Malta:

Convergence Programme

2004 - 2007

Ministry of Finance
May 2004

The following symbols have been used throughout this document:

. . .	to indicate that data are not available;
- -	to indicate that the figure is negligible;
-	to indicate that the figure is zero;
n/a	to indicate that data are not applicable or cannot be determined;
n/c	to indicate that there is no change in the data.

Figures may not add up due to rounding.

This document is based on statistical information available up to mid-April 2004.

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Introduction

Within the framework of the multilateral surveillance of budgetary positions and the surveillance and co-ordination of economic policies within the European Union (EU), Malta is submitting its first Convergence Programme. This programme, which covers the 2004-2007 period, was prepared in accordance with the Council Regulation (EC) No. 1466/97 which sets out the rules covering the content of Stability and Convergence Programmes and it is in line with the revised Opinion on the content and format of Stability and Convergence Programmes (2001 code of conduct).

This Programme was compiled by the Ministry of Finance, with important inputs being received from various Ministries as well as entities, including the Central Bank of Malta, the National Statistics Office and the National Commission for Welfare Reform.

This document sets out the fiscal policy objectives within a macroeconomic policy framework. It is structured into the following six sections: Section 1 outlines Government's objectives for macroeconomic policy as well as the monetary and exchange rate policy; Section 2 presents the medium-term projections of the key macroeconomic variables; Section 3 provides a review of Malta's fiscal policy and the medium-term fiscal projections, together with an analysis of Government revenue and expenditure; Section 4 contains sensitivity analyses of the budgetary projections together with a comparison of the current forecasts of the main economic indicators and the fiscal projections with those presented in the Pre-Accession Economic Programme (PEP) for 2003; Section 5 presents an analysis of the long-term sustainability of public finances; and finally Section 6 reviews certain structural reforms as well as administrative reforms.

1. Overall Policy Framework and Objectives

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1.1 Main Macroeconomic Policy Objectives

The main medium-term macroeconomic policy objectives of the Maltese Government are presented below:

The achievement of sustainable economic growth and a high and stable level of employment so as to attain a higher standard of living for all: This is the centrepiece of the Government's economic policy.

Given the small size and openness of the domestic economy, Malta's economic growth and development is dependent on its ability to generate export activity. International competitiveness is thus vital in order to be able to improve the domestic standard of living. Consequently, the key to sustainable economic growth is the implementation of structural reforms to instil competitiveness and efficiency in the domestic economy and to create the right environment conducive to private sector initiative and investment. Structural reforms are also required to achieve a flexible economy which is capable of undertaking quick adjustment in the face of a changing international environment and of taking advantage of emerging opportunities. Government is currently engaged in discussions with the social partners on the measures which are considered necessary in order to sustain the competitiveness of the Maltese economy. Within this context, Government's priorities include addressing excess bureaucracy which is hindering enterprise, encouraging creativity and innovation and supporting small and medium sized enterprises, which provide a vital contribution to the Maltese economy. Structural reforms will put domestic enterprises in a better position to be successful internationally and therefore to generate sustainable jobs within the Maltese economy. At the same time, specific measures are being earmarked to stimulate further job creation. Government views employment not only as important from the economic perspective, but also as a key instrument to achieve social cohesion and to avoid poverty.

In order to foster economic growth and employment, specific focus is particularly being made to attract foreign direct investment and to the tourism industry. In particular, there will be a re-invigoration of the efforts earmarked to promote foreign investment in growth sectors. As regards tourism, Government aims to work closely with the operators in the industry so that Malta's attributes are exploited to the full advantage.

All this should facilitate the generation of economic prosperity and thus the attainment of real convergence with the rest of the EU.

Restoring fiscal balances to sustainable levels in the medium term, which in turn, should ascertain that levels of Government debt grow at a slower rate than economic growth: A healthy fiscal position is a prerequisite for sound macroeconomic conditions. Thus, efforts to improve the public finance situation will contribute to ensure price stability and to facilitate economic growth. Government's fiscal consolidation programme aims to reduce the deficit to below 3 per cent in 2006. As a result, the debt ratio will start to decline to around 70 per cent by the end of the programme period, from the 72 per cent level in 2003.

In order to achieve the fiscal targets, efforts will be undertaken to improve productivity and efficiency in Government departments as well as in public sector enterprises and to increase accountability in the use of public funds. Thus, better public services can be delivered whilst curbing public expenditure. At the same time, there will be strong prioritisation in public expenditure, with priority being given to growth-enhancing expenditure. As regards the welfare system, the aim is to preserve social cohesion through the availability of a social safety net. Hence, expenditure will be focused on those that need most Government support whilst measures will continue to be taken to avoid abuse of the system.

The long-term sustainability of the public finances requires that fiscal measures are implemented particularly in the area of pension and health-care systems. In the case of the former, the Government is undertaking intensive discussions with the social partners, which are expected to be concluded in the coming months. Discussions on health reform are expected to be concluded by the end of this year.

Ensuring stability in the external sector: Safeguarding the exchange rate peg is essential in order to maintain price stability in Malta and hence to ensure a stable macroeconomic framework. An improved fiscal position should stabilise domestic demand whilst structural reforms earmarked to increase the competitiveness of the Maltese economy should result in improved export performance. All this should lead to an improvement in the external sector and hence to improve the credibility of the exchange rate peg. This has assumed increased importance in view of the liberalisation of capital movements.

1.2 Monetary and Exchange Rate Policy

The Central Bank of Malta is responsible for the conduct of monetary policy in Malta, with the primary objective of maintaining price stability. Responsibility for exchange rate policy is shared between the Bank and the Government.

The Bank's monetary policy strategy aims to maintain price stability by pegging the Maltese lira to a basket of three currencies of low inflation countries, with the euro having a weight of 70 per cent.

By maintaining a pegged exchange rate as the nominal anchor underpinning monetary policy, the Bank has contributed to Malta's low rate of inflation. The Bank is responding to the changing policy environment, in particular, to the removal of capital controls, with interest rates in Malta moving more closely in line with rates abroad. The ending of uncertainty about Malta's future relations with the European Union and the economic policy disciplines implied by membership have added to the credibility of the exchange rate peg.

The increased share of the euro in the Maltese lira basket has already strengthened the link between the monetary policy stance of the Eurosystem and the conduct of monetary policy in Malta. The Maltese Government and the Central Bank of Malta believe that there are significant advantages that can be derived from membership in the euro area. The Maltese authorities intend to move to the final stage of EMU as rapidly as economic convergence permits.

1.2.1 Exchange Control Liberalisation

The steady removal of controls on capital movements gathered further momentum with the entry into effect of the External Transactions Act (Cap. 233) on 1 January 2004. The Act, which replaced the Exchange Control Act, establishes a framework for the liberalisation of external transactions and provides for the collection of related statistical information. The Act liberalised all capital movements, subject to a number of restrictions. These remaining controls were however removed on 19th April, with two minor exceptions that apply solely to transactions involving non-residents from countries outside the European Economic Area. In these cases, controls on non-resident participation in Maltese firms operating in certain sectors, as well as the participation by residents in long-term insurance contracts with non-resident insurance firms, were retained.

2. Economic Outlook

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2.1 Economic Developments during 2003

Given the high degree of openness of the Maltese economy, the unfavourable international economic environment persisting since 2001 has significantly impinged on the performance of the domestic economy. The weak performance of Malta's main trading partners, coupled with increasing competition from emerging market economies, influenced the outcome of export-oriented manufacturing industries negatively. The domestic tourism industry has also been registering a subdued performance. Furthermore, the restructuring process being undertaken in various sectors of the economy also left its mark on the performance of the domestic economy. The discussion in this section is based on data provided in Table 1 in the Statistical Appendix. It is important to note that the data for GDP and its components in this section are in accordance to the System of National Accounts 1993 (SNA 1993) and hence are not comparable to national accounts data compiled according to ESA 95 methodology and presented in other sections of this document.

During 2003, real Gross Domestic Product (GDP) contracted by 1.7 per cent. Private consumption in real terms advanced by a relatively low 0.3 per cent as compared to a growth rate of 2.6 per cent in 2002. On the other hand, in real terms, Government current expenditure advanced by 6.0 per cent during the same period, reflecting the expansionary fiscal stance.

Gross fixed capital formation increased by 21.2 per cent in real terms in 2003. This notable increase in gross investment should be seen in light of the significant decline in 2002 resulting from the sale of aircraft by the national airline. If this exceptional item were excluded, gross fixed capital formation would have advanced by 8.6 per cent. In real terms, the machinery component advanced by 35.1 per cent, while construction activity, mainly driven by public sector projects, advanced by 3.0 per cent. During 2003, in real terms, the ratio of gross fixed capital formation to GDP increased to 24.8 per cent when compared to the 20.1 per cent registered during the previous year.

The economy's degree of openness is reflected in the high ratio of exports and imports to GDP. In 2003, exports of goods and services accounted for 89.2 per cent of GDP in real terms while imports constituted 95.3 per cent. During 2003, a decline of 2.2 per cent in real terms was registered in exports of goods and services, while imports of goods and services increased by 6.4 per cent.

As regards export activity, a recovery in exports of electronics and transport equipment and in gross tourism earnings (which rose despite a drop in tourist arrivals) was registered. However, total export activity was heavily affected by the decline in re-exports, after having risen significantly during 2002, mainly due to the sale of aircraft during that year.

The rise in imports of goods and services was underpinned by an increase in the imports of consumer goods, reflecting some substitution from domestic to foreign goods following the complete removal of import levies on industrial products as from the beginning of 2003. Imports of industrial goods also registered an increase although the terms of trade are estimated to have worsened. An increase in imports of capital goods was also registered, reflecting the increase in investment in machinery. Furthermore, the leasing of the national airline's fleet led to higher service payments abroad.

The current account deficit stood at 5.9 per cent of GDP in 2003, as compared to 1.1 per cent of GDP in the previous year. The widening of the current account deficit was mainly due to the increase in the negative balance of the merchandise account. The latter reflects an increase in imports and the one-off re-export of aircraft recorded during the previous year. Furthermore, an increase in net outflows in the services account and increased net payments for current transfers also contributed to the widening of the current account deficit. These factors outweighed a higher surplus on the income account.

Following the exceptional net outflow of direct investment recorded during 2002 (which was related to a loan repayment made by a foreign-owned bank to its parent company overseas), net direct investment for 2003 stood at Lm134.3 million. The net outflow of funds abroad in the form of portfolio investment increased from Lm173.3 million to Lm580.6 million during the period under review. Increases in inflows of other investments were recorded during 2003, which stood at Lm540.7 million, up from Lm454.6 million. As a result of these developments, reserve assets increased by Lm54.7 million during the period under review, compared to a rise of Lm121.8 million in 2002.

In December 2003, the labour supply declined by 428 persons or 0.3 per cent when compared to the level recorded in the previous year, reaching 144,409. The gainfully occupied population fell by 1,087 or 0.8 per cent during the same period and stood at 136,234. Employment in private direct production declined by 1,245 in December 2003 mainly due to job shedding in certain manufacturing sectors such as textiles and clothing which are facing increasing competitive pressures from low-cost countries. Employment in the public sector fell by 576, to 46,907, mainly due to the restructuring process in the shipyards, which included voluntary early retirement schemes. Employment in private market services increased marginally and stood at 52,066 in December 2003. The number of registered unemployed persons[1] increased by 659 and stood at 8,175 in December 2003. Thus, the unemployment rate stood at 5.7 per cent when compared to 5.2 per cent registered in the previous year.

Labour productivity growth for the whole economy, measured as real output per employee, registered a decline from 2.3 per cent recorded in 2002 to –0.9 per cent in 2003. This decline in productivity is due to lower real GDP in 2003.

The inflation rate for December 2003, based on a twelve-month moving average[2], stood at a relatively low 1.3 per cent when compared to annual inflation rates for previous years. This was influenced by a relatively large decline in the clothing and footwear sub-index, as well as a decline in the household equipment and house maintenance cost sub-index. On the other hand, during 2003, the largest increase in average price fluctuations was recorded in the personal care and health sub-index. This was followed by an increase in the beverages and tobacco sub-index, which was mainly due to an increase in the price of cigarettes following the implementation of the measures announced in the Government's 2003 budget. An increase was also registered in the transport and communication sub-index and the food sub-index.

During 2003, GDP at factor cost advanced by a relatively subdued rate of 1.4 per cent in nominal terms. Economic activity as measured by GDP at factor cost was underpinned by increases in the insurance, banking and real estate, wholesale and retail trade and private services sectors. Improvements were also registered in public administration and manufacturing services. These advances more than offset the fall registered in the other sectors of the economy, particularly within the transport and communication sector, property income and Government enterprises. The agriculture and fishing and construction and quarrying sectors registered only minor changes when compared to the previous year. At 48.6 per cent, market services[3] made up the largest share of GDP at factor cost in 2003. Non-market services, namely public administration, accounted for 16.8 per cent of GDP at factor cost whilst direct production[4] accounted for 34.6 per cent of total domestic activity.

Movements of the Maltese lira reflect the composition of the basket of currencies to which the lira is pegged[5] and international foreign exchange market developments. Indeed, despite the significant appreciation of the euro in international foreign exchange markets, by the end of 2003, the Maltese lira depreciated by only 3.1 per cent against the euro given the large weight of the euro in the Maltese lira basket. On the other hand, the Maltese lira gained 16.4 per cent against the US dollar, reflecting the dollar's sharp depreciation against the euro. The value of the Maltese lira also continued to strengthen against the Sterling and the Japanese yen, rising by 5.1 per cent and 4.9 per cent, respectively.

During 2003, the real effective exchange rate index gained 1.1 per cent, as a decline over the first three quarters was offset by a rise towards the end of the year, when year-on-year inflation in Malta picked up and exceeded inflation abroad.

Following an acceleration of 12.1 per cent in 2002, broad money expanded by 2.4 per cent during 2003. This relatively slower pace of monetary expansion reflected the slowdown in economic growth and lower inflation. Lower interest rates on bank deposits induced investors to shift towards alternative assets such as bonds. Furthermore, a decline in capital inflows from abroad following a substantial increase in 2002, also contributed to the slowdown in monetary growth. Monetary expansion registered during 2003 was mainly driven by an increase in both net foreign assets and domestic credit.

During 2003, the net foreign assets of the banking system continued to expand, albeit at a slower rate than that recorded in the previous year, increasing by 8.6 per cent. The deceleration in the rate of growth of net foreign assets was attributable to both a slower growth in the net foreign assets held by the Central Bank as well as holdings by the rest of the banking system. This reflected developments in the current account of the balance of payments and a deceleration in capital inflows. The strong recovery in equity markets abroad together with the lowering of the premium in favour of the Maltese lira interest rates contributed to the decline in portfolio inflows. Furthermore, lower inflows related to the repatriation of residents' foreign holdings also contributed to the deceleration in net foreign assets.

Domestic credit expanded at a faster pace in 2003, increasing by 10.5 per cent. This was mainly attributable to an exceptional rise in claims on other residents, as a foreign-owned bank broadened its equity base through an injection of foreign capital and subsequently re-invested the funds in a subsidiary company. In contrast, the annual growth rate of net claims on central Government continued to slow down when compared to that registered in the previous year.

The official interest rates were lowered three times during the year by a quarter of a percentage point each time, bringing the discount rate and the central intervention rate down from 3.75 per cent at the end of 2002 to 3.00 per cent at the end of 2003. These reductions reflect monetary policy easing in view of the significant interest rate differential in favour of the Maltese lira interest rates as well as further growth in the net foreign assets. Moreover, subdued inflationary pressures and weak economic performance also reinforced the lowering of interest rates.

2.2 The Medium-Term Scenario

Table 2.1 presents the main macroeconomic indicators for 2002 and 2003 and forecasts up to 2007. The baseline scenario reflects the path that the Maltese economy is expected to follow in the short to medium term. Although some key uncertainties surrounding the global economy have diminished, significant risks still remain. The world economy, and in particular the economies of the euro area, have exhibited signs of improvement in 2003, and the near-term outlook is for further improvement in the forecast years.

The short term outlook for the Maltese economy is for a gradual and modest recovery in the growth rate of GDP to 1.1 per cent in 2004, accelerating to 1.7 per cent in 2005, then stabilising at around the 2.0 per cent mark in 2006 and 2007. The projected trend for GDP growth, together with its components is illustrated in Chart 2.1. The rate of inflation in 2004 is expected to register an increase, mainly reflecting the one-off increase in the Value Added Tax rate[6] for 2004, but returning to rates of around 2.0 per cent till the end of the forecast period. The unemployment rate[7] is projected to rise to 6.0 per cent in 2004, then to gradually decline, to fall back to 5.4 per cent by 2007.

