Assessment of the Draft Budgetary Plan 2020

MALTA FISCAL ADVISORY COUNCIL

December 2019

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Minister for Finance
Maison Demandols,
South Street,
Valletta. VLT 2000

Dear Minister,

OVERALL ASSESSMENT OF THE MACROECONOMIC AND FISCAL FORECASTS FOR 2019 AND 2020 & COMPLIANCE WITH THE FISCAL RULES

As a follow-up to the letter of endorsement in relation to the macroeconomic forecasts, dated 14 October 2019, the Malta Fiscal Advisory Council is hereby presenting the full assessment report dealing with the Draft Budgetary Plan 2020, in terms of the Fiscal Responsibility Act.

The Malta Fiscal Advisory Council considers the updated macroeconomic and fiscal forecasts for 2019 and 2020 to be within its endorsable range. The plans also comply 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. Comparisons with the forecasts prepared by other independent institutions were also carried out, and these indicated close similarity with the official forecasts.

The assessment carried out on the individual GDP expenditure components suggests a broadly neutral risk outlook vis-à-vis real GDP growth for 2019 and 2020. This is the net result of opposing risks to some of the components which compensate for each other. In turn, the assessment carried out on the individual revenue and expenditure components, suggests possible upside risks for the fiscal balance in 2019, but downside risks for 2020. This is contingent on the materialisation of the macroeconomic scenario as presented in the Draft Budgetary Plan, and close adherence to the stated fiscal plans.

The Fiscal Council confirms there was full compliance with the fiscal rules in 2018, and based on the updated macroeconomic and fiscal outlook, such fiscal rules are expected to continue being adhered to over the forecast horizon. 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.

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. Such fiscal space would prove beneficial in the eventuality that economic conditions become less favourable at some future date. Vigilance remains important, particularly as elements of uncertainty remain. The external economic conditions might become more challenging and / or the intensity of domestic demand could abate. The Council also reiterates the importance that expenditure developments should be monitored carefully, to factor in any possible future risks to the robustness of revenues.

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	Auto-Regressive Integrated Moving Average
CBM	Central Bank of Malta
COM	European Commission
DBP	Draft Budgetary Plan
EBU	Extra-Budgetary Unit
ECB	European Central Bank
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
IMF	International Monetary Fund
LFS	Labour Force Survey
MFAC	Malta Fiscal Advisory Council
MFIN	Ministry for Finance
MGS	Malta Government Stock
MOSS	Mini One Stop Shop
MTO	Medium-Term Budgetary Objective
NDSF	National Development and Social Fund
NPISH	Non-Profit Institutions Serving Households
NSO	National Statistics Office
PPP	Public-Private Partnership
pp	percentage point
SGP	Stability and Growth Pact
STEMM	Short-Term Quarterly Economic Forecasting Model
STG	sterling
USD	US dollar
USP	Update of Stability Programme
VAR	Vector Auto-Regressive
VAT	Value-Added Tax
VECM	Vector Error-Correction Model

Executive Summary

This Report assesses the macroeconomic and fiscal forecasts for 2019 and 2020 contained in the Draft Budgetary Plan, which the Ministry for Finance submitted to the European Commission on 15 October 2019. The Malta Fiscal Advisory Council considers these macroeconomic and fiscal forecasts to lie within its endorsable range.

The Plan anticipates that the Maltese economy will maintain strong growth over the forecast horizon. However, real GDP growth is expected to decelerate gradually, from 6.8% in 2018, to 5.0% in 2019, and 4.3% in 2020. Supported by this economic outlook, the Plan targets further fiscal surpluses over the forecast horizon, albeit smaller than in 2018. The fiscal surplus, which in 2018 amounted to 1.9% of GDP, is set to stabilise at 1.4% in both 2019 and 2020. Meanwhile, the debt-to-GDP ratio is expected to maintain its gradual downward trend, falling from 45.8% in 2018 to 40.3% by 2020.

The assessment carried out on the individual GDP expenditure components, suggests a broadly neutral risk outlook vis-à-vis real GDP growth for 2019 and 2020. This follows the possibility that in 2019, the downside risks to investment are matched by downside risks to imports. In turn, the downside risk to gross fixed capital for 2020 is broadly compensated for by the upside risk to government consumption and the downside risk to imports. The Fiscal Council's neutral risk outlook vis-à-vis the official real GDP growth forecasts is consistent with the fact that the macroeconomic forecasts for Malta produced by other independent institutions are broadly similar.

On the fiscal front, the assessment carried out on the individual revenue and expenditure components, suggests possible upside risks for the fiscal balance in 2019, but downside risks for 2020. The risk outlook for total revenue is neutral throughout the forecast horizon since no clear upside or downside risk has been associated with the major revenue categories. On the other hand, in 2019 total expenditure may be less than budgeted, in the eventuality of lower-than-planned capital expenditure. This factor applies also for 2020, but its effect may be offset by upside risks associated with compensation of employees and intermediate consumption. The fiscal risk assessment 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 Draft Budgetary Plan. The fact that the projections produced by other independent institutions all indicate a fiscal surplus and a decline in the public debt-to-GDP ratio, strengthen the plausibility of the official fiscal forecasts.

The Fiscal Council confirms that the fiscal rules were met in 2018 and are expected to be fully complied with in 2019 and 2020. This conclusion is shared by the European Commission in its separate assessment. The debt rule is expected to be comfortably satisfied, with the trajectory for the debt ratio remaining well below the 60% of GDP ceiling over the forecast horizon. At the same time, the structural surplus, which in 2018 stood at 0.9% of potential output, and is targeted at 0.8% and 1.3%, respectively in 2019 and 2020, would enable Malta to continue over-achieving its Medium-Term Objective of structural balance. The latter also implies that the expenditure benchmark remains not binding, provided the Medium-Term Objective continues to be satisfied without resort to windfalls.

Notwithstanding the benign macro-fiscal environment, which is expected to prevail in 2019 and 2020, vigilance remains important, particularly as elements of uncertainty remain. Malta's very open economy makes it subject to possible adverse shocks arising from the external sector. Factors currently maintaining buoyant domestic demand conditions may also abate. On the fiscal front, certain budget components may be subject to sudden changes, and some fiscal risks might eventually crystallise. At the same time, the benign macroeconomic and fiscal conditions offer a window of opportunity for carrying out the necessary reforms to address long-term challenges.

Chapter 1

Introduction

European Union (EU) Member States that share the euro as their currency must submit a Draft Budgetary Plan (DBP) to the European Commission (COM) by 15 October of each year.[1,2] Malta's DBP for 2020 contains the latest official macroeconomic and fiscal forecasts for the current year (2019) and next year (2020). These represent an update to the previous forecast vintage which was published in April 2019, as part of the Update of Stability Programme (USP) 2019 – 2022.

To support the quality of the macroeconomic forecasts, each Member State must either delegate their production to an independent institution (not forming part of government), or alternatively, such forecasts must be endorsed by an independent institution. In the case of Malta, the second option was chosen, with the Ministry for Finance (MFIN) producing the macroeconomic forecasts and the Malta Fiscal Advisory Council (MFAC) tasked to endorse or otherwise such forecasts. The Fiscal Responsibility Act (FRA), which outlines the MFAC's tasks, goes beyond the minimum requirements prescribed by the European rules, as it requires the fiscal projections to be endorsed too.[3,4]

On 14 October 2019, the Chairman of the MFAC addressed 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

[1] The DBP for 2020 submitted by each euro area 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-2020_en.

[2] The COM evaluates each country's DBP, and may issue requests for clarifications and further information, to which the governments need to reply. Thereafter the COM provides an assessment on the extent to which the fiscal rules prescribed in the Stability and Growth Pact (SGP) have been adhered to in the previous year and are expected to be satisfied in the following year. The Commission's assessment report on Malta's DBP for 2020 is available on https://ec.europa.eu/info/sites/info/files/economy-finance/swd-2019-924.pdf.

[3] The FRA ACT XXVII of 2014 as amended by Act VII of 2018 is available on: http://www.justiceservices.gov.mt/DownloadDocument.aspx?app=lom&itemid=12215&l=1.

[4] 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 and provide an assessment of the official forecasts".

forecasts for the period 2019 to 2020 prepared by the Ministry for Finance as part of the Draft Budgetary Plan 2020 to lie within its endorsable range".[5]

This Report, whose cut-off date is 20 November 2019, presents the analysis carried out by the MFAC as part of the endorsement process, in relation to both the macroeconomic and the fiscal forecasts presented in the DBP. **Chapter 2** reviews the methodologies and assumptions used by the MFIN to prepare the official forecasts. **Chapter 3** evaluates the expected trajectory for the various macroeconomic variables in 2019 and 2020, identifying any possible upside or downside risks. **Chapter 4** compares the latest macroeconomic forecasts with those prepared by the MFIN during the previous round, and the latest available forecasts produced by other institutions. **Chapter 5** presents an overview of the fiscal outlook and examines the extent to which the forecasts for the main revenue and expenditure components, and public debt, can be considered as plausible. **Chapter 6** compares the MFIN's fiscal forecasts presented in the DBP to the previous vintage contained in the USP, and the latest available fiscal forecasts prepared by other institutions. **Chapter 7** evaluates the ex-post compliance with the fiscal rules in 2018, and the ex-ante expected compliance in 2019 and 2020, based on the information contained in the DBP. **Chapter 8** presents the Report's conclusions.

[5] A copy of the letter is available on https://mfac.org.mt/publications/reports/reports-2019/.

Chapter 2

Forecast methodologies and assumptions

2.1 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 were generated through STEMM (Short-Term Quarterly Economic Forecasting Model), which is an econometric model built and maintained by the MFIN.[6,7] STEMM is a Keynesian model with output determined by aggregate demand. Equation re-estimations are carried out when necessary, to ensure that these adequately reflect the developments and structural changes in the Maltese economy, as well as to address material data revisions which take place from time to time.

A key feature of STEMM is the disaggregation of exports and imports into the various NACE sectors.[8] Exports are divided between electrical and machinery; fuels; chemicals and pharmaceuticals; other goods; financial services; other business services; remote gaming; tourism earnings; and other services. On the other hand, imports are split between consumption goods; capital goods; intermediate goods; fuels; other goods; financial services; other business services; remote gaming; and other services. The various types of exports and imports are modelled in nominal terms, with a separate equation for each dependent variable. This allows for the different exports and imports to have different elasticities with respect to the explanatory variables employed, such as world economic activity, exchange rates and relative prices.

Employment is also disaggregated into ten different sectors and each sector is modelled separately. These include domestically-oriented sectors, such as: real estate

[6] The model was originally developed in 2001 by the Economic Policy Department through the assistance of Cambridge Econometrics (UK).
[7] In July 2019 the MFIN published a report and a technical appendix outlining the key features of STEMM, including the estimated equations and parameters. These documents are available on: https://mfin.gov.mt/en/epd/Pages/Library.aspx.
[8] The Statistical classification of economic activities in the European Community, abbreviated as NACE, is the classification of economic activities in the European Union (EU); the term NACE is derived from the French Nomenclature statistique des activités économiques dans la Communauté européenne. For further details refer to https://ec.europa.eu/eurostat/statistics-explained/index.php/Glossary:Statistical_classification_of_economic_activities_in_the_European_Community_(NACE).

and construction; public sector; wholesale and retail trade; and other domestic sectors; and export-driven sectors, such as manufacturing; tourism; other business services; remote gaming; financial and insurance activities; and other services.

Regression estimates are complemented with expert judgement which is gained through regular monitoring of economic developments and discussions with key stakeholders. The latter include government departments, authorities and private sector 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. This reinforces the sectoral focus underpinning the modelling framework employed by the MFIN. Such meetings play a significant role in shaping the MFIN's outlook particularly for employment, exports, imports and investment plans for key sectors, which might be driven by very specific factors. Given the small size of the Maltese economy, such an approach is particularly useful as sector-specific developments can drive the economy-wide outturn, and model equations may not adequately capture such specificities.[9] In addition, the MFIN regularly monitors past forecast errors to identify any potential inaccuracies and biases with a view to rectify them where possible. This evaluation is included in the sensitivity analysis section which features in the yearly USP and DBP.

2.2 Assumptions underpinning the macroeconomic forecasts

The MFIN adopt a set of assumptions for certain exogenous variables which are necessary to produce the macroeconomic forecasts. Chart 2.1 shows the trajectory of the exogenous variables used in the DBP for 2020. It also compares them with the values used in the previous round (USP 2019 – 2022). The exogenous variables are mainly related to the external sector. The assumptions specify the values for the short-term and long-term interest rates; real GDP growth of Malta's main trading partners; the exchange rate of the euro with respect to the US dollar and sterling; world prices; and oil prices. The values for these exogenous variables are based on authoritative and reputable sources, predominantly from Consensus Economics (September 2019

[9] The MFIN compile a dossier with the relevant summary information collected from the stakeholders. This dossier is also forwarded to the MFAC prior to the issue of the endorsement letter, to assist the Council in better evaluating the special factors underpinning the official macroeconomic forecasts.

edition), and in the case of the interest rate assumptions, from the European Central Bank (ECB).[10] These assumptions have a cut-off date of 9 September 2019.

Chart 2.1: Main macroeconomic assumptions

Note: 2018 refers to actual data while 2019 and 2020 are forecasts.

Source: MFIN

Compared to the previous forecast round, the assumption of a zero per cent short-term interest rate has been retained. On the other hand, the long-term interest rate was scaled down by approximately 0.5 pp throughout the forecast horizon, reflecting the inversion of yield curves worldwide.

[10] Consensus Economics is an international economic survey organisation which polls more than 700 economists each month to obtain their latest forecasts and views. For further details refer to https://www.consensuseconomics.com/.

With regards to external demand, which is proxied by the real GDP growth in Malta's main trading partners, the DBP expects a deceleration, from 1.5% in 2018, to just below 1.0% over the forecast horizon. The external growth outlook is slightly weaker than that assumed in the USP.

In relation to the exchange rate, the DBP factors in the scenario whereby the euro is expected to depreciate vis-à-vis the US dollar in 2019 and appreciate slightly in 2020. This pattern is in line with that assumed in the USP, but the value of the euro against the US dollar is slightly lower throughout the forecast horizon. In turn, the DBP assumes that the value of the euro against sterling will remain stable, in contrast with the USP which featured a slight depreciation in the euro-sterling rate.

For 2019, world prices are assumed to grow at the same pace in both the DBP and the USP, at 1.4%. This represents a deceleration compared to a year earlier. On the other hand, the DBP assumes that in 2020 world prices will maintain stable growth, in contrast with the USP, which had anticipated a slight acceleration.

The DBP also assumes that oil prices will drop over the forecast horizon, from $71.1 per barrel in 2018, to $61.9 per barrel by 2020. The decline projected for 2019 is larger than that indicated in the USP. Furthermore, the USP had anticipated a slight pick-up in oil prices in 2020, an assumption which has been reversed in the DBP.

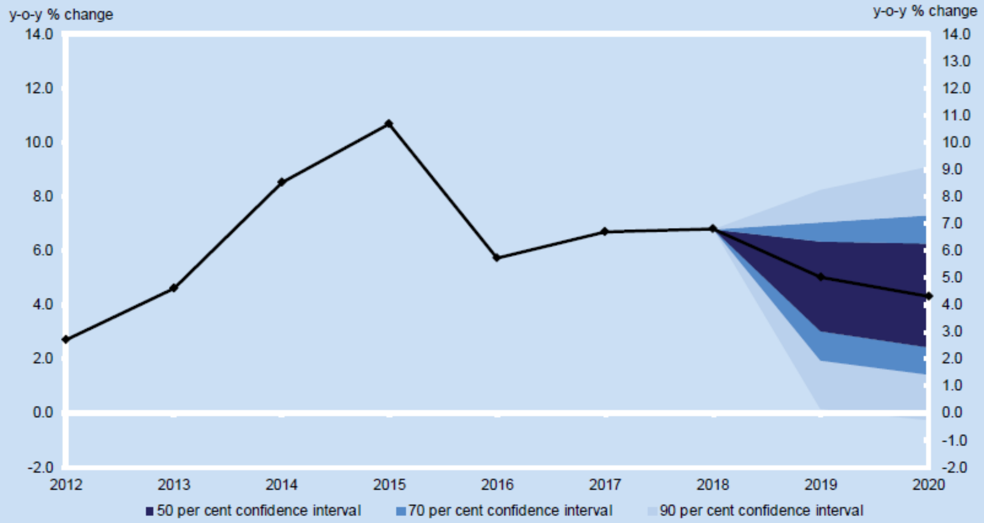
An important technical assumption is used to model inventory adjustments.[11] For the current year (2019), the MFIN estimated inventory adjustments to contribute negatively to growth by 0.7 pp. This is the result of combining the actual impact of inventory changes during the first half of the year, and assuming an identical value of inventory adjustments as in the previous year for the second half of 2019. In the outer forecast year (2020), inventories are assumed to generate no contribution to growth.

To evaluate the robustness of the forecasts, the MFIN present a sensitivity analysis, which involves modelling alternative scenarios which the MFIN considered as plausible.[12] The alternative real GDP growth forecasts are based on different assumptions than those used in the baseline. These vary from a shock to an

[11] Inventory changes include the effect of changes in actual inventories, as well as any statistical errors.
[12] Refer to page 15 of the DBP for the full list of scenarios that were considered by the MFIN. The MFIN carried out a survey among stakeholders to collect views about the likelihood that certain scenarios materialise.

exogenous variable, to sector-specific shocks. Alternative forecasting models (apart from STEMM) are also used to evaluate the results.[13] The MFIN's calculations suggest that real GDP growth would remain positive, even under the more adverse scenarios (see Chart 2.2).

Chart 2.2: Fan chart with real GDP growth forecasts (%)



Note: Reproduced from the DBP Chart 2.2, page 18.

Source: MFIN

2.3 The preparation of the fiscal forecasts

The preparation of the fiscal projections also remained practically the same as in previous rounds. Two approaches are used to finalise the fiscal targets. Government departments provide their input through cash-based estimates of their anticipated revenues and expenditures. These cash-based forecasts are built on specific knowledge and information available at departmental level. These include past trends, expert judgment, knowledge about specific fiscal legislation, outstanding creditor and debtor balances and other ad-hoc factors. Senior MFIN officials then discuss and fine-tune these projections, to ensure that projections are realistic. Information about the impact of new measures is also factored in.

