Assessment of the Draft Budgetary Plan 2019

MFAC
MALTA FISCAL ADVISORY COUNCIL

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Minister for Finance
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Dear Minister,

OVERALL ASSESSMENT OF THE UPDATED MACROECONOMIC AND FISCAL FORECASTS FOR 2018 AND 2019 & THE COMPLIANCE WITH THE FISCAL RULES BASED ON THE DRAFT BUDGETARY PLAN 2019

As a follow-up to the letter of endorsement for the macroeconomic forecasts dated 15 October 2018, the Malta Fiscal Advisory Council is hereby presenting the full assessment report of the Draft Budgetary Plan 2019, in terms of the Fiscal Responsibility Act.

The Malta Fiscal Advisory Council considers the macroeconomic and the fiscal forecasts for 2018 and 2019, as presented in the Draft Budgetary Plan 2019, to be within its endorsable range. This Plan also complies with the fiscal rules prescribed in the Fiscal Responsibility Act and the Stability and Growth Pact.

The assessment carried out by the Fiscal Council remained predominantly qualitative. The forecasts were examined based on the explanations and evidence provided by the Ministry, supplemented with the general assessment of the consistency with the historical patterns characterising such variables, and any specific factors which are expected to influence the trajectory of these forecasts.

The Fiscal Council positively notes that the official macroeconomic and fiscal outlook for Malta is broadly shared by the European Commission and the Central Bank of Malta. This adds to the plausibility of such forecasts, which is instrumental for correct policymaking. Nonetheless, a certain element of uncertainty remains since Malta's very open economy makes it subject to possible economic shocks arising from the external sector, while on the fiscal front, some budget components may be volatile and subject to sudden changes. Overall, the risk assessment carried out by the Fiscal Council points towards a marginal downside risk to real GDP growth for 2018 and neutral risk for 2019. On the other hand, it is possible that the fiscal surplus could turn out higher than planned in 2018, but lower than planned in 2019.

Based on the updated macroeconomic and fiscal outlook, the Fiscal Council confirms that the fiscal rules are expected to be met again in both 2018 and 2019. This in view of the plans which indicate that the debt ratio would remain below the 60% of GDP ceiling, and the fiscal balance would remain in surplus in structural terms, thus enabling the country to continue over-achieving its Medium-Term Objective.

The Fiscal Council acknowledges the clear commitment by the Government towards the Medium-Term objective. This strategy helps sustain the planned reduction in the debt ratio. A low public debt ratio is key to sustaining Malta's economic fundamentals. Strong public finances are important not only to comply with the fiscal rules, but to ensure that appropriate fiscal buffers are created at a time when the economic performance is favourable. The benign macroeconomic and fiscal conditions offer a window of opportunity for carrying out the necessary reforms to address long-term challenges. At the same time, the Fiscal Council reiterates the importance that the fiscal plans adequately factor in the challenges associated with Malta's rapid structural changes, population growth and international environmental obligations, particularly in relation to Europe 2020 targets.

Finally, the Council would like to express its sincere gratitude to the staff at the Ministry for Finance for the ongoing fruitful collaboration and assistance.

Yours sincerely,

John Cassar White

Chairman

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Abbreviations

ARIMA	Autoregressive Integrated Moving Average
BO	Budget Office
CBM	Central Bank of Malta
COM	European Commission
DBP	Draft Budgetary Plan
DOC	Department of Customs
EBU	Extra-Budgetary Units
ECB	European Central Bank
EIA	US Energy Information Administration
ESA	European System of National and Regional Accounts
EU	European Union
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
IIP	Individual Investor Programme
IRD	Inland Revenue Department
MFAC	Malta Fiscal Advisory Council
MFIN	Ministry for Finance
MOSS	Mini One Stop Shop
MTO	Medium Term Budgetary Objective
NAO	National Audit Office
NPISH	Non-Profit Institutions Serving Households
NSO	National Statistics Office
pp	percentage point
SGP	Stability and Growth Pact
STEMM	Short-Term Quarterly Economic Forecasting Model
USP	Update of Stability Programme
VAR	Vector Autoregression
VAT	Value Added Tax
VECM	Vector Error Correction Model

Executive summary

This Report assesses the macroeconomic and fiscal forecasts for 2018 and 2019 contained in the latest Draft Budgetary Plan, which the Ministry for Finance submitted to the European Commission on 15 October 2018. The Draft Budgetary Plan anticipates that the Maltese economy will maintain strong growth over the forecast horizon. However, real GDP growth is expected to decelerate gradually, from 6.7% in 2017, to 5.8% in 2018, and 5.3% in 2019. Supported by this economic outlook, the Draft Budgetary Plan targets further fiscal surpluses over the forecast horizon, albeit smaller than in 2017. The fiscal surplus, which in 2017 amounted to 3.5% of GDP, is anticipated to drop to 1.1% in 2018, and thereafter increase slightly, to 1.3% in 2019. Meanwhile, the debt-to-GDP ratio is expected to maintain its gradual downward trend, falling to 46.9% in 2018 and to 43.8% in 2019.

The methodologies used to prepare both the macroeconomic and the fiscal forecasts remained the same as those used in previous rounds. The external assumptions underpinning the macroeconomic forecasts continued to be derived from reputable sources. The Malta Fiscal Advisory Council considers both the macroeconomic and the fiscal forecasts to lie within its endorsable range. Furthermore, the Fiscal Council positively notes that the official macroeconomic and fiscal outlook for Malta is broadly shared by the European Commission and the Central Bank of Malta. This adds to the plausibility of such forecasts, which is instrumental for correct policymaking. Nonetheless, a certain element of uncertainty remains since Malta's very open economy makes it subject to possible shocks arising from the external sector, while on the fiscal front, some budget components may also be volatile and subject to sudden changes.

The assessment of the macroeconomic and fiscal forecasts carried out by the Fiscal Council remained predominantly qualitative. The forecasts were examined based on the explanations and evidence provided by the Ministry, supplemented with the general assessment of the consistency with the historical patterns characterising such variables, and any specific factors which are expected to influence the trajectory of these forecasts.

The assessment carried out on the individual GDP expenditure components, suggests possible downside risks for 2018 in relation to growth in gross fixed capital formation, government consumption and exports, which in turn feed into downside risks for imports. The net effect results in a marginal downside risk for real GDP growth for 2018. The downside effect is contained due to the high import content for gross fixed capital formation and to a slightly lesser extent in the case of exports. In 2019 there is a neutral risk for real GDP growth since the downside risk to exports is broadly neutralised by the upside risk to government consumption and the downside risk to imports.

Contingent on the materialisation of the updated macroeconomic outlook, the assessment carried out on the individual revenue and expenditure components, suggests possible upside risks for the fiscal balance in 2018 and downside risks for 2019. In 2018, total revenue may exceed the targets. This is primarily due to the possibility of higher revenue generated from taxes on production and imports and social contributions. The beneficial impact on the fiscal balance is further supported by the downside expenditure risks, the latter linked to the possibility of spending shortfalls on gross fixed capital formation and 'other' expenditure. On the other hand, in 2019, it is possible that the fiscal surplus turns marginally smaller than planned, as spending on compensation of employees may exceed the target, with the impact being however partially mitigated by savings on 'other' expenditure.

Based on the updated macroeconomic and fiscal outlook, the Fiscal Council confirms that the fiscal rules are expected to be met in both 2018 and 2019. The debt rule is expected to be comfortably satisfied as the trajectory for the debt ratio remaining well below the 60% of GDP ceiling over the forecast horizon. At the same time, the planned structural surpluses, amounting respectively to 0.6% and 1.2% of potential output, in 2018 and 2019, would enable Malta to continue over-achieving its Medium-Term Objective of structural balance. The latter also implies that the expenditure benchmark is not binding, provided the Medium-Term Objective continues to be satisfied and this is not due to windfalls.

The Fiscal Council considers that strong public finances are important not only to comply with the fiscal rules, but to ensure that appropriate buffers are created at a time when the economic performance is favourable. The benign macroeconomic and fiscal conditions also offer a window of opportunity for carrying out the necessary reforms to address both short-term and long-term challenges.

1. Introduction

European Union (EU) countries that share the euro as their currency must submit a Draft Budgetary Plan (DBP) to the European Commission (COM) by 15 October every year.[1] The COM then assesses the plans to ensure that economic policy among the euro area countries is coordinated and that every country respects the EU's economic governance rules.

The DBP contains macroeconomic forecasts which underpin the fiscal plans for the year ahead. To strengthen confidence in the reliability of the macroeconomic forecasts, EU regulations specify that a country must either delegate their production to an institution which is completely independent from government, or else, when the government produces the macroeconomic forecasts itself, such macroeconomic forecasts must be endorsed by an independent institution. In the case of Malta, the latter option was adopted, with the Malta Fiscal Advisory Council (MFAC) tasked to carry out this endorsement. Accordingly, on 15 October 2018, the Chairman of the MFAC forwarded a letter to the Minister for Finance stating that "based on the information available to the Malta Fiscal Advisory Council, and after taking due consideration of the uncertainty inherent in macroeconomic forecasts, the Council considers the full set of macroeconomic forecasts for 2018 and 2019 prepared by the Ministry for Finance as part of the Draft Budgetary Plan 2019 to lie within its endorsable range".[2]

The Fiscal Responsibility Act (FRA), which among other things established the MFAC and specified its tasks, goes beyond this requirement by also prescribing the endorsement of the fiscal projections. Article 13, sub-article 3 (a), of the FRA states that the MFAC shall "endorse, as it considers appropriate the macroeconomic and fiscal forecasts prepared by the Ministry for Finance (MFIN) and provide an assessment of the official forecasts". Article 13, sub-article 4, of the FRA, further requires that the MFAC makes public its assessment.

This Report, whose cut-off date is 23 November 2018, outlines the analysis carried out by the MFAC to support its endorsement decision for both the macroeconomic and the fiscal forecasts contained in the DBP 2019. The Report proceeds as follows. Section 2 reviews the methodologies used by the MFIN to prepare the macroeconomic and fiscal forecasts and provides an analysis of the main assumptions which underpin the macroeconomic forecasts. Section 3 evaluates the expected trajectory for the various macroeconomic variables for 2018 to 2019 and identifies any

[1] The DBP submitted by each country is available on https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries/draft-budgetary-plans-2019_en.

[2] A copy of the letter is available on https://mfac.org.mt/en/publications/Documents/Letter%20of%20Endorsement%20Macroeconomic%20Forecasts%20DBP%202019.pdf.

possible upside or downside risks. Section 4 compares the MFIN's latest macroeconomic forecasts with those prepared by the MFIN during the previous forecast round, and the latest available forecasts produced by other institutions, namely the COM and the Central Bank of Malta (CBM). Section 5 presents an overview of the main fiscal aggregates for 2018 and 2019 and examines the extent to which the forecasts for the main revenue and expenditure components, and public debt, can be considered as plausible. It also identifies any upside or downside risks to the baseline forecasts. Section 6 compares the MFIN's fiscal forecasts contained in the DBP to those prepared as part of the latest Update of Stability Programme (USP), and the latest available forecasts by the COM and the CBM. Section 7 evaluates the ex-ante compliance with the fiscal rules. Section 8 presents the conclusions and final recommendations.

2. Forecast methodologies and assumptions

2.1 The preparation of the macroeconomic forecasts

The methodologies used by the MFIN to produce the macroeconomic forecasts remained the same as in the previous rounds. The macroeconomic forecasts are generated using the MFIN's macroeconometric model (Short-Term Quarterly Economic Forecasting Model - STEMM). This is a Keynesian model, with output determined by the aggregate demand components. Latest available data are used as inputs into the model. Updates and re-estimations of the equations are carried out when necessary, to ensure that these reflect adequately the developments and structural changes in the Maltese economy.

Estimated equations are complemented with expert judgement gained through regular discussions with key stakeholders, which include government departments, authorities and large firms. These meetings offer the opportunity to discuss prospects and gather information about key issues which might have a bearing on the economic outlook, particularly at a sectoral level. Such meetings play a significant role in shaping the MFIN's outlook for employment, exports and investment plans for some sectors, as these might be driven by very specific factors. Given the small size of the Maltese economy, the MFAC considers that this approach is particularly useful as sector-specific developments can drive the economy-wide outturn, and model equations may not be able to capture such specificities.

2.2 Assumptions underpinning the macroeconomic forecasts

The modelling framework used by the MFIN to produce the macroeconomic forecasts relies on a set of assumptions for certain exogenous variables. These variables are mainly related to the external sector and are not influenced by domestic factors. The main external assumptions relate

to the values for the short-term and long-term interest rates; exchange rates of the euro with respect to the US dollar and sterling; real GDP growth of Malta's main trading partners; and oil prices. These are respectively sourced from the European Central Bank (ECB), Consensus Economics (September 2018 issue) and the US Energy Information Administration (EIA). It is good practice that forecasts about these exogenous variables are based on authoritative sources and that the values correspond to latest available by the cut-off date. Chart 1 shows the trajectory of the exogenous variables used in the DBP 2019, compared to the profile adopted in the previous forecast round (USP 2018 – 2021). These assumptions have a cut-off date of 10 September 2018.

Chart 1: Main macroeconomic assumptions

Note: 2017 refers to actual data while 2018 and 2019 are forecasts.

Source: MFIN

The assumption for the short-term interest rate, which at the time of the USP was expected to start increasing marginally by 2019, has been revised to stable, at zero per cent, throughout the forecast horizon. In contrast, the long-term interest rate was lifted to 1.3% for both years, marginally higher than what was assumed in the USP.

In terms of exchange rates, the euro is expected to appreciate vis-à-vis the US dollar. However, the degree of appreciation is less than what had been assumed in the USP. On the other hand, whereas in the USP, the euro was expected to depreciate slightly against sterling in 2018, and to remain at this lower level in 2019, in the DBP, the assumption is for the value to remain stable across the forecast horizon.

With regards to external demand, which is proxied by the real GDP developments in Malta's main trading partners, the DBP embeds a gradual deceleration from 2.0% in 2017 to 1.8% in 2018 and 1.7% in 2019. This scenario is somewhat different from the pick-up which had been anticipated for 2018 in the USP.

According to the DBP, oil prices are expected to rise in 2018, from $54.2 per barrel to $72.1 per barrel, and remain stable at this level in 2019. Although this pattern mirrors that factored into the USP, the increase shown in the DBP is more pronounced than had been anticipated in the USP.

To complete the forecasts, it is necessary to impose other technical assumptions. The MFIN assume that the impact generated by the inventory adjustment during the first half of the year, as reported in the official GDP data published by the NSO (News Release 139/2018), is carried forward for the whole year.[3] Since in 2018, the inventory adjustment during the first six months of the year was positive, it is thus assumed that inventories would make a positive contribution to GDP growth for 2018 as a whole. On the other hand, for 2019 this component is modelled to generate no contribution to GDP growth.[4]

To evaluate the robustness of the forecasts, the MFIN also present a sensitivity analysis, which involves modelling alternative scenarios which are considered plausible. The alternative forecasts are based on different assumptions than those used in the baseline. These vary from a shock to an exogenous variable, to sector-specific shocks. Furthermore, apart from STEMM, alternative forecasting models are used to evaluate the similarity of results.[5]

[3] Inventory changes include the effect of changes in actual inventories, as well as any statistical errors.
[4] In the USP the MFIN normally assume that the contribution to growth stemming from inventories is zero throughout the forecast horizon since at that time no data for the current year is available.
[5] These models include model-free statistical forecasts (Random Walk and Holt-Winters Seasonal Smoothing Method), model based univariate forecasts (2 ARIMA models) and model-based multivariate forecasts (2 VAR models and one VECM model).

2.3 The preparation of the fiscal forecasts

The methodologies used by the MFIN to prepare the fiscal forecasts also remained largely unchanged compared to the previous forecast rounds (Box 1 provides a detailed description of the process as documented by the National Audit Office (NAO) in one of its recent audits). The framework continued to be based on the expert input provided by the line ministries, working along the line items of the Consolidated Fund. In turn, the expert input is supported by the analysis of trends by the various departments, as well as knowledge about specific fiscal legislation and ad-hoc factors. This bottom-up approach ensures the tapping of expert knowledge and micro information which is available at ministry level.

Top-down ESA-based forecasts are also produced, based on the estimated relationships between the fiscal variables and their respective proxy bases. The top-down projections act as an envelope, to ensure prudence and the overall consistency between the fiscal forecasts and the official macroeconomic outlook. The bottom-up and top-down fiscal projections are discussed among senior ministry officials and fine-tuned. The objective is to ensure that the official projections contained in the DBP, are compatible with the budgetary targets, and respect the fiscal rules. The attainment, and in some cases, the overachievement of the headline targets for the fiscal balance and public debt, observed in recent years, suggest that the current forecasting framework used by the MFIN tends to be somewhat conservative, whereas financial controls appear to be adequate.

Box 1: The preparation of the revenue projections by the Inland Revenue Department (IRD), The Value Added Tax (VAT) Department and the Department of Customs (DOC)

Reproduced from pages 9-10 of An Analysis of Revenue Collection, carried out by the NAO, published in December 2017. This report is available on http://nao.gov.mt//loadfile/08d6f413-ae2d-4e94-82c8-a2bf51fec90a.

Communication by the NAO with the Budget Office (BO) showed that revenue projections required as part of the 2016 budget preparatory process were initially prepared by the respective Departments as per MFIN Circular No. 1/2015 - '2016 – 2018 Business and Financial Plans'. Each Department provided its three-year revenue projections, in response to said Circular. However, during the meeting held with Senior Management, information collected by the NAO suggested that a top-down approach was being adopted with regard to revenue projections and that ultimately, the revenue targets for the year 2016 were those set by MFIN.

It was also confirmed that while departmental projections were submitted to MFIN in the first quarter of 2015, the official budgetary estimates for 2016 were finalised late in the year, whereby the BO had a better picture of the relevant revenue trends, including any planned budget measures and their impact on projected revenue.

Upon request by the NAO, the BO provided the revenue projections submitted by each of the three Departments. Subsequently, these figures were compared to the amounts included in the Financial Estimates for the year 2016. It was noted that the published estimated revenue figures provided by MFIN exceeded the ones submitted by each of the Departments.

Whilst each Department submits its projections in the first quarter of the year, the final 2016 Financial Estimates were presented in Parliament in October 2015.

It was confirmed that throughout the year ongoing discussions were held between the BO and the respective Departments, through which the relative projections were updated to reflect any monthly performance fluctuations. Since current year performance serves as a baseline for the forthcoming year's estimate, estimated amounts reflect improvement, or otherwise. In addition, the Financial Estimates may be revised further due to various initiatives deemed necessary at any given point in time, including increased enforcement measures.

Subsequently, the Economic Planning Division within MFIN performs independent forecasts through econometric modelling, where the macroeconomic performance and outlook are assessed for each revenue item. Ongoing revisions are made during the analysis, with material variances analysed to establish the underlying assumptions, as well as to compare results. Towards the end of the process, the final estimates are the ones most compatible with the macroeconomic scenario for the year to which they refer.

