



# **Malta:**

## **Stability Programme**

### **2007 - 2010**

**Ministry of Finance**  
**December 2007**

The following symbols have been used throughout this document:

... to indicate that data are not available;

— to indicate that the figure is negligible;

0 to indicate that the figure is zero;

- to indicate that data are not applicable or cannot be determined;

n/c to indicate that there is no change in the data.

Figures may not add up due to rounding.

This document is based on statistical information available up to 23<sup>rd</sup> November 2007.

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# Introduction

This is the first Stability Programme of Malta. This document fulfils the requirement in the Stability and Growth Pact that a Member State joining the Euro Area shall submit a Stability Programme within six months of the Council Decision on its participation in the single currency.

This Stability Programme has been prepared in accordance with Council Regulation (EC) No. 1466/97 as amended by Council Regulation (EC) No. 1055/05. The document is in line with the ‘Specifications on the implementation of the Stability and Growth Pact and Guidelines on the Format and Content of the Stability and Convergence Programmes’, endorsed by the Ecofin Council on 11 October 2005. The changes to the standard tables annexed to the code of conduct on stability and convergence programmes, agreed to by the Economic and Financial Committee in September 2007, have been taken into account.

This document, which constitutes an update of the December 2006 Update of Convergence Programme, was compiled by the Ministry of Finance, with an important contribution from the National Statistics Office as well as from other Ministries and entities. The Programme comprises seven sections: Chapter 1 presents Government’s objectives for economic policy; Chapter 2 outlines the projections for the main macroeconomic variables for the medium-term; Chapter 3 presents the medium-term fiscal projections and debt developments together with the overall fiscal policy framework and Malta’s medium term objective; Chapter 4 contains a sensitivity analysis of the budgetary projections as well as a comparison between the current forecasts and those presented in the December 2006 Update of the Convergence Programme; Chapter 5 analyses the quality of public finances and includes a review of the Budget for 2008; the integration with the National Reform Programme is also outlined; Chapter 6 reviews the long-term sustainability of public finances, and finally Chapter 7 reviews the institutional features of public finances.





## 1. Overall Policy Framework and Objectives

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# 1. Overall Policy Framework and Objectives

Over the past few years, Government's economic programme has focused on consolidating public finances, achieving a stable macroeconomic framework and on implementing structural reforms aimed at improving the competitiveness of the Maltese economy. These policies, backed up by appropriate monetary policy, have enabled Malta to satisfy all the relevant convergence criteria. On 10 July 2007, the Council adopted the decision allowing Malta to adopt the Euro as from 1 January 2008, with the conversion rate for the Maltese lira against the Euro being set at the same level as the central parity rate it held vis-à-vis the Euro within the ERM II exchange rate mechanism.

The Maltese economy is already highly integrated with the European Union's (EU) economy and Euro adoption will further reinforce Malta's integration with the Euro Area economy. Thus, the adoption of the Euro constituted the subsequent logical step in Malta's economic development process.

As a member of the Euro Area, Government's main macroeconomic policy objectives will be the following:

- achieving sustainable economic growth and ensuring real convergence with EU average levels;
- generating a high level of employment and securing a relatively low unemployment rate;
- strengthening the public finance situation so as to secure a sustainable fiscal position;
- ensuring a low and stable level of inflation.

In order to attain a stable and sound macroeconomic framework, Government will continue to implement policies aimed at securing a sustainable fiscal position, in line with the provisions of the Stability and Growth Pact. Following the abrogation of the decision on the excessive deficit in Malta by the Ecofin Council on 5 June 2007, the Maltese Government remains committed to pursue further fiscal consolidation, by adopting structural measures notably expenditure restraint measures. This should enable Malta to reach its medium-term objective (MTO) of a balanced structural budget. As set out in the fiscal targets presented in this Stability Programme, the MTO will be achieved in 2010. The increasing primary surpluses, together with GDP growth, will enable the debt-to-GDP ratio to maintain a declining path, such that the debt ratio will fall to 60 per cent of GDP in 2008 and continue to decrease further thereafter.

Government is committed to the fiscal targets presented in this Programme and stands ready to introduce additional corrective measures, should this be warranted by unforeseen circumstances.

In December 2006, Parliament adopted a pension reform, with impacts on both revenue and expenditure, and which Government considers to be a valid effort to improve the adequacy and long-term sustainability of the public pension system in Malta. This pension reform together with the reduction of the debt ratio will contribute to improve the long-term sustainability of public finances.

Government's fiscal policy aims not only to maintain fiscal prudence, but also to enhance the growth potential of the Maltese economy. Thus, Government is proceeding to improve the supply-side of the economy. In particular, the fiscal programme provides for the necessary investment in the development of infrastructure, education as well as environment. This will be achieved also through the effective and efficient absorption of EU funds. Furthermore, in the Budget for 2008, Government has announced further measures aimed at improving the incentive to work, in order to encourage an increase in the labour force participation rate.

A fiscal policy earmarked to achieve sustainability in public finances, whilst also improving the growth potential of the economy, should contribute to achieve a low and stable inflation rate. Such a favourable macroeconomic environment is necessary to ensure the competitiveness of local enterprises in view of the

high degree of openness of the domestic economy. It is also a precondition to attract foreign direct investment. Whilst recognising that recent developments in international oil prices as well as in other commodity prices will have a bearing on the domestic inflation rate, Government will remain vigilant on inflationary developments. Furthermore, Government considers that it is important that wage developments reflect trends in labour productivity, whilst taking due account of developments in competitor countries.

Enhancing competitiveness is a key challenge in order to achieve sustainable economic growth. In this context, promoting the development of high value added growth sectors constitutes a high priority in Government's economic policy agenda. Furthermore, Government will continue to implement productivity-enhancing structural reforms. The National Reform Programme provides a comprehensive agenda of the main structural reforms underway, with the main relevant measures targeting the areas of the business environment, the attraction of foreign direct investment, product and labour market reforms and the promotion of research and innovation. These reforms will also instil further flexibility in the economy, thus facilitating national adjustment capacity within the Monetary Union.

The overall goal of Government's economic and fiscal policy is to achieve a growing economy which is capable of sustaining improvements in the standard of living of the Maltese population. This should encompass not only economic well-being, but rather a wider concept of the quality of life, to include also the environmental and social aspects. In particular, the Budget for 2008 announced a number of measures aimed to improve social cohesion, which together with the investment in the health system, should enhance the social fabric of the Maltese society.





## 2. Economic Outlook

### 2.1 The Medium Term Scenario

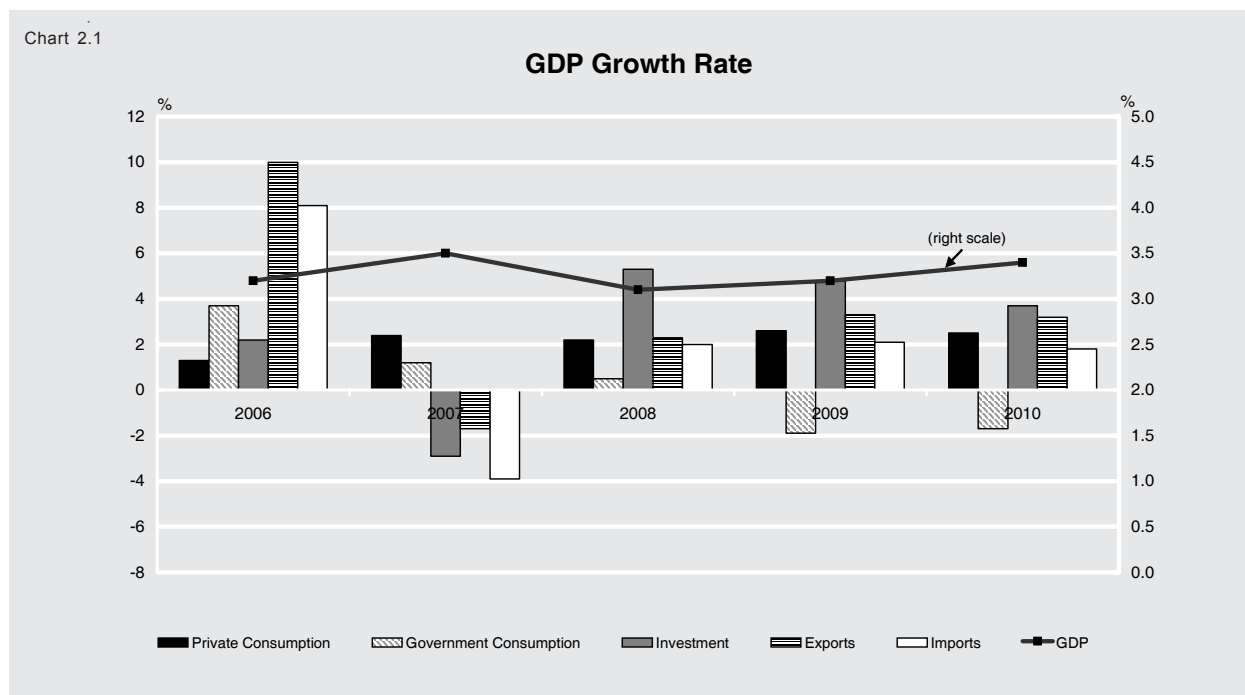
Over the forecast period the Maltese economy is expected to grow at around 3.3 per cent in real terms. Both the domestic and the external sectors are expected to contribute positively towards economic growth. However, from 2008 onwards, the contribution of the domestic sector is expected to be greater than that of the external sector. The former is expected to be underpinned mainly by private consumption expenditure and to a lesser extent by investment expenditure. Table 2.1 presents the main macroeconomic indicators for the years 2005-2010. The figures for 2005 and 2006 have been published by the National Statistics Office (NSO)<sup>1</sup>. Figures from 2007 to 2010 are forecasts. The macroeconomic forecasts by the Ministry of Finance take into account the latest available data and are outlined in Tables 1a, 1b, 1c, and 1d of the Statistical Appendix.

During 2007, real GDP growth is expected to reach 3.5 per cent. The external sector is expected to be the major contributor to economic growth in 2007. Although both exports and imports of goods and services registered decreases in real terms, the decline in exports is forecasted to be more than outweighed by the fall in imports. This pattern is expected to be reversed from 2008 onwards, where the contribution of the domestic sector towards real GDP growth is expected to be stronger than that of the external sector. In line with the heightened downside risk levels surrounding the global macroeconomic outlook, GDP growth is expected to moderate slightly in 2008, then picking up in the later years of the forecast. In 2008, real GDP growth is expected at 3.1 per cent, whilst in 2009 and 2010 real GDP is expected to increase by 3.2 and 3.4 per cent respectively. The projected growth rates of GDP together with a detailed breakdown of the various expenditure aggregates are illustrated in Chart 2.1.

	2005	2006	2007 <sup>(1)</sup>	2008	2009	2010
GDP growth at current market prices (%)	6.1	6.0	6.4	6.1	5.5	5.6
GDP growth at constant (2000) prices (%)	3.1	3.2	3.5	3.1	3.2	3.4
<b>Expenditure Components of GDP at constant (2000) prices (% change)</b>						
Private final consumption expenditure <sup>(2)</sup>	2.3	1.3	2.4	2.2	2.6	2.5
General government final consumption expenditure	0.3	3.7	1.2	0.5	-1.9	-1.7
Gross fixed capital formation	4.9	2.2	-2.9	5.3	4.8	3.7
Exports of goods and services	-1.2	10.0	-1.7	2.3	3.3	3.2
Imports of goods and services	1.3	8.1	-3.9	2.0	2.1	1.8
Inflation rate (%)	2.5	2.6	0.9	2.5	2.3	2.1
Employment growth (%)	1.8	0.9	1.6	1.2	1.3	1.4
Unemployment rate (%)	7.3	7.3	6.6	6.8	6.7	6.6
Labour productivity (% change)	1.3	2.2	1.8	1.8	1.9	2.0
External Goods and Services Balance (% of GDP)	-5.4	-3.9	0.6	1.4	2.6	3.9

<sup>(1)</sup> Forecasts from 2007 onwards  
<sup>(2)</sup> Includes NPISH final consumption expenditure

Chart 2.1



### 2.1.1 Assumptions for Projections

The forecasts presented in this section and the different sensitivity scenarios presented within this document were estimated using econometric techniques and related analytical methods. The main assumptions used in obtaining the base forecasts for 2007-2010 are in line with the European Commission's forecast assumptions presented in the 'Economic Forecasts – Autumn 2007'.

- Economic activity in Malta's main trading partners is expected to grow by 2.4 per cent in 2007, by 2.0 per cent in 2008 and by 2.1 per cent thereafter. Meanwhile HICP prices in Malta's major trading partners, are assumed to increase by 2.0 per cent in 2007, by 2.1 per cent in 2008 and then decline to 2.0 per cent thereafter.
- Oil prices are assumed to increase in 2007 to US\$70.6 per barrel, whilst in 2008 oil prices are assumed to increase further to US\$78.8 per barrel and then decline slightly to US\$76.0 in 2009.
- Interest rates and exchange rates are assumed to remain constant throughout the forecast period.
- Compensation per employee is expected to grow by an average of around 2.9 per cent during the 2007-2010 period, increasing slightly in the later years of the forecast period. Moreover, it is assumed that Government employment continues a downward trajectory path in line with Government's policy of restricting recruitment in non-essential categories.
- The share of inventory changes in GDP is assumed to hover close to 0 per cent during the forecast period.

### 2.1.2 Risks to Outlook

Downside risks include the uncertain climate prevailing the global macroeconomic outlook as a result of the recent financial turmoil in credit markets. Other downside risks include the continued upward spiral in the price of oil and continued inflationary pressures in the commodities markets in general and in agricultural



commodities in particular. On the other hand, possible upside risks include a swift resolution of the uncertainty in financial markets which could help attain more robust growth in major trading partners as well as more benign outlook for oil and agricultural commodity prices.

### **2.1.3 Private Final Consumption Expenditure**

In 2007, private final consumption expenditure is expected to grow by 2.4 per cent. Consumption growth is hence expected to return to the trend level of growth exhibited over the recent past following the low growth rate registered in 2006. Changes in income tax bands, cash-dehoarding, higher employment and a relatively low rate of inflation are expected to influence consumption positively. Consumption growth is expected to be marginally weaker in 2008 at 2.2 per cent, as higher prices and the end of cash-dehoarding are expected to outweigh the increase in disposable income resulting from budget measures. Private consumption growth is expected to rebound in the outer years at 2.5 – 2.6 per cent growth.

### **2.1.4 General Government Final Consumption Expenditure**

Government final consumption expenditure is expected to grow at steadily decreasing rates in 2007 and 2008, and to decrease in real terms in 2009 and 2010. In line with developments in the past two years, the nominal growth rate in Government final consumption expenditure is expected to be considerably less than GDP growth. This factor reflects the central role that the containment of expenditure growth plays within Government's fiscal consolidation strategy.

In real terms, Government consumption is expected to grow at 1.2 per cent during 2007 whilst in 2008 government consumption will expand at a marginal rate of 0.5 per cent. Subsequently, Government consumption is expected to increase marginally by 0.5 per cent in nominal terms and decline by 1.9 and 1.7 per cent in real terms in 2009 and 2010 respectively.

### **2.1.5 Gross Fixed Capital Formation**

The contribution of gross fixed capital formation is forecasted to be negative in 2007, but will turn positive in the following years. In 2007 gross fixed capital formation is expected to decrease by 2.9 per cent, where the decrease is attributed to both the private and the public sector. It is noteworthy to mention that the 2007 investment expenditure figures reflect a substantial decrease in capital outlays related to the new hospital which became operational in the second half of the year as well as the inclusion of exceptional imports of a capital nature in the preceding year.

In 2008 investment expenditure is forecasted to grow by 5.3 per cent, reflecting an increase in private sector investment, particularly the initiation of the Smart City project and to a lesser extent by the public sector. In 2009 and 2010 investment expenditure is expected to continue to grow by 4.8 and 3.7 per cent, respectively, reflecting sustained growth by the private sector.

### **2.1.6 External Balance of Goods and Services**

Latest data on economic performance for 2007 published by NSO suggest that a relatively strong recovery in tourism earnings has been registered in conjunction with continued positive performance in a number of emerging growth sectors. On the other hand, following the significant recovery in the previous year, exports of semiconductors in 2007 have maintained the 2006 levels. Though exports are expected to increase in nominal terms, growth is expected to be negative in real terms, reflecting the relatively high export price deflator. In fact, recently published data by NSO suggests that during the first two quarters of 2007, the export deflator exhibited a 10.3 per cent growth. The external sector is still expected to generate a positive contribution of 2.4 percentage points to economic growth in 2007, in view of the fact that the decline in imports is expected to more than offset the decrease in exports.

Exports and imports are expected to exhibit positive growth rates in the forecast period, with the growth rate of the deflators gradually declining to lower levels. The contribution of the external sector to economic growth is expected to decline considerably in 2008 to 0.2 percentage points and gradually pick-up to around 1.0 and 1.3 percentage points in 2009 and 2010, respectively. In 2008 exports are expected to grow by 2.3 per cent whilst imports are forecasted to increase by 2.0 per cent. Export growth of 3.3 per cent and import growth of 2.1 per cent are expected to be registered in 2009, whilst in 2010 exports are forecasted to increase by 3.2 per cent, and imports are expected to grow by 1.8 per cent.

### **2.1.7 Productivity and Employment Prospects**

During the forecast period an average employment growth (based on National accounts definition) of 1.4 per cent is expected to be registered. In 2007, employment growth is expected to peak at 1.6 per cent, and then decline marginally in subsequent years in line with the macroeconomic outlook over the forecast period. Real labour productivity growth per person is expected to average 1.9 per cent during the forecast horizon.

The unemployment rate, (based on the Harmonised definition) for 2007 is forecasted at 6.6 per cent, significantly below the average unemployment rate of 7.4 per cent recorded in the previous 5 years. The marginally lower real GDP growth is expected to trigger a slight increase in the unemployment rate in 2008. However, in line with the improvement in economic activity in the subsequent two years, the unemployment rate is expected to return to the 6.6 per cent rate forecasted for 2007.

### **2.1.8 Inflation**

The inflation rate (calculated as the twelve month moving average of the HICP) is expected to return to its trend following the low inflation rate of 0.9 per cent that is expected to be registered in 2007. The relatively low rate of inflation forecasted in 2007 reflects a significant base effect associated with the increase in the surcharge on water and electricity rates in the previous year as well as lower prices for accommodation services. In particular, the increased price pressures in international oil and food commodities are expected to contribute to an inflation rate of 2.5 per cent in 2008. Inflationary pressures beyond 2008 are expected to be relatively moderate, with the inflation rate being 2.3 and 2.1 per cent in 2009 and 2010, respectively.

