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An assessment of the main fiscal forecasts prepared by the Ministry for Finance and presented in the Draft Budgetary Plan 2015

An independent report prepared for the National Audit Office

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Abbreviations

BO	Budget Office
CION	European Commission
COLA	Cost of Living Adjustment
DBP	Draft Budgetary Plan
EBU	Extra-Budgetary Units
EPD	Economic Policy Department
ESA	European System of Accounts
EU	European Union
EUROPOP	Eurostat’s Population Projections
GDP	Gross Domestic Product
GHRC	Grand Harbour Regeneration Corporation plc
MFIN	Ministry for Finance
NAO	National Audit Office
NSO	National Statistics Office
SFA	Stock-Flow Adjustment
SP	Stability Programme
VAT	Value Added Tax

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

The Ministry for Finance (MFIN) presented its Draft Budgetary Plan (DBP) on 15 October 2015 and this was submitted to the European Commission (CION) and made public, in line with the requirements of Article 4 of Regulation (EU) 473/2013. This Regulation as well as Council Directive 2011/85/EU require that fiscal forecasts are realistic, based on the most up-to-date information and based on independent macroeconomic forecasts. Furthermore, following the adoption of the Fiscal Responsibility Act (2014), the Fiscal Council has been tasked to "endorse, as it considers appropriate, the macroeconomic and fiscal forecasts prepared by the Ministry for Finance and provide an assessment of the official forecasts" (Article 13). This same Article provides that, in the first year after the coming into force of the Fiscal Responsibility Act, until the Fiscal Council is set up, this monitoring and assessment exercise shall be carried out by the National Audit Office (NAO). This report evaluates the fiscal projections included in the DBP to this effect[1] .

The DBP includes fiscal projections for 2014 and 2015. The assessment presented in this report focused on the forecasts for the main revenue and expenditure budgetary components and the projections for the aggregate fiscal indicators of the general government deficit and debt. It involved:

a) an assessment of the methodologies and processes used to generate the fiscal forecasts;
b) a comparison to the fiscal projections included in the most recent Stability Programme (SP) 2014;
c) an evaluation of the projections for the main budgetary components by applying tests of reasonableness in the context of the macroeconomic projections, historical trends and other relevant available information, namely:
    i. 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 recent years, and taking into account the impact of discretionary measures and other relevant information;
    ii. an assessment of the projections for the main expenditure categories on the basis of projected growth rates compared to historical and recent trends, and taking into account the impact of discretionary measures and other relevant information;
    iii. a comparison of the annual fiscal targets for 2014 to the actual outturn available in the context of similar developments in recent years: this analysis was carried out for the main tax revenue categories and those expenditure components where outlays follow a broadly stable pattern over the year, namely compensation of employees, intermediate consumption, social payments and interest payments;
    iv. an assessment of the impact of the main discretionary measures based on the methodology used to estimate the impact of these measures and the information available;
d) an assessment of the macroeconomic risks surrounding the fiscal projections, based on the findings of the report prepared for the NAO in October 2014;
e) a comparison of the projections for the main budgetary components and the aggregate fiscal indicators with the most recent forecasts of the European Commission.

Following the publication of the DBP, the Ministry's fiscal projections for 2014 and 2015 were forwarded to the National Audit Office and subsequently relayed to the authors of this report on 17th October 2014. In order to carry out this exercise, a detailed analysis was carried out of the projections and historical trends for the main revenue and expenditure category, using

[1] The assessment of the macroeconomic forecasts included in the Draft Budgetary Plan 2015 is presented in a separate National Audit Office report: An assessment of the macroeconomic forecasts for the Maltese economy prepared by the Ministry for Finance in September 2014, of 20th October 2014.

disaggregated fiscal data, provided by the Ministry for Finance and the National Statistics Office. During the course of the assessment, other supporting documents related to the key drivers of the main budgetary components were also reviewed. Additional data and information, as well as clarification on issues which arose during the assessment exercise, were requested by means of detailed sets of written queries (via email). Furthermore, the main areas of concern were discussed in meetings held with various officials from the Ministry for Finance, namely officials from the Economic Policy Department (EPD) and the Budget Office (BO), as well as from the National Statistics Office (NSO). The exercise would have been facilitated if disaggregated data for certain revenue and expenditure components had been made immediately available in a comprehensive manner.

This assessment was carried out within a limited timeframe and thus it was not possible to carry out the equivalent of a complete audit of the fiscal projections. Given the time limitations, the assessment focused on the fiscal projections as presented in the DBP, i.e. covering the general government sector and in ESA 2010 terms[2]. The analysis did not cover the Consolidated Fund budgetary projections or the transition from cash fiscal data to general government data in ESA 2010 terms. Furthermore, a detailed analysis of the implications of the transition from ESA 1995 to ESA 2010 methodology was not carried out. It is important to note that this change in methodology constrained the relevance of the comparative analysis with the fiscal projections included in the latest SP. In addition, a comparison with recent fiscal forecasts produced by other institutions could only be made with the European Commission's Autumn 2014 forecasts, since these were the only set of comparable budgetary projections based on the ESA 2010 methodology.

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

This Section presents an assessment of the methodology and process used to generate, revise and finalise the budgetary forecasts. This process is carried out jointly by a number of entities namely the BO, the EPD, the NSO and the Treasury.

As detailed earlier in this report, the budgetary forecasts presented in the DBP are in conformity with the ESA 2010 methodology. During meetings held with the respective entities, it was ascertained that other aspects of the process to formulate the budgetary projections remained significantly similar to that described in another report[3] prepared by the same authors in May 2014 (later referred to as the May 2014 Assessment).

After taking into account the registered performance in revenue items over the first nine months of 2014, the macroeconomic scenario unfolding over the same period and also taking into account seasonal trends, the BO and the EPD confirmed the revenue targets for 2014 (on cash basis and covering only central government) which were underpinning the projections presented in the SP. These revenue targets were subsequently revised to reflect updated status of the budgetary measures announced for 2014. These revenue forecasts were then transposed to ESA 2010 methodology and presented in the DBP.

The process of forecasting revenue items for 2015 was initiated by BO who produced budgetary projections on a cash basis and covering only central government. These projections were derived after taking into account the financial plans provided by the respective departments, past trends, the current year revised estimates and any relevant budget measures. A series of discussions were subsequently held between BO and EPD on these projections in order to ensure that these are

[2] The assessment did not cover the cyclically adjusted and structural deficit.

[3] 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, 5th May 2014

aligned with macroeconomic projections and also taking into account estimates of revenue elasticities observed over past years.

On the expenditure side, projections were estimated on the basis of lengthy discussions between the BO and each line Ministry on the basis of their financial plans. The EPD derived projections for social benefits following discussions with the respective department. It also generated projections for public sector employment and average wage growth which served as a basis for the forecasts for compensation of employees. Expenditure projections were finalised to reflect the overall expenditure targets which are set on the basis of the targets for the fiscal balance and the revenue projections.

The process by which the NSO transposed these expenditure forecasts - prepared by the BO on cash basis and covering only central government - to ESA 2010 methodology remained the same as that described in the May 2014 Assessment. The necessary adjustments to align the forecasts to ESA 2010 methodology were estimated on the basis of a number of underlying assumptions. In particular, it was assumed that the accruals adjustment and the time adjusted cash remain constant. Similarly, the net borrowing/net lending of Extra Budgetary Units (EBUs) were also assumed to remain unchanged over the same period. These assumptions concern items which are relatively volatile thus increasing the risk of significant forecast error.

The methodology used to break down expenditure forecasts in different items according to the ESA 2010 methodology also remained the same over the recent past. Indeed, since the expenditure forecasts are still firstly compiled on a cash basis and later transposed into accrual basis and also since detailed information by vote and project item is lacking, a number of assumptions were still necessary. For example, the capital expenditure was broken down into different items of expenditure by resorting to the use of ratios of the capital expenditure outturn for the preceding three years. This does not imply a risk of forecast error for aggregate expenditure. However, as noted in the May 2014 Assessment, this process may still result in distortions at an expenditure component level in terms of ESA 2010 as also highlighted later on in this report.

The detailed level at which these projections are generated taking into account all available information at departmental level is positively noted. The fact that the preparation of the fiscal forecasts, which includes an inevitable element of expert judgement, is the result of internal discussion between experts from BO and EPD also merits acknowledgement. However, the authors note that the process is characterised by significant fragmentation since firstly forecasts are finalised on a cash basis and only subsequently transposed into ESA 2010 methodology by separate entities. This disaggregation in the process of formulating the projections increases the risk of forecast error. This fragmentation of the process is also leading to the need to take a number of important assumptions on highly volatile items resulting in more uncertainty surrounding the forecasts. A more streamlined process would contribute to achieve a smoother forecasting exercise and reduce the risk associated with the projections.