Higher exports and Government capital expenditure are expected to be the main contributors to economic growth in 2004. The projected increase in the export component of GDP is mainly based on the external

Main Macroeconomic Indicators

Table 2.1

	2002	2003	2004[1]	2005	2006	2007
GDP at constant (1995) prices (Lm million)	1,444.8	1,419.6	1,435.3	1,459.7	1,490.4	1,521.7
GDP at current market prices (Lm million)	1,685.6	1,712.2	1,789.2	1,850.0	1,925.9	2,014.5
GDP growth at constant (1995) prices (%)	2.3	-1.7	1.1	1.7	2.1	2.1
Expenditure Components of GDP at constant 1995 prices (% change)						
Private consumption expenditure	2.6	0.3	0.2	0.8	1.5	1.8
Government consumption expenditure	2.8	6.0	1.1	-1.1	-0.3	-0.9
Gross fixed capital formation	-13.3	21.2	6.7	2.1	-2.6	1.7
Exports of goods and services	4.7	-2.2	1.3	2.9	3.0	2.7
Imports of goods and services	-1.4	6.4	2.3	1.6	0.8	1.8
Inflation rate (%)	2.2	1.3	3.4	2.1	2.1	2.0
Employment growth (%)	-0.1	-0.8	0.8	0.7	0.7	0.7
Unemployment rate (%) [2]	5.2	5.7	6.0	5.8	5.6	5.4
Labour productivity (% change)	2.3	-0.9	0.2	1.0	1.3	1.4
External Goods and Services Balance (% of GDP)	-0.6	-5.7	-5.8	-5.0	-3.3	-2.0

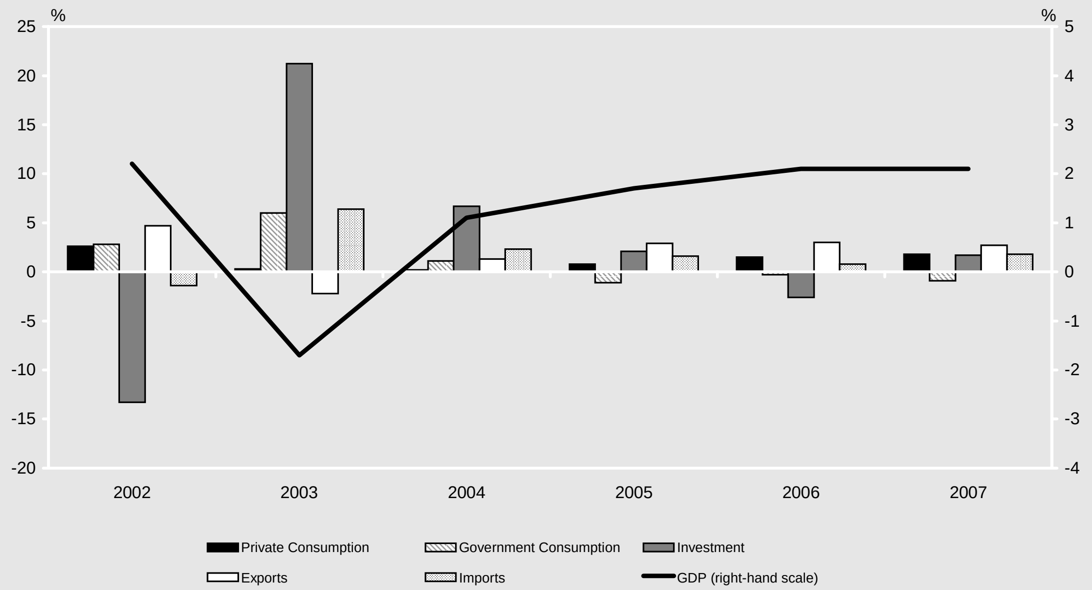
[1] Forecasts from 2004 onwards

[2] Based on ETC registered unemployed data

assumptions that underpin this forecast. Gross fixed capital formation is expected to increase significantly, boosted mainly by capital expenditure projects to be undertaken by Government. In particular, the expenditure on the new hospital should account for the major part of this expected increase, whilst the projected expenditure on new road construction should also serve to boost gross fixed capital formation in 2004. The main assumptions underlying these forecasts are presented below. This is followed by a more detailed analysis of the projections of the main macroeconomic indicators in the medium-term scenario.

Chart 2.1

GDP Growth Rate



2.2.1 Assumptions for Projections

The baseline scenario and simulations were estimated using econometric techniques and analytical methods. The following are the main assumptions used in obtaining the base forecasts for 2004-2007.

- A key assumption relates to prospects for world economic activity. A modest pick-up in foreign demand is expected, with real GDP growth in Malta's main trading partners of 1.9 per cent in 2004 and 2.3 per cent in 2005 and thereafter. For the tourism sector, foreign demand is assumed to grow by 2.1 per cent in 2004 and 2.5 per cent in subsequent years. World prices, based on producer price indices of the euro area, are assumed to rise modestly by 1.6 per cent in 2004 and 1.7 per cent in 2005 to 2007, reflecting the low expected inflation rates in the euro area. It is pertinent to note that the assumptions underlying the foreign sector of the economy are in line with those as presented in the 2004 Convergence programmes – external assumptions of the European Commission.

- Assumptions for changes in the rate of interest and world oil prices are also in line with the European Commission's forecast assumptions. For 2006 and 2007 growth rates for these variables are assumed to remain the same as in 2005.

- The nominal effective exchange rate of the Maltese lira and the Dollar exchange rate are assumed to remain constant throughout the forecast period.

- Average wage inflation is assumed to be relatively low compared to historical growth rates, reflecting the global competitiveness pressure on employment costs. Average wages in the private and public sector are expected to grow by an average 2.1 per cent per annum during the forecast period. Meanwhile, it is assumed that Government employment remains unchanged at the 2003 level.

- Stock building (which also includes the residual error term) is assumed to remain at around 4.0 per cent of GDP during the forecast period.

2.2.2 Private Consumption Expenditure

Growth in private consumption expenditure is expected to remain weak, at 0.2 per cent in 2004. This mainly reflects the one-off impact of the increase in the VAT rate, which is expected to increase prices of consumer goods and thus reduce real household disposable income. The one-off compensation given by Government is expected to mitigate only partially the negative effects on consumption. Growth in private consumption expenditure is forecasted to remain well below historical levels throughout the forecast period. This is primarily due to the fiscal consolidation process which will be undertaken to bring the deficit level down to acceptable levels. Consumption growth is expected at 0.8 per cent in 2005. It is then projected to record a gradual recovery in 2006 and 2007 to a growth rate of 1.5 per cent and 1.8 per cent respectively, as the impact of fiscal consolidation is partially offset by some improvement in the labour market.

2.2.3 Government Expenditure

Following the significant increase in Government consumption in 2003, Government consumption expenditure is expected to register a marginal growth of 1.1 per cent in 2004. This is expected to turn negative after 2005 in line with Government's fiscal consolidation programme.

2.2.4 Gross Fixed Capital Formation

Investment is expected to expand significantly during 2004, mainly driven by Government expenditure on the new hospital together with the planned investment on a number of arterial roads financed by grants under the

Italian Fifth Financial Protocol. Investment expenditure by the private sector is also expected to increase, in line with the restructuring process taking place, the recovery of foreign demand and measures undertaken by public administration to attract foreign direct investment. Growth in private sector investment will be maintained throughout the forecast period. During the forecast period, Government capital expenditure will also be affected by projects financed by EU funds. Nevertheless, capital expenditure by Government is projected to decline in 2006, as major investment relating to the new hospital as well as projects financed by the Italian Protocol are completed. This is expected to result in a drop in investment of 2.6 per cent in 2006. In 2007, investment expenditure is expected to pick up again, primarily through increases in private sector investment as Government capital expenditure is projected to fall in 2007.

2.2.5 External Balance of Goods and Services

Export growth in 2004 is expected to be positive though still relatively modest reflecting a slow recovery in world demand. It is also influenced by the competitive pressures abroad which are causing a number of manufacturing concerns, typically in labour-intensive industries, to restructure their operations or cease operating in such sectors altogether.

The growth rate of exports of goods and services is expected to grow from 1.3 per cent in 2004 to around 3.0 per cent in 2005 and 2006, fuelled primarily by a recovery in world demand, including in the electronics sub-sector. Tourism activity is also expected to recuperate. Exports of goods and services are expected to become the main contributors to the increase in GDP in this period, thus compensating for the subdued domestic demand.

The increase in export activity will however be partially offset by higher imports, reflecting the high degree of openness of the domestic economy. Imports of goods and services are expected to increase by 2.3 per cent in 2004 mainly as a result of the increase in investment expenditure. Furthermore, the dismantling of the remaining import levies on agricultural and agro-industry products in May 2004 is also expected to contribute to higher imports. The low growth rate of 1.6 per cent in 2005 is related to both the decline in the growth rate of investment expenditure and the persistently slow growth in private consumption. In 2006, despite the increase in private consumption and the maintaining of export growth, the fall in capital spending is expected to lead to a significant drop in the growth rate of imports to 0.8 per cent. The growth in imports of goods and services will pick up again in 2007 as gross fixed capital formation embarks again on a positive growth path.

As a result of these developments, the negative external balance of goods and services in 2004 is expected to remain practically unchanged from the 2003 ratio. The external deficit is projected to fall in the 2005-2007 period to reach 2.0 per cent at the end of the forecast period. The external balance is expected to start contributing positively to economic growth in this period.

2.2.6 Productivity and Employment Prospects

The gradual recovery of economic activity during the forecast period is expected to translate into a modest increase in employment creation compared to the employment performance of the last three years. However, the increase in output is expected to exceed employment creation implying that labour productivity will increase steadily during the forecast period.

Unemployment is expected to remain relatively high in the short term, mainly reflecting the restructuring process taking place in the private sector. The unemployment rate is expected to remain above 5.5 per cent between 2004 and 2006, reaching a high of 6.0 per cent in 2004 and falling thereafter. By 2007, the unemployment rate is expected to fall to 5.4 per cent as the gradual improvement in the economy and the resulting rise in demand for labour exceeds the effect of a slowly rising participation rate of the female component of the labour force.

2.2.7 Inflation

During 2004, a one-off increase in the Retail Price Index is expected, with annual inflation rising to 3.4 per cent. This is mainly the result of the increase in the VAT rate as from the beginning of the year as well as the introduction of a reduced rate of VAT (at 5 per cent) on printed matter and medical equipment on May 1st. These effects are expected to be only partly offset by the impact of the removal of the remaining import levies as from EU accession. Subsequently, the inflation rate is expected to fall back to its pre-2004 levels of around 2.0 per cent per annum.

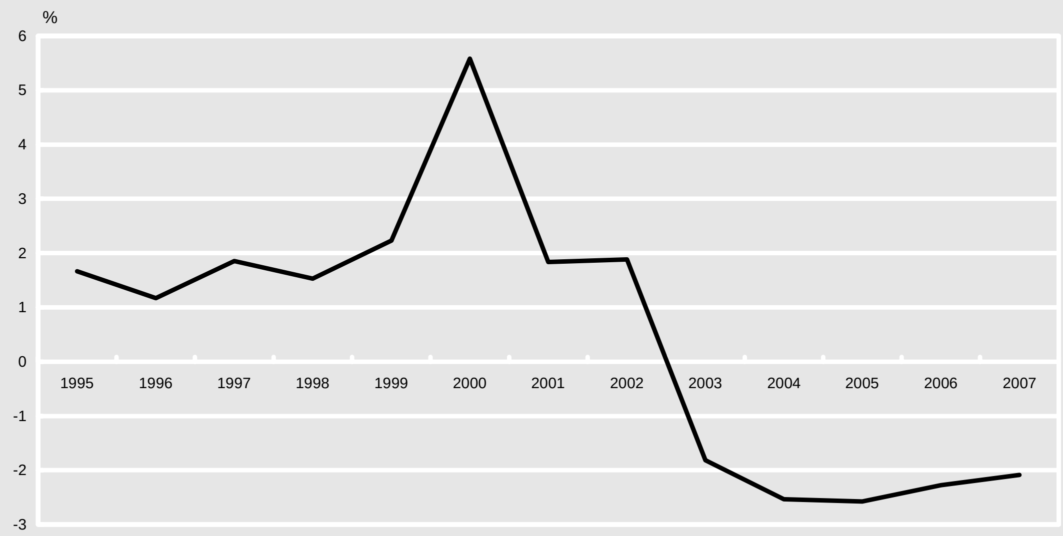
2.3 Potential Output and the Output Gap

Estimates of the output gap under a baseline scenario, based on the Hodrick-Prescott (HP) filter, are shown in Chart 2.2. Results should however be treated with caution in view of the end of sample bias problem[8] .

The Maltese economy was operating above its potential during the period 1995-2002. The negative growth rate of 1.7 per cent in real GDP pushed the Maltese economy below its potential level during 2003 when the output gap turned negative. During the period under study, the rate of growth in potential output is following a downward trend. Indeed, the average growth rate of potential output in the past four years was around 2.4 per cent compared to an average of 3.7 per cent in the last five years of the previous decade. During the forecast period, potential output growth is expected to continue to decline to an average of 1.8 per cent, stabilising in 2005. As a result of this and despite the prospects of an economic recovery, real output is expected to remain below trend throughout the forecast period. The negative output gap is predicted to reach a peak of 2.6 per cent in 2005, after which it is anticipated to narrow reflecting a return of output to its trend rate. This will be reflected in an improvement in labour market performance.

Chart 2.2

Output Gap[1]



[1] Defined as actual output less potential output as a per cent of potential output.

Notes:

[1] Under Part I and Part II of the Unemployment Register.

[2] As from January 2003, the twelve-month moving average inflation rate is based on a new Retail Price Index (RPI) series with base December 2002.

[3] Market services activities comprise the transport and communication, wholesale and retail trade, insurance, banking and real estate, property income and private services sectors.

[4] Direct production comprises agriculture and fisheries, construction and quarrying, manufacturing and public utilities.

[5] In August 2002, the Maltese authorities revised the composition of the Maltese lira basket. As a result, the weight of the euro was raised to 70 per cent, with the pound sterling and the US dollar being allocated weights of 20 per cent and 10 per cent respectively.

[6] The standard VAT rate was increased from 15 per cent to 18 per cent as from January 2004.

[7] Based on Employment and Training Corporation (ETC) registered unemployed data.

[8] Additional four-year forecasts of real GDP were obtained using an ARIMA model to remedy for the end of sample bias problem.

3. Public Finance

3. Public Finance

Over the medium to long term, the aim of fiscal policy, which is an important instrument for any coherent economic policy design, should be that of ensuring that public finances are sustainable, thereby contributing to a stable economic environment and promoting growth. Maintaining firm control on budgetary outcomes ensures stable prices and low interest rates which, in turn, are conducive to higher real incomes and investment - two prerequisites to attain the 'more and better jobs' objective of the EU. Government acknowledges that fiscal consolidation measures are required to maintain macroeconomic stability over time.

Successive deficits will result in the accumulation of debts, undermining the ability of fiscal policy to act as a stabiliser in the event of an economic downturn. Increasing debt levels will also make fiscal policy more susceptible to interest rate fluctuations. Thus, fiscal consolidation should be viewed in the context of strengthening fiscal policy as a tool for macroeconomic stabilisation.

Other policy considerations highlight the need for a sustainable fiscal policy. As discussed in Section 5, a long-term outlook is required in view of the ageing population and the demands this is expected to put on the future sustainability of expenditure related to pensions and health-care. The sustainability of public finances should also allow more investment-related Government expenditure on capital, human resources and infrastructure, thus favouring real convergence of the Maltese economy with the rest of the EU. The sustainability of public finances also has a favourable impact on the credibility of a small open economy like Malta, which is essential in order to attract direct foreign investment and long-term portfolio investments thus augmenting national savings.

In light of this, Government is adopting the necessary policy measures to achieve a sound public finance position in the medium term. To this end, the revenue and expenditure mix are being reviewed so as to attain this fiscal policy goal. In particular, efforts will focus on combating tax evasion and on rationalisation and curtailment of expenditure. This fiscal consolidation process will contribute to ensure that the public finance position is sustainable in the medium-term and also well-placed to address additional fiscal pressures over the longer term, including the budgetary consequences of an ageing population.

