Assessment of the Annual Report 2020 and Half-Yearly Report 2021

MFAC
MALTA FISCAL ADVISORY COUNCIL

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Assessment of the Annual Report 2020

and Half-Yearly Report 2021

St Calcedonius Square
Floriana FRN 1530, Malta
T: +356 2247 9200
Fax: +356 2247 9219
info@mfac.org.mt
www.mfac.org.mt

10 September 2021

The Hon Mr Clyde Caruana B.Com. (Hons) Economics, M.A. Economics
Minister for Finance and Employment
Maison Demandols,
South Street,
Valletta. VLT 2000

Dear Minister,

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

In terms of the Fiscal Responsibility Act, the Malta Fiscal Advisory Council is hereby presenting its assessment of the Annual Report and the Half-Yearly Report which were published by the Ministry for Finance and Employment in 2021.

The Council notes that in 2020 Malta experienced a severe economic recession as a result of the COVID-19 pandemic. The economic growth which was envisaged for 2020 did not materialise. The fiscal targets were also missed since the economic recession impacted tax revenues negatively and necessitated various unbudgeted support measures. This translated into a large fiscal deficit and higher public debt, in contrast with the original plans. The Council acknowledges that the large deviations between the outturn and the macroeconomic and fiscal forecasts for 2020 were exceptional, since the shock created by the pandemic could not have been anticipated in 2019, when the estimates were produced.

The Council notes that the official macroeconomic forecasts and fiscal projections for 2021 specified in the Half-Yearly Report remained the same as published in the Update of Stability Programme in April 2021. The Programme envisaged 3.8% real GDP growth for 2021, a fiscal deficit amounting to 12.0% of GDP and a public debt-to-GDP ratio of 65.0%. The Council had considered these forecasts within its endorsable range in its previous Report. The limited official statistics which became available since the publication of the forecast endorsement remain compatible with the macroeconomic and fiscal scenario as presented by the Government.

In its assessment report, the Council identified missing information, relating to the absorption of EU funds and the outstanding creditors, which is prescribed in the Fiscal Responsibility Act. The Council invites the Ministry to address such lacunae in its forthcoming reports.

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

AML	Anti-money laundering
COM	European Commission
COVID-19	Coronavirus disease 2019
DBP	Draft Budgetary Plan
EBU	Extra Budgetary Unit
ESA	European System of National and Regional Accounts
FATF	Financial Action Task Force
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
MFAC	Malta Fiscal Advisory Council
MFE	Ministry for Finance and Employment
MTFS	Medium-Term Fiscal Strategy
NAO	National Audit Office
NSO	National Statistics Office
pp	percentage point
RRF	Recovery and Resilience Facility
SURE	Support to mitigate Unemployment Risks in an Emergency
USP	Update of Stability Programme
VAT	Value Added Tax

Executive Summary

The latest Annual Report and Half-Yearly Report published by the Ministry for Finance and Employment respectively focus on an ex-post assessment of the deviations between the actual and forecast macroeconomic and fiscal developments in 2020 and present the macroeconomic and fiscal outlook for 2021.

According to the NSO News Release 097/2021, nominal GDP growth was estimated to have contracted by 6.5% in 2020. Malta's economy entered recession in 2020 as a result of the impact of the pandemic. This event was exceptional and was the key reason why the nominal GDP growth forecasts for 2020, which were prepared the year before, failed to materialise (+8.3%, Update of Stability Programme – April 2019; and +6.5%, Draft Budgetary Plan – October 2019).

Likewise, the fiscal performance was very different from what was originally planned. In 2020 the pandemic led to revenue shortfalls and necessitated substantial new expenditures, which were not budgeted for. The Consolidated Fund recorded a deficit of €1,467.9 million, in contrast with the €114.0 million surplus which was approved in the Financial Estimates. The general government balance (on an ESA basis) recorded a deficit of 10.1% of GDP in 2020, missing the surplus targets which had been presented in 2019 as part of the Update of Stability Programme and the Draft Budgetary Plan.

The Malta Fiscal Advisory Council acknowledges that 2020 was an exceptional year. The observed deviations of the official macroeconomic and fiscal forecasts are in large part be attributed to the extraordinary circumstances actualized in 2020 which were beyond the control of government rather than to forecast modelling issues. The unplanned fiscal support was necessary to mitigate the effects of the pandemic and was made possible through the agreement at the European Union level to temporarily suspend the fiscal rules.

The Half-Yearly Report restated the macroeconomic and fiscal outlook for 2021 which had been indicated in April 2021 as part of the Update of Stability Programme. The Council notes that the Government did not consider the need to carry out changes before the next forecast round (October 2021). The real GDP growth estimate for 2021 was reconfirmed at +3.8%, while the targets for the fiscal balance and the public debt ratios remained -12.0% and 65.0% respectively. The Council considers that the macroeconomic and fiscal forecasts for 2021 continue to lie within its endorsable range and the risk assessment which it had presented in its previous Report remains valid.

Chapter 1
Introduction

The Fiscal Responsibility Act (FRA) requires that on a yearly basis the Ministry for Finance and Employment (MFE) publishes an Annual Report and a Half-Yearly Report. These two documents serve to enhance economic and fiscal transparency in Malta. The FRA further prescribes that the Malta Fiscal Advisory Council (MFAC) publishes its assessment on these two reports.

The latest Annual Report presents the actualized macroeconomic developments in 2020 in relation to the forecasts which had been prepared by the Ministry for Finance and Employment the year before. It also provides information on the execution of the fiscal budget and compares the outcome with the targets which had been indicated in April 2019 and in October 2019. In the first case, the projections formed part of the Update of Stability Programme (USP) / Medium-Term Fiscal Strategy (MTFS), and in the second case, the projections were part of the Draft Budgetary Plan (DBP). This ex-post assessment serves to evaluate the quality of the official forecasts, and to help detect any possible forecast bias over the years. The ex-post assessment for 2020 is however strongly conditioned by the fact that the start of the pandemic created severe economic and fiscal consequences, which were totally unexpected, and which thus led to very large deviations from the original plans and forecasts.

In turn, the latest Half-Yearly Report focuses on the macroeconomic and fiscal forecast vintages which formed part of the October 2020 and April 2021 forecast rounds. The Half-Yearly Report reconfirmed both the macroeconomic and fiscal forecasts which were presented in the Update of Stability Programme that was submitted to the European Commission (COM) in April 2021.

The main purpose of the Half-Yearly Report is to assess whether any significant developments have occurred since the latest forecast round which might necessitate some corrective measures or fine-tuning in the macroeconomic and/or fiscal forecasts for the current year. In this respect, the Half-Yearly Report refers to the decision in June 2021 by the Financial Action Task Force (FATF) "to insert Malta in its list of countries identified as having strategic anti-money laundering (AML) deficiencies" and states the government's official position that this "is not expected to have substantive negative economic effects over the short term". The MFAC takes note of the government's assessment stated in the Half-Yearly Report that a revision in the macro-economic forecast is not deemed necessary at this stage since "projections were already cautious at the time of preparation in April" and because of "the potential materialization of upside risks from the external side".

This Report, whose cut-off date is 13 August 2020, proceeds as follows. **Chapter 2** evaluates the macroeconomic developments and the forecasting performance in relation to 2020. **Chapter 3** focuses on the variances between the fiscal targets and the actual outturn for 2020, both as reflected in the Consolidated Fund, and according to the European System of National and Regional Accounts (ESA). **Chapter 4** reviews the forecasts for 2021, presented in the USP 2021 – 2024, and compares them with the forecasts which were published in the DBP for 2021. **Chapter 5** then presents an assessment of the updates to the fiscal projections for 2021 in the context of the estimated developments during the first half of the year. **Chapter 6** concludes with an overall assessment.

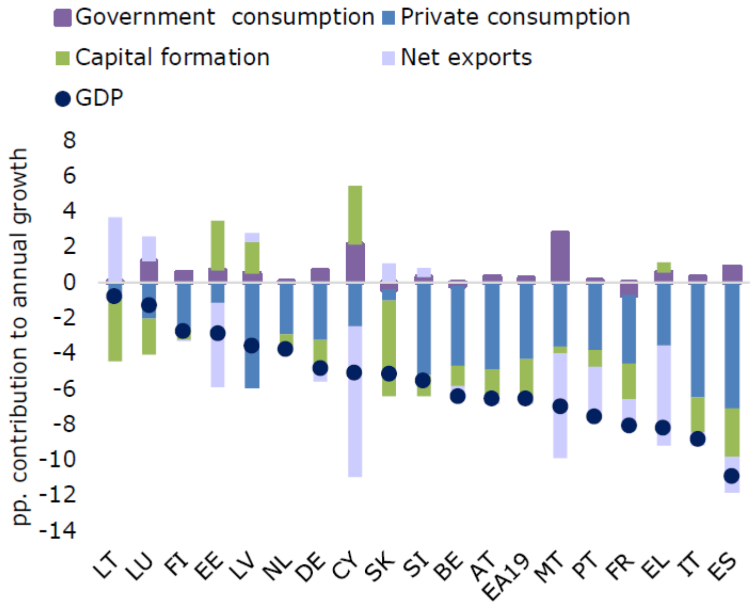
Chapter 2

Nominal macroeconomic developments in 2020

The MFE's Annual Report evaluates the accuracy of the 2020 forecast growth rates for the GDP components and other macroeconomic variables which were included in the USP 2019 – 2022 (published in April 2019) and the DBP 2020 (published in October 2019). These forecasts were compared with the official statistics published by NSO, mainly contained in the national accounts released in May 2021 (News Release 097/2021).[1] The MFE's Annual Report focuses on developments in nominal terms, since these serve as the main input to prepare the official fiscal projections.

In 2020, the economic outcome was completely different from what was expected a year before, due to the COVID-19 pandemic. This event was exceptional and took by surprise economic forecasters worldwide. In Malta's case, real GDP declined by 7.8%, as opposed to real GDP growth which was forecast (USP: +5.7%; DBP: +4.3%). Empirical analysis by the COM shows that Malta, being a very small open economy, was among the worst hit countries in the euro area, as it suffered a very negative contribution from net exports (see Chart 2.1).

