Assessment of the Draft Budgetary Plan 2021

MFAC
MALTA FISCAL ADVISORY COUNCIL

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Dear Minister,

OVERALL ASSESSMENT OF THE MACROECONOMIC AND FISCAL FORECASTS PRESENTED IN THE DRAFT BUDGETARY PLAN 2021

As a follow-up to the letter of endorsement in relation to the macroeconomic forecasts, dated 15 October 2020, the Malta Fiscal Advisory Council is hereby presenting the full assessment report dealing with the Draft Budgetary Plan 2021, in terms of the Fiscal Responsibility Act. Compliance with the fiscal rules is not assessed in view of their temporary suspension, as per European Council agreement reached on 23 March 2020.

The Malta Fiscal Advisory Council acknowledges the high uncertainty created by COVID-19 and considers the macroeconomic and fiscal scenario for 2020 and 2021 to be within its endorsable range. The Council also confirms the existence of 'exceptional circumstances' which under national and European law allow for greater flexibility in the conduct of fiscal policy.

The assessment carried out on the individual GDP components suggests an overall downside risk outlook vis-à-vis the profile for real GDP for the period 2020 and 2021. The trajectory over the forecast horizon for private consumption, investment and exports could be more subdued than indicated in the official forecasts and the combined effect is considered to outweigh the possibility of a higher-than-planned upward push from government consumption and the prospect that imports could be less than expected. The Council further notes that the resilience of the job market underpinning the Plan is consistent with the job-support measures which were

launched in 2020 and which are expected to remain in place at least during the first months of 2021.

On the fiscal front, the assessment carried out on the individual revenue and expenditure components suggests an overall downside risk outlook vis-à-vis the fiscal balance for the period 2020 and 2021. This reflects the impact of a downside revenue risk related to current taxes on income and wealth and 'other revenue', combined with an upside expenditure risk related to compensation of employees, intermediate consumption, subsidies and 'other expenditure'. The possibility of a larger fiscal deficit and higher-than-planned stock-flow adjustments, combined with the downside risk to economic growth, pose an upside risk to the forecast trajectory for the public debt ratio.

At the same time, the Council notes that the official forecasts for real GDP, and the targets for the fiscal balance and public debt are within the range of estimates produced by other reputable institutions, thereby corroborating their plausibility.

The Council highlights the importance to target again strong public finances once the downside effects of the pandemic ease out, and the need for direct support measures diminishes. The fiscal space which was available pre-COVID-19, because of the stream of fiscal surpluses and the low level of public debt, made it possible to implement aggressive fiscal measures to mitigate the simultaneous negative supply and demand shocks. Rebuilding fiscal space would be useful to counteract any future adverse shocks.

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

Yours sincerely,

John Cassar White
Chairman

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Abbreviations

CBM	Central Bank of Malta
COM	European Commission
COVID-19	Coronavirus disease 2019
DBP	Draft Budgetary Plan
EBU	Extra Budgetary Units
ECB	European Central Bank
EFSF	European Financial Stability Facility
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
MTO	Medium-Term Budgetary Objective
NPISH	Non-Profit Institutions Serving Households
NSO	National Statistics Office
pp	percentage point
SFA	Stock-Flow Adjustments
SGP	Stability and Growth Pact
STEMM	Short-Term Quarterly Economic Forecasting Model
STG	sterling
USD	US dollar
USP	Update of Stability Programme
VAT	Value Added Tax

Executive Summary

This Report, whose cut-off date is 26 November 2020, assesses the macroeconomic and fiscal forecasts for 2020 and 2021 contained in the Draft Budgetary Plan, which the Ministry for Finance submitted to the European Commission on 15 October 2020.

These forecasts lie within the endorsable range of the Fiscal Council. Notwithstanding the high level of uncertainty surrounding such forecasts, the Council considers the macroeconomic and fiscal scenario to be consistent with the COVID-19 related assumptions. Any material departure from such assumptions could however deviate the macroeconomic and fiscal outturn, possibly significantly, from that presented in the Draft Budgetary Plan.

The official outlook is that the Maltese economy will suffer a drop of 7.4% in real GDP in 2020, followed by a quick, yet partial recovery in 2021, estimated at 5.0%. The consequent adverse shock to the tax base and the COVID-19 mitigation measures are projected to swing the fiscal balance from a surplus into a deficit, estimated at 9.4% of GDP in 2020. The fiscal deficit is then expected to decline to 5.9% in 2021, consistent with the expected economic recovery and the gradual phasing out of the support measures. COVID-19 is also expected to halt the trend decline in the debt-to-GDP ratio, which is thus estimated to rise from 42.6% in 2019, to 58.6% by 2021.

The assessment carried out on the individual GDP components suggests an overall downside risk outlook vis-à-vis the profile for real GDP for the period 2020 and 2021. This follows the possibility that the overall growth pattern for private consumption, investment and exports is more subdued than indicated in the official forecasts and this effect outweighs the possibility of a higher-than-expected upward push from government consumption and import dynamics.

The assessment carried out on the individual budget components suggests an overall downside risk outlook vis-à-vis the fiscal balance for the period 2020 and 2021. This reflects the possible impact of a downside revenue risk related to current taxes on income and wealth and ‘other revenue’, combined with an upside expenditure risk related to compensation of employees, intermediate consumption, subsidies, and

‘other expenditure’. In turn, the downside risk to economic growth, together with the possibility of a larger fiscal deficit and higher-than-planned stock-flow adjustments pose an upside risk to the forecast trajectory for the public debt ratio.

The Fiscal Council considers that the macroeconomic forecasts for 2020 and 2021 and the trajectory for the fiscal deficit and public debt over the same period, as presented in the Draft Budgetary Plan, as plausible and within its endorseable range. The Fiscal Council further considers the risks to the attainment of the latest official macroeconomic and fiscal scenario as contained particularly when considering that the official forecasts for real GDP, the fiscal balance and public debt over the period 2020 to 2021 all fit within the range of estimates produced by other reputable institutions.

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] Malta's DBP for 2021 contains the latest official macroeconomic and fiscal forecasts prepared by the Ministry for Finance (MFIN).

In March 2020 the 'general escape clause' in the Stability and Growth Pact (SGP) was activated by the European Council.[2] Such flexibility facilitates the coordination of budgetary policies in times of a severe economic downturn across the EU, a condition which the COM and the European Council agreed that was met as a result of the effects created by COVID-19. In September 2020, the COM offered further guidance, stating that this clause will remain active in 2021, and the situation will be re-assessed in spring 2021.[3]

As a result of the agreement at the European Council, which the Malta Fiscal Advisory Council (MFAC) takes note of, the Government is allowed to temporarily depart from the Medium-Term budgetary Objective (MTO), provided that this does not endanger fiscal sustainability in the medium term. The MFAC confirms that on the basis of the information available to date, and the latest suite of macroeconomic forecasts for Malta, the period 2020 – 2021 continues to fall within the definition of 'exceptional circumstances' as defined in the Fiscal Responsibility Act (FRA).[4,5]

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[1] The DBP for 2021 submitted by each country is available on https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries/draft-budgetary-plans-2021_en.

[2] The escape clause is set out in Articles 5(1), 6(3), 9(1) and 10(3) of Regulation (EC) 1466/97 and Articles 3(5) and 5(2) of Regulation (EC) 1467/97.The statement by the EU Council on the agreement to activate the clause is available on https://www.consilium.europa.eu/en/press/press-releases/2020/03/23/statement-of-eu-ministers-of-finance-on-the-stability-and-growth-pact-in-light-of-the-covid-19-crisis/.

[3] This was confirmed in the 'Commission guidance for Malta on fiscal policy orientations for 2021' available on https://ec.europa.eu/info/sites/info/files/economy-finance/mt.pdf.

[4] Exceptional circumstances are defined as "a period during which an unusual event outside the control of the State has a major impact on the financial position of the general government, or a period of severe economic downturn within the meaning of the Stability and Growth Pact".

[5] Chapter 4 in this Report compares the official macroeconomic forecasts to those prepared by other institutions. All available forecasts to date point towards an economic recession in Malta in 2020 as a result of COVID-19.

Therefore, the country is not expected to keep its MTO of a structural fiscal balance during the period under review.[6] This permits the Government to implement revenue and expenditure measures to counteract the challenges created by COVID-19, without the constraints posed by fiscal rules. Moreover, even the EU's state aid rules were eased during this period, to enable greater assistance by the state to companies facing financial difficulties.[7]

On 15 October 2020, the Chairman of the MFAC addressed a letter to the Minister for Finance and Financial Services, stating that "based on the information available to the Malta Fiscal Advisory Council by the date of this letter, and after taking due consideration of the uncertainty inherent in macroeconomic forecasts, and the added uncertainty brought about by the COVID-19 pandemic, the Council considers the full set of macroeconomic forecasts for the period 2020 to 2021 prepared by the Ministry for Finance and Financial Services as part of the Draft Budgetary Plan 2021 to lie within its endorsable range".[8,9]

The FRA requires that even the fiscal projections are endorsed by the MFAC. Since the law does not prescribe that such endorsement should take place prior to the publication of the DBP, as in previous years, the detailed fiscal forecasts were forwarded to the MFAC after the Budget Speech which was delivered on 19 October 2020.[10]

This Report, whose cut-off date is 26 November 2020 presents the analysis carried out by the MFAC as part of the endorsement process in relation to the DBP, both in relation to the macroeconomic forecasts and the fiscal forecasts. The Report is structured as follows. **Chapter 2** reviews the methodologies, assumptions and baseline scenario used by MFIN in the preparation of the official macroeconomic and fiscal forecasts. **Chapter 3** evaluates the expected trajectory of the main macroeconomic variables for 2020 and 2021, identifying possible upside or downside risks associated with the

[6] Structural balance is the actual budget balance net of the cyclical component and one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance. Source: https://ec.europa.eu/info/sites/info/files/economy-finance/glossary.pdf.
[7] Background information on state aid in the EU is available on https://ec.europa.eu/competition/state_aid/overview/index_en.html.
[8] A copy of the letter is available on https://mfac.org.mt/publications/reports/reports-2020/.
[9] The MFIN forwarded to the MFAC the provisional macroeconomic forecasts on 7 October 2020 and the final set on 15 October 2020.
[10] The text of the Budget Speech is available on https://mfin.gov.mt/en/The-Budget/Pages/The-Budget-2021-ND111213.aspx.

baseline scenario. **Chapter 4** compares the latest official macroeconomic forecasts to the previous vintage, and those produced by other reputable institutions. **Chapter 5** presents an overview of the fiscal targets and examines the trajectory for the main revenue and expenditure components, and public debt, focusing on their consistency and plausibility, while identifying the direction of risk where relevant. **Chapter 6** compares the fiscal scenario presented in the DBP to the figures included in the Update of Stability Programme (USP) and the latest available fiscal forecasts by other reputable institutions. **Chapter 7** then presents the Report's conclusions and recommendations.

Chapter 2
Forecast methodologies and assumptions

2.1 Preparation of the macroeconomic forecasts

MFIN continued to produce the official macroeconomic forecasts using STEMM (Short-Term Quarterly Economic Forecasting Model).[11] This is a quarterly Keynesian model with output determined by aggregate demand. The equations are regularly re-estimated to ensure that these continue to reflect adequately the economic features and relationships in the Maltese economy.[12]

Regression estimates are complemented with expert judgement based on ad-hoc information and regular discussions with key stakeholders, which include government departments, authorities and large firms. Such dialogue plays a significant role in shaping MFIN's outlook for key sectors which might be driven by very specific factors, particularly to forecast employment, exports and investment. The unprecedented circumstances created by COVID-19 make such expert judgement even more important since past empirical relationships may not adequately capture the various possible economic and behavioural reactions to the pandemic.

2.2 Assumptions underpinning the macroeconomic forecasts

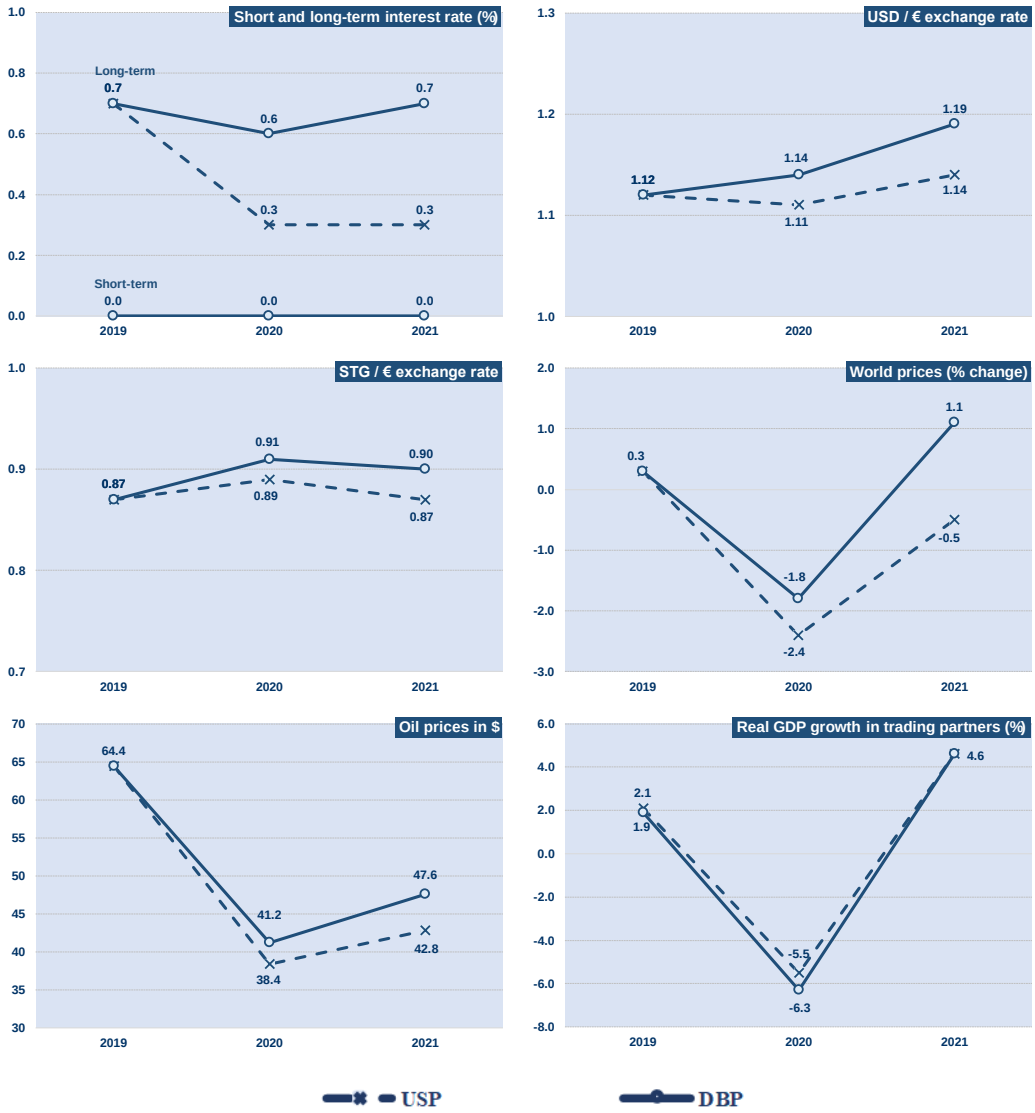
MFIN adopt a set of assumptions for exogenous variables which are necessary to produce the macroeconomic forecasts. The exogenous variables are mainly related to the external sector and include the short-term and long-term interest rates; the exchange rate of the euro with respect to the US dollar and sterling; world prices; oil prices and real GDP growth of Malta's main trading partners. These variables are sourced from authoritative and reputable sources, predominantly from Consensus

[11] The model was originally developed in 2001 through the assistance of Cambridge Econometrics (UK). It is maintained on a regular basis by MFIN staff. In July 2019 MFIN published a report and a technical appendix about STEMM. These documents are available on https://mfin.gov.mt/en/epd/Pages/Library.aspx.

[12] Re-estimations were even more important during this forecast round due to the benchmark revision carried out by NSO in August 2020, which led to significant changes in past data. For further details refer to https://nso.gov.mt/en/nso/Sources_and_Methods/Documents/National_Accounts/National%20Accounts%20-%20Benchmark%20Revision%202020.pdf.

Economics (September 2020), and in the case of the interest rate assumptions, from the European Central Bank (ECB).[13] Chart 2.1 shows the trajectory of the exogenous variables used in the DBP 2021 and compares them with the values used in the USP 2020 – 2021 (previous round).

Chart 2.1: Main macroeconomic assumptions



Note: 2019 refers to the estimated values while 2020 and 2021 are forecasts.

Source: MFIN

The assumption of a zero per cent short-term interest rate has been retained. On the other hand, the long-term interest rate has been raised from 0.3%, to 0.6% for 2020, and to 0.7% for 2021. The euro is expected to be stronger in relation to both the US dollar and sterling, when compared to the previous forecast round. On the other hand,

[13] The cut-off date for the external assumptions used by MFIN was 14 September 2020.

the DBP assumes a lower decline in world prices followed by a faster pick-up than the USP. Likewise, the updated assumption for oil prices indicates a lower drop in 2020 and a higher oil price level for 2021. Oil prices are set to drop from $64.4 per barrel in 2019 to $41.2 in 2020, and then rise to $47.6 in 2021. With regards to external demand (using real GDP developments in Malta's main trading partners as a proxy), the DBP assumes a slightly worse outlook, -6.3% in 2020, followed by a 4.6% rebound in 2021. The forecast growth in external demand in 2021 is identical to that used in the USP.

Another important assumption relates to inventory adjustments.[14] In 2020 inventories are assumed to generate a positive contribution to growth in GDP equal to the amount indicated in the published GDP statistics for the first half of the year. In 2021 inventories are then assumed to exert zero contribution to real GDP growth. For both years, the approach is in line with that used in previous DBPs.

The high uncertainty created by COVID-19 required further assumptions, particularly in relation to the depth of the health problems created by the pandemic, the potential behavioural changes of domestic consumers and firms, and the possible impact of the pandemic on the tourism and other key sectors in the economy. The DBP assumes the "distribution of an effective vaccine throughout the first and second quarters of next year". This assumption paves the way for the baseline scenario of a "gradual recovery in economic activity in the third quarter of 2020, and a modest recovery in 2021".

The official macroeconomic outlook also factors in the extension of various social and economic support measures throughout 2020 and going into 2021. On the other hand, the USP had assumed an earlier phasing out of such assistance. Such measures are assumed to mitigate to a significant extent the adverse shock to the labour market created by the severe contraction in domestic and external demand because of the pandemic.

2.3 The preparation of the fiscal forecasts

The preparation of the fiscal forecasts remained broadly the same as in previous rounds. However, in the context of very fluid and uncertain conditions created by COVID-19, there was need to explore various scenarios up until the baseline scenario

[14] Inventory changes include the effect of changes in actual inventories, as well as any statistical errors.

was selected. This was necessary to budget adequate resources for the forthcoming fiscal year, and to ensure consistency with the macroeconomic outlook.

Government departments and entities continued to provide their input through cash-based estimates of their anticipated revenues and expenditures. These estimates are built on specific knowledge and information available at departmental level, which include past trends, expert judgment, knowledge about specific fiscal legislation, outstanding creditor and debtor balances and other ad-hoc factors. These estimates are then reviewed to provide stronger consistency between the macroeconomic forecasts and the fiscal projections.

Owing to the challenges created by the pandemic, on the expenditure front there was even closer coordination across the public sector to ensure adequate additional funding for health and to cost the mitigation measures which were launched. There was strong involvement from the Ministry for Health to estimate the emergency additional spending on health-related compensation of employees, capital expenditure and intermediate consumption. Likewise, the Ministry for the Family, Children's Rights and Social Solidarity was greatly involved with respect to the costing of the additional social payments for income support. In turn, Malta Enterprise provided strong input for the estimation of the required budget for subsidies, since it acted as the lead entity responsible for the channelling of such payments to various enterprises. The costing of such measures relied on the estimated number of eligible beneficiaries and applied the same assumption vis-à-vis the duration of such measures.

This bottom-up approach was then supplemented with a top-down approach which is based on the accrual-based European System of National and Regional Accounts (ESA). This process was mainly related to the estimation of tax revenues where the bottom-up revenue forecasts were verified and fine-tuned with 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 forecasts and the official macroeconomic outlook.

In 2020 the Government launched tax deferral schemes to assist with the cashflow of businesses and self-employed. Taxpayers had the possibility to apply to: defer Provisional Tax and Social Security Contributions of self-employed persons for basis year 2020 falling due between March, up to and including, August 2020; to defer Value

Added Tax (VAT) falling due between March, up to and including, August 2020; and to defer employee taxes, maternity fund payments and social security contributions falling due in March, up to and including, June 2020.[15] Such deferrals have to be settled by 31 May 2021.

Eurostat issued a note on the statistical treatment of some policy measures in the context of the COVID-19 pandemic.[16] The guidance stated that tax payments due for 2020 but whose payment will be deferred to 2021 are to be accrued onto 2020.[17] Because of these guidelines, the tax deferral schemes launched in 2020 are assumed to have no impact on the fiscal balance for the year. On the other hand, such deferrals are expected to impact the outstanding level of public debt as government needs to borrow funds to make up for any cash shortfall. Instead of the time adjusted method, to estimate the accrual adjustments authorities used information about average recent tax payments, while in the case of VAT, such information was available, since taxpayers who qualified for the deferral scheme were still required to file a VAT return.

It should also be noted that the fiscal projections depend to a large extent on the specific macroeconomic outlook used as baseline, which is characterised by a sharp economic contraction in 2020, followed by an anticipated quick, but partial, rebound in 2021. The V-shaped pattern shapes the amounts budgeted for the various support measures, and the outlook for public finances critically builds on the assumption that such support measures will be phased out by early 2021.

