# An Assessment of the Fiscal Forecasts for Malta prepared by the Ministry for Finance in October 2016

A report prepared by the
Malta Fiscal Advisory Council

November 2016

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MALTA FISCAL ADVISORY COUNCIL

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29 November 2016

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Minister for Finance
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Dear Minister

**LETTER OF TRANSMITTAL**

In terms of Article 13 of the Fiscal Responsibility Act, 2014 (Cap 534), I have the honour to transmit a report by the Malta Fiscal Advisory Council (MFAC) on the assessment of the fiscal forecasts, prepared by the Ministry for Finance in October 2016, as part of the Draft Budgetary Plan for 2017.

The Council considers the official deficit target of 0.7% of GDP for 2016, and 0.5% of GDP for 2017 as well as the public debt target of 63.3% of GDP for 2016 and 61.9% of GDP for 2017, to be achievable and within the Council's endorsable range. These forecasts are also broadly in line with those prepared by other institutions, namely the European Commission, as part of its autumn round, and those published in June 2016 by the Central Bank of Malta in its Quarterly Review.

The Council understands that the planned improvement in the fiscal balance in both years is the result of expected larger absolute increases in revenues than in expenditures, while the expansion in nominal GDP fully explains the lower debt-to-GDP ratio. In the latter case the Council notes the practice by the Ministry to assume positive stock flow adjustments over the forecast horizon, thus slowing somewhat the convergence towards the 60% debt-to-GDP threshold.

The Council views positively that the methodologies to prepare the fiscal projections continue to rely on micro-based knowledge and expertise, through the decentralised input by the various departments, combined with the co-ordination and horizontal assessment undertaken by the Ministry. This practice appears to work well to safeguard the plausibility of the fiscal forecasts.

The trajectory envisaged for total revenue and expenditure for 2016 and 2017 has been evaluated by the Council on an individual component basis. Overall, the Council considers the projections for revenue and expenditure, and hence for the fiscal balance, to be prudent, with the opportunity for a larger decline in the deficit-to-GDP ratio. Indeed, the Council's assessment points towards possible upside risks for total revenue both for 2016 and 2017. The possible positive effect on the fiscal balance is reinforced by downside risks to total expenditure for 2016, albeit this is partially dampened by upside expenditure risks for 2017.

The Council considers that if recent revenue trends are maintained, and if labour market conditions remain buoyant, the actual outturn for current taxes on income and wealth, as well as that for social contributions, may be higher than expected in both forecast years. On the other hand, there may be some downside risks as the absorption of EU funds in 2016 and property income in 2017, may be lower than envisaged, respectively in view of possibly slower progress in EU-funded projects and dividend shortfalls. On balance, the Council views upside risks for total revenue for both forecast years.

As for the attainment of the announced expenditure targets, this is conditional on successful restraint, through scaling back of a number of expenditure categories, when compared to nominal GDP. This challenge appears rather significant in the case of compensation of employees. However, the Council's view is that for 2016 the latter's upside risk is more than compensated for by the downside risk stemming from possibly lower-than-budgeted spending on gross fixed capital formation. Turning to 2017, there appear to be more generalised upside expenditure risks. Apart from spending on compensation of employees, which may exceed targets, spending on intermediate consumption may also be higher than projected. This observation is based on the fact that the latter includes outlays associated with the EU Presidency, which could possibly exceed the budgeted amounts. Further upside risks relate to spending on social benefits, owing to the fact that the absolute budgeted increase is similar to that anticipated for 2016, notwithstanding the new expansionary measures announced in this field for 2017. In the case of subsidies, no specific justification was detailed to explain the envisaged scaling back when compared to the projections which had been presented to the Commission in the latest Update of Stability Programme.

The Council is assuming that both in 2016 and in 2017 no recourse will be made to the Contingency Reserve Fund, in which case expenditure savings of 0.1% of GDP would be achieved in each year. The Council would like to highlight the importance that this Reserve is only resorted to in exceptional cases. The Council would also like to recommend that should the actual revenue and expenditure performance enable the fiscal balance to improve by more than what is originally being targeted, the Government would take the opportunity to build fiscal buffers, rather than offset such windfalls through new expenditure initiatives.

Finally, the Council expresses its satisfaction at the ongoing constructive dialogue with the Ministry. The Council also positively observes that fiscal transparency continues to improve, not only in the contents of the published official documents but also through the additional information which the Ministry regularly provides to the Council to facilitate its work. Going forward, the Council considers there could be scope to boost transparency further, particularly by providing a broader coverage of the risk scenarios used in the sensitivity analysis related to fiscal risks.

Yours sincerely

**Rene Saliba**
**Chairman**

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## Abbreviations

| | |
|---|---|
| **CBM** | Central Bank of Malta |
| **COM** | European Commission |
| **DBP** | Draft Budgetary Plan |
| **EBU** | Extra Budgetary Unit |
| **ESA** | European System of National and Regional Accounts |
| **EU** | European Union |
| **FRA** | Fiscal Responsibility Act |
| **FTS** | Foundation for Tomorrow Schools |
| **GDP** | Gross Domestic Product |
| **IIP** | Individual Investor Programme |
| **MCAST** | Malta College for Arts Science and Technology |
| **MCST** | Malta Council for Science and Technology |
| **MFAC** | Malta Fiscal Advisory Council |
| **MFF** | Multiannual Financial Framework |
| **MFIN** | Ministry for Finance |
| **MFSA** | Malta Financial Services Authority |
| **MGS** | Malta Government Stock |
| **MSE** | Malta Stock Exchange |
| **NPISH** | Non-Profit Institutions Serving Households |
| **NSO** | National Statistics Office |
| **PSO** | Public Service Obligation |
| **SGP** | Stability and Growth Pact |
| **UoM** | University of Malta |
| **USP** | Update of Stability Programme |
| **VAT** | Value Added Tax |

## Executive summary

This Report presents an assessment of the fiscal projections contained in the Draft Budgetary Plan 2017, carried out by the Malta Fiscal Advisory Council in line with the requirements prescribed in the Fiscal Responsibility Act, 2014 (Cap. 534).

In 2016, the fiscal deficit is expected to practically halve, narrowing from €120.3 million in 2015 to €67.0 million, equivalent to a drop from 1.4% to 0.7% of nominal GDP. Further consolidation is planned for 2017, with the deficit target being set at €50.0 million or 0.5% of GDP. The planned improvement in the fiscal balance in 2016 and 2017 is the result of expected larger increases in revenues when compared to the projected increases in expenditures. In view of the anticipated stream of fiscal deficits, the outstanding public debt is thus expected to increase in absolute terms. However, when expressed as a percentage of GDP, the debt ratio is expected to continue converging towards the 60% threshold, as it is planned to drop from 64.0% in 2015 to 63.3% in 2016 and 61.9% in 2017.

The autumn fiscal forecasts presented by the European Commission are broadly in line with the Ministry for Finance's projections. However, while the Commission's deficit ratio projection for 2016 is identical to that of the Ministry, for 2017 the Commission is forecasting a slightly higher deficit ratio consequent to slightly higher expenditures and slightly lower non-tax revenues. Nevertheless, the Commission's debt ratio projections are lower than those of the Ministry over both forecast years, due to different assumptions regarding stock flow adjustments. The Council also notes that both the deficit and debt projections by the Central Bank of Malta are within a close range to those prepared by the Ministry.

The methodologies adopted by the Ministry to prepare the fiscal projections remained largely similar to those used in previous years. A particular strength of the approaches used is the fact that micro-based knowledge and expertise are embedded into the forecasts. This is ensured through the decentralised input by the various departments combined with the co-ordination and horizontal assessment undertaken by the Ministry. At the same time, the top-down macro-driven forecasts provide a useful envelope within which the plausibility of the fiscal targets, conditional on the macroeconomic forecasts, can be safeguarded.

The plausibility of the trajectory envisaged for total revenue and total expenditure for 2016 and 2017 has been evaluated by the Fiscal Council on an individual component basis. Overall the Fiscal Council considers the projections for total revenue and total expenditure, and hence for the fiscal balance, for both years to be within its endorsable range, with the opportunity for a larger decline in the deficit ratio. This follows the Council's assessment which identified possible upside risks for total revenue for both forecast years, which are reinforced by downside risks to total expenditure for 2016. This is partially dampened by upside risks to total expenditure for 2017.

On the basis of the Council's assessment of the debt projections, these are also deemed to be plausible, and indeed rather conservative when considering the positive stock flow adjustments being assumed by the Ministry.

In the Fiscal Council's view, if recent revenue trends are maintained and if labour market conditions remain buoyant, the projections for current taxes on income and wealth, as well as those for social contributions may be exceeded in both forecast years. On the other hand, downside revenue risks relate specifically to the absorption of EU funds in 2016, and the intake from property income in 2017, which in both cases may be less than envisaged, respectively in view of possibly slower progress in projects, and dividend shortfalls. The Fiscal Council considers the risks to the other major revenue components to be broadly neutral.

With regard to the attainment of the announced expenditure targets, this is conditional on successful restraint, through scaling back of a number of expenditure categories, when compared to nominal GDP. This challenge appears more difficult in the case of compensation of employees. However, the Council's view is that for 2016 this risk is more than compensated for through the likely lower spending on gross fixed capital formation. Risks stemming from the other expenditure categories are judged to be broadly neutral in 2016. Turning to 2017, upside risks remain for compensation of employees, but could also extend to spending on intermediate consumption, particularly as the latter includes the outlays associated with the EU Presidency which could possibly exceed the allocated amount. With regard to social benefits, there are also upside risks stemming from the fact that the absolute budgeted increase is similar to that expected in 2016, notwithstanding new expansionary measures in this field. In the case of subsidies, no specific justification was detailed to explain the envisaged scaling back when compared to the projections presented to the Commission in April this year in the Update of Stability Programme.

Finally, the Council would like to recommend that should the actual revenue and expenditure performance enable the fiscal balance to improve by more than what is originally being targeted, the Government would take the opportunity to build fiscal buffers rather than offset such windfalls through new expenditure initiatives.

## 1. Introduction

Euro area Member States are required to submit to the European Commission (COM) a Draft Budgetary Plan (DBP) by 15 October of each year, as specified in EU Regulation No 473/2013.[1,2] The DBP presents the government's latest macroeconomic outlook and the updated fiscal projections for the current year and the next. The fiscal projections are outlined on the basis of revenue and expenditure categories which are compiled in accordance with the European System of National and Regional Accounts (ESA 2010).[3]

To strengthen confidence in the reliability of the fiscal projections, article 13 sub-article 3 (a) of the Fiscal Responsibility Act (FRA) prescribes that the Malta Fiscal Advisory Council (MFAC) "shall endorse, as it considers appropriate the macroeconomic and fiscal forecasts prepared by the Ministry for Finance". To support fiscal transparency, article 13 sub-article 4 also requires that the MFAC makes public all its assessments. This Report analyses specifically the fiscal projections contained in the DBP for 2017, and complements an earlier report wherein the MFAC had endorsed the macroeconomic forecasts for 2016 and 2017 which underpin such fiscal projections.[4]

This Report, whose cut-off date is 15 November 2016, proceeds as follows. Section 2 presents an overview of the main fiscal aggregates outlined in the DBP. Section 3 evaluates the methodologies and processes adopted by the Ministry for Finance (MFIN) to prepare the latest vintage of fiscal forecasts. Section 4 examines the extent to which, the forecasts for the main revenue components can be considered to be plausible, and whether there could be any upside or downside risks to the baseline forecasts. Section 5 carries out the same type of assessment for the main expenditure projections. Section 6 examines the extent to which the projections for the fiscal balance for 2016 and 2017 can be considered to be within the endorsable range of the MFAC. Section 7 focuses on the plausibility of the planned trajectory for public debt. Section 8 compares the MFIN's fiscal forecasts to those prepared by the COM and the Central Bank of Malta (CBM). Section 9 concludes with an overall assessment.

## 2. Overview of the fiscal projections

Table 1 presents the actual fiscal turnout in 2015, together with the updated fiscal targets for 2016 and 2017. Figures are presented in absolute terms and also expressed as a percentage of nominal GDP. In 2016, the fiscal deficit is expected to practically halve, narrowing from €120.3 million in 2015 to €67.0 million. This is equivalent to a drop from 1.4% of nominal

[1] In 2016 a number of Member States, including Malta, submitted their DBP few days after 15 October since this deadline fell on a Saturday.
[2] Greece is not obliged to submit its DBP since the country is currently subject to a macroeconomic adjustment programme.
[3] ESA methodologies are mandatory across European Union (EU) Member States to ensure comparability of data across countries.
[4] The MFAC's assessment of the latest DBP's macroeconomic forecasts was published on 14 October 2016 and is available on www.mfac.gov.mt.

GDP to 0.7% of nominal GDP. Further consolidation is planned for 2017, with the deficit target being set at €50.0 million or 0.5% of GDP. The planned improvement in the fiscal balance in 2016 and 2017 is the result of expected larger increases in revenues when compared to the projected increases in expenditures. Nevertheless, both the revenue-to-GDP and the expenditure-to-GDP ratios are expected to scale back compared to 2015, as nominal GDP is forecasted to grow at a faster pace, partly reflecting the extraordinary high revenues from EU funds and associated capital expenditure in that year

Table 1: Summary of the main fiscal aggregates (2015 – 2017)

| | 2015 | | 2016 | | 2017 | |
|---|---|---|---|---|---|---|
| | EUR millions | % of GDP | EUR millions | % of GDP | EUR millions | % of GDP |
| **Total revenue** | **3,694.4** | **42.0** | **3,740.6** | **40.3** | **3,910.2** | **39.8** |
| Taxes on production and imports | 1,188.5 | 13.5 | 1,262.7 | 13.6 | 1,324.4 | 13.5 |
| Current taxes on income and wealth | 1,237.6 | 14.1 | 1,302.5 | 14.0 | 1,379.5 | 14.0 |
| Capital taxes | 15.0 | 0.2 | 16.9 | 0.2 | 17.2 | 0.2 |
| Social contributions | 596.3 | 6.8 | 629.2 | 6.8 | 658.5 | 6.7 |
| Property income | 95.4 | 1.1 | 95.3 | 1.0 | 105.0 | 1.1 |
| Other revenue | 561.6 | 6.4 | 434.0 | 4.7 | 425.6 | 4.3 |
| **Total expenditure** | **3,814.7** | **43.4** | **3,807.6** | **41.0** | **3,960.2** | **40.3** |
| Compensation of employees | 1,117.2 | 12.7 | 1,180.5 | 12.7 | 1,240.8 | 12.6 |
| Intermediate consumption | 598.2 | 6.8 | 650.5 | 7.0 | 684.0 | 7.0 |
| Social payments | 1,031.2 | 11.7 | 1,063.9 | 11.4 | 1,096.2 | 11.1 |
| Interest expenditure | 227.8 | 2.6 | 212.7 | 2.3 | 207.7 | 2.1 |
| Subsidies | 110.6 | 1.3 | 111.6 | 1.2 | 112.4 | 1.1 |
| Gross fixed capital formation | 397.7 | 4.5 | 322.5 | 3.5 | 352.1 | 3.6 |
| Capital transfers payable | 134.9 | 1.5 | 55.8 | 0.6 | 45.2 | 0.5 |
| Other expenditure | 197.1 | 2.2 | 210.2 | 2.3 | 221.9 | 2.3 |
| **Fiscal balance** | **-120.3** | **-1.4** | **-67.0** | **-0.7** | **-50.0** | **-0.5** |
| One-off and temporary effects | 13.1 | 0.1 | -11.8 | -0.1 | -20.0 | -0.2 |
| Cyclical effects* | 59.6 | 0.8 | 41.8 | 0.5 | 2.3 | 0.0 |
| **Structural balance*** | **-166.4** | **-2.3** | **-100.5** | **-1.1** | **-45.6** | **-0.3** |
| **Gross Debt** | **5,621.9** | **64.0** | **5,884.0** | **63.3** | **6,093.0** | **61.9** |

* expressed as percentage of potential GDP

*Source: MFIN*

The net impact on the headline fiscal balance exerted by one-off and temporary effects is expected to remain low over both 2016 and 2017. However, whereas in 2015 the net effect of such factors on the fiscal balance was slightly positive (0.1% of GDP), in 2016 and 2017 the net effect is expected to be slightly negative, equivalent to 0.1% of GDP and 0.2% of GDP respectively.