3. Overview of Fiscal Targets presented in the Draft Budgetary Plan 2015

According to the DBP, the deficit ratio is expected to remain under the 3 per cent reference value in 2014 and 2015. The fiscal targets presented in this Plan show a gradual and consistent improvement of around 0.5 percentage points of the Gross Domestic Product (GDP) per annum, so that the deficit falls to 1.6 per cent of GDP in 2015. One-off and other temporary measures amount to 0.2 per cent of GDP in both 2014 and 2015. These one-off measures consist of proceeds from sale of land, which are projected to increase significantly in 2015, as well as receipts from the Asset Registration Scheme for 2014 only. As regards proceeds from sale of Government property in 2015, the authorities confirmed that they are confident that the relevant transactions yielding this higher revenue will materialise over the forecast period, but further information to assess this budgetary item was not available. Proceeds from the Asset Registration Scheme are considered in Section 5.2. The fiscal adjustment strategy presented in the DBP is revenue-based, with increases in the revenue ratio offsetting a higher expenditure ratio. In 2014, the total revenue ratio is projected to increase by

Table 3.1. Analysis of the Fiscal Adjustment

	2014	2015	2014	2015
	MFIN DBP October 2014		MFIN SP May 2014	
	per cent of GDP			
Fiscal balance	-2.1	-1.6	-2.1	-1.6
One-off and other temporary measures[1]	0.2	0.2	0.2	0.1
	percentage points of GDP			
Adjustment in the deficit ratio	0.6	0.5	0.8	0.5
Change in revenue ratio	1.1	0.9	1.1	0.3
of which:				
Discretionary measures[1]	0.4	0.7	0.3	0.1
Change in expenditure ratio[2]	-0.5	-0.4	-0.3	0.2
of which:				
Discretionary measures[1]	-0.1	0.1	0.0	0.1
Incremental impact of the equity injection in the national airline	0.3	-0.3	0.3	-0.4

[1] A plus sign means a deficit-reducing impact

[2] A minus sign means an increase in the expenditure ratio, with a deficit-increasing impact

Source: Malta Update of the Stability Programme 2014-2017, Ministry for Finance, May 2014; Malta Draft Budgetary Plan 2015, Ministry for Finance, October 2014; Ministry of Finance

1.1 percentage points of GDP, with notable increases expected mainly in taxes on production and imports and the other category of revenue. On the other hand, the revenue from current taxes on income and wealth, social contributions and property income is projected to remain broadly stable as a ratio to GDP. The net impact of discretionary measures on the revenue side is expected to amount to 0.4 per cent of GDP, thus contributing to the increase in the revenue ratio. The expenditure ratio is projected to increase by 0.5 percentage points of GDP, largely reflecting higher outlays on intermediate consumption, subsidies and gross fixed capital formation. On the expenditure side, discretionary measures are deficit-increasing and involve measures affecting social payments, with an estimated impact of 0.1 per cent of GDP. Furthermore, the incremental impact of the equity injection in the national airline has a deficit-reducing impact of 0.3 percentage points of GDP in 2014.

The 2015 fiscal targets follow a broadly similar pattern in the total revenue and expenditure ratios. The targeted improvement in the fiscal balance of 0.5 percentage points of GDP reflects an increase in the total revenue ratio of 0.9 percentage points, which offsets the increase in the total expenditure ratio of 0.4 percentage points. On the revenue side, increases are projected for the ratio of taxes on production and imports, current taxes on income and wealth, market output and other capital transfers and investment grants receivable. The net impact of discretionary revenue measures is estimated at 0.7 per cent of GDP. On the expenditure side, intermediate consumption, subsidies, gross fixed capital formation and capital transfers are projected to increase as a ratio to GDP, whilst declines are targeted in the ratio of compensation of employees, social payments and other current transfers payable. The net impact of discretionary expenditure measures is deficit-reducing (0.1 per cent of GDP). The impact of the equity acquisition in the national airline is deficit-increasing in 2015 and amounts to 0.3 per cent of GDP.

Table 3.2. Discretionary Measures underpinning the fiscal adjustment

Components of Revenue	**2014**	**2015**
	Eur millions	
Main revenue measures	**28.3**	**56.1**
of which:		
Taxes on Production and Imports	21.5	24.2
Current Taxes on Income and Wealth	-8.4	-28.3
Social Contributions	10.2	10.7
Other	5.0	49.5
Main expenditure measures	**19.5**	**-23.3**
of which:		
Compensation of employees	0.0	9.9
Social payments	-5.5	-5.2
Equity acquisition in national airline	25.0	-28.0
Net impact of discretionary measures	**47.8**	**32.9**

Note: The budgetary impact is the incremental impact of measures. A positive sign implies that the budget deficit decreases as a consequence of the measure.

Source: Malta Draft Budgetary Plan 2015, Ministry for Finance, October 2014; Ministry of Finance

4. Differences between the fiscal projections presented in the Draft Budgetary Plan 2015 and those presented in the Update of Stability Programme 2014-2017

The fiscal projections presented in the Draft Budgetary Plan 2015 involve some notable revisions from those presented in the latest SP, including differences in the macroeconomic scenario and some changes to the discretionary measures included in the budgetary forecasts. Furthermore, differences in the fiscal projections also reflect base effects stemming from revisions to historical data up to 2013.

In this regard, it is particularly important to highlight the change in methodology used to produce both the fiscal and macroeconomic projections, from ESA 1995 to ESA 2010[4]. The first transmission of fiscal data using ESA 2010 methodology was made by the NSO on 30 September (News Release 197/2014). The new dataset for national accounts based on the ESA 2010 methodology was published by NSO on 17 October 2014 (News Release 195/2014). This new fiscal and national

[4] The European System of National and Regional Accounts (ESA 2010) is an internationally compatible EU accounting framework for a systematic and detailed description of an economy. The relevant ESA 2010 regulation was published in 2013 (Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the European Union). From September 2014 onwards, the data transmission from EU Member States to Eurostat must follow ESA 2010 rules.

accounts data also includes various other 'benchmarking' revisions which are not specifically related to the change in methodology. The DBP incorporates the new revised national accounts and fiscal

Table 4.1. Comparison of Fiscal Projections
Draft Budgetary Plan October 2014 - Stability Programme May 2014

	2013	2014	2015	2013	2014	2015
	Actual	MFIN DBP October 2014		MFIN SP May 2014		
			per cent of GDP			
General government balance	-2.7	-2.1	-1.6	-2.8	-2.1	-1.6
General government debt	69.8	70.1	69.0	73.0	69.5	68.5
			Eur millions			
Taxes on production and imports	978.5	1,083.5	1,157.1	967.7	1,058.9	1,108.9
Current taxes on income and wealth	1,043.3	1,085.6	1,155.8	1,043.3	1,071.8	1,132.3
Capital taxes	12.7	12.2	12.2	12.7	15.3	15.7
Social contributions	524.8	557.4	582.3	524.8	559.4	586.4
Other revenue	432.2	491.8	551.5	402.0	466.8	496.3
Total revenue	2,991.6	3,230.5	3,458.8	2,950.5	3,172.2	3,339.6
Compensation of employees	977.8	1,014.2	1,049.3	970.9	993.9	1,022.8
Intermediate consumption	462.7	505.0	547.8	454.0	490.2	509.9
Social payments	969.2	1,009.3	1,034.4	972.6	1,016.4	1,069.4
Interest expenditure	220.2	220.6	229.3	217.2	222.5	227.8
Subsidies	80.3	114.1	131.2	79.5	113.4	97.8
Gross fixed capital formation	208.8	261.7	285.9	195.6	242.7	247.8
Other expenditure	274.6	268.1	310.8	263.7	248.1	287.1
Total expenditure	3,193.5	3,393.0	3,588.7	3,153.5	3,327.2	3,462.6
General government balance	-202.0	-162.5	-130.0	-203.0	-155.0	-123.0

Source: Malta Update of the Stability Programme 2014-2017, Ministry for Finance, May 2014; Malta Draft Budgetary Plan 2015, Ministry for Finance, October 2014; Ministry of Finance; National Statistics Office News Release 197/2014

data up to 2013 based on the ESA 2010 methodology and both the macroeconomic and fiscal projections are based on this new methodology.

Given these revisions, the fiscal and macroeconomic data and projections presented in the DBP are not directly comparable to the data and forecasts presented in the SP of May 2014. Thus, this Section does not aim to present a detailed comparative assessment of the two sets of fiscal projections, but rather a general overview of the main differences in the contributors to the fiscal adjustment and of the differences in the major revenue and expenditure components. The comparison of the main revenue and expenditure categories was made in absolute terms, since the considerable magnitude of the revisions to the nominal GDP level had a notable impact when the ratio of the different expenditure and revenue components to GDP was computed.

The targets for the general government budget balance as a ratio to GDP presented in the DBP have remained unchanged from those presented in the latest SP. However, the composition of the fiscal adjustment differs markedly. The marginal revision in the absolute level of the deficit in both 2014 and 2015 reflects offsetting larger revisions in total revenue and expenditure.

