

# Part II – Fiscal Policy Strategies in Small States

## 3

# Economic liberalisation and privatisation programme

The Maltese government over the years has pursued a policy of gradual economic liberalisation and privatisation. The economic liberalisation/privatisation programme was carried out with the aim of changing the focus of orientation of trade and financial policies towards a market mechanism principle. As a result, this has shifted policy orientation from reliance on direct government intervention and control towards a pro-market mechanism.

Part of the liberalisation/privatisation programme saw many formerly state-owned companies being privatised and the market liberalised. So far, the reform programme has been successful, judging by the results. The process of economic liberalisation has brought about significant change to Malta's economy. As a consequence of the liberalisation reform, Malta has experienced a three-year-long expansion driven mainly by FDI and export diversification.<sup>1</sup> For three years in succession over the period 2005–2007, Malta recorded an average real growth rate of 3.85 per cent. Meanwhile in 2007, current account deficit dropped to 5.5 per cent of GDP and unemployment was also down to 6.48 per cent, one of its lowest rates for years. The remarkable growth rate has been spearheaded by booming new manufacturing and export services activities, and a revitalised tourism industry.

The public enterprises being privatised recently were mainly in the sector of telecommunication, harbour towage and cargo handling, and postal services. The government is keen to continue with the streamlining of the public sector as part of its reform programme. The privatisation is in full swing and intended to continue with other sectors, namely shipyards, liquid petroleum gas (LPG) and gasoline distribution. Despite the reforms being hailed as successful by international standards, the Maltese economy remains fairly regulated and continues to be hampered by some longstanding structural weaknesses.

### **3.1 Measures to address budget deficit**

In its endeavour to curtail the budget deficit, the Maltese authorities have introduced a system of budgetary targets. As for the year 2008, a targeted budget deficit of -1.2 per cent of GDP was established. Nonetheless, provisional estimates as depicted by Figure 2.6 above indicates that they are well below their target (-4.6 per cent). In the light of the

unforeseeable circumstances, especially higher than projected oil prices and other costs, the authorities have taken precautionary measures to contain the deficit. Measures taken include prioritising and sequencing of capital projects and additional hiring controls. The authorities have also raised the electricity prices, thus limiting electricity subsidies to 0.7 per cent of GDP.

The authorities are determined to pursue the fiscal reform aimed at curbing the budget deficit. The reform programme was premeditated to give the government the upper hand with its revenue and expenditure through stronger fiscal consolidation. The authorities intend to press on with subsidies reduction and also streamline the large public sector employment. With regard to subsidies reduction, the authorities have already indicated the abolition of shipyard and bread subsidies in 2009. Other areas have already been earmarked as potential for reducing subsidies and cost-cutting. Health is one such area. The Maltese authorities are determined to press ahead with their medium-term objective of a balanced structural budget by 2010, claiming that this will provide domestic stability, thus cushioning the economy from external shocks.

## **3.2 The business environment in Malta**

The key to the success of businesses in Malta is its excellent infrastructure and good telecommunications facilities. Supported by an efficient public administration, Malta provides a conducive environment and is an effective place to conduct business. Furthermore, foreign investors are welcomed with open arms and are entitled to 100 per cent ownership of businesses in nearly all sectors. There are extensive investment incentive schemes (see below). To date there are over 250 foreign companies with manufacturing operations located in Malta.

Businesses have been boosted further by the existence of a sound and robust financial system. A number of local and foreign banks offering a variety of services ranging from e-banking to advanced (cross-border) payment systems further amplify the excellent business environment. Nonetheless, as part of the Exchange Control Act, 1972, foreign banks in Malta were subject to a large degree of control. Upon Malta's accession to the EU, free capital movements were permitted and the act was gradually repealed. As a result, banks can now operate freely.

In its endeavour to boost existing investments and attract new ones, the Maltese government introduced a new incentive package in 2001 predominantly targeting the manufacturing sector, with over 30,000 employees. The new investment package provides fiscal incentives including reduced rates of corporate tax, investment tax credits, value added incentive schemes, special provisions for small businesses and other incentives related to training and job creation.

### **3.2.1 Malta's freeport**

Like Singapore and most recently Mauritius, Malta has been actively engaged in freeport<sup>2</sup> services since the introduction of the Freeport Act in 1989. The Freeport Act made

provision for a number of fiscal and other incentives to companies operating in the freeport zone. Among the incentives are exemption from customs duties, income tax, stamp duty, withholding tax (except for distributions to Maltese residents), exchange control and death duties. Furthermore, employees of freeport companies may benefit from a slight reduction in income tax and importation of personal items duty- and tax-free for the first six months of their stay.

