

Assessment of the Update of Stability Programme 2021-2024



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Update of Stability Programme 2021-2024**



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21 June 2021

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Dear Minister,

**OVERALL ASSESSMENT OF THE MACROECONOMIC AND FISCAL FORECASTS
PRESENTED IN THE UPDATE OF STABILITY PROGRAMME 2021 – 2024**

As a follow-up to the letter of endorsement in relation to the macroeconomic forecasts, dated 29 April 2021, the Malta Fiscal Advisory Council is hereby presenting the full assessment report dealing with the Update of Stability Programme 2021 – 2024, in terms of the Fiscal Responsibility Act. The MFAC's Report has a cut-off date of 21 May 2021. 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 takes note of the government's statement that "the medium-term outlook beyond 2021 represents primarily a tentative no-policy-change projection which will be updated once a more stable economic situation unfolds". The Fiscal Council acknowledges the uncertainty which remains because of the pandemic and views favourably the clear identification in the Stability Programme of the critical assumptions which shaped the official outlook.

Overall, the Council considers the macroeconomic and fiscal scenario for the period 2021 – 2024 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 neutral risk outlook vis-à-vis the profile for real GDP for the period 2021 to 2024. The trajectory over the forecast horizon for private consumption and government consumption could provide a stronger upward push to GDP growth than anticipated, but this effect is broadly offset by the possibility that investment progresses at a slower pace than expected. The risk outlook vis-à-vis the remaining GDP components, namely exports and imports, was considered neutral. The Council notes that the resilience of the job market underpinning the Programme is consistent with the job-support measures which were launched in 2020 and which are expected to remain in place throughout 2021.

On the fiscal front, the assessment carried out on the individual revenue and expenditure components suggests that over the period 2021 to 2024 the fiscal deficit could be higher than targeted. This mostly reflects the upside risk on the expenditure side of the budget. Challenges to remain within the budgeted amounts apply in relation to compensation of employees, intermediate consumption, subsidies, and 'other' expenditure. Added pressures stem from the downside risk to revenue, mainly should the proceed from the citizenship schemes be less than forecasted. In turn, public debt could be higher than planned, accounting for the possible larger fiscal deficit, but also should the settlement of deferred taxes take longer than expected.

The Fiscal Council supports the government's initiatives aimed at mitigating the adverse economic effects of the pandemic and the stimulus provided for the economic recovery. At the same time, the Council welcomes the Government's plan to lower the fiscal deficit to below 3.0% of GDP by 2024. This would permit the stabilisation of the public debt ratio, albeit above 60.0% of GDP.

Such projected fiscal developments make use of the flexibility granted by the suspension of the fiscal rules across the EU because of the activation of the general escape clause. At the same time, the Council reminds that when economic conditions allow, fiscal policies should again be aimed at achieving a prudent medium-term fiscal position, and ensuring debt sustainability, while enhancing investment.

It is important to be adequately prepared for the possibility that the escape clause could be deactivated as of 2023. Rebuilding fiscal space would be useful to counteract any

future adverse shocks and enhance the economy's overall resilience. The fiscal space, which was available pre-pandemic, because of the stream of fiscal surpluses and the low level of public debt, proved very valuable by making possible the implementation of aggressive fiscal support measures.

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 Unit |
| ECB | European Central Bank |
| EFB | European Fiscal Board |
| EFSF | European Financial Stability Facility |
| EIB | European Investment Bank |
| ESA | European System of National and Regional Accounts |
| EU | European Union |
| FRA | Fiscal Responsibility Act |
| GDP | Gross Domestic Product |
| HICP | Harmonised Index of Consumer Prices |
| IIP | Individual Investor Programme |
| IMF | International Monetary Fund |
| LFS | Labour Force Survey |
| MFAC | Malta Fiscal Advisory Council |
| MFE | Ministry for Finance and Employment |
| MGA | Malta Gaming Authority |
| MGS | Malta Government Stock |
| NPISH | Non-Profit Institutions Serving Households |
| NAO | National Audit Office |
| NSO | National Statistics Office |
| pp | percentage point |
| PPP | Public-Private Partnership |
| RRF | Recovery and Resilience Facility |
| SFA | Stock-Flow Adjustment |
| SGP | Stability and Growth Pact |
| STEMM | Short-Term Quarterly Economic Forecasting Model |
| STG | sterling |
| SURE | Support to mitigate Unemployment Risks in an Emergency |
| USD | US dollar |
| USP | Update of Stability Programme |
| VAT | Value Added Tax |

Executive Summary

This Report, whose cut-off date is 21 May 2021, assesses the macroeconomic and fiscal forecasts for the four-year period 2021 to 2024 contained in the Update of Stability Programme, which the Ministry for Finance and Employment submitted to the European Commission on 30 April 2021.

Both the macroeconomic and fiscal forecasts lie within the endorsable range of the Fiscal Council. At the same time, the Council highlights the critical role of COVID-19 related assumptions in shaping the macro-fiscal scenario. Any material departure from such assumptions could deviate the outturn, possibly significantly, from that presented in the Update of Stability Programme.

The official outlook points to a 3.8% growth rate in real GDP in 2021. The bulk of the economic recovery is anticipated for 2022, when real GDP is expected to rise by 6.8%. Growth is then forecast to ease slightly over 2023 and 2024, respectively to 4.5% and 4.0%. Against this background, the fiscal deficit is expected to widen to 12.0% of GDP in 2021, from 10.1% a year earlier. This reflects the elevated expenditure on support measures, as well as the slow recovery in tax revenue. From 2022 onwards, the Stability Programme then targets a progressive reduction in the fiscal deficit ratio, to below 3.0% of GDP by 2024. This is mostly due to the non-repetition of certain outlays, as well as the expectation that certain expenditure components grow at a slower pace than nominal GDP. These plans would permit the stabilisation of the public debt ratio throughout the forecast horizon, slightly above 65.0% of GDP.

The risk assessment carried out by the Fiscal Council suggests a broadly neutral risk outlook vis-à-vis the profile for real GDP growth over the forecast horizon. On the other hand, the fiscal deficit and the public debt ratios could be higher than planned, particularly should expenditure growth exceed the budget allocations, and the settlement of tax deferrals take longer than assumed.

The Fiscal Council takes note that in view of the activation of the general escape clause by the European Council, it is possible for the Government to take all the initiatives deemed necessary to mitigate the adverse effects of the pandemic and to stimulate the economic recovery. At the same time, the Council reminds that when economic conditions allow, fiscal policies should again be aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability.

Chapter 1

Introduction

European Union (EU) Member States that share the euro as their currency must submit an Update of Stability Programme (USP) to the European Commission (COM) by the end of April each year.¹ Malta's latest USP presents the official macroeconomic forecasts and fiscal projections prepared by the Ministry for Finance and Employment (MFE) covering the four-year period 2021 to 2024.² It was prepared a year after the start of the COVID-19 pandemic, accompanied by initial signs of a possible gradual economic recovery starting from 2021, after the severe shock which was experienced in Malta and the other euro area Member States in 2020. However, since the level of uncertainty remains high, the USP specifies that the macroeconomic and fiscal outlook beyond 2021 represents primarily a tentative no-policy-change projection, which the Ministry will be updating, once a more stable economic situation unfolds.

On 3 March 2021, the COM adopted a Communication providing Member States with broad guidance on the conduct of fiscal policy in the period ahead.³ The Communication specified that fiscal policy should remain agile and adjust to the evolving situation, warning against a premature withdrawal of fiscal support.⁴ The COM further indicated that it would continue to monitor the situation to determine when it is appropriate to deactivate the general escape clause in the Stability and Growth Pact (SGP).⁵ The COM clarified that the key quantitative criterion for such de-activation shall

¹ The USP submitted by each country in 2021 is available on https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester/european-semester-timeline/national-reform-programmes-and-stability-or-convergence-programmes/2021-european_en.

² In 2020 Malta made use of the concession to produce forecasts for a two-year period (year t and t+1) instead of the standard four-year period, in view of the extremely uncertain conditions which prevailed at that time.

³ The document is available on https://ec.europa.eu/commission/presscorner/detail/en/ip_21_884.

⁴ Fiscal support had been made easier because EU state aid rules were also eased in 2020. Background documents on state aid and COVID-19 are available on https://ec.europa.eu/competition/state_aid/what_is_new/covid_19.html.

⁵ Following the outbreak of COVID-19, on 23 March 2020 the 'general escape clause' was activated by the European Council. This clause allows governments to temporarily depart from the budgetary requirements imposed by the EU fiscal rules. This added flexibility permitted the full implementation of revenue and expenditure measures necessary to tackle the health and economic challenges created by the pandemic. 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 is available on

be the level of economic activity in the EU, or euro area, compared to pre-crisis levels (end-2019), noting that “current preliminary indications would suggest to continue applying the general escape clause in 2022 and to deactivate it as of 2023”.

The Malta Fiscal Advisory Council (MFAC) continues to follow closely the discussions and decisions taken at the EU level in relation to the general escape clause and the guidance on the conduct of fiscal policy. Based on the information to date, the MFAC confirms that the situation of ‘exceptional circumstances’ as defined in the Fiscal Responsibility Act (FRA) is deemed to persist.⁶ Therefore, the assessment of compliance with the fiscal rules by the MFAC is temporarily suspended until the general escape clause is revoked and the situation is no longer considered as exceptional.⁷ The MFAC takes note of the declarations in the USP that it is “premature at this stage to anticipate when these exceptional circumstances will cease to exist” and that “the plan will be revised once exceptional circumstances cease to exist, after which, the Government will continue to pursue policies aimed at achieving prudent medium-term fiscal positions”.

Apart from the added flexibility supported by the activation of the general escape clause, further assistance was provided by the COM through the SURE (Support to mitigate Unemployment Risks in an Emergency) instrument and the Recovery and Resilience Facility (RRF), which forms part of the NextGenerationEU.⁸ Against this

<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/>.

⁶ FRA Article 2(1) defines exceptional circumstances 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”.

⁷ The European fiscal rules might also be amended in future. In its 2020 Annual Report, the European Fiscal Board (EFB) has reiterated the need to simplify the current fiscal framework around three core principles: i) a medium-term debt anchor; ii) a single operational rule that caps the growth rate of net primary expenditures for countries while protecting government investment; and iii) one general escape clause. For further details refer to https://ec.europa.eu/info/sites/default/files/efb_annual_report_2020_en_1.pdf.

⁸ SURE provides loans for the temporary support to the labour market. NextGenerationEU is a €750 billion temporary recovery instrument to help repair the immediate economic and social damage brought about by the coronavirus pandemic. The RRF is the centrepiece of NextGenerationEU with €672.5 billion in loans and grants available to support reforms and investments undertaken by EU countries. The COM made available the RRF grants and loans with the intention to provide a sizeable fiscal impulse and help mitigate the risk of divergences in the euro area and the EU, whilst enabling the green and digital transitions. Further details are available on https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/financial-assistance-eu/funding-mechanisms-and-facilities/sure_en; https://ec.europa.eu/info/strategy/recovery-plan-europe_en#nextgenerationeu; and https://ec.europa.eu/info/business-economy-euro/recovery-coronavirus/recovery-and-resilience-facility_en#national-recovery-and-resilience-plans.

background, the macroeconomic forecasts and fiscal projections contained in the USP factored in the loans obtained from SURE, and the grants to be derived from the RRF, stating that “Malta is currently concluding its Recovery and Resilience Plan”.

On 29 April 2021, the Chairman of the MFAC addressed a letter to the Minister for Finance and Employment confirming that on the basis of detailed analysis and bilateral discussions, the macroeconomic forecasts for the period 2021 to 2024 were considered to lie within the Fiscal Council’s endorsable range.⁹ This Report contains the analysis carried out to support the endorsement of the macroeconomic forecasts, as well the assessment pertaining to the endorsement of the fiscal projections over the same timeframe.¹⁰

The MFAC’s Report has a cut-off date of 21 May 2021 and is structured as follows. **Chapter 2** examines the methodologies, assumptions and characteristics of the baseline scenario used by the MFE in the preparation of the macroeconomic and fiscal forecasts. **Chapter 3** evaluates the expected trajectory for the main macroeconomic variables over the period 2021 to 2024, and where relevant, identifies possible upside or downside risks. **Chapter 4** compares the latest macroeconomic forecasts with the previous official forecasts (contained in the DBP) and with those produced by other institutions. **Chapter 5** focuses on the fiscal targets for the balance and debt. It examines the plausibility of the anticipated trajectories for the main revenue and expenditure components in the budget, and identifies the direction of risk, where relevant. **Chapter 6** compares the fiscal scenario presented in the USP to that contained in the DBP, and to the latest available fiscal forecasts by other institutions. **Chapter 7** presents the conclusions.

⁹ A copy of the letter is available on <https://mfac.org.mt/publications/reports/reports-2021/>.

¹⁰ The FRA does not prescribe that the endorsement of the fiscal forecasts should take place prior to the publication of the USP. Hence, as per usual practice, the detailed fiscal forecasts and measures underpinning the USP were forwarded to the Council after the document was published. This approach is also used in relation to the endorsement of the fiscal forecasts contained in the annual Draft Budgetary Plan (DBP).

Chapter 2

Forecast methodologies and assumptions

2.1 Preparation of the macroeconomic forecasts

As in recent years, the macroeconomic forecasts produced by MFE continued to be estimated using STEMM (Short-Term Quarterly Economic Forecasting Model), which is a quarterly Keynesian model with output determined by aggregate demand.¹¹ The equations are regularly re-estimated to ensure that these reflect adequately the economic features and relationships in the Maltese economy. Regression estimates are complemented with expert judgement, based on ad-hoc information and regular discussions with key stakeholders, namely government departments, authorities, and the private sector. Such dialogue plays a significant role in shaping the outlook for key sectors which might be driven by very specific factors. Such insight is valuable particularly to gauge employment and export prospects at a sectoral level, and to project better the future path for investment, especially in the context of a very small open economy. The dependence on expert judgement has increased because of the pandemic, since past empirical relationships may not adequately capture the economic effects created by Covid-19.

2.2 Assumptions underpinning the macroeconomic forecasts

The values for the exogenous variables which are used to produce the macroeconomic forecasts continued to be obtained from authoritative and reputable sources.¹² Specifically, the March 2021 edition of 'Consensus Forecasts' was the source for the assumptions relating to: 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.¹³ In turn, the interest rate assumptions were derived by converting the monthly rates published by the European Central Bank (ECB) into quarterly averages

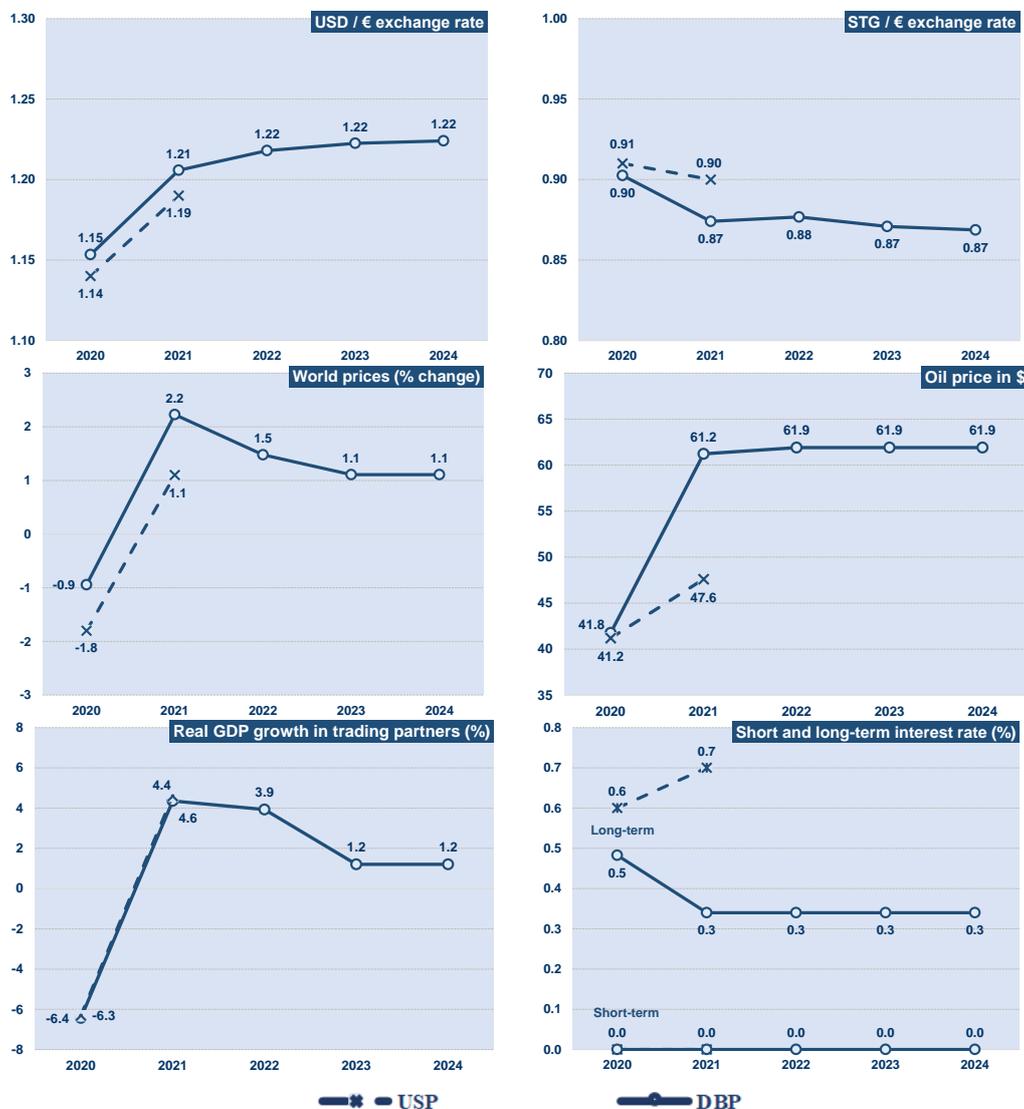
¹¹ See <https://mfin.gov.mt/en/epd/Pages/Library.aspx> for technical details about STEMM.

¹² The cut-off date for the external assumptions used by MFE was 8 March 2021.

¹³ The monthly publication by Consensus Economics surveys professional forecasters for their estimates of a range of variables.

and keeping these values unchanged over the forecast horizon.¹⁴ The trajectories of the exogenous variables adopted in the USP are displayed in Chart 2.1 and compared with the values which were used in the DBP (previous round).¹⁵

Chart 2.1: Main macroeconomic assumptions



Note: 2020 refers to the estimated values, while 2021 – 2024 are forecasts.

Source: MFE

For 2021, the USP assumed a stronger value for the euro in relation to the US dollar, but weaker vis-à-vis sterling, compared to the previous forecast round. In the following

¹⁴ Source: https://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/long_term_interest_rates/html/index.en.html.

¹⁵ The DBP presented forecasts for 2020 and 2021 and hence the assumptions covered only these two years.

years, the assumed euro exchange rate movements against both currencies are minimal. The USP portrays a stronger expected pick-up in world prices in 2021, in reaction to the smaller-than-anticipated fall in world prices in 2020. A gradual easing in world inflation is then assumed, stabilising at 1.1% towards the end of the forecast horizon. This pattern broadly mirrors the updated outlook for the oil price. It is expected that the price of Brent crude oil will rise from \$41.8 per barrel in 2020, to \$61.2 in 2021, as the global demand is set to recover. In the outer years, the price of oil is then assumed to remain stable at around that level. The profile for external demand (using real GDP developments in Malta's main trading partners as a proxy) reiterates the outlook upon which the DBP was based, that is, a strong, yet partial, rebound in 2021. The USP then assumes further elevated growth in 2022, but some easing thereafter, stable at 1.2% in 2023 and 2024. The assumption of a zero per cent short-term interest rate across the forecast horizon was retained in the USP. However, the assumed value for the 2021 long-term interest rate is lower from that used in the DBP. The USP extends a stable long-term interest rate of 0.3% throughout the four years.

Apart from the specific values for these exogenous variables, another assumption related to the inventory adjustments for the period 2021 to 2024.¹⁶ As per normal practice in the April forecast round, the USP assumed that throughout the entire forecast horizon, inventories amount to their value (in real terms) recorded in the preceding year (i.e. 2020), thereby exerting no material impact on growth.¹⁷

The high uncertainty created by COVID-19 necessitated further assumptions to shape the macroeconomic scenario. These related to progress in the vaccination roll-out programme; the duration of the fiscal support measures in place; population dynamics in the coming years; and the expected path for the yearly inbound tourists.¹⁸

The macroeconomic forecasts are built on the premise stated in the USP (page 19) that “from the third quarter of 2021, the vaccination progress in Malta and abroad is

¹⁶ Inventory changes include the effect of changes in actual inventories as well as any statistical errors. MFE do not forecast inventory changes but assume a stable value.

¹⁷ In 2020 there was a build-up of inventories (i.e. positive inventory adjustment), which contributed 0.6 percentage points (pp) to real GDP growth in that year. This can be ascribed to the fact that production was in most cases continued even when demand was subdued. The approach used by MFE implies positive inventory adjustments throughout the four-year forecast horizon (indicating persistent stock build-up). One would expect that as conditions improve, stock levels would again return to lower levels. However, in view of the difficulty in estimating such changes with confidence, the approach used by MFE is considered as valid. It is also in line with the approach used by other institutions.

¹⁸ Tourism was the worst hit sector by the pandemic.

expected to have made sufficient progress to allow for the gradual resumption of ordinary activity and liberating pent-up demand”. This assumption paves the way for the baseline of a partial recovery in economic activity in 2021, and further growth thereafter.

The USP assumes that the easing of the latest set of restrictive measures which started in the second quarter of 2021 is not subsequently reversed.¹⁹ In fact, the USP clarifies that “the outlook for 2022 is subject to the assumption that the vaccination rollout would be complete by the end of 2021, and there will be a resolution of the health crisis in 2022, followed by a gradual tapering of containment measures”. Against this background, tourism flows are assumed to start improving, reaching 30% of the 2019 levels in 2021, 75% by 2022, and attaining pre-pandemic levels by 2024.

Consistent with the expected improvement in economic conditions, the various social and economic support measures are expected to remain in place throughout 2021, possibly to varying degrees. These are then expected to be phased out from 2022, as the economy transitions from a crisis to a post-crisis period.

Population growth, primarily through the influx of foreign workers, was a key driver for growth in employment and output in the years preceding the pandemic.²⁰ The higher amount of foreign workers also contributed to sustain demand for rented property. The USP assumes that the population in Malta will continue to increase throughout the forecast horizon, albeit at a slower pace than pre-pandemic.

2.3 The preparation of the fiscal forecasts

The process to prepare the fiscal forecasts remained the same as in the previous rounds. Various scenarios were explored, in the context of very fluid and uncertain conditions created by COVID-19, until the baseline scenario was selected. This was necessary to budget adequate resources for the temporary fiscal mitigation measures

¹⁹ For details about the restrictive measures see <https://deputyprimeminister.gov.mt/en/health-promotion/covid-19/Pages/mitigation-conditions-and-guidances.aspx>.

²⁰ Whereas as at end 2009, employed foreign nationals in Malta were below 10,000, over a decade they had risen significantly, to 67,596 by end 2019. Source: <https://jobsplus.gov.mt/resources/publication-statistics-mt-mt-en-gb/labour-market-information/foreigners-data>.

which were being launched, as well as to align the fiscal projections 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.

This bottom-up approach is supplemented with a top-down approach, using the accrual-based European System of National and Regional Accounts (ESA). This process involves the forecasting of budget items using estimated relationships with their respective macroeconomic proxy bases. The main purpose of these top-down calculations is to act as an envelope, thereby maintaining prudence and supporting broad consistency between the fiscal projections and the official macroeconomic outlook. This step is also necessary since the fiscal forecasts need to be presented in ESA data format rather than the figures included in the Consolidated Fund.

Close coordination across the public sector remained key to provide adequate funding for the health sector and for the pandemic-related economic support measures.²¹ The USP specifies that the projections rest on the assumed “evolution of the virus and the efforts at identifying and distributing a suitable vaccine against the virus and its variants”. Importantly, the fiscal projections build on the premise that the expected economic recovery would pave the way for the phasing out of the support measures by end 2021. Another assumption stated in the USP (page 21) is that “the vaccine doses will not need to be administered on a recurrent annual basis”, thus allowing for the possibility of future costs savings.

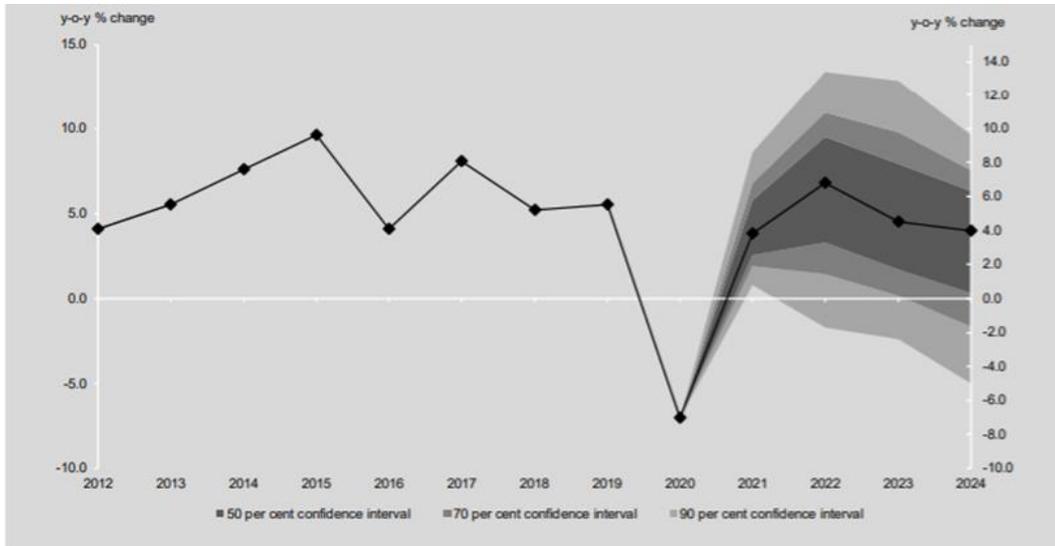
2.4 Risk outlook presented by MFE in the Update of Stability Programme

Any significant departure from the assumptions used by MFE could deviate the macroeconomic and fiscal outturn, possibly significantly, from the outlook as presented in the official forecasts. Therefore, the USP presents a range of real GDP growth and

²¹ A detailed list of measures launched in 2020 is included in the preliminary review of the measures relating to the COVID-19 pandemic undertaken by the National Audit Office (NAO). Refer to <https://nao.gov.mt/loadfile/71ab28ce-3885-4c20-997d-379965498191>.