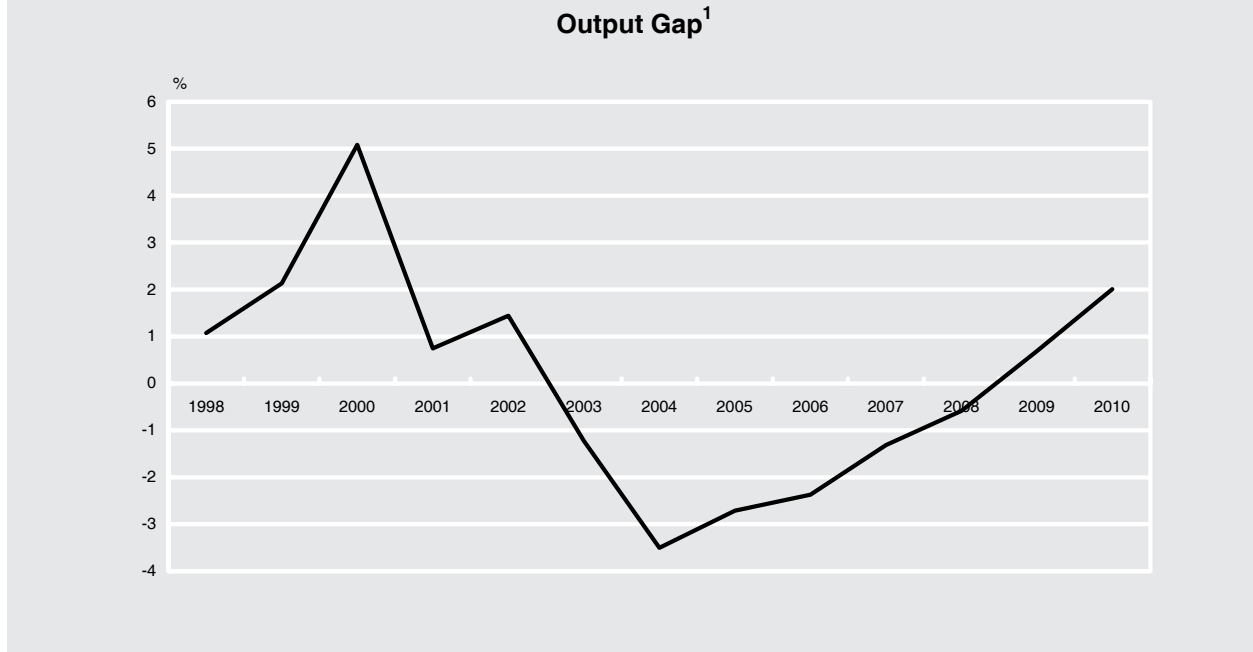
## **2.2 Potential Output and the Output Gap**

The method used in the estimation of the output gap is based on the commonly agreed Production Function method with the main differences related to the macroeconomic forecasts and the working age population figures. Developments in the output gap are depicted in Chart 2.2.

Economic performance between 2001 and 2004 was both sluggish and volatile, with an average growth rate of 0.2 per cent, as the economic growth performance was conditioned by the process of economic restructuring, heightened external competitive pressures and the unfolding of the fiscal consolidation programme that acted as a drag on economic growth. An economic recovery was registered in 2005, where the rate of growth stood at 3.1 per cent. This momentum was maintained in 2006 with a growth rate of 3.2 per cent and is expected to be sustained over the forecasted period 2007-2010, with the average annual increase in economic growth expected to be around 3.3 per cent.

Average potential output growth stood at 2.2 per cent for the period 2002-2005 down from an average rate of 3.0 per cent during the previous 4 year period. For 2006, the growth in potential output stood at 2.8 per cent while for 2007 the growth rate is expected to decline to 2.4 per cent. This decline in potential output growth is partly attributed to a relatively slower rate of capital accumulation and more so to demographic and labour market developments. Over the period 2008-2010, average potential growth is estimated at 2.1 per cent.

Chart 2.2



<sup>1</sup> Defined as actual output less potential output as a per cent of potential output.

The output gap, defined as the difference between actual and potential output as a ratio of potential output, is indicative of the cyclical developments in the Maltese economy. The output gap was positive during the 1998-2002 period, peaking at 5.1 per cent of GDP in 2000. Since 2003, the output gap turned negative and reached a trough of -3.5 per cent of GDP in 2004. However, in line with the recovery in real GDP growth, the output gap narrowed since then and is expected to be -1.3 per cent of GDP for 2007. Over the forecasted period, the output gap is expected to continue to narrow, turning positive in 2009 and increasing further in 2010 as actual GDP is expected to grow at a higher rate than the estimated potential GDP.

*Note:*

<sup>1</sup>Data in line with NSO News Release (National Accounts, GDP, June Quarter 2007), No. 145/2007



### **3. General Government Balance and Debt**

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### 3. General Government Balance and Debt

Government's fiscal policy framework remains geared towards the achievement of a sustainable fiscal stance so as to ensure a stable and sound macroeconomic framework which is conducive to price stability, sustainable economic growth and employment creation.

The previous Programme outlined Government's fiscal plan aimed at adhering to the Council Recommendation under Article 104(7) to abrogate the excessive deficit procedure. Indeed, as a result of Government's efforts to correct the excessive deficit, Malta's general Government deficit maintained a downward trajectory path declining to 2.5 per cent of GDP in 2006, thus below the 3.0 per cent reference value. As a result, and also in view of the Commission Services Spring 2007 forecast which projected further narrowing of the deficit, the Council abrogated the decision on the existence of an excessive deficit in June 2007.

Against this backdrop, this Update sets out Government's medium-term fiscal plan based on the principle of maintaining fiscal consolidation and on the sustainability of public finances in the long-term. Indeed, in the Budget Speech for 2008, Government reaffirmed its priority to achieve fiscal consolidation wherein the general Government deficit is projected to fall to 1.6 per cent in 2007 and to continue to improve thereafter to a budget surplus of 0.9 per cent by 2010.

Government's fiscal consolidation programme is designed such that, whilst fiscal sustainability is ensured, a number of fiscal measures are implemented to stimulate further economic activity and employment as well as social cohesion, thereby contributing to the key goals of the Lisbon Strategy. Progress in the fiscal consolidation process is ensured through consolidation measures primarily on the expenditure side such that fiscal consolidation is achieved without undermining the competitiveness of the economy.

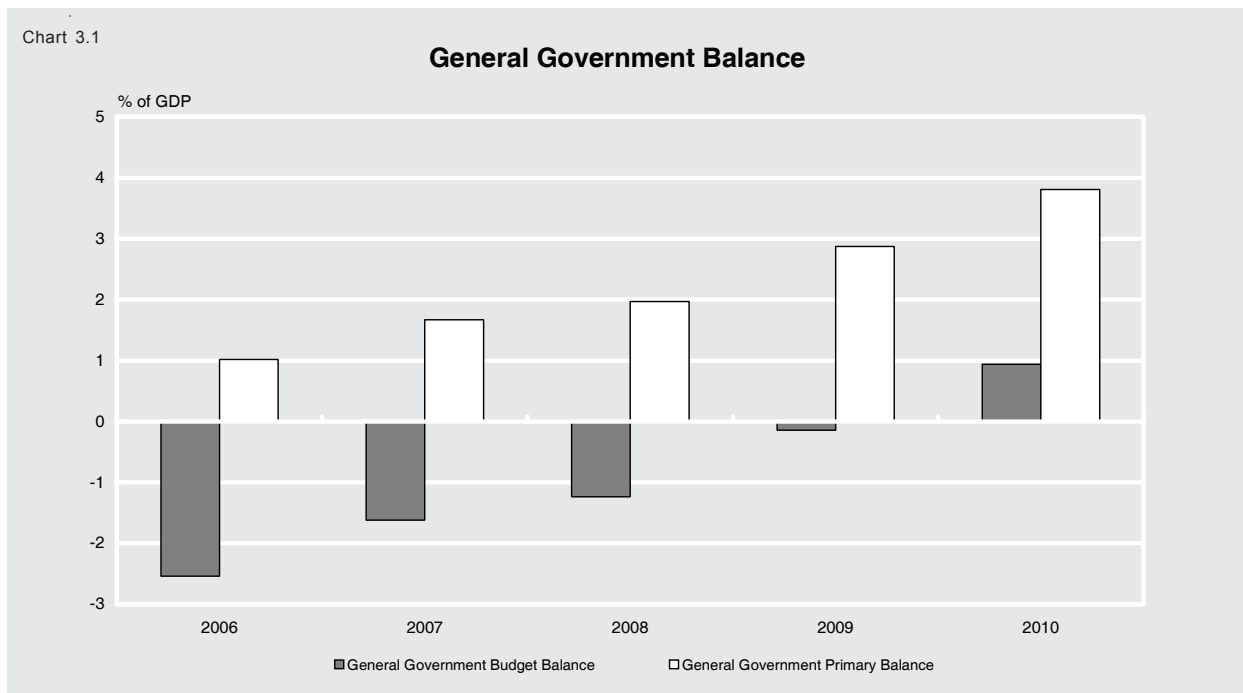
As presented in this Programme, the envisaged fiscal consolidation is being undertaken in the context of an economic recovery which is expected to translate into a declining negative output gap which turns positive in 2009 and 2010. If one were to exclude both the cyclical component and one-off deficit-reducing measures, the medium term fiscal framework is underpinned by an average annual structural adjustment of 0.6 percentage points of GDP. This structural adjustment will translate into a structural budget surplus of 0.1 per cent of GDP in 2010, thus allowing Malta to reach its medium term objective.

Government's ongoing fiscal consolidation programme also contributes to the attainment of a declining debt-to-GDP ratio. In fact, the debt-to-GDP ratio is expected to decline from 64.7 per cent in 2006 to 62.9 per cent in 2007. Subsequently, the debt ratio is expected to maintain the downward trend registered in the past years to reach the reference value of 60.0 per cent by 2008 and decline further thereafter.

#### 3.1 The Medium-Term Fiscal Framework

The general Government deficit as a per cent of GDP declined below the 3.0 per cent of GDP reference value in 2006, and is expected to continue on a downward path thereafter. In fact, the general Government deficit ratio is expected to decrease further from 2.5 per cent of GDP in 2006 to 1.6 per cent and 1.2 per cent in 2007 and 2008 respectively. Details of the Budget for 2008 are presented in Chapter 5. Subsequently, as highlighted in Chart 3.1 (which illustrates developments in the general Government balance between 2006 and 2010) the general Government balance is expected to decline to close to a balanced budget in 2009 and to reach a surplus of 0.9 per cent of GDP in 2010. Table 2 in the Statistical Appendix presents general Government revenue and expenditure projections for the 2006-2010 period.

In the analysis of the budgetary position, it is also pertinent to consider the projected trend for the primary balance. In fact, the primary balance as a per cent of GDP is expected to improve further, from a surplus of 1.0 per cent in 2006 to a surplus of 1.7 per cent of GDP in 2007. In 2008, the primary surplus is expected to



reach 2.0 per cent of GDP. Thereafter, the primary budget balance is expected to increase significantly to 2.9 per cent and 3.8 per cent in 2009 and 2010 respectively.

In 2007, one-off deficit-reducing measures amounted to 0.8 per cent of GDP and mainly constituted revenue from sale of property and the Currency and Bank Deposits Registration Scheme. In this context, it is noteworthy to highlight that sale of land planned for 2006 has materialised in 2007. Revenue from one-off operations in the following years is expected to decline significantly to around 0.2 per cent of GDP. During the 2008-2010 period such revenue reflects income from sale of property. When revenue from these one-off measures is excluded, the general Government budget deficit is still expected to be below the reference value of 3.0 per cent of GDP in 2007. In fact, the general Government deficit net of one-off revenue is expected to reach 2.4 per cent of GDP in 2007. This consolidation is expected to persist during the remaining Programme period. Consequently, the general Government budget deficit net of one-off and temporary measures is projected to decline to 1.4 per cent of GDP and 0.3 per cent of GDP in 2008 and 2009 respectively. Thereafter, in 2010, a general Government budget surplus net of one-off measures of 0.8 per cent of GDP is envisaged. This represents an annual fiscal nominal adjustment of 1.1 per cent of GDP between 2008 and 2010.

The fiscal consolidation envisaged over the medium-term framework relies on expenditure restraint measures. In fact, the decline in the deficit-to-GDP ratio reflects a lower expenditure ratio that outweighs a decrease in the revenue ratio. This is in line with Government's priority to pursue fiscal consolidation without undermining the competitiveness of the Maltese economy by increasing the tax burden. When capital expenditure relating to the new hospital is excluded, the ratio of gross fixed capital formation to GDP is expected to increase from 2.9 per cent of GDP in 2007 to 3.5 per cent in 2010. This reflects Government's commitment to undertake the public investment necessary in order to move towards the Lisbon goals of growth and employment.

### 3.1.1 Comparison with the December 2006 Update of Convergence Programme

While Government remains firmly committed to achieve a sustainable fiscal position, the targeted general Government deficit-to-GDP ratios presented in this Programme represent a revised pace of fiscal consolidation particularly in the earlier years of the Programme period, when compared to that presented in the December 2006 Programme. It is noteworthy that the fiscal deficit recorded in 2006 is only marginally different from



that reported in the previous Programme. In 2007, the nominal deficit has been revised significantly downwards, though this largely reflects the impact of changes in one-off revenues as explained below. Meanwhile, the fiscal target for 2008 was revised upwards when compared to the previous Programme. The fiscal position projected for 2009 has also been revised but a fiscal position of close to balance is still envisaged.

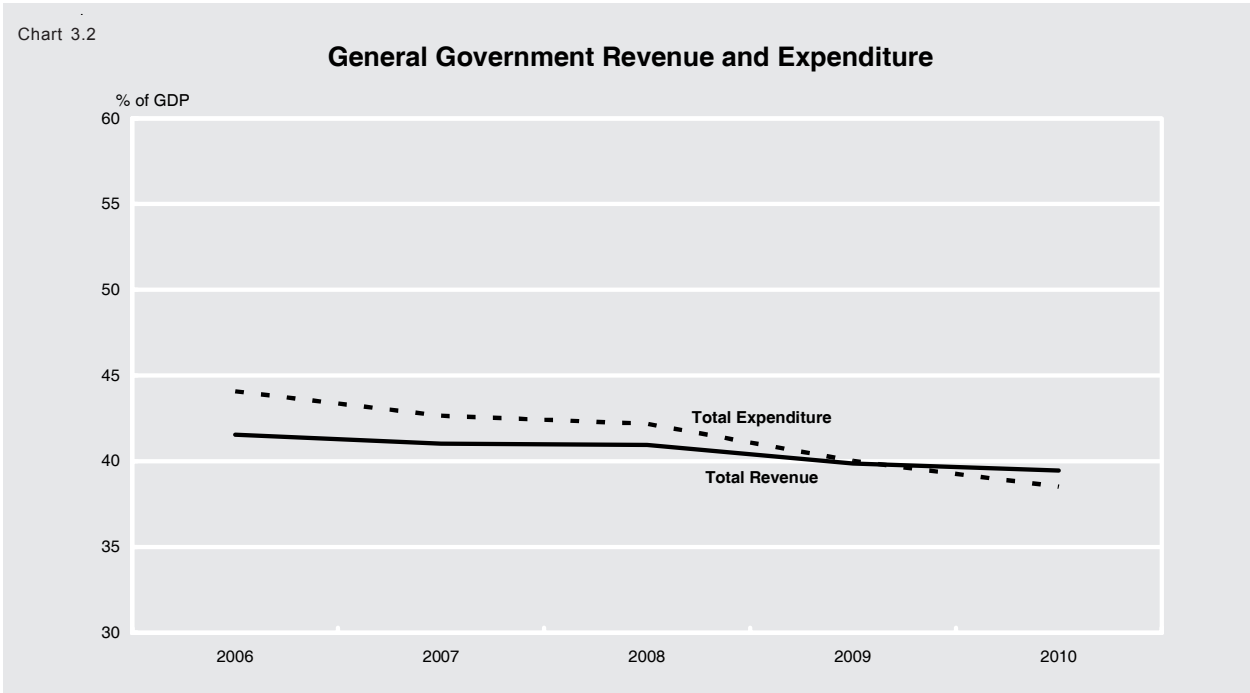
While the 2006 Update targeted a deficit of 2.3 per cent of GDP for 2007, the deficit is now expected to decline to 1.6 per cent of GDP. This mainly reflects receipts in relation to a one-off operation related to sale of land which was originally booked in 2006, but which is now included in 2007. This accounting treatment was necessary to reflect the fact that the legal title over the property sold by Government was transferred to private parties in 2007. Indeed, the deficit net of one-offs for 2007 remained largely unchanged and stood at 2.4 per cent of GDP.

In 2008, the deficit-to-GDP ratio is expected to stand at 1.2 per cent of GDP, or 0.3 percentage points higher than the ratio projected in the 2006 Programme. This upward revision in the ratio reflects a higher absolute level for the deficit as increases in expenditure are expected to outstrip forecasted increases in Government revenue.

The fiscal adjustment of around 1.0 percentage points envisaged for 2009 in the previous Programme is broadly unchanged. The deficit-to-GDP ratio for 2009 was adjusted by 0.2 percentage points of GDP, from a surplus of 0.1 per cent to a deficit of 0.1 per cent when compared to the 2006 Programme. This was mainly attributed to a revision in the deficit level.

### 3.1.2 General Government Revenue Projections

The ratio of general Government revenue to GDP is expected to decline from 41.6 per cent in 2006 to 41.0 per cent in 2007, mainly on account of lower ratios of the ‘other’ component of revenue as well as of property income, which more than offset an increase in the tax burden. Meanwhile, as highlighted in Chart 3.2, in 2008, general Government total revenue as a per cent of GDP is expected to remain broadly unchanged, at around 41 per cent, as marginal reductions in the ratios of proceeds from taxes and social contributions are expected to be partly offset by increases in the ‘other’ component of revenue (which includes EU grants). In the subsequent two years, general Government total revenue as a ratio of GDP is forecasted to decline to 39.5 per cent of GDP in 2010. This development is mainly underpinned by lower growth in tax



revenue and social contributions when compared to GDP growth as well as a lower ratio of the ‘other’ component of revenue.

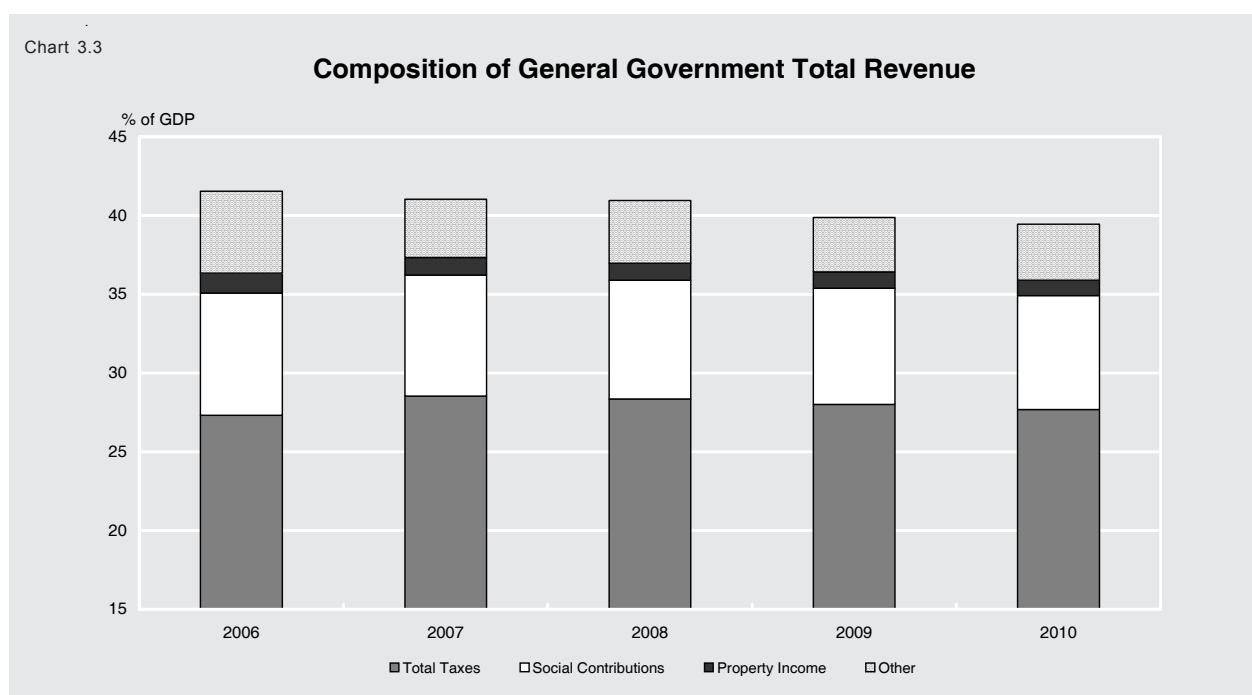
### 3.1.2.1 Tax Revenue

During the forecast period, Government will continue to implement efforts towards a more efficient revenue collection and to curb tax evasion. The ratio of tax revenue to GDP is expected to increase from 27.3 per cent recorded in 2006 to 28.5 per cent in 2007. Subsequently, as illustrated in Chart 3.3, the tax revenue ratio is expected to follow a downward path to 27.7 per cent of GDP by 2010.

