An assessment of the main fiscal forecasts prepared by the Ministry of Finance and presented in the Update of the Stability Programme for Malta 2014-2017

An independent report presented by the National Audit Office

May 2014

Table of Contents

1. Introduction: Aims, methodology and limitations of this assessment 3
2. Assessment of the methodologies and processes used to produce the budgetary forecasts 5
3. Assessment of risks to the budgetary projections 6
   3.1. Macroeconomic risk 7
   3.2. Assessment of revenue projections 9
   3.3. Assessment of expenditure projections 11
   3.4. Assessment of impact of major discretionary measures 16
   3.5. Assessment of debt projections 19
4. Comparison of MFIN budgetary forecasts with the fiscal projections generated by the European Commission in its Winter Forecast 2014 20
5. Conclusion 23

List of Tables

Table 3.1 Analysis of the Fiscal Adjustment 7
Table 3.2 Macroeconomic Projections 8
Table 3.3 Main Components of Revenue 10
Table 3.4 Main Components of Expenditure 12
Table 3.5 Discretionary Measures underpinning the budgetary adjustment 16
Table 3.6 Debt Dynamics 20
Table 4.1 Comparison of Fiscal Projections 21

Abbreviations

BO	Budget Office
CBM	Central Bank of Malta
CION	European Commission
CPIC	China Power Investments Corporation
EBU	Extra-Budgetary Units
EDP	Excessive Deficit Procedure
EFSF	European Financial Stability Facility
EPD	Economic Policy Department
ESA	European System of Accounts
EU	European Union
GDP	Gross Domestic Product
IRD	Inland Revenue Department
MFIN	Ministry of Finance
NAO	National Audit Office
NSO	National Statistics Office
SFA	Stock-Flow Adjustment
VAT	Value Added Tax

1. Introduction: aims, methodology and limitations of this assessment

Article 4 of Council Directive 2011/85/EU requires that "fiscal planning is based on realistic macroeconomic and budgetary forecasts using the most up-to-date information" and that both "the macroeconomic and budgetary forecasts shall be compared with the most updated forecasts of the Commission and, if appropriate, those of other independent bodies". Furthermore, Article 4 of Regulation (EU) 473/2013 requires that national medium-term fiscal plans "shall be based on independent macroeconomic forecasts, and shall indicate whether the budgetary forecasts have been produced or endorsed by an independent body".

The Ministry of Finance has prepared the Update of Stability Programme for Malta 2014-2017, thereafter referred to as the Stability Programme, and has chosen the endorsement approach in order to assess the macroeconomic and budgetary forecasts included therein. The National Audit Office (NAO), as an independent body, has thus been requested to provide a public evaluation of the Update of Stability Programme 2014-2017 and to endorse or express an opinion on same.

This report assesses the budgetary forecasts included in the Stability Programme[1] as required by Council Directive 2011/85/EU and Regulation (EU) 473/2013. It focuses on the projections of the Ministry of Finance for the main revenue and expenditure components of the budget and the forecasts for the aggregate fiscal indicators of the general government deficit and debt.

This assessment is based on an examination of the methodologies, processes and the main assumptions used to produce these fiscal forecasts. It comprises:

(i) an assessment of the methodologies and processes used to generate, revise and finalise the budgetary forecasts;

(ii) an evaluation of the forecasts for the main budgetary aggregates by applying tests of reasonableness in the context of the macroeconomic outlook, historical trends and other relevant available information, namely:
   a) an assessment of the projections for the main tax revenue categories on the basis of the implied elasticities for the forecast period, when compared to the recent years, taking into account the impact of discretionary measures and other relevant information;
   b) an assessment of the forecasts for the broad expenditure components on the basis of projected growth rates compared to historical trends, taking into account the impact of discretionary measures and other relevant information;
   c) an assessment of the impact of the main discretionary measures, which took into account the robustness of the method used to estimate the impact of these measures, the information available on the measures and their status;

(iii) an assessment of the macroeconomic risk to the fiscal projections as well as a broader assessment of risks:
   a) the assessment of the macroeconomic risk was based on the findings of the report prepared for the NAO in April 2014 (referred to above);
   b) the broader assessment of risks focused on specific known issues and transactions related to Enemalta Corporation, Air Malta plc, the operation of the public transport service and the stock of government guaranteed debt.

(iv) a comparison of the forecasts for the main fiscal aggregates with the most recent forecasts of the European Commission.

[1] The assessment of the macroeconomic forecasts is presented in a separate National Audit Office report: An assessment of the macroeconomic forecasts for the Maltese economy performed by the Ministry of Finance in April 2014.

The budgetary forecasts for 2014-2017, prepared by the Ministry of Finance, were presented to the National Audit Office for review during the week starting 21st April, 2014. The work related to the assessment of these projections commenced during that week and was completed by5th May. In the assessment, particular attention was paid to how key assumptions were established and to the degree of prudence embedded in the fiscal forecasts. The assessment involved a certain element of judgement, based on the expertise and experience of the authors of this report in economic and fiscal analysis and forecasting.

This assessment involved reviewing the information related to the fiscal projections included the Update of Stability Programme 2014-2017. Other supporting documents related to the key drivers of the main budgetary components were also reviewed and referred to during the course of this assessment. Further information was obtained in meetings with various officials from the Ministry of Finance, including the Permanent Secretary and officials from the Economic Policy Department, the Budget Office, the National Statistics Office and the Treasury, who explained the methods and processes used to formulate budgetary projections. Additional information on specific budgetary components and measures was obtained in discussions with officials from the Inland Revenue Department and the Ministry for Transport and Infrastructure. During these meetings, areas of concern or uncertainty regarding the projections for the main budgetary aggregates as well as regarding the impact of discretionary measures were probed with the officials concerned. Further information and clarification on issues which arose during the assessment in writing were requested through a detailed set of written queries. When necessary, these were supplemented with additional queries in writing (via email) or through contacts with the relevant officials over the telephone.

This assessment was carried out in the context of significant time constraints and it was not possible to do the equivalent of a complete audit of the budget forecasts. A related difficulty which was faced was that certain information and data was only provided whilst the assessment was being carried out. In particular, the Stability Programme was still being drafted when the assessment was being prepared. This assessment thus focused on Chapter 3 (Fiscal Outlook and the Medium Term Fiscal Strategy) of the Stability Programme and the relevant Appendix Tables[2]. Given these time limitations and constraints, the assessment focused on fiscal data for the general government sector and in ESA95 terms, and the analysis did not include the Consolidated Fund budgetary forecasts and the transition from cash fiscal data to budgetary data in ESA95 terms. Furthermore, the assessment covered only the main budgetary components and the major discretionary measures underpinning the fiscal consolidation[3]. Due to the time constraints, it was also not possible to carry out an assessment of the risk associated with the budgetary forecasts based on past forecast errors. In particular, the 2013 fiscal outturn was not compared to the projections included in the Budget for 2014 and the implications of such differences on the current budgetary forecasts were not analysed. In addition, an attempt was not made to compare the budgetary projections with the actual fiscal outturn available for 2014, which covers the first three months of the year. The authors considered that it would not be possible to derive reliable trends from data for the first quarter, especially since this data is only available for the Consolidated Fund (cash) data. Finally, as regards the comparison with recent forecasts made by other agencies, this analysis was limited to the most recent available budgetary forecasts by the European Commission (Winter 2014). Time constraints did not permit further comparisons to other recent fiscal projections presented by other independent institutions, such as the Central Bank of Malta.

[2] The assessment did not cover the cyclically adjusted and structural deficit and the budgetary implications of major structural reforms.

[3] The assessment only analysed the estimated impact of the discretionary deficit-reducing measures which are included in the budgetary forecasts, and the widening of the income tax bands, given its magnitude. The impact of other deficit-increasing measures were not included in this assessment.

2. Assessment of the methodologies and processes used to produce the budgetary forecasts

The following section outlines the methodologies and processes by which the fiscal forecasts are estimated as described during meetings between the authors and the respective entities. It should be noted that the fiscal forecasts have a cut-off date specified for the 22nd April, 2014. Also, one notes that the fiscal targets for 2014 presented in the Programme are in line with those submitted in the Excessive Deficit Procedure (EDP) notification in March 2014.