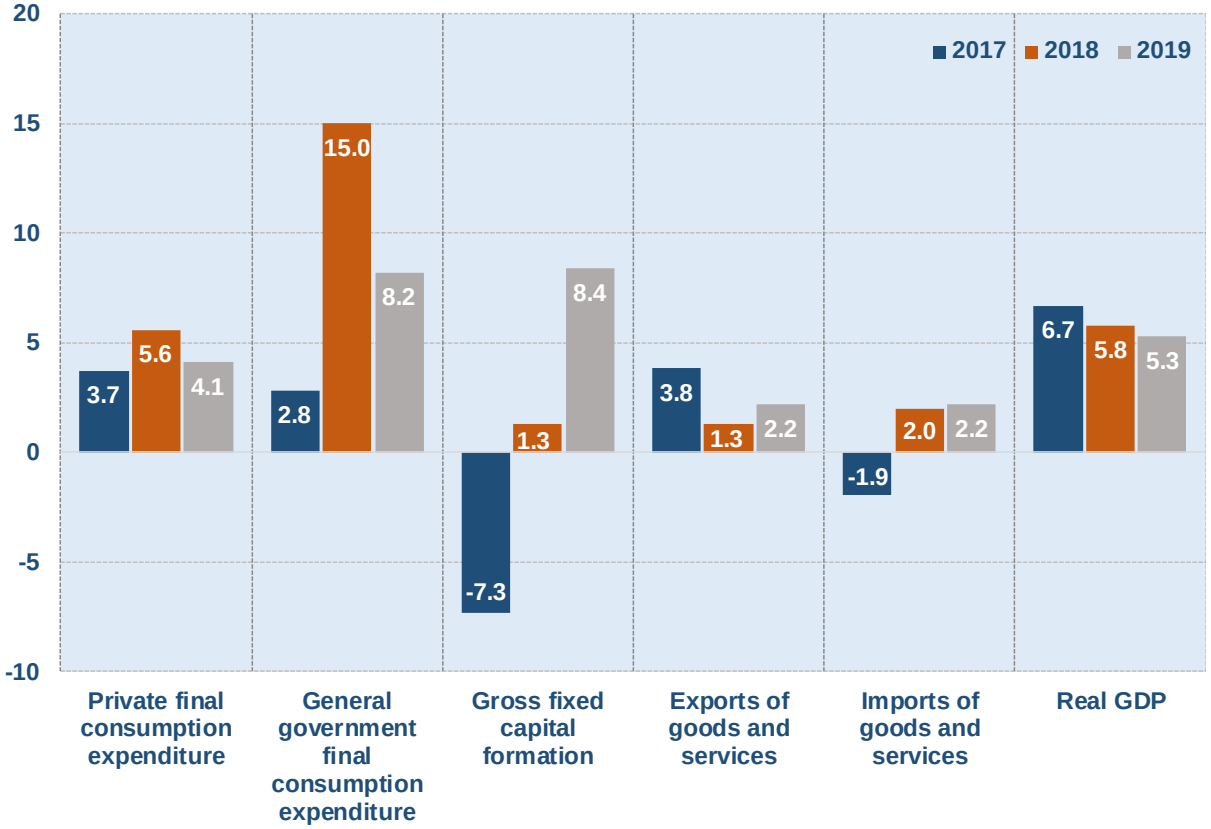
Such estimates are provided net of any new initiatives, since such measures only become known as the annual National Budget approaches. Consequently, targeted revenue to be derived from such initiatives would have to be reflected at a later stage accordingly. In addition, the Financial Estimates may be further revised due to various initiatives deemed necessary at any given point in time, including increased enforcement measures and higher collection of revenue arrears.

3. Assessment of the macroeconomic forecasts 2018 – 2019

3.1 Overall macroeconomic outlook for 2018 – 2019

The DBP anticipates that the Maltese economy will maintain strong growth over the forecast horizon. However, real GDP growth is expected to decelerate gradually, from 6.7% in 2017, to 5.8% in 2018, and 5.3% in 2019 (see Chart 2 and Table 1). Growth rates vary among the different GDP expenditure components. Gross fixed capital formation, exports and imports of goods and services, are expected to grow faster in 2019 than in 2018. Private consumption and government final consumption expenditure are also expected to grow, in the outer forecast year, albeit at a slower pace than in 2018.

Chart 2: Growth rates of selected macroeconomic variables (chain linked volumes) (%)



Note: Figures for 2017 are based on actual values as published by the NSO at the time of preparation of the DBP (News Release 139/2018), while figures for 2018 and 2019 represent the forecasts prepared by the MFIN.

Source: MFIN

In nominal terms, GDP is expected to expand at a stable rate of 7.7% in both 2018 and 2019. This is slightly below the 9.4% nominal growth recorded in 2017. The higher increase in the GDP deflator in 2019 is expected to compensate for the projected small decline in real GDP growth in that year.

Table 1: Macroeconomic variables for 2017 – 2019

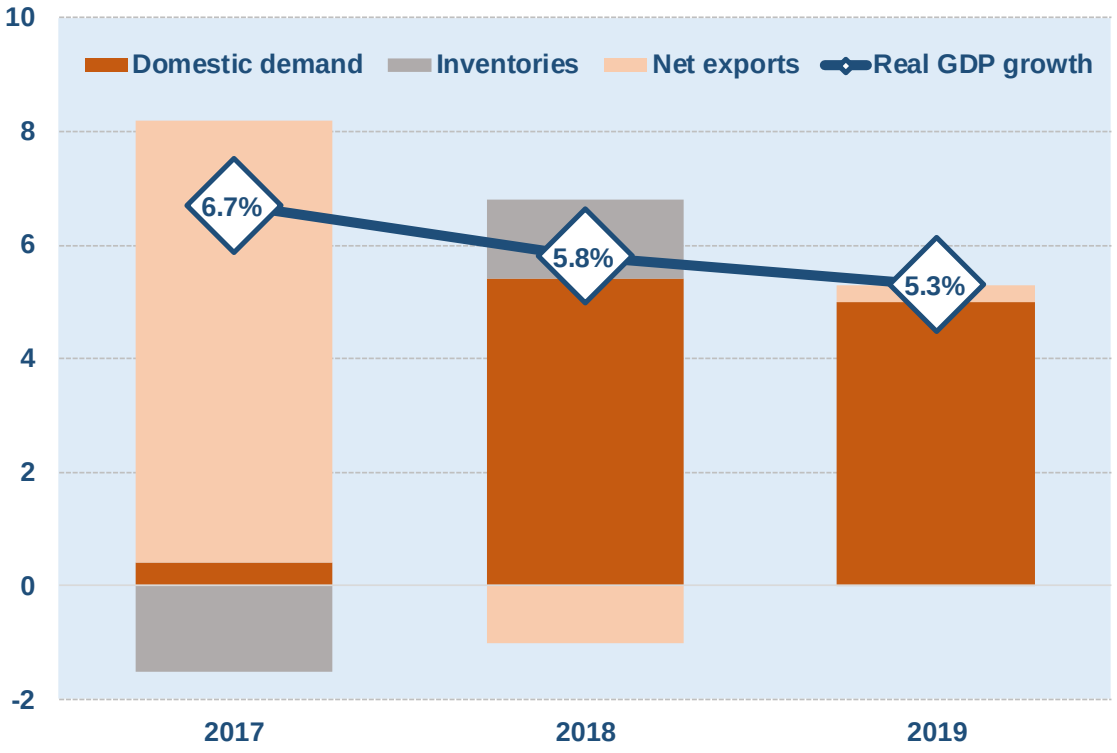
	2017	2018	2019
Real GDP components			
Private final consumption expenditure (including NPISH)	3.7	5.6	4.1
General government final consumption expenditure	2.8	15.0	8.2
Gross fixed capital formation	-7.3	1.3	8.4
Exports of goods and services	3.8	1.3	2.2
Imports of goods and services	-1.9	2.0	2.2
Real GDP	6.7	5.8	5.3
Contribution to real GDP growth			
Domestic demand (pp)	0.4	5.4	5.0
Inventories (pp)	-1.5	1.4	0.0
Net exports (pp)	7.8	-1.0	0.3
Deflators			
Private final consumption expenditure (including NPISH)	1.0	0.7	1.0
General government final consumption expenditure	1.7	3.5	1.9
Gross fixed capital formation	2.2	3.6	2.2
Exports of goods and services	3.4	3.3	1.8
Imports of goods and services	2.5	3.3	1.9
GDP deflator	2.6	1.8	2.2
Labour market			
Employment (National Accounts definition)	4.0	5.0	3.7
Unemployment rate (based on the LFS) (%)	4.6	4.0	4.1
Compensation per employee (in nominal terms)	1.8	2.9	2.9
Labour productivity (real GDP per person employed)	1.4	0.8	1.4
Other macroeconomic variables			
Inflation rate (based on the HICP) (%)	1.3	1.7	1.9
Nominal GDP	9.4	7.7	7.7
Potential output	6.6	6.2	6.2
Output gap (% of potential output)	1.4	0.9	0.1

Note: All figures refer to year-on-year percentage changes unless otherwise indicated. Figures for 2017 refer to actual values as published by the NSO at the time of preparation of the DBP (News Release 139/2018), while figures for 2018 and 2019 represent the forecasts prepared by the MFIN.

Source: MFIN

Domestic demand is expected to be the main driver of real GDP growth in both 2018 and 2019 (see Chart 3). This contrasts with developments in 2017, when the main driver of growth was net exports. Net exports are expected to dampen growth in 2018, as imports are expected to grow at a faster pace than exports. On the other hand, in 2019, net exports are expected to contribute 0.3 percentage points (pp) to growth.

Chart 3: Contributions to real GDP growth (pp)

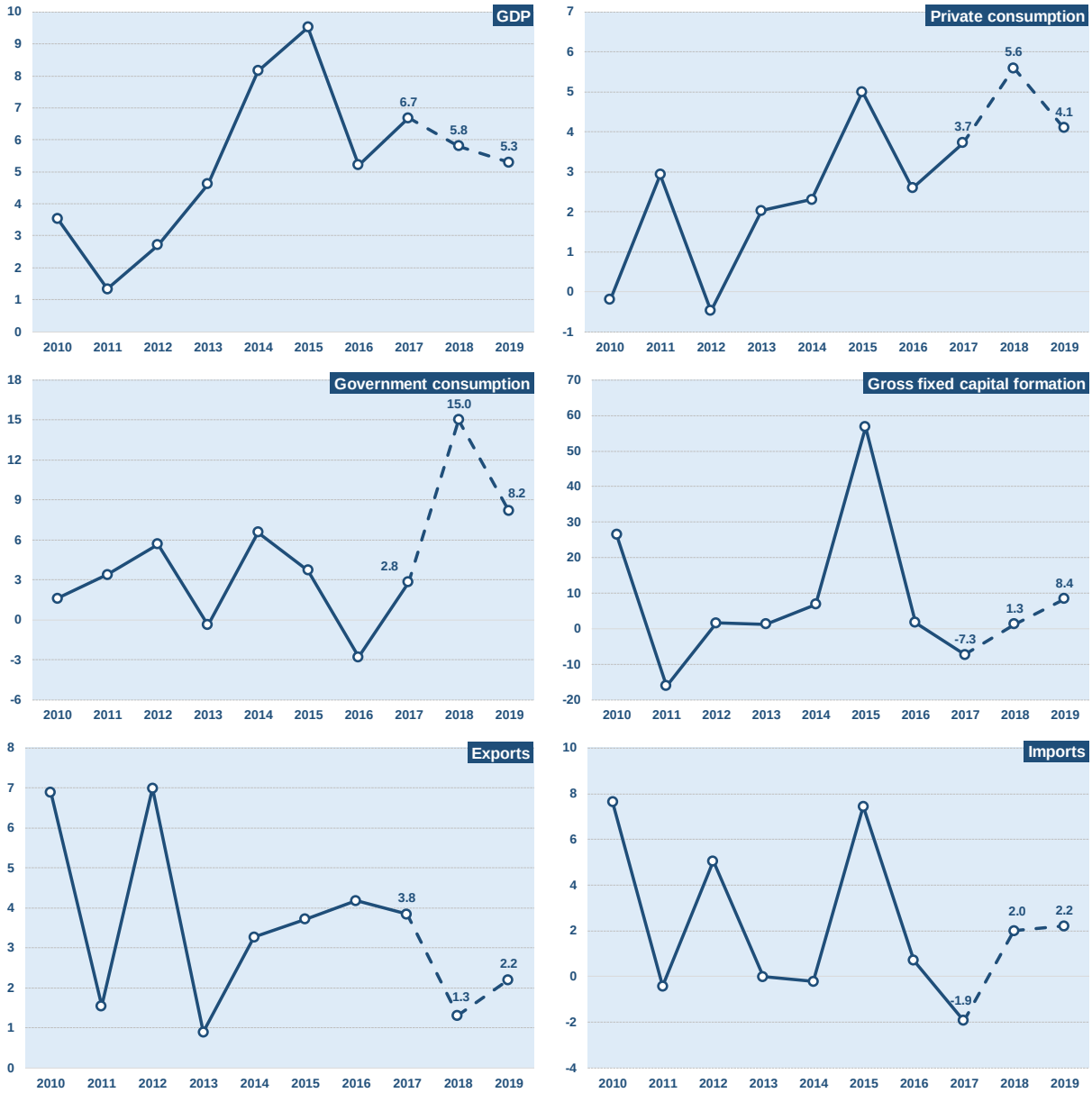


Source: MFIN

Another difference between the macroeconomic forecasts for 2018 and 2019 and the actual data for 2017 relates to the impact of inventory changes. Whereas in 2017 inventory changes exerted a negative impact on growth, equivalent to -1.5 pp, in 2018 this effect is reversed as inventory changes are assumed to contribute 1.4 pp to growth. On the other hand, in 2019, the contribution to growth stemming from inventory changes is assumed to be nil.

A detailed assessment of the forecasts for the various macroeconomic variables follows (see Chart 4).

Chart 4: Growth in individual macroeconomic variables - chain-linked volumes (%)



Note: Figures for 2010 – 2017 refer to actual values as published by the NSO at the time of preparation of the DBP (News Release 139/2018), while figures for 2018 and 2019 represent the forecasts prepared by the MFIN.

Source: NSO, MFIN

3.2 Private consumption

In 2018, private consumption is projected to grow by 5.6% in real terms.[6] This reflects an acceleration compared to the 3.7% growth recorded in 2017. It is also higher than the yearly growth rates recorded between 2010 and 2017. The 2018 forecast is in line with the 5.9% actual year-on-year growth in consumption recorded during the first half of the year. The projected path for private consumption is supported by the anticipated labour market developments. Expectations are that headcount employment will grow by 5.0% year-on-year and that the unemployment rate will remain low and decline further, to hover around 4.0% over the forecast horizon. Further support is provided by the anticipation that compensation per employee will expand by 2.9% in nominal terms, thus exceeding the projected HICP inflation rate of 1.7%.

For 2019, the MFIN anticipate a slight deceleration in real private consumption growth, to 4.1%. This is mainly ascribed to the expected easing in employment growth, to 3.7%. Further dampening effect derives from the anticipation that growth in nominal compensation per employee will remain stable at 2.9%, whereas the inflation rate will rise marginally, to 1.9%.

The projected path for consumption growth for 2018 and 2019 is to a large extent driven and consistent with the anticipated dynamics in real incomes. This pattern of job-rich growth experienced by the economy is expected to persist throughout the forecast horizon. In turn, the plausibility of such labour market outlook is supported by the positive outlook in certain key sectors, namely remote gaming and tourism. These sectors are expected to add significantly to their employment levels, reflecting the positive sentiment in these areas. The anticipated job creation is also compatible with the active labour market policies undertaken in recent years, as well as the continued influx of foreign workers.

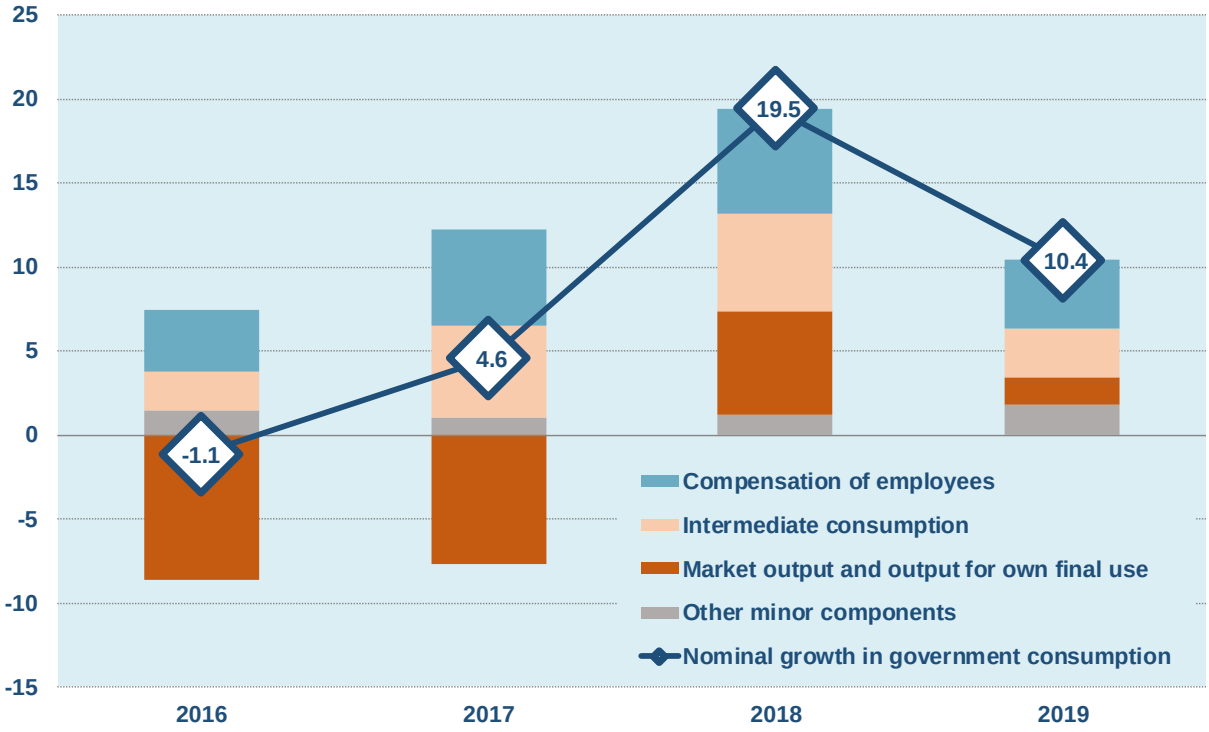
The deflator for private consumption is expected to grow by 0.7% in 2018 and by 1.0% in 2019. These growth rates are comparable to the 1.0% growth recorded in 2017. The consumption deflator is projected to grow by less than the HICP inflation rate. This pattern was already observed in 2017. Indeed, the MFIN's forecasts extend the pattern where tourism-related prices, (which feature as part of the HICP but do not form part of the consumption deflator) outpace the rise in the prices of the other consumption components. The positive performance in the tourism sector has enabled firms to raise prices, a scenario which is expected to continue prevailing over the forecast horizon.

[6] Private consumption is the largest component within domestic demand, accounting for approximately half of GDP in real terms.

3.3 Government consumption

Government consumption is expected to continue growing unevenly across the forecast horizon. In real terms, the forecasts point towards 15.0% growth in 2018 and 8.2% growth in 2019. This anticipated trajectory can be assessed by focusing on the different components making up government consumption, based on the fiscal forecasts which are presented in the DBP. The caveat is that such variables are only available in nominal terms (see Chart 5).

Chart 5: Breakdown of nominal government consumption growth (pp, %)



Source: MFIN

The anticipated surge in government consumption (both in nominal and in real terms) in 2018, is almost entirely driven by developments in market output, which mainly consists of the proceeds of the Individual Investor Programme (IIP). The DBP assumes that in 2018 IIP proceeds will be lower than in 2017, thus contributing positively to growth in government consumption.[7] For 2019, a repetition of this effect is expected to occur, albeit with lower intensity.

Otherwise, the contribution to nominal growth in government consumption which is driven by compensation of employees and intermediate consumption is expected to be slightly higher in 2018 when compared to 2017. On the other hand, in 2019, growth in these two components is

[7] When estimating the value of government consumption, market output is deducted from the other expenditure components. Since the DBP assumes that in 2018 market output will be less than in 2017, this corresponds to a deduction of a smaller value, thus explaining the upward push to government consumption.

projected to slow down, thus explaining further the anticipated deceleration in nominal government consumption growth in 2019.

The assessment of the fiscal forecasts (see Section 5), suggests that there could be upside risks for market output in 2018 and upside risks for compensation of employees for 2019. These risks give rise to a downside risk for real government consumption growth in 2018, and an upside risk to real growth for 2019.

