Assessment of the Update of Stability Programme 2023-2026

MFAC
MALTA FISCAL ADVISORY COUNCIL

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UPDATE OF STABILITY PROGRAMME

2023 - 2026

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30 June 2023

The Hon Mr Clyde Caruana B.Com. (Hons) Economics, M.A. Economics
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Dear Minister,

OVERALL ASSESSMENT OF THE MACROECONOMIC AND FISCAL FORECASTS PRESENTED IN THE UPDATE OF THE STABILITY PROGRAMME 2023 - 2026

As a follow-up to the letter of endorsement in relation to the macroeconomic forecasts, dated 01 May 2023, the Malta Fiscal Advisory Council is hereby presenting the full assessment report of the Update of the Stability Programme 2023 - 2026, in terms of the Fiscal Responsibility Act. The MFAC's Report has a cut-off date of 24 May 2023.

The Malta Fiscal Advisory Council notes that despite the fact that the general escape clause is still active for this year, the Update of the Stability Programme is framed within a transitional context towards new fiscal rules, which places debt sustainability at its core. As a result, the Council is satisfied that the Ministry for Finance and Employment heeded the recommendation of the European Commission as communicated in its guidelines of fiscal policy to design the Stability or Convergence Programmes for the period 2023-2026 in accordance with the fiscal rules as stipulated in the new governance framework.

The Council notes that the Ministry for Finance and Employment is forecasting GDP growth at 4.1% in 2023, slightly accelerating to 4.5% and 4.6% in 2024 and 2025 before dipping back to 4.2% in 2026. The Council considers the Government's macroeconomic projections to be feasible. At the same time, the Government is expecting the fiscal deficit to narrow down to 5.0% of GDP in 2023, from 5.8% a year earlier. For the outer years, the Update of the Stability Programme targets a progressive reduction in the fiscal deficit ratio, reaching just under 3.0% of GDP by 2026. The Government is also projecting the public debt ratio to remain below the 60% threshold over the Programme period but to increase slightly from 55.7% at the end of 2024 to 56.1% by the end of 2026.

Overall, the Council considers the macroeconomic and fiscal forecasts for the forecast horizon to be within its endorsable range. They embed the assumptions used and the information available at the time the Update of the Stability Programme was produced. Nonetheless, the Council identified a number of uncertainties in its assessment which could materially deviate the outturn from that presented in the Update of the Stability Programme.

According to the risk assessment carried out, the Council opines that the balance of short-term risks associated with economic growth tilts slightly on the upside for 2023, mainly on the back of stronger domestic developments. Indeed, the Fiscal Council attributes upside risks for private consumption expenditure, which is expected to more than offset the downside risks in gross fixed capital formation on GDP growth when incorporating the resulting effects on imports. For the outer years, the Fiscal Council opines that stronger expected consumption growth, mainly emanating from easing price pressures, and a stronger external trade balance, could pose upside risks for the medium term. Nonetheless, the Council notes that the output gap is projected to remain negative over the forecast horizon despite core inflation remaining above the 2% threshold of price stability. The Council opines that this may be the result of some underestimation of actual economic growth coupled with an overestimation of potential output growth.

The Fiscal Council acknowledges that the presented macroeconomic projections hinge on the assumptions employed and given the high degree of openness of the Maltese economy, any material departure from the exogenous assumptions could significantly alter the growth outlook. In particular, the Council identifies the persistent inflationary pressures both locally and abroad and ensuing effects, and the possibility of any exogenous shocks on the domestic financial system as being the more prominent risks surrounding the Government's macroeconomic projections.

The Council positively notes that the Government is targeting to reduce the budget deficit to below the 3% deficit benchmark within the Programming period. However, this threshold will only be reached in the final year of the Programming period and the budget deficit target for 2026 is only 0.1 percentage points below the benchmark, thus leaving little to no room for manoeuvre in case of any unforeseen shocks which may require the Government's fiscal support. Furthermore, the Council opines that while revenue could turn out better than expected in the USP, the Council also views the risk that the expenditure side could turn out stronger than anticipated in the USP, particularly for the outer forecast years. Indeed, the Council assesses the risk that a higher fiscal deficit materialises to be more pertinent over the outer forecast years.

The Council's risk assessment largely hinges on the Government's planned expenditure on energy subsidies, due to their magnitude as well as the uncertainty surrounding these outlays. In particular, the Council notes the material deviation in the energy subsidy estimates, submitted by the Ministry for Finance and Employment, in the USP for 2023 relative to those set in the Draft Budgetary Plan. The Council notes that the commitment by the government to continue offering energy price subsidies to all households and businesses is still in place. At the same time, the risk outlook for the cost of energy subsidies remains highly uncertain, given the ongoing war between Russia and Ukraine and its effect on international energy price levels. Furthermore, changes in the attitude of households and enterprises towards energy-saving, the usage of energy and the employed energy mix, amongst other factors, could all influence the level of subsidies required to be paid by the government, either more positively or negatively. The Council opines that this uncertainty surrounding this expenditure component constitutes an important risk element to the fiscal projections.

Furthermore, the Council also identifies the future of Air Malta and potential associated costs as another important fiscal risk. The global minimum level of taxation rules applicable to the multinational investor market could also affect Malta's ability to retain its competitive position relative to our foreign counterparts and may also potentially lead to deviations in the fiscal revenue targets during the Programme period.

The Fiscal Council notes that the activation of the general escape clause in the Stability and Growth Pact and in the Fiscal Responsibility Act permitted the Government to take all the initiatives deemed necessary to mitigate the adverse effects created by the pandemic and ensuing supply-chain disruptions and the subsequent Russia-Ukraine war. However, following the de-activation of the general escape clause in 2024, the Council would again like to emphasize the importance of achieving a prudent medium-term fiscal position. The Council recommends that any potential savings from energy subsidies or higher than projected revenue should be used to rebuild fiscal buffers. Furthermore, any deviations from the revenue and expenditure targets should not be compensated for by curtailing planned productive capital expenditure.

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. Considering the cut-off date assumed for these projections, the Council urges the Ministry for Finance and Employment to submit their projections in the future as early as possible to provide sufficient time for the Council to process the information and advance the publication of the Report to an earlier date.

Yours sincerely,

Moira Catania

Dr Moira Catania
Chairperson of the Malta Fiscal Advisory Council

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Abbreviations

ARIMA	Autoregressive Integrated Moving Average
CBM	Central Bank of Malta
COM	European Commission
COICOP	Classification of Individual Consumption by Purpose
COLA	Cost-of-living Allowance
COVID-19	Coronavirus disease 2019
CSRs	Country-Specific Recommendations
DBP	Draft Budgetary Plan
EA	Euro Area
EBU	Extra Budgetary Unit
EC	European Council
ECB	European Central Bank
ESA	European System of National and Regional Accounts
EU	European Union
EUNIFI	EU Network of Independent Fiscal Institutions
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
GVA	Gross Value Added
GCFC	Gross Fixed Capital Formation
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
MFF	Multiannual Financial Framework
MGS	Malta Government Stock
MOU	Memorandum of Understanding
NACE	Nomenclature of Economic Activities
NDSF	National Development and Social Fund
NPISH	Non-Profit Institutions Serving Households
NSO	National Statistics Office
pp	percentage point
RPI	Retail Price Index
RRF	Recovery and Resilience Facility
SFA	Stock-Flow Adjustment
SGP	Stability and Growth Pact
STEMM	Short-Term Quarterly Economic Forecasting Model
STG	Pound Sterling
TFP	Total Factor Productivity
USD	US Dollar
USP	Update of Stability Programme
VAT	Value Added Tax

Executive Summary

The Malta Fiscal Advisory Council (MFAC), entrusted with the role of an independent fiscal institution, is commissioned with reporting on the Update of the Stability Programme 2023-2026 (USP), both regarding the macroeconomic and fiscal forecasts, responding to the mandate contained in the Fiscal Responsibility Act. Indeed, this Report, the cut-off date of which is 24 May 2023, assesses the macroeconomic and fiscal forecasts for the four-year period 2023 to 2026 contained in the Update of the Stability Programme as submitted by the Ministry for Finance and Employment to the European Commission on 02 May 2023.

The context of this year's USP is different to previous years, as the European Commission is currently leading efforts towards transitioning to a new framework of fiscal governance.[1] The proposed framework is designed with the objective of strengthening the medium-term stance of fiscal policy by promoting a more prominent role for debt sustainability. It also establishes targets at the country level that each EU Member State must follow and implement through their structural plans.

Despite maintaining the general escape clause active for this year, the European Commission, in its guidelines on the design of fiscal policy, recommended that the Stability or Convergence Programmes for the period 2023-2026 should already include medium-term budgetary and structural plans as required by the new governance framework, i.e., (a) USP to be in line with the SGP's reference value of 3% of GDP deficit and that this remains below this threshold value at constant policies in the medium-term, and (b) ensure a plausible and continuously declining rate of public debt to sustainable levels through the reference period.[2] This year's USP and the assessment conducted by the MFAC take into account the European Commission's fiscal policy guidance for the year 2024.

[1] The European Commission presented its legislative proposals on the new framework of fiscal governance on April 26. The new framework is planned to enter into force in 2024.
[2] The European Commission has adopted a Communication providing Member States with guidance on the conduct and coordination of fiscal policy in 2024. This can be found here.

The economic outlook presented in the USP points to a 4.1% growth rate in real GDP in 2023, continuing the momentum of economic growth registered in the previous two years. This represents an upward revision from the 3.5% growth projected in the Draft Budgetary Plan. Growth is expected to remain strong over the outer years and even outpace the forecast for 2023. Amid this, growth is projected to remain below potential output over the forecast horizon leading to a negative output gap. At the same time, core inflation is projected to remain strong over the next two years. Against this background, the fiscal deficit is projected to narrow to 5.0% of GDP in 2023, from 5.8% a year earlier. For the outer years, the Stability Programme targets a progressive reduction in the fiscal deficit ratio, reaching just under the 3% of GDP reference value by 2026. As a result, the USP is in line with the Commission's fiscal policy guidelines for 2024, recommending a correction of the excessive deficit within the period covered by the Programme. Furthermore, the correction of the fiscal deficit ratio is consistent with an annual average structural effort of 0.7% of GDP and an average annual reduction of the structural primary deficit of 0.9% of GDP over the Programme horizon. The MFAC notes that the effort being targeted by the Government is more ambitious than the minimum 0.5% of GDP requirement of the current fiscal framework and the Commission's proposed governance framework. Furthermore, according to the USP, the general government debt-to-GDP ratio is expected to remain consistently below the 60% reference value, although it is projected to increase slightly from 55.7% at the end of 2024 to 56.1% by the end of 2026.

The MFAC considers the macroeconomic and budgetary forecasts to lie within the endorsable range identified by the Council. They embed the assumptions used and the information available at the time the Update of the Stability Programme was produced. Nonetheless, the Council identified several uncertainties in its assessment which could materially deviate the outturn from that presented in the Update of the Stability Programme.

According to the risk assessment carried out, the Council opines that the balance of short-term risks associated with economic growth tilts slightly on the upside for 2023, mainly on the back of stronger domestic developments. Indeed, the Fiscal Council attributes upside risks for private consumption expenditure, which is expected to more than offset its assessment of downside risks in gross fixed capital formation. For the outer years, the Fiscal Council opines that stronger expected consumption growth, mainly emanating from easing price pressures and a stronger external trade balance, could pose upside risks for the medium term. Nonetheless, the Council notes that the output gap is projected to remain negative over the forecast horizon despite core inflation remaining above the 2% threshold of price stability. The Council opines that this may be the result of some underestimation of actual economic growth coupled with an overestimation of potential output growth.

The Fiscal Council acknowledges that the presented macroeconomic projections hinge on the assumptions employed and given the high degree of openness of the Maltese economy, any material departure from the exogenous assumptions could significantly alter the growth outlook. In particular, the Council identifies the persistent inflationary pressures both locally and abroad and ensuing effects, and the possibility of any exogenous shocks on the domestic financial system as being the more prominent risks surrounding the Government's macroeconomic projections.

Against this background, the Council opines that over the short term, total revenue could turn out to be stronger than projected by the Ministry for Finance and Employment, specifically current taxes on income and wealth and taxes on production and imports. However, the Council also views that growth in expenditure could turn out stronger than anticipated in the USP, particularly for the outer forecast years. Indeed, the Council assesses the risk that a higher fiscal deficit materialises to be more pertinent over the outer forecast years. Nonetheless, the fiscal balance as a percentage of GDP is supported by the upside risks to GDP, which acts as the denominator in this ratio. Various factors could underpin the trajectory of the fiscal balance, and any changes in government policy, or the materialisation of certain ad-hoc risks could result in deviations from the deficit targets. Such risks are particularly relevant given that any deviances that worsen the fiscal deficit ratio may result in not adhering to the 3% deficit benchmark by the final year of the Programme period. The fact that the budget deficit target for 2026 is only 0.1 percentage points below the 3% threshold, leaves little to no room for manoeuvre for Government to provide support through countercyclical fiscal policy in case of any unforeseen shocks.

The Council's risk assessment largely hinges on the Government's planned expenditure on energy subsidies, due to their magnitude as well as the uncertainty surrounding these outlays. In particular, the Council notes the material deviation in the energy subsidy estimates submitted by the Ministry for Finance and Employment in the USP for 2023 relative to those set in the Draft Budgetary Plan. The Council notes that the commitment by the government to continue offering energy price subsidies to all households and businesses is still in place. At the same time, the risk outlook for the cost of energy subsidies remains highly uncertain, given the ongoing war between Russia and Ukraine and its effect on international energy price levels. Furthermore, changes in the attitude of households and enterprises towards energy-saving, the usage of energy and the employed energy mix, amongst other factors, could all influence the level of subsidies required to be paid by the government, either more positively or negatively. The Council opines that this uncertainty surrounding this expenditure component constitutes an important risk element to the fiscal projections.

Furthermore, the Council also identifies the future of Air Malta and potential associated costs as another important fiscal risk. The global minimum level of taxation rules applicable to the multinational investor market could also affect Malta's ability to retain its competitive position relative to our foreign counterparts and may also potentially lead to deviations in the fiscal revenue targets during the Programme period.

The Fiscal Council notes that the activation of the general escape clause in the Stability and Growth Pact and in the Fiscal Responsibility Act permitted the Government to take all the initiatives deemed necessary to mitigate the adverse effects created by the pandemic and ensuing supply-chain disruptions and the subsequent Russia-Ukraine war. However, following the de-activation of the general escape clause in 2024, the Council would again like to emphasize the importance of achieving a prudent medium-term fiscal position. The Council recommends that any potential savings from energy subsidies or higher than projected revenue should be used to rebuild fiscal buffers. Furthermore, any deviations from the revenue and expenditure targets should not be compensated for by curtailing planned productive capital expenditure.

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. Considering the cut-off date assumed for these projections, the Council urges the Ministry for Finance and Employment to submit their projections in the future as early as possible to provide sufficient time for the Council to process the information and advance the publication of the Report to an earlier date.

Chapter 1

Introduction

Countries that form part of the Euro Area (EA) must submit an Update of Stability Programme (USP) to the European Commission (COM) by the end of April each year.[3] Malta's latest USP presents the updated official macroeconomic and fiscal forecasts prepared by the Ministry for Finance and Employment (MFE) covering the four-year period 2023 to 2026. The forecasts presented in the USP update the latest report published in October 2022 as part of the Draft Budgetary Plan (DBP).

The forecasts are prepared at a time of high uncertainty. The external shocks emanating from the conflict between Russia and Ukraine and the ensuing supply constraints triggered a global inflationary shock. The increased inflationary pressures have led global central banks to increase their key interest rates, leading to a deceleration in global trade and economic growth. As a small open economy, Malta is highly susceptible to these external shocks which further adds pressure when preparing macroeconomic forecasts covering a four-year horizon. The risks influencing the macroeconomic outlook could, in turn, also influence the fiscal outcome. Unprecedented fiscal expenditures were undertaken over the past years to mitigate the effects from the pandemic and more recently, the surge in prices, particularly those in energy. Such significant spending was permitted following the activation of the Stability and Growth Pact (SGP)'s general escape clause in 2020.

The enforcement of fiscal rules is still suspended, until the escape clause is revoked, which should happen by the end of 2023. The Malta Fiscal Advisory Council corroborates the COM's stance that the situation of 'exceptional circumstances' defined in the SGP and replicated in the Fiscal Responsibility Act (FRA), should be terminated by 2023.[4,5] Since the rules were suspended, the COM has been working to implement a comprehensive reform of the EU's economic governance rules. On 26

[3] The USP submitted by each country in 2023 can be found here.
[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 here.

April 2023, the COM presented legislative proposals in this regard.[6] In its fiscal policy guidance for 2024, issued on 8 March 2023, the COM suggests that fiscal policy should ensure medium-term debt sustainability and promote sustainable and inclusive growth.[7] Also, Member States were invited to set out their fiscal targets in Stability Programmes which already factor in the Commission's reform orientations and outline reform and investment plans, particularly those to facilitate the green and digital transitions. Indeed, in its guidelines on the design of fiscal policy, the COM recommended that the Stability or Convergence Plans for the period 2023-2026 should already include medium-term structural-fiscal plans to guarantee that debt remains on a plausible downward and continuous path or at prudent levels, and that the deficit should fall to below 3% in the period covered by the Stability Programme and remain below this reference rate, at constant policies, in the medium term.

As per EU regulation No 473/2013, the government's official macroeconomic forecasts must be endorsed by an independent institution. The FRA mandates the MFAC to perform this endorsement. In this respect, on 01 May 2023, the Chairperson of the MFAC addressed a letter to the MFE confirming that based on the information available by that date, and after considering the inherent risks and uncertainty surrounding the macroeconomic projections, the Council considers the full set of macroeconomic projections for the period 2023 to 2026 prepared by the MFE as part of the Update of the Stability Programme 2023 – 2026, to lie within its endorsable range.[8] This Report contains the analysis carried out to support the endorsement of the macroeconomic projections. It also contains the assessment pertaining to the endorsement of the fiscal forecasts over the same forecast horizon.[9]

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[6] The proposals include the following legislative acts:
A proposal for replacing Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (this is the Regulation that establishes the European Semester and "the preventive arm" of the Stability and Growth Pact). A proposal for amending Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (known as "the corrective arm" of the Stability and Growth Pact). A proposal for amending Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States. The proposed legislation can be accessed here.

[7] The fiscal policy guidance for 2024, can be accessed here.

[8] A copy of the letter is available on the MFAC's website, here.

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

This Report has a cut-off date of 24 May 2023 and is structured in the following manner. **Chapter 2** provides an overview of the methodologies used by the MFE to prepare the official forecasts and reviews the assumptions and risk scenarios employed. **Chapter 3** provides an assessment of the macroeconomic forecasts, identifying possible risks to the main variables. **Chapter 4** compares the macroeconomic outlook to that published in October in the DBP. It also compares the forecasts to those produced by other reputable institutions. **Chapter 5** focuses on the fiscal projections for the forecast years, examining the plausibility of the main revenue and expenditure components. This is followed by an evaluation of the resulting fiscal balance and a review of public debt dynamics, identifying possible risks. **Chapter 6** compares the fiscal scenario presented in the USP to that outlined in the DBP, and to the latest fiscal forecasts published by other reputable institutions. **Chapter 7** presents the Report's conclusions.

Chapter 2
Forecast methodologies and assumptions

2.1 Preparation of the macroeconomic forecasts

The methodology utilised by the MFE to generate macroeconomic estimates remained unchanged from previous forecast rounds. The MFE relies primarily on STEMM (Short-Term Quarterly Economic Forecasting Model) to produce its macroeconomic projections.[10] STEMM is a quarterly demand-driven model. The MFE routinely revises the model equations to ensure that they reflect the latest macroeconomic underpinnings and relationship developments that impact the Maltese economy and the external sector.

The model solution and forecasts are based on several exogenous assumptions about the external economy produced by Consensus Economics and the European Central Bank (ECB) as outlined in the following section. The model enables expert judgment based on ad hoc data and routine discussions with key stakeholders, namely government departments, authorities, and the private sector. Expert judgement is crucial given Malta's small size and high level of openness, as it bridges the gaps not addressed by an aggregate demand model, including supply-side factors which may significantly influence the Maltese economy. The value added, employment, investment plans, and trade prospects at a sectoral level, which are influenced by highly explicit factors, are significantly shaped by expert judgement.

Over the forecast horizon, there is an element of uncertainty, substantiating the use of expert judgment. In particular, in the current scenario, global economic growth could be hampered by the possibility of an escalation in the conflict between Russia and Ukraine, further geopolitical fragmentation, and continued tightening of financial conditions by global Central Banks due to inflationary pressures. In addition, the recent financial events in the US banking system, although the shock has been relatively contained, has added a new headwind risk for global economic growth. Moreover,

[10] The MFE also developed seven alternative forecasting models, ranging from model-free statistical forecasts (2 Holt-Winters Seasonal Smoothing Method), model-based univariate forecasts (2 ARIMA models), and model-based multivariate forecasts (3 VAR models). These models are used by the MFE to corroborate the results attained using their core econometric model.

while inflationary pressures abroad have started to abate, core inflation remains high, posing a further stumbling block for short-term economic growth as tight monetary financial conditions are expected to persist. These factors further accentuate the requirement for expert judgement as historical empirical relationships may not be able to account fully for these one-off developments. Thus, the role of expert judgment is even more essential when it comes to volatile economic drivers like gross fixed capital formation and specific industries like tourism, as they are particularly more vulnerable to these shocks due to their high degree of openness. The manufacturing industry and various other service sectors which are export-oriented are more susceptible to shocks in the international environment.

2.2 Assumptions underpinning the macroeconomic forecasts

The macroeconomic forecasts are generated using exogenous assumptions which are sourced from authoritative and reputable sources.[11] The main source for the assumptions relating to the euro exchange rate in relation to the US dollar and sterling, world prices, oil prices, and real GDP growth of Malta's main trading partners were based on the March 2023 edition of the Consensus forecast.[12] In addition, projections for short and long-term interest rates were sourced from the ECB. The trajectories of the exogenous variables assumed in the USP are compared to the figures used in the last published DBP (see Chart 2.1).

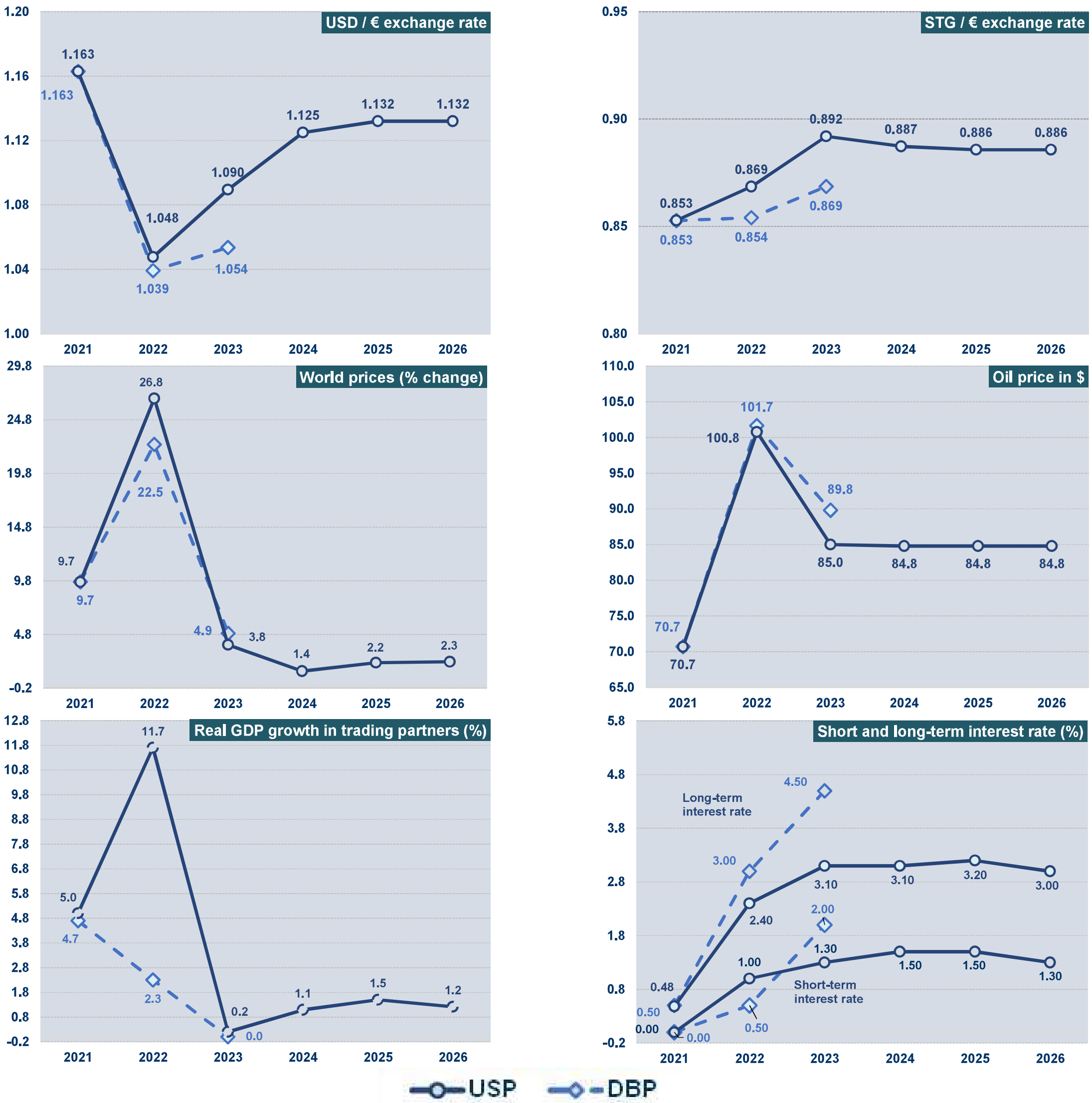
The USP assumes the euro to appreciate against both the US Dollar (USD) and the Pound Sterling (STG) in 2023 by more than what was assumed at the time of the DBP. The expected appreciation of the euro in 2023 over 2022 is stronger vis-à-vis the US Dollar than the Pound Sterling. The euro is expected to continue to appreciate in relation to the US Dollar in both 2024 and 2025 while it is expected to remain stable in 2026. In contrast, the euro is expected to have a slightly weaker value with respect to the Pound Sterling across the forecast horizon.

