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Analysis by the Commission's services of the action taken

by Malta

in response to the Council Recommendation of 16 February 2010 with a view to bringing an end to the situation of excessive government deficit

COM(2010) 809 final

Introduction

The impact of the economic downturn and some discretionary expenditure increases in 2008 led to a widening of the general government deficit in Malta to 4.8% of GDP in 2008 and 3.8% in 2009, compared to 2.3% in 2007. Against this background, on 7 July 2009, the Council decided that an excessive deficit existed and addressed recommendations to Malta in accordance with Article 104(7) of the Treaty establishing the EC with a view to bringing an end to the situation of an excessive government deficit by 2010.[1] In its recommendations, the Council established a deadline of 7 January 2010 for effective action to be taken.

On 16 February 2010, the Council concluded that effective action had been taken in compliance with the above recommendations but unexpected adverse economic events with major unfavourable consequences for the government finances were also considered to have occurred. As a result, the Council recommended that the deadline for the Maltese authorities to put an end to the excessive deficit be extended by one year, to 2011, in accordance with Article 3(5) of Regulation (EC) No 1467/97. In particular, the Maltese authorities were recommended by the Council to (a) achieve the 2010 deficit target set in the budget, if necessary by adopting additional consolidation measures, and ensure in 2011 a fiscal effort of ¾ pp. of GDP. This should also contribute to bringing the general government gross debt ratio back on a declining path that approaches the 60% of GDP reference value at a satisfactory pace by restoring an adequate level of primary surplus; and (b) specify the measures that are necessary to achieve the correction of the excessive deficit by 2011, cyclical conditions permitting, and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than expected. In addition, the Maltese authorities were recommended to seize any opportunity beyond the fiscal effort, including from better economic conditions, to accelerate the reduction of the gross debt ratio back towards the 60% of GDP reference value. To limit risks to the adjustment, a strengthening of the binding nature of Malta's medium-term budgetary framework and better monitoring of budget execution throughout the year were requested.

The present paper reviews the actions taken by the Maltese authorities to meet the above recommendations, in light of the economic and budgetary developments since the Council recommendations were issued on 16 February 2010. In particular, it reviews budgetary implementation in 2010 by comparing the projected budgetary developments in 2010 according to the Commission services' autumn 2010 forecast with the economic and budgetary scenario underpinning the Council recommendations. That scenario was based on the Commission services' autumn 2009 forecast and the budgetary projections underlying the 2010 budget[2], which was adopted soon after the publication of that forecast (and subsequently fully incorporated in the stability programme update of 19 February 2010). For 2011, the basis for the assessment of action taken towards the correction of the excessive deficit is again the Commission services' autumn 2010 forecast, which incorporates the 2011 budget, adopted by the Maltese government on 25 October.

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[1] All EDP-related documents for Malta can be found at the following website: http://ec.europa.eu/economy_finance/sgp/deficit/countries/malta_en.htm

[2] The publication of the budgets for 2010 and 2011 can be found at: http://www.finance.gov.mt/

Economic developments

The impact of the global crisis on the Maltese economy has been rather mild and short-lived. Following a contraction of real GDP by 2.1% in 2009, compared to 4.1% for the euro-area average, the first half of 2010 witnessed a stronger-than-expected rebound of economic activity. The Commission services' autumn 2010 forecast expects real GDP in 2010 as a whole to expand by 3.1%. Real GDP is then projected to grow by 2% in 2011 and 2.2% in 2012, driven by domestic demand.

The outlook for the Maltese economy for the period 2010-11 has progressively improved since the Commission services' autumn 2009 forecast underpinning the Council recommendations of 16 February 2010 (Table 1). Also the national authorities have revised their economic projections upwards during the course of the year: in the stability programme update of February 2010, economic activity was expected to expand by 1.1% and 2.3% in 2010 and 2011, respectively; the projections underlying the 2011 budget were higher, at 3.4% and 3%, respectively. The main factors contributing to the improved economic outlook are investment and net exports, that is, components that are less tax-rich than others.

