Assessment of the Annual Report 2018 and Half-Yearly Report 2019 published by the Ministry for Finance

MFAC
MALTA FISCAL ADVISORY COUNCIL

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18 September 2019

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M.A. (Toronto), Ph.D (Toronto), D.S.S (Oxon) MP
Minister for Finance
Maison Demandols,
South Street,
Valletta. VLT 2000

Dear Minister,

OVERALL ASSESSMENT OF THE ANNUAL REPORT AND HALF-YEARLY REPORT PUBLISHED BY THE MINISTRY FOR FINANCE

In terms of the Fiscal Responsibility Act, the Malta Fiscal Advisory Council is hereby presenting its assessment of the Annual Report and the Half-Yearly Report published by the Ministry for Finance, respectively in June and July 2019.

Both reports contribute positively to fiscal transparency, by providing an account of the outturn of the previous year compared to the targets, and by outlining the macroeconomic and fiscal forecast updates for the current year. Good quality forecasts are a pre-requisite for sound policy making, and it is important that the Ministry continues to allocate adequate resources and time for their production.

The Council welcomes the general level of prudence which continued to characterise the macroeconomic forecasts. Indeed, in 2018 the outturn for nominal GDP growth exceeded again the official forecasts which had been presented in the Draft Budgetary Plan and the Update of stability Programme.

Looking ahead, the Ministry is invited to explore how to improve the accuracy of specific forecasts at a component level. Achieving more accurate forecasts for gross fixed capital formation, especially vis-à-vis public investment, should be prioritised, since in this case, deviations have tended to be among the highest. This is important since public sector investment impacts not only the government expenditure projections but also the broader national accounts forecasts, particularly imports. Ministries and public sector entities should aim to maintain investment plans which are as detailed, accurate, and closely adhered to, as possible.

The Council also welcomes the fact that in 2018 the fiscal surplus (on an ESA basis) was larger than originally targeted, on the back of superior revenue performance overall. It is important that any surplus revenue is not channelled into new unsustainable expenditure initiatives. At the same time, the Council invites the Ministry to analyse and follow closely why the target for current taxes on income and wealth was missed in 2018, as part of improved risk monitoring.

The Council notes that the Half-Yearly Report reconfirmed the macroeconomic and fiscal forecasts which were presented in the Update of Stability Programme 2019 – 2022. The information available to the Council by the cut-off date, relating mainly to the first quarter national accounts statistics and the mid-year provisional fiscal estimates, do not alter the plausibility of the official forecasts, which thus remain within the endorsable range of the Council.

At the same time the Council invites the Ministry to remain vigilant to ensure that the fiscal targets for the year are met, particularly in those areas where the required changes during the second half of 2019 appear ambitious, when compared to the outturn during the first half of the year.

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

COM	European Commission
DBP	Draft Budgetary Plan
EBU	Extra Budgetary Unit
ESA	European System of National and Regional Accounts
EU	European Union
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
IIP	Individual Investor Programme
IRD	Inland Revenue Department
MFAC	Malta Fiscal Advisory Council
MFIN	Ministry for Finance
MGS	Malta Government Stock
NDFS	National Development and Social Fund
NSO	National Statistics Office
pp	percentage point
USP	Update of Stability Programme
VAT	Value-Added Tax

Executive Summary

The Annual Report and the Half-Yearly Report published by the Ministry for Finance contribute to fiscal transparency, respectively by providing an account of the outturn of the previous year compared to the targets, and by outlining the forecast updates for the current year (which have already been endorsed by the Fiscal Council). These two reports by the Ministry for Finance also provided explanations on the reported deviations and the updates which were carried out between forecast rounds.

The Draft Budgetary Plan (published in October 2017) had anticipated nominal GDP growth for 2018 of 7.6%, while the Update of Stability Programme 2018 – 2021 (published in April 2018) had anticipated nominal GDP growth of 8.3%. The actual nominal GDP growth rate (published in March 2019) was slightly higher, at 8.9%. At a component level, the main deviation related to gross fixed capital formation, which grew at a slower pace than had been anticipated in both forecast rounds.

In 2018, the Consolidated Fund recorded a deficit of €70.2 million, which was €48.8 million more than originally approved in the Financial Estimates. However, the general government fiscal balance (which is measured according to the European statistical guidelines, is accruals based and has a broader coverage) recorded a surplus of €250.8 million. This was significantly higher than the €54.0 million originally indicated in the Draft Budgetary Plan, and the €132.0 million targeted in the Update of Stability Programme. Such stronger fiscal surplus (on an ESA basis) can be ascribed to the superior revenue performance than originally anticipated.

In the April 2019 forecast round, as part of the Update of Stability Programme, the nominal and real GDP growth forecasts for 2019 were revised slightly upwards, respectively to 9.3% and 6.2%. In real terms, the updated forecasts indicated faster growth in private consumption, government consumption and gross fixed capital formation, compared to the forecasts which were presented in October 2018, as part of the Draft Budgetary Plan. There was also an upward revision in import growth, which exceeded the upward revision in export growth.

The fiscal surplus target for 2019 (on an ESA basis) was also updated, to €120.3 million, equivalent to 0.9% of GDP. This is slightly less ambitious than had been anticipated in the Budget Speech (October 2018), particularly as the revision in expenditure (+€115.1 million) exceeded the revision in the anticipated revenue (+€70.4 million).

The information available by the cut-off date, relating mainly to the first quarter national accounts statistics and the mid-year fiscal estimates, do not alter the plausibility of the official forecasts, which thus remain within the Fiscal Council’s endorsable range. At the same time the Council invites the Ministry for Finance to remain vigilant to ensure that the fiscal targets for the year are met. This is more important particularly in those cases where the revenue and expenditure performance required during the second half of 2019 appears relatively ambitious compared to the actual performance recorded during the first half of the year.

Chapter 1
Introduction

To enhance fiscal transparency, the Fiscal Responsibility Act (FRA) requires that the Ministry for Finance (MFIN) publishes an Annual Report (by end of June) and a Half-Yearly Report (by end of July). The Act also prescribes that the Malta Fiscal Advisory Council (MFAC) publishes its own assessment on these two reports.

The main purpose of the Annual Report is to review the macroeconomic developments of the previous year and provide explanations for the possible variances vis-à-vis the official forecasts, as well as provide information on the execution of the previous budget, and compare its outcome with the fiscal targets as announced in the previous annual budget.

This ex-post assessment is useful to evaluate the quality of the official forecasts. It also helps detect any possible systematic forecast bias over the years, so that corrective measures can be taken. Reliable and accurate macroeconomic and fiscal forecasts are necessary for good policymaking, while acknowledging the challenges in undertaking such an exercise in the case of a small open economy.

In turn, the Half-Yearly Report reviews the macroeconomic and fiscal developments since the presentation of the Budget in Parliament (in October) and the submission to the European Commission (COM) of the Draft Budgetary Plan (DBP) (in October) and the Update of Stability Programme (USP) (in April). The Half-Yearly Report assesses whether any significant developments have occurred, which in turn, might necessitate some corrective measures or fine-tuning in the announced targets for the fiscal balance and public debt for the current year.

This is important to ensure that the official forecasts are consistent with the most recent information. The MFIN's report also provides an update on the outstanding payments facing the Government and the progress in relation to the collection of revenue arrears.

This Report, whose cut-off date is 30 August 2019, proceeds as follows. **Chapter 2** evaluates the macroeconomic forecasting performance in relation to 2018. **Chapter 3** focuses on the variances between the fiscal targets and the actual outturn for 2018, both as reflected in the Consolidated Fund, and according to the European System of

National and Regional Accounts (ESA). **Chapter 4** reviews the macroeconomic forecast updates for 2019 and the actual developments recorded during the first quarter of 2019. **Chapter 5** presents the updates to the fiscal projections for 2019 and the developments recorded during the first half of the year. **Chapter 6** concludes with an overall assessment.

Chapter 2

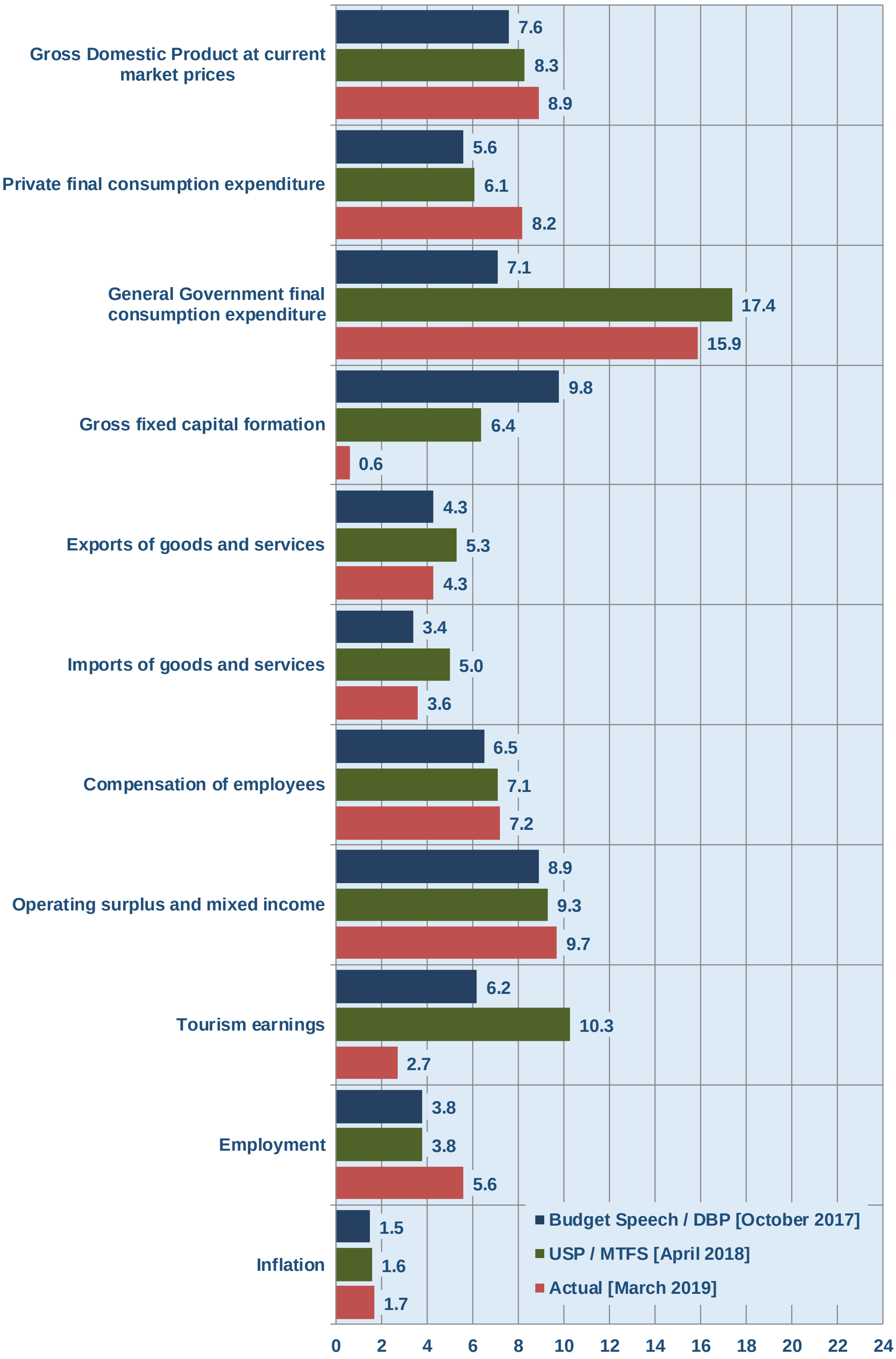
Nominal macroeconomic developments in 2018