3.4 Gross fixed capital formation

After having contracted by 7.3% in 2017, gross fixed capital formation is expected to grow by 1.3% in 2018, and by 8.4% in 2019. During the first half of the year, investment declined by 1.5%, but this was mainly the result of base effects, owing to the elevated levels of investment recorded during the same period of 2017. The information compiled by the MFIN suggests that different projects in the tourism, education, health, technology and telecommunication sectors are expected to start or accelerate during the second half of 2018. This factor explains the different patterns between the actual outturn during the first half of the year and that anticipated during the second half. It is also anticipated that certain EU-funded investment will gather momentum as from the second half of the year. Turning to 2019, higher spending by the aviation and the construction sectors accounts for the anticipated faster growth in gross fixed capital formation.

Gross fixed capital formation has exhibited significant swings across the years, making it challenging to achieve accurate forecasts for this expenditure component. The MFIN's practice of maintaining regular contact with key stakeholders and the decision to only incorporate those projects that have a strong political commitment or a high prospect of realisation, is considered by the MFAC as a sensible approach. Furthermore, the assumption of high import content for investment reduces the effect of forecast errors spilling unto the real GDP growth forecasts.

Nevertheless, since the profile for investment during the second half of 2018, is largely contingent on the initiation of new projects, possible delays with these projects pose a downside risk to the growth forecast for 2018. Such downside risks are also pertinent to public investment spending (see Section 5). At the same time, the risk outlook for 2019 remains neutral, as the possible shifting of some investment from 2018 to 2019, may be followed by further shifting of investment beyond the forecast horizon.

3.5 Exports of goods and services

Exports of goods and services are expected to grow by 1.3% in 2018 and by 2.2% in 2019. These are lower than the growth rates generally experienced throughout the period 2010 to 2017. The expectations of rather low export growth are based on the assumptions that growth in the main trading partners will decelerate, and that the euro appreciates, particularly vis-à-vis the US dollar. At a sectoral level, expectations are uneven. Exports of services, which include financial services, tourism and remote gaming, are expected to maintain good momentum, but the outlook for goods is more subdued. Apart from the before-mentioned assumptions, which are exerting a dampening effect on export growth, the export forecasts are also driven by the sector specific information compiled by the MFIN after discussions with key stakeholders in the various sectors. It is also worth pointing out that between January and June 2018 exports grew by 0.8% year-on-year, with the yearly forecast implying that the growth rate for the second half should grow slightly faster, by 1.8%. For 2019, export performance is underpinned by the outlook among the financial, pharmaceutical, tourism and remote gaming sectors.

The forecast for the export deflator, which is expected to rise by 3.3% in 2018, extends the pattern recorded in 2017. In 2019, the projected growth in the expert deflator is less, at 1.8%. The forecasts for the export deflator are in line with the forecasts for the import deflator for both 2018 and 2019, thus exerting a virtually neutral impact on the terms of trade over these two years.

Overall, the MFAC considers that there could be small downside risks to the forecasts for export growth throughout the forecast horizon due to the possibility that the deceleration in the growth rate of Malta's main trading partners be more pronounced than was factored into the MFIN's DBP forecasts (see Chart 1).

3.6 Imports of goods and services

Imports are forecast to grow by 2.0% in 2018 and by 2.2% in 2019. These growth rates are comparable to the 2.3% average yearly growth recorded between 2010 and 2017. Yearly fluctuations in import growth are often driven by the volatility of gross fixed capital formation, which in the case of Malta has a very high import content.[8] The acceleration in imports expected for 2018 is consistent with the faster growth in all the domestic demand components when compared to 2017. It is plausible that their combined upward push on imports more than offsets the impact of slower export growth anticipated for 2018. The 2018 forecast is also fully in line with the 1.9% growth recorded during the first half of the year.

[8] The correlation coefficient between the growth rates in imports and gross fixed capital formation for the period 2010 – 2017 was estimated at 0.8.

With regards to 2019, the faster import growth mainly reflects the pick-up in investment, but also coincides with the faster growth in exports, which similarly has a significant import content. These two factors are expected to more than compensate for the anticipated slowdown in consumption growth. The growth in the types of imports varies, with more pronounced changes by capital goods (which are linked to investment), when compared to consumer goods.

The before-mentioned downside risks associated with the growth rate in gross fixed capital formation and exports, translate into a downside risk also for the growth rate in imports throughout the forecast horizon, in view of the significant import content of these two GDP components.

3.7 Inflation

Inflation, based on the HICP, is forecast to rise over the forecast horizon but to remain below the ECB's target of close to but below 2.0%. Inflation is expected to accelerate from 1.3% in 2017 to 1.7% in 2018 and 1.9% in 2019. This is consistent with the upside pressure resulting from the assumption of higher oil prices throughout the forecast horizon. This effect is partly offset by the downside pressure stemming from the assumption of a stronger euro. At a component level, the growth rates in the prices of processed food and services are expected to outpace those in energy and non-energy industrial goods.

The scenario underpinning the MFIN's inflation forecasts is that the highly elastic labour supply, facilitated by the inflow of foreign workers, continues to maintain overall wage pressures under check, particularly towards the lower end of the labour market. This is also supported by developments in the economy-wide labour productivity, which is expected to rise by 0.8% and 1.4% respectively in 2018 and 2019.

Developments in the various deflators suggest that apart from the private consumption deflator, the other expenditure deflators will all rise by slightly more than 3.0% in 2018.

In 2019, the private consumption deflator will continue to rise at the slowest pace compared to the rest, albeit accelerating. The latter contrasts with the generalised slowdown in the other deflators, in each case of slightly more than one percentage point. This pattern is consistent with the assumption of stabilisation in oil prices in 2019.

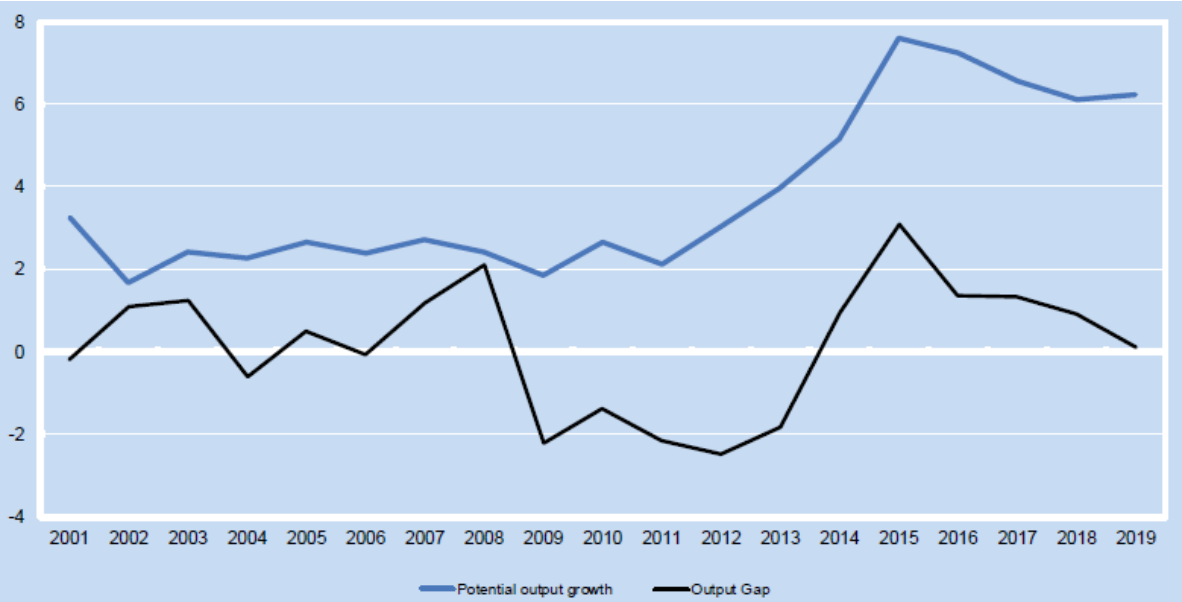
3.8 Labour market

Labour demand is expected to remain strong throughout the forecast horizon. This is consistent with the job-rich growth being experienced by the country. Sectors such as remote gaming and the services sector in general are expected to continue expanding their employment levels. The steady influx of foreign workers makes such employment growth possible. Further expansion in labour supply results from the trend rise in the female labour force. Administrative measures aimed at facilitating the influx of foreign workers, even from non-EU countries, as well as the family-friendly measures and tax incentives, should enable the labour supply in Malta to continue expanding, thus catering for the rising labour demand, and containing wage pressures. The forecasts contained in the DBP anticipate that such positive developments will continue prevailing, but with some moderation.

3.9 Potential output and the output gap

The potential output and the output gap are estimated by the MFIN using the commonly agreed methodology across the EU.[9] This is based on the production function approach, with growth stemming from the labour contribution, the capital contribution and total factor productivity. Accordingly, potential output is forecast to grow at a steady pace of 6.2% throughout the forecast horizon (see Chart 6).

Chart 6: Potential output growth and output gap estimates (%)



Note: Reproduced from the DBP Chart 2.1, page 13.

Source: MFIN

[9] For further details refer to http://ec.europa.eu/economy_finance/publications/economic_paper/2014/ecp535_en.htm.

In relation to both 2018 and 2019, around half of the growth in potential output stems from the projected expansion in labour supply. The other half is practically divided between the capital contribution and total factor productivity. In turn, the expansion in labour supply reflects growth in the working-age population, the higher participation rate and the lower natural rate of unemployment. These are consistent with the rest of the macroeconomic scenario underpinning the DBP.

Since real GDP growth is expected to grow by 5.8% in 2018 and by 5.3% in 2019, that is below the projected growth in potential output, the output gap is expected to narrow. As a result, the output gap is expected to virtually close off over the forecast horizon, declining from 1.4% in 2017 to 0.9% in 2018 and 0.1% in 2019.

3.10 Macroeconomic risk outlook

The assessment carried out on the individual GDP expenditure components, suggests possible downside risks for 2018 in relation to growth in gross fixed capital formation, government consumption and exports, which in turn feed into downside risks for imports (see Table 2). The net effect results in a marginal downside risk for real GDP growth for 2018. The downside risk to real GDP growth is contained due to the high import content for gross fixed capital formation and to a slightly lesser extent in the case of exports. In 2019 there is a neutral risk for real GDP growth. The downside risk to exports is broadly neutralised by the upside risk to government consumption and the downside risk to imports.

Table 2: Summary of risks to the GDP expenditure components

	2018	2019
Private final consumption expenditure (including NPISH)	⇔	⇔
General government final consumption expenditure	⇓	⇑
Gross fixed capital formation	⇓	⇔
Exports of goods and services	⇓	⇓
Imports of goods and services	⇓	⇓
Real GDP	⇓	⇔

Note: ⇔ indicates neutral risks, ⇑ indicates upside risks and ⇓ indicates downside risks.

Source: MFAC

4. Comparison across different macroeconomic forecasts

The plausibility of the macroeconomic forecasts underpinning the DBP 2019 can also be assessed by evaluating the extent of similarity or divergence with the other macroeconomic forecasts which are available for the Maltese economy. Specifically, comparisons are carried out with respect to the previous vintage produced by the MFIN, as part of the USP 2018 – 2021, and the forecasts produced independently by the CBM and the COM. However, it should be noted that these forecasts are not necessarily directly comparable due to differences in the data available to the institutions at the time of their undertaking of the forecast exercise, which results in different cut-off dates. Moreover, certain divergences may arise due to differences relating to the institution's forecasting methodologies and the assumptions employed within their econometric modelling framework.

The DBP's forecasts and those produced by the COM are based on a broadly similar information set, as they both capture the actual data for the first half of 2018 as published by the NSO. Indeed, these two sets of forecasts are the most recent. This is not the case for the USP and the CBM's forecasts which were produced at an earlier point in time and whose cut-off dates were respectively 26 March 2018 and 31 July 2018. Table 3 presents forecasts published by the three institutions for 2018 and 2019.

4.1 Comparison between the DBP 2019 and the USP 2018 – 2021 forecasts

The DBP presents a broadly similar trajectory for the real GDP growth rate compared to what was indicated in the USP. The downward revision for 2018 was marginal, from 6.1% to 5.8%. For 2019, the forecast for real GDP growth figure remained the same, at 5.3%. However, significant revisions were carried out at a component level.

Final domestic demand remained the main source of growth across both forecast rounds. For 2018, the effect remained the same, at 5.4 pp, but for 2019, there was an upward revision from 4.2 pp to 5.0 pp. The most significant revision related to net exports. Whereas in the USP, net exports were expected to generate a small positive contribution to real GDP growth in 2018, the DBP has revised this to a small negative contribution to growth amounting to -1.0 pp. For 2019, the 1.1 pp positive contribution to growth, which was anticipated at the time of the USP, was also scaled back to 0.3 pp. In the case of inventories, the USP had assumed a zero contribution to growth in 2018, but this was revised to a positive 1.4 pp following the actual data released by the NSO for the first half of the year. For 2019, the assumption of zero contribution to growth stemming from inventory changes was however retained.

Table 3: Macroeconomic forecasts by the MFIN, COM and CBM (%)

	2018				2019			
	MFIN DBP	MFIN USP	COM AUT	CBM AUT	MFIN DBP	MFIN USP	COM AUT	CBM AUT
	Growth rate in GDP components in real terms							
Private consumption	5.6	4.4	5.2	3.9	4.1	3.8	3.8	3.9
Government consumption	15.0	15.2	15.7	17.0	8.2	1.8	9.0	6.9
Gross fixed capital formation	1.3	4.2	1.6	1.0	8.4	10.0	8.2	12.2
Exports of goods and services	1.3	3.1	1.5	1.6	2.2	3.4	1.9	2.4
Imports of goods and services	2.0	2.9	1.9	1.2	2.2	2.8	2.3	3.1
GDP	5.8	6.1	5.4	5.4	5.3	5.3	4.9	5.0
	Contributions to real GDP growth							
Final domestic demand (pp)	5.4	5.4	5.1	4.6	5.0	4.2	4.9	5.3
Inventories (pp)	1.4	0.0	0.4	0.0	0.0	0.0	0.0	0.0
Net exports (pp)	-1.0	0.8	-0.1	0.9	0.3	1.1	-0.1	-0.4
	Deflators							
Private consumption	0.7	1.7	-	-	1.0	1.8	-	-
Government consumption	3.5	1.9	-	-	1.9	1.8	-	-
Gross fixed capital formation	3.6	2.2	-	-	2.2	2.2	-	-
Exports of goods and services	3.3	2.2	-	-	1.8	1.9	-	-
Imports of goods and services	3.3	2.1	-	-	1.9	1.7	-	-
GDP	1.8	2.2	2.2	2.2	2.2	2.2	2.2	2.2
	Other macroeconomic variables							
Inflation rate (HICP)	1.7	1.6	1.8	1.6	1.9	1.8	1.9	1.8
Employment growth	5.0	3.8	5.0	4.2	3.7	3.5	3.6	3.4
Unemployment rate	4.0	3.8	3.9	4.3	4.1	3.9	4.0	4.3
Compensation per employee	2.9	3.2	2.3	2.8	2.9	3.2	3.2	3.1

Sources: MFIN, COM, CBM

In the DBP, the forecast growth rate for private consumption was increased for both 2018 and 2019, compared to the USP. This upward revision is consistent with the upward revision of employment growth prospects. This effect was slightly dampened by the fact that the growth rate for compensation per employee was reduced slightly. A concurrent downward revision to the consumption deflator contributed further to the higher private consumption growth forecast for both 2018 and 2019. Government consumption is seen as buoyant in 2018 across both forecast rounds, with the year-on-year growth settling around 15.0%. On the other hand, for 2019, there was a significant upward revision from the 1.8% growth indicated in the USP, to the 8.2% growth indicated in the DBP. This is in line with the plans for additional expenditure outlined in the DBP compared to the USP.

The growth rate for gross fixed capital formation was revised downwards across the forecast horizon. The revision was pronounced for 2018, as the growth rate was changed from 4.2% to 1.3%. Although for 2019 the acceleration in investment was confirmed, the growth rate was moderated slightly, from 10.0% to 8.4%.

The less favourable external demand conditions, following the downward revision in the forecast GDP growth forecasts in Malta's main trading partners, lowered the export growth forecasts (see Chart 1). In 2018, the updated export growth forecast stands at 1.3%, as opposed to 3.1% for 2018. In turn, the downward revision for 2019 was from 3.4% to 2.2%.

The downward revision in investment and export growth contributed to the reduction in the forecast growth rate for imports in both 2018 and 2019. These two components have a significant import content, and their effect more than offset the upward push on imports stemming from the upward revision in private consumption and government consumption growth.

In turn, the trajectory for inflation remained broadly the same, with a minor upward revision of 0.1 pp. Both forecast vintages suggest that economy-wide wage pressures will remain contained.

4.2 Comparison with the forecasts produced by other institutions

This section compares the main macroeconomic forecasts produced by the MFIN in the DBP 2019, and the latest available published forecasts by the COM, in November 2018, and by the CBM, in August 2018.

The three institutions anticipate strong GDP growth in both 2018 and 2019. However, the MFIN's DBP forecasts are higher than those produced by the COM and the CBM, with the latter two institutions being more cautious in their approach. For 2018, the variation amounts to 0.4 pp, both

with respect to the forecast by the COM and that by the CBM. For 2009, the difference is again 0.4 pp with respect to the COM's forecast, and 0.3 pp in the case of the CBM.

All institutions are expecting final domestic demand to be the main contributor to GDP growth in both 2018 and 2019. Furthermore, all institutions anticipate that, contrary to what happened in 2017, net exports will exert either a negative contribution or a very small positive contribution to GDP growth. In relation to inventory changes, the COM has assumed a similar positive effect for 2018 like the MFIN, whereas the CBM maintained the standard assumption of zero contribution to growth. For 2019, there are no differences, with the three institutions adopting the zero-growth assumption for inventories.

Both the COM and the CBM are forecasting a slower rate of growth in private consumption over 2018 and 2019. On the other hand, the profile for growth in real government consumption is broadly similar across the three institutions, with very strong growth anticipated for 2018 and some deceleration for 2019. Likewise, the forecasts for gross fixed capital formation for 2018 are similarly low across all institutions, with the MFIN's forecast fitting between the 1.0% growth projected by the CBM and the 1.6% growth indicated by the COM. For 2019, all institutions anticipate an acceleration in investment growth, with the MFIN's and COM's forecasts very close, respectively 8.4% and 8.2%, and the highest, 12.2% indicated by the CBM. In the case of exports, there is broad similarity across forecasts, with the three institutions anticipating a scenario of positive yet low growth in exports for 2018 and improving slightly in 2019. Likewise, the variation across import growth forecasts is contained, with the three institutions forecasting an acceleration in import growth in 2019 compared to 2018.

The outlook for the labour market and inflation is also shared by the three institutions. They all anticipate the labour market to remain buoyant, with high employment growth, a low unemployment rate and moderate growth in compensation of employees. The inflation rate forecasts also portray a similar scenario with low inflation in 2018, rising marginally in 2019, but remaining below the ECB's target of close to but below 2.0%. The GDP deflator forecasts by the MFIN, COM and CBM are also very similar for 2018 and identical for 2019.

5. Assessment of the fiscal forecasts 2018 – 2019

5.1 Overview of the fiscal projections

The DBP targets further fiscal surpluses over the forecast horizon, albeit smaller than in 2017. The fiscal surplus, which in 2017 amounted to 3.5% of GDP, is anticipated to drop to 1.1% in 2018, and thereafter increase slightly, to 1.3% in 2019 (see Table 4).[10] Likewise, the structural balance, which nets off the cyclical effects and one-off and temporary measures, is anticipated to drop from 3.1% of potential GDP in 2017 to 0.6% in 2018. However, the structural balance is then expected to increase to 1.2% in 2019, which corresponds to a larger improvement when compared to the headline fiscal balance. These developments are projected to take place against a background of a small positive output gap, which by 2019 is expected to practically close off.[11] Meanwhile, the debt-to-GDP ratio is expected to maintain its gradual downward trend, falling from 50.9% of GDP in 2017, to 46.9% of GDP in 2018 and to 43.8% in 2019. This planned trajectory is contingent on the actualisation of the projected expansion in nominal GDP and the anticipated stream of fiscal surpluses over the forecast horizon.