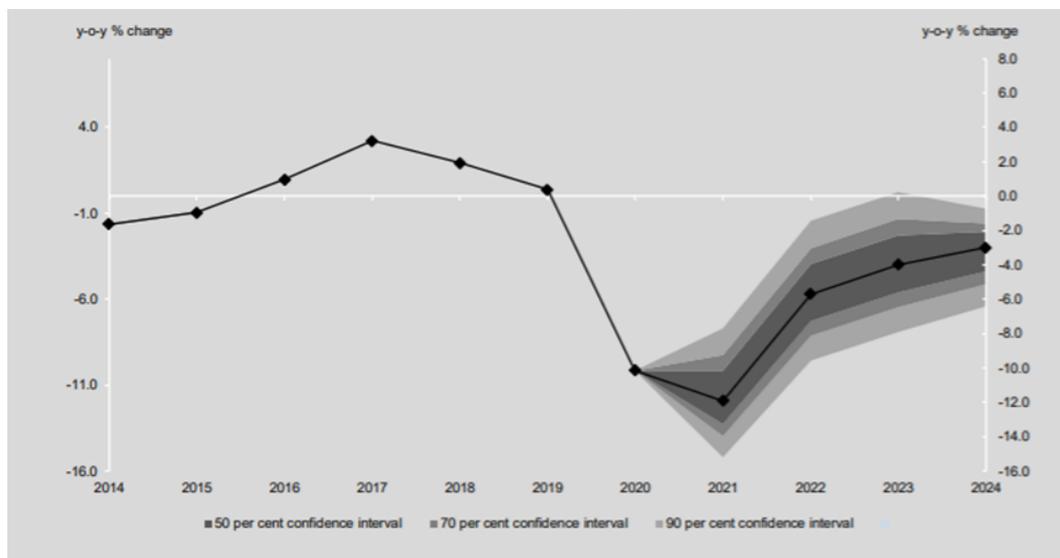
fiscal balance outcomes that could arise based on alternative scenarios, which are more positive or adverse than used in the baseline (see Chart 2.2 and Chart 2.3).

Chart 2.2: Alternative real GDP growth forecasts (%)



Note: Reproduced from the USP Chart 4.1, page 50.
 Source: MFE

Chart 2.3: Alternative projections for the fiscal balance (% of GDP)



Note: Reproduced from the USP Chart 4.2, page 51.
 Source: MFE

The scenarios considered by MFE included: different growth rates for external demand; higher interest rates; different tourism forecasts; higher investment; and higher precautionary savings. All scenarios point to positive real GDP growth in 2021 at the 90% confidence level. The wider range of estimates calculated over the period 2022 to 2024 portrays real GDP growth rates which are mostly positive (growth rates

which are even higher than pre-pandemic), but also include negative growth rates (in the more adverse cases). The baseline macroeconomic scenario fits approximately with the average of the scenarios considered, because the number of more optimistic and more pessimistic scenarios, as well as the magnitude of their respective effects, are broadly similar.

On the fiscal side, the range of estimates for the balance (based on the identical alternative scenarios for the real GDP growth fan chart) encompass the possibility of a reduction, as well as a widening, of the fiscal deficit in 2021. In the outer years, the outcomes at the 90% confidence level indicate a stream of fiscal deficits-to-GDP, within an approximate range of 6.0 pp between the more optimistic and pessimistic scenarios. All scenarios point towards a situation where from 2022 onwards, the deficit is lower than that recorded in 2020. A main caveat of this analysis is that these calculations show fiscal estimates based exclusively on alternative macroeconomic scenarios and do not consider specific fiscal risks which might materialise. Examples of fiscal risks which are not explicitly embedded in the fan chart for alternative fiscal balance projections published in the USP include: financial difficulties faced by state owned-enterprises; calls on government guarantees; added obligations from Public-Private Partnerships (PPP); and legal claims.²²

²² For an in-depth review refer to IMF (2009) Fiscal Risks: Sources, Disclosure and Management, available on <https://www.imf.org/external/pubs/ft/dp/2009/dp0901.pdf>.

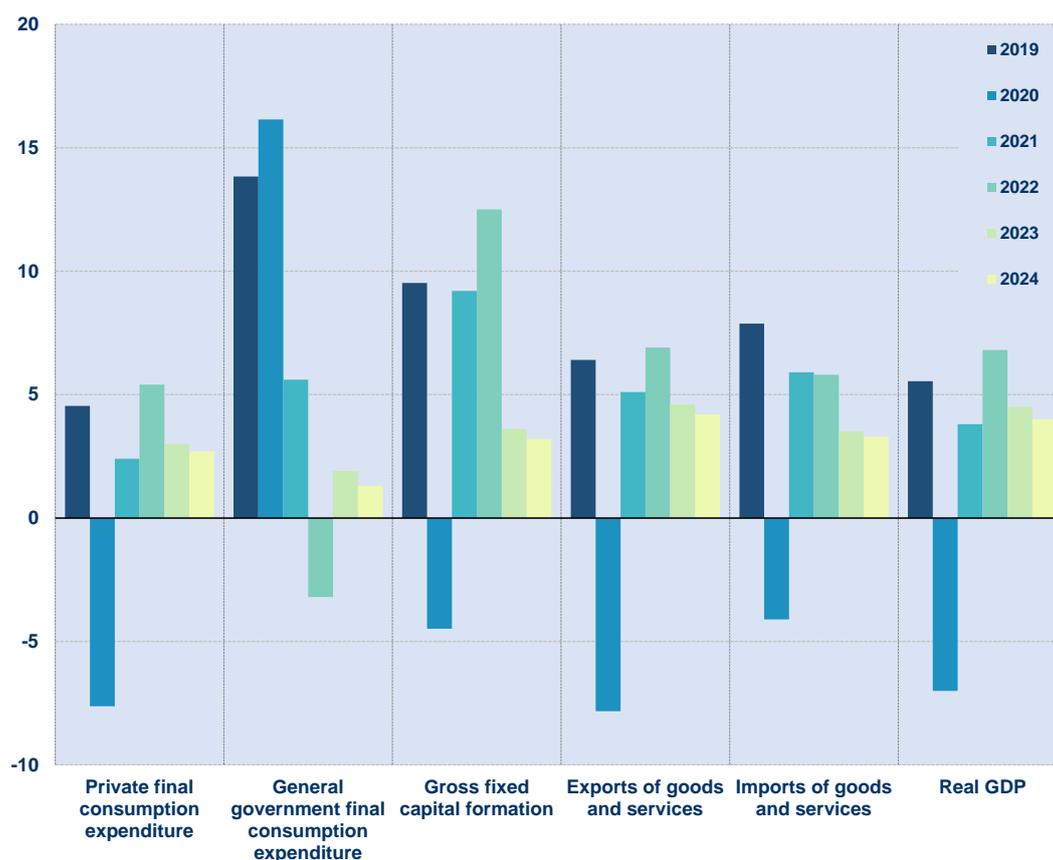
Chapter 3

Assessment of the macroeconomic forecasts 2021 – 2024

3.1 Macroeconomic outlook 2021 – 2024

The Maltese economy suffered a significant fall in output in 2020, as real GDP declined by 7.0%, which is comparable to the 6.6% contraction recorded across the euro area (see Chart 3.1 and Table 3.1).²³ Part of the lost output is anticipated to be recovered in 2021, as the adverse economic effects caused by the pandemic are expected to ease. Real GDP is expected to grow by 3.8% in 2021, and to accelerate to 6.8% in 2022. Growth in real GDP is forecast to remain high in the outer years, but it is expected to moderate slightly, to 4.5% in 2023, and 4.0% in 2024.

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



Source: MFE

²³ Figures for 2019 and 2020 are based on the provisional values as published by the National Statistics Office (NSO) on 1 March 2021 (News Release 040/2021), while figures for the period 2021 to 2024 represent the forecasts prepared by MFE.

Table 3.1: Macroeconomic variables 2019 – 2024 (% change over previous period)

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 |
|--|------|-------|------|------|------|------|
| Real GDP components | | | | | | |
| Private final consumption expenditure* | 4.5 | -7.6 | 2.4 | 5.4 | 3.0 | 2.7 |
| General government final consumption expenditure | 13.8 | 16.1 | 5.6 | -3.2 | 1.9 | 1.3 |
| Gross fixed capital formation | 9.5 | -4.5 | 9.2 | 12.5 | 3.6 | 3.2 |
| Exports of goods and services | 6.4 | -7.8 | 5.1 | 6.9 | 4.6 | 4.2 |
| Imports of goods and services | 7.9 | -4.1 | 5.9 | 5.8 | 3.5 | 3.3 |
| Real GDP | 5.5 | -7.0 | 3.8 | 6.8 | 4.5 | 4.0 |
| Contribution to real GDP growth | | | | | | |
| Domestic demand (pp) | 6.3 | -1.7 | 4.5 | 4.9 | 2.7 | 2.3 |
| Inventories (pp) | 0.0 | 0.6 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net exports (pp) | -0.8 | -5.9 | -0.7 | 1.9 | 1.8 | 1.7 |
| Deflators | | | | | | |
| Private final consumption expenditure | 2.2 | 1.1 | 1.4 | 1.5 | 1.3 | 1.2 |
| General government final consumption expenditure | 2.9 | 2.4 | 2.2 | 2.5 | 2.0 | 2.1 |
| Gross fixed capital formation | 1.2 | 0.9 | 1.1 | 1.3 | 1.2 | 1.1 |
| Exports of goods and services | 2.1 | 0.5 | 1.3 | 1.4 | 1.5 | 1.5 |
| Imports of goods and services | 1.7 | 0.4 | 0.8 | 1.1 | 1.0 | 0.9 |
| GDP deflator | 2.5 | 1.3 | 2.1 | 2.1 | 2.2 | 2.2 |
| Labour market | | | | | | |
| Employment (National Accounts definition) | 6.5 | 4.1 | 2.2 | 3.5 | 3.2 | 3.0 |
| Unemployment rate (%) (LFS definition) | 3.6 | 4.3 | 4.3 | 3.9 | 3.8 | 3.7 |
| Nominal compensation of employees | 8.6 | 2.4 | 3.4 | 5.7 | 5.3 | 5.2 |
| Nominal compensation per employee | 2.6 | -0.8 | 1.2 | 2.1 | 2.1 | 2.1 |
| Labour productivity (real GDP per person employed) | -0.9 | -10.7 | 1.6 | 3.2 | 1.3 | 0.9 |
| Other macroeconomic variables | | | | | | |
| Inflation rate (%) (based on the HICP) | 1.5 | 0.8 | 1.3 | 1.5 | 1.6 | 1.7 |
| Nominal GDP | 8.0 | -5.7 | 5.9 | 8.9 | 6.7 | 6.2 |

Note: Figures for 2019 and 2020 are actual, while figures for 2021 to 2024 are forecasts.

* Includes Non-Profit Institutions Serving Households (NPISH)

Source: MFE

Nominal GDP is anticipated to recover to pre-pandemic levels faster than real GDP, particularly since its downturn was slightly less. In 2021, nominal GDP is expected to grow by 5.9%, thereby reversing the 5.7% contraction recorded a year earlier. Since the GDP deflator is projected to rise by slightly more than 2.0% annually, the trajectory for nominal GDP growth broadly mirrors that in real GDP. Nominal GDP growth is thus expected to peak in 2022 and be slightly lower in the subsequent two years.

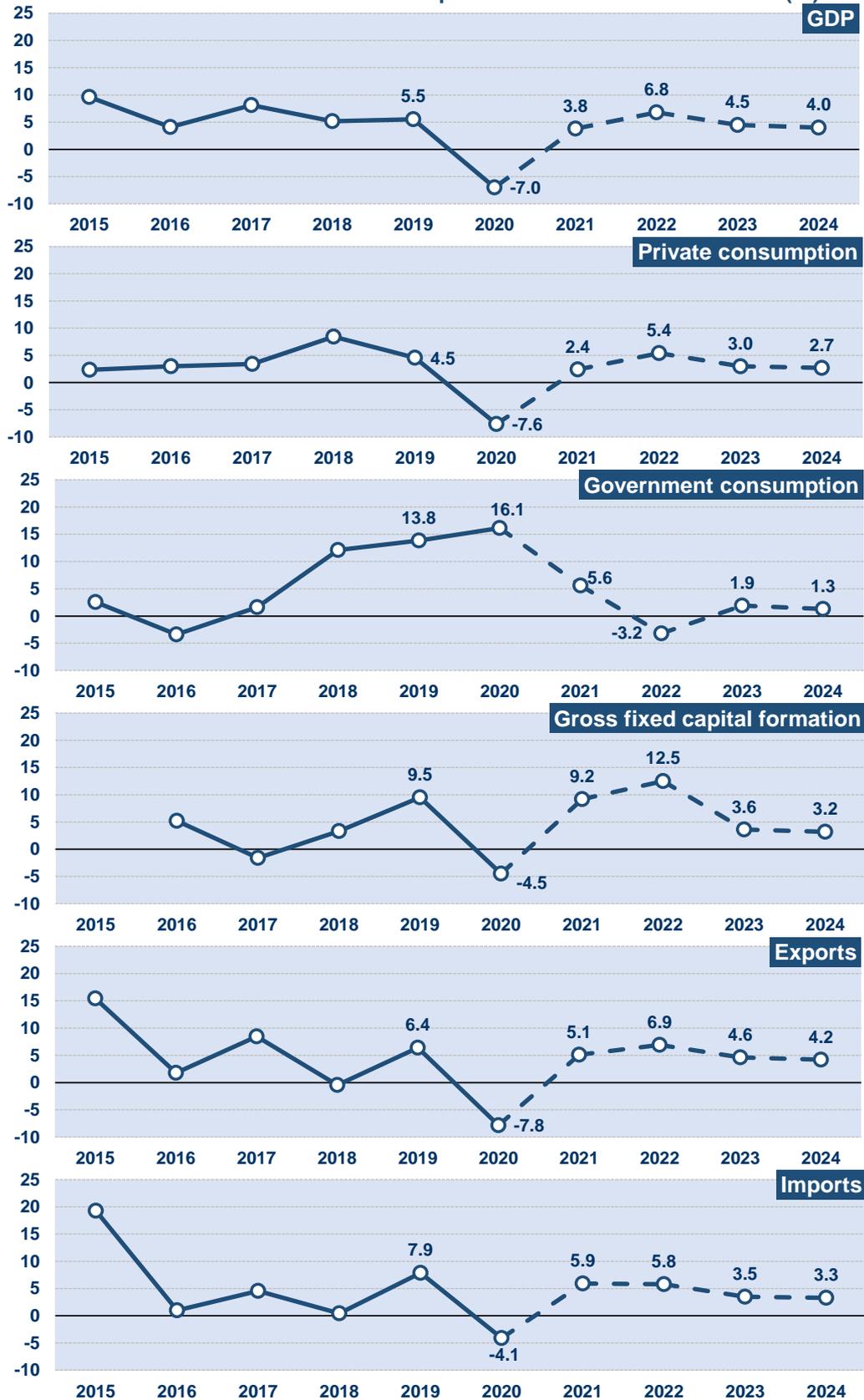
The forecast profile for the different real GDP expenditure components over the four-year period is broadly similar, except for government consumption (see Chart 3.2). In 2021, government consumption is expected to decelerate, growing by 5.6%, after having been the only component which grew the year before. The measures implemented to mitigate the effects of the pandemic boosted growth in government consumption in 2020 and are expected to continue exerting a material impact even in 2021. Consumption, investment, exports, and imports are forecast to rebound, albeit to varying degrees, following the declines registered in 2020. In 2021, investment is expected to grow most, up by 9.2%. Meanwhile exports and imports are forecast to advance at broadly similar rates, respectively by 5.1% and 5.9%. However, the anticipated recovery in private consumption is muted, up by only 2.4% on a year earlier.

In 2022, growth in private consumption, gross fixed capital formation and exports is expected to gain momentum as these components are all forecast to exceed their respective growth rates predicted for 2021. On the contrary, government consumption is predicted to contract in 2022, due to the lower activity related to COVID-19. The combined effect of these developments is in turn estimated to raise imports by a similar rate as in 2021.

The forecast profile for 2023 and 2024 shows a broad-based slight easing of growth. This no-policy change scenario reflects the expected resumption of growth dynamics across the various GDP expenditure components which are more in line with those recorded during pre-pandemic years.²⁴ This pattern reflects the absence of special factors and base effects which shaped the forecasts for 2021 and 2022.

²⁴ The no-policy change scenario for 2022 onwards involves the extrapolation of revenue and expenditure trends after deducting the impact of temporary measures of the current year and before adding the impact of the measures included in the forthcoming year's budget.

Chart 3.2: Growth in real GDP and its components – chain-linked volumes (%)

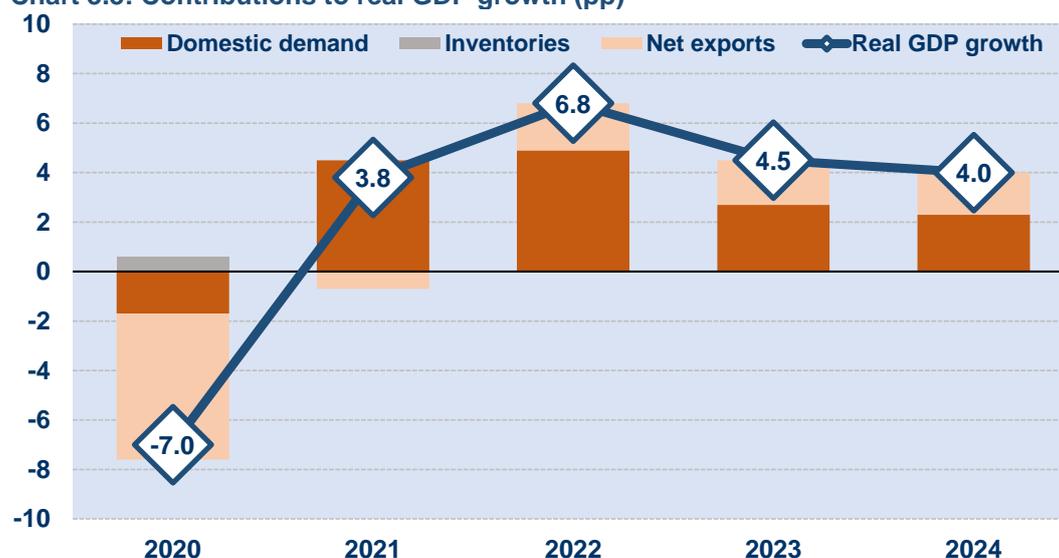


Note: In 2015 the growth rate for gross fixed capital formation was 62.3% (not shown in Chart).

Source: MFE

Domestic demand is expected to be the main contributor to real GDP growth throughout the forecast horizon (see Chart 3.3). In 2021, its upward effect is slightly dampened by the negative contribution expected from net exports. However, from 2022 onwards, net exports are anticipated to provide a positive and stable contribution to growth, as exports are forecast to grow faster than imports. On the other hand, no impact on growth is foreseen from changes in inventories, as the latter are assumed unchanged compared to their level in 2020.

Chart 3.3: Contributions to real GDP growth (pp)



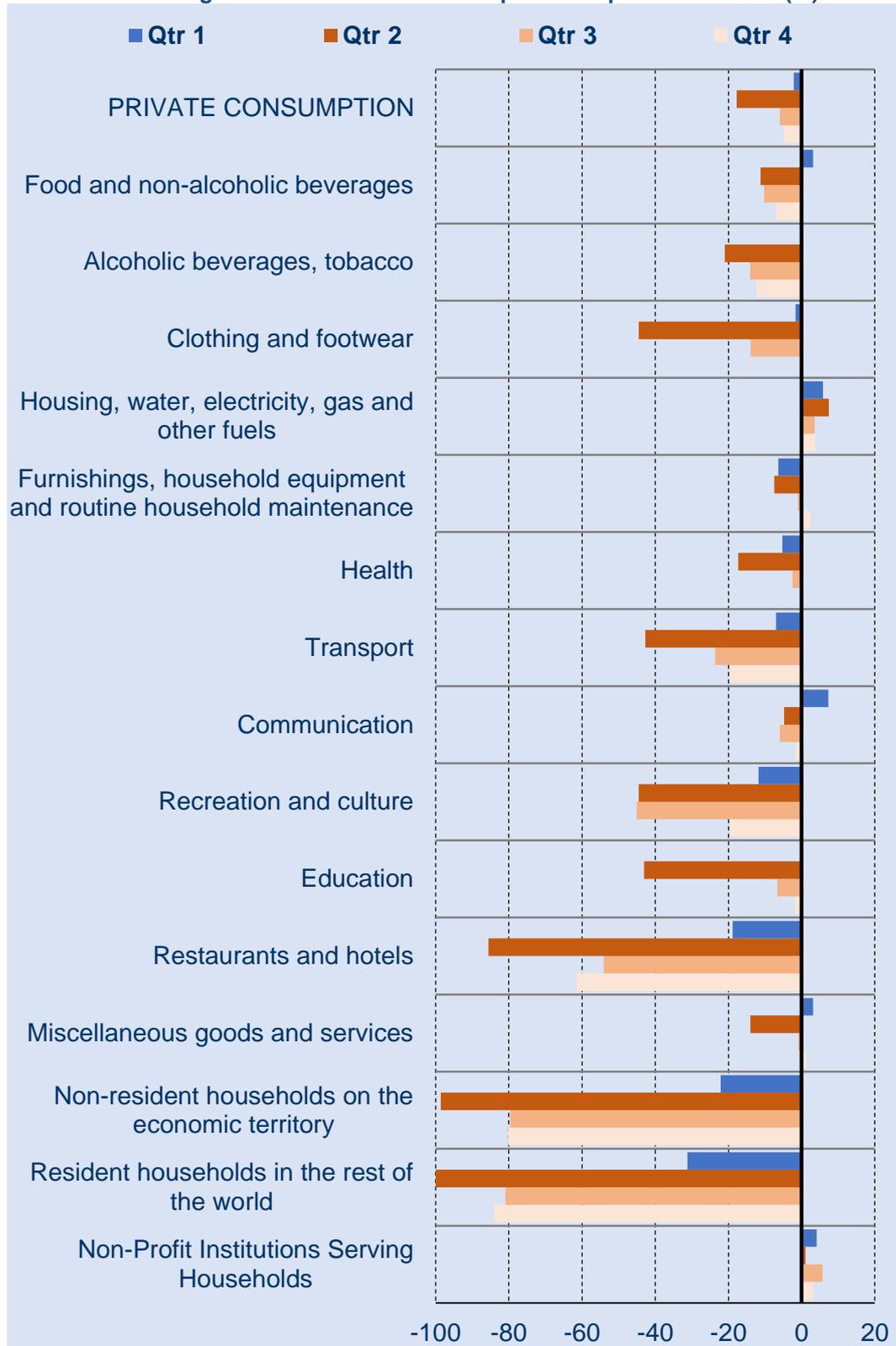
Source: MFE

3.2 Private consumption

In 2021, private consumption is forecast to rise by 2.4% in real terms, reversing part of the 7.6% contraction recorded in the previous year. The anticipated partial recovery builds on the premise that, in 2021 the period when restrictions are in place is shorter, and that the measures are less stringent, than in 2020. This factor plays a key role, since the virus containment measures created a strong downside effect, particularly on recreational and other non-essential spending (in certain cases, the limitations even prohibited households from consuming a share of their normal expenditure basket).

The restrictions which were in place in 2020, and their gradual phasing-out planned for 2021 lead to uneven prospects for consumption along the year, and hence different base effects. In the first year of the pandemic, private consumption declined in each quarter, but the sharpest year-on-year contraction, amounting to 17.8%, was recorded during the second quarter (see Chart 3.4).

Chart 3.4: Annual growth rates in real consumption components in 2020 (%)



Note: The data shows the various expenditures on goods and services by households and by Non-Profit Institutions. In the compilation of GDP, total spending by non-resident households which features in this data is then re-classified as exports. Hence, the various categories indicated in this chart have an element of exports in them, mostly reflecting spending by tourists in Malta.

Source: NSO

Although the yearly declines attenuated in the subsequent two quarters, these still exceeded the contraction which was recorded during the first three months of 2020. Drops were broad based, but the adverse impact on the consumption basket was uneven, with the items facing the toughest restrictions being the worst hit.

The forecast growth in real private consumption in 2021 is the lowest among the GDP expenditure components. This embeds the expectation that the recovery in consumption will be gradual and concentrated towards the second half of the year, with a potential resurgence of pent-up demand. This accounts for the gradual improvement in conditions foreseen by the assumption that 70% of the population would be vaccinated by the third quarter of 2021.²⁵ The expected rise in real household incomes is another factor sustaining the forecast growth in private consumption. Purchasing power is expected to increase on account of the 3.4% forecast growth in total nominal compensation of employees, which is higher than the 1.4% expected rise in the consumption deflator, or the 1.3% HICP inflation rate.

In 2022, real private consumption growth is expected to gain momentum, accelerating to 5.4%. This is consistent with the view that the recovery in private consumption is mostly delayed to 2022. This presupposes a return to normality scenario, characterised by no or limited restrictions and health concerns, implied by the USP's assumptions that "the virus will not persist throughout 2022" and that the "vaccine doses will not need to be administered on a recurrent annual basis". The acceleration in private consumption growth envisaged for 2022 mirrors the concurrent expected faster rise in compensation of employees. Indeed, the 5.7% forecast growth in nominal compensation of employees is much higher than the 1.5% estimated change in the consumption deflator.

