OCCASIONAL PAPER 4

Lessons from Economic Thought for Fiscal Discipline in Malta:
THE NINETIES AND BEYOND

E.P. DELIA
CHAIRMAN APS BANK LTD

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CONTENTS

FOREWORD

APS Bank launched the *Occasional Papers* series to encourage discussion of selected economic and social issues. *Occasional Paper 4* evaluates macroeconomic policies, primarily fiscal policy, applied in Malta in the nineties with the aim of identifying those factors on which attention has to be focused on the way to the Economic and Monetary Union (EMU).

Some contend that the Malta government's budget deficit and the size of the national debt are the main issues that have to be addressed if Malta were to join the EMU at the earliest. Several decisions referring to other economic, financial and social factors have to be sought and critically evaluated if economic sustainability in the single market environment is to be rendered realizable. They span a wide range of areas and options. But in the end they will be reflected in the revenue and expenditure flows of the Malta government. The public sector still accounts directly for about a third of directly productive employment and supports an extensive welfare system. On the way to ERM 11 and the EMU, the Maltese economy must identify those areas that have to be strengthened in order to render economic activity in traded goods and services viable. The fiscal consolidation that has to be undertaken in the coming years must keep such an objective in sight. Fiscal tools are means to an end: to empower individuals, engender the optimal use of capital, and ensure a transfer of resources that enable people to live in reasonable comfort. The significance of a move to EMU has to be judged in terms of its success in attaining these ends.

The ideas presented in this Occasional Paper were discussed at a Seminar on *The Budget Deficit: The major obstacle to Malta's participation in EMU?* organised by the Institute of Financial Services, Malta, in April 2004. This publication is an edited version of the submission made by this writer at the seminar.

APS Bank presents this Occasional Paper with the objective of widening the debate on this important subject. The views expressed are the author's. APS Bank has no corporate view on the subject.

E.P. Delia
Chairman, APS Bank

April 2004

LESSONS FROM ECONOMIC THOUGHT FOR FISCAL DISCIPLINE IN MALTA: THE NINETIES AND BEYOND

The theme of this conference identifies the Malta Government's budget deficit as the major obstacle to Malta's participation in Economic and Monetary Union. The conference programme observes: "As far as economic convergence is concerned, Malta has satisfied on a sustainable basis the criteria relating to the long term interest rate, inflation and exchange rate stability, but the Maastricht criteria relating to the budget deficit and the public debt are far from satisfied. The budget deficit is currently substantially above the stipulated 3% of GDP and the government has to achieve rapid progress on addressing this issue if it wishes to qualify for EMU membership in a relatively short time".

Indeed, this approach to the EMU has already attracted the attention of various commentators on economic affairs. Suggestions are offered to the Ministry of Finance for consideration, such as the re-assessment of tax incentives to encourage investment, a rise in marginal income tax

Paper delivered at the Annual Seminar, 'The Budget Deficit: The major obstacle to Malta's participation in EMU?', organised by the Institute of Financial Services, Malta, on 15 April 2004 at the Malta Hilton.

rates on incomes above given thresholds, and other trade-related measures at stimulating enterprise and output growth. Besides, documents proposing a blue print for a 'Social Pact', notably one publication issued by a trade union, (UĦM, 2004), propose a series of suggestions that span education, economic sectors and the labour market. One consideration relating to the labour market refers to wage determination constraints and highlights productivity growth. It influences directly the eventual cost of financing the public sector labour force and, therefore, impacts on public sector expenditure. In addition, some analysts questioned the 'suitability' of the external value of the Malta Lira for long-term economic growth and suggested considering a downward adjustment.

So, to focus solely on fiscal and aggregate output statistics is perhaps misleading. It limits the scope of analysis. The present fiscal performance of the Malta government is the outcome of a long process that involves ethical principles, administrative efficiency, electoral operations and the selected policy decisions taken over, say, three decades that are still vibrant in the economy today. It is an understanding and appreciation of this complex decision/conditioning network that has to be undertaken first before one can revert to statistical data.

International trade and capital movements, monetary targets and fiscal policies have been closely intertwined in Malta. For three decades the commercial banks had the government as a major – at times the sole – shareholder. Banks' profits were directly influenced by the combined operation of monetary policy of keeping interest rates fixed for long stretches of time, sheltering the money market by tight exchange controls. In turn, banks' profits were

transferred to the Treasury; retained profits enhanced the banks' capital base and the net asset value for the government as a shareholder. These gradual gains may be realised at a future date if these public assets are privatised.

The same comment applies for the Central Bank of Malta whose annual and/or retained profits are passed on, in whole or in part, to its owner, the government of Malta. So, all of five criteria that constitute the statistical profile under the Growth and Stability Pact, and referred to in this seminar's programme, are actually open to scrutiny and may have to be re-assessed at the time of adoption of the euro as Malta's currency. How they will perform will depend on several factors as these behave throughout the years that Malta forms part of ERM-11. It is not just the budget and national debt conditions that are truly under analysis.

Thus, it is only now that exchange controls are practically gone. Hence, one has to see how capital movements will behave under ERM-11. Again, official reserves have reached a high recently following the net positive interest rate differential in favour of lira denominated assets and in the wake of the capital repatriation scheme implemented by the Ministry of Finance in the past few years; they did not grow as a result of trade surpluses. Therefore, the related decisions regarding the interest rate levels recorded in recent months derive, in part, from such capital inflows that back up the supply of Lira in circulation. And, the performance of the average price level in the coming months will be influenced by the various price adjustments that have to be made to reflect fiscal policy itself and new product compliance measures. If prices behave ratchet-wise, being flexible upwards but resistant downwards, then there could be a series of exogenous pressures that repeatedly may push the average price level upwards notwithstanding the slack in the economy. So, it is the 'sustainability' of the five criteria, rather than solely of the two fiscal parameters, that is at stake.