2.4 Risk outlook as presented by MFIN in the Draft Budgetary Plan

Any significant departure from the assumptions used by MFIN could deviate the macroeconomic outturn, possibly significantly, from the outlook as presented in the

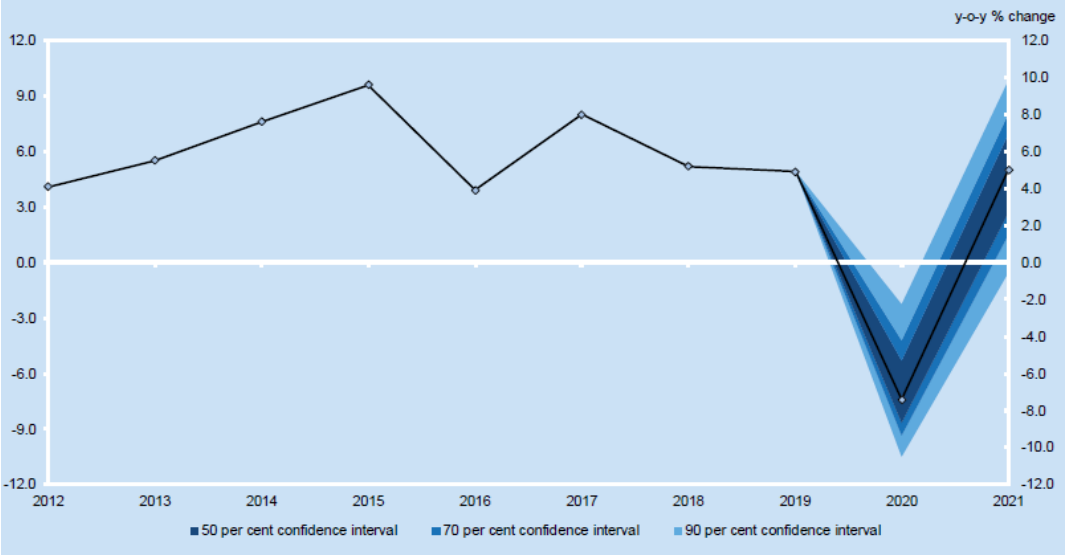
[15] Source: https://cfr.gov.mt/en/News/Pages/2020/Fiscal-Assistance-Postponement-of-Payment-of-Certain-Taxes.aspx.

[16] Source: "Draft note on statistical implications of some policy measures in the context of the COVID-19 pandemic" available on https://ec.europa.eu/eurostat/documents/1015035/2041357/Draft+note+on+statistical+implications+of+some+policy+measures+in+the+context+of+the+COVID-19+measures+-+09+April+2020/efc6d52f-39e0-fd92-c760-f27d90676ef0.

[17] This implies that the NSO will be departing from the time adjusted method which used to be carried out as part of the accrual adjustments. The time adjustments were as follows: t+1 for VAT; and t+2 for Income Tax and Social Security Contributions. For further details refer to the metadata published by the NSO on https://nso.gov.mt/en/nso/Sources_and_Methods/Unit_A2/Public_Finance/Pages/Tax-Revenues.aspx.

official forecasts. To shed more light on this issue, the DBP presents a chart with the range of alternative macroeconomic outcomes which could arise based on specific alternative scenarios (see Chart 2.2). The identical alternative scenarios were in turn used to construct alternative fiscal balance projections (see Chart 2.3).

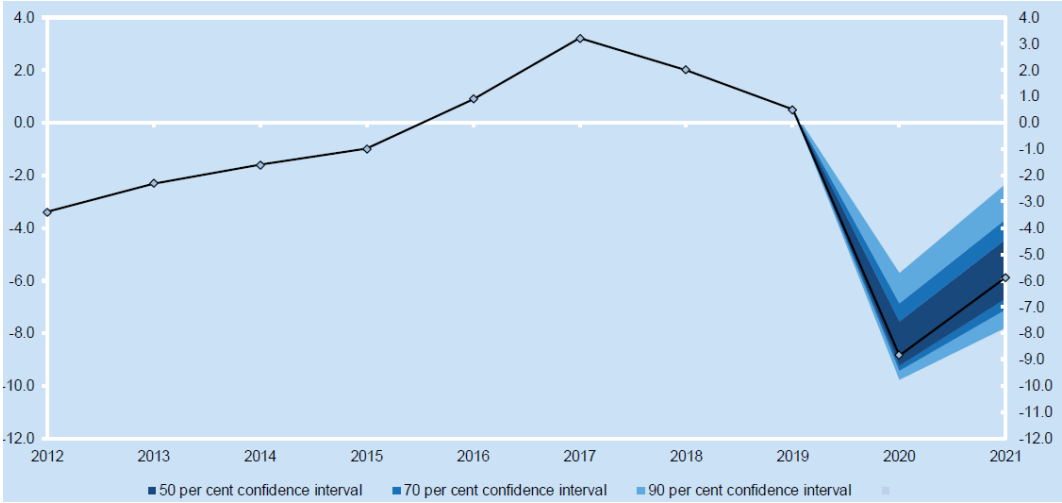
Chart 2.2: Alternative real GDP growth forecasts produced by MFIN (%)



Note: Reproduced from the DBP Chart 2.2, page 17.

Source: MFIN

Chart 2.3: Alternative fiscal balance projections produced by MFIN (% of GDP)



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

Source: MFIN

The alternative scenarios considered by MFIN included: different growth rates for external demand; a quicker and a slower economic recovery; different labour market dynamics; higher investment; and higher interest rates. All scenarios point to negative

real GDP growth in 2020 and practically all scenarios indicate positive real GDP growth in 2021. In the DBP, MFIN also expressed the view that the upside risk for 2020 was “mild” and the downside risk for 2021 was “marginal”. The mild upside risk for 2020 suggests the possibility that the fall in real GDP could be slightly more contained than shown in the baseline, while the marginal upside risk for 2021 suggests the possibility that the rebound could be slightly less vigorous than portrayed by the baseline.

All alternative scenarios which MFIN presented in the DBP point to a fiscal deficit throughout the period 2020 to 2021. This contrasts with the stream of fiscal surpluses which were recorded between 2016 and 2019. However, in the DBP, MFIN also stated that “there seems to be an upside risk for the attainment of a lower budget deficit in both 2020 and 2021”, indicating the possibility that the fiscal balance could turn out slightly less negative than indicated in the baseline.

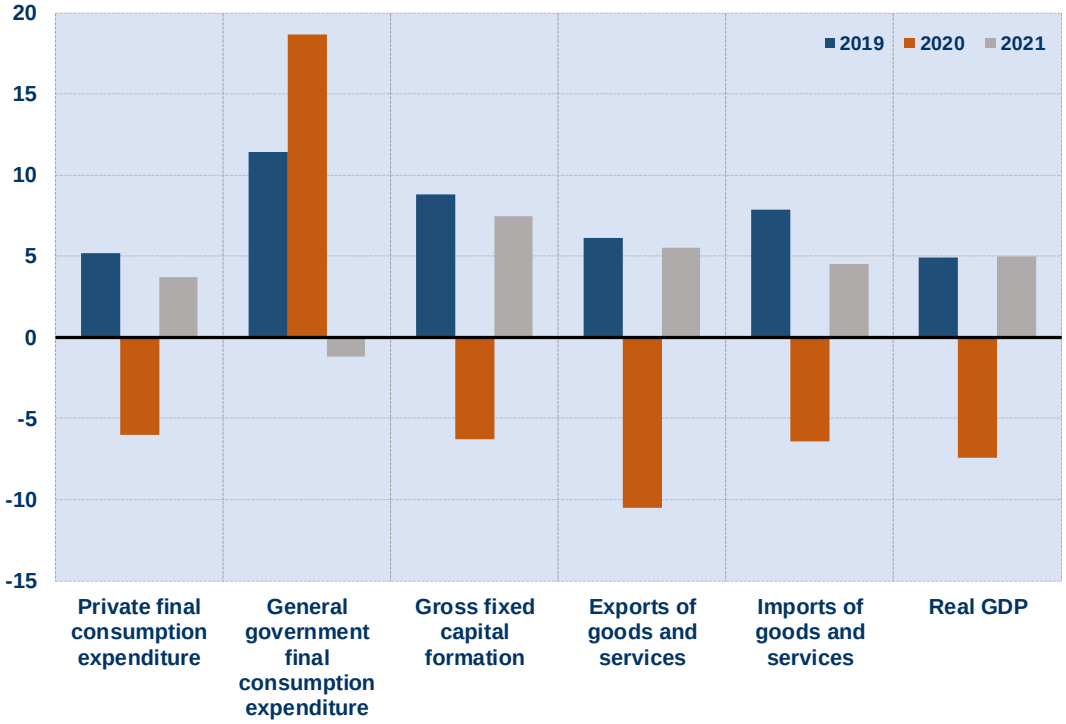
Chapter 3

Assessment of the macroeconomic forecasts 2020 – 2021

3.1 Macroeconomic outlook 2020 – 2021

Due to COVID-19 the Maltese economy is expected to suffer a fall in output in 2020, followed by a partial rebound in 2021. According to the DBP, real GDP growth is forecast to swing from +4.9% in 2019, to -7.4% in 2020, and +5.0% in 2021 (see Chart 3.1 and Table 3.1).[18] Nominal GDP growth is also expected to follow a V-shaped pattern, but in this case, the initial 6.3% drop is anticipated to be fully recovered by the 6.4% expansion in the outer forecast year.

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



Source: MFIN

According to the official forecasts, all GDP expenditure components, except government consumption, are anticipated to decline in 2020 and then rise in 2021, albeit to varying degrees. In 2020, only government consumption is expected to expand on a year earlier, by 18.7%. This significant growth reflects the measures taken

[18] Figures for 2019 refer to the data published by NSO on 28 August 2020 (News Release 142/2020), while figures for 2020 and 2021 are the forecasts prepared by MFIN.

by the Government to address the challenges posed by COVID-19. This base effect explains the planned small decline in government consumption in 2021.

Table 3.1: Macroeconomic variables 2019 – 2021 (%)

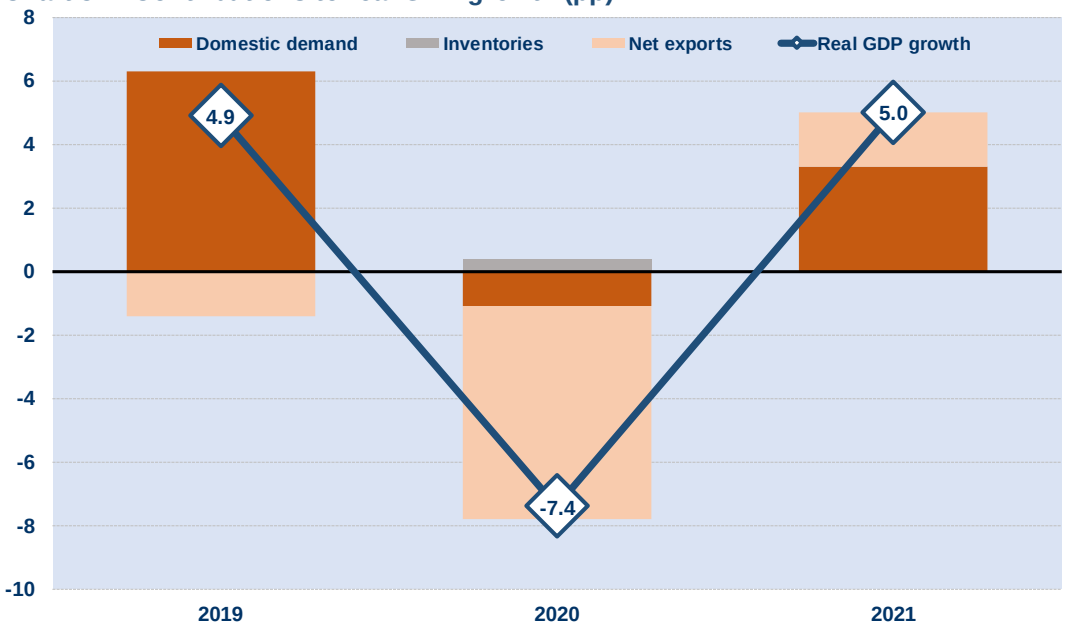
	2019	2020	2021
Real GDP components			
Private final consumption expenditure (including NPISH)	5.2	-6.0	3.7
General government final consumption expenditure	11.5	18.7	-1.2
Gross fixed capital formation	8.8	-6.3	7.5
Exports of goods and services	6.1	-10.5	5.5
Imports of goods and services	7.9	-6.4	4.5
Real GDP	4.9	-7.4	5.0
Contribution to real GDP growth			
Domestic demand (pp)	6.3	-1.1	3.3
Inventories (pp)	0.0	0.4	0.0
Net exports (pp)	-1.4	-6.7	1.7
Deflators			
Private final consumption expenditure	2.0	0.9	1.1
General government final consumption expenditure	2.4	1.6	2.4
Gross fixed capital formation	1.1	1.3	1.2
Exports of goods and services	1.7	1.2	1.1
Imports of goods and services	1.5	1.1	1.1
GDP deflator	2.3	1.1	1.4
Labour market			
Employment (National Accounts definition)	6.5	-0.7	2.3
Unemployment rate (%) (LFS definition)	3.4	4.8	4.0
Nominal compensation of employees	8.4	0.1	4.8
Nominal compensation per employee	2.8	0.8	2.3
Labour productivity (real GDP per person employed)	-0.8	-8.1	2.6
Other macroeconomic variables			
Inflation rate (%) (based on the HICP)	1.5	0.9	1.3
Nominal GDP	7.2	-6.3	6.4

Note: figures for 2020 and 2021 are forecasts
Source: MFIN

The forecast profile for private consumption and gross fixed capital formation indicates similar drops in these two domestic demand components in 2020, estimated at 6.0% and 6.3% respectively. However, in 2021, investment is expected to rebound more strongly, up by 7.5%, thereby compensating for the previous year's decline. On the other hand, private consumption is only expected to recover slightly more than half of its contraction, up by 3.7% on a year earlier. In turn, exports (which include tourism) are expected to be the worst hit by the pandemic. Compared to 2019, the DBP indicates a 10.5% drop in exports, which is then anticipated to partially recover in 2021 following a 5.5% increase. The projected developments in domestic demand and exports are estimated to lower imports of goods and services by 6.4% in 2020 and to subsequently raise them by 4.5% in 2021. Given the high import content of gross fixed capital formation and exports in Malta, developments in these components play a significant role in influencing the overall import growth dynamics throughout these two years.

Both domestic demand and net exports are expected to contribute negatively to growth in 2020, with the effect being marginally dampened by the assumed additions to inventories (see Chart 3.2). The planned expansion in government consumption in 2020 does not fully compensate for the drag created by the adverse shock to private consumption and investment. Still, the downside impact from domestic demand is smaller when compared to the significant negative contribution to growth attributable to net exports.

Chart 3.2: Contributions to real GDP growth (pp)

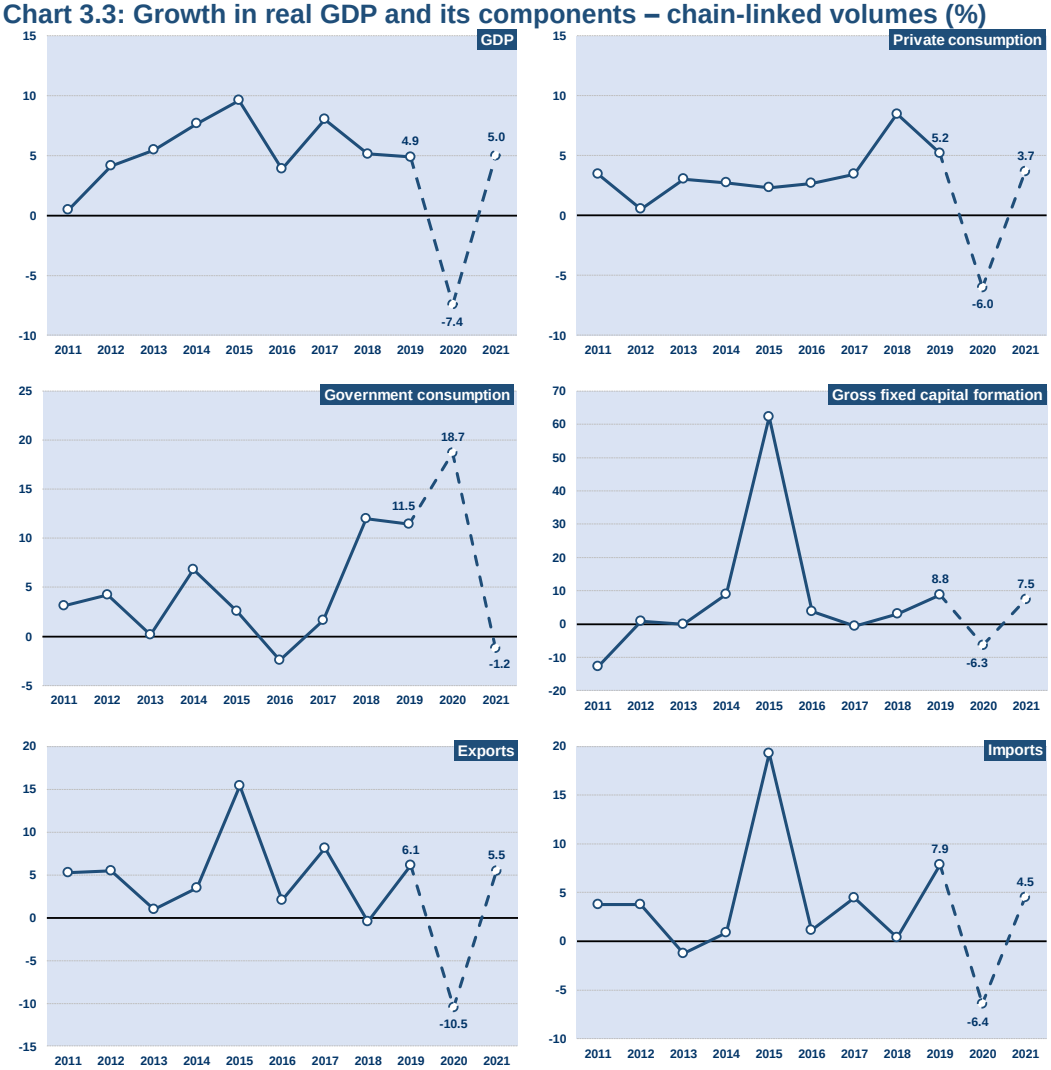


Source: MFIN

The assumed attenuation of the negative effects created by the pandemic paves the way for both domestic demand and net exports to fuel GDP growth in 2021. The contribution to growth stemming from domestic demand is forecast to be higher than that from net exports, particularly since the improvement in the export performance is expected to be gradual. In 2021 no growth impact is assumed from inventory changes.

Chart 3.3 evidences how most real GDP components present a v-shaped pattern, with a decline in 2020 and subsequent rebound in 2021, albeit to varying degrees. In turn, Table 3.2 highlights the significant negative second quarter growth recorded across all GDP components apart from government consumption. It also compares the actual developments during the first half of 2020 with those necessary to match the annual growth forecasts stated in the DBP.

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



Source: NSO, MFIN

An assessment of the forecasts for the individual macroeconomic variables follows. Each component is analysed separately to better evaluate the internal consistency and plausibility of the baseline scenario which is presented in the DBP. This approach also facilitates the tracing of possible upside or downside risks to real GDP growth to specific final demand expenditure components.

Table 3.2: Actual and implied year-on-year real growth rates in 2020 (%)

	Q1	Q2	H1	H2*	Year
Private final consumption expenditure (including NPISH)	-1.6	-20.7	-11.1	-1.2	**-6.0**
General government. final consumption expenditure	12.9	11.9	12.4	24.9	**18.7**
Gross fixed capital formation	-14.5	-11.0	-12.9	0.5	**-6.3**
Exports of goods and services	2.6	-12.8	-5.2	-15.5	**-10.5**
Imports of goods and services	0.3	-7.9	-3.7	-9.0	**-6.4**
Real GDP	**1.4**	**-16.2**	**-7.7**	**-7.1**	**-7.4**

* MFAC calculations

Note: Q1 and Q2 denote the first quarter (January – March) and second quarter (April – June) of 2020; H1 and H2 denote the first half (January – June) and second half (July – December) of 2020; and year covers the period January to December 2020. Figures for Q1, Q2 and H1 refer to actual data and year refers to the forecast by MFIN contained in the DBP. MFAC calculations for H2 show the implied year-on-year growth during the second half of 2020 required to be consistent with the yearly forecast, assuming that there are no revisions in the historical data.

Source: MFIN, MFAC calculations

3.2 Private consumption

In 2020 private consumption is forecast to drop by 6.0% in real terms, while in 2021 it is expected to rise by 3.7%. Various factors contribute to the forecast sharp contraction in private consumption. The negative shock to consumption embeds the forced (involuntary) saving which took place due to the restrictions in place throughout part of the year.[19]

[19] Various types of restrictions were in place. From 18 March 2020, bars, gyms and restaurants were closed (take-away and deliveries were still permitted). Restaurants re-opened on 22 May, whereas bars and gyms re-opened on 5 June. All non-essential shops

Such restrictions prevented certain expenditures from taking place. Indeed, when the strongest restrictions were in place (second quarter of 2020), private consumption fell by 20.7% on a year earlier. Apart from consumption on "Housing, Water, Electricity, Gas and other fuels", and consumption by Non-Profit Institutions Serving Households (NPISH), all other consumption components experienced significant declines (in real terms) during the second quarter.

The anticipated yearly drop in private consumption also factors in the contraction in the population experienced in 2020 following the voluntary repatriation of several workers through the assistance of the Maltese government.[20] Further drag on consumption is due to the expected unfavourable developments in real household income. Indeed, total nominal compensation of employees is expected to remain virtually the same as in 2019 (+0.1%), resulting in a small erosion in purchasing power, when compared to the anticipated rise in the consumption deflator (+0.9%). A weakening of consumer confidence may also occur since the unemployment rate is forecast to rise from 3.4% in 2019 to 4.8% in 2020.