In 2023 and 2024, the rate of growth in real private consumption is forecast to decelerate, to 3.0% and 2.7% respectively. The post-pandemic consumption trajectory for the outer years relies on the expected slightly more than 5.0% annual rise in nominal compensation of employees, and an estimated inflation rate (using the consumption deflator) of slightly more than 1.0%, in both years. The moderation in consumption growth also builds on the assumption of a slightly lower post-pandemic growth in the size of the population.

²⁵ The latest information published by the Ministry for Health shows that the number of persons who received at least a first dose of the COVID-19 vaccine by the Report's cut-off date (21 May 2021) amounted to 296,548, which represents around 57.7% of the total population in Malta (estimated at 514,564 in 2020).

3.3 Government consumption

The forecast profile for real government consumption shows a deceleration in its growth rate from the double-digit rates recorded between 2018 and 2020, to 5.6% in 2021. Although in 2020 the strong expansion was conditioned by the higher pandemic-related health expenditure, even in earlier years, government consumption grew rapidly.²⁶ The fiscal outlook differs from the historical pattern also in relation to the other forecast years. In 2022, real government consumption is expected to decline by 3.2%, whereas in 2023 and 2024, the estimated growth rates are respectively limited to 1.9% and 1.3%.

The significantly lower, or even negative, growth scenario (at constant prices) for government consumption reflects the temporary expenditure base effects caused by the pandemic, as well as an element of expenditure restraint.²⁷ The factors explaining such outlook can be traced to the specific budgeted amounts for the items which make up government consumption.²⁸ The caveat is that such data is only available in nominal terms. However, given that the growth rate in the deflator for government consumption is broadly stable throughout the forecast horizon, developments in real and nominal government consumption follow a similar pattern.

The budgeted allocations underpinning the USP lead to an estimated 8.2% growth in nominal government consumption in 2021, compared to the 17.6% nominal growth recorded a year earlier (see Chart 3.5).^{29,30} This slowdown reflects the smaller expected increment in intermediate consumption. In turn, this is consistent with the smaller increase in requirements caused by the assumed evolution of the pandemic.

²⁶ Not all expenditure related to the pandemic is classified as government consumption. For example, the wage subsidy scheme does not form part of government consumption.

²⁷ New initiatives are undertaken every year. However, these are normally announced the year before (in the Budget Speech), or else during the year in progress. Hence information about fiscal initiatives applicable for the outer years is generally not available. This is another reason for the tendency to show subdued growth forecasts for government consumption in the outer years.

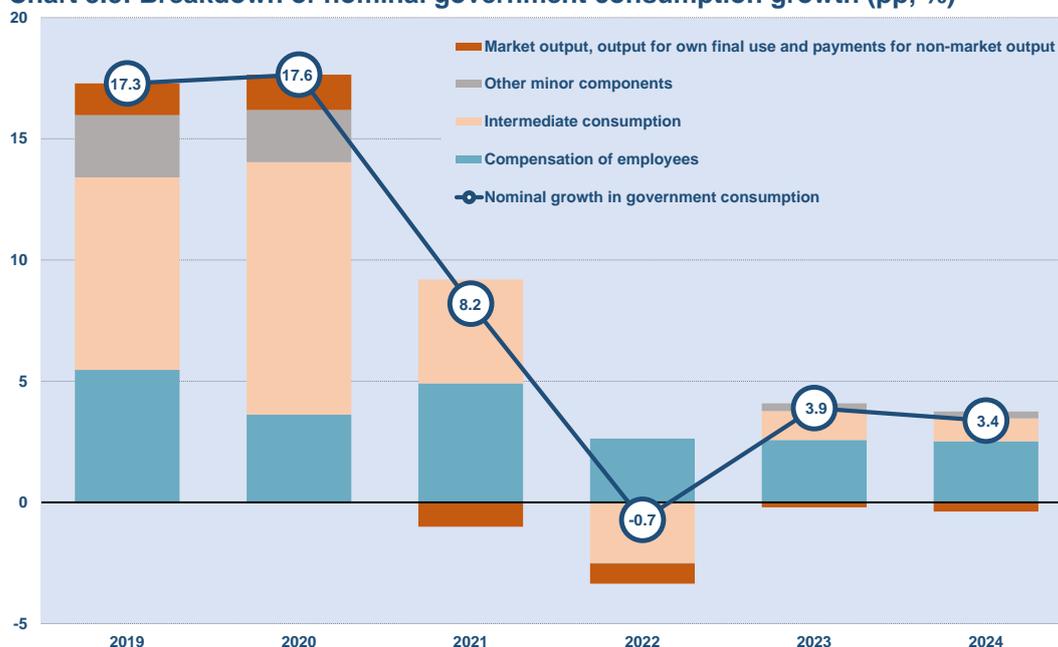
²⁸ Refer to Chapter 5 in this Report for an assessment of the forecast trajectory for the relevant budget components.

²⁹ The nominal growth rates in government consumption for 2020 and 2021 which are quoted in the text are consistent with the updated fiscal data used by MFE in the preparation of the USP and which are assessed in chapter 5 of this Report. The growth rate for 2020 is not identical to that indicated in the GDP statistics published by NSO through News Release 040/2021. Since the macroeconomic forecasts are finalized before the detailed fiscal forecasts, Table 2.1 of the USP quotes the slightly different nominal growth rates for government consumption in 2020 and 2021, respectively, 18.5% and 7.9%.

³⁰ The heading “other minor components” referred to in the chart includes social transfers in kind and consumption of fixed capital.

The expected higher market output in 2021 also lowers government consumption.³¹ These effects are partially compensated for by the slightly higher upward push due to the larger allocation for the public sector's wage bill.³²

Chart 3.5: Breakdown of nominal government consumption growth (pp, %)



Source: MFAC calculations

In 2022, nominal government consumption is forecast to decline by 0.7% on a year earlier. This pattern is based on the premise that the additional amount budgeted on compensation of employees (albeit rising at a slower pace than in 2021), is fully offset by the reduction in intermediate consumption (due to the non-repetition of pandemic-related expenditures), as well as the downward drag created by market output (since it is expected to be higher than in the previous year).³³

Subsequently, in 2023 and 2024, the forecast growth in nominal government consumption is contained to below 4.0% per annum. The expansion in the budget allocation for compensation of employees is roughly stable, while that for intermediate

³¹ 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 USP assumes that in 2021 the total for these items will be more than in 2020, this corresponds to a deduction of a larger value, thus explaining the downward push to government consumption resulting from these sources. This pattern contrasts with that recorded in 2019 and 2020 when the falling amount of market output raised the growth in nominal government consumption.

³² This includes not only government departments but also the employees of the entities classified as Extra-Budgetary Units (EBUs).

³³ The USP assumes that the COVID-19 vaccine does not need to be administered on a recurrent annual basis.

consumption envisages a return to limited growth.³⁴ The forecast profile for the remaining components within government consumption does not exert a significant impact on the overall pattern for the period 2023 to 2024.

The average growth in nominal government consumption over the forecast horizon is below that recorded during the pre-pandemic years. This gives rise to a possible upside risk for the government consumption growth profile over the forecast horizon, in the absence of specific factors contributing to the change in trend compared to recent patterns. Further upside risks could result if market output turned out lower than included in the fiscal projections.

3.4 Gross fixed capital formation

The 4.5% contraction (in real terms) in investment is expected to be fully reversed in 2021. Indeed, the USP states that “based on communications with key stakeholders, several investment projects which were put on hold during 2020, due to uncertainty, have resumed course”. At constant prices, gross fixed capital formation is forecast to rise by 9.2% in 2021. An even larger expansion, 12.5%, is anticipated in the following year. On the other hand, the forecast growth rates for 2023 and 2024 are much lower, respectively at 3.6% and 3.2%.

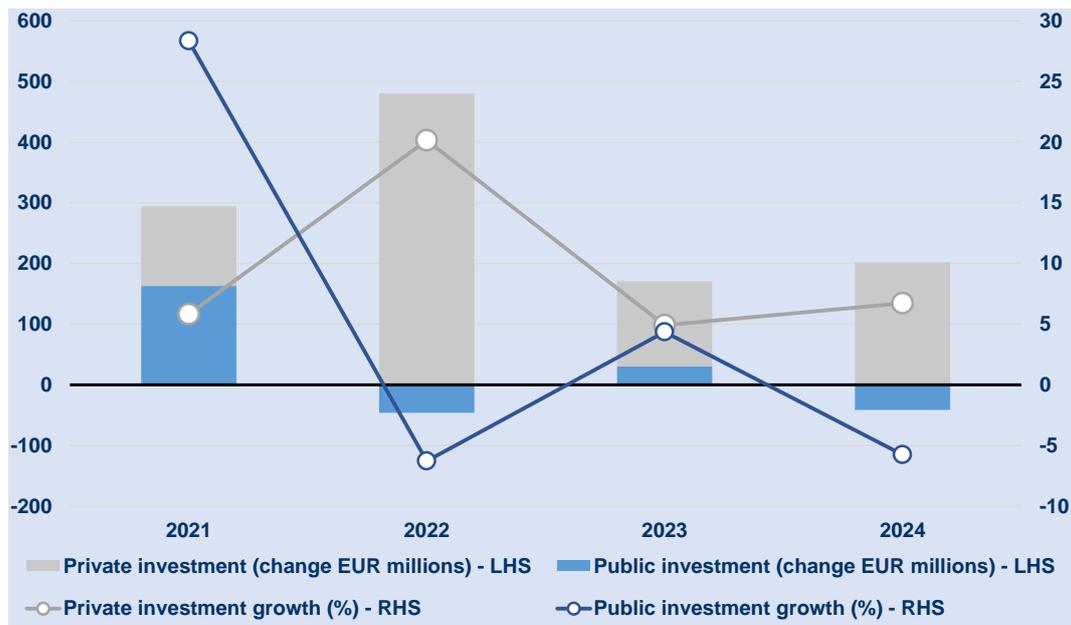
Information about investment spending in nominal terms suggests that in 2021 the expected increase is broadly equally contributed by the public sector and the private sector (see [Chart 3.6](#)).³⁵ Although public investment accounts for approximately one-fifth of total investment, in 2021 it is expected to grow at a double-digit rate, which is approximately five times faster than envisaged for private sector investment. The strong momentum in public investment extends the rapid growth recorded pre-pandemic as well as during 2020. In relation to private sector investment, the forecast growth rate mostly reverses the drop caused by the pandemic the year before.

³⁴ The budget allocation for intermediate consumption tends to be more volatile than compensation of employees because this component is more discretionary.

³⁵ Since the forecast growth in the deflator for gross fixed capital formation is broadly stable, slightly higher than one percent in each year, and identical for both the public and private sector, the general patterns indicated by the nominal outlays apply for the developments at constant prices.

In contrast, the 2022 forecast growth in total investment is mainly driven by the expectation of very strong private investment. The acceleration in private investment builds on the commencement of numerous projects in the pipeline as investor sentiment is restored. This compensates for the slightly smaller budget for public investment for 2022, following the significantly higher allocation for 2021.

Chart 3.6: Public and private sector investment in nominal terms



Source: MFE

The expected moderation in total investment growth in 2023 reflects different paths for public and private investment. The former is forecast to rise after a fall, whereas the latter is expected to decelerate after a surge. A similar rate of growth in total investment growth is then expected to be repeated in 2024. In this case, a slightly higher growth forecast for private sector investment offsets the reduction foreseen in the public investment budget.

Gross fixed capital formation has exhibited significant swings in recent years, where even pre-pandemic, negative growth rates have at times been recorded by the public and private sector. This makes it challenging to achieve accurate forecasts for this GDP expenditure component especially within the context of a small open economy. However, the high import content for investment which is assumed by MFE reduces the risk that forecast errors in this component spill onto the overall GDP growth forecast.

The investment growth forecast over the period 2021 to 2024 is built on completely different expected trajectories for the public and private sector components. The public investment profile embodies the information about the utilisation of the RRF funds, as well as the yearly plans for other domestically financed investment.³⁶ Different timings and magnitudes of the outlays involved can explain the swings exhibited in the public investment forecasts. The forecast trajectory for private sector investment is relatively smoother, shaped by the expectation of a recovery in 2021, further strengthening in 2022, and moderation in the period 2023 to 2024. This pattern builds on the premise that the shock to investment will be absorbed within a year and the gradual return to normality will stimulate further growth, particularly since some large sized projects are in the pipeline.^{37,38} The subsequent moderation in private sector investment in the outer two years partly reflects the conservative approach adopted by MFE. This element of prudence also allows for the possibility that progress on certain large investments may deviate from plans.

3.5 Exports of goods and services

Compared to the other GDP components, exports suffered the largest contraction in 2020, dropping by 7.8% in real terms. This is expected to be partially recovered in 2021, as the volume of exports is set to rise by 5.1%. Further acceleration, to 6.9%, is anticipated in 2022. Export growth is then expected to moderate, but remain high, respectively at 4.6% in 2023 and 4.2% in 2024.

The forecast profile for exports accounts for the assumed developments in Malta's main trading partners. However, Malta's swing in exports between 2020 and 2021 is expected to be larger (the 2020 drop in Malta's exports was slightly more than in foreign demand, and this base effect paves the way for the possibility of a slightly higher

³⁶ Refer to chapter 5 in this Report for the analysis of public sector investment expenditure forecast.

³⁷ Information derived from the CBM business dialogue reports that during the first quarter of 2021, 69% of respondents reported that investment plans continued as scheduled, while the share of contacts claiming that they postponed, or paused, their investment plans and adopted a 'wait-and see' approach broadly halved compared to the previous quarter, to 13%. For further details refer to <https://www.centralbankmalta.org/site/Publications/CBM-Business-Dialogue-Vol-1.pdf?revcount=2361>.

³⁸ A survey by the European Investment Bank (EIB) indicated that only 35% of firms in Malta planned to abandon or delay at least some of their investments as a result of COVID-19 (same as the EU average), while a further 15% planned to continue with a reduced scale/scope (similar to the EU average). The full report is available on <https://www.eib.org/en/publications/flip/eibis-2020-malta/#p=7>.

rebound in exports than in foreign demand in 2021). This pattern is consistent with the regression estimations which suggest that Malta's exports (for various categories) tend to have a higher than unitary elasticity with respect to real GDP developments in Malta's main trading partners.³⁹

The assumed euro exchange rate plays a limited role in shaping the export growth profile. In 2021, there is an offsetting effect from the assumed strengthening of the euro against the US dollar and the weakening against sterling. In turn, the other years show minimal exchange rate movements.

The slight easing of export growth in 2023 and 2024 is mostly explained by the assumption of slower growth in foreign demand. However, Malta's exports are still envisaged to gain market share, by expanding faster than foreign demand.

Almost every sector is expected to register increased activity in 2021 (in some cases, this follows good performance even in 2020). The remote gaming sector is expected to continue registering positive robust growth, thereby contributing the bulk of export growth for the year. On the other hand, during 2021, the improvement in exports driven by tourism is limited. This in line with the assumption that in 2021 the total tourist numbers will only amount to around 30.0% of the 2019 levels. In the first half of 2021 tourism is expected to be at very low levels, with modest growth anticipated for the third quarter, and a strong recovery in tourism only expected in the final quarter.

Remote gaming and tourism account for most of the forecast growth in exports over the period 2022 to 2024. The upbeat performance expected for the remote gaming sector is based on the sector's positive track record in recent years. Indeed, the outlook for the sector remains positive.⁴⁰ In the case of tourism, the scenario chosen by MFE as the baseline is that in 2022 tourism reaches 75% of the level in 2019. The percentage then rises to around 90% in 2023 and 100% in 2024.

³⁹ The report describing STEMM states that “the elasticity of world GDP on sectoral exports is relatively high when compared to literature, exacerbating the response of exports to changes in foreign demand”. The Report is available on: <https://finance.gov.mt/en/epd/Pages/Library.aspx>.

⁴⁰ The Interim Performance report published by the Malta Gaming Authority (MGA) in December 2020 notes that notwithstanding the challenges posed by the COVID-19 pandemic, “on balance, it appears that the outlook for the gaming sector in Malta is one which promises continued growth”. The report is available on <https://www.mga.org.mt/wp-content/uploads/Interim-Performance-Report-2020.pdf>.

This gradual return to pre-pandemic levels in tourism is consistent with global consensus which suggests that the recovery in tourism worldwide may take years. A factor which may condition the number of tourists coming to Malta is the share of individuals who opt for domestic tourism instead of international travel, particularly until health concerns are dissipated, and social distancing and travel measures are eased. The pace at which vaccination is administered not only in Malta but also in other countries is thus a key element shaping the speed of recovery in tourism.

The non-repetition of the disruptions caused by strict border controls and temporary shutdowns should pave the way for better export prospects.⁴¹ Indeed, the forecast profile for exports depends on the assumed pace at which other countries manage to return to normality, even if the pandemic is still underway, and the extent to which growth can be sustained post-pandemic. The expectation of rising market share, although consistent with recent trends, may also become increasingly difficult to attain, especially in view of the possible shift towards more onshoring.⁴²

3.6 Imports of goods and services

The forecast growth profile for real imports differs between the first two years and the subsequent two years. Indeed, 2021 and 2022 are characterised by high import growth rates, respectively at 5.9% and 5.8%. Thereafter, in 2023 and 2024, real growth is expected to moderate to 3.5% and 3.3%, respectively.

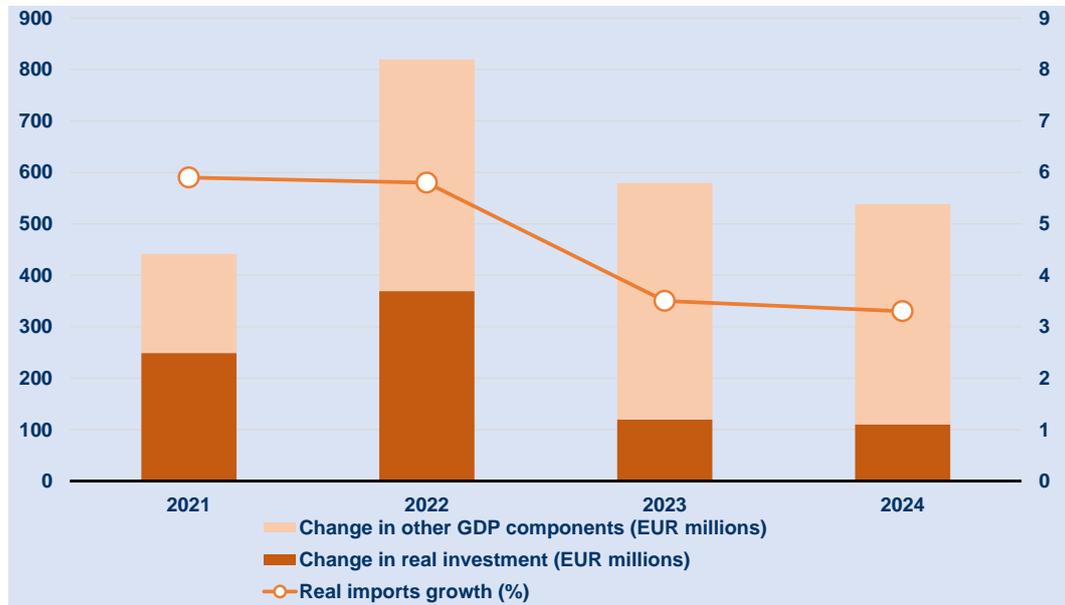
The forecast trajectory for imports reflects the anticipated dynamics in domestic demand and exports together with their assumed import content. In 2021 and 2022, the forecast change in real investment accounts for approximately half of the expected increase in real GDP over these two years (see Chart 3.7). Since investment is assumed to have a very high import content, more than 80% in many cases, this factor leads to very strong demand for imports, primarily in the form of capital goods. As the yearly change in real GDP attributed to investment is then expected to diminish, this factor explains the forecast deceleration in import growth in 2023 and 2024. The

⁴¹ The Central Bank of Malta business dialogue reported that companies had faced challenges in their supply chains. Available on <https://www.centralbankmalta.org/en/news/88/2021/8930>.

⁴² Onshoring refers to the sourcing or relocating a business' production operations within domestic national borders. This may be driven by greater level of protectionism, as well as companies wanting to make their supply chains less vulnerable to problems in logistics created by major crisis, such as what has happened with the pandemic.

anticipated yearly composition of GDP growth thus plays a key role in shaping the outlook for import growth, something which is a recurring feature in the Maltese economy.

Chart 3.7: Developments in real GDP components and imports



Note: The bars indicate the absolute yearly changes. Other GDP components refer to the aggregate of real private consumption, government consumption and exports, net of imports.

Source: MFE

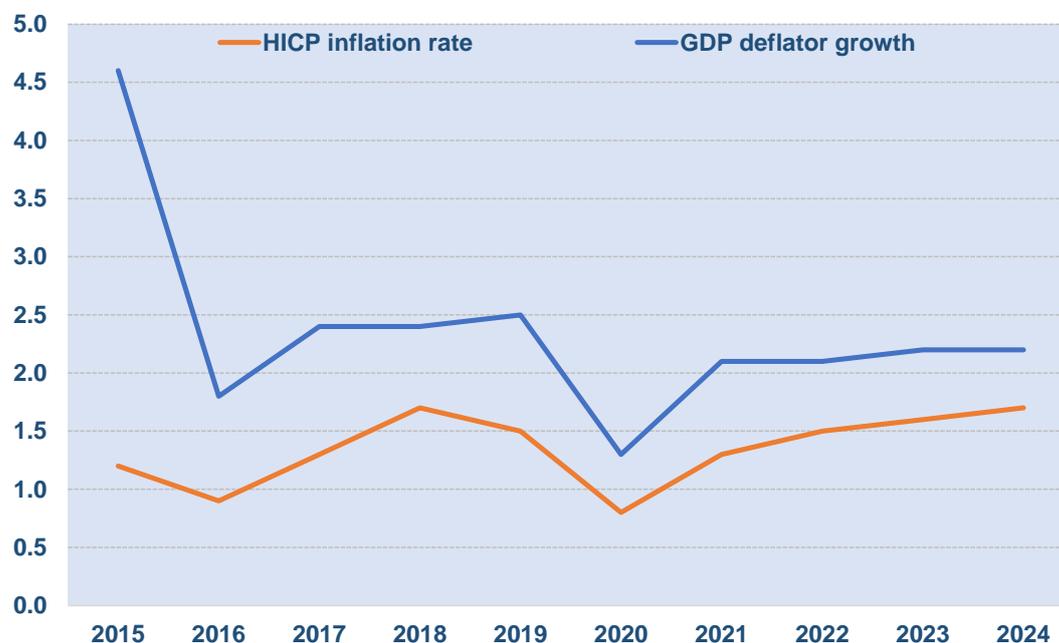
3.7 Inflation and GDP deflators

In 2020, the HICP inflation rate amounted to 0.8%, which was the lowest since 2014. Throughout the forecast horizon, inflation is forecast to remain below 2.0%, in line with the previous years' pattern (see Chart 3.8). However, inflation is expected to gain some momentum, climbing to 1.7% by 2024.

The projected pick-up in inflation is front-loaded to 2021. The 1.3% inflation forecast for 2021 follows the assumptions of higher oil prices and a rebound in world prices for this year. The subsequent further slight acceleration in inflation is compatible with the outlook of a gradual recovery in demand (consumption and tourism) over the forecast horizon. The expected wage dynamics exert limited impact on inflation, as the average compensation per employee is forecast to rise at a slower pace than in pre-pandemic years. Even imported inflation is limited since the assumed trajectory for growth in

world prices from 2022 onwards is decelerating while the assumed exchange rate movements over these years are minimal.

Chart 3.8: HICP inflation rate and GDP deflator growth (%)



Source: MFE

The annual forecast growth in the GDP deflator is marginally higher than the HICP inflation rate, settling just above 2.0% in each year. The forecast for the GDP deflator thus maintains a broadly stable gap between the two measures, extending the same pattern recorded earlier. The deflators for the various GDP components all exhibit low growth throughout the forecast horizon. In fact, all deflators are expected to grow by less than 2.0% annually, except for the government consumption deflator whose forecast growth rate is slightly higher. Export prices are projected to rise faster than import prices in all years, implying a consistent small improvement in the terms of trade between 2021 and 2024, replicating the pattern recorded since 2013.⁴³

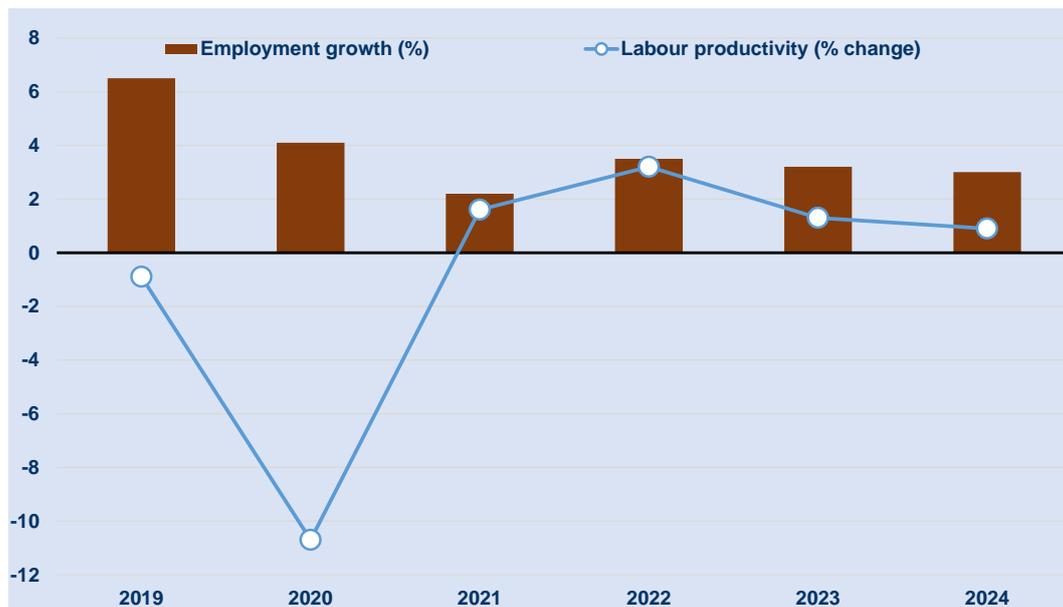
3.8 Labour market

Despite the adverse economic shock recorded in 2020, employment rose by a further 4.1% on a year earlier (see Chart 3.9). Higher employment was recorded across all sectors. Three factors are likely to have contributed to such positive outturn. The broad-

⁴³ The faster growth in export prices than in import prices may be due to the changing orientation of the economy towards higher-priced exports.

based wage support schemes offered by the government enabled businesses to maintain their employee headcount, despite the much lower demand. At the same time, the administrative procedures to be eligible for government assistance could have contributed to improve the representativeness of labour statistics, yielding an upward revision in the number of jobs. Some operators have also expanded their workforce to meet the higher demand for specific goods and services induced by the pandemic, compensating for declines in other sectors.