Besides, the data themselves need to be evaluated for what they are supposed to stand for. Many believe that they know what the size of the budget deficit is; they follow official data as published. But, two recent statistical revisions by Malta's National Statistics Office stand as a stark reminder that the data themselves may be subject to wide variations. They render a critical appreciation of the issue under study harder to obtain.

One statistical revision referred to the Gross Domestic Product. The value for aggregate value added, based on the European System of Accounts 1995 (ESA 1995), was topped up by an average of 7.5% for the years 1999 to 2002. These results are based, in part, on a wider coverage of economic activities. By themselves, such revisions would have meant lower Budget deficit/GDP and national debt/GDP ratios. However, a second revision that redefined the items included under the term "general government budget deficit" raised the shortfall in government revenue from Lm105million to Lm175 million for 2003. According to the revised deficit and GDP measures, the ratio now stands at 9.5%, instead of 5.8%, while the General Government Debt/GDP ratio at end 2003 stood at 72%, instead of 61.7%.

Similar observations may be made regarding data on unemployment and average price movements. The number and relative share of job seekers are now established through a Labour Force Survey, instead of enumerating persons on the unemployment register: this source shift raised the rate

of jobseekers to around 8% of the labour force compared to around 6% on the historic definition. Again, a switch to a Harmonised Index of Consumer Prices may yield a different result from that obtained from the Retail Price Index currently in place.

The fiscal results outlined above are based on a cash flow approach to measuring government's revenue and expenditure. They do not account for the impact of aggregate business activity on the budget, or intergenerational considerations of tax regimes, or, on balance sheet accounting! Besides, they focus on an *end result* when it is much more fruitful to zoom on *underlying forces* that shape the size and configuration of a government's revenue and expenditure flows at a given time, irrespective of the methodology being used. One can always compare flows based on set methodologies to derive inter-temporal performance.

In the budget speech for fiscal year 2004, the Minister of Finance and Economic Affairs stated government's intentions to reduce the deficit/GDP ratio from 6.43% recorded in 2003 to 5.68% in 2004 and cut it further to 3.08% in 2006. These ratios refer to unrevised data sets and differ from those indicated above (Ministry of Finance and Economic Affairs, 2003:78). Elsewhere, the same minister establishes as a fiscal policy objective the balancing of the government's books by 2010 (John Dalli, 2004:26).

However, it is pertinent to point out that way back in November 1992, in the budget speech for fiscal year 1993 (Minister of Finance, 1992) the Finance Minister announced a series of key policy objectives and several measures that spanned the fiscal, monetary and exchange rate domains. The objectives were the following:

a) Contain the budget deficit to less than 3 % of GDP;
b) Inflation target set at 2% – 3% annually;
c) Curtail public sector employment to between 25% and 30% from the then prevailing 44% of gainful employment;
d) Assess the widening welfare gap in the context of the envisaged changing demographic patterns;

The policy measures included:
1) A devaluation of the Malta Lira by 10%;
2) Containment of commercial banks' interest rate mark ups to between 1% and 3% above the discount rate, then standing at 5.5%;
3) The introduction of a capital gains tax;
4) The increase of employers' contribution to the National Insurance Scheme from 8.33% to 10%;
5) An announcement to introduce VAT in 1994.

These policy targets and measures were not part of an EMU scenario. But they look familiar in the context of the Growth and Stability Pact of the European Union. Therefore it is a useful exercise to understand the reason why some of these policy objectives, in particular, the size of the budget deficit and, over time, the increasing national debt seem to remain elusive to the Maltese fiscal policy maker.

This presentation proposes to first derive insight from the history of economic thought on the role of the government's budget in an economy. In turn, it assesses the main thrusts in fiscal, monetary and foreign exchange policies implemented in Malta in the past two decades. Finally, it draws on these combined experiences to identify the main constraints that Malta has to face in the EMU.

1. The Government's Budget in Economic Thought

The history of economic thought sheds an insight into the ways that a complex system, like a market economy, works. One can draw several important perceptions for the evaluation of macroeconomic policy from the history of economic ideas. These observations may be expressed in terms of a set of propositions, which at times are referred to as "laws" or "general theories". They will serve, in turn, as a backdrop against which the past performance of fiscal behaviour in the Maltese Islands may be assessed and, at the same time, they may indicate the way ahead as Malta moves towards the EMU.

Proposition 1:
Government budgets affect market signals and, so, human behaviour

A market economy is a complex system in which individuals respond to the myriad price signals that surround them. Such signals are not costless to transmit or to receive. Therefore, human judgement may be based on 'false' signals leading consumers and suppliers to act accordingly. Legislation, taxes, and state subventions condition these price signals. Changes over time of any of these will therefore induce a reconsideration of personal decision-making and, in its wake, the composition of goods and services produced and consumed over specific time periods.

In particular, personal behaviour is bound to differ following radical changes in government ownership of assets and the related generation of employment: the nationalization of private assets will lead to different demand configuration from that obtained by a privatisation programme. Similarly, programmes that supply services at zero prices will induce consumer habits that will have to be reassessed if government starts charging cost-related prices or/and expose producers to competitive domestic and/or international trade pressures.

As personal behaviour changes, so do revenues generated to finance government programmes and related expenditure commitments by the state.

Proposition 2:
Government expenditure is bounded by taxpayers' willingness to pay

It was observed that there seemed to be a tendency for the share of government activity in a country's output to grow over time. This expanding participation by government is conditioned by the government's ability to raise tax revenue, although this constraint could be pushed ahead by 'industrious' people. This idea is sometimes referred to as Wagner's 'Law of increasing expansion of public, and particularly state activities', which becomes for the 'fiscal economy the law of increasing expansion of fiscal requirements' (See Musgrave and Peacock: 1967:8). Therefore, the limit to public expenditure is ultimately set not by policy but by revenue, not by politicians but by taxpayers. Productivity gains contribute to the possibility of transferring a larger amount and, perhaps, a greater share of resources to the State but productivity gains are not boundless, at given times, and often they may tend to

zero, if not outright negative, in government controlled enterprises.

