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COMMISSION STAFF WORKING DOCUMENT

Analysis by the Commission services of the budgetary situation in Malta

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Malta

{COM(2013) 391 final}

1. INTRODUCTION

Since accession to the EU, Malta has been subject to two excessive deficit procedures (EDP)[1]. The first was launched by the Council decision of 7 July 2004 and was abrogated by the Council on 5 June 2007. The second was launched on 7 July 2009 and abrogated on 4 December 2012, following a one-year extension, to 2011, of the deadline for correcting the excessive deficit on account of unexpected adverse economic events with major unfavourable consequences for the government finances that occurred in 2010.

According to data notified by the Maltese authorities in April 2013[2], the general government deficit in Malta reached 3.3% of GDP in 2012, up from 2.8% of GDP in 2011. In addition, in 2012 the general government gross debt was above the 60%-of-GDP reference value and Malta did not make sufficient progress towards compliance with the debt reduction benchmark, in line with the requirements of the transition period[3] following the correction of its excessive deficit.

The report prepared by the European Commission under Article 126(3) of the Treaty on the Functioning of the European Union ('the Treaty'), which represents the first step in the EDP, analysed the reasons for the breach of the deficit and debt criteria of the Treaty, with due regard to the economic background and all other relevant factors. According to the report, both the deficit and debt criteria of the Treaty are not fulfilled, and, according to the Article 126(6) of the Treaty, the Council decided that an excessive deficit exists in Malta.

2. RECENT MACRO-ECONOMIC DEVELOPMENTS

The Maltese economy demonstrated resilience throughout the crisis. In 2009, real GDP declined by 2.4%, better than the 4.4% contraction in the euro area. The subsequent rebound was more pronounced, averaging 2.4% as opposed to 1.7% in the euro area, mainly driven by net exports. Job creation was strong and the unemployment rate remained at a low level, but against a background of still very low participation rates, especially among women and older workers.

In 2012, real GDP grew by 0.8% (see Table 1), driven by exports and public spending. International trade remained a key driver of economic growth, despite the challenging environment, contributing to the correction of Malta's current account deficit. The labour

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[1] All EDP-related documents for Malta can be found at the following website: http://ec.europa.eu/economy_finance/sgp/deficit/countries/malta_en.htm.

[2] According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Malta can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/excessive_deficit/edp_notification_tables.

[3] Following the abrogation of the EDP in December 2012, in line with the Stability and Growth Pact, Malta benefits from a three-year transition period to comply with the debt reduction benchmark, starting in 2012. The structural effort implemented by Malta in 2012 was not sufficient to meet the requirements of the transition period for the debt reduction benchmark. The Minimum Linear Structural Adjustment (MLSA) required for 2012 was equal to 0.4 pps of GDP, while Malta worsened its structural deficit by ½ pp. of GDP in 2012.

market performed better than the euro-area average with continued job creation, while unemployment remained low and stable, reaching 6.4%.

According to the Commission 2013 spring forecast, economic growth in Malta will continue to outperform the euro-area average until the end of the forecast horizon. Real GDP growth is projected to accelerate to 1.4% in 2013 and 1.8% in 2014, underpinned by a gradual recovery in domestic demand. Growth is expected to remain job-rich, mainly thanks to catching-up employment rates among women and older workers, with unemployment and inactivity decreasing as a result. Price inflation, after spiking in 2012, is forecast to moderate, but to remain above the euro area average.

Table 1: Comparison of macroeconomic developments and forecasts

	2011	2012	2013		2014	
	Outturn	**Outturn**	**COM**	**SP**	**COM**	**SP**
Real GDP (% change)	1.7	0.8	1.4	1.4	1.8	1.6
Contributions to real GDP growth:						
- Final domestic demand	0.6	0.4	1.1	0.8	1.6	1.1
- Change in inventories	-1.7	-0.5	0.0	0.0	0.0	0.0
- Net exports	2.8	1.0	0.3	0.6	0.2	0.5
Output gap (% of potential GDP)	0.2	-0.3	-0.4	-0.5	-0.1	-0.3
Employment (% change)	2.7	2.1	1.8	0.7	2.1	0.9
Unemployment rate (%)	6.5	6.4	6.3	6.6	6.1	6.4
Labour productivity (% change)	-1.0	-1.2	-0.4	0.2	-0.3	0.8
HICP inflation (%)	2.5	3.2	1.9	2.0	1.9	1.6
Comp. of employees (per head, % change)	0.5	2.4	1.8	0.7	1.8	1.1
General government balance (% of GDP)	-2.8	-3.3	-3.7	-2.7	-3.6	-2.1
Government gross debt (% of GDP)	70.3	72.1	73.9	74.2	74.9	74.2

Source:
2013 Stability Programme (SP); Commission 2013 spring forecast (COM); Commission services' calculations.