Chart 3.9: Employment growth and labour productivity (%)



Source: MFE

Notwithstanding the increase in the number of jobs, similar to the other EU Member States, even in Malta there was a reduction in the total number of hours worked (in seasonally adjusted terms) throughout each quarter of 2020 (see Chart 3.10).⁴⁴

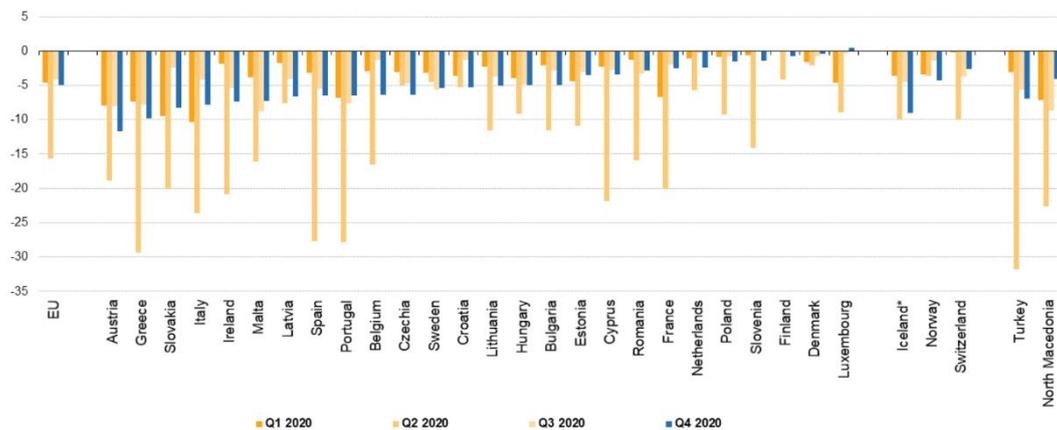
The employment forecast extends the pattern of job-rich growth, but less strongly than in previous years. As the economy recovers, employment is thus projected to rise by 2.2% in 2021 and grow at an average of 3.2% in the subsequent three years.

In 2020, the retention of employees and the reduction in working hours lowered labour productivity (measured as real GDP per person employed) by 10.7%. According to MFE’s calculations, labour productivity is expected to start recovering, improving in

⁴⁴ The chart is reproduced from https://ec.europa.eu/eurostat/statistics-explained/images/8/8e/Q4_Quarterly_change_in_total_actual_hours_worked_in_the_main_jobs_by_country%2C_Q1-Q4_2020_compared_to_Q4_2019.png.

each year from 2021 onwards. This scenario is based on the expectation that the rise in real GDP will be faster than that in employment, as firms seek to re-establish labour productivity and resume their normal working hours.

Chart 3.10: Quarterly change in hours worked in the main job by country
Q1-Q4 2020 compared to Q4 2019
 (% , age group 20-64, seasonally adjusted)



Note: No data available for Q1, Q2, Q3 and Q4 2020 for Germany, Montenegro and Serbia.
 *Break in time series for Q4 for Iceland

eurostat

Source: Eurostat

Notwithstanding some repatriations (particularly of Third Country Nationals), labour supply continued to expand in 2020.⁴⁵ As a result, despite the higher employment, the unemployment rate rose slightly, from 3.6% in 2019, to 4.3% in 2020 (see Chart 3.11). This temporary increase is expected to be corrected gradually. The unemployment rate is estimated to remain stable in 2021 and then start falling from 2022. By 2024, the unemployment rate is forecast to decline to 3.7%, which is comparable to the rate which prevailed pre-pandemic. This improvement builds on the expectation that labour demand grows slightly faster than labour supply, particularly as the latter is assumed to expand at a slower rate than pre-pandemic.

The resilience of the job market portrayed in the USP is consistent with the assumption that the economy will shift onto a path to recovery in 2021 which is sustained thereafter. It is also based on the premise that the phasing out of the temporary wage support initiatives (which are budgeted up to end 2021) would not generate any material

⁴⁵ A press release issued by the Ministry for Foreign and European Affairs on 9 April 2020 indicated that 4,206 individuals were repatriated over the previous three weeks through the voluntary assistance repatriation schemes. Source: <https://www.gov.mt/en/Government/DOI/Press%20Releases/Pages/2020/April/09/pr200644.aspx>.

repercussions on the labour market, as it is assumed that business conditions would have improved by then.

Chart 3.11: Unemployment rate (%)



Source: MFE

3.9 Potential output and the output gap

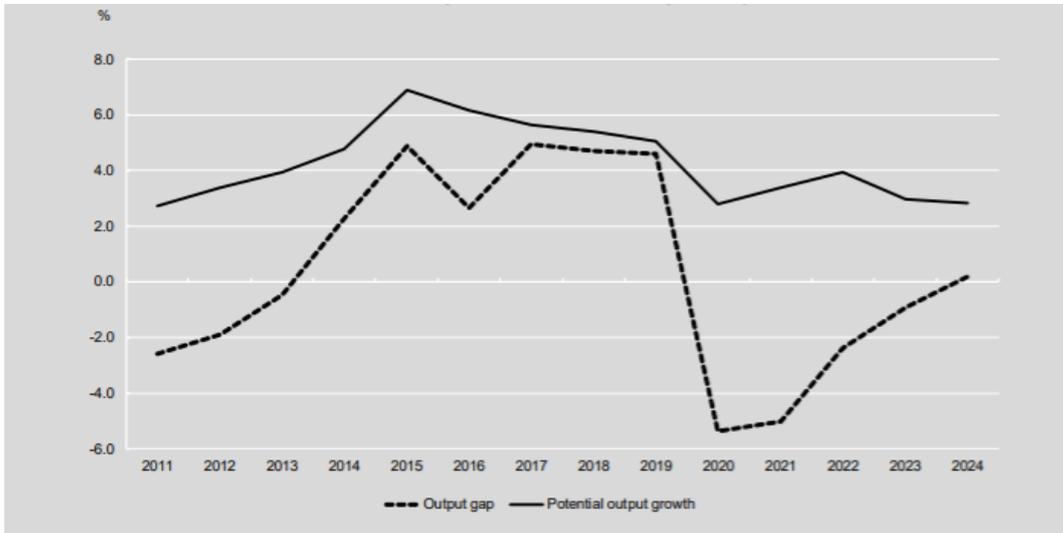
Potential output and the output gap are estimated by MFE using the commonly agreed methodology across the EU.⁴⁶ This is based on the production function approach, with growth driven by labour, capital, and total factor productivity. In 2020, potential output growth is estimated to have decelerated to 2.8%. This was a larger change compared to the small downward trend observed since its peak in 2015 (see Chart 3.12). This pattern is projected to be partially reversed. The estimated potential output growth is thus set to accelerate to 3.4% in 2021, and 3.9% in 2022. Subsequently, potential output growth is projected to stabilise around 3.0% per annum, which is slower than the rates calculated for the five years prior to the pandemic.

Up until 2022, the expansion in labour supply is expected to contribute most to the growth in potential output, extending the pattern observed in previous years (see Chart

⁴⁶ For further details refer to https://ec.europa.eu/economy_finance/publications/economic_paper/2014/ecp535_en.htm.

3.13). On the other hand, in view of the anticipated slowdown in labour supply growth, capital accumulation is expected to contribute a slightly higher share in 2023 and 2024.

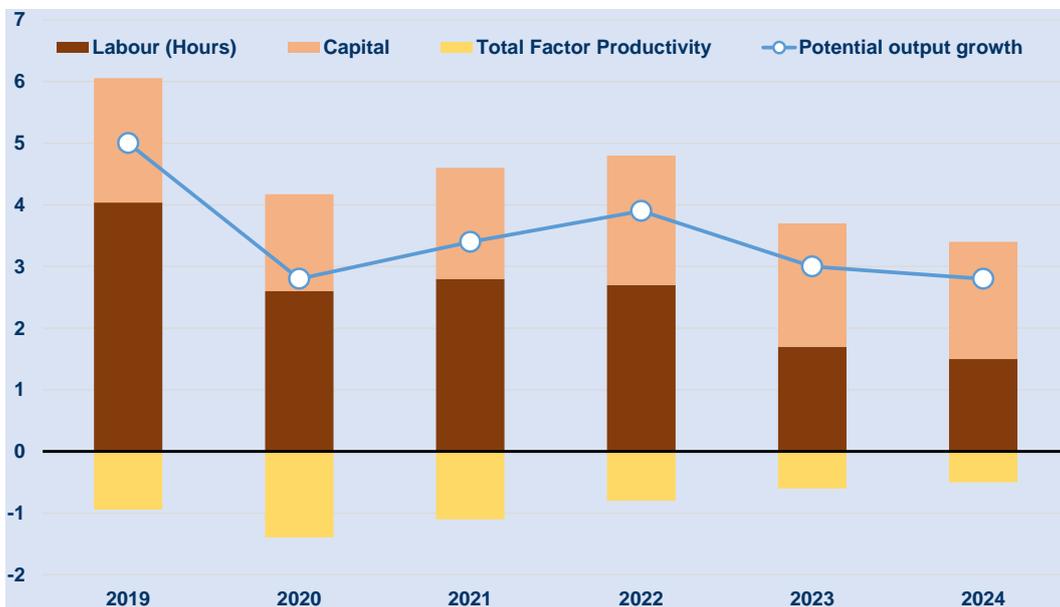
Chart 3.12: Potential output growth and output gap estimates (%)



Note: Reproduced from the USP Chart 2.2, page 25.

Source: MFE

Chart 3.13: Sources of potential output growth



Source: MFE

Throughout the forecast horizon, developments in total factor productivity are on the contrary expected to contribute negatively to potential output growth.⁴⁷ Such pattern has been observed in Malta since 2018 but was most pronounced in 2020. The forecast scenario extends the drag on resource productivity, albeit to a smaller extent, than has been calculated for recent years.⁴⁸

The start of the pandemic pushed the economy below potential in 2020, in contrast with the positive output gap which was recorded since 2015.⁴⁹ The output gap swung to -5.4% of potential output in 2020 and is expected to remain negative, at around that level, even in 2021. This mirrors the subdued aggregate demand conditions created by the pandemic, as manifested through the fall in real GDP in 2020, and the incomplete recovery in 2021. However, starting from 2022, the correction process is expected to initiate, such that by 2024 the output gap is expected to be closed off completely. This calculation builds on the expected recovery in aggregate demand against a background of slower growth in potential output than in pre-pandemic years. It also builds on the pattern of cyclical fluctuations which countries normally pass through.⁵⁰

3.10 Macroeconomic risk outlook

In view of the significant uncertainty which continues to prevail in relation to the possible short-term and medium-term economic effects of COVID-19, the MFAC's macroeconomic risk outlook focuses on the expected profile for each real GDP component over the entire forecast horizon, rather than on the yearly growth rates

⁴⁷ Total factor productivity (TFP) (also referred to as Solow residual) is a measure of productive efficiency in that it measures how much output can be produced from a certain amount of inputs. For relatively small percentage changes, the rate of TFP growth can be estimated by subtracting growth rates of labour and capital inputs from the growth rate of output. A negative TFP indicates that potential output growth is lower than can be attributed to the accumulation of labour and capital.

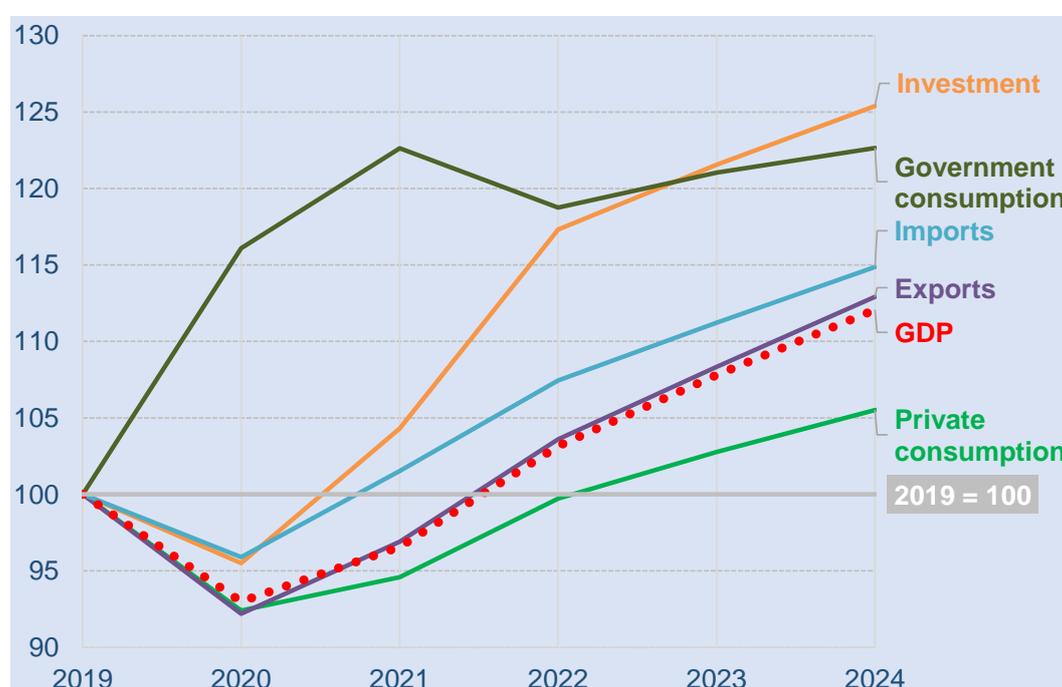
⁴⁸ Instances of lower resource productivity may happen when the accumulation of labour input has a lower stock of human capital, or when firms engage in labour hoarding, that is, employing more workers than justified by the level of demand.

⁴⁹ A positive output gap means that the economy was operating above potential.

⁵⁰ Business cycle theory suggests that countries pass through periods of economic expansion, recession, trough, and recovery. Stated differently, years of above potential output are followed by years of below potential output, with the gap opening, or closing off, slowly. However, the length and amplitude of the cycle are not necessarily the same as in previous cycles.

separately (see Chart 3.14).⁵¹ The macroeconomic forecasts are very sensitive to the assumptions employed, especially in relation to the timing and speed of the recovery from the pandemic. Any material departure from such assumptions could deviate the outturn, possibly significantly, from those presented in the official forecasts.⁵² The USP explicitly acknowledges that “the medium-term outlook beyond 2021 represents primarily a tentative no-policy-change projection”. Hence, assessing the plausibility of the forecast profile for the index worked out for the different real GDP components as at 2024, relative to that recorded in 2019 (pre-pandemic), is considered more appropriate than focusing on each year in isolation.⁵³

Chart 3.14: Index for the real GDP components 2019 – 2024 (2019 = 100)



Source: MFAC calculations

All the real GDP expenditure components which suffered a significant hit in 2020 are predicted on a path to recovery in 2021.⁵⁴ Investment and imports are associated with

⁵¹ The MFAC adopted this approach for its risk assessment since the start of the pandemic, that is, from the assessment of the macroeconomic forecasts produced in April 2020 as part of the USP 2020 – 2021.

⁵² For example, should the economic recovery start later than anticipated, lower growth in one year could possibly be compensated through higher growth in the subsequent year.

⁵³ The index is calculated by cumulating the yearly growth rates for each variable. Setting the starting point for each variable at 100, which corresponds to the respective level in 2019, allows for an easier visualization of the speed of recovery. Full recovery takes place when the index exceeds 100.

⁵⁴ This corresponds to what has been termed as the “V-shaped” recovery, which is the scenario where the initial drop (in 2020) is followed by a pick-up (with no further declines), albeit not necessarily full within the first year after the initial shock.

a more than full recovery within a year, since both variables are forecast to surpass their pre-pandemic level already in 2021 (index exceeding 100). On the other hand, exports and private consumption are anticipated to take longer to compensate for the 2020 downturn. This recognises the fact that exports and private consumption experienced the largest shocks when the pandemic hit. In both cases their fall was in the region of 8.0%.

Over the period 2021 to 2024, the USP envisages the most optimistic progress for investment. Indeed, this variable is expected to reach 25.4% above its level in 2019. Over the same period, the second highest expansion is foreseen for government consumption. However, in this case the pattern is front-loaded due to the upward spike which has already taken place in 2020. Otherwise, over the four-year horizon, the cumulated forecast growth in government consumption is limited. On the other hand, the forecast profile for private consumption depicts the smallest expansion compared to 2019. This acknowledges the possibility that the pandemic could lead to changes in households' spending patterns, such as by encouraging greater precautionary saving, or else by changing consumption habits. As a result, exports are expected to outpace consumption over the forecast horizon, despite both variables having suffered a shock of comparable magnitude in 2020. This builds on the premise that trade will revert quicker to previous trends.

The combined prospects for domestic demand and exports pave the way for a smooth increase in imports over time. Investment is the prime upside driver to import growth in view of its very high import intensity. On the other hand, private consumption is expected to impact imports in a more limited way, since the forecast change in consumption over the years is more limited.

Overall, according to the baseline scenario, the output loss in 2020 is anticipated to be recovered, in level terms by 2022, and by 2024 real GDP is forecast to reach 12.1% above its 2019 level. The 4.8% average growth in real GDP between 2021 and 2024, which is lower than the 5.7% average growth recorded over the four-year period 2016 to 2019, makes room for the possibility of a deceleration in economic growth post-pandemic.

The conservative forecast for private consumption, to the extent that by the end of the forecast horizon its profile lags the expected recovery in GDP, provides room for an upside risk associated with this variable (i.e. it offers the possibility that the variable

turns out higher than anticipated) (see Table 3.2).⁵⁵ This upside risk appears most pertinent to 2021, particularly when benchmarked against the more upbeat consumption forecasts published by the COM and CBM.

Table 3.2: Summary of risks to the GDP expenditure components

| | 2021 – 2024 |
|--|-------------|
| 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

Another upside risk is associated with government consumption. In this case, the forecast horizon envisages a growth profile in the outer years which is much more subdued than experienced pre-pandemic. The fact that government consumption had expanded at double digit-growth rates already in 2018 and 2019 suggests that this component tended to grow rapidly, irrespective of the pandemic. In this case, the upside risk appears more pertinent for the period 2022 to 2024, since the forecast growth dynamics over these years imply a sudden break from the trend observed over the previous years, without any announced policy change to support such development.

On the other hand, it may be challenging to achieve the rapid growth anticipated in investment, especially if delays take place. The downside risk to investment emanates principally due to the MFE's rather optimistic perspective that a large number of large-scale investment plans made prior to the pandemic will resume. Furthermore, the materialisation of some large investments may be uncertain, as plans are still at the

⁵⁵ The ratio of real consumption to real GDP would fall from 47.1% in 2020, to 44.6% in 2024.

initial stages, and the pandemic might derail plans. Moreover, the absorption rate of RRF grants, which according to the USP are all earmarked for investment, is subject to further uncertainty, given that this instrument has just been launched and hence there is no prior experience with which to gauge. Overall, the downside risk to investment appears most pertinent for 2021 and 2022, since these years are associated with the highest forecast growth rates.

The expected profile for exports faces a neutral risk outlook. Export forecasts appear to adequately balance the possible upside and downside considerations. In particular, the fact that the USP assumes a road to recovery in tourism which is prolonged embeds a reasonable degree of prudence. On the other hand, the resilience of key export sectors embodied in the forecasts (such as remote gaming) is supported by the good performance recorded by these companies both before and during the pandemic.

The interplay of the upside risk to private consumption and government consumption and the downside risk to investment suggests offsetting impacts over the forecast horizon. This leads to a neutral risk outlook for both imports and GDP.⁵⁶ The neutral risk outlook for real GDP is also supported by the observation that the range of real GDP forecasts by other institutions encompasses the baseline scenario presented in the USP.⁵⁷

⁵⁶ Investment has a much higher import content than private consumption and exports, thereby balancing the opposing forces.

⁵⁷ Refer to Chapter 4 in this Report for the comparison with respect to the others sets of macroeconomic forecasts.

Chapter 4

Comparison across different macroeconomic forecasts

4.1 Introduction

The plausibility of the macroeconomic scenario presented in the USP can be further assessed by comparing it to the outlook presented in the DBP 2021 (previous round) and then tracing the new information which could justify the direction of the revisions carried out. A further check is possible by examining the similarity or otherwise with respect to the macroeconomic forecasts for Malta which are produced by other institutions, namely the COM, CBM, International Monetary Fund (IMF), and the three main credit-rating agencies (Fitch, Moody's and S&P). One can verify whether the official forecasts fit within the range of available estimates, or else, whether they stand out as outliers.

The caveat is that the suite of forecasts is not necessarily perfectly comparable, due to different information available at the time of preparation. The scenarios considered may also be different, such as in relation to the severity and duration of the effects of the pandemic. Different assumptions and methodologies can be other sources of discrepancy. Nonetheless, the MFAC considers such comparisons as a valid benchmark to support the assessment carried out in Chapter 3.

4.2 Comparison with the DBP 2021

According to the USP, in 2021, the rebound in real GDP is expected to be more moderate than envisaged in the DBP (see Table 4.1). Indeed, the USP adjusted the real economic growth down by 1.2 pp compared to the outlook which was presented in the DBP. The USP foresees a slower path to recovery, as further spread of the pandemic resulted in more restrictions to local and foreign economic activity during 2021, than had been anticipated in the October forecast round. Both forecast vintages employed the identical assumption of zero contribution to growth from inventory changes for 2021. Therefore, the inventory component is not linked to the change in the economic outlook.

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

| | 2021 | | | | 2022 | | |
|-------------------------------|--|-------------|------|------|-------------|------|-----|
| | DBP | USP | COM | CBM | USP | COM | CBM |
| | <i>Growth rate in GDP components in real terms</i> | | | | | | |
| Private consumption | 3.7 | 2.4 | 4.4 | 4.7 | 5.4 | 5.8 | 5.4 |
| Government consumption | -1.2 | 5.6 | 6.2 | 0.3 | -3.2 | -2.2 | 1.2 |
| Gross fixed capital formation | 7.5 | 9.2 | 8.5 | 17.5 | 12.5 | 10.1 | 4.9 |
| Exports of goods and services | 5.5 | 5.1 | 5.2 | 5.0 | 6.9 | 5.7 | 5.3 |
| Imports of goods and services | 4.5 | 5.9 | 6.0 | 6.1 | 5.8 | 4.8 | 4.3 |
| Real GDP | 5.0 | 3.8 | 4.6 | 5.0 | 6.8 | 6.1 | 5.5 |
| | <i>Contributions to real GDP growth</i> | | | | | | |
| Domestic demand (pp) | 3.3 | 4.5 | 5.2 | 6.0 | 4.9 | 4.4 | 3.9 |
| Inventories (pp) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net exports (pp) | 1.7 | -0.7 | -0.6 | -1.0 | 1.9 | 1.7 | 1.6 |
| | <i>Deflators</i> | | | | | | |
| Private consumption | 1.1 | 1.4 | - | - | 1.5 | - | - |
| Government consumption | 2.4 | 2.2 | - | - | 2.5 | - | - |
| Gross fixed capital formation | 1.2 | 1.1 | - | - | 1.3 | - | - |
| Exports of goods and services | 1.1 | 1.3 | - | - | 1.4 | - | - |
| Imports of goods and services | 1.1 | 0.8 | - | - | 1.1 | - | - |
| GDP | 1.4 | 2.1 | 1.6 | 1.7 | 2.1 | 2.0 | 1.8 |
| | <i>Other macroeconomic variables</i> | | | | | | |
| Inflation rate (HICP) | 1.3 | 1.3 | 1.2 | 0.0 | 1.5 | 1.5 | 1.4 |
| Employment growth* | 2.3 | 2.2 | 1.1 | 0.5 | 3.5 | 1.9 | 2.2 |
| Unemployment rate | 4.0 | 4.3 | 4.3 | 4.3 | 3.9 | 3.8 | 4.2 |
| Compensation per employee | 2.3 | 1.2 | 2.5 | 0.9 | 2.1 | 3.0 | 2.6 |

Note: Figures by the COM were published as the Spring 2021 economic forecasts, while those by the CBM were published in its Annual Report 2020.

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

Sources: MFE, COM, CBM

There has been a complete inversion in the outlook for the net exports component of real GDP. The positive contribution to growth expected from net exports was changed to negative. In fact, the USP lowered slightly the export growth forecast (compatible with the assumption of a stronger euro against the US dollar) and simultaneously lifted the expected growth in imports. The re-appraisal of the import growth forecast, from 4.5% to 5.9% is consistent with the expected additional growth stemming from domestic demand. This reflected the updated higher growth in gross fixed capital formation, as well as a change in the outlook for government consumption growth (based on the updated fiscal plans), from negative to positive. The ensuing expected rise in imports (especially when considering the very high import content associated with certain types of investment) is reasonably expected to more than compensate for the downside effect created by the more muted outlook for private consumption.

The generally low expected price dynamics were retained in the USP. Indeed, there were no major changes to the price forecasts across the two rounds. The forecast for the HICP inflation rate is identical, at 1.3%. However, the increase in the GDP deflator was raised slightly, from 1.4% to 2.1%. This small revision can be traced to the expectation of slightly higher growth in the deflators for consumption and for exports, and the lower growth in the deflator for imports.