During 2003, the General Government budget deficit increased to 9.7 per cent of GDP, from 5.7 per cent in the previous year. This outcome was heavily influenced by a one-off transaction relating to the implementation of the restructuring programme for the shipyards. This programme included a financial transaction designed to free the new shipyards' operation from the burden of existing debts and recurrent interest payments. Thus, Government assumed all liabilities of Malta Drydocks Corporation and the Malta Shipbuilding Co. Ltd., and this exerted a negative impact on the deficit for 2003. If the impact of this transaction were excluded, the deficit-to-GDP ratio would reach 6.5 per cent. Meanwhile, the expansion registered in total expenditure more than offset an increase in recurrent revenue, thus also contributing to an increase in the deficit-to-GDP ratio from the 2002 level.

The General Government debt-to-GDP ratio stood at 72.0 per cent during 2003 as compared to 61.7 per cent during the previous year, reflecting the developments in the fiscal imbalance. Moreover, this increase in the debt-to-GDP ratio also reflected the assumption by Government of all liabilities of the Malta Shipyards, which amounted to 2.3 per cent of GDP.

3.1 The Medium-Term Fiscal Framework

The weakening domestic economic activity registered in 2003 is expected to give way to a gradual and modest recovery in 2004 and subsequent years, reflecting the pick-up in the international economic environment. These developments, which are presented in detail in other parts of this document, are expected to be reflected in some improvement in the budget balances during the medium-term. On the other hand, outlays on interest payments are expected to rise during the 2004-2007 period and this will impact negatively on the budget balance. The improvement in the fiscal position forecasted during the Programme period primarily stems from the fiscal consolidation efforts.

The deterioration in the budgetary balance registered in 2003, is expected to be reversed during 2004, reflecting ongoing efforts to consolidate the public finances. In fact, the General Government budget deficit is projected to decrease to 5.2 per cent in 2004. This decline is attributable to an increase in General Government total receipts which exceeds the rise in expenditure. The primary balance for 2004 is expected to register a significant cutback to 1.4 per cent of GDP, as compared to 6.0 per cent in 2003, thus offsetting the impact of higher interest payments.

A deficit of 3.7 per cent of GDP on the General Government finances is currently projected for 2005. While the revenue ratio is expected to remain stable, the ratio of total expenditures is expected to decline during 2005. Thereafter, the ratio of receipts is expected to decrease coupled with further declines in the ratio of total expenditures. As a result, the budget deficit-to-GDP ratio is expected to fall to 2.3 per cent in 2006 and 1.4 per cent in 2007. This downward trend projected for the budget deficit reflects the developments in the primary balance. In fact, the General Government primary balance is expected to reach a close to balance position in 2005 and a surplus of 1.4 per cent and 2.2 per cent, respectively, in the subsequent two years. These developments in the budgetary position of General Government are presented in Statistical Appendix Table 2. Meanwhile, Chart 3.1 illustrates expected trends in General Government balance.

The declining General Government budget deficits projected for the medium-term framework coupled with other financial operations namely privatisation influence the level of General Government borrowing. The gross debt of General Government is expected to remain relatively stable during the two-year period to 2005, at around 72 per cent of GDP as registered in 2003. Subsequently, during the following years to 2007, the debt-to-GDP ratio is expected to decline to 70 per cent of GDP.

3.1.1 Government Revenue Projections

The share of General Government total receipts in GDP is expected to increase from 42.8 per cent in 2003 to 45.3 per cent in 2004 as depicted in Chart 3.2. This mainly reflects an increase in both the tax and non-tax revenue to GDP ratio. The ratio of total receipts is expected to remain relatively stable in 2005. Subsequently, the ratio of total receipts is expected to decline to 43.9 per cent of GDP in 2006 and further to 43.0 per cent

Chart 3.1

General Government Balance

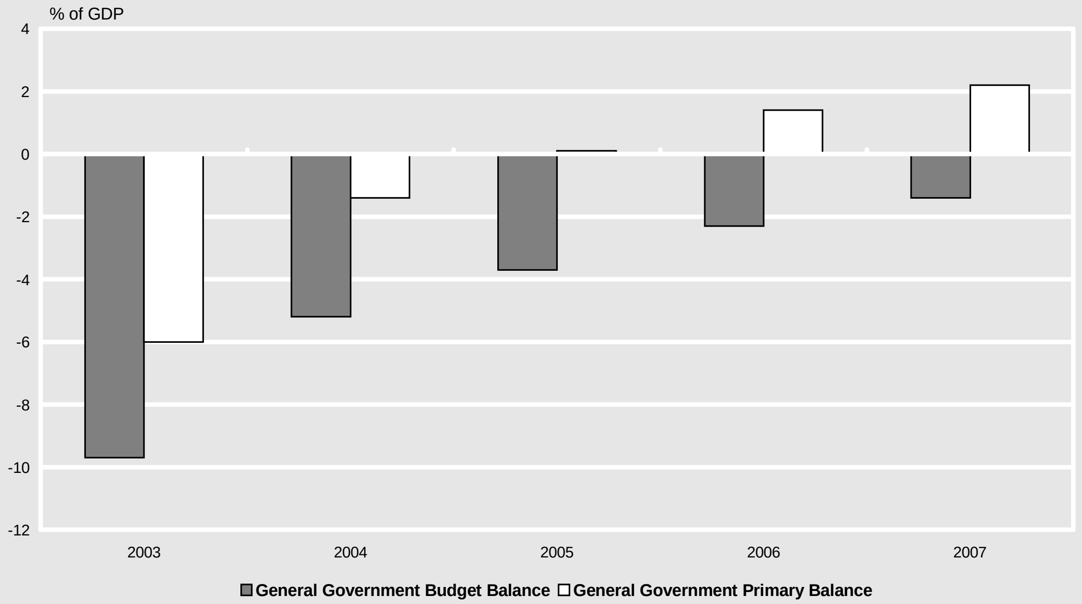
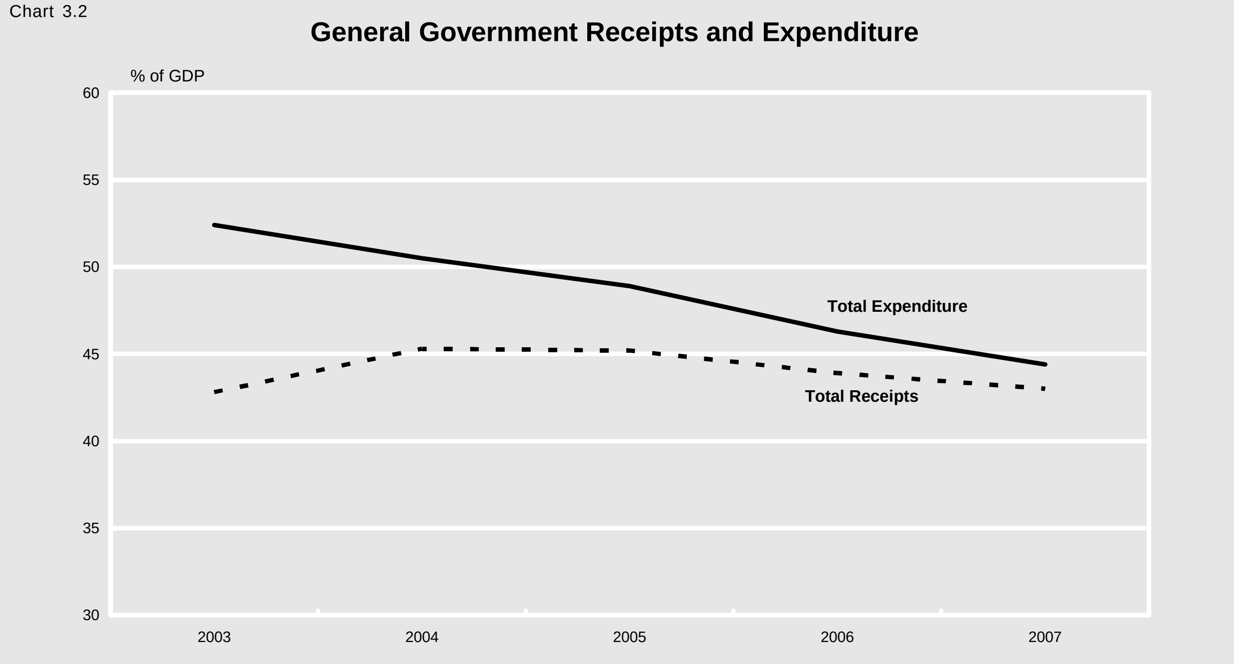


Chart 3.2



of GDP in 2007. In fact, during the 2005-2007 period, Government revenues are expected to increase by an average of 2.2 per cent annually, considerably lower than an annual average nominal output growth of 4 per cent over the same period.

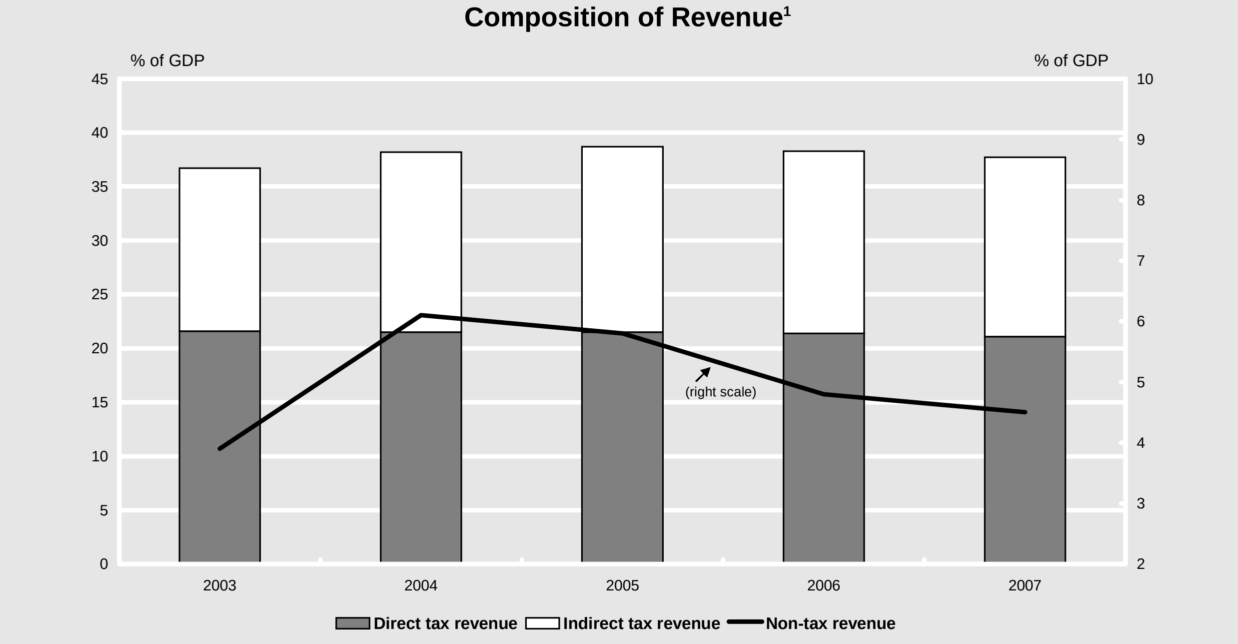
General Government total receipts constitutes Government tax and non-tax revenue as well as revenue generated by extra-budgetary units and other adjustments necessary for the application of the ESA 95 methodology.

During 2004, tax receipts[1], which constitute around 86 per cent of General Government total receipts, are expected to increase to 38.2 per cent of GDP, from 36.8 per cent in 2003. This reflects the introduction of new tax measures as well as stricter tax enforcement. The increase in tax receipts for 2004 is mainly attributable to a higher indirect tax ratio. In fact, indirect tax receipts are expected to increase to 16.7 per cent of GDP as compared to a ratio of 15.1 per cent in 2003. This rise mainly reflects an increase in the VAT rate as from 1st January 2004 as well as higher licences, taxes and fines. The latter is underpinned by licence fees received upon privatisation of the operations of the lotteries as well as higher receipts from duty on documents on transfer of immovable property, following measures introduced this year to combat tax evasion in the property market. These are expected to offset the impact of complete removal of import levies by 1st May. Meanwhile, direct tax receipts are expected to increase at a rate close to the nominal GDP growth rate.

During the 2005-2007 period, tax revenues are expected to increase by an annual average rate of 3.6 per cent, closely reflecting the increase in nominal GDP. Direct taxes, which constitute around 56 per cent of total taxes, are projected to increase over the same period by an annual average of around 3.4 per cent. Meanwhile, indirect taxes are forecasted to increase by an annual average of 3.7 per cent. Thus, the ratio of direct taxes to GDP is expected to remain relatively stable over the three-year period to 2007 at slightly over 21 per cent, while the indirect tax ratio is expected to increase slightly in 2005 but decline at the period's end. Developments in the main components of revenue over the medium-term framework are depicted in Chart 3.3.

Non-tax revenue is expected to increase significantly from 3.9 per cent of GDP in 2003 to over 6 per cent in 2004. This increase is mainly attributable to higher grants mainly comprising funds forthcoming from the European Union as well as through the Fifth Financial Protocol with Italy. During 2005, the ratio of non-tax revenue to GDP is expected to remain relatively constant, despite higher grants which are offset by lower

Chart 3.3



[1] As classified in the statement of the Consolidated Fund

other non-tax revenue. During the subsequent two years, non-tax revenue is expected to decline reflecting lower funds received by way of grants due to the expiry of the Italian Financial Protocol.

Receipts of extra-budgetary units, which form part of the General Government, are expected to remain relatively constant over the same period.

3.1.2 Government Expenditure Projections

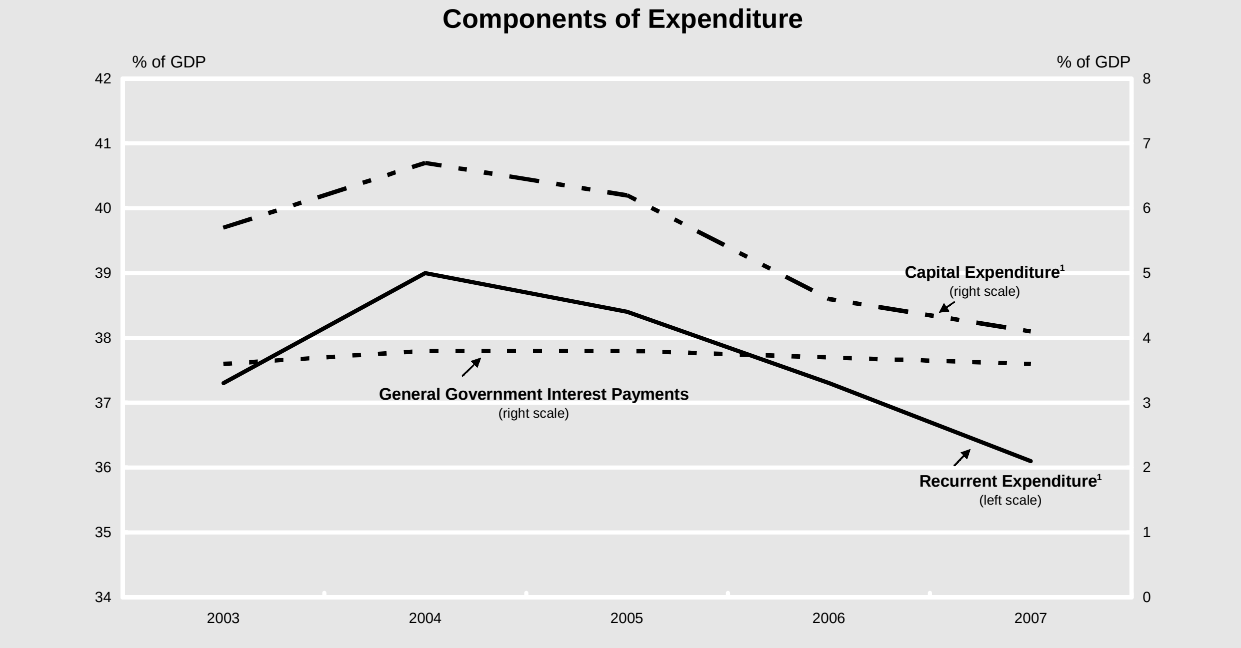
The share of total Government expenditure to GDP is expected to decrease from 52.4 per cent in 2003 to 44.4 per cent in 2007. This declining trend reflects the fact that Government expenditure is expected to rise at a much slower rate than GDP. Indeed Government expenditure is expected to rise by less than 1 per cent with the exception of 2006 when it is expected to decrease by 1.6 per cent. This containment in expenditure shall be attained through controlling recruitment with the Government as well as by improving the value for money of expenditure incurred and prioritising Government expenditure.

