
MALTA MEETS MAASTRICHT

A Strategy for Deficit Containment and Debt Reduction

A SET OF PROPOSALS PRESENTED TO THE

MINISTER OF FINANCE AND ECONOMIC AFFAIRS

by

Alternattiva Demokratika

Economic Policy Working Group

CONTENTS

EXECUTIVE SUMMARY_____	2
INTRODUCTION_____	4
OVERRIDING PRINCIPLES_____	4
THE UNDERLYING ECONOMIC FUNDAMENTALS_____	6
RECURRENT REVENUE_____	6
RECURRENT EXPENDITURE_____	8
CAPITAL EXPENDITURE_____	9
CONTRIBUTIONS TO GOVERNMENT ENTITIES_____	10
INTEREST ON PUBLIC DEBT_____	12
DEBT REDUCTION_____	12
 <u>BUDGET FORECASTS</u>	
FORECAST BUDGET EXTRACT 5-YEARS_____	13
FORECAST RECURRENT REVENUE 5-YEARS_____	14
FORECAST RECURRENT EXPENDITURE 5-YEARS_____	15
FORECAST CAPITAL EXPENDITURE 5-YEARS_____	16
FORECAST CONTRIBUTION TO GOVERNMENT ENTITIES 5-YEARS_____	17
FORECAST INTEREST ON PUBLIC DEBT 5-YEARS_____	18

EXECUTIVE SUMMARY

The primary challenges our country, now a member of the European Union faces, are those relating to the environment, public finances and the extent and direction of economic growth. In view of the poor state of our public finances, including a seemingly uncontrollable fiscal deficit and a ballooning national debt, we will soon be slapped with an official reprimand from the European Commission. Alternattiva Demokratika is concerned but not surprised that so soon after our accession we are being admonished on a matter that government has successively failed to deal with. Further we are very troubled at the laissez-faire attitude government has developed in the management of public finances. We believe that this matter is of national importance and therefore we have taken the time and effort to compile a set of proposals that government could adopt in devising a workable strategy that must, be formally communicated to the European Commission within ten days from the receipt of the official reprimand. **The wakeup call has indeed arrived!**

The major proposals in this report are:

- The targeting of growth in Direct Tax Revenue to 90% of the mean forecast nominal rate of economic growth over a five-year period i.e. 3.75%.
- The targeting of growth in Indirect Tax Revenue to the full forecast nominal rate of economic growth of 4.25%.
- The targeting of growth in non-tax revenue to the forecast rate of inflation over 5 years of 2.5%.
- Containment of recurrent expenditure (primarily government payroll and social security benefits) to the forecast rate of inflation over 5 years of 2.5%, in order to ensure that, at worst, workers and pensioners' spending power is maintained intact throughout the 5-year period.
- Recommendations relating to capital expenditure, including the need to compile, monitor and report on a detailed five-year capital expenditure

programme, the institutionalisation of the recommendations made by the Auditor General in regards to government's capital projects, and the targeting of capital expenditure increases by the forecast inflation rate of 2.5% apart from certain sectors like Environment, Tourism, Education & Infrastructure that warrant higher levels of investment.

- Government must publish immediately the expected cost to completion of the "Mater Dei" hospital and a firm commitment to stick to this estimate must be made. The whole project must be subject to a full financial and quantitative audit.
- Contributions to Government entities must not grow at more than 1% per annum over the forecast 5 years. A proper strategy to develop Public-Private Partnerships in order to take over the management of certain public entities is recommended. The resulting efficiency savings from the PPP's should be channelled into re-training initiatives, educational programmes as well as well as research and development projects.
- Finally, in order to meet the ambitious target of reducing national debt to 60% of Gross Domestic Product, we recommend the sale of agricultural land to farmers, as well as the privatisation of entities that are not natural monopolies e.g. Maltacom. In any case government should never resort to asset sales/privatisation lower the fiscal deficit, but only to pay down the national debt.

