COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 16.5.2007
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Recommendation for a

COUNCIL DECISION

abrogating Decision 2005/186/EC on the existence of an excessive deficit in Malta

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. BACKGROUND

Article 104 of the Treaty establishes that Member States should avoid excessive deficits and lays down a procedure for their identification and correction. The excessive deficit procedure (EDP) 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 planned or actual government deficit exceeds the reference value of 3% of GDP (unless either the deficit 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) whether government debt exceeds the reference value of 60% of GDP (unless the debt ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

In accordance with the Protocol on the excessive deficit procedure annexed to the Treaty, the Commission provides the data for the implementation of the EDP. As part of the application of this Protocol, Member States have to notify data on government deficits and debt and other associated variables twice a year, namely before 1 April and before 1 October, in accordance with Article 4 of Council Regulation (EC) No 3605/93[2,3].

On 12 May 2004, the Commission initiated the EDP for Malta with the adoption of a report under Article 104(3), based on a general government deficit of 9.7% of GDP and government debt of 72% of GDP in 2003.[4] On 5 July 2004, the Council decided, on a recommendation from the Commission, that Malta was in excessive deficit according to Article 104(6)[5]. At the same time, and also based on a Commission recommendation, the Council addressed recommendations under Article 104(7) to Malta with a view to bringing the situation of an excessive government deficit to an end, by 2006 at the latest[6].

In its recommendation under Article 104(7), the Council recommended the Maltese authorities to:

– "put an end to the present excessive deficit situation as rapidly as possible;

– take action in a medium-term framework in order to achieve their objective of bringing the deficit below 3% of GDP in 2006 in a credible and sustainable manner, in accordance with the path for deficit reduction specified in the

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1 OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

2 OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 2103/2005 (OJ L 337, 22.12.2005, p. 1).

3 The most recent notification of Malta can be found at: http://epp.eurostat.ec.europa.eu/portal/page?_pageid=2373,58110711&_dad=portal&_schema=portal.

4 SEC(2004) 580.

5 OJ L 62, 9.3.2005, p. 21.

6 All EDP-related documents for Malta can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/edp_list_en.htm.

Council Opinion of 5 July 2004 on the convergence programme submitted in May 2004;

– implement with vigour the measures envisaged in the May 2004 convergence programme, in particular those of a structural nature aimed at rationalising and reducing expenditures;

– take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target;

– ensure that the rise in the debt ratio is brought to a halt in 2005 and reversed thereafter as specified in the Council Opinion on the convergence programme submitted in May 2004".

In addition, the Council invited the Maltese authorities to "ensure that budgetary consolidation towards the medium term budgetary position of close to balance or in surplus is sustained after the excessive deficit has been corrected".

Table 1: Adjustment endorsed by the Council on 5 July 2004

% of GDP, unless indicated otherwise	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	-9.7	-5.2	-3.7	-2.3	-1.4
Government gross debt	72.0	72.1	72.4	70.5	70.4
p.m.: Real GDP growth (%)	-1.7	1.1	1.7	2.1	2.1

Source: Council recommendation under Article 104(7) to Malta and Council opinion on the May 2004 convergence programme of Malta, both adopted on 5 July 2004.

On 22 December 2004 the Commission concluded in a Communication[7], of which the Council took note on 18 January 2005, that the Maltese government had taken, in response to the Council recommendation, effective action regarding the measures envisaged to achieve the 2005 deficit target by the deadline of 5 November 2004.

According to Article 104(12), a Council Decision on the existence of an excessive deficit is to be abrogated, on the basis of a Commission Recommendation, when the excessive deficit in the Member State concerned has, in the view of the Council, been corrected.

2. RECENT DEFICIT DEVELOPMENTS

According to the latest information, the general government deficit reached a high of 10% of GDP in 2003 including a one-off expenditure-increasing transaction of 2.9% of GDP in relation to the restructuring of two State-owned shipyard companies. Thereafter, the deficit-to-GDP ratio followed a downward path declining to 4.9% of GDP in 2004 and 3.1% of GDP in 2005.

[7] SEC(2004) 1630.