In 2022, world prices increased by 26.8%, around 4.3 percentage points (pp) higher than assumed in the DBP. On the other hand, compared to the DBP, world prices for

[11] The cut-off date for the exogenous assumptions used by MFE is 13 March 2023.
[12] The monthly publication by Consensus Economics surveys professional forecasters for their estimates of a range of macroeconomic variables.

2023 were revised slightly downwards but are still projected to increase by 3.8%. Thereafter, world prices are anticipated to rise at lower steady rates of 1.4% in 2024, 2.2% in 2025, and 2.3% in 2026. At the same time, the price of Brent crude oil is expected to fall from $100.9 per barrel in 2022 to $85.0 per barrel in 2023, which is lower than anticipated in the DBP. In 2024, the price of oil is assumed to decrease slightly to $84.8 per barrel and remain at that level over the outer forecast years.

Chart 2.1: Main macroeconomic assumptions



Note: The DBP presents forecasts for 2022 and 2023 thus, the assumptions covered only these two years. The USP shows actual estimates for 2021 and 2022 while 2023-2026 represent forecasts.
Source: MFE

Following the 11.7% increase in the economic growth of Malta's main trading partners in 2022, the MFE is expecting this growth to slow down considerably to 0.2% in 2023, albeit slightly higher than the zero-growth expected in the DBP. The USP assumes that growth will pick up slightly in 2024 and 2025, to 1.1% and 1.5%, respectively and fall slightly in 2026 to a growth rate of 1.2%. The trajectories for the short-term and long-term interest rates projected in the USP are lower than those assumed in the last forecast round. Indeed, the short-term interest rate is projected to continue rising in 2023 to 1.3% before expanding even further to 1.5% in 2024. It is expected to remain constant in 2025 and decelerate again to 1.3% in 2026. With regards to the long-term interest rate, it is expected to increase to 3.1% in 2023 and remain relatively stable across the forecast horizon to reach 3.0% in 2026.

Apart from the assumptions relating to the exogenous variables, the MFE consistently adopts another assumption relating to inventory adjustments.[13] As is per established practice, in the April forecast round, the MFE assumes that inventory changes do not contribute to GDP growth. This assumption is retained across all forecast years.

To shape its macroeconomic forecast projections, the MFE makes additional assumptions based on expert judgement. Indeed, the MFE is assuming inflationary pressures to be sticky throughout 2023. However, this is not expected to lead to a wage-price spiral effect.

The MFE indicated that some upward price pressures are expected to resume towards the end of the forecast horizon. This is consistent with the rise in import prices brought on by the implementation of different regulatory measures related to emissions that will alter the cost of shipping. In addition, over the forecast horizon, no inflation in the energy component is projected since energy subsidies by the government are anticipated to remain over the course of the programme period. Another important assumption made by MFE relates to inbound tourism. Whereas in the previous forecast round, inbound tourists were expected to remain below the 2019 levels in 2023, in this forecast round the MFE expects the number of inbound tourists in 2023 to surpass pre-pandemic levels.

[13] In the compilation of national accounts data, inventory changes include the effect of changes in actual inventories as well as any statistical errors.

2.3 The preparation of the fiscal forecasts

The fiscal forecasting procedure was conducted using an approach similar to that utilised in previous years. The process continued to be based on the input provided by line ministries, working along the Consolidated Fund framework. Amounts to be received and those payable are provided by government departments and entities. Estimates are then produced based on historical patterns, expert opinions and projections, updates for specific governmental measures and changes in legislation, and outstanding debtor and creditor amounts, among other factors.

European System of National and Regional Accounts (ESA) based forecasts are also produced. Revenue line items are forecasted using estimated relationships with the corresponding macroeconomic proxy bases. These top-down computations keep the budgetary projections and the official macroeconomic outlook consistent. Accordingly, the fiscal forecasts must be reported in ESA terms for official purposes, even though the Consolidated Fund figures are primarily used in Malta to develop and guide the budgeting process.[14]

Various estimates based on different macroeconomic and fiscal scenarios are also considered. A final decision is then taken to select the revenue and expenditure estimates consistent with the baseline macroeconomic outlook which are deemed achievable and appropriate to serve as the official fiscal targets.

In terms of forecast preparation, the fiscal forecasts are prepared in nominal terms. In view of national and EU requirements, such forecasts are also converted in structural terms, thus corrected for economic cycle effects and temporary and one-off measures. By means of the proposed economic governance reforms, the 'nationally-financed net primary expenditure' shall be at the centre of the government's fiscal forecast preparation in future rounds.[15] Indeed, in this USP, the MFE has included an estimate of this variable's average growth over the medium-term, at 3.9%. This follows the

[14] Developments in the Consolidated Fund are not directly comparable to official statistics based on ESA. The former is primarily cash-based, while ESA has broader coverage and includes accrual adjustments.
[15] The 'nationally-financed net primary expenditure' is defined as expenditure net of discretionary revenue measures and excluding interest expenditures as well as cyclical unemployment expenditure and expenditure on Union programmes fully matched by revenue from Union funds.

recommendation to start factoring in the proposed economic governance reform from this forecast round, though not yet a legal obligation.

An important government policy with a considerable bearing on the budget balance has been the decision to insulate the economy from the effects of the increase in international energy prices. The current forecasts reflect the assumption that the government maintains its commitment to continue supporting the economy by providing price support measures, particularly to the energy sector.

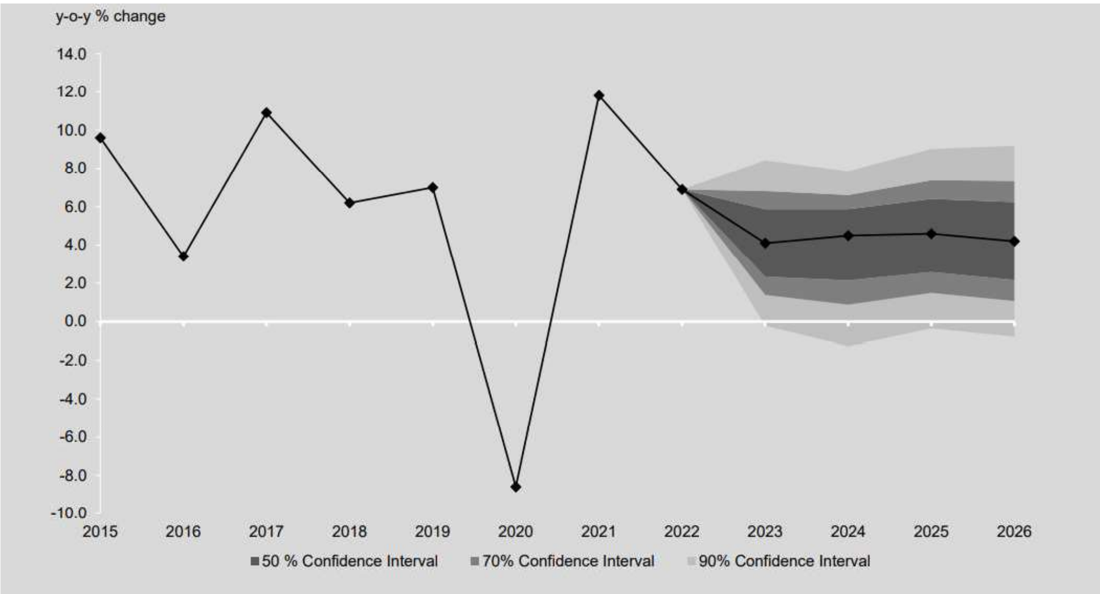
2.4 Risk outlook presented by MFE in the Update of Stability Programme

Any deviation from the assumptions used by the MFE could cause the macroeconomic and fiscal outcomes to differ from the outlook as outlined in the official forecasts. For this reason, the USP proposes a range of real GDP growth and fiscal balance outcomes that could occur contingent on alternative, more favourable or negative scenarios than the baseline (see Chart 2.2 and Chart 2.3). The distinct scenarios taken into consideration by MFE included: (i) different rates for global economic growth; (ii) higher interest rates; (iii) improved medium-term private investment; (iv) appreciation of the euro; (v) higher disposable income; (vi) persistent inflation; (vii) lower inflation; (viii) a more upbeat tourism outlook; and (ix) higher labour supply growth.

In general, all scenarios point toward a positive real GDP growth in 2023 at the 50.0% and 70.0% confidence levels. The wider range of estimates calculated for the forecast years portrays real GDP growth rates which are mostly positive but also include negative growth rates at the 90.0% confidence level. The balance of risks is neutral for 2023 and 2026, and downside for 2024 and 2025.

Regarding the fiscal outlook, the estimated range for the balance (the MFE use the same alternative scenarios as the real GDP growth fan chart) suggests that the fiscal deficit may either decrease or widen throughout the period 2023-2026. The risks are rather balanced over the forecast years, with the budgetary target standing close to the middle of the probabilistic fan. However, risks tilt slightly on the upside in 2023 and 2024, thus more towards a better balance, but slightly on the downside in the outer years. It is important to note that this analysis only considers alternative macroeconomic scenarios and does not consider any specific fiscal risks that may arise.

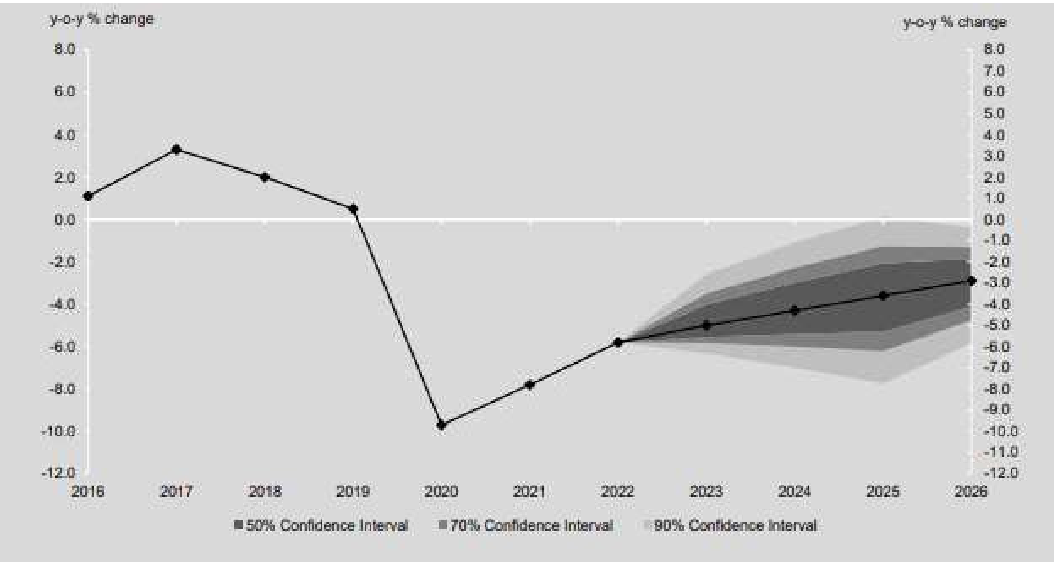
Chart 2.2: Alternative real GDP growth forecasts (%)



Note: Reproduced from USP Chart 4.1, page 53

Source: MFE

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



Note: Reproduced from USP Chart 4.2, page 53

Source: MFE

Chapter 3

Assessment of the macroeconomic forecasts 2023 – 2026

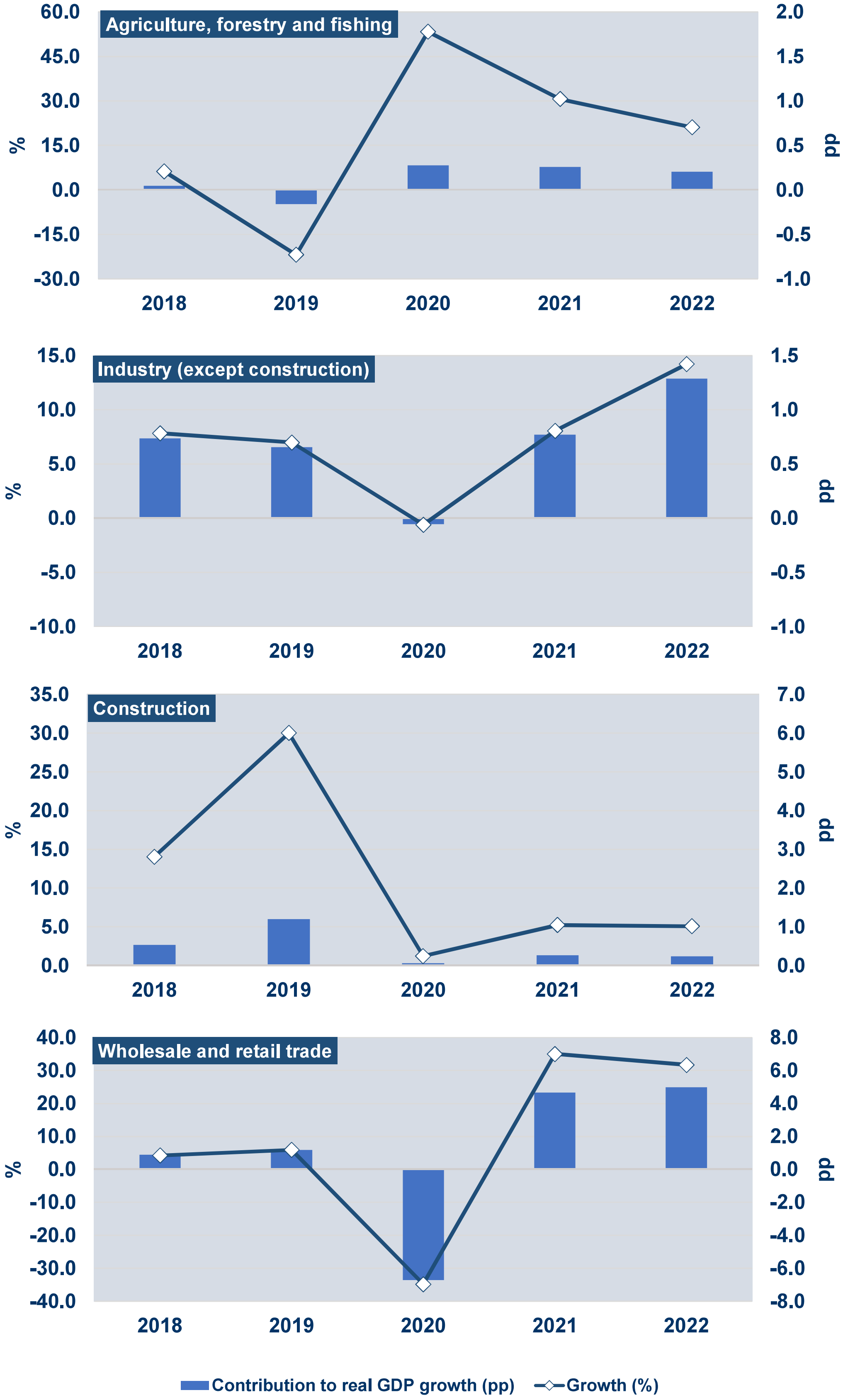
3.1 Macroeconomic outlook 2023 – 2026

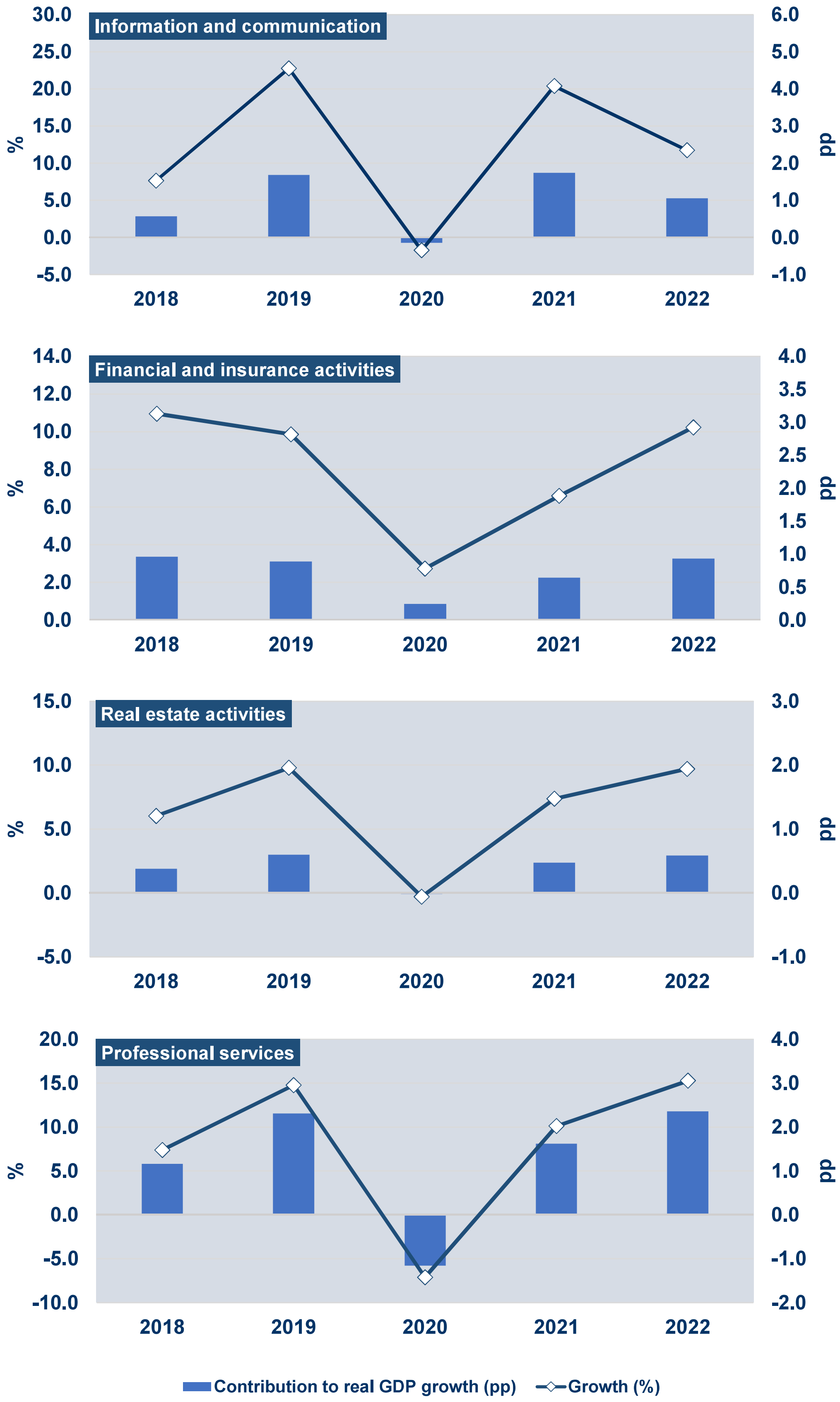
In 2022, the Maltese economy continued to expand strongly, albeit at a slower pace than recorded in 2021, growing by 6.9% in real terms and 12.5% in nominal terms. Domestic demand was the principal contributor to economic growth in 2022, contributing to 10.9 pp of GDP growth. On the other hand, the external demand and inventory components impacted economic growth negatively by 4.0 pp and 0.1 pp, respectively.

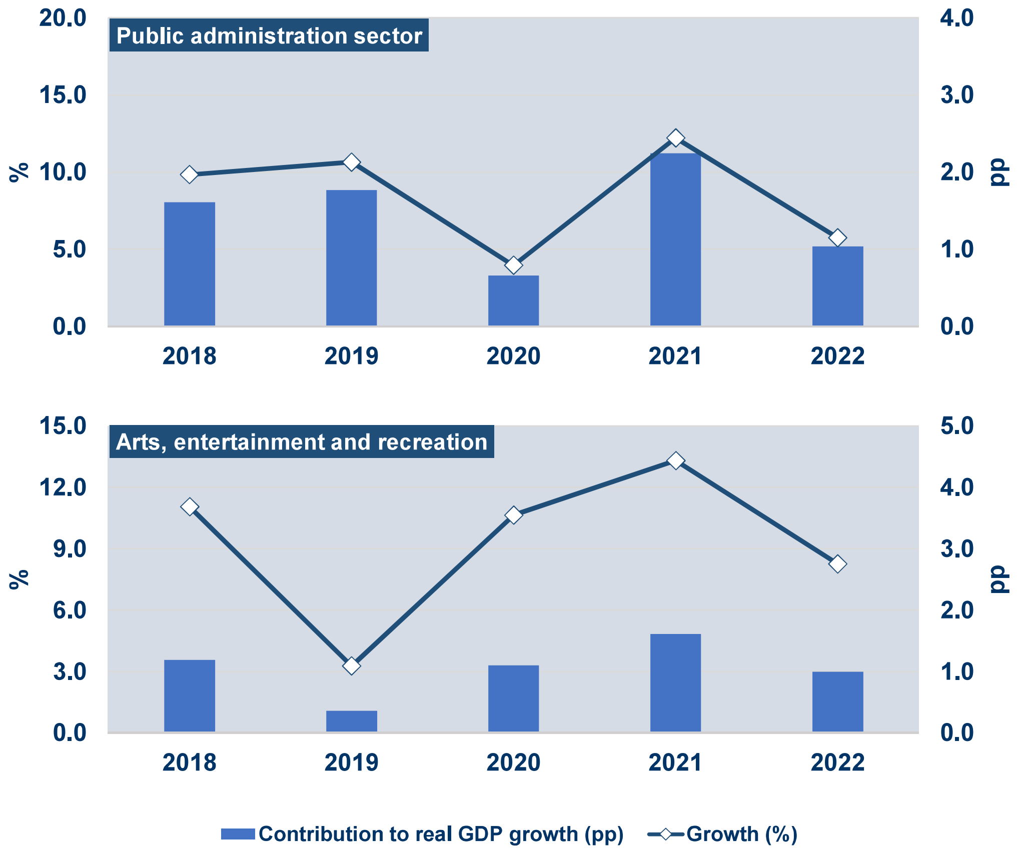
From the output approach, nominal Gross Value Added (GVA) expanded by 13.7% in 2022. Growth in GVA was broad-based, with its key contributors being the 'wholesale and retail trade, transport, accommodation, and food service activities' (5.0 pp) and 'professional services' (2.4 pp). Tourism-related activities and other contact-intensive service industries, which were negatively impacted by the pandemic, continued to recover strongly. Indeed, the 'wholesale and retail trade, transport, accommodation, and food service activities' sector grew the most in 2022, by 31.7%, followed by the 'agriculture, forestry and fishing' (21.0%), manufacturing (16.2%) and 'professional, scientific and technical activities services' (15.3%) (see Chart 3.1).

During 2022, economic growth was hindered by the COVID-19 outbreak in China, the global economic recovery from the pandemic, and the conflict between Russia and Ukraine, which increased further inflationary pressures. The Russia-Ukraine conflict is still expected to be present in 2023, along with global central banks' tightening of financial conditions in order to address inflationary pressures. Nonetheless, the re-opening of the Chinese economy might spur growth given that trade disruptions may subside.

