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MALTA: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE NOVEMBER 2007 STABILITY PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not. Malta's first stability programme was submitted on 30 November 2007.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission, was finalised on 26 February 2008. Comments should be sent to Ivan Ebejer (ivan.ebejer@ec.europa.eu). The main aim of the analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

The analysis takes into account (i) the Commission services' autumn 2007 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. Technical issues are explained in an accompanying "methodological paper" prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 13 February 2008. The ECOFIN Council is expected to adopt its opinion on the programme on 4 March 2008.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

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SUMMARY AND CONCLUSIONS

As part of the preventive arm of the Stability and Growth Pact, each Member State that uses the single currency, such as Malta, has to submit a stability programme and annual updates thereof. Malta submitted its first stability programme, covering the period 2007-2010, on 30 November 2007.

On 1 January 2008, Malta joined the euro area with GDP growth on a recovery path since 2004. During the early 2000s, weak economic performance was a result of both external factors, to which Malta is particularly exposed, and domestic structural weaknesses. Productivity contracted by an annual average of around 1% between 2001 and 2003. In addition, significant wage growth led to a sharp rise in unit labour cost and, as a result, to a loss in external competitiveness. Since 2004, economic performance improved primarily due to favourable cyclical conditions but also owing to wage moderation and a recovery in productivity. On the fiscal side, euro area entry followed a period of considerable consolidation, a decline in debt as a percent of GDP as well as progress towards lower inflation. Enhancing the room for manoeuvre of fiscal policy, which could be achieved by pursuing further budgetary consolidation and via expenditure reforms, namely in the fast-increasing healthcare spending, represents a challenge for Malta's adjustment capacity to asymmetric disturbances. Moreover, such spending reforms would improve the long-term sustainability of public finances, as well as allow a re-direction of expenditure to growth-enhancing categories, thereby boosting productivity. Higher productivity, together with a continuation of wage moderation would bolster competitiveness – another challenge facing the Maltese economy, particularly within a euro area context.

The macroeconomic scenario underlying the programme envisages real GDP to grow by 3.5% in 2007, slow down in 2008 and accelerate thereafter to reach 3.4% by 2010. For the programme period, the contribution of domestic demand is expected to increase on account of sustained private consumption and investment expenditure. According to the programme, exports are expected to recover and grow at a fast pace throughout the outlook period, peaking in 2009. Assessed against currently available information[1], this scenario appears to be based on plausible growth assumptions for 2007. For the period 2008-2010, GDP growth projections seem favourable, mainly due to strong contribution of net exports projected in the outer years of the programme period. The programme's projections for inflation appear realistic and are in line with the Commission services' autumn 2007 forecast. However, the possibility of further increases in public sector wages, which could lead to overall wages rising in excess of productivity gains, may entail a less favourable development in Malta's competitiveness than implied by the stability programme. The Maltese economy seems to be in good economic times throughout this period, but some risks exist in the outer years.

For 2007, the general government deficit is estimated at 1.6% of GDP in the stability programme, against a target of 2.3% of GDP set in the last update of the convergence programme. Net of one-off transactions (consisting mainly of sale of land, which are conventionally recorded as negative expenditure), however, the 2007 deficit outturn is

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[1] The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

broadly in line with the target in the 2006 convergence programme. As the structural adjustment in 2007 now seems below a ½ percentage point of GDP, compared to around 1 percentage point as planned in the last update of the convergence programme, budgetary implementation is not in line with the invitation in the Council opinion of 27 February 2007 on the previous programme[2] to "pursue adequate progress towards the MTO as foreseen in the programme".

As in the last update of the convergence programme, the main budgetary goal outlined in the stability programme is to pursue further fiscal consolidation, with the overarching objective of achieving the MTO of a balanced position in structural terms (i.e. cyclically-adjusted net of one-off and other temporary measures) by 2010. The general government balance is planned to improve from a deficit of 1.6% of GDP in 2007 to a surplus of 0.9% of GDP by 2010. The nominal adjustment is to be achieved through a decline in the primary expenditure ratio of over 3½ percentage points of GDP, which more than offsets a fall in the revenue ratio of 1½ percentage points of GDP. Lower recourse will be made to deficit-reducing one-off measures than in the recent past. The structural balance is projected to improve by 2 percentage points of GDP in the period 2007-2010. Against the background of a broadly unchanged macroeconomic scenario, the budgetary targets for 2008 and 2009 in the stability programme are less ambitious than in the 2006 update, by around a ¼ of a percentage point of GDP. Government gross debt, estimated to fall to around 63% of GDP in 2007, still above the 60% of GDP Treaty reference value, is projected to further decline by almost 10 percentage points over the programme period.

The budgetary outcomes could be worse than projected in the programme. For 2008, the assumption that the changes to the personal income tax system will be covered by other, typically volatile revenue items, such as capital gains tax and profit taxes, constitutes a risk. There is also a possibility of expenditure slippages linked, for instance, to the decision to subsidise utility prices without compensating measures. Additionally, generous wage increases granted to health sector employees could lead to similar claims within the rest of the public sector. For 2009 and 2010, outcomes could be worse than targeted due to the favourable macroeconomic scenario underlying the programme's projections (although tax projections for these years seem cautious assuming that no discretionary tax reductions are envisaged) and also due to the lack of information on measures underpinning the consolidation process. In view of these negative risks to the budgetary targets, the evolution of the debt ratio is likely to be less favourable than projected in the programme, especially after 2008. On the positive side, the outturn of expenditure as ratio of GDP in the past years has consistently been lower than planned in successive programmes. Furthermore, Malta's track record of achieving its targets for the general government deficit has been good, as outcomes have usually been better than planned.

In view of this risk assessment, the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by 2010, as envisaged in the programme. However, a sufficient safety margin against breaching the 3% of GDP deficit threshold would be provided from 2008. The planned consolidation is in line with the Stability and Growth Pact, which prescribes an annual improvement in the structural balance of 0.5% of GDP as a benchmark and a larger effort provided that Malta remains in good economic times. However, given the risks above, the pace of adjustment towards the

2 OJ C 72, 27.3.2007, p. 9.

MTO implied by the programme should be backed up with measures, especially in the years 2009 and 2010. Finally, taking into account the risks to the debt projections, the debt ratio seems to be sufficiently diminishing towards the reference value over the programme period and would fall below it in 2009.

Malta appears to be at medium risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is significantly lower than the EU average, with pension expenditure decreasing as a share of GDP over the long-term. Yet, the 2006 pension reform, which aims both at increasing the retirement age and improving the level of pension, is likely to imply higher spending over the long run. In addition, the current level of gross debt is still above the Treaty reference value. The budgetary position in 2007 as estimated in the programme, which is better than the starting position of the previous programme, contributes to offsetting the projected long-term budgetary impact of ageing populations. Improving the budgetary position, including by enhancing the efficiency and flexibility of public spending, such as in the fast-increasing healthcare expenditure that is also subject to the impact of ageing, would contribute to reducing the risks to the sustainability of public finances.

Malta's national reform programme identified the sustainability of public finances, competitiveness, the environment, employment and education and training as key challenges. On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Malta's national reform programme.[3] The Commission's assessment was that Malta has made good progress in the implementation of its national reform programme over the period 2005-2007. Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that the Council recommends Malta to give highest priority to the challenges in the areas of: competition and state aid, attracting more people into the labour market, tackling undeclared work and making work pay. In addition, Malta should also focus on the areas of: healthcare reform, improving further the regulatory environment, diversifying energy sources, raising educational attainment and reducing early school leaving. The stability programme seems to be to some extent consistent with the October 2007 implementation report of the national reform programme. In particular, the programme's budgetary projections take into account the public finance implications of the measures identified in the national reform programme. The measures in the area of public finances envisaged in the stability programme seem consistent with those foreseen in the national reform programme. However, healthcare reform - a key area in public finance identified in the national reform programme - is not dealt with in the stability programme. The budgetary strategy in the programme is partly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines and with the guidelines for the euro area in the area of budgetary policies issued in the context of the Lisbon strategy.

The overall conclusion is that the stability programme envisages continued progress towards reaching the MTO, which is planned to be achieved by 2010, brought about by expenditure restraint in a context of sustained economic growth. The reduction of the general government gross debt is planned to proceed at a satisfactory pace and is expected to fall below the 60% of GDP reference value by 2009. However, there are

[3] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

risks to the achievement of the budgetary targets linked to a reliance on volatile tax revenue items in 2008, the envisaged degree of spending restraint, the favourable macroeconomic outlook after 2008 and the lack of information of the underlying measures, in particular as regards the envisaged continued restraint in the public wage bill. These may hinder the achievement of the MTO by the target year 2010. In addition, Malta's competitiveness within the euro area may be at risk in the event of a departure from wage moderation in the public sector, which may spill over to the private sector. In terms of the long-term sustainability of public finances, Malta is at medium risk.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	**SP Nov 2007**	**3.2**	**3.5**	**3.1**	**3.2**	**3.4**
	COM Nov 2007	3.2	3.1	2.8	2.9	n.a.
	CP Dec 2006	*2.9*	*3.0*	*3.1*	*3.1*	*n.a.*
HICP inflation (%)	**SP Nov 2007**	**2.6**	**0.9**	**2.5**	**2.3**	**2.1**
	COM Nov 2007	2.6	0.8	2.5	2.2	n.a.
	CP Dec 2006	*3.1*	*2.2*	*2.1*	*2.0*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Nov 2007**	**-1.9**	**-0.8**	**-0.1**	**0.5**	**1.9**
	COM Nov 2007[2]	-1.5	-0.6	-0.1	0.5	n.a.
	CP Dec 2006	*-2.1*	*-1.3*	*-0.3*	*0.9*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Nov 2007**	**-3.7**	**-0.5**	**0.2**	**3.2**	**5.5**
	COM Nov 2007	-3.7	-0.9	-0.6	0.0	n.a.
	CP Dec 2006	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
General government balance (% of GDP)	**SP Nov 2007**	**-2.5**	**-1.6**	**-1.2**	**-0.1**	**0.9**
	COM Nov 2007	-2.5	-1.8	-1.6	-1.0	n.a.
	CP Dec 2006	*-2.6*	*-2.3*	*-0.9*	*0.1*	*n.a.*
Primary balance (% of GDP)	**SP Nov 2007**	**1.0**	**1.7**	**2.0**	**2.9**	**3.8**
	COM Nov 2007	1.0	1.5	1.6	2.1	n.a.
	CP Dec 2006	*1.1*	*1.1*	*2.5*	*3.2*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**SP Nov 2007**	**-1.8**	**-1.3**	**-1.2**	**-0.3**	**0.3**
	COM Nov 2007	-2.0	-1.6	-1.5	-1.2	n.a.
	CP Dec 2006	*-1.8*	*-1.8*	*-0.8*	*-0.2*	*n.a.*
Structural balance[3] (% of GDP)	**SP Nov 2007**	**-2.5**	**-2.1**	**-1.4**	**-0.5**	**0.1**
	COM Nov 2007	-2.7	-2.3	-1.7	-1.2	n.a.
	CP Dec 2006	*-2.9*	*-2.0*	*-1.0*	*-0.4*	*n.a.*
Government gross debt (% of GDP)	**SP Nov 2007**	**64.7**	**62.9**	**60.0**	**57.2**	**53.3**
	COM Nov 2007	64.7	63.1	61.3	59.2	n.a.
	CP Dec 2006	*68.3*	*66.7*	*63.2*	*59.4*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of of 2.3%, 2.2%, 2.3% and 2.3% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.7% of GDP in 2006, 0.8% in 2007, 0.2% in 2008, 0.2% in 2009 and 0.1% in 2010; all deficit-reducing according to the 2007 stability programme and 0.7% of GDP in 2006, 0.8% in 2007, 0.2% in 2008 and 0% in 2009; all deficit-reducing in the Commission services' autumn forecast.

Source :

Stability programme (SP); Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

Malta submitted its first stability programme covering the period 2007 to 2010 on 30 November 2007.[4] The programme fully reflects the Budget for 2008 as approved by Parliament on 15 October 2007. The programme is a government document and will not be discussed in Parliament.

This assessment is further structured as follows. Section 2 discusses key challenges for public finances in Malta, with a particular focus on public expenditure in Malta: past developments and future issues. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the stability programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the National Reform Programme and its implementation reports and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key economic indicators of past economic performance (Annex 2).

2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON PUBLIC EXPENDITURE IN MALTA: PAST DEVELOPMENTS AND FUTURE ISSUES

2.1. Introduction

Malta's fiscal consolidation during 1998-2006 has been notable even in periods of weak economic growth. While most fiscal adjustment episodes before EU accession were underpinned by increases in revenue[5], the focus in recent years has increasingly turned to expenditure control. The experience in the EU suggests that expenditure-based fiscal adjustments are more durable than those relying on increasing revenue.[6] As a result of the progress achieved in restoring the fiscal imbalance, the Ecofin Council on a proposal

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[4] Article 4 of Council Regulation (EC) No 1466/97 stipulates that "a Member State adopting the single currency at a later stage [i.e. later than 1 January 1999, when the first EU Member States adopted the single currency] shall submit a stability programme within six months of the Council decision on its participation in the single currency". On 10 July 2007 the Council adopted a decision on Malta's adoption of the single currency on 1 January 2008 in accordance with Article 122(2) of the Treaty (2007/504/EC, OJ L 186, 18.7.2007, p. 32).

[5] Indeed, during the 1996-2005 ten year period, Malta recorded the fastest increase in the tax burden among the EU Member States (Eurostat News Release No. 89 of 26 June 2007).

[6] See, for example, European Commission (2007), Public finances in EMU – 2007, *European Economy* No 3.

by the Commission decided to abrogate the excessive deficit procedure which paved the way for Malta's adoption of the euro on 1 January 2008.[7]

Being part of the single currency essentially implies forfeiting national monetary policy. Along with market- and structural adjustment channels, fiscal policy – within the parameters of the Treaty, as elaborated by the Stability and Growth Pact – becomes a key instrument of macroeconomic management. Indeed, faced with certain types of short-run shocks fiscal policy, more specifically automatic stabilisers, enhances the economic adjustment process. However, for automatic stabilisers to work fully in moderating normal cyclical fluctuations, a budgetary position of close to balance or in surplus in the medium-term should be pursued. In the specific case of small open economies, while automatic stabilisers have an important role in mitigating the impact of country-specific disturbances, their smoothing capacity may be limited due to leakage effects.[8] This makes the task of assessing Malta's fiscal policy challenging, and there is a need for a better judgement of the flexibility and efficiency of public expenditure. In this respect, enhancing the flexibility and efficiency of public spending will contribute positively towards increasing the adjustment capacity in EMU.

In the context of an apparent change in the Maltese authorities' policy in favour of reversing the uptrend in the tax burden, and Malta's medium-term objective of a balanced budget, further consolidation should by definition be achieved through spending restraint. Moreover, the pressure posed by an ageing population on public expenditure constitutes an additional factor in favour of a spending-oriented adjustment. Consolidation of public finances necessitates increased efficiency and cost effectiveness of public expenditure. A containment of expenditure and an increase of its efficiency will at the same time make room for increased expenditure on growth-enhancing categories, thus expanding the production potential of the Maltese economy. An improvement of the quality of public finances in Malta requires the identification of those categories of expenditure for which there is scope for containment, also through an enhancement of the efficiency of public spending. In turn, the extent to which Malta can contain expenditure is dependent on the degree of spending flexibility. Rigidity limits the authorities' latitude to adjust expenditures making it more tempting to target traditionally flexible spending, such as capital investment, to address the fiscal challenges.

This chapter is structured in four sections. The next section analyses the composition and evolution of public expenditure by economic composition. The third section attempts to determine the extent of spending inflexibility, which may hamper Malta’s ability to adjust in response to changing policy priorities or macroeconomic circumstances. The latter two sections try to identify those categories of expenditure for which there seems to be scope for containment. Section 2.4 assesses expenditure efficiency in Malta focusing on public education and health. Section 2.5 concludes.

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7 Council Regulation (EC) No 836/2007 of 10 July 2007 amending Regulation (EC) No 974/98 as regards the introduction of the euro in Malta.

8 European Commission (2006), The EU Economy: 2006 review, *European Economy* No. 6.

2.2. Composition and evolution of public expenditure

During the period 1998-2003, total expenditure generally followed an upward trend, reaching a high of 48.6% of GDP in 2003.[9] Thereafter, this trend was reversed and by 2006 the expenditure ratio fell to 44.1% of GDP. Total public spending during the 1998-2006 period averaged 44% of GDP lower than the 47% in the EU-15, but was constantly above the EU-10 average since 2003. In almost all of the years during the 1998-2006 period, the rise in total expenditure as a ratio of GDP was compensated by higher government revenue which, especially since 2004, led to a progressive decline in the general government deficit from 9.8% of GDP in 1998 to 2.5% in 2006. Revenue increased on account of both new and higher taxes and in response to the government's drive to achieve a more efficient tax collection.

