

The Stolper report at 60... ...still provides lessons to policymakers

**Alexander Demarco
Acting Governor
Central Bank of Malta**

Introduction

The Stolper Report, recently published by Professor Godfrey Baldacchino, is interesting not simply for its historical account of the structure of the Maltese economy in the 1960s, but it is a report which in many aspects contains important lessons that remain very much relevant today, despite that the Maltese economy and the institutional setting in Malta is very different from what it was in the 1960s.

The report very much resembles in spirit the reports of the IMF's Article IV mission that visit Malta every year, where outsiders come to assess the health of our economy and its financial system, not simply by undertaking a desktop exercise but by meeting various economic players and exchange views with them to get to know a higher level of detail about Malta.

The Stolper Report perhaps is more comprehensive and delves into the institutional framework and prevailing attitudes, and given its mandate to outline a development plan for the 5-years until 1969 also provides an outlook for this period on the basis of its recommendations.

In essence, Stolper made a number of observations and recommendations that some remain very much relevant today, and highlights issues that are still topical, even though perhaps for different reasons. I will mention three, which, in my view, are the more important ones.

Productivity

In my view, the most important observation made by Stolper was that from a global perspective he identified Malta as a very small economy with an insignificant domestic market. This remains very much so today and is expected to remain a constant reality of our economy.

Although this observation may seem obvious to many, however its implications are very much far reaching, and in my view the biggest message of the Stolper report is precisely that given the smallness of the Maltese economy, there is no choice for Malta but to be highly exposed to international trade and therefore focus on being an export-oriented economy.

As an international trade economist, famous for the Stolper-Samuelson theorem he developed with Paul Samuelson in 1941, it became obvious for him that given its small domestic market, Malta could never produce efficiently all that domestic consumers would like to consume, especially also because Malta has no natural resources except people and what he termed as “stone”.

Therefore, he (rightly) argued that improving the welfare or living standards of Maltese would require the Maltese economy to be engaged in international trade. Indeed, this has been the characteristic of the Maltese islands since the time of the Phoenicians, with Malta being usually described as a trading outpost.

Interestingly, at that time Stolper had advocated Malta to seek a very close commercial collaboration with the UK and was not of the view that Malta should become part of the Common Market (now EU) unless the UK becomes part of the common market itself, which was not at that time, and neither it is today, but had been in between. Alternatively, he advocated a close relationship with Italy, probably given its geographical proximity, or alternatively membership with EFTA.

Stolper’s view probably was driven by the very close ties that Malta had with the UK at that time and saw opportunities for Malta to trade with the UK, particularly in manufacturing and tourism. On this matter, Stolper had a more shorter-term perspective, as clearly the experience of the early 1980s at the time of the great recession in the UK taught us that concentration in foreign trade, for both goods and services, can be very painful and diversification of both import and export markets is more appropriate from a risk strategy perspective.

However, more importantly, Stolper stressed the importance that to engage successfully in international trade, irrespective of the kind of trade arrangements, and enable the Maltese to earn sufficient income to pay for their imports, productivity is key.

Productivity is all about being able to produce more or better output of goods and services demanded at the least possible time and hence reduce cost of production. He also reminds us that when there are shocks to raw material prices – today one can think of energy – Malta needs to become even more productive or efficient to compensate for such adverse terms of trade shocks, to be able to pay the higher price of such commodities imported from abroad.

This is an extremely important message that very often local economic agents tend to forget or seek to skirt. Indeed, in his report, Stolper remarked that *“it must be stressed that the Mission found present attitudes among the people, unions, the business community and even some government officials to be little conducive to the solution of these problems”*, namely that of increasing efficiency and hence productivity.

He found a prevalent tendency for blaming present problems to the past (a usual favourite among many); an attitude that the only hope was that other countries will come to aid Malta (relations with Libya in the 1970s following the oil crisis, Italy in the 1980s, and then EU membership sold mostly on the benefit of EU Funds in the 1990s and 2000s all spring to mind), a desire of trade unions and government to maintain employment at all costs

irrespective of efficiency (re-deployment of workers in failed public entities within the public sector), and a business community with the attitude to get the best help it can receive from government either in the form of capital and protection, especially against competition.

He was quick to realise how various economic players at that time had sought to retain the status quo by seeking support from the State to avoid reforms that are necessary to improve productivity which very often have painful consequences in the short term, including job losses, but eventually their fortunes do turn around if implemented well. Greece has been an example of this in recent years following the Troika reforms after 2012.

Such attitudes are sometimes still very much alive today. For example, very recently low profitability concerns have been expressed publicly by the restaurant sector, and calls were made on Government from various quarters over time to reduce VAT on restaurants to address this loss in profitability - this at a time when tourism has been experiencing its biggest boom in decades with strong increases in visitor flows and expenditure!

The lesson here is very clear, while private operators are free to invest their capital in business that they think will provide them with their desired return, however they should fully bear the risks if such investments do not turn out to be as profitable, and not expect governments to bail them out by spooking them with prospects of job losses.

