Malta:

Update of Convergence Programme

2005 - 2008

Ministry of Finance
December 2005

The following symbols have been used throughout this document:

. . .	to indicate that data are not available;
—	to indicate that the figure is negligible;
0	to indicate that the figure is zero;
-	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 data and information available up to 31st October 2005.

Contents

Charts

Introduction

This document presents an Update of Malta's Convergence Programme. This Update was prepared in accordance with the 'Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of the Stability and Convergence Programmes', endorsed by the ECOFIN Council on the 11 October 2005. This Code of Conduct takes into consideration the report endorsed by the European Council on 22 March 2005 entitled 'Improving the implementation of the Stability and Growth Pact' and the Council Regulations amending Regulations No.1466/97 and No.1467/97.

This update was compiled by the Ministry of Finance, with important contributions being received from various Ministries, including the Central Bank of Malta and the National Statistics Office. This document is structured into the following seven sections. Chapter 1 highlights Government's objectives for macroeconomic policy and monetary and exchange rate policy; Chapter 2 presents the medium-term projections of the main macroeconomic variables; Chapter 3 deals with Malta's medium-term objectives, fiscal policy and the medium-term fiscal projections and debt developments; Chapter 4 contains a number of sensitivity analysis of the budgetary projections together with an analysis of the divergences between the current forecasts and those presented in the November 2004 Update of Convergence Programme; Chapter 5 reviews the quality of public finances, with an overview of the main features of the Budget for 2006 and the way in which the fiscal targets will be achieved; Chapter 6 analyses the sustainability of public finances, including long-term budgetary prospects and the implications of ageing populations; and finally Chapter 7 deals with the institutional features of public finances.

1. Overall Policy Framework and Objectives

1. Overall Policy Framework and Objectives

1.1 Main Macroeconomic Policy Objectives

Government's vision for Malta is that of a dynamic, high-value added economy founded on competence, skills and excellence and capable of sustaining a high standard of living for its people. Within this context, the main macroeconomic policy objectives of the Maltese Government remain the following:

- The achievement of sustainable economic growth and a high and stable level of employment;
- Restoring fiscal balances to sustainable levels and ensuring a reduction in the debt-to-GDP ratio;
- Ensuring stability in the external sector.

Achieving a sustainable fiscal position remains a priority to ensure a stable macroeconomic framework, capable of fostering economic growth, generating employment opportunities and sustaining social responsibilities. The Budget Speech for 2006, as well as a number of measures taken during 2005, ensures that Government remains on track to reduce the fiscal deficit to below 3 per cent of GDP and to achieve a reduction in the debt-to-GDP ratio in 2006. Furthermore, Government is committed to ensure the long-term sustainability of public finances. In particular, in the area of pensions, following the launch of the White Paper on Pensions Reform in November 2004, an extensive national consultation and discussion process was carried out and the Pensions Working Group has now presented its final report to Government. It is the intention of Government to communicate its decisions in the near future and thereby embark upon the implementation phase of the reform of the pension system.

A stable macroeconomic environment also entails stability in the external sector, as this is essential to maintain price stability. This continues to be a priority, especially in view of Malta's participation in ERM II, as from May 2005.

Being a small and open economy and operating within an increasingly globalised and competitive international environment implies that improving competitiveness is vital for the Maltese economy to continue to expand and grow. Improved competitiveness cannot be achieved only by focusing on the cost component of competitiveness, although this remains important. Competitiveness also is enhanced by increasing productivity and by shifting to higher value-added economic activities. Indeed, the most important means through which an adequate standard of living for the Maltese population can be secured in the longer term is by maximising the country's productivity. Within this context, structural reforms to instil greater efficiency and to enhance the supply side of the economy are important. Government remains committed to increase efficiency in the public sector whilst focusing on its role as a regulator rather than participating as an operator in economic activities. Furthermore, other priorities include improving the business environment, supporting small businesses, which are the backbone of the Maltese economy, promoting entrepreneurship and encouraging creativity and innovation.

In order to generate economic growth and employment opportunities, specific attention is being given to the manufacturing industry, tourism as well as other tertiary sectors, in particular financial services. As regards manufacturing, efforts are being focused on attracting new investment in target and niche markets which are high value added and where Malta can remain competitive in the years to come. Tourism remains an important sector in the Maltese economy and Government remains committed to further develop this industry. The effectiveness of Government's support to the tourism industry is being improved, whilst improving the competitiveness of this industry is also essential. The financial services sector has assumed growing importance over recent years and Government wants to strengthen this sector and to realize its potential for additional growth.

In line with the policy to shift the economy to higher value-added sectors and in order to increase productivity levels, significant importance is being attached to improving the educational and skill levels of Malta's human resources. Government views employment as important, not only from the economic perspective, but also as an instrument to achieve social cohesion and avoid poverty. Government strongly believes that Malta should remain a caring society in which everybody is secured an adequate standard of living, and it is only through economic growth that the goal of social inclusiveness can be sustained in the years to come.

In order to ensure a holistic approach to the economic and social well-being of the Maltese population, the improvement of the environment is another priority of the Government. This will not only ensure an improved quality of life through sustainable development, but also support other economic activities, such as the tourism industry.

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.

In a major development in the conduct of monetary and exchange rate policy in Malta, on 2 May 2005 the Maltese lira entered the Exchange Rate Mechanism II (ERM II) at a central parity rate of MTL/EUR 0.429300, unchanged from the closing rate on the previous trading day. In order to retain the benefits of the fixed exchange rate regime enjoyed in the past, the Maltese authorities decided to maintain the MTL/EUR exchange rate at its central parity rate in ERM II, eschewing the use of the permitted fluctuation bands. In this way, the lira was re-pegged from a three-currency basket in which the Euro had a weight of 70 per cent to the Euro alone.

On 8 April 2005, the Central Bank of Malta raised the central intervention rate by 25 basis points to 3.25 per cent. The Bank has since left the central intervention rate unchanged, judging that it provided adequate support to the exchange rate.

The entry of the Maltese lira into ERM II and the commitment of the Maltese authorities to maintain the exchange rate for the lira at the established central parity rate had a favourable impact on the financial market sentiment, and the Bank's net foreign assets improved. At the same time, the increased interest rate differential in favour of the Maltese lira resulting from the removal of the pound sterling and the US dollar - which carried relatively high interest rates - from the currency basket upon ERM II entry provided further support to the exchange rate. Indeed, participation in ERM II has been smooth and the MTL/EUR rate has remained unchanged from the central parity rate throughout this period.

Malta's entry into ERM II has to be seen in the light of the Maltese authorities' intention for Malta to adopt the euro on 1 January 2008. This would be possible in view of the progress made in fiscal consolidation so far and the fiscal projections outlined in the Update of Convergence Programme. Euro adoption would allow the Maltese economy to reap the significant advantages that membership of the Euro Area holds for an extremely small open economy.

2. Economic Outlook

2. Economic Outlook

2.1 The Medium-Term Scenario

The economic recovery during the forecast period is expected to be moderate. Malta's economic performance is expected to be influenced by the sluggish rate of economic growth in Malta's main trading partners, as well as the increase in the international price of oil. Additionally, domestic demand is expected to be somewhat dampened by the unfolding of Government's consolidation programme, slow growth in personal incomes and the globalisation challenges faced by a number of sectors. On the other hand, investment expenditure is expected to boost demand and overall output growth in the short-term. Table 2.1 presents the main macroeconomic indicators for the years 2003-2008. The figures for 2003 and 2004 have been published by the National Statistics Office (NSO), whilst figures for 2005 and after are forecasts. Forecasts for the Maltese economy take into account the latest available data, including the preliminary estimates for national accounts data for the third quarter of 2005. The macroeconomic forecasts are also being provided in Tables 1a, 1b, 1c, and 1d of the Statistical Appendix.

The Maltese economy is estimated to grow by 0.9 per cent in real terms during 2005. This is expected to be driven by domestic demand, primarily from investment activity. The external balance of goods and services will contribute negatively following an expected decline in exports which is not completely offset by the decline in imports. The outlook over the medium term forecast horizon for the local economy is for a modest and gradual recovery, driven primarily by the external sector. GDP is expected to grow by 1.1 per cent in 2006 and 1.2 per cent in 2007. Whilst the external sector will continue to be the main contributor to economic growth in 2008, domestic demand will also contribute positively to GDP growth during the same period. This will be primarily underpinned by the growth in private final consumption expenditure. As a result, the economy

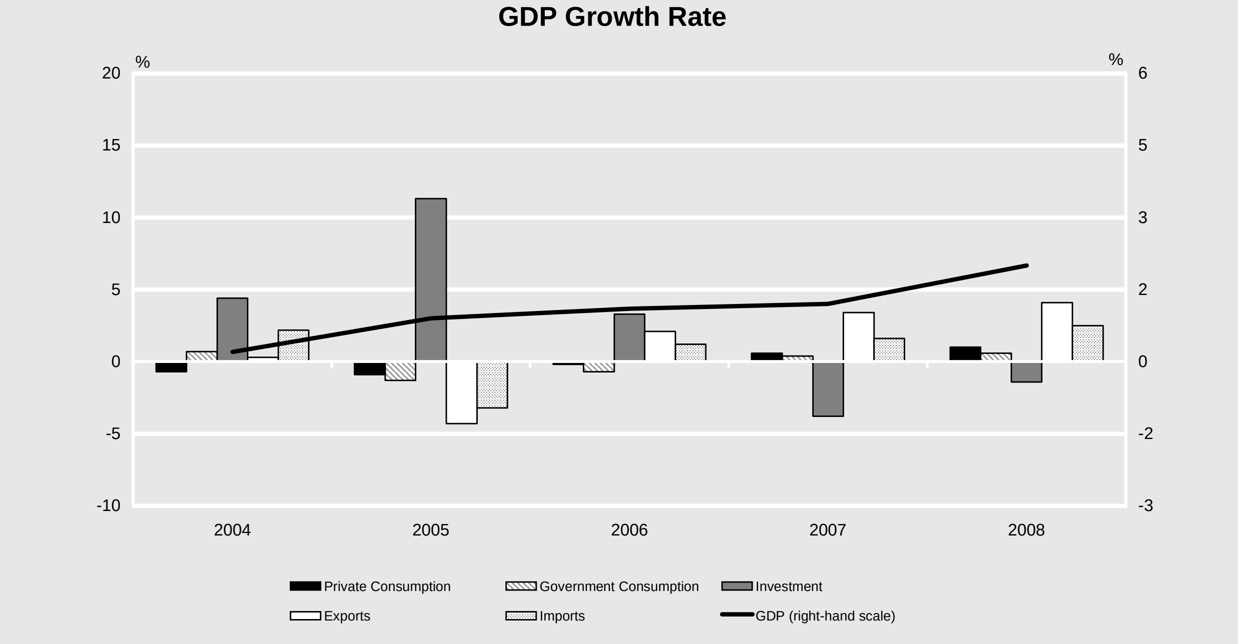
Main Macroeconomic Indicators

Table 2.1

	2003	2004	2005 (1)	2006	2007	2008
GDP at constant (2000) prices (Lm million)	1,648.2	1,651.5	1,666.0	1,684.8	1,704.5	1,737.7
GDP at current market prices (Lm million)	1,792.7	1,828.0	1,898.9	1,973.0	2,050.6	2,133.3
GDP growth at constant (2000) prices (%)	-2.1	0.2	0.9	1.1	1.2	2.0
Expenditure Components of GDP at constant (2000) prices (% change)						
Private final consumption expenditure (2)	1.9	-0.7	-0.9	-0.2	0.6	1.0
General government final consumption expenditure	2.9	0.7	-1.3	-0.7	0.4	0.6
Gross fixed capital formation	31.4	4.4	11.3	3.3	-3.8	-1.4
Exports of goods and services	-2.5	0.3	-4.3	2.1	3.4	4.1
Imports of goods and services	7.1	2.2	-3.2	1.2	1.6	2.5
Inflation rate (%) (3)	1.3	2.8	2.8	3.1	2.5	1.9
Employment growth (%)	-0.5	0.3	0.3	0.9	1.0	1.1
Unemployment rate (%) (4)	5.6	5.6	5.1	4.9	4.7	4.7
Labour productivity (% change)	-1.6	-0.1	0.6	0.2	0.2	0.8
External Goods and Services Balance (% of GDP)	-4.3	-7.6	-8.0	-7.6	-6.0	-4.3

(1) Forecasts from 2005 onwards
(2) Includes NPISH final consumption expenditure
(3) As measured by the Retail Price Index (RPI)
(4) Based on registered unemployed data of the Employment and Training Corporation (ETC)

Chart 2.1



is expected to grow by 2.0 per cent in 2008. The projected growth rates of GDP together with a detailed breakdown of the various expenditure aggregates are illustrated in Chart 2.1.

2.1.1 Assumptions for Projections

The forecasts presented in this section and the different sensitivity scenarios presented in this document were estimated using econometric techniques and analytical methods. The following are the main assumptions used in obtaining the base forecasts for 2005-2008.

- Economic activity among Malta's main trading partners is expected to grow by 1.3 per cent in 2005 and by 1.8 per cent thereafter. World prices, based on producer price indices of the Euro Area, are assumed to rise by 3.5 per cent in 2005, reflecting higher costs of production as a result of the increase in energy prices. Growth in world prices are expected to stabilise to 1.7 per cent by 2008.

- Assumptions for world oil prices are in line with the European Commission's forecast assumptions presented in the 'Economic Forecasts – Autumn 2005'. Oil prices are assumed to continue increasing in 2006, but are then expected to stabilise in 2007 and maintain the same level in 2008.

- Interest rates are assumed to remain constant throughout the forecast period.

- 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 are expected to grow by an average of 2.9 per cent per annum during the forecast period. Meanwhile, it is assumed that Government employment continues to decline in line with past trends reflecting Government's policy of restricting recruitment to non-essential categories.

- Inventory changes are assumed at around 1.3 per cent of GDP during the forecast period.

2.1.2 Private Final Consumption Expenditure

The fiscal consolidation exercise currently being undertaken by Government is expected to continue exerting a negative influence on private final consumption expenditure. This includes the effect of the recently announced measures to counteract the significant rise in the international price of oil. Furthermore, this component of expenditure is also being affected by the relatively slow growth in personal incomes. Growth in private final consumption expenditure is thus expected to remain negative in 2005 and 2006, declining by 0.9 per cent and 0.2 per cent in real terms, respectively. A marginal recovery of 0.6 per cent is expected in 2007, whilst private final consumption expenditure is expected to rise by a further 1.0 per cent in 2008. Thus, although private final consumption expenditure is projected to improve towards the end of the forecast period, growth rates are still expected to remain relatively subdued.

2.1.3 General Government Final Consumption Expenditure

In line with Government's fiscal consolidation programme, Government final consumption expenditure is expected to decrease by 1.3 per cent in 2005 and to decline by a further 0.7 per cent in 2006. Forecasts for 2007 and 2008 indicate that the marginal growth rates in Government final consumption expenditure will remain significantly below real GDP growth rates for the respective years.

2.1.4 Gross Fixed Capital Formation

Investment activity is expected to remain the main driving force of economic growth in the short-term, increasing by 11.3 per cent in 2005 and 3.3 per cent in 2006. This will primarily reflect public investment in the economy. In 2005 and 2006, public investment includes outlays on projects financed by the Fifth Italian Financial Protocol and by EU Structural and Cohesion Funds. Furthermore, public investment outlays are significantly being affected by expenditure related to the new hospital. In particular, public investment expenditure for 2006 includes outlays on the hospital which were previously expected to materialise in 2007 but were brought forward to 2006, reflecting the targeted completion of this project by 2007. Indeed, as a result, public investment activity is expected to contract in 2007 and 2008. Meanwhile, private sector investment activity is expected to contribute positively to total investment throughout the forecast period. Nevertheless, a decline in total investment of 3.8 per cent and 1.4 per cent in 2007 and 2008, respectively, is being projected.

2.1.5 External Balance of Goods and Services

Latest available data published by the NSO indicates that export activity registered a substantial decline during 2005. This is primarily related to the effect that declining international semiconductor prices are exerting on the manufacturing performance of a major firm in the sector which contributes to around half of Malta's exports of goods. As a result, exports are projected to fall by 4.3 per cent in 2005.

Fiscal consolidation efforts, negative private final consumption expenditure growth and a subdued export activity are expected to result in a decline in imports of goods and services in 2005. In particular, lower imports of consumer goods and industrial supplies are being projected for 2005. These will be partly offset by a higher fuel import bill as a result of the rise in international oil prices and the strengthening of the US Dollar against the Euro and consequently against the Maltese Lira. In addition, investment activity is expected to contribute towards an increase in imports of capital goods. As a result of these developments, imports of goods and services are projected to decline by 3.2 per cent in 2005. Since this is lower than the forecasted decline in export growth, a deterioration in the external goods and services balance is expected. These developments imply that the external sector is expected to contribute negatively to GDP growth in 2005.

The expected improvement in the international semiconductor market is expected to yield positive results in 2006. However, the still relatively subdued foreign demand, particularly among Malta's main trading partners within the EU, together with the competitive challenges faced by certain manufacturing sectors, will continue to exert a negative influence and export growth in 2006 is projected to remain relatively low at 2.1 per cent. As a result of the expected recovery in foreign demand and the efforts being undertaken to attract new investment in the manufacturing industry, exports are projected to pick up momentum in the medium term, reaching positive growth rates of 3.4 per cent in 2007 and 4.1 per cent in 2008. Imports of goods and services are expected to increase marginally in 2006 and 2007, reflecting the subdued domestic demand projected for this period. An increase of 2.5 per cent is expected in 2008 in line with the modest pick up in domestic demand as well as the improvement in manufacturing activity.

2.1.6 Productivity and Employment Prospects

In response to the gradual improvements expected in the local economy over the forecast horizon, employment growth is expected to improve progressively over the forthcoming years. Employment is expected to increase by an average of 1 per cent per annum between 2006 and 2008. Over the next three years, the increase in real GDP is expected to exceed the forecasted increase in the number of gainfully employed. As a result, real productivity is expected to increase modestly over the forecast time-frame.

The unemployment rate for 2005 is projected to reach 5.1 per cent, from 5.6 per cent a year earlier, in line with recent unemployment figures for the first nine months of 2005. In the subsequent years, the unemployment rate is expected to fall gradually, primarily due to the expected improvement in the economy.