Chart 2.1: Developments in real GDP expenditure components in 2020

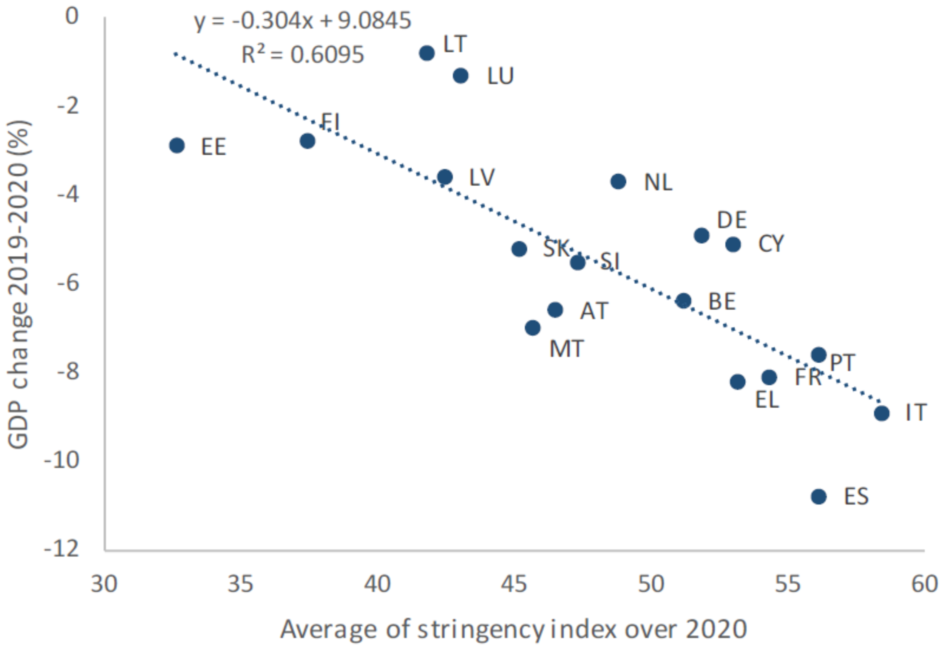


Source: COM - Reproduced from Quarterly report on the Euro Area. Volume 20, No.2 (2021).

[1] This News Release provided the latest official GDP statistics at the time the Annual Report was prepared. GDP statistics remain provisional for many years, which means that the "actual" data for the year may change across vintages because of revisions.

The restrictions on economic activity necessary to contain the spread of the pandemic, together with the adverse shock to aggregate demand, led to an economic recession. Research by the COM evidenced a negative correlation between the degree of stringency imposed by governments in the euro area and the fall in real GDP (see Chart 2.2).[2]

Chart 2.2: Real GDP impact and government stringency



Source: COM - Reproduced from Quarterly report on the Euro Area. Volume 20, No.2 (2021).

Furthermore, the contraction in real GDP was more pronounced in those countries (including Malta) which were more vulnerable to the pandemic because they had a high share of the sectors considered as contact-intensive (see Chart 2.3).[3]

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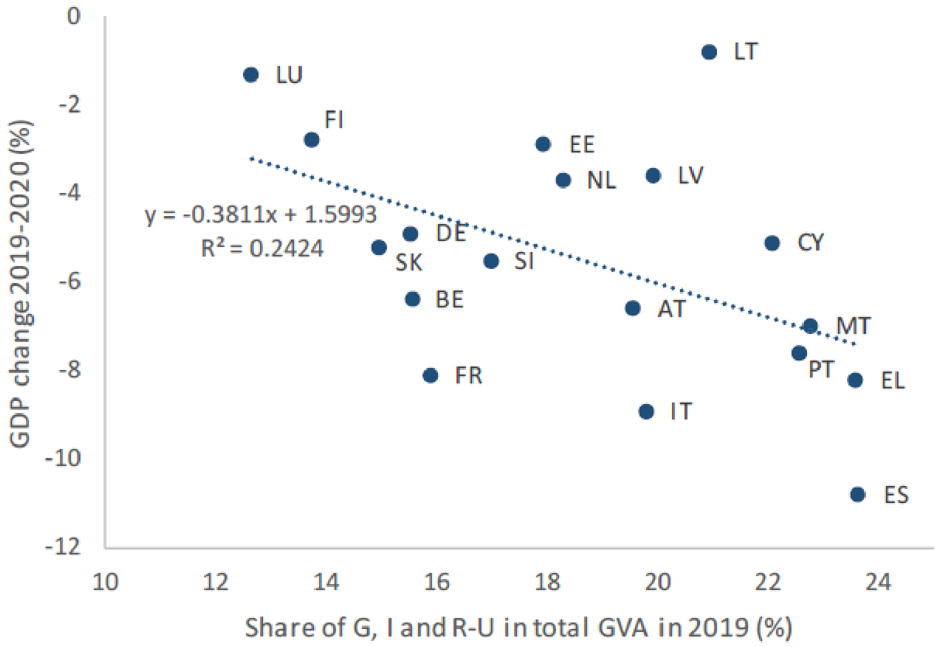
[2] The stringency indicator was compiled by the COM. This indicator covers (i) lockdown and closure measures (including school closing, workplace closing, cancelation public events, restrictions on gathering size, closing of public transport, stay-at-home requirements, restrictions on internal movement, and restrictions on international travel), (ii) economic response (including income support, debt/contract relief for households, fiscal measures and giving international support) and (iii) health system measures (including public information campaign, testing policy, contact tracing, emergency investment in health, investment in COVID-19 vaccines, facial coverings and vaccination policies).

[3] Contact-intensive activities are those where businesses rely on close physical interactions either in production or in the delivery of their goods and services. As a result of the pandemic, such businesses (example tourism, non-essential offline retail, arts and entertainment) had to shut down or change the nature of their operations. For the purposes of its analysis, the COM considered as contact-intensive the following sectors: Wholesale & Retail; I: Accommodation & Food services; R-U: Arts & Recreation and Other services.

Chart 2.3: Real GDP impact and share of COVID-19 vulnerable services



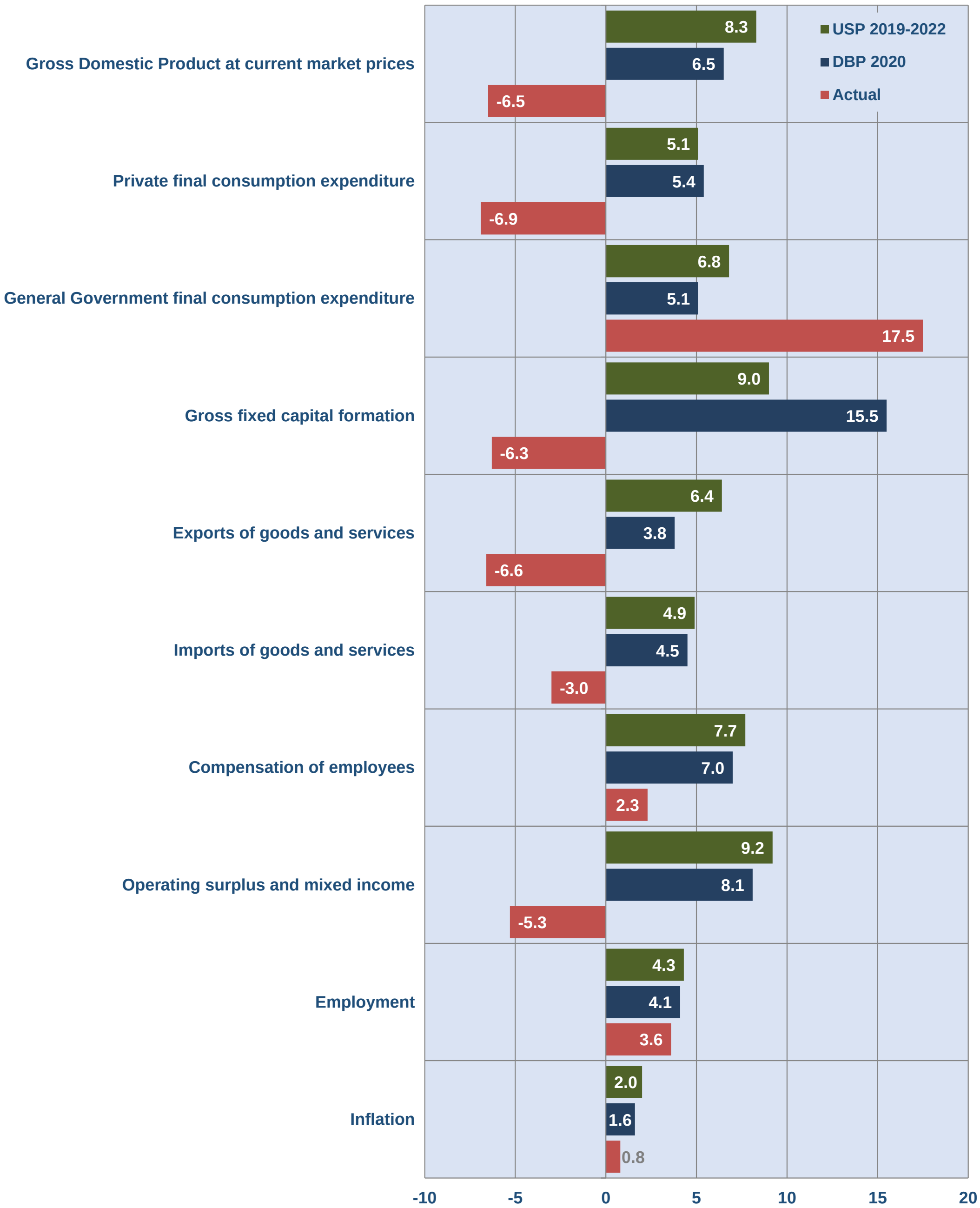
Source: COM - Reproduced from Quarterly report on the Euro Area. Volume 20, No.2 (2021).

The 2020 projected nominal GDP growth in Malta (USP: +8.3%; DBP: +6.5%), which underpinned the fiscal projections for the year, failed to materialise. Instead, nominal GDP contracted by 6.5% (see Chart 2.4). At a component level, declines were broad-based. In nominal terms, private consumption suffered the largest decline in 2020, down by 6.9% on a year earlier. The inability to carry out certain types of household consumption (because of the restrictions imposed) was a critical factor in explaining the forecast divergence. Nominal gross fixed capital formation experienced a similar reduction, as it contracted by 6.3% compared to 2019. In turn this was mostly because certain planned private sector projects were postponed because of the pandemic.

The contraction in private consumption and investment were not anticipated before the pandemic, particularly since in the previous years these two components had recorded rather elevated growth rates, and the forecasts had broadly extended such patterns. The substantial differences recorded between the forecasts and the outturn for these two components derive from the unexpected shock created by the pandemic and its consequent severe economic effects.

Nominal exports declined by 6.6% in 2020, in contrast with the 6.4% and the 3.8% growth forecasts which were indicated in the USP and DBP respectively. The unanticipated economic recession in Malta's main trading partners exerted a substantial knock-on effect on Malta's exports. Although certain sectors, such as remote gaming, were resilient, the shock was amplified by the fact that tourism suffered a very strong hit, particularly as travel came to a complete halt in certain months. Indeed, earnings from tourism declined by an unprecedented 78.5% compared to 2019.