The MFIN's Annual Report focuses on the growth rates for GDP and its components in nominal terms, since these are the main figures used to prepare the fiscal projections. The MFIN marginally underestimated the 2018 nominal GDP growth rate. According to NSO News Release 038/2019 (published in March 2019) it was estimated that nominal GDP grew by 8.9% in 2018, slightly higher than the 7.6% indicated in the DBP 2018 (published in October 2017) and the 8.3% presented in the USP 2018 – 2021 (published in April 2018) (see Chart 2.1). The forecasts for nominal GDP growth were close to the outturn across both forecast rounds, however at a component level there were some noticeable variances.

In 2018, private consumption grew by 8.2%, more than two percentage points (pp) above the rate anticipated in the DBP and the USP. Indeed, in 2018 nominal consumption growth was exceptionally high. On the other hand, the outturn for government consumption growth, at 15.9% was more than double that anticipated in the DBP, particularly in view of higher contributions from intermediate consumption and from consumption of fixed capital than originally anticipated. Nominal growth in government consumption was however slightly below that expected in the USP, because of differences in market output.[1] This suggests that in this case, the availability of in-year data contributed to improve the forecast accuracy. This was not the case in relation to gross fixed capital formation as nominal growth was significantly overestimated in both forecast rounds. Indeed, investment projects proceeded at a slower pace than anticipated, as gross fixed capital grew by 0.6%, much lower than the 9.8% and 6.4% envisaged in the DBP and the USP, respectively. The discrepancy was attributable to the private sector component of investment.

[1] Market output is deducted from expenditure items in the compilation of government consumption.

Chart 2.1: Nominal macroeconomic developments in 2018 (year-on-year % change)



Source: MFIN

In relation to the external sector, the variances for exports and imports were smaller. Exports grew by 4.3%, in line with the DBP's forecast, but 1.0 pp lower than indicated in the USP. In turn, imports grew by 3.6%, close to the growth rate indicated in the DBP (3.4%) and slightly less than that anticipated in the USP (5.0%). The initial export and import growth forecasts included in the DBP were thus closer to the outturn when compared with the subsequent forecasts included in the USP.

Turning to the income side of GDP, growth in compensation of employees, and operating surplus and mixed income, were within a range of less than 1.0 pp than had been indicated in the DBP and the USP.

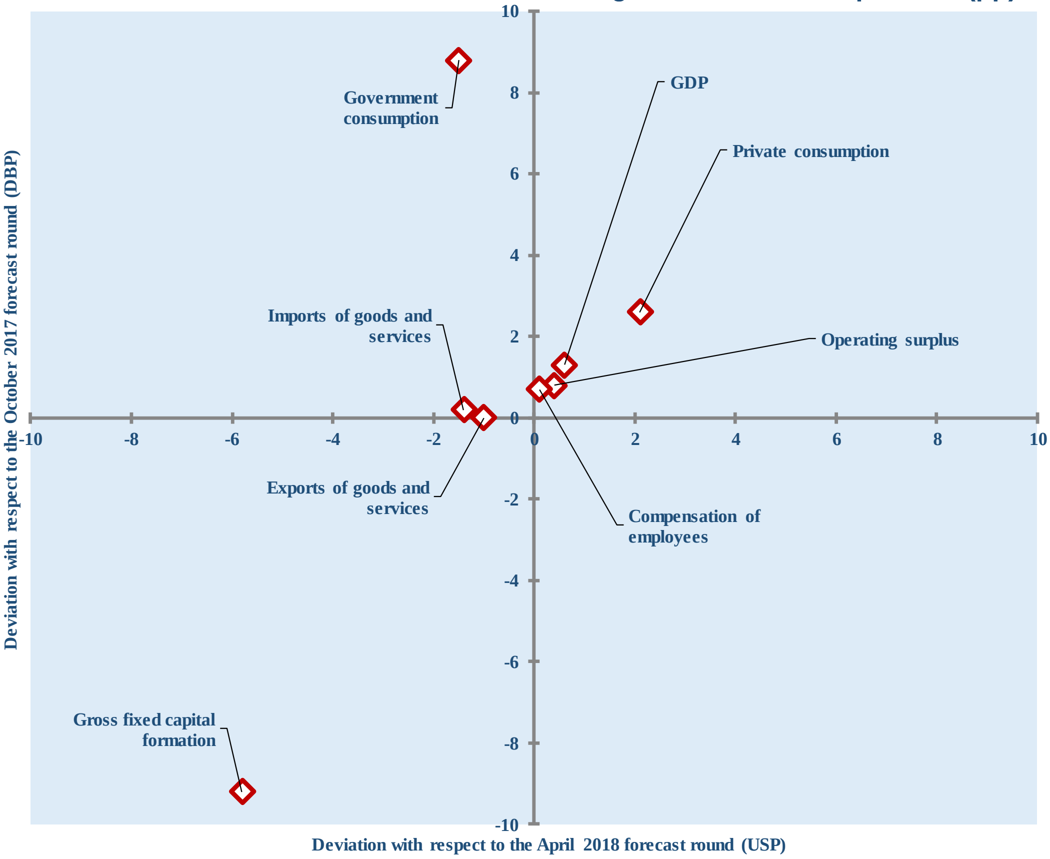
Compensation of employees expanded by 7.2%, merely 0.7 pp higher than indicated in the DBP, and 0.1 pp higher than shown in the USP. However, the economic expansion was more job-rich than had been anticipated. Indeed, employment growth stood at 5.6%, higher than the 3.8% envisaged in both the DBP and the USP. The faster-than-expected employment growth was however mostly offset by slower-than-anticipated growth in average wages.

The forecasts for the annual growth in operating surplus and mixed income also proved accurate. Operating surplus increased by 9.7%, which was only 0.8 pp higher than indicated in the DBP, and 0.4 pp higher than anticipated in the USP. Likewise, the inflation forecasts were close, with the outturn being only 0.2 pp above what was expected in the DBP and 0.1 pp above that expected in the USP.

On the other hand, the forecasts for tourism earnings proved optimistic. Indeed, tourism earnings expanded by 2.7% on a year earlier, which is below the 6.2% and 10.3% specified in the DBP and the USP, respectively.

In 2018, the GDP expenditure components which exhibited the largest deviations vis-à-vis the official forecasts were gross fixed capital formation and government consumption (see Chart 2.2). From a longer-term perspective (the five-year period between 2014 and 2018), further observations can be made when comparing the actual data (as presented in NSO News Release 038/2019) to the various forecast vintages (see Chart 2.3).

Chart 2.2: Deviations in relation to nominal GDP growth and its components (pp)



Note: The top-left quadrant indicates instances when the actual turnout was higher than indicated in the October 2017 (DBP) forecast round, but lower than indicated in the April 2018 (USP) forecast round. The top-right quadrant indicates instances when the actual turnout was higher than indicated in both the October 2017 (DBP) and the April 2018 (USP) forecast rounds. The bottom-left quadrant indicates instances when the actual turnout was lower than indicated in both the October 2017 (DBP) and the April 2018 (USP) forecast rounds. The bottom-right quadrant indicates instances when the actual turnout was lower than indicated in the October 2017 (DBP) forecast round, but higher than indicated in the April 2018 (USP) forecast round.

Source: MFIN

In interpreting these variances, it is important to note that revisions are undertaken in the official statistics between the vintage utilised in the respective forecast round and the vintage assessed here. Upward statistical revisions have generally contributed towards a prudent bias in the macroeconomic forecasts. Indeed, substantial revisions were undertaken between the GDP Q2/2018 release used for the Autumn 2018 forecast and the GDP Q4/2018 release used for the Spring 2019 forecast. As documented by the National Statistics Office (NSO) in the GDP Q3/2018 News Release 193/2018, national accounts and balance of payments data were revised upwards particularly as a result of new data on arts, entertainment and recreation activities for the reference years 2014 and 2015. These upwards revisions were undertaken from 2015 onwards, adding to the forecast errors for both nominal GDP and its expenditure components.

Between 2014 and 2018, nominal GDP growth was higher than the forecasts, to varying degrees, confirming an element of conservativeness in the forecasts. The forecast vintages evidence how the nominal GDP growth forecasts presented in the USP have never diverged much from those presented few months earlier, in the DBP. Furthermore, in all cases, the revision to the nominal GDP growth forecast was marginally upwards.

