ANNUAL REPORT AND STATEMENT OF ACCOUNTS

2016

MFAC

MALTA FISCAL ADVISORY COUNCIL

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30 March 2017

The Hon Prof Edward Scicluna B.A. (Hons) Econ, M.A. (Toronto),
Ph.D (Toronto), D.S.S (Oxon) MP
Minister for Finance
Maison Demandols
South Street
Valletta VLT 2000

Dear Minister

LETTER OF TRANSMITTAL

In terms of article 58 of the Fiscal Responsibility Act, 2014 (Cap 534), I have the honour to transmit to you a copy of the Annual Report of the Malta Fiscal Advisory Council for the year 2016.

In terms of article 56 of the Fiscal Responsibility Act, I am also transmitting a copy of the audited accounts of the Council for the financial year ended 31 December 2016.

Yours sincerely

Rene Saliba
Chairman

Vision

To contribute to stronger fiscal governance in Malta and offer assurance about the quality of the official economic and fiscal projections, and about fiscal sustainability, through independent analysis and advice.

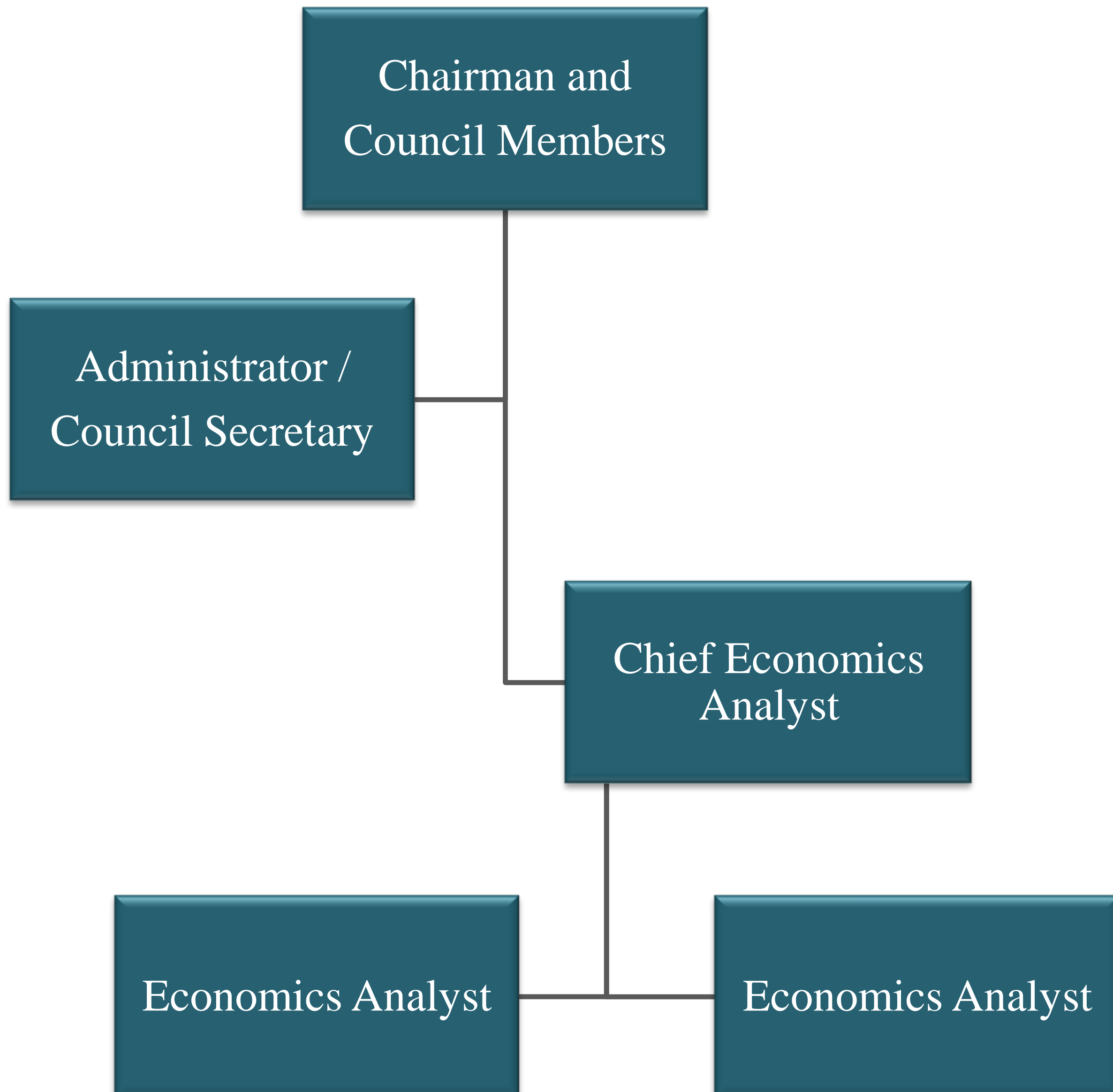
Mission Statement

The Malta Fiscal Advisory Council (MFAC) is an independent institution established under the Fiscal Responsibility Act (2014) which has the primary objective to contribute to sustainable public finances and sound economic policy making in Malta.

The MFAC seeks to carry out its statutory responsibilities by:

i. Assessing the plausibility of the Government's macroeconomic forecasts and fiscal projections and endorsing them as it considers appropriate;
ii. Assessing whether the fiscal stance is conducive to prudent economic and budgetary management;
iii. Assessing the extent to which the conduct of fiscal policy in Malta is consistent with the country's fiscal commitments as a member of the European Union;
iv. Assessing the extent to which the annual budgetary plan and medium term fiscal plan comply with the Fiscal Responsibility Act and the Stability and Growth Pact;
v. Assessing the extent to which the fiscal and economic policy objectives proposed by the Government are being achieved;
vi. Determining whether exceptional circumstances, which would allow for a departure from the announced fiscal plans, exist or have ceased to exist;
vii. Issuing opinions and formulating recommendations in the areas of public finances and economic management;
viii. Advising the Government and the Public Accounts Committee concerning the maintenance of fiscal discipline; and
ix. Disseminating information and analysis to the public to increase awareness and understanding of economic and fiscal issues.

Organisation Chart



Council Members

The Council

From left to right: **Ms Doriette Camilleri** (Council Secretary), **Dr Carl Camilleri** (Council Member), **Mr Rene Saliba** (Chairman) and **Dr Ian Cassar** (Council Member)

Staff

The economists

From left to right

Mr Kurt Davison

Economics Analyst

Mr Malcolm Bray

Chief Economics Analyst

Mr Christian Xuereb

Economics Analyst

The administrator

Ms Doriette Camilleri

Administrator & Council Secretary

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Abbreviations

AMECO	Annual Macroeconomic Database of the Directorate General for Economic and Financial Affairs
CBM	Central Bank of Malta
CCA	Contingent Claims Analysis
COFOG	Classification of the Functions of Government
COM	European Commission
CSR	Comprehensive Spending Review
DAS	Departmental Accounting System
DBP	Draft Budgetary Plan
DSA	Debt Sustainability Analysis
DSM	Debt Sustainability Monitor
EA-19	Euro Area (19 countries)
EBU	Extra-Budgetary Unit
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs
EDP	Excessive Deficit Procedure
EEA	European Environment Agency
EFC	Economic and Financial Committee
EMU	Economic and Monetary Union
ESA	European System of National and Regional Accounts
ESDP	Economic Statistics Development Programme
EU	European Union
EUNIFI	EU Network of Independent Fiscal Institutions
FDI	Foreign Direct Investment
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
IFI	Independent Fiscal Institution
IIP	Individual Investor Programme
IMF	International Monetary Fund

MCAST	Malta College of Arts Science and Technology
MEUSAC	Malta-EU Steering and Action Committee
MFAC	Malta Fiscal Advisory Council
MFIN	Ministry for Finance
MGS	Malta Government Stock
MTBF	Medium Term Budgetary Framework
MTFS	Medium Term Fiscal Strategy
MOU	Memorandum of Understanding
MTO	Medium-Term Objective
NAO	National Audit Office
NDSF	National Development and Social Fund
NI	National Insurance
NPL	Non-Performing Loans
NSO	National Statistics Office
OECD	Organisation for Economic Cooperation and Development
PAC	Public Accounts Committee
PAYG	Pay-As-You-Go
pp	percentage point
PPP	Public-Private Partnership
R&D	Research and Development
RPI	Retail Price Index
SDP	Significant Deviation Procedure
SGP	Stability and Growth Pact
SPE	Special Purposes Entities
SYMBOL	SYstemic Model of Banking Originated Losses
TB	Treasury Bill
TSCG	Treaty on Stability, Coordination and Governance
UoM	University of Malta
USP	Update of Stability Programme
VaR	Value at Risk
VAR	Vector auto regression

Chairman’s Statement

The Malta Fiscal Advisory Council (MFAC) has achieved important milestones in its second year of operations. In particular, I note the strengthening of the organisational structure; the establishment of a regular publications timetable; and a gradual expanding visibility of the organisation’s role.

In 2016, the MFAC completed the staff recruitment phase, developed its work-related policies and introduced the Staff Handbook, which sets out the Code of Professional Conduct for Council employees, as well as the terms and conditions of employment. It also established a set of Council Bye-Laws which, in conjunction with the Fiscal Responsibility Act (FRA), govern the workings of the Council members and provide for a Code of Professional Conduct for members. These Bye-Laws were published on the MFAC’s website to ensure greater transparency and accountability regarding Council members. The Council also began managing directly the financial resources allocated to it under the FRA. These developments enable the smooth carrying out of the Council’s functions and permit the MFAC to broaden and deepen its activities in the years ahead.

The full series of reports which are mandated by the FRA have been published during the course of the year in line with the anticipated timetable. This will serve as a template for the expected timing of the MFAC’s regular publications. Looking ahead, the aim is to improve the quality and the depth of the analytical insight provided by these reports. Where possible, the intention is to expand into additional economic research, to better support the MFAC’s activities.

I share the Council’s satisfaction that the reports have been gradually gaining increasing attention by the various stakeholders, which include the Ministry for Finance (MFIN), the Public Accounts Committee (PAC) and the media. This not only contributes to greater awareness about the MFAC’s activities, but more importantly, boosts transparency about the conduct of Malta’s fiscal policy.

Sound fiscal policy is critically dependent on taking the right and timely decisions with regard to fiscal sustainability which is supportive of economic stabilisation and growth. In this respect, the MFAC works to promptly identify and make recommendations in situations where the actual or planned policies risk being unsustainable, or else fall short of safeguarding full compliance with the applicable fiscal rules.

Although the FRA does not provide for a formal 'comply or explain principle', the MFAC highly values the informal exchange of opinions with the MFIN through periodic bilateral meetings. The Council would however welcome the introduction of a more systematic mechanism whereby the feedback presented by the MFIN on the MFAC's recommendations would be more extensive and made public, thus enhancing the exchange of views among stakeholders and contributing to greater fiscal policy transparency.

The MFAC also notes the Government's sustained commitment to reduce the headline fiscal deficit and the public debt, expressed as a ratio to nominal GDP, in line with the medium term objective of achieving a balanced fiscal position by 2019. The benign macroeconomic growth conditions, which the country has registered in recent years, have also contributed strongly to this consistent decline in the headline deficit and debt ratios to GDP. Indeed, the convergence towards the stipulated 60% debt-to-GDP threshold can be achieved earlier than originally anticipated, as long as the existing fiscal plans remain unchanged.

In this context, the Council would however like to underline that the fiscal rules prescribed by the FRA and the Stability and Growth Pact (SGP) go a step further, as they focus on fiscal consolidation in structural terms, that is, net of cyclical and one-off factors.

The Council fully understands that this rules-based framework, which emanated from the 'Six-Pack' measures issued by the Commission in 2011, is still somewhat new for Malta, and at times can be rather complex to interpret and administer. Still, it is important that the strategic focus would be broadened beyond the traditional headline fiscal targets to direct more attention towards the fiscal indicators and the numerical fiscal rules specified in the FRA and SGP.

The MFAC in its assessment of the Draft Budgetary Plan (DBP) for 2017 had noted that for 2016, both the required improvement in the structural fiscal balance and the expenditure benchmark would be adequately met, thereby fully complying with the fiscal rules. However, for 2017, there appears to be a risk of some deviation from the required path in terms of these two fiscal thresholds. The MFAC's view is that, in order to ensure full compliance with the structural effort and expenditure benchmark requirements on a yearly basis, it is important that whenever there are instances of tax revenues exceeding the target, one would take the opportunity to build up fiscal buffers rather than opting for almost identical upward expenditure revisions.

The Council believes that there needs to be greater awareness among the various ministries and Extra-Budgetary Units (EBUs) of the importance that possible revenue windfalls are not tantamount to higher spending limits. In particular, revenue windfalls should not be used to finance permanent spending initiatives which will impact adversely the future fiscal position. Likewise it is necessary to ensure that concurrently, expenditure growth is contained within the prescribed yearly limits indicated by the expenditure benchmark.

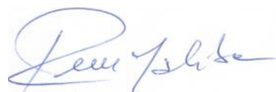
Starting from 2017, the MFAC aims to delve deeper into the major revenue and expenditure components within Malta's fiscal budget. The objective is to identify better the respective

drivers, and undertake a more robust diagnosis, of possible threats to fiscal sustainability. In turn, this would enable more focused and effective recommendations to address possible fiscal risks and to safeguard long term fiscal sustainability.

The Council would like to acknowledge with satisfaction the fruitful collaboration with the MFIN that has been ongoing since the establishment of the MFAC. The Council believes that such collaboration can be extended to other areas within the public sector.

The Annual Report for 2016 follows a similar style to that adopted for the first edition. Apart from presenting information about the role and activities of the MFAC, the Annual Report provides an overall coverage of the recommendations made by the Council in the various reports published to date. Special themes in this year's edition focus on: a comparison of Malta's public finances with those in the euro area; an outline of the concept of fiscal risks, with a focus on public debt sustainability and contingent liabilities; and an overview of the expenditure benchmark. I believe the content offers useful insight about issues which are highly relevant for the conduct of sound fiscal policy in Malta.

On behalf of the Council members, I express my appreciation and gratitude for the support and collaboration extended by all stakeholders to facilitate the MFAC's operations. Finally, I would like to thank my fellow members of the Council and the staff for their professional work carried out throughout the year. Through their dedication and effort the MFAC was able to carry out its functions effectively and efficiently.



Rene Saliba
Chairman

Chapter 1

The role of the MFAC

1.1 Introduction

The Malta Fiscal Advisory Council (MFAC) is an independent fiscal institution which was established on 1 January 2015 in terms of the Fiscal Responsibility Act (FRA), 2014. The MFAC is composed of a chairman and two executive members. They are appointed by the Minister for Finance for a period of four years, but their appointment can only be renewed once. The MFAC, at present, is supported by three economists and an administrator. The institution's yearly funding is prescribed by the FRA, which set the initial allocation (that is for 2015) at €250,000 and stipulates that this amount rises annually by the inflation rate, as measured by the Retail Price Index (RPI) published by the National Statistics Office (NSO).

1.2 Main role

The raison d'être of a fiscal council is to foster an appropriate governance framework which is conducive to the promotion of sound fiscal policies. In particular, the MFAC offers assurance about the plausibility of the macroeconomic forecasts and the fiscal projections which are prepared by the Ministry for Finance (MFIN), in April and October each year. These forecasts are included in the Update of Stability Programme (USP) and the Draft Budgetary Plan (DBP), which are two key reports that need to be submitted to the European Commission (COM) in terms of the European Semester as part of Malta's obligations under the Stability and Growth Pact (SGP).

Under EU regulations, the country is required to submit independent macroeconomic forecasts, which means macroeconomic forecasts produced, or endorsed, by independent bodies. In the case of Malta, the second option was adopted. Thus, the FRA specifies that the MFAC is required to endorse, as it considers appropriate, the official macroeconomic forecasts contained in the USP and the DBP. The aim is to safeguard against a biased macroeconomic outlook by the Government, through an independent assessment. Since the macroeconomic forecasts serve as a basis for the preparation of the fiscal projections, particularly revenues, but also to a lesser extent expenditures, the endorsement of the macroeconomic forecasts strengthens the robustness of the fiscal forecasts.

The FRA stipulates a wider mandate for the MFAC compared to that of some European Union (EU) fiscal councils. Indeed the MFAC is also required to assess the fiscal projections

and evaluate whether these lie within its endorsable range. However, whereas the MFAC's endorsement of the macroeconomic forecasts is required ahead of the submission of the USP and the DBP, in the case of the fiscal projections, the assessment is carried out ex-post, that is, after the submission of these documents. The assessment of the fiscal projections involves scrutiny of the major revenue and expenditure categories, which are compiled according to the European System of National and Regional Accounts (ESA) guidelines. Although the mandate of the MFAC does not explicitly request the costing of Government's tax and expenditure initiatives ex-ante, this is done indirectly ex-post, in order to evaluate the plausibility of the estimates provided by the Government.

As part of its regular activities, the MFAC may from time to time, be invited to attend the Public Accounts Committee (PAC), when issues dealing with public finances are discussed. The MFAC also regularly meets with senior officials from foreign institutions such as the COM, the International Monetary Fund (IMF) and credit rating agencies to outline its views on the official macroeconomic outlook and on public finance developments. It also takes part in meetings abroad, particularly those organised by the EU Network of Independent Fiscal Institutions (EUNIFIs) [as a member] and the Organisation for Economic Cooperation and Development (OECD) [as an observer].[1]

> **"The requirement to have a fiscal council in place is a major step towards strengthening national budgetary frameworks. Experience with such independent institutions, although still limited, shows that they can improve budgetary discipline when they monitor governments' compliance with fiscal targets, critically assess the appropriateness of fiscal policy-making and, as an independent voice, provide recommendations on specific fiscal policy questions."**
>
> *Fiscal Councils in EU Countries, ECB Monthly Bulletin, June 2014.*

1.3 The MFAC's approach

With regard to both the macroeconomic forecasts and the fiscal projections, the MFAC does not produce its own forecasts, but rather evaluates their plausibility, within the context of the various risks which may surround the baseline forecast estimates. This is done by examining the consistency with identifiable patterns, information available to date and by comparison to the forecasts published by other institutions, namely the COM and the Central Bank of Malta (CBM). The MFAC carries out regular meetings and keeps close contact with the MFIN, NSO and CBM in order to discuss areas relevant to its mandate. This approach is considered to be very useful to ensure the availability of relevant and comprehensive information, as

[1] For further details refer to Chapter 2 in this Report.

well as to conduct a better evaluation of the assumptions used in the production of the macroeconomic and fiscal projections.

The FRA empowers the MFAC to request information from government departments, local councils and public authorities in order to carry out its duties effectively. So far, the MFAC has considered these provisions as sufficient, and for the time being, did not deem the need to sign any specific Memorandum of Understanding (MOU) with these institutions.

1.4 Fiscal rules

An important portion of the MFAC's work deals with the assessment of compliance with the fiscal rules prescribed in the FRA and in the SGP. The purpose of such rules is to safeguard against an unsustainable fiscal policy. In Europe, fiscal rules were initially outlined in the so called 'Maastricht criteria', which required a country to achieve a fiscal deficit below the reference value of 3% of GDP, together with a debt-to-GDP ratio which is either below 60% of GDP or at least converging to this reference limit at a satisfactory pace.[2] Over time, and in particular, following the lessons learnt as a result of the sovereign debt crisis in the EU, there was a shift towards more comprehensive and detailed fiscal rules particularly for euro area countries. The aim of the so-called 'Six Pack' and 'Two Pack' regulations was to enhance fiscal and macroeconomic surveillance and strengthen budgetary co-ordination, particularly across the euro area.[3]

The current three key rules, termed the 'debt rule', the 'structural effort rule' and the 'expenditure benchmark', are meant to drive public finances towards the country's Medium-Term Objective (MTO). In Malta's case, the Government has set the MTO of attaining a structural balance of 0% of GDP by 2019. This also facilitates the convergence of the debt ratio towards the 60% of GDP threshold according to a stipulated timeframe. Whereas the 'debt rule' and the 'structural effort rule' are directly transposed from the SGP into the FRA, the FRA only makes indirect reference to the 'expenditure benchmark', namely in the eventuality that the country receives a warning from the COM as a result of a significant deviation in the government's budgetary policy. Nevertheless, when carrying out its bi-annual compliance assessments, the MFAC covers all three fiscal rules.

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[2] The Maastricht Treaty launched the Economic and Monetary Union (EMU), among other things. For further details refer to http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3Axy0026.

[3] The 2011 'Six Pack' is a collection of new laws through which the SGP was made more comprehensive and predictable with a major enhancement of the EU's economic governance rules. The 2013 'Two Pack' reinforced economic coordination between Member States and introduced new monitoring tools. For further details, including the legislative text, refer to https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/history-stability-and-growth-pact_en.

1.5 Recommendations

The MFAC makes recommendations throughout the year in the area of public finances. These feature in the various reports which are published during the year and which are also summarised in the MFAC's Annual Report (see Chapter 3 and Chapter 4). The FRA explicitly allows for such recommendations and states that these shall be considered by the Government when preparing and approving its fiscal strategy and the annual budget. The MFAC's recommendations are non-binding. However, the FRA provides that if the Government does not accept an assessment made by the MFAC, in relation to compliance with the budgetary rule (for instance, an MFAC opinion that there is a failure to comply with the budgetary rule due to a significant deviation from the adjustment path towards the MTO), the Finance Minister shall, within two months of the MFAC's opinion, lay before the House of Representatives a statement of the Government's reasons for not accepting such opinion. Other than in the case of such an incident, there is as yet no formal mechanism in place with regard to the 'comply or explain' principle. Nevertheless, the Council views very positively the informal exchange of opinions between the MFIN and the MFAC through periodic bilateral meetings. The MFAC would welcome a systematic arrangement whereby the MFIN's views on the MFAC's recommendations are made public, thereby strengthening further the institutional dialogue and fiscal transparency. The MFAC's recommendations to date have focused on boosting transparency, strengthening the robustness of the budgetary process, improving the conduct of fiscal policy and suggesting legislation with regard to the issuance of state guarantees.

The MFAC performs a very important communications function. Indeed, a fiscal council can improve the sustainability of public finances by increasing transparency and accountability of fiscal policymaking, by providing unbiased information to the public and to stakeholders in the budget process. The MFAC further helps clarify the sophisticated fiscal rules which are in place, thus facilitating the understanding by the public of whether there is compliance or not.

The MFAC identifies possible policy trade-offs, particularly when assessing whether any new measures are likely to comply with fiscal rules or not. Thus, while expansionary measures might at times be desirable to meet certain policy objectives, these should not be to the detriment of full compliance with fiscal rules. Likewise, compliance with fiscal rules should not undermine the efficacy of fiscal policy. At the same time, the MFAC further highlights possible medium-term risks to fiscal sustainability as a result of possible unsustainable revenue or expenditure trajectories. This helps frame the public debate on fiscal issues within an appropriate context, while providing warning signals to the public about whether budgetary targets and rules have been missed or are unlikely to be met in the future.

Fiscal rules and the MFAC serve as complements. On one hand, fiscal rules, which are a relatively new feature within Malta's fiscal governance framework, establish clear benchmarks and public commitments. On the other hand, the MFAC helps build pressure towards compliance with such rules, particularly by its ongoing public reports, assessments and recommendations, as well as through dialogue with stakeholders.

Chapter 2

Activities of the MFAC

2.1 Council meetings

In 2016 the MFAC held eleven formal meetings to discuss administrative and operational issues. In particular, meetings focused on: the annual work programme; financial control; human resources; capacity–building; and planning of official travel and training programmes. From time to time ad-hoc meetings are held to discuss macroeconomic and fiscal issues. The Council also discussed and approved its Bye-Laws and Staff Handbook (see Box 2.1).[4]

Box 2.1: Council Bye-Laws

The Bye-Laws were established by the Council in November 2016 to better guide the activities of the MFAC. The Bye-Laws supplement and are to be interpreted in conjunction with clauses 42 to 61 stipulated under Part V of the FRA.

The Bye-Laws clarify the responsibilities of the Council members. Council members are duty-bound to observe the Council's mandate, the letter and spirit of the FRA, the SGP and other applicable legislation. The general principles regarding code of professional conduct and the formal practice of Council meetings are also outlined. They specify that the Council shall hold a minimum of ten scheduled meetings each year, with additional meetings called as required. The Bye-Laws ascertain the Chairman's and Council members' authority and stipulate that a Council Secretary is to offer general support to the MFAC.

Council members shall maintain integrity, honesty and loyalty in the course of their work and in their relationship with stakeholders, while maintaining confidentiality in respect of all information obtained by virtue of their position. Council members shall also maintain both the actual and perceived political neutrality of the MFAC and be reticent in matters of public or political controversy. The MFAC members shall not use their position on the Council to gain unfair advantage for their personal affair. Council members should strive to achieve economy, efficiency and effectiveness of operations. They should not be involved in financial arrangements, acceptance of gifts or contractual arrangements which might instil conflict of interest or appear to affect their judgement, or use social media in a way that could damage the MFAC's reputation.

[4] The Council Bye-Laws are available on http://mfac.gov.mt/en/Home/Pages/General-Information.aspx.

The Bye-Laws respectively outline the general practices of the Council members as well as the general working conditions of its staff. The MFAC's published reports were also discussed and approved during these meetings.

2.2 Other meetings in Malta

The Council and staff held meetings with various stakeholders during the year. These included public officials and representatives from local and foreign organisations.

2.2.1 Ministry for Finance (MFIN)

Technical meetings were held with the MFIN to discuss and exchange views on the preliminary macroeconomic projections, as well as to help clarify the assumptions used. Other meetings were held to discuss the fiscal projections as presented by the MFIN in the annual USP and DBP documents. Methodologies and practices used in the production of macroeconomic and fiscal forecasts, together with their respective risk assessment were also discussed. Aspects relating to the budgetary process were discussed to enable the MFAC to gain a better understanding of the key budgetary procedures and intra-departmental dependencies. Exchange of opinions about the MFAC's public recommendations also took place during such meetings. Other meetings were held with the advisor to the Minister for Finance who was responsible for carrying out the Comprehensive Spending Reviews (CSRs) in the areas of social benefits, health and education. The objective was to share results and re-iterate the importance that the MFAC assigns to such exercises. From an administrative perspective, meetings with senior MFIN officials were set up to discuss financial aspects of the MFAC's operations and also to get assistance with the updating of the MFAC's website which is expected to be carried out during 2017.

