			percentage points of GDP		
Adjustment in the Deficit Ratio	0.5	0.5	0.5	0.5	0.4
Change in Revenue Ratio	2.0	0.9	-2.0	-0.7	-0.5
of which:					
Discretionary measures[1]	0.7	0.5	-0.1	0.0	0.0
Tax Revenue Buoyancy	1.0	-0.1	-0.5	-0.2	-0.3
Change in Expenditure Ratio[2]	-1.6	-0.3	2.5	1.2	0.9
of which:					
Discretionary measures[1]	-0.1	-0.2	0.1	0.0	0.1
Incremental impact of the equity injection in the national airline	0.3	-0.3	0.5	0.0	0.0
Change in gross fixed capital formation	-1.0	-0.3	0.9	0.1	0.1

[1] A plus sign means a deficit-reducing impact

[2] A minus sign means an increase in the expenditure ratio, with a deficit-increasing impact

Source: Malta Update of the Stability Programme 2015-2018, Ministry for Finance

Table 3.2. Discretionary Measures underpinning the fiscal adjustment

Components of Revenue	2014	2015	2016	2017	2018
			Eur millions		
Main revenue measures	**57.2**	**42.8**	**-3.4**	**5.0**	**5.0**
of which:					
Taxes on Production and Imports	19.9	29.9	10.3	5.0	5.0
Current Taxes on Income and Wealth	13.0	-40.2	-0.7	0.0	0.0
Social Contributions	10.2	11.7	-0.5	0.0	0.0
Other	14.1	41.3	-12.4	0.0	0.0
Main expenditure measures	**14.3**	**-46.1**	**49.7**	**3.5**	**4.4**
of which:					
Compensation of employees	0.0	4.5	-4.5	0.0	0.0
Social payments	-7.5	-23.5	13.1	4.3	4.4
Equity acquisition in national airline	25.0	-28.0	43.0	0.0	0.0
Net impact of discretionary measures	**71.5**	**-3.4**	**46.4**	**8.5**	**9.4**

Note: The budgetary impact is the incremental impact of measures. A positive sign implies that the budget deficit decreases as a consequence of the measure.

Source: Malta Update of the Stability Programme 2015-2018, Ministry for Finance

In the outer years of the forecast, the fiscal adjustment is expected to be expenditure-based. The impact of discretionary measures included in the SP is marginal, both on the revenue and on the expenditure side of the budget. In 2016, the total expenditure ratio is projected to decrease by a notable 2.5 percentage points of GDP, offsetting a decline of 2.0 percentage points in the total revenue ratio. These large changes are partly influenced by developments in EU-funded capital outlays. As the last equity injection in the national airline is expected to take place in 2015, this leads to an improvement in the fiscal balance of 0.5 percentage points in 2016. In 2017, total expenditure is projected to decrease by 1.2 percentage points of GDP, offsetting a decline of 0.7 percentage points in total revenue. In 2018, a slightly lower decline in the expenditure ratio of 0.9 percentage points still compensates for a decrease of 0.5 percentage points in the revenue ratio.

4. Differences between the fiscal projections presented in the Update of Stability Programme 2015-2018 and those presented in the Draft Budgetary Plan 2015

This Section provides a comparison of the fiscal projections presented in the SP with those included in the DBP which covered only up to 2015. In particular, this comparative assessment analyses the implications of divergences between the previous estimates for 2014 and the actual outturn on the current fiscal projections. Furthermore, the effects of differences in the macroeconomic scenario, changes in the discretionary measures and their impact and in other assumptions underpinning the fiscal projections are also discussed. It is pertinent to note that, as confirmed by officials from the Ministry for Finance and the NSO, there have been no notable changes in the methodology used to produce the fiscal projections included in the SP and that used to produce the forecasts included in the DBP. Both sets of projections are based on the ESA 2010 methodology.

Against a background of broadly similar nominal GDP growth rates, the SP presents budget deficit targets for 2014 and 2015 which, as a share of GDP, are unchanged from those included in the DBP. In absolute terms, there are only minor differences between the two sets of deficit targets. However, there are larger offsetting revisions in total revenue and expenditure.

A better than expected revenue outturn in 2014 was not reflected in an improvement in the budget deficit, but rather almost fully compensated for higher than expected outlays. Total revenue amounted to 41.7 per cent of GDP compared to a projected 40.9 per cent in the DBP, mainly reflecting higher revenue from current taxes on income and wealth and from the other category. The IRS yielded 0.3 percentage points of GDP more revenue than estimated in the DBP. Furthermore, although the actual outturn for both nominal GDP growth was very similar to the DBP forecasts, income tax cash receipts were higher than expected. Furthermore, revenue generated from the International Investor Programme (IIP), classified under the other category, was also higher than that included in the DBP. Total expenditure stood at 43.8 per cent of GDP, 0.8 percentage points higher than the DBP estimate. There were slippages from the targets for compensation of employees and intermediate consumption[5]. Furthermore, higher capital outlays were recorded and the authorities explained that this was due to higher than expected absorption of EU funds.

For 2015, the SP also presents higher total revenue and expenditure ratios, when compared to the DBP estimates, reflecting the base effect of a higher than expected outturn in 2014. The total revenue ratio is projected at 42.6 per cent of GDP in the SP, compared to 41.8 per cent in the DBP, whilst the difference for the total expenditure ratio is a similar 0.8 percentage points.

Higher revenue is mainly projected from the other category of revenue and to a lesser extent from current taxes on income and wealth and social contributions. In comparison to the DBP, the SP includes a new deficit-reducing discretionary measure which involves combatting tax avoidance with an impact of 0.16 per cent of GDP. This measure affects taxes on production and imports, current taxes on income and wealth and social contributions.

Higher expected proceeds under the other category of revenue largely reflect an assumed larger inflow of EU funds in the SP, when compared to the DBP. Since this is also reflected in higher expected capital outlays, it has a broadly neutral impact on the budget balance. On the other hand, as the actual proceeds generated from the IIP in 2014 were higher than expected in the DBP, the incremental impact from this measure in the SP for 2015 is lower.

Under current taxes on income and wealth, discretionary measures have a larger incremental deficit-increasing impact in 2015, reflecting the higher one-time proceeds generated by the IRS in 2014. This was partly offset by a new measure combatting avoidance of income tax and capital gains tax as well as a higher estimated impact expected from the widening of the tax base due to the IRS. When taking into account these revisions in the impact of discretionary measures, the upward revision in current taxes on income and wealth for 2015 remains below the base effect of the higher actual 2014 outturn. In the context of similar assumptions for nominal GDP growth this indicates some element of prudence in MFIN’s 2015 projection. The upward revision in social contributions can largely be attributed to the improved prospects for wage growth as the impact of the new measure combating tax avoidance is only marginal.

[5] Higher intermediate consumption in the SP, compared to the DBP, also reflects the reclassification of an expenditure item from social transfers in kind, which has a neutral effect on total expenditure.

Table 4.1 Comparison of Fiscal Projections
Stability Programme May 2015 - Draft Budgetary Plan October 2014

	2014 Actual	2015 MFIN SP May 2015	2014 MFIN DPB Oct 2014	2015 MFIN DPB Oct 2014
		per cent of GDP		
General Government Balance	-2.1	-1.6	-2.1	-1.6
General Government Debt	68.0	66.8	70.1	69.0
		EUR millions		
Taxes on production and imports	1,087.2	1,155.1	1,083.5	1,157.1
Current taxes on income and wealth	1,155.4	1,173.6	1,085.6	1,155.8
Capital taxes	11.8	12.7	12.2	12.2
Social contributions	560.3	594.9	557.4	582.3
Other revenue	507.0	615.3	491.8	551.5
Total Revenue	3321,8	3,551.5	3,230.5	3,458.8
Compensation of employees	1,051.9	1,082.4	1,014.2	1,049.3
Intermediate consumption	525.5	566.6	505.0	547.8
Social payments	1,008.4	1,039.8	1,009.3	1,034.4
Interest expenditure	230.2	222.9	220.6	229.3
Subsidies	103.6	128.3	114.1	131.2
Gross fixed capital formation	300.2	342.5	261.7	285.9
Other expenditure	270.3	302.3	268.1	310.8
Total Expenditure	3,490.1	3,684.6	3,393.0	3,588.7
General Government Balance	-168.3	-133.1	-162.5	-130.0

Source: Malta Update of the Stability Programme 2105-2018, Ministry for Finance, May 2015; Malta Draft Budgetary Plan 2015, Ministry for Finance, October 2014; Ministry for Finance;

On the expenditure side, compensation of employees was revised upwards, to take into account the higher than expected outlays in 2014 as well as the smaller effect of the discretionary measure impacting on the wage bill in 2015 (from 0.1 to 0.05 per cent of GDP). The projected outlays for intermediate consumption for 2015 are also higher than in the DBP, largely reflecting a base effect. The upward revision in outlays on social payments is relatively minor compared to the higher deficit-increasing impact of discretionary measures (0.3 per cent of GDP, compared to 0.1 per cent in the DBP) resulting from the new social cohesion measures announced in the Budget for 2015 (which did not feature in the DBP).