The growth in the tax ratio in 2007 reflects an increase in revenue from current taxes on income and wealth in excess of GDP growth. This higher ratio of current taxes on income and wealth is attributable to higher revenue from capital gains tax as well as provisional tax (which mainly constitutes tax on profits reported by companies and self-employed persons). Meanwhile, the level of tax from income on employment remained relatively stable reflecting the revision of the income tax brackets, as announced in the 2007 Budget. Moreover, receipts from the implementation of the Currency and Bank Deposits Registration Scheme contributed to the increase in the ratio of current taxes on income and wealth. In anticipation of Euro adoption, the scheme offered residents the opportunity to regularise their position in respect of their holdings of certain financial asset classes. This measure, which is included as a one-off measure in the Programme, yielded revenue amounting to 0.1 per cent of GDP.

In 2008, the tax ratio to GDP is expected to decline marginally as a lower ratio of proceeds from taxation on production and imports is expected to be partly offset by a marginal increase in the ratio of revenue from current taxes on income and wealth. The level of revenue from current taxes on income and wealth is expected to be affected by the tax measures announced in the 2008 Budget. Further details are provided in Chapter 5.

In 2009 and 2010, the downward trend in the ratio of total taxes to GDP is expected to be sustained as the slowdown in the rate of growth of taxes on production and imports as compared to GDP is expected to be only partly offset by a higher ratio of proceeds from current taxes on income and wealth to GDP.



### 3.1.2.2 Social Contributions

The ratio of social security contributions is expected to decline marginally to 7.7 per cent of GDP in 2007. Thereafter, this component of revenue is expected to follow a gradual downward path to reach 7.2 per cent of GDP in 2010. Whilst projections for social security contributions reflect projected compensation of employees, a slower growth in social security contributions compared to nominal GDP growth is expected owing to the capping of contributions to a wage ceiling.

### 3.1.2.3 Property and Other Income

Revenue from property income is expected to decline marginally during the Programme period from 1.3 per cent of GDP in 2006 to 1.0 per cent in 2010.

The 'other' component of revenue, which mainly includes revenue of Extra-Budgetary Units (EBUs), local councils, and other non-tax revenue including grants, is expected to decline significantly in 2007 to 3.7 per cent of GDP from 5.2 per cent a year earlier. This decrease is mainly underpinned by a substantial lower level of forthcoming funds under the Fifth Italian Financial Protocol and EU grant funds. The latter mainly reflects the commencement of the Financial Framework for the period 2007-2013, and the termination of temporary compensating grants associated with Malta's accession to the EU. In 2008, the 'other' component of revenue is expected to increase to 4.0 per cent of GDP. Thereafter, total revenue from this component is expected to decline to 3.5 per cent of GDP in 2009 and then remain broadly unchanged at 3.6 per cent of GDP in 2010. These developments largely reflect the expected time line for the implementation of projects financed from EU funds. Meanwhile, receipts of EBUs and local councils over the medium-term framework are not expected to register significant changes.

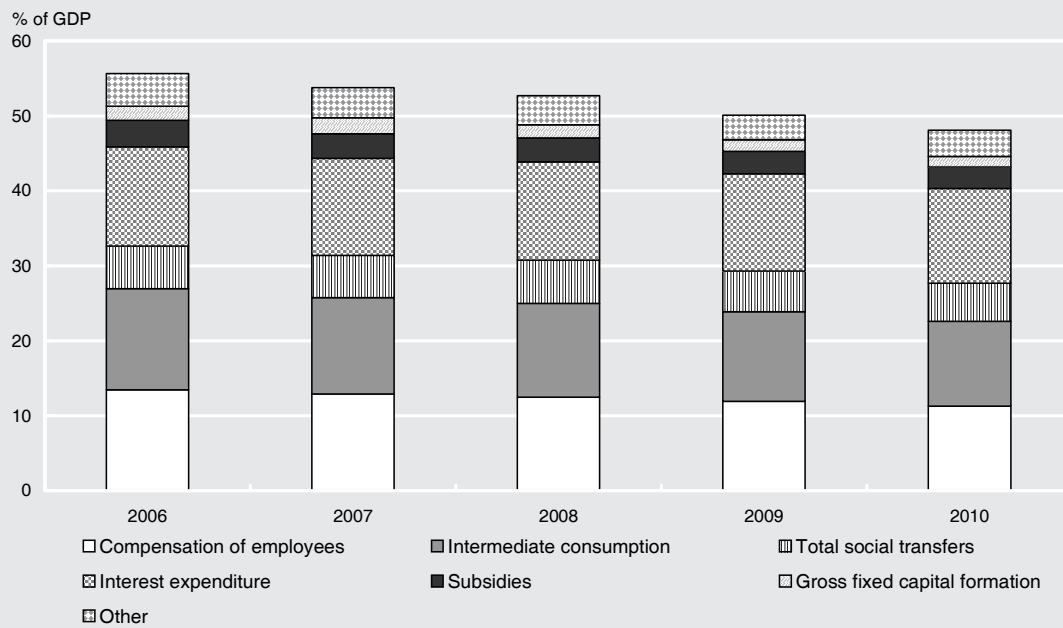
## 3.1.3 General Government Expenditure Projections

The ratio of general Government expenditure to GDP is expected to follow a declining trend over the medium-term. As presented in Table 3.1, which highlights the expenditure consolidation in the medium-term fiscal framework, total expenditure as a per cent of GDP is expected to decline by 5.6 percentage points between 2006 and 2010. Indeed, Government's commitment towards expenditure consolidation through stricter controls on expenditure outlays is reaffirmed in this Programme.

	2007	2008	2009	2010
<b>Expenditure</b>				
Compensation of employees	-0.6	-0.4	-0.5	-0.7
Intermediate consumption	0.0	0.1	-0.3	-0.3
Social Payments	-0.3	0.2	-0.2	-0.3
Interest Expenditure	-0.3	-0.1	-0.2	-0.2
Subsidies	0.2	-0.4	-0.2	-0.1
Gross Fixed Capital Formation	-0.3	-0.2	-0.6	0.2
Other	-0.2	0.2	-0.1	-0.1
<b>Total Expenditure</b>	<b>-1.4</b>	<b>-0.5</b>	<b>-2.2</b>	<b>-1.5</b>

Chart 3.4

### Composition of General Government Total Expenditure



The ratio of total Government expenditure to GDP is expected to decrease from 44.1 per cent in 2006 to 38.5 per cent in 2010, reflecting lower expenditure ratios for all components of expenditure, but in particular compensation of employees. Following the completion of the new hospital, as well as other major capital projects financed from the Fifth Italian Financial Protocol, the ratio of gross fixed capital formation to GDP is expected to decline by 0.3 percentage points of GDP in 2007, remain relatively stable in 2008, and decline further by 2010. Trends in gross fixed capital formation in the forecast period reflect the expected timing in the implementation of projects financed from EU funds. Chart 3.4 illustrates the developments in the components of general Government total expenditure between 2006 and 2010.

#### 3.1.3.1 Compensation of Employees

Over the Programme period, employee compensation is forecasted to decline from 13.5 per cent of GDP in 2006 to 11.3 per cent in 2010 as a result of measures implemented by Government to contain outlays on compensation for employees. Government's policy is to restrict recruitment in non-essential categories in the public sector. Hiring in the public sector, both new and replacements, requires vetting by an ad hoc committee co-chaired by the Permanent Secretaries within the Office of the Prime Minister and the Ministry of Finance, assisted by the Management and Personnel Office within the Office of the Prime Minister and the Budget Affairs Division and the Financial Management Monitoring Unit within the Ministry of Finance. Recruitment is being done on a strictly needs basis. Moreover, the development of online services by the public sector is also contributing to contain recruitment requirements in front-office operations. Indeed, employment in the general Government sector has declined by 3.8 per cent between 2003 and 2006.

#### 3.1.3.2 Intermediate Consumption

The ratio of intermediate consumption to GDP is expected to remain broadly stable in 2007 and 2008, before declining in the outer years of the Programme period. Government is committed to control the growth of intermediate consumption below GDP growth. To this intent, the Ministry of Finance ensures that all entities administer public funds within stricter financial control parameters - a policy that aids the Government in reducing public spending. Moreover, lower outlays on projects funded from EU Structural Funds, EU Transition Facility and EU Interreg, classified under such category also contribute to the decline in the ratio of intermediate consumption in 2009 and 2010.

### **3.1.3.3 Social Payments**

Social payments as a ratio of GDP are expected to follow a declining trend, over the forecast period, except in 2008. In fact, the ratio of social payments to GDP is expected to decline by 0.3 percentage points of GDP in 2007. However, it is expected to edge up in 2008 on account of an increase in children's allowance outlays reflecting the measures announced in the 2008 Budget. This ratio is projected to decrease again in the outer years of the Programme period to 12.7 per cent of GDP by 2010.

Notwithstanding the decline in the ratio to GDP, the major components of social payments, namely retirement and widows' pensions, pensions allowance and social assistance are nonetheless projected to register an increase in absolute terms. In this context, it is pertinent to highlight the recent reform implemented in the invalidity pension system, as well as the concerted effort to curb abuse of social benefits which was intensified with the setting up of the Benefit Fraud and Investigations Directorate within the Ministry for the Family and Social Solidarity in 2005. Consequently, social benefits are more effective as they target better the most needy.

### **3.1.3.4 Interest Expenditure**

Interest payments, which mainly consist of disbursements relating to long-term local loans, are projected to decline from 3.6 per cent of GDP in 2006 to 2.9 per cent of GDP in 2010. The reduction in the debt-to-GDP ratio is contributing to a lower share of outlays on interest payments.

Fiscal consolidation, as well as an improvement in Malta's credit rating in view of the adoption of the Euro as the national currency, affect the risk premium and are expected to contain further the growth of interest expenditure below GDP growth.

### **3.1.3.5 Subsidies**

Subsidies are expected to increase by 0.2 percentage points to 2.1 per cent of GDP in 2007. Thereafter, subsidies are expected to follow a downward trend to 1.4 per cent in 2010. This mainly reflects lower financial support to the shipyards sector in line with the provisions of the Accession Treaty. Whilst Government will aim to achieve a viable position for the shipyards, in case this does not fully materialise, financial provisions have been included in the fiscal projections for schemes in line with mechanisms implemented in the past which are in line with EU regulations.

### **3.1.3.6 Gross Fixed Capital Formation**

The ratio of gross fixed capital formation to GDP is estimated to decline from 4.3 per cent of GDP in 2006 to 4.0 per cent in 2007. The completion of the new hospital in the second half of 2007, as well as the completion of other major capital projects partly financed from the 2004-2006 EU funds and the fifth Italian Financial Protocol, account for this drop. In 2008, the ratio of gross fixed capital formation to GDP is anticipated to remain relatively stable as further declines in capital outlays relating to the new hospital are expected to be in part offset by capital projects partly financed from funds forthcoming from the EU.

The ratio of gross fixed capital formation to GDP is expected to decline to 3.3 per cent of GDP in 2009, while in 2010 the ratio of gross fixed capital formation will increase to 3.5 per cent. Developments in capital outlays in the last two years of the Programme reflect the implementation of projects financed from EU funds under the 2007-2013 Financial Framework as well as projects financed from national sources.

In this context, it is noteworthy to highlight that if capital expenditure relative to the new hospital is excluded, the ratio of gross fixed capital formation to GDP will increase from 2.9 per cent in 2007 to 3.3 per cent in 2008. In 2009 the ratio of gross fixed capital formation to GDP would remain stable at 3.3 per cent but it will increase to 3.5 per cent in 2010.

### 3.1.3.7 Other Expenditure Components

The 'other' expenditure category is expected to decline from 1.9 per cent of GDP in 2006 to 1.7 per cent in 2007, mainly underpinned by lower acquisition of property. In 2008, the 'other' expenditure category is expected to increase to 2.0 per cent reflecting lower one-off revenues from sale of property, which is recorded as negative expenditure in the 'other' expenditure category. This is in line with Government's policy to decrease dependence on one-off measures for fiscal consolidation. During the outer years of the Programme period, the 'other' expenditure category is expected to decline to reach 1.7 per cent of GDP by 2010.

## 3.2 Structural Adjustment

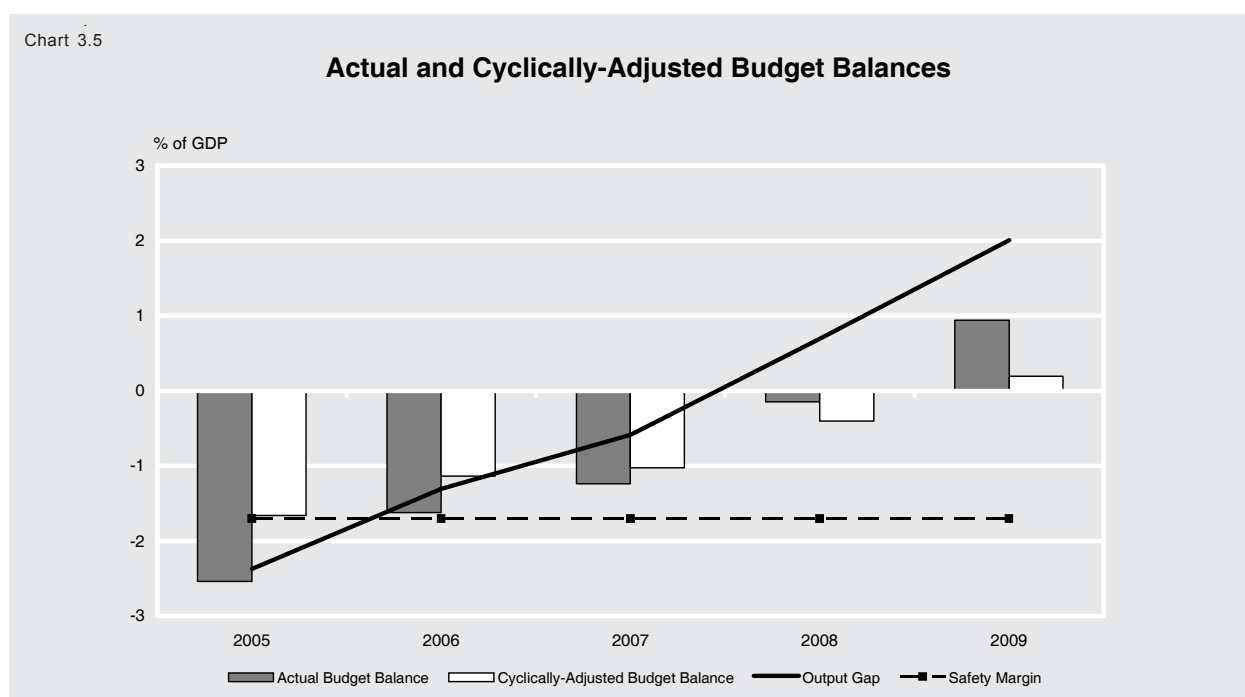
The fiscal consolidation expected to be undertaken in the medium-term framework should be viewed in the context of a recovery in economic growth. This is expected to result in a declining output gap from a negative of 1.3 per cent of GDP in 2007 turning positive in 2009 and reaching 2.0 per cent of GDP in 2010.

If one were to correct for cyclical developments occurring during the forecast period, the cyclically adjusted budget deficit records an improvement from 1.1 per cent of GDP in 2007 to a surplus in 2010. Excluding one-off revenue measures, the structural balance improves from 1.9 per cent of GDP in 2007 to a marginal structural budget surplus in 2010.

It is notable that the cyclically adjusted budget balance between 2007 and 2010 is within the safety margin for Malta, estimated at 1.7 per cent of GDP. This implies that should an unexpected negative shock affect the Maltese economy, automatic stabilisers can be allowed to act freely without undermining the 3 per cent deficit target.

It is also noteworthy that the fiscal adjustment projected in the medium-term framework is less reliant on one-off measures which are not expected to exceed 0.2 per cent of GDP between 2008 and 2010. Underlying the substantial improvement in public finances in the medium term is a fiscal adjustment driven primarily by expenditure restraint and consolidation.

The medium-term framework is underpinned by an average annual adjustment of 0.6 per cent of GDP between 2008 and 2010. The structural effort remains in excess of the minimum 0.5 percentage point of



**Fiscal Consolidation**  
as a percentage of GDP

Table 3.2

	2005	2006	2007	2008	2009	2010	Annual Average Adjustment 2008/2010
General Government Balance	-3.0	-2.5	-1.6	-1.2	-0.1	0.9	0.9
One-off Measures	1.6	0.7	0.8	0.2	0.2	0.1	
General Government Balance net of One-offs	-4.7	-3.2	-2.4	-1.4	-0.3	0.8	1.1
Output Gap Estimates	-2.7	-2.4	-1.3	-0.6	0.7	2.0	
Cyclically-Adjusted Budget Balance	-2.0	-1.7	-1.1	-1.0	-0.4	0.2	0.4
Structural Balance	-3.7	-2.3	-1.9	-1.2	-0.6	0.1	
Structural Adjustment	0.7	1.3	0.4	0.7	0.6	0.6	0.6

GDP structural adjustment required by the SGP. The excess allows a sufficient structural adjustment after allowing for the necessary investments required by the Maltese economy in order to sustain the process of convergence, particularly the implementation of reforms within the Lisbon framework.

### 3.3 The Medium-Term Budgetary Objective (MTO)

Over the three-year period between 2008 and 2010 an accumulated adjustment of 1.9 per cent of GDP is projected. The structural adjustment projected for the period under analysis should allow Malta to reach the MTO of a balanced structural budget position in 2010. This target is within the MTO set out in the December 2005 Update of the Convergence Programme, which target is expected to be achieved in 2010.

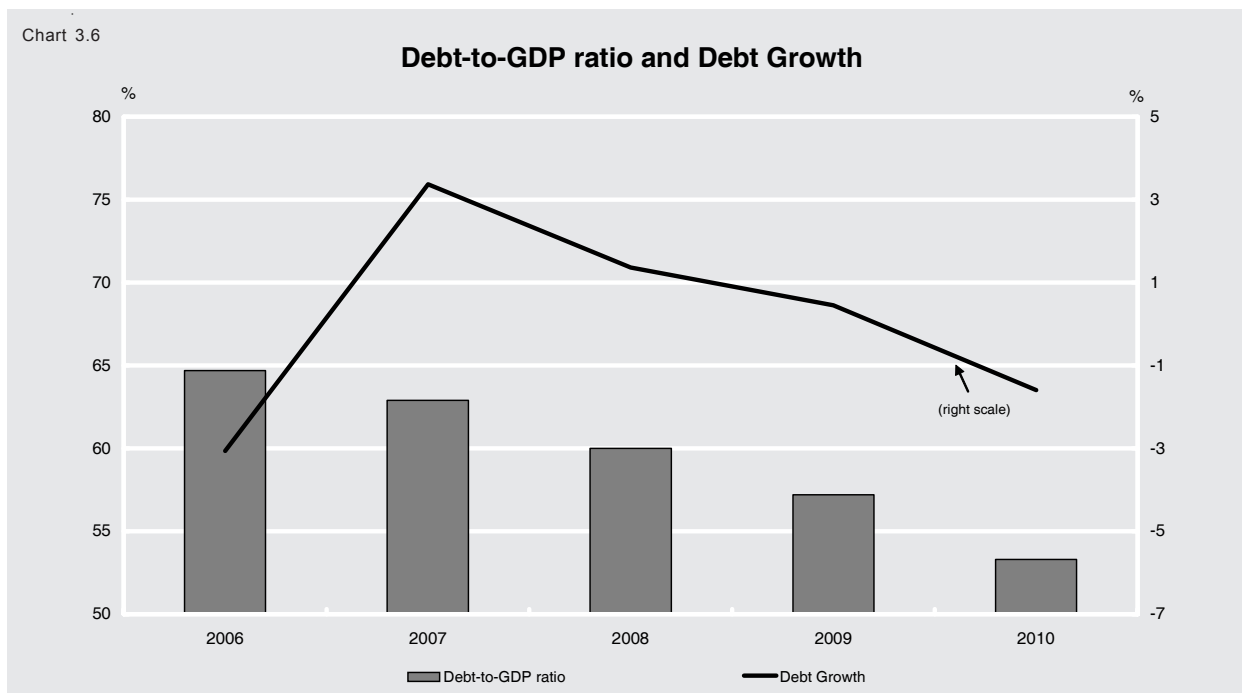
### 3.4 Debt Levels and Developments

Government's fiscal consolidation programme focuses not only on addressing the fiscal imbalance in a gradual and consistent manner but also on the attainment of a declining debt-to-GDP ratio. In turn, this will also contribute towards an improvement in the fiscal position through lowering of the debt servicing costs. It is Government's objective to ensure that the financing needs of the public sector are met at the lowest possible cost whilst minimising the level of exchange and interest rate risk in the medium and long term.