This bottom-up approach is then supplemented with a top-down approach which is based on the European System of National and Regional Accounts (ESA). In this case,

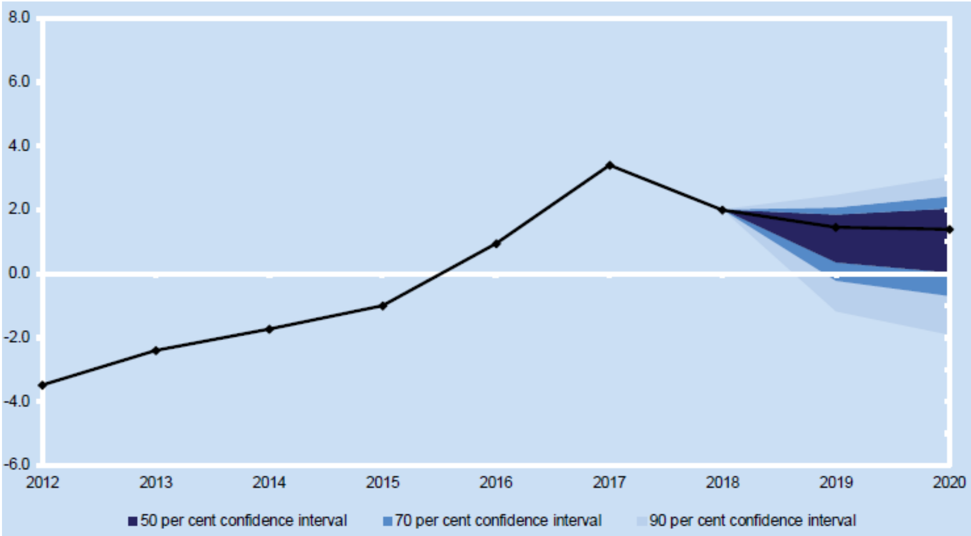
[13] These models include model-free statistical forecasts (Random Walk and Holt-Winters Seasonal Smoothing Method), model based univariate forecasts (2 ARIMA models) and model-based multivariate forecasts (2 VAR models and one VECM model).

the fiscal forecasts are derived from the estimated relationships between the fiscal variables and their respective macroeconomic proxy bases. The top-down projections act as an envelope, to ensure prudence and the overall consistency between the fiscal projections and the official macroeconomic outlook.

Discussions among the various departments and entities are undertaken to align the top-down fiscal projections with the bottom-up estimates. The objective is to ensure that the official fiscal projections contained in the DBP are attainable, consistent with the economic outlook, and the targets respect the requirements of the European and domestic fiscal rules. The fact that in recent years there has been an attainment, and in certain instances an overachievement of the headline targets for the fiscal balance and public debt, suggests that the current methodology used to forecast the various fiscal components is adequate. At the same time, sound fiscal controls appear to be in force to ensure that main targets are adhered to, even when certain revenues or expenditures deviate from the original plans.

To evaluate the robustness of the fiscal projections, the MFIN present a fan chart summarising alternative fiscal balances calculated using scenarios which are different from the baseline.[14] These calculations show that the fiscal balance would remain in surplus under most of the alternative scenarios which were considered (see Chart 2.3).

Chart 2.3: Fan chart with the fiscal balance targets (% of GDP)



Note: Reproduced from the DBP Chart 2.3, page 18.

Source: MFIN

[14] The alternative scenarios are the same as those used in the production of the fan chart for real GDP growth.

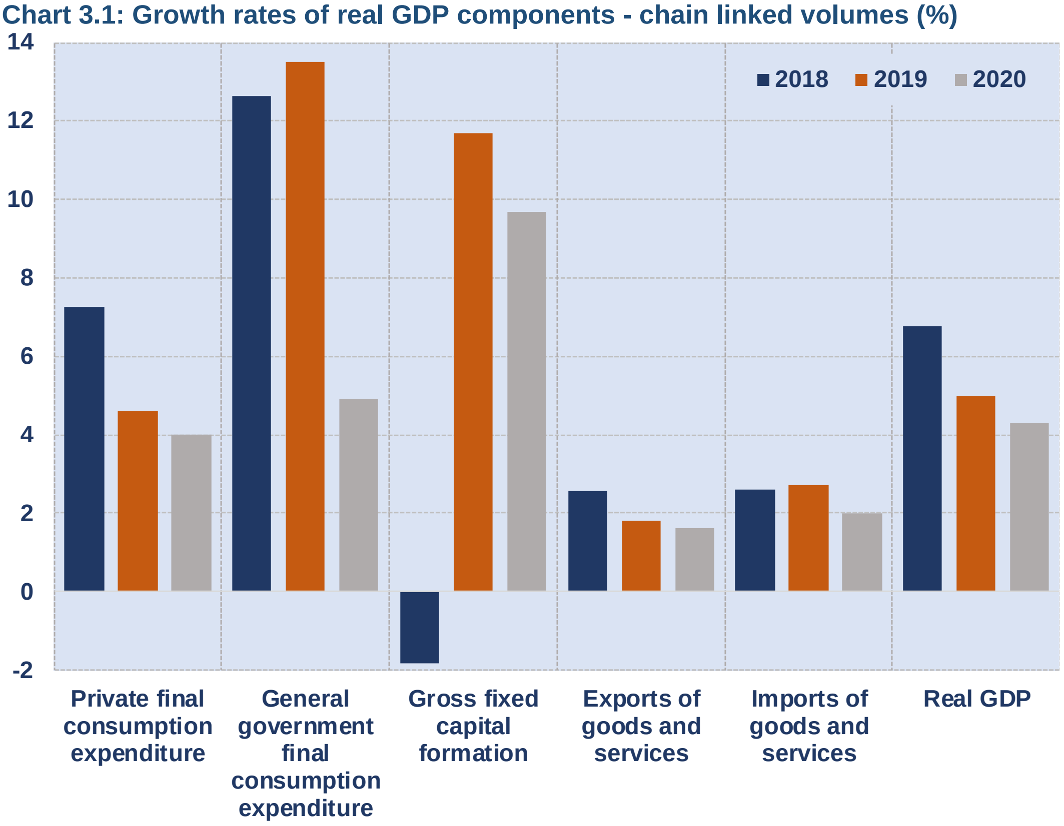
Chapter 3

Assessment of the macroeconomic forecasts 2019 – 2020

3.1 Macroeconomic outlook 2019 – 2020

The Maltese economy is expected to maintain a strong growth momentum over the forecast horizon. However, real GDP growth is expected to gradually ease, from 6.8% in 2018, to 5.0% in 2019 and 4.3% in 2020 (see Chart 3.1 and Table 3.1).[15] Nominal GDP is expected to follow a similar pattern, with growth anticipated to decelerate smoothly, from 9.0% in 2018, to 7.5% in 2019, and 6.5% in 2020.

Chart 3.1: Growth rates of real GDP components - chain linked volumes (%)



Source: MFIN

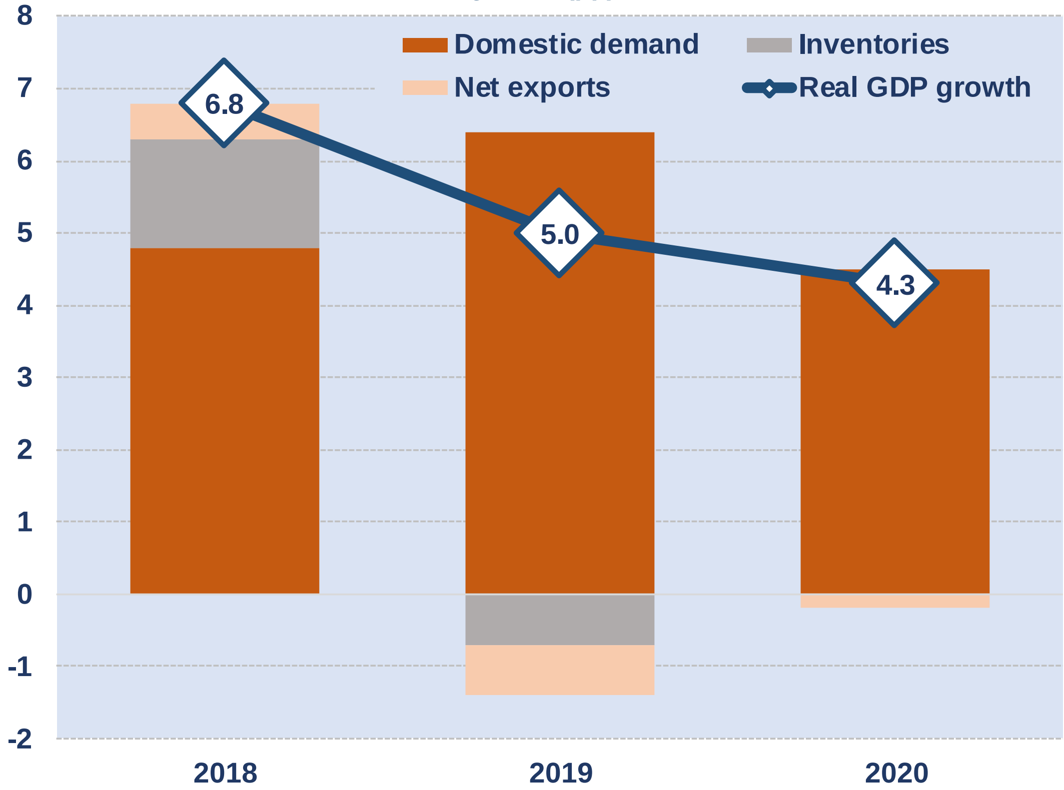
The growth trajectories vary across the real GDP expenditure components. Private consumption growth is forecast on a decelerating path. Government consumption is expected to repeat the previous' year double-digit growth but is then anticipated to slow

[15] Figures for 2018 refer to the provisional data published by the NSO on 6 September 2019 (News Release 145/2019), while figures for 2019 and 2020 are the forecasts prepared by the MFIN.

down markedly in 2020. The forecast trajectory for gross fixed capital formation indicates a strong rebound from the negative growth recorded in 2018, with elevated growth in both forecast years. In turn, growth in exports is expected to be slightly slower throughout the forecast horizon, when compared to 2018. These expenditure developments are estimated to maintain import growth stable in 2019.[16] In 2020, growth in imports is expected to slow down slightly, mirroring the anticipated deceleration in real GDP growth.

Throughout the forecast horizon, domestic demand is set to remain the main driver of real GDP growth, as was the case in 2018 (see Chart 3.2). Net exports are projected to dampen growth slightly both in 2019 and 2020, since the rise in imports is expected to outpace that in exports. Inventories are assumed to contribute negatively to growth in 2019 and exert no impact in the outer forecast year.[17]

Chart 3.2: Contributions to real GDP growth (pp)



Source: MFIN

[16] Given the high import content of gross fixed capital formation in Malta, developments in the latter play a significant role in influencing import growth dynamics.
[17] Refer to chapter 2 in this Report for further details.

Table 3.1: Macroeconomic variables 2018 – 2020 (%)

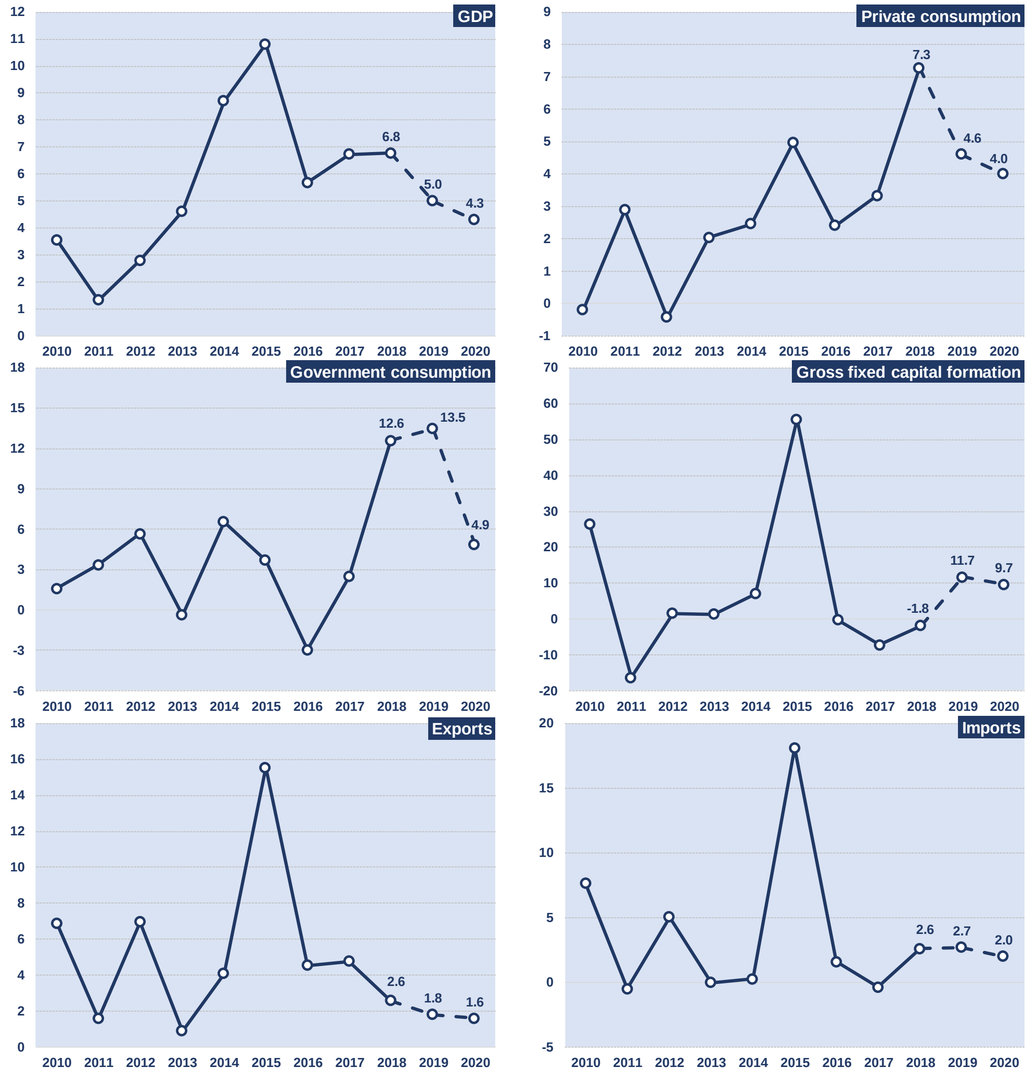
	2018	2019	2020
Real GDP components			
Private final consumption expenditure*	7.3	4.6	4.0
Gen. govt. final consumption expenditure	12.6	13.5	4.9
Gross fixed capital formation	-1.8	11.7	9.7
Exports of goods and services	2.6	1.8	1.6
Imports of goods and services	2.6	2.7	2.0
Real GDP	6.8	5.0	4.3
Contribution to real GDP growth			
Domestic demand (pp)	4.8	6.4	4.5
Inventories (pp)	1.5	-0.7	0.0
Net exports (pp)	0.5	-0.7	-0.2
Deflators			
Private final consumption expenditure	0.7	1.5	1.4
Gen. govt. final consumption expenditure	2.5	2.4	2.3
Gross fixed capital formation	2.8	2.8	3.2
Exports of goods and services	2.8	2.2	2.2
Imports of goods and services	2.5	2.4	2.2
GDP deflator	2.1	2.4	2.1
Labour market			
Employment (National Accounts definition)	5.4	4.8	4.1
Unemployment rate (%) (LFS definition)	3.7	3.5	3.5
Nominal compensation per employee	2.0	1.7	2.8
Labour productivity**	1.3	0.2	0.2
Other macroeconomic variables			
Inflation rate (%) (based on the HICP)	1.7	1.7	1.6
Nominal GDP	9.0	7.5	6.5
Potential output	6.3	5.7	5.6
Output gap (% of potential output)	1.8	1.2	-0.1

Note: figures for 2019 and 2020 are forecasts
* includes NPISH
** real GDP per person employed

Source: MFIN

A detailed assessment of the forecasts for the various macroeconomic variables follows (see Chart 3.3). The purpose is to evaluate the extent to which the anticipated trajectory for each real GDP component is plausible, when examined against the actual developments since 2010, and to assist in the identification of any possible upside or downside risks to the yearly growth forecasts.

Chart 3.3: Growth in GDP and its components – chain-linked volumes (%)



Source: NSO, MFIN

3.2 Private consumption

In 2019, private consumption is forecast to grow by 4.6% in real terms. The expected yearly outturn is in line with the 4.5% year-on-year real consumption growth recorded during the first half of 2019. Real consumption growth is expected to remain elevated even in 2020, but it is forecast to decelerate marginally, to 4.0%. This outlook represents a moderation when compared to the 7.3% expansion in real consumption which was recorded in 2018. The latter was rather exceptional when considering that the outturn in 2018 was the highest growth recorded between 2010 and 2017, and significantly above what the MFIN or other institutions were anticipating for that year.

The consumption growth forecasts are commensurate with the expected increase in the size of the population in Malta. The latter predominantly reflects the expansion in foreign labour supply to cater for the strong labour demand in Malta. At slightly more than 3.0% per annum, population growth is projected to maintain a similar momentum as observed in recent years. The expected increase in private consumption per capita is thus within 1.0% - 2.0%, in 2019 and 2020.

The anticipated trajectory for private consumption is supported by the labour market dynamics. Employment is forecast to rise by 4.8% in 2019, and by 4.1% in 2020. The small deceleration in consumption growth in the outer forecast year is consistent with the attenuation of job creation in 2020. There is muted support to consumption growth offered by the expected average wage developments. In 2019, compensation per employee is forecast to rise by 1.7%, which is equivalent to the HICP inflation rate. This implies stable wages in real terms in that year. In 2020, the projected nominal increase in compensation per employee, at 2.8%, exceeds the forecast HICP inflation rate of 1.6%. The low unemployment rate, which is forecast to stabilise at 3.5% in 2019 and 2020 (slightly lower than the 3.7% recorded in 2018), should also mitigate economic uncertainty and thereby contribute positively to the consumption growth prospects over the forecast horizon.

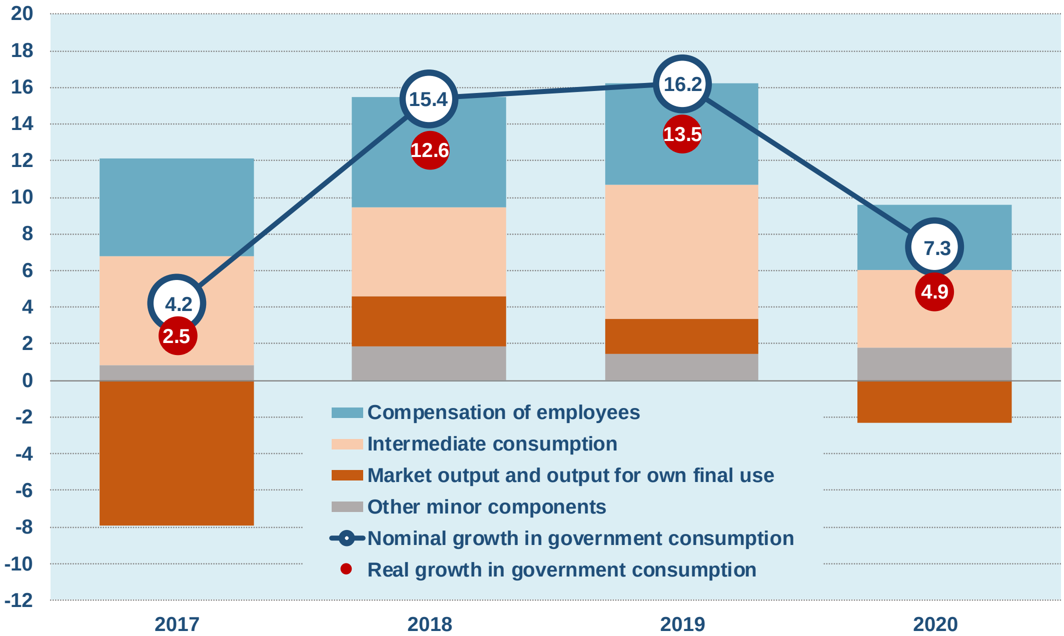
The consumption deflator is forecast to grow by 1.5% in 2019 and 1.4% in 2020. The acceleration in the deflator, compared to the developments between 2016 and 2018, dampens slightly the consumption growth forecasts in real terms.

