

Assessment of the Draft Budgetary Plan 2022



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Draft Budgetary Plan 2022**



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Dear Minister,

**OVERALL ASSESSMENT OF THE MACROECONOMIC AND FISCAL FORECASTS
PRESENTED IN THE DRAFT BUDGETARY PLAN 2022**

As a follow-up to the letter of endorsement in relation to the macroeconomic forecasts, dated 11 October 2021, the Malta Fiscal Advisory Council is hereby presenting the full assessment report dealing with the Draft Budgetary Plan 2022, in terms of the Fiscal Responsibility Act. The MFAC's Report has a cut-off date of 19 November 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 included in the Draft Budgetary Plan that "the temporary support is expected to be phased out, in line with the Government's commitment to contain expenditure as the public health situation improves and the economy recovers". The MFAC notes that this is the central premise underpinning the macroeconomic and fiscal forecasts which are presented in the Draft Budgetary Plan for 2022. The Fiscal Council also notes that this scenario also broadly underpins the forecasts for Malta available by the cut-off date which were prepared independently by other institutions, and which are used by the Council as a benchmark. At the same time, the Fiscal Council acknowledges that the evolution of the pandemic remains highly uncertain.

Overall, the Council considers the macroeconomic and fiscal forecasts for 2021 and 2022 to be within its endorsable range. They embed correctly the assumptions used and the information available at the time the Draft Budgetary Plan was produced. 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.

To ensure consistency, the Council’s assessment was carried out using the assumptions specified in the Draft Budgetary Plan and the information set available when the official macroeconomic and fiscal forecasts were produced. On this basis, the macroeconomic forecasts are deemed to be plausible. At the same time, it is possible that real GDP growth could turn out slightly higher than indicated in the Draft Budgetary Plan, mostly as private and government consumption growth could exceed the official forecasts. Caveats to the MFAC’s risk outlook are due to the macroeconomic outlook being strongly dependent on the assumption that the pandemic is gradually subsiding, not only in Malta but also on a global level. The latter depends entirely on health-related factors which are hard for the MFAC to hypothesise about with a reasonable degree of certainty.

The Council’s assessment carried out on the individual revenue and expenditure components of the fiscal budget takes the macroeconomic forecasts as given. The MFAC considers the targets for the fiscal balance and public debt indicated in the Draft Budgetary Plan as plausible. However, the Council notes that it is possible that the fiscal deficit in 2022 could exceed the target, due to a possible shortfall in total revenue and total expenditure exceeding the plans.

The MFAC understands that since the budgeting process in Malta is built on the Consolidated Fund framework, the ESA forecasts at a component level are partially driven by approximations, fixed ratios, and rules of thumb. In this respect, the Ministry may consider the merit of shifting the emphasis to a budgeting framework which is more driven by the ESA framework. This would help improve the robustness of the specific forecasts at a component level. Likewise, more detailed information about the envisaged stock flow-adjustments and their economic interpretation would be useful.

The Council welcomes the Government's intention to start narrowing the fiscal deficit as from 2022, as part of the gradual consolidation process. This would help contain the increase in the public debt ratio, which rose rapidly in 2020 and 2021 because of the pandemic. The Council also reminds of the importance to be adequately prepared for the possibility that the escape clause could be deactivated as of 2023, meaning that fiscal rules, whether the same, or different, from those which were in place before the pandemic, would again be binding. At the same time, the Council would once again like to emphasize the importance that when economic conditions allow, the fiscal stance should again be aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability.

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
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
EFSF	European Financial Stability Facility
ESA	European System of National and Regional Accounts
EU	European Union
FATF	Financial Action Task Force
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
MOU	Memorandum of Understanding
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
SURE	Support to mitigate Unemployment Risks in an Emergency
TFP	Total factor productivity
USP	Update of Stability Programme
WHO	World Health Organization

Executive Summary

This Report, whose cut-off date is 19 November 2021, assesses the macroeconomic and fiscal forecasts for 2021 and 2022 contained in the Draft Budgetary Plan, which the Ministry for Finance and Employment submitted to the European Commission on 15 October 2021.

Both the macroeconomic and the fiscal forecasts lie within the endorsable range of the Fiscal Council. However, the Council highlights the critical role of COVID-19 related assumptions in shaping the macro-fiscal scenario, and any material departure from such assumptions could deviate the outcome, possibly significantly, from that presented in the Draft Budgetary Plan.

The official outlook points to a 4.8% growth rate in real GDP in 2021, and an acceleration to 6.5% growth in 2022. Against this background, the fiscal deficit is expected to widen to 11.1% of GDP in 2021. This reflects the elevated expenditure on support measures, as well as the slow recovery in tax revenue. For 2022 the government's objective is to lower the fiscal deficit to 5.6% of GDP. These plans would permit the stabilisation of the public debt ratio throughout the forecast horizon, at slightly above 61.0% of GDP.

Based on the information set available by the cut-off date, the Fiscal Council highlights a number of possible upside risks, as well as downside risks to the macroeconomic and fiscal forecasts presented in the DBP. The Council considers as possible the realization of a higher real GDP growth rate than that indicated in the official forecasts, mainly resulting from a larger than anticipated growth in private and government consumption. On the other hand, the fiscal deficit could turn out to be larger than expected in 2022 in view of possible revenue shortfalls and expenditure overruns. The effect of a possible higher fiscal deficit could however be broadly compensated should the level of nominal GDP be higher than expected, thereby leading to a neutral risk outlook vis-à-vis the public debt ratio.

The Fiscal Council takes note that the activation of the general escape clause in the Stability and Growth Pact and in the Fiscal Responsibility Act permits the Government to take all the initiatives deemed necessary to mitigate the adverse effects of the

pandemic and to stimulate the economic recovery in view of the temporary suspension of the fiscal rules. At the same time, the Council would once again like to emphasize the importance that when economic conditions allow, the fiscal stance 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 a Draft Budgetary Plan (DBP) to the European Commission (COM) by 15 October each year.¹ Malta's DBP for 2022 presents the updated official macroeconomic and fiscal forecasts prepared by the Ministry for Finance and Employment (MFE) for 2021 (current year) and 2022 (next year). These forecasts update the vintage which was published in April 2021 as part of the Update of Stability Programme (USP).

EU regulations specify that when the government produces the macroeconomic forecasts, these must be endorsed by an independent institution. The Fiscal Responsibility Act (FRA) prescribes that this role is performed by the Malta Fiscal Advisory Council (MFAC). To this effect, on 11 October 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, and after taking due consideration of the uncertainty inherent in macroeconomic forecasts, and the added uncertainty brought about by the COVID-19 pandemic, the macroeconomic forecasts for 2021 and 2022 were considered to lie within the Council's endorsable range.² This Report contains the analysis carried out to support the endorsement of the macroeconomic forecasts. It also contains the assessment pertaining to the endorsement of the fiscal projections for 2021 and 2022 which are outlined in the DBP.³

In March 2020, the general escape clause of the Stability and Growth Pact (SGP) was activated. This introduced flexibility in the European fiscal framework, allowing Member States room for manoeuvre to quickly respond and implement emergency measures to mitigate the economic and social impact of the pandemic. These initiatives ultimately translated into higher fiscal deficits and larger public debts across the EU, without however being in breach of the fiscal rules. The assessment of compliance with the

¹ The DBP for 2022 submitted by each country is available on https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries/draft-budgetary-plans-2022_en.

² A copy of the letter is available on <https://mfac.org.mt/publications/reports/reports-2021/>.

³ The FRA does not prescribe that the endorsement of the fiscal forecasts should take place prior to the publication of the DBP. Hence, the detailed fiscal forecasts and measures underpinning the DBP were forwarded to the Council after the document was published, in line with the approach adopted in previous years.

fiscal rules by the MFAC was also suspended and this situation will remain in place until the general escape clause is revoked and the situation is no longer considered as exceptional. The MFAC confirms that the situation of ‘exceptional circumstances’ as defined in the SGP and replicated in the FRA, is still deemed to persist.^{4,5}

This Report has a cut-off date of 19 November 2021 and is structured as follows. **Chapter 2** reviews the methodologies and assumptions used in the preparation of the macroeconomic and fiscal forecasts. **Chapter 3** evaluates the expected trajectory for the main macroeconomic variables for 2021 and 2022, and where relevant, identifies possible upside or downside risks. **Chapter 4** compares the latest macroeconomic forecasts with those published in the USP 2021 – 2024, and those produced by other reputable institutions. **Chapter 5** focuses on the fiscal projections for 2021 and 2022, examining the plausibility of the anticipated trajectories for the main revenue and expenditure components in the budget. It also assesses the envisaged fiscal balance and public debt dynamics and identifies the direction of risk vis-à-vis the official fiscal targets. **Chapter 6** compares the fiscal scenario presented in the DBP to that outlined in the USP, and to the latest fiscal forecasts published by other reputable institutions. **Chapter 7** presents the Report’s conclusions.

⁴ 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”.

⁵ In 2021 the MFAC signed a Memorandum of Understanding (MOU) with the MFE to clarify the procedures and documents necessary when the situation of ‘exceptional circumstances’ is invoked or terminated. The MOU is available on <https://mfac.org.mt/wp-content/uploads/2021/08/MOU.pdf>.

Chapter 2

Forecast methodologies and assumptions

2.1 Preparation of the macroeconomic forecasts

Macroeconomic forecasts are produced using various types of econometric models. The MFE relies mostly on STEMM (Short-Term Quarterly Economic Forecasting Model) to produce the official macroeconomic outlook. STEMM is a quarterly Keynesian model with output determined by aggregate demand.⁶ The equations within STEMM 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, constituted bodies and large firms. Such dialogue plays a significant role in shaping the outlook and risk assessment for key sectors, which might be driven by very specific factors. This insight is valuable particularly to gauge employment and export prospects at a sectoral level, and to better project the path for investment. Additional insight is obtained from the business and consumer surveys published by the COM, as well as from the mobility and search trends data published by Google.^{7,8,9}

Expert judgement has become more important because of the pandemic. Indeed, past empirical relationships may not capture adequately the possible economic and behavioural effects triggered by the pandemic. Expert judgement is also necessary to

⁶ See <https://mfin.gov.mt/en/epd/Pages/Library.aspx> for technical details about STEMM.

⁷ The COM publishes monthly regular harmonised surveys which are conducted by the Directorate General for Economic and Financial Affairs for different sectors of the economies in the EU and in the applicant countries. For further details refer to https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/business-and-consumer-surveys_en.

⁸ The Google Global Mobility Report is a report which charts the daily movement trends over time by geography, across different categories of places such as retail and recreation, groceries and pharmacies, parks, transit stations, workplaces, and residential. For further details refer to <https://datastudio.google.com/reporting/a529e043-e2b9-4e6f-86c6-ec99a5d7b9a4/page/yY2MB?s=ho2bve3abdM>.

⁹ Google Trends is a tool which is used to assess a time-series of worldwide searches. It is primarily used as a gauge of user interest in a certain search query over time. For further details refer to <https://support.google.com/trends/?hl=en-GB#topic=6248052>.

gauge the speed and the magnitude of the eventual rebound from such major and unprecedented adverse event, characterised by simultaneous large negative demand and supply shocks.

2.2 Assumptions underpinning the macroeconomic forecasts

The values for the exogenous variables which are used to produce the macroeconomic forecasts are based on authoritative and reputable sources. The cut-off date for the external assumptions used by MFE was 17 September 2021.¹⁰ Specifically, the September 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.¹¹ In turn, the interest rate assumptions were derived by converting the monthly rates published by the European Central Bank (ECB) into quarterly averages and keeping these values unchanged over the forecast horizon.¹² The trajectories of the exogenous variables adopted in the DBP are displayed in [Chart 2.1](#). The values used in the DBP are shown as continuous lines while those used in the USP 2021 – 2024 (previous round) are depicted with dotted lines.

Compared to the USP, the DBP assumed a weaker value for the euro against the US dollar and sterling, both for 2021 and 2022. Still, the trajectories are broadly similar to the exchange rate movements assumed in the USP (a slight appreciation vis-à-vis the US dollar applicable to both years; and a depreciation against sterling in 2021 and then remaining stable in 2022).

The outlook for world prices in the DBP shows a significant increase in 2021 and deceleration in 2022, yet still with a high inflation rate. Although for 2021 and 2022 the USP had already assumed higher increases in world prices compared to 2020, the DBP assumes a much stronger international inflationary push for both years, around twice as high as was indicated in the USP. Indeed, the expected pick-up in world prices

¹⁰ An important development which took place after the cut-off date, was the Communication by the COM on 13 October 2021 about tackling the rising energy prices. For further details refer to https://ec.europa.eu/commission/presscorner/detail/en/QANDA_21_5202.

¹¹ The monthly publication by Consensus Economics surveys professional forecasters for their estimates of selected variables.

¹² Source:

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

for 2021 was revised to 5.6%, whereas for 2022, foreign inflation was assumed at 2.9%. This pattern broadly mirrors the updated outlook for the oil price, which, because of a quick rebound in international demand and the inability of oil producers to adjust supply sufficiently, is expected to reach higher levels than previously thought. The price per barrel of Brent crude oil for 2021 was thus assumed at \$68.3 (up from \$41.8 in 2020) and at \$67.5 for 2022. These prices replaced the \$61.2 and \$61.9 which featured in the USP.

Chart 2.1: Main macroeconomic assumptions



Note: 2020 refers to the estimated values, while 2021 and 2022 are forecasts. The values for 2020 are in most cases identical across the two forecast rounds. Any marginal differences reflect revisions carried out to the historical data.

Source: MFE

The updated profile for external demand (using real GDP growth in Malta's main trading partners as a proxy) reproduced very similar assumptions as in the USP. The pick-up in external demand is assumed to be strong, yet partial, in 2021. The recovery was estimated at 4.7%, following the estimated 6.4% contraction recorded in 2020. This is then followed by elevated growth in world demand in 2022, expected at 4.3%. Both growth rates are slightly higher than was assumed in the previous forecast round.

The assumption of a zero per cent short-term interest rate across the forecast horizon was retained in the DBP. On the other hand, the updated outlook for the long-term interest rate shows a constant rate of 0.5%, which replaced the 0.3% rate assumed for 2021 and 2022 in the USP.

Apart from the specific values for these exogenous variables, the macroeconomic forecasts also implicitly assume the value of inventory adjustments.¹³ The Ministry continued to adopt the same approach as in previous DBPs. In this respect, for the first half of 2021, inventories are assumed equal to the amount indicated in the published GDP statistics available by the cut-off date, whereas for the second half, the values are assumed equal to the values of the previous year. This leads to the assumption of a small positive contribution to real GDP growth in 2021. In 2022, the value of inventories is then assumed at a level such that there is no impact on real GDP growth for the outer forecast year.

Further assumptions were necessary to account for the effects created by COVID-19 and to characterise fully the macroeconomic scenario. These assumptions related to the expected path for the yearly inbound tourists; the timing of the phasing out of the fiscal support measures; and the future population dynamics.

Tourism related activities were amongst the worst hit during the pandemic. In 2021, inbound tourism is assumed to reach 31.0% of 2019 levels. In 2022 this percentage is assumed to rise to 75.0%. These percentages are basically the same as was assumed in the USP, since the overall progress registered in the number of tourists by the cut-off date, and the provisional bookings for the remaining part of 2021, are broadly in line with the original expectations for the year.

¹³ Inventory changes include the effect of changes in actual inventories as well as any statistical errors. Owing to the erratic behaviour of this variable it is not possible to model it through a specific equation like the other expenditure components making up GDP.

In the first half of 2021, the economy started to show signs of recovery as substantial progress was made in vaccinations and containment measures were gradually eased. The official macroeconomic outlook builds on the premise that the economy maintains its positive momentum in the second half of 2021. It is also assumed that the pandemic-containment measures which were relaxed are not reinstated. Consistent with the improved economic conditions, most social and economic support measures are thus assumed to be phased out by the end 2021, without creating any material adverse effect on economic activity and the labour market.

Population growth, primarily through the influx of foreign workers, was a key driver for the rise in employment and output in the years prior to the pandemic. The DBP assumes that the working-age population in Malta will continue to increase throughout the forecast horizon, albeit at a slower pace than pre-pandemic. Any difficulties related to the employment of Third-Country Nationals, such as due to vaccination and quarantine requirements, are assumed to be of a temporary nature and resolved within a short period of time.

2.3 The preparation of the fiscal forecasts

The budgetary process involves numerous iterations. The costs and possible impacts of various measures under discussion are quantified and evaluated. The calculations are fine-tuned up until the final specific details of the measures and their estimated impact on the budget are confirmed. Different estimates based on alternative macroeconomic and fiscal scenarios are also thoroughly examined. A final decision is then taken to select the revenue and expenditure estimates which are consistent with the baseline macroeconomic outlook and at the same time deemed to be achievable and appropriate to serve as the official fiscal targets.

The key fiscal assumption is that the economy maintains its recovery momentum such that the fiscal support can be phased out over time, thus impacting positively on public finances. Another important premise is that the health costs of the pandemic diminish over time because of lower hospitalisations and lower vaccination costs (as the number of administered doses diminishes). The fiscal outlook and the macroeconomic outlook are thus in sync with regards to the assumptions related to the possible evolution of the pandemic.

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. Expert judgement was instrumental since the unprecedented shock created by the pandemic could have altered the historical elasticities between the tax revenues and their respective proxy macroeconomic 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, even though the budgeting process in Malta is primarily driven by the figures which are included in the Consolidated Fund.

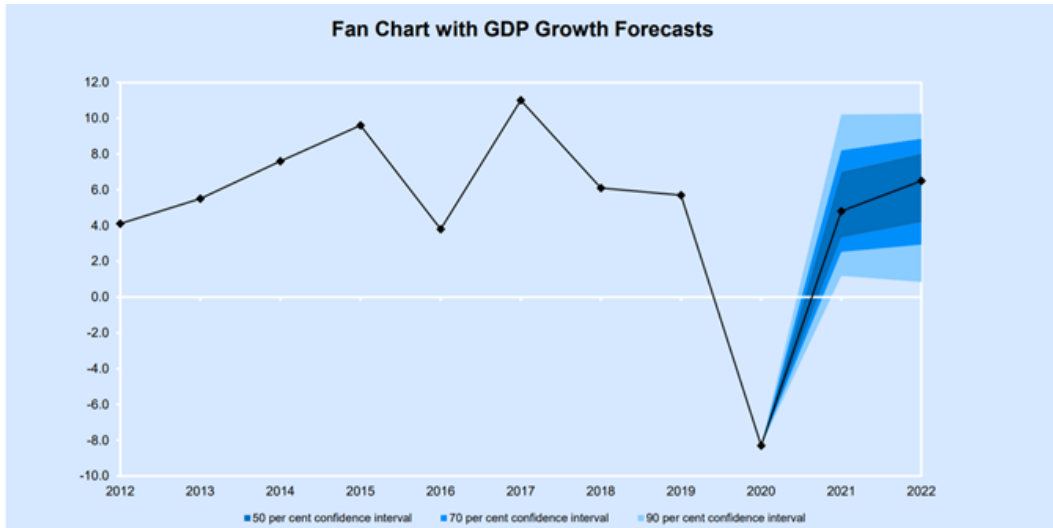
2.4 Risk outlook as presented by MFE in the Draft Budgetary Plan

Any significant departure from the assumptions used by MFE could deviate the macroeconomic outcome from the outlook as presented in the official forecasts. Therefore, the DBP presents a range of real GDP growth outcomes which could arise (see [Chart 2.2](#)). These are based on specific alternative scenarios, which are either more positive or negative than used in the baseline.

The choice of alternative scenarios is based on internal discussions and a subjective assessment by the Ministry of the scenarios which are considered as more realistic or useful for policy making purposes. In turn, these alternative real GDP growth estimates are used as input in the calculation of the range of possible values for the fiscal balance, should the macroeconomic conditions turn out as estimated in the alternative scenarios (see [Chart 2.3](#)). In both instances, past forecast errors are also embedded in the calculations to construct the macroeconomic and fiscal fan charts. The fan charts

offer some insight on the degree of uncertainty surrounding the baseline forecasts for real GDP growth and the fiscal balance-to-GDP ratio.

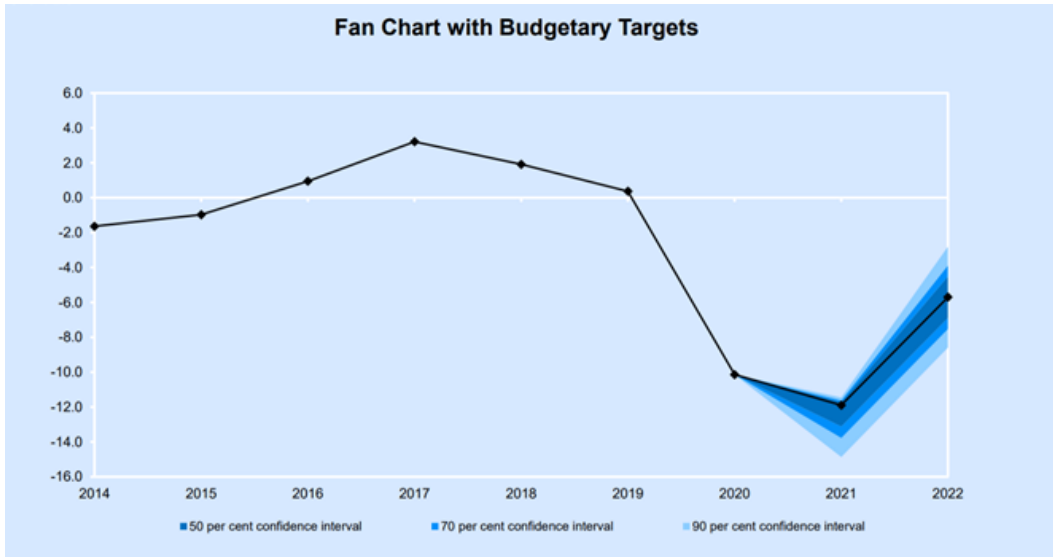
Chart 2.2: Alternative real GDP growth forecasts produced by MFE (%)



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

Source: MFE

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



Note: Reproduced from the DBP Chart 2.3, page 17.

Source: MFE

The alternative scenarios considered by MFE included: different growth rates for external demand; higher interest rates; higher investment; higher energy and world prices and a less optimistic tourism scenario (different percentages compared to 2019 from those included in the baseline).

All scenarios point to positive real GDP growth in 2021 and 2022. The baseline lies approximately around the centre of the fan chart. The range of possible outcomes for both years is wide, with an almost ten percentage point difference between the worst scenario (corresponding to marginal growth throughout the two years) and the best outcome (corresponding to around 10% growth in each year). The DBP refers to a ‘mild’ upside risk for 2021 (suggesting the possibility that the growth in real GDP could be slightly more than shown in the baseline) and a ‘marginal’ downside risk for 2022 (suggesting that the recovery in the outer year could be slightly less than portrayed by the baseline).

The range of alternative macroeconomic outcomes all point to a fiscal deficit-to-GDP ratio in 2021, which could be higher than that recorded in 2020. On the other hand, the fiscal deficit for 2022 is estimated to be less, under all scenarios which were considered. The DBP states that “the budget balance risk is skewed towards the downside in 2021 (the deficit could be larger) and neutral in 2022 (indicating that there is a similar possibility that the deficit could be less or more than shown in the baseline)”.

These alternative fiscal balances are however based exclusively on variations in domestic and external macroeconomic conditions. The calculations do not embed specific fiscal risks which might materialise. Examples of fiscal risks which are not explicitly embedded in the fan chart include: financial difficulties faced by state owned-enterprises; calls on government guarantees; added obligations from Public-Private Partnerships (PPP); and legal claims.¹⁴

2.5 Assessment

The methodologies used to prepare the macroeconomic and fiscal forecasts remained broadly the same as those used in previous forecast rounds. The approach to supplement the results derived from econometric tools with expert judgement is considered to be valid. Indeed, such an approach is desirable given that Malta’s small size means that in some cases even specific transactions can have a significant impact on the overall outturn. This is even more important in periods of high uncertainty. The increased use of high frequency data obtained from digital sources also serves to

¹⁴ For an in-depth review of hypothetical fiscal risks refer to IMF (2009) Fiscal Risks: Sources, Disclosure and Management, available on <https://www.imf.org/external/pubs/ft/dp/2009/dp0901.pdf>.

strengthen the forecasting framework further. The selection of external assumptions by MFE is transparent and in line with the approach used by other institutions. Any other key assumptions used, such as those relating to the evolution of the pandemic and the expected recovery of tourism activities are also adequately disclosed in the DBP.