Chart 2.4: Nominal macroeconomic developments in 2020 (% change over 2019)



Source: MFE

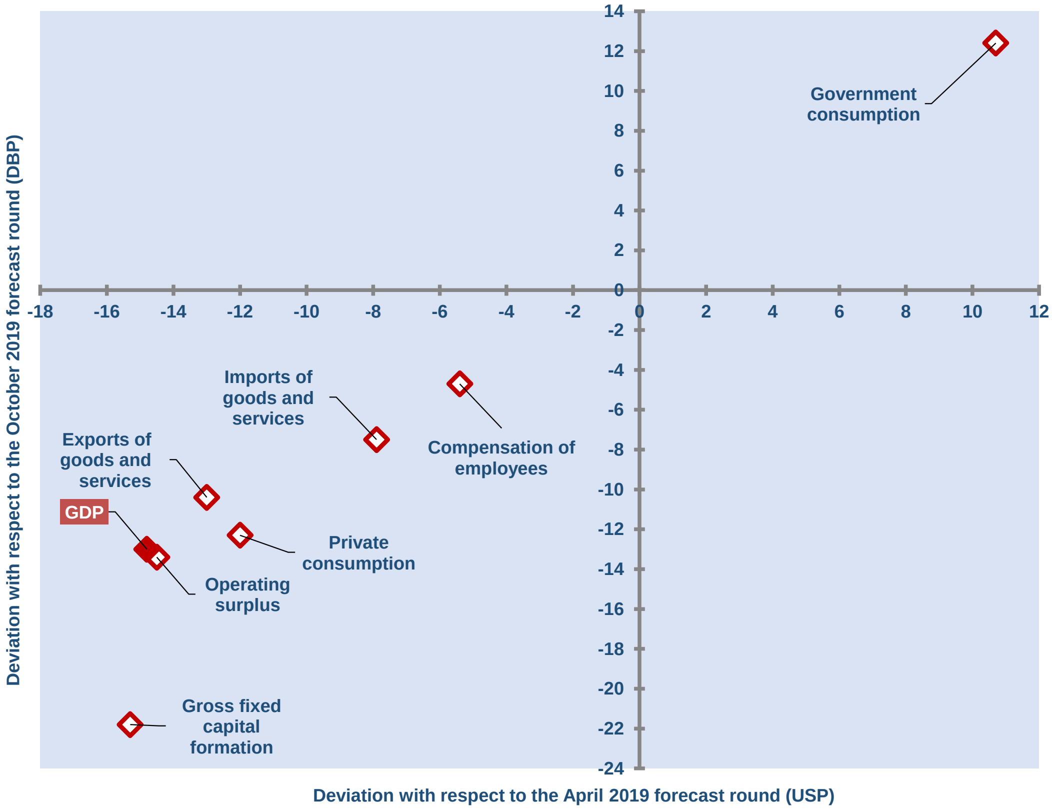
Even nominal imports declined in 2020, though to a lower extent than exports. Imports were down by 3.0%, instead of the average 4.7% growth envisaged in the USP and the DBP. The forecast variation in imports was the lowest among the GDP components. Consumption, investment, and exports, which have a high import content experienced larger declines, but their effect was dampened by the fact that inventory changes for the year were significantly positive. The latter suggests that the drop in imports was contained (resulting in a relatively smaller divergence between the forecasts and the actual data) because some production continued, despite the decline in aggregate demand. Moreover, changes in the relative import content across the GDP components could also have taken place because of the pandemic, thus moderating the drop in imports.

The only GDP component which grew at a faster pace than forecast was government consumption (see Chart 2.5). Due to the unplanned health expenditure and the launch of various temporary fiscal initiatives to support the economy, government consumption grew much more strongly than had been anticipated. Such outlays had not been budgeted for but were in line with the recommendation offered by the COM for Members States to support as much as possible their economy. The very strong fiscal support became possible because of the temporary suspension of the fiscal rules in the EU.

From the income side of GDP variations were also very significant, but performance was rather skewed. Gross operating surplus and mixed income diverged much more than compensation of employees from the original forecasts. Indeed, the government implemented strong wage support measures at the beginning of the pandemic to mitigate its effects.

In 2020, total compensation of employees was higher than in 2019, up by 2.3%, sustained by the wage support offered by the government. Nevertheless, the outturn for total compensation of employees was still below projections (USP: +7.7%; DBP: +7.0%), particularly as the forecasts had extended the pattern of strong growth recorded in earlier years.

Chart 2.5: Deviations between nominal GDP growth and its components (pp)



Note: The top-right quadrant indicates instances when the actual turnout was higher than indicated in both the April 2019 (USP) and the October 2019 (DBP) forecast rounds. The bottom-left quadrant indicates instances when the actual turnout was lower than indicated in both the April 2019 (USP) and the October 2019 (DBP) forecast rounds. There are no observations in the other two quadrants.

Source: MFE

The decomposition of the forecast error indicates that employment growth was broadly in line with expectations of around 4.0%. The broad-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. These two factors explain why the employment growth outturn was broadly in line with the forecasts. Therefore, the deviation in the outturn for compensation of employees was driven by the variation in the average wage in the economy, which was lower than expected. Indeed, although the government's measures, which covered a significant share of employees in Malta, subsidised the enterprises to maintain their workers, the monthly salary which was offered was lower than what workers earned on average before the pandemic.

On the other hand, gross operating surplus and mixed income declined by 5.3% in 2020. This contrasts with the 9.2% and 8.1% growth rates which were respectively indicated in the USP and DBP. Indeed, the adverse shock to nominal GDP was reflected mostly on profits which experienced broad-based declines on a year earlier. The outturn for gross operating surplus in 2020 differed significantly from the 9.4% average growth recorded during the five-year period 2015 to 2019.[4]

Despite the unanticipated economic recession in 2020, the overall price level in the economy rose. The HICP inflation rate in Malta was 0.8%. This was lower than the 2.0% and 1.6% respectively indicated in the USP and DBP. The reduction in aggregate demand resulted in lower upward price pressures than had been anticipated.

[4] In 2020, the share of gross operating surplus in nominal GDP amounted to 46.8%, whereas in 2015 this share stood at 48.3%.

Chapter 3

Fiscal developments in 2020

The accuracy of the 2020 fiscal forecasts is evaluated by comparing the actual developments with the targets set for the Consolidated Fund and on an ESA basis.[5,6] Whereas the Consolidated Fund is based on cash transactions (which are not usually revised), ESA fiscal data is compiled on an accruals basis (subject to revisions) and has a wider coverage, since the activities of Extra-Budgetary Units (EBUs) are also included.[7] Since the fiscal forecasts under review were prepared before the start of the pandemic, deviations between the fiscal outturn in 2020 and the projections were large. These deviations were inevitable and justifiable since the outbreak of the pandemic was an exceptional event, which created severe economic effects, and necessitated many unplanned fiscal measures.

3.1 Developments in the Consolidated Fund

The Consolidated Fund recorded a deficit of €1,467.9 million in 2020, in sharp contrast with the €114.0 million surplus which was originally planned (see Table 3.1). This large divergence was the result of the pandemic, which simultaneously led to a large drop in revenue and necessitated significant unplanned expenditures. The unexpected economic recession resulted in an adverse shock to tax revenues. The latter were further hit by the concessions to delay tax payments. Successive rounds of fiscal measures, which had not been budgeted for, were launched to sustain economic activity and the labour market.[8] Pandemic-related health expenditure was another important contributor to the significant budget overrun in 2020. On a cash basis,

[5] The Consolidated Fund targets for 2020 were tabled in Parliament together with the Budget Speech on 14 October 2019. These figures formed the basis for the DBP 2020.
[6] Unless otherwise indicated, the ESA fiscal targets for 2020 referred to in this Report are those which were included in the USP 2019 – 2022 and submitted to the COM in April 2019. Given that the USP contains multi-annual targets, different fiscal targets for 2020 featured in other USPs.
[7] Since the Consolidated Fund records transactions on a cash basis, these are not directly comparable to the other statistics discussed in this Report. Links between the Consolidated Fund data and macroeconomic developments are also imperfect.
[8] A review of the various COVID-19 measures launched by Government is available in the preliminary review carried out by the National Audit office (NAO) available on https://nao.gov.mt//loadfile/71ab28ce-3885-4c20-997d-379965498191.

revenue was thus €1,062.4 million less than projected, while expenditure was €519.5 million over budget.

Table 3.1: Main developments in the Consolidated Fund in 2020 (EUR million)

	Target	Actual	Difference
Revenue	5,451.7	4,389.3	-1,062.4
Expenditure	5,337.8	5,857.2	519.5
Consolidated Fund balance	114.0	-1,467.9	-1,581.9

Note: Figures may not add up due to rounding. The actual values are those published in NSO News Release 058/2021. The difference represents the deviation between the target specified in the Annual Report and the actual value published in the NSO release.
Source: MFE

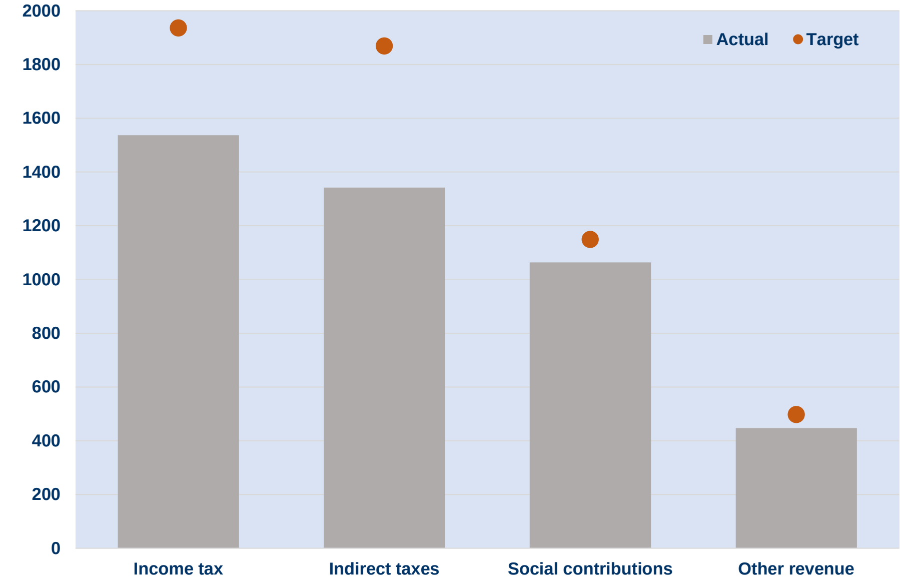
The revenue shortfall in the Consolidated Fund was broad-based, with the pandemic impacting all major categories (see Chart 3.1). In absolute terms, indirect taxes experienced the largest discrepancy, €527.0 million less than projected. This reflected both the downturn in consumption and tourism spending, as well as the concessions to delay tax payments. In turn, income tax was €399.3 million below target. Even in this case, the contraction in the tax base, as well as concessions to delay tax payments exerted a strong downward effect. On the other hand, the shortfall in social contributions was limited to €85.6 million, mostly due to the concession to delay tax payment, as otherwise the labour market was resilient, aided by the wage support schemes launched by the government at the beginning of the pandemic. Still, part of the decline in social contributions reflects the fact that the wage support scheme provided income which was lower than the average wage in the economy. Similarly, the shortfall in other revenue was contained, since the lower-than-expected intake from grants and dividends was partially compensated for through higher revenue from other miscellaneous sources.

On the expenditure side, spending on personal emoluments was in line with the budgeted amount (see Chart 3.2). There was slower recruitment in some areas because of the pandemic, and this compensated for a higher wage bill on health. A significant share of the expenditure overrun in the Consolidated Fund was recorded in the capital expenditure category, which exceeded the budget by €302.2 million.[9] Other

[9] The classification of capital expenditure in the Consolidated Fund is based on definitions which do not correspond precisely to the methodology used to estimate gross fixed capital

expenditure components were in turn €213.1 million over budget. Pandemic related health expenditure, the Business Assistance Programme (which includes the wage supplement scheme), as well as the Economic Regeneration Voucher Scheme had not been budgeted for, thus explaining the bulk of the expenditure overruns recorded in 2020.