The official 2016 deficit-to-GDP target remained unchanged at 0.7% when compared to that outlined in the Update of Stability Programme (USP) presented in April 2016 (see Table 2). The USP had presented a more ambitious deficit-to-GDP target when compared to the original 1.1% target announced in the DBP for 2016, particularly to take account of the strong economic growth conditions. However, the DBP 2017 indicates that both the revenue and expenditure ratios for 2016 have been revised upwards compared to those indicated in the USP. The 0.4 percentage point reduction in the deficit target indicated in the DBP 2017 reflects an additional 0.2 percentage point in the revenue ratio and a 0.2 percentage point lower expenditure ratio compared to the targets stated in the DBP 2016. With regard to 2017, both revenue and expenditure ratios have been adjusted upwards, respectively by 0.5 percentage point and 0.4 percentage point from the targets published in the latest USP. On balance, the DBP 2017 has thus lowered the deficit target for 2017 by 0.1 percentage point when compared to the target which had been indicated in the USP. Overall, the MFAC notes a certain element of consistency with regard to the deficit-to-GDP targets, since revisions to the revenue and expenditure targets tend to offset each other.

Table 2: Main fiscal targets as percentage of GDP

| 2016 | | | | 2017 | | | |
|---|---|---|---|---|---|---|---|
| **Revenue** | **Expenditure** | **Balance** | **Debt** | **Revenue** | **Expenditure** | **Balance** | **Debt** |
| **DBP 2016** | | | | **DBP 2016** | | | |
| 40.1 | 41.2 | -1.1 | 65.2 | N/A | N/A | N/A | N/A |
| **USP 2016 – 2019** | | | | **USP 2016 – 2019** | | | |
| 39.4 | 40.1 | -0.7 | 62.6 | 39.3 | 39.9 | -0.6 | 60.4 |
| **DBP 2017** | | | | **DBP 2017** | | | |
| 40.3 | 41.0 | -0.7 | 63.3 | 39.8 | 40.3 | -0.5 | 61.9 |

*Source: MFIN*

The positive cyclical effects on the fiscal balance are expected to diminish progressively over time, as economic growth converges closer to its potential (see Table 1). Indeed, cyclical effects, which in 2015 were estimated at 0.8% of potential GDP, are expected to be less strong in 2016, estimated at 0.5% of potential output. In turn, practically no cyclical effects are being anticipated for 2017. This corresponds to the closing off of Malta's output gap, which according to the macroeconomic forecasts contained in the DBP, is projected to contract from 1.7% of potential output in 2015 to 1.1% in 2016 and to 0.1% in 2017.

As a result, the structural balance as percentage of potential output is expected to narrow from -2.3% in 2015 to -0.3% by 2017.[5] Hence, the difference of 0.2 percentage point between the headline fiscal balance and the structural balance in 2017 is practically exclusively driven by one-off and temporary effects, with no material cyclical effects.

[5] The structural balance represents the actual budget balance net of one-off and temporary effects and net of cyclical effects. The structural balance thus provides a more accurate measure of the underlying trend in the budget balance.

The outstanding public debt is expected to rise in absolute terms, mainly in view of the anticipated stream of fiscal deficits. Public debt is expected to rise from just over €5.6 billion as at end 2015 to just under €6.1 billion by 2017. However, when expressed as percentage of GDP, the debt ratio is expected to continue converging towards the 60% threshold, as it is planned to drop from 64.0% in 2015 to 63.3% in 2016 and 61.9% in 2017. Indeed, growth in nominal GDP is expected to outpace the amount of debt accumulation, in line with what has occurred over recent years. At the same time, the MFAC notes that the targets for the debt ratios are slightly less ambitious than those indicated in the latest USP, as they have been raised by 0.7 percentage points for 2016 and by 1.5 percentage points for 2017. This notwithstanding the more ambitious targets set for the fiscal deficit-to-GDP ratio.

## 3. Assessment of the MFIN's methodologies used to prepare the fiscal projections

The ESA-based fiscal projections for the years 2016 to 2017 were carried out by the MFIN. The MFAC positively notes that the MFIN has managed to build up capacity to transpose Consolidated Fund cash-based data into accruals-based ESA nomenclatures, thereby reducing the need for technical assistance from the National Statistics Office (NSO).

Various government departments initially provided inputs through estimates based on the Consolidated Fund classifications and methodologies. These forecasts, which are essentially cash-based, were mainly prepared on the basis of the specific knowledge and information available at departmental level, past trends and expert judgment. Outstanding balances in terms of debtors and creditors were also factored in to move from cash-based forecasts to a basic accrual system. The expected impact of new measures was also quantified and factored into the forecasts.

These decentralised projections were subsequently reviewed by senior MFIN officials, particularly in the light of the requirements in terms of the intended target for the annual fiscal balance. In certain cases, this entailed certain fine-tuning to ensure that revenue and expenditure projections were on one hand attainable, but on the other hand also addressed the annual consolidation efforts prescribed by the Stability and Growth Pact (SGP) and the FRA. Initial revenue targets were revised upwards in cases where these were deemed to be insufficiently ambitious, while when the departments' estimates appeared to be excessively optimistic, further discussions were held, and clarifications sought, in order to fine-tune such projections and ensure their robustness.

In parallel with this bottom-up approach, the MFIN also prepared top-down forecasts using directly ESA fiscal data. These forecasts were derived using the forecast macroeconomic variables as proxy bases, combined with empirically-based elasticities. Discussions were subsequently held among the various departments and entities to align these top-down fiscal projections with the bottom-up estimates, in order to finalise the overall revenue targets. The main objective remained that such revenue forecasts were consistent with macroeconomic forecasts while maintaining an element of prudence. As in previous years, the MFIN maintained a general bias towards conservative revenue estimates. The revenue forecasts then established the spending ceilings consistent with the announced budgetary targets. With regard to the expenditure projections, these remained mainly driven by the information and expertise available at ministerial and departmental levels.

The methodologies used to prepare the projections contained in the latest DBP remained largely similar to those used in previous years. A particular strength of the approaches used is the fact that micro-based knowledge and expertise about very specific features of the various tax and expenditure laws in Malta are embedded into the forecasts. This is ensured through the decentralised input by the various departments combined with the co-ordination and horizontal assessment undertaken by the MFIN. On the other hand, the top-down macro-driven forecasts provide a useful envelope within which the plausibility of the fiscal targets, conditional on the macroeconomic forecasts, can be judged.

The practice of estimating the impact of measures for the initial year and then freezing the effect for the remaining years may introduce a certain element of bias since the estimates for subsequent years remain static and are assumed not to vary in response to changing macroeconomic dynamics. Such estimates thus are not fully consistent with the forecast macroeconomic dynamics.[6] In actual fact, it is likely that the yearly impact of any particular measure will change over time as this is influenced by macroeconomic developments. Such bias may however be small when the overall estimated impact of the measure is low in the first place, as has generally been the case in recent years.

The MFAC's view is that the current fiscal forecasting approach appears to have worked well in terms of prudence of the projections particularly for the plausibility of the target balance for general government. The MFAC considers positively the fact that in recent years there were increased efforts by the MFIN to ensure that the fiscal and macro projections are internally consistent. At the same time the MFAC underscores the importance that the process for the preparation of fiscal forecasts takes full consideration of the deadlines imposed by the European Semester and the requirements of the FRA.[7]

A useful exercise which has also been introduced in the DBP is the risk assessment of the budget balance forecast.[8] The methodology relies on the use of alternative macroeconomic scenarios, which can be more benign or more adverse when compared to the baseline scenario, and on an evaluation of their impact on the overall fiscal balance. Results are then summarised in the form of a fan chart (see Chart 1).

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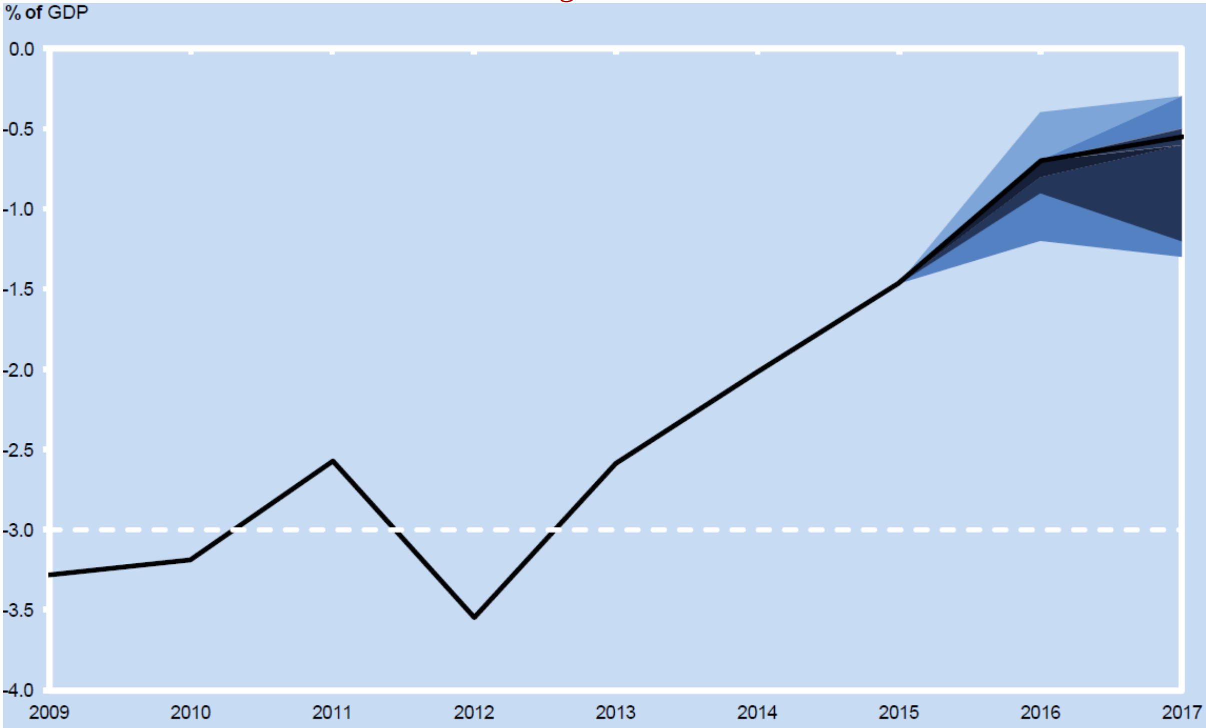
[6] The direction of the bias may vary depending whether the underlying base is expected to expand or contract over time in line with the macroeconomic outlook.

[7] Certain fiscal forecasts influence the macroeconomic forecasts, particularly those that feature directly in GDP as they impact government consumption. Hence, any delay in the preparation of such forecasts would also delay the finalisation of the macroeconomic forecasts, which under the current European framework have to be endorsed by the MFAC by 15 October.

[8] This type of analysis previously used to be published only in the USP.

Chart 1: MFIN's risk assessment of the budget balance forecast*




* The chart is reproduced from the 2017 DBP document.
*Source: MFIN*

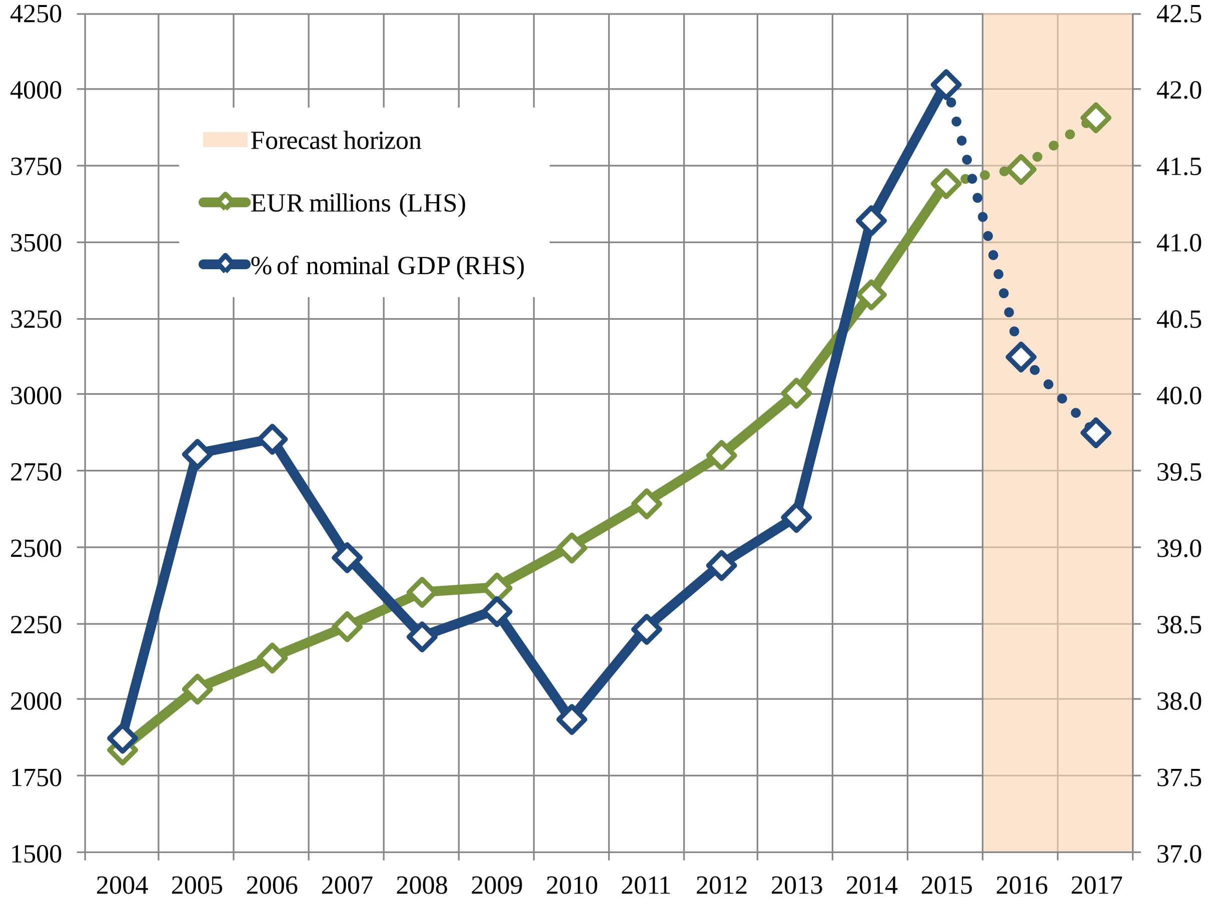
On the basis of the alternative scenarios considered and the techniques employed by MFIN, the MFAC notes that the range of estimates for the fiscal balance under the various scenarios varies by less than one percentage point, from close to 1.2% of GDP over 2016 – 2017 under the worst scenario to 0.4% and 0.3% of GDP under the most favourable scenario. It is however pertinent to note that these estimates only take into account the possible effect of the different macroeconomic scenarios being considered and not necessarily the full set of risks to the fiscal balance which may materialise under more stressful conditions or a broader coverage of hypothetical fiscal risks. The balance of risks is tilted towards the downside for both forecast years, since the distribution of results is skewed below the baseline forecast.

The MFAC considers the presentation of risks in a quantitative manner through the use of a fan chart as helpful. However, it would be beneficial that the fan chart is supplemented by technical details to enable a clearer public evaluation of the plausibility of such estimates, as well as to better identify the technical assumptions which could be impacting directly such results. The MFIN is also invited to explore whether the scenarios considered could be expanded to cover a fuller set of fiscal risks.

## 4. Assessment of the revenue projections for 2016 and 2017

Total revenue is expected to increase by €46.3 million or 1.3% in 2016 and by €169.5 million or 4.5% in 2017. These revenue increases extend the upward pattern observed over the past decade albeit with some moderation (see Chart 2). As a result, the revenue-to-GDP ratio, which in 2015 peaked at 42.0%, is expected to slide back to 40.3% in 2016. In 2017, this ratio is expected to decrease further, to 39.8%. Indeed, total revenue growth is projected to be slower than nominal GDP growth throughout the forecast horizon.