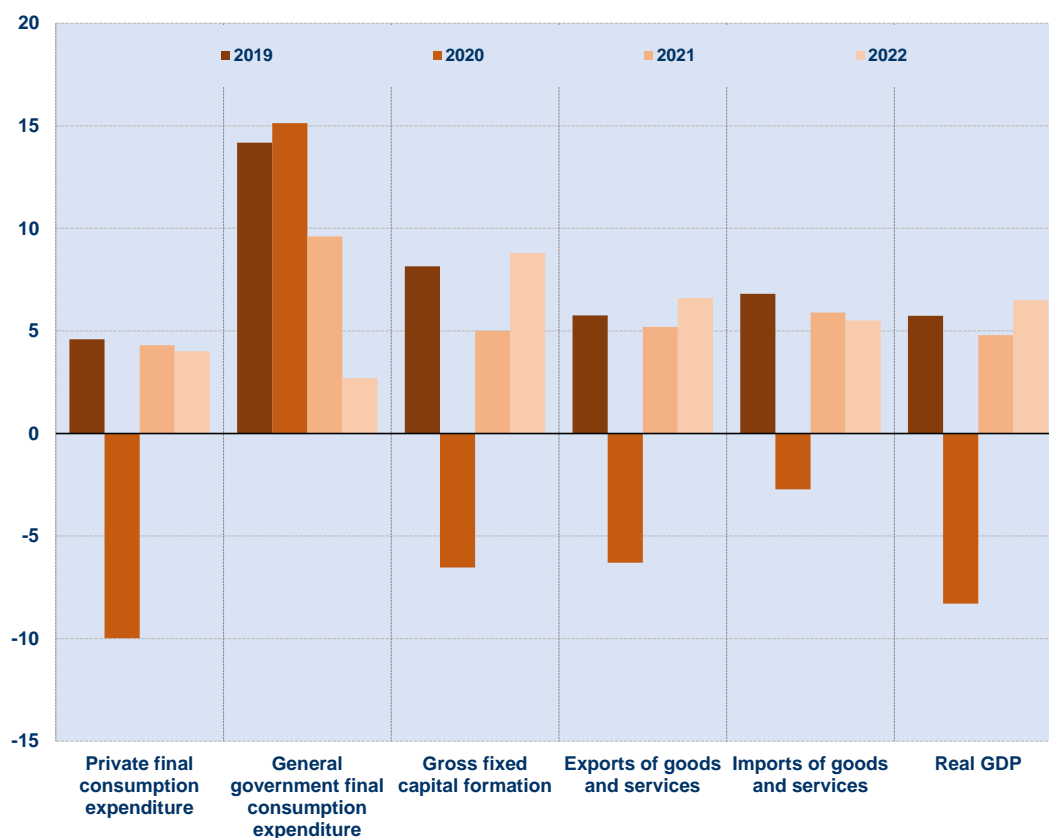
Chapter 3

Assessment of the macroeconomic forecasts 2021 – 2022

3.1 Macroeconomic outlook 2021 – 2022

Real GDP is forecast to grow by 4.8% in 2021, partially reversing the 8.3% contraction experienced in 2020 due to COVID-19 (see Chart 3.1 and Table 3.1).¹⁵ Since in 2022 the adverse effects caused by the pandemic are assumed to ease further, economic growth is then expected to accelerate, to 6.5%. The materialisation of the 2021 and 2022 growth forecasts would lift real GDP above its-pre-pandemic level by 2022. In nominal terms, Malta's GDP is expected to recover in 2021. Nominal GDP is forecast to rise by 7.0%, practically reversing completely the 7.1% contraction recorded in 2020. In 2022, nominal GDP growth is anticipated to be even higher, at 8.6%.

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



Source: MFE

¹⁵ Figures for 2019 and 2020 are based on the provisional values as published by the National Statistics Office (NSO) on 27 August 2021 (News Release 156/2021), while figures for 2021 and 2022 represent the forecasts prepared by MFE.

Table 3.1: Macroeconomic variables 2019 – 2022 (% change over previous period)

	2019	2020	2021	2022
Real GDP components				
Private final consumption expenditure (including NPISH)	4.6	-10.0	4.3	4.0
General government final consumption expenditure	14.2	15.1	9.6	2.7
Gross fixed capital formation	8.2	-6.5	5.0	8.8
Exports of goods and services	5.8	-6.3	5.2	6.6
Imports of goods and services	6.8	-2.7	5.9	5.5
Real GDP	5.7	-8.3	4.8	6.5
Contribution to real GDP growth				
Domestic demand (pp)	6.0	-3.4	5.1	4.4
Inventories (pp)	0.1	0.6	0.3	0.0
Net exports (pp)	-0.3	-5.5	-0.5	2.1
Deflators				
Private final consumption expenditure	2.0	1.1	1.2	1.6
General government final consumption expenditure	2.7	2.1	2.7	2.5
Gross fixed capital formation	1.1	0.8	1.3	1.2
Exports of goods and services	2.0	0.4	2.1	2.1
Imports of goods and services	1.6	0.3	1.8	1.9
GDP deflator	2.5	1.2	2.2	2.1
Labour market				
Employment (National Accounts definition)	5.7	2.7	2.3	2.2
Unemployment rate (%) (LFS definition)	3.6	4.3	3.8	4.0
Nominal compensation of employees	9.2	2.1	6.4	4.3
Nominal compensation per employee	3.6	-0.3	3.9	2.1
Labour productivity (real GDP per person employed)	0.0	-10.7	2.3	4.2
Other macroeconomic variables				
Inflation rate (%) (based on the HICP)	1.5	0.8	0.7	1.7
Nominal GDP	8.2	-7.1	7.0	8.6

Note: Figures for 2019 and 2020 are actual (based on NSO News Release 156/2021), while figures for 2021 and 2022 represent the forecasts by MFE. Figures may not add up due to rounding

Source: MFE

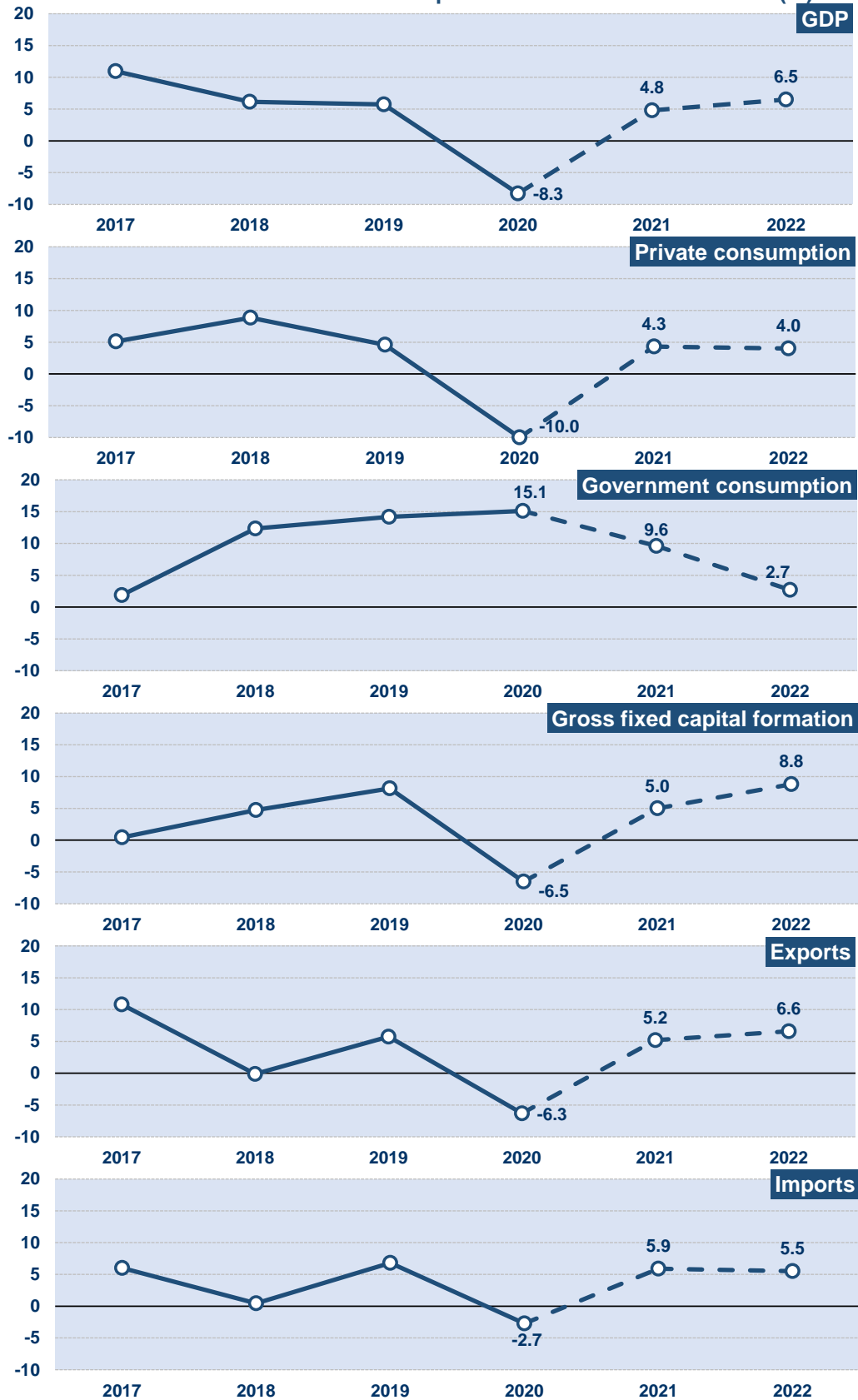
The forecast pattern for the different real GDP expenditure components over the two-year period is broadly similar, corresponding to the so-called “V-shaped recovery”, except for government consumption (see [Chart 3.2](#)). The latter was the only component which expanded in 2020, and in 2021 it is expected to register the highest growth. Indeed, the pandemic necessitated additional government consumption particularly on health and to support domestic economic activity. In 2021, government consumption is estimated to rise by 9.6% in real terms, which nonetheless, represents a deceleration compared to the 15.1% growth in 2020.

The other four GDP expenditure components, which had suffered declines in 2020, are expected to rebound in 2021. The forecast growth in real private consumption is 4.3%. This would correspond to a recovery which is slightly less than half the decline recorded in 2020. Investment is also anticipated to make an incomplete recovery in 2021. It is forecast to rise by 5.0%, which is slightly less than the 6.5% drop recorded a year earlier. In turn, exports are expected to grow by 5.2%, supported by the improving external demand conditions. The forecast developments in domestic demand and exports are estimated to raise imports by 5.9% in 2021.

The real growth in private consumption is expected to remain broadly stable in 2022, up by 4.0% on a year earlier. Meanwhile, growth in government consumption is estimated to decelerate to 2.7%, as certain pandemic-related activities are not repeated, or are rolled back. On the contrary, investment and exports are both expected to grow faster in 2022 than in 2021. Investment is forecast to increase by 8.8%, the highest growth rate among the GDP components, while exports are expected to rise by 6.6%. The combined effect of the expected higher expenditure and its associated assumed import content is projected to raise real imports by 5.5% in 2022, which is a broadly similar rate as in 2021.

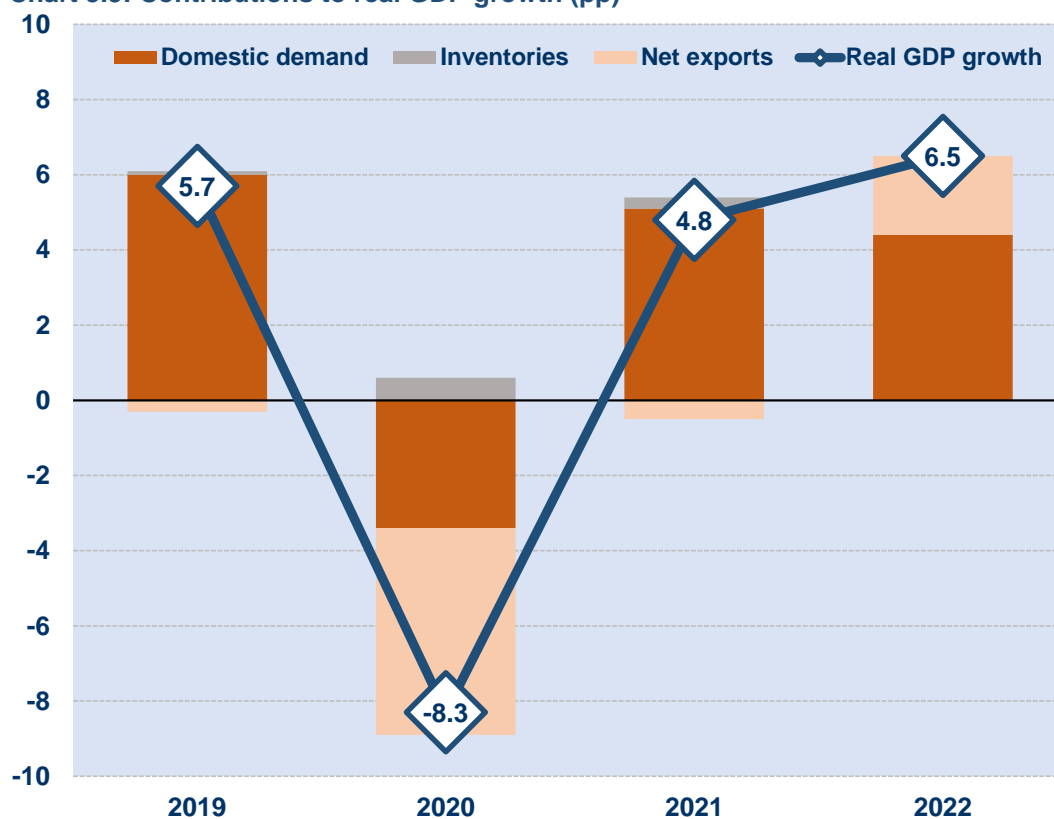
Domestic demand is projected to be the main contributor to real GDP growth throughout the forecast horizon (see [Chart 3.3](#)). In 2021, its upward effect is slightly dampened by the negative contribution from net exports. The growth in imports is expected to marginally outpace that in exports. However, in 2022, net exports are envisaged to reinforce growth, as exports are forecast to grow faster than imports.

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



Source: MFE

Chart 3.3: Contributions to real GDP growth (pp)



Source: MFE

The switch in the contribution from net exports explains why real GDP growth in 2022 is expected to be higher than in 2021. This effect outweighs that created by the assumed inventory dynamics.¹⁶ The DBP embeds the assumption that in 2021 inventories would contribute a slight positive effect on economic growth, whereas for 2022, no impact on growth from inventories is factored.

3.2 Private consumption

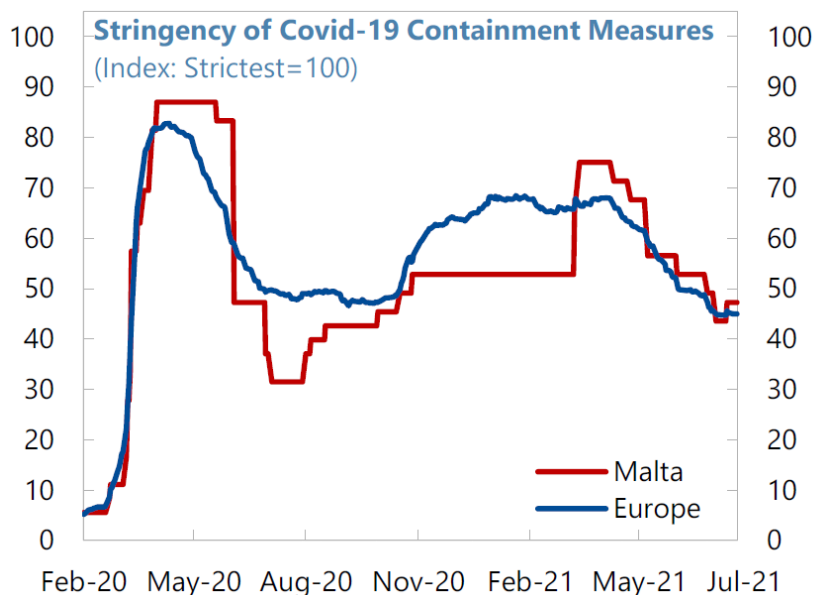
In 2021, private consumption is forecast to rise by 4.3% in real terms, reversing part of the 10.0% contraction recorded in 2020. The anticipated recovery, albeit partial, is consistent with the upside push stemming from the progressive easing of the pandemic-related restrictions implemented in 2021 (see Chart 3.4).¹⁷ The diminishing

¹⁶ The assumption related to inventory changes is the same as the one used in previous DBPs.

¹⁷ Restrictions were gradually relaxed as the proportion of the vaccinated population in Malta increased and the number of COVID-19 active cases declined. Information about the guidelines in place during different phases of the pandemic is available on

downside effect on private consumption following the gradual easing of the virus containment measures offered households the opportunity to slowly resume their spending habits, thus supporting the positive outlook for private consumption.

Chart 3.4: Degree of restraint imposed by the pandemic containment measures



Note: Reproduced from Figure 1, page 23, Malta Staff Report for the 2021 Article IV Consultation by the International Monetary Fund (IMF)

Source: IMF

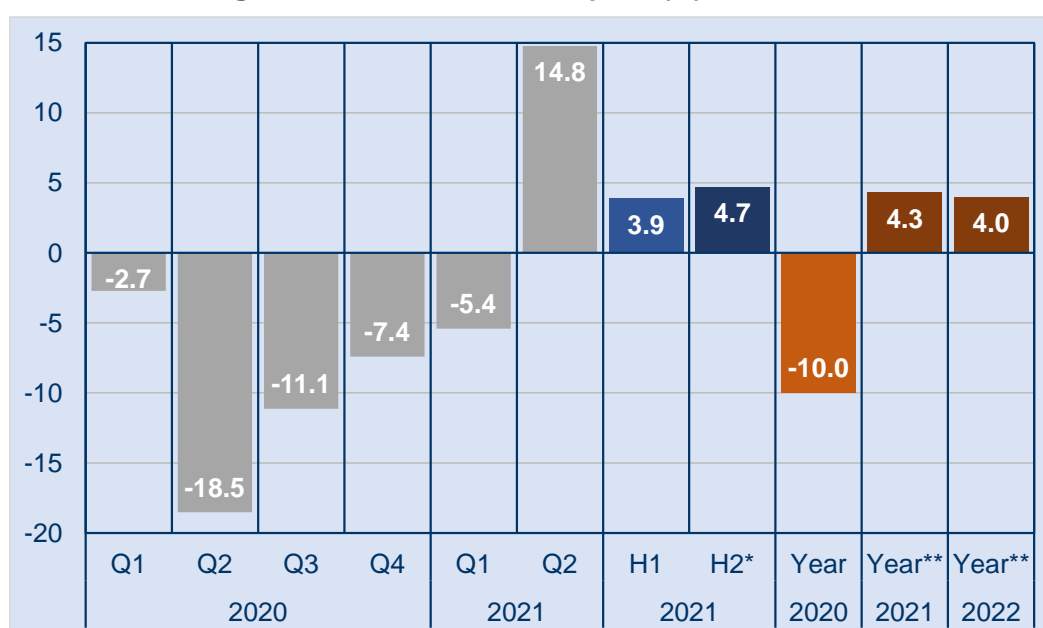
Year-on-year, private consumption registered declines for five consecutive quarters, between the first quarter of 2020 and the first quarter of 2021 (see Chart 3.5). The sharpest contraction, amounting to 18.5%, was recorded during the second quarter of 2020, when the most stringent measures were in place. The year-on-year declines in private consumption slowly attenuated thereafter. Due to the large base effect, strong annual growth in private consumption, estimated at 14.8%, was thus recorded during the second quarter of 2021. The turnaround was broad-based, spread across the various consumption components (see Chart 3.6). The increased consumption also reflects the higher spending by Maltese residents abroad, since in 2020, this was hampered, due to the travel restrictions, including the cancellation of most flights.

The rebound in private consumption noted as from the second quarter of 2021 is expected to maintain its positive momentum. The attainment of the 4.3% annual forecast growth requires that during the second half of 2021, real private consumption

<https://deputyprimeminister.gov.mt/en/health-promotion/covid-19/Pages/mitigation-conditions-and-guidances.aspx>.

expands by 4.7% on the corresponding period of 2020. This rate is slightly higher than the 3.9% growth which was recorded during the first half of 2021. This small acceleration is backed up by the easing of the restrictions in place during the second half of 2021, when compared to the same period of 2020. During the third quarter of 2021 the recovery in consumption is also likely to have been maintained, corroborated by various factors, namely: improved consumer sentiment indicators; data showing increased person mobility; and the Government support in place, particularly through spending vouchers which were distributed to households in Malta (repeating the scheme which was implemented during the same period in 2020).

Chart 3.5: Annual growth rates in real consumption (%)



* The estimated growth rate during the second half of 2021 necessary to attain the yearly forecast.

** The forecast prepared by MFE.

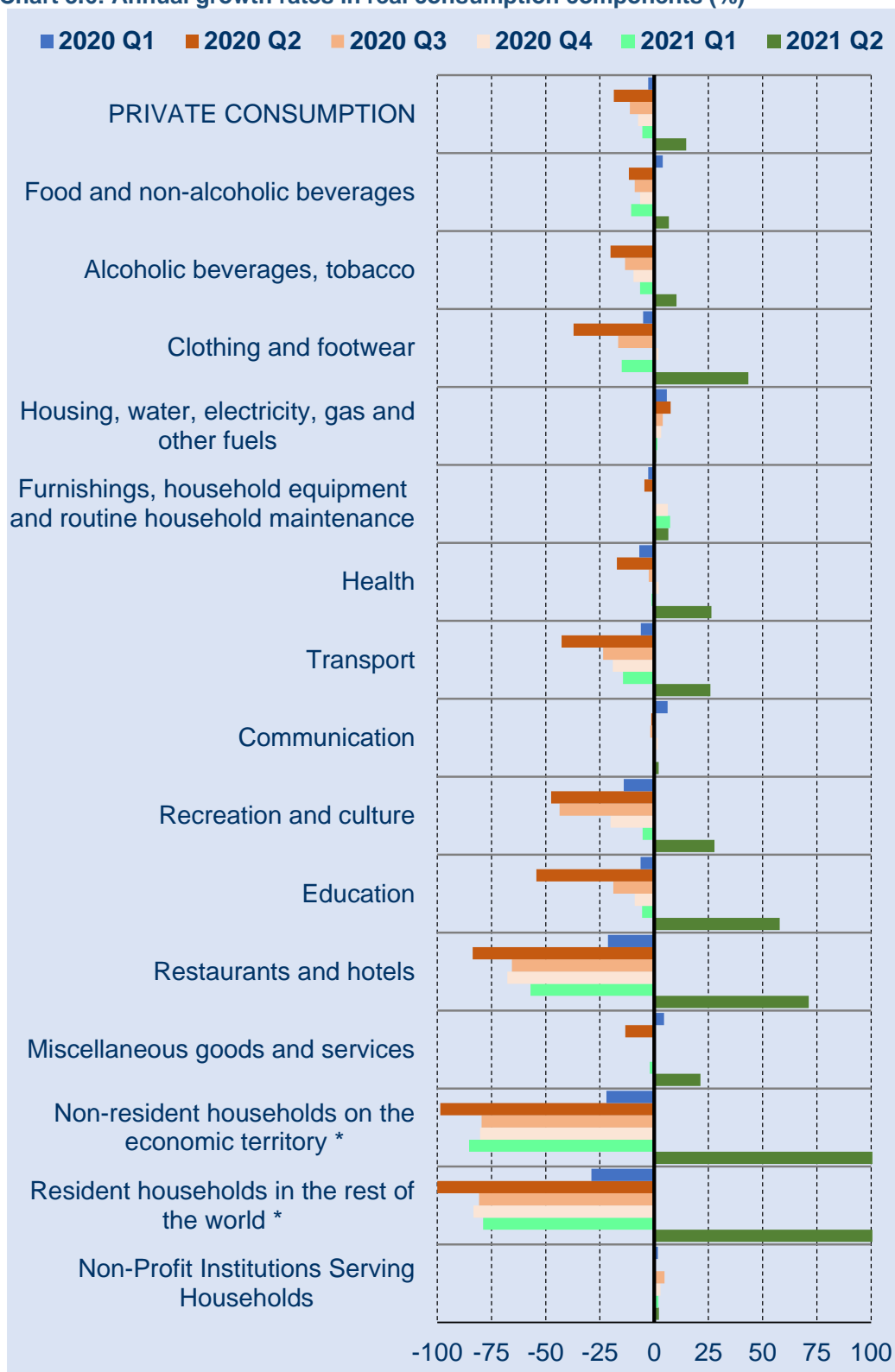
Source: NSO, MFE, MFAC calculations

The gradual recovery in consumption accounts for the dampening effect created by the negative growth recorded during the first quarter of 2021. It can also be attributed to the somewhat conservative assumptions employed by MFE about a rather limited upside push from pent up demand.¹⁸ Indeed, the forecast growth in private consumption is comparable to the rise envisaged in real household incomes, implying that no material drawdown of forced savings is being assumed.¹⁹

¹⁸ Pent up demand is a build-up of demand for goods and services in an economy where consumers are unable or unwilling to make desired purchases because of constraints, such as because of the closure of shops, or the prohibition of mass events.

¹⁹ Forced savings occur when households end up saving more than desired, often reflected in a build-up of short-term bank deposits.

Chart 3.6: Annual growth rates in real consumption components (%)



* The percentage change during 2021 Q2 exceeded 100%.

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

The higher purchasing power in 2021 is entirely supported by the 6.4% forecast growth in total nominal compensation of employees.

In 2022, the momentum in real private consumption growth is expected to stabilise. Real consumption is forecast to expand by 4.0% on a year earlier. This forecast trajectory balances two opposing forces. There could be a possible upside push stemming from the further recovery in spending patterns, on the assumption that the pandemic situation normalises further. This effect could however be offset by the estimated slower growth in household real incomes in 2022 compared to a year earlier. This scenario builds on the expectation that in 2022 nominal compensation of employees rises by less than in 2021, by 4.3%, whereas inflationary pressures pick up (1.6% according to the consumption deflator and 1.7% based on the HICP).

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 9.6% in 2021, and 2.7% in 2022. The strong expansion recorded in 2020, together with that planned for 2021, is conditioned by the higher pandemic-related health expenditure.²⁰ However, high growth rates in government consumption were also recorded before the pandemic. The fiscal outlook for 2022 differs from such historical pattern since the envisaged growth in real government consumption is lower than recorded in previous years.

The decelerating profile for government consumption growth mostly builds on the premise that the base effect created by the extraordinary activities during the pandemic paves the way for the slower subsequent expansion, as specific expenditure is not repeated. An element of expenditure restraint, to be consistent with the specified fiscal balance targets, contributes further to the projected slower growth in government consumption.

²⁰ 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 since this is classified as a subsidy.

The specific factors explaining such outlook can be traced to the budgeted amounts for the items which make up government consumption.²¹ 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, rising by slightly less than 3.0% per annum, the expected developments in real and nominal government consumption follow a similar pattern.

The budgeted allocations underpinning the DBP lead to an estimated 13.1% growth in nominal government consumption in 2021, compared to the 16.8% nominal growth recorded a year earlier (see Chart 3.7).^{22,23} This slowdown reflects two main factors. There is a smaller expected increment in intermediate consumption, due to the assumed gradual decline in costs related to the pandemic over the forecast horizon.²⁴ The expected higher market output in 2021 compared to 2020 also lowers government consumption growth.²⁵ These effects are partially dampened by the slightly higher upward push created by the larger allocation for the public sector's wage bill, as some recruitment which was originally planned for 2020 was delayed to 2021 because of the pandemic.²⁶

In 2022, growth in nominal government consumption is forecast to remain high. However, it is planned to decelerate slightly, to 7.1%.²⁷ This pattern is based on the

²¹ Refer to Chapter 5 in this Report for an assessment of the forecast trajectory for the relevant budget components.