General Government expenditure is composed of Government's recurrent and capital expenditure, interest payments as well as expenditure of Extra Budgetary Units and other adjustments in line with ESA 95 methodology.

As shown in Chart 3.4, Government's recurrent expenditure is projected to decrease from 39 per cent of GDP in 2004 to 36 per cent of GDP in 2007. This is mainly due to total recurrent expenditure (including all its components consisting of personal emoluments, operations and maintenance, programmes and initiatives and contributions to Government entities) rising at a slower rate than the increase in GDP. Indeed, growth in recurrent expenditure is projected to decelerate to reach 1 per cent between 2006 and 2007.

The share of personal emoluments in recurrent expenditure is expected to increase marginally from about 27 per cent between 2004 and 2005 to about 28 per cent between 2006 and 2007. The yearly increase in personal emoluments, of about 2 per cent between 2004 and 2007, leading to a total increase of around 8 per cent, covers increases in average wage and salary levels. These reflect increments, cost of living adjustments and, for 2004 only, the effect of the collective agreement for public service employees. During the period

Chart 3.4



[1] As classified in the statement of the Consolidated Fund

2004-2007, employment with government is expected to remain constant at 2003 levels with recruitment being undertaken only in the technical and professional grades in which there is a shortage of staff while other grades are expected to decrease in employment levels due to natural wastage.

The share of operation and maintenance expenditure in recurrent outlays is about 6 per cent. About 50 per cent of expenditure under this category are materials and supplies, most of which relate to the provision of free medicines under the national health system. Operation and maintenance expenditure is projected to increase by 4 and 6 per cent respectively between 2004 and 2005 mainly due to an increased budget allocation to this item in order to pay a significant amount of arrears. However, there should be decreases of 1 per cent and 3 per cent in 2006 and 2007 respectively in this item of expenditure following this adjustment. Thus, there should be an overall increase of 2 per cent in expenditure on operation and maintenance between 2004 and 2007.

Programmes and initiatives constitute about 55 per cent of total recurrent expenditure. Expenditure under programmes and initiatives should increase by 2 per cent between 2004 and 2007 with the rate of increase decreasing each year to reach 0.8 per cent in 2007. The main item of increased expenditure under this category is retirement pensions, which are projected to rise from Lm89 million in 2004 to Lm104 million in 2007. This increase is due to both a higher number of beneficiaries as well as the cost of living adjustment to the pensions paid. It is pertinent to note that the projections for retirement pension outlays are baseline forecasts and do not take into account any reforms to the welfare system that are currently being discussed within the Malta Council for Economic and Social Development. As a member of the European Union, Malta is contributing 1 per cent of GDP from own resources between the period 2004 and 2007.

The expenditure on contributions to Government entities constitutes about 11 per cent of total recurrent expenditure. This item of expenditure is expected to increase by 5 and 6 per cent respectively in 2004 and 2005, slowing down to 1 and 3 per cent in 2006 and 2007 respectively. Contributions to Government entities between 2004 and 2007 will increase mainly for the new hospital and the post secondary education institutions while it will decrease for other Government entities reflecting their restructuring as detailed in Section 6. In particular, the state aid to the Malta Shipyards is expected to decrease by about 50 per cent between 2004 and 2007, in line with the commitments under the EU Accession Treaty.

Capital expenditure should decrease from 6.7 per cent of GDP in 2004 to 4.1 per cent of GDP in 2007 with an absolute decrease between 2004 and 2007 of about 30 per cent mainly due to lower outlays on the new hospital as this project is completed. Besides this, projects tied to the EU's Structural and Cohesion funds and other foreign financing are the main components of capital expenditure during the 2004-2007 period. Most outlays on the hospital will be spent till 2006, most outlays on roads under the Italian protocol are expected to be spent by 2005, while most expenditure on projects tied to EU funds will be spent between 2006 and 2007. About 60 per cent of the projects tied to Structural and Cohesion funds will be aimed at improving the environment, transport infrastructure, support to SMEs and the productive sector. About 16.6 per cent will be aimed at increasing employability and adaptability, gender equality, life long learning and decreasing social exclusion. Around 11 per cent will be aimed at investment in the agriculture and fishing sector whilst 10.2 per cent will be aimed at improving the infrastructure and human resources in Gozo so as to decrease the disparity in the level of economic development between Malta and Gozo. Thus, priority is being attached to improve the competitiveness and to boost the supply side of the domestic economy, by addressing the infrastructural deficit and targeting funds available towards investment in human resources and enterprise support.

The interest payments on General Government debt should remain constant at around 4 per cent of GDP between 2004 and 2007. Expenditure on interest payments is projected to rise by 5 per cent during this period, with increases slowing down each year to reach 0.1 per cent in 2007. These figures are premised on the assumption of constant interest rates. The figures are also a reflection of the slowing down of debt growth between 2004 and 2007.

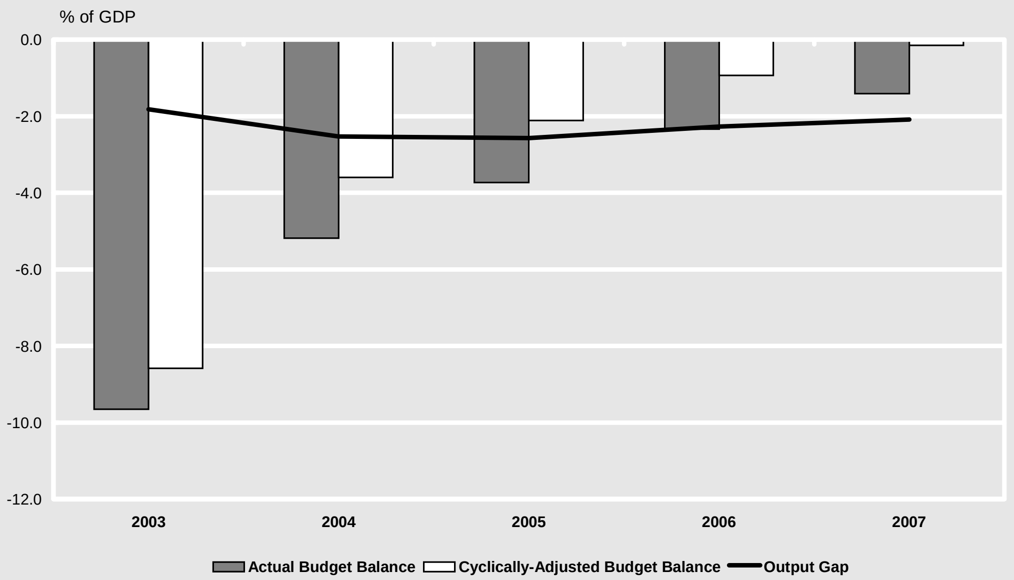
3.2 The Effect of Cyclical Fluctuations on Budget Balances

It is important to take into account the effect of cyclical fluctuations on budget balances when assessing public finances and related policies. However, estimates of the cyclically-adjusted budget balance and inferences on the appropriateness of the budgetary stance require to be treated with caution, in view of uncertainty in the estimation of potential output discussed in Section 2 as well as uncertainty regarding budget sensitivity to changes in the rate of GDP growth.

Chart 3.5 and Table 4 in the Statistical Appendix present estimates of Malta's output gap and the cyclically adjusted budget balance. A detailed description of the methodology applied in the estimation of the cyclically-adjusted budget balance is provided in Annex 1. Assessments carried out by the Ministry of Finance show

Chart 3.5

Actual and Cyclically-Adjusted Budget Balances



that a 1.0 percentage point change in the output gap has an average impact of 0.59 per cent of GDP on the actual budget balance. In 2003, a negative output gap was recorded, causing the actual deficit to exceed the cyclically-adjusted deficit. The deficit in 2003 stood at 9.7 per cent of GDP. However, 1.1 per cent of this deficit was entirely attributable to the business cycle.

The economy is predicted to operate below potential during the forecast period. As a result, the projected budget deficit will be higher than its cyclically-adjusted counterpart. It is expected that by 2005, the adverse effect of the cycle on the actual deficit will reach a peak of 1.6 per cent of GDP. The subsequent narrowing of the negative output gap will exert a favourable effect on fiscal balances, with the cyclical budgetary component declining to a negative of 1.3 per cent of GDP by 2007 and the cyclically-adjusted deficit falling to 0.2 per cent of GDP.

A further refinement on the cyclically-adjusted balance, mainly eliminating the effect of interest payments would lead to a cyclically-adjusted primary balance (CAPB). The CAPB is considered to be a more appropriate measure of the structural balance. It excludes the effects of interest expenditures incurred as a result of fiscal operations of previous years and thus reflects better Government's current fiscal operations. Moreover, annual changes in the CAPB are considered to be a good indicator of the fiscal stance and are used to evaluate the degree of consolidation efforts. The CAPB is projected to turn to a surplus in 2004 and increase to reach 3.4 per cent by the end of the forecast period.

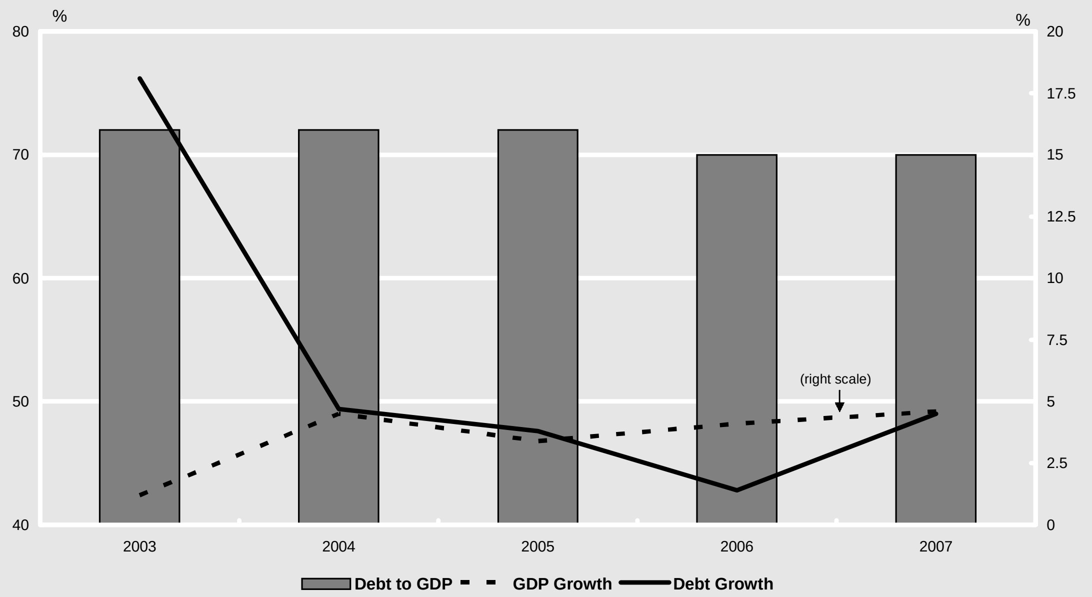
3.3 Debt Levels and Developments

The main objective of Malta's debt management is to ensure that the financing needs of the public sector are met at the lowest possible cost while bearing an acceptable level of risk in the medium and long term. Other objectives are to ensure that public sector borrowing levels are kept within agreed ceilings and that the domestic debt market continues to be developed. Efforts are being stepped up to strengthen Malta's capability in public debt management, particularly to ensure that debt management is integrated into the overall macro-economic strategy.

The level of General Government debt is expected to rise during the Programme period, to reach Lm1.5 billion in 2007 from Lm1.3 billion in 2003. The developments in General Government debt primarily reflect the performance of Central Government debt, which in 2003 accounted for over 90 per cent of the total, as no

Chart 3.6

Debt to GDP ratio, GDP and Debt Growth



major changes are expected in the debt levels of Extra Budgetary Units and local councils during the 2004-2007 period.

The debt-to-GDP ratio is expected to rise from 72.0 per cent in 2003 to 72.4 per cent in 2005, but then is projected to decline to 70.4 per cent of GDP in 2007 as shown in Chart 3.6. This partly reflects the fact that in general GDP at market prices is projected to grow at a faster rate than debt in 2006 and 2007. In fact, as shown in Statistical Appendix Table 3 increased nominal GDP is expected to have a contractionary effect on the debt-to-GDP ratio of about 2 to 3 percentage points per year between 2004 and 2007.

The primary deficit is expected to increase the debt-to-GDP ratio in 2004 by 1.4 percentage points. However, subsequently as the primary balance turns positive, this is projected to lead to a contraction in this ratio reaching a 2.3 percentage point decrease in the debt-to-GDP ratio in 2007. Interest payments are expected to increase the debt-to-GDP ratio by about 3 to 4 percentage points between 2004 and 2007. The implicit interest rate on debt is expected to be about 5 to 5.3 per cent between 2004 and 2007. Between 2004 and 2006, privatisation receipts are expected to lead to a decrease in the debt-to-GDP ratio of about 2 percentage points.

Thus the contractionary effect of GDP growth and privatisation on the debt-to-GDP ratio will be outweighed by the augmentative impact of the primary balance and interest payments in 2004, thus leading to an increase in this ratio. In 2005, the contractionary impact of the primary balance, GDP growth and privatisation receipts should also be outweighed by the expansionary impact of the interest payments leading again to an increase in the debt-to-GDP ratio. In 2006 the contractionary effect of the primary balance, GDP growth and privatisation will outweigh interest payments leading to a decrease in the debt-to-GDP ratio. This will also happen in 2007 even though no privatisation receipts are expected.

During the Programme period, Government aims to maintain its high dependence on domestic borrowing to finance its budget deficit. Indeed, the proportion of foreign loans to total loans is projected to remain at around 6 per cent till 2007 thus relying for most debt financing on the domestic market. This helps not only in building the local debt market but also in minimising the drain on foreign currency due to interest payments as well as limiting the exposure to exchange rate risk. The foreign debt, which has recently been entered into, is tied to the building of the new hospital and offers financing at relatively advantageous conditions.

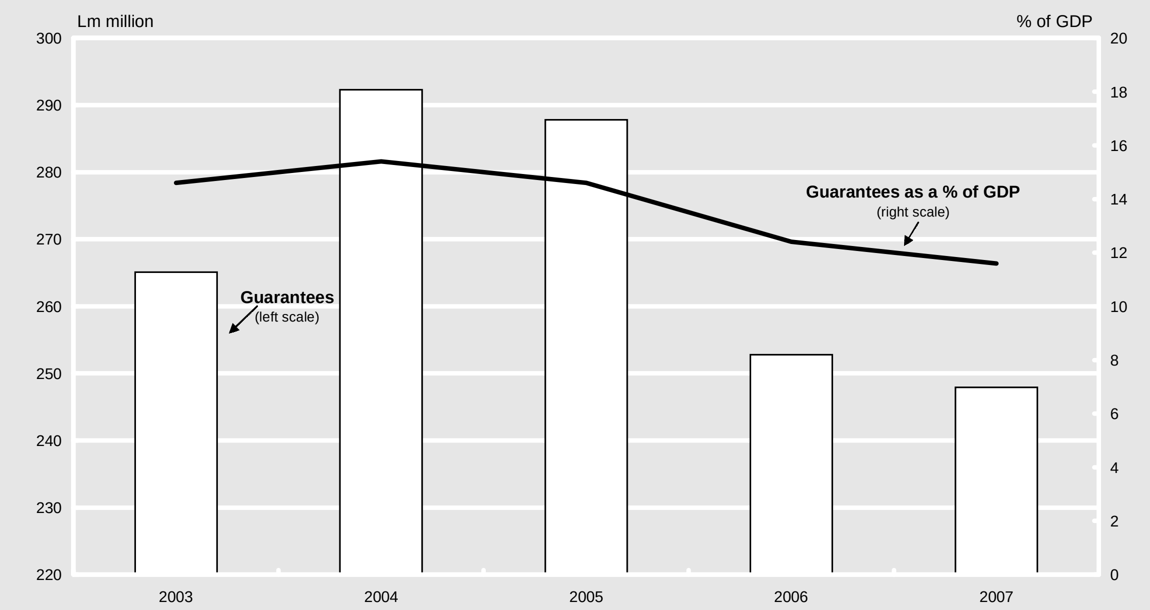
The Government has increasingly resorted to debt of a long-term maturity to finance its borrowing requirement. Long-term financing constituted around 81 per cent of total financing in 2003 and this is expected to increase to about 87 per cent in 2006 and 2007. Long-term financing is preferred as it decreases the risk of cash flow problems for Government. Furthermore, in the context of the prevailing low interest rate environment, and the very good local demand for Government bonds, advantageous terms on such long-term financing have been obtained.