INTRODUCTION

Alternattiva Demokratika (AD) is troubled at the state of public finances, over which government have obviously lost control. The level of the fiscal deficit during the past 5 years and the related increase in the national debt to over Lm 1.2 billion are cause of much concern to many sectors of our society. The existing and future social, economic and political effects resulting from this existing state of affairs will prove to be critical to the survival and prosperity of existing and future generation. The expected reprimand from the European Commission has brought about a sense political realism and national emergency in order to collectively tackle this issue. It is for these reasons that AD has taken time out during an historical electoral campaign in order to present a number of proposals to government in order to assist it in compiling a credible and realistic reply to the reprimand received from the EC. We treat this issue in a manner that is above partisan politics and we wish to contribute in any way we can to this urgent debate. We expect that, in the spirit of our very recent entry into the EU-fold, our proposals are taken into account. In any other case we will communicate these proposals directly to the EC.

OVER-RIDING PRINCIPLES

AD, as a leading advocate of Malta's membership of the European Union, is committed to seeing Malta meet the Maastricht criteria for Euro-membership. However we believe even more strongly that we must aim to meet these criteria because it will assist us in achieving a fiscal environment that is business-friendly, fair and sustainable. Irrespective of the shape and form that a medium term strategic fiscal plan can take we insist that the following principles are always adhered to:

- Any fiscal action must give due weight to the principles of economic, social, political and environmental sustainability. Once and for all we must stop

borrowing the wealth and welfare of future generations in order to satisfy our capricious and destructive need to consume at all cost.

- We should only borrow to invest – apart from very extraordinary circumstances (e.g. natural disasters, chronic unemployment) we must never borrow to consume.
- Taxes must be of a progressive nature and progressively government should target a fair shifting of the tax burden from labour and enterprise onto taxes on consumption, pollution and reckless speculation. This will ensure more social justice, whilst boosting investment and fostering healthy and sustainable economic growth.
- Recurrent expenditure should not be lowered because this is likely to damage the economy's capability of growth as well as resulting in severe economic hardship to the more vulnerable sectors of society. However AD is aware of the irresponsible attitude that has developed in the expenditure of public funds, and therefore we recognise the importance of developing a new strategy for the long-term management of public expenditure.
- We recognise the importance of maintaining a substantial and healthy investment in public infrastructure. Indeed substantial capital expenditure is needed to upgrade our infrastructure and environment to European Union standards. A significant portion of this expenditure **must** be financed from our taxes.
- Many subsidies and subventions provided to government owned and/or controlled entities have proven to be an intolerable burden on the public purse. The overall level of subsidies must be fixed for a period of five years. This can only be achieved if a clear distinction is made between contributions that are made because of specific and insurmountable social and economic circumstances and other that are made out of political and/or electoral convenience. Specific examples of the two kinds are well known to most sectors of society and their mentioning in this report is therefore not appropriate.

THE ECONOMIC FUNDAMENTALS UNDERLYING OUR PROPOSALS

Our proposals are based on fiscal forecasts covering the years from 2004 up to and including 2008. We believe that during this time Malta must face a period of economic and fiscal consolidation due to further industry-specific restructuring that is necessary to meet the twin challengers of EU membership and globalisation. This restructuring will result in the exploitation of new EU-enabled opportunities, as well as the challenge of labour re-training and re-deployment into more viable and remunerative sectors. It is imperative that in such a scenario government is in a position to significantly improve the management of its finances in order to free up economic resources and provide for the needy.

Due to the irresponsible delay in the restructuring of many government-controlled enterprises and the associated costs needed to re-train, retire or redeploy labour, we are not confident in Malta's ability to achieve above average economic performance. We forecast that during the coming five years the economy will see the following developments:

- Nominal Economic growth of between 3½ -6½ % , with a 5-year mean of 4¼%.
- Inflation to range between 1.5%-3%, with a 5-year mean of 2½%.
- Consequently a mean real rate of economic growth of 1.75%.
- Unemployment (as measured by ETC) will range between 6.25% - 8%.