Overall, the expected developments in the explanatory variables for real consumption support the consumption growth forecast as presented in the DBP, with a neutral risk outlook for 2019 and 2020.

3.3 Government consumption

Real government consumption is expected to continue growing strongly in 2019. Indeed, it is expected to grow by 13.5% in real terms, slightly faster than in 2018 (see Chart 3.4). The projected yearly outturn is compatible with the 14.0% year-on-year real growth in government consumption recorded during the first half of 2019. On the other hand, the forecast for 2020 points towards a sharp deceleration in the annual real growth rate, to 4.9%.

Chart 3.4: Breakdown of nominal government consumption growth (pp, %)



Source: MFIN

The deflator for government consumption is projected to rise by 2.4% and 2.3% respectively in 2019 and 2020, along the same lines as in 2018. Developments in the deflator thus play a marginal role vis-à-vis the real government consumption growth pattern over the forecast horizon, including the anticipated slowdown in 2020.

The reasons for the elevated growth in 2019 and the subsequent deceleration can be traced to the fiscal plans and their resulting impact on the components making up government consumption.[18] The caveat is that such variables are only available in nominal terms.

The planned fiscal activities for 2019 contribute to an estimated 16.2% growth in nominal government consumption, which is slightly faster than the 15.4% nominal growth recorded in 2018. The faster growth is predominantly driven by intermediate consumption. Otherwise, the contribution to growth from the remaining components is expected to be slightly less than a year earlier.[19] The deceleration in government consumption growth projected for 2020 reflects the planned containment in expenditure growth on intermediate consumption, and on compensation of employees, as well as the statistical impact created by the swings in market output.[20,21]

The assessment of the fiscal forecasts, as presented in Chapter 5 in this Report, points towards neutral risks for government consumption growth for 2019.[22] On the other hand, there could be upside risks to growth for 2020. Such risks mainly stem from the possibility that spending on compensation of employees and intermediate consumption could expand at a faster pace than planned.

3.4 Gross fixed capital formation

In 2019, gross fixed capital formation is expected to rebound by 11.7% in real terms. This would reverse the negative growth recorded during the previous three years. During the first half of 2019, investment rose by 15.0% on a year earlier, supporting such positive investment outlook for the year. The projected rebound in 2019 reflects the expansion in both private and public investment, with the latter anticipated to increase significantly on a year earlier, a pace which might prove challenging to achieve.

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[18] Refer to chapter 5 in this Report for an assessment of the forecast trajectory for the relevant budget components.
[19] When estimating the value of government consumption, market output is deducted from the other expenditure components. Since the DBP assumes that in 2019 market output will be less than in 2018, this corresponds to a deduction of a smaller value, thus explaining the upward push to government consumption resulting from market output. This pattern was also recorded in 2018, but in that year the upward effect was slightly larger.
[20] Since the DBP assumes that market output will rise in 2020, this corresponds to a deduction of a larger value, thus explaining the downward push to government consumption.
[21] Refer to chapter 5 in this Report for further details.
[22] The possibility that in 2019 market output could be higher than anticipated is considered not to create a material impact on the overall risk outlook for government consumption growth.

The slight deceleration in investment growth projected for 2020 is due to the base effect created by the planned surge in public investment in 2019. Despite public investment outlays in 2020 are marginally less than a year earlier, planned public investment is still forecast to remain elevated. Moreover, private sector investment is expected to accelerate in the outer forecast year.

The overall investment outlook is driven by higher planned activities related to telecommunications and aviation, as well as the materialisation of some large-scale investment projects of a construction nature, particularly in health, real-estate, tourism and transport.

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 incorporate those projects that have a strong political commitment or are judged as having a high prospect of realisation, is considered by the MFAC as a sensible approach. Furthermore, the assumption of high import content adopted by the MFIN for investment reduces the risk that forecast errors in this area spill unto the overall GDP growth forecasts.

The estimated outlays and the scheduled progress on the various projects which are embedded into the projections are compatible with the investment growth forecasts. However, any delays in the implementation of the said projects, both private and public, would materially impact the yearly trajectory for investment.

The forecast growth in the investment deflator, 2.8% in 2019 and 3.2% in 2020, is comparable to the recent developments recorded in the actual data. It is also compatible with the nature of the investment projects planned. The path for the investment deflator is thus not influencing the strong investment growth anticipated over the forecast horizon.

Overall, the MFAC considers there are downside risks for investment growth in 2019 and 2020, related principally to the public sector investment component.[23] However, progress on some large private sector projects could also be slower than originally envisaged.

[23] Refer to chapter 5 in this Report for further details.

3.5 Exports of goods and services

Growth in exports of goods and services is expected to decelerate from 2.6% in 2018, to 1.8% in 2019, and 1.6% in 2020. This outlook reflects the exogenous assumptions employed by the MFIN, as well as sector specific information.[24] The forecast for 2019 is in line with the 1.5% year-on-year growth in real exports recorded during the first half of the year.

Malta's main trading partners are expected to experience a slowdown, from 1.5% growth in 2018, to slightly below 1.0% over the forecast horizon. Malta's exports are however still expected to continue growing at a faster pace than the main trading partners. This is consistent with the MFIN's empirical estimates of an income elasticity for exports higher than unitary with respect to foreign demand.[25,26] The exchange rate assumptions exert a limited effect, as changes are rather small and in the main offsetting each other. Between 2019 and 2020, the euro is seen as appreciating against sterling but depreciating against the US dollar, when compared to 2018.

The MFIN rely to a great extent on sector specific information to drive their sectoral outlook, based on discussions with key stakeholders. On this basis, services are expected to be the main driver of export growth. This follows the positive outlook particularly by the remote gaming sector, which is expected to contribute around half of the overall expansion in exports over the forecast horizon.

The export deflator is expected to rise by 2.2% in both 2019 and 2020. This rate is slightly below the 2.8% growth in the export deflator recorded in both 2017 and 2018. Over the forecast horizon, export prices are forecast to grow at a similar pace as the import deflator, thus exerting a broadly neutral impact on the terms of trade.[27]

The MFAC considers that there are neutral risks for export growth in both 2019 and 2020.[28] The export growth rates are lower than the actual rates recorded during the

[24] Refer to chapter 2 in this Report for an overview of the assumed trajectory for the various exogenous variables.
[25] Refer to chapter 2 in this Report for further details.
[26] Income elasticity is defined as the responsiveness of demand when income changes. The higher the income elasticity, the more sensitive demand for a product is to changes in income.
[27] This also takes into consideration the fact that Malta's exports have a high import content.
[28] Possible small upside risks to the market output by Government, of which a significant proportion is classified as exports, is considered to have a negligible overall effect on the risk outlook for exports (refer to chapter 5 in this Report for further details).

previous five-year period, preserving their feasibility, even though in the context of an increasingly less positive external environment.

3.6 Imports of goods and services

In 2019, imports are forecast to grow by 2.7% in real terms, comparable to the 2.6% growth recorded in 2018. This is slightly faster than the 2.1% growth recorded during the first half of the year. Growth in imports is then expected to decelerate slightly, to 2.0% in 2020. These forecasts are significantly influenced by the MFIN's assumed import content of domestic demand and exports. Such developments would lower the ratio of imports to GDP (both expressed in real terms), from 125.5% in 2018, to 119.9% by 2020. This is consistent with the view that as the Maltese economy expands, the share of domestic value added in output increases.

The growth in imports is mainly driven by capital goods, both in 2019 and 2020. Yearly fluctuations in import growth are influenced significantly by the volatility in gross fixed capital formation, which in the case of Malta has a very high import content. The relative stability in import growth expected for 2019, compared to the outturn in 2018, is consistent with the anticipated strong growth in investment, which compensates for the slower growth in private consumption and exports. In turn, the expected slowdown in import growth in 2020 mirrors the lower growth rates for these three expenditure components indicated for the outer forecast year.

The import deflator is forecast to rise by slightly more than 2.0% annually. This is consistent with the external price and exchange rate assumptions and is close to the developments observed over the previous two years.

On balance, the risk outlook for import growth in 2019 and 2020 is downside, primarily in view of the downside risks to investment, which in the case of Malta has a very high import content. The latter effect more than outweighs that associated with the upside risk to government consumption for 2020.

3.7 Inflation

The annual inflation rate, based on the HICP, is forecast to remain below 2.0% throughout the forecast horizon. The absence of significant inflationary pressures, despite the elevated economic growth, is consistent with the moderation in wage pressures. The framework underpinning the MFIN's inflation forecasts is that the highly elastic labour supply, facilitated by the inflow of foreign workers, maintains wage inflation under check.

The low inflation scenario is further supported by the assumption that in 2019 oil prices will be less than in 2018, and that these fall further in 2020.[29] The assumed fluctuations in the euro against major currencies are also contained and hence with a limited impact on inflation. Moreover, world prices are projected to increase by 1.4% in both 2019 and 2020, which is a slower pace than in 2018.

The GDP deflator is expected to rise by 2.4% in 2019 and 2.1% in 2020. This builds on the consumption deflator advancing at a rate below 2.0%, compensating for the higher dynamics forecast for the other deflators, which range between 2.2% and 3.2%.

3.8 Labour market

Labour demand is expected to remain strong both in 2019 and 2020. This is consistent with the job-rich growth being experienced by the country in recent years. As a result, the implied labour productivity (real GDP per person employed) over the forecast horizon is expected to grow by only 0.2% in each forecast year. This is below the performance recorded between 2015 and 2018.

In 2019, all sectors are expected to register growth in employment, with the highest rates of growth expected to be in the professional, scientific and technical services sector, the remote gaming sector, as well as the real estate and construction sectors. The projected expansion in labour supply is supported by the inflow of foreign workers, combined with the increasing female and older worker participation rates. Employment within general government is also expected to increase in both 2019 and 2020.

[29] Refer to chapter 2 in this Report for an overview of the assumed trajectory for the relevant exogenous variables.

The DBP places employment growth on a decelerating path, from 5.4% recorded in 2018, to 4.8% in 2019 and 4.1% in 2020. These forecasts embed an element of prudence, since they factor in the possibility that the influx of foreign workers may attenuate.

The DBP anticipates that labour demand will grow slightly faster than labour supply. As a result, the unemployment rate is projected to drop slightly, from 3.7% in 2018, to stabilise at 3.5% in 2019 and 2020.

3.9 Potential output and the output gap

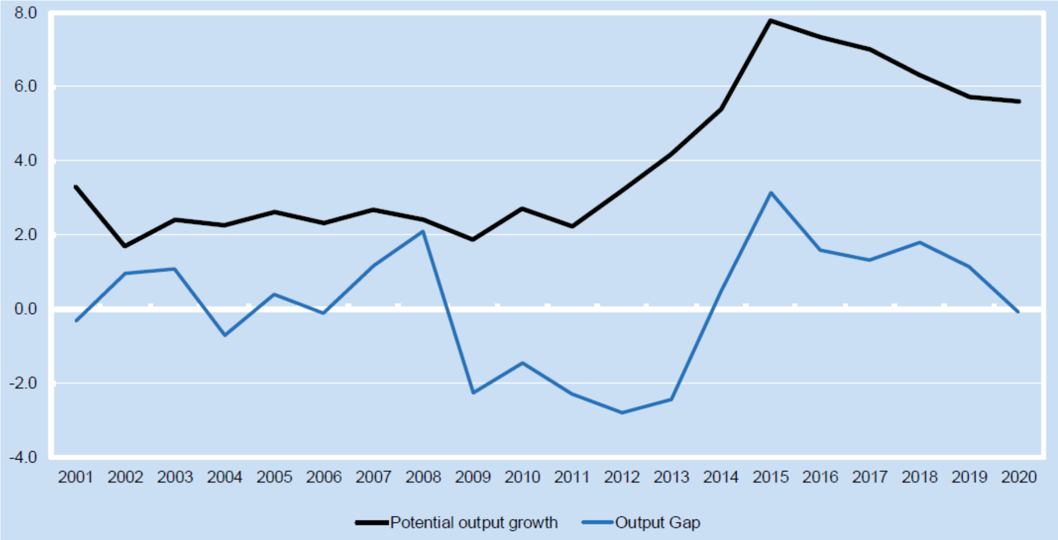
The MFIN estimates potential output and the output gap using the commonly agreed methodology across the EU.[30] This is based on the production function approach, with growth driven by labour, capital and total factor productivity.

Potential output growth is expected to remain high over the forecast horizon. However, it is projected to continue decelerating gently from the peak attained in 2015 (see Chart 3.5). Potential output growth is expected to decline from 6.3% in 2018, to 5.7% in 2019, and 5.6% in 2020. On the other hand, the expected real GDP growth, at 5.0% in 2019 and 4.3% in 2020 is slightly slower than the estimated potential output growth during these two years. This makes way for the output gap to narrow in 2019, and close off in 2020, after having been positive (i.e. the economy operating above potential output) since 2014.

The expansion in labour supply is the dominant source of potential output growth over the forecast horizon, in line with the patterns estimated for previous years. The expansion in labour supply reflects the growth in the working-age population, the assumed further increase in the participation rate and a reduction in the natural rate of unemployment. In turn, the growth potential contributed by capital accumulation is consistent with the higher investment spending over the forecast horizon. Meanwhile, total factor productivity is modelled to rise, but at a slightly slower pace than the estimated progress in recent years.

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

Chart 3.5: Potential output growth and output gap estimates (%)



Note: Reproduced from the DBP Chart 2.1, page 14.

Source: MFIN

3.10 Macroeconomic risk outlook

The assessment carried out on the individual expenditure components suggests a broadly neutral risk outlook vis-à-vis real GDP growth in 2019 (see Table 3.2). This primarily on the basis that the downside risks to investment are largely matched by downside risks to imports.

Even the risk outlook for real GDP growth for 2020 is neutral. This is the net result of the downside risk to gross fixed capital formation being broadly offset by the upside risk to government consumption and the downside risk to imports.[31]

The neutral risk outlook vis-à-vis real GDP growth for 2019 and 2020 is also consistent with the fact that the other institutions producing macroeconomic forecasts for Malta broadly share a similar outlook as the MFIN.[32]

[31] The risk outlook for 2019 and 2020 is very similar, with the only exception being that in 2020 the risk outlook for government consumption is on the upside, whereas for 2019 it is neutral. This effect is however thought to be small, explaining why there is no difference in the risk outlook vis-à-vis real GDP growth across both forecast years.

[32] Refer to chapter 4 in this Report for the comparison with respect to the macroeconomic forecasts produced by the other institutions.

Table 3.2: Summary of risks to the GDP expenditure components

	2019	2020
Private final consumption expenditure	⇔	⇔
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

Chapter 4

Comparison across different macroeconomic forecasts

4.1 Introduction

The plausibility of the macroeconomic forecasts can be further assessed by evaluating the similarity or otherwise with respect to the other forecasts which are available. Specifically, the macroeconomic forecasts presented in the latest DBP are compared with those produced by the MFIN as part of the USP 2019 – 2022 (previous round), and the forecasts produced by the CBM, COM, IMF and credit-rating agencies which were available by the cut-off date. An important caveat is that such forecasts may not necessarily be directly comparable, due to differences in the availability of data when such forecasts were produced. Other differences could arise due to the different assumptions and methodologies used by the various institutions. Nonetheless, the MFAC considers such comparisons as a valid benchmark to support the qualitative assessment carried out in Chapter 3.

4.2 Comparison with the USP 2019 – 2022

The DBP maintained the same pattern of a smooth economic deceleration over the forecast horizon as in the USP. However, the DBP anticipates a slower real GDP growth trajectory than indicated in the USP. The real GDP growth outlook for 2019 was revised down from 6.2% to 5.0% (see Table 4.1). The downward revision for 2020 is of a similar magnitude, from 5.7% to 4.3%.

Domestic demand is still seen as the main source of growth in both 2019 and 2020. However, the intensity of domestic demand was moderated slightly, contributing around half of the downward revision to the growth outlook for 2019. Larger negative inventory changes, than assumed in the previous round, explain the rest of the downward revision for the year. The slight negative contribution from net exports expected for 2019 was virtually unchanged across the two forecast rounds.

Table 4.1: Macroeconomic forecasts by the MFIN, COM and CBM (%)

	2019				2020			
	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	4.6	5.8	4.2	5.5	4.0	3.9	3.8	4.3
Government consumption	13.5	11.6	12.7	9.8	4.9	4.7	3.6	5.8
Gross fixed capital formation	11.7	13.7	10.0	12.0	9.7	5.4	9.5	9.6
Exports of goods and services	1.8	2.4	1.7	2.1	1.6	4.1	1.8	2.2
Imports of goods and services	2.7	3.4	2.6	3.1	2.0	3.0	2.1	2.9
Real GDP	5.0	6.2	5.0	5.4	4.3	5.7	4.2	4.3
	Contributions to real GDP growth							
Domestic demand (pp)	6.4	7.0	5.8	6.3	4.5	3.7	4.2	4.8
Inventories (pp)	-0.7	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Net exports (pp)	-0.7	-0.8	-0.7	-0.8	-0.2	2.1	0.0	-0.5
	Deflators							
Private consumption	1.5	1.7	-	-	1.4	1.2	-	-
Government consumption	2.4	3.8	-	-	2.3	2.0	-	-
Gross fixed capital formation	2.8	3.2	-	-	3.2	3.5	-	-
Exports of goods and services	2.2	2.3	-	-	2.2	2.2	-	-
Imports of goods and services	2.4	2.4	-	-	2.2	1.8	-	-
GDP	2.4	2.9	2.1	2.1	2.1	2.4	2.0	2.0
	Other macroeconomic variables							
Inflation rate (HICP)	1.7	1.9	1.6	1.6	1.6	2.0	1.7	1.7
Employment growth*	4.8	4.6	4.0	4.5	4.1	4.3	3.0	3.5
Unemployment rate	3.5	3.8	3.6	3.7	3.5	3.9	3.5	3.7
Compensation per employee	1.7	3.3	2.4	2.5	2.8	3.2	3.4	3.3

** Figures may not be directly comparable due to different definitions used by the institutions.*

Sources: MFIN, COM, CBM

In relation to 2020, the contribution to growth stemming from net exports was changed from positive (+2.1 pp) as indicated in the USP, to negative (-0.2 pp) as indicated in the DBP. This reflected a downward re-assessment of the country's export growth from 4.1% to 1.6%, at a time of deteriorating conditions in Malta's main trading partners, and rising challenges faced by some sectors. This effect was however dampened by an upward re-appraisal of domestic demand, whose contribution was lifted from 3.7 pp to 4.5 pp for 2020. The latter mostly reflected the updated growth forecast for gross fixed capital formation which, at 9.7%, is almost double that indicated in the USP.