²² The nominal growth rates in government consumption shown in the chart and quoted in the text are consistent with the updated fiscal data used by MFE in the preparation of the DBP and which are assessed in Chapter 5 of this Report. There are some slight differences both with respect to historical and forecast growth rates in nominal government consumption. Since the macroeconomic forecasts are finalized before the detailed fiscal forecasts, Table 2.1 of the DBP quotes slightly different nominal growth rates for government consumption (2019:16.9%; 2020: 17.2%; 2021:12.6%; 2022: 5.3%).

²³ The heading "other minor components" referred to in the chart includes social transfers in kind and consumption of fixed capital.

²⁴ As the health pressures of the pandemic are assumed to ease, related hospitalisation costs are expected to decline.

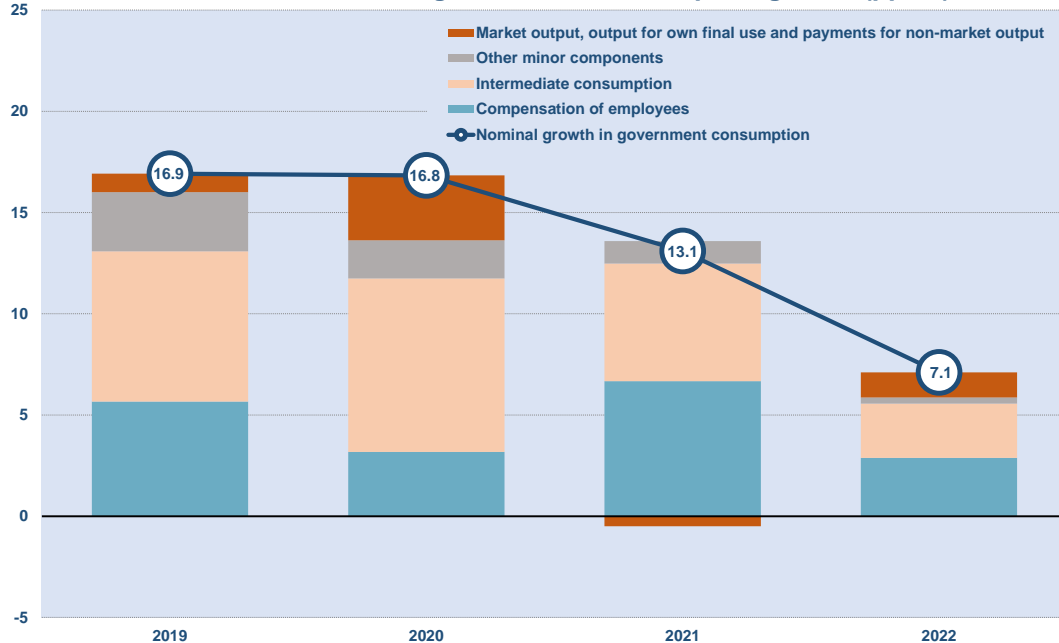
²⁵ When estimating the value of government consumption, certain items (market output, output for own final use and payments for non-market output) are deducted from the other expenditure components. Since the DBP assumes that in 2021 the total for these items will be more than in 2020, this corresponds 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 for these years.

²⁶ This includes not only government departments but also the employees of the entities classified as Extra-Budgetary Units (EBUs).

²⁷ Since the fiscal forecasts were finalized after the macroeconomic forecasts, there is a small element of inconsistency. Table 2.1 of the DBP shows that the general government final consumption expenditure growth forecast for 2022 is 2.7%, while Appendix Table 1.b shows that the forecast growth in the consumption deflator for 2022 is 2.5%. The final fiscal forecasts

premise that the spending on compensation of employees and intermediate consumption remain within their respective budget, which is rising at a slower pace than in 2021. This effect is slightly offset by the upward push created by the assumed profile for market output (since in 2022 the target amount is less than that for 2021).

Chart 3.7: Breakdown of nominal government consumption growth (pp, %)



Source: MFEs

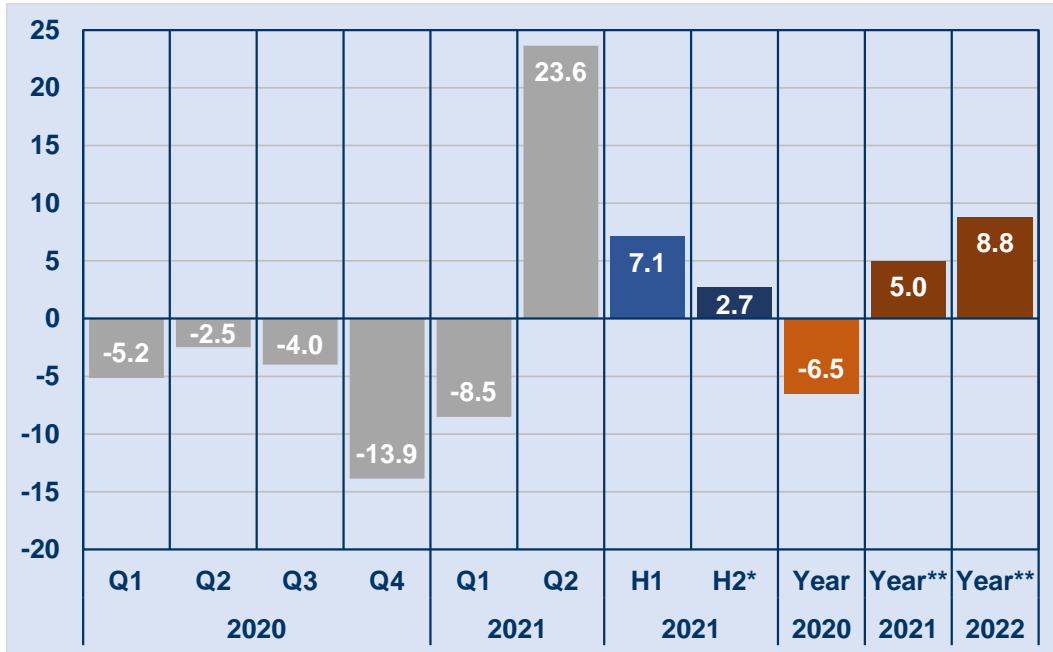
3.4 Gross fixed capital formation

In 2021, gross fixed capital formation is expected to increase by 5.0% in real terms, following the 6.5% decline recorded in 2020. During the first half of 2021, total investment expanded by 7.1%, as the 8.5% decline recorded during the first quarter was more than offset by the 23.6% growth registered during the second quarter. Based on the premise that such figures are not revised, to attain the annual forecast, the required investment growth over the second half of 2021 is only 2.7% (see Chart 3.8). The forecast growth in investment thus appears somewhat cautious when viewed against the mid-year developments. The expected rise in investment in 2021 is

in nominal terms produce a growth rate of 7.1%, which is above that suggested by the combination of the real government consumption growth rate and developments in the government deflator. In turn this would imply that the 2022 forecast real government consumption growth and / or the forecast growth in the government deflator could be underestimated.

compatible with the subsiding uncertainty and improving financial conditions relative to 2020.

Chart 3.8: Annual growth rates in gross fixed capital formation (%)



* The estimated growth rate during the second half of 2021 necessary to attain the yearly forecast.
 ** The forecast prepared by MFE.

Source: NSO, MFE, MFAC calculations

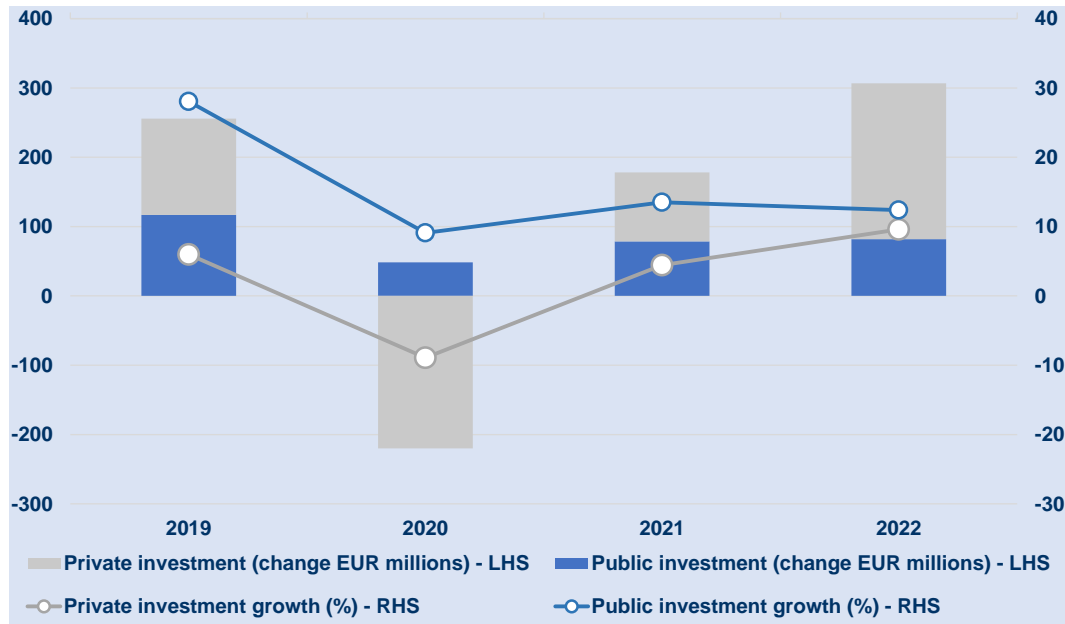
In nominal terms, the official investment outlook shows that in 2021, both private and public sector investment are expected to be higher than in 2020 (see Chart 3.9).²⁸ In absolute terms, the change in private sector investment in 2021 is marginally higher than that planned by the public sector, but the amount is still lower than the drop registered in the previous year. Indeed, the expected recovery in private sector investment is backloaded to 2022. On the other hand, the planned trajectory for government investment is generally more stable over the forecast horizon, both in terms of absolute and percentage changes.

For 2022, total investment growth is set to accelerate to 8.8%, with broadly similar growth rates for public and private investment. The DBP refers to several large-scale investment projects in transport and aviation, tourism, real estate, healthcare, education, and digital sectors, which are expected to materialise over this period.

²⁸ Nominal private sector investment is calculated as the difference between total investment and spending on gross fixed capital formation by government (as reported in the ESA fiscal data assessed in Chapter 5 in this Report).

Some projects are set to be financed from the Recovery and Resilience Facility (RRF). An equivalent of 0.5% of GDP is set to be utilised in 2022, with the rest spread over the following years.^{29,30}

Chart 3.9 Public and private sector investment in nominal terms



Source: MFE, MFAC calculations

The expected rebound and acceleration in investment is consistent with the initiation of the projects which were postponed because of the pandemic, and the new projects forming part of the RRF. In the past, investment has registered strong growth rates, but as the level of investment rises, there could be challenges to increase investment further at such high rates. Still, the risk that forecast errors in this component translate into risks to the overall profile for GDP is, to a large extent, muted by the high import content assumed for investment.

²⁹ In 2021 the government investment financed from the RRF is small, amounting to 0.1% of GDP. These mainly relate to the education sector and the renovation and greening of buildings.

³⁰ The COM made these funds available 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. To this effect countries had to submit a plan of how to use such funds. Malta's RRF was endorsed on 16 September 2021, with a planned disbursement of €316.4 million in grants. Malta's plan devotes 54% of its total allocation to measures that support climate objectives, whilst 26% are allocated to measures that support the digital transition. More information on the endorsement of Malta's RRF is available on https://ec.europa.eu/commission/presscorner/detail/en/IP_21_4705.

The inherently volatile nature of gross fixed capital formation makes it relatively challenging to achieve accurate forecasts, especially within a context of a small open economy. Indeed, there were times, even pre-pandemic, where large swings in investment were recorded. Another source of uncertainty relates to the fact that the government's plans are originally drawn up along the Consolidated Fund framework and rules of thumb (such as fixed ratios) are used to convert such figures into ESA forecasts and produce the split among the different ESA components such as intermediate consumption and investment. These calculations are subject to ex-post revision when the precise details of the transactions are known.³¹

3.5 Exports of goods and services

In 2021, real exports of goods and services are forecast to expand by 5.2%, reversing a significant proportion of the 6.3% contraction experienced in 2020. Exports are expected to accelerate further in 2022, up by 6.6% over the previous year. The outlook for exports is compatible with the assumed recovery in external demand. Indeed, the real GDP of Malta's main trading partners is assumed to grow by 4.7% and 4.3% respectively in 2021 and 2022. The slightly faster growth rates for Malta's exports anticipated over the forecast period are consistent with the empirical evidence from the pre-pandemic period that suggests that in Malta certain exports have a higher than unitary elasticity vis-à-vis real GDP developments in Malta's main trading partners.³²

The anticipated exchange rate movements for 2021 exert an offsetting effect since the euro is assumed to appreciate against the US dollar but depreciate against sterling. Minimal exchange rate movements are assumed for 2022. As a result, the exchange rate plays a limited role in influencing the export forecast patterns. On the other hand, higher costs of transportation and freight, which are factored into the deflator for exports (estimated to rise by 2.1% both in 2021 and 2022), act as partial drag on Malta's export recovery.

³¹ For example, outlays initially classified as investment in the forecasts could be subsequently re-classified as intermediate consumption, and vice-versa.

³² 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". This is true for most sectors, particularly for financial services, remote gaming and the chemicals and pharmaceutical sectors. The Report is available on: <https://finance.gov.mt/en/epd/Pages/Library.aspx>.

Most sectors are anticipated to contribute positively towards export growth over both forecast years. For 2021, the remote gaming sector, the chemical and pharmaceuticals sector, the information and communication sector, and tourism, account for the bulk of the expected increase in exports. In particular, the pattern of double-digit growth registered by the remote gaming sector in 2019, and even in 2020, is expected to be repeated in 2021 and 2022, as the prospects for this sector are assumed to remain buoyant.³³

After the strong hit in 2020, the outlook for tourism is positive, based on the monthly tourism flows which were recorded in 2021. Tourism forecasts are mainly driven by the assumed path to recovery. The forecast trajectory embeds information about the likely performance of similar destinations together with the number of flights which are estimated to be available during 2021 and 2022.

The assumptions employed by MFE remained practically unchanged to what had been used in the USP, namely that in 2021, the number of tourists reaches 31.0% of the level recorded in 2019, and in 2022 the percentage rises to 75.0%. The view of a prolonged path to recovery is consistent with the broad consensus that as economies recover from the pandemic, tourism should pick-up, albeit slower than other types of activities, as confidence and safety concerns may take longer to be restored.

The assumed growth in tourism makes the sector the largest contributor to export growth in 2022, followed by the remote gaming sector. On the other hand, exports by the financial sector were down during the first half of 2021, and such pattern was maintained even for the rest of the year. However, in 2022 financial services exports are anticipated to expand again. Exports of fuel and other business services are also expected to pick up in 2022, in contrast with the declines anticipated for 2021.³⁴

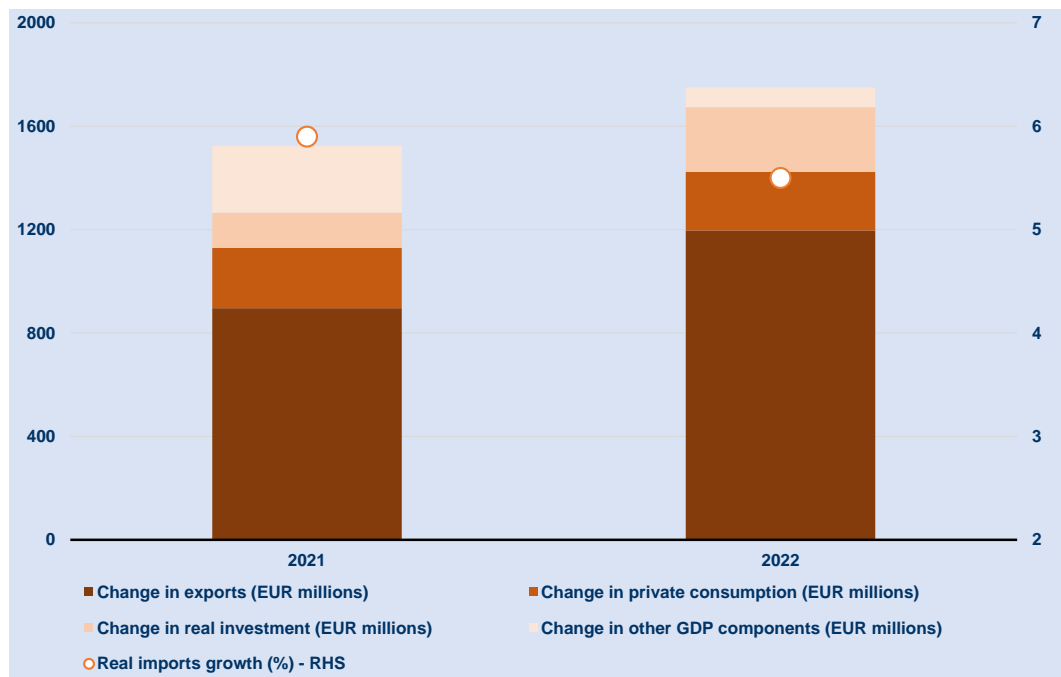
³³ The 2021 Half-Yearly Report published by the Ministry had referred to the decision in June 2021 by the Financial Action Task Force (FATF) “to insert Malta in its list of countries identified as having strategic anti-money laundering (AML) deficiencies” and stated the government’s official position that this “is not expected to have substantive negative economic effects over the short term”.

³⁴ At a component level, certain sectors tend to exhibit volatility in their yearly performance. These patterns are to an extent repeated in the forecasts, based on the regression estimates used to generate such forecasts.

3.6 Imports of goods and services

In 2020, imports contracted by 2.7% in real terms. The expected recovery in real GDP is estimated to raise imports by 5.9% in 2021, and by 5.5% in 2022. These rates are closer to the expected growth in real GDP over the same period. Import developments across the forecast horizon reflect the pick-up across the various GDP components (see Chart 3.10). In absolute terms, the expansion in exports is the largest, but developments in private consumption and investment also contribute to shape the expected import dynamics.³⁵ Higher imports of business services, capital goods, and fuel, account for the bulk of the forecast growth in imports over the two years. Any deviation from the anticipated profile for the GDP expenditure components could have a material impact, both on the overall growth rates, and composition of imports, over the forecast horizon.

Chart 3.10: Developments in real GDP components and imports



Note: Changes in other GDP components refer to government consumption and inventories.

Source: MFE

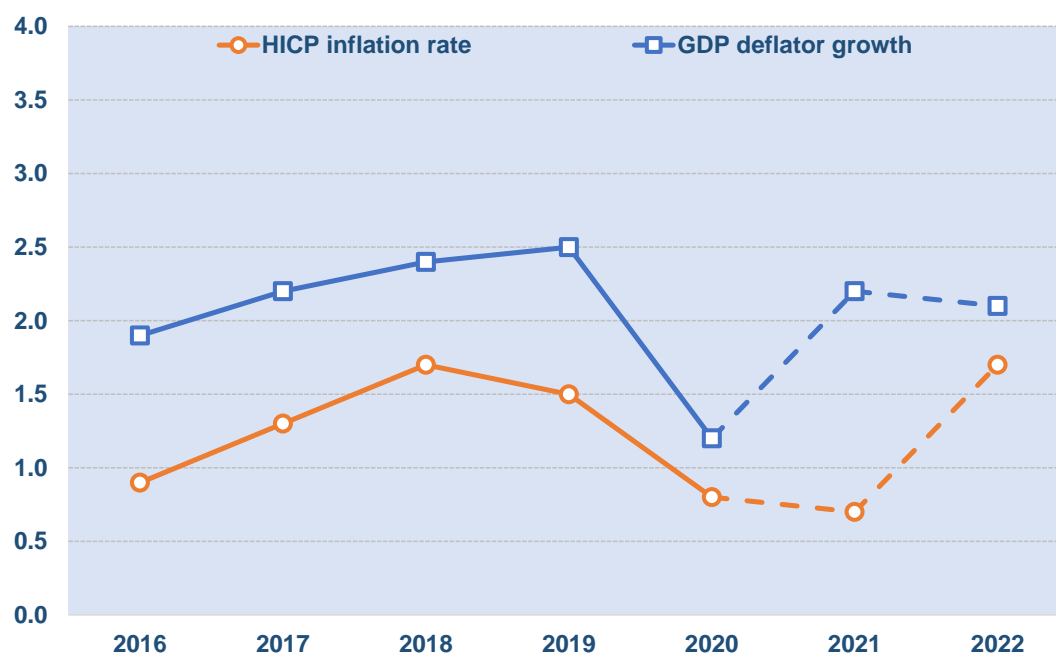
³⁵ In the case of certain exports, the domestic value added is low compared to the import content. Even Investment is assumed to have a very high import content, more than 80% in many cases. This leads to very strong demand for imports, primarily in the form of capital goods. On the other hand, the import content of household consumption is lower than for the other two components.

Although the expected absolute increase in real GDP in 2022 amounts to €807.2 million, which is more than the €568.8 million projected for 2021, import growth is forecast to decelerate slightly in the outer forecast year. This reflects the interplay of the different composition of real GDP, where it is estimated that the growth in real GDP in 2022 has a slightly lower import content than in the preceding year. Specifically, the acceleration in exports in 2022 is ascribed to the envisaged strong improvement in tourism, which tends to have lower import content compared to other forms of exports.

3.7 Inflation and GDP deflators

In 2020, the rate of inflation measured by the HICP stood at 0.8%, which was the lowest rate recorded since 2014. In 2021, the inflation rate is again expected to be low. Indeed, it is forecast to decelerate further, to 0.7% (see Chart 3.11). However, inflation is then expected to gain momentum quickly, climbing to 1.7% in 2022.

Chart 3.11: HICP inflation rate and GDP deflator growth (%)



Source: MFE

The low HICP inflation rate forecast for 2021 reflects some abatement in the inflationary pressures related to goods, which more than compensates for the slight acceleration in the prices of services. The low inflation scenario is conditioned by the downward effect created by specific factors, such as the changes in the HICP weights for certain products (which reflect changing consumer spending at the beginning of the

year). The reduction in fuel prices which was announced in 2020 as part of the initiatives to support the economy during the pandemic dragged inflation further down. These effects are temporary and not applicable for 2022. Together with the recovery in domestic demand and the assumed rise in world prices and oil prices, such factors are expected to raise inflation in the outer forecast year. However, the inflation forecast assumes a rather muted pass-through of foreign prices into domestic prices. Indeed, the forecast for the HICP is much lower than the 5.6% and 2.9% assumed increase in foreign prices for the two years.

The annual forecast growth in the GDP deflator is above the HICP inflation rate, settling slightly above 2.0% in both years. The gap between the two measures is thus expected to widen in 2021. The deflators for private consumption, investment and imports are expected to grow below 2.0% while the deflators for government consumption and exports are expected to grow by slightly more.³⁶ Export prices are projected to rise slightly faster than import prices in both years, implying a consistent small improvement in the terms of trade in both years. This development replicates the pattern recorded since 2013 and is compatible with the perspective that the faster growth in export prices than in import prices could be due to the changing orientation of the Maltese economy towards higher-priced exports.

3.8 Labour market

Despite the drop in real GDP which took place in 2020, employment rose by 2.7% on a year earlier (see [Chart 3.12](#)). The employment forecast extends the pattern of job-rich growth, but less strongly than in previous years. The rebound in economic activity is estimated to raise employment by 2.3% in 2021, and by 2.2% in 2022. This reproduces similar growth rates as that registered in 2020. However, the positive labour market outturn in that year could in part be ascribed to the possible improvement in the representativeness of labour statistics due to the strengthened administrative procedures for people to be eligible for the wage support offered by Malta Enterprise.

³⁶ The consumption deflator and the HICP normally follow similar growth patterns. However, for 2021, given the increase in prices in the second half of the year in food, personal services, transport and recreational activities, the consumption deflator growth is likely to deviate temporarily from the measurement offered by the fixed-weight HICP (with weights set at the beginning of the year).

Chart 3.12: Employment growth and labour productivity (%)



* Forecasts by MFE

Source: MFE

The employment growth envisaged for 2021 and 2022 accounts for the expected higher output, but also acknowledges the need to make up for the fallen productivity levels. 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%. Labour productivity is modelled to start recovering, growing by 2.3% in 2021 and 4.2% in 2022, as firms seek to re-establish labour productivity and operate towards their full potential. This explains why the labour market outlook is characterised by a slower growth in jobs than in real GDP.³⁷

Following the increase in the unemployment rate in 2020, this is expected to fall to 3.8% in 2021 (see Chart 3.13). The unemployment rate is subsequently estimated to remain low, but to increase slightly, to 4.0%, in 2022. Although labour demand is expected to grow less strongly than in pre-pandemic years, even growth in labour supply is assumed to decelerate compared to earlier years. This assumption would further support the low unemployment rate outlook. The resilience of the job market factored in the DBP is consistent with the expectation of the economic recovery and is based on the premise that the phasing out of the temporary wage support initiatives,

³⁷ The termination of the temporary wage assistance might also lead to labour shifting from one sector to another, contributing to restore economy-wide productivity, as workers shift from low to higher productivity jobs.

which are budgeted for up to end 2021, do not create any material adverse repercussions on the labour market.

Chart 3.13: Unemployment rate (%)



Source: MFE

3.9 Potential output and the output gap

Malta's potential output and the output gap are estimated by MFE using the commonly agreed methodology across the EU.³⁸ This is based on the production function approach, with growth driven by labour, capital, and total factor productivity (TFP).³⁹ According to these estimates, Malta's potential output growth peaked in 2015, at around 7.0%, but thereafter it decelerated gradually, to 5.3% by 2019 (see Chart 3.14).

