Assessment of the Annual Report 2019 and Half-Yearly Report 2020

MFAC
MALTA FISCAL ADVISORY COUNCIL

October 2020

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7 October 2020

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

Dear Minister,

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

In terms of the Fiscal Responsibility Act, the Malta Fiscal Advisory Council is hereby presenting its assessment of the Annual Report and the Half-Yearly Report which were published by the Ministry for Finance and Financial Services in 2020.

Both reports contribute positively to fiscal transparency, by providing an account of the outturn of the previous year compared to the targets, and by outlining the updates to the fiscal projections for the current year.

The Council notes that in 2019 nominal GDP growth was below that which had been indicated in the Draft Budgetary Plan and the Update of Stability Programme. This factor is likely to have contributed to the miss in the revenue targets for the year. Consequently, in 2019 the fiscal balance remained in surplus but was lower than projected. The Council also notes that the Half-Yearly Report reproduced the macroeconomic forecasts which had been presented in April (as part of the Update of Stability Programme), whereas the fiscal projections were revised to a larger fiscal deficit and higher public debt.

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The Council acknowledges that when the Half-Yearly Report was produced, only the official GDP statistics for the first quarter of 2020 were available. This also applies to the report produced by the Council, whose cut-off date is 14 August 2020. The Council understands that as part of next year's budget preparations, the Ministry is closely analysing the 2020 second quarter GDP statistics (which included a benchmark revision for previous years), when the full force of the COVID-19 restrictive measures were in place, and the possible implications for the macroeconomic outlook for the year as a whole.

The Malta Fiscal Advisory Council takes note of the Recommendation adopted by the European Council on 20 July 2020 wherein Member States were advised that: "In line with the general escape clause, take all necessary measures to effectively address the pandemic, sustain the economy and support the ensuing recovery. When economic conditions allow, pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment."

In its assessment report, the Fiscal Council identified missing information, which is prescribed in the Fiscal Responsibility Act, and invites the Ministry to address such lacunae in forthcoming reports. Moreover, the Council invites the Ministry to ensure that the production of the Half-Yearly Report follows a timetable which allows it to be tabled in Parliament before the summer recess, in line with the end-July deadline.

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

Yours sincerely,

John Cassar White
Chairman

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Abbreviations

COM	European Commission
COVID-19	Coronavirus disease
DBP	Draft Budgetary Plan
EBU	Extra-Budgetary Unit
ESA	European System of National and Regional Accounts
EU	European Union
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
IIP	Individual Investor Programme
MFAC	Malta Fiscal Advisory Council
MFIN	Ministry for Finance and Financial Services
MGS	Malta Government Stock
NDSF	National Development and Social Fund
NSO	National Statistics Office
pp	percentage point
USP	Update of Stability Programme
VAT	Value-Added Tax

Executive Summary

The Annual Report and the Half-Yearly Report published by the Ministry for Finance and Financial Services contribute to economic transparency, respectively by comparing the macroeconomic and fiscal outturn in 2019 to the forecasts, and by updating the fiscal projections for 2020, based on the estimated outturn during the first six months of the year.

According to the NSO News Release 034/2020, nominal GDP growth was estimated at 6.8% in 2019. As a result, the nominal GDP growth forecasts for 2019, of 7.7% and 9.3%, respectively published in the Draft Budgetary Plan (in October 2018) and the Update of Stability Programme (in April 2019), were both overstated.

Likewise, in 2019, the fiscal turnout, despite being in surplus, was less positive than anticipated. The Consolidated Fund recorded a surplus of €9.4 million (on a cash basis), short of the €33.3 million approved in the Financial Estimates. In turn, the ESA fiscal balance (on an accrual basis) recorded a surplus of €71.0 million, which was higher than in the Consolidated Fund, but smaller when compared to the €165.0 million and €120.3 million respectively targeted in the Draft Budgetary Plan and the Update of Stability Programme.

In 2020, public finances are expected to shift again into deficit. This is due to the COVID-19 pandemic and the ensuing negative macroeconomic outlook, which according to the official forecasts available by the cut-off date, is expected to lower real GDP by 5.4%, and nominal GDP by 3.6%. The Update of Stability Programme had originally indicated a fiscal deficit of €951.9 million, but this has been updated to €1,109.7 million in the Half-Yearly Report. The forecast for the outstanding public debt has likewise been revised from €6,939.7 million to €6,988.3 million, by the end of 2020.

The Malta Fiscal Advisory Council takes note of the Recommendation adopted by the European Council on 20 July 2020 wherein Member States were advised that: “In line with the general escape clause, take all necessary measures to effectively address the pandemic, sustain the economy and support the ensuing recovery. When economic conditions allow, pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment.”

Chapter 1

Introduction

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

The main purpose of the Annual Report is to review the macroeconomic developments of the previous year and provide explanations for the possible variances vis-à-vis the official forecasts; as well as to provide information on the execution of the previous budget, and compare its outcome with the fiscal targets as announced in the previous annual budget. This ex-post assessment is useful to evaluate the quality of the official forecasts and help detect any possible systematic forecast bias over the years. Accurate macroeconomic and fiscal forecasts are necessary for good policymaking, while acknowledging the challenges in producing precise forecasts in the case of a small open economy.

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

This Report, whose cut-off date is 14 August 2020, proceeds as follows. **Chapter 2** evaluates the macroeconomic forecasting performance in relation to 2019. **Chapter 3** focuses on the variances between the fiscal targets and the actual outturn for 2019, both as reflected in the Consolidated Fund, and according to the European System of National and Regional Accounts (ESA). **Chapter 4** reviews the official macroeconomic forecasts for 2020, which had been initially presented in the USP. **Chapter 5** presents the updates to the fiscal projections for 2020 in the context of the estimated developments during the first half of the year. **Chapter 6** concludes with an overall assessment and recommendations.

Chapter 2

Nominal macroeconomic developments in 2019

The MFIN's Annual Report focuses on the growth rates for GDP and its components in nominal terms, since these are the main aggregates used to prepare the fiscal projections. The nominal GDP growth forecast for 2019 was overestimated in both the DBP (published in October 2018) and the USP (published in April 2019). NSO News Release 034/2020 (representing the first vintage for the year), which was published in February 2020, indicated that nominal GDP grew by 6.8% in 2019 (see Chart 2.1).[1] The DBP's forecast, at 7.7%, was the closest, yet still over-estimated, while the USP had indicated an even higher nominal GDP growth forecast of 9.3%. Thus, the revised stronger economic outlook envisaged in the USP did not materialise.

In 2019, private consumption grew by 3.9%, 0.8 percentage points (pp) lower than anticipated in the DBP and almost halve the growth forecast in the USP.[2] On the other hand, government consumption increased by 14.7%, which was 4.1pp above that expected in the DBP, but slightly below that indicated in the USP. In this case, the availability of in-year data contributed to improve the forecast accuracy.