For an economy to be dynamic it needs both births and deaths of businesses who are not sufficiently efficient to produce goods and services. Of course, countries need to have in place an adequate social safety net that focuses mainly on providing incentives that make work pay and provide effective training and reskilling to enable those who lose out from economic transformations to reintegrate themselves as rapidly as possible in the labour market.

Interestingly, the recurring theme in the Stolper report of improving efficiency to enable the Maltese to improve in a lasting way their living standards relative to those in the UK at that time, is also echoed in the latest Draghi report who highlighted that the decline in productivity in the EU is the major factor that has given rise, especially in the post pandemic period, for GDP per capita in the EU to diverge from that in the US. Hence his call for structural reforms and need for more investment.

Europe has very much lost out compared to the US in respect of research and development, especially in technology, which in the US has led to big technology firms, such as Google, Microsoft, Apple, Amazon, Meta, Invidia and Tesla (the Magnificent 7 of the US Stock Market), which Europe does not have. To put things into perspective, in July 2024, the market capitalisation of these Magnificent 7, at \$15.4 trillion, was broadly equal to the market capitalisation of the top 6 European Stock Exchanges (UK included) taken together and almost 30% of market capitalisation in the US.

- These firms do make a difference in overall productivity at the national level, and this is why Draghi in his report also called for cross-border mergers in the EU as size does matter in respect of research and development, and hence in innovation and productivity. However, the EU is not the US. It is fragmented along national lines, and the nationalistic attitude is

very much prevalent and rising. The resistance by some quarters to the recent Unicredit-Commerzbank proposed deal is one such example. Europe (including Malta) overall do tend to embrace the usage of technology, but then lag behind in its development, which is where the lion's share in productivity growth comes from.

The message of Stolper that productivity and innovation is ultimately the underlying source of wealth generation remains very much a constant over time and cannot be overemphasised enough.

Public sector efficiency

A second message from the Stolper report that remains valid relates to the importance of efficiency in the public sector and reduction of red tape and bureaucracy. Today we tend to label this issue as “good governance” where in essence its absence translates into inefficiencies and costs.

Stolper remarked that at the time the public sector was too large, inefficient, and hence there was plenty of scope for greater productivity and in lessening burdens to the private sector.

The scope of reducing red tape and bureaucracy, as well as need for better governance remains very much relevant today for Malta. Over the years we have witnessed a proliferation of authorities and regulation, mostly arising from the need to transpose EU regulations and directives. Incidentally, this issue is also highlighted by Draghi in his report as one of the sources of losses in competitiveness of the EU and recommended the creation of a Competitiveness Coordination Framework.

In terms of public sector employment, Malta has come a long way in reducing direct public sector employment, which stood at 38% of the gainfully occupied 30 years ago in 1994, which was broadly the same share in 1962 when one aggregates government administration, the British services, and the dockyard. This came down to 24% by 2000 and currently it stands at around 18%, which is nevertheless still slightly higher than the EU average of around 16%, but overall, good progress has been made in this respect.

On the other hand, government expenditure as a proportion of GDP in 2023 stood at 38.4%, which compares very favourably to the EU average of 49.3% (50% for EA) and represents a slight drop from around the 40% average for the 25 years before COVID (1995-2019), but broadly in line with that of the early 1960s.

While overall expenditure has not changed much, public expenditure on gross fixed capital formation stood at 3.5% of GDP in 2023, in line with its average for the past 30 years and that for the EU, although in the early 1960s it stood much higher at around 8.5% of GDP.

However, controlling growth in government spending and especially ensuring quality of public expenditure in terms of outcomes, which perhaps is more challenging, remains essential. Indeed, Stolper observes that in respect of expenditure considerations, emphasis

should be placed on what expenditure could imply for efficiency and productivity. Even if tax revenue growth is strong due to economic growth, improved efficiency in tax collection, and reduction of tax evasion, expenditure needs to remain very much in check and more effective in its outcomes, also to build fiscal buffers for future economic shocks that will invariably come.

In the case of burden of regulation, according to the World Economic Forum, in 2021 Malta scored a bit better than the EU average both in respect of government regulation and business regulation, but there are still several EU countries with better scores than Malta, like Ireland, Luxembourg, Estonia and the Nordic countries. However, most EU member states, including Malta, since 2012 have seen declines in the World Bank's governance scores. Although the US and UK have seen declines too, they nevertheless remain at much higher levels than the EA and Malta, which suggest that there is still significant scope for efficiency gains in the public sector.

Tackling over-population

Over-population was also a major issue in the 1960s highlighted in the Stolper report, which of course is a very topical issue today. This may seem somewhat surreal given that in the early 1960s Malta's population stood at around 330,000, while last year according to NSO it stood at around 563,000.

However, in the 1960s, the problem of over-population did not arise from congestion issues, unlike today, but rather because of lack of sufficient job creation and job-rich productive investment to cater for the size of the population of that time, which inevitably meant a heavier burden on public finances.