The process of producing the budgetary forecasts is carried out by a number of entities namely Budget Office (BO), the Economic Policy Department (EPD) and the Treasury. The National Statistics Office (NSO) is involved as the entity which has the ultimate responsibility for the compilation of the EDP Notification.

The BO forecasts cash revenue items mainly on the basis of financial plans provided by respective departments, past trends, current year revised estimates, expected performance and budget measures where applicable. In parallel, the EPD produces revenue forecasts in ESA95 terms conditional upon the macroeconomic projections taking into account estimates of revenue elasticities observed in past years. These forecasts are fine-tuned to take into account the budgetary measures and also involve an element of judgement to reflect other available information. These forecasts are then translated into cash terms based on a number of assumptions. Following exchange of views with the EPD regarding the assumptions underpinning the forecasts as well as macroeconomic considerations, the BO estimates are subsequently fine-tuned wherever necessary.

With regards to expenditure, the BO engages in lengthy discussions with each line Ministry on the basis of their financial plans. The EPD provides estimates for compensation of employees and social benefits and these are discussed with BO. Expenditure projections are finalized to reflect the overall expenditure targets which are set on the basis of the targeted structural effort and the revenue projections.

The forecasts on cash basis and covering only central government produced by BO are transposed to accruals data and extended to general government with the input of the NSO and the Treasury. These provide an estimate of the necessary adjustments on the basis of a number of underlying assumptions. In particular, over the 2014-2017 period, it was assumed that the accruals adjustment and the time adjusted cash remain constant. These will eventually be revised to reflect actual figures. Similarly, the net borrowing/net lending of EBUs are also assumed to remain unchanged over the forecast period. The fact that these assumptions are, very often, taken on highly volatile items, increases the risk of significant forecast error. Given the time constraints in producing this report, these assumptions were not assessed in detail even though these may have an impact on the General Government balance.

One also notes that the fact that expenditure forecasts are first compiled on a cash basis and later transposed into accrual basis and since detailed information by vote and project item would not be finalized for the outer years of the forecast period, the breakdown of expenditure in the different items using the ESA95 codes necessitates some assumptions. In particular, the capital expenditure category is broken down into different type of expenditure items according to the ESA95 methodology by resorting to the use of ratios of the capital expenditure outturn for the preceding three years. This may result in distortions at an expenditure component level in ESA95 terms but does not imply a risk of forecast error for aggregate expenditure.

The fiscal forecasts presented in Chapter 3 of the Stability Programme are an output of a healthy synergy between the EPD and BO. One positively notes the detailed process undertaken by BO to ensure that all available information at departmental level is taken into account in the forecasts. Similarly, the EPD employs a well-structured process to integrate the macroeconomic assumptions into the fiscal forecasts prior to discussions with BO to finalize the forecasts. This should facilitate consistency between the fiscal forecasts and the macroeconomic projections. The authors also welcome the fact that the element of expert judgement, which is necessary in any forecasting exercise, is done after taking into consideration the view of experts from both entities.

On the other hand, the authors note that the forecasting exercise involves an element of fragmentation since the forecasts are firstly finalised on a cash basis and subsequently translated into ESA95 methodology and furthermore this requires a number of important assumptions on highly volatile items. We consider that a more streamlined process would reduce the risk associated with these assumptions.

3. Assessment of risks to the budgetary projections

The fiscal outlook presented in the Stability Programme shows a gradual but consistent improvement in the fiscal balance. The general government deficit was reduced to below the 3 per cent reference value in 2013 (at 2.8 per cent of GDP) and is projected to continue to decline gradually to reach a position of close to balance in 2017 (deficit of 0.3 per cent of GDP). This implies a fiscal adjustment of around 0.6 percentage points of GDP per annum over the forecast period.

The decline in the deficit in 2014 results from a rise in total revenue of 1.1 percentage points of GDP, which is partly offset by the increase in the expenditure ratio of 0.3 percentage points of GDP. In 2015, the improvement is more balanced between revenue and expenditure, with the revenue ratio rising by 0.3 percentage points of GDP and the expenditure ratio falling by 0.2 percentage points of GDP. On the other hand, the improvement in the fiscal balance in 2016 reflects a decrease in the expenditure ratio of 1.7 percentage points, which compensates for the decline in the revenue ratio of 0.9 percentage points of GDP. In 2017, there is an increase in the revenue ratio of 0.3 percentage points and a further improvement reflects a decline in the expenditure ratio of 0.1 percentage points of GDP.

During the forecast period, the net impact of the discretionary measures on the revenue side of the budget account for 0.3 percentage points of GDP of the improvement in the fiscal balance during 2014, and continue to contribute positively, albeit to a smaller extent in 2015 and 2016. In 2017, the projections do not include any new discretionary measures on the revenue side. Tax revenue buoyancy contributes to 0.3 percentage points of GDP of the fiscal adjustment in both 2014 and 2015, but has a marginal impact in the subsequent years. Changes in other revenue also affect the fiscal adjustment during the forecast period, but these mainly reflect fluctuations in EU investment grants, which correspond to similar changes in outlays and thus have a largely neutral impact on the budget balance.

On the expenditure side, the net impact of the discretionary measures is marginally negative in 2014, but positive in the following years, amounting to between 0.1 and 0.2 percentage points of GDP. Developments in the expenditure ratio are significantly affected by fluctuations in other expenditure and by the incremental impact of the equity injection in the national airline. The latter has a deficit-reducing impact of 0.3 and 0.5 percentage points of GDP in 2014 and 2016, respectively, and a deficit-increasing impact amounting to 0.4 percentage points of GDP in 2015.

According to the Programme, the net deficit-reducing one-off measures are projected to amount to 0.2 per cent of GDP in 2014 and 0.1 per cent of GDP in each subsequent year to 2017. These one-off measures are planned to consist entirely of proceeds from the sale of land. Since the projected

levels are similar to previous years, the risk of such proceeds to materialize is considered to be contained.

Table 3.1. Analysis of the Fiscal Adjustment

	2014	2015	2016	2017
	per cent of GDP			
Fiscal balance	-2.1	-1.6	-0.7	-0.3
One-off and other temporary measures[1]	0.2	0.1	0.1	0.1
	percentage points of GDP			
Adjustment in the deficit ratio	0.8	0.5	0.8	0.4
Change in revenue ratio	1.1	0.3	-0.9	0.3
of which:				
Discretionary measures	0.3	0.2	0.1	0.0
Tax revenue buoyancy	0.3	0.3	0.0	0.1
Change in expenditure ratio	-0.3	0.2	1.7	0.1
of which:				
Discretionary measures	0.0	0.1	0.2	0.1
Incremental impact of the equity injection in the national airline	0.3	-0.4	0.5	0.0

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

Source: Malta Update of the Stability Programme 2014-2017

3.1. Macroeconomic risk

Budgetary projections are based on assumptions for the macroeconomic scenario and uncertainty surrounding the growth prospects of the Maltese economy could constitute a risk to the attainment of the fiscal targets.

The macroeconomic forecasts presented in the Stability Programme show a generally positive stable outlook with the economic growth rate of 2.4 per cent registered in 2013 being largely sustained in the current year, and thereafter decelerating slightly to around 2 per cent. In nominal terms, GDP growth is projected at 4.7 per cent in 2014, and to gradually slow down to 4.4. per cent in 2017. Throughout the forecast period, domestic demand is projected to be the driver to economic growth. In particular, growth in private consumption expenditure is projected to pick up from 1.8 per cent in 2013 to 2.3 per cent in 2014, spurred by the projected increase in employment and higher disposable income, reflecting a reduction in utility tariffs as of April 2014 and various fiscal measures implemented within the Budget for 2014. In the outer years of the programme, private consumption expenditure is projected to remain relatively strong, with a growth rate of around 2 per cent per annum. In nominal terms, private consumption expenditure is forecasted to increase by around 4 per cent during the forecast period. In 2014, investment is expected to be a main contributor of economic growth, with a growth rate of 15.6 per cent in real terms, mainly spurred by the projected investment outlays within the energy sector, as well as EU funded projects. In the subsequent years, investment is projected to continue to grow at a rate of around 3 per cent per annum. In the external sector, both exports and imports of goods and services are expected to recover following

the downturn in performance in 2013, but the contribution of net exports to economic growth is expected to remain negative in 2014, as imports are estimated to grow at a faster rate than exports, reflecting the strong expansion in investment. In the subsequent years, the external sector is generally projected to contribute positively to economic growth, albeit marginally, as imports and exports are forecasted to grow at a similar pace.