Chart 3.1: Growth of GVA by sector and contribution to growth




Information and communication
Financial and insurance activities
Real estate activities
Professional services
%
pp
2018
2019
2020
2021
2022
Contribution to real GDP growth (pp)
Growth (%)



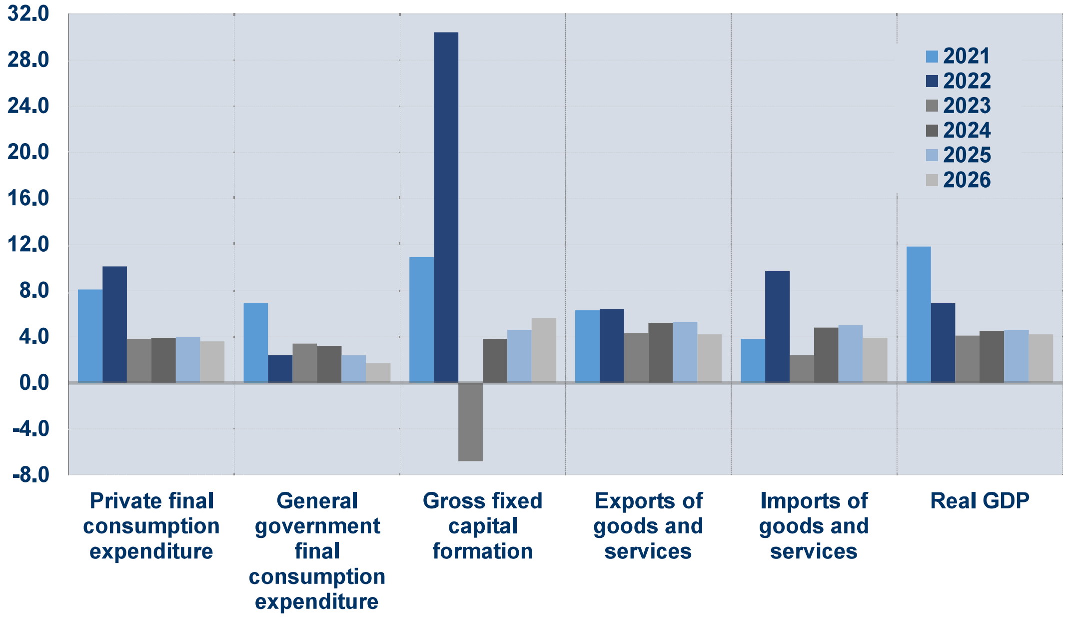
Source: Eurostat and MFAC calculations

Following the rebound in economic growth in 2021, the MFE forecasts real GDP to continue to grow by 4.1% in 2023, resulting in the output gap becoming negative to -0.1%. In 2024 and 2025 real GDP is expected to expand by 4.5% and 4.6% respectively, moving down the output gap to -0.4%. However, real GDP growth is projected to ease to 4.2% in 2026, widening the output gap even further to -0.8%. Nominal GDP growth is expected to rise by 8.6% in 2023 and 7.7% in 2024. In the outer forecast years, nominal GDP growth will moderate to 7.2% and 7.0%, respectively.

In 2023, all GDP expenditure components are expected to grow save for gross fixed capital formation, which following an increase of 30.4% in 2022, is forecasted to contract by 6.8%. The sizeable increase in 2022, is due to a one-time investment in machinery and equipment, creating a significant base effect in the following year.

Private consumption in real terms is expected to grow by 3.8% in 2023 which is considerably lower than the growth registered in 2022. Although a higher compensation per employee is projected for 2023 (5.3%), inflationary pressures are still anticipated to be high (5.7%) such that lower disposable income per household is expected, leading to lower private consumption. Nonetheless, a buoyant labour market and sustained population growth is expected to keep private consumption growth positive. Government consumption is expected to increase by 3.4% in 2023, mainly driven by increases in intermediate consumption and compensation of employees. Real exports are expected to rise by 4.3% in 2023, steered by a favourable tourism outlook following the stronger-than-anticipated tourism levels achieved in 2022. Meanwhile, as regards exports of goods, the reopening of China and the reduction of supply disruptions may balance losses in the competitiveness of European exports due to a stronger euro. Finally, developments in domestic and external demand are expected to lead to an increase of 2.4% in imports of goods and services. (See Table 3.1 & Chart 3.2).

Chart 3.2: Growth rates of real GDP components – chain-linked volumes (%)[16]



Source: MFE

[16] Figures for 2021 and 2022 are actual, while figures for 2023 to 2026 are forecasts

Table 3.1: Macroeconomic variables 2021 – 2026 (%)

	2021	2022	2023	2024	2025	2026
Real GDP components						
Private final consumption expenditure*	8.1	10.1	3.8	3.9	4.0	3.6
General government final consumption expenditure	6.9	2.4	3.4	3.2	2.4	1.7
Gross fixed capital formation	10.9	30.4	-6.8	3.8	4.6	5.6
Exports of goods and services	6.3	6.4	4.3	5.2	5.3	4.2
Imports of goods and services	3.8	9.7	2.4	4.8	5.0	3.9
Real GDP	11.8	6.9	4.1	4.5	4.6	4.2
Contribution to real GDP growth						
Domestic demand (pp)	7.2	10.9	0.6	3.2	3.3	3.2
Inventories (pp)	-0.3	-0.1	0.0	0.0	0.0	0.0
Net exports (pp)	4.9	-4.0	3.5	1.2	1.3	1.0
Deflators						
Private final consumption expenditure	1.2	5.4	5.3	3.3	2.3	2.5
General government final consumption expenditure	2.3	3.9	2.3	2.4	2.4	2.7
Gross fixed capital formation	2.5	6.7	2.7	1.7	1.1	1.4
Exports of goods and services	2.0	4.7	3.3	2.8	2.4	2.6
Imports of goods and services	2.0	4.7	2.9	2.5	2.2	2.4
GDP deflator	1.9	5.2	4.3	3.0	2.5	2.6
Labour market						
Employment (National Accounts definition)	2.9	6.0	3.5	3.7	3.7	3.6
Unemployment rate (%) (LFS definition)	3.4	2.9	3.0	3.1	3.1	3.1
Nominal compensation of employees	7.8	9.4	9.0	7.8	6.7	6.5
Nominal compensation per employee	4.6	2.8	5.3	3.9	2.8	2.8
Labour productivity (real GDP per person employed)	8.6	0.8	0.6	0.7	0.8	0.6
Other macroeconomic variables						
Inflation rate (%) (based on the HICP)	0.7	6.1	5.7	3.5	2.0	2.4
Nominal GDP	13.9	12.5	8.6	7.7	7.2	7.0

Note: Figures for 2021 and 2022 are actual, while figures for 2023 to 2026 are forecasts. All figures are sourced from MFE.

* Includes Non-Profit Institutions Serving Households (NPISH)

Source: MFE and National Statistics Office (NSO)

Strong labour market expansion, sustained population increase, and a further ease in inflation are expected to continue to impact private consumption positively with growth anticipated at an average of 3.8% in the outer forecast years. General government consumption will further expand by 3.2% in 2024, while it is expected to rise by an average of 2.1% in the outer forecast years. Although uncertainty and higher financing costs continue to be prevalent, business and investor sentiment is expected to improve in 2024. As a result, gross fixed capital formation is forecasted to rebound by 3.8% in 2024. In the outer years, investment is anticipated to stabilize and expand by an average of 5.1%. Export growth is estimated to average 5.3% in 2024 and 2025 before dipping to 4.2% in 2026. This is on the back of an improvement in world GDP that is expected to influence exports positively. Imports are expected to increase by an average of 4.9% in 2024 and 2025, in line with domestic and export activity, before declining to 3.9% in 2026.

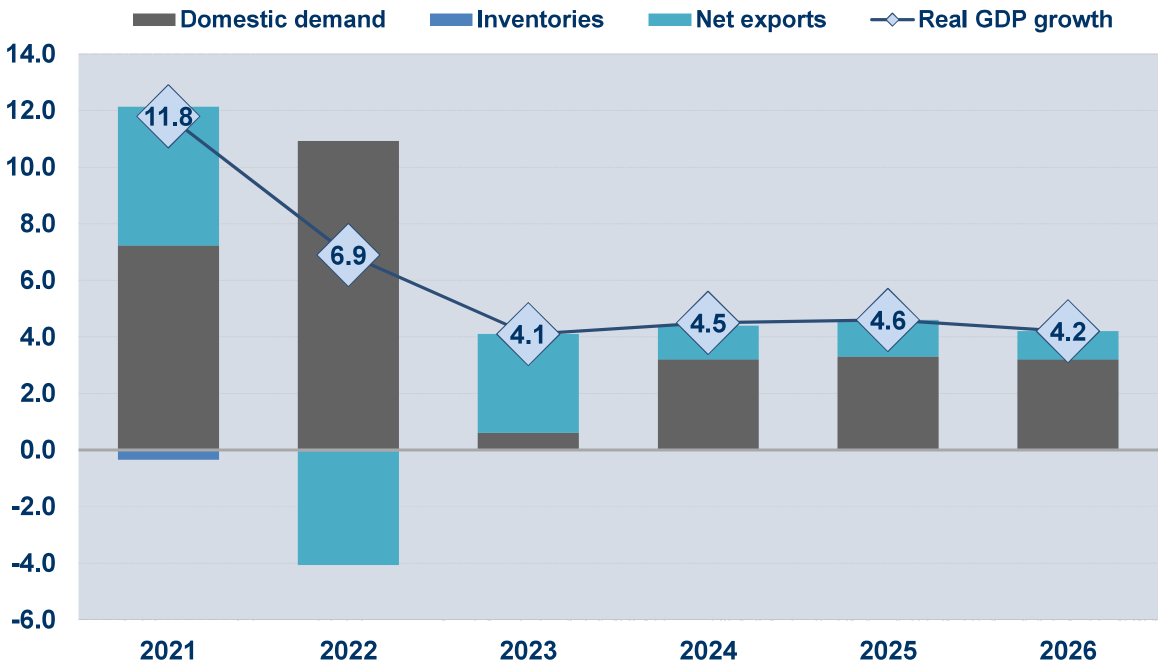
The labour market is anticipated to remain tight, resulting in an average employment growth rate of 3.6% during the projection horizon. The unemployment rate is projected to be 3.0% in 2023 and to keep on hovering at this rate over the outer forecast years.

Inflation is forecasted to remain sticky in the short term due to a tight labour market and the staggered nature of wage and rent contracts. The inflation rate is expected to return closer to the ECB's price stability target of 2.0% in 2025 and 2026.

With a projected contribution of 3.5 pp in 2023, the economy's external sector is anticipated to be the main driver of real GDP growth. The domestic side will still contribute positively to real economic growth, but to a lower extent at 0.6 pp. No growth contribution is anticipated from the changes in the inventories component over the forecast horizon.

In contrast to 2023, in the outer forecast years, domestic demand is expected to be the main contributor to real GDP growth, however, net exports are still expected to contribute positively, albeit to a smaller degree. On average, in the outer forecast years, the domestic economy is expected to contribute 3.2 pp to real GDP growth, while the external side of the economy is anticipated to contribute around 1.2 pp to real GDP growth (See Chart 3.3).

Chart 3.3: Contributions to real GDP growth (pp)



Source: MFE

3.2 Private consumption

In 2021, private consumption recorded a growth rate of 8.1% in real terms, followed by stronger rate of 10.1% in 2022. This growth reflected the buoyancy of the labour market and strong increases in compensation per employee which were only partly counteracted by inflationary pressures in 2022.

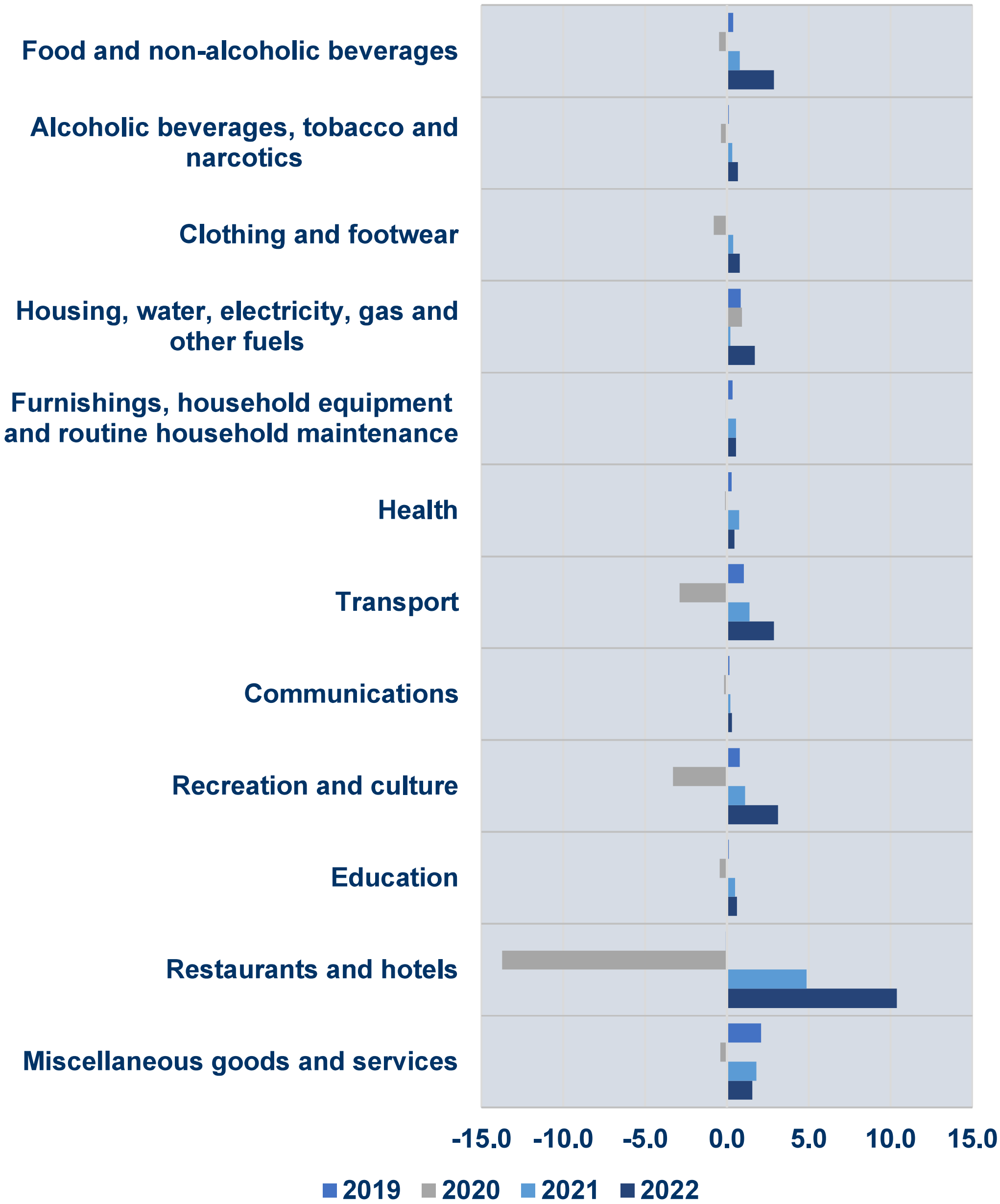
Data on the Classification of Individual Consumption by Purpose (COICOP) show that the nominal growth in private consumption in 2022 was broad-based, with most components recording double-digit growth. Similar to 2021, the highest contributor to growth was consumption in restaurants and hotels (10.4 pp), followed by recreation and culture (3.1 pp), transport (2.9 pp) and food and non-alcoholic beverages (2.9 pp) (see Chart 3.4). Interestingly, these consumption items were among the most impacted during the pandemic and had recorded significant negative contributions to nominal growth in private consumption. However, all consumption expenditure items recorded higher pre-pandemic levels in 2022, save for restaurants and hotels, which stood at 96.4% of the level in 2019.[17]

In 2023, the MFE is projecting the growth in real private consumption expenditure to moderate to 3.8%, supported by population growth and a buoyant labour market. This growth rate needs to be seen within the context of strong growth rates over the previous two years, rising interest rates, and declining real incomes due to high inflation. Indeed, the deflator for private consumption is expected to follow the trajectory of inflation and increase by 5.3% in 2023, the highest deflator increase among all expenditure components.

In the outer forecast years, the labour market is set to remain buoyant, being supported by foreign workers. In fact, economic growth is expected to remain rather job rich while the unemployment rate is expected to remain hovering at the 3.0% rate. The tight labour market conditions are expected to lead to real increases in compensation per employee, with the pressures from a tight labour market and relatively strong inflation, being eased by foreign labour supply. Reflecting these developments, over the outer years, private consumption expenditure is projected to increase by an average of 3.8% per annum.

[17] COICOP expenditure item 'Restaurants and hotels' is heavily related to tourism. It is worth pointing out that 2019 was a record year for tourism in Malta, having attracted more than 2.7 million tourists.

Chart 3.4: Contributions to nominal private consumption growth (domestic concept) – COICOP (pp)[18]



Source: NSO

[18] The nominal domestic private consumption growth by COICOP categories includes consumption by non-resident households on the economic territory and excludes consumption by resident households in the rest of the world. Nominal private consumption expenditure used to derive the GDP excludes consumption by non-resident households on the economic territory and includes consumption by resident households in the rest of the world. As a result, these two measures of private consumption indicate different growth rates for 2019 - 2022.

3.3 Government consumption

Supportive fiscal policy during the COVID-19 pandemic led to an increase in real government consumption expenditure of 6.9% and 2.4% in 2021 and 2022, respectively. These increases were mainly on the back of increases in compensation of employees and intermediate consumption.

Real government consumption is expected to grow by 3.4% in 2023 and then decelerate progressively over the forecast horizon to reach 1.7% in 2026. The specific factors explaining such an outlook can be traced to the budgeted amounts for the items which make up government consumption.[19] 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 on average by around 2.5% per annum, the expected developments in real and nominal government consumption follow a similar pattern.

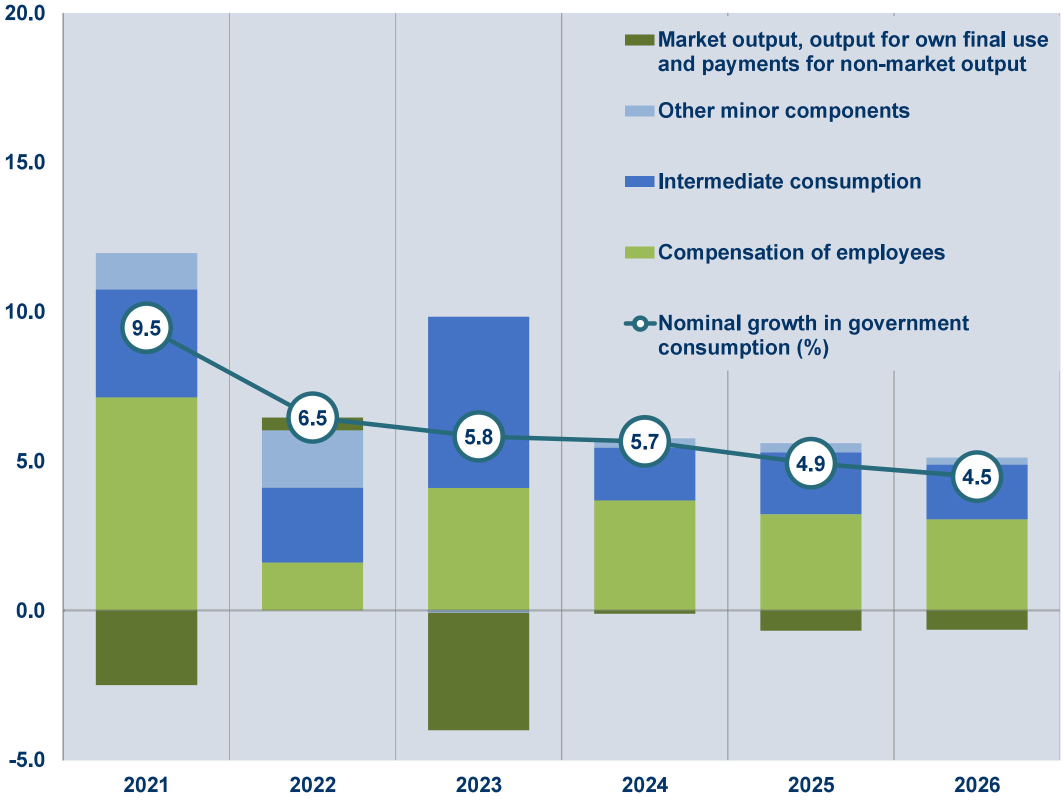
The budgeted allocations underpinning the USP lead to an estimated 5.8% growth in nominal government consumption in 2023, only slightly lower when compared to the 6.5% nominal growth recorded a year earlier (see Chart 3.5).[20] In 2023, increments are expected in all components of government consumption, apart from consumption of fixed capital which is anticipated to fall slightly. In 2023, the main contributors to growth are expected to be intermediate consumption and compensation of employees, which are expected to increase substantially compared to a year earlier. Nonetheless, the expected higher market output in 2023 compared to 2022 outweighs the increased expenditure in these components and thus contributes to lower government consumption growth. In the outer forecast years, all government consumption expenditure components are expected to increase slightly year-on-year at a slower

[19] Government consumption is made up of intermediate consumption, compensation of employees, consumption of fixed capital and social transfers in kind, less market output, output for own final use and payments for non-market output. Refer to Chapter 5 in this Report for an assessment of the forecast trajectory for the relevant budget components.

[20] 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 USP and which are assessed in Chapter 5 of this Report. The growth rate for 2021 and 2022 which are quoted in the text are not identical to that indicated in the GDP statistics published by NSO through News Release 036/2023. Since the macroeconomic forecasts are finalized before the detailed fiscal forecasts, Table 2.1 of the USP quotes the slightly different nominal growth rates for government consumption in 2021 and 2022, respectively, 9.4% and 6.4%.

pace, including market output, which explains the slight reduction in growth in each forecast year from 2024 to 2026.[21]

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



Source: MFE

3.4 Gross fixed capital formation

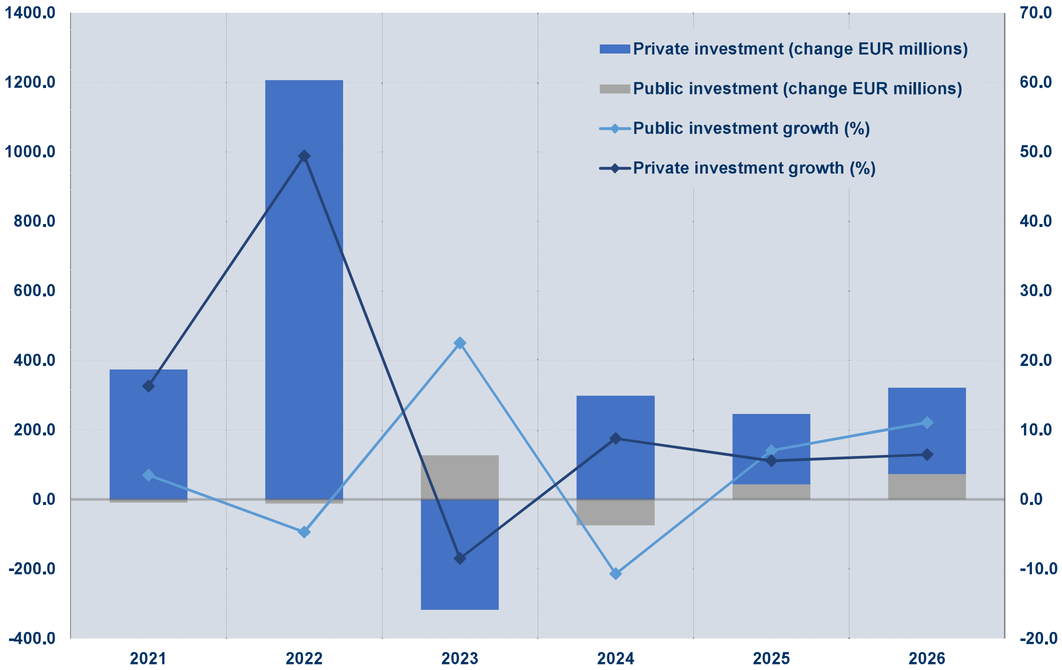
Following a significant expansion of 30.4% in 2022, driven by one-off investments in machinery and equipment, real investment is expected to contract by 6.8% in real terms in 2023. On the other hand, the MFE's forecast expects real investment to grow by 3.8% in 2024, 4.6% in 2025 and 5.6% in 2026.

[21] When estimating the value of government consumption, certain items (market output, output for own final use and payments for non-market output) are deducted from the other expenditure components. Since the USP assumes that in 2023 the total for these items will be higher than in 2022, this corresponds to a deduction of a larger value, thus explaining the downward push in government consumption resulting from these sources.

For 2023, the MFE is projecting a contracting growth rate for investment, partly as a result of the large base effect for 2022, while the high uncertainty and tighter financial conditions are expected to lead to the deferral of several one-off projects. Despite the uncertainty and higher financing costs which are still expected to prevail in 2024, the MFE is assuming that business sentiment will improve, also considering the relatively strong economic growth expected for the year, leading to a partial recovery in investment. Indeed, in the outer forecast years, real growth in investment is expected to stabilize, averaging 5.1% in the period 2024 to 2026. The forecasts for gross fixed capital formation embody information on the utilisation of the Recovery and Resilience Facility (RRF) funds as well as projects funded from the Multiannual Financial Framework (MFF). Indeed, the USP assumes gross fixed capital formation financed from the RRF grants to be 0.5% of GDP in 2023, 0.6% of GDP in 2024, 0.4% of GDP in 2025 and 0.1% of GDP in 2026.

Information about investment spending in nominal terms suggests that in 2023, the bulk of the expected reduction in investment is projected to stem from the private sector (see Chart 3.6). Indeed, the projected growth rate for private investment in 2023 is -8.5% compared to the 22.5% expected growth in public investment. The fall in private investment is mainly the result of the base effect previously identified from the one-off large investment in 2022, while the relatively strong growth in public investment reflects the utilisation of RRF funds as well as the closure of the 2014 – 2020 financial programme.

