Malta:

Update of Convergence Programme

2004 - 2007

Ministry of Finance
November 2004

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;
- -	to indicate that data are deemed immaterial;
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 24th November 2004.

Contents

Introduction

This document presents an update of Malta's Convergence Programme presented in May 2004. This update was prepared in accordance with the Council Regulation (EC) No.1466/97 which sets out the rules covering the content of Stability and Convergence Programmes and conforms with the revised Opinion on the content and format of Stability and Convergence Programmes (2001 code of conduct). Given that the budgetary process in Malta is based on a three-year cycle and that the business plans of Government Ministries and Departments taken into account for the budgetary process cover the same three year period, projections in this update provided for macroeconomic variables cover the 2004-2007 period.

This update was compiled by the Ministry of Finance, with important contributions being received from various Ministries as well as entities, including the Central Bank of Malta and the National Statistics Office. The document is structured into the following six sections. Chapter 1 highlights Government's objectives for macroeconomic policy and monetary and exchange rate policy; Chapter 2 presents recent economic developments and the medium-term projections of the main macroeconomic variables; Chapter 3 deals with Malta's fiscal policy and presents the medium-term fiscal projections; Chapter 4 contains a number of sensitivity analysis of the budgetary projections together with an analysis of the divergences between the current forecasts and those presented in the Convergence Programme May 2004; Chapter 5 analyses the quality of public finances, with an overview of the main features of the Budget for 2005 and the way in which the fiscal targets will be achieved and finally Chapter 6 reviews certain structural reforms and other reform areas.

1. Overall Policy Framework and Objectives

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1.1 Main Macroeconomic Policy Objectives

As highlighted in the Convergence Programme May 2004, the main economic policy objectives of the Maltese Government are the following:

1. The achievement of sustainable economic growth and a high and stable level of employment;
2. The attraction of new foreign direct investment;
3. Improving the competitiveness of the Maltese economy;
4. Restoring fiscal balances to sustainable levels.

The attainment of these objectives are essential to achieve Government's vision for Malta of a strong economy which guarantees more and better jobs, a fiscal position which can support further development, a sustainable social framework, particularly as regards the education and health system, and an improved environment.

The implementation of structural reforms is considered the key to the achievement of the above policy objectives. The main structural reforms that are currently being pursued include port reform, privatisation, encouragement of creativity and innovation, the reduction of excess bureaucracy and the support of small and medium sized enterprises. In the Budget Speech for 2005, a number of measures aimed at increasing the productivity of the labour force, including measures aimed at improving education and promoting private investment, have been announced.

The consolidation of fiscal balances continues to be a main priority area in order to ensure a stable macro-economic framework. The Budget Speech for 2005 highlights the restructuring of public entities, the control of public sector employment, the reduction of abuse of government expenditure, and the control of tax evasion, as being crucial in the fiscal consolidation process. Furthermore, a number of other fiscal measures, which will generate additional Government revenue, were announced. With regard to the welfare system, a White Paper on the proposed reform of the pension system, entitled "Pensions Adequate and Sustainable", has been published.

In addition to these policy objectives, as highlighted in the Convergence Programme May 2004, the stability of the external sector, particularly the safeguarding of the exchange rate peg, is an essential tool to maintain price stability. This continues to be a priority area, particularly in view of the liberalisation of external transactions as well as the eventual adoption of the Euro.

1.2 Monetary and Exchange Rate Policy

The Central Bank of Malta is responsible for the conduct of monetary policy in Malta. The primary objective of monetary policy is price stability. This objective is achieved primarily by pegging the exchange rate to a basket of low-inflation currencies, with the Euro having a weight of 70 per cent.

Interest rates in Malta continued to move with interest rates abroad. In this regard, the increased share of the Euro in the Maltese lira basket has continued to strengthen the link between the policy stance of the Eurosystem and the conduct of monetary policy in Malta. The Maltese Government and the Central Bank of Malta believe that there are significant advantages that can be derived from membership in the Euro Area. The Maltese authorities intend to move to the final stage of EMU as rapidly as economic convergence permits, and in particular depending on the achievement of Government's fiscal targets as published in the Convergence Programme May 2004.

2. Economic Outlook

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2.1 Recent Economic Developments

During the first nine months of 2004, local economic activity remained relatively subdued although some positive developments were recorded. The domestic economy is operating within an increasingly competitive global environment which, in light of the high degree of openness of the Maltese economy, calls for increased efforts to improve competitiveness. Domestic-oriented enterprises are now also operating within a liberalised and hence more competitive environment. The improvements in the competitiveness edge of local enterprises and the attainment of a stable macroeconomic framework are crucial for the creation of more employment opportunities and an improvement in the standard of living of the Maltese population. It is pertinent to note that national accounts data presented in this document are based on the European System of Accounts (ESA95) methodology.

During 2003, real Gross Domestic Product (GDP) declined marginally by 0.3 per cent. Latest data provided for GDP covering the period January-September 2004 shows that real GDP increased marginally by 0.6 per cent over the comparable period of 2003. Given the high degree of openness of the Maltese economy, the unfavourable international economic environment persisting since 2001, has significantly impinged on the performance of the local economy.

Private final consumption expenditure in real terms advanced by 1.2 per cent during the January-September 2004 period as compared to 0.2 per cent recorded in the corresponding period of 2003. Increases were also registered in general Government final consumption expenditure, which increased by 5.2 per cent in nominal terms during the first three quarters of 2004, in particular reflecting increased expenditure related to health and social protection. In real terms, this component of final expenditure advanced by 2.2 per cent as compared to 1.6 per cent registered during the comparable period of 2003.

Gross fixed capital formation, recorded a marginal increase of 0.6 per cent in real terms during the January-September 2004 period. Growth rates for gross fixed capital formation have fluctuated significantly during recent years primarily due to significant one-off exceptional transactions which materialised during the respective years. Specifically, the sharp decline in investment figures in 2002 reflects the disposal of aircraft, which in turn also explains a notable increase in investment in 2003. The ratio of investment to GDP during the first three quarters of 2004 practically maintained the same level recorded in the previous January-September period and stood at 20.9 per cent in real terms.

The generally unfavourable international economic environment combined with an increasingly competitive global scenario has proved particularly challenging for the export-oriented sectors of the economy. The high degree of openness of the Maltese economy is reflected in the high ratio of exports and imports to GDP. In 2003, exports of goods and services accounted for 91.2 per cent of GDP in real terms whilst the ratio of imports of goods and services to GDP amounted to 98.8 per cent. During the first nine months of 2004, exports of goods and services stood at 93.9 per cent of GDP in real terms, whilst imports of goods and services in real terms constituted 102.4 per cent of GDP.

The negative real rate of growth, in exports of goods and services, registered during the first nine months of 2003, was reversed during the subsequent nine months to September 2004. Indeed, exports of goods and services advanced by 3.6 per cent in real terms. This increase in exports of goods and services was mainly underpinned by a drop in average export prices. Developments in exports of goods and services during the first nine months ending September 2004 were underpinned by a decline in exports of goods and higher foreign exchange earnings from tourism. Such trends were in turn offset by lower receipts from other services.

Imports of goods and services advanced by 3.2 per cent in real terms during the January-September 2004 period, compared to a growth rate of 8.6 per cent during the corresponding months of 2003. The increase in imports of goods and services in real terms was influenced by lower average import prices. The increase recorded in nominal imports was the result of increases in imports of consumer goods, fuels and capital goods, which more than offset the fall in imports registered for industrial supplies. The fall recorded in imports of services was mainly attributable to a deterioration in transportation services partly brought about by the increase recorded in imports of goods.

During the January-September 2004 period, the current account deficit reached 10.3 per cent of GDP, as compared to 4.4 per cent of GDP in the corresponding period of the previous year. In 2003, the current account deficit stood at 5.6 per cent of GDP. The deterioration of the current account balance during the first nine months of 2004 was mainly brought about by an increase in net outflows in the investment income account, due to higher net re-invested earnings (particularly in the banking sector) and lower net interest earnings from abroad. Furthermore, higher imports of goods (in particular, higher merchandise imports), coupled with higher payments for repairs on goods and lower receipts from bunkering activities led to a higher deficit in the goods account. The improvement in net receipts on the services account, underpinned by higher tourist earnings, partly compensated for the deterioration in the goods account. The negative balance on current transfers continued to increase during the course of 2004, reflecting higher private transfers abroad which more than offset the fall in Government transfers abroad and the increase in Government transfers received.

During 2003, net foreign direct investment improved substantially when compared to the level recorded in 2002, and stood at Lm100.2 million, or 5.4 per cent of GDP. The increase in net flow of funds during 2003 was due to movements in net investment portfolios. In particular, net outflows of portfolio debt accounted for 31.4 per cent of GDP in 2003 compared to 10.5 per cent in 2002, whilst net outflows of portfolio equity flows stood at 0.3 per cent of GDP in 2003. Net foreign liabilities in the form of financial derivatives represented 0.5 per cent of GDP in 2003[1] . Net other investment flows increased from Lm425.2 million, or 24.1 per cent of GDP in 2002 to Lm535.0 million or 29.0 per cent of GDP in 2003. As a result, reserve assets increased during 2003 and reached 3.0 per cent of GDP as compared to 6.9 per cent in 2002.

At the end of September 2004, the labour supply stood at 145,414, representing an increase of 0.3 per cent or 492 persons, over the corresponding period of last year, whilst the gainfully occupied population recorded an increase of 294 persons over the twelve months to September 2004, to reach 137,274. As a result, the number of unemployed persons registering under Part I and Part II of the Register increased by 198, reaching a level of 8,140 at the end of September 2004, or 5.6 per cent of the labour supply. The developments recorded in the Maltese labour market during the past months show an increased reliance on the private sector and particularly on market services as the main generator of employment. Employment in total private sector as a share of total employment increased by 0.5 percentage points to 66.0 percent. In particular, a significant increase of 1,135 jobs was recorded in private market services. This increase served to offset the fall in private direct production of 132 jobs recorded for the January-September 2004 period. Public sector employment including temporary employees followed a downward trend, declining from 47,293 as at the end of September 2003 to 46,649 by the end of September 2004. This drop was mainly brought about by several restructuring programmes implemented in a number of state-owned enterprises, which included early retirement schemes and the redeployment of surplus staff within the public sector.

Labour productivity growth, measured as real output per employee, in the domestic economy registered a favourable improvement of 0.4 per cent during the first three quarters of 2004. This reversed the trend followed by labour productivity growth during the corresponding period of 2003, when a negative growth rate of 0.9 per cent was recorded.

The inflation rate, based on the twelve-month moving average[2] as at September 2004 stood at 2.57 per cent as compared to 1.10 per cent in September 2003. The domestic inflation rate declined throughout most of 2002 and 2003, reaching its lowest level of 1.05 per cent in October 2003, but subsequently followed a gradual increasing trend. The evolution of inflation during the course of the first nine months of 2004 was primarily influenced by domestic factors. The upward trend in the twelve-month moving average rate of inflation during the eleven months to September 2004 was mainly attributable to higher prices recorded within the Beverages and Tobacco sub-index on account of higher excise duties on cigarettes and alcohol as announced by Government in the Budget Speech for 2004. Higher average prices were also recorded within the Other Goods and Services sub-index, followed by the Personal Care and Health sub-index and the Housing sub-index. All the remaining sub-indices of the Retail Price Index (RPI) reported percentage increases, with the exception of the Clothing and Footwear sub-index which registered lower average prices.

It is noteworthy that in May 2004, the National Statistics Office (NSO) published the Harmonised Index of Consumer Prices (HICP) for the first time. Due to the different methodologies applied in the compilation of the RPI and HICP, the inflation rate calculated according to these two indices are not directly comparable. The inflation rate as measured by the twelve-month moving average HICP fluctuated from 1.95 per cent in September 2003 to 2.75 per cent in September 2004.

Gross Value Added (GVA) at basic prices, which measures the value generated by any unit engaged in a production activity excluding taxes less subsidies on products stood at Lm1,230.7 million as at September 2004. During the first nine months of 2004, GVA at basic prices increased by 1.8 per cent over the level recorded during the corresponding period of 2003. The growth of GVA at basic prices was primarily attributable to financial intermediation, wholesale and retail trade, real estate, renting and business activities, public administration and defence, health and social work and education. The increases recorded in these sectors, in addition to minor increases recorded in other sectors during the first three quarters of 2004 more than offset the fall registered in the manufacturing and electricity, gas and water supply sectors. Services activities[3] accounted for 72.3 per cent of GVA at basic prices during the first nine months of 2004, up from 70.4 per cent recorded during the corresponding period of 2003. In contrast, the share of industry[4] declined by 1.9 percentage points over the comparable period of 2003, and stood at 25.4 per cent as at September 2004. The share of agriculture, hunting and forestry[5] remained unchanged from 2.3 per cent recorded during the nine months to September 2003.

The Maltese lira is pegged to a basket of currencies of low-inflation countries - the Euro, Sterling and the US dollar – thus minimising the impact of imported inflation on consumer prices. During the first nine months of 2004, the value of the Maltese lira vis-à-vis the Euro and the US dollar remained practically unchanged from the level recorded at the end of 2003. These developments in the Maltese lira exchange rate reflected the fact that the major currency markets have been broadly stable. Meanwhile, the Maltese lira weakened by 2.1 per cent against the Sterling but appreciated by 2.4 per cent against the Japanese Yen.

During the first quarter of 2004, the real effective exchange rate (REER) remained broadly unchanged when compared to the rate recorded in December 2003. This was mainly due to the favourable inflation differential registered between Malta’s trading partners and competitors and the domestic inflation rate, which offset the nominal effective appreciation of the lira against the euro. On the other hand, the REER increased by 0.1 per cent between March and June 2004 as the depreciation of the Maltese lira against the dollar was outweighed by a wider inflation differential. In July 2004, the REER index rose by a further 0.8 per cent.

During the first nine months of 2004, broad money (M3) continued to expand reflecting the prevailing low interest rate environment and thus the low opportunity cost of holding monetary instruments. Indeed, broad money expanded by 3.9 per cent as compared to the 2.7 per cent growth rate registered during the corresponding 2003 period. The relatively higher growth rate in M3 was mainly attributable to the reversal of the decline in residents’ time deposits registered in the first nine months of 2004. Domestic credit, which is the main counterpart of broad money also increased rapidly, contributing to the acceleration in monetary growth during the same period. Furthermore, the slower growth in net foreign assets of the banking system was partly offset by a similar slowdown in the growth of the other counterparts of broad money.