Reflecting the projected sustained growth in economic activity, as well as the introduction of supply side policies which are expected to impact in particular on female employment, the prospects for job creation in the Stability Programme are positive. Employment growth is expected at around 2 per cent per annum over the forecast period, whilst the unemployment rate is projected to remain stable at 6.5 per cent.

Table 3.2. Macroeconomic Projections

	2014	**2015**	**2016**	**2017**	**2014**	**2015**
	MFIN April 2014				**CION Winter 2014**	
At Constant (2000) prices	**per cent**					
Private final consumption expenditure	2.3	2.2	1.9	1.9	1.9	2.2
General government final expenditure	1.9	0.9	0.5	0.6	1.0	0.8
Gross fixed capital formation	15.6	3.4	2.8	2.2	1.3	1.8
Exports of goods and services	2.3	4.2	3.6	3.4	4.0	5.9
Imports of goods and services	3.9	4.3	3.5	3.2	3.7	5.9
Real GDP	**2.3**	**2.1**	**1.9**	**1.9**	**2.1**	**2.1**
At Current Prices						
Private final consumption expenditure	3.6	4.0	3.7	3.6	3.1	4.1
General government final expenditure	4.8	2.8	2.3	2.6	3.1	3.6
Gross fixed capital formation	20.2	7.4	6.6	6.5	5.3	5.3
Exports of goods and services	4.8	4.9	4.4	4.3	4.0	7.3
Imports of goods and services	6.6	4.5	3.9	3.7	3.9	7.6
Nominal GDP	**4.7**	**4.6**	**4.4**	**4.4**	**3.8**	**2.5**
Employment	**2.1**	**1.8**	**1.8**	**1.7**	**2.2**	**2.0**

Source: An assessment of the macroeconomic forecasts for the Maltese economy performed by the Ministry of Finance in April 2014, National Audit Office

The macroeconomic forecasts presented in the Stability Programme have been reviewed in the report: “An assessment of the macroeconomic forecasts for the Maltese economy performed by the Ministry of Finance in April 2014” (NAO, 2014). This report concluded that these macroeconomic forecasts are based on sound methodology, with assumptions for exogenous variables being based on the views of international reputable institutions and taking into account relevant ad-hoc information from local sources. Although the report highlights that the achievement of the projected economic growth rate for 2014 hinges in particular on the expected developments in gross fixed capital formation and also on the sustained increase in private consumption, its assessment is that the projected economic growth in the Programme “might well be a plausible trajectory for growth

given the assumed underlying developments within the separate GDP aggregates for the forecast years" (NAO, 2014, p.18). Nevertheless, it highlights the following main risks associated to this macroeconomic scenario: "the expected absorption rate for the implementation of government projects, the developments in the export and import deflators, and the assumptions imposed on the inventories component" (NAO, 2014, p.18).

It is noteworthy that these identified risks do not affect the major tax-rich components of GDP and thus are not expected to constitute a significant risk to the attainment of the fiscal targets.

The aforementioned report also compared the Ministry of Finance's macroeconomic projections to other institution's expectations for the Maltese economy, namely the most recent forecasts by the European Commission (Winter 2014) and those by the Central Bank of Malta (CBM) (published in its Annual Report 2013, in April 2014). For 2014, the CBM's forecast for real economic growth is similar to that of the Ministry of Finance, whilst the European Commission expects slightly lower growth. On the other hand, in nominal terms, the European Commission projects a GDP growth rate of 3.8 per cent, compared to the 4.7 per cent expected by the Ministry of Finance. Focusing on private consumption, which is a tax-rich component of GDP, both the CBM and the European Commission expect growth which is slightly below that of the Ministry of Finance. It is however pertinent to note that the European Commission's forecasts do not take into account the most recent national accounts data for the full year 2013. As regards the labour market, the Ministry's and European Commission's forecasts for employment growth in 2014 are similar, whilst the CBM's view is positive but more cautious.

For 2015, the projected real economic growth rate by the European Commission is similar to that of the Ministry of Finance, whilst the CBM projects a slightly higher rate of growth. However, in nominal terms, the forecast of the European Commission is notably below that of the Ministry of Finance (2.5 per cent, compared to 4.6 per cent). As regards private consumption, the European Commission expects the same growth rate as the Ministry of Finance, whilst the CBM projects marginally stronger growth. At 2 per cent, the projected employment growth by the European Commission is somewhat higher than the Ministry's forecasts, whilst that of the CBM is marginally lower.

Thus, both the European Commission and the CBM project a broadly similar trajectory for real GDP growth, private consumption and employment to that included in the Stability Programme, and in certain respects their forecasts are slightly more optimistic. However, in nominal terms, the European Commission projects lower GDP growth rates for 2014 and 2015 and lower nominal private consumption expenditure growth for 2014. Since developments in macroeconomic indicators in nominal terms have a direct bearing on fiscal outcomes, these discrepancies add some uncertainty to the fiscal projections.

3.2. Assessment of revenue projections

This section provides an assessment of revenue forecasts presented by the Ministry of Finance in the Stability Programme. The time constraints to produce this assessment did not allow for a thorough assessment of each item of revenue in the fiscal forecasts and therefore, in several instances, the tests of reasonableness and probability of the expected outcomes for the main broad revenue categories were applied.

According to the Programme, the total revenue ratio is expected to increase by 1.1 percentage points from 41.1 per cent in 2013 to 42.2 per cent in 2014. In 2015, total revenue ratio is expected to remain relatively stable before declining by 0.9 percentage points in 2016. Towards the end of the forecast period, the revenue ratio is expected to increase again slightly to 41.9 per cent of GDP.

Table 3.3. Main Components of Revenue

	2013	2014	2015	2016	2017
			per cent of GDP		
Total Revenue	41.1	42.2	42.4	41.5	41.9
of which					
Taxes on production and imports	13.5	14.1	14.1	14.1	14.2
Current taxes on income and wealth	14.5	14.2	14.4	14.4	14.6
Capital taxes	0.2	0.2	0.2	0.2	0.2
Social Contributions	7.3	7.4	7.5	7.4	7.3
Property Income	1.3	1.2	1.2	1.2	1.1
Other revenue	4.3	5.0	5.1	4.3	4.5

Source: Malta Update of the Stability Programme 2014-2017

Underpinning the projections for 2014 is mainly an increase in the ratio for indirect taxes which more than offset the projected decline in the ratio for direct taxes. Moreover, the Programme forecasts a relatively significant increase in the 'Other' category of revenue. For the period 2015-2017, developments in the revenue ratio are mainly underpinned by changes in the 'Other' category of revenue.

One notes that these revenue projections are particularly contingent upon the materialization of the projected economic growth and its components as discussed earlier. Moreover, the achievement of these revenue targets particularly for 2014, are dependent on the proceeds from discretionary measures which are discussed later on in this report. It is also pertinent to highlight that the forecasting exercise to project tax revenue necessitates a number of assumptions particularly with respect to elasticities. Analysing the robustness of these assumptions sheds light on any existing risk of achieving worse than projected revenue targets.

Assessment of implied elasticities in the main revenue components

As noted earlier, the projected economic growth and its components exert a direct influence on the fiscal forecasts. In particular, excluding the impact of any budgetary measures, one expects that a constant relationship is maintained over the years between the tax revenue and its respective tax base. The robustness of the assumptions concerning projections for the tax bases, which is very often either a component of GDP or a variable that has significant influence on GDP, has been discussed earlier in this report. Thus, the following assessment of the revenue projections hinges on an examination of the implied elasticity – the relationship between the forecasted revenue and the forecasted tax base – and the extent to which this is in line with the elasticity recorded in previous years.

According to the Programme, taxes on production and imports are expected to increase from 13.5 per cent of GDP in 2013 to around 14.1 per cent in subsequent years. If one were to exclude the discretionary measures for 2013 and 2014, this category of tax revenue is projected to increase by a significantly higher rate than the expected increase in the tax base (assumed as private consumption and tourism earnings). This implied elasticity is significantly higher than the average for the past years. This points towards some element of downside risk associated to the realization of the forecast estimates of this category of revenue for 2014.