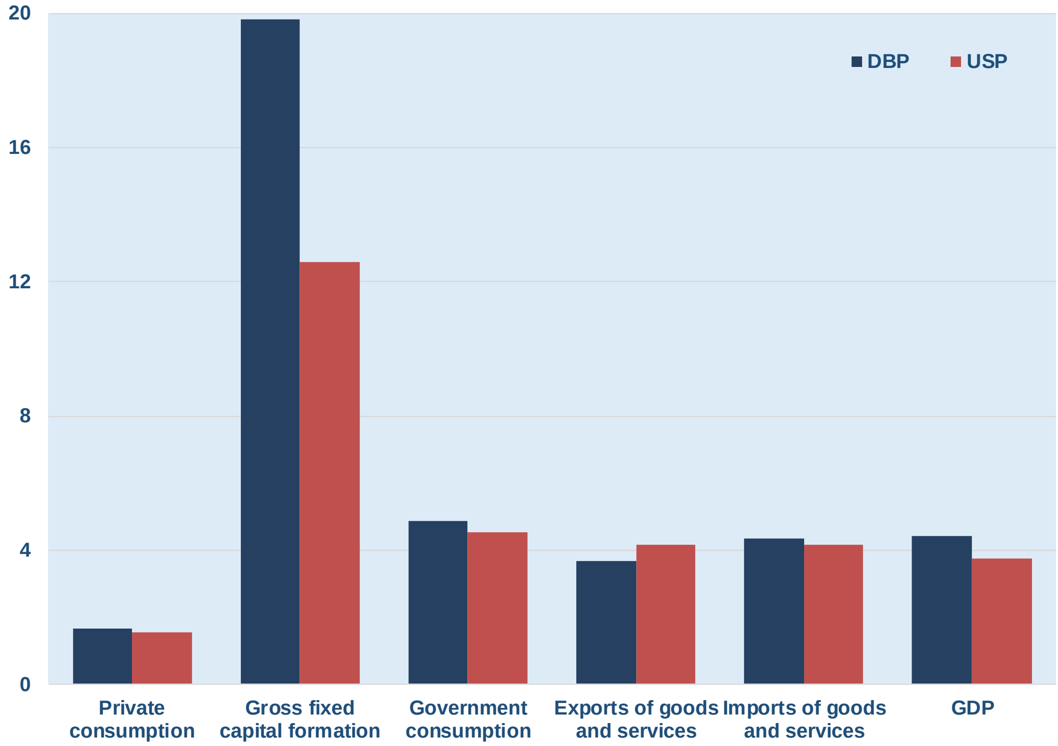
Chart 2.3: Nominal growth – actual vs forecast (pp)

Note: The actual values for 2014-2018 are based on NSO News Release 038/2019. The forecasts labelled 'DBP' correspond to the forecasts for period 't' published in October (in period 't-1'), while the forecasts labelled 'USP' correspond to the forecast for period 't' published in April (in period 't').

Source: MFIN

At a component level, there were instances of over- and under-estimation. The forecasts for private consumption registered the smallest average absolute deviations between 2014 and 2018 (see Chart 2.4).[2] On the other hand, the forecasts for gross fixed capital formation exhibited the largest deviations throughout this five-year period.[3] This suggests that the 2018 forecast error in relation to gross fixed capital formation is not an isolated phenomenon. Although the USP forecasts for nominal investment growth were closer to the actual data, as suggested by the relatively smaller absolute average deviations compared to the DBP, the gap was still significant. This while acknowledging the significant challenges involved in forecasting private sector investment, which can be influenced by specific factors which are only loosely related to macroeconomic conditions. In the case of the remaining expenditure components, namely government consumption, exports and imports, the forecasting performance over a five-year period was superior and comparable across the forecast rounds.

Chart 2.4: Average absolute forecast deviations 2014 – 2018 (pp)



Source: MFAC estimates

[2] The calculation involves taking the absolute difference between the actual growth and the forecast growth rate for the respective variable. The absolute difference means that positive and negative differences are treated equally. The sum of these differences is divided by the number of years (in this case 5) to determine the average yearly deviation. Lower average deviations indicate greater forecast accuracy.

[3] A large proportion of this forecast error is however concentrated in 2015 and relates to the timing of a single investment project.

Chapter 3

Fiscal developments in 2018

The accuracy of the official fiscal forecasts is evaluated vis-à-vis the targets set for the Consolidated Fund and the ESA targets. Whereas the Consolidated Fund is based on cash transactions, the ESA is accruals-based and has a wider coverage, as the activities of Extra-Budgetary Units (EBUs) are also included.[4,5]

3.1 Developments in the Consolidated Fund

In 2018, the Consolidated Fund recorded a deficit of €70.2 million, €48.8 million more than had been originally approved in the Financial Estimates (see Table 3.1). Total recurrent revenue exceeded the target by €209.7 million, but total expenditure exceeded the original budgeted amount by more, €258.5 million.[6]

Table 3.1: Main developments in the Consolidated Fund in 2018 (EUR million)

	Financial Estimates	Actual	Difference
Total recurrent revenue	4350.1	4559.8	209.7
Total expenditure	4371.5	4630.0	258.5
Consolidated Fund balance	-21.4	-70.2	-48.8

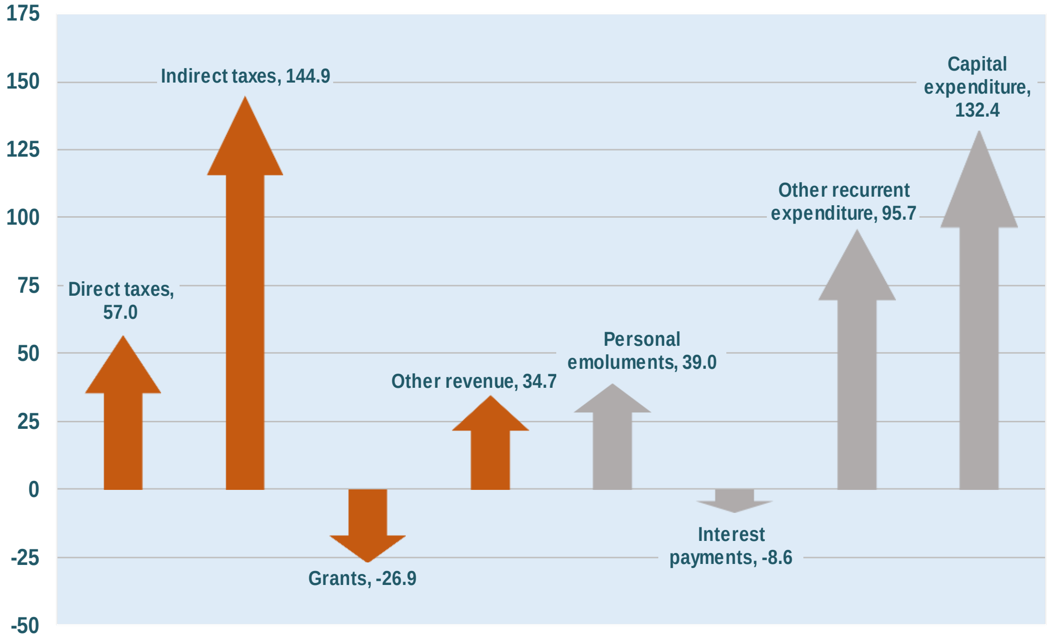
Source: MFIN

Indirect taxes contributed most to the above-target revenue for 2018 (see Chart 3.1). Indirect taxes exceeded the target by €144.9 million, of which, €92.5 million were due to higher Value-Added Tax (VAT). This coincided with the stronger-than-expected nominal growth recorded in private consumption in 2018. Licences, taxes and fines

[4] Since the Consolidated Fund transactions are recorded on a cash basis, they are not directly comparable to the other statistics discussed in this Report. Links with macroeconomic statistics are also imperfect.
[5] Compliance with fiscal rules is evaluated using the ESA figures.
[6] The revenue and expenditure categories featuring in the Consolidated Fund do not correspond precisely to the ESA categories, and hence, the data is not directly comparable.

were also €57.3 million higher than expected. On the contrary, there was a €4.9 million shortfall in customs and excise duties compared to the target.

Chart 3.1: Consolidated Fund – Actual less Estimates (EUR millions)



Source: MFIN

Direct taxes also exceeded the target. Social contributions and income tax were respectively €47.8 million and €9.1 million higher-than-expected. This mirrors the fact that in 2018 growth was more job-rich than expected.

Overall, non-tax revenue was slightly above target, with some components over-achieving but others under-performing. Grants were €26.9 million lower than forecasted, while profits transferred from the Central Bank of Malta were €15.0 million below target. However, these variances were more than offset by increases in miscellaneous components, including fees of office and reimbursements.[7]

On the expenditure side there were overruns both on recurrent and capital expenditure. On the other hand, interest payments were slightly less than projected. This reflected the fact that the outstanding balance of Malta Government Stock (MGS) was lower than anticipated.

[7] Fees of office include revenues due from the Individual Investor Programme (IIP), 30% of which is transferred directly to the Consolidated Fund, while the other 70% is transferred to the National Development and Social Fund (NDSF).

The overrun in recurrent expenditure was broad-based. It was spread across education, health, water, waste, energy, financial intelligence and tourism. Above-target expenditure was reported in the four recurrent expenditure categories in the Consolidated Fund. The largest overrun was on contributions to government entities, which was €47.8 million more than expected. In turn, personal emoluments, programmes and initiatives, and operations and maintenance, had overruns of €39.0 million, €31.8 million and €16.1 million respectively. Spending on capital expenditure exceeded the target by €132.4 million, mainly reflecting a larger co-financing element in relation to EU-funded projects than was previously anticipated.

Over a five-year period, there is a consistent pattern whereby the Consolidated Fund revenue and expenditure targets turn out higher than projected (see Table 3.2). In three out of five years, this resulted in the Consolidated Fund recording a more positive balance (2014, 2016, 2017) and in the other two (2015, 2018) the Consolidated Fund recorded a worse balance. The more positive balance occurred when the actual revenue exceeded the target by more than the additional expenditure, while the worse balance occurred when the actual expenditure exceeded the target by more than the additional revenue.

Apart from grants, all other recurrent revenue components, namely direct taxes, indirect taxes, and 'other revenue' have exceeded their respective target each year between 2014 and 2018, consistent with the prudent revenue forecasts. Expenditure patterns are more complex. Interest payments have consistently been overestimated throughout this period. Likewise, in three out of five years, capital expenditure was less than budgeted. On the other hand, personal emoluments recorded overruns in four years, and 'other recurrent' expenditure in five years.

Table 3.2: Consolidated Fund 2014-2018 – Actual less Estimates (EUR millions)

	2014	2015	2016	2017	2018
Recurrent revenue	**114.3**	**79.7**	**193.7**	**403.6**	**209.7**
Direct taxes	103.3	71.2	140.3	215.2	57.0
Indirect taxes	43.9	60.7	25.9	71.8	144.9
Grants	-64.4	-87.2	2.9	47.3	-26.9
Other revenue	31.5	35.0	24.6	69.3	34.7
Total expenditure	**99.3**	**159.5**	**-11.2**	**92.6**	**258.5**
Personal emoluments	40.7	31.5	-8.0	6.4	39.0
Other recurrent expenditure	94.7	71.2	66.7	102.0	95.7
Interest payments	-3.6	-7.9	-3.4	-4.1	-8.6
Capital expenditure	-32.5	64.7	-66.5	-11.8	132.4
Fiscal balance	**15.0**	**-79.7**	**204.9**	**311.0**	**-48.8**

Source: MFIN

3.2 Developments in the general government balance and debt as per ESA

The general government fiscal balance recorded a surplus of €250.8 million on an ESA basis, significantly higher than the €54.0 million originally indicated in the DBP 2018, and the €132.0 million targeted in the USP 2018 – 2021 (see Table 3.3).[8]

Revenue and expenditure were higher than anticipated, both when compared to the DBP, and when compared to the USP. However, in the latter case the differences were smaller, particularly as the USP had revised upwards the revenue and expenditure projections. The DBP underestimated revenue by €414.0 million or 9.5%, and underestimated expenditure by €217.1 million or 5.0%. Despite upward revisions

[8] The difference in methodology between the Consolidated Fund and the ESA transactions may be so significant to the extent that as has happened for the year 2018, the Consolidated Fund recorded a fiscal deficit whereas according to the ESA, a fiscal surplus was recorded.

undertaken in the USP, revenue and expenditure were still underestimated in the USP. However, whereas the revenue variance remained significant, at €128.1 million, in the case of expenditure the variance was limited to €9.2 million.