Based on data provided by the Commission (Eurostat)[8] in accordance with Article 8g(1) of Regulation (EC) No 3605/93 following the notification by Malta before 1 April 2007, the general government deficit stood at 2.6% of GDP in 2006[9].

Although the outcome for the general government deficit in 2004 and 2005 was somewhat better than the deficit reduction path recommended by the Council under Article 104(7), that for 2006 was slightly above. However, the deficit-to-GDP ratio for 2006 was slightly better than the official target as set out in the January 2006 update of the convergence programme (2.7%).

The decline in the general government deficit has started in unfavourable growth conditions and continued in the recent economic upturn. The total adjustment over the 2003-2006 period amounted to 7.4 percentage points of GDP. Around four percentage points of the reduction in the deficit ratio during the 2003-2006 period was accounted for by higher revenue, reflecting changes in indirect taxation as well as government's drive to achieve a more efficient tax collection during these years. A lower expenditure-to-GDP ratio explains the remaining 3½ percentage points[10], which was underpinned by a decline in total capital spending mainly on account of a higher recourse to one-off operations (namely sale of land, which is conventionally recorded as negative expenditure). Indeed, between 2004 and 2006 one-off deficit-reducing operations averaged around 1% of GDP per year. Without one-offs, the 2006 deficit would have remained above the reference value, at 3.3% of GDP.

In structural terms, i.e. adjusted for the cycle and one-off and other temporary measures, the deficit is estimated to have improved from a high of around 6½% of GDP in 2003 to around 3¾% in 2005. For 2006, the structural deficit declined further to 2¾% of GDP[11].

In its Article 104(7) Recommendation, the Council invited Malta to take structural measures designed at rationalising and reducing government expenditure. Throughout the 2004-2006 period, a number of such measures were implemented. Specifically, the measures were aimed at downsizing employment in the public sector, improving work practices and increasing overall efficiency in key public enterprises with the aim of reducing government transfers. Public entities considered to have a core strategic role have been restructured, while others identified as non-core have been privatised. Moreover, hiring in the public service was done on a strict-need basis. The limited increases in wages and salaries provided for in the new multi-annual collective agreement for public service employees, covering the period 2005-2010, was another factor contributing to the fall in the government expenditure as a share of GDP. Expenditure control was also achieved through tightening eligibility of social benefits and setting up the necessary infrastructure to reduce benefit fraud.

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8 Eurostat News Release No 55 of 23 April 2007.

9 Deficit ratios are usually revised – upwards or downwards – after the publication of the first outcome in the spring notification. For most EU Member States, the revisions are usually relatively small and on average insignificantly different from zero. For Malta, in view of the distance between the currently reported deficit for 2006 and the deficit reference value, there is a low probability that any potential future revision in government accounts will raise the 2006 deficit ratio to a level in excess of 3% of GDP.

10 Netting out the substantial one-off expenditure-increasing operation in 2003 of 2.9% of GDP related to the debt restructuring of the shipyards, would imply a lower decline in the expenditure ratio of 0.4 percentage points over the 2003-2006 period.

11 It should be underlined that there are significant difficulties in computing the output gap and the structural balance in many Member States especially the smaller ones like Malta, mainly due to the unavailability of all required data.

3. DEFICIT PROJECTIONS FOR 2007 AND BEYOND

According to the Commission services' spring 2007 forecast, the general government deficit is projected to decline further, reaching 2.1% of GDP in 2007 and, under the no-policy change scenario, 1.6% of GDP in 2008. This is expected to be achieved in the context of sustained economic growth over the forecast horizon. The lower general government deficit for 2007 is explained by a decline in the expenditure ratio of slightly less than 1 percentage point of GDP. The fall in the current expenditure ratio, underpinned by a decline in government consumption and interest expenditure, is expected to more than offset the increase in government gross fixed capital formation. For 2008, the reduction in the deficit-to-GDP ratio is accounted for by a projected decline in total expenditure-to-GDP ratio, helped mainly by a sharp fall in public investment linked with the completion of a large healthcare facility. Expressed as a proportion of GDP, total revenue is projected to decline in 2007 and 2008 primarily due to a lower intake from direct taxes and social contributions. Recourse to one-off transactions in 2007 and 2008 are anticipated to be lower than in the average of the past years[12]. Without one-offs, the deficit according to the Commission services' spring forecast would be below the 3% of GDP reference value in 2007 (2.7% of GDP) and fall further in 2008 (1.6%)[13].