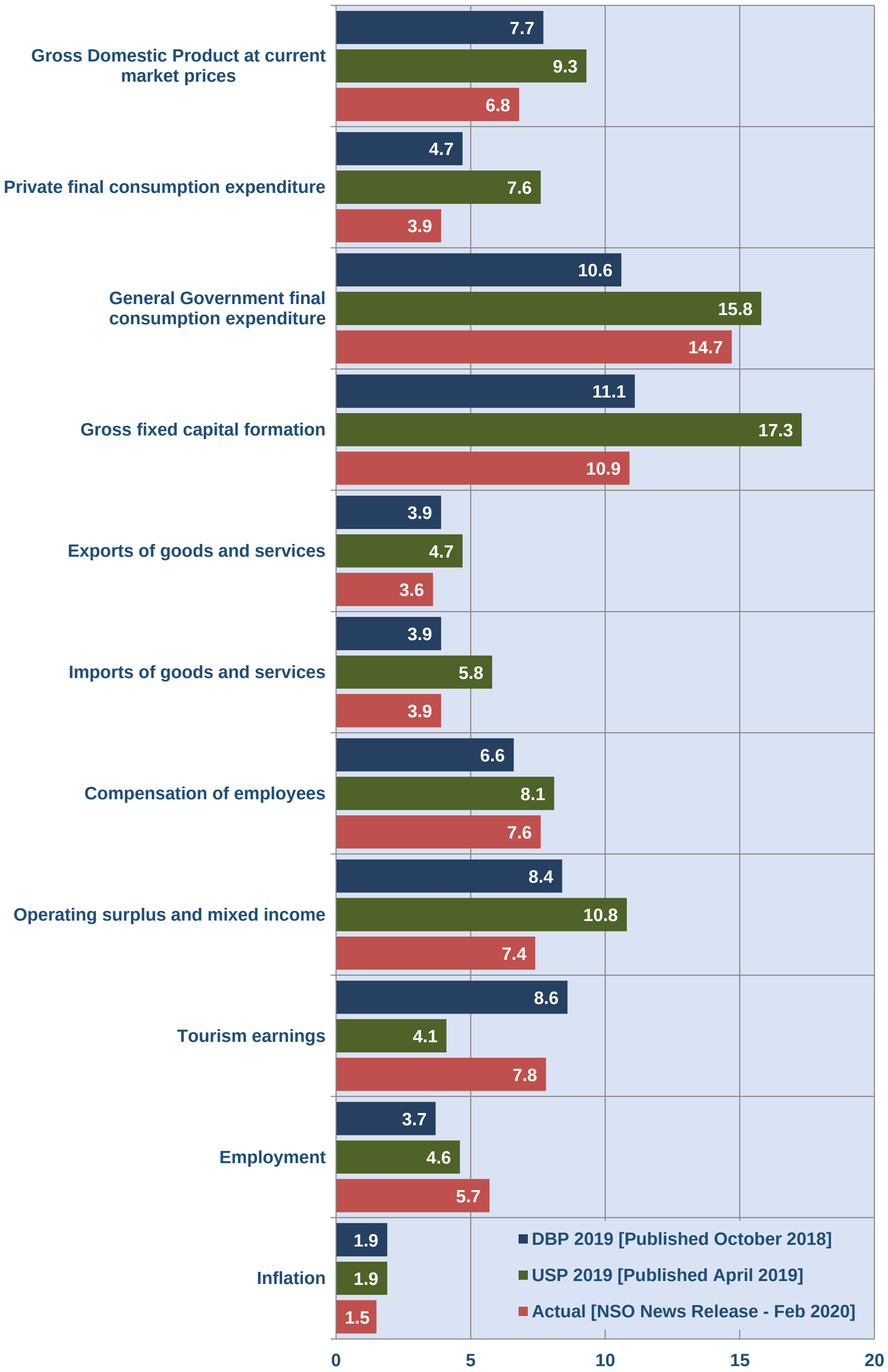
This contrasts with the pattern for gross fixed capital formation whose growth forecast was accurate in the DBP but overestimated in the USP. Indeed, as was the case with private consumption, the USP had significantly overestimated the nominal growth for gross fixed capital formation.

Even in relation to the external sector, the forecast errors for exports and imports were smaller in the DBP than the USP. Exports grew by 3.6%, merely 0.3pp lower than presented in the DBP, but 1.1 pp lower than indicated in the USP. In turn, imports grew by 3.9%, in line with the nominal growth rate indicated in the DBP but much lower than the 5.8% nominal growth anticipated in the USP.

[1] The subsequent NSO News Release 091/2020 (second vintage) revised the nominal GDP growth slightly higher to 7.1%. The MFAC has used the first vintage for its assessment, to be in line with the content presented by the MFIN in its Annual Report.

[2] Private consumption is the only GDP component which is modelled in real terms in the MFIN's framework. Nominal private consumption growth is then calculated by combining it with the forecast for the consumption deflator. In 2019, the deviation predominantly reflected the forecast error in real private consumption growth. Indeed, the DBP and the USP had indicated forecast consumption growth rates of 4.1% and 5.8%, respectively, in real terms, but according to the NSO, the actual real growth in consumption was estimated at 2.4%.

Chart 2.1: Nominal macroeconomic developments in 2019 (year-on-year % change)



Source: MFIN

Turning to the income side of GDP, compensation of employees expanded by 7.6%, in between the range of forecasts presented across the two rounds. However, the economic expansion was more job-rich than had been anticipated in either forecast round. Indeed, employment grew by 5.7%, faster than the 3.7% and 4.6% rates of growth forecast in the DBP and the USP respectively.

Variations between the outturn for operating surplus and mixed income and the forecasts explain relatively more of the overall forecast error vis-à-vis nominal GDP growth for 2019. Operating surplus and mixed income increased by 7.4%, only one pp below that indicated in the DBP, but 3.4 pp lower than anticipated in the USP. Hence, even in this case, the forecasts proved more accurate in the DBP than in the USP.

Likewise, the forecast for tourism earnings contained in the DBP was more accurate than that in the USP. Earnings expanded by 7.8% on a year earlier, and together with the employment growth forecast, were the only two cases where the USP underestimated the actual performance.

The inflation forecasts were maintained stable across the two forecast rounds and the turnout was marginally lower.

Overall, the DBP forecasts for the various GDP components, both from the expenditure side and the income side were closer to the outturn than those presented in the USP, which indeed overestimated all the component growth forecasts (see Chart 2.2).[3]

Whereas in previous years, the official nominal GDP growth forecasts consistently turned out on the conservative side compared to the outturn (both vis-à-vis the forecasts contained in the DBP and those presented in the USP), in 2019, the actual nominal growth, despite being elevated, was lower than indicated in either forecast round (see Chart 2.3). Nonetheless, the average absolute forecast deviations for nominal GDP growth across the five-year period 2015 to 2019 remained within an acceptable range (see Chart 2.4).[4] This observation applies to all expenditure

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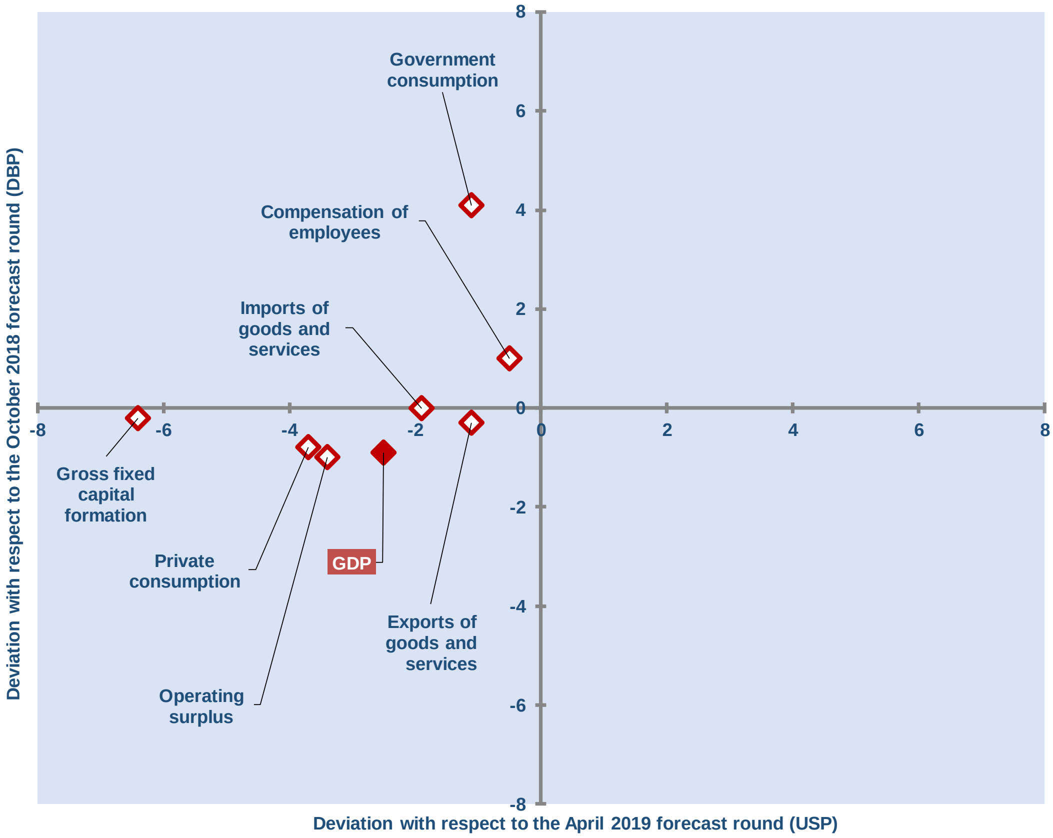
[3] The superior DBP forecasts is indicated by the fact that the deviations are smaller and hence rather close to the x axis on the chart. The consistent overestimation of the USP forecasts is indicated by the fact that the deviations with respect to the forecasts presented in the USP were all negative, and hence to the left of the x axis.
[4] The deviations are computed by taking the absolute difference between the actual and the forecast growth rate in each year. Positive and negative differences are treated equally. The sum of these differences is divided by the number of years (in this case 5) to determine the

components except for gross fixed capital formation where the deviations were much higher. Despite the USP forecasts for nominal investment growth were closer to the actual data, as suggested by the relatively smaller absolute average deviation compared to the DBP, the forecast error across the years was still significant.