The projected partial rebound in private consumption in 2021 reflects the economic recovery considered in the baseline scenario and is compatible with the strong base effect of a year earlier. Job losses are expected to be more than reversed as employment is forecast to rise by 2.3% on a year earlier. As a result, the unemployment rate is expected to slide back to 4.0%. Meanwhile, total nominal compensation of employees is forecast to rise by 4.8%, and slightly less in real terms, in view of the 1.1% forecast rise in the consumption deflator. The positive labour market outlook thus supports the anticipated recovery in private consumption in the outer forecast year.

The profile for private consumption, characterised by a sharp decline in 2020 and partial recovery in 2021, is compatible with the assumption employed by MFIN that the adverse shock created by the pandemic gradually diminishes after the period when the strongest restrictions were in place. The baseline scenario considers that the recovery in consumption starts from the second half of 2020 when the restrictions started being

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were closed from 23 March and most re-opened on 4 May. From 19 August, only bars having restaurant services (sit-down) were permitted to remain open, while wedding receptions could only be held in a seated environment. Bars were again ordered to close from 29 October until 1 December. Throughout the year there were also restrictions on the permissible number of persons in social gatherings, with the maximum being revised from time to time.

[20] As at May 2020, 10,278 persons were repatriated. Source: http://pq.gov.mt/pqweb.nsf/5ab326fbcb184092c1256877002c4f19/c1257d2e0046dfa1c1258581004a125d!OpenDocument.

lifted. This can be deduced by the fact that whereas the actual drop in consumption during the first half of the year amounted to 11.1%, the implicit forecast for the second half (i.e. the required year-on-year growth rate to match the forecast for the full year) points to a contraction of only 1.2% on a year earlier. Further improvements, albeit gradual, are then considered for 2021, as private consumption is anticipated to grow again, but at a slower rate than recorded in 2018 and 2019.

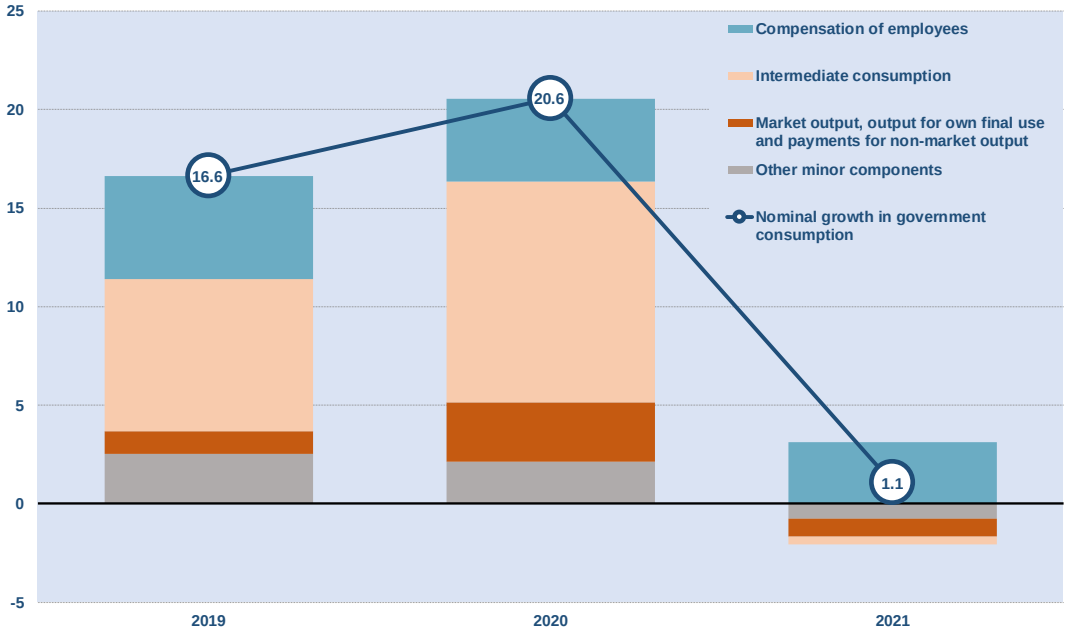
3.3 Government consumption

Real government consumption is expected to grow by 18.7% in 2020 but it is then projected to contract by 1.2% in 2021. The scenario portrays an acceleration from the double-digit growth recorded in 2019 and marginal retrenchment in the outer forecast. The reasons for the elevated growth in 2020 and the subsequent negative growth in 2021 can be traced to the government's fiscal plans and their resulting impact on the components making up government consumption.[21] The caveat is that data for such variables are only available in nominal terms.

The materialisation of these plans would contribute to an estimated 20.6% growth in nominal government consumption in 2020, which is faster than the 16.6% nominal growth recorded a year earlier (see Chart 3.4).[22] In 2020, a stronger contribution to growth driven by intermediate consumption is expected to be partially dampened by a smaller contribution from compensation of employees (compared to 2019). Further growth in government consumption is attributable to the forecast trajectory for the remaining components.[23]

[21] Refer to Chapter 5 in this Report for an assessment of the forecast trajectory for the relevant budget components.
[22] The 16.6% nominal growth in government consumption which is quoted in this Report is consistent with the fiscal data used by MFIN in the preparation of the DBP. This growth rate is higher than the 14.1% growth which can be estimated form the GDP statistics published by NSO through News Release 142/2020. This discrepancy arose since the figures used by MFIN were based on updated data sources, particularly the audited accounts for some EBUs.
[23] When estimating the value of government consumption, certain items (market output, output for own final use and payments for non-market output) are deducted from the other expenditure components. Since the DBP assumes that in 2020 the total for these items will be less than in 2019, this corresponds to a deduction of a smaller value, thus explaining the upward push to government consumption resulting from these sources. This pattern was also recorded in 2019. In 2021 the total for market output, output for own final use and payments for non-market output is expected to be higher than in 2020, thus producing a negative contribution to growth in nominal government consumption.

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



Source: MFIN, MFAC calculations

On the other hand, the sharp deceleration in government consumption growth projected for 2021, to 1.1%, reflects the planned containment in expenditure growth. Indeed, apart from compensation of employees, all other components are expected to retrench slightly on a year earlier, mostly due to the non-repetition of the exceptional COVID-19 related outlays.

COVID-19 has resulted in higher health-related expenditure by government, thereby creating upward pressures, primarily on intermediate consumption, but also on public sector compensation of employees and social transfers in kind.[24] The non-repetition of such expenditure, or the much lower anticipated outlays, are the main reason behind the expected sharp deceleration in nominal government consumption in 2021, as presented in the baseline scenario. Still, challenges persist when noting that the average growth in nominal government consumption over the two-year forecast horizon is below that recorded during the previous two years (pre-pandemic).[25] This gives rise to a possible upside risk for the government consumption growth profile over the forecast horizon.

[24] Social transfers in kind are included under the heading “other minor components”, together with consumption of fixed capital.
[25] Focusing on a two-year period allows one to even out the effect of a strong surge and subsequent small decline.

3.4 Gross fixed capital formation

Gross fixed capital formation is expected to drop by 6.3% in 2020. Notwithstanding public investment is expected to be higher than in 2019, this effect is overshadowed by the expected decline in private investment. Although total investment contracted by 12.9% during the first half of 2020, the forecast annual decline is less severe because of the better performance expected during the second half of the year (investment is expected to register a +0.5% growth during H2).[26] This view is corroborated by the resumption of investment projects which had been put on hold. In fact, the baseline scenario assumes that the planned capital projects will still take place.

In 2021 investment is forecast to grow by 7.5% in real terms as firm and investor sentiment is assumed to be gradually restored. This outlook builds on the expected materialisation of several large-scale investment projects particularly in transport and aviation, tourism, real estate and health. Both public and private sector investment are expected to be higher than in 2020.

The expected investment decline in 2020 is consistent with the adverse shock created by the pandemic. In turn the rebound expected in 2021 builds on the assumption of the temporary nature of such shock. At the same time, the investment outlook factors in the significant support provided by public investment throughout the two forecast years.

Gross fixed capital formation has exhibited significant swings across the years, making it challenging to achieve accurate forecasts for this GDP expenditure component. However, it is acknowledged that the assumption of a high import content adopted by MFIN for investment implicitly reduces the risk that forecast errors in this component spill unto the overall GDP growth forecast.

3.5 Exports of goods and services

The baseline scenario indicates that in 2020 exports are expected to suffer the largest hit among the GDP components, dropping by 10.5% in real terms. A 5.5% partial

[26] The growth in the second half of the year is viewed against a base effect of a small increase of 2.1% in real investment recorded in the second half of 2019, as opposed to 16.4% which was recorded in the first half of the same year.

rebound is then forecasted for 2021. This scenario presents larger swings in Malta's exports when compared to the contraction and subsequent expansion of GDP in Malta's main trading partners, which were respectively estimated at -6.3% for 2020 and 4.6% for 2021. This pattern reflects the strong downside impact caused by the temporary lockdown on tourism activities during part of 2020, as well as sector-specific export prospects.[27] Indeed, even after the relaxation of constraints, the tourism sector continues to face significant challenges.

Despite the more negative external assumptions regarding GDP growth in Malta's main trading partners, together with a stronger euro, and a more adverse outlook for tourism compared to the previous official forecast vintage (USP 2020 – 2021), the decline in exports in 2020 is slightly less than anticipated in April. This re-appraisal is driven by the better-than-expected performance in the remote gaming sector which registered a notable expansion in the first months of 2020, as the demand for games increased.[28] At the same time, the forecast pattern for exports remains the most cautious compared to the other components of GDP. Indeed, the expected export recovery in 2021 lags that in the other expenditure components and is only around half the shock experienced in 2020. The positive export growth anticipated for 2021 is underpinned by the expected gradual recovery in tourism and the ongoing good performance by the remote gaming sector.

3.6 Imports of goods and services

In 2020 imports are forecast to decline by 6.4% in real terms, and then grow by 4.5% in 2021. The lower volume of imports in 2020 is compatible with the temporary contraction in domestic production as a result of COVID-19. The subsequent increase in imports is then driven by the expected economic recovery. These forecasts are significantly influenced by the import content assumed by MFIN for the domestic demand components and exports. Hence, any deviation from the anticipated profile for these expenditure components could have a material impact on the growth rates for imports over the forecast horizon. For 2020, the main contributors to the expected

[27] Passenger flights inbound to Malta were suspended after 20 March 2020, and the first scheduled traveller flights to Malta restarted on 1 July 2020.
[28] The growth rate of exports of goods and services for 2019 experienced a significant revision. When the USP (2020 – 2021) was published, the official data indicated a growth rate of 1.7%, whereas in the DBP (2021) the updated growth rate was raised to 6.1%. This much stronger past performance could also explain the relatively less pessimistic view for exports for 2020.

import declines are capital goods, fuel and intermediate goods. In turn, the expected rebound in these components contributes to the pick-up in imports in the outer forecast year.

3.7 Inflation and GDP deflators

The annual inflation rate (based on the HICP) is expected to remain low but still positive. The DBP points to a deceleration in inflation from 1.5% in 2019, to 0.9% in 2020. This reflects some abatement in the inflationary pressures related to goods, which more than compensate for the slight acceleration in the prices of services. In 2021, the gradual recovery in domestic and external demand is then expected to lift HICP inflation to 1.3%.

The rate of growth in the GDP deflator is slightly lower than recorded in recent years. In fact, the GDP deflator is forecast to rise by only 1.1% in 2020 and 1.4% in 2021. This builds on the scenario where the deflators for the various GDP components experience limited growth. The baseline scenario also indicates stable terms of trade, as import prices are set to rise practically in line with export prices over the forecast horizon.

The relative stability in the growth rates of the various deflators stands out against the background of strong swings in the different GDP components. Under the baseline scenario the adjustments to the shocks created by the pandemic take place predominantly via changes in activities, with limited impact on price dynamics. This approach was used for the full set of GDP expenditure components, thereby maintaining a consistent view in relation to the deflator forecasts.[29]

3.8 Labour market

In 2020 employment is expected to decline only marginally, by 0.7%, which is very limited compared to the 7.4% anticipated decline in real GDP. Indeed, the baseline scenario accounts for the various government initiatives aimed at safeguarding jobs,

[29] The same scenario of limited price changes had been used in the USP. Indeed, to date there is no information about significant prices drops as a result of COVID-19, thereby consistent with the view that the strongest impact could be felt on quantities rather than prices.

primarily through wage assistance schemes and initiatives to sustain domestic demand. The retention of employees leads to a sharp fall in labour productivity in 2020, estimated at -8.1% (calculated both on per person employed and per hour worked). The expected job losses are mostly concentrated in the tourism sector, the wholesale and retail sector and certain manufacturing sub-sectors. Such downside effect on employment is however mitigated by the anticipated higher employment levels in remote gaming, construction and the public sector.

Overall, in 2020, job losses are expected to lift the unemployment rate to 4.8%. Besides the job-retention support measures implemented by the government, another factor limiting the expected spike in the unemployment rate is the concurrent contraction in labour supply as a result of the repatriation of foreign workers. In 2021 the unemployment rate is anticipated to fall back to 4.0% as employment is expected to rise by 2.3%. This expansion in jobs is distributed across most sectors.

The resilience of the job market portrayed in the DBP is consistent with the assumption that the adverse shock created by the pandemic will diminish in line with the assumption that a vaccine will be found by the first quarter of 2021. The relatively benign outlook also factors in the various job-support measures which have been implemented in 2020 and which, based on the information available by the Report's cut-off date, will be extended at least till March 2021. The shock created by the pandemic is thus seen as impacting mostly the business sectors (through profits) and to a much lesser extent the labour market. In turn, Eurostat data suggests that the biggest impact on Malta's labour market could be manifested through a reduction in temporary contracts and part-time work.[30]

3.9 Potential output and the output gap

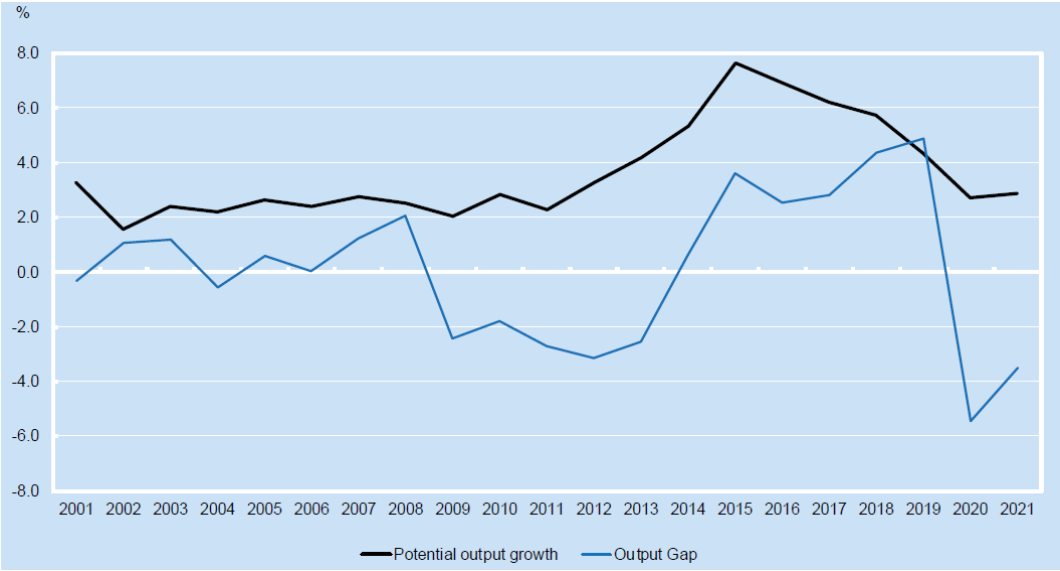
Potential output and the output gap are estimated by MFIN using the commonly agreed methodology across the EU.[31] This is based on the production function approach, with growth driven by labour, capital and total factor productivity. In 2020, potential output

[30] Data for 2020 Q2 and 2019 Q4 shows double digit declines across this period in both temporary contracts and part-time employment in Malta. Source: https://ec.europa.eu/eurostat/web/products-eurostat-news/-/DDN-20201113-1?inheritRedirect=true&redirect=%2Feurostat%2F.

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

growth is expected to continue decelerating, to 2.7%, from its peak attained in 2015 (see Chart 3.5). In 2021 potential output growth is then expected to stabilise. Throughout the two years, the contributors to potential output growth are labour input, supported to a lesser extent by capital accumulation, with total factor productivity set to diminish. Due to the sharp contraction in real GDP, the output gap is expected to swing from significantly positive (4.9% above potential) in 2019 to significantly negative (5.5% below potential) in 2020. The negative output gap is then expected to narrow slightly in 2021 but remain larger than over the past two decades.

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



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

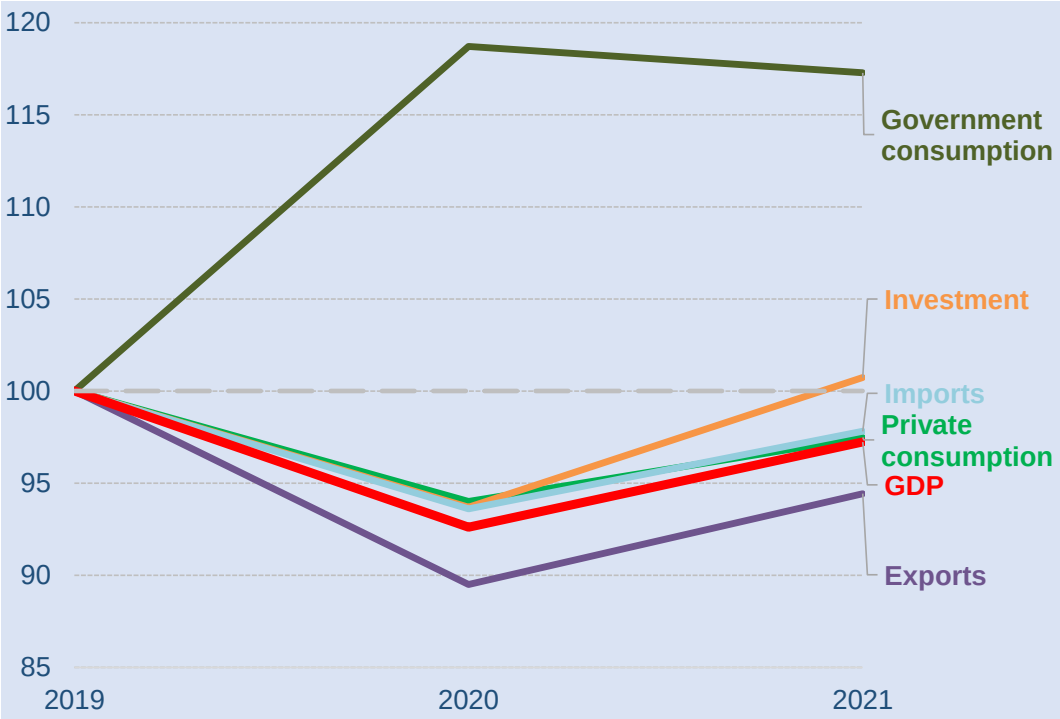
Source: MFIN

3.10 Macroeconomic risk outlook

Owing to the highly uncertain duration and severity of the COVID-19 effects, both from a health and economic perspective, the MFAC's risk outlook focuses on the joint profile pattern for each GDP component over the two forecast years rather than for each year separately (see Chart 3.6).[32] The macroeconomic outlook is very sensitive to the assumptions employed, especially those related to the timing of recovery from COVID-19. Any material departure from such assumptions could deviate the outturn, possibly significantly, from those presented in the official forecasts.

[32] The MFAC adopted the same approach for its risk assessment carried out in relation to the macroeconomic forecasts contained in the USP 2020 – 2021.

Chart 3.6: Real GDP components (2019 = 100)



Source: MFIN

For 2020 the baseline scenario is characterised by a drop in private consumption, investment and exports, which lead to a drop in GDP and imports. Only government consumption is set to experience growth in 2020. For 2021, private consumption, investment and exports are then expected to rebound. However, only in the case of investment will the rebound forecast growth suffice to attain a level higher than pre-pandemic. The forecast recovery in private consumption and exports is more gradual, suggesting that by 2021 their level would remain below that which prevailed pre-pandemic. This observation also applies to GDP and imports. In the case of government consumption, despite the marginal easing anticipated for 2021, this component is still expected to remain significantly above the pre-pandemic level.

There is a risk that the drop in private consumption could be larger than expected in 2020, and this would create a negative base effect for the outer forecast year. Indeed, the required containment in the fall in consumption during the second half of the year, of only 1.2%, may be challenging to achieve (see Table 3.2). This risk could be larger should consumers adopt more cautious behaviour than assumed in the baseline, or if the labour market turns out weaker than expected. The challenge to limit the downturn in consumption specified in the DBP is larger when considering that post its publication new restrictive measures were introduced which could again depress consumption.

Likewise, there are downside risks vis-à-vis the investment profile since the decline in investment may be more pronounced and the subsequent recovery less vigorous (see Table 3.3). This risk emanates principally due to the strong assumption employed by MFIN that the investment plans made prior to the pandemic only experience few months delays. The materialisation of some large investments may also be more uncertain than others, as plans are still at the initial stages.

Table 3.3: Summary of risks to the GDP expenditure components

	2020 – 2021
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

Further downside risks relate to the profile of exports of goods and services. The downside effect could materialise if the recovery in tourism proves weaker than expected, particularly as an increasing number of countries impose testing or quarantine requirements. Additional downside risks could stem from sharper declines in foreign demand for Malta's exports, resulting from a worse deterioration in international trade. Indeed, post submission of the DBP an increasing number of countries started reintroducing new restrictive measures to combat COVID-19, which could depress their economies further.