Despite a largely unchanged budget deficit, the actual debt ratio in 2014 resulted to be lower than that targeted in the DBP by 2.1 percentage points. A higher GDP level only accounts for 0.6 percentage points of this difference. The remaining discrepancy reflects revisions in the stock flow adjustment from an estimated 1.6 percentage points of GDP in the DBP to an actual 0.1 percentage points of GDP in the SP due to significant divergences in the cash balance item. For 2015, the debt ratio has been similarly revised downwards to 66.8 per cent, largely reflecting the base effect of a lower than expected debt ratio in 2014, and to a lesser extent the impact of the higher projected level of GDP in the SP and the downward revision in the expected stock flow - adjustment.

5. Assessment of risks to the budgetary projections

This Section first examines the uncertainty surrounding the macroeconomic forecasts and the consequent risks for the fiscal projections. Subsequently, the risks surrounding each revenue and expenditure category are analysed, including where relevant the impact of discretionary measures. Finally, an assessment of the specific risks surrounding the debt projections is also presented.

5.1 Macroeconomic Risk

This sub-section of the report provides an overview of the macroeconomic forecasts underpinning the fiscal projections presented in the SP and an analysis of the associated risks based on the report prepared by the MFAC: "An Assessment of the Macroeconomic Forecasts for the Maltese Economy prepared by the Ministry for Finance in April 2015" (MFAC, April 2015). An overview of the findings of the sensitivity analysis included in Chapter 4 of the SP to assess the balance of risk surrounding the macroeconomic forecasts is also presented. In this assessment of the SP's fiscal projections, the macroeconomic risk is particularly relevant in view of the important contribution of cyclical factors to narrow the deficit in 2014 and also since the medium-term fiscal adjustment presented in the SP is highly dependent on the projected strong economic growth.

The strong economic growth registered in 2014 is expected to be largely sustained over the forecast period. Real GDP growth is projected at 3.4 per cent in 2015 and is then projected to decelerate slightly to 2.8 per cent by 2018. In nominal terms, GDP is expected to increase by 4.7 per cent in 2015, and then increase at a slightly higher rate of 5.2 per cent in 2016 and 2017 and 5.4 per cent in 2018.

Similarly to 2014, domestic demand is expected to be the driver of economic growth in 2015 and 2016, mainly driven by strong growth in private consumption and investment. On the other hand, the contribution from the external sector is projected to be negative in both years. In 2017 and 2018, the domestic and external sectors provide more balanced contributions to growth. The contribution of domestic demand remains positive but falls to 0.9 and 1.5 percentage points, respectively, whilst the contribution of the external sector turns positive, and is expected at 2.0 and 1.3 percentage points.

In nominal terms, private final consumption expenditure is expected to accelerate from 3.4 per cent in 2014 to around 4.3 per cent in 2015 and 2016 and to around 4.5 per cent in the outer years of the forecast. Over the forecast period, this growth is supported by the expected positive development in the labour market, whilst a number of budget measures and lower energy prices provide a further boost to consumption in 2015. In real terms, private consumption is projected to increase by 3.4 per cent in 2015 and by a slower rate of around 2.5 per cent during the rest of the forecast period, as inflation is expected to pick up. Following strong growth in 2014, gross fixed capital formation is expected to increase by similar or even higher rates in 2015 and 2016, reflecting various projects both in the public and private sectors. Subsequently, investment is projected to decline marginally in 2017 and to remain relatively stable in 2018. During the forecast period, growth in government consumption is projected to be positive, but considerably lower than that registered in 2014.

Table 5.1. Macroeconomic Projections

	2014	2015	2016	2017	2018
	Actual	MFIN SP May 2015			
		percentage change			
At Constant (2000) prices					
Private final consumption expenditure	3.4	3.4	2.7	2.5	2.4
General government final expenditure	7.3	0.6	1.2	0.5	0.5
Gross fixed capital formation	14.0	23.6	13.1	-2.8	0.2
Exports of goods and services	-0.2	2.8	2.4	1.0	1.9
Imports of goods and services	0.1	5.0	3.5	-0.3	1.0
Real GDP	**3.5**	**3.4**	**3.1**	**2.8**	**2.8**
At Current Prices					
Private final consumption expenditure	3.4	4.3	4.2	4.6	4.5
General government final expenditure	8.8	3.8	4.3	3.3	3.6
Gross fixed capital formation	13.7	25.9	15.3	-0.6	2.5
Exports of goods and services	-0.5	5.4	4.7	3.0	3.9
Imports of goods and services	-1.1	8.2	5.7	1.5	2.9
Nominal GDP	**5.2**	**4.7**	**5.2**	**5.2**	**5.4**
Employment	2.0	2.0	1.8	1.7	1.8

Source: An assessment of the macroeconomic forecasts for the Maltese economy prepared by the Ministry for Finance, April 2015, Malta Advisory Fiscal Council

In 2015, exports of goods and services are expected to recover from the contraction registered last year, in view of assumed favourable exchange rate developments and the positive outlook in the economies of Malta’s main trading partners. Exports are projected to continue to grow at around 5 per cent in nominal terms in 2016 and then to decelerate slightly in the last two years of the forecast period, as a number of non-traditional industries are expected to move from a period of strong expansion to one of consolidation. Imports of goods and services are projected to increase by 8.2 per cent in 2015 and 5.7 per cent in 2016, in nominal terms, reflecting the high import content of the expected investment projects. This offsets the recovery in exports and results in a negative contribution to growth from the external sector in both years. On the other hand, the projected growth in imports is lower in 2017 and 2018, largely reflecting expected developments in capital outlays, so that the external sector contributes positively to economic growth.

The SP presents a positive outlook for the labour market over the forecast period, reflecting the anticipated improvements in economic activity as well as the positive impact of various on-going and planned active labour market policies aimed at particular segments of the labour force. Employment growth is expected at around 2 per cent per annum, whilst the unemployment rate is projected to remain broadly stable at around a low 5.8 per cent. Wage growth is also expected to be strong, with an increase of 3.1 per cent in 2015, rising to around 3.5 per cent during 2016-2018.

The MFAC report assessing these macroeconomic forecasts positively noted “the structured and well documented process leading to the final preparation of the forecasts” (MFAC, 2015, p.21) and considered the use of assumptions adopted by international reputable organisations as a good practice. Nevertheless, that report highlighted the need for more streamlining and coordination between the different entities which provide their input to the macroeconomic forecast exercise (MFAC, 2015, p.21). Such enhanced streamlining and coordination is also highly desirable in respect of the different entities contributing to the fiscal projections, given the different methodologies used in the macroeconomic and fiscal forecasting exercises to produce forecasts for government consumption and the different cut-off dates used.

The MFAC’s assessment of the macroeconomic projections stated that “the headline GDP figures (both in nominal and real terms) as forecasted by the MFIN may indeed be achievable for the forecast years under consideration” (MFAC, 2015, p.20). It also noted the similarity in the overall forecasted real GDP growth rate for 2015 with that of the CION’s Winter 2015 forecasts as well as that of the CBM (in its Annual Report 2014, published in April 2015), whilst for 2016, the MFIN is projecting a slightly higher rate of real GDP growth than both the CION and the CBM.