Another observation to note is that when focusing at the sub-categories within this item of tax revenue, it transpires that the elasticity of value added type taxes is significantly higher than that for taxes on products except Value Added Tax (VAT) and import taxes. This implies that the risk identified earlier is more associated to the attainment of the projected revenue from the value added type taxes.

For the 2015-2017 period, excluding the impact of the planned measures, the implied elasticity for taxes on production and imports is broadly in line with the average for the past years. Nevertheless, the element of risk surrounding the 2014 forecast may easily spill over the following years if shortfall in revenues materialize in 2014.

Current taxes on income and wealth are expected to fall from 14.5 per cent to 14.2 per cent of GDP in 2014, followed by a smooth upward trend to 14.6 per cent of GDP by 2017. Excluding the impact of the budgetary measures, the growth in the estimated revenue is projected to closely reflect developments in GDP over the 2014-2017 period. Moreover, the implied elasticity of this item of revenue for the forecast period is somewhat below that recorded in the past years, indicating some element of prudence in the forecast for this tax item.

According to the Programme, social contributions are projected to remain relatively stable at around 7.5 per cent of GDP over the forecast period. Excluding the impact of the budgetary measures, the implied elasticity of social contributions is projected to be higher than that recorded in the past years in 2014 and thus constitutes a downside risk. On the other hand, in the subsequent years, the implied elasticity is in line with the historical average.

The 'Other' category of revenue is expected to increase by 0.7 percentage points in 2014 and then increase slightly to 5.1 per cent in 2015 before declining in 2016 and 2017 to similar levels as registered in 2013. This component is significantly influenced by the assumptions concerning inflows of EU funds which are reflected in gross fixed capital formation and capital transfers and therefore exert a marginal impact on the deficit.

3.3. Assessment of expenditure projections

Total expenditure is projected to rise by 0.3 percentage points of GDP in 2014, to reach 44.2 per cent, and to remain roughly stable in 2015. A relatively sharp fall of 1.7 percentage points of GDP is expected in 2016, whilst in 2017 the expenditure ratio is projected to remain relatively unchanged. Compensation of employees, likewise as a share of GDP, is projected to decline throughout the forecast period. Intermediate consumption and interest expenditure as a share of GDP are also expected to follow a general downward trend, although the projected declines are of a smaller magnitude. Social payments, gross fixed capital, current transfers payable and the other category of expenditure are expected to remain broadly stable over the forecast period. On the other hand, subsidies are projected to increase by 0.4 percentage points of GDP in 2014 but to decline to 1.2 per cent in 2015 and remain at that level in the following two years. The forecasts for capital transfers exhibit significant volatility, reflecting the incremental effect of the equity injection in the national airline.

Savings in compensation of employees contribute significantly to the fiscal adjustment during 2014-2017. As a ratio to GDP, compensation of employees is projected to decline consistently by around 0.2 percentage points per annum during the forecast period, from 13.5 per cent in 2013 to 12.6 per cent in 2017. This reflects the discretionary measure of restrictions on recruitment, which is analysed in more detail later on in this report. The forecasts in the Programme imply that when this measure is excluded, general government employment remains stable at the 2013 level. This would result in a more gradual decline in the share of compensation to employees to GDP.

Table 3.4. Main Components of Expenditure

	2013	2014	2015	2016	2017
			per cent of GDP		
Total Expenditure	43.9	44.2	44.0	42.3	42.2
of which					
Compensation of employees	13.5	13.2	13.0	12.8	12.6
Intermediate consumption	6.3	6.5	6.5	6.3	6.2
Social Payments	13.5	13.5	13.6	13.5	13.6
Interest expenditure	3.0	3.0	2.9	2.9	2.8
Subsidies	1.1	1.5	1.2	1.1	1.2
Gross fixed capital formation	2.7	3.2	3.1	2.9	3.0
Capital transfers	1.3	0.9	1.4	0.7	0.8
Other	2.4	2.4	2.2	2.1	2.1

Source: Malta Update of the Stability Programme 2014-2017

The projections for compensation of employees were derived on the basis of assumptions for the average wage growth, based on the latest public service collective agreement which covers from 2011 to 2016, as well other sectoral agreements for employees within the general government sector and assumptions for the level of general government employment. Since 2017 is not covered by the current public service collective agreement, the average wage growth for 2014-2015 was assumed to apply, which, in our view, constitutes a reasonable assumption. In order to assess the plausibility of these projections, the implied average wage growth was compared to the historical average wage growth, adjusted for the effect of the reclassification of Malta Shipyards in the general government sector in 2008[4]. The assumptions for average wage growth for the forecast period appear plausible when compared to this adjusted historical average.

In the projections, retirements and resignations from general government employment are assumed to be close to the average registered between 2008 and 2013. The assumption for new recruitment (excluding the discretionary measure) is similar to past recent trends, when the relatively high increases registered in 2008 and 2013 are excluded. Overall, our assessment is that the projections for compensation of employees (excluding the effect of the discretionary measure) are based on reasonable assumptions when compared to the general trends in recent years.

Following a slight increase in 2014, intermediate consumption is projected to decline marginally over the forecast period from 6.5 per cent in 2014 and 2015 to 6.2 per cent in 2017, thus contributing to the decrease in the budget deficit over the Programme period.

The assessment of the plausibility of the projections for intermediate consumption was carried out by comparing the annual projected increases to the historical average for 2001-2013 (excluding the effect of the reclassification of Malta Shipyards within the general government sector in 2008). Whilst in 2014, the projected increase is slightly higher than the adjusted historical average, for the outer years of the Programme the projected annual percentage increases are significantly lower. However, these changes in the projections for intermediate consumption are generally explained by

[4] This effect amounted to €75.8 million, of which €40.3 million consisted of outlays regarding employment termination schemes.

the developments in capital expenditure classified under this component of expenditure. As explained earlier, the assumptions used for this classification may result in distortions at a component level.

There are no specific discretionary measures underpinning the forecasts for this expenditure component, but the Stability Programme (Ministry of Finance, 2014, p.28) refers to the ongoing Ministerial Spending Review, which was initiated in July 2013, but whose positive impacts on efficiency are expected to be felt over a number of years. During the meetings, the authorities highlighted their commitment to continue to review the expenditure programme through this spending review. They explained that this review is assisting each Ministry to identify cost savings through the elimination of waste and inefficiencies, as well as by facilitating the exchange of good practices and incentives. The review provides a framework for Ministries to explore their line budget items to introduce zero budgeting and outputs for lines of expenditure. The review thus ensures that spending is continually being reviewed according to needs and priorities. Whilst the budgetary projections do not specifically include an estimate of the impact of the ongoing spending review, we consider that its implementation and results would contribute to reduce the risk of any possible slippages in the attainment of the targets for this component of expenditure.

Social benefits and social transfers in kind are projected to remain roughly stable at around 13.5 per cent of GDP over the Programme period. In 2014 and 2015, the net impact of discretionary measures on this expenditure category is deficit-increasing (0.1 per cent of GDP), as the impact of the pension reform initiatives is more than offset by the conditional children allowance and the assistance to help the elderly in 2014. In the outer years of the Programme, the discretionary measures affecting social payments relate only to the pension reform and thus are deficit-reducing (with a marginal impact of around 0.01 per cent of GDP in both years).

When the incremental net effect of the discretionary measures is excluded from the projections, on average total social payments are projected to grow at a rate which is close to the average in recent years. However, the growth rates for 2014 and 2016 are relatively lower than this average. Due to time constraints, it was not possible to delve deeper in the individual items of social benefits which are comprised in this category of expenditure in order to analyse the reasons for these annual fluctuations.

The authorities provided information on how the projections for outlays on social benefits are formulated. In particular, projections are generated for the main types of contributory and non-contributory benefits and are based on administrative data for the number of beneficiaries by age, gender, benefit type and the average rate of benefit. Assumptions for the projected number of beneficiaries for the different types of benefits are generally based on the trends in recent years as well as demographic projections (EUROPOP 2010 projections by Eurostat), where relevant. Assumptions for the average benefit per person take into account the cost of living adjustment, where relevant. The projections take into account the most recent trends from the administrative data. On the basis of the information provided by the authorities, our assessment is that the projections for outlays on social benefits are generated at a detailed level using a sound methodology which is based on the main factors driving these outlays and on plausible assumptions.