Except for government consumption, the growth rates for the other GDP expenditure components were all revised down for 2019. The DBP sees faster growth in government consumption, 13.5% compared to 11.6% stated in the USP. However, for 2020, the outlook for government consumption remained largely the same. Private consumption growth for 2019 was changed from 5.8% to 4.6%, whereas the outlook for 2020 was kept practically the same. In relation to imports, the outlook was revised slightly downwards, from 3.4% to 2.7% in 2019, and from 3.0% to 2.0% in 2020. This reflects the updated import content associated with a lower GDP growth rate.

The expected price developments in 2019 were revised marginally down across the board. The growth rates for all the deflators except the import deflator were lowered, contributing to a 0.5 pp reduction in the GDP deflator growth forecast for the year, to 2.4%. A 0.3 pp reduction was also carried out vis-à-vis the GDP deflator growth for 2020. The largest revision was carried out in the import deflator, which is seen rising at a faster pace.

4.3 Comparison with the forecasts produced by other institutions

Detailed macroeconomic forecasts are also produced by the CBM (August 2019) and the COM (November 2019).[33] The DBP and the COM Autumn forecasts embed the actual national accounts data up to the second quarter of 2019 (NSO News Release 145/2019). On the other hand, the forecasts by the CBM incorporate earlier data up to the first quarter of the year (NSO News Release 090/2019). Equally pertinent is the fact that since the forecasts by the MFIN and the COM were prepared at approximately

[33] Dates in brackets indicate the time of publication of the forecasts available by the cut-off date used in this Report, 2 December 2019.

the same time, they are more likely to be based on more similar assumptions than the CBM forecasts, which are dated earlier.

The three institutions anticipate a continuation of the strong real GDP growth scenario in both 2019 and 2020. Indeed, the forecasts stand within a relatively close range. This reinforces the MFAC's neutral risk outlook vis-à-vis real GDP growth for this period.[34] For 2019, the MFIN and COM present the identical real GDP growth forecast of 5.0%. This is slightly more conservative than the estimate by the CBM, which is 0.4 pp higher. For 2020 the three institutions forecast for real GDP growth is almost the same, ranging between 4.2% and 4.3%.

Both the COM and the CBM share the MFIN's outlook that domestic demand is likely to be the only contributor to real growth over the forecast horizon. Consensus exists that imports are likely to grow at a faster pace than exports. The intensity of domestic demand is also similar across institutions. For 2019, the MFIN and CBM are anticipating a contribution of slightly more than 6.0 pp from domestic demand, whilst the COM anticipates a slightly lower contribution, at 5.8 pp. For 2020, the CBM and the MFIN anticipate a negative contribution from net exports, whereas the COM is projecting a neutral impact.

There is also broad consensus on the trajectory of the individual GDP components. The institutions anticipate a slower pace of growth for 2020 in private and government consumption, gross fixed capital formation and imports. At the same time, both the CBM and the COM anticipate growth in exports to accelerate marginally, contrasting with the marginal deceleration anticipated by the MFIN.

The COM is the most conservative in its estimation of private consumption growth for both 2019 and 2020, whereas the forecast by the CBM is the highest. These differences may be partly attributed to the small differences in the forecast trajectory for compensation per employee and employment growth. As for government consumption growth, the MFIN's estimate for 2019 is above that by the other institutions. For 2020, the DBP indicates higher government consumption growth than the COM, but slightly lower than the CBM.[35] Still, views converge that growth in government consumption will be high in 2019 and markedly lower in 2020.

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[34] Refer to chapter 3 in this Report for further details.

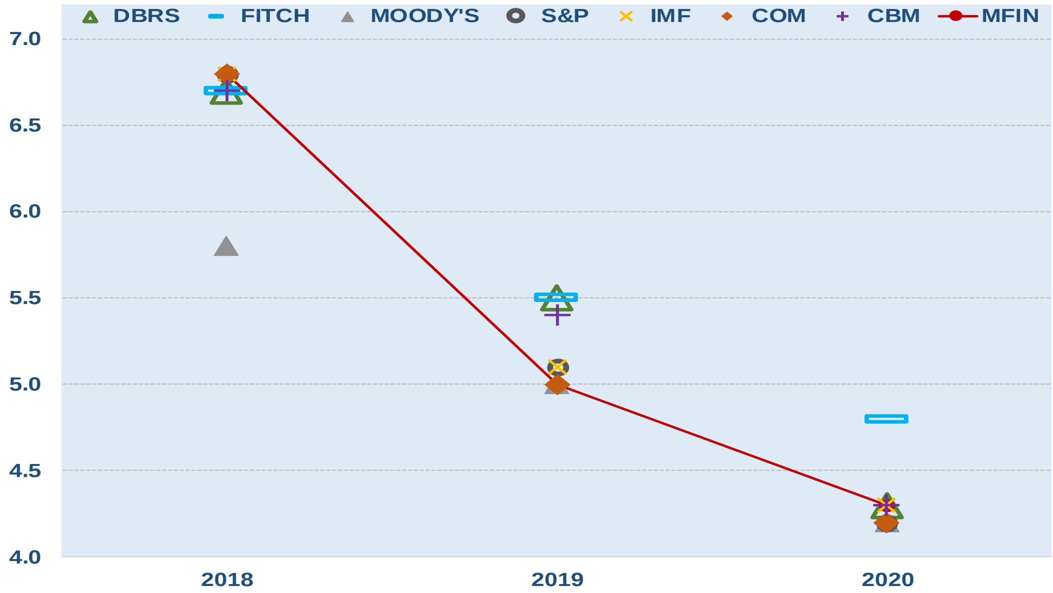
[35] Different revenue forecasts for the Individual Investor Programme (IIP) may also play a part since this item enters the compilation of the government consumption aggregate as part of market output, which is deducted from the expenditure components.

There is a high degree of similarity in the investment growth forecasts. Indeed, in 2019 investment growth is expected to be 11.7% by the MFIN and 12.0% by the CBM. For 2020, the MFIN anticipates growth to be 9.7%, and the CBM to be 9.6%. The forecasts by the COM are similar, at 10.0% and 9.5% respectively in 2019 and 2020. With respect to the growth in exports and imports, the forecasts presented in the DBP and those produced by the COM are nearly identical, and more conservative than those produced by the CBM. Throughout the forecast horizon, the three institutions expect rather similar gaps between the growth in imports and the growth in exports.

The outlook for inflation is shared across the institutions, at around 1.6% and 1.7% in both forecast years. The growth in the GDP deflator is also similar, with the MFIN predicting a slightly higher GDP deflator than the other institutions.

The latest available forecasts by the International Monetary Fund (IMF) (World Economic Outlook - October 2019) concur that real GDP growth in Malta is expected to decelerate, from 6.8% in 2018 to 5.1% in 2019 and 4.3% in 2020. Likewise, the forecasts produced by the main credit rating agencies, DBRS, FITCH, MOODY'S, and S&P point in the same direction, corroborating the MFAC's risk assessment in relation to real GDP growth for 2019 and 2020 (see Chart 4.1).[36]

Chart 4.1: Real GDP growth by institution (%)



Source: MFIN, CBM, COM, IMF, DBRS, FITCH, MOODY'S, S&P

[36] The publication dates were as follows: MOODY'S (March 2019), FITCH (July 2019); DBRS (August 2019); S&P (September 2019).

Chapter 5

Assessment of the fiscal forecasts 2019 – 2020

5.1 Fiscal outlook 2019 – 2020

The DBP targets a fiscal surplus equivalent to 1.4% of GDP in both 2019 and 2020, extending the surpluses which were recorded since 2016 (see Table 5.1).[37] In 2019, the anticipated fiscal surplus is slightly lower than in 2018, as the planned increase in the expenditure-to-GDP ratio exceeds that in the revenue ratio. In turn, the stability in the fiscal surplus-to-GDP ratio in 2020 reflects a projected marginal decline of equal magnitude in both the revenue ratio and the expenditure ratio.

Table 5.1: Main fiscal targets (% of nominal GDP)

	Total revenue	Total expenditure	Fiscal balance	Structural balance*	Gross debt
2018	38.7	36.7	1.9	0.9	45.8
2019	39.3	37.9	1.4	0.8	43.0
2020	39.1	37.8	1.4	1.3	40.3

* As per cent of potential GDP
Note: Figures may not add up due to rounding.

Source: MFIN

The estimated changes in the structural balance, which nets off cyclical effects and one-off and temporary measures, are larger. The structural balance is expected to contract marginally from 0.9% of potential GDP in 2018, to 0.8% in 2019.[38] However, the structural surplus is expected to rise again to 1.3% in 2020.

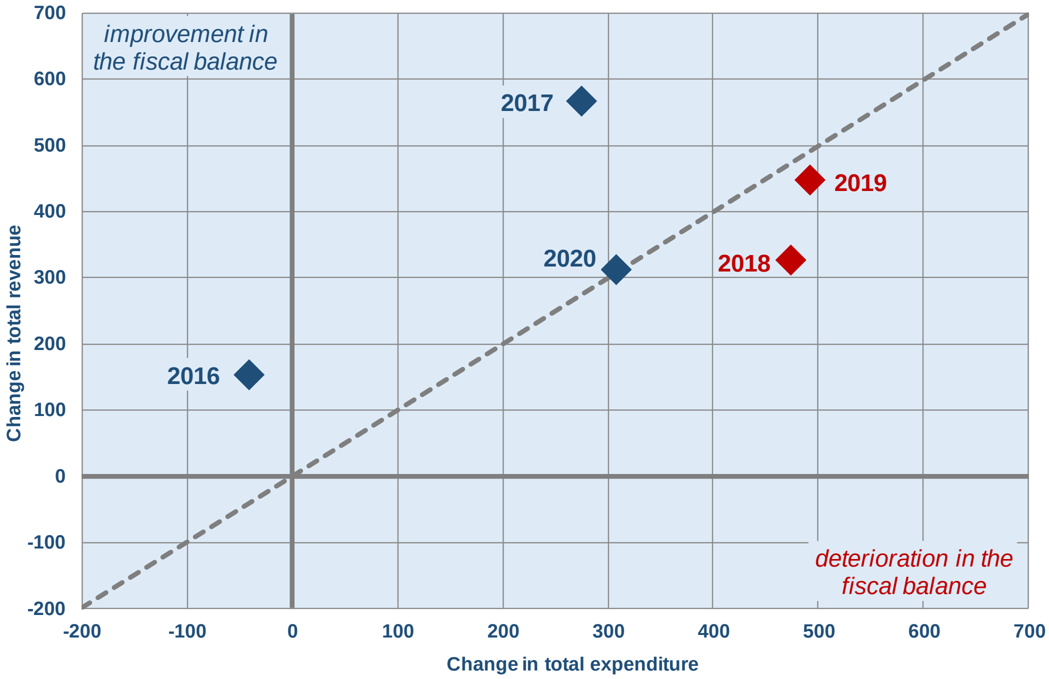
The differences between the headline and structural balances are mainly driven by the expected developments in the output gap. In fact, the output gap is estimated to be less positive in 2019 and turn marginally negative in 2020. In turn, the one-off revenues over the forecast horizon are marginally lower than in 2018.

[37] The fiscal projections suggest that a small surplus would still be attained even if the proceeds from the IIP were excluded.
[38] The structural balance removes the effect of cyclical and net temporary and one-off effects from the headline balance.

Meanwhile, the public debt-to-GDP ratio is anticipated to decline further, to 40.3% by 2020, as a result of the projected fiscal surpluses and nominal GDP growth. Their combined effect more than offsets the upside push created by the stock-flow adjustments (SFA). The reduction in the debt ratio is anticipated to amount to some 2.7 pp in each forecast year.

In absolute terms, the fiscal surplus is expected to amount to €190.0 million in 2019, which is €45.6 lower than in 2018 (see Table 5.2). The planned narrowing in the fiscal surplus follows the similar pattern recorded in 2018 (see Chart 5.1). In 2019 total expenditure is expected to increase by 10.9%, slightly faster than the 9.4% growth in revenue. On the other hand, in 2020, the forecast growth rates in expenditure and revenue are broadly similar, 6.2% and 6.0% respectively, contributing to a stable outlook for the fiscal balance in absolute terms.

Chart 5.1: Annual 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 contraction in the fiscal surplus (deterioration in the fiscal balance). Anywhere along the dashed line corresponds to a stable fiscal balance.

Source: MFIN

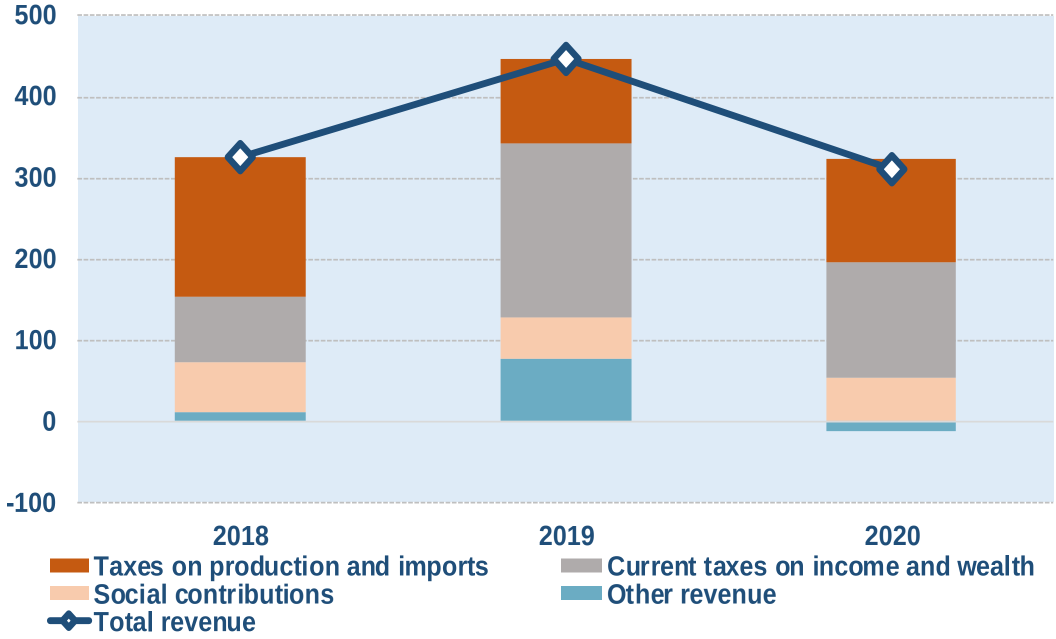
Table 5.2: Fiscal targets in absolute terms (EUR millions)

	2018	2019	2020
Total revenue	**4,764.2**	**5,211.7**	**5,523.6**
Taxes on production and imports	1,572.4	1,677.9	1,804.9
Current taxes on income and wealth	1,650.4	1,863.9	2,007.0
Social contributions	764.8	817.0	870.6
Capital taxes*	20.7	27.2	27.9
Property income*	96.7	68.0	74.6
Other revenue*	659.3	757.7	738.5
Total expenditure	**4,528.6**	**5,021.7**	**5,330.6**
Compensation of employees	1,373.5	1,484.5	1,567.9
Intermediate consumption	810.9	957.4	1,055.4
Social payments	1,180.9	1,238.5	1,308.6
Gross fixed capital formation	376.9	580.6	573.8
Interest expenditure**	190.3	171.0	175.2
Subsidies**	168.2	181.1	195.7
Capital transfers payable**	168.4	132.6	151.9
Other expenditure**	259.5	276.0	302.2
Fiscal balance	**235.6**	**190.0**	**193.0**
One-off and temporary effects (net)	19.0	9.6	9.6
Cyclical effects	120.2	92.8	30.3
Structural balance	**96.4**	**87.6**	**153.1**
Gross debt	**5,641.1**	**5,703.7**	**5,690.7**
Nominal GDP	*12,323.8*	*13,245.6*	*14,102.8*
Output gap (% of potential GDP)	*1.8*	*1.2*	*-0.1*

Note: The fiscal figures are compiled in line with the ESA methodology.
* Considered as ‘other revenue’ elsewhere in this Report.
** Considered as ‘other expenditure’ elsewhere in this Report.
Source: MFIN

In 2019 total revenue is planned to rise by more than in 2018 in absolute terms (see Chart 5.2). Current taxes on income and wealth and 'other' revenue are expected to add more than a year earlier, thereby compensating fully for the smaller increments anticipated from taxes on production and imports and social contributions.[39] Current taxes on income and wealth are again expected to contribute the bulk of the revenue increase in 2020, despite the forecast change being lower than a year earlier.

Chart 5.2: Yearly changes in revenue components (EUR millions)



Source: MFIN

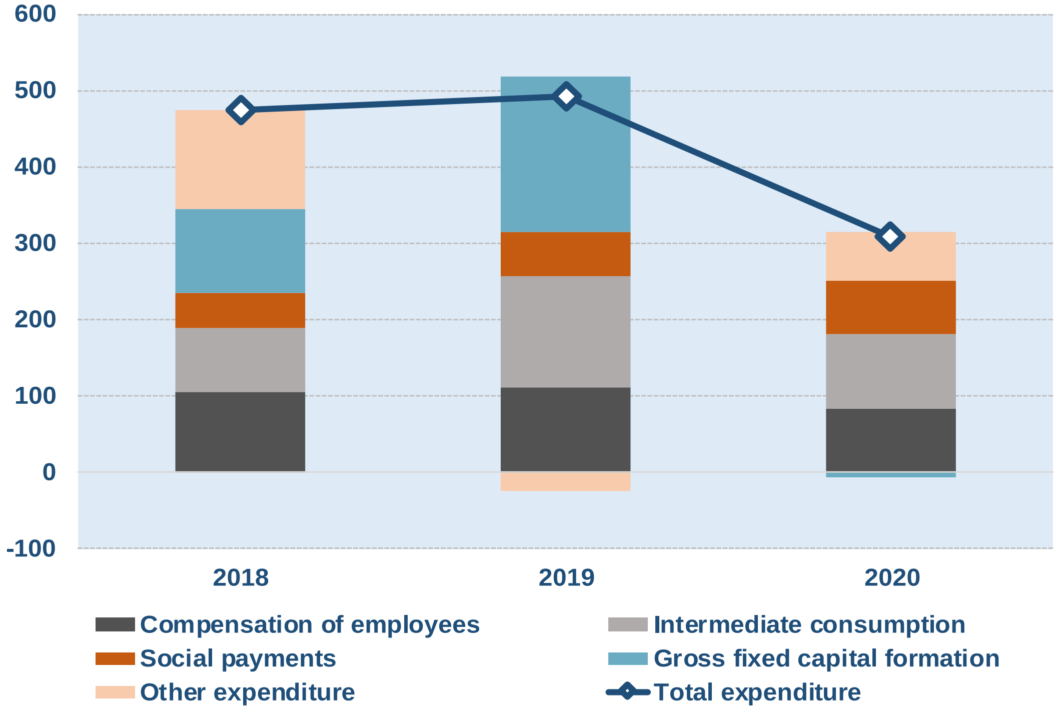
The intake from 'other' revenue sources is expected to fluctuate across the forecast horizon. Such revenue is expected to increase in 2019 and decline in 2020. This pattern mainly reflects the assumed proceeds from the IIP (included as part of market output by government) and the absorption of EU funds during these two years.