According to the MFAC report, there is “a certain degree of risk associated with the expected GDP forecast values in relation to the overall expected developments within the domestic demand variables as well as the external sector” (MFAC, 2015, pp.20-21). In particular, the actualisation of the anticipated investment projects was considered to be crucial to the attainment of the expected growth in 2015 and 2016 (MFAC, 2015, p.11). The report also identified possible risks to the projected recovery in exports, related to adverse developments in the economic performance of Malta’s main trading partners as well as in the geo-political scenario, which could hinder the expected growth in the tourism sector (MFAC, 2015, p.10). Investment and exports are not considered to be major tax-rich components of GDP. But the reliance of the projected economic growth presented in the SP on the actualisation of the planned capital projects still implies an element of risk to the attainment of the fiscal targets, since significant deviations from the planned investment trajectory would have notable repercussions on other components of GDP, such as private consumption and also on the labour market, thus affecting various tax bases.

The SP presents an analysis of the balance of risks surrounding the macroeconomic forecasts, based on a number of alternative model-based growth projections involving different scenarios, including different assumptions for the exchange rate, the Euro Area economic outlook, sectoral developments, energy prices and investment. Based on this analysis, the balance of risks was found to be more favourable in the short term, but tilted to the downside in the outer years of the forecast period (MFIN, 2015, p.39). Under more favourable growth scenarios, a budget surplus could be reached as from 2017, whereas under the worst possible cyclical scenarios considered, the budget deficit would remain close to 2 per cent of GDP, thus below the 3 per cent reference value.

5.2 Assessment of Revenue Projections

This Section aims to identify the risks associated with the realization of the revenue forecast presented by the Ministry for Finance in the SP. This assessment of the revenue estimates was, in many instances, based on tests of reasonableness and probability of the expected outcome.

According to the SP, total revenue is projected to rise by slightly less than 1 percentage point of GDP in 2015, to reach 42.6 per cent of GDP. A relatively sharp fall of 2 percentage points of GDP is expected in 2016. Subsequently, in 2017 and 2018, the revenue ratio is expected to decline by 0.7 and 0.5 percentage points respectively.

The ratio of current taxes on income and wealth is projected to decline in 2015 but remain relatively stable in the following years of the forecast period. Meanwhile, the ratio of taxes on production and imports is forecasted to increase in 2015 before declining gradually at a modest pace in each of the subsequent years. Moreover, the SP forecasts a relatively significant increase in the other category of revenue for 2015. However, this is expected to be more than reversed in the following year, and decline even further over the subsequent two years. No significant changes are projected in the share of social contributions to GDP as well as in capital taxes and property income categories of revenue.

The revenue forecasts are particularly contingent upon the materialization of the projected economic growth and its drivers. Besides the assessment of the macroeconomic risk discussed earlier, in order to comprehend the risks associated with the attainment of the main revenue targets, the relationship between the revenue forecasts as presented in the SP (excluding the impact of any budgetary measures) and the forecasted tax base – very often a component of GDP – was examined. This examination was carried out on two fronts:

> Firstly, the implied elasticities - derived from an examination of the relationship between the forecasts for the main revenue components presented in the SP and their respective tax base - was compared to the elasticity of the tax to the respective tax base recorded in the past years given that, such relationship is normally expected to remain constant. This historical average elasticity was calculated after excluding the impact of any discretionary measures that had an impact on the tax revenue over the years.
>
> Secondly, the implied elasticities were compared to another benchmark – namely the tax to tax base elasticity estimates of main revenue components published by the OECD (2014) in the context of the EU fiscal surveillance and forecasting processes.

The above two benchmarks are presented in Table 5.2. At this juncture, it is pertinent to note that elasticity estimation is highly influenced by the choice of methodology adopted which, very often, differ in the degree of simplification used to calculate the relationship between tax revenue and the respective tax base and the level of aggregation involved for the various tax revenue categories. Thus, these benchmarks are not directly comparable and should be considered merely as indicative. A discussion on the tax to tax base elasticity for each main item of revenue as detailed above is presented later on in this section.

Table 5.2 Summary of Revenue Elasticities

	Tax to Tax Base Elasticities	
	Historical Average[5]	OECD estimates
Corporate Income Tax[1]	1.3	NA
Personal Income Tax[2]	1.3	2.11
Current Taxes on Income and Wealth[3]	1.9	NA
Social Security Contributions[2]	0.8	0.92
employee	NA	0.60
employer	NA	1.01
Indirect tax[4]	0.9	0.97

[1]Relative to operating surplus
[2]Relative to total personal income
[3]Relative to GDP
[4]Relative to consumption
[5]Historical average (2001-2014) excluding the impact of budgetary measures;

Source: Price, R. W., t. Dang and Y. Guillemette (2014), 'New tax and expenditure elasticity estimates for EU Budget Surveillance' OECD Economics Department Working Papers No. 1174, OECD Publishing; authors calculations

The achievement of the revenue targets also depends on the actualisation of the expected impact of discretionary measures. Indeed, in 2015 one-fifth of the projected absolute increase in total revenue is expected to result from the implementation of the measures on the revenue side of the budget. It is noted that practically all the budgetary measures which are expected to have an impact on the revenue projections have already come into force and therefore no risk of delays in implementation are identified. Nevertheless, despite that the necessary legislative framework to implement the budgetary measures is in place, the realization of the expected proceeds from these fiscal measures also requires effective and efficient implementation. In this regard, the authorities stressed that significant efforts are being undertaken to enhance the operation of revenue collection and to intensify the fight against tax evasion.

In 2015, discretionary revenue-increasing measures mainly related to taxes on production and imports and to social contributions (reflecting the effect of the 2006 pension reform) are expected to offset the lower revenue emanating from current taxes on income and wealth – which reflects the widening of the income tax bands – and the base effect from revenue received in 2014 under the Investment Registration Scheme. Moreover, a substantial increase in revenue is also expected from the IIP. In 2016-2018, the discretionary measures are included under indirect taxes and their impact on the revenue forecasts is marginal. In 2016, the deficit-reducing impact of indirect taxation measures is more than offset by lower income from the IIP.

It is noteworthy that whilst a revision in the property tax system aimed towards improved tax efficiency was announced in the Budget for 2015, the authorities stopped short of including an estimate of its impact in their fiscal forecasts. Moreover, the fiscal projections presented in the

SP also exclude any proceeds that may result from the revision in tax on rental income. A number of discretionary measures aiming to improve labour market participation could also have positive indirect impact on tax revenue in the medium-term by widening the tax base. This prudent decision by the authorities to exclude the revenue-increasing impact of these measures provides an element of upside risk.

Table 5.3 Main Components of Revenue

	2014	2015	2016	2017	2018
			per cent of GDP		
Total Revenue	**41.7**	**42.6**	**40.6**	**39.9**	**39.4**
of which					
Taxes on production and imports	13.7	13.9	13.7	13.5	13.3
Current taxes on income and wealth	14.5	14.1	14.0	14.0	14.1
Capital taxes	0.1	0.2	0.1	0.1	0.1
Social contributions	7.0	7.1	7.0	7.0	6.8
Property income	1.2	1.2	1.1	1.1	1.0
Other revenue	5.2	6.2	4.7	4.2	4.0

Source: Malta Update of the Stability Programme 2015-2018, Ministry for Finance

Taxes on Production and Imports

According to the SP, taxes on production and imports are expected to increase from 13.7 per cent of GDP in 2014 to 13.9 per cent in 2015. Subsequently, a gradual modest decline is projected for the ratio of this category of revenue over the forecast period. The ratio of taxes on production and imports for 2015 is estimated to be positively affected by discretionary measures generating additional revenue amounting to 0.4 per cent of GDP in 2015.