2.1.7 Inflation[1]

Despite the slow economic growth expected over the short term, the twelve-month moving average inflation rate is expected to remain at the level of 2004, of 2.8 per cent in 2005. Inflation is expected to rise further to 3.1 per cent in 2006. The relatively high inflation scenario projected in 2005 and 2006 is primarily due to the domestic increase in energy prices, which in turn is reflecting the rise in international fuel prices. The rate of inflation is expected to decline thereafter, to reach 1.9 per cent in 2008.

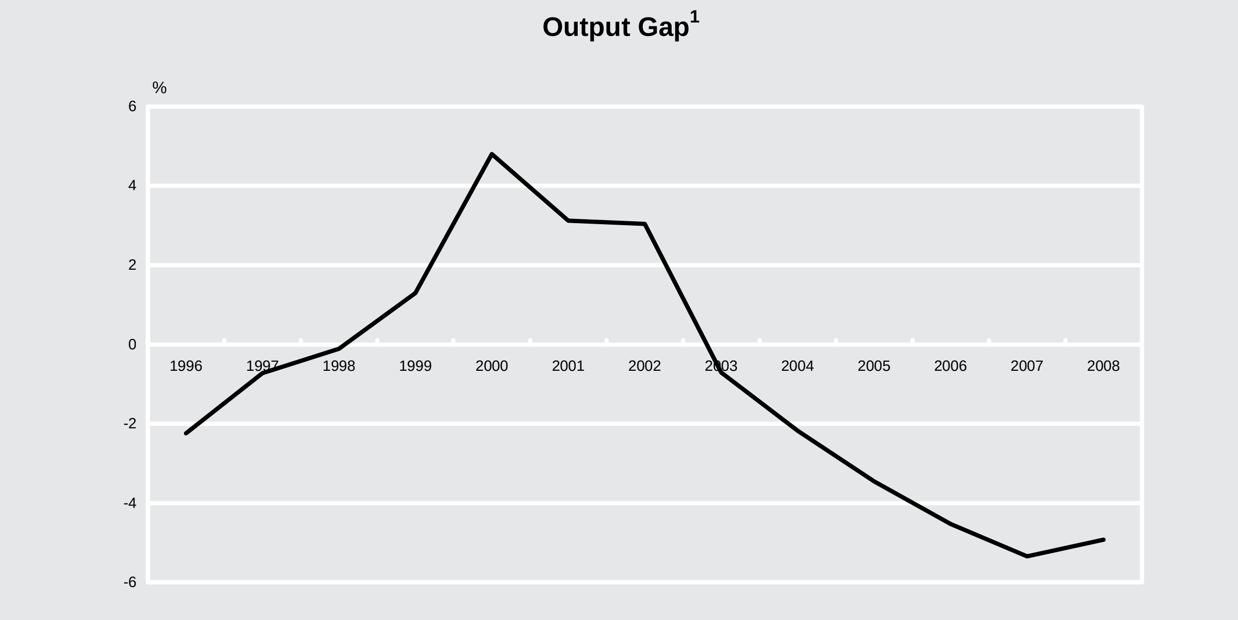
2.2 Potential Output and the Output Gap

GDP growth for 2005 is expected to reach 0.9 per cent, up from 0.2 per cent recorded during 2004. However, in spite of the improved outturn, output growth is expected to remain below potential output growth during 2005. As explained in the Annex, the method used in the estimation of the output gap is based on the European Commission's Production Function method, with the main differences related to the macroeconomic forecasts and the working age population figures. Developments in the output gap are depicted in Chart 2.2.

The rate of economic growth registered between 2001 and 2005 was relatively low as well as volatile owing to the effects of external economic shocks and domestic developments. The latter mainly concerns measures related to the fiscal consolidation process and the competitiveness challenges faced by a number of sectors. In fact, the average yearly growth rate between 2001 and 2004 stood at -0.1 per cent, down from the average yearly growth rate of 4.7 per cent recorded between 1997 and 2000. Although the economic fluctuations in 2000 reflect to an extent the exceptional developments incurred by a major player in the semiconductor manufacturing sector, average growth recorded during the period would still be higher than 2001-2004 when one excludes this particular event. Over the period 2005-2008, the yearly average growth rate is expected to rise to 1.3 per cent.

The average yearly growth rate of potential output stood at 2.9 per cent during the period 1997-2000, and declined to 1.6 per cent between 2001 and 2004. The decline in potential output growth reflects amongst other things, the relatively slower rate of capital accumulation recorded during the period, as well as demographic and labour market developments. Over the forecast period 2005-2008, potential output is expected to rise slightly to 2.0 per cent.

Chart 2.2



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

The output gap, defined as the difference between actual and potential output as a share of potential output, is indicative of cyclical developments of the Maltese economy. As shown in Chart 2.2, the output gap was negative, though diminishing over the period 1996-1997. The output gap was positive during 1998-2002, peaking at 4.8 per cent during 2000. Since 2003, the output gap turned negative again, and is expected to remain so over the forecast period. The output gap is expected to reach a trough at 5.3 per cent during 2007 and to narrow during the following year.

Note:

[1] Inflation forecasts are temporarily being based on the twelve-month moving average of the Retail Price Index. However, work is in progress to produce inflation forecasts based on the Harmonised Index of Consumer Prices (HICP).

3. General Government Balance and Debt

3. General Government Balance and Debt

Government's fiscal policy framework remains geared towards the sustainability of public finances over the medium term as priority is attached to addressing the current imbalance in public finances. The achievement of this objective will result in the attainment of a stable and sound macroeconomic framework which is necessary for price stability, employment creation and sustainable economic growth.

Government's fiscal consolidation programme is proceeding on track, despite lower than expected economic growth. In fact, the fiscal deficit is expected to register an improvement in 2005 declining by 1.2 percentage points to 3.9 per cent of GDP. Moreover, further consolidation is planned over the Programme period.

In the Budget Speech for 2006, Government confirmed its priority towards fiscal consolidation wherein the general Government deficit is projected to fall below 3 per cent of GDP in 2006, and to continue to decline thereafter to 1.2 per cent of GDP by 2008. General Government debt is expected to reach 76.7 per cent of GDP in 2005 and to decline thereafter to 67.3 per cent of GDP by 2008. These fiscal targets are in line with the Ecofin Council's Opinion of 17 February 2005 which stated that Malta was to implement necessary measures ensuring the correction of the excessive deficit in 2006 while ensuring that the debt ratio declines towards the 60 per cent of GDP Treaty reference value at a satisfactory pace.

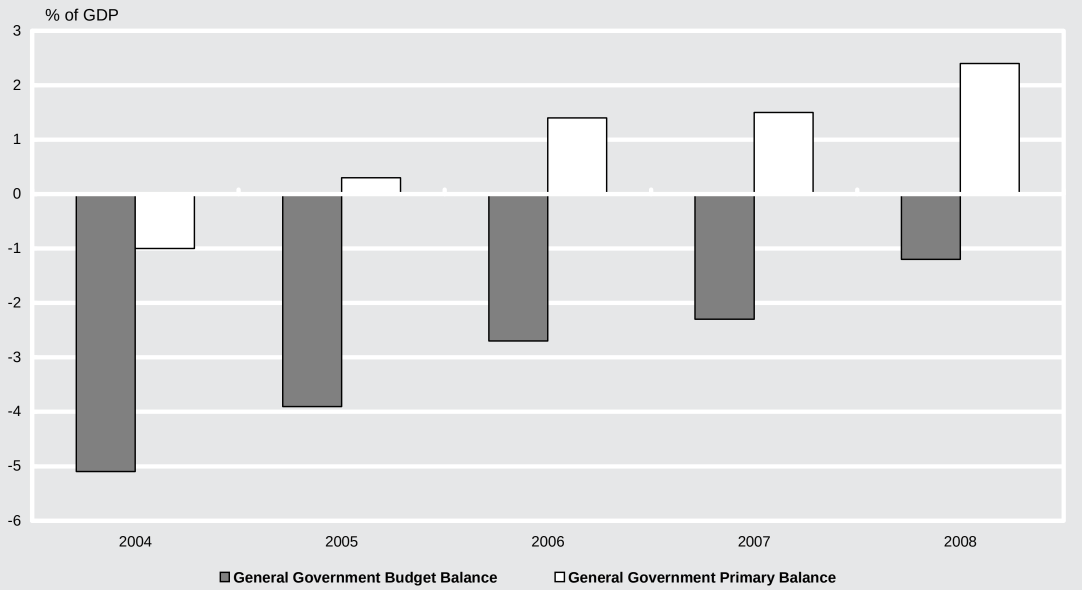
3.1 The Medium-Term Fiscal Framework

The Budget Speech for 2006 was drawn up within a framework which aims to bring public finances to a sustainable level, thus building on the achievements of recent years.

As highlighted in Chart 3.1, the general Government deficit as a per cent of GDP is projected to decline below the 3.0 per cent of GDP reference value in 2006 and to continue to fall thereafter. In fact, the general Government deficit ratio is expected to follow a downward path from 3.9 per cent in 2005 to 2.7 per cent and 2.3 per cent in 2006 and 2007 respectively. By 2008, the general Government deficit ratio is expected to decline further to 1.2 per cent of GDP. It is pertinent to note that the budgetary projections presented in this Convergence Programme are based on the latest available information. In particular, assumptions were made regarding Malta's contribution to the EU budget and entitlement to EU funds on the basis of the

Chart 3.1

General Government Balance



Luxembourg compromise of June 2005 on the Financial Perspectives for 2007-2013. Thus, projections for 2007 and 2008 should be considered in the context of the lack of agreement on the Financial Perspectives.

It is also noteworthy that the fiscal imbalance over the Programme period is significantly influenced by public investment. In fact, the recurrent imbalance (defined as the deficit excluding Government fixed capital formation) as a per cent of GDP stood at 0.6 per cent in 2004. Such recurrent balance is projected to improve to a surplus of around 3 per cent in 2005 and 2006. Subsequently, the recurrent surplus declines to 2.3 per cent and 1.8 per cent of GDP in 2007 and 2008 respectively. These projected developments indicate Government's commitment to undertake the necessary public investments to improve infrastructure, offer an improved provision of educational and health services and increase domestic productivity levels.

3.1.1 Comparison with the November 2004 Update of Convergence Programme

The targeted general Government deficit-to-GDP ratios presented in this Convergence Programme have been revised when compared to the ratios projected in the November 2004 Update of Convergence Programme. The absolute level of general Government deficit for 2005 was curtailed further when compared to that projected in the previous Update. Nevertheless, the general Government deficit as a per cent of GDP was revised upwards by 0.2 percentage points for 2005, following a downward revision in nominal GDP for 2005. During the 2006-2007 period, the deficit-to-GDP ratio was revised upwards when compared to the previous Programme. This is attributable to lower GDP projections while absolute deficit levels were also revised upwards. The latter revisions were undertaken in view of the measures taken to counteract the rising international prices of oil, so as to avoid undue economic and social disruptions during the fiscal consolidation phase. Nevertheless, the Government remains committed to achieve a deficit below 3 per cent of GDP in 2006 and the current fiscal targets still show an adjustment of 2.7 percentage points of GDP between 2005 and 2008.

3.1.2 General Government Revenue Projections

From a ratio of 43.6 per cent in 2004, General Government total revenue as a per cent of GDP is expected to increase in 2005 and 2006 to 45.7 per cent and 45.9 per cent respectively, followed by a declining trend thereafter, as depicted in Chart 3.2. The increase in the ratio of total receipts to GDP projected for 2005 and 2006 mainly reflect a higher tax to GDP ratio which is expected to advance by 1.8 percentage points in 2005 and a further 0.6 percentage point in 2006. Meanwhile, the ratio of the 'Other' component of revenue, which is expected to advance by 1.0 percentage point and 0.8 percentage point in 2005 and 2006 respectively, also

Chart 3.2

General Government Revenue and Expenditure

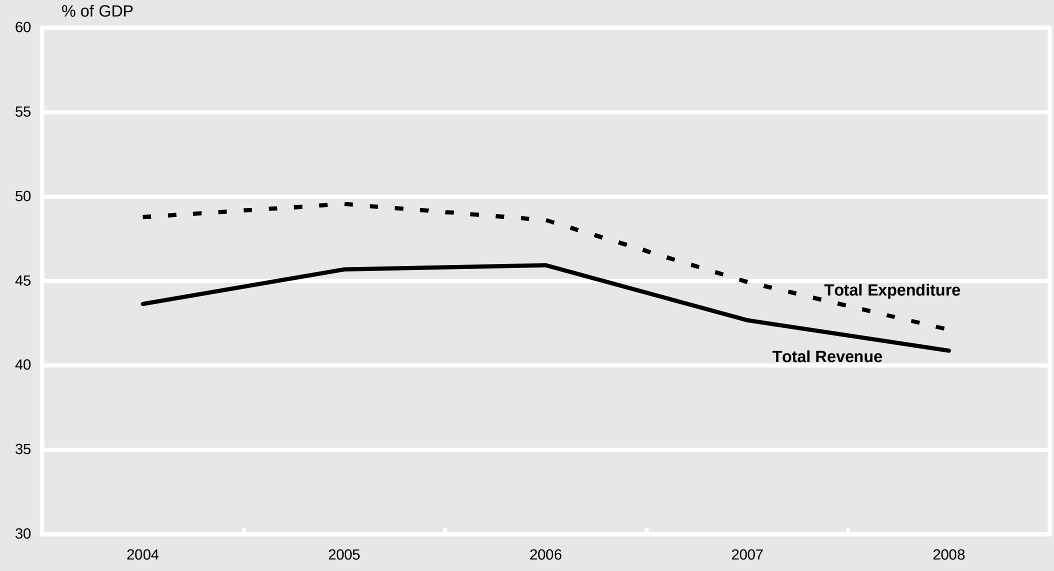
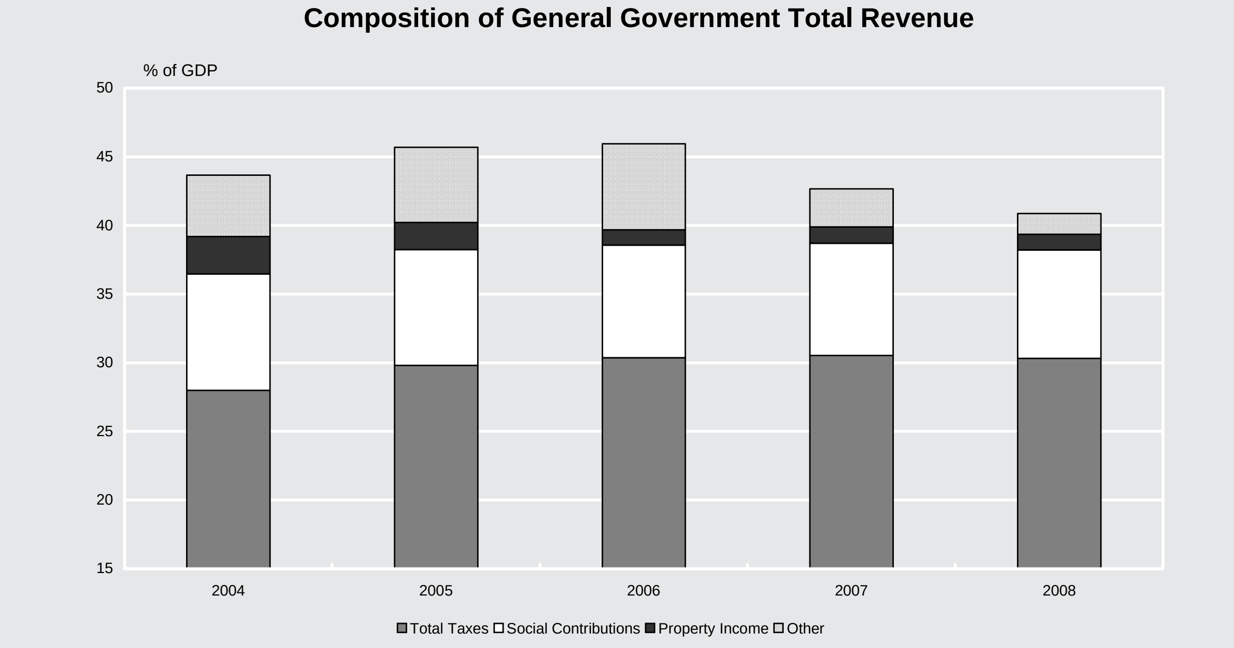


Chart 3.3



contributes to the rise in the ratio of total revenue to GDP. The declining total revenue to GDP ratio in 2007 and 2008 is mainly due to lower revenue from the 'Other' component of receipts on account of lower non-tax revenue.

Taxes, which constitute around 69 per cent of General Government total receipts, are expected to increase from 28.0 per cent of GDP in 2004 to 29.8 per cent in 2005. Higher receipts are expected from income tax and Value Added Tax, mainly due to enforcement efforts. Meanwhile, higher proceeds are also expected to be collected as a result of a number of revenue raising measures announced in the Budget Speech for 2005. Between 2006 and 2008, the ratio of taxes to GDP is expected to be slightly above 30 per cent. Sustained efforts to curb tax evasion are anticipated to contribute to an increase in the absolute level of revenue from taxes. Chart 3.3 portrays the developments in the components of General Government total receipts over the medium-term framework.

Social security contributions, which represent around 19 per cent of General Government total receipts, are estimated to follow a downward trend over the programme period, declining from 8.5 per cent of GDP in 2004 to 7.9 per cent of GDP in 2008. Increasing enforcement efforts in relation to undeclared work are expected to increase proceeds from social security contributions. However, in the context of the existing social security legislation, the growth in social security contributions is to be outpaced by the nominal growth in GDP, resulting in expected declines in the ratio of social security contributions to GDP.

The 'Other' component of revenue, which accounts for approximately 9 per cent of General Government total receipts, is expected to register significant fluctuations over the Programme period. This component accounts for revenue of Extra-Budgetary Units (EBUs) and local councils, and other non-tax revenue. This component is estimated to increase to 5.5 per cent of GDP in 2005 and to rise further to 6.3 per cent of GDP in 2006. Such growth in 2005 will be mainly underpinned by higher forthcoming funds from the EU as well as additional transfers received in terms of the Fifth Italian Financial Protocol. The expected increase in the 'Other' component of revenue in 2006 is mainly attributable to proceeds from the sale of Government property. As from 2007, the 'Other' component of Government receipts as per cent of GDP is expected to decline significantly reflecting lower revenue from one-off items as well as a result of an expected decline in inflows from EU funds. No significant change is anticipated for receipts of EBUs and local councils over the medium-term framework.

3.1.3 General Government Expenditure Projections

General Government expenditure is made up of Government's recurrent and capital expenditure, interest payments and expenditure of EBUs and local councils and other adjustments in line with ESA95 methodology.