On the expenditure side, the increase for 2019 is mainly driven by higher planned spending on gross fixed capital formation and intermediate consumption (see Chart 5.3). In turn, the smaller change in total expenditure in 2020, mainly reflects the lower outlays on gross fixed capital formation planned in that year. Additional expenditure volatility across the forecast horizon reflects the budgeted amount for 'other expenditure', which in 2019 is less than in 2018, but is seen rising in 2020.[40] The

[39] Other revenue comprises capital taxes, property income and 'other' revenue.
[40] Other expenditure comprises interest expenditure, subsidies, capital transfers payable and 'other' expenditure.

budgeted increments in compensation of employees and social payments are relatively more stable over the forecast horizon.

Chart 5.3: Yearly changes in expenditure components (EUR millions)



Source: MFIN

A detailed analysis and assessment of the forecasts for the various revenue components within the budget is presented in the next section. This is followed by a similar assessment with respect to the various expenditure elements. This contributes to the overall fiscal risk outlook for 2019 and 2020 vis-à-vis the fiscal surplus and debt targets stated in the DBP.

5.2 Assessment of the revenue projections

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 and the developments to date, 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. The risk outlook for each revenue and expenditure component is deemed to be neutral, unless a sufficiently clear upside or downside risk can be identified. The fiscal risk assessment is carried out on the premise that the macroeconomic forecasts as indicated in the DBP materialise. This caveat is mitigated by the MFAC's assessment of a neutral risk outlook for real GDP growth for 2019 and 2020.[41]

5.2.1 Taxes on production and imports

Taxes on production and imports are expected to increase by 6.7% in 2019 and 7.6% in 2020 (see Table 5.3). These growth rates are lower than those recorded in 2017 and 2018. For 2019, the projected growth in taxes on production and imports is comparable to that in nominal consumption. It is also compatible with the 7.5% growth recorded during the first half of the year. In 2020, growth in indirect taxes is projected to accelerate slightly, contrasting with the anticipated slight deceleration in consumption growth (both in nominal and real terms).[42] This is however in line with the empirical elasticities with respect to the tax base, which tend to exceed unity. Still, the ratio of taxes on production and imports with respect to nominal GDP is projected to stabilise around 12.8% throughout the forecast horizon, in line with the outturn in 2018 (see Chart 5.4).

The DBP does not feature any significant changes to indirect taxes, apart from minimal changes to the concessions related to property transactions. The most relevant factor impacting the indirect tax intake from 2019 onwards relates to the expected negative effect of the VAT directive on electronic commerce, which the MFIN estimated at €15.0 million annually.[43] This factor supports the moderation in indirect tax growth anticipated for 2019, when compared to the previous two years. In turn, the projected

[41] Refer to chapter 3 in this Report for further details.
[42] The bulk of indirect taxes are levied on values, hence related to developments in nominal consumption. In the case of taxes levied on quantities, the real growth in private consumption is the more appropriate proxy base.
[43] Under the new rules, VAT will be paid in the Member State of the consumer. The negative 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/.

growth in indirect tax revenue in 2020 is consistent with the developments recorded in previous years.

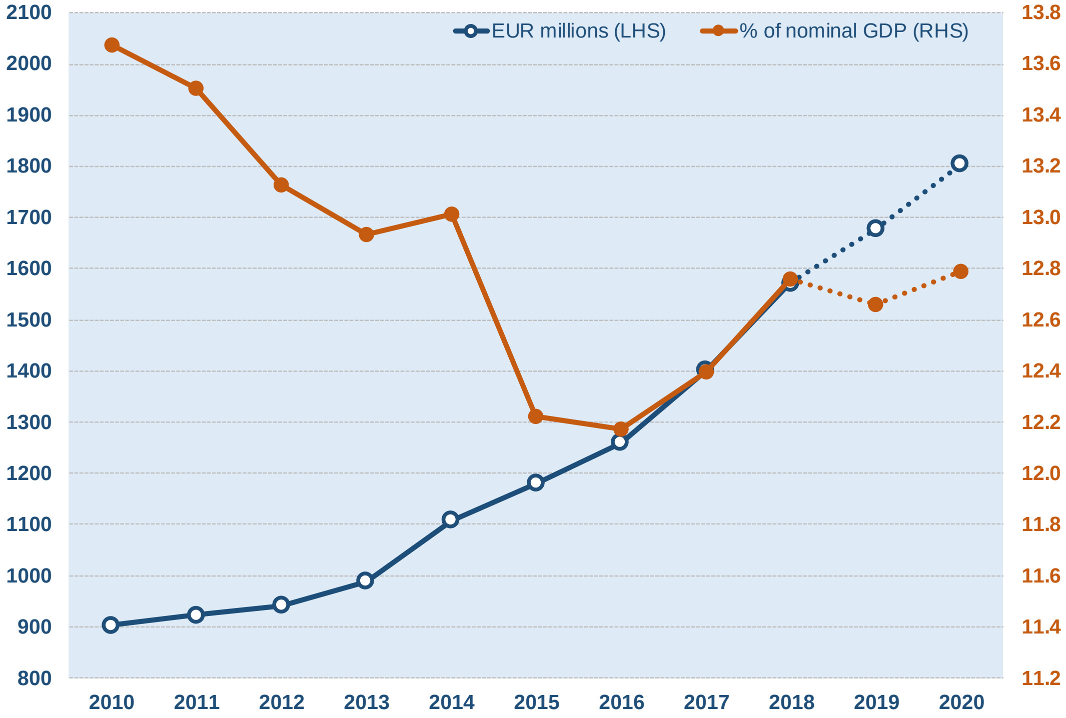
Based on the analysis performed, the projections for taxes on production and imports appear to be plausible, with neutral risks for 2019 and 2020.

Table 5.3: Taxes on production and imports

	Taxes on production and imports		Growth in private consumption	
	Growth (%)	Change (EUR millions)	Nominal (%)	Real (%)
2017	11.3	141.8	4.4	3.3
2018	12.2	171.0	8.1	7.3
2019	6.7	105.5	6.2	4.6
2020	7.6	127.1	5.4	4.0

Source: MFIN

Chart 5.4: Taxes on production and imports

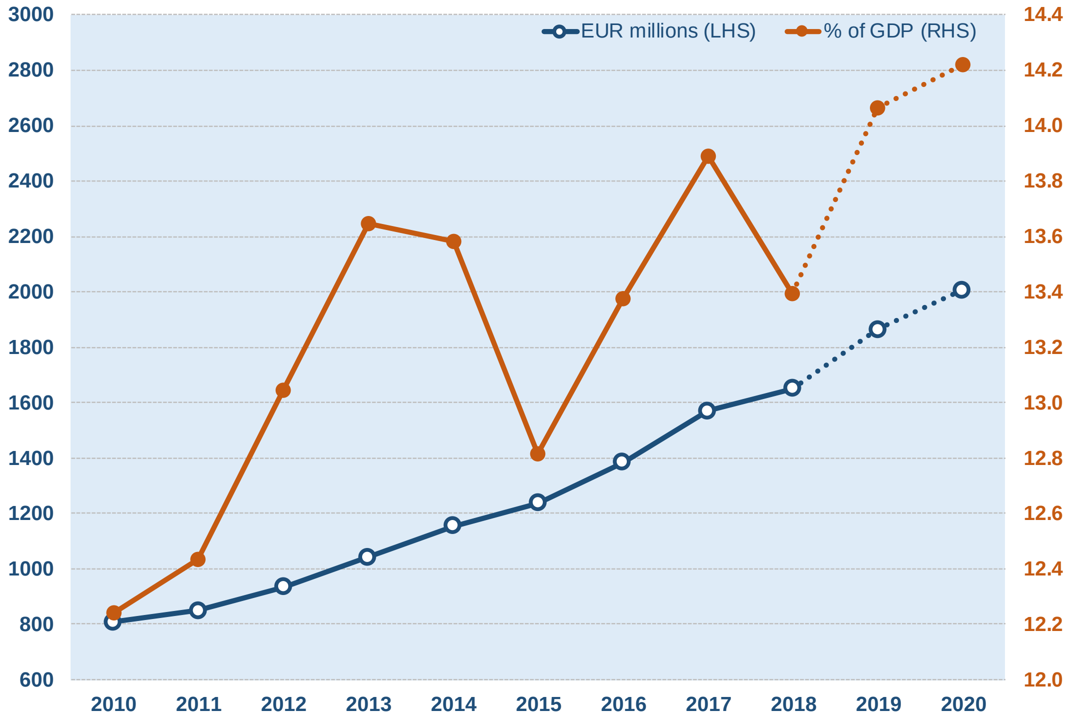


Source: MFIN

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 5.5). Their growth rate is expected to be slightly faster than nominal GDP growth across the forecast horizon. As a result, the ratio of current taxes on income and wealth to nominal GDP is expected to climb from 13.4% in 2018, to 14.1% in 2019 and 14.2% in 2020. These ratios are higher than recorded over the past decade, and if attained, would completely reverse the 0.5 pp drop recorded in 2018.

Chart 5.5: Current taxes on income and wealth



Source: MFIN

The forecast expansion in direct taxes in 2019 is higher than the anticipated growth in compensation of employees and gross operating surplus, which are the two most relevant proxy macroeconomic bases for this revenue component (see Table 5.4). However, during the first six months of 2019, direct taxes rose by 17.7% compared to 2018, supporting the view of a particularly tax-rich growth.[44] This double-digit growth forecast for direct taxes in 2019 thus appears feasible.

[44] This may also be in part due to a possible base effect since in 2018, growth in current taxes on income and wealth was lower than in the previous five years, as a result of larger amount of refunds.

The projected growth in current taxes on income and wealth for 2020 mirrors the forecast growth in compensation of employees and gross operating surplus. This could be somewhat conservative as the progressivity of the personal income tax system leads to a theoretical tax elasticity with respect to wages which is above unity. However, such an element of prudence with respect to personal income taxes compensates for the inherent uncertainty in relation to the outlook for corporate taxes. This reflects the fact that a proportion of corporate taxes are derived from the operations of companies whose activities are detached from the developments in the Maltese economy, and which can fluctuate heavily.

Table 5.4: Current taxes on income and wealth

	Growth (%)	Change (EUR millions)	Compensation of employees (%)	Gross operating surplus (%)
2017	13.4	185.9	7.4	10.4
2018	5.1	80.6	7.5	10.2
2019	12.9	213.5	6.6	9.6
2020	7.7	143.1	7.0	7.6

Source: MFIN

Changes to the direct tax system are minimal. No material changes to corporate taxes feature in the DBP. Changes to personal taxes are also contained. The MFIN estimated that the concessions for pensioners and low-income earners, incentives for the take up of private pensions, and education-related incentives, jointly cost around €3.7 million from 2019 onwards. In turn, new tax concessions on overtime payments are estimated to produce a further downside effect, but whose budgetary impact as from 2020 is limited to around €4.0 million.

Based on the above analysis, the MFAC considers the projections for current taxes on income and wealth to be plausible, with neutral risks for 2019 and 2020.

5.2.3 Social contributions

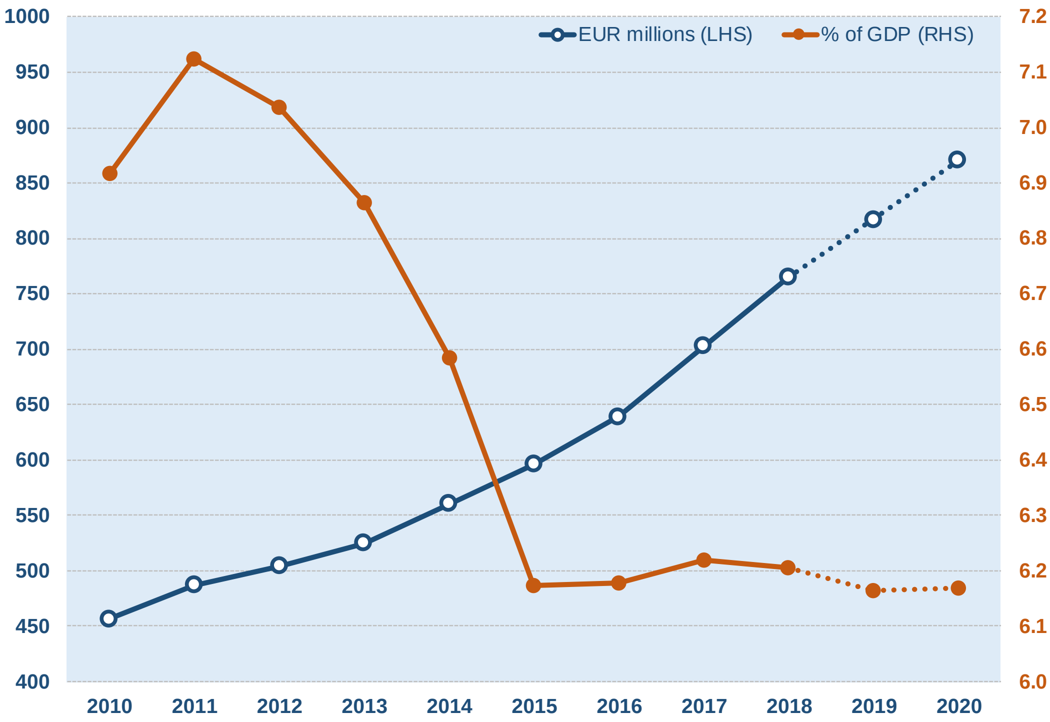
Social contributions are forecast to increase by almost 7.0% annually throughout the forecast horizon, comparable to the expansion in nominal GDP (see Table 5.5). The ratio of social contributions to GDP is thus expected to remain stable at around 6.2%, extending the pattern observed since 2015 (see Chart 5.6). Such developments are driven entirely by the expansion in the tax base, and the statutory increase in the payment ceiling, as no additional policy changes or measures are being factored in the official projections.

Table 5.5: Social contributions

	Growth (%)	Change (EUR millions)	Compensation of employees (%)
2017	10.0	63.6	7.4
2018	8.8	61.9	7.5
2019	6.8	52.2	6.6
2020	6.6	53.6	7.0

Source: MFIN

Chart 5.6: Social contributions



Source: MFIN

During the first six months of 2019, growth in social contributions was subdued, below 1.0%. However, this was possibly influenced by the exceptionally high contributions recorded during the second quarter of 2018, and which were subsequently offset by a decline in the third quarter. Hence the yearly target for the year still appears feasible, as the slow growth recorded to date is possibly due to a timing factor.

Social contributions are set to grow in tandem with total compensation of employees throughout the forecast horizon. Despite the existence of a cap on social contributions, the latter is likely to exert limited effect as growth in incomes is anticipated to remain primarily concentrated in the brackets below the threshold.[45] The extension of such patterns throughout the forecast horizon appears plausible.

Based on the above explanations, the MFAC considers the projections for social contributions to be plausible, with neutral risks for 2019 and 2020.

5.2.4 Other revenue components

Taxes on production and imports, current taxes on income and wealth, and social contributions account for the bulk of total revenue. In 2018, their combined share made up 83.7% of total revenue, and by 2020, it is projected to increase to 84.8%. The remaining revenue components consist of capital taxes, property income and 'other' revenue. The latter includes EU funds, as well as the proceeds from the IIP. The forecast trajectories for the revenue components, as percentage of nominal GDP, are shown in Chart 5.7.

In absolute terms, capital taxes represent only a small share of total revenue. These amounted to €20.7 million, or 0.2% of GDP, in 2018. In absolute terms the official forecasts indicate an increase of €6.5 million in 2019 and a rise of €0.7 million in 2020. However, the ratio of capital taxes to nominal GDP is projected to remain stable, at 0.2%, as was the outturn over the past decade.

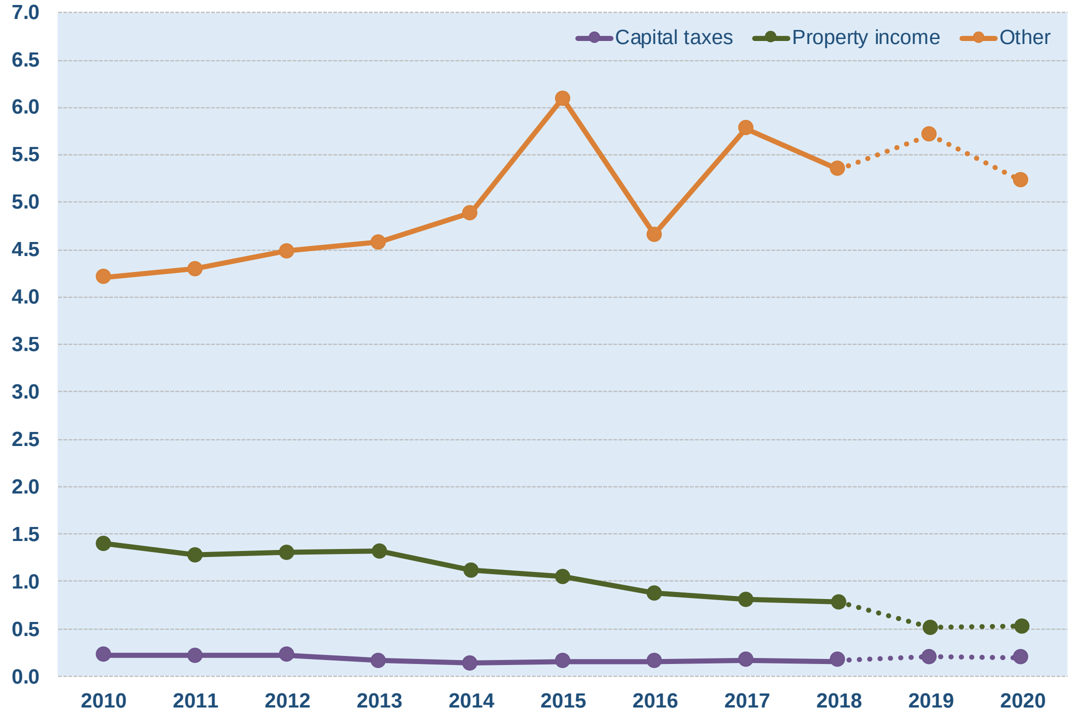
In 2019, property income is expected to be lower than in 2018. It is expected to increase slightly in 2020, but to remain below its 2018 level. Property income is thus projected to experience a reduction in the ratio to GDP, from 0.8% in 2018, to 0.5% in 2019 and 2020. This decline mainly reflects the lower anticipated dividends from public listed companies, in line with current distribution patterns and the expected profitability.

'Other' revenue, which is a residual category, tends to be rather volatile. When compared to GDP, the ratio of 'other' revenue is expected to increase from 5.3% in

[45] The cap means that once the maximum annual amount payable has been reached, additional income does not lead to more social security payments, hence producing a theoretical elasticity below unity.

2018 to 5.7% in 2019. In 2020 it is then expected to decline to 5.2%. In absolute terms 'other' revenue is projected to increase from €659.3 million in 2018, to €757.7 million in 2019, but slide back to €738.5 million in 2020.