2.2.2 National Statistics Office (NSO)

Discussions with the National Accounts unit within the NSO focused on the analysis of GDP statistics and the revisions which are undertaken between News Releases. Regular dialogue with the Public Finance unit within the NSO was also maintained, particularly in relation to the classification of specific revenue and expenditure items according to the ESA methodologies. A representative from the MFAC was also invited to deliver a presentation and attend the meetings which formed part of Eurostat's Excessive Deficit Procedure (EDP) dialogue visit to Malta which was held on 8-10 June 2016.[5] The NSO also invited the MFAC to start participating in the meetings of the Economic Statistics Development Programme (ESDP) as from 2017,

[5] The final findings are available on: http://ec.europa.eu/eurostat/documents/1015035/7756561/Final-findings-EDP-dialogue-visit-MT-8-10-Jun-2016.pdf

wherein methodological and other technical issues related to the compilation of statistics are regularly discussed by the main stakeholders.

2.2.3 Central Bank of Malta (CBM)

A meeting was held with the Governors and senior officials of the CBM to discuss areas of possible future collaboration and assistance. In turn, during meetings with the Economics and Research Department of the CBM, the fiscal and the macroeconomic forecasts and the methodologies used to compile them were discussed. Differences between the MFIN's and the CBM's projections and methodologies were also explained.

2.2.4 European Commission (COM)

Two meetings were held with the COM during 2016. These were held prior to the publication of the COM's assessment of Malta's USP 2016-2019 and the DBP for 2017. During these meetings, the MFAC outlined its views on the current and projected macroeconomic and fiscal developments.

2.2.5 International Monetary Fund (IMF)

As in previous years, the MFAC was invited to take part in the IMF's Article IV consultation mission. During the meeting the two institutions exchanged views particularly on the Malta's fiscal outlook and budgetary framework.

2.2.6 Credit rating agencies

The MFAC occasionally held meetings with credit rating agencies during their visits to Malta as part of their country rating assessment. During these meetings, the MFAC elaborated on its assessment of the macroeconomic and fiscal outlook, as published in its various reports.

2.3 Public Accounts Committee (PAC)

On 28 June 2016, the MFAC was convened to a meeting of the PAC for a discussion on the Council's 'First Annual Report and Statement of Accounts 2015', in terms of Article 57 of the FRA (see Box 2.2).[6] This was the first time that the MFAC was invited to appear in front of the PAC.

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[6] The agenda documents, minutes, transcript and audit file of the PAC Meeting No.96 of the 12th Legislature are available on: http://www.parlament.mt/sittingdetails?sid=5395&l=1&legcat=13&forcat=4
The full session can also be viewed on a video clip on: http://conference.connectedviews.com/?i=malta-SCPA&session=7881

Box 2.2: Article 57 of the FRA

57. (1) The Chairperson of the Fiscal Council shall, whenever requested in writing by Chairperson of the Public Accounts Committee of the House of Representatives, be required to give evidence to that Committee on:

(a) the regularity and propriety of the transactions recorded or required to be recorded in any account kept under article 56,

(b) the economy and efficiency of the Fiscal Council in the use of its resources,

(c) the systems, procedures and practices employed by the Fiscal Council for the purpose of evaluating the effectiveness of its operations, and

(d) any other matter affecting the Fiscal Council and its operations.

(2) The Chairperson of the Fiscal Council shall, whenever requested to do so, account for the performance of the functions of the Fiscal Council to the Public Accounts Committee of the House of Representatives.

At the meeting, the Chairman of the MFAC delivered a presentation on the first Annual Report, focusing on the establishment of the MFAC, together with the duties and activities carried out during the year. The Chairman outlined the various recommendations made by the MFAC, and also presented the financial statements for the year ended. A discussion among members of the PAC followed, and further clarifications from the MFAC were sought. The PAC Chairman also requested the MFAC to forward a tentative timetable with respect to the yearly publications, in order to co-ordinate better the future appearances of the MFAC before the PAC. It was agreed that each report of the MFAC would henceforth also be forwarded to the PAC.

2.4 International affiliations, meetings and seminars abroad

In order to ensure high quality standards in its deliverables, the MFAC continued to develop further its links with other international fiscal institutions and counterparts abroad. In particular, the MFAC sought to participate more actively in meetings of the EUNIFIs. During the year, eleven separate events were attended by representatives of the MFAC. Of these, four reflected travel as part of the official representation of the MFAC, and seven involved attendances at seminars and training workshops (see Diagram 2.1 and Table 2.1). The MFAC agreed to participate in the Working Group that the EUNIFIs set up to evaluate the Medium Term Budgetary Framework (MTBF) in European countries.

Diagram 2.1: Participation in international events

Source: MFAC

Table 2.1: Travel

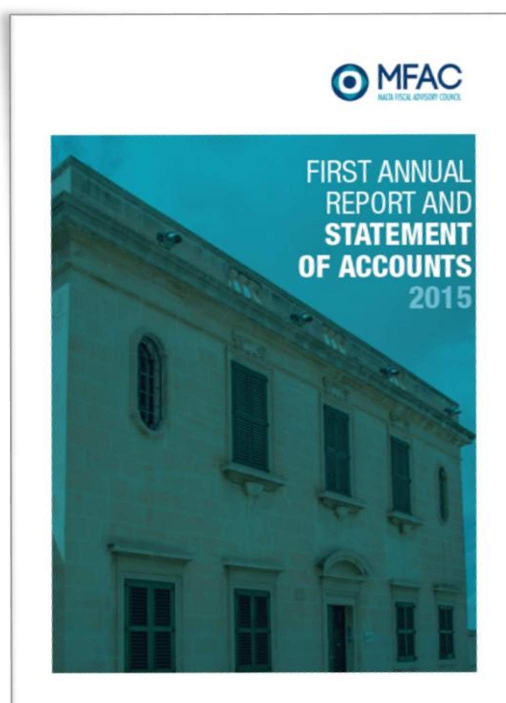
Type of event	Number of events	Number of participants
Official travel	4	6
Training, workshops and seminars	7	13
Total	11	19

Source: MFAC

2.5 Publications

In 2016 the MFAC, at the request of the PAC, established a regular publications timetable.[7] This serves as a template for the expected timing of the MFAC's nine annual publications, which are requested by the FRA. The Council issued its first Annual Report and Statement of Accounts, for 2015, which was its year of establishment. The MFAC then issued three reports on the assessment of the Medium Term Fiscal Strategy (MTFS) of the Maltese Government for 2016-2019. These related to the endorsement of the macroeconomic forecasts, the endorsement of the fiscal forecasts, and an overall assessment in terms of compliance with fiscal rules. The same modus operandi was used for the assessment of the DBP for 2017. Two further reports were issued during the year, which assessed the MFIN's Annual and Half-Yearly Report respectively.

2.5.1 Annual Report



[7] Refer to Appendix B in this Report for the full set of publications and the dates when the MFAC's reports were published.

2.5.2 Endorsement of macroeconomic forecasts

2.5.3 Endorsement of fiscal forecasts

2.5.4 Overall assessment and compliance with fiscal rules

2.5.5 Assessment of the MFIN's Annual Report and Half-Yearly Report

2.6 Public relations of the MFAC

The MFAC also featured several times in local newspapers, following the publication of its press releases. During the year, the MFAC published nine press releases, available in both English and Maltese. These are available on the Council's website (see Diagram 2.2). The press releases were reported and commented upon in both the online and printed versions. There was an improvement in the coverage of the Council's publications compared to the year before.

The Chairman and the Chief Economics Analyst also participated in TV and radio interviews and discussions. The objective is to explain to the public relevant fiscal policy issues and information. During the year the Chief Economics Analyst also delivered presentations to the final year students following the economics degree at the University of Malta (UoM), as well as to the second year business students attending the Malta College of Arts Science and Technology (MCAST). The aim was to familiarise students with the activities of the MFAC, as well as to explain issues relating to the Maltese economy and public finance developments.

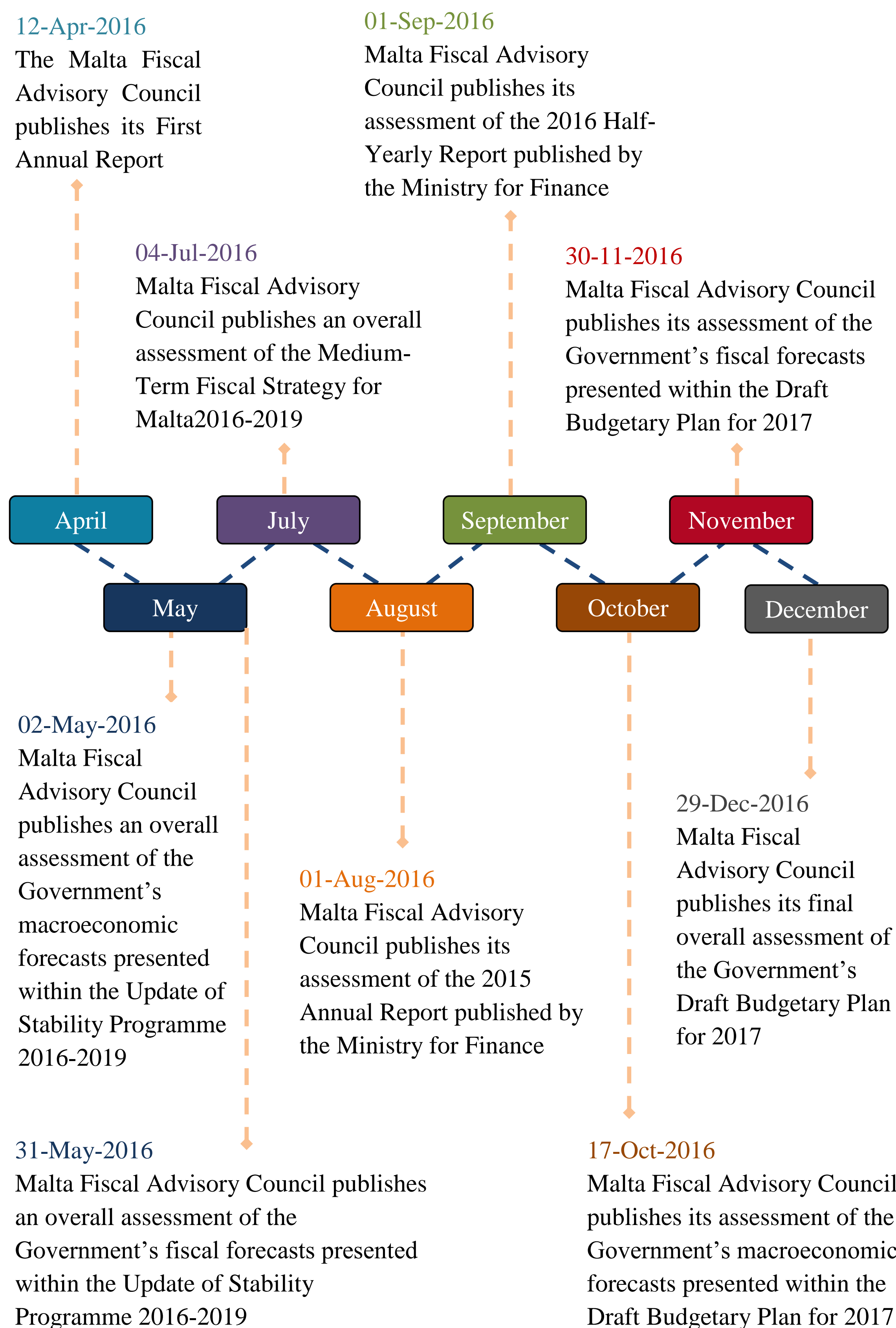
> **"...engagement by national parliaments, national IFIs and all economic agents in each Member State is crucial for implementing a stability-oriented fiscal policy, coupled with efficiency-oriented government expenditure. In doing so, fiscal and budgetary policies should be able to fully deploy their functions of income redistribution and of management of the business cycle in a counter-cyclical manner."**
>
> *José Luis Escrivá, Chair of the Network of EU Independent Fiscal Institutions, Plenary Session of the European Parliament, 31 January 2017.*

2.7 Human resources

During 2016 an administrator and an economics analyst were recruited. This brought the full staff complement of the MFAC of four employees, consisting of three economists and an administrator. Given the available funding and the MFAC's work plan, the Council considers this to be the full staff complement.

The MFAC encourages its staff to pursue further studies in courses deemed relevant to its activities. Indeed, the Council has offered part funding to staff pursuing post-graduate studies in economics and in Maltese studies at the UoM. The MFAC's economists also successfully concluded an online course, organised by the IMF on 'Macroeconomic Forecasting'.

Diagram 2.2: Press releases issued during 2016



Source: MFAC

Chapter 3

Recommendations update - 2015

3.1 Introduction

In its first Annual Report for 2015, the MFAC made a series of interrelated recommendations, dealing with the conduct of fiscal policy, introduction of new legislation, the budgetary process and fiscal transparency. This chapter reviews the progress which the Council considers to have been made in respect of these recommendations, grouped according to the specific area of focus.

3.2 Update on the recommendations dealing with the conduct of fiscal policy

Rationalise expenditure

Partially addressed

Three CSRs have been carried out by the MFIN in recent years, focusing on the three largest cost categories, namely social benefits, health and education. In the case of social benefits, a number of initiatives have resulted in significant cost savings, particularly through stronger enforcement on benefit eligibility and work-for-pay programmes. In the case of the reviews dealing with health and education, the majority of findings still need to be translated into effective action, in order to achieve expenditure savings in these areas.

Advance further in pension reform

Partially addressed

The most recent pension-related reforms focused primarily on income support for lower-earning pensioners, the launch of an education strategy emphasising the importance of saving for old age, and the setting up of savings products related to the Third Pillar. Legislation related to the pensionable age remained unchanged. The Pensions Strategy Working Group continued to carry out reviews of various aspects related to the pension systems in Malta. Options are also being explored in order to incentivise the voluntary development of the Second Pillar.[8]

[8] The Minister for Finance was quoted saying "We want to promote both second pillar and third pillar pension schemes" and "while any such scheme will be voluntary, we will provide employers with fiscal incentives to establish them", during a core group meeting of social partners and representatives from the Malta – EU Steering and Action Committee (MEUSAC). Source:

Extend further the average maturity of public debt

Fully addressed

The weighted average maturity of Malta Government Stocks (MGS) increased from 8.6 years at the end of 2014, to 8.7 years at the end of 2015.[9] Further lengthening of the MGS maturity profile was registered in 2016 since the bulk of the new issues during the year mature between 2036 and 2041. These bonds have a maturity ranging between twenty and twenty-five years, which is higher than the current average debt maturity.[10] As a result, the average maturity of MGS increased rather significantly, to 9.8 years as at the end of 2016. Given the current low cost of servicing public debt, this can generate important cost savings in the longer term. Indeed, the COM reported that the interest rate savings were estimated to have contributed to 0.4% of GDP to the country's overall structural effort over 2012 – 2015.[11]

Table 3.1: Maturity of new MGS issued during 2016 (EUR million)

	MGS maturing in			
Issue	**2022**	**2036**	**2039**	**2041**
February	3.0	196.7		
April	55.0	25.0		
August	5.3			153.7
October	0.1		159.1	
Total	**63.4**	**221.7**	**159.1**	**153.7**

Source: MFIN

Use revenue windfalls primarily to build fiscal buffers

Fully addressed

The fiscal deficit for 2016 was initially targeted at €102.0 million in the DBP for 2016. However, the revenue forecasts contained in the USP 2016 – 2019 and the DBP for 2017 were higher than in the original projections.[12] On this basis, the latest official target for the 2016 fiscal deficit (included in the DBP for 2017) was set at €67.0 million. This is a more ambitious target than what was indicated a year earlier and fully in line with the

http://www.maltatoday.com.mt/news/national/63567/government_plans_voluntary_second_pillar_pension_scheme.

[9] Source: http://treasury.gov.mt/en/Documents/Debt_Management_Directorate/Annual_Report/DMD-Annual_Report_2015.pdf.

[10] Source: http://treasury.gov.mt/en/Pages/Library/Publications/Malta_Government_Stocks/Issuance_Results.aspx.

[11] Source: Country Report Malta 2017, Commission Staff Working Document.

[12] The target revenue ratio for 2016 was initially set at 40.1% of GDP in the DBP published in October 2015 but this was raised to 40.3% of GDP in the DBP published in October 2016, notwithstanding the higher level of GDP in absolute terms, in the more recent document.

recommendation made by the MFAC to channel revenue windfalls primarily towards a faster decline in the deficit.[13] This was achieved despite the amount of expenditure undertaken in 2016 was higher than originally indicated in the DBP for 2016.

Use IIP funds cautiously

Fully addressed

Between the launch of the Individual Investor Programme (IIP) [through Legal Notice 47 of 2014 published on 4 February 2014] and 30 June 2016, €54.9 million were distributed by Identity Malta Agency to the National Development and Social Fund (NDSF).[14] Such transfers do not impact the fiscal balance, since both Identity Malta Agency and the NDSF form part of General Government according to the ESA framework. The way in which the NDSF can utilise such funds is prescribed in subsidiary legislation, which lists the contribution to projects of national importance, better public services and research and development among others.[15] During 2016, the NDSF Board of Governors was putting in place the necessary infrastructure to get the Fund going. As a result, the funds were unutilised during 2016, contributing fully to the reduction in the fiscal deficit. It is important that when such funds are eventually utilised, they are either used to fund activities such as investment in financial assets which do not impact the fiscal balance, or else fund expenditures which contribute clear positive value added without endangering fiscal sustainability. The remaining funds collected through the IIP, financed the Government's recurrent expenditure as well as the commissions due to the authorised agents.

Consider a buffer over the minimum structural effort required

Fully addressed

The structural effort planned by the MFIN is estimated after having imputed as expenditure the 0.1% of GDP yearly allocation to the Contingency Reserve. Thus, whenever there is no recourse to the Contingency Reserve, as was the case in 2016, the structural effort would increase by the unutilised funds. This approach fully addresses the recommendation made by the MFAC. It is important that the gradual building up of a prudential fiscal buffer is sustained.

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[13] Owing to the MFIN's practice of opting for rather conservative revenue forecasts, not all revenues above target are strictly speaking windfall revenues, but rather evidence that the initial published revenue forecasts were indeed very prudent.

[14] Source: Third Annual Report on the Individual Investor Programme of the Government of Malta.

[15] Refer to National Development and Social Fund (Establishment as an Agency) order, Legal Notice 2 of 2015, Article 4.

Replenish the Contingency Reserve and establish clear policies on its use

Partially addressed

The 2017 Financial Estimates indicate that for 2016, €9.0 million were allocated for the Contingency Reserve, while for 2017 an allocation of €9.8 million was made.[16] These amounts correspond to the 0.1% of GDP allocation prescribed by the FRA. During 2016, no recourse to the Contingency Reserve was made, thus implying that the Contingency Reserve was notionally replenished to €18.8 million. However, apart from what is specified in the FRA, namely that 'drawdown from the Contingency Reserve shall only be made in urgent, temporary and unforeseen circumstances following a proposal from the Ministry for Finance and with the approval of the Prime Minister', no additional operational guidelines dealing with the possible recourse to the Contingency Reserve have been published so far. The publication of such guidelines would better ensure that recourse to the Contingency Reserve is more transparent and resorted to only in extraordinary circumstances.

Appraise the current system of property-related taxes

Partially addressed

The budget for 2017 featured some amendments to the property-related taxes, such as tax incentives for restoration works in urban conservation areas, and a one-time reduction in the stamp duty on property bought in Gozo. These initiatives can help maintain the supply of housing, while balancing the demand across different geographical areas. Such initiatives are in line with the MFAC's recommendation to fine-tune property related taxes. Further improvements can be explored particularly to ensure more stable property-related tax revenues by reducing the dependence on market transactions, which may be unstable over time, and also address issues of long-term vacant properties which represent unutilised capital and also create negative externalities.

Allocate more resources towards attaining Europe 2020 targets[17]

Partially addressed

In some areas, particularly the labour market, the national target has already been achieved. In other areas, particularly those related to the targets for the proportion of early school leaving, investment in Research and Development (R&D) as a percentage of GDP and the environment objectives, progress towards the attainment of the Europe 2020 targets is proving more challenging.[18] Indeed, on the basis of 2014 data, Malta fell behind in terms of the greenhouse gas emissions, use of

[16] The allocation is made under Vote 5782 of the Financial Estimates.
[17] Europe 2020 is a ten-year strategy proposed by the COM for advancement of the economy of the EU. It aims at 'smart, sustainable, inclusive growth' with greater coordination of national and European policy.
[18] For the current state of play refer to http://ec.europa.eu/europe2020/europe-2020-in-your-country/malta/progress-towards-2020-targets/index_en.htm.

renewable energy and in terms of energy efficiency.[19] While the MFAC acknowledges that a number of environmental initiatives are in place, these may need to be supplemented to accelerate convergence towards the specified targets. Attaining these targets would generate welfare improvement to the population.

3.3 Update on the recommendations dealing with legislation

New legislation on the issuing of government guarantees

Partially addressed

The Authorities took note of this recommendation. Indeed, the Government is actively considering establishing a stronger governance system and more specific controls in relation to the award of state guarantees, as part of an overhaul in the legislation related to Government borrowing and the management of the public debt. This is considered beneficial in the long term, particularly when taking note of the fact that the amount of outstanding guarantees remains rather high when compared to other EU Members States.[20] Although guarantees are useful to attract Foreign Direct Investment (FDI) and to entice additional bank credit for fixed capital formation, they also represent a contingent liability for the Government which if not appropriately controlled could potentially give rise to significant concerns regarding long term fiscal sustainability.

3.4 Update on the recommendations dealing with the budgetary process

Ensure full consistency between the macro and fiscal forecasts

Fully addressed

Macroeconomic and fiscal forecasts are interdependent. The MFIN made good progress in ensuring that macroeconomic and fiscal forecasts are, to the extent possible, fully consistent. The MFAC considers the achieved level of consistency as acceptable. The macroeconomic forecasts adequately take into consideration the fiscal plans underpinning the USP and the DBP, while the fiscal projections are based on the expected macroeconomic conditions, particularly in terms of prudent tax base developments. There is a trade-off between achieving further synchronisation, with the need to finalise the macroeconomic forecasts with sufficient lead time to make them available to the MFAC ahead of the submission deadlines, for endorsement purposes.

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[19] Source: Trends and projections in Europe 2016 – Tracking progress towards Europe's climate and energy targets, published by the European Environment Agency (EEA) available on: http://www.eea.europa.eu/publications/trends-and-projections-in-europe.

[20] Refer to Chapter 6 in this Report for further details.

Ensure close synergy across government departments and entities

Partially addressed

In order to prepare the fiscal projections, the MFIN requires the expert input by the various line ministries. This approach strengthens the robustness of the forecasts. It is important that the necessary inputs are provided with sufficient lead time and in reasonable detail. This is necessary to ensure sufficient time for the finalisation of such forecasts, and also the availability of supporting explanations to justify the plausibility of the different budget components being forecasted. The MFAC believes that further co-ordination can enable the MFIN to finalise the relevant forecasts slightly earlier than the current practices, in order to provide reasonable lead time to the MFAC to carry out its assessment.

Coincide budgetary planning with the requirements of the European Semester

Partially addressed

The European Semester requires that the USP is submitted annually by 30 April and the DBP is submitted annually by 15 October. The macroeconomic forecasts contained in these two reports must also be endorsed by the MFAC before being transmitted to the COM. The current practices are resulting in a situation where the budget speech document, which underpins the DBP is being finalised very close to the 15 October deadline. In order to ensure a smoother process, it may be opportune to initiate budget discussions earlier to allow more time for the finalisation of the DBP. This issue does not seem to be applicable in the case of the USP, which is generally prepared with reasonable lead time, since this document involves fewer discussions and negotiations than in the case of the DBP.

Monitor regularly the output gap developments and its implications

Partially addressed

Compliance with the fiscal rules stated in the FRA and the SGP relies on output gap estimates. In the case of Malta, such estimates have tended to be rather volatile, in recent years. It is important to maintain adequate surveillance in this area, and be ready to act when available information suggests that updated output gap estimates could have implications of whether the rules are likely to be respected or not.[21] While the MFIN's surveillance of output gap conditions is regular, it appears that the current framework falls short of ensuring that the headline fiscal targets are equally responsive to changes in the output gap conditions. Indeed, revisions in the output gap estimates have at times resulted in the actual structural effort undertaken falling short of the initial plans.

[21] To ensure less susceptibility to latest changes, the output gap estimates are frozen ahead, thereby ensuring that policy makers have sufficient time to adopt the necessary policies.

> **"Fiscal councils can increase transparency of fiscal policymaking, for instance by discussing policy trade-offs, emphasizing a longer-term perspective and highlighting risks to fiscal sustainability. In particular, they can provide warning signals to the public if budgetary targets have been missed or are unlikely to be met in the future. In doing so, fiscal councils can help to foster greater transparency around fiscal policy, increase accountability and thereby compliance."**
>
> *Wruck et al (2016), Better Budgeting in Europe, What can Fiscal Councils contribute?, Deutsche Bank Research.*

3.5 Update on the recommendations dealing with transparency

Provide greater detail in the official publications

Partially addressed

The MFAC views positively that the amount of detail included in the MFIN's publications has been increasing over time. Economic commentaries have become more exhaustive and with robust supporting information. In particular, the MFIN maintains very good supporting documentation relating to investment projects planned and underway. The MFAC considers that there is further room for improvement in certain aspects, particularly through offering a broader assessment of fiscal risks, and better identification of key assumptions. This would ensure that the general public and analysts can assess better the conduct of fiscal policy and the challenges being faced, while obtaining a better insight into the factors contributing to the improvement in the headline and structural fiscal balances.