Proposition 3:
Balanced Budgets are expansionary but not necessarily a sign of good management

Balanced budgets generate economic growth. This idea is based on two strands of behaviour. Taxpayers divide their income between consumption and saving. So when they transfer resources to the State via taxes, they reduce their consumption by only that part that would have been allocated for consumption. However, the State spends in its entirety the income generated from taxes. So the initial impact on the economy is greater by the difference between government expenditure and the cut in taxpayers' consumption. This net primary income gain brings about a chain of secondary expenditures, until, eventually, income grows sufficiently to induce a generation of households' saving/imports that match the resources transferred to the State. (See Annex 1)

Such line of reasoning is used to recommend the balancing of government budgets. But whatever the merits of such fiscal constraint, balanced budgets do not imply that government is well managed. The budget may be 'balanced', but funds could still be misspent or tax revenue collection inefficient! Besides, a balanced budget rule will involve a reconsideration of the package of policy tools as explained in Proposition 7 below.

Proposition 4:
The Impact of a government's budget on household behaviour depends not so much on how expenditure is financed as on households' reaction via saving in anticipation of higher future taxes.

Fiscal debates refer to the method through which governments finance expenditure. Taxes alter the relative price of goods and services, returns on various forms of investments, and the relationship between work and leisure. Borrowing will, under certain conditions, affect the cost of capital and may consequently 'crowd out' private investment. But a government deficit is often seen as being expansionary irrespective of how it is financed.

However, it may be argued that the method of financing a deficit may be immaterial if only taxpayers realize that there will have to be an eventual rise in taxes to pay for the higher interest rate payments due and if they consider safeguarding the interests of their dependents. Under such circumstances, taxpayers will cut down on their consumption and build up their savings in order to make good for the higher future taxes they and their children will have to incur. As a result the positive gains in economic activity that follow an injection of resources by government will be countervailed by a cut in households' consumption expenditure, and by those investment outlays that are driven by growth in consumption. The net impact of these two decisions may be zero growth of domestic value added.

In this scenario, taxpayers' saving and investment behaviour is seen as being conditioned by potential future tax payments to finance rising interest payments accruing on the national debt. A household's consumption (or saving) is made dependent on income, the cost of capital – as a proxy for time preference -, the net worth of the household, and the envisaged future tax payment which determine the household's net worth in the years to come.

Proposition 5:
Different taxes and government outlays have varying effects on economic activity.

References to government budgets should not be restricted to financial flows. The impact on economic activity tends to differ from one tax to another and from one expenditure outlay to another. Thus Lm1million raised from a tax on cigarettes will induce a different reaction from consumers than Lm1million raised in income tax or in withholding tax on bank deposits. The closing down of revenue gaps will have to consider the Expenditure Restraining Effect of the various taxes in use. This is measured by the reduction in households' consumption and investment as a result of transferring Lm1million to government in one tax or another.

Similarly, Lm1million spent on stipends for tertiary students will induce a demand for goods and services that is not the same if the Lm1million were allocated to retirement pensions or to the construction of roads. These effects are known as the Expenditure Generating Effects of Government Expenditure. They refer to the increase in consumption and investment that is induced by the specific government outlay.

Ideally, therefore, there has to be information on how government raises resources and the manner it disposes of them. A given amount of resources will induce different net effects on aggregate economic activity.

Proposition 6:
Policies may be flexible/discretionary or subject to rules. But they have to be time consistent

Functional fiscal policy, as applied in the past fifty years, meant that governments used the budget as a tool to countervail cyclical economic behaviour. In order to do so, it was thought that taxes and expenditure had to be sufficiently flexible to move against the perceived behaviour of the private sector. Such timely intervention meant an anticipation of future economic performance, relying on a mastery of econometric techniques to identify the turning points in business cycles.

Frustration with repeated failure to pin point in time these cyclical inflexions revamped the idea of applying economic rules and let the economy adapt to them. These rules may refer to the rate of growth of the money supply, average price level change, exchange rate values with varying ranges of flexibility; or pay rises. The Growth and Stability Pact criteria may be taken to represent a set of rules to which participating countries must adapt their economies.

However, it is seen that having rules is not enough. There has to be time consistency on the part of policy makers. If they set objectives, they have to be seen by *all* operators – consumers, providers of services, producers, trade union leaders - that they will stick to attaining those targets. If policy makers keep shifting their targets, in

order to feel freer to adapt to changing economic environment conditions, then all those who will be hit by their decisions will strive to learn how to anticipate them. They may not succeed at all times, but the behaviour will be such as to try to beat the policy maker!

The EU member states introduced economic targets as a guide. These were meant to discipline member states, even though the values set are surely not 'perfect' guidelines. But to ignore these policy targets implies that member states want discretionary powers to adapt to the changing circumstances. They are therefore suggesting that they have a very good idea of the maximum growth potential of their economies and of the actual growth, and they also have a ready recipe of how to bridge the output gap. It seems that the cycle 'discretion-rules-consistency' is about to start again. In policy approach, we are back where we were fifty years ago.

Proposition 7:
Policy objectives must be matched by an equal number of policy tools

There shall be a number of policy tools as there are policy objectives. This statement is known as Tinbergen's rule. Say, four objectives: full employment, relative price stability, balance of payment equilibrium, and equitable distribution of income. The main policy tools may be the following: the rate of exchange, the rate of interest, taxes, and government expenditure. If there are additional targets, such as a balanced budget or a defined budget deficit or, still, a desired stock of foreign exchange reserves or pension liabilities to be met, then additional policy tools will have to be identified. Controls, sale of assets, the introduction of charges are three such tools.

Besides, once a particular parameter is identified as a policy target, it will lose its independent significance and there will be pressures from various interested groups to influence the value of that parameter. (This intuition is referred to in economic literature as Goodhart's Law). Thus, a policy decision to link wage increases to inflation or to productivity growth will induce employers and workers' representatives to influence the values of the policy indicators. Those who pay will try to keep low the value of the strategic parameter; those who receive payment will attempt to round it upwards! In this context, witness the debate going on regarding GDP value and country status in the European Union where status entitlement to funding is concerned.