Table 4: Main fiscal targets (% of nominal GDP)

	Total revenue	Total expenditure	Fiscal balance	Structural balance*	Gross debt
2017	39.7	36.2	3.5	3.1	50.9
2018	39.4	38.4	1.1	0.6	46.9
2019	39.1	37.8	1.3	1.2	43.8

* As per cent of potential GDP

Source: MFIN

In 2018, the fiscal surplus is expected to amount to €127.0 million, which is lower than the €392.7 million recorded in 2017 (see Table 5). Indeed, in 2018, total expenditure is expected to grow by 14.1%, more than double the 6.9% anticipated growth in total revenue. As a result, in 2018, the expenditure-to-GDP ratio is set to increase by 2.2 pp, to reach 38.4%. On the other hand, the revenue-to-GDP ratio is expected to decline by 0.3 pp, to 39.4%.

[10] The outturn for 2017 is based on NSO News Release 168/2018.
[11] In 2019, the output gap is forecast at 0.1% of potential output.

Table 5: Fiscal targets in absolute terms (EUR millions)

	2017	2018	2019
Total revenue	**4,424.0**	**4,725.6**	**5,054.0**
Taxes on production and imports	1,401.4	1,521.9	1,613.8
Current taxes on income and wealth	1,569.8	1,744.7	1,935.4
Social contributions	702.9	753.7	807.3
Capital taxes *	19.3	24.8	26.5
Property income *	85.4	86.8	66.2
Other revenue *	645.2	593.7	604.8
Total expenditure	**4,031.3**	**4,598.6**	**4,889.0**
Compensation of employees	1,272.9	1,381.9	1,467.7
Intermediate consumption	723.3	825.5	886.8
Social payments	1,138.4	1,212.1	1,290.3
Gross fixed capital formation	252.1	392.1	465.3
Interest expenditure **	204.9	194.0	187.8
Subsidies **	139.9	165.5	177.0
Capital transfers payable **	98.2	180.0	157.7
Other expenditure **	201.6	247.4	256.4
Fiscal balance	**392.7**	**127.0**	**165.0**
One-off and temporary effects (net)	-17.3	3.6	2.4
Cyclical effects	56.9	42.4	5.3
Structural balance	**353.1**	**81.0**	**157.3**
Gross debt	**5,670.1**	**5,624.2**	**5,659.6**
Nominal GDP	*11,139.7*	*11,998.6*	*12,923.9*
Output gap (% of potential GDP)	*1.3*	*0.9*	*0.1*

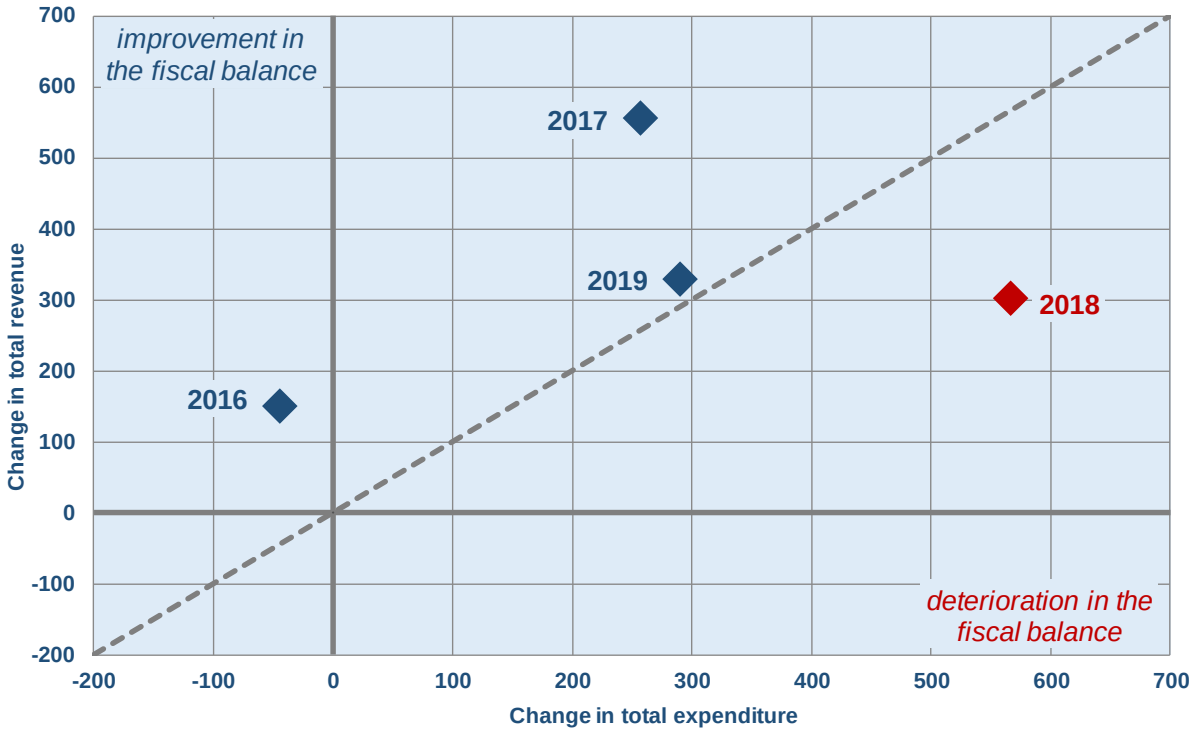
* These revenue components are together considered as other revenue in the rest of this section.

** These expenditure components are together considered as other expenditure in the rest of this section.

Source: MFIN

In 2019, the fiscal surplus is expected to be larger than in 2018. Indeed, total revenue is expected to grow by €328.4 million, and exceed the €290.4 million planned rise in total expenditure. This is in line with the patterns observed in 2016 and 2017, where improvements in the fiscal balance where underpinned by larger additions to revenue than to expenditure (see Chart 7). Still, in both cases, growth in these budget items is expected to be slower than the growth in nominal GDP, thus lowering the revenue and expenditure-to-GDP ratios for 2019 compared to a year earlier.

Chart 7: Year-on-year changes in total revenue and total expenditure (EUR millions)



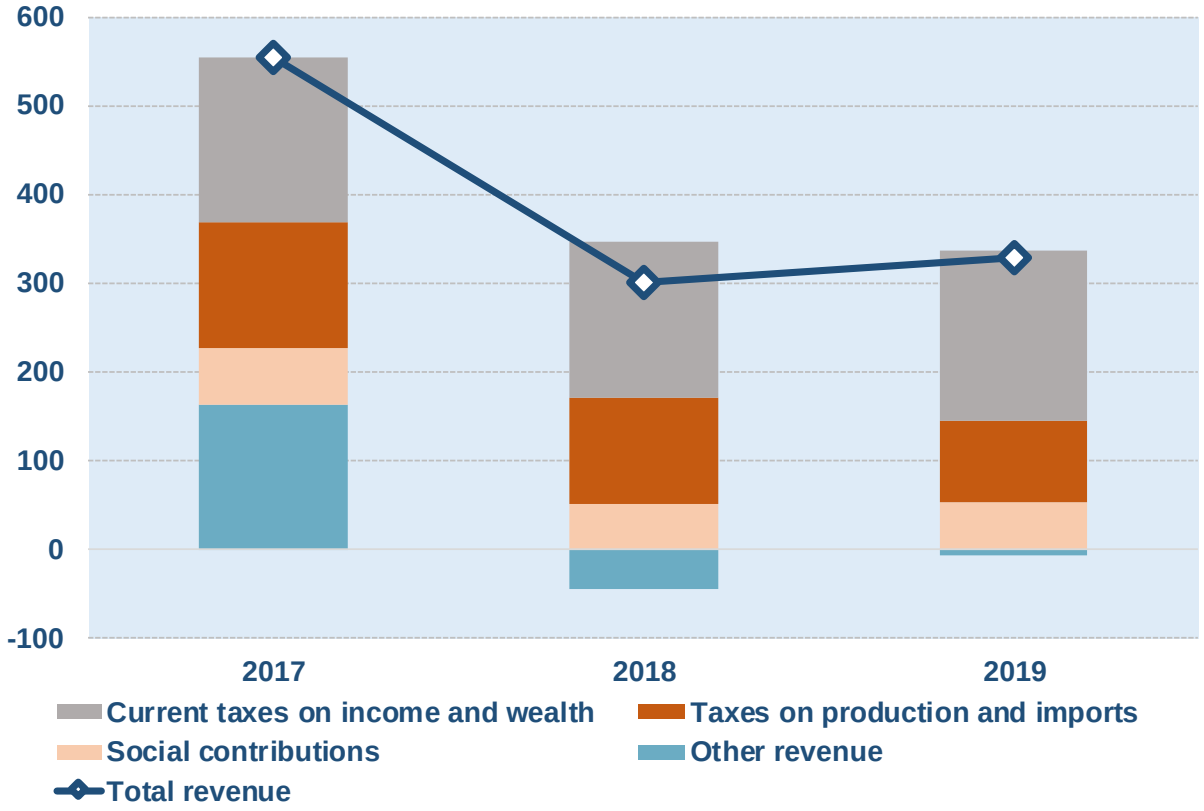
Note: Anywhere above the dashed line (blue diamonds) indicates combinations of revenue and expenditure developments leading to an improvement in the fiscal balance, whereas anywhere below the dashed line (red diamonds) indicates combinations which lead to a deterioration in the fiscal balance. Anywhere along the dashed line corresponds to a stable fiscal balance.

Source: MFIN

Over the forecast horizon, current taxes on income and wealth and social contributions are expected to contribute broadly stable revenue increases in absolute terms (see Chart 8). On the other hand, taxes on production and imports are expected to yield gradually smaller increases over time. In turn, the yield from other revenue sources is expected to remain rather volatile.[12] Such swings are mainly attributed to the yearly fluctuations in the proceeds from the IIP and the absorption of EU funds, being assumed by the MFIN over the forecast horizon.

[12] Other revenue comprises capital taxes, property income and 'other' revenue.

Chart 8: Yearly changes in revenue components (EUR millions)



Source: MFIN

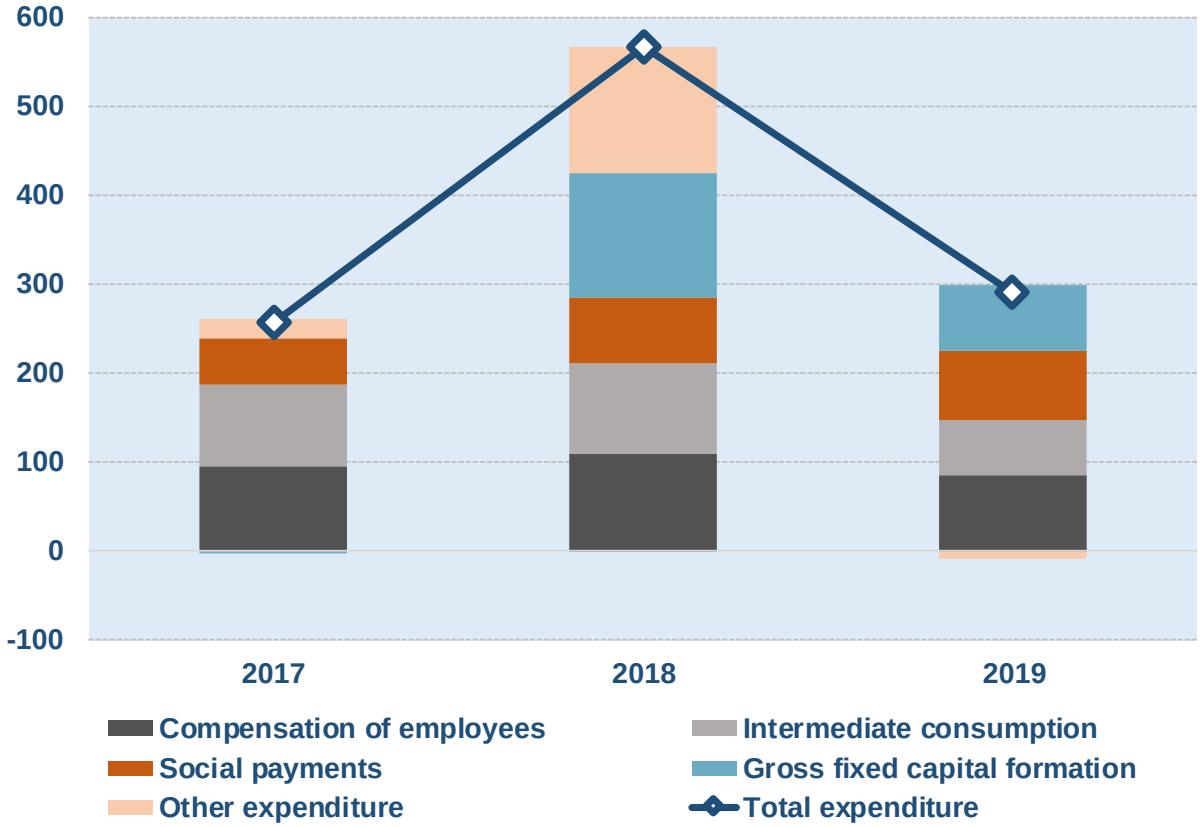
On the expenditure side, the planned strong increase in spending on gross fixed capital formation in 2018 is a notable difference compared to the small decline which was recorded in the previous year (see Chart 9). On the other hand, the allocations for the three largest expenditure components (compensation of employees, intermediate consumption and social payments) rise over the forecast horizon by broadly similar amounts as in 2017. Other expenditure is also expected to increase significantly in 2018, due to higher outlays on capital transfers and subsidies.[13] In the former case, this reflects the higher transfers to public entities, linked to the absorption of EU funds.

The planned increase in total expenditure in 2019 is comparable to that recorded in 2017. The lower increase compared to 2018 reflects a slowdown across the main categories, except for social payments.

A detailed assessment of the forecasts for the various revenue components within the budget is presented in section 5.2. This is followed by a similar assessment for the different expenditure components, included in section 5.3.

[13] Other expenditure comprises interest expenditure, subsidies, capital transfers payable and 'other' expenditure.

Chart 9: Yearly changes in expenditure components (EUR millions)



Source: MFIN

5.2 Assessment of the revenue components

The forecasts for the different components making up total revenue are analysed separately. The assessment consists in a review of the projected trajectory for each variable, with a focus on the consistency with the respective proxy macroeconomic base, together with any fiscal measures or known factors, which are expected to exert an impact over the forecast horizon. Based on the analysis undertaken, the direction of risk for each component is then indicated.

5.2.1 Taxes on production and imports

In 2018 and 2019 taxes on production and imports are expected to grow by 8.6% and by 6.0% respectively (see Table 6). These growth rates are slightly faster than those projected for nominal private consumption, which is the most relevant proxy base for the bulk of this revenue component.[14] Patterns are nevertheless similar, as the forecasts for both indirect taxes and private consumption (both in nominal and in real terms) exhibit faster growth in 2018 than in 2019. This

[14] In the case of indirect taxes which are levied on quantities (rather than values) the real growth in private consumption is the more appropriate proxy base.

follows the strong increase in 2017, which the MFIN attributed to the strong domestic demand conditions, tourism earnings and elevated construction activity.

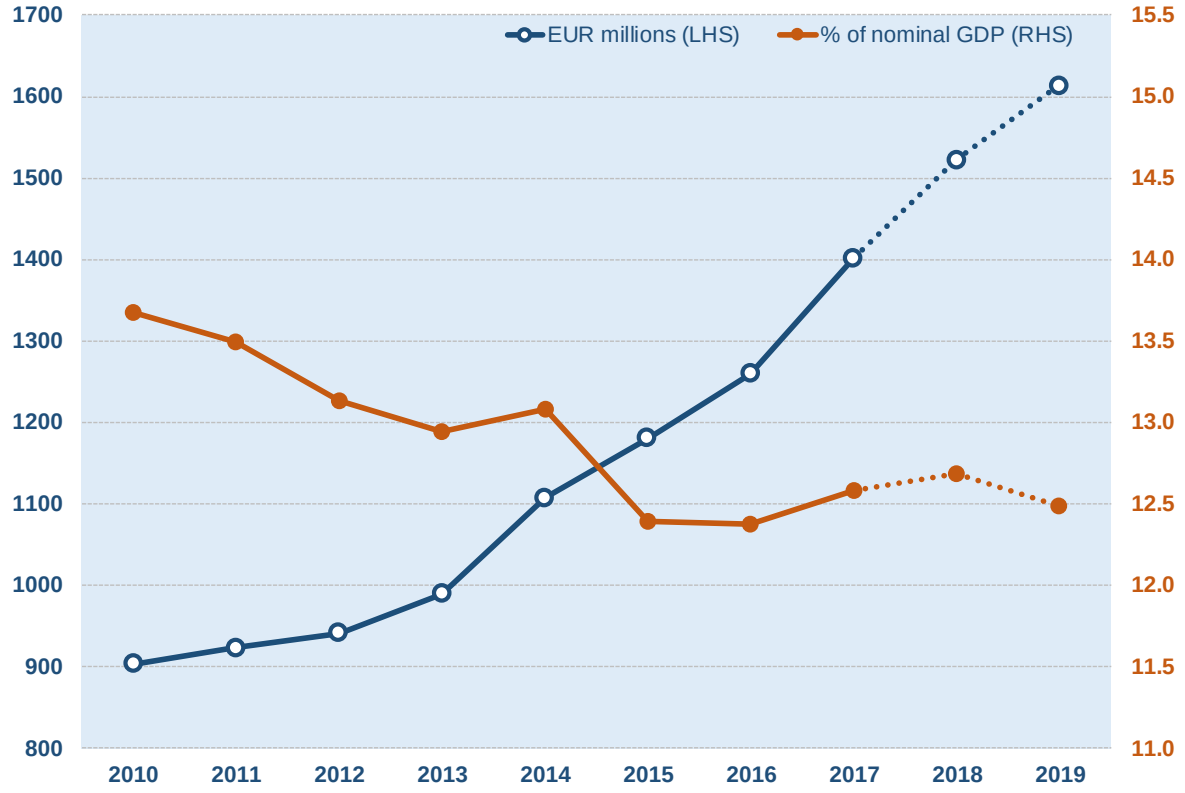
Table 6: Taxes on production and imports

	Taxes on production and imports		Private consumption	
	Growth (%)	Change (EUR millions)	Nominal growth (%)	Real growth (%)
2016	6.7	79.1	3.2	2.6
2017	11.3	141.8	4.8	3.7
2018	8.6	120.5	6.3	5.6
2019	6.0	91.9	4.7	4.1

Source: MFIN

The ratio of taxes on production and imports with respect to nominal GDP is projected to remain stable over the forecast horizon, close to 12.5% (see Chart 10). However, when expressed as a ratio to nominal private consumption, this ratio is expected to rise marginally, from 28.0% in 2017, to 28.6% in 2018, and to 28.9% in 2019. This is in line with the increases recorded in recent years.[15]

Chart 10: Taxes on production and imports (2010 – 2019)



Note: 2010 – 2017 refer to actual data while 2018 and 2019 are forecasts.

Source: MFIN

[15] For example, in 2012 the ratio of taxes on production and imports to nominal private consumption stood at 23.0%. Over consecutive years, increases brought this ratio to 28.0%, in 2017.

The DBP does not introduce new indirect taxes for 2019. However, a relevant factor impacting the 2019 forecasts relates to the expected negative effect of the VAT directive on electronic commerce.[16] Under the new rules, VAT will be paid in the Member State of the consumer and according to the MFIN's calculations, this factor is expected to reduce permanently the intake from indirect taxes in Malta by €15.0 million, as from 2019. This partly justifies the anticipated deceleration in the growth in taxes on production and imports in 2019.

During the first half of 2018, taxes on production and imports rose by 9.7% over the corresponding period of 2017, thus exceeding the projected yearly growth rate for 2018. It should be noted that 46.5% of the target amount was collected by mid-2018. This percentage is slightly higher than in 2017, where this ratio stood at 45.5%. Cash data confirms that growth in taxes on production and imports remained strong as during the first nine months of 2018 these rose by 12.2% on a year earlier.[17]

Based on the explanations presented in this section, and the actual outturn to date indicated by the ESA data and cash data, the MFAC considers the projections for taxes on production and imports to be plausible, with upside risks for 2018 and neutral risks for 2019. The upside risks for 2018 mainly follow the strong growth in this revenue component which was recorded to date. On the other hand, the forecast for 2019 appears to be consistent with the macroeconomic outlook and the revenue elasticity relevant for this tax component.