Chart 2: Total government revenue

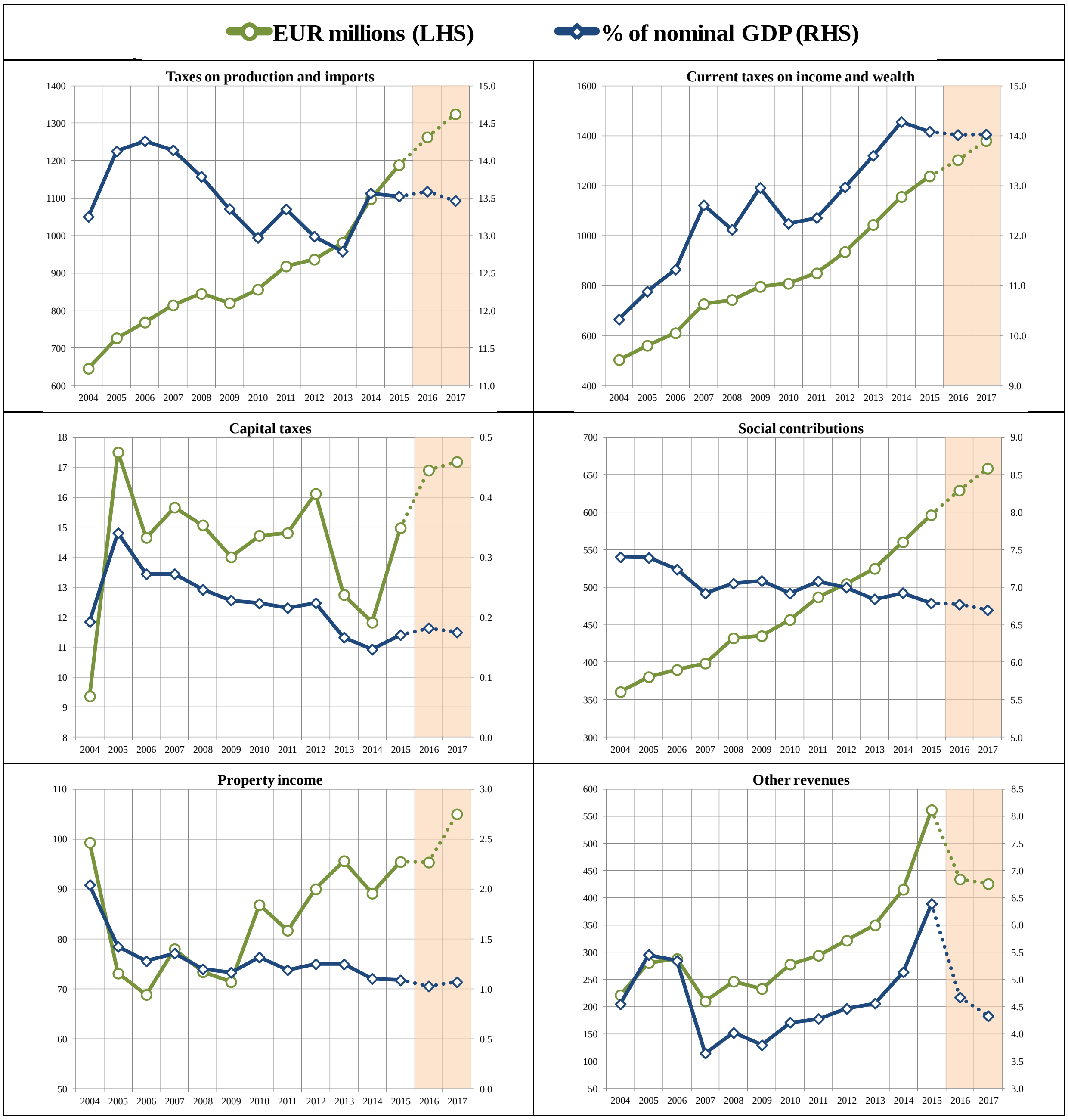



*Source: MFIN*

In order to evaluate the plausibility of the trajectory envisaged for total revenue, each main component is evaluated separately (see Chart 3).[9] The separate assessment of each revenue component separately permits a more robust analysis, since each component may be influenced by completely different factors. The MFAC's assessment is based on the fiscal assumptions underpinning the DBP 2017 ; figures for the Consolidated Fund for the first nine months of 2016; existing tax and expenditure laws; announced fiscal measures; information obtained from public sources; and supplementary information made available by the MFIN and the NSO through internal discussions and communications. The MFAC does not prepare its independent revenue forecasts but relies on expert judgment, based on historical trends and identified regular patterns in the actual fiscal data

[9] The ESA codes of the various revenue components and brief descriptions are reproduced from the ESA 2010 manual.

## Chart 3: Revenue components




*Source: MFIN*

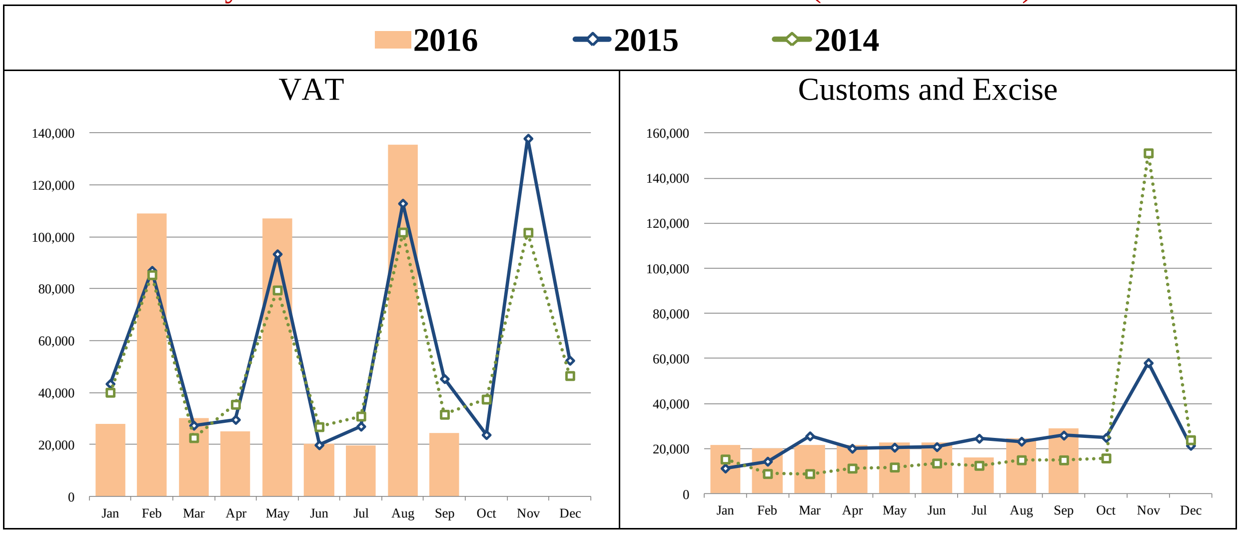
### 4.1. Taxes on production and imports (D.2)

*Definition:* *Compulsory, unrequited payments, in cash or in kind, which are levied by general government, or by the institutions of the European Union, in respect of the production and importation of goods and services, the employment of labour, the ownership or use of land, buildings or other assets used in production. Such taxes are payable irrespective of profits made.*[10]

Taxes on production and imports are expected to grow by €74.2 million or 6.2% in 2016 and by €61.7 million or 4.9% in 2017. Compared to the previous two years, lower growth is being projected, both in absolute as well as in percentage terms. Their share as a percentage of GDP is expected to remain stable around 13.5%.

Consolidated Fund data shows that, during the first nine months of 2016, Value Added Tax (VAT) and customs and excise duties, which are the two largest elements within taxes on production and imports, respectively increased by 2.7% and 7.2% year-on-year. VAT collection remained concentrated in specific months (see Chart 4). In 2016, VAT cash receipts were however influenced by different timings in relation to some refunds. On the other hand, the intake from customs and excise taxes was more regular.

Chart 4: Monthly revenue from VAT and customs and excise (EUR thousands)




*Source: NSO*

In 2016, the consumption base which is the single most important driver of indirect taxes, is expected to grow by just under 5% in nominal terms.[11] Overall, there appears to be no

[10] This revenue component is dominated by VAT (representing more than half of the total), with other important contributors being levies on petroleum; levies on cigarettes and tobacco; property taxes; gaming taxes; motor vehicle registration tax; duties on insurance products; taxes on spirits, alcohol and beverages; taxes on cement and the Eco-contribution. The list of contributors in this revenue component is in descending order based on 2015 data.

[11] Growth in real consumption is forecasted at 3.5% while the consumption deflator is expected to increase by 1.1% in 2016.

particular evidence to suggest that the projected growth rate in taxes on production and imports for 2016 is not achievable. Indeed for 2016, the projected ratio of taxes on production and imports to consumption is similar to that which resulted in 2015. Moreover, for the first half of the year, ESA data shows that the growth rate in taxes on production and imports stood at 6.2%, in line with the projected annual growth rate.

In 2017, new measures relating to taxes on production and imports with an estimated positive total net effect on the fiscal balance of €14.9 million (equivalent to 0.15% of GDP) are factored into the forecasts (see Table 3). Around two-thirds of the impact is of a permanent nature while the other third is of a temporary nature. Individually each measure has a very small impact, less than 0.1% of GDP.

Table 3: Budgetary impact of measures affecting taxes on production and imports in 2017

| **Measure*** | **EUR millions** |
|---|---|
| Excise duty on machine-made cigarettes and other tobacco products | 5.140 |
| Concessions on stamp duty for business inheritance** | 5.000 |
| Estimated increase in VAT from 2017 Budget measures | 1.609 |
| Excise duty on construction related material | 1.397 |
| Excise duty on toiletries and washing preparations | 1.200 |
| Financial support to first-time buyers** | -0.500 |
| Anti-abuse diesel measure | 0.420 |
| Excise duty on glass and ceramic tiles | 0.350 |
| Excise duty on garbage bags | 0.230 |
| Excise duty on non-alcoholic beverages | 0.200 |
| VAT reduction on domestic crafts | -0.170 |
| **Total net effect** | **14.876** |
| **of which: Permanent** | **10.376** |
| **of which: Temporary** | **4.500** |

* A positive sign indicates a positive impact on the fiscal balance while a negative sign indicates a negative impact

** Indicates temporary measure

*Source: MFIN*

It is expected that the increase in the excise duties on smoking and the reduction in the stamp duty in relation to business inheritance will generate around €5 million additional revenue in each case. The increase in excise duties on cigarettes and other tobacco products is respectively expected to increase the average prices by 3.8% and 5.5%. Assuming an annual consumption of around 24 million packets of 20 cigarettes each, the projected additional revenue intake appears plausible, subject to the caveat that any changes to smoking behaviours or increases in the size of the illicit cigarette market could pose downside risks to the estimate.[12]

Furthermore, the measure whereby the stamp duty relating to the transfer of shares in the case of family business will be reduced from 5% to 1.5%, is assumed to incentivise the transfer of shares to an extent that the overall revenue intake is estimated to increase, despite the lower tax rate. While in Malta family businesses play an important role in the economy, it is hard to pin down precisely the popularity of such a scheme. This poses risks which may be both downside as well as upside.

On balance, the MFAC takes note that the effects of the indirect tax measures for 2017 have been calculated on the basis of detailed information available to the various government departments and the MFAC is not aware of any factor which would contradict such estimates. After taking account of the net impact of the measures announced for the year, the implied elasticity with respect to the nominal consumption growth forecast appears reasonable. Hence, even in this case the MFAC considers that there are no specific risks to the attainment of the revenue target.[13]

Overall, the MFAC considers the projections for taxes on production and imports to be plausible for 2016 and 2017, with risks deemed to be neutral in both years.

### 4.2. Current taxes on income and wealth (D.5)

*Definition:* *Compulsory, unrequited payments levied periodically by general government on the income and wealth of institutional units*.[14]

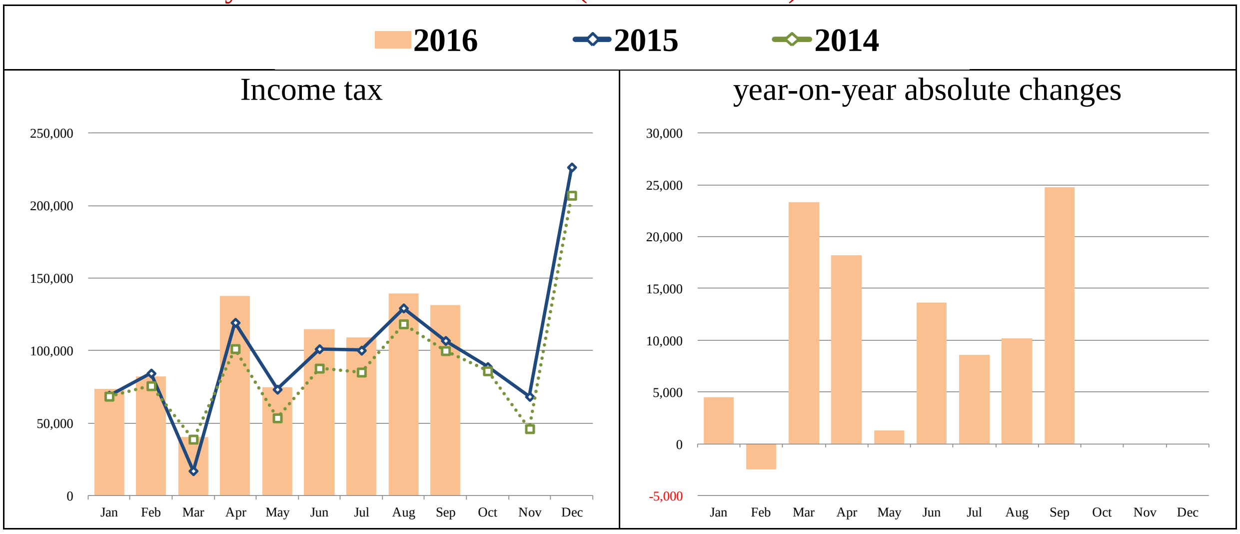
Current taxes on income and wealth are expected to grow by €64.9 million or 5.2% in 2016 and €76.9 million or 5.9% in 2017. Their share in GDP is projected to stabilise at the 2015 level, at around 14.0% of GDP. This pattern contrasts with that observed between 2011 and 2014 wherein this ratio to GDP was on an upward trend.

For 2016, the MFAC notes that this component may however be exposed to a number of upside risks. Indeed, the Consolidated Fund data for the first nine months of the year shows that revenues from income tax, which account for around 96% of this item, were up by €101.9 million or 12.7% year-on-year (see Chart 5). Significant increases were reported across different months. This view is further supported by the fact that ESA data for the first

[12] A study by KPMG LLP in the UK had estimated that the cigarette consumption in Malta stood around 0.48 billion cigarettes in Malta in 2014 (source: Project SUN available on https://home.kpmg.com/uk/en/home/insights/2015/05/project-sun-a-study-of-the-illicit-cigarette-market.html).
[13] In 2017 growth in real consumption is forecasted at 3.2% while the consumption deflator is forecast to increase by 1.2%.
[14] This revenue component is driven to a large extent by taxes on employment income, on interest income and on profits. Another relevant contributor to this revenue item is the annual car circulation tax.

half of 2016 shows that current taxes on income and wealth even grew at a faster pace, up by 14.4% on a year earlier.[15] This implies that the absolute increase recorded during the first six months exceeded the planned increase which was expected for the year as a whole.

Chart 5: Monthly revenue from income tax (EUR thousands)




*Source: NSO*

In 2016, the tax base is expected to be well supported as a result of higher employment income, consistent with the 3.3% forecast employment growth and 2.8% forecast growth in compensation per employee. The favourable impact on tax revenue growth is further supported by the progressivity of the income tax system in Malta.[16] Likewise, the forecast scenario characterised by expanding gross operating surplus should further support the expansion of the corporate tax base.[17,18]

In 2017, a limited amount of new measures, with an estimated total negative net effect on the fiscal balance of €3.65 million (equivalent to 0.04% of GDP) are factored into the forecasts (see Table 4). These relate primarily to an increase in the amount of non-taxable income for pensioners, as well as certain capped tax deductions for businesses, both of which are of a permanent nature.

[15] In a number of cases, as is the case with the compilation of current taxes on income and wealth, under ESA guidelines a time adjustment is made, which means that the year over which the Consolidated Fund data is cumulated is different from the calendar year. In the case of Malta this is specifically shifted by two months, that is, from March to February. This approach addresses the issue that the payment of taxes may spill over from one year to the next. This may give rise to further mismatches between Consolidated Fund and ESA developments.
[16] Since income tax rates rose with income, one percentage growth in income would lead to a larger percentage change in tax due. As result the effective elasticity with respect to the tax base is higher than one.
[17] Around half of current taxes on income and wealth is collected from companies with the other half from individuals.
[18] Gross operating surplus may be a rather imprecise proxy for the corporate tax base in Malta because of lack of synchronisation between the timing of tax payments and the generation of profits in any given year.