Table 3.3: Main developments in 2018 on an ESA basis (EUR millions)

	DBP October 2017	USP April 2018	Actual April 2019	Difference with respect to the DBP		Difference with respect to the USP	
				Amount	%	Amount	%
Revenue	4,369.3	4,655.2	4,783.3	414.0	9.5	128.1	2.8
Expenditure	4,315.3	4,523.2	4,532.4	217.1	5.0	9.2	0.2
Balance	54.0	132.0	250.8	196.8	-	118.8	-

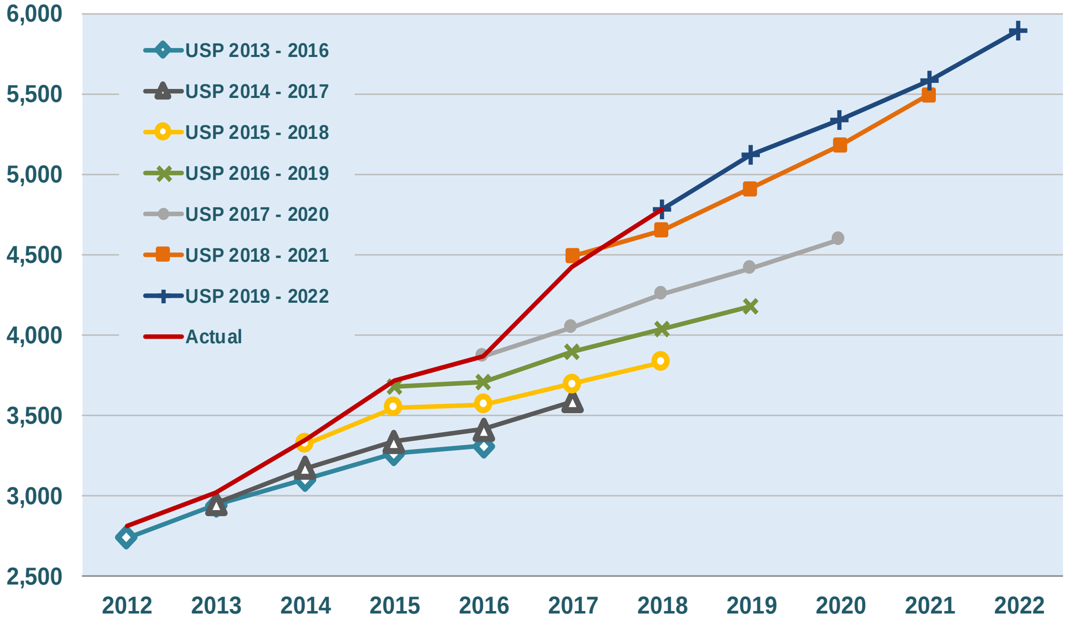
Source: MFIN

The stronger fiscal surplus recorded in 2018 can thus be ascribed to the superior revenue performance. This was underpinned by higher taxes on production and imports and higher market output, which respectively yielded €106.6 million and €99.5 million more than budgeted. The higher indirect taxes were in line with the stronger-than-expected nominal consumption growth, whereas the additional market output was driven by proceeds from the Individual Investor Programme (IIP). On the other hand, the target for current taxes on income and wealth was missed by €92.9 million, with the MFIN stating that this was mainly due to the larger amount of refunds processed during the year.

On the expenditure side, capital transfers and social payments were €35.4 million and €32.3 million less than budgeted, while interest payments were €3.4 million less than anticipated. However, these shortfalls were more than offset by broad-based overruns across the other expenditure components. In absolute terms the largest deviation was in intermediate consumption which amounted to €26.7 million higher than expected. Other variances were as follows: subsidies +€15.4 million, gross fixed capital formation +€12.4 million, compensation of employees +€8.8 million and ‘other expenditure’ +€17.2 million.

Over a medium-term horizon, despite revenue forecasts being revised upwards over consecutive years, such forecasts continued to under-estimate the yearly revenue (see Chart 3.2).[9] Similar patterns emerge in the case of expenditure where the actual expenditure was consistently higher than planned (see Chart 3.3). Between 2013 and 2015, the additional revenue was practically matched with additional expenditure. Indeed, the fiscal balance targets remained stable during these years and the actual outturn was close to the target (see Chart 3.4). On the other hand, between 2016 and 2018, the actual fiscal balance exceeded the targets, as part of the surplus revenue was channelled into a larger fiscal surplus.

Chart 3.2: Revenue targets indicated in consecutive USPs (EUR millions)



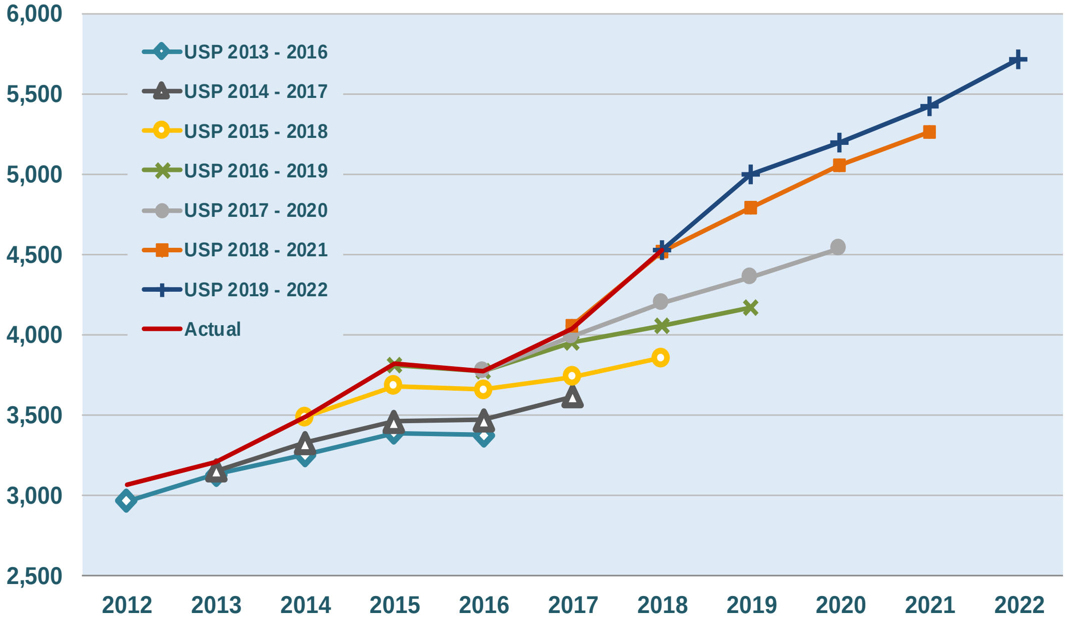
Sources: MFIN, NSO

In the case of the public debt-to-GDP ratio, the 2018 forecasts were accurate, with the variance being only 0.2 pp. Indeed, the USP had targeted a ratio of 45.8%, whereas the outturn was 46.0% (see Chart 3.5). Higher-than-expected stock-flow adjustments practically offset the impact of a larger fiscal surplus and stronger nominal GDP growth.

The discrepancies related to the earlier forecast vintages (prior to 2018) were to a large degree underpinned by upward revisions carried out by the NSO to the historical nominal GDP series, which resulted in lower public debt ratios than previously estimated.

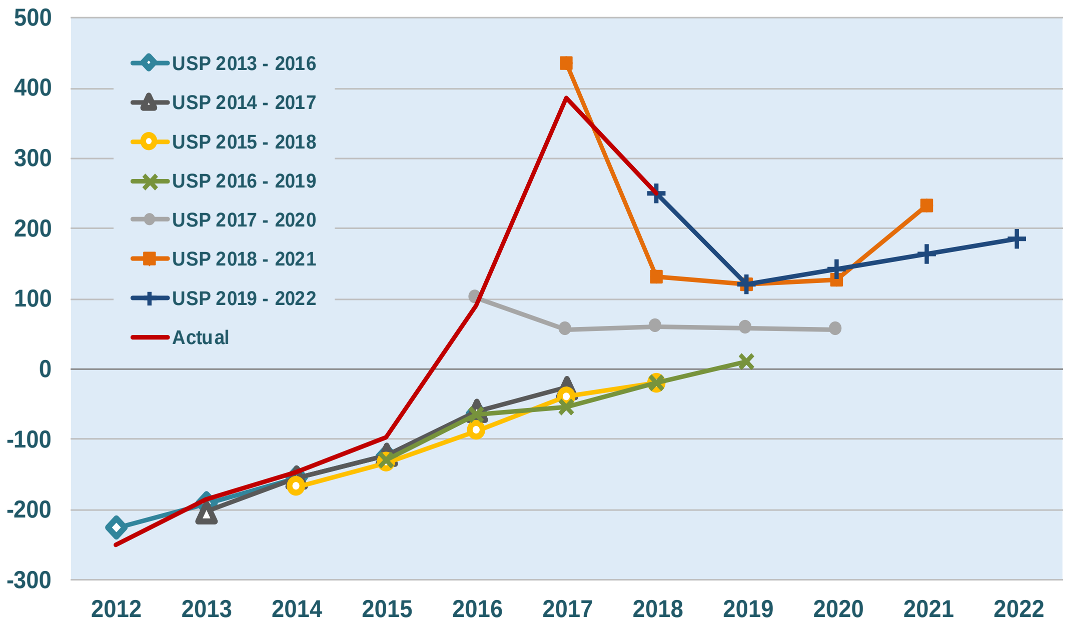
[9] This can be deduced from the upward shifts in the forecasts which nonetheless remained below the actual outturn.