Malta's Government debt is almost totally denominated in local currency. Indeed, foreign debt accounts for only 4.0 per cent of total Government debt and thus the risk of exchange rate fluctuations is negligible. This exchange rate risk will be even lower after Euro adoption. Total Government debt is characterised by long-term debt with only around 23.0 per cent of total debt maturing during the 2008-2010 period. Together with the improvement in the fiscal position over the Programme period, this implies that the projected amount of new debt issuances will be very low in relation to the total stock of debt outstanding. As a result, it is estimated that a 1.0 per cent increase in interest rate payments will exert a relatively minimal effect on total interest expenditure. This implies that the fiscal balance is not highly sensitive to a change in interest rates.

#### 3.4.1 Projected Debt Developments

Developments in the debt-to-GDP ratio are conditioned primarily by the trajectory in the primary deficit, the real rate of interest and the growth rate of the economy. Moreover, other factors which influence the debt



ratio are captured by the stock flow adjustment. The debt-to-GDP ratio is expected to decline by 9.6 percentage points from 62.9 per cent in 2007 to 53.3 per cent in 2010. In 2006, the debt ratio fell significantly to 64.7 per cent of GDP, reflecting both the reduction in the fiscal deficit as well as privatisation proceeds. In 2007, the debt-to-GDP ratio is expected to decline by a further 1.9 percentage points. As illustrated in Chart 3.6, in subsequent years, the debt ratio is expected to maintain a downward trend to reach the reference value of 60 per cent by 2008. Indeed, the debt ratio is expected to decline by around 2.8 percentage points in both 2008 and 2009, and a further 3.9 percentage points in 2010. Statistical Appendix Table 4 presents developments in the debt ratio for the Programme period as well as the contributors to the downward trajectory path of the debt ratio.

Throughout the 2007-2010 period, the primary balance is expected to be the main contributor to the change in the debt-to-GDP ratio. Indeed, the primary surplus projected for this period will exert an increasing contractionary effect on the debt ratio of 1.7 percentage points and 2.0 percentage points in 2007 and 2008, respectively. Thereafter, the increasing primary surplus is expected to exert an even higher contractionary effect on the debt ratio of 2.9 percentage points and 3.8 percentage points in 2009 and 2010 respectively.

The trajectory of the debt ratio is also dependent on the relative contributions of the real rate of interest and the real GDP growth rate, referred to as the 'snowball effect'. Throughout the projected period, the 'snowball effect' is expected to contribute positively to the reduction of the debt ratio reflecting an increasing effect exerted by interest payments which is more than offset by the decreasing effect exerted by real GDP growth and inflationary pressures.

As illustrated in Table 3.3, in 2007, the 'snowball effect' is expected to exert a debt decreasing effect of around 0.6 percentage points. In 2008, the 'snowball' effect is expected to contribute to the reduction in the debt ratio by a lower magnitude of 0.4 percentage points and this contribution is expected to fall further to 0.1 percentage points in both 2009 and 2010. Indeed, interest payments are expected to increase the debt-to-GDP ratio by around 3.2 percentage points in 2007 and 2008, falling to around 3.0 per cent in the outer years of the Programme. Nominal GDP growth is expected to contribute to a reduction in the debt ratio ranging between 3 and 4 percentage points yearly.



### The Dynamics of Government Debt<sup>(1)</sup>

Table 3.3

Percentages of GDP	2006	2007	2008	2009	2010
Gross debt	64.7	62.9	60.0	57.2	53.3
Change in gross debt	-6.1	-1.9	-2.8	-2.9	-3.9
<b>Contribution to change in gross debt</b>					
Primary Balance	-1.0	-1.7	-2.0	-2.9	-3.8
Snowball Effect	-0.5	-0.6	-0.4	-0.1	-0.1
Interest Expenditure	3.6	3.3	3.2	3.0	2.9
Real GDP growth	-2.2	-2.2	-1.9	-1.9	-1.9
Inflation Effect	-1.9	-1.7	-1.8	-1.2	-1.2
Stock-flow adjustment	-4.6	0.4	-0.4	0.1	0.1
p.m. implicit interest rate on debt	5.3	5.4	5.4	5.3	5.3

<sup>(1)</sup> Developments in the debt- to-GDP ratio depend on: 
$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left( \frac{D_{t-1}}{Y_{t-1}} \cdot \frac{i_t - y_t}{1 + y_t} \right) + \frac{SFA}{Y_t}$$

where t denotes a time subscript, D, PD, Y and SFA are the government debt, primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth.

In 2006, the stock-flow adjustment component contributed significantly to the reduction of the debt ratio mainly reflecting privatization operations. In 2007, the stock flow adjustment is estimated to increase the debt ratio by 0.4 percentage points. While privatisation operations took place during 2007 as highlighted in Section 5.4, it is pertinent to note that proceeds from privatisation have, to date, been retained as ‘currency and deposits’ and thus had a neutral effect on the net accumulation of financial assets. Consequently, privatisation operations did not contribute to the reduction in the debt ratio in 2007. In contrast with 2007, in 2008 the stock flow adjustment is expected to exert a contractionary effect of around 0.4 percentage points. This component is expected to be negligible in 2009 and 2010.

#### 3.4.2 Comparison with the December 2006 Update of Convergence Programme

The ratios of general Government debt-to-GDP presented in this Programme are expected to be significantly lower when compared to those presented in the previous Programme. These downward revisions, which range from 3.8 percentage points in 2007 to 2.2 percentage points in 2009, mainly reflect upward revisions in the level of GDP while a lower level of debt also contributed to the revisions in 2007 and 2008. As a result of these revisions, in this Programme, the debt-to-GDP ratio is expected to reach the 60.0 per cent reference value in 2008 rather than in 2009 as projected in the 2006 Update of Convergence Programme.

The debt-to-GDP ratio for 2006 was revised downwards from 68.3 per cent in the 2006 Programme to 64.7 per cent in this Programme. This was mainly attributed to an upward revision in GDP which lowered the debt ratio by 2.8 percentage points. This downward pressure on the debt-to-GDP ratio was augmented by a lower level of debt, which contributed an additional 0.8 percentage points to the downward revision of the debt ratio for 2006.

The debt-to-GDP ratios for 2007 and 2008 were revised downwards primarily as a result of revisions in the nominal level of GDP while revisions in the debt levels also contributed to the lowering of the debt-to-GDP ratio projected in this Programme. Indeed, the debt ratio was revised downwards by 3.8 percentage points in 2007, as the upward revision in GDP lowered the debt ratio by 2.9 percentage points while the remaining revision of 1.0 percentage point resulted from lower debt levels. The debt-to-GDP ratio for 2008 was revised downwards by 3.2 percentage points, of which 2.8 percentage points were attributed to revisions in GDP.

For 2009, the revision in the debt-to-GDP ratio was fully attributed to revisions in GDP growth. In fact, while the debt-to-GDP ratio was revised downwards by 2.2 percentage points from 59.4 per cent to 57.2 per cent, revisions in nominal GDP contributed to the lowering of the debt ratio by 2.3 percentage points. On the other hand, the expected debt level was marginally revised upwards contributing to 0.1 percentage point increase in the debt ratio.

As a result of these developments, the annual downward adjustments projected for the 2007-2009 period were revised accordingly. In the December 2006 Update of Convergence Programme, the debt-to-GDP ratio was expected to decline from 68.3 per cent in 2006 to 59.4 per cent in 2009. This reflected a decline of 1.6 percentage points in 2007 and further declines amounting to around 3.7 percentage points in both 2008 and 2009. In contrast, the debt-to-GDP ratio presented in the 2007 Programme is expected to decline from 64.7 per cent in 2006 to 57.2 per cent in 2009. This implies that this Programme projects a higher downward adjustment in the debt ratio in 2007. In contrast, a lower downward adjustment is projected for 2008 and 2009.

#### **4. Sensitivity Analysis and Comparison with the December 2006 Update of Convergence Programme**

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# 4. Sensitivity Analysis and Comparison with the December 2006 Update of the Convergence Programme

## 4.1 Sensitivity Analysis

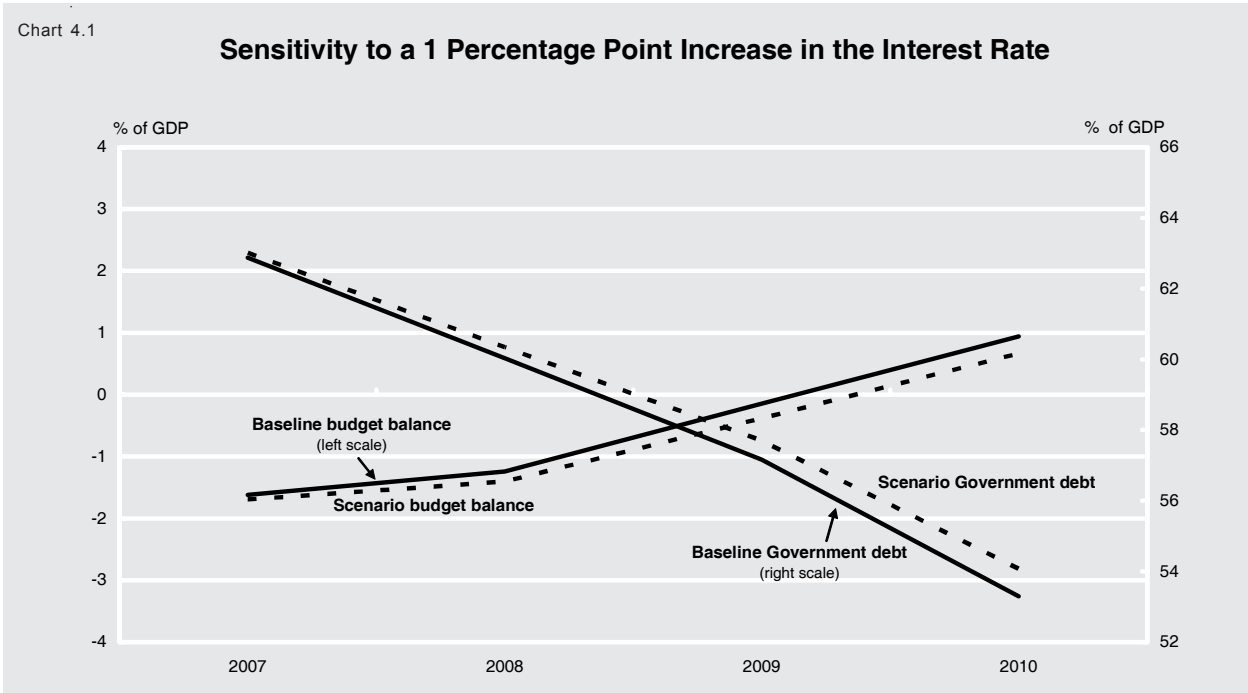
Forecasting exercises are subject to a degree of uncertainty. Thus it is important to analyse the sensitivity of the macroeconomic and budgetary forecasts to changes in the underlying macroeconomic assumptions.

This Chapter presents the results of three alternative sensitivity scenarios, and in each case, 2007 is considered as the first year of the forecast. The three different scenarios are a change in the interest rate, an increase in economic activity in Malta’s main trading partners, leading to a higher external demand for domestically produced goods and services, and a higher rate of economic growth. The results of these scenarios are presented in terms of the effect of the deviation from the baseline on the GDP, General Government Budget Deficit, and Gross General Government debt. Charts 4.1, 4.2 and 4.3 illustrate these sensitivity changes and are similar to those presented in the Update of the Convergence Programme 2006-2009. There are no major changes in the sensitivity analyses that need to be reported in this Update as there have been no substantial structural changes in the Maltese economy during the same period.

It is important to note that given the uncertainty involving the responses in the economic environment to shocks, the results of the sensitivity analysis featured here should be taken as indicative.

### 4.1.1 Sensitivity to Interest Rate Fluctuations

A domestic interest rate shock is expected to affect economic activity through the real and monetary sectors. The magnitude of these changes depends on the degree of elasticity of the components of output to changes in the interest rate. Furthermore, a change in the interest rate affects also Government finances through the impact on components of revenue and expenditure that are sensitive to economic activity as well as the effect of changes in the interest rate on the debt servicing costs. However, it is noteworthy that taking into consideration the long-term nature of Government debt in Malta, changes in the interest rate are mainly expected to affect the debt servicing costs in relation to the rolling-over of past long term debt and new issues



of stock. Therefore, the impact of a change in the interest rate on the deficit and debt positions is expected to be relatively low.

This scenario models an increase in the interest rate of 1 percentage point between 2007 and 2010. In reflection of this change, economic growth is expected to decline by around 0.1 percentage points in 2007 and remain practically unchanged in the subsequent years. Moreover, this increase in the interest rate will worsen the budget balance by 0.3 percentage points of GDP by the end of the forecast period and it will also increase the Government debt-to-GDP ratio by around 0.8 percentage points at the end of the forecast period when compared to the baseline. Since the impact of this shock on the total revenue in the budget balance is negligible, the change indicates an increase in total expenditure which amounts to around 0.4 per cent by the end of the forecast period.

#### 4.1.2 Sensitivity to Change in External Demand

The shock in this scenario is modeled as a 1 percentage point in the external demand in the first year and throughout the forecast horizon until 2010.

When there is a positive shock in external demand for domestically-produced goods and services, this is expected to generate an increase in aggregate demand and consequently an increase in output. The latter, through the multiplier effect, is expected to affect positively the domestic economy. Nevertheless, given the high degree of import-content of domestically produced goods and services, the effect of an increase in demand for exports on output and economic growth is expected to be partly offset by a subsequent increase in imports.

The increase in external demand is expected to raise real GDP by around 0.5 percentage points at the end of forecast period when compared to the base scenario. The shock is also expected to result in an improvement in the budget balance by 0.4 percentage points of GDP when compared to the baseline whilst the Government debt-to-GDP ratio is estimated to decline by around 1.6 percentage points by the end of the forecast period. The developments in the budget balance mainly reflect an increase in total revenue of 0.7 per cent by 2010 as the impact on total expenditure is negligible.

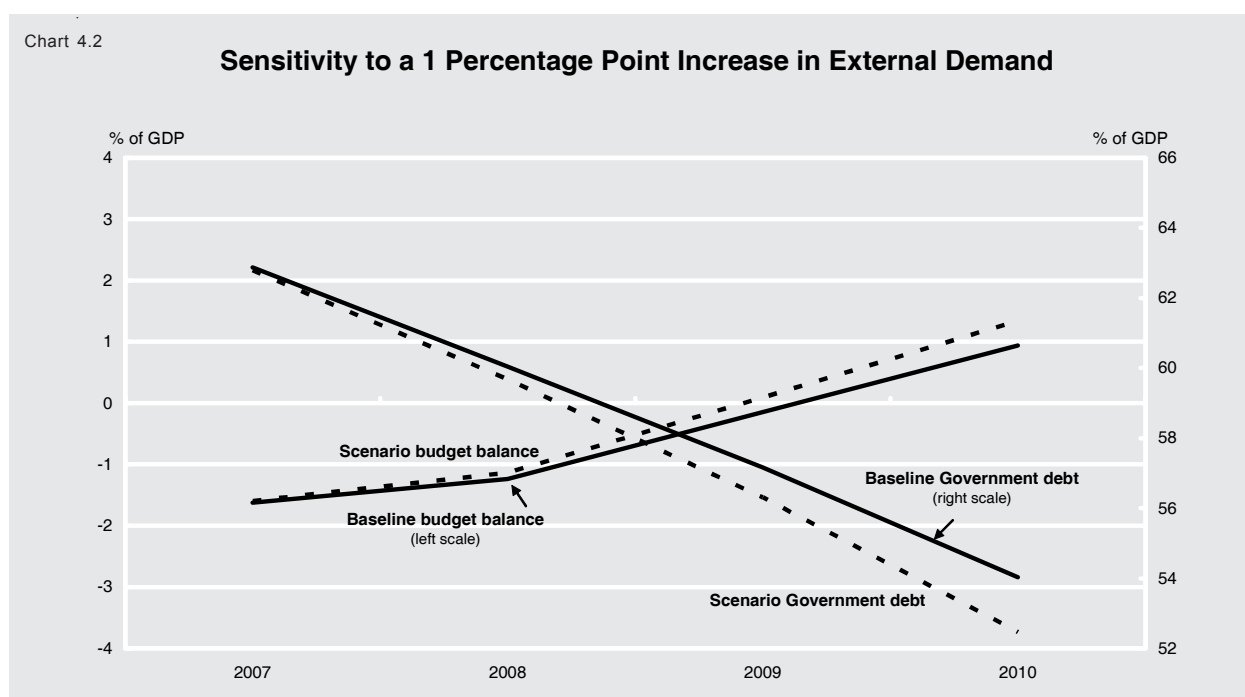
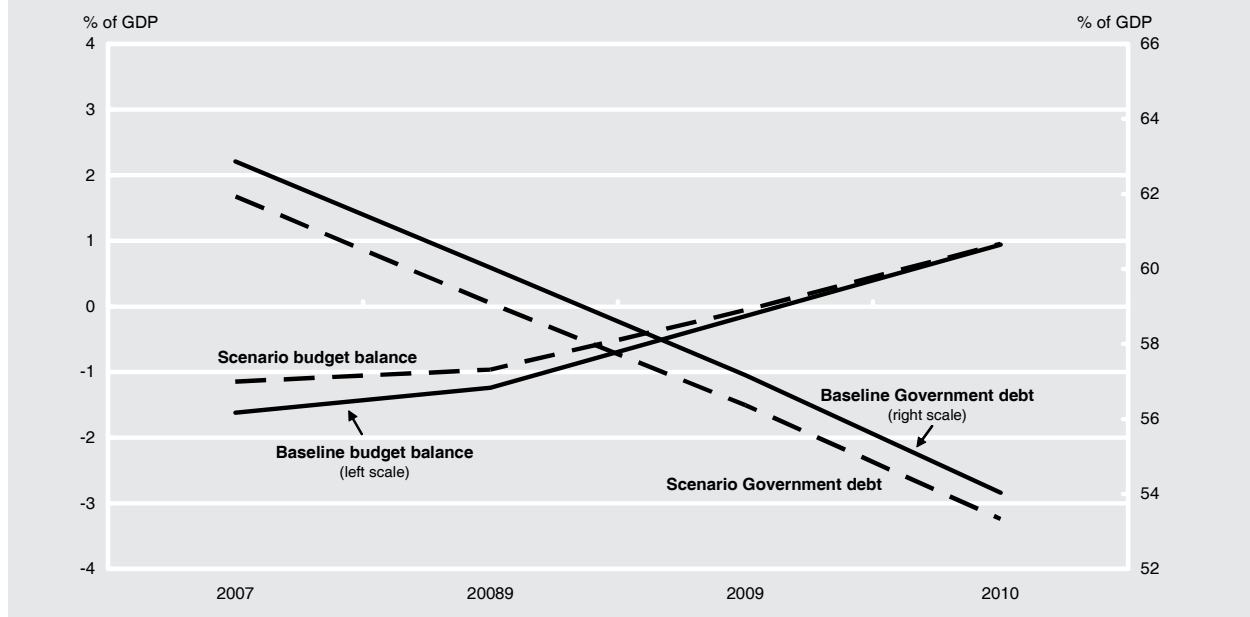


Chart 4.3

### Sensitivity to a 1 Percentage Point Increase in GDP



#### 4.1.3 Sensitivity to Change in the Growth Rate of Real Gross Domestic Product

This subsection models a 1-percentage point increase in GDP. It is assumed that this increase in the growth rate of real GDP is stimulated through an increase in private final consumption expenditure, resulting in higher demand for goods and services. This rise in demand, consequently generates an increase in domestic output as well as an increase in demand for imports of goods. The latter is expected to partly offset the positive effects of the increase in consumption.

