COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 13.2.2008
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Recommendation for a

# COUNCIL OPINION

**in accordance with the second paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997**

**On the stability programme of Malta, 2007-2010**

(presented by the Commission)

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# EXPLANATORY MEMORANDUM

## 1. General background

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes. The first convergence programme of Malta was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. Malta submitted annual updates of the convergence programme until end-2006, on which the Council also delivered opinions following the same procedure.

Malta joined the euro area on 1 January 2008 and submitted its first stability programme on 30 November 2007[2]. In accordance with the regulation, the Council shall, within a period of three months from its submission, examine the stability programme and, acting on a recommendation from the Commission and after consulting the Economic and Financial Committee, shall deliver an opinion on the programme. The Commission recommends the attached Council opinion (see box for the main points covered by the assessment).

## 2. Background for the assessment of the stability programme

In order to set the scene against which the budgetary strategy in the stability programme is assessed, the following paragraphs summarise:

(1) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the last update of the convergence programme);

(2) the orientations for budgetary policies adopted by the April 2007 Eurogroup;

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1 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2 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 (Council Decision 2007/504/EC, OJ L 186, 18.7.2007, p. 32).

(3) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies;

(4) the Commission's assessment of the October 2007 implementation report of the national reform programme.

### 2.1. The assessment in the Council opinion on the last update of the convergence programme

In its opinion of 27 February 2007, the Council summarised its assessment of the last update of the convergence programme, covering the period 2006-2009, as follows. "The Council considers that the programme is consistent with a correction of the excessive deficit by 2006 and, in a context of strong growth prospects, envisages adequate progress towards the MTO thereafter. The debt ratio as envisaged by the programme seems to be diminishing at a satisfactory pace towards the 60% of GDP reference value. However, there are risks to the achievement of the budgetary targets after 2007. Maintaining a budgetary position that is robust to possible reversals of the projected strong growth pattern is important especially in light of the recent build-up of external imbalances". The Council invited Malta to "pursue adequate progress towards the MTO as foreseen in the programme and ensure that the debt-to-GDP ratio is reduced accordingly, while spelling out the budgetary strategy, especially on the expenditure side, with a longer time perspective". Moreover, in view of level of debt and the projected increase in age-related expenditure, the Council invited Malta to "improve the long-term sustainability of public finances by achieving the MTO and making further progress in the design and implementation of the healthcare reform".

### 2.2. Orientations for budgetary policies adopted by the Eurogroup in April 2007

On 20 April 2007, with a view to improving the coordination of fiscal policies in the euro area, Eurogroup ministers discussed national budgetary developments in 2007 and the preliminary policy outlook for 2008 and their implications for the euro area.

Reaffirming their adherence to the sound fiscal policy principles of the revised Stability and Growth Pact and to national fiscal rules, Ministers committed to (i) build on the better-than-expected budgetary outcomes in 2006 to pursue more ambitious budgetary targets than those set in the end-2006 updates of the stability programmes; (ii) implement their 2007 budgets as planned, avoiding expenditure overruns, and using unexpected extra revenues to reduce government deficit and debt; and (iii) carefully design fiscal policy plans for 2008 so as to accelerate the adjustment towards the MTO for Member States which have not reached it and for those which have reached it to avoid feeding macroeconomic imbalances overall[3].

[3] The entire statement can be found at: www.gouvernement.lu/salle_presse/actualite/2007/04/20pm_krecke_berlin/MTBR_EG_conclusions-finalCLEAN.rtf

### 2.3. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[4]. In the area of budgetary policies, Malta was encouraged to "implement and reinforce delayed measures on health care reform". In addition, all euro area Member States were recommended to "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" and "to improve the quality of public finance by reviewing public expenditures and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability".

### 2.4. 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[5]. This can be summarised as follows.

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

The Commission's assessment was 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 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: health care reform, improving further the regulatory environment, diversifying energy sources, raising educational attainment and reducing early school leaving.

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4 OJ L 92, 3.4.2007, p. 23.

5 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)", COM(2007) 803, 11.12.2007.

**Box: Main points covered by the assessment**

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[6];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[7], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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[6] Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU", COM(2006) 574, 12.10.2006 and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

[7] "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.

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**in accordance with the second paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997**

**On the stability programme of Malta, 2007-2010**

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[8], and in particular Article 5(2) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [4 March 2008] the Council examined the first stability programme of Malta, which covers the period 2007 to 2010.

(2) 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 sectors such as tourism and the electronics industry, which have proven to be volatile. 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, 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 – 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, 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

8 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

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 help boost 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.

(3) 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 the end of the programme period. Assessed against currently available information[9], 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 resulting improvement in the net lending/borrowing vis-à-vis the rest of the world of 6 percentage points of GDP by 2010 projected in the programme seems optimistic. 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 far in excess of productivity gains, may entail a less favourable development in Malta's competitiveness than implied by the stability programme.

(4) For 2007, the general government deficit is estimated at 1.8% of GDP in the Commission services' autumn 2007 forecast and at 1.6% 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 broadly in line with the target in the 2006 convergence programme in spite of a favourable base effect from 2006. Revenue as a ratio of GDP is significantly below expectations largely owing to lower-than-expected absorption of EU funds. As a consequence, the expenditure ratio for 2007 is also lower than planned 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[10] to "pursue adequate progress towards the MTO as foreseen in the programme".

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9 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.

10 OJ C 72, 27.3.2007, p. 9.

(5) As in the last update of the convergence programme, the main budgetary goal outlined in the stability programme is to pursue further fiscal consolidation over the programme period, 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. With a projected decline in the interest burden, the primary surplus is expected to increase to 3.8% of GDP by 2010. The structural balance is projected to improve by 2 percentage points of GDP in the period 2007-2010. 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. Expenditure restraint is relatively broad-based with particular emphasis on compensation of employees. The marked fall in indirect taxes as a share of GDP in the outer years is not explained in the programme, while the cost of the 2008 changes to the personal tax reform system is assumed to be more than covered by higher revenue from other direct taxes. 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, reflecting a lower adjustment effort in 2008. 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.

(6) 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 particular as regards the envisaged continued restraint in the public wage bill. 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.

(7) 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 with normal macroeconomic fluctuations 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 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 mentioned above, the debt ratio seems to be sufficiently diminishing towards the reference value over the programme period and would fall below it in 2009.

(8) 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 rapidly increasing healthcare expenditure that is also subject to the impact of ageing, would contribute to reducing the risks to the sustainability of public finances.

(9) 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. In particular, the main policy measure presented in the stability programme, i.e. a further revision of the personal income tax regime, is in line with 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. Also, the programme does not clearly spell out the way in which expenditure will be channelled to growth-enhancing categories, especially in the outer years.

(10) 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. In particular, the programme does not envisage significant progress in healthcare reform, as encouraged by the Council in its recommendation.

(11) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in both the compulsory and optional data[11].

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 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.

In view of the above assessment, Malta is invited to:

(i) pursue further fiscal consolidation as envisaged in the programme so as to reach the MTO by 2010 and ensure that the debt-to-GDP ratio is reduced accordingly, by spelling out the measures supporting the planned consolidation, especially on the expenditure side;

(ii) enhance the efficiency and flexibility of public spending, including by accelerating the design and implementation of a comprehensive healthcare reform.

[11] The missing data include the contribution of labour, capital and total factor productivity to potential GDP growth, the breakdown of stock-flow adjustments for the general government and some items in the projections for the long-term sustainability of public finances.

## 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 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 programmes (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations.*