Chart 3.6: Public and private sector investment in nominal terms



Note: Data for 2021 and 2022 refers to actual data, whilst 2023 to 2026 represent forecasts by the MFE. The MFAC calculates private investment as a residual of total investment minus public investment.
Source: MFE and MFAC calculations

On the other hand, most of the change in 2024 emanates from higher private investment (8.8%), as opposed to public investment growth, which is expected to contract by 10.7%. In the subsequent two years, both private and public investment are expected to record positive growth, but the contribution of private investment is expected to be stronger.

Amongst the GDP expenditure components, gross fixed capital formation has exhibited the most volatility over the past years. Significant swings were recorded, whereby growth has been extraordinary at times, whilst in other years it was negative, even pre-pandemic. Such inherent volatility makes it more challenging to produce accurate forecasts for this component. The MFE's approach is to factor in only one-off projects with a high probability of realisation while assuming a relatively high import content.[22] As a result, the contribution from investment to real GDP growth is assumed limited across the forecast period. This reduces the risk that discrepancies in this component spill over to the overall GDP growth forecast.

[22] For most of the one-off investment projects, the MFE assumes an import content of between 75% and 95%.

3.5 Exports of goods and services

Real exports of goods and services increased by 6.4% in 2022, sustaining the trend of expansion registered in 2021. Exports are anticipated to grow further by 4.3% in 2023, albeit at a slower rate than the previous year due to persistent price increases and a stronger Euro which reduce the competitiveness of exports and a significant deceleration in world GDP. In 2024 and 2025, real exports are forecasted to grow at a faster pace (5.2% and 5.3%) as global economic activity is expected to pick up. In 2026, exports are anticipated to grow by 4.2% due to a deceleration in the world GDP. The rate of increase in world prices is anticipated to subside significantly in the forecast years relative to the increase registered in 2022. Consequently, a decline in the deflator of exports is forecasted which impacts the anticipated trajectory of exports.

The forecast profile for exports is based on the expected developments in Malta's main trading partners. In 2022, the growth of real GDP in Malta's trading partners was revised upwards when compared to the last forecast round, outpacing the revisions in the exchange rates and export deflator. Partly, this explains the upward revision in export growth for 2023 relative to that forecasted in the DBP. Notably, Malta's growth in exports is significantly larger than the growth in world GDP as weighted by the country's main trading partners. This pattern is in line with the regression estimations which suggest that Malta's exports (for various categories) are likely to have a higher than unitary elasticity with respect to real GDP developments in Malta's main trading partners.[23] The growth trajectory of Malta's main trading partners for the forecast years is consistent with the growth trajectory for real exports, as both variables are projected to ease in 2023 and accelerate in 2024 and 2025 before slowing down again in 2026.

Export growth is mainly forecasted to be driven by the services sector, albeit the goods sector is still expected to contribute positively. The tourism sector accounts for a sizeable portion of the services industry. For 2022, the MFE in the DBP had forecasted tourism exports to reach 75.0% of 2019 levels. The most recent data shows that at the end of 2022, inbound tourism stood at 83.1% of pre-pandemic levels, surpassing initial expectations. Consequently, 2023 has a more upbeat outlook as inbound tourism numbers are expected to exceed pre-pandemic levels. However, despite the positive

[23] The report describing STEMM states that "the elasticity of world GDP on sectoral exports is relatively high when compared to literature, exacerbating the response of exports to changes in foreign demand". The Report is available here.

prospects, it is anticipated that global growth will remain subdued due to the fragile state of the financial markets and core inflation of European Union (EU) countries remaining high as seen in the first quarter of 2023, eroding the purchasing power of consumers.

The euro exchange rate assumed for the forecast years plays a role in shaping the growth forecast for exports. The euro is expected to appreciate against the sterling in 2023 and depreciate in the outer forecast years. The euro is forecasted to appreciate in all forecast years in relation to the USD. A stronger euro is anticipated to negatively impact exports by reducing the competitiveness of European exports.

3.6 Imports of goods and services

Real imports of goods and services grew by 9.7% in 2022, an acceleration of 5.9 pp compared to the growth in 2021. In 2023, growth in real imports of goods and services is anticipated to remain positive but slow down to a growth of 2.4% due to slight deceleration in exports when compared to 2022 and a slower domestic demand driven primarily by the base effect created by the significant investments that occurred in 2022. In 2024, imports are expected to move in line with domestic activity and increase by 4.8% in 2024 before averaging 4.5% in the outer forecast years.

Since Malta is a small and open economy, the expected dynamics in domestic demand, exports, and presumed imported content considerably impact the forecast trajectory for imports. Indeed, the growth of imports follows the growth trajectory of domestic and external demand, which growth is anticipated to be positive in the forecast years but at a less rapid pace than in 2022. The weakening of the euro vis-à-vis the Sterling in the outer forecast years further inflates the price of particular imports. The expansion in real imports only partially offsets the growth in real exports. Thus, it is projected that the external balance of goods and services as a percentage of GDP will be positive during the whole forecast period, improving annually.

The dependence of imports on exports and domestic demand implies that any deviation from the anticipated profile for the other GDP expenditure components could have a material impact on the growth rates for imports over the forecast horizon. This is especially true for investment, which has a significant import content in Malta.

3.7 Inflation and deflators

The Harmonized Index for Consumer Prices (HICP) inflation rate increased drastically from 0.7% in 2021 to 6.1% in 2022 (see Box A). The MFE anticipate that the HICP inflation rate will decelerate slightly to 5.7% in 2023. The slight fall in inflation for 2023 reflects declines in the prices of commodities and moderating economic activity, which is expected to gradually subside inflationary pressures. Given Malta's heavy reliance on cargo transportation via sea, the decline in freight rates registered in the second quarter of 2022 is expected to ease inflationary pressures. The increase in food prices, particularly unprocessed food and to a lesser extent, processed food continue to be the main factors contributing to the projected inflation rate for 2023. Another significant factor is services inflation, which is anticipated to remain high due to considerable wage growth.

Prices are expected to slow down throughout the rest of the forecast years. Indeed, in 2024, inflation is expected to decelerate to 3.5%, while in the outer forecast years, inflation is anticipated to return closer to the ECB's objective for price stability of around 2.0%. However, by the end of the forecast horizon, a slight increase in the inflation rate is projected as the MFE expects that there will be an increase in shipping costs due to the introduction of different regulatory measures concerning emissions, which will impact Malta owing to its openness to trade and insularity.[24] On the other hand, given the government's commitment to keeping utility prices stable by absorbing energy price increases, energy inflation is anticipated to remain zero for all forecast years.

The deflators of the different GDP components are all expected to exhibit heightened growth in 2023, albeit to a lower extent than in 2022, with the GDP deflator anticipated to register a 4.3% increase. The highest growth is expected to be recorded in the private consumption deflator (5.3%), while the lowest growth is anticipated to be in the government consumption deflator (2.3%) for 2023. Growth in the deflators is expected to scale back but remain within the range of 1.0% and 3.5% in the remaining forecast years.

[24] In 2024, emission regulations will go into effect. The Carbon Border Adjustment will also go into effect in 2025 and will be retrospectively applied for emissions in 2024. The European Emission Trading System and the FuelEU (part of the Fit for 55 package) provisional agreement to decarbonize the maritime industry will cover maritime transportation. Additionally, a sulphur emission control zone will be set up in the Mediterranean Sea to allow ships to use marine fuel with lower sulphur content.

Box A: Inflation Developments in 2022 and Short-Term Outlook

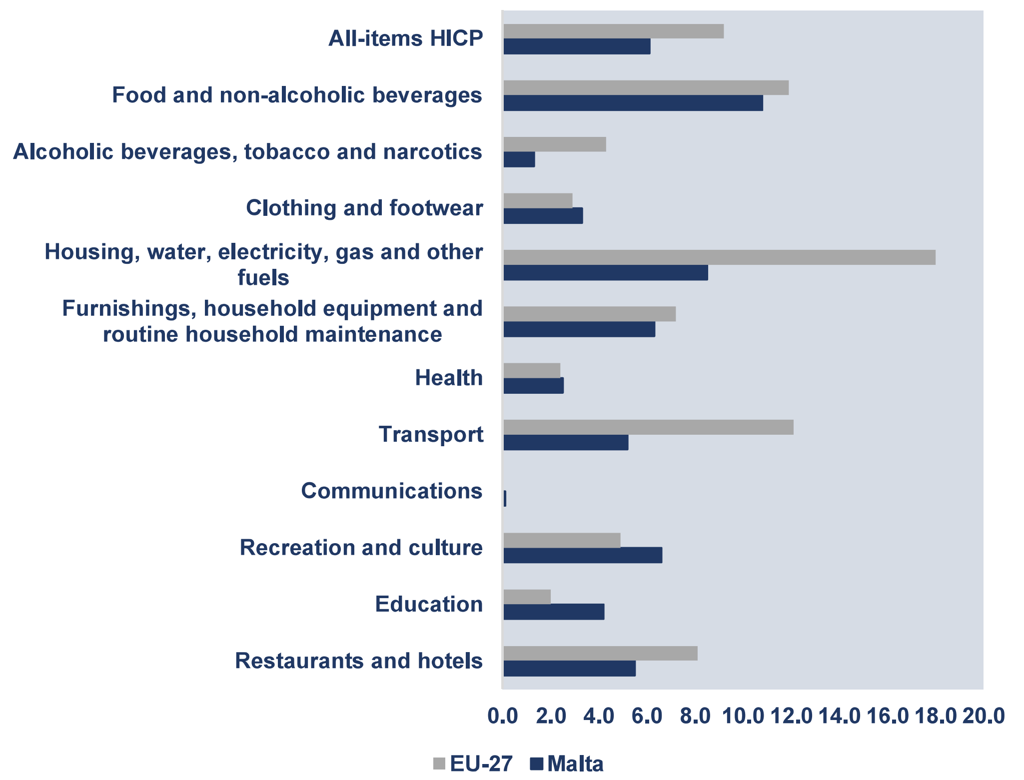
In 2022, the inflation rate determined by the HICP for Malta recorded an increase of 6.1% over the previous year. Prices of ‘food and non-alcoholic beverages’ had the highest increase out of all the composite items of HICP, increasing by an annual rate of 10.8%. Food inflation intensified significantly from 2021 to 2022, rising by 9.0 pp to 11.6%, and non-alcoholic beverages increased by 5.2 pp to 5.0%. The food items with the highest increases in inflation rates were oil and fats (16.4%), dairy goods (12.3%), bread and cereals (12.2%).[25] Another component that experienced rapid price increases is ‘housing, water, electricity, gas and other fuels’ with a growth of 8.5%, mostly emanating from increasing prices in maintenance and repair of dwellings and actual rentals for housing, followed by ‘recreation and culture’ which increased by 6.6%. The EU-27 registered an annual rate of change in the HICP inflation rate of 9.2%, which is 3.1 pp higher than the HICP inflation rate registered for Malta. The ‘housing, water, electricity, gas and other fuels’ division had the highest rate of change in the EU-27 inflation rate with 18.0%, followed by ‘transport’ (12.1%) and ‘food and non-alcoholic beverages’ (11.9%) (see Chart 3.7).

The Maltese Government is addressing the impact of rising energy costs by providing energy subsidies. This partly explains the 9.5 pp gap between Malta and the EU-27 in the inflation rate of ‘housing, water, electricity, gas, and other fuels’. Indeed, Malta had the biggest net budgetary impact of energy measures out of any EU country in 2022, at 2.9% of GDP, compared to the EU's budgetary impact of 1.2%.[26] Food price increases in the EU-27 (11.9%) were slightly greater than those in Malta (10.8%). The Maltese government provided subsidies on certain food items to partly counteract the international price hikes. Nonetheless, the increase is still significant which may partly be due to the upward pressure from heightened import costs that Malta faces as an island due to its insularity.

[25] These were all impacted by international price developments following Russia's invasion of Ukraine in February 2022.

[26] This information was presented to the MFAC by EUNIFI in a virtual meeting held on 17 March 2023 titled ‘Fiscal Support measures in response to high energy prices’. It is noteworthy that some EU countries have curbed food inflation through VAT reductions. Such measures have not been adopted in Malta.

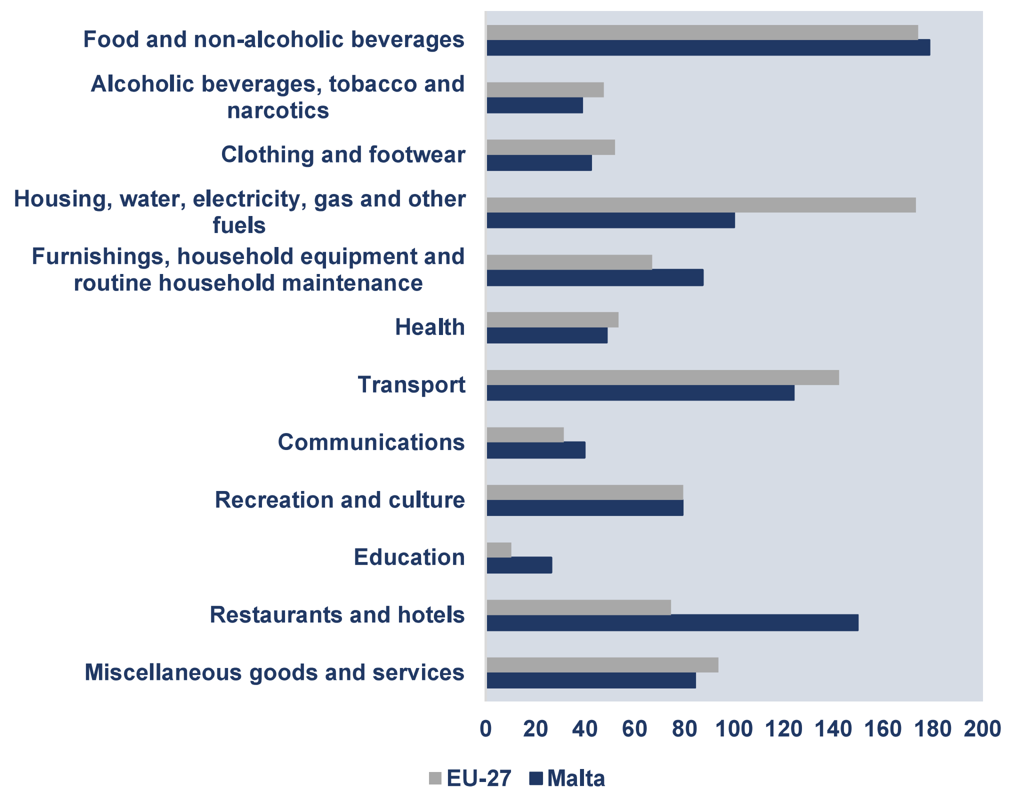
Chart 3.7: Annual rates of 2022 at component level



Source: Eurostat

In 2022, ‘food and non-alcoholic beverages’ (178.71), followed by ‘restaurants and hotels’ (149.75) and ‘transport’ (124.02) had the highest weights in the consumption basket of Malta. Similarly, 'food and non-alcoholic beverages’ (174.21) and ‘transport’ (142.39) had amongst the highest weights in the EU-27 consumption basket, but the division of ‘housing, water, electricity, gas and other fuels’ had a much higher weight (173.24). ‘Education’ had the lowest weight in both Malta and the EU-27 (see Chart 3.8).

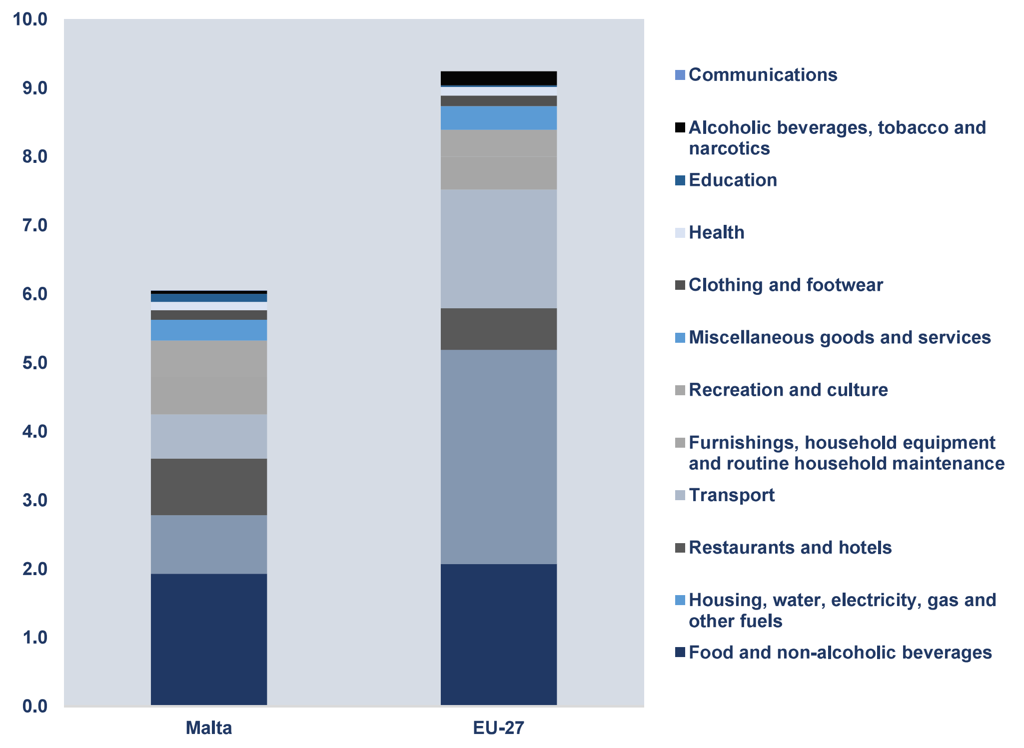
Chart 3.8: Weights assigned by Malta and EU-27 to COICOP items



Source: Eurostat

The assigned weights determine how much each item contributes to the overall HICP inflation rate. 'Food and non-alcoholic beverages' had the largest contribution of 1.9 pp to Malta's HICP inflation rate in 2022, followed by 'housing, water, electricity, gas and other fuels' (0.9 pp) and 'restaurants and hotels' (0.8 pp). In 2022, the considerable rise in this contribution is primarily due to the significant price increases in food, primarily in bread and cereal, meat, and dairy items. Other food items like vegetables and fruits have contributed to the increase in the food inflation rate but to a lesser extent. On the other hand, the 'housing, water, electricity, gas and other fuels' division contributed the most to the EU-27 annual rate of change of inflation with 3.1 pp. The 'food and non-alcoholic beverages' division is another significant contributor to the EU-27 contributing 2.1 pp, followed by transport which contributed 1.7 pp (see Chart 3.9).

Chart 3.9: Contribution of COICOP items to HICP inflation rate of Malta and EU-27

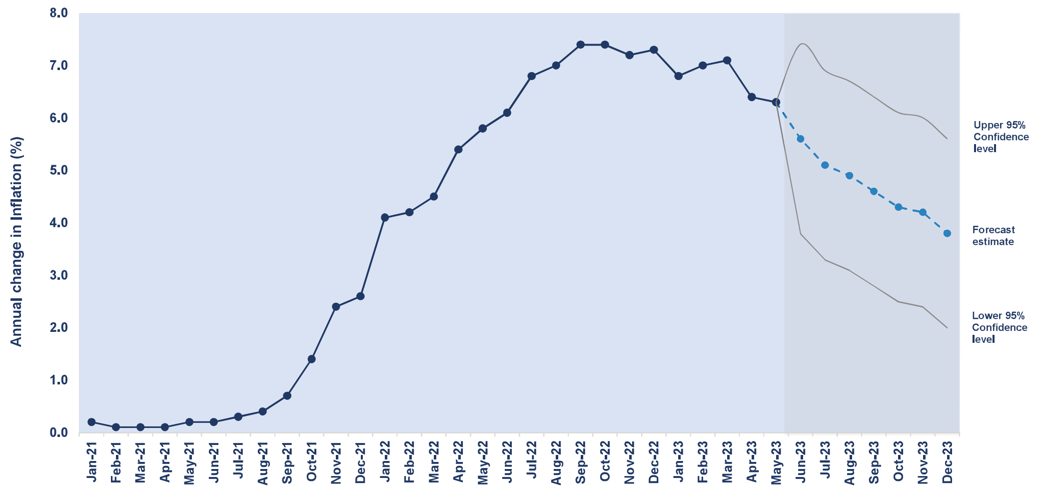


Source: Eurostat

The difference in inflation rates between Malta and the EU-27 is mainly caused by the fact that certain subcomponents of Malta's HICP inflation are determined or partially determined by the government. The variation mainly emanates from the contribution of 'housing, water, electricity, gas, and other fuels'. Government subsidies kept the cost of electricity, gas, and transportation fuels at the same level as the previous year in 2022, thereby avoiding the inflationary impact of energy on this component. Apart from energy, the government subsidizes the price of post-secondary and tertiary education, as well as public transport which thereby lowers the contribution of this division to Malta's HICP inflation rate.

According to the USP, the MFE is projecting the inflation rate for 2023 at 5.7%. Using a simple ARIMA model specification, the MFAC is forecasting a slightly lower inflation rate for 2023 than that forecasted by the MFE, at 5.5% (see Chart 3.10).

Chart 3.10: MFAC's Projection for HICP overall annual inflation in 2023 using a simple ARIMA model specification



Source: Eurostat; MFAC's Calculations

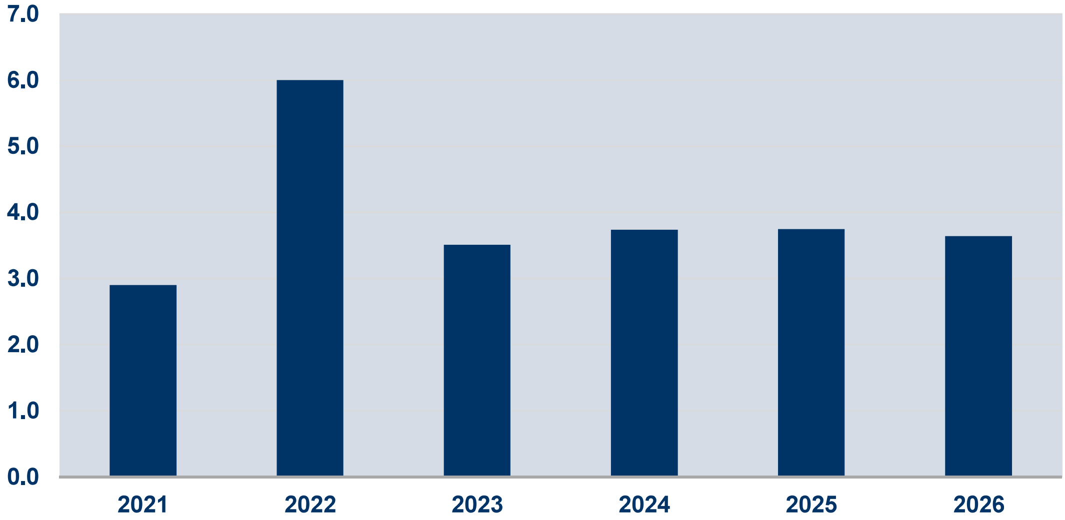
3.8 Labour market

In 2022, employment grew strongly by 6.0% (see Chart 3.11) and expected to continue to growth further stemming from the fact that Malta has a tight labour market, highly characterised by labour shortages and skills gaps.[27] In 2023, employment growth is projected to grow by 3.5% before reaching an average of 3.7% over the forecast horizon.

Tight labour market conditions and rising prices are expected to support an increase in compensation of employees, anticipated to grow by 9.0% in 2023. Thereafter, the compensation of employees is expected to fall slightly in 2024 to 7.8% and average 6.6% in the outer forecast years. This trajectory translates into a compensation per employee growth of 5.3% in 2023, slowing down to 3.9% in 2024 and average 2.8% in 2025 and 2026.

[27] In a policy note published by the Central Bank of Malta (CBM) on March 2023 find that "Scenarios published in the National Employment Policy 2021-2030 suggest that skills gaps are expected to persist well into the future. These scenarios point to the possibility of growing gaps in almost all occupations. These could be exacerbated if traditional sectors that are more labour intensive continue to grow".

