COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2009
SEC(2009) 849 final

Recommendation for a

**COUNCIL DECISION**

**on the existence of an excessive deficit in Malta**

# EXPLANATORY MEMORANDUM

## 1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States, with more room for manoeuvre for those Member States that have achieved sustainable public finance positions and improved their competitive positions. It also called for structural reforms that support demand and promote resilience in the short term, while paying special attention to actions in the four priority areas of the Lisbon strategy. Finally, several countries have taken measures to stabilise the financial sector, some of which impact on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

## 2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 “on speeding up and clarifying the implementation of the excessive deficit procedure”[1], which is part of the Stability and Growth Pact.

According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b)

[1] OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on the “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, endorsed by the ECOFIN Council of 11 October 2005, available at: http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm

whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

On the basis of the data notified by the Maltese authorities in March 2009[2] and subsequently validated by Eurostat[3] and taking into account the Commission services' spring 2009 forecast, the Commission adopted a report under Article 104(3) for Malta on 13 May 2009[4].

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 28 May 2009.

## 3. THE EXISTENCE OF AN EXCESSIVE DEFICIT

According to data notified by the authorities in March 2009 and subsequently validated by Eurostat, the 2008 general government deficit in Malta reached 4.7% of GDP, thus largely exceeding the 3% of GDP reference value. In the light of this information, on 13 May 2009 the Commission adopted a report under Article 104(3) for Malta. The report considers that the 2008 deficit was not close to the 3% of GDP reference value and that the excess over the reference value cannot be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it does not result from an unusual event or from a severe economic downturn in 2008 in the sense of the Treaty and the Stability and Growth Pact. Indeed, real GDP growth between 2005 and 2007 was above 3% annually, significantly higher than potential growth. Economic growth slowed down in 2008, but remained positive at 1.6%.[5] Furthermore, the excess over the reference value cannot be considered temporary. According to the Commission services' spring 2009 forecast, the deficit ratio is projected to decline but remain above the threshold over the forecast horizon, at 3.6% of GDP in 2009 and, under the customary no-policy-change assumption, 3.2% of GDP in 2010. The deficit criterion in the Treaty is therefore not fulfilled.

General government gross debt has been above the 60% of GDP reference value since 2001 and stood at 64.1% of GDP in 2008. According to the Commission services' spring 2009 forecast, general government debt is projected to follow an upward trend, increasing to almost 69% by 2010. The debt ratio cannot be considered as diminishing sufficiently and approaching the reference value at a satisfactory pace within the meaning of the Treaty and the Stability and Growth Pact. The debt criterion in the Treaty is therefore not fulfilled.

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2 According to Council Regulation (EC) No 3605/93, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Malta can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables.

3 Eurostat news release No 56/2009 of 22 April 2009.

4 All EDP-related documents for Malta can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

5 According to the latest data, GDP growth for 2008 was revised upwards to 2.5%.

In line with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report "relevant factors". According to the Stability and Growth Pact, these can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the deficit satisfies the double condition of closeness and temporariness. In the case of Malta, the double condition is not met. Considered on their own merit, the relevant factors in the current case on balance present a mixed picture.

The opinion of the Economic and Financial Committee in accordance with Article 104(4) of the Treaty is consistent with the assessment in the Commission report under Article 104(3).

The Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), is of the opinion that an excessive deficit exists in Malta. This opinion, adopted by the Commission on 24 June 2009, is herewith addressed to the Council according to Article 104(5). The Commission recommends that the Council shall decide accordingly, in conformity with Article 104(6). In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Malta with a view to bringing the situation of an excessive deficit to an end according to Article 104(7).

## 4. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned as well as a deadline for the correction of the excessive deficit, which "should be completed in the year following its identification unless there are special circumstances". Article 2(6) of the Regulation implies that the "relevant factors" considered in the Commission report under Article 104(3) of the Treaty have to be taken into account in deciding whether special circumstances exist. Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

In the case of Malta, the relevant factors, as clarified in Article 2(3) of Regulation (EC) No 1467/97 and examined in the Commission's report under Article 104(3), present a mixed picture and do not suggest the existence of special circumstances warranting a departure from the standard deadline for correcting the deficit. The breach of the deficit reference value in 2008 is partly due to specific developments on the expenditure side rather than to the impact of the economic downturn, which was only starting in 2008. Despite decelerating, real GDP growth in 2008 remained positive, at 1.6%.

