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COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

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

On the updated stability programme of Malta, 2008-2011

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. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, 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.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the update of the stability programme of Malta, submitted on 3 December 2008, and has adopted a recommendation for a Council opinion on it.

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

- (1) the Commission Communication of 26 November 2008 ("A European Economic Recovery Plan");
- (2) 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 previous programme).

2.1. The Commission Communication of 26 November 2008 ("A European Economic Recovery Plan")

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)². The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to €200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of €170 bn. (around 1.2% of EU GDP) and EU funding in support of

¹ OJ L 209, 2.8.1997, 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 Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

immediate actions of the order of €30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term, is made in the opinions of stability or convergence programmes.

2.2. The assessment in the Council opinion on the previous programme

In its opinion of 4 March 2008, the Council summarised its assessment of the previous stability programme, covering the period 2007-2011, as follows: "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 this light, the Council invited Malta 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".

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On the updated stability programme of Malta, 2008-2011

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 policies³, and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

- (1) On [10 March 2009] the Council examined the updated stability programme of Malta, which covers the period 2008 to 2011.
- (2) While until now the financial crisis has had a modest effect on Malta, economic activity, especially the external sector, is expected to suffer from the ensuing global slowdown. The notable reduction in the general government deficit which took place over the period 2004-2007 was temporarily halted in 2008, when it is estimated to have increased to 3.5% of GDP, linked to specific expenditure-increasing decisions. As part of a broader strategy to resume fiscal consolidation, the 2009 budget provided a counter-cyclical response to the economic slowdown by increasing public investment (partly financed by EU funds), bolstering purchasing power and providing direct support targeted at manufacturing, tourism and SMEs. Resuming the path towards budgetary consolidation, while at the same time further diversifying the economic base and bolstering the export sector by strengthening competitiveness, are key challenges facing Malta. While Malta's pursues a strategy of promoting non-price competitiveness by facilitating upwards shifts in value-added activity, cost competitiveness remains key to export-led growth.

³ OJ L 209, 2.8.1997, 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.

- (3) The macroeconomic scenario underlying the programme envisages real GDP growth to decelerate from 2.8% in 2008 to 2.2% in 2009 before recovering to an average rate of 2.7% over the rest of the programme period. Assessed against currently available information⁴, this scenario is based on markedly favourable growth assumptions because of relatively strong assumed recovery in exports. The programme's projections for inflation appear to be on the high side in 2009 but are plausible thereafter. The possibility that further increases in public sector wages could give rise to overall wages rising in excess of productivity gains may result in a less favourable development in Malta's competitiveness than implied by the updated stability programme.
- (4) For 2008, the general government deficit is estimated at 3.5% of GDP in the Commission services' January 2009 interim forecast, against a target of 1.2% of GDP set in the previous programme⁵. The difference primarily reflects higher-than-planned expenditure growth, driven mainly by: (i) the unbudgeted one-off cost related to the granting of early retirement schemes to shipyard employees (1% of GDP); (ii) additional expenditure in respect of energy subsidies (0.8% of GDP) and (iii) a higher-than-planned increase in the wage bill on account of additional recruitment and higher wages in particular in the health sector (0.5% of GDP).
- (5) According to the programme, the general government deficit is targeted to fall to 1.5% of GDP in 2009 (one-off deficit-reducing transactions taking the form of sales of land are projected to amount to 0.3% of GDP). The budgetary impact of the measures taken to support the economy in 2009 is expected to amount to 1.5% of GDP. However, the reduction in energy and other subsidies, the vanishing of the one-off cost related to early retirement schemes to shipyard employees and an increase in excise duties together with higher tax buoyancy (from international companies) are planned to exert a deficit-reducing effect of around 2¼% of GDP.
- (6) The medium-term budgetary strategy outlined in the update aims at pursuing further fiscal consolidation over the programme period, with the overarching aim of achieving the medium-term objective (MTO) of a balanced budgetary position in structural terms (i.e. in cyclically-adjusted terms net of one-off and other temporary measures) by 2011, one year later than planned in the 2007 stability programme. The headline deficit is foreseen to decline further to 0.3% of GDP in 2010, before turning into a surplus of 1.2% of GDP in 2011, although the programme gives no indications about the measures underlying this path. The consolidation envisaged over the programme horizon will be primarily achieved through expenditure restraint, with a cut in the expenditure ratio by 3.2 percentage points of GDP, whilst revenue is expected to increase by 1.2 percentage points. Expenditure restraint is underpinned by lower subsidies and social payments (both front-loaded to 2009) and government consumption (back-loaded to 2010-2011). The bulk of the increase in revenue over the programme horizon is due to an assumed higher yield from direct taxes, which the programme attributes to a higher number of registered international operators in Malta. Government gross debt, estimated at 62.8% of GDP in 2008, is projected to decline by

⁴ The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has become available since then.