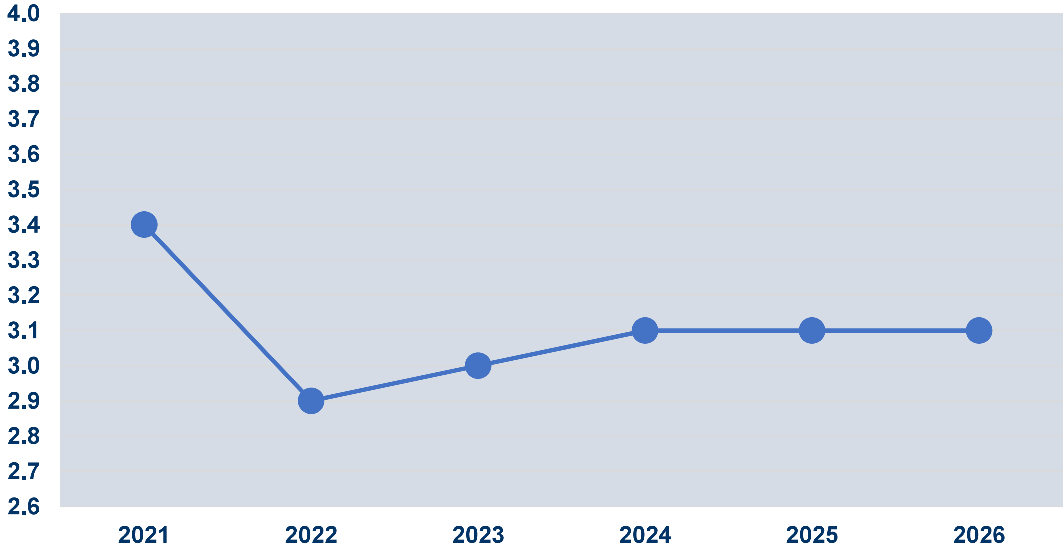
Chart 3.11: Employment growth (%)



Source: MFE

The unemployment rate declined further to reach a historic low of 2.9% in 2022, following the 3.5% unemployment rate recorded in 2021 (see Chart 3.12). Given the persistent labour market shortages and sustained economic growth, the unemployment rate is estimated to remain relatively low at 3.0% in 2023 and average around 3.1% in the outer forecast years.

Chart 3.12: Unemployment rate (%)



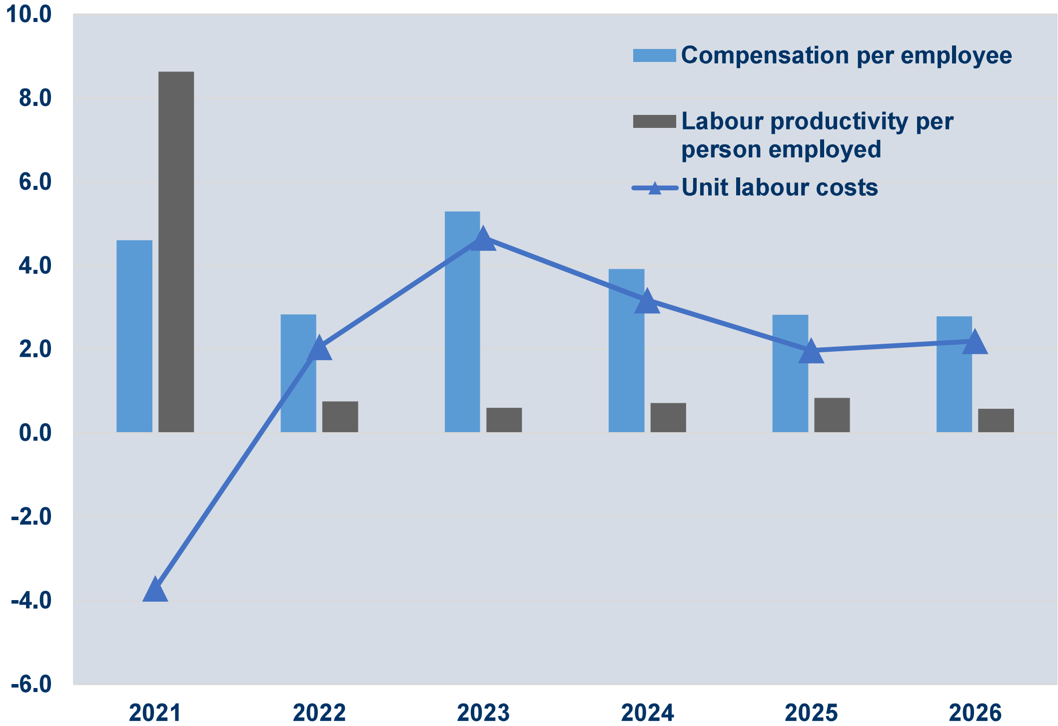
Source: MFE

3.9 Productivity developments

Following the substantial recovery in labour productivity in 2021 from the fall recorded in 2020, as a result of the retention of employees and the reduction in working hours during the pandemic, labour productivity grew at a slower pace in 2022 and is expected to retain the slower growth across the forecast horizon. Given the expected developments in real GDP and employment growth, the MFE expects that labour productivity (real GDP per person employed) will grow at a slower pace, hovering around 0.7% across the forecasted period.

Unit labour costs in 2021 contracted by 3.7% as a result of an increase in labour productivity (8.6%) which outpaced the positive growth registered in compensation per employee (4.6%) (see Chart 3.13). Subsequently, in 2022, unit labour cost grew by 2.1% as the growth registered in the compensation of employees (2.8%) outgrew that of labour productivity (0.8%).

Chart 3.13: Nominal unit labour costs (%)



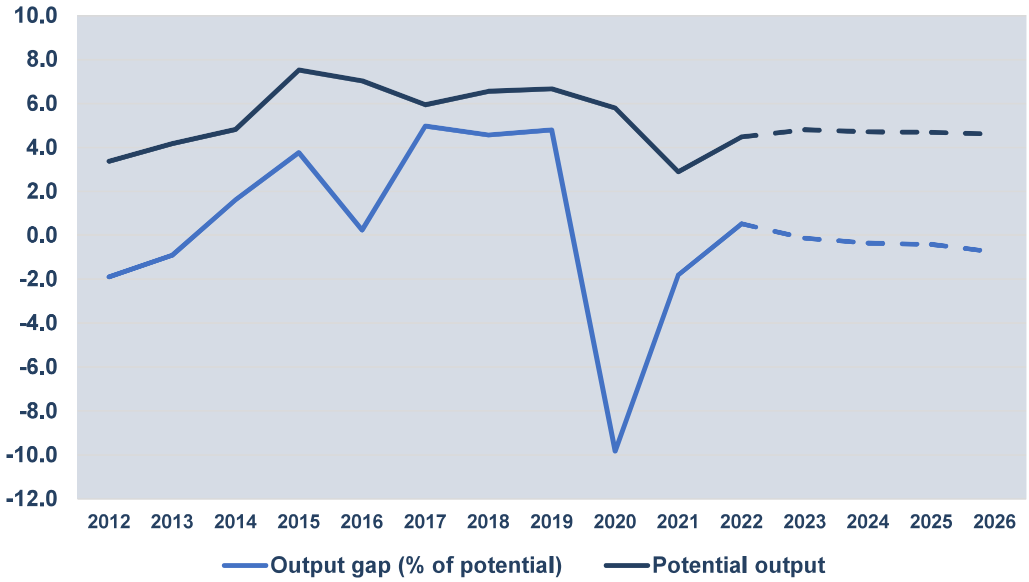
Source: MFE calculations

In 2023, nominal compensation per employee is anticipated to increase by 5.3% compared to a 0.6% increase in labour productivity, resulting in growth in nominal unit labour costs of 4.7%. Although nominal compensation per employee is projected to increase by 3.9% in 2024, growth in labour productivity per person employed is expected to slow down to a growth of 0.7%. The slowdown of growth in nominal unit labour cost is expected to continue in 2025 and 2026, with growth in compensation per employee expected to reach 2.8% in both years. Indeed, for the outer forecast years nominal unit labour cost is expected to average 2.1%.

3.10 Potential output and the output gap

Potential output and the output gap are estimated by the Ministry for Finance and Employment using the commonly agreed methodology of the EU.[28] This is based on the production function approach, with growth driven by labour, capital, and total factor productivity. According to these estimates, potential output growth increased by 2.9% in 2021 and 4.5% in 2022. In 2023, potential output growth is expected to increase by 4.8% and remain growing at a similar rate across the forecast horizon, averaging 4.7% (See Chart 3.14).

Chart 3.14: Potential output growth and output gap estimates (%)



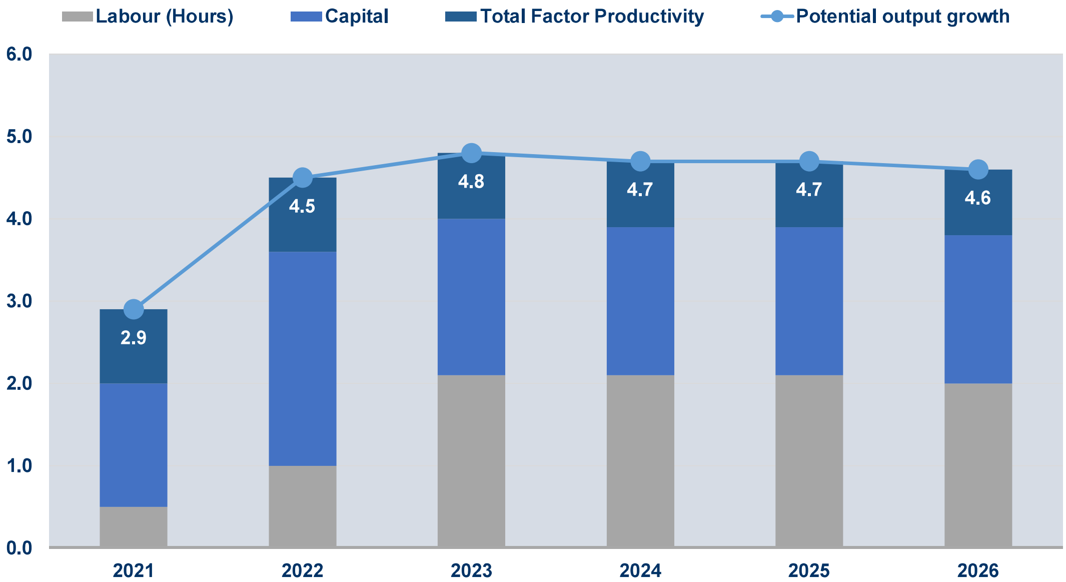
Source: MFE

[28] For further details on the commonly agreed methodology, please see here.

In both 2021 and 2022, capital accumulation was the main driver of potential output growth, contributing 1.5 pp and 2.6 pp, respectively (see Chart 3.15). Across the forecast horizon, the MFE anticipate that this trajectory will change, with a more balanced contribution from labour and capital to potential output growth. Labour is anticipated to contribute 2.1 pp annually to potential GDP growth on average from 2023 to 2025 and decrease slightly to 2.0 pp by 2026. On the other hand, capital is expected to contribute 1.9 pp in 2023 and fall slightly to 1.8 pp across the rest of the forecast period. Total factor productivity is anticipated to continue contributing positively throughout the projected horizon, with contributions of around 0.8 pp.[29]

The negative output gap (-1.8% of potential GDP) recorded in 2021 closed in 2022 and recorded a slightly positive output gap of 0.5% of potential GDP since real GDP outpaced potential output growth.[30] In the future, the output gap is expected to turn slightly negative (-0.1%) in 2023 and remain slightly negative across the forecast horizon, reaching -0.8% in 2026.

Chart 3.15: Sources of potential output growth (pp, %)



Source: MFE

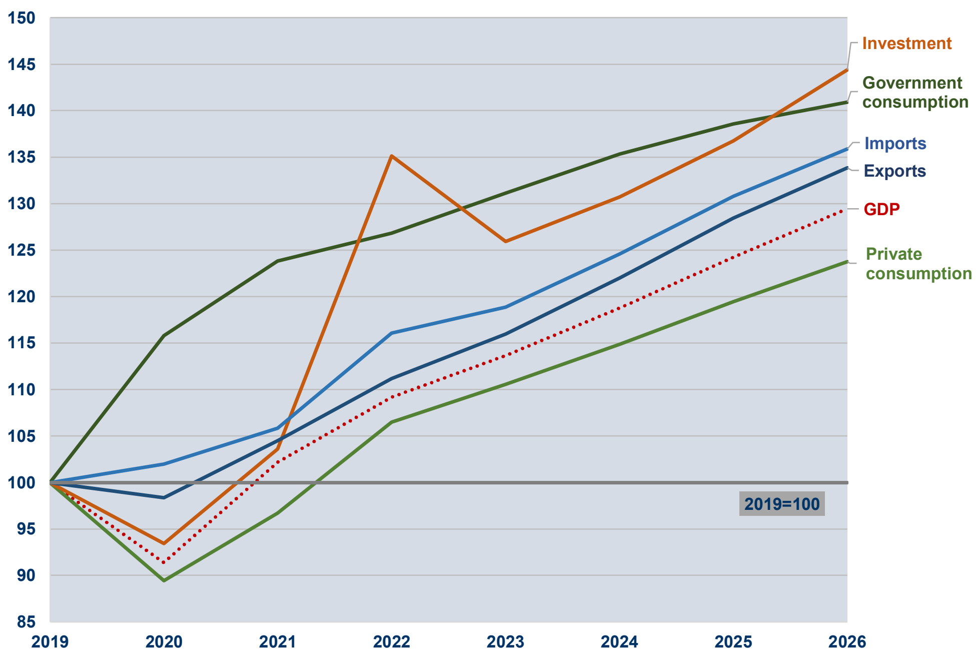
[29] Total factor productivity (TFP) (also referred to as Solow residual) is a measure of productive efficiency in that it measures how much output can be produced from a certain amount of inputs. For relatively small percentage changes, the rate of TFP growth can be estimated by subtracting growth rates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

[30] A positive output gap means that the economy is operating above potential, signalling overutilisation of resources.

3.11 Macroeconomic risk outlook

In 2021, all real GDP expenditure components expanded from the previous year (see Chart 3.16).[31] Indeed, during this year, most of the components which were adversely impacted by the pandemic had recovered, with only private consumption remaining below its pre-pandemic levels. Similarly, in 2022, all real GDP expenditure components grew when compared to the previous year's level. In 2022, private consumption exceeded its pre-pandemic level. The official outlook indicates that all real GDP expenditure components will continue to grow steadily during the forecast horizon, with only investment expected to drop by 6.8% in 2023, following the exceptional increase in the previous year.

Chart 3.16: Index for the real GDP components 2019 – 2026 (2019=100)



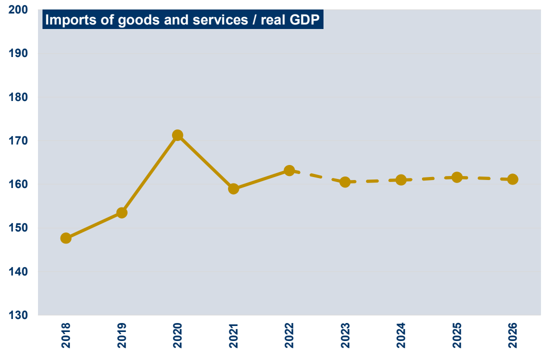
Source: MFAC Calculations

The ratios of the GDP components to real GDP have in general increased during the past years (see Chart 3.17). The ratio of private consumption to real GDP was the only ratio that fell prior to the pandemic from its peak in 2018. Thereafter, this component's ratio to real GDP continued falling due to the COVID-19 pandemic and the substantial

[31] 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.

fall in private consumption growth at the time, which was stronger than the fall in real GDP growth. Apart from the ratio of gross fixed capital formation, which remained relatively stable during the pandemic years, the ratios of the other components peaked in 2020. While the ratio of government consumption to real GDP grew due to the increase in COVID-19 measures put in place during the pandemic to stimulate the economy, the other components' ratios mainly increased due to the fall in the real GDP level, which more than outpaced the growth in the respective expenditure component. In the forecast horizon, the MFE expects these ratios to remain relatively stable relative to the ratio recorded in 2022. However, the investment-to-real GDP ratio is expected to remain slightly elevated across the forecast horizon, following its increase in 2022.

Chart 3.17: Ratios of the GDP components to real GDP



Sources: MFE, NSO, MFAC calculations

The MFE expects real private consumption to grow by 3.8% in 2023. Given the buoyant labour market conditions, population growth and the expected growth in compensation per employee, the Council opines that this growth is slightly cautious and indicates an upside risk for 2023, notwithstanding the prevalent inflationary pressures expected for the year. On the other hand, the contraction of 6.8% assumed in the investment component indicates risks on the downside. The Council notes that the inherent volatility in this component makes it more difficult to predict this expenditure component accurately. However, considering the large base effect of 30.4% growth in 2022 as a result of one-off investments in machinery and equipment and unless there is another large one-off investment in 2023, the MFAC expects that investment will return to levels similar to that of 2021. According to the Council's opinion, if one had to clean the time-series from the one-off investment which took place in 2022 and compute the projected growth rate on the underlying investment assumed by the MFE, the underlying private investment is way above historical trends. Consequently, the MFAC considers the projected growth rate for gross fixed capital formation to contain downside risks. The outer years are then influenced accordingly by the resultant base effect emanating from 2023.

In turn, real government consumption growth for 2023, which is expected to grow by 3.4%, is considered to have neutral risk, based on the assessment of the expected developments in the different components defining government consumption for the year.[32] Overall, the Council is of the opinion that the contribution of the domestic side of the economy could be lower than expected since the downside risks associated with

[32] For further information refer to Chapter 5 of this report.

gross fixed capital formation outweigh the upside risks identified in private consumption.

Meanwhile, exports are assumed to grow by 4.3% in 2023. The Council is of the opinion that the assumption on inbound tourism and tourism expenditure levels contains risks on the upside. However, expected developments in the relative competitiveness of the other sectors may lead to downside risks, which may tilt the balance of risk to a more neutral one. Overall, the downside risks identified with respect to the domestic side of the economy for 2023 are expected to lead to a lower level of imports relative to that expected by the MFE due to the different import content assumed between private consumption expenditure and gross fixed capital formation. Thus, if imports turn out lower than expected and given the neutral risk identified for exports, the contribution to GDP from the external side of the economy could turn out larger. The Council also opines that gross operating surplus and mixed income is considered to have risks on the upside in 2023 in line with higher expected private consumption growth.

Overall, for 2023, the Council is of the opinion that the balance of risks to the forecast of 4.1% real GDP growth tilts slightly on the upside. Indeed, the upside risks identified for private consumption expenditure, are expected to more than offset the downside risks in gross fixed capital formation on GDP growth when incorporating the resulting effects on imports.

For the outer years, the Fiscal Council opines that stronger expected consumption growth, mainly emanating from easing price pressures and a stronger external trade balance, could pose upside risks for the medium term. Nonetheless, the Council notes that the output gap is projected to remain negative over the forecast horizon despite core inflation remaining above the 2% threshold of price stability. This indicates either an underestimation of actual economic growth or an overestimation of potential output growth. The Council's assessment is inclined towards the possibility that it is a mix of both these factors.

Chapter 4

A comparison of different macroeconomic forecasts

4.1 Introduction

The plausibility of the macroeconomic scenario presented in the USP can be further evaluated by comparing it to the outlook presented in the DBP 2023 (previous round) and then tracing the new information that could clarify the direction of the revisions. Furthermore, the macroeconomic forecasts produced by the MFE are also juxtaposed to those of other institutions, namely the COM, Central Bank of Malta (CBM), International Monetary Fund (IMF) and credit-rating agencies (Fitch, Moody's, S&P and Scope) to determine the degree of variability between these forecasts.

The caveat is that the suite of forecasts is not necessarily perfectly comparable due to different information available at the time of preparation.[33] Other sources of discrepancy include different assumptions and methodologies as well as diverse expert judgement. Nonetheless, the MFAC opines that such comparisons are a valid benchmark to support the assessment undertaken in Chapter 3.

4.2 Comparison with the DBP 2023

In its latest forecast for 2023, the MFE is expecting real GDP to grow by 4.1%, somewhat more optimistic than envisaged in the DBP (3.5%) (see Table 4.1). Actual data for 2022 used in the USP shows that real GDP grew by 6.9%, around 0.9 pp higher than the growth MFE had projected at the time of the DBP for 2022. Thus, in the most recent projections, the base effect would be slightly higher when compared to that at the time of the DBP.

[33] Forecasts referred to in this Chapter were published in 2022 and 2023 on the following dates: S&P - 2 September 2022; IMF - 8 February 2023; Scope - 17 March 2023; Fitch - 31 March 2023; CBM - 20 April 2023; MFE - 1 May 2023; COM – 15 May 2023; Moody's – 23 May 2023. DBRS Morning Star do not conduct their own macroeconomic forecasts but rather refer to the forecasts produced by the IMF.

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

	2023				2024		
	USP	DBP	COM	CBM	USP	COM	CBM
	Growth rate in GDP components in real terms						
Private consumption	**3.8**	4.0	3.8	4.9	**3.9**	4.0	4.8
Government consumption	**3.4**	-2.4	5.0	4.3	**3.2**	3.3	3.8
Gross fixed capital formation	**-6.8**	5.9	-5.0	1.7	**3.8**	3.5	-0.3
Exports of goods and services	**4.3**	2.5	3.6	2.8	**5.2**	3.0	3.2
Imports of goods and services	**2.4**	2.0	2.2	2.9	**4.8**	2.7	3.1
Real GDP	**4.1**	3.5	3.9	3.7	**4.5**	4.1	3.6
	Contribution to real GDP growth						
Domestic demand (pp)	**0.6**	2.5	1.4	3.3	**3.2**	3.2	2.8
Inventories (pp)	**0.0**	0.0	0.0	0.0	**0.0**	0.0	0.0
Net exports (pp)	**3.5**	0.9	2.6	0.4	**1.2**	0.9	0.8
	Deflators						
Private final consumption expenditure	**5.3**	3.8	-	-	**3.3**	-	-
General government final consumption expenditure	**2.3**	2.3	-	-	**2.4**	-	-
Gross fixed capital formation	**2.7**	4.2	-	-	**1.7**	-	-
Exports of goods and services	**3.3**	3.2	-	-	**2.8**	-	-
Imports of goods and services	**2.9**	2.9	-	-	**2.5**	-	-
GDP deflator	**4.3**	3.8	4.2	2.7	**3.0**	3.1	2.0
	Other macroeconomic variables						
Inflation rate (%) (HICP)	**5.7**	3.7	5.4	4.5	**3.5**	2.8	2.3
Employment growth*	**3.5**	3.4	2.3	3.3	**3.7**	2.3	2.0
Unemployment rate	**3.0**	3.1	2.9	3.0	**3.1**	2.9	3.2
Compensation per employee	**5.3**	3.1	5.6	4.8	**3.9**	3.1	4.2
Labour Productivity	**0.6**	0.0	1.6	-	**0.7**	1.8	-
Unit Labour Costs	**4.7**	3.1	3.9	4.4	**3.2**	1.3	2.6

Note: Figures by the COM were published as the Spring 2023 economic forecasts, while those by the CBM were published in its Economic Projections 2023:1 and partly updated in its Annual Report 2022.
** Figures may not be directly comparable as definitions may vary.*

Sources: MFE, COM, CBM

The USP expects growth in real GDP in 2023 to be primarily driven by the external economy, contrary to what was assumed at the time of the DBP. Indeed, in the latest forecast round, the MFE revised the contribution from net exports to 3.5 pp in 2023, an increase of 2.6 pp from the DBP. On the other hand, the MFE is now anticipating a lower contribution from domestic demand of 0.6 pp, representing a downward revision of 1.9 pp from that assumed in the DBP. The higher anticipated contribution of net exports in 2023 is primarily attributed to a larger upward revision by 1.8 pp in export growth compared to the 0.4 pp increase in the forecast for the growth in imports. The upwards revision in export growth is only partly explained by higher expected growth in Malta's main trading partners (0.2 pp) in the USP. A lower contribution from domestic demand in 2023 reflects lower growth in private consumption (-0.2 pp) and negative growth in gross fixed capital formation (-12.7 pp), outweighing the more positive outlook for government consumption growth (5.8 pp). The significant revision downwards in growth of gross fixed capital formation stems out from a larger increase than anticipated in investment in 2022 which has created a strong base effect. The contribution from changes in inventories has been assumed not to contribute to GDP growth in the forecast horizon in both forecast rounds.

The GDP deflator for 2023 was revised upwards by 0.5 pp to 4.3% in the USP. This revision largely emanates from the increase in the private consumption deflator and, to a smaller extent, the export deflator which follows the trajectory of world prices. The private consumption deflator and the export deflator were revised upwards by 1.5 pp and 0.1 pp to stand at 5.3% and 3.3%, respectively, in the USP. On the other hand, the investment deflator was revised downwards by 1.5 pp to 2.7%. The government consumption deflator and the import deflator remained the same as assumed in the previous forecast round. The outlook for the private consumption deflator follows that expected for the inflation rate. Indeed, the HICP inflation rate for 2023 was revised upwards by 2.0 pp to 5.7% in the USP. The revision upwards emanates from more persistent inflation increases registered in the last quarter of 2022 and the beginning of 2023 compared to the first three quarters of 2022.

The outlook for the labour market remained broadly similar across both rounds. Employment growth is expected to be 3.5% in the USP, only 0.1 pp higher than anticipated in the DBP, while the unemployment rate was adjusted by 0.1 pp downwards to 3.0% in the USP. The growth in compensation per employee expanded from 3.1% in the DBP to 5.3% in the USP, an increase of 2.2 pp, largely explained by the outlook for higher inflationary pressures expected for the year. In the USP, the MFE assumes higher growth in labour productivity in 2023, revised from 0.0% to 0.6% growth. Regarding unit labour cost, the USP forecasts 4.7% growth in 2023, up by 1.6 pp than anticipated in the DBP.

4.3 Comparison with forecasts produced by other institutions

The COM and CBM also published comprehensive macroeconomic estimates for 2023 and 2024.[34] The COM's forecasts are based on the information available up to the fourth quarter of 2022 (refer to NSO News Release 036/2023), while the CBM incorporates actual data up to the third quarter of 2022 (refer to NSO News Release 218/2022). As a result, since the COM's and the MFE's forecasts are based on the same actual data, the COM's estimates are more comparable to those published in the USP.

