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COMMISSION STAFF WORKING DOCUMENT

Analysis by the Commission services of the budgetary situation in Malta in response to the Council Recommendation of 16 February 2010 with a view to bringing an end to the situation of excessive deficit

Accompanying the document

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

Assessment of budgetary implementation in the context of the ongoing Excessive Deficit Procedures after the Commission services' 2011 Autumn Forecast

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1. INTRODUCTION

The impact of the economic downturn, together with some discretionary expenditure increases in 2008, led to a widening of the general government deficit in Malta, to 4.6% of GDP in 2008 and 3.7% in 2009, compared to 2.4% 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 European Community (TEC)[1] with a view to bringing an end to the situation of an excessive government deficit by 2010[2]. In its recommendations, the Council established a deadline of 7 January 2010 for effective action to be taken.

On 16 February 2010, on the basis of a Commission recommendation, 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 126(7) of the Treaty. Specifically, Malta was recommended to achieve the 2010 deficit target set in the budget, if necessary by adopting additional measures, and to ensure in 2011 a fiscal effort of ¾% of GDP, which should also contribute to bringing the government debt ratio back on a declining path. 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.

On 6 January 2011, the Commission adopted a Communication to the Council concluding that, on information available at the time, Malta appeared to have taken action representing adequate progress towards the correction of the excessive deficit by 2011 and that no further steps under the excessive deficit procedure were needed at that stage. At the same time, the Maltese authorities had to monitor budgetary developments closely and be ready to take

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[1] The corresponding article in the Treaty on the Functioning of the European Union, which entered into force on 1 December 2009, is Article 126(7).

[2] 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

corrective measures should risks (related to the upcoming restructuring of Air Malta and a new public sector collective agreement) materialise. On 18 January 2011, the Council concluded that it shared these views.

This paper examines progress made by Malta towards a timely and sustainable correction of the excessive deficit. In particular, it examines budgetary developments since the Commission Communication to the Council on action taken of 6 January 2011. The assessment takes into account all decisions publicly announced by the government on budgetary developments in Malta.

2. ECONOMIC DEVELOPMENTS AND OUTLOOK

The Maltese economy rebounded relatively strongly after the global crisis and real GDP grew by 2.7% in 2010, compared to the euro area average of 1.9%, supported by external demand and business investment (see Table 1). Relatively robust growth continued in the first half of 2011 on the back of net exports but the positive momentum is expected to largely disappear in the second half of the year. For 2011 as a whole, real GDP growth is thus forecast to decelerate somewhat, to 2.1% according to the Commission services' 2011 Autumn Forecast. This forecast is slightly lower than that of the national authorities (2.3%), reflecting different assumptions about global trade as well as a different outlook for private investment and the depletion of inventories.

Table 1: Comparison of macroeconomic developments and forecasts

	2010	2011		2012		2013
	Outturn	National projections	COM AF 2011	National projections	COM AF 2011	COM AF 2011
Real GDP (% change)	2.7	2.3	2.1	2.1	1.3	2.0
Contributions to real GDP growth						
Final domestic demand	0.9	0.8	0.0	0.3	0.7	1.4
Changes in inventories	-2.7	-2.5	0.2	0.0	0.0	0.0
Net exports	4.6	4.0	1.9	1.8	0.6	0.6
GDP deflator (% change)	2.9	2.6	2.5	2.7	2.5	2.7
Nominal GDP (% change)	5.7	4.9	4.6	4.8	3.9	4.8
Employment (% change)	2.3	1.3	1.0	1.2	0.8	1.4
Total compensation per employee (% change)	-0.4	0.8	2.0	1.2	2.4	2.3

Note: COM AF 2011 – Commission services' 2011 Autumn Forecast; national projections – information received from the national authorities complementing the 2012 Budget speech
Sources: National Statistics Office, Commission services, national authorities

In 2012, real GDP growth is projected to moderate further to 1.3%, according to the Commission services' 2011 Autumn Forecast, on the back of a lower contribution from net exports, resulting from the projected economic slowdown in the euro area as a whole. The growth forecast underpinning the Maltese budget for 2012 is notably higher (2.1%), mainly as a result of a more optimistic outlook for exports, itself reflecting more positive assumptions for growth in Malta's main trading partners. At the same time, the contribution to real GDP growth from domestic demand is higher in the autumn forecast given a more positive outlook for private investment, which more than compensates for the weaker outlook for private consumption. Differences in the macroeconomic outlook for 2012 are markedly less pronounced in terms of the underlying tax bases for the main tax categories such as nominal private consumption and economy-wide compensation of employees.