RECURRENT REVENUE

Over the past five years government has increased its tax revenue by a rate which was significantly higher than the rate of economic growth in the economy. In fact in year 2003 government's participation in the economy superseded the 50% mark. This has had the effect of increasing disproportionately the government's participation in the economy resulting in a loss of competitiveness and chronic

economic crowding-out i.e. competing with the private sector for limited resources. We believe that during the coming five years, government's recurrent revenue must not exceed the nominal rate of economic growth which we forecast at 4.25% p.a. More specifically we are recommending,

- Income tax should be targeted to grow by 3.75% p.a. over the five year period, in order for individuals and businesses to keep a larger share of the target growth rate in the economy of 4.25% p.a.
- Social Security Contributions should be targeted to grow at an annual 5-year average of 2.75%, because it is not possible for the SSC to grow at the full 4.25% p.a. due to the capping of contributions.
- Overall Indirect Tax Revenue, including Value Added Tax, Excise, Licences, Stamp Duty, Registration and Gaming Taxes should be targeted to grow by the full rate of nominal economic growth i.e. 4.25% p.a. However we are recommending two exceptions to this policy. The first is a lowering of the rate of stamp duty on the purchase of first homes and the second is the lowering of the VAT rate on tourist services from 5% to 4%. This drop in revenue should be compensated by compensatory increases in stamp duties on second residences, gaming taxes, tobacco and alcohol taxes.
- Non-Tax Revenue is a very heterogeneous category that includes items like Rents Received, Profits from the Central Bank and Funds from the European Union. We believe that government should target increases that range from 2%-4%. In particular this category should not include revenue of a capital nature, like the sale of government land and the sale of ex-Church property. These items are of a capital nature and revenue from such should be used for debt reduction. Revenue from miscellaneous receipts (Lm 8,750,000) should be elaborated upon.

RECURRENT EXPENDITURE

Government's recurrent expenditure primarily consists of salaries for the civil service and social security benefits. It is not an easy task to control such expenditure categories and indeed we declare that, apart from certain discretionary items, it is impossible to lower the nominal amount of expenditure without creating severe economic and social hardships to one or more sectors of society. However it is very possible and reasonable to expect government to **control the rate of growth** in these classes of expenditure over a target 5 year period. This cannot be decided by a ruthless dictat to lower expenditure by 10% across-the-board ensuing from the Ministry of Finance in a last minute attempt to hit a recklessly set target. Neither should one hope to contain expenditure growth through the cancellation of Christmas parties. Such measures reveal a lack of medium-term planning and display blatant electoral opportunism. Such "policies" might have worked in the Malta of the 80s and 90s. In the economic reality of the 21st century, our country and its citizens demand and deserve more serious political leadership.

The over-riding principle should be that no expenditure control measures must result in any sector(s) of employees/beneficiaries having a lower spending power from year to year. In practice the way to do this is to use the government's own slogan of "biex hadd ma' jibqa' lura" and link payroll and social security benefits to target inflation of 2.5% so that nobody loses spending power. At worst if government is to ask people to make a sacrifice this would amount to the maintenance in people's standard of living rather than a lowering of it.

However if government is to possess the moral leadership to request a collective effort to solve our fiscal problem, **for which it is solely responsible**, then it must lead by example. Ministers cannot and indeed should not ask their teams to cut down on expenditure if they are not willing to show that they can do without the odd perk here and there. When the Prime Minister blows Lm 13,000 on a trip to Brussels he is

not guilty of bankrupting Malta, but he is very culpable of contributing towards the elimination of that sense of guilt that some of our citizens feel when they fail to declare all their hard-earned income. Fiscal Morality must take-off from Castille!

CAPITAL EXPENDITURE

“Lots of room for improvement” – this expression is most apt to the level of control over this category of expenditure in Malta over the last decade. The Maltese taxpayer is sick and tired of seeing money wasted in badly planned infrastructural projects, roads that get badly tarmaced, a hospital project that has gone at least 200% over budget not to mention the blatant lack of accountability and responsibility from those who supposedly are in charge. If a government minister does not feel it appropriate to tender his resignation for overspending about Lm 170 million on one project, then we provide every citizen with the moral excuse to cheat. Worse still is the lacking of certainty about the running costs expected to operate this hospital once ready. The “Value for Money” test applies to all government expenditure – everything has an opportunity cost!

In order to improve the management and allocation of capital expenditure we are making the following proposals.

- Government must prepare a detailed capital expenditure budget for the coming five years in collaboration with Ministries, Local Councils and interested parties.
- The suggestions made by the Auditor General regarding capital expenditure must be institutionalised. Full accountability must be had and total responsibility must be taken for significant deviations from the capital expenditure budget.
- Generally capital expenditure should not increase by more than the target rate of inflation over the five year period.