According to the SP, the impact of higher indirect taxes included under this category of revenue is estimated at 0.3 per cent of GDP. These consist mainly of revisions in the excise duty on cigarettes and tobacco, fuel, cement, wine, tyres, mobile telephony, fish feed used in fish farms, revision in the road licence fee and revision in the duty on documents on insurance products. It is pertinent to note that this budgetary impact is practically unchanged from that included in the projections presented in the Draft Budgetary Plan in October 2014. Thus, as had also been observed in the NAO's November 2014 Assessment of Fiscal Projections (p.13), it is felt that the estimated impact of these measures is considered plausible.

According to the SP, Government's implementation of measures to strengthen tax compliance will result in a further increase in revenue from taxes on production and imports of 0.07 per cent of GDP in 2015. These measures include the initiative, announced in the Budget for 2015, whereby any person carrying out a commercial activity is obliged to register with the VAT department irrespective of the turnover. Moreover, additional measures with respect to increasing tax compliance related to duty on documents are also expected to have a positive impact on this category of tax revenue. In addition, the on-going merger of tax revenue departments is expected to result in a stronger capacity to tackle tax evasion. However, the plausibility of the estimated impact of these measures to strengthen tax compliance could not be assessed due to lack of information.

The forecasts for taxes on production and imports presented in the SP include other permanent discretionary measures which are still to be specified in the respective budgets. These measures are expected to amount to 0.1 per cent of GDP in 2016 and 0.05 per cent of GDP in each of the subsequent two years. One notes that this has also been the practice in previous years when specifications of some consolidation measures were not announced in the Stability Programmes but were included in subsequent Budgets.

One notes that, similar to the previous year, the projected revenue related to excise taxes (also included in taxes on production and imports) for 2015 recorded on cash basis is highly influenced by the repayment of accumulated arrears by Enemalta which are expected to take place during the current year[6]. Nevertheless, when this sub-component of taxes on production and imports is recorded according to ESA 2010 methodology and therefore on accrual basis, this settlement of arrears does not impact this item of revenue for 2015. Therefore, the risk that this repayment of excise taxes does not materialize does not constitute a downside risk on the realisation of the forecast for taxes on production and imports.

Since Value Added Tax comprises more than half of the revenue from taxes on production and imports, a separate assessment is conducted on projections for VAT. In this regard, when one excludes budgetary measures related to value added tax, this category of tax is projected to increase by a higher rate than the related tax base, which is being assumed as private consumption on which VAT is charged. For the subsequent years, VAT is projected to increase in line with the growth rate for the corresponding tax base. A comparison of these implied elasticities to the historical average reveals that the implied elasticity for 2015 is higher than the average for the past years, but the elasticity for the subsequent years is in line with the historical average. This points towards some element of downside risk associated to the realization of the forecast estimate of this category of revenue for 2015. Moreover, this element of risk surrounding the 2015 forecast may easily spill over the following years if a shortfall in revenues materializes in 2015.

Forecasts for the other sub-category of tax – mainly excise taxes – are expected to increase at a significantly lower rate than the consumption of goods subject to excise tax. Also, the implied elasticity is significantly lower than the average for the past years. This indicates some element of prudence in the forecasts for this sub-category of tax which may mitigate the downside risk identified with respect to VAT for 2015.

Indeed, overall, excluding the impact of the budgetary measures, the growth in the estimated revenue from taxes on production and imports is projected to increase at a lower rate than the expected increase in the tax base (assumed as private final consumption expenditure). This implied elasticity is in line with the average for the past years as well as in line with the OECD elasticity estimate for indirect tax.

[6] A first part of these dues were paid in 2014 and the remaining balance expected to be paid in 2015.

Current Taxes on Income and Wealth

The ratio of current taxes on income and wealth is expected to decline to 14.1 per cent of GDP in 2015 and remain relatively stable over the subsequent years to 2018. According to the SP, the budgetary measures related to this category of tax are estimated to have a negative impact of 0.5 per cent of GDP in 2015. These measures mainly consist of the widening of income tax brackets, the asset registration scheme and measures to curb tax avoidance.

According to the SP, the widening of the income tax bands is estimated to have a negative impact of 0.2 per cent of GDP in 2015. This is partly offset by a favourable impact amounting to 0.07 per cent of GDP estimated in relation to the widening of the income tax base as a result of the Investment Registration Scheme.

The estimate of the fiscal impact of widening of the income tax bands included in the forecasting exercise was carried out in 2014 and was not revised and/or updated. In view of this consideration, it is felt that the assessment of the impact of this measure as presented in the NAO's May 2014 Assessment (p.17) is still valid and that a degree of prudence was exercised in estimating the impact for 2015.

The IRS is estimated to have contributed by 0.4 per cent of GDP to the ratio for current taxes on income and wealth recorded in 2014. This is significantly higher than the amount expected in the Draft Budgetary Plan October 2014. Consequently, the forecasts presented in the SP for 2015 include a corresponding larger negative incremental impact related to this scheme.

The forecasts presented in the SP for current taxes on income and wealth for 2015 also include an additional 0.08 per cent of GDP anticipated to result from Government's efforts to curb avoidance related to income tax and capital gains tax. No explanation was provided to explain how this impact was calculated and on the basis of the limited information available the plausibility of these estimates could not be assessed.

Since current taxes on income and wealth constitute three different elements of taxation - namely taxes on individual income, taxes on corporate income and other current taxes - forecasts for the first two sub-categories related to income tax were assessed separately. When one excludes budgetary measures related to individual income tax, this sub-category of revenue is expected to increase in line with its tax base (assumed as compensation of employees) for 2015 and 2016 and slightly exceed it for the subsequent two years. Again, in this case, the implied elasticity of the forecasted individual income tax to the tax base is slightly lower than the average for the past years as well as lower than the OECD elasticity estimate for income tax (assuming total personal income as the tax base).

When one considers the income tax related to the corporate sector, one notes that this category of tax revenue is projected to increase by a similar rate as the tax base (assumed as operating surplus). This implied elasticity for the forecast period is very slightly lower than the historical average.

The above analysis does not indicate any particular risk for the materialisation of the projections for both individual income tax and corporate income tax forming part of current taxes on income and wealth presented in the SP.

Overall, considering the total revenue for the current taxes on income and wealth category, if one were to exclude the impact of the discretionary measures, the growth in this category of revenue is projected to hover around the expected development in GDP over the forecast period. This implied elasticity for the 2015-2018 period is below the historical average indicating an element of prudence.

Social Contributions

According to the SP, social contributions are projected to remain relatively stable at round 7.0 per cent of GDP in the 2015-2017 period, declining slightly to 6.8 per cent of GDP in 2018. The 2006 pension reform initiatives are expected to have a deficit-reducing impact of 0.14 per cent of GDP in 2015. This impact remains unchanged from that estimated by the authorities in the Stability Programme of May 2014 and the Draft Budgetary Plan of October 2014. As in the May and November 2014 Assessment, based on the information available no particular risks were associated with the estimate of this budgetary impact. The authorities are confident that the fight against tax evasion and avoidance will also result in higher revenue from social contributions estimated at 0.01 per cent of GDP in their fiscal forecasts.

Excluding the impact of the budgetary measures, the implied elasticity of social contributions is projected to be broadly in line with the average for the past years. This is also confirmed when one compares the implied elasticities with the estimates published by the OECD (refer to Table 5.2). This limits the uncertainty surrounding the projections for social contributions.

'Other' Components of Revenue

The ratio of the 'Other' category of revenue is expected to increase by 1 percentage point to 6.2 per cent of GDP in 2015. The main items of revenue under this category are capital transfers and market output. The former is expected to increase by 0.7 percentage points of GDP in 2015. Subsequently, this revenue component is expected to decline by 1 percentage point of GDP in 2016 and by a lower 0.3 percentage points in 2017, remaining unchanged in 2018. Expected developments in this item of revenue are significantly influenced by changes in the expected inflows of EU funds which are correspondingly reflected on the expenditure side of the budget and therefore exert a marginal impact on the deficit.