The decline in expenditure as a ratio of GDP, which started in 2004, was part of an effort to bring the situation of an excessive deficit to an end.[10] Although data show that, between 2004 and 2006, one-off deficit-reducing operations amounted on average to 1% of GDP annually, the consolidation was mainly structural in nature. The main measures were aimed at downsizing employment, improving work practices and increasing overall efficiency in the public sector. Public entities considered to have a core strategic role have been restructured, while others identified as non-core have been privatised. Moreover, the public sector adopted a policy of recruiting new staff only in those areas in which it was deemed to be absolutely necessary. A new multi-annual collective agreement for public service employees, covering the period 2005-2010, provided for limited increases in wages and salaries in the first two years. Expenditure control was also achieved through some tightening in the eligibility of social benefits and further efforts to reduce benefit fraud.

The composition of expenditure and its inter-temporal development shows that social benefits and compensation of employees have traditionally accounted for some 60% of total expenditure. Figure 1 shows that, following an increase between 1998 and 2004, the public sector wage bill as a ratio of GDP followed a downward path. This reflects both the strict control on hiring within the public sector as well as limited wage rises granted by collective agreements. Despite this improvement, compensation of employees still accounts for 13.8% of GDP and remains significantly above the EU-25 average of 10.7%.

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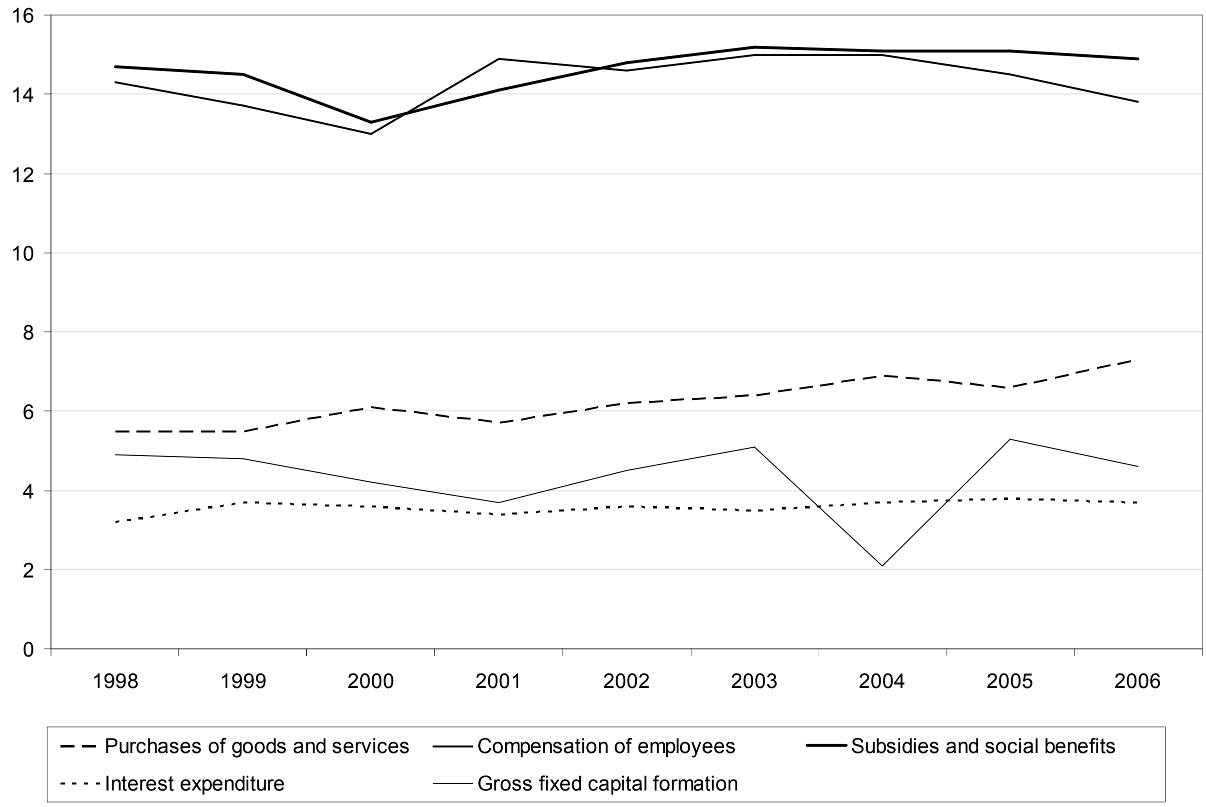
[9] The figure for 2003 includes a substantial one-off expenditure-increasing operation related to the restructuring of the shipyards of around 3% of GDP. Netting out this item would imply that the public expenditure ratio would have increased until 2004.

[10] On the basis of a deficit-to-GDP ratio of 9.7% and general government debt of 72% of GDP, on 5 July 2004 the Council decided, on a recommendation from the Commission, that Malta was in excessive deficit according to Article 104(6).

Figure 1: Developments of expenditure by economic composition, 1998-2006
(as percent of GDP)



Source: AMECO

On the other hand, expressed as a ratio of GDP, social benefits in Malta followed an upward trend until 2004 mainly reflecting spending on early retirement to employees as part of the restructuring of public entities, but remained stable in 2005 and 2006..

The increasing trend in social transfers contrasts with the decline observed in the EU over the past decade. Purchases of goods and services by general government rose by 1.8 percentage points between 1998 and 2006, representing the highest increase during this period. This outcome appears to be mainly driven by the ever rising costs of medicines and surgical devices, which in most cases are provided free-of-charge within the public health system. Public investment has fluctuated considerably during the period 1998-2006, with the bulk of these movements dependent on the degree of progress achieved in a specific year in the construction of a large healthcare facility. Interest expenditure has also increased during the past decade on account of a rising public debt.

2.3. Spending inflexibility

While the level and inter-temporal development of spending is considered to be important in indicating potential categories with a scope for containment and an increase in efficiency, there is a growing interest among policymakers to tackle inflexible budget structures that hinder the adjustment of the fiscal stance in response to changing policy priorities or macroeconomic circumstances. This section focuses on assessing expenditure flexibility in Malta. For this purpose, an expenditure component is considered inflexible if its inclusion in the budget is not dependent upon the discretion of the authorities in the short-term. Therefore, expenditure items which have a legislative basis, such as social benefits and subsidies, are considered as mandatory and thus inflexible. In addition, other spending categories like interest payments and compensation of employees, which due to their nature are difficult to change at least in the short-term, are also considered as mandatory and hence fall under the inflexible category.[11]

During the period 1998-2006, inflexible spending represented some 75% of total expenditure. Social benefits and compensation of employees represent the bulk of inflexible spending. Excluding social benefits, all the sub-components of inflexible spending in Malta are, on average, higher than that registered in the EU-15 and NMS-10. Moreover, while the share of mandatory spending fell since 2000 in both Malta and the EU, the decline in Malta has been smaller. Still, the proportion of mandatory spending in total expenditure in Malta is higher when compared to the average for the EU-25 (see Figure 2). It is noted that a high level of inflexible spending components makes expenditure containment more difficult.

Although on a downward path since 2004, compensation of employees accounted for around 30% of total inflexible expenditure. Given its significant proportion in total expenditure, the public sector wage bill represents, in principle, a category with a substantial scope for savings. This could be achieved by further streamlining public sector employment as well as by ensuring that the wage moderation, started in 2005, is continued in the future. The latter would also prevent against the possibility that wage increases in the public sector spill over in other sectors of the economy. Subsidies accounted for 4.2% of total public expenditure in 2006, representing 1.9% of GDP as compared to an EU-25 average of 1.1%. The largest part, or 97%, of these subsidies were directed to sectoral uses. The fact that subsidies are higher than the EU average suggests that this category is a source of spending rigidity. Apart from avoiding a further build-up of expenditure pressures[12], further public enterprise reform would facilitate a re-direction of sectoral aid to growth-enhancing horizontal objectives, in line with the Council's country-specific recommendations for Malta in the context of the renewed Lisbon strategy. In the process, this would help to increase the production potential of the Maltese economy.

As evident from Figure 3, the adjustment in spending which took place during the 2003-2006 period was underpinned by lower primary expenditure as a ratio to GDP. However, more than 40% of this adjustment was accounted for by spending categories which are considered as being flexible, specifically public investment and capital transfers. The less flexible spending items, such as compensation of employees and subsidies, declined by a lower proportion.

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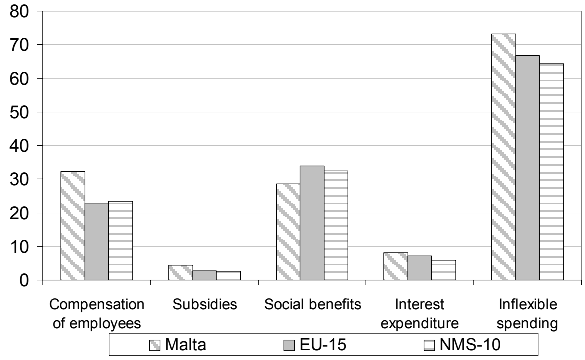
11 In practice, a large part of purchases of goods and services also exhibit a level of rigidity. For example, for Malta spending related to medicines and surgical devices constitutes more than a tenth of government purchases of goods and services.

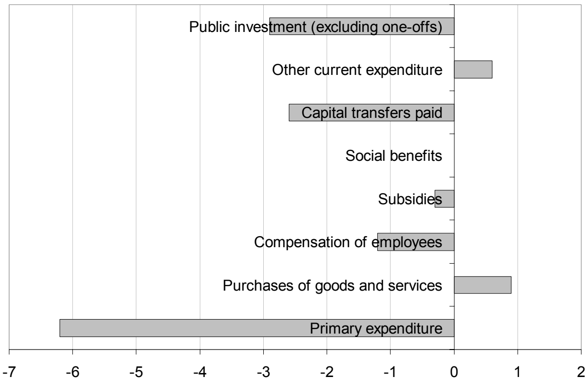
12 International Monetary Fund (2007), Malta: 2007 Article IV Consultation – Staff report, IMF country report No. 07/305.

Figure 2: Composition of inflexible spending, 1998-2006 (as percent of total expenditure)



Source: AMECO

Figure 3: Composition of expenditure adjustment, 2003-2006 (change in p.p. of GDP)



Source: AMECO

The lack of spending flexibility in Malta is also evident when looking at developments in key general government expenditure categories by function (see Table 1). Expressed as a percent of GDP, total expenditure increased from 43% in 1998 to 47.8% in 2003, implying that during this period spending grew at a faster pace than GDP. The main drivers behind this trend were health expenditure which increased by 1.5 percentage points of GDP, followed by education and general public services (both by 0.7 pp). In 2004, total expenditure as a ratio of GDP fell to 45.9% and to slightly above 45% in 2005, which appears to signal an improved flexibility in the latter years. The next section provides further insight on social protection, health and education which account for almost 60% of total government expenditure and therefore display substantial scope for spending restraint.

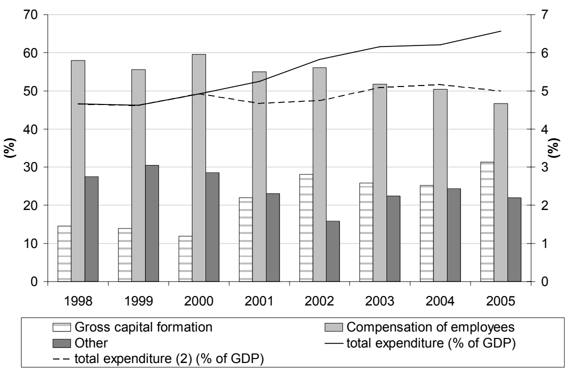
Table 1: General government expenditure by function (per cent of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005
Total expenditure	43.0	43.0	41.0	43.1	43.2	47.8	45.9	45.1
General public services	5.5	6.1	6.6	6.3	6.3	6.2	7.8	7.5
Health	4.6	4.6	4.9	5.2	5.8	6.1	6.2	6.6
Education	5.4	5.5	5.2	5.9	6.0	6.1	5.8	5.7
Social protection	13.4	13.5	12.7	13.4	13.3	13.6	13.8	13.7
Other	14.1	13.3	11.6	12.3	11.8	15.8	12.3	11.6
Source: AMECO								

2.3.1. Healthcare

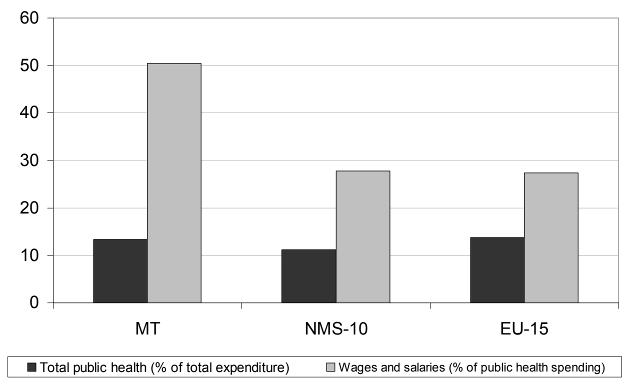
Public health provision in Malta is free at the point of use to all the population and is financed through general taxation. No user charges or co-payments apply, while a few health services are means-tested. Since 1998, public health spending has been following an upward trend, increasing from 4.6% in 1998 to 6.6% of GDP in 2005 (see Figure 4). While healthcare expenditure is on a par with the average for the EU-15 (6.5% of GDP),

Figure 4: Structure of public health spending



Note: Total expenditure (2) simulates the path of health expenditure had capital investment remained at the same level of 1998.
Source: AMECO

Figure 5: Public health spending, 2004



Source: AMECO

it is relatively much higher than the average of the NMS-10 (4.3%). As a share of total government expenditure, health spending accounts for 13.3% (see Figure 5).

For most of the past decade, the rise in health expenditure in Malta was influenced by capital outlays linked with the construction of a large-scale healthcare facility. However, even after netting out this higher investment, health spending generally moved upwards (see dashed line in Figure 4), underpinned mainly by higher compensation of employees, although the health wage bill as a share of GDP has declined marginally during the past three years. However, with wages constituting around half of public health expenditure, compared to around 27% in the EU, the authorities' discretionary scope to adjust this spending component appears more difficult. The rigidity of this component is of particular concern in view of the expected future requirement to increase the number of employees to meet the needs associated with running the new hospital. Moreover, an unchanged policy of handing out free medicines and surgical devices will imply that the cost of this item will continue to increase.

2.3.2. Education

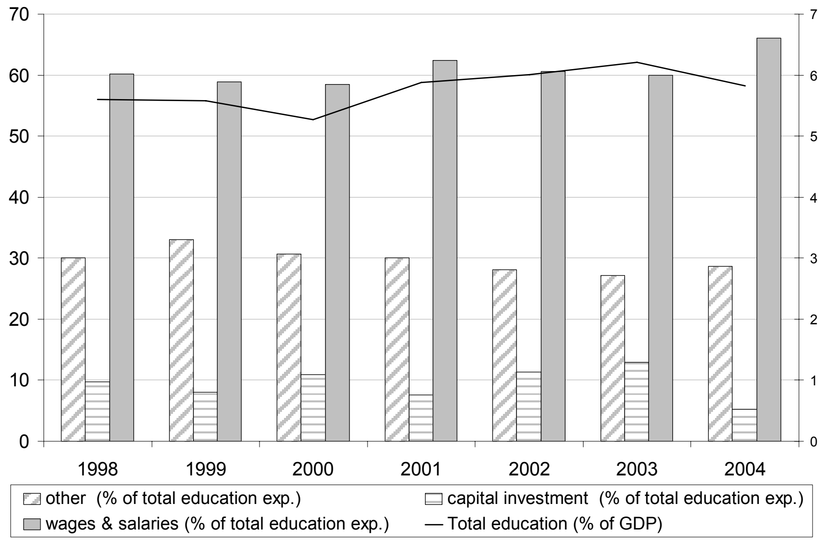
State education in Malta is administered at the national level. The educational administration is highly centralised, though recent efforts have been made to give schools greater freedom of action.[13] Currently, the pre-school, the primary and secondary education levels as well as two schools at higher education level are administered and supervised by the education division.[14] There are no fees for attending state schools. Furthermore, the state is committed to subsidise other non-state schools when these are

[13] A recent reform in education proposes that schools be grouped in networks which, to some extent should bring about a regional approach to the administration of educational institutions. Each school network will bring together a number of schools and will be considered as a legal entity with specific responsibilities, roles and functions with relative autonomy from the influence of the central authorities.