Malta should therefore bring the nominal deficit below the 3% of GDP reference value by 2010. According to the Commission services' spring 2009 forecast, the general government deficit is projected to decline on a no-policy change basis to 3.2% of GDP in 2010, just above the reference value. The projected decline in the headline deficit between 2008 and 2009 reflects the revenue-increasing measures announced in the 2009 budget (which help stem the impact on taxes of the slowing economy) as well as the disappearance of the bulk of the one-off deficit-increasing impact of the following measures: the granting of early retirement benefits to Malta Shipyards Ltd. employees, the liquidation of the shipyards expected to occur in the course of the year, and the reduction in energy subsidies to households. Based on a very favourable macroeconomic scenario that has become outdated, the budgetary strategy envisaged in the December 2008 update of the stability programme of Malta aimed at bringing the headline deficit well below the reference value in 2009, to 1.5% of GDP[6], and at further improving the general government balance over the programme horizon, to a surplus position of 1.2% of GDP in 2011.

In order to bring the deficit below the reference value by 2010 in a credible and sustainable manner, it is necessary that Malta rigorously implements the budgetary measures planned for 2009 and avoids any further deterioration in public finances. For 2010, new consolidation measures will need to be spelled out and implemented. Budgetary consolidation should remain strong also beyond the correction of the excessive deficit so as to ensure progress towards the medium-term objective (MTO) of a balanced budgetary position in structural terms.

This path for the general government balance would also be instrumental to ensure that the increasing trend in the debt ratio since 2008 is reversed so as to allow the debt ratio to diminish sufficiently and approach the reference value at a satisfactory pace.

While expenditure outturns have been below plans over the period 2004-2007, the budgetary framework shows signs of weaknesses at the execution stage. As noted by the Council in its Opinion of 10 March 2009 on the Maltese stability programme, public expenditure is still subject to discretionary decisions in the implementation phase, whilst the budget lacks a clear medium-term focus. Accordingly, the Council invited Malta to strengthen the medium-term budgetary framework.

Almost 70% of general government expenditure is accounted for by compensation of employees, social benefits and interest expenditure, which are difficult to change in the short term, making fiscal adjustment in response to changing macroeconomic circumstances difficult to attain. In the medium term, the renewal of the public sector wage agreement scheduled for 2011 may lead to increased pressure on the expenditure side, while demographic shifts, the need to recruit additional personnel and heightened running costs including more expensive pharmaceuticals would push up public healthcare spending. Accordingly, in its Opinion on the December 2008 update of the stability programme of Malta, the Council invited Malta to enhance the efficiency and effectiveness of public spending, including by accelerating the design and implementation of a comprehensive healthcare reform.

Enhanced surveillance under the EDP will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit.

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[6] For 2008, the December 2008 update of the stability programme estimated a general government deficit of 3.3% of GDP. The deficit target of 1.5% of GDP for 2009 was confirmed in the data notified by the authorities in March 2009.

## Key macroeconomic and budgetary projections

| | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|
| Real GDP (% change) | 3.6[1] | 1.6[1] | -0.9 | 0.2 |
| Output gap[2] (% of potential GDP) | 1.4 | 1.8 | -0.2 | -1.1 |
| General government balance (% of GDP) | -2.2 | -4.7 | -3.6 | -3.2 |
| Primary balance (% of GDP) | 1.1 | -1.4 | -0.2 | 0.4 |
| Cyclically-adjusted balance (% of GDP) | -2.7 | -5.4 | -3.6 | -2.8 |
| Structural balance[3] (% of GDP) | -3.3 | -4.9 | -3.6 | -2.8 |
| Government gross debt (% of GDP) | 62.1 | 64.1 | 67.0 | 68.9 |

Notes:

[1] According to the latest data, GDP growth was revised upwards to 4.2% in 2007 and 2.5% in 2008.