When compared to the April 2007 fiscal notification, the Commission services’ spring 2007 forecast projects a slightly more cautious downward path in the general government deficit. For 2007, the difference amounts to 0.2% of GDP and is primarily due to lower social contributions which move in line with expected developments in compensation of employees. In 2008, the divergence in the deficit-to-GDP ratio amounts to 0.7% of GDP. This is mainly because the national authorities anticipate lower spending in terms of both compensation of government employees and purchases of goods and services.

According to the Commission services’ spring 2007 forecast, the structural deficit (i.e. cyclically-adjusted deficit net of one-off and other temporary measures) is projected to improve in 2007 and 2008. From just under 2¾% of GDP in 2006, the structural deficit is forecast to decline marginally in 2007, to slightly above 2½% of GDP in 2007 and, on a no-policy-change basis, more significantly in 2008, to around 1½%. The combined effort over the 2006-2008 period, of slightly more than one percentage point of GDP, appears to be broadly in line with the Recommendation by the Council under Article 104(7) which called for “sustained budgetary consolidation” towards the medium-term objective (MTO) for the budgetary position (for Malta, a balanced budgetary position in structural terms) following the correction of the excessive deficit. Although the effort in 2007 is limited, the average adjustment in 2007-2008 seems to be broadly in line with the 0.5% of GDP annual structural improvement specified in the Stability and Growth Pact for euro-area and ERM II Member States.

In its opinion of 27 February 2007 on the December 2006 update of the convergence programme[14], the Council noted that the programme did not aim at achieving the MTO within the programme period (which ends in 2009). Moreover, while the pace of adjustment towards

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12 One-off transactions for 2006 and 2007 have been revised from the 2006 update convergence programme to take account of an operation (sale of land) that was finalised in 2007 and appropriately booked as deficit-reducing in that year.

13 It is noted that, for 2008, the Maltese authorities plan deficit-reducing one-offs (sale of land) amounting to 0.2% of GDP.

14 OJ C 72, 29.3.2007, p. 9.

the MTO implied by the programme in the years following the correction of the excessive deficit was deemed to be broadly in line with the Stability and Growth Pact, the Council also stated that there were some risks to the budgetary projections in the programme, especially with regard to the assumed favourable macroeconomic assumptions in 2008 and 2009.

4. DEBT DEVELOPMENTS AND PROJECTIONS

The general government debt has exceeded the 60% of GDP reference value since 2001. It peaked at almost 74% of GDP in 2004. In line with the Council recommendation under Article 104(7), the rise in general government debt was halted and reversed in 2005 reaching 72.4% of GDP, on account of a primary surplus and receipts from privatisation. A further decline was recorded in 2006 when the debt ratio stood at 66.5% of GDP largely as a result of substantial privatisation proceeds amounting to around 3.5% of GDP.

According to the Commission services' spring 2007 forecast, the debt-to-GDP ratio is expected to continue on a downward path in 2007 and 2008. For 2007, general government debt is projected to be lowered below 66% of GDP and to decline further in 2008, under a no-policy-change assumption, to 64¼%.

5. CONCLUSIONS

The general government deficit decreased from 10% of GDP in 2003 to 2.6% in 2006, below the 3% of GDP reference value. In spite of a number of one-off transactions (excluding which the 2006 deficit would still be above the reference value), the measures underlying the deficit reduction are mainly of a permanent nature. In 2006, the structural balance, i.e. the cyclically-adjusted balance net of one-off and other temporary measures, improved by slightly more than 1% of GDP. According to the Commission services’ spring 2007 forecast, the government deficit is expected to narrow to 2.1% of GDP in 2007 and, on a no-policy change basis, to 1.6% in 2008, with deficit-reducing one-offs projected to fade away. This indicates that the deficit has been brought below the 3% of GDP reference value in a credible and sustainable manner.