Owing to the import content associated with private consumption, investment and exports, the downside risks related to these expenditure components translate into downside risks also for imports. This effect partly mitigates the overall downside risk for real GDP growth, as the correction in imports acts as a cushion.

The assessment of the fiscal scenario, characterised by a surge in 2020, and limited retrenchment in 2021, points towards upside risks with respect to the profile for government consumption. Such risks mainly stem from the possibility that the necessary measures implemented by the Government could be higher than planned. The extent to which spending growth can be slowed down so suddenly also appears ambitious when observing that even in pre-COVID years, high growth was recorded and there could be demands for higher public sector involvement.

The assessment carried out on the individual expenditure components suggests an overall downside risk outlook vis-à-vis the profile for real GDP for the period 2020 and 2021. However, this downside risk is deemed to be contained since other reputable institutions producing macroeconomic forecasts have indicated a range of forecasts which encompass the baseline scenario presented in the DBP.[33]

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

Chapter 4
Comparison across different macroeconomic forecasts

4.1 Introduction

The macroeconomic scenario presented in the DBP is further assessed by comparing the latest official forecasts to the previous vintage which was produced as part of the USP 2020 – 2021. The plausibility of the official forecasts can also be evaluated by examining the similarity or otherwise with respect to the forecasts for the Maltese economy which are produced by other reputable institutions, namely the COM, CBM, IMF, and three credit-rating agencies (Fitch, Moody's and S&P). The caveat remains that such forecasts are not necessarily perfectly comparable, due to different information available at the time of preparation, and the possibly different scenarios considered, particularly in relation to the COVID-19 effects. Other variations could arise due to 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 2020 – 2021

The 7.4% estimated decline in real GDP for 2020 indicated in the DBP represents a 2.0 pp worsening in the outlook compared to the forecasts contained in the USP (see Table 4.1). The DBP anticipates domestic demand to contribute negatively to real GDP growth in 2020. This contrasts with the positive contribution envisaged in the USP. This revision reflects the larger expected declines in private consumption and gross fixed capital formation, which are marginally compensated for by the slightly higher growth in government consumption.

On the other hand, the negative contribution from net exports in 2020 is expected to be less strong than indicated in the USP. According to the DBP, the decline in exports is expected to be slightly less than originally forecasted. This factor outweighs the effect created by the smaller fall in imports shown in the DBP compared to the USP. Further support to GDP is offered by the assumed profile for inventory changes, which, in the USP was nil, while it is shown as contributing positively in the DBP, by 0.4 pp.

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

	2020				2021			
	MFIN USP	MFIN DBP	COM AUT	CBM AUG	MFIN USP	MFIN DBP	COM AUT	CBM AUG
	Growth rate in GDP components in real terms							
Private consumption	-0.8	**-6.0**	-9.8	-2.4	1.8	**3.7**	4.2	6.1
Government consumption	16.5	**18.7**	18.4	13.6	-3.2	**-1.2**	-0.4	1.7
Gross fixed capital formation	-4.0	**-6.3**	-10.1	-10.8	8.6	**7.5**	8.0	16.1
Exports of goods and services	-12.1	**-10.5**	-10.4	-17.2	6.8	**5.5**	2.3	7.4
Imports of goods and services	-8.0	**-6.4**	-8.4	-15.4	5.6	**4.5**	2.4	8.5
Real GDP	-5.4	**-7.4**	-7.3	-6.6	3.9	**5.0**	3.0	6.1
	Contributions to real GDP growth							
Domestic demand (pp)	1.8	**-1.1**	-3.6	-0.8	1.8	**3.3**	3.5	6.0
Inventories (pp)	0.0	**0.4**	0.3	0.0	0.0	**0.0**	-0.5	0.0
Net exports (pp)	-7.2	**-6.7**	-4.1	-5.7	2.1	**1.7**	0.0	0.1
	Deflators							
Private consumption	1.2	**0.9**	-	-	1.5	**1.1**	-	-
Government consumption	2.0	**1.6**	-	-	2.4	**2.4**	-	-
Gross fixed capital formation	3.1	**1.3**	-	-	3.5	**1.2**	-	-
Exports of goods and services	0.8	**1.2**	-	-	1.1	**1.1**	-	-
Imports of goods and services	1.2	**1.1**	-	-	1.3	**1.1**	-	-
GDP	1.8	**1.1**	0.6	1.3	2.0	**1.4**	1.5	1.3
	Other macroeconomic variables							
Inflation rate (HICP)	1.0	**0.9**	0.8	0.9	1.4	**1.3**	1.3	1.0
Employment growth*	-3.3	**-0.7**	-0.8	-0.7	3.2	**2.3**	1.9	1.9
Unemployment rate	5.9	**4.8**	5.1	4.9	3.7	**4.0**	4.7	4.6
Compensation per employee	1.6	**0.8**	1.0	-3.2	2.8	**2.3**	2.0	4.0

** Figures may not be directly comparable as definitions may vary.*

Sources: MFIN, COM, CBM

The revision in the macroeconomic outlook for 2020 (more negative real GDP growth) was accompanied by compensating changes (more positive real GDP growth) in the outlook for 2021. In the outer forecast year MFIN is anticipating a stronger positive contribution to real GDP growth from domestic demand when compared to the USP. The forecast growth in private consumption in 2021 has been raised and this can be partly ascribed to the expected worse outcome in 2020. Still, the baseline scenario has become more conservative. Whereas in the USP, the baseline scenario indicated that private consumption would fully recover by 2021, this has been replaced by the scenario of a partial recovery. The scenario for gross fixed capital formation has also been made more conservative. The expected pick-up in investment in 2021 has been moderated slightly, notwithstanding the larger expected drop in 2020. Even the updated export profile indicates slower growth in 2021 compared to the previous forecast round. At the same time, even though the DBP forecasts higher real GDP growth in 2021, imports are expected to grow at a slower pace than indicated in the USP. This reflects the changed contributors to GDP growth which generate an overall lower import content.[34]

When compared to the previous round, the updated profile for the deflators reconfirmed the USP's low price pressure scenario throughout the forecast horizon, with further abatement in certain cases. For 2020, the growth rates for all deflators except that for exports were reduced. For 2021, there was a reduction in the deflator growth for private consumption, investment and imports, while the growth in the remaining deflators (government consumption and exports) remained unchanged. The pattern of low, yet non-negative price dynamics throughout the forecast horizon has thus been reconfirmed in the DBP.

The job market scenario is more benign in the DBP when compared to the USP, despite the worse expected decline in real GDP in 2020. The USP had anticipated that employment would drop by 3.3% in 2020 and this effect would be practically neutralised by a subsequent 3.2% recovery in 2021. The DBP presents a more optimistic view as it anticipates a smaller decline in employment in 2020 (-0.7%), followed by 2.3% growth in 2021.

The employment forecast for 2020 presented in the DBP thus anticipates larger recourse to 'labour hoarding' and a consequent drop in labour productivity than what

[34] Growth in imports can slow down when expansion in GDP is driven by components which have lower import content compared to others.

was factored in the USP.[35] This scenario would effectively place employment above the pre-pandemic level. Such updated forecasts build on the success of the job retention schemes launched by the government and the relative resilience displayed by the labour market during the first months of the pandemic. Such subsidy schemes allow for most or all the cost of lower labour productivity to be subsidised by the government instead of impacting the private sector's financials.

The less negative job prospects in 2020 explain why the unemployment rate has meanwhile been lowered from 5.9% in the USP to 4.8% in the DBP. However, the unemployment rate has been prudently raised slightly for 2021. On the other hand, the yearly growth rate in compensation per employee, though forecast to remain positive in each year, has been scaled down both for 2020 and 2021. The forecast positive growth in compensation per employee in 2020 is based on the scenario whereby total wages paid in the economy remains broadly stable against a small reduction in employment, whereas in 2021, this reflects faster expected growth in total wages than in employment.

4.3 Comparison with the forecasts produced by other institutions

Detailed macroeconomic forecasts are also published by the CBM (August 2020) and the COM (November 2020).[36] Owing to the earlier production, the forecasts by the CBM incorporate official data up to the first quarter of 2020 (NSO News Release 091/2020) whereas the DBP and the Autumn forecasts by the COM include the official

[35] The limited adjustment of employment in a period of subdued economic activity is described in the economic literature as 'labour hoarding'. This happens when businesses hold on to more workers than necessary in the downturn. Labour hoarding is that part of labour input which is not fully utilised during the production process at any given point in time. Under-utilisation of labour can manifest itself in various forms, such as reduced effort or hours worked, and the shift of labour to other uses, such as training. From the business point of view, some labour hoarding may be optimal given the fixed costs associated with adjusting staff numbers (which include costs of recruitment, screening and training of new workers, as well as costs related to the termination of contracts such as severance pay). Therefore, in the face of a downturn in activity, businesses may prefer to reduce labour input, at least to some extent, by shortening the hours worked, which is less costly than reducing staff numbers. This behaviour is reflected in the fact that labour productivity, measured by output divided by total employment, tends to decline in economic downturns. In view of the wage subsidy schemes which were launched by the government, the costs of labour hoarding are not faced by the private sector but rather by the state, thereby making such practice even more feasible. For further explanations about the concept of labour hoarding refer to "Labour hoarding in the euro area", ECB Monthly Bulletin (July 2003), available on https://www.ecb.europa.eu/pub/pdf/other/mb200307_focus04.en.pdf.

[36] Dates in brackets indicate the latest respective forecasts which were published by the Report's cut-off date of 26 November 2020.

data up to the second quarter of 2020 (NSO News Release 142/2020).[37] The forecasts contained in the DBP and those prepared by the COM may thus be more comparable, since they are based on identical historical data.

The magnitude of the expected contraction in real GDP in 2020 is very similar across the three sets of forecasts, with the figures in the DBP showing the largest decline. On the other hand, for 2021 the official real GDP forecast by MFIN fits with the range of forecasts by the CBM (most optimistic) and the COM (less optimistic).

For 2020 the three institutions expect negative contribution to growth from both domestic demand and external demand. At a component level, a main divergence relates to the expected drop in private consumption. The latter is forecast to contract by 9.8% according to the COM, by 6.0% according to MFIN and by only 2.4% according to the CBM.[38] The outlook further diverges in that the forecasts by the CBM show the pick-up in consumption in 2021 more than offsetting the COVD-19 effect, whereas both MFIN and COM only expect partial recovery. The COM is the most cautious vis-à-vis private consumption when considering the profile over the entire forecast horizon.

Even the profile for gross fixed capital formation differs across institutions. For 2020, the COM and CBM forecasted a much larger decline in investment than MFIN. The COM's estimates are the most conservative, since the forecast rebound for 2021 would still place investment lower than pre-pandemic levels. This contrasts with the outlook shared by MFIN and the CBM (which is the most optimistic) that the growth in 2021 will suffice to fully offset the COVID-19 initial downturn.

On the other hand, there is consensus vis-à-vis the outlook for government consumption. All institutions anticipate rapid growth in 2020, followed by a sharp deceleration in 2021. This is fully in line with the calls made globally by international institutions for governments to mitigate the recessionary impact of the pandemic

[37] This is an important caveat in the case of the CBM's forecasts since in August 2020 the NSO carried out a benchmark revision in the data. For further details refer to https://nso.gov.mt/en/nso/Sources_and_Methods/Documents/National_Accounts/National%20Accounts%20-%20Benchmark%20Revision%202020.pdf.

[38] The less pessimistic outlook for private consumption by the CBM may also be attributed to the fact that such forecast was produced at a time when the easing of restrictions was expected to remain in place with no further tightening planned. This scenario has changed because new restrictions have been introduced in Malta since the publication of the CBM's forecasts.

through expansionary fiscal policy.[39] However, whereas MFIN and the COM expect negative growth in government consumption in the outer forecast year due to the large base effect, the CBM still expects a slightly positive rate of growth.

Even in the case of exports, there is consensus about an expected sharp contraction in 2020 and a partial rebound in 2021. However, the 2021 export growth forecasts by the CBM and COM suggest a much slower recovery to pre-pandemic levels than indicated in the DBP.[40]

All institutions expect a v-shaped profile for imports, with a strong decline in 2020 followed by partial recovery in 2021. The differences in the magnitude of the import growth rates can be ascribed to the different mix in the sources of growth and related assumptions about their respective import content. Differences could also be due to the different data which was available and the way in which the pandemic is assumed to impact the various expenditure components.

A low inflation outlook, hovering close to the one percent level across the two forecast years, is also shared among the three institutions. Even the forecast growth in the GDP deflator is broadly similar. However, for 2020 the COM is predicting slightly lower growth in the GDP deflator compared to the other institutions.

In relation to the labour market, the forecasts for employment growth (first negative and then positive) and the unemployment rate (rise and subsequent fall) are similar across the three institutions. In 2020 all institutions expect an almost identical decline in employment of below one per cent, while in 2021 the employment growth forecast by MFIN, at 2.3% is slightly higher than that by COM and CBM, which indicated a rise of 1.9%. Likewise, the unemployment rate forecast by all institutions is very close to 5.0%, while for 2021, MFIN's forecast, at 4.0% is slightly lower than the 4.7% and 4.6% respectively forecast by the COM and CBM. On the other hand, in the case of compensation per employee, the CBM anticipates a contraction in 2020, in contrast

[39] Certain initiatives, such as subsidies and social payments form part of government expenditure but are not classified as government consumption.
[40] Although the export growth forecast by the CBM for 2021 is higher than that by MFIN, when considering the much larger drop anticipated by the CBM in 2020, the exports level forecast by the CBM would still be lower than that indicated by MFIN.

with MFIN and the COM which indicate positive rate of growth for the year. For 2021 all institutions expect compensation per employee to rise.[41]

Apart from the COM and CBM, other real GDP forecasts for Malta are regularly produced by the IMF and credit rating agencies Fitch, Moody's and S&P (see Table 4.2). These other sets of forecasts reinforce the view of a worse economic shock for 2020 than anticipated earlier this year, factoring the estimated impact of the second wave of the pandemic in Malta and its main trading partners.

In fact, there is a generalised revision for 2020 pointing towards a worse economic contraction. The updated outlook for 2020 shows an expected decline of 6.6% at best (CBM) and 8.0% (S&P) at worst.[42] Despite the high uncertainty created by COVID-19, the real GDP forecasts for 2020 are all within a very narrow range, with those by MFIN around the middle.

For 2021, all forecasts point towards an economic rebound, in view of the base effect created by the economic shock in 2020 and the common assumption of the abating of the COVID-19 crisis. There are variations in the degree of optimism across the institutions. However, all forecasts concur that real GDP growth in 2021 would be insufficient to compensate for the economic downturn in 2020, supporting the plausibility of MFIN's macroeconomic outlook presented in the DBP which is generally more cautious than that presented in the USP. This also takes due consideration of the increased level of uncertainty which has arisen in view of the unprecedented circumstances created by the pandemic. Indeed, prudence is even more important when the selection of the specific assumptions to generate the baseline scenario becomes unavoidably more subjective, in view of the unknown duration and severity of the pandemic.

[41] The CBM's report stated "As regards wages, these are expected to drop significantly. The envisaged contraction in 2020 primarily reflects the fact that during part of the year, certain employees were participating in the wage supplement scheme. Under the scheme, the government and the employer pay employees a wage that is mostly lower than the average wage normally paid in the sector, at least for the duration of the scheme. Once the scheme expires, wage levels begin to normalise, although in level terms annual compensation per employee is expected to be significantly lower than in 2019. It is then projected to increase strongly in 2021 and 2022 as labour market conditions improve." Source: https://www.centralbankmalta.org/file.aspx?f=92954.

[42] The revision by S&P between the forecast rounds is the largest. This can be ascribed to the fact that the earlier round by S&P was produced at a time when the global pandemic was at the initial stages and in fact S&P was still anticipating an economic expansion for Malta in 2020.

Table 4.2: Real GDP growth forecasts by different institutions (%)

	Issued in	2020	2021
MFIN	April	-5.4	3.9
MFIN	October	-7.4	5.0
Revision		**-2.0**	**1.1**
COM	July	-6.0	6.3
COM	November	-7.3	3.0
Revision		**-1.3**	**-3.3**
CBM	June	-4.8	5.8
CBM	August	-6.6	6.1
Revision		**-1.8**	**0.3**
IMF	April	-2.8	7.0
IMF	October	-7.9	4.8
Revision		**-5.1**	**-2.2**
FITCH	April	-5.9	3.6
FITCH	July	-6.9	4.1
Revision		**-1.0**	**0.5**
Moody's	April	-3.8	3.2
Moody's	August	-6.9	3.9
Revision		**-3.1**	**0.7**
S&P	March	2.0	3.7
S&P	September	-8.0	5.5
Revision		**-10.0**	**1.8**

Source: MFIN, COM, CBM, IMF, FITCH, Moody's, S&P

4.4 Assessment

The revisions in the macroeconomic outlook for 2020 carried out by MFIN in the DBP factor in the more severe shock impacting private consumption and a more cautious view vis-à-vis investment. This effect is partially dampened by a slightly less negative outlook for exports and stronger growth in government consumption.

The consequent revision to a larger fall in real GDP in 2020 than originally expected is in line with the downside risk to real GDP growth which the MFAC had identified in its endorsement of the macroeconomic forecasts which were contained in the USP. The

changes are also compatible with the downside risks vis-à-vis private consumption and investment which the MFAC had identified. On the other hand, the less negative forecast for exports is in line with the resilience shown by certain sectors (particularly gaming) during the pandemic. On this basis, the revisions in the official outlook carried out in the DBP appear to be consistent with the information available by this Report's cut-off date. The fact that all other independently produced forecasts show a very similar decline in real GDP in 2020 adds further to the robustness of the official macroeconomic outlook as presented in the DBP.

The MFAC also notes that the revised official real GDP growth forecast for 2021 still maintains the cautious scenario of a partial economic recovery.[43] This view is in line with that presented in the other available forecasts, thus strengthening the plausibility of the DBP's estimates.[44] Still the inevitable high degree of uncertainty which persists, particularly for the outer forecast year, needs to be acknowledged. Although there is broad agreement that the aftermath of the COVID-19 shock will attenuate in 2021, the pace of the recovery remains subject to high uncertainty. This notwithstanding, the fact that the available sets of forecasts present a broadly similar outlook supports the plausibility of the DBP's macroeconomic scenario.

[43] Despite the higher real GDP growth rate compared to the USP, this is preceded by a larger expected decline in 2020.
[44] Only the CBM anticipated the recovery to be almost full.

Chapter 5

Assessment of the fiscal forecasts 2020 – 2021

5.1 Fiscal outlook 2020 – 2021

The stream of fiscal surpluses which were recorded between 2016 and 2019 is projected to end abruptly as a result of COVID-19. The country is expected to register a fiscal deficit equivalent to 9.4% of GDP in 2020 and 5.9% of GDP in 2021 (see Table 5.1).[45] COVID-19 will also reverse approximately half of the declines recorded in Malta's public debt-to-GDP ratio since 2011 (see Chart 5.1). The debt ratio is set to increase from 42.6% in 2019, to 55.0% in 2020, and 58.6% in 2021, thus edging close to, yet remaining below, the 60.0% debt ceiling indicated in the SGP and the FRA.

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

	Total Revenue	Total expenditure	Fiscal balance	Structural balance*	Gross debt
2019	37.7	37.3	0.5	-1.9	42.6
2020	37.7	47.1	-9.4	-6.9	55.0
2021	39.0	44.9	-5.9	-4.3	58.6

* As percent of potential GDP
Source: MFIN

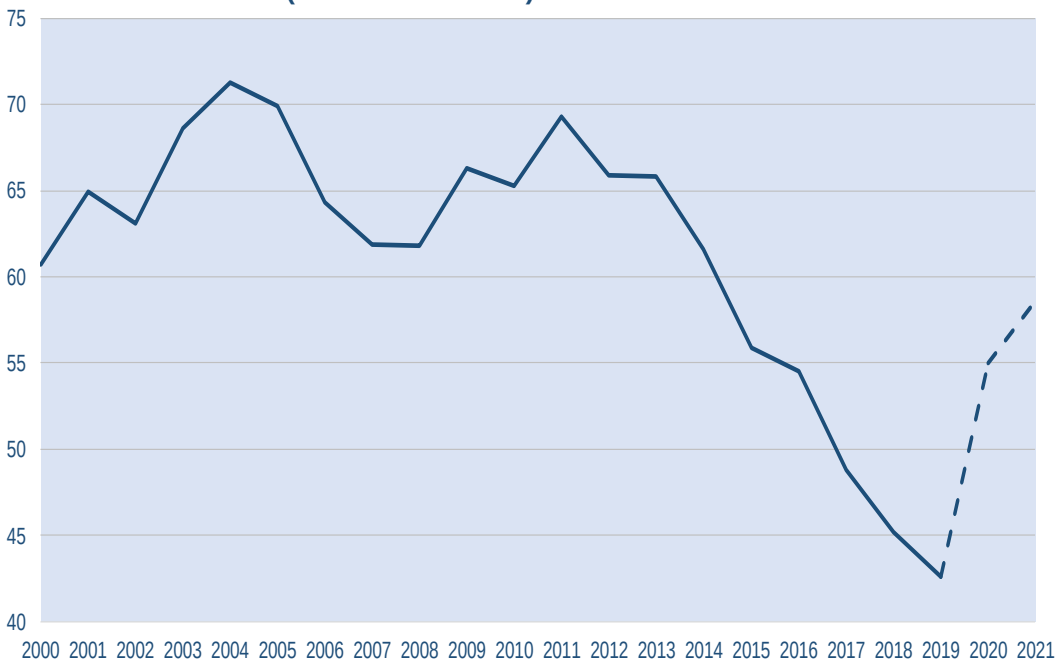
The expenditure-to-GDP ratio is expected to climb sharply, from 37.3% in 2019 to 47.1% in 2020. This reflects the combined upward effect on this ratio created by an 18.4% planned rise in expenditure and a 6.3% forecast contraction in nominal GDP (which acts as a denominator). On the other hand, the revenue-to-GDP ratio is expected to remain stable in 2020 as the projected percentage drop in revenue is very similar to the expected contraction in nominal GDP.