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



Note: The top-left quadrant indicates instances when the actual turnout was higher than indicated in the October 2018 (DBP) forecast round, but lower than indicated in the April 2019 (USP) forecast round. The top-right quadrant indicates instances when the actual turnout was higher than indicated in both the October 2018 (DBP) and the April 2019 (USP) forecast rounds. The bottom-left quadrant indicates instances when the actual turnout was lower than indicated in both the October 2018 (DBP) and the April 2019 (USP) forecast rounds. The bottom-right quadrant indicates instances when the actual turnout was lower than indicated in the October 2018 (DBP) forecast round, but higher than indicated in the April 2019 (USP) forecast round.

Source: MFIN

The MFAC acknowledges the greater challenge involved in attaining accurate forecasts for gross fixed capital formation, particularly as this component has exhibited very high and volatile growth patterns across the years. At the same time, the MFAC notes that such inaccuracies do not, under normal circumstances, create a significant

average yearly deviation. Lower average deviations indicate greater forecast accuracy across the period.

impact upon the nominal GDP growth forecast since, in the case of Malta, gross fixed capital formation exhibits a high import content.[5]

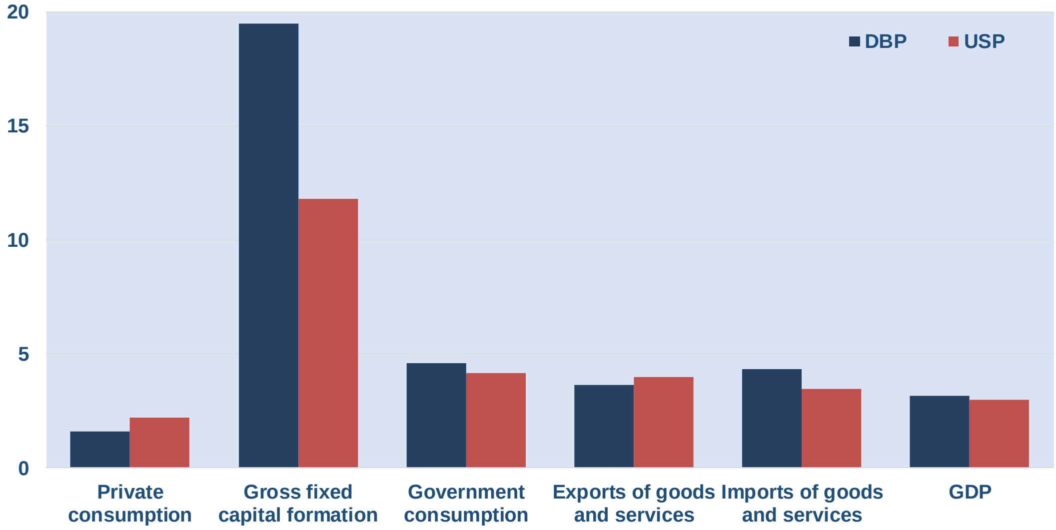
Chart 2.3: Nominal growth – actual vs forecast (pp)

Note: The actual values for 2015-2019 are based on NSO News Release 034/2020. The forecasts labelled 'DBP' correspond to the forecasts for period 't' published in October (in period 't-1'), while the forecasts labelled 'USP' correspond to the forecast for period 't' published in April (in period 't').

Source: MFIN

[5] The high import content implies that any errors vis-à-vis the investment forecast impacts mostly the import growth forecast, with limited effect on the GDP growth forecast.

Chart 2.4: Average absolute forecast deviations 2015 – 2019 (pp)



Source: MFAC

Chapter 3

Fiscal developments in 2019

The accuracy of the official fiscal forecasts is evaluated vis-à-vis the targets set for the Consolidated Fund (as had been indicated at the time of the announcement of the Budget Speech, which is consistent with the DBP) and the ESA targets (as stated in the DBP and the USP). Whereas the Consolidated Fund is based on cash transactions, ESA fiscal data is accruals-based and has a wider coverage, since the activities of Extra-Budgetary Units (EBUs) are also included.[6,7]

3.1 Developments in the Consolidated Fund

In 2019, the Consolidated Fund recorded a surplus of €9.4 million, which was €24.0 million less than originally approved in the Financial Estimates (see Table 3.1).[8] Total recurrent revenue was €40.9 million short of the target, but the effect on the balance was contained since total expenditure was €16.9 million less than planned.[9]

Table 3.1: Main developments in the Consolidated Fund in 2019 (EUR million)

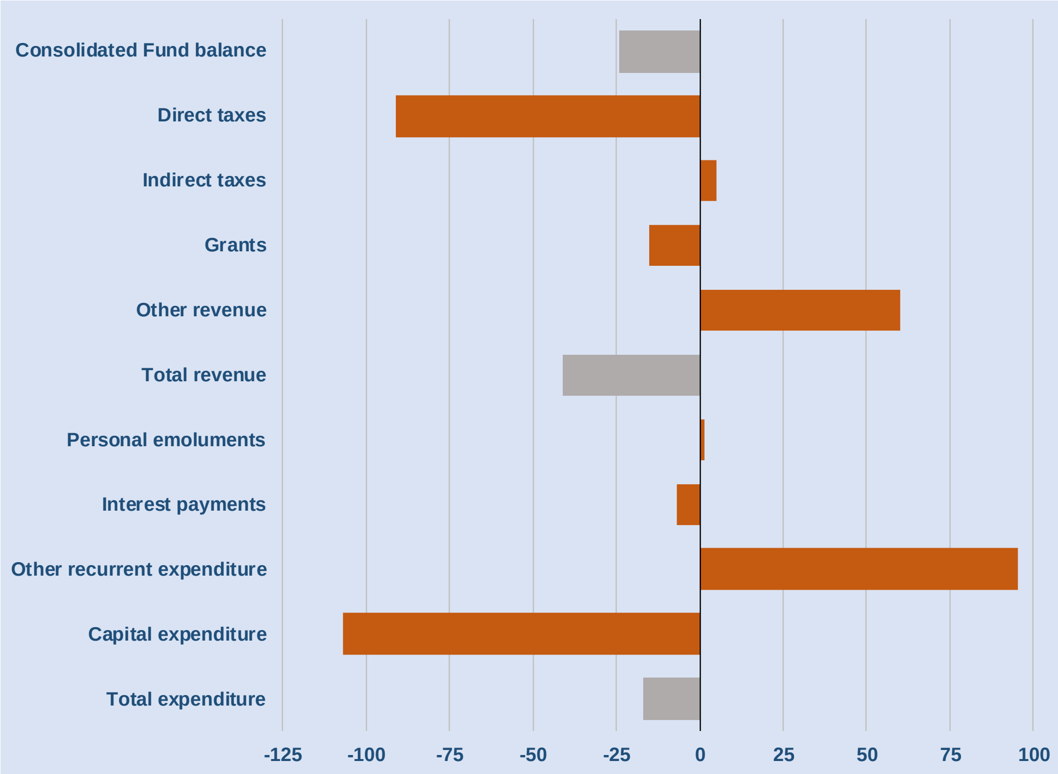
	Financial Estimates	Actual	Difference
Total recurrent revenue	5,013.8	4,972.9	-40.9
Total expenditure	4,980.5	4,963.5	-16.9
Consolidated Fund balance	33.3	9.4	-24.0

Source: MFIN

[6] Since the Consolidated Fund records transactions on a cash basis, these are not directly comparable to the other statistics discussed in this Report. Links with macroeconomic variables are also imperfect.
[7] Compliance with fiscal rules is evaluated using ESA figures.
[8] The approved Financial Estimates which were announced on 22 October 2018 are available on https://mfin.gov.mt/en/The-Budget/Documents/The_Budget_2019/Estimates%202019.zip.
[9] The revenue and expenditure categories featuring in the Consolidated Fund do not correspond precisely to the ESA categories, and hence, the data in section 3.1 and section 3.2 is not directly comparable.

Direct taxes missed the target by €91.1 million, explaining most of the revenue shortfall (see Chart 3.1). Such shortfall contrasts with the pattern observed over the previous five years, when direct taxes consistently exceeded the target (see Table 3.2). This was entirely due to income tax, which in 2019 yielded €103.2 million less than expected, due to higher tax refunds.[10] Social contributions partially mitigated this effect, as the target was exceeded by €12.1 million.

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



Source: MFIN

Revenue from indirect taxes was broadly on target. Some sources performed better than expected (Licenses, taxes and fines +€8.1 million; VAT +€0.7 million) and compensated for the €3.8 million shortfall in Customs and excise duties.

In turn, grants were €15.2 million less than anticipated as the progress on certain projects was slower than planned and thus the absorption of EU funds was below target. On the contrary, other revenue was higher than expected due to better performance in the following sources: the premium on the issue of Malta Government

[10] Certain companies with limited links with the Maltese economy benefit from a favourable tax regime which allows for a share of tax paid to be refunded. These transactions may be large and volatile across the years.