In 2013, economic growth is projected to increase to 2.0% according to the Commission services' 2011 Autumn Forecast. This acceleration reflects a more positive outlook for domestic demand, while the contribution from net exports is projected to remain unchanged.

It should be noted that real GDP growth in the period since the adoption of the Council recommendation to Malta under Article 126(7) of the Treaty generally turned out better than expected at the time (namely in the Commission services' 2009 Autumn Forecast). While the decline in real GDP in 2009 was somewhat more acute according to the latest estimate than foreseen in the Commission services' 2009 Autumn Forecast (-2.6% as opposed to -2.2%), growth in 2010 and 2011 exceeded expectations at the time of the adoption of the Council recommendation. The recovery in 2010 was notably more vigorous (+2.9% as opposed to 0.7% in the 2009 Autumn Forecast) and for 2011, the 2011 Autumn Forecast projects growth of 2.1% as opposed to 1.6% in the 2009 Autumn Forecast.

3. BUDGETARY SITUATION AND OUTLOOK

3.1. Estimated outturn for 2011

In the budget for 2011, presented in November 2010, the authorities targeted a deficit of 2.8% of GDP for 2011, i.e. 1.1pp. lower than in 2010, based on revenue-enhancing measures, the phasing-out of most of the stimulus measures introduced in 2010 as well as expenditure-containment measures, namely improved spending efficiency and limits on recruitment in the public sector. This target was confirmed in the 2011 update of Malta's Stability Programme (SP). The October 2011 EDP notification and budget for 2012 estimate the deficit outturn to be fully in line with the target, although with a changed composition: a strong upward revision in current taxes by 1 pp. of GDP is estimated to offset an upward revision in current expenditure by 0.7 pp. of GDP and of net capital expenditure by 0.3 pp. of GDP.

The Commission services' 2011 Autumn Forecast estimates the deficit for 2011 at 3.0% of GDP, slightly higher than the estimate of the authorities because of less dynamic direct taxes and social contributions, which is partly offset by lower public investment than budgeted. The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) is estimated to improve by 1% of GDP in 2011, above the fiscal effort of ¾% of GDP recommended under the EDP for that year (see Table 2). However, when taking into account the change in the macroeconomic scenario between the projections underlying the EDP recommendations and the 2011 Autumn Forecast, it appears that the current estimate of the fiscal effort has benefited from an upward revision of underlying growth prospects; when correcting for this upward revision, the estimated fiscal effort in 2011 would nonetheless still be in line with the one recommended by the Council.

Table 2: Comparison of fiscal effort and change in the structural balance (% of GDP) based on the Commission services' 2011 Autumn Forecast

Change in the structural balance in 2011		Fiscal effort recommended by the Council	Deadline for the correction
Uncorrected	Corrected		
1.0	0.7	¾% in 2011	2011

Note: The uncorrected annual change in the structural balance is the estimated change in the structural balance from the Commission services' 2011 Autumn Forecast. The corrected annual change in the structural balance is the uncorrected annual change in the structural balance plus a correction factor capturing the effect of revisions to potential output growth between the projections at the time of the EDP recommendations and the Commission services' 2011 Autumn Forecast (see European Commission (2004) Public Finances in EMU – 2004, European Economy, Brussels; and European Commission (2006) Public Finances in EMU – 2006, European Economy, Brussels).
Source: Commission services

3.2. Deficit projections for 2012-13

The public finance projections in the Commission services' 2011 Autumn Forecast were finalised before the draft budget for 2012 was presented. Under the no-policy-change assumption, the deficit is forecast to exceed the 3% of GDP reference value again in 2012 and 2013 (at 3.5% and 3.6% of GDP respectively), while also in structural terms there is deterioration (see Table 3).

