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REPORT FROM THE COMMISSION

Malta

Report prepared in accordance with Article 126(3) of the Treaty

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1. LEGAL BACKGROUND

Article 126 TFEU lays down the excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 “on speeding up and clarifying the implementation of the excessive deficit procedure”¹, which is part of the Stability and Growth Pact. According to Article 126(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 126(3) stipulates that, if a Member State does not fulfil the requirements under one or both of the above criteria, the Commission has to prepare a report. This report also has to “take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State”.

This report, which represents the first step in the “excessive deficit procedure” (EDP), analyses the reasons for a breach of the deficit and debt criterion of the Treaty with due regard to the economic background and all other relevant factors. The amendments to the Stability and Growth Pact in 2011 addressed some weaknesses in the surveillance framework. In particular, the corrective arm was strengthened by putting the debt requirement on an equal footing with the deficit requirement in order to ensure that, for countries with a debt-to-GDP ratio above the 60% reference value, the ratio is brought below (or sufficiently declining towards) that value. The Stability and Growth Pact² stipulates that Member States that were subject to an excessive deficit procedure on 8 November 2011 benefit from a three-year transition period, starting in the year following the correction of the excessive deficit, during which they are expected to ensure a sufficient improvement of their structural balance, as measured by the cyclically adjusted balance net of one-offs and temporary measures, in order to comply with the debt reduction benchmark by the end of the three-year period. The “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes” of 3 September 2012 spell out how the requirement for the structural balance is defined and assessed.

¹ OJ L 209, 2.8.1997, p. 6. The report also takes into account the “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, endorsed by the ECOFIN Council of 3 September 2012, available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm.

² Council Regulation (EC) No 1467/97 Article 2(1a), available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm.

Since accession to the EU, Malta has been subject to two EDPs³. The first was launched by the Council decision of 7 July 2004 and was abrogated by the Council on 5 June 2007. The second was launched on 7 July 2009 and abrogated on 4 December 2012, following a one-year extension, to 2011, of the deadline for correcting the excessive deficit on account of unexpected adverse economic events with major unfavourable consequences for the government finances that occurred in 2010.

Data notified by the authorities in April 2013⁴ show that the general government deficit in Malta reached 3.3% of GDP in 2012 (see Table 1), thus exceeding the 3% of GDP reference value. In addition, the general government gross debt was still above the 60% of GDP reference value and Malta did not make sufficient progress towards compliance with the debt reduction benchmark during the transition period (see Table 3).

Table 1: General government deficit and debt (% of GDP)

| | | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | | 2014 | |
|-------------------------------|--|------|------|------|------|------|------|----------------------|------|----------------------|
| | | | | | | | COM | National Authorities | COM | National Authorities |
| General government balance | | -4.6 | -3.7 | -3.6 | -2.8 | -3.3 | -3.7 | -2.7 | -3.6 | -2.1 |
| General government gross debt | | 60.9 | 66.4 | 67.4 | 70.3 | 72.1 | 73.9 | 74.2 | 74.9 | 74.2 |

Source: Eurostat and Commission services' spring 2013 forecast.

The Commission has therefore decided to initiate the excessive deficit procedure for Malta with the adoption of this report. Section 3 of the report examines the deficit criterion. Section 4 examines the debt criterion. Section 5 deals with public investment and other relevant factors. The report takes into account the Commission services' spring 2013 forecast, released on 3 May.

2. DEFICIT CRITERION

In 2012, the general government deficit reached 3.3% of GDP, from 2.8% of GDP in 2011.

While in excess of 3% of GDP reference value, the deficit is close to the Treaty reference value. However, the excess is not exceptional. In particular, it does not result from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. In 2010 and 2011, real GDP growth was, on average, above 2% annually, higher than potential growth. According to preliminary GDP data published by the national statistics office on 1 March 2013, economic growth slowed down in 2012, but remained positive at 0.8%. Looking forward, according to the Commission services' spring 2013 forecast, GDP growth is projected to pick up, reaching 1.8% in 2014. The positive output gap in 2011 is estimated to have turned slightly negative in 2012 and widen marginally in 2013-14.