Chart 5.7: Other revenue components (% of nominal GDP)



Source: MFIN

The projected increase in the 'other' revenue category for 2019 is largely driven by the assumption of higher take up of EU funds, which more than compensates for the assumption of a decline in proceeds from the IIP compared to a year earlier. However, there is the possibility that the intake from the EU funds may be less than planned as capital expenditure during the first half of the year was below the 50% of the total for 2019. On the other hand, it is possible that the outturn for the IIP may turn out slightly higher than anticipated, since more than 85% of the budgeted amount was collected by the first nine months of the year.

For 2020, the DBP factors in a small increase in the proceeds from the IIP on a year earlier. This is expected to dampen the effect of more conservative assumptions for the utilisation of EU funds compared to 2019. The 2020 target for the IIP proceeds appears feasible particularly if the outturn in 2019 exceeds the amount factored in the DBP. At the same time, the more conservative estimates for the utilisation of EU funds makes such targets easier to be attained.

Overall, the MFAC considers the projections for other revenue to be plausible, with neutral risks for 2019 to 2020. Owing to the nature of these revenue items, upside and downside risks appear to be equally possible, thus offsetting each other.

5.3 Assessment of the expenditure projections

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 drivers and developments to date, 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 considered as neutral, unless a sufficiently clear upside or downside risk can be identified.[46]

5.3.1 Compensation of employees

Spending on compensation of employees is projected to grow by 8.1% in 2019, following the 8.3% growth recorded in 2018 (see Table 5.6 and Chart 5.8). In 2020, the budget allocation on public sector wages rises more moderately, by 5.6%. Accordingly, the government's wage bill is budgeted to rise by €111.0 million in 2019, but by a lower amount, €83.3 million, in 2020. The ratio of compensation of employees to nominal GDP is projected to stay broadly stable at around 11.2% since 2017.

Table 5.6: Compensation of employees

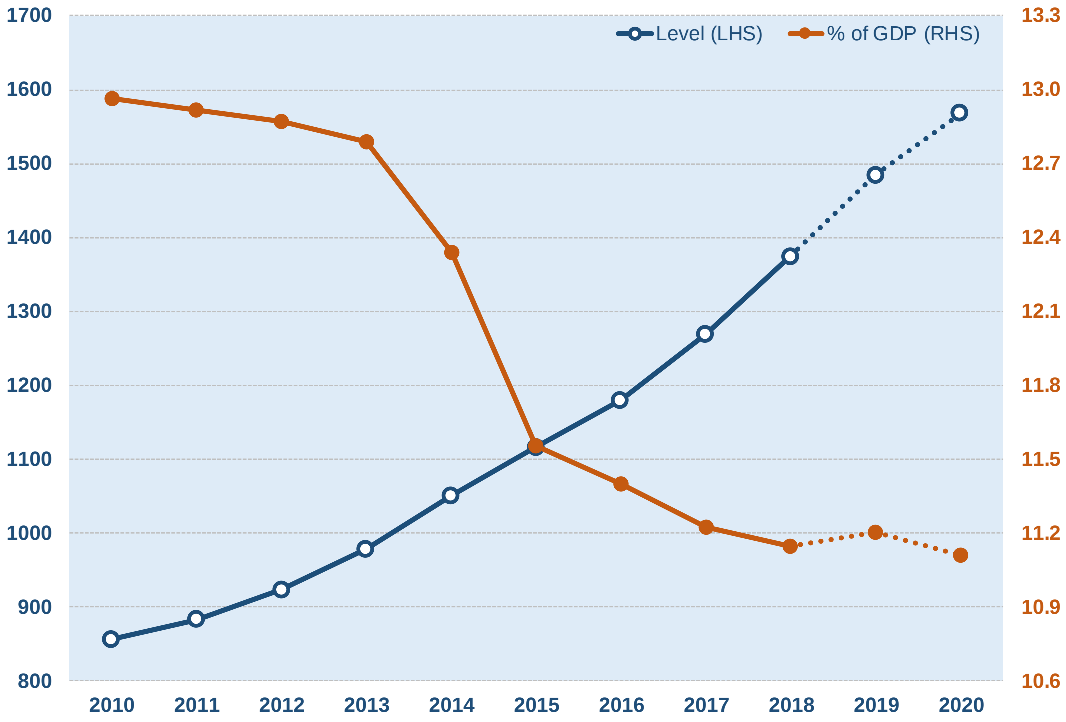
	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2017	7.5	89.0
2018	8.3	105.0
2019	8.1	111.0
2020	5.6	83.3

Source: MFIN

[46] The risk assessment takes the macroeconomic scenario outlined in Chapter 3 in this Report as given, although in this case, the relationship with macroeconomic variables is much less relevant, owing to the more discretionary element.

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. Still, the current policy requires that recruitment costs remain within the parameters of the approved budgetary estimates, unless otherwise authorised. Underpinning the planned public sector wage bill is the assumption of an approximate 2.0% yearly increase in employment within general government in 2019 and 2020.[47]

Chart 5.8: Compensation of employees



Source: MFIN

When considering the fiscal plans for previous years, one can note that the forecasts for compensation of employees for the outer year tend to exhibit upward revisions (see Table 5.7). Indeed, the forecast for 2018 presented in the DBP was set at €1,314.3 million, which is below the outturn of €1,373.5 million (indicated in the DBP 2020). Likewise, the forecast for 2019, which was placed at €1,467.7 million, was subsequently updated to €1,484.5 million (indicated in the DBP 2020). Such revisions

[47] Employment with general government includes not only civil servants but also employees with the Extra-Budgetary Units (EBUs).

point to a recurring tendency to underestimate the level of public sector employment and / or wage drift for the outer forecast year.[48]

Table 5.7: Forecast vintages for compensation of employees (EUR millions)

	DBP 2018	DBP 2019	DBP 2020
2016	1,182.1	-	-
2017	1,267.9	1,272.9	-
2018	1,314.3	1,381.9	1,373.5
2019	-	1,467.7	1,484.5
2020	-	-	1,567.9

Source: MFIN

Overall, the MFAC considers the projections for compensation of employees to be neutral for 2019, but with upside risks for 2020. The budgeted amount for 2019 appears adequate, and more so when considering that during the first half of the year, the growth rate was contained to 4.7%. The slower growth is interpreted more as a timing issue rather than a clear sign that the spending in this area will be less than planned. On the other hand, the upside risks for 2020 emanate from the fact that the budget allocation for the year is growing at a slower pace than in the previous years, without an identifiable factor contributing to such deceleration. The before-mentioned past spending overruns weigh further on the upside risk outlook in this case.

5.3.2 Intermediate consumption

In 2019 intermediate consumption is expected to rise by €146.5 million, or 18.1% (see Table 5.8). Both in absolute and in percentage terms, the change is higher when compared to the developments recorded in 2018. Apart from elements which tend to produce steady yearly increases, such as health-related expenditure, intermediate consumption is regularly influenced by special factors.[49] The fast growth anticipated over the forecast horizon reflects added outlays particularly towards the health and

[48] Wage drift is defined as the difference in the wage paid to a worker as compared to the negotiated wage. The increase could be due to several reasons such as overtime, bonus payment or promotion.

[49] For example, in 2018 additional expenditures were related to Valletta 2018. However, over the years, different initiatives, events and special factors were in place such that temporary expenditure outlays were followed by other temporary expenditure outlays, effectively keeping spending on intermediate consumption from reverting to lower levels.

elderly care sectors. The latter embed the Public-Private Partnership (PPP) agreements which are in place.

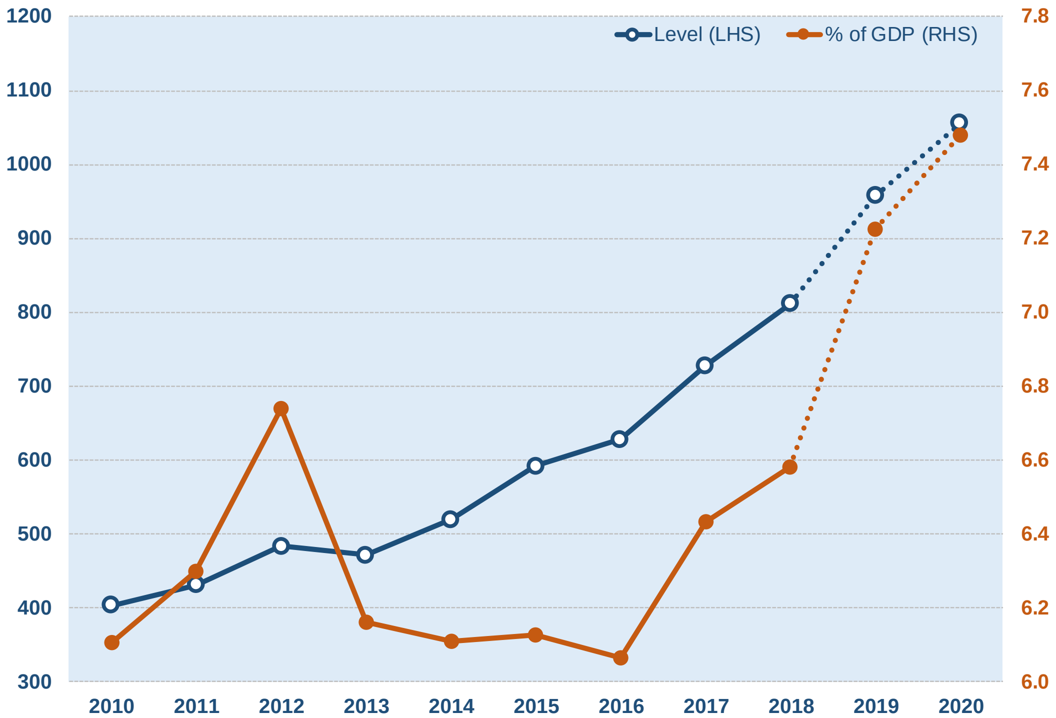
In 2020 the allocated budget for intermediate consumption rises at a slower pace, by 10.2%. Nevertheless, this exceeds nominal GDP growth. As a result, intermediate consumption is expected to maintain its steady increase as a ratio to nominal GDP, rising from around 6.1% in the period between 2013 and 2016, to 7.5% by 2020 (see Chart 5.9).

Table 5.8: Intermediate consumption

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2017	15.9	99.8
2018	11.5	83.7
2019	18.1	146.5
2020	10.2	98.0

Source: MFIN

Chart 5.9: Intermediate consumption



Source: MFIN

During the first six months of 2019, intermediate consumption rose by 22.0% on a year earlier, supporting the elevated growth outlook for the year. Upward revisions to the initial spending ceiling have regularly taken place, and these tended to be larger for the outer forecast year (see Table 5.9). Indeed, the fiscal plans initially targeted a budget of €773.9 million for 2018, but the actual spending rose to €810.9 million (as indicated in the DBP 2020). Likewise, spending on intermediate consumption, which was budgeted at €886.8 million has been revised up to €957.4 million according to the latest plans.

Table 5.9: Forecast vintages for intermediate consumption (EUR millions)

	DBP 2018	DBP 2019	DBP 2020
2016	636.6	-	-
2017	727.9	723.3	-
2018	773.9	825.5	810.9
2019	-	886.8	957.4
2020	-	-	1,055.4

Source: MFIN

Overall, the MFAC considers the projections for intermediate consumption to be plausible, with neutral risks for 2019, but with upside risks for 2020. Pressures on intermediate consumption are likely to remain high, when considering the planned expansion in the government's activities, and the anticipated further rise in the population. Despite growth during the first six months was faster than the planned yearly rise, there remains the possibility that spending on intermediate consumption stays within the budget. On the other hand, the upside risks for 2020 emanate from the fact that the budget allocation for the year is growing at a slower pace than in the previous years. The before-mentioned past spending overruns weigh further on the risk outlook in this case.

5.3.3 Social payments

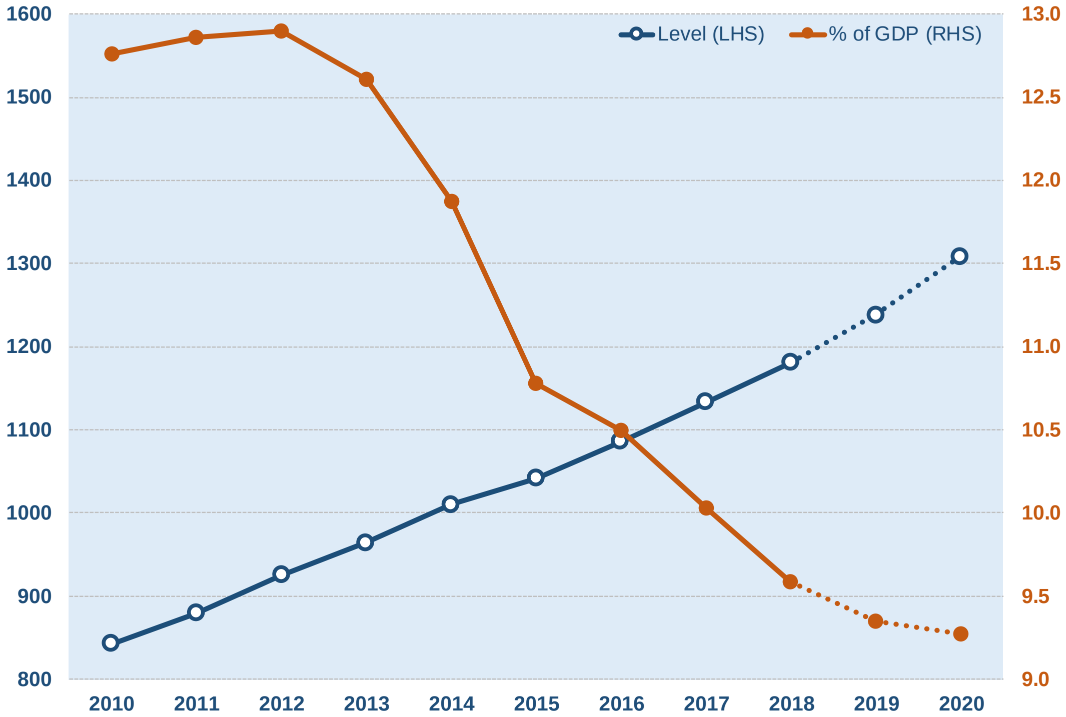
Social payments are expected to increase by 4.9% in 2019, equivalent to an additional €57.6 million (see Table 5.10). This is slightly more than the increase recorded during the previous two years. In 2020, the budget for social payments is accelerating further, as spending is planned to rise by 5.7% or €70.1 million. Nonetheless, the ratio of social payments to nominal GDP is expected to maintain its downward trend (see Chart 5.10).

Table 5.10: Social payments

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2017	4.4	47.7
2018	4.2	47.2
2019	4.9	57.6
2020	5.7	70.1

Source: MFIN

Chart 5.10: Social payments



Source: MFIN

Among the measures contributing to the faster growth in 2019, the most relevant are the provision of free school transport, upward adjustments to certain pensions and the provision of financial assistance to alleviate the burden of property rent costs. Their combined incremental impact was however estimated at just above 0.2% of GDP in 2019. In turn, the MFIN estimated that the new initiatives for 2020, which primarily target pensioners, are expected to have a cost which is limited to around 0.3% of GDP.

Overall, the MFAC considers the projections for social payments to be plausible, with neutral risks for 2019 and 2020. 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 maintain very strong momentum in 2019, rising by €203.7 million or 54.0% (see Table 5.11). This follows similar buoyant developments which were recorded in 2018. Public investment spending is expected to remain elevated in 2020, but the budgeted amount is slightly less than a year earlier (see Chart 5.11). Such patterns tend to repeat the cyclical developments observed in previous years. Indeed, the share of public investment spending to GDP has fluctuated over time, with the share in GDP often hovering between 2.0% and 4.0%.

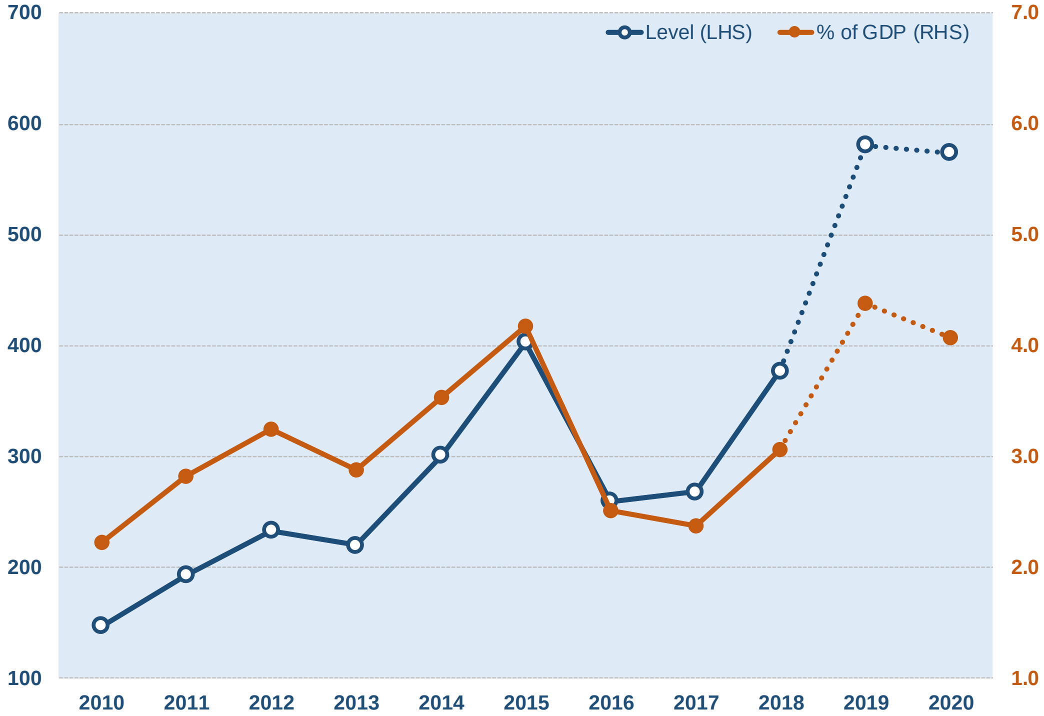
Table 5.11: Gross fixed capital formation

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2017	3.3	8.5
2018	40.7	109.0
2019	54.0	203.7
2020	- 1.2	- 6.7

Source: MFIN

The MFAC considers the projections for gross fixed capital formation to be plausible with a downside risk both for 2019 and 2020. During the first six months of 2019. investment spending was very buoyant, up by 78.2% on a year earlier. Nevertheless, the spending during the first six months of the year was still 36.5% of the amount budgeted for the year. In absolute terms, the planned outlays over the forecast horizon are very high and some delays in the implementation of projects cannot be ruled out, thus effecting the outturn both for 2019 and 2020.