Market output is projected to increase by 0.3 percentage points to 2.6 per cent of GDP in 2015, declining marginally to 2.1 per cent by 2018. The increase in 2015 reflects the expected increase in revenue from the impact of the IIP. Indeed, the IIP is estimated to have a positive incremental impact of 0.5 per cent of GDP in 2015 on the fiscal balance. Limited information was made available for a thorough assessment of the estimate of the impact of the IIP. The authorities are confident that, following the higher-than-expected revenue that was generated from the IIP in 2014, the target for 2015 will be reached. However, since the impact of the IIP depends on the number of applications that are examined and approved, an element of uncertainty still prevails. This is particularly relevant since the incremental impact of this measure accounts for around one-sixth of the total revenue increase for 2015.

5.3 Assessment of Expenditure Projections

The total expenditure ratio is projected to rise by 0.3 percentage points of GDP in 2015 to 44.2 per cent, whereas it is expected to follow a gradual downward trend during the outer years of the forecast period, falling to 39.6 per cent in 2018. In 2015, the increase in total expenditure reflects higher gross fixed capital formation, capital transfers, intermediate consumption and subsidies. On the other hand, the share of compensation of employees, social payments and interest expenditure to GDP is projected to decline. In 2016, the expenditure ratio is projected to fall by 2.5 percentage points of GDP, reflecting sharp drops in capital outlays and capital transfers, as well as smaller declines in compensation of employees, intermediate consumption and social payments. In 2017 and 2018, the projected decline in the total expenditure ratio is more modest, at around 1 per cent of GDP, largely reflecting gradual downward trends in the share of compensation of employees, intermediate consumption and social payments to GDP.

In 2015, discretionary expenditure measures (excluding the impact of the equity injections in the national airline) are expected to increase the deficit by 0.2 percentage points of GDP. Higher outlays on various social cohesion measures announced in the Budget for 2015 more than offset the deficit-reducing impact of the discretionary measure aiming to contain government's public wage bill (amounting to 0.05 per cent of GDP)[7]. On the other hand, in 2016, the net impact of discretionary expenditure measures is deficit-reducing (0.1 per cent of GDP), reflecting the base effect of the one-time additional bonus in 2015 (to compensate those individuals who did not benefit from the lowering of the income tax rates) as well as the positive fiscal effects of measures aimed to encourage labour participation and reduce dependency on social benefits among targeted beneficiaries, namely the tapering of social benefits and the youth guarantee scheme, which is partly financed by EU funds. In 2017 and 2018, the net impact of discretionary expenditure measures is marginally positive, mainly reflecting the incremental impact of the tapering of social benefits.

Table 5.4 Main Components of Expenditure

	2014	2015	2016	2017	2018
			per cent of GDP		
Total Expenditure	**43.8**	**44.2**	**41.7**	**40.5**	**39.6**
of which					
Compensation of employees	13.2	13.0	12.8	12.6	12.3
Intermediate consumption	6.6	6.8	6.5	6.3	5.9
Social payments	12.7	12.5	12.1	11.9	11.7
Interest expenditure	2.9	2.7	2.6	2.5	2.5
Subsidies	1.3	1.5	1.4	1.4	1.3
Gross fixed capital formation	3.8	4.1	3.2	3.1	3.0
Capital transfers	1.1	1.4	0.9	0.7	0.7
Other expenditure	2.3	2.3	2.2	2.1	2.4

Source: Malta Update of the Stability Programme 2015-2018, Ministry for Finance

Fluctuations in the equity injection in the national airline affect considerably the expenditure ratio during 2015 and 2016. The higher equity injection in 2015 implies a deficit-increasing incremental impact of 0.3 per cent of GDP. Since this is the last capital injection in Air Malta plc

[7] In the SP, this measure is presented as temporary, having a deficit-reducing effect only in 2015. Thus, it has a deficit-increasing incremental impact in 2016.

foreseen in the restructuring plan, there is a deficit-reducing incremental impact amounting to 0.5 per cent of GDP in 2016.

According to the SP, a comprehensive spending review is on-going which aims to improve efficiency in public spending, reduce waste and achieve more value for money (MFIN, 2015, p.55). This spending review, which provides a methodology for zero budgets, line by line analysis and connecting expenditure inputs to policy outputs, was conducted in all 14 Ministries focusing on the programmes and initiatives expenditure category. Following the review of social security expenditure which was completed in 2014, the SP highlights that another comprehensive spending review is on-going within the Ministry for Health, which is expected to provide the basis for reforms in the sector which will be announced in the Budget for 2016 (MFIN, 2015, p.56). The SP also identifies other measures being undertaken in the public health service which should result in cost savings, including the implementation of financial governance models, recruitment of financial and audit expertise and centralisation of procurement services (MFIN, 2015, p.56). The authorities showed an element of caution by not including an estimate of the impact of the spending reviews in the SP. This constitutes a possible upside risk to the attainment of the expenditure targets, particularly in the outer years of the forecast period when the results of these reviews become more tangible.

Compensation of Employees

Following increases in both 2013 and 2014, the share of compensation of employees is projected to decline from 13.2 per cent of GDP in 2014 to 13.0 per cent in 2015, and then to continue to follow a downward trend, to 12.3 per cent of GDP in 2018. The target for 2015 includes the impact of a discretionary measure aiming to restrict growth in the public wage bill, amounting to 0.05 per cent of GDP. The authorities pointed out that this measure is only required to meet the targets for outlays on compensation of employees for 2015 but not for the rest of the forecast period. According to the authorities, containment of the wage bill will be achieved by restricting new recruitment (excluding the education and health sectors) and by restricting growth in outlays on overtime and allowances, roughly in line with the inflation rate. The authorities explained that this measure is being implemented through procedures established in past years, namely circulars issued by the Ministry for Finance and meetings and exchanges with line ministries to determine budget limits within which recruitment can take place.

The projections for compensation of employees reflect the BO's targets for outlays on personal emoluments which in turn are based on micro data at a departmental level. The EPD produces an alternative projection, derived at an aggregate level, based on assumptions for the average wage growth and the level of general government employment. The assumptions for average wage growth are based on information from the public service collective agreement up to 2016 and updated information from sectoral and other collective agreements for employees within the general government sector. For 2017 and 2018, which are not covered by the latest public service collective agreement, the assumed wage growth appears reasonable in view of recent trends. The EPD projection constitutes a consistency check with the BO's targets, which is a good practice, given the large share of the wage bill in total expenditure.

The projected modest increase in the wage bill for 2015 contrasts with the strong increases registered in the previous two years and is also lower than the average historical growth rate (adjusted for the effect of the reclassification of Malta Shipyards in the general government sector in 2008). The discretionary measure included in the SP for 2015 implies containing new recruitment so that public service employment declines by around 200. It is noted that this measure is less ambitious than that envisaged in the DBP and that the authorities show commitment to attain this target. Nevertheless, its attainment remains challenging in the light of past trends and since no institutional reforms affecting the recruitment process are envisaged. The medium-term projections for compensation of employees provide for additional recruitment due to Malta's EU presidency in 2017. But excluding this factor, the projections imply broadly stable employment levels, so that there is some risk of slippage from the wage bill targets also in the medium term.

Intermediate Consumption

The ratio of intermediate consumption to GDP is projected to increase by 0.2 percentage points in 2015, but thereafter the projections show a gradual downward trend, with the share expected to fall to 5.9 per cent of GDP by 2018. The SP does not include any discretionary measures impacting on this expenditure component. The projected increase in intermediate consumption in 2015 is higher than the historical average (adjusted for the impact of the reclassification of Malta Shipyards in the general government sector in 2008), but considerably lower in the rest of the forecast period. The large increase in intermediate consumption in 2015 reflects the projected increase in capital expenditure which is included under intermediate consumption. This is due to the methodology used to compile the expenditure component levels in ESA terms from Consolidated Fund data, which as highlighted earlier, can result in distortions at an expenditure component level. In 2016, the base effect in capital expenditure classified under intermediate consumption is offset by higher outlays in connection with Malta's EU Presidency, resulting in an overall marginal decline (in absolute terms) in this expenditure category. The projections for 2016-2018 for operational and maintenance expenditures and medicines and surgical materials classified under intermediate consumption involve more modest increases than those in the previous few years, resulting in some uncertainty surrounding the attainment of government's targets for intermediate consumption.