Net foreign assets of the banking system continued to expand during the first three quarters of 2004, though at a slower pace than in the corresponding 2003 period. In fact, net foreign assets increased by 4.1 per cent compared to the 6.5 per cent growth rate registered during the corresponding January-September 2003 period. This expansion in the net foreign assets was mainly attributable to higher banks' holdings.

During the first nine months of 2004, domestic credit increased by 5.1 per cent. This is relatively higher than the 3.1 per cent expansion rate recorded during the same period in 2003. The expansion in domestic credit was primarily underpinned by a faster increase in the claims on other residents. Indeed, claims on other residents increased by 6.3 per cent, mainly attributable to private sector credit while loans and advances to public non-financial companies contributed to this increase only marginally. Net claims on central Government increased by 0.9 per cent, compared to a growth rate of 4.1 per cent recorded during the January-September 2003 period.

Following an easing of the Central Bank's monetary policy stance during 2003, the central intervention rate was left unchanged at 3.0 per cent during the first three quarters of 2004. Hence, during this period, domestic money market interest rates remained broadly stable and close to the rates applied by the Central Bank in its open market operations. Given that these developments took place in the context of an international environment characterised by gradual rises in money market rates abroad, the interest rate premium on short-term Maltese lira assets narrowed.

2.2 The Medium-Term Scenario

Table 2.1 presents the main macroeconomic indicators for the years 2002-2007. The figures for 2002 and 2003 are as published recently by the National Statistics Office (NSO), whilst figures for 2004 and after are forecasts. Forecasts for the Maltese economy have been revised to take into account the latest available data covering the first three quarters of 2004. The baseline scenario reflects the short to medium term forecasted path for the Maltese economy. The forecast assumes a moderate, though stable growth in the international environment.

The Maltese economy is estimated to grow by 0.6 per cent in real terms during 2004. The outlook over the forecast horizon for the local economy is for a modest and gradual recovery. GDP is expected to grow by 1.5 per cent in 2005, 1.8 per cent in 2006 and 2.2 per cent in 2007. The projected growth rates of GDP together with a detailed breakdown of the various expenditure aggregates are illustrated in Chart 2.1. The inflation rate is expected to reach a peak in 2004 and it is expected to return to rates of around 2.0 per cent by the end of the forecast horizon. The unemployment rate[6] is forecasted to reach 5.8 per cent in 2004, and then to gradually decline in the forecast years.

GDP growth in 2004 is expected to be mainly driven by an increase in exports of goods and services, whilst an increase in imports of goods and services is expected to dampen the positive effect of export growth on GDP growth. Marginal increases are also expected in the other components of GDP growth. The main assumptions underlying these forecasts are presented below. This is followed by a more detailed analysis of the projections of the main macroeconomic indicators in the medium term.

2.2.1 Assumptions for Projections

The forecasts presented in this section and the different sensitivity scenarios presented in this document were estimated using econometric techniques and analytical methods. The following are the main assumptions used in obtaining the base forecasts for 2004-2007.

- World economic activity is expected to grow by 2.1 per cent in 2004, 2.2 per cent in 2005 and 2.1 per cent thereafter. World prices, based on producer price indices of the Euro Area, are assumed to rise modestly

Main Macroeconomic Indicators

Table 2.1

	2002	2003	2004[1]	2005	2006	2007
GDP at constant (2000) prices (Lm million)	1,687.8	1,682.0	1,692.8	1,718.4	1,749.7	1,787.5
GDP at current market prices (Lm million)	1,767.3	1,846.1	1,902.4	1,992.0	2,079.2	2,161.9
GDP growth at constant (2000) prices (%)	2.6	-0.3	0.6	1.5	1.8	2.2
Expenditure Components of GDP at constant 2000 prices (% change)						
Private final consumption expenditure[2]	-0.4	1.6	0.4	1.0	1.4	1.6
General government final consumption expenditure	3.8	1.6	1.2	-1.0	-0.1	-0.5
Gross fixed capital formation	-29.6	41.4	2.0	7.8	-1.6	0.4
Exports of goods and services	6.6	-3.8	2.8	2.0	3.6	4.1
Imports of goods and services	-2.4	7.1	1.6	3.5	2.0	2.8
Inflation rate (%)	2.2	1.3	2.9	2.4	1.9	1.9
Employment growth (%)	-0.1	-0.8	0.5	0.7	0.7	0.6
Unemployment rate (%) [3]	5.2	5.7	5.8	5.7	5.4	5.1
Labour productivity (% change)	2.7	0.5	0.2	0.8	1.2	1.6
External Goods and Services Balance (% of GDP)	1.1	-5.3	-4.6	-5.3	-3.3	-2.3

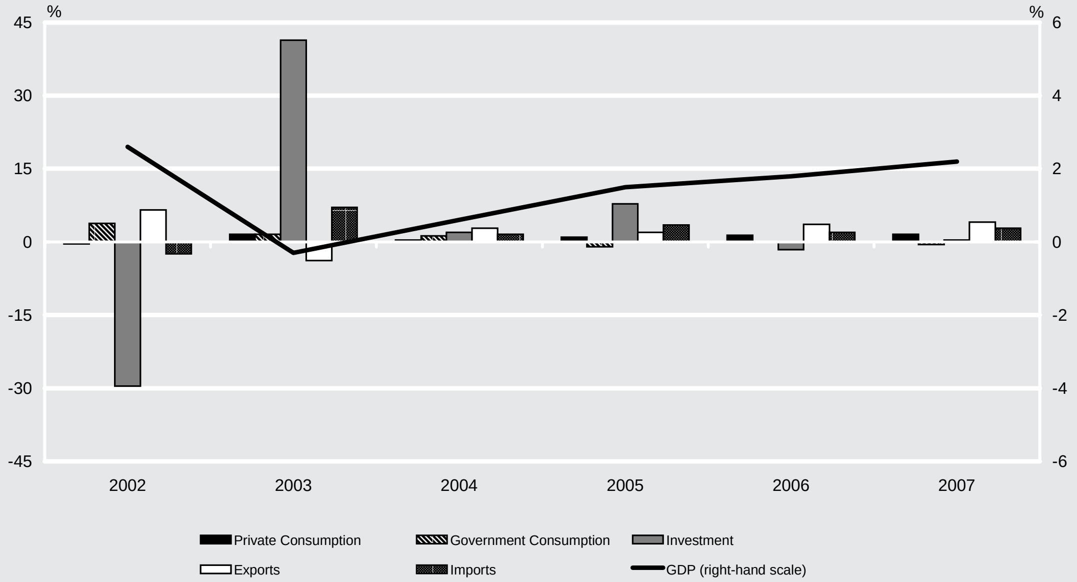
[1] Forecasts from 2004 onwards
[2] Includes NPISH final consumption expenditure
[3] Based on ETC registered unemployment data

by 1.9 per cent in 2004 and 2005 and by 1.8 per cent in 2006 and 2007, reflecting the low expected inflation rates in the Euro Area.

- Assumptions for changes in world oil prices are in line with the European Commission's forecast assumptions presented in the 'Economic Forecasts – Autumn 2004'. Oil prices are assumed to increase in

Chart 2.1

GDP Growth Rate



2005 when compared to the values for 2004, but are then expected to decrease in 2006 and maintain the same level in 2007.

• When compared to 2004, the rate of interest is assumed to increase slightly in 2005 and then remain at the 2005 level in 2006 and 2007.

• The nominal effective exchange rate of the Maltese lira and the Dollar exchange rate are assumed to remain constant throughout the forecast period.

• Average wage inflation is assumed to be relatively low compared to historical growth rates, reflecting the global competitiveness pressure on employment costs. Average wages in the private and public sector are expected to grow by an average of 2.2 per cent during the forecast period. Meanwhile, it is assumed that Government employment remains unchanged at the 2004 level.

• Inventory changes are assumed at around 3.0 per cent of GDP during the forecast period.

2.2.2 Private Final Consumption Expenditure

Growth in private final consumption expenditure is expected to remain relatively weak. Private final consumption expenditure is expected to grow by 0.4 per cent in 2004 and by 1.0 per cent in 2005. Over the forecast horizon consumption growth is expected to accelerate slowly growing by 1.4 per cent in 2006 and 1.6 in 2007. The relatively marginal growth rates for consumption expenditure reflect the continuing fiscal consolidation program by Government which has and still is expected to impact on households' real disposable income.

2.2.3 General Government Final Consumption Expenditure

General Government final consumption expenditure is estimated to grow marginally by 1.2 per cent in 2004. In line with Government's fiscal consolidation programme, Government final consumption expenditure is expected to decrease by 1.0 per cent in 2005 and decline further in 2006 and 2007.

2.2.4 Gross Fixed Capital Formation

Investment activity has fluctuated during 2002 and 2003, primarily due to significant one-off exceptional transactions which materialised during 2002. Growth in gross fixed capital formation in 2004 is estimated at 2.0 per cent. This rate of growth reflects increases in both private and public sector investment. It is expected that the completion of some road building projects spill into 2005, with the result that the figure for public expenditure in 2005 will register a significant increase over 2004. For 2005, private investment is also expected to register moderate growth. Reflecting these developments, total gross fixed capital formation is expected to grow by 7.8 per cent in 2005. Capital expenditure by Government is though expected to decline in 2006 given the completion of a number of planned projects. Investment in the private sector is expected to register further increases in 2006 and 2007. As a result, investment is expected to drop by 1.6 per cent in 2006 and increase marginally by 0.4 per cent in 2007.

2.2.5 External Balance of Goods and Services

Exports of goods and services are expected to increase by 2.8 per cent in 2004. The growth rate of exports of goods and services is expected at 2.0 per cent in 2005 and around 4 per cent in 2006 and 2007. The increase in exports of goods and services partially reflects the recovery in world demand. Aside from growth in merchandise exports, tourism activity is also expected to grow in the forecast period. Furthermore, one should note that the increase in exports for 2004 is also affected by the significant drop in the average price deflator for exports which registered significant declines over the recent months. The increase in exports of goods and services is expected to serve as a main contributor to GDP growth throughout the forecast period.

The impact of the increase in exports of goods and services on GDP growth is expected to be partially offset by the increase in imports of goods and services. Imports of goods and services are expected to increase by 1.6 per cent in 2004. This increase in imports reflects on the one hand the increase in imports of consumer goods, resulting from the removal of the import levies, and on the other hand the modest increase expected in investment growth and in consumption expenditure. In 2005, imports are expected to grow by 3.5 per cent, primarily reflecting the expected increase in gross fixed capital formation, and in particular the expected increase in Government capital expenditure. Imports of goods and services are expected to register noticeable increases in 2006 and 2007.

In line with the above developments, the negative external balance of goods and services is expected to worsen in 2005, when compared to the negative of 4.6 per cent of GDP expected for 2004. The negative external goods and services balance for 2006 and 2007 is expected to contract to reach a negative 2.3 per cent in 2007.

2.2.6 Productivity and Employment Prospects

In response to the gradual improvements expected in the local economy over the forecast horizon, employment growth is expected to improve progressively over the forthcoming years. If realised, similar expectations will reverse the downward trend in gainfully occupied population recorded over the past few years. Over the next three years, the increase in real GDP is expected to exceed the forecasted increase in the number of gainfully employed. As a result, real productivity is expected to increase modestly over the forecast time-frame.

The unemployment rate for 2004 is projected to reach 5.8 per cent. This relatively high rate of unemployment reflects the current restructuring program which is being undertaken in a number of sectors within the Maltese economy. The unemployment rate is expected to fall gradually in the forthcoming years, primarily due to the expected improvement in the economy.

2.2.7 Inflation

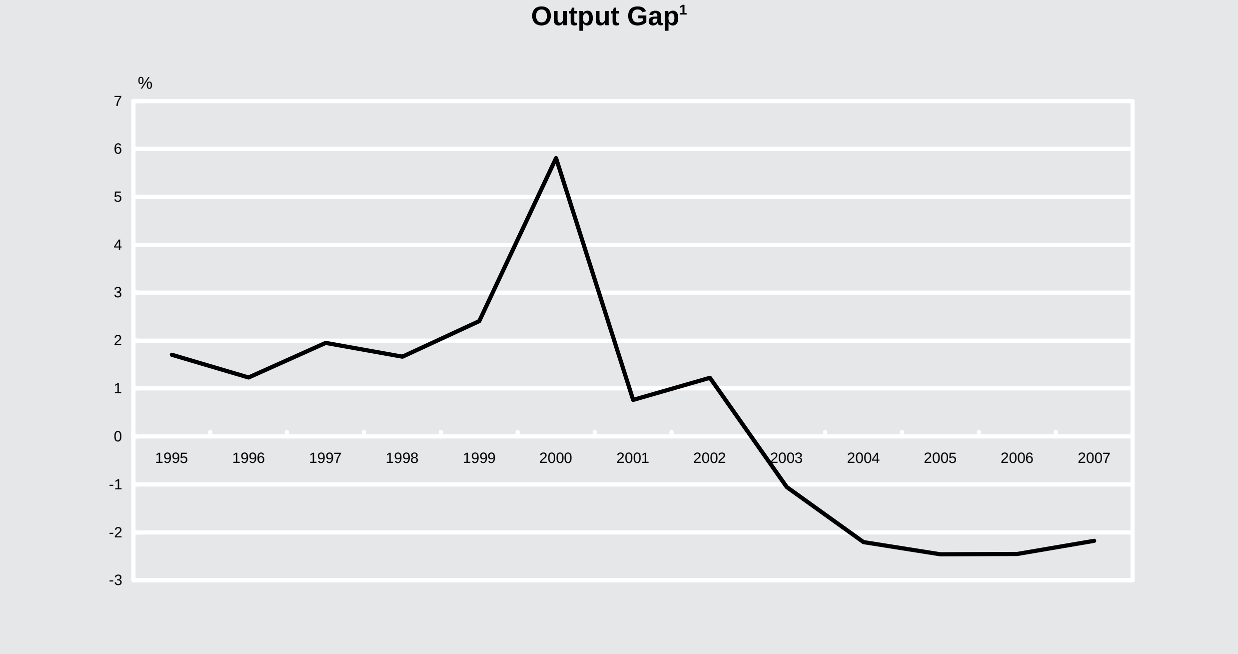
The twelve-month moving average inflation rate is expected to reach 2.9 per cent in 2004. This relatively high rate of inflation, compared to the rate registered for 2003, is primarily attributable to effects of domestic factors. The rate of inflation expected for 2005 is of 2.4 per cent. The inflation rate for 2005 is expected to exceed the level forecasted in the Convergence Programme May 2004, partly due to measures undertaken to make the domestic market more responsive to trends in international commodity markets. The rate of inflation is expected to stabilise around the 2.0 per cent mark in 2006 and 2007.