3.4 Fiscal Risks

Government's programme of budgetary consolidation is exposed to certain fiscal risks and uncertainties. Beyond the uncertainty of macroeconomic performance which may negatively impinge on the outlook of Government's financial position, other types of risks warrant concern.

Despite that Government guarantees do not impinge on the current budgetary position they represent a source of fiscal risk. It is Government's policy to adhere to the budgetary rules governing the issuance of such implicit contingent liabilities in order to limit the risk exposure of its financial position. The rules governing the issuance of guaranteed debt are contained in the Financial Administration and Audit Act (Cap. 174).

Chart 3.7



At the end of 2003, the level of Government guarantees[2] stood at around Lm265 million or around 15 per cent of GDP. Other guarantees amounting to some Lm50 million or 3 per cent of GDP were issued to entities which form part of the General Government and thus are already accounted for as General Government debt. As illustrated in Chart 3.7, state guarantees as a per cent of GDP are expected to decline from around 15 per cent in 2004 to around 12 per cent over the medium-term framework. There have been no calls on guarantees and there is no indication that such guarantees are likely to be called.

Privatisation may serve to contain the increase in public debt by creating a source of financing the budget deficit. Moreover, in privatising assets, Government divests the risks associated with the performance of the entities being privatised. On the other hand, the Government is still at risk in cases where it retains a financial obligation in the entity concerned. In case of a lack of achievement of the planned privatisation programme, pressure is put on public finances as this would necessitate the use of alternative sources of financing the deficit thus increasing Government debt. In turn, this would increase interest payments and thus impinge on the borrowing requirements over subsequent years.

Government's budgetary position is subject to minimal interest rate and exchange rate risk. Exchange rate risk is considered negligible given that, currently, around 94 per cent of Government debt is denominated in local currency. Interest rate risk is also minimal as Government prefers debt of a long-term maturity rather than short-term debt.

The long-term sustainability of public finances is subject to fiscal risk arising from the demographic realities of an ageing population, particularly as this exerts pressure for increased spending on such areas as public pensions and health care systems. In order to alleviate this potential risk, as mentioned in other sections of this document, importance is being attached by Government to reform the pension and health care system, even though, in the case of the former, this may have an adverse impact on public finances particularly in the early stages of the reform process.

Notes:

[1] Tax receipts are defined as classified in the statement of the Consolidated Fund.

[2] It is pertinent to note that data for Government guarantees, which excludes guarantees to entities which form part of the General Government, are not comparable with that presented in the PEP for 2003.

4. Sensitivity Analysis and Comparison with PEP 2003

4. Sensitivity Analysis and Comparison with PEP 2003

4.1 Sensitivity Analysis

The base economic forecasts presented in this document represent an assessment of Malta's growth prospects for the forthcoming years up to 2007. As with any other projections, these forecasts are subject to some degree of uncertainty. Hence, it was deemed necessary to examine different scenarios and their effect on the budgetary forecasts.

This section includes two alternative sensitivity analyses[1] where the assumptions made regarding the interest rate and the expected level of growth in Malta's main trading partners, differ from the base scenario. The results of these sensitivity analyses should be seen as indicative, given the uncertainty regarding the responses in the economy to changes in interest rates or to changes in external demand. These analyses focus on the impact of deviations from the baseline on the General Government budget deficit, gross General Government debt and growth in Gross Domestic Product for the years 2004-2007. The impact of changes in the interest rate on the fiscal position is illustrated in Chart 4.1 whilst Chart 4.2 presents the impact under the scenario of higher external demand.

4.1.1 Sensitivity to Interest Rate Fluctuations

This scenario is built on the assumption of a 1 percentage point increase in the interest rate between 2004 and 2007. Variations in the interest rate impact the budgetary position in two ways, primarily by increasing debt service costs directly and by impacting on revenue and expenditure items within the Government budget through lower economic activity. It is important to highlight at the outset that one expects a minimal impact on Government's budgetary position from a change in interest rate, since most of Government debt is of a long-term rather than short-term maturity nature. Thus, the impact on the budget balance and on Government debt of an increase in the interest rate would arise from the higher rate of interest pledged on any new issue of stock by Government and as a result of the rolling-over of past debt.

Higher interests would reduce investment and consumption spending, thus impacting on the budget. Estimates for the Maltese economy show that when the interest rate is 1 percentage point higher than that projected in the base forecast, economic growth would be about 0.1 percentage points lower. The increase in the interest

Chart 4.1

Sensitivity to a 1 Percentage Point Increase in the Interest Rate

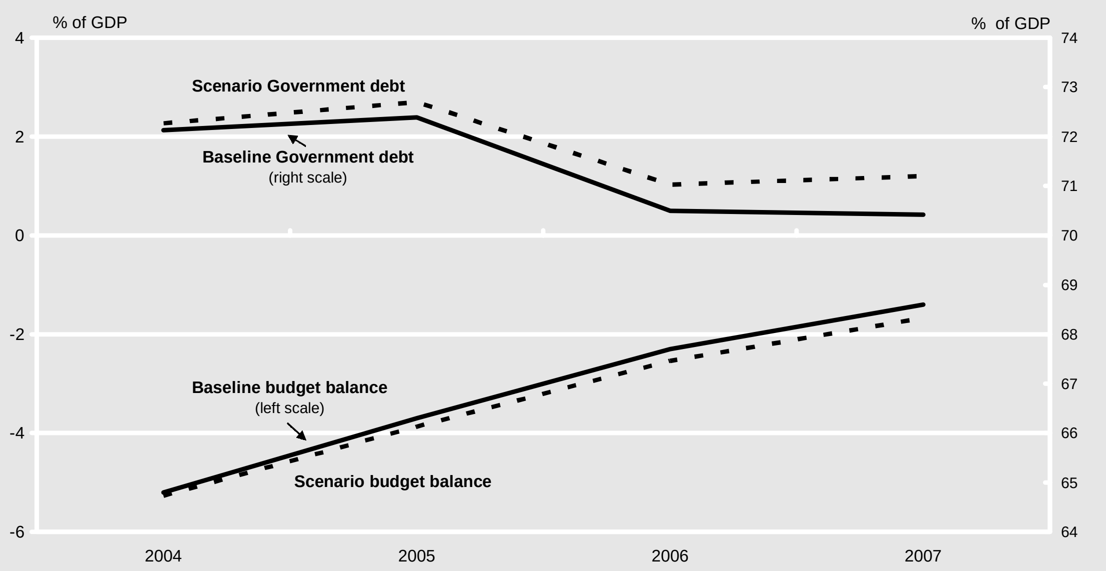
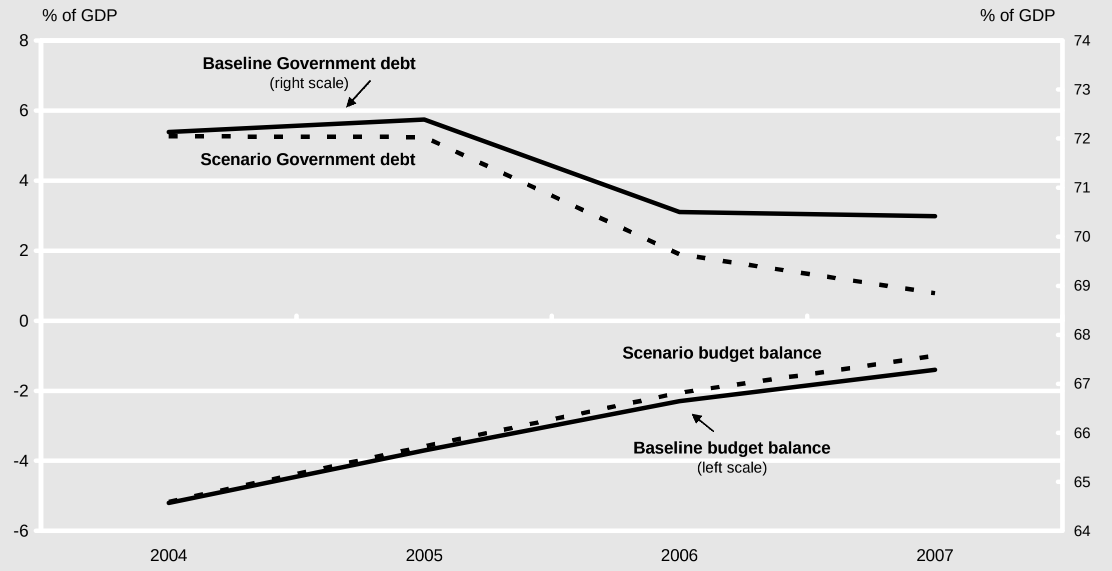


Chart 4.2

Sensitivity to a 1 Percentage Point Increase in External Demand



rate is estimated to worsen the public budget balance by about 0.3 percentage points of GDP after four years. The increase in the budget balance would in turn increase Government's borrowing requirements and thus increase the ratio of gross Government debt-to-GDP. It is estimated that the higher interest rate increases the ratio of gross Government debt-to-GDP by around 0.1 percentage points in 2004, with the deviation increasing to around 0.8 percentage points by 2007.

4.1.2 Sensitivity to Change in External Demand

The Maltese economy has been characterised by a relatively subdued performance since 2001, primarily reflecting the unfavourable international economic environment. Still, uncertainties remain as to the timing and magnitude of the international recovery in Malta's main trading partners. This sensitivity scenario estimates the responsiveness of the performance of the Maltese economy in the light of these uncertainties and the effect of such developments on the budget balance and Government debt. In this sensitivity analysis, the annual growth rate in external demand has been increased by 1 percentage point in the first year of the forecast and throughout the forecast period till 2007.

The stronger growth in foreign demand, as postulated in this scenario, has spill-over effects on the Maltese economy with real GDP estimated to grow initially by around 0.2 percentage points more when compared to the baseline projection. Estimates show that the difference from the baseline forecast increases to around 0.3 percentage points in 2005 and then gradually increases to around 0.5 percentage points by 2007. The primary component affected by the increase in external demand is domestic exports, which impact on GDP is counteracted by an increase which is registered in the imports component of GDP, given that a significant component of local exports are imported. Compared to the base scenario, the higher growth rate in external demand, affects the budget balance positively. It is estimated that by 2007, the budget balance as a percent of GDP would be improved by around 0.4 percentage points. Government debt as a per cent of GDP is estimated to be around 1.6 percentage points lower in 2007 when compared to the baseline scenario.

4.2 Comparison with the Projections in the PEP for 2003

Economic growth projections as presented within this Convergence Programme have been revised downwards when compared to previous estimates as published in the PEP of 2003. The subdued growth projected for 2003 actually turned out to be an economic contraction. This was mainly the result of higher imports, lower exports and a significantly lower growth rate for household consumption compared to that projected in the PEP for 2003. The following general comments can be made regarding the discrepancy between last year's forecasts and the outturn for 2003.

The export performance in 2003 was significantly affected by a slower than expected economic recovery in world demand, particularly by Malta's main trading partners in the EU. Whereas a growth rate of 2.1 per cent in foreign demand was expected last year, a more recent forecast indicates a growth rate of 0.6 per cent for 2003. In addition, it is pertinent to note that a primary reason for the divergence in the 2003 export growth forecasts results from a revision in the export figures due to an extraordinary item in the form of the re-export of aircraft in 2002. These were not included in the national accounts data available when the forecasts for the PEP 2003 were compiled. This disposal of assets also resulted in a downward revision of investment expenditure such that this transaction had no effect on GDP growth.

Real imports in 2003 also turned out to be substantially higher. This discrepancy mainly reflects significant adjustments in import prices, which were expected to rise by 2.1 per cent in 2003. However, actual data for 2003 shows that the deflator for imports declined by around 3.8 per cent. As a result of the substantial decline in import prices, the real value of imports has increased considerably.

Despite the relatively low rate of inflation and the low cost of borrowing, private consumption expenditure in 2003 was substantially lower than projected. The performance of the labour market may have underpinned this result. Indeed, the unemployment rate in 2003 stood at 5.7 per cent, whilst employment growth stood at a negative of 0.8 per cent, compared to the forecast of 5.3 per cent and 0.7 per cent respectively presented in the PEP for 2003. Indeed, unemployment started to increase significantly in the second half of the year, whilst the restructuring of the shipyards implemented towards the end of the year also had an impact on employment figures.

The current forecasts for the 2004-2006 period are also significantly lower than those presented in the PEP for 2003. This primarily reflects lower private consumption and exports. The former reflects the impact of fiscal consolidation measures aimed at reducing the budget deficit level to more sustainable proportions. These measures include the increase in the VAT rate announced in the last budget, which should reduce consumption growth levels for 2004 relative to last year's forecasts. Furthermore, the current forecasts show further curtailment of Government current consumption and of Government capital expenditure towards the end of the medium term framework. One also notes the divergence in the expected rate of inflation for 2004 as compared to the figures quoted in the PEP for 2003. The divergence is primarily attributed to the one-off effect as a result of the increase in the VAT rate as from 1st January 2004.

Meanwhile, the lower export performance is mainly due to a downward revision in foreign demand projections as it is now expected that the recovery of growth levels to above 2 per cent in the 2004-2006 period by Malta's main trading partners has been postponed by at least one year.

At a ratio of 9.7 per cent, the General Government deficit-to-GDP is 2.3 percentage points higher than the projection presented in the PEP for 2003. However, it is pertinent to note that as outlined in other sections of the document, this deviation was primarily due to the restructuring of the shipyards implemented towards the end of 2003. In fact, this one-off transaction influenced the deficit-to-GDP ratio by 3.2 percentage points. If the impact of this transaction were excluded, the deficit to GDP ratio would have stood at 6.5 per cent, as compared to 7.4 per cent forecasted last year. In light of this development, the fiscal framework for the medium-term has been revised. During 2004, the General Government budget deficit is projected to decline to 5.2 per cent of GDP, as compared to 5.8 per cent presented in the PEP for 2003. This revision is mainly attributable to higher projections for expected tax and non-tax revenue which more than offset higher forecasted outlays in respect of recurrent expenditure. Over the subsequent years, the General Government budget deficit is expected to follow a downward trend to 3.7 per cent of GDP in 2005 and 2.3 per cent in

2006. As compared to the projections presented in the PEP for 2003, this outlines a somewhat more rapid reduction of the fiscal imbalance.

The General Government debt stood at 72.0 per cent of GDP in 2003, slightly higher than the ratio of 71.7 per cent presented in the PEP for 2003. This divergence reflects the negative impact of the assumption of debt of the shipyards by Government. This adjustment, which affected the debt ratio by 2.3 percentage points, offset the positive impact on the debt ratio emerging from the lower than expected fiscal imbalance in 2003. As a result of this transaction, over the subsequent years, the debt ratio presented in this Convergence Programme is expected to be slightly higher than that presented in the PEP for 2003.

Notes:

[1] The sensitivity analyses presented in this Section consider 2004 as the first year of the forecast and thus any fluctuations from the baseline are commenced in the year 2004.

5. Long-term Sustainability of Public Finances

5. Long-term Sustainability of Public Finances[1]

In securing sustainable public finances, the focus must not be solely on developments occurring in the near-term, as this may mask any underlying emerging trends which, although requiring a longer time to surface, need to be tackled in time without provoking undue economic disruptions. Therefore the necessity to take a long-term view of the evolution of public finances. Demographic shifts and their implications on the future operation of welfare systems and Government revenue streams represent a central issue in the endeavour of fiscal sustainability. Indeed, the likely outcomes of the future path of pension and healthcare expenditure have become a main policy challenge in most economies faced with an ageing population and ever expensive healthcare services.

Like many of these countries, old-age pensions and healthcare expenditure are expected to represent a formidable challenge to Malta in the coming years. In 2002, old-age pensions accounted for around 12 per cent of Government total expenditure, whilst healthcare and long-term outlays amount to another 9 per cent. It is anticipated that the pressure on public finances arising from pensions will peak around the year 2020. As a result of a falling birth rate, longer life expectancy together with the entry of the post-war baby boomers into retirement, the amount of benefits paid by Government will rise. This will move the current system into a higher deficit.