Likewise, the prospects for the labour market remained broadly similar across both rounds. Employment is expected to expand by 2.2% in 2021, merely 0.1 pp lower than indicated in the DBP. The unemployment rate forecast was adjusted slightly upwards, from 4.0% in the DBP, to 4.3% in the USP. This is consistent with the downward revision in the forecast real GDP growth for 2021. Meanwhile, the forecast rate of growth in compensation per employee was lowered from 2.3% to 1.2%. This is compatible with the likely absence of wage pressures, as economic activity remains below potential because of the pandemic.

4.3 Comparison with the forecasts produced by other institutions

Detailed macroeconomic forecasts are also published by the COM and CBM.⁵⁸ The COM's forecasts are based on the GDP statistics up to the fourth quarter of 2020 (as published through NSO News Release 040/2021), whereas those by the CBM

⁵⁸ The COM's latest figures relate to the Spring 2021 forecast round published on 12 May, while the CBM's latest forecasts are those published on 13 April in its 2020 Annual Report.

incorporate actual data up to the third quarter of 2020 (as published through NSO News Release 194/2020). Thus, the forecasts by the COM may be considered as more comparable to those in the USP since they were published closer to each other, and therefore based on similar information.

For 2021, the three institutions expect a similar partial recovery in real GDP (see [Table 4.1](#)). Likewise, the three institutions anticipate a strengthening of real GDP growth in 2022. The difference is that the USP presents a slightly more gradual progress, with a slower recovery in 2021, followed by a stronger pick-up in 2022.

There is consensus with regards to the drivers of real GDP growth in 2021 and 2022. For both years, all institutions anticipate growth to be mainly driven by higher domestic demand: in 2021, because external demand is expected to depress growth; and in 2022, because the positive contribution from external demand is not as strong as that from domestic demand. The three institutions also adopted the identical assumption that inventory dynamics exert no material impact on growth.

On the other hand, the outlook for private consumption for 2021 by the COM and CBM is more optimistic than indicated in the USP, although for 2022 the expected growth rates are broadly similar. In relation to government consumption, the MFE and COM both projected a similar pattern of strong growth in 2021, followed by negative growth the year after. In contrast, the CBM's forecast shows slow growth in government consumption in both years, but this can be possibly attributed to the fact that the latest fiscal plans were not available at the time the CBM's forecasts were prepared.

The USP and the COM's forecasts also exhibit a similar pattern for investment, characterised by high growth in 2021, and further acceleration in 2022. In this case, the MFE's numbers are the more optimistic for both years. On the other hand, the CBM's forecasts point towards much stronger growth in investment in 2021, followed by a deceleration in 2022. This difference must be interpreted against the difficulty in forecasting this expenditure component and the consequent higher subjectivity used in the forecasting process. Differences in data which is available to the institutions can also lead to such variations.

The expected trade dynamics are similar across institutions. The growth rates for exports and imports are within a close range. Compared to 2021, in 2022 all institutions expect slightly higher growth in exports and slightly lower growth in imports, though to

a varying extent. Any differences broadly compensate each other, such that the outlook for net exports growth is still broadly similar.

The three institutions expect the inflation rate to remain below 2.0%, with the CBM's forecast indicating the least pressures. The forecast growth in the GDP deflator is also similar, hovering close to 2.0%.

In relation to the labour market, there is consensus that the temporary rise in the unemployment rate which occurred in 2020 will persist in 2021. However, in the subsequent year a material improvement is anticipated by the MFE and COM, but in the case of the CBM, this process is expected to take longer. Some variation is also noticeable in the employment forecasts, as the USP indicates higher growth in jobs than either the COM or the CBM. In the case of the COM, the slower increase in jobs is however compensated for through a higher forecast growth in compensation per employee across both years, than indicated in the USP.

Besides the before-mentioned institutions, the IMF and three main credit rating agencies (Fitch, Moody's, and S&P) publish macroeconomic forecasts for Malta (see Chart 4.1). The available forecasts broadly replicate the pattern for real GDP growth indicated by the USP throughout the period 2021 to 2024.

Chart 4.1: Real GDP growth forecasts by institution (%)



Source: MFE, COM, CBM, IMF, S&P, Moody's, Fitch

The slight difference is that the range of estimates suggest a slightly more front-loaded recovery. The various real GDP growth forecasts concur that the rebound will be insufficient to offset the output drop of a year earlier. However, in broad terms, the expectations cluster around a slightly higher growth in 2021 than indicated in the USP. In turn, for 2022, all institutions expect a slightly lower growth than indicated in the USP. Though the high economic growth is expected to be repeated in 2022, Fitch and Moody's anticipate a slight deceleration on a year earlier, while the IMF and S&P anticipate a slight acceleration. For the period 2023 and 2024, the available forecasts suggest an ongoing benign scenario of between 4.0% and 5.0% real GDP growth in each year.

4.4 Assessment

The revisions for 2021 carried out by MFE in the USP re-confirm the expectation of a partial recovery, which is however more cautious, since the real GDP growth forecast for the year has been lowered. This is also compatible with the downside risk to real GDP growth which the MFAC had identified in its endorsement of the macroeconomic forecasts contained in the DBP (published in October 2020). In turn, the new set of forecasts for the outer years, build on the premise of a full or quasi-complete return to normality starting from 2022, with the additional boost to growth that this entails. The forecasts for 2023 and 2024 anticipate the return to more stable growth rates in the absence of the base effects caused by the pandemic. The fact that all other independently produced forecasts show very similar real GDP growth rates across the forecast period, offers comfort that, based on the information available to date, the USP scenario appears to be the one around which there is broad consensus. This while acknowledging the still inevitable high degree of uncertainty, and the strong dependency of the macroeconomic developments on the progress of the pandemic.

Chapter 5

Assessment of the fiscal forecasts 2021 – 2024

5.1 Fiscal outlook 2021 – 2024

In 2020, the pandemic created a significant adverse effect on public finances, ending the stream of fiscal surpluses which were recorded between 2016 and 2019. The fiscal balance turned into a deficit amounting to 10.1% of nominal GDP in 2020 (see Table 5.1).⁵⁹ Public expenditure is planned to remain higher than revenue throughout the forecast horizon. In 2021, the fiscal deficit is expected to widen, to 12.0% of GDP, but in the following years it is targeted to decline progressively. The plan is to bring the fiscal deficit down to 2.9% of GDP by 2024. The trajectory for the structural fiscal balance over the period 2021 to 2024 broadly follows a similar path as the headline balance, characterised by a deterioration in 2021 and improvements over the next three years.⁶⁰ In 2024, the estimated magnitude of the output gap and temporary factors are very small, and as a result, the structural balance (as percent of potential GDP) is very similar to the fiscal balance (as percent of nominal GDP).

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

| | Total Revenue | Total expenditure | Fiscal balance | Structural balance* | Gross debt |
|------|---------------|-------------------|----------------|---------------------|------------|
| 2019 | 37.2 | 36.8 | 0.4 | -1.9 | 42.0 |
| 2020 | 36.5 | 46.6 | -10.1 | -7.6 | 54.3 |
| 2021 | 36.7 | 48.7 | -12.0 | -9.6 | 65.0 |
| 2022 | 36.6 | 42.2 | -5.6 | -4.5 | 65.8 |
| 2023 | 36.2 | 40.1 | -3.9 | -3.5 | 66.0 |
| 2024 | 35.7 | 38.6 | -2.9 | -3.0 | 65.6 |

* As percent of potential GDP

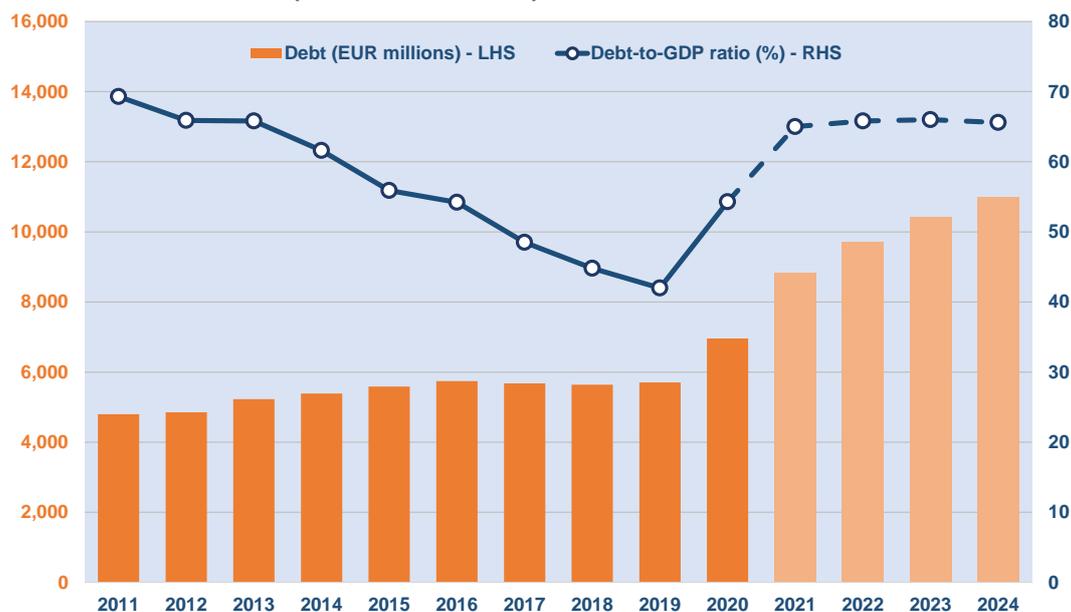
Source: MFE

⁵⁹ A deterioration in public finances was also observed across the euro area due to the pandemic. The euro area fiscal deficit was estimated at 7.2% of GDP in 2020.

⁶⁰ The structural balance refers to the fiscal balance net of cyclical effects and one-off and temporary measures. It is expressed as percent of potential output.

Fiscal developments in 2020 reversed approximately half of the decline in the public debt-to-GDP ratio which was recorded between 2013 and 2019 (see Chart 5.1). The public debt ratio climbed to 54.3% in 2020, from 42.0% a year earlier. In 2021, public debt is forecast to increase further, to 65.0% of GDP. Such developments would practically offset the entire reduction observed over the past decade. Up to 2024, the public debt-to-GDP ratio is then expected to stabilise, hovering slightly above 65.0%.

Chart 5.1: Public debt (% of nominal GDP)



Note: Figures for 2021-2024 are forecasts produced by MFE.

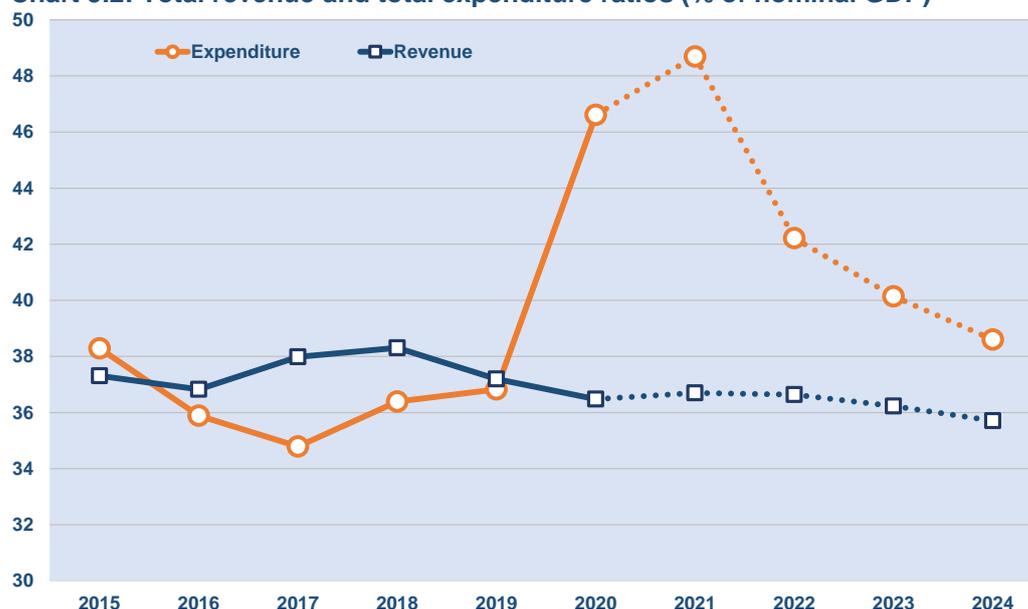
Source: Eurostat, MFE

In 2020, the expenditure-to-GDP ratio rose by 9.8 pp, to 46.6% (see Chart 5.2). It is expected to rise further in 2021, to 48.7%. However, in subsequent years the expenditure ratio is forecast to slide back, to 38.6% by 2024. The most significant drop in the ratio is anticipated for 2022, whereas the reductions in the outer years are relatively smaller. The materialisation of these plans would place the expenditure-to-GDP ratio in 2024 slightly higher than the value recorded in 2019.

The forecast profile for the revenue-to-GDP ratio is different. The latter is expected to remain rather stable throughout the forecast horizon, in the region of 36.0%. Notwithstanding the shock created by the pandemic, changes to the revenue components are expected to maintain a broadly similar ratio as observed before the pandemic.

Compared to 2020, the fiscal deficit is projected to widen by €330.2 million in 2021, to €1,630.4 million. The anticipated deterioration in public finances reflects a €639.2 million planned increase in expenditure, which is partially offset by a €309.0 million forecast rise in revenue (see Chart 5.3). This follows other weakening of the fiscal position noticed since the record surplus of 2017, albeit for different reasons. In 2019, the fiscal surplus had diminished because expenditure had increased more than revenue, while in 2020 the deterioration in public finances reflected the simultaneous rise in expenditure and drop in revenue which were caused by the pandemic.

Chart 5.2: Total revenue and total expenditure ratios (% of nominal GDP)



Note: Figures for 2021-2024 are forecasts produced by MFE.

Source: Eurostat, MFE

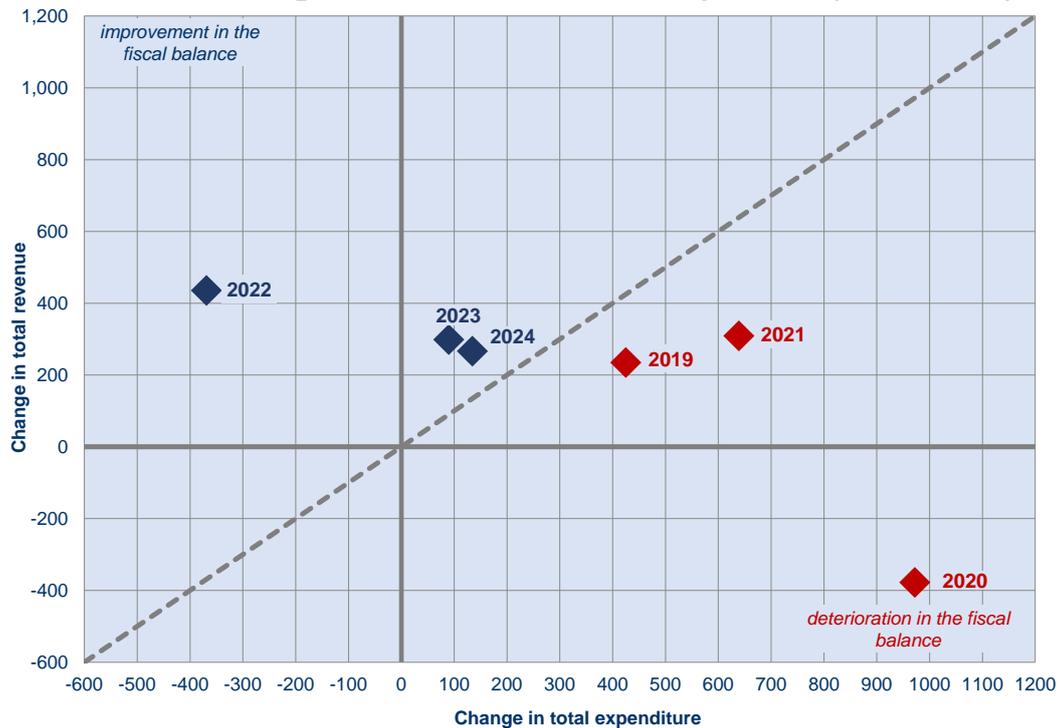
The correction of the large fiscal imbalances of 2020 and 2021 is expected to start from 2022. The plan is to lower the deficit to €826.1 million in 2022. This expected improvement in public finances is the result of the projected rise in revenue and the planned reduction in expenditure on a year earlier. Further correction is envisaged to take place in 2023 and 2024, based on the expectation that during these two years revenue rises by more than expenditure.

Following the widespread revenue reductions in 2020, all major revenue components are expected to be higher in 2021 (see Chart 5.4). In absolute terms, 'other revenue' is expected to rise most.⁶¹ However, the expected rebound in taxes on production and

⁶¹ Other revenue comprises capital taxes, property income and 'other' revenue.

imports and in current taxes on income and wealth is insufficient to compensate fully for the declines registered by both sources in 2020. In turn, the higher additional revenue anticipated in 2022 is mainly driven by indirect taxes, though the outlook for direct taxes also indicates a larger rise than a year earlier. In the outer two years, the absolute change in total revenue is less than in 2022, particularly in view of the smaller expansion in indirect tax revenue. On the other hand, the forecast annual increases in social contributions, extend a broadly stable pattern throughout the forecast horizon.

Chart 5.3: Annual changes in total revenue and total expenditure (EUR millions)



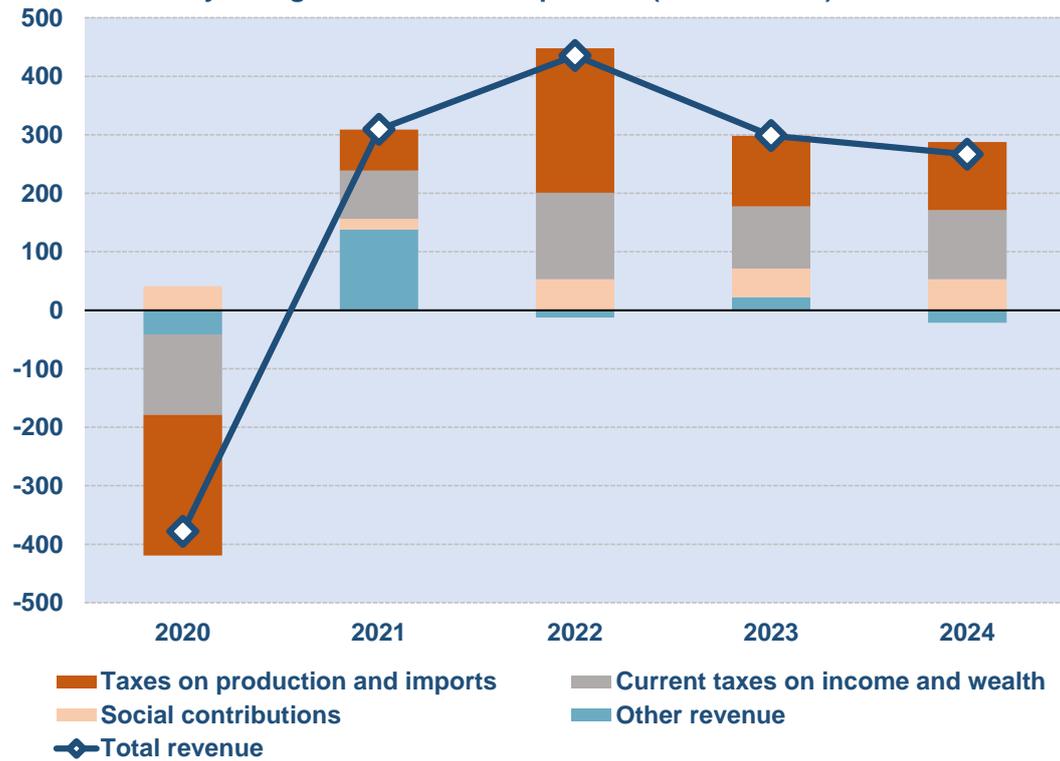
Note: Anywhere above the dashed line (blue diamonds) indicates combinations of revenue and expenditure developments leading to an improvement in the fiscal balance, whereas anywhere below the dashed line (red diamonds) indicates combinations which lead to a deterioration in the fiscal balance. Anywhere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

Source: MFE

Higher subsidies and larger outlays on intermediate consumption accounted for most of the strong increase in expenditure in 2020 (see Chart 5.5). In fact, these two components were strongly impacted by the pandemic, due to the economic assistance measures and the added pressures on healthcare.⁶²

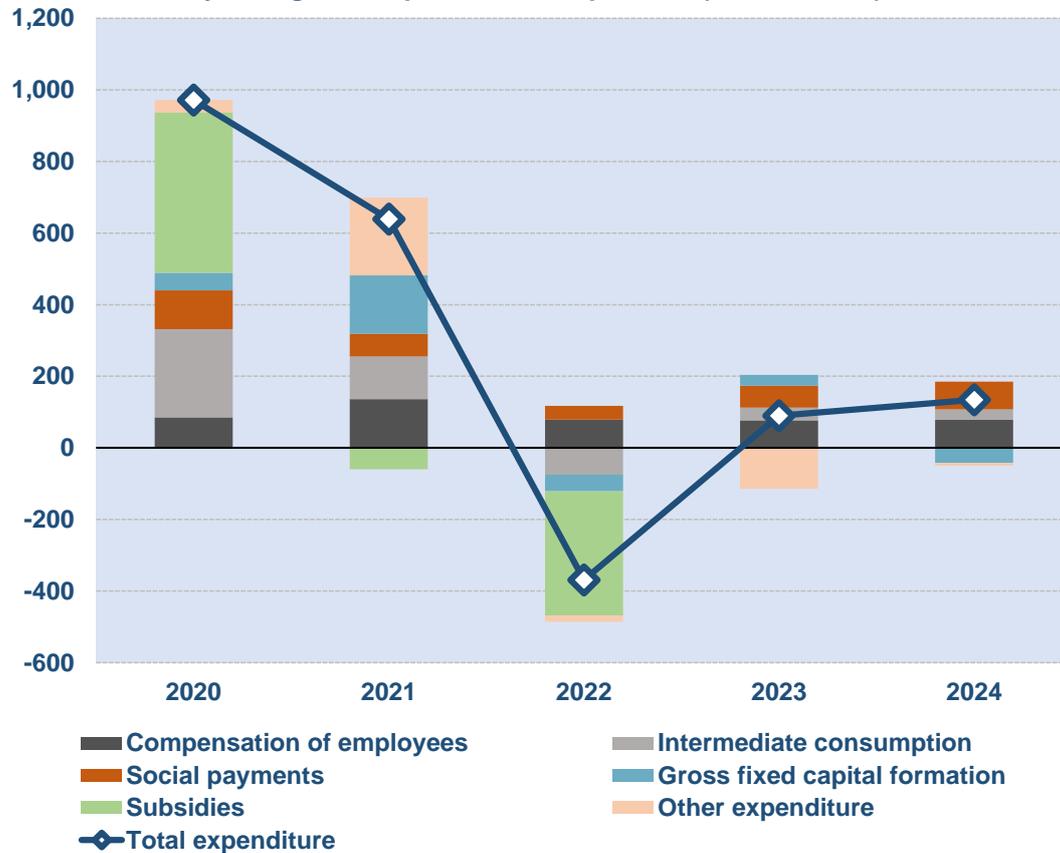
⁶² The wage supplement offered to workers, which is recorded as a subsidy, accounted for the largest expenditure initiative. A detailed list and costings of the measures introduced by the government to deal with COVID-19 pandemic is produced in Appendix 1 of the report by the NAO available on <https://nao.gov.mt/loadfile/71ab28ce-3885-4c20-997d-379965498191>.

Chart 5.4: Yearly changes in revenue components (EUR millions)



Source: MFE

Chart 5.5: Yearly changes in expenditure components (EUR millions)



Source: MFE

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

| | Actual | | Forecasts | | | |
|------------------------------------|----------------|-----------------|-----------------|----------------|-----------------|-----------------|
| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 |
| Total revenue | 5,055.9 | 4,677.8 | 4,986.8 | 5,422.3 | 5,720.8 | 5,987.2 |
| Taxes on production and imports | 1,613.0 | 1,372.3 | 1,442.6 | 1,689.5 | 1,810.5 | 1,927.4 |
| Current taxes on income and wealth | 1,827.0 | 1,689.8 | 1,772.3 | 1,920.2 | 2,026.2 | 2,144.1 |
| Social contributions | 800.1 | 841.1 | 859.4 | 912.5 | 961.4 | 1,014.4 |
| Capital taxes* | 26.1 | 22.6 | 17.6 | 25.6 | 27.2 | 28.9 |
| Property income* | 81.8 | 92.6 | 79.2 | 84.3 | 84.4 | 84.5 |
| Other revenue* | 708.0 | 659.3 | 815.6 | 790.3 | 811.1 | 787.9 |
| Total expenditure | 5,005.8 | 5,977.9 | 6,617.1 | 6,248.4 | 6,338.2 | 6,472.9 |
| Compensation of employees | 1,481.2 | 1,566.6 | 1,702.9 | 1,782.0 | 1,858.9 | 1,937.1 |
| Intermediate consumption | 975.9 | 1,221.5 | 1,340.2 | 1,265.2 | 1,300.9 | 1,330.0 |
| Social payments | 1,238.0 | 1,346.8 | 1,410.8 | 1,448.7 | 1,510.0 | 1,587.5 |
| Gross fixed capital formation | 525.1 | 574.1 | 736.8 | 690.4 | 720.5 | 678.9 |
| Subsidies | 195.1 | 642.9 | 583.2 | 236.2 | 234.2 | 233.3 |
| Interest expenditure** | 183.0 | 170.2 | 160.6 | 163.4 | 174.0 | 182.1 |
| Capital transfers payable** | 110.4 | 142.3 | 306.6 | 297.2 | 167.9 | 148.7 |
| Other expenditure** | 297.3 | 313.7 | 376.1 | 365.2 | 371.8 | 375.2 |
| Fiscal balance | 50.1 | -1,300.2 | -1,630.4 | -826.1 | -617.4 | -485.7 |
| Gross debt | 5,702.8 | 6,960.0 | 8,828.4 | 9,731.9 | 10,429.0 | 10,996.6 |
| Nominal GDP | 13,592.2 | 12,823.8 | 13,588.2 | 14,799.4 | 15,789.5 | 16,767.5 |

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

* Considered as part of 'other revenue' elsewhere in this Report.