2.3 Potential Output and the Output Gap

The GDP growth of 0.6 per cent estimated for 2004 is expected to remain below the potential growth rate. The output gap estimated for 2004 is expected to reach a negative of 2.2 per cent of potential output. The method used to measure the output gap is based on the Hodrick-Prescott (HP) filter. Estimates of the output gap are shown in Chart 2.2. Results should be treated with caution in view of the end of sample bias problem[7].

The last four years have been marked by a decline in economic growth rates. Average yearly growth rates for real GDP have declined from 4.5 per cent in the five-year period from 1995 to 1999 to an average growth rate of 1.5 per cent in the last four years. In the period from 2004 to 2007, the average growth rate is expected to remain around this level. As a result of the low growth rates being registered, potential output

Chart 2.2



[1] Defined as actual output less potential output as a per cent of potential output.

growth has also started to decline since the mid-1990s. In addition, the growth rates recorded since 2001 with the exception of 2002 have tended to be lower than potential output growth. This situation is expected to prevail until 2006 when the growth in GDP is expected to equal potential output growth. As a result of these developments, the negative output gap recorded in 2003 is expected to remain in the forecast period, reaching a high of a negative of 2.5 per cent of potential output in 2005, and then narrowing throughout the rest of the forecast period.

[1]The measure of financial derivatives is included for the first time in data for 2003

[2]As from January 2003, the twelve-month moving average inflation rate is based on a new Retail Price Index (RPI) series with base December 2002

[3]Services activities include wholesale and retail trade (including repair of motor vehicles), hotels and restaurants, transport, storage and communication, financial intermediation, real estate, renting and business activity, public administration and defence (including compulsory social security), education, health and social work and other community, social and personal services

[4]Industry comprises mining and quarrying, manufacturing, electricity, gas and water supply, and construction

[5]Agriculture, hunting and forestry include fishing and operation of fish hatcheries and fish farms

[6]Based on Employment and Training Corporation (ETC) registered unemployed data

[7]Additional four-year forecasts of real GDP were obtained using an ARIMA model to remedy for the end of sample bias problem

3. General Government Balance and Debt

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Addressing the current imbalance in public finances is of priority for the Maltese Government. In fact, the Government's fiscal policy framework is geared towards ensuring sound public finances in the medium term. Government acknowledges that it is in Malta's immediate economic interests to undertake the necessary fiscal consolidation so as to ensure a stable and sound macroeconomic framework, which is conducive to price stability, employment creation and strong sustainable economic growth. In this context, Government's fiscal policy objectives are to ensure fiscal control and fiscal discipline, to provide a degree of stabilisation for the economy and to promote efficiency in service delivery through procedures that provide incentives for greater productivity.

The weakening international economic environment prevailing in recent years impinged significantly on the domestic economic activity, particularly in view of the high degree of openness of the Maltese economy. In turn, these developments in the domestic economy were reflected in the balances of the public finances. The general Government deficit increased significantly to 9.6 per cent of GDP in 2003. This increase was attributable to cyclical factors as well as to a one-off transaction relating to the implementation of the restructuring programme for the shipyards. To this effect, the Convergence Programme submitted in May 2004 outlined a planned programme concerning public finances aiming to attain medium-term fiscal sustainability.

Government is adopting the necessary policy measures to ensure that public finances are sustainable in the medium term. To this end, Government has taken a number of decisions on taxation and spending to restore the public finances to a sustainable position. The public finance projections set out in this update of the Convergence Programme show that Government targets will be met.

3.1 The Medium-Term Fiscal Framework

The Budget Speech for 2005 announced towards the end of November, confirms that the fiscal targets set in the Convergence Programme for the 2004-2007 period will be achieved. The Budget Speech for 2005 also presents an outline of the main budgetary measures being taken to achieve the objectives of the Programme, a summary of which is presented in Chapter 5.

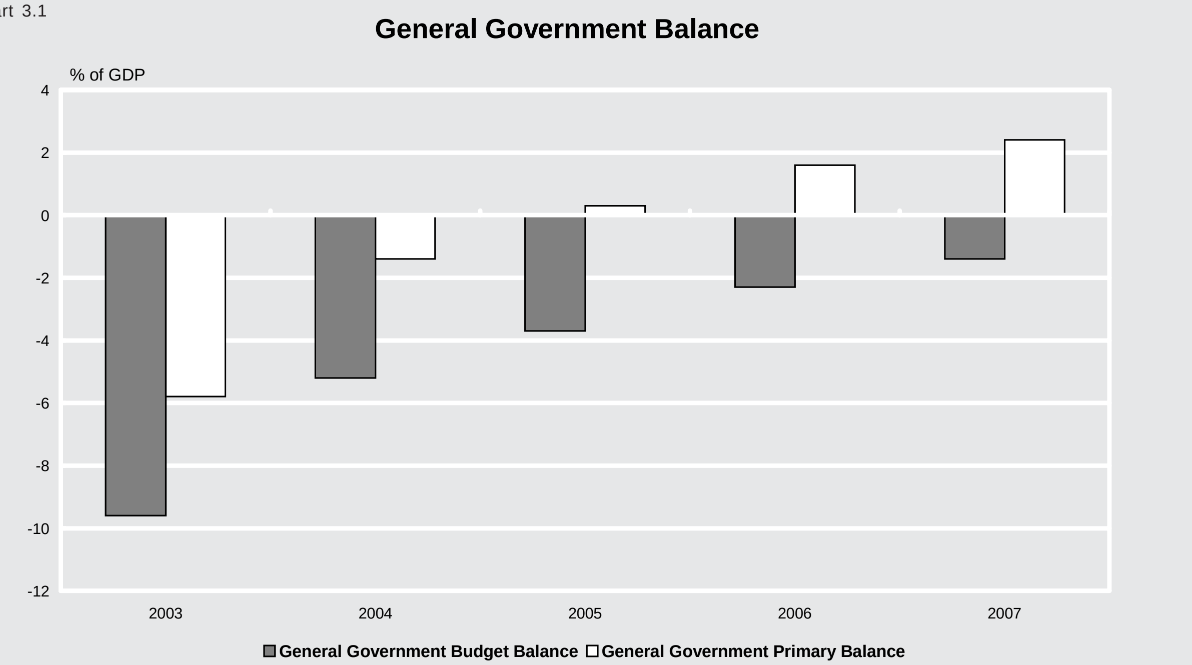
The achievement of the targeted general Government deficit-to-GDP ratio presented in the May 2004 Convergence Programme depends on the attainment of projected general Government deficit level as well as the expected performance of the economy. The general Government deficit level for 2004 presented in the May 2004 Convergence Programme is expected to be attained. The nominal GDP level is expected to remain relatively unchanged, thereby ensuring that the general Government deficit ratio of 5.2 per cent is attained.

The general Government deficit levels are expected to vary only marginally from the levels targeted in the May 2004 Convergence Programme. Meanwhile, higher expected nominal GDP levels exert minimal contractionary effect on the deficit-to-GDP ratio. Thus, the deficit-to-GDP ratios for the period 2005-2007 presented in the May 2004 Convergence Programme remain achievable targets.

As a result of these developments, the general Government deficit ratio is expected to follow a downward path from 5.2 per cent in 2004 to 3.7 per cent in 2005 as illustrated in Chart 3.1. At around 2.3 per cent and 1.4 per cent in 2006 and 2007 respectively, the deficit ratio is projected to reach levels below the 3 per cent reference value.

In the analysis of the budgetary position, it is also pertinent to consider the projected trend for the recurrent balance. In fact, the recurrent balance as a per cent of GDP is expected to improve from a deficit of around 1.0 per cent in 2004 to a surplus of around 3 per cent of GDP in 2005 and 2006. In 2007, the recurrent surplus

Chart 3.1



is expected to be above 2 per cent of GDP. These projected developments shed light on the changing structure of the budget deficit. It also highlights Government's determination to undertake those public investments necessary for the provision of health and educational services, an improved infrastructure and increased productivity levels for the domestic economy.

3.1.1 Government Revenue Projections

After peaking in 2005 at 45.9 per cent, the ratio of general Government total receipts to GDP is expected to follow a declining trend in the forecast horizon as depicted in Chart 3.2. The rising total receipts to GDP ratio between 2003 and 2005 is mainly due to the Other component which is expected to advance by 3.2 percentage points, on account of higher non-tax revenue. The taxes to GDP ratio will also rise, albeit by a lower 2 percentage points. Conversely, during the period 2005-2007, the total receipts ratio is expected to decline, reflecting lower ratios in all the components of the general Government revenue. The main decline is anticipated

Chart 3.2

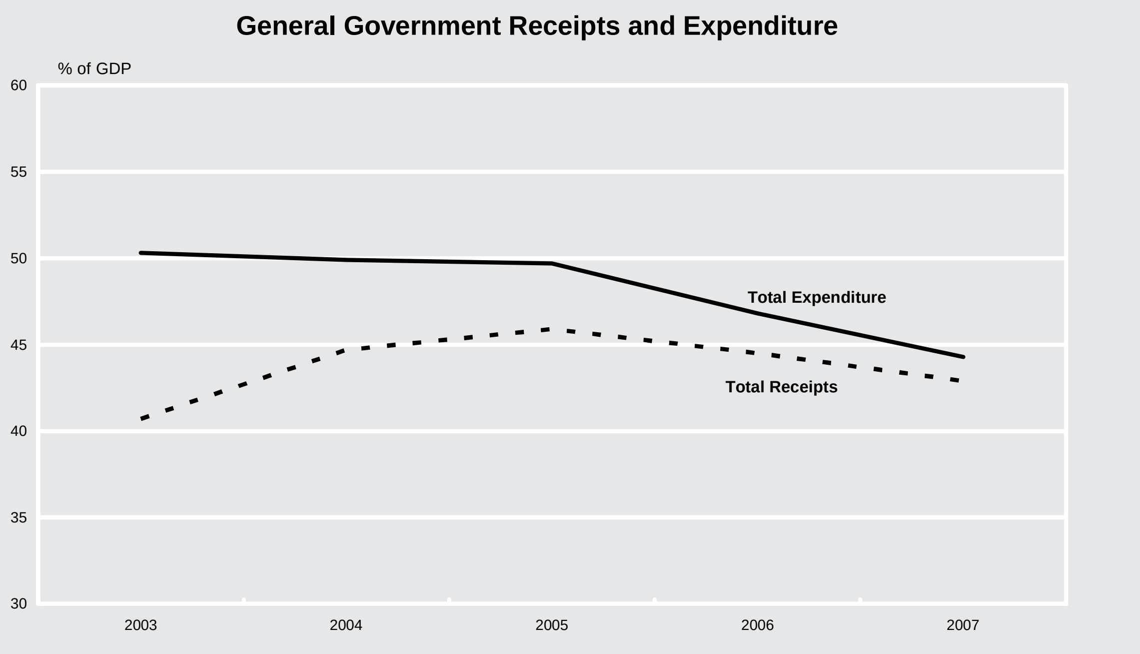
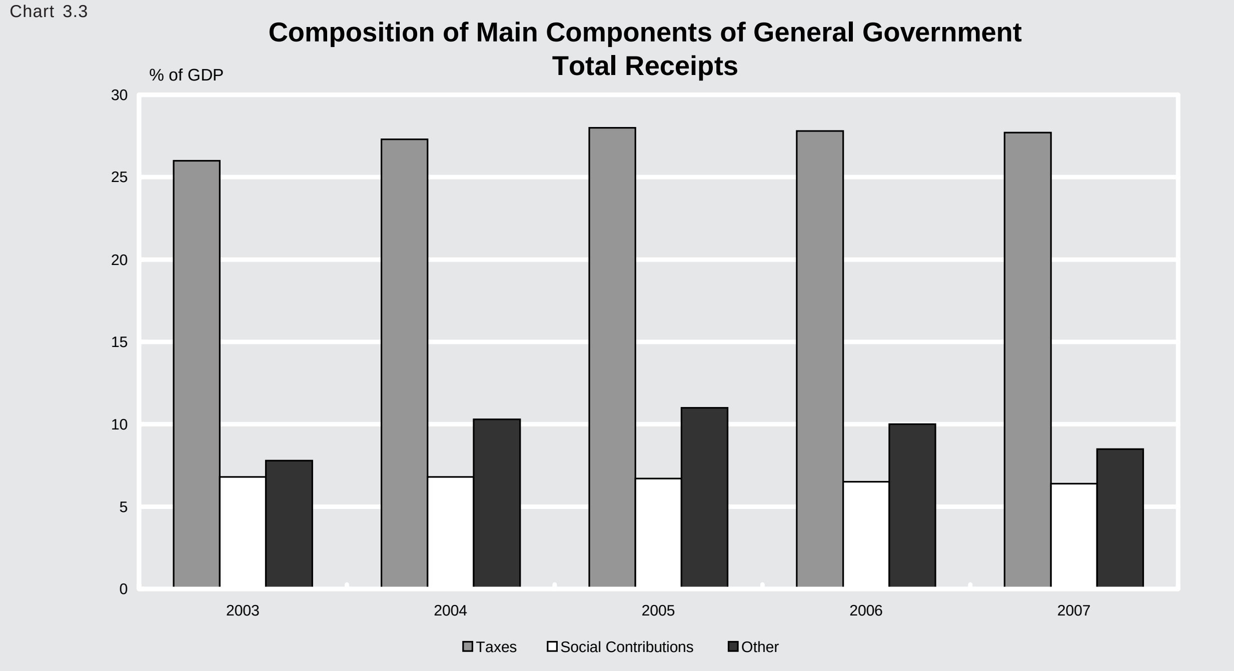


Chart 3.3



to occur in the Other component of receipts as a result of a fall in non-tax revenue. Despite the falling trend in the two years to 2007, the total receipts ratio is anticipated to be above that recorded in 2003.

During 2004, taxes - which constitute around 61 per cent of general Government total receipts - are estimated to amount to 27.3 per cent of GDP. This ratio is expected to increase to 28.0 per cent in 2005. In particular, higher proceeds are expected from income tax and VAT mainly due to enforcement efforts. The budgetary measures announced in the area of duty on documents will also result in higher proceeds. For the subsequent two years, the tax ratio will fall slightly but remain around 28 per cent of GDP. Developments in the main components of general Government total receipts over the medium-term framework are depicted in Chart 3.3.