As in the latest SP, the fiscal adjustment in 2014 is revenue-based, as the projected increase in the revenue ratio is expected to more than offset the increase in the expenditure ratio. The increase in the revenue ratio has remained unchanged at 1.1 percentage points of GDP. In absolute terms, higher revenue is expected from taxes on production and imports, current taxes on income and wealth and the other category of revenue. These revisions were affected by the inclusion in the DBP of the impact of the asset registration scheme (a one-off measure)[5]. As a result, discretionary revenue measures are expected at 0.4 per cent of GDP, compared to 0.3 per cent in the latest SP. The expected increase in the total expenditure ratio has been revised up from 0.3 to 0.5 percentage points of GDP. In absolute terms, higher outlays are mainly expected on compensation of employees, intermediate consumption, gross fixed capital formation and other current transfers payable. On the other hand, outlays on social payments were revised downwards. The net impact of the discretionary expenditure measures has been revised from a neutral impact in the SP to a deficit-increasing effect of 0.1 per cent of GDP in the DBP, as the measure aiming to restrict recruitment in the public sector which was included in the SP is not incorporated in the DBP.

For 2015, whilst the fiscal adjustment strategy presented in the latest SP showed a rather balanced consolidation from both the revenue and expenditure side, the fiscal adjustment presented in the DBP is entirely revenue-based. In the latest SP, the total revenue ratio was projected to increase by 0.3 percentage points whilst the total expenditure ratio was expected to decline by 0.2 percentage points of GDP. On the other hand, the fiscal projections in the DBP show a larger increase in the total revenue ratio, amounting to 0.9 percentage points of GDP, which offsets the projected increase of 0.4 percentage points in the total expenditure ratio. On the revenue side, in absolute terms, a higher intake is expected from taxes on production and imports, current taxes on income and wealth and the other category of revenue. The net deficit-reducing impact of discretionary revenue measures is considerably larger in the DBP (0.7 per cent of GDP, compared to 0.1 per cent of GDP in the latest SP). The DBP includes additional discretionary measures affecting indirect taxes, the income tax base and a significantly higher impact in terms of revenue from the International Investor Programme. On the other hand, there is a base effect from the one-off revenue under the Asset Registration Scheme. On the expenditure side, higher outlays are mainly expected for compensation of employees, intermediate consumption, subsidies, gross fixed capital formation and other current transfers payable. On the other hand, there was a considerable downward revision in the projected outlays on social payments. The expenditure discretionary measures have remained the same, though the impact of the measure relating to compensation of employees is expected to be lower, so that the net deficit-reducing impact of discretionary measures has been marginally revised from 0.08 to 0.06 per cent of GDP.

The targeted debt ratio for 2014 has remained broadly unchanged at around 70 per cent, as the impact of the higher projected level of GDP was offset by an upward revision in the general government debt level. As discussed later on in this report, this reflects different assumptions related to cash balances by Government. A higher level of debt for 2015 is projected in the DBP, largely reflecting the base effect from the revision in the 2014 debt level. The impact of this change has only been partly offset by a higher projected level of GDP so that the debt ratio has been revised from 68.5 per cent to 69 per cent.

5. Assessment of risks to the budgetary projections

This Section first analyses the macroeconomic risk surrounding the fiscal projections. Subsequently, the risks surrounding the forecasts for each revenue and expenditure component is assessed, including an evaluation of the uncertainty surrounding the impact of the discretionary measures, where relevant. This Section concludes with an assessment of the specific risks surrounding the debt projections.

[5] This measure had been announced in the Budget for 2014 but its expected revenue had not been included in the fiscal projections presented in the Stability Programme of May 2014.

5.1. Macroeconomic risk

An important assumption underlying any fiscal projections concerns the macroeconomic scenario on which they are based. Thus, uncertainty surrounding the economic growth forecasts would also have a bearing on the risks relating to the attainment of the fiscal targets.

Following overall positive economic results registered in 2013, a further improvement in the macroeconomic scenario is projected in the DBP. Real GDP growth is projected to pick up further, from 2.5 per cent in 2013, to 3.0 per cent in 2014, to accelerate even further to 3.5 per cent in 2015. In nominal terms, GDP rose by 4.6 per cent in 2013, and is projected to increase by 5.1 per cent in 2014, and to slow down to a marginally lower growth rate of 4.8 per cent in 2015.

Table 5.1 . Macroeconomic Projections

	2013	2014	2015
	Actual	MFIN October 2014	
	percentage change		
At Constant (2000) prices			
Private final consumption expenditure	1.7	2.1	2.1
General government final consumption expenditure	0.5	6.0	2.5
Gross fixed capital formation	2.2	14.3	4.8
Exports of goods and services	-1.6	0.7	5.9
Imports of goods and services	-1.7	1.9	5.5
Real GDP	**2.5**	**3.0**	**3.5**
At Current Prices			
Private final consumption expenditure	2.8	2.7	4.3
General government final consumption expenditure	3.0	7.7	5.7
Gross fixed capital formation	4.3	14.4	3.6
Exports of goods and services	-1.3	0.1	4.9
Imports of goods and services	-1.8	0.3	4.7
Nominal GDP	**4.6**	**5.1**	**4.8**
Employment	**2.4**	**2.1**	**1.9**

Source: An Assessment of the macroeconomic forecasts for the Maltese economy prepared by the Ministry for Finance in September 2014, National Audit Office

As in 2013, domestic demand is expected to be the main contributor to economic growth during the forecast period. In particular, private final consumption expenditure is projected to increase by 2.1 per cent in both 2014 and 2015, which is somewhat higher than the growth of 1.7 per cent registered in 2013. This reflects relatively strong growth in employment and in compensation per employee over the forecast period. In nominal terms, growth in private final consumption expenditure is forecasted at 2.7 per cent in 2014, which is broadly in line with the nominal growth registered in the previous year, and at a higher 4.3 per cent in 2015, as consumer prices are projected to pick up from the low inflationary environment of the previous year. In 2014, domestic demand is also expected to be driven by relatively strong increases in general government final consumption expenditure and gross fixed capital formation, of 6.0 per cent and 14.3 per cent, respectively. The robust growth in gross fixed capital formation mainly reflects a large-scale project in the energy sector. In 2015, these two components of domestic demand are projected to continue to grow, but at a relatively more moderate pace. Government consumption expenditure is projected to increase by 2.5 per cent in 2015, whilst gross fixed capital formation is forecasted to rise by 4.8 per cent, being supported by additional investment undertaken in the energy sector. In nominal terms, government consumption expenditure is forecasted to increase by 7.7 per cent in 2014 and by 5.7 per cent in 2015. Nominal growth in gross investment is projected at 14.4 per cent and 3.6 per cent in 2014 and 2015, respectively.

The external sector is expected to contribute negatively to real economic growth in 2014, thus partly offsetting the strong domestic contribution, whilst in 2015, the contribution of net exports is projected to be positive, but small. Following a contraction in both exports and imports during 2013, an improvement is expected over the forecast period. During 2014, exports are projected to grow marginally, reflecting the subdued economic recovery in Malta's main trading partners and a weaker exchange rate. In 2015, export growth is forecasted to gain significant momentum, reaching 5.9 per cent in real terms, largely on the back of the expected significant depreciation of the euro against the US dollar. In nominal terms, exports are forecasted to increase by 4.9 per cent in 2015, from 0.1 per cent in 2014. A similar trajectory is projected for imports. Following negative growth in 2013, imports in real terms are forecasted to increase by a moderate 1.9 per cent in 2014 and by a relatively strong growth rate of 5.5 per cent in 2015. Growth in imports is largely driven by the expected strong growth in private consumption over the forecast period, as well as the expected developments in investment, particularly in 2014, and the higher export activity projected in 2015. In nominal terms, imports are projected to increase by a marginal 0.3 per cent in 2014 and to pick up to 4.7 per cent in 2015.

Employment growth is projected to remain positive and relatively robust during the forecast period, at around 2 per cent, though this is slightly lower than the rate of job creation registered in 2013. According to the DBP (2014, p.9), these positive employment prospects reflect the expected robust growth in economic activity across a number of sectors, as well as Government's efforts to increase female participation in the labour market and increased employment flexibility. The unemployment rate is projected to decline from 6.4 per cent in 2013 to 6.0 per cent in 2014 and to register a further marginal decline to 5.9 per cent in 2015.

The macroeconomic forecasts presented in the DBP have been reviewed in the report: "An assessment of the macroeconomic forecasts for the Maltese economy prepared by the Ministry for Finance in September 2014" (NAO, 2014). This report noted the exceptional circumstances under which these macroeconomic forecasts were prepared, in view of the revision exercise carried out by the NSO. Whilst recognising the efforts undertaken by the agencies involved in the forecasting exercise to ensure a smooth transition to the new system, and in particular by the EPD to incorporate the new methodology data within the existing forecasting framework, nevertheless, the report notes "the need for further improvements in the overall planning and co-operation channels between the various institutions involved in the forecast preparation exercise" (NAO, 2014, p.14). On the other hand, on a positive note, the report commended the structured process to internalise into the macroeconomic forecast all ad-hoc information available from different sources as well as the use of assumptions adopted by international reputable organisations as a basis for the exogenous assumptions used in the forecasting exercising.

The report concluded that "in view of the latest available information, the realisation of the overall GDP growth rates for 2014 and 2015 may indeed be feasible, although subject to a number of risks" (NAO, 2014, p.14). In particular, the report identified risks linked to the expected trajectory in the components of gross fixed capital formation and general government consumption expenditure, as well as developments in the various expenditure component deflators. Gross investment is not considered to be a major tax-rich component of GDP and thus, this identified risk is not expected to add significantly to uncertainty to the fiscal forecasts. On the other hand, the risks linked to the expected developments in the various expenditure component deflators result in higher uncertainty surrounding the projected nominal growth for various tax bases, thus constituting some risk to the attainment of the fiscal targets. Uncertainty surrounding the various general government expenditure components is discussed in more detail in Section 5.3 of this report.