The three institutions anticipate slower growth in real GDP in 2023 compared to 2022. The MFE and COM expect real GDP growth to increase in 2024, while the CBM expects a slight deceleration. The forecasts for real GDP growth by the MFE and the COM are broadly aligned for 2023, but COM is projecting somewhat lower growth in 2024. On the other hand, the CBM expects lower growth rates in both 2023 and 2024 relative to the forecast of the MFE, with the gap increasing from 0.4pp in 2023 to 0.9pp in 2024 (See Table 4.1).

Both the COM and the MFE expect economic growth to be primarily driven by the external side of the economy in 2023, while the CBM anticipates growth to be dominated by the domestic side.

For 2024, all three institutions anticipate growth to be mainly propelled by the domestic side of the economy, while the external side is expected to contribute positively, although to a lesser extent. The three institutions expect that inventory dynamics do not materially impact growth in the short term.

[34] The COM's latest figures relate to the Spring 2023 forecast round published on 15 May 2023, while the CBM's latest forecasts are those published on 20 April 2023 in its 2022 Annual Report. The CBM'S forecast cut-off date was 7 February 2023 and thus pre-date the latest release of national accounts on 28 February 2023.

The COM expects broadly similar private consumption growth as that expected by the MFE for both 2023 and 2024. On the other hand, the CBM is more bullish in the short-term and expects growth rates in this expenditure component to be more aligned with recent historical averages. As regards government consumption, both the COM and the CBM are expecting stronger growth compared to the forecasts of the MFE in both years, with the discrepancy being more marked in 2023, especially for the COM.

Both the COM and the MFE anticipate investment growth to be negative in 2023, largely attributed to the base effect in 2022. However, growth in 2024 is expected to return back to positive trajectories by both institutions. The MFE's outlook for investment growth is more pessimistic in 2023 but slightly more positive than the COM's in 2024, notwithstanding a more negative base effect. The CBM anticipates that investment will expand positively in 2023 but turns slightly negative in 2024. Caution must be applied when interpreting these disparities in this expenditure component due to its volatility and the ensuing higher subjectivity used in the forecasting process. Additionally, differences in data availability further hinder comparability between forecasts.

The expected trade dynamics vary across institutions, although all three institutions assume a lower growth in real exports and real imports for 2023 and 2024, than the actual growth recorded in 2022. Both the COM and the MFE estimate the net exports balance to turn positive in both years, since real imports are expected to decelerate more than real exports. The MFE anticipates more swift export growth than the COM (3.6%) and CBM (2.8%), at 4.3% in 2023. The COM projects the lowest growth rate for imports in 2023 at 2.2%, 0.2 pp and 0.7 pp lower than that forecasted by the MFE and CBM, respectively. In 2024, the MFE is forecasting the highest growth rate for exports (5.2%) relative to the COM (3.0%) and the CBM (3.2%). The differences in the anticipated export growth largely explain the anticipated dynamics in import growth across all three institutions. Nonetheless, in both years all institutions project net exports to be positive except for the CBM which in 2023 anticipates imports to grow slightly more than exports such that the external balance is estimated to become slightly negative.

In 2023 and 2024, the MFE forecasts inflation rates of 5.7% and 3.5%, while the COM projects slightly lower rates of 5.4% and 2.8%, respectively. In the short-term, both the

COM and the MFE expect the growth in the GDP deflator to be around 4.0% in 2023 and 3.0% in 2024. On the other hand, the CBM expects a more modest increase in the GDP deflator of 2.7% and 2.0% in 2023 and 2024, respectively, reflecting its projections of somewhat lower inflation in both years. This discrepancy is however affected by the earlier cut-off date for the CBM forecast.

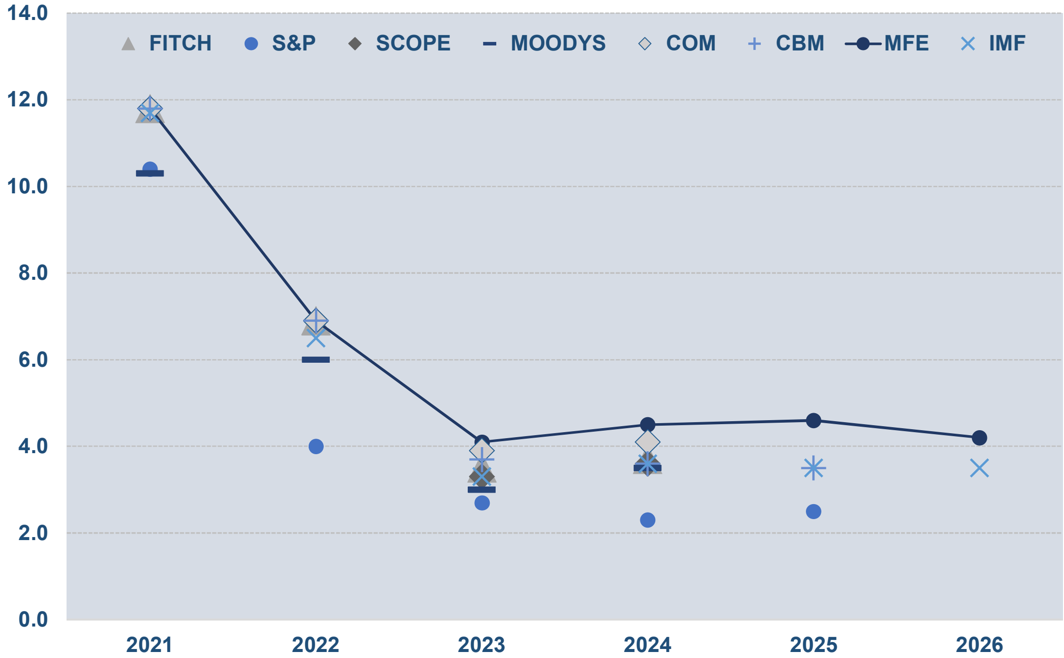
All institutions are expecting labour market fundamentals to remain strong in the short term. Unemployment is expected to continue hovering at historically low levels in the short term, while growth is anticipated to remain rather job rich, with varying magnitudes. In 2023, the CBM is anticipating employment growth to be 3.3% while the COM expects growth to be more modest (2.3%). Both the COM and CBM expect lower employment growth in 2024, hovering around 2.2%.

All three institutions expect the growth in compensation per employee for 2023 to be above the rates recorded in recent years. In fact, the MFE expects compensation per employee to increase by 5.3% in 2023, 0.3 pp lower than the forecast by the COM. However, in 2024, the MFE expects the growth in compensation per employee to decelerate (3.9%), although this rate is 0.8 pp higher than the projected growth rate by the COM for the same year. Regarding labour productivity, the COM anticipates stronger growth compared to the MFE in the short term. Disparities between the COM and the MFE in the forecasts for compensation per employee and labour productivity in the short term explain the different unit labour costs forecasts. In 2023, the COM is forecasting unit labour costs to grow by 3.9%, 0.8 pp lower than forecasted by the MFE. On the other hand, the disparity in unit labour costs between these two institutions in 2024 increases to 1.9 pp, with the MFE projecting a stronger growth rate (3.2%).

In addition to the COM and the CBM, the IMF and four credit rating agencies (Fitch, Moody's, S&P, and Scope) publish macroeconomic forecasts for Malta (see Chart 4.1). The forecasts by the other institutions lie somewhat below the trajectory for real GDP growth specified in the USP across the forecast period.

In 2023, all institutions are expecting a slowdown in real GDP growth from that registered in 2022. The range of forecasts for 2023 by the credit rating agencies and IMF ranges between 2.7% (S&P) and 3.5% (FITCH). In 2024, all institutions expect real GDP growth to accelerate except for S&P and the CBM, which expect real GDP growth to decelerate by 0.4 pp and 0.1 pp, respectively. The upward variation in growth forecasts made by the different institutions between 2023 and 2024 ranges from 0.2 pp (COM and FITCH) to 0.5 pp (MOODY's). The growth projections made by the institutions for 2025 and 2026 follow a similar pattern, but that of S&P is marginally higher for 2025.

Chart 4.1: Real GDP growth forecasts by institution (%)[35,36]



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

4.4 Assessment

The MFAC in its assessment of the DBP had anticipated upside risks for real GDP, private consumption, and export growth. The revisions for 2023 carried out by the MFE in the USP, from the previous forecast round, confirm that the MFE's projections were generally prudent in the previous forecast round. In fact, the macroeconomic projections by MFE for 2023 in the USP show that real GDP growth and export growth

[35] Not all institutions extend their forecast until 2026.
[36] In the latest data published by NSO (News Release 036/2023), real GDP growth for 2021 and 2022 has been revised upwards, implying a base impact for the forecasts produced by institutions using News Releases 218/2022 (CBM) and 154/2022 (S&P), compared to those using the more recent data (MFE, COM, IMF, Scope and Moody's).

were revised upwards. However, this is not the case for private consumption which was revised slightly downwards. The MFAC opines that the actual data for 2022 is providing a base effect for 2023, and the international outlook is more favourable making the upward revision of real GDP growth and export growth plausible. Inflation was also adjusted upward which is reasonable given the persistently high inflation registered in the first months of 2023.

In both 2023 and 2024, the MFE anticipates higher real GDP growth than both COM and CBM, with a larger difference in 2024. The wider gap that emerges when comparing to CBM projections is partly attributable to an earlier cut-off date than that of the MFE and the COM, as higher base effects for 2021 and 2022 emerge from the more recent data. The projections for the outer years assume that growth will continue, albeit more subdued and returning to more stable growth rates. Since the growth trajectory of the COM is similar to that of the MFE, it offers some reassurance that based on the information available to date, the latest MFE's macroeconomic projections are plausible, though acknowledging that a certain degree of uncertainty prevails.

Chapter 5
Assessment of the fiscal forecasts 2023-2026

5.1 Fiscal Outlook

The Maltese economy has experienced a strong recovery from the COVID-19 recession, which, together with a deceleration in government expenditure growth in 2022, resulted in a narrowing of the deficit-to-GDP ratio to 5.8%, from 7.8% in 2021 (see Table 5.1).[37] The robust growth in revenue due to higher economic activity and inflation, the government's ad-hoc spending reviews, and the termination of the COVID-19 business assistance schemes as of May 2022, aided the reduction in the fiscal balance. However, the medium-term economic scenario is still clouded by the indirect effects of Russia's war in Ukraine. In particular, the current forecast includes the government's commitment to retain energy price support measures introduced in 2022 to keep inflation under control.

The fiscal balance is targeted at 5.0% of GDP in 2023, thus declining by 0.8 pp over the previous year. Thereafter, the headline fiscal consolidation envisaged by the government, is targeted to decline to 0.7 pp per annum, with the deficit-to-GDP ratio only planned to fall just below the SGP's 3% threshold in 2026.

Similar to the headline fiscal balance, the structural fiscal balance is projected to improve consecutively each year.[38] As the output gap turns negative between 2023 and 2026, the structural balance is less negative than the headline balance, reaching 2.5% by the end of the forecast horizon. As the estimated magnitude of the output gap by the MFE turns more negative in the outer years, the gap between the structural balance (as a percentage of potential GDP) and the fiscal balance (as a percentage of GDP) gets marginally wider. In structural terms, the estimated effort is slightly higher than that in the headline fiscal balance. Achieving these targeted efforts would adhere

[37] The deficit of the Euro Area, according to the COM's Spring Economic Forecast, is projected to stand at -3.2% in 2023.
[38] The structural balance refers to the fiscal balance net of cyclical effects and one-off and temporary measures. It is expressed as a per cent of potential output. The output gap represents the difference between actual and potential output.

to the proposed yearly adjustment of 0.5% of GDP. Notwithstanding this, the MFE's deficit targets for 2024 and 2025 still surpass the 3% benchmark.

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

	Total Revenue	Total expenditure	Fiscal Balance	Structural balance*	Gross Debt
2021	36.1	44.0	-7.8	-7.0	55.1
2022	35.1	40.9	-5.8	-6.1	53.4
2023	35.7	40.7	-5.0	-4.9	54.5
2024	34.2	38.5	-4.3	-4.1	55.7
2025	34.0	37.6	-3.6	-3.4	56.2
2026	33.7	36.6	-2.9	-2.5	56.1

** As a per cent of potential GDP*
Note: Figures for 2021-2022 are actual, while those for 2023-2026 are forecasts produced by the MFE.
Source: Eurostat, MFE

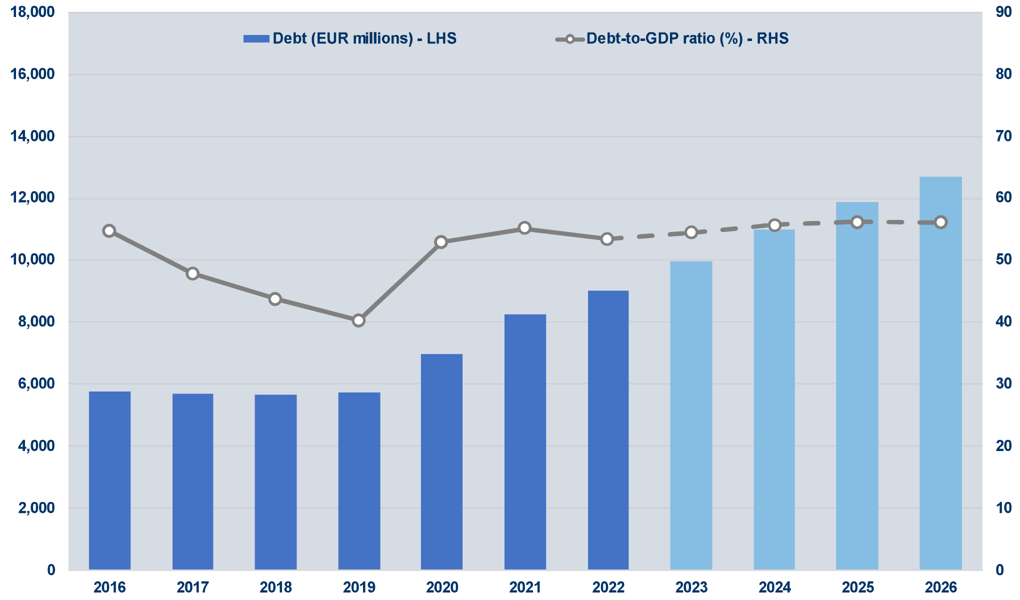
The USP does comment on the extent to which the fiscal targets, should they materialise, result in compliance with the proposed nationally financed net primary expenditure indicator.[39] The MFE's estimate is that this variable would grow at an average of 3.9% over the medium term, compared to the 5.9% growth threshold to ensure the necessary fiscal effort, as indicated by the COM.[40] The fiscal targets indicated in the USP are thus in line with the recommended growth of this indicator.

In terms of Malta's governmental debt-to-GDP ratio, the pandemic put an end to a period of significant declines. Indeed, general government debt as a proportion of GDP increased to 55.1% by 2021, from 40.3% in 2019, because of the government's significant increase in expenditure in response to the pandemic (see Chart 5.1). In 2022, Malta's debt ratio mirrored a general decline experienced across Euro Area countries and dropped to 53.4%.[41] An improvement in the primary balance, a decrease in interest expenses, and a negative stock-flow adjustment (SFA) contributed to this

[39] This refers to expenditure net of discretionary revenue measures and excluding interest expenditure as well as cyclical unemployment expenditure and expenditure on Union programmes fully matched by revenue from Union funds. Sourced from the legislative proposal published by the COM on 26th April 2023, available here.
[40] See paragraph (23) of the Council Recommendation on the 2023 National Reform Programme of Malta and delivering a Council opinion on the 2023 Stability Programme of Malta, available here.
[41] The debt of the Euro Area, according to the COM's Spring Economic Forecast, is projected to fall to 90.8% in 2023 from 93.1% in 2022.

decline. Similar to 2021, when GDP had increased significantly, the interest-growth disparity had a debt-decreasing effect in 2022. In terms of the forecast, the debt-to-GDP ratio is projected to gradually increase up to 56.2% by 2025 and stabilise at 56.1% in 2026. Notwithstanding the higher headline balance when compared to most Member States, the Maltese government debt-to-GDP ratio is forecast to remain well below that in the Euro Area, and below the 60% Maastricht benchmark.

Chart 5.1: Public debt (% of nominal GDP)



Note: Figures for 2023-2026 are forecasts produced by MFE.
Source: Eurostat, MFE

Total expenditure, when measured as a percentage of GDP, fell sharply by 3.1 pp to 40.9% in 2022 (see Table 5.1). Over the four forecasted years, an average drop of 1.1 pp is anticipated, with the largest targeted decline, of 2.2 pp, being in 2024. The materialisation of such plans would place the expenditure-to-GDP ratio at 36.6% in 2026, a level close to that recorded prior to the pandemic.

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

	Actual		Forecasts			
	2021	**2022**	**2023**	**2024**	**2025**	**2026**
Total revenue	**5,420.1**	**5,913.9**	**6,542.7**	**6,751.2**	**7,187.7**	**7,617.4**
Taxes on production and imports	1,578.3	1,777.5	1,924.7	2,035.7	2,166.6	2,299.6
Current taxes on income and wealth	2,052.7	2,299.1	2,463.1	2,617.2	2,792.6	2,998.2
Social contributions	914.8	990.6	1,059.0	1,128.0	1,188.5	1,251.9
Capital taxes*	29.3	36.2	25.8	26.5	27.2	27.9
Property income*	83.5	80.6	50.2	61.0	80.1	81.2
Other revenue*	761.5	729.9	1,019.9	882.8	932.7	958.6
Total expenditure	**6,595.8**	**6,894.9**	**7,456.1**	**7,598.4**	**7,942.5**	**8,270.3**
Compensation of employees	1,781.7	1,830.2	1,962.0	2,087.5	2,203.4	2,318.4
Intermediate consumption	1,290.1	1,365.9	1,550.3	1,610.5	1,684.7	1,753.8
Social payments	1,389.1	1,489.1	1,616.5	1,730.9	1,813.5	1,904.6
Gross fixed capital formation	576.1	563.9	690.8	616.8	660.2	733.3
Subsidies	695.4	849.4	685.9	572.1	559.4	491.3
Interest expenditure**	169.9	166.0	225.6	288.6	306.6	324.6
Capital transfers payable**	178.8	154.2	229.5	189.5	208.6	235.1
Other expenditure**	514.7	476.3	495.5	502.5	506.1	509.2
Fiscal balance	**-1,175.7**	**-981.1**	**-913.3**	**-847.2**	**-754.8**	**- 652.8**
Gross debt	**8,263.9**	**9,003.4**	**9,980.3**	**10,992.0**	**11,886.8**	**12,691.9**
Nominal GDP	15,001.9	16,870.3	18,315.6	19,717.8	21,141.2	22,617.2

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.

Note: Figures for 2023-2026 are forecasts produced by MFE.

Source: Eurostat, MFE

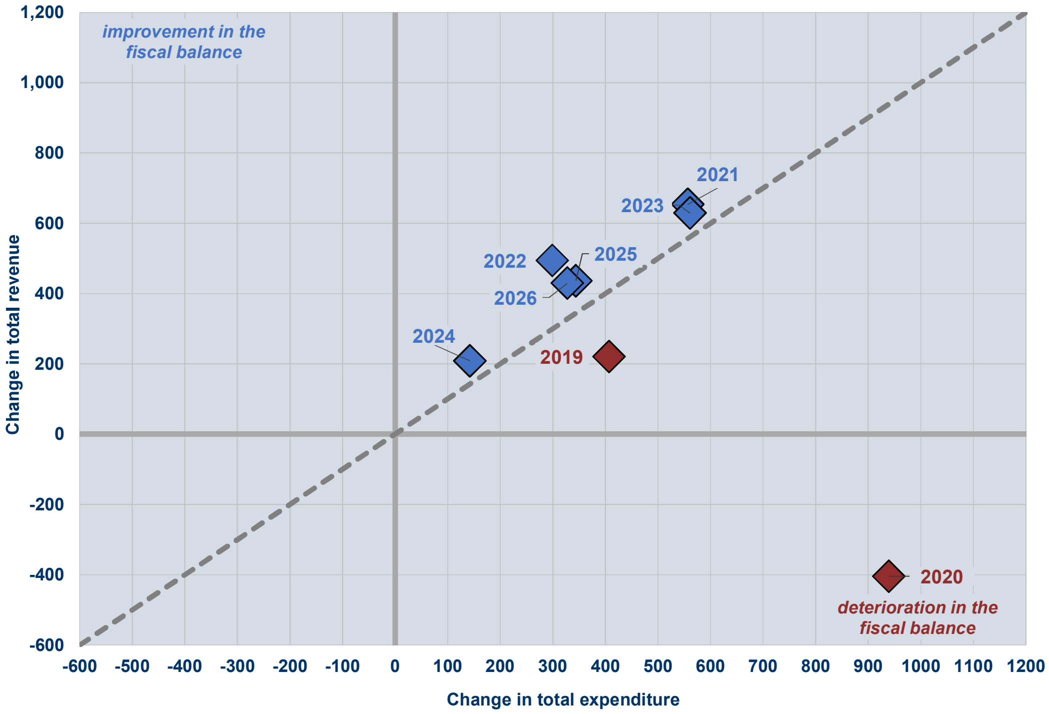
The revenue-to-GDP forecast profile broadly resembles the pattern exhibited by the expenditure ratio. In 2022, the revenue ratio declined by 1 pp to 35.1%, partly because of lower elasticities for the main revenue components. However, this decline is anticipated to be reversed in 2023, rising by 0.7 pp as elasticities are projected to be higher, though remaining below long-term historical trends. Consequently, the revenue to GDP ratio is projected to gradually fall to 33.7% by 2026.

In absolute terms, it is estimated that the fiscal deficit would decrease once again by €67.8 million in 2023, and by a further €66.1 million in 2024, following the improvement of €194.7 million reported in 2022. Larger declines in the fiscal balance are anticipated for 2025 and 2026 of close to €100 million respectively (see Table 5.2). These targets imply that increases in spending would, for each year, be less than those in revenue (see Chart 5.2). From Chart 5.2, it can be noted that for the forecast years, the yearly change is very close to the dashed line, albeit marginally higher, indicating consecutive improvements.

Total revenue experienced an annual growth rate of 9.1% in 2022. This follows the 13.7% rise in 2021, when revenue components recovered from the widespread reductions suffered during the pandemic. Growth in revenue components is still expected throughout the forecast period, though these are not expected to be as substantial as those in past years (see Chart 5.3).

The growth in current taxes on income and wealth, which is the largest revenue component, is envisaged to slow down to €164.0 million in 2023. Annual increments of €154.1 million and €175.4 million are expected in 2024 and 2025, respectively. In 2026, growth in this component will gain more momentum and an additional increase of €205.6 million is anticipated.

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



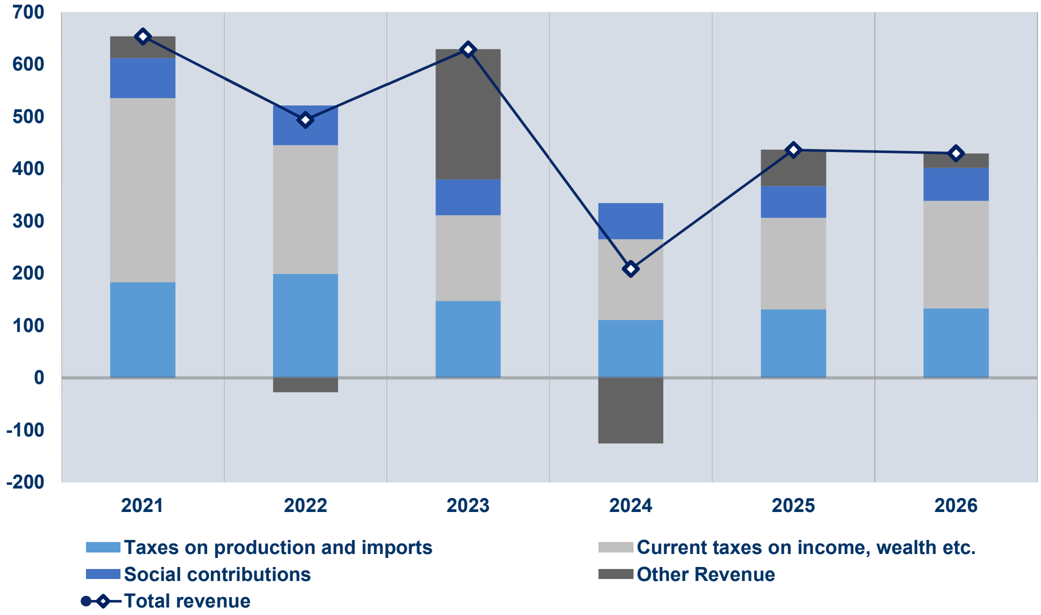
Note: Anywhere above the dashed line (blue diamonds) indicates combinations of revenue and expenditure developments leading to an improvement in the fiscal balance, whereas anywhere below the dashed line (red diamonds) indicates combinations that lead to a deterioration in the fiscal balance. Anywhere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

Note: Figures for 2019-2022 correspond to actual data, while figures for 2023-2026 are forecasts produced by MFE.