** Considered as part of 'other expenditure' elsewhere in this Report.

Source: MFE

In 2021, subsidies are expected to remain high, but the budgeted amount is slightly less than in the previous year. In turn, intermediate consumption and social payments are expected to expand by slightly less than in 2020. On the contrary, in 2021, the amounts budgeted for compensation of employees, gross fixed capital formation were raised by more than the respective increases recorded in 2020. The same applies for ‘other’ expenditure.⁶³

The expenditure allocations for 2022 portray several reductions on a year earlier. This is primarily due to the expected non-repetition of most pandemic-related expenditures. Thereafter, the forecasts for the various expenditure categories for 2023 and 2024 indicate either small increases, or even reductions.

A detailed assessment of the forecasts for the various revenue and expenditure components follows (see Table 5.2). The analysis contributes to the overall risk outlook vis-à-vis the targets for the fiscal balance and public debt outlined in the latest USP.

5.2 Assessment of the revenue projections

The projections 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 USP, and the estimated magnitude of any fiscal measures, or known factors, which are relevant over the forecast horizon.

A very important set of measures implemented by the government at the beginning of the pandemic related to tax deferrals. These were applicable to the three main tax sources: taxes on production and imports; current taxes on income and wealth; and social contributions. The impact of these tax deferrals was estimated by MFE and fully imputed, thereby exerting no impact on revenue in ESA terms. In all cases, the assumption used by MFE is that all taxes which were deferred will be collected by the stipulated deadlines.

⁶³ Other expenditure comprises interest expenditure, capital transfers payable and ‘other’ expenditure.

5.2.1 Taxes on production and imports

In 2021, taxes on production and imports are expected to increase by €70.3 million, corresponding to a 5.1% growth rate over 2020 (see Table 5.3). This increase represents a fraction of the previous' year revenue shortfall from this source. In fact, the major part of the indirect tax rebound is postponed to 2022, when a very significant expansion is anticipated.

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 | 8.4 | 3.0 |
| 2019 | 2.6 | 40.6 | 6.7 | 4.5 | 7.9 |
| 2020 | -14.9 | -240.7 | -6.5 | -7.6 | -78.5 |
| 2021 | 5.1 | 70.3 | 3.7 | 2.4 | 15.1 |
| 2022 | 17.1 | 246.8 | 7.1 | 5.4 | 199.1 |
| 2023 | 7.2 | 121.0 | 4.4 | 3.0 | 22.0 |
| 2024 | 6.5 | 116.9 | 4.0 | 2.7 | 10.5 |

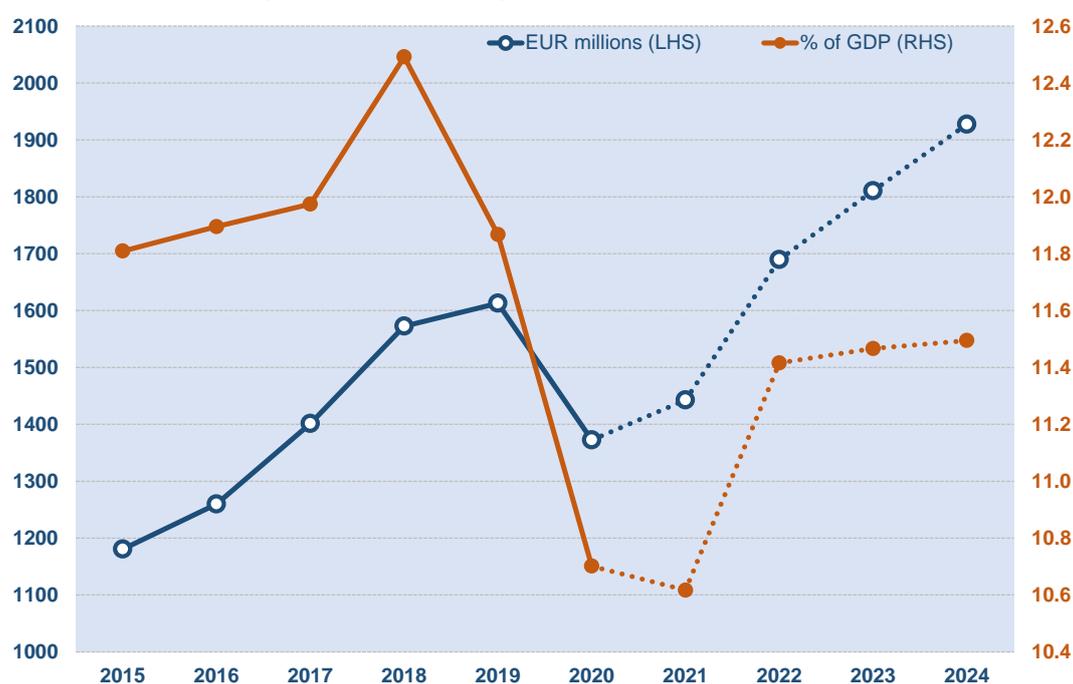
Source: MFE

Indirect taxes are then expected to grow at an average of 6.8% per annum between 2023 and 2024, which is slightly lower than the 7.9% average growth recorded over the five-year period 2015 to 2019 (pre-pandemic). The materialisation of this scenario would place the ratio of indirect taxes to nominal GDP at 11.5% in 2024, which is above the trough anticipated for 2021 (at 10.6%), but still below the ratio recorded in pre-pandemic years (see Chart 5.6). This is consistent with the macroeconomic outlook where consumption (which is the most relevant tax base for indirect taxes) lags the recovery in GDP. This factor, apart from leading to a decline in the share of consumption in GDP, would constrain the growth in indirect taxes.

The anticipated partial recovery in indirect tax revenue in 2021 partly reflects the forecast slow pick-up in consumption growth for the year (3.7% consumption growth in

nominal terms and 2.4% in real terms).⁶⁴ The estimated net budgetary impact of indirect tax measures (mainly temporary concessions on property taxes) plays a more significant role in shaping the outlook.⁶⁵ In fact, whereas in 2020 their combined budgetary effect was estimated at around -0.4% of GDP (i.e. lowering revenue), for 2021 this was quantified at around +0.2% of GDP (i.e. increasing revenue).⁶⁶ These calculations build on the premise that some measures do not remain in place. This factor also applies for 2022, yielding a further boost to indirect taxes estimated at +0.3% of GDP.

Chart 5.6: Taxes on production and imports



Source: MFE

On the other hand, the projected indirect tax revenue increases for 2023 and 2024 are primarily driven by the forecast macroeconomic developments and the assumed tax elasticity, as no additional discretionary measures are factored into the projections.

⁶⁴ 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.

⁶⁵ The estimated effect of measures related to fuel taxes and increase in the minimum threshold for VAT, was estimated by MFE at less than 0.1% of GDP in each case.

⁶⁶ When a temporary tax measure reduces revenue, this is shown as a negative impact on the budget. When such measure is not renewed, this translates into a positive impact on the budget. Sometimes this reversal effect may be spread over more than one year, explaining why the size may not be identical.

The rise in indirect taxes in each year is expected to be higher than the forecast expansion in private consumption (both in nominal and in real terms). Such pattern (faster growth in indirect taxes than the consumption tax base) is the result of the expected large changes in tourism spending, which also forms part of the indirect tax base. Indeed, after the substantial drop in inbound tourism in 2020, tourism expenditure is expected to advance at double-digit growth, based on the baseline scenario of full recovery in the number of tourists within a four-year period.

5.2.2 Current taxes on income and wealth

Current taxes on income and wealth are expected to increase by €82.4 million, or 4.9%, in 2021 (see Table 5.4). Direct taxes are anticipated to grow at a faster rate in 2022, up by 8.3%. The forecast growth rates for the outer two years then ease, to slightly less than 6.0%. Both personal and corporate income taxes are expected to contribute to the recovery in direct taxes over the forecast horizon, consistent with the expected increases in compensation of employees and gross operating surplus.⁶⁷

Table 5.4: Current taxes on income and wealth

| | Growth (%) | Change (EUR millions) | Compensation of employees (%) | Gross operating surplus (%) |
|------|------------|-----------------------|-------------------------------|-----------------------------|
| 2018 | 5.1 | 80.6 | 9.3 | 5.7 |
| 2019 | 10.7 | 176.6 | 8.6 | 8.8 |
| 2020 | -7.5 | -137.2 | 2.4 | -3.4 |
| 2021 | 4.9 | 82.4 | 3.4 | 1.5 |
| 2022 | 8.3 | 148.0 | 5.7 | 10.5 |
| 2023 | 5.5 | 106.0 | 5.3 | 7.2 |
| 2024 | 5.8 | 118.0 | 5.2 | 6.8 |

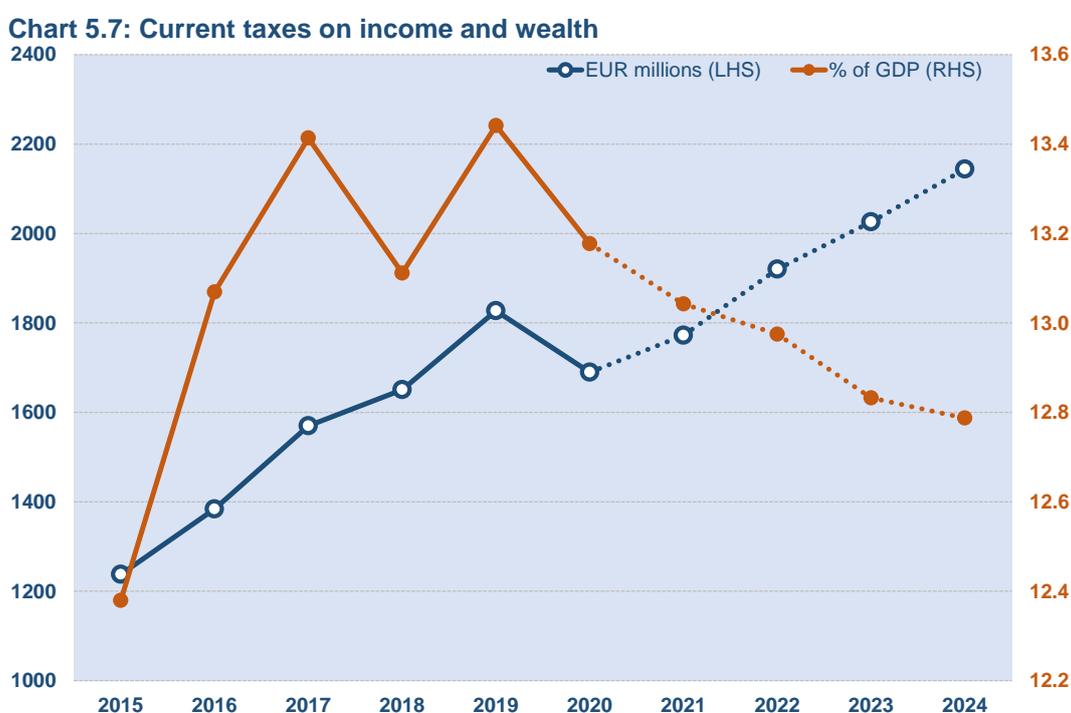
Source: MFE

In 2021, the budgetary impact of direct tax measures is negligible, while for 2022, it amounts to merely +0.1% of GDP, and it is nil in the outer two years. In 2021, direct taxes are expected to grow at a slightly faster rate than either compensation of employees or gross operating surplus. This mainly reflects the base effect caused by

⁶⁷ Compensation of employees and gross operating surplus are the two most relevant proxy tax bases for direct taxes. Personal income tax and corporate income tax broadly account for half of direct taxes each.

the 7.5% drop in 2020.⁶⁸ Between 2022 and 2024, the forecast growth in direct taxes then fits within the range of growth rates for compensation of employees and gross operating surplus.

Although in absolute terms, the USP projects that the upward rise in direct taxes will resume, after the dip experienced in 2020, the rate of increase is slightly less (see Chart 5.7). As a result, the ratio of direct taxes to nominal GDP is expected to fall consistently throughout the forecast horizon. The forecast scenario embeds a lower level of tax buoyancy than recorded in pre-pandemic years.⁶⁹ This also accounts for a cautious outlook in the projections for direct taxes paid by companies whose operations are detached from the Maltese economy.



Source: MFE

⁶⁸ 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. Thus, direct taxes reacted more quickly to the adverse shock created by the pandemic. Another downside factor applicable for 2020 was related to the lower tax yield from companies whose operations are detached from the Maltese economy.

⁶⁹ Tax buoyancy is an indicator to measure the responsiveness of revenue to growth in GDP. A tax is said to be buoyant if the tax revenues increase more than proportionately in response to a rise in national income or output.

5.2.3 Social contributions

The 2021 forecast growth in social contributions, at 2.2%, is lower than any of the growth rates recorded over the past decade (see Table 5.5). This allows for a possible slowdown since even when the pandemic hit, social contributions increased, contrary to what has happened to direct and indirect taxes. The resilience of social contributions is explained by the fact that these were automatically being deducted from the wage support measures which were provided by the government.⁷⁰

Table 5.5: Social contributions

| | Growth (%) | Change (EUR millions) | Compensation of employees (%) |
|------|------------|-----------------------|-------------------------------|
| 2018 | 8.8 | 61.9 | 9.3 |
| 2019 | 4.6 | 35.3 | 8.6 |
| 2020 | 5.1 | 41.0 | 2.4 |
| 2021 | 2.2 | 18.4 | 3.4 |
| 2022 | 6.2 | 53.0 | 5.7 |
| 2023 | 5.4 | 48.9 | 5.3 |
| 2024 | 5.5 | 53.0 | 5.2 |

Source: MFE

Over the forecast horizon, nominal GDP is expected to grow at a faster pace than social contributions. Thus, the ratio of social contributions to GDP is expected to fall gradually, to just under 6.1% by 2024 (see Chart 5.8). Such developments would offset almost entirely the upward spike created in 2020 (due to the higher social contributions and the fall in nominal GDP).⁷¹ The forecast trajectory is entirely driven 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.

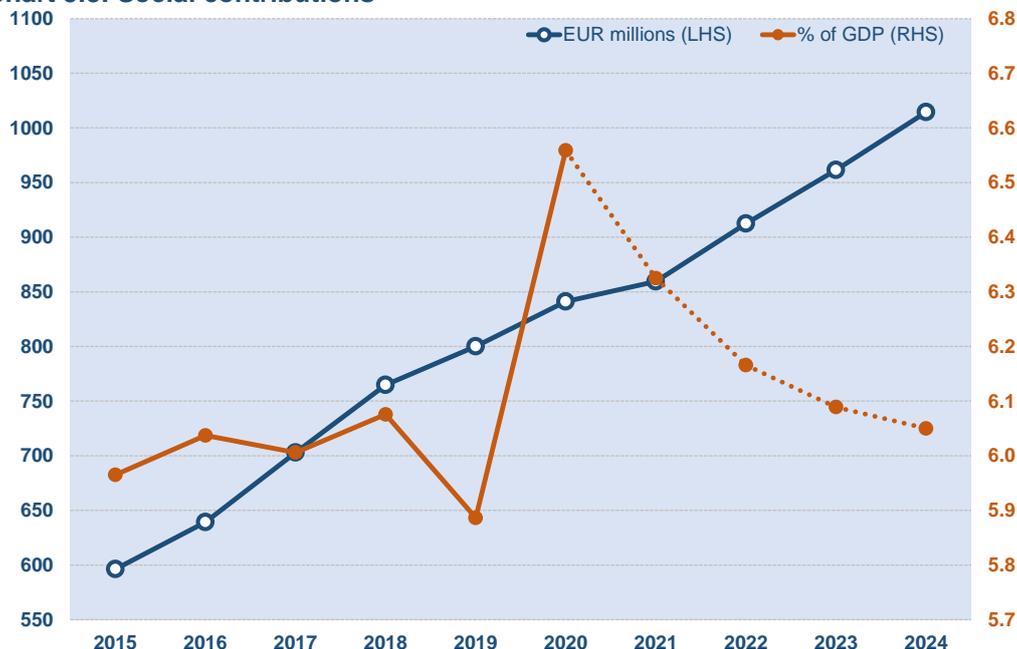
Between 2022 and 2024, growth in social contributions is forecast marginally higher than that in total compensation of employees. The effect of the capping system on social contributions (whereby any income changes above the ceiling have no effect on the payments due) is broadly compensated for by the expected yield from the social

⁷⁰ This created an equivalent impact on the revenue and expenditure side of the budget.

⁷¹ The drop in nominal GDP was driven by gross operating surplus whereas compensation of employees was resilient. This explains why social contributions still increased in 2020.

contributions paid by the self-employed (whose activities are proxied by developments in gross operating surplus).⁷²

Chart 5.8: Social contributions



Source: MFE

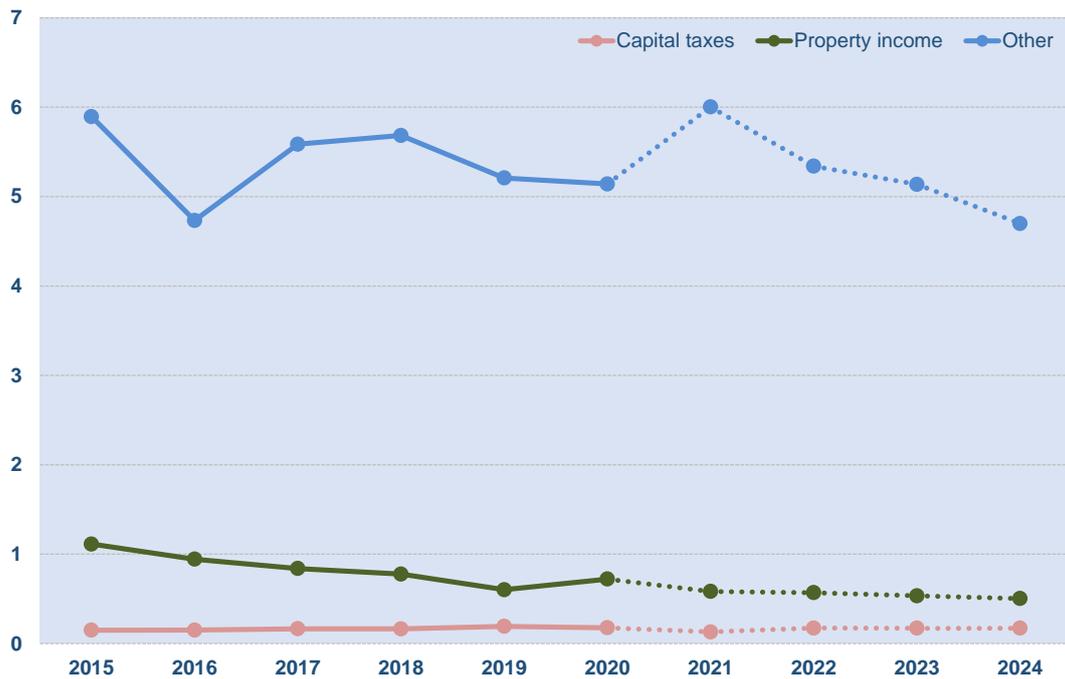
5.2.4 Other revenue components

Taxes on production and imports, current taxes on income and wealth, and social contributions together account for the bulk of total revenue. In 2020, their combined share made up 83.4% of total revenue. Throughout the forecast horizon this share is expected to hover around this level. 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 towards the end of 2020.⁷³ The forecast trajectories for the revenue components as percentage of nominal GDP are shown in Chart 5.9.

⁷² The cap means that once the maximum annual amount payable has been reached, additional income does not lead to more social security payments.

⁷³ Malta's Granting of Citizenship for Exceptional Services by Direct Investment Regulations (S.L. 188.05), under the Maltese Citizenship Act Cap. 188, LN437 of 2020, allow for the granting of citizenship by a certificate of naturalization to foreign individuals and their families who contribute to the country's economic development. The legal notice is available on <https://legislation.mt/eli/ln/2020/437/eng/pdf>.

Chart 5.9: Other revenue components (% of nominal GDP)



Source: MFE

Throughout the forecast horizon property income and capital taxes are assumed to maintain their ratios to nominal GDP stable and low, comparable to the values recorded in 2020 (respectively 0.7% and 0.2%). As a result, these items exert a limited influence on the overall fiscal scenario for the period 2021 to 2024.

Fluctuations in the revenue from the remaining miscellaneous components are more material. In 2021, the combined amount from the other revenue sources is set to rise by €156.2 million on a year earlier. The bulk of this change reflects inflows associated with EU funds (including RRF funds). On the other hand, other revenue is expected to remain broadly stable over the other three years, explaining the projected drop in its ratio to nominal GDP. Throughout the forecast horizon, the target revenue from residency schemes is stable and less pronounced than in pre-pandemic years.

5.3 Assessment of the expenditure projections

The forecasts for the different expenditure components are analysed separately. The assessment 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 outlook for certain categories remains very sensitive to the

assumptions about the size and duration of pandemic-related expenditures. Another determining factor is the planned timeframe and priority areas for the utilisation of the EU funds (including the RRF grants).

5.3.1 Compensation of employees

Spending on compensation of employees is projected to increase by 8.7% in 2021, which is higher than the growth rate recorded in 2020 (see Table 5.6). Indeed, because of the pandemic, in 2020 recruitment within the public sector was slower than originally envisaged. This factor, together with the payment of certain arrears explains the stronger growth in compensation of employees anticipated in 2021.

Table 5.6: Compensation of employees

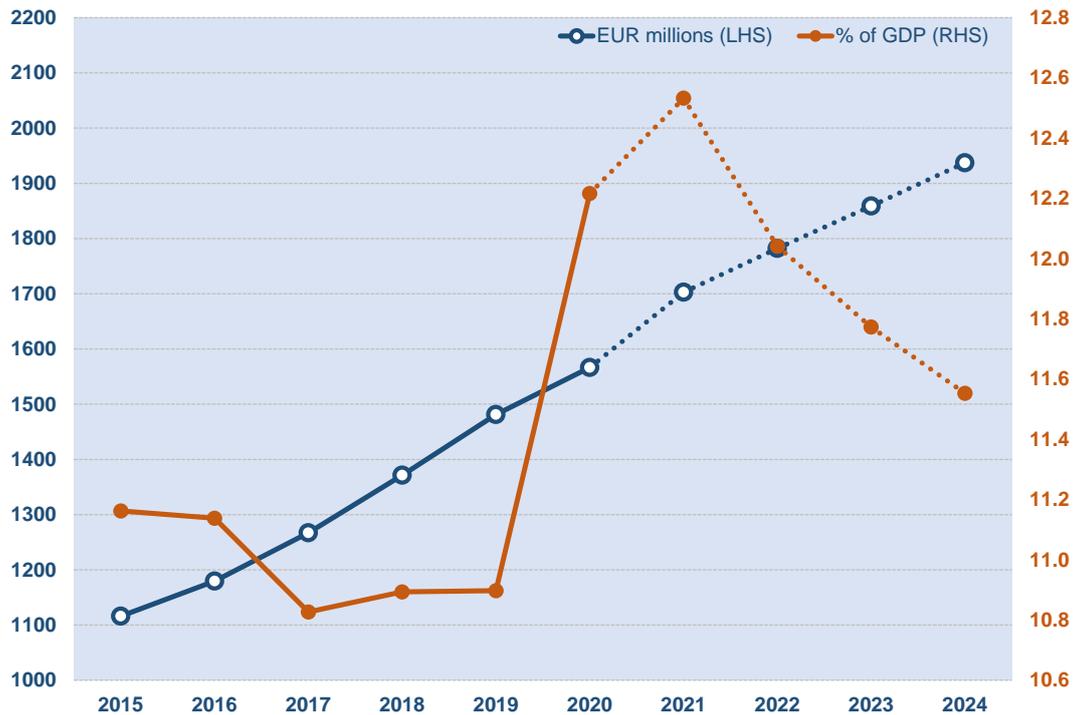
| | Yearly growth rate (%) | Yearly absolute change (EUR millions) |
|------|------------------------|---------------------------------------|
| 2018 | 8.2 | 104.1 |
| 2019 | 8.0 | 110.0 |
| 2020 | 5.8 | 85.4 |
| 2021 | 8.7 | 136.4 |
| 2022 | 4.6 | 79.1 |
| 2023 | 4.3 | 76.8 |
| 2024 | 4.2 | 78.2 |

Source: MFE

Over the period 2022 to 2024, the yearly expansion in the budget allocation for the public sector wage bill is contained to slightly more than 4.0%. Hence the forecast trajectory for the ratio of government compensation of employees to nominal GDP shows a change in pattern along the years (see Chart 5.10).

After having hovered close to 11.0% in pre-pandemic years, in 2020 the ratio rose to 12.2% (due to the contraction in nominal GDP). In 2021, compensation of employees is set to rise further as percentage of nominal GDP. On the other hand, over the following three-year period, the budget allocation on public sector wages is expected to rise at a slower pace than nominal GDP, contributing to the forecast drop in the ratio. Still, the ratio is expected to remain above that recorded in recent years.

Chart 5.10: Compensation of employees



Source: MFE

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).⁷⁴ The latter may be covered by separate collective agreements and employment contracts, though they are still expected to follow the government's general guidelines on remuneration.

⁷⁴ 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.