Chart 3.1: Consolidated Fund – Revenue (EUR millions)



Source: MFE

Chart 3.2: Consolidated Fund – Expenditure (EUR millions)

Source: MFE

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formation in ESA terms. Hence the distinction between capital expenditure and other expenditure in the Consolidated Fund is not very informative.

Due to the pandemic, the forecasting performance differed from the pattern recorded over the five-year period 2016 to 2020 (see Table 3.2). In 2020, the Consolidated Fund revenue was significantly less than projected. This contrasts with what happened between 2016 and 2018, when actual revenue exceeded the target, while in 2019, the revenue shortfall was small.

Table 3.2: Deviations in the Consolidated Fund - actual less target (EUR millions)

	2016	2017	2018	2019	2020
Revenue	**193.7**	**403.6**	**209.7**	**-40.9**	**-1,062.4**
Direct taxes	140.3	215.2	57.0	-91.1	-484.9
Indirect taxes	25.9	71.8	144.9	5.1	-527.0
Grants	2.9	47.3	-26.9	-15.2	-97.7
Other revenue	24.6	69.3	34.8	60.3	47.2
Expenditure	**-11.2**	**92.6**	**258.5**	**-16.9**	**519.5**
Personal emoluments	-8.0	6.4	39.0	1.3	4.1
Other recurrent expenditure	66.7	102.0	95.7	95.6	215.5
Interest payments	-3.4	-4.1	-8.6	-6.8	-2.3
Capital expenditure	-66.5	-11.8	132.4	-107.0	302.2
Fiscal balance	**204.9**	**311.0**	**-48.8**	**-24.0**	**-1,581.9**

Note: Figures may not add up due to rounding. Direct taxes consist of income tax and social contributions. The deviations for 2020 r*epresent the difference between the target specified in the Annual Report and the actual value published in the NSO release 058/2021.*
Source: MFE

On the expenditure side, the overshooting followed years characterised by instances when expenditure was either marginally less than planned, or else exceeded the budget, but not to the same extent as in 2020. Overall, the pandemic resulted in a much worse fiscal balance than planned. Instead of a fiscal surplus, a large deficit was recorded. Even in the previous two years (2018 and 2019) the Consolidated Fund balance was below target, but only slightly. On the other hand, in 2016 and 2017, the Consolidated Fund balance was much stronger than projected.

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

In 2020, the general government fiscal deficit amounted to €1,300.2 million on an ESA basis (see Table 3.3). The outturn was slightly less than the deficit recorded in the Consolidated Fund. Nevertheless, even in this case, the performance was very different from the surplus targets indicated in the USP 2019 – 2022 and the DBP 2020, respectively of €141.7 million and €193.0 million. The main reason why the revenue forecasts have been so much overestimated and expenditure projections so much underestimated was because of the effects of the pandemic and the actions to deal with it.

Table 3.3: Main developments in 2020 on an ESA basis (EUR millions)

	USP 2020 published April 2019	DBP 2020 published October 2019	Actual April 2021	Actual less USP	Actual less DBP
Revenue	5,346.8	5,523.6	4,677.8	-669.0	-845.8
Expenditure	5,205.1	5,330.6	5,977.9	772.8	647.3
Balance	141.7	193.0	-1,300.2	-1,441.9	-1,493.2
Gross debt	5,740.2	5,690.7	6,960.0	1,219.8	1,269.3

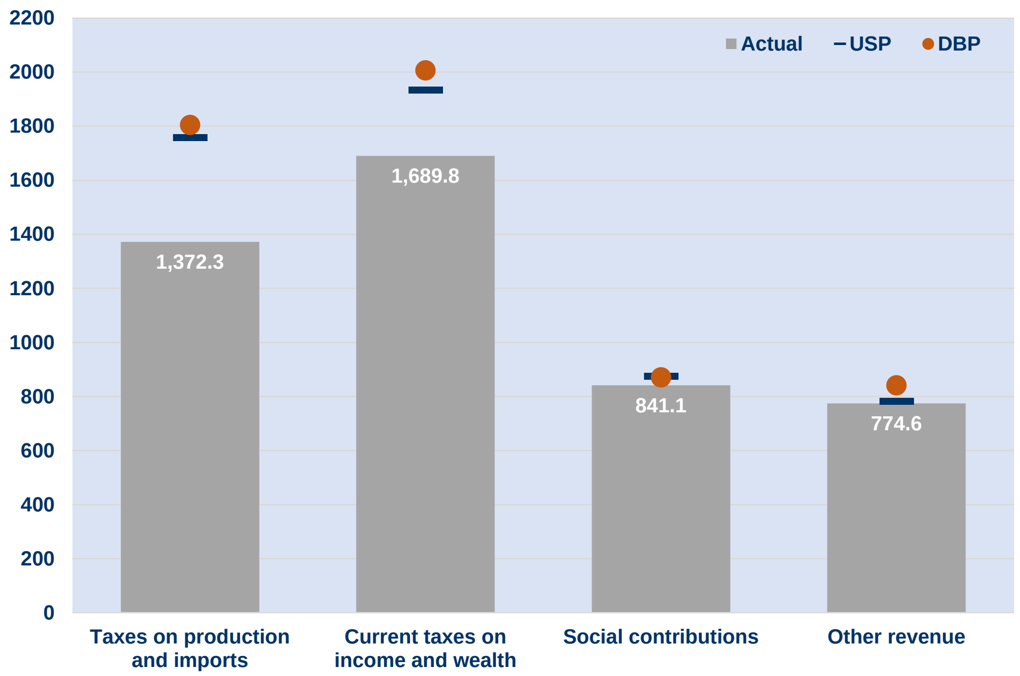
Source: MFE

Revenue shortfalls were mostly due to the underperformance of taxes on production and imports and current taxes on income and wealth (see Chart 3.3). In the first case, this mainly reflected the adverse impact on Value Added Tax (VAT), because of the unexpected contraction in nominal and real consumption. In the second case, the deviation was mostly in corporate income tax, because of the unexpected contraction in gross operating surplus.[10] In both instances, calculations by the MFE which were

[10] In 2020, compensation of employees grew by 2.3% in nominal terms, thus supporting personal income taxes.

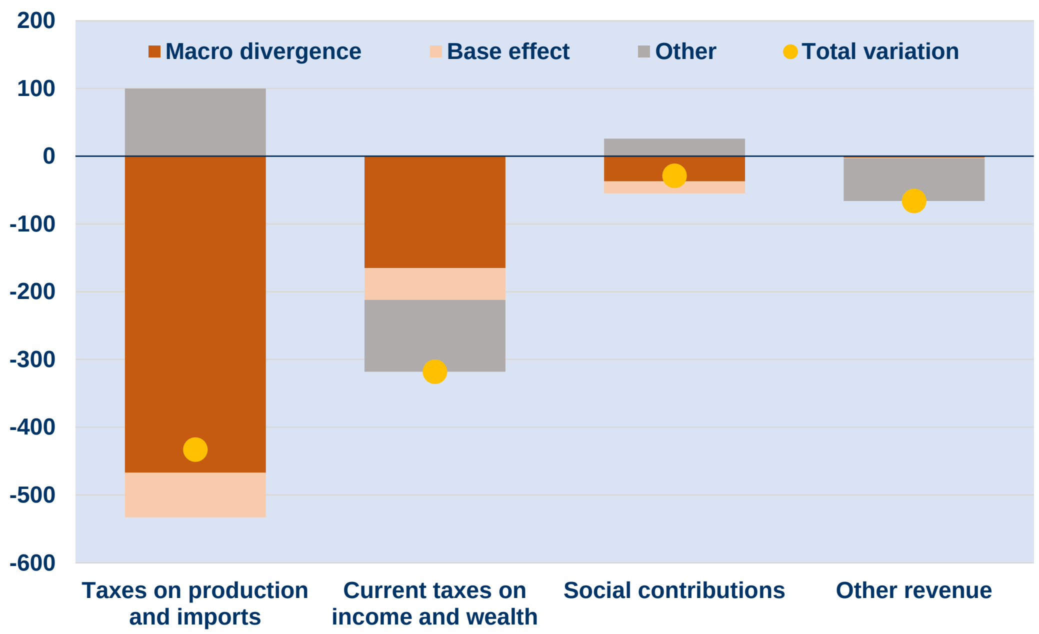
presented in its Annual Report show that the main issue was the macro divergence – the difference between the macroeconomic outlook that was predicted and that which materialised because of the pandemic (see Chart 3.4).

Chart 3.3: ESA – Revenue (EUR millions)



Source: MFE

Chart 3.4: ESA – Revenue forecast error compared to the DBP (EUR millions)



Source: MFE

A small base effect, because the outturn in 2019 was less than originally estimated, contributed further to the deviation between the actual and the projected revenue from indirect and direct taxes.[11] According to the calculations which the MFE presented in its Annual Report, other variations between the actual and forecast values could not be explained by normal economic fluctuations or base effects. Such variations, which were smaller than that captured by the macroeconomic effect, could indicate that the actual relationships between the specific tax revenue component and economic developments resulted in different elasticities from that which the MFE had assumed in the original forecast.[12] Given the unprecedented economic changes created by the pandemic, it is plausible to hypothesise that in 2020 the actual tax elasticities could have departed from their normal values.

Although the concessions to delay certain tax payments had an impact on cash figures, as evidenced in the Consolidated Fund, Eurostat guidance allowed for such revenues to be imputed (net of any possible irrecoverable payments). Thus, as per Eurostat's note on statistical implications of some policy measures in the context of the COVID-19 pandemic, the impact of tax deferrals was fully imputed by MFE, with no fiscal impact on revenue in ESA terms, on the assumption that all deferred taxes shall be collected by the stipulated timeframes.

Revenue from social contributions was close to the target. This reflected the resilience of the labour market. Indeed, assisted by the wage support measures introduced by the government, in 2020 compensation of employees grew on a year earlier. Social contributions were automatically deducted from wages paid, explaining the limited deviation in this revenue component. Even in the case other revenue, although below-target, the drop was contained since this was not strongly impacted by the pandemic.