Among the facilities offered by the freeport are: extensive storage space including a container terminal; ship repair; and a range of other support services.

For a company to be qualified to operate in the freeport, it must be incorporated in Malta and must operate under one of the following headings:<sup>3</sup>

- the labelling, packaging, sorting, warehousing, storage, exhibition or assembly of any goods, materials, commodities, equipment, plant or machinery; or
- any activity concerned solely with the conduct of a freeport including, but not limited to stevedoring, wharfage, operation of terminals and container handling; or
- the rendering of services analogous or complementary to the activities mentioned in (i) above.

The main benefits of the freeport include employment generation and foreign currency earnings. In terms of employment generation, new employment opportunities have been created, as well as the introduction of new skills and technologies. The types of employment created range from ship repair to insurance. The freeport has given a further boost to Malta's economy in terms of foreign currency earnings, as most of the revenue is generated in US\$.

### **3.2.2 Foreign investment**

In its endeavour to encourage more foreign investment to Malta, the government set up the Malta Enterprise in 2004. This newly-incorporated body assumed the responsibility previously discharged by three separate entities, i.e. the Malta Development Corporation (MDC), the Malta External Trade Corporation (METCO), and the Institute for the Promotion of Small Enterprise (IPSE). Technically the three entities are still operational but function under the umbrella of the Malta Enterprise.

The main function of the MDC is to look at business development. This basically involves attracting FDI, trade promotion, marketing strategies, knowledge management, and foreign offices. METCO's role is principally to handle client relationship management while IPSE was mandated to deal with corporate services.

Since the incorporation of Malta Enterprise in 2004, direct investment seems to have received a new breath of life. As depicted by Figure 3.1 below, from a peak of about €800 million in 1999, direct investment has since dropped and remained below €400 million. As of 2004 the trend in direct investment somehow took a different turn and started rising until it hit a record height of about €1.5 billion in 2006.

Figure 3.1 below depicts trends in direct investment in Malta over the period 1998–2008.

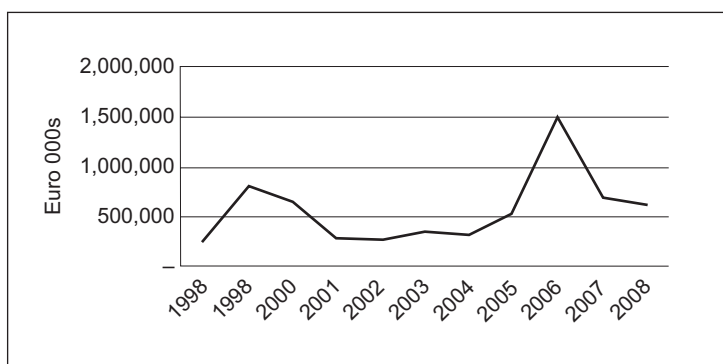


Figure 3.1 Direct investment in Malta, 1998–2008

Malta is well-known for having a long tradition of stable institutions and a favourable business environment. This has been the cornerstone in attracting large FDI inflows, which in turn has been a major source in financing the current account deficit.

### 3.2.3 Malta Offshore Tax System

In Malta, offshore companies can be incorporated under the following headings:

- International trading company (ITC, now closed to new entrants)
- International holding company (IHC)
- SICAV (Société d'Investissement à Capital Variable)
- Offshore company (now defunct)
- Trust

Malta is considered to be a low-tax country, having tax treaties with many countries including most of the OECD countries. The offshore tax is regarded as very generous. Nonetheless upon accession to the EU, there were concerns about which aspects of Malta offshore regime would remain. In August 2003, as part of a European Commission (EC) exercise carried out in ten potential acceding countries, the EC identified seven harmful tax practices that Malta had to eliminate. In March 2006, under EC Treaty state aid rules, Malta's was made to abolish the tax regime for Maltese companies with foreign income (CFI) and the international trading companies' (ITC) regime by the end of 2010 at the latest.

In May 2006, Malta formally accepted the EC recommendation to phase out the preferential tax regime. Accepting the EC recommendation implies that:<sup>4</sup>

- the existing ITC and CFI schemes were effectively abolished by 1 January 2007;
- a new refundable tax credit system was to be enacted by Malta provided that it does not effectively favour foreign-owned companies over domestic-owned companies;
- the tax status of ITC is prohibited to any new company registered in Malta after 31 December 2006;

- the existing ITCs will benefit from the current system only until 31 December 2010; and
- the number of newly-created ITCs between the date of acceptance of the appropriate measures and 31 December 2006 was limited to the yearly average number of ITC companies created in the last five years.