The budget balance is expected to show an improvement of around 0.5 percentage points upon impact and 0.3 percentage points in 2008, remaining unchanged from the baseline scenario thereafter. On the other hand, Government debt as a percentage of GDP is expected to decline by 0.7 percentage points by 2010, when compared to the baseline scenario. Total revenue increases by 0.9 per cent upon impact, though by the end of the forecast period total revenue is unchanged relative to the baseline. Additionally, the increase in consumption has a negligible impact on total expenditure by the end of the forecast period.

## 4.2 Comparison with the Projections in the December 2006 Update of Convergence Programme

### Economic Growth<sup>1</sup>

The main revisions in real economic growth are largely concentrated in 2007, with forecasts for 2008 and 2009 remaining effectively unchanged. The economic growth forecast for 2007 presented in this Programme has been revised upwards by 0.5 percentage points to 3.5 per cent. The improved outlook for the Maltese economy reflects the latest published national accounts data. During 2006 the economy grew by 3.2 per cent, compared to a forecast growth rate of 2.9 per cent expected in the December 2006 Update of the Convergence Programme. Provisional data suggests that during the first half of 2007, the Maltese economy registered a growth rate of 3.6 per cent. The GDP growth rate for 2008 is unchanged whilst that of 2009 has been marginally revised to 3.2 per cent from 3.1 per cent forecasted in the previous Update.

Nevertheless there were changes in the composition of growth. In 2006, the contribution of the external sector to economic growth was positive, compared to a negative contribution expected in the 2006 Update. This more than offset the lower contribution to economic growth registered by the domestic sector. This rebalancing of economic growth contribution from the domestic sector to the external sector persisted in the

first six months of 2007. In this context, the contribution of the external sector in 2007 is expected to be 2.4 percentage points as opposed to the negative of 0.4 percentage points presented in the previous forecast. Moreover, the domestic sector's contribution to economic growth has been revised downwards to 1.3 per cent from the 3.4 per cent expected last year.

Private consumption expenditure has been revised downwards by 0.3 percentage points for 2007 and by 0.6 and 0.1 percentage points for 2008 and 2009 respectively. This downward revision was triggered by a considerably lower growth rate of 1.3 per cent in private consumption in 2006, compared to a forecast of 2.6 per cent growth in the December 2006 Update of the Convergence Programme. Furthermore, the higher outlook in respect of inflation for 2008 and 2009 is expected to somewhat weigh negatively on the expected increase in disposable income.

In view of the latest trends in available data, Government consumption expenditure has been revised upwards by 1.0 percentage points in 2007 and by 0.2 percentage points in 2008. On the other hand in line with recent fiscal forecasts, the growth rate in Government consumption has been revised down significantly in 2009 from a marginal positive growth of 0.5 per cent in the 2006 Update to a decline of 1.9 per cent in this Programme.

Gross fixed capital formation for 2007 has been significantly revised downwards to a negative growth rate of 2.9 per cent. This revision reflects a significantly lower growth in the latest published national accounts data for 2006 and the first two quarters of 2007. Growth in gross fixed capital formation in 2008 and 2009 has been revised upwards by 4.5 and 3.5 percentage points respectively. The 2008 revision reflects a lower base effect in public sector investment.

Downward revisions in the external sector reflect the lower growth rates compared to earlier expectations in exports and imports registered during the first two quarters of 2007, and the heightened risk levels currently prevailing in the international economic environment. In particular, these reflect the recent turmoil in credit markets as well as price developments in commodity markets. Such downward revisions were carried out over the entire forecast horizon on both exports and imports forecasts. Hence, export growth for 2007 has been revised downwards by 4.0 percentage points to a negative 1.7 per cent, whilst export growth for 2008 and 2009 has been revised downwards by 1.8 percentage points and 1.3 percentage points respectively. Such downward revisions in real export growth also resulted from higher forecasted deflators when compared to last year. Similarly, import growth has been revised downwards to a negative growth rate of 3.9 per cent for 2007 and by 0.6 and 1.1 percentage points respectively for 2008 and 2009.

Furthermore, in line with the latest published national accounts data the contribution of the external sector in economic growth has been revised upwards by 2.8 percentage points to 2.4 per cent in respect of 2007. The contribution of the external sector has been revised downwards by 0.7 percentage points for 2008 whilst for 2009 the contribution is largely in line with that outlined in the December 2006 Update of the Convergence Programme.

### **Inflation and Employment prospects**

The downward trend forecasted in December 2006 Update of the Convergence Programme in respect of the 2007 inflation rate did materialise. However the magnitude of the decline was larger than expected. In this context the forecast for inflation was reduced by 1.3 percentage points to 0.9 per cent. However, in view of the potential inflationary repercussions of the recent developments in the commodities market, the inflation rate for 2008 and 2009 has been revised upwards by 0.4 and 0.3 percentage points respectively.

The forecast for the 2007 unemployment rate is largely in line with last year's forecast, yet over the forecast period unemployment has been revised marginally upwards in view of the forecasted softening in economic growth in 2008. In line with recently published data, the employment growth for 2007 has been revised



upwards by 0.5 percentage points to 1.6 per cent. However, employment growth in later years is expected to remain significant though at a slower pace.

*Note:*

<sup>1</sup>Projections contained in this Programme reflect the latest National Accounts published by the National Statistics Office (NSO) including provisional estimates for the first half of the year 2007.







## 5. Quality of Public Finances

The consolidation of fiscal balances, notably the further reduction in the fiscal deficit in line with the requirements of the Stability and Growth Pact, remains one of Government's main medium term fiscal and economic policy objectives. Government expects that this trajectory path of the fiscal balance reflects in a declining general Government debt ratio, reaching the 60 per cent reference value within the Programme period.

### 5.1 The 2008 Budget

Government's fiscal target of achieving a deficit below the 3 per cent of GDP reference value was achieved in 2006 while additional consolidation is expected during the current fiscal year. Indeed, in 2007, the deficit ratio is expected to decline further to 1.6 per cent. In 2008, the deficit ratio is expected to continue on a downward path to reach 1.2 per cent.

The 2008 Budget continues to build upon previous Budgets and aims for fiscal consolidation while at the same time channelling the economy towards more growth and employment. Fiscal consolidation is expected to be achieved through restraints on the expenditure side. This would ensure that fiscal consolidation is not achieved at the cost of reducing the economy's competitiveness. Within this context, the 2008 Budget announced a number of measures to boost the supply-side of the economy and to enhance social cohesion.

### 5.2 Structural Measures

This Chapter firstly reviews the main fiscal measures announced in the 2008 Budget and their budgetary impact. Section 5.4 then provides an analysis of the composition of the fiscal effort for 2008.

#### Deficit-Reducing One-Off Operations

In 2008, the reliance on deficit-reducing one-off operations is expected to decline significantly when compared to the previous year. In fact, receipts from one-off operations in 2008 are expected to amount to €9.3 million as compared to €40.3 million in 2007. It is noteworthy that the one-off revenue stream in 2007 reflects the proceeds from the sale of Government property as well as receipts from the Currency and Bank Deposits Registration Scheme. In 2008, one-off revenues relate to the sale of property.

#### Growth Enhancing Measures

The economic recovery recorded since 2005 has been sustained during the first six months of 2007. As the economy's rebound gathers momentum, a closing in the output gap can provide a stumbling block to further sustainable economic growth. In this context, the expansion of the economy's productive capacity becomes critical. To this end, Government announced a number of initiatives with the specific intent of enticing a higher work effort in the economy. In addition, a number of incentives were announced to promote the growth of emerging sectors including the arts and culture sector.

In the 2008 Budget, Government built further upon the revision in the income tax bands initiated in the 2007 Budget. In fact, the income tax paid by employees has been reduced further by extending the tax-free range of household income and by broadening the income tax brackets. This measure is expected to have a gross budgetary impact of around €28 million.

In order to further promote employment amongst disadvantaged groups, the Budget for 2008 announced a measure to exempt long-term unemployed aged over forty-five years who start-up their own business from national insurance contribution during their first year of operation. This measure is expected to have a gross budgetary impact of around €0.6 million. In addition, a measure was introduced whereby persons who reach

## Main Measures Budget 2008

Table 5.1

	€ million	Percentage of GDP
<b>Main Measures impacting on Revenue</b>		
Change in income tax bands	-28.0	-0.5
Revisions in income tax exemptions	-1.7	—
Amendments in respect of duty on documents	-3.4	-0.1
<b>Total</b>	<b>-33.1</b>	<b>-0.6</b>
<b>Main Measure impacting on Expenditure</b>		
Increases in children's allowance and other family benefits	11.9	0.2
Increases in benefits to pensioners	6.3	0.1
Incentives to encourage work on a self-employed basis	0.6	—
Measures to facilitate purchase of property by first time buyers	2.3	—
<b>Total</b>	<b>21.1</b>	<b>0.4</b>

pension age but decide to continue working will receive a pension irrespective of the income earned. Previously, such persons, if under 65 years of age, were disqualified from receiving a pension if they earned a weekly income which exceeded the National Minimum Wage.

### Social Cohesion Measures

In line with Government's social policy, in the Budget for 2008, on the redistribution front, Government announced measures to enhance support to clearly-targeted disadvantaged strata of the population. These initiatives support pensioners, families with children and first-time property buyers amongst others.

Measures targeting specific social groups and families include the introduction of income tax exemptions for senior citizens residing in certain classes of old people's homes. Assistance will also be given to encourage the diffusion of a healthier lifestyle for children. Moreover, a new deduction from income tax was introduced in respect of the expenses incurred on children attending private kindergartens. This measure is intended to affect positively the work-life balance, and thus contribute to increasing the female participation rate. In total, these measures are expected to have a gross impact of €1.7 million.

The Budget for 2008 announced various revisions to the system of children's allowance which result in higher allowances to families with children, especially those with low income and those having more than one child. On a more general level, the minimum children's allowance to families with children was extended. Other revisions include the lowering of the minimum household income limit for children's allowance purposes and doubling the allowance from the second child onwards. Moreover, other family benefits, such as orphans and fostering allowances were also increased. It is estimated that these measures will increase Government expenditure by €11.9 million.

To improve the standard of living of senior citizens, the Maltese Government announced a number of measures to increase the disposable income of pensioners. These measures are expected to increase Government expenditure by €6.3 million.

To facilitate access to the housing market by first-time property buyers, Government announced financial assistance schemes which will facilitate purchase of property whenever specific conditions are met. These measures are estimated to have an impact of around €2.3 million.

Furthermore, the 2008 Budget announced a number of amendments in respect of duty on documents aimed at facilitating home ownership. Such measures are expected to have a budgetary impact of €3.4 million.

### **5.3 Privatisation**

During 2007, Government sold 74 per cent of its shareholding in an operating company licensed to carry out towing activities within and between the harbours of Malta for €24.7 million. Government also divested 25 per cent of its shareholding in the local postal services company for €2.3 million. Government also intends to sell its remaining 40 per cent stake in this company on the Malta Stock Exchange (MSE) over the coming months. Government is not expected to raise significant revenue from privatisation of assets during the period 2008-2010.

### **5.4 Determinants of the 2008 Fiscal Outcome**

Government remains committed to reduce further the imbalance in public finances to achieve a sustainable fiscal stance. To this end, the general Government deficit is projected to fall to 1.6 per cent of GDP in 2007, and to continue to decline thereafter. Indeed, in 2008, the budget deficit ratio is expected to decline to 1.2 per cent of GDP, representing an improvement of 0.38 percentage points of GDP.

The decline in the fiscal imbalance in 2008 is driven by expenditure reducing measures. In fact, whilst the revenue-to-GDP ratio is expected to decline, a decrease of a bigger magnitude is expected in expenditure as a proportion of GDP. Table 5.2 and Chart 5.1 illustrate the sources of improvement in the deficit-to-GDP ratio in 2008.

The negative contribution of revenue to the fiscal imbalance reflects a number of measures announced in the 2008 Budget. These measures, of which the revision in the income tax bands has the largest impact, have an adverse effect on the deficit-to-GDP ratio of 0.58 percentage points of GDP.

The negative impact of revenue-reducing measures will be partly offset by tax revenue buoyancy and stricter enforcement of tax collection, as well as an increase in 'other' revenue. Indeed, tax revenue buoyancy and enforcement will have a positive impact of 0.19 percentage points on the deficit-to-GDP ratio, whereas changes in 'other' revenue (which includes EU funds) will yield a decline in the deficit ratio of 0.31 percentage points of GDP.

The decline in the deficit-to-GDP ratio mainly reflects a lower expenditure ratio that is expected to fall from 42.7 per cent in 2007 to 42.2 per cent in 2008. This is mostly due to a decline in compensation of employees and subsidies. Employee compensation is forecasted to decline from 12.9 per cent of GDP in 2007 to 12.5 per cent in 2008, reflecting a continuation of Government's policy regarding recruitment in the public sector. Meanwhile, subsidies are expected to decline by 0.37 percentage points of GDP in 2008 mainly reflecting lower financial support to the shipyards sector.

Intermediate consumption is expected to have an expansionary effect on the deficit-to-GDP ratio in 2008 as the ratio of intermediate consumption to GDP is expected to increase from 5.6 per cent in 2007 to 5.8 per cent in 2008.

Social payments as a ratio of GDP are expected to increase and hence contribute to a 0.17 percentage point increase in the ratio. The expansionary effect of social payments on the deficit is mainly on account of higher retirement pensions and an increase in children's allowance reflecting the measures announced in the 2008 Budget.

## Analysis of Improvement in Deficit-to-GDP Ratio for 2008

(percentage points)

Table 5.2

Revenue reducing measures	-0.58	
Tax revenue buoyancy and enforcement	0.19	
Other	0.31	
<b>Change in revenue ratio</b>		<b>-0.09</b>
Compensation of employees	0.40	
Intermediate consumption	-0.14	
Total social transfers	-0.17	
Interest expenditure	0.08	
Subsidies	0.37	
Gross fixed capital formation	0.17	
Other	-0.24	
<b>Change in expenditure ratio</b>		<b>0.47</b>
<b>Improvement in deficit ratio</b>		<b>0.38</b>

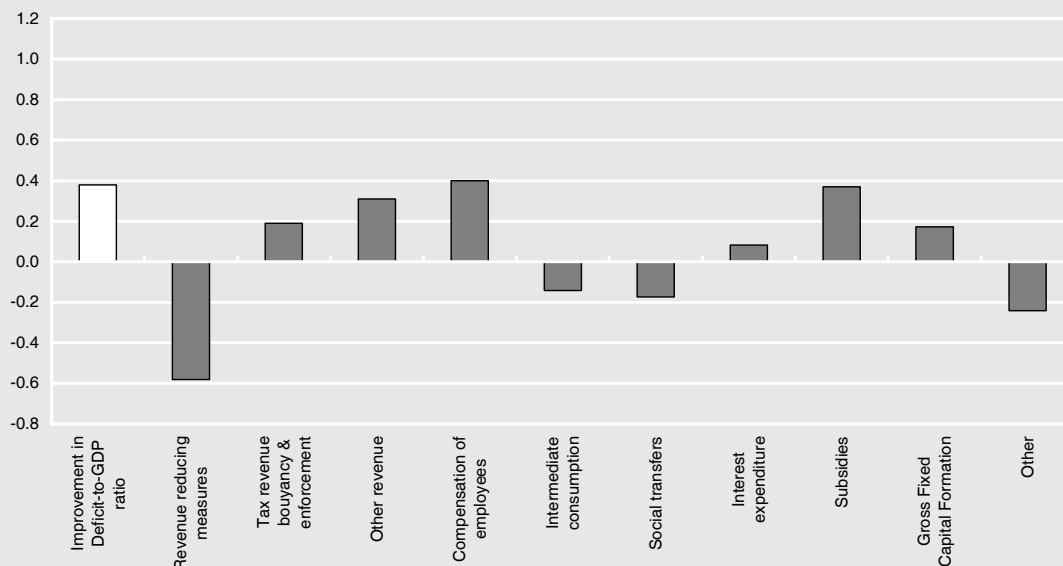
*Note:* positive sign represents a decline in the deficit-to-GDP ratio

The slowdown in debt growth is anticipated to result in a decline in the ratio of interest expenditure to GDP. Indeed, in 2008, interest expenditure is expected to contribute, albeit by a marginal 0.1 percentage point of GDP, to an improvement in the deficit ratio.

In 2008, the ratio of gross fixed capital formation to GDP is anticipated to remain relatively stable as further declines in capital outlays relating to the new hospital are expected to be offset by new capital projects co-financed through funds forthcoming from the EU.

Chart 5.1

### Analysis of Improvement in Deficit-to-GDP ratio for 2008





Meanwhile, in 2008, the 'other' expenditure category is expected to increase to 2.0 per cent reflecting lower one-off revenue from sale of land. Consequently, the 'other' component of expenditure is expected to have an expansionary effect on the deficit ratio of 0.24 percentage points.

## **5.5 Functional Classification of Expenditure**

The following section analyses the main components of general Government expenditure by functional classification, namely Social Protection, General Public Service, Health, Economic Affairs and Education, as well as Environmental Protection. Developments in these components of general Government expenditure as a share of GDP for the period 2005-2010 are illustrated in Chart 5.2.

After rising from 7.5 per cent of GDP in 2005 to 8.0 per cent of GDP in 2006, the ratio of expenditure on General Public Service is expected to follow a downward trend reaching 6.8 per cent of GDP in 2010. This trend largely reflects Government's efforts to curtail expenditure outlays of a recurrent nature, including compensation of employees. Moreover, the ratio of interest expenditure to GDP is also expected to follow a downward trend, thus contributing to the projected decline in the ratio of this item of expenditure.

Expenditure on Economic Affairs as a proportion of GDP is expected to follow a generally downward trend, declining from 6.2 per cent in 2005 to 4.2 per cent in 2010. This decline mainly reflects lower levels of subsidies.

Government's policy aims at balancing economic and social development with the conservation of the natural environment. The ratio of expenditure on Environmental Protection to GDP increased from 1.0 per cent in 2005 to 1.4 per cent in 2006 but is projected to stand at around 1.3 per cent thereafter. Around half of the expenditure on Environmental Protection is of a capital nature and relates mainly to the development of infrastructure for waste management activities.

The ratio of expenditure on Health to GDP is expected to follow a downward trend, declining from 6.6 per cent in 2005 to 4.6 per cent in 2009 and then to 4.4 per cent in 2010. The significant decreases mainly reflect lower capital expenditure due to the completion of the new hospital.