³ All EDP-related documents for Malta can be found at the following website: http://ec.europa.eu/economy_finance/sdp/deficit/countries/malta_en.htm.

⁴ According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Malta can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/excessive_deficit/edp_notification_tables.

Table 2: Macroeconomic and budgetary developments^a

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | | 2014 | |
|--|------|------|------|------|------|------|----------------------|------|----------------------|
| | | | | | | COM | National Authorities | COM | National Authorities |
| Real GDP (% change) | 3.9 | -2.6 | 2.9 | 1.7 | 0.8 | 1.4 | 1.4 | 1.8 | 1.6 |
| Potential GDP (% change) | 2.2 | 1.7 | 1.9 | 1.3 | 1.4 | 1.4 | 1.3 | 1.5 | 1.4 |
| Output gap (% of potential GDP) | 3.3 | -1.1 | -0.1 | 0.2 | -0.3 | -0.4 | -0.5 | -0.1 | -0.3 |
| General government balance | -4.6 | -3.7 | -3.6 | -2.8 | -3.3 | -3.7 | -2.7 | -3.6 | -2.1 |
| Primary balance | -1.4 | -0.6 | -0.6 | 0.3 | -0.2 | -0.5 | 0.5 | -0.4 | 1.1 |
| One-off and other temporary measures | 0.0 | 0.6 | 1.1 | 0.7 | 0.9 | 0.3 | 0.2 | 0.1 | 0.1 |
| Government gross fixed capital formation | 2.3 | 2.3 | 2.1 | 2.5 | 3.1 | 3.1 | 3.5 | 3.2 | 3.7 |
| Cyclically-adjusted balance | -2.8 | -3.3 | -3.5 | -2.9 | -3.2 | -3.5 | -2.5 | -3.6 | -2.0 |
| Cyclically-adjusted primary balance | -2.8 | -0.2 | -0.6 | 0.2 | -0.1 | -0.3 | 0.7 | -0.4 | 1.2 |
| Structural balance ^b | -5.9 | -3.9 | -4.6 | -3.6 | -4.1 | -3.8 | -2.7 | -3.7 | -2.2 |
| Structural primary balance ^b | -2.8 | -0.8 | -1.7 | -0.5 | -1.0 | -0.6 | 0.5 | -0.5 | 1.0 |

Notes:

^a In percent of GDP unless specified otherwise.

^b Cyclically-adjusted balance excluding one-off and other temporary measures.

Source: Eurostat and Commission services' spring 2013 forecast.

The increase in the headline deficit in 2012 compared to 2011 reflected an increase in current expenditure by 1.3 pps. of GDP, which more than offset the impact of a significant amount of net deficit-reducing one-off measures (0.9% of GDP), mainly consisting of the proceeds from the concession fee on the local lottery operator.

According to the Commission services' spring 2013 forecast, the excess over the 3% of GDP reference value is not temporary in the sense of the Treaty and the Stability and Growth Pact. The forecast indicates that the deficit will continue to be above the reference value in 2013 and 2014, despite the expected increase in real GDP growth. These budgetary projections are based on current policies, thus incorporating the 2013 budget that was endorsed by Parliament in April 2013, which includes expansionary measures on both the revenue and expenditure side as well as the already planned equity injection into Air Malta (0.6% of GDP), with a net deficit-increasing impact of 0.3% of GDP. The expansionary measures are only partially compensated by increases in excise duties, the collection of tax arrears as well as the expenditure savings and higher social contributions stemming from the 2006 pension reform. In addition, the contribution of net deficit-reducing one-offs, as identified by the Commission, to the consolidation effort would fall sharply after 2012 (from 0.9% of GDP to 0.3% and 0.1% in 2013 and 2014, respectively). It should be stressed that the adopted budget is broadly similar to the one that was originally presented in November 2012⁵, which was based on a deficit target for 2012 at 2.3% of GDP, 1 pp lower than the notified outturn. After the submission of the 2013 stability programme, the Maltese authorities informed the Commission of further measures planned with a view to bringing the deficit below 3% of GDP in 2013 and 2014. The Commission will evaluate them and if appropriate will review its assessment of temporariness of the excess of the deficit over the 3% of GDP reference value.