Total expenditure as a per cent of GDP in 2005 is expected to increase to 49.6 per cent as the growth rate in general Government spending will exceed the growth rate in nominal GDP. The higher growth in Government spending is attributable to increases in gross fixed capital formation coupled with higher collective consumption as well as higher social transfers. As from 2006, the ratio of total expenditure to GDP is expected to follow a declining trend to 42.1 per cent of GDP in 2008. The expected downward trend in gross fixed capital formation contributes significantly to the declining ratio of total expenditure to GDP. All the other components of expenditure will register decreases in their share to GDP.

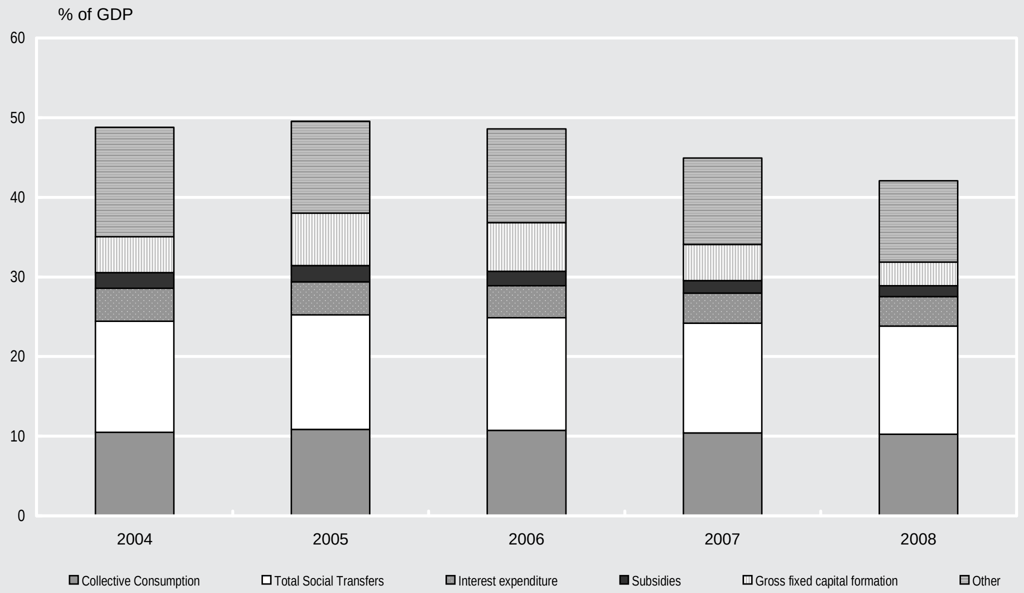
Chart 3.4 presents the expected developments in the main components of general Government expenditure classified according to ESA95 methodology.

The share of collective consumption in total expenditure in 2005 and 2006 is estimated to remain at around 22 per cent and is projected to increase to 24.4 per cent by 2008. Collective consumption, of which compensation of employees makes up a significant part, is expected to reach 10.9 per cent of GDP in 2005 and is projected to decline in the subsequent years to 10.3 per cent of GDP by 2008. This reflects the fact that collective consumption is expected to increase at a rate lower than the growth in GDP during the 2006-2008 period.

Total social transfers as a share of total expenditure is estimated around 29 per cent in 2005 and 2006, rising to 32.3 per cent by the end of 2008. Total social transfers are expected to increase to 14.4 per cent of GDP in 2005 but to follow a downward trend thereafter to reach 13.6 per cent of GDP in 2008. Retirement and widows pensions, pension allowances and social assistance, which constitute the main items of this category of expenditure, are expected to rise in absolute terms.

Chart 3.4

Composition of General Government Total Expenditure



The share of subsidies to total Government expenditure which is estimated at around 4 per cent in 2005, is expected to follow a declining trend to 3.2 per cent in 2008. In line with Government's policy, expenditure on subsidies as a per cent of GDP is projected to decline by 0.6 percentage points to 1.4 per cent of GDP by 2008. This downward trend is mainly attributable to declines in the level of subsidies directed towards the shipyard sector.

Gross fixed capital formation is expected to constitute 13.3 per cent of total expenditure in 2005, with the share falling to 10.1 per cent in 2007 and 7.1 per cent in the following year. The ratio of gross fixed capital formation to GDP is estimated to increase from 4.5 per cent of GDP in 2004 to above 6.0 per cent in 2005 and 2006. Thereafter, the ratio of gross fixed capital formation to GDP is expected to fall to 4.5 per cent and 3.0 per cent of GDP in 2007 and 2008 respectively. These developments primarily reflect outlays on the new hospital which will be completed by 2007.

The share of interest expenditure in total expenditure is expected to fluctuate around 8.5 per cent during the 2005-2008 period. Interest expenditure, which is mainly made up of interest payments on long-term local loans, is expected to make up around 4 per cent of GDP up to 2006, declining marginally to 3.7 per cent by 2008.

The share of compensation of employees in total expenditure, which is projected at 30.5 per cent in 2005, is estimated to increase to 34.4 per cent in 2008. The ratio of this component of expenditure to GDP is estimated at around 15 per cent between 2005 and 2006, with the ratio declining marginally thereafter to 14.5 per cent in 2008.

3.2 Medium-Term Objectives (MTOs)

According to the Code of Conduct on the format and content of Stability and Convergence Programmes, "Member States will present in their Stability and Convergence Programmes budgetary targets for the general government balance in relation to the MTO …", where, "MTOs are defined in cyclically-adjusted terms, net of one-off and other temporary measures". The aim of this section is to set out the medium term budgetary objectives for Malta and the adjustment path which Malta intends to follow in order to achieve these objectives. In the context of the revised Stability and Growth Pact (SGP) it is essential to define the basic principles upon which medium term budgetary objectives can be set and the conditions under which the adjustment path towards these objectives should be achieved.

The SGP lays down the obligation for all Member States to adhere to the medium-term objective for their budgetary positions of 'close to balance or in surplus' (CTBOIS). However, Regulation (EC) No. 1466/97 as amended by Council Regulation (EC) No. 1055/2005 clearly allows Member States to set country specific medium term budgetary objectives which may diverge from the CTBOIS as long as these objectives:

1. provide a safety margin with respect to the 3% of GDP government deficit ratio;
2. ensure rapid progress towards sustainability;
3. allow room for budgetary manoeuvre, considering in particular the needs for public investment.

For Euro Area and ERM II Member States, the divergence from CTBOIS is bound within a range of -1 per cent of GDP and balance or surplus, in cyclically-adjusted terms, net of one-off and temporary measures. Furthermore, the Code of Conduct specifies that, "the country-specific MTOs for Euro Area and ERM II Member States would be in a range between -1 per cent of GDP for low debt / high potential growth countries and balance or surplus for high debt / low potential growth countries".

Minimum benchmarks, corresponding to the cyclically-adjusted budget balance which allows a country to let automatic stabilisers work freely without risking to breach the 3 per cent of GDP reference value under normal cyclical circumstances, have been set for all Member States. The minimum benchmark set for Malta is fixed at a deficit of 1.8 per cent of GDP.

3.2.1 Malta’s Medium Term Budgetary Objective

The current general Government gross debt ratio reached 76.7 per cent of GDP in 2004 and is expected to remain at this level in 2005. Although this is above the EU average and above the Maastricht Convergence criteria of 60 per cent, it is significantly below the highest debt ratios registered among EU Member States and thus can be considered as ‘moderately high’. In addition, potential growth over the period 2000-2050 as projected by the Economic Policy Committee is estimated at an average of 2.4 per cent per annum, significantly above the 1.7 per cent average EU potential growth. Within this context, Malta is aiming for a balanced budgetary position in cyclically-adjusted terms net of one-off and temporary measures as its MTO. Since Malta is still in the process of reaching this target, the Code of Conduct stipulates further that “Member States that have not yet reached their MTO should take steps to achieve it over the cycle”. In line with these specifications, Malta aims to achieve a balanced budgetary position net of one-off and temporary measures over the cycle.

The Code of Conduct also clarifies how the adjustment path towards the MTOs should be reached. In particular, for Member States in ERM II that have not yet reached their MTOs, the Code of Conduct stipulates that an annual adjustment in cyclically-adjusted terms, net of one-off and other temporary measures, of 0.5 per cent of GDP as a benchmark should be made.

The above considerations underline the relevance of Malta’s output gap, the resulting cyclically-adjusted budget deficit and the one-off and temporary measures included in the budget deficit figure.

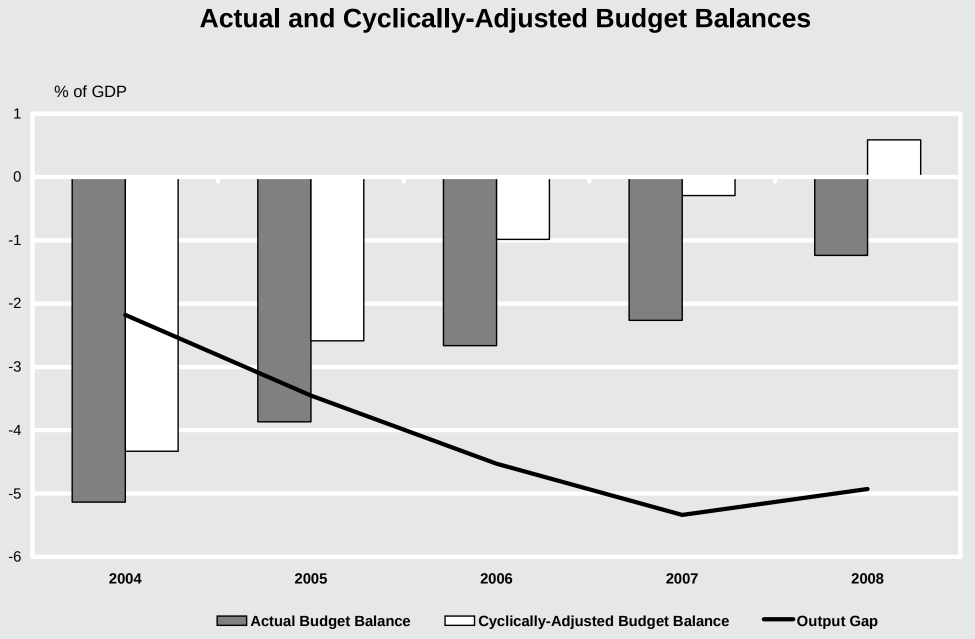
3.2.2 The Cyclically-Adjusted Budget Deficit

The output gap stood at 2.2 per cent during 2004, thus contributing to around 0.8 percentage point to the actual budget balance of 5.1 per cent of GDP recorded during that year. Over the forecast period, the economy is expected to continue to operate below potential thus giving rise to a negative output gap, reaching a trough during 2007 before narrowing in 2008. As a result the projected budget balance is expected to remain above the cyclically-adjusted budget balance throughout the forecast period.

During 2005, the output gap is expected to reach 3.5 per cent with the expected decline in the budget balance amounting to 1.3 percentage points of GDP. Thus the cyclically-adjusted budget balance is expected to reach 2.6 per cent of GDP during 2005, compared to the estimated budget deficit of 3.9 per cent of GDP. By 2006, the adverse effect of the cycle on the actual budget balance will reach 1.7 percentage points of GDP and a further 2.0 percentage points of GDP during the following year. In view of the expected narrowing in the output gap during 2008, the cyclical component of the budget deficit is expected to decrease to 1.8 percentage points of GDP. Hence the cyclically-adjusted budget balance is expected to turn to surplus in 2008. Details on the methodology used to calculate the cyclically-adjusted balanced budget is provided in the Annex.

Since interest expenditure reflects the outcome of past fiscal operations, the cyclically-adjusted primary balance (CAPB), which excludes interest expenditures is a better indicator of Government’s current fiscal operations. The CAPB for 2005 is estimated at -0.2 per cent of GDP and in view of the expected trends in cyclical developments and interest expenditure, it is expected to turn into surplus of 1.5 per cent of GDP in 2005. The CAPB surplus is expected to reach 4.3 per cent of GDP in 2008. Chart 3.5 and Table 5 in the Statistical Appendix present estimates of Malta’s output gap and the cyclically-adjusted balanced budget.

Chart 3.5



3.2.3 One-off and Temporary Measures

According to discussions at the Economic and Financial Affairs Committee level, the assessment of whether specific measures can be considered one-off or temporary inevitably involves judgement and can be made only on a case-by-case basis, whilst respecting recent assessments. However, only non-recurrent measures having a temporary and significant impact on the general balance should be considered. The relevance of deficit increasing measures may be broadly confined to cases of short-term emergency costs associated with major catastrophes and changes in revenues or expenditure consecutive to Court rulings or consecutive to Commission decisions.

During the Programme's period, the temporary deficit-increasing measure with the largest magnitude is the capital expenditure project involving the new hospital. This project which involves outlays of around 2 per cent of GDP will be concluded in 2007 and will not be repeated thereafter.

One-off and temporary deficit-reducing measures comprise revenue from the foreign investment registration scheme, '3G' Communications Licences, the Value Added Tax penalty amnesty scheme and sale of land in 2005. These measures, which in total amount to 1.0 per cent of GDP, will not be repeated in the following years. Between 2006 and 2008 the only temporary measure of a deficit-reducing nature will consist of the sale of land, which will amount to 1.0 per cent, 0.7 per cent and 0.1 per cent respectively. These measures will not feature in the following years. It is important to note that these one-off revenue measures compensate for the increase in capital outlays resulting from the construction of the new hospital. During 2005-2007, this particular project alone involves outlays of around 2 per cent of GDP per annum. This project will be concluded in 2007 and will not be repeated thereafter.

3.2.4 The Medium-Term Budgetary Objective and Minimum Benchmarks

Table 3.1 illustrates how the fiscal consolidation programme will lead to the attainment of Malta's medium-term budgetary objective. The adjustment path fulfills the requirement of a minimum 0.5 per cent adjustment for ERM II Member States. The cyclically-adjusted budget deficit, net of one-off and temporary measures, is estimated to reach –3.6 per cent of GDP in 2005 and will continue to decline, reaching 1.0 per cent in 2007. Projections for 2008 indicate that the structural balance will reach 0.5 per cent of GDP.

Cyclically-Adjusted Budget Deficit Net of One-off and Temporary Measures
as a percentage of GDP

Table 3.1

	2004	2005	2006	2007	2008
Actual Budget Balance	-5.1	-3.9	-2.7	-2.3	-1.2
Cyclically-Adjusted Budget Deficit	-4.3	-2.6	-1.0	-0.3	0.6
One-Off Measures	0.7	1.0	1.0	0.7	0.1
Cyclically-Adjusted Budget Deficit net of One-offs	-5.0	-3.6	-2.0	-1.0	0.5
Adjustment Path		1.4	1.6	1.1	1.5

3.3 Debt Levels and Developments

Government's main medium-term fiscal objective is to restore public finances to a sustainable path. In order to achieve this objective, the Maltese Government is not solely addressing the current imbalance in public finances but importance is also attached to the need to reduce the debt-to-GDP ratio at a satisfactory pace, which remains one of Government's prime goals.

Government debt is characterized by local currency denominated debt, which accounts for around 96 per cent of total financing. The low proportion of foreign loans to total loans coupled with the fact that around 80 per cent of foreign debt is denominated in Euros imply very limited risk to exchange rate fluctuations. Moreover, given that about 67 per cent of total financing will mature in the next five years, interest rate risk is relatively low. Debt of Extra Budgetary Units (EBUs) accounts for around 3 per cent of General Government debt.

3.3.1 Projected Debt Developments

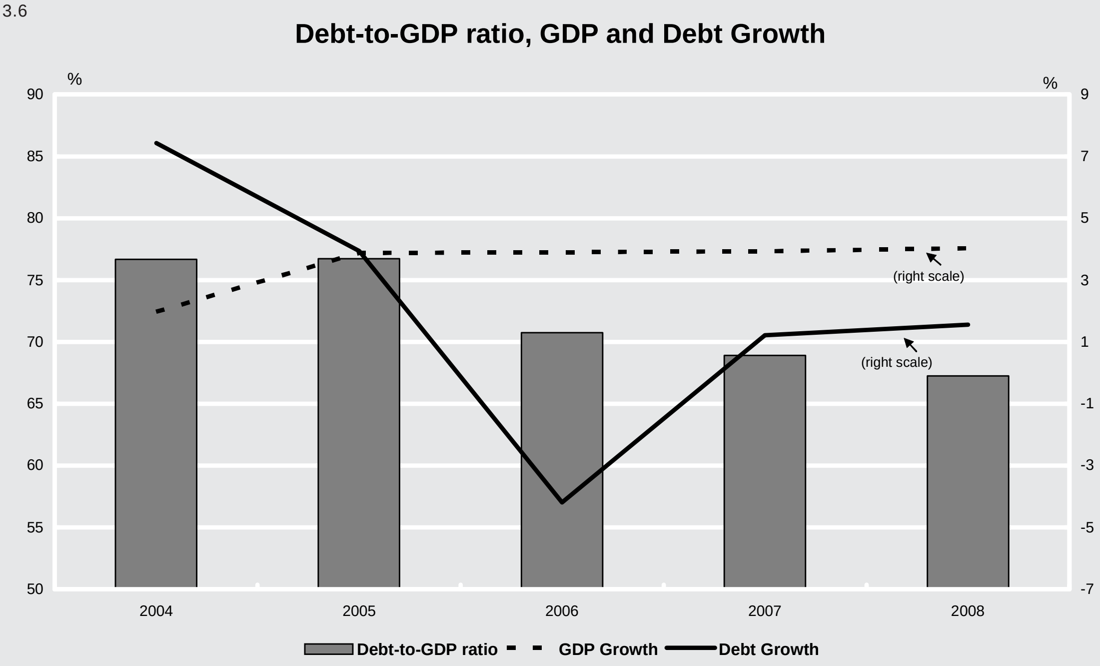
As at the end of 2005, the debt-to-GDP ratio is expected to reach 76.7 per cent, remaining at the same level registered at the end of 2004. As illustrated in Chart 3.6, the debt-to-GDP ratio is expected to decrease significantly to 70.8 per cent in 2006 and thereafter to maintain a downward trend to reach around 67 per cent by 2008.

As Government deficit and debt are closely interrelated, Government's policy aimed at bringing a gradual reduction in the fiscal imbalance and a parallel increase in the primary surplus is reflected in a gradual improvement in the debt level. Meanwhile, the debt trajectory is also influenced by other factors, namely interest and growth contribution as well as the stock-flow adjustment (SFA).