Source: Eurostat, MFE

Moderate and rather stable growth levels are projected for taxes on production and imports. These average €130.5 million over the forecast years. Because of a decelerating growth in the tax base, the growth over the forecast horizon is less than that experienced in 2021 and 2022, when private consumption was still recovering after the pandemic. The forecasted yearly increments in social contributions also demonstrate a broadly stable trend throughout the projection horizon, averaging €65.3 million. In terms of the three main revenue components mentioned above, although their elasticity is assumed to be higher overall than in 2022, the slowdown in the forecast for the macro proxy-bases, in general, outweighs this effect.

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



Note: Figures for 2021-2022 correspond to actual data, while figures for 2023-2026 are forecasts produced by MFE.
Source: Eurostat, MFE

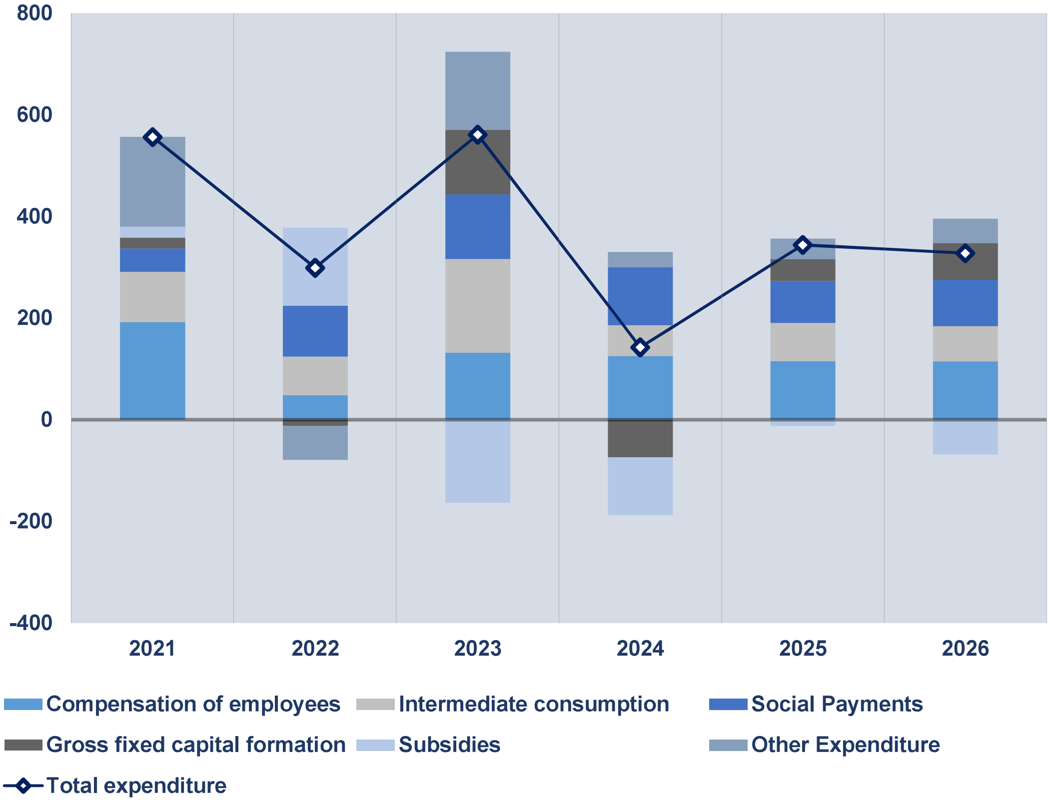
In 2023, the 'other revenue' component is anticipated to be the largest contributor to the growth in government revenue but is then set to decline in the following year. This negative contribution to revenue growth, reflects, in part lower revenue from EU funding, following the completion of the financial programming period in 2023.[42] This base effect, in part, explains the lower revenue growth in 2024, of 3.2%.

Moving on to expenditure, it is forecasted that overall spending shall still rise by a substantial 8.1% in 2023, despite the lower expenditure projected for subsides when compared to the previous forecast round published in October 2022 (see Chart 5.4). The downward revision primarily reflects a lower cost of energy subsidies due to lower than expected energy prices. Inflationary pressures are nonetheless still high and certain components, particularly intermediate consumption, social benefits and compensation of employees are set to increase by larger amounts in 2023 than in 2022. With higher growth in gross fixed capital formation and 'other expenditure', in 2023, government's increased spending is almost evenly distributed among the

[42] Other revenue comprises capital transfers, including capital taxes, property income and 'other' revenue.

expenditure components, though a slightly higher proportion is allocated towards intermediate consumption.[43]

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



Note: Figures for 2021-2022 correspond to actual data, while figures for 2023-2026 are forecasts produced by MFE.

Source: Eurostat, MFE

The 'other expenditure' category is projected to decelerate, following the high base effect from capital transfers in 2023, to an average growth of €39.4 million between 2024 and 2026. Meanwhile, gross fixed capital formation will drop in 2024, following the relatively high expenditure in 2023, but then pick up in the remaining years. The drop in spending on gross fixed capital formation, coupled with the year-on-year smaller increase in intermediate consumption and a lower outlay on subsidies, will contribute to a low 1.9% growth in the government's spending in 2024. The yearly growth in compensation of employees, intermediate consumption and social payments exhibits a stable trend as of 2024. This results in a modest 4.3% average increase in

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

spending for 2025 and 2026. When comparing charts 5.3 and 5.4, the trajectory for total expenditure, which is more discretionary in nature than that of revenue, is rather aligned and follows a similar pattern to that of total revenue.

This section is followed by an evaluation of the main revenue and expenditure components and their forecast. The analysis feeds into the MFAC's assessment of the fiscal balance and public debt targets outlined in the USP 2023 -2026.

5.2 Assessment of the revenue projections

This section analyses the estimates for each component of total revenue separately. The MFAC's evaluation consists of an analysis of the trajectory anticipated for each variable, with a focus on the consistency with the corresponding macro-proxy variables by an evaluation of the assumed elasticities, divergences from historical trends, the projected magnitude of fiscal measures, and other known factors that are significant over the forecast horizon. Following this analysis, a summary of the risks as opined by the MFAC for each revenue component is provided in Section 5.4.

5.2.1 Taxes on production and imports

Taxes on production and imports increased by €199.2 million in 2022, or 12.6% more than in 2021 (see Table 5.3). Such a rise follows the 13.1% growth in 2021, which covered most of the revenue shortfall that had occurred in 2020 as a result of reduced demand due to the pandemic. Although a 12.6% increment in 2022 is significant, it reflected a lower elasticity than typically realised. Indeed, revenue generated from indirect taxes in 2022 turned out to be €53.7 million less than forecasted by MFE in the DBP, even though the tax base turned out better than forecasted. Particularly, the elasticity for Value-Added Taxation (VAT), when using private consumption expenditure and tourism earnings as proxy bases, turned out below unitary.[44] This means that the revenue flow from this component reacted less to higher macroeconomic demand. Also, property-related revenue only increased marginally, as

[44] According to the MFE, this is, in part, due to a shift in the consumption basket of households towards more zero VAT-rated (necessities) or reduced VAT-rated items.

although property prices increased and property-related measures were maintained, transactions were lower than in 2021.

According to the MFE, for the first forecast year, taxes on production and imports are anticipated to increase by €147.2 million, equivalent to an increase of 8.3% over 2022. For 2024, the forecast by the MFE is that this revenue component will increase by a further 5.8%, totalling €111.0 million more than in 2023. Over the other years, indirect taxes are expected to grow at a rate close to 6.3%, a level which is below the 7.9% average growth recorded over the five-year period 2015 to 2019 (pre-pandemic). The materialisation of these scenarios would place the ratio of indirect taxes to GDP on a gradual decline, from 10.5% in 2022 to 10.2% in 2026 (see Chart 5.5).

Between 2023 and 2026, indirect taxes are expected to fit within the range of growth rates for private consumption and tourism export growth.[45] Although the elasticity for taxes and production and imports is assumed to recover from the low value experienced in 2022, the MFAC's estimates are that the elasticity shall remain close to unitary over the forecast period, similar to the MFE's view and targets. For VAT, the elasticity is expected to be slightly higher over the outer forecast years than in 2023 and 2024. The developments in this component are entirely driven by the assumed tax elasticities (and the profile for the tax base), as no new discretionary measures are included in the forecasts.

Changes in taxes on production and imports could occur should the projected growth in private consumption expenditure and tourism exports be different. The macroeconomic assessment (Chapter 3 of this Report) portrays the possibility of having a larger tax base for taxes on production and imports, both from private consumption expenditure and tourism exports. In the case of tourism exports, the upside risk is higher, particularly for 2024, where the MFE are assuming low growth in tourism exports.

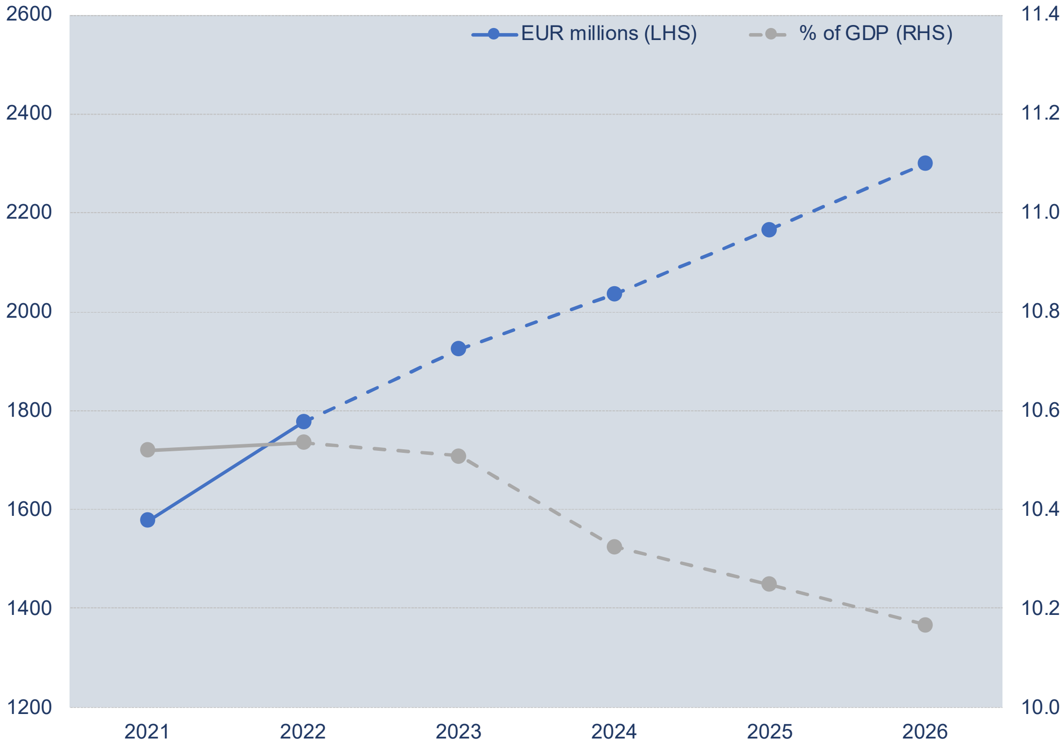
[45] Inbound tourists must pay local taxes upon consuming goods and services. Thus, their expenditure should be included in the tax base for indirect taxation.

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 (%)
2021	13.1	183.2	9.4	8.1	92.3
2022	12.6	199.2	16.1	10.1	179.6
2023	8.3	147.2	9.2	3.8	8.2
2024	5.8	111.0	7.3	3.9	0.1
2025	6.4	130.9	6.4	4.0	3.0
2026	6.1	133.0	6.3	3.6	2.9

Source: MFE

Chart 5.5: Taxes on production and imports



Source: MFE

5.2.2 Current taxes on income and wealth

Following a significant increase of €352.0 million in 2021, a rebound from the decline of €155.1 million in 2020, direct taxes increased by a further 12.0% or €246.4 million in absolute terms in 2022 (see Table 5.4). While the tax base turned out stronger than anticipated by the MFE in the DBP, the total current taxes on income and wealth turned out weaker in 2022, in level terms, than expected in the DBP because of lower elasticities.

Positive growth is anticipated for current taxes on income and wealth throughout the forecast period. The MFE is assuming a rather stable growth profile for this revenue component, with the increments varying between 6.3% and 7.4% across all four years. This stability is transposed onto the variable's ratio to GDP. Indeed, between 2023 and 2025, a gradual steady reduction is anticipated, with the ratio falling from 13.4% to 13.2%, before picking up marginally in 2026 (see Chart 5.6).

Table 5.4: Current taxes on income and wealth

	Growth (%)	Change (EUR millions)	Compensation of employees (%)	Gross operating surplus (%)
2021	20.7	352.0	7.8	19.1
2022	12.0	246.4	9.4	16.2
2023	7.1	164.0	9.0	6.0
2024	6.3	154.1	7.8	5.7
2025	6.7	175.4	6.7	6.2
2026	7.4	205.6	6.5	4.7

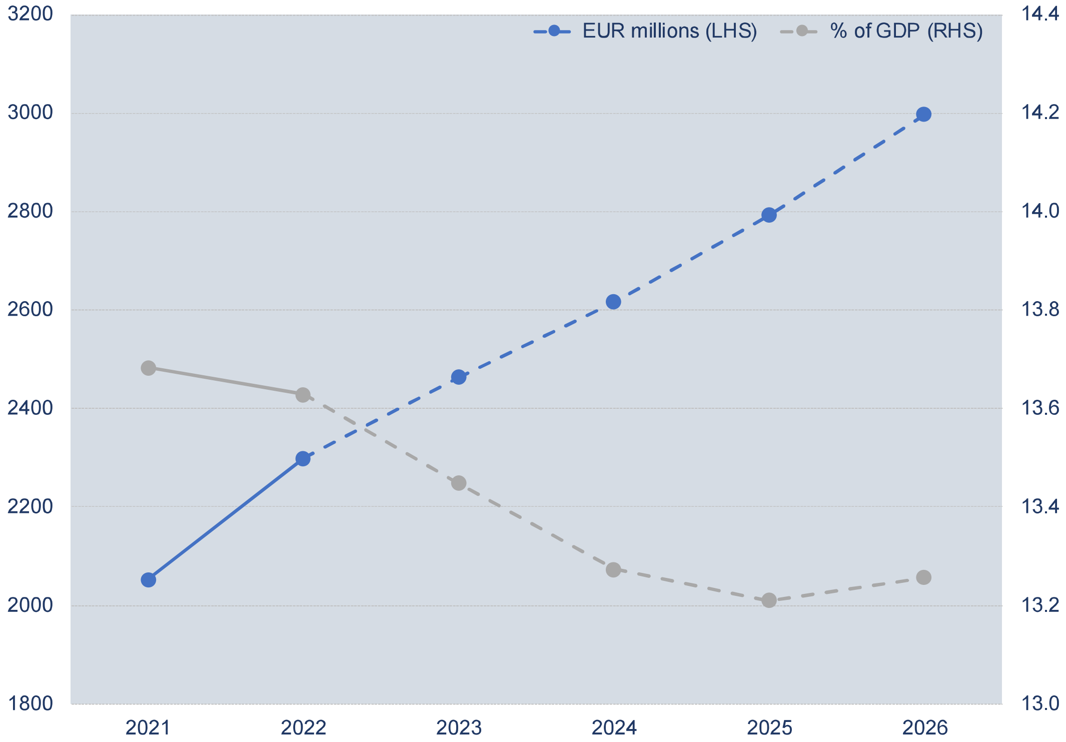
Source: MFE

Between 2023 and 2025, direct taxes are expected to fit within the range of growth rates for compensation of employees and gross operating surplus, while in 2026, direct taxes are expected to grow at a slightly faster rate than the two most relevant proxy tax bases.[46,47] This reflects a marginal increase in the projected elasticity, from that of

[46] Apart from the implied elasticities to compensation of employees and gross operating surplus, other changes could include those relating to ITUs, derived from a separate model, and other adjustments relating to property market dynamics.
[47] Compensation of employees and gross operating surplus are the two most relevant proxy tax bases for direct taxes.

unitary, or very close to unitary, over the prior forecast years. Nevertheless, the applied elasticities are assumed at lower than historical averages. The MFAC considers that, based on its estimates, marginally higher elasticities can be realised.

Chart 5.6: Current taxes on income and wealth



Source: MFE

Lower levels of growth are expected for both compensation of employees and gross operating surplus over the forecasted years when compared to 2021 and 2022. However, changes in these proxy bases, apart from the estimated elasticities, could lead to shifts in the targeted profile of direct taxes. In particular, upside risks to profits can lead to higher direct taxes than targeted in the USP. When combined, the MFAC's assessment based on the possibility of a higher elasticity and a higher tax base results in an upside risk for this component of tax revenue. These forecasts do not include any new discretionary measures or structural changes in tax rates. Also, part of the increase in revenue results is resulting from the relatively high Cost-of-Living Allowance (COLA) included in the projections, especially for 2023 and even more for

2024, reflecting the expected inflationary developments. Changes to COLA can have an impact on current taxes on income and wealth, though not to a large extent.[48]

5.2.3 Social contributions

In 2022, social contributions increased by 8.3% over the prior year. The Ministry projects that growth in this component is to gradually decelerate from 2023, reaching 5.3% in 2026 (see Table 5.5). However, in absolute terms, this translates into very stable increments of between €60.5 million to €69.0 million over each forecast year. Over the entire forecast period, the growth in nominal GDP is expected to outpace the growth in social contributions. Indeed, the ratio of social contributions to GDP is to exhibit a downward trend from 5.9% in 2022 to 5.5% in 2026 (see Chart 5.7).

Social contributions are set to grow at a slightly slower pace than total compensation of employees over all forecast years. This is consistent with the cap which exists on the yearly social contribution payments.[49] The MFAC concurs with the MFE's estimates of close to unitary elasticities for this revenue variable. The developments in social contributions are driven entirely by the expansion in the tax base, as elasticities are assumed to remain relatively stable, and no additional policy changes or measures are factored into the baseline scenario.

[48] The MFAC estimates that in 2023, income taxation on COLA would account for around 0.8% of current taxes on income and wealth. If the COLA is higher in 2024, the MFAC expects this estimate to increase further. For this estimate, a number of assumptions were used. The average wage and labour hours from the LFS were used. Based on an average wage of €1,785.0, a 25% rate was applied to the estimated number of full-time equivalent employees. The calculations assume a single-rate tax bracket and non-linear effects of taxes.

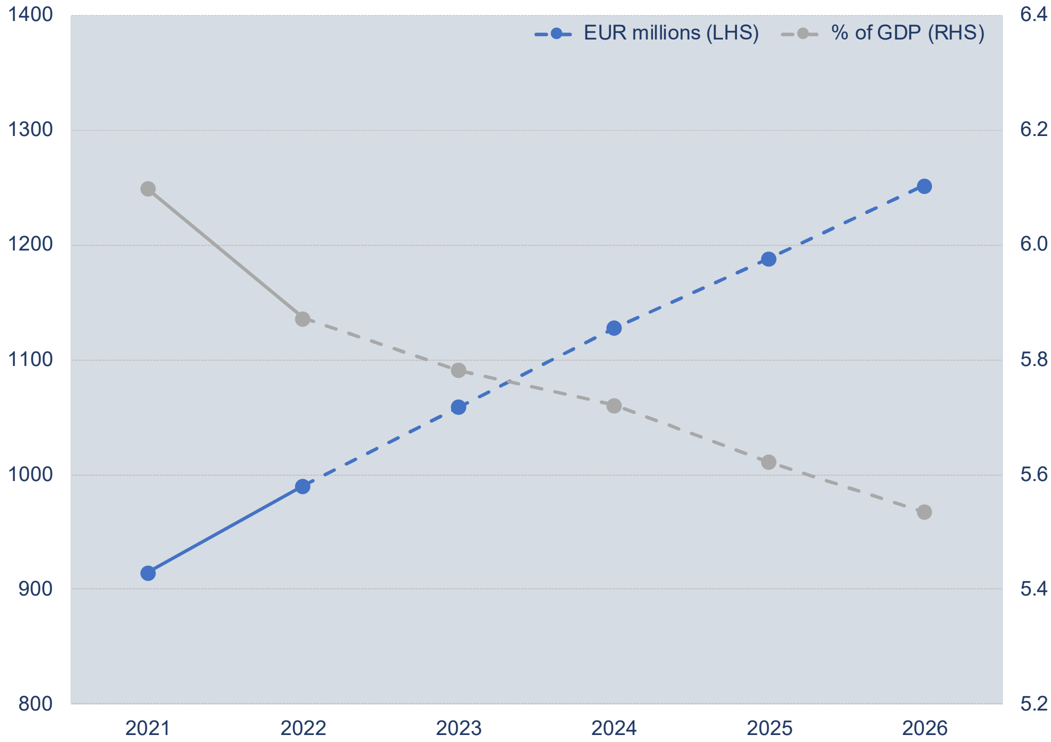
[49] The cap means that once the maximum annual amount payable has been reached, additional income does not lead to more social security payments, hence producing a stable elasticity, unless there are ad-hoc factors or permanent changes in the contributory system.

Table 5.5: Social contributions

	Growth (%)	Change (EUR millions)	Compensation of employees (%)
2021	9.1	76.6	7.8
2022	8.3	75.8	9.4
2023	6.9	68.4	9.0
2024	6.5	69.0	7.8
2025	5.4	60.5	6.7
2026	5.3	63.4	6.5

Source: MFE

Chart 5.7: Social contributions



Source: MFE

5.2.4 Other revenue components

Most of the overall revenue is comprised of the three previously mentioned revenue sources: taxes on production and imports, current income and wealth taxes, and social contributions. Their combined share represented 85.7% of the total revenue in 2022. This share is projected to decline to 83.2% in 2023, as other revenue is targeted to be considerably higher than in 2022. This share then reverts back to between 85.0% and

86.0% across the forecast years 2024 – 2026. Capital taxes, property income, and 'other' revenue make up the remaining minor revenue components. The latter component includes EU funds and market output revenues, which also includes those from the permanent residency programme. Chart 5.8 shows the projected growth rates for the other revenue components as a share of nominal GDP.

Property income and capital taxes are forecasted to broadly maintain low ratios to nominal GDP throughout the forecast period. When taken together, these factors have a minimal impact on the overall fiscal outlook for the forecast period of less than 1.0% of GDP.

A notable development in the "other revenue" component is the increase of €290.1 million in 2023. This comprises of increases of €137.5 million in capital transfers, most of which relate to EU-funds, as the programme 2014-2020 terminates in the current year. It also includes market output, which is projected to increase by €126.2 million in 2023. Part of this increase relates to higher revenues from the residency programme as these are targeted to have an additional budgetary impact of 0.2% of GDP, which translate into €70.0 million in revenue. Such revenue is then assumed to remain at €55.0 million over the rest of the forecast years.[50] The growth in market output is still positive over the rest of the forecast years, but is much more subdued, and does not exceed 4.0%.

"Other revenue" tends to be rather volatile. When compared to GDP, the ratio of "other revenue" is expected to increase to 5.6% in 2023, but thereafter it is expected to decline progressively to 4.2% by 2026. Sources of uncertainty relating to this revenue component relate to the eventual proceeds collected through the IIP and the absorption of EU funds. Some sales listed as market output can also create variances when these are of a discretionary nature. In the case of EU funds, the inflows are contingent on the realisation of the projects as planned, particularly those relating to the Programme 2014 - 2020. It is plausible to assume increased efforts to ensure that available funds are fully utilised towards the end of the period. The projections also include the utilisation of funds relating to the RRF and the MFF 2021 – 2027.[51]

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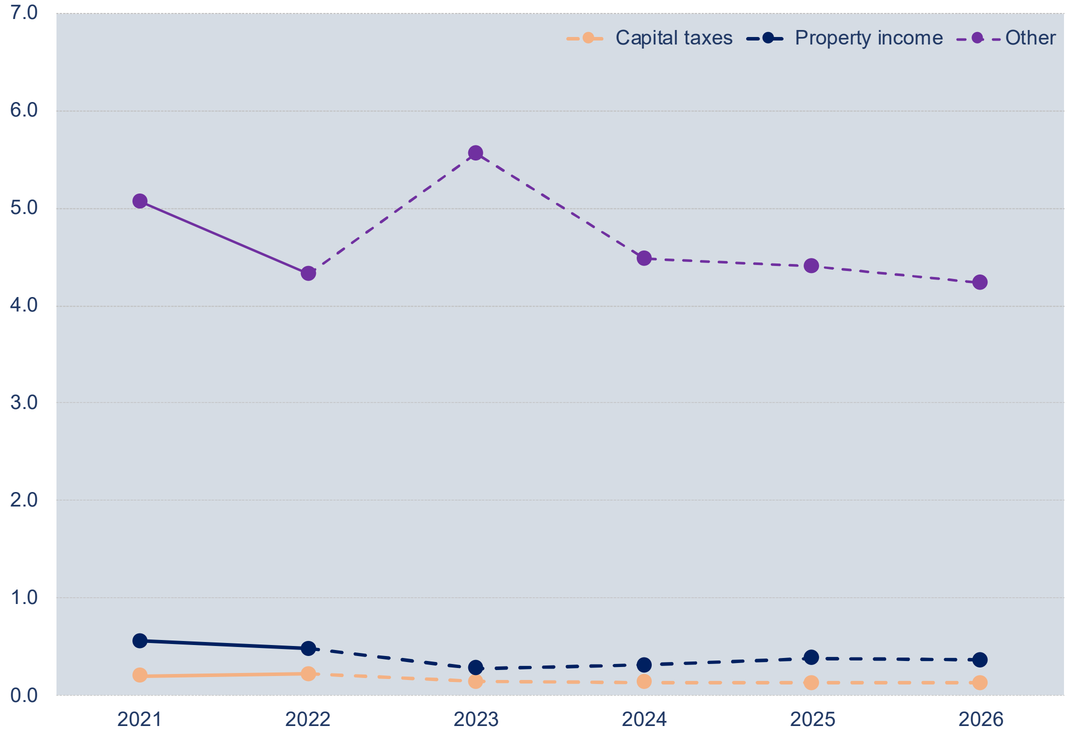
[50] The estimated figures take into account discussions with Community Malta Agency and are based on current and expected application revenues. The policy is that annual financial results do not rely extensively on proceeds from this programme, also given that the programme is still under scrutiny by the Court of Justice of the European Union.