The April 2013 stability programme sets the deficit target at 2.7% of GDP in 2013. The difference with the 3.7% of GDP projected in the Commission services' spring 2013 forecast

⁵ The draft 2013 budget was presented by the previous government at the end of November but failed to receive parliamentary endorsement.

reflects higher growth for current taxes, in particular driven by higher elasticity of indirect taxes to private consumption growth. For the remaining years, the programme targets the deficit to continue declining, to 0.8% of GDP by 2016, but only provides details on some specific measures.

In sum, in the Commission's assessment the deficit is close to the 3% of GDP reference value in 2012, but the excess over the reference value is neither exceptional nor temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis thus suggests that the deficit criterion of the Treaty is not fulfilled.

3. DEBT CRITERION

In 2012, the general government gross debt reached 72.1% of GDP, above the 60% of GDP Treaty reference value. The downward trend registered between 2004 and 2007 was reversed in 2008, when the primary balance turned negative. According to the Commission services' spring 2013 forecast, the expected continued primary deficits in 2013 and 2014 are projected to result in the general government debt rising further, to 73.9% of GDP in 2013 and to 74.9% of GDP in 2014.

Following the abrogation of the EDP in December 2012, Malta benefits from a three-year transition period to comply with the debt reduction benchmark, starting in 2012 (see Section 1). In order to ensure continuous and realistic progress towards compliance during the transition period, Member States should respect simultaneously the two conditions below:

- (i) First, the annual structural adjustment, ensuring compliance with the debt benchmark at the end of the transition period, should not deviate by more than $\frac{1}{4}$ % of GDP from the required linear structural adjustment;
- (ii) Second, at any time during the transition period, the remaining annual structural adjustment should not exceed $\frac{3}{4}$ % of GDP.

The structural effort implemented by Malta in 2012 is not sufficient to meet the requirements of the transition period for the debt reduction benchmark. First, the Minimum Linear Structural Adjustment (MLSA) required for 2012 was equal to 0.4 % of GDP, while Malta worsened its structural deficit by $\frac{1}{2}$ pp. of GDP in 2012; second, the remaining annual structural adjustment exceeds $\frac{3}{4}$ % of GDP.

This analysis, thus, suggests that the debt criterion of the Treaty is not fulfilled.

Table 3: Compliance with the debt reduction benchmark (transition period)

| Correction of the excessive deficit | Gross debt (% of GDP) at EDP deadline | Gross debt (% of GDP) at the end of the 3-years transition period | MLSA ¹ required in... | | | Structural adjustment forecast in... | | |
|---|---------------------------------------|---|----------------------------------|------------|-------------------|--------------------------------------|------------|-------------------|
| | | | 2012 | 2013 | 2014 ² | 2012 | 2013 | 2014 ² |
| 2011 | 70.3 | 74.9 | 0.4 | 0.9 | 1.6 | -0.5 | 0.3 | 0.1 |
| ¹ Minimum linear structural adjustment. | | | | | | | | |
| ² The budget for 2014 still needs to be adopted. | | | | | | | | |

Source: Eurostat and Commission services' spring 2013 forecast.

4. RELEVANT FACTORS

Article 126(3) of the Treaty provides that the Commission report “shall also take into account whether the government deficit exceeds government investment expenditure and take into

account other relevant factors, including the medium-term economic and budgetary position of the Member State”.