Chart 3.3: Expenditure targets indicated in consecutive USPs (EUR millions)



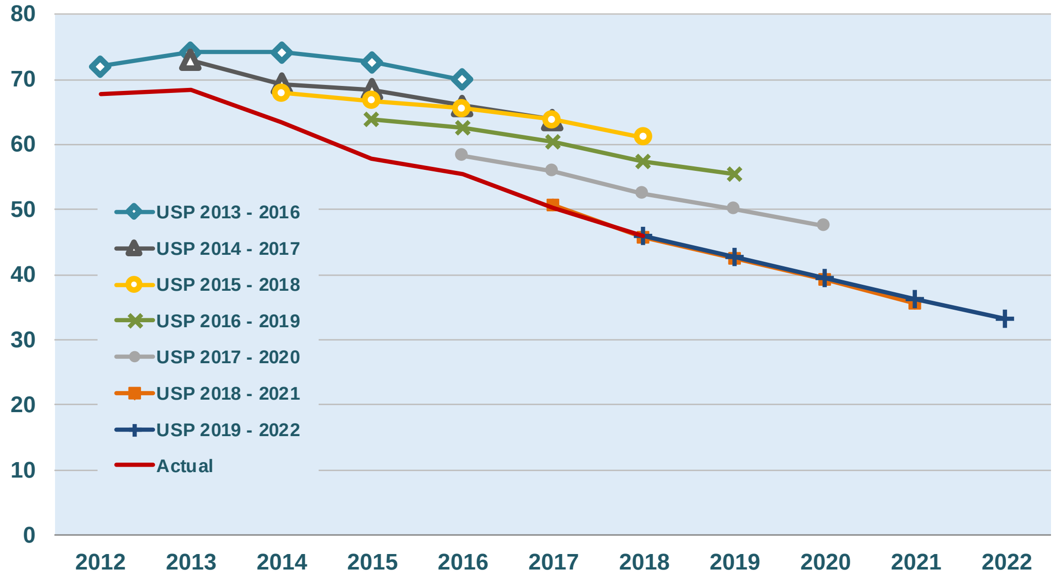
Sources: MFIN, NSO

Chart 3.4: Fiscal balance targets indicated in consecutive USPs (EUR millions)



Sources: MFIN, NSO

Chart 3.5: Public debt targets indicated in consecutive USPs (% of GDP)



Sources: MFIN, NSO

Chapter 4

Macroeconomic updates for 2019

The Half-Yearly Report reconfirmed the macroeconomic forecasts which had been presented in the USP 2019 – 2022, in line with the approach adopted in previous years. The macroeconomic forecasts published in the USP 2019 – 2022, which have been analysed and endorsed by the MFAC, thus serve as Malta's latest official macroeconomic forecasts.[10] The MFIN considered that "a revised growth outlook is not yet being considered at this stage". The MFIN acknowledged that some external risks were materialising, suggesting that downward revisions in export growth may be warranted. However, labour market conditions in Malta remained strong. In turn, the expected strong pace of investment activity remained plausible, as some unanticipated large-scale investments in the transport sector, compensated for potential delays in construction.

The USP had revised the 2019 nominal and real GDP growth forecasts slightly upwards, compared to the DBP 2019. The revisions were respectively in the order of 1.6pp and 0.9pp (see Chart 4.1). Both forecasts rounds anticipated domestic demand to be the main driver of growth for 2019 (see Chart 4.2). However, there was a generalised upward revision in the growth rates of the domestic demand components. Indeed, the USP indicated faster growth in private consumption, government consumption and gross fixed capital formation, compared to the DBP. On the other hand, the contribution to growth stemming from the external sector was revised from slightly positive, in the DBP, to slightly negative, in the USP. This change reflected the fact that the upward revision in import growth exceeded the upward revision in export growth.

Following the publication of the USP (in April), the NSO published the official first quarter national accounts data for 2019 (in June).[11] These indicate that during the first quarter, year-on-year nominal and real GDP growth was 7.4% and 4.9% respectively, 1.9pp and 1.3pp lower than indicated in the USP forecasts for the entire year.

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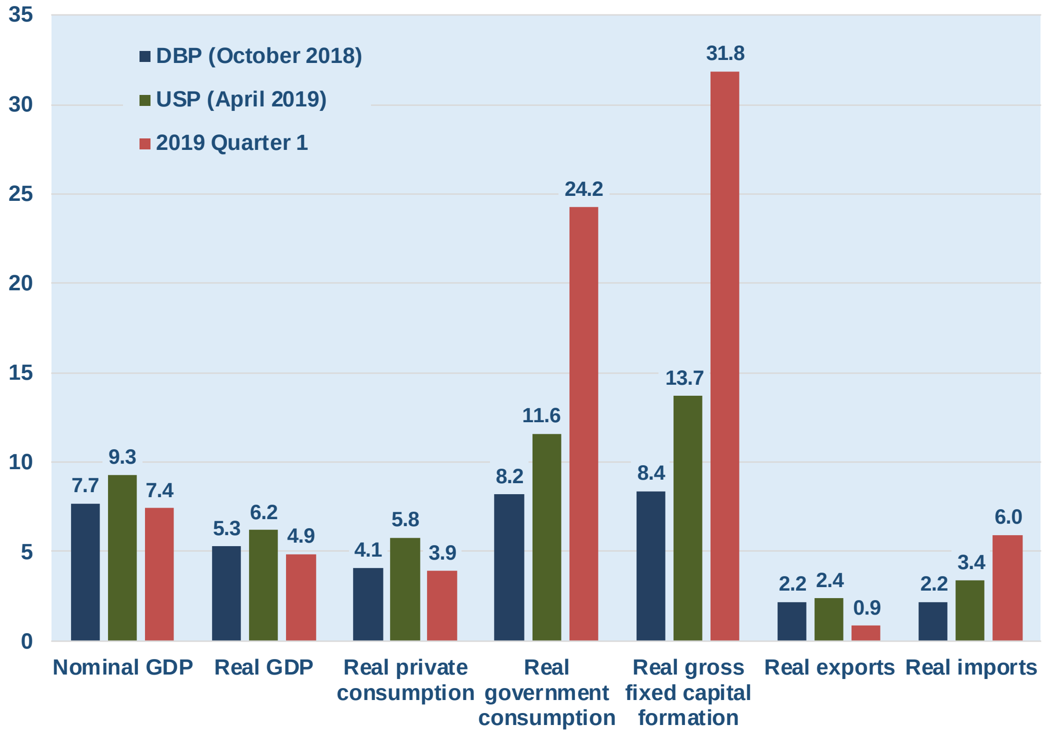
[10] The MFAC's assessment is available on https://mfac.org.mt/en/publications/Pages/Publications.aspx.

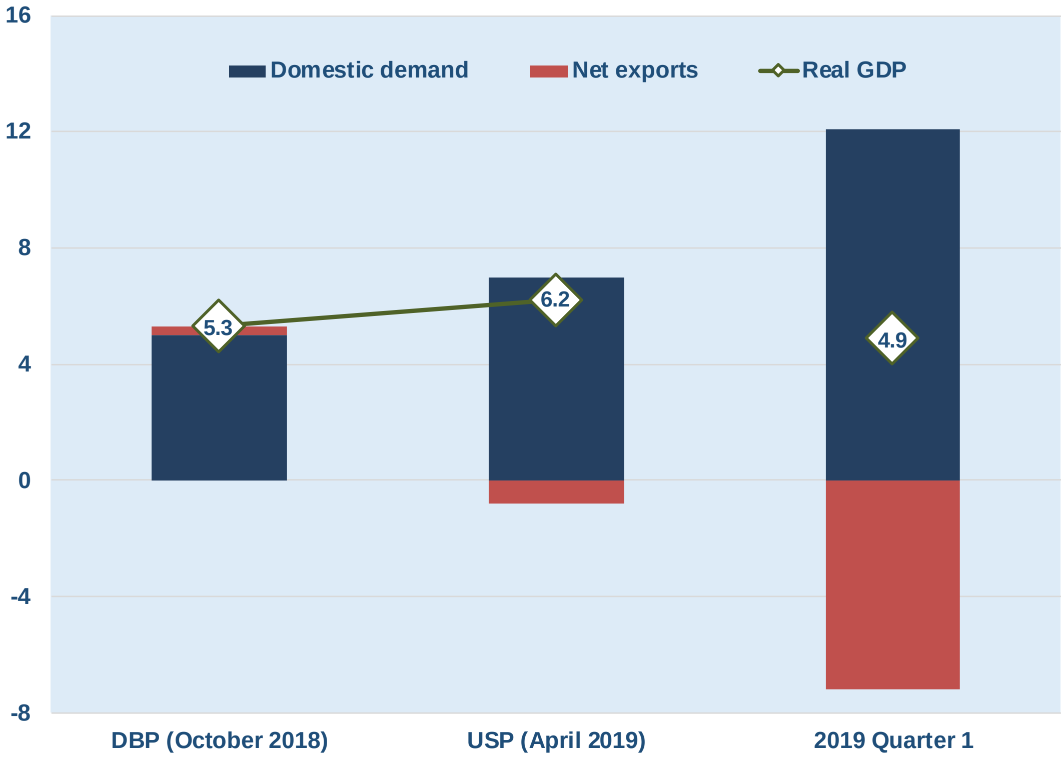
[11] Source: NSO News Release 090/2019 available on https://nso.gov.mt/en/News_Releases/View_by_Unit/Unit_A1/National_Accounts/Documents/2019/News2019_090.pdf.

Chart 4.1: Growth in GDP and its components (y-o-y % change)



Note: figures for the DBP and the USP relate to the full year.
Source: MFIN

Chart 4.2: Contributions to real GDP growth (pp)



Note: figures for the DBP and the USP relate to the full year.
Source: MFIN

The official data indicates that domestic demand was the main driver of growth during the first quarter of 2019, compatible with the pattern indicated in the USP. However, the magnitude was larger, owing to stronger growth in government consumption and gross fixed capital formation, which more than compensated for the slower growth in private consumption. Meanwhile, the magnitude of the negative contribution to growth from the external sector was significantly larger, as real imports grew faster, while real exports grew slower, than indicated in the USP. Such developments are however to be considered as only indicative. The information derived from the first quarter national accounts developments is not necessarily indicative of the yearly outturn, in view of possible volatility in the data, and possible revisions in the historical data.