Social security contributions, which represent around 15 per cent of general Government total receipts, are estimated to reach 6.8 per cent of GDP in 2004. In the context of the existing social security legislation, this ratio is anticipated to decline marginally to 6.7 per cent of GDP in 2005, due to nominal GDP growth outpacing the growth in social security contributions.

Although accounting for around one-fourth of general Government total receipts, the Other component is expected to register the largest changes among all the components during the period 2004-2007. In 2004, this component – which includes revenue of Extra-Budgetary Units (EBUs), non-tax revenue and the State's direct contribution in respect of social security contributions – is estimated to amount to 10.3 per cent of GDP and is anticipated to reach 11.0 per cent of GDP in 2005 on account of higher non-tax revenues. This will be mainly underpinned by a rise in grants reflecting inflows from EU funds and those related with the Fifth Italian Protocol. Higher proceeds are also expected from fees of office. In 2006 and 2007, the Other component as a per cent of GDP is anticipated to decline, although remaining above the ratio registered in 2003. This reversal in the trend mainly reflects lower funds by way of grants. Receipts of EBUs, are expected to remain relatively constant over the same period.

3.1.2 Government Expenditure Projections

During 2004 and 2005, total expenditures as a ratio of GDP are expected to follow a declining trend as the growth rate in total Government spending will be below the growth rate in nominal GDP. The lower growth in Government expenditure is planned to be achieved through a number of measures including controlling recruitment of new employees and improving further the value for money of expenditure. Moreover, as outlined in Chapter 5, a number of expenditure-reduction measures were announced in the Budget for 2005. Absolute declines for expenditure levels for 2006 and 2007 serve to reinforce a decline in total expenditure to GDP ratio for these two years.

General Government expenditure comprises Government's recurrent and capital expenditure, interest payments as well as expenditure of EBUs and other adjustments in line with ESA95 methodology.

The share of Government's expenditure of a recurrent nature in total Government expenditure in 2004 is estimated to equal to 81.0 per cent. After increasing to 38.8 per cent of GDP in 2004, Government's recurrent expenditure is projected to decline slightly to 38.2 per cent of GDP in 2005. This is mainly due to total recurrent expenditure rising at a slower rate than the increase in GDP. This declining trend is expected to continue in the subsequent years when the recurrent expenditure to GDP ratio will amount to around 36 per cent of GDP.

Public investment spending, estimated to constitute around 12 per cent of total Government expenditure in 2004, is expected to register a relative high increase in 2005 and amount to 6.9 per cent of GDP. This will be mainly due to increased expenditure on major infrastructural projects. By 2007, the ratio of public investment expenditure to GDP is anticipated to decline to around 4 per cent, as the above-mentioned projects will reach an advanced stage of completion. Interest payments on general Government debt are estimated to remain constant at around 4 per cent of GDP between 2004 and 2007.

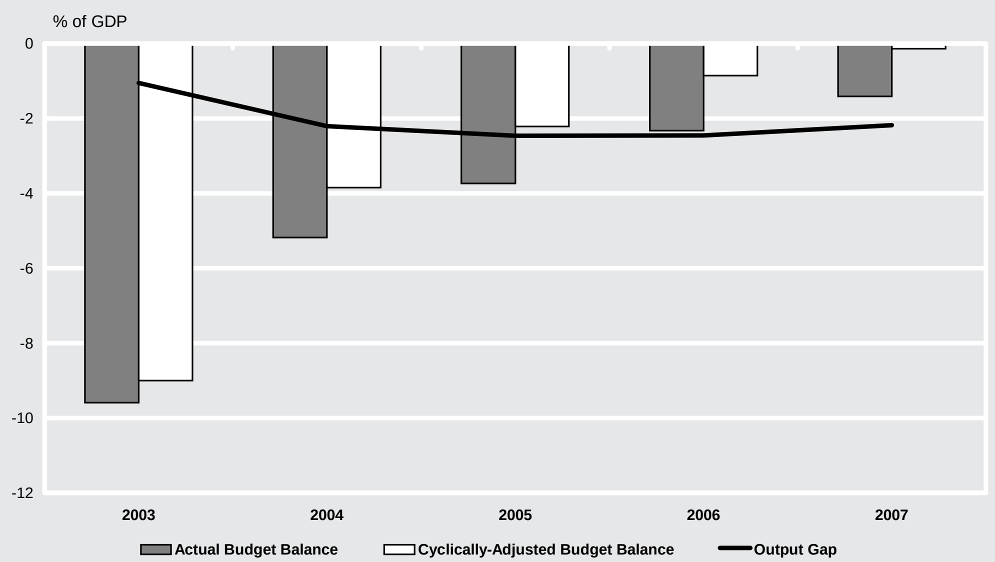
3.2 The Effect of Cyclical Fluctuations on Budget Balances

In 2003, a negative output gap of 1.1 per cent of GDP was recorded, causing the actual deficit to increase by 0.6 percentage points to 9.6 per cent of GDP. The cyclically-adjusted budget balance estimated for 2003 thus stands at 9.0 per cent of GDP. In 2004, the negative output gap is estimated to reach 2.2 per cent of GDP. This is expected to result in a deterioration in the budget balance equivalent to 1.3 per cent of GDP. Thus, if the economy were operating at its full potential, the budget deficit for 2004 would be equivalent to 3.8 per cent of GDP, compared to the estimated budget deficit of 5.2 per cent of GDP.

The economy is expected to continue operating below its potential for the forecast period. As a result, the projected budget deficit will remain higher than its cyclically-adjusted counterpart. It is expected that by

Chart 3.4

Actual and Cyclically-Adjusted Budget Balances



2005, the adverse effect of the cycle on the actual deficit will reach a peak of 1.5 per cent of GDP. The subsequent narrowing of the negative output gap will exert a favourable effect on fiscal balances, with the cyclical budgetary component declining to a negative of 1.3 per cent of GDP by 2007 and the cyclically-adjusted deficit falling to 0.1 per cent of GDP.

The cyclically-adjusted primary balance (CAPB) excludes the effects of interest expenditures incurred as a result of fiscal operations of previous years and thus reflects better Government's current fiscal operations. The CAPB for 2004 is estimated at a negative of 0.1 per cent of GDP. This is expected to turn into a surplus of 1.8 per cent of GDP by 2005 and increase further to 3.7 per cent by 2007. Chart 3.4 and Table 4 in the Statistical Appendix present estimates of Malta's output gap and the cyclically adjusted budget balance.

3.3 Debt Levels and Developments

One of the central aims of fiscal policy is the reduction in the debt ratio. It is worth highlighting that Malta's level of debt as a proportion of GDP has been affected by Government's ambitions to increase productivity levels through investment expenditure on infrastructural facilities. Moreover, importance is also attached to the attainment of the lowest possible cost of financing and to ensure that the public sector borrowing levels are kept within stipulated ceilings.

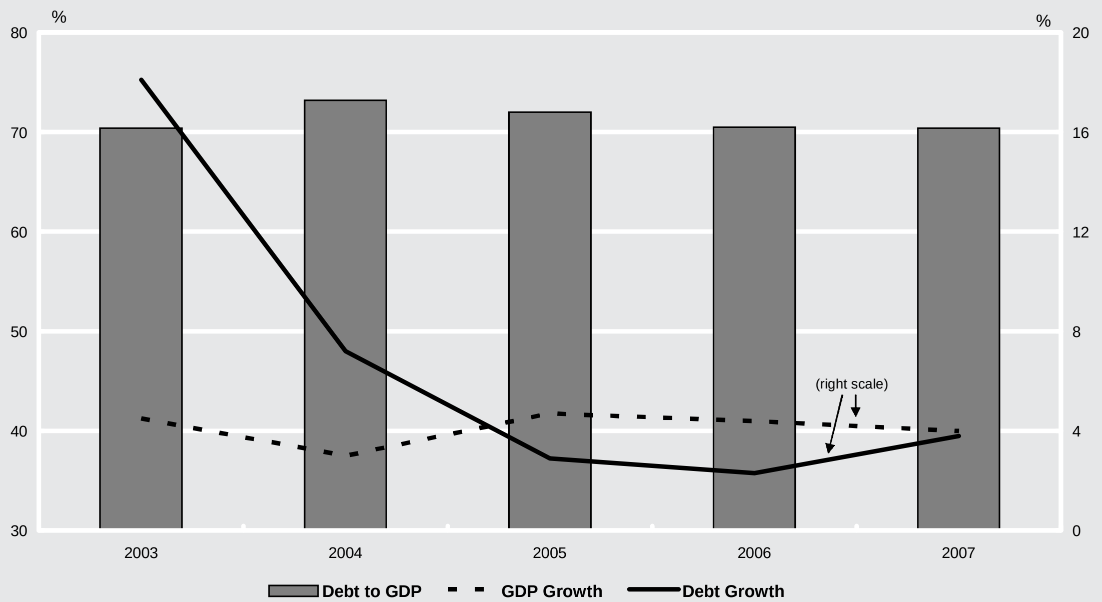
General Government debt is characterised by debt of a long-term maturity. In fact, long-term financing accounts for around 80 per cent of total financing. The share of foreign debt is around 5 per cent, implying a high dependency on the domestic market and thus a very limited risk to exchange rate fluctuations. Around 95 per cent of total debt is accounted for by the central Government.

3.3.1 Projected Debt Developments

As illustrated in Chart 3.5, as at the end of 2004, the debt is estimated to reach 73.2 per cent of GDP, an increase from 70.4 per cent of GDP in 2003. Expectations are that the debt ratio will decline annually as from 2005, to around 70.4 per cent of GDP in 2007. The debt trajectory is influenced by the primary balance, interest payments, economic growth, proceeds from privatisation and other factors. In particular, economic growth, progressive increases in the primary surplus and the sale of assets, permit the slowdown in the debt-to-GDP ratio registered as from 2005.

Chart 3.5

Debt to GDP ratio, GDP and Debt Growth



As shown in the Statistical Appendix Table 3, increased nominal GDP is expected to have a contractionary effect on the debt-to-GDP ratio of about 3 percentage points per year between 2004 and 2007. During 2004, the debt level is expected to increase at a faster rate than economic growth resulting in a higher debt-to-GDP ratio. On the other hand, during the 2005-2007 period debt levels are expected to increase at a slower rate than economic growth, resulting in declining debt-to-GDP ratios.

Half of the increase in the debt-to-GDP ratio in 2004 is attributable to the primary deficit. In fact, the primary deficit is expected to increase the debt-to-GDP ratio by 1.4 percentage points. Between 2005 and 2007, the expected primary surplus will exert an increasing contractionary effect in the debt-to-GDP ratio leading to a decrease in the debt-to-GDP ratio of 2.5 percentage points in 2007. Interest payments are expected to increase the debt-to-GDP ratio by about 4 percentage points between 2004 and 2007. During the same period, the implicit interest rate on debt is expected to range between 5.2 and 5.6 per cent. Privatisation receipts which are expected to materialise in 2005 and 2006 are expected to have a contractionary effect on the debt-to-GDP ratio of about 2 percentage points.

During 2004, the contractionary impact of the GDP growth and of other factors influencing the debt ratio are outweighed by the expansionary impact of the interest payments and the primary balance leading to an increase in the debt-to-GPD ratio. On the other hand, during 2005 and 2006, the augmentative impact of interest payments is offset by the effect of the primary surplus, GDP growth, and privatisation receipts leading to a declining debt-to-GDP ratio. During 2007, the expansionary effect of interest payments and other factors influencing the debt ratio are expected to be outweighed by the impact of the primary surplus and GDP growth.

3.3.2 Comparison with Convergence Programme May 2004

In the May 2004 Convergence Programme, Government debt ratio was expected to increase to 72.1 per cent and 72.4 per cent in 2004 and 2005 respectively, but follow a downward trend thereafter. However, since the submission of the Convergence Programme, the revision in the expected path of economic growth as well as the lack of proceeds from privatisation which were expected to materialise in 2004 had an impact on the underlying debt ratio.

In 2004, the increase in debt in absolute terms is expected to be stronger than assumed in the Convergence Programme submitted in May 2004. This revision is primarily the result of lack of estimated proceeds from privatisation which are not expected to materialise. This reflects delays in the privatisation process due to the prevailing economic and business climate which was not very conducive to investment. In these circumstances, it would not have been in Malta’s best interest to hasten unduly the privatisation process. Nevertheless, it is pertinent to point out that important developments have been registered in this context in 2004 and, as outlined in Chapter 6, the privatisation process of a number of other entities is currently underway. As a result of these developments, the debt-to-GDP ratio will be higher than expected for 2004, despite a relatively unchanged level of nominal GDP. In fact, the debt-to-GDP ratio is expected to be 1.1 percentage points higher than projected earlier, to reach 73.2 per cent in 2004.

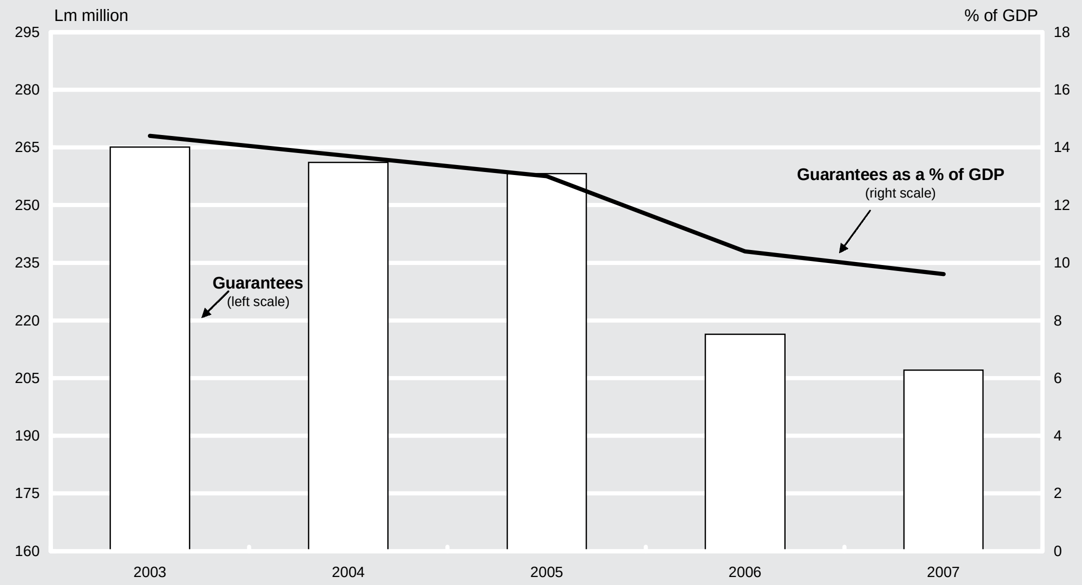
The shortfall of privatisation proceeds in 2004 is expected to be reflected in the debt levels for 2005 and subsequent years. The impact of this on the debt ratio is, however, offset by higher nominal GDP level when compared to the projections in the Convergence Programme May 2004. Thus, the increase in the anticipated level of debt coupled with a higher level of GDP is expected to leave the debt-to-GDP ratio practically unchanged from the ratios projected earlier.