Table 1: Comparison of macroeconomic developments and forecasts

	2009	2010		2011	
	outturn	COM AF09	COM AF10	COM AF09	COM AF10
Real GDP (% change)	-2.1	0.7	3.1	1.6	2.0
Contributions to real GDP growth:					
Final domestic demand	-2.7	0.9	2.4	1.5	2.3
Changes in inventories	-2.5	0.2	0.1	0.0	0.0
Net exports	3.1	-0.3	0.6	0.1	-0.3
Employment (% change)	-0.5	0.3	1.1	0.6	1.2
GDP deflator (% change)	2.3	2.3	3.0	2.4	2.7

Source: COM AF09 - Commission services' autumn 2009 forecast; COM AF10 - Commission services' autumn 2010 forecast.

Budgetary implementation in 2010

After reaching 3.8% of GDP in 2009, the Maltese authorities project the deficit ratio to increase slightly to 3.9% of GDP in 2010, in line with the target set with the 2010 budget underpinning the Council recommendation, later confirmed in the stability programme update. The Commission services' autumn 2010 forecast projects a higher deficit ratio in 2010, of 4.2% of GDP, mainly due to expected shortfalls in tax collection.

The increase of excise duty rates on tobacco and of the registration tax on commercial vehicles was implemented as planned in the 2010 budget. Actions to enhance tax enforcement, especially addressing evasion of excise in petroleum, were also put in place according to the 2010 budget plans. However, cash data for the first ten months of 2010 pointed to shortfalls in both direct and indirect tax revenue, particularly when removing the effect of a tax amnesty (estimated to have yielded around 0.7% of GDP) that is mainly attributable (some 0.5% of GDP) to 2009 in ESA95 terms. In light of this, the national authorities revised their revenue projections down in the 2011 budget when compared to the stability programme update, but they anticipate an acceleration in tax collection over the last two months of 2010, due to, among other factors, higher corporate income taxes related to improving profitability, the payment of over-due excise duties by the state-owned electricity provider (Enemalta) and a shift in the timing of payment of VAT for those making intracommunity transactions. The Commission services' forecast incorporates part of this expected acceleration, which, according to preliminary data for November, appears to be materialising.

It should be noted that, in its opinion on the stability programme update, the Council stated, following a recommendation from the Commission, that the expected contribution from tax buoyancy and enhanced tax compliance to the budgeted increase in the tax ratio in 2010 seemed optimistic and represented a risk for the programme's projections. This risk seems to have materialised, even in the context of a more favourable economic environment.

With regard to expenditure, the Commission services project lower overall growth than the Maltese authorities, both in the stability programme update of February 2010 and in the more recent projections underpinning the 2011 budget. This is explained by lower capital expenditure[3] in the Commission services projections, partly compensated for by slightly higher growth of current primary expenditure. In particular, there appears to have been some slippages in the area of compensation of employees and intermediate consumption, as also acknowledged by the authorities in the latest projections for the 2011 budget.