Proposition 8:
Translating economic concepts into real world policy parameters is not a straightforward exercise

At times, one gets the impression that the concepts used in economic models have a ready counterpart in the real world. We speak of budgets, the rate of interest, unemployment rate, rate of average price change, real effective exchange rates, and so on. In reality, economic concepts may be subject to more than one interpretation and, therefore, measurement. Besides, at times the values that a policy maker will like to have at hand may not be available and proxies have to be used instead. These

conceptual and statistical limitations point at a fact: judgements will have to be made when policies are introduced. One cannot rely solely on statistical data sets as a definite guide. They help but they are not 'infallible' indicators.

For example, reference has already been made in the introduction to potential approaches applied when drawing up government budgets. For some purposes, cash flow series will do; for others such data will have to be 'smoothed' to account for business cycles or to incorporate some equity consideration. Again, when referring to the 'burden' of the national debt in the context of what may be termed 'sustainable development' one may refer to the capital stock passed on to future generations. But one may consider also defining a 'burden' governments' decision to raise what are termed 'harmful taxes' or halt public investment projects following hefty interest payments that have to be met on a growing, large public debt. Therefore, one has to be clear about the 'meaning' of an economic term and the context in which it is used.

Proposition 9:
Democracy seems to affect negatively economic growth

Research on the determinants of economic growth highlights the role of institutions in facilitating economic development and growth. There is reason to believe that society's perception of a sound institutional framework – rule of law and order, finance, trade – lead to higher rates of economic growth over time. Besides, democratic systems of government may be considered to affect growth in various ways. They foster growth by extending the empowerment of people through education and health and, less so, by lowering income inequality. However, democracy seems to hinder growth by reducing the rate of physical capital accumulation and, less so, by raising the ratio of government consumption to GDP. The net effect of these forces on economic growth seems to be 'moderately negative' (Tavares and Wacziarg, 2001).

On the efficiency of physical infrastructure networks, one writer recently concluded that dictatorial regimes have an inclination to go for 'white elephant' type of project that enhance their image and military regimes choose to invest in well-maintained road networks that facilitate the transportation of troops. But democratic governments tend to have relatively poor road systems (Saiz, 2002). For a country that thrives on tourism, such a condition cannot be considered advantageous!

Proposition 10:
To be efficient, parliamentary decisions on budgets have to evaluate both benefits and costs of the respective projects involved

It may come as a shock for many that economists have upheld for the past half-century that decisions in a democracy are either imposed or dictated! Decisions need not come from the grass roots as many may wish to believe. In upholding this view, economists tend to follow the insight given by Kenneth Arrow's "Impossibility Theorem". Besides, economists hold that there is a tendency for multiparty systems to converge in two groups in order to

create a workable government, groups that may keep re-ordering themselves to vie for the loyalty and support at the ballot box of the 'median voter'. It is this competition for votes that induces political parties to offer a larger number of welfare support programmes without considering the full cost implications involved. Such behaviour tends to lead to expanding expenditures without parallel increases in revenue generation. This goes against the idea expressed in Proposition 2.

Unless all fiscal policy measures are decided after account is taken of both objectives and their costs such decisions need not necessarily be optimal from an efficient resource allocation perspective. Decisions may lead to waste of resources.

In sum, these ten propositions indicate the complexity of policy making in a parliamentary democracy. The historical analysis of economic growth suggests that development is a multifaceted phenomenon that comprises cultures, beliefs, and competencies to organise and manage trade relations. It will therefore be an oversimplification of reality to talk of controlling a few economic parameters, especially since very often the conceptual framework applied to understand an issue might not be readily transferred to real world data sets and institutions. But such ideas are useful when assessing fiscal performance in a particular country at a particular time period. This exercise is undertaken in section 2 where we examine the main thrusts in fiscal, monetary and foreign exchange policies implemented in Malta in the nineties. This serves as a benchmark against which we identify the policy decisions that have to be addressed as Malta approaches the EMU.

2. Macroeconomic policies in Malta since the eighties

The past three decades witnessed an expanding government sector that, in part, replaced the activity formerly generated by the UK military bases on the Island. Government relied on a wide array of controls, tariffs and subsidies that facilitated the transfer of resources to identified sectors or selected groups. Such controls 'determined' interest rates, capital outflows and the allocation of funds among economic sectors, prices of public utility services, import and export prices and wages. Over time, this policy created a matrix of 'artificial' prices to which buyers and sellers reacted in the process bringing into being the economic configuration that we observe today.

This set up was successful in the sense that it helped develop a restructuring of the Maltese economy and fill the void left by the running down of the UK bases in Malta. But such an economic strategy was meant to be comparatively short-term once Malta had applied for Associate membership of the European Community (Common Market) in 1970 with the intent to undertake a customs union by the mid-seventies. However, a political 'rethinking' in the seventies regarding Malta-Economic Community relations halted the move to a customs union and saw, instead, a revamped role for the government. The government undertook a wider directly productive role in the economy and it based, in part, its funding sources on financial flows from abroad. Such funds were 'exchanged' for, either a military base – in the case of the UK – or for upholding Malta's neutrality – as in the case of the protocols with Italy since the eighties.

From a fiscal perspective this meant that revenue sources were extended beyond taxation and borrowing; government introduced appropriation (profits from government-owned enterprises) and foreign transfers (grants). Operating profits also arose from the combined result of exchange controls on the movement of capital and the determination of interest rates in Malta by the Monetary Authorities. Since interest rates abroad were much higher than those obtained locally, and since Maltese were not allowed to transfer capital abroad, the interest rate differentials that accrued on the foreign exchange reserves and local deposits represented income, and in turn profits, for the Central Bank of Malta (Delia, 2002:38)

This revenue pattern is still in place with a difference. Profits from government enterprises will disappear with privatisation and foreign grants under the Italian protocol will come to an end next year. Any funds coming in future from EU sources will have to be complemented by local contributions and be addressed to specific projects after presenting formal requests for approval. The Malta government is no longer 'free' to allocate the incoming funds.