⁵ The programme estimates the 2008 deficit outcome at 3.3% of GDP, confirming the value reported in the EDP notification of October 2008. In view of the reported breach of the Treaty reference value, the Commission prepared on 18 February 2009 a report under Article 104.3 of the Treaty.

3 percentage points by 2010 and further by 3.5 percentage points in 2011, mainly driven by the growing primary surplus from 2009 onwards.

- (7) The budgetary outcomes are subject to downside risks throughout the programme period. The risks mostly relate to the favourable macroeconomic scenario, the reliance on volatile revenue items (an uncertain increase in direct taxes from international companies) and the possibility of expenditure slippages compared to the envisaged back-loaded decline in public consumption. For 2010 and 2011, an additional risk factor is the lack of information on measures underpinning the consolidation process, in particular as regards the envisaged continued restraint in the public wage bill. The risks to the deficit projections imply that the debt ratio could turn out higher than expected in the programme. In addition, based on currently available information, the liquidation of the Malta Shipyards during the course of 2009 could result in a higher debt level.
- (8) 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 according to the projections made in 2005. Yet, the 2006 pension reform, which aims at improving the level of pension while also increasing the retirement age, is likely to imply higher spending over the long run. In addition, the current level of gross debt is above the Treaty reference value. The budgetary position in 2008 as estimated in the programme, which is worse than the starting position of the previous programme, compounds the budgetary impact of population ageing on the sustainability gap. Improving the budgetary position would contribute to reducing the medium risks to the sustainability of public finances.
- (9) While expenditure outturns over the period 2004-2007 were below budgeted amounts, experience in 2008 has shown that public expenditure is still subject to discretionary decisions in the budget implementation phase, whilst the budget lacks a clear medium-term focus. The programme does not envisage improvements in this area. In addition, the efficiency and effectiveness of expenditure in education, health, R&D and public infrastructure seems to be weak.
- (10) In October 2008, the government announced an increase in the guarantee on deposits held with banks in Malta from €20,000 to €100,000. No other measures to help stabilise the financial system have proved necessary so far.
- (11) In line with the European Economic Recovery Plan agreed in December 2008 by the European Council, Malta adopted several measures to support the economy in 2009. The measures with budgetary impact are part of a broader consolidation effort, which is adequate in the light of the high deficit and debt ratios and the competitiveness challenge. Most of them are timely and targeted and are addressed to sectors which are expected to be hit hardest by the economic slowdown, e.g. tourism and manufacturing. With the exception of public investment, which will moderate as a share of GDP in 2011, the measures seem to be of a permanent nature. A number of structural measures, which are part of the longer-term policy reform agenda, should provide support in view of the challenges posed by the downturn by enhancing growth potential. Specifically, the planned liberalisation of public transport will render the sector more efficient and competitive, while the implementation of a flexicurity roadmap will help ensure an adequate supply of skills in emerging high-skill sectors. Furthermore, the programme envisages higher outlays on infrastructure and

environmental projects. The measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs.

- (12) According to the programme, the structural balance as recalculated by the Commission services on the basis of the information in the programme is expected to improve further by a yearly average of 1¼ percentage points of GDP in 2010-2011. Taking into account the important risks to the budgetary targets, the stance in the programme would not provide a sufficient safety margin against breaching the 3% of GDP deficit limit by the end of the programme period. The planned consolidation in the outer years should be backed up by measures. Taking into account the risks to the debt projections, the debt ratio seems to be sufficiently diminishing towards the reference value in a medium-term perspective, bearing in mind the significant decline in the ratio during the period 2004-2007.
- (13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data⁶.