Social Payments

Social payments are projected to decline from 12.7 per cent of GDP in 2014 to 11.7 per cent in 2018, thus contributing significantly to the fiscal adjustment. The net incremental impact of discretionary measures included under this category of expenditure is deficit-increasing in 2014 and 2015, amounting to 0.1 and 0.3 per cent of GDP, respectively, but deficit-reducing, amounting to 0.2 per cent in 2016 and around 0.1 per cent in 2017 and 2018. In 2014, the incremental deficit-increasing impact mainly resulted from higher outlays on assistance to help the elderly live independently and the introduction of free child care centres. Further increases in outlays on these measures are also expected in 2015. Moreover, in 2015, the introduction of a conditional children allowance as well as measures announced in the Budget for 2015, namely the in-work benefit for low-income households with children, a one-time additional bonus to individuals who did not benefit from the lowering of the income tax rates as well as a number of measures affecting pensioners, all exert a negative effect on the fiscal balance. On the other hand, the Budget for 2015 also announced the deficit-reducing youth guarantee scheme and tapering of social benefits, which are estimated to result in savings of around 0.05 per cent of GDP in 2015, with the incremental impact falling slightly to 0.04 per cent of GDP by 2018. The 2006 pension reform also exerts a deficit-reducing impact over the forecast period (up to 2017), albeit the effect is marginal.

The estimates of the impact of the supplementary children's allowance and the 2006 pension reform have not been revised from that included in the DBP. Thus, as was noted in the NAO's November 2014 Assessment, whilst the estimate of the former appears plausible, the cost savings from the pension reform may be marginally underestimated. The authorities provided detailed information on the assumptions underlying the estimation of the impact of the youth guarantee scheme and the tapering of social benefits measure. The estimates are based on the number of people expected to be struck off social benefits (derived from administrative data at an individual level and following discussions with the Ministry for the Family and Social Solidarity) and the average benefit rate. There is an element of uncertainty surrounding the estimated impact of these measures, since these involve behavioural changes amongst the targeted groups. According to the SP (MFIN, p.56), up to March 2015, 450 single parents have found employment and shifted to tapered benefits whilst over 90 young people have shifted from unemployment assistance to the youth guarantee scheme. Whilst these figures are notable given the recent launch of these measures, they are considerably lower than the annual targets underpinning the fiscal projections. Thus overall, the estimated savings from these two measures are subject to some element of risk. As regards the other discretionary measures, the assessment of the plausibility of their budgetary impact was constrained by a lack of information on how the estimates included in the SP were derived.

Over the forecast period, the projected increases in social transfers in kind are broadly comparable to the historical average. The main component of social payments is however the social transfers other than in kind category, with a share of around 95 per cent of the total. Over the forecast period, the growth rates in this expenditure component are somewhat below the historical average. Increases are mainly expected in retirement pensions, and to a lesser extent pensions in respect of widowhood and the contributory bonus[8].

The authorities explained that the EPD has generated projections for expenditure on social security benefits, based on Consolidated Fund data, which served as a basis for the projections included in the SP. A technical note was provided to explain the methodology and assumptions used to derive the number of beneficiaries (based on Eurostat's population projections EUROPOP2013) and the average benefit rates. Such documentation constitutes a good practice, which could be applied also to explain the projections of other important budgetary components. The EPD projections are based on a sound methodology, using available data and information at a detailed level and the most recent 'external' demographic projections (EUROPOP2013). However, this exercise is not well integrated in the generation of the final forecasts for social payments, due to different classifications used and further updates of data are not always taken into account. Nevertheless, the assumptions for the number of beneficiaries and the average benefit rate which underpin the forecasts for the main social benefits included in the SP appear to be consistent with demographic projections, the forecasts for the inflation rate and the resulting assumed cost of living adjustment (COLA) and also appear plausible compared to recent trends.

Interest Expenditure

Interest expenditure is projected to decline from 2.9 per cent of GDP in 2014 to 2.7 per cent in 2015 followed by a marginal decline to 2.5 per cent in 2017 and 2018. The overall risks to the attainment of the deficit and debt targets (which are discussed separately elsewhere in the report)

[8] This includes the cost of living bonus, being one-third of COLA, which is paid to pensioners through a bonus at the start of the year, with the rest of the COLA being included in the pension payments.

also apply to interest expenditure. Meanwhile, uncertainty regarding the future cost of borrowing is considered contained since this concerns only the cost of borrowing of new loans, which comprises debt issued to finance the borrowing requirements, rolling over of maturing stocks as well as Treasury Bills. The share of maturing stocks is expected at around 7 per cent over the forecast period whilst the share of short-term debt will be around 3 per cent except in 2016 when it will temporary increase to around 6 per cent.

The implicit interest rate on debt is expected to hover around 4.1 per cent during the forecast period. This is consistent with the assumption of stable interest rates used to generate the macroeconomic forecasts included in the SP (MFIN, 2015, p.10).

Subsidies

Subsidies are projected to increase by 0.2 percentage points to 1.5 per cent of GDP in 2015, but subsequently are expected to decline back to 1.3 per cent by 2018. The assessment of the plausibility of the projections for this item of expenditure was not based on a comparison to past trends, given the volatility of this component, being highly influenced by government's decisions on public service obligations and the restructuring of public enterprises. Consequently, the assessment was based on the available information on known major risk factors. It is also important to note that the large changes in capital expenditure in 2015 and 2016 are also reflected in the subsidies category, due to the methodology used to categorise the Consolidated Fund expenditure items into ESA terms, as explained earlier.

Subsidies related to the operation of the public transport service are expected to decline in 2015, as outlays in 2014 included the government subvention to cover the losses incurred by the government company which temporarily operated the public transport service (Malta Public Transport Services (Operations) Limited)[9]. In January 2015, the new private operator started providing public transport services. As from 2015, the subsidies related to this sector constitute the public service obligation as specified in the contractual agreements between the government and the service provider, with an increase in subsidies in 2016 and remaining stable thereafter at around 0.3 per cent of GDP. As in the DBP, a subvention amounting to 0.2 per cent of GDP is included in the projections as from 2015 to reflect the service level agreements with Enemalta, relating to the obligation to provide spare capacity for electricity. The outlays in connection with these two major subsidy items reflect the respective contractual agreements thus limiting the uncertainty surrounding the related projected outlays.

Gross Fixed Capital Formation

Gross fixed capital formation increased to 3.8 per cent of GDP in 2014, from around 3 per cent in the previous few years. In 2015, capital outlays are projected to increase further to 4.1 per cent of GDP, but are expected to fall back to around 3 per cent in the following years. The main component underpinning the projections for gross fixed capital formation is an apportionment of the capital expenditure in the Consolidated Fund using the average ratio for the last three years. Since the nature of projects may differ considerably over the years, this methodology can result in distortions when analysing trends in gross fixed capital formation.

[9] This company was outside the general government sector as it was privatised within a calendar year from when it was set up.

The trajectory for gross fixed capital formation presented in the SP is highly influenced by the assumptions concerning the implementation of EU funded projects. The authorities explained that following higher than expected absorption of EU funds in 2014, a further pick-up in the implementation of EU funded projects is expected in 2015, as the 2007-2013 programming period is concluded by year end, and to a lesser extent, by the start of the implementation of projects financed under the 2014-2020 programme. In 2016, activity in projects financed from the 2014-2020 programming is expected to accelerate and projects funded from national sources are also set to increase, but these only partly offset the effect of the closure of the previous EU financial programme. In the outer years of the forecast, both EU funded capital outlays as well as those financed from national funds are expected to remain broadly stable.

As in the May 2014 and November 2014 Fiscal Projections Assessments by the NAO, the authorities confirmed that the capital outlays involving the new power station and the Valletta infrastructural projects fall outside the scope of the general government sector.

The projected capital outlays included in the SP are relatively high, when compared to past years, particularly in 2015. Problems of absorption capacity of EU funds during the current year would have negative fiscal repercussions since this constitutes the deadline for closure of the 2007-2013 financial programme. We note the resolve of the authorities to step up the absorption of EU funds, as reflected in the higher than expected outlays in 2014. The authorities have confirmed that they have no indications that the allocated funds would not be completely utilised by the end of this year. For the outer years of the forecast period, lower than expected capital outlays would either not have a material impact on the budget balance (in the case of projects financed from the EU's 2014-2020 financial programme) or impact the fiscal balance positively (in the case of nationally-funded projects).