From an expenditure perspective, the public sector assumed responsibility for the employment of a greater number of employees and, so, for their wage bills and related costs. As pointed out above, in 1992 the Malta government employed 44% of the registered gainfully occupied in public administration and in those companies in which the government was a shareholder. As government proceeds with its privatisation programme, in part to finance a persistent budget deficit and to contain the growth of a fast growing national debt, the number of employees transferred to the private sector and subjected to profit-related market conditions will rise.

One main economic characteristic of this economic evolution was the stability factor that a big government offers and that is now gradually being eroded. In government-controlled organisations the profit motive, if any, is complemented by the objective of generating work. Such dual-objective behaviour will be attained in a production environment that is different from the one that lies ahead in the EU's single market. With a greater weight being allotted to profit arising within a competitive environment, the feasibility of ongoing activities will have to be re-assessed. Once the profitability conditions are changing, the role of the Malta government in 'guaranteeing' jobs will also have to be re-addressed. It is this appraisal of government's role in the labour and welfare sectors, especially since job support has been one main component of the government's social security programme, which many Maltese are finding it difficult to understand. But, as explained in section 3 below, the main corrective elements under the 'control' of the Maltese economic policy makers lie in the labour market domain.

The end result of government's activity as reflected in the annual balancing of accounts may be observed in Table 1 below. Two main fiscal messages emerge from the data. First, the government budget deficit has been around for quite some time. In fact the first excess of total expenditure over total revenue appeared in 1982, before the time recorded in the data below. But, at the time, government had transferred one half of the profits of the Central Bank of Malta to a separate fund, the Posterity Fund; it under-recorded revenue in the Consolidated Account. Besides,

the Consolidated Account was in surplus. Indeed, government relied on both these savings until 1987 to finance revenue shortfall before it had to resort to borrowing.

A second observation refers to government's saving. Table 1 shows that ordinary revenue fell short of ordinary expenditure (so-called, government consumption) since 1996, with the exception of 1999 and 2000. This means that government has to rely on non-tax sources to finance its consumption. It needs to borrow to finance more than its capital needs.

Table 1

Government Revenue and Expenditure 1990-2002

	Revenue			Expenditure			000s
Period	Ordinary	Grants	Total	Ordinary	Capital	Total	Deficit (-) Surplus (+)
1990	329,890	7,678	337,567	273,415	108,276	381,690	-44,123
1991	355,932	16,374	372,306	301,909	115,493	417,403	-45,097
1992	341,766	16,392	358,158	330,014	58,017	388,032	-29,874
1993	388,179	8,428	396,607	368,624	59,673	428,297	-31,690
1994	416,068	12,853	428,921	410,365	62,340	472,705	-43,784
1995	482,834	4,517	487,351	452,478	70,344	522,823	-35,472
1996	447,470	20,805	468,275	505,195	73,527	578,722	-110,447
1997	504,415	9,809	514,224	538,276	103,392	641,668	-127,444
1998	539,070	10,043	549,113	569,150	96,846	665,997	-116,884
1999	628,168	9,684	637,852	584,834	106,129	690,965	-53,113
2000	632,754	9,549	642,303	617,677	98,552	716,232	-73,929
2001	667,228	1,392	668,620	686,031	80,627	766,658	-98,038
2002	717,084	2,720	719,804	721,652	97,671	819,324	-99,520

Notes: Ordinary Revenue includes Government's contribution to the National Insurance Fund (both its contribution as employer, and its contribution in terms of the Social Security Act, 1987). As from 1992, Ordinary Revenue excludes the contribution by the public authorities/corporations to their own capital programme; includes privatisation receipts and sinking funds of converted loans up to 2000

Ordinary Expenditure includes total public debt servicing.
Capital Expenditure: From 1992, data excludes capital expenditure incurred by the public authorities/corporations. In 1997, a loan to the Malta Drydocks Corporation amounting to Lm24.6 million in included under capital expenditure.

Source: Central Bank of Malta, ***Quarterly Review, December 2003****: Table 2.1, page 116.*

However, even such impressions have to be qualified. As the notes to Table 1 indicate, Ordinary Revenue includes proceeds from sinking funds and privatisations receipts. And, Capital Expenditure includes outlays that do not add to the physical capital stock of the country. They may represent funds transferred to certain publicly owned companies to fund interest payments due or to cover losses incurred throughout that financial year. The reference in note 4 to the Malta Drydocks 'loan' is a case in point. Once allowance for this fiscal accounting is made, the ordinary revenue-expenditure shortfall will rise even higher and the fiscal balance changes as pointed out in the introduction: the revised 'general government budget deficit' increases to Lm175million, which is higher than the Lm105 million recorded for 2003. *The argument made in Proposition 2, namely, rising government expenditure must be matched by rising revenue, has not been carefully considered.*

However, judging from the macroeconomic tools applied throughout the period, especially with regard to the reform of tax regimes, monetary instruments and

exchange rate mechanism, it may be claimed that policy makers had moved the economy with the times. But they went completely off the mark where appropriations were involved. Instead of reaping the profits they envisaged from publicly owned companies, thus complementing tax revenues and grants from abroad, policy makers saw these enterprises demanding continuous subventions to remain economically active. In this sense, the concomitant expansion of revenue that was meant to match an expanding commitment on the social welfare/security front did not materialise. The outcome is that the very existence of these enterprises has to be addressed and other policy tools, like sale of assets (privatisation), withdrawal of subventions, and employment downsizing, have to be considered in order to attain the desired economic objectives. What is, therefore, at stake is a reconsideration of the social contract in place for the past three decades (Delia, 2002a: 27-46).

The policy changes introduced in the past decade or so regarding the main macroeconomic policy parameters are summarised below.