Chart 5.11: Gross fixed capital formation



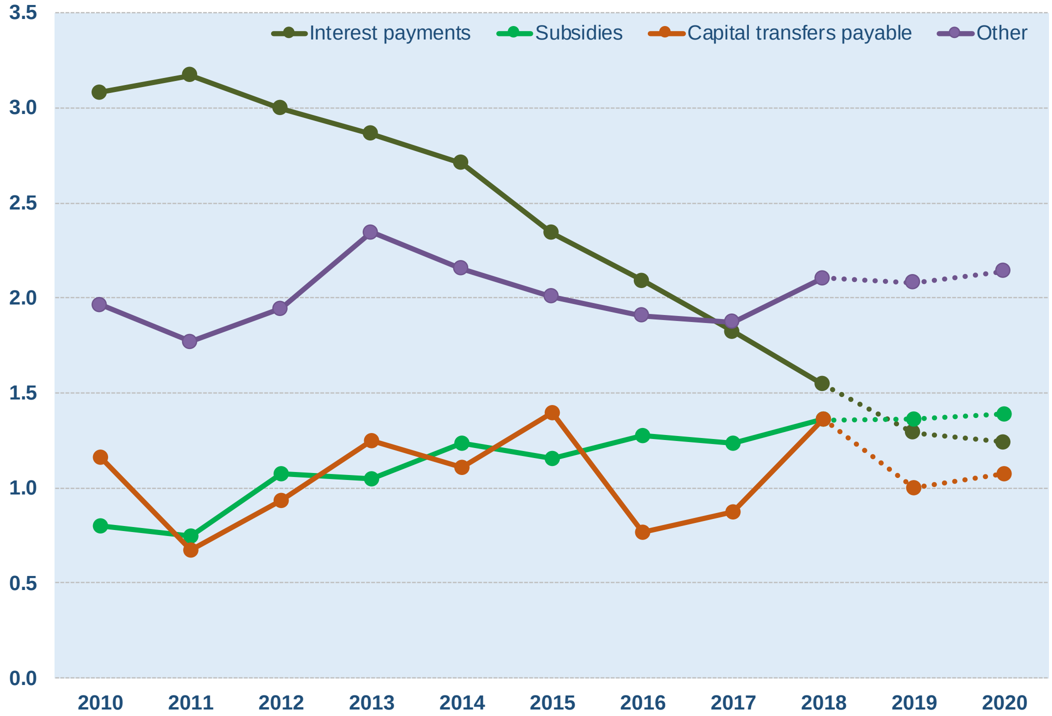
Source: MFIN

5.3.5 Other expenditure components

Compensation of employees, intermediate consumption, social payments and gross fixed capital formation account for the bulk of total expenditure. Their combined share made up 82.6% of total expenditure in 2018 and is expected to rise to 84.5% by 2020. The remaining components consist of interest payments, subsidies, capital transfers payable and 'other' expenditure. Chart 5.12 shows the forecast profile for these respective categories, expressed as percentage of nominal GDP.

The forecasts for interest payments extend the downward trend in the ratio to nominal GDP which was observed since 2011. In absolute terms, interest payments are expected to decline further in 2019, amounting to €171.0 million, the lowest in a decade. This decline reflects the further reduction in the implicit interest rate on public debt, from 3.3% in 2018 to 3.0% in 2019. This factor more than compensates for the additional costs created by the anticipated higher outstanding level of debt (in absolute terms) in 2019. In turn, the broad stability in the budget for interest payments in 2020 corresponds to the fact that both the outstanding level of debt and the implicit interest rate on public debt are not expected to vary much, compared to a year earlier.

Chart 5.12: Other expenditure components (% of nominal GDP)



Source: MFIN

Subsidies are also expected to maintain a low share with respect to GDP. In absolute terms subsidies are expected to increase from €168.2 million in 2018 to €181.1 million in 2019 and €195.7 million in 2020. However, as a share of GDP, their ratio is set to remain stable at around 1.4%. Likewise, capital transfers are forecast to remain low, equivalent to 1.0% in 2019 and 1.1% in 2020, which is below the 1.4% recorded in 2018. Within this category, the scheme related to the ex-gratia payment on car registration tax has a cost of around €5.0 million, in 2019, which is the last year when such scheme will be operating. On the other hand, 'other' expenditure is expected to follow broadly the expansion in nominal GDP, thereby stabilising the ratio at around 2.1%.

Overall, the MFAC considers the projections for these minor expenditure components to be plausible.

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 2019, but downside risks for 2020 (see Table 5.12).[50]

Table 5.12: Fiscal risk outlook

	2019	2020
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

The risk outlook for total revenue is neutral throughout the forecast horizon since no clear upside or downside risk has been associated with any revenue component. On the other hand, in 2019 total expenditure may be less than budgeted, in the eventuality of lower-than-planned capital expenditure . The latter two factors apply also for 2020,

[50] An upside (downside) risk to the fiscal balance means that the fiscal balance could be better (worse) than the target.

but their effect is more than offset by the larger upside risks associated with compensation of employees and intermediate consumption.

Overall, the risk assessment carried out by the MFAC suggests that, based on the information available by the cut-off date, the planned fiscal surpluses for 2019 and 2020 are attainable. This on condition that no unexpected significant fiscal risks, beyond what has been discussed in this chapter, materialise over the forecast period.[51]

5.5 Assessment of the public debt projections

In 2019, the outstanding level of public debt is expected to increase by €62.6 million on a year earlier, from €5,641.1 million to €5,703.7 million. The positive stock-flow adjustments, totalling €252.6 million, are expected to outweigh the planned fiscal surplus for the year (See Chart 5.13).[52] On the other hand, in 2020 the outstanding level of debt is projected to decline by €13.0 million as the planned fiscal surplus, estimated at €193.0 million, is expected to outweigh the positive stock-flow adjustment, amounting to €180.1 million.

Notwithstanding the expected absolute increase in debt in 2019, the ratio of public debt as a percentage of nominal GDP is still planned to fall throughout the forecast horizon, from 45.8% in 2018, to 43.0% in 2019, and 40.3% in 2020 (see Chart 5.14). The downward push in the debt-to-GDP ratio over the forecast horizon reflects the projected expansion of nominal GDP, which serves as a denominator for this ratio, and the planned stream of fiscal surpluses.

Stock-flow adjustments are expected to create an upward push on the public debt ratio both in 2019 and 2020, equivalent to 1.9% and 1.3% of nominal GDP respectively. The largest two adjustments relate to the ESA methodology, owing to the difference between cash and accrual recording of transactions, and the holdings of debt by the government (see Table 5.13).[53]

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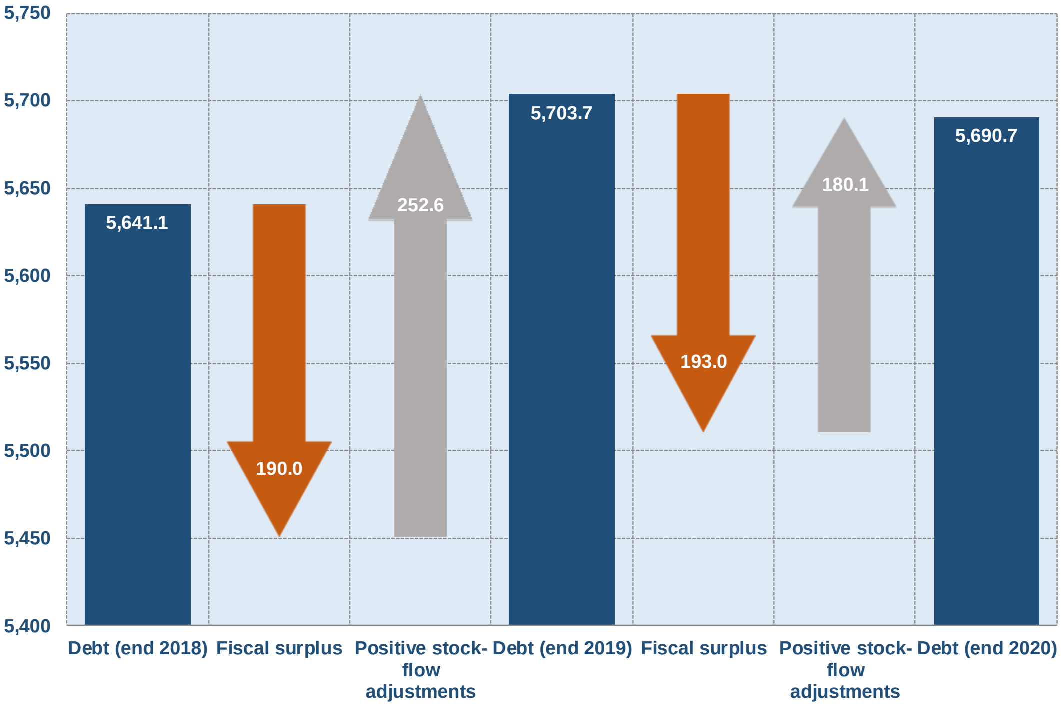
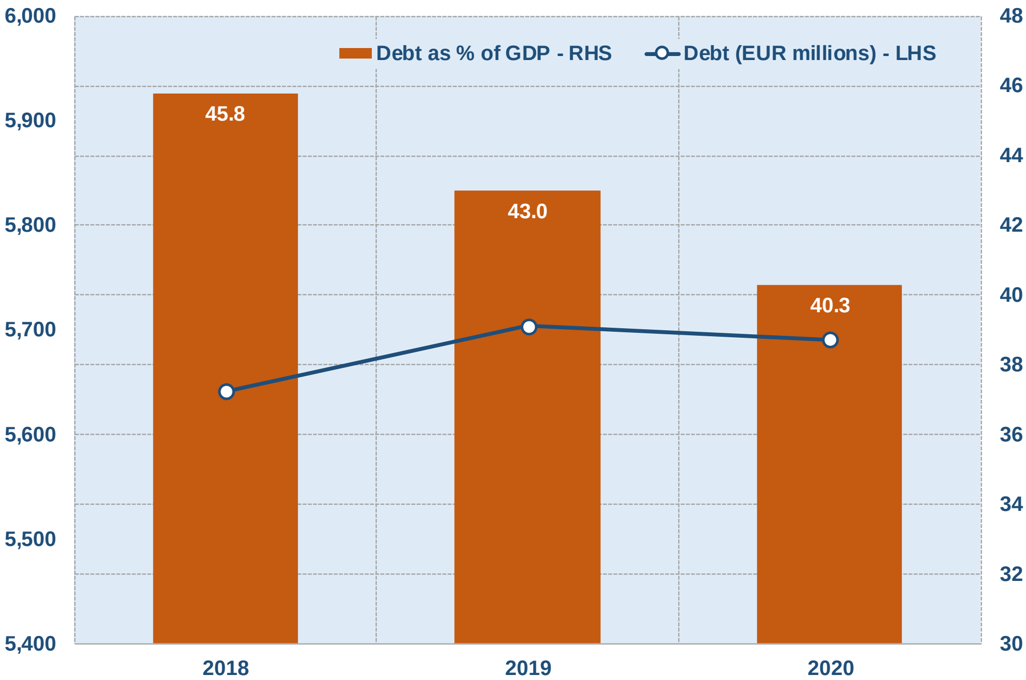
[51] Refer to Table 3.1 in the 2018 Annual Report of the MFAC for a full list of fiscal risks, available on https://mfac.org.mt/publications/reports/reports-2019/.
[52] Stock-flow adjustment are termed 'positive' when they raise the stock of debt and 'negative' when they lower the stock of debt.
[53] A significant part of the ESA adjustment is because the bulk of the IIP revenue accrues to the National Development and Social Fund (NDSF), which forms part of general government for statistical purposes, and which to date has mainly invested such funds in financial assets.

Chart 5.13: Drivers of public debt (EUR million)



Source: MFIN

Chart 5.14: Public debt dynamics



Source: MFIN

This gives rise to the situation where certain revenues are contributing to the fiscal surplus but are not simultaneously contributing to a reduction in the public debt.

Table 5.13: Stock-flow adjustments (EUR millions)

	2019	2020
ESA adjustment	141.5	79.0
Changes in Sinking Fund balances and MGS holdings	43.8	41.8
Equity acquisitions	19.2	10.1
Net impact of EBU-related transactions	9.8	0.0
Changes in cash balances	18.5	1.5
Euro currency issue	10.6	7.8
ESA re-routed debt	4.2	37.0
Other adjustments	5.0	2.9
Total stock-flow adjustment	**252.6**	**180.1**

Source: MFIN

Overall, the trajectory for the public debt ratio can be considered as plausible, since the MFAC considers both the macroeconomic and the fiscal outlook for 2019 and 2020 to be within its endorsable range, and the anticipated sock-flow adjustments are also deemed to be realistic. So long as the plans underpinning the DBP projections are closely adhered to, the debt targets should be achievable.

The upside risk to the fiscal balance which was identified in relation to 2019 could translate into a downside risk to the debt in that year.[54] In turn, should the outstanding debt as at end 2019 end up lower than projected, this would create a base effect which would carry onto 2020, since debt is a stock variable. On the other hand, the downside risk to the fiscal balance identified in relation to 2020 could translate into an upside risk to the debt in that year. The latter risk could more than offset the possible base effect carried forward from 2019.

[54] A downside risk to public debt means that the outstanding debt in absolute terms could be less than the target.

Chapter 6

Comparison across different fiscal forecasts

6.1 Introduction

The plausibility of the fiscal forecasts contained in the DBP 2020 can be further assessed by examining the extent of similarity or divergence with the forecasts produced by other institutions. In this respect, a comparison is carried out with respect to the previous vintage of official forecasts (USP 2019 – 2022) and the forecasts published by the CBM, COM, IMF and credit rating agencies. As in the case of the macroeconomic forecasts, the main caveat remains that such forecasts are based on different data vintages.

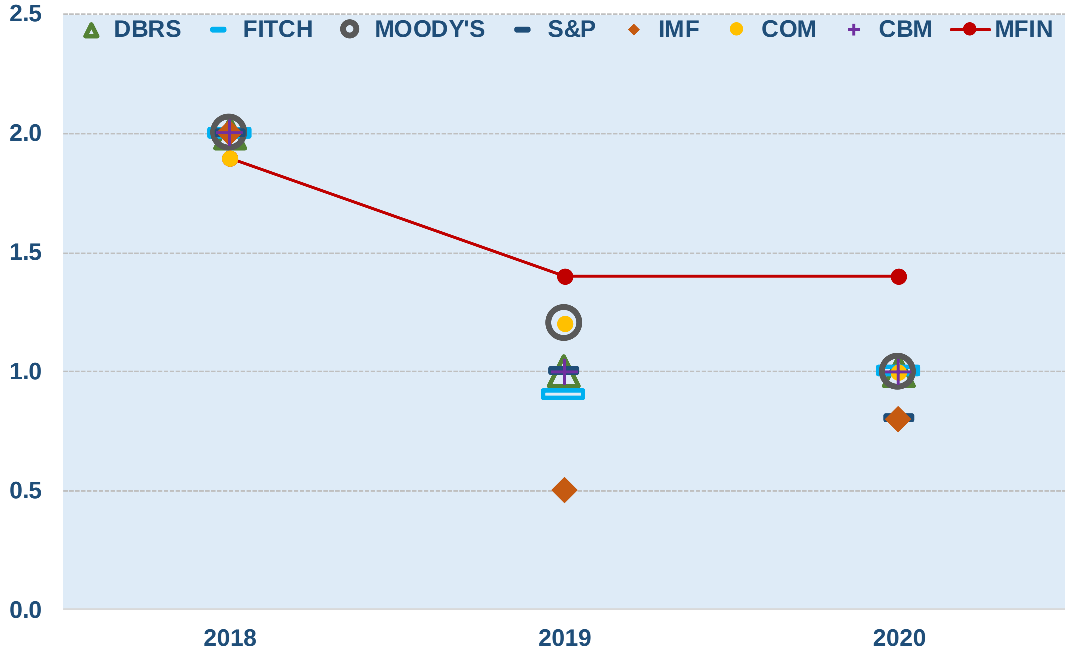
6.2 Fiscal balance

All institutions expect the fiscal balance to remain in surplus, and broadly stable, over the forecast horizon. However, the MFIN is targeting a slightly more ambitious fiscal surplus compared to the other institutions (see Chart 6.1).[55] For 2019, the fiscal surplus ranges from 0.5% of GDP by the IMF, to 1.2% by the COM and Moody's, and thus slightly below the 1.4% indicated by the MFIN in the DBP. Similarly, the forecasts for 2020 cluster around a surplus equivalent to 1.0% of GDP, which is below the 1.4% stated in the DBP. This is consistent with the downside risk to the fiscal balance for 2020 identified by the MFAC.[56]

The targets for the fiscal balance were revised upwards in the DBP compared to the USP. For 2019, the DBP targets a surplus of €190.0 million, which is €69.7 million higher than indicated in the USP (see Table 6.1). Indeed, there was a larger revision in total revenue, amounting to €87.3 million, when compared to the €17.6 million upward adjustment in total expenditure.

[55] The publication dates were as follows: MOODY'S (March 2019), FITCH (July 2019); DBRS (August 2019); S&P (September 2019).
[56] Refer to chapter 5 in this Report for further details.

Chart 6.1: Fiscal surplus estimates by institution (% of GDP)



Source: MFIN, CBM, COM, IMF, DBRS, FITCH, MOODY'S, S&P

The upward revision in total revenue was mostly driven by an upward re-assessment of current taxes on income and wealth, where the target was lifted by €67.5 million. The intake from taxes on production and imports was also increased by €12.1 million. Other revenue was revised upwards by €8.2 million. The forecasts for social contributions remained unchanged.

In turn, the upward revision in expenditure, was concentrated in increases in gross fixed capital formation and intermediate consumption, which were respectively raised by €55.5 million and €20.5 million. These were partially offset by downward revisions to social payments, and to a lesser extent, compensation of employees and 'other' expenditure.

For 2019, the revenue forecasts by the COM are very close to those indicated in the DBP, whereas the CBM's forecasts are slightly less. The forecasts produced by the CBM diverge from those by the MFIN mainly in relation to the expected lower yield from current taxes on income and wealth by the former institution. Differences in 'other' revenue can be ascribed to the different assumptions in relation to the absorption of EU funds and the proceeds from the IIP.

Table 6.1: Fiscal forecasts by the MFIN, COM and CBM (EUR millions)

	2019				2020			
	MFIN DBP	MFIN USP	COM AUT	CBM AUT	MFIN DBP	MFIN USP	COM AUT	CBM AUT
Total Revenue	**5,211.7**	**5,124.4**	**5,202.0**	**5,105.3**	**5,523.6**	**5,346.8**	**5,493.0**	**5,359.0**
Taxes on production & imports	1,677.9	1,665.8	1,677.0	1,678.0	1,804.9	1,758.0	1,808.0	1,766.2
Current taxes on income & wealth	1,863.9	1,796.4	1,860.0	1,798.7	2,007.0	1,932.9	1,997.0	1,925.5
Social contributions	817.0	817.5	812.0	808.4	870.6	875.0	862.0	852.5
Other *	852.9	844.7	853.0	820.2	841.1	780.9	826.0	814.8
Total expenditure	**5,021.7**	**5,004.1**	**5,040.0**	**4,966.4**	**5,330.6**	**5,205.1**	**5,352.0**	**5,213.1**
Compensation of employees	1,484.5	1,490.3	1,490.0	1,482.6	1,567.9	1,577.4	1,580.0	1,595.1
Intermediate consumption	957.4	936.9	958.0	924.6	1055.4	987.1	1,053.0	981.5
Social payments	1,238.5	1,275.1	1,247.0	1,246.4	1,308.6	1,327.8	1,324.0	1,313.1
Gross fixed capital formation	580.6	525.1	580.0	501.3	573.8	485.9	571.0	482.9
Other **	760.7	776.7	765.0	811.5	824.9	826.9	824.0	840.5
Fiscal balance	**190.0**	**120.3**	**163.0**	**139.0**	**193.0**	**141.7**	**140.0**	**145.9**
Gross debt	**5,703.7**	**5,755.8**	**5,716.0**	**5,731.7**	**5,690.7**	**5,740.2**	**5,758.0**	**5,735.8**

* Include capital taxes, property income and 'other' revenue.
** Include interest payments, subsidies, capital transfers payable and 'other' expenditure.