[14] This potentially conflicting double role of the division has been resolved as part of the education reform which involved the separation in two directorates, the one dealing with the operation of the state schools and the other one monitoring and supervising state and non-state schools.

of a non-profit-making nature. Parents whose children attend independent private schools, are given a tax rebate on school fees. University education in Malta is offered at the undergraduate and post-graduate levels. It is totally funded by government and is autonomous and self-governing. Similarly, post-compulsory institutions providing initial and continuing vocational education and training are fully financed from state funds. The state also pays maintenance grants to post-secondary students.

Figure 6: Structure of public education spending



Source: AMECO

During the period 1998-2006, public education spending increased by an annual average of 5.2%. Expressed as a percent of GDP, public spending on education in 2004 stood at 5.8%, which was higher than the average of both the EU-15 (5.2%) and the NMS-10 (5.5%). However, a look at the composition of spending shows a bias towards components which are inflexible. Indeed, public education expenditure is dominated by staff wages and salaries which accounted for more than 60% in 2004 (see Figure 6), slightly higher than the average for the EU-25. Another one-third is explained by other current expenditure which is higher than the average of the EU. Around 65% of the other current expenditure is attributable to handouts granted to students attending post-secondary and tertiary institutes and subsidies to non-profit-making non-state schools. Capital spending amounted to 5.4% of total education expenditure, which is significantly below the EU average. Other indicators confirm that during the past years, the cost of operating the education system has been on the rise. As shown in Table 2, while spending per student in euro purchasing-parity standards (PPS) terms has been modest in Malta compared to the EU average, expenditure per student expressed as a share of per capita GDP (which represents the 'price' of public education provision) has been rising and exceeded the EU average since 2003.

Table 2: Expenditure on public education institutions, 1999-2004

	1999		2000		2001		2002		2003		2004	
	MT	EU25	MT	EU25	MT	EU25	MT	EU25	MT	EU25	MT	EU25
Expenditure per student (PPS)	3337	4687	3593	5010	3366	5366	3796	5499	4200	5661	4435	5949
Expenditure per student (% of per capita GDP)	23.0	23.8	22.9	23.9	21.9	24.6	23.5	24.5	25.9	24.9	27.4	26.6

Source: Eurostat

Indeed, during the period 2000-2004, annual outlays per student grew by more (6.1%) than the total public expenditure on education (5.8%), further suggesting that the cost-effectiveness in public education has deteriorated. In brief, education expenditure also manifests signs of rigidity.[15] Enhancing expenditure efficiency takes an added importance in the case of education, since it is widely held that human capital plays a vital role in economic growth. The gap in educational attainment in Malta compared to the EU may not be due to inadequate expenditure levels, but to the spending mix and how efficiently that spending is translated into educational output. The additional funding needed to bridge this gap could be achieved by re-orienting education spending to those areas with a higher potential impact on productivity. This would improve the performance of the system without raising outlays.

2.3.3. Social protection[16]

Social protection is strongly entrenched in Malta and is considered to be a vital component in combating poverty. In 2005, the at-risk-of-poverty rate after social transfers indicator[17] stood at 15%, which compares favourably with that of the EU average (16%). On average, social spending increased by around 5% annually over the 1998-2005 period. Expressed as a percentage of GDP, social protection spending stood at around 13.7% in 2005, significantly below the EU average (19%). The share of social protection in total expenditure has declined marginally from 31% in 1998 to around 30% in 2004. The bulk of social protection consists of cash transfers to households in the form

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[15] Other factors which introduce an element of rigidity in education spending include the requirement, stipulated in the existing Education Act, that every town and village in Malta should have its primary school.

[16] In this section, social protection covers general government expenditure according to the COFOG classification and includes spending in respect of sickness and disability, old age, survivors, family and children, unemployment, housing, other forms of social exclusion, and R&D on social protection. Spending related to health is dealt with in the healthcare section.

[17] The share of persons with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60 % of the national median equivalised disposable income (after social transfers).

of benefits. Such benefits are either contributory, in which case entitlement is subject to some form of contribution, or non-contributory, granted to claimants satisfying a financial means-test. Almost all households receive some kind of income transfer at some point of the lifecycle. Indeed, the social security system is characterised by the universality and a lack of targeting of benefits to those in most need, with means-testing accounting for around a quarter of total entitlements.[18] Unlike most European countries, Malta does not have a specific social security fund, therefore funding of the social welfare system is through taxes, mainly compulsory contributions payable by employers and employees. These contributions are transferred to central government revenue which in turn finances the bulk of social protection in Malta.

Table 3: Share of social benefits in total social security expenditure (in per cent)

	1998	1999	2000	2001	2002	2003	2004	2005
Retirement/survivors pensions	44.8	45.0	45.2	46.5	46.4	46.1	45.8	47.3
Invalidity/disability	7.5	7.7	7.7	7.7	8.0	8.7	8.9	9.0
Unemployment	6.8	7.4	7.0	6.7	7.3	7.6	8.1	8.0
Children/family	11.3	10.2	9.3	7.6	7.4	6.8	6.5	5.9
Sickness/injury	1.1	1.2	1.1	1.0	1.2	1.2	1.0	1.0
Bonus (cash grant to all employees)	5.8	5.9	5.5	5.2	5.2	5.2	5.2	5.1
Government social contributions	21.7	21.8	23.3	24.2	23.9	23.6	23.0	22.5
Administration	0.9	0.9	0.9	1.0	0.7	0.8	1.5	1.3

Source: National Statistics Office, Malta; Department of Social Security, Malta

As evident in Table 3, retirement and survivors' pensions account for the bulk of social security benefits, with the share of pensions in total social security expenditure increasing by 2.5 percentage points since 1998.[19] With the prospect of more people reaching retirement age, higher pension spending over the medium-term would increase the rigidity of public expenditure. Moreover, the universality of social benefits and lack of targeting give rise to spending inflexibility, while potentially weakening the counter-cyclicality of spending.[20] Better targeting of benefits would facilitate containment in this category of expenditure and would allow a re-direction of additional resources to low-income households.

2.4. Expenditure efficiency

A decisive factor in improving the quality of public finance is an enhancement of the efficiency with which inputs, in this case public expenditure, are transformed into desired social outcomes. The efficiency aspect will be looked into more detail in this section for public spending on healthcare and education in Malta relative to EU Member States.

[18] Measures announced in the 2008 Budget may have reduced further the proportion of social benefits which are means-tested.

[19] Although a reform of pension system came into force in 2007, the effects will not be felt until 2014 when the gradual increase in the retirement age, a new method of calculating the pension income and an increase in the maximum pensionable income will become effective. The economic assessment of the 2006 convergence programme suggest that by 2050 pension expenditure would increase by 3.5 pp of GDP following the reform.

[20] Over the 2000-2005 period, the elasticity of social protection with respect to GDP averaged 1.

Several methodological approaches have been proposed in the literature to measure efficiency of government expenditure. This section applies the Free Disposal Hull (FDH) technique to assess the level of efficiency of key government expenditure components in Malta[21] (see Box 1 for details).

An analysis was undertaken among a number of EU Member States to determine input efficiency scores along with the respective ranking for education using three output measures: primary level student-teacher ratio, secondary level enrolment and tertiary level enrolment.[22] Input is measured by public expenditure per student as a percent of per capita GDP corresponding to each level of education. The results indicate that the efficiency of primary and secondary education in Malta is high. This reflects both a relatively low spending per primary school student as a ratio of GDP and also an above average student-teacher ratio. However, tertiary education in Malta displays less efficient outcomes. The score of 0.77 denotes that at least the same level of output could be achieved with 77% of the present level of expenditure per student, suggesting important scope for improving efficiency at this level of education.

Given the importance of tertiary education in the context of the goals set in the renewed Lisbon strategy, it would be interesting to assess efficiency from the output side. In other words, compared to the relatively more efficient countries how much could tertiary education output in Malta increase if spending was fully efficient. The output efficiency score for Malta is 0.65 or only 65% of what it could be if spending was efficient. This implies that if educational spending was efficient, the tertiary enrolment rate would rise to around 90%, instead of the current 59%. This suggests that a more efficient transformation of spending into tertiary educational output could lead to higher attainment levels in Malta.

A similar analysis for healthcare provision estimates input efficiency scores along with the respective ranking using life-expectancy at birth, infant deaths and standardised death rates[23] (SDR) as three output measures. In this case, input is measured by per capita public expenditure expressed in PPP terms. They show that for the three indicators, input efficiency in Malta is low amounting to a score of less than 0.4. Put differently, this means that the same level of output could be achieved by reducing expenditure by three-fifths, demonstrating ample scope for improving efficiency.

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21 See Ebejer and I., Mandl U., "The efficiency of public expenditure in Malta", ECFIN Country Focus, forthcoming

22 In the literature, enrolment and graduation are the mostly used indicators to gauge output at the tertiary level. In the case of Malta, 'tertiary level enrolment' is considered to be a more appropriate output indicator given that grants given to tertiary level students (which are given to enrolled students and are not related to success) constitute an important proportion of public expenditure at that level of education.

23 Standardised death rates is a weighted average of age-specific mortality rates and so enables a comparison of death rates between populations with different age structures by relating them to a standard population.

Box 1: Assessing technical efficiency using non-parametric approaches: the FDH and DEA techniques

Since the seminal work by Farell[24], a number of studies have applied non-parametric techniques to measure the relative technical efficiency with which decision-making units (DMUs) churn inputs into outputs. In the case of public sector DMUs, non-parametric methodologies are considered to be superior to econometric techniques since the former do not make assumptions on an unknown functional form between the relationship of inputs and outputs or distributional properties of the data.

The two main non-parametric techniques proposed in the literature to measure the efficiency of government expenditure are the Full Disposal Hull (FDH) and the Data Envelopement Analysis (DEA). In evaluating the efficiency of public spending, both methodologies try to establish a production possibility frontier delineated by best practices in specific government expenditure items in the form of efficient cross-country input-output combinations. The degree of efficiency of each country is then measured as the radial distance of an observation from the best practice frontier and a ranking is computed. The production frontier under the FDH approach takes the form of a vertical step-up connecting the most efficient input-output observations. On the other hand, the DEA approach assumes a linear combination of inputs and outputs and typically postulates a convex frontier. The difference between the two approaches implies that in FDH analysis, more observations tend to be identified as efficient, than in DEA. This is because the FDH assumes that inputs and/or outputs can be disposed of freely. Given that previous analyses of public spending in education and health have found no conclusive justification on the appropriate shape of the frontier, the analysis in section 4 is based on the FDH approach and draws heavily on the work carried out by Deprins et. al.[25] and subsequently developed by Gupta et. al.[26]

The FDH and DEA techniques allow for the computation of both input and output efficiency scores. The latter indicate by how much more output could be increased with the same input level. Conversely, input efficiency scores reveal how much less input could be employed to attain the same level of output. The analysis in section 2.4 focuses on input efficiency scores since their interpretation is more straightforward. Moreover, input scores are more relevant given that expenditure allocations are determined by policymakers.

The FDH technique suffers from a number of shortcomings and hence results should be interpreted with caution. For instance, FDH is sensitive to sampling variability, to data quality and to the presence of outliers. Moreover, FDH focuses only on quantifiable indicators of input and output, disregarding important considerations like quality. Another weakness of the FDH technique is that it does not account for private spending which contributes to the outcomes targeted by policymakers with the consequence that efficiency scores could be biased.

Despite these limitations, a comparison of efficiency estimates using the DEA approach generate similar trends to those suggested by the FDH methodology for Malta i.e. high relative efficiency in primary and secondary level of education and inefficient tertiary public education spending. Similarly, results from the DEA analysis point to the existence of a substantial scope for efficiency

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24 Farell, M.J. (1957), "The measurement of productive efficiency," *Journal of the Royal Statistical Society A,* 120, 253-281.

25 Deprins Dominique, Leopold Simar and Henry Tulkens (1984), “Measuring Labour-Efficiency in Post Offices” in *The Performance of Public Enterprises: Concepts and Measurement*, ed. by M. Marchand, P. Pistieau and H. Tulkens (Amsterdam: North-Holland).

26 Gupta Sanjeev, Keiko Honjo and Maijn Verhoeven (1997), “The Efficiency of Government Expenditure: Experiences from Africa”, Working Paper 97/153 (Washington: International Monetary Fund).

improvement in public health expenditure in line with the findings in the FDH technique.

2.5. Conclusions

From an analysis of the general government expenditure in Malta, there seems to be scope for a containment of public expenditure and an increase of the efficiency of public spending. This is particularly the case for the following categories of expenditure: compensation of employees, subsidies, health care, education and social welfare. A closer look into the efficiency aspect, using the Free Disposal Hull approach, has indicated that in the case of education expenditure in Malta efficiency is high at the primary and secondary level of education, but is inefficient at the tertiary level. Ensuring a more efficient transformation of spending into tertiary educational output could result in higher attainment levels and is in line with the 2007 Spring European Council recommendations to Malta within the renewed Lisbon strategy framework. Similarly, the analysis has shown that the efficiency of health-related spending is low since the same level of output can be attained with lower outlays. Containing expenditure would ensure the financial sustainability of the public health provision, consistent with the conclusions of the 2007 spring European Council.

The considerable degree of rigid subcomponents of expenditure specifically in health, social spending and education make the task of containing and increasing the efficiency of expenditure more difficult. Left unchecked, a rise in obligatory expenditure subcomponents will increasingly compress discretionary spending which allows room for manoeuvre of fiscal policy on the side of expenditure. Among the most important features of rigidity is the high proportion in public health and education spending that goes into wages and salaries, the universality of social benefits and the weak targeting which characterise the social security system.

These findings suggest that there is a need to create effective expenditure control mechanisms to restrict growth in those expenditure items considered to be rigid in order to generate additional resource savings. Success in the overall effort of containing expenditure and increasing its efficiency, would make possible the reallocation of resources to growth enhancing expenditure categories, which would increase the production potential of the Maltese economy and facilitate the convergence process. Furthermore, it would increase the effectiveness of the fiscal policy instrument to respond to changing policy priorities or macroeconomic circumstances. This is particularly important now that the Maltese economy is operating within the parameters of the euro area.

3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail. Finally, it describes how the macroeconomic vulnerabilities identified in the preceding section are expected to develop according to the programme.

3.1. Economic activity

According to the stability programme, Malta's real GDP growth is estimated to remain relatively strong averaging 3¼% per year between 2007 and 2010[27] (see Table 4). The negative output gap (as recalculated by the Commission services according to the commonly agreed methodology, based on the information provided in the programme) which developed in 2003 is expected to continue narrowing between 2007-2008 before it turns positive in 2009.

27 The external assumptions behind the programme's macroeconomic scenario are broadly in line with that in the Commission services' autumn 2007 forecast.