The Rate of Exchange

1. The Malta Lira daily rate of exchange, since the early seventies, was based on a trade-weighted basket. In the late eighties, the basket was extended to include all transactions recorded in the current external account (Delia, 1986). Capital movements were subject to controls up to a few months ago. This 'basket' approach served the purpose of introducing an element of

exchange rate stability against which other policy measures could be introduced.

2. The Central Bank of Malta stuck to a 'currency board' set up to support the Lira. The local currency was backed up 100% by foreign currencies, SDRs, and gold and other precious metal. Legislation set a 60% limit, but the 100% rule has been applied throughout the period under review. Gold, valued at cost on the Central Bank's books, was revalued at market prices in 1985 (Central Bank of Malta, 1985:41) and a quantity of the metal was sold in 1989 (Central Bank of Malta, 1989:63) The 1985 revaluation was a case of using 'hidden' reserves to boost the profit position in a given year. Government benefited from the transfer of profits that ensued.

3. The Lira was devalued by 10% in November 1992. It was the third change in the value of the Lira in the past thirty years. Revaluation gains arose as a result of such a decision. The Central Bank distributed these gains to government over a period of years as indicated by a Parliamentary resolution. The tourism sector benefited from these profits.

Monetary Policy and National Debt Management

4. Monetary policy was relegated to a secondary role throughout the seventies and the eighties. Interest rates were retained fixed for many years. The Central Bank relied on the discount rate, commercial banks'

reserve requirement ratio, and, at times, direct specific instructions to implement monetary policy. In the nineties, the Central Bank activated monetary policy instruments; such action became necessary to move the economy towards a liberalised monetary and foreign exchange environment after Malta's application for membership of the European Community in 1990. The Central Bank issued its own certificates of deposits in 1995 followed by Open Market Operations through the treasury bill and bond markets in 1996. Till then, government used to borrow from the Central Bank on the 'Ways and Means' facility; these loans were paid back before the last day of December. In 1995, Parliament empowered the government to borrow short-term loans up to Lm100million, a sum raised to Lm200 in 1997 and to Lm300 million in 2002.

5. There is no policy regarding the management of the national debt. In recent years, the issuance of government paper occurred more by default than design. Bonds were issued because the government's privatisation programme fell behind schedule, year after year. Government paper and other monetary instruments are not issued with the aim of keeping the market buoyant. Government paper is issued only if there is a gap between revenue and expenditure and the Treasury 'fails' to close it from assets held or grants. Such an approach to the money and capital market results in having the bond market flooded in one year and dry in another. The management of the national debt locks fiscal programming into monetary

policy. This synchronised relationship has been missing so far.

Fiscal Policy

6. Fiscal policy saw a major overhaul. A radical reform was introduced in the tax regime through a multi-pronged programme. Income tax rates were reduced from a high of 65% to a maximum 35% with a withholding tax of 15% imposed on income from bank deposits and from certain instruments listed on the Malta Stock Exchange. A Capital Gains Tax replaced Succession duties, which became an appendage of the income tax structure. Excise and Import duties were replaced by a VAT in 1995, reintroduced under a new format in 1997, and replaced again by VAT in 1999. It was this uneasy tax reform period, 1995 – 1999, that coincided with the resurgence of high budget deficits, and the related acceleration of the national debt, as may be seen from Table 1 above. These years created what may be termed a 'tax regime vacuum' at the expense of a surge in interest rate payments to finance the resultant public debt. In 1996, the bill for interest payments amounted to Lm20 million; it is three and a half times that amount seven years later! The national debt amounted to about Lm517million in 1996; it was in excess of Lm1.2 billion in 2003.

7. The external tariff structure was taken off over a prescribed period, except in the case of selected activities in the agro-industry sector. And industrial

support through subvention to particular sectors, like tourism, had been addressed and moves towards a more competitive environment undertaken. The same considerations apply to the aids to industry in place, in one format or another since 1959. Supporting the creation of wealth through fiscal measures has to be assessed in the context of EU competition law and a more integrated world trade environment.

8. Proceeds from profit appropriation declined, including those of the Central Bank of Malta, as interest rates abroad fell gradually. However, a big policy shift occurred in the nineties regarding the role of the government as an owner of productive assets. Privatisation had been applied sparingly, with the actual word not directly pronounced. But after 1996, privatisation came to be seen as a tool to contain the increase of the national debt and, hence, its related costs. This shift culminated with the publication of a White Paper on the subject in 1999 (Ministry of Finance, 1999). But implementing such a programme is taking longer than government projected.

9. The sustainability of the welfare support programmes had long been discussed. An attempt was made in 1995 to integrate the income tax and welfare entitlement – in this case receipt of children's allowance. Further moves were made to reconsider the student stipends scheme and token payments for government-provided medical services. Besides, the retirement pension and health schemes are under review (Delia, 2003) .

There has been a policy re-thinking primarily of the role of the State in Malta and the tools that policy-makers might use to attain socio-economic objectives. This rethinking has been spurred on by a series of considerations. These include a changing demographic profile with the number of 60plus exceeding 105,000 in twenty years' time and a deteriorating fiscal position. Besides there is a world wide reassessment of trade liberalisation and the role of country governments that will follow such an exercise, and Malta's membership of the European Union that introduces policy discipline on member states. This last consideration simply transposes the issues from a country basis to a Union basis.

Malta will move to ERM 11 in 2005. Such a move brings with it decisions related to monetary and exchange rate policies. But it also has strong connotations for fiscal policy and labour market considerations. This inter-related parametric macroeconomic environment is examined below.

3. The Maltese Economy and ERM 11

Two main facts emerge from the discussion so far. First, the target set by government in 1992 with regard to the state of government finances was not met. It happens to be identical to that pertaining to the Growth and Stability Pact that the government is expected to observe. Secondly, the fiscal and monetary regimes were enhanced during the nineties and made more conducive to the exigencies of an open economy. So, what went wrong?