Over the 2005-2008 period, the contractionary effect emerging from the expected primary surplus coupled with stock-flow operations more than offset the combined expansionary contribution from interest expenditure and growth, thus leading to a declining debt-to-GDP ratio. In fact, the debt-to-GDP ratio is expected to decrease by 6 percentage points in 2006 followed by 1.8 percentage points and 1.6 percentage points in 2007 and 2008 respectively.

As shown in Table 3.2, the primary surplus, which is expected to follow an upward trend during the Programme period, will exert an increasing contractionary effect on the debt-to-GDP ratio. In fact, the projected primary surplus will decrease the debt-to-GDP ratio by 0.3 percentage points in 2005. Thereafter, the primary surplus

Chart 3.6



will contribute to a more significant decline in the debt-to-GDP ratio, contracting the debt ratio by around 1.5 percentage points per year in 2006 and 2007. The primary surplus is expected to increase notably in 2008, thus exerting a contractionary effect of around 2.5 percentage points in the debt-to-GDP ratio.

The implicit interest rate on debt is expected to remain constant at 5.5 per cent over the Programme period. Interest payments are expected to exert an increasing effect on the debt-to-GDP ratio ranging from 4.3 percentage points in 2005, down to 3.8 percentage points in 2008. Meanwhile, the nominal GDP growth of around 4 per cent per annum over the programme period is expected to decrease the debt-to-GDP ratio by around 2.8 percentage points per year. As a result of these projections, the so-called 'snow-ball effect' defined as the impact on the debt ratio exerted from interest payments and nominal GDP growth, is projected to have a debt increasing effect throughout the Programme period. In fact, as shown in Statistical Appendix Table 4, the snow-ball effect is expected to increase the debt-to-GDP ratio by around 1.3 percentage points in 2005 followed by around 1 percentage point each year up to 2008.

The Dynamics of Government Debt

Table 3.2

	2004	2005	2006	2007	2008
Gross debt level	76.7	76.7	70.8	68.9	67.3
Change in gross debt	3.9	0.0	-6.0	-1.8	-1.6
Contribution to change in gross debt					
Primary Balance	1.0	-0.3	-1.4	-1.6	-2.5
Interest Expenditure	4.2	4.3	4.2	3.9	3.8
Nominal GDP growth	-1.4	-2.9	-2.9	-2.7	-2.7
Stock-flow adjustment*	0.1	-1.1	-5.9	-1.5	-0.3
of which privatisation proceeds	0.0	-1.0	-7.2	0.0	0.0

*Derived as a residual

The stock-flow adjustment is estimated to contribute to the reduction in the debt ratio by 1.0 percentage points in 2005. Meanwhile, in 2006, the stock-flow adjustment is estimated to exert a contractionary effect of 5.8 percentage points on the debt ratio. Thereafter, the stock-flow adjustment is estimated to exert a contractionary impact of 1.4 percentage points and 0.2 percentage points in 2007 and 2008 respectively. It is pertinent to note that these projections take into account possible stock-flow adjustments produced by expected privatization operations.

Indeed, privatization receipts, which are expected to materialize in 2005 and 2006, will contribute to a significant stock-flow adjustment. Privatization receipts are expected to have a contractionary effect on the debt-to-GDP ratio of 1.0 percentage point and 7.2 percentage points in 2005 and 2006 respectively. If privatization receipts are not accounted for in the stock-flow adjustment, the estimated stock-flow component decreases the debt ratio over the Programme period with the exception of 2006. In fact, in 2006, the stock-flow component excluding privatization receipts is estimated to increase the debt ratio by around 1.3 percentage points. It is pertinent to note that the stock-flow adjustment not accounted for by privatization proceeds is significant and positive only in 2006, but is minimal and negative in the other years.

3.3.2 Comparison with the November 2004 Update of Convergence Programme

In the November 2004 Update of Convergence Programme, the debt-to-GDP ratio was expected to decrease from 72 per cent in 2005 to 70.5 and 70.4 in 2006 and 2007 respectively. In fact, the debt ratio was expected to contract by 1.2 and 1.5 percentage points in 2005 and 2006 respectively, and to decline by a marginal 0.1 percentage points in 2007. However, the projections of the debt ratio are revised in this Programme, remaining unchanged at the 2004 level in 2005 but declining by a significant higher magnitude in 2006 and 2007. Such revisions are mainly as a result of divergences in the expected path of economic growth as well as to reflect the change in the timing and magnitude of the privatization operations.

The revisions in the debt ratio are highly attributable to the revision in GDP growth. In fact, the debt ratio for 2004 was revised from 73.2 per cent as presented in the previous Update to 76.7 per cent. This revision mainly reflects a downward revision in nominal GDP. Meanwhile, the debt ratio for 2005, which was projected at 72 per cent in the previous Update, was revised upward by 4.7 percentage points to 76.7 per cent. This revision was also mainly attributable to the downward revision in nominal GDP for 2005. In fact, such revision accounts for 3.6 points of the 4.7 percentage points revision in the debt ratio for 2005. Moreover, lower expected privatization proceeds in 2005 also exert an expansionary impact on the debt ratio.

In 2006, the expected debt ratio is revised by a marginal 0.3 percentage points from 70.5 per cent presented in the previous Update to 70.8 per cent. Despite this minimal revision, it is pertinent to note that the downward revision in the nominal GDP is expected to increase the debt ratio for 2006 by 3.7 percentage points. However, such increase is highly offset by a decline of 3.4 percentage points in the debt ratio, reflecting higher expected privatization proceeds.

A 1.5 percentage points lower debt-to-GDP ratio is expected in 2007 as compared to the projection presented in the previous Update. While the downward revision in GDP increased the debt ratio by 3.5 percentage points, the lower expected absolute debt level is contributing to a decline of 5 percentage points in the debt ratio.

4. Sensitivity Analysis and Comparison with the November 2004 Update of Convergence Programme

4. Sensitivity Analysis and Comparison with the November 2004 Update of Convergence Programme

4.1 Sensitivity Analysis

This document presents an economic assessment of Malta's growth prospects for the current year, and up to 2008. Any forecasting exercise is subject to uncertainties, hence, it was deemed important to illustrate the sensitivity of the macroeconomic and budgetary forecasts to changes in a number of economic assumptions.

Three alternative sensitivity scenarios are presented in this section[1]. The first sensitivity scenario concerns fluctuations in the interest rate, the second scenario deals with an increase in economic activity in Malta's main trading partners leading to a higher external demand for domestically produced goods and services, and the third sensitivity scenario features a higher rate of economic growth driven by higher domestic private sector investment. The results of the three different scenarios are presented in terms of the effect of the deviation from the baseline on the Gross Domestic Product, General Government budget deficit, and gross General Government debt. These sensitivity analyses, illustrated in Charts 4.1, 4.2 and 4.3, are similar to those presented in the November 2004 Update of Convergence Programme. Moreover, given the relatively short period of time that elapsed since the submission of the previous Update and the absence of major structural changes in the Maltese economy during the same period, there are no major changes in the results in these sensitivity analyses that need to be reported in this Update. It is noteworthy, that given the uncertainty involving the responses in the economic environment, the results of the sensitivity analysis presented should be seen as indicative.

4.1.1 Sensitivity to Interest Rate Fluctuations

Economic activity can be affected by changes in the domestic interest rate through the real and monetary sectors. The magnitude of these changes depends on the degree of elasticity of the components of output to changes in the interest rate. Moreover, Government finances are also directly affected by the change in the interest rate through the impact on economic activity as well as the effect of changes in the interest rate on the debt servicing costs. However, it is important to note at the outset that in view of the long-term nature of Government debt in Malta, changes in the interest rate are mainly expected to affect the debt servicing costs

Chart 4.1

Sensitivity to a 1 Percentage Point Increase in the Interest Rate

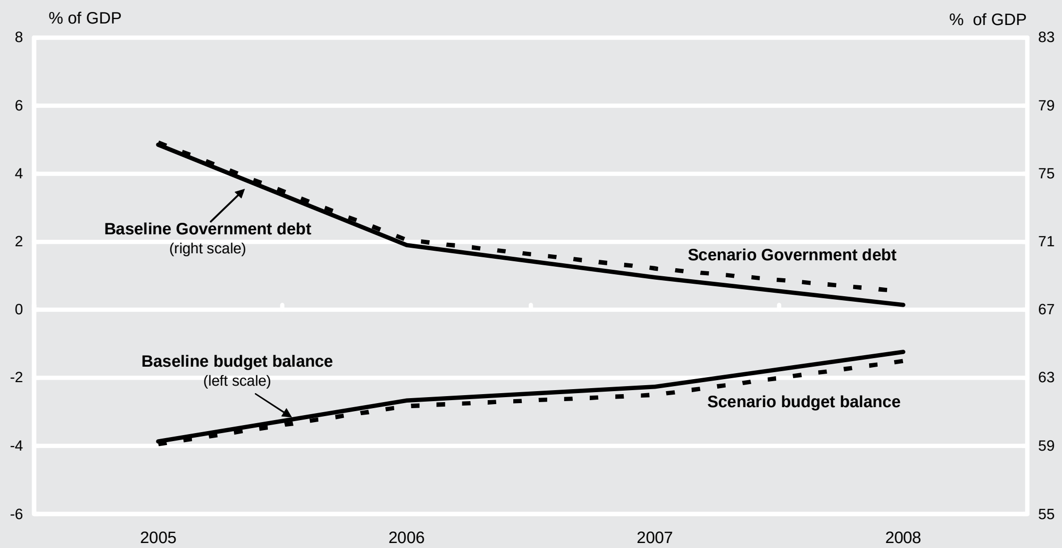
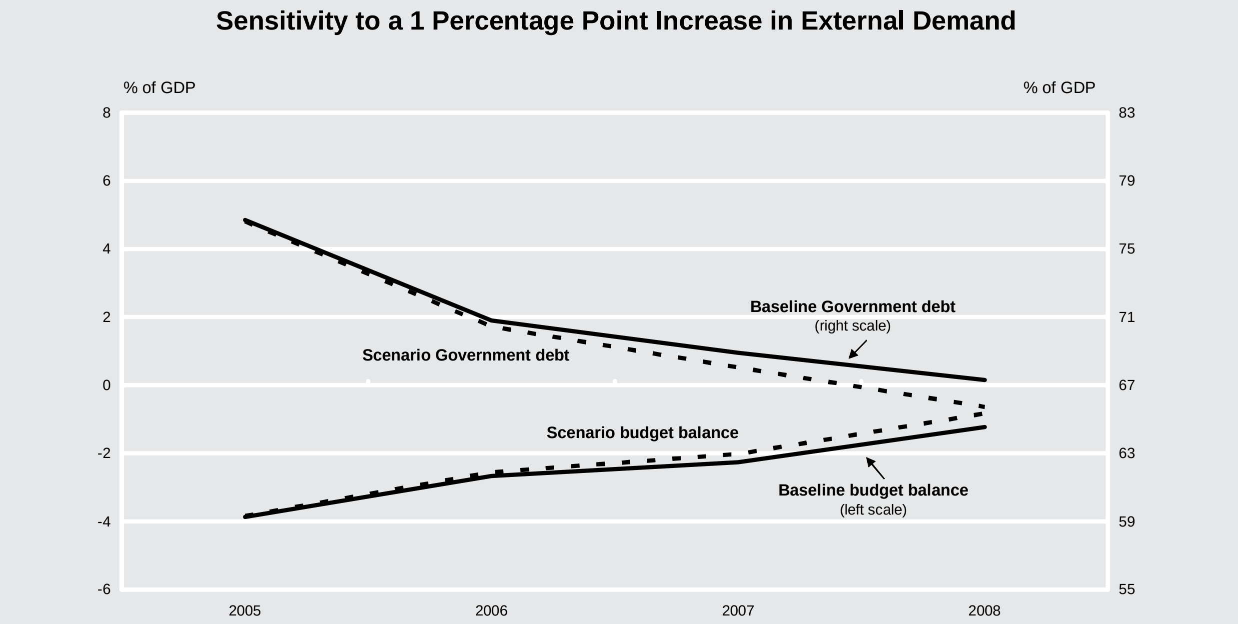


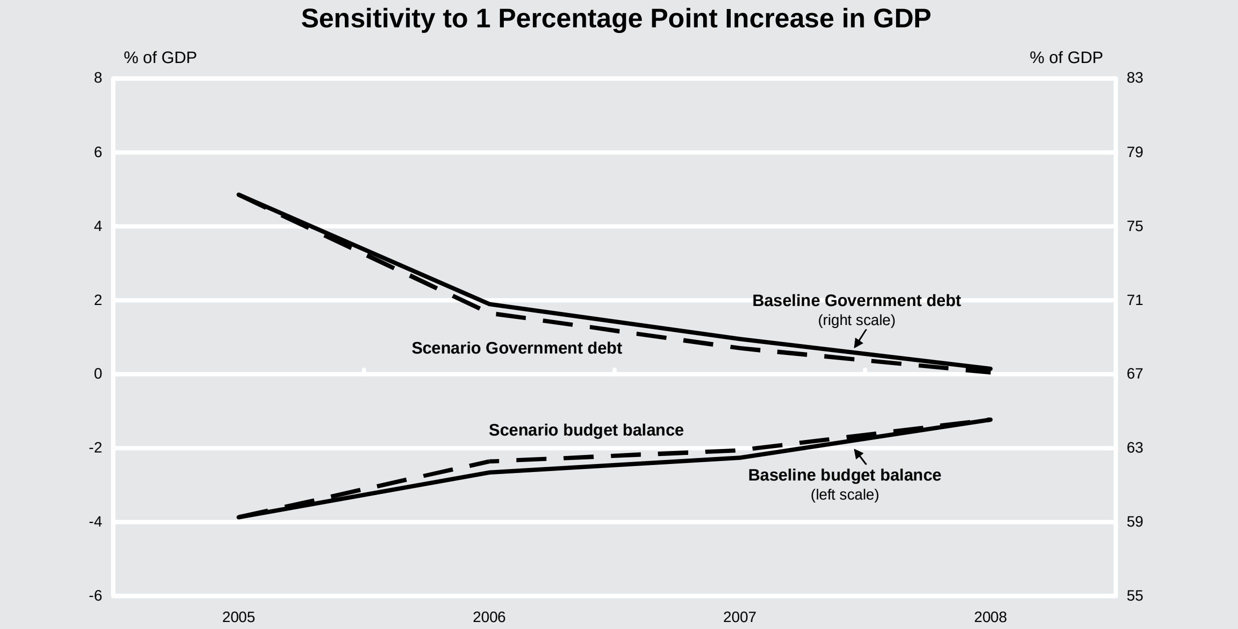
Chart 4.2



in relation to the rolling-over of past long-term debt and new issues of stock. Hence, the impact of a change in the interest rate on the deficit and debt positions is not expected to be significant in the short-term.

This sub-section assumes an increase in the interest rate of 1 percentage point between 2005 and 2008. As a result of this change, economic growth is expected to decrease by 0.1 percentage points in 2005, whilst practically registering no effect on GDP growth in subsequent years compared to the baseline. Moreover, this increase in the interest rate will also result in a worsening of the budget balance of around 0.3 percentage points of GDP and a subsequent increase in Government debt-to-GDP ratio of around 0.8 percentage points at the end of the forecast period when compared to the baseline.

Chart 4.3



4.1.2 Sensitivity to Change in External Demand

The scenario in this sub-section assumes an increase in external demand of 1 percentage point in the first year and throughout the forecast horizon until 2008.

Stronger foreign demand for domestically produced goods and services results in an increase in aggregate demand and consequently in output. This increase in output, through the multiplier effect, will have spill-over effects on the domestic economy. However, given the high degree of import-content of domestically produced goods and services, the effect of an increase in demand for exports on output and on economic growth is expected to be partly offset by a subsequent increase in imports.

An increase in external demand results in an increase of 0.5 percentage points in GDP at the end of forecast period when compared to the base scenario. The effects on the fiscal front are expected to be of an improvement in the budget balance of 0.4 percentage point when compared to the baseline in 2008 and a decline in the Government debt as a percentage of GDP of 1.6 percentage points by 2008.

4.1.3 Sensitivity to Change in the Growth Rate of Real Gross Domestic Product

In this sub-section a 1 percentage point increase in GDP is assumed. This increase in the growth rate of real GDP, which is assumed to be stimulated through an increase in private sector investment, leads to higher demand for goods and services. This increase in demand is accompanied by an increase in demand for imports which is expected to partly offset the positive effects of higher investment demand.

At the end of the forecast period, the budget balance as a percentage of GDP is expected to remain unchanged from the baseline scenario, hence, standing at 1.2 per cent at the end of the forecast period. On the other hand, the Government debt as a percentage of GDP is expected to decline by 0.2 percentage points by 2008, when compared to the baseline scenario.

4.2 Comparison with the Projections in the November 2004 Update of Convergence Programme

Economic Growth

The growth performance of the Maltese economy forecasted in November 2004 is not expected to materialise as a result of a slower recovery in the main trading partners' economies, particularly low demand for Maltese exports in the electronics sub-sector, and slower growth in private consumption expenditure. Indeed, growth forecasts for 2005 have been revised downwards from 1.5 per cent projected last year to the current 0.9 per cent projected this year. Net foreign demand is expected to contribute negatively to economic growth by 2.7 percentage points, compared to a negative 1.6 percentage points projected in the November 2004 Update of Convergence Programme. This is expected to be partly compensated by domestic demand which is expected to contribute 2.1 percentage points to GDP growth in 2005, unchanged from previous forecasts. It is pertinent to note that the projections contained in this Programme reflect the latest revisions by the National Statistics Office (NSO), including revised data for 2004, as well as preliminary estimates for the third quarter of 2005.

Medium-term growth prospects have also been revised downwards in this Programme. Growth prospects for 2006 have been revised downwards by 0.7 percentage points, with foreign demand remaining the main contributor to this decline. Meanwhile economic growth in 2007 is expected to reach 1.2 per cent, compared to 2.2 per cent projected in November 2004. This revision relates to lower domestic demand whilst the performance of the external sector is expected to improve marginally.