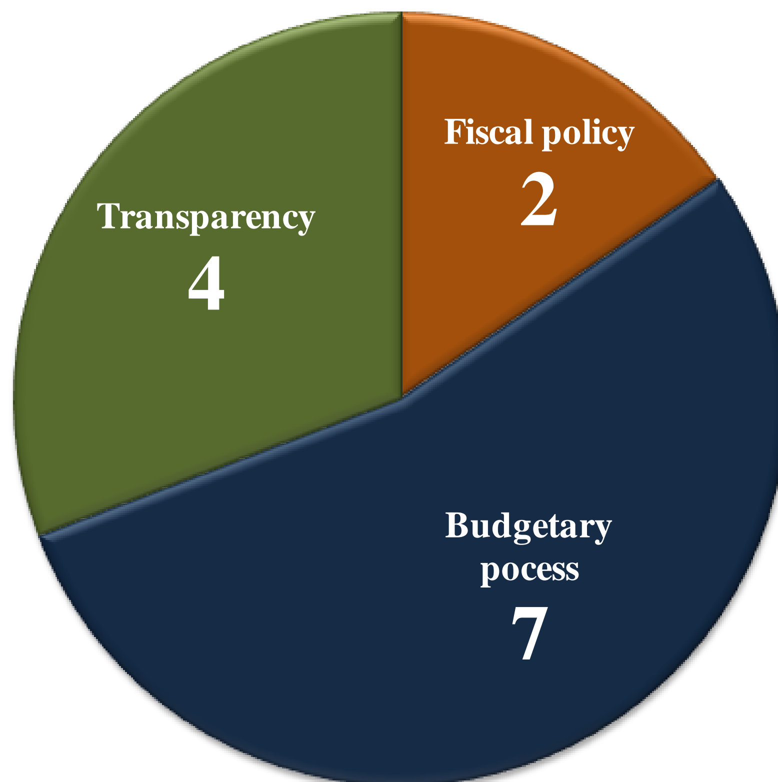
Chapter 4

New recommendations in 2016

4.1 Introduction

Apart from restating a number of recommendations that had already been outlined in the 2015 Annual Report, the MFAC made 13 new recommendations in 2016 (see Chart 4.1). The recommendations focused again on the conduct of fiscal policy (2 recommendations); improving the budgetary process (7 recommendations); and enhancing fiscal transparency (4 recommendations). No proposal for new legislation was made in 2016. This chapter provides an explanation and the rationale for each recommendation (grouped according to the particular category).[22]

Chart 4.1: New recommendations by type and number of recommendations



Source: MFAC

[22] Refer to Appendix A for the full list of recommendations included in the MFAC's published reports.

4.2 Recommendations dealing with the conduct of fiscal policy

4.2.1 Safeguard the efficacy of fiscal policy

The overriding thrust of Malta's fiscal strategy is to converge towards the MTO of a balanced budget in structural terms by 2019. This can be achieved through additional revenue measures, expenditure rationalisation or a combination of both. The specific policy mix may vary from time to time. However, it is important that consolidation does not focus too narrowly on the yearly improvement in the fiscal balance as this could limit the efficacy of fiscal policy. In particular, the improvement in public finances, and compliance with fiscal rules must simultaneously safeguard other important policy objectives, such as addressing income distribution in order to minimise the risk of poverty, and ensuring that sufficient resources are available for merit goods, such as healthcare and education. A fair income distribution helps contain social problems. An ageing population inevitably increases the demand for health services and old care facilities. Furthermore, the need to improve human capital necessitates adequate financial resources. It is essential that budgetary discipline and fiscal consolidation measures are complemented by growth-friendly strategies that are supportive of sustainable socio-economic development.

4.2.2 Evaluate the economic efficiency of the tax framework

In the public finance literature, there are five main accepted properties of a good tax system (see Table 4.1). It is important that the country's tax framework is periodically evaluated against these desirable properties. This approach is useful to minimise any possible unintended and negative consequences stemming from taxation. Whenever a particular tax does not meet these criteria, there is scope for fine-tuning or revising the system. The optimality or otherwise of a particular tax may change over time, as economic circumstances change, and thus occasional reviews of the various taxes is considered useful.

Table 4.1: Desirable characteristics of any tax system

Properties	Explanation
Economic efficiency	The tax system should not interfere with the efficient allocation of resources.
Administrative simplicity	The tax system ought to be easy and relatively inexpensive to administer. Good tax systems rely on self-compliance, so the system should be designed to make compliance easy and voluntary.
Flexibility	The tax system ought to be able to respond easily, in some cases, automatically, to changed economic circumstances.
Transparent political responsibility	The tax system should be designed so that individuals can ascertain what they are paying, and evaluate how accurately the system reflects their preferences.
Fairness	The tax system ought to be fair in its relative treatment of different individuals.

Source: Reproduced from Stiglitz J.E. and Rosengard J.K. (2015), Economics of the Public Sector, fourth edition, W.W. Norton Company, Inc., USA.

4.3 Recommendations dealing with the budgetary process

4.3.1 Focus greater attention on developments in the structural balance

The headline fiscal balance can be distorted by the effects of the economic cycle and temporary and one-off effects. To overcome these problems, the structural balance corrects for the output gap conditions, and removes temporary effects and one-off measures. Hence, the structural balance indicates more accurately the underlying developments in public finances, and is therefore more relevant from a policy-making perspective. Furthermore, the requirements specified in the FRA and the SGP are spelled out in terms of the structural balance rather than the headline fiscal balance. For these two reasons, it is necessary that the surveillance carried out by the MFIN of developments in the structural balance is assigned more importance, at least equivalent to the attention and importance given to the headline fiscal targets. Moreover, the MFAC considers important that the MFIN carries out an explicit type of plausibility assessment with respect to the forecasts for potential GDP growth and the output gap. This is important to better evaluate the robustness and identify any potential bias which may surround these key variables.

4.3.2 Ensure feasibility of expenditure restraint targets

Expenditure restraint is desirable as it permits more growth-friendly fiscal consolidation, by reducing the need for additional taxes. Nevertheless, it is important that expenditure restraint targets are not over-ambitious, with the result that they would frequently need to be revised at a later stage. Expenditure restraint is more likely to be durable if it takes the form of permanent efficiency gains, as can be obtained on the basis of the recommendations of the various CSRs, rather than merely deferral of expenditures. Over ambitious expenditure limits may understate the underlying challenges necessary to meet such tight constraints and may end up being fully reversed in the medium term.

4.3.3 Address revenue arrears more strongly

Revenue arrears arise when taxes are not collected within the stipulated timeframe. As long as these revenues have been established with reasonable confidence and they are judged to be collectable, such arrears are considered as part of the yearly fiscal revenues on an ESA basis, and feature as part of the accrual adjustments. However, such arrears must be kept as low as possible, since higher outstanding balances may eventually undermine their collectability. Furthermore, the delayed payments mean that the revenue shortfall would have to be covered through the issuance of public debt, with the associated cost of servicing such debt. The current buoyant economic conditions and exceptionally low interest rates are likely to have improved business cash flow conditions and thus offer a good opportunity for the settling of arrears.

4.3.4 Establish clear guidelines on cash holdings

The objective of public debt management is to ensure that the yearly borrowing requirements by the Government are met in a cost effective manner and in line with prudent risk management practices. In turn, active treasury management ensures that funds are always available to meet payments when due. The daily fluctuations of government receipts and payments require a financial buffer, which can be in the form of cash deposits with financial institutions or with the CBM. The opportunity cost of holding such buffers amounts to the interest expense on debt instruments, namely Treasury Bills (TB) and MGS. The desirability of envisaging positive stock-flow adjustments throughout the forecast horizon, by raising the absolute value of debt beyond the yearly fiscal deficit can be re-appraised.[23] The current extraordinary monetary conditions across the whole euro area are enabling the MFIN to issue TBs at a premium, implying negative yields, potentially downplaying the need for proper guidelines at the current juncture.

[23] For an overview of stock-flow adjustments refer to Box 2 in the MFAC report "An overall assessment of the Draft Budgetary Plan 2016".

4.3.5 Ensure technical issues are adequately addressed before announcing changes to tax or expenditure policies

Changes to the tax system or expenditure programmes generally involve operational and legal issues which at times could be rather complex. Therefore, it is important that such issues are adequately tackled ahead of the planned changes. This would ensure a seamless and timely implementation. Otherwise, there exists the risk that delays would be necessary, to clarify and resolve possible areas of uncertainty. For example, in 2016 the introduction of an environmental contribution to be paid by tourists was postponed by some months to clarify some issues, leading to a downward adjustment in the revenue estimate for the year. In turn, this could result in missing out on the announced targets for that specific revenue or expenditure item. Lack of clarity could also have negative effects on economic activities and on compliance.

4.3.6 Maintain close monitoring and control on EBU's activities which have fiscal implications

Extra-Budgetary Units (EBUs) form part of general government according to the ESA methodology.[24] Their operations are funded through transfers from the Consolidated Fund. EBUs may also be able to borrow on their behalf to cover any funding shortfalls, provided they seek prior approval from the MFIN. Although the operations of most EBUs are small in relation to the Government's activities, some EBUs play a much more significant role. Close monitoring of the EBUs activities requires that the expenditure allocations budgeted for these institutions do indeed cover the normal and planned operations of these institutions, without the need for subsequent supplementary allocations. At the same time, it is important to monitor closely the performance of EBUs against targets and to limit any shortfalls which are incurred by these institutions, as this could impact the Government's annual fiscal balance.

4.3.7 Use consistent definitions and methodologies across forecast rounds

An important exercise in the assessment of macroeconomic and fiscal forecasts is the comparison of revisions undertaken between one round and another, as well as the comparison between forecasts and the actual turnout. In order to make the analysis more meaningful and robust, it is important that, as much as possible, the definitions and methodologies used by the MFIN in the USP and the DBP are consistent across rounds.[25] Such departures from previous methodologies should be clearly explained and the impact resulting from such revisions clearly identified.

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[24] The list of EBUs does not include entities which are already accounted for within the Departmental Accounting System (DAS) of Central Government.

[25] For example, in 2016 the MFIN used different definitions for employment in the USP and the DBP resulting in differences in the measurement of labour productivity and unit labour costs, and also changed the assumptions related to the forecasting of inventories in GDP.

4.4 Recommendations dealing with transparency issues

4.4.1 Elaborate more on fiscal risks

Baseline fiscal projections present likely and plausible trajectories for the fiscal deficit and debt ratios. Such projections are conditional on the assumptions used. Deviations from these assumptions may result in alternative trajectories, which can be either more positive, or more negative, depending on the nature of the shock. In this respect, it is useful to clarify better the extent of uncertainty surrounding the fiscal projections, by quantifying how each macro scenario which can potentially materialise would impact on the baseline forecasts. In this respect, it is also useful if the scenarios considered by the MFIN are more exhaustive, to cover more fiscal risk scenarios, rather than focusing only on those risks emanating from macroeconomic conditions. It is also prudent if even those risks which rank rather low in terms of their probability of materialising are presented so as to enhance the comprehensiveness of the risk assessment exercise.

"Better fiscal risk management can help make the public finances more robust. The experience of recent years has underscored the need to better understand the size and nature of these risks and their implications. Being better aware of fiscal risks can allow governments to put in place policies to budget for these more carefully and to take steps, where appropriate, to limit their exposure to shocks. Better understanding of fiscal risks, greater transparency, and effective risk management practices can also help underpin credibility and market confidence."

IMF *(2016), Analyzing and Managing Fiscal Risks – Best Practices.*

4.4.2 Provide updates on the performance of fiscal measures announced in the budget

The magnitude of new fiscal measures is provisionally estimated on the basis of the information available within the various ministries. However, the actual revenue intake or spending may vary from the original estimates. In this respect, while the Half-Yearly Report published by the MFIN in July provides an intra-year insight on developments regarding the main revenue and expenditure line items, it is also useful to measure progress intra-year about the effects of the announced measures, and make such information public. This would help clarify better the progress achieved, and the possible implications with respect to the achievement of the annual fiscal targets.

4.4.3 Focus more attention on the expenditure benchmark outlined in the SGP

The expenditure benchmark is only indirectly referred to in the FRA.[26] As a result, reference to the expenditure benchmark is only sporadic in the MFIN's publications. However, the expenditure benchmark plays an important role in the SGP, and is anticipated to assume even greater importance in the near future.[27] In this respect, it would be useful to provide more information to enable analysts to better evaluate the extent to which fiscal plans safeguard compliance with the expenditure benchmark. It would also help stakeholders become more aware about this fiscal rule.

4.4.4 Consider reacting publicly to the recommendations made by the MFAC

One of MFAC's roles is to make public recommendations in the area of public finances. Likewise, the MFAC considers beneficial if the MFIN also makes public its reactions to such recommendations. This would ensure a more transparent and regular dialogue among the parties. In turn, this would promote better understanding by the stakeholders and the public at large about the conduct of fiscal policy, and the implications of the proposals being suggested.

[26] Refer to Chapter 1 in this Report for further details.
[27] Refer to Chapter 7 in this Report for further details.

Special Features

Chapter 5

Public finances in Malta and the euro area

5.1 Introduction

This chapter compares public finance developments in Malta with those in the 19 euro area countries (EA-19) over the period 2004 to 2015 based on ESA 2010 methodology.[28,29] These years cover the period since Malta joined the EU up to the latest available data for the full set of 19 countries. The high-level comparison identifies the similarities and differences relating to the conduct of fiscal policy. The analysis covers the yearly fiscal and outstanding debt balances, as well as the developments and composition of fiscal revenues and expenditures. This analysis helps identify areas where policy changes might be worth exploring and also areas of possible strengths and weaknesses in the conduct of fiscal policy in Malta. At the same time, the differences between Malta and the euro area may be entirely the result of historic developments and country preferences. Membership in the euro area does not imply harmonisation in the conduct of fiscal policy.

5.2 Macro-fiscal situation

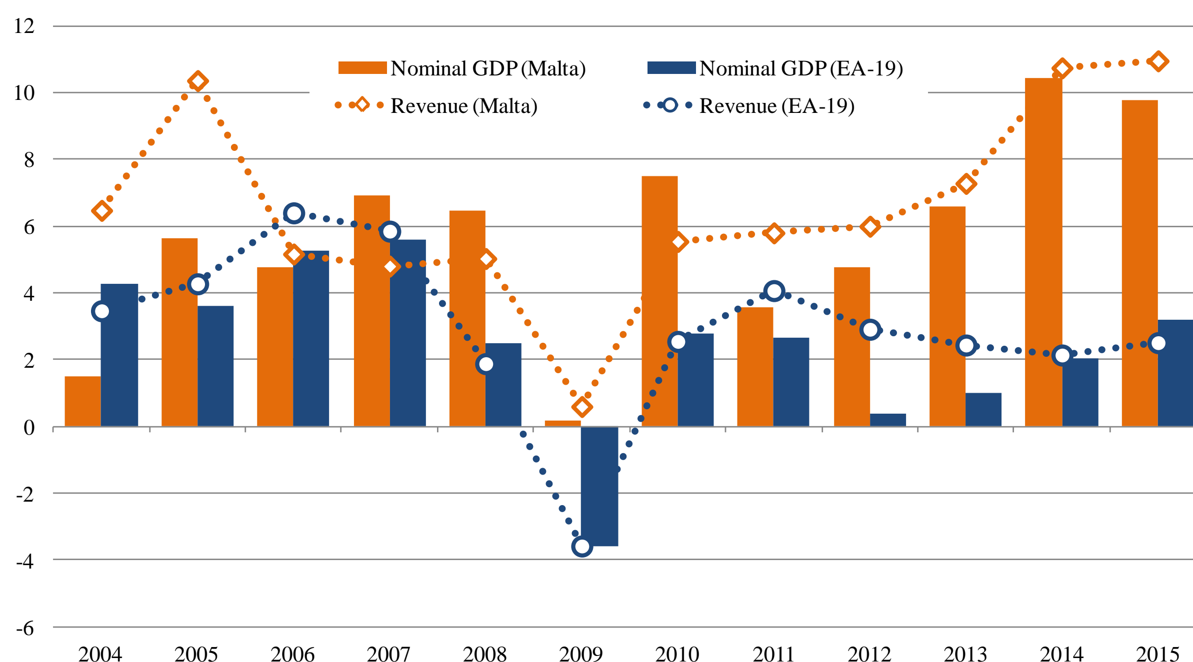
Nominal macroeconomic developments impact public finances as they drive tax bases, and hence tax revenues. The nominal macroeconomic developments underpinning the economy's business cycle implicitly also affect the economy's fiscal stance. They may also influence certain elements of government expenditure, particularly outlays on unemployment benefits. Therefore, macroeconomic developments provide useful background to help understand the observed fiscal outturn in a country. Indeed, standard economic theory suggests that fiscal policy should be counter-cyclical, that is, expansionary in times of recessions and contractionary in times of booms, thereby dampening business cycle fluctuations.

[28] Since the launch of the euro, the number of countries which adopted the euro as their currency increased to 19 [Austria; Belgium; Cyprus; Estonia; Finland; France; Germany; Greece; Ireland; Italy; Latvia; Lithuania; Luxembourg; Malta; The Netherlands; Portugal; Slovakia; Slovenia and Spain]. The euro area developments analysed in this chapter reflect 'unchanged composition', that is, the 19 countries are included for the whole period, even though some countries, including Malta joined after 2004.

[29] The ESA 2010 methodology ensures meaningful cross-country comparisons. For background information about ESA 2010 refer to http://ec.europa.eu/eurostat/web/esa-2010.

During the period under review, nominal GDP growth in Malta was almost always higher than the average rate in the euro area (see Chart 5.1). The gap actually widened in the more recent years, as nominal GDP growth in Malta accelerated while that in the euro area tended to decelerate. Correspondingly, government revenue growth in Malta generally exceeded that in euro area. The positive correlation between nominal GDP growth and revenues is quite high for Malta, at 0.71, albeit not as high as that of 0.91 for the euro area. These figures confirm that GDP developments matter significantly for government revenues, though in the case of Malta the strength of the relationship is slightly less strong than in the euro area, suggesting that factors apart from GDP also play an important role for determining overall government revenue in Malta.[30]

Chart 5.1: GDP and revenue developments (year-on-year percentage growth rates)

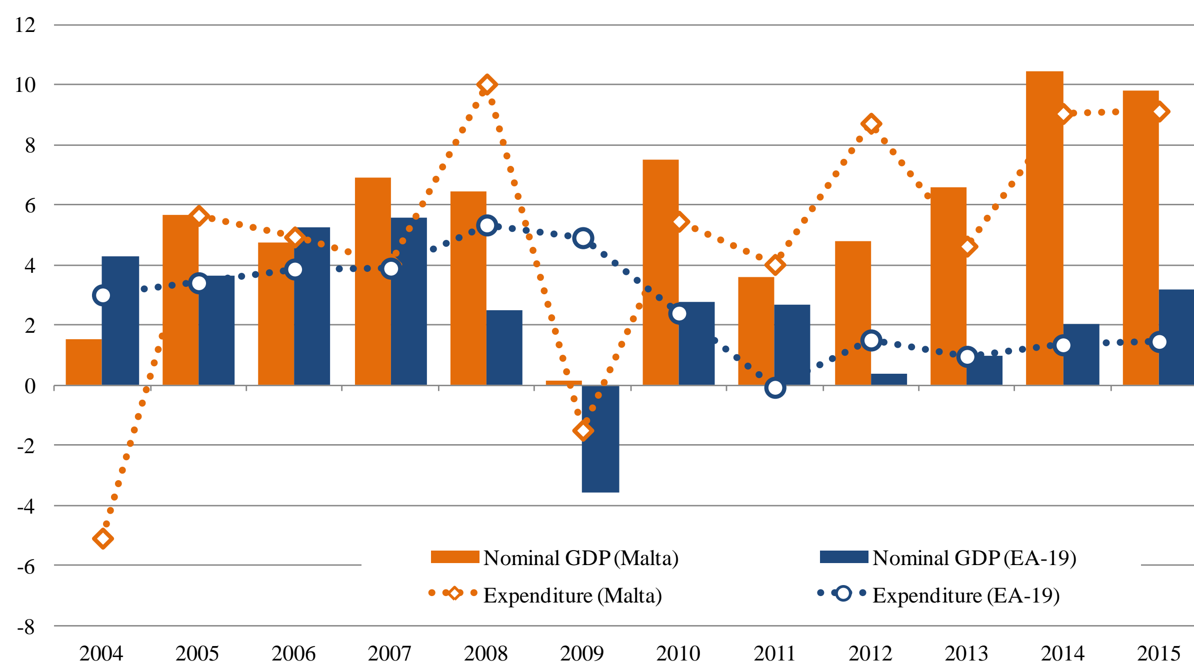


Source: Eurostat

Likewise, government expenditure growth in Malta was in most years faster than in the euro area (see Chart 5.2). It also exhibited more fluctuations, particularly when compared to the expenditure growth pattern for the euro area. Euro area expenditure growth was higher throughout the first half of the period and markedly slower in the second half. Conversely, expenditure growth in Malta tended to be faster in the second half of the period in relation to the first half. Another difference between Malta and the euro area relates to the fact that whereas the correlation between nominal GDP growth and expenditure growth in Malta was high, at 0.78, in the case of the euro area, this was marginally negative, at -0.02. This would suggest that in Malta, government expenditure has contributed positively to economic growth, as periods of higher government expenditure growth were generally associated with periods of higher nominal GDP growth.

[30] For example certain Special Purposes Entities (SPE) contribute to tax revenues but their profits are not included in the measurement of GDP. Varying tax collection efficiency across the years could also weaken the link between the year's GDP and tax revenue collected.

Chart 5.2: GDP and expenditure developments (year-on-year growth rates)



Source: Eurostat

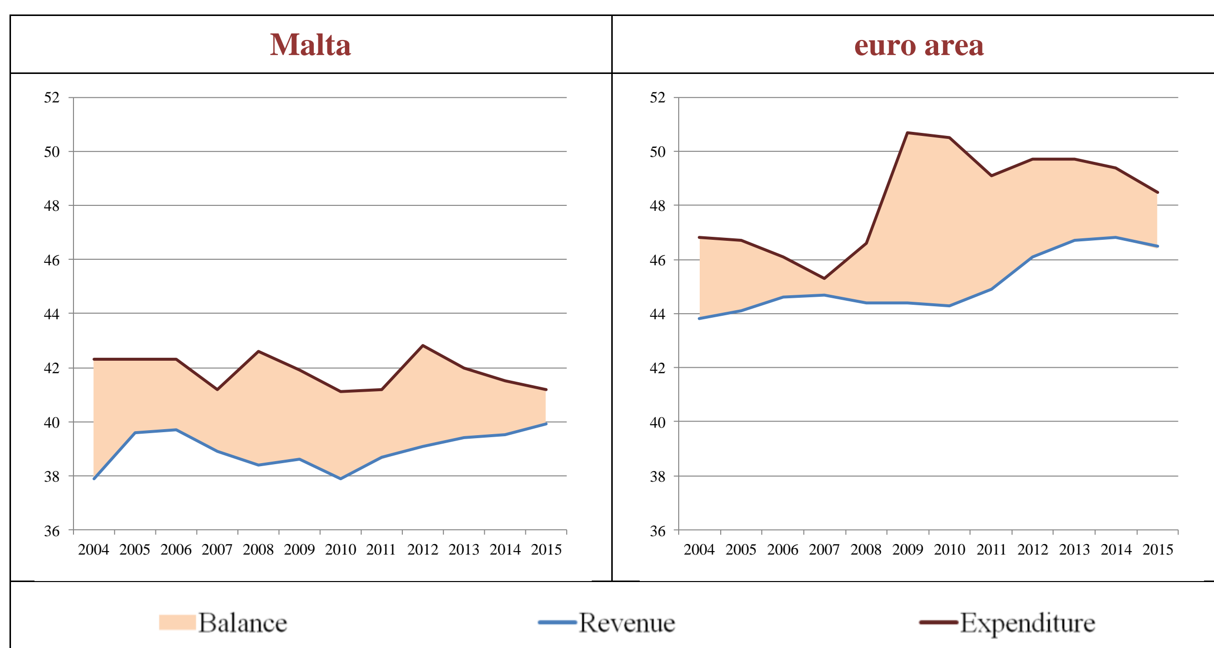
5.3 Revenue, expenditure and balance ratios

When expressed as percentage of GDP, both revenue and expenditure ratios were lower in Malta than in the euro area, throughout the whole period (see Chart 5.3). In Malta, both the revenue and expenditure ratios moved along a rather narrow range. Between 2004 and 2015, the average revenue-to-GDP ratio in Malta was 39.0% while the average expenditure-to-GDP ratio stood at 41.9%. The corresponding average revenue and expenditure ratios for the euro area were respectively 45.1% and 48.3%. These figures portray a structural difference between Malta and the euro area in terms of the extent of state intervention in the economy. The amount of services and outlays by the state across the euro area are higher than in Malta (as indicated by the higher expenditure ratio), which in turn requires higher government revenues (as indicated by the higher revenue ratio).

Indeed, the tax burden in Malta was also lower than that in the euro area, despite having increased by 1.7 percentage points (pp) between 2005 and 2015.[31] Thus, the tax burden in Malta rose from 33.0% in 2005 to 34.7% in 2015 and a similar increase was recorded in the euro area, whose tax-to-GDP ratio rose from 39.5% in 2004 to 41.4% in 2015 (see Table 5.1). Tax-to-GDP ratios varied widely within the euro area, with the highest in 2015 being 47.9% in France and the lowest 24.4% in Ireland. Malta had the eighth lowest rate within the euro area.

[31] The tax (fiscal) burden covers the categories direct taxes (D.5), indirect taxes (D.2), social contributions (D.61) and capital taxes (D.91). ESA codes are in brackets.