Interest expenditure is projected to decline marginally from 3 per cent of GDP in 2013 and 2014 to 2.8 per cent in 2017. Besides the risks relating to the attainment of the overall deficit and debt targets (which are discussed separately elsewhere in this report), uncertainty regarding the future cost of borrowing may also constitute a risk relating to the projections for interest expenditure. The authorities explained that the estimate for the cost of borrowing is based on past take up of stocks issued and prevailing and expected market conditions. Uncertainty surrounding this estimate only concerns the cost of borrowing of new loans, which comprises debt issued to finance the borrowing requirements, rolling over of maturing stocks as well as Treasury Bills. Short-term debt is projected

to constitute less than 5 per cent of GDP over the forecast period, whilst the share of maturing stocks is expected to fluctuate around 7 per cent of GDP (Ministry of Finance, 2014, p.28).

The implicit interest rate on debt[5] is projected to decrease slightly from 4.5 per cent in 2013 to 4.2 per cent in 2014, and thereafter to recover slightly and remain generally stable at around 4.4 per cent. This is consistent with the recent low interest rate environment and the assumption of stable interest rates used in the generation of the macroeconomic forecasts included in the Stability Programme (Ministry of Finance, 2014, p.80). Thus, overall, the risk of not attaining the target for this expenditure component is relatively limited.

After remaining broadly stable at around 1 per cent of GDP since 2009, subsidies are projected to increase by 0.4 percentage points of GDP in 2014, to reach 1.5 per cent. Thereafter, subsidies are projected to return to their previous level, fluctuating between 1.1 and 1.2 per cent of GDP. Given the nature and inherent volatility in this item of expenditure, the assessment was not based on past trends but on the basis of the available information on known major risk factors.

The increase in 2014 is mainly attributable to higher subsidies for the operation of the public transport service, which were taken over by Government as from the beginning of 2014. Besides the amount equivalent to 0.1 per cent of GDP in respect of the public service obligation which had been agreed to with the previous public transport operator, the 2014 projection includes an estimate for the losses incurred by the government company which is operating the public transport service (Malta Public Transport Services (Operations) Limited). The authorities have confirmed that this company has not been classified within the general government sector, since it is assumed to be privatised within the current year. Nevertheless, since its losses are covered by a Government subvention, this still impacts on the budget deficit. According to the Stability Programme, "it is Government's firm commitment to divest itself of the operation in the near future and as such this allocation is not expected to take place in the outer years of the Programme period" (Ministry of Finance, 2014, p.25). In fact, the subsidies projected for 2015-2017 for the public transport service are assumed to revert back to 0.1 per cent of GDP.

The amount of subsidies projected for 2014 is broadly in line with extrapolations made from the actual operation losses incurred by Malta Public Transport Services (Operations) Limited during the first quarter. However, delays in the divestment of this operation beyond the last quarter of 2014 may require additional subventions than those projected for 2015. Furthermore, risks to the subsidy projections from 2015 onwards also stem from the possibility that the subsidy agreed to with the new operator is higher than the projected amount. The authorities have explained that negotiations between the selected operator and Government are still ongoing[6] and that the subsidy is influenced by various factors, including bus routes, tariffs and other factors. They also highlighted the commitment to ensure the sustainability of such outlays. Nevertheless, we consider that this risk cannot be disregarded given the substantial losses incurred by the previous private operator of the public transport service.

Following an increase of 0.5 percentage points of GDP in 2014, gross fixed capital formation as a share of GDP is projected to fall marginally and to fluctuate around 3 per cent during the outer years of the Programme. This is somewhat higher than the average of 2.5 per cent registered in recent years. Developments in gross fixed capital formation over the forecast period are significantly affected by the assumptions regarding the uptake of EU funds. In particular, the projected increase in gross fixed capital formation in 2014 primarily reflects higher outlays on capital projects financed from EU funds under the 2007-2013 programming period. Expenditure on projects financed from this programming period are also expected to remain relatively high in 2015 as this programme

[5] Calculated as the interest expenditure for year *t* divided by the stock of debt in year *t-1*
[6] The call for expressions of interest closed in the beginning of April 2014.

nears completion. Capital projects financed from the 2014-2020 programme are assumed to gradually come on stream and to be significant in 2016 and 2017. By 2017, the forecasts are comparable to the level in the last two years of the previous programme. Thus, there is a risk that investment expenditure is lower than projected, due to absorption capacity issues. Nevertheless, this would not have a negative impact on the fiscal balance since the capital outlays correspond to analogous increases in revenue[7].

The authorities have confirmed that significant major investment projects which are expected to materialise during the forecast period, namely the investment relating to the new power station and the Valletta infrastructural projects are classified outside of the general government sector and their implementation does not have an impact on the fiscal deficit.

Overall, no significant negative risks to the budget deficit were identified from gross fixed capital formation.

After rising by 0.3 percentage points of GDP in 2013, capital transfers payable are projected to fall from 1.3 per cent of GDP to 0.9 per cent of GDP in 2014 and then to rise again to 1.4 per cent of GDP in 2015. In the subsequent two years, capital transfers payable are projected to be substantially lower at around 0.7 per cent of GDP. This category of expenditure was considerably affected by the incremental effect of the transactions relating to the equity injections in Air Malta plc. Following capital injections of €20 million and €40 million in 2012 and 2013, respectively, the projections for capital transfers include a capital injection of €15 million in 2014 and a final capital injection of €43 million in 2015. The latter relates to the conversion of a loan granted in 2012 into a capital injection. The loan amounted to €52 million and the remaining €12 million will be converted into equity in 2016. The authorities have highlighted that the latter is assumed not to impact on the general government deficit since it is being assumed that the national airline will turn profitable in 2016. However, this is conditional on achieving the planned targets in the restructuring plan for the company. There remains the risk that the impact on the deficit of the restructuring of the national airline would be higher than projected if the company does not turn profitable by 2016, although this risk is contained to 0.1 per cent of GDP in 2016. The implications of these transactions on the debt projections are discussed later on in this report.

Another risk associated with the projections for capital transfers relates to the impact of the ex-gratia payment in relation to registration tax paid on imported vehicles for personal use between 1 May 2004 and 31 December 2008. The authorities confirmed that the projections for capital transfers payable include an allocation of around 0.04 per cent of GDP for this scheme in each year of the forecast period. However, this estimate is subject to significant uncertainty since currently applications are still being vetted and there is a lack of information both as regards the number of eligible applicants as well as regarding the amounts due in respect of each vehicle. Our assessment is that given the uncertainty involved, there is a risk that disbursements under this scheme may be higher than projected.

The 'other' category of expenditure, which mainly comprises the component of other current transfers payable, fluctuated around 1.4 per cent of GDP throughout the period from 2000 till 2012, but rose to 2.4 per cent of GDP in 2013. The increase in the ratio in 2013 reflects a base effect stemming from the revenue accruing from the concession fee paid by the lottery operator, which is recorded as negative expenditure in 2012. Higher EU own resources also contributed to this increase. Over the forecast period, this component of expenditure is projected to remain relatively stable in absolute terms at the 2013 level and to decline gradually as a ratio of GDP to 2.1 per cent by 2017. Since the 2013 level is relatively high compared to the historical average, we consider that

[7] Rather, a lower absorption of EU funds than that projected would imply savings of the co-financing element and thus impact positively on the fiscal balance.

the authorities have shown a certain degree of prudence in the projections for this component of expenditure, which is appropriate since outlays in connection with the EU own resources tend to be subject to a high degree of uncertainty since these contributions are affected by any revisions to the statistical data for GDP.

3.4. Assessment of impact of major discretionary measures

During the period under review, discretionary measures under taxes on production and imports in 2014 and in social contributions (reflecting the effect of the 2006 pension reform) and other measures compensate for the lower revenue under current taxes on income and wealth, mainly due to the widening of the income tax rates. The pension reform also yields some savings in social payments throughout the forecast period, whilst restrictions on recruitment contribute significantly to the fiscal adjustment as from 2015.