Table 4: Comparison of macroeconomic developments and forecasts

	2007		2008		2009		2010
	COM	SP	COM	SP	COM	SP	SP
Real GDP (% change)	3.1	3.5	2.8	3.1	2.9	3.2	3.4
Private consumption (% change)	2.7	2.4	2.8	2.2	2.7	2.6	2.5
Gross fixed capital formation (% change)	-2.9	-2.9	1.5	5.3	0.6	4.8	3.7
Exports of goods and services (% change)	-1.4	-1.7	0.7	2.3	1.2	3.3	3.2
Imports of goods and services (% change)	-2.9	-3.9	0.3	2.0	0.4	2.1	1.8
Contributions to real GDP growth:							
- Final domestic demand	1.4	1.3	2.4	2.6	2.2	2.3	2.1
- Change in inventories	0.0	-0.2	0.0	0.3	0.0	-0.1	0.1
- Net exports	1.6	2.4	0.3	0.2	0.7	1.0	1.3
Output gap[1]	-0.6	-0.8	-0.1	-0.1	0.5	0.5	1.9
Employment (% change)	1.4	1.6	1.2	1.2	1.1	1.3	1.4
Unemployment rate (%)	6.8	6.6	6.6	6.8	6.5	6.7	6.6
Labour productivity (% change)	1.7	1.8	1.6	1.8	1.8	1.9	2.0
HICP inflation (%)	0.8	0.9	2.5	2.5	2.2	2.3	2.1
GDP deflator (% change)	2.5	2.8	2.7	3.0	2.4	2.2	2.1
Comp. of employees (per head, % change)	2.8	2.1	3.0	3.0	3.1	3.3	3.3
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-0.9	-0.5	-0.6	0.2	0.0	3.2	5.5

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source:

Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP)

The programme foresees economic growth in 2007 being primarily underpinned by net exports, on the back of a significant decline in capital imports reflecting a normalisation from the exceptionally high purchases in 2006. For the programme period, the contribution of domestic demand is expected to increase on account of sustained private consumption and investment expenditure. Furthermore, according to the programme exports are expected to recover and grow at a fast pace throughout the outlook period, peaking in 2009. GDP growth between 2007 and 2010 (3¼%) projected in the programme represents a marked acceleration vis-à-vis Malta's average economic performance in the past 5 years (1¾%). The higher pace of growth in the outlook period

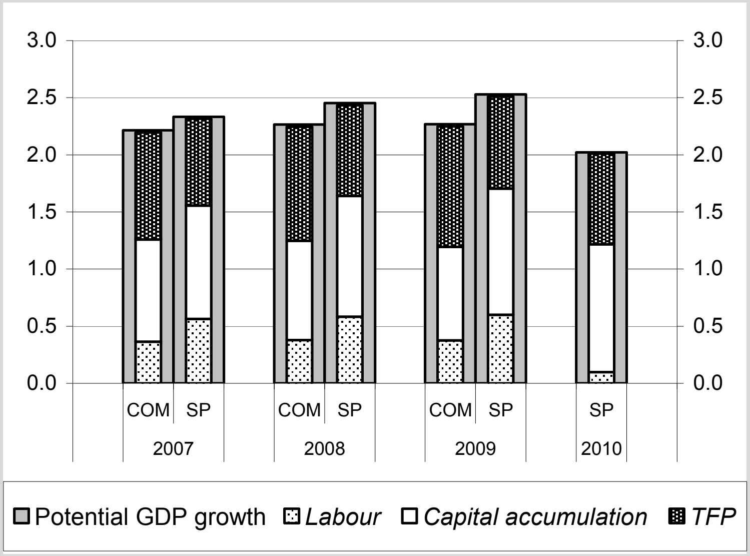
compared to the past five years is mostly explained by an increased contribution projected for the external sector. The programme does not provide any explanation of the

Box 2: Potential growth and its determinants

Estimates of potential output growth consistent with the programme's macroeconomic scenario (as recalculated by Commission services on the basis of the information provided in the programme according to the agreed methodology) show slight differences when compared to the Commission services' autumn 2007 forecasts. These variances mainly stem from the programme's higher projected contribution of labour throughout the outlook period. In addition, for 2008 and 2009 the programme foresees a stronger contribution of capital accumulation to potential growth. This reflects the programme's assumption of a strong gross fixed capital formation growth during these years mainly underpinned by private sector investment.

The Commission services' re-calculations of potential GDP growth between 2007 and 2010 also show some differences with historical trends. In particular, estimates of potential GDP growth for the programme horizon are slightly below the average GDP growth in the period 1996-2005, but significantly higher than the average GDP growth in the period 2001-2005 (see Annex 2 table) which may further suggest that the programme's macroeconomic outlook is favourable.

Potential growth and its determinants



reasons underlying the change between the weak economic performance in recent years and the projected recovery in the years 2007 and 2010.

In 2007, GDP is estimated to grow by 3.5% which is higher than the Commission services' autumn 2007 forecast of 3.1%. However, recent upward revisions in real GDP for the first half of 2007 and the strong GDP growth for the third quarter of 2007, in particular private consumption expenditure, suggest that the programme's growth estimate for 2007 is plausible. For 2008, the programme foresees GDP growth to slow down to 3.1%, which appears to be optimistic when compared to the corresponding Commission projection of 2.8%. According to the programme, real GDP is projected to grow by 3.2% in 2009, which seems favourable in comparison to the Commission services forecast of 2.9%. Similarly, the programme foresees GDP to grow by 3.4% in 2010 which also appears markedly favourable when compared to the average potential growth projected in the Commission services' autumn 2007 forecast for 2007-2009. The contribution of domestic demand projected in the programme broadly in line with the Commission services' autumn 2007 forecast, although there are large differences in investment growth the plausibility of which cannot be assessed on the basis of the information in the programme. The difference in the growth path is mainly due to the improved performance of the external sector, especially in the outer years. The resulting improvement in the external balance of goods and services of 3.3 percentage points of GDP by 2010 projected in the programme seems optimistic.

Cyclical conditions as recalculated by the Commission services using the commonly agreed methodology on the basis of the data presented in the programme, are projected to improve substantially over the forecast horizon. The negative output gap for 2007 is marginally wider than that projected by the Commission services' forecasts. Thereafter, the trajectory of the output gap in the programme coincides with that projected by the Commission services. A comparison across the latest three programmes and Commission services' forecast rounds shows a high degree of instability of output gap estimates which underlines the uncertainty surrounding such real-time estimates.

3.2. Labour market and cost and price developments

According to the programme, labour market conditions are expected to remain strong throughout the programme period. After an exceptional growth of 1.6% in 2007, the programme projects employment growth to hover around 1.3% in the 2008-2010 period. This is slightly higher than the Commission services' autumn 2007 forecast, and appears to be explained by stronger growth in exports and investment. As a result, unemployment is expected to fall, reaching 6.6% by 2010. These developments are in line with the Commission services' autumn 2007 forecast. Throughout the programme period, gains in productivity explain the bulk of growth in GDP, whereas the projected average labour content of GDP growth is marginally higher than historical values but in line with the Commission services' forecast.

According to the stability programme, HICP inflation is expected to stand at 0.9% in 2007 and to increase to 2.5% in 2008. Thereafter, inflation is expected to recede to 2.3% in 2009 and decline further to 2.1% in 2010. The trajectory of HICP inflation over the forecast horizon is in line with that projected by the Commission services' autumn 2007 forecast.

The programme envisages wage growth to accelerate from 2.1% in 2007 to 3.3% in 2010. Apart from a tightening labour market, this also seems to reflect a rise in the public service remuneration as the period of wage moderation between 2005 and 2006 contemplated in the sector's six-year collective agreement, is followed by higher compensation. At an average annual growth rate of around 2%, labour productivity is expected to fall short of wage growth throughout the programme horizon. Consequently, nominal unit labour costs are projected to rise. The evolution of unit labour costs and its components, as presented in the programme, are broadly in line with the Commission services' autumn 2007 forecast. As a result, competitiveness could deteriorate further, which would represent a risk to the programmes' assumption of strong expansion in exports and to the anticipated strong improvement in the net external balance. Moreover, a recently signed agreement which provides generous wage increases to public health service employees, may possibly lead to similar pay claims by other sectors with the consequence that this would spill over into the private sector wage settlements. In such an event, overall wages could rise far in excess of productivity gains which would entail a less favourable development in Malta's competitiveness than implied by the stability programme.

3.3. Macroeconomic challenges

On 1 January 2008, Malta joined the euro area with GDP growth on a recovery path since 2004. During the early 2000s, weak economic performance was partly a result of external factors, to which Malta is particularly exposed, being a small open economy and relying on dominant sectors such as tourism and the electronics industry. Domestic structural weaknesses also explain the sluggish GDP growth. Productivity contracted by an annual average of around 1% between 2001 and 2003. In addition, significant wage growth led to a sharp rise in unit labour cost and as a result a loss in external competitiveness. Since 2004, economic performance improved primarily due to favourable cyclical conditions but also owing to wage moderation and a recovery in productivity. On the fiscal side, euro area entry followed a period of considerable consolidation – with debt as a percent of GDP on a declining path since 2005 - as well as progress towards lower inflation. In this new context, enhancing the room for manoeuvre of fiscal policy would increase Malta's adjustment capacity to short-run asymmetric disturbances. This could be achieved by pursuing further budgetary consolidation through structural expenditure reforms aimed at enhancing flexibility and efficiency, specifically of health spending. Apart from improving the long-term sustainability of public finances, this would also allow a re-direction of expenditure to growth-enhancing categories, thereby boosting productivity. This, together with policies which are conducive to wages moving in line with productivity, would bolster competitiveness – another challenge facing the Maltese economy.

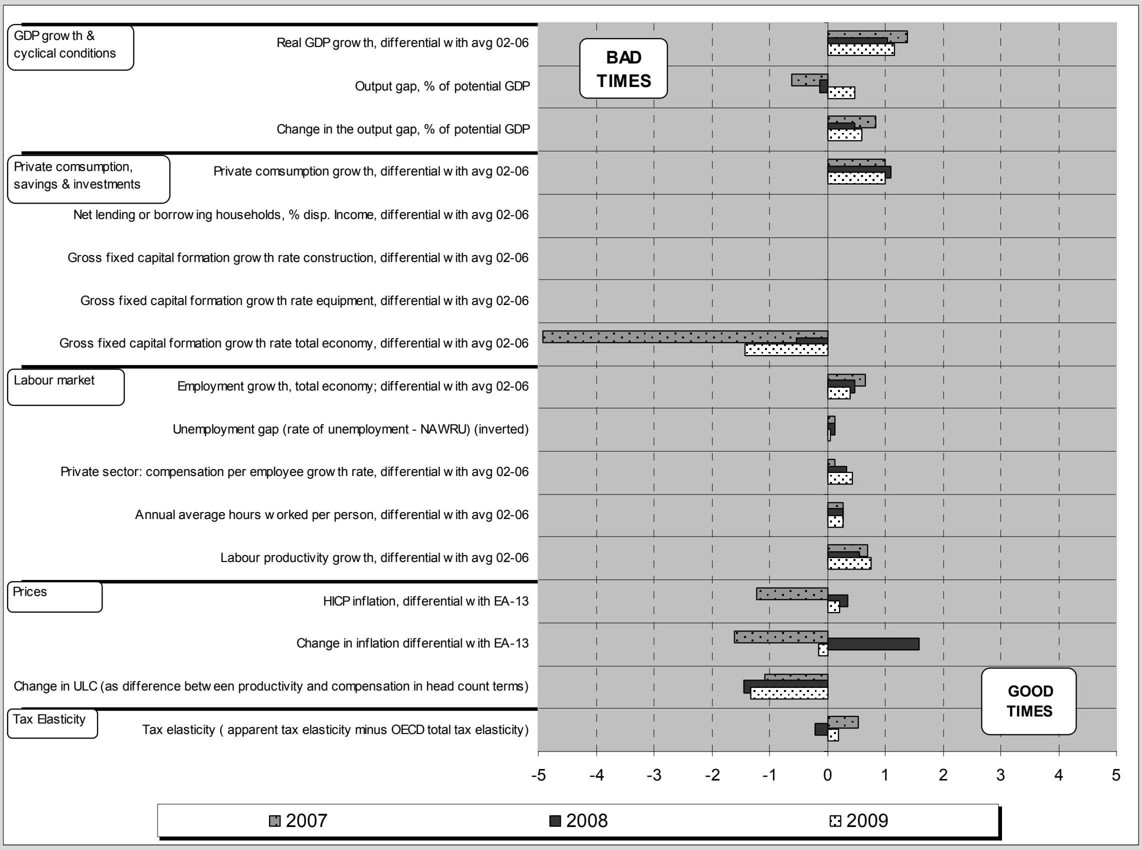
The stability programme makes some attempts at addressing these challenges. Further fiscal consolidation is envisaged leading to the achievement of the MTO by the end of the programme period. However, although the programme foresees a decline in the expenditure ratio, no information is provided on how pertinent categories which could potentially lead to cost pressures in the medium term (ex. healthcare costs) will be addressed. Similarly, the programme does not clearly spell out how will expenditure be channelled to growth-enhancing categories, especially in the outer years. This is reflected in an unchanged projected growth in productivity (compared to the average of the past 10 years) which is expected to be lower than wage growth.

Box 3: Good or bad economic times?

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Taking into account tax elasticities in the period 2007-2009, the Maltese economy seems to be in good economic times throughout this period, but some risks exist in the outer years.

For comparison purposes, the period 2002-2006 is considered to be the most relevant for Malta, given that the economy underwent a structural break in the beginning of the 2000s. GDP growth and cyclical conditions indicators show that the negative output gap will continue to narrow rapidly over the programme horizon. On the other hand, the performance of the labour market is projected to ease somewhat in the outer years. The anticipated increase in wage inflation over the outlook period will not compensate for softer job creation, giving rise to weaker private consumption especially in 2009. The acceleration in unit labour costs foreseen in 2008 and 2009 represents a risk to the good times expected for the Maltese economy. The bottom part of the graph compares the apparent tax elasticity in the Commission services' 2007 autumn forecast with the OECD ex-ante elasticity. It shows that the high tax yield in 2007 is projected to decline in 2008 partly capturing lower revenue following the revision in personal income tax. An improvement in the apparent tax elasticity is anticipated for 2009, although the differential with the ex-ante elasticity is still foreseen to be lower than that prevailing in 2007.

Good versus bad times



4. General government balance

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the stability programme. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2007

Table 5 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the 2006 convergence programme with the results of the Commission services' autumn 2007 forecast. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue/expenditure growth effect[28]:

[28] A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

Table 5: Budgetary implementation in 2007

	2006		2007	
	Planned CP Dec 2006	Outcome COM	Planned CP Dec 2006	Outcome COM
Revenue (% of GDP)	43.8	41.6	43.9	41.1
Expenditure (% of GDP)	46.4	44.1	46.2	42.9
Government balance (% of GDP)	-2.6	-2.5	-2.3	-1.8
Nominal GDP growth (%)			6.0	5.7
Nominal revenue growth (%)			6.2	4.5
Nominal expenditure growth (%)			5.5	2.8
Revenue surprise compared to target (% of GDP)			**-2.8**	
Of which [1] *:* 1. Base effect			-2.3	
2. GDP growth effect on the denominator			0.1	
3. Revenue growth effect			-0.6	
Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than 1 [2]			*-0.5*	
Expenditure surprise compared to target (% of GDP)			**-3.3**	
Of which [1] *:* 1. Base effect			-2.3	
2. GDP growth effect on the denominator			0.1	
3. Expenditure growth effect			-1.1	
Government balance surprise compared to target (% of GDP)			**0.5**	
Of which: 1. Base effect			0.0	
2. GDP growth effect on the denominator			0.0	
3. Revenue / expenditure growth effect			0.4	

Notes:

[1] A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive GDP growth effect (on the denominator) indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.

[2] Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.

Source:
Commission services; Convergence programme (CP)

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue/expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of revisions to the GDP series.
- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher or lower than anticipated in the previous update of the programme (therefore reducing/increasing the denominator of the revenue and expenditure ratio).
- The revenue/expenditure growth effect captures the part of the difference related to the revenue/expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme. This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex ante tax elasticities (or both).

The 2006 update of the convergence programme targeted a deficit-to-GDP ratio of 2.3% for 2007. For the same year, the Commission services' autumn 2007 forecast estimates a general government deficit ratio of 1.8%.[29] On the other hand, the 2007 stability programme projects a deficit ratio of 1.6% of GDP. Netting out one-off transactions which amounted to around ¾% of GDP (consisting mainly of sale of land, which are conventionally recorded as negative expenditure), however, the 2007 deficit outturn is broadly in line with the target in the 2006 convergence programme. In 2007, revenue as a ratio of GDP is projected to be around 2.8 points lower than planned in the 2006 update. Of this, 2.3 percentage points are accounted for by a base effect mainly reflecting lower-than-anticipated revenue from taxes and social contributions. Lower revenue growth, mainly as a result of lower-than-planned absorption of EU funds in 2007, explain the remaining 0.6 percentage points. In 2007, the expenditure to GDP ratio is estimated to be 3.3 percentage points lower-than-planned in the 2006 programme. Of this, 2.3 percentage points relate to a base effect primarily on account of lower-than-planned capital expenditure. The remaining 1 percentage point is due to expenditure growth effects and is explained partly by lower investment in 2007 reflecting the lower-than-planned EU capital inflows as well as higher-than-planned one-off transactions (mainly sale of land) of around 0.5 percentage points.

As the structural adjustment in 2007 now seems below a ½ percentage point of GDP, compared to around 1 percentage point as planned in the last update of the convergence programme, budgetary implementation is not in line with the invitation in the Council opinion of 27 February 2007 on the previous programme[30] to "pursue adequate progress towards the MTO as foreseen in the programme".

4.2. The programme's medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the 2006 convergence programme - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

4.2.1. The main goal of the programme's budgetary strategy

As in the last update of the convergence programme, the main budgetary goal outlined in the programme aims at pursuing further fiscal consolidation over the programme period, with the overarching objective of achieving the MTO of a balanced position in structural terms by 2010. The programme also aims at reducing the debt ratio in each year to just above 53% of GDP by the end of the programme period.

According to the programme, the general government balance is projected to improve by around 2½ percentage points over the period 2007-2010. By 2010, the general government balance is anticipated to turn into a surplus of around 1% of GDP (see Table

[29] The currently estimated deficit for 2007 does not include expenditure related to VAT refunds in relation to a judicial ruling. On 14 December 2007, the Court of Malta decided in favour of a telecoms company which had objected to the payment of VAT in connection with international termination charges. This ruling implies government has to refund around 0.2% of GDP of previously-collected taxes. Government expenditure in relation to judicial decisions are, in principle, to be booked at the time of the court ruling. However, in this case, the appropriate accounting recording is still under discussion between Eurostat and the National Statistics Office, given a number of uncertainties, notably the fact that government may appeal. Note, however that if ever there is any refund to be recorded in 2007, the expenditure has a one-off nature, and does not add to the structural deficit.