5.2.2 Current taxes on income and wealth

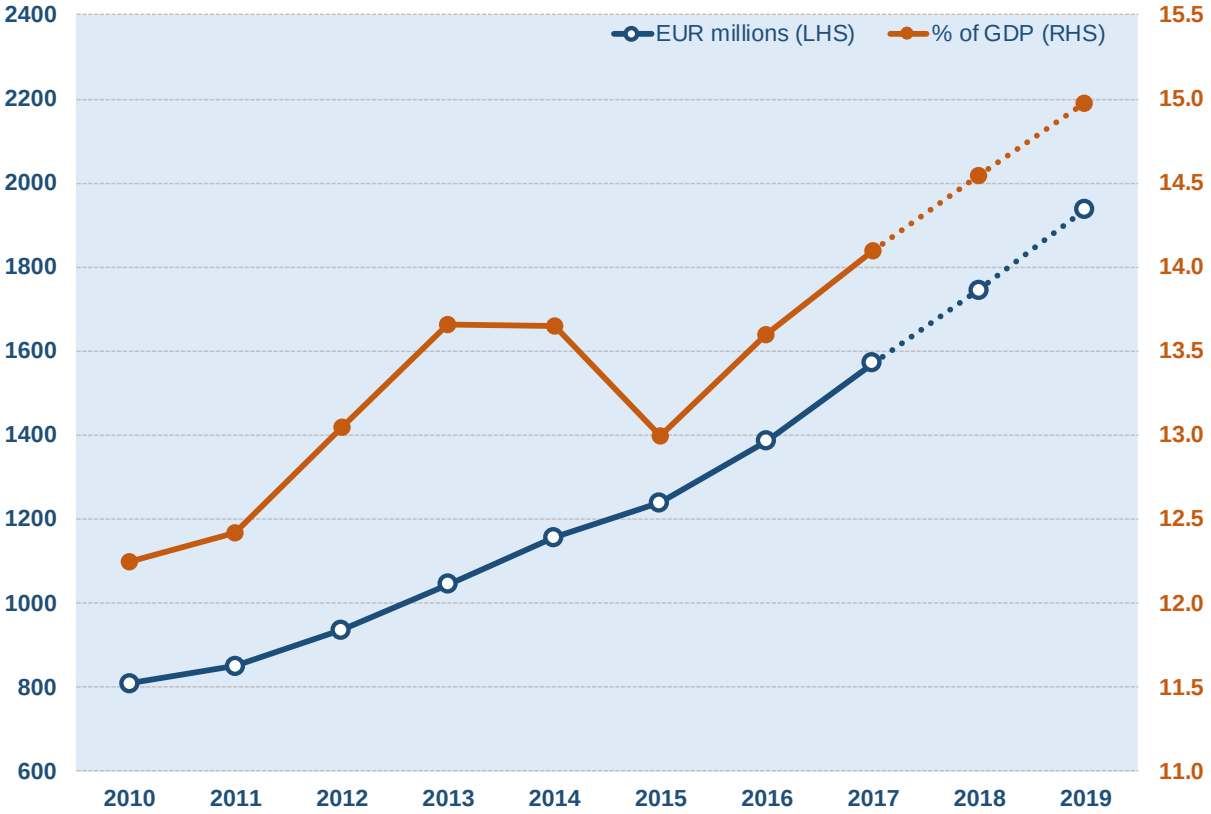
Current taxes on income and wealth are projected to maintain an upward trend in absolute terms (see Chart 11). Their growth rate is expected to remain stronger than that in nominal GDP over both 2018 and 2019. As a result, the ratio of current taxes on income and wealth to nominal GDP is expected to rise by approximately one percentage point, to 15.0%, over the forecast horizon. This projected development mirrors the pattern recorded between 2015 and 2017. Indeed, the

[16] The effect refers to the loss of commission from the Mini One Stop Shop (MOSS), as per Council Implementation Directive (EU) No 1042/2013. The MOSS allows taxable persons supplying telecommunication services, television and radio broadcasting services and electronically supplied services to non-taxable persons in Member States, in which they do not have an establishment, to account for the VAT due on those supplies via a web-portal in the Member State in which they are identified. VAT collected is eventually forwarded to the Member State where purchases are affected. However, a percentage of VAT used to be retained by the Member State. As from 2019, all VAT collected will be transferred and no more proceeds will be retained from this scheme. For further details refer to http://www.consilium.europa.eu/en/press/press-releases/2017/12/05/vat-on-electronic-commerce-new-rules-adopted/.

[17] The cash-data being referred to throughout this section is compiled by the NSO according to the ESA nomenclatures but based exclusively on the Consolidated Fund and data provided by the Extra-Budgetary Units (EBUs). This data can be retrieved from https://nso.gov.mt/en/Services/Council_Directive/Pages/Council-Directive-85_2011.aspx.

11.1% and 10.9% anticipated growth in current taxes on income and wealth are comparable to the elevated growth rates recorded during the previous two years (see Table 7).

Chart 11: Current taxes on income and wealth (2010 – 2019)



Note: 2010 – 2017 refer to actual data while 2018 and 2019 are forecasts.

Source: MFIN

Table 7: Current taxes on income and wealth

	Growth (%)	Change (EUR millions)	Compensation of employees (%)	Gross operating surplus (%)
2016	11.8	146.4	7.1	6.6
2017	13.4	185.9	7.1	11.1
2018	11.1	174.9	8.0	7.1
2019	10.9	190.7	6.6	8.4

Source: MFIN

The forecast growth in direct taxes exceeds that for total compensation of employees. This reflects the general progressivity of the income tax system in Malta, which implies an elasticity greater than unity with respect to the relevant tax base. The strong growth in gross operating surplus, which is the proxy for the corporate tax base, also supports the elevated forecast growth for direct taxes over the forecast horizon.

The DBP does not indicate any new direct taxes for 2019, but the MFIN estimated that the concessions for pensioners and low-income earners, and some incentives for the take up of private pensions, are expected to have a combined downside impact on this revenue component amounting to €3.7 million.[18]

During the first six months of 2018, current taxes on income and wealth expanded by 10.0% on a year earlier. Such revenues accounted for 44.4% of the target set for 2018. This is in line with the outturn in 2017, when during the first half of the year, 44.9% of the yearly revenue from this source was collected. On the other hand, cash-based data up to September indicates slightly lower growth, amounting to 6.9% year-on-year.

Overall, the MFAC considers the projections for current taxes on income and wealth to be plausible, with neutral risks for both 2018 and 2019. This view is based on the observation that the available information on the developments during the first part of 2018 appear to be consistent with the forecast for the full year. Likewise, the forecast for this revenue component for 2019 is consistent with the trajectory observed in recent years and the macroeconomic outlook as presented in the DBP.

5.2.3 Social contributions

Social contributions are projected to grow by 7.2% in 2018 and by 7.1% in 2019 (see Table 8). The ratio of social contributions to GDP is expected to remain broadly stable over the forecast horizon at around 6.3% of GDP (see Chart 12). This is in line with the pattern observed throughout the period 2015 – 2017, but contrasts with the pattern recorded in the years preceding 2015.

Table 8: Social contributions

	Growth (%)	Change (EUR millions)	Compensation of employees (%)
2016	7.2	43.0	7.1
2017	9.9	63.6	7.1
2018	7.2	50.8	8.0
2019	7.1	53.6	6.6

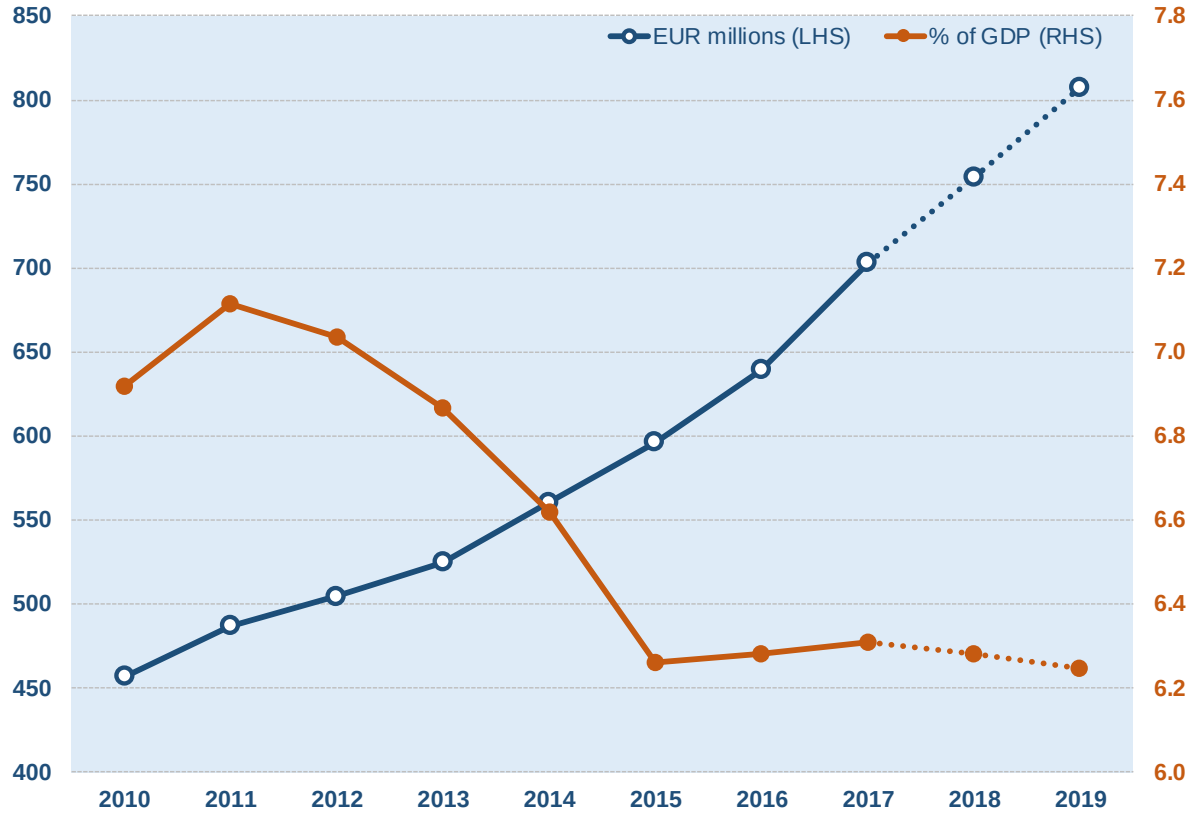
Source: MFIN

The projected growth rates for 2018 and 2019 are marginally lower than that in total compensation of employees. Indeed, the elasticity with respect to compensation of employees (which is the proxy

[18] The incentives include an increase in the amount of tax-exempt annual financial investment to a maximum of €2,000 each year with respect to the take up of the private voluntary occupational scheme.

base for this revenue item) is slightly less than unity due to the cap which exists on the yearly payments. However, this factor appears to be dampened by the fact that growth is expected to be job-rich, with the majority of new incomes generated from within the taxable range. No new measures are applicable to social contributions for 2019 and thus growth is driven entirely by the expansion in the tax base, and the statutory increase in the payment ceiling.

Chart 12: Social contributions (2010 – 2019)



Note: 2010 – 2017 refer to actual data while 2018 and 2019 are forecasts.

Source: MFIN

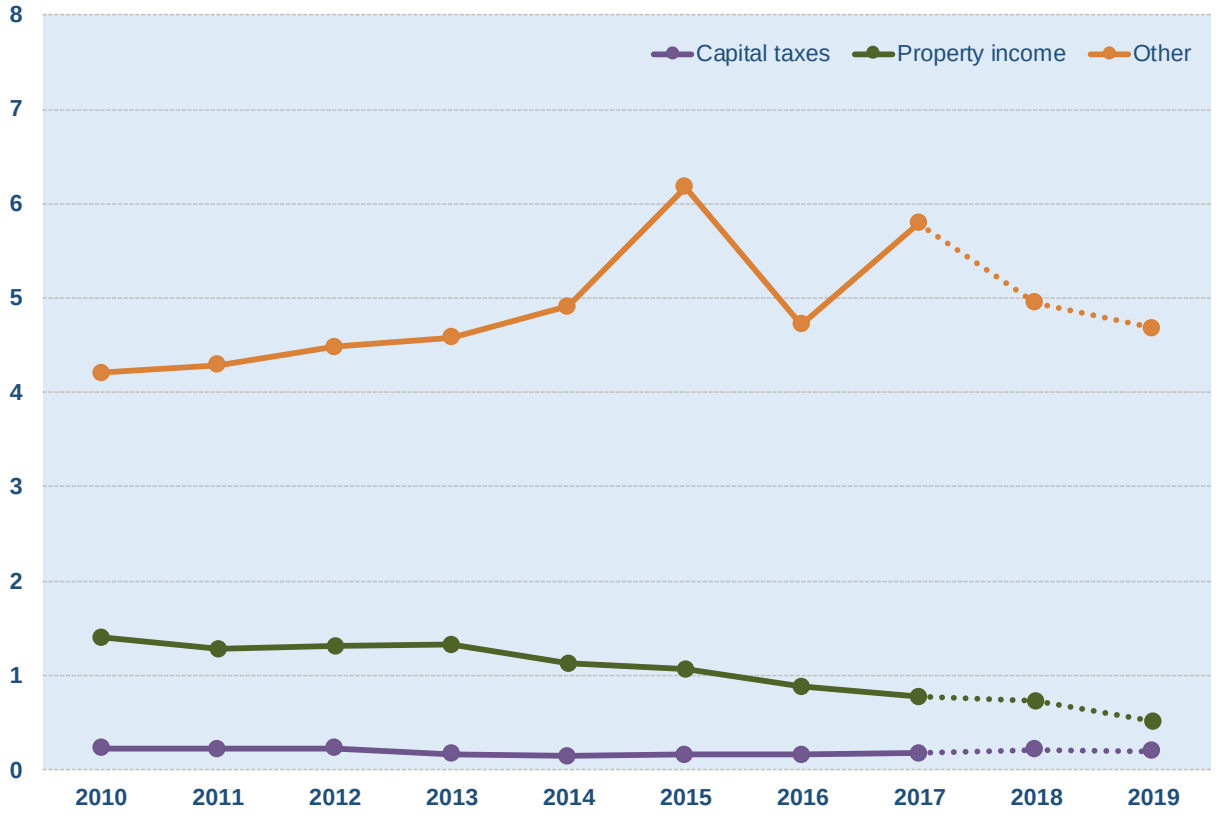
During the first half of 2018, social contributions increased by 14.2% over the corresponding period of 2017, and amounted to 50.6% of the yearly target. This is slightly higher than in 2017, where the ratio stood at 47.5%. In turn, Consolidated Fund cash-based data shows this item growing by 7.4% during the first nine months of 2018.

Based on the explanations presented in this section, and the actual outturn to date indicated by the ESA data and cash data, the MFAC considers the projections for social contributions to be plausible, with upside risks for 2018 and neutral risks for 2019. The upside risks for 2018 mainly follow the strong growth in this revenue component which was recorded to date. On the other hand, the forecast for 2019 appears to be consistent with the macroeconomic outlook and the revenue elasticity relevant for this tax component.

5.2.4 Other revenue components

The before-mentioned three revenue components account for the bulk of total revenue. In 2017, their combined share made up 83% of total revenue. The remaining minor revenue components consist of capital taxes, property income and 'other' revenue.[19] The forecast trajectories for these respective categories as percentage of nominal GDP is shown in Chart (13).

Chart 13: Other revenue components (2010 – 2019) (% of GDP)



Note: 2010 – 2017 refer to actual data while 2018 and 2019 are forecasts.

Source: MFIN

In absolute terms, capital taxes represent only a small share of total revenue. In 2017, these amounted to €19.3 million or 0.2% of GDP. The forecasts show an increase in 2018 and 2019, respectively to €24.8 million and €26.5 million. This is compatible with the activity in the property market, in relation to which capital taxes are mostly linked. Nevertheless, their share as percentage of GDP is expected to remain stable at 0.2%, in line with the pattern observed since 2010.

In turn, property income is expected to maintain a small share when compared to GDP, declining slightly over the forecast horizon. Property income is projected to amount to €86.8 million in 2018,

[19] 'Other' revenue includes EU funds as well as proceeds related to the IIP.

in line with the €85.4 million recorded in 2017. In 2019, property income is then forecast to decline to €66.2 million. This decline reflects expectations of lower dividends and other receipts.[20]

'Other' revenue tends to be a rather volatile component. When compared to nominal GDP, the ratio of 'other' revenue is expected to decline from 5.8% in 2017 to 4.9% in 2018 and 4.7% in 2019. In absolute terms 'other' revenue is projected to decline from €645.2 million in 2017, to €593.8 million in 2018. This decline is predominantly driven by the lower proceeds expected from the IIP, following the very strong performance in 2017. In 2019 'other' revenue is then expected to increase slightly, to €604.8 million. In this case, the effect of the reduction in the proceeds from the IIP, is more than offset by the anticipation of higher absorption of EU funds.

The major sources of uncertainty relating to these smaller revenue components relate to the absorption of EU funds and the proceeds collected through the IIP. In the case of EU funds this is contingent on the progress recorded in the projects being funded. In the case of the IIP, the MFAC notes that the MFIN continued to apply a prudent approach with respect to how this component is forecasted in that they assume declining revenues from this source over the forecast horizon.

Overall, the MFAC considers that the possibility that EU funds are less than anticipated (due to slower progress in capital projects), is compensated for by the possibility that IIP revenues are higher than anticipated (based on the revenues generated during the first nine months of the year), thus resulting in neutral risks for both 2018 and 2019.

5.3 Expenditure

The forecasts for the different components making up total expenditure are analysed separately. The assessment consists in a review of the projected trajectory for each variable, with a focus on the consistency with the respective main determinants, together with any fiscal measures or known factors, which are expected to exert an impact over the forecast horizon. Based on the analysis undertaken, the direction of risk for each component is then indicated.

5.3.1 Compensation of employees

In 2018 and 2019, spending on compensation of employees is projected to grow by 8.6% and by 6.2% respectively (see Table 9). These growth rates correspond to an additional spending of €109.0 million and €85.8 million in these two years, extending the upward pattern recorded in the previous years. However, in relation to nominal GDP, the ratio is expected to remain stable, hovering close to 11.5% (see Chart 14).