Table 4: Budgetary impact of measures affecting current taxes on income and wealth in 2017

| **Measure*** | **EUR millions** |
|---|---|
| Income tax rebate for pensioners | -3.500 |
| Capped tax incentive for businesses sponsoring local council projects | -0.150 |
| **Total net effect** | **-3.650** |
| **of which: Permanent** | **-3.650** |
| **of which: Temporary** | **NA** |

* A positive sign indicates a positive impact on the fiscal balance while a negative sign indicates a negative impact

*Source: MFIN*

In spite of the before-mentioned measures, the projected increase in employment income for 2017, consistent with the 2.7% forecast employment growth and the 2.8% forecast growth in compensation per employee, should again make the revenue target attainable. There is even the possibility of upside risk, should the potentially higher revenue intake in 2016 maintain a permanent upward base effect.

Furthermore, the positive outlook for consumption suggests that the intake from the car circulation tax (included within this revenue component) should maintain a positive upward momentum, both in 2016 and 2017, thereby supporting the revenue streams from this component.

The stability of the current taxes on income and wealth, in terms of the ratio to GDP appears to be a prudent forecast. Indeed, apart from 2015, this ratio was on a steady upward trend. Overall, the MFAC thus considers that the estimates for current taxes on income and wealth could have some upside risks both for 2016 and also for 2017.

### 4.3. Capital taxes (D.91)

<u>*Definition:*</u> *Taxes levied at irregular and very infrequent intervals on the values of the assets or net worth owned by institutional units or on the values of assets transferred between institutional units as a result of legacies, gifts between persons, or other transfers.*[19]

Historically the revenue intake from this source has been low and fluctuated along a narrow range, averaging around €14 million between 2004 and 2015. The forecasts assume an intake slightly above the 2015 level. No specific measures impacted this revenue component in 2016 and none are specified for 2017. The marginal anticipated increases of €1.9 million in 2016 and €0.3 million in 2017 are compatible with the current buoyant property market conditions.

[19] This revenue component consists mainly of taxes imposed on certain property transfers.

Owing to the fact that this revenue source accounts for only 0.4% of the total revenue throughout the forecast horizon, and in view of its observed historical stability, the MFAC does not identify particular upside or downside risks stemming from this revenue component both for 2016 and for 2017.

### 4.4. Social contributions (D.61)

*Definition:* *The actual or imputed contributions made by households to social insurance schemes to make provision for social benefits to be paid.*[20]

In 2016 and 2017 social contributions are expected to grow respectively by 5.5% and 4.7%. In both years, the planned growth in social contributions is slightly below the forecast growth in total compensation of employees, which is respectively estimated slightly above 6% and 5% in 2016 and 2017.

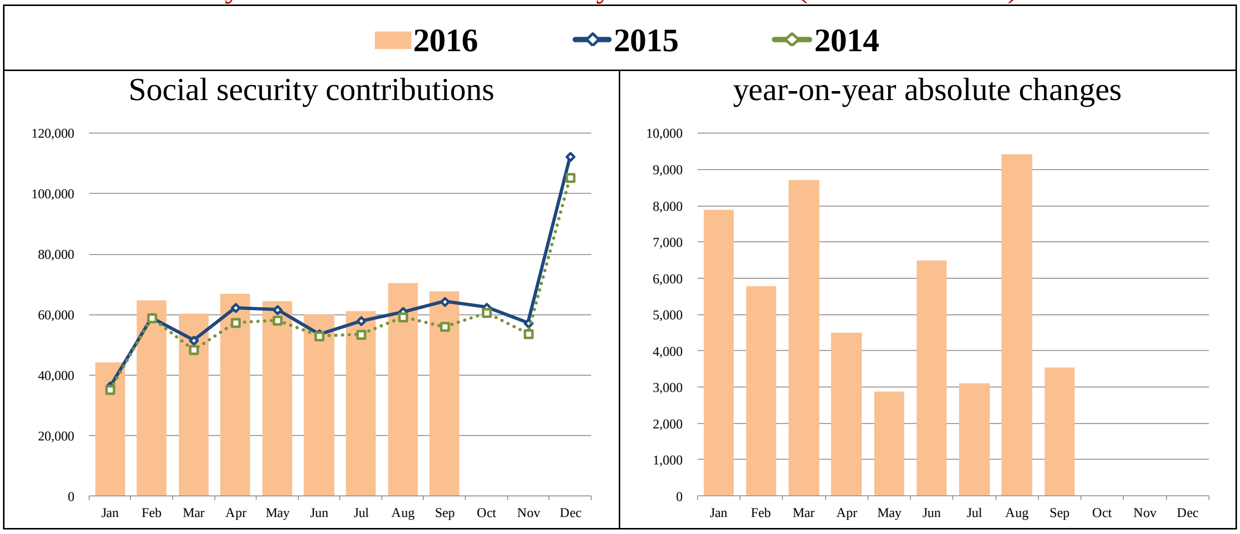
Owing to the fact that social contributions are capped above a certain level of income, the elasticity is necessarily less than unitary. The implied elasticities adopted by the MFIN, are deemed to be realistic by the MFAC. The forecast trajectory for the ratio of social contributions to GDP ratio, characterised by a further marginal decline, is consistent with the previous years' turnout. This fall is due to the fact that nominal GDP is growing at a faster pace than social contributions. The forecast pattern thus appears to be plausible also since the latest DBP contains no specific new measure impacting this revenue component.

During the first nine months of the year, revenue from social security contributions, as recorded in the Consolidated Fund, were up by 10.3%, confirming the positive outlook for this revenue item. Higher revenues were recorded in each month (see Chart 6).

ESA data also shows that during the first half of 2016 social contributions increased by 9.9% year-on-year. As a result, the required implied growth rate for the second half of the year to achieve the target annual growth is only 1.6%. During the first six months of the year 48.9% of revenues were collected, compared to 47.0% in 2015. Overall, the MFAC considers that the forecasts for social contributions could have possible upside risks for 2016, which could also apply to 2017, should the base effect persist.

[20] This revenue component captures the national insurance contributions paid by employees, their employers and the self-employed.

Chart 6: Monthly revenue from social security contributions (EUR thousands)




*Source: NSO*

## 4.5. Property income (D.4)

*<u>Definition:</u> Accrues when the owners of financial assets and natural resources put them at the disposal of other institutional units. The income payable for the use of financial assets is called investment income, while that payable for the use of a natural resource is called rent. Property income is the sum of investment income and rent.*[21]

This revenue item represented only 2.6% of total government revenue in 2015. In 2016, the estimated revenue from property income is expected to remain practically unchanged compared to 2015, at €95.3 million. On the other hand, property income is estimated to increase to €105.0 million in 2017, higher than any other year since Malta joined the EU. The increase is predominantly ascribed to higher dividends expected to be received from the MFSA and from Identity Malta Agency (see Table 5). On the other hand, the expected dividends from the CBM (the largest component) are forecast to remain unchanged.

The MFAC considers the 2016 estimate to be plausible as it is in line with the recent expected developments for this component. On the other hand, there may be some downside risks for the 2017 estimate since there are no identifiable factors to justify the significantly higher dividends anticipated from the MFSA.

[21] Property income represents mainly the dividends received in particular from the CBM, and to a lesser extent the companies listed on the Malta Stock Exchange (MSE) and the Malta Financial Services Authority (MFSA), together with rent earned from government properties and interest earned on holdings of bonds and other loans.

Table 5: Revenues from different entities

| | 2015<br>Actual | 2016<br>Approved Estimate | 2017<br>Approved Estimate |
|---|---|---|---|
| | | EUR millions | |
| Central Bank of Malta | 48.0 | 50.0 | 50.0 |
| Malta Financial Services Authority | 7.0 | 8.0 | 14.0 |
| Identity Malta Agency | 10.4 | 12.5 | 15.5 |
| Dividends from public limited companies | 13.0 | 13.5 | 13.2 |

*Source: MFIN*

### 4.6. Other revenues

*Definition:* *Other revenues not elsewhere classified.*[22]

Compared to 2015, other revenues are projected to decline from €561.6 million to €434.0 million in 2016, and drop by a further €8.4 million in 2017 (see Table 6). As a result, their share in GDP is expected to slide back from the 6.4% peak recorded in 2015 to 4.7% in 2016 and 4.3% in 2017.

Table 6: Other revenues

| | 2015 | 2016 | 2017 |
|---|---|---|---|
| | | EUR millions | |
| **Other revenues** | **561.6** | **434.0** | **425.6** |
| Of which | | | |
| Individual Investor Programme | 50.2 | 133.0 | 100.0 |
| European Union funds | 253.1 | 99.4 | 114.9 |

*Source: MFIN*

In 2016, market output is expected to yield an additional €76.5 million on a year earlier, while in 2017 it is projected to decline by €24.9 million. This volatility mirrors the fluctuations in the anticipated revenues from the IIP.[23] In 2015, revenues from the IIP amounted to €50.2 million, and according to the latest DBP, the annual intake from the IIP is expected to amount to €133 million in 2016. In 2017, IIP revenue estimates are more

[22] This budget item represents residual revenue components, mainly accounted for by market output and capital transfers. Market output consists primarily of revenues derived from permits and charges for the services offered by the public sector, and also of the revenues accruing from the Individual Investor Programme (IIP). Capital transfers receivable relate mainly to the absorption of EU funds.

[23] Although in the Consolidated Fund only 30% of the revenues of the IIP are included, and the other 70% are recorded as a below-the-line transaction, for ESA purposes the full receipts from the IIP is treated as revenue.

conservative, at €100 million. Revenues collected through the IIP during the first nine months of 2016 amounted to 73% of the target. As a result, achieving the annual IIP target for 2016 appears to be feasible. With regard to 2017, the more conservative IIP estimate is judged to be prudent.

The 2016 decline in the 'other revenue' category is attributable to the assumption of lower absorption of EU funds, when compared to 2015. Indeed, the intake of EU funds during 2015 was exceptionally high, at €253.1 million (equivalent to 2.9% of GDP) as that year represented the final take up of funds, before the expiry of the programmes pertaining to the EU's Multiannual Financial Framework (MFF) 2007 – 2013. As is normal, the take up of funds at the start of a new EU's MFF period, covering 2014 to 2020, is expected to be low and accordingly is assumed to amount to €99.4 million or 1.1% of GDP. In 2017 it is expected to pick up slightly, to 1.2% of GDP. The approximate increase of €15.5 million in EU funds between 2016 and 2017 appears to be plausible.

The six monthly ESA developments show a decline in other revenues. The targets for the year allow for further declines during the second half of the year. The risks to 'other revenues' are mainly related to the expected intake of EU funds. For 2016, downside risks exist to the 'other revenues' category. Given the uncertainty surrounding the actualization of the forecasted spending on gross fixed capital formation, this could result in lower absorption of EU funds.[24,25] Risks to 'other revenues' are considered to be broadly neutral for 2017, on the assumption that possible shortfalls (compared to the targets) in gross fixed capital formation are not repeated in that year. Uncertainty however remains rather elevated, particularly in view of the historic volatility in 'other revenues'.

### 4.7. Total government revenue

Assuming that any revisions to the published ESA fiscal data for 2015 and 2016 are minimal, the plausibility of the annual target for 2016 can be further assessed on the extent to which the planned revenue intake during the second half of the year is similar or differs from what was recorded during the first half, paying due consideration to any identifiable and known seasonal and special factors. On this basis, the MFAC highlights that revenues from current taxes on income and wealth and from social contributions have progressed significantly during the first half of the year, thereby justifying the upside risks identified earlier (see Table 7). Indeed, the year-on-year change reported in the first half of 2016 already covered all the target increase for the full year in the case of current taxes on income and wealth and covered around 84.2% in the case of social contributions. The MFAC is not aware of any special factors which should have inflated the performance during the first half of the year on an ESA basis, thereby reinforcing the earlier analysis that there could be upside risks to both revenue categories for 2016.

[24] Refer to section 5.6 for the assessment of the forecast for gross fixed capital formation.
[25] The impact on the fiscal balance could actually be positive because any shortfall in the utilisation of EU funds would create savings on the co-financing element by the Government.

Table 7: Actual and projected revenue performance for 2016 compared to 2015

| | Year-on-year | | | | | |
|---|---|---|---|---|---|---|
| | **H1** | | **H2** | | **Total** | |
| | *Change* | *Growth* | *Change* | *Growth* | *Change* | *Growth* |
| | € m | % | € m | % | € m | % |
| Taxes on production and imports | 33.0 | 6.2 | 41.2 | 6.3 | 74.2 | 6.2 |
| Current taxes on income and wealth | 81.9 | 14.4 | -16.9 | -2.5 | 64.9 | 5.2 |
| Social contributions | 27.7 | 9.9 | 5.2 | 1.6 | 32.9 | 5.5 |
| Property income | -2.0 | -3.7 | 1.9 | 4.6 | -0.0 | -0.1 |
| Capital taxes | -0.5 | -7.4 | 2.5 | 16.4 | 1.9 | 12.8 |
| Other revenues | -50.5 | -24.3 | -77.2 | -21.8 | -127.6 | -22.7 |
| **Total revenue** | **89.6** | **5.4** | **-43.4** | **-2.1** | **46.2** | **1.3** |

*Source: MFIN, NSO*

In the case of 'other revenues', the anticipated annual drop materialised in the first half of 2016 and there is the possibility that the drop during the second half of the year could be larger than expected. On the other hand, progress in taxes on production and imports appears to be in line with the achievement of the target. With regard to revenues from property income and capital taxes, the planned changes are small and no particular risks have been identified. The balance of risks concerning these two revenue components appears to be neutral. In turn, no material downside risks to revenue forecasts have been identified for 2016.

With regard to 2017, the same upside risks exist, mainly in view of the possible base effect created by the superior revenue turnout during 2016. These are however partly dampened through a possible downside risk to revenue from property income. On balance, however, there remains an upside risk to total revenue also for 2017.

Overall, the MFAC considers that the projection for total government revenue for 2016 and 2017 to be within its endorseable range, with on balance possible upside risks for total revenue (see Table 8).

Table 8: Summary of risks to the revenue projections

| | 2016 | 2017 |
|---|---|---|
| Taxes on production and imports | ⇔ | ⇔ |
| Current taxes on income and wealth | ⇑ | ⇑ |
| Capital taxes | ⇔ | ⇔ |
| Social contributions | ⇑ | ⇑ |
| Property income | ⇔ | ⇓ |
| Other revenues | ⇓ | ⇔ |
| Total revenue | ⇑ | ⇑ |

Note: ⇔ indicates neutral risks, ⇑ indicates upside risks and ⇓ indicates downside risks. All risks are assessed with respect to the specific revenue component and based on the information made available to the MFAC by the cut-off date.
*Source: MFAC*

## 5. Assessment of the expenditure projections for 2016 and 2017

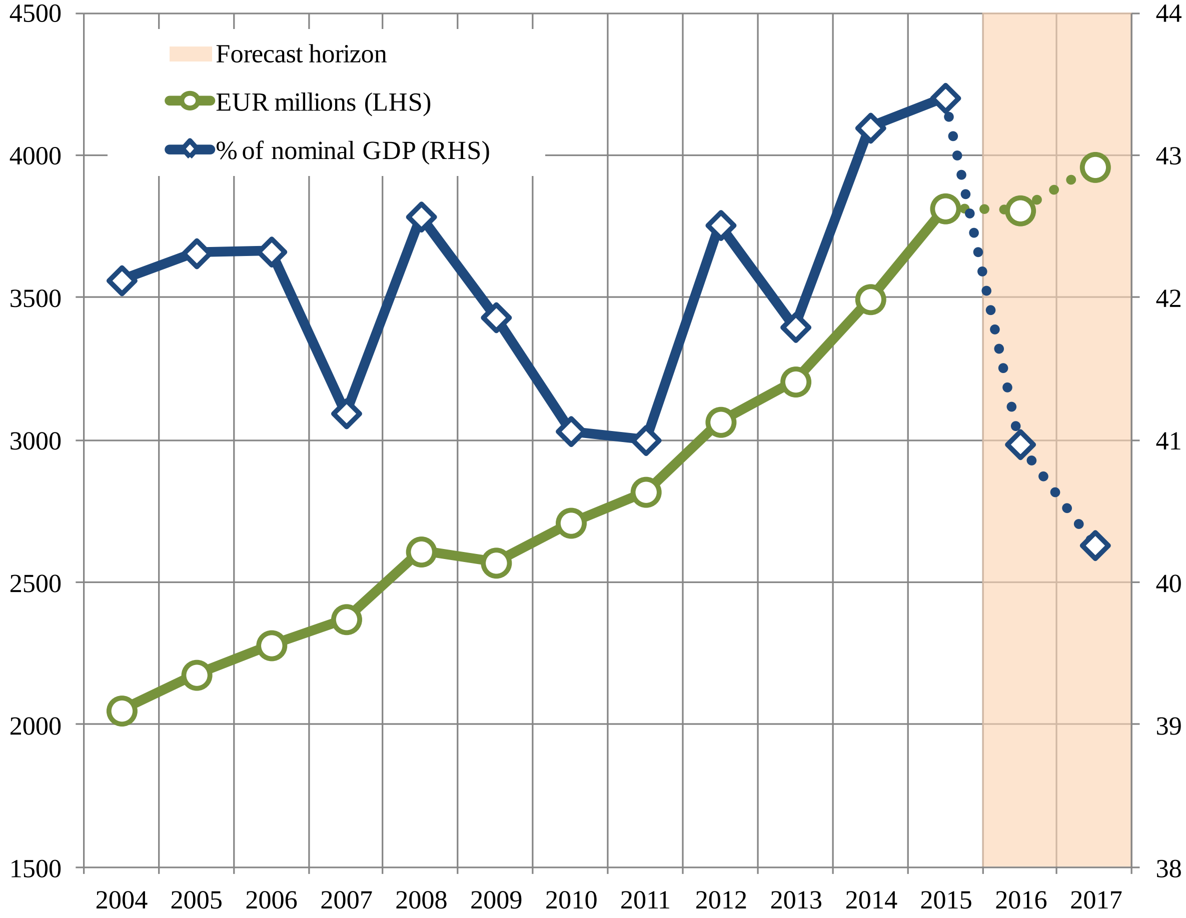
The projections included in the latest DBP show that total expenditure is expected to drop marginally by €7.0 million in 2016, to slightly above €3.8 billion (see Chart 7). This development contrasts with the increases noted over the past decade.[26] Expenditure is subsequently expected to rise by €152.5 million in 2017, which is nonetheless still lower than the increases which were recorded over 2014 and 2015.