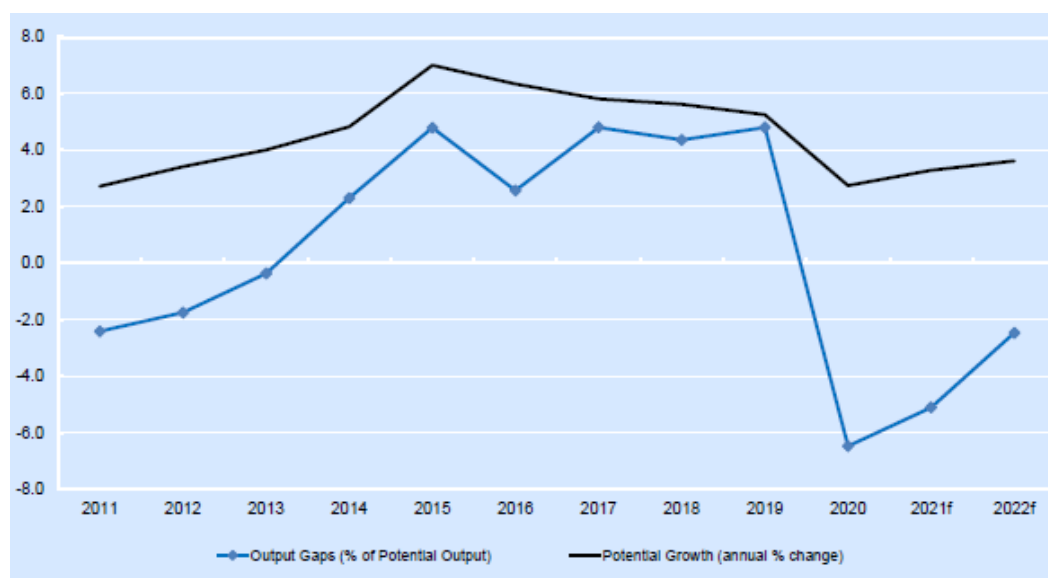
In 2020 potential output growth declined to 2.8% due to the COVID-19 pandemic. This deceleration was ascribed to labour developments, capital developments and changes in TFP. Between 2019 and 2020, the contribution from labour supply dropped from 4.2% to 2.5%; that from capital accumulation was reduced from 2.0% to 1.5%; whilst

³⁸ For further details refer to https://ec.europa.eu/economy_finance/publications/economic_paper/2014/eep535_en.htm.

³⁹ 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 the available 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.

the negative contribution from TFP worsened by 0.3 pp. Indeed, because of the pandemic, labour and capital resources were adversely impacted and resources were partly idle.

Chart 3.14: Potential output growth and output gap estimates



Note: reproduced from DBP Chart 2.1, page 14

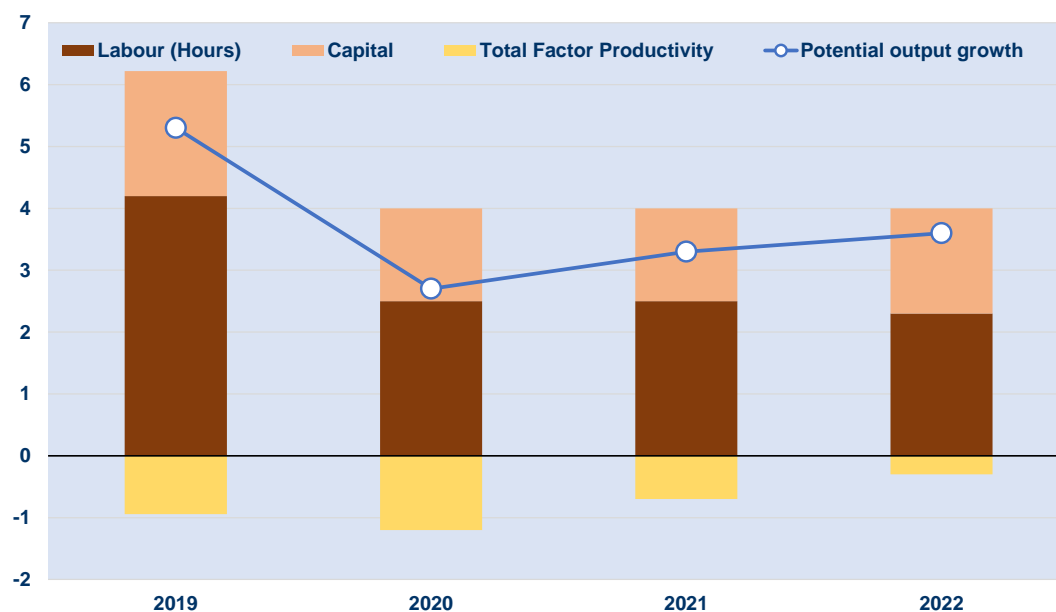
Source: MFE

Starting from 2021, Malta’s potential output growth is expected to gradually start recovering yet remaining below the rates attained pre-pandemic. The rate of accumulation of labour and capital inputs is expected to be more muted than in pre-pandemic years. Potential output growth is thus estimated to rise to 3.3% in 2021, and to 3.6% in 2022. The expansion in labour supply is expected to continue accounting the most towards potential output growth, with the contribution from capital accumulation being slightly less (see Chart 3.15).

Both for 2021 and 2022, the MFE’s calculations suggest that labour supply and capital accumulation would respectively contribute around 2.5 pp and 1.5 pp to growth in each year, which are similar magnitudes as estimated for 2020. The envisaged progressive improvement in potential output growth over the forecast period is driven by the expected attenuating impact of the drag created by the negative TFP. 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. According to the MFE’s calculations this effect was present in 2018 and 2019 and was reinforced further in

2020. The wage support schemes offered by Malta Enterprise were precisely designed to encourage businesses to maintain their workforce, despite the slump in demand. Indeed, economic activity declined significantly (real GDP fell by 8.3% in 2020) whereas employment still expanded (increased by 2.7% in 2020). The potential output growth scenario envisaged in the DBP thus allows for this effect of idle resources to diminish in importance gradually over time, explaining the negative, yet smaller effect from TFP.

Chart 3.15: Sources of potential output growth



Source: MFE

According to the calculations by MFE, since 2014 Malta's economy was operating above its potential. Between 2017 and 2019, the output gap was rather stable, close to 5.0% of potential output. However, the collapse in real GDP which took place in 2020 was much stronger than the deceleration in potential output growth. This led to a sharp change in the output gap, from positive to negative.

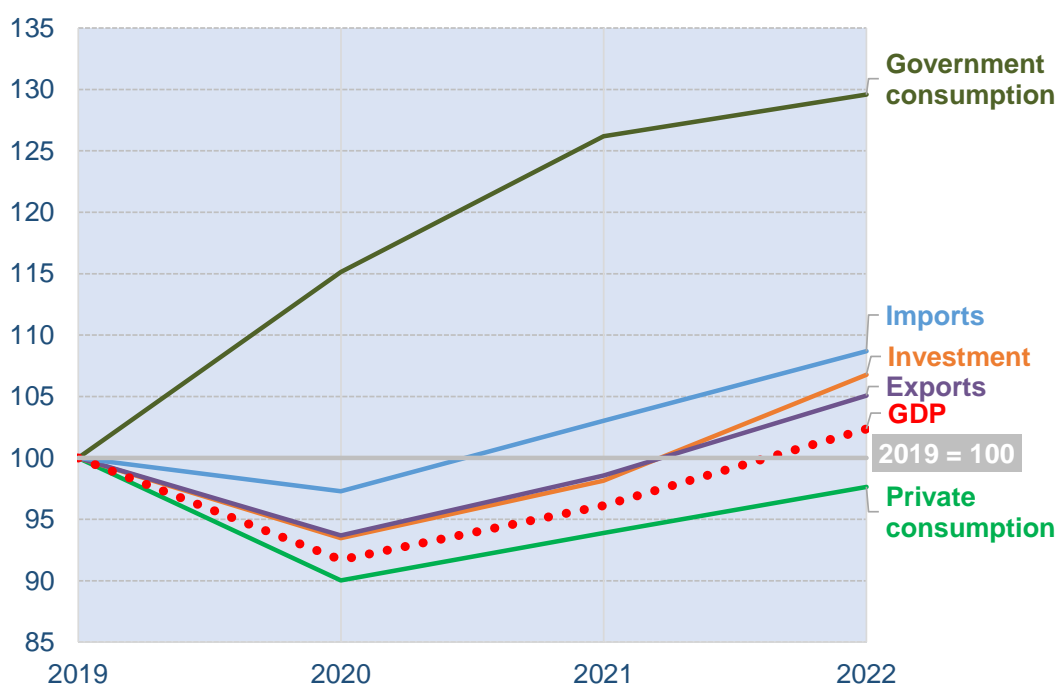
Indeed, the output gap turned to -6.5% of potential output in 2020, indicating that the economy's real GDP was significantly below potential output. The situation is envisaged to start improving as from 2021, as the output gap is forecast to slowly close over time. In 2021, the output gap is expected to narrow to -5.1% of potential output. For 2022, a stronger improvement is expected, with the output gap narrowing to -2.5% of potential output. These calculations are based on the scenario that real GDP accelerates at a faster pace than potential output growth during these two years. In

turn, this presupposes a pick-up in aggregate demand assuming the adverse effects of the pandemic diminish.

3.10 Macroeconomic risk outlook

In 2020, all real GDP expenditure components declined, except for government consumption, which expanded on a year earlier. The official outlook indicates that all those components which were adversely impacted by the pandemic are expected to start recovering as from 2021, albeit at a different pace (see Chart 3.16).⁴⁰

Chart 3.16: Index for the real GDP components 2019 – 2022 (2019 = 100)



Source: MFAC calculations

In real terms, imports are expected to surpass the level recorded in 2019 (pre-pandemic) already in 2021. On the other hand, investment and exports are forecast to recover completely by 2022. The additional year required for their recovery partly reflects the larger downturn experienced by these two components (slightly more than 6.0% in both cases), compared to the drop in imports, which was contained to 2.7%.

⁴⁰ 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.

The relatively more muted prospects for investment and exports are the result of the uncertainty created by the pandemic, which is assumed to be subsiding, though not completely, by the end of the forecast horizon. Moreover, the assumption that even international demand would recover partially in 2021 shapes the MFE's cautious outlook, not only for exports, but also for investment, particularly as a significant share of the latter also serves the export market.

The outlook for private consumption is also cautious as the full recovery is anticipated to take place later, beyond the forecast horizon. Private consumption was the worst hit expenditure component, and the gradual pick-up scenario allows for possible deceleration in spending momentum going forward when compared to previous years. Such trajectory factors in the possibility that households' consumption behaviour adjusts post pandemic.

The forecast profile for government consumption is completely different from the rest of the GDP components. In this case, the prospects are for the sharp increase recorded in 2020, to be followed by another strong expansion in 2021, and further growth in 2022. Still, in 2022 the level of government consumption is expected to be almost 30.0% more than in 2019, by far exceeding the cumulative change forecast in the other GDP components over the same period.

Overall, the combined effect of the forecast dynamics for the various expenditure components are expected to restore real GDP fully by 2022, as it is forecast to be 2.4% above its level in 2019. The forecast profile for imports mirrors that for GDP, but the expected cumulative change in imports over the same period is larger. Imports are expected to reach 7.0% above their level in 2019, but this is mostly due to the much lower drop registered by this component in 2020.

The rather 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 (see [Table 3.2](#)). It is possible that consumption growth turns out higher than anticipated, particularly if the evolution of the pandemic remains under control and the general improvement in consumer confidence is confirmed. The mid-year consumption developments according to the official data also show that good progress was already made during the first half of 2021 towards the attainment of the annual forecast. The upside risk to consumption

growth, applicable to both years, is also corroborated by the fact that some forecasts by other independent institutions provide more upbeat consumption growth forecasts.

Table 3.2: Summary of risks to the GDP expenditure components

	2021	2022
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 which is more subdued than experienced in the pre-pandemic years. 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. The upside risk appears pertinent for both 2021 and 2022, since the forecast growth dynamics over these years imply changes from the trend observed over the previous years. This change hinges critically on the envisaged pandemic cost savings and the yearly targets for the proceeds from market output, both of which may be uncertain.⁴¹

In the case of investment, the risk outlook is upside for 2021 and neutral for 2022. The mid-year developments in investment recorded in the official data suggests that good progress was already achieved during the first half of 2021, supporting the upside risk for the year. Moreover, the detailed fiscal forecasts indicate that the government's investment plans for 2021 could have been revised upwards when the macroeconomic

⁴¹ When market output by government is estimated to increase, this reduces government consumption, and vice-versa.

forecasts had been already finalised.⁴² This would offer further room for total investment to grow at a faster pace than indicated in the official outlook.

On one hand, the MFE's assumption that many large-scale investment plans made prior to the pandemic would resume could be optimistic. Furthermore, the materialisation of some large investments appears uncertain, as plans are still at the initial stages, and the pandemic or other factors might derail such plans. The absorption rate of RRF grants, which according to the DBP 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. However, these considerations tend to be compensated for by the possibility of a strong drive towards investment, and the fact that in the past investment growth was also high, thereby supporting the neutral risk outlook for the outer year.

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 DBP 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.

Overall, the upside risk associated with private consumption and government consumption throughout the forecast horizon, and investment for 2021, together with the neutral risk for exports suggest an upside risk to imports and to GDP, based on the information available by the cut-off date. If domestic demand turns out higher than forecast, part of this would be reflected in higher demand for domestic production, and hence GDP, and part for imported products. This explains the upside risk for GDP and import growth throughout the forecast horizon.

There are however two relevant caveats to the MFAC's risk outlook as presented. It must be acknowledged that the forecasts are strongly dependent on the assumption that the pandemic is gradually subsiding, not only in Malta but also on a global level. This depends entirely on health-related factors upon which it is very hard to hypothesise about with any certainty. Another caveat is that the potential impact

⁴² The detailed fiscal forecasts are provided to the MFAC after the DBP is submitted to the COM. The information made available by MFE at the time of the endorsement of the macroeconomic forecasts only relates to a split between the private and public investment forecasts.

caused by Malta's placement under increased scrutiny by the FATF remains highly uncertain and difficult to ascertain, especially since this is also a function of how long this period takes.

Chapter 4

Comparison across different macroeconomic forecasts

4.1 Introduction

The plausibility of the macroeconomic scenario presented in the DBP can be further assessed by comparing it with the outlook which was presented in the previous forecast round by MFE (USP 2021 – 2024). The direction of the revisions which were undertaken in the DBP compared to the USP can be traced and evaluated against the new information which became available between the two forecast rounds. A further plausibility check is carried out by examining the similarity or otherwise with respect to the macroeconomic forecasts for Malta produced by other reputable institutions, namely the COM, the Central Bank of Malta (CBM), the International Monetary Fund (IMF), and the three main credit-rating agencies (Fitch, Moody's, and S&P).

The caveat remains that such forecasts are not necessarily perfectly comparable since these were published at different times and were thus based on different information sets. Variations in the methodologies and the assumptions used to compile the forecasts could be another source of discrepancy. Nonetheless, the MFAC considers such comparisons as a valid benchmark to support the assessment carried out in Chapter 3 of this Report.

4.2 Comparison with the USP 2021 – 2024

For 2021, the economic scenario presented in the DBP puts forward a more positive outlook than that presented in the USP. The forecast for real GDP growth was raised by one percentage point, from 3.8% to 4.8% (see Table 4.1). This upward revision mostly reflects a stronger expected positive contribution to growth from domestic demand, supported by a slightly smaller negative contribution from net exports. Furthermore, the assumption of no impact on growth from inventories was replaced by a small positive contribution, based on the actual developments recorded during the first half of 2021.

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

	2021					2022				
	USP	DBP	COM	IMF	CBM	USP	DBP	COM	IMF	CBM
	<i>Growth rate in GDP components in real terms</i>									
Private consumption	2.4	4.3	4.3	5.1	4.7	5.4	4.0	4.6	3.1	6.3
Government consumption	5.6	9.6	9.6	8.6	5.7	-3.2	2.7	3.4	-1.7	0.0
Gross fixed capital formation	9.2	5.0	6.5	3.0	9.6	12.5	8.8	8.5	8.5	8.2
Exports of goods and services	5.1	5.2	5.2	5.1	6.3	6.9	6.6	6.4	5.8	5.7
Imports of goods and services	5.9	5.9	5.9	4.8	7.0	5.8	5.5	5.8	3.8	5.2
Real GDP	3.8	4.8	5.0	5.7	5.1	6.8	6.5	6.2	6.0	5.9
	<i>Contributions to real GDP growth</i>									
Domestic demand (pp)	4.5	5.1	5.3	4.9	5.4	4.9	4.4	4.6	2.8	4.6
Inventories (pp)	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports (pp)	-0.7	-0.5	-0.3	0.8	-0.3	1.9	2.1	1.5	3.2	1.2
	<i>Deflators</i>									
Private consumption	1.4	1.2	-	-	-	1.5	1.6	-	-	-
Government consumption	2.2	2.7	-	-	-	2.5	2.5	-	-	-
Gross fixed capital formation	1.1	1.3	-	-	-	1.3	1.2	-	-	-
Exports of goods and services	1.3	2.1	-	-	-	1.4	2.1	-	-	-
Imports of goods and services	0.8	1.8	-	-	-	1.1	1.9	-	-	-
GDP	2.1	2.2	1.8	1.3	1.6	2.1	2.1	1.8	1.7	1.8
	<i>Other macroeconomic variables</i>									
Inflation rate (HICP)	1.3	0.7	1.1	0.7	0.5	1.5	1.7	1.6	1.8	1.7
Employment growth*	2.2	2.3	2.4	0.9	1.1	3.5	2.2	2.5	2.3	2.2
Unemployment rate	4.3	3.8	4.0	3.6	3.9	3.9	4.0	3.8	3.5	3.7
Compensation per employee	1.2	3.9	2.9	-	2.1	2.1	2.1	1.9	-	2.8

Note: Figures by the COM were published as the Autumn 2021 economic forecasts (November 2021), those by the IMF refer to those published for the Article IV Consultation (September 2021), while those by the CBM were published in August 2021. Figures may not add up due to rounding.
* Figures may not be directly comparable as definitions may vary.

Sources: MFE, COM, IMF, CBM

The stronger expected contribution from domestic demand in 2021 indicated in the DBP reflects the upward revisions in private and government consumption growth, which more than compensated for the downward revision in investment growth. The more positive outlook for private consumption was driven by the data for the first six months of 2021 published by the NSO which suggested a stronger recovery than previously anticipated. The higher private consumption growth forecast is also compatible with the updated outlook of higher growth in compensation per employee.

In turn, the higher expected growth in government consumption in 2021 compared to the figures which were presented in the USP accounts for the updated fiscal plans for the year. On the other hand, investment growth was scaled down in the DBP, as some projects were postponed to after 2021. On the external front, changes were minimal across the two forecast rounds. For 2021, export growth was lifted marginally higher, while import growth was unchanged.

For 2022, the outlook for real GDP growth was changed only slightly, from 6.8% to 6.5%. Changes to the growth rates for the various GDP components tended to offset each other. Domestic demand remained the predominant driver of economic growth for 2022. However, its contribution was revised slightly downwards. This effect was partially offset by a slight increase in the expected positive contribution from net exports in the outer forecast year.

The DBP presents a somewhat different outlook for private consumption than the USP. Whereas in the latter, consumption growth was expected to accelerate in 2022, this view was replaced by more stable growth rates across the two forecast years. This adjustment reflects the base effect created by the stronger expected pick up in consumption in 2021 than previously anticipated. As a result, consumption growth in 2022 was lowered slightly.

Even investment growth was lowered slightly, as certain investment projects are expected to be spread over a longer timeline than originally expected. A proportion of the investment which the USP had allocated to 2022 was thus shifted to beyond the forecast horizon allowing for possible delays in the implementation of certain projects.

On the contrary, the outlook for government consumption was changed radically. The contraction envisaged in the USP for 2022 was replaced by moderate growth in the DBP. This is consistent with the fact that the evolution of the pandemic during 2021

may have been less benign than anticipated in the USP, thus requiring more government consumption than originally expected.

On the external side, the 2022 forecast growth rates for exports and imports were both lowered by 0.3 pp compared to the rates indicated in the USP. Such changes are marginal and factor the new information which became available between the two forecast rounds. In turn the assumption for inventory changes in 2022 remained the same, namely that these do not contribute to growth in the outer forecast year.

When compared to the previous forecast round, developments in most deflators show slightly higher growth, mainly due to international cost pressures. However, in the case of private consumption and investment, the growth in the respective deflators remained broadly the same. In the case of government consumption and exports, there were small upward revisions. At the same time, there was a small increase in the growth rate for the imports deflator, and as a result, the expected growth in the GDP deflator between the two forecast rounds remained the same, at 2.1%.

The 2021 forecast for the HICP inflationary rate was lowered by 0.6 pp. The HICP takes into consideration a given basket of products, for which the actual data for the year suggested that prices were rising by less than originally anticipated. This factor is expected to be temporary, and for 2022 the HICP inflation rate, whilst still expected to remain below 2.0%, was raised slightly, due to the expectation of higher imported inflation. Still, the contained inflationary effect is compatible with the downward revision in energy taxes announced after the submission of the DBP.⁴³

The prospects for the labour market remained broadly similar across both rounds, with employment still expected to continue registering stable growth, albeit slower than in pre-pandemic years. Unemployment is also expected to remain low. In the DBP the unemployment rate for 2021 was reduced slightly compared to the USP, on the back of the resilient labour market developments and the extension of the wage support scheme till the end of the year, which is beyond what was originally planned. The outlook for growth in compensation per employee in 2021 was also raised from 1.2% in the USP to 3.9% in the DBP. This change was mainly driven by the new labour data which became available after the publication of the USP. However, the growth in compensation per employee in 2022 was kept the same, at 2.1%. The higher expected

⁴³ Refer to Chapter 5 in this Report for further details.

growth in total wages and salaries in the economy was mostly ascribed to higher employment.

4.3 Comparison with the forecasts produced by other institutions

Apart from the official forecasts, other detailed macroeconomic forecasts for the Maltese economy are published by the CBM, IMF and COM. The latest forecast vintages by these three institutions which were available by the Report's cut-off date (19 November 2021) were respectively published in August, September and November 2021.⁴⁴ Hence, the forecasts by the CBM and IMF incorporate the official GDP statistics up to the first quarter of 2021 (NSO News Release 097/2021), whereas the DBP and the COM's forecasts are based on the official GDP statistics up to the second quarter of 2021 (NSO News Release 156/2021).⁴⁵ Since the forecasts by the CBM and IMF were issued before the DBP, these factor information about the fiscal measures which were specified in the USP, but do not include any new measures specified in the DBP. On the other hand, since the COM's forecasts were published after the DBP, these are based on the same historical data and fiscal measures specified in the DBP and should thus be more comparable.

The available forecasts all point to a partial economic recovery in 2021 from the downturn experienced in 2020. Indeed, the estimated real GDP growth for 2021 by the three institutions is in line with the MFE's estimate, and within a range of 0.9pp. The DBP's 2021 real GDP growth forecast is slightly more conservative than the estimates by the IMF, COM or CBM. The main difference appears to relate to a slightly different view about the speed of economic recovery. The MFE's forecasts suggest a recovery which is slower in 2021, since the bulk of the recovery is prospected for 2022. This explains in large part why the MFE's real GDP growth forecast for 2022 is then slightly more optimistic than the rates indicated by the other institutions. However, even in this

⁴⁴ The forecasts by the CBM, IMF and COM are respectively available on: <https://www.centralbankmalta.org/site/Publications/Projections-2021-3.pdf?revcount=9573>; <https://www.imf.org/en/Publications/CR/Issues/2021/09/17/Malta-2021-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-465870>; and https://ec.europa.eu/economy_finance/forecasts/2021/autumn/ecfin_forecast_autumn_2021_mt_en.pdf.

⁴⁵ The NSO news releases are available on: https://nso.gov.mt/en/News_Releases/View_by_Unit/Unit_A1/National_Accounts/Pages/Gross-Domestic-Product.aspx.

case, the real GDP growth forecasts are all close, within an even narrower range, of 0.6pp.

All institutions anticipate a positive contribution to growth from domestic demand in 2021. There is also broad consensus that developments in net exports would contribute slightly negatively to growth in 2021, except for the IMF, which estimated a small positive contribution. In relation to 2022, all institutions anticipate that both domestic demand and net exports would contribute positively to growth, though with some variations in their relative strength. The common assumption for inventory changes is that this component would not exert any material impact on growth over the two years, except for the MFE's calculations. The latter allow for a small positive contribution in 2021, based on the developments recorded during the first half of the year.

The outlook for private consumption, characterised by partial recovery in 2021, is shared by all institutions. On the other hand, views about consumption growth differ with respect to 2022. Whereas the DBP and the IMF suggest that consumption growth would decelerate, the calculations by the COM and CBM point towards an acceleration. The CBM's consumption growth forecasts are the most optimistic since they embed full recovery to pre-pandemic levels by 2022. The difference in the forecast consumption growth pattern over the two years confirms the uncertainty relating to this variable. Such uncertainty can be ascribed to two main factors: the quantification of the possible upside push created by the pent-up demand; and the future households' behaviour in the aftermath of the huge shock created by the pandemic.

Even the forecast growth rates in gross fixed capital formation reflect an element of uncertainty. The most optimistic investment growth forecast for 2021 was produced by the CBM (+9.6%), whereas the IMF had the least optimistic estimate (+3.0%). The MFE's forecast (+5.0%) lies towards the middle of the range. This variation reflects the challenges to project this variable, in view of the volatility which was registered even in pre-pandemic years. While there is consensus that investment should rebound from the drop recorded in 2020, the possible magnitude remains uncertain. The volume of public investment, whose trajectory is discretionary, can also explain part of the divergences in the 2021 outlook. On the other hand, the anticipated growth in gross fixed capital formation in 2022 is shared by all, at slightly more than 8.0% in each case.

There are variations also in the case of government consumption. The DBP and the COM share the highest forecast growth for 2021, both estimating this at 9.6%, while on the other end, the CBM's forecast is at 5.7%. The outlook for 2022 shows even more divergence, as the three possible scenarios are presented: an expansion (DBP, COM); stability (CBM); and negative growth (IMF). This heterogeneity is the result of the strong element of discretionary spending in government consumption, about which forecasters rely heavily on assumptions, which may differ from those of the government.

On the other hand, a similar outlook is broadly shared for 2021 and 2022 in the case of export growth. For both years the forecast export growth rates are all somewhat stable, in the region of 5-6%. The dependence of Malta's exports on foreign demand, and the similar reputable sources used to estimate this proxy by the various institutions, could explain the similarity in the export growth outlook.