5.3.2 Intermediate consumption

In 2021, intermediate consumption is expected to rise by €118.7 million or 9.7% (see Table 5.7). Despite the elevated growth rate, this represents a deceleration on a year earlier. This reflects the base effect created by the strong growth registered in 2020 due to the pandemic. The forecast accounts for the expected attenuation of the outlays related to the pandemic in line with the expected improvement in the health situation.⁷⁵

Table 5.7: Intermediate consumption

| | Yearly growth rate (%) | Yearly absolute change (EUR millions) |
|------|------------------------|---------------------------------------|
| 2018 | 13.4 | 96.2 |
| 2019 | 19.6 | 159.7 |
| 2020 | 25.2 | 245.6 |
| 2021 | 9.7 | 118.7 |
| 2022 | -5.6 | -74.9 |
| 2023 | 2.8 | 35.6 |
| 2024 | 2.2 | 29.1 |

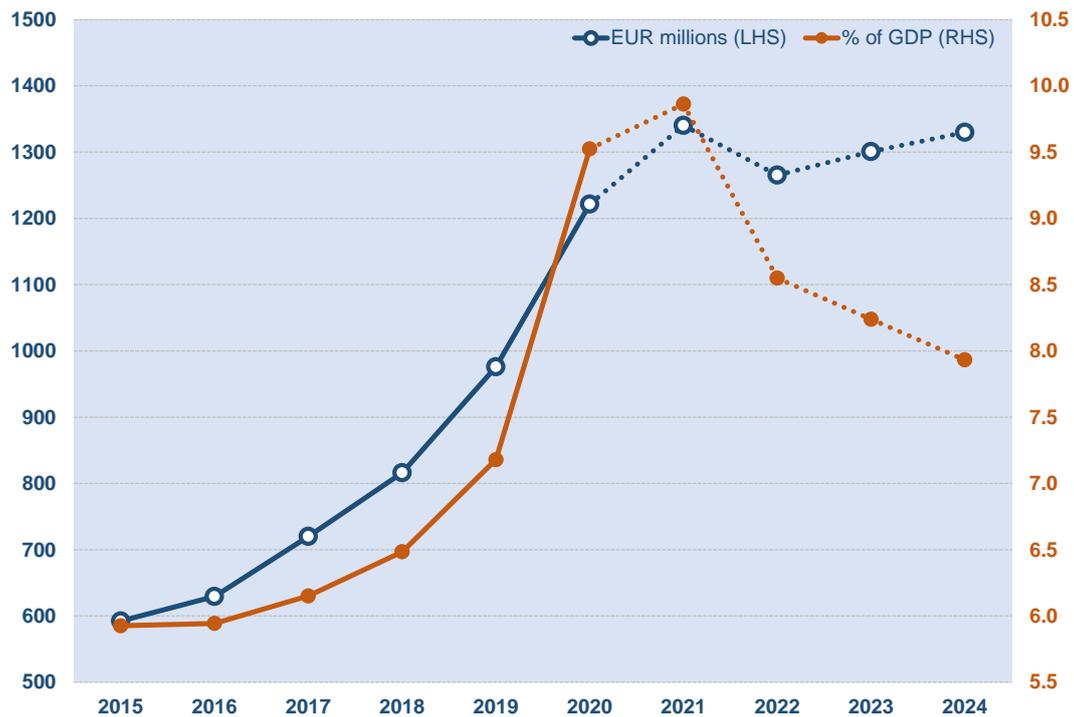
Source: MFE

The non-repetition of COVID-19 related expenditures then explains the 5.6% planned reduction in the budget on intermediate consumption in 2022. Subsequently, in 2023 and 2024, the expansion in the budget allocation on intermediate consumption is contained to less than 3.0% per annum (see Chart 5.11). It is acknowledged that this component tends to be volatile over time particularly as it has a rather strong discretionary element. However, it may be challenging to remain within budget in the outer forecast years as the planned developments are much lower than the 13.5% average growth recorded over the five-year period 2015 to 2019 (pre-pandemic).⁷⁶ Over time, initiatives have tended to be replaced by other expenditure. This pattern effectively makes it more difficult for intermediate consumption to depart from previous trends, unless driven by specific cost savings.

⁷⁵ Items which are classified as intermediate consumption include outsourced health services and medical supplies.

⁷⁶ The budgeted expenditure amounts specified in the USP 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. This approach tends to limit the comparability between actual and forecast data, an observation which does not apply only to intermediate consumption but to the other expenditure components too.

Chart 5.11: Intermediate consumption



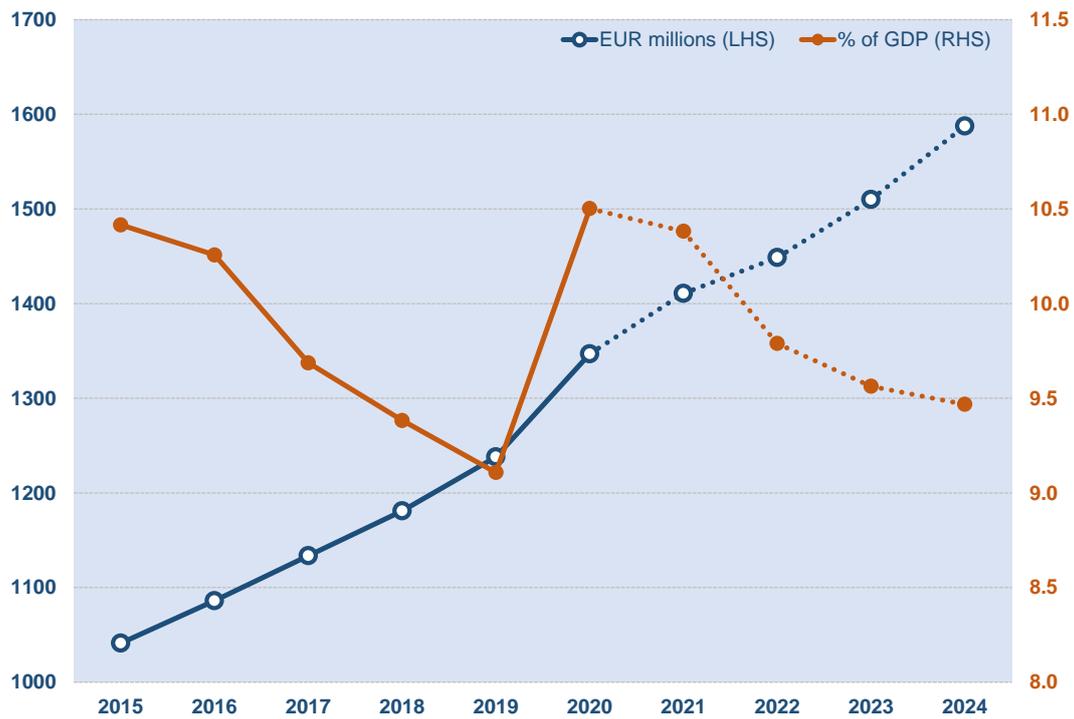
Source: MFE

5.3.3 Social payments

The downward trend in the ratio of social payments to nominal GDP was reversed in 2020 (see Chart 5.12). This reflected both the stronger growth in social payments (numerator), due to the launch of further assistance measures, and the contraction in nominal GDP (denominator). In 2020, social payments rose by 8.8%, equivalent to an additional €108.8 million (see Table 5.8).

The planned rise in social payments in 2021 is lower than in the previous year. This is due to the base effect created by some temporary assistance measures in 2020 which are assumed to expire in 2021. New measures for 2021 are also limited. The gradual reduction in certain health expenditure (pandemic-related) which is classified under social payment further explains the decelerating growth in 2021 and 2022. The 4.8% planned growth for 2021 is comparable to growth rates recorded before the pandemic, whereas in 2022 social payments are expected to grow at a slower rate than usual. The absence of further announced measures also contributes to the deceleration in the expected outlays on social payments in the outer forecast years.

Chart 5.12: Social payments



Source: MFE

Table 5.8: Social payments

| | Yearly growth rate (%) | Yearly absolute change (EUR millions) |
|------|------------------------|---------------------------------------|
| 2018 | 4.2 | 47.3 |
| 2019 | 4.8 | 57.0 |
| 2020 | 8.8 | 108.8 |
| 2021 | 4.8 | 64.0 |
| 2022 | 2.7 | 38.0 |
| 2023 | 4.2 | 61.2 |
| 2024 | 5.1 | 77.5 |

Source: MFE

Social measures have regularly been introduced in consecutive years, but the USP does not budget amounts for initiatives which are not announced. Still, the growth forecasts for 2023 and 2024 are broadly in line with those recorded over the five-year period 2015 to 2019. The expenditure forecasts build on the calculations that outlays on pensions, and more generally age-related spending, grow at a slower pace than nominal GDP. This factor underpins the resumption of the downward trend in the social payments to GDP ratio portrayed in the forecasts.

5.3.4 Gross fixed capital formation

The planned spending on gross fixed capital formation is volatile along the forecast horizon. In 2021, the budget allocation anticipates spending on gross fixed capital formation to regain strong momentum, rising by €162.7 million or 28.3% (see Table 5.9 and Chart 5.13).⁷⁷ The planned investment spending in 2021 is the highest on record, both in absolute terms, and as percent of nominal GDP. The subsequent yearly changes in the budget for investment over the remaining forecast years can be attributed to the timeline factored in the utilisation of the EU funds. The RRF funds have been included in these calculations but the specific plan has not yet been finalised, thereby justifying the absence of fully identified projects supporting the specific timelines assumed.

Table 5.9: Gross fixed capital formation

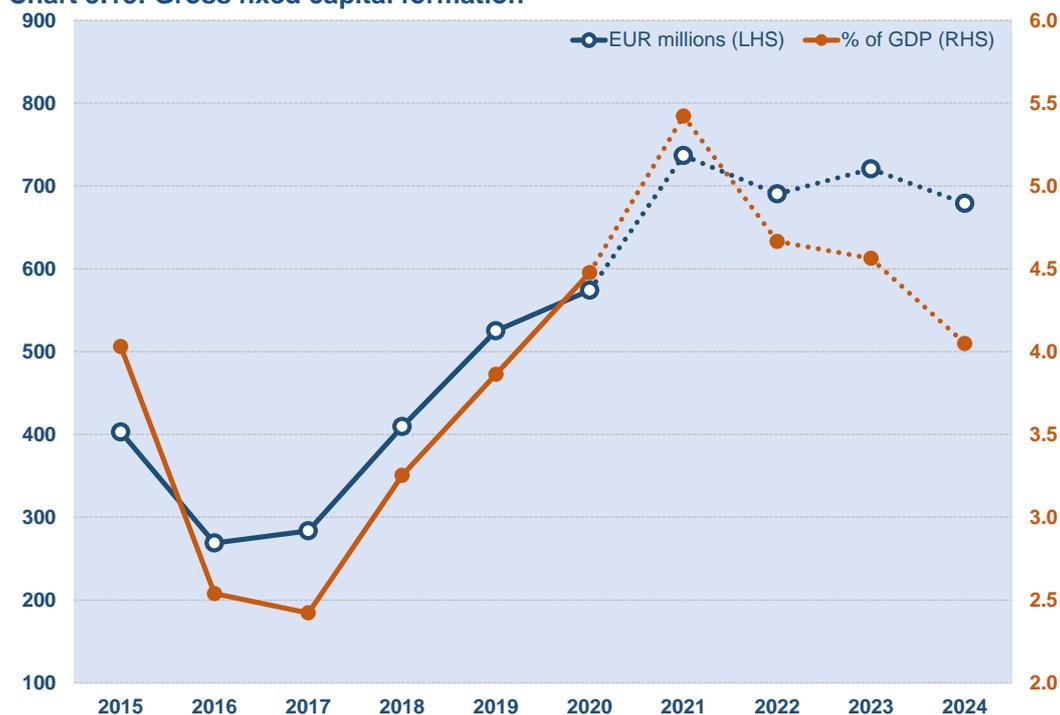
| | Yearly growth rate (%) | Yearly absolute change (EUR millions) |
|------|------------------------|---------------------------------------|
| 2018 | 44.4 | 125.9 |
| 2019 | 28.2 | 115.6 |
| 2020 | 9.3 | 49.0 |
| 2021 | 28.3 | 162.7 |
| 2022 | -6.3 | -46.4 |
| 2023 | 4.4 | 30.0 |
| 2024 | -5.8 | -41.5 |

Source: MFE

The ratio of public investment to GDP is expected to hover around 5.0% over the forecast horizon. This is an ambitious plan when considering that the ratio is higher than in the previous five years, when it fluctuated between 2.4% and 4.0% of GDP. The USP specifies that investment projects will focus on the continuation of arterial road construction projects, as well as roads in residential and rural areas, the regeneration of ports and improvement of facilities for the maritime sector, industrial infrastructure, the modernisation of health facilities, investment in higher education institutions and schools, sports facilities, and social housing.

⁷⁷ This figure includes an equivalent of 0.3% of GDP in RRF grants channeled into public investment which have been factored into the forecasts. No public details on Malta's RRF were available by the cut-off date of the Report.

Chart 5.13: Gross fixed capital formation



Source: MFE

5.3.5 Subsidies and other expenditure components

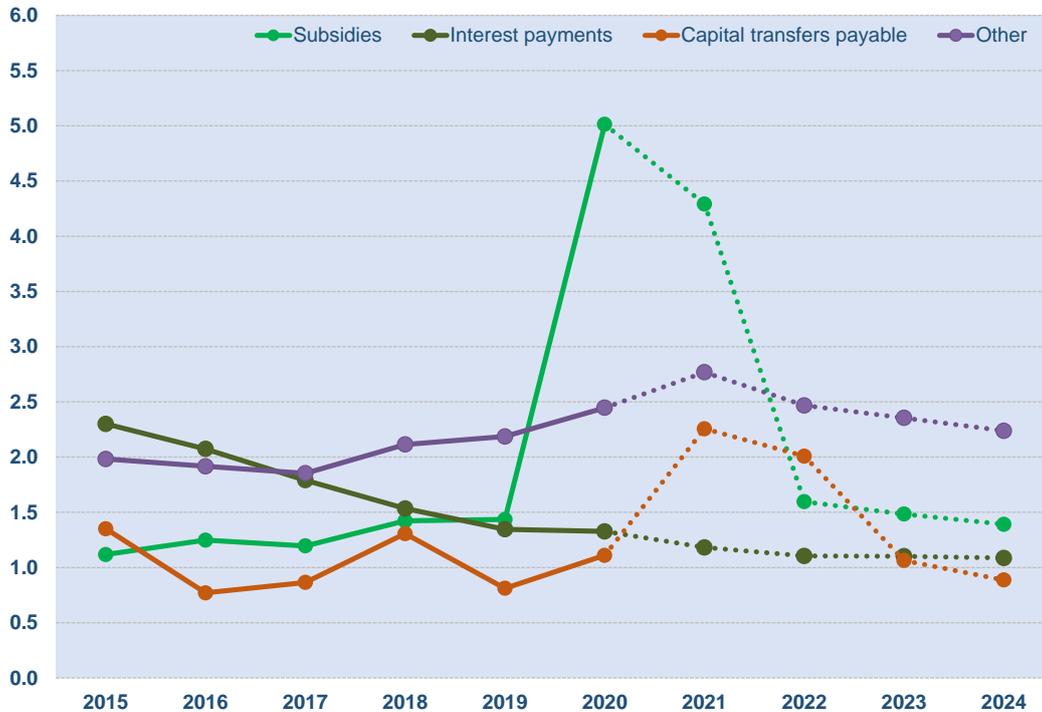
Compensation of employees, intermediate consumption, social payments, and gross fixed capital formation account for the bulk of total expenditure. Their combined share made up 78.8% of total expenditure in 2020 (slightly less than the 84.3% share in 2019). The remaining components consist of subsidies, interest payments, capital transfers payable and 'other expenditure'. Chart 5.14 shows the forecast profile for the respective categories, expressed as a percentage of nominal GDP.

Among these smaller components, subsidies experienced the largest change in 2020. This mainly reflected the assistance provided by the government to support employment through various initiatives.⁷⁸ As a result, subsidies accounted for an equivalent of 5.0% of GDP in 2020, compared to an average of 1.3% between 2015 and 2019. The budget allocation for subsidies in 2021 was maintained at around 91% of the level in 2020. As economic conditions are forecast to start improving, it was

⁷⁸ 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. Other measures, such as state guarantees, have not impacted public finances in financial terms. However, these represent a contingent liability, and would turn into a cost in case such guarantees are called in.

assumed that the assistance would be scaled down during the second half of 2021. Subsequently, over the period 2022 to 2024, the budget for subsidies approximately re-establishes the ratio to GDP which existed prior to the pandemic.

Chart 5.14: Other expenditure components (% of nominal GDP)



Source: MFE

Spending on interest payments is expected to drop for the seventh year running, down by €9.5 million in 2021. However, from 2022 onwards interest payments are forecast to start rising by small amounts, due to the new debt which was accumulated to finance the pandemic mitigation measures.⁷⁹ Overall, the ratio of interest payments to GDP is expected to stabilise over the forecast horizon, to just over 1.0%. The projected interest savings in 2021 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 2021, 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 and 2021 is expected to create a much stronger upward cost effect starting from 2022. This explains the budgeted increase in interest payments in the outer forecast years. The overall

⁷⁹ The USP assumes that there will not be any recourse to RRF loans.

increase is however contained since the implicit interest rate on public debt is estimated to drop to 1.7% by 2024, compared to 3.0% calculated for 2020.

In 2021 and 2022, capital transfers are expected to shoot up compared to previous years. This reflects the intention of the government to provide financial assistance to the national airline, amounting close to €300 million over these two years as part of a proposed five-year plan.⁸⁰ Even though negotiations are still ongoing this amount was included in the calculations prepared by MFE for the USP. Subsequently, capital transfers are assumed to revert to their original ratio to GDP. The budgeted amount for capital transfers is also linked to the assumed utilisation of EU funds over this period.⁸¹

The budget for 'other expenditure' has been raised by €62.4 million in 2021 compared to a year earlier. More than half of this increase reflects a higher estimate for the EU Own Resources payments. Overall, the ratio of other expenditure to GDP is expected to continue hovering slightly above 2.0% throughout the forecast period, which is comparable to its historical pattern.

5.4 Fiscal risk outlook

In 2020, COVID-19 created a significant impact on public finances as it lowered various revenue streams and drove public expenditure up. Though attenuating, the adverse impact on public finances is expected to persist over several years. Budget components are not expected to return to pre-pandemic patterns immediately. Owing to the highly uncertain duration and severity of the COVID-19 effects, the impact on public finances could vary significantly. The MFAC's risk outlook thus focuses on the joint profile pattern for each revenue and expenditure component over the forecast horizon, using 2019 as the base year, rather than for each year separately (see [Chart 5.15](#) and [Chart 5.16](#)).

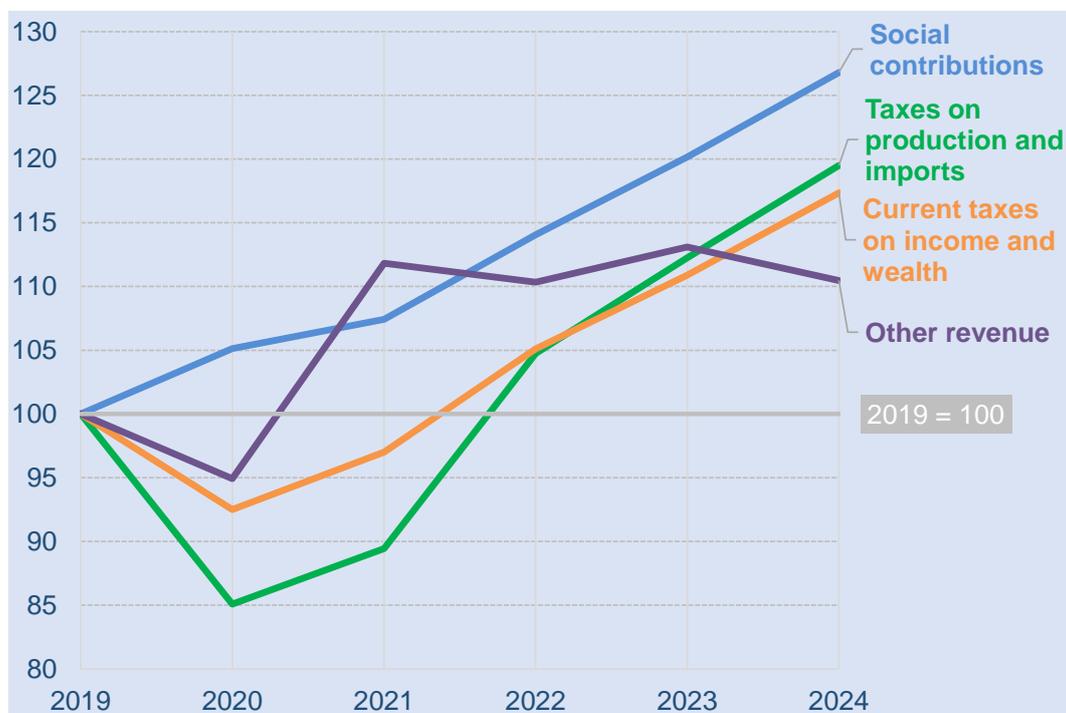
The risk assessment for public finances takes the macroeconomic scenario as presented in the USP as given. The neutral risk identified by the MFAC vis-à-vis the profile for real GDP for the period 2021 and 2024 mitigates the extent of such risks.

⁸⁰ The proposed assistance to the national airline is classified as capital transfers.

⁸¹ Some EU funds are transferred to entities outside general government and are classified by the NSO as capital transfers.

Nevertheless, a different composition of growth (which may be more, or less, tax rich) than envisaged in the USP could still influence the trajectory for certain revenue components.⁸²

Chart 5.15: Index for the revenue components (2019 = 100)



Source: MFE

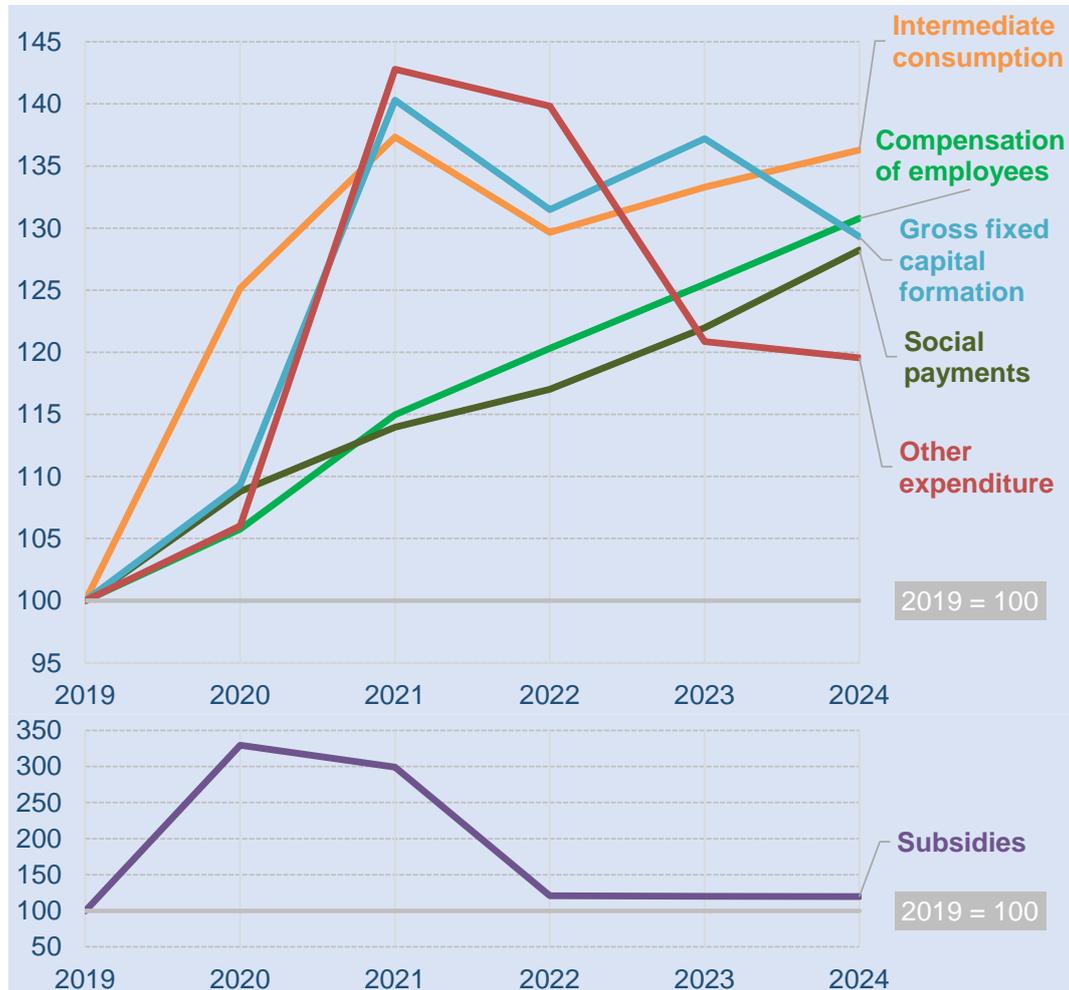
Under the baseline scenario, the drops in revenue which were recorded in 2020 are expected to be recovered by 2022, with further revenue increases anticipated thereafter. The pattern for social contributions is different as this source was not much impacted in 2020 and is expected to maintain a smooth upward trajectory throughout the forecast horizon. In percentage terms, social contributions are expected to grow most over the forecast period, up by 26.8% over their level in 2019.

Despite taxes on production and imports suffered the largest shock in percentage terms, indirect taxes are still projected to amount to 19.5% more than in 2019. This is slightly more optimistic than the forecast for current taxes on income and wealth, which is expected to expand slightly less, reaching 17.4% over its level in 2019. The slightly more cautious outlook for direct taxes contrasts with the greater resilience shown by direct taxes as opposed to indirect taxes in 2020. The profile for the other revenue is different from the rest, since in this case there is a big jump anticipated in 2021, which

⁸² Refer to Chapter 3 in this Report for further details.

is however followed by limited changes thereafter. Overall, the forecast for other revenue shows the lowest positive change over 2019.

Chart 5.16: Index for the expenditure components (2019 = 100)



Note: The chart for subsidies is separate from the rest due to a very different scale compared to the other expenditure components.