Against this background, Government has set-up a National Commission for Welfare Reform composed of a wide representation of social partners charged with the task of presenting proposals for reform. Concurrently, the discussions are being held within the Malta Council for Economic and Social Development (MCESD), a tripartite forum comprising trade unions, employers' organisations and the Government. The discussions, with a view to establishing a final reform plan, are currently proceeding in earnest within MCESD and are expected to be concluded in the coming months. In preparing population projections and the likely trajectory of the pension system, the Commission and MCESD were supported by World Bank experts. The results presented in this Section are also based on simulations carried out by the World Bank's Pension Reform Option Simulation Toolkit (PROST) model. This model uses country-specific data to generate population projections which are then combined with economic assumptions to obtain future numbers of contributors and beneficiaries. The model then projects fiscal balances.

The projections presented in this Section are limited to the evolution of age-related public spending under an 'unchanged policy' scenario. This should not be interpreted as meaning that policy will not change over time,

Box 5.1: Assumptions Underlying Age-Related Projections

In projecting the Maltese population and its impact on age-related public expenditure for the period covering 2002 to 2050, two main sets of assumptions were used:

As regards the **demographic** evolution, the fertility rate is assumed to decline from 1.37 in 2002 to 1.28 in 2012 and subsequently increase to 2.1 by 2050. Life expectancy at birth is assumed to increase gradually from the present 77.8 years to 83.8 years, whilst net migration is assumed to be zero. As a result, the working age population per one dependent is expected to decrease by the end of 2050. Female working age population is assumed to decrease from about 1.7 per one dependent in 2002 to 1.0 by 2050, while male working age population is assumed to decrease from about 1.8 in 2002 to about 1.2 per one dependent by 2050.

In terms of **macroeconomic** assumptions, labour productivity growth is assumed to increase from –1.8 per cent in 2002 to 0.3 per cent in 2005, and subsequently remains below 4 per cent. Given an 'unchanged policy' scenario in which the working age population is made up of individuals between 16 and 61 years, the participation rate is assumed to increase from 64.1 per cent in 2002 to reach 73.3 by mid-century. In the case of the male labour participation, the rate is assumed to decrease slightly from 84.6 per cent in 2002 to 81.6 per cent by 2050, whilst in the case of females participation is assumed to rise from 43.4 in 2002 to 63.4 per cent by 2050. The unemployment rate is assumed to decrease from a level of 7.7 per cent in 2002 to 6.0 per cent in 2050.

but rather is used not to prejudge the conclusions of the discussions with social partners and the resulting reforms. Explanations of the assumptions underlying the projections contained in this Section are given in Box 5.1.

5.1 Demographic Developments

As shown in Table 5.1, in the next four decades Malta will witness a significant increase in ageing. The age structure of the population will move from one predominantly characterised by people within working age in 2000 to one in which the majority of the population is inactive fifty years on. Falling birth rates during the first half of the century will translate in a shrinking youth population (0-19 years old). As a result, the population in the 20-59 bracket will, starting from 2010, decline and by 2050 will be a quarter less than that recorded in 2000. The generation of 'baby-boomers' will move into the 59+ age bracket; an effect which will start to be felt in the year 2010 but which will accelerate during the subsequent forty years when the old-age population will almost double from the 2000 level.

In line with these trends, the demographic dependency ratios are also expected to exhibit substantial shifts. The youth ratio (0-19 year olds as a proportion of those within the 20-59 bracket) is expected to fall by around 5 percentage points during the next 50 years, reflecting a falling birth rate in the same period. This ratio is anticipated to decline and reach a low in 2020, but will rise thereafter. A more radical change is anticipated in the old age dependency ratio (59 years and above as a share of the 20-59 population). For this cohort, population projections show that the ratio will increase during the period under review and is expected to more than double by 2050. This effect will intensify between 2030 and 2050 when the old-age ratio will rise sharply by around 20 percentage points. Compared with 2000, the net effect of developments in these two age brackets is such that until 2010 the effect of the declining youth ratio more than offsets the rise in the old-age ratio. However, starting from 2010 the increase in the old-age ratio exceeds the fall in the youth ratio and as a consequence the total dependency ratio will begin to rise. By 2050, the total dependency ratio will amount to around 126 per cent, meaning that every person in the working age population will have to support around 1.3 non-active persons compared to 0.8 non-active persons in 2000.

Maltese Population Trends

Table 5.1

	2000	2005	2010	2020	2030	2050
			Total population			
0-19 yrs	104,975	96,400	86,400	74,000	73,500	70,300
20-59 yrs	212,821	226,900	224,100	213,300	199,100	158,100
59+ yrs	64,729	74,200	89,600	111,900	118,200	128,200
Total	382,525	397,500	400,100	399,200	390,800	356,600
			Percentage of total population			
0-19 yrs	27.4	24.3	21.6	18.5	18.8	19.7
20-59 yrs	55.6	57.1	56.0	53.4	50.9	44.3
59+ yrs	16.9	18.7	22.4	28.0	30.2	36.0
			Demographic dependency ratio			
0-19 yrs	49.3	42.5	38.6	34.7	36.9	44.5
59+ yrs	30.4	32.7	40.0	52.5	59.4	81.1
Total	79.7	75.2	78.5	87.2	96.3	125.6

Source: World Bank, own calculations

5.2 The Cost of Ageing

Like many other countries, Malta is reaching the point where the pension system needs to be seriously revisited to ensure that it can provide adequate and fiscally sustainable benefits for workers in the future. As pointed out earlier, projections of old-age pension are derived from simulations carried out by the World Bank's PROST model. These projections portray the evolution of the expenditure in the first half of this century under an 'unchanged policy' scenario. For the purpose of this assessment the coverage of old-age pensions includes various benefits (representing some 93 per cent of total pay-as-you-go public expenditure) such as retirement pensions, invalidity pensions and survivors' pensions. Box 5.2 provides an overview of the main features of the present Maltese pension system.

Based on contributions of employer and employees only, which is the usual basis for looking at pension systems, the current pensions system in 2003 was running a moderate deficit of 0.2 per cent of GDP. This deficit is currently being covered by the Government contribution of 10 per cent. It should be stressed that, under the present system, the revenue generated from contributions is also used to finance health expenditure. Chart 5.1 illustrates the path of the pensions system balance based on the World Bank's PROST model. The deficits are projected to increase to 2.4 per cent of GDP by 2010 and to 4.7 per cent of GDP by 2030 before falling in the future. This outcome mainly reflects a fall in contributions as a ratio to GDP which is expected to drop by 5.5 percentage points to 1.7 per cent of GDP by 2050 as, under an 'unchanged policy' scenario, less people enter the working age population and more retire. To a lesser extent, the rise in the pensions payment deficit is also affected by higher payments to GDP ratio. In fact, the payments to GDP ratio is projected to increase by around 1 percentage point by 2030, after which the ratio is expected to decline to reach around 6 per cent by 2050. This is a consequence of the mechanics of the current system whereby pensions, while indexed to wage growth, are subject to a ceiling which also increases with the annual cost of living adjustment. Thus as wages continue to grow, more pensioners will hit this ceiling resulting in lower pension expenditure per head. However, the higher number of pensioners will more than offset this effect.

Box 5.2: The Current Pension System in Malta

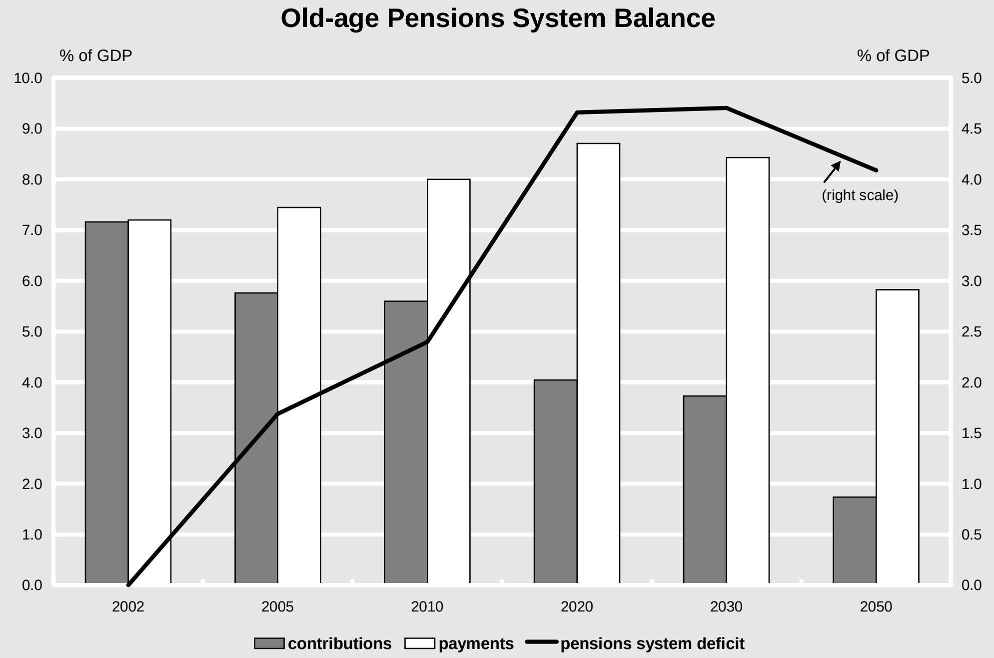
The present Maltese pension system has its origins in 1979 with the establishment of the so-called two-thirds pension which focuses on income replacement. The post-1979 system terminated the occupational pension funds that existed previously with the exception of those for public service employees employed before that year. Private pension savings schemes are still in the initial stages in Malta.

The current pension system is a traditional defined benefit pay-as-you-go system with contributions from current workers being used to finance benefits for current pensioners. The pensions are funded by contributions paid by both employer and employee each paying a rate of 10 per cent of the basic wage, while Government contributes another 10 per cent. The self-employed pay only 15 per cent, with 7.5 per cent coming from Government. Apart from retirement pensions, these funds are used to finance a variety of other benefits such as the entire health bill, and other social benefits with none of the contributions earmarked for any specific benefit. Currently, the retirement age in Malta is 60 years for females and 61 years for males.

The pensions are determined by a formula based on the average of the best three years out of the last ten years' salaries for employees, and the average of the last ten years' income for the self-employed, with a pension equal to two-thirds of this average wage for those having contributed thirty years. A critical feature of the Maltese pension system is the ceiling on income subject to contributions. Currently, this ceiling is 78 per cent higher than the average wage but increases with COLA (cost of living adjustment), which is less than inflation. Additionally, while pensions are indexed to wage growth, they are subject to a maximum which also grows with COLA.

Presently there is a relatively high coverage, in terms of both contributions and benefits, among labour force participants and also among retiree ages. In fact, the overall male labour force participation rate and coverage rates are currently around 90 per cent. Meanwhile, 66 per cent of males over the age of 60 receive two-thirds old age pensions, and another 33 per cent receive partial pensions from the State, where the remainder of their pension comes from old occupational plans; and another 1 per cent continue to receive invalidity pensions. By contrast, but consistent with a lower labour force participation, only 19 per cent of women over the age of 60 receive old age pensions; 7 per cent receive some form of benefit from the public system to complement the occupational pension; 29 per cent receive widow's pensions, and only 0.1 per cent receive invalidity pensions.

Chart 5.1



5.3 The Cost of Healthcare and Long-term Care

Projections of healthcare and long-term care expenditures are shown in Table 5.2. In this case too, calculations reflect outcomes under an 'unchanged policy' scenario and were obtained by following the methodology described in Annex 2. Expressed as a ratio of GDP, total expenditure on healthcare and long-term care are anticipated to rise by around 3 percentage points over the fifty years to 2050. Spending on health care is the main contributor in this total. Long-term care costs to GDP ratio is expected to increase threefold, whilst healthcare outlays will increase by 1.6 percentage points. Both spending categories are predicted to increase in the years under review with the largest increase in healthcare and long-term costs occurring between 2020 and 2030.

Baseline Projections for Public Spending on Healthcare and Long-Term Care

Table 5.2

	Total health and long-term care		Health care		Long-term care	
	Exp. as share of GDP	Change in exp in % of GDP on 2002	Exp. as share of GDP	Change in exp in % of GDP on 2002	Exp. as share of GDP	Change in exp in % of GDP on 2002
2002	4.3	-	3.7	-	0.6	-
2005	4.5	0.3	3.8	0.1	0.7	0.1
2010	4.8	0.6	4.0	0.4	0.8	0.2
2020	5.6	1.3	4.5	0.9	1.1	0.5
2030	6.5	2.2	5.0	1.3	1.5	0.9
2050	7.1	2.9	5.3	1.7	1.8	1.2

Source: Ministry of Health, the Elderly and Community Care, own calculations

5.4 Impact on the Deficit and Debt

Results from simulations carried out to assess the likely budgetary impact of long-term age-related liabilities under an 'unchanged policy' scenario are shown in Statistical Appendix Table 6. Given the high degree of uncertainty regarding future developments, it is appropriate to state clearly the main assumptions used to estimate the path of these results.

In projecting the long-term evolution of interest rate payments the following procedure was observed. Debt during the period under review was calculated by topping the debt stock in the previous period with the fiscal gap between total revenue and expenditure. Next, the ratio of interest payments to debt for 2005 was obtained and assuming that this implicit interest rate holds for the remaining years, interest payments for the subsequent years was estimated as a percentage of the debt stock calculated previously. As regards total revenues, the component of non-age related revenue was obtained by deducting pensions contributions from the estimated cyclically-adjusted total revenue for 2005. It was assumed that the ratio of this component to GDP will hold throughout the projection period. This allowed the calculation of the non-age related revenue for the next years which when added with the pensions contributions gives the respective total revenues. For total expenditures, a similar methodology was applied. Old-age pension spending, healthcare costs and interest payments were subtracted from the total expenditure for 2005 obtaining a ratio of non-age related expenditure to GDP. This ratio was then assumed to hold for the subsequent years and applied to GDP to obtain total expenditure for the projected period.

Based on these assumptions, if the current pensions and healthcare systems persist, the demographic evolution that is expected to take place in the next decades will double the gap between Government revenue and expenditure from 6 per cent of GDP in 2002 to around 12 per cent by 2050. As a result, estimates show that the debt-to-GDP ratio would rise from approximately 67 per cent in 2002 to around 119 per cent by 2050.

Clearly, these results underline the budgetary challenges that lie ahead in particular with respect to the pressures that an ageing population will generate on those areas of public finance, such as health and pensions, which are related to life-cycle developments. These developments will have implications for the sustainability of the present old-age pay-as-you-go pension system, the health system and for the economy in general. These implications will be even higher if the assumptions, such as those relating to labour force participation, upon which the projections are based are not realised. All this reinforces the need for reforms in order to ease the economic burden of ageing.

Notes:

[1] Data in this Section is based on the World Bank's PROST model and thus may not be strictly comparable with that found in other Sections of this document.

6. Horizontal Issues affecting Public Finances

6. Horizontal Issues affecting Public Finances

6.1 Structural Reforms

6.1.1 Privatisation

Following the privatisation of a number of Government enterprises since the late 1980s, the size of the public sector in the Maltese economy has been significantly reduced. In order to adopt a more structured and planned approach, Government's privatisation programme was outlined through a White Paper published in 2000. Meanwhile, in June 2000 a Privatisation Unit was set up in order to oversee the whole privatisation process.

As Government's privatisation programme proceeded along the years, all direct productive activities except for the shipyards are now within the private sector. Moreover, a number of enterprises in the services sector namely in the postal services, telecommunications and banking sectors as well as the national airport company have also been privatised. At the same time non-core operations are being divested, as certain activities are now being carried out in the private sector. During 2003, the overall weak international scenario reduced the pace with which divestiture took place as the international economic and business climate were not very conducive to investment. Hence there was a substantial risk that a hastening of the privatisation process could result in a less than optimal financial offer for valuable public assets, with a negative impact on the fiscal sphere and to the detriment of Maltese interests. In the beginning of 2004, the Privatisation Unit completed the privatisation of the National Lottery Licence. Moreover, the Unit is in the final phase of selling Government's shareholding in Malta Freeport Terminals Limited, while it expects to embark on the process leading to Government's divestment of its remaining holdings in Bank of Valletta plc and Maltacom plc.

The privatisation of the National Lottery Licence was concluded in February 2004 with the award of a seven year licence to a consortium made up of an international operator and two Maltese companies. Under the terms of the National Lottery Licence, the consortium will be granted exclusive rights to run games previously run by the Department of Public Lotto as well as new games. The terms of the licence included the immediate payment of an agreed one-time upfront fee of Lm5 million and further payment of Lm3 million when the company commences operations. Over the next seven years, the operator will pay the Lotteries and Gaming Authority as well as Government an annual royalty fee based on sales and a yearly licence fee. The Lotteries and Other Games Act (Cap. 438) was enacted in September 2002 to regulate lotteries and other games. With the enactment of this Act, the Lotteries and Gaming Authority was established to regulate and monitor the performance of gaming operations in Malta.