[30] OJ C 72, 27.3.2007, p. 9.

6). The consolidation in nominal terms is concentrated in the outer years, while the programme foresees a much-reduced reliance on one-off transactions from 2008 onwards. The bulk of the improvement in the general government balance is accounted for by a growing primary surplus which is expected to rise by around 2 percentage points of GDP.

Table 6: Evolution of budgetary targets in successive programmes

		2006	**2007**	**2008**	**2009**	**2010**
General government balance (% of GDP)	**SP Nov 2007**	**-2.5**	**-1.6**	**-1.2**	**-0.1**	**0.9**
	CP Dec 2006	*-2.6*	*-2.3*	*-0.9*	*0.1*	*n.a.*
	COM Nov 2007	-2.5	-1.8	-1.6	-1.0	n.a.
General government expenditure (% of GDP)	**SP Nov 2007**	**44.1**	**42.7**	**42.2**	**40.0**	**38.5**
	CP Dec 2006	*46.4*	*46.2*	*42.7*	*40.1*	*n.a.*
	COM Nov 2007	44.1	42.9	42.6	41.8	n.a.
General government revenue (% of GDP)	**SP Nov 2007**	**41.6**	**41.0**	**40.9**	**39.9**	**39.5**
	CP Dec 2006	*43.8*	*43.9*	*41.8*	*40.1*	*n.a.*
	COM Nov 2007	41.6	41.1	41.1	40.8	n.a.
Structural balance[1] (% of GDP)	**SP Nov 2007**	**-2.5**	**-2.1**	**-1.4**	**-0.5**	**0.1**
	CP Dec 2006	*-2.9*	*-2.0*	*-1.0*	*-0.4*	*n.a.*
	COM Nov 2007	-2.7	-2.3	-1.7	-1.2	n.a.
Real GDP (% change)	**SP Nov 2007**	**3.2**	**3.5**	**3.1**	**3.2**	**3.4**
	CP Dec 2006	*2.9*	*3.0*	*3.1*	*3.1*	*n.a.*
	COM Nov 2007	3.2	3.1	2.8	2.9	n.a.

Note:

[1]Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.7% of GDP in 2006, 0.8% in 2007, 0.2% in 2008, 0.2% in 2009 and 0.1% in 2010; all deficit-reducing according to the 2007 stability programme and 0.7% of GDP in 2006, 0.8% in 2007, 0.2% in 2008 and 0% in 2009; all deficit-reducing in the Commission services' autumn forecast.

Source :

Stability programme (SP); Convergence programmes (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

The programme projects a decline in the structural deficit (as recalculated by the Commission services) over the programme's horizon which would lead to a balanced position by 2010. The planned fiscal stance can be characterised as restrictive in the years 2008-2010 as the primary structural deficit is projected to decline by around ¾ of a percentage point of GDP in 2008 and 2009, respectively. For 2010, the primary structural deficit is projected to decline by around ½ a percentage point. The deficit-to-GDP ratio for 2008 and 2009 is a ¼ of a percentage point of GDP higher in each year compared to the budgetary projections in the 2006 update. The stability programme slightly backloads the planned adjustment against a broadly unchanged macroeconomic scenario.

4.2.2. The composition of the budgetary adjustment

The budgetary consolidation envisaged over the programme horizon will be achieved through expenditure restraint. Indeed, expenditure is projected to decline by slightly more than 4 percentage points of GDP which more than compensates for an expected fall in revenue of 1.5 percentage points (see Table 7). Recourse to one-off transactions is planned to fall to around ¼% of GDP from 2008 onwards, which is below the yearly average of 1% in the period 2004-2006. Net of one-offs, the general government deficit

Table 7: Composition of the budgetary adjustment

(% of GDP)	2006	2007	2008	2009	2010	Change: 2010-2007
Revenue	**41.6**	**41.0**	**40.9**	**39.9**	**39.5**	**-1.5**
of which:						
- Taxes on production and imports	15.1	15.1	14.8	14.2	13.6	**-1.4**
- Current taxes on income, wealth, etc.	11.9	13.2	13.3	13.6	13.8	**0.6**
- Social contributions	7.8	7.7	7.5	7.4	7.2	**-0.4**
- Other (residual)	6.8	5.2	5.3	4.8	4.9	**-0.3**
Expenditure	**44.1**	**42.7**	**42.2**	**40.0**	**38.5**	**-4.1**
of which:						
- Primary expenditure	40.5	39.4	39.0	37.0	35.6	**-3.7**
of which:						
Compensation of employees	13.5	12.9	12.5	11.9	11.3	**-1.6**
Intermediate consumption	5.7	5.6	5.8	5.4	5.1	**-0.5**
Social payments	13.3	12.9	13.1	12.9	12.7	**-0.2**
Subsidies	1.9	2.1	1.8	1.5	1.4	**-0.7**
Gross fixed capital formation	4.3	4.0	3.9	3.3	3.5	**-0.6**
Other (residual)	1.9	1.7	2.0	1.9	1.7	**0.0**
- Interest expenditure	3.6	3.3	3.2	3.0	2.9	**-0.4**
General government balance (GGB)	**-2.5**	**-1.6**	**-1.2**	**-0.1**	**0.9**	**2.6**
Primary balance	**1.0**	**1.7**	**2.0**	**2.9**	**3.8**	**2.1**
One-off and other temporary measures	0.7	0.8	0.2	0.2	0.1	**-0.6**
GGB excl. one-offs	**-3.2**	**-2.4**	**-1.4**	**-0.3**	**0.8**	**3.2**
Output gap[1]	-1.9	-0.8	-0.1	0.5	1.9	**2.6**
Cyclically-adjusted balance[1]	-1.8	-1.3	-1.2	-0.3	0.3	**1.6**
Structural balance[2]	**-2.5**	**-2.1**	**-1.4**	**-0.5**	**0.1**	**2.2**
Change in structural balance		*0.4*	*0.7*	*0.9*	*0.6*	
Structural primary balance[2]	1.0	1.2	1.9	2.5	3.0	**1.8**
Change in structural primary balance		*0.1*	*0.7*	*0.7*	*0.4*	

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability programme; Commission services' calculations

would amount to 2.4% of GDP in 2007, tapering off to 1.4% in 2008, 0.3% in 2009 and turn into a surplus of almost 0.8% in 2010. While the programme provides information on the policy measures for 2008, which are consistent with the 2008 Budget Law (see Box 4 and Section 6), details on the measures underpinning the consolidation process are not disclosed for 2009 and 2010, making an overall assessment of the plausibility of the budgetary strategy difficult to ascertain.

Total expenditure is set to fall by slightly more than 4 percentage points, from 42.7% of GDP in 2007 to 38.5% of GDP in 2010. The bulk of the decline is planned to be carried out through lower primary expenditure (around 3.7 percentage points of GDP). Specifically, compensation of employees as a ratio of GDP is projected to decline by 1.6 percentage points. According to the programme, this would be achieved through a continuation of the government's policy to limit recruitment in the public sector.

Following an increase in 2007, subsidies are expected to decline by 0.7 percentage points by 2010, mainly reflecting lower state aids to the shipyards as foreseen in the Accession Treaty. Gross fixed capital formation is also expected to decline by some 0.5 percentage points over the period 2007-2010.[31] Lower interest expenditure is expected to contribute around 0.5 percentage points of GDP to the decline in expenditure.

The fall in the expenditure ratio is expected to be only partially offset by lower revenue over the forecast horizon. According to the stability programme, revenue is planned to fall by 1.5 percentage points from 41% of GDP in 2007 to 39.5% in 2010. Revenue from indirect taxes and, to a lesser extent, social contributions account for the bulk of this downward trend. For 2008, taxes on production and imports are estimated to decline, despite a higher growth in nominal private consumption expenditure. This downtrend will proceed in 2009 and 2010, when indirect taxes are projected to grow at rates below what historical trends would suggest. Current taxes on income and wealth are foreseen to increase by slightly more than 0.5 percentage points of GDP over the forecast horizon. Notwithstanding further revisions to the personal income tax regime introduced in 2008 above those implemented in the previous year, the programme still projects an increase in the direct tax-to-GDP ratio for 2008.[32] For the remaining years, direct tax revenue is expected to continue to grow at a pace which is slightly lower than historical values, reaching 13.8% of GDP by 2010. Despite strong growth in compensation of employees, social contributions are projected to decline by slightly less than 0.5 percentage points of GDP over the period 2007-2010. This reflects a key feature of the Maltese pension system whereby social contributions are calculated as a percentage of wages but are subject to an established maximum contribution. Therefore, as compensation continues to grow, more contributors will hit this ceiling thereby disrupting the linearity between

Box 4: The Budget for 2008

The 2008 Budget was presented in Parliament on 15 October 2007 and was approved by Parliament on 2 November 2007. The 2008 Budget targets a general government deficit of 1.2% of GDP for 2008. The main measures presented in the 2008 Budget include a reform of the personal income tax regime (more favourable personal income tax bands effective in 2008), increases in the amount of cash benefits granted to children as well as improved social entitlements given to specific social groups including pensioners and first-time property buyers. The budgetary cost of the main measures are presented in the table below.

Main measures in the budget for 2008

Revenue measures*	Expenditure measures**
o Income tax reform (-0.5% of GDP) o Duty on documents amendments (-0.1% of GDP)	o Restraint on public service wage bill*** (-0.4% of GDP) o Increases in children & family benefits (0.2% of GDP) o Increases in benefits to pensioners (0.1% of GDP)

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
*** On-going measure, not specific to 2008 Budget
Sources: Commission services, 2007 stability programme and the Budget for 2008

31 It should however be noted that public investment expenditure in 2007 reflects spending related to a large healthcare facility, which was completed in the middle of that same year. Netting out this item would show an upward trend in the general government gross fixed capital formation between 2007 and 2010.

32 The Maltese authorities expect that buoyant revenue from capital gains tax on property as well as taxes on profits declared by certain companies will again compensate for the loss in tax revenue on personal income.

developments in compensation of employees and social contributions.[33]

4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009, Table 8 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the stability programme.

The budgetary projections as presented in the stability programme appear to be optimistic compared to the Commission services' 2007 autumn forecast. The difference of around a ½ of a percentage point of GDP in 2008 widens to around 1 percentage points in 2009 and is partly explained by the customary no-policy change scenario used in the Commission forecast.

The risks stemming from the macroeconomic outlook for the achievement of the budgetary targets projected in the programme are mainly related to the performance of the external sector (where the main differences reside), especially in the outer years. This is particularly relevant for Malta in view of the economy's high degree of openness. A lower-than-projected growth in exports would result in slower GDP growth with consequences on fiscal adjustments. Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2006-2010 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the central scenario), reveal that, by 2010, the cyclically-adjusted balance is around 0.5 percentage point of GDP above the central scenario. Hence, in the case of persistently lower real growth, additional measures of around 0.5 percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.

The programme provides a sensitivity analysis of general government balance to an increase in the interest rate and external demand. In the case of a 1 percentage point rise in market interest rates over the programme period, the deficit-to-GDP ratio at the end of 2010 would be around ¼ of a percentage point higher than the baseline scenario. An increase of 1% in external demand over the programme period would translate into a improved general government balance of around ½ percentage point from the baseline scenario by 2010. This further underscores the downside risks attached to the reduction in the general government deficit in the event that the relatively optimistic expansion of net exports envisaged by the programme fails to materialise.

[33] Although the reformed pension system introduced in 2007 has provided for annual increases in this ceiling - by the cost of living adjustment during the 2007-2010 period and by further adjustments thereafter - the non-linearity effect on revenue from social contributions remains.

Table 8: Comparison of budgetary developments and projections

(% of GDP)	2006	2007		2008		2009		2010
	COM	COM	SP	COM	SP	COM[1]	SP	SP
Revenue	**41.6**	**41.1**	**41.0**	**41.1**	**40.9**	**40.8**	**39.9**	**39.5**
of which:								
- Taxes on production and imports	15.1	15.0	15.1	14.9	14.8	14.9	14.2	13.6
- Current taxes on income, wealth, etc.	11.9	13.2	13.2	13.1	13.3	13.8	13.6	13.8
- Social contributions	7.8	7.7	7.7	7.5	7.5	7.3	7.4	7.2
- Other (residual)	6.8	5.2	5.2	5.5	5.3	4.9	4.8	4.9
Expenditure	**44.1**	**42.9**	**42.7**	**42.6**	**42.2**	**41.8**	**40.0**	**38.5**
of which:								
- Primary expenditure	40.5	39.6	39.4	39.4	39.0	38.7	37.0	35.6
of which:								
Compensation of employees	13.5	13.0	12.9	12.7	12.5	12.4	11.9	11.3
Intermediate consumption	5.7	5.7	5.6	5.9	5.8	5.9	5.4	5.1
Social payments	13.3	13.0	12.9	13.2	13.1	13.1	12.9	12.7
Subsidies	1.9	2.1	2.1	1.9	1.8	1.9	1.5	1.4
Gross fixed capital formation	4.3	4.1	4.0	3.9	3.9	3.4	3.3	3.5
Other (residual)	1.9	1.8	1.7	1.9	2.0	2.1	1.9	1.7
- Interest expenditure	3.6	3.3	3.3	3.2	3.2	3.1	3.0	2.9
General government balance (GGB)	**-2.5**	**-1.8**	**-1.6**	**-1.6**	**-1.2**	**-1.0**	**-0.1**	**0.9**
Primary balance	**1.0**	**1.5**	**1.7**	**1.6**	**2.0**	**2.1**	**2.9**	**3.8**
One-off and other temporary measures	0.7	0.8	0.8	0.2	0.2	0.0	0.2	0.1
GGB excl. one-offs	**-3.2**	**-2.6**	**-2.4**	**-1.7**	**-1.4**	**-1.0**	**-0.3**	**0.8**
Output gap[2]	-1.5	-0.6	-0.8	-0.1	-0.1	0.5	0.5	1.9
Cyclically-adjusted balance[2]	-2.0	-1.6	-1.3	-1.5	-1.2	-1.2	-0.3	0.3
Structural balance[3]	**-2.7**	**-2.3**	**-2.1**	**-1.7**	**-1.4**	**-1.2**	**-0.5**	**0.1**
Change in structural balance		*0.3*	*0.4*	*0.7*	*0.7*	*0.5*	*0.9*	*0.6*
Structural primary balance[3]	0.9	0.9	1.2	1.5	1.9	1.9	2.5	3.0
Change in structural primary balance		*0.0*	*0.1*	*0.6*	*0.7*	*0.4*	*0.7*	*0.4*

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

For 2008, changes in the tax-to-GDP ratio envisaged in the programme appear to be in line with those in the Commission services' autumn 2007 forecast (see Table 9). However, this masks the stronger reliance on volatile revenue items in the programme. As noted in Section 4.2.2 above, the increase in revenue from taxes on income and wealth in 2008 despite the revision in personal income tax rates relies to some extent on the Maltese authorities' assumption of stronger revenue from capital gains tax and taxes on profits declared by certain companies than projected in the Commission services' autumn 2007 forecast.

Table 9: Assessment of tax projections

	2008			2009			2010
	SP	**COM**	**OECD[3]**	**SP**	**COM[1]**	**OECD[3]**	**SP**
Change in tax-to-GDP ratio (total taxes)	-0.3	-0.3	0.5	-0.5	0.4	0.5	-0.5
Difference (SP – COM)	0.0		/	-0.9		/	/
of which [2] :							
- discretionary and elasticity component	*0.3*		/	*-1.0*		/	/
- composition component	*-0.2*		/	*0.0*		/	/
Difference (COM - OECD)	/	-0.8		/	0.0		/
of which [2] :							
- discretionary and elasticity component	/	*-1.0*		/	*-0.2*		/
- composition component	/	*0.1*		/	*0.1*		/
p.m.: Elasticity to GDP	0.9	0.8	1.0	0.7	1.2	1.0	0.7

Notes:

[1]On a no-policy change basis.