In 2021 total expenditure is expected to increase by a further 1.5% (from €5,907.5 million to €5,994.0 million), whereas total revenue is set to grow more strongly, up by 10.0% (from €4,727.5 million to €5,201.5 million). Since in the outer forecast year nominal GDP is forecast to grow by 6.4%, it is therefore estimated that the expenditure

[45] COVD-19 has brought a deterioration in public finances across the whole euro area. The Autumn forecasts by the COM indicate a fiscal deficit-to-GDP ratio for the euro area at 8.8% in 2020 and 6.4% in 2021.

ratio will slide back to 44.9%, whereas the revenue ratio will increase to 39.0%. Should the actual fiscal and nominal GDP developments be in line with these forecasts, in 2021 both the revenue and the expenditure ratios would be above those recorded before the pandemic.

Chart 5.1: Public debt (% of nominal GDP)



Note: The figures for 2020 and 2021 are the forecasts produced by MFIN.
Source: Eurostat, MFIN

The fiscal balance is expected to swing from a surplus of €64.1 million in 2019 to a deficit of €1,180.0 million in 2020 (see Table 5.2). The projected deterioration in public finances is driven by a €919.2 million increase in expenditure and a concurrent €324.9 million reduction in revenue (see Chart 5.2).[46] In 2021, part of the fiscal imbalance will be corrected through an estimated €474.0 million rise in revenue, which more than compensates for the €86.5 million planned rise in expenditure.

The estimated falls in taxes on production and imports and current taxes on income and wealth are expected to generate most of the revenue decline in 2020 (see Chart 5.3). Social contributions and 'other revenue' are forecast to experience only marginal declines.[47] In turn, the bulk of the projected revenue increase for 2021 reflects the anticipated rebound in indirect taxes and the resumed growth in direct taxes.

[46] In 2018 and 2019 a similar pattern was recorded whereby the increase in expenditure was larger than the increase in revenue. However, in these two years, the fiscal balance remained in surplus, albeit lower than in 2017, when the fiscal surplus was at its peak.
[47] Other revenue comprises capital taxes, property income and 'other' revenue.

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

	2019	2020	2021
Total revenue	**5,052.3**	**4,727.5**	**5,201.5**
Taxes on production and imports	1,613.0	1,413.5	1,663.3
Current taxes on income and wealth	1,827.0	1,722.2	1,857.5
Social contributions	800.1	789.5	819.4
Capital taxes*	26.1	19.3	24.4
Property income*	81.8	81.5	82.9
Other revenue*	704.4	701.4	754.0
Total expenditure	**4,988.2**	**5,907.5**	**5,994.0**
Compensation of employees	1,479.5	1,578.9	1,667.7
Intermediate consumption	968.7	1,232.3	1,220.8
Social payments	1,238.0	1,368.6	1,387.6
Gross fixed capital formation	519.3	606.4	676.5
Subsidies	195.0	633.2	405.4
Interest expenditure**	182.9	126.0	157.0
Capital transfers payable**	107.3	50.7	115.3
Other expenditure**	297.6	311.5	363.7
Fiscal balance	**64.1**	**-1,180.0**	**-792.5**
Gross debt	**5,707.2**	**6,895.7**	**7,825.5**
Nominal GDP	13,390.0	12,543.9	13,351.4

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

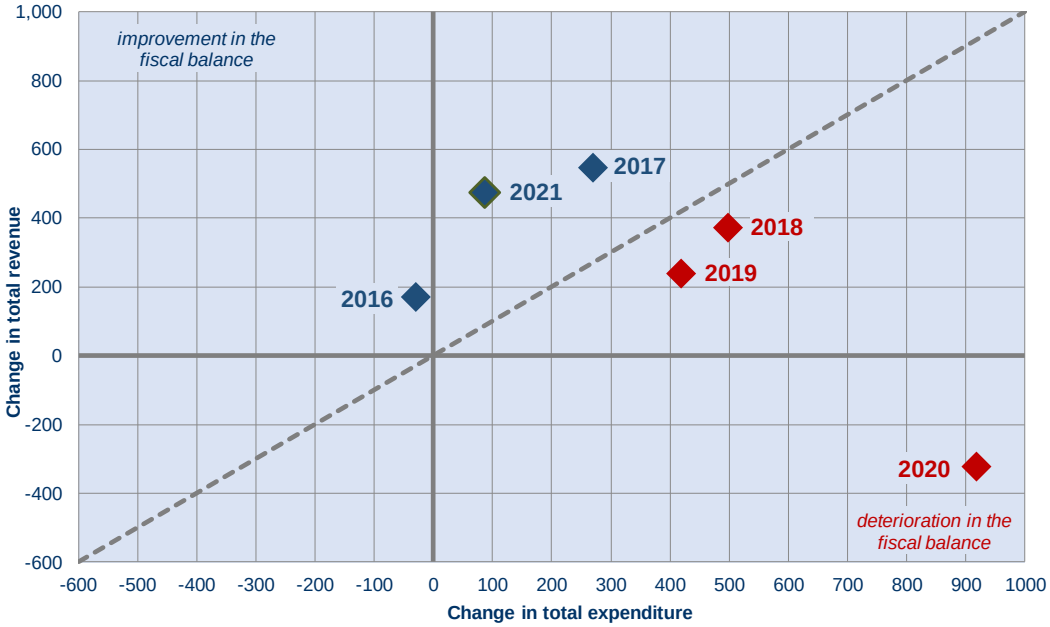
Note: Some figures might not add up due to rounding.

* Considered as ‘other revenue’ elsewhere in this Report.

** Considered as ‘other expenditure’ elsewhere in this Report.

Source: MFIN

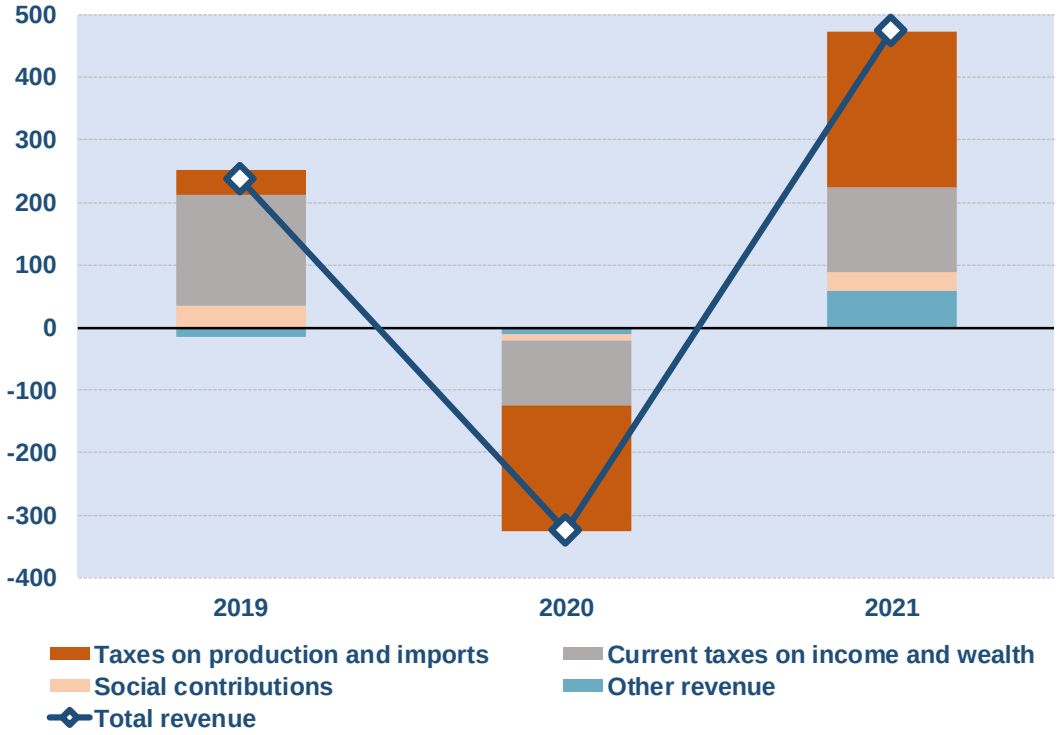
Chart 5.2: Annual changes in total revenue and total expenditure (EUR millions)



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 deterioration in the fiscal balance. Anywhere along the dashed line corresponds to a stable fiscal balance which happens when the absolute changes in revenue and expenditure are equal.

Source: MFIN

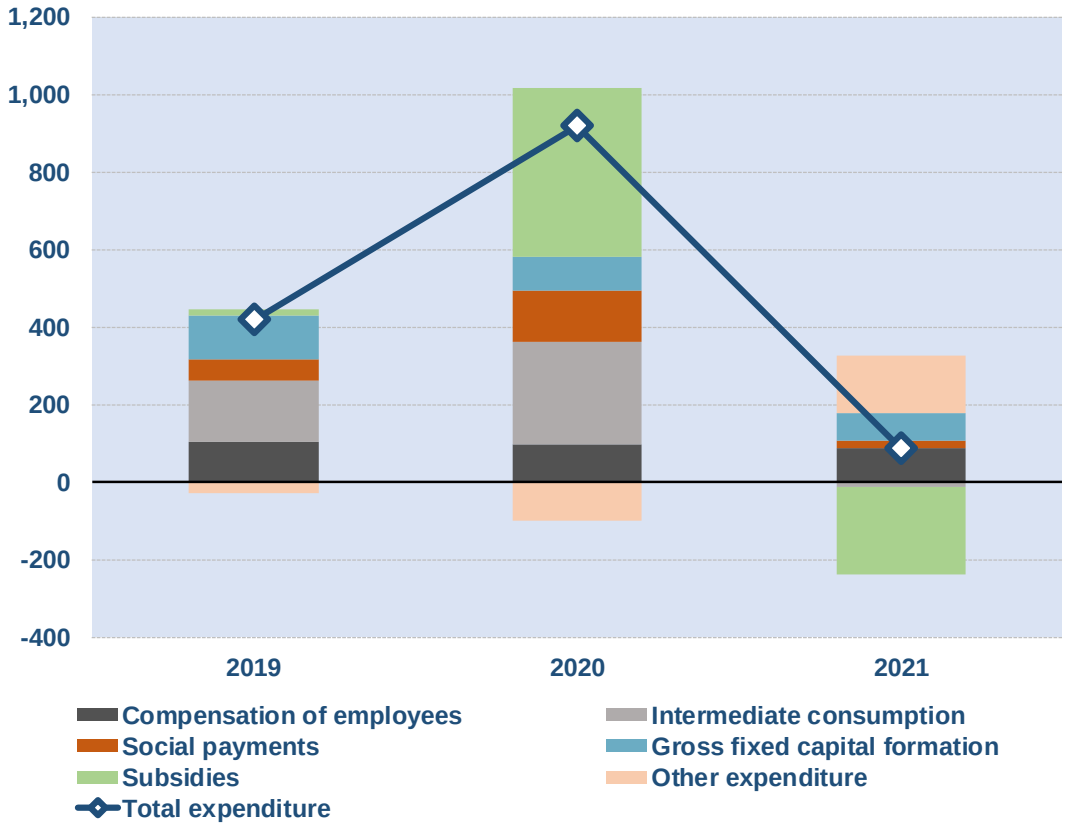
Chart 5.3: Yearly changes in revenue components (EUR millions)



Source: MFIN

The plans for higher expenditure in 2020 are spread across all the main components, except for 'other expenditure' (see Chart 5.4).[48] Additional spending on subsidies and on intermediate consumption are the main drivers of this projected expenditure growth. In the following year, subsidies are expected to be scaled back. This decline is expected to be complemented by a slight drop in intermediate consumption. However, moderate increases in the rest of the components are anticipated to keep total expenditure rising in 2021.

Chart 5.4: 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 then followed by a similar assessment with respect to the various expenditure elements. This contributes to the overall risk outlook vis-à-vis the targets for the fiscal balance and public debt which are stated in the latest DBP.

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

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 macroeconomic scenario as presented in the DBP, and the estimated magnitude of any fiscal measures, or known factors, which are relevant over the forecast horizon. The fiscal projections are sensitive to the assumptions used by MFIN, especially vis-à-vis the possible magnitude of the COVID-19 shock to the various tax bases, and the period over which the fiscal support measures have been budgeted for. Any material departure from these assumptions could deviate the outturn, possibly significantly, from the anticipated revenue and expenditure trajectories for 2020 and 2021.

5.2.1 Taxes on production and imports

Taxes on production and imports are expected to drop by 12.4% in 2020 and rise by 17.7% in 2021 (see Table 5.3). At the end of the forecast horizon the revenue intake from indirect taxes is thus expected to exceed the amount recorded in 2019. The materialisation of this scenario would place the ratio of indirect taxes to nominal GDP at 12.5% in 2021, which is slightly above the average recorded over the five-year period 2015 to 2019 (see Chart 5.5).

Table 5.3: Taxes on production and imports

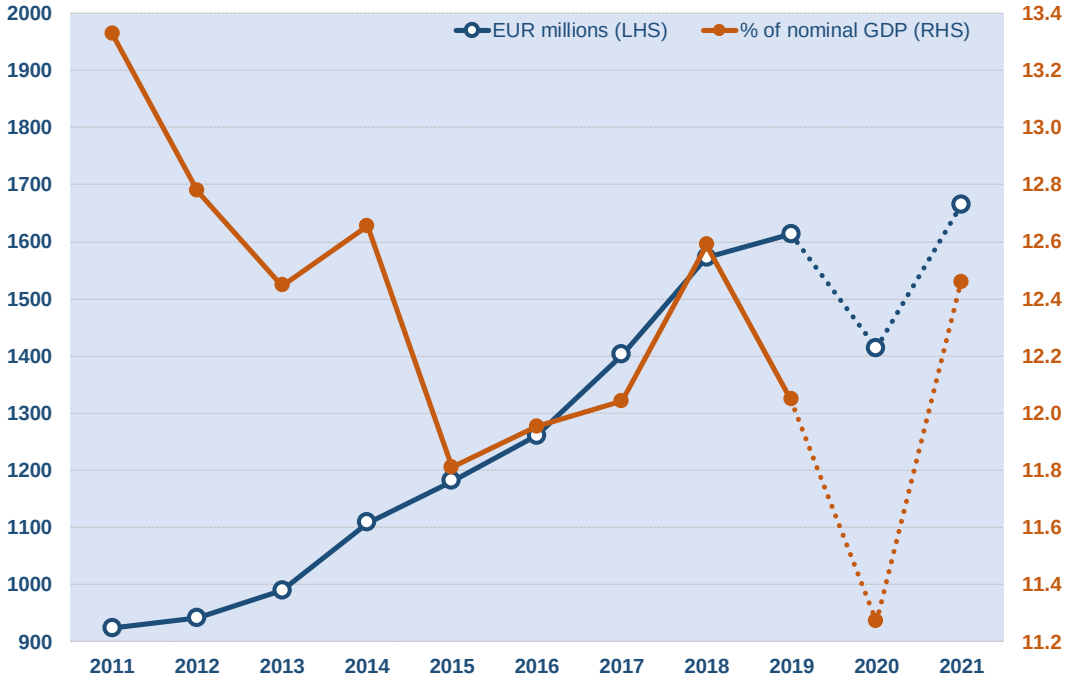
	Taxes on production and imports		Growth in private consumption		Growth in tourism exports
	Growth (%)	Change (EUR millions)	Nominal (%)	Real (%)	Nominal (%)
2018	12.2	171.0	9.4	8.6	3.0
2019	2.6	40.6	7.3	5.2	7.9
2020	-12.4	-199.5	-5.2	-6.0	-82.3
2021	17.7	249.8	5.0	3.7	167.8

Source: MFIN

The anticipated decline in indirect taxes in 2020 is mostly attributable to the forecast contraction in demand. On a net basis, the estimated budgetary cost of temporary indirect tax measures, namely the extension of concessions on property taxes, and a

temporary reduction in fuel taxes, is small, around 0.3% of GDP. In turn, the projected revenue rebound in 2021 predominantly reflects the forecast of a macroeconomic recovery. This is supplemented with additional revenues amounting to 0.2% of GDP because of the assumed phasing out of some property and fuel related temporary tax measures.

Chart 5.5: Taxes on production and imports



Source: MFIN

The projected drop in indirect taxes in 2020 is approximately double the expected contraction in private consumption (both in nominal and in real terms).[49] Similarly, the estimated growth in indirect taxes in 2021 is much stronger than the forecast recovery in nominal and real private consumption. Such weak relationship between indirect taxes and the consumption tax base is the result of the expected large swing in tourism spending, which also forms part of the indirect tax base. Indeed, inbound tourism expenditure is expected to experience a very sharp contraction in 2020 and rise in 2021, thus amplifying the changes in the indirect taxes derived from the tourism related expenditure. Moreover, the baseline factors a decline in average property prices throughout the forecast horizon, thereby exerting a negative effect on the indirect taxes levied on property transactions, both for 2020 and 2021.

[49] 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.

5.2.2 Current taxes on income and wealth

Current taxes on income and wealth are expected to decline by 5.7% in 2020 (see Table 5.4). This drop is predominantly due to the anticipated lower yield from corporate taxes. In fact, compensation of employees, upon which the bulk of personal direct taxes are imposed, are forecast to remain stable on a year earlier.[50] In turn, the forecast growth in direct taxes in the outer forecast year reflects the higher growth in compensation of employees since the outlook for gross operating surplus is negative also for 2021.

Table 5.4: Current taxes on income and wealth

	Growth (%)	Change (EUR millions)	Compensation of employees (%)	Gross operating surplus (%)
2018	5.1	80.6	9.5	5.1
2019	10.7	176.6	8.4	7.3
2020	-5.7	-104.8	0.1	-5.6
2021	7.9	135.3	4.8	-2.2

Source: MFIN

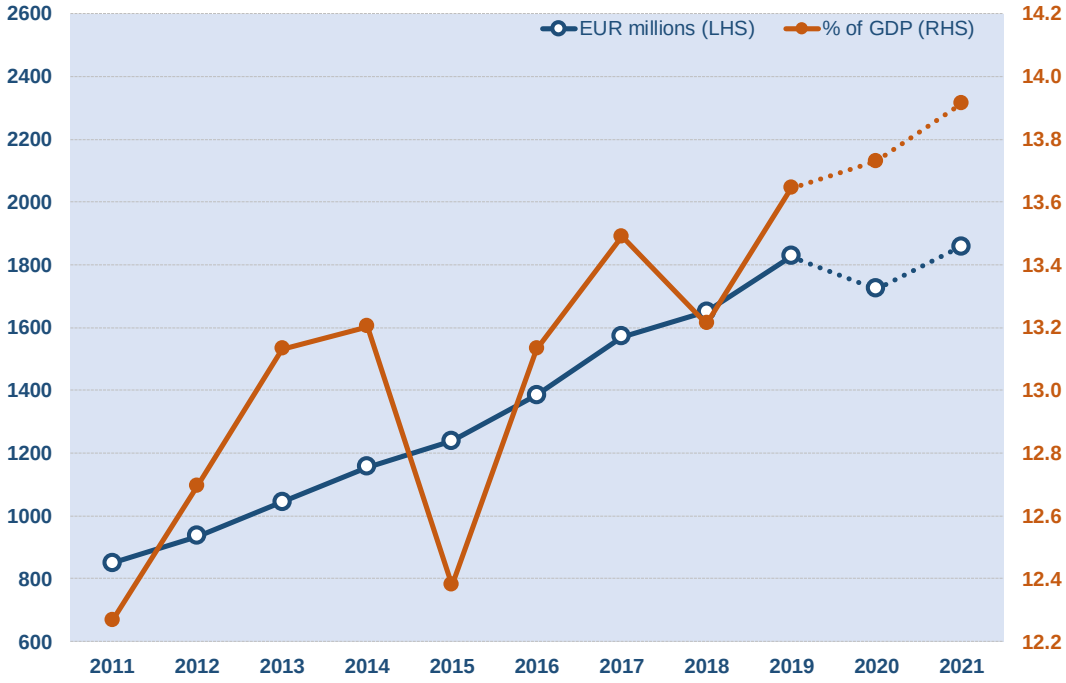
Two consecutive years of expected negative growth in gross operating surplus are likely to depress corporate direct taxes. Under normal circumstances companies pay income tax based on previous years' taxable income. However, when faced with losses, there is the possibility for taxpayers to contest the provisional tax estimates based on the previous years. Accordingly, the baseline assumes that direct taxes react quickly to the adverse shock created by the pandemic, thereby depressing corporate taxes throughout the forecast horizon.

Overall, the ratio of direct taxes to nominal GDP is expected to continue rising throughout the forecast horizon (see Chart 5.6). However, in absolute terms, the DBP anticipates a halt in the prolonged upward rise observed over the years. Changes to direct taxes applicable during the forecast horizon are minimal. On a net basis, these are estimated at 0.2% of GDP. They include the effect of a permanent tax concession on overtime payments, temporary concessions on property transfers, and the

[50] Compensation of employees and gross operating surplus are the two most relevant proxy tax bases for direct taxes. In 2019, personal income tax accounted for 53.7% of direct taxes. Source: NSO News Release 174/2020 available on https://nso.gov.mt/en/News_Releases/Documents/2020/10/News2020_174.pdf.

reimbursement of commercial licenses in 2020. In 2021, the expected revenue shortfall due to higher incentives for private pensions is estimated to be fully compensated for by the assumed non-repetition of the reimbursement of commercial property licenses.