Chart 5.3: Revenue, expenditure and balance ratios (% of GDP)



Source: Eurostat

Table 5.1: Tax-to-GDP ratios (%)

	2005	2010	2015
Malta	33.0	32.5	34.7
euro area	39.5	39.2	41.4

Source: Eurostat News Release 234/2016

Since 2012, Malta's fiscal deficit narrowed, driven by a gradual rise in the revenue-to-GDP ratio and a decline in the expenditure-to-GDP ratio. The euro area fiscal deficit also fell, particularly when compared to the substantial widening which took place in 2009 as a result of the international financial crisis. Indeed, the financial crisis had caused a spike in the euro area expenditure ratio of 4.1 pp, whilst the revenue ratio remained rather stable. At 1.3% of GDP, Malta's 2015 fiscal deficit was the sixth lowest when compared to the other euro area countries.[32]

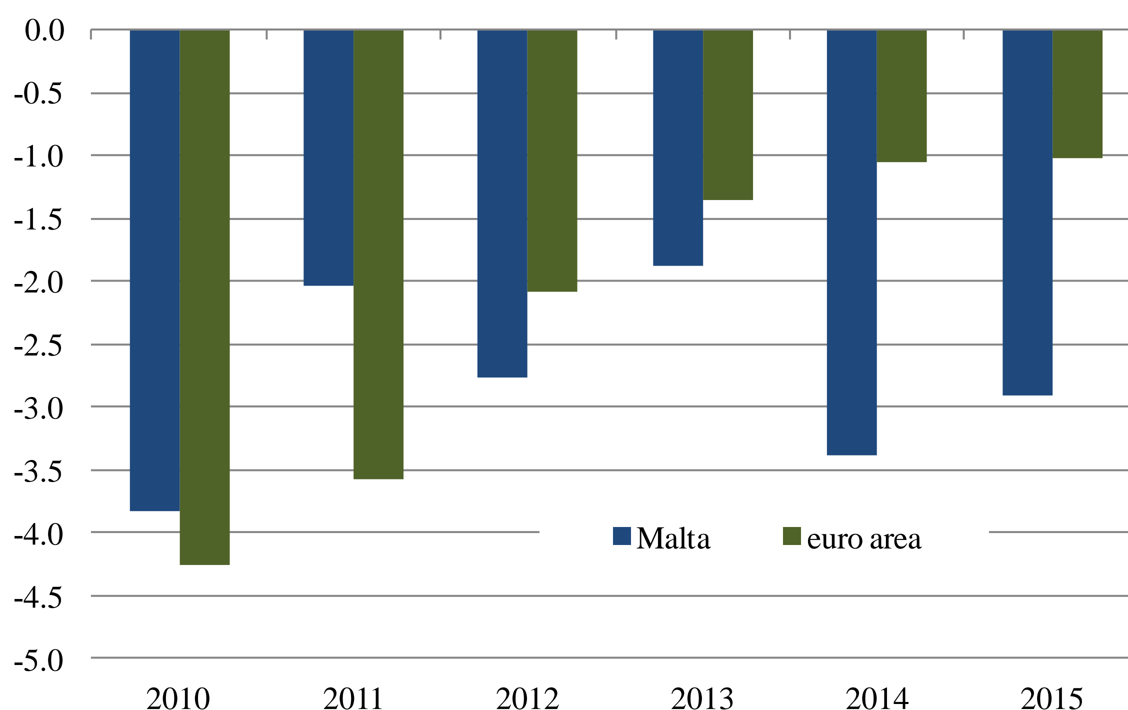
The analysis of the country's fiscal situation can also be assessed by focusing on the structural balance ratio.[33] The latter adjusts for cyclical and one-off and temporary measures, by following a standard methodology, thereby offering a potentially better gauge of the country's underlying fiscal position. This helps identify whether the reduction in the fiscal

[32] Germany and Estonia were the only two countries which recorded a fiscal surplus, equivalent to 0.7% and 0.1% of GDP respectively.
[33] In order to ensure comparability across countries the figures are reproduced from AMECO which is the statistical database of the COM.

deficit is due to genuine fiscal consolidation, or else mainly the result of one-off or cyclical factors. The structural balance is expressed as a percentage of potential output.

Malta's structural balance was rather volatile between 2010 and 2015 (see Chart 5.4).[34] Apart from 2010 and 2011, the structural deficit in Malta was higher than in the euro area. In the euro area, the fiscal consolidation was more sustained, with a consistent yearly decline in the structural deficit recorded throughout the whole period.

Chart 5.4: Structural balance (% of potential GDP)



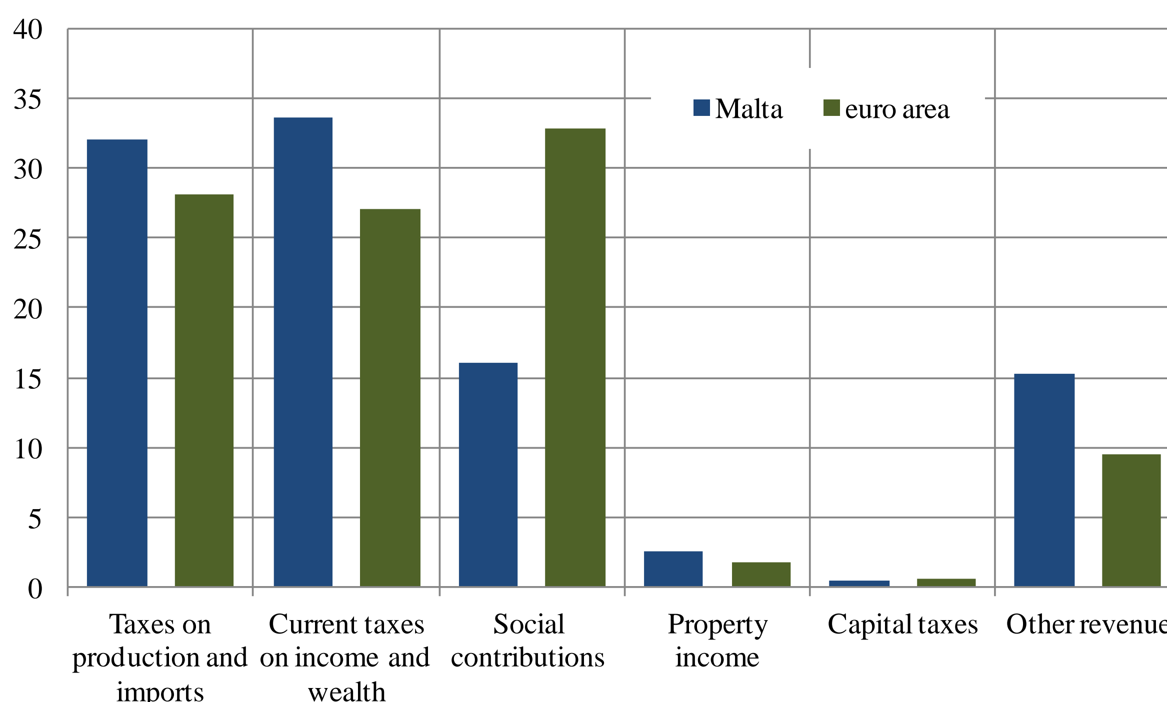
Source: AMECO

5.4 Revenue components

Government revenue patterns in Malta are slightly different when compared to those in the euro area (see Chart 5.5). The most notable difference relates to social contributions which accounted for only 16.0% of total revenues in 2015. Across the euro area, the share of social contributions in total revenue was twice as high. Indeed, when expressed as percent of GDP, social contributions in Malta, at 6.4% in 2015, were the second lowest among euro area countries where they accounted for 15.3%. This is in part attributable to the approach that has been adopted by Malta for the past years in respect of the Pay-As-You-GO (PAYG) system whereby the 10% employee and employer National Insurance (NI) contributions are capped in the case of the higher earning employees rather than applicable on the full salary.

[34] Figures for the structural balance are only available from 2010 onwards. Figures for Malta are reproduced from the COM's database and may be different from figures reported by the MFIN in its publications.

Chart 5.5: Revenue by category in 2015 (% of total revenue)



Source: Eurostat

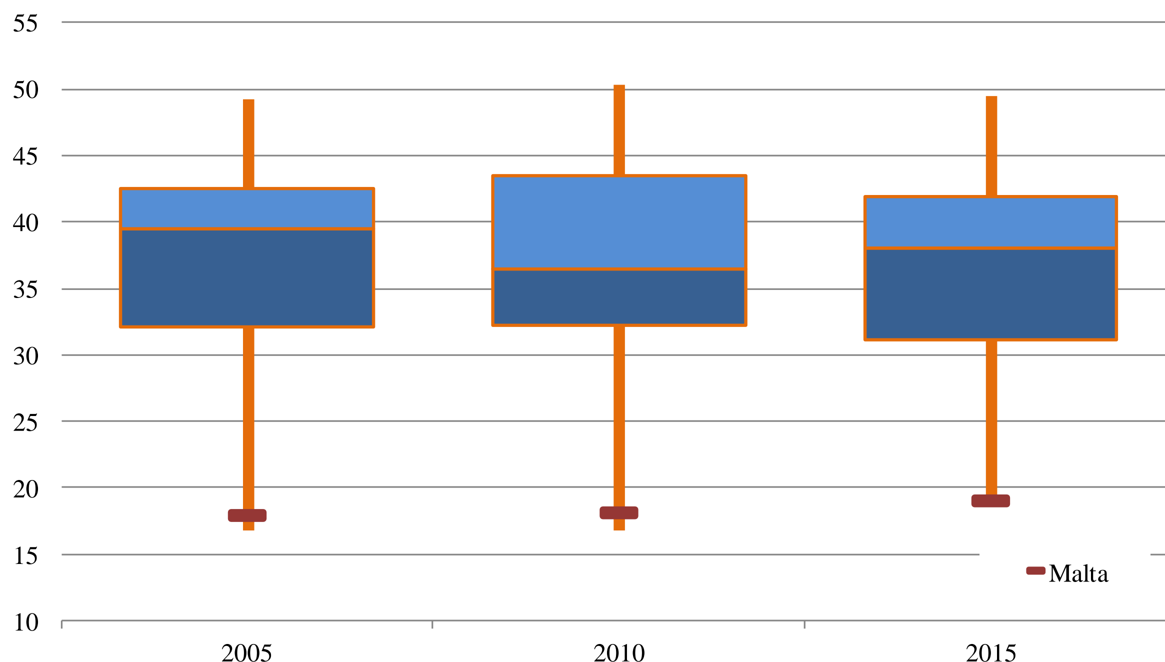
The relatively low social contributions in Malta have thus kept the tax wedge on labour among the lowest across the euro area despite the divergent trends registered by Malta and the euro area since 2005[35]. In fact, notwithstanding that Malta's tax wedge on labour costs increased from 17.9% in 2005 to 19.0% in 2015, Malta registered the lowest tax wedge amongst the euro area in 2015 (see Chart 5.6). Such low tax wedge acts as an incentive for employment generation in Malta. The tax wedge in the euro area on average declined from 42.6% to 41.4% over the same period. The highest tax wedge registered in 2015 was that of Belgium at 49.5%, followed by Germany, at 45.3%.

On the other hand, taxes on production and imports (indirect taxes) and current taxes on income and wealth (direct taxes) both accounted for a larger proportion of total revenue in Malta, respectively 3.9 pp and 6.5 pp higher than in the euro area in 2015. As a percentage of GDP, taxes on production and imports in Malta stood at 12.8% in 2015, slightly lower than the euro area average of 13.1%. The share of taxes on income and wealth was marginally higher in Malta, at 13.4% of GDP in 2015 compared to 12.6% in the euro area. This was entirely due to the higher tax-to-GDP ratio for corporates, at 6.6% for Malta against 2.5% for the euro area. In contrast, taxes on household income represented 6.7% of GDP for Malta

[35] The tax wedge on labour costs is defined as income tax on gross wage earnings plus the employee's and the employer's social security contributions, expressed as a percentage of the total labour costs of the earner. The total labour costs of the earner are defined as gross earnings plus the employer's social security contributions plus payroll taxes (where applicable). A low tax wedge boosts employment and pushes towards a more growth-friendly composition of public finances. On the other hand, when labour taxes are high, this may weigh on economic activity and employment.

compared to 9.3% for the euro area. Indeed, the reliance on corporate taxation in Malta is higher than across the euro area.

Chart 5.6: Tax wedge box plots[36] (% of total labour costs)



Source: Eurostat

Environmental taxes (largely included under taxes on production and imports) represented 2.9% of GDP in 2014 in Malta, slightly higher than in the euro area, which stood at 2.4% of GDP.[37,38] Likewise, other revenues were 5.8 pp higher in Malta, reflecting the utilisation of EU funds as well as revenues from the IIP included within this category. Revenue shares for property income and capital taxes, which are much smaller than other categories, were broadly similar in Malta and the euro area. Reliance on these sources of revenue is low both in Malta and across the euro area.[39]

[36] Box plots split the data set into quarters. The dark blue box represents the second quarter, while the light blue box represents the third quarter, showing the range of values of those countries which rank in the second lowest quarter and the second highest quarter of the dataset, respectively. The orange line in between the blue boxes represents the median. The two vertical lines (whiskers), extending from the top and bottom of the box reflect the divergence of values within the range, with the lower whisker going from quartile 1 to the lowest value while the upper whisker goes from quartile 3 to the highest value. A quartile value represents the 'cut-off' between each group. Therefore, the value of quartile 1 represents the value of the country that ranks at a quarter from the lowest value within the dataset, the value of quartile 2 represents the median, while quartile 3 represents the value of the country that ranks at a quarter from the highest value within the dataset.

[37] An environmental tax is a tax whose tax base is a physical unit (or a proxy of it) of something that has a proven, specific negative impact on the environment. Total revenues for environmental taxes include taxes on transport, energy, pollution and resources.

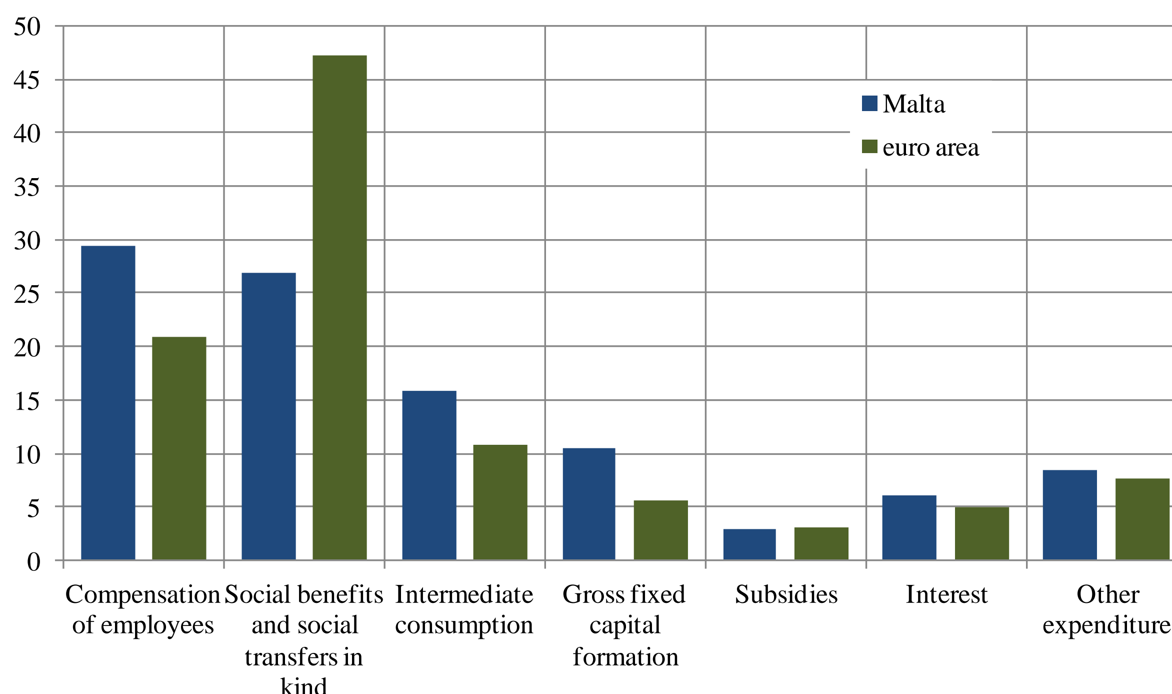
[38] Source: Environmental Trends in the European Union, 2016 edition.

[39] In the case of Malta capital taxes are mainly imposed on certain property transfers while property income mainly consists of dividends and rental earnings.

5.5 Government expenditure

The substantial difference in social contributions referred to above is also reflected in a comparable gap in social payments (see Chart 5.7). While in the euro area social benefits accounted for close to half of total expenditure, in Malta their share was lower, at 26.9%. On the other hand, Malta's spending on compensation of employees and intermediate consumption was higher than in the euro area, when expressed as percent of total expenditure. Spending on gross fixed capital formation was also relatively higher in Malta, reflecting the strong contribution of EU-funded capital projects, particularly since the absorption of EU funds was very elevated in that year as it was the last period when certain funds could be utilised. Interest payments and the 'other' expenditure categories were also marginally higher in Malta, while subsidies broadly accounted for a similar proportion in terms of percent of total expenditure.

Chart 5.7: Expenditure by category in 2015 (% of total expenditure)

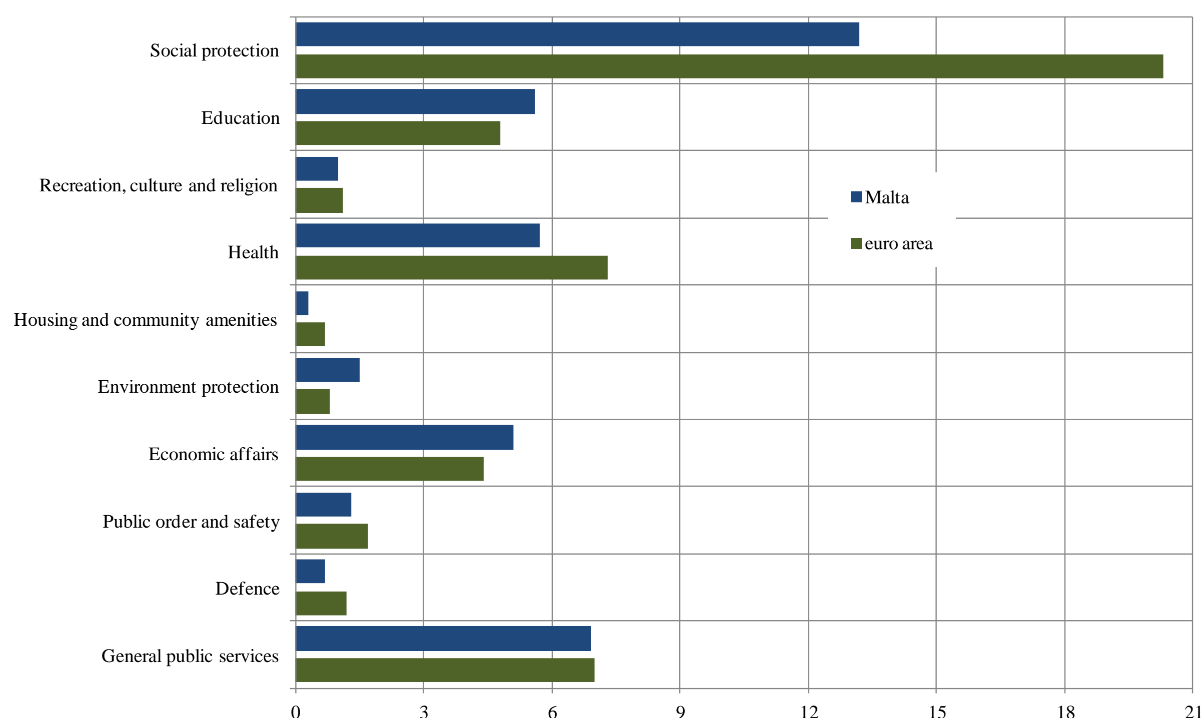


Source: Eurostat

To facilitate the analysis of expenditure patterns, government expenditure can also be assessed in terms of the Classification of the Functions of Government (COFOG). In 2014, spending on social protection and on health in Malta as a percentage of GDP was below that in the euro area (see Chart 5.8).[40] On the other hand, Malta's spending on education and on economic affairs in proportion to GDP was higher than in the euro area. Spending on other major categories was broadly in line with that in the euro area.

[40] 2014 was the last year for full country data.

Chart 5.8: Expenditure by COFOG category in 2014 (% of GDP)



Source: Eurostat

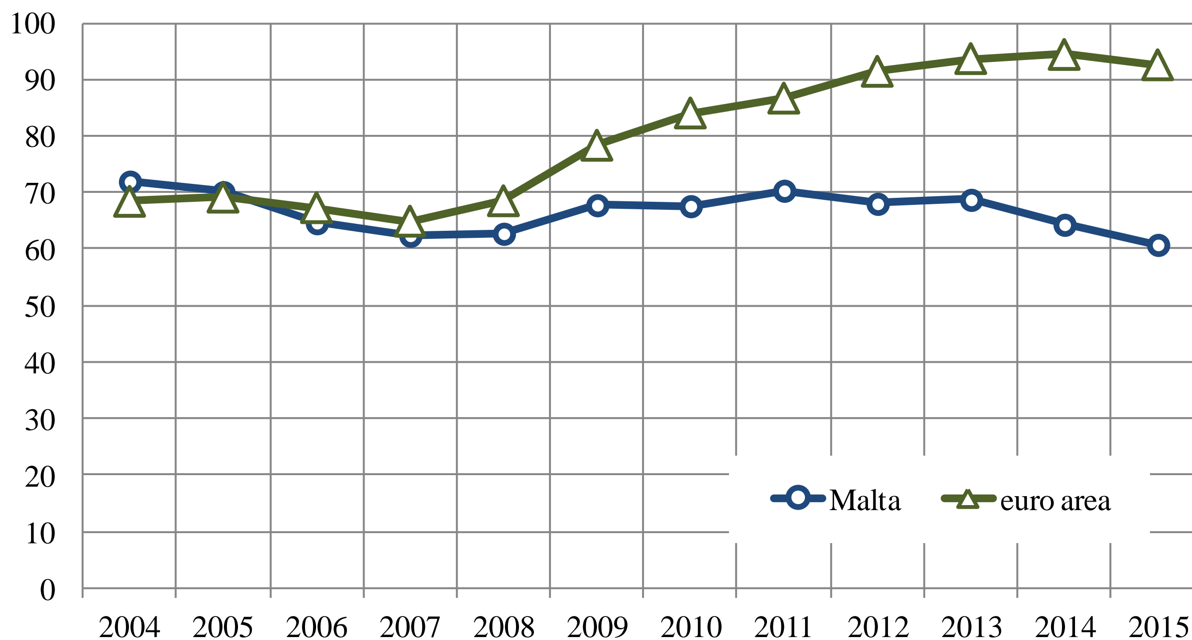
5.6 Public debt

Yearly fiscal deficits contribute to the accumulation of public debt. As a result, public debt has risen in absolute terms both in Malta and in the euro area. From an economic perspective, however, it is better to evaluate debt dynamics, when compared to nominal GDP, since the latter acts as a gauge on the extent to which there could be threats to sustainability, or otherwise. Furthermore, the SGP debt rule is specified in terms of nominal GDP. In 2004, debt-to-GDP ratios in Malta and the euro area were rather similar, close to 70.0% and remained rather close up to 2008 (see Chart 5.9). However, patterns departed with the onset of the global financial crisis after 2009 which impacted very adversely a number of euro area countries. Malta's debt ratio subsequently continued to hover around 70.0% for some years, before embarking on a downward trend, converging towards the 60.0% SGP threshold, by 2015.

On the other hand, the euro area debt ratio increased significantly during this period, and peaked to 94.4% of GDP in 2014, before declining slightly, to 92.6% in 2015. Contributing factors to this deterioration included the sharp increase in expenditure in relation to GDP in various euro area countries under the impact of substantial bail-out programmes which coincided with a deceleration in economic activity. As a result, whereas in 2005 Malta's debt ratio featured among the fourth (highest) quartile, by 2010 it retracted close to the median,

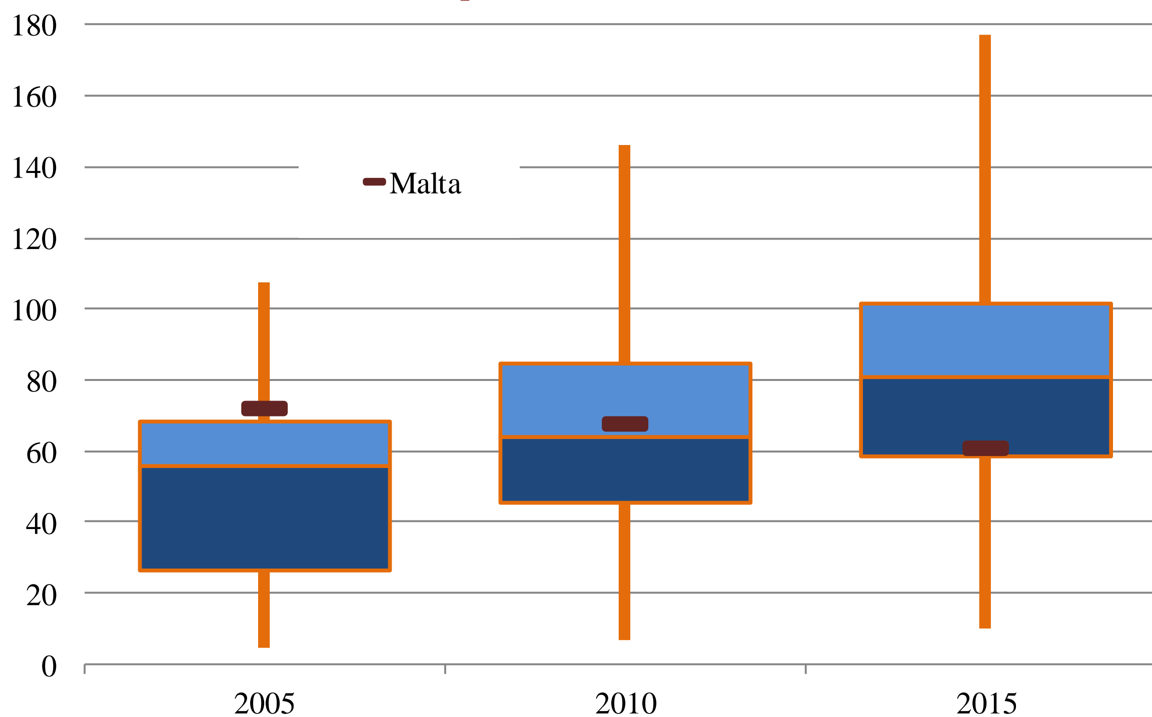
and in 2015 stood at the lower end of the second quartile (see Chart 5.10).[41] This is largely explained by the very elevated nominal GDP growth rates which were recorded in recent years when compared to the other euro area countries.