The DBP shows that the expenditure-to-GDP ratio is projected to decline significantly over the forecast horizon. This is particularly evident when compared to 2014 and 2015 when this ratio was above those recorded in previous years partly as a result of elevated spending on capital projects financed from EU funds.

Should the expenditure projections materialise, the total government expenditure-to-GDP ratio would fall from 43.4% in 2015 to 41.0% in 2016 and to 40.3% in 2017. In both cases these ratios are lower than recorded over the past decade. The scaling back of a number of expenditure components, when expressed as percentage of GDP, relies on restraining expenditure growth below that in nominal GDP, which is projected to expand by 5.7% in 2016 and 5.8% in 2017.

[26] Over the past decade, 2009 was the only other year when total expenditure had declined.

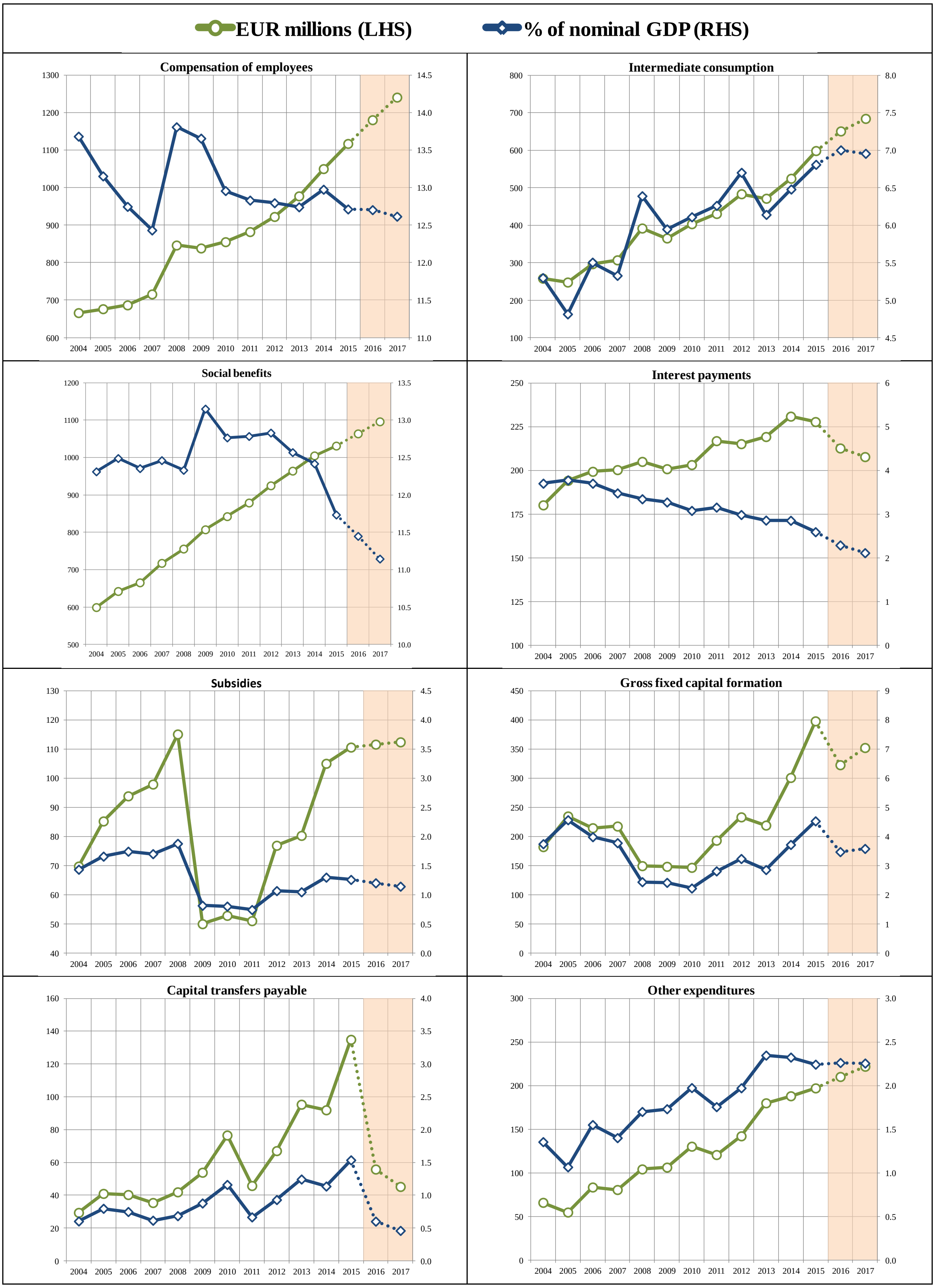
Chart 7: Total government expenditure




*Source: MFIN*

The attainment of these expenditure targets is conditional on restraint and scaling back across main expenditure categories (see Chart 8). The assessment of general government expenditure projections for 2016 and 2017 is carried out in a disaggregated manner, adopting the same approach used in the case of revenues.

## Chart 8: Expenditure components




*Source: MFIN*

### 5.1. Compensation of employees (D.1)

<u>Definition:</u> *The total remuneration, in cash or in kind, payable by an employer to an employee in return for work done by the latter during an accounting period.*[27]

The drivers for spending on compensation of employees are the number of public sector employees and their average wage. Public sector employment is influenced by the number of employees who retire, or resign from the public sector, and the number of new recruits. In turn, the average wage depends on the collective agreements in place, the level of seniority, bonuses, over-time pay and other allowances. Changing employment composition, particularly more qualified staff, can also exert an impact on the average wage paid in the public sector.

The plausibility of the forecasts for compensation of employees depends on the extent to which employment and salaries within the public sector are maintained consistent with the budgeted amounts. To some extent this is facilitated through directives, and in particular Directive number 10 issued by the Office of the Principal Permanent Secretary, which require that recruitment by ministries can only be made as long as the wage bill is covered by the allocated funds.[28] Hence, under this framework, the expenditure cap applies to outlays on salaries rather than in terms of employment.

The latest DBP indicates that growth in compensation of employees should reach 5.7% in 2016 while in 2017 this should decelerate slightly, to 5.1%. These growth rates are below the 6.6% average annual growth recorded during the period 2013 – 2015. In absolute terms, the increases in compensation of employees were established at €63.3 million for 2016 and €60.3 million for 2017, compared to the €70 million average increases recorded during the previous two years. As a result, the ratio for compensation of employees as percentage of GDP is planned to remain stable at 12.7% in 2016 and fall marginally to 12.6% in 2017.

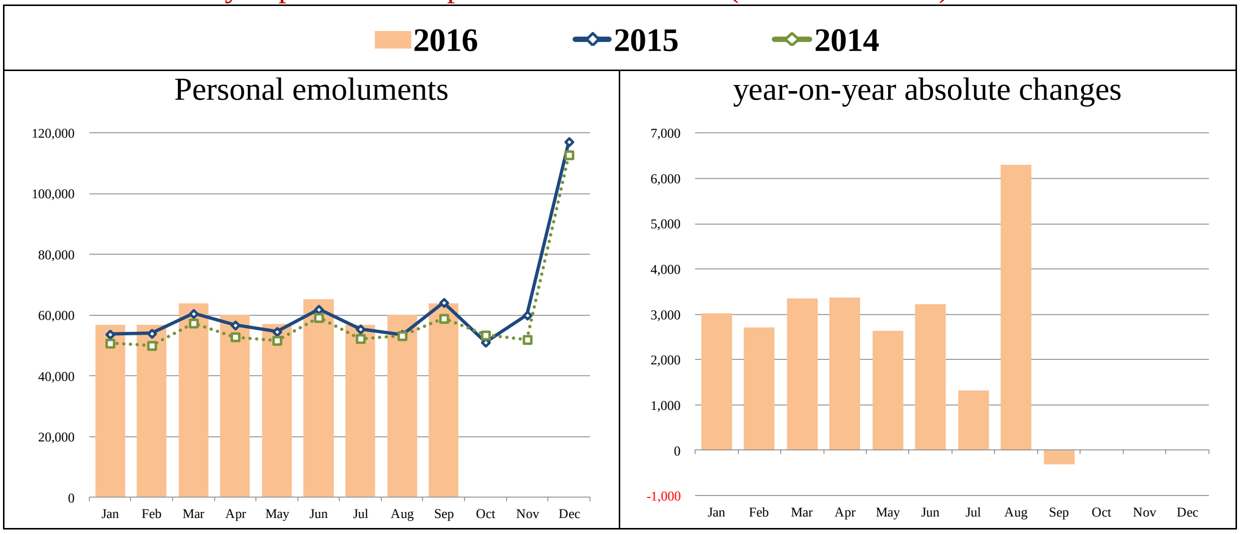
Specifically, the latest USP had indicated that some €4.1 million saving would be achieved in 2016 through restrictions on employment growth and cuts on overtime payment as communicated to each respective government department.[29] This intention was restated in the 2017 DBP. However no further details were provided to identify clearly the areas where such savings could be achieved.

The latest available NSO data on the gainfully occupied population indicates that full-time employment within the public sector increased by 309 employees in April 2016 compared to

[27] This budget item consists of the wages and salaries of civil servants, and employees in local councils and government entities. These include Extra Budgetary Units (EBUs) that are funded fully or in large part by subventions from the Government and are therefore classified within the general government sector for ESA purposes.
[28] Directive number 10, entitled “The submission and approval of business and HR plans” is available on https://www.gov.mt/en/Government/Press%20Releases/Documents/pr152813a.pdf .
[29] This measure had not been anticipated in the DBP for 2016.

a year earlier.[30] Given the delay in the publication of labour statistics, it is not possible to verify the extent to which employment growth is indeed being restricted. At the same time, expenditure on 'personal emoluments' in the Consolidated Fund, which captures approximately two-thirds of the overall category, shows that during the first nine months of 2016, this expenditure item increased by an average of €2.8 million per month, registering a 5.0% rise compared to the same period in 2015 (see Chart 9). In turn, ESA data shows that compensation of employees expanded by €32.6 million during the first half of the year, growing by 5.9% year-on-year. This implies that the increase during the second half of 2016 must be restrained to €30.6 million or 5.5% in order to satisfy the annual expenditure target.

Chart 9: Monthly expenditure on personal emoluments (EUR thousands)




*Source: NSO*

While the available information suggests that the 2016 target remains feasible, this is clearly contingent on the successful achievement of the before-mentioned €4.1 million cost savings. Thus the MFAC considers that in view of the lack of information on these specific measures there exist upside risks to this forecast for 2016. Such risks spill over into the 2017 forecasts, particularly since in 2017 Malta will be assuming the EU Presidency, and hence restraint on employment and salaries may be more challenging. Further uncertainty relates to the fact that the civil service collective agreement expires in 2016 and this could exert further upside risks depending on the eventual wage increases that are negotiated.

### 5.2. Intermediate consumption (P.2)

| |
|---|
| Definition: *Goods and services consumed as inputs by a process of production, excluding fixed assets whose consumption is recorded as consumption of fixed capital. The goods and services are either transformed or used up by the production process.*[31] |

[30] Source: NSO News Release 159/2016

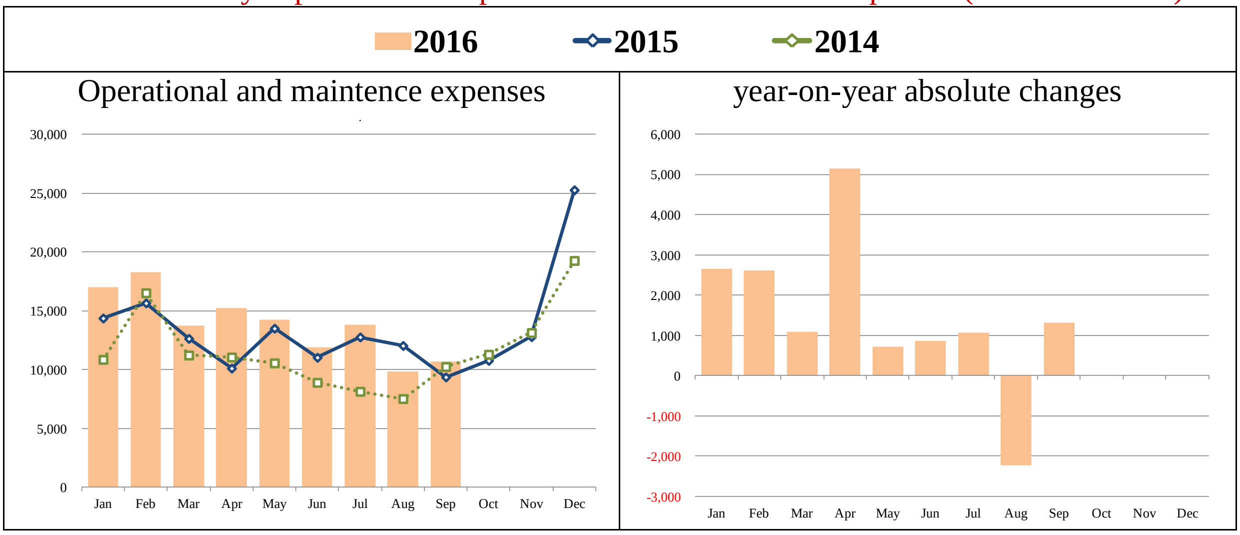
[31] Intermediate consumption consists of a vast array of expenditures incurred as part of the activities carried out by the Government. A significant proportion is associated with the health sector, and includes other special

Spending on intermediate consumption is expected to increase by €52.3 million or 8.7% in 2016 and by €33.5 million or 5.1% in 2017. As a result, its share in nominal GDP is expected to rise slightly from 6.8% in 2015 to around 7.0% in 2016 and 2017. Owing to the heterogeneity of the various components forming part of intermediate consumption and the rather frequent occurrence of one-off and special factors, this item's trajectory has been rather volatile historically.

Specifically in 2016, €16.0 million has been budgeted for the 2017 EU Presidency. Its impact is marginally dampened through permanent expenditure consolidation measures amounting to €1.6 million. Further expenditure declines are attributable to the non-repetition of two summit meetings which were held in Malta in 2015. With regard to 2017, €26.3 million was budgeted for the EU Presidency. Additional outlays, amounting to €3.5 million annually, have been factored in the projections in order to set up and manage the Tourism Environmental Trust.

Consolidated Fund data shows that during the first nine months of 2016, spending on operational and maintenance expenditure (which is one of the components of intermediate consumption) has increased by 11.9% year on year (see Chart 10). In turn, ESA data shows that during the first half of the year spending on intermediate consumption increased by 9.6% year-on-year. Hence, in order to keep the annual spending within the budget, expenditure growth on intermediate consumption during the second half of the year should follow a more restrained path, and grow by 8.1%.