[2]The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

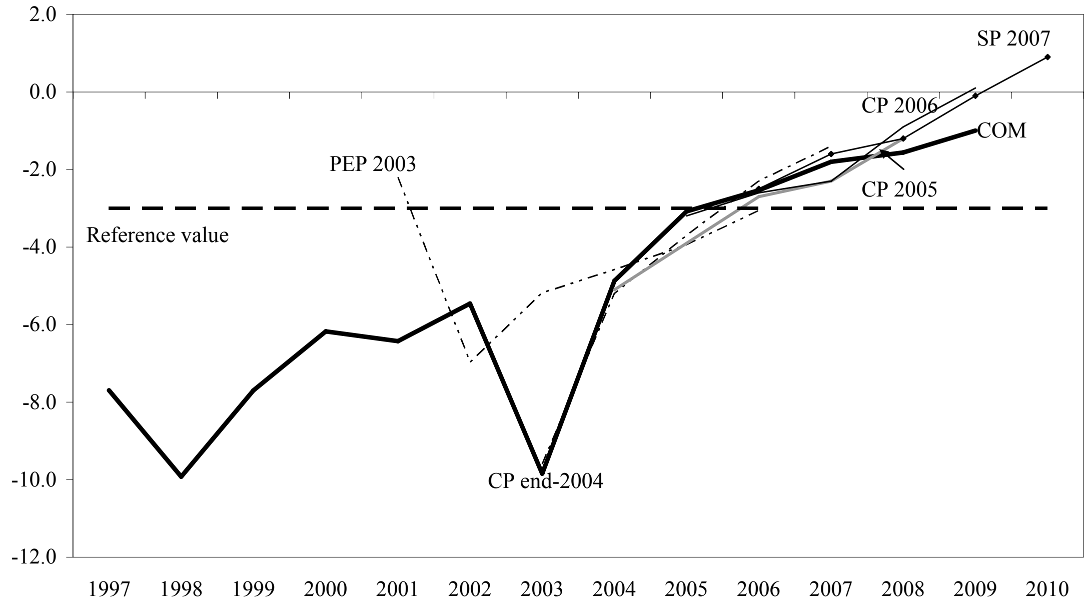
[3]OECD ex-ante elasticity relative to GDP.

Source:

Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).

The reliance on such volatile revenue items could present downside risks to the 2008 budgetary targets. For 2009, changes in the tax-to-GDP ratio envisaged in the programme show some divergences with the Commission services' autumn 2007 forecast. Whereas the Commission services' projection for changes in tax-to-GDP moves in line with the ex-ante elasticity, the programme assumes a more pessimistic impact of the discretionary and elasticity component. This seems to be particularly the case for taxes on production and imports which, as pointed out in Section 4.2.2 above, are projected to grow below historical values. Similarly, the tax-to-GDP ratio is projected to decline by around ½ percentage points of GDP in 2010 according to the programme, mainly explained by a sharp drop in taxes on production and imports. The different projections in changes in the tax-to-GDP ratio should be seen in the light of lack of information in the programme regarding policy measures for 2009 and 2010 and that, for 2009, the Commission services' projections are based on the customary no-policy-change assumption. Although this makes it difficult to assess budgetary outcomes, it appears that as a far as the evolution of tax-to-GDP ratio is concerned, there are upside risks to the target for 2009.

Figure 7: Government balance projections in successive programmes (% of GDP)



<u>Source</u>: Commission services' autumn 2007 forecast (COM); stability programme (SP); convergence programme (CP) and pre-accession economic programme (PEP).

The budgetary adjustment throughout the programme period relies on keeping current spending below nominal GDP growth. Specifically, the downward trajectory of expenditure depends to a large extent on restraining compensation of employees which, according to the programme, will grow by slightly less than 1% in nominal terms in 2009 and contract in 2010. Recent recruitment in certain public service posts, additional staff needed to ensure the full operation of the new large healthcare facility in the medium-term as well as the possibility that a generous sectoral wage agreement reached with health sector employees could trigger calls by other public sector employees for similar conditions, could pose risks to the programme's projected decline in this expenditure component. Another downside risk on the expenditure side relates to the authorities' decision to cap utility prices until mid-2008 by providing increased subsidies on fuel procured for energy generation.[34] In the event that no measures are taken to compensate for this higher expenditure, this decision represents a downside risk to the budgetary target for 2008. A commitment stated in the programme that the authorities stand ready to introduce additional corrective measures, should this be warranted by unforeseen circumstances mitigates downside risks in the remaining years. Similarly, a comparison of spending plans in successive programmes shows that when compared to outturns, expenditure ratios have been overestimated in the past years. Furthermore, Malta's track record of achieving its targets for the general government deficit has been good, as outcomes have usually been better than planned (see Figure 7).

The overall balance of risks attached to the budgetary adjustment outlined in the programme is that outcomes could be worse than targeted in the programme. For 2008, this mostly relates to the reliance on volatile revenue items and the possibility of expenditure slippages. For 2009 and 2010, outcomes could be worse than targeted due to the favourable macroeconomic scenario underlying the programme's projections

34 This measure is estimated to cost around 0.4% of GDP.

(although tax projections for these years seem cautious assuming that no discretionary tax reductions are envisaged) and also due to the lack of information on measures underpinning the consolidation process, in particular as regards the envisaged continued restraint in the public wage bill.

4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value and, second, the final assessment also taking into account risks.

Table 10: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with the targets taken at face value)	**Assessment** (taking into account risks to the targets)
a. Safety margin against breaching 3% of GDP deficit limit[1]	from 2008 onwards	from 2008 onwards
b. Achievement of the MTO	by 2010	probably not within the programme period
c. Adjustment towards MTO in line with the Pact[2]?	in line	should be backed up with measures, especially for 2009 and 2010

Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the minimum benchmark (estimated as a deficit of around 1¾% of GDP for Malta). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]The Stability and Growth Pact requires Member States to make progress towards their MTO (for countries in the euro area or in ERM II, this has been quantified as an annual improvement in the structural balance of at least 0.5% of GDP as a benchmark). In addition, the structural adjustment should be higher in good times, whereas it may be more limited in bad times.
[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.

Source:
Commission services

According to Commission services' calculations, based on the information provided in the programme, the structural deficit in 2007 is estimated at around 2% of GDP and improves by ¾ percentage points of GDP on average in the years thereafter. With the minimum benchmark (i.e. the estimated cyclically-adjusted budgetary position that provides a sufficient safety margin for automatic stabilisers to operate freely during normal economic downturns without breaching the 3% of GDP deficit reference value) estimated at around 1¾% of GDP, a safety margin appears to be provided from 2008 onwards, even taking into account the risks to the budgetary target for 2008.

The planned cumulative structural adjustment towards the MTO is around 2¼ percentage points of GDP over the programme horizon and is more or less evenly spread over the period. The planned adjustment is in line with the Pact which prescribes an annual adjustment of 0.5% of GDP as a benchmark for the euro area and ERM II countries not yet in the MTO and a higher effort in good times, which currently Malta seems to enjoy. However, taking into account the risks mentioned above, the structural adjustment towards the MTO implied by the programme should be backed up with measures especially in the years 2009 and 2010. Taking into account the risks, the MTO would probably not be achieved within the programme horizon.

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

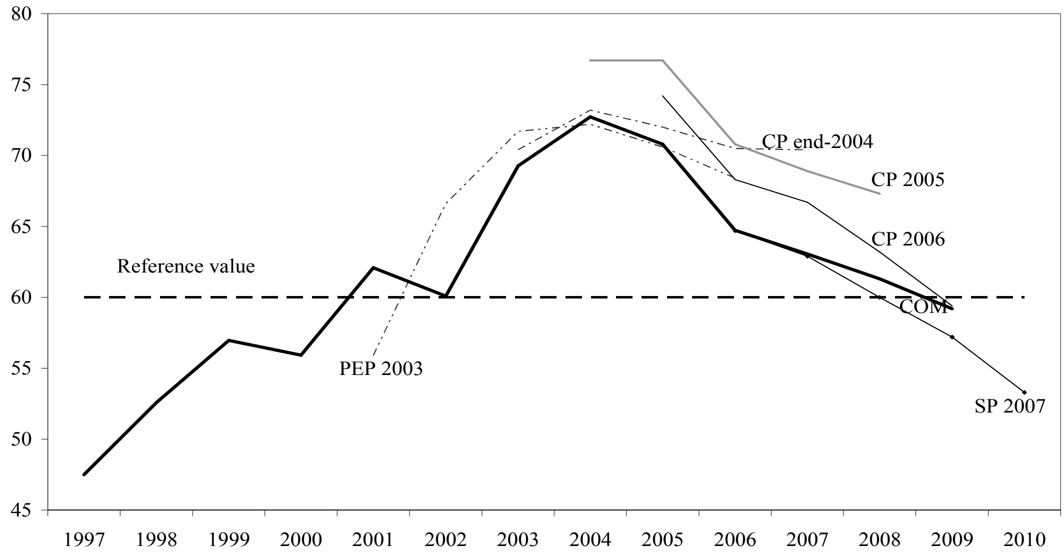
5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

After reaching a peak of 72¾% of GDP in 2004, gross government debt progressively declined thereafter. In 2006, the debt-to-GDP ratio stood at 64¾%. According to the programme, the debt level will continue to follow a downward path during the outlook period. For 2007, the debt-to-GDP ratio is estimated to fall by around 1¾ percentage points of GDP mainly on account of a higher primary surplus. In 2008, the gross government debt is projected at 60% of GDP and will fall to around 53¼% of GDP by 2010. These targets are optimistic when compared to the targets of the 2006 update convergence programme and more favourable than the projections of the Commission services' 2007 autumn forecast.

The programme's projected reduction in the gross debt is back-loaded with a growing primary surplus and nominal GDP growth being the main drivers of the decline. Falling interest expenditure as a ratio of GDP also leads to the reduction in debt. The programme does not foresee proceeds from new privatisation contributing to the decline in gross debt.

Figure 8: Debt projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM); stability programme (SP); convergence programme (CP) and pre-accession economic programme (PEP).

5.1.2. Assessment

The Commission services' autumn 2007 forecast projects a slower decline in the general government debt between 2007 and 2009. While the difference in 2007 is negligible, for 2008 the programme foresees a larger decline in gross government debt. A higher primary surplus and more optimistic nominal GDP growth explain half of the variance. The remainder is due to the stock-flow adjustment.[35] For 2009, the difference is mainly explained by the programme's more favourable projection of the primary balance[36], projected to reach almost 3% of GDP, against 2% of GDP in the Commission services' autumn 2007 forecasts.

The risks associated with the downward path of the debt-to-GDP ratio are similar to those referred to earlier relating to the budgetary adjustment. A lower GDP growth and the possibility of expenditure slippages would pose downside risks to fiscal adjustment and hence to the decline in the gross debt as envisaged in the programme. The programme provides a sensitivity analysis of gross debt to an increase in the interest rate, external demand and real GDP. In the case of a 1 percentage point rise in market interest rates over the programme period, the debt-to-GDP ratio at the end of 2010 would be around ¾ of a percentage point higher than the baseline scenario. An increase of 1% in external demand over the programme period would translate into a drop in the debt-to-GDP ratio of around 1½ percentage point from the baseline scenario by 2010. This further underscores the downside risks attached to the debt reduction path in the event that the

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35 The stability programme notes that proceeds from privatisation amounting to 0.4% of GDP that took place in 2007 have been retained as 'currency and deposits'. Although not specified, it appears that the proceeds will be used for debt reduction in 2008.

36 It should be noted that the Commission services' autumn 2007 forecast for 2009 is based on the customary no-policy change scenario.

Table 11: Debt dynamics

(% of GDP)	average 2002-05	2006	2007 COM	2007 SP	2008 COM	2008 SP	2009 COM	2009 SP	2010 SP
Gross debt ratio[1]	**68.2**	**64.7**	**63.1**	**62.9**	**61.3**	**60.0**	**59.2**	**57.2**	**53.3**
Change in the ratio	2.2	-6.1	-1.7	-1.8	-1.7	-2.9	-2.1	-2.8	-3.9
Contributions [2] *:*									
Primary balance	**2.2**	**-1.0**	**-1.5**	**-1.7**	**-1.6**	**-2.0**	**-2.1**	**-2.9**	**-3.8**
"Snow-ball" effect	**1.0**	**-0.4**	**-0.2**	**-0.5**	**-0.1**	**-0.4**	**0.0**	**-0.1**	**-0.1**
Of which:									
Interest expenditure	3.6	3.6	3.3	3.3	3.2	3.2	3.1	3.0	2.9
Growth effect	-0.9	-2.1	-1.9	-2.1	-1.6	-1.8	-1.7	-1.8	-1.8
Inflation effect	-1.7	-1.9	-1.5	-1.7	-1.6	-1.7	-1.4	-1.3	-1.2
Stock-flow adjustment	**-1.0**	**-4.6**	**0.0**	**0.4**	**0.0**	**-0.5**	**0.0**	**0.2**	**0.1**
Of which:									
Cash/accruals diff.	-0.8	-0.8		n.a.		n.a.		n.a.	n.a.
Acc. financial assets	-0.2	-3.7		n.a.		n.a.		n.a.	n.a.
Privatisation	*-0.8*	*-4.4*		*n.a.*		*n.a.*		*n.a.*	*n.a.*
Val. effect & residual	0.0	0.0		n.a.		n.a.		n.a.	n.a.

Notes:

[1]End of period.

[2]The change in the gross debt ratio can be decomposed as follows:

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

where t is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

relatively optimistic expansion of net exports envisaged by the programme fails to materialise. According to the programme, a 1% increase in real GDP growth would lead to a decline of ¾ of a percentage point in the debt-to-GDP ratio from the baseline scenario by 2010.

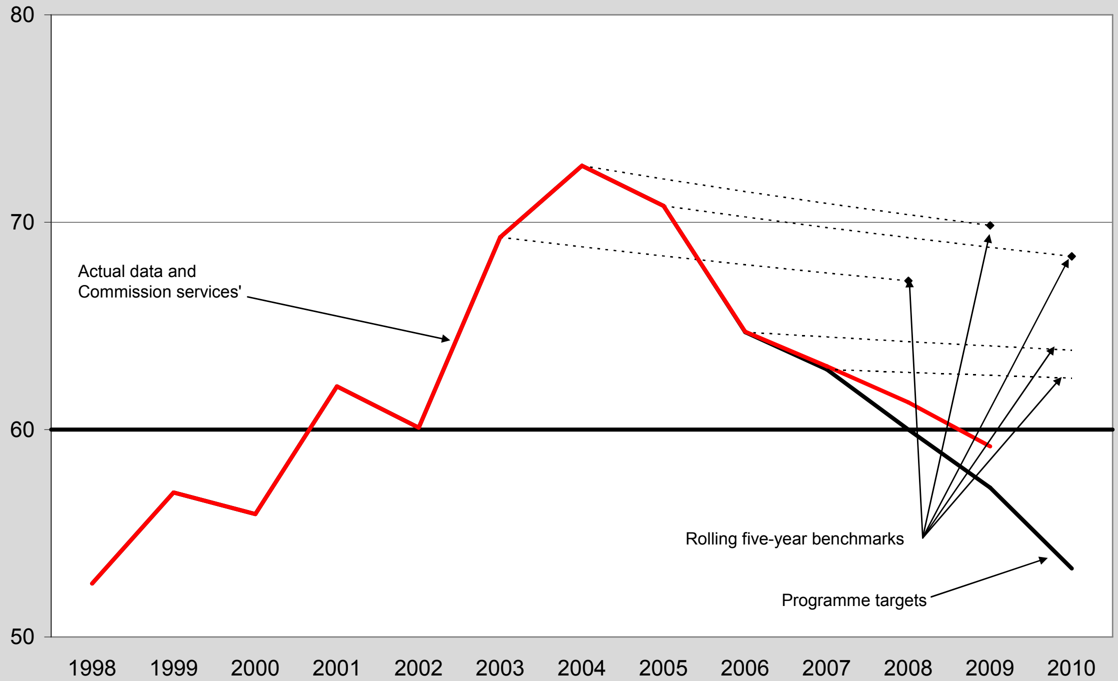
The trajectory of the general government debt as presented in the programme is projected to develop in accordance with the budgetary targets and the favourable economic growth. During the programme period, debt-increasing below-the-line operations are relatively low, which is in line with the experience in the past years. In light of these considerations and bearing in mind that the rising trend in general government debt has been reversed in 2005, the debt projections in the programme – provided that they materialise – can be considered as sufficiently diminishing and below 60% of GDP from 2009.

Box 5: The rolling debt reduction benchmark

Malta entered the EU with a debt ratio in excess of 60% of GDP. A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in the accompanying graph. It shows historical data, the Commission services' autumn 2007 forecasts until 2009 (which are on a no-policy change scenario) and the multi-annual debt projections in the update and compares them with the paths obtained by applying an illustrative "rolling debt reduction benchmark" (*). The benchmark reflects the idea that a minimum debt reduction should be ensured not year after year but over a medium-term horizon (five years in the graph). For instance, the debt projection for 2008 is compared with the value obtained for the same year by applying the formula starting in 2003. Debt level projections in the programme exceeding those obtained by applying the benchmark are taken as an indicator of a slow reduction in the debt ratio.