Chart 5.9: Debt levels (% of GDP)



Source: AMECO

Chart 5.10: Government debt box plots (% of GDP)



Source: AMECO

[41] In 2015 Greece had the highest debt-to-GDP ratio, at 177.4%, while Estonia had the lowest ratio, at 10.1%.

5.7 Conclusion

Malta's headline fiscal situation has tended to improve during the period surveyed. Buoyant economic growth has contributed positively to this improvement. This was facilitated by the strong economic resilience demonstrated by the Maltese economy when faced with both the international financial crises as well as the EU sovereign debt crisis which negatively impacted several EU countries. This was reinforced by a process of fiscal consolidation measures and expenditure rationalisation initiatives, in part reflecting the impact of the CSR exercises.

The fiscal trends observed during the period surveyed also highlighted a number of structural differences between Malta and the euro area countries in terms of revenue sources and expenditure allocations as witnessed by the lower revenue and expenditure ratios in Malta compared to the euro area. To a large extent these mirror the policy response in respect of the range and extent of services offered by the government and the tax framework which has prevailed in Malta for many years. At the same time, by comparing the fiscal outturn for Malta and the euro area, one can re-assess whether the current conduct of fiscal policy is deemed to be the most suitable for Malta, or else whether possible fine-tuning of revenue and expenditure policies could be considered.

Chapter 6

Fiscal risks with a focus on public debt sustainability and contingent liabilities

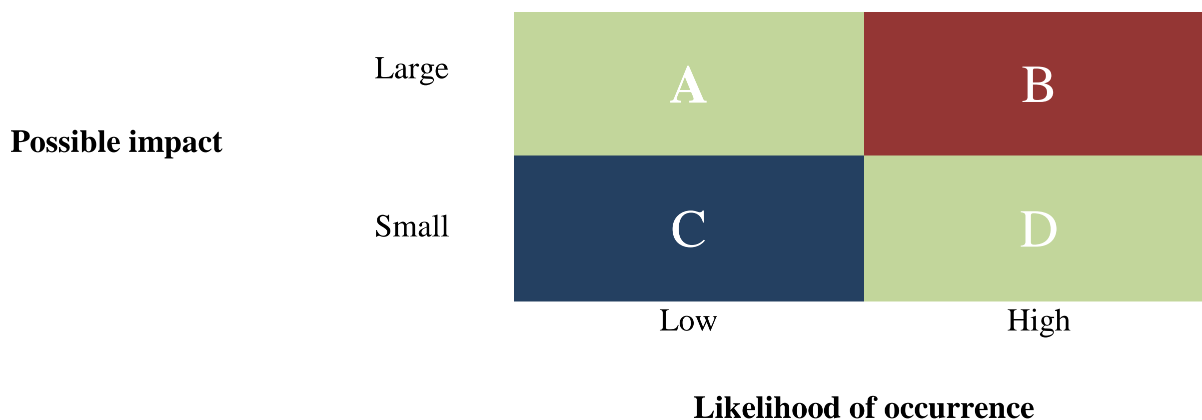
6.1 Introduction

Risk relates to the possibility that an outcome is different from what is originally expected. An upside risk exists when the outcome could be higher than anticipated, while a downside risk captures the possibility of a lower-than-expected realisation. Applied to public finances, downside risks to revenues entail the possibility that revenues are lower than expected, while upside risks to expenditures indicate that expenditures may exceed the forecasts. These two forms of risk are highly relevant for the assessment of public finances, as they would worsen the fiscal balance, should they materialise. These risks are also very relevant within the context of assessing the fiscal sustainability of a country. Risks may either be 'short term' in the sense that they relate to the near future, or 'medium term', associated with a horizon within the next 5 to 10 years, or 'long term', which views the outlook beyond 10 years.

Apart from the direction of potential impact, risks are also evaluated in terms of their probability of occurrence. Some risks may be highly likely, that is with high probability of occurrence, while others remote, that is, the probability of materialisation is very low (see Diagram 6.1).

The importance attached to each risk varies, depending on the magnitude of the eventual impact and the likelihood that it occurs. A particular risk with high probability of occurrence and large impact [cell B], deserves much closer surveillance, than a risk which is remote, and whose possible outcome is anticipated to be small [cell C]. In other intermediate situations, the low likelihood of occurrence dampens somewhat the concern from the large possible impact [cell A], whereas a high probability could be compensated for by a low eventual outcome [cell D].

Diagram 6.1: Risk matrix



Source: MFAC

6.2 Sources of fiscal risks

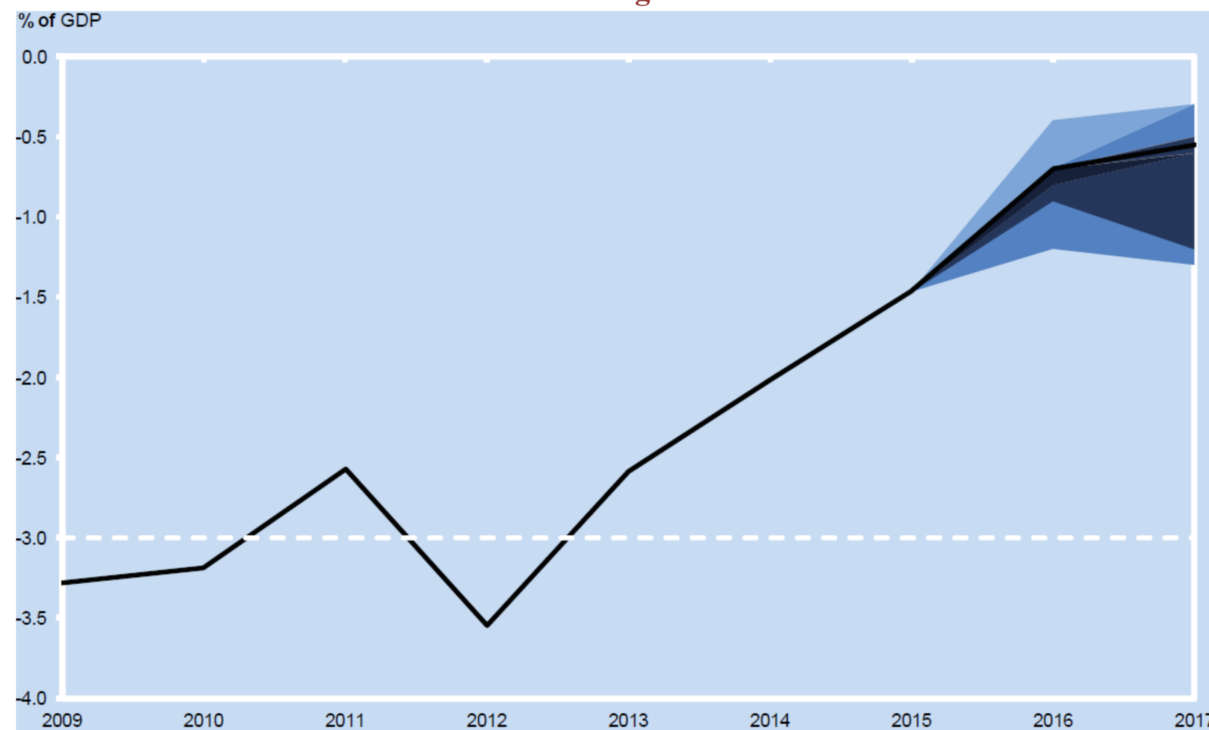
Fiscal projections present a baseline, that is, the most likely outcome which is being anticipated. The robustness of the forecasting exercise depends crucially on the underlying assumptions used, and on the expectation of stable economic relationships over time. To increase transparency, and help evaluate the robustness of such projections, fiscal projections are normally supplemented with a risk assessment. The main purpose of such a risk assessment is to point out specific risks, and indicate how such risks can change the baseline forecasts, should they materialise. One popular way how such risks could be presented is through the use of a fan chart. This type of chart shows the range of possible values over time and the associated probability estimates attached to such ranges under different scenarios. For example, the fan chart included in the DBP for 2017 indicated that on the basis of the macroeconomic risks considered by the MFIN, the balance of risk associated to the fiscal balance forecasts under a number of alternative scenarios was tilted slightly to the downside, with the most favourable scenario projecting a deficit of 0.3% of GDP in 2017 whereas the worst scenario envisaged a deficit of 1.2% of GDP (see Chart 6.1).[42]

Another way by which fiscal risks can be measured is through the coefficient of variation of the total revenue to GDP ratio, which is an indicator of the relative volatility of revenue and of the associated fiscal risks.[43] A recent discussion paper by the COM's staff indicated that whereas in 2014 receipts from sources other than taxes accounted for slightly more than one-tenth of total government revenue in the EU, the fiscal risk emanating from the volatility of

[42] In the DBP and the USP, the MFIN includes only the risk assessment dealing with macroeconomic shocks.
[43] The coefficient of variation is a measure of spread that describes the amount of variability relative to the mean. Since the coefficient of variation is unitless, it can be used instead of the standard deviation to compare the spread of data sets that have different units or different means.

non-tax revenue is estimated to be three times higher than that from the volatility of tax revenue.[44]

Chart 6.1: MFIN's risk assessment of the budget balance forecast



Source: MFIN

This pattern however does not appear to apply to Malta. In fact, according to this discussion paper, an analysis of the contribution of the volatility (variance) of non-tax revenue to total revenue in proportion to the share of non-tax revenue to total revenue shows that the volatility in non-tax revenue in Malta is proportionately one of the lowest in the EU. On the other hand, the COM's paper also showed that the coefficient of variation for tax revenue for Malta between 1995 and 2014 was 9.0% or twice the EU average of 4.5%.[45] In the case of non-tax revenue it was 14.9%, which was comparable to the EU average of 13.6%. Whereas in about one half of the EU members, the direction of change in tax and non-tax revenues tended to be similar (positive covariance), in the other half of EU members, including Malta, the change in tax and non-tax revenue tended to move in opposite directions (negative covariance). This negative covariance between non-tax revenue and tax revenue for Malta reduced the relative volatility of total revenue to 6.1%, which however was still higher than the EU average of 4.3%.

[44] Source: Mourre et al (2017) 'Non-tax revenue in the European Union: A source of fiscal risk?', European Economy Discussion Paper 44.

[45] The standard deviation provides a measure of the absolute level of volatility in revenue. The coefficient of variation is computed by dividing the standard deviation with the average value. This provides a more useful measure than the absolute volatility as it corrects for differences in the mean of the two series.

Other approaches are also discussed in the literature regarding fiscal risks. These include:

(a) **Early Warning Indicators** which are based on leading indicators thought to be linked to fiscal vulnerabilities and which in turn are converted into an index, using the past forecast accuracy as weights. The resulting index is then compared against a threshold.

(b) **Vector Auto Regressions (VARS)** which are used to describe the dynamic evolution of a number of variables based on their history in order to identify unsustainable patterns.

(c) **Value at Risk (VaR)** which attempts to measure the maximum potential loss that the government could suffer at a given confidence level.

(d) **Contingent Claims Analysis (CCA)** which provides an estimate of the market value of government's implicit and explicit support to the private sector. [46]

Moreover, the IMF identifies eight different sources of possible fiscal risks (see Table 6.1). These vary according to the initial source, but also in terms of the frequency of occurrence and the magnitude of the implications for public finances. International experience shows that macroeconomic shocks tend to be the most frequent, tend to be highly correlated, and may occur as a chain reaction rather than in isolation.

[46] These are outlined in Discussion Paper Number 2 by the Office for Budget Responsibility titled 'What should our Fiscal risks report cover?', published in October 2016.

Table 6.1: Possible sources of adverse fiscal risks

Source	Explanation
Macroeconomic shocks	When economic conditions are worse than expected resulting in lower tax bases and hence tax revenues, and/or, higher expenditure commitments such as unemployment benefits.
State-owned enterprises	When the negative financial performance of companies with government shareholding requires additional state support to continue operations.
Public private partnerships	When the joint activity does not work out as originally planned resulting in the need for higher government involvement in terms of financing.
Sub-national governments	When expenditure undertaken by local councils is higher than budgeted for by the central government.
Legal cases	When the Government loses a court case resulting in the request for compensation to the other party.
Natural disasters	When additional Government services need to be deployed to offer relief from natural disasters.
Financial sector	When problems in the financial sector necessitate state intervention to safeguard financial stability.
Private non-financial companies	When private sector companies face problems, this may give rise to some form of Government assistance, for example to protect jobs.

Source: Based on IMF (2016) Analysing and Managing Fiscal Risks – Best Practices

6.3 Public Debt Sustainability

High debt levels and population ageing can pose threats to the sustainability of public finances, particularly in the medium to longer term. Indeed, the assessment of Member States' debt developments is a key component of fiscal surveillance under the SGP. To this effect, twice a year the COM prepares an internal Debt Sustainability Monitor (DSM) report which includes for each Member State, a detailed public Debt Sustainability Analysis (DSA), as well as the analysis of fiscal sustainability indicators.

The DSM framework offers an insight into the fiscal sustainability challenges in the short, medium and long run. It includes measures of the so-called S0, S1 and S2. The S0 is a composite indicator aimed at evaluating the extent to which there might be a fiscal stress risk

in the short term, based on a set of 25 fiscal, financial and competitiveness variables. The S1 is the medium term sustainability indicator which shows what additional adjustment is required, in terms of improvement in the government primary balance in structural terms over the next 5 years, in order to reach the 60% debt-to-GDP ratio within 15 years. The S2 is the long term sustainability indicator which shows the adjustment in the current primary balance in structural terms that is required in order to stabilise the debt-to-GDP over the infinite horizon.[47]

The DSA framework includes 5 objective criteria to determine the degree of vulnerability of countries in terms of their risks to public debt sustainability (see Box 6.1). If a country is found to be vulnerable on the basis of these criteria, apart from the standard DSA, an enhanced DSA is carried out by the COM, where additional discussions are held regarding the assumptions used for the projections and the actual risks, and the analysis is supplemented with additional sensitivity tests around the baseline public debt projections.

Box 6.1: Debt Sustainability Analysis

If one or more of the following criteria are met, countries are subjected to an enhanced DSA.

1. the country has a value of the composite indicator of short-term fiscal stress risk, S0, above the critical threshold, and/or a value of the S0 fiscal sub-index above threshold;
2. the country's current and/or forecasted gross public debt is at, or higher than, 90% of GDP;
3. the country's current and/or forecasted change in gross public debt over GDP is at, or higher than, 5 pp;
4. the country's gross financing needs are at, or higher than, 15% of GDP; or
5. the country is under a macroeconomic adjustment programme, under post-programme surveillance or enhanced surveillance as from the Two-Pack regulation.

Source: Reproduced from http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp200_en.pdf

In the event that none of the criteria used to identify a vulnerable country are met, only a standard DSA would be carried out. The standard DSA relies on several tools including: deterministic and stochastic public debt projections; sensitivity analysis of key variables around baseline public debt projections; the analysis of risks relating to the financing of public debt and government contingent liabilities; financial market information; and forecast accuracy analysis.

[47] The Debt Sustainability Monitor 2016 may be accessed https://ec.europa.eu/info/publications/debt-sustainability-monitor-2016_en.

The fiscal sustainability analysis is based on the S0, S1 and S2 indicators. Respectively, these capture whether countries will be facing fiscal sustainability challenges in the short-term, medium-term and long-term. In the case of the medium-term, the assessment of sustainability challenges relies on the use of both the DSA and the S1 indicator. The use of both indicators allows a comprehensive analysis of sustainability challenges, by considering fiscal risks related both to population ageing and to other risk factors affecting future debt developments.

Based on the COM's latest DSM 2016, S0 results show that Malta would be at no risk in the short-term (see Table 6.2). When looking at the medium term horizon Malta is also deemed to be at low risk of facing sustainability challenges based on both the DSA and the S1 indicator. On the other hand, in the longer term, Malta is considered by the DSM framework to face medium risk in terms of sustainability challenges based on the S2 indicator, the main factor being the challenges associated with age-related costs, namely pensions, health care and long term care. According to the DSM, in the event that ageing costs are less favourable than projected over the longer term horizon, Malta would be facing high rather than medium risk.

Table 6.2: Malta's risk outlook over the short, medium and long term

Overall short-term risk category (S0)	Overall medium-term risk category (S1/DSA)	Overall long-term risk category (S2)
LOW	LOW	MEDIUM

Source: Reproduced from https://ec.europa.eu/info/publications/debt-sustainability-monitor-2016_en

The IMF also carried out a Public DSA of Malta which considered a number of adverse scenarios including low growth, higher borrowing costs, a deterioration in the primary balance, and a materialization of contingent liabilities.[48] On the basis of this analysis, the IMF concluded that "the debt dynamics are robust to most shocks, though under a contingent liability shock that is combined with a low growth scenario, the public debt ratio would increase considerably and remain elevated throughout the projected horizon. The moderate gross financing needs and the low share of debt held by non-residents limit potential liabilities."

6.4 Contingent liabilities

Another potential key driver of fiscal risks is the existence and the eventual possible realisation of contingent liabilities. These are 'obligations that do not arise unless a particular, discrete event(s) occurs in the future'.[49] Contingent liabilities can be 'explicit' in the sense of being obligations which are defined by law or contract, depending on the realisation of an identifiable event. However, they may also be of an 'implicit' nature. In this case, although

[48] Malta Staff Report for Article IV Consultation, February 2017 available on https://www.imf.org/~/media/Files/Publications/CR/2017/cr1756.ashx.
[49] Source: IMF (2011) Public Sector Debt Statistics Guide for Compilers and Users.

there is no legal obligation for the government to act in cases of risk materialisation, the government is nonetheless expected to do so by the public, thus creating a sort of moral obligation. Examples of implicit guarantees include future obligations for pensions or the clean-up of liabilities of entities to be privatised, or employment support for companies in distress.

Another mode of assessing fiscal risks used by the COM in its DSA framework is by evaluating contingent liability risks arising from the banking sector. Such risks are captured indirectly through a methodology using heat maps of variables that measure banking sector vulnerabilities as well as through model estimates of the theoretical probability of significant bank losses that could impact on public finances in a simulated bank crisis.[50] The main vulnerability in this regard is associated to a possible high level of non-performing loans (NPL), particularly of significantly important banks, and a possible insufficient level of NPL-provisions coverage ratio. In general, the strengthening of the regulatory framework following the international financial crisis has contributed to mitigate the fiscal risks linked to the banking sector.

Council Directive 2011/85/EU on requirements for budgetary frameworks of Member States requires countries to publish relevant information on contingent liabilities with potentially large impacts on public budgets, including government guarantees (one-off or standardised), non-performing loans, and liabilities arising from the operation of public corporations.

In Malta, the bulk of explicit contingent liabilities are in the form of Government guarantees of a one-off nature.[51] Government guarantees are defined by Eurostat as ‘arrangements whereby the guarantor undertakes to a lender that if a borrower defaults, the guarantor will make good the loss the lender would otherwise suffer’. In turn, guarantees are considered as one-off when they are ‘individual and guarantors are not able to make a reliable estimate of the risk of calls, while being linked to debt instruments (such as loans and bonds)’.[52]

Total Government guarantees increased from 7.2% of GDP in 2005 to 11.8% in 2010, surging to around 16.0% in 2012 and remaining rather stable at this level up to 2015 (see Chart 6.2). However, according to the MFIN’s projections in the USP 2016-2019, the ratio is envisaged to decline to 11.9% of GDP in 2017 and to stabilise around 11.8% of GDP by 2019. This projected sharp drop in the ratio by 2019 reflects the fact that one large guarantee, related to the energy sector, was of a temporary nature.

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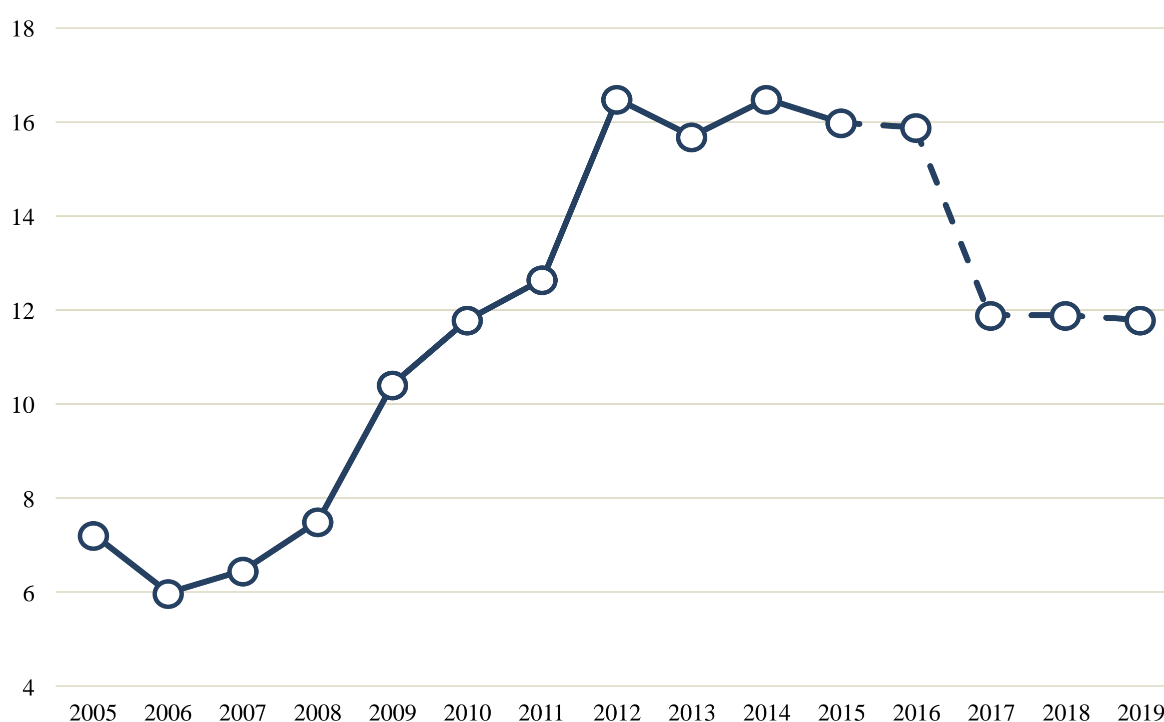
[50] The COM derives such simulation results using SYMBOL (SYstemic Model of Banking Originated Losses). A short explanation of the SYMBOL model is provided in Annex 4 of: http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp200_en.pdf.

[51] In many other EU countries there is also the practice of awarding standardised guarantees which are guarantees that are issued in large numbers, usually for fairly small amounts, along identical lines. To date no such guarantees have been awarded in Malta.

[52] Source: http://ec.europa.eu/eurostat/cache/metadata/en/gov_cl_esms.htm.

Chart 6.2: Total Government guarantees (% of GDP)



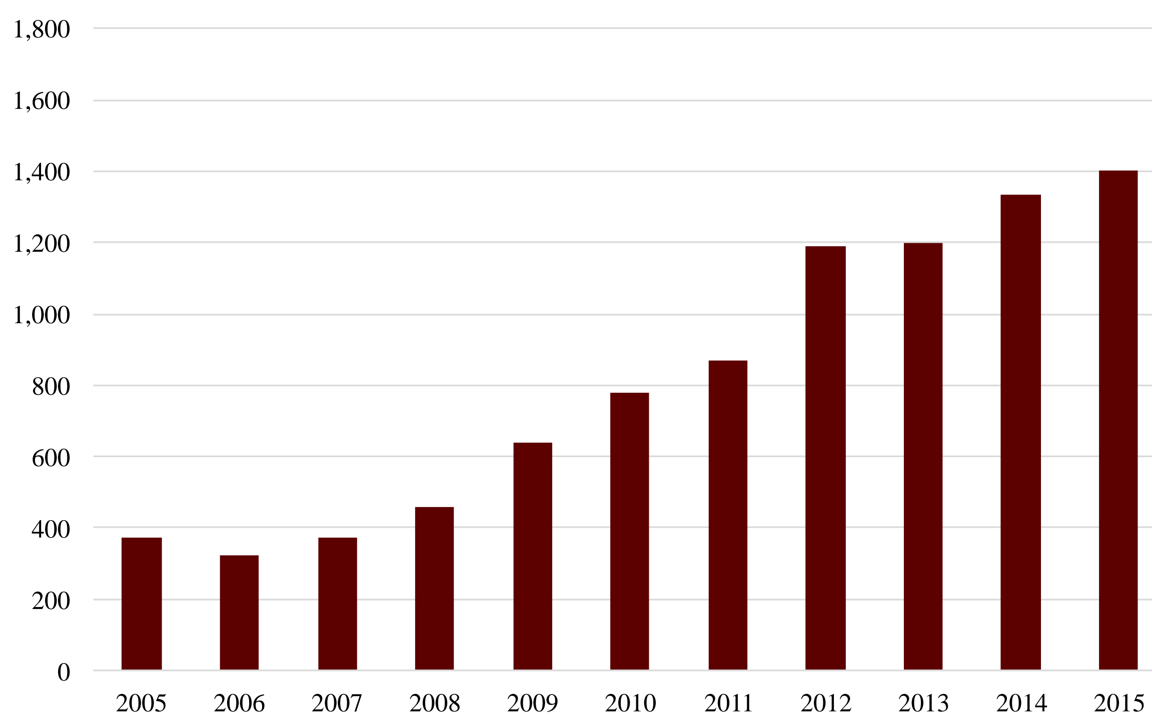
Source: Eurostat, MFIN

In absolute terms, the total volume of outstanding guarantees increased from €371.6 million in 2005 to slightly more than €1.4 billion in 2015 (see Chart 6.3). Of the latter, €812.2 million (56%) were granted to cover financing facilities by local financial institutions whereas €644.5 million (44%) were in respect of facilities by foreign institutions.