Table 3.5. Discretionary Measures underpinning the budgetary adjustment

	2014	2015	2016	2017
		Euro millions		
Main measures impacting on components of revenue	19.4	10.9	8.8	0.0
of which				
Taxes on Production and Imports	19.9	0.6	0.0	0.0
Current Taxes on Income and Wealth	-18.8	-20.4	-0.7	0.0
Social Contributions	10.2	10.7	-0.5	0.0
Other	8.1	20.0	10.0	0.0
Main measures impacting on expenditure	24.2	-21.8	56.0	8.8
Total impact of discretionary measures	43.6	-10.9	64.8	8.8

Note: The budgetary impact is the incremental impact of measures as reported in the Update of the Stability Programme 2014-2017. A positive sign implies that deficit declines as a consequence of the measure.

Source: Malta Update of the Stability Programme 2014-2017

Discretionary measures on the revenue side of the budget

The impact of discretionary measures related to taxes on production and imports is estimated at 0.3 per cent of GDP in 2014. These consist mainly of revisions in the excise duty on cigarettes and tobacco, fuel, cement, alcohol and beer and revisions in the tax rate on fuel bunkering. Since similar measures have been implemented in previous years, the estimated impact from these measures can be compared to the increases in revenue estimated from similar measures over previous years. Taking into account any differences in the changes in the tax rates, this comparative assessment indicates that the estimated fiscal impact of these measures for 2014 is in line with the revenue that was generated from similar measures in previous years. Moreover, an ex-post assessment of the revision in excise duty on fuel, on cement and on cigarettes and tobacco in 2013 indicates that the observed budgetary impact exceeded the expected impact thus suggesting some element of prudence in these estimations.

The ratio of the current taxes on income and wealth is estimated to be negatively affected by budgetary measures in 2014 and 2015. Indeed, according to the Programme, the widening in income

tax brackets is estimated to have a negative impact of 0.2 per cent of GDP in 2014 and a further 0.3 per cent of GDP in 2015.

The estimate of the fiscal impact of widening of the income tax rates for 2013 and 2014 was computed by the Inland Revenue Department (IRD). This Department explained that the estimates were computed on a micro level i.e. based on the actual database of taxpayers and their income for 2012. It is pertinent to note that these estimates were computed with a number of underlying assumptions, namely that both the number of taxpayers and their respective income remain constant in 2013 and 2014. These assumptions may imply some underestimation of the impact of this measure due to growth in employment and wages. This is corroborated by a comparison of the estimated budgetary impact for 2013 which stood at €11.5 million and the observed budgetary impact to date for 2013[8] estimated at €13.3 million.

In 2015, the tax rates are planned to decrease further by 4 percentage points (from 29 per cent to 25 per cent). The estimate for loss of revenue emanating from this decrease was computed by the Economic Policy Department. There are methodological differences in the computation of this estimate particularly since income is assumed to grow in line with inflation and the estimate is based on income distribution data. The estimated loss of revenue from this measure in 2015 amounts to €19.2 million or 0.2 per cent of GDP. If the income level for 2012 used in the estimation by IRD is adjusted to take into account of annual growth in income, a somewhat lower impact is indicated, which suggest that the budgetary impact estimated in the Programme for 2015 is prudent.

The 2006 pension reform initiatives included a more dynamic indexation of the ceiling on pensionable income. This is estimated to have an impact on social contributions of 0.15 per cent of GDP each year in 2014 and 2015. The authorities have explained that this estimate takes into account the number of persons earning a salary above the ceiling. Based on the limited information available, there are no grounds indicating particular risks with the estimate for the impact of this measure.

The forecasts presented in the Programme also take into account another fiscal measure namely the International Investor Programme. It is assumed that this measure will generate revenue of 0.07 per cent of GDP in 2014 and 1.3 per cent of GDP in 2015. One notes that this estimate for 2014 is more prudent than that presented in the 2014 Budget. The impact of this measure is subject to significant uncertainty since it depends on the number of approved applications which, at this stage, is too early to determine. Nevertheless, the authorities emphasised their confidence that the actual intake from this Programme is expected to be higher than that included in the projections.

It is noteworthy that whilst the Budget for 2014 announced a revision in the tax rate on rental income[9], in view of the fact that the estimation of the impact on government revenue is highly dependent on the response of the rental property market which is highly unpredictable, the authorities stopped short of including an estimate of the revenue which may stem from this measure in their fiscal forecasts. The fiscal projections presented in the Programme also exclude proceeds generated by the Asset Registration Scheme[10], which was announced in the Budget for 2014. The prudent decision by the authorities to exclude the revenue-increasing impact of these two measures provides an upside risk.

[8] The IRD highlights the fact that the actual impact of the tax reform for 2013 will be determined only later on in 2014 when the income tax returns for basis year 2013 are processed.

[9] The housing rental sector has been identified as an important source of tax evasion and therefore a revision in the tax rate on rental income was announced in the Budget for 2014 aimed to incentivise the rental market whilst regulating it more efficiently.

[10] An Asset Registration Scheme was launched providing the opportunity to residents of Malta who hold any assets to previously disclosed, to regularise their position.

It is noted that all the budgetary measures which are expected to have an impact on the revenue projections have already come into force and therefore no risk of delays in implementation are identified[11]. Besides having the necessary legislative framework in place to implement the budgetary measures, the materialisation of the planned revenue impact also requires efficient and effective implementation. In this regard, authorities stressed that significant efforts are being undertaken to enhance the operation of revenue collection and to intensify the fight against tax evasion.

It is also pertinent to highlight that the fiscal projections for 2015 and 2016 include measures amounting to 0.1 per cent of GDP, which are still to be specified in the respective budget, including the mix between revenue and expenditure measures. One notes that this has also been the practice in previous years when specifications of some consolidation measures were not announced in the Stability Programmes but were included in subsequent budgets. Nevertheless, a downside risk in the forecasts remains from the lack of information on these measures.

Discretionary deficit-reducing measures on the expenditure side of the budget

Restrictions on recruitment contribute to cost savings of around 0.1 per cent of GDP (on an incremental basis) in each year of the forecast. Authorities explained that this measure entails that resignations and retirees in the public sector (excluding health and education) will be replaced by new employees on a ratio of 2:3. This discretionary measure implies a decline in government employment of around 500 per year in both 2014 and 2015, whilst thereafter employment is projected to remain stable at the 2015 level. The implied new recruitment in 2014 and 2015 is around one-third lower than the average in recent years, even when 2008 and 2013 (which recorded significant increases in employment) are excluded.

The authorities reiterated their commitment to reduce employment to the targeted level implied by the Stability Programme projections and referred to the capacity building exercise, whereby public sector entities submit their human resource requirements for 2015 within the entities' financial plans and the Ministry of Finance then assesses claims for new recruitment accordingly. Whilst this exercise provides some element of control for the Ministry of Finance over new recruitment in the public sector, the restrictive recruitment policy in 2014 and 2015 implied by this discretionary measure still appears challenging in the context of the general trends in recent years. It is thus our assessment that there is some risk attached to the cost savings implied by this discretionary measure.

The gradual increase in the pensionable age resulting from the pension reform legislated in 2006 is expected to result in lower outlays on retirement pensions during the forecast period, albeit the magnitude of this measure is marginal during 2014-2017 (around €1 million or 0.01 per cent of GDP)[12]. The authorities provided information on how the impact of the pension reform was calculated. The estimate of the number of beneficiaries affected by the pension reform was based on EUROPOP demographic projections and the probability of early retirement was also taken into account, with assumptions for this made on the basis of administrative data. The average pension used to estimate the impact of this measure was the average for 2012 adjusted for the cost of living

[11] The Asset Registration Scheme mentioned earlier has not as yet been implemented, however, no estimate of its fiscal impact was taken into account in the fiscal projections and therefore there is no downside risk in case of delayed implementation.

[12] The impact of this measure was of a larger magnitude in 2012 and 2013 (amounting to around 0.1 and 0.2 per cent of GDP respectively) as the first age cohort (those born during 1952-1955) was affected by the gradual increase in the exit age (from 61 to 62 years). The next increase in the exit age (to 63 years) will take effect as from 2018.

adjustment in order to estimate the cumulative effect of the reform. The information available does not indicate any reasons for particular risks associated with the impact of this reform.