Sources: MFIN, COM, CBM

On the expenditure front, the 2019 projections by the COM are slightly higher whereas those by the CBM are slightly lower, when compared to the DBP. The COM expects virtually identical outlays on intermediate consumption and gross fixed capital formation as the MFIN, but slightly higher outlays on the remaining expenditure categories. On the other hand, the CBM's lower expenditure projections are traceable to lower values for intermediate consumption and gross fixed capital formation, when compared to the DBP.

In relation to 2020, both the COM and the CBM anticipate lower revenue than the MFIN. The projections by the CBM are lower across all revenue components. The revenue projections by the COM are also lower except for taxes on production and imports which are marginally higher.

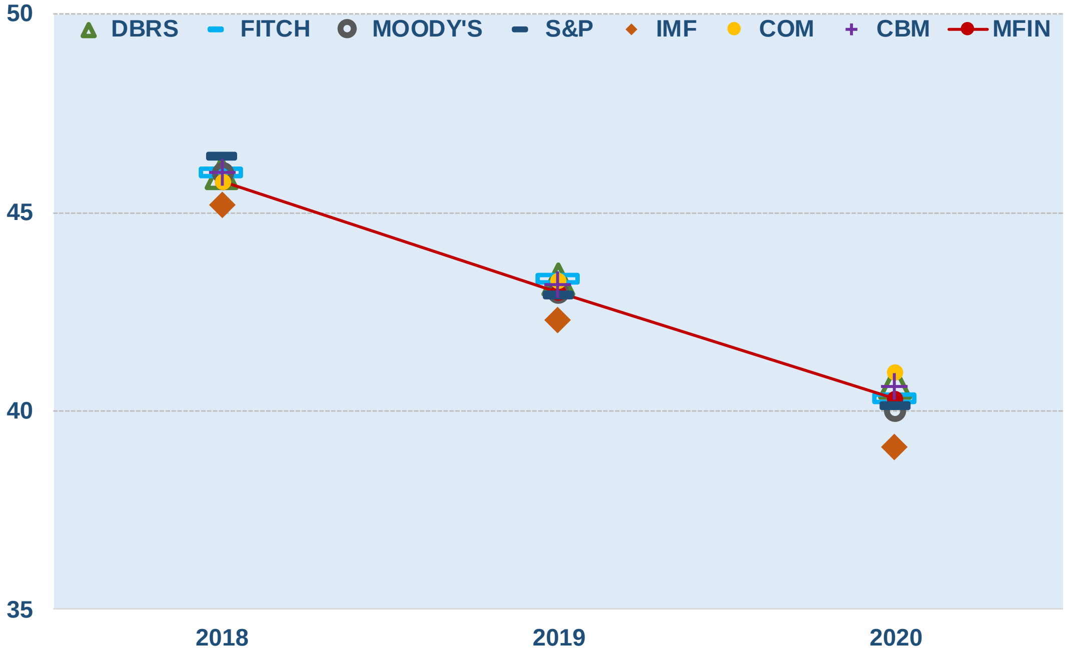
The COM anticipates higher expenditure outlays in 2020, mainly in relation to compensation of employees and social payments. The differences between the expenditure forecasts by the MFIN and the COM are minimal with respect to the remaining categories. On the other hand, the expenditure forecasts by the CBM differ mainly on account of the lower values for gross fixed capital formation and intermediate consumption when compared to the DBP. These are partially offset by higher forecasts for the remaining expenditure categories.

6.3 Public debt

The DBP targets a debt level of €5,703.7 million for 2019, which is €52.2 million below that indicated in the USP. This is also lower than that indicated by both the COM and the CBM as both these institutions are expecting a lower fiscal surplus than targeted by the MFIN. Such discrepancies are carried forward onto the following year. Thus, even for 2020, the absolute debt targets indicated in the DBP are lower than those projected by the CBM and the COM. There is also a difference in the trajectory, since in 2020 both the COM and the CBM expect the debt to increase slightly, whereas the MFIN is targeting a small decline. Apart from the different estimates for the fiscal balance, different assumptions on the value of stock-flow adjustments contribute to this divergence.

The expectations of a downward trajectory in the debt-to-GDP ratio is shared by all institutions, including the IMF and the credit rating agencies (see Chart 6.2).[57] Indeed, there is very strong similarity in the outlook, with the projections by the MFIN fitting within the narrow range of debt forecasts produced by the other institutions.

Chart 6.2: Public debt estimates by institution (% of GDP)



Source: MFIN, CBM, COM, IMF, DBRS, FITCH, MOODY'S, S&P

6.4 Assessment

The revisions undertaken by the MFIN between the USP and the DBP appear plausible. The changes across the forecast rounds can be easily traced. Plausibility support is also offered by the fact that the fiscal forecasts by other independent institutions are broadly in line with those presented in the DBP. The fact that the COM, IMF and credit rating agencies, to varying degrees, concur on the overall fiscal outlook, characterised by a fiscal surplus and a falling debt ratio, suggests that the forecasts included in the DBP have adequately factored in all available information.

[57] When considering the debt-to-GDP ratio, an additional source of discrepancy relates to the different forecasts for the value of nominal GDP, which acts as the denominator for this ratio.

Chapter 7
Compliance with fiscal rules

7.1 Introduction

EU Member States are required to respect the budget balance rule, the debt rule and the expenditure benchmark, as stipulated in the SGP (see Table 7.1). These rules are designed to encourage countries to prioritise fiscal sustainability and prevent the build-up of imbalances in government finances. The debt rule and the budget balance rule feature identically in the 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 where the COM identifies a 'significant deviation' from the country's Medium-Term Budgetary Objective (MTO).

Table 7.1: Requirements currently applicable to Malta's fiscal policy

	2018	2019	2020
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	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

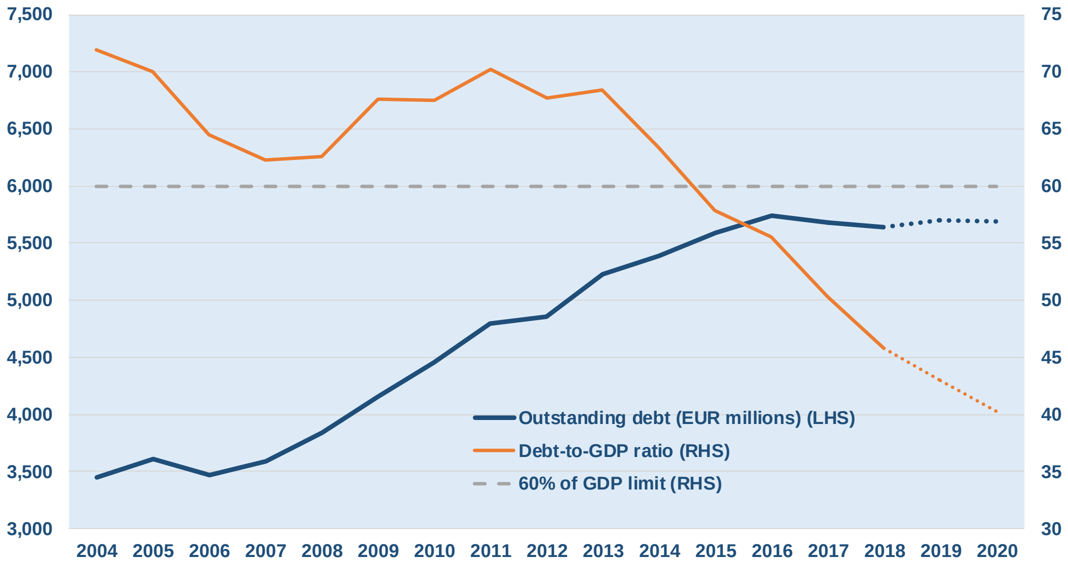
In 2018 there was full compliance with the fiscal rules as the public debt ratio remained below 60% of GDP, while the country continued to run a structural fiscal surplus, thereby over-achieving its MTO. The plans presented in the DBP suggest that both in 2019 and 2020, the debt ratio will remain below 60% of GDP, and the country will continue to over-achieve its MTO. Hence, there is ex-ante full compliance with the fiscal rules over the forecast horizon.[58]

The European Commission shares the same compliance assessment, stating that "overall, the Commission is of the opinion that the Draft Budgetary Plan of Malta is compliant with the provisions of the Stability and Growth Pact".[59]

7.2 Debt rule

The debt rule, which requires that the debt-to-GDP ratio is below 60%, has been consistently respected since 2015 (see Chart 7.1). In 2018, public debt amounted to 45.8% of GDP, well below the ceiling. The ratio is expected to continue declining steadily, to reach 40.3% by 2020. This would safeguard full compliance with the debt rule with a significant margin. Over the forecast horizon, public debt is expected to remain rather stable in absolute terms, close to the levels recorded in 2017 and 2018, and contrasting with the trend increase registered over the previous decade.

Chart 7.1: Public debt trajectory



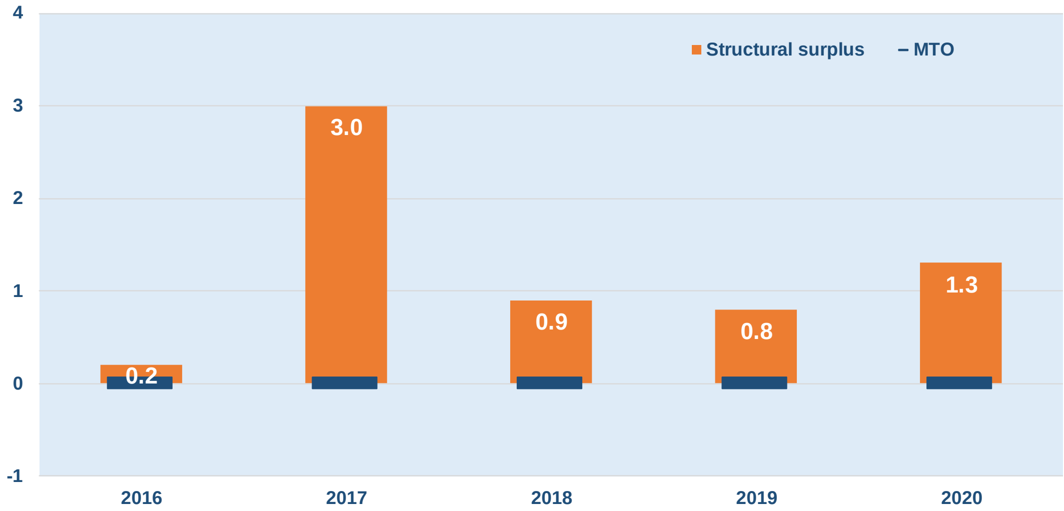
Source: MFIN

[58] Throughout the period 2018 to 2020, the expenditure benchmark is not binding.
[59] Commission Opinion of 20.11.2019 on the Draft Budgetary Plan of Malta available on https://ec.europa.eu/info/sites/info/files/economy-finance/c-2019-9114.pdf.

7.3 Budget balance rule

The MTO for Malta has been set at balanced budget in structural terms, which is equivalent to 0.0% of potential output. The initial commitment was to reach the MTO by 2019. However, this objective was over-achieved starting from 2016. In 2017 and 2018, the structural surpluses amounted respectively to 3.0% and 0.9% of potential output (see Chart 7.2). The structural surplus is expected to reach 0.8% of potential output in 2019 and 1.3% in 2020. This would ensure full compliance with the budget balance rule over the forecast horizon.

Chart 7.2: Structural balance and MTO (% of potential output)



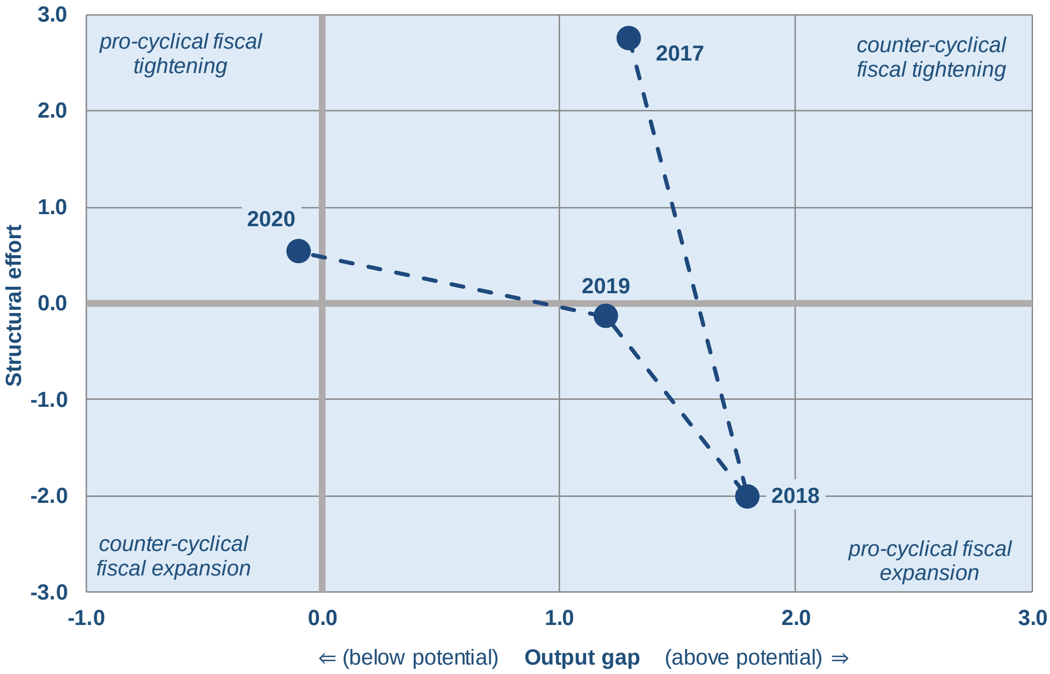
Source: MFIN

The reduction in the structural surplus in 2018, and that planned for 2019, corresponds to a negative structural effort over these two years. On the other hand, the estimated increase in the structural surplus in 2020 is tantamount to a positive structural effort (see Chart 7.3). The positive output gap in 2018 and 2019, combined with the negative structural effort, gives rise to a pro-cyclical fiscal expansion, in these two years. On the other hand, in 2020, the planned larger structural surplus, at a time when the output gap is expected to turn slightly negative, corresponds to a pro-cyclical fiscal tightening.

7.4 Expenditure benchmark

Due to the over-achievement of Malta's MTO in 2018, and based on the projections by the MFIN and the COM indicating that the MTO is expected to continue being over-achieved, the expenditure benchmark does not need to be assessed.[60] This is because the expenditure benchmark is a corrective measure, useful to steer countries towards achieving their MTO, an objective which Malta has already achieved and is expected to maintain. This on condition that such achievement is not driven by windfalls. Malta's structural surplus is not a result of such windfalls. These factors make the expenditure benchmark 'non-binding' in terms of compliance with the SGP. No significant deviation was identified by the COM for Malta's public finances, thus making the FRA's clause referring to the expenditure benchmark as not applicable. This notwithstanding, the MFAC considers important that expenditure developments continue to be carefully monitored by the MFIN, to avoid possible unsustainable developments. This mirrors the same view expressed by the EU Commission "expenditure developments should be monitored carefully, especially in light of possible future risks to the robustness of revenues, to safeguard compliance in line with the Stability and Growth Pact".[61]

Chart 7.3: Cyclical conditions and structural effort (pp of GDP)



Source: MFIN

[60] 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.

[61] Source: Commission Staff Working Document "Analysis of the Draft Budgetary Plan of Malta" accompanying the document Commission Opinion on the Draft Budgetary Plan of Malta. Available on https://ec.europa.eu/info/sites/info/files/economy-finance/swd-2019-924.pdf.

Chapter 8
Conclusion

The positive performance of the Maltese economy over recent years is set to continue in 2019 and 2020, but to moderate slightly. Based on the information available, and on the assessment undertaken, the MFAC considers that the macroeconomic forecasts presented in the latest DBP to be within its endorsable range. This assessment is corroborated by the broad similarity between the macroeconomic forecasts presented in the DBP and those produced by the CBM, COM, IMF, and credit rating agencies.

Similarly, 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 within its endorsable range. The MFIN's fiscal projections are in line with those published by the CBM, COM, IMF, and credit rating agencies, adding to their plausibility. This assessment 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.

It is important that should new policy initiatives be undertaken, beyond what is embedded in the DBP, these are compensated for by measures which safeguard the attainment of the announced fiscal targets. In addition, any revenue windfalls which could materialise, should be used primarily to reduce the debt further.

The MFAC acknowledges the clear commitment by the Government to continue running a structural surplus, thus continuing to over-achieve the country's MTO and enabling 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. Such fiscal space would prove invaluable in the eventuality that economic conditions become less favourable at some future date. [62] At the same time, the MFAC positively notes the fact that all fiscal rules

[62] Fiscal space can be defined as the room for undertaking discretionary fiscal policy relative to existing plans without endangering market access and debt sustainability. For an overview refer to IMF (2018) "Assessing fiscal space: an update and stocktaking" available on https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/06/15/pp041118assessing-fiscal-space.

continued to be fully met and the implementation of the budget plans is expected to safeguard full compliance.[63]

Notwithstanding the benign macro-fiscal environment, which is expected to prevail between 2019 and 2020, vigilance remains important, particularly as elements of uncertainty remain. Malta's very open economy makes it subject to possible adverse shocks arising from the external sector. Factors currently maintaining buoyant domestic demand conditions may also abate. On the fiscal front, certain budget components may be subject to sudden changes, and some fiscal risks might eventually crystallise.

The benign macroeconomic and fiscal conditions also offer a window of opportunity for carrying out the necessary reforms to address long-term challenges. In this respect, the report on the current state of public pensions, which the Pensions Strategy Working Group will be presenting by 2020, will serve as good basis for taking stock of the situation, and consider policy action if necessary.

Apart from this, the MFAC reiterates the importance that the fiscal plans maintain a long-term focus, to adequately cater for the challenges associated with Malta's rapid structural change, population growth, infrastructural requirements and international environmental obligations.

[63] Malta was one of the nine euro-area countries whose Draft Budgetary Plans were found to be compliant by the European Commission. For further details refer to "Communication from the Commission to the European Parliament, the Council and the European Central Bank on the 2020 Draft Budgetary Plans: Overall Assessment", which is available on https://ec.europa.eu/info/sites/info/files/economy-finance/comm_chapeau_201119.pdf.

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