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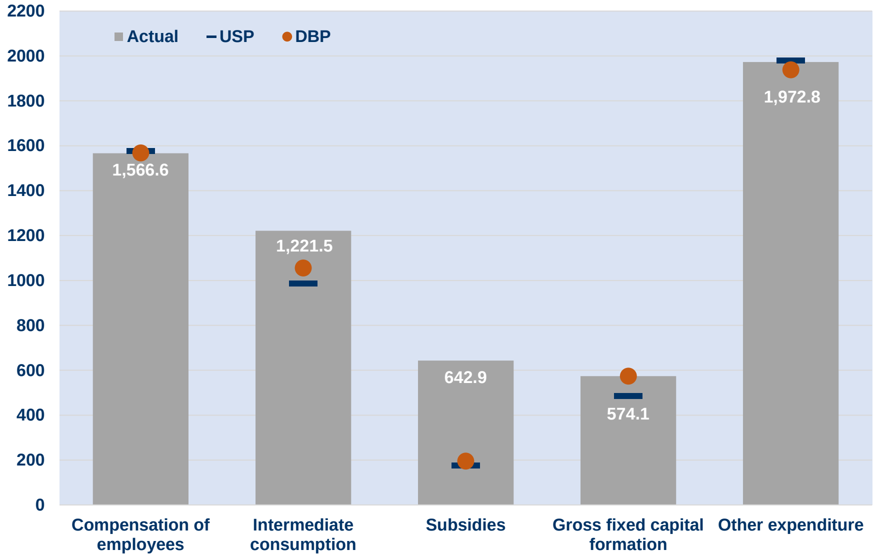
[11] Tax revenue projections are normally calculated by taking the value of the previous year and augmenting it by an amount based on the forecast growth in the tax base and the assumed tax elasticity. A revision in the historic data can thus contribute to a forecast error due to a changing starting point. Provisional ESA data is normally revised when more information becomes available. The larger the revision in the data, the larger could be the forecast error attributable to the base effect created by the revision.

[12] Since taxes on production and imports dropped by less than could be ascribed to economic developments and the base effect, this could be due to the possibility that indirect taxes reacted less strongly, i.e. with a lower elasticity, than what was assumed. In the case of current taxes on income and wealth the drop was larger than could be attributed to local economic developments and the base effects. This could be due to the possibility that direct taxes reacted more strongly, i.e. with a higher elasticity, than what was assumed. It was also due to the effects on global profits of international companies due to COVID-19. Indeed, in the Half Yearly Report, MFE categorized 2021 variances stemming from corporate taxes paid by international companies as due to the macroeconomic effect.

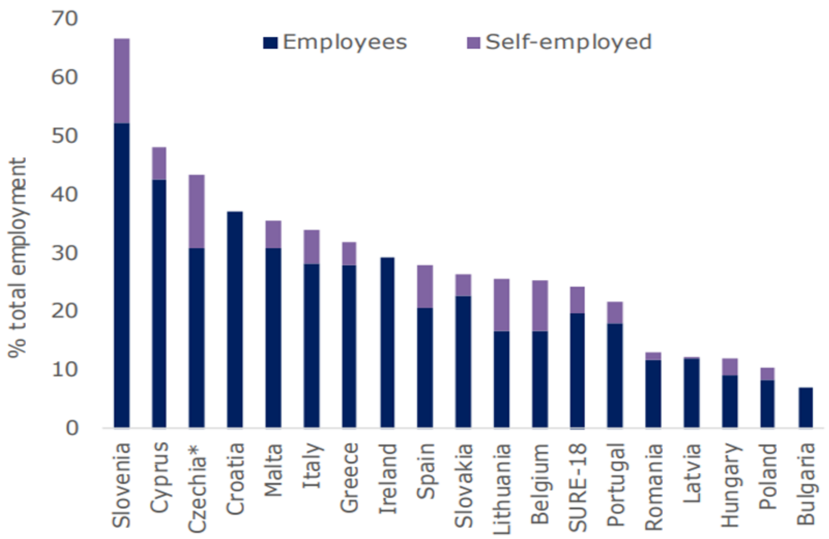
The overshoot in public spending was predominantly due to the unplanned higher subsidies in the form of the wage assistance for businesses which were negatively impacted by the pandemic (see Chart 3.5). Indeed, Malta's assistance to the labour market, supported by the COM's SURE covered among the highest percentage of workers in the European Union (see Chart 3.6).[13]

Chart 3.5: ESA – Expenditure (EUR millions)



Source: MFE

Chart 3.6: Number of workers covered by SURE (% of 2020 employment)



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Source: COM

[13] SURE is a European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE). It provides loans for the temporary support to the labour market. For further details refer to https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/financial-assistance-eu/funding-mechanisms-and-facilities/sure_en.

Spending on intermediate consumption exceeded the budgeted amounts in view of the unanticipated costs associated to the effects of the pandemic, such as healthcare, repatriation costs and cargo transport expenses. On the other hand, expenditure on compensation of employees and gross fixed capital formation remained rather close to the targets.[14]

In 2020, the exceptional circumstances created by the pandemic resulted in revenue being lower than indicated across most vintages of the USP (see Chart 3.7). Although the USP 2020 – 2021 was prepared in April 2020, when the pandemic had started, it still underestimated the drop in revenue. On the other hand, the multi-annual expenditure budgets prepared before the pandemic were mostly overshot in 2020 because of the unexpected pandemic-related expenditure (see Chart 3.8). However, the USP prepared in 2020, that is, after the pandemic had started, budgeted for an expenditure level which was relatively close to the outturn.

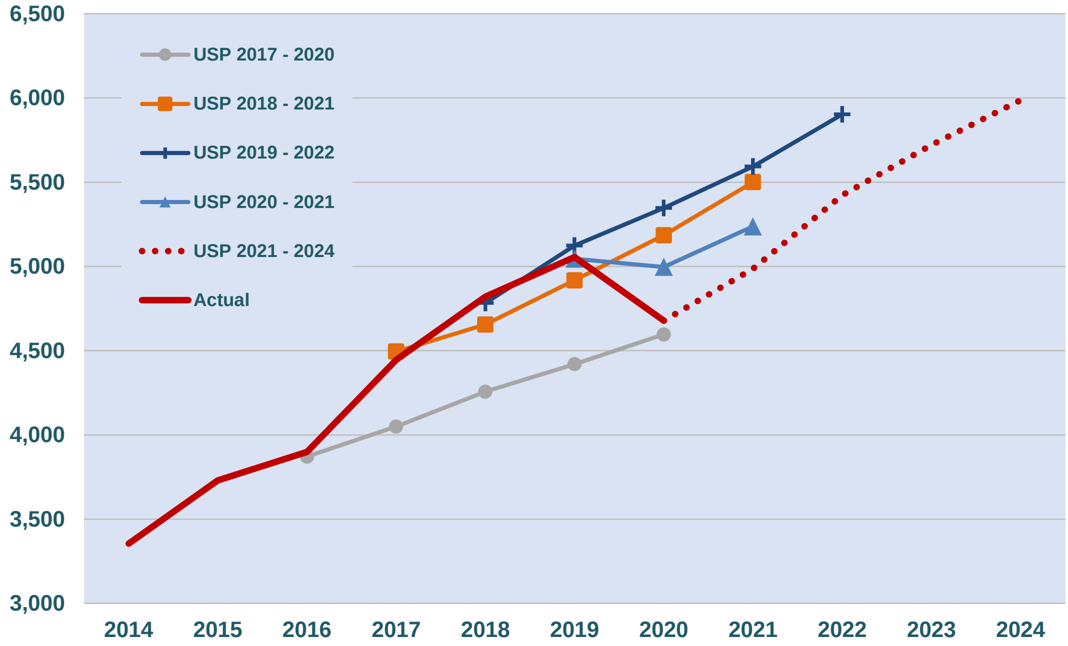
Whereas between 2017 and 2019 the fiscal surplus turned out close, or even better, than the targets indicated in the USP, this was not the case in 2020 (see Chart 3.9). Indeed, the stream of fiscal surpluses recorded since 2016 came to a halt, as a large fiscal deficit was recorded in 2020. The fiscal deficit recorded in 2020 was larger than the sum of the surpluses recorded between 2016 and 2019, using up the fiscal buffers which were built over recent years.

Due to the unanticipated large fiscal deficit and the 6.5% contraction in nominal GDP in 2020, public debt went up from 42.0% to 54.3% of GDP (see Chart 3.10). Prior to the pandemic, consecutive USPs envisaged a downward trajectory for the public debt ratio, consistent with the pattern observed over the previous years. Such dynamics were abruptly reversed in 2020.

Whereas the USP and DBP prepared in 2019 had targeted an outstanding gross debt for 2020 below €6.0 billion, public debt turned out much higher, at €7.0 billion. The deviation amounted to almost €1.3 billion compared to the targets indicated in the USP and the DBP. The overshoot in public debt was slightly less than the discrepancy recorded in the fiscal balance (of around €1.5 billion), suggesting that in 2020 Stock-Flow Adjustments (SFA) were slightly less than originally envisaged.

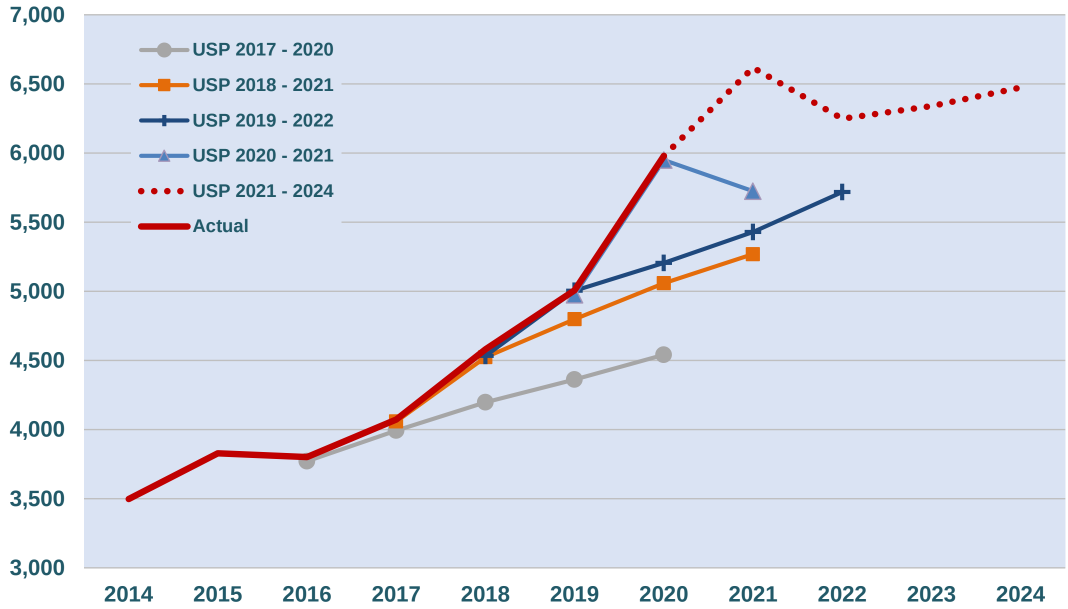
[14] In the case of gross fixed capital formation, the target was raised in October 2019 (DBP) compared to April 2019 (USP). Hence, the DBP target was closer to the outturn than the USP target.