Table 3: Comparison of budgetary developments and projections

	2010		2011				2012				2013	
	Outturn		National projections		COM AF 2011		National projections		COM AF 2011		COM AF 2011	
	%GDP	%ch	%GDP	%ch	%GDP	%ch	%GDP	%ch	%GDP	%ch	%GDP	% ch
Total current revenue	37.5	2.8	38.3	7.1	37.4	4.4	39.1	7.2	37.1	3.0	36.7	3.8
of which:												
Taxes on production and imports	13.6	2.8	14.3	10.7	14.1	8.5	15.2	11.7	13.9	2.6	13.7	3.3
Current taxes on income and wealth	13.1	1.6	13.4	7.3	12.9	3.2	13.1	2.1	12.8	3.1	12.8	4.5
Social contributions	7.4	4.9	7.4	4.8	7.2	2.4	7.5	6.9	7.1	2.5	7.0	3.0
Capital Transfers, received	1.8	76.0	2.0	16.0	2.0	16.0	3.0	56.5	2.1	9.1	2.1	4.4
Total government revenue	39.3	4.8	40.3	7.5	39.4	4.9	42.1	9.7	39.2	3.3	38.8	3.8
Total current expenditure	39.4	3.4	39.2	4.4	39.3	4.5	38.4	2.6	39.4	4.1	39.2	4.1
Capital expenditure	3.5	20.5	3.9	15.7	3.1	-7.4	5.5	48.6	3.3	9.4	3.3	4.8
Total government expenditure	42.9	4.6	43.1	5.3	42.4	3.5	43.9	6.7	42.7	4.5	42.4	4.1
Net lending (+) / net borrowing (-)	-3.6		-2.8		-3.0		-2.3		-3.5		-3.6	
- primary balance	*-0.6*		*0.4*		*0.2*		*1.0*		*-0.2*		*-0.4*	
General government debt	69.0		70.1		69.6		68.9		70.8		71.5	

Notes: COM AF 2011 – Commission services' 2011 Autumn Forecast (finalised before the presentation of the budget for 2012). National projections – 2012 budget and additional information provided by the authorities (revenue and expenditure projections for 2012 do not add up to the deficit target of 2.3% of GDP because expenditure reflects the review of spending allocations of 6 January 2012 that was undertaken as a precautionary measure).

Sources: Commission services, national authorities

The draft budget for 2012 was presented on 14 November 2011 and adopted by Parliament on 15 December 2011. It targets a deficit of 2.3% of GDP, slightly higher than the one set in the 2011 update of the SP (2.1%). The upward revision of the deficit target must be seen against the background of only a mild downward revision of real GDP growth (to 2.1% from 2.3% in the SP), while nominal GDP growth has actually been revised slightly up (4.8% compared to 4.5% in the SP).

Taking the official budgetary targets for 2011-2012 from the budget for 2012 at face value and using the output gap series from the Commission services' 2011 Autumn Forecast, the fiscal effort would amount to around ¼% of GDP in 2012 (the incentives to reduce tax arrears, see below, are treated by the Commission services as one-off).

The main budgetary measures for 2012, based on official information, are presented in Table 4. They include the impact of the review of spending allocations of 6 January 2012 that was undertaken as a precautionary measure to support the deficit target set in the budget in view of "increasing risks in the international economic situation as well as developments within the public finance sector"; current primary expenditure was thus adjusted downward by 0.6% of GDP, especially in the areas of compensation of employees and intermediate consumption.

Taken together, these measures have a net deficit-reducing impact of around 1% of GDP. Contrary to the expenditure-based consolidation strategy laid down in the 2011 update of the SP, the consolidation is to a large extent based on revenue-increasing measures that are partly compensated by an increase in especially net capital expenditure, including the planned equity injection into Air Malta[3]. The revenue measures taken together are estimated to generate around 1.4% of GDP in net terms, more than one-third of which is due to "increased efficiency in revenue collection", which includes pecuniary incentives to reduce tax arrears, expected to yield around 0.4% of GDP. Total revenues are thus projected to increase by 1¾pps in 2012 (to 42.1% of GDP from 40.3% in 2011), which should more than offset the planned increase in total expenditure by ¾pp (to 43.9% of GDP in 2012 from 43.1% in 2011).

3 The Commission services' 2011 Autumn Forecast did not make provisions for the upcoming restructuring of Air Malta, stating that this might give rise to additional government expenditure and thus entailed risks for both the deficit and debt projections in the forecast.

Table 4: Main budgetary measures for 2012

Revenue	Expenditure
Increased efficiency in revenue collection (0.5% of GDP), mostly pecuniary incentives to reduce VAT and car license arrears (0.4% of GDP) Higher concession fees from the local lottery operator (0.4% of GDP) Pension reform initiatives and enforcement (0.3% of GDP) Increase in registration tax for vehicles Euro 1 to 3 and older (0.1% of GDP) Increase in customs duty on fuel for bunkering of ships outside territorial waters (0.1% of GDP) Increase in excise duty rates on mobile telephony, cement and tobacco products (0.1% of GDP) New income tax category ('parent computation') for parents supporting children who are not gainfully employed (-0.2% of GDP)	Restraint in compensation of employees (i.a. tightened recruitment policy) (-0.1% of GDP) Net savings in social transfers (-0.2% of GDP) resulting from increased efforts to curb benefit fraud and the gradual impact from the 2006 pension reform, partly offset by measures targeted at supporting families with children and elderly aged over 80 and a cost-of-living adjustment Increase in net capital expenditure (0.6% of GDP), including Air Malta restructuring (equity acquisition) (0.3% of GDP)