3.4 Fiscal Risks

Government’s programme of fiscal consolidation is subject to certain fiscal risks and uncertainties. Unexpected fluctuations in the economy resulting from unforeseen domestic or international developments can have

Chart 3.6

Government Guaranteed Debt



significant impacts on the public finances. In addition, other types of risks may also negatively impinge on the outlook of Government's financial position.

Government is vigilant to the risks associated with Government liabilities other than debt, namely contingent and implicit liabilities, even though such liabilities do not impinge on the current budgetary position.

The stock of contingent liabilities, namely Government guarantees, stood at around Lm265 million or around 14 per cent of GDP at the end of 2003. In addition, guarantees to entities which form part of the General Government amounted to around Lm50 million or 3 per cent of GDP. In the medium-term framework, the level of guarantees is expected to follow a downward trend from around Lm265 million in 2004 to around Lm207 million in 2007. As illustrated in Chart 3.6, state guarantees as a per cent of GDP are expected to decline from around 14 per cent in 2004 to around 10 per cent in 2007. To date, there have been no guarantees that led to the disbursement of Government funds. Moreover, there is no indication that any guarantees are likely to be called in the future.

Increased budgetary risks may also arise from the lack of achievement of the planned privatisation programme. The unexpected shortfall of privatisation receipts exerts pressure on public finances since this would necessitate the use of alternative sources of financing the deficit. In turn, this would also increase interest payments and thus exert an adverse impact on the borrowing requirement in subsequent years. On the other hand, in privatising assets, Government divests the risks associated with the performance of the entities being privatised although risk still exists in cases where Government retains a financial obligation in the entity concerned.

Fiscal risks related to the characteristics of Government debt are minimal. Currently, around 95 per cent of Government debt is denominated in local currency thus exerting insignificant exchange rate risk. Moreover, given that long-term debt constitutes around 80 per cent of total financing, interest rate risk is also minimal.

The sustainability of public finances is exposed to fiscal risk arising from long-term structural tendencies in demography, particularly as ageing populations increase expenditures on such areas as public pensions and health care systems. In order to mitigate this potential risk, one of Government's main objectives is to reform the welfare system and ensure that such system is socially adequate and financially efficient and viable. In fact, as outlined in other Chapters of this document, a White Paper on Pension Reform was recently published for national discussion and consultation.

4. Sensitivity Analysis and Comparison with the Convergence Programme
May 2004

4. Sensitivity Analysis and Comparison with the Convergence Programme May 2004

4.1 Sensitivity Analysis

This document presents an economic assessment of Malta's growth prospects for the forthcoming years up to, and including 2007. Given the degree of uncertainty attached to any forecasting exercise, it was deemed important to illustrate the sensitivity of the budgetary forecasts to changes in the base environment.

This section describes the effect of three alternative scenarios on budget forecasts. The sensitivity scenarios featuring interest fluctuations and economic activity in Malta's main trading partners presented in the Convergence Programme May 2004 were re-estimated in this Update. An additional sensitivity analysis was conducted with respect to higher GDP growth, emanating from higher private sector investment. The results are presented in terms of the effect of the deviation from the baseline on the General Government Budget Deficit, gross General Government debt and Gross Domestic Product. It is pertinent to note that in view of the uncertainty surrounding the responses in the economic environment, the results reported below should be seen as only indicative of the likely effects of the simulated shocks. These sensitivity analyses are illustrated in Charts 4.1, 4.2 and 4.3.

4.1.1 Sensitivity to Interest Rate Fluctuations

Changes in the domestic interest rate affect both the real and monetary sectors of the economy with a consequent impact on the economic activity that varies according to the degree of elasticity of the respective component of output with respect to changes in the interest rate. In turn, changes in economic activity are reflected in changes in the General Government Budget Deficit and the level of gross General Government debt. Government finances are also directly affected as changes in the interest rate affect the debt servicing costs. However, it is pertinent to note that in view of the long-term nature of Government debt in Malta, changes in the interest rate are mainly likely to affect the debt servicing costs in relation to the rolling-over of past long-term debt.

Similar to the scenario presented in the Convergence Programme May 2004, this sub-section is based on an assumption of a 1 percentage point increase in the interest rate between 2004 and 2007. Given the relatively

Chart 4.1

Sensitivity to a 1 Percentage Point Increase in the Interest Rate

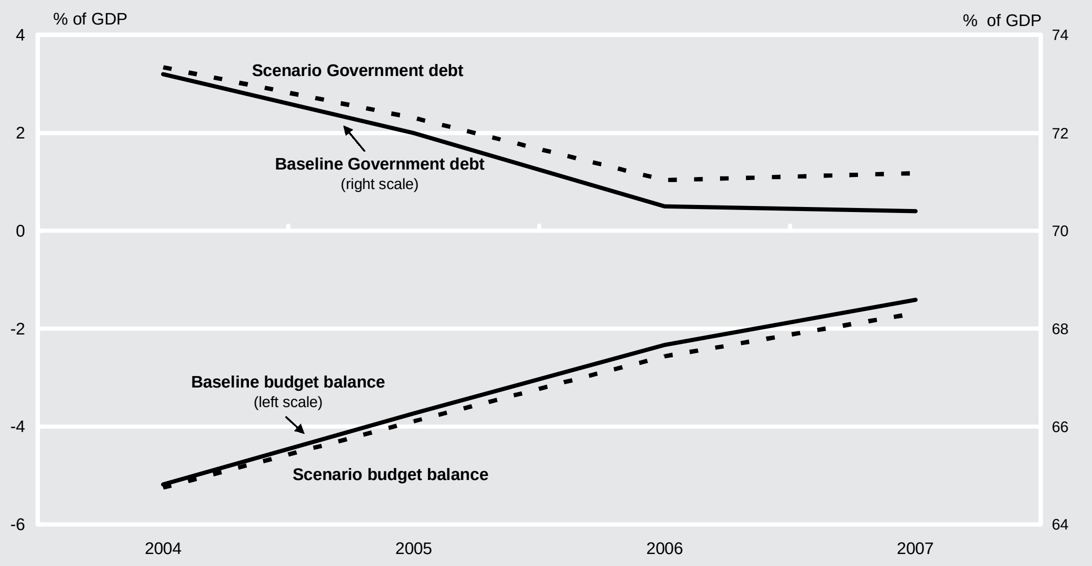
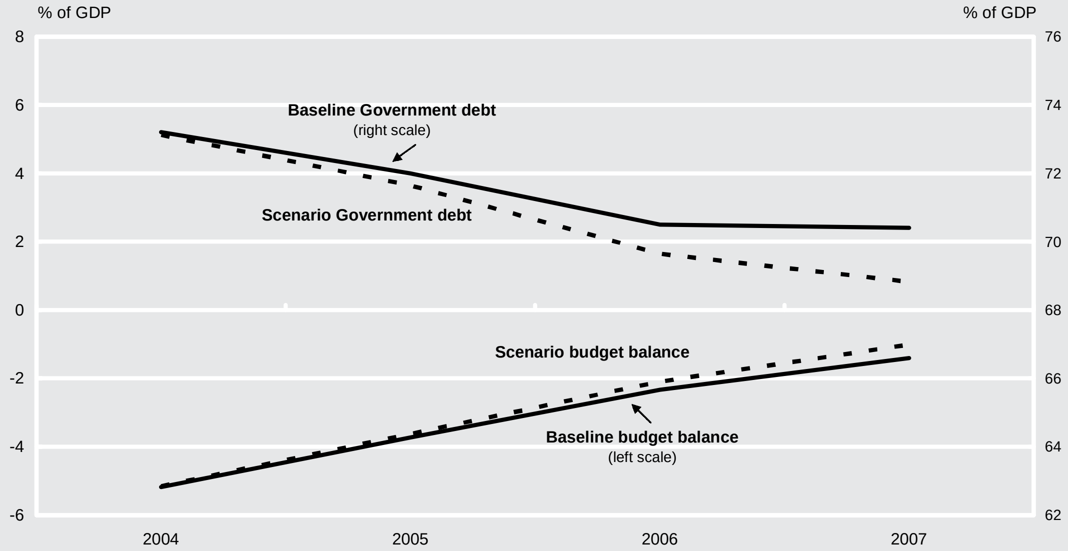


Chart 4.2

Sensitivity to a 1 Percentage Point Increase in External Demand



short period of time that elapsed since the submission of the Convergence Programme and the absence of major structural changes in the Maltese economy during the same period, there are no major changes that need to be reported in this Update. Thus, an increase in the interest rate of 1 percentage point results in a decrease of 0.1 percentage points in economic growth as well as a worsened budget balance by about 0.3 percentage points of GDP at the end of forecast period when compared to the base forecast. This consequently leads to a deviation in the Government debt-to-GDP ratio of around 0.8 percentage points by 2007.

4.1.2 Sensitivity to Change in External Demand

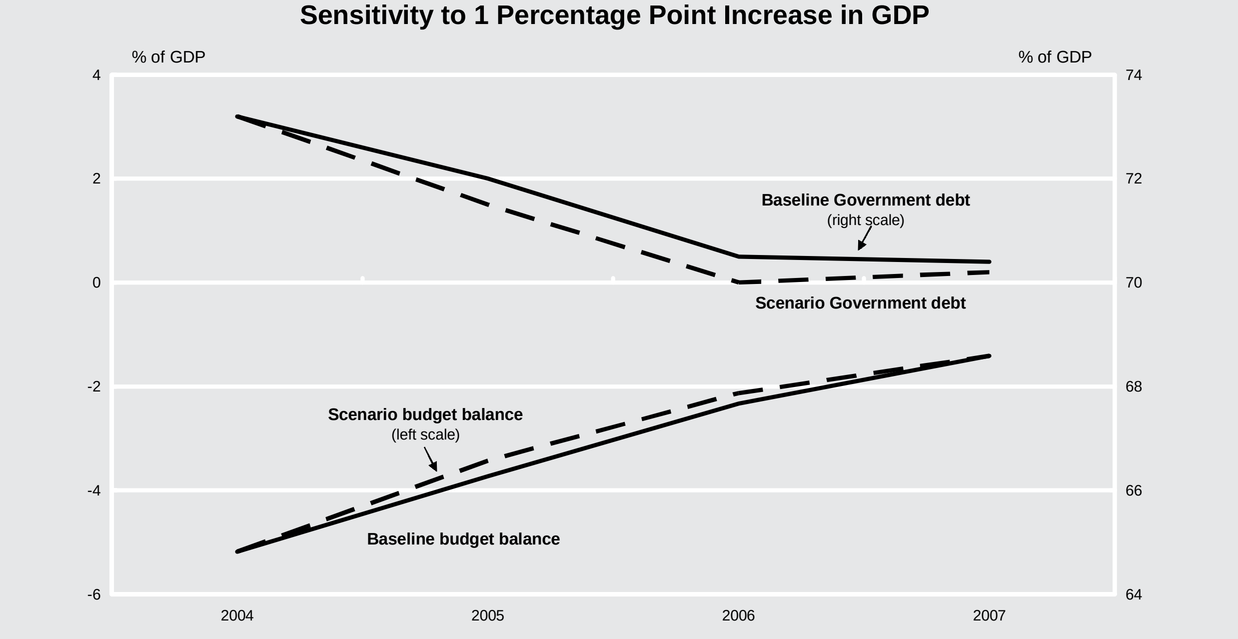
The scenario in this subsection, similar to that presented in the Convergence Programme May 2004, assumes an increase in external demand of 1 percentage point in the first year of the forecast period and throughout the forecast horizon until 2007. As explained above, as a result of the relatively short period of time since the May submission and the absence of major structural changes during the intervening period, no major changes in the responses to such a shock need to be reported in this Update.

An increase in external demand for domestically produced goods and services results in an increase in output that in turn has several spill-over effects on the domestic economy. In particular, given the relatively high import-content of domestically produced goods and services, the effect of higher export demand on output is expected to be partly offset by a rise in imports. Stronger foreign demand results in an increase in real GDP growth of around 0.2 percentage points, an impact that increases gradually to around 0.5 percentage points by 2007, when compared to the baseline. Higher external demand is also expected to result in an improvement in the budget balance, as the budget balance as a percentage of GDP is expected to improve by around 0.4 percentage points by 2007. Consequently, the share of Government debt as a percentage of GDP is expected to decline by around 1.6 percentage points by 2007, when compared to the baseline scenario.

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

An increase in the growth rate of GDP, stimulated through an increase in private sector investment, leads to higher demand for goods and services and consequently an increase in output. As in the case of export demand, higher investment demand is expected to be partly reflected in higher imports, reflecting the high degree of openness of the Maltese economy. Such a development is *a priori* expected to lead to an improvement in the public balance as higher economic growth automatically raises Government revenue.

Chart 4.3



This scenario is based on an increase in private sector investment which results in an increase of 1 percentage point in GDP during 2005. In accordance with *a priori* expectations, the public balance as a percentage of GDP improves by around 0.3 percentage points when compared to the baseline forecast, and becomes negligible by the end of the forecast period. Similarly, Government Debt as a percentage of GDP declines by around 0.5 percentage points upon impact, and it is estimated to be around 0.2 percentage points lower than the baseline, towards the end of the forecast period.

4.2 Comparison with the Projections in the Convergence Programme May 2004

The economic growth forecasts presented in this Update have been revised downwards when compared to those published in the Convergence Programme May 2004. Indeed, real GDP growth has been revised down by 0.5 percentage points in 2004 to a growth rate in GDP at constant prices of 0.6 per cent. This was primarily the result of a lower than expected rate of growth of investment activity during 2004. In 2005 and 2006, economic growth is expected to remain below the forecasts presented in the Convergence Programme May 2004. Economic growth in 2007 is expected to recover and marginally exceed the May forecasts.