Chart 3.7: Revenue targets indicated in consecutive USPs (EUR millions)



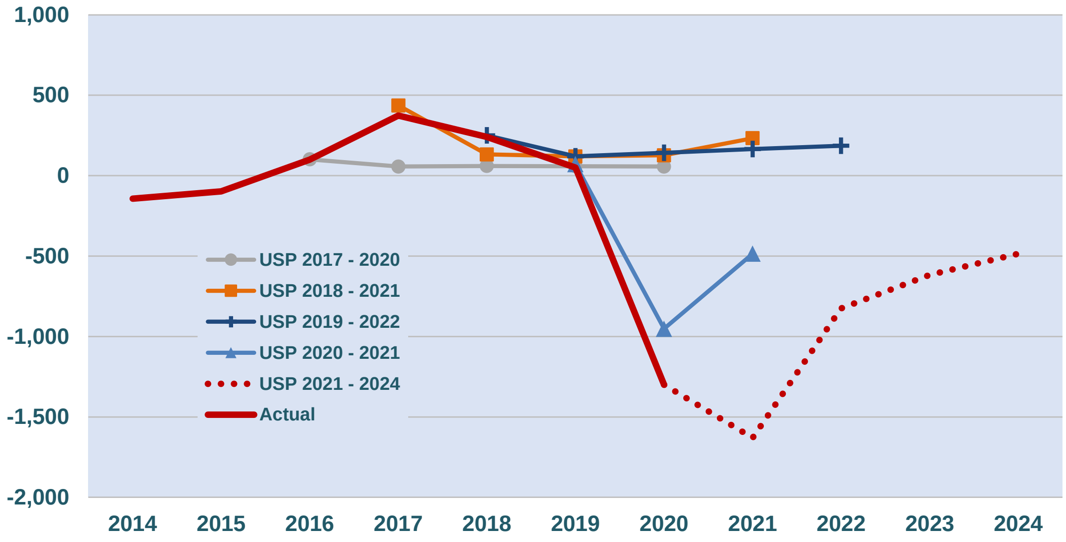
Source: MFE, Eurostat

Chart 3.8: Expenditure targets indicated in consecutive USPs (EUR millions)



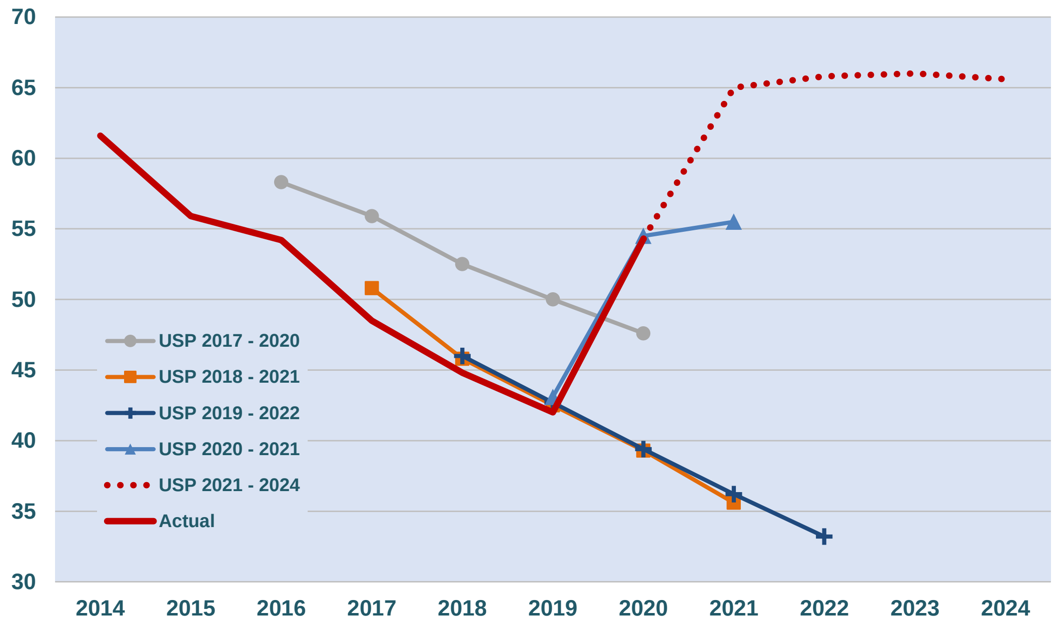
Source: MFE, Eurostat

Chart 3.9: Fiscal balance targets indicated in consecutive USPs (EUR millions)



Source: MFE, Eurostat

Chart 3.10: Public debt targets indicated in consecutive USPs (% of GDP)



Source: MFE, Eurostat

Chapter 4
Macroeconomic updates for 2021

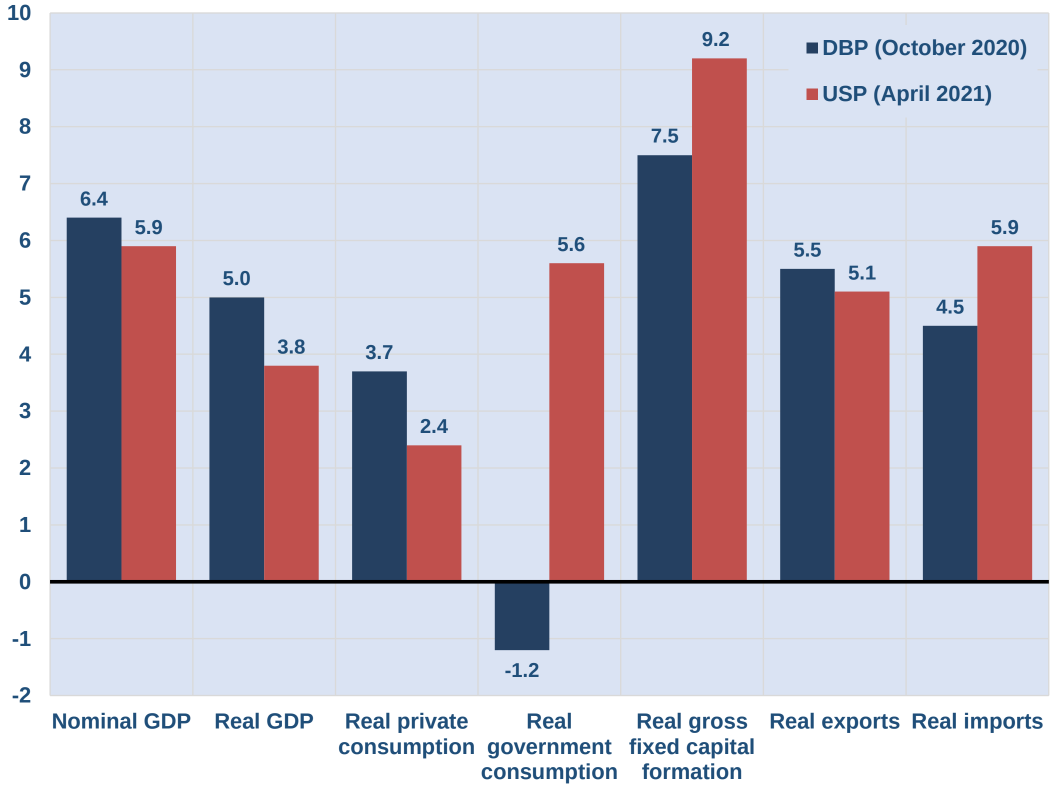
The Half-Yearly Report reconfirmed the macroeconomic forecasts which had been presented in the USP 2021 – 2024. This approach is identical to that adopted in previous years. Between the submission of the USP and the preparation of the Half-Yearly Report, the actual GDP statistics for the first quarter of 2021 become available. However, the informativeness of the first quarter statistics in relation to the annual outturn is normally considered by MFE to be somewhat limited, owing to the fluctuations in the quarterly patterns, as well as the revisions which are regularly carried out by NSO. The pandemic adds further to the economic uncertainty. The macroeconomic forecasts published in the USP 2021 – 2024, which have been analysed and endorsed by the MFAC, thus serve as Malta's latest official macroeconomic forecasts to date.[15]

The USP had revised the 2021 nominal and real GDP growth forecasts downwards, when compared to the DBP 2021. This downward revision was mainly due to the reassessment of the effects created by the COVID-19 pandemic and the slower anticipated road to recovery. Nominal GDP growth was lowered by 0.5 pp, while real GDP was revised down by 1.2 pp between the two forecast vintages (see Chart 4.1).

Domestic demand was still expected to be the main driver of economic growth in 2021 (see Chart 4.2). Its contribution to growth was in fact strengthened between the two forecast rounds. This reflected the reversal in government consumption growth from a negative growth rate to a positive rate. Indeed, the prolongation of the pandemic required stronger fiscal support than originally anticipated and delayed the planned rolling back of the government's initiatives. Domestic demand was further supported by the stronger expected growth in gross fixed capital formation. In turn, this was due to the inclusion of the Recovery and Resilience Funds (RRF). The combined upward effect from government consumption and gross fixed capital formation more than compensated for the slower than expected recovery in private consumption. The latter followed the renewal of certain restrictions by the health authorities which impacted certain items of households' consumption.

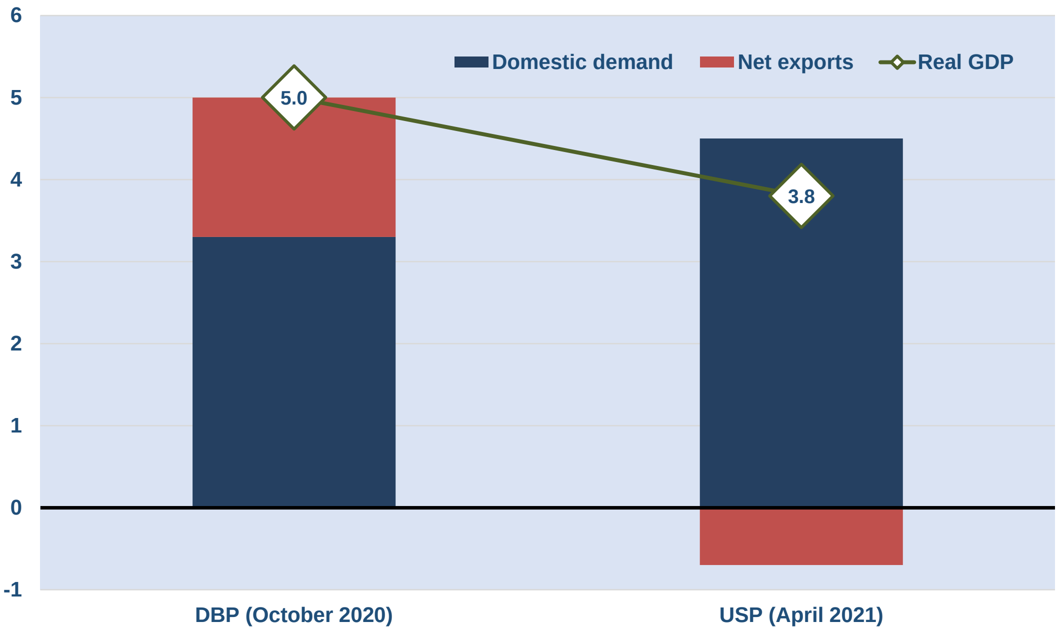
[15] The MFAC's assessment which was published in June 2021 is available on https://mfac.org.mt/publications/reports/reports-2021/.