Growth forecasts for 2005 were significantly influenced by the performance of the electronics sub-sector. A drop of 4.3 per cent in exports of goods and services is expected in 2005, compared to a growth of 2.0 per cent projected in November 2004. This reflects recent data published by the NSO as well as lower GDP growth forecasts in Malta's main trading partners. Meanwhile, imports of goods and services, previously projected to rise by 3.5 per cent in 2005 are now projected to decline by 3.2 per cent. This primarily reflects lower imports of industrial supplies, in line with lower export prospects. In 2006 and 2007, both imports and exports of goods and services are expected to recover. However, growth rates have been revised downwards compared with the forecasts presented last year. These forecasts primarily reflect lower than expected foreign demand as a result of lower GDP growth forecasts in Malta's main trading partners. Furthermore, although a moderate recovery is expected in the international semiconductor market, the growth rates are considerably lower than those projected in November 2004. Thus, the scenario now reflects a more modest pick-up in external trade.

Although the contribution of domestic demand is expected to remain unchanged in 2005 and 2006, its composition is expected to change substantially. In particular, whereas private consumption expenditure was projected to grow by 1.0 per cent in 2005 and 1.4 per cent in 2006, these forecasts have now been revised downwards to a negative growth of 0.9 per cent and 0.2 per cent in the corresponding years. This revision takes into account the available data for private consumption expenditure for the first nine months of 2005 as well as the impact of the recently announced measures which aim to mitigate the significant increase in the international price of oil. In addition, growth in government consumption has also been revised downwards, reflecting trends in the latest available data.

On the other hand, growth projections for gross fixed capital formation for 2005 and 2006 have been significantly revised upwards to reflect revised capital expenditure projections by the public sector. This primarily relates to the expenditure by Government on the new hospital which is expected to be completed by 2007. As a result, investment expenditure is expected to increase by 11.3 per cent in 2005 compared to a growth of 7.8 per cent projected in November 2004. Forecasts for 2006 have also been revised upwards from a negative 1.6 per cent to a positive growth of 3.3 per cent.

GDP growth in 2007 has been revised downwards from 2.2 per cent projected in November 2004 to 1.2 per cent projected in this Programme. In 2007, a recovery in private consumption expenditure is expected, although growth forecasts at 0.6 per cent are still 1.0 percentage point lower than projected last year. A marginal growth in Government final consumption expenditure is now expected in 2007. On the other hand, investment expenditure has been revised downwards by 4.2 percentage points to a negative growth of 3.8 percent, reflecting the completion of the new hospital. As a result of these developments, the contribution of final domestic demand to GDP growth is expected to turn negative, compared to a positive contribution projected in the November 2004 Update. Meanwhile, whilst lower growth is projected in exports of goods and services in 2007, the growth in imports of goods and services has also been revised downwards, but by a larger magnitude. As a result, the net contribution of the external sector to GDP growth is projected to rise.

Inflation

Despite a lower projected economic growth performance, forecasted inflation has been edged upwards to reflect supply-side shocks. In particular, inflation in 2005 is expected to be 2.8 per cent compared to 2.4 per cent projected last year. This primarily relates to the effects of the increase in the international price of oil. The inflation projections for 2006 have also been revised upwards by 1.2 percentage points to 3.1 per cent, mainly reflecting the increase in the fuel surcharge on water and electricity consumption announced in October 2005. Subsequently, the inflation rate is expected to decline to 2.5 per cent in 2007, which however remains 0.6 percentage points higher than that projected in the November 2004 Programme.

Employment Prospects

Unemployment is expected to be lower than its level projected in November 2004. This is in line with recent unemployment figures which show a decline in the first nine months of 2005. For 2006 and 2007, the unemployment rate is expected to fall, in line with the trend in the November 2004 forecasts.

Note:

[1] The sensitivity analyses presented in this section consider 2005 as the first year of the forecast and thus any fluctuations from the baseline are commenced in the year 2005.

5. Quality of Public Finances

5. Quality of Public Finances

The consolidation of fiscal balances remains one of Government's main medium term fiscal objectives, entailing both a reduction in the General Government budget deficit to below 3 per cent of GDP and achieving a declining General Government debt ratio.

As outlined in the November 2004 Convergence Programme 2004-2007, the General Government deficit ratio is expected to follow a downward path during the medium term. Although the fiscal trajectory path has been revised, Government remains committed to the goal of achieving a budget deficit below 3 per cent of GDP in 2006. The revisions in the fiscal targets, which are discussed in Section 3.1.1, have been undertaken in view of the increase in international oil prices so as to avoid undue social and economic disruptions during the fiscal consolidation phase.

In parallel with fiscal consolidation, Government expenditure is being redirected towards growth-enhancing initiatives, mainly education and the environment, in order to further develop our human resources and to ensure a better quality of life through sustainable development. The level and standard of education have an important impact on economic activity, particularly when considering the requirements of certain high-value added sectors that are key for Malta's economy and which require a highly skilled and adaptable workforce. On the other hand, the quality of the environment impinges directly on the quality of life of both the local inhabitants as well as on the tourism industry.

In view of these priorities, the Budget for 2006 set out the policies and measures for the accomplishment of the fiscal targets for 2006 and the further development of various economic sectors in Malta. In addition, other measures having a fiscal implication were introduced along the year in response to Government's main medium term objectives. These mainly include redeployment of public sector employees, the collective agreement for the public service, the reform in the students' maintenance grants system and measures to reflect the rising international price of fuel.

5.1 The 2006 Budget

Fiscal consolidation is necessary to ensure the sustainability of Government's financial position thus securing a stable macroeconomic framework, as well as to re-establish the role of fiscal policy as an instrument for economic stabilisation purposes. Achieving a sustainable fiscal position is essential to regain the necessary fiscal flexibility that would spur long-term economic growth. In fact, fiscal consolidation promotes productive investment not only by releasing financial and other resources for use by the private sector, but perhaps even more importantly by removing uncertainty regarding the future tax burden.

In this respect, Government is pursuing the implementation of a number of measures aimed to reduce the fiscal deficit, whilst also unfolding a programme of structural reforms intended to instil competitiveness and efficiency, and to create an environment which is conducive to private sector initiative and investment. Growth-enhancing initiatives are intended to strengthen Malta's international competitiveness through investment in infrastructure, education, research and development, as well as through incentives to industry, including SMEs and micro-enterprises, and tourism.

Fiscal consolidation will be brought about by both revenue-raising measures as well as policies intended to reduce expenditure. In the case of the latter, Government will continue to reform its public sector entities such that entities that have a strategic role will be restructured to reflect their core business, and functions identified as non-core are transferred to the private sector. This is in line with Government's policy of focusing its role in the economy on the regulatory aspect, facilitating rather than participating as an operator in economic activities. Furthermore, such measures also aim to improve the efficiency of public entities and decrease their reliance on Government assistance.

A case in point is the restructuring programme at the Malta Tourism Authority, following which Lm0.6 million previously allocated to administration expenses will be channelled towards the marketing of Malta and Gozo as a tourist destination. Another example of restructuring is the shipyard, as a result of which subsidies are to be phased out by the end of 2008.

Another area where greater control over expenditure is being exercised concerns abuse of social benefits. The fight against the abuse of social benefits has been intensified and a Benefit Fraud and Investigations Directorate was set up in the Ministry for Family and Social Solidarity on 1 November 2005 to carry out investigations in cases of fraud of social benefits as well as in other areas of social policy. The focus at present is on social assistance, invalidity payments and children's allowance, but it is intended to broaden further the scope of investigations. This enforcement is expected to impact on expenditure on social security benefits for 2006, which is expected to grow at a slower rate than had enforcement not been intensified.

Table 5.1 gives more detail on the main measures announced in the 2006 Budget, which list is sub-divided into corrective measures and growth enhancing measures. For measures of a substantive nature, quantification is also provided.

Main Measures Budget 2006

Table 5.1

	Lm thousand
Corrective Measures	
Structural	
Prevention against fraud of income tax	2,700
Prevention against fraud of excise duty payable on the importation of alcohol	500
Sub-total	3,200
One-Offs	
Sale of land	20,400
Sub-total	20,400
Growth-enhancing Measures	
Business Promotion	
Incentives to industry	2,300
Investment to improve the Industrial Zones	825
New incentives under the BPA	5,000
Film Industry Incentives	1,500
Increased expenditure for the development of Industrial zones for SMEs	100
Programmes for SMEs and Micro-enterprises	260
Sub-total	9,985
Tourism Industry	
Reallocation of MTA Budget	600
Malta Branding	500
Management of tourist zones	150
Investment in pre-historic temples	1,500
Sub-total	2,750
Education and the labour market	
A higher education fund for Government Scholarships (Masters and PhD)	200
Child care centers	130
Sub-total	330

Corrective Measures

The corrective measures announced in the Budget for 2006 amount to Lm19.2 million, of which Lm3.2 million represent structural measures in the context of prevention against fraud of payable taxes. The remaining Lm20.4 million are of a one-off nature.

a. Structural Measures

Structural measures account for 0.16 percentage point of the 1.2 percentage points improvement in the deficit-to-GDP ratio planned for 2006. Permanent measures to increase revenue, which will come into effect next year, include the following:

- In order to strengthen the investigative powers of both the Tax Compliance Unit and the Benefit Fraud and Investigations Directorate, amendments to the Income Tax Act (Cap. 123) will enable the sharing of tax and social benefits information. Furthermore, amendments will also be introduced so that money loaned by financial institutions and banks for property development will be made available against the contract of acquisition and fiscal receipts on the work carried out. Hence, revenue from Income Tax is anticipated to increase by Lm2.7 million in 2006 as a result of enforcement measures, thereby contributing to 0.14 percentage point of the 1.2 percentage point improvement in the deficit-to-GDP ratio.

- The Customs Department will introduce banderols on alcohol bottles to sustain efforts against illegal importation of alcohol. Consequently, excise duty payable on spirits is forecast to increase by approximately Lm0.5 million, representing 0.03 percentage point of the 1.2 percentage point improvement in the deficit-to-GDP ratio.

b. One-Off Revenue Measures

Revenue estimates for 2006 also include a number of one-off measures, which are discussed in Section 3.2.3, that will contribute to reduce the fiscal imbalance. In total, the yield from one-off measures will amount to Lm20.4 million, or 1.03 percentage points of the decline in the deficit-to-GDP ratio. For 2006, the only temporary measure of a deficit reducing nature will consist of the sale of land.

Growth-enhancing Measures

The Budget for 2006 contains several measures that aim to boost the economic growth potential of the local economy. Growth enhancing measures mainly focus on industry, tourism, and education in an effort to increase Malta's competitiveness. The main growth-enhancing measures contained in the 2006 Budget include:

- An amount of Lm2.3 million was allocated to Malta Enterprise Corporation in the form of incentives to industry, while a further Lm0.1 million have been allotted for the development of Industrial Zones for SMEs. Moreover, Lm0.8 million co-financed from the EU Structural Funds have been earmarked for the upgrading and improvement of Industrial Estates.

- For 2006, Lm0.3 million, co-financed by the EU Structural Funds, will finance programmes for SMEs and micro-enterprises to enhance their competitiveness, particularly through life-long learning.

- The 2006 Budget includes a number of new incentives under the Business Promotion Act (Cap. 325), amounting to Lm5 million, in the form of tax credits for firms investing in ICT, research and development, back office service work and e-business services. Fiscal incentives have been targeted as well to the film production industry, for which Lm1.5 million have been allocated.

- Tourism is a main contributor towards GDP. Consequently, various measures have been announced for 2006 to increase Malta's attractiveness as a tourist location. In particular, following the restructuring programme of the Malta Tourism Authority, Lm0.6 million previously allocated to administration expenses will be channelled towards the marketing of Malta and Gozo as a tourist destination. Thus, investment in the marketing of Malta and Gozo will increase to Lm6.2 million. Furthermore, Lm0.5 million have been allocated to carry out a comprehensive branding exercise of the Maltese Islands.

- In an effort to sustain an improved tourist product, a project is planned for the pre-historic temples. The project includes a visitors centre, protection of the temples, security systems and conservation projects with an investment of Lm1.5 million which are co-financed from the EU Structural Funds. Furthermore, to ensure that tourist zones are kept at an appropriate quality level, the sum of Lm0.2 million has been allocated.

- Education, particularly in the fields of science and ICT, is considered to be a main driver of economic growth. Towards this end, the 2006 Budget announced the provision of full tax credits for those companies who pay the studies of employees in the areas of science and IT, and tax credits for persons following advanced studies leading to a PhD in science. Furthermore, Lm0.2 million will be allocated for the 'Government of Malta Scholarship Scheme' for studies and research at Master and PhD levels.

- A further Lm0.1 million will assist 45 existing childcare centres to upgrade their standards in order to comply with the new regulations that will be enacted as from next year. Childcare centres are one important factor in the efforts being undertaken to increase female participation in the labour market.

5.2 Additional Measures

Apart from the revenue and expenditure decisions announced in the Budget for 2006, a number of Government policy decisions were taken during 2005 that affected the fiscal position.

In particular these concerned redeployment of public sector employees, the collective agreement for the public service, the reform in the students' maintenance grants system and corrective measures to reflect the rising international price of fuel.

Redeployment of public sector employees

During the second quarter of 2005 Government set up the Redeployment Advisory Group with the aim of retraining and redeploying employees within the public sector, reduce public sector wage disparities and improve relativity of positions and conditions of employment. Hiring into the public sector was made subject to approval by this Group on a strictly real need basis. It is estimated that the actions taken to date yielded around Lm2 million in expenditure savings or 0.1 percentage points of the 1.2 percentage points reduction in the deficit-to-GDP ratio for 2005.

Collective agreement for public service employees

During the fourth quarter of 2005, an agreement was reached between Government and the employees' representatives over a renewed collective agreement for employees in the public service. The agreement covers a six-year period and it is backdated from 1 January 2005. Amongst the highlights of the new collective agreement, one notes the establishment of a conciliation mechanism in the case of industrial disputes. The new agreement provides for improvements in the working conditions particularly by enabling employees to better combine work and family responsibilities. The agreement also promotes employee flexibility particularly by enabling the Government to introduce new work schedules in areas where public services to the business and tourism sectors are involved and the extension of private-public partnerships with an aim of retraining and redeploying underemployed employees. These measures thus contribute to increasing productivity of public service employees.

As regards, the compensation of employees in the public service, the salary increases awarded over the period 2005-2010 are inclusive of the cost of living adjustment (COLA). In the case where the COLA awarded in a particular year is higher than the prescribed salary increase, then the difference will be awarded as a cash payment. Since the difference in compensation will be paid in cash, it will leave the hourly and overtime rate of pay unaffected. Given that limited increases in the salaries are envisaged during the first two-year period covered by the agreement, the increase in salaries in various employment categories is expected to be equivalent to the COLA. Indeed, the share of total personal emoluments in the public service in nominal GDP is projected to decline from 10.7 per cent during 2005 to 9.7 per cent by 2008.

The reform in students' maintenance grants

A reform of the students' maintenance grants system was announced during the third quarter of 2005. The changes were twofold: a reform of the normal grant to students attending full-time courses at the University of Malta whilst strengthening the social element through the introduction and extension of means-tested supplementary grants and other special grants. The reform to the system of normal grants was aimed at extending the incentives to students attending courses considered important in the context of the socio-economic development of Malta. These courses are mainly science-oriented and include information technology and engineering. At the same time the grant received by students attending other courses was reduced. This reform applies for students attending the first year of an undergraduate course at the University of Malta in October 2005.

The reform has substantial fiscal implications that are expected to accrue over time. In fact, the expenditure on students' maintenance grants is projected to remain unchanged over the period 2004-2008 at around Lm8.0 million, despite the projected increase in the number of students attending tertiary education. These gains are likely to offset any minor increases in expenditure associated with the extension of means-tested supplementary grants and other special grants.

Measures to mitigate the increase in the international price of fuel

In view of the increase in the international price of fuel recorded during 2005, especially during the second half of the year, Government announced that it would be introducing a number of corrective measures. These measures entail a sharing of the costs of the international fuel prices between the public and private sector. The state-owned Enemalta Corporation, which provides the generation, transmission and distribution of electricity, absorbed in its balance sheet around Lm29 million of the increased costs associated with the hike in fuel prices. At the same time, Government announced that from 1 November 2005, the fuel surcharge on water and electricity consumption will be increased from 17 per cent to 55 per cent. This will rise gradually to 84 per cent over a period of 24 months. At the same time the excise duty on petrol was increased by Lm0.03 per litre, which will be reduced gradually over a period of 24 months. These two measures are estimated to generate around Lm33 million.

5.3 Privatisation

Government's strategy is to continue to implement its privatisation programme. This serves to redefine the role of the state, generate productivity gains, and attract foreign investment, whilst also contributing to reduce the burden of the public debt.

Following the sale on the Malta Stock Exchange of 20 per cent of the shares in Malta International Airport plc, and the privatisation of Sterling Travel and Tourism Ltd. and Air Supplies and Catering Co. Ltd., the Privatisation Unit is engaged in concluding the privatisation process of Bank of Valletta plc and Maltacom plc. The privatisation of Sea Malta Co. Limited – the national shipping line operating regular liner and maritime-related services – to an Italian shipping company, is in its final stances. The privatisation of Interprint Limited has not materialised as no strategic partner has been identified. Consequently, the company has been liquidated.

In addition, currently, the privatisation of the Kordin Grain Terminal, Maltapost plc, Tug Malta Ltd., Malta Dairy Products Ltd., and three hotels forming part of Air Malta is ongoing. Furthermore, the production and distribution of gas and the Enemalta Oil Facilities are also in the process of being divested to a strategic partner. In 2006, Government will also consider the privatisation of yacht marinas, thereby providing new opportunities for private investment.

Revenue from privatisation is set at Lm136 million in 2006. Revenue generated from the sale of government shares and assets will have a contractionary effect on the debt-to-GDP ratio and on interest payments in the following years.

5.4 Determinants of the 2006 Fiscal Outcome

The projected fiscal consolidation for 2006 is due to a combination of revenue-raising measures as well as policies aimed at containing expenditure. General Government Total Receipts are expected to improve by 2.0 per cent of GDP, while General Government Expenditure is projected to decline by 1.0 per cent of GDP. Table 5.2 presents an outline of the revenue components that are projected to contribute to higher revenue in 2006.

The corrective measures introduced in 2006 are expected to yield 1.2 per cent of GDP, that is made up of 0.2 per cent structural measures and 1.0 per cent in one-off measures. The contribution of grants to fiscal consolidation is expected to be negligible, as receipts for 2006 are expected to be slightly lower than the level for 2005. Stricter enforcement of revenue collection as well as revenue buoyancy associated with economic growth is expected to contribute around 1.3 per cent of GDP. Meanwhile receipts from other sources are expected to decrease by 0.5 per cent of GDP.