3. BUDGETARY OUTLOOK

The baseline scenario on which this adjustment path is built incorporates the Commission 2013 spring forecast and extends it up to 2016 relying on standard assumptions about the closure of the output gap and the sensitivity of the budget to the cycle.

The budgetary projections for 2013 incorporate the 2013 budget that was endorsed by Parliament in April 2013, which includes expansionary measures on both the revenue and expenditure side, with a net deficit-increasing impact of 0.3% of GDP. In particular, the 2013 budget stipulates: the gradual reduction in the income tax rate for the middle income bracket, as well as its widening, over the period 2013-2015; a lower registration tax on "clean" private vehicles; and an increase in the minimum rate of child allowances. The budget also incorporates the previously planned equity injection into Air Malta (0.6% of GDP). These expansionary measures are only partially compensated by increases in excise duties, the collection of tax arrears, as well as the expenditure savings and higher social contributions stemming from the 2006 pension reform.

Table 2: Forecast of key macroeconomic and budgetary variables under the baseline scenario

% of GDP	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Revenues	39.3	40.5	41.0	41.2	41.3	41.3
Current revenues	37.6	38.3	38.2	38.4	38.5	38.5
Discretionary measures with impact on current revenue (1)	0.6	0.8	-0.6	-0.3	-0.2	0.0
Expenditure	42.1	43.9	44.6	44.9	44.7	44.8
Real GDP growth (%)	1.7	0.8	1.4	1.8	1.8	2.2
Nominal GDP growth (%)	3.8	3.0	3.4	3.9	4.0	4.3
Potential GDP growth (%)	1.3	1.4	1.4	1.5	1.7	2.1
Structural balance	-3.6	-4.1	-3.8	-3.7	-3.5	-3.5
General government balance	-2.8	-3.3	-3.7	-3.6	-3.4	-3.4
p.m CAB methodology revenue elasticity (2)	*0.9*	*0.9*	*0.9*	*0.9*	*0.9*	*0.9*
p.m Apparent revenue elasticity	*1.7*	*1.7*	*0.9*	*1.1*	*1.0*	*1.0*
p.m Output gap (% of pot. Output)	*0.2*	*-0.3*	*-0.4*	*-0.1*	*-0.1*	*0.0*

(1) Measures clearly specified and committed to by governments according to the 2013 Stability programme.
(2) The standard revenue elasticity has been revised in line with the recently endorsed by EPC methodology for computing cyclically-adjusted balances.
Source:
Stability programme (SP); Commission 2013 spring forecast (COM); Commission services' calculations.

The general government deficit is projected to remain above the 3% of GDP reference value until 2016. For 2015, the baseline scenario does not include the additional capital injection into Air Malta that is planned in 2015 according to the 2013 stability programme. It is thus assumed that the capital injection will not take place or be offset by measures in the opposite direction. After decreasing by ½ pp. of GDP in 2012, the structural balance is projected to improve by around ½ pp. of GDP between 2012 and 2016. Thus, in the baseline scenario, the structural effort will remain insufficient to ensure progress towards the medium-term objective of a balanced budget in structural terms. According to the baseline scenario, the general government debt is projected to increase from 72.1% of GDP in 2012 to 75.6% of GDP by 2016.

4. PROPOSED ADJUSTMENT PATH

The EDP scenario implies the correction of the excessive deficit with respect to both the deficit and debt criteria by 2014. For a debt-based-EDP, the recommendation should embed a fiscal trajectory ensuring that, if followed, the debt complies with at least the forward looking element of the debt benchmark[4] at the end of the recommendation period (this is a necessary condition for abrogation). This can only be achieved by calibrating the necessary structural

[4] The calculation of the debt benchmark is specified by the Code of Conduct: the forward looking element of the debt benchmark is fulfilled when the debt-to-GDP ratio forecast by the Commission services is below the debt benchmark for the year t+2.