These contingent liabilities were spread over 31 letters of guarantee which were awarded in favour of 14 entities. The bulk of these guarantees were concentrated within a limited number of beneficiaries. Indeed, 8 entities accounted for 97.7% of the aggregate outstanding amount as at end 2015 (see Table 6.3). The energy sector absorbed almost two thirds of such guarantees. Other sizable guarantees related to the transport sector, water services, the industrial sector and education. In addition to these letters of guarantees, at the end of 2015 the Government had also 5 letters of comfort in favour of 4 entities for an outstanding value of €25.3 million.

The Government received revenue fees amounting to €11.8 million during 2015 in respect of these guarantees and letters of comfort, equivalent to a premium of 0.8%. It is important that the premium charged for the provision of such guarantees reflects adequately the risks that the Government is exposing itself to.

Chart 6.3: Government guarantees in absolute terms (EUR million)



Source: Eurostat

Table 6.3: Largest Government guarantees as at 31 December 2015

Beneficiaries	EUR million	%
ElectroGas Ltd	320.5	21.6
Vault Finance Ltd	290.5	19.6
EneMalta p.l.c	280.8	18.9
Malta Freeport Corporation	200.8	13.5
Malta Industrial Parks Ltd	113.4	7.7
Petrolmal Co. Ltd.	85.0	5.7
Water Services Corporation	83.4	5.6
Foundation for Tomorrow's Schools	76.2	5.1

Source: Report by the Auditor General Public Accounts 2015, National Audit Office (NAO).

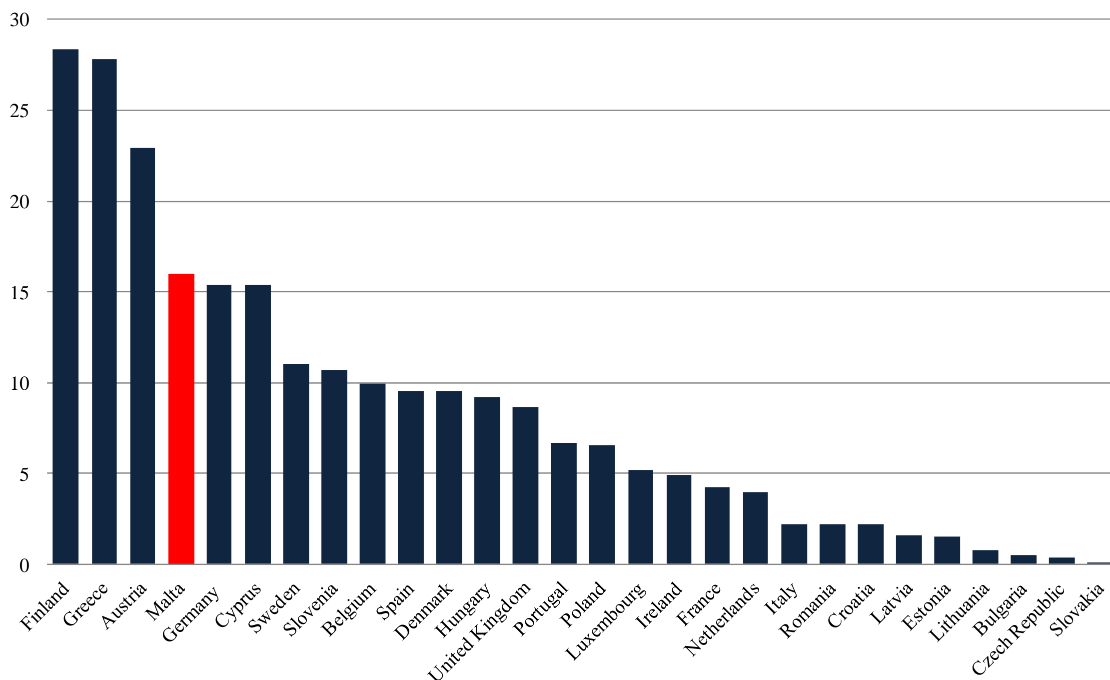
The purposes for awarding such guarantees and letters of comfort can be different. However, they are all intended as security to cover banking facilities, thereby facilitating the operations of the beneficiaries on the premise that such support is considered beneficial for the country. These include offering safeguards to private investors, facilitating borrowing procedures by

the private investors, re-organisation of accumulated debt and assisting with derivative transactions. Such assistance must also be compatible with existing European regulations, particularly in the area of State Aid.[53]

Apart from the above-mentioned one-off guarantees, other contingent liabilities are linked to the liabilities of government-controlled entities which are classified outside general government. Although such entities are classified as part of the private sector, their links with Government suggest that there could be the possibility that some form of state assistance might be made available in case of need. As at end-2015 the liabilities of government-controlled entities amounted to almost €2.0 billion. On the other hand, contingent liabilities related to Public-Private Partnerships (PPPs) are limited in Malta, and stood at €6.5 million as at 2015.

Contingent liabilities may represent an additional risk to Malta's public finances, as frequently remarked by the COM, IMF and credit rating agencies, particularly owing to the heavy concentration of such exposure and the rather high level of outstanding amounts. Indeed, as at end 2015, Malta ranked the fourth highest within the EU in terms of the outstanding guarantees-to-GDP ratio (see Chart 6.4).[54]

Chart 6.4: Government guarantees by EU Member States as at end 2015 (% of GDP)



Source: Eurostat

[53] For further details on State Aid refer to http://ec.europa.eu/competition/state_aid/overview/index_en.html.
[54] Figures may not be strictly comparable as countries may have different collection methods and different coverage.

"Contingent liability realizations are correlated among each other and tend to occur during periods of growth reversals and crises, accentuating pressure on the budget during already difficult times. Countries with stronger institutions are able to better control and address the underlying risks so that they are less exposed to contingent liability realizations."

Bova et al *(2016), The Fiscal Costs of Contingent Liabilities: A New Dataset, IMF Working Paper 16/14.*

6.5 Conclusion

In the aftermath of the international sovereign debt crisis, there has been a broad-based strengthening in the governance system regarding the EU fiscal framework alongside an accentuation of focus on more thorough risk management mechanisms to safeguard fiscal sustainability.

Government guarantees in Malta are relatively high when compared to other EU countries. An important factor with regard to government guarantees is that they are usually of limited or low concern during expansionary periods but may become problematic in the eventuality of an economic downturn. Contingent liabilities, whether explicit or implicit, can occasionally materialise. Indeed, as documented by the IMF, there were at least three significant instances where contingent liabilities of a significant nature materialised in Malta.[55]

It is thus important to maintain the levels of risks linked to contingent liabilities within pre-defined prudential limits. It is also important that when the Government is offering some form of insurance, the associated risks of moral hazard are adequately addressed.[56] It will therefore be desirable to introduce legislation providing for an appropriate framework governing the monitoring of risks and controls on the issuance of Government guarantees. Legislative proposals towards this end are at an advanced stage which should contribute significantly to the introduction of a more robust fiscal governance mechanism. Better controls and risk management of outstanding government guarantees, coupled with a declining public debt-to-GDP ratio, would be highly instrumental in enhancing Malta's medium and long term fiscal sustainability, thereby also offering the opportunity for the country's credit rating to improve further.

[55] For further details about the estimated effects refer to Bova et al (2016) 'The Fiscal Costs of Contingent Liabilities: A New Dataset', IMF Working Paper WP/16/14.
[56] Moral hazard relates to the lack of incentive to guard against risk when an organisation is protected from its consequences.

Chapter 7

The expenditure benchmark

7.1 Introduction

Fiscal governance across the EU features rules that were initially established through the Maastricht Treaty of 1992 and the SGP of 1997 (see Box 7.1). Following the onset of the economic and financial crisis in 2008, and the experience with the concrete implementation of the SGP, the Pact was subsequently amended. Significant changes were implemented through a package of legislation referred to as the 'Six Pack' of 2011 and another package of legislation termed the 'Two Pack' of 2013.[57] In particular, these legislative changes strengthened the 'preventive arm' of the Pact and enhanced surveillance and monitoring in the euro area.[58]

A key objective for the launch of the 'Six Pack' and the 'Two Pack' was to encourage countries to pursue policies which lead to healthy public finances particularly in good economic times. An important development with the 'Six Pack' was the setting up of a new requirement, termed the 'expenditure benchmark', to supplement the other two fiscal rules which were previously in place, namely the 'debt criterion' and the 'structural effort' criterion (see Table 7.1). In terms of the expenditure benchmark, the expansion in adjusted expenditure must not exceed the growth in potential output unless any excess expenditure is fully matched by additional discretionary revenue measures.

Under the revised SGP, compliance with the preventive arm takes into account the three fiscal rules. Such rules complement each other and are meant to offer a more comprehensive and robust assessment of the suitability of a country's current and planned fiscal policy towards the achievement and maintenance of the MTO.

[57] Links to the full set of relevant legislative texts is available in Annex 1 of the Vade Mecum on the Stability and Growth Pact, 2016 edition, European Economy Institutional Paper 21, published by the COM in March 2016. The publication is available on http://ec.europa.eu/economy_finance/publications/eeip/ip021_en.htm.
[58] Apart from the 'preventive arm', the SGP also features a 'corrective arm' which deals with the appropriate policy responses that a MS which is under the Excessive Deficit Procedure (EDP) must undertake to rectify its position when the fiscal deficit exceeds the 3% of GDP threshold.

Box 7.1: History of the SGP

1992	**Maastricht Treaty signed:** EU Member States sign the Maastricht Treaty, paving the way for the creation of the euro as the common currency of the EU. The Treaty limits government deficits to 3% of GDP and public debt levels to 60%, so as to enable countries to share a single currency.
1997	**Stability and Growth Pact**: EU Member States agree to strengthen the monitoring and coordination of national fiscal and economic policies to enforce the deficit and debt limits established by the Maastricht Treaty. The Stability and Growth Pact is born.
1998	**Preventive rules**: The SGP's preventive rules enter into force in respect of EU Member States whose budget deficit is less than 3% of GDP.
1999	**Corrective rules**: The SGP's corrective rules, also called the Excessive Deficit Procedure, enter into force in respect of EU Member States whose budget deficit exceeds 3% of GDP.
2005	**SGP amendment**: EU lawmakers amend the SGP to allow it to better consider individual national circumstances and to add more economic rationale to the rules that have to be complied with. Surveillance and coordination are strengthened. The excessive deficit procedure is clarified and made faster.
2011	**Six Pack**: The SGP is made more comprehensive and predictable with a major enhancement of the EU's economic governance rules through a collection of new laws, known as the 'Six Pack' consisting of five Council Regulations and one Directive. The monitoring of both budgetary and economic policies is organised under the European Semester and further details on the implementation of the SGP's rules are laid down in a 'Code of Conduct'.
2013	**Fiscal Compact**: The importance of the budgetary targets set by the SGP's preventive arm (the Medium-Term Objectives), are strengthened by a law known as the 'Fiscal Compact', which is part of an inter-governmental treaty known as the Treaty on Stability, Coordination and Governance (TSCG).
	Two Pack: Adherence to the SGP is further strengthened by new laws, known as the 'Two Pack,' which reinforce economic coordination between Member States and introduce new monitoring tools. Further details on the implementation of the 'Two Pack' provisions are laid down in a 'Code of Conduct'.
2014	**SGP review**: A review of the 'Six Pack' and 'Two Pack' rules, which was called for in the legislation, determines that the legislation has contributed to the progress of fiscal consolidation in the EU. The review highlights some strengths as well as possible areas for improvement, which will be discussed with the European Parliament and Member States.
2015	**SGP Flexibility**: The Commission issues guidance on how it will apply the SGP rules to strengthen the link between structural reforms, investment and fiscal responsibility in support of jobs and growth.

Source: Based on http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm

Table 7.1: Fiscal rules under the SGP

Rules	Focus
1. **Debt criterion**	Scaling back of the debt-to-GDP ratio towards the 60% threshold according to a pre-defined timeline
2. **Structural effort criterion**	Improvements in the structural budget balance, generally of at least 0.5% of GDP annually
3. **Expenditure benchmark**	Country-specific limits on expenditure growth

Source: Vade Mecum on the Stability and Growth Pact, 2016 edition

The expenditure benchmark acts as a guide to ensure that a country's policies are consistent with maintaining the fiscal balance stable at the MTO, when the latter has already been attained. On the other hand, in cases when the MTO has not been attained, as in Malta's case, the expenditure benchmark guides the adjustment towards the MTO. Indeed, the expenditure benchmark reinforces the pressure towards fiscal consolidation as it sets an upper limit, referred to as the 'reference rate' on the permissible annual growth in government expenditure. The desirable feature of the expenditure benchmark is the fact that it limits the possibility that revenue windfalls would be used to fund additional expenditures, rather than being used to achieve faster progress towards the MTO.

> **"Expenditure rules, in particular, have received increasing attention as they exhibit a number of features. In particular, they are directly aimed at addressing the expenditure pressures often at the origin of excessive deficits, they are transparent and generally easy to monitor, they fully accommodate revenue shortfalls resulting from adverse economic shocks (allowing for a stabilizing role of fiscal policy), and they are most directly related to the formulation of the annual budget, which sets legally binding appropriations, thus contributing to the rules' enforceability. Importantly, and unlike deficit caps, expenditure rules also help creating buffers in good times, when revenue windfalls can make spending pressures difficult to resist. These countercyclical properties also make expenditure rules particularly attractive for countries where estimates of the structural budget balance are challenging to obtain because the economic cycle is not well-defined (e.g., developing or transition economies and developed small open economies)."**
>
> Cordes et al *(2015), Expenditure Tools for Sound Fiscal Policy?, IMF Working Paper 15/29.*

Thus, the expenditure benchmark complements the other two rules which respectively focus on ensuring that debt levels are sustainable (debt rule) and that the pace of fiscal consolidation is sustained while being commensurate with the business cycle conditions in the country (structural effort criterion).

The framework for the expenditure benchmark is characterised by two main elements, the 'reference rate' and the 'adjusted expenditure growth'. The reference rate acts as a ceiling, while the adjusted expenditure growth is derived from a new expenditure aggregate which is computed according to fixed guidelines. Both components necessitate a significant amount of macroeconomic and fiscal data, both historical as well as forecasts.

7.2 Components of the reference rate

The annual reference rate acts as a guide towards the permissible growth in yearly expenditure. Its estimation is based on two different components. These broadly relate to the country's growth potential, and indirectly to the size of its public sector. The latter plays a role in the estimation of the magnitude of the necessary restraint on expenditure growth, which is implemented through the convergence margin (see Table 7.2).

Table 7.2: Components of the reference rate

Input	Purpose
Medium-term rate of potential GDP growth	To offer guidance on the long-term average growth rate of the economy
Convergence margin	To slow down expenditure growth to below that in potential output in order to achieve convergence towards the MTO

Source: Vade Mecum on the Stability and Growth Pact, 2016 edition

7.3 Methodology to calculate the medium-term rate of potential GDP growth

The applicable medium-term rate of potential GDP growth is set on a country-by-country basis. It is defined as an average over time and is expressed in terms of potential GDP growth rather than actual real GDP growth. This approach ensures that the application of the expenditure benchmark does not lead to the problem of pro-cyclicality. The latter describes a situation when an economic variable moves in the same direction as the economic cycle, thereby amplifying the economic cycle and thus contributing to more instability.[59]

[59] The use of actual real GDP growth rates would result in a situation where above-trend actual growth would lead to a higher permissible growth rate while below-trend actual growth would lead to a lower permissible growth rate. Such situation would not lead to sound policy making.

The medium-term rate of potential GDP growth is calculated by a ten-year average of potential GDP, comprising five years of outturn data, the year underway, and four years of forward-looking data. The back data are provided by Eurostat, while the other figures build on the COM's forecasts. Figures for the years beyond the scope of the COM's forecasts are based on the commonly agreed methodology set out by the COM's Output Gap Working Group.[60]

In the case of Malta, the medium-term rate of potential GDP growth used for the assessment of the 2015 budgetary figures was established at 1.8%, while that used for the assessment of the 2016 budgetary figures was established at 2.7% (see Table 7.3).

Table 7.3: Medium-term rate of potential GDP growth

Assessment of budgetary figures for	Growth rate
2015	1.8%
2016	2.7%

Source: Annex 4 of the Vade Mecum on the Stability and Growth Pact, 2016 edition

The methodology prescribes that the medium-term rate of potential GDP growth applied in year [t] is set on the basis of the COM's spring forecast in [t-1]. This ensures that the results of the calculations are fully known to the country and can be used to prepare the necessary fiscal plans for compliance.

7.4 Methodology to calculate the convergence margin

The convergence margin is applicable only to countries which have not yet attained their MTO and thus need to undertake more ambitious fiscal restraint than those that have already achieved their MTO. The size of the convergence margin is related to the share of general government expenditure in GDP. The magnitude of the convergence margin is based on the assumption that any decrease in the public expenditure-to-GDP ratio would then translate into an exact proportional improvement of the structural balance. On this basis, larger public sectors would require less expenditure restraint, in percentage terms, to achieve the same tightening of the structural budget, when compared to countries having a smaller public sector.

The convergence margin for year [t] is set in spring [t-1] according to a prescribed methodology. Specifically, the computation utilises the size of the government primary expenditure (total expenditure net of interest payments) in nominal GDP. The figure comes from the same COM's forecast vintage on which the ten-year medium term potential GDP

[60] The MFIN is a member of this working group.

growth is centred. Specifically the formula used is [C=50/P] where [C] is the convergence margin and [P] is the share of primary expenditure in GDP.[61] In the case of Malta, the value of [P] was approximately 38.5% in 2015 and 41.7% in 2016. This translates into a default conversion margin [C] of 1.3% for 2015 and 1.2% for 2016.

However, since Malta's Country Specific Recommendations indicated a required improvement in the structural balance of 0.6% of GDP rather than 0.5% of GDP, the convergence margin needs to be recalibrated in order to be consistent with the recommended tightening in the structural balance. The recalibrated convergence margin multiplies the default convergence margin by the specific structural effort requirement (0.6% in the case of Malta), and dividing by the standard structural effort requirement of 0.5%. Accordingly the recalculated convergence margin for Malta for 2015 was established at 1.5%, while that for 2016 was established at 1.4% (see Table 7.4). Effectively, the convergence margin guides the necessary restraint which the country must undertake as long as it has not yet attained its MTO. Thereafter, once the MTO is attained, no convergence margin remains applicable.

Table 7.4: The recalibrated convergence margin*

Assessment of budgetary figures for	Share of Primary expenditure in GDP [P]	Convergence Margin [C]	Ratio of required structural effort compared to standard structural effort	Recalibrated convergence margin
a	b	c = 50 / b	d = 0.6% / 0.5%	e = c x d
2015	38.5%	1.3%	1.2	1.5%
2016	41.7%	1.2%	1.2	1.4%

***Figures may not add up due to rounding.**
Source: Box 1.10 and Annex 4 of the Vade Mecum on the Stability and Growth Pact, 2016 edition

7.5 Methodology to calculate the reference rate

In the case of Malta the reference rate is calculated by subtracting the convergence margin from the potential growth rate. A specific reference rate is calculated for each respective year (see Table 7.5).

Thus, the reference rate for 2015 was calculated at 0.3%, while that for 2016 was estimated at 1.3%. These growth rates define the expenditure limits for the year. The significant increase in the reference rate from 2015 to 2016 reflects the updated COM's forecasts which indicate

[61] The figure 50 is related to the requirement of generating the necessary annual improvement in the structural balance.

a much higher medium-term potential growth rate. This follows the surge in investment spending and the positive labour market developments which were recently achieved.

Table 7.5: The reference rate

Assessment of budgetary figures for	Potential growth rate	Convergence margin recalculated	Reference rate
2015	1.8%	1.5%	0.3%
2016	2.7%	1.4%	1.3%

Source: Annex 4 of the Vade Mecum on the Stability and Growth Pact, 2016 edition

7.6 Methodology to calculate the modified expenditure aggregate

The expenditure benchmark's reference rate does not apply to overall expenditure but rather to a modified aggregate. The latter takes into account a number of adjustments. The rationale for these adjustments is to focus on that element of expenditure which is more of a structural nature, and thus more indicative of the conduct of fiscal policy. In order to arrive at the modified expenditure aggregate, four main adjustments are carried out to the overall government expenditure (see Table 7.6).

Table 7.6: Adjustments to total government expenditure

Adjustment	Rationale
Netting out of interest payments	To focus on expenditure which is totally within the government's control
Netting out of spending on EU programmes paid for by EU funds	To focus on expenditure which is paid out of tax revenues
Netting out of the cyclical elements of unemployment benefits	To focus on expenditure which is independent of cyclical conditions
Smoothing investment spending over four years	To avoid penalising peaks in investment spending

Source: Vade Mecum on the Stability and Growth Pact, 2016 edition

Calculation of the modified expenditure aggregate thus requires information about: total expenditure; interest payments; EU-funded expenditure; the cyclical component of unemployment benefits; and a four-year time series of investment spending. [62]

[62] The calculation of the cyclical element of unemployment benefits further requires information about macroeconomic indicators such as the output gap conditions and the latter's impact on actual unemployment.

7.7 Methodology to convert nominal expenditure growth into real terms

Since the reference rate of the expenditure benchmark is established in real terms, the modified annual government expenditure growth rate needs to be converted into real terms to enable meaningful comparison. This is achieved by deflating the nominal government expenditure using a suitable deflator. The methodology specifically prescribes the use of the percentage change in the GDP deflator as the appropriate measure for inflation in this case. This choice is based on the need to use an indicator which is consistent with the workings used to derive potential output. Another advantage is the fact that the GDP deflator typically displays less volatility than other measures of inflation and is therefore more conducive to supporting transparent and stable policy-making. The particular GDP deflator vintages to be used are also prescribed according to a specific pattern (see Table 7.7).

Table 7.7: GDP deflators

Budget and year of in year assessment	Year of ex post assessment	COM's deflators to use
2015	2016	Average of 2014 spring and autumn forecasts
2016	2017	Average of 2015 spring and autumn forecasts

Source: Table 1.1 of the Vade Mecum on the Stability and Growth Pact, 2016 edition

When the COM assesses the fiscal plans for year [t] depicted in the USP or the DBP of the same year, the average GDP deflator from the Commission's spring forecast and that of autumn of the preceding year is used. The ex-post assessment of outturn data of year [t] which is undertaken in year [t+1] is then based on the average GDP deflator forecast for [t] taken from the COM's spring and autumn forecasts of [t-1].

7.8 Compliance with the expenditure benchmark

Countries that have exceeded their MTO do not need to be assessed for compliance with the expenditure benchmark, as long as the MTO is maintained. For the other countries (including Malta), compliance with the expenditure benchmark is ascertained by evaluating whether in each year the expenditure plans result in expenditure growth (converted into real terms) that satisfies the yearly reference rate.

Compliance with the expenditure benchmark in the country's USP or DBP is assessed against both the plans' own forecasts and those of the COM. The latter form the basis for the COM's risk assessment of the plans. With regard to the ex-post assessment of compliance, this is based on outturn data, with the exception of deflator values which follow the previous explained methodology.

If the country is compliant on an ex-ante basis, this means that if the plans turn out as forecast, the country would comply with the preventive arm of the SGP. On an ex-post basis, the assessment would conclude whether compliance has taken place in the previous year.

In order to ensure the predictability of the ex-post assessment's outcome and enable the country to take the appropriate measures in the forthcoming budget plan, the applicable convergence margin and the resulting reference rate are communicated in the spring of year [t-1] for year t and are kept fixed – unless the required structural adjustment is reset – for all the assessments (ex ante, in-year and ex post) of the budgetary figures of year [t]. This is based on the principle of the so-called 'freezing' of the requirements. The advantage of freezing requirements is that it allows for the limits to be known by the country ex-ante and hence the country is able to plan accordingly. The disadvantage of the freezing requirements is that they may not capture fully latest developments. This issue may be particularly relevant for countries like Malta which are experiencing rapid structural changes.

The purpose of aiming towards full compliance with the expenditure benchmark is to ensure that a country maintains its MTO or else closes the gap towards it (see Table 7.8). In particular, it ensures that benign fiscal revenue conditions do not translate into an expansion of the public sector through new expenditure initiatives but are rather channelled into faster progress towards the MTO.

Table 7.8: Link between compliance with the expenditure benchmark and the MTO

Member State at MTO	Member State not at MTO
Net expenditure growth is in line with reference potential growth rate	Net expenditure growth is in line with a rate below the reference potential growth rate
The share of government expenditure as per cent of potential GDP remains constant (in the absence of revenue measures)	The share of government expenditure as per cent of potential GDP decreases (in the absence of revenue measures)
The structural balance is constant over time	The structural balance improves over time
The Member State remains at its MTO	The gap with the MTO closes over time

Source: Vade Mecum on the Stability and Growth Pact, 2016 edition

7.9 The role of discretionary revenue measures

Irrespective of whether a country is at the MTO or not, compliance with the expenditure benchmark can also be achieved if any excess expenditure growth over the medium term potential growth rate is matched by discretionary revenue measures. The latter can take place principally via the introduction of new taxes or increases in tax rates.

Specifically, any excess expenditure growth over the medium-term reference is not counted as a breach of the benchmark if it is fully offset by revenue increases mandated by law. This provision is applicable to situations where country has revenue sources that are linked by law to certain expenditure items, so that when expenditure increases, the revenues automatically increase to fund that higher expenditure.[63] To date, in Malta there is no such framework of automatic revenue adjustment in place.

By factoring in the possibility of revenue measures within the expenditure benchmark calculations, the framework is flexible to accommodate a country's preferences in the area of public finances. The expenditure benchmark does not limit, or in any way determine, the size of government spending. It only requires that any 'excessive' expenditure growth is fully funded by equivalent discretionary revenue measures. Compliance with the expenditure benchmark is thus possible, independent of whether the political preferences in a country favour a large or small public sector.