General government gross debt declined from its peak of 73.9% of GDP in 2004 to 66.5% in 2006. According to the Commission services’ spring 2007 forecast, the debt ratio is expected to fall further to almost 64% of GDP by 2008 (on a no-policy change basis).

From an overall assessment, it follows that the excessive deficit situation in Malta has been corrected. Accordingly, the Commission recommends to the Council to abrogate its decision on the existence of an excessive deficit in Malta.

Table 2: Budgetary developments, 2003-2008

% of GDP, unless indicated otherwise		2003	2004	2005	2006	2007 COM	2007 CP[2]	2008 COM[3]	2008 CP[2]
General government balance		**-10.0**	**-4.9**	**-3.1**	**-2.6**	**-2.1**	**-2.3**	**-1.6**	**-0.9**
							[-1.9[5]]		
- Total revenues		38.6	41.9	42.9	42.7	42.2	43.9	41.9	41.8
- Total expenditure		48.6	46.8	46.0	45.2	44.3	46.2	43.4	42.7
Of which :	*- interest expenditure*	*3.5*	*3.7*	*3.8*	*3.7*	*3.3*	*3.4*	*3.3*	*3.4*
	-gross fixed capital formation	*5.1*	*2.1*	*5.3*	*4.6*	*5.2*	*6.1*	*4.0*	*4.0*
Primary balance		**-6.5**	**-1.2**	**0.7**	**1.1**	**1.2**	**1.1**	**1.8**	**2.5**
One-off and temporary measures		-2.9	0.7	1.7	0.7	0.6	0.2	0.0	0.2
Structural balance[1]		**-6.4**	**-4.3**	**-3.8**	**-2.7**	**-2.6**	**-2.0**	**-1.6**	**-1.0**
Structural primary balance[1]		-2.9	-0.6	0.0	1.0	0.8	1.4	1.7	2.4
Government gross debt[4]		**70.4**	**73.9**	**72.4**	**66.5**	**65.9**	**66.7**	**64.3**	**63.2**
							[66.0[5]]		
Change in debt ratio (a) = (b) + (c) + (d)		9.6	3.5	-1.5	-5.9	-0.6	-1.6	-1.6	-3.5
Contributions:	*- primary balance (b)*	*6.5*	*1.2*	*-0.7*	*-1.1*	*-1.2*	*-1.1*	*-1.8*	*-2.5*
	- "snow-ball" effect (c)	*2.2*	*2.4*	*0.1*	*-0.1*	*-0.1*	*-0.5*	*0.2*	*-0.4*
	- stock-flow adjustment (d)	*0.9*	*-0.2*	*-0.8*	*-4.7*	*0.7*	*0.0*	*0.0*	*-0.6*
Pm	*Real GDP growth (%)*	*-2.3*	*0.4*	*3.0*	*2.9*	*3.0*	*3.0*	*2.8*	*3.1*
Pm	*Output gap*	*-2.1*	*-3.4*	*-2.5*	*-1.5*	*-0.6*	*-1.3*	*0.1*	*-0.3*

(1) Cyclically-adjusted balance excluding one-off and temporary measures.

(2) Cyclically-adjusted and structural balances and output gaps according to the programme as calculated by Commission services on the basis of the information in the programme. In the April 2007 fiscal notification, the deficit and debt ratios for 2007 were revised, which means that the projections in the 2006 update convergence programme are somewhat outdated.

(3) No-policy change assumption.

(4) The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where *t* is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and *i* and *y* represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.

(5) Data from the April 2007 fiscal notification.

Sources: Commission services' spring 2007 forecast (COM) and December 2006 update of the convergence programme.

Recommendation for a

COUNCIL DECISION

abrogating Decision 2005/186/EC 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(12) thereof,

Having regard to the recommendation from the Commission,

Whereas:

(1) By Council Decision 2005/186/EC[15], following a recommendation from the Commission in accordance with Article 104(6) of the Treaty, it was decided that an excessive deficit existed in Malta. The Council noted that the general government deficit was 9.7% of GDP in 2003 (of which 2.9% of GDP was due to a one-off operation), above the 3% of GDP Treaty reference value, while general government gross debt stood at 72% of GDP and was likely to further diverge from the 60% of GDP Treaty reference value in 2004.