5.2. Assessment of revenue projections

This Section provides an assessment of the revenue forecasts presented in the DBP aiming to comprehend the risks associated with the realization of these forecast estimates. Such assessment was, in many instances, based on tests of reasonableness and probability of the expected outcome.

Total revenue is projected to rise by 1.1 percentage points of GDP in 2014, to reach 40.9 per cent of GDP, followed by a similar increase of 0.9 percentage points to 41.8 per cent of GDP in 2015. In 2014, the ratio of taxes on production and imports is expected to increase whilst the ratio for current taxes on income and wealth is projected to remain relatively stable. Meanwhile, in 2015 both these ratios are forecasted to increase, though at a modest pace. The 'other' category of revenue is also expected to contribute to the increase in the ratio for total revenue for 2014 and 2015. No significant changes are projected in the other categories of revenue.

Table 5.2. Main Components of Revenue

	2013	2014	2015
		per cent of GDP	
General Government Balance	-2.7	-2.1	-1.6
Total Revenue	39.8	40.9	41.8
of which			
Taxes on production and imports	13.0	13.7	14.0
Current taxes on income and wealth	13.9	13.8	14.0
Capital taxes	0.2	0.2	0.1
Social contributions	7.0	7.1	7.0
Property Income	1.3	1.2	1.2
Other revenue	4.4	5.0	5.5

Source: Malta Draft Budgetary Plan 2015, Ministry for Finance, October 2014; NSO Release 198/2014

As noted earlier, the budgetary projections hinge upon the materialization of the forecasted macroeconomic scenario. Indeed, the economic outturn and its drivers exert a direct influence on the fiscal forecasts. Conventionally, over the years, the tax revenue is expected to maintain a constant relationship with its respective tax base, which is very often a component of GDP. Thus, in order to assess the risks associated with the achievement of the revenue targets an examination was carried out of the implied elasticity – the relationship between the forecasted revenue and the forecasted tax base – in context of the elasticity recorded in previous years. This analysis could only be carried out for broad categories of tax revenue since more detailed information for each sub-component was not made available at the time of writing this report.

Moreover, the attainment of the revenue projections for 2015 also depends on the proceeds from discretionary measures. Indeed, the estimated net impact of the measures on the revenue side of the budget is expected to contribute towards a quarter of the projected absolute increase in total revenue for 2015. Whilst the measures for 2014 are already in force, the impact of the budgetary measures expected to be adopted in 2015 and included in the fiscal forecasts presented in the DBP are subject to their respective announcement in the forthcoming budget. Moreover, the realization of the expected proceeds from the budgetary measures also depends on effective and efficient implementation which may otherwise lead to a shortfall in revenue and slippage of the fiscal targets.

In 2015, discretionary revenue-increasing measures mainly relating to taxes on production and imports and to social contributions (reflecting the effect of the 2006 pension reform) are expected to more than offset the lower revenue emanating from current taxes on income and wealth – which reflects the widening of the income tax rate – and the base effect from revenue received in 2014 under the Asset Registration Scheme. Moreover, a substantial increase in revenue is also expected from the International Investor Programme.

Taxes on production and imports

According to the DBP, taxes on production and imports are projected to increase from 13.0 per cent of GDP in 2013 to 13.7 per cent in 2014 and further to 14.0 per cent in 2015. Excluding the impact of the budgetary measures, the growth in the estimated revenue for 2014 is projected to significantly exceed the expected increase in the tax base (assumed to be private final consumption expenditure). This is accentuated by the fact that this implied elasticity for 2014 is somewhat higher than that recorded in the past years. Nevertheless, such downside risk may be contained given that revenue collected over the first two quarters of 2014 from taxes on production and imports constitutes a similar share of the estimate for the whole year when compared to the performance of this item of revenue in previous years. This is further confirmed from cash based data for Value Added Tax (VAT), which is the main component of taxes on production and imports, covering the first nine months of 2014, which indicates that revenue collection for this sub-item of revenue is on track.

It is also pertinent to note that forecasted revenue related to excise taxes (also included in taxes on production and imports) for 2014 recorded on cash basis is highly influenced by the repayment of accumulated arrears by Enemalta which are expected to take place towards the end of 2014. Nevertheless, when this sub-component of taxes on production and imports is recorded according to ESA 2010 methodology and therefore on accrual basis, this settlement of arrears does not impact this item of revenue for 2014. Therefore, the risk that this repayment of excise taxes does not materialize does not constitute a downside risk on the realisation of the forecast for taxes on production and imports.

For 2015, if one were to exclude the discretionary measures, the increase in this category of tax revenue is projected to closely reflect developments in the related component of GDP. Moreover, the implied elasticity for this item of revenue for 2015 is in line with the historical average. Nevertheless, it is noteworthy that any shortfall in revenues that might materialize in 2014 may impact negatively on the attainment of the target for 2015.

The ratio of taxes on production and imports is estimated to be positively affected by budgetary measures in 2014 and 2015. Indeed, according to the DBP, the impact of the measures announced in the Budget for 2014 mainly consisting of revisions in the excise duty on cigarettes and tobacco, fuel, cement, alcohol and beer and revisions in the tax rate on fuel bunkering, are estimated at 0.3 per cent of GDP in 2014. It is pertinent to note that, this budgetary impact is unchanged from that presented in the SP and therefore one can refer to the respective analysis carried out in the May 2014 Assessment (p.16) whereby the same authors reported that the estimated impacts were prudent.

According to the DBP, a number of permanent discretionary measures related to indirect taxation will be adopted in 2015, exerting an increase in revenue of 0.3 per cent of GDP. Details of these measures were not included in the DBP. However, the Ministry for Finance provided information on the planned measures to the authors in order to conduct a thorough assessment of their respective estimate. Indeed, on the whole, rough calculations based on the data available indicate that the estimated impact of these measures seem plausible. Assuming that the measures are effectively implemented as planned, there are no grounds indicating particular downside risks.

Current taxes on income and wealth

The ratio of current taxes on income and wealth is expected to decline marginally to 13.8 per cent of GDP in 2014 and increase by 0.2 percentage points to 14.0 per cent of GDP in 2015. If one were to exclude the impact of the discretionary measures, the growth in this category of revenue is projected to be lower than the expected development in GDP in 2014 but significantly higher in 2015. Nevertheless, this implied elasticity for 2015 is in line with the historical average whilst that for 2014 indicates some element of prudence in the forecast for this tax item.

On an accrual basis, during the first two quarters of 2014, the revenue collected from current taxes on income and wealth constitutes a similar share of the annual forecasted target compared to the share collected over the same period in previous years. Similarly, the latest data available for income tax, measured on cash basis, indicates that over the first nine months of 2014, actual revenue collected as a proportion of the revenue targeted for the whole year is in line with that in previous years.

The budgetary measures related to current taxes on income and wealth are estimated to have a negative impact of 0.1 per cent of GDP in 2014 and 0.4 per cent of GDP in 2015. These measures mainly consist of the widening of income tax brackets and the asset registration scheme.

According to the DBP, the widening of the income tax rates is estimated to have a negative impact of 0.2 per cent of GDP in 2014. An additional impact of 0.3 per cent of GDP in 2015 is estimated as the tax rates are reduced further by 4.0 percentage points (from 29 per cent to 25 per cent). The estimate of the fiscal impact of widening of the income tax rates included in the forecasting exercise carried out earlier this year and presented in the SP was not revised and/or updated. This implies that the assessment of the impact of this measure presented by the same authors in the May 2014 Assessment (p.17) – that is, the possibility of some underestimation of the impact in 2014 and a degree of prudence in the impact for 2015 – remains.

The forecasts presented in the DBP also take into account the impact of the Asset Registration Scheme which is estimated to reach 0.1 per cent of GDP in 2014 with a corresponding negative impact in 2015. The authorities specified that this estimate was based on past performance of similar schemes and on revenue received up till September. No further information was made available to verify the impact of this scheme.

Social contributions

Social contributions are expected to hover around 7.0 per cent of GDP in 2014 and 2015. Excluding the impact of the budgetary measures, the growth in the estimated revenue is projected to closely reflect developments in GDP in 2014 and 2015. Moreover, this implied elasticity is in line with the average for the past years. Both the actual data on cash basis covering the first three quarters of 2014 as well as the data on accrual basis covering the first six months of 2014 indicate that revenue collection related to this item is following the pace registered in previous years and therefore the annual fiscal target seems attainable.

The changes in the social security system emanating from the reform law of 2006 are expected to have an annual impact of slightly more than 0.1 per cent of GDP in 2014 and 2015. This impact remains unchanged from that estimated by the authorities in the SP. As in the May 2014 Assessment, based on the information available no particular risks were associated with the estimate of this budgetary impact.