[2] Based on estimated potential growth of 2.0%, 1.1%, 1.1% and 1.1% respectively in the period 2007-2010.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.6% of GDP in 2007, -0.5% of GDP in 2008, 0.1% in 2009 and zero in 2010 according to the Commission services' spring 2009 forecast.

*Source:*

*Commission services' spring 2009 forecasts.*

Recommendation for a

# COUNCIL DECISION

## on the existence of an excessive deficit in Malta

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(6) thereof,

Having regard to the recommendation from the Commission,

Having regard to the observations made by Malta,

Whereas:

(1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The excessive deficit procedure (EDP) under Article 104, as clarified by Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[7] (which is part of the Stability and Growth Pact), provides for a decision on the existence of an excessive deficit. The Protocol on the excessive deficit procedure annexed to the Treaty sets out further provisions relating to the implementation of the EDP. Council Regulation (EC) No 3605/93[8] lays down detailed rules and definitions for the application of the provision of the said Protocol.

(4) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(5) Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. Having taken into account its report in accordance with Article 104(3) and having regard to the opinion of the Economic and Financial Committee in

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[7] OJ L 209, 2.8.1997, p. 6.
[8] OJ L 332, 31.12.1993, p. 7.

accordance with Article 104(4), the Commission concluded that an excessive deficit exists in Malta. The Commission therefore addressed such an opinion to the Council in respect of Malta on 24 June 2009[9].

(6) Article 104(6) of the Treaty states that the Council should consider any observations which the Member State concerned may wish to make before deciding, after an overall assessment, whether an excessive deficit exists. In the case of Malta, this overall assessment leads to the following conclusions.

(7) According to data notified by the authorities in March 2009 and subsequently validated by Eurostat, the general government deficit in Malta reached 4.7% of GDP in 2008, thus largely exceeding the 3% of GDP reference value. The deficit is not close to the 3% of GDP reference value and the excess over the reference value cannot be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it does not result from an unusual event or from a severe economic downturn in 2008 in the sense of the Treaty and the Stability and Growth Pact. Indeed, real GDP growth between 2005 and 2007 was above 3% annually, significantly higher than potential growth. Economic growth slowed down in 2008, but remained positive at 1.6%.[10] Furthermore, the excess over the reference value cannot be considered temporary. According to the Commission services' spring 2009 forecast, the deficit ratio is projected to decline but remain above the threshold over the forecast horizon, at 3.6% of GDP in 2009 and, under the customary no-policy-change assumption, 3.2% of GDP in 2010. The deficit criterion in the Treaty is therefore not fulfilled.

(8) General government gross debt has been above the 60% of GDP reference value since 2003 and stood at 64.1% of GDP in 2008. According to the Commission services' spring 2009 forecast, general government debt is projected to follow an upward trend, increasing to almost 69% by 2010. The debt ratio cannot be considered as sufficiently diminishing and approaching the reference value at a satisfactory pace within the meaning of the Treaty and the Stability and Growth Pact. The debt criterion in the Treaty is therefore not fulfilled.

(9) According to Article 2(4) of Council Regulation (EC) No 1467/97, "relevant factors" can only be taken into account in the steps leading to the Council decision on the existence of an excessive deficit in accordance with Article 104(6) if the double condition – that the deficit remains close to the reference value and that its excess over the reference value is temporary – is fully met. In the case of Malta, this double condition is not met. Therefore, relevant factors are not taken into account in the steps leading to this decision.

HAS ADOPTED THIS DECISION:

*Article 1*

From an overall assessment it follows that an excessive deficit exists in Malta.

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9 All EDP-related documents for Malta can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

10 According to the latest data, GDP growth for 2008 was revised upwards to 2.5%.

*Article 2*

This decision is addressed to the Republic of Malta.

Done at Brussels,

*For the Council*
*The President*