Capital expenditure by Government for 2004 is expected to be well below the level anticipated in May 2004, whilst investment activity by the private sector was also lower than anticipated in the forecasts as presented in the Convergence Programme May 2004. As a result, the growth in gross fixed capital formation was revised from 6.7 per cent to 2.0 per cent for 2004.

Private consumption expenditure was also marginally revised. The expected growth in private consumption expenditure was edged upwards by 0.2 percentage points to 0.4 per cent in 2004. At 3.4 per cent, inflation forecasts for 2004 as presented in the Convergence Programme in May were significantly higher than the current estimate of 2.9 per cent. The impact of the increase in the VAT rate from 15 per cent to 18 per cent was lower than anticipated, whilst the effect of the removal of remaining levies on imported goods was greater than expected. This had a positive effect on private consumption. Meanwhile, Government expenditure forecasts remained virtually unchanged.

Export performance for 2004 is now expected to be higher than that anticipated in May. This is partly due to a more favourable pick-up in external demand as economic activity in the EU turned out to be slightly better than forecasted. In addition, a significant fall in export prices is also evident. As a result, the expected export growth was increased by 1.5 percentage points to a growth rate of 2.8 per cent.

The growth in imports of goods and services has been revised downwards for 2004. This is primarily the result of the lower demand for capital goods resulting from the lower forecasts of investment activity. At 1.6 per cent, the growth in imports for 2004 is 0.7 percentage points lower than that originally forecasted.

As a result of these developments, whereas the external balance of goods and services was expected to contribute to a fall of 1.0 percentage point in real GDP, current forecasts indicate that the external balance of goods and services will contribute to a rise of 0.9 percentage points of GDP. The contribution of final domestic demand to GDP growth continues to be positive. However, as a result of the performance in investment activity, the contribution to GDP growth fell from 2.0 per cent to 0.9 per cent. Meanwhile, changes in inventories are forecasted to have a negative effect of 1.2 percentage points on GDP growth compared to a relatively neutral effect as forecasted in the Convergence Programme May 2004.

The downward revision in economic growth prospects was reflected in a fall in employment growth, compared to the May 2004 forecasts. Meanwhile, the unemployment rate in 2004 is estimated to be 5.8 per cent compared to the 6.0 per cent forecast in May 2004. Such a result is due to the fact that revised forecasts for 2004 are underpinned by a lower than expected increase in the labour supply for 2004.

Economic growth prospects for 2005 are now slightly lower than those projected in May 2004. In 2005, growth prospects have been revised downwards by 0.2 percentage points, primarily as a result of a lower export growth and a higher growth in imports. Lower exports are partly related to a marginal downward revision in foreign demand forecast for 2005, whilst higher imports reflect the significant increase in forecast investment activity and the improved forecast for private consumption expenditure. The increase in investment activity projected for 2005 is mainly related to higher expected outlays on capital by Government.

Although economic growth in 2006 is expected to pick up, it is still expected to be below the growth rate forecast presented in the Convergence Programme May 2004. Growth performance in 2006 is expected to originate mainly from the external sector. By 2007, economic growth is expected to marginally exceed the growth performance projected in the Convergence Programme May 2004. Again, this will continue to be driven primarily by the external sector.

A comparison of the projections in this Update with those in the Convergence Programme May 2004 for public finances, is provided in Chapter 3 and Chapter 5 of this document.

5. Quality of Public Finances

5. Quality of Public Finances

The attainment of public finances on a sustainable path remains one of Government's main medium-term fiscal objectives. Apart from reducing the macroeconomic imbalances, the achievement of this objective will help bolster sustained economic growth.

The global events that unfolded since 2001 had an adverse effect on the local economy possibly due to Malta's greater exposure to international trade and sensitivity to developments occurring overseas. After peaking in 2000 at 5.8 per cent above potential, output fell to 1.1 per cent below potential in 2003. The economic slowdown has affected public finances. The annual average growth of total expenditure was higher than that for total revenues during the three years to 2003. Although the growth rate of both total expenditure and total revenues decelerated during this period, by 2003 the growth rate of the latter was around half that registered for total expenditure. Consequently, the deficit-to-GDP ratio in 2003 reached 9.6 per cent of GDP (including the cost of a major one-off operation estimated at 3.2 per cent of GDP).

In response to this outcome, the Convergence Programme of May 2004 presented medium-term fiscal targets aimed at bringing a gradual reduction in the fiscal imbalance to 1.4 per cent of GDP by 2007. So as to avoid undue economic disruptions, the fiscal adjustment path contained in the Programme envisaged that a budget deficit above the 3 per cent reference value will persist in 2004 and 2005, till it falls below the benchmark level in 2006.

The Budget for 2005 reflects Government's commitment to put public finances on a sustainable path. Section 5.1 gives an overview of the main features of the Budget and describes the way in which the fiscal target for 2005 will be achieved.

5.1 The 2005 Budget

In line with Government's medium-term objectives, the Budget for 2005 plans for further budget consolidation and aims to increase the growth potential of the Maltese economy. The effects to be reaped by expanding the growth of the Maltese economy go beyond the positive impact this leaves upon financial consolidation efforts. In fact, such growth potential is expected to stimulate the supply side of the economy. These growth-enhancing initiatives are intended to strengthen Malta's international competitiveness through infrastructural investment, support research and development, incentivise industry and tourism, assist SMEs and encourage more labour participation, whilst improving productivity. A number of structural reform measures were also announced in the Budget for 2005. These will be dealt with in Chapter 6.

Fiscal consolidation will be brought about by both revenue-raising measures as well as policies intended to reduce expenditure. In the case of the latter, policies fall under three categories:

a. restructuring of public entities: further efforts in this direction will cover a number of public entities namely, Sea Malta Co. Ltd, Enemalta Corporation and the Malta Tourism Authority. Another initiative will involve identifying those public entities which can reap benefits by merging their respective structures.

b. limiting public sector hiring and reducing administrative costs: the Budget for 2005 confirmed Government's stated policy of limiting the replacement of retirees only in those cases deemed essential. Moreover, greater flexibility and mobility of public sector employees will be sought with the aim of improving service and increasing productivity. The Government will be establishing a new unit which will be responsible for exploring new opportunities to expand public private partnerships. In addition, during 2005 one-off non-core expenditure initiatives, including for instance the replacement of vehicles, will only be authorised in exceptional cases.

c. strengthening the fight against tax and benefit fraud: in a bid to reduce VAT evasion in the construction sector, a new procedure will be introduced whereby those applying for electricity services will be obliged to provide pertinent details of construction services bought from specific suppliers. On the other hand, the fight against benefits' fraud will be widened through a reform of the system governing the application of invalidity pensions. Similarly, unemployment registration abuse will be tightened further through amendments in the law. The fight against benefit fraud will be strengthened in 2005, by means of a comprehensive law, whilst legislative amendments will strengthen the collection of information on economic activity.

Table 5.1 gives more detail on the main measures announced in the 2005 Budget. For those measures of a substantive nature, a quantification is also provided. This list is further sub-divided into corrective measures and growth-enhancing measures. A full list of the measures announced in the Budget for 2005 is provided in Annex 1.

Corrective Measures

The corrective measures announced in the Budget for 2005 amount to Lm22.4 million. Two-thirds of the total, or Lm15 million, represent structural measures and mainly consist of adjustments in taxes, whilst the remaining Lm7.4 million are of a one-off nature. Structural measures account for 1 percentage point of the 1.5 percentage points improvement in the deficit-to-GDP ratio planned for 2005. Permanent measures to increase revenue which will come into effect next year include the following:

- Heirs of property derived from inheritance between a specified period will be given the opportunity to adjust, by mid-2005, the declared value in order to take into account the accretion in the value of the property up to 25 November 2003. Revenue from capital gains tax generated by this measure is expected to raise an additional Lm4 million or 0.27 points of the 1.5 percentage points reduction in the deficit-to-GDP ratio.
- In September 2004, a new eco-contribution scheme was introduced to encourage responsibility by producers and importers for the products which will eventually become waste. The eco-contribution is charged

Main Measures Budget 2005

Table 5.1	Lm thousand
Corrective Measures	
Structural	
Electricity excise	200
Excise duty and VAT on kerosene (net)	2,000
Excise duty on tobacco and cigarettes	1,000
Broadening of eco-contribution base	2,500
Capital gains tax on inherited property	4,000
Excise duty on mobile telephony	1,300
Departure tax	2,000
Other income	2,000
Sub-total	15,000
One-Offs	
Repayment of pending pension claims	750
Income from listed/unlisted companies	2,400
Sale of property and other income	4,235
Sub-total	7,385
Growth Measures	
Labour participation initiatives	1,000
Incentives to Industry, including venture capital fund	1,850

on products when they enter the Maltese market from abroad, or in the case of locally-manufactured goods when these are put on sale. The Budget for 2005 provides a broadening of the items that will be subject to eco-contribution. The additional yield of this measure will amount to Lm2.5 million or 0.17 points of the 1.5 percentage points decline in the deficit-to-GDP ratio.

- Excise duty and VAT will be charged on kerosene and as a result its price will be equivalent to the price of diesel. Moreover, like the remaining fuel products, the price of kerosene will fluctuate according to international oil prices. A one-off compensation of Lm12 will be paid in 2005 to persons entitled to non-contributory social benefits and contributory unemployment benefits. The net proceeds from this measure in 2005 will amount to Lm2 million or 0.13 points of the 1.5 percentage points improvement in the deficit-to-GDP ratio.
- With effect from 1 August 2005 the passenger departure tax payable on outgoing air fares will be doubled to Lm20. This measure will yield an additional Lm2 million representing 0.13 points of the 1.5 percentage points reduction in the deficit-to-GDP ratio.
- Additional revenues are expected from excise duty levied on mobile telephony. As a result of this measure, Government revenue in 2005 is expected to increase by Lm1.3 million or 0.09 points of the 1.5 percentage points improvement in the deficit-to-GDP ratio.

Revenue estimates for 2005 also include a number of one-off measures which will contribute in reducing the fiscal imbalance. In total, the yield from one-off measures will amount to Lm7.4 million, or 0.5 points of the 1.5 percentage points decline in the deficit-to-GDP ratio. These one-off measures include:

- Additional receipts of Lm2.4 million are expected to be raised from listed/unlisted companies. This will represent 0.16 points of the 1.5 percentage points decline in the deficit ratio.
- Another Lm0.8 million will result from repayment of pending pension claims. This measure will contribute to 0.05 points of the 1.5 percentage points fiscal effort in 2005.
- Revenue from the sale of Government property in 2005 and other income is expected to generate Lm4.2 million or 0.28 points of the 1.5 percentage points decline in the deficit-to-GDP ratio.

The use of such one-off measures should be seen against the background of a number of exceptional expenditure items that are planned to occur during 2005. These exceptional items include outlays of around Lm0.6 million in respect of Malta's Permanent Representation in Brussels, the hosting of the Commonwealth's Heads of Government Meeting which is estimated to cost around Lm1.5 million and an increase of approximately Lm5 million earmarked for the *Mater Dei* hospital. These spending items are temporary and will not recur indefinitely.

Growth-enhancing Measures

The Budget for 2005 contains several measures which aim to boost the economic growth potential of the Maltese economy. The main thrust in this aspect is enhancing Malta's competitiveness. The main growth-enhancing measures contained in the 2005 Budget include:

- Until now, public holidays which fell on weekends were compensated by additional days of vacation leave. As of 2005 this arrangement will be removed, a measure which is expected to enhance productivity and competitiveness.
- An amount of Lm1.85 million was allocated in the form of incentives to industry and the setting-up of a new venture capital fund. Investors in the fund will be entitled to a tax credit of part of their investment and will also be entitled to a partial exemption for tax on any capital gains accruing from the disposal of such investment.
- The 2005 Budget included a number of fiscal incentives targeted at specific economic activities. In particular, the incentives cover call centre and data processing activities, film production as well as certain activities in the tourism industry.
- Horizontal measures were announced in the 2005 Budget for those SMEs having less than eleven full-time employees which will be eligible for a full tax deduction in respect of information technology spending.

- Research and development is considered to be a main driver of competitiveness. The 2005 Budget has increased the incentives on scientific research allowing for a 200 per cent total deduction of the actual expenditure from liabilities. It also allows for the definition of certain expenditure, such as wages paid to employees undertaking post-graduate studies to be deductible. Besides, tax deductions equivalent to 50 per cent of the employer's social security contributions in respect of employees having a post-graduate are being catered for.
- As part of the implementation of the National Action Plan for Employment, the Budget for 2005 contains two key measures aimed at boosting labour participation, in particular that of females. The first measure targets women who have been inactive during the previous five years. They will benefit from a one-off income tax exemption on income from employment earned in the first year. Another incentive which will encourage more females to join the labour force involves a 15 per cent reduced rate of tax on the first Lm3,000 income earned from part-time work by a spouse if the couple opts for a joint computation provided that the other spouse is in full-time employment or is a pensioner or is a full-time student.

5.1.1 Determinants of the 2005 Fiscal Outcome

The fiscal consolidation that is projected to occur in 2005 is attributable to both revenue-raising measures as well as policies intended to contain expenditure. Indeed, General Government Total Receipts are expected to improve by 3.3 per cent of GDP, which will more than outweigh the higher expenditure of 2.0 per cent of GDP. Table 5.2 provides a detailed breakdown of revenue components that are anticipated to contribute to higher revenue in 2005.

Corrective measures introduced in 2005 are expected to yield 1.1 per cent of GDP composed of 0.8 per cent in structural measures and 0.4 per cent in one-off measures. Grants are anticipated to increase by 1.9 per cent on account of inflows from EU funds and the Fifth Italian Protocol. Meanwhile, General Government Total Receipts are expected to rise by 0.6 per cent of GDP as a result of revenue buoyancy and more enforcement. Revenue from other sources are estimated to decline by 0.9 per cent of GDP.