The graph clearly shows that the planned reduction of the debt ratio in the stability programme is more than implied by the five-year rolling debt reduction benchmark.

Malta: rolling five-year debt benchmark



Source : *Convergence/Stability programmes and Commission services*

(*) The rolling debt reduction benchmark for successive five-year periods is defined as a reduction in the difference between the debt ratio and the 60% of GDP reference value of 5 percent per year:

$$\left(\frac{D_{t+1}}{Y_{t+1}}\right)_{benchmark} = \left(\frac{D_t}{Y_t}\right)_{benchmark} - 5\% \times \left[\left(\frac{D_t}{Y_t}\right)_{benchmark} - 60\right],$$

where t is a time subscript and D and Y are the stock of government debt and nominal GDP, respectively. In the first year of the five-year period, the debt ratio in the previous year is the actual debt ratio. Given the usual approximation of the change in the debt ratio

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{DEF_t}{Y_t} - \frac{y_t}{1+y_t} \times \frac{D_{t-1}}{Y_{t-1}} \cong \frac{DEF_t}{Y_t} - y_t \times \frac{D_{t-1}}{Y_{t-1}}$$

and assuming that the stock-flow adjustment is zero, it is easy to show that the rolling debt reduction benchmark describes the path for convergence of the debt ratio towards 60% of GDP which would take place with the deficit at 3% of GDP and nominal GDP growth at 5%. In other words, the 5 percent per year benchmark is the value that makes consistent a continuous respect of the 3% of GDP deficit threshold and an asymptotic respect of the 60% of GDP debt reference value.

5.2. Long-term debt projections and the sustainability of public finances

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

5.2.1. Sustainability indicators and long-term debt projections

Table 12 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections and property income received by general government according to an agreed methodology.[37] Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

Table 12: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	Change up to 50
Total age-related spending	18.2	19.1	20.4	20.0	19.2	18.5	0.3
- Pensions	7.4	8.8	10.2	9.1	7.9	7.0	-0.4
- Healthcare	4.2	4.5	5.0	5.5	5.9	6.1	1.8
- Long-term care	0.9	0.9	0.9	1.0	1.1	1.1	0.2
- Education	4.4	3.7	3.2	3.3	3.3	3.3	-1.2
- Unemployment benefits	1.2	1.2	1.0	1.0	1.0	1.0	-0.2
Property income received	1.5	1.3	1.2	1.2	1.1	1.1	-0.4

Source: Economic Policy Committee and Commission services.

The projected increase in age-related spending in Malta is among the five lowest increases in the EU, rising by 0.3 p.p. of GDP between 2004 and 2050. This is particularly due to pension expenditure being projected to decrease by around 0.4 p.p. of GDP. This reflected notably the specific design of the Maltese pension system, which, in effect puts a cap on the level of both pensions and contributions. As a result, pensions are projected to decrease as a share of GDP between 2020 and 2050. However, those projections do not include the impact of the pension reform enacted at the end of 2006. The increase in health-care expenditure is projected to be 1.8 p.p. of GDP, higher than on average in the EU. For long-term care, the projected increase of 0.2 p.p. of GDP up to 2050, is slightly below the average in the EU.

Table 13: Sustainability indicators and the required primary balance

	2007 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	-0.2	-0.6	0.2	-2.1	-2.4	0.1
of which:						
Initial budgetary position (IBP)	-0.8	-0.5	-	-2.6	-2.3	-
Debt requirement in 2050 (DR)	-0.1	-	-	-0.1	-	-
Long-term change in the primary balance (LTC)	0.6	-0.1	-	0.6	-0.1	-

Source: Commission services.

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 13 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period and the programme scenario assumes that the programme's budgetary plans are fully attained.

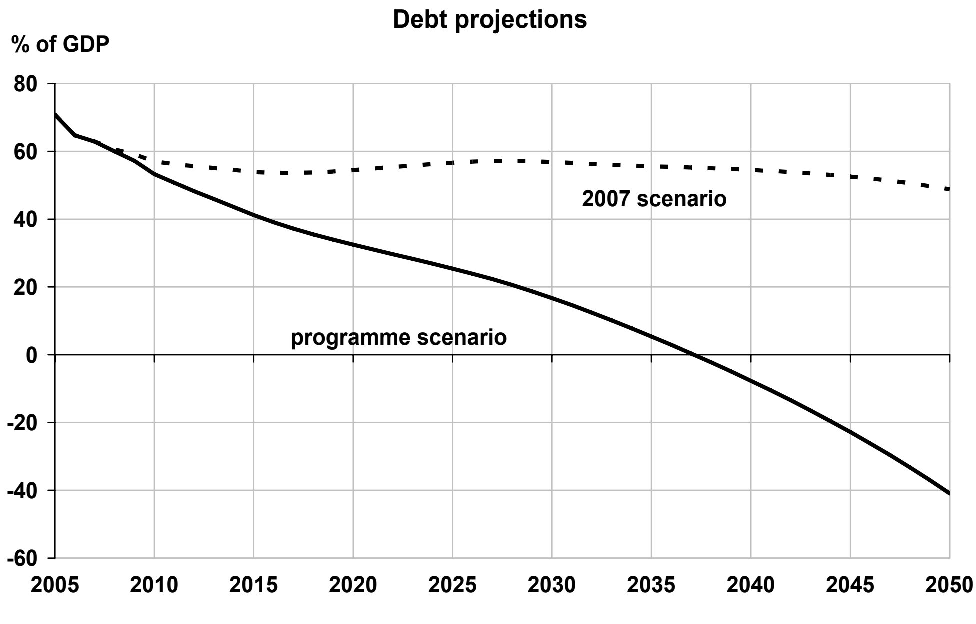
[37] See the accompanying "methodological paper" for a description of the property income projections.

In the “2007 scenario”, the sustainability gap (S2) which satisfies the intertemporal budget constraint would be -0.6 p.p. of GDP.[38] The sustainability gap is slightly lower than in last year assessment, inter alia, due to the improvement in the structural primary balance (1.2 p.p. of GDP) in 2007 compared to 2006 (0.8 p.p. as estimated for the assessment of last year's programme).

The initial budgetary position with a structural primary balance of 1.2 p.p. of GDP contributes to the reduction of gross debt. According to both sustainability gaps, the long-term budgetary impact of ageing is very small notably to, before the implementation of the 2006 pension reform, the decrease in pension expenditure as a share of GDP. The programme plans a structural primary budgetary consolidation of 2.0 p.p. of GDP between 2007 and 2010. If achieved, such a consolidation would appreciably reduce risks to long-term sustainability of public finances by reducing the S2 sustainability gap (“programme scenario”). The difference between the initial budgetary position in the '2007 scenario' and the 'programme scenario' illustrates how the full respect of the stability programme targets, would contribute to tackling the budgetary challenges raised by the demographic developments.

The required primary balance (RPB) is almost 0% of GDP, reflecting the significant decrease in pension expenditure as a share of GDP before the reform, and is lower than the structural primary balance over the programme period.

Figure 9: Long-term projections for the government debt ratio



Source: Commission services

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 9. The gross debt ratio is currently

[38] The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be -0.2 p.p. of GDP.

above the 60% of GDP reference value, estimated in the programme at close to 63% of GDP in 2007. According to the "2007 scenario", the debt ratio is projected to decrease and remain slightly below 60% of GDP over the projection period up to 2050. In the "programme scenario", thanks to the stronger budgetary position in 2010, debt level would fall significantly below 60% of GDP over the projection period.

5.2.2. *Additional factors*

To reach an overall assessment of the sustainability of public finances, other relevant issues are taken into account which in addition allows to better qualify the assessment with regard to where the main risks are likely to stem from.

First, the current level of debt is above the Treaty reference value at 62.9% of GDP. A reduction in the debt to below the reference value, as projected in the programme, would strengthen the resilience of public finances to adverse shocks and reduce the risks to public finance sustainability.

Second, Malta has enacted a pension reform at the end of 2006. This reform includes several important measures, notably:

- the pension age (currently 60 years for women and 61 years for men) will progressively increase to 65 years; early retirement is possible after 61 provided that the insured is (i) no longer gainfully occupied and (ii) has paid contributions for 40 years;

- the pensionable income will be calculated on the basis of the best 10 wages of the past 40 years (compared to the best 3 consecutive years of the last 10 years in the previous legislation);

- the condition on the number of years worked to be entitled to the full rate of a pension ("two-thirds" of pensionable income) will be progressively tightened;

- the maximum pensionable income will be indexed partly on wages (70%) and partly on prices (30%). This is in sharp contrast with the pre-reform projection, where pension were more or less indexed to prices[39] and would have led to a significant decrease in the benefit ratio;[40]

- the guaranteed national minimum pension will be revised upwards.

The addendum to the 2006/07 Maltese programme provides provisional estimates of the effect of the 2006 pension reform. According to those estimates,[41] pension expenditure would be lower than before the reform up to 2030, but significantly higher in 2050 by

[39] Under the previous legislation, pensions were indexed to wage growth but, *importantly,* they were subject to a maximum which in turn increased more slowly than prices (the Cost of Living Adjustment (COLA)). As a result, this would eventually entail very slow growth of individual pensions and pension expenditure would fall as a share of GDP after 2020 when the maximum would be reached, despite an increasing number of pensioners.

[40] See the Sustainability Report Section III-2

[41] Those projections were not submitted to a peer review within the Ageing working group.

around 3½% of GDP. On the one hand, the increase in the pension age, as well as the increase of the number of wages (contribution years) over which the pension is calculated, will curb pension expenditure. On the other hand, those effects will be offset in the long run by the fact that the maximum pensionable income will be, from now on, significantly more dynamic compared with the previous legislation. This should lead to a more dynamic average pension, and therefore higher pension expenditure, over the long run.[42] If those provisional projections taking into account the pension reform were included, the sustainability gap would be higher by around 2 p.p. of GDP and would be close to 1.5 p.p. of GDP.

5.2.3. Assessment

The long-term budgetary impact of ageing in Malta is significantly lower than the EU average, with pension expenditure decreasing as a share of GDP over the long-term. Yet, the 2006 pension reform, which aims at both increasing the retirement age and improving the level of pension, is likely to imply higher spending over the long run.

The current budgetary position, which improved compared with 2006, contributes to ease the projected long-term budgetary impact of ageing populations. However, the current level of gross debt is above the Treaty reference value. Improving the budgetary position, as projected in the programme, would contribute to reducing the risks to the sustainability of public finances.

Overall, Malta appears to be at medium risk with regard to the sustainability of public finances.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

According to Malta's stability programme, while the primary objective of fiscal policy will remain further consolidation, more emphasis will be laid on improving the supply-side of the economy. Against a background of low activity rate and a further tightening of the Maltese economy projected throughout the outlook period, the programme lists measures that will be implemented in 2008 intended to enhance the economy's growth potential in the context of the renewed Lisbon strategy. However, the programme does not provide detailed information on the reforms envisaged for 2009 and 2010.

The main reform effective in 2008 presented in the stability programme relates to revisions, further to those implemented last year, in the personal income tax regime. The objective of the reform, according to the programme, is to improve the incentive to work by lowering taxation on income. While tax rates have remained unchanged, tax bands have been revised for both single individuals and married couples. The income threshold below which no tax is payable has been raised by around 8% for both married couples and single taxpayers. The remaining income tax bands of 15%, 25% and 35% have also been widened. According to the stability programme, the revised personal income tax code would have a gross budgetary impact of around 0.5% of GDP.

42 This would imply a higher benefit ratio (i.e. average pension relative to GDP per worker) in the period to 2050. The Ageing Report had projected a fall in the benefit ratio by 45%.

Old-age employment has been historically low in Malta, averaging at around 31% between 2002 and 2006. In part, this is explained by the relatively low retirement age (61 years for males, 60 years for females) under the previous pension system. While the pension reform which came into effect on 1st January 2007 provides for a gradual rise in the retirement age to 65 years for both males and females, its effects will only be felt from 2014. Even under the reformed pension system, employed persons under 65 years of age and earning more than the minimum wage were not entitled to a pension. According to the programme, a measure will be adopted in 2008 whereby persons reaching a pensionable age and choosing to remain in employment will receive a pension irrespective of the income earned.

The stability programme gives some details about new procedures introduced in 2007 intended to assess the priority and improve the effective implementation of capital projects. These procedures are result-oriented in that they target national priority initiatives and budgetary targets. According to the programme, through this procedure the allocation of resources improves the efficiency in the provision of public goods and services by strengthening the link between inputs and outcomes.

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

The main policy measure presented in the stability programme, i.e. further revision of the personal income tax regime (see Section 6), is in line with the NRP. The implementation report spells out the first steps taken by Malta in respect of healthcare reform. However, this measure is not dealt with in the stability programme. Both the stability programme and the 2007 Implementation report provided details on the reformed pension system introduced in 2007 and underscore that fiscal consolidation is planned to be achieved through public spending restraint. The measure related to increasing old-age employment described in the programme, is not included in the 2007 Implementation report.

The programme does not contain a qualitative assessment of the overall impact of the national reform programme within the medium-term fiscal strategy. However, the programme's budgetary projections take into account the public finance implications of the measures identified in the NRP. In addition, the stability programme provides information on the direct budgetary costs for most of the measures envisaged in the NRP.

Box 6: The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Malta's national reform programme[43] and is summarised as follows.

Malta's national reform programme identifies as key challenges/priorities the sustainability of public finances, competitiveness, the environment, employment and education and training as key challenges.

[43] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

The Commission's assessment is that Malta has made good progress in the implementation of its National Reform Programme over the 2005-2007 period. Against the background of strengths and weaknesses identified, the Commission recommends that Malta is recommended to take action in the areas of: competition and state aid, attracting more people into the labour market, tackling undeclared work and making work pay.

Against the background of progress made, the Commission recommends that Malta is encouraged to also focus on the areas of: health care reform, improve further the regulatory environment, diversify energy sources, raise educational attainment and reduce early school leaving.

However, the direct budgetary costs related to sustainability of public finances are not provided. For those measures for which information on the direct budgetary costs is provided, the impact will amount to around 1% of GDP in both 2007 and 2008. The stability programme and the 2007 Implementation report seem to be integrated to some extent.

The tables below provide an overview of whether the strategy and policy measures in the stability programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs. The first table makes the assessment against the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005. The second table makes the assessment against the country-specific recommendations/points to watch and the recommendations for the euro area, adopted by the Council in March 2007. The budgetary strategy in the stability programme is broadly consistent with the recommendations for the euro area but partly consistent with the point to watch on healthcare reform.

Table 14: Consistency with the broad economic policy guidelines (integrated guidelines)

Broad economic policy guidelines (integrated guidelines)	Yes	Steps in right direction	No	Not applicable
1. To secure economic stability				
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].	X			
– Member States should avoid pro-cyclical fiscal policies[2].				X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].				X
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.	X			
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,				
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.	X			
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)		X		
3. To promote a growth- and employment-orientated and efficient allocation of resources				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the		X		

Broad economic policy guidelines (integrated guidelines)	Yes	Steps in right direction	No	Not applicable
relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.				

Notes:
[1]As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.
[2]As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times".
[3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.

Source:
Commission services

Table 15: Consistency with the broad economic policy guidelines (country-specific recommendations and points to watch)

Broad economic policy guidelines (country-specific recommendations and points to watch)	Yes	Steps in right direction	No	Not applicable
1. Country-specific recommendations				
– *None*				X
2. Points to watch				
– Implement and reinforce delayed measures on health care reform		X		
3. Recommendations for euro area Member States				
– Make use of the favourable cyclical conditions to aim at or pursue ambitious budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment of at least 0.5% of GDP as a benchmark	X			
– Improve the quality of public finances by reviewing public expenditure and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability	X			

Source:
Commission services

* * *

Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

(i) Model structure

The programme broadly follows the model structure for stability and convergence programmes specified in Annex 1 of the new code of conduct.

(ii) Data requirements

The programme has few gaps in compulsory data and gaps in the optional data prescribed by the code of conduct. However, these gaps did not prevent an assessment of the stability programme.

The gaps in compulsory data relate to changes in inventories and net acquisition of valuables and the unemployment level both for 2006.

The gaps in optional data relate to: data on general government debt developments, in particular data on stock-flow adjustment in respect of differences between cash and accruals, net accumulation of financial assets, net accumulation of financial assets - privatisation proceeds, valuation effects and other, liquid financial assets, net financial debt, all for the period 2006-10. Long-term sustainability of public finances figures for the following are missing throughout the years; total expenditure, social security pension, other age-related expenditures, interest expenditure, total revenue, participation rate males (aged 20-64). Data for the following are missing for the year 2000 while data for 2004 is presented instead of 2005; age-related expenditures, pension expenditure, old-age and early pensions, other pensions (disability, survivors), health care, long-term care, education expenditure, property income, pensions contributions, labour productivity growth, real GDP growth, participation rates females (aged 20-64), total participation rates (aged 20-64), unemployment rate, population aged 65+ over total population.