Chart 10: Monthly expenditure on operational and maintenance expenses (EUR thousands)




*Source: NSO*

The MFAC acknowledges that micro data available at the MFIN and the commitment towards the announced fiscal targets can justify some restraint. Indeed, owing to the special

expenditures such as the initiative of free child care, the organisation of international summits and other similar initiatives, and payments in relation to the provision of public services (such as lighting, transport and water services). This item also captures the activities of the Environmental Landscapes Consortium Ltd and Engineering Resources Ltd, which have assumed some of the employees previously employed in the ship repair and energy sectors, following the restructuring which has been undertaken in these sectors.

nature of intermediate consumption, in general, the Government may have more leeway to adjust this expenditure item, albeit, in either direction. Furthermore, some payments may be of a contractual nature and hence fixed for a certain period of time, allowing for stability over time. However, upward pressures from health-related expenditures tend to persist, particularly because of ageing and demand for more and better services. Spending on free child care could also increase if the take up rises further. At the same time, the eventual renegotiation of existing contracts of service in various fields may entail some upward financial adjustments, particularly in the eventuality that costs of production would have increased.

The fact that the DBP 2017 allows for an increase in expenditure over the forecast horizon, both in absolute terms as well as when expressed as percentage of GDP is considered prudent. Indeed, growth in nominal GDP is considered as a useful benchmark against which the plausibility of highly volatile components can be assessed. However, the MFAC notes that should the absolute spending on the EU Presidency exceed the allocated amount this could pose a risk that the final spending could turn out higher than expected. On this basis the MFAC considers the risks to spending on intermediate consumption for 2016 to be neutral but upside for 2017.

### 5.3. Social benefits and social transfers in kind (D.62, D.632)

*Definition:* *Benefits payable in cash to households by social security funds and other benefits payable by employers in the context of other employment related social insurance schemes. In kind benefits refer to individual goods and services provided for free or at prices that are not economically significant to individual households by government units and Non-Profit Institutions Serving Households (NPISH), whether purchased on the market or produced as non-market output by government units or NPISHs. They are financed out of taxation, other government income or social security contributions, or out of donations and property income in the case of NPISHs.*[32]

This expenditure category peaked at 13.2% of GDP in 2009 but since then, this ratio has embarked on a downward trend. The projections assume that the same pattern of below GDP growth will persist in 2016 and 2017. Consequently, the ratio is projected to fall from 11.7% in 2015 to 11.4% in 2016 and 11.1% in 2017. If such projections materialise, this ratio would be at its lowest over the past decade.

The fall in the ratio of social payments to GDP primarily reflects the low inflationary environment, which translates into a low cost of living adjustment relative to nominal GDP

[32] This budget item consists of the various welfare programmes, both contributory and non-contributory, such as pensions, children allowances, social assistance and stipends. The direct provision of pharmaceutical products accounts for the bulk of social transfers in kind, with another element consisting of the provision of free school transport.

growth. Initiatives aimed to shift people into employment have also contributed to such declines. These factors are partly offset by the expansion of social payments through an increase in the number of recipients for particular benefits and increases in certain benefits beyond the cost of living adjustment.

The DBP projects that in 2016 social benefits will increase by €32.7 million or 3.2%. One notes that, during the first six months social benefits increased by 5.0% on an ESA basis, with €25.6 million more being spent. Meeting the 2016 target thus requires that expenditure growth on social payments be contained to €7.1 million or 1.4% during the second half of the year. On this basis there could be some upside risks to the forecast for social payments for 2016 particularly when considering the significant second half slowdown embedded into the forecasts. However, such risks are somewhat balanced by the fact that the Consolidated Fund indicates that during the first nine months of 2016, the increase in social security benefits (which represents the bulk of social payments) amounted to €20.5 million or 3.2%.[33] Contributory benefits expanded by €31.1 million but non-contributory benefits declined by €10.6 million. Hence, on balance, the MFAC considers the risks to the forecast for social payments for 2016 to be neutral.

With regard to 2017, social payments are projected to rise by €32.3 million or 3.0% in 2017. In absolute terms the increase is practically identical to that projected for 2016. This notwithstanding that the DBP specifies a series of new permanent measures which in 2017 should boost social payments by €13.0 million (see Table 9).

Each social welfare measure is small and at an individual level all amount to less than 0.1% of nominal GDP. The MFAC notes that the respective estimates are judged to be plausible as these were based on micro data available at departmental level. Given the additional spending on welfare programmes, the MFAC understands that these are likely to be partly offset by some reductions in non-contributory benefits, in line with the government's announced initiatives in this area. However, when considering that the additional spending on social payments for 2017 is estimated at €13.0 million, there still remains an element of upside risk to the forecast for social payments for 2017.

[33] Source: NSO News Release 179/2016.

Table 9: Budgetary impact of measures affecting social payments in 2017

| Measures* | EUR millions |
|---|---|
| Supplementary allowance | -3.230 |
| Rent subsidy | -2.300 |
| Service pension | -1.400 |
| Extended in-work benefit scheme | -1.000 |
| Social fund for students in difficulty | -1.000 |
| Disability allowance | -1.000 |
| Tal-linja card to 18 year olds | -0.900 |
| Compensation for non-beneficiaries of the National Minimum Pension | -0.600 |
| Married National Minimum Pension | -0.500 |
| Increase in carers allowance | -0.400 |
| Gender equality pension increases | -0.300 |
| Free child care centres | -0.300 |
| Single means test | -0.100 |
| **Total net effect** | **-13.030** |
| **of which: Permanent** | **-13.030** |
| **of which: Temporary** | **NA** |

* A positive sign indicates a positive impact on the fiscal balance while a negative sign indicates a negative impact

*Source: MFIN*

### 5.4. Interest expenditure (D.41)

*Definition: Property income receivable by the owners of a financial asset for putting it at the disposal of another institutional unit.*[34]

In 2016 interest payments are expected to be €15.1 million less than in 2015 and they are projected to drop by a further €4.9 million in 2017. As a result, the trajectory for the interest payments to GDP ratio is expected to prolong its downward trend, declining from 2.6% in 2015 to 2.3% in 2016 and 2.1% in 2017.

The projections for interest payments are contingent on the anticipated outstanding level of public debt and the effective interest rate paid. In particular, the outstanding level of debt is expected to rise by €262.1 million in 2016 and by a further €209.0 million in 2017. These increases create an upward push on interest payments. On the other hand, the effective interest rate on public debt is assumed to drop from around 4.2% in 2015 to 3.8% in 2016 and 3.5% in 2017, creating offsetting downward pressures.

[34] This budget item consists of the interest payments made on public debt.

The projected annual drops in interest payments thus reflect the stronger savings effect as a result of the issuance of debt carrying lower coupon rates than maturing debt. Further gains are achieved from Treasury bills as a result of the negative interest rates which were realised during 2016. The assumed low interest rate scenario is consistent with the high levels of domestic liquidity and the attractiveness of such instruments, as well as the anticipation of a prolonged low interest rate scenario across the euro area.

In 2016, €417.8 million worth of Malta Government Stock (MGS) matured, while in 2017 another €346.8 million will be maturing. Debt maturing in 2016 carried a weighted average coupon rate of 4.9% while debt maturing in 2017 carries a coupon rate of 4.2%. Since the MGS which were issued during 2016 carried lower coupon rates and were also issued at a premium, the assumed reduction in the effective interest rate is fully supported.[35]

ESA data shows that in the first half of the year €4.7 million savings were achieved. The bulk of the roll-over saving projected for 2016 is thus anticipated for the second half of the year. This appears to be plausible. On balance, the projection of lower interest payments contained in the DBP thus appears to be plausible both for 2016 and for 2017. The MFAC considers that the debt management strategy employed by the Treasury can reasonably attain the specified targets for interest payments, and thus maintain neutral risks to these projections.

### 5.5. Subsidies (D.3)

*Definition: Current unrequited payments which general government or the institutions of the European Union make to resident producers.*[36]

This item is expected to remain practically stable over the forecast horizon, rising by merely €1.0 million in 2016 and €0.8 million in 2017. As a result, the ratio of subsidies to GDP is expected to decline slightly from 1.3% in 2015 to 1.2% in 2016 and 1.1% in 2017. Some of these subsidies represent contractual agreements, in the form of public service obligations (PSOs), and hence they can be projected with a degree of certainty by the MFIN. Upward risks would however exist when such agreements expire and are renegotiated or else if new subsidy initiatives are undertaken. The latter possibility is however constrained by the requirement to be in conformity with the EU's State Aid Rules.

The latest DBP revised slightly upwards the planned subsidies, up from €109.4 million to €111.6 million (see Table 10). Since ESA data shows that during the first half of 2016 subsidies were €1.3 million higher than in 2015, during the second half of the year these are required to be €0.3 million lower, to ensure that the target is met. At the same time, the planned subsidies for 2017 have been reduced by €3.7 million compared to what had been

[35] According to ESA methodology the premium is spread over the entire lifetime of the bond.
[36] This budget item consists mainly of the subsidies paid to the transport, energy and agricultural sectors.

indicated in the USP, mainly in connection with the revision for the allocations for Feed-in-Tariff and Eco Reduction. While acknowledging that the amount of subsidies is reasonably within the control of the Government, the MFAC considers that on balance, there may be upside risks both for 2016 and for 2017.

Table 10: Subsidies

| | USP | DBP | Change |
|---|---|---|---|
| | | EUR millions | |
| 2015 | 110.6 | 110.6 | 0.0 |
| 2016 | 109.4 | 111.6 | 2.2 |
| 2017 | 116.1 | 112.4 | -3.7 |

*Source: MFIN*

### 5.6. Gross fixed capital formation (P.51)

*Definition: Resident producers' acquisitions, less disposals, of fixed assets during a given period plus certain additions to the value of non-produced assets realised by the productive activity of producer or institutional units. Fixed assets are produced assets used in production for more than one year.*[37]

In 2015, gross fixed capital formation spiked to €397.7 million. This followed strong investment, which was largely financed through EU funds. According to the projections, in 2016 investment spending is expected to drop by 18.9% or €75.2 million but still remain higher in absolute terms when compared to 2014. It is expected to rise again in 2017, by 9.2% or €29.5 million. Consequently, the public investment ratio to GDP is expected to fall from 4.5% in 2015 to 3.5% in 2016 and rise marginally to 3.6% in 2017.

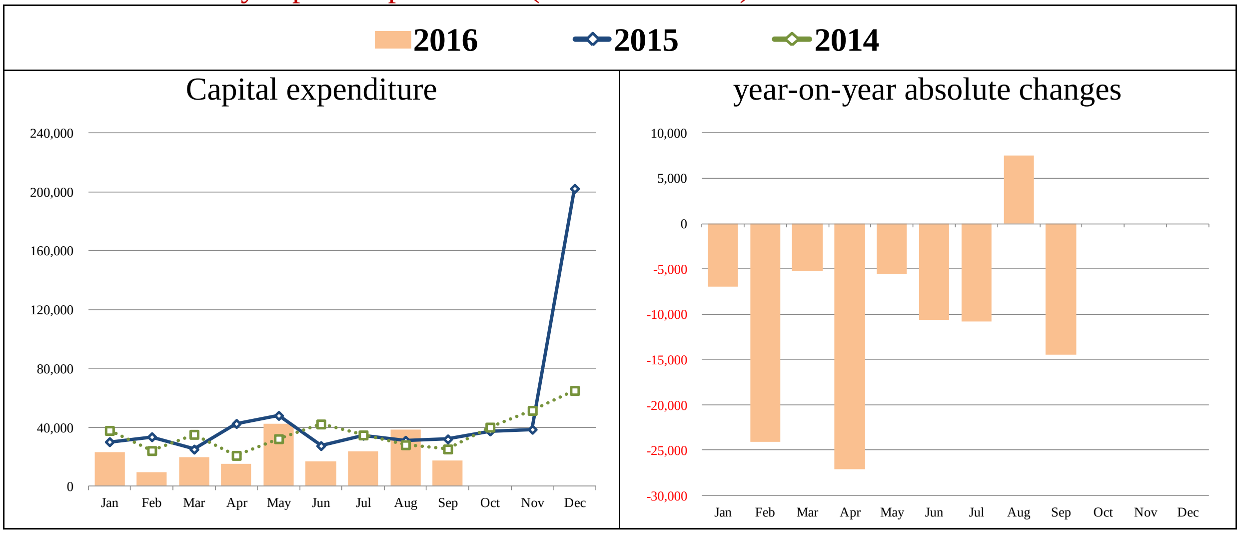
Although the anticipated trajectory for gross fixed capital formation is rather elevated in absolute terms compared to the past decade, it is nonetheless in line with the levels recorded in recent years. This assumes that the absorption of funds out of the EU's Multiannual Financial Framework (MFF) 2014 – 2020 follows a more even path compared to what was the case for the previous seven-year EU's Financial Framework. While the planned take up of EU funds is possible, there remains the possibility that the actual progress in such projects could be slower than planned.

Indeed, ESA data shows that during the first half of 2016, spending on gross fixed capital formation was €76.2 million below the 2015 level. Hence, in order to meet the target for gross fixed capital formation for 2016, during the second half of the year spending has to be €1.0 million higher than in 2015. This appears rather challenging particularly since

[37] This budget item consists of the capital expenditure undertaken by the various ministries and EBUs.

Consolidated Fund data shows that spending on capital expenditure was exceptionally high in December 2015 (see Chart 11).[38] Monthly data up to September provides evidence that during the third quarter capital expenditure remained lower than in 2015. On this basis, the MFAC identifies downside risks to the 2016 projections for gross fixed capital formation.

Chart 11: Monthly capital expenditures (EUR thousands)




*Source: NSO*

With regard to 2017, the assessment of risks is rather challenging, particularly as this expenditure component is largely of a discretionary nature. Any expenditure-below target in 2016 could be made up for during 2017. However, on balance, the MFAC considers the risks to the 2017 projection for gross fixed capital formation to be neutral.

## 5.7. Capital transfers payable (D.9)

<u>Definition:</u> *capital transfers require the acquisition or disposal of an asset, or assets, by at least one of the parties to the transaction. Whether made in cash or in kind, they result in a commensurate change in the financial, or non-financial, assets shown in the balance sheets of one or both parties to the transaction.*[39]

In 2015, this item had peaked at €134.9 million, equivalent to 1.5% of GDP. This was the result of a significant equity injection in the national airline of €43 million (see Table 11). In 2016, capital transfers are planned to be reduced sharply, down by €79.1 million. Of these, €31 million is attributable to the reduction in capital transfers to the national airline since in 2015 such transfers amounted to €43 million and in 2016 these were limited to €12 million. Another €8.7 million permanent reduction is based on unspecified consolidation measures

[38] This was the last month wherein projects could be financed under the previous EU financial framework.
[39] This budget item consists mainly of transfers to a number of public sector entities to cover their capital expenditure. These include Wasteserv, Foundation for Tomorrow Schools (FTS), Malta Enetrprise, Malta College for Arts Science and Technology (MCAST), Malta Council for Science and Technology (MCST) and the University of Malta (UoM). Part of this expenditure is also matched by EU funds.

initially announced in the USP. Likewise the DBP does not elaborate further on these expenditure cuts. On the other hand, higher outlays are envisaged as a result of the hotel energy efficiency scheme and the ongoing ex-gratia payment on car registration tax.

Table 11: Budgetary impact of specific capital transfer measures in 2015, 2016 and 2017

| **Measures*** | **2015** | **2016** | **2017** |
|---|---|---|---|
| | | EUR millions | |
| Equity acquisition in the national airline** | -43.000 | -12.000 | NA |
| Consolidation measures | NA | 8.770 | 8.770 |
| Ex-gratia payment on car registration tax** | -2.331 | -4.200 | -4.650 |
| Hotel energy efficiency scheme** | NA | -0.400 | -0.500 |
| **Total net effect** | **-45.331** | **-7.830** | **3.620** |
| **of which: Permanent** | **NA** | **8.770** | **8.770** |
| **of which: Temporary** | **-45.331** | **-16.600** | **-5.150** |

* A positive sign indicates a positive impact on the fiscal balance while a negative sign indicates a negative impact

** Indicates temporary measure

*Source: MFIN*

ESA data for the first six months indicates that capital transfers declined by €42.0 million during the first half of 2016. This suggests good progress towards the target for the year. With regard to 2017, the DBP indicates that capital transfers will fall by another €10.6 million. This can be ascribed to the non-repetition of the capital transfer which was made to the national airline in 2016.

The MFAC acknowledges the inherent challenges in projecting with certainty this item, given that this expenditure component is rather discretionary. Overall, the MFAC considers the risk to the projection for capital transfers for 2016 and 2017 to be both neutral, contingent on the successful implementation of the quantified yet not publically specified consolidation measures.