'Other' components of revenue

According to the DBP, the 'Other' category of revenue is expected to increase from 4.4 per cent to 5.0 per cent in 2014 and further to 5.5 per cent in 2015. The main items of revenue under this category are capital transfers and market output. The ratio of capital transfers is expected to increase by 0.7 percentage points of GDP in 2014 and 0.2 percentage points of GDP in 2015. Expected developments in this item of revenue mainly constitute changes in the inflows of funds from the European Union (EU) which are correspondingly reflected on the expenditure side of the budget and therefore exert minimal impact on the fiscal balance.

Market output is projected to remain relatively stable at 2.2 per cent of GDP in 2014. Subsequently, in 2015, market output is expected to increase to 2.6 per cent on account of the expected impact of the International Investor Programme whereby Maltese citizenship is granted to foreign individuals and families. Indeed, according to the DBP, this Programme is estimated to have a positive impact of 0.5 per cent of GDP in 2015. Limited information was made available for a thorough assessment of the estimate of the impact of this Programme. Nevertheless, the authorities ascertained that this estimate is based on reliable information available on the applications submitted so far. It is also noteworthy, however, that since the impact of this Programme depends on the number of applications that are examined and approved an element of uncertainty still prevails. This is accentuated by the magnitude of this measure which accounts for around one-fifth of the total projected increase in revenue.

The fiscal forecasts presented in the DBP exclude any proceeds that may emanate from the revision in the tax rate on rental income announced in the Budget for 2014 in view of the degree of uncertainty that surrounds the housing market. This element of prudence maintained by the authorities with respect to this fiscal measure provides an element of upside risk.

5.3. Assessment of expenditure projections

The DBP projects total expenditure to increase from 42.5 per cent of GDP in 2013 to 43.0 per cent in 2014 and to rise again to 43.4 per cent in 2015. This upward trend in the total expenditure ratio mainly reflects higher ratios of intermediate consumption, subsidies and gross fixed capital formation. Capital transfers are projected to fall marginally in 2014 and then increase in 2015, largely reflecting the incremental impact of the equity injections in the national airline. On the other hand, compensation of employees and social payments are projected to decline as a ratio to GDP over the forecast period, whilst the ratio of interest expenditure and the 'other' category of expenditure are projected to remain broadly stable between 2013 and 2015.

Discretionary expenditure measures (excluding the impact of the equity injections in Airmalta plc) amount to 0.1 per cent of GDP in both 2014 and 2015, but have a net deficit-increasing impact in the first year of the forecast period and a net deficit-reducing impact in the subsequent year. Both in 2014 and 2015, discretionary expenditure measures result in higher outlays on social payments, but in 2015, this impact is more than offset by the deficit-reducing measure aiming to contain the government's wage bill. The expenditure ratio is significantly affected by the incremental impact of the equity injections in Airmalta plc, which has a deficit-reducing impact of 0.3 per cent of GDP in 2014 but a deficit-increasing effect of 0.3 per cent of GDP in 2015.

The authorities provided details on a comprehensive spending review forming part of government's efforts towards further fiscal discipline. The aim of this review is to establish the relevance of the government's financial allocations in its annual budget and relocating existing expenditures to address priorities and other needs by using current financial resources. Each Ministry is assisted to identify cost savings through the elimination of waste and other inefficiencies. In this regard, as a first step an in-depth review was carried out in the area of social security. In view of the fact that

Table 5.3. Main Components of Expenditure

	2013	2014	2015
		per cent of GDP	
Total expenditure	**42.5**	**43.0**	**43.4**
of which:			
Compensation of employees	13.0	12.8	12.7
Intermediate consumption	6.2	6.4	6.6
Social payments	12.9	12.8	12.5
Interest expenditure	2.9	2.8	2.8
Subsidies	1.1	1.4	1.6
Gross fixed capital formation	2.8	3.3	3.5
Capital transfers	1.2	1.0	1.5
Other	2.4	2.4	2.3

Source: Malta Draft Budgetary Plan 2015, Ministry for Finance, October 2014; Ministry of Finance

expenditure savings are highly dependent on the tangible outcomes emanating as this review unfolds, the authorities exercised an element of prudence and stopped short of including an estimate of these expenditure savings in the fiscal forecasts leading to a possible upside risk to the expenditure targets.

Compensation of employees

Compensation of employees is projected to decline by 0.2 percentage points of GDP in 2014 and by a further 0.1 percentage points of GDP in 2015. The DBP does not include any discretionary measures impacting on the wage bill for 2014, implying that the discretionary measure aiming to control recruitment (amounting to 0.1 per cent of GDP), which was included in the most recent SP, has not been implemented. On the other hand, the target for 2015 includes the impact of a deficit-reducing discretionary measure, amounting to 0.12 per cent of GDP, aimed to contain the government wage bill. Authorities explained that this measure comprises two components: the first component entails that resignations and retirements overall will be replaced by new employees on a ratio of 2:3; whilst the second component involves containment of outlays on non-wage components, namely by keeping outlays on overtime and allowances unchanged in 2015 at the 2014 level[6]. The authorities highlighted that as in past years, further control on the government wage bill will be exercised through the yearly or 'ad hoc' capacity building meetings and exchanges which are held as necessary between the line ministries and the Ministry for Finance. Such meetings or exchanges normally determine the setting of headcount or dedicated budget limits within which recruitment is to be contained.

The projections for compensation of employees are based on projections for targeted personal emoluments made by the BO using micro data at a departmental level. A consistency check was carried out using an alternative projection computed independently by the EPD. The latter is derived at an aggregate level, on the basis of assumptions for the average wage growth and the level of

[6] Compared to growth rates of 5 per cent and 3 per cent for allowances and overtime per capita, respectively, in the no policy change scenario.

general government employment. The assumption for average wage growth is based on the latest public service collective agreement which covers from 2011 to 2016, and other sectoral agreements for employees within the general government sector. The undertaking of such robustness checks for an important expenditure component, such as the wage bill, is acknowledged as a good practice.

The compensation of employees targets for 2014 and 2015 imply projected growth rates which are lower than the historical average (adjusted for the effect of the reclassification of Malta Shipyards in the general government sector in 2008[7]). This contrasts with the relatively strong increase in compensation of employees registered in 2013 and during the first half of 2014, despite the containment on recruitment which had been envisaged in the latest SP. These targets are based on an assumed increase of around 1,000 employees in 2014 but a decrease of around 480 employees in 2015. In both years, retirements and resignations from general government employment are assumed to be close to the average registered in recent years. Gross new recruitment is assumed to be around 2,500 in 2014, which is broadly comparable to the increase recorded in the previous year. But for 2015 gross new recruitment is projected to be only around 950. This amounts to around one-half of the average gross new recruitment registered during 2008-2013 and it remains notably lower even when the two years with the highest increases (2008 and 2013) are excluded from this average.

Another important assumption affecting the projections for compensation of employees concerns the average wage growth, and thus the assessment of the forecasts for this category of expenditure also involved a comparison of the implied average wage growth[8] to recent historical averages and to the estimated impact of the public service collective agreement (and other collective agreements affecting employees within the general government sector). This comparison suggests that the assumed average wage growth may be underestimated in 2014.

Furthermore, the plausibility of the forecast for 2014 was also assessed by comparing the annual target for the wage bill and for general government employment to the actual developments over the first half of the year. A strong increase in the wage bill was registered during the first half of 2014. As expected, the outlays on compensation of employees tend to be quite stable over the year and indeed over the past years, the average wage bill in the first six months has been very close to 50 per cent of the annual expenditure. On the other hand, the ratio of the actual outlays on compensation of employees for the first half of 2014 to the annual target is somewhat higher, and the implied outlay in the last two quarters of 2014 is slightly lower than the comparable outlay in the second half of the previous year. Furthermore, it is noted that the assumption of an increase of around 1,000 employees for 2014 largely reflects the actual outturn up to the first quarter of 2014 (being the latest available data for general government employment), an assumed similar increase in the second quarter and an unchanged employment level in the third and fourth quarters. The authorities pointed out that in the remaining months of 2014, recruitment will only be approved in exceptional circumstances and line ministries and departments will be enjoined to exercise further control intended towards containment of overtime and allowance levels, within the approved budgets.

Whilst we recognise the resolve of the authorities to contain the government wage bill, we consider that overall, there are downside risks attached to the targeted projections for compensation of employees in both 2014 and 2015. The target for 2014 seems ambitious in view of the strong growth in compensation of employees registered during the first two quarters, and the assumption of unchanged employment levels in the second half of the year. Furthermore, the implied average wage growth for 2014 may also be underestimated. For 2015, the main risk concerns the assumption

[7] This had an effect amounting to €75.8 million, of which €40.3 million consisted of outlays regarding employment termination schemes.

[8] Derived from the total compensation of employees and the targeted general government employment

of a decline of around 480 employees in the general government sector which is highly challenging in view of the general trends in recent years.

Intermediate consumption

Intermediate consumption as a share of GDP is projected to increase by 0.2 percentage points per annum in both 2014 and 2015. No discretionary measures impacting on this category of expenditure are foreseen in the DBP. The projected nominal increases in this component of expenditure are higher than the historical average (excluding the impact of the reclassification of Malta Shipyards within the general government sector in 2008). However these increases mainly reflect the projected growth in capital expenditure classified under intermediate consumption. This is due to the methodology used to compile the expenditure component levels in ESA 2010 terms from Consolidated Fund data, which, as explained in Section 2, can result in some distortions at an expenditure component level. The actual outlays on intermediate consumption incurred during the first two quarters of 2014 are quite close to the average ratio for recent years (being just below half the projected annual expenditure). Thus, based on the available information, particular downside risks concerning intermediate consumption were not identified.