The answer may be given in four words: Consistent, Complementary, Coherent and Credible. Policies must

support one another if the signals are to be understood in such a way as to lead all participants to work for a common perceived goal. They have to be implemented with consistency and given time to work. Only such a coherent behaviour on the part of policymakers will render the policies themselves coherent and therefore credible.

It may be argued that the various policy measures in the fiscal, monetary, exchange rate and labour markets were introduced in a fragmented fashion. They were not always necessarily complementary to one another nor pursued with persistence. As a result a coherent overall policy framework did not develop. Haziness of policy vision, in turn, led to policy decisions that were not compatible with the declared goal of creating and supporting a competitive economy that can generate enough jobs to meet a growing labour supply and, at the same time, improve incomes and their distribution.

Several examples may be cited to illustrate this theory. First, the tax overhaul was not marketed sufficiently as one process that sees the shifting of the relative share of tax revenue move towards expenditure. This went in line with recent tax thinking to tax people when they spend rather than when they earn their income. Therefore, the income tax-capital gains tax/succession duty-Value Added Tax reform was meant to be one single project, understood and implemented accordingly. Instead, the tax reform emerged as three tax changes that were unrelated in the minds of many.

Again, in this tri-partite project, tax efficiency and an efficient tax administration had to apply throughout all stages. Because, the project was 'sold' piecemeal, taxpayers associated VAT with its audit trails not as a modern way of raising taxes but primarily as a tool to boost income tax revenue. A general uproar went against VAT, but the real target was the income tax. As political events evolved, the initial taxpayers' reaction induced the 1995-1999 'tax regime vacuum' with VAT, CET, VAT introduced in quick succession. If the tax authorities ensured administrative efficiency in the collection of income tax in the first half of the nineties, then the taxpayers' approach to VAT might have been different and the unstable tax period avoided.

Besides, the decision to change and retract marginal rates of income tax that favoured the taxpayer in fast succession sent a signal that the tax regime was not 'stable'. It did not help to reduce marginal rates one year, raise them at another, or to widen the tax base on financial products that were sold as tax efficient vehicles only to be described some years later as 'inequitable' commodities compared to other financial products. Again, the announcement in the budget for 2004 of potential retroactive measures related to inheritance of capital stock is another instance of seeming insecurity in front of the tax authorities. Taxpayers expect a relatively stable tax environment in order to plan their future allocation of time and resources.

In addition, at times policies tended to move one against the other. Such moves might be interpreted by observers as reflecting the absence of an overall convergence of economic and social objectives. Or, that if such a convergence exists in principle, there is no coordination among the respective implementing departments with the result that decisions appear unilateral and conflicting. Thus, the introduction of VAT led to a surge in imports in anticipation of the tax, and consequently to a drain on foreign exchange reserves. Such a drain affected negatively

the money supply. With the 100% external reserves-money supply rule in place, the Central Bank tightened monetary policy. This measure sent a signal that expenditure was considered to be too strong and it had to be tempered by rendering financing more expensive.

However, this move was offset by a readjustment shift of marginal income tax rates to support households' spending power. The 'income effect' prevailed over the interest rate 'substitution effect' and consumption surged ahead. So did government expenditure pushing income, and hence expenditure power, even more. The two policy tools were pushing in opposite directions!

A similar experience happened in 1992 following the competitive devaluation of the Malta Lira. A devaluation of a currency is undertaken to adjust the local price matrix to its international counterpart because it is believed that local prices are higher than they ought to be in terms of trade competition. It makes export prices more attractive but raises import prices. If, therefore, the resultant rise in prices of consumer goods and intermediate products is fed back into the local price and wage system, the country finds itself back at the initial situation within a short period of time. This is especially true for an open economy like Malta where the import content on manufactured goods and of services is relatively high. As predicted (Delia, 1992) the lack of attention to focus on labour costs and productivity in the wake of the Lira devaluation meant that the gains from the exchange rate adjustment were eroded by 1995 (Vide Annex 2).

Finally, a highly relevant example of disregard for the fact that economies are complex social systems is the rapid exchange VAT–CET–VAT regimes in 1995-1999. *Systems* *must be given time to adapt*. This is the main idea behind establishing rules rather than relying on discretionary policy adjustment; the Growth and Stability Pact conditions of the EU subscribe to such an approach. Fiscal policy is generally regarded as slow to adjust to changing circumstances because tax and expenditure changes have to be approved by Parliament. Monetary policy and a floating exchange rate regime respond faster. Fiscal rules rely on inherent economic mechanism to claw back income and slow certain welfare payments when the going is good, and to slow down income receipts and boosts same welfare payments when the economy is weak. But to keep the tax system in a state of flux for a relatively long period of time implies that signals are being repeatedly changed inducing taxpayers to constantly attempt to anticipate them. If the financial situation is assessed to be in dire straits, it makes policy sense not to introduce radical tax system changes especially if such changes are not structured in the first place. The suspense thus created can only render the weak fiscal position worse.

Towards the EMU via ERM 11

If the above interpretation is taken as the economic policy background in the recent past, it can guide policy formation as Malta move towards the ERM 11 and the EMU. There has to be a comprehensive approach to policy-making and allow enough time for the policies to be effective.

Two key issues have to be addressed. First, identify those factors that are suppressing the rate of growth of the economy. Such low rates are being realized notwithstanding

a) a rising government deficit (b) a relatively low cost of borrowing and (c) households' average consumption propensity tending to unity. It is not enough to refer to such generic terms as "competitiveness' but one has to focus on the determinants of productivity per worker per sector. If one holds the conclusions expressed in Proposition 9 above, namely that 'white elephants' and the absence of suitable infrastructure facilities follow 'high handed' administrations and popular democracies, then the search for solutions has to combine insights from economics, sociology, politics, anthropology and management. Measuring productivity is not an easy task especially in the services sector (Delia, 2004)

Second, Malta is moving towards an economic scenario where two important policy parameters will be given up, namely the rate of exchange of the currency and the cost of capital. Pegging to the euro, the next step in ERM 11, before adopting this currency demands a lot of economic discipline that Malta has not shown to date. This interim period will test the ability of the Monetary Authorities to stabilise the currency in the absence of capital controls and to keep the interest rate in line with that prevailing in the euro zone.