The authorities highlighted that the estimated impact of the reform includes only an increase in the average pension to reflect the cost of living adjustment, but the pension of new retirees tends to be higher than that of previous cohorts, which implies that the potential savings from this measure may be under-estimated. They also pointed out that the proportion of early retirees was assumed to remain constant but could decrease over time as the loss in pension income from early retirement increases and as age cohorts with a higher employment rate enter into the system. We share their view that there is the possibility that cost savings from this measure may be higher than estimated, though we consider that such underestimation reflects the effect of increasing pensions over time, whilst the possibility of a lower proportion of early retirees is subject to more uncertainty. Any additional savings however are unlikely to have a substantial impact on the overall fiscal balance.

3.5. Assessment of debt projections

According to the Programme, the debt-to-GDP ratio is projected to decline from 73 per cent of GDP in 2013[13] to 69.4 per cent of GDP in 2014. This decrease reflects the drop in the primary balance and, to a larger extent, the expected influence of the stock-flow adjustment (SFA), the latter mainly on account of the expected repayment of accumulated arrears of excise taxes by Enemalta. At this juncture, one notes that the risk that the repayment of these accumulated arrears does not materialize is foreseen to be limited given the agreement between the Government and China Power Investments Corporation (CPIC), whereby Shanghai Electric Power, a subsidiary of CPIC will become a minority shareholder in Enemalta, providing the Maltese utility company with a cash injection that will improve its financial position. Moreover, the stock-flow adjustment also reflects the underlying assumption of a significant decrease in aggregate cash balances by Government.

Table 3.6. Debt Dynamics

	2013	**2014**	**2015**	**2016**	**2017**
			per cent of GDP		
General Government Gross Debt	73.0	69.4	68.5	66.0	63.9
Change in the Ratio	2.2	-3.5	-0.9	-2.5	-2.2
Contributions:					
1. Primary Balance	-0.2	-0.9	-1.3	-2.1	-2.5
2. 'Snow-ball' effect	0.0	-0.3	-0.2	0.0	0.0
of which:					
Interest expenditure	3.0	3.0	2.9	2.9	2.8
Growth effect	-1.6	-1.6	-1.4	-1.3	-1.2
Inflation effect	-1.4	-1.6	-1.6	-1.6	-1.6
3. Stock-flow adjustment	2.4	-2.3	0.6	-0.3	0.3

Source: Malta Update of the Stability Programme 2014-2017

[13] One notes that in 2013, General Government debt ratio increased by 2.2 percentage points to 73.0 per cent of GDP mainly due to a positive SFA reflecting accumulated accruals payable to Government by Enemalta, EFSF rerouting as well as an expansion of cash holdings.

The General Government gross debt is projected to continue decreasing from 68.5 per cent of GDP in 2015 to 63.9 per cent of GDP in 2017 helped by increasing primary surplus. Over this period, the 'snow-ball' effect is projected to have a minimal impact on the debt ratio as the envisaged economic growth is expected to largely offset the expansionary impact exerted by interest expenditure. The stock-flow adjustment is expected to have a relatively minor effect on debt developments during this period. The authorities explained that the repayment of part of a loan by Air Malta and the corresponding equity injection have a neutral effect on the debt in 2015.

The same risks highlighted for the deficit targets apply to the Programme's debt projections. Moreover, uncertainty surrounding the debt ratio projections also stems from underlying assumptions particularly those concerning aggregate cash balances and borrowing by Extra-Budgetary Units (EBUs). Moreover, since the government-guaranteed debt amounted to 16.6 per cent of GDP in 2013, this could constitute a downside risk to the SFA. However, in view of the fact that the public energy utility corporation accounts for a significant share of the government-guaranteed debt, the steps already taken towards the restructuring of this entity are likely to help reduce the exposure to the contingent liabilities. If potential proceeds from privatisation materialize this would contribute towards lowering even further the debt ratio.

4. Comparison of MFIN budgetary forecasts with the fiscal projections generated by the European Commission in its Winter Forecast 2014

In order to further assess the plausibility of the Ministry of Finance's (MFIN) fiscal projections presented in the Stability Programme, a comparative assessment is made with the budgetary projections generated by the European Commission (CION). This evaluation covers only forecasts for 2014 and 2015, since the Commission presents projections extending only up to 2015 in its most recent Winter 2014 forecast.

Since the Winter 2014 forecasts were published by the European Commission on 25th February 2014,[14] more updated national accounts as well as fiscal data[15]published by the NSO after this date were not taken into account. On the other hand, macroeconomic and fiscal forecasts presented in the Stability Programme were based on the more updated data thus contributing to discrepancies between the two sets of forecasts due to this base effect. Moreover, possible divergences relate to the different methodologies and assumptions used by the CION and MFIN in their forecasting exercises. Furthermore, whilst both sets of budgetary projections take into account the 2014 budget measures, the Commission's fiscal forecasts for 2015 are based on a no-policy-change assumption. It is also relevant to highlight that discrepancies in the fiscal projections could also reflect differences in the expected path for the relevant macroeconomic indicators[16].

[14] The European Commission's Spring 2014 forecasts were due to be published on 5th May 2014 and thus it was not possible to take them into account in this comparative analysis.

[15] The first provisional estimates for GDP for the year 2013 were published on 11th March 2014 (NSO News Release 047/2014), whilst the report on government deficit and debt levels for the years 2010-2013 was submitted to Eurostat on 28th March 2014 and published on 23rd April 2014 (NSO News Release 075/2014).

[16] A detailed comparative assessment of the macroeconomic forecasts presented in the Programme and those included in CION Winter 2014 forecasts is found in Section 5.2 of the separate NAO report: An assessment of the macroeconomic forecasts for the Maltese economy performed by the Ministry of Finance in April 2014.

Table 4.1. Comparison of Fiscal Projections

	2013	2014	2015	2013	2014	2015
	Actual	MFIN April 2014		CION Winter 2014		
	per cent of GDP					
General government balance	-2.8	-2.1	-1.6	-3.0	-2.7	-2.7
General government debt	73.0	69.4	68.5	72.0	72.4	71.5
	Eur millions					
Taxes on production and imports	967.7	1,058.9	1,108.9	980.7	1,035.9	1,083.9
Current taxes on income and wealth	1,043.3	1,071.8	1,132.3	1,001.3	1,039.7	1,078.2
Capital taxes	12.7	15.3	15.7	16.0	17.3	18.1
Social contributions	524.8	559.4	586.4	527.9	555.0	577.4
Capital transfers receivable	152.2	213.7	231.9	187.1	193.2	202.3
Other revenue	249.8	253.1	264.4	229.0	245.2	252.2
Total revenue	2,950.5	3,172.2	3,339.6	2,942.1	3,086.2	3,212.0
Compensation of employees	970.9	993.9	1,022.8	965.1	996.4	1,027.3
Intermediate consumption	454.0	490.2	509.9	463.0	487.1	511.5
Social payments	972.6	1,016.4	1,069.4	982.1	1,020.9	1,056.7
Interest expenditure	217.2	222.5	227.8	218.1	224.2	229.5
Gross fixed capital formation	195.6	242.7	247.8	201.4	209.4	222.0
Subsidies	79.5	113.4	97.8	93.4	93.7	94.4
Other expenditure	263.7	248.1	287.1	233.0	256.3	282.7
Total expenditure	3,153.5	3,327.2	3,462.6	3,156.0	3,288.1	3,424.1
General government balance	-203.0	-155.0	-123.0	-213.9	-201.8	-212.1

Source: Malta Update of the Stability Programme 2014-2017, Ministry of Finance, Ameco (website accessed on 1st May 2014)

Whilst the European Commission also expects a decline in the deficit ratio, this decrease is much more contained and gradual than that presented in the Stability Programme. Starting from a relatively higher expected deficit ratio for 2013 (at 3 per cent of GDP, compared to the actual outturn of 2.8 per cent), the Commission projected that the deficit would fall to 2.7 per cent of GDP in 2014 and remain stable in 2015. The discrepancy with the MFIN's fiscal targets is thus significant, at 0.6 and 1.1 percentage points of GDP in 2014 and 2015, respectively.