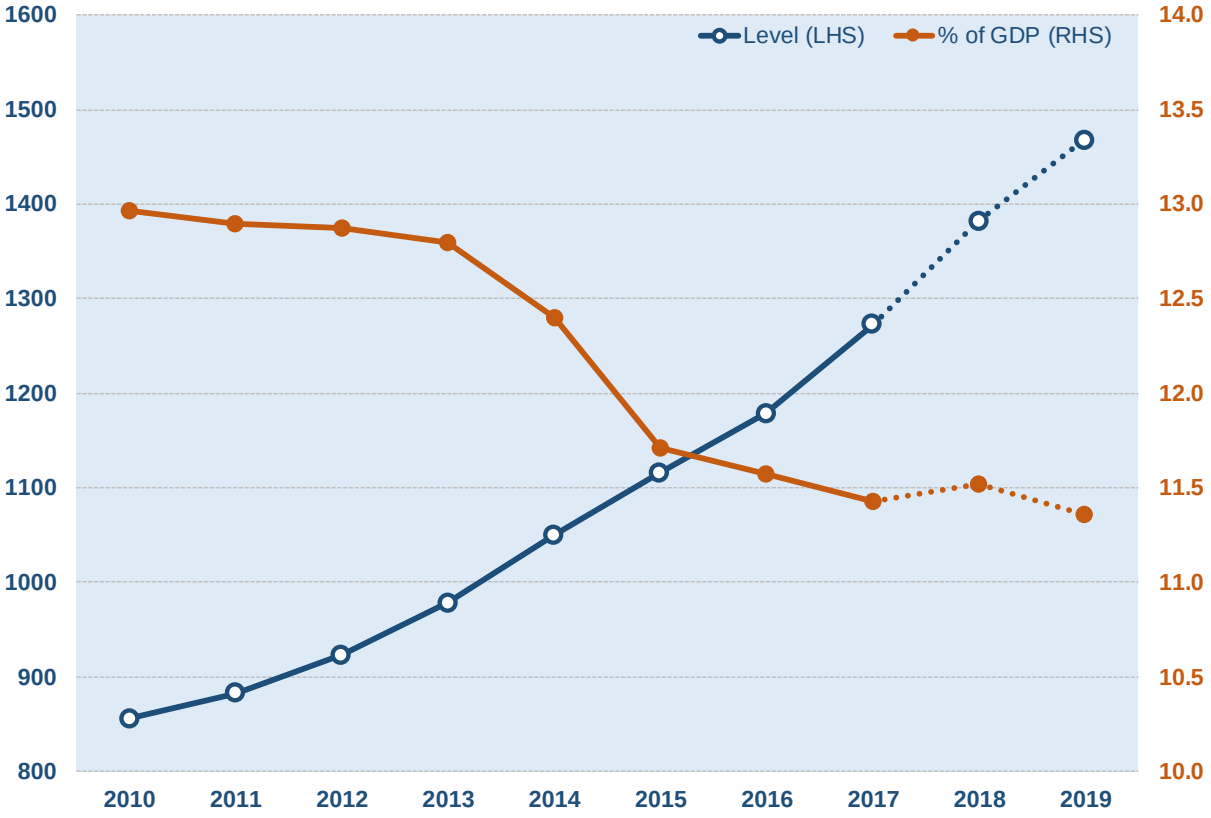
[20] Dividends received from the CBM are expected to be €7.0 million lower than in 2018.

Table 9: Compensation of employees

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2016	5.6	62.6
2017	8.0	94.6
2018	8.6	109.0
2019	6.2	85.8

Source: MFIN

Chart 14: Compensation of employees (2010 – 2019)



Note: 2010 – 2017 refer to actual data while 2018 and 2019 are forecasts.

Source: MFIN

Spending on compensation of employees is driven by the number of public sector employees and their average wage. Since employment within the government departments has been decentralised, the projections for compensation of employees effectively show the allocated budget for this item. Ministries are free to determine their employment levels, based on the planned recruitment, as envisaged in the ministries' and departments' plans. The current policy requires that recruitment costs remain within the parameters of the approved budgetary estimates, unless otherwise authorised.

However, upward revisions to the initial spending ceilings have frequently occurred in the case of compensation of employees (see Table 10). For example, the forecast outlays on compensation of employees for 2017 was initially indicated at €1,240.8 million in the DBP 2017 (submitted in October 2016). However, this figure was increased in subsequent forecast vintages. Nonetheless, the actual spending (as reported in the DBP 2019) amounted to €1,272.9 million, exceeding the four forecast vintages for that year. Similarly, the spending on compensation of employees for 2018, which in the DBP 2018 (submitted in October 2017) amounted to €1,314.3 million, has been raised in the various forecast vintages, with the latest forecast (included in the DBP 2019) standing at €1,381.9 million, up by 5.1% on the forecast produced a year earlier.

Table 10: Forecast vintages for compensation of employees (EUR millions)

	DBP 2017	USP 2017 - 2020	HYR 2017	DBP 2018	Actual
2017	1,240.8	1,263.6	1,268.4	1,267.9	1,272.9
	DBP 2018	**USP 2018 - 2021**	**HYR 2018**	**DBP 2019**	**Actual**
2018	1,314.3	1,367.3	1,380.3	1,381.9	-

Source: MFIN

During the first half of 2018, compensation of employees increased by 9.7% over the corresponding period of 2017, amounting to 49.8% of the yearly target (2017: 49.4%). In turn, cash-based data shows that during the first nine months this item increased by 6.5% based on the Consolidated Fund data. At the same time, spending on compensation of employees by the Extra-Budgetary Units (EBUs) (which in 2018 amount to an equivalent to 30.2% of the spending recorded through the Consolidated Fund) increased by 6.1%. In both cases the cash-based data indicates slightly lower growth rates than the yearly growth anticipated in the DBP 2019 for 2018.

Overall, the MFAC considers the projections for compensation of employees to be plausible, with neutral risks for 2018 and upside risks for 2019, the latter being mainly influenced by the past forecast performances in this respect. The neutral risk outlook in relation to 2018 is mainly based on the explanations presented in this section, and the actual outturn to date indicated by the ESA data and cash data, which are compatible with the full year forecast. On the other hand, the upside risks noted for 2019 are influenced by the past patterns of spending overruns in relation to compensation of employees, as well as the fact that the budget allocation for 2019 is growing at a slower pace than indicated for in the previous two years.

5.3.2 Intermediate consumption

In 2018, intermediate consumption is expected to rise by €102.2 million, or 14.1% (see Table 11). This is comparable to the developments recorded in 2017. Some special factors affected this

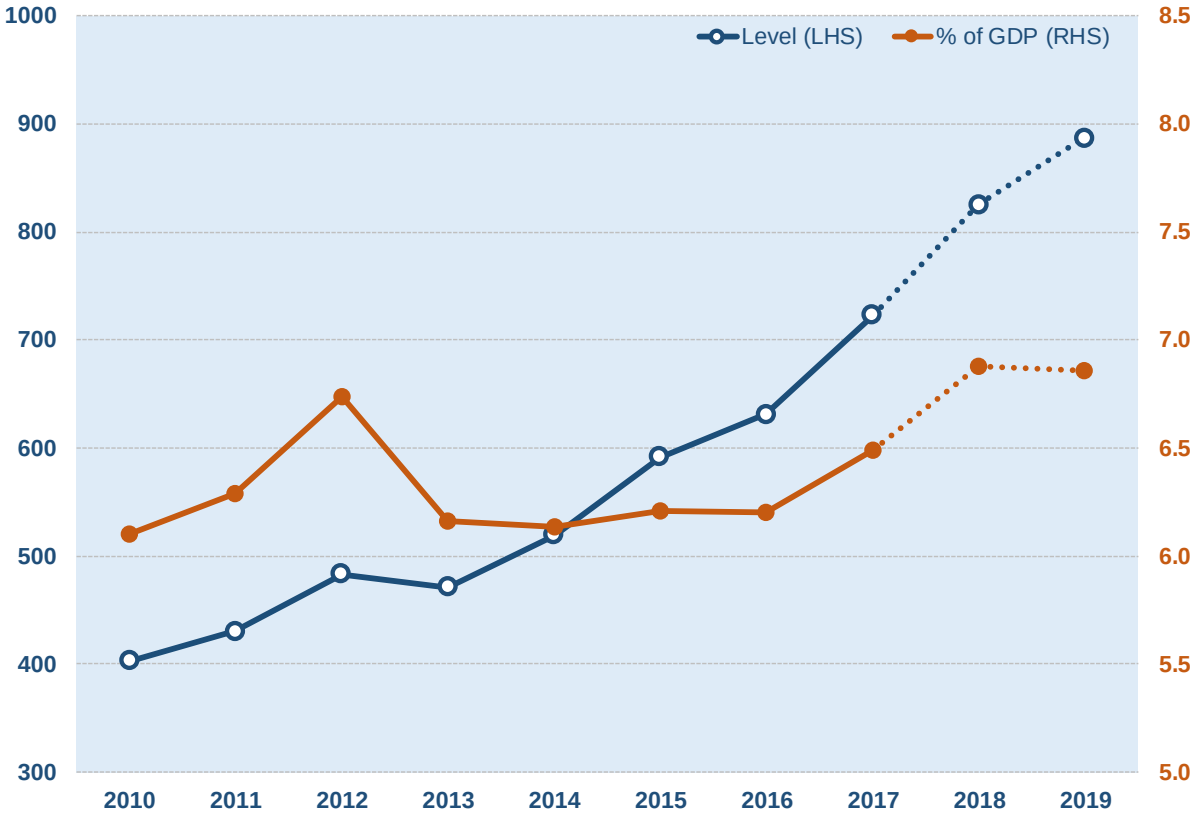
expenditure category in both 2017 and 2018. These included Malta's holding of the EU Presidency, and the general elections in 2017, and Valletta being the European Capital of Culture in 2018. As a result, growth in intermediate consumption is expected to practically halve in 2019, to 7.4%, mainly due to the base effect created in the previous year. Overall, intermediate consumption is expected to rise to 6.9% of GDP in 2018, the highest ratio compared to recent years, and remain stable at that level in 2019 (see Chart 15). Apart from the before-mentioned special factors, health-related spending is an important factor which contributes to the sustained yearly increases in intermediate consumption.

Table 11: Intermediate consumption

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2016	6.7	39.5
2017	14.6	92.1
2018	14.1	102.2
2019	7.4	61.3

Source: MFIN

Chart 15: Intermediate consumption (2010 – 2019)



Note: 2010 – 2017 refer to actual data while 2018 and 2019 are forecasts.

Source: MFIN

During the first half of 2018, intermediate consumption expanded by 10.0% over the corresponding period of 2017 and amounted to 46.0% of the yearly target. Cash-based data shows that during the first nine months this item increased by 5.6% as per transactions carried out through the Consolidated Fund data. However, the intermediate consumption by the EBUs (which is equivalent to around half the Consolidated Fund outlays) expanded at a much faster pace, up by 27.6% on a year earlier. The combined increase in intermediate consumption thus amounted to 12.1% during the first nine months of 2018.

In relation to intermediate consumption, upward revisions to the initial spending ceiling have taken place both for 2017 and 2018 (see Table 12). The forecast outlays on intermediate consumption for 2017 were initially indicated at €684.0 million in the DBP 2017 (submitted in October 2016). However, this figure was increased in subsequent forecast vintages. Similarly, spending on intermediate consumption for 2018, which in the DBP 2018 (submitted in October 2017) amounted to €773.9 million, has been raised, with the latest forecast (included in the DBP 2019) standing at €825.5, up by 6.7% on the forecast produced a year earlier.

Table 12: Forecast vintages for intermediate consumption (EUR millions)

	DBP 2017	USP 2017 - 2020	HYR 2017	DBP 2018	Actual
2017	684.0	716.0	714.0	727.9	723.3
	DBP 2018	**USP 2018 - 2021**	**HYR 2018**	**DBP 2019**	**Actual**
2018	773.9	807.7	827.1	825.5	

Source: MFIN

Overall, the MFAC considers the projections for intermediate consumption to be plausible, with neutral risks for 2018 and 2019. Despite the upward revisions noted earlier, the fact that the budgeted amount represents a higher ratio to GDP than in previous years, should allow the spending to remain within this target, while acknowledging the inherent risks given the volatility exhibited by this expenditure component over time.

5.3.3 Social payments

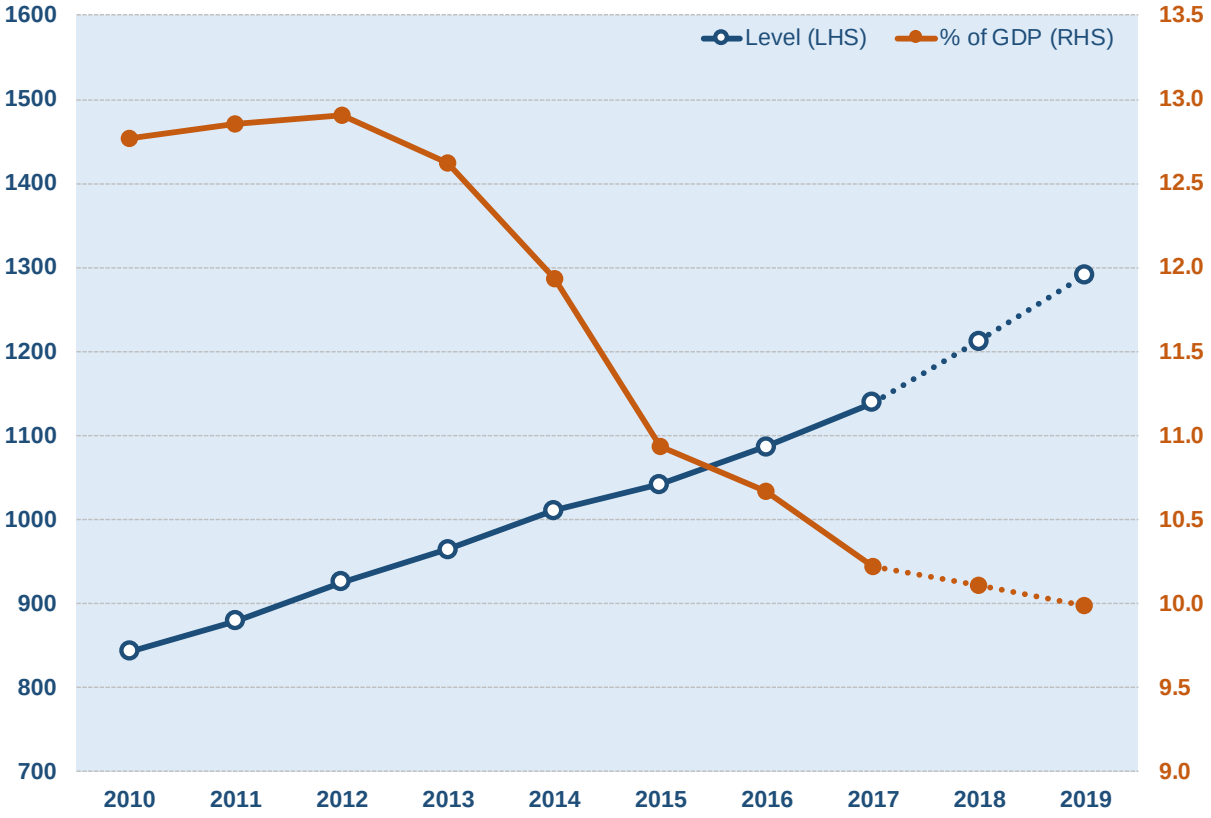
Social payments are expected to increase by €73.7 million in 2018 and by €78.2 million in 2019 (see Table 13). These are larger increases than those recorded during the previous two years. Nonetheless, since the projected annual growth rates at 6.5% and 6.4%, are still lower than the 7.7% forecast growth in nominal GDP, the ratio of social payments to nominal GDP is expected to continue declining (see Chart 16). However, this decline is more gradual than in recent years.

Table 13: Social payments

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2016	4.3	44.9
2017	4.8	52.3
2018	6.5	73.7
2019	6.4	78.2

Source: MFIN

Chart 16: Social payments (2010 – 2019)



Note: 2010 – 2017 refer to actual data while 2018 and 2019 are forecasts.

Source: MFIN

During the first half of 2018, social payments increased by 4.7% on a year earlier and accounted for 48.6% of the annual budget, slightly below the 49.4% utilised the same period of 2017. Furthermore, cash data based on the Consolidated Fund indicates that social payments increased by 2.7% during the first nine months of the year.[21] In part, these lower growth rates can be explained by the fact that a new measure, related to the extension of free school transport, was introduced as from the 2018-2019 scholastic year. In relation to 2019, apart from the full impact of the free school transport, other expansionary measures relate to higher payments to pensioners

[21] NSO News Release 172/2018.

as well as an extension of rent subsidies. Such measures compensate for the fact that at unchanged policies, social payments as a share of GDP would decline at a faster pace. The latter reflects primarily the low inflationary environment, as well as measures legislated in previous years encouraging further participation in the labour market.

Overall, the MFAC considers the projections for social payments to be plausible, with neutral risks for 2018 and 2019. The forecast growth rates appear to adequately embed the measures in place over the forecast horizon, as well as the general trends recorded by this expenditure component in recent years.

5.3.4 Gross fixed capital formation

Spending on gross fixed capital formation is planned to increase by €140.0 million in 2018 and by €73.2 million in 2019 (see Table 14). These increases contrast with the declines recorded in 2016 and 2017. Indeed, investment spending has been rather volatile over time, with its share in GDP peaking in 2015, at 4.2% (see Chart 17).

Table 14: Gross fixed capital formation

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2016	-36.7	-147.7
2017	-0.9	-2.4
2018	55.5	140.0
2019	18.7	73.2

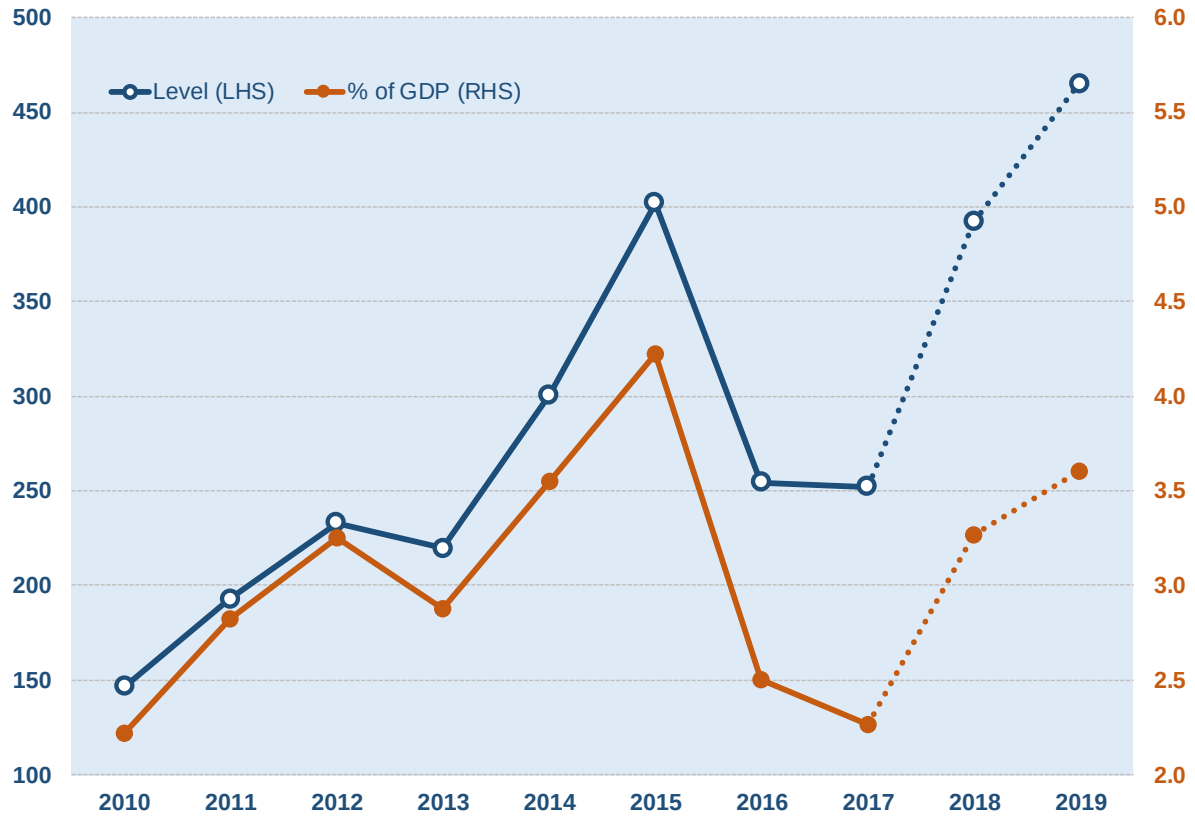
Source: MFIN

During the first half of 2018, spending on gross fixed capital formation was approximately 10.0% below that in 2017. Cash data for the first nine months indicates that spending on gross fixed capital formation increased by 9.2% in relation to transactions carried out through the Consolidated Fund and by 2.3% by the EBUs. These growth rates are considerably lower than the 55.5% growth projected for 2018. The MFIN's projections assume investment growth to recover in the second half of 2018, based on the expected acceleration in EU-funded investment. Rapid pick-up in investment is challenging but possible, when considering the actual developments in recent years. Indeed, during the first nine months of 2018, only 45.0% of the budgeted amount on capital expenditure which was indicated in the Consolidated Fund was utilised.