Besides, the fiscal tools are now constrained in more ways than one. It is not only the relative size of the budget deficit and the national debt that are specified. The outline of revenue sources and expenditure is now also redefined. The Malta government, like all other EU government, is being urged to follow EU competition law that reflects the characteristics of a single market. This has to be demonstrated in the tax-spending programme of the Malta government. It may be argued that there is still leeway to manoeuver in the medium term because of transition periods and the emergence of a more uniform set of fiscal tools in the EU space. But this time period has to be utilised optimally.

With monetary and exchange rate policies being surrendered, and fiscal freedom bounded, one can only refer to the labour market tools through which the objectives of full employment and economic growth in a competitive market environment might be approached. This emerging scenario represents a fundamental break with the past. Other policy tools have to replace the ones being 'given up' in order to attain the objectives that fall under Production (Full employment, growth, and regional balance of trade, protection of the environment) and Distribution (Price stability and an equitable distribution of income) until producers learn to adapt to the floating euro and a cost of capital that reflects the monetary needs of the entire EU economic space. The rate of exchange of the euro and the cost of capital will not be subordinated to negotiations!

As from May 1, this EU economic space has to be the focal point for all EU members. As yet it is not. There is the risk that every country will continue to choose and pick from the EU agenda. Such behaviour might create complex social-economic structures that evolve at different speeds and emphasise regional interests rather than the interest of the whole group. If this happens a hazy economic and social vision for the EU zone will emerge and render an understanding more difficult to achieve.

To avoid such a situation, certain decisions, like the timing of the adoption of the euro by new member states, may be 'dictated', as Proposition 10 above suggests! This is one policy option that may also have to be considered. In this eventuality, the 'obstacle to Malta's participation in the

EMU', the theme of this conference, will be removed. But it will mean that the Maltese economy will have to adapt to the new economic environment in which two key economic parameters, the euro and the cost of capital, will be influenced by factors that will bear little reference to the level and composition of economic activity in Malta. The relative weights of local conditions in the overall weighted average indices that guide monetary policy in the EU zone and the movements of the euro in the international foreign exchange markets are very small!

4. Summary

Markets are complex systems in which buyers and sellers of goods and services are conditioned by all kinds of signals that interest them. These signals include legislation and prices. Prices are influenced by the tax and expenditure decisions adopted by governments.

A major change in the social contract is under way in Malta. It is in part an element in a process that is seeing a more liberal trade environment in the making following membership of the European Union. Such membership implies a re-dimensioning of the package of policy tools at the disposal of the Maltese government and the Central Bank of Malta to influence sectoral and aggregate economic activity. This follows from the fact that certain controls are being given up and market players have to learn to adapt to this new economic condition.

The present coefficients for the government budget deficit/GDP and national debt/GDP are off the targets indicated in the Growth and Stability Pact of the European

Union. These 'ratios' have to be kept under observation. But, more important, is the query related to the weak economic performance notwithstanding these rising injections by government into the economy. Valid answers to this query will become useful tools for the drawing up of a coherent policy programme.

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Annex 1

The basic idea supporting Proposition 3, referred to as 'The Balanced Budget Theorem", may be illustrated as follows. Assume that tax is a lump sum and expenditure goes on locally produced goods and services.

1. A balanced budget condition reflecting a change in the budget will be represented by the equation: Δ Taxes = Δ Expenditure = Δ Budget, where Δ = change.

   A change in taxes reduces household expenditure by the amount that reflects the household's 'inclination' to consume out of the last Lm100. Let us say that this value is equal to 0.8. So a transfer of Lm100 in taxes to the government will reduce a household's consumption by Lm80.

2. Government spends the Lm100 received in tax.

3. The net initial impact on economic activity is therefore equal to Lm100 – Lm80 = Lm20.

4. This initial addition to aggregate demand will generate further activity until, eventually, income grows by an amount equal to the original government additional injection, which equals the change in tax revenue and the balanced budget.

In algebraic terms:

If ***c*** represents the marginal propensity to consume locally produced goods and services, a change in taxation via a lump sum tax, ΔT, will induce a reduction of private consumption expenditure by $-c\,\Delta T$.

Government spends the entire change in tax receipts. So public sector expenditure rises by ΔE, where $\Delta E = \Delta T$. The initial net impact on aggregate demand is equal to $(1 - c)\,\Delta T$.

However, such an expenditure profile will produce a multiplier effect. The value of this 'simple' multiplier is given by the coefficient $1/1\text{-}c$.

The growth in aggregate demand (ΔY) will eventually reach an amount equal to $\Delta T(1 - c) \,.\, 1/1\text{-}c$. This value matches the initial tax change or budget change. Income expands by an amount equal to the initial tax transfer.

Annex 2

Unit Labour Cost Index for the Manufacturing Industry

(1) Year	(2) MHLC	(3) RVA	(4) Lm/$ $	(5) (1)x(3)	(6) ULC (4)/(2)	ULCI 1990=100
1990	Lm1.67	Lm1.53	3.1527	5.2650	3.4412	100.00
1991	1.79	1.56	3.1002	5.5494	3.5573	103.37
1992	1.85	1.54	3.1462	5.8205	3.7795	109.95
1993	2.02	1.57	2.6171	5.2865	3.3672	97.85
1994	2.11	1.61	2.6486	5.5885	3.4711	100.87
1995	2.27	1.63	2.8333	6.4361	3.9485	114.66

Notes:

MHLC = Mean Hour Labour Compensation

RVA = Real Value Added per Man-hour

ULC = Unit Labour Cost

ULCI = Unit Labour Cost Index

Source: Delia, E.P., 1998: Table 4.2

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