Capital Transfers Payable

Following an increase from 1.1 per cent of GDP in 2014 to 1.4 per cent in 2015, capital transfers payable are projected to decline to 0.9 per cent of GDP in 2016 and thereafter are expected at 0.7 per cent. This category of expenditure is significantly affected by the incremental effects of the transactions relating to the equity injection in Air Malta plc. The equity injections amount to €15 million in 2014 and a final injection of €43 million in 2015, which have a deficit-increasing incremental impact of 0.3 per cent of GDP in 2015 and a deficit-reducing incremental impact of 0.5 per cent of GDP in 2016. Based on information provided for the May 2014 Assessment, the capital injections include the conversion of a loan granted in 2012, with the remaining balance of €12 million being converted into equity in 2016. As in previous budgetary forecasting exercises, the SP does not include any possible negative fiscal repercussions from this transaction, on the assumption that the national airline will turn profitable in 2016, in line with the restructuring plan for the company. Any adverse deviation from the planned targets in the restructuring plan would constitute a downside fiscal risk, though this is contained to 0.1 per cent of GDP.

This category of expenditure includes the discretionary measure relating to the ex-gratia payment in relation to registration tax paid on imported vehicles for personal use between 1 May 2004 and 31 December 2008. The actual disbursements of this measure amounted to 0.04 per cent of GDP in 2014. The remaining dues to the eligible beneficiaries will be spread out over a number of years, with the incremental impact of this measure projected to be marginal during the forecast period.

Other Category of Expenditure

Outlays included under the other category are projected to remain stable at 2.3 per cent of GDP in 2015, decline marginally to 2.1 per cent by 2017 and then increase back to 2.4 per cent in 2018. The SP does not include any discretionary measures under this expenditure category.

Other current transfers payable account for over 95 per cent of the total outlays under this category. In turn, EU own resources and the financing of church schools account for around one-half and one-quarter, respectively, of other current transfers payable. In 2014, EU own resources (in ESA terms) included a one-off deficit-increasing item, amounting to 0.2 per cent of GDP, related to the revision of Malta's contribution to the EU budget following the recalculation of historical GNI data. The projections show increases in 2015 and 2018, but in 2016 and 2017 Malta's contribution to the EU budget is assumed to remain largely stable. Whilst we recognise the difficulty to forecast these outlays as they are affected by revisions to GDP statistics, no information was provided to explain the expected trajectory, which adds further uncertainty to these projections. The projections for the contribution toward the financing of church schools are broadly in line with the developments in the last few years. No details were provided to explain the projected increase in the other category of expenditure in 2018.

As in the DBP, as from 2015, the projections for other current transfers payable also include a contingency reserve of 0.1 per cent of GDP, established in line with the Fiscal Responsibility Act 2014. As stated in the SP, this can be used in the case of unforeseen expenditure or revenue developments, whilst if unused, it would contribute towards further improvement in the fiscal balance (MFIN, 2015, p.29). This reserve thus reduces the risks surrounding the attainment of the fiscal targets, though only to a limited extent in view that the amount allotted is at the lower bound of the 0.1 – 0.5 per cent range specified in the said Act.

5.4 Assessment of Debt Projections

According to the SP, the debt-to-GDP ratio is projected to decline from 68 per cent of GDP in 2014 to 66.8 per cent of GDP in 2015. This decrease partly reflects the primary surplus which exerts a downward pressure on the debt. Moreover, the fact that the nominal GDP growth rate exceeds the growth in the absolute debt levels also contributes towards a declining debt ratio. The stock-flow adjustment (SFA) is expected to have a relatively minor effect on debt developments projected for 2015. Notwithstanding this, the SFA for 2015 constitutes some significant items exerting a downward pressure on the debt ratio such as the repayment of loans and the repayment of accumulated arrears of excise taxes by Enemalta. These are, however, offset by other major items that give rise to a positive SFA including the contribution of the IIP to the National Development and Social Fund and the contribution to a special Malta Government Stocks Sinking Fund.

Table 5.5. Debt Dynamics

	2014	2015	2016	2017	2018
			per cent of GDP		
General Government Gross Debt	68.0	66.8	65.6	63.8	61.2
Change in the Ratio	-1.2	-1.2	-1.2	-1.8	-2.6
Contributions:					
1. Primary Balance	-0.8	-1.1	-1.5	-2.0	-2.3
2. 'Snow-ball' effect	-0.5	-0.4	-0.7	-0.7	-0.8
of which:					
Interest expenditure	2.9	2.7	2.6	2.5	2.5
Growth and inflation effect	-3.4	-3.1	-3.3	-3.3	-3.2
3. Stock-flow adjustment	0.1	0.3	1.1	0.9	0.5

Source: Malta Update of the Stability Programme 2015-2018, Ministry for Finance

The General Government gross debt is projected to continue decreasing from 66.8 per cent of GDP in 2015 to 61.2 per cent of GDP in 2018 mainly on account of an increasing primary surplus. Over this period, the ‘snow-ball’ effect is also projected to exert downward pressure on the debt-to-GDP ratio albeit to a lesser extent. This mainly reflects the fact that the nominal GDP growth rate is forecasted to more than offset the effect of interest expenditure on the debt. The SFA is expected to have a relatively significant expansionary effect on debt developments in 2016 and 2017 before declining in 2018. For 2016 and 2017, the contribution of the Malta Government Stocks Sinking Fund together with the contribution of the IIP to the National Development and Social Fund are not expected to be offset by other items so that overall the SFA exerts an upward pressure on the debt ratio. A lower SFA is forecasted for 2018 due to a substantial withdrawal from the Sinking Fund which exerts a downward pressure on the debt ratio.

Given that the fiscal balance is the primary factor influencing the change in the debt, the same risks highlighted for the deficit targets characterise the debt projections presented in the SP. Moreover, since a number of underlying assumptions underpin the SFA, there is a risk of significant forecast error exerting an element of uncertainty to the realization of the debt ratio projections. This is further compounded by the assumptions concerning the borrowing of EBUs.

An element of downside risk also emanates from the stock of government debt guarantees which amounted to almost 17 per cent of GDP in 2014. Since about half of the contingent liabilities relate to the energy sector, a relatively significant degree of exposure to the contingent liabilities hinges upon developments within this particular sector.

6. Comparison of MFIN Budgetary Forecasts with the Fiscal Projections generated by the European Commission in its Spring Forecast 2015 and the Central Bank of Malta in April 2015

This Section starts with a detailed comparison of the fiscal projections for 2015 and 2016 presented in the SP with the most recent forecasts generated by the (CION)[10], being the Spring 2015 Forecasts published on 5th May 2015. Subsequently, a comparison is also made with the fiscal projections presented in the CBM Annual Report 2014 published in April 2015.

Comparison with the CION Spring Forecasts 2015

The CION's forecasts and those of the Ministry are directly comparable as they are based on the same macroeconomic and fiscal data for 2014, as published by the NSO[11]. Divergences between the CION's and MFIN's budgetary projections thus reflect different methodologies and assumptions used in the forecasting exercises, including the underlying macroeconomic outlook. Moreover, whilst for 2015, both the CION and the MFIN take into account the discretionary measures announced in the Budget for 2015 (although the estimates of their impact may vary), the CION's fiscal projections for 2016 are based on a no-policy change scenario and thus do not take into account the proposed discretionary measures included in the SP.

Similarly to MFIN, the CION expects the budget deficit to decline between 2014 and 2016, but it presents a more gradual downward trend, with the discrepancy amounting to 0.2 and 0.5 percentage points of GDP in 2015 and 2016, respectively. Differences in the GDP estimates to calculate the deficit ratio are not relevant to explain this gap, as the CION's projected nominal GDP levels are higher than in the SP for both years. For 2016, discretionary measures, which are included in the SP but not in the CION's no-policy change forecast, amount to only 0.1 per cent of GDP[12] and thus explain only a minor part of the discrepancy in the expected fiscal balance.