Government intends to sustain investment in human resources through education and training so as to ensure that the local labour force is equipped with the skills and capabilities required in today's competitive environment. It is noteworthy that expenditure of a capital nature on Education is expected to triple between 2006 and 2010, mainly to finance projects related to the University of Malta and to the vocational training institute - the Malta College for Arts, Science and Technology (MCAST) - several of which are co-financed from EU funds. Nevertheless, expenditure on Education as a per cent of GDP is projected to decline over the Programme period, reflecting developments in expenditure of a recurrent nature.

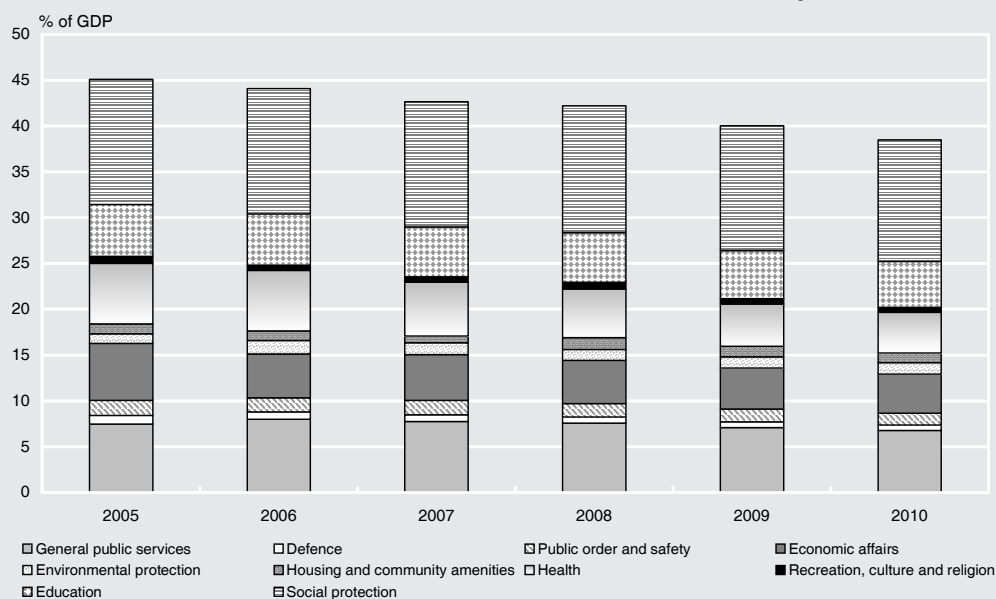
Expenditure on Social Protection comprises the largest component of total expenditure, mainly reflecting outlays on pensions. The ratio of expenditure on Social Protection to GDP is expected to remain broadly unchanged at around 13.7 per cent during the 2005-2008 period, declining thereafter to 13.3 per cent of GDP in 2010. This decline reflects a projected absolute increase in expenditure on pensions that is expected to be outweighed by a larger increase in GDP.

## **5.6 Integration between the Stability Programme and the National Reform Programme**

The National Reform Programme (NRP) which was set in 2005 outlined Government's reform plan to address key challenges facing the Maltese economy over the 2005-2008 period. This Programme, in line with the re-launched Lisbon Strategy, identified a number of priority areas such as the sustainability of public

Chart 5.2

### Functional Classification of General Government Expenditure



finances, competitiveness, employment, education and training, and the environment. The first annual progress report on Malta's implementation of these reforms was presented in October 2006. This report indicated that significant progress has been registered particularly in the policy areas of sustainability of public finances, environment and education and training. In October 2007, the second annual progress report was presented and it highlighted further areas where progress was achieved.

Progress towards the Lisbon goals is conditioned by the prevailing fiscal conditions. To this end, the fiscal framework presented in this Stability Programme for the 2007-2010 period encompasses the budgetary implications of the planned reforms identified in the latest annual progress report. The following Implementation Grid presents these planned reforms which focus on improving the business environment, boosting the competitiveness of the economy, encouraging employment, providing education and training as well as enhancing the quality of the environment.

NRP - Implementation Grid										
Key challenges	Integrated Guidelines	Measure	Implementation		Direct budgetary costs (as a percentage of GDP)					
					Status	Timeline	2005	2006	2007	2008
Sustainability of Public Finances	1, 2, 4	Review of the existing taxation framework (1.1) - Also addressing Key Challenges of Employment and Reviewing the tax and benefit system and reducing the tax burden on labour	Completed	Q4 2005 - Q4 2006	—					
	2, 19	Develop a more aggressive plan against benefit fraud (1.7) - Also aimed at reviewing the tax and benefit system and reducing the tax burden on labour	Completed	Q4 2005 - Q4 2006	Absorbed by Ministry					
	2, 3	Assess the role of means-testing instruments that determines eligibility for means-tested benefits (1.8)	Ongoing	Q2 2006 - Q4 2007	Absorbed by Ministry through the allocation of in-house resources					
	1, 2, 21	Commencement of incremental measures in pensions reform (1.9)	In Place	Q1 2006 - Q4 2006						
	2, 3	Introduce a new Health Services Act to separate the regulatory from the operational and service-delivery functions of the Health Division (1.10)	Ongoing	Q4 2005 - Q4 2008						
Competitiveness	1, 10, 13	Enhance price flexibility through the liberalisation of monopolies and actively considering liberalisation entry into certain service sectors particularly distribution, transport, and construction sectors, commencing with the liberalization of the fuel and ports sector (1.2)	Ongoing	Q4 2005 - Q4 2008	This is a revenue-raising measure					
	10, 14, 15	Develop SME loan guarantee scheme (2.1.3)	Ongoing	Q1 2005 - Q4 2007	—					
	1, 10, 13	Re-engineer FDI Procedures for business set-up in Malta (2.1.5)	Ongoing	Q1 2005 - Q4 2008	—					
	10, 14, 22	Set up a Better Regulation Unit (2.2) - Also aimed at improving the quality of the regulatory system	In Place	Q4 2005 - Q1 2006	—					
	7, 8	Enhance existing tax incentives for R&D (2.4)	Ongoing	Q1 2005 - Q4 2008	0.05	0.05	0.05	0.04		

NRP - Implementation Grid										
										continued
Key challenges	Integrated Guidelines	Measure	Implementation	Timeline	Direct budgetary costs (as a percentage of GDP)					
					2005	2006	2007	2008	2009	2010
Competitiveness	8, 15	Introduce a loan guarantee scheme to support start-ups, particularly innovative ones (2.6)	Ongoing	Q1 2005 - Q4 2008	—					
	9, 17, 21	Publish an eWork Framework with guidelines on incentives and awareness raising (2.7) - Also aimed at improving employment	Ongoing	Q1 2006 - Q4 2008		0.04	0.03	0.03		
	9, 23, 24	Address skills requirements in ICT sectors and raise the educational attainment within the field of ICT so as to ensure a skilled workforce for the sector (2.8.2)	Ongoing	Q1 2006 - Q4 2008		0.01	0.01	0.01		
	9	Review Malta's broadband connectivity (2.9)	Ongoing	Q1 2006 - Q4 2008		0.13	0.12	0.11		
	10, 13, 14	Improve accessibility, conservation and promotion of key heritage sites (2.11)	Ongoing	Q1 2005 - Q4 2008	0.05	0.05	0.05	0.04		
		Introduce tourism zone management tools to raise quality standards (2.12)	Ongoing	Q1 2005 - Q4 2008	0.02	0.02	0.02	0.02		
		Implement a branding exercise for tourism (2.13)	Ongoing	Q1 2006 - Q4 2008		0.02	0.02	0.02		
	10, 14	Privatisation of all yacht marinas and identification of new marina sites to be developed by the private sector (2.14.3)	Planned	Q4 2008	This is a revenue generating measure					
		Initiate divestiture of the entire gas function and supply chain from importation of fuel to distribution in petrol stations from Enemalta Corporation (2.15)	Ongoing	Q1 2006 - Q4 2008						
	Environment	11	Develop a National Biodiversity Action Plan (5.1)	Ongoing	Q4 2005 - Q4 2008	—				
Develop a Regional Project for Marine and Coastal Protected Areas (5.3)			Ongoing	Q1 2005 - Q4 2008	—					
Construction of three sewage treatment plants (5.5)			Ongoing	Q2 2005 - Q2 2009	0.31	0.39	0.37	0.35	0.33	

NRP - Implementation Grid											
										continued	
Key challenges	Integrated Guidelines	Measure	Implementation	Direct budgetary costs (as a percentage of GDP)							
					Status	Timeline	2005	2006	2007	2008	2009
Environment	11	Draft a national Environmental Technologies Action Plan (ETAP) (5.6)	Ongoing	Q1 2005 - Q4 2007	—						
		Introduction of the Polluter Pays Principle (5.8)	Ongoing	Q3 2005 - Q4 2007	—						
		Prepare and implement Green Procurement Plan (5.9)	Ongoing	Q3 2005 - Q1 2009	—						
	11, 16	Capture of methane from waste disposal and treatment (5.10)	Ongoing	Q1 2005 - Q4 2008	0.05	0.05	0.05	0.04			
		Replace uncontrolled landfills and improve treatment of Municipal Solid Waste (5.11)	Ongoing	Q2 2005 - Q4 2008	0.21	0.27	0.25	0.23			
	11	Promote use of biofuels through exemption from excise duties on importation: pilot collection scheme for the collection of used cooking oil (5.12)	Ongoing	Q1 2005 - Q4 2008	—						
		Measure to encourage the greater utilization of non-conventional sources of water (5.13)	Planned	Q4 2008	...						
	Employment	17, 19, 23	Revise the Employment and Training Corporation (ETC) youth strategy (3.1)	Ongoing	Q3 2006 - Q2 2008		—	0.01	—		
19, 23		Train and engage mothers absent from the labour market (3.2)	Ongoing	Q1 2005	—						
		Review tax and pensions system to encourage female participation in the workforce (3.3)	Completed	Q1 2005 - Q4 2005	—						
		Promote family friendly measures (3.4)	Ongoing	Q1 2004	—						
17, 19, 24		Develop a programme obliging the unemployed beneficiary of subsidies to attend training and community services (3.5) - Also aimed at improving education and training	Ongoing	Q4 2005 - Q4 2008	0.01	0.02	0.02	0.02			
19, 23		Review policy in the field of employment of third country nationals (3.6)	Ongoing	Q1 2005 - Q4 2008	—						
14, 15, 24		Launch the foster entrepreneurial skills scheme (3.8)	Completed	Q1 2006 - Q2 2007	—						

NRP - Implementation Grid										
										continued
Key challenges	Integrated Guidelines	Measure	Implementation	Timeline	Direct budgetary costs (as a percentage of GDP)					
					2005	2006	2007	2008	2009	2010
Education and Training	9, 23, 24	Financial and other assistance to foster ICT competencies (2.8.3)	Ongoing	Q1 2006 - Q4 2008		0.04	0.03	0.03		
	23, 24	Implement the reforms of the compulsory education system in the strategy document entitled "For all Children to succeed" (4.1)	Ongoing	Before 2004 - Q4 2008	0.01	0.01	0.01	0.01		
	21, 23, 24	Initiate training in basic computer skills for those registered for employment and establish Community Technology Centres (CTLC) (4.3)	Ongoing	Q1 2005 - Q4 2008				—		
	23, 24	Intensify guidance services in order to enable the establishment of a comprehensive career pathway (4.4)	Ongoing	Q4 2005 - Q4 2008				—		
		Ensure that formal, informal and non-formal qualifications and skills are certified (4.5) - Also aimed at improving employment	Ongoing	Q3 2006 - Q4 2008		—	0.01	—		

## 6. Sustainability of Public Finances

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## 6. Sustainability of Public Finances

As in other nations, demographic changes in Malta are expected to represent a significant challenge in the coming years. In particular, the combination of lower birth rate, longer life expectancy and the entry into retirement of the ‘baby-boom’ generation is likely to pose major economic, budgetary and social challenges. These changes are expected to have a notable impact on growth and lead to significant pressures to increase public spending, representing a central issue in the endeavour to achieve long-term fiscal sustainability.

As a result of the demographic shifts, the outlays on pensions paid by Government will rise over the next twenty years leading to a worsening in the balance of the current system. In light of these developments, in December 2006, the House of Representatives formally adopted a bill reforming the public pension system. This represented the conclusion of a process that commenced a number of years back. In particular, in June 2004, Government tasked the Cabinet Committee’s Support Unit to head a Pensions Working Group (PWG) to review all previous work carried out on pensions and submit recommendations to Government on the way forward. The PWG submitted its final report in June 2005 following an extensive process of national consultation and discussion. The reform law adopted by the Maltese Parliament is aimed at enhancing the sustainability of the pension system whilst improving the adequacy of the pension enjoyed by retirees in the future. Some of these measures entered into force as from 2007, while others shall come into force as from the 1<sup>st</sup> of January 2011.

This Chapter provides an assessment of Malta’s long-term sustainability of public finances by reviewing two sets of projections. The first set of projections is based on the common budgetary projections for the EU25 Member States on the basis of common assumptions as prepared by the Economic Policy Committee (EPC) in 2006. However, some of these assumptions diverge from those adopted by the PWG. Hence, a second set of projections is being presented on the basis of the work prepared by the PWG. These projections are based on the baseline scenario and thus do not reflect the reform. In addition, this Chapter provides a review and qualitative assessment of the reform measures enacted towards the end of 2006.

### 6.1 Projections based on the work of the Economic Policy Committee

This section provides an analysis of the long-term sustainability of public finances on the basis of the 2006 EPC projections of age-related expenditure. Budgetary projections over the long-term are based on a common set of demographic and macroeconomic assumptions that ensure comparability of results and equal treatment among MS.

The pension projections are based on simulations carried out using the Pension Reform Option Simulation Toolkit (PROST) model. Following the receipt of a full set of underlying assumptions from the EPC, the PROST input files were calibrated, to incorporate such assumptions where possible. The variables included in the assumptions as provided by the EPC are the real GDP growth rates, inflation rates, population projections, participation rates and unemployment rates. A number of variables included in the assumptions as provided by the EPC were not incorporated in the PROST workings, primarily due to the fact that such variables are not required as PROST inputs. The demographic and macroeconomic assumptions used are listed in Malta’s Update of the Convergence Programme 2005-2008.

#### 6.1.1 Demographic Developments

Population projections based on the EPC underlying assumptions are presented in Table 6.1 which shows a breakdown of the population into three main age brackets. Total population is projected to grow to around 487,000 by 2030 and increase further to around 513,000 by 2050. It is pertinent to note that under this scenario it is assumed that net migration will amount to an annual average of around 2,500 during the projection period up to 2050. The share of the sixty-one plus is projected to grow from 15.9 per cent in 2003 to 18.9 per cent in 2010 and then rise persistently to reach 29.6 per cent in 2050. The youth ratio (0-15 year olds as a

## Population Trends

(based on Economic Policy Committee Assumptions)

Table 6.1

	2003	2010	2020	2030	2050
Total population					
0-15 yrs	80,742	75,154	77,048	79,654	79,854
16-61 yrs*	254,618	269,391	273,070	280,802	281,521
61+ yrs	63,169	80,509	109,553	126,975	151,659
Total	398,529	425,054	459,671	487,431	513,034
Percentage of total population					
0-15 yrs	20.3	17.7	16.8	16.3	15.6
16-61 yrs*	63.9	63.4	59.4	57.6	54.9
61+ yrs	15.9	18.9	23.8	26.0	29.6
Demographic dependency ratio					
0-15 yrs	31.7	27.9	28.2	28.4	28.4
61+ yrs*	24.8	29.9	40.1	45.2	53.9
Total	56.5	57.8	68.3	73.6	82.2
Support ratio					
16-61 yrs*/61+ yrs	4.0	3.3	2.5	2.2	1.9

\*Figures based on pension system prior to the reform, where pension age was 60 years for females and 61 years for males

Note: Figures may not add up due to rounding

Source: PROST

proportion of those within the 16-61 years bracket) is expected to decrease by 3.3 percentage points by 2050 compared to 2003. The old-age dependency ratio is expected to increase as from 2010, with a more pronounced effect in 2020 where it will reach around 40.1 per cent and then it will continue to rise to 53.9 per cent by 2050. By 2050, the total dependency ratio will amount to 82.2 per cent, which means that every person in the working age population will have to support around 0.8 non-active persons compared to 0.6 non-active persons in 2003. The support ratio declines steadily over the projection period, reaching 1.9 by 2050. This means that while in 2003 there were around 4 persons in employment for a retired person, by 2050 there will only be around 2 employed persons compensating for a retired person.

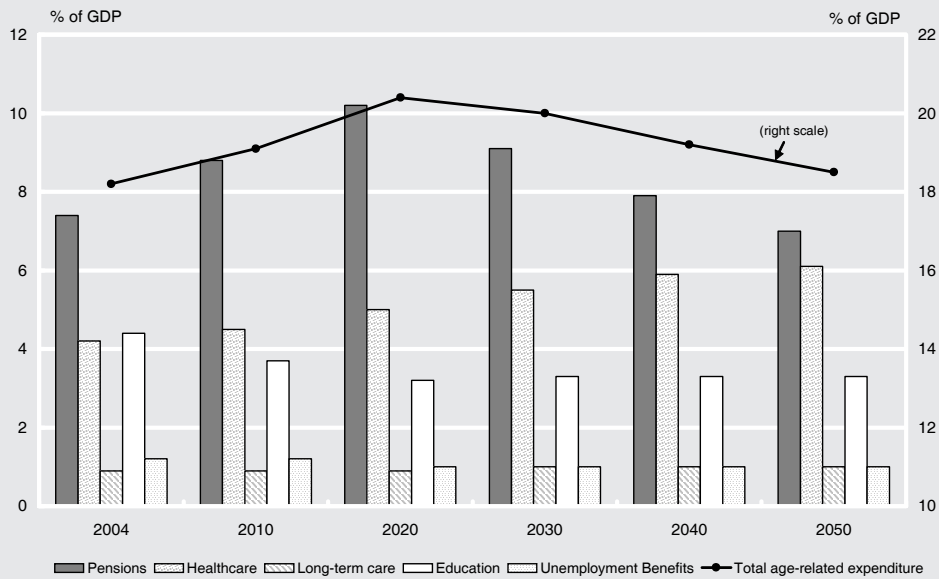
### 6.1.2 Age-related Public Expenditure

Age-related spending in Malta is projected to increase by 0.3 percentage points of GDP between 2004 and 2050. This level is composed of changes in the public expenditure on pensions, healthcare, long-term care, unemployment benefits and education expenditure. Chart 6.1 shows the age-related public expenditure as a share of GDP for the projection period. Appendix Table 7 shows the projections for age-related public expenditure and the assumptions used. It is noteworthy that Malta has been classified as a country at medium risk with regards to the sustainability of public finances, in the Commission Services report entitled, 'The Long-term Sustainability of Public Finance in the European Union', published in October 2006.

Public expenditure on pensions is the most important age-related government expenditure item, in terms of size both at present and in the future. Pension payments in Malta mainly include the two-thirds retirement pension, survivors' pension and the invalidity pensions. Occupational pension schemes in Malta are of relatively minor importance. Expenditure on pensions is projected to fall by 0.4 percentage points between 2004 and 2050. As regards the starting position in 2004, public pension spending accounted for 7.4 per cent of GDP, being expected to reach a peak in 2020 with a level of 10.2 per cent of GDP, and then decline to 7.0 per cent of GDP by 2050.