effort, which – on the basis of the underlying macro scenario – would lead to certain levels of nominal deficit ensuring a sufficiently diminishing debt-to-GDP ratio. Based on the baseline scenario, compliance with the forward looking component of the debt benchmark in 2014 (hence looking at the debt-to-GDP ratio in 2016) implies a nominal deficit target of no more than 2.7% of GDP in 2014. For 2013, the headline deficit target would be of 3.4% of GDP. The primary balance would be at -0.2% of GDP in 2013 and at 0.5% of GDP in 2014. The attainment of these targets is consistent with an improvement in the structural budget balance of 0.7 pps. of GDP in both 2013 and 2014. From 72.1% of GDP in 2012, the debt-to-GDP ratio would peak at 74% of GDP in 2014 before decreasing to 72.2% of GDP by 2016.

Based on the Commission 2013 spring forecast, to reach the above mentioned structural targets, the Maltese authorities would need to implement additional consolidation measures of 0.4% of GDP in 2013 and ¾% of GDP in 2014 on top of the measures already included in the baseline scenario. These targets for the annual improvement in the structural budget balance take into account the need to compensate for the negative second-round effects of fiscal consolidation on the public finances, through its impact on GDP growth. They also assume that a possible capital injection into Air Malta for 2015 would be fully compensated by additional consolidation measures. The general government debt is projected to increase to 73.5% of GDP in 2013 and stabilize in 2014 as a consequence of the restored primary surplus.

Table 3: Forecast of key macroeconomic and budgetary variables under the EDP scenario

% of GDP	**2012**	**2013**	**2014**
Real GDP growth (%)	0.8	1.2	1.6
Potential GDP growth (%)	1.4	1.4	1.5
Structural balance	-4.2	-3.5	-2.7
General government balance	-3.3	-3.4	-2.7
p.m Output gap (% of pot. output)	*-0.2*	*-0.4*	*-0.3*

Source:
Commission services' calculations.

The deterioration in the 2012 budgetary position resulted from slippages in current expenditure, which suggests that the non-binding nature and short horizon of fiscal planning in Malta are not supportive of a sound fiscal position. In light of this, it would be important to underpin the adjustment path with a more binding and effective multiannual fiscal framework and improved monitoring of budgetary execution throughout the year. The setting up of an independent body would help to ensure compliance with fiscal rules[5]. At the same time, fiscal consolidation needs to be designed in a growth-friendly manner (including by conducting systematic expenditure reviews).

[5] According to Article 6 of Council Directive 2011/85/EU of 8 November 2011, independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities of the Member State shall provide reliable and independent analysis of the effective and timely monitoring of compliance with numerical fiscal rules. Article 5 of Regulation No 473/2013 of the European Parliament and of the Council of 21 May 2013 emphasises the role of independent bodies in monitoring and assessing compliance with the national fiscal rules.

5. CONCLUSIONS

The 2013 Stability Programme of Malta sets out deficit targets for 2013 and 2014 that, in light of the Commission 2013 spring forecast, do not appear credible. In particular, the Commission services project a deficit that remains above the reference value in 2013 and 2014, and is indeed higher than the 2012 outturn. The lower deficit target in the Stability Programme compared with the Commission services' forecast mainly reflects a higher growth for current taxes that is not credibly justified[6]. For 2014, the Programme projects the deficit to decline further, but provides details only on some specific measures.

On current information, a gradual correction of the excessive deficit in Malta, which would bring the deficit below the 3%-of-GDP reference value and ensure compliance with the debt reduction benchmark in 2014 seems appropriate. This would correspond to intermediate headline deficits of 3.4% of GDP in 2013 and 2.7% of GDP in 2014. The underlying improvement in the structural budget balance implied by these targets is 0.7 pps of GDP in both 2013 and 2014. The fiscal measures needed on top of those already included in the baseline scenario of the Commission 2013 spring forecast are estimated at around 0.4% in 2013 and ¾% of GDP in 2014.

Malta's fiscal framework is quite flexible, and its non-binding nature and the short horizon of fiscal planning are not supportive of a sound fiscal position. It is important to underpin the adjustment path by a more binding and effective multiannual fiscal framework.

[6] According to Article 4.1 of Council Directive 2011/85/EU of 8 November 2011, the macroeconomic and budgetary forecasts by Member States shall be compared with the most updated forecasts of the Commission and, if appropriate, those of other independent bodies. Significant differences between the chosen macrofiscal scenario and the Commission's forecast shall be described with reasoning.