(2) On 5 July 2004, in accordance with Article 104(7) of the Treaty and Article 3(4) of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[16], the Council made, based on a recommendation from the Commission, a recommendation addressed to Malta with a view to bringing the excessive deficit situation to an end by 2006 at the latest. The recommendation was made public.

(3) In accordance with Article 104(12) of the Treaty, a Council Decision on the existence of an excessive deficit is to be abrogated when the excessive deficit in the Member State concerned has, in the view of the Council, been corrected.

(4) In accordance with the Protocol on the excessive deficit procedure annexed to the Treaty, the Commission provides the data for the implementation of the procedure. As part of the application of this Protocol, Member States are to notify data on government deficits and debt and other associated variables twice a year, namely before 1 April and before 1 October, in accordance with Article 4 of Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol

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[15] OJ L 62, 9.3.2005, p. 21.

[16] OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

on the excessive deficit procedure annexed to the Treaty establishing the European Community[17].

(5) Based on data provided by the Commission (Eurostat) in accordance with Article 8g(1) of Regulation (EC) No 3605/93 following the notification by Malta before 1 April 2007 and on the Commission services' spring 2007 forecast, the following conclusions are warranted:

– the general government deficit was reduced from 10% of GDP in 2003 to 2.6% of GDP in 2006, which is below the 3% of GDP deficit reference value. This is slightly better than the target set for 2006 in the January 2006 update of the convergence programme, although somewhat above the targets endorsed by the Council in its recommendation under Article 104(7),

– more than half (around four percentage points) of the 7.4 percentage points of GDP reduction in the deficit ratio between 2003 and 2006 was accounted for by higher revenue, reflecting changes in indirect taxation as well as a more efficient tax collection. A lower expenditure-to-GDP ratio explains the remaining 3.5 percentage points[18], in part reflecting higher recourse to one-off operations (namely sales of land, which are conventionally recorded as negative expenditure). In addition, expenditure restraint was achieved through downsizing and restructuring of public entities, restrictions in hiring in the public services and control in social payments. One-off deficit-reducing operations averaged around 1% of GDP between 2004 and 2006. Without one-offs (0.7% of GDP), the 2006 deficit would have remained above the reference value, at 3.3% of GDP. The improvement in the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) in 2006 is estimated at slightly above 1% of GDP,

– for 2007, the Commission services' spring 2007 forecast projects the deficit to be reduced further, to 2.1% of GDP, driven by additional expenditure savings. One-offs are envisaged to amount to 0.6% of GDP, broadly similar in magnitude to the preceding year, so that even without one-offs the deficit would be below the reference value. This is broadly in line with the official deficit estimate for 1.9% of GDP set in the April 2007 notification. For 2008, the spring forecast projects, on a no-policy change basis, a further decline in the deficit to 1.6% of GDP (without recourse to one-offs). This indicates that the deficit has been brought below the 3% of GDP ceiling in a credible and sustainable manner. The structural balance is projected to improve marginally in 2007 and, on the basis of a no-policy change scenario, by an additional 1 percentage point in 2008. This has to be seen against the need to make progress towards the medium-term objective (MTO) for the budgetary position, which for Malta is a balanced budget position in structural terms,

– government debt declined from its peak of 73.9% of GDP in 2004 to 66.5% in 2006. According to the Commission services' spring 2007 forecast, the debt

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[17] OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 2103/2005 (OJ L 337, 22.12.2005, p. 1).

[18] The expenditure ratio would have declined by less if the substantial one-off expenditure-increasing operation related to the restructuring of the shipyards of around 3% of GDP in 2003 is excluded.

ratio is projected to fall further to around 64.3% by end-2008, thus coming closer to the 60% of GDP reference value.

(6) In the view of the Council, the excessive deficit in Malta has been corrected and Decision 2005/186/EC should therefore be abrogated.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that the excessive deficit situation in Malta has been corrected.

Article 2

Decision 2005/186/EC is hereby abrogated.

Article 3

This Decision is addressed to the Republic of Malta.

Done at Brussels,

For the Council
The President