It is pertinent to note that these differences are not attributable to the different estimates for GDP which are used to calculate the deficit ratio. The base effect of a larger deficit for 2013 in the Commission's Winter forecasts, when compared to the actual outturn is marginal in 2014, amounting to 0.1 per cent of GDP, but the cumulative base effect accounts for 0.6 per cent of GDP in 2015. Since the Commission's forecasts for 2015 are based on a no-policy change assumption[17], discretionary measures included in the Ministry's projections account for a further 0.2 per cent of GDP of the difference between the two sets of forecasts.

In order to carry out a more in-depth analysis of the remaining differences between the Commission's and Ministry's fiscal targets for 2014 and 2015, a comparative assessment of the fiscal projections was also undertaken for the main budgetary categories[18]. Whilst the Ministry's projections for both total revenue and expenditure are higher than those of the Commission, the discrepancy in the expected revenue is of around 1 per cent of GDP in 2014 and around 1.5 per cent of GDP in 2015, which more than compensates for the difference in outlays which amounts to around 0.5 per cent of GDP in both years.

On the revenue side, the Ministry expects higher revenue from both taxes on production and imports and from current taxes on income and wealth. The higher assumed intake from taxes on production and imports in the Ministry's projections is particularly noteworthy given the 'negative' base effect, (since the actual revenue from this component in 2013 was lower than that projected by the Commission in its Winter 2014 forecasts). The discrepancy in the forecasts for taxes on production and imports reflect stronger growth in private consumption expenditure by the Ministry as well as a higher estimated elasticity in 2014. On the other hand, as regards current taxes on income and wealth, the Ministry's higher revenue projections for 2014 are explained by the base effect. Indeed, taking into account the outturn for 2013, the Ministry's projections for 2014 for this tax category appear to be more cautious when compared to those of the Commission, particularly in the context of the higher nominal GDP growth in the Ministry's projections. In 2015, differences in the underlying macroeconomic outlook[19] contribute to the higher forecasted revenue by MFIN. On the revenue side, another significant difference between the Ministry's and the Commission's projections, involves capital transfers receivable, with a notably higher intake expected by the Ministry in both 2014 and 2015, despite that the actual outturn for 2013 was lower than the forecasted amount in the Commission's Winter 2014 forecasts. However, since this discrepancy largely reflects different assumptions regarding the absorption rate of EU funds and corresponds to higher capital outlays in the Ministry's projections, the effect on the budget balance is broadly neutral.

On the expenditure side of the budget, the differences between the Ministry's and Commission's forecasts are of a relatively smaller magnitude and mainly concern subsidies and gross fixed capital formation. Despite that the actual outturn for subsidies was lower than that predicted by the Commission, the Ministry's projections for subsidies are higher particularly in 2014. This discrepancy could reflect recent information on the expected losses by the government-owned company operating the public transport service, which was included in the Ministry's projections. As in the case of capital transfers receivables, the higher capital outlays in the Ministry's projections largely

---

[17] However, CION's fiscal forecasts include the impact of the equity injection and loan repayment relating to the national airline.

[18] In order to exclude the impact of discrepancies in the GDP level for 2013 and in the expected GDP growth rates for 2014 and 2015, the comparative assessment at a budgetary component level was carried out in absolute terms rather than as a share of GDP.

[19] In particular, the Commission Winter 2014 forecasts show a nominal GDP growth of 3.8 per cent and 2.5 per cent in 2014 and 2015, respectively, compared to the 4.7 per cent and 4.6 per cent presented in the Stability Programme.

reflect the implementation of EU-funded projects and thus do not have a material impact on the net fiscal balance.

The Commission's Winter 2014 fiscal projections and the Ministry's budgetary forecasts as presented in the Stability Programme present notable differences as regards the expected path for the general government debt ratio to GDP. Whereas the Ministry projects the debt ratio to fall consistently and at a relatively rapid pace, from 73 per cent in 2013 to 68.5 per cent in 2015, the Commission's forecasts show a slight increase in the debt ratio of 0.4 percentage points of GDP in 2014 and a decline of 0.9 percentage points in 2015. The Commission's projections for the debt ratio are thus around 3 percentage points of GDP higher in both 2014 and 2015, so that its debt ratio stands at 71.5 per cent in 2015, even though the Commission's estimate for 2013 was 1 percentage point below the actual outturn. Around 1 per cent of GDP is due to the relatively lower GDP level used by the Commission in order to compile the debt ratio. The cumulative contribution of the more gradual fiscal adjustment in the Commission's forecasts accounts for a further 0.8 and 1.8 per cent of GDP in 2014 and 2015, respectively.

In 2014, the remaining discrepancy is largely explained by the SFA relating to the payment of the accumulated tax arrears by Enemalta which is included only in the Ministry's debt projections. In 2015, after taking into account differences in GDP levels and deficit forecast, the remaining discrepancy is minimal.

5. Conclusion

As regards the methodology and processes used to produce the budgetary forecasts, the authors of this report positively note the detailed level at which these projections are generated and the involvement of expert inputs, as necessary. In particular, one notes the close collaboration between the Budget Office and the Economic Policy Department which should facilitate consistency between the fiscal and the macroeconomic projections. We recognise that the process of generating fiscal projections for the medium-term is complex and necessitates various assumptions, which entail a certain degree of uncertainty. However, the transition from Consolidated Fund cash data to projections in ESA95 terms necessitates additional assumptions and the fragmentation in the process of generating the fiscal projections can result in higher forecast errors.

The Stability Programme presents a gradual but consistent fiscal improvement over the 2014-2017 period. This fiscal consolidation is subject to some downside risks, but there are also some upside risks.

As regards the macroeconomic outlook, the projections in real terms might well be a plausible trajectory for growth and the main identified sources of uncertainty[20] do not concern the major tax-rich components of GDP and thus do not represent a significant risk to the fiscal projections. However, one notes some uncertainty since the European Commission's Winter 2014 forecasts for nominal GDP and private consumption growth are lower than the Ministry's projections.

On the revenue side, the main downside risks to the projections involve the relatively high elasticities for taxes on production and imports and social contributions in 2014. On the other hand, the assumed elasticity for current taxes on income and wealth over the forecast period appears cautious.

The estimated impact of 2014 discretionary measures concerning taxes on production and imports indicates some element of prudence. On the other hand, the impact of the widening of the income

[20] In the separate National Audit Office report: An assessment of the macroeconomic forecasts for the Maltese economy performed by the Ministry of Finance in April 2014.

tax bands may be slightly underestimated in 2014, but it may be somewhat lower than expected in 2015.

There are some risks of slippages on the expenditure side of the budget. In particular, outlays on compensation of employees could be higher than projected, since the planned measure of restrictions on recruitment appears challenging compared to the experience in past years. There are downside risks also for the projections of subsidies for public transport and as regards the ex gratia payment in relation to tax on vehicles. Furthermore, the fact that some of the measures underpinning the fiscal consolidation are not specified in the Programme constitutes a further element of downside risk. No additional risk is foreseen from the conversion of the loan repayment by the national airline into an equity injection, though this is conditional on the company turning profitable in 2016 as planned.

On the positive side, savings in expenditure could result from the implementation of the Ministerial Spending Review. Cost savings from the pension reform initiatives could also be higher than estimated, though to a limited extent. Moreover, proceeds from the International Investor Programme may be higher than that included in the Programme, if the authorities' expectations materialise. Another element of upside risk emanates from the fact that the revenue-increasing impact of the tax rate on rental income and the Asset Registration Scheme was not included in the fiscal projections.

The abovementioned risk factors also apply to the debt projections presented in the Programme. The debt forecasts are subject to additional uncertainties reflecting the assumptions for aggregate cash balances and borrowing by EBUs. The repayment of accumulated tax arrears by Enemalta is not considered to be a significant risk, as long as the restructuring of the utility company progresses as planned. An improvement in the financial position of this company would also reduce the risk to the debt projections stemming from government-guaranteed debt. If potential proceeds from privatisation materialise, the debt ratio would improve even further than projected.

Overall, we consider that the fiscal targets presented in the Programme are attainable, subject to the risks highlighted above, but require strong commitment by the authorities to achieve the projected revenue targets and adhere to the forecasted expenditure ceilings.