The USP also updated other key macroeconomic forecasts (see Chart 4.3). Potential GDP growth was raised slightly, from 6.2% to 6.5%. As a result, the output gap was increased slightly, from 0.1% to 0.4% of potential GDP. In turn, the unemployment rate was lowered from 4.1% to 3.8%, while employment growth was increased from 3.7% to 4.6%. Labour force survey statistics for the first quarter of 2019, confirm the strong labour market performance, with estimates indicating that employment increased by 6.6% year-on-year, while the unemployment rate stood at 3.5%.[12] The inflation rate forecast was retained at 1.9% in the USP. This is in line with the annual inflation rate based on the Harmonised Index of Consumer Prices (HICP), which stood at 1.8% as at June 2019.[13]

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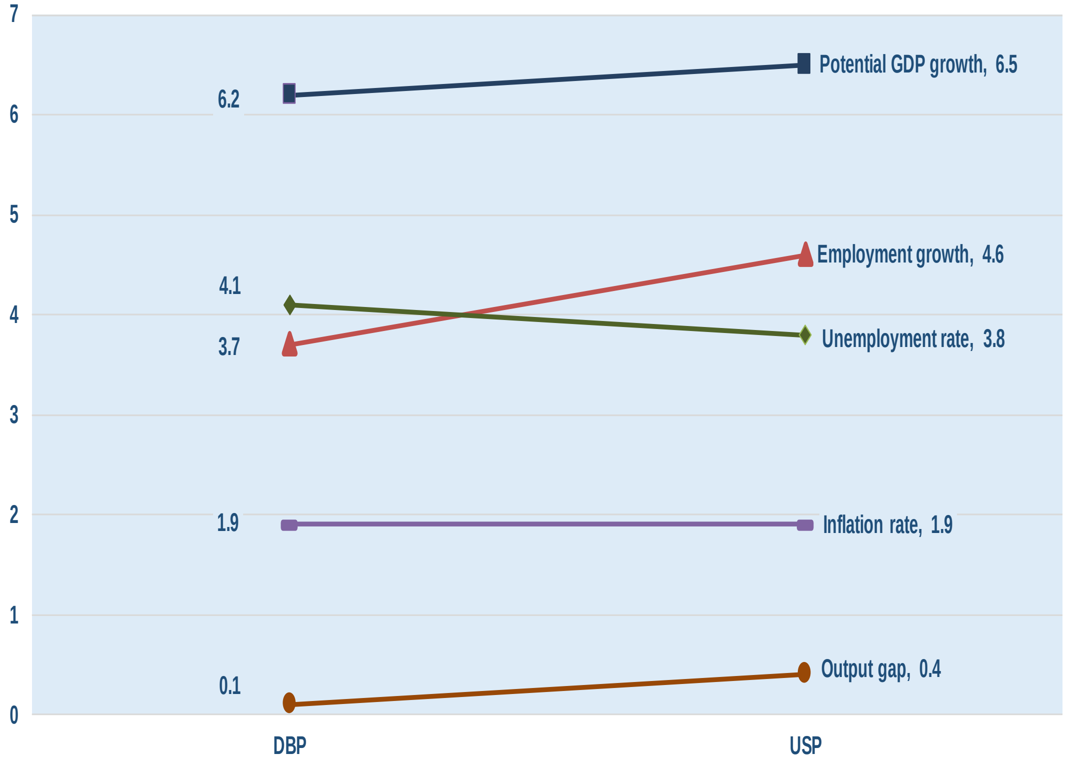
[12] Source: NSO News Release 101/2019 available on https://nso.gov.mt/en/News_Releases/View_by_Unit/Unit_C2/Labour_Market_Statistics/Documents/2019/News2019_101.pdf.

[13] Source: NSO News Release 101/2019 available on https://nso.gov.mt/en/News_Releases/View_by_Unit/Unit_C2/Labour_Market_Statistics/Documents/2019/News2019_101.pdf.

Chart 4.3: Forecasts for other macroeconomic variables for 2019 (%)



Source: MFIN

Chapter 5
Fiscal updates for 2019

5.1 Fiscal targets on an ESA basis

The Half-Yearly Report reconfirmed the fiscal forecasts which had been presented in the USP 2019 – 2022. These forecasts, which have been analysed and endorsed by the MFAC, thus serve as Malta's latest official fiscal forecasts.[14] The fiscal surplus for 2019 is targeted at €120.3 million, equivalent to 0.9% of GDP (see Table 5.1). In structural terms, the fiscal surplus is estimated to amount to 0.7% of potential output. In both cases, the targets indicated in the USP are slightly less ambitious than had been anticipated in the DBP, particularly as the planned higher expenditure (+€115.1 million) exceeds the upward revision in the anticipated revenue (+€70.4 million). The outstanding public debt was also raised in absolute terms, but its ratio to nominal GDP was lowered slightly, to 42.7%, in view of the upward revision in the denominator. Such revisions reflected updated information or special factors, with limited contributions stemming also from the macroeconomic forecast updates presented in the USP.[15]

5.1.1 Revenue targets

The estimated intake from current taxes on income and wealth was lowered by €139.0 million. This was mainly ascribed to a base effect, since the 2018 outturn for this revenue component fell short of its target, in view of larger amount of refunds.[16] On the other hand, the upward revision in taxes on production and imports reflected the carrying forward of the positive base effect created by the better-than-expected outturn in 2018, as well as the higher nominal consumption growth anticipated in the USP, when compared to the DBP. Other revenue was scaled up by €144.2 million, underpinned by updated estimates on the inflow of EU funds and the market output of the EBUs (which include the proceeds derived from the IIP). Upward revisions were also undertaken in relation to social contributions (consistent with the upward revision in employment growth), property income and capital taxes.

[14] The MFAC's assessment is available on https://mfac.org.mt/en/publications/Pages/Publications.aspx.
[15] Refer to chapter 4 in this Report for details about the macroeconomic forecast revisions.
[16] Refer to chapter 3 in this Report for details about the fiscal outturn in 2018.

Table 5.1: Fiscal forecasts for 2019 (EUR millions)

	DBP October 2018	USP April 2019	Change USP–DBP	% USP–DBP
Total revenue	**5,054.0**	**5,124.4**	**70.4**	**1.4**
Taxes on production and imports	1,613.8	1,665.8	52.0	3.2
Current taxes on income & wealth	1,935.4	1,796.4	-139.0	-7.2
Capital taxes	26.5	27.2	0.7	2.7
Social contributions	807.3	817.5	10.3	1.3
Property income	66.2	68.5	2.2	3.4
Other revenue	604.8	749.0	144.2	23.8
Total expenditure	**4,889.0**	**5,004.1**	**115.1**	**2.4**
Compensation of employees	1,467.7	1,490.3	22.6	1.5
Intermediate consumption	886.8	936.9	50.0	5.6
Social payments	1,290.3	1,275.1	-15.2	-1.2
Interest expenditure	187.8	186.5	-1.3	-0.7
Subsidies	177.0	165.4	-11.6	-6.5
Gross fixed capital formation	465.3	525.1	59.7	12.8
Capital transfers payable	157.7	168.6	10.9	6.9
Other expenditure	256.4	256.2	-0.2	-0.1
Fiscal balance – EUR millions	**165.0**	**120.3**	**-44.7**	**-27.1**
Fiscal balance – % of GDP*	**1.3%**	**0.9%**	**-0.4%**	**-**
Structural balance – % of Pot GDP*	**1.2%**	**0.7%**	**-0.5%**	**-**
Gross debt	**5,660.1**	**5,755.8**	**95.7**	**1.7**
Gross debt – % of GDP*	**43.8%**	**42.7%**	**-1.1%**	**-**

* The value of nominal GDP and potential GDP is that specified in the respective forecast round.

Source: MFIN

5.1.2 Expenditure targets

The upward expenditure revisions were primarily channelled into higher spending on gross fixed capital formation (+€59.7 million) and intermediate consumption (+€50.0 million). In the first case, these reflected plans for higher spending on EU-funded capital projects, while in the second case, this related mainly to higher allocations for urban area landscaping and social sector residential homes. Compensation of employees and capital transfers were also revised upwards, but their impact on the budget was fully offset by savings on social payments and subsidies. The USP also factored marginal savings in relation to interest payments and ‘other’ expenditure compared to the DBP.

5.2 The outturn for the first half of 2019

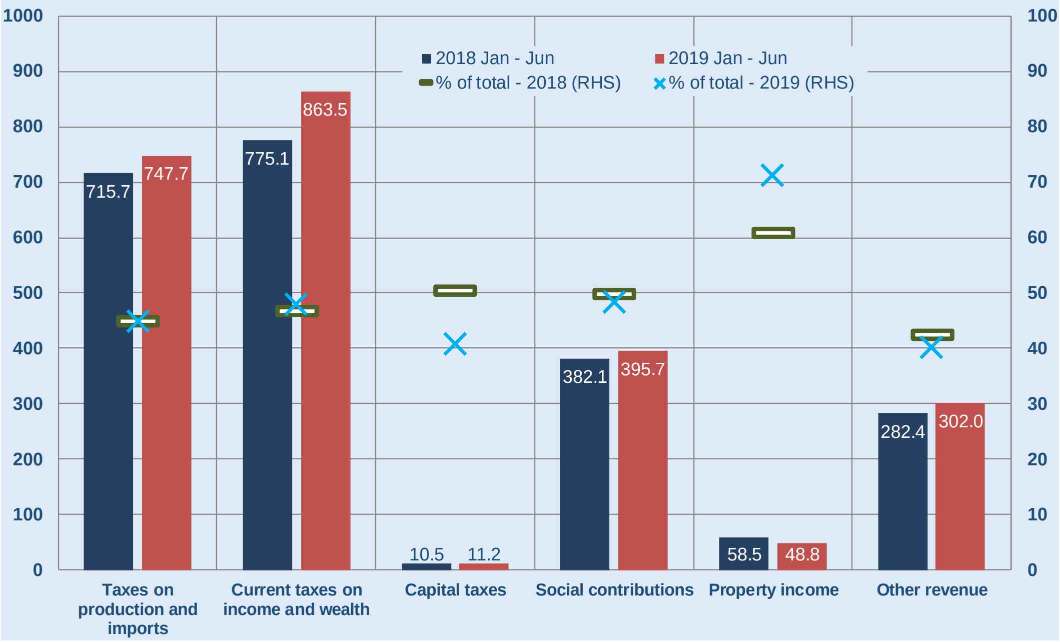
The mid-year fiscal performance can be used to gauge the progress towards the attainment of the fiscal targets for 2019, as specified in the USP. The caveat is that such data is highly provisional. Whereas the first quarter data is based on official estimates published by the NSO (News Release 105/2019), the data for the second quarter is provisionally estimated by the MFIN.[17]

As at June 2019, revenue was 46.2% of the annual target indicated in the USP. The three main revenue items, taxes on production and imports, current taxes on income and wealth and social contributions, were all close to the 50.0% benchmark, respectively recording 44.9%, 48.1% and 48.4% of the anticipated revenue (see Chart 5.1). Performance was in line with that observed in 2018. ‘Other’ revenue reached 40.3% of the total, comparable to 2018. The variations relating to capital taxes and property income, despite being larger, are deemed to be less material, as these components account for a small proportion of total revenue.