Table 2: Composition of the budgetary adjustment

	2009		**2010**						**2011**			
	outturn	**SP Feb 2010**	**SP Feb 2010**		**Budget 2011**		**COM AF 2010**		**Budget 2011**		**COM AF 2010**	
	% of GDP	**% of GDP**	**% ch yoy**	**% of GDP**	**% ch yoy**	**% of GDP**	**% ch yoy**	**% of GDP**	**% ch yoy**	**% of GDP**	**% ch yoy**	**% of GDP**
Current primary expenditure	**37.7**	**38.0**	**4.1**	**38.2**	**4.7**	**36.9**	**4.6**	**37.1**	**2.7**	**35.9**	**1.7**	**36.0**
Capital expenditure	**3.1**	**4.0**	**62.6**	**6.2**	**67.1**	**4.8**	**54.3**	**4.5**	**23.7**	**5.6**	**15.7**	**4.9**
Primary expenditure	**40.7**	**41.9**	**9.6**	**44.4**	**9.4**	**41.8**	**8.3**	**41.5**	**5.2**	**41.6**	**3.2**	**40.9**
Interest expenditure	3.2	3.3	4.7	3.3	3.6	3.1	3.6	3.1	6.0	3.1	6.0	3.1
Current expenditure	**40.8**	**41.3**	**4.1**	**41.5**	**4.6**	**40.0**	**4.5**	**40.2**	**3.0**	**39.1**	**2.1**	**39.2**
Total expenditure	**43.9**	**45.2**	**9.2**	**47.7**	**9.0**	**44.9**	**8.0**	**44.6**	**5.2**	**44.7**	**3.4**	**44.1**
Current taxes on income and wealth	13.8	14.8	4.8	15.0	5.3	13.7	3.2	13.4	3.3	13.4	4.3	13.4
Taxes on production and imports	14.1	13.7	10.5	14.6	4.9	13.9	3.9	13.8	9.2	14.4	7.3	14.2
Total current taxes	**28.0**	**28.5**	**7.5**	**29.7**	**5.1**	**27.6**	**3.6**	**27.3**	**6.2**	**27.7**	**5.8**	**27.6**
Social contributions	7.6	7.6	3.6	7.6	3.8	7.4	3.9	7.4	6.2	7.4	3.6	7.3
Total current revenues	**39.0**	**39.9**	**5.2**	**40.6**	**4.5**	**38.3**	**3.4**	**38.0**	**5.6**	**38.3**	**4.8**	**38.0**
Capital revenues	**1.1**	**1.5**	**120.6**	**3.2**	**162.5**	**2.7**	**134.0**	**2.4**	**40.6**	**3.6**	**30.9**	**3.0**
Total revenues	**40.1**	**41.4**	**9.4**	**43.8**	**8.9**	**41.0**	**7.0**	**40.5**	**7.9**	**41.9**	**6.4**	**41.1**
Primary balance	**-0.6**	**-0.5**		**-0.6**		**-0.8**		**-1.1**		**0.3**		**0.2**
Budget balance	**-3.8**	**-3.8**		**-3.9**		**-3.9**		**-4.2**		**-2.8**		**-3.0**
One-offs	0.7	0.1		0.2		0.6		0.6		0.2		0.4
Real GDP growth	-2.1	-2.0		1.1		3.4		3.1		3.0		2.0
GDP deflator	2.3	3.0		2.4		3.3		3.0		2.6		2.7
Nominal GDP	0.1	1.0		3.5		6.7		6.2		5.6		4.7

Source : SP Feb 2010 - Stability Programme February 2010; Budget 2011 - Malta's Budget for 2011; COM AF10 - Commission services' autumn 2010 forecast.

Projected budgetary developments in 2011 and 2012

According to the 2011 budget, the authorities target a deficit of 2.8% of GDP for 2011, i.e. 1.1 pps. lower than in 2010. This objective is slightly lower than that set in the February 2010 update of the stability programme of 2.9% of GDP.

[3] Capital expenditure in 2010 was curbed by the sale of equipment pertaining to the shipyards (amounting to 0.3% of GDP), accounted for both in the Commission services' forecast and 2011 budget.

The authorities plan to reach this target mainly through revenue-enhancing measures, namely by increasing excise taxes on energy products, alcoholic beverages, cigarettes and tobacco, and cement (0.3% of GDP) and the VAT rate on collective and private accommodation (0.1% of GDP). In addition, the authorities plan to raise 0.2% of GDP from enhanced tax enforcement and collection of tax arrears and 0.1% of GDP from annual lease concessions. On the expenditure side, the planned phasing out of most of the stimulus measures introduced in 2010 should result in savings amounting to 0.4% of GDP. Additional expenditure-containment measures are also planned, namely improved spending efficiency and limiting the number of new recruits in the public sector, which are estimated to yield up to 0.4% of GDP. At the same time, the 2011 budget also incorporates a number of expansionary measures, amounting to 0.3% of GDP, particularly targeting education, training, employment policies, R&D, environment, infrastructure and health.