Stock (MGS); proceeds from the Individual Investor Programme (IIP); proceeds from the Residency and Visa Programme; and reimbursements.[11]

Table 3.2: Consolidated Fund 2015-2019 – Actual less Estimates (EUR millions)

	2015	2016	2017	2018	2019
Recurrent revenue	**79.7**	**193.7**	**403.6**	**209.7**	**-40.9**
Direct taxes	71.2	140.3	215.2	57.0	-91.1
Indirect taxes	60.7	25.9	71.8	144.9	5.1
Grants	-87.2	2.9	47.3	-26.9	-15.2
Other revenue	35.0	24.6	69.4	34.8	60.3
Total expenditure	**159.5**	**-11.2**	**92.6**	**258.5**	**-16.9**
Personal emoluments	31.5	-8.0	6.4	39.0	1.3
Other recurrent expenditure	71.2	66.7	102.0	95.7	95.6
Interest payments	-7.9	-3.4	-4.1	-8.6	-6.8
Capital expenditure	64.7	-66.5	-11.8	132.4	-107.0
Fiscal balance	**-79.7**	**204.9**	**311.0**	**-48.8**	**-24.0**

Source: MFIN

On the expenditure side the largest variance related to capital expenditure which was €107.0 million less than expected as projects progressed at a slower pace.[12] Around half of these projects were EU-funded while the other half were funded nationally. There were also €6.8 million additional savings on interest payments as the interest rate environment was more favourable and the outstanding debt was slightly less than projected.

Spending on personal emoluments was in line with the budget allocations. On the other hand, there were broad-based overruns in other recurrent expenditure. These were

[11] 30% of the revenue from the IIP was transferred to the Consolidated Fund, while the other 70% was transferred to the National Development and Social Fund (NDSF).
[12] Between 2015 and 2019 there were three instances out of five where capital expenditure was less than planned.

spread across higher funding needs of government entities; and additional spending on health, education, the extension of the school transport network and operations and maintenance. Such overruns were partially offset by the fact that the budget for social payments was not fully utilised. This reflected lower actual retirements than expected; an over-estimation of the number of beneficiaries; and over-estimation of the impact of budget measures.

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

The general government fiscal balance recorded a surplus of €71.0 million on an ESA basis (see Table 3.3). This was higher than the balance recorded on the Consolidated Fund. However, it was lower when compared to the €165.0 million originally indicated in the DBP 2019, and the €120.3 million targeted in the USP 2019 – 2022. The USP had revised upwards both the revenue and expenditure projections when compared to the DBP, and on a net basis lowered the surplus target. The actual revenue turned out lower than anticipated in either the DBP or the USP, while in the case of expenditure, it was underestimated in the DBP but overestimated in the USP.

Table 3.3: Main developments in 2019 on an ESA basis (EUR millions)

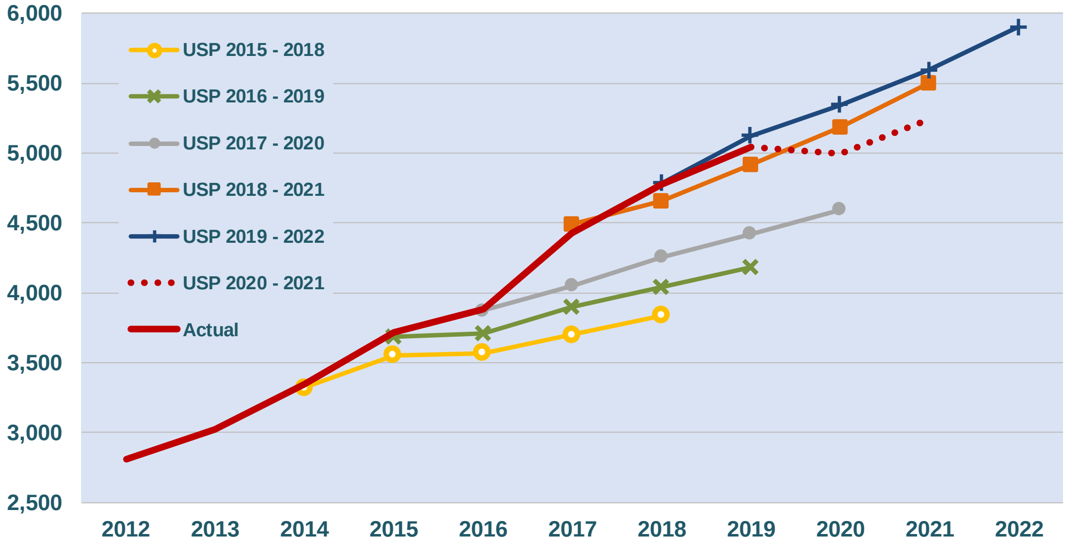
	DBP 2019 Published October 2018	USP 2019 Published April 2019	Actual April 2020	Actual less DBP	Actual less USP
Revenue	5,054.0	5,124.4	5,045.3	-8.7	-79.1
Expenditure	4,889.0	5,004.1	4,974.3	85.3	-29.8
Balance	165.0	120.3	71.0	-94.0	-49.3
Gross debt	5,660.1	5,755.8	5,695.6	-35.5	-60.2

Source: MFIN

When compared to the DBP, the smaller fiscal surplus recorded in 2019 can be mostly ascribed to expenditure overruns. The latter mainly reflected higher spending on intermediate consumption which exceeded the budgeted amount by €99.1 million. On the other hand, revenue shortfalls explain most of the difference in the fiscal balance when compared to the USP. These were mainly the result of underperformance in: the absorption of EU funds; indirect taxes (mirroring the below-forecast household consumption growth); and social contributions (as growth in compensation of employees was slower than expected).

The fact that the revenue forecast for 2019 was not attained contrasts with the pattern observed in previous years, when revenue projections were consistently underestimated (see Chart 3.2).[13] Likewise, in 2019 spending was slightly below budget, in contrast with the patterns which emerged in previous years when the actual expenditure was consistently higher than planned (see Chart 3.3). Such developments yielded a smaller fiscal balance than planned, as opposed to the period 2015 – 2018, when the actual fiscal balance was stronger than targeted (see Chart 3.4).

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

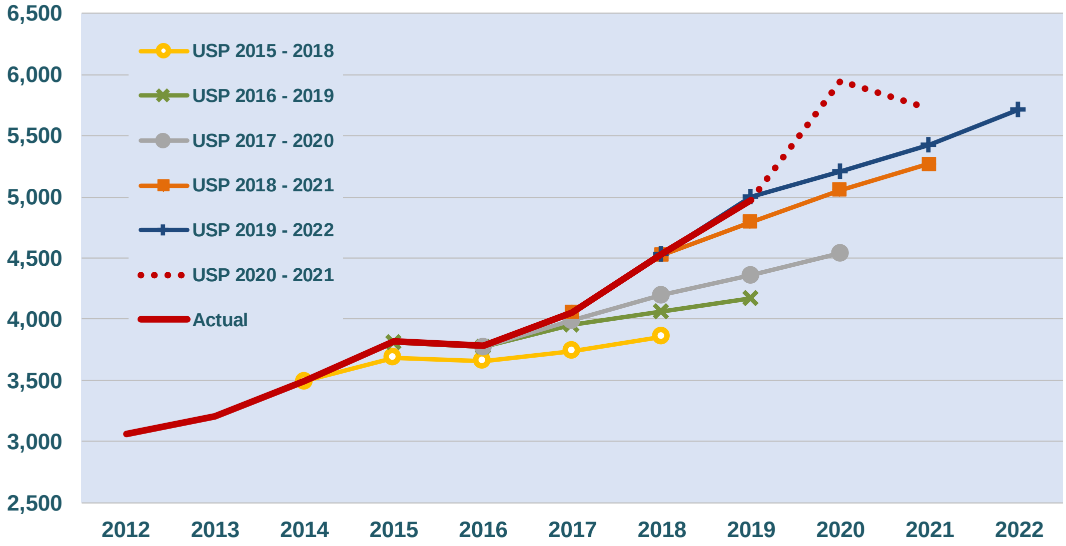


Sources: MFIN, Eurostat

In 2019 public debt amounted to 43.1% of GDP, slightly higher than indicated in the USP (see Chart 3.5). This was entirely due to the fact that the estimated nominal GDP (which acts as denominator to this ratio) was less than projected, since in 2019 nominal GDP growth was 6.8%, compared to the 9.3% indicated in the USP. This effect fully outweighed the fact that outstanding debt (in absolute terms) was less than projected in either the DBP or the USP.[14]