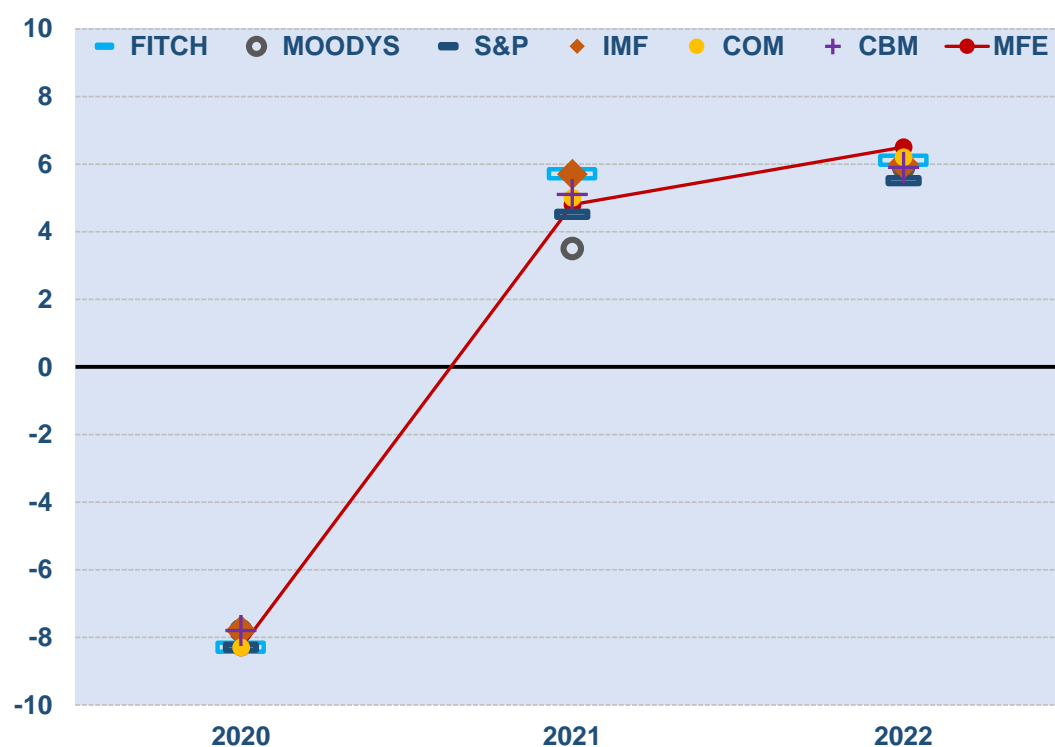
In the case of imports, the 2021 forecast growth rates range between 4.8% (IMF) and 7.0% (CBM), with the MFE's forecasts standing towards the middle (5.9%). As in the case of exports, the COM's 2021 forecast for import growth is identical to that indicated in the DBP. For 2022, three institutions (MFE, COM and CBM) indicated a growth rate slightly higher than 5.0%, while the IMF's forecast is less, at 3.8%. The slightly different forecast import dynamics can be ascribed to the different composition of GDP growth and the assumed import content of the GDP expenditure components.

The inflation outlook for Malta is similar across institutions. In 2021, the HICP inflation rate is expected to be low, with the COM's estimate being the highest, at 1.1%. All institutions predict a pick-up in inflation in 2022, which nevertheless is still anticipated to be less than 2.0%. In the case of the GDP deflator, the growth rate estimated by MFE, which is marginally higher than 2.0% each year, is slightly above the rates calculated by the other institutions.

In relation to employment, there is consensus about the ongoing resilience of Malta's labour market in 2021 and 2022. After having increased in 2020, employment is expected to continue rising in both years. The outlook by the COM and MFE is very similar, showing slightly more than 2.0% growth per annum. The estimates for 2021 by the IMF and CBM are slightly more cautious, with their growth forecast around 1.0%, but for 2022 even these institutions had produced employment growth forecasts which are similar to the MFE's estimates.

A further benchmark for the macroeconomic outlook presented by the MFE is provided by the forecasts prepared by the credit rating agencies. The real GDP growth rates by FITCH, Moody's and S&P are shown in [Chart 4.1](#). Their forecasts broadly replicate the trajectory for real GDP growth indicated in the DBP. The forecasts by the credit rating agencies available by the cut-off date thus corroborate the view of an economic recovery in 2021, which is however insufficient to make up for the economic downturn suffered in 2020. In turn, for 2022, there is consensus that the growth momentum in economic activity should accelerate further. The unanimous view about higher real GDP growth forecast in 2022, when compared to 2021, is based on the identical premise used by all institutions that the effects of the pandemic diminish in the outer forecast year, thereby allowing for the stronger rebound.

Chart 4.1 Real GDP growth forecasts by institution (%)



Sources: MFE, COM, CBM, IMF, S&P, Moody's, FITCH

4.4 Assessment

The information available to the MFAC by the cut-off date corroborates the MFE's more positive real GDP growth outlook for 2021 compared to the USP. It also supports the confirmed expectation that the real GDP growth for 2022 should be stronger than in 2021, as had been suggested in the USP. The broad similarity of the real GDP growth

forecasts by the COM, IMF, CBM, and the credit rating agencies to the MFE's estimates, adds to the latter's plausibility. The revisions carried out by the MFE across the two forecast rounds are plausible and broadly in line with the risk assessment carried out by the MFAC in relation to the USP.⁴⁶ At a component level, there are instances where deviations between the forecasts by the MFE and those by the COM, IMF and CBM are rather significant. This further suggests that the prospects remain rather uncertain and very much conditioned by the assumptions used. At the same time, it is acknowledged that the COM's macroeconomic forecasts for 2021 and 2022, which are based on the more similar information set as that used by the MFE, mirror rather closely the government's forecasts.

⁴⁶ In its assessment of the forecasts contained in the USP 2021 – 2024, the MFAC had identified an upside risk in relation to private consumption and government consumption, and a downside risk vis-à-vis gross fixed capital formation.

Chapter 5

Assessment of the fiscal forecasts 2021 – 2022

5.1 Fiscal outlook 2021 – 2022

In 2020, a fiscal deficit equivalent to 9.7% of GDP was recorded (see Table 5.1).⁴⁷ This ended the stream of fiscal surpluses which were achieved between 2016 and 2019. The large fiscal deficit recorded in 2020 was to a large extent driven by the significant negative shock experienced across numerous sectors of the economy as a result of COVID-19. In 2021, the pandemic is again expected to condition public finances significantly and the fiscal deficit is projected to remain high. The fiscal deficit is forecast to widen to 11.1% of GDP.

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

	Total Revenue	Total expenditure	Fiscal balance	Structural balance*	Gross debt
2019	36.4	35.9	0.5	-1.9	40.7
2020	36.2	45.9	-9.7	-6.6	53.4
2021	36.2	47.3	-11.1	-8.6	61.3
2022	37.0	42.6	-5.6	-4.5	61.8

* As percent of potential GDP

Source: MFE

The government's plan as indicated in the DBP is to start lowering the fiscal deficit as from 2022. This is in line with the government's commitment to aim towards fiscal sustainability when conditions permit. The fiscal deficit target for 2022 has been set at 5.6% of GDP. The attainment of this target is strongly based on the premise that both the public health and economic conditions in Malta gradually improve, in line with the assumption adopted in the DBP that the pandemic gets under control by the outer forecast year.

⁴⁷ The negative fiscal outturn in 2020 was in line with developments in other countries, with the euro area fiscal deficit estimated at 7.2% of GDP.

The forecast trajectory for the structural fiscal balance mirrors that for the headline fiscal balance.⁴⁸ The estimates point to some deterioration in the structural balance in 2021, but an improvement is expected in 2022. In both years, the forecast structural deficit is smaller than the headline fiscal deficit since part of the revenue shortfall is ascribed to the economy operating below potential.⁴⁹

Public debt increased significantly in 2020, due to the large fiscal deficit, rising by 22.0% (see Chart 5.1). In 2021, public debt is set to rise by a further 22.7%, as the large fiscal imbalance is expected to persist. As a result, the debt-to-GDP ratio is anticipated to exceed the 60.0% threshold specified in the SGP and FRA.⁵⁰ The public debt ratio in Malta is forecast to reach 61.3% in 2021, reversing most of the decline recorded before the pandemic. In 2022 the outstanding amount of public debt is expected to build up further. However, the government's aim is to stabilise the ratio of public debt to nominal GDP in 2022, through a smaller fiscal deficit and faster growth in nominal GDP.

The expenditure-to-GDP ratio rose rapidly in 2020, by 10.0 pp, to 45.9% (see Chart 5.2). This reflected the simultaneous contraction in nominal GDP (denominator) and the additional spending induced by the pandemic, not only on health, but also to support the economy and jobs. The expenditure ratio is expected to rise further in 2021, to 47.3%, as the planned expenditure growth for the year is expected to outpace the rate of recovery in nominal GDP. However, in 2022 the government's aim is to scale the expenditure ratio back to 42.6%, as most of the pandemic-induced outlays are assumed not to be repeated.⁵¹

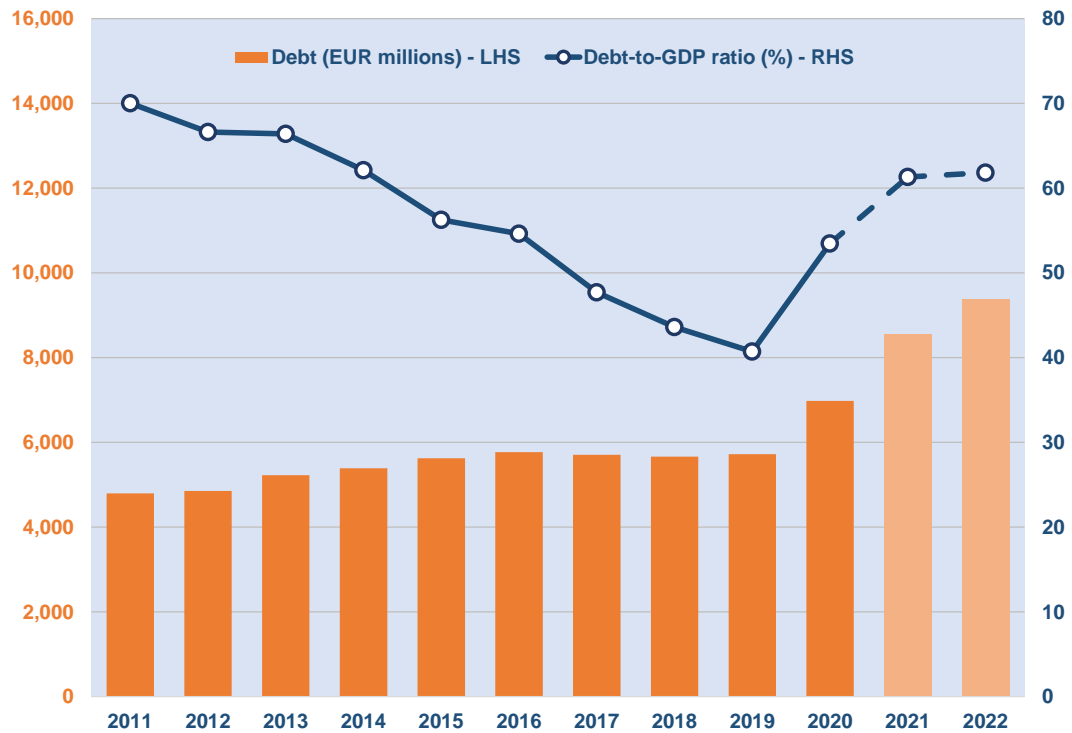
⁴⁸ The structural balance adjusts the headline fiscal balance by removing the cyclical effects and one-off and temporary measures. It is expressed as a percentage of potential output.

⁴⁹ When the economy operates below potential (with a negative output gap), the tax bases contract compared to when the economy is operating at, or above, potential. In Malta, the output gap turned negative in 2020 because of the pandemic. The output gap is expected to gradually narrow but remain negative in both 2021 and 2022. For further details refer to Chapter 3 in this Report.

⁵⁰ The suspension of the fiscal rules in the EU (including Malta), because of the activation of the escape clause, allow countries to have a public debt ratio above the threshold.

⁵¹ The DBP contains statements such as "most of the fiscal support measures supporting the economy during the Pandemic will expire as planned" (page 4); "The general Government expenditure is estimated to decline in 2022, as the temporary support is expected to be phased out, in line with the Government's commitment to contain expenditure as the public health situation improves and the economy recovers" (page 25).

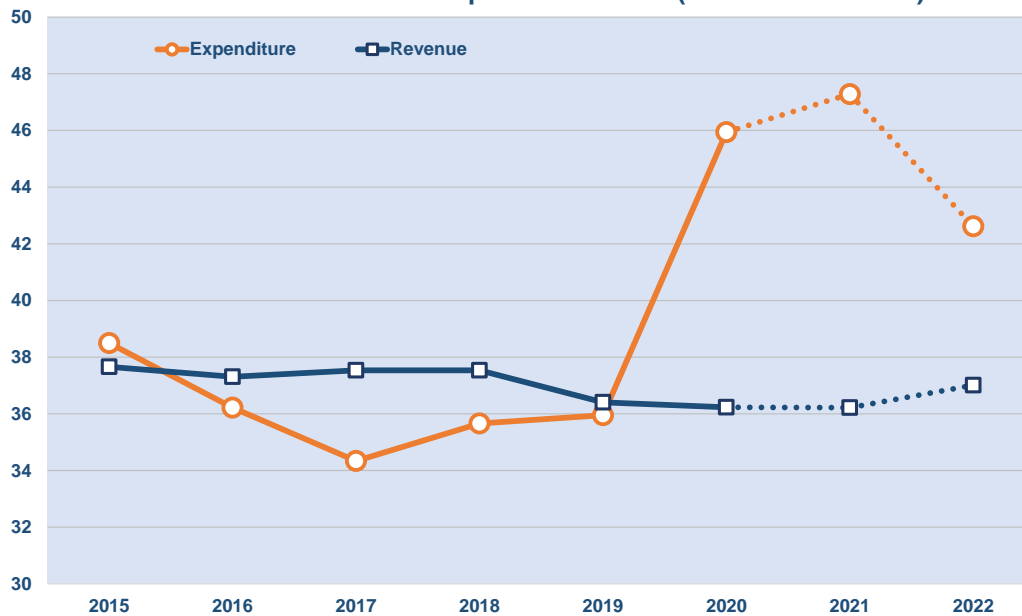
Chart 5.1: Public debt (% of nominal GDP)



Note: Figures for 2021 – 2022 are forecasts produced by MFE.

Source: Eurostat, MFE

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



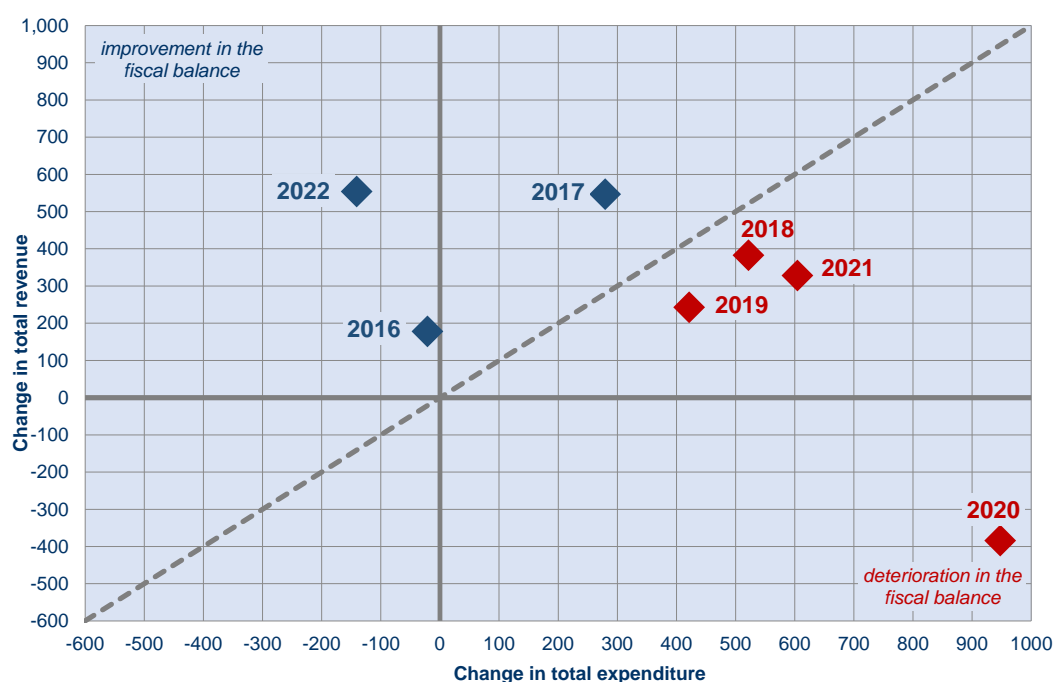
Note: Figures for 2021 – 2022 are forecasts produced by MFE.

Source: Eurostat, MFE

The forecast trajectory for the revenue-to-GDP ratio differs from that for expenditure. The forecast revenue ratio broadly extends the stable pattern which has been recorded in previous years. The revenue ratio is expected to hover between 36.0% and 37.0% in 2021 and 2022. Contrary to what happened in the case of expenditure, the revenue ratio did not change much in 2020. Indeed, the drop in revenue (numerator) and the drop in nominal GDP (denominator) which were recorded in 2020 broadly compensated for each other.

The deterioration in public finances in 2020 was driven by a large increase in expenditure and a concurrent drop in revenue (see Chart 5.3). The increase in expenditure was much larger than in previous years, while the drop in revenue contrasts with the increases achieved before the pandemic. The fiscal balance was in surplus in 2018 and 2019, but some deterioration had already started taking place during these two years, as expenditure increases outpaced the additional revenue. Indeed, the fiscal surplus peaked in 2017, at €382.8 million, but then the surplus declined to €243.4 million in 2018, and to €64.3 million in 2019.

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



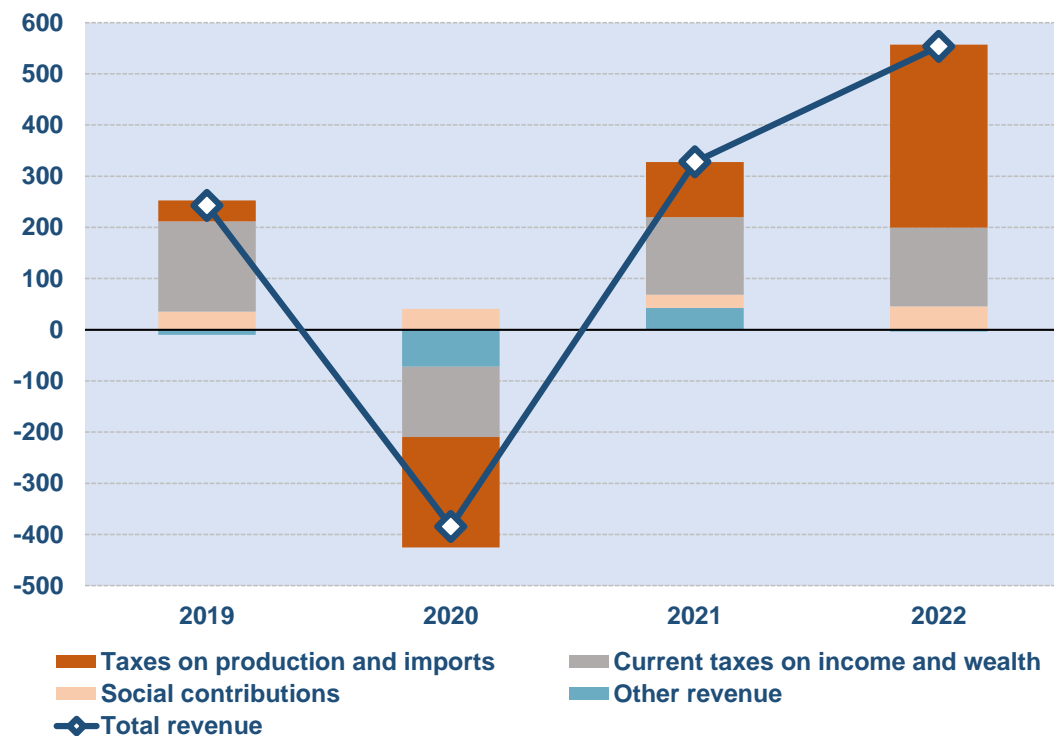
Note: Anywhere above the dashed line (blue diamonds) indicates combinations of revenue and expenditure developments leading to an improvement in the fiscal balance, whereas anywhere below the dashed line (red diamonds) indicates combinations which lead to a deterioration in the fiscal balance. Anywhere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

Source: MFE

In 2021 revenue is expected to be higher than in 2020. However, this change still falls short of the planned expenditure increase for the year, resulting in a wider fiscal deficit. On the other hand, in 2022 a large fiscal correction is planned. Approximately two-thirds of the envisaged reduction in the fiscal deficit reflects the anticipation of higher revenue, while the other one-third is due to the downsizing of the expenditure budget compared to 2021.

The drop in revenue in 2020 was broad based, as most components were impacted, except for social contributions (see Chart 5.4).⁵² A reversal in revenue is expected in 2021, as all components are set to rise. In absolute terms, current taxes on income and wealth are expected to rebound most in 2021. In 2022, the targeted absolute increase in revenue is larger than a year earlier, with the bulk of the projected change attributed to higher revenue from taxes on production and imports.

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



Source: MFE

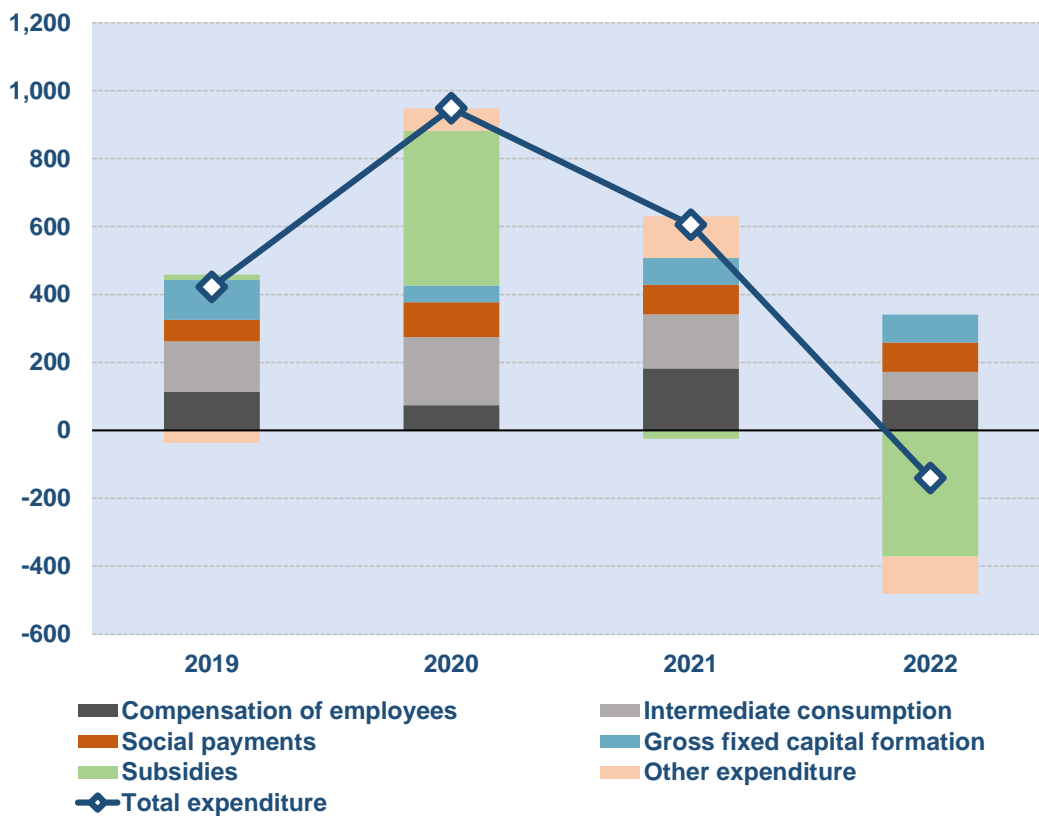
Throughout the forecast horizon, social contributions are expected to rise by similar amounts. The relatively stable dynamics for social contributions contrasts with the volatility in the other revenue components. This is because the tax base for social

⁵² Other revenue comprises capital taxes, property income and 'other' revenue.

contributions was only marginally impacted by the pandemic. This reflects the resilience of Malta's labour market as well as the fact that social contributions were automatically deducted from the wage support which was offered by the government at the start of the pandemic.

The increase in public expenditure in 2020 was mainly in the form of subsidies (see Chart 5.5). Indeed, subsidies accounted for around half of the total yearly change in expenditure. This component includes the outlays associated with the wage supplement scheme offered by the government.⁵³ Overall, the changes in the remaining expenditure items were more in line with those recorded in 2019.⁵⁴

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



Source: MFE

⁵³ 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>.

⁵⁴ Other expenditure comprises interest expenditure, capital transfers payable and 'other' expenditure.

In 2021 subsidies are expected to remain elevated (more than three times the amount in 2019), declining only marginally on a year earlier. Hence developments in subsidies do not shape the expected changes in expenditure for 2021. The planned change in total spending in 2021 is spread across the remaining components. The larger budgets for compensation of employees and intermediate consumption absorb most of the planned expenditure rise for 2021.

On the other hand, the planned reduction in total expenditure in 2022 mostly reflects the lower budget for subsidies, based on the planned phasing out of the wage support scheme. Even the funds allocated for 'other' expenditure is less due to a base effect created by a one-off payment in 2021. These reductions outweigh the expansion in the budgets for the rest of the expenditure components. The funds allocated for intermediate consumption are rising by smaller amounts than in previous years, due to base effect created by pandemic-induced activities which are not expected to be repeated in 2022.

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 DBP.

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 forecast trajectory for each variable, with a focus on the consistency with the macroeconomic scenario as presented in the DBP, and the estimated magnitude of any fiscal measures, or known factors, which are relevant over the period 2021 and 2022.