The tables on the following pages show the data presented in the November 2007 stability programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

The SCP…	Yes	No	Comments
a. Involvement of parliament			
… mentions status vis-à-vis national parliament.	X		
… indicates whether Council opinion on previous programme has been presented to national parliament.		X	
b. Economic outlook			
… (for euro area and ERM II Member States) uses "common external assumptions" on main extra-EU variables.	X		
… explains significant divergences with Commission services' forecasts[1].		X	
… bears out possible upside/downside risks to economic outlook.	X		
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.		X	
c. Monetary/exchange rate policy			
… (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable

The SCP…	Yes	No	Comments
d. Budgetary strategy			
… presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		
… (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			Not applicable
… explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).	X		No rectifying measures mentioned
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.	X		Only for 2008
… specifies state of implementation of measures.	X		
e. "Major structural reforms"			
… (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.			Not applicable
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.			Not applicable
f. Sensitivity analysis			
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	 X X		 Not applicable Not applicable
… (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth.			Not applicable
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.	X		
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
i. Long-term sustainability			
… outlines strategies to ensure sustainability.	X		Not on healthcare
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	X		
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		
Notes: SCP = stability/convergence programme; CP = convergence programme [1]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme. *Source:* *Commission services*			

Table 1a. Macroeconomic prospects

	ESA Code	2006 [1] Level	2006 rate of change	2007 [2] rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Real GDP	B1*g	*4254.3*	3.2	3.5	3.1	3.2	3.4
2. Nominal GDP	B1*g	*5025.3*	6.0	6.4	6.1	5.5	5.6
Components of real GDP							
3. Private consumption expenditure [3]	P.3	*2866.9*	1.3	2.4	2.2	2.6	2.5
4. Government consumption expenditure	P.3	*829.2*	3.7	1.2	0.5	-1.9	-1.7
5. Gross fixed capital formation	P.51	*849*	2.2	-2.9	5.3	4.8	3.7
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*n.a.*	0.0	-0.2	0.1	0.0	0.1
7. Exports of goods and services	P.6	*4196.5*	10.0	-1.7	2.3	3.3	3.2
8. Imports of goods and services	P.7	*4486.4*	8.1	-3.9	2.0	2.1	1.8
Contributions to real GDP growth							
9. Final domestic demand		-	2.1	1.3	2.6	2.3	2.1
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.0	-0.2	0.3	-0.1	0.1
11. External balance of goods and services	B.11	-	1.1	2.4	0.2	1.0	1.3

[1] € million

[2] Forecasts from 2007 onwards

[3] Includes NPISH final consumption expenditure

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. GDP deflator		*118.1*	2.8	2.8	3.0	2.2	2.1
2. Private consumption deflator		*113*	2.4	0.6	2.5	2.3	2.1
3. HICP[1]		*102.6*	2.6	0.9	2.5	2.3	2.1
4. Public consumption deflator		*121.4*	1.8	1.9	3.7	2.4	2.3
5. Investment deflator		*114.9*	3.5	0.6	1.4	1.1	2.3
6. Export price deflator (goods and services)		*104.9*	8.3	4.9	2.8	2.4	2.3
7. Import price deflator (goods and services)		*102.5*	7.6	2.0	2.1	2.1	2.1

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*154.2*	0.9	1.6	1.2	1.3	1.4
2. Employment, hours worked[2]		*295891*	1.6	1.6	1.2	1.3	1.4
3. Unemployment rate (%)[3]		*n.a.*	7.3	6.6	6.8	6.7	6.6
4. Labour productivity, persons[4]		*27591*	2.2	1.8	1.8	1.9	2.0
5. Labour productivity, hours worked[5]		*14.4*	1.5	1.8	1.8	1.9	2.0
6. Compensation of employees	D.1	*2205*	3.6	3.7	4.2	4.6	4.7
7. Compensation per employee		*16205*	2.7	2.1	3.0	3.3	3.3

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-3.7	-0.5	0.2	3.2	5.5
of which :						
- Balance on goods and services		-3.9	0.6	1.4	2.6	3.9
- Balance of primary incomes and transfers		-2.8	-3.2	-3.3	-1.5	-0.4
- Capital account		3.0	2.2	2.1	2.0	2.0
2. Net lending/borrowing of the private sector	B.9	-4.2	-1.1	-0.7	1.3	2.6
3. Net lending/borrowing of general government	EDP B.9	-2.5	-1.6	-1.2	-0.1	0.9
4. Statistical discrepancy		-1.8	optional	optional	optional	optional

Table 2. General government budgetary prospects

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	*-127.5*	-2.5	-1.6	-1.2	-0.1	0.9
2. Central government	S.1311	*-127.1*	-2.5	-1.6	-1.2	-0.1	0.9
3. State government	S.1312	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	*-0.4*	0.0	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.
General government (S13)							
6. Total revenue	TR	*2088*	41.6	41.0	40.9	39.9	39.5
7. Total expenditure	TE[1]	*2215.5*	44.1	42.7	42.2	40.0	38.5
8. Net lending/borrowing	EDP B.9	*-127.5*	-2.5	-1.6	-1.2	-0.1	0.9
9. Interest expenditure	EDP D.41	*178.7*	3.6	3.3	3.2	3.0	2.9
10. Primary balance[2]		*51.2*	1.0	1.7	2.0	2.9	3.8
11. One-off and other temporary measures[3]		*33.3*	0.7	0.8	0.2	0.2	0.1
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		*1372.8*	27.3	28.5	28.3	28.0	27.7
12a. Taxes on production and imports	D.2	*758.5*	15.1	15.1	14.8	14.2	13.6
12b. Current taxes on income, wealth, etc	D.5	*599.6*	11.9	13.2	13.3	13.6	13.8
12c. Capital taxes	D.91	*14.7*	0.3	0.3	0.3	0.3	0.3
13. Social contributions	D.61	*390.4*	7.8	7.7	7.5	7.4	7.2
14. Property income	D.4	*63.2*	1.3	1.1	1.1	1.0	1.0
15. Other[4]		*261.6*	5.2	3.7	4.0	3.5	3.6
16=6. Total revenue	TR	*2088*	41.6	41.0	40.9	39.9	39.5
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]			35.5	36.6	36.3	35.8	35.3
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	*962*	19.1	18.5	18.3	17.4	16.4
17a. Compensation of employees	D.1	*677.2*	13.5	12.9	12.5	11.9	11.3
17b. Intermediate consumption	P.2	*284.8*	5.7	5.6	5.8	5.4	5.1
18. Social payments (18=18a+18b)		*666*	13.3	12.9	13.1	12.9	12.7
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*32.1*	0.6	0.6	0.6	0.6	0.6
18b. Social transfers other than in kind	D.62	*633.9*	12.6	12.3	12.5	12.3	12.1
19=9. Interest expenditure	EDP D.41	*178.7*	3.6	3.3	3.2	3.0	2.9
20. Subsidies	D.3	*94.5*	1.9	2.1	1.8	1.5	1.4
21. Gross fixed capital formation	P.51	*218.3*	4.3	4.0	3.9	3.3	3.5
22. Other[6]		*96*	1.9	1.7	2.0	1.9	1.7
23=7. Total expenditure	TE[1]	*2215.5*	44.1	42.7	42.2	40.0	38.5
p.m.: Government consumption (nominal)	P.3	*1012*	20.1	19.5	19.2	18.2	17.2

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

[5]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2005	2010
1. General public services	1	7.5	6.8
2. Defence	2	0.9	0.6
3. Public order and safety	3	1.6	1.3
4. Economic affairs	4	6.2	4.2
5. Environmental protection	5	1.0	1.3
6. Housing and community amenities	6	1.1	1.0
7. Health	7	6.6	4.4
8. Recreation, culture and religion	8	0.8	0.5
9. Education	9	5.7	5.0
10. Social protection	10	13.7	13.3
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	45.1	38.5

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4. General government debt developments

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Gross debt[1]		64.7	62.9	60.0	57.2	53.3
2. Change in gross debt ratio		-6.1	-1.9	-2.8	-2.9	-3.9
Contributions to changes in gross debt						
3. Primary balance[2]		-1.0	-1.7	-2.0	-2.9	-3.8
4. Interest expenditure[3]	EDP D.41	3.6	3.3	3.2	3.0	2.9
5. Stock-flow adjustment		-4.6	0.4	-0.4	0.1	0.1
of which:						
- Differences between cash and accruals[4]		n.a.	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets[5]		n.a.	n.a.	n.a.	n.a.	n.a.
of which:						
- privatisation proceeds		n.a.	n.a.	n.a.	n.a.	n.a.
- Valuation effects and other[6]		n.a.	n.a.	n.a.	n.a.	n.a.
p.m.: Implicit interest rate on debt[7]		5.3	5.4	5.4	5.3	5.3
Other relevant variables						
6. Liquid financial assets[8]		n.a.	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		n.a.	n.a.	n.a.	n.a.	n.a.

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure divided by the debt level of the previous year.

[8]AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Real GDP growth (%)		3.2	3.5	3.1	3.2	3.4
2. Net lending of general government	EDP B.9	-2.5	-1.6	-1.2	-0.1	0.9
3. Interest expenditure	EDP D.41	3.6	3.3	3.2	3.0	2.9
4. One-off and other temporary measures[1]		0.7	0.8	0.2	0.2	0.1
5. Potential GDP growth (%)		2.8	2.4	2.3	1.9	2.0
contributions:						
- labour		n.a.	n.a.	n.a.	n.a.	n.a.
- capital		n.a.	n.a.	n.a.	n.a.	n.a.
- total factor productivity		n.a.	n.a.	n.a.	n.a.	n.a.
6. Output gap		-2.4	-1.3	-0.6	0.7	2.0
7. Cyclical budgetary component		-0.9	-0.5	-0.2	0.3	0.7
8. Cyclically-adjusted balance (2 - 7)		-1.7	-1.1	-1.0	-0.4	0.2
9. Cyclically-adjusted primary balance (8 + 3)		1.9	2.2	2.2	2.6	3.1
10. Structural balance (8 - 4)		-2.3	-1.9	-1.2	-0.6	0.1

[1]A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

	ESA Code	2006	2007	2008	2009	2010
Real GDP growth (%)						
Previous update		2.9	3.0	3.1	3.1	n.a.
Current update		3.2	3.5	3.1	3.2	3.4
Difference		0.3	0.5	0.0	0.1	n.a.
General government net lending (% of GDP)	EDP B.9					
Previous update		-2.6	-2.3	-0.9	0.1	n.a.
Current update		-2.5	-1.6	-1.2	-0.1	0.9
Difference		0.1	0.7	-0.3	-0.2	n.a.
General government gross debt (% of GDP)						
Previous update		68.3	66.7	63.2	59.4	n.a.
Current update		64.7	62.9	60.0	57.2	53.3
Difference		-3.6	-3.8	-3.2	-2.2	n.a.

Table 7. Long-term sustainability of public finances

% of GDP	2000	2004[1]	2010	2020	2030	2050
Total expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which: age-related expenditures	n.a.	18.2	19.1	20.4	20.0	18.5
Pension expenditure	n.a.	7.4	8.8	10.2	9.1	7.0
Social security pension	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Old-age and early pensions	n.a.	3.8	5.2	7.0	6.9	6.5
Other pensions (disability, survivors)	n.a.	3.6	3.6	3.2	2.2	0.5
Occupational pensions (if in general government)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health care	n.a.	4.2	4.5	5.0	5.5	6.1
Long-term care *(this was earlier included in the health care)*	n.a.	0.9	0.9	0.9	1.0	1.1
Education expenditure	n.a.	4.4	3.7	3.2	3.3	3.3
Other age-related expenditures	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Interest expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total revenue	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which: property income	n.a.	2.2	1.2	1.1	0.7	0.3
Of which : from pensions contributions (or social contributions if appropriate)	n.a.	7.1	6.8	5.9	4.7	3.3
Pension reserve fund assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which : consolidated public pension fund assets (assets other than government liabilities)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Assumptions						
Labour productivity growth	n.a.	1.4	0.9	2.4	2.7	1.7
Real GDP growth	n.a.	1.9	2.5	2.7	3.1	1.7
Participation rate males (aged 20-64)	n.a.	84.2	85.8	86.3	86.4	86.4
Participation rates females (aged 20-64)	n.a.	40.9	48.1	55.3	57.8	58.3
Total participation rates (aged 20-64)	n.a.	62.6	66.7	70.4	71.6	71.7
Unemployment rate	n.a.	9.0	9.4	9.0	8.8	8.6
Population aged 65+ over total population	n.a.	15.9	18.9	23.8	26.0	29.6

[1] Year 2004 used instead of 2005

Table 8. Basic assumptions

	2006	2007	2008	2009	2010
Short-term interest rate[1] (annual average)	3.5	4.3	4.3	4.3	4.3
Long-term interest rate (annual average)	4.3	4.9	4.9	4.9	4.9
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.30	1.40	1.40	1.40	1.40
Nominal effective exchange rate	1.0	3.0	1.2	1.2	1.2
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	6.0	5.6	5.3	5.4	5.4
EU GDP growth	3.0	2.9	2.4	2.4	2.4
Growth of relevant foreign markets	2.5	2.4	2.0	2.1	2.1
World import volumes, excluding EU	8.0	7.8	7.1	7.7	7.7
Oil prices (Brent, USD/barrel)	66.2	70.6	78.8	76.0	76.0

[1]If necessary, purely technical assumptions.

Annex 2: Key economic indicators of past economic performance

This annex displays key economic indicators that summarise the past economic performance of Malta. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the euro area.

	Malta						Euro area					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	2,7	4,5	0,8	3,1	3,2	3,1	2,1	2,7	1,4	1,5	2,8	2,6
Contributions to real GDP growth:												
Domestic demand	*2,0*	*3,8*	*0,3*	*5,6*	*2,1*	*1,5*	*2,0*	*2,7*	*1,3*	*1,7*	*2,6*	*2,4*
Net exports	*0,6*	*0,7*	*0,5*	*-2,5*	*1,1*	*1,6*	*0,1*	*0,0*	*0,1*	*-0,1*	*0,2*	*0,2*
Real GDP per capita (PPS; EU27 = 100)	79	80	77	76	76	76	113	114	112	110	110	109
Real GDP per capita (% change)	2,0	3,9	0,1	2,5	2,6	2,6	1,6	2,5	0,8	0,9	2,3	2,2
Prices, costs and labour market												
HICP inflation (%)	2,8	3,2	2,5	2,5	2,6	0,8	1,9	1,5	2,2	2,2	2,2	2,0
Labour productivity (% change)	1,8	3,8	-0,1	1,2	2,2	1,7	1,2	1,5	0,8	1,0	1,4	1,1
Real unit labour costs (% change)	0,0	-0,5	0,5	-2,6	-2,2	-1,4	-0,5	-0,6	-0,5	-0,8	-0,9	-0,8
Employment (% change)	0,8	0,8	0,9	1,8	0,9	1,4	1,2	1,5	0,9	0,9	1,5	1,6
Unemployment rate (% of labour force)	6,9	6,4	7,5	7,3	7,3	6,8	9,1	9,8	8,5	8,9	8,3	7,3
Competitiveness and external position												
Real effective exchange rate (% change)	1,1	-1,0	3,3	-1,5	0,0	2,2	-1,3	-5,5	2,8	-2,6	-0,6	0,6
Export performance (% change)[1]	-3,3	-3,9	-2,8	-6,7	2,1	-5,8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-5,0	-7,2	-2,8	-5,5	-3,7	-0,9	0,8	0,9	0,7	0,3	0,0	0,1
Public finances												
General government balance (% of GDP)	-6,9	-7,9	-5,9	-3,1	-2,5	-1,8	-2,3	-2,1	-2,5	-2,5	-1,5	-0,8
General government gross debt (% of GDP)	58,7	50,4	67,0	70,8	64,7	63,1	70,6	72,2	69,0	70,3	68,6	66,6
Structural balance (% of GDP)[2]	n.a.	n.a.	-4,7	-3,1	-2,7	-2,3	n.a.	n.a.	-2,6	-2,1	-1,1	-0,7
Financial indicators												
Short-term real interest rate (%)[3]	2,2	3,6	0,8	0,2	0,7	1,7	1,3	2,5	0,6	0,3	1,2	2,0
Long-term real interest rate (%)[3]	2,4	2,8	2,4	1,6	1,5	2,4	n.a.	n.a.	1,9	1,5	1,9	2,1

Notes:
[1]Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.
[2]Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.
[3]Using GDP deflator.

Source :
Commission services