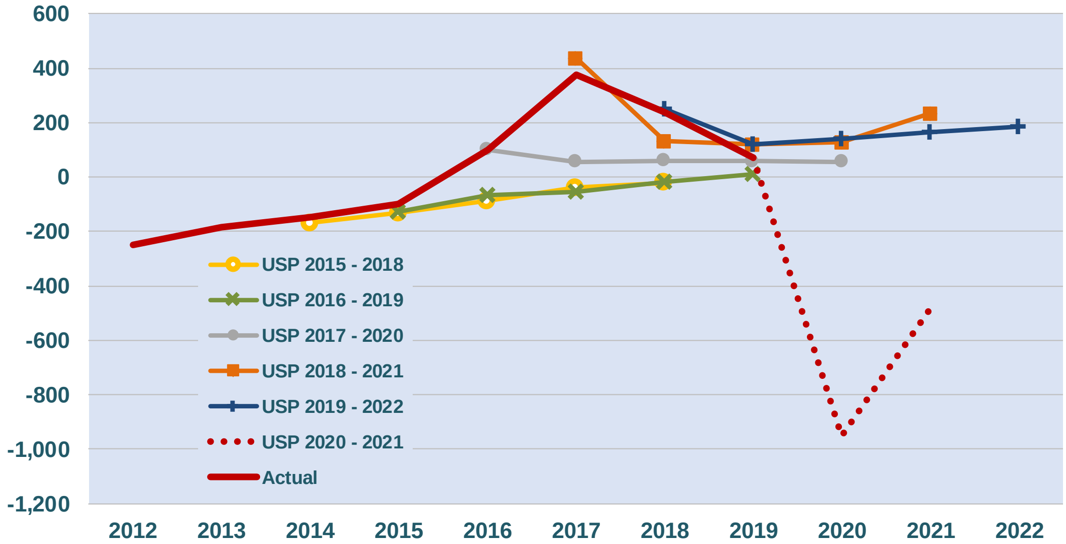
[13] This can be deduced from the upward shifts in the forecasts which nonetheless remained below the actual outturn. The actual revenue over-achieved the targets set.
[14] Stock flow adjustments fully neutralized the effect of a smaller fiscal surplus.

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



Sources: MFIN, Eurostat

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



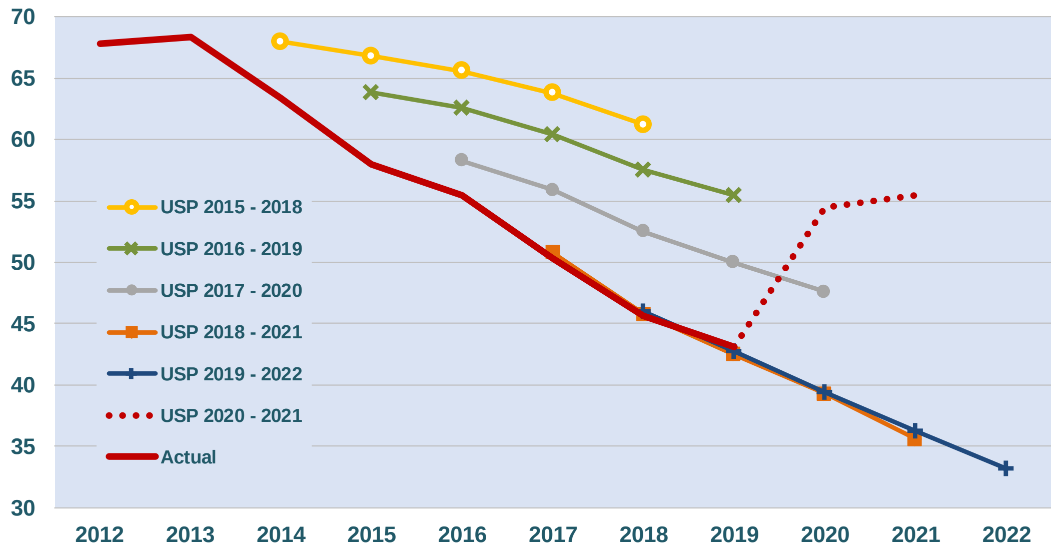
Sources: MFIN, Eurostat

A broadly similar assessment emerges when comparing the fiscal forecasts contained in the various DBPs with the actual data since 2015 (see Chart 3.6). The forecasts published in the current year [DBP (t)] are consistently more accurate than those published the year before [DBP (t-1)] for the four main fiscal targets.[15] Other notable patterns which emerge are: 2019 was the first year when the DBP revenue targets

[15] This is to be expected since the forecasts published in October of the same year embed the actual fiscal developments for the bulk of that year. This is indicated in the Chart by the smaller bars for DBP (t) compared to DBP (t-1).

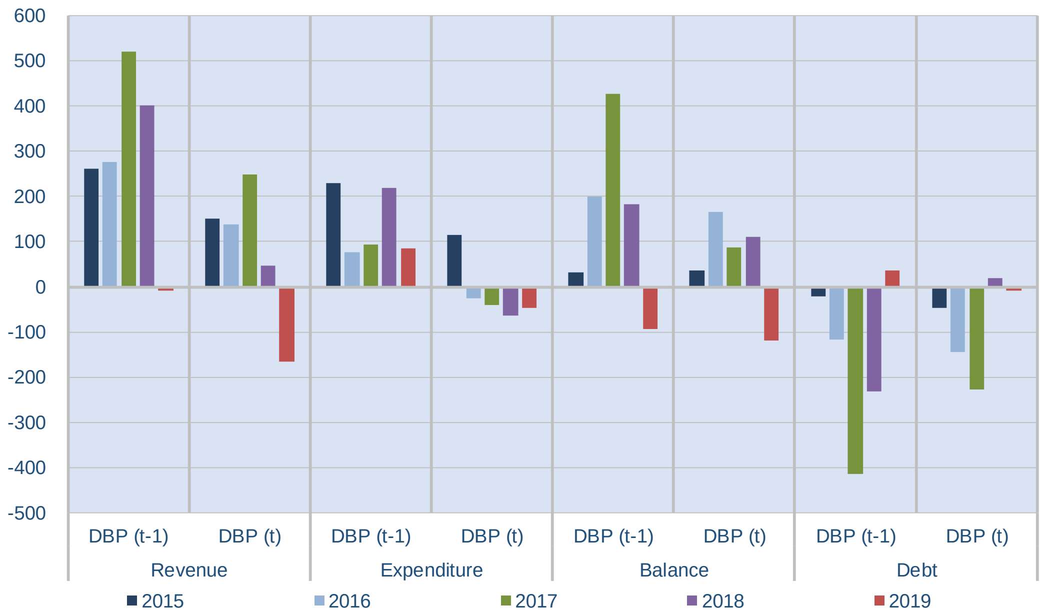
were underachieved; expenditure targets indicated in period (t-1) were consistently exceeded, while the actual turnout was slightly lower than the targets indicated in period (t); the fiscal balance always turned out better than targeted with the exception of 2019; and the actual debt was mostly lower than indicated in the various DBPs.

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



Sources: MFIN, Eurostat

Chart 3.6: Forecast errors across different DBPs (EUR millions)



Note: The chart indicates the difference between the actual outturn and the targets indicated in the DBP. DBP (t-1) corresponds to the document published in the preceding year while DBP (t) corresponds to the document published in the current year.