Expenditure absorbed 47.5% of the budgeted amount during the first six months of 2019. Even in this case, the three largest components, compensation of employees, intermediate consumption and social payments were all close to the 50.0% benchmark (see Chart 5.2).

[17] This practice has always been used by the MFIN since the official second quarter fiscal data is not available by the cut-off date for the preparation of the Half-Yearly Report.

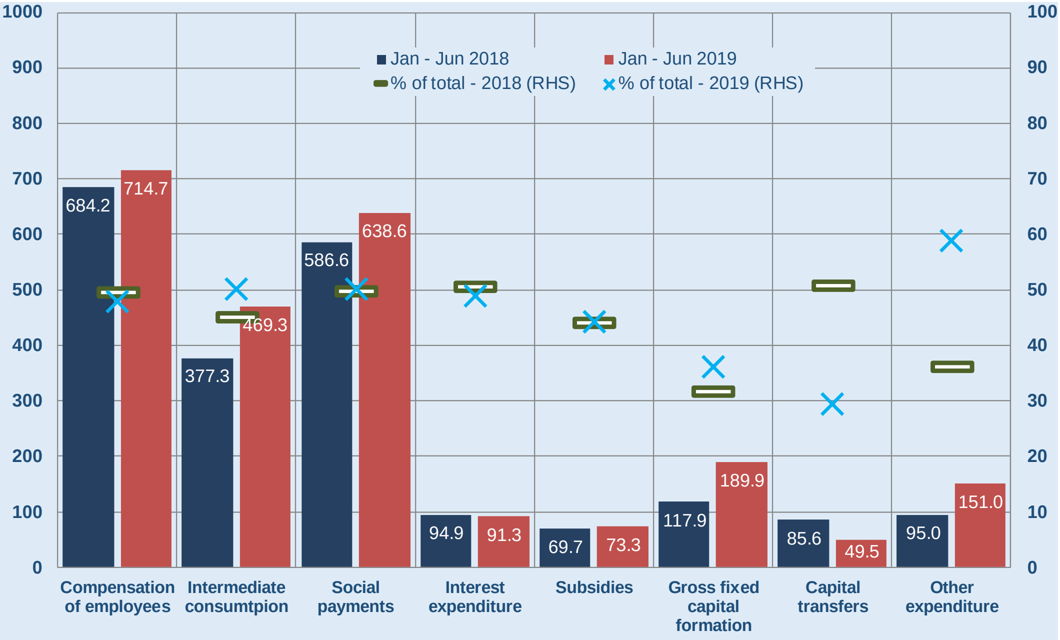
Chart 5.1: Half-yearly revenue developments (EUR millions, %)



Note: The chart shows the absolute amounts and the percentage utilisation of the annual budget for the first half of the year.

Source: MFIN

Chart 5.2: Half-yearly expenditure developments (EUR millions, %)



Note: The chart shows the absolute amounts and the percentage utilisation of the annual budget for the first half of the year.

Source: MFIN

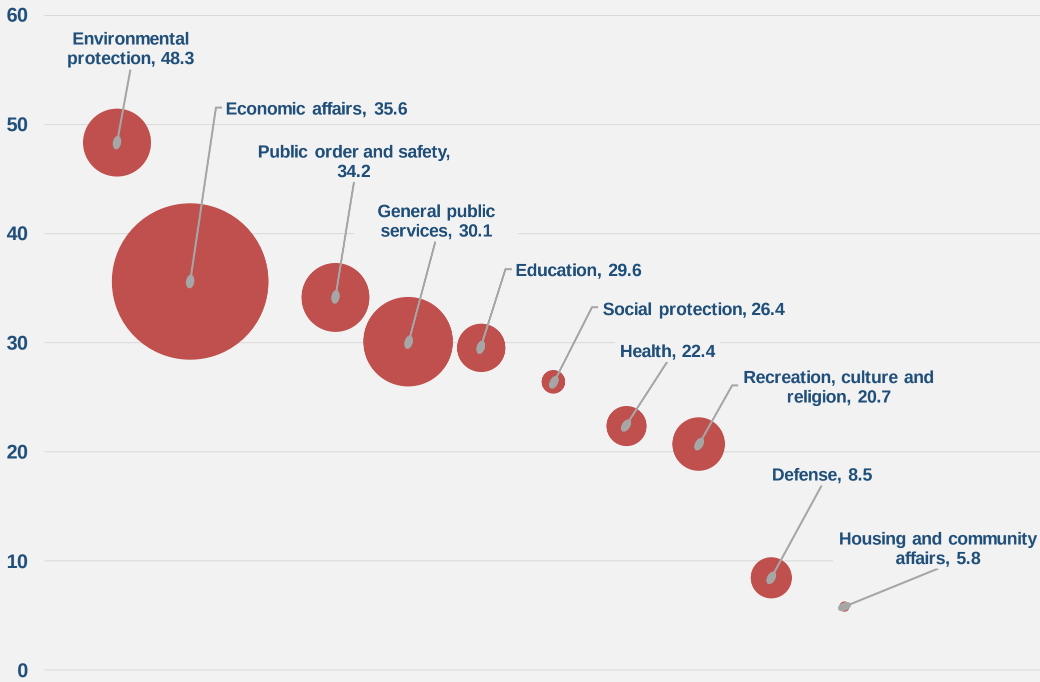
On the other hand, the utilisation of funds for gross fixed capital formation was 36.2% of the budgeted amount (see Box 5.1). However, in absolute terms it is above the level recorded a year earlier, and it is also higher than the 31.8% budget utilisation recorded in 2018. Indeed, intra-year progress in this expenditure component can be rather uneven. Capital transfers were down on a year earlier, utilising only 29.3% of the budgeted amount. On the contrary, 'other' expenditure amounted to 58.9% of the annual budget, which is higher than the 36.2% recorded in 2018.

Box 5.1: Progress in capital expenditure

The Consolidated Fund provides information about the utilisation of capital expenditure by function. However, patterns are only indicative as this is compiled on a cash basis and has different coverage and thus not directly comparable to the ESA data.

During the first six months of 2019, progress was rather uneven across functions (see Chart A).

Chart A: Utilisation of the capital budget by function (%)



Note: the size of the circles shows the relative size of the amount budgeted for the year (the larger the circles the larger the budgeted amounts). The economic functions are ranked in descending order according to the utilisation of the budget in percentage terms.

Source: MFIN

Spending on environmental protection amounted to 48.3% of the total. On the other hand, spending on economic affairs, and on general public services, which represent the two largest components of capital expenditure, amounted to 35.6% and 30.1% respectively. Defence and housing and community affairs utilised the least, in percentage terms. However, these components account for a small share in total capital expenditure, thus exerting a small impact on the overall aggregate.

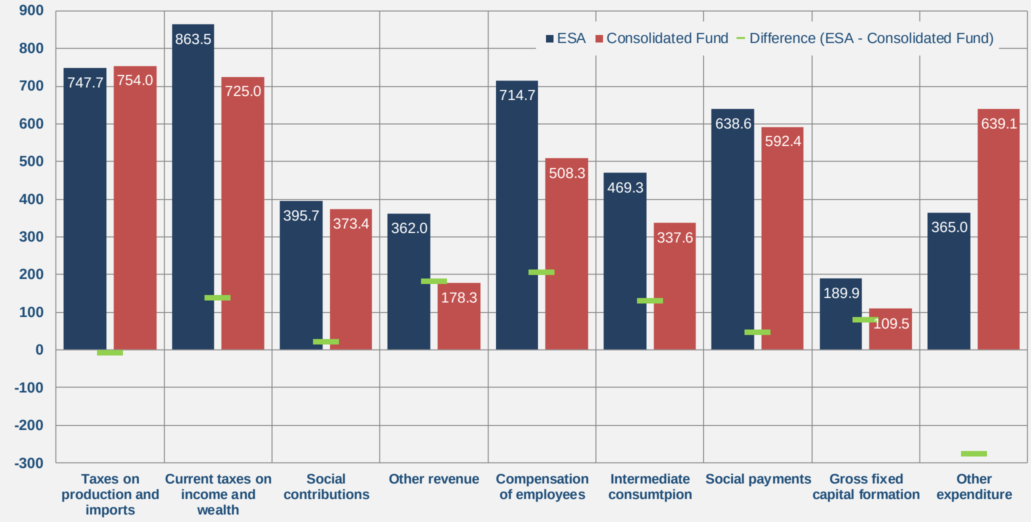
According to the provisional ESA estimates, the fiscal balance recorded a deficit of €8.5 million during the first half of 2019, compared to the fiscal surplus target for the whole of 2019 of €120.3 million. Meanwhile the Consolidated Fund showed a deficit of €156.2 million during the first six months of 2019, compared to the €33.3 million surplus target for the whole of 2019 indicated in the Approved Estimates (see Box 5.2). However, the six-monthly outturn is not necessarily indicative for the year in view of uneven revenue collection and spending patterns.

Box 5.2: Reconciliation between the ESA and the Consolidated Fund data

ESA data for the first six months of 2019 shows total revenue and total expenditure which are respectively €338.2 million and €190.5 million higher than indicated in the Consolidated Fund, giving rise to the difference between the fiscal balance as compiled under both methodologies.

On the revenue side, current taxes on income and 'other' revenue exhibit the largest differences, being larger under ESA (see Chart B). In the first case this mainly reflects arrears, while in the second case, this mainly reflects the 70% of the revenues associated with the IIP (which in both cases are included in the ESA, but not in the Consolidated Fund). On the other hand, the additional ESA expenditure under the various main components mainly reflects the operations of the EBUs. This effect is partially mitigated by netting off certain expenditure which represent transfers within the public sector (this explains the lower ESA expenditure under the 'other' category compared to the figures in the Consolidated Fund).