### 5.8. Other expenditures

*Definition:* *Other expenditures not elsewhere classified.*[40]

In absolute terms, 'other expenditures' are expected to maintain an upward path similar to that observed in recent years. It is projected to rise from €197.1 million in 2015 to €210.2 million in 2016 and €221.9 million in 2017. Other expenditures are projected to maintain a

[40] This budget item represents residual expenditure components, mainly accounted for by current transfers to the numerous government entities to fund their operations. Within this aggregate there is also included the annual budget allocation equivalent to 0.1% of GDP for the Contingency Reserve. Sale of government land is treated as a negative value among these components.

stable share of GDP of around 2.3%. Specifically, revenue from the sale of land, which is netted off from this expenditure category, is expected to amount to €2.8 million in 2016, less than the €14.6 million recorded in 2015. In 2017, revenue from sale of land is then expected to increase again to €6.8 million.

The MFAC positively notes that the assumption of a stable ratio to GDP ensures that the envisaged expenditure outlays should be reasonably attainable. Owing to the heterogeneity of this expenditure item, it is hard to project such expenditures at an aggregate level. Nevertheless, the fact that ESA data indicates that during the first half of 2016, spending was €19.9 million lower than in 2015, there appears to be some downside risk specifically for 2016. Should no exceptional circumstances materialise by the end of the year, saving equivalent to the 0.1% of GDP mandatory allocation to the Contingency Reserve would be achieved. This further supports the MFAC's view of downside risks to the 2016 estimate for 'other expenditures'.

With regard to 2017, the MFAC is not aware of any significant factor which would contradict the MFIN's forecast. Hence, assuming that even in 2017 no recourse in made to the Contingency Reserve, the risks to this expenditure component would be downside.

### 5.9. Total government expenditure

The MFAC notes that total expenditure declined significantly during the first half of 2016 compared to 2015 (see Table 12). This pattern was primarily driven by the lower spending on gross fixed capital formation and capital transfers, which both recorded double digit declines. On the other hand, compensation of employees, intermediate consumption and social benefits appeared to rise at a faster pace than projected for the year as a whole.

The above item by item examination of risks to the expenditure forecasts indicated possible upside risks for 2016 in the case of compensation of employees. On the other hand, downside risks were identified with respect to gross fixed capital formation and 'other expenditures'. The MFAC considers that the downside risks associated to these two components may tend to outweigh the upside risks relating to compensation of employees (see Table 13). Hence, on balance the MFAC considers that there is a downside risk to total government expenditure for 2016.

With regard to the 2017 expenditure projections, there appear to be a number of upside risks across multiple components. Hence overall the MFAC deems that the risks to the 2017 expenditure forecasts appear to be on the upside.

Table 12: Actual and projected expenditure performance for 2016 compared to 2015

| | Year-on-year | | | | | |
|---|---|---|---|---|---|---|
| | H1 | | H2 | | Total | |
| | *Change* | *Growth* | *Change* | *Growth* | *Change* | *Growth* |
| | '000 | % | '000 | % | '000 | % |
| Compensation of employees | 32.6 | 5.9 | 30.6 | 5.5 | 63.3 | 5.7 |
| Intermediate consumption | 25.0 | 9.6 | 27.3 | 8.1 | 52.3 | 8.7 |
| Social benefits | 25.6 | 5.0 | 7.1 | 1.4 | 32.7 | 3.2 |
| Interest expenditure | -4.7 | -4.2 | -10.4 | -9.0 | -15.1 | -6.6 |
| Subsidies | 1.3 | 2.5 | -0.3 | -0.6 | 1.0 | -0.9 |
| Gross fixed capital formation | -76.2 | -42.9 | 1.0 | 0.5 | -75.2 | -18.9 |
| Capital transfers payable | -42.0 | -64.1 | -37.1 | -53.4 | -79.1 | -58.6 |
| Other expenditures | -19.9 | -17.7 | 33.0 | 39.0 | 13.1 | 6.6 |
| **Total expenditure** | **-58.2** | **-3.1** | **51.2** | **2.6** | **-7.1** | **-0.2** |

*Source: MFIN*

Table 13: Summary of risks to the expenditure projections

| | 2016 | 2017 |
|---|---|---|
| Compensation of employees | ⇑ | ⇑ |
| Intermediate consumption | ⇔ | ⇑ |
| Social benefits | ⇔ | ⇑ |
| Interest expenditure | ⇔ | ⇔ |
| Subsidies | ⇔ | ⇑ |
| Gross fixed capital formation | ⇓ | ⇔ |
| Capital transfers payable | ⇔ | ⇔ |
| Other expenditures | ⇓ | ⇓ |
| **Total expenditure** | ⇓ | ⇑ |

*Source: MFAC*

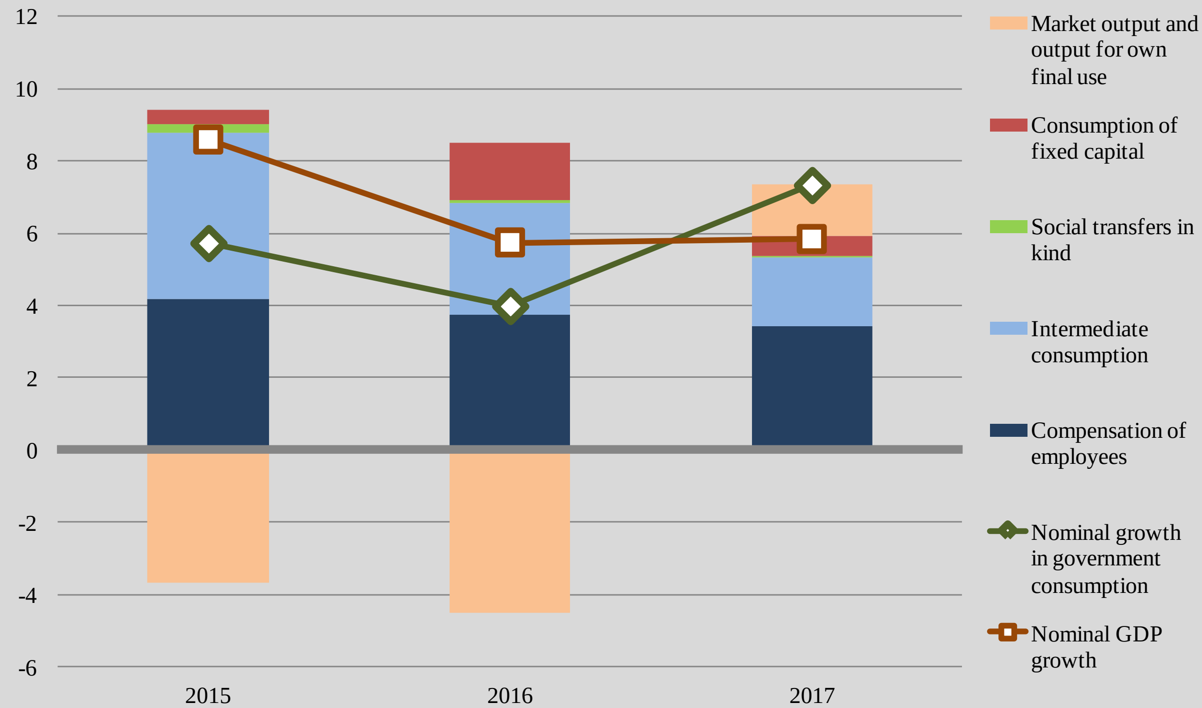
On the basis of the detailed assessment of the various budget components, Box 1 evaluates the plausibility of the 2016 and 2017 projections for real government consumption.[41] Accordingly, the MFAC considers the forecast for real government consumption to be within its endorsable range both for 2016 and for 2017.

## Box 1: Assessment of the projections for real government consumption

Real government consumption is expected to decelerate from 4.6% in 2015 to 2.8% in 2016 and then accelerate again to 5.9% in 2017. The forecast government consumption deflator is stable, at 1.1% in 2016 and 1.2% in 2017. These deflator rates are quite similar to the 1.0% reported in 2015.

Hence the volatility in the forecast for real government consumption is entirely driven by the volatility in the estimates for nominal government consumption, which in 2016 is expected to be below nominal GDP growth but above nominal GDP growth in 2017. In turn, the major impact is created by swings in the forecasts for market output, which is a sub-component of the 'other revenues' category (see Chart A).

Chart A: Components of nominal government consumption




*Source: MFIN*

[41] Real government consumption is compiled by aggregating a number of expenditure items and netting the market output. The resulting nominal government consumption is then deflated using an appropriate deflator.

This is driven by the anticipated trajectory for revenues from the IIP, which in 2016 are expected to be higher than in 2015, while in 2017 they are expected to be less than in 2016. It is worth highlighting that notwithstanding that the revenue streams generated from the IIP have a depressing effect on the estimate of government consumption, the effect on GDP is however fully neutralised, since an equivalent amount is added to service exports.

In 2016, the downward push exerted by market output is expected to be more pronounced than in 2015. Further deceleration in nominal government consumption is due to the planned slower growth in compensation of employees and in intermediate consumption. Their slowdown effect is partly mitigated through higher consumption of fixed capital, in line with the elevated investment which was carried out in 2015.

Notwithstanding that compensation of employees, intermediate consumption and consumption of fixed capital are planned to exert a smaller contribution to growth in 2017, nominal growth in government consumption is set to pick up. This reflects the swing created by market output, whose contribution is anticipated to change from negative to positive, due to its anticipated decline in 2017 compared to 2016.

The assessment for real government consumption mirrors the conclusions for its various components. The dynamics in the deflator appear to be plausible and consistent with the low inflation scenario. With regard to the nominal components, the before-identified upside risks to compensation of employees for 2016 could exert a similar upside risk to government consumption, both in nominal and in real terms. Upside risks similarly exist for 2017, on account of the upside risks to compensation of employees and to intermediate consumption. On balance, however, these identified risks could be outweighed by the uncertainty characterising the revenues from IIP, whose potential volatility is much higher.

## 6. Assessment of the trajectory for the fiscal balance for 2016 and 2017

Risks to the revenue projections appear to be tilted to the upside for both 2016 and 2017. On the other hand, the MFAC considers the risks to the expenditure projections to be downside for 2016 but upside for 2017. Notwithstanding the risks to the baseline revenue and expenditure projections for 2016 and 2017, both sets of projections are deemed to be within the endorseable range of the MFAC. As a result, even the targets for the 2016 and 2017 fiscal deficit are within the endorsable range of the MFAC. On a net basis, there may be an upside risk to the fiscal balance both for 2016 and for 2017 (see Table 14).

Table 14: Summary of risks to the fiscal projections

| | 2016 | 2017 |
|---|---|---|
| Total revenue | ⇑ | ⇑ |
| Total expenditure | ⇓ | ⇑ |
| Fiscal balance | ⇑ | ⇑ |

*Source: MFAC*

This view is supported by the assessment that in 2016 total revenue may exceed its target, while total expenditure may be less than planned. In the case of 2017, while the increase in both total revenue and total expenditure may exceed the respective target, however, on balance there may be a possible upside risk to the fiscal balance. This assessment is based on the assumption that any revenue above targets in 2016 is permanent and thus spills over from 2016 into 2017, while any expenditure above target for 2017 is below the possible revenue surplus. This view is contingent on three important assumptions namely that the possible expenditure shortfall in 2016 is not fully compensated for in 2017; that no recourse to the Contingency Reserve is made during the forecast horizon; and that no new expenditure initiatives are undertaken beyond those outlined in the DBP.

## 7. Assessment of the trajectory for the public debt for 2016 and 2017

According to the projections contained in the DBP, in 2016 and 2017 total revenues are expected to exceed the planned expenditures net of interest payments. The resulting primary fiscal surplus is expected to amount to 1.6% of GDP in each of the forecast years. This development is expected to contribute to a downward push to the outstanding level of debt. However this effect is more than offset by the upward push generated by the yearly interest payments (see Chart 12 and Chart 13).

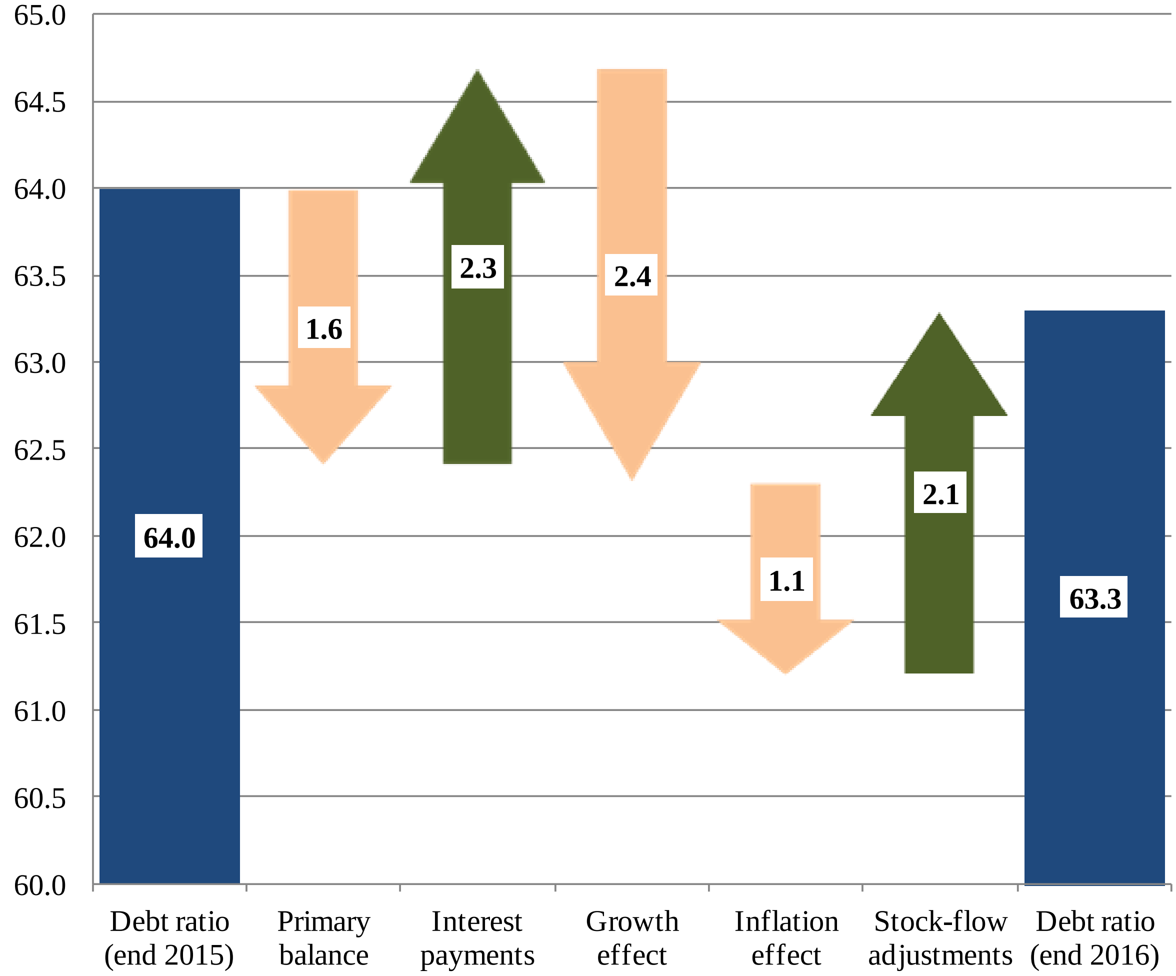
Developments in nominal GDP also matter when focusing on the debt ratio (public debt expressed as a percentage of GDP), since these influence the denominator of this ratio. These can be further decomposed into the contribution stemming from real GDP growth and that from inflation.[42] In particular, the downward push exerted by the growth effect is estimated to amount to 2.4% of GDP in 2016 and 2.1% of GDP in 2017, while the inflation effect is expected to contribute a downward push equivalent to 1.1% of GDP in 2016 and 1.4% of GDP in 2017.

The plausibility of the debt dynamics arising from the primary balance effect and the interest payments effect depends on the MFAC's assessment of the plausibility of the fiscal forecasts

[42] For a technical exposition on debt dynamics, please refer to Box 2 contained in the MFAC's report "An Overall Assessment of the Draft Budgetary Plan 2016" published in January 2016, available on www.mfac.gov.mt.

which underpin such calculations. Likewise, the estimates for the growth and inflation effects are based on the forecasts for real GDP growth and the GDP deflator for 2016 and 2017, both of which have already been endorsed by the MFAC in its previous report published in October 2016.