Chart 6.1

### Age-related Public Expenditure Projections (based on Economic Policy Committee Assumptions)

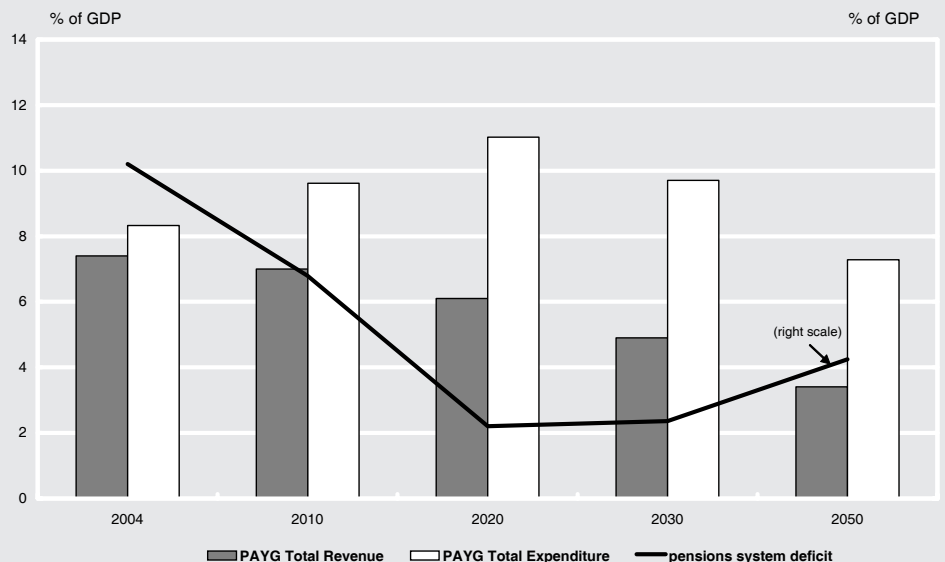


Public expenditure on healthcare is projected to increase from a level of 4.2 per cent in 2004 to 6.1 per cent of GDP by 2050, an increase of 1.8 percentage points over the projection period. Meanwhile, expenditure on long-term care is expected to increase by 0.2 percentage points of GDP, from a level of 0.9 per cent of GDP in 2004 to 1.1 per cent in 2050. Expenditure on unemployment benefits is projected to decline by 0.2 percentage points over the projection period, from a level of 1.2 per cent of GDP in 2004 to 1.0 per cent of GDP in 2050, while expenditure on education is projected to decline from 4.4 per cent of GDP in the starting year, to 3.3 per cent of GDP in 2050.

Chart 6.2 presents the main developments in PAYG Total Revenue, PAYG Total Expenditure and Pensions System Balance on the basis of the EPC common assumptions. The PAYG Total Revenue is on a declining trend from 7.4 per cent of GDP in 2004 to 3.4 per cent of GDP by 2050. Meanwhile PAYG Total Expenditure is on a rising trend up to around 2020, declining to 7.3 per cent of GDP by 2050. As a result, the pension system balance worsens from a deficit of 0.9 per cent of GDP in 2004 to 4.9 per cent of GDP in 2020. In

Chart 6.2

### Pensions System Balance (based on Economic Policy Committee Assumptions)



subsequent years, the pension system balance is projected to register an improvement reaching 3.9 per cent of GDP by 2050.

## 6.2 Projections based on the work of the PWG

This Section presents projections for pension expenditure based on work carried out by the PWG using the World Bank's PROST model. The macroeconomic and demographic assumptions used to derive such projections are presented in the December Update of the Convergence Programme, 2005-2008. One main difference between the two sets of assumptions relates to the net migration projection since the PWG assumes that the population will be augmented annually by the inflow of 500 immigrants and by 150 returned migrants. This contrasts with the EPC assumption that net migration will increase by an annual average of around 2,500 persons over the projection period, thus leading to different trends in population projections relative to the PWG.

### 6.2.1 Demographic Developments

The projected demographic shift up to 2050 may be observed from Table 6.2, which shows the population divided into three separate age classifications. Population projections indicate that total population is projected to grow to around 410,000 by 2030 and then decline to around 387,000 twenty years later. The challenge for the Maltese economy arises in particular when taking into account the shifts envisaged to the dependency ratios, particularly to age 61 and over. The share of the sixty-one plus is projected to grow from 15.9 per cent in 2002 to 20.0 per cent in 2010 and then rise sharply to a high of 33.8 per cent in 2050.

The youth ratio (0-15 year olds as a proportion of those within the 16-61 years bracket) is expected to fall by 1.9 percentage points during the next 50 years, while the old-age dependency ratio (61 years and over as a share of the 16-61 years bracket) is projected to increase from 24.9 per cent to 66.1 per cent. The generation of the 'baby-boomers' will move into the 61+ age bracket, where such an effect will intensify primarily in 2020 and continue to increase by 2050, when the old-age ratio will rise sharply by around 17 percentage points compared to 2030. Accordingly, after 2010, the increase in the old-age ratio leads to a continuous

<b>Population Trends</b>					
(based on Pensions Working Group Assumptions)					
Table 6.2	2002	2010	2020	2030	2050
Total population					
0-15 yrs	80,002	65,410	59,877	61,068	58,576
16-61 yrs*	254,027	257,805	246,391	233,912	197,780
61+ yrs	63,267	80,862	102,050	114,541	130,716
Total	397,296	404,077	408,318	409,521	387,072
Percentage of total population					
0-15 yrs	20.1	16.2	14.7	14.9	15.1
16-61 yrs*	63.9	63.8	60.3	57.1	51.1
61+ yrs	15.9	20.0	25.0	28.0	33.8
Demographic dependency ratio					
0-15 yrs	31.5	25.4	24.3	26.1	29.6
61+ yrs*	24.9	31.4	41.4	49.0	66.1
Total	56.4	56.7	65.7	75.1	95.7
Support ratio					
16-61 yrs*/61+ yrs	4.0	3.2	2.4	2.0	1.5
*Figures based on pension system in 2006, whereby retirement age is 60 years for females and 61 years for males					
Note: Figures may not add up due to rounding					
Source: PROST					

significant increase in the total dependency ratio. By 2050, the total dependency ratio will amount to 95.7 per cent, which means that every person in the working age population will have to support around 1 non-active person compared to 0.6 non-active persons in 2002. The support ratio records a decline throughout the projection period, reaching 1.5 by 2050, which implies that while in 2002 there were around 4 persons in employment for each retired person, by 2050 there will only be around 1.5 employed persons contributing for a retired person. In contrast, under the EPC population projections, by 2050 there will be around 2 employed persons contributing for a retired person. These differences in projections are attributable to different population development assumptions.

## 6.2.2 The Cost of Ageing

As in the scenario based on the common EPC assumptions, pension expenditure under the PWG assumptions includes two-thirds retirement pensions, invalidity pensions and survivors' pensions based on contributions of employer and employees only. Table 6.3 highlights the PWG projections of the pensions system balance and presents the main assumptions used for these projections. More detail can be found in the December 2005 Update of the Convergence Programme.

While the pension system in 2002 was running a small surplus of 0.3 per cent of GDP, it is projected that as from 2005 onwards the balance will turn into deficit throughout the projection period. The deficit is projected to increase to 2.7 per cent of GDP by 2010 and 4.4 per cent of GDP by 2020, then declining to 3.3 per cent of GDP by 2050. This outcome mainly reflects developments in both Pay As You Go (PAYG) total revenue and expenditure over the projection horizon. Total PAYG revenue as a percentage of GDP is expected to reach 1.5 per cent of GDP in 2050, whilst PAYG expenditure will reach a peak of around 10 per cent of GDP in 2020, then fall to 4.8 per cent of GDP by 2050. Developments in these two important variables are the result of changes in the structure of population, output developments over time and also the result of the mechanics of the pension rules of the current Maltese pension system.

It is important to highlight that the projections for PAYG total revenue and expenditure on the basis of the PWG assumptions differ from those based on the EPC assumptions due to the differences in both demographic and macroeconomic assumptions. In particular, the projections by the PWG are underpinned by a higher nominal GDP over the projection period relative to those based on common EPC assumptions. Secondly, as

### Pensions Working Group Projections

Table 6.3

Percentages of GDP	2002	2010	2020	2030	2050
PAYG Total Revenue	8.0	6.6	5.3	3.5	1.5
PAYG Total Expenditure	7.6	9.3	9.7	7.8	4.8
Pensions System Balance	0.3	-2.7	-4.4	-4.3	-3.3
		Assumptions			
Real GDP growth rate (%)	-1.8	2.8	3.8	3.8	3.2
Inflation (%)	2.2	2.1	2.2	2.2	2.2
Male Participation rate (aged 16-61)	85.2	84.3	83.3	82.3	80.2
Female Participation rate (aged 16-60)	37.8	40.4	43.7	47.0	53.5
Population (000's)	397.3	404.1	408.3	409.5	387.1

Note: Figures may not add up due to rounding

Source: PROST

## Pension Reform: Summary of Selected Measures

Table 6.4

		Pension Age			
		Before		After	
		Males	Females	Males	Females
<b>2004</b>		61	60	61	60
<b>2010</b>		61	60	61	60
<b>2013</b>		61	60	62	62
<b>2018</b>		61	60	63	63
<b>2022</b>		61	60	64	64
<b>2026</b>		61	60	65	65
<b>No of Contributions Years for Full-Pension Entitlement</b>					
Before					30 years
After	Born or before 31 December 1951				30 years
	Born during the years 1952 to 1961				35 years
	Born on or after 1 January 1962				40 years
<b>Calculation of Pensionable Income</b>					
Before	Best 3 out of last 10 years for employed persons Last 10 years for self-occupied persons				
After	No change for persons born before 1962 For persons born on or after 1962 pension shall be determined as the yearly average of the basic wage/ salary/net income/net earnings of the best ten years within the last forty years				
<b>Minimum Pension</b>					
Before	4/5ths of the National Minimum Wage for a couple 2/3 of the National Minimum Wage for any other person				
After	Establishment of the Guaranteed National Minimum Pension payable at a rate that is not less than 60 per cent of the National Median Income				

explained above, population projections differ markedly. Accordingly, the current pensions deficit balance as a percentage of GDP is lower under the projections by the PWG as from 2020 onwards.

### 6.3 The Pension Reform Act

Act No. XIX of 2006 entitled the Social Security (Amendment) (No. 2) Act, was published in the Supplement of the Government Gazette on the 7 December 2006, after it was formally adopted by the House of Representatives. By virtue of Legal Notice 336 published in the Malta Government Gazette of the 29 December 2006, Government announced the dates when provisions of the Social Security (Amendment) (No. 2) Act, will enter into force. It was announced that some of these measures entered into force as from 2007 while others shall come into force as from the 1<sup>st</sup> of January 2011. Table 6.4 provides an outline of selected parameters of the pension reform. This Act mainly provides for changes in the:

#### Definition of Pension Age

Prior to the reform, pension age stood at sixty years for females and sixty-one years for males. Following the implementation of the reform, pension age was raised to sixty-five years, subject to a number of conditions. As outlined in Table 6.4, in the case of a person born on or before the 31 December 1951, pension age shall remain unchanged; in the case of a person born during the calendar years 1952 to 1955, pension age shall be

sixty-two years; for persons born during the period 1956 to 1958, pension age shall be sixty-three years; for persons born in the period 1959 to 1961, pension age shall be sixty-four years.

### **Disqualification from a Pension in respect of Retirement**

Prior to the adoption of the pension reform bill, a retired person under the age of sixty-five years would be disqualified from receiving a pension during any period in which he/she is gainfully occupied when his/her earnings from such occupation exceed a weekly average equivalent to the National Minimum Wage. Following the implementation of the reform bill, a person under the age of sixty-five years born on or before the 31 December 1961, shall be disqualified from receiving a pension during any period in which he/she is gainfully occupied when his/her earnings from such occupation exceed a weekly average equivalent to the National Minimum Wage<sup>1</sup>. Meanwhile, a person under the age of sixty-five years born on or after the 1 January 1962 shall be disqualified from receiving a pension during any period in which he/she is gainfully occupied.

### **Retirement before Pension Age**

A person who has attained the age of sixty-one years but has not yet attained pension age, may after attaining sixty-one years of age claim a pension in respect of retirement if such person is no longer gainfully occupied. It is necessary that since reaching his eighteenth birthday, the claimant has had a total of:

- 2,080 (or 40 years) paid or credited contributions in the case of a person born on or after the 1<sup>st</sup> January 1962, or
- 1,820 (or 35 years) paid or credited contributions in the case of a person born during calendar years 1952 to 1961.

### **Full rate of Two-Thirds Pension**

Prior to the enactment of the reform, the full rate of the Two-Thirds Pension was equal to two-thirds of the pensionable income subject to a ceiling of the claimant, who has paid or has been credited with a yearly average of 50 contributions over a period of 30 years. Under the reform law, the period of contribution was changed as follows:

- (i) 30 years in the case of a person born on or before the 31 December 1951;
- (ii) 35 years for a person born during calendar years 1952 to 1961; and
- (iii) 40 years in the case of a person born on or after the 1 January 1962.

For a person born on or after the 1 January 1962, the yearly average of contributions required for the purposes of awarding a Two-Thirds Pension shall be assessed on any period of 40 years between the first day of his contribution year in which he reaches the age of eighteen and the last day of his last complete contribution year before the beginning of his benefit year.

### **Calculations of Pensionable Income**

Prior to the pension reform, the pension was determined on the basis of the yearly average of the basic wage during the best three years of the last ten years in the case of gainfully-occupied persons while the best ten years were taken into consideration for self-occupied persons. Under the reform law, in the case of a person born on or after the 1 January 1962, the pension shall be determined by taking the yearly average of the basic wage/salary/net income/net earnings as the case may be, during the best ten calendar years within the last forty years immediately preceding his retirement or invalidity.

### **The Maximum Pensionable Income**

The maximum pensionable income, prior to the reform, was fixed by law at Lm6,750 (€15,723) and was revised in recent years in line with the cost of living adjustment. The maximum pensionable income has now changed as follows: In the case of a person born on or before the 31 December 1961, whose retirement occurs on or after the 1 January 2007, the basic wage/salary/net income/net earnings and the resultant

pensionable income, shall not exceed Lm6,958 (€16,208) increased by such sum as the Government may award as a cost of living increase. The following provisions stand: (i) for a person born on or before the 31 December 1951, the resultant pensionable income including any such cost of living increase shall not exceed the sum of Lm7,500 (€17,470); (ii) in the case of a person born during calendar years 1952 to 1961, the resultant pensionable income including any such cost of living increase shall not exceed the sum of Lm9,000 (€20,964).

In the case of a person born on or after the 1 January 1962 whose retirement occurs on or after the 1 January 2007, the resultant pensionable income shall not exceed: (i) Lm6,958 (€16,208) increased by such sum that the Government awards for the cost of living, in respect of the years 2007 to 2010; (ii) Lm6,958 (€16,208) increased on the 1 January of each year between 2011 and 2013 by one third of the difference between the sum referred to above and Lm9,000 (€20,964); (iii) Lm9,000 (€20,964) increased annually by 70 per cent of the percentage increase in the national average wage for the previous calendar year, plus 30 per cent of the inflation rate for that same year. This applies as from the 1 January 2014.

### **The Guaranteed National Minimum Pension**

Changes were enacted to the National Minimum Pension, which stood at 4/5ths of the National Minimum Wage for a couple and 2/3rds of the National Minimum Wage for any other person. Following the enactment of the reform law, a person born on or after the 1 January 1962 who is not entitled to a Service Pension shall be entitled to a Guaranteed National Minimum Pension (GNMP) which shall be payable at a rate that is not less than 60 per cent of the National Median Income. This represents a higher rate than that awarded to pensioners at present. The exact rate shall be determined by the Minister in charge of the Department of Social Security with the concurrence of the Minister responsible for Finance. In any case, the rate of GNMP cannot be less than that declared for the preceding year.

### **Crediting of Contributions**

The categories of persons to whom credit of contributions is allowed has been extended to include persons born on or after the 1 January 1962, who have the legal care and custody of a child who is less than six years old, or ten years old in the case of a child suffering from a serious disability. Crediting of contributions may be claimed for a maximum period of two years in the case of a parent who has stopped working to take care of his/her child, extended to four years in the case of a child suffering from a serious disability. An adoptive parent is also able to claim such credits. Credits may be claimed for every child, with no distinction between employed and self-employed persons. The claimant is bound to have worked a minimum number of years equal to the duration of the crediting period. In the case of a parent's death, this latter binding ceases to apply.

### **Ministerial Powers and Responsibilities**

The Minister in charge of the Department of Social Security will, within intervals not exceeding five years, prepare a report reviewing the workings regarding the Retirement Pensions together with recommendations for achieving further adequacy, sustainability and social solidarity. The first report shall be submitted by not later than the end of the year 2010, and shall then be discussed by the Social Affairs Committee of the House of Representatives.

The Minister, in concurrence with the Minister of Finance has the power to make and vary any regulations requiring persons who have not reached pension age and their employers as the case may be, to make contributions into Mandatory Second Pension Funds. Such regulations may provide for the rate of contribution payable, method and frequency of payment. Second Pension funds shall be governed by the Special Funds (Regulation) Act (Cap. 450).

The Minister may in conjunction with the Minister for Finance provide exemptions from income tax in respect of contributions made by any person to Third Pension funds. These funds will be governed by the Special Funds (Regulation) Act (Cap. 403) as applicable.



### **6.3.1 Illustration of the Impact of the Reform**

As illustrated in the previous section, the pension reform adopted by the Maltese Parliament is composed of a number of measures that may have differing implications for employment, the number of pensioners and total expenditure on pensions.

#### **Changes in the Pension Age**

Prior to the reform, the pension age stood at sixty years for females and sixty-one years for males. The gradual introduction of a higher pension age and the consequent lengthening of the working life are expected to result in a gradual reduction in the number of pensioners at each point in time - a development having a positive effect on the pensions system balance.

#### **Changes to the Contribution Period and the Calculation of Pensionable Income**

The changes in the contribution period and the calculation of pensionable income are expected to have no impact on the number of pensioners and the employment levels. Moreover, by themselves these parametric changes are likely to result in a positive effect on pension system balance.

#### **Changes to the Maximum Pensionable Income, Maximum Pension Indexation and the Guaranteed National Minimum Pension**

The changes to the maximum pensionable income, maximum pension indexation and the guaranteed national minimum pension are expected to have no impact on the number of pensioners and employment levels. However, in view of dynamics of the Maltese pension system, especially the presence of a cap on pensionable income, these measures by themselves are likely to increase expenditure on pensions as well as revenue from contributions relative to the pre-reform scenario.

Thus, in balance, one may conclude that the pension reform in Malta is likely to result in an increase in the number of employees coupled with decreases in the number of pensioners. Additionally, the combination of measures enlisted here are likely to result in an increase in total pension expenditures and revenue from contributions. Furthermore, the introduction of the Guaranteed National Minimum Pension should enhance the adequacy of the pension system in future.

*Note:*

<sup>1</sup>Subsequently, in the Budget 2008, a measure was announced whereby a person reaching pension age will be entitled to receive his /her social security pension in respect of whether he/she has retired from a gainful occupation and irrespective of the income from such an occupation.



## **7. Institutional Features of Public Finances**

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## 7. Institutional Features of Public Finances

Government recognises the importance of fiscal governance in order to ensure that the budgetary targets are achieved. Furthermore, the effective and efficient functioning of public administration, encompassing accountability and control, the measurement of results, public sector employment practices and transparency in Government activities, play an important role in achieving a growth supportive environment. In this context, the Maltese Government recognises the need of a consistent and transparent administration of public finances, supported by an appropriate institutional framework.

### 7.1 Budgetary Procedure

Planning of public expenditure and revenue takes place through three-year Business and Financial Plans prepared by Ministries and Government Departments in perspective of Government's overall economic and social targets within the framework of the fiscal consolidation process. These Financial Business Plans are in turn reflected in the Budget presented and discussed on an annual basis in Parliament, with discussions leading to the approval of the annual Financial Estimates of the various Ministries.

As has been the practice in the last three years, Government publishes a pre-Budget document outlining the state of the economy and Government's vision for Malta's economic and social development as well as Government's policies in various spheres. The document also presents Government's views and options regarding the priorities and measures under consideration for the forthcoming Budget. This consultation document, intended as a precursor to the Budget, has become a well-established practice and is the basis for consultation well before the Budget is formally presented to Parliament. This consultation process has been extended to engage all strata of society, social partners, civil society and the general public in addition to the Malta Council for Economic and Social Development (MCESD).