Social payments

Outlays on social payments are projected at 12.8 per cent of GDP in 2014 and at 12.5 per cent of GDP in 2015. The net incremental impact of the discretionary measures affecting this category of expenditure is deficit-increasing (0.07 per cent of GDP in 2014 and 0.06 per cent in 2015). The marginal deficit-reducing impact (0.01 per cent of GDP) of the 2006 pension reform (which results in lower pension expenditure mainly as the increase in the retirement age leads to a lower number of retirees[9]) is more than offset by higher outlays due to the introduction of a supplementary children's allowance as from September 2014 and by higher expenditure on assistance to elderly (in 2014 only).

The estimate of the impact of the 2006 pension reform has not been revised or updated from that included in the latest SP. Thus, as in the May 2014 Assessment, there is the possibility that cost savings from this measure may be underestimated, however, are unlikely to have a substantial impact on the overall fiscal balance.

As regards the estimate of the impact of the supplementary children's allowance, this has been computed by the Ministry for the Family and Social Solidarity. The number of assumed beneficiaries seems reasonable in the context of data on households with dependent children who are at risk of poverty. No explanation was provided on how the impact of the measure involving higher assistance to elderly was estimated.

Whilst no information was provided on the computation of the social benefits projections for 2014, the authorities explained that the EPD has generated projections for expenditure on social security benefits for 2015 which served as a basis for the projections featuring in the DBP. The authorities provided detailed information, in the form of a Technical Note, on the methodology and assumptions used to derive the number of beneficiaries (based on Eurostat's population projection EUROPOP2013) and the average benefit rates underpinning these EPD forecasts. Such documentation is recognised as a good practice, to be replicated for other budgetary projections.

Whilst we consider that this methodology is sound, with projections being generated at a detailed level and being based on plausible assumptions, using the most recent 'external' demographic projections (EUROPOP2013), there are important caveats which need to be highlighted. Firstly this

[9] The impact of this measure is marginal in 2014 and 2015 as the first increase in the exit age (from 61 to 62 years) took place in 2013, whilst the next increase (to 63 years) will take place in 2018.

projection exercise involves Consolidated Fund data, which then has to be translated into ESA 2010 data by the NSO, as explained in Section 2 of this Report. Furthermore, the projections featuring in the DBP include subsequent fine-tuning to take into account recent developments in actual outlays on the different social benefits and thus there are discrepancies with the EPD Technical note. Moreover, the analysis of the projections by different type of social benefits could only be made using Consolidated Fund data, since a comparable breakdown in ESA 2010 terms was not available. The fragmentation in the fiscal forecasting exercise, highlighted in Section 2 of this Report, has been very evident in the process leading to the projections for social benefits and has resulted in disjointed projections by the different entities involved, constraining significantly our assessment of these forecasts.

The DBP projects social payments to decline to 12.5 per cent of GDP in 2015, compared to a broadly stable ratio of around 13 per cent between 2010 and 2014. In absolute terms, in 2014, social payments are projected to grow at a rate which is comparable to the average growth rate in recent years (2010-2013). As in past years, the ratio of outlays on social payments for the first two quarters of 2014 to the projected annual expenditure is very close to 50 per cent, which indicates that the annual target is feasible. However, an analysis of the two main components included under social payments revealed very different projected increases. In 2014, social transfers in kind are projected to increase markedly by around 30 per cent, whilst a more modest growth of around 4 per cent is projected for 2015. The authorities explained that the high growth rate in 2014 is due to the use of ratios to classify expenditure on medicines and surgical materials into social transfers in kind and intermediate consumption. On the other hand, the other component of social payments (which accounts for around 95 per cent of the total) is projected to grow by around 3 per cent and 2.5 per cent in 2014 and 2015, respectively, which are lower than the historical average.

Based on an analysis of developments for the main types of social security benefits included under this component of social payments (using Consolidated Fund data), the main contributors to this relatively modest growth rate are retirement pensions, the contributory bonus (only in 2015) and children's allowance. However, the projected developments in retirement pensions reflect the relatively low cost of living adjustment (COLA) in 2015 compared to previous years, as the rate of retirement pensions is adjusted annually with COLA. On the other hand, for 2014, the targeted increase in outlays for retirement pensions may be conservative, compared to recent trends. The contributory bonus comprises the six monthly bonus and the special weekly bonus, which involve lump-sum payments, as well as the cost of living bonus. The latter was introduced following the budget 2008 measure whereby pensioners started to receive the full amount of COLA, one-third of which is paid through a bonus at the start of each year. Thus, the projected small increase in outlays on the contributory bonus for 2015 compared to previous years is explained by the relatively low COLA. Outlays on children's allowance are projected to remain broadly stable over the forecast period. Based on demographic developments and the way in which the children's allowance is computed[10], this could well be a feasible trajectory for this particular social benefit.

The assessment of the plausibility of the projections for 2014 was constrained by a lack of information. However, as highlighted above possible downside risks cannot be ruled out which may spill over into 2015. Thus the attainment of the targeted outlays for social payments is subject to some element of uncertainty.

[10] For households with income exceeding €24,439, children's allowance is paid at a fixed rate per child. For households with income below this threshold, the allowance is calculated as a percentage of the difference between the declared household income and this threshold.

Interest expenditure

Interest expenditure is projected to remain broadly stable at around 2.8 per cent of GDP during the forecast period. Risks relating to this component of expenditure relate to the overall risks to the attainment of the deficit and debt targets (which are discussed separately elsewhere in the report) as well as uncertainty regarding the future cost of borrowing.

The implicit interest rate on debt[11] has followed a downward trend in recent years and is projected to continue to decline from 4.5 per cent in 2013 to 4.1 per cent in 2015. These developments are consistent with the recent low interest rate environment and the projections for further declines in the interest rates used to generate the macroeconomic forecasts included in the DBP (Ministry for Finance, 2014, p.11).

The actual expenditure on interest payments incurred during the first half of 2014 amounts to slightly above 50 per cent of the forecast for the whole year which is similar to the ratio in previous years. Thus, overall, no major risks concerning the 2014 and 2015 projections for interest expenditure are identified.

Subsidies

Subsidies are expected to increase from 1.1 per cent of GDP in 2013 to 1.4 per cent in 2014 and to rise by a further 0.2 percentage points of GDP in 2015. Outlays on subsidies tend to be quite volatile and are highly dependent on specific government policies, such as decisions on public service obligations and restructuring of government-owned enterprises. Thus, the assessment of the plausibility of the projections for subsidies was not based on past trends, but on the basis of the available information on known major risk factors.

The increase in subsidies projected for 2014 mainly reflects higher outlays related to the operation of the public transport service, which was temporarily taken over by Government as from the beginning of the year. Whilst expenditure in respect of the public service obligation for public transport remained unchanged at the 2013 level (0.1 per cent of GDP), additional outlays, amounting to 0.2 per cent of GDP, are estimated for 2014 to cover the losses incurred by the government company which is operating the public transport service (Malta Public Transport Services (Operations) Limited) and which are covered by a Government subvention. This company does not form part of the general government sector since it is expected to be privatised within a calendar year. Currently, negotiations with the preferred bidder are ongoing and the new operator is expected to start providing public transport services as from January 2015. Thus, the projections for subsidies for 2015 do not include outlays in respect of the subvention to Malta Public Transport Services (Operations) Limited. However, the amount of the public service obligation for public transport is projected to increase to 0.2 per cent of GDP. The authorities confirmed that this reflects the agreed amount with the preferred bidder during the ongoing negotiations which are now at a relatively advanced stage and thus the uncertainty surrounding these projections is quite limited.

In 2015, the increase in subsidies mainly reflects the introduction of a new subvention related to the service level agreements with Enemalta, amounting to 0.2 per cent of GDP. This outlay, which was not included in the SP of May 2014, follows an act of entrustment by virtue of which Government of Malta entrusts Enemalta which accepts the obligations to provide and maintain a reliable and continuous source of supply of electricity in line with the provisions of the EU Commission's Decision on the undertakings entrusted with the operation of services of general economic interest. This subsidy is not considered to be subject to uncertainty given that the authorities pointed out that this

[11] Calculated as the interest expenditure for year *t* divided by the stock of debt in year *t-1*

act stipulates that the amount of compensation is not to exceed that included in the 2015 projections.