Chart 4.1: Forecast growth in GDP and its components for 2021 (y-o-y % change)



Source: MFE

Chart 4.2: Forecast contributions to real GDP growth in 2021 (pp)



Source: MFE

The upward revision in domestic demand growth was however offset by the change in the outlook for net exports. In the USP net exports are shown as contributing negatively to growth, as opposed to the positive contribution which was envisaged in the DBP. Growth in exports was reduced slightly in view of a more cautious outlook particularly for tourism, whereas import growth was increased, mirroring the faster expected growth in investment.[16]

Potential GDP growth for 2021 was increased slightly, from 2.9% to 3.4%, consistent with the updated investment growth outlook (see Table 4.1). Due to the concurrent upward revision in potential output growth and the expected lower real GDP growth, in 2021 the Maltese economy is expected to slide below potential more than originally estimated. Indeed, the updated calculations for the output gap in 2021 were revised from -3.5% to -5.1% of potential GDP. Meanwhile, employment growth was reduced marginally, from 2.3% to 2.2%. Accordingly, the unemployment rate was raised slightly, from 4.0% to 4.3%. However, the inflation rate forecast remained unchanged, at 1.3%.

Table 4.1: Other macroeconomic forecasts for 2021 (%)

	DBP (October 2020)	USP (April 2021)	Difference (pp)
Inflation rate	1.3	1.3	0.0
Employment growth	2.3	2.2	- 0.1
Unemployment rate	4.0	4.3	0.3
Potential GDP growth	2.9	3.4	0.5
Output gap	- 3.5	- 5.1	- 1.6

Source: MFE

The main development post April's macroeconomic forecast round was the FATF decision to place Malta under increased surveillance. The MFAC acknowledges the Government's reaction to the FATF decision and its decision that the forecasts "will be updated for the next round in Autumn 2021". The MFAC considers important that such development be incorporated either in the baseline, or as one of the specific downside risk scenarios which will be presented in the upcoming DBP.

[16] Investment in Malta has a high import content. Indeed, the MFE assume an import content of more than 80% for most of the large capital projects in Malta.

Chapter 5
Fiscal updates for 2021

The DBP had targeted a fiscal deficit amounting to €788.0 million and a public debt-to-GDP ratio of 58.6% for 2021 (see Table 5.1).[17] These targets were however revised significantly in the USP as the effects of the COVID-19 pandemic were more prolonged than originally anticipated, thereby requiring a larger fiscal support. Consequently, in the USP the deficit target for 2021 was revised upwards, to €1,630.4 million, whereas that for the public debt ratio was raised to 65.0%. These targets remained the same in the Half-Yearly Report published by MFE.

The deterioration in the outlook for the fiscal balance across the two forecast vintages reflects updated plans for €618.3 million additional public expenditure, as well as a €223.7 million downward re-assessment of total revenue for the year (see Chart 5.1). Such developments explain the upward revision in the trajectory for public debt.

The USP allocated higher budgets across all expenditure categories when compared to the DBP. In absolute terms the largest increase (+€190.6 million) relates to capital transfers. The bulk of this revision reflects the intention of the government to provide financial assistance to the national airline (subject to approval by the COM), with the first tranche planned for 2021. The second largest absolute change relates to the expansion in the budget for subsidies (+€178.9 million). Indeed, the government decided to extend the provision of the wage support (with tapering) longer than originally planned, until the end of 2021.[18]

The budget allocation for intermediate consumption was also raised by €117.5 million (third largest increase). This was mostly due to additional health expenditure and the launch of further temporary initiatives to mitigate the impact of the pandemic. In turn, the planned spending on gross fixed capital formation was raised by €60.8 million (fourth largest increase). This mostly reflected the inclusion of the expected funds from

[1717] The figures referred to as DBP in this chapter relate to the Budget Forecast indicated in the Half-Yearly Report. Normally these figures are the same. However, for 2021 there were minor differences because of last minute updated calculations carried out by the MFE in between the submission of the DBP and the reading of the Budget Speech in parliament.
[18] The details of the wage supplement scheme managed by Malta Enterprise for the period August to December 2021 are available on https://covid19.maltaenterprise.com/wage-supplement-main/.

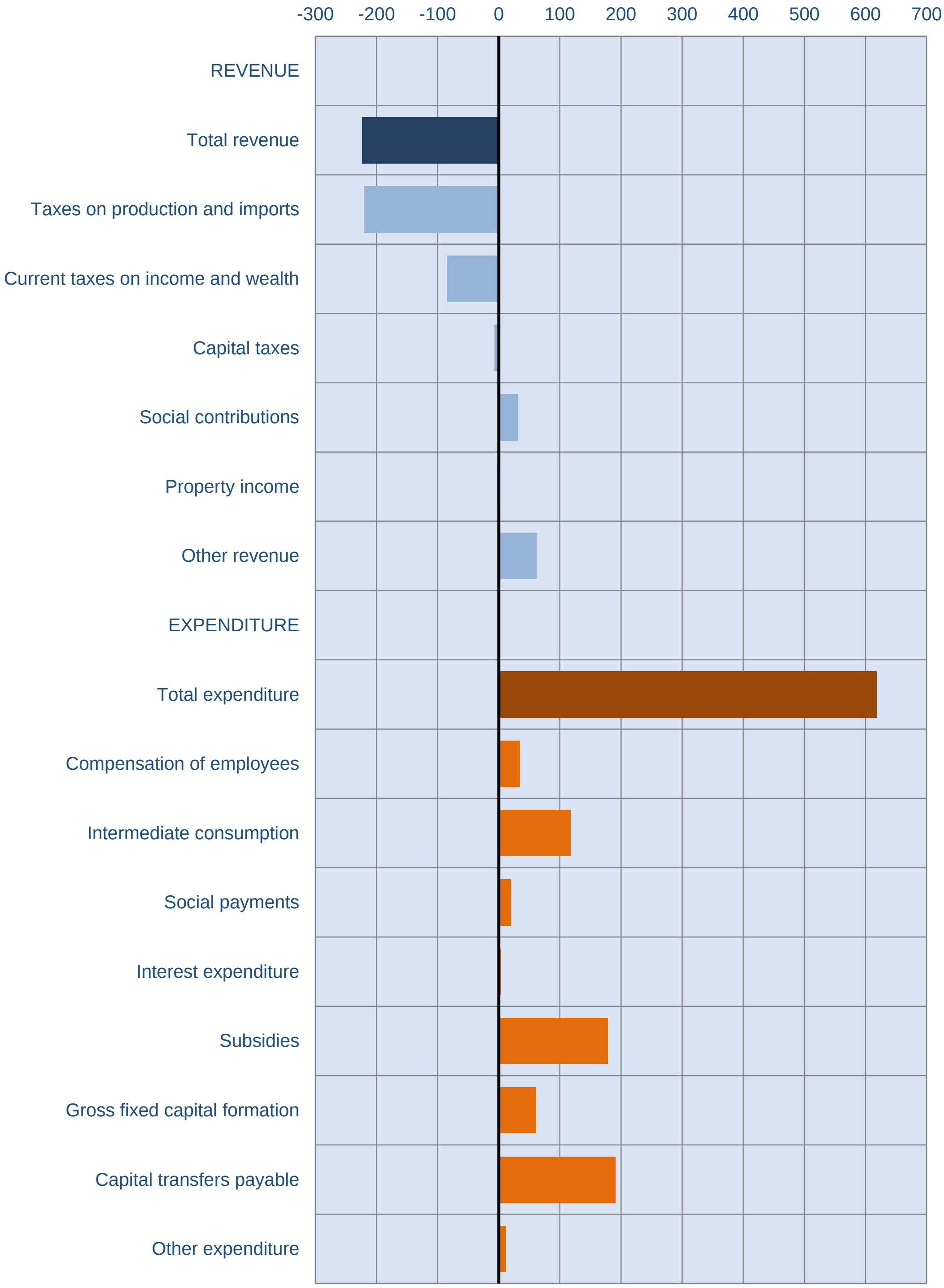
the Recovery and Resilience Facility (RRF), which the government plans to start using in 2021, and to channel entirely on public investment. Changes to the budgets for the remaining expenditure components were smaller, and mainly reflected updated estimates, based on the expenditure outturn in 2020 and the monthly fiscal developments post submission of the DBP.

Table 5.1: Fiscal projections for 2021 (EUR millions)

	DBP *October 2020*	USP *April 2021*
Total revenue	**5,210.5**	**4,986.8**
Taxes on production and imports	1,663.3	1,442.6
Current taxes on income and wealth	1,857.5	1,772.3
Social contributions	828.4	859.4
Capital taxes	24.4	17.6
Property income	82.9	79.2
Other revenue	754.0	815.6
Total expenditure	**5,998.8**	**6,617.1**
Compensation of employees	1,668.1	1,702.9
Intermediate consumption	1,222.7	1,340.2
Social payments	1,390.9	1,410.8
Gross fixed capital formation	676.0	736.8
Subsidies	404.3	583.2
Interest expenditure	157.0	160.6
Capital transfers payable	115.9	306.6
Other expenditure	363.8	376.1
Fiscal balance	**-788.0**	**-1,630.4**
as % of nominal GDP	*-5.9*	*-12.0*
Gross debt	**7,825.5**	**8,828.4**
as % of nominal GDP	*58.6*	*65.0*
Nominal GDP	13,351.4	13,588.2

Note: Figures may not add up to rounding. The fiscal figures are compiled in line with the ESA methodology.
Source: MFE

Chart 5.1: Update to the fiscal projections for 2021 (EUR millions)

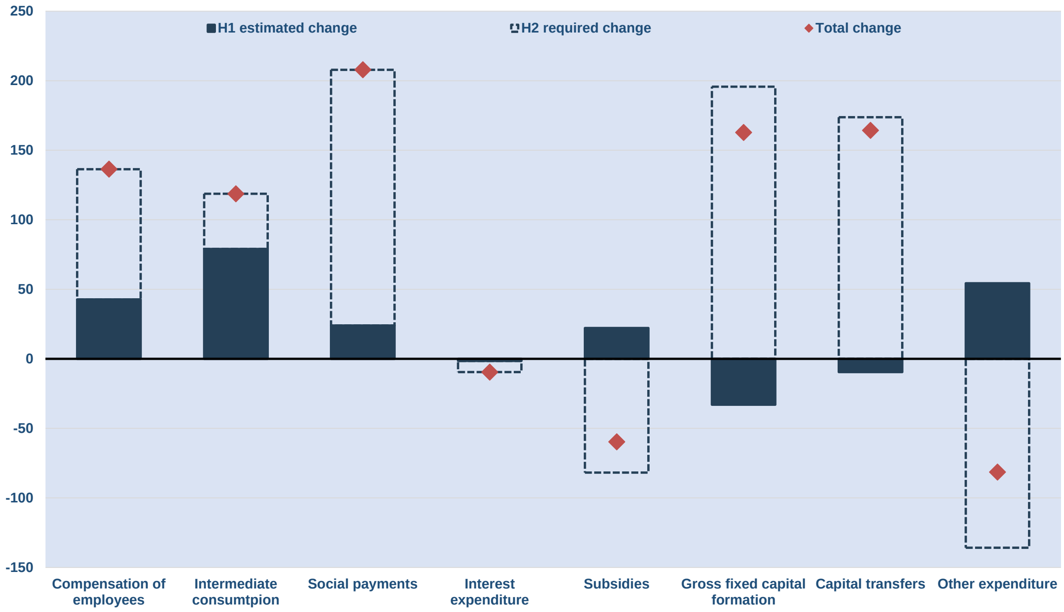


Note: The bars show the change carried out in the USP to the DBP figures. The dark blue and dark brown bars indicate the changes in total revenue and total expenditure respectively. The light blue and orange bars indicate the changes in the revenue and expenditure components respectively.