Source: MFE

Overall, the MFAC considers that there could be downside risks to the total revenue profile indicated in the USP (see Table 5.10). In particular, the revenue from market output (which includes the proceeds from residency schemes) could be less than anticipated, while the absorption of EU funds could be slower than planned. Both factors place a downside risk on 'other' revenue over the forecast horizon. On the other hand, the risk outlook for the main tax sources (taxes on production and imports, current taxes on income and wealth and social contributions) is considered neutral. In these cases, the revenue projections factor a degree of caution. At the same time, uncertainty remains because the actual amounts of deferred taxes could turn out

different than what was calculated. Moreover, it could be difficult to recover all tax due in line with the timeframes set.

Table 5.10: Summary of risks to the fiscal balance

| | 2021 – 2024 |
|------------------------------------|-------------|
| 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, patterns amongst the individual components are varied. Compensation of employees and social payments are characterised by close to linear upward trend throughout the forecast horizon. On the other hand, the forecasts for intermediate consumption, gross fixed capital formation and ‘other’ expenditure exhibit much higher budgeted amounts in 2021, but then relative stability, or even some scaling back, thereafter. Such projection is based on the premise that pandemic-related expenditures are not repeated and that no new expenditure measures are factored in the outer years. In the case of subsidies, these surged in 2020, and are

then expected to remain elevated in 2021 (but slightly less). The plan is then for subsidies to drop significantly thereafter but remain above pre-pandemic levels.

Upside risks appear pertinent in the case of compensation of employees and intermediate consumption, in part because the budgeted amounts over the forecast horizon appear somewhat tight when compared to the developments recorded during pre-pandemic years. Upside risks also relate to subsidies, should the assistance be needed beyond what has been budgeted for, or else be more costly than calculated. Further upside risks relate to 'other' expenditure in the eventuality that any of the state guarantees which were offered during the pandemic require the settlement by the government in case of repayment difficulties facing the borrowers.⁸³ On the contrary, there are downside risks to gross fixed capital formation in case the absorption of EU funds (including RRF funds) progresses at a slower pace than anticipated, particularly since by the Report's cut-off date the RRF plan was not yet submitted to the COM. In turn, the risk outlook for social payments is considered as neutral since it largely replicates the pre-pandemic patterns. On the other hand, since negotiations with the COM are ongoing, at the current juncture, it is not possible to ascertain whether the capital transfers to the national airline (classified as part of 'other' expenditure) will go ahead as planned or otherwise.

The assessment carried out on the individual revenue and expenditure components suggests an overall downside risk outlook vis-à-vis the fiscal balance (larger deficit) for the period 2021 to 2024. The fiscal deficit could be larger than targeted mostly in view of the upside risk on the expenditure side of the budget, with added pressures stemming from the possible downside revenue risk.

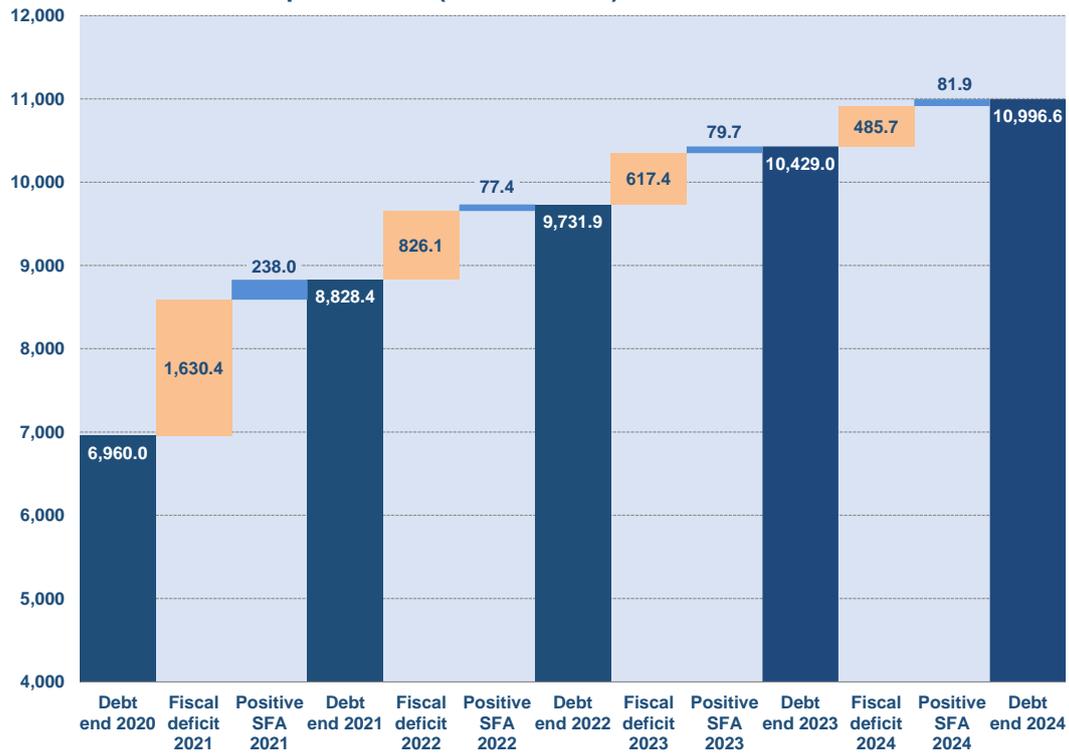
5.5 Assessment of the public debt projections

In 2021, the outstanding level of public debt is expected to rise by €1,868.4 million, from €6,960.0 million to €8,828.4 million (see [Chart 5.17](#)). The increase mainly reflects the financing of the projected €1,630.4 million fiscal deficit for 2021, but also includes the estimated stock-flow adjustment (SFA). The latter is expected to push up debt by a further €238.0 million in 2021.⁸⁴

⁸³ The USP assumes that no guarantees are called.

⁸⁴ SFA refers to the difference between the change in government debt and the government deficit or surplus for a given period. This arises when transactions impact the fiscal balance (in

Chart 5.17: Drivers of public debt (EUR millions)



Source: MFE

Between 2022 and 2024 public debt is expected to keep rising in absolute terms, but the accumulation of debt is expected to get smaller over time. This is due to the planned gradual reduction in the fiscal deficit over the forecast horizon. Moreover, the upward effect caused by the positive SFA between 2022 and 2024 is expected to be much lower than in 2021, stabilising at around €80.0 million per year.

The SFA for 2021 is largely impacted by tax deferrals.⁸⁵As per Eurostat’s guidance, MFE imputed pending tax payments to the time when the economic activity generating the tax liability took place. No further adjustments related to this transaction were included over the period 2022 to 2024. Furthermore, the most relevant transaction driving the SFA relates to the ESA re-routed debt.⁸⁶ Other smaller adjustments relate to the expected changes to the MGS sinking fund balance and the issue of euro

ESA terms) but not the public debt, or vice-versa. SFA is termed ‘positive’ when the adjustment raises the stock of debt and ‘negative’ when it lowers the stock of debt.

⁸⁵ The estimated taxes which were deferred were imputed, hence exerting no impact on the fiscal balance. However, since the cash shortfall needs to be financed through the issue of public debt, this leads to a positive SFA.

⁸⁶ 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 public debt.

coins.⁸⁷ However, in all cases, the yearly estimates (net of the tax deferral effect) are broadly stable, explaining the relative stability of the SFA.

The yearly increase in public debt over the period 2021 to 2024 is consistent with the macroeconomic and fiscal scenario, and the estimated SFA. The overall neutral risk vis-à-vis the profile for real GDP for the period 2021 and 2024, compounded with the overall downside risk vis-à-vis the fiscal balance for the same period, places an upside risk for the debt-to-GDP profile (i.e. leading to a higher debt ratio) throughout the forecast horizon.⁸⁸ The upside risk is reinforced should the yearly SFA turn out larger than factored in the USP, in the eventuality that deferred taxes take longer than expected to be settled.

⁸⁷ Sinking funds balances include designated funds for repayment of public debt at maturity.

⁸⁸ Real GDP growth combined with the GDP deflator determines the value for nominal GDP, which acts as the denominator for the public debt ratio. The upside risk relates to the numerator (the possibility of a larger fiscal deficit), since the risk outlook vis-à-vis nominal GDP (in level terms) is neutral.

Chapter 6

Comparison across different fiscal forecasts

6.1 Introduction

The plausibility of the fiscal projections contained in the USP 2021 – 2024 can be further evaluated by examining the similarity or otherwise with respect to the forecasts produced by other institutions, namely the COM, CBM, IMF, Fitch, Moody's and S&P. The caveat remains that the fiscal forecasts are not based on the same data sets, since these were prepared at different times. The assumptions related to the pace of recovery from the pandemic may also differ across institutions. Nonetheless, the MFAC considers such comparison 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 USP is also compared to that in the DBP, to trace the revisions which contributed to the higher fiscal deficit and public debt than originally planned for 2021.

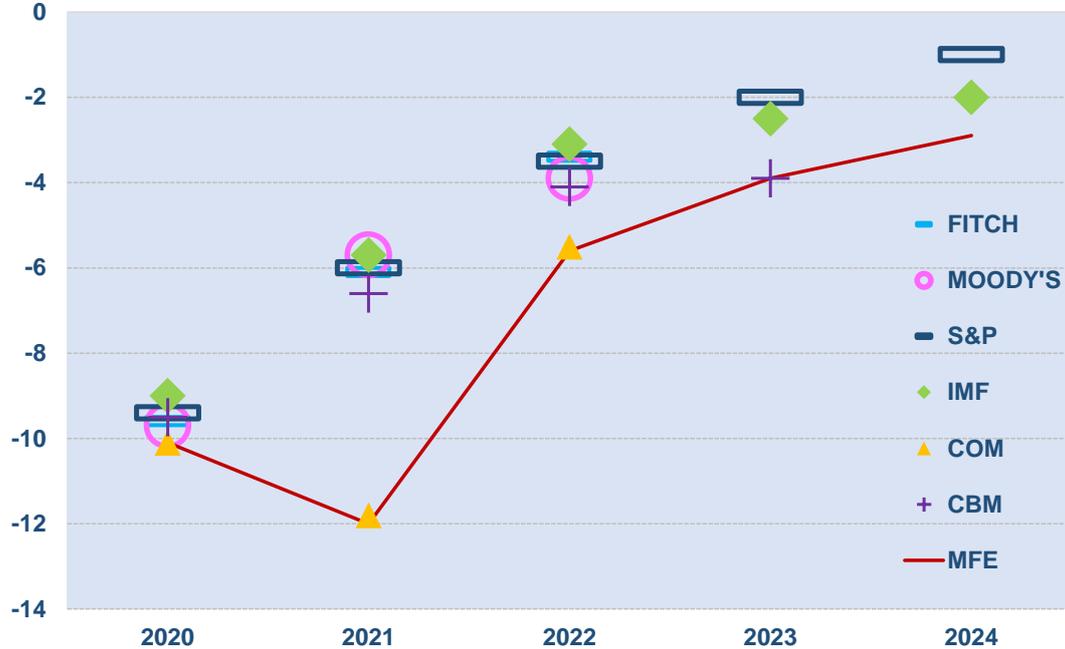
6.2 Fiscal balance

The forecasts by all institutions indicate a fiscal deficit throughout the period 2021 to 2024 (see [Chart 6.1](#)). They also all point to a significant correction in the deficit by the end of the forecast horizon. However, there are material differences in the deficit expectations for 2021. The updated fiscal plans by MFE indicate the intention to undertake further support measures, against a background of a weaker than previously anticipated economic rebound. This also in large part explains the MFE's expected widening of the fiscal deficit in 2021.

This information was available to the COM whose forecasts were published afterwards, on 12 May 2021. Accordingly, the updated MFE plans were taken on board, explaining why the COM's estimate resulted in a very similar deficit for 2021. On the other hand, since the fiscal forecasts by the other institutions were prepared before such plans became public, their forecasts built on the premise that the improvement in public finances would start from 2021. Hence the fiscal forecasts by the CBM, IMF and the

credit rating agencies failed to anticipate this policy decision, which could lead to a possible deterioration in public finances in 2021.

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



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

All institutions envisage an improvement in the fiscal balance in 2022, compared to 2021. The forecasts by MFE and COM show the strongest improvement, but their forecast for the fiscal deficit, which is almost identical, is still above that anticipated by the other institutions. A similar gap applies to the deficit trajectory for 2023 and 2024, since the MFE's plans remain more expansionary (larger deficit) than projected by the other institutions. However, the available forecasts for the fiscal balance in the outer years remain within a narrow range and concur on the expectation of a gradual correction, albeit insufficient to reach balance between revenue and expenditure by 2024.

The USP targets a deficit of €1,630.4 million in 2021, which is more than double the €792.5 million deficit indicated in the DBP (see Table 6.1). This update factors in both the downward revision in the macroeconomic outlook, as well as the need for more fiscal support than previously budgeted for. Consequently, both the revenue and the expenditure figures were revised significantly. The planned expenditure was raised by €623.1 million, whereas the revenue forecast was lowered by €214.7 million.

Table 6.1: Fiscal balance forecasts by institution (EUR millions)

| | 2021 | | | | 2022 | | |
|----------------------------------|----------------|-----------------|-----------------|----------------|----------------|----------------|----------------|
| | MFIN DBP | MFIN USP | COM SPR | CBM AR | MFIN USP | COM SPR | CBM AR |
| Total Revenue | 5,201.5 | 4,986.8 | 5,022.6 | 5,015.4 | 5,422.3 | 5,451.7 | 5,414.3 |
| Taxes on production & imports | 1,663.3 | 1,442.6 | 1,462.6 | 1,504.1 | 1,689.5 | 1,680.0 | 1,722.5 |
| Current taxes on income & wealth | 1,857.5 | 1,772.3 | 1,758.8 | 1,748.1 | 1,920.2 | 1,890.7 | 1,851.2 |
| Social contributions | 819.4 | 859.4 | 858.8 | 809.2 | 912.5 | 887.7 | 838.5 |
| Other * | 861.3 | 912.5 | 942.4 | 954.0 | 900.1 | 993.3 | 1,002.1 |
| Total expenditure | 5,994.0 | 6,617.1 | 6,635.0 | 5,906.1 | 6,248.4 | 6,259.5 | 6,001.8 |
| Compensation of employees | 1,667.7 | 1,702.9 | 1,701.9 | 1,636.2 | 1,782.0 | 1,804.0 | 1,721.8 |
| Intermediate consumption | 1,220.8 | 1,340.2 | 1,344.2 | 1,188.8 | 1,265.2 | 1,260.9 | 1,229.9 |
| Social payments | 1,387.6 | 1,410.8 | 1,411.0 | 1,435.9 | 1,448.7 | 1,451.7 | 1,454.0 |
| Gross fixed capital formation | 676.5 | 736.8 | 765.7 | 653.9 | 690.4 | 776.6 | 697.5 |
| Subsidies | 405.4 | 583.2 | 528.3 | 373.4 | 236.2 | 216.8 | 200.5 |
| Other ** | 636.0 | 843.2 | 883.9 | 617.9 | 825.9 | 749.5 | 698.1 |
| Fiscal balance | -792.5 | -1,630.4 | -1,612.4 | -890.7 | -826.1 | -807.9 | -587.6 |
| Gross debt | 7,825.5 | 8,828.4 | 8,820.0 | 7,997.9 | 9,731.9 | 9,660.0 | 8,620.6 |

* Includes capital taxes, property income and 'other' revenue.

** Includes interest payments, capital transfers payable and 'other' expenditure.

Source: MFE, COM

Higher budgets were allocated across all expenditure components. The largest revision was in the 'other' expenditure component (+€207.2 million), mostly due to the new information about the planned capital transfer in favour of the national airline which is stated in the USP but still under discussion with the COM. Subsidies were also raised by €177.8 more, as the fiscal assistance for businesses impacted negatively by the pandemic was extended till the end of 2021 (beyond what was initially anticipated). The budget for intermediate consumption was also raised by €119.4 million, to ensure sufficient funds are available to meet the requirements created by the pandemic. In turn, the planned spending on gross fixed capital formation was revised upwards by

€60.3 million, as the utilisation of the RRF funds was factored in.⁸⁹ Updated calculations also resulted in upward revisions in compensation of employees and social payments, which were however less strong, respectively up by €35.2 million and €23.2 million.

The downward revision in total revenue was attributable to the €220.7 million reduction in the expected intake from taxes on production and imports and the €85.2 million lower yield expected from current taxes on income and wealth. This is consistent with the less optimistic macroeconomic scenario portrayed in the USP than in the DBP. However, these reductions were partially offset by the €40.0 million increase in the forecast for social contributions and an additional €51.2 million classified under 'other revenue'. In the first case this reflected the very resilient labour market, whose performance led to a more positive outlook for social contributions, while in the second case, the inclusion of RRF funds played a role.

The COM's revenue and expenditure forecasts for 2021 and 2022 are slightly higher, but very close to the MFE's estimates. In relation to 2021, the COM produced a slightly higher estimate for indirect taxes and 'other' revenue, but a slightly lower forecast for direct taxes. On the other hand, the COM's estimate for social contributions is in line with the USP. For 2022, the COM's estimated revenue from the main sources (indirect taxes, direct taxes, and social contributions) are slightly lower than the MFE's estimates. However, their combined effect is overshadowed by the COM's much higher expected revenue from 'other' sources.

The revenue discrepancies between the CBM's forecasts and those by MFE are also minimal. The overall difference in total revenue across the two institutions is limited to €28.6 million in 2021 and €8.0 million in 2022. Indeed, the discrepancies at a component level tended to offset each other. In 2021, the CBM's estimated revenue is slightly more optimistic than indicated in the USP, while in 2022, the situation is the opposite.

On the expenditure front, the COM's estimates for 2021 for the largest three components (compensation of employees, intermediate consumption, and social payments) are very close to the figures indicated in the USP. On the other hand, there are larger differences with respect to the rest of the expenditure components. The

⁸⁹ Malta's RRF plan was not yet published by the cut-off date of this Report.

COM's forecasts point to higher gross fixed capital formation and 'other expenditure', whose effect is partially dampened by a lower estimate for subsidies. Even for 2022, the COM's total expenditure forecast is merely €11.1 million above that indicated in the USP. Indeed, differences at a component level compensated for each other. The largest discrepancies relate to gross fixed capital formation, which is €86.2 million higher in the COM's figures, and 'other' expenditure, where the figures by MFE are €76.4 million higher. Such discrepancies may in part be ascribed to different assumptions on how certain transactions could be classified particularly when details are limited.

On the other hand, variations between the CBM's expenditure forecasts and those by MFE are much larger. The CBM's forecasts were prepared much earlier and hence did not embody the full set of fiscal initiatives factored in the USP. Hence, the CBM's forecasts are less comparable than those of the COM. For 2021, the expenditure profile anticipated by MFE is €711.0 million more, while for 2022 it is €246.6 million more than indicated by the CBM. Such large differences make the comparisons at a component level between the two sets of forecasts not so informative.⁹⁰

6.3 Public debt

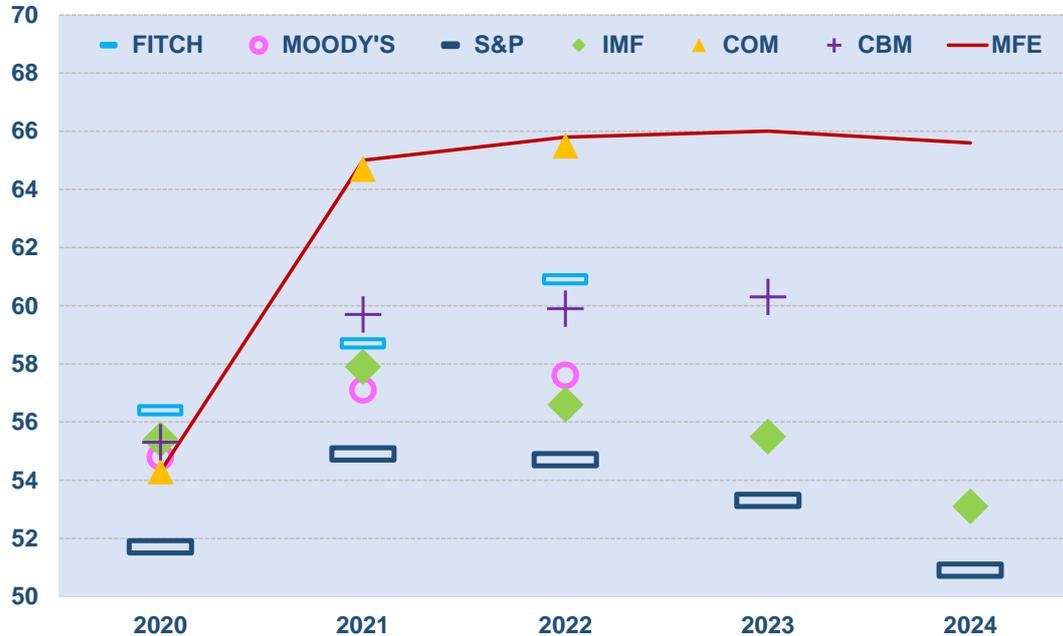
The USP raised the debt target for 2021 by €1,002.9 million compared to the DBP, to €8,828.4 million. This revision reflects mainly the larger fiscal deficit for the year, but even the estimate for the SFA was increased. The 2021 debt estimate by the COM and MFE are very similar, just above €8.8 billion. On the contrary, the debt projection for 2022 by the COM is €71.9 million less than indicated in the USP. The difference is mainly due to the lower estimate for SFA used by the COM. A relatively smaller effect is exerted by the slightly lower fiscal deficit forecast by the COM for 2022, as well as the small discrepancy relating to the outstanding debt in 2021. The debt projections by the CBM are lower than indicated in the USP. This largely follows from the fact that the fiscal deficit which had been projected by the CBM is much lower than shown in the latest official forecasts.

There is heterogeneity in the possible trajectory for the debt-to-GDP between 2021 and 2024 (see [Chart 6.2](#)). The seven institutions concur about an expected rise in the

⁹⁰ The CBM's forecasts available by the Report's cut-off date, were published on 17 February 2021.

debt-to-GDP ratio in 2021, though to varying degrees. However, in the remaining years the debt forecast patterns diverge. According to the USP, the debt-ratio will stabilise, at a level which is above that indicated by the other institutions. On the other hand, some other forecasts point to a more gradual increase in the public debt ratio. Some others point to eventual decreases, such that, by 2024 the increase in the debt ratio which took place because of the pandemic would be fully reversed. Larger divergences in the outlook for the public debt are driven by the cumulative nature of public debt (which is a stock variable), whereby differences over time tend to amplify. This trajectory is also impacted by the differences in the estimate for nominal GDP over the period 2021 to 2024, which acts as the denominator for the public debt ratio.

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



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

6.4 Assessment

The fiscal revisions for 2021 carried out by MFE in the USP allow for the less benign macroeconomic scenario (which impacts tax revenue negatively) and the greater need for expenditure measures. This is also compatible with the downside risk to the fiscal balance which the MFAC had identified in its endorsement of the fiscal forecasts contained in the DBP (published in October 2020). In turn, the new set of fiscal forecasts for the outer years, build on the premise of a full or quasi-complete return to

normality starting from 2022, which thus contributes to an expected positive boost to tax revenues, and permits the phasing out of some temporary expenditure measures. The fact that all other independently produced forecasts show a correction in the fiscal deficit by 2024, though to varying degrees, offers comfort that, based on the information available to date, the USP scenario appears plausible and there is broad consensus around it. On the other hand, the differences in the debt-to-GDP ratios can be largely explained by the fact that those which were produced last (MFE and COM) factored in more timely information which was unavailable when the other sets of forecasts were produced. Such differences cumulate over time, explaining the rather wide range of estimates for the debt ratio at the end of the forecast horizon. The MFE's debt calculations adequately factor in the intention to undertake a relatively more expansionary fiscal policy than anticipated by the other institutions.

Chapter 7

Conclusion

The USP is based on the scenario that in 2021 Malta's real GDP grows by 3.8%, thus start recovering from the 7.0% contraction recorded a year earlier. In 2022, the real GDP growth momentum is anticipated to be stronger, at 6.8%. Real GDP growth is then forecasted to remain high, but ease slightly in 2023 and 2024, respectively to 4.5% and 4.0%.

The partial economic recovery and the need for fiscal support measures are expected to continue exerting a strong negative impact on public finances in 2021. For 2021, the projected fiscal deficit-to-GDP ratio exceeds that recorded in 2020. However, as from 2022 onwards, the USP targets a progressive reduction in the fiscal deficit, to below 3.0% of GDP by 2024. This would permit the stabilisation of the public debt ratio, albeit above 60.0% of GDP. Such projected fiscal developments make use of the flexibility granted by the suspension of the fiscal rules across the EU because of the activation of the general escape clause.⁹¹ The communications by the COM suggest that the general escape clause could be deactivated as from 2023. However, in view of the discussions on the reform of the economic governance framework in the EU, it is not yet known whether the same fiscal rules (relating to the fiscal balance, public debt and expenditure growth) would start to be applied, or else, whether there would be changes.

Both the macroeconomic and the fiscal forecasts are considered to lie within the endorsable range of the MFAC. This while acknowledging that uncertainty remains high and key assumptions, particularly those relating to the pandemic's progress, shape the macro-fiscal scenario over the period 2021 to 2024. The MFAC's risk assessment suggests a broadly neutral risk outlook vis-à-vis the profile for real GDP growth over the forecast horizon, but the fiscal deficit and the public debt ratios could be higher than planned.

The Fiscal Council supports the government's initiatives aimed at mitigating the adverse economic effects of the pandemic and the stimulus provided for the economic

⁹¹ Details about the fiscal rules are 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_en.

recovery. It is important that the additional funds derived from the RRF are channelled into projects which yield the highest net benefits, both on the economy's supply side, as well as in terms of environmental improvements.

The MFAC reminds that when economic conditions allow, fiscal policies should again be aimed at achieving a prudent medium-term fiscal position, and ensuring debt sustainability, while enhancing investment. It is important to be adequately prepared for the time when the general escape clause will eventually be revoked, and the fiscal rules thus become binding again. Rebuilding fiscal space would be useful to counteract any future adverse shocks and enhance the economy's overall resilience. The fiscal space, which was available pre-pandemic, because of the stream of fiscal surpluses and the low level of public debt, proved very valuable by making possible the implementation of aggressive fiscal support measures.

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