Overall, the MFAC considers the projections for gross fixed capital formation to be plausible, with downside risks for 2018 and neutral risks for 2019. This is based on the observation that the necessary increased spending during the second half of 2018 is rather challenging to implement.

The actual utilisation of funds for 2018 suggests that it is quite challenging to achieve the planned spending for the year. On the other hand, the planned spending for 2019 appears more feasible since the scale of the increase is less pronounced, and hence more manageable.

Chart 17: Gross fixed capital formation (2010 – 2019)



Note: 2010 – 2017 refer to actual data while 2018 and 2019 are forecasts.

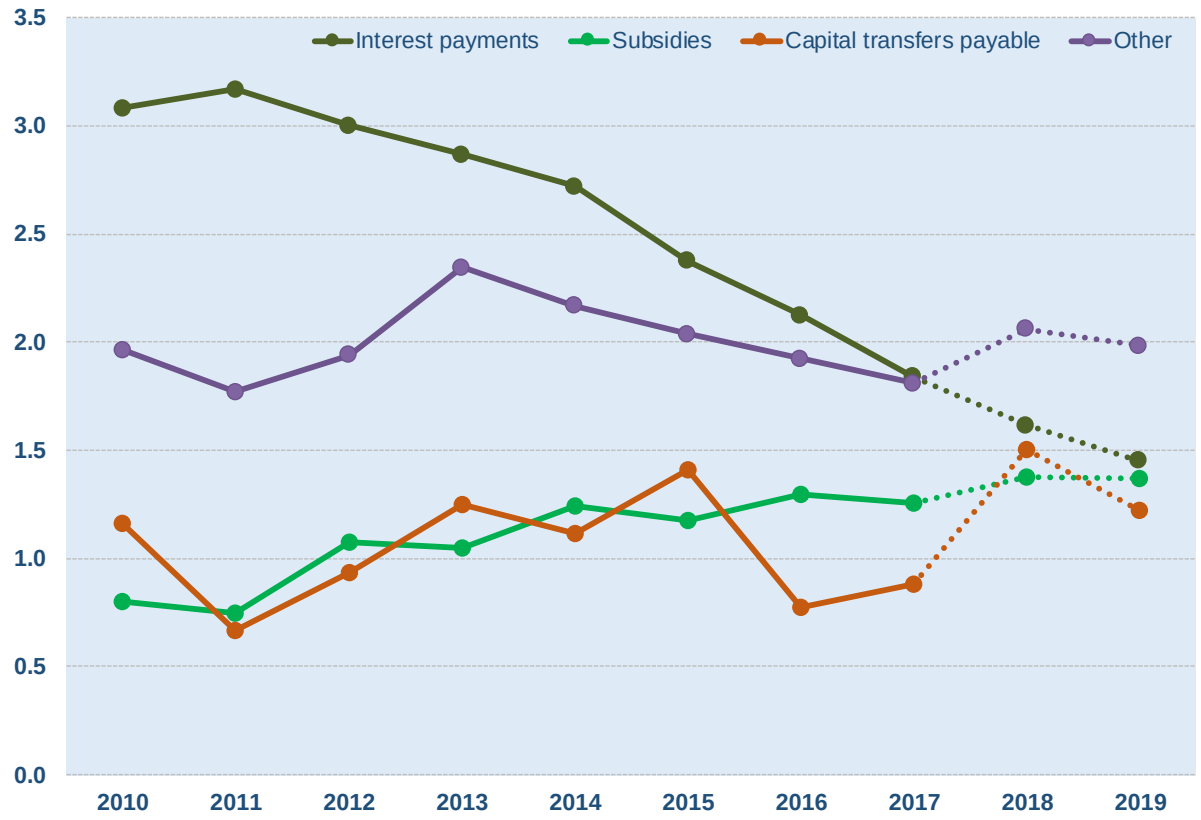
Source: MFIN

5.3.5 Other expenditure components

The before-mentioned four expenditure components account for the bulk of total expenditure. Their combined share made up 84.0% of total expenditure in 2017. The remaining expenditure components consist of interest payments, subsidies, capital transfers payable and 'other'. Chart 18 shows the forecast profile for these respective categories as percentage of nominal GDP.

In the case of interest payments, the forecasts extend the downward trend observed since 2011. The low interest rate environment, which generates savings on the roll-over of debt, together with the reduction in the outstanding level of debt, contribute to the anticipated decline in the interest payments amounting to €10.9 million in 2018. For 2019, the decline is slightly less, estimated at €6.2 million. In 2019, gross debt is expected to increase, thereby dampening in part the roll-over savings.

Chart 18: Other expenditure components (2010 – 2019)



Note: 2010 – 2017 refer to actual data while 2018 and 2019 are forecasts.

Source: MFIN

On the other hand, subsidies are expected to remain low but to increase by 0.1 pp over the forecast horizon, to 1.4% of GDP in both 2018 and 2019. Likewise, spending on capital transfers and 'other' expenditure is expected to increase and be higher over the forecast horizon compared to the previous two years. In the case of capital transfers payable, fluctuations can be ascribed to the variation in the utilisation of EU funds which are transferred to certain entities and recorded under this expenditure category. In turn, the funds allocated for the Contingency Reserve, amounting to €12.9 million in 2019 are accounted for with the 'other' expenditure category.[22]

Overall, the MFAC considers the projections for these various minor expenditure components to be plausible. Specific downside risks for 2018 and 2019 are related to the possibility that, as in previous years, during these two years there is no recourse to the Contingency Reserve, thereby automatically achieving cost savings.

[22] The Contingency Reserve is a fiscal buffer fund which can be resorted to in case of exceptional expenditure developments and which shall amount to between 0.1% and 0.5% of GDP in any particular year, as prescribed by the FRA.

5.4 Fiscal risk outlook

The assessment carried out on the individual revenue and expenditure components, suggests possible upside risks for the fiscal balance in 2018 and downside risks for 2019 (see Table 15). In 2018, total revenue may exceed the targets. This is primarily due to the possibility of higher revenue generated from taxes on production and imports and social contributions. For 2018, the beneficial impact on the fiscal balance is further supported by the downside expenditure risks. The latter are linked to the possibility of spending shortfalls on gross fixed capital formation and 'other' expenditure. On the other hand, the MFAC considers that there are downside risks to the fiscal balance in 2019. This allows for the possibility of a marginally smaller fiscal surplus than planned in that year. This reflects the possibility that spending on compensation of employees exceeds the target, with the impact being however partially mitigated by savings on 'other' expenditure.

Table 15: Fiscal risk outlook

	2018	2019
REVENUE	⇑	⇔
Taxes on production and imports	⇑	⇔
Current taxes on income and wealth	⇔	⇔
Social contributions	⇑	⇔
Other revenue	⇔	⇔
EXPENDITURE	⇓	⇑
Compensation of employees	⇔	⇑
Intermediate consumption	⇔	⇔
Social payments	⇔	⇔
Gross fixed capital formation	⇓	⇔
Other expenditure	⇓	⇓
BALANCE	⇑	⇓

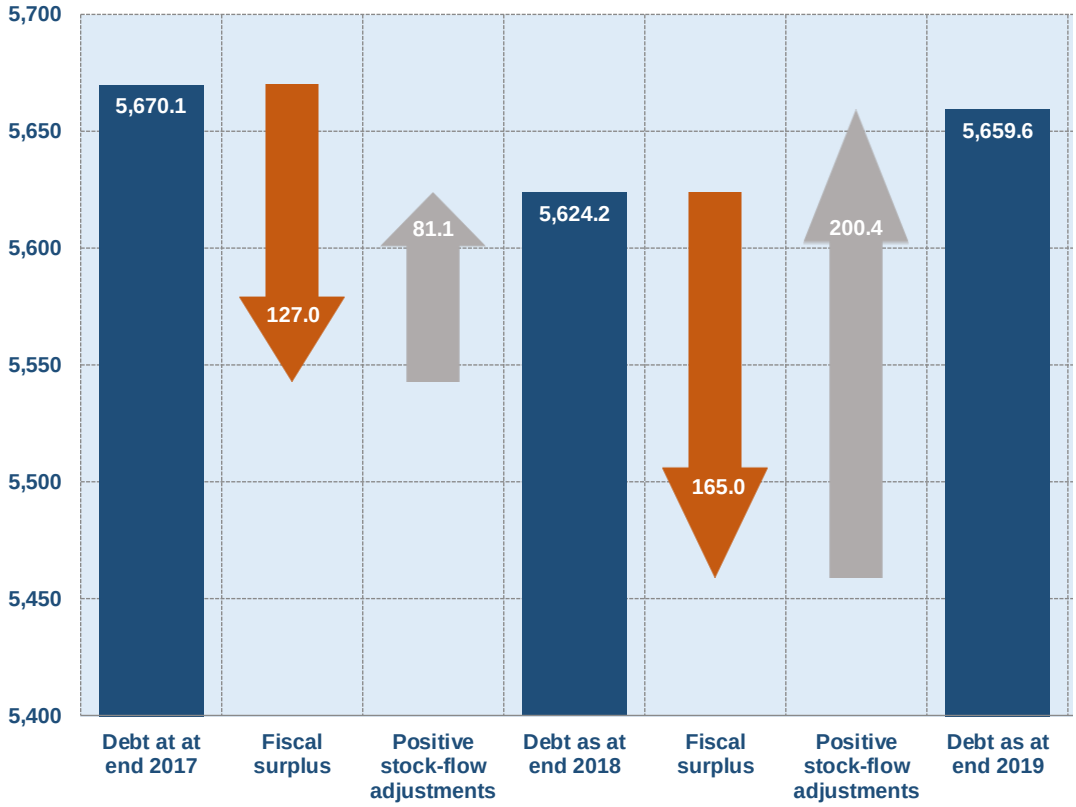
Note: ⇔ indicates neutral risks, ⇑ indicates upside risks and ⇓ indicates downside risks.

Source: MFAC

5.5 Assessment of public debt

In 2018, the outstanding level of public debt is expected to decline by €45.9 million on a year earlier, from €5,670.1 million, to €5,624.1 million. This drop is less than the planned fiscal surplus for the year, due to positive stock-flow adjustments, totalling €81.1 million (see Chart 19). In 2019, positive stock-flow adjustments, estimated at €200.4 million, are again expected to outweigh the effect of the planned €165.0 fiscal surplus for the year. Consequently, the MFIN project that public debt would increase by €35.4 million, to €5,659.6 as at end 2019. Nonetheless, the ratio of public debt as a percentage of GDP is expected to fall throughout the forecast horizon from 50.9% in 2017, to 46.9% in 2018, and 43.8% in 2019. One of the main contributing factors of the downward push in debt-to-GDP ratio in 2019 relates to the expansion of nominal GDP, which serves as a denominator for this ratio.

Chart 19: Drivers of public debt (EUR millions)



Source: MFIN

The plausibility of the trajectory for the public debt ratio for 2018 and 2019 depends on the extent to which the planned fiscal surpluses and the stock-flow adjustments for these years can be considered as plausible. In this respect, the MFAC notes that, the upside risk to the fiscal surplus, identified in relation to 2018, would pose a downside risk to the end of year outstanding debt, since a higher fiscal surplus could enable larger debt repayments. On the other hand, the downside risk

for the fiscal balance for 2019, could translate into an upside risk for the outstanding debt as at end 2019. However, this effect would be neutralised should the downside risk for 2018 materialise, since in this case the level of debt at the beginning of 2019 would be lower than anticipated.

With regards to the stock-flow adjustments, these are to a large extent policy-driven, and thus, if the plans which underpin the DBP projections are closely adhered to, the outcome should be in line with such projections. The DBP indicates the full list of stock flow adjustments over 2018 and 2019 (see Table 16). The largest adjustments relate to the ESA methodology (owing to the difference between cash and accrual recording of transactions), changes in the holdings of debt by the government, and equity acquisitions.

Table 16: Stock-flow adjustments (EUR millions)

	2018	2019
ESA adjustment	116.0	131.7
Changes in Sinking Fund balances and MGS holdings	-99.5	45.1
Equity acquisitions	65.9	10.6
Net impact of EBU-related transactions	-3.9	0.0
Changes in cash balances	-7.9	-0.2
Euro currency issue	9.7	8.2
Other adjustments	0.8	5.0
Total stock-flow adjustment	**81.1**	**200.4**

Source: MFIN

The MFAC considers that the planned stock-flow adjustment for 2018 and 2019 are plausible. These estimates are compatible with the plans by the MFIN. Hence, the MFAC considers the projections for the trajectory of the outstanding public debt in absolute terms as plausible. Given that the macroeconomic forecasts, including that for nominal GDP growth for 2018 and 2019 have already been considered as plausible (see Section 3), the forecasted public debt-to-GDP ratio for 2018 and 2019 are also considered to lie within the MFAC's endorsable range.

6. Comparison across different fiscal forecasts

The plausibility of the fiscal forecasts contained in the DBP 2019 can also be assessed by evaluating the extent of similarity or divergence with the other fiscal forecasts which are available. Specifically, in this Report, comparisons are carried out with respect to the previous vintage produced by the MFIN (as part of the USP 2018 – 2021), and the fiscal forecasts produced independently by the CBM and the COM.[23] These forecasts were however produced in different periods, and thus are not perfectly comparable since they are based on different datasets.[24] Only the COM's forecasts embed the latest vintage of macroeconomic data for 2017, as published by the NSO on 6 September 2018.[25] The MFIN's USP forecasts and the CBM's forecasts were published before such data became available.

6.1 Fiscal balance

The forecasts for the 2018 fiscal balance are similar across institutions. The MFIN's DBP and USP vintages indicate a surplus equivalent to 1.1% of GDP (see Chart 20). The COM's and the CBM's forecasts are slightly more optimistic, at 1.3% and 1.6% of GDP.[26] Accordingly, in absolute terms, the forecasts for the 2018 fiscal surplus produced by the CBM and the COM are slightly above the €127.0 million indicated by the MFIN in the DBP (see Table 17).[27]

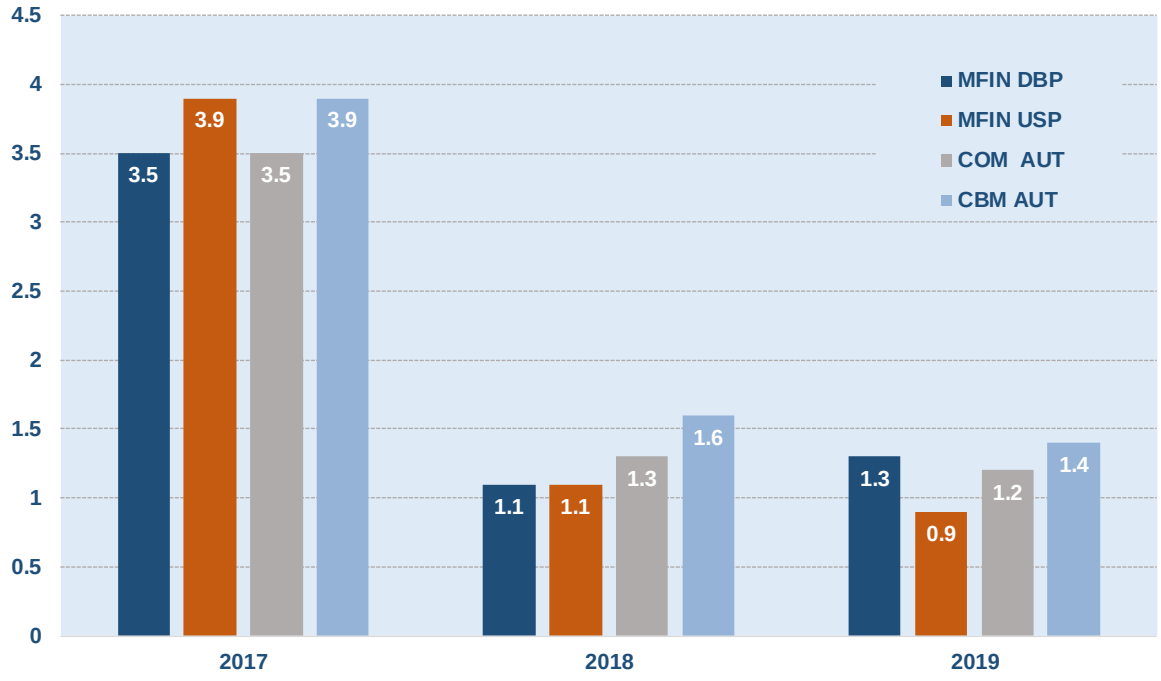
The downward revision in the 2018 target for the fiscal surplus (carried out by the MFIN between the USP and the DBP) is minimal in absolute terms, amounting to only €5.0 million. However, both total revenue and total expenditure have been revised upwards, respectively by €70.4 million and €75.4 million. The upward revision in total revenue was driven by taxes on production and imports, and other smaller share revenue components. On the other hand, the upward revision to total expenditure was more broad-based. Indeed, this was spread across the main expenditure categories.

The forecasts for total revenue indicated in the DBP are higher than those by the COM and the CBM. The latter two institutions presented lower revenues across all the main components. On the other hand, the expenditure forecasts show more variations across institutions. The CBM projected

[23] The latest CBM and COM forecasts can be downloaded respectively from https://www.centralbankmalta.org/file.aspx?f=71946 and https://ec.europa.eu/info/files/autumn-2018-economic-forecast-malta-0_en.
[24] The cut-off date for the forecasts published within the USP 2018 – 2021 was 18 May 2018; the cut-off date for the CBM's forecasts was 30 November 2018; and the cut-off date for the COM's forecasts was 22 October 2018.
[25] NSO News Release 139/2018.
[26] This is consistent with the upside risk to the fiscal balance identified by the MFAC in section 5.
[27] In absolute terms the 2018 target for the fiscal surplus has been revised down from €132.0 million stated in the USP to €127.0 as reported in the DBP.

generally lower expenditure except in the case of intermediate consumption. On the other hand, the COM's expenditure forecasts were very close for all main components, except in the case of gross fixed capital formation which was significantly lower.

Chart 20: Fiscal surplus estimates by the MFIN, COM and CBM (% of GDP)



Source: MFIN, COM, CBM

All institutions are forecasting a fiscal surplus in 2019, but in this case, there is more variation. The DBP targets a fiscal surplus of 1.3% of GDP, up from the 0.9% of GDP which had been indicated in the USP. The forecasts by the COM is slightly less optimistic, at 1.2% of GDP, whereas that by the CBM is slightly more optimistic, at 1.4% of GDP. However, the main difference relates to the fact that whereas according to the DBP the fiscal surplus is expected to be higher in 2019 than in 2018, the forecasts by the other institutions show the opposite pattern. This is also consistent with the downside risks to the 2019 fiscal surplus identified by the MFAC in section 5 of this Report.

For 2019, the MFIN is targeting a fiscal surplus which is €45.0 million higher than was indicated in the USP. Even for 2019 total revenue and total expenditure have been revised upwards. However, in this case, the upward revision in total revenue exceeded that in total expenditure. Upward revisions were spread across most budget components.

The revenue and expenditure projections by the CBM for 2019 are relatively closer to those which had been prepared by the MFIN for the USP. This is in part attributable to the fact that the two vintages were prepared within the same period and hence based on similar information. In the case of the COM, the revenue forecasts are marginally lower, in absolute terms, across all

components, when compared to those produced by the MFIN in the DBP. At the same time, the COM is anticipating lower expenditure. Lower forecast spending on public investment more than compensates for the higher anticipated spending on compensation of employees, intermediate consumption and social payments when compared to the MFIN's DBP forecasts.