Sources: MFIN, Eurostat

Chapter 4

Macroeconomic updates for 2020

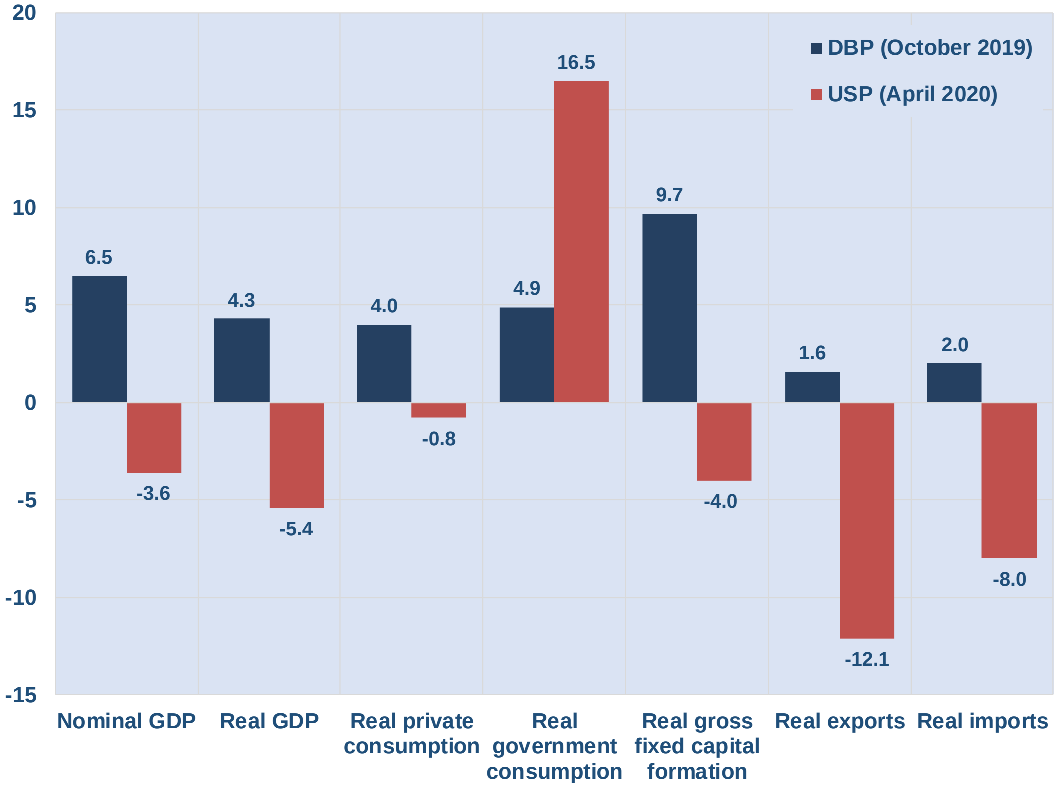
The Half-Yearly Report reconfirmed the macroeconomic forecasts which had been presented in the USP 2020 – 2021, in line with the approach adopted in previous years. The macroeconomic forecasts published in the USP 2020 – 2021, which have been analysed and endorsed by the MFAC, thus serve as Malta's latest official macroeconomic forecasts.[16,17]

Due to the adverse shocks created by the COVID-19 pandemic, the USP (published in April 2020) had revised significantly the overall economic outlook compared to the forecasts which were presented in the DBP (published in October 2019). The macroeconomic forecast revisions were large and all pointing down, except for government consumption whose growth rate was raised (see Chart 4.1). Such changes are consistent with the consensus that COVID-19 creates an adverse shock on the GDP expenditure components, while necessitating higher government spending to combat the health and economic effects of the pandemic. Although in the USP domestic demand was still seen as contributing positively to growth, its intensity was scaled down (see Chart 4.2). The updated forecasts also showed a strong negative contribution to growth resulting from net exports, particularly as tourism came to an abrupt halt and demand for other exports slumped as a result of the global recession.

Potential GDP growth was also reduced significantly in the April 2020 forecast round, from 5.6% to 1.2% (see Table 4.1). This mirrored the expected adverse shock to labour supply and investment. Nonetheless, the output gap, which was initially expected to be negligible, was re-estimated at -5.5% of potential GDP, as the scenario presented a larger shock to aggregate demand than in aggregate supply.[18] In turn, the unemployment rate was raised from 3.5% to 5.9%, particularly as the outlook for employment growth was changed completely, from 4.1% to -3.3%. On the other hand, the inflation rate forecast was lowered by 0.6 pp in the USP, to 1.0%, reflecting the expected further abatement of price pressures as a result of subdued demand.

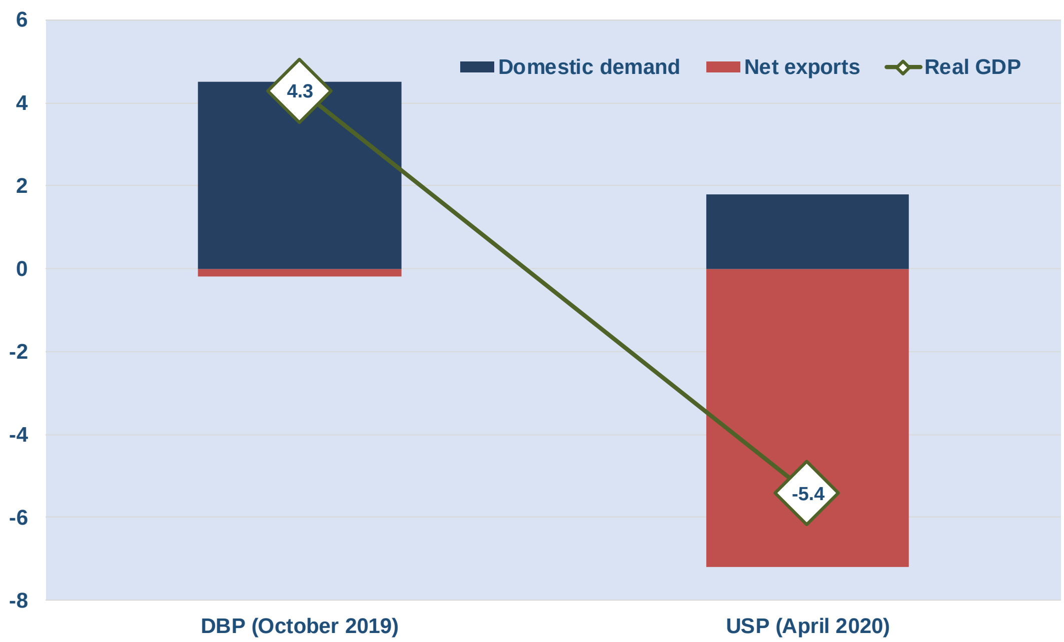
[16] The MFAC's assessment which was published in June 2020 is available on https://mfac.org.mt/publications/reports/reports-2020/.
[17] By the cut-off date of the Half-Yearly Report, only provisional estimates for the first quarter of 2020 were available (NSO News Release 091/2020). However, the major economic impact from COVID-19 started from the second quarter of 2020.
[18] A negative output gap means that the economy is operating below potential.

Chart 4.1: Forecast growth in GDP and its components for 2020 (y-o-y % change)



Source: MFIN

Chart 4.2: Forecast contributions to real GDP growth in 2020 (pp)



Source: MFIN

In its assessment report the MFAC had concluded that the unprecedented circumstances, and the uncertain duration and severity of the COVID-19 problems, made the magnitude and span of the economic downturn highly conditional on the specific scenario considered by the MFIN.[19]

Table 4.1: Other macroeconomic forecasts for 2020 (%)

	DBP (October 2019)	USP (April 2020)	Difference (pp)
Inflation rate	1.6	1.0	- 0.6
Employment growth	4.1	- 3.3	- 7.4
Unemployment rate	3.5	5.9	2.4
Potential GDP growth	5.6	1.2	- 4.4
Output gap	- 0.1	- 5.5	- 5.4

Source: MFIN

[19] The MFIN's scenario is built on the assumption that the main economic impact of the COVID-19 pandemic is going to be concentrated primarily within the second quarter of 2020 and that some partial recovery will commence from the third quarter onwards.

Chapter 5

Fiscal updates for 2020

The DBP had initially targeted a fiscal surplus and a further drop in the public debt ratio for 2020. These targets were however revised significantly in the USP in the wake of the COVID-19 pandemic. Indeed, public finances were anticipated to be significantly adversely impacted by the contraction in economic activity and the fiscal mitigation measures which became necessary. In its assessment report dealing with the USP, the MFAC had considered the estimates of a fiscal deficit and a rise in the debt ratio in 2020 as plausible and within its endorsable range. Still, it was stated that the planned fiscal outturn remained challenging since it was highly conditional on the period during which the COVID-19 mitigation measures remained in place, which in turn depended on the way in which the economy absorbed and reacted to the pandemic-induced demand and supply shocks.

The Half-Yearly Report updated the fiscal projections which were indicated in the USP. These changes mainly factored the cash revenue and expenditure performance which became available post submission of the USP, as well as some additional fiscal measures which were announced in June 2020.[20] The latter included further extension in tax deferrals, a reduction in the price of fuels, a reduction in stamp duty on property purchases and spending vouchers for households.[21]

The projected fiscal deficit for 2020 has been raised further, to slightly above €1.1 billion, equivalent to 8.7% of GDP (see Table 5.1).[22] The target for the outstanding public debt was also lifted marginally to 54.6% of GDP. The deterioration in the outlook for the fiscal balance mainly reflects a €209.2 million downward re-assessment of total revenue for the year compared to the USP (see Chart 5.1). Its budgetary impact is

[20] The HYR did not revise the official macroeconomic forecasts which were presented in the USP, but it was stated that "estimates suggest that the measures restored around 2.0 percentage points to GDP growth whilst supporting the liquidity of enterprises to help them avoid job losses".
[21] The Tax Deferral Scheme, applicable to companies and self-employed businesses which suffered a significant downturn in turnover, was extended for provisional tax, social security contributions of self-employed persons and Value Added Tax which fall due in March up to and including August 2020 (previously April and subsequently June 2020). Eligible taxes are to be settled by May 2021 (formerly October 2020) with no interest charged.
[22] The value of nominal GDP is that which was indicated in the USP (unchanged).

however partially mitigated by a concurrent €51.4 million reduction in the planned total expenditure for the year.