Chart 5.6: Current taxes on income and wealth



Source: MFIN

5.2.3 Social contributions

Social contributions are forecast to drop by only 1.3% in 2020 and rise by 3.8% in 2021 (see Table 5.5). The relative resilience of social contributions is explained by the fact that social contributions were automatically being deducted from the wage support measures which were provided by government.[51]

Table 5.5: Social contributions

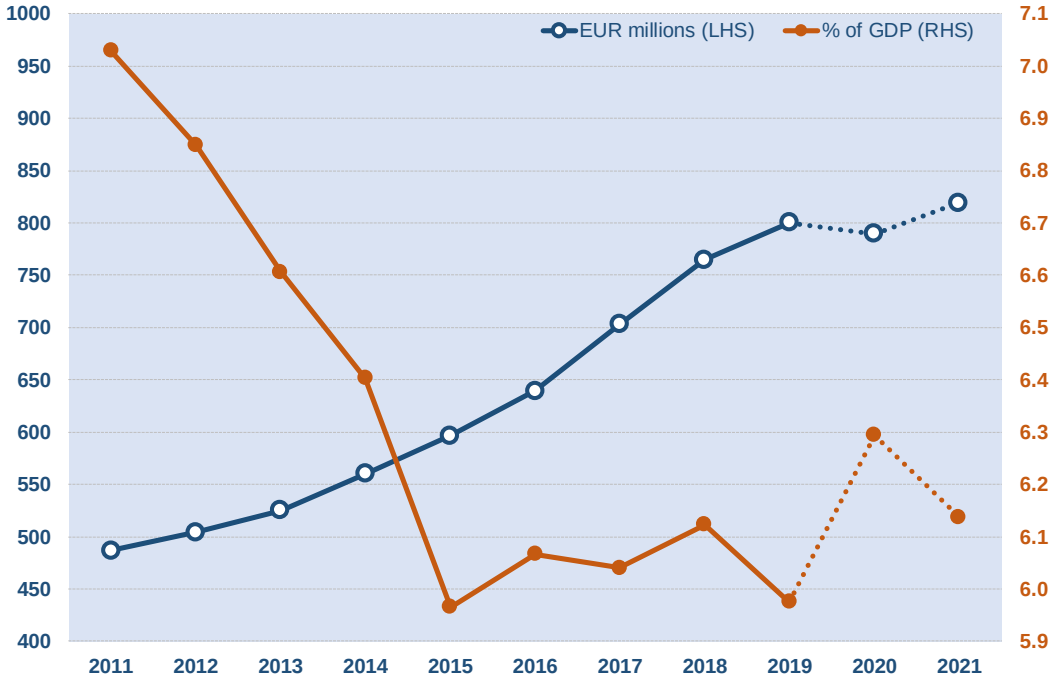
	Growth (%)	Change (EUR millions)	Compensation of employees (%)
2018	8.8	61.9	9.5
2019	4.6	35.3	8.4
2020	-1.3	-10.5	0.1
2021	3.8	29.9	4.8

Source: MFIN

[51] This created an equivalent impact on the revenue and expenditure side of the budget.

Since nominal GDP is expected to decline by more than the estimated drop in social contributions, the ratio of social contributions to GDP is expected to rise to 6.3% in 2020 (see Chart 5.7).[52] Such developments are driven entirely by the developments in the tax base and the statutory increase in the payment ceiling, as no additional policy changes or measures are being factored in the baseline scenario.

Chart 5.7: Social contributions



Source: MFIN

In 2021, growth in social contributions is expected to be less than in total compensation of employees. This reflects the capping system on social contributions whereby any income changes above the ceiling have no effect on the payments due.[53]

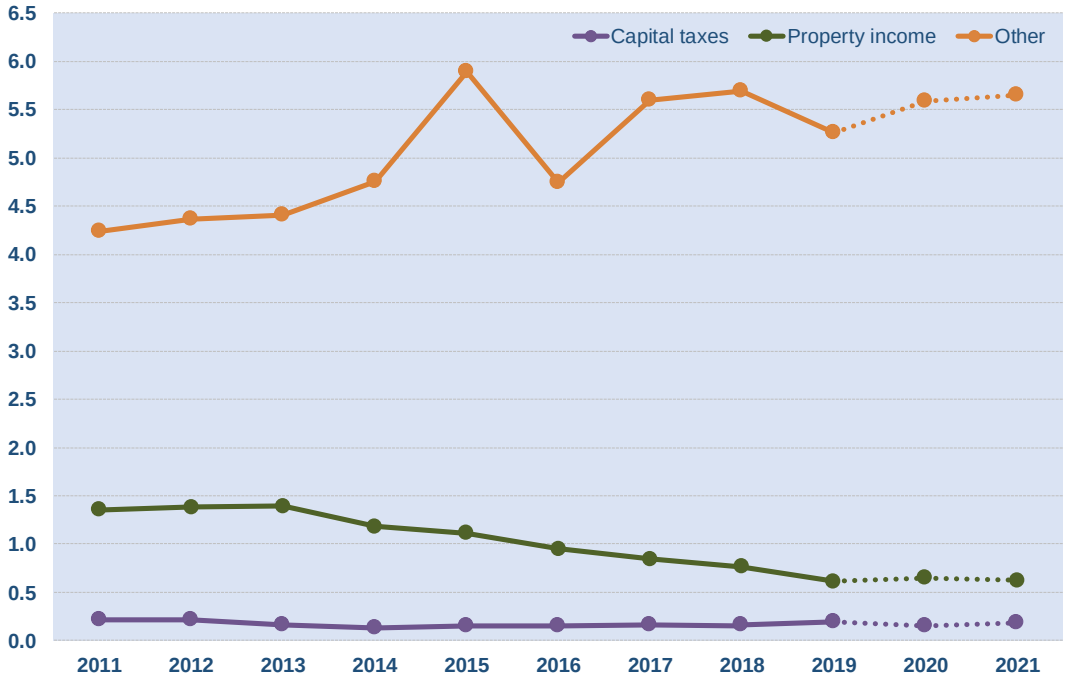
5.2.4 Other revenue components

Taxes on production and imports, current taxes on income and wealth, and social contributions together account for the bulk of total revenue. In 2019, their combined

[52] The forecast drop in nominal GDP is driven by gross operating surplus with compensation of employees being resilient.
[53] 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. Likewise, when incomes remain above the ceiling, any fall in income does not lower the social contributions which need to be paid.

share made up 83.9% of total revenue. Throughout the forecast horizon this share is expected to remain practically unchanged. 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 Individual Investor Programme (IIP) and the new residency programme which replaced it during 2020. The forecast trajectories for the revenue components as percentage of nominal GDP are shown in Chart 5.8.

Chart 5.8: Other revenue components (% of nominal GDP)



Source: MFIN

In 2020, the combined amount from the other revenue sources is set to drop marginally on a year earlier, down by €10.0 million. The estimated impact of lower proceeds from the Maltese residency schemes is practically matched by the expectation of higher utilisation of EU funds. In turn, a planned larger utilisation of EU funds underpins the 2021 forecast increase in total revenue from these miscellaneous sources, which combined are expected to rise by €59.0 million.

Throughout the forecast horizon property income and capital taxes are assumed to fluctuate closely with nominal GDP. The fiscal scenario maintains their ratios to nominal GDP stable and low, respectively at 0.6% and 0.2%. As a result, these items exert a limited influence on the overall fiscal scenario for 2020 and 2021.

5.3 Assessment of the expenditure projections

The forecasts for the different expenditure components are analysed separately. The assessment mainly consists in a review of the projected trajectory for each variable and the estimated magnitude of the fiscal measures or known factors which are relevant over the forecast horizon. The expenditure outlook is very sensitive to the assumption about the scale, scope and duration of the various support measures in place to address the challenges posed by COVID-19.

5.3.1 Compensation of employees

Spending on compensation of employees is projected to grow by 6.7% in 2020 and by 5.6% in 2021 (see Table 5.6 and Chart 5.9). The budget allocation on public sector wages over the forecast horizon is rising more moderately compared to the previous two years, despite COVID-19. Indeed, the latter does not appear to have had any major impact on overall public sector employment strategy, as increases in areas such as health appear to have been neutralised by slower recruitment in other areas.

Table 5.6: Compensation of employees

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2018	8.2	104.6
2019	7.7	105.3
2020	6.7	99.4
2021	5.6	88.9

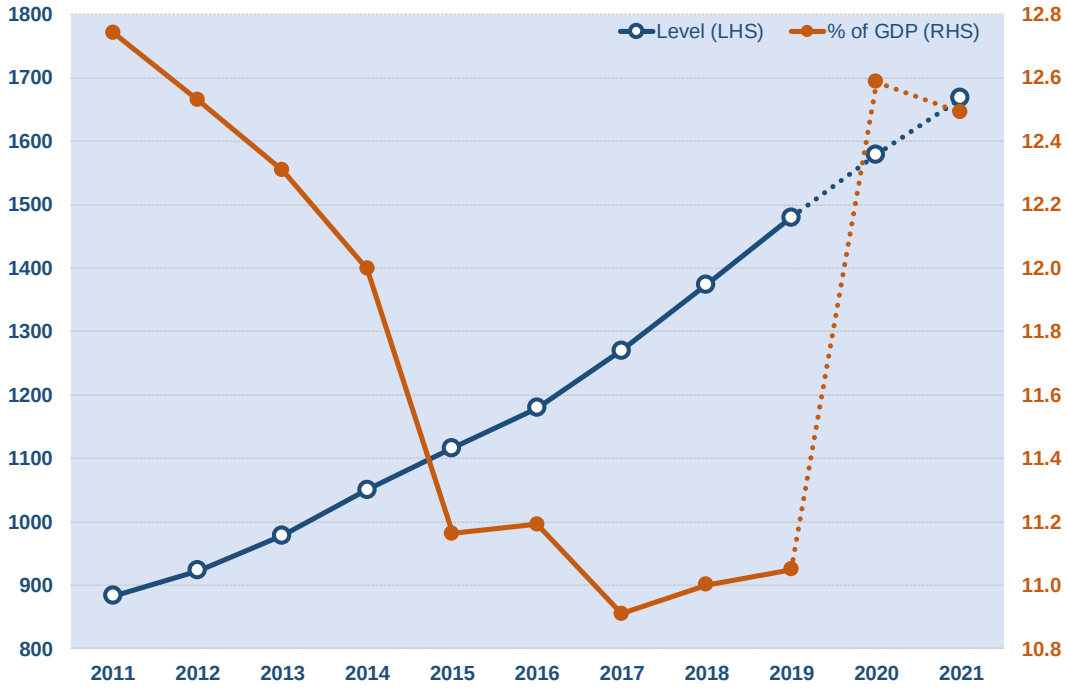
Source: MFIN

Nevertheless, in view of the contraction in nominal GDP, the ratio of compensation of employees to nominal GDP is expected to rise in 2020. In 2021 it is anticipated that this ratio will drop slightly, since compensation of employees is expected to rise by 5.6% whereas nominal GDP is expected to grow by 6.4%. However, the ratio is expected to remain above that recorded in recent years.

The DBP shows that COVID-19 related additional expenditure on compensation of employees amounts to around 0.2% of GDP. This notwithstanding, the budgeted rise in compensation of employees is decelerating in 2020. The average forecast growth in

compensation of employees over the forecast horizon is below the average growth recorded in the five-year period 2015 to 2019. This scenario presumes a slower increase in public sector employment and / or slower growth in the average wage in the public sector.

Chart 5.9: Compensation of employees



Source: MFIN

The public sector wage bill is driven by the number of public sector employees and their average wage. Since employment within 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.

At the same time, it is worth highlighting that public sector employees include not only those in government departments but also all the employees within institutions classified as Extra-Budgetary Units (EBUs).[54] The latter may be covered by separate

[54] Around two-thirds of the employees in the public sector fall under the collective agreement for public service employees. Public sector employment accounts for around one-fifth of total employment.

collective agreements and employment contracts, though they are still expected to follow the government's general guidelines on remuneration.

5.3.2 Intermediate consumption

In 2020 intermediate consumption is expected to rise by €263.6 million or 27.2% (see Table 5.7). This component registered steady growth in recent years, both in absolute terms and as percentage of nominal GDP.

Table 5.7: Intermediate consumption

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2018	12.2	88.3
2019	19.2	155.9
2020	27.2	263.6
2021	-0.9	-11.5

Source: MFIN

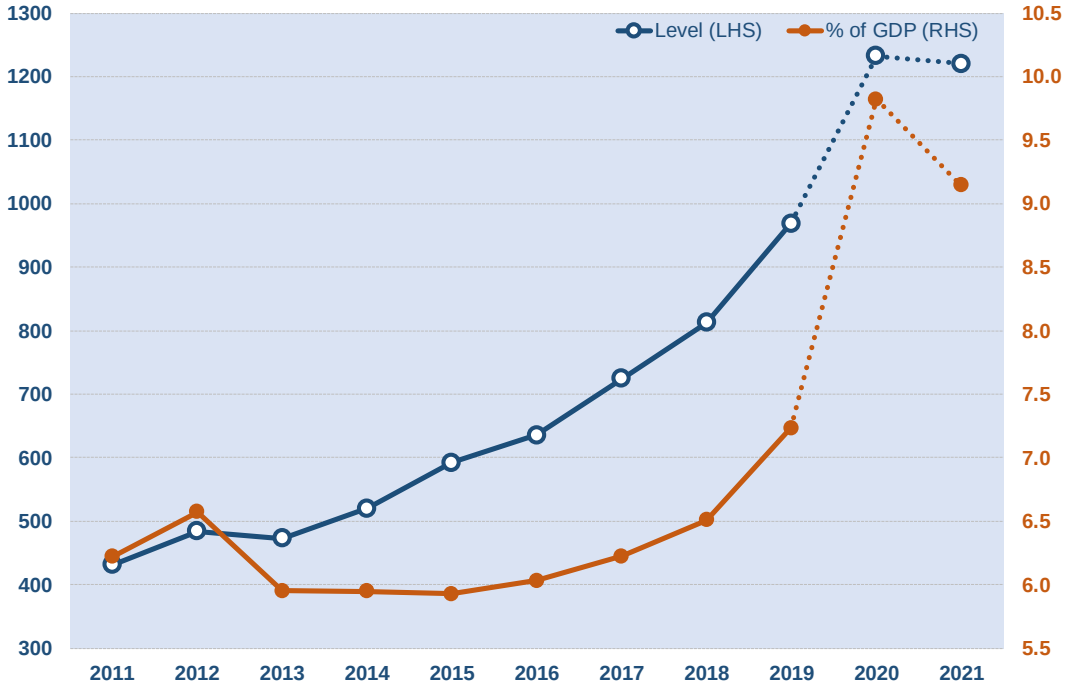
COVID-19 is expected to contribute additional upward pressures in 2020. Indeed, the DBP estimates that €154.2 million additional spending on intermediate consumption will be incurred, the bulk in the form of temporary higher health spending. This strong base effect in turn explains the small planned decline in the outer forecast year.

Intermediate consumption is expected to shoot up to 9.8% of GDP in 2020. In 2021 it is then projected to remain much higher than in previous years (see Chart 5.10). MFIN's baseline assumes that slower growth in certain areas would compensate for the COVID-19 driven higher outlays on intermediate consumption. This may be possible since intermediate consumption has a rather strong discretionary element. However, intermediate consumption is often influenced by special factors. Over time initiatives have tended to be replaced by other expenditure. This pattern effectively makes it more difficult for intermediate consumption to revert to lower levels, unless driven by specific cost savings.

The budgeted amount for intermediate consumption has also to be seen in connection with the other components. Indeed, certain public sector activities can be carried out using alternative strategies, such as through direct employment (which would influence the wage bill) or outsourcing (which would impact intermediate consumption). Hence

there is some leeway in the utilisation of the budgeted amounts, and this could give rise to a mismatch between the forecasts for the individual components and the outturn.

Chart 5.10: Intermediate consumption



Source: MFIN

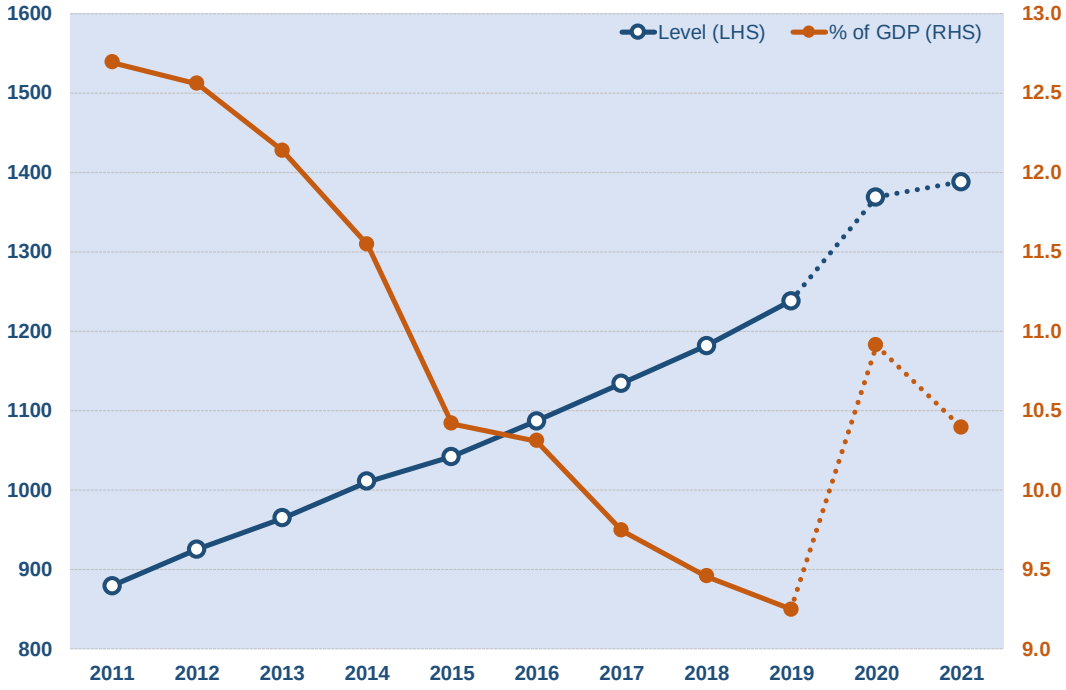
Furthermore, the budgeted expenditure amounts specified in the DBP sometimes act as an envelope on expenditure without the full granular specification, thereby creating instances when certain amounts are initially categorised under one heading (using historic ratios), but ex-post are reallocated to other headings when detailed information becomes available.[55] This aspect is particularly relevant in the case of intermediate consumption. Indeed, some capital expenditure is at times not known in sufficient detail during the preparation of the fiscal projections, and the practice used by MFIN is to classify it as intermediate consumption based on past ratios. Such expenditure is then reclassified in the appropriate headings once the actual projects materialise.[56]

[55] This observation does not apply only to intermediate consumption but to the other expenditure components too.
[56] This approach tends to limit the comparability between actual and forecast data, particularly for intermediate consumption.

5.3.3 Social payments

The downward trend in the ratio of social payments to nominal GDP observed in recent years is expected to be partially reversed in 2020 (see Chart 5.11). Indeed, social payments are expected to rise at more than double the rate recorded in the previous two years. In 2020, the budget for social payments was raised by 10.6%, equivalent to an additional €130.6 million (see Table 5.8).

Chart 5.11: Social payments



Source: MFIN

Table 5.8: Social payments

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2018	4.2	47.3
2019	4.8	57.0
2020	10.6	130.6
2021	1.4	19.0

Source: MFIN

From the planned rise in social payments for 2020, €21.5 million are of a temporary nature, mostly related to COVID-19 mitigating initiatives. Other measures include additional payments to pensioners, a higher budget for in-work benefits, additional transport related concessions and compensation payments. In turn, the base effect

created by the temporary COVID-19 assistance and the limited costs of social initiatives to be launched in 2021 explains the deceleration in the expected outlays on social payments in the outer forecast year.

5.3.4 Gross fixed capital formation

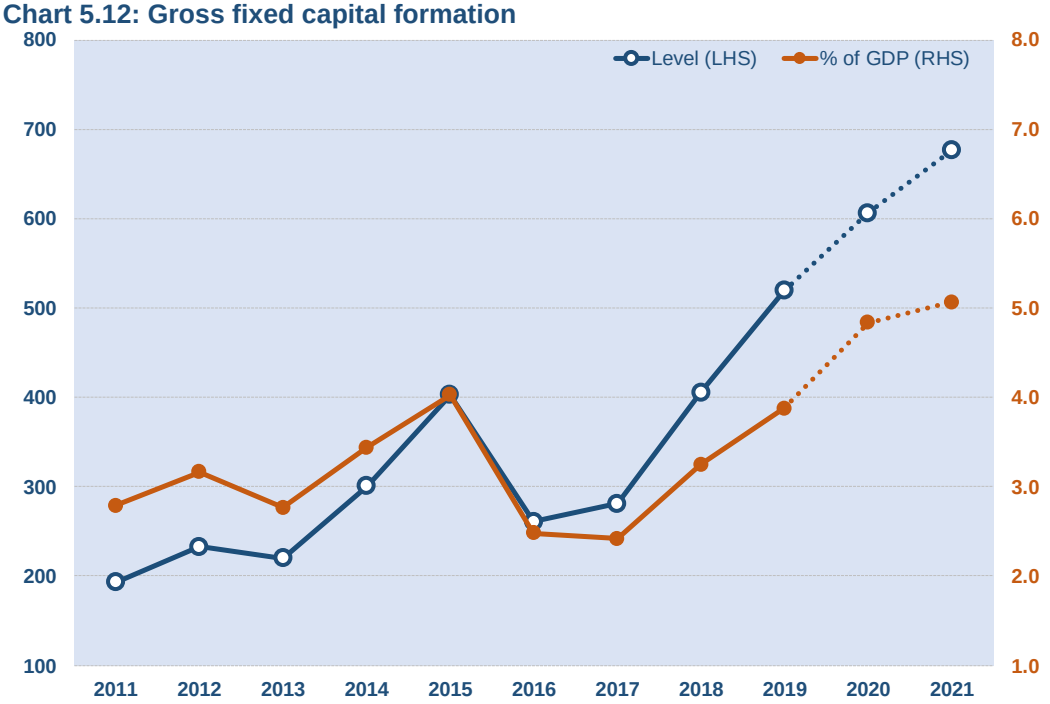
Spending on gross fixed capital formation is planned to maintain strong momentum in 2020, rising by €87.1 million or 16.8% (see Table 5.9 and Chart 5.12). Still, public investment is forecast to grow at a slower pace than in the previous two years, when growth was very high. In turn, the further deceleration in 2021 reflects the fact that in the previous year some €20.0 million represented a base effect created by the additional health-related capital spending as a result of COVID-19.