At that time, there were more than 6000 persons unemployed, and this at a time when Malta had a very low female participation rate in the labour market. Today, the registered unemployed total around only 1100.

Stolper was of the view that attracting sufficient investment at the time to create more employment with the rundown of the British military services was very challenging and it was unlikely that productivity of workers displaced from the British services would have high productivity levels in new occupations.

Interestingly, he also dispelled arguments made locally at that time that as population increases, demand will increase, thereby creating employment. Similarly, more recently, it has been argued that population growth is causing the economy to grow. This is not the case because in the absence of domestic resources, such demand would create imports, and hence give rise to the necessity to finance such imports through foreign debt in the absence of sufficient productive investment.

Therefore, Stolper's vision was that Malta needed emigration of "*a considerably larger scale than has been obtained before*", and the goal of Stolper's mission was emigration of 10,000 per annum, though he recognised that given the pressure to reduce immigration

quotas in advanced economies, he advised Government to negotiate higher quotas with some Anglo-phone countries.

However, Stolper understood that emigration could not be a long-term solution of unemployment and the run-down of the British services, because many advanced countries were decreasing immigration quotas and were being selective in the type and education of migrants.

Therefore, he highlighted the need for more education and training, especially in respect of what he labelled as “*technical and scientific*” manpower, as well as “*entrepreneurs*” (he emphasizes this with an underline), accountants and executives, rather than lawyers and doctors which were deemed sufficient in number.

This also very much applies today. Although Malta has made progress in terms of literacy and number of students in tertiary level of education, it still lags behind and is not among exemplary performers in the EU, as well as with the UK and US, in terms of the Programme for International Student Assessment (PISA) results.

In terms of tertiary education graduates in science, mathematics, computing, engineering and manufacturing, in 2021 Malta was the laggard in the EU with just 1% of the population aged 20 to 29 graduating in such areas, amounting to half of the EU average of over 2% and compared to 4% in Ireland. These are skills that are considered to be most conducive to innovation and technological developments which generate potential for strong productivity growth.

Although since the 1960s Malta has overcome the challenge of unemployment, and today Malta is enjoying full-employment, nevertheless given population aging and declining working-age headcount among the indigenous Maltese population, the Maltese economy requires steady growth in employment, and consequently growth in population, to sustain those in retirement with an adequate pension.

While strong economic progress has been undoubtedly made, a quality leap is needed because over the past 20 years around 30% of the increase in employment in the private sector came from sectors that were among the bottom third with the lowest compensation per employed in 2023.

These are mostly related to sectors directly or indirectly connected to tourism (and indirectly property-related) which puts into question whether the huge expansion of the sector (building permits for hotels, restaurants, bars and tourism-related activity rose from 373 in the decade between 2003-2012, to 3160 in the following decade – a rise of 750% or 8.5 times) is sufficiently rewarding given the externalities in terms of infrastructure investment required (water & electricity which are both subsidised, sewage and waste treatment – funded from general taxation) and impact of construction activity (of apartments and hotels) on the environment, and higher housing costs (both to rent and to purchase), to sustain a greater number of visitors and employees to service them.

Although, equipping those of working age with higher skill levels, and hence higher productivity levels, that generate higher tax revenues from higher incomes, could help in

alleviating to some extent the financing of pensions, it is highly unlikely that this would be sufficient. Hence, shifting from a pay-as-you-go pension scheme to self-funded pension schemes – possibly a mandatory one which is still resisted by both unions and employers - is one other policy choice to tackle over-population by breaking the link of pension adequacy and sustainability with the dependency ratio and its demographic implications.

Conclusion

To conclude, the main messages of the Stolper report, namely the need for higher productivity, both in the private and public sector, through investment in both technology and human capital in skills development, to achieve long lasting higher living standards for the Maltese population remains a constant given that Malta will remain inescapably a very small economy which needs to trade internationally to enable its population to enjoy living standards of advanced economies. Indeed, strong prospects of the return of trade tariffs globally and trade fragmentation across geo-political blocs is bad news for both Europe and Malta.

Since the 1960s Malta has come a long way: in achieving very low unemployment, both from a historical perspective and is indeed among the lowest in the EU today without resorting to emigration, but rather needing inward migration; in increasing GDP per capita at purchasing power standards from 84% in 2003 to 105% by 2023; with public debt at below 50% of GDP; HICP inflation in September 2024 at just 2.1% (RPI 1.2%), GDP growing by 6% in the first half of this year; and a Net International Investment Position (Assets > Liabilities) in credit of €14 billion in 2022.

However, as a country Malta cannot remain complacent to the challenges it has and assume that such results will remain achievable in the future without adequate productivity growth and efficiency in both the public and private sector, enhancement of skills through education and training, and more prudence in public finances with policies that provide the appropriate incentives and signals for desirable economic activity and consumer behaviour, that also take into account environmental and other kinds of externalities that impinge on the well-being of citizens.

6 November 2024