In spite of the above measures, the Malta offshore sector continues to perform well. Malta is ranked 6th out of 37 countries globally that are described as ‘frontrunners’ in terms of high FDI potential.<sup>5</sup> Furthermore Malta is placed in the 4th position among 66 jurisdictions as a centre ‘that is most likely to increase in importance over the next few years’.<sup>6</sup>

### **3.3 Effect of regional and international agreements on fiscal policy**

Following Malta’s accession into the EU in 2004, there has been a rise in the number of worldwide blue chip companies, banks and international entrepreneurs coming to settle in the country. On average, 250 new companies are registered per month, and this trend is expected to grow further.

#### **3.3.1 Double taxation treaties**

To date, Malta has double taxation agreements with a number of countries (46 in all and 15 pending) spread over five continents. These agreements have brought a lot of benefits to Malta, where those benefits are available to all Maltese companies. The agreement between Malta and Singapore for example is expected to facilitate the cross-flow of trade, investment, financial activities and technical know-how between the two countries. The Maltese double tax treaties are based on the OECD Model Convention.<sup>7</sup>

Malta has a growing network of double tax treaties with countries like Australia, Kuwait, Holland, France, India, South Africa, Singapore, USA, Barbados, Canada and Scandinavia to name but a few. Besides the main treaties mentioned above, Malta has offered three additional types of avoidance from double taxation treaties, namely Commonwealth income tax relief, unilateral relief and a flat rate foreign tax credit.

Commonwealth income tax relief is applicable where double tax treaty relief is not available. As the name suggests this makes provision for tax relief on income under the law of a Commonwealth country (other than Malta and the UK). However, this also implies that the law in the respective country provides for a similar relief in respect of tax charged on income both in that country and in Malta.

Unilateral relief is granted in circumstances where overseas tax is imposed on income received from a country with which Malta does not have a double tax treaty and Commonwealth income tax relief is not available.

Flat rate foreign tax credit is applicable in situations where the other forms of tax relief are unavailable. This form of tax relief is available to a Maltese company that receives income from overseas. This is evaluated at a rate of 25 per cent of the amount of the overseas income or gain received by the company, before allowable expenses.

### **3.3.2 Other international agreements**

In January 2004, a memorandum of understanding (MOU) was signed between the Malta Financial Services Authority (MFSA) and the Guernsey Financial Services Commission. This MOU had set a platform for greater co-operation, which includes the exchange of information and investigative assistance between the two regulatory bodies.

In May 2004, financial regulators from Malta and the UK entered into a MOU, with the aim of facilitating the exchange of information and investigative assistance.

In July 2004, the MFSA and the Gibraltar Financial Services Commission signed a MOU on exchange of information. The MOU had set a framework for more formal co-operation, especially in the fields of banking, insurance, investment services, provision of professional trusteeship and company management services, and the exchange of information on supervisory practices and techniques.

In November 2005, the Jersey Financial Services Commission and the MFSA entered into a MOU, specifically aiming at the exchange of information between the two financial services regulators. In May 2008, a declaration of signing of a MOU was made between the Central Bank of Cyprus and the MFSA.

The MOU had set the platform for mutual co-operation and exchange of information between the two authorities. This would facilitate the consolidated supervision of cross-border establishments and ensure the safe functioning of credit institutions in the respective countries, in accordance with their national laws and regulations.

In February 2009, The Cayman Islands Monetary Authority and the MFSA formally established bilateral ties.

## **3.4 The factors that reduce the fiscal size in the country**

### **3.4.1 Labour participation**

Malta has a low labour participation rate, with only 54 per cent of the working-age population actually engaged in full-time employment. This is far below the 70 per cent required in the Lisbon Strategy. The low participation rate is particularly concentrated among women.

### **3.4.2 Diversification of industry and exports**

A typical challenge faced by most small island economies, including Malta, is economic diversification. Despite their relentless effort to diversify, governments of small states have to face a daunting task trying to overcome this challenge. Furthermore, the development capacity of the country is seriously constrained by the small size of its domestic market, high production costs, limited natural resources and shortage of labour, in particular skilled labour.

As a small state, Malta has not been spared from these challenges. The difficulties in diversifying have consequentially led to Malta becoming disproportionately dependent on exports in a narrow sphere of industry sectors, most notably electronics and technology. The dependence on exports and tourism makes Malta hugely vulnerable to global economic

downturn. Nonetheless there is a strong call for Malta to diversify at least into less traditional sectors. This, according to analysts, will allow the economy to switch to competing in an alternative range of areas when conventional industries begin to fail.