In view of the above provisions, the following four subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) the developments in the medium-term government debt position, its dynamics and sustainability; (4) other factors put forward by the Member State; and (5) other factors considered relevant by the Commission.

4.1. Medium-term economic position

Cyclical conditions and potential growth. Even if Malta's growth outperforms that of the euro area, the crisis negatively affected its potential growth. After averaging 2.3% in 2006-08, potential growth, as estimated by the Commission services, dropped to 1.3% by 2011 on account of a declining contribution from capital accumulation and total factor productivity. As capital accumulation is projected to remain modest, potential growth is forecast to improve only slightly and to average 1.6% in 2013-15. After contracting by 2.6% in 2009, real GDP growth exceeded potential growth in 2010-11. However, as both domestic demand and net exports moderated in 2012, real economic growth slowed down to below potential growth. Despite a projected domestic-demand-driven rebound, real GDP growth is forecast to remain below potential growth in 2013 and to exceed it again only in 2014. As a result of these developments, the calculated output gap turned negative in 2012 and is projected to remain negative in 2013-14.

Recent structural reforms. A detailed account and an assessment of the reform actions undertaken by the Maltese authorities in response to the recommendations issued by the Council in July 2012 will be undertaken in the context of the third EU semester. Among the structural reforms that could have a positive impact on the budgetary outcomes, it is worth noting that the 2006 pension reform contributes to fostering labour market participation of older workers and has a positive short-term impact on the budgetary position. The government has also undertaken relevant measures in the energy sector, most notably the construction of the electricity interconnector with Italy, which, added to measures to strengthen the functioning of the internal market and to lower the administrative burden on businesses, could have a favourable impact on potential growth.

4.2. Medium-term budgetary position

Structural deficit and fiscal consolidation in good times. In 2010 and 2011 Malta was clearly in good economic times, as evidenced by strong GDP growth. In 2011, Malta ran substantial budgetary consolidation both in nominal and structural (net of cyclical factors and one-off measures) terms, thus allowing bringing the deficit back below the 3% reference value. The budgetary consolidation was also supported by the continued recourse to one-off measures. In 2012 Malta loosened the fiscal stance. In structural terms, i.e. adjusted for the cycle and one-off and other temporary measures, the deficit is estimated to have worsened by ½ pp. of GDP, to 4.1% of GDP in 2012, reversing the declining trend towards the medium-term objective (MTO) of a balanced position in structural terms, which the April 2013 stability programme still does not plan to achieve within the programme period. According to the Commission services' 2013 spring forecast, the structural deficit is expected to improve by ¼ pp. of GDP in 2013 on account of a decreasing contribution from deficit-reducing one-off measures and, on a no-policy-change assumption, only marginally in 2014. According to the April 2013 stability programme, the structural balance, as recalculated by the Commission services' using the commonly agreed method, is estimated to improve by 1½ pp. of GDP in 2013 and by ½ pp. of GDP in 2014.

Public investment. Government investment (as a share of GDP) amounted to 3.1% of GDP in 2012, up by 0.6 pps of GDP from 2011. The general government nominal deficit in 2012 has therefore exceeded total public investment in that year and, according to the Commission services' 2013 spring forecast, will remain above it in 2013-14. In structural terms, in 2012 the deficit of 4.1% of GDP was higher than public investment and is forecast to remain above it.

Quality of public finances. The medium-term budgetary framework is non-binding in nature, which added to the lack of numerical fiscal rules and of an independent fiscal council, undermines the credibility of the government's consolidation strategy. Malta has not yet transposed Directive 2011/85/EU on budgetary frameworks. In addition, a structural budget balance rule, as provided for in the Treaty on Stability, Coordination and Governance, has not yet been introduced in national law. The stability programme announces a reform of the budgetary framework with a view to making it more binding through the introduction of fiscal rules, while increasing flexibility for reallocating expenditure across different headings and functions of public expenditure. It also announces the setting up of a Fiscal Council. However, concrete action has yet to be taken in these areas.