#### 7.1.1 Control and Effectiveness of Public Expenditure

Once the Financial Estimates of the various Ministries are approved by Parliament, it is the responsibility of Permanent Secretaries and Heads of Departments to ensure that the Budget is implemented as planned and that the global financial allocation is not exceeded. The Budget Affairs Division, within the Ministry of Finance, closely scrutinises the month-on-month performance of each Government department and entity utilising or contributing towards public funds.

During 2007, procedures have been introduced concerning proposals for capital projects to gauge their priority and importance and to improve the effectiveness of their implementation and especially in order for objectives to be achieved in a timely manner, at the quality expected and according to budget.

The performance review process, applicable for the performance of officers whose appointment is regulated by a Performance Agreement (i.e. senior management positions in the public service), aims at particular attention being paid to the results attained in relation to national priority initiatives as well as financial objectives and budgetary targets.

The use of formal performance information in the decision-making of resource allocation can help improve efficiency in the provision of public goods and services through a better assessment, and consequent strengthening, of the link between inputs and outputs/outcomes. However, in this context, it should be noted that where public outlays are concerned the link between inputs and outputs/outcomes may not be straightforward and outputs/outcomes may be tardy. A case in point is capital expenditure on education and

health. Indeed, whilst budgetary appropriations may have been exhausted, the immediate outcomes may be experienced at a later stage.

## **7.2 Fiscal Targets and Institutions Supporting the Budget Framework**

Fiscal policy and budgetary surveillance are formulated on the basis of national objectives within the context of the Stability and Growth Pact. Annual fiscal targets on deficit and debt ratios are set by Government and act as guiding principles for conducting fiscal policy, in particular expenditure commitments. These targets are backed by political commitment and ownership from national political representatives and sustained by appropriate monitoring and enforcement administrative systems.

The Budget Affairs Division, within the Ministry of Finance, monitors the financial performance of Ministries and Departments, as well as public sector organisations, including those that either depend on a Government subvention for their operations or those that contribute towards the Government Budget through part of their profits. In doing so, it ensures that the annual contributions voted in the Financial Estimates in favour of public organisations are efficaciously utilised. More specifically, the Financial Management Monitoring Unit, within the Ministry of Finance, supervises the financial operations of public entities.

The Budget Affairs Division regularly monitors closely recurrent and capital expenditures and revenue collection performances with the aim that budgetary targets are attained and financial projections are adhered to, making appropriate recommendations in order that Government may take corrective measures well in time where trends indicate overspending or revenue shortfalls by year-end. This monitoring is made possible through the monthly evaluation of financial reports of Government Departments and management accounts of public entities. In addition, procedures ensuring more effective monitoring and review of budgetary performance by Ministries and Departments have been put in place.

Public funds are also managed and supervised by the Accountant General who is also responsible for the day-to-day cash-flow position of the operations of Government. Moreover, the system and procedure used in Government accounting within Ministries and Government Departments is scrutinized by the Internal Audit and Investigations Directorate. Furthermore, the accounts of all departments and offices of Government are externally audited and reported upon annually by the Auditor General to the House of Representatives. Further scrutiny on the financial conduct of Government Departments is exercised by the Parliamentary Standing Committee on Public Accounts, which is chaired by a member of the Opposition to ensure a more transparent scrutiny of how public finances have been utilised.

As regards Public Debt, the Treasury implements the borrowing plan based on the strategy approved by Government. Moreover, it prepares debt sustainability analysis to assess the long-term sustainability of projected public sector borrowing levels. Overall, the Public Debt Management Committee, under the chairmanship of the Permanent Secretary, within the Ministry of Finance, is charged with the policy making mechanism relating to public debt management issues.

### **7.2.1 Institutions Supporting the Absorption of European Funds**

The Planning and Priorities Co-ordination Division (PPCD) forms an integral part of the administrative infrastructure required to manage the funds allocated to Malta by the EU. The PPCD, acting as a Managing Authority, aims at ensuring the efficient absorption and management of European assistance, both EU and bilateral, through effective coordination across Government Departments, Authorities, Agencies and other stakeholders. Apart from providing the above-mentioned services, PPCD also ensures maximum transparency and information in relation to the funds which fall under its responsibility. This function is carried out through the organisation of training sessions, information activities and communication with the media, potential applicants for funding and the general public.

The European Union (Paying Authority) Directorate within the Ministry of Finance is entrusted with the certification of the declarations of expenditure and applications for payment. As the Certifying Authority, the EU Paying Authority certifies expenditure and subsequent drawdown of EU funds, manages accounts in connection with receipts and payments of EU-related funds, and disburses funds relating to Own Resources as part of Malta's contribution to the EU Budget.

Meanwhile, the Internal Audit and Investigations Directorate (IAID), within the Ministry of Finance, is entrusted with the effective functioning of the management and control system for EU funded projects, through the carrying out of continuous internal audits.









## Macroeconomic Prospects

Table 1a

Percentages unless otherwise indicated	ESA Code	2006 <sup>(1)</sup>	2006	2007 <sup>(2)</sup>	2008	2009	2010
1. Real GDP	B.1g	4,254.3	3.2	3.5	3.1	3.2	3.4
2. Nominal GDP	B.1g	5,025.3	6.0	6.4	6.1	5.5	5.6
<b>Components of real GDP</b>							
3. Private consumption expenditure <sup>(3)</sup>	P.3	2,866.9	1.3	2.4	2.2	2.6	2.5
4. Government consumption expenditure	P.3	829.2	3.7	1.2	0.5	-1.9	-1.7
5. Gross fixed capital formation	P.51	849.0	2.2	-2.9	5.3	4.8	3.7
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52+P.53	-	—	-0.2	0.1	—	0.1
7. Exports of goods and services	P.6	4,196.5	10.0	-1.7	2.3	3.3	3.2
8. Imports of goods and services	P.7	4,486.4	8.1	-3.9	2.0	2.1	1.8
<b>Contribution to real GDP growth</b>							
9. Final domestic demand		-	2.1	1.3	2.6	2.3	2.1
10. Change in inventories and net acquisition of valuables	P.52+P.53	-	—	-0.2	0.3	-0.1	0.1
11. External balance of goods and services	B.11	-	1.1	2.4	0.2	1.0	1.3

<sup>(1)</sup> € million

<sup>(2)</sup> Forecasts from 2007 onwards

<sup>(3)</sup> Includes NPISH final consumption expenditure

## Price Developments

Table 1b

Percentages unless otherwise indicated	ESA Code	2006 <sup>(1)</sup>	2006	2007 <sup>(2)</sup>	2008	2009	2010
1. GDP deflator		118.1	2.8	2.8	3.0	2.2	2.1
2. Private consumption deflator		113.0	2.4	0.6	2.5	2.3	2.1
3. Harmonised Index of Consumer Prices		102.6 <sup>(3)</sup>	2.6	0.9	2.5	2.3	2.1
4. Public consumption deflator		121.4	1.8	1.9	3.7	2.4	2.3
5. Investment deflator		114.9	3.5	0.6	1.4	1.1	2.3
6. Export price deflator (goods and services)		104.9	8.3	4.9	2.8	2.4	2.3
7. Import price deflator (goods and services)		102.5	7.6	2.0	2.1	2.1	2.1

<sup>(1)</sup> Index (base 2000 unless otherwise indicated)

<sup>(2)</sup> Forecasts from 2007 onwards

<sup>(3)</sup> Average 2005=100

## Labour Market Developments

Table 1c

Percentages unless otherwise indicated	ESA Code	2006	2006	2007 <sup>(1)</sup>	2008	2009	2010
1. Employment, persons <sup>(2)</sup>		154.2 <sup>(3)</sup>	0.9	1.6	1.2	1.3	1.4
2. Employment, hours worked <sup>(4)</sup>		295,891 <sup>(3)</sup>	1.6	1.6	1.2	1.3	1.4
3. Unemployment rate <sup>(5)</sup>		-	7.3	6.6	6.8	6.7	6.6
4. Labour Productivity, persons <sup>(6)</sup> (€)		27,591	2.2	1.8	1.8	1.9	2.0
5. Labour Productivity, hours worked <sup>(7)</sup> (€)		14.4	1.5	1.8	1.8	1.9	2.0
6. Compensation of employees (€ million)	D1	2,205	3.6	3.7	4.2	4.6	4.7
7. Compensation per employee (€)		16,205	2.7	2.1	3.0	3.3	3.3

<sup>(1)</sup> Forecasts from 2007 onwards

<sup>(2)</sup> Occupied population, domestic concept national accounts definition

<sup>(3)</sup> Thousands

<sup>(4)</sup> Annual actual hours (LFS Data)

<sup>(5)</sup> Harmonised definition, Eurostat; levels.

<sup>(6)</sup> Real GDP per person employed

<sup>(7)</sup> Real GDP per hour worked

## Sectoral Balances

Table 1d

Percentages of GDP	ESA Code	2006	2007	2008	2009	2010
1. Net lending/ borrowing						
vis-à-vis the rest of the world	B.9	-3.7	-0.5	0.2	3.2	5.5
of which:						
Balance on goods and services		-3.9	0.6	1.4	2.6	3.9
Balance of primary incomes and transfers		-2.8	-3.2	-3.3	-1.5	-0.4
Capital account		3.0	2.2	2.1	2.0	2.0
2. Net lending/ borrowing of the private sector	B.9	-4.2	-1.1	-0.7	1.3	2.6
3. Net lending/ borrowing of General Government	EDP B.9	-2.5	-1.6	-1.2	-0.1	0.9
4. Statistical discrepancy		-1.8	-	-	-	-

## General Government Budgetary Developments

Table 2

Percentages of GDP		ESA Code	2006 <sup>(1)</sup>	2006	2007	2008	2009	2010
<b>Net Lending (EDP B.9) by sub-sector</b>								
1.	General Government	S.13	-127.5	-2.5	-1.6	-1.2	-0.1	0.9
2.	Central Government	S.1311	-127.1	-2.5	-1.6	-1.2	-0.1	0.9
3.	State Government	S.1312	-	-	-	-	-	-
4.	Local Government	S.1313	-0.4	—	—	—	—	—
5.	Social security funds	S.1314	-	-	-	-	-	-
<b>General Government (S.13)</b>								
6.	Total revenue	TR	2,088.0	41.6	41.0	40.9	39.9	39.5
7.	Total expenditure	TE	2,215.5	44.1	42.7	42.2	40.0	38.5
8.	Net lending / borrowing	EDP B.9	-127.5	-2.5	-1.6	-1.2	-0.1	0.9
9.	Interest expenditure	EDP D.41	178.7	3.6	3.3	3.2	3.0	2.9
10.	Primary balance		51.2	1.0	1.7	2.0	2.9	3.8
11.	One-off and other temporary measures <sup>(2)</sup>		33.3	0.7	0.8	0.2	0.2	0.1
<b>Selected Components of Revenue</b>								
12.	Total Taxes (12=12a+12b+12c)		1,372.8	27.3	28.5	28.3	28.0	27.7
12a.	Taxes on production and imports	D.2	758.5	15.1	15.1	14.8	14.2	13.6
12b.	Current Taxes on Income, Wealth, etc.	D.5	599.6	11.9	13.2	13.3	13.6	13.8
12c.	Capital Taxes	D.91	14.7	0.3	0.3	0.3	0.3	0.3
13.	Social Contributions	D.61	390.4	7.8	7.7	7.5	7.4	7.2
14.	Property Income	D.4	63.2	1.3	1.1	1.1	1.0	1.0
15.	Other <sup>(3)</sup>		261.6	5.2	3.7	4.0	3.5	3.6
16=6.	Total Revenue	TR	2,088.0	41.6	41.0	40.9	39.9	39.5
p.m.:	Tax Burden (D.2+D.5+D.61+D.91-D.995) <sup>(4)</sup>		1,785.1	35.5	36.6	36.3	35.8	35.3
<b>Selected Components of Expenditure</b>								
17.	Compensation of employees + intermediate consumption	D.1+P.2	962.0	19.1	18.5	18.3	17.4	16.4
17a.	Compensation of employees	D.1	677.2	13.5	12.9	12.5	11.9	11.3
17b.	Intermediate consumption	P.2	284.8	5.7	5.6	5.8	5.4	5.1
18.	Social payments (18=18a+18b)		666.0	13.3	12.9	13.1	12.9	12.7
18a.	Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	32.1	0.6	0.6	0.6	0.6	0.6
18b.	Social transfers other than in kind	D.62	633.9	12.6	12.3	12.5	12.3	12.1
19=9.	Interest expenditure	EDP D.41	178.7	3.6	3.3	3.2	3.0	2.9
20.	Subsidies	D.3	94.5	1.9	2.1	1.8	1.5	1.4
21.	Gross fixed capital formation	P.51	218.3	4.3	4.0	3.9	3.3	3.5
22.	Other <sup>(5)</sup>		96.0	1.9	1.7	2.0	1.9	1.7
23=7.	Total Expenditure	TE	2,215.5	44.1	42.7	42.2	40.0	38.5
p.m.:	Government consumption (nominal)	P.3	1,012.0	20.1	19.5	19.2	18.2	17.2

<sup>(1)</sup> € million

<sup>(2)</sup> A plus sign means deficit-reducing one-off measures

<sup>(3)</sup> P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91)

<sup>(4)</sup> Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate

<sup>(5)</sup> D.29+D.4 (other than D.41)+D.5+D.7+D.9+P.52+P.53+K.2+D.8

### General Government Expenditure by Function

Table 3

Percentages of GDP	COFOG Code	2005	2006	2007	2008	2009	2010
1. General public services	1	7.5	8.0	7.8	7.6	7.1	6.8
2. Defence	2	0.9	0.8	0.7	0.7	0.6	0.6
3. Public order and safety	3	1.6	1.5	1.6	1.5	1.4	1.3
4. Economic affairs	4	6.2	4.8	5.0	4.7	4.5	4.2
5. Environmental protection	5	1.0	1.4	1.3	1.2	1.2	1.3
6. Housing and community amenities	6	1.1	1.1	0.7	1.3	1.1	1.0
7. Health	7	6.6	6.6	5.9	5.3	4.6	4.4
8. Recreation, culture and religion	8	0.8	0.6	0.6	0.7	0.6	0.5
9. Education	9	5.7	5.6	5.5	5.4	5.2	5.0
10. Social protection	10	13.7	13.7	13.7	13.8	13.6	13.3
11. Total Expenditure	TE	45.1	44.1	42.7	42.2	40.0	38.5



## General Government Debt Developments

Table 4

Percentages of GDP	ESA Code	2006	2007	2008	2009	2010
1. Gross debt		64.7	62.9	60.0	57.2	53.3
2. Change in gross debt ratio		-6.1	-1.9	-2.8	-2.9	-3.9
<b>Contributions to changes in gross debt</b>						
3. Primary balance		-1.0	-1.7	-2.0	-2.9	-3.8
4. Interest expenditure	EDP D.41	3.6	3.3	3.2	3.0	2.9
5. Stock-flow adjustment		-4.6	0.4	-0.4	0.1	0.1
p.m. implicit interest rate on debt <sup>(1)</sup>		5.3	5.4	5.4	5.3	5.3

<sup>(1)</sup> Proxied by interest expenditure divided by the debt level of the previous year.

## Cyclical Developments

Table 5

Percentages of GDP	ESA Code	2006	2007	2008	2009	2010
1. Real GDP growth (%)		3.2	3.5	3.1	3.2	3.4
2. Net lending of General Government	EDP B.9	-2.5	-1.6	-1.2	-0.1	0.9
3. Interest expenditure	EDP D.41	3.6	3.3	3.2	3.0	2.9
4. One-off and other temporary measures		0.7	0.8	0.2	0.2	0.1
5. Potential GDP growth (%)		2.8	2.4	2.3	1.9	2.0
6. Output Gap		-2.4	-1.3	-0.6	0.7	2.0
7. Cyclical Budgetary Component		-0.9	-0.5	-0.2	0.3	0.7
8. Cyclically-Adjusted Balance (2-7)		-1.7	-1.1	-1.0	-0.4	0.2
9. Cyclically-Adjusted Primary Balance (8+3)		1.9	2.2	2.2	2.6	3.1
10. Structural Balance (8-4)		-2.3	-1.9	-1.2	-0.6	0.1

## Divergence from the December 2006 Update of Convergence Programme

Table 6

Percentages of GDP	ESA Code	2006	2007	2008	2009	2010
<b>Real GDP growth</b>						
Previous update		2.9	3.0	3.1	3.1	...
Current update		3.2	3.5	3.1	3.2	3.4
Difference		0.3	0.5	0.0	0.1	-
<b>General Government net lending</b>						
	EDP B.9					
Previous update		-2.6	-2.3	-0.9	0.1	...
Current update		-2.5	-1.6	-1.2	-0.1	0.9
Difference		0.1	0.7	-0.3	-0.2	-
<b>General Government gross debt</b>						
Previous update		68.3	66.7	63.2	59.4	...
Current update		64.7	62.9	60.0	57.2	53.3
Difference		-3.6	-3.8	-3.2	-2.2	-

## Long-term Sustainability of Public Finances

Table 7

Percentages of GDP	2004	2010	2020	2030	2050
Total Expenditure	-	-	-	-	-
of which: age-related expenditures	18.2	19.1	20.4	20.0	18.5
Pension expenditure	7.4	8.8	10.2	9.1	7.0
Social security pensions*	-	-	-	-	-
Old-age and early pensions	3.8	5.2	7.0	6.9	6.5
Other pensions (disability, survivors)	3.6	3.6	3.2	2.2	0.5
Occupational pensions	-	-	-	-	-
Health care	4.2	4.5	5.0	5.5	6.1
Long-term care	0.9	0.9	0.9	1.0	1.1
Educational expenditure	4.4	3.7	3.2	3.3	3.3
Other age-related expenditures	-	-	-	-	-
Interest expenditure	-	-	-	-	-
Total revenue	-	-	-	-	-
of which: property income	2.2	1.2	1.1	0.7	0.3
of which: from pensions contributions	7.1	6.8	5.9	4.7	3.3
Pension reserve fund assets	-	-	-	-	-
of which: consolidated public pension fund assets	-	-	-	-	-
			Assumptions		
Labour productivity growth	1.4	0.9	2.4	2.7	1.7
Real GDP growth	1.9	2.5	2.7	3.1	1.7
Participation rate males (aged 16-61)	84.2	85.8	86.3	86.4	86.4
Participation rate females (aged 16-60)	40.9	48.1	55.3	57.8	58.3
Total participation rates (aged 16-61)	62.6	66.7	70.4	71.6	71.7
Unemployment rate (aged 16-61)	9.0	9.4	9.0	8.8	8.6
Population aged 61+ over total population	15.9	18.9	23.8	26.0	29.6
* Malta's two-thirds pension included under the pension expenditure category					
<i>Note:</i> Figures may not add up due to rounding					

## Basic Assumptions

Table 8

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	2006	2007	2008	2009	2010
Short-term interest rate (annual average)	3.5	4.3	4.3	4.3	4.3
Long-term interest rate (annual average)	4.3	4.9	4.9	4.9	4.9
USD/€ exchange rate (annual average)	1.3	1.4	1.4	1.4	1.4
Nominal effective exchange rate	1.0	3.0	1.2	1.2	1.2
World excluding EU, GDP growth	6.0	5.6	5.3	5.4	5.4
EU GDP growth	3.0	2.9	2.4	2.4	2.4
Growth of relevant foreign markets	2.5	2.4	2.0	2.1	2.1
World import volumes, excluding EU	8.0	7.8	7.1	7.7	7.7
Oil prices, (Brent, USD/barrel)	66.2	70.6	78.8	76.0	76.0

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