### **3.4.3 Reform in the education system**

Contrary to general wisdom, Malta has a very high rate of early school leavers. Statistics have shown that only 45 per cent of people in their twenties had attained an education up to upper secondary level. This represents one of the lowest rates among the EU member states as of 2004. This lack of qualified manpower is a real setback for Malta given its reliance on the electronics industry, much of which requires highly technical skill and broad knowledge for continued innovation. Critics are challenging the efficiency of the education system and are calling for reform to reverse the current trend, rather than focusing on policy aiming at increasing funding and expansion.

### **3.4.4 High unemployment**

Historically, unemployment in Malta has been relatively high despite the sustainable rapid growth of the economy. Ironically, despite the relatively high unemployment rate, Malta is suffering from acute skilled labour shortage. Unemployment in Malta is concentrated largely among the unskilled.

### **3.4.5 Large public sector enterprises**

Despite the recent restructuring of the vast and inefficient PES, it is still relatively large by international standards. The PES is not only weighing on the budget but is also a drag on economy-wide productivity. Malta needs to undertake further reform if it is to curtail the budget deficit and attain a surplus. In addition, the PES is a source of distortions and the substantial subsidies awarded to it are another source of budgetary pressure.

### **3.4.6 High social cost**

The high social expenditure (predominantly due to health care, pension outlays and benefits fraud) is a drain on the budget. In 2009 alone it was estimated that Malta taxpayers paid an approximate €354 million towards social security benefits. On average, the share of social security benefit to GDP is about 15 per cent; 40 per cent of total government expenditure. For a small country with a population of 410,290, this is extremely high when compared to countries like Switzerland and Australia, 11 per cent and 8 per cent of GDP respectively.

### **3.4.7 Persistent competitive pressure**

Malta is currently faced with considerable competitive pressure from outside. This can pose a substantial challenge for potential growth and standard of living in Malta over the

medium term. A number of factors have been identified as contributing towards the erosion of international competitiveness and they are:<sup>8</sup> large wage increases in the public sector, low labour productivity, and the need for substantial and sustainable adjustment among major trading partners.

### **3.4.8 Persistent current account deficit**

Malta's current account balance has persistently remained in deficit and has deteriorated over the years. Moreover, as identified by the IMF Country Report 2007, the export sectors and tourism have both lost market share during this decade.

## **Notes**

1. IMF Country Report 2008.
2. A freeport is an area or section of a port whereby transactions are exempted from customs regulations such as tariffs and other duties. Duty is levied only if the goods are moved from the freeport section into other area not designated as a freeport.
3. <http://www.lowtax.net/lowtax/html/jmaoltr.html>
4. <http://www.lowtax.net/lowtax/html/jmaoltr.html>
5. The World Investment Report, released by the UN Conference on Trade and Development.
6. The Global Financial Centres Index 3 – City of London Report.
7. The OECD model ensures that the same income is not taxed twice in different jurisdictions.
8. IMF Country Report 2007.

## 4

# The socio-economic context

Like Seychelles and Mauritius, the Maltese government has long recognised the fact that despite economic development being regarded as the driving force, this is insufficient for sustainable development. Sustainable and durable development and progress (including human resources development) need a solid base in the form of good infrastructure and facilities. Without considerable investment in capital and human resources, economic and social progress will take longer to achieve. This has been manifested by the huge public investment over the past decade to provide the foundation (ICT infrastructure) the private sector so needed.

Over the years, Malta has emerged as a technology-based economy with the state-of-the-art ICT infrastructure that global capital and business require. Malta's technological knowledge has lifted the country's international image and placed it among the elite in the ICT sphere. Today, Malta is ranked second among the EU states for e-Government services. Other achievements include; excellent access to broadband (66 per cent); two satellite stations; two submarine fibre optic cables and more planned; a fully-liberalised communications market; three competitive mobile operators; ICT regional centre of excellence – Microsoft, Oracle and CISCO training centres.

Despite Malta's lack of natural fresh water sources, the island still has robust water and electricity supplies. Over half of Malta's potable water comes from the desalination process.

With a small population of 405,165 and surface area of only 316 square kilometres Malta is considered to be one of the most densely-populated countries. The population density per square km is 1,298. Despite the high number of licensed road vehicles (699.8 per 1,000 inhabitants) Malta has one of the lowest road casualty rates at only 2.9 per 1,000 inhabitants.