Table 5.3 provides an overview of total Government expenditure expressed as a ratio of GDP. General Government expenditure as a proportion of GDP is expected to decline by 1.0 percentage points to 48.6 per cent during 2006, a noteworthy development in view of the increasing trend recorded in recent years. The decline in the total expenditure to GDP ratio is mainly due to a decline of 0.7 percentage points recorded in recurrent expenditure. Declines are anticipated primarily in personal emoluments. Increases are mainly projected in social security benefits and pensions. The share of interest payments (as classified in the statement of the Consolidated Fund) in GDP is expected to decline by 0.2 percentage points to 3.8 per cent.

Capital expenditure for 2006 is anticipated to decline marginally by 0.1 percentage points of GDP. A decline of 0.5 percentage points of GDP is projected in capital expenditure on health, the elderly and housing reflecting

Changes in General Government Total Receipts* - 2006
(per cent of GDP)

Table 5.2

Corrective measures		1.2
structural	0.2	
one-offs	1.0	
Changes in Grants		-
Revenue buoyancy and enforcement		1.3
Others		-0.5
Total		2.0

*positive represents an increase

Total Expenditure
(per cent of GDP)

Table 5.3

	2004	2005	2006
Recurrent expenditure(1)	36.6	37.1	36.4
Personal emoluments	11.0	10.7	10.4
Social security benefits and pensions(1)	9.5	9.4	9.9
Education	2.4	2.6	2.5
Health, the elderly and community care	2.2	2.2	2.3
Others	11.6	12.2	11.3
Interest payments	3.8	4.0	3.8
Capital expenditure	5.7	7.6	7.5
Roads	0.3	0.3	0.4
Education	0.3	0.2	0.2
Health, the elderly and housing	1.5	2.5	2.0
Subsidies / subventions	1.1	1.0	1.0
Others, of which	2.5	3.7	4.0
Projects financed by EU funds	0.2	0.7	1.3
Total expenditure(1)	46.2	48.7	47.7
EBUs and other adjustments	2.6	0.8	0.9
General Government expenditure	48.8	49.6	48.6

(1)excluding State Contribution in terms of the Social Security Act (Cap. 318)

outlays on the new hospital which although in 2006 remain significant, are below the level of 2005. On the other hand, increases were recorded in the other category. This reflects expenditure related to environmental matters and waste management, which is co-financed from the EU Structural Funds. Expenditure on roads as a share of GDP is expected to increase marginally, whilst the share of capital expenditure on education in GDP will be maintained. Subsidies as a share of GDP are also anticipated to remain unchanged.

As a result of the developments in the receipts and expenditure described above, the General Government Budget Deficit is projected to decline from 3.9 per cent in 2005 to 2.7 per cent in 2006.

6. Sustainability of Public Finances

6. Sustainability of Public Finances

There is a growing recognition that ageing populations will pose major economic, budgetary and social challenges in the coming decades. In particular, ageing could lead to significant pressures to increase public spending, making it difficult for countries to maintain sound and sustainable public finances in the long term. This indicates that in order to secure sustainable public finances, a long-term view of the evolution of public finances is required. Demographic shifts and their implications on the future operation of welfare systems and Government revenue streams represent a central issue in the endeavour of long-term fiscal sustainability.

Pension payments are expected to represent a formidable challenge to Malta in the coming years. As a result of a falling birth rate, longer life expectancy together with the entry of the post-war baby boomers into retirement, the outlays on pensions paid by Government will rise over the next twenty years. As a result, the current system will bear a higher deficit. In light of these developments in June 2004, Government tasked the Cabinet Committees' Support Unit to head a Pensions Working Group to review all previous work carried out on pensions and to submit recommendations to Government on the way forward. The Government published a White Paper, 'Pensions Adequate and Sustainable' in November 2004. Following an extensive and embracing national consultation and discussion process the Pensions Working Group presented a final report in June 2005 to Government with a set of recommendations for reform. The report provides a comprehensive and detailed analysis of developments in the Maltese pension system under a baseline 'no reform' scenario and includes a set of recommendations together with the expected impact of the proposed reforms on long-term fiscal sustainability. Following the public consultation process after the publication of the White Paper, the feedback received by the Pensions Working Group was unanimous in the fundamental conclusion that an option of 'no reform' to the current pensions system is not a solution. The process of reform is a sensitive matter and a measured and balanced solution needs to be sought to ensure both the adequacy and the sustainability of the pension system. It is the intention of Government to communicate its decisions in the coming weeks and thereby embark upon the implementation phase of reform of the pension system. Box 6.1 provides an overview of the main features of the present Maltese pension system, while Box 6.2 presents the main recommended reforms to the current pension framework as proposed by the Pensions Working Group.

This Chapter provides an assessment of Malta's long-term sustainability of public finances by reviewing two sets of projections. The first set of projections being presented is based on the work of the Economic Policy Committee (EPC). The aim of this work is to produce common budgetary projections for the EU25 Member States. Such projections based on common assumptions as prepared by the EPC ensure comparability between countries. However, some of these assumptions diverge from those presented by the Pensions Working Group. Hence, a second set of projections is being presented on the basis of the work prepared by the Pension Working Group entrusted by Government to analyse the current pension system and to chart the way forward with regards to pension reform. A detailed explanation of the main divergencies in the assumptions is also provided in this Chapter.

6.1 Projections based on the work of the Economic Policy Committee

This section provides an analysis of the long-term sustainability of public finances on the basis of the 2005 EPC projections of age-related expenditure. Given the increased recognition that ageing populations, ever expensive healthcare services and the contribution of education expenditure will pose major economic, budgetary and social challenges in the long-term, the ECOFIN Council gave the EPC a mandate to produce a new set of long-run budgetary projections for all twenty-five EU Member States. This work is being carried out by the Ageing Working Group attached to the EPC. In order to enhance comparability across countries, consistency across expenditure items and the economic basis for the underlying assumptions, it was agreed that the projections should be made on the basis of a common demographic projection and common macroeconomic assumptions as provided by the EPC.

Box 6.1: The Current Pension System in Malta

The current pension scheme in Malta is based on the Social Security Act (Cap. 318). The Act provides for the two basic schemes: the Contributory Scheme and the Non Contributory Scheme. In the Contributory Scheme, the basic requirement for entitlement is that specific contribution conditions are satisfied. In the Non Contributory Scheme, the basic requirement is that the conditions of the means test are satisfied.

Through the process of targeting the Non Contributory Scheme has succeeded in the provision of additional assistance to certain specific categories such as, in the case of persons with a disability, in the case of single parents, as well as in the case of the family as a single unit. The Contributory Scheme is universal since it practically covers all strata of the Maltese society. The contributory scheme in Malta is a system where an employee, self-occupied or self-employed persons pays a weekly contribution as laid down by the Social Security Act. Due to the fact that such persons contribute during the period that he or she is gainfully active in order to provide for oneself when a later contingency occurs such as sickness, unemployment or retirement occurs, this system is referred to as a 'pay as you go' system.

Contributions are payable by all gainfully occupied persons between the age of 16 and the age of their retirement. The retirement age under the Social Security Act is 61 years for men and 60 years for women. The scheme allows for different types of contributions in order to extend coverage to all types of persons in employment. Employed persons pay Class One contributions, while the self-employed pay Class Two contributions. Class One contributions imply that any person employed under a contract of service in Malta is considered to be in insurable employment and subject to the payment of these contributions. For each person a tripartite contribution is payable: the employed person, the employer and the State each pay 10 per cent of the basic salary of the employee, with the contribution capped to a maximum wage ceiling. The rate of Class Two contributions is equally shared by the State and self-employed persons.

Pensions in Malta are determined by a formula based on the average of the best three consecutive calendar years out of the last ten years basic wages in the case of employees; and the average of the last ten years' net income in the case of self-employed persons. The pension amounts to two-thirds of this average wage or income. The full weight of a pension is payable to a person who has paid or has been credited with a yearly average of 50 contributions over a 30-year contributions period. Fewer years of contribution result in linearly reduced pensions, with the minimum years of contributions paid required to collect a pension set at nine years. Following the receipt of the pension, the pension income is subsequently increased by a cost of living increase statutorily provided by Government on an annual basis.

A critical feature of the Maltese pension system is the ceiling on income subject to contributions. Currently, this ceiling is 33.0 per cent higher than the average wage. It increases with the cost of living adjustment (COLA), which is lower than the annual increase in the inflation rate. Additionally, while pensions are indexed to wage growth, they are subject to a maximum which also grows with COLA.

Member States have been invited by the Ageing Working Group within EPC to run pension expenditure projections on the basis of national pension models. The pension projections presented in this Section are based on simulations carried out using the Pension Reform Option Simulation Toolkit (PROST) model. PROST is a model developed by the World Bank to analyse pension contributions, entitlements, revenue and expenditure over the long-term. Following the receipt of a full set of underlying assumptions from the EPC the PROST input files were calibrated, where possible to incorporate such assumptions. The variables included in the assumptions as provided by the EPC are the real GDP growth rates, inflation rates, population projections, participation rates and unemployment rates. A number of variables included in the assumptions as provided by the EPC were not incorporated in the PROST workings, primarily due to the fact that such variables are not required as PROST inputs. Accordingly, the budgetary projections covering the period up to 2050 include the following two main sets of assumptions:

Box 6.2: Recommendations for Pension Reform in Malta

In finalising its proposal for reforms to the current pension system the Pensions Working Group in Malta was motivated by one fundamental principle: that of securing a measured solution that balances adequacy and sustainability upon which consensus for the reform to the pensions system can be built. The following list includes the main reform options as highlighted in the final report of the Pensions Working Group:

- Reform measures must be introduced incrementally, in a phased manner and differentiating in varying degrees.
- The reformed pensions system must be calibrated by means of a Five Year Structured Review to reflect arising opportunities and challenges stemming from the macro-economic performance and behaviour of Malta over time.
- A Minimum Pension Guarantee should be established at approximately 50 per cent of the average wage.
- The Minimum Pension Guarantee, the post-retirement pensions and the Maximum Pension Income ceiling should be automatically indexed to a mechanism that is constituted of 70 per cent wages and 30 per cent inflation. The ceiling should be subject to a Control Lever that may be applied following the Five Year Structural Review that could result to an increase of the guarantee ceiling by the average percentage of wage increases occurring between one Five Year Structured Review and the other.
- The statutory retirement age for non-manual workers to be increased gradually to 65 years, with women reaching the 61-year threshold in January 2007. For those aged 45 years and below as at 1 January 2007 the retirement age should be 65 years.
- The contribution period for the accumulation of the Two-Thirds Pension should be increased from 30 years to 40 years.
- The calculation period of the Two-Thirds Pension should be on the basis of the average of the best 10 years from the last 20 years. It is proposed that the change will be of a gradual nature.
- The Pensions Working Group recommends an increase in the Maximum Pensionable income starting from 2007 (applicable to those aged 45 years and below as at 1 January 2007).
- The Second Pillar Pension Scheme should be introduced in a neutral manner. The neutral introduction of a mandatory Second Pillar Pension Scheme should be achieved by 'carving out' 1 per cent Employer and 1 per cent Employee from the Class One contribution and a 1 per cent Self-Employed from the Class Two contribution respectively into the Second Pillar Pension Scheme as from 1 January 2007.
- The contributions on the mandatory second pillar are to increase incrementally in line with developments in the economy.

Accordingly, the Pensions Working Group in the proposed recommendations seeks to achieve the following goals:

- Strengthen the adequacy level of the Two-Thirds Pension and in doing so ensure that this pension pillar remains as the central component of the pensions system.
- Complement the adequacy level of the Two-Thirds Pension through the introduction of a mandatory Second Pillar Pension.
- Secure the adequacy of the pensions system on a financial sustainable basis.

As regards the **demographic** evolution, the fertility rate is assumed to decline from 1.7 in 2003 to 1.5 in 2010, and subsequently rise to 1.6 by 2050. Life expectancy at birth for men is assumed to increase gradually to 81.3 years in 2050, whilst, in the case of women it is assumed that it will increase to 84.5 years by 2050. Another important assumption incorporated in the population projections deals with net migration, where it is assumed that this will amount to annual average of around 2,500 during the forecast period.

In terms of **macroeconomic** assumptions, inflation is assumed to be 2.0 per cent throughout the whole projection period, whilst GDP growth in real terms is assumed to reach 3.1 per cent by 2030 and then decline to 1.7 per cent by 2050. The unemployment rate (16-61 years) is assumed to increase to around 9.0 per cent by 2020, and then to decline slightly to 8.6 per cent in 2050. The female participation rate (16-60 years) is assumed to increase to 42.2 per cent by 2005 from 39.4 per cent in 2003, and subsequently increase to 58.3 per cent by 2050. The male participation rate (16-61 years) is assumed to increase to 84.6 per cent by 2005 from 83.6 per cent in 2003, reaching 86.4 per cent by 2050.

The projections presented in this Section are limited to the evolution of age-related public spending on the basis of 'no policy change' in line with the mandate and broad principles of the 2005 EPC projections of age-related expenditure. Preliminary estimates of these projections based on the EPC assumptions are shown in Statistical Appendix Table 7.

6.1.1 Demographic Developments

Population projections based on the EPC underlying assumptions are presented in Table 6.1, which shows a breakdown of the population into three main age brackets. Total population is projected to grow to around 487,000 by 2030 and increase further to around 513,000 by 2050. According to this scenario, the share of the sixty-one plus is projected to grow from 15.9 per cent in 2003 to 18.9 per cent in 2010 and then rise persistently to reach 29.6 per cent in 2050. This means that there will be around 152,000 Maltese aged 61 and over in 2050, compared to around 63,000 in 2003. Meanwhile, the share of the population in the 16-61 years bracket will start to decline from 2010, and by 2050 will be 8.6 percentage points lower compared to 2003.

The youth ratio (0-15 year olds as a proportion of those within the 16-61 year brackets) is expected to fall by 3.3 percentage points by 2050 compared to 2003. This ratio is anticipated to decline and reach a low in 2010, increase by 0.3 percentage points up to 2020, and then to stay constant at a level of 28.4 per cent. Meanwhile, the old-age dependency ratio (61 years and over as a share of the 16-61 years bracket) is projected to increase as from 2010. This effect will intensify particularly in 2020 where the old-age ratio will reach around 40.0 and then it will continue to rise to 53.9 by 2050. Until 2005, the decline in both the youth ratio and the old-

Population Trends
(based on Economic Policy Committee Assumptions)

Table 6.1

	2003	2005	2010	2020	2030	2050
			Total population			
0-15 yrs	80,742	79,181	75,154	77,048	79,654	79,854
16-61 yrs*	254,618	262,617	269,391	273,070	280,802	281,521
61+ yrs	63,169	64,549	80,509	109,553	126,975	151,659
Total	398,529	406,346	425,055	459,671	487,431	513,034
			Percentage of total population			
0-15 yrs	20.3	19.5	17.7	16.8	16.3	15.6
16-61 yrs*	63.5	64.6	63.4	59.4	57.6	54.9
61+ yrs	15.9	15.9	18.9	23.8	26.0	29.6
			Demographic dependency ratio			
0-15 yrs	31.7	30.2	27.9	28.2	28.4	28.4
61+ yrs*	24.8	24.6	29.9	40.1	45.2	53.9
Total	56.5	54.7	57.8	68.3	73.6	82.2
			Support ratio			
16-61 yrs*/61+ yrs	4.0	4.1	3.3	2.5	2.2	1.9

* Retirement age in Malta is 60 years for females and 61 years for males

Source: Calculations based on PROST

age ratio lead to a declining total dependency ratio. However, after 2010, the youth ratio records a slight increase while the old-age ratio records a higher persistent increase, thus leading to a continuous increase in the total dependency ratio. By 2050, the total dependency ratio will amount to 82.2 per cent, which means that every person in the working age population will have to support around 0.8 non-active persons compared to 0.6 non-active persons in 2003. Besides, given this background, the support ratio as from 2005 declines steadily to 1.9 by 2050. This means that while in 2003 there were around 4 persons in employment for a retired person, by 2050 there will only be around 2 employed persons compensating for a retired person.

6.1.2 The Cost of Ageing

Chart 6.1 presents the trend of the pensions system balance for Malta on the basis of the EPC assumptions. Pension payments in Malta mainly include the two-thirds retirement pension, survivors' pension and the invalids' pension. Occupational pension schemes in Malta are of minor importance. 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 modest deficit of 0.6 per cent of GDP. The deficit is projected to increase to 2.6 per cent of GDP by 2010, reach a maximum of 4.9 per cent of GDP by 2020, and thereafter to decline to reach 3.9 per cent of GDP by 2050.

This outcome mainly reflects developments in both Pay As You Go (PAYG) total revenue and expenditure over the forecast horizon. In particular, until 2020 the PAYG total expenditure as a ratio of GDP increases significantly compared to a declining PAYG total revenue to GDP ratio. After 2020, both PAYG revenue and expenditure as a percentage of GDP fall. These developments are mainly the result of a number of demographic and macroeconomic factors, and the ceiling imposed on revenues and payments inbuilt within the current Maltese pension system.

6.1.3 The Cost of Healthcare

Increased spending on healthcare in an ageing society will be a cause for concern, as it will make the tasks of achieving and sustaining a sound budgetary position more challenging. This section is based on preliminary estimates for healthcare expenditure projections based on common EPC assumptions. These preliminary estimates are being assessed by the national authorities.