An important measure implemented by the government at the beginning of the pandemic related to tax deferrals. The concession was applicable to the three main tax sources: taxes on production and imports; current taxes on income and wealth; and social contributions. MFE calculated the amount of taxes which were deferred because of this concession using information available at the respective departments.

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

	Actual		Forecasts	
	2019	2020	2021	2022
Total revenue	5,114.3	4,729.9	5,057.7	5,611.3
Taxes on production and imports	1,613.0	1,397.0	1,505.0	1,862.3
Current taxes on income and wealth	1,827.0	1,689.8	1,841.3	1,995.5
Social contributions	800.1	841.1	866.7	912.2
Capital taxes*	26.1	22.6	18.6	25.8
Property income*	81.2	86.3	80.2	71.0
Other revenue*	767.0	693.1	745.9	744.5
Total expenditure	5,050.0	5,997.8	6,602.7	6,462.0
Compensation of employees	1,509.5	1,583.9	1,766.4	1,855.7
Intermediate consumption	979.6	1,180.1	1,338.9	1,421.6
Social payments	1,244.9	1,347.1	1,434.3	1,521.3
Gross fixed capital formation	533.6	582.1	660.7	742.4
Subsidies	195.1	651.2	626.2	254.8
Interest expenditure**	183.7	170.7	160.2	166.1
Capital transfers payable**	110.4	147.0	167.5	162.1
Other expenditure**	293.3	335.8	448.5	338.0
Fiscal balance	64.3	-1,267.9	-1,545.0	-850.7
Gross debt	5,718.5	6,977.5	8,562.4	9,373.7
Nominal GDP	14,047.6	13,054.9	13,964.1	15,162.7

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

The estimated amount of tax deferrals for each revenue component was imputed for the respective year. Hence the impact of tax deferrals on revenue (in ESA terms) was very small, limited to the provisions for unrecoverable deferred taxes. The total provisions for unrecoverable taxes (covering direct taxes, indirect taxes, and social contributions) were calculated by MFE at €7.8 million for 2020, and €7.0 million for 2021. These amounts represent a marginal amount compared to the yearly intake from the three sources. The inclusion of such adjustment changes the previous assumption used in the USP that all deferred taxes would be settled in full by the stipulated time.

5.2.1 Taxes on production and imports

In 2021, taxes on production and imports are expected to increase by €108.0 million, corresponding to 7.7% growth over 2020 (see Table 5.3). This increase represents half of the previous' year revenue shortfall from this source. However, in 2022 indirect taxes are envisaged to rise strongly, by €357.3 million, equivalent to 23.7% growth on a year earlier. The materialisation of this scenario would place the ratio of indirect taxes to nominal GDP at 12.3% in 2022, which is above that recorded since 2016 (see Chart 5.6). This change is backloaded to the expected developments in 2022.

Table 5.3: Taxes on production and imports

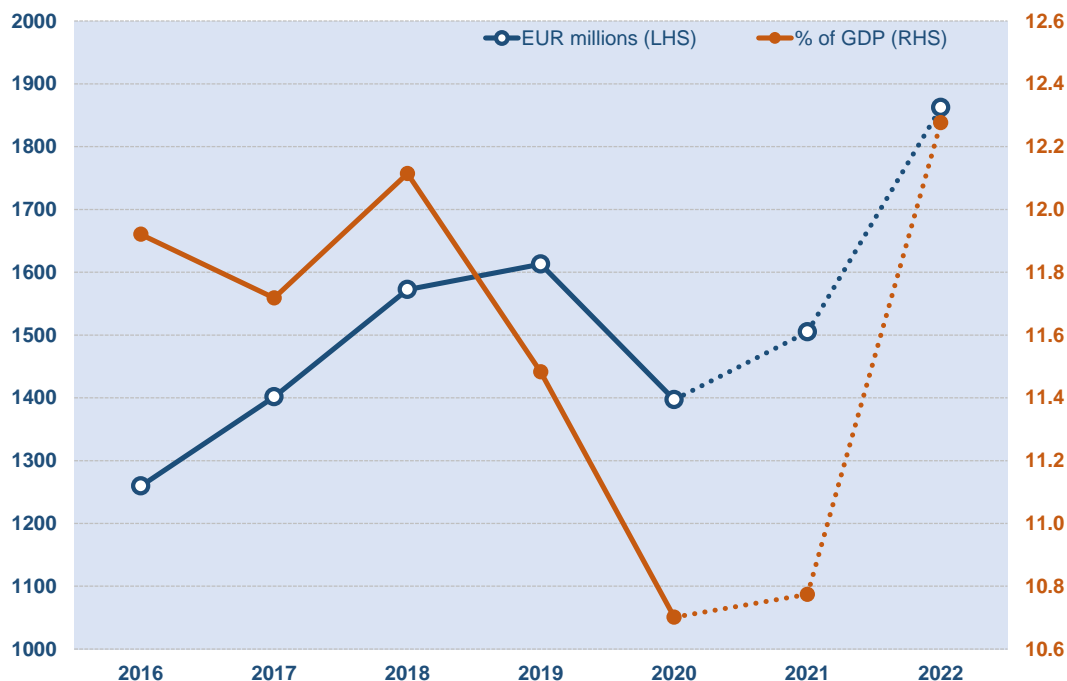
	Taxes on production and imports		Growth in private consumption		Growth in tourism exports
	Growth (%)	Change (EUR millions)	Nominal (%)	Real (%)	Nominal (%)
2018	12.2	171.0	9.7	8.8	3.0
2019	2.6	40.6	6.6	4.6	7.9
2020	-13.4	-216.0	-8.9	-10.0	-78.5
2021	7.7	108.0	5.7	4.3	23.3
2022	23.7	357.3	5.7	4.0	196.8

Source: MFE

The anticipated partial recovery in indirect tax revenue in 2021 is supported by the magnitude of the forecast pick-up in consumption, which is also expected to be partial. Still the growth in indirect taxes is expected to outpace the developments in consumption, which is forecast to rise by 5.7% in nominal terms and by 4.3% in real

terms.⁵⁵ In absolute terms, around half of the expected rise in indirect taxes in 2021 reflects an estimated lower budgetary cost of property-related tax concessions, together with the phasing out of temporary concessions on fuel taxes and commercial licenses, which had been launched at the beginning of the pandemic.

Chart 5.6: Taxes on production and imports



Source: MFE

Even for 2022, part of the expected rise reflects the lower estimated budgetary cost of property-related tax concessions. Over the years, the application of a temporary reduced indirect tax rate on a subset of property transactions has been implemented through various initiatives. The budgetary impact estimated by MFE can vary from one year to the other due to the size of the concessions and the eligibility criteria.⁵⁶ Consistent with the approach used by MFE in previous forecast rounds, the calculations build on the premise that measures do not extend beyond their announced date of expiry and these are not replaced. An additional €10.0 million indirect tax revenue for 2022 is derived from the assumed improvement in tax efficiency as a result of an upward revision in the interest rates and penalties applicable for non-payment.

⁵⁵ 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.

⁵⁶ 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 also vary from one year to the next.

The target increases in indirect taxes in 2021 and 2022 are higher than the forecast expansion in private consumption (both in nominal and in real terms). Such pattern (faster growth in indirect taxes than the proxy consumption tax base) is the result of the expected large changes in tourism spending over these years. Tourism spending also forms part of the indirect tax base, and after the substantial drop in inbound tourism recorded in 2020, tourism expenditure is assumed to advance at double-digit growth rates over the forecast horizon. The expected very strong improvement in tourism, which is generally a tax-rich source, underpins the substantial boost to indirect taxes envisaged for 2022.

5.2.2 Current taxes on income and wealth

Current taxes on income and wealth are expected to increase by €151.4 million, or 9.0%, in 2021 (see Table 5.4). Direct taxes are anticipated to proceed at a broadly similar pace in 2022, up by €154.2 million or 8.4%. Both personal and corporate income taxes are expected to contribute to the recovery in direct taxes over the forecast horizon. This is consistent with the expected increases in compensation of employees and gross operating surplus.⁵⁷ If achieved, the forecast developments for direct taxes would lift the ratio of direct taxes to nominal GDP to above that recorded pre-pandemic but broadly in line with the ratio attained in 2016 and 2017 (see Chart 5.7).

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	7.7
2019	10.7	176.6	9.2	8.7
2020	-7.5	-137.2	2.1	-6.7
2021	9.0	151.4	6.4	5.4
2022	8.4	154.2	4.3	4.0

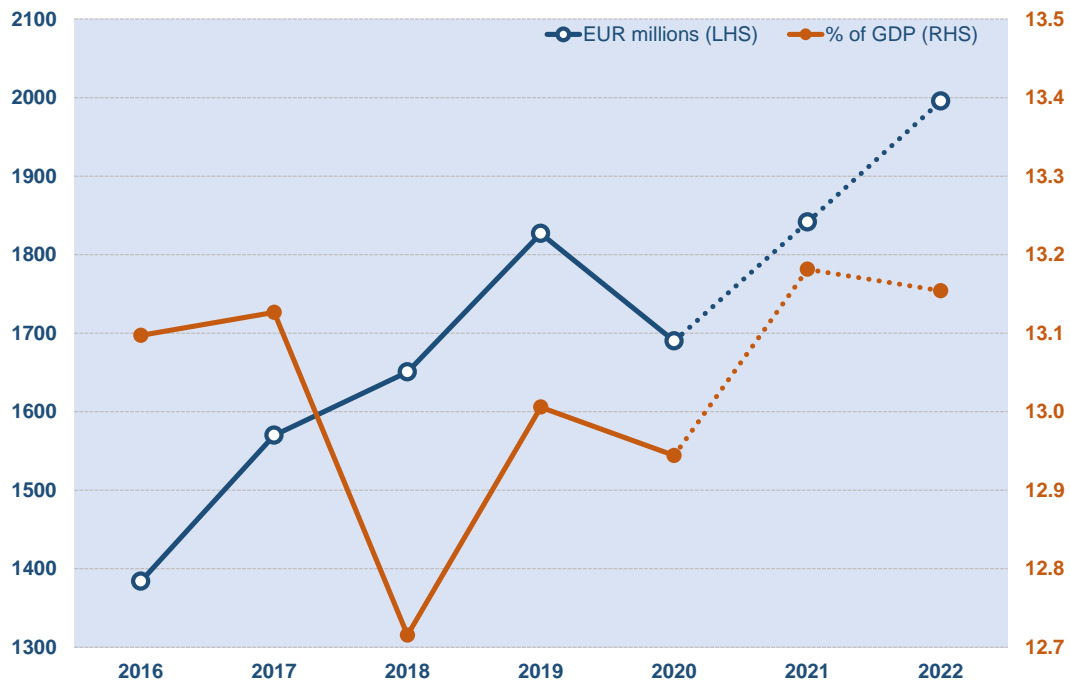
Source: MFE

The budgetary cost of various direct tax measures over the forecast horizon plays a limited role in the overall dynamics, as the effects tend to compensate for each other.

⁵⁷ Compensation of employees and gross operating surplus are the two most relevant proxy tax bases for direct taxes. In Malta, personal income tax and corporate income tax broadly account for half of direct taxes each.

For 2022, the positive effect created by the expiry of temporary revenue measures (mostly related to the expiry of the concession on capital gains on property taxes) is broadly offset by the introduction of other permanent revenue measures (namely further tax rebates for pensioners and a reduction in the overtime and part-time tax rates).

Chart 5.7: Current taxes on income and wealth



Source: MFE

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 the 7.5% drop in direct taxes in 2020.⁵⁸ Even in 2022, current taxes on income and wealth are envisaged to outpace the growth rates for compensation of employees and gross operating surplus. This builds on the progressive nature of the income tax system (resulting in an elasticity with respect to personal income higher than unity), as well as good prospects for corporate income taxes. An additional €10.0 million direct tax revenue for 2022 factors an envisaged improvement in tax efficiency

⁵⁸ 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.

as estimated by MFE. To increase tax compliance and widen the tax base, the applicable interest rates, and penalties due on unsettled tax balances were revised.

5.2.3 Social contributions

The 2021 forecast growth in social contributions, at 3.1%, is lower than the momentum recorded by this revenue source in recent years (see Table 5.5). When the pandemic hit, social contributions still increased, in sharp contrast to what 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.⁵⁹ The slower forecast growth in social contributions in 2021 allows for a possible deceleration due to the base effect created in 2020 when the government support could have resulted in the regularisation of certain jobs which previously were not registered.⁶⁰

Table 5.5: Social contributions

	Growth (%)	Change (EUR millions)	Compensation of employees (%)
2018	8.8	61.9	9.3
2019	4.6	35.3	9.2
2020	5.1	41.0	2.1
2021	3.1	25.7	6.4
2022	5.2	45.5	4.3

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 progressively, to 6.0% by 2022 (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).⁶¹ The forecast trajectory for social contributions is entirely driven by the developments in the tax base and the statutory increase in the payment

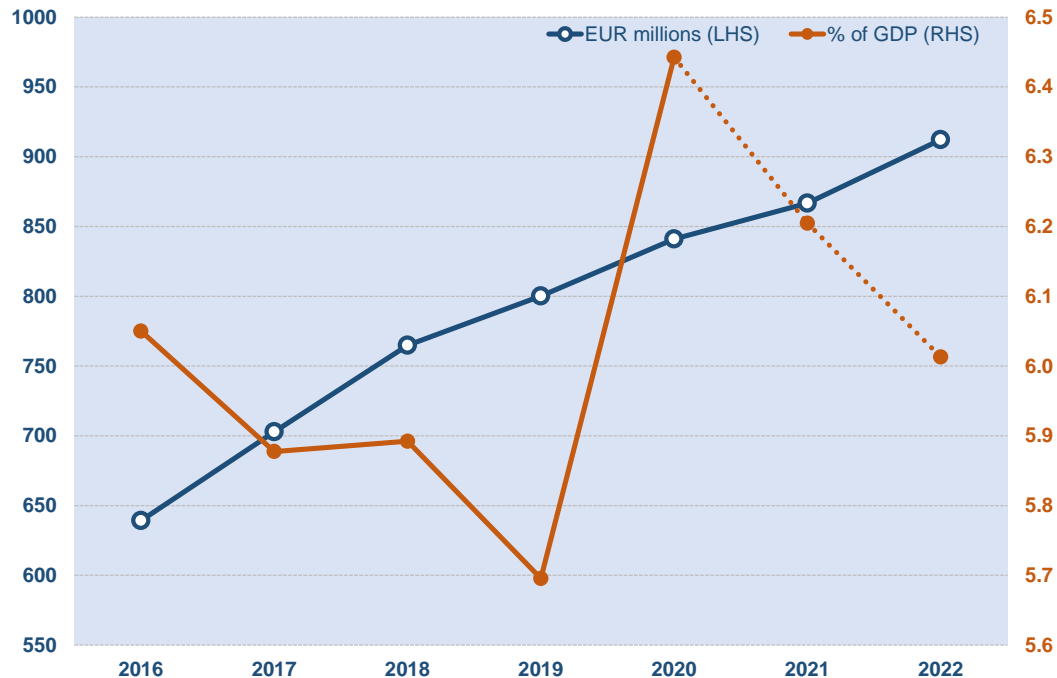
⁵⁹ This created an equivalent impact on the revenue and expenditure side of the budget.

⁶⁰ In order to be eligible for the wage support scheme offered by Malta Enterprise, persons needed to be registered with Jobsplus.

⁶¹ 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.

ceiling, as no additional policy changes or measures are being factored in the baseline scenario.⁶²

Chart 5.8: Social contributions



Source: MFE

In 2022, 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 contributions paid by the self-employed (whose activities are proxied by developments in gross operating surplus).⁶³

5.2.4 Other revenue components

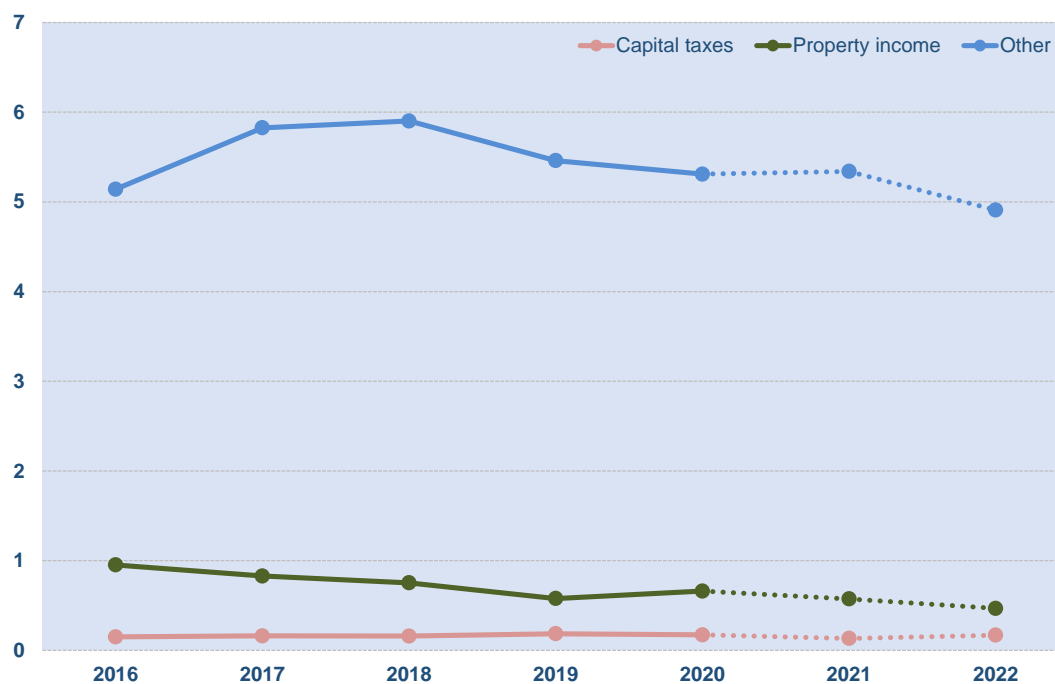
Taxes on production and imports, current taxes on income and wealth, and social contributions together account for the bulk of total revenue. In 2020, their combined share made up 83.0% of total revenue. Throughout the forecast horizon this share is expected to hover around this percentage. The remaining revenue components consist

⁶² The impact of tax deferrals is negligible in this case.

⁶³ The cap means that once the maximum annual amount payable has been reached, additional income does not lead to more social security payments.

of capital taxes, property income and 'other revenue'. The latter includes revenues from very different sources, such as the EU funds and the proceeds from the Individual Investor Programme (IIP) and the new residency programme which replaced it towards the end of 2020.⁶⁴ The forecast trajectories for the revenue components as a percentage of nominal GDP are shown in Chart 5.9.

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



Source: MFE

In 2021 and 2022 property income and capital taxes are assumed to maintain their ratios to nominal GDP stable and low, below 1.0% in both cases. The expected developments in these items thus exert a limited influence on the overall fiscal scenario. The expected fluctuations in the revenue from the various miscellaneous components exert a bigger impact. In 2021, the combined amount from the remaining miscellaneous sources (depicted as other in Chart 5.9) is set to rise by €52.8 million on a year earlier. The bulk of this change reflects higher inflows associated with EU funds. In 2022 other revenue is expected to remain broadly stable in absolute terms. This is the result of the higher amount planned to be used from the RRF, which compensates for the reduction in the target for proceeds derived from residency

⁶⁴ 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>.

schemes. This stability in the absolute amount expected from such miscellaneous sources compared to the expansion projected in nominal GDP explains the projected drop in the ratio to nominal GDP in 2022.

5.3 Assessment of the expenditure projections

The forecasts for the different expenditure components are analysed separately in the section below. The assessment consists in a review of the projected trajectory for each variable and the estimated magnitude of the fiscal measures or known factors applicable for 2021 and 2022. The outlook for certain expenditure categories remains very sensitive to the assumptions about the progress of the pandemic and the associated size and duration of pandemic-induced expenditures. Another determining factor is the planned timeframe 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 11.5% in 2021, which is higher than the growth rate recorded in previous years (see Table 5.6). In 2020, recruitment within the public sector was slower than originally envisaged, because of the constraints created by the restrictive measures adopted to contain the spread of the pandemic. The upward push in the public sector wage bill was delayed to 2021, when the recruitment process regained momentum. This factor, together with the payment of certain arrears, explains the stronger growth in compensation of employees anticipated in 2021.

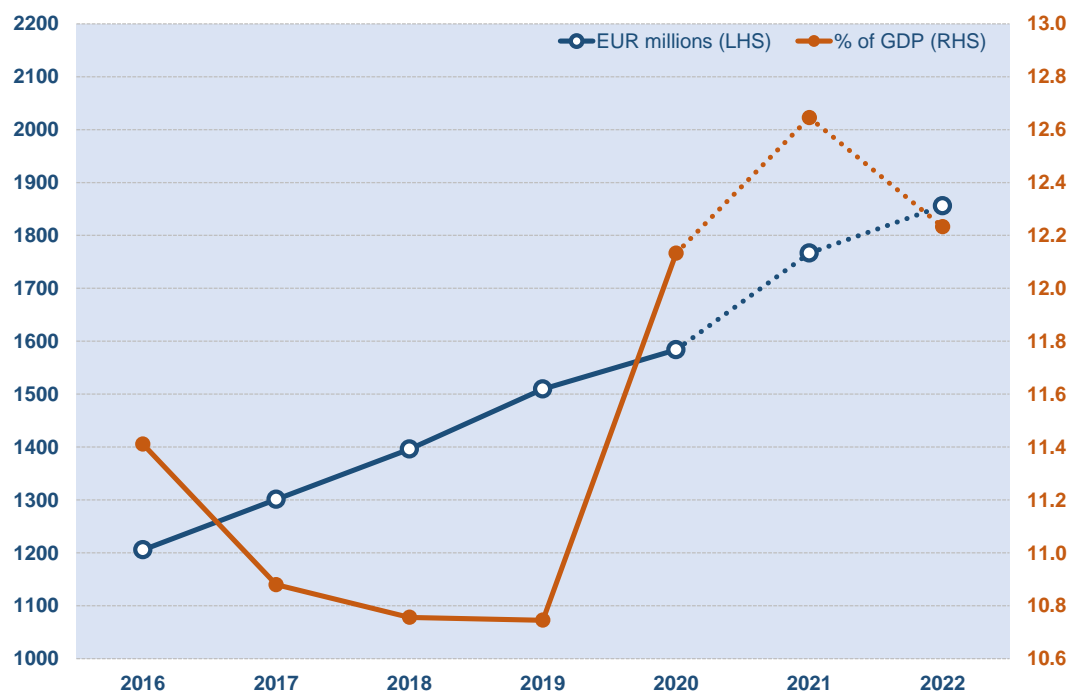
Table 5.6: Compensation of employees

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2018	7.3	95.0
2019	8.1	113.4
2020	4.9	74.4
2021	11.5	182.5
2022	5.1	89.2

Source: MFE

The base effect created by the strong growth in 2021 paves the way for the anticipated slower growth in the public sector wage bill in 2022. The yearly expansion in the budget allocation for wages is thus contained to 5.1%, which is less than in pre-pandemic years. Hence the ratio of government compensation of employees to nominal GDP is projected to stand at 12.2% in 2022, which is below that expected for 2021, but above that recorded in pre-pandemic years (see Chart 5.10).

Chart 5.10: Compensation of employees



Source: MFE

The public sector wage bill is driven by the number of 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 plans put forward by the ministries and government departments. 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).⁶⁵ The latter may be covered by

⁶⁵ 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 in Malta.

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

5.3.2 Intermediate consumption

In 2021, intermediate consumption is expected to rise by €158.8 million or 13.5% (see Table 5.7 and Chart 5.11). Despite the elevated growth rate, this represents a deceleration on a year earlier. This is due to the base effect created by the strong growth registered in 2020 due to the pandemic. The budget for intermediate consumption accounts for the expected reduction in the outlays related to the pandemic, in line with the expected improvement in the health situation.⁶⁶ The budgetary cost of the additional intermediate consumption required to contain the spread of the pandemic and to care for COVID-19 patients is estimated to decline evenly over the period 2021 and 2022, thereby generating savings over the forecast period.

Table 5.7: Intermediate consumption

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2018	16.1	115.5
2019	17.9	148.7
2020	20.5	200.6
2021	13.5	158.8
2022	6.2	82.7

Source: MFE

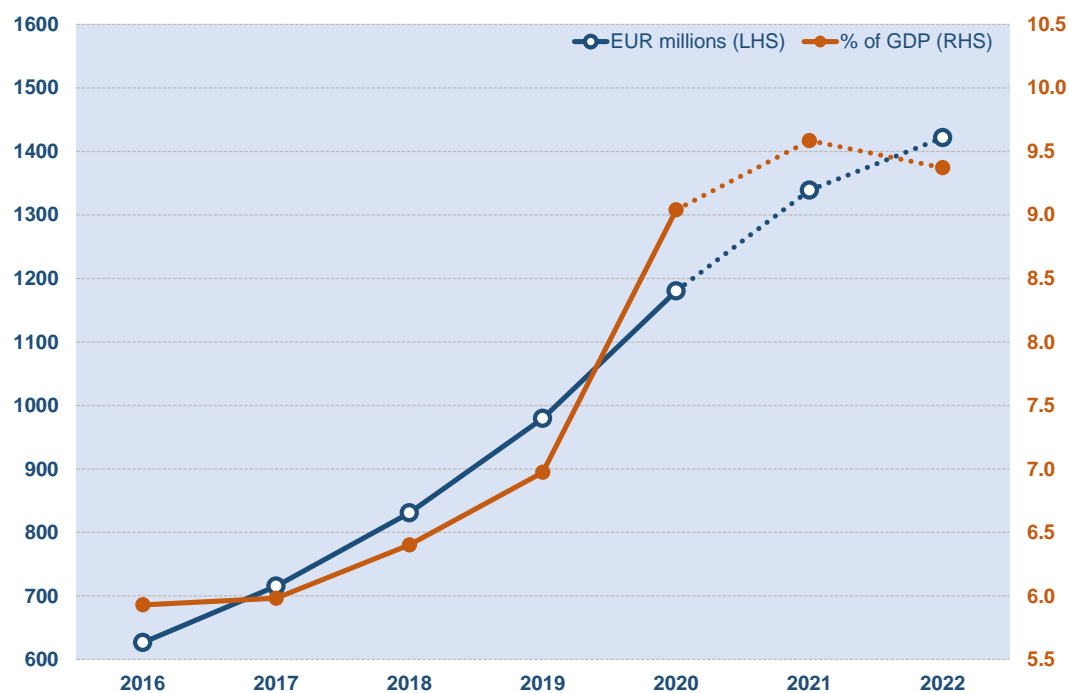
The non-repetition of COVID-19 related expenditures explains the further deceleration in growth, to 6.2% in the budget on intermediate consumption in 2022. It is acknowledged that this component tends to be volatile over time particularly as it has a rather strong discretionary element. However, it may be challenging to remain within budget in the outer forecast year as intermediate consumption grew rapidly even in pre-pandemic years.⁶⁷ Over time, initiatives which involved new spending have tended

⁶⁶ Items which are classified as intermediate consumption include outsourced health services and medical supplies.