In both years, the CION's larger deficit reflects a higher level of total expenditure, which more than offsets a higher level of revenue. The gap in total revenue is marginal in 2015 but more notable in the subsequent year. In both 2015 and 2016, the CION is projecting higher outlays for all categories of expenditures with the exception of gross fixed capital formation. The lower expected capital outlays in the CION's forecasts correspond to similarly lower forecasts for capital transfers and thus reflect different assumptions concerning the absorption of EU funds.

In 2015, on the expenditure side, the CION's forecasts for compensation of employees, social payments and outlays under the other category are notably higher than that of the MFIN. On the revenue side, the CION's forecast for current taxes on income and wealth is substantially higher than that of MFIN, reflecting both the slightly stronger nominal GDP growth as well as a higher implied elasticity than that estimated by MFIN. The CION's forecast for taxes on production and imports is also higher than that of the MFIN, though the gap is less accentuated. This discrepancy also reflects a slightly higher estimated elasticity by the CION whilst the projected growth in nominal private consumption expenditure is similar. On the other hand, the CION's expected intake from social contributions is more conservative than that of MFIN, despite a largely similar outlook for the labour market.

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[10] The CION's forecast period covers only up to 2016.

[11] News Releases 46/2015 and 75/2015.

[12] The CION's forecasts include the base effect of the equity injection in the national airline in 2015.

Table 6.1 Comparison of Fiscal Projections
MFIN Stability Programme April 2015 - CION Spring 2015

	2014	2015	2016	2015	2016
	Actual	MFIN SP April 2015		CION Spring 2015	
		per cent of GDP			
General government balance	-2.1	-1.6	-1.1	-1.8	-1.5
General government debt	68.0	66.8	65.6	67.2	65.4
		Eur millions			
Taxes on production and imports	1,087.2	1,155.1	1,198.7	1,164.3	1,218.0
Current taxes on income and wealth	1,155.4	1,173.6	1,226.1	1,213.6	1,264.4
Social contributions	560.3	594.9	616.4	583.8	607.5
Capital transfers receivable	200.7	272.4	195.1	239.9	168.8
Other revenue	318.2	355.6	328.4	353.8	331.8
Total revenue	3,321.8	3,551.5	3,564.7	3,555.3	3,590.5
Compensation of employees	1,051.9	1,082.4	1,123.3	1,096.5	1,140.4
Intermediate consumption	525.5	566.6	566.1	570.0	604.0
Social payments	1,008.4	1,039.8	1,062.9	1,048.0	1,086.0
Interest expenditure	230.2	222.9	227.0	227.0	231.5
Gross fixed capital formation	300.2	342.5	277.7	320.0	240.0
Subsidies	103.6	128.3	125.7	133.6	141.6
Other expenditure	270.3	302.3	274.3	313.0	280.0
Total expenditure	3,490.1	3,684.6	3,657.0	3,707.9	3,723.0
General government balance	-168.3	-133.1	-92.3	-152.5	-132.5

Source: Malta Update of the Stability Programme 2015-2018, Ministry for Finance; European Commission's AMECO and General Government data [online]

In 2016, the CION is projecting significantly higher outlays for compensation of employees, intermediate consumption, social payments and subsidies. The discrepancy in the forecast for the government's wage bill largely reflects a base effect. As regards intermediate consumption, the CION is projecting an increase similar in magnitude to that in 2015, but the MFIN is expecting this expenditure component to remain largely stable. The discrepancy in the forecasts for social payments is explained by the base effect as well as discretionary deficit-reducing measures included in the MFIN's forecasts. The CION is also projecting higher outlays on subsidies in 2016 and considers "higher-than-expected subsidies to Malta's new public transport service provider" as a downside risk to the fiscal projections (CION, 2015, p.101). On the revenue side, in 2016, the CION is again projecting considerably higher revenue from current taxes on income and wealth. This is largely explained by the base effect, as the nominal GDP growth rate and estimated elasticity are quite similar to those of the MFIN. The CION's forecast for taxes on production and imports is also higher, despite the inclusion of deficit-reducing discretionary measures in MFIN's projection. This gap reflects a base effect, higher growth in nominal private consumption as well as a slightly higher estimated elasticity.

The trajectory for the debt ratio in the CION's forecasts is quite similar to that presented in the SP. Both sets of forecasts expect the debt ratio to decrease both in 2015 and in 2016, but the

CION's debt ratio is 0.4 percentage points of GDP higher in 2015, but 0.2 percentage points lower in 2016. The gap in 2015 is attributable to its higher projected deficit level and different assumptions for the stock-flow adjustment. Differences in the GDP estimates explain 0.1 percentage points of the difference between the CION's and MFIN's debt ratios for 2016. The remaining discrepancy is attributable to a higher stock-flow adjustment underpinning the MFIN's debt projections.

Comparison with the Central Bank of Malta Fiscal Projections April 2015

Whilst the forecasts of the MFIN and the CBM are based on the same macroeconomic data for 2014, the fiscal data differ because the CBM's figures were published before the NSO Release with the actual data in April. However, the discrepancies are minor, with the deficit amounting to 2.2 per cent of GDP in the CBM forecasts as compared to an actual 2.1 per cent whilst the debt ratio is only 0.4 percentage points of GDP higher.

Against a broadly similar macroeconomic outlook, the CBM like the MFIN is also projecting a downward trend in the deficit ratio, although more gradual, with the gap amounting to 0.2 percentage points in 2015 and to 0.5 percentage points in 2016. This is reflected in the trajectory for the debt ratio with the CBM's projection a debt ratio of 67.3 per cent in 2015 compared to the MFIN's 66.8 per cent. In 2016, the gap amounts to 0.3 percentage points of GDP.

7. Conclusion

As regards the methodology and processes underpinning the fiscal forecasts, one positively notes the detailed process undertaken to take into account all available information and the internal discussions between experts to finalize the forecasts. However, the process remains characterised by significant fragmentation and disaggregation which can lead to inconsistencies and increase the risk of forecast errors. Furthermore, there is a lack of formal documentation explaining the methodologies and processes behind the fiscal projections.

This assessment was conducted against the backdrop of the attainment of the fiscal targets for 2014. Although it is noted that the fiscal consolidation in 2014 was reliant on cyclical factors and one-off and other temporary measures, the fiscal consolidation plan presented in the SP is less reliant on such factors.

The macroeconomic projections may be achievable but are subject to an element of risk particularly given the high dependence on the planned strong growth in investment. This may have notable repercussions on other components of GDP which could thus affect various tax bases and spill over to the fiscal forecasts.

At an aggregate level, the MFIN's projections for the deficit ratio are quite similar to the most recent forecasts by the CION and the CBM although these two entities expect a more gradual pace of fiscal adjustment.

On the revenue side, based on an analysis of elasticity estimates, no particular risks were identified for taxes on production and imports and social contributions while the projections for current taxes on income and wealth show some element of prudence. This is also confirmed in the comparison to the CION's forecasts. Other upside risks stem from the fact that any proceeds resulting from the revision in tax on rental income and in the property tax system are not taken into account in the fiscal projections. Moreover, the authorities also showed caution by not taking into account the indirect impact on tax revenue of the structural reforms to increase labour market participation. On the other hand, there is some uncertainty regarding the expected impact of the measure to combat tax avoidance.

On the expenditure side, some risks of slippages are noted particularly with respect to compensation of employees as well as intermediate consumption. The CION's fiscal forecasts also project higher outlays for these two categories. Some uncertainty also surrounds the impact of the deficit-reducing measures under the social payments category. On the other hand, the implementation of the spending review constitutes a possible upside risk.

These risk factors also apply to the actualisation of the debt projections. Furthermore, it is noted that important contributors to the debt are based on a number of assumptions increasing the risk of forecast error. One also notes that the stock of government guaranteed debt is substantial.

Although subject to the above mentioned risks, the fiscal targets are considered attainable. Nevertheless, given the uncertainty surrounding some key drivers of the budgetary projections, the attainment of these targets requires close monitoring by the authorities to identify and correct any deviations from the projections included in the SP.