Chart 6.1

Pensions System Balance

(based on Economic Policy Committee Assumptions)

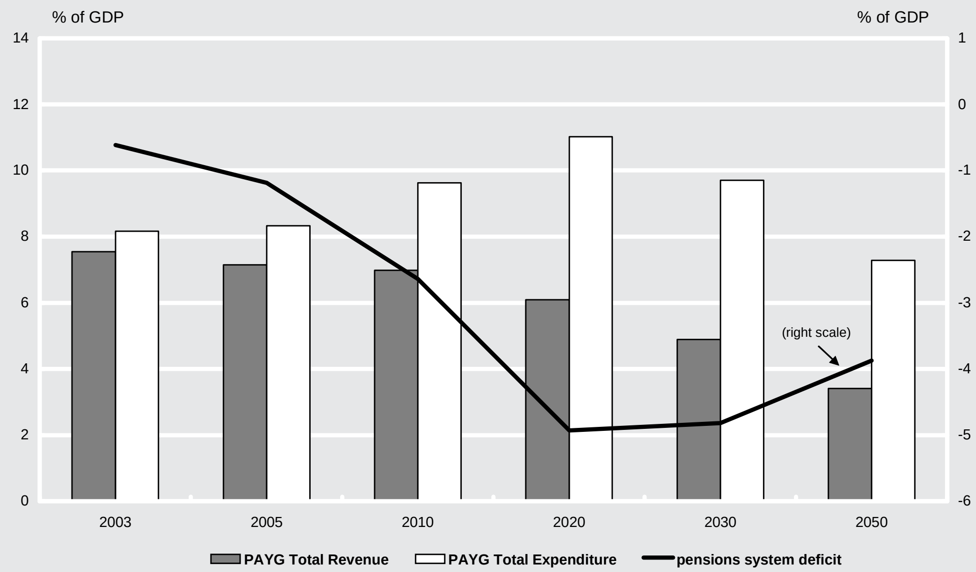


Chart 6.2

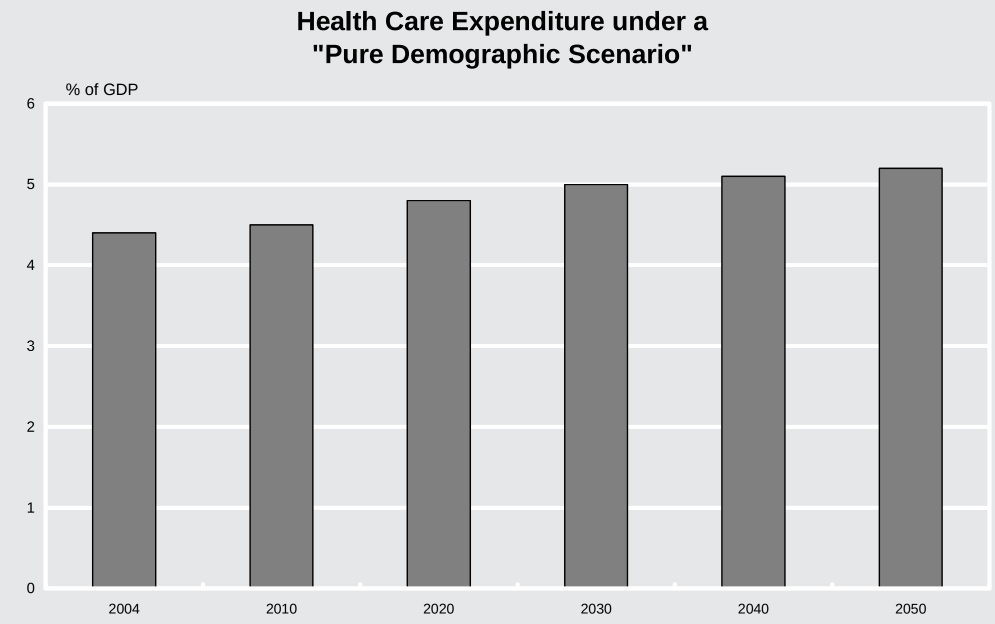
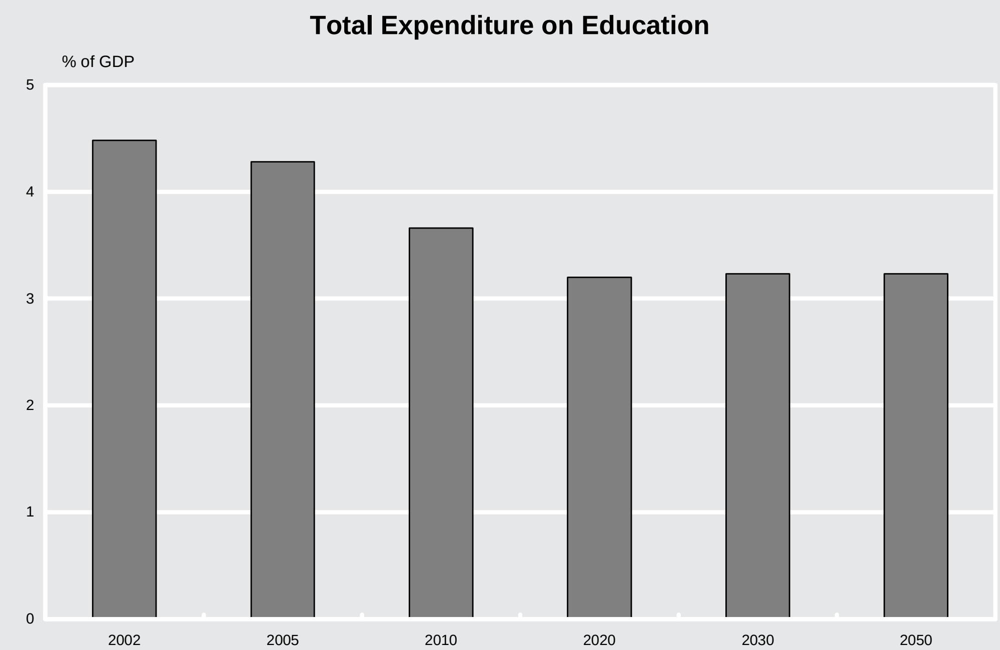


Chart 6.2 shows projections under a ‘Pure Demographic Scenario’ whereby healthcare costs evolve in line with GDP per capita. Expressed as a ratio of GDP, total expenditure on healthcare is anticipated to rise from 4.5 per cent in 2005, to 5.2 per cent by 2050, an increase of around 0.8 percentage points.

6.1.4 The Cost of Education

The cost of education is included in the assessment of long-term sustainability of public finances in order to determine whether trends in the number of children and young people will result in education expenditure, which can possibly offset the expected increase in old-age related expenditure. This section presents preliminary estimates for education expenditure projections based on EPC assumptions. These estimates are being assessed by the national authorities.

Chart 6.3



As indicated in Chart 6.3, these preliminary estimates forecast a reduction in the ratio of total education expenditure to GDP in Malta. In 2003, total expenditure on education as a share of GDP is 4.5 per cent, declining to 3.2 per cent by 2020 and remaining relatively stable thereafter up to 2050.

6.2 Projections based on the work of the Pensions Working Group

This Section present projections for pension expenditure based on work carried out by the Pensions Working Group using the World Bank's PROST model (starting year 2002). The following section includes a brief explanation of the main assumptions underlying these projections.

In projecting the Maltese population and its impact on pension expenditure for the period covering 2002 to 2050, two main sets of assumptions can be singled out:

As regards the **demographic** evolution, the fertility rate is assumed to decline from 1.4 in 2002 to around 1.3 in 2010, and subsequently increase gradually to 2.1 by 2050. Life expectancy at birth for men is assumed to increase gradually from 75.7 years in 2002 to 80.7 years in 2050. In the case of women it is assumed that it will increase from 80.0 years to 84.1 years in 2050. With regards to net migration, it is assumed that the population will increase annually by the addition of 500 immigrants, whereby 70 per cent are assumed to be in the age cohort of 18-45 years, while 30 per cent are assumed to be in the age cohort of 45-60 years. It is further assumed that the workforce will increase annually by the addition of 150 returned migrants, which are assumed to be in the age group of 36-40 years.

In terms of **macroeconomic** assumptions, the inflation rate is assumed at 2.2 per cent during the projected period of 2002 to 2050. Real GDP is projected to grow by 2.8 per cent in 2010, increasing gradually to reach around 4.0 per cent growth by 2030, and then to decline to around 3.0 per cent growth by 2050. The unemployment rate is assumed to fall to around 7.0 after 2015, from 8.0 per cent in 2002. The female participation rate (16-60 years) is assumed to increase to around 55.0 per cent by 2050 from around 38.0 per cent in 2002. The male participation rate (16-61 years) is assumed to record a modest decline from 85.2 per cent in 2002 to 82.3 per cent in 2030, and 80.2 per cent in 2050.

6.2.1 Demographic Developments

The projected demographic shift up to 2050 may be observed from Table 6.2, which shows the population divided into three separate age brackets. Population projections indicate that total population is projected to grow to around 410,000 by 2030 and then decline to around 387,000 twenty years later. It is pertinent to note that these population projections include the assumption that the workforce will increase annually by 500 immigrants and by 150 returned migrants. This contrasts with the EPC assumption that net migration will increase by an annual average of around 2,500 during the forecast period, thus leading to a higher influx of immigrants from that assumed under the Pensions Working Group population projections. This influx is leading to a significantly higher growth in Malta's population by the year 2050 under the projections based on the work of the EPC.

The challenge for the Maltese economy arises in particular when taking into account the envisaged changes in the demographic age composition. As from 2010 the age profile shifts to the dependency groups, particularly to age 61 and over. The share of the sixty-one plus is projected to grow from 15.9 per cent in 2002 to 20.0 per cent in 2010 and then rise sharply to a high of 33.8 per cent in 2050. There will be around 131,000 Maltese aged 61 and over in 2050, compared to around 63,000 in 2002. In addition, the population in the 16-61 year bracket will, starting from 2010, decline and by 2050 will be 22.1 per cent lower than that recorded in 2002.

Accordingly, the demographic dependency ratios are expected to exhibit substantial shifts over the forecast years. The youth ratio (0-15 year olds as a proportion of those within the 16-61 year brackets) is expected to fall by 1.9 percentage points during the next 50 years, meanwhile, the old-age dependency ratio (61 years and

Population Trends
(based on Pensions Working Group Assumptions)

Table 6.2

	2002	2005	2010	2020	2030	2050
			Total population			
0-15 yrs	80,002	73,899	65,410	59,877	61,068	58,576
16-61 yrs*	254,027	259,192	257,805	246,391	233,912	197,780
61+ yrs	63,267	65,544	80,862	102,050	114,541	130,716
Total	397,296	398,635	404,077	408,318	409,520	387,073
			Percentage of total population			
0-15 yrs	20.1	18.5	16.2	14.7	14.9	15.1
16-61 yrs*	63.9	65.0	63.8	60.3	57.1	51.1
61+ yrs	15.9	16.4	20.0	25.0	28.0	33.8
			Demographic dependency ratio			
0-15 yrs	31.5	28.5	25.4	24.3	26.1	29.6
61+ yrs*	24.9	25.3	31.4	41.4	49.0	66.1
Total	56.4	53.8	56.7	65.7	75.1	95.7
			Support ratio			
16-61 yrs*/61+ yrs	4.0	4.0	3.2	2.4	2.0	1.5

*Retirement age in Malta is 60 years for females and 61 years for males

Source: Calculations based on PROST

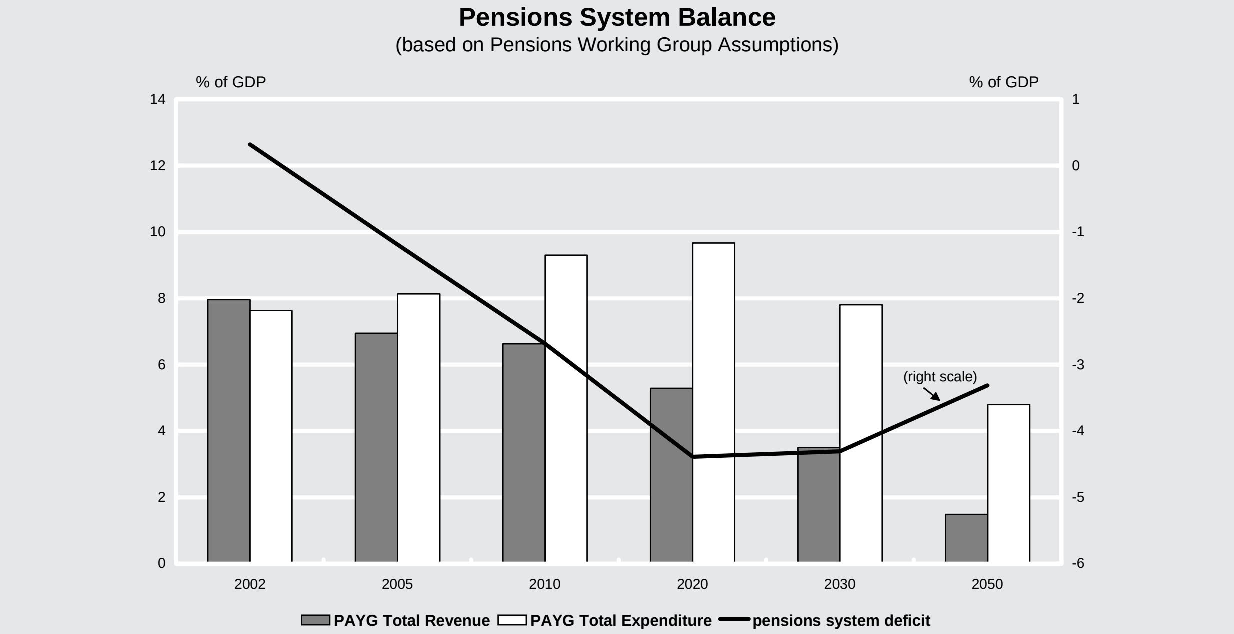
over as a share of the 16-61 year old population) is projected to increase as from 2005. The generation of 'baby-boomers' will move into the 61+ age bracket; an effect which will start to be felt around the year 2010 but which will intensify primarily in 2020 and continue to increase by 2050, when the old-age ratio will rise sharply by around 17.0 percentage points compared to 2030.

Until 2005, the declining youth ratio and the decline in the old-age ratio leads to a declining total dependency ratio. However, after 2010, the increase in the old-age ratio leads to a continuous increase in the total dependency ratio. By 2050, the total dependency ratio will amount to 95.7 per cent, which means that every person in the working age population will have to support around 1 non-active person compared to 0.6 non-active persons in 2002. Accordingly, as from 2010 the support ratio records a decline through the forecast period, reaching 1.5 by 2050. This means that while in 2002 there were around 4 persons in employment for each retired person, by 2050 there will only be around 1.5 employed persons compensating for a retired person. In contrast, under the EPC population projections, by 2050 there will be around 2 employed persons compensating for a retired person. These differences in projections are primarily attributable to different population development assumptions.

6.2.2 The Cost of Ageing

Chart 6.4 portrays the evolution of the PAYG expenditure and PAYG revenue in the first half of this century under an 'unchanged policy' scenario. For the purpose of this assessment total expenditure includes two-thirds retirement pensions, invalidity pensions and survivors' pensions based on contributions of employer and employees only. Occupational pension schemes in Malta are of minor importance. Table 6.3 highlights the Pensions Working Group projections of the pensions system balance and presents the main assumptions used to estimate the path of these results.

Chart 6.4



The current pension system in 2002 was running a small surplus of 0.3 per cent of GDP, while from 2005 onwards a deficit is recorded throughout. The deficit is projected to increase to 2.7 per cent of GDP by 2010 and 4.4 per cent of GDP by 2020, then declines to 3.3 per cent of GDP by 2050. PAYG total revenue as a percentage of GDP is expected to register declines over the forecast horizon, whilst PAYG expenditure as a percentage of GDP is expected to register increases up to around 2020 and then start to decline. Total PAYG revenue as a percentage of GDP is expected to reach 1.5 per cent of GDP in 2050, whilst PAYG expenditure will reach a peak of around 10.0 per cent of GDP in 2020, then fall to 4.8 per cent of GDP by 2050. Developments in these two important variables are the result of changes in population and GDP projections over time and also the result of the mechanics of the pension indexation rules of the current Maltese pension system.

It is pertinent to point out that the projections for PAYG total revenue and expenditure based on the assumption of the Pensions Working Group differ from those based on the assumption of the EPC on the premise that

Pensions Working Group Projections

Table 6.3

Percentages of GDP	**2002**	**2005**	**2010**	**2020**	**2030**	**2050**
PAYG Total Revenue	8.0	6.9	6.6	5.3	3.5	1.5
PAYG Total Expenditure	7.6	8.1	9.3	9.7	7.8	4.8
Pensions System Balance	0.3	-1.2	-2.7	-4.4	-4.3	-3.3
			Assumptions			
Real GDP growth rate (%)	-1.8	1.7	2.8	3.8	3.8	3.2
Inflation (%)	2.2	2.4	2.1	2.2	2.2	2.2
Male Participation rate (aged 16-61)	85.2	84.9	84.3	83.3	82.3	80.2
Female Participation rate (aged 16-60)	37.8	38.8	40.4	43.7	47.0	53.5
Population (000's)	397.3	398.6	404.1	408.3	409.5	387.1

Source: Calculations based on PROST

there are differences in both demographic and macroeconomic assumptions. In particular, the work by the Pensions Working Group shows a forecast with a higher nominal GDP over the forecast period than that presented under the EPC. Secondly, population projections differ markedly. Although both the Pensions Working Group and EPC scenarios follow the same trajectory forecast, expenditure and revenue as a percentage of GDP over the forecast period, under the projections based on the EPC assumptions the current deficit balance as a percentage of GDP is higher than under the work by the Pensions Working Group as from 2020 onwards.

7. Institutional Features of Public Finances

7. Institutional Features of Public Finances

The planning and control of public expenditure is vital to ensure that resources are used as efficiently and effectively as possible. Consequently, a public expenditure framework should aim to deliver a consistent and transparent administration of public finances within a long-term perspective.

In Malta, the Budget Speech for the following year is presented on an annual basis in Parliament towards the end of the year, usually late in October or November, and is followed by discussions in Parliament leading to approval of the Financial Estimates of the various Ministries. The Budget reflects the three-year Business and Financial Plans of the various Ministries and Government Departments, in perspective of Government's overall economic and social targets within the framework of the fiscal consolidation process.

The roll-on three-year Business and Financial Plans encourage Ministries and Government Departments to plan over the medium term as it offers the stability to plan operations on a sensible time scale without the fear of shocks otherwise avoidable and that resources may be cut back in the following year. The estimates of revenue and expenditure of each department are prepared by the respective Head of Department within the ambit of a financial package offered by the Ministry of Finance.

Expenditure proposals need to be backed with full information on their respective financial aspects and must be as accurate an estimate as possible of the funds likely to be required, in particular as regards future manpower requirements.

Furthermore, the Budgetary Operations Division, which incorporates the Budget Office, during the year, monitors the financial performance of Ministries and Departments, as well as public sector organisations, in particular, those that either depend on a Government subvention for their operations or contribute towards the Government Budget through part of their profits. In doing so, it ensures that the annual contributions voted in the Financial Estimates in favour of public organisations are efficaciously utilised. More specifically, the Financial Management Monitoring Unit, within the Ministry of Finance, supervises the financial operations of public entities.

Towards this aim, the Budgetary Operations Division regularly monitors closely recurrent and capital expenditures and revenue collection performances with the aim that budgetary targets and projections are adhered to, making recommendations in order that Government may take corrective measures well in time where trends indicate overspending or revenue shortfalls by year-end. This is made possible through the monthly evaluation of financial reports of Government Departments and management accounts of public entities.