7.10 Deviation from the expenditure benchmark

The assessment of the expenditure benchmark focuses on whether the growth rate of government expenditure, net of discretionary revenue measures, contributes to the appropriate adjustment towards the MTO, or whether it is in line with the medium-term rate of potential GDP growth for countries at their MTO. A deviation from the expenditure benchmark occurs when expenditure growth exceeds the reference rate. This is evaluated both on a yearly basis, as well as an average over a rolling two-year period.

Possible deviations fall under two categories, 'significant' or 'not significant'. The assessment of whether a deviation is significant is based on the following criteria: whether the deviation has a total impact on the government balance of at least 0.5% of GDP in a single year, or at least 0.25% of GDP per year when averaged over two consecutive years for a cumulative amount of at least 0.5% of GDP over two years.

In the case of Malta, the modified expenditure growth for 2015 was estimated by the COM at 1.4% thus exceeding the reference rate by 1.1% (see Table 7.9). On the other, the modified expenditure growth for 2016 was estimated by the COM at 0.5% and hence 0.6% below the limit. As a result, over a two-year average, the deviation was estimated at -0.3% indicating that modified expenditure growth has indeed exceeded the limit to an extent to be considered as 'significant'.

[63] A revenue (change) mandated by law is a change in a specific tax or contribution rate which is – in principle – triggered automatically (i.e. through a specific piece of pre-existing legislation) by a change in a well-specified and clearly linked expenditure category, with the intention of ensuring sufficient financing for this expenditure category. An example of this is the case where health and medical expenses are funded by a hypothecated tax which is automatically adjusted to cover these expenses when they increase (or decrease).

Table 7.9: Compliance with the expenditure benchmark (COM's assessment)

Year	Reference Rate	Modified expenditure growth (deflated)	Yearly deviation	Two-year average deviation
2015	0.3%	1.4%	-1.1%	-0.3%
2016	1.3%	0.7%	+0.6%	

Source: Table 6 of the Commission Staff Working Document accompanying the analysis of the draft budgetary plans for Malta published on 16 November 2016. Figures may not add up due to rounding.

Deviations of expenditure developments are not considered significant if the country has over-achieved the MTO, after factoring in the possibility of significant revenue windfalls, and also as long as the budgetary plans laid out in the USP do not jeopardise that objective over the programme period. Similarly, the deviation may be left out of consideration when it results from an unusual event outside the country's control and which has a major impact on the financial position of the general government. It is also not considered significant in the case of a severe economic downturn for the euro area or the Union as a whole, provided that this does not endanger the fiscal sustainability in the medium-term.

In all other cases the conclusion depends on the 'overall assessment', which should include an in-depth analysis based both on the structural effort criterion as well as the expenditure benchmark. The risk of or the conclusion of an ex-post significant deviation requires at least one indicator to be in significant deviation. In case the country is considered to be in significant deviation on both indicators, this gives a strong presumption of a (risk of or observed) significant deviation, but an overall assessment is still needed before reaching such a conclusion. The overall assessment uses a certain element of judgement by putting everything into perspective. Indeed, there is no element of automaticity in the Regulation in reaching the conclusion of a significant deviation.

In the overall assessment, particularly when only one indicator points to a significant deviation, the COM analyses the factors which lead to the discrepancy between the two indicators. It informs the European Council about this analysis, explaining the discrepancy between both indicators and the reasons behind the conclusion of the overall assessment. The conclusion of the assessment of the country's plans considers whether the resulting change in the structural balance, including the analysis of the expenditure net of discretionary revenue measures, appears to be appropriate or whether a significant deviation from the adjustment path can be expected – either on a one year or on a two-year basis.

Where a conclusion of overall significant deviation is reached on an ex post basis on outturn data, this triggers a Significant Deviation Procedure (SDP), which starts with a COM's warning to the country in question and can lead to an interest-bearing deposit being required, for euro area countries, in the event that the significant deviation is not addressed appropriately.

7.11 Latest updates

At the Council meeting of the Economic and Financial Affairs (ECOFIN) which was held on 6 December 2016, reference was made to the expenditure benchmark (see Box 7.2). In particular an agreement has been reached at the European level whereby stronger focus on an expenditure-based indicator is envisaged for setting and assessing fiscal policies and outcomes. While this agreement could fine-tune some of the calculations referred to in this Chapter, there will not be any need for changes to the legislation underlying the SGP. The agreement follows from the Five Presidents Report which among other things has suggested the reduction in the complexity of the SGP framework.[64] The COM intends to publish the relevant details about the way in which the new agreement will take place in practice in the next edition of the Vade Mecum on the SGP.

Box 7.2: Outcome of the 3506th meeting of the Economic and Financial Affairs Council

Fiscal rules – Predictability and Transparency

The ECOFIN Council on 6 December 2016 endorsed an agreement concluded at the Economic and Financial Committee (EFC) aimed at improving the predictability and transparency of the EU's fiscal rulebook, the SGP.

On 29 November 2016, the EFC reached agreement on how to simplify the assessment of compliance with the SGP's rules. The agreement covers both the preventive and corrective arms of the Pact as relating to the assessment of Member States' fiscal policies and outcomes. No change to the legislation underlying the Pact is envisaged.

Stronger focus on an expenditure-based indicator is envisaged for setting and assessing fiscal policies, thereby aiming to reduce complexity in the fiscal surveillance framework.

The indicator involves setting an upper limit for the growth rate of government expenditure. This is considered an operational and easy-to-measure target that will guide Member States in the preparation and monitoring of their budgets. However, the structural balance indicator will still remain an essential part of the fiscal surveillance framework.

The SGP is based on articles 121 and 126 of the Treaty on the Functioning of the European Union and a treaty protocol on the excessive deficit procedure. Its rules were initially developed by a resolution and two regulations adopted by the Council in 1997.

Source: Based on www.consilium.europa.eu/en/meetings/ecofin/2016/12/st15205_en16_pdf

The information available to date indicates that under the corrective arm, the expenditure benchmark will in future be used as the operational indicator for determining compliance

[64] The Report can be downloaded from https://ec.europa.eu/commission/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en.

with the COM's recommendations made under the EDP.[65] In particular, the agreement stipulates that the expenditure benchmark will become the cornerstone of the COM's assessment of the Member States' compliance with the SGP. Accordingly, future EDP recommendations will be formulated also in terms of the expenditure benchmark. The expenditure benchmark will be the maximum allowable growth rate of government expenditure (net of any possible discretionary revenue measures) consistent with meeting the targets for the headline deficit and the change in the structural balance.

In the case of Member States who are in the preventive arm of the SGP and have not yet attained their MTOs, the adjustment requirements, which currently are set out by the Council only in terms of change in the structural balance, will be formulated ex-ante also in terms of the expenditure benchmark.

By establishing the use of the expenditure benchmark under both the preventive and corrective arms, the agreement will increase the overall consistency of the SGP. The COM's view is that the expenditure benchmark has the benefit of being easier to measure than the structural balance, as it is based on observable variables once the benchmark is set ex-ante. Another advantage is that the expenditure benchmark is directly connected to the evolution of non-cyclical expenditure, a policy lever which is directly under the control of government. Furthermore, the expenditure benchmark has the merit of being easier to communicate, both with the general public and with policy makers, as it essentially translates into an expenditure ceiling.

[65] Source: Report on Public Finances in EMU 2016, European Economy Institutional Paper 045, December 2016.

Appendices

Appendix A

Recommendations made in 2016

The MFAC made 28 different recommendations during 2016 in its publications. Thirteen recommendations were new, while the others restated recommendations that were made in 2015. This Appendix reproduces abstracts from the text as published by the MFAC during 2016 in the reports listed hereunder.

Report number	
1	An Assessment of the Macroeconomic Forecasts for the Maltese Economy prepared by the Ministry for Finance in April 2016
2	An Assessment of the Fiscal Forecasts for Malta prepared by the Ministry for Finance in April 2016
3	An Overall Assessment of the Medium-Term Fiscal Strategy for Malta 2016-2019
4	An Assessment of the Annual Report 2015 published by the Ministry for Finance
5	An Assessment of the Half-Yearly Report 2016 published by the Ministry for Finance
6	An Assessment of the Macroeconomic Forecasts for the Maltese Economy prepared by the Ministry for Finance in October 2016
7	An Assessment of the Fiscal Forecasts for Malta prepared by the Ministry for Finance in October 2016
8	An Overall Assessment of the Draft Budgetary Plan for 2017

Recommendations dealing with the conduct of fiscal policy

- **Rationalise expenditure**

"The MFAC invites the Government to remain vigilant and maintain its commitment to keep public finances under control, particularly through expenditure restraint and further expenditure rationalisation measures along the lines proposed through the Comprehensive Spending Reviews (CSRs)." (*Report no 3, page 9)*

"In this respect the MFAC considers important that expenditure savings of a permanent nature are sought and crystallised, where possible, through decisive improvements in the efficiency of the public services and the undertaking of structural reforms, similar to those carried out in the area of social benefits." (*Report no 3, page 10)*

"The Government is invited to take stock of the findings resulting from the CSRs which to date have been concluded in the areas on social benefits and health, and which is currently being undertaken in the area of education. The MFAC recommends that the findings of the various CSRs will continue to be followed up by appropriate decisions, to ensure that non-productive expenditures are phased out, and that inefficiencies are addressed." (*Report no 3, pages 10-11)*

"However, it invites the Government to exert further restraint in expenditure in order to address the risk of a significant deviation from the reference rate and thereby ensure full compliance with the expenditure growth benchmark. Indirectly this would also help to address the risk that revenue windfalls are channelled into higher expenditures." *(Report no 3, page 21)*

"The MFAC continues to emphasise the need for expenditure restraint and continuous vigilance to ensure that fiscal commitments are maintained. The possibility of revenue surpluses should not be viewed as an opportunity to extend further permanent expenditure initiatives." *(Report no 4, page 13)*

"The MFAC re-iterates the importance of keeping expenditure growth under control in order to ensure that the expenditure benchmark, which forms part of the requirements under the SGP, is respected in 2016, after having been missed in 2015." *(Report no 5, page 14)*

"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." *(Report no 7, page 47)*

"The MFIN is invited to explore whether fine-tuning of expenditure plans for 2017 could be possible so as to at least aim towards the annual 0.6 percent of GDP requirement in the

improvement of the structural balance, if one were to exclude the effect of the costs relating to the EU Presidency from the calculations." *(Report no 8, page 4)*

- **Use revenue windfalls primarily to build fiscal buffers**

"The MFAC also re-iterates its recommendation that any revenue windfalls, as distinguished from normal revenue forecast errors, which could materialise over the forecast horizon, should be used to achieve a faster decline in the fiscal deficit, rather than finance additional permanent expenditures." *(Report no 3, page 13)*

"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." *(Report no 7, page 47)*

- **Achieve further progress in pension reform**

"The Government is invited to utilise the current benign macroeconomic conditions to continue to address the age-related expenditure challenges through further strategic choices, aimed to safeguard public finances from undue future pressures, while keeping the tax burden at acceptable levels." *(Report no 3, page 27)*

"Further progress in pension reform, which aims to improve sustainability while addressing poverty considerations, on the basis of the suggestions put forward by the Pensions Strategy Group, is encouraged, in order to strike a good balance between financial sustainability and equitable growth and development." *(Report no 3, page 28)*

- **Establish rigorous policies of how the Contingency Reserve can be resorted to**

"The MFAC recommends such a prudent approach (here referring to the Contingency Reserve not being resorted to), which would generate a buffer over the minimum annual structural effort required. This in turn would enable the Government to be in a better position to address any unforeseen deterioration in economic or fiscal conditions. At the same time, the MFAC reiterates the need to establish clear and objective criteria which specify more thoroughly when recourse to the Contingency Reserve may be resorted to." *(Report no 3, page 28)*

- **Use IIP funds cautiously**

"The MFAC suggests that revenues from the IIP are not channelled into additional spending of a recurrent nature but are rather used to finance one off initiatives consistent with the expenditures budgeted in the MTFS." *(Report no 3, page 29)*

- **Evaluate the economic efficiency of the tax framework**

"The MFAC also encourages the Government to study whether certain elements of the current tax framework, such as in the case of immovable property, can be improved upon." *(Report no 3, page 29)*

- **Extend the average maturity profile of public debt**

"The MFAC re-iterates that there is scope to extend further the average maturity of public debt in order to spread savings resulting from the exceptionally low interest rate environment over many years." *(Report no 3, page 29)*

- **Safeguard the efficacy of fiscal policy**

"It is however important that compliance with rules is done in a way which does not limit the efficacy and the meeting of fiscal policy objectives" *(Report no 8, page 4)*

Recommendations dealing with legislation

- **Consider new legislation to guide the issuing of government guarantees**

"The MFAC invites again the Government to consider new legislation on the issuing of government guarantees, particularly since these remain rather high when compared to other EU Member States." *(Report no 3, page 29)*

Recommendations dealing with the budgetary process

- **Use consistent definitions and methodologies across forecast rounds**

"The variation in employment growth between the projection of 1.9% and the actualized growth of 3.9% is in large part explained by the different definitions utilized for total employment between the USP and the October 2015 forecast exercise, which implies that the two figures are therefore not strictly comparable. The MFAC is of the opinion that the use of a consistent definition across forecasting rounds would ensure a more congruent assessment process" *(Report no 1, pages 18-19)*

"It must be said that, as opposed to previous years, when the inventory component was assumed to have a zero contribution rate to GDP, the role of the inventory component in terms of its contribution to real GDP growth is now assumed by EPD to be positive for 2016. In this regard, the MFAC would like to highlight the importance of retaining consistency in the treatment of this component over future forecast rounds." *(Report no 6, page 9)*

- **Ensure closer synergy across government departments**

"While significant efforts have been made to enhance the coordination and streamlining of activities between the different entities which provide their inputs to the fulfilment of the forecasting exercise, there is a need for further initiatives towards this end." *(Report no 1, page 27)*

"The MFAC would like to encourage further improvement in the streamlining and overall coordination of the whole forecast exercise so as to cater more adequately for this alignment to the timeline. The MFAC would like to stress the importance of ensuring that the final round of forecasts and all information pertinent to the relative analysis are made available to the users with enough lead time to enable the smooth undertaking of the required analysis." *(Report no 6, page 27)*

- **Ensure that the budget timetable is consistent with European Semester**

"The forecasts prepared by the MFIN are used as a base input within a number of reports compiled by various government departments and other entities. It is in this regard that the MFAC recommends that the preparation of these forecasts should give enough lead time to other entities that use the forecasts as inputs for their reports and analysis." *(Report no 1, page 27)*

"The MFAC underscores the importance that as much as possible, working practices should be better aligned to the timelines envisaged by the European Semester. More specifically, while the MFAC notes that the formal deadline (30 April) for the submission of the USP to the Commission is being respected by the MFIN, the time allocated for the MFAC's assessment of the macroeconomic forecasts is being conditioned by the fact that these are being finalised very close to this deadline, in view of the fluidity of the fiscal projections" *(Report no 2, page 13)*

"The MFAC invites the MFIN to push further ahead in this respect (here referring to the increased collaboration across departments), particularly to ensure that the processes are consistent with the timelines envisaged by the European Semesters, allowing sufficient time for the exchange of views and assessment by the MFAC, particularly with respect to the endorsement of the macroeconomic projections which needs to be submitted twice-yearly, concurrently with the USP and with the Draft Budgetary Plan" *(Report no 3, page 27)*

- **Maintain detailed documentation on how the fiscal data is compiled**

"The MFAC views positively that the USP document contains information about revenue elasticities underpinning the forecasts, but considers that transparency and estimates' robustness would be improved further if formal documentation outlining the way the fiscal projections are being carried out were to be published by the MFIN." *(Report no 2, pages 13-14)*

- **Focus greater attention on developments in the structural balance**

"While acknowledging that the evaluation of structural conditions could be rather challenging in view of ongoing revisions in the output gap estimates, the MFAC would like to recommend that increased attention should be given by the MFIN to the structural balance, as ultimately the COM evaluates progress towards the MTO on the basis of developments in the structural balance rather than the headline balance." *(Report no 3, page 20)*

"The MFAC re-iterates its recommendation that the MFIN should pay increasing attention to the structural balance, similar to the focus on the headline balance. This is necessary so as to

correctly identify possible revenue windfalls, as a result of better-than-expected macroeconomic conditions, and endeavour that these are not channelled into new current expenditure." *(Report no 4, page 18)*

- **Ensure technical issues are adequately addressed before announcing changes to tax or expenditure policies**

"The MFAC invites the Government to ensure that when new taxes are introduced, such as in the case of the environmental contribution to be paid by tourists, all operational and legal aspects are pro-actively dealt with to avoid the derailing from the initial plans." *(Report no 3, page 28)*

- **Perform closer monitoring of output gap and its implications**

"Since the output gap is a crucial determinant of the structural balance, which in turn determines whether a country has satisfied the annual required structural effort in terms of the SGP, it is important that to the extent possible this aspect is better factored into the budgetary practices." *(Report no 3, page 29)*

"The MFAC considers important that the MFIN carry out an explicit type of plausibility assessment with respect to the forecasts for potential GDP growth and the output gap. This is important to better evaluate the robustness and identify any potential bias which may surround these key variables." *(Report no 5, page 11)*

- **Ensure feasibility of expenditure restraint targets**

"The MFAC considers that the robustness of expenditure projections can be further enhanced through stronger monitoring and vigilance, and through an accelerated implementation of the findings of the Comprehensive Spending Review (CSR) exercises, particularly in respect of ambitious expenditure restraint targets. This is important in order to avoid situations where expenditure projections would otherwise need to be subsequently revised upwards." *(Report no 4, page 13)*

"The MFIN is invited to ensure that going forward the actual spending on compensation of employees be closer to the targets. Forecast accuracy would increase through more precise information about the expected year-end headcount, seniority structures, overtime pay and bonuses." *(Report no 4, page 14)*

- **Establish clear guidelines on cash holdings**

"The MFAC invites the MFIN to clarify better its strategy for cash holding and on how such strategy contributes to ensure that financial resources are allocated optimally." *(Report no 5, page 13)*

- **Maintain closer monitoring and control of EBU's activities which have fiscal implications**

"The MFAC invites the MFIN to be vigilant about the financing needs of EBUs to avoid setting unrealistic targets, while at the same time maintain closer monitoring of expenditures

by EBUs to ensure that these entities fully respect the targets agreed at the time of the Budget." *(Report no 5, page 13)*

- **Address revenue arrears more strongly**

"The MFAC emphasises on the need that revenue arrears are kept under scrutiny in order not to prejudice their collectability. Given the rather buoyant macroeconomic conditions and the exceptionally low interest rate conditions, there appears to be scope for a more ambitious target for the collection of such arrears in future." *(Report no 5, page 21)*

- **Consider the publication of more timely official statistics**

"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." *(Report no 7, page 10)*

Recommendations dealing with transparency issues

- **Enhance the commentary on the drivers of variation in fiscal data**

"The reason for the volatility in the implied yearly elasticity for this revenue item (here referring to taxes on production and imports), stemming from the methodologies being used, as well as the assumptions adopted and expert judgement, could however be better explained in the USP." *(Report no 2, page 18)*

"When compared to the ESA fiscal statistics for the first half of 2015, published by the NSO through News Release 106/2016 (the latest available by the cut-off date), the estimated figures reported in the 2015 HYR were within a close range. However, both revenues and expenditures were underestimated. The MFAC is aware that the MFIN carry out an internal exercise to explore the possible reasons of such underestimation in order to improve further the quality of such estimates in the future. It would be useful if such reasons are explained in the HYR." *(Report no 5, page 11)*

"The MFAC notes that there are no explanations about the specific changes to the stock-flow adjustments to explain why, despite a somewhat higher projected 2016 deficit in the HYR compared to the USP (up by €4.4 million), the forecast for gross debt has been scaled down in the HYR, by €6.1 million. Whereas the MFAC appreciates that these revisions are relatively marginal in relation to the level of outstanding debt, the MFAC considers that, in order to boost transparency further, it would be useful that any revisions beyond a certain amount, compared to previously announced forecasts (in this case in the USP), are clearly identified and explained." *(Report no 5, page 20)*

- **Elaborate more on fiscal risks**

"Results (in terms of the sensitivity analysis by the MFIN) are then summarised in two fan charts, which present the possible range of outcomes on real GDP growth and on the fiscal balance-to-GDP ratio. To enable a clearer valuation of the robustness of these results, it would however be important to include additional explanations as to how these scenarios have been chosen and identify the underlying critical technical assumptions which are driving such results." *(Report no 3, page 8)*

"The MFAC refers to Article 39 (9) of the FRA which provides that the HYR "must take into account, to the extent possible, any Government decisions or other developments, which may have an effect on the fiscal and economic prospects for the year." In this context, the MFAC considers useful that the HYR would pro-actively elaborate more fully on potential risks that the latest developments may pose to the outturn for public finances, at least in a qualitative manner." *(Report no 5, pages 21-22)*

"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." *(Report no 7, page 11)*

"The MFIN is also invited to explore whether the scenarios considered (in the fan chart) could be expanded to cover a fuller set of fiscal risks." *(Report no 7, page 11)*

- **Provide details about fiscal measures for years t+1, t+2**

"The MFAC invites the Government to explore ways how measures for the outer years, which are embodied into the MFIN's projections, can be better delineated." *(Report no 3, pages 27-28)*

- **Provide more details on the assumptions used to prepare the forecasts**

"In order to boost transparency further, the MFAC encourages the MFIN to consider including in its Annual Report, explanations about the profit deviations for the key sectors of the Maltese economy. This may be useful since the eventual impact on public finances may be different depending which sectors experience growth or contraction" *(Report no 4, page 7)*

- **Focus more attention on the expenditure benchmark outlined in the SGP**

"The MFAC considers the evaluation of compliance with the expenditure benchmark of importance and in this respect would welcome the possibility that the MFIN also dedicates a specific section to the analysis of the expenditure benchmark in its Annual Report. This would ensure a more comprehensive ex-post assessment of the conduct of fiscal policy during the previous year in the context of the Government's European commitments, in particular the terms of the SGP" *(Report no 4, page 20)*

- **Consider reacting publicly to the recommendations made by the MFAC**

"At the same time, the Council invites the MFIN to evaluate the merit of using its Annual Report to make public its views on the various recommendations made by the MFAC throughout the year, also summarised in the MFAC's first Annual Report, as this would strengthen further the institutional dialogue and add more fiscal transparency." *(Report no 4, page 20)*

- **Provide updates on the performance of fiscal measures announced in the Budget**

"It would be useful for the MFIN to include in the HYR, an update with regard to the specific progress achieved with respect to the measures announced in the Budget and also about other specific important items within the Budget. By identifying specifically the percentage of the estimated revenue or expenditure impact which has materialised during the first six months in respect of such measures, it would be easier to assess the extent to which the yearly targets are likely to be attained or otherwise." *(Report no 5, page 22)*

Appendix B

Publications to date

In terms of the Article 13(3) of the FRA, the MFAC is required to submit an assessment or opinion on the MFIN's official reports to the Minister for Finance as soon as is practicable, and to publish such assessments within ten days beginning on the day on which the copy is so given. During its first two years of operations, the MFAC published 15 reports in total, 5 reports in 2015 and 10 reports in 2016. As the MFAC's publishing timetable stabilizes, 9 standard reports are expected to be published yearly (see Box A).[66] Besides the standard reports, the MFAC intends to start publishing occasional working and research papers as a means of broadening the debate on fiscal policy issues.

The following is a list all the official MFAC's reports published to date and the date when they were actually published.

2015

30 April	An Assessment of the Macroeconomic Forecasts for the Maltese Economy prepared by the Ministry for Finance in April 2015
26 May	An Assessment of the Main Fiscal Forecasts prepared by the Ministry for Finance and presented in the Update of the Stability Programme for Malta 2015-2018
30 September	An Assessment of the Medium Term Fiscal Strategy 2015-2018, Annual Report 2014 and Half-Yearly Report 2015 published by the Ministry for Finance
15 October	An Assessment of the Macroeconomic Forecasts for the Maltese Economy prepared by the Ministry for Finance in October 2015
3 December	An Assessment of the Fiscal Forecasts prepared by the Ministry for Finance and presented in the Draft Budgetary Plan 2016

[66] In 2015 the number of reports was fewer than 9 as some assessments were combined in a single report. Furthermore, no Annual Report was published in that year since the MFAC only started its operations in 2015. On the other hand, in 2016, the number of reports exceeded 9 because the publication of a report pertaining to 2015 was published in January 2016.

2016

11 January	An overall assessment of the Draft Budgetary Plan 2016
11April	MFAC First Annual Report and Statement of Accounts 2015
29 April	An Assessment of the Macroeconomic Forecasts for the Maltese Economy prepared by the Ministry for Finance in April 2016
27 May	An Assessment of the Fiscal Forecasts for Malta prepared by the Ministry for Finance in April 2016
30 June	An Overall Assessment of the Medium-Term Fiscal Strategy for Malta 2016-2019
29 July	An Assessment of the Annual Report 2015 published by the Ministry for Finance
31 August	An Assessment of the Half-Yearly Report 2016 published by the Ministry for Finance
14 October	An Assessment of the Macroeconomic Forecasts for the Maltese Economy prepared by the Ministry for Finance in October 2016
29 November	An Assessment of the Fiscal Forecasts for Malta prepared by the Ministry for Finance in October 2016
28 December	An Overall Assessment of the Draft Budgetary Plan for 2017

Box A: Standard publication timetable

Publication	Date
MFAC Annual Report	**31 March ***
Assessment of the macroeconomic forecasts contained in the Update of Stability Programme	**30 April ***
Assessment of the fiscal forecasts contained in the Update of Stability Programme	**31 May**
Overall assessment of the Update of Stability Programme / Medium Term Fiscal Strategy	**30 June**
Assessment of the Ministry for Finance's Annual Report	**31 July**
Assessment of the Ministry for Finance's Mid-Year Report	**31 August**
Assessment of the macroeconomic forecasts contained in the Draft Budgetary Plan	**15 October ***
Assessment of the fiscal forecasts contained in the Draft Budgetary Plan	**30 November**
Overall assessment of the Draft Budgetary Plan	**31 December**

* These reports must be published by the set date, as specified by the requirements of the FRA and the European Semester. In the case of the other reports, the FRA does not indicate a specific deadline.