Table 5.3 provides a breakdown of total Government expenditure expressed as a per cent of GDP. Estimates of total expenditure for 2005 show that despite increasing to 49.0 per cent of GDP, the rise will be smaller than that in 2004. The main contributor of higher total expenditure-to-GDP ratio in 2005 will be capital outlays which are planned to advance by 1.1 percentage points due to higher spending related with health, the elderly and housing, education, road construction works, projects financed with EU funds and other categories. On the other hand, subsidies and subventions as a percentage of GDP are expected to decline. It is pertinent to note that the increase in total capital expenditure partly reflects extraordinary circumstances relating to the proper definition of liabilities in relation to a major contract. These issues were however resolved towards the

Changes in General Government Total Receipts* - 2005
(per cent of GDP)

Table 5.2

Corrective measures		1.1
structural	0.8	
one-off	0.4	
Grants		1.9
Revenue buoyancy and enforcement		0.6
Others		-0.9
Total		3.3

*positive represents an increase

Total Expenditure
(per cent of GDP)

Table 5.3

	2003	2004	2005
Recurrent expenditure	36.7	38.8	38.2
Personal emoluments	10.6	10.6	10.4
Social security benefits and pensions	12.4	12.4	12.2
Education	2.3	2.4	2.5
Health, the elderly and community care	1.6	2.1	2.0
Others	9.8	11.4	11.1
Interest payments	3.4	3.7	3.9
Capital expenditure	5.6	5.8	6.9
Roads	0.4	0.5	0.7
Education	0.4	0.3	0.4
Health, the elderly and housing	1.7	1.6	1.9
Subsidies / subventions	1.6	1.1	0.9
Others, of which	1.6	2.3	3.0
Projects financed by EU funds	-	0.2	0.7
Total expenditure	45.8	48.3	49.0
EBUs and other adjustments	4.6	1.6	0.7
General Government expenditure	50.3	49.9	49.7

end of 2004. Another contributor to the higher expenditure-to-GDP ratio in 2005 will be interest payments, which will increase slightly by 0.2 percentage points to 3.9 per cent. On the other hand, the ratio of Government recurrent expenditure-to-GDP is expected to fall marginally to 38.2 per cent on account of GDP growth outpacing that of recurrent expenditure. Lower GDP ratios are anticipated for personal emoluments, social security benefits and pensions, and other categories. On the other hand, the ratio of education-related recurrent expenditure-to-GDP is expected to increase.

As a consequence of these developments, the general Government budget deficit is expected to decline from 5.2 per cent in 2004 to 3.7 per cent in 2005.

5.2 Comparison with Convergence Programme May 2004

In general, the path of both total receipts and total expenditures over the 2004-2007 period will remain unchanged from that expected in the previous Convergence Programme. As was the case in the May Programme, receipts and expenditures as a ratio to GDP are projected to decline, albeit by less than previously anticipated. This is because current forecasts predict that over the projection period, both total receipts and expenditures will on average grow at a faster pace than what was anticipated in the previous Programme, whilst the average annual growth in nominal GDP remained practically unchanged under both scenarios. Despite these developments, as shown in Statistical Appendix Table 5, the budget consolidation path is expected to remain unchanged from that anticipated in May 2004.

6. Horizontal Issues affecting Public Finances

6. Horizontal Issues affecting Public Finances

6.1 Structural Reforms

The pursuit of structural reforms is a pre-requisite to achieve higher economic growth as microeconomic and institutional reforms affect the degree of capacity utilisation. The implementation of structural reforms contributes to enhance the competitiveness of the Maltese economy, which is imperative in view of the high degree of openness of the domestic economy. In this respect, Government initiated a number of reforms in the past years as well as in the Budget Speech for 2005, aimed to instil competitiveness and efficiency in the Maltese economy and to create an environment which is conducive to private sector initiative and investment.

6.1.1 Privatisation

During 2004, privatisation continued to play a pivotal role in redefining the role of the state, generate productivity gains, and attract strategic investors by way of foreign investment. The privatisation of Malta Freeport Terminals Limited was concluded in October 2004 when a thirty-year operation and development licence in respect of the Freeport was granted to a French shipping company. The operator agreed to pay a lease in respect of the Freeport site and the Freeport Centre. Moreover, the operators are also committed to invest in new equipment in order to increase the transhipment of the Freeport from 1.3 million containers per year to 2.3 million per year. Government will however still retain the ownership of the land.

During 2004, the Privatisation Unit completed its evaluation of the expressions of interest from various companies in the privatisation of Sea Malta Co. Ltd – the national shipping line which operates regular liner services and a range of maritime-related services. Presently, the Government has majority shareholding in the national shipping line, whilst private investors own 31 per cent of its shares. Currently, the Privatisation Unit is engaged in negotiations with two prospective buyers, so that the Public Service Obligation reached between Government and the company will be honoured.

The Privatisation Unit is also engaged in concluding the privatisation process of Bank of Valletta plc and Maltacom plc in the coming months. In the case of Bank of Valletta plc, the divestiture would imply the sale of the 40 per cent shareholding retained by Government and Banco di Sicilia to a strategic partner. Government intends to sell its majority shareholding (60 per cent) in Maltacom plc to a strategic partner that will contribute to the company’s ability to thrive in such a competitive sector.

Government is also re-assessing its stance in relation to Kordin Grain Terminal, Maltapost plc and the Libyan Arab Maltese Holding Co. Ltd. In the 2005 Budget, Government announced its intention to foster further privatisation initiatives that will be completed over the next three years. In particular, Government intends to sell its shareholding in Interprint Ltd and Malta Dairy Products Ltd. A strategic partner will be sought to take over the control of operations of Tug Malta Ltd where Government intends to retain a shareholding of at least 40 per cent. Government intends to sell a further 20 per cent of its shares in Malta International Airport plc through an Initial Public Offering (IPO) in Malta Stock Exchange. Three hotels forming part of Air Malta plc’s assets will also be sold off whilst the management of Sterling Services Ltd and Air Supplies Co. Ltd will be entrusted to a strategic partner. Government also announced its intention to lease Enemalta plc’s oil storage facilities, after integrating Malta Oil Bunkering Co. Ltd in its operations, to a strategic partner. The production and distribution of gas will also be divested to a strategic partner.

6.1.2 Restructuring of Public Enterprises

An integral part of Government’s strategy to restore sustainability of public finances includes a programme of reforms designed to ensure that public sector entities operate in a more efficient and effective manner. In turn, the restructuring of public enterprises contributes to increasing the country’s competitiveness. In order to reduce the size of the public sector, during 2003 Government liquidated a number of parastatal companies that no longer provided essential services, namely the state-controlled grain importing monopoly Medigrain Ltd and the state-owned export insurance broker Malta Export Credit Insurance Ltd.

During 2004, Government commenced the reform of the Gozo Channel Co. Ltd, which provides the ferry transport service from Malta to the sister island of Gozo. The restructuring programme aims to ensure that the service provided is consistent, reliable and efficient. A revision of the tariffs was undertaken in order to reflect more the value of the service provided. Furthermore, Gozo Channel Co. Ltd carried out internal reforms to reduce operation costs in order to attain its aim of becoming commercially viable by the end of 2005. In order to ensure the continuity of the service that is so essential to Gozitans the restructuring of this entity also involved a public service obligation contract with Government.

Meanwhile, the restructuring programme of Air Malta plc continued during the current year. In particular, the restructuring process includes the development of a strategic plan that aims to make the national airline profitable by 2008. In order to achieve this, Air Malta plc will focus more on its core business while divesting from its subsidiaries, namely its shareholding in three hotels as highlighted in Section 6.1.1. In addition, any profits generated will be re-invested rather than transferred to Government as its major shareholder. Moreover, the management of the company is also being restructured whilst efforts are being made to reduce the operational and administrative costs. To this effect, an agreement was reached with the four unions representing the company's workers to reduce labour costs. Furthermore, the restructuring programme includes the allocation of higher capital outlays as well as expansion in the services provided by the national airline. Better and efficient use of advanced IT and communications systems is also part of the restructuring programme for Air Malta plc.

During 2005, Government intends to continue to unfold the restructuring process of public entities including Sea Malta Co. Ltd (the national shipping line) and Public Broadcasting Services Ltd. Moreover, the Malta Tourism Authority will be restructured on the basis of the report prepared by private consultants. This report will be discussed with all stakeholders before being implemented. Another initiative involves the reform of Enemalta Corporation, the state energy provider, with the aim being to ensure that the service provided reflects the needs of the citizens.

6.2 Additional Reform Areas

6.2.1 The Pension System Reform

As Government acknowledges that the demographic realities of an ageing population pose a major challenge to the sustainability of public finances, specific importance is being attached to reform the welfare system in order to secure the provision of appropriate welfare support into the future.

In June 2004, a Working Group was set up with the task of analysing all the reports on the pension reform drawn up in past years. The analysis carried out by this Working Group was presented in the form of a White Paper published in November 2004 as part of Government's strategy for the coming years. This White Paper includes a number of recommendations and decisions which have to be considered for the effective implementation of the reform of the pension system over a number of years.

6.2.2 The Health Sector Reform

Government also attaches considerable importance to the reform of the health care sector in order to ensure its sustainability in the future, whilst securing the provision of appropriate health-related support particularly to those that are most in need. The Malta Council for Social and Economic Development (MCESD) set up a committee made up of representatives of the social partners to study the proposals brought forward by experts in this area. Government is committed to continue the consultation process with all parties concerned in the reform process of the health system.

6.2.3 Restructuring of Industry

Malta's recent industrial restructuring process has been focused on two main fronts: trade liberalisation and support to enterprises. Trade liberalisation, which was initiated in the late 1980s was finalised by Malta's accession to the EU on 1st May 2004. Meanwhile, local industry is being supported to adjust operations in the wake of restructuring. As announced in the Budget Speech for 2005, additional funds are earmarked to support the industry as specified in the Business Promotion Act (Cap. 325). Moreover, funds are allocated for Malta Industrial Parks Ltd earmarked for the construction of factories and the maintenance of industrial areas. Moreover, other incentives are earmarked to particular sectors such as the back-office industry, certain activities in the tourism industry, film production and call centre and data processing activities. The setting up of a new venture capital fund will also encourage investment by small and medium-sized enterprises (SMEs). Investors in this fund will benefit from tax credit on part of their investment as well as from partial exemptions from capital gains tax due on such investment. In addition, support is also earmarked for SMEs.

Companies are also being encouraged to invest in research and development and innovation as this leads to higher competitiveness. In fact, 200 per cent of the total expenditure on research and development will be exempt for tax purposes. Moreover, other incentives are being earmarked to encourage companies to support their employees in post-graduate studies. Government is also preparing a package of fiscal incentives to promote capital investment in the storage and distribution sector, whilst exploring the possibility of having free trade zones according to European customs rules.

6.2.4 The Port Reform

Government intends to implement reforms in various aspects of the handling of cargo and provision of services within Maltese harbours. The aim of these reforms is to liberalise the provision of services at the Maltese ports as well as to improve the existing facilities to ensure that the service provided is of a better quality to users and at a lower cost. In this context, Government plans to issue a call for offers regarding the management of cargo handling within the ports by the first quarter of 2005.

6.2.5 The Public Transport Reform

In the Budget Speech for 2005, Government expressed its commitment towards reforming the public transport in order to meet the needs of the public as well as encourage its use further. In October 2004, Government reached an agreement with the Public Transport Association and discussions on certain aspects of its implementation are currently underway. This will form the basis of a new agreement, which will remain in force until 2009. Government also recently announced that the amount of subsidies granted to the sector will depend on the implementation of the restructuring exercise as well as on the demand for the service, which would constitute an incentive for the operators to provide an efficient service and thus to increase its use by the public.

6.2.6 Energy Sector

Government's reform programme for the energy sector seeks to ensure a secure, diverse and sustainable supply of energy at competitive prices, taking into account the specific characteristics of the Maltese economy. In fact, Malta's electricity market suffers from structural weaknesses, namely the small size of the island and the fact that the domestic electricity system is not connected to other systems. Currently, Malta's primary energy requirements are all imported and the inland and aviation market needs are met by a state-owned enterprise, which also has the monopoly for the importation, storage and wholesale distribution of oil products. Such trading restrictions will be removed by the end of 2005, resulting in more competition to the benefit of consumers through wider choice and better prices.

The regulatory powers of the local energy sector were taken away from the local operator and invested in the Malta Resources Authority (MRA). The MRA was set up in 2001 and its regulatory responsibility also extends to water and mineral resources. Furthermore, an important reform, which took place in the energy sector, concerns the pricing mechanism on the main fuel products. In 2002, Government introduced a new pricing mechanism on the main fuel products, namely petrol, diesel and kerosene. The new price mechanism for these products includes a fuel cost factor which tracks the import price and an adjustment factor that, over the reform period aligns current to real market prices. This price adjustment process spread over three and a half years implies that fuel prices will fluctuate according to underlying market cost. In the Budget Speech for 2005, Government announced the introduction of a fuel surcharge of 17 per cent on water and electricity consumption as from 1st January 2005. This surcharge will be revised every six months according to the international price of oil.

Annex

Annex 1: Main Measures announced in the Budget for 2005

The following is a detailed list of the main measures announced in the Budget for 2005.