Table 17: Fiscal forecasts by the MFIN, COM and CBM (EUR millions)

	2018				2019			
	MFIN DBP	MFIN USP	COM AUT	CBM AUT	MFIN DBP	MFIN USP	COM AUT	CBM AUT
Total Revenue	**4,725.6**	**4,655.2**	**4,678.0**	**4,630.4**	**5,054.0**	**4,917.8**	**4,967.0**	**4,920.3**
Taxes on production and imports	1,521.9	1,484.0	1,505.0	1,503.6	1,613.8	1,540.6	1,587.0	1,578.4
Current taxes on income and wealth	1,744.7	1,743.4	1,733.0	1,687.2	1,935.4	1,885.4	1,900.0	1,831.3
Social contributions	753.7	759.6	751.0	745.2	807.3	804.9	798.0	786.4
Other *	705.3	668.2	689.0	694.4	697.5	686.9	682.0	724.2
Total expenditure	**4,598.6**	**4,523.2**	**4,523.0**	**4,433.5**	**4,889.0**	**4,797.8**	**4,815.0**	**4,745.6**
Compensation of employees	1,381.9	1,367.3	1,387.0	1,366.4	1,467.7	1,429.7	1,491.0	1,466.2
Intermediate consumption	825.5	807.7	826.0	1,206.8	886.8	867.2	896.0	1,270.6
Social payments	1,212.1	1,207.7	1,217.0	797.0	1,290.3	1,252.3	1,297.0	851.5
Gross fixed capital formation	392.1	358.3	302.0	315.1	465.3	429.5	357.0	403.6
Other **	787.0	782.2	791.0	748.2	778.9	819.1	774.0	753.7
Fiscal balance	**127.0**	**132.0**	**154.0**	**196.9**	**165.0**	**120.0**	**151.0**	**174.7**
Gross debt	**5,624.2**	**5,506.3**	**5,746.0**	**5,531.3**	**5,659.6**	**5,500.8**	**5,765.0**	**5,513.1**

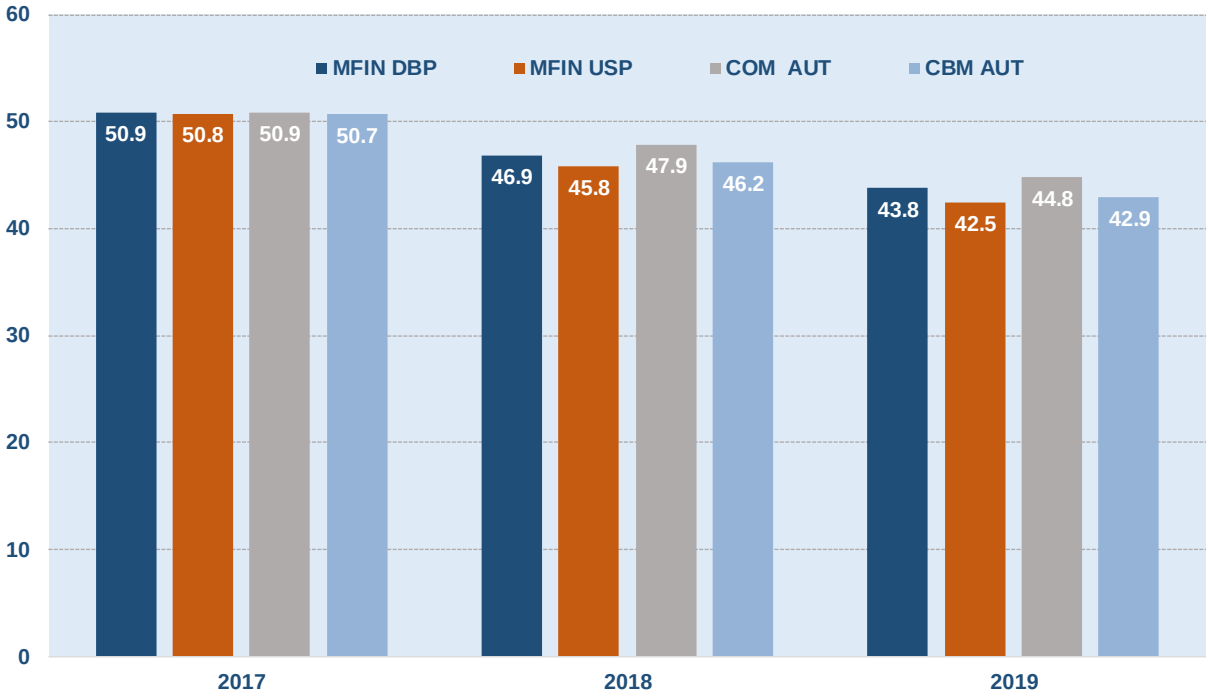
* Include capital taxes, property income and 'other' revenue.
** Include interest payments, subsidies, capital transfers payable and 'other' expenditure.
Source: MFIN, COM, CBM

6.2 Public debt

There is also strong similarity in the projections for the debt-to-GDP ratio across the three institutions (see Chart 21). Indeed, the forecasts all point towards further scaling back of the debt ratio over the forecast horizon. However, the pace varies slightly across forecast vintages. In the DBP, the MFIN are anticipating a slightly more gradual decline in the debt ratio when compared to the USP targets. The MFIN's debt forecasts contained in the DBP fit within the range of forecasts

produced by the CBM and the COM. The CBM has a slightly more positive outlook for the debt ratio for both 2018 and 2019. On the other hand, the COM's forecasts evidence a slightly higher debt ratio over the forecast horizon. Sources of difference across the institutions relate to the size of the fiscal surplus, as well as different assumptions for the stock-flow adjustments and a different level for the nominal GDP which acts as denominator to the debt ratio. Nonetheless, the difference across institutions is very much contained, again reinforcing the plausibility of the MFIN's debt projections contained in the DBP.

Chart 21: Public debt estimates by the MFIN, COM and CBM (% of GDP)



Source: MFIN, COM, CBM

7. Compliance with fiscal rules

The EU's fiscal framework envisages that Member States respect the debt rule, the budget balance rule, and the expenditure benchmark.[28] These rules are designed to encourage countries to prioritise fiscal sustainability and prevent the build-up of fiscal imbalances. The debt rule and the budget balance rule feature identically in the Stability and Growth Pact (SGP) and the FRA. On the other hand, the expenditure benchmark which features in the SGP, is only indirectly referred to in the FRA, in the case the COM identifies a 'significant deviation' from the Medium Term Budgetary Objective (MTO). Table 18 outlines the requirements currently applicable to Malta's fiscal policy, based on the SGP and the FRA.

[28] For a detailed exposition of these rules, refer to the Vade Mecum on the Stability and Growth Pact, 2018 edition, available on https://ec.europa.eu/info/publications/economy-finance/vade-mecum-stability-and-growth-pact-2018-edition_en.

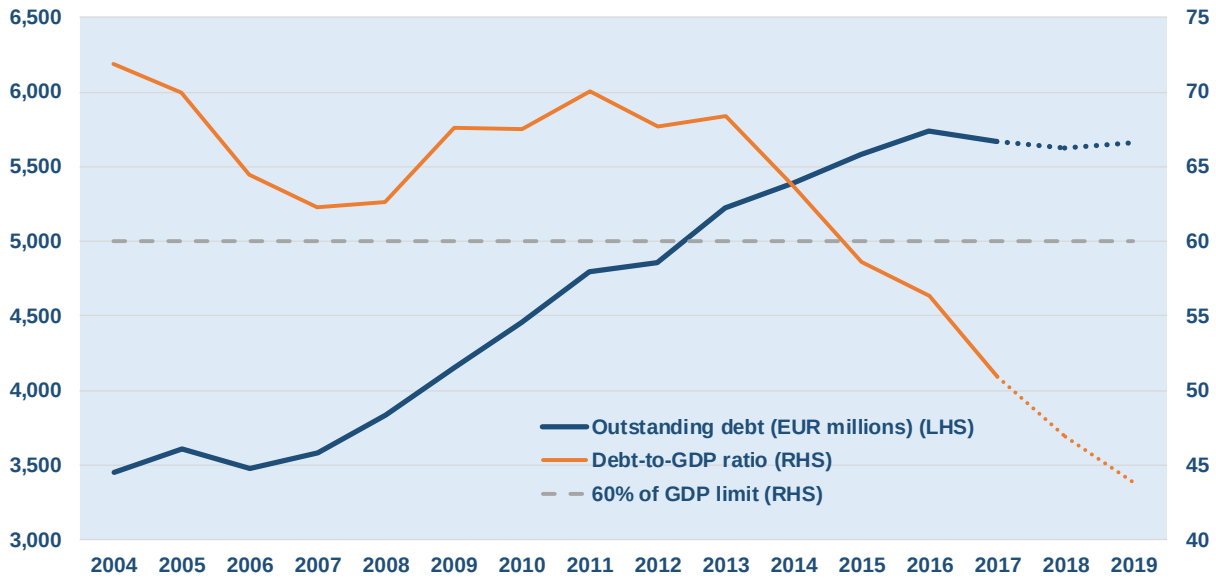
Table 18: Requirements currently applicable to Malta's fiscal policy

	2018	2019
Debt rule: The debt-to-GDP ratio must not be higher than 60% of GDP	✓	✓
Budget balance rule: The country must maintain its MTO	✓	✓
Expenditure benchmark: Annual expenditure growth should not exceed a reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures	NA	NA

Note: ✓ means that the requirement is met. In the case of the expenditure benchmark, since the country has over-achieved its MTO and is expected to maintain its MTO, the expenditure benchmark is not binding.
Source: MFAC

The DBP indicates that in 2018 and 2019, the outstanding level of debt in absolute terms is projected to remain relatively stable, at a level comparable to that in 2017 (see Chart 22). This contrasts sharply with the strong upward trend recorded between 2004 and 2016. The relative stability in the outstanding debt, coupled with the 7.7% projected yearly expansion in nominal GDP in both 2018 and 2019, is expected to bring about further declines in the debt-to-GDP ratio. The ratio of public debt to GDP fell below the 60% threshold for the first time in 2015. In the following years this limit continued to be respected. Indeed, the debt ratio dropped further in 2016 and 2017, and according to the plans outlined in DBP, the ratio will continue falling, to 46.9% and 43.8% of GDP over the forecast horizon. This would ensure that the debt rule continues to be complied with, by an even stronger margin.

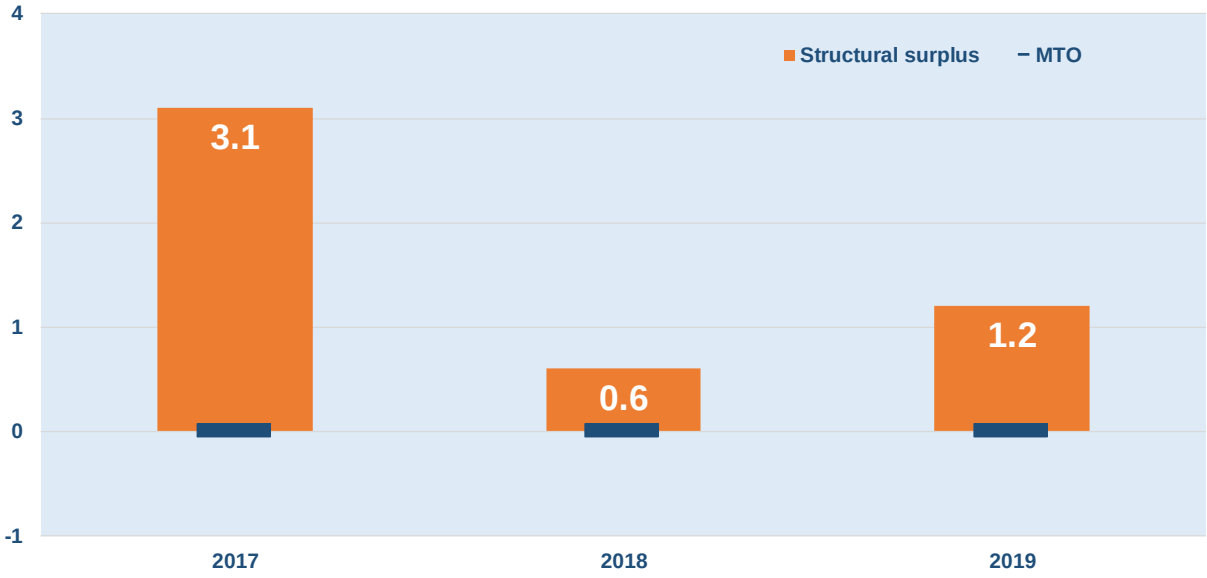
Chart 22: Public debt trajectory (2004 – 2019)



Source: MFIN

In relation to the yearly budgetary position, the MTO for Malta has been set at balanced budget in structural terms. Malta first achieved its MTO in 2016, three years ahead of the initially planned date. In 2017, an even larger structural surplus, equivalent to 3.1% of potential output, was attained (see Chart 23). Although in 2018 and 2019, the structural surplus is expected to be smaller, respectively at 0.6% of potential output and 1.2% of potential output, Malta's MTO (equivalent to a structural balance of 0.0% of potential output) would still be complied with by a reasonable margin.

Chart 23: Structural balance and MTO (% of potential output)



Source: MFIN

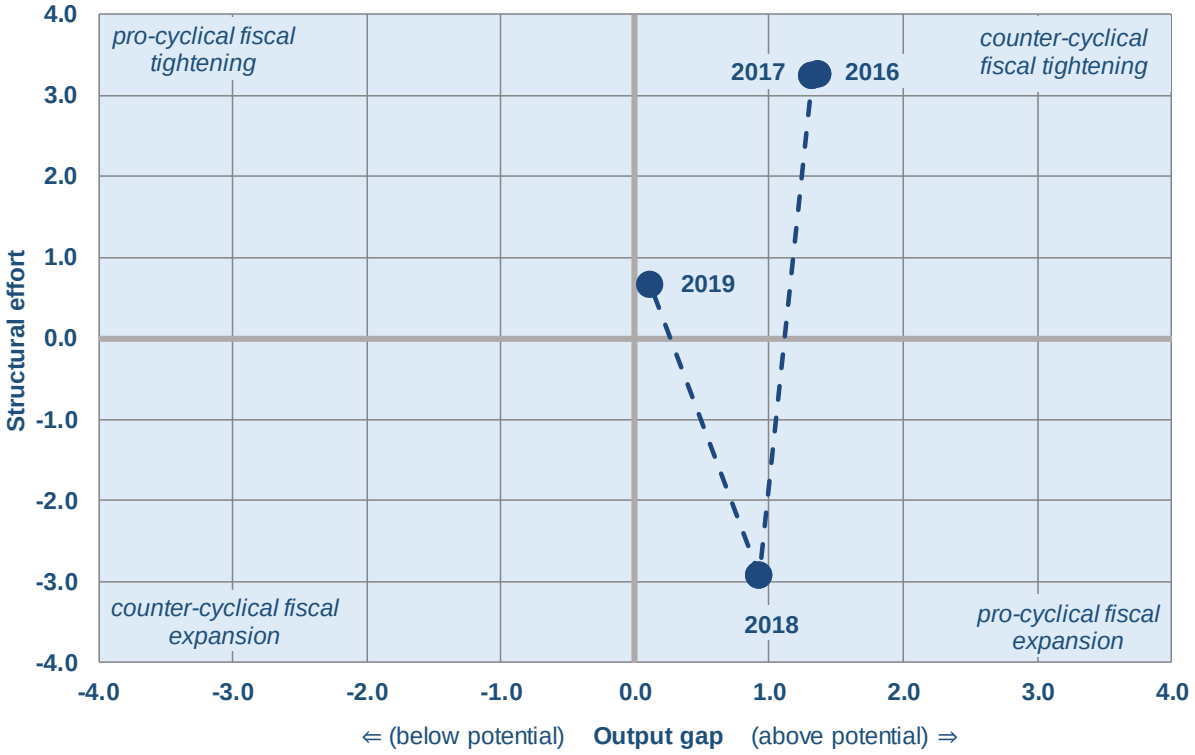
The planned developments in the structural balance imply that in 2018, a pro-cyclical fiscal expansion would be taking place. Indeed, the easing of the structural surplus planned for the year coincides with a period wherein the economy is operating above potential, i.e. with a positive output gap (see Chart 24). On the other hand, in 2019, counter-cyclical fiscal tightening is anticipated since the improvement in the fiscal surplus, that is fiscal tightening is expected to take place at a time where the economy is still expected to operate marginally above potential.

Due to the over-achievement of Malta's MTO in both 2016 and 2017, and the fact that the projections by both the MFIN and the COM indicate that the MTO is expected to continue being overachieved, the expenditure benchmark does not need to be assessed.[29] Indeed, the expenditure benchmark serves primarily to steer countries towards their MTO, something which Malta has already attained, and is expected to maintain. This on condition that the achievement of the MTO is not driven by windfalls. In this respect, the expenditure benchmark can be interpreted as non-binding in terms of compliance with the SGP, as Malta's structural surplus is not the result

[29] The expenditure aggregate upon which the rule is based is comprised of overall government expenditure net of interest payments, spending on EU programmes paid for by EU funds and cyclical elements of unemployment benefits, while nationally financed government investment is smoothed over four years.

of windfalls. Furthermore, since the COM has not identified any 'significant deviation' by the country, the FRA's clause relating to the expenditure benchmark is not applicable in current circumstances. This notwithstanding, the MFAC considers important that expenditure developments continue to be carefully monitored, to avoid unsustainable developments.

Chart 24: Cyclical conditions and structural effort (percentage points of GDP)



Source: MFIN

8. Conclusion

The positive performance of the Maltese economy over recent years is expected by the MFIN to be sustained in 2018 and 2019. Based on the information made available, and on the assessment undertaken, the MFAC considers that the macroeconomic forecasts presented in the DBP 2019 to be within the MFAC's endorsable range. This assessment is corroborated by the broad similarity between the MFIN's macroeconomic forecasts and those presented by both the COM and the CBM.

In relation to the fiscal forecasts, the MFAC considers the targets for a fiscal surplus, and a decline in the debt-to-GDP ratio, in each of the forecast years, to be feasible and plausible, and within its endorsable range. The justifications provided by the MFIN in the DBP, and through further internal communication, suggest that such fiscal targets are indeed achievable. This is conditional on the macroeconomic scenario not diverging significantly from the official forecasts, and the equally important proviso that the Government adheres closely to the plans outlined in the DBP. As with

the macroeconomic forecasts, the MFAC notes that even the fiscal forecasts presented by the MFIN are in line with those published by the COM and the CBM.

The MFAC considers very positively the fact that both the macroeconomic and the fiscal outlook for Malta, presented by the MFIN, to a large extent shared by the COM and the CBM. This adds to the plausibility of such forecasts, which is instrumental for correct policymaking. Nonetheless, a certain element of uncertainty remains since Malta's very open economy makes it subject to possible shocks arising from the external sector, while on the fiscal front, some budget components may also be volatile and subject to sudden changes.

The MFAC acknowledges the clear commitment by the Government to continue running a structural surplus, thus maintaining the country's MTO. This strategy further helps sustain the planned further reduction in the debt ratio. A low public debt ratio is key to sustaining Malta's economic fundamentals. Strong public finances are important not only to comply with the fiscal rules, but to ensure that appropriate buffers are created at a time when the economic performance is favourable. The benign macroeconomic and fiscal conditions also offer a window of opportunity for carrying out the necessary reforms to address long-term challenges.[30] At the same time, the MFAC reiterates the importance that the fiscal plans adequately factor in the challenges associated with Malta's rapid structural changes, population growth and international environmental obligations.[31]

[30] The S2 indicator compiled by the European Commission indicates medium risk to fiscal sustainability in the long run. This is entirely due to the projected increase in age-related expenditure which is estimated at 6.9 pp of GDP. This reflects the higher anticipated outlays for pensions, health care and long-term care. When compared to the other Member States, Malta stands out as the country with the second-highest projected change in age-related expenditure between 2016 and 2070. The favourable initial budgetary position, due to the fiscal surpluses attained in 2016 and 2017, mitigates, in part, this long-term risk, thus placing the country at medium risk, according to the S2 indicator. For further details refers to https://ec.europa.eu/info/publications/debt-sustainability-monitor-2017_en.

[31] Europe 2020 specifies specific targets in relation to climate change and energy use. In the case of Malta, the latest available statistics show that not all targets have been met and there remain challenges to ensure that such targets are attained by 2020. For the relevant statistics refer to https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester/framework/drafteurope-2020-strategy/europe-2020-targets-statistics-and-indicators-eu-level_en.

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