Gross fixed capital formation

After registering relatively low levels of around 2.4 per cent of GDP between 2008 and 2010, gross fixed capital formation picked up in the following three years, fluctuating around 3 per cent of GDP, and is projected to increase further during the forecast period, reaching 3.5 per cent in 2015. The projections for this component of expenditure are significantly affected by the assumptions regarding the implementation of EU funded projects. Indeed, the projected strong increase in investment outlays in 2014 and the further, though more moderate, increase in 2015, reflect assumptions of a pick-up in the implementation of capital projects financed from EU funds, as the 2007-2013 programming period approaches its completion. For 2015, a notable increase in capital outlays financed from national funds further contributes to the projected total increase in total investment expenditure. Whilst recognising that due to its nature, the pattern of investment outlays over the year tends to exhibit significant volatility, the target for outlays financed from EU funds for 2014 seems ambitious given actual developments (based on Consolidated Fund data) in the first half of the year. The authorities have highlighted that they are stepping up efforts to address absorption capacity issues in the implementation of EU funded projects. Nevertheless, we consider that there remains some risk that investment expenditure is lower than projected both in 2014 and 2015. However, this would not have a negative impact on the fiscal balance.[12]

During 2014-15, two known major investment projects implemented by government-owned entities are the new power station and the Valletta infrastructural projects. The authorities have confirmed that the major investment project relating to the new power station is classified outside of the general government sector and that its implementation will not impact the budget deficit. The impact of the implementation of the Valletta infrastructural projects is included under the other category of expenditure, discussed below.

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

Capital transfers payable

Capital transfers payable are projected to fall from 1.2 per cent of GDP in 2013 to 1.0 per cent in 2014 and to rise again to 1.5 per cent in 2015. These developments are significantly affected by the incremental effect of the transactions relating to the equity injections in Air Malta plc. As in the most recent SP, the DBP includes a capital injection of €15 million in 2014 and a final capital injection of €43 million in 2015[13]. The incremental impact of these transactions amounts to 0.3 per cent of GDP in 2014 and is deficit-reducing, whilst it is deficit-increasing in 2015, amounting to 0.3 per cent of GDP. We consider that the uncertainty surrounding these impacts are mitigated since they reflect the restructuring plan of the national airline, as agreed with the European Commission.

The projections for capital transfers also include outlays relating to the ex-gratia payment in relation to registration tax paid on imported vehicles for personal use between 1 May 2004 and 31

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[12] Rather, a lower absorption of EU funds than that projected would imply a small savings effect, reflecting the co-financing element, whilst lower outlays on nationally funded capital projects would impact positively on the budget balance.

[13] The capital injection of €43 million in 2015 relates to the conversion of a loan granted in 2012 into a capital injection. The loan amounted to €52 million and the remaining balance will be converted into equity in 2016. The implications of this transaction on fiscal projections for 2016 are not assessed in this Report since the fiscal projections included in the DBP cover up to 2015. The implications of this transaction on the debt projections for 2015 are discussed in Section 5.4 of this report.

December 2008. These are projected to amount to 0.04 per cent of GDP in 2014 and to a slightly lower 0.03 per cent in 2015. The projection for 2014 reflects the actual outlays disbursed to date on this measure, which has already been implemented. The authorities explained that the remaining dues to the eligible beneficiaries will be spread out over a number of years, and the projection for 2015 reflects the information obtained from the vetted applications for this payment. Thus, we consider that the uncertainty surrounding disbursements under this scheme, which was identified in the May 2014 Assessment is no longer relevant.

'Other' category of expenditure

The 'other' category of expenditure as a share of GDP is projected to decline marginally over the forecast period, from 2.4 per cent of GDP in 2013 to 2.3 per cent in 2015. The DBP does not include any discretionary measures under this category of spending.

Other current transfers payable account for around 95 per cent of total expenditure under this category. An important component of other current transfers payable is EU own resources, which are projected to increase by around 10 per cent in 2014, but to decline in 2015, falling back to close to the 2013 level. The authorities explained that the projection for 2014 for this item of expenditure has been revised up from that included in the latest SP and that the revised 2014 projection reflects the higher contribution under EU own resources. We acknowledge the effort to adequately take into account this revised contribution in the projections, announced during the October European Council. However, we consider that there is some element of risk surrounding the projected contribution to the EU budget for 2015, given the uncertainty surrounding these contributions being affected by revisions to statistical data for GDP.

The authorities also pointed out that the 2014 projections for other current transfers payable also reflect a base effect stemming from recurrent transfers amounting to 0.2 per cent of GDP to the Grand Harbour Regeneration Corporation plc (GHRC) in 2013. New information was provided on the operation of GHRC, which is the government entity responsible for the Valletta infrastructural projects and other capital projects entrusted to it by the Ministry for Transport and Infrastructure. In particular, the authorities explained that the bulk of the recurrent transfers to GHRC relate to the VAT element of the City Gate project, which is covered by Government. The authorities confirmed that this part of the transfer payments has a neutral effect on the fiscal deficit since it corresponds to similar amounts included under VAT revenue. The remaining amount of current transfers payable to GHRC included in the projections are marginal.

It is pertinent to note that the 2015 projection for other current transfers payable also includes a contingency reserve of 0.1 per cent which, in line with the Fiscal Responsibility Act 2014, has been established by the Ministry for Finance to ensure that unforeseen expenditure or revenue slippages do not jeopardise the compliance with fiscal rules enshrined in the same Act. According to the DBP (2014, p.19), "if unused this will contribute towards further improvement in the budget balance and the structural balance" beyond the targets included therein. Although the amount in the contingency reserve is relatively small, this constitutes a commendable step to reduce the risks surrounding the attainment of the fiscal targets, in case of unforeseen developments, particularly since as a small economy, Malta tends to be subject to significant volatility from external shocks.

5.4. Assessment of debt projections

The general Government gross debt is projected to increase from 69.8 per cent of GDP in 2013 to 70.1 per cent of GDP in 2014. This increase reflects the expected effect of the stock-flow adjustment (SFA) which is only minimally offset by other factors that exert a decreasing pressure on the debt ratio. The latter factors constitute the primary surplus as well as the projected economic growth which more than offset the expansionary impact of the interest expenditure.

Despite that the repayment of accumulated arrears of excise taxes by Enemalta is assumed to take place in 2014, the favourable effect this would have had on the debt ratio – and the resulting negative SFA – is more than offset by a relatively significant positive cash flow position expected at the end of the year. The authorities explained that this reflects the fact that the repayment of tax dues is expected to happen late in the year. Moreover, the SFA also reflects the contribution to a special Malta Government Stocks Sinking Fund which exerts additional upward pressure on the debt ratio.

Table 5.4. Debt Dynamics

	2013	2014	2015
		per cent of GDP	
General Government Gross Debt	69.8	70.1	69.0
Change in the Ratio	2.0	0.3	-1.1
Contributions:			
1. Primary Balance	-0.2	-0.7	-1.2
2. 'Snow-ball' effect			
of which:			
Interest expenditure	2.9	2.8	2.8
Growth and inflation effect	-3.1	-3.4	-3.3
3. Stock-flow adjustment	2.3	1.6	0.6

Source: Malta Draft Budgetary Plan 2015, Ministry for Finance, October 2014; Malta: In-Year Budgetary Report October 15, 2014

In 2015, the debt-to-GDP ratio is expected to decline from 70.1 per cent of GDP to 69.0 per cent of GDP. The primary surplus is expected to be the main contributor towards this decline. Albeit to a lesser extent, the ‘snowball effect’ is also projected to exert downward pressure on the debt-to-GDP ratio as the forecasted GDP growth rate will more than offset the effect of interest expenditure on the debt. On the other hand, the SFA is expected to have an expansionary effect on the debt ratio. The contribution of the sinking fund mentioned earlier is expected to contribute towards this upwards pressure on the debt ratio. Moreover, the fact that 70 per cent of the contribution of the International Investor Programme will be made to the National Development and Social Fund (rather than the Consolidated Fund) gives rise to a positive SFA. On the other hand, the assumption of a decrease in aggregate cash balances by Government at the end of 2015 and the expected repayment of part of a loan by the national airline will exert a downward pressure on the debt ratio. It is pertinent to note that most of the factors affecting the SFA mentioned above are based on a number of assumptions thus exerting an element of uncertainty to the attainment of the debt ratio projections.

Given the direct relationship between the deficit and the change in debt, the debt projections presented in the DBP are subject to the same risks highlighted for the deficit targets. Moreover, besides the uncertainty with respect to the SFA highlighted earlier, projections of the debt ratio are influenced by other assumptions particularly concerning the borrowing by the EBUs.

An element of downside risk also emanates from the stock of government debt guarantees which amounted to almost 16 per cent of GDP in 2013. Projections of government guaranteed debt for 2014 and 2015 were not made available. Since about 40 per cent of the guaranteed debt corresponds to Enemalta, a relatively significant degree of exposure to the contingent liabilities hinges upon the materialization of the restructuring of this entity.

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

In this Section, the fiscal projections presented in the DBP are compared with those generated by the European Commission (CION) for 2014 and 2015[14]. CION's most recent budgetary forecasts are those published on 4 November 2014 (Autumn 2014 forecasts). These projections are based on the ESA 2010 methodology and take into account the updated national accounts and fiscal data published by the NSO in October[15]. The CION's and the MFIN's projections are thus directly comparable, since they are based on the same data for 2013. Thus, divergences between the two set of budgetary forecasts reflect different methodologies and assumptions used by the two institutions in their respective forecasting exercises, including differences in the macroeconomic forecasts underpinning the fiscal projections. Furthermore, another discrepancy is that CION's fiscal forecasts for 2015 are based on a no-policy change scenario and thus do not take into account the proposed discretionary measures included in the DBP.