- Specific Ministries should be allowed larger increases in capital expenditure allocation; in particular Tourism, Rural/Environment & Education (10% p.a.), Gozo and Resources/Infrastructure (5% p.a.). We identify these Ministries as ones with more urgent and critical capital requirements.
- The expected cost to completion from the “Mater Dei” hospital must be published immediately. Any over-run on this estimate of more than 10% must result in political and economic accountability i.e. contractors should not be paid and the minister responsible must resign. The project must be completed and operational by 2005. We estimate that a further Lm 80-120 million is required to complete and thereafter we are accruing an amount of Lm 20 million per annum to provide for the additional cost of running this hospital compared to the operational cost of the existing G’Mangia hospital.
- The “savings” in capital expenditure that will be achieved once “Mater Dei” is complete should be channelled into further investment in Education (20% p.a.), Tourism (20% p.a.), Gozo (10% p.a.),

CONTRIBUTIONS TO GOVERNMENT ENTITIES

Alternattiva Demokratika believes that this category of expenditure is bundled recklessly, because it includes such diverse items as direct subsidies to state enterprises which successive governments have failed to restructure (e.g. Shipyards), subsidies to lower the cost of public services to consumers provided by inefficient public companies (e.g. WSC) and subsidies to critical institutions (e.g. UOM, MCAST and ETC).

Our policy for these contributions is the following:

- Industries/Companies which in their current format, have no realistic hope of long-term survival should be gradually right-sized through re-training and “natural wastage”. Government should avoid the policy of “restructuring”

public companies through the combination of early retirement schemes or transfer of staff to other unrelated government departments where they are often left totally unengaged in productive employment. This politically-convenient policy has the immediate effect of lowering state subsidy, but the medium to long-term consequence of artificially disguising subsidies as ordinary payroll, permanently lowering our productive capacity, and furthering the culture of state dependency of public-sector employees. The correct policy is one that offers serious long-term retraining/re-skilling whilst providing these workers with adequate income during their absence from paid employment. Government should also encourage apprenticeships and flexible working hours for the over 50. The contributions to these entities must be reduced by 5% per annum over the next 5 years. These savings must be channelled into educational initiatives for the employees made redundant in the various restructuring exercises.

- As regards natural monopolies like Enemalta and WSC the ultimate aim is to provide quality public services at an affordable price to both domestic and industrial consumers. AD is well aware of the need to introduce new working practices and efficiency measures in many public companies. We believe that this is best done if these companies are retained in public ownership, with the day-t-day operational control being delegated to private sector management who can contribute proven know-how and expertise. We believe that in such a scenario, the state contributions made to such entities can gradually diminish and resulting efficiency savings should be channelled to re-training, education and R & D initiatives.
- On the other hand, contributions to the entities reporting to the Ministry of Education must be increased. The UOM, MCAST and Junior College are starved off investment. The best investment that we can make during the next 5 years of consolidation is that in our people's knowledge, skills and capabilities. We recommend that the subventions to these educational institutions be increased by 10% per annum. Further in order to equip the

ETC for the challenges of retraining/reskilling, we recommend that the contribution is increased by 20% for the next 5 years.

- All other contributions to government controlled entities must be limited to grow at a maximum of the target rate of inflation of 1%.

INTEREST ON PUBLIC DEBT

There is little that government can do to contain the interest charges on national debt apart from containing the budget deficits. Whilst the interest coupon will be set by market forces, government must bear in mind that the medium-term trend is for interest rates to rise. Therefore the containment of fiscal deficits is imperative to control the level of borrowing cost which has already superseded Lm 200,000-per-day mark.

DEBT REDUCTION

The only way to reduce the level of national debt is to either generate fiscal surpluses or proceeds from the sale of government-owned assets (e.g. government land, shares in public companies). Alternattiva Demokratika is advocating that over the next five years government should embark on two major asset-sales programmes, namely the full privatisation of Maltacom and the sale of government land (primarily agricultural land) to the private sector, particularly farmers. It is critical that government is in a position to lower the level of national debt as a percentage of Gross Domestic Product not only because this is a requirement to meet the Maastricht criteria, but more importantly to guarantee long-term sustainability of our public finances. Under no circumstances should government use proceeds from privatisation to cover-up fiscal deficits. Asset sales should be used only to pay down the national debt.