The overall conclusion is that, against a backdrop of weakening economic growth and a breach of the 3% of GDP deficit reference value in 2008, the programme envisages a return to budgetary consolidation from 2009 onwards, brought about by expenditure restraint and, to a lesser extent, higher revenue. The measures adopted by the government in response to the downturn are in line with the European Economic Recovery Plan and can be regarded as adequate given the high deficit and debt ratios and the competitiveness challenge. However, there are risks to the achievement of the deficit and debt targets over the programme period stemming from the favourable macroeconomic scenario, the reliance on volatile revenue, the possibility of expenditure slippages and the lack of information on the consolidation measures in the outer years. The debt ratio, which is targeted to fall gradually over the programme period to below the 60% of GDP reference value but is subject to the risks mentioned above, seems to be sufficiently diminishing towards the reference value in a medium-term perspective, bearing in mind the significant decline in the ratio during the period 2004-2007. Although improving in recent years, the lack of diversification in the economic base increases Malta's exposure to external shocks, especially in the face of the current economic downturn. Moreover, competitiveness remains vulnerable, especially if higher compensation in the public sector causes overall wages to move out of line with productivity.

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

- (i) resume fiscal consolidation as envisaged in the programme and ensure that the general government debt ratio is reduced accordingly, by spelling out the measures underlying the planned consolidation in the outer years;
- (ii) strengthen the medium-term budgetary framework and enhance the efficiency and effectiveness of public spending, including by accelerating the design and implementation of a comprehensive healthcare reform.

⁶ In particular, the 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 2007-11, are not provided.

Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011
Real GDP (% change)	SP Dec 2008	3.7	2.8	2.2	2.5	2.8
	COM Jan 2009	3.9	2.1	0.7	1.3	n.a.
	CP Nov 2007	3.5	3.1	3.2	3.4	n.a.
HICP inflation (%)	SP Dec 2008	0.7	4.5	2.7	2.3	2.0
	COM Jan 2009	0.7	4.6	1.9	2.2	n.a.
	CP Nov 2007	0.9	2.5	2.3	2.1	n.a.
Output gap ¹ (% of potential GDP)	SP Dec 2008	0.0	0.1	-0.3	-0.5	0.5
	COM Jan 2009 ²	1.1	1.2	0.0	-0.6	n.a.
	CP Nov 2007	-0.8	-0.1	0.5	1.9	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	SP Dec 2008	-5.5	-5.1	-3.1	-2.7	0.7
	COM Jan 2009	-4.6	-5.5	-5.5	-5.3	n.a.
	CP Nov 2007	-0.5	0.2	3.2	5.5	n.a.
General government revenue (% of GDP)	SP Dec 2008	40.6	40.6	41.7	41.8	41.9
	COM Jan 2009	40.4	40.7	41.1	41.2	n.a.
	CP Nov 2007	41.0	40.9	39.9	39.5	n.a.
General government expenditure (% of GDP)	SP Dec 2008	42.4	43.9	43.2	42.1	40.7
	COM Jan 2009	42.2	44.2	43.7	43.8	n.a.
	CP Nov 2007	42.7	42.2	40.0	38.5	n.a.
General government balance (% of GDP)	SP Dec 2008	-1.8	-3.3	-1.5	-0.3	1.2
	COM Jan 2009	-1.8	-3.5	-2.6	-2.5	n.a.
	CP Nov 2007	-1.6	-1.2	-0.1	0.9	n.a.
Primary balance (% of GDP)	SP Dec 2008	1.6	0.0	1.9	3.0	4.3
	COM Jan 2009	1.6	-0.2	0.8	0.8	n.a.
	CP Nov 2007	1.7	2.0	2.9	3.8	n.a.
Cyclically-adjusted balance ¹ (% of GDP)	SP Dec 2008	-1.8	-3.4	-1.4	-0.1	1.0
	COM Jan 2009	-2.2	-4.0	-2.6	-2.3	n.a.
	CP Nov 2007	-1.3	-1.2	-0.3	0.3	n.a.
Structural balance ³ (% of GDP)	SP Dec 2008	-2.4	-3.7	-1.7	-0.2	0.9
	COM Jan 2009	-2.8	-3.3	-2.9	-2.3	n.a.
	CP Nov 2007	-2.1	-1.4	-0.5	0.1	n.a.
Government gross debt (% of GDP)	SP Dec 2008	62.2	62.8	61.9	59.8	56.3
	COM Jan 2009	61.9	63.3	64.0	64.2	n.a.
	CP Nov 2007	62.9	60.0	57.2	53.3	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%, 1.9% and 1.9% respectively in the period 2007-2010.

³ Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.6% of GDP in 2007, 0.3% of GDP in 2008, 0.3% of GDP in 2009 and 0.1% of GDP in 2010; all deficit-reducing, according to the 2008 stability programme and 0.6% of GDP in 2007, -0.6% of GDP in 2008 and 0.3% of GDP in 2009 in the Commission services' January 2009 interim forecast.

Source:

Stability programme (SP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.