Both the MFIN and the CION expect the budget deficit to decrease between 2013 and 2015. However, the MFIN's fiscal targets are significantly below the CION's projections, with a discrepancy of 0.4 percentage points of GDP in 2014, which rises to a full 1 percentage point in 2015. Differences in the GDP estimates used to calculate the deficit ratio account for 0.1 percentage point of the discrepancy in 2014 only, but are irrelevant for the gap in 2015. For 2015, 0.7 percentage points of the difference is accounted for by discretionary measures which are included in MFIN's projections but not in the CION's forecasts, since these are based on a no-policy change assumption[16]. Excluding these two factors, the gap is much lower, at 0.3 percentage points in both years. These discrepancies are partly attributable to different macroeconomic assumptions which underpin the fiscal forecasts. In particular, the CION is projecting a slightly less optimistic nominal GDP growth rate both for 2014 and 2015, at 4.4 per cent and 4.5 per cent, compared to the MFIN's 5.1 per cent and 4.8 per cent.

In order to exclude the impact of these discrepancies in the expected GDP growth rates, the comparative analysis of the differences between the two sets of forecasts at a component level was undertaken in absolute terms, rather than as a share of GDP. In both 2014 and 2015, the MFIN is projecting a higher level for total revenue, but lower total expenditure, compared to the CION.

On the revenue side, both in 2014 and 2015, the MFIN is projecting a higher intake from taxes on production and imports as well as higher revenue from capital transfers, but lower proceeds from current taxes on income and wealth. In 2015, the MFIN's targeted social contributions are slightly higher than those of the CION, whilst it has a lower forecast for the other component of revenue. Discrepancies in the expected growth in nominal private consumption expenditure do not explain the differences in the forecasts for taxes on production and imports in 2014 since the CION and the MFIN both project private consumption to increase by 2.7 per cent in 2014, whilst in 2015, the MFIN's forecast is only slightly more optimistic (4.3 per cent compared to the CION's 3.9 per cent). The gap in the forecasts for taxes on production and imports in 2014 thus reflects a higher estimated

[14] The CION's forecasting period covers up to 2016. However, 2015 is not included in this comparative assessment since the DBP only includes projections for 2014 and 2015.

[15] News Releases 195/2014 and 197/2014

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

elasticity by the MFIN, whilst the difference in the 2015 projections are mostly accounted for by the base effect, stemming from the MFIN's higher 2014 forecasts, and the impact of discretionary measures included in the MFIN's projections. Despite a more favourable macroeconomic outlook, the MFIN is projecting a lower intake from current taxes on income and wealth, both in 2014 and 2015. For 2015, the MFIN's forecasts include the impact of the widening of the income tax bands, whilst the CION's projections are based on a no-policy change assumption. Particularly in 2014, the MFIN's estimated elasticity seems to be more prudent than that in the CION's forecasts. Another significant difference between the MFIN's and the CION's revenue projections relates to the expected intake from capital transfers, with the Ministry projecting higher revenue in both 2014 and 2015. This discrepancy is influenced by different assumptions regarding the absorption of EU funds and corresponds to higher expected capital outlays in the MFIN's projections, so that the effect on the fiscal balance is broadly neutral.

Table 6.1. Comparison of Fiscal Projections
MFIN Draft Budgetary Plan October 2014 - CION Autumn 2014

	2013	**2014**	**2015**	**2014**	**2015**
	Actual	**MFIN DBP October 2014**		**CION Autumn 2014**	
		per cent of GDP			
General government balance	-2.7	-2.1	-1.6	-2.5	-2.6
General government debt	69.8	70.1	69.0	71.0	71.0
		Eur millions			
Taxes on production and imports	978.5	1,083.5	1,157.1	1,044.7	1,092.8
Current taxes on income and wealth	1,043.3	1,085.6	1,155.8	1,122.6	1,177.8
Capital taxes	12.7	12.2	12.2	12.3	12.3
Social contributions	524.8	557.4	582.3	557.8	577.9
Capital transfers receivable	144.1	202.46	228.20	187.6	214.0
Other revenue	288.1	289.3	323.3	289.4	334.4
Total revenue	**2,991.6**	**3,230.5**	**3,458.8**	**3,214.3**	**3,409.1**
Compensation of employees	977.8	1,014.2	1,049.3	1,036.7	1,079.4
Intermediate consumption	462.7	505.0	547.8	506.0	549.0
Social payments	969.2	1,009.3	1,034.4	1,018.0	1,052.0
Interest expenditure	220.2	220.6	229.3	220.7	228.5
Gross fixed capital formation	208.8	261.7	285.9	240.1	268.9
Subsidies	80.3	114.1	131.2	114.9	129.9
Other expenditure	274.6	268.1	310.8	271.1	314.2
Total expenditure	**3,193.5**	**3,393.0**	**3,588.7**	**3,407.5**	**3,621.8**
General government balance	**-202.0**	**-162.5**	**-130.0**	**-193.1**	**-212.8**

Source: Malta Draft Budgetary Plan 2015, Ministry for Finance, October 2014; Ministry of Finance; European Commission's AMECO and General Government data [online]

On the expenditure side of the budget, the main differences between the two sets of projections concern compensation of employees, social payments and gross fixed capital formation. The MFIN's targeted wage bill is significantly lower than that projected by the CION both in 2014 and 2015. In its Autumn forecasts, the CION has referred to the increase in employment in the public sector during 2014 "despite the restrictions on recruitment envisaged by the 2014 budget" (CION, 2014, p.93). The gap in 2015 largely reflects a base effect and the impact of the discretionary measure included in the

MFIN's projections. The MFIN is also projecting lower outlays on social payments in both 2014 and 2015, despite discretionary measures in 2015 with a net deficit-increasing impact. On the other hand, the Ministry is projecting higher capital outlays than the CION both in 2014 and 2015. As noted earlier, this reflects differences in assumptions concerning the implementation of EU-funded projects and has only a minimal impact on the budget deficit.

The MFIN's and CION's fiscal projections show different trajectories for the debt ratio. The MFIN expects the debt ratio to rise only marginally in 2014 (from 69.8 per cent in 2013 to 70.1 per cent) and then to fall to 69 per cent in 2015. On the other hand, in 2014, the CION projects a higher increase in the debt ratio to 71 per cent and in 2015 it expects the debt ratio to remain stable at that level. This results in the CION's projected debt ratio being 0.9 percentage points higher than that of the MFIN in 2014, with the gap increasing to 2 percentage points in 2015. The MFIN's relatively higher nominal GDP estimate, which is used to compute the debt ratio, accounts for 0.5 and 0.7 percentage points of this difference in 2014 and 2015, respectively. The remaining discrepancy largely reflects the cumulative contribution of the more gradual fiscal adjustment in the CION's projections.

7. Conclusion

On a positive note, the methodology and process by which fiscal forecasts are formulated entails the involvement of experts and each category of the fiscal budget is projected in significant detail. However, the process is characterised by significant fragmentation particularly since the projections of every line item based on the Consolidated Fund and then transposed to ESA 2010 terms are generated by different entities. Furthermore, this process gives rise to the need of various assumptions entailing a certain degree of uncertainty. The authors consider that these established processes are resulting in a disjointed forecasting exercise.

The fiscal consolidation which is forecasted to continue during 2014 and 2015 is subject to some risks. Firstly, the assumptions for the macroeconomic scenario and the uncertainty that surround the growth prospects of the Maltese economy may constitute a risk to the attainment of the fiscal targets. In particular, the projections for general government consumption expenditure and various expenditure component deflators are surrounded by an element of uncertainty.

On the revenue side, the actual outturn for the first half of the year for the main tax components indicates that the attainment of the annual fiscal target is on track. However, projections for taxes on production and imports for 2014 reflect relatively high elasticity emanating an element of downside risk. This is also evident from the comparison to the Commission's Autumn Forecasts. Some risk to the revenue targets also relates to the relative high reliance for the increase in the total revenue on one particular measure, namely the International Investor Programme. On the upside, an element of prudence is noted as any proceeds that may emanate from the revision in the tax rate on rental income announced in the Budget for 2014 are not included in the fiscal forecasts.

On the expenditure side, there are risks of slippages particularly for compensation of employees both for 2014 and 2015. The projected wage bill appears ambitious compared to recent developments as also reflected in the CION's projections. Some element of downside risk is also noted for social payments especially in 2014 as well as in the projections for Malta's contribution to the EU budget for 2015.

On the other hand, the implementation of the spending review may result in additional cost savings to those projected in the DBP though the impact of this exercise is difficult to quantify at this early stage. We also positively note the introduction of a contingency reserve which could be used to offset slippages in the targets, though to a limited extent.

The debt projections are also subject to the risk factors mentioned above. Moreover, the expected debt ratio is also subject to the assumptions for aggregate cash balances for 2014 and the assumptions of the debt of the EBUs for both 2014 and 2015. Some element of risk is also evident from the fact that a relatively high percentage of government guaranteed debt relates to Enemalta whose financial position hinges on the success of the planned restructuring process.

Overall, whilst the set fiscal targets could be attainable, they are subject to important risks as highlighted above.