Structural measures:

- Reduce Value Added Tax evasion particularly in the construction sector
- The fight against benefit frauds will be widened through a reform of the system governing the application of invalidity pensions
- Unemployment registration abuse will be tightened through amendments in the law
- Introduction of a new comprehensive law relating to abuse of benefits and fraud
- Introduction of an excise duty levied on mobile telephony
- With effect from 1 August 2005, the passenger departure tax payable on outgoing air fares will be increased
- Capital gains tax on inherited property
- Re-adjustment in the excise duty rate applied on tobacco products

Enhancing research and innovation:

- Identification of the official entity responsible for research and innovation
- Increased incentives on scientific research

Promotion of Information Technology and Innovation:

- Implement a three year National Strategic Plan for Information Technology and Communication
- Enhance the use and availability of computers in Government schools
- Enhance information technology to meet the needs of foreign investors
- Incentives will be offered to companies who create or improve e-commerce or e-business systems, as well as those investing in technology to improve their productivity levels

Enhancing culture and history to promote tourism:

- Increase cultural tourism and tourism related to sports, language learning, conferences and other niche tourism such as cruise and stay, health and retirement, short breaks, agro tourism, gastronomy, main events and yachting
- Increase the financial allocation for Heritage Malta to enhance restoration and conservation projects
- Take necessary decisions regarding golf courses
- Enhance Gozo tourism
- Funds are allocated for the restoration of Ggantija temples
- Additional funds allocated to the Malta Tourism Authority based on improved performance of the tourism sector
- Partial refund of VAT to foreign conference organizers
- Donations for national museums will be exempted from tax
- Fiscal incentives will be given to those performing restoration works
- A refund of 15.25 per cent will be given on the price of musical instruments bought

Education:

- Increase investment in education
- Reform the quality of primary state schools
- State schools would be given more autonomy and central structures would be set up to ensure a more effective operation and regulation
- Implementation of a programme for education reform in terms of lifelong learning
- The modernization and restructuring of state schools
- Funds allocated for church schools
- Sustain, reform and adjourn the policies relating to participation in education programmes by youths
- Increased funds allocated to University, Junior College, and Malta College of Arts, Science and Technology (MCAST)
- A national commission for higher education will be set up to facilitate the education reform
- Setting up of evaluation systems to monitor the quality of work done and the results achieved in this sector

Environment:

- Investments to build the necessary facilities to manage domestic and industrial waste collection
- Government will issue a contract to deal with the infrastructural problems of landfills
- Extend initiatives for the separation of waste
- Identify sites where bulk refuse can be disposed
- Two implants will be set up for the purification of drainage
- Establish three centers for monitoring air quality
- Malta Resources Authority will continue to work and envisage policies with respect to alternative sources of energy
- Government will reimburse 15.25 per cent of the value of any household product that works with solar energy given that the payment does not exceed Lm50. This is also extended to the buying of an electric car given that the payment does not exceed Lm500.
- Exemption from excise duty on bio-diesel
- Importers and producers who encourage customers to return back empty containers will be exempted from eco-contribution
- A broadening of the items that will be subject to eco-contribution
- Building of implants to process waste generated

Agriculture and Fisheries:

- Modernization of agricultural sites to enhance quality and competitiveness of farmers
- Promotion of production methods that are environmental friendly and protect the cultural heritage
- Implementation of a development plan for agriculture
- Investment in fishing infrastructure

Measures earmarked for Gozo:

- Construction of golf course
- Construction of better yacht facilities
- Construction of casino
- Increase artificial dive sites and recompression chamber

- Completion of project relating to Mgarr and Cirkewwa ports
- Establishment of incubation centre for the setting up of small businesses in artisan fields and information technology
- Chambrey project and Ggantija project
- Strategy to enhance industry and commerce in Gozo
- Financial aid to compensate for Gozo insularity problems

Energy:

- Excise duty and VAT will be charged on kerosene and as a result its price will be equivalent to the price of diesel. Moreover, like the remaining fuel product, the price of kerosene will fluctuate according to international oil prices. A one-off compensation of Lm12 will be paid in 2005 to persons entitled to non-contributory social benefits and contributory unemployment benefits.
- The Government with the aid of the Customs department will increase administrative control on the distribution of duty free diesel.
- Government announced the introduction of a fuel surcharge of 17 per cent on water and electricity consumption. This surcharge will be revised bi-annually such that changes in the international price of oil are taken into consideration.

Support to small and medium sized enterprises (SMEs):

- Horizontal measures were announced for those SMEs having less than eleven full-time employees which will be eligible for a full tax deduction in respect of information technology spending.
- Those with pending VAT bills will be exempted from paying the fine given that they settle their bills within the time frame stipulated

Restructuring of Industry:

- Lm1.85 million was allocated in the form of incentives to industry and the setting up of a new venture capital fund. Investors in the fund will be entitled to a tax credit of part of their investment and will also be entitled to a partial exemption for tax on any capital gains accruing from the disposal of such investment.
- Funds are allocated for Malta Industrial Parks Ltd earmarked for the construction of factories maintenance of industrial areas.
- Incentives are earmarked to particular sectors such as the back-office industry, certain activities in the tourism industry, film production and call centre and data processing activities.
- Exploring the possibility of having free trade zones according to European customs rule.

Continuation of the privatisation plan over the next three years:

- A unit will be set up within the Ministry of Finance to provide the necessary expertise to explore all the possible ways of entering into a partnership with the private sector and thus provide better value compared to public sector investment.
- Selling of Government's shareholding in Interprint Ltd. and Malta Dairy Products Ltd.
- The Privatisation Unit is engaged in negotiations with prospective buyers for the privatization of Sea Malta Co. Ltd.
- The Privatisation Unit is engaged in concluding the privatization process of Bank of Valletta plc and Maltacom plc.
- The re-assessment of Government's stance in relation to Kordin Grain Terminal, Maltapost plc, Libyan Arab Maltese Holding Co. Ltd
- A strategic partner will be sought to take over the control of operations of Tug Malta Ltd where Government intends to retain a shareholding of at least 40 per cent.

- The sale of 20 per cent of Government's shares in Malta International Airport plc
- Three hotels forming part of Air Malta plc's assets will be sold off whilst the management of Sterling Services Ltd and Air supplies Co. Ltd will be entrusted to a strategic partner.
- Government intends to lease Enemalta plc's storage facilities, after integrating Malta Oil Bunkering Co. Ltd in its operations to a strategic partner.
- The production and distribution of gas will be divested to a strategic partner.

Port Reform:

- Liberalize the provision of services at the Maltese ports
- Improve the existing facilities to ensure that the service provided is of a better quality to users and at a lower cost

The Public Transport Reform:

- Amount of subsidies granted to the sector will depend on the implementation of the restructuring exercise as well as on the demand for the service
- Bus fares will be increased except for pensioners and students

Restructuring of Public enterprises:

- Government's strategy includes a programme of reforms designed to ensure that public sector entities operate in a more efficient and effective manner to increase the countries competitiveness. These entities include Gozo Channel Co. Ltd, Air Malta plc, Public Broadcasting Service Ltd, Sea Malta Co. Ltd, Malta Tourism Authority and Malta Oil Bunkering Co. Ltd.

Government and Public service:

- Increase efficiency in the provision of public services and function of local councils
- Limiting the replacement of retirees only in those cases deemed essential
- Greater flexibility and mobility of public sector employees will be sought with the aim of improving services and increasing productivity
- Decrease administrative costs
- As of 2005, the arrangement whereby public holidays falling on weekends were compensated by additional days of vacation leave will be removed.
- A Public service Act is being drafted, following the launching of a White Paper on this topic in 2003.

Implement of National Action Plan which includes:

- Measures to match skills and abilities with employment
- Schemes for traineeship and community work for the unemployed whereby employers will be given fiscal aid for training unemployed persons
- Schemes for retraining the unemployed who are over 40 years of age
- Childcare project providing incentives to companies to set up and run a childcare facility for its employees
- Supported Employment Scheme which supports persons with disabled that are registering for work
- Specific incentives earmarked for Gozo in respect of support for small companies, assistance for those setting up their business and other measures for those registering for employment
- Provision of temporary or permanent support through job coaching, personal assistance and training and financial incentives for employers

- 15 per cent reduced rate of tax on the first Lm3000 income earned from part-time work by a spouse if the couple opts for a joint computation provided that the other spouse is in full-time employment or is a pensioner or is a full-time student.
- Females who have been inactive during the previous five years will benefit from a one-off income tax exemption on income from employment earned in the first year.

Other social measures:

- Amend family law and policies
- Discussions are to be stimulated within the framework of the White Paper that was presented regarding the Pension Reform for the coming five years. These discussions are to lead to final decisions and implementation of the recommendations
- Government is committed to continue the consultation process with all parties concerned in the reform process of the health system.
- Increase in the rates of children's allowances especially those families having four or more children
- Tax exemption for parents with disabled children who attend church schools
- Tax exemption on the first Lm4,000 of the income of parents with disabled children attending private schools or paying for a facilitator
- Refund of Vat on products bought by disabled persons and necessary for their exclusive use
- Extensions of disability allowance to both partners when they enter in marriage whereas before it was only entitled to one of the spouses

Statistical Appendix

Growth and Associated Factors

Table 1

	ESA Code	2003	2004(1)	2005	2006	2007
Percentages unless otherwise indicated						
GDP growth at constant market prices (7+8+9)	B1g	-0.3	0.6	1.5	1.8	2.2
GDP level at current market prices (Lm million)	B1g	1,846.1	1,902.4	1,992.0	2,079.2	2,161.9
GDP deflator		1.1	1.1	1.2	1.2	1.2
RPI change (annual average)		1.3	2.9	2.4	1.9	1.9
Employment growth		-0.8	0.5	0.7	0.7	0.6
Labour productivity growth (2)		0.5	0.2	0.8	1.2	1.6
Sources of growth: percentage changes at constant prices						
1. Private final consumption expenditure(3)	P3	1.6	0.4	1.0	1.4	1.6
2. General government final consumption expenditure	P3	1.6	1.2	-1.0	-0.1	-0.5
3. Gross fixed capital formation	P51	41.4	2.0	7.8	-1.6	0.4
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52+P53	3.2	2.0	3.0	3.0	3.0
5. Exports of goods and services	P6	-3.8	2.8	2.0	3.6	4.1
6. Imports of goods and services	P7	7.1	1.6	3.5	2.0	2.8
Contribution to GDP growth						
7. Final domestic demand (1+2+3)		7.3	0.9	2.1	0.5	1.0
8. Change in inventories and net acquisition (=4) of valuables	P52+P53	2.4	-1.2	1.1	—	0.1
9. External balance of goods and services	B11	-10.1	0.9	-1.6	1.3	1.1

(1) Forecasts from 2004 onwards
(2) Growth of GDP at market prices per person employed at constant prices
(3) Includes NPISH final consumption expenditure

General Government Budgetary Developments

Table 2

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
Net lending (B9) by sub-sectors						
1. General government	S13	-9.6	-5.2	-3.7	-2.3	-1.4
2. Central government	S1311	-9.6	-5.2	-3.7	-2.3	-1.4
3. State government	S1312	-	-	-	-	-
4. Local government	S1313	—	—	0.0	0.0	0.0
5. Social security funds	S1314	-	-	-	-	-
General government (S13)						
6. Total receipts	ESA	40.7	44.7	45.9	44.5	42.9
7. Total expenditures	ESA	50.3	49.9	49.7	46.8	44.3
8. Budget balance	B9	-9.6	-5.2	-3.7	-2.3	-1.4
9. Net interest payments		3.8	3.8	4.0	3.9	3.8
10. Primary balance		-5.8	-1.4	0.3	1.6	2.4
Components of revenues						
11. Taxes	D2+D5	26.0	27.3	28.0	27.8	27.7
12. Social contributions	D61	6.8	6.8	6.7	6.5	6.4
13. Interest income	D41	0.2	0.4	0.3	0.2	0.3
14. Other		7.8	10.3	11.0	10.0	8.5
15. Total receipts	ESA	40.7	44.7	45.9	44.5	42.9
Components of expenditure						
16. Collective consumption	P32	10.6	11.2	…	…	…
17. Social transfers in kind	D63	—	—	—	—	—
18. Social transfers other than in kind	D62	12.8	12.8	12.5	12.2	12.0
19. Interest payments	D41	3.8	3.8	4.0	3.9	3.8
20. Subsidies	D3	2.1	1.7	1.5	1.3	1.2
21. Gross fixed capital formation	P51	4.6	4.8	…	…	…
22. Other		16.3	15.5	…	…	…
23. Total expenditures	ESA	50.3	49.9	49.7	46.8	44.3

General Government Debt Developments

Table 3

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
Gross debt level		70.4	73.2	72.0	70.5	70.4
Change in gross debt		8.1	2.8	-1.2	-1.5	-0.1
Contributions to change in gross debt						
Primary balance		6.0	1.4	-0.3	-1.7	-2.5
Interest payments	D41	4.0	3.9	4.2	4.1	4.0
Nominal GDP growth	B1g	-2.7	-2.1	-3.3	-3.0	-2.7
Other factors influencing the debt ratio		0.8	-0.4	-1.8	-0.9	1.1
Of which: Privatisation receipts		0.0	0.0	-2.6	-2.5	0.0
p.m. implicit interest rate on debt		5.4	5.2	5.6	5.6	5.4

Cyclical Developments

Table 4

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
1. GDP growth at constant prices	B1g	-0.3	0.6	1.5	1.8	2.2
2. Actual balance	B9	-9.6	-5.2	-3.7	-2.3	-1.4
3. Interest payments	D41	3.8	3.8	4.0	3.9	3.8
4. Potential GDP growth		1.9	1.8	1.8	1.8	1.9
5. Output gap		-1.1	-2.2	-2.5	-2.4	-2.2
6. Cyclical budgetary component		-0.6	-1.3	-1.5	-1.5	-1.3
7. Cyclically-adjusted balance (2-6)		-9.0	-3.8	-2.2	-0.9	-0.1
8. Cyclically-adjusted primary balance (7-3)		-5.2	-0.1	1.8	3.1	3.7

Divergence from Convergence Programme May 2004

Table 5

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
GDP growth						
previous update	B1g	-1.7	1.1	1.7	2.1	2.1
latest update	B1g	-0.3	0.6	1.5	1.8	2.2
Difference		1.4	-0.5	-0.2	-0.3	0.1
Actual budget balance						
previous update(1)	B9	-9.7	-5.2	-3.7	-2.3	-1.4
latest update	B9	-9.6	-5.2	-3.7	-2.3	-1.4
Difference		0.1	0.0	0.0	0.0	0.0
Gross debt levels						
previous update		72.0	72.1	72.4	70.5	70.4
latest update		70.4	73.2	72.0	70.5	70.4
Difference		-1.6	1.1	-0.4	0.0	0.0

(1) The 2003 figure includes the effect of a one-off operation related to the restructuring of the shipyards
This effect is of about 3.2 percentage points of GDP

Basic Assumptions

Table 6

	2003	2004	2005	2006	2007
Interest Rates (in % p.a., annual averages)					
Short-term interest rate	3.0	3.0	3.5	3.5	3.5
Long-term interest rate	4.7	4.7	5.2	5.2	5.2
United States: short-term (three-month money market)	1.2	1.6	2.1	2.1	2.1
United States: long-term (10-year government bonds)	4.0	4.3	4.8	4.8	4.8
Exchange Rates					
USD/EUR exchange rate (level)	1.1	1.2	1.2	1.2	1.2
Nominal effective exchange rate (annual averages)	1.1	1.1	1.1	1.1	1.1
Exchange rate vis-a-vis the EUR	2.3	2.3	2.3	2.3	2.3
GDP (in real terms %)					
World GDP growth, excluding EU	4.2	5.7	4.8	4.6	4.6
United States,GDP growth	3.1	4.4	3.0	2.9	2.9
Japan, GDP growth	2.4	4.2	2.1	2.3	2.3
EU-25 GDP growth	1.0	2.5	2.3	2.4	2.4
World Trade (% change)					
Growth of relevant foreign markets	0.7	2.1	2.2	2.1	2.1
World import volumes, excluding EU	10.3	11.6	8.8	8.3	8.3
International Prices					
World prices based on the producer price Indices of the Euro Area (% change)	2.1	1.9	1.9	1.8	1.8
Oil prices, (Brent, USD/barrel)	28.9	36.4	41.8	37.2	37.2
Non-oil commodity prices (in USD)	6.3	12.9	-2.9	-0.5	-0.5