Note: Budgetary impact according to national sources. A positive sign implies that revenue / expenditure increases as a consequence of this measure.
Source: Budget for 2012 and additional information provided by the national authorities

Based on a prudent assessment of the budgetary measures for 2012 and using the Commission services' 2011 Autumn Forecast's weaker estimated 2011 deficit outturn and macroeconomic scenario, the Commission services project the deficit for 2012 at 2.6% of GDP (see Table 5). The difference with the budget target, amounting to 0.3% of GDP, can be mainly explained by a higher deficit outcome estimated for 2011. Looking at budget components, the Commission services project current revenue growth in 2012 to be lower than the authorities (6.3% vs 7.3% in the national projections). This is explained mainly by less dynamic indirect taxes, especially from a more prudent assessment by the Commission services of the item “increased efficiency in revenue collection”. The Commission services also project current expenditure growth in 2012 to be higher than the authorities after the January 2012 review (3.4% vs 2.6% in the national projections). This reflects more dynamic social transfers other than in kind including from a more prudent assessment by the Commission services of increased efforts to curb benefit fraud. Finally, while projecting a very significant increase on 2011, the Commission services foresee much lower net capital expenditure given issues with absorption capacity (1.7% of GDP vs 2.5% in the national projections). Using the output gap series from the Commission services’ 2011 Autumn Forecast and the Commission services’ assessment of the budget measures, the fiscal effort in 2012 would amount to ½% of GDP.

In 2013, the Commission services project that the deficit would widen further on a no-policy-change basis, to 2.9% of GDP, partly as a result of a further, higher capital injection into Air Malta. The budget for 2012 presents a deficit target of 1.8% of GDP for 2013 based on an as yet unspecified additional consolidation effort of 0.7% of GDP.

Table 5: Comparison of budgetary projections, including impact of measures announced post Commission services' 2011 Autumn Forecast, general government balance (% of GDP)

	2010	2011	2012	2013
COM AF 2011	-3.6	-3.0	-3.5	-3.6
National projections	-3.6	-2.8	-2.3	-1.8
COM Jan 2012	-3.6	-3.0	-2.6	-2.9

Notes: COM AF 2011 – Commission services' 2011 Autumn Forecast. National projections – information provided by the authorities complementing the budget 2012 speech. COM Jan 2012 – Commission services' assessment of January 2012. National projections and COM Jan 2012 take into account the measures in the 2012 draft budget.
Sources: Commission services, national authorities

3.3. Debt developments

According to the budget for 2012, gross general government debt is projected to peak in 2011, at around 70% of GDP, and decline by just over 1 pp. in 2012, thanks to an increasing primary surplus and a debt-decreasing stock-flow adjustment.

The Commission services' 2011 Autumn Forecast projects the debt ratio to continue to slowly increase on a no-policy-change basis from almost 70% in 2010 to 71.5% by the end of the forecast horizon. Debt projections include the impact of the guarantees to the EFSF, bilateral loans to Greece and the participation in the capital of the ESM, but not the rescue loan to Air Malta[4].

Beyond 2013 and under the assumption of no further policy changes on top of the Commission services' 2011 Autumn Forecast, the debt ratio would be on an increasing path and reach 90% of GDP by 2020. An additional annual structural fiscal consolidation of 0.5 pp of GDP from 2014 onwards in order to reach the Medium-Term Budgetary Objective (MTO) – in the case of Malta a balanced budget in structural terms - would limit the rise in the debt ratio, reaching 77% of GDP in 2020. A more ambitious consolidation effort (of 1 pp. per annum) would set the debt ratio on a declining path from 2017 onwards in Malta.

[4] In November 2010, the Maltese government agreed to provide Air Malta with a rescue loan to meet its cash-flow requirements until May 2011, after which a restructuring plan has been presented to the Commission. The loan was granted at market conditions and no debt financing was allegedly required, with government deposits used to make the necessary payments. Therefore the rescue loan is not incorporated in the Commission services’ 2011 Autumn Forecast deficit and debt projections.