The privatisation process of Malta Freeport Terminals Limited resumed in early 2004. This followed an agreement reached during 2003 with a strategic partner regarding the management of the Terminal for 30 years. During the negotiations on the privatisation of this company, Government is planning to give due consideration to employment issues and consult representatives of the workers engaged with this company.

Other entities for which the privatisation process is expected to be initiated during the coming months include Bank of Valletta plc and Maltacom plc. In the former, the divestiture consists of the sale of the 40 per cent shareholding retained by Government and Banco di Sicilia to a strategic partner. In the case of the privatisation of Maltacom plc, Government intends to sell its majority shareholding (60 per cent) to a strategic partner.

Privatisation proceeds during 2004 are expected to amount to around Lm35 million. Government is committed to continuing the programme in the subsequent years, aiming at privatisation proceeds amounting to Lm50 million during both 2005 and 2006.

6.1.2 Restructuring of Malta Shipyards

The domestic ship repair and shipbuilding industry, which operates in a highly competitive international climate, experienced difficulties for the past years in achieving long-term viability. The industry's efforts to attain the latter objective have also been hindered by prevailing low productivity and the attendant substantial financial burden which it has inevitably incurred. In fact, the shipyards registered losses and relied significantly on Government financial assistance. In order to address this situation, in September 2001, Government set up a Task Force entrusted with drawing up and implementing a restructuring plan for the shipyards. This restructuring plan, which is spread over 7 years, involves, amongst other things, the gradual scaling down of capacity at the yards in terms of both human and physical resources, as well as training schemes and support to surplus employees seeking alternative occupation.

The restructuring plan started to be implemented in 2002, when early and voluntary retirement schemes resulted in a reduction in the workforce at the yards of around 700 persons. Another important development was the agreement reached between the management and the union representing the employees on the restructuring of the yards. This agreement, which was signed in November 2003, embodies a new collective agreement for the shipyards which includes various reforms in work practices needed to improve the productivity of the yards.

In order to implement the restructuring of the yards, legislation - Dockyard and Shipbuilding Yard (Restructuring) Act (Cap.466) - came into force on the 7th November 2003 and provided for the setting up of a new wholly owned Government company – Malta Shipyards Ltd. This company absorbed around 1,700 workers while the remaining 900 workers were offered four types of early retirement or voluntary resignation schemes, according to age groups. Meanwhile, another new, wholly owned Government company, Industrial Projects and Services Ltd, was entrusted with deploying those employees who decline the schemes offered to work assignments where they can be productive. Arrangements are currently being finalised whereby these workers (currently deployed with the public sector) would be retrained and employed by the private sector.

This legislation also provides for a financial restructuring designed to free the new shipyards' operation from the burden of existing debts and recurrent interest payments. In fact, this financial restructuring implied that all liabilities of Malta Drydocks and Malta Shipbuilding are assumed by Government. Likewise, all assets of both enterprises are transferred to Government. This financial transaction impinged on the level of General Government deficit for 2003 by around Lm58 million; this was a one off-effect. It also gave rise to an increase in the level of General Government debt for 2003 of around Lm42 million which is reflected in the debt level for subsequent years.

Although the shipbuilding and ship repair industry is currently a major beneficiary of state aid, one of the major aims of the restructuring programme is to fully eliminate the industry's reliance on public funds. In this context, subsidies to the industry will be phased out by the end of 2008, in line with the transition period agreed upon during the accession negotiations. In this interim period, and in line with these negotiations, the 2003 restructuring agreement provides for a ceiling on the amount of state aid that may be granted to this particular sector.

Now that agreement of reforms has been reached and the shipyards have shed their excess labour, efforts are being focused to redirect the newly-formed company to improve productivity and eventually become commercially viable.

6.1.3 Restructuring of Public Enterprises

The restructuring of public enterprises is recognised as an integral part of Government's strategy to restore sustainability in public finances. Such programme of reforms is designed to ensure that public sector entities operate in a more efficient and effective manner, in turn contributing to increasing the country's competitiveness.

The restructuring of public enterprises aims to change management ethics and work practices such that the operations of such enterprises become more viable and efficient. While designing the restructuring programme of public enterprises, Government is seeking to give due consideration to employment issues while also ensuring good management for the enterprises. The restructuring process also aims to ensure that the prices of the products and services provided are attained through a balancing act between cost-recovery and social obligations, particularly where the service provided is a necessity.

Government has recently announced the continuation of the restructuring programme of the national airline – Airmalta plc. The process of restructuring includes the re-investment of any profits of the enterprise rather than transferred to Government as its major shareholder and the reduction of losses from its core business. The latter is planned to be achieved through the containment of administrative costs, better and more efficient use of IT and communications and the reduction of operational costs.

Another structural reform is being planned for the Gozo Channel Co. Ltd, which provides the ferry transport service from Malta to the sister island of Gozo. The restructuring programme of this enterprise aims to ensure that the service provided is consistent, reliable and efficient and that the price reflects the value of the service provided. As part of this restructuring, Government has entered into a public service obligation contract (PSO) in order to ensure the availability of the service which is of great importance particularly to Gozitans. Meanwhile, innovative commercial incentives are to be introduced to increase the demand for the service provided by this enterprise.

Other entities which are being restructured include Malta Traffic Services Co. Ltd, Maltapost plc, Tug Malta Co. Ltd and Sea Malta Co. Ltd. The main objective of the restructuring of these enterprises is to ensure the long term viability of the service provided as well as to provide a more efficient service. This objective will be achieved through down-sizing and the adoption of new management and work practices.

An organisational restructuring is also taking place within other entities including Water Services Corporation, Enemalta Corporation and Public Broadcasting Services. Reform of these entities aims to achieve the right personnel complement, reduce any Government subvention where present and ensure an efficient service delivery. These objectives of the restructuring process will be achieved through rightsizing of the workforce, reduction of administration costs as well as the use of public private partnerships.

6.2 Institutional Developments

6.2.1 Administrative Reforms

As Government acknowledges that good governance is an important factor for long-term economic growth, the reform of public administration and the improvement of the public services are considered as key priorities. In this context, one of Government's main objectives remains that of implementing an ongoing programme of administrative reforms, thus ensuring that the efficiency, effectiveness and service quality are improved. In this regard, Government aims to boost the efficiency of public service provision and administration by improving the services through Quality Service Charters (QSC), furthering the digitalisation of public administration, (e-Government), make use of Public Private Partnerships (PPP) and drafting a Public Service Act following the launching of a White Paper on this matter.

Quality Service Charter

The Quality Service Charter (QSC) programme, which was launched in 1999, aims to improve service delivery across the public service, emphasising on promoting responsiveness, quality and effectiveness. In order to facilitate this initiative, the Charter Support Unit was set up to assist in the monitoring and auditing of Service Charter Standards. To date, a total of around 46 charters were published covering various services offered by Government departments or other units, each of which embodies significant improvements in service delivery, obtained through the re-engineering of internal processes as well as, in many cases, investments in information technology.

e-Government

The attainment of a first class information society is considered as a high-priority national objective. In this regard, in the last years, efforts have been stepped up, particularly through the implementation of the e-Government programme with the aim of improving and streamlining public services and increasing the participation of citizens in Government decision-making. A number of public and private entities are taking part in this initiative. In 1999, the Central Information Management Unit (CIMU) was set up to improve Government's capacity in the development of an efficient information society in Malta. Moreover, Malta's electronic policy initiative was aligned with the eEurope initiative by adopting the eEurope+ Action Plan as Government's strategic roadmap.

Since the launch of this initiative, a large number of electronic services were introduced, facilitating the access to public services. Moreover, in 2002, an electronic payment gateway was put in place allowing for the payment of Government services on-line in a secure environment and confidential manner. Moreover, Government entered into a joint venture with the private sector to provide a registration authentication mechanism for e-Government services. This allows the availability of e-Government services, which due to their sensitive nature necessitate the deployment of an identification mechanism guaranteeing limited accessibility and high security. Other essential services include a Central Data Repository, which acts as a central reference point for Government services, thus using only one location of information. Progress has also been registered on the establishment of a local electronic policy enabling the delivery of e-Government services through the front offices of all the local councils.

As an integral part of the e-Government programme, e-Government services are offered via a variety of service delivery channels apart from the Internet such as mobile telephony. Such m-Government services include notification of examination results and notification of court deferrals while other services are currently being developed. The implementation of the Government Portal, which serves as the principal point of entry to all Government information and services, is another significantly important development. Moreover, an e-Government Customer Care system launched in 2002 enables the public to submit complaints and requests to Government departments, thus improving the service offered to the public.

Public Private Partnership

Government views public private partnership (PPP) as a means to achieve more effective and efficient use of publicly owned assets. The use of PPPs provides the opportunity to increase efficiency in the public sector by making optimal use of personnel employed in the public sector and providing better value compared to public sector investment. A PPP was introduced in the administration of homes for the elderly, through the establishment of a joint venture with a private firm operating in the care for the elderly service sector. Other areas of activity that could benefit from the principle of PPPs are being considered such that a higher quality of public service is provided without additional pressures on public finances.

White Paper on a Public Service Act

Major progress has been registered since the beginning of the implementation of a public service reform programme in 1990. However, in light of new challenges of governance, the public service needs to gain additional management flexibility and to place further emphasis on delivering performance improvements.

To this end, in October 2003, a White Paper on a Public Service Act (A Public Service for the 21st Century) was published. The proposed Act will consolidate the achievements to date and pave the way for additional and far-reaching changes within the Public Service. The objective of the Public Service Act is to promote improvements in efficiency of public administration. The proposed Act has three overall objectives:

- The improvement of the efficiency of Government operations through more flexible results-oriented management,
- The establishment of safeguards over the use of delegated powers, and
- The strengthening of the leadership of the Public Service so as to ensure that the above provisions are put into effect and to ensure that it is capable of taking co-ordinated action.

The proposed Act, amongst other things, will give heads of departments greater management powers and provides for the creation of a new form of public organisation – the Government agency - which will replace Government-controlled foundations as well as a number of units in the Public Service. The proposed Act also provides for better monitoring of performance. Another aim is to ensure that management powers would be exercised only in the public interest and to this end, a set of ethical values and a full Code of Ethics are presented. Moreover, a Merit Protection Commission will be established to monitor and audit staffing decisions throughout the public sector. In addition, the proposed Act incorporates a number of provisions designed to strengthen professional leadership in public administration and provides for the establishment of a Minister for the Public Service, the establishment of the office of Principal Permanent Secretary and a Senior Executive Service.

Other Initiatives

Other initiatives, which will facilitate the improvement of the efficiency of the Public Service and the quality of services it delivers to the public, include the implementation of a results-oriented employee appraisal system referred to as the Performance Management Programme (PMP). Moreover, the efficiency review initiative was launched aimed to improve the performance of Government departments through benchmarking with comparable organisations in the private sector.

Annex 1: Methodology used in Estimating the Cyclically-Adjusted Budget Balance

The method for compiling the cyclically-adjusted budget balance (CAB) in this document is broadly based on the method employed by European Commission. The notion of CAB is based on the idea that fluctuations in the budget balances are made up of a structural and a cyclical component, with the cyclical fluctuations related to the deviation of output from trend (potential) output. Thus, in order to identify the cyclical component of the budget balance, it is first necessary to estimate the output gap, defined as the deviation of output from trend. Estimates of potential output have been based on the HP method as reported in Section 2 of this document. Once the gap has been estimated it is possible to calculate the effects of cyclical fluctuations of economic activity on revenue and expenditure components which are sensitive to economic fluctuations. The sensitivity of budget components to deviations in output from trend is calculated by applying revenue and expenditure elasticities. The cyclical component of the actual Government budget is then deducted to obtain the CAB.

The Cyclical Component of Budget Revenue

The elasticity of Government revenue to changes in GDP is the weighted average of specific elasticities of the revenue components, which are deemed to be sensitive to economic fluctuations. The revenue components are personal income taxes, corporate income taxes, social security contributions and indirect taxes. The weights are an average calculated over the period 1994-2003 of the share of these categories to total revenue. The figure for social security contributions excludes the contribution made by Government in its role as an employer. This is because public service employment is not normally affected by fluctuations in the cycle. Additionally, social security contributions exclude the State grant equal to half the total amount contributed by all employees and employers since this item has a counterpart entry in the expenditure side and hence the net effect on the budget balance is null.

The respective elasticities of each revenue category are in turn estimated through Ordinary Least Squares (OLS) estimation by regressing the revenue of the individual taxes on output. The problem with this approach is that the estimated elasticities are period averages rather than the current elasticities and therefore embody policy changes in addition to “automatic effects” (Giorno et al., 1995). Moreover, no correction for lags in revenue collection for any given year is carried out. The method was chosen for its simplicity and clarity and as data shortages did not allow a more accurate estimation of elasticities, in line with the OECD methodology as applied by the Commission.

The estimated revenue elasticity for corporate taxes and indirect taxes is exactly one. The revenue elasticity of personal income taxes exceeds unity indicating the progressivity of such taxes. For both personal income tax and social security contributions the elasticity stands at 1.1 per cent. The weighted average revenue elasticity is estimated at 1.03.

The product of the weighted average revenue elasticity and the average rate of receipts[1] gives the marginal rate of change of Government revenue in relation to GDP. This is estimated at 0.45 in the case of Malta. It effectively measures the impact on of a 1 percentage change in deviations of output from trend on Government revenue. When the revenue elasticity is applied to the output gap, the cyclical component of budget revenue is obtained. In 2003, this is estimated at –0.81. The negative sign indicates that the Government is collecting less revenue than it would since the economy was performing below potential.

Algebraically,

$$r = \left(\frac{R}{Y}\right)_t . \varepsilon_R . GAP_t$$

$$GAP = \frac{Y_t - Y_t^*}{Y_t^*}$$

$$\varepsilon_R = \left(\frac{R_p}{\sum R_n}\right)\varepsilon_p + \left(\frac{R_c}{\sum R_n}\right)\varepsilon_c + \left(\frac{R_i}{\sum R_n}\right)\varepsilon_i + \left(\frac{R_s}{\sum R_n}\right)\varepsilon_s$$

p,c,i,s = personal income tax, corporate income tax, indirect tax and social security contributions

r = cyclical component of budget revenue (in % points of GDP)

GAP = output gap

Y_t = actual GDP at constant market prices

Y_t^* = trend GDP at constant market prices

ε = revenue elasticity

R_n = revenue components

R = recurrent revenue

The Cyclical Component of Budget Expenditure

The adjustment of Government expenditure to cyclical fluctuations of GDP is carried out in a similar manner. However, the only category of expenditure deemed sensitive to fluctuations in output is unemployment benefits. In this case however, the marginal rate of change of Government expenditure with respect to GDP is the product of the inverse of the Okun coefficient and the marginal cost in unemployment benefits with respect to the unemployment rate. These two variables are obtained by estimating the following equations, through OLS.

$$GAP_t = a + b(U_t^* - U_t) + e_t$$

$$h = \frac{1}{b}$$

U_t = unemployment rate

U_t* = natural rate of unemployment (estimated via HP method)

b = Okun Coefficient

$$(UB_t - UB_{t-1}) = a + c(U_t - U_{t-1}) + e_t$$

UB = expenditure on unemployment benefits (in % points of GDP)

c = marginal cost of unemployment benefits w.r.t. the unemployment rate

The Okun coefficient measures the sensitivity of changes in unemployment from trend to deviations of output from trend. The coefficient is derived from a regression of the output gap on the deviation of the actual unemployment rate from the natural rate of unemployment using the HP method. In the case of Malta, this coefficient is estimated at 1.17. Meanwhile, the marginal cost in unemployment benefits with respect to the unemployment rate is estimated at 0.17.

The cyclical component of budget expenditure is the product of the marginal rate of change of budget expenditure with respect to GDP and the output gap and is represented by,

$$d_t = (c.h).GAP_t$$

d_t	=	cyclical component of budget expenditure (in % points of GDP)
c	=	marginal cost of unemployment benefits w.r.t. the unemployment rate
h	=	elasticity of the unemployment rate w.r.t. GDP (inverse of Okun coefficient)
c.h	=	marginal rate of change of budget expenditure w.r.t. GDP

A minus sign is added to the result in order to indicate the inverse relationship between the output gap and the expenditure on unemployment benefits. It shows the proportion of the budget expenditure that is related to cyclical fluctuations. In 2003 the cyclical component of budget expenditure is estimated at 0.26. The positive sign indicates that the economy is performing below its potential, inducing more payments by Government on unemployment benefits.