⁶⁷ The budgeted expenditure amounts specified in the DBP sometimes act as an envelope on expenditure without the full granular specification, thereby creating instances when certain amounts are initially categorised under one heading (using historic ratios), but ex-post are

to be replaced by other initiatives when the former were no longer in place. This practice effectively makes it more difficult for intermediate consumption to depart from previous trends, unless driven by specific cost savings.

Chart 5.11: Intermediate consumption



Source: MFE

5.3.3 Social payments

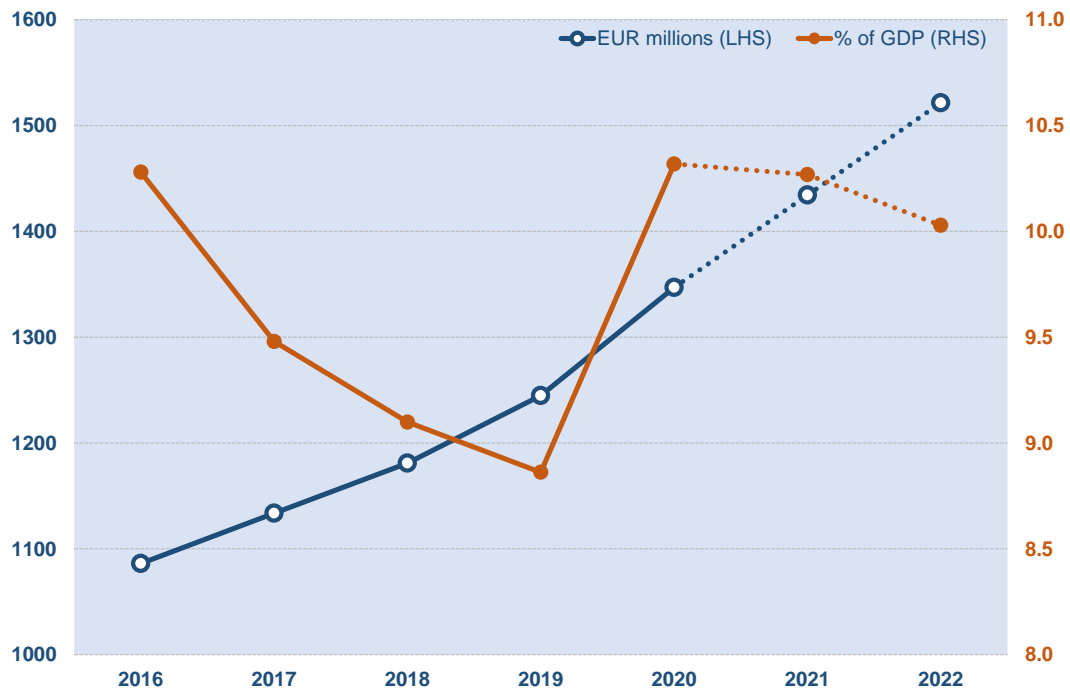
The downward trend in the ratio of social payments to nominal GDP was reversed in 2020 (see Chart 5.12). This reflected both the stronger growth in social payments (numerator), due to the launch of further assistance measures, as well as the contraction in nominal GDP (denominator). In 2020, social payments rose by 8.2%, equivalent to an additional €102.2 million (see Table 5.8).

The planned rise in social payments in 2021 and 2022 is around €87.0 million each year. The declining budgetary costs for the pandemic-related social assistance in 2021, and the plan not to repeat such outlays in 2022, dampens the overall expansion in social payments over the forecast horizon. This effect is offset by an upward push

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.

created by the announcement of new social initiatives for 2022 which target primarily pensioners, as well as the decision to offer free public transport to all Maltese citizens starting from October 2022. The social expenditure forecasts build on the MFE's 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.

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	5.4	63.8
2020	8.2	102.2
2021	6.5	87.2
2022	6.1	87.0

Source: MFE

5.3.4 Gross fixed capital formation

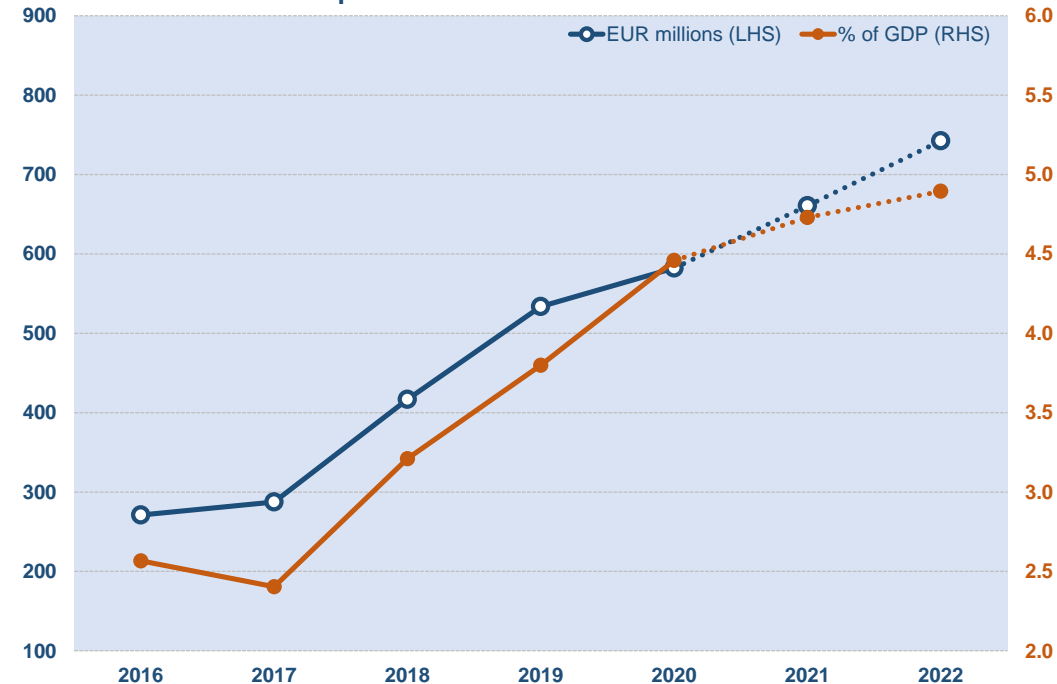
The planned spending on gross fixed capital formation rises in the region of €80.0 million per annum over the forecast horizon, which corresponds to an annual growth rate of around 13.0% (see Table 5.9 and Chart 5.13). This quasi-linear expansion in planned investment contrasts somewhat with the volatility experienced by this budget component in previous years.⁶⁸

Table 5.9: Gross fixed capital formation

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2018	45.0	129.2
2019	28.1	116.9
2020	9.1	48.5
2021	13.5	78.6
2022	12.4	81.7

Source: MFE

Chart 5.13: Gross fixed capital formation



Source: MFE

⁶⁸ The stable pattern may also partly reflect the approximations and rules of thumb used by MFE to allocate certain expenditure into the various ESA categories over the forecast period.

In 2020 the pandemic limited government investment, which increased less vigorously than in 2018 and 2019. In 2021, the budget allocation anticipates public gross fixed capital formation to regain momentum. An equivalent of 0.1% of GDP in RRF funds is assumed to be used in 2021, while 0.5% of GDP is factored for 2022.

The planned investment spending in 2021 and 2022 is the highest on record, both in absolute terms, and as percent of nominal GDP. The ratio of public investment to GDP is thus expected to converge towards 5.0% over the forecast horizon. This is an ambitious plan, but it is in line with the steady progress recorded since 2017. The caveat remains that it is hard to assess the feasibility of such an ambitious investment programme since the DBP does not map the specific projects to which such budgeted funds relate.⁶⁹

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 78.2% of total expenditure in 2020. 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.

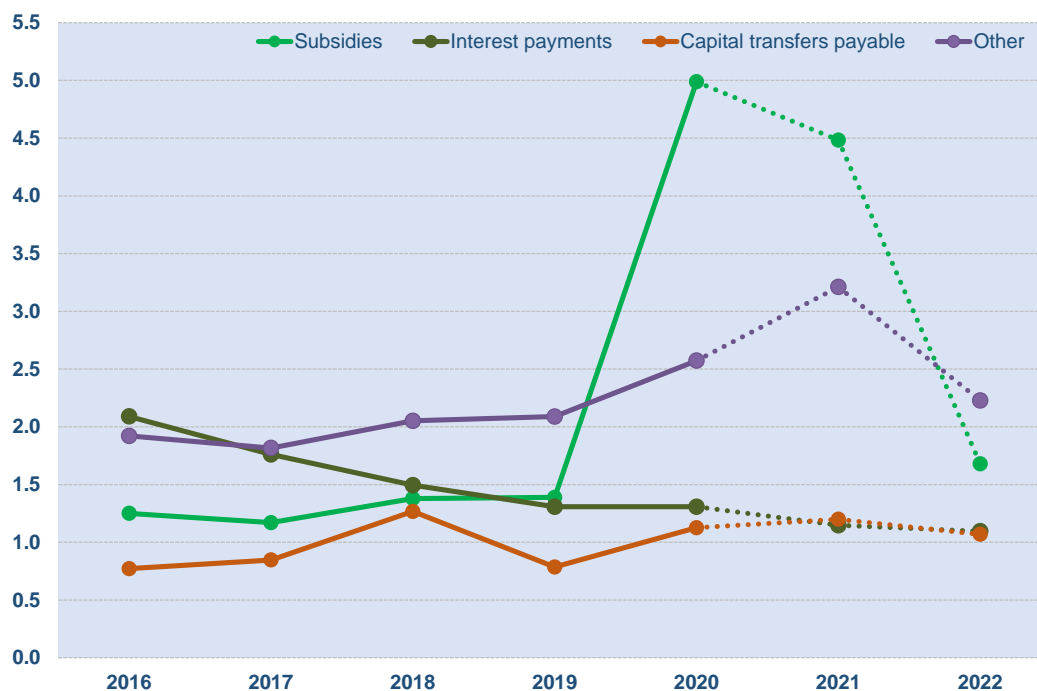
Among these miscellaneous components, subsidies experienced the largest change in 2020. This mainly reflected the assistance provided by the government to support employment through various initiatives.⁷⁰ As a result, subsidies accounted for an equivalent of 5.0% of GDP in 2020, compared to an average of 1.3% between 2016 and 2019. The budget allocation for subsidies in 2021 was maintained almost unchanged, at around 96% of the level in 2020. On the other hand, in 2022, subsidies are expected to be more than halved on a year earlier. These calculations build on the

⁶⁹ The information on capital expenditure reproduced in the Draft Financial Estimates which accompany the Budget Speech is compiled using a methodology which differs from the ESA, thereby limiting its use in the assessment of the ESA forecasts. No granular information on the forecast government investment in ESA terms is produced.

⁷⁰ 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.

premise that the wage support scheme does not remain in place in 2022. The budget for subsidies was nevertheless maintained slightly above the pre-pandemic years, both in absolute terms and as percentage of nominal GDP.

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



Source: MFE

In 2021, spending on interest payments is expected to be €10.5 million less than in 2020, dropping for the seventh consecutive year. However, in 2022 interest payments are forecast to rise marginally, due to the new debt which was accumulated to finance the pandemic mitigation measures.⁷¹ 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, and in some cases even negative, interest rates. In 2021, the very low interest rate environment is expected to more than compensate for the additional costs created by the anticipated higher outstanding public debt. However, the strong accumulation of public debt generated in 2020 and 2021 is expected to create an upward effect on interest payments starting

⁷¹ The DBP assumes that there will not be any recourse to RRF loans as only the grants were applied for.

from 2022. The increase is however contained since the implicit interest rate on public debt is estimated to drop from 3.0% in 2020, to 2.3% in 2021, and to 1.9% in 2022.

Throughout the forecast horizon capital transfers are expected to be slightly higher than in 2020. Nevertheless, the budget allocation for this component has been revised downwards since April 2021 mainly on account of updated budgeted financial assistance to the national airline, as part of a proposed five-year plan.⁷² The updated profile for capital transfers broadly assumes a stable ratio to GDP, with the yearly changes being influenced by the assumed utilisation of EU funds which are transferred to certain entities.

The budget for 'other expenditure' has been temporarily raised by €112.7 million in 2021 compared to a year earlier partly because of an exceptional payment related to the EU's Own Resources. In 2022 there is no such effect and other expenditure is thus expected to decline by €110.5 million. The ratio of other expenditure to GDP is thus expected to revert to slightly above 2.0% in 2022, 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 resulted in a substantial drop in various revenue streams and drove public expenditure up. Though attenuating, the adverse impact on public finances is expected to be prolonged. The prospects for the budget components compared to the situation which prevailed in 2019 (pre-pandemic) are depicted in [Chart 5.15](#) and [Chart 5.16](#).

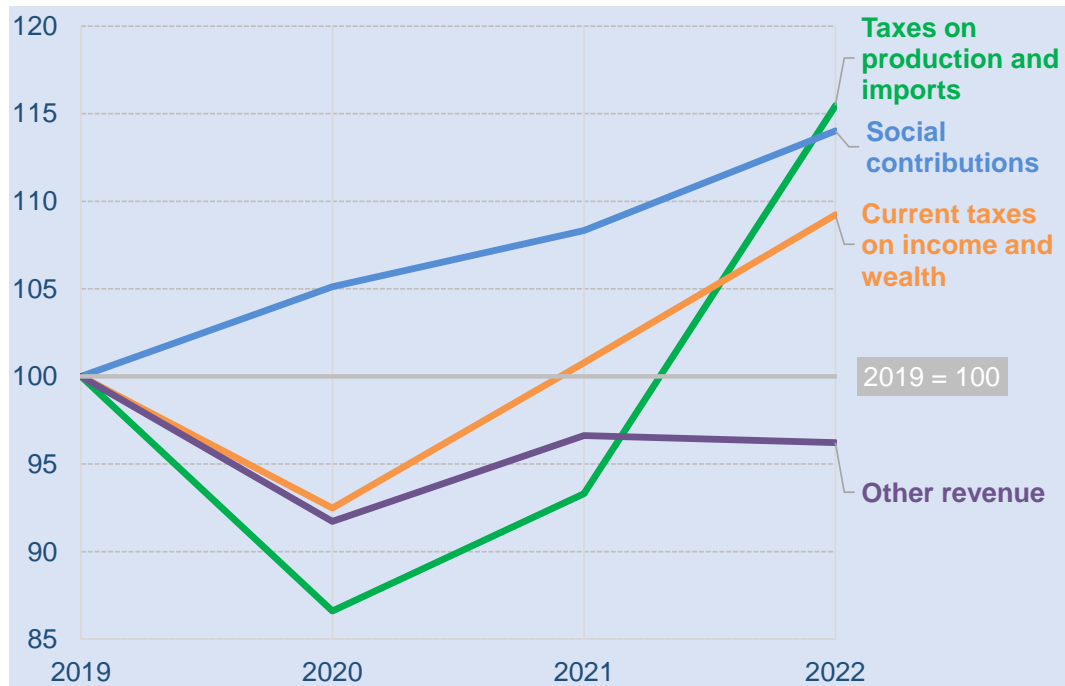
The risk assessment for public finances takes the macroeconomic scenario as presented in the DBP as given. The upside risk identified by the MFAC vis-à-vis real GDP growth for 2021 and 2022 could possibly lead to higher tax revenue.⁷³ The actual composition of growth (which may be more, or less, tax rich than envisaged) could also change the path for certain revenue components compared to what is predicted. In particular, higher GDP growth, or growth which is more skewed towards domestic demand, could lead to higher direct and indirect tax revenue. However, this possibility

⁷² Discussions with the COM in relation to the proposed assistance to the national airline were still ongoing by the Report's cut-off date.

⁷³ Refer to Chapter 3 in this Report for further details.

does not feature in the risk assessment vis-à-vis the fiscal projections presented in this section, since this assumes that the economic outturn is in line with the macroeconomic forecasts which are presented in the DBP.

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



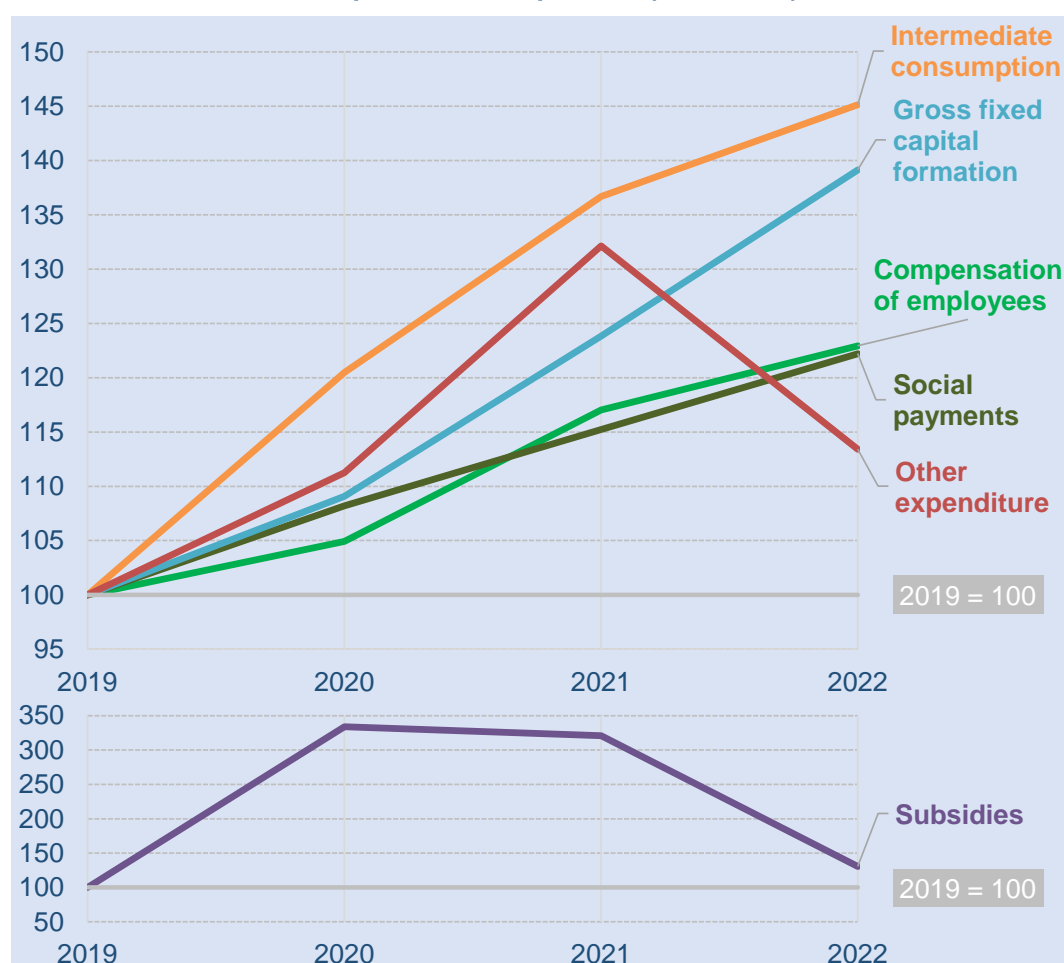
Source: MFAC calculations

Under the baseline scenario, social contributions are expected to maintain a smooth upward trajectory. On the other hand, there is variation in the forecast profile for those revenue components which dropped in 2020. Current taxes on income and wealth are expected to recover by 2021, as their decline in 2020 was less pronounced than for others. On the other hand, taxes on production and imports are expected to recover partially in 2021, but then are set to accelerate substantially in 2022. Indirect taxes are expected to grow most over the forecast period, up by 15.5% over their level in 2019. In turn, other revenue is expected to be higher over the forecast horizon than in 2020, but the estimates show that this is still expected to remain below the amount collected in 2019.

On the expenditure front, the budget allocations indicate increases with varying magnitudes and pace. By 2022 intermediate consumption is expected to be 45.1% more than in 2019. Its forecast trajectory is broadly mirrored by that for gross fixed capital formation which is also expected to be 39.1% higher than pre-pandemic. In turn, compensation of employees and social payments are characterised by a similar linear

upward trend throughout the forecast horizon, with their budget in 2022 amounting to close to 23.0% more than in 2019. On the other hand, other expenditure is expected to shoot up in 2021, mostly because of a one-off payment in relation to the EU Own resources and is then scaled back in 2022. In turn, the projection for subsidies, characterised by a spike in 2020 and 2021 and a reversal in 2022 is based on the plan to phase out the wage subsidy offered by the government. Still, the amount budgeted for subsidies in the DBP is higher than the amount spent in 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: MFAC calculations

The MFAC considers that there is a neutral risk outlook for the fiscal balance in 2021. However, for 2022 the MFAC considers that there could be downside risks to the fiscal balance (see Table 5.10). The fiscal deficit could be larger than expected in 2022 due to possible revenue shortfalls and expenditure overruns.

Table 5.10: Summary of risks to the fiscal balance

	2021	2022
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

The risk outlook for the main tax sources in 2021 (taxes on production and imports, current taxes on income and wealth and social contributions) is neutral. Their envisaged growth rates over 2020 appear to balance adequately the upside push created by the anticipated recovery in tax bases and a reasonable level of cautiousness.

For 2022 there could be a downside risk related to taxes on production and imports. This is mainly in view of the very strong rebound shown in the MFE's estimates, which relies heavily on the assumed strong recovery in tax-rich tourism activities. The large magnitude of the envisaged growth in indirect taxes may be challenging to achieve. Moreover, after the submission of the DBP, on 9 November 2021, a legal notice was

issued revising downwards certain energy taxes in a bid to offset the higher international energy prices for consumers.⁷⁴ This new measure, whose cost was estimated by MFE at around €2.5 million per month, is expected to remain in place until the end of 2022, but was not included in the DBP. This development also justifies the downside risk for indirect taxes in 2022.

A further downside risk to revenue in 2022 is related to market output, which includes the proceeds from residency schemes. The take up from the new scheme could be slower than anticipated, since it takes time for the applications to be processed, and the period since its launch is still relatively short. The evolution of the pandemic may also still exert a downside effect on international travel slowing down the application procedures which need to be followed to be granted the Maltese citizenship. In view of the infringement procedures initiated by the COM vis-à-vis Malta in relation to the citizenship-by-investment scheme, which could impact the attractiveness of such scheme, the authorities' prudent management of the revenue from the scheme is viewed positively.⁷⁵

On the expenditure front, there is a neutral risk outlook for the 2021 forecasts. The expenditure forecasts embed well the developments to date and the budgets for the various components appear adequate. However, for 2022 there could be upside risks which are rather broad-based. The budget allocations for compensation of employees and intermediate consumption appear somewhat tight when compared to the developments recorded during pre-pandemic years. In both cases the pattern depicted in the official outlook hinges critically on the premise that base effects limit growth in the outer forecast year. The lack of granular forecasts does not make it possible to disentangle precisely that expenditure which would not be repeated and that which forms part of the regular suite of activities performed by the government. Upside risks also relate to subsidies, should the need for assistance provided by the government arise because the progress in the pandemic turns out less benign than anticipated.⁷⁶ Any extension beyond the stipulated December 2021 deadline for the wage assistance would raise the expenditure outlays beyond what is currently budgeted for. Further upside risks relate to 'other' expenditure in the eventuality that any of the state

⁷⁴ The legal notice is available on <https://legislation.mt/eli/ln/2021/429/eng>.

⁷⁵ Information about the infringement procedure is available on https://ec.europa.eu/commission/presscorner/detail/en/inf_21_2743.

⁷⁶ A statement issued by the World Health Organization (WHO) on 4 November 2021 stated that Europe was once again at the epicenter of the pandemic. For further details refer to <https://www.euro.who.int/en/media-centre/sections/statements/2021/statement-update-on-covid-19-europe-and-central-asia-again-at-the-epicentre-of-the-pandemic>.

guarantees which were offered during the pandemic require the settlement by the government in case of repayment difficulties facing the borrowers.⁷⁷

5.5 Assessment of the public debt projections

The outstanding level of public debt is expected to rise by €1,584.9 million in 2021, from €6,977.5 million to €8,562.4 million (see Chart 5.17). The increase is almost entirely due to the financing of the projected fiscal deficit for 2021, which amounts to €1,545.0 million. A further small upward push is accounted for by the positive stock-flow adjustment (SFA), whose magnitude in 2021 is calculated at €39.9 million.⁷⁸ In 2022, the outstanding public debt is projected to rise further. However, the accumulation of debt is expected to be smaller due to the lower fiscal deficit planned for 2022, amounting to €850.7 million. The forecast change in outstanding public debt is €39.4 million less than the planned fiscal deficit for 2022 due to the adjustment carried out to reflect the negative SFA calculated for that year.

The overall balance for the SFA adjustments in 2021 is almost entirely accounted for by the small upward push created by the ESA re-routed debt, equity acquisitions and the issue of euro coins (see table 5.11).^{79,80} In 2022, the expected combined upward effect ascribed to these three factors is slightly less than that of the previous year. The negative overall SFA anticipated for 2022 reflects the larger downward push from other adjustments, the bulk of which is attributable to the expected payment of the taxes which were deferred from 2020.⁸¹

⁷⁷ The DBP assumes that no guarantees are called.