Chart B: ESA and Consolidated Fund (EUR millions)



Source: MFIN

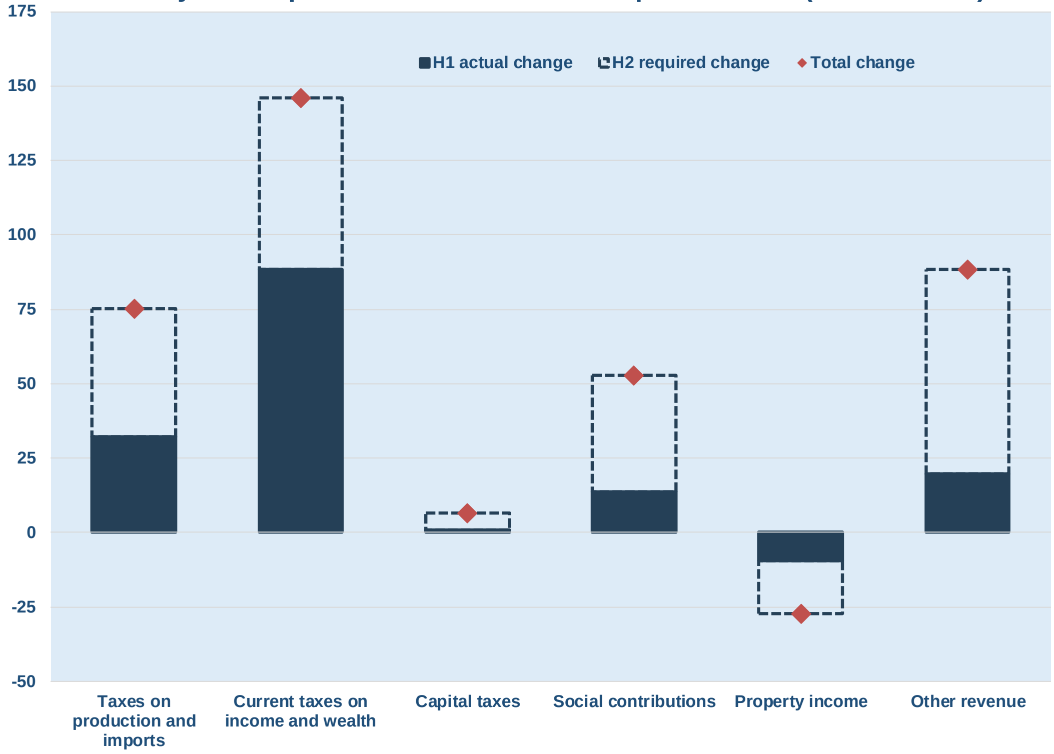
5.3 The required fiscal outturn for the second half of 2019

The mid-year provisional performance (in ESA terms) indicates that in some cases, progress is in line with the annual target changes over 2018, but there is a bigger challenge to reach the stated targets in some other cases.

On the revenue side, it can be noted that the required second-half performance in social contributions and 'other' revenue is superior to that recorded during the first half (see Chart 5.3). On the other hand, the estimated and required performance in the remaining revenue categories during the first and second half is broadly similar.

On the expenditure front, the additional intermediate consumption recorded during the first half absorbed the bulk of the budgeted increase for the year (see Chart 5.4). 'Other' expenditure increased, in contrast with the planned decline for the year. These overshoots are however mitigated by the lower than-planned budget utilisation in the remaining expenditure categories.

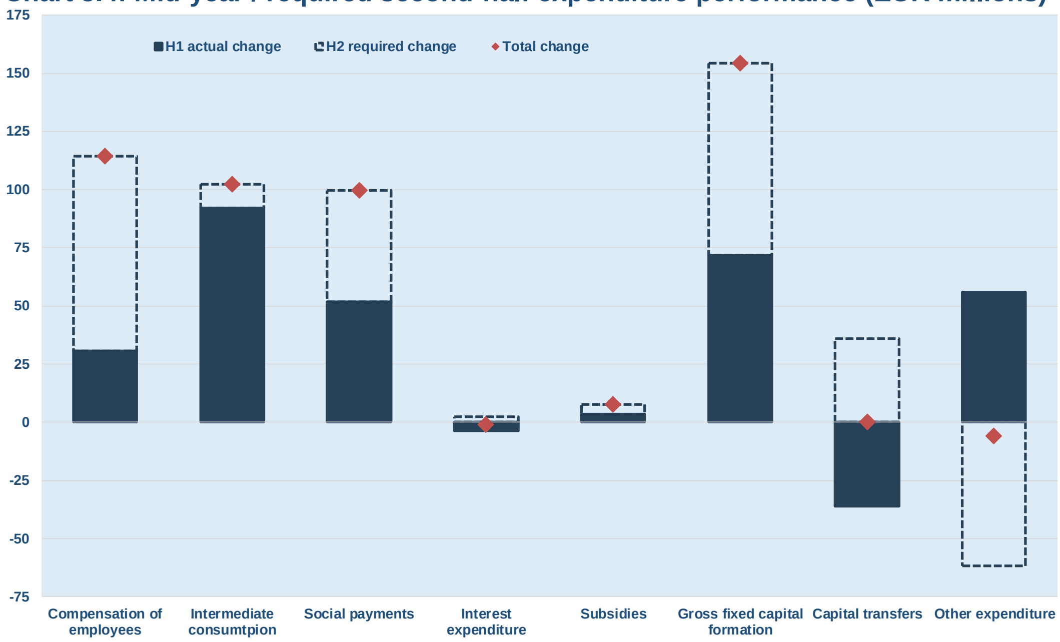
Chart 5.3: Mid-year / required second-half revenue performance (EUR millions)



Note: The shaded bars show the actual change during the first half of 2019 compared to the first half of 2018, while the transparent bars indicate the required change during the second half of 2019 compared to the second half of 2018, to ensure that the annual change is in line with the fiscal targets.

Source: MFIN

Chart 5.4: Mid-year / required second-half expenditure performance (EUR millions)



Note: The shaded bars show the actual change during the first half of 2019 compared to the first half of 2018, while the transparent bars indicate the required change during the second half of 2019 compared to the second half of 2018, to ensure that the annual change is in line with the fiscal targets.

Source: MFIN

5.4 Outstanding creditors and revenue arrears

As at June 2019, the outstanding creditors increased by €54.6 million compared to December 2018 (see Table 5.2). This estimate is however provisional.[18] Higher outstanding creditors were reported by the Ministry for Education and Employment (+€14.5 million), the Ministry for Transport, Infrastructure and Capital Projects (+€11.0 million), the Ministry for Energy and Water Management (+€8.0 million), the Ministry for Justice, Culture and Local Government (+€7.3 million) and Social Security Benefits (+€3.6 million). Other smaller changes were spread across the various entities, which together had an estimated net upward effect amounting to €17.6 million. On the other hand, declines were reported by the Government Pharmaceutical Services (-€6.0 million) and the Elderly and Community Care (-€1.6 million).

Table 5.2 Outstanding creditors (EUR millions)

	December 2018	June 2019	Difference
Total outstanding creditors	**127.9**	**182.5**	**54.6**
Government Property Division*	44.4	44.4	0.0
Government Pharmaceutical Services**	29.9	23.9	-6.0
Elderly and Community Care**	23.5	21.9	-1.6
Ministry for Education and Employment***	2.4	16.9	14.5
Ministry for Transport, Infrastructure and Capital Projects	5.8	16.8	11.0
Ministry for Energy and Water Management***	0.0	8.0	8.0
Ministry for Justice, Culture and Local Government**	0.1	7.4	7.3
Social Security Benefits	1.5	5.1	3.6
Other***	20.4	38.1	17.6

Note: The entities are ordered according to their outstanding creditors as at end June 2019.
* The latest data submitted relate to September 2018.
** The figures relate to March 2019.
*** Provisional data yet to be validated.
Source: MFIN

[18] Not all data had been validated for accuracy by the MFIN and in the case of the Government Property Division (which accounts for a substantial part of the overall outstanding creditors), the latest data submitted related to September 2018.

With respect to revenue arrears, the amount collected during the first half of 2019 amounted to €47.3 million, which exceeded the €26.6 million target (see Table 5.3). Revenue arrears are mainly related to the MFIN, specifically the Inland Revenue Department (IRD) and Value Added Tax (VAT). The revenue arrears collected by the IRD was practically double the targeted amount, while in the case of VAT, the collection of arrears exceeded the targeted amount by €9.9 million. On a net basis, arrears across the rest of the government departments fell €2.3 million short of the target, spread across different departments.

Table 5.3 Revenue arrears (EUR millions)

	Target	Collected	Difference
Total revenue arrears	**26.6**	**47.3**	**20.7**
Of which			
Inland Revenue	13.3	26.4	13.1
VAT	5.5	15.4	9.9
Other	7.8	5.5	-2.3

Source: MFIN

Chapter 6
Conclusion

Nominal GDP growth and the size of the fiscal surplus for 2018, on an ESA basis, turned out better than was anticipated by MFIN. This is in line with the general level of prudence employed by the MFIN in the preparation of the macroeconomic and fiscal forecasts. The MFIN's macroeconomic forecasting performance track record is judged to be reasonably good, when considering the challenges created by volatile official data and data revisions. Moreover, the attainment, and at times, the exceeding of the headline fiscal targets, confirms the prudent track record of the official fiscal projections, and the commitment to the stated targets. Good quality macroeconomic and fiscal forecasts are a pre-requisite for sound policy making, and it is important that the MFIN continues to allocate adequate resources and time for their production.

Looking ahead, the MFIN is invited to explore how to improve the accuracy of specific forecasts at a component level. Achieving more accurate forecasts for gross fixed capital formation, especially vis-à-vis public investment, should be prioritised, since in this case, deviations have tended to be among the highest. This is important since public sector investment impacts not only the government expenditure projections but also the broader national accounts forecasts, particularly imports.[19] Ministries and public sector entities should aim to maintain investment plans which are as detailed, accurate, and closely adhered to, as possible.

The MFAC takes note that the MFIN reconfirmed the macroeconomic and fiscal forecasts for 2019, as had been published in the USP, in April 2019. These forecasts have already been endorsed by the MFAC. The explanations provided by the MFIN to justify the macroeconomic and fiscal revisions undertaken in the USP compared to the DBP contribute to enhanced transparency and better accountability. The information available by the cut-off date, relating mainly to the first quarter national accounts statistics and the mid-year fiscal estimates, do not alter the plausibility of the official forecasts, which thus remain within the MFAC's endorsable range. At the same time the MFAC invites the MFIN to remain vigilant to ensure that the fiscal targets for the year are met. This is more important particularly in those cases where the revenue and expenditure performance required during the second half of 2019 appears relatively ambitious compared to the actual performance recorded during the first half of the year.

[19] The impact on the fiscal balance is mitigated if the investment is mainly financed through EU funds. The impact on GDP is also mitigated when gross fixed capital formation is mainly imported.

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