Glossary

Budget balance: The difference between total government revenue and total government expenditure. A balanced budget occurs when expenditure is equal to revenue.

Budgetary rule: A rule which sets limits on the conduct of fiscal policy such as for example by establishing limits on the permissible annual fiscal deficit or the yearly expenditure growth.

Central Government: Consists of all administrative departments of the state and other central agencies whose responsibilities cover the whole economic territory of a country, except for the administration of social security funds.

Comprehensive Spending Review: Consists of a line-by-line analysis carried out by the Ministry for Finance of each ministry's expenditure inputs and outputs in order to determine the effective cost of government's activities. The objective is to prioritise expenditure and identify areas where savings can be attained.

Consolidated Fund: This fund is the government's main account and it captures the activities of the Government Ministries and Departments. This Fund records transactions on a cash basis. All allocations provided from the Consolidated Fund are either authorised by Parliament under an Appropriation Act, or are permanently appropriated by Parliament under other relevant legislation.

Contingency Reserve: A contingency reserve with the purpose of reducing the risks surrounding the attainment of the fiscal targets, and its utilisation is permitted on the basis of exceptional conditions, as specified in the Fiscal Responsibility Act.

Country-Specific Recommendations: Provide tailored advice by the European Council following a proposal by the European Commission to Member States on how to boost jobs and growth, while maintaining sound public finances.

Cyclically-adjusted budget balance: Computed as the difference between the actual balance-to-GDP ratio and an estimated cyclical component. It is the balance (deficit or surplus) that would exist if the economy were at potential.

Debt criterion: A country whose public debt-to-GDP ratio exceeds the 60% threshold must converge to this limit, at a satisfactory pace. This criterion is part of the corrective arm of the Stability and Growth Pact (also referred to as the Debt Rule).

Dependency ratio: the sum of persons aged less than 15 years plus persons aged 65 years and over, expressed as a percentage of the working-age population, between 15 and 64 years.

Draft Budgetary Plan: A document which presents the Government's updated official macroeconomic outlook and the fiscal projections for the current and the following year, taking account of the new fiscal measures.

Europe 2020 targets: 10-year targets which were launched in 2010, as part of the EU's growth and jobs strategy. The targets relate to employment, R&D, emissions levels, renewable energy use, energy efficiency, early school leaving, tertiary education and population at risk of poverty.

European Semester: This is a yearly cycle of economic policy co-ordination, guidance and surveillance. It provides a framework and a binding annual timeline for managing pro-growth measures at the European level.

European System of National and Regional Accounts: The European accounting standard for the reporting of economic data by Member States in the EU. The ESA methodology is based on the accruals accounting concept.

Excessive Deficit Procedure: A procedure under the corrective arm of the Stability and Growth Pact. This is applicable to Member States judged to have an excessive deficit (above 3% of GDP) or public debt levels not diminishing at a satisfactory pace towards the 60% of GDP benchmark.

Expenditure Benchmark: A reference value for the permissible expenditure growth which depends on the estimates for potential GDP growth. Any excess expenditure growth must be matched by discretionary revenue measures.

Extra Budgetary Units: entities forming part of General Government, but which are not accounted for within the Departmental Accounting System (DAS) of Central Government.

Fiscal Compact: Refers to the fiscal part of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union which is an intergovernmental agreement signed on 2 March 2012 and which introduced a stricter version of the SGP.

Fiscal consolidation: Governments' actions and policies to lower the deficit-to-GDP ratio in structural terms.

Fiscal deficit: A situation when government expenditure exceeds government revue.

Fiscal governance: Rules, regulations and procedures that influence how budgetary policy is planned, approved, carried out and monitored.

Fiscal policy: The act of regulating government revenue and expenditure to attain macroeconomic objectives.

Fiscal Responsibility Act, 2014: An Act approved by the Maltese Parliament on 8 August 2014 to provide for fiscal responsibility (Act No XXVII of 2014 – Chapter 534)

General Government: Includes Central Government and other activities such as those of Local Councils and Extra-budgetary units (which comprise institutional units under public control that are principally engaged in the production of goods and services not usually sold on a market and / or that are involved in the redistribution of national income and wealth).

Government guarantees: Financial Guarantees provided by the government to certain borrowers to enable them to obtain the necessary amount of funding and at more advantageous interest rates.

Gross Domestic Product: This represents the standard measure of economic activity carried out in a country, at quarterly or annual intervals. Nominal GDP measures activity at market prices while real GDP measures activity at chain-linked prices.

Gross Fixed Capital Formation: Consists of various types of investment, primarily in the form of dwellings, other building and structures, transport equipment, machinery and intellectual property products.

Independent Fiscal Institutions: Independent oversight bodies responsible for the monitoring of fiscal performance and adherence to fiscal rules in their respective country. In some countries they are also mandated to provide forecasts and costing of fiscal measures.

Individual Investor Programme: The programme allows for the grant of citizenship by a certificate of naturalization to foreign individuals and their families who contribute to the economic development of Malta, as provided in the regulations contained in Legal Notice 47 of 2014.

Inflation: The general increase in the price of goods and services over time. The annual inflation rate measures the percentage change in the general price level compared to the previous year.

Maastricht criteria: Five criteria which must be adhered to by European countries in order to qualify for the adoption of the euro. The criteria relate to inflation, fiscal deficit, public debt, exchange rate and interest rates.

Medium Term budgetary Objective: This is the budgetary target to be reached by a specific year, which is assigned to each EU Member State, in order to keep governments on track towards meeting their commitments to pursue sound fiscal policies.

Medium Term Fiscal Strategy: The Government's fiscal objectives, presented as part of a three-year rolling target for fiscal management.

One off and temporary measures: Budget items whose impact is constrained to one or few years.

Output gap: The difference between the level of actual and potential output expressed as a percentage of potential output.

Potential output: This is an estimate of the maximum output that an economy can produce, without creating inflationary pressures, when its resources are utilised in the most efficient manner.

Primary balance: The budget balance excluding interest payments.

Public debt: That amount of debt accumulated over time by the general government.

Revenue windfalls: Unexpected fiscal revenues accruing as a result of better-than anticipated economic developments or other special factors.

Six pack: Five Regulations and one Directive which entered into force on 13 December 2011. It applies to all Member States with some specific rules for euro-area Member States. In particular the six-

pack reinforced both the preventive and the corrective arm of the Stability and Growth Pact.

Stability and Growth Pact: This is a set of rules aimed at assuring that countries in the EU pursue sound public finances and coordinate their fiscal policies. The Pact includes specific rules for countries under the preventive or the corrective arm.

Stock-flow adjustment: Stock flow adjustments relate to certain type of transactions which create a difference between the annual change in gross debt and the budget deficit.

Structural budget balance: The actual budget balance net of the cyclical component and net of one-off and other temporary measures.

Structural effort criterion: The required annual improvement of the general government's fiscal balance measured in structural terms that should be achieved by each Member State following a fiscal adjustment path towards its Medium Term Objective.

Two-pack: Two Regulations which entered into force on 30 May 2013 in all euro area Member States providing for increased transparency on countries' budgetary decisions, stronger coordination in the euro area starting with the 2014 budgetary cycle, and recognising the special needs of euro area Member States under severe financial pressure.

Financial Statements

31 December 2016

The Members of the Council present the annual report and the audited financial statements of Malta Fiscal Advisory Council (the "Council") for the year ended 31st December 2016.

Principal Activity

The Malta Fiscal Advisory Council ("the Council") was established by the Minister for Finance with effect from 1 January 2015 in terms of the Fiscal Responsibility Act, 2014, Cap 534. The Council's aim is to review and assess the extent to which the fiscal and economic policy objectives proposed by the Government are being achieved and thus contribute to more transparency and clarity about the aims and effectiveness of economic policy. The Council is independent in the performance of its functions.

Performance Review

The Council received €253,000 in Government Subvention during the year ended 31st December 2016 (2015: €150,017) in terms of the Fiscal Responsibility Act and incurred €229,761 in expenditure (2015: €150,017). The Council registered a surplus of €23,259 for the year ended 31st December 2016 (2015: break-even) as shown in the statement of comprehensive income on page 103.

Post Balance Sheet Events

There were no particular significant events affecting the Council which occurred since the end of the accounting period.

Future Developments

The Council is not envisaging to change its principal activity.

Council Members

In accordance with the Fiscal Responsibility Act, the Council shall consist of the Chairman and two other members.

The Committee constitutes of the following members:

Mr. Rene Saliba – Executive Chairman
Dr. Ian Cassar – Executive Member
Dr. Carl Camilleri – Executive Member

Statement of Responsibilities of the Council

The Council members are required to prepare the financial statements for each financial year which give a true and fair view of the state of affairs of the Council at the end of the financial year and of the income and expenditure of the Council for that year:
In preparing these financial statements, the Council members are required to:-

- Adopt the going concern basis, unless it is inappropriate to presume that the Council will continue in business;
- Select suitable accounting policies and apply them consistently from one accounting year to another;
- Make judgement and estimates that are reasonable and prudent;
- Account for income and charges relative to the accounting year on the accruals basis; and
- Value separately the components of assets and liability items on a prudent basis.

Statement of Responsibilities of the Council (Cont'd)

The Council members are responsible for keeping proper accounting records which disclose with reasonable accuracy, at any time, the financial position of the Council and to enable them to ensure that the financial statements have been properly prepared. The Council members are also responsible for safeguarding the assets of the Council and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Disclosure of Information to the Auditors

So far as the Council Members are aware, all relevant information has been brought to the attention of the Council's Auditors.

Auditors

PKF Malta, Certified Public Accountants and Registered Auditors, have intimated their willingness to continue in office.

Approved by the Fiscal Council and signed on its behalf on 17th March 2017 by:

Mr. Rene Saliba
Chairman

Dr. Carl Camilleri
Council Member

Dr. Ian Cassar
Council Member

Registered Office:
Malta Fiscal Advisory Council,
Pope Pius V Street,
Valletta

Report on the Audit of the Financial Statements

We have audited the financial statements of Malta Fiscal Advisory Council (the 'Council'), set out on pages 103 to 113, which comprise the statement of financial position as at 31st December 2016, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

Opinion

In our opinion, the accompanying financial statements give a true and fair view of the financial position of the Council as at 31st December 2016, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Council in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) together with the ethical requirements that are relevant to our audit of the financial statements in accordance with the Accountancy Profession (Code of Ethics for Warrant Holders) Directive issued in terms of the Accountancy Profession Act (Cap. 281) in Malta, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. We have determined the matters described below to be the key audit matters to be communicated in our report:

Tax Status

During 2016, the Malta Fiscal Advisory Council incurred expenses amounting to €229,761, reporting a surplus of €23,259. The financial statements for the year ended 31st December 2016 do not provide for 35% tax on the surplus.

Other Information

The Council is responsible for the other information. The other information comprises the Council Member's report. Our opinion on the financial statements does not cover this information, including the Council Member's report. In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

In addition, in light of the knowledge and understanding of the Council and its environment obtained in the course of the audit, we are required to report if we have identified material misstatements in the Council Member's report. We have nothing to report in this regard.

Responsibilities of the Council

The Council Members are responsible for the preparation of the financial statements that give a true and fair view in accordance with International Financial Reporting Standards as adopted by the EU, and for such internal control as the Council Members determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the Council Members are responsible for assessing the Council's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the Council Members either intends to liquidate the Council or to cease operations, or has no realistic alternative but to do so.

Auditors' Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Council's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the Council Members.
- Conclude on the appropriateness of the Council Members' use of the going concern basis of accounting and based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Council's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Council to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with the Council Members regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

Auditors' Responsibilities for the Audit of the Financial Statements (Cont'd)

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current year and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

This report has been signed by
Donna M. Greaves Bonello (Partner) for and on behalf of PKF (Malta)

PKF (Malta)
Certified Public Accountants and Registered Auditors
35, Mannarino Road,
Birkirkara BKR 9080,
Malta

17th March 2017

Malta Fiscal Advisory Council
Statement of Comprehensive Income
For the year ended 31st December 2016

	Note	2016 EUR	2015 EUR
Income	3	253,000	150,017
Expenditure		(229,761)	(150,017)
Other Income		23	-
Surplus before tax		23,262	-
Taxation		(3)	
Surplus for the year		23,259	-
Other Comprehensive Income for the year		-	-
Total Comprehensive Income for the year		23,259	-

The notes to the financial statements on pages 107 to 113 form an integral part of these financial statements.

Malta Fiscal Advisory Council
Statement of Financial Position
For the year ended 31st December 2016

	Note	2016 EUR
ASSETS		
Non-Current Assets		
Intangible Assets	7	2,346
Plant and Equipment	8	4,320
		6,666
Current Assets		
Other Receivables	9	8,330
Cash and Cash Equivalents	10	15,445
		23,775
Total Assets		**30,441**
CAPITAL AND LIABILITIES		
Capital And Reserves		
Accumulated Reserve – Recurrent vote and operating activities	11	28,920
Current Liabilities		
Other Payables	12	1,521
Total Capital and Liabilities		**30,441**

The notes to the financial statements on pages 107 to 113 form an integral part of these financial statements.

These financial statements were approved by the Fiscal Council, authorised for issue on 17th March 2017 and signed on its behalf by:

Mr. Rene Saliba
Chairman

Dr. Carl Camilleri
Council Member

Dr. Ian Cassar
Council Member

Malta Fiscal Advisory Council
Statement of Changes in Equity
For the year ended 31st December 2016

	Note	Accumulated Reserve EUR	Total EUR
Balance as at 31st December 2015		-	-
Plant and equipment acquired in 2015, Net	8	3,579	3,579
Intangible assets acquired in 2015, Net	7	2,082	2,082
Surplus for the year		23,259	23,259
Balance as at 31st December 2016		**28,920**	**28,920**

The notes to the financial statements on pages 107 to 113 form an integral part of these financial statements.

Malta Fiscal Advisory Council
Statement of Cash Flows
For the year ended 31st December 2016

	Note	2016 EUR
Cash flows from Operating Activities		
Surplus before tax		23,262
Adjustments for:		
Depreciation of intangible non-current assets	7	1,013
Depreciation of tangible non-current assets	8	1,490
Operating surplus before working capital changes		25,765
Movement in Other Receivables		(8,330)
Movement in Other Payables		1,521
Tax Paid		(3)
Net cash flow from Operating Activities		18,953
Cash flows from Investing Activities		
Purchase of Intangible Assets	7	(1,277)
Purchase of Plant and Equipment	8	(2,231)
Net cash used in Investing Activities		(3,508)
Movement in Cash and Cash Equivalents		15,445
Cash and Cash equivalents at start of the year		-
Cash and Cash equivalents at end of the year	10	**15,445**

The notes to the financial statements on pages 107 to 113 form an integral part of these financial statements.

1. Basis of Preparation

The principal accounting policies adopted in the preparation of these financial statements are set out below:

a) Statement of Compliance

The financial statements of Malta Fiscal Advisory Council for the year ended 31st December 2016 have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. The comparative figures for the year ended 31st December 2015 are presented in accordance with Article 56 of the Fiscal Responsibility Act (Chapter 534 of the Law of Malta). These are the Council's first financial statements prepared under IFRS.

b) Basis of Measurement

These financial statements have been prepared on the historical cost basis.

c) Accounting Estimates and Judgements

The preparation of financial statements in conformity with IFRS's requires the Council to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimate and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an on-going basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that year or in the year of the revision and future year if the revision affects both current and future year.

During the year under review, the Council did not make use of significant judgements or accounting estimates.

d) Functional and Presentation Currency

The financial statements are presented in euro (€), which is the Council's functional currency.

2. Significant Accounting Policies

a. Intangible Assets

An acquired intangible asset is recognised only if it is probable that the expected future economic benefits that are attributable to the asset will flow to the Council and the cost of the asset can be measured reliably. An intangible asset is initially measured at cost, comprising its purchase price and any directly attributable cost of preparing the asset for its intended use.

Intangible assets are subsequently carried at cost less any accumulated amortisation and any accumulated impairment losses. Amortisation is calculated to write down the carrying amount of the intangible asset using the straight-line method over its expected useful life. Amortisation of an asset begins when it is available for use and ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) or the date that the asset is derecognised.

Computer Software is amortised over four years on a straight line basis.

b. Plant and Equipment

Recognition and Measurement

The cost of an item of plant and equipment is recognised as an asset when it is probable that the future economic benefits that are associated with the asset will flow to the Council and the cost can be measured reliably. Plant and equipment are initially measured at cost comprising the purchase price and any costs directly attributable to bringing the assets to a working condition for their intended use. Subsequent expenditure is capitalised as part of the cost of plant and equipment only if it enhances the economic benefits of an asset in excess of the previously assessed standard of performance, or it replaces or restores a component that has been separately depreciated over its useful life.

After initial recognition, plant and equipment may be carried under the cost model, that is at cost less any accumulated depreciation and any accumulated impairment losses, or under the revaluation model, that is at their fair value at the date of the revaluation less any accumulated depreciation and any accumulated impairment losses.

After initial recognition plant and equipment are carried under the cost model.

Depreciation

Depreciation is calculated by writing off the cost of the non-current assets on a straight-line basis over the estimated useful lives of the assets concerned. The principal annual rates used for this purpose are:

	Years
- Furniture and Fittings	10
- Computer and Office Equipment	4
- Library Books	10

c. Financial Instruments

Financial assets and financial liabilities are recognised when the Council becomes a party to the contractual provisions of the instrument. Financial assets and financial liabilities are initially recognised at their fair value plus directly attributable transaction costs.

Financial assets and financial liabilities are offset and the net amount presented in the balance sheet when the Council has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Financial assets are derecognised when the contractual rights to the cash flows from the financial assets expire or when the Council transfers the financial asset and the transfer qualifies for derecognition.

Financial liabilities are derecognised when they are extinguished. This occurs when the obligation specified in the contract is discharged, cancelled or expires.

i. Other Receivables

Other receivables are classified with current assets and are stated at their nominal value. Appropriate allowances for estimated irrecoverable amounts are recognised in profit or loss when there is objective evidence that the asset is impaired.

ii. Other Payables

Other payables are classified with current liabilities and are stated at their nominal value.

d. Impairment

Financial Assets

A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset. An impairment loss in respect of a financial asset measured at amortised cost is calculated as the difference between its carrying amount, and the present value of the estimated future cash flows discounted at the original effective interest rate. An impairment loss in respect of an available-for-sale financial asset is calculated by reference to its current fair value.

Individually significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed collectively in groups that share similar credit risk circumstances. All impairment losses are recognised in profit or loss. Any cumulative loss in respect of an available-for-sale financial asset recognised previously in equity is transferred to profit or loss.

An impairment loss is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognised. For financial assets measured at cost and available-for-sale financial assets that are debt securities, the reversal is recognised in profit or loss. For available-for-sale financial assets that are equity securities, the reversal is recognised directly in equity.

Non-Financial Assets

The carrying amount of non-financial assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If such indication exists then the asset's recoverable amount is estimated.

An impairment loss is recognised if the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. A cash-generating unit is the smallest identifiable group that generates cash flows that largely are independent from other assets and groups. Impairment losses are recognised in profit or loss.

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and its fair value less cost to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

Impairment losses recognised in prior periods are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

e. Cash and Cash Equivalents

Cash and cash equivalents comprise the bank balance as at the year ended 31st December 2016.

f. Income Recognition

Income comprises the Government Subvention available in terms of the Fiscal Responsibility Act to cover recurrent expenditure reflected in the income statement of the Council.

g. Going Concern

The financial statements have been prepared on the going concern basis, which assumes that the Government of Malta will continue to provide the subvention to the Council in accordance with Article 55 of the Fiscal Responsibility Act (Chapter 534 of the Laws of Malta) in the order to continue with the performance of its functions.

3. Income

Income represents the subvention voted to the Council by the Government of Malta and is analysed as follows:

	2016 EUR	2015 EUR
Government Subvention	253,000	150,017

The Government subvention as per Article 55 sub-articles (2), (4a) and (4b) of the Fiscal Responsibility Act amounts to not less than €250,000 annually and increases by the Index of Inflation as established and published by the National Statistics Office in each subsequent year.

As from 1 January 2016, the subvention was passed on to the Council and expenses incurred were directly paid by the Council. In 2015, the subvention was not passed on to the Council and payments in respect of Council expenses were executed by the Ministry for Finance on behalf of the Council.

4. Council Honoraria

	2016 EUR	2015 EUR
Honoraria	62,833	53,167
Number of Council Members	3	3

The total annual honoraria entitled to the Council Members' amounts to €58,000 in both years presented in the financial statements. The Honoraria for the year ended 31 December 2016 includes a sum of €4,833 relating to services rendered in December 2015 but paid in January 2016.

5. Salaries and Consultancy Fees

	2016 EUR	2015 EUR
Administrator & Other Consultancy Fees	14,868	44,932
Staff Gross Salaries and Social Security Contributions	89,895	21,690
	104,763	66,622
Average Number of Employees	3	2

6. Auditors' Remuneration

Total remuneration paid to the auditors during the year amounted to:

	2016 EUR	2015 EUR
Audit Fees	885	885
Other Non-Audit Services	-	-
Total Auditors' Remuneration	885	885

7. Intangible Assets

	Computer Software	Total
	EUR	**EUR**
Cost		
As at 1st January 2016	2,776	2,776
Additions	1,277	1,277
Disposals	-	-
As at 31st December 2016	4,053	4,053
Depreciation		
As at 1st January 2016	694	694
Charge for the year	1,013	1,013
Released on disposal	-	-
As at 31st December 2016	1,707	1,707
Net Book Value		
As at 31st December 2015	2,082	2,082
As at 31st December 2016	**2,346**	**2,346**

8. Plant and Equipment

	Fixtures & Fittings	Computer and Office Equipment	Library Books	Total
	EUR	**EUR**	**EUR**	**EUR**
Cost				
As at 1st January 2016	590	3,627	364	4,581
Additions	-	1,765	466	2,231
Disposals	-	-	-	-
As at 31st December 2016	590	5,392	830	6,812
Depreciation				
As at 1st January 2016	59	907	36	1,002
Charge for the year	59	1,348	83	1,490
Released on disposal	-	-	-	-
As at 31st December 2016	118	2,255	119	2,492
Net Book Value				
As at 31st December 2015	531	2,720	328	3,579
As at 31st December 2016	**472**	**3,137**	**712**	**4,320**

9. Other Receivables

	2016
	EUR
Prepayments	8,330

10. Cash and Cash Equivalents

For the purpose of the cash flow statements, the year-end cash and cash equivalents comprise the following amounts:

	2016
	EUR
Bank Balances	15,445

11. Accumulated Reserve – Recurrent Vote and Operating Activities

The recurrent vote and operating activities represent the accumulated deficit or surplus resulting from operations.

12. Other Payables

	2016
	EUR
Creditors	98
Accruals	1,423
	1,521

13. Financial Instruments

Fair Values of Financial Assets and Financial Liabilities

At 31st December 2016 the carrying amounts of financial assets and financial liabilities classified with current assets and current liabilities respectively approximated their fair values due to the short term maturities of these assets and liabilities.

Financial Risk Management

The exposures to risk and the way risks arise, together with the Council's objectives, policies and processes for managing and measuring these risks are disclosed in more detail below. The objectives, policies and processes for managing financial risks and the methods used to measure such risks are subject to continual improvement and development.

Liquidity Risk

The Council monitors and manages its risk to a shortage of funds by maintaining sufficient cash and by monitoring the availability of raising funds to meet commitments associated with financial instruments and by maintaining adequate banking facilities.

Financial Instruments (Cont'd)

Capital Risk Management

The Council's objectives when managing capital are to safeguard its ability to continue as a going concern.

The capital structure of the Council consists of cash and cash equivalents as disclosed in note 10 and items presented within the accumulated reserve in the statement of financial position.

14. Related Parties

Malta Fiscal Advisory Council is an independent fiscal institution and reports to Parliament on an annual basis. The Council Members are appointed by the Government of Malta. In terms of the Fiscal Responsibility Act, Council Members will not seek or receive instructions from public authorities or from any other institution or authority.

Transactions with Council Members which occurred during the years ended 31st December 2015 and 2016 are disclosed in note 4.

15. First-Time Adoption of IFRS

As explained in note 1, the Council first-time adopted IFRS in these financial statements. The previous year consisted of a Statement of Income and Expenditure. Thus, there is no comparative in the Statement of Financial Position.

16. Comparative Information

Certain comparative information has been reclassified to conform to the current's year disclosure for the purpose of fairer presentation.

Malta Fiscal Advisory Council
Schedule to the Expenditure Account
For the year ended 31st December 2016

Recurrent Expenditure

		(Accruals Basis) 2016 EUR	(Cash Basis) 2015 EUR
Council Honoraria		62,833	53,167
Salaries and Consultancy fees		104,763	66,622
Audit fees	Note A	1,835	-
Telecommunication and Internet Costs		6,900	4,608
IT installation and Equipment Fees		39	9,428
Travel and Training costs		12,248	4,739
Recruitment costs		1,263	2,550
Rental fees		18,836	-
Premises Fees		3,918	5,200
Study loans		2,700	-
Photocopier lease expenses		1,857	638
Postage, Printing and Stationery		5,685	1,011
Insurance		827	-
Subscriptions		381	745
Depreciation of tangible assets		1,490	-
Amortisation of intangible assets		1,013	-
Sundry Expenses		3,146	1,309
Bank Charges		27	-
Total Recurrent Expenditure		229,761	150,017

Note A Audit fees for the year ended 31st December 2016 comprise of the fees incurred in relation to the services rendered for the year 2015 and 2016. Comparative figures are presented on cash basis.

This Schedule does not form part of the audited financial statements.

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