4.3. Medium-term government debt position

Long-term sustainability of public finances. The sustainability of Malta's public finances appears to be challenging in the medium to long term. According to "The 2012 Ageing Report", pension expenditure in Malta has in the past been below the EU average (10.4% of GDP against 11.3% of GDP in EU27 in 2010). However, the projected growth in age-related expenditure is well above the EU average, with the increase in pension expenditure – including the impact of the 2006 pension reform – accounting for more than half of it. Over the period 2010-60, pension expenditure is projected to increase by 5.5 pps. of GDP in Malta against 1.5 pps of GDP in the EU. Health care expenditure is projected to contribute as well to the projected growth in age-related expenditure, as it would increase by 2.9 pps. of GDP over the period 2010-60 in Malta, against 1.1 pps of GDP in the EU.

Total stock of debt guaranteed by government. The high level of contingent liabilities represents an additional risk for Malta's public finances. Government-guaranteed debt in Malta is high, following a substantial increase since the start of the crisis. At 17.6% of GDP in 2012 (from 16.3% in 2011), contingent liabilities imply a total public guaranteed debt of almost 90% of GDP in 2012. More than half of these liabilities, as well as most of their increase since 2008, are accounted for by the public energy utility corporation (Enemalta). Moreover, new guarantees in 2012 (for an amount equal to 3.6% of GDP) have been given to the special purpose vehicle set up for the restructuring of Enemalta's debt⁶.

4.4. Other factors put forward by the Member State

The authorities of Malta have not presented any relevant factors as they can do according to Article 2(3) of Council Regulation (EC) No 1467/97.

4.5. Other factors considered relevant by the Commission

In assessing sufficient progress towards compliance with the debt benchmark through the MLSA, financial assistance to Euro Area Member States⁷ with a debt or a deficit-increasing

⁶ A debt restructuring plan for Enemalta, adopted by the authorities in December 2012, concerns about half of the company's current debt (which, at end-2010 and including only bank and other borrowings, stood at EUR 687mn, or EUR 836mn when adding also trade-related and other payables).

⁷ Article 2(3), Regulation (EC) No 1467/97: "[...] particular consideration shall be given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of

impact must be taken into account. For Malta, the cumulative impact of Greek loan facility, EFSF disbursements, capital contributions to the ESM, and operations under Greek programme over the period 2011-2014 would be 3.9% of GDP on debt, and 0.1% of GDP on deficit. When taking into account the impact of these operations, the required MLSA for 2012 would be lower, at 0.3% of GDP, but remains well above the structural effort implemented by Malta in 2012.

5. CONCLUSIONS

The general government deficit in Malta reached 3.3% of GDP in 2012, above but close to the 3% of GDP reference value. The excess over the reference value cannot be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. According to the Commission services' spring 2013 forecast, it is not temporary either. This suggests that the deficit criterion in the Treaty is not fulfilled. However, after the submission of the 2013 stability programme, the Maltese authorities informed the Commission of further measures planned with a view to bringing the deficit below 3% of GDP in 2013 and 2014. The Commission will evaluate them and if appropriate will review its assessment of temporariness of the excess of the deficit over the 3% of GDP reference value.

General government gross debt reached 72.1% of GDP in 2012, above the 60% of GDP reference value, and Malta has not made sufficient progress towards compliance with the debt reduction benchmark during the transition period. This suggests that the debt criterion in the Treaty is not fulfilled, even when taking into account the impact of financial assistance to Euro Area Member States.

In line with the Treaty, this report has also examined “relevant factors”. As specified in the Stability and Growth Pact, these factors can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the general government deficit remains close to the reference value and its excess over the reference value is temporary, which is not the case. Considered on their own merit, the relevant factors on balance do not seem to question the decision on the existence of an excessive deficit.

safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances”.