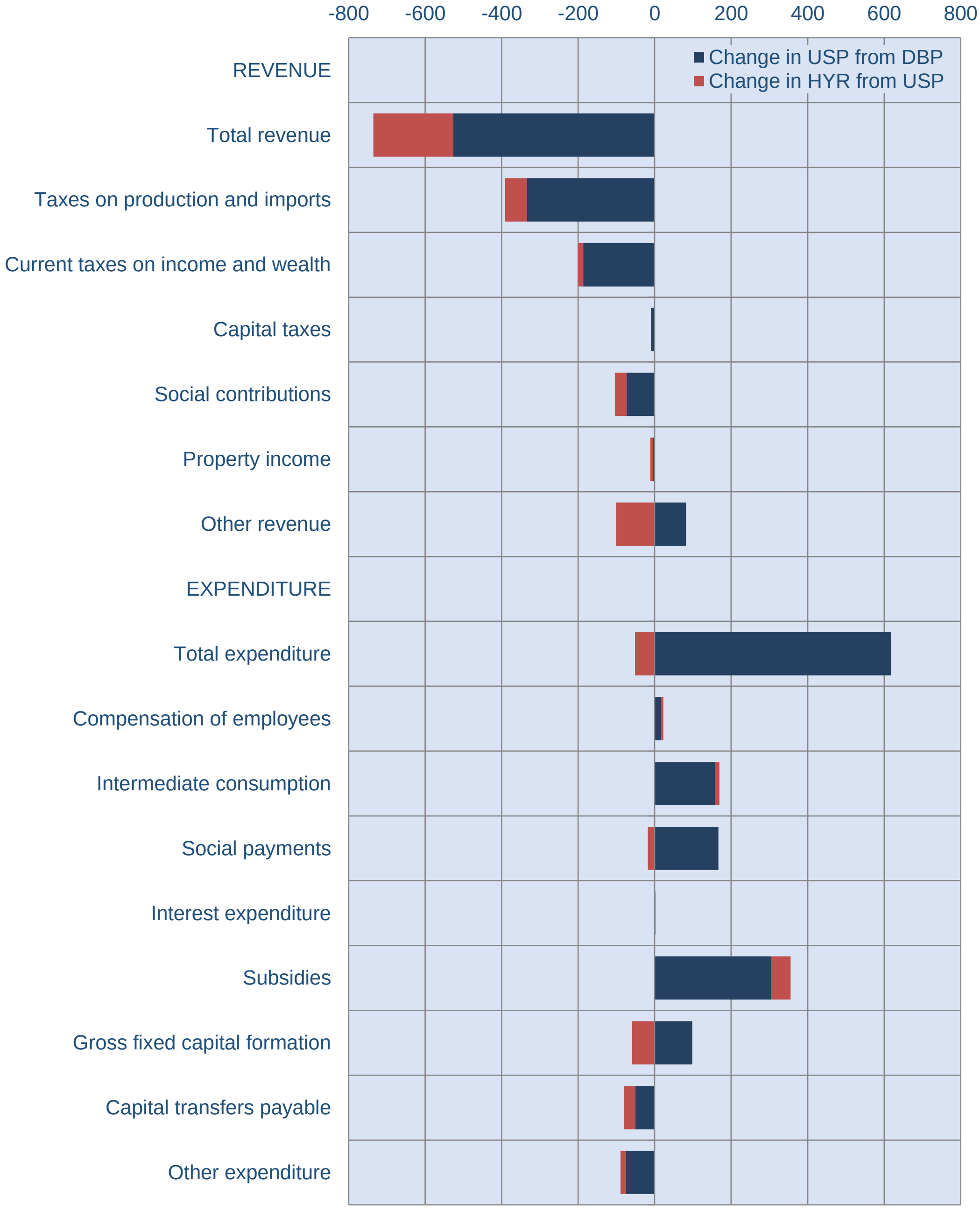
Table 5.1: Fiscal projections for 2020 (EUR millions)

	DBP	USP	HYR
Total revenue	**5,523.6**	**4,997.1**	**4,787.9**
Taxes on production and imports	1,804.9	1,471.0	1,413.9
Current taxes on income and wealth	2,007.0	1,820.0	1,806.4
Social contributions	870.6	797.4	766.2
Capital taxes	27.9	18.7	18.7
Property income	74.6	69.7	63.1
Other revenue	738.5	820.2	719.6
Total expenditure	**5,330.6**	**5,949.0**	**5,897.6**
Compensation of employees	1,567.9	1,584.6	1,590.5
Intermediate consumption	1,055.4	1,212.8	1,225.0
Social payments	1,308.6	1,378.0	1,360.4
Gross fixed capital formation	573.8	672.2	612.8
Subsidies	195.7	499.6	550.9
Interest expenditure	175.2	177.1	177.1
Capital transfers payable	151.9	100.9	71.2
Other expenditure	302.2	323.9	309.8
Fiscal balance	**193.0**	**-951.9**	**-1,109.7**
as % of nominal GDP	*1.4*	*-7.5*	*-8.7*
Gross debt	**5,690.7**	**6,939.7**	**6,988.3**
as % of nominal GDP	*40.3*	*54.5*	*54.6*
Nominal GDP	14,102.8	12,738.9	12,738.9

Note: The fiscal figures are compiled in line with the ESA methodology.

Source: MFIN

Chart 5.1: Updates to the fiscal projections (EUR millions)



Source: MFIN

Apart from capital taxes which remained unchanged, the projected revenues from the main sources were scaled back in the Half-Yearly Report compared to the USP. In absolute terms, the main revenue adjustments related to ‘other revenue’, which was lowered by €100.6 million, and taxes on production and imports, which were reduced by €57.1 million. These two components account for 75.4% of the overall reduction in the total revenue forecast for the year when compared to the targets presented in the USP. The other downward changes were smaller in magnitude, in order, social contributions (-€31.2 million), current taxes on income and wealth (-€13.6 million), and property income (-€6.6 million).

On the expenditure front, revisions were carried out in both directions. The largest absolute increase was reported in subsidies, whose budget allocation was expanded by a further €51.3 million. The budgeted spending on intermediate consumption and compensation of employees was also raised by €12.2 million and €5.9 million respectively. These increases were however more than offset by downward adjustments across the rest of the expenditure components, namely, social payments, gross fixed capital formation, capital transfers payable and other expenditure.[23]

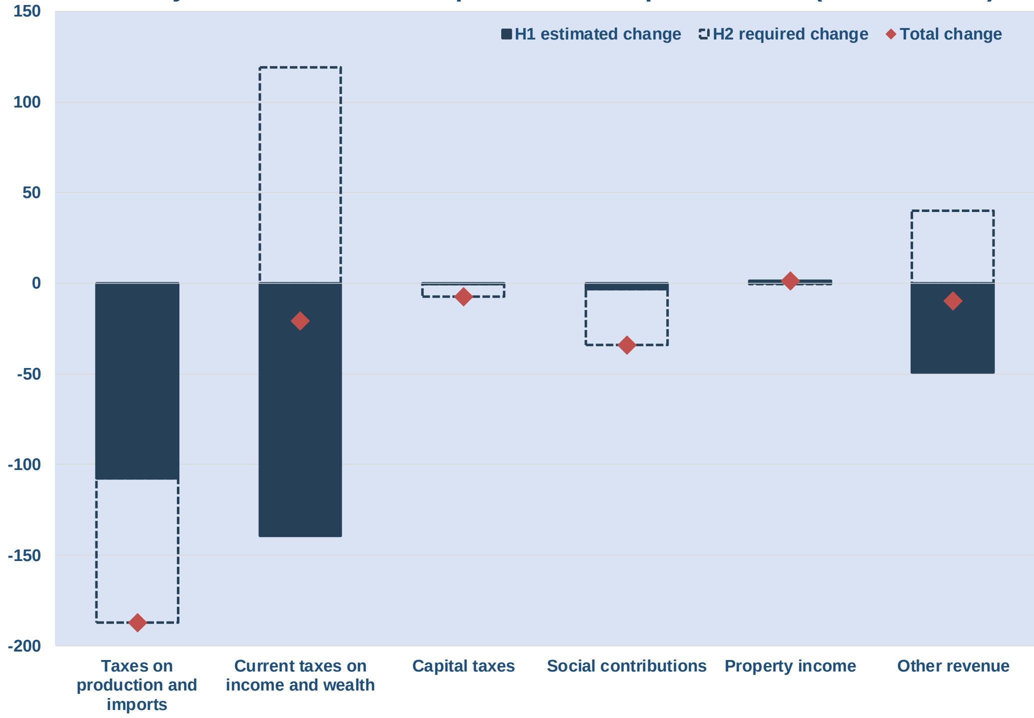
The downward reappraisal in the projection for total revenue is consistent with the downside risk to total revenue which was identified by the MFAC in its assessment of the USP. Still challenges in attaining the updated revenue targets persist when considering the estimated revenue performance during the first half of the year (see Chart 5.2).[24] These relate mainly to current taxes on income and wealth and 'other revenue'. These two sources were estimated to have registered declines during the first half of the year, and in order to attain the annual target, the outturn for the second half of year would need to be higher than during the same period in 2019. At the same time, the MFAC takes note of the statement in the Half-Yearly Report that "seasonal patterns observed in previous years may not be indicative of anticipated developments in the second half of 2020. The latter depend on the shape the recovery is expected to take, as households and businesses adjust to economic 'normality' post-COVID."