The Cyclical Component of Budget Balance

By deducting the cyclical component of budget revenue and expenditure from the actual budget balance, the CAB is obtained. It measures that part of the budget balance which is not affected by fluctuations in output. This allows a decomposition of the budget deficit into a structural and cyclical component. For 2003, this component amounted to –1.1 per cent of GDP.

The Marginal Rate of Change of the Budget Balance with respect to GDP

This is defined as the sum of the marginal rate of change in revenue (0.45) and the marginal rate of change in expenditure (0.14) and is equal to 0.59 implying that a deterioration in the output gap of 1 percentage point increases the Government deficit by 0.59 percentage points.

Notes:

[1] Defined as the ratio of recurrent revenue to nominal GDP.

Annex 2: Note on the Calculation of Healthcare and Long-term Costs

In establishing projections for healthcare and long-term costs, the Ministry of Finance broadly followed the approach agreed by the EU Economic Policy Committee (EPC). The Ministry was provided with data collected by the Ministry of Health, the Elderly and Community Care on the age structure of healthcare and long-term care beneficiaries. As regards coverage, healthcare spending includes publicly funded health and public capital expenditure in the health sector, whilst long-term care includes public spending on care for dependent older persons, home care, institutional care other than hospitalisation, and home and services for the disabled.

However, a lack of available data prevented a complete repetition of the approach recommended by the EPC. First, it was not possible to collect data on gender-specific age-related expenditure profiles for healthcare and long-term costs. Moreover, age-apportioned healthcare expenditure reflects the current demographic distribution in Malta. Estimates were obtained by evaluating a number of health-related indicators: bed-days, surgical operations, accident and emergency attendance and outpatient attendance. Each of these categories was assigned a relative weighting according to the current expenditure. The expenditure for each age cohort was thus apportioned for the abovementioned indicators. It was not possible to include data on primary care and medicines since the relevant information was not available. Hence, the demographic distribution for these two items was assumed to be as for the other health expenditure categories. As regards long-term care, the age distribution of institutional homes was used to age-apportion the expenditure. In this part of the exercise, it was assumed that the daily cost of a resident remains unchanged irrespective of age. Moreover, it is important to point that the impact of technological advances on health expenditure is not taken into account. Despite these shortcomings and considering the lack of data, the results obtained still represent a fair approximation of the relevant age-related cost structure.

The available data was that relating to 2002. The share of expenditure for each age cohort was used to apportion the total health expenditure for the base year. Chart 1 depicts the results obtained for the age profiles for public expenditure on health care. As evident from the chart, health care costs per head increase with age and are particularly high for the oldest age group. The structure of expenditure for this item across

Chart 1

Age Profiles for Public Expenditure per head on Health Care

Average per capita expenditure as a share of GDP per capita

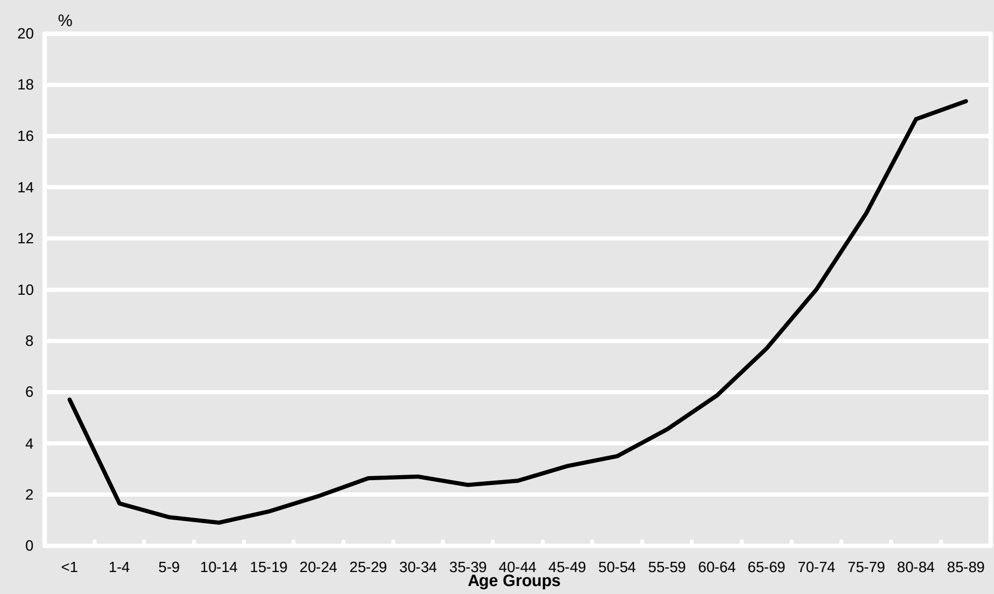
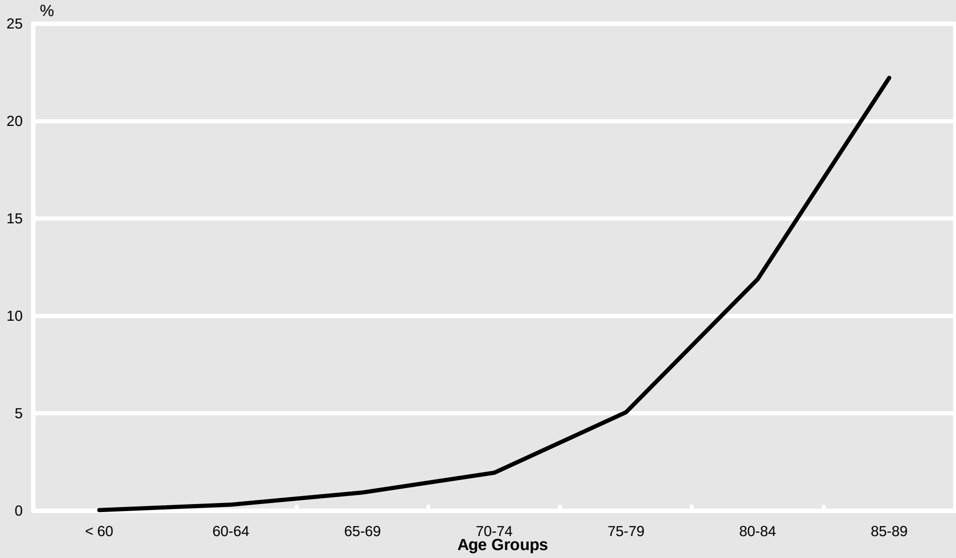


Chart 2

Age Profiles for Public Expenditure per head on Long-term Care

Average per capita expenditure as a share of GDP per capita



the different age cohorts are broadly similar to those in EU-15. In fact the average per capita expenditure peaks at 17.4 per cent which is within the range obtained in EU-15.

The same methodology was applied for long-term care. In this case, the data provided by the Ministry of Health, the Elderly and Community Care was age-apportioned for those above retirement age. However, one would be justified to think that, in Malta too, long-term care outlays for young and prime-age persons are low as is the case in EU-15. Chart 2 shows the age-profiles obtained for long-term care expenditure in 2002. As one would expect, expenditure per capita on long-term care increases with age peaking at around 22.2 per cent for the 85-89 age bracket. The relatively low expenditure levels per head compared to the EU-15 may be explained by the widespread provision of informal care by family members and the increasing provision of private and non for profit long-term care.

Next the age-related expenditure profiles obtained in the base-year were used to project the evolution of healthcare and long-term care expenditure until 2050. This was done by applying the demographic projections under the cost assumption of expenditure per capita of both healthcare and long-term care growing in line with GDP per capita. The results for healthcare and long-term care public expenditure along the projected years are reported in Section 5.

Statistical Appendix

Growth and Associated Factors

Table 1

	2003	2004 (1)	2005	2006	2007
Percentages unless otherwise indicated					
GDP growth at constant market prices	-1.7	1.1	1.7	2.1	2.1
GDP level at current market prices (Lm million)	1,712.2	1,789.2	1,850.0	1,925.9	2,014.5
GDP deflator	1.2	1.2	1.3	1.3	1.3
RPI change (annual average)	1.3	3.4	2.1	2.1	2.0
Employment growth	-0.8	0.8	0.7	0.7	0.7
Labour productivity growth (2)	-0.9	0.2	1.0	1.3	1.4
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	0.3	0.2	0.8	1.5	1.8
2. Government consumption expenditure	6.0	1.1	-1.1	-0.3	-0.9
3. Gross fixed capital formation	21.2	6.7	2.1	-2.6	1.7
4. Changes in inventories and net acquisition of valuables as a % of GDP	-4.2	-4.0	-4.1	-4.1	-4.1
5. Exports of goods and services	-2.2	1.3	2.9	3.0	2.7
6. Imports of goods and services	6.4	2.3	1.6	0.8	1.8
Contribution to GDP growth					
7. Final domestic demand	5.5	2.0	0.9	0.2	1.4
8. Change in inventories and net acquisition of valuables	0.3	0.1	-0.2	-0.1	-0.1
9. External balance of goods and services	-7.6	-1.0	1.0	1.9	0.8

Note: National Accounts figures are based on the System of National Accounts 1993 (SNA 1993).

(1) Forecasts from 2004 onwards.

(2) Growth of GDP at market prices per person employed at constant prices.

General Government Budgetary Developments

Table 2

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
Net lending (B9) by sub-sectors						
1. General government	S13	-9.7	-5.2	-3.7	-2.3	-1.4
2. Central government	S1311	-9.7	-5.2	-3.8	-2.4	-1.4
3. State government	S1312	n/a	n/a	n/a	n/a	n/a
4. Local government	S1313	--	--	--	--	--
5. Social security funds	S1314	n/a	n/a	n/a	n/a	n/a
General government (S13)						
6. Total receipts	ESA	42.8	45.3	45.2	43.9	43.0
7. Total expenditures	ESA	52.4	50.5	48.9	46.3	44.4
8. Budget balance	B9	-9.7	-5.2	-3.7	-2.3	-1.4
9. Net interest payments		3.6	3.8	3.8	3.7	3.6
10. Primary balance		-6.0	-1.4	0.1	1.4	2.2
Components of revenues						
11. Taxes	D2+D5	26.3	27.8	28.5	28.3	27.9
12. Social contributions	D61	6.9	6.8	6.8	6.7	6.5
13. Interest income	D41	0.3	0.2	0.2	0.2	0.2
14. Other		9.3	10.4	9.7	8.8	8.3
15. Total receipts	ESA	42.8	45.3	45.2	43.9	43.0
Components of expenditure						
16. Collective consumption	P32	10.8	11.2	…	…	…
17. Social transfers in kind	D63	--	--	--	--	--
18. Social transfers other than in kind	D62	13.0	12.9	12.7	12.4	12.1
19. Interest payments	D41	3.6	3.8	3.8	3.7	3.6
20. Subsidies	D3	3.1	2.5	2.2	2.0	1.8
21. Gross fixed capital formation	P51	4.7	4.8	…	…	…
22. Other		17.2	15.2	…	…	…
23. Total expenditures	ESA	52.4	50.5	48.9	46.3	44.4

General Government Debt Developments

Table 3

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
Gross debt level		72.0	72.1	72.4	70.5	70.4
Change in gross debt		10.3	0.1	0.3	-1.9	-0.1
Contributions to change in gross debt						
Primary balance		6.1	1.4	-0.1	-1.5	-2.3
Interest payments	D41	3.7	4.0	4.0	3.9	3.8
Nominal GDP growth	B1g	-0.8	-3.1	-2.4	-2.9	-3.1
Other factors influencing the debt ratio		1.3	-2.2	-1.2	-1.5	1.5
Of which: Privatisation receipts		-	-1.9	-2.6	-2.5	-
p.m. implicit interest rate on debt		5.0	5.3	5.3	5.3	5.1

Cyclical Developments

Table 4

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
1. GDP growth at constant prices		-1.7	1.1	1.7	2.1	2.1
2. Actual balance	B9	-9.7	-5.2	-3.7	-2.3	-1.4
3. Interest payments	D41	3.6	3.8	3.8	3.7	3.6
4. Potential GDP growth		2.0	1.8	1.8	1.8	1.9
5. Output gap		-1.8	-2.5	-2.6	-2.3	-2.1
6. Cyclical budgetary component		-1.1	-1.6	-1.6	-1.4	-1.3
7. Cyclically-adjusted balance (2-6)		-8.6	-3.6	-2.1	-0.9	-0.2
8. Cyclically-adjusted primary balance (7-3)		-5.0	0.2	1.7	2.8	3.4

Note: National Accounts figures are based on the System of National Accounts 1993 (SNA 1993).

Divergence from PEP for 2003

Table 5

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
GDP growth[1]						
previous update		1.3	2.5	3.2	3.6	n/a
latest update		-1.7	1.1	1.7	2.1	2.1
Difference		-3.0	-1.4	-1.5	-1.5	n/a
Actual budget balance						
previous update	B9	-7.4	-5.8	-4.1	-3.4	n/a
latest update[2]	B9	-9.7	-5.2	-3.7	-2.3	-1.4
Difference		-2.3	0.6	0.4	1.1	n/a
Gross debt levels						
previous update		71.7	72.2	70.6	68.4	n/a
latest update		72.0	72.1	72.4	70.5	70.4
Difference		0.3	-0.1	1.8	2.1	n/a

[1] National Accounts figures are based on the System of National Accounts 1993 (SNA 1993).

[2] The 2003 figure includes the effect of a one-off operation related to the restructuring of the shipyards.
This effect is of about 3.2 percentage points of GDP.

Long-Term Sustainability of Public Finances

Table 6

Percentages of GDP	2002	2005	2010	2020	2030	2050
Total expenditure	49.9	53.0	53.9	55.0	56.1	56.4
Old-age pensions	7.2	7.4	8.0	8.7	8.1	5.8
Healthcare (including care for the elderly)	4.3	4.5	4.8	5.6	6.5	7.1
Interest payments	4.0	4.4	4.2	3.7	4.5	6.6
Total revenues	43.8	49.0	50.0	49.2	47.2	44.2
of which: from pensions contributions[(1)]	10.7	8.7	7.8	7.6	5.6	2.6
National pension fund assets (if any)	-	-	-	-	-	-
Assumptions						
Labour productivity growth	-1.8	0.3	3.7	3.0	3.1	3.8
Real GDP growth	-1.0	1.7	4.3	3.1	2.5	2.5
Participation rate males (aged 16-61)	84.6	79.7	77.9	77.5	77.4	81.6
Participation rate females (aged 16-61)	43.4	42.7	43.7	47.2	51.5	63.4
Total participation rates (ages 16-61)	64.1	61.5	61.3	63.1	65.3	73.3
Unemployment rate	7.7	7.5	7.3	7.0	6.6	6.0

[(1)]Includes Government contribution

Note: Data in this table is based on the World Bank's PROST model and thus may not be strictly comparable with that found in other tables in this document.

Basic Assumptions

Table 7

	2003	2004	2005	2006	2007
Interest Rates (in % p.a., annual averages)					
Short-term interest rate	3.0	3.0	3.5	3.5	3.5
Long-term interest rate	4.7	4.7	5.2	5.2	5.2
United States: short-term (three-month money market)	1.2	1.2	1.7	1.7	1.7
United States: long-term (10-year government bonds)	4.0	4.2	4.6	4.6	4.6
Exchange Rates					
USD/EUR exchange rate (level)	1.1	1.1	1.1	1.1	1.1
Nominal effective exchange rate (annual averages)	1.1	1.1	1.1	1.1	1.1
Exchange rate vis-a-vis the EUR	2.3	2.3	2.3	2.3	2.3
GDP (in real terms %)					
World GDP growth, excluding EU	4.4	5.1	4.7	4.7	4.7
United States,GDP growth	3.1	4.2	3.2	3.2	3.2
Japan, GDP growth	2.7	3.4	2.3	2.3	2.3
EU-15 GDP growth	0.8	2.0	2.4	2.4	2.4
World Trade (% change)					
Growth of relevant foreign markets	0.6	1.9	2.3	2.3	2.3
World import volumes, excluding EU	7.3	9.7	8.5	8.5	8.5
International Prices					
World prices based on the producer price Indices of the Euro Area (% change)	2.0	1.6	1.7	1.7	1.7
Oil prices, (Brent, USD/barrel)	28.5	31.1	28.9	28.9	28.9
Non-oil commodity prices (in USD)	6.6	15.6	-2.6	-2.6	-2.6