The Accountant General, as the chief accounting officer of Government, manages and supervises the accounting operations of Government, thereby supervising public expenditure to ensure that no payment is made which is not covered by proper authority. The Accountant General is also responsible for the day-to-day cash-flow position of the operations of Government.

Subsequently, the accounts of all departments and offices of Government administering, holding, or using funds belonging to Government are audited and reported upon annually by the Auditor General to the House of Representatives.

Further scrutiny on the financial conduct of Government Departments is exercised by the Parliamentary Standing Committee on Public Accounts. The main duty of the Committee is the examination of the Reports produced by the Auditor General of the economy, efficiency and effectiveness with which Government Departments and other bodies have utilised their resources to further their objectives. The Committee is chaired by a member of the Opposition to ensure a more transparent scrutiny of how public finances have been utilised.

As regards Public Debt, the Treasury implements the borrowing plan based on the strategy approved by Government. Moreover, it prepares debt sustainability analysis to assess the long-term sustainability of projected public sector borrowing levels.

Annex 1: Methodological and Estimation Issues related to the Output Gap and the Cyclically-Adjusted Budget Balance

1. Potential Output

The methodology used in the estimation of the output gap for Malta is based on the European Commission's Production Function method. Potential output (Y^P) is determined by potential employment (L^P), the capital stock (*K*) and Total Factor Productivity (*TFP*). Assuming that the production function takes the Cobb-Douglas form, potential output can be characterised as follows:

$$Y_t^P = (L_t^P TFP_t)^{\alpha} K_t^{1-\alpha} \tag{1}$$

Potential employment is a function of the population of working age (*popw*), trend participation rate (*parts*), the non-accelerating inflation rate of unemployment (*NAIRU*) and the average annual hours worked per person employed (*h*):

$$L_t^P = popw_t \cdot parts_t \cdot (1 - NAIRU_t) \cdot h_t \tag{2}$$

Capital accumulation is determined by the investment to potential output ratio (*iy*):

$$I_t = iy_t \cdot Y_t^P \tag{3}$$

while

$$K_t = I_t + (1 - dep) \cdot K_{t-1} \tag{4}$$

where *dep* is the depreciation rate. The *NAIRU* is calculated as follows:

$$NAIRU_t - u_t = lur_t + \frac{\Delta^2 ulc_t}{\beta_{ULC}} \tag{5}$$

where *u* are shocks to the *NAIRU* and *lur* represents the harmonised unemployment rate. The unit labour costs (*ulc*) are estimated as the difference between compensation per employee and real output per employee. β_{ULC} is the wage elasticity parameter with respect to the harmonised unemployment rate. The *NAIRU* is obtained by filtering the right hand side of (5). The wage elasticity parameter (β_{ULC}) for Malta was estimated at 10.9 by DG ECFIN in the 'Application of the Production Function Approach to the Acceding Member States' (ECFIN/473/03).

2. The Cyclically-Adjusted Budget Balance (CAB)

The cyclically-adjusted budget balance (*CAB*) is derived by deducting the cyclical component of the budget balance from the nominal figure:

$$CAB_t = b_t - \varepsilon \cdot OG_t \tag{6}$$

where b is the nominal budget balance-to-GDP ratio, ε is the budgetary sensitivity parameter and OG is the output gap. The output gap is defined as:

$$OG_t = \frac{Y_t - Y_t^P}{Y_t^P} \cdot 100 \tag{7}$$

where potential output (Y^P) is defined in (1). The budgetary sensitivity parameter (ε) is obtained by aggregating the elasticities of individual budgetary items and transforming the aggregated elasticities into sensitivities. Overall revenue elasticity (η_r) is obtained by aggregating individual revenue elasticities ($\eta_{r,i}$) using the share of each component in total current tax burden as weight:

$$\eta_r = \sum_i \eta_{r,i} \frac{R_i}{R} \tag{8}$$

where R represents the current tax burden. The revenue components (R_i) are personal income tax, corporate tax, social security contribution and indirect taxes. Similarly, the elasticity of expenditure components (η_g) is calculated as:

$$\eta_g = \sum_i \eta_{g,u} \cdot \frac{G_u}{G} \tag{9}$$

where $\eta_{g,u}$ represents the elasticity of unemployment-related expenditure and G_U/G is the share of unemployment-related expenditure in total current primary expenditure. The budgetary elasticities are transformed into sensitivities parameters as follows:

$$\varepsilon_r = \eta_r \cdot \frac{R}{Y}, \qquad \varepsilon_g = \eta_g \cdot \frac{G}{Y} \tag{10}$$

where R/Y and G/Y are the share of the current tax burden in GDP and the share to primary current expenditure in GDP, respectively. Consequently the overall budgetary sensitivity parameter (ε) is calculated as the difference between the revenue and expenditure elasticities:

$$\varepsilon = \varepsilon_r - \varepsilon_g \tag{11}$$

The overall budgetary sensitivity parameter (ε) was estimated at 0.37 by DG ECFIN in the 'New and Updated Budgetary Sensitivities for the EU Budgetary Surveillance' (ECFIN/B/6(2005)REP54508).

3. Estimation Issues

Potential output was estimated using the RATS code 'aut05_eu10.prg' downloadable from the CIRCA website. The code was amended in order to extend the forecast period by one period. The program calls two further data files, 'aut05.rat' which contains the main macroeconomic variables and 'popw2004.rat' that contains long-term developments in the working-age population. The 'aut05.rat' datafile was updated using the latest national accounts data as well as the macroeconomic forecasts over the period 2005-2008. The historical data on working-age population in 'aut05.rat' was amended and now it reflects the series obtainable from National Sources. Meanwhile, the working-age population projections contained in 'aut05.rat' and 'popw2004.rat' have been amended and now reflect the projections of the Pensions Working Group (further details on these population projections are provided in Section 6.2.1).

Statistical Appendix

Macroeconomic Prospects

Table 1a

Percentages unless otherwise indicated	ESA Code	2004[1]	2004	2005[2]	2006	2007	2008
1. GDP at constant (2000) prices	B1g	1,651.5	0.2	0.9	1.1	1.2	2.0
2. GDP at current market prices	B1g	1,828.0	2.0	3.9	3.9	3.9	4.0
Components of real GDP							
3. Private final consumption expenditure[3]	P3	1,073.1	-0.7	-0.9	-0.2	0.6	1.0
4. General government final consumption expenditure	P3	352.2	0.7	-1.3	-0.7	0.4	0.6
5. Gross fixed capital formation	P51	348.4	4.4	11.3	3.3	-3.8	-1.4
6. Changes in inventories and net acquisition of valuables as a % of GDP	P52+P53	-	1.1	1.2	1.2	1.3	1.4
7. Exports of goods and services	P6	1,560.3	0.3	-4.3	2.1	3.4	4.1
8. Imports of goods and services	P7	1,700.8	2.2	-3.2	1.2	1.6	2.5
Contribution to real GDP growth							
9. Final domestic demand		-	0.6	2.1	0.5	-0.4	0.5
10. Change in inventories and net acquisition of valuables	P52+P53	-	1.6	1.7	0.0	0.1	0.2
11. External balance of goods and services	B11	-	-2.0	-2.7	0.6	1.5	1.3

(1) Lm million

(2) Forecasts from 2005 onwards

(3) Includes NPISH final consumption expenditure

Price Developments

Table 1b

Percentages unless otherwise indicated	ESA Code	2004[1]	2004	2005[2]	2006	2007	2008
1. GDP deflator		110.7	1.8	3.0	2.7	2.7	2.0
2. Private consumption deflator		107.5	3.4	3.4	3.1	3.1	1.9
3. Retail Price Index		103.6[3]	2.8	2.8	3.1	2.5	1.9
4. Public consumption deflator		117.0	3.4	1.5	2.6	2.5	1.7
5. Investment deflator		109.1	1.2	2.9	2.9	1.4	1.3
6. Export price deflator (goods and services)		88.8	-4.4	1.8	2.1	1.0	0.1
7. Import price deflator (goods and services)		89.6	-2.2	1.9	2.3	0.7	-0.5

(1) Index (base 2000 unless otherwise indicated)

(2) Forecasts from 2005 onwards

(3) Index (base December 2002)

Labour Market Developments

Table 1c

Percentages unless otherwise indicated	ESA Code	2004	2004	2005[1]	2006	2007	2008
1. Employment, persons		137.1[2]	0.3	0.3	0.9	1.0	1.1
2. Employment, hours worked		…	…	…	…	…	...
3. Unemployment rate		-	5.6	5.1	4.9	4.7	4.7
4. Labour Productivity, persons[3]		12,045.0	-0.1	0.6	0.2	0.2	0.8
5. Labour Productivity, hours worked		…	…	…	…	…	...
6. Compensation of employees (Lm million)	D1	864.4	1.0	3.0	4.0	4.0	3.8

[1] Forecasts from 2005 onwards

[2] Thousands

[3] Real GDP per person employed

Sectoral Balances

Table 1d

Percentages of GDP	ESA Code	2004	2005	2006	2007	2008
1. Net lending/ borrowing						
vis-à-vis the rest of the world	B.9	-8.6	-	-	-	-
of which:						
Balance on goods and services		-7.6	-8.0	-7.6	-6.0	-4.3
Balance of primary incomes and transfers		-2.7	-	-	-	-
Capital account		1.6	-	-	-	-
2. Net lending/ borrowing of the private sector	B.9/ EDP B.9	-3.5	-	-	-	-
3. Net lending/ borrowing of general government	B.9	-5.1	-3.9	-2.7	-2.3	-1.2
4. Statistical discrepancy		4.8	-	-	-	-

General Government Budgetary Developments

Table 2

Percentages of GDP		ESA code	2004[1]	2004	2005	2006	2007	2008
Net Lending (EDP B9) by sub-sectors								
1.	General Government	S13	-93.9	-5.1	-3.9	-2.7	-2.3	-1.2
2.	Central Government	S1311	-94.1	-5.1	-3.9	-2.7	-2.3	-1.2
3.	State Government	S1312	-	-	-	-	-	-
4.	Local Government	S1313	0.2	-	-	-	-	-
5.	Social Security Funds	S1314	-	-	-	-	-	-
General Government								
6.	Total Revenue	TR	797.9	43.6	45.7	45.9	42.7	40.9
7.	Total Expenditure	TE	891.8	48.8	49.6	48.6	44.9	42.1
8.	Net Lending / borrowing	EDP B9	-93.9	-5.1	-3.9	-2.7	-2.3	-1.2
9.	Interest expenditure (excl. FISIM)	EDP D41	75.8	4.1	4.1	4.0	3.8	3.7
9a.	FISIM		…	…	…	…	…	…
10.	Primary Balance		-18.0	-1.0	0.3	1.4	1.5	2.4
Selected Components of Revenue								
11.	Total Taxes		511.7	28.0	29.8	30.4	30.5	30.3
11a.	Taxes on production and imports	D2	285.2	15.6	16.5	17.3	17.3	17.2
11b.	Current Taxes on Income, Wealth, etc.	D5	222.5	12.2	13.1	12.9	13.0	13.0
11c.	Capital Taxes	D91	4.0	0.2	0.2	0.2	0.2	0.2
12.	Social Contributions	D61	155.1	8.5	8.4	8.2	8.2	7.9
13.	Property Income	D4	49.7	2.7	2.0	1.1	1.2	1.1
14.	Other		81.4	4.5	5.5	6.3	2.8	1.5
15=16	Total Revenue	TR	797.9	43.6	45.7	45.9	42.7	40.9
p.m.	Tax Burden		666.8	36.5	38.2	38.6	38.7	38.2
Selected Components of Expenditure								
16.	Collective Consumption	P32	191.9	10.5	10.9	10.7	10.4	10.3
17.	Total Social Transfers	D62+D63	254.9	13.9	14.4	14.2	13.8	13.6
18=9	Interest expenditure	EDP D41	75.8	4.1	4.1	4.0	3.8	3.7
19.	Subsidies	D3	35.5	1.9	2.0	1.8	1.6	1.4
20.	Gross fixed capital formation	P51	82.2	4.5	6.6	6.1	4.5	3.0
21.	Other		251.4	13.8	11.5	11.8	10.8	10.2
22=7	Total Expenditure	TE	891.8	48.8	49.6	48.6	44.9	42.1
p.m.	Compensation of employees	D1	282.1	15.4	15.1	15.0	14.8	14.5

[1] Lm million

General Government Expenditure by Function

Table 3

	Percentages of GDP	COFOG code	2003	2008
1.	General public services	1	6.7	…
2.	Defence	2	0.9	…
3.	Public order and safety	3	1.8	…
4.	Economic affairs	4	10.5	…
5.	Environment protection	5	0.9	…
6.	Housing and community amenities	6	1.6	…
7.	Health	7	6.5	…
8.	Recreation, culture and religion	8	0.6	…
9.	Education	9	6.6	…
10.	Social protection	10	14.3	…
11.	Total Expenditure	TE	50.4	42.1

General Government Debt Developments[1]

Table 4

Percentages of GDP	2004	2005	2006	2007	2008
1. Gross debt	76.7	76.7	70.8	68.9	67.3
2. Change in gross debt ratio	3.9	0.0	-6.0	-1.8	-1.6
Contributions to changes in gross debt					
3. Primary balance	1.0	-0.3	-1.4	-1.5	-2.4
4. Interest expenditure[2] and nominal GDP growth	2.7	1.3	1.1	1.1	1.0
5. Stock-flow adjustment	0.2	-1.0	-5.8	-1.4	-0.2
p.m. implicit interest rate on debt	5.8	5.6	5.5	5.5	5.5

[1] Developments in the debt- to-GDP ratio depend on: $$\frac{D_t}{Y_t}-\frac{D_{t-1}}{Y_{t-1}}=\frac{PD_t}{Y_t}+\left(\frac{D_{t-1}}{Y_{t-1}}\cdot\frac{i_t-y_t}{1+y_t}\right)+\frac{SFA_t}{Y_t}$$

where t denotes a time subscipt, D, PD, Y and SFA are the government debt, primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth.

[2] Excluding FISIM

Cyclical Developments

Table 5

Percentages of GDP	ESA code	2004	2005	2006	2007	2008
1. Real GDP growth (%)		0.2	0.9	1.1	1.2	2.0
2. Net lending of general government	EDP B.9	-5.1	-3.9	-2.7	-2.3	-1.2
3. Interest expenditure (excl. FISIM recorded as consumption)	EDP D.41	4.1	4.1	4.0	3.8	3.7
4. Potential GDP growth (%)		1.7	2.2	2.3	2.0	1.5
5. Output Gap		-2.2	-3.5	-4.5	-5.3	-4.9
6. Cyclically budgetary component		-0.8	-1.3	-1.7	-2.0	-1.8
7. Cyclically-adjusted balance (2-6)		-4.3	-2.6	-1.0	-0.3	0.6
8. Cyclically-adjusted primary balance (7-3)		-0.2	1.5	3.0	3.5	4.3

Divergence from the November 2004 Update of Convergence Programme

Table 6

Percentages of GDP	ESA code	2004	2005	2006	2007	2008
GDP growth (%)						
previous update		0.6	1.5	1.8	2.2	…
latest update		0.2	0.9	1.1	1.2	2.0
Difference		-0.4	-0.6	-0.7	-1.0	-
Actual budget balance	EDP B.9					
previous update		-5.2	-3.7	-2.3	-1.4	…
latest update		-5.1	-3.9	-2.7	-2.3	-1.2
Difference		0.1	-0.2	-0.4	-0.9	-
Gross debt levels						
previous update		73.2	72.0	70.5	70.4	…
latest update		76.7	76.7	70.8	68.9	67.3
Difference		3.5	4.7	0.3	-1.5	-

Long-term Sustainability of Public Finances

Table 7

Percentages of GDP	2003	2005	2010	2020	2030	2050
Total Expenditure	-	-	-	-	-	-
of which: age-related expenditures	-	-	-	-	-	-
Pension expenditure	7.6	7.8	9.1	10.5	9.3	7.2
Social security pensions*	-	-	-	-	-	-
Old-age and early pensions	3.9	4.1	5.4	7.2	7.1	6.6
Other pensions (disability, survivors)	3.7	3.7	3.7	3.3	2.2	0.6
Occupational pensions	-	-	-	-	-	-
Health care**	…	4.5	4.8	5.0	5.1	5.2
Long-term care	…	…	…	…	…	…
Educational expenditure**	4.5	4.3	3.7	3.2	3.2	3.2
Other age-related expenditures - unemployment benefit spending**	…	1.2	1.2	1.0	1.0	1.0
Interest expenditure	-	-	-	-	-	-
Total revenue	-	-	-	-	-	-
of which: property income	-	-	-	-	-	-
of which: from pensions contributions	7.5	7.1	7.0	6.1	4.9	3.4
Pension reserve fund assets	-	-	-	-	-	-
of which: consolidated public pension fund assets	-	-	-	-	-	-
of which: consolidated public pension fund assets	-	-	-	-	-	-
			Assumptions			
Labour productivity growth	1.5	1.4	0.9	2.4	2.7	1.7
Real GDP growth	1.5	2.0	2.5	2.7	3.1	1.7
Participation rate males (aged 16-61)	83.6	84.6	85.8	86.3	86.4	86.4
Participation rate females (aged 16-60)	39.4	42.2	48.1	55.3	57.8	58.3
Total participation rates (aged 16-61)	61.2	63.2	66.7	70.4	71.6	71.7
Unemployment rate (aged 16-61)	8.0	9.2	9.4	9.0	8.8	8.6
Population aged 61+ over total population	15.9	15.9	18.9	23.8	26.0	29.6

* Malta's two-thirds pension included under the pension expenditure category

** Preliminary estimates based on Economic Policy Committee Assumptions

Basic Assumptions

Table 8

	2004	2005	2006	2007	2008
Short-term interest rate	3.0	3.3	3.3	3.3	3.3
Long-term interest rate	4.7	4.4	4.4	4.4	4.4
USD/EUR exchange rate (level)	1.2	1.2	1.2	1.2	1.2
Nominal effective exchange rate (annual averages)	1.0	1.0	1.0	1.0	1.0
World GDP growth, excluding EU	5.7	5.1	4.9	4.6	4.6
EU-25 GDP growth	2.5	1.5	2.1	2.4	2.4
Growth of relevant foreign markets	2.3	1.3	1.8	1.8	1.8
World import volumes, excluding EU	11.6	8.6	8.7	8.4	8.4
Oil prices, (Brent, USD/barrel)	37.8	55.0	61.4	60.3	60.3