### *Socio-economic development*

The Human Development Index (HDI) 2007/2008 has awarded Malta a value of 0.878, which gives the country a ranking of 34th out of 177 countries. The HDI presents a measure of three magnitudes of human development, namely living a long and healthy life, being educated, and having a decent standard of living. These are measured by life expectancy, adult literacy and enrolment at the primary, secondary and tertiary level, and purchasing power parity (PPP) income, respectively.

The HDI ranking for 2007/2008 is based on 2005 information. As for the case of Malta the following factors were accounted for; life expectancy at birth was 79.1 years, adult literacy rate (ages 15 and older) was 87.9 per cent, combined primary, secondary and tertiary gross enrolment ratio was 80.1 per cent and GDP per capita (PPP US\$) was US\$19,189.

### *EU membership*

The entry of Malta into the EU had stimulated interest in the island's strategic location as an ideal place for service providers. The types of services provided include call centres, aircraft repair and back-office operations. According to the IMF Country Report 2007, companies offering these services were attracted by Malta's skilled work force, which benefited from significant public investment in technical and vocational training, particularly through the Malta College of Arts, Science, and Technology (MCAST). It is important to note that these activities are operating on a small scale.

### *Measures to address climate change*

In their quest to address the issue of climate change, the government has devised a plan of action that includes the following:

- Capture of methane from waste disposal and treatment.
- Replace existing uncontrolled landfill with alternative engineered landfills and further improve upon the treatment of municipal solid waste (MSW).
- Promote the increased use of biofuels through the exemption of excise duties on their importation as well as by encouraging increased throughput volumes as a result of a pilot collection scheme currently underway for the collection of used cooking oil.
- Encourage the greater utilisation of non-conventional sources of water, namely treated sewage effluent and surface water run-off, instead of more costly drinking water for uses that are of a non-potable origin.

The success of the above measures remains to be seen, but their implementation will be costly.

## **4.2 Key development indicators**

The following tables illustrate the national demographic and socio-economic indicators for Malta.

**Table 4.1** Demographic indicators

<i>Indicators</i>	<i>Year</i>	<i>Value</i>
Adult literacy rate (%)	2000–2007*	92%
Age distribution (%)		
0–14	2006 est.	17.1%
15–64		69.1%
65 and over		13.7%
Child mortality rate (per 1,000 children aged 1–4 years)	2007	4
Crude death rate (per 1,000 population)	2007	8
Dependency ratio	2005	19.8%
GDP per capita (US\$)	2005	19,189
Human Development Index (rank)	2005	34th
Infant mortality rate (per 1,000 live births)	2007	4
Life expectancy at birth (yrs)	2007	79
Maternal mortality rate (per 100,000 live births)	2005	8
Net enrolment rate in primary education (%)	2000–2007*	91%
Percentage of population below national poverty line		N/A
Percentage of underweight under-five children		N/A
Population growth rate (%)	1990–2007	0.6%
Population size (mid-year)	2007	400,000
Population with access to treated water supply	2006	100%
Population with access to flush toilets	2006	100%
Ratio of girls to boys in primary education (%)	2007	101.1
Sex ratio (per 100 females)	2008	106 males
Total fertility rate	2007	2

\*Source: Unicef <http://www.unicef.org/infobycountry/malta.html>

**Table 4.2** Education indicators, 2002–2006

<i>Description</i>	<i>Year</i>	<i>Value</i>
Primary school enrolment ratio, gross, male	2007	101
Primary school enrolment ratio, gross, female	2000–2007	99
Enrolment and attendance ratio: females as a % of males, net secondary school, enrolled	2000–2007*	107
Female adult literacy rate (as to % of male rate)	2006	103
Net secondary school enrolment ratio of male to female	2006	1.06

\*Sources: Unicef [www.unicef.org/infobycountry/malta.html](http://www.unicef.org/infobycountry/malta.html)

By the end of 2007, the number of fixed line and mobile phone subscribers stood at 55.6 per cent and 91 per cent respectively. The number of personal computers in use and internet users has surpassed the 50 per cent mark at over 300,000 and 250,000 respectively. It has been testified by the Malta Communications Authority that by the end of September 2005 there were 324,763 wireless subscribers in the country, representing a penetration rate of 81 per cent.

**Table 4.3** Selective indicators (per 100 population)

<i>Indicator</i>		2004	2005	2006	2007
Fixed subscriptions	telephone	52.4	51.8	51.5	55.6
Mobile subscription	telephone	76.8	80.2	84.9	91.0
Pagers subscription		1.1	1.2	1.2	1.2
Cable TV subscriptions		25.1	25.3	27.7	29.3
Internet subscriptions		21.9	21.9	23.4	24.4

*Source:* National Statistics Office, Malta

# **MONETARY POLICY FRAMEWORK**