The Commission services' autumn 2010 forecast projects a slightly higher deficit for 2011, at 3% of GDP. The forecast assumes a strict implementation of the 2011 budget, including the planned spending efficiency gains. It is therefore the higher deficit base from 2010 that explains the Commission services' higher deficit forecast for 2011 compared to the official one. The forecast also points to an improvement in the structural balance (the cyclically-adjusted balance net of one-off and other temporary measures) relative to GDP by 1¼ pps. in 2011, after a worsening of around 1 pp. anticipated in 2010. The budgetary targets put forward in the stability programme implied a ¾ % of GDP improvement in the structural balance in 2011, after a ¼ pp. worsening in 2010.

However, the Commission services see risks to the achievement of the 2011 deficit target, mainly stemming from the possible support provided to Air Malta. In addition to the risk that the Commission services see pertaining to the repayment of the rescue loan by the national airline[4], the government deficit in 2011 could also be affected by measures introduced in the forthcoming restructuring plan. The public sector wage bill may also be affected by the new collective agreement to come into force in January 2011, details of which are not yet available.

For 2012, the authorities target the deficit to decline to 2.1% of GDP, thanks to additional consolidation measures still to be adopted. Based on a no-policy-change assumption, the Commission services' autumn 2010 forecast project the deficit to widen again to 3.3% of GDP, mainly due to the projected lower impact of one-off deficit-reducing measures and substantial increases in capital spending, although partly financed with EU funds.

Debt developments

In the 2011 budget, the Maltese authorities project the government debt to increase slightly to 69.0% of GDP in 2010, from 68.6% in 2009. The positive impact of the significant projected acceleration in nominal GDP growth is partly offset by a debt-increasing stock-flow adjustment – of around ¾ % of GDP, of which ½ % of GDP due to the need to finance the loan to Greece. For 2011, the authorities project a slight decline in the debt ratio to 68.7%, thanks to the achievement of a small primary surplus and dynamic nominal GDP growth. The stock-flow adjustment is projected to partly offset the decline of the debt ratio.

[4] On 15 November, the Maltese Parliament adopted a Bill authorising the government to grant a rescue loan to Air Malta. The rescue loan will be in place for a period not exceeding six months so as to meet the short term cash-flow requirements of Air Malta. By the end of these six months, a restructuring plan for the company is likely to be put into operation.

In the autumn 2010 forecast, the Commission services estimate Malta's gross government debt-to-GDP ratio to increase to 70.8% by 2011 also due to the incorporation of the financial needs related to the rescue loan amounting to EUR 52m (or more than ¾ % of GDP) to Air Malta, adopted after the presentation of the 2011 budget. In addition, both the primary balance and nominal GDP growth are expected to remain below the government projections, thus providing a smaller debt-decreasing contribution.

Table 3: Debt Developments

(% of GDP)	2009		2010			2011	
	outturn	**SP Feb 2010**	**SP Feb 2010**	**Budget 2011**	**COM AF10**	**Budget 2011**	**COM AF10**
Gross debt ratio	68.6	66.8	68.6	69.0	70.4	68.7	70.8
Change in debt ratio	5.5	3.0	1.8	0.3	1.8	-0.3	0.3
Primary balance effect	0.6	0.5	0.6	0.8	1.1	-0.3	-0.2
"Snow Ball" effect	3.1	2.6	1.1	-1.2	-0.9	-0.5	0.0
of which:							
Interest expenditure	3.2	3.3	3.3	3.1	3.1	3.1	3.1
Nominal GDP growth effect	-0.1	-0.6	-2.2	-4.3	-4.0	-3.7	-3.2
Stock-Flow Adjustment	1.8	-0.1	0.1	0.8	1.6	0.5	0.5
of which :							
Cash/accrual diff.	0.9	n.a.	n.a.	n.a.	0.2	n.a.	0.0
Acc. financial assets	0.9	n.a.	n.a.	n.a.	1.4	n.a.	0.5
Valuation effects & residual	0.0	n.a.	n.a.	n.a.	0.0	n.a.	0.0