Table 5.9: Gross fixed capital formation

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2018	44.2	124.3
2019	28.0	113.7
2020	16.8	87.1
2021	11.6	70.1

Source: MFIN

Chart 5.12: Gross fixed capital formation



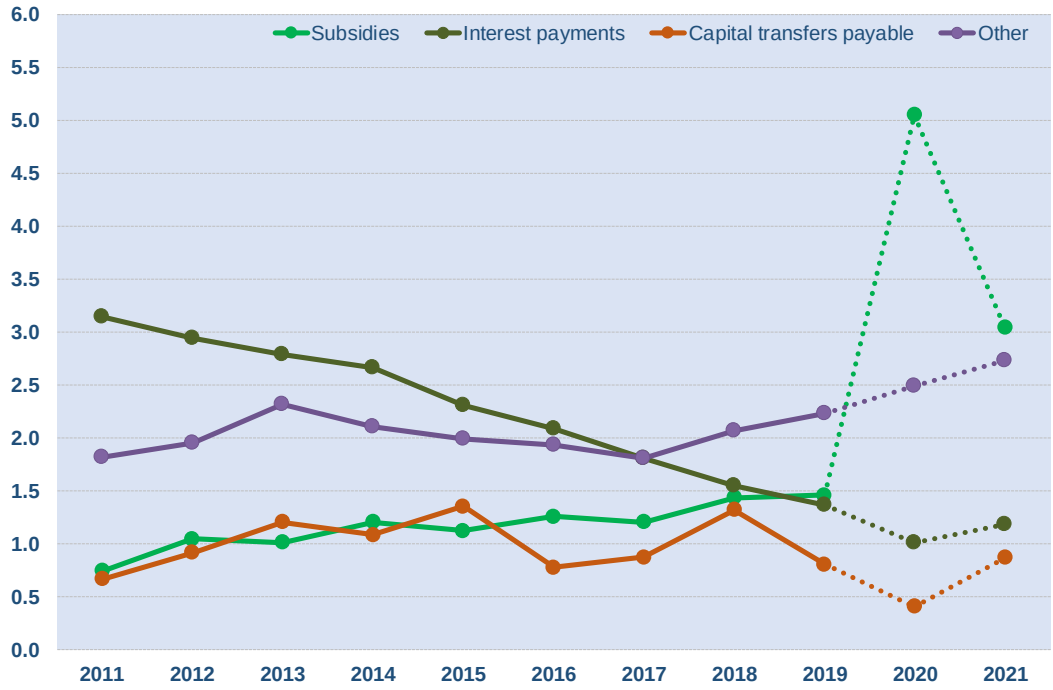
Source: MFIN

Nevertheless, the ratio of public investment to GDP is expected to hover around 5.0% over the forecast horizon. This ratio is higher than in the previous five years when it fluctuated between 2.4% and 4.0% of GDP and compares favourably with the average spending of 3.0% of GDP recorded in the EU in 2019. The planned public capital expenditure over the forecast horizon is mainly related to roads, the environment, health and education. These include infrastructure expenditure financed both from EU funds and local financing. The baseline scenario for capital expenditure does not repeat the very high growth rates which were recorded in previous years.

5.3.5 Subsidies and 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 84.3% of total expenditure in 2019. The remaining components consist of subsidies, interest payments, capital transfers payable and 'other expenditure'. Chart 5.13 shows the forecast profile for these respective categories, expressed as a percentage of nominal GDP.

Chart 5.13: Other expenditure components (% of nominal GDP)



Source: MFIN

Subsidies have been rising marginally faster than GDP over the last decade. However, as at 2019 they still accounted for a small share of public spending, equivalent to 1.5% of GDP, which is in line with the EU average. The support measures implemented by government are expected to contribute to a strong spike in subsidies. These mostly consisted of wage support schemes and other schemes administered by Malta Enterprise to assist those businesses which were impacted by the full or partial lockdown, together with spending vouchers for households.[57] For 2020, €418.6 million was budgeted for these two measures, explaining most of the rise in the total allocation for subsidies for 2020. As a result, subsidies are expected to shoot up to 5.0% of GDP. In turn, the expected phasing out of the wage support measures in early 2021 explains the lower budget on subsidies in the outer forecast year. This effect is partially dampened by the plans for a new round of spending vouchers to be distributed in early 2021. Further amounts have also been budgeted for subsidies on business interest payments in the outer forecast year.

Spending on interest payments is expected to drop for the sixth year running, down by €56.9 million in 2020. However, in 2021 interest payments are forecast to increase by €31.0 million. Overall, interest payments are set to fluctuate at a lower ratio to GDP than in recent years. The projected interest savings in 2020 reflect the further reduction in the implicit interest rate on public debt as it is rolled over at lower rates, and in some cases even at negative rates. In 2020, this very low interest rate environment is expected to more than compensate for the additional costs created by the anticipated rise in the outstanding public debt. However, the strong accumulation of public debt generated in 2020 is expected to create a much stronger upward cost effect in 2021. This explains the budgeted increase in interest payments in the outer forecast year.

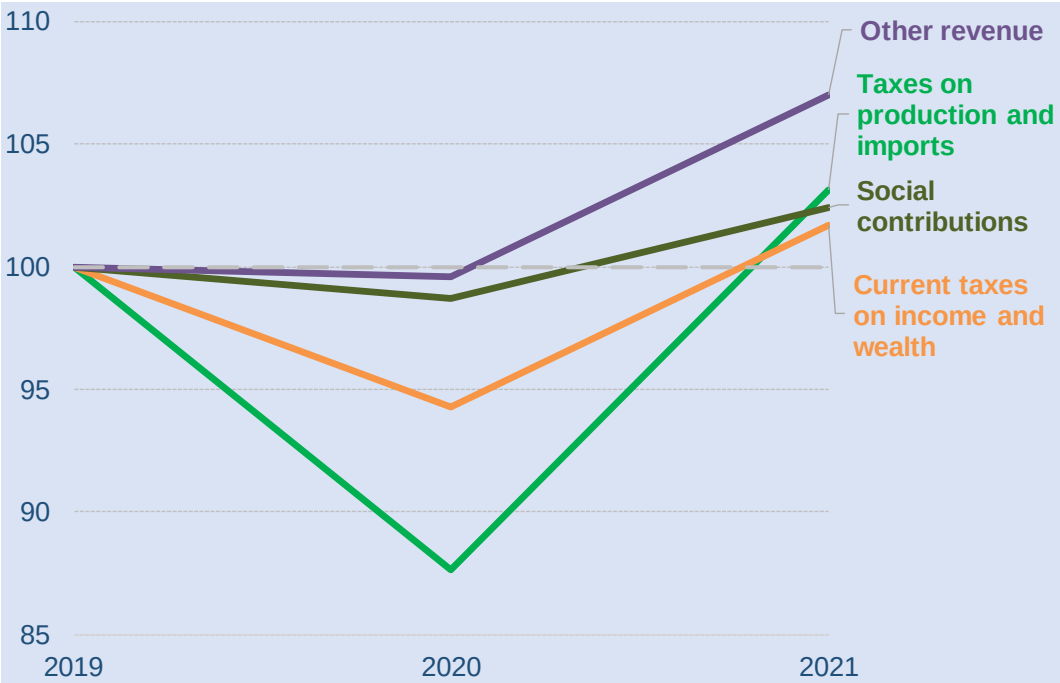
Capital transfers are forecast to remain low, equivalent to 0.4% of GDP in 2020 but rising to 0.9% of GDP in 2021. The budgeted amount for capital transfers is also linked to the assumed utilisation of EU funds over this period.[58] On the other hand, the budget for 'other expenditure' has been raised by €13.9 million for 2020 and a further €52.2 million in 2021, thus lifting the ratio to nominal GDP slightly above its historical pattern.

[57] Other measures, such as state guarantees, have not impacted public finances in financial terms. However, these represent a contingent liability, and would represent a cost in case such guarantees are called in.
[58] Some EU funds are transferred to entities outside general government and are thus considered as capital transfers.

5.4 Fiscal risk outlook

COVID-19 has created a significant impact on public finances as it has affected various revenue streams negatively, while raising public expenditure significantly in a bid to mitigate its adverse health and economic effects. Owing to the highly uncertain duration and severity of the COVID-19 effects, the possible impact on public finances can vary significantly. The MFAC's risk outlook thus focuses on the joint profile pattern for each revenue and expenditure component over the two forecast years, using 2019 as the base year, rather than for each year separately (see Chart 5.14 and Chart 5.15).

Chart 5.14: Revenue components (2019 = 100)



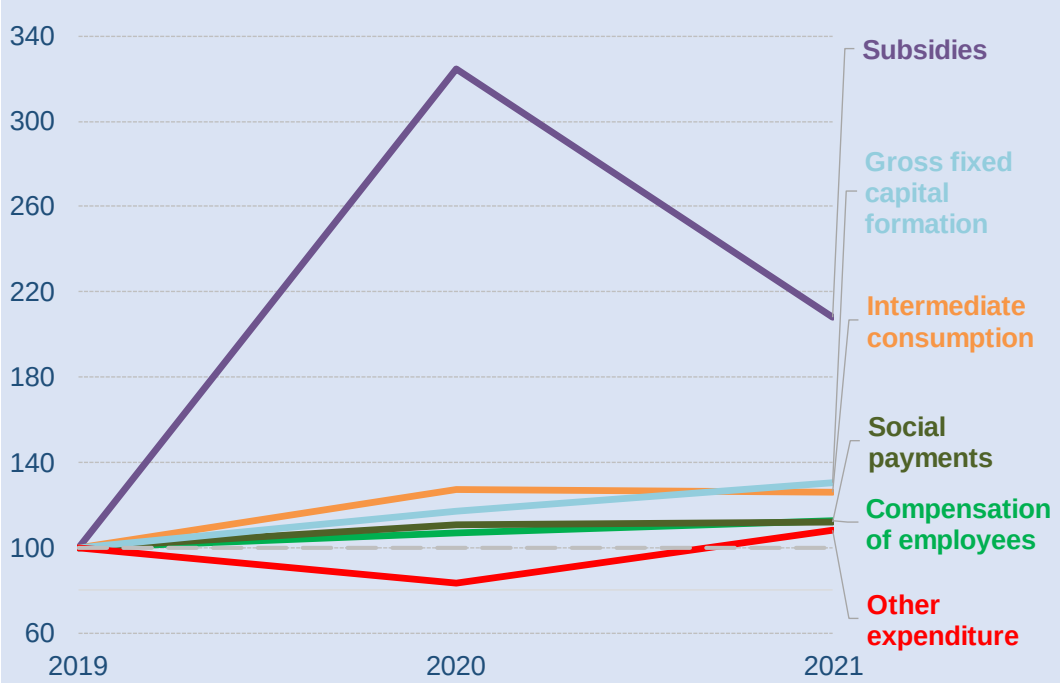
Source: MFIN

The risk assessment for public finances takes the macroeconomic scenario as presented in the DBP as given. The downside risk identified by the MFAC vis-à-vis the profile for real GDP for the period 2020 and 2021 would amplify the downside risks to revenue and the upside risks to expenditure.[59] These risks would worsen the outlook for the fiscal balance and public debt, resulting in a possibly larger fiscal deficit and higher public debt than presented in the DBP.

[59] Refer to Chapter 3 in this Report for further details.

Under the baseline scenario, there is a broad-based decline across all major revenue categories in 2020, followed by a recovery to above pre-pandemic levels in 2021. However, the magnitude of the revenue shock varies. It is expected that in 2020 the largest impact in percentage terms would be on taxes on production and imports, whereas current taxes on income and wealth could be the second worst hit. On the other hand, the drop in social contributions and other revenue in 2020 is contained. This pattern builds critically on the resilience of the labour market and the amount of EU funds expected to be utilised.

Chart 5.15: Expenditure components (2019 = 100)



Source: MFIN

On the expenditure front, the most significant development relates to the surge in subsidies in 2020, followed by a partial scaling back in 2021. Nevertheless, this would still leave this expenditure component significantly above pre-pandemic levels. On the other hand, the rest of the expenditure components are expected to have a more stable pattern, with most growing in 2020 and rising further in 2021.

Overall, the MFAC considers that there could be downside risks to the total revenue profile indicated in the DBP (see Table 5.10). These mainly relate to the fact that the intake from current taxes on income and wealth could be lower than expected. The losses suffered by business could exert a stronger downward effect than accounted for. At the same time, the net tax payments made by companies with limited links to

the Maltese economy, could suffer a downturn which is larger than expected. Another downside risk relates to 'other revenue' should the revenues collected through the new residency scheme be more gradual than targeted, particularly in view of operational difficulties created by COVID-19 travel protocols.

Table 5.10: Summary of risks to the fiscal balance

	2020 – 2021
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	⇔
Subsidies	⇑
Other expenditure	⇑
BALANCE	⇓

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

Source: MFAC

On the expenditure front, upside risks appear pertinent in the case of compensation of employees and intermediate consumption. The budgeted amounts over the two-years appear somewhat tight in the light of the additional COVID-19 related outlays. Wage readjustments or the need for further COVID-19 induced overtime or employment could lead to expenditure overruns in these areas.

There is also an upside risk vis-à-vis subsidies in the eventuality that some support measures may be needed beyond the first quarter of 2021. Another relevant risk relates to the request by the Maltese government for additional state aid for the national airline, as a result of the sharp decline in the travel market. The eventuality of such aid is not specifically budgeted for in the DBP. Likewise, the DBP does not account for the possibility that loans backed up by state guarantees would require further state assistance to make up for possible repayment problems.

On the other hand, the rather elevated budget allocations for social payments and gross fixed capital formation suggest a neutral risk outlook in relation to these components over the forecast horizon.

The assessment carried out on the individual revenue and expenditure components suggests an overall downside risk outlook vis-à-vis the fiscal balance for the period 2020 and 2021.[60] This reflects the joint impact of a downside risk on the revenue side and an upside risk on the expenditure side of the budget.

However, the size of downside risk to the fiscal balance (i.e. the possibility that the fiscal deficit turns out larger than targeted) is deemed to be small in view of the fact that other reputable institutions producing fiscal forecasts, and which have factored in the impact of COVID-19 have produced a range of fiscal scenarios which are broadly similar and in cases less adverse than that presented by MFIN.[61]

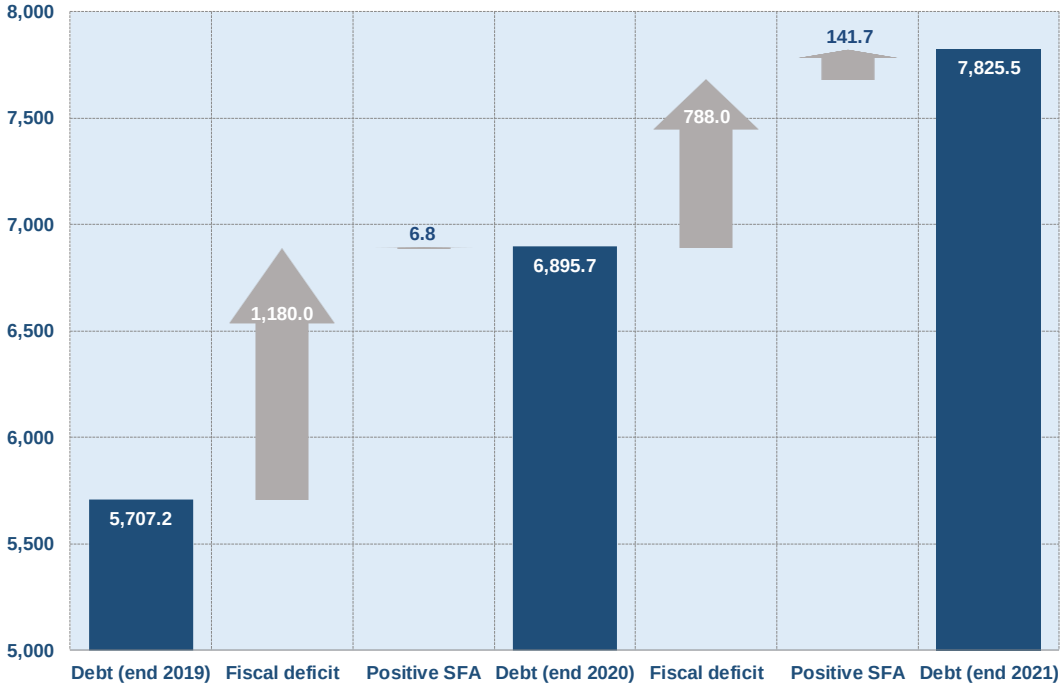
5.5 Assessment of the public debt projections

In 2020 the outstanding level of public debt is expected to rise by €1,188.5 million, from €5,707.2 million to €6,895.7 million (see Chart 5.16). This increase reflects almost entirely the financing of the projected fiscal deficit for 2020, which amounts to €1,180.0 million. Indeed, the estimated net upside impact of Stock-Flow Adjustments (SFA) is marginal, contributing merely €6.8 million (equivalent to less than 0.1% of GDP) to the projected increase in public debt in 2020 (see Table 5.11).[62] Although certain

[60] A downside risk to the fiscal balance means that the fiscal deficit could be worse than targeted.
[61] Refer to Chapter 6 in this Report for the comparison with respect to the fiscal forecasts produced by the other institutions.
[62] Stock-flow adjustment are termed ‘positive’ when they raise the stock of debt and ‘negative’ when they lower the stock of debt.

adjustments are large, some are exerting an upside push and others a downside push thereby offsetting each other.

Chart 5.16: Drivers of public debt (EUR millions)



Source: MFIN

Table 5.11: Stock-flow adjustments (EUR millions)

	2020	2021
ESA adjustment	40.8	-36.9
ESA re-routed debt	32.2	60.1
Changes in Sinking Fund balances and MGS holdings	50.1	30.1
Equity acquisitions	37.1	10.5
Euro currency issue	6.5	7.0
Other adjustments	2.7	1.5
Total consolidation	-162.6	69.4
Total stock-flow adjustment	**6.8**	**141.7**

Source: MFIN

In 2021 public debt is expected to increase again significantly, by a further €929.7 million, to reach €7,825.5 million. The upside effect of a much larger positive SFA (estimated at €141.7 million or 1.1% of GDP), is partially dampened by the planned smaller deficit when compared to 2020. The magnitude of individual SFA adjustments is again large in 2021, but in this year, they are being offset to a lower degree than in 2020.

The prolonged decline in the public-debt to GDP ratio, which fell from 69.3% in 2011 to 42.6% by 2019, is thus expected to be partially reversed due to the impact of COVID-19 (see Chart 5.1). Indeed, the debt ratio is expected to shoot up to 55.0% in 2020 and rise further, to 58.6%, in 2021. The anticipated 6.3% contraction in nominal GDP in 2020 magnifies the upside impact on the debt ratio in that year, while the 6.4% forecast nominal GDP growth in 2021 moderates the projected rise in the debt ratio in the outer forecast year.[63]

The major factor which is limiting the overall rise in public debt in 2020 relates to the development whereby financial assets held by public sector entities were during the year converted into holdings of Malta Government Stock (MGS). This is the main explanation provided by MFIN for the significant negative value labelled as total consolidation (-€162.6 million).[64] This strategy appears rational when considering the negative interest rates charged by banks on certain large corporate account balances. Indeed, Government securities were viewed to be a better investment compared to other financial assets.

On the other hand, the other adjustments for 2020 all contribute to higher public debt. The larger amounts contributing to the stock flow adjustment relate to the MGS sinking funds, equity acquisitions and re-routed debt.[65,66]

ESA adjustments were estimated at €40.8 million, despite the significant concessions to delay tax payments by certain categories.[67] This presumes that the taxpayers who

[63] Nominal GDP acts as the denominator for the public debt ratio. Hence, a decline in nominal GDP pushes up the ratio, while a rise in nominal GDP lowers the ratio.
[64] Purchases of MGS by entities within general government is tantamount to debt buy-backs.
[65] Sinking fund balances include designated funds for repayment of public debt at maturity.
[66] ESA re-routed debt includes financial assistance from the European Financial Stability Facility (EFSF). Since the EFSF is acting on behalf of Malta (the guarantor), the lending is rerouted through the government accounts, thus increasing national gross debt.
[67] ESA adjustments reflect the concession to defer certain tax payments to a later stage. Indeed, according to the ESA methodology these would still be imputed with revenues, even

benefited from the tax deferral concessions start settling their balances as from 2020. As a result, the end of year accrual adjustment indicated by MFIN in the DBP is much lower than the overall volume of tax deferrals granted in the beginning of the year. This view is supported by the good progress in payments in September and October which was detected by MFIN in the Consolidated Fund cash data. This was also corroborated by other information by the tax authorities that suggest the settlement of certain outstanding balances by enterprises.

In 2021 the ESA adjustment is mostly reversed, contributing to a downside impact on public debt. This adjustment reflects the fact that the delayed payments relating to 2020 are expected to be fully settled in 2021. This would result in higher cash receipts than measured on an accruals basis for the year.

On the other hand, the other adjustments for 2021 all contribute to higher debt. These are all instances when the inflow of funds into the budget is not being corresponded into less funding requirements by the government. This can take place when an entity included within general government receives money which in ESA terms is included as part of government revenue, but where such funds are not being transferred into the Consolidated Fund. This applies for part of the funds received from the residency schemes.