On the expenditure front, one challenge relates to the yearly spending on gross fixed capital formation, which is targeted to be higher than in 2019, but during the first half of the year, such spending was lower (see Chart 5.3).[25] Therefore, this would require a strong acceleration during the second half of 2020 to match the target for the year. On the contrary, 'other expenditure' increased during the first half of 2020 but is planned to decline during the second half, to remain within the updated budget allocation. The planned developments in the rest of the main expenditure components appear more consistent with the estimated six-monthly fiscal developments, as the

[23] The budget for interest payments was maintained identical to that indicated in the USP.
[24] The values for the first half of 2020 are based on the actual data for the first quarter and the estimates by the MFIN for the second quarter. This practice is necessary and in line with the approach used in previous years, since the official data by the NSO covering the first half of the year is unavailable at the time when the Half-Yearly Report is produced.
[25] This would also contribute to a downside risk to the forecast for gross fixed capital formation in GDP (which is composed of public and private investment).

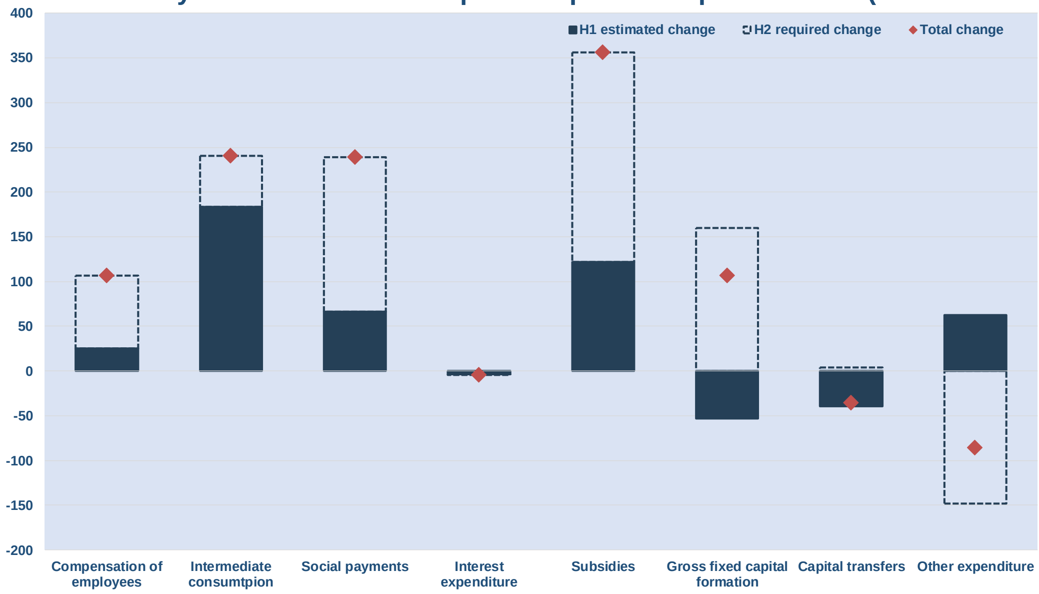
anticipated pattern during the second half is more in line with the fiscal patterns estimated for the first half of the year.

Chart 5.2: Mid-year estimated and required revenue performance (EUR millions)



Note: The shaded bars show the estimated change during the first half of 2020 compared to the first half of 2019, while the transparent bars indicate the required change during the second half of 2020 compared to the second half of 2019, to ensure that the annual change is in line with the fiscal targets.
Source: MFIN

Chart 5.3: Mid-year estimated and required expenditure performance (EUR millions)



Note: The shaded bars show the estimated change during the first half of 2020 compared to the first half of 2019, while the transparent bars indicate the required change during the second half of 2020 compared to the second half of 2019, to ensure that the annual change is in line with the fiscal targets.
Source: MFIN

Chapter 6
Conclusion

In 2019, nominal GDP growth remained very elevated, but it turned out lower than had been anticipated in either the DBP or the USP. While the challenges of achieving accurate forecasts in a small open economy are duly acknowledged, it is important for the MFIN to maintain close watch on economic developments both at a macro level and at a sectoral level, to better capture possible turning points in the economic cycle. The forecast errors vis-à-vis private consumption and gross fixed capital formation deserve attention. In the first case, consumption accounts for a large proportion of GDP, and hence, any forecast errors would exert a material impact on the outlook for GDP. In the case of investment, there is merit in exploring further the reason for the relatively higher forecast errors observed over the past years when compared to the other GDP components.

The lower than anticipated nominal GDP growth is likely to have contributed to the miss in the revenue targets for the year, both when considering the DBP and the USP, as well as in relation to the Consolidated Fund Approved Estimates. In turn, this resulted in a fiscal balance which although was still in surplus in 2019, was lower than projected, both on an ESA basis and on a cash basis (Consolidated Fund).

Good quality macroeconomic and fiscal forecasts are a pre-requisite for sound policy making, and it is important that the MFIN continues to allocate adequate resources and time for their production, as well as for their ex-post assessment. The MFAC takes note that in the Half-Yearly Report, the MFIN presented the same macroeconomic forecasts for 2020 as had been published in the USP in April 2020. This is in line with the approach used in previous years. The MFAC acknowledges that the rapidly evolving circumstances give rise to many different macroeconomic scenarios, including the one which had been presented in the USP.

On the other hand, the 2020 fiscal projections, which in the USP had been revised significantly following the outbreak of COVID-19 pandemic, were revised further in the Half-Yearly Report (swinging from a fiscal surplus into a deficit target, and an increase rather than decline in the public debt ratio). The updated targets thus indicate a larger fiscal deficit and higher outstanding public debt, reflecting the cash performance in the fiscal aggregates and the additional fiscal measures announced in June 2020.

The MFAC takes note of the Recommendation adopted by the European Council on 20 July 2020 wherein Member States were advised that: “In line with the general escape clause, take all necessary measures to effectively address the pandemic, sustain the economy and support the ensuing recovery. When economic conditions allow, pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment.”

In terms of the specific contents which feature in the Half-Yearly Report, the MFAC draws attention to Article 39(8)(h) of the FRA which prescribes “data on the absorption of European funds, indicating the approved program, the results achieved in the first six months and an updated forecast for the entire year” and Article 39(8)(i) of the FRA which prescribes “data on all outstanding creditors for the first six months of the year”. Such data does not feature in the Half-Yearly Report for 2020 and the MFIN is invited to publish such information in next year’s Report.[26,27] This would be in line with the principle of fiscal transparency.

Another observation relates to Article 39(7) of the FRA which states that “in July of each year, the Minister for Finance shall compile and lay on the table of the House of Representatives a half-yearly report on the economic and budgetary situation”. Since Parliament was in recess when the Half-yearly Report was submitted to the Clerk of the House, its actual publication was postponed.[28] However, such delay reduces the usefulness of such a report, which is meant to offer a timely update of latest developments for stakeholders. While the MFAC acknowledges the possible disruptions created by the pandemic, earlier production, to ensure that the Report is published by the July deadline, is encouraged.

[26] In the case of EU funds data, this has never been published in any Half-Yearly Report to date, whereas data on creditors normally used to be included in previous Half-yearly Reports. The Half-Yearly Report 2019 had quoted a value for total outstanding creditors amounting to €182.5 million.

[27] FRA Article 39(8)(k) requires information about revenue arrears. This information is duly presented in the Half-Yearly Report. The original targeted amount of €31.1 million as appearing in Appendix I of the 2020 Financial Estimates for the first half of 2020, has in fact been exceeded, reaching €46.4 million by the end of the second quarter.

[28] The Report was forwarded by the MFIN to the MFAC on 10 August 2020 on an embargo basis.

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