Chart 12: Forecast debt developments in 2016 (% of GDP)

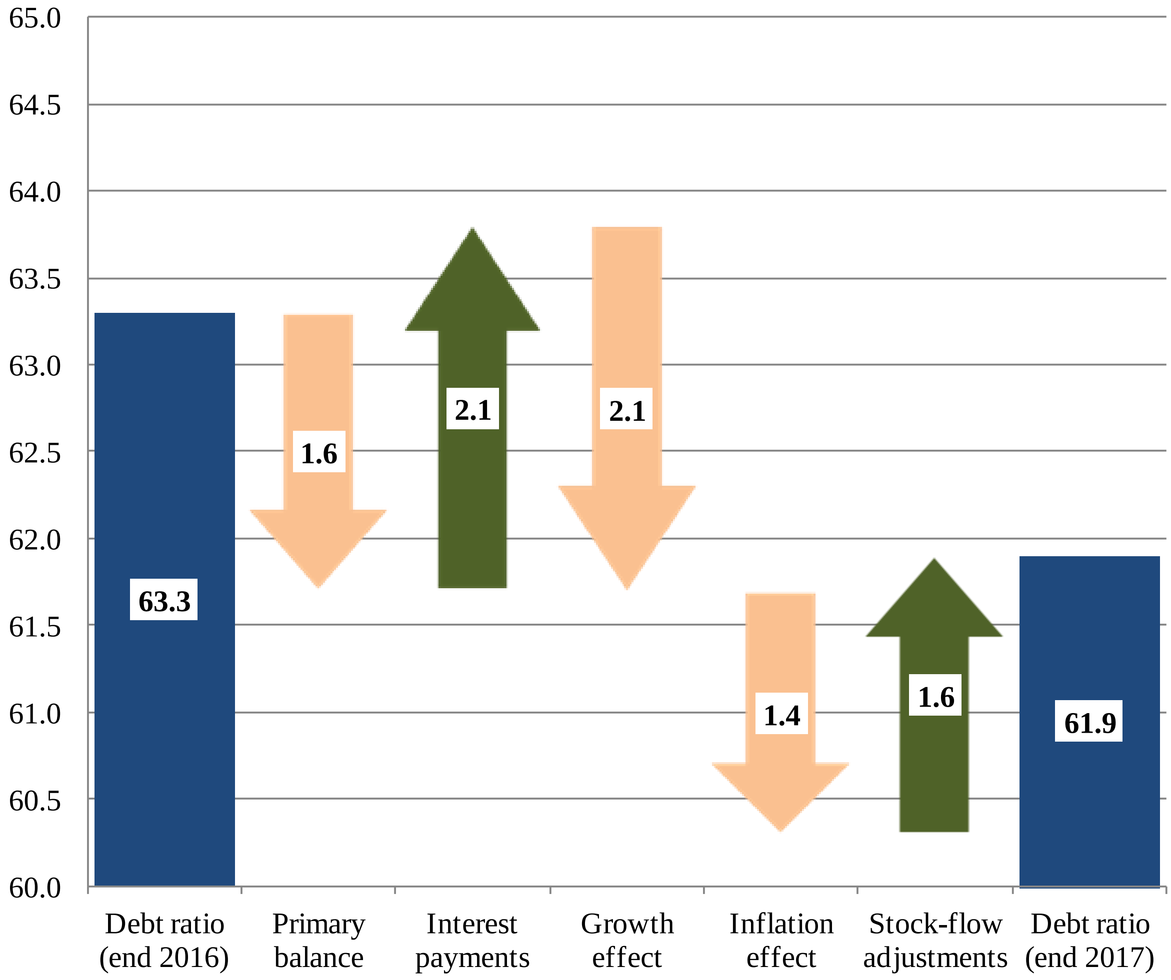



*Source: MFIN, MFAC calculations*

Hence, the assessment of the trajectory for the debt ratio, which is projected to scale back from 64.0% of GDP in 2015 to 63.3% in 2016 and 61.9% in 2017, essentially depends on the validity of the stock-flow adjustments that are being assumed. These transactions impact the level of debt but do not influence the fiscal balance. In particular, the 2017 DBP indicates that stock-flow adjustments will amount to €269.4 million in 2016 and €159.0 million in 2017. These positive stock flow adjustments are thus assumed to exert an upward push on the debt ratio equivalent to 2.1% of GDP in 2016 and 1.6% of GDP in 2017.

The MFAC welcomes the inclusion of a detailed list of stock flow adjustments in the DBP. These transactions are largely discretionary and include assumptions such as that certain amounts of revenues received from the IIP will not be used to lower the outstanding level of debt but will rather be maintained in the form of financial assets. Other assumptions include the further build up of a portfolio of MGS holdings and changes to the holdings of cash balances.

Chart 13: Forecast debt developments in 2017 (% of GDP)




*Source: MFIN, MFAC calculations*

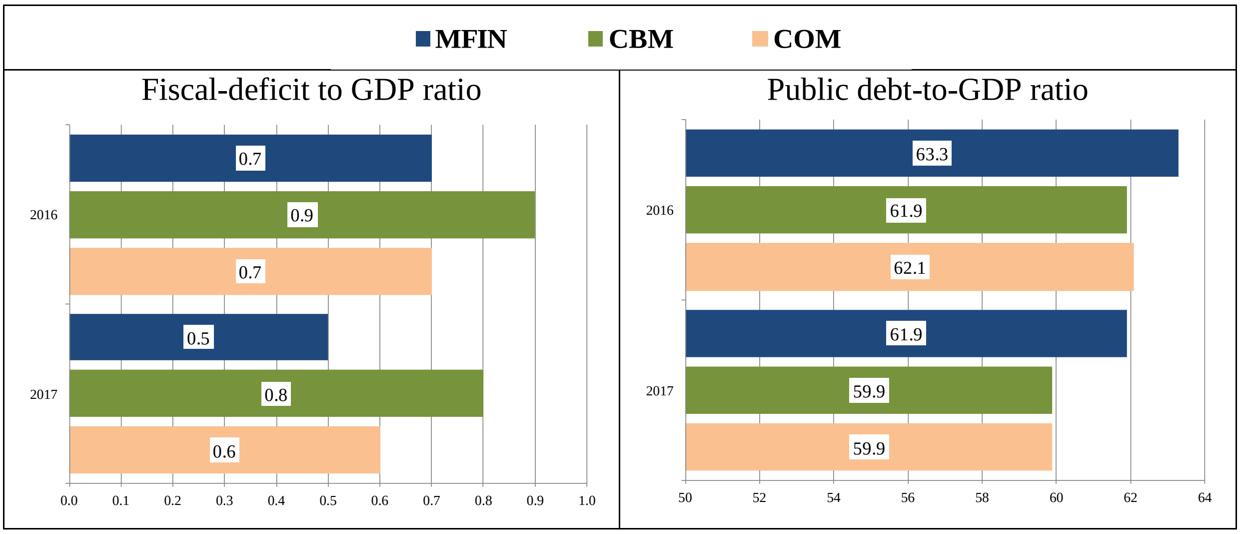
The MFAC is not aware of any specific factor which would contradict the estimates for the stock flow adjustments being assumed in the DBP. The MFAC notes that the DBP is assuming a slower pace in the reduction of the debt ratio than justified by the underlying fiscal developments owing to the before-mentioned stock flow adjustments. The MFAC considers the relatively less ambitious debt ratio reduction targets for 2016 and 2017 to be within the endorsable range of the MFAC.

## 8. Comparison with other forecasts for the fiscal balance and public debt

The plausibility of the MFIN's projections contained in the latest DBP can also be evaluated by comparing them to the forecasts which are prepared by other institutions, namely the CBM and the COM.

The latest publicly available projections by the CBM, point towards a deficit-to-GDP ratio amounting to 0.9% in 2016, and 0.8% in 2017 (see Chart 14). The deficits are respectively 0.2 percentage point and 0.3 percentage point higher than the MFIN's targets for 2016 and 2017. On the other hand, the CBM estimates the debt-to-GDP ratio to fall to 61.9% in 2016 and to 59.9% in 2017, or 1.4 percentage points and 2.0 percentage points respectively below the MFIN's debt targets.

Chart 14: Forecasts by different institutions (% of GDP)




*Source: CBM, COM, MFIN*

The MFAC notes that both the deficit and debt projections by the CBM are within a close range to those prepared by the MFIN. The two sets of forecasts are however not directly comparable since the CBM's forecasts were based on earlier macroeconomic and fiscal data. Indeed, these forecasts were included in the CBM's first issue of its Quarterly Review for 2016, which was published on 22 June 2016.[43] Furthermore, the CBM's forecasts do not include the effects of the new revenue and expenditure measures which were announced in the latest DBP. At the same time, since the CBM does not publish separate forecasts for the various revenue and expenditure components, it is not possible to trace precisely the reasons behind the slightly wider deficit projections by the CBM. On the other hand, the lower projections for the debt ratio by the CBM are driven primarily by different assumptions with respect to the amount of stock flow adjustments for 2016 and 2017.

The fiscal forecasts published by the COM on 9 November 2016 are more detailed, thus allowing for a fuller analysis.[44] The COM's forecast for the fiscal balance for 2016 is identical to the MFIN's target for the year. That for 2017 is slightly less optimistic, with the difference estimated at around €12 million (see Table 15). As a result, the COM's 2016 forecast deficit-to-GDP ratio is identical to the MFIN's target, at 0.7%. However, with regard

[43] The cut-off date for the CBM forecasts was 18 May 2016. The report is available on: https://www.centralbankmalta.org/economic-projections
[44] The cut-off date for the COM's forecasts was 31 October 2016. The forecasts are available on: http://ec.europa.eu/economy_finance/eu/forecasts/2016_autumn_forecast_en.htm

to the outturn for 2017, the COM is expecting the deficit to contract by slightly less, by 0.1 percentage point, rather than by 0.2 percentage points, as indicated in MFIN's forecast.

Table 15: Differences between the forecasts prepared by the COM and the MFIN*

| | 2016 | | | 2017 | | |
|---|---|---|---|---|---|---|
| | EUR millions | | | EUR millions | | |
| | **COM** | **MFIN** | **Diff*** | **COM** | **MFIN** | **Diff*** |
| **Total revenue** | **3,727.0** | **3,740.6** | **-13.6** | **3,907.0** | **3,910.2** | **-3.2** |
| Taxes on production and imports | 1,262.0 | 1,262.7 | -0.7 | 1,330.0 | 1,324.4 | 5.6 |
| Current taxes on income & wealth | 1,329.0 | 1,302.5 | 26.5 | 1,422.0 | 1,379.5 | 42.5 |
| Social contributions | 628.0 | 629.2 | -1.2 | 659.0 | 658.5 | 0.5 |
| Other revenues** | 508.0 | 546.2 | -38.2 | 496.0 | 547.8 | -51.8 |
| **Total expenditure** | **3,794.0** | **3,807.6** | **-13.6** | **3,969.0** | **3,960.2** | **8.8** |
| Compensation of employees | 1,184.0 | 1,180.5 | 3.5 | 1,249.0 | 1,240.8 | 8.2 |
| Intermediate consumption | 652.0 | 650.5 | 1.5 | 691.0 | 684.0 | 7.0 |
| Social payments | 1,068.0 | 1,063.9 | 4.1 | 1,103.0 | 1,096.2 | 6.8 |
| Interest expenditure | 213.0 | 212.7 | 0.3 | 210.0 | 207.7 | 2.3 |
| Subsidies | 113.0 | 111.6 | 1.4 | 116.0 | 112.4 | 3.6 |
| Gross fixed capital formation | 270.0 | 322.5 | -52.5 | 287.0 | 352.1 | -65.1 |
| Other expenditures** | 294.0 | 266.0 | 28.0 | 313.0 | 267.1 | 45.9 |
| **Fiscal balance** | **-67.0** | **-67.0** | **0.0** | **-62.0** | **-50.0** | **-12.0** |

* Figures represent the absolute differences between the COM's forecasts when compared to the MFIN's projections. A positive figure indicates a higher forecast by the COM while a negative figure indicates a lower forecast by the COM. Figures may not add up due to rounding.
** The values for other revenues and other expenditures do not correspond to the same values described in the other sections in this Report since they include revenue and expenditure items which are not separately identified in the COM's projections.
*Source: COM, MFIN*

The COM's 2016 estimate for total revenue is €14 million lower than indicated in the MFIN's projections, while for 2017 the difference is very small, just around €3 million. However, at a component level there are some noticeable differences. The COM is estimating higher intake from current taxes on income and wealth, both for 2016 and 2017. The COM's forecasts are respectively €27 million and €43 million higher. These estimates are consistent with the MFAC's assessment of possible upside risks to this revenue component over the forecast horizon. Differences across the other main revenue components are negligible, with the exception of taxes on production and imports which are some €6 million higher in the COM's forecasts. The latter can be explained by the fact that the COM's forecast for nominal consumption growth is slightly higher than that by the MFIN. The lower total revenue forecasts by the COM thus relate to lower amounts classified under 'other revenues'.[45] The COM estimates other revenues to amount to €38 million and €52 million less than anticipated by the MFIN for 2016 and 2017 respectively. In particular, the COM's projections assume a slower absorption of EU funds when compared to the MFIN's plans, with additional differences stemming from other minor components.

In turn, the COM's outlook for total expenditure is compatible with the MFAC's assessment of possible downside risks for 2016 and possible upside risks for 2017. Indeed, the COM is forecasting total expenditure to be €14 million below the MFIN' targets in 2016 but to exceed the target by €9 million in 2017. The COM's expenditure forecasts are higher across virtually all main current expenditure components. This reaffirms the expenditure restraint challenges which the MFAC has identified to the attainment of the DBP's expenditure targets. The only exception relates to spending on gross fixed capital formation which the COM expects to be less than targeted. The latter is consistent with the scenario of a slower take up of EU funds embedded in the COM's forecasts and possibly different progress with respect to some investment projects.

On balance the COM's slightly more cautious outlook for the 2017 deficit is based on the expectation of slightly faster expenditure dynamics than anticipated in the DBP, with the slower anticipated absorption of EU funds impacting both the overall revenue and expenditure projections.[46]

Notwithstanding the identical fiscal deficit forecast for 2016 and the slightly wider fiscal deficit in 2017, the COM's estimates point to a lower debt-to-GDP ratio for both 2016 and 2017 than indicated in the DBP. Indeed, the COM is forecasting the debt-to-GDP ratio to decline to 62.1% in 2016 and 59.9% in 2017, which are more in line with the CBM's forecasts in this case. As in the case of the CBM, the more positive outlook by the COM reflects different assumptions about the amount of stock flow adjustments to be carried out during the forecast horizon, which are nevertheless largely at the discretion of government.

## 9. Conclusion

The MFAC acknowledges that the process used by the MFIN to prepare its fiscal projections is rigorous and has a good track record.[47] This is reflected in the historical accuracy of the forecasts for the fiscal balance-to-GDP ratio in recent years.

[45] Other revenues are a residual component made up of different items. Their definition is different from that used in the other parts of the Report.

[46] A slower take up of EU funds implies that the co-financing expenditure element by government is less, and hence there is overall a favourable impact on the budget balance in net terms.

[47] For further details refer to https://mfin.gov.mt/en/epd/Documents/Working_Papers/Working_Paper_Full.pdf.

The MFAC considers the MFIN's revenue projections to lie within its endorsable range, leaving the possibility for upside risks both for 2016 and 2017. This view is contingent on the materialisation of the macroeconomic outlook as envisaged in the DBP 2017. Should the macroeconomic performance be less positive than that underpinning the DBP's calculations, or else, be driven by completely different contributors (which may be relatively more or less tax rich), the fiscal turnout could however be impacted, since most revenues are endogenous. It is thus important that the MFIN remains vigilant to quickly detect and address any departure from current revenue trends.

Even the planned expenditures are within the MFAC's endorsable range both for 2016 and 2017. However, the MFAC considers that expenditure may undershoot its target in 2016 but overshoot that for 2017. The MFAC acknowledges that there is a material share of expenditure which is discretionary, and hence directly under the control of Government. Thus there is still the possibility that expenditures can be adjusted to make them consistent with the attainment of the expenditure targets as specified in the DBP. Nevertheless, the MFAC considers important that any expenditure reductions which have been achieved in specific areas as a result of the government's ongoing fiscal efforts should be maintained across subsequent budget exercises.

On the basis of this assessment and the information available up to the cut-off date, the MFAC concludes that the risks to the fiscal balance appear to be on the upside both for 2016 and for 2017. This is in line with the prudent approach generally adopted by the MFIN in the preparation of both the macroeconomic and fiscal forecasts. The MFAC would like to recommend that should the actual revenue and expenditure performance enable the fiscal balance to improve by more than what is originally being targeted, the Government would take the opportunity to build fiscal buffers rather than offset such windfalls through new expenditure initiatives.

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