Source : SP Feb 2010 - Stability Programme February 2010; Budget 2011 - Malta's Budget for 2011; COM AF10 - Commission services' autumn 2010 forecast; Commission services' calculations

Fiscal governance and the quality of the public finances

No specific measures have been outlined by the authorities to strengthen the binding nature of Malta's medium-term budgetary framework. The Commission's assessment of the stability programme update of February 2010[5] highlighted the importance of addressing expenditure overruns resulting from the absence of binding expenditure ceilings, shortcomings related to intra-year monitoring of adherence to the budgetary targets and the possibility of increasing/reducing spending even after budget approval in Parliament. This is particularly important since budgetary targets are often met through unplanned expenditure cuts, often at the expense of investment, as was the case in 2009. In addition, no independent institution is involved in the formulation of the macroeconomic assumptions underlying the budgetary projections.

On 16 February 2010, the Council also invited the Maltese authorities to introduce reforms to enhance the quality of public finances, namely through enhanced efficiency of government expenditure especially in the areas of health and education. In addition, the Council called for reforms of the social security system and measures to reduce the budgetary costs of ageing, with a view to reducing risks to the long-term sustainability of the public finances. The authorities are currently preparing a proposal for further reforming the pension system. The government also envisages enhanced controls with the aim of combating abuse of pharmaceuticals and improved procurement methods and processes in the public sector.

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[5] Malta's Macro Fiscal Assessment can be found at: http://ec.europa.eu/economy_finance/sgp/pdf/20_scps/2009-10/02_technical_assessment/mt_2010-04-07_ta_en.pdf

Table 4: Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012
Real GDP (% change)	COM	2.6	-2.1	3.1	2.0	2.2
	MT	2.6	-2.1	3.4	3.0	2.9
	SP	2.1	-2.0	1.1	2.3	2.9
Output gap (% of potential GDP)	COM	0.6	-2.6	-0.8	-0.2	0.5
	MT	n.a.	n.a.	n.a.	n.a.	n.a.
	SP	1.2	-1.5	-1.6	-0.4	1.4
General government balance (% of GDP)	COM	-4.8	-3.8	-4.2	-3.0	-3.3
	MT	-4.8	-3.8	-3.9	-2.8	-2.1
	SP	-4.7	-3.8	-3.9	-2.9	-2.8
Primary balance (% of GDP)	COM	-1.5	-0.6	-1.1	0.2	-0.2
	MT	-1.5	-0.6	-0.8	0.3	0.9
	SP	-1.4	-0.5	-0.6	0.3	0.4
Cyclically-adjusted balance (% of GDP)	COM	-5.0	-2.9	-3.9	-2.9	-3.5
	MT	n.a.	n.a.	n.a.	n.a.	n.a.
	SP	-5.1	-3.2	-3.4	-2.8	-3.3
Structural balance (% of GDP)	COM	-5.3	-3.5	-4.5	-3.3	-3.5
	MT	n.a.	n.a.	n.a.	n.a.	n.a.
	SP	-5.4	-3.3	-3.6	-2.9	-3.3
Government gross debt (% of GDP)	COM	63.1	68.6	70.4	70.8	70.9
	MT	63.1	68.8	69.1	68.8	67.8
	SP	63.6	66.8	68.6	68.0	67.3

Source: COM - Commission services' 2010 autumn forecast; MT - Malta's Budget for 2011; SP - Stability Programme February 2010.