The profile for public debt, characterised by a surge in 2020 and a further increase in 2021 is consistent with the macroeconomic and fiscal scenario, and the estimates for SFA which are specified in the DBP. However, the MFAC considers there are upside risks to the profile for the debt ratio over the period 2020 to 2021. Such upside risks reflect various factors. The overall downside risk vis-à-vis the real GDP profile identified in Chapter 3, leads to a corresponding downside risk for nominal GDP which acts as the denominator in the debt ratio. Another upside risk for the debt ratio is due to the possibility that the fiscal deficits in 2020 and 2021 turn out larger than indicated in the DBP, as suggested by the MFAC's risk assessment in relation to the fiscal balance targets. Another upside risk relates to the possibility that SFA could be larger than expected.

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though the funds would not yet have been collected. In turn, this would contribute to a significant difference between cash and accrual recording of transactions.

Chapter 6
Comparison across different fiscal forecasts

6.1 Introduction

The plausibility of MFIN's fiscal projections can be evaluated by examining the similarity or otherwise with respect to the forecasts produced by the COM, CBM, IMF, Fitch, Moody's and S&P. This is the same approach adopted for the assessment of the macroeconomic forecasts presented in Chapter 4. The caveat remains that even the fiscal forecasts are not necessarily based on the same information sets. The critical assumptions related to the duration and severity of the pandemic may also differ. Nonetheless, the MFAC considers such comparisons as a valid benchmark to support the qualitative assessment in relation to the fiscal projections which was carried out in Chapter 5. The fiscal outlook presented in the DBP is also compared to that in the USP in order to trace the budget components which are contributing to a larger fiscal deficit and higher public debt than originally planned.

6.2 Fiscal balance

All institutions anticipate a similar trajectory for Malta's public finances, characterised by a large fiscal deficit in 2020, followed by a smaller fiscal deficit in 2021 (see Table 6.1). The latest forecast round by every institution shows a worse fiscal balance in each of the two forecast years, when compared to the previous vintage by the same institution.[68] These forecasts are thus consistent with the more negative view presented by MFIN in the DBP when compared to the USP. Indeed, the stream of fiscal deficits projected by MFIN in the DBP, equivalent to 9.4% of GDP in 2020 and 5.9% of GDP in 2021 are within the latest range of estimates produced by the other institutions.

The different estimates for the fiscal balance in 2020 lie within a narrow range of 1.7 pp. The CBM is forecasting the smallest deficit equivalent to 8.6% of GDP, while Moody's is anticipating the highest deficit, equivalent to 10.3% of GDP. For 2021, the

[68] The revision by S&P between the forecast rounds is the largest. This can be ascribed to the fact that the earlier round by S&P was produced at a time when the global pandemic was at the initial stages and in fact S&P was still anticipating a fiscal surplus for Malta in 2020.

estimates are spread over a wider range. This is justified by the fact that the degree of uncertainty normally rises along the forecast horizon. Moody's estimates show the more benign scenario with a deficit forecast of 3.0% of GDP. At the other end of the spectrum, the COM shows the highest expected deficit, amounting to 6.3% of GDP.

Table 6.1: Fiscal balance estimates by institution (% of GDP)

	Issued in	2020	2021
MFIN	April	-7.5	-3.6
MFIN	October	-9.4	-5.9
Revision		**-1.9**	**-2.3**
COM	May	-6.7	-2.5
COM	November	-9.4	-6.3
Revision		**-2.7**	**-3.8**
CBM	June	-6.8	-3.0
CBM	August	-8.6	-3.5
Revision		**-1.8**	**-0.5**
IMF	April	-7.2	-0.4
IMF	October	-9.4	-3.9
Revision		**-2.2**	**-3.5**
FITCH	April	-8.2	-5.0
FITCH	July	-9.2	-6.1
Revision		**-1.0**	**-1.1**
Moody's	April	-5.0	-1.0
Moody's	August	-10.3	-3.0
Revision		**-5.3**	**-2.0**
S&P	March	0.5	0.7
S&P	September	-8.7	-4.5
Revision		**-9.2**	**-5.2**

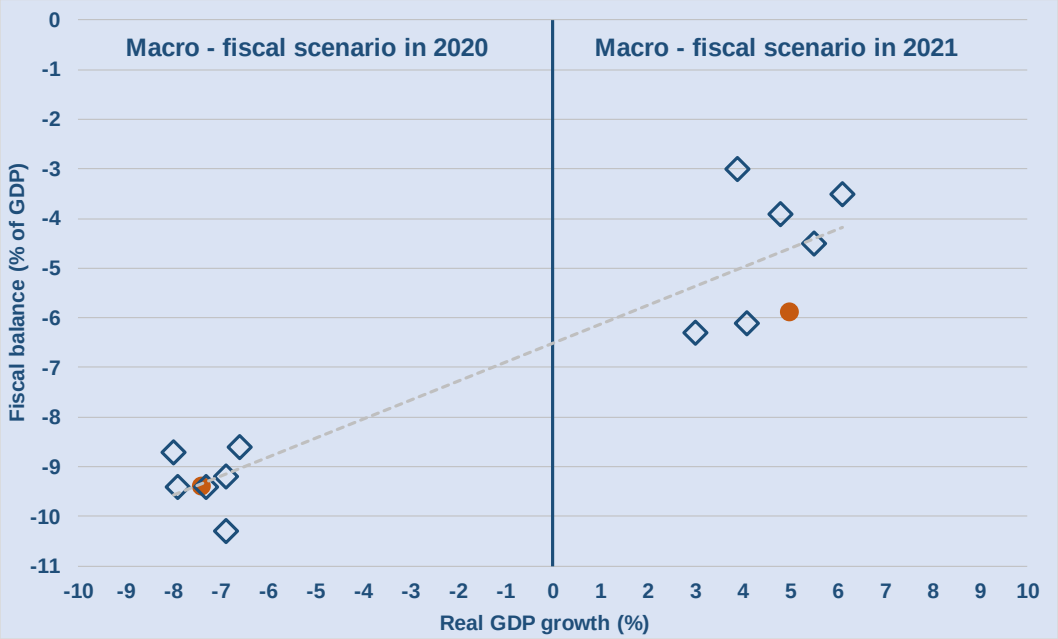
Source: MFIN, COM, CBM, IMF, FITCH, Moody's, S&P

The fiscal scenarios produced by the various institutions are consistent with their respective macroeconomic outlook as presented in Chapter 4.[69] Indeed there is a clear

[69] For example, the forecasts for 2020 by the CBM are the more benign from those available, both with respect to the macroeconomic and the fiscal forecasts.

pattern whereby 2020 is characterised by a large negative shock to real GDP, and consequent large fiscal deficit, while in 2021 the expected economic recovery is accompanied by a partial correction in the fiscal imbalance (see Chart 6.1).

Chart 6.1: Macroeconomic and fiscal forecasts



Note: The orange circles indicate the forecasts for real GDP and the fiscal balance-to-GDP produced by MFIN for 2020 and 2021. The diamond markers indicate the corresponding forecasts produced by the other institutions mentioned in the Report. The dashed line shows the best fit among the data points, highlighting the positive relationship between the improving outlook for the economy and public finances for 2021 compared to 2020.
Source: MFIN, COM, CBM, IMF, FITCH, Moody's, S&P

The DBP revised the deficit target for 2020 by €228.1 million, from €951.9 million to €1,180.0 million (see Table 6.2). For 2021, the revision was larger, amounting to €306.9 million. The updated target for the fiscal deficit in the outer forecast year was changed from €485.6 million to €792.5 million. This suggests a changed strategy towards a more gradual path towards fiscal consolidation than originally planned, in response to an economic shock whose impact could be more severe than previous thought i.e. when the USP was produced.

The more negative outlook for the fiscal balance in 2020 reflects a €269.6 million downward revision in the expected revenue compared to what was indicated in the USP, which is partially compensated for by a €41.6 million reduction in the planned expenditure. MFIN carried out a generalised reduction in the expected yields from the various revenue sources. In absolute terms, the largest revision was in 'other revenue' which was lowered by €106.4 million. In turn, the expected yield from current taxes on

income and wealth was reduced by €97.8 million. Taxes on production and imports was also lowered by €57.6 million. However, in the case of social contributions, the downward revision compared to the USP was limited to only €7.8 million, consistent with the scenario of a resilient labour market.

Table 6.2: Fiscal forecasts by MFIN, COM and CBM (EUR millions)

	2020				2021			
	MFIN USP	MFIN DBP	COM AUT	CBM AUG	MFIN USP	MFIN DBP	COM AUT	CBM AUG
Total Revenue	**4,997.1**	**4,727.5**	**4,750.0**	**4,772.9**	**5,237.9**	**5,201.5**	**5,169.0**	**5,133.2**
Taxes on production & imports	1,471.0	**1,413.5**	1,399.0	1,373.0	1,592.1	**1,663.3**	1,673.0	1,571.4
Current taxes on income & wealth	1,820.0	**1,722.2**	1,748.0	1,719.4	1,928.6	**1,857.5**	1,823.0	1,809.0
Social contributions	797.4	**789.5**	802.0	779.1	828.4	**819.4**	824.0	812.2
Other *	908.7	**802.3**	801.0	901.4	888.8	**861.3**	849.0	940.6
Total expenditure	**5,949.0**	**5,907.5**	**5,929.0**	**5,849.5**	**5,723.6**	**5,994.0**	**5,985.0**	**5,611.8**
Compensation of employees	1,584.6	**1,578.9**	1,582.0	1,569.3	1,619.3	**1,667.7**	1,672.0	1,678.9
Intermediate consumption	1,212.8	**1,232.3**	1,225.0	1,163.3	1,220.8	**1,220.8**	1,220.0	1,181.6
Social payments	1,378.0	**1,368.6**	1,377.0	1,407.4	1,386.8	**1,387.6**	1,391.0	1,405.0
Gross fixed capital formation	672.2	**606.4**	608.0	549.7	664.5	**676.5**	671.0	568.8
Subsidies	499.6	**633.2**	636.0	633.1	203.7	**405.4**	404.0	198.1
Other **	601.8	**488.1**	501.0	526.7	628.5	**636.0**	627.0	579.4
Fiscal balance	**-951.9**	**-1,180.0**	**-1,179.0**	**-1,076.6**	**-485.6**	**-792.5**	**-817.0**	**-478.7**
Gross debt	**6,939.7**	**6,895.7**	**6,893.0**	**7,034.6**	**7,484.8**	**7,823.7**	**7,829.0**	**7,562.6**

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

On the expenditure side, the bulk of the reduction was in the 'other expenditure' category, which was cut by €113.7 million. The planned spending on gross fixed capital formation was also lowered by €65.8 million. The downward revisions to social payments and compensation of employees were smaller in absolute terms, respectively €9.4 million and €5.7 million. These reductions were mostly offset by a €133.6 million increase in the budget for subsidies and a €19.5 million rise in the budget for intermediate consumption. The changed budget allocations reflected some expenditure re-prioritisation and the need for higher spending to mitigate the adverse economic and health effects created by COVID-19.[70]

In the latest forecast round, the total revenue estimates for 2020 by MFIN, COM and CBM are very similar. Even the estimates for the individual components are close, with some relatively minor differences. It can be observed that the DBP is more optimistic vis-à-vis the expected yield from indirect taxes, as corroborated by the actual developments by the cut-off date. Another observation is that the CBM's forecasts for the various tax sources are the more conservative among the three institutions. This factor is however broadly compensated by the more optimistic view in relation to 'other revenue' indicated in the CBM's forecasts.

In relation to 2021, the total revenue forecast by MFIN is slightly higher than what the COM and CBM are anticipating. The estimate for direct taxes by MFIN is higher than indicated in the forecasts prepared by the COM and CBM. On the other hand, there is consensus with respect to the forecasts for social contributions. Discrepancies exist in relation to 'other revenue'. These reflect similar discrepancies in the outlook for 'other expenditure' and can be mostly attributed to different timing and inflows of EU funds. Nonetheless this factor should exert a neutral impact on the overall balance, in view of similar outlays on both sides of the budget.

On the expenditure front, the estimates for 2020 and 2021 by MFIN and the COM are very similar while those by the CBM are lower. Certain differences can be explained by the fact that when the CBM's forecasts were produced, some measures were not yet announced. At an expenditure component level, the divergence which stands out relates to the sharp fall in subsidies in 2021 indicated in the CBM's forecasts. However, this is fully explained by the extension of the support measures which was announced

[70] Possible different categorisations used across the forecast rounds can also lead to changes in the budgets for certain components.

after the preparation of such forecasts. Otherwise, the expenditure items are close to each other across the two forecast years.

6.3 Public debt

Notwithstanding in 2020 MFIN expect a larger fiscal deficit, the official debt target for the year was revised down by €45.7 million, to €6,894.0 million. This follows a downward re-calculation of the impact of SFA for the year. The debt level indicated in the DBP is practically identical to that produced by the COM. On the other hand, the debt estimates by the CBM are higher. This is exclusively due to different assumptions about the impact of SFA since the fiscal deficit indicated in the CBM's forecast is lower than shown in the DBP.

On the contrary, MFIN revised the debt target for 2021 upwards by €338.9 million, mirroring the funding of the higher fiscal deficit for the year. Even in this case, the debt figure by the COM is very much in line with that presented in the DBP. The 2021 debt forecast by the CBM is lower than indicated by either MFIN or the COM, mainly in view of the lower fiscal deficit forecast for the year. This factor contributes to a slower build-up in debt, fully compensating for the fact that the CBM's debt forecast at the end of 2020 is higher.

MFIN's forecast trajectory for the public debt ratio fits within the range of available estimates for both forecast years (see Table 6.3). The view that the previous years' declines in the debt ratio will be partially reversed over the period 2020 to 2021 is shared by all institutions, including credit rating agencies. All institutions raised their forecasts for the debt-to-GDP ratio for 2020 compared to their respective previous vintage.[71] For 2021 there is also consensus that a further rise in the debt-to-GDP ratio is anticipated, with the exception of the CBM, which anticipates an earlier debt stabilisation.[72]

[71] 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.
[72] The forecasts by the CBM were published in August 2020, while the other sets of forecasts were mostly published afterwards.

Table 6.3: Public debt estimates by institution (% of GDP)

	Issued in	2020	2021
MFIN	April	54.5	55.5
MFIN	October	55.0	58.6
Revision		**0.5**	**3.1**
COM	May	50.7	50.8
COM	November	55.2	60.0
Revision		**4.5**	**9.2**
CBM	June	53.7	53.5
CBM	August	56.0	56.1
Revision		**2.3**	**2.6**
IMF	April	51.4	47.6
IMF	October	**56.7**	**57.1**
Revision		**5.3**	**9.5**
FITCH	April	55.7	59.2
FITCH*	July	56.3	60.0
Revision		**0.6**	**0.8**
Moody's	April	50.5	49.8
Moody's	August	56.6	55.4
Revision		**6.1**	**5.6**
S&P	March	42.5	40.0
S&P	September	54.9	55.7
Revision		**12.4**	**15.7**

* FITCH does not provide an exact figure for 2021 but states that 'public debt will stabilise in 2021 – 2022 close to 60.0%'.

Source: MFIN, COM, CBM, IMF, FITCH, Moody's, S&P

6.4 Assessment

The revised fiscal outlook by MFIN is more cautious as it factors a stronger and longer downside economic impact of COVID-19. The DBP factors in the view of a possible larger contraction in the overall tax base and budgets for more temporary support expenditure measures.

In the case of the revenue revisions, this is in line with the downside risk which the MFAC had identified in its assessment of the USP. In turn, the revisions in the expenditure components mostly reflect the extension of measures announced post-USP. Despite the high level of uncertainty, the fact that the forecasts for the fiscal balance and the public debt produced by MFIN fit within the range of estimates by the other institutions, supports the overall plausibility of the official fiscal forecasts.

Chapter 7
Conclusion

The scenario presented by MFIN in the DBP indicates that Malta's real GDP would fall by 7.4% in 2020 due to the temporary negative supply and demand shocks caused by COVID-19. The country is then expected to recover quickly, albeit partially, as real GDP is forecast to expand by 5.0% in 2021.

The V-shaped economic growth recovery pattern is what most forecasters are to date anticipating for many countries, such that the significant losses in output experienced in 2020 would start being recovered in 2021. This builds on the confidence that the approved vaccines and their roll-out would prove successful, thereby bringing the pandemic under better control, and enabling economic activity to proceed under more normal conditions. At the same time, the partial rebound scenario factors in the concern that certain economic behaviours may take longer to adjust, and some weaknesses may persist.[73]

The MFAC considers that the macroeconomic forecasts for 2020 and 2021 presented in the DBP provide a plausible and internally consistent scenario which fits within its endorsable range, whilst acknowledging the high degree of uncertainty. Indeed, the outturn for important sectors such as tourism, remote gaming and financial services plays a critical role in shaping the overall outlook for the economy. Another critical factor is the continued wage subsidy scheme which has to date protected against major job cuts, despite the strong fall in output in the worst-hit sectors. At the same time, the assessment carried out on the individual expenditure components suggests the possibility of an overall downside risk outlook vis-à-vis the profile for real GDP for the period 2020 and 2021.

[73] The relevant issues were well summarised in an interview by a Member of the Executive Board of the ECB on 22 November 2020, where it was stated that "Our projections assume that the vaccine will be rolled out throughout next year. But the full recovery of GDP, back to where it was in 2019, will not happen before the autumn of 2022. So we do not assume that everything just bounces back to where it was before COVID-19, because there's going to be longer-term effects in terms of confidence and savings, and getting people back to work. In spite of the vaccine, there will be some persistent damage and the European economy will not exit this crisis without being weakened over a long period of time." Source: https://www.ecb.europa.eu/press/inter/date/2020/html/ecb.in201122~3a68c446f1.en.html.

Nonetheless, the fact that the official real GDP growth rates are within the range of estimates published by other reputable institutions further corroborates the plausibility of such forecasts. Despite facing high uncertainty, and considerable subjectivity vis-à-vis the choice of ad-hoc assumptions needed to model the possible duration and effects of the pandemic, it is noted that the available macroeconomic forecasts lie within a relatively narrow range.

The MFAC also considers the estimates of a large fiscal deficit in 2020 and a relatively smaller fiscal deficit in 2021, combined with an upward public debt trajectory, as plausible and within its endorsable range. The change from the stream of fiscal surpluses and declining public debt ratio, which were recorded in previous years, is unavoidable and indeed justified, given the exceptional circumstances facing the Maltese economy.

The projected fiscal developments are also compatible with the EU Council's recommendation addressed to Malta on 20 July 2020 "to take all necessary measures, in line with the general escape clause of the SGP, to effectively address the COVID-19 pandemic, sustain the economy and support the ensuing recovery".[74] The partial reduction in the planned fiscal deficit in 2021 and the expenditure allocations specified in the DBP are also compatible with the recommendation "to pursue, when economic conditions allow, fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment".

The MFAC takes note and shares the COM's opinion that "most of the measures set out in the Draft Budgetary Plan of Malta are supporting economic activity against the background of considerable uncertainty" and likewise joins the COM in inviting authorities "to regularly review the use, effectiveness and adequacy of the support measures and stand ready to adapt them as necessary to changing circumstances."[75]

A major caveat is that the fiscal outturn remains highly conditional on the period during which the COVID-19 mitigation measures remain in place, which in turn are conditional on the way in which the economy absorbs and reacts to the pandemic-induced demand and supply shocks. The attainment of the fiscal targets thus remains challenging and subject to downside risk for the fiscal balance over the forecast horizon. These

[74] Available on: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020H0826(18)&from=GA.
[75] Available on https://ec.europa.eu/info/sites/info/files/economy-finance/opinion_on_dbp_malta.pdf.

challenges translate into an upside risk to the profile for the public debt ratio. However, the information available by the cut-off date, suggest that the magnitude of these risks appear contained, since the official fiscal forecasts are corroborated by similar fiscal forecasts for Malta produced by other reputable institutions.

The MFAC takes note that In its assessment of the DBP, the COM stated that Malta is anticipated to submit its Recovery and Resilience Plan in 2021.[76] This would allow for the undertaking of further expansionary economic initiatives, which nevertheless would be budget neutral since they would be matched by corresponding EU revenues. At the same time, it is important that authorities maintain close monitoring of the long-term implications of any forthcoming agreements at EU level in relation to the way in which such schemes will be financed.[77]

The MFAC acknowledges that the temporary suspension of the fiscal rules, combined with the stronger financial assistance from the EU, relaxation of state aid rules, and the very supportive monetary policy by the ECB, provide manoeuvre for the government to carry out the necessary measures to alleviate the economic hardship created by the pandemic. At the same time, the MFAC highlights the importance to target again strong public finances once the significant downside effects of the pandemic ease out. The fiscal space which was available pre-COVID-19, because of the stream of fiscal surpluses and the low level of public debt, made it possible to implement aggressive fiscal measures to mitigate the negative shock. Rebuilding fiscal space would be useful to counteract any future adverse shocks and enhance the economy's overall resilience.

[76] Background information on the Recovery and Resilience Facility is available on https://ec.europa.eu/commission/presscorner/detail/en/QANDA_20_949.

[77] The Press Release issued by the COM on 10 November 2020 stated the following: "As proposed in May 2020 and agreed by EU leaders on 21 July 2020, to finance the recovery, the EU will borrow on the markets at more favourable costs than many Member States and redistribute the amounts. A clear roadmap towards new own resources to help repay the borrowing. The Commission has committed to put forward proposals on a carbon border adjustment mechanism and on a digital levy by June 2021, with a view to their introduction at the latest by 1 January 2023. The Commission will also review the EU Emissions Trading System in spring 2021, including its possible extension to aviation and maritime. It will propose an own resource based on the Emissions Trading System by June 2021. In addition, the Commission will propose additional new own resources, which could include a Financial Transaction Tax and a financial contribution linked to the corporate sector or a new common corporate tax base. The Commission will work to make a proposal by June 2024." Source: https://ec.europa.eu/commission/presscorner/detail/en/ip_20_2073.

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