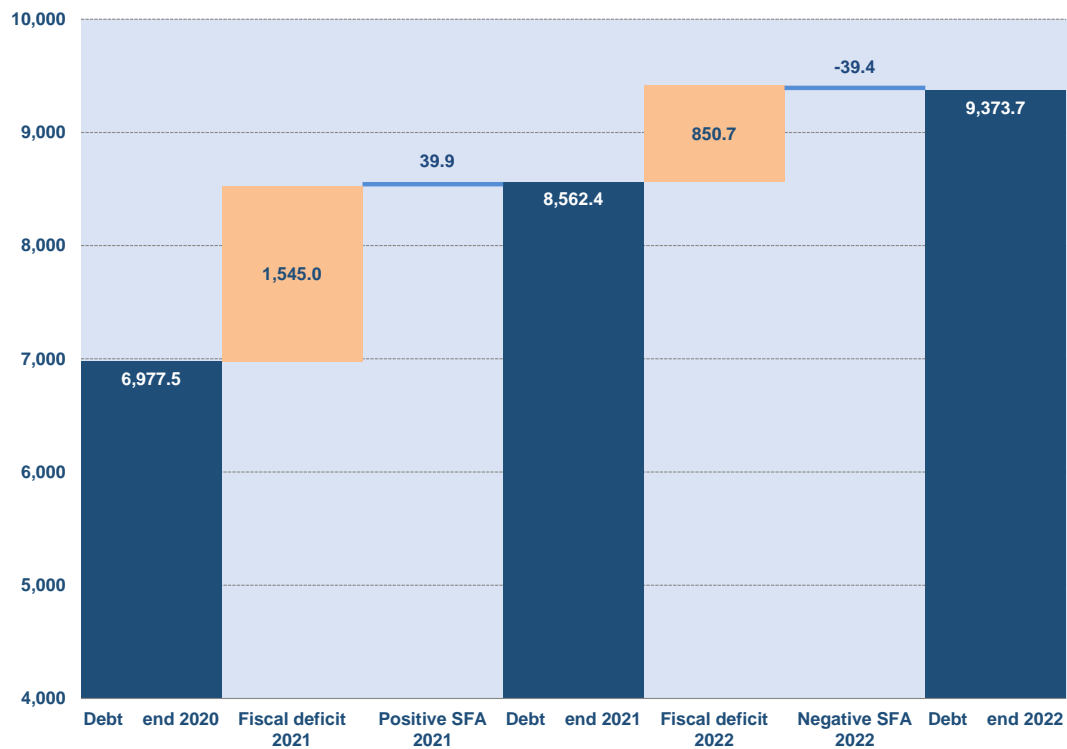
⁷⁸ SFA refers to the difference between the change in government debt and the government deficit or surplus for a given period. This arises when transactions impact the fiscal balance (in ESA terms) but not the public debt, or vice-versa. SFA is termed 'positive' when the adjustment raises the stock of debt and 'negative' when it lowers it.

⁷⁹ 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.

⁸⁰ The issue of euro coins (as opposed to euro notes) is considered part of domestic debt in the ESA public finance statistics.

⁸¹ When taxes were deferred, because of the pandemic, such deferred taxes were imputed and hence exerted no impact on the fiscal balance, but public debt rose (through a positive SFA) since the cash shortfall needed to be financed. In 2022, this transaction is basically assumed to be reversed, since when the taxes would be paid, the cash received would lower the financing needs of the government (reflected as a negative SFA).

Chart 5.17: Drivers of public debt (EUR millions)



Source: MFE

Table 5.11: Stock-flow adjustments (EUR millions)

	2021	2022
ESA re-routed debt	12.3	15.0
Equity acquisitions	15.0	5.0
Euro currency issue	10.0	5.1
Other adjustments	2.6	-64.5
Total stock-flow adjustment	39.9	-39.4

Source: MFE

As a result of the projected absolute increase in the outstanding debt and the nominal GDP growth forecast, public debt is expected to rise to 61.3% of GDP in 2021, from 53.4% of GDP in 2020 (see Chart 5.1). On the other hand, in 2022 the public debt ratio is expected to remain broadly stable, at 61.8% of GDP. The 7.0% forecast growth in nominal GDP in 2021 (which acts as the denominator), attenuates the projected rise in the debt ratio. In turn, the 8.6% nominal GDP growth forecast for 2022 suffices to

neutralise the financing needs created by the fiscal deficit, also since the latter is smaller than that planned for 2021.

The anticipated profile for the public debt ratio in 2021 and 2022 is consistent with the macroeconomic and fiscal outlook, and the estimated SFA for these years. The overall upside risk vis-à-vis real GDP growth for 2021 and 2022 identified by the MFAC in Chapter 3 of this Report, translates into a similar upside risk on nominal GDP growth.⁸² The possibility of a higher level for nominal GDP (denominator) throughout the forecast horizon, compensates for the possibility that the fiscal deficit could be larger than planned in 2022. The MFAC considers that these effects broadly cancel out each other, leading to a broadly neutral risk outlook for the public debt ratio for 2021 and 2022.

⁸² The neutral risk outlook vis-à-vis the various deflators forming part of the GDP deflator implies that analysis carried with respect to the real GDP components would apply equally for the nominal GDP counterparts.

Chapter 6

Comparison across different fiscal forecasts

6.1 Introduction

The fiscal outlook for 2021 and 2022 presented in the latest DBP is further assessed by comparing it with the previous forecasts which were published in the USP. This helps to trace the budget components which led to the changes in the government's targets for the balance and debt across the two forecast vintages. It can also help identify the factors which could explain the size and direction of such revisions. The plausibility of MFE's fiscal forecasts is further analysed by looking at the similarity or otherwise with respect to the fiscal forecasts produced by other reputable institutions. This follows the same comparative approach used to evaluate the macroeconomic forecasts in Chapter 4.

The MFAC considers such comparisons as a useful benchmark to support the qualitative assessment of the plausibility of the fiscal projections carried out in the previous chapter. At the same time, the MFAC acknowledges the caveat that possible differences in the assumed duration and effects of the pandemic, could limit the comparability of the figures. The evolution of the pandemic remains highly uncertain, and the expectations about the possible time when conditions would return to normal are highly sensitive to the epidemiological information which emerges. The different publication dates of such forecasts could thus contribute to the divergences between the various fiscal projections which are available for Malta.⁸³

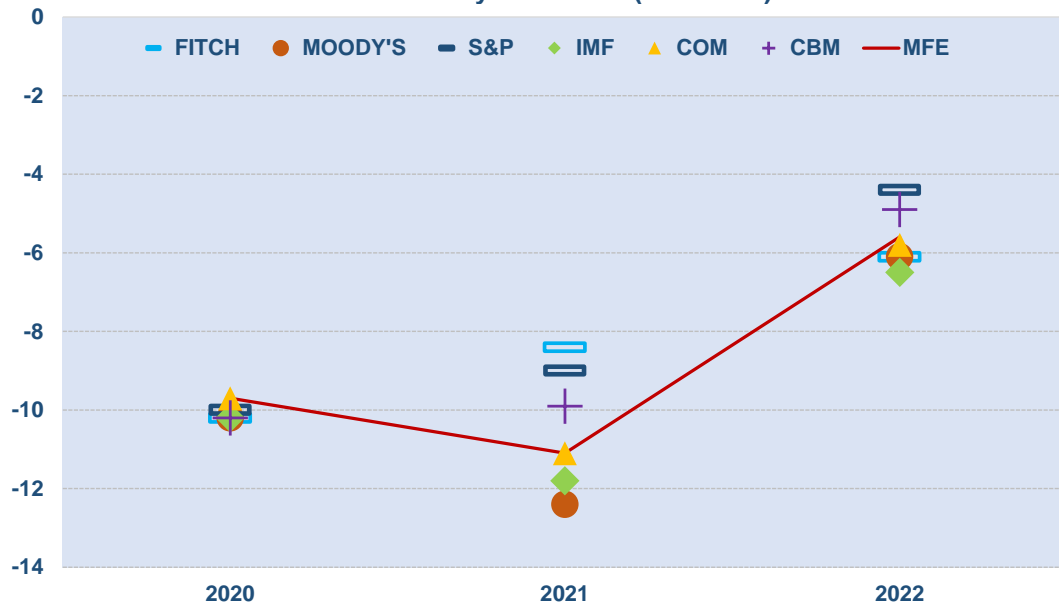
6.2 Fiscal balance

All available forecasts indicate a large fiscal deficit for 2021, which ranges between 12.4% of GDP, by Moody's, and 8.4%, by FITCH (see Chart 6.1). The forecasts by the COM, IMF, and Moody's all point to some deterioration compared to 2020, mirroring

⁸³⁸³ In chronological order, the forecasts referred to in this Chapter were published in 2021 on the following dates: MOODY's – 12 August; CBM – 17 August; S&P – 14 September; IMF – 17 September; MFE – 15 October; COM – 11 November; and FITCH – 19 November.

the pattern indicated in the government’s projections. Indeed, the COM presented an identical deficit-to-GDP forecast as the MFE, whereas the other two institutions anticipate a slightly higher deficit. On the other hand, the other institutions, namely FITCH, S&P and CBM expect a small improvement compared to the fiscal balance outturn of 2020. The slightly more optimistic outlook by these institutions reflects higher revenue-to-GDP and lower expenditure-to-GDP forecasts for 2021.⁸⁴ In turn, the slightly more pessimistic deficit forecasts are mostly due to the higher expenditure-to-GDP estimates compared to the MFE’s projections.

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



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

For 2022, all projections place Malta’s fiscal deficit much lower than in 2021. The premise across the sets of forecasts is that the worst of the pandemic would be over, thereby enabling the economic recovery to proceed further, and the strong fiscal support to unwind according to the government’s plan. The government’s aim is to contain the fiscal deficit in 2022 to 5.6% of GDP. The fiscal deficit forecasts by the other institutions lie within a range of 2.1 pp and are rather evenly clustered around the MFE’s target. In the case of S&P and CBM, the smaller fiscal deficit forecast for 2022 is consistent with the similar lower estimate for the outturn in 2021. However, in both cases, the forecasts were published before the DBP, and hence did not embed the

⁸⁴ The report by FITCH, whose forecasts were published last, ascribes the anticipated improvement in the fiscal balance due to better-than-expected revenue, as cash data indicated that revenue collection had already surpassed the 2019 levels by end-September 2021.

latest fiscal plans and the latest information which was available when the DBP was finalised.

The DBP targets a deficit of €1,545.0 million in 2021, which is €85.4 million less than had been indicated in the USP (see Table 6.1). For 2022, the USP's planned strong correction in public finances was reconfirmed in the DBP, but the updated deficit target is €24.6 million more.

The downward revision in the estimated fiscal deficit for 2021 mostly reflected the higher expected revenue (+€70.9 million), but also included a marginal reduction in the planned expenditure (-€14.4 million). The revenue revisions are consistent with the improved economic outlook presented in the DBP compared to the USP.⁸⁵ The forecast for taxes on production and imports was raised by €62.4 million, mirroring the updated stronger consumption growth outlook. In turn, the projected revenue from current taxes on income and wealth was increased by €69.0 million, reflecting the better growth prospects for compensation of employees and gross operating surplus than was envisaged in the USP. The upward revision in social contributions was smaller, €7.3 million, as the intra-year tax base progressed broadly in line with the expectations. On the other hand, the forecast for other revenue was lowered by €67.8 million as the absorption of EU funds is expected to be less than originally planned.

Despite the overall change in total expenditure between the two forecast rounds was very small, revisions carried out to the budgets for the different components were significant. Some of these changes could be ascribed to the increased availability of information. Indeed, when the fiscal forecasts are produced in the April round (for the USP), often there is insufficient information to precisely classify such outlays along the ESA guidelines, leading to subsequent reclassifications in the October round (for the DBP). Other deviations could be attributed to overshoots in certain outlays, which are however compensated for by the veering of expenditure from one allocation to another, to adhere when possible to the yearly fiscal balance target.

The budget for spending on compensation of employees in 2021 was expanded by €63.5 million, to cover overruns. Another €43.0 million were added to the budget for subsidies, as the wage support measures were extended beyond the original plans. On the contrary, the expected spending on gross fixed capital formation was lowered

⁸⁵ Refer to Chapter 4 in this Report for further details.

by €76.1 million. Progress on certain projects was slower than planned. The budget for 'other expenditure' was also lowered by €67.0 million, as some items were reallocated to the main expenditure categories. On the other hand, the changes to the budgets for social payments and intermediate consumption across the two forecast rounds were smaller and mainly driven by the information about the outlays on these two items to date.

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

	2021				2022			
	MFE USP	MFE DBP	COM AUT	CBM AUG	MFE USP	MFE DBP	COM AUT	CBM AUG
Total Revenue	4,986.8	5,057.7	5,028.6	4,970.8	5,422.3	5,611.3	5,526.5	5,420.3
Taxes on production & imports	1,442.6	1,505.0	1,476.9	1,442.8	1,689.5	1,862.3	1,759.1	1,698.4
Current taxes on income & wealth	1,772.3	1,841.3	1,848.0	1,756.2	1,920.2	1,995.5	1,995.3	1,825.4
Social contributions	859.4	866.7	865.8	860.2	912.5	912.2	905.0	892.7
Other *	912.5	844.7	838.0	911.6	900.1	841.3	867.1	1,003.8
Total expenditure	6,617.1	6,602.7	6,583.2	6,315.9	6,248.4	6,462.0	6,397.7	6,143.3
Compensation of employees	1,702.9	1,766.4	1,752.7	1,686.8	1,782.0	1,855.7	1,822.8	1,795.6
Intermediate consumption	1,340.2	1,338.9	1,338.1	1,295.1	1,265.2	1,421.6	1,416.3	1,272.5
Social payments	1,410.8	1,434.3	1,451.9	1,419.2	1,448.7	1,521.3	1,504.3	1,450.4
Gross fixed capital formation	736.8	660.7	660.3	648.0	690.4	742.4	740.6	736.0
Subsidies	583.2	626.2	619.9	587.0	236.2	254.8	250.3	177.8
Other **	843.2	776.2	760.4	679.9	825.9	666.2	663.5	711.0
Fiscal balance	-1,630.4	-1,545.0	-1,554.6	-1,345.1	-826.1	-850.7	-871.2	-723.0
Gross debt	8,828.4	8,562.4	8,570.0	8,482.6	9,731.9	9,373.7	9,400.0	9,274.0

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

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

Source: MFE, COM

In the DBP, the revenue and expenditure forecasts for 2022 were both revised upwards compared to the USP. The planned expenditure was raised by €213.6 million, but the impact on the deficit target was mostly offset through a €189.0 million rise in the expected total revenue.

The projected higher expenditure in 2022 was spread across all categories, except for 'other' expenditure. The budget for the public sector wage bill was increased by €73.7 million, reflecting the base effect created by the upward revision carried out in the allocation for 2021. The outlook for spending on intermediate consumption was completely changed. The DBP allows for an increase in spending on intermediate consumption in 2022, as opposed to the decline which was envisaged when the USP was prepared. This change is to an extent driven by the way in which the ESA fiscal forecasts are produced, where for certain categories, fixed ratios are used to allocate spending across the components. A higher planned total spending would thus result in a higher allocation for the categories such as what happened in the case of intermediate consumption. The higher forecast for intermediate consumption also provides for higher spending on health than previously budgeted for (both COVID and non-COVID related), as well as the introduction of carbon credits.⁸⁶ There was also a shift in the timeline for public sector investment from 2021 to 2022, resulting in the higher allocation planned for the outer forecast year. The DBP retained the planned reduction in subsidies, but the allocation for subsidies for 2022 was kept slightly higher than was indicated in the USP.

In absolute terms, the largest change in revenue for 2022 was in respect of taxes and production and imports, which were raised by €172.8 million. Meanwhile, current taxes on income and wealth were increased by €75.3 million. Such updates cumulate the better prospects for their respective tax bases in view of the more benign economic scenario portrayed in the DBP compared to the USP. On the other hand, the €58.8 million reduction in 'other revenue' reflects a downward re-assessment of the expected proceeds from citizenship schemes. In turn, the expected revenue from social contributions was broadly unchanged compared to the USP, since this component is mostly driven by the labour market developments, whose outlook did not change much between the forecast rounds.

⁸⁶ Carbon credits will enable public and private entities to invest in green and environmental projects with the aim of creating a carbon credit surplus that could then be acquired, on a voluntary basis, by other public or private entities to help them meet their own carbon targets.

In absolute terms, the fiscal deficit for 2021 and 2022 estimated by the COM is slightly higher than that presented by MFE.⁸⁷ The COM's forecasts indicate slightly lower revenue and expenditure across both years. The main difference on the revenue side relates to taxes on production and imports, which are slightly more conservative than those by MFE. The COM's forecasts for the rest of the revenue components are fairly close. Even in the case of expenditure, the COM's estimates for both 2021 and 2022 are broadly in line with those presented by MFE across the various components.

On the other hand, there are larger variations between the CBM's fiscal forecasts and those presented by MFE.⁸⁸ This can be mainly attributed to the fact that the CBM's forecasts were produced much earlier, and hence embody less fiscal information and measures than is factored in the DBP. For both 2021 and 2022, the CBM's forecasts show a lower value for taxes on production and imports, current taxes on income and wealth, and social contributions, than in the DBP. The overall deviation is however dampened by a higher forecast for 'other revenue' by the CBM.

The CBM's expenditure estimates for 2021 are lower than those indicated by MFE across all categories. For 2022, CBM's figures are mostly below those indicated in the DBP, with the largest deviation in absolute terms featuring in intermediate consumption. The CBM's forecast is closer to the figure which was publicly available at the time when such forecasts were produced, namely that published by the government in April as part of the USP.

6.3 Public debt

The DBP lowered the debt target for 2021 by €266.0 million compared to the USP. This revision reflected mostly a downward adjustment in the SFA, but also included a small reduction in the planned deficit for the year. Although the SFA indicated in the DBP is positive, its estimate is much lower than was indicated in the USP. This development relates to a significant downward revision in the expected amount of equity acquisitions and ESA rerouted debt for 2021. The base effect created by the

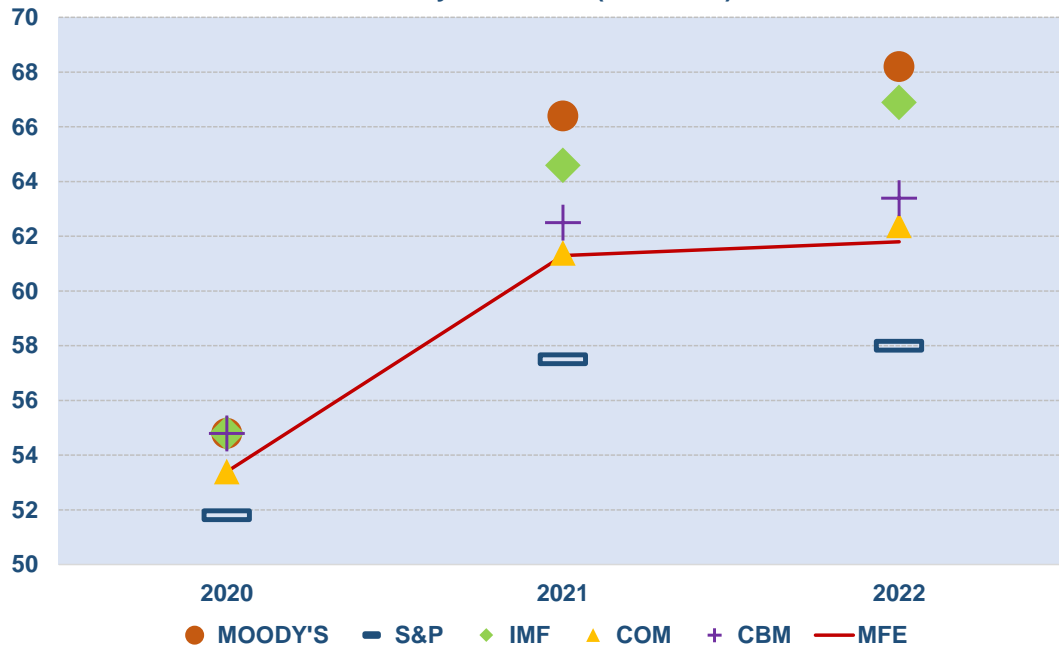
⁸⁷ The detailed fiscal projections by the COM are available on the AMECO database: https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/macro-economic-database-ameco/ameco-database_en.

⁸⁸ The CBM publishes the fiscal forecasts as percentage of GDP. These are available on <https://www.centralbankmalta.org/economic-projections>. The absolute figures are forwarded separately to the MFAC for its assessment.

lower projected outstanding debt at the end of 2021 also explains why the 2022 public debt forecast was lowered by €358.2 million in the DBP compared to that published in the USP. The lower value assumed for SFA in 2022 is also due to lower amounts for equity acquisitions and ESA rerouted debt in the DBP compared to the USP.

The estimated public debt by the COM is very close to that presented by the MFE. For 2021, the COM's figure is €7.6 million more, whereas for 2022 it is €26.3 million more. The variation reflects the difference in the estimated fiscal balance, as otherwise the assumed SFA for each year are very similar. On the other hand, the debt projections by the CBM are lower than indicated in the DBP in view of the lower fiscal deficit forecasts by the CBM, which is partially mitigated by the higher assumed SFA by CBM for both years.⁸⁹

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



Note: In the commentary by FITCH, it is stated that public debt is forecast to peak at 61% of GDP by 2023, without providing specific forecasts for 2021 and 2022.

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

There is heterogeneity with regards to the forecast trajectory for the debt-to-GDP ratio for 2021 and 2022 by the various institutions (see Chart 6.2). Although there is consensus about a rising debt ratio in 2021, compared to 2020, the range is rather

⁸⁹ Public information about SFA is very limited. Indeed, the main source for the SFA was that published in the USP. Thus, the CBM's SFA assumptions are closer to the values which had been indicated in the USP.

wide. S&P presented the lower debt forecast, 57.5% of GDP, while Moody's forecast is the highest, at 66.4% of GDP. These forecasts encompass the MFE's target, which lies around the middle of the range. The different estimates for the public debt ratio can be ascribed to differences in the forecasts for the absolute level of debt and in the level of nominal GDP.

The range for the 2022 debt forecasts is slightly higher as there is greater variation in the outlook among institutions. All institutions concur that there will not be a repetition of the rapid increase in the debt ratio observed over 2020 and anticipated for 2021. There is also consensus that the public debt ratio would increase further in 2022. However, the magnitude of the forecast change is slightly different. The MFE's estimate exhibits the smallest increase in the debt-to-GDP ratio, equivalent to 0.5 pp. On the other hand, the forecasts by the other institutions indicate a larger expected rise in the debt ratio, with Moody's presenting the highest debt forecast for 2022, at 68.2% of GDP.

6.4 Assessment

The fiscal revisions for 2021 and 2022 carried out by MFE in the DBP factor in the improved macroeconomic scenario, which impacts tax revenue positively. They also embed the plans for higher public expenditure in 2022 than had been envisaged in the USP. This upward revision is consistent with the upside expenditure risks which the MFAC had identified in its assessment of the USP 2021 – 2024.

The MFAC notes that all independently produced forecasts show a correction in the fiscal deficit in 2022, though to varying degrees. Moreover, the range of estimates for the public-debt to GDP ratio all lie below 70.0%. This broad consensus offers comfort that, based on the information available to date, the DBP's scenario of a gradual correction in public finances, starting from 2022, and a containment of the strong upward trend in the debt ratio, appears plausible. At the same time, the MFAC highlights the major caveat that all available fiscal forecasts build on the premise of a full or quasi-complete return to normality starting from 2022.

Chapter 7

Conclusion

The DBP is based on the scenario that in 2021 Malta's real GDP grows by 4.8%, partially recovering from the 8.3% contraction recorded a year earlier. In 2022, the real GDP growth momentum is anticipated to be stronger, at 6.5%. The fiscal support measures in place since the beginning of the pandemic have been instrumental to support economic activity and the labour market, but their cost is expected to result in a consecutive large fiscal deficit in 2021. Indeed, the projected fiscal deficit-to-GDP ratio for 2021 stands at 11.1%, exceeding the 9.7% deficit recorded in 2020. However, for 2022, the DBP targets a reduction in the fiscal deficit, to 5.6% of GDP. This target is in line with the intention to bring public finances on a sustainable track over the next few years, and gradually within the 3.0% ceiling specified in the SGP.

By 2022, the projected macroeconomic and fiscal outlook would halt the strong increases registered in the public debt ratio since the beginning of the pandemic. The public debt ratio is thus expected to stabilise at slightly less than 62.0% of GDP throughout 2021 and 2022, marginally higher than the 60.0% threshold indicated in the SGP. The activation of the general escape clause of the SGP, and which is identically referred to in the FRA, permitted the temporary departure from both the fiscal balance and public debt limits with the onset of the pandemic.⁹⁰

Both the macroeconomic and the fiscal forecasts presented in the latest DBP are considered to lie within the endorsable range of the MFAC. Based on the information available by the cut-off date, the MFAC's risk outlook suggests that there is the possibility that GDP growth could be higher than expected, but the fiscal deficit could exceed the target in 2022. This while acknowledging that uncertainty remains high and key assumptions, particularly those relating to the pandemic's progress and the planned phasing out of support measures, shape to a great extent the macro-fiscal scenario over the period 2021 to 2022. Any delays in the implementation of the phasing

⁹⁰ EU Member States were able to provide an unprecedented amount of fiscal support not only through the activation of the escape clause but also with the adoption of the State Aid Temporary Framework, the Corona Response Investment Initiatives, and the establishment of new emergency tools, such as the Support to mitigate Unemployment Risks in an Emergency (SURE).

out of the economic support could also have a significant impact, possibly cushioning the macroeconomic effect, but resulting in a wider fiscal imbalance than planned.

At present, the flexibility granted to Member States allows for very expansionary fiscal policies across the EU to mitigate the adverse shock of the pandemic. This is indeed justifiable. However, the MFAC reminds that when economic conditions allow, fiscal policy in Malta should again be aimed at achieving a prudent medium-term fiscal position and ensuring debt sustainability. It is important to be adequately prepared for the time when the general escape clause will eventually be revoked, and fiscal rules become binding again.

The fiscal space in Malta, 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. In this respect, the MFAC considers that post-pandemic, the rebuilding of fiscal space should again be prioritised to have adequate buffers to counteract any future adverse shocks and to enhance the overall resilience of Malta's economy.

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