Source: MFE

Expenditure during the first half of 2021 represented 46.0% of the amount budgeted for in the USP.[19] However, at a component level, performance was uneven. The magnitude of the actual changes estimated over the first half of 2021 and those required during the second half of 2021 (to be consistent with the overall yearly change) are somewhat different in certain cases (see Chart 5.2). However, such variations may be partly due to the different monthly spending patterns in 2021 compared to 2020 particularly because of the timing of the temporary pandemic related measures and initiatives. Still, some variations may suggest that in certain cases it might be challenging to achieve the planned yearly spending, either because the budget appears tight or else high.

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



Note: The shaded bars show the estimated change during the first half of 2021 compared to the first half of 2020, while the transparent bars indicate the required change during the second half of 2021 compared to the second half of 2020, to ensure that the annual change is in line with the fiscal targets.

Source: MFE

In the case of gross fixed capital formation, the RRF funds were not yet available during the first half of 2021, which is a relevant factor explaining why there is a big difference between the developments estimated over the first half of 2021 and the required developments during the second half of the year. Likewise, the approval for the financial transfer to the national airline was not yet obtained by the first half of 2021, explaining the different patterns for capital transfers between the first and second half

[19] As in previous years, ESA fiscal data for the first half of 2021 was estimated by MFE since the official data is published by NSO after the production of the Half-Yearly Report. Such data is to be considered highly provisional and subject to revisions.

of the year. On the other hand, the announced tapering of the wage support scheme explains why subsidies during the second half are targeted to be less than in 2020.

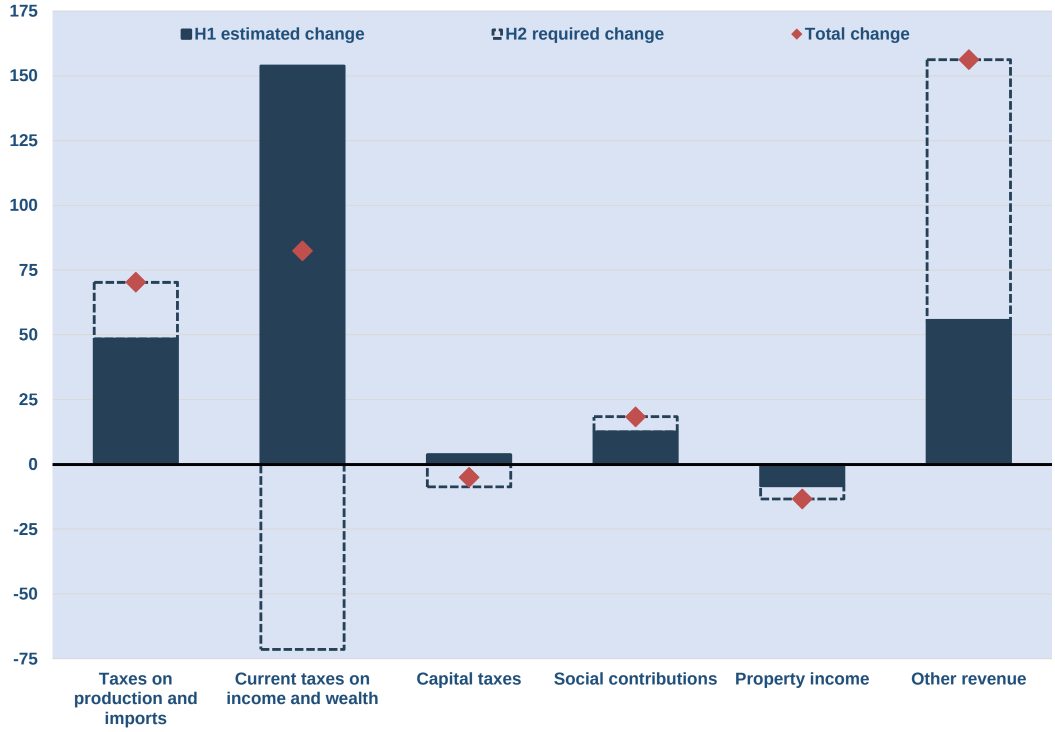
In the case of compensation of employees and social payments, progress during the first half of 2021 indicates a much smaller change compared to that implicit for the second half the year. This may however be due to timing factors since in both cases, the mid-year spending was rather close to the 50% benchmark. On the other hand, the additional spending on intermediate consumption reported during the first half of the year absorbed a significant share of the planned change for the year. The challenge to remain within budget appears even stronger in the case of 'other expenditure'. Indeed, during the second half of 2021 spending on 'other expenditure' needs to be lower than in 2020 to remain within the annual budget. In the case of interest payments, the changes are small and there is consistency between the estimated six-monthly performance and the annual target.

On the revenue side, the overall change in the projections between the DBP and the USP was dominated by the reduction in the expected intake from taxes on production and imports. The reduction in indirect taxes (-€220.7 million) followed the downward re-appraisal in the expected recovery in private consumption and tourism earnings for 2021, due to the prolongation of the restrictive measures induced by the pandemic. The weaker macroeconomic outlook also led to a reduction in the expected revenue from current taxes on income and wealth (-€85.3 million) when compared to the DBP.

These reductions were partially dampened by an upward assessment in the expected yield from other revenue (+€61.6 million), mostly attributed to the inclusion of the RRF funds. There was also an upward revision in the expected yield from social contributions (+€31.0 million), supported by the resilience of the labour market. The expected revenue intake from capital taxes and property income were on the other hand scaled slightly down.

In terms of cashflow (as recorded in the Consolidated Fund), revenues have been significantly impacted, due to the concession to delay certain tax payments. In the case of companies and self-employed persons that suffered a significant downturn in their turnover and liquidity (because of the economic constraints arising from the coronavirus pandemic), the settlement of provisional tax, social security contributions of self-employed persons and Value Added Tax which falling due in August 2020 up to and including December 2021 was extended. The concession allows that eligible taxes may be settled from May 2022 with no interest or penalties charged. However, such concessions had no impact on the ESA fiscal data since in line with Eurostat guidance, such revenues were imputed (net of unrecoverable amounts). MFE imputed all revenue due, on the assumption that all payments would be settled by the stipulated timeframe. The caveat created by the fact that ESA revenue data has a strong element of imputation, must be acknowledged when assessing the revenue performance during the first six months of 2021 (see Chart 5.3).

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



Note: The shaded bars show the estimated change during the first half of 2021 compared to the first half of 2020, while the transparent bars indicate the required change during the second half of 2021 compared to the second half of 2020, to ensure that the annual change is in line with the fiscal targets.

Source: MFE

The estimated mid-year performance of both current taxes on production and imports as well as current taxes on income and wealth was rather strong compared to the annual target. On the other hand, the mid-year change in 'other revenue' is less than half of the yearly planned change. This can be explained by the fact that the RRF funds are expected to be transferred during the second half of the 2021. In the case of the other revenue components (social contributions, property income and capital taxes), the yearly changes are relatively small, and the mid-year performance appears broadly consistent with the target annual developments.

Chapter 6
Conclusion

The macroeconomic forecasts for 2020 did not materialise because of the unexpected economic recession which the country suffered due to the pandemic. Likewise, the fiscal targets for 2020 were missed because of the implementation of a significant number of fiscal measures to support the economy, which had not been budgeted for. The unanticipated shortfall in tax revenues, caused by the contraction in economic activity due to the restraint measures implemented in the country, contributed further to the deviation. The MFAC acknowledges that 2020 was an exceptional year, and the forecast deviations do not reflect poor quality of the official macroeconomic and fiscal forecasts, but rather, were the result of extraordinary circumstances, which were beyond the control of MFE. The temporary suspension of the fiscal rules which was agreed upon at the European level made such deviations permissible.

Good quality macroeconomic and fiscal forecasts are a pre-requisite for sound policy making, and it is important that the MFE continues to allocate adequate resources and time for their production, as well as for their ex-post assessment. The MFE needs to continue monitoring closely the ongoing economic developments to evaluate whether Covid-19 has produced any temporary or permanent changes in the economic and fiscal relationships which existed before the pandemic. This information is necessary to construct the next macroeconomic and fiscal forecast round (in October 2021) on robust foundations.

The MFAC takes note that in the Half-Yearly Report, the MFE presented the same macroeconomic forecasts for 2021 as had been published in the USP in April 2021. The MFAC acknowledges that the amount of additional information available between the publication of the USP and the Half-Yearly Report justifies this approach, which has been consistently adopted in previous years. Maintaining the current biannual macroeconomic forecast rounds, in April and October each year, appears the most feasible, particularly in view of resource constraints.

Likewise, the fiscal projections presented in the Half-Yearly Report reproduce those which had been included in the USP. In previous years, some fine-tuning used to be carried out to the USP fiscal figures, based on the estimated performance during the first six months of the year. However, the MFAC understands that the fiscal situation remains fluid, and the cash figures may be less informative than in previous years in view of the concessions awarded by the Government to delay certain tax payments. Hence, the departure from the previous years' practice appears justified in this case.

The MFAC considers that the macroeconomic and fiscal forecasts for 2021 continue to lie within its endorsable range and the risk assessment which it had presented in its previous Report remains valid. The risk assessment carried out by the Fiscal Council had suggested a broadly neutral risk outlook vis-à-vis the profile for real GDP growth over the forecast horizon whereas the fiscal deficit and the public debt ratios could be higher than planned.

Nonetheless, the MFAC invites the MFE to remain vigilant to ensure that the fiscal deficit and debt targets for the year are to the extent possible not exceeded. Close attention is warranted particularly in those cases where the revenue and expenditure performance required during the second half of 2021 appears more challenging to attain, when seen in the light of the estimated performance recorded during the first half of the year.

In terms of the specific contents which feature in the Half-Yearly Report, the MFAC draws attention to Article 39(8)(h) of the FRA which prescribes "data on the absorption of European funds, indicating the approved program, the results achieved in the first six months and an updated forecast for the entire year" and Article 39(8)(i) of the FRA which prescribes "data on all outstanding creditors for the first six months of the year". Such data does not feature in the Half-Yearly Report for 2021. The MFAC understands that the problem is due to lack of high-quality statistics in these two areas and invites the MFE to explore ways how robust data can eventually be compiled and published.[20,21] This would be in line with the principle of fiscal transparency.

[20] In the case of EU funds data, this has never been published in any Half-Yearly Report to date, whereas data on creditors was last included in the Half-Yearly Report of 2019.

[21] FRA Article 39(8)(k) requires information about revenue arrears. This information is duly presented in the Half-Yearly Report. During the first half of 2021, €67.8 million revenue arrears were collected, of which €52.1 million from the Government Printing Press.

Malta Fiscal Advisory Council
St Calcedonius Square, Floriana FRN 1530
Tel: +356 22479200 Fax: +356 22479219
Email: info@mfac.org.mt www.mfac.org.mt