[51] More detail on the utilisation of these funds are provided in section 5.3.5.

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



Source: MFE

5.3 Assessment of the expenditure projections

As part of the evaluation of the fiscal policy projections, the forecast of each expenditure component is examined separately. The assessment mainly entails an analysis of the anticipated trajectory for each variable, which is compared to historical patterns, known factors and expectations pertinent across the forecast horizon, and any announced fiscal measures pertaining to each component. Section 5.4 highlights the direction of risk for each component based on the analysis in this section.

The outlook for certain categories continues to be very sensitive to the global inflation rate and the government's commitment to stabilise energy prices and secure the supply of gas, petroleum, electricity, grains and animal fodder. Another important element in this forecast round is the anticipated timetable and priority areas for of the absorption of using EU funds (including the RRF grants and the MFF).

5.3.1 Compensation of employees

The key determinants of the public sector's wage bill are the number of public sector employees and their average pay. According to registered employment data, 51,037 individuals were full-time employees within the public sector in 2022 (see Box B).[52] This figure decreased by 0.9 % (449 individuals) when compared to December of the previous year.

The total spending on compensation of employees in 2022 increased by 2.7%, which is €32.1 million less than that projected in the previous forecast round, thus in the DBP (see Table 5.6). This lower growth partially reflects the government's commitment in 2022 to limit public recruitment and related expenditure. This followed the spike experienced in 2021, which was driven by additional recruitment to replace employment not realised in 2020 due to the pandemic.

The annual growth of this component is anticipated to rise by another €131.8 million in 2023, mainly reflecting the provisions for added outlays from negotiated sectoral collective agreements as well as an additional weekly increase to public sector

[52] December 2022 registered employment data may be found here.

employees, over and above the yearly increases in the COLA. The COLA is expected to remain high also in 2024, reflecting expected inflationary developments. The latter year will also be the year when the collective agreement for public service employees shall expire. Yet, the MFE is foreseeing a deceleration in the absolute change in the compensation of employees, forecasted to grow by around €115.0 million in 2025 and 2026. The MFE is assuming that the higher outlay due to the new collective agreement shall be, to a certain extent, compensated for by a lower COLA in 2025.

Table 5.6: Compensation of employees

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2021	12.1	192.6
2022	2.7	48.5
2023	7.2	131.8
2024	6.4	125.5
2025	5.6	115.9
2026	5.2	115.0

Source: MFE

Employment within government agencies is decentralised, and Ministries are free to decide on their employment levels, contingent on the planned recruitment outlined in their plans. The staff of entities categorised as Extra-Budgetary Units (EBUs) are also considered part of the public sector.[53] Although such employees may be bound by individual collective agreements and employment contracts, they are nonetheless expected to adhere to the general salary criteria set forth by the state.

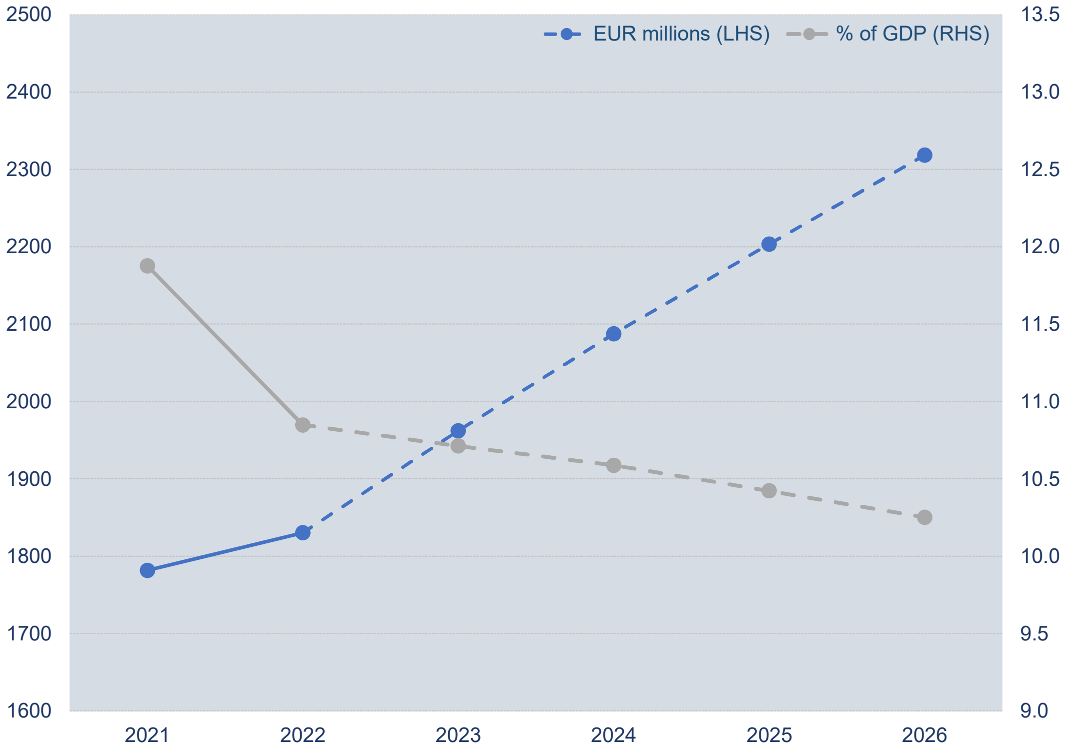
Consolidated Fund and EBU emoluments comprised 65.2% and 27.7% of the total amount spent on wages and salaries, respectively. The growth rates for both Consolidated Fund and EBUs emoluments are expected to accelerate in 2023 and decelerate marginally at comparable growth rates over the following years. Therefore, no significant changes are envisaged in the spending proportions and wages and

[53] These comprise institutional units under public control that are principally engaged in producing goods and services not usually sold on a market and/or involved in the redistribution of national income and wealth.

salaries allocated towards Consolidated Fund and EBU employees over the forecast horizon.[54]

When expressed as a ratio to GDP, compensation of employees shall decrease at rather constant rates to 10.3% by 2026. This reflects stable increments in the compensation of employees, which is counteracted by a similar factor of growth in nominal GDP each year (see Chart 5.9). Apart from certain areas where recruitment is prioritised to keep up with increasing demand (such as in the health and education sectors), the government aims to manage its recruitment whilst trying to limit that undertaken by government entities, to be absorbed within their financial position particularly if these have accumulated savings.

Chart 5.9: Compensation of employees



Source: MFE

[54] The figures in this section may not be entirely consistent with the reported figures in Box B due to different definitions.

Box B: Public sector employees on a full-time basis, by economic activity

The NSO issues registered employment monthly data which includes the number of full-timers employed within the public sector. Registered employment data, including revised data and the relevant classifications, is based on administrative records held at Jobsplus.[55] Data for month t-1 and year y-1 are revised with each registered employment news release. Such data is split according to NACE divisions. Data in this Box refers to employment as stated for December of each year. [56]

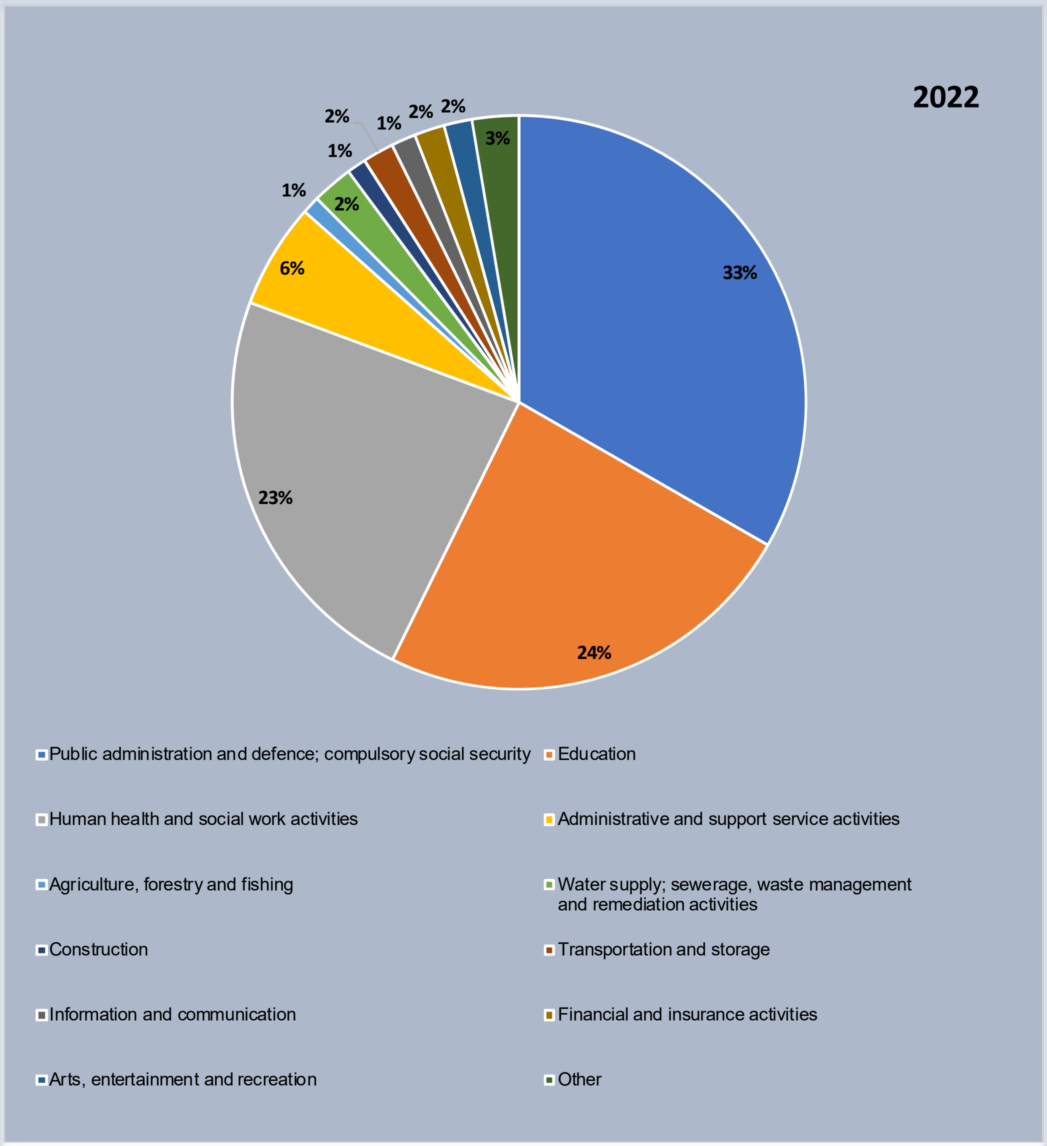
According to NSO's News Release NR083/2023, titled 'Registered Employment: December 2022', 'public sector administration and defence; compulsory social security contributions' constituted around one-third of all full-time employees as of December 2022 (see Chart 5.10).[57] The next largest NACE divisions which employ full-time public sector employees are 'education' and 'human health and social work activities'. Together these two account for 47.4% of the public sector full-time employees registered in December of 2022, with each division employing similar numbers. Administrative and support service activities occupy close to 6.0% of total full-time employees, whilst the rest of the categories occupy less than 3.0% each.

Some changes have occurred in the shares of each division in total public sector full-time employees over the past years. Since 2015, the share of the largest category has increased from 28.7% to 33.3%. Whilst still increasing in absolute terms, the share of employees in the education sector lost 1pp to 24.0%. The share of 'human health and social care activities' stood relatively similar in 2022 as in 2015.

The changes since 2015 are reflected in Table 5.7. The index (2015=100) shows that in 2022 total public sector full-time employees listed by registered employment data have increased to 115% of the level in 2015. The increase was gradual over the years, except for 2022 since recruitment was more limited and the total was less than in 2021. The largest 3 categories increased to 133% (public administration), 110% (education) and 114% (human health and social care activities) of 2015 levels.

[55] This definition of employment is broader in scope than that included in the fiscal forecasts, which is general government sector. This is being used because disaggregated data by sector is only available for public sector employment.
[56] Employment figures used in this box, for historical years prior to 2022, refer to the revised registered employment figures (published in year t+2).
[57] NR083/2023 can be accessed here.

Chart 5.10: Full-time public employees by NACE division in 2022



Note: The 'other' category comprises another 10 NACE divisions which do not each exceed 500 full-time employees, grouped together.

Source: NSO

In percentage terms, the categories which increased the most were the 'arts, entertainment and recreation' division, almost having 1.5 times the number of full-time employees in 2022 than in 2015, and the 'other' division, having more than double employees compared to the base year. On the other hand, 'construction' and 'transportation and storage' have reduced their employees by around half. The employees listed under the rest of the divisions have all seen increments over the seven years considered in this analysis. The index for these categories rose to 115 or less.

Table 5.7: Full-time public sector employees – index (2015=100)

	2015	2016	2017	2018	2019	2020	2021	2022
Agriculture, forestry and fishing	100	71	80	86	108	86	102	105
Water supply; sewerage, waste management and remediation activities	100	103	120	118	117	115	113	112
Construction	100	93	88	85	59	54	53	52
Transportation and storage	100	89	98	107	106	64	63	45
Information and communication	100	106	105	103	114	116	116	115
Financial and insurance activities	100	101	104	110	99	106	109	110
Administrative and support service activities	100	99	99	102	103	104	101	103
Public administration and defence; compulsory social security	100	109	114	114	123	132	134	133
Education	100	103	106	106	107	110	111	110
Human health and social work activities	100	95	94	99	101	112	114	114
Arts, entertainment and recreation	100	101	108	109	135	143	150	148
Other	100	151	164	171	134	164	187	211
Total	**100**	**102**	**105**	**107**	**110**	**114**	**116**	**115**

Source: NSO, compiled by MFAC

5.3.2 Intermediate consumption

Spending on intermediate consumption increased by 5.9% in 2022, thus slowing down when compared to the previous year's growth of 8.3% (see Table 5.8). The actual expenditure on this component turned out to be €41.2 million lower than the MFE's forecast in the DBP, reflecting lower spending on programmes and initiatives and capital expenditure classified under this category. In this context, it is relevant to highlight the spending reviews conducted by the government which aim to achieve more efficiency and value for money in public spending.

Table 5.8: Intermediate consumption

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2021	8.3	98.6
2022	5.9	75.8
2023	13.5	184.3
2024	3.9	60.2
2025	4.6	74.2
2026	4.1	69.2

Source: MFE

This component is anticipated to rise by 13.5% in 2023. In part, this increase factors in some elements of consumption related to the completion of various projects covered by the 2014-2020 Programme of EU funds. In addition, inflationary pressures are expected to significantly impact this component, affecting contractual commitments and increasing the cost of intermediate goods and services. Given this budgetary allocation, intermediate consumption is set to surpass the €1.5 billion mark in 2023, which is 8.5% of GDP (see Chart 5.11). The target for 2023 is €141.5 million higher than anticipated by the MFE at the time of the DBP, a significant change when compared to the no growth which was being projected, on which the MFAC had highlighted upside risks (possibility of higher expenditure). Aside from the abovementioned reasons, higher outlays by EBUs are also envisaged when compared to the previous forecast round.

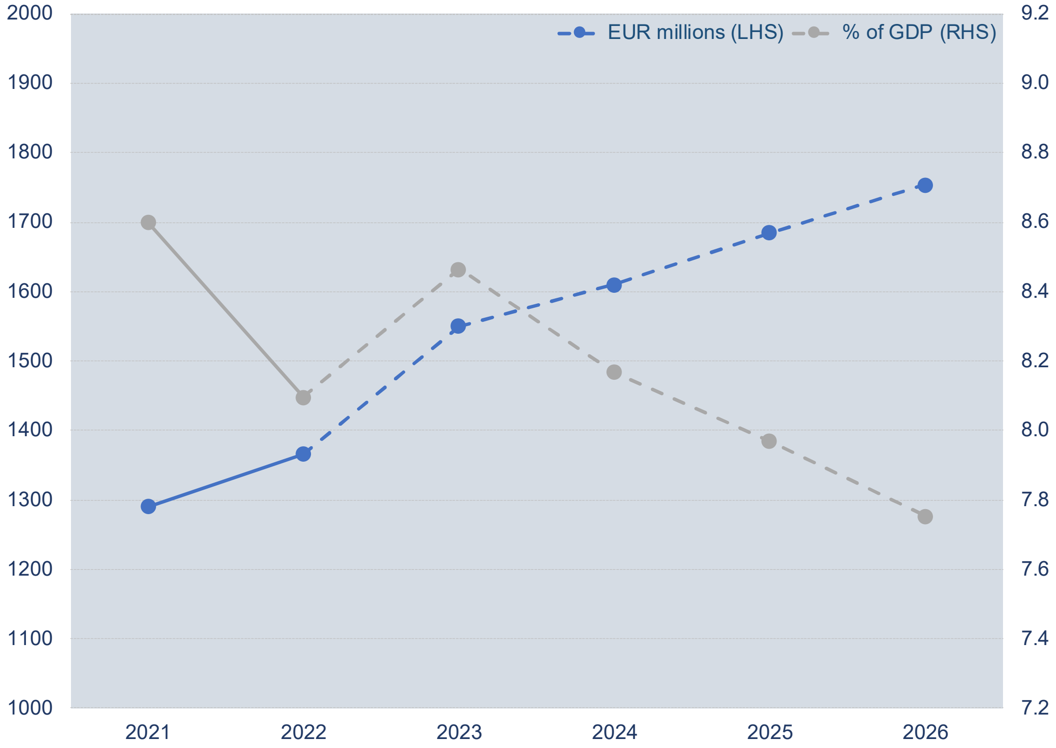
Following the growth in 2023, it is anticipated that the expenditure on intermediate consumption will decelerate, particularly in 2024, to growth rates closer to 4.0%, with inflationary pressures assumed to be less significant, and there being a base effect from the completion of EU-funded projects in 2023. As a result, the ratio to GDP is expected to decrease yearly and gradually to slightly below 7.8% in 2026. In terms of discretionary measures, no new measures are factored in the forecasts, though COVID-related health expenditures, mainly related to the distribution of vaccines, are expected to be significantly lower in 2023 and assumed to be completely phased out by the end of 2024 as no discretionary expenditure is factored in the forecast for 2025.

This component is known to be volatile over time as it is susceptible to a significant discretionary element. Before the pandemic, between 2015 and 2019, this component was increasing by an average of 13.2%. Growth rates for the outer forecast years appear low, particularly as certain elements of expenditure have a history of being gradually re-classified to other expenditures.[58] This particularly applies to the forecast growth for intermediate consumption related to programmes and initiatives and those by EBU's (which collectively account for nearly two-thirds of the component). Nevertheless, this component is one to which cost-saving initiatives can be applied.

[58] The budgeted expenditure amounts specified in the USP frequently serve as an envelope on expenditure without the full granular specifications, resulting in situations where specific components are initially categorised under one heading (using historic ratios), but ex-post are reallocated to other headings as detailed information becomes available. This method tends to limit the comparability of actual and forecast data, an observation that holds for other expenditure components, not just intermediate consumption.

More spending reviews are encouraged given the desired fiscal consolidation path over the medium term.

Chart 5.11: Intermediate consumption



Source: MFE

5.3.3 Social payments

The amount spent on social payments was close to €1.5 billion in 2022, very close to the forecast produced in October by the MFE. This represented an increase of 7.2% over the prior year (see Table 5.9). Higher outlays in terms of retirement pensions were the main factor causing this expenditure growth. As was the case in 2022, 8.8% of nominal GDP is forecast to be spent on this component in 2023 (see Chart 5.12).

Table 5.9: Social payments

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2021	3.5	46.4
2022	7.2	100.0
2023	8.6	127.4
2024	7.1	114.4
2025	4.8	82.6
2026	5.0	91.2

Source: MFE

Several measures which fall under this component have been introduced in the budget for 2023, reflecting the government's commitment to social welfare and addressing societal needs. New policies that improve the income of the elderly and pensioners, and low-income households, were introduced to further reduce the risk of poverty for the most vulnerable members of society. While the non-taxable threshold was raised, most contributory and non-contributory pensions increased above the COLA. Over the forecast period, both contributory and non-contributory benefits are assumed to increase each year consecutively. The MFE assumes that the ratio of benefits to the number of beneficiaries (persons) increases over the forecast horizon for contributory and non-contributory benefits, as the number of beneficiaries remain relatively unchanged whilst benefits increase. In the future years, this expenditure is accentuated because of the ageing problem that the country faces.

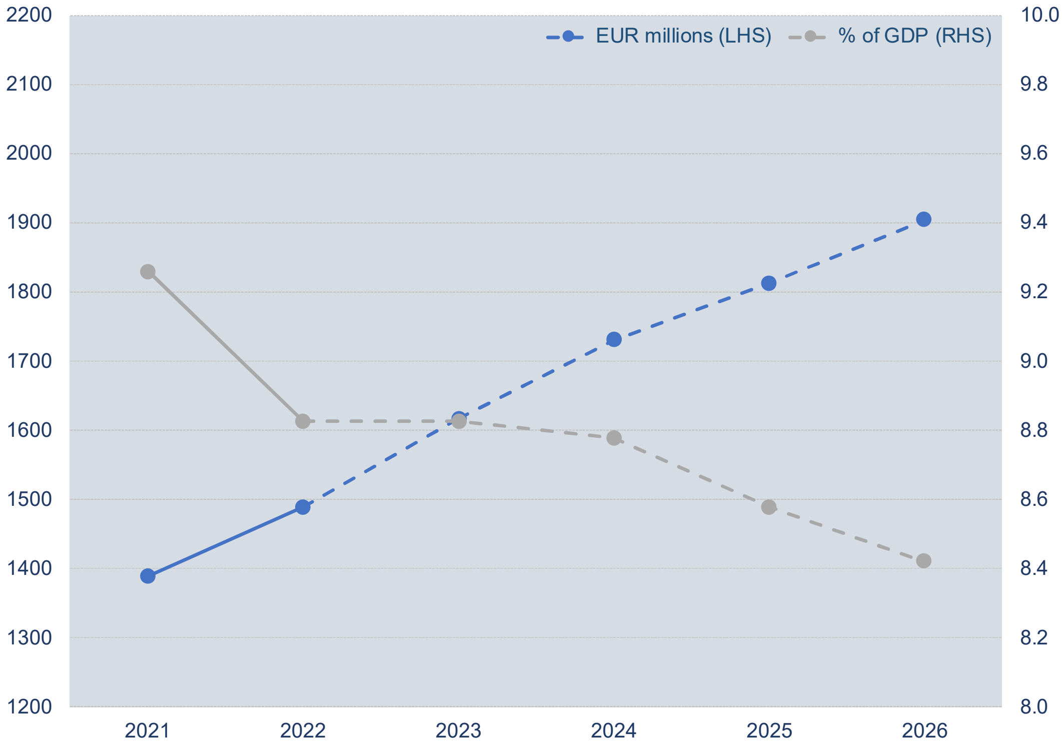
An extended COLA mechanism targeting vulnerable households is expected to have a fiscal impact of €13.0 million from 2023. This mechanism is triggered when overall inflation exceeds 2.0% and when the change in prices among at least three out of five components of the RPI index deemed essential for vulnerable households exceeds the five-year rolling average increases.[59] Additional measures introduced were social support measures, other measures rectifying previous anomalous schemes, and social measures for couples. These four measures are projected to cost close to €77.8 million. 2023 will also be the first full year where the government will shoulder the full expense of the free public transport policy (listed as a discretionary measure). These measures, and other underlying factors, including demographic developments, result

[59] Additional information on how the extended mechanism applies can be found here.

in the growth of this component remaining elevated, at 8.6%, equivalent to an absolute change of €127.4 million in 2023.

Discretionary measures introduced in 2023 in terms of social payments are assumed to have no incremental impact beyond year 't', and no new measures are factored in the estimates for 2024 or beyond. The estimates for social payments plausibly fit within the observed upward trend, though marginally decelerating in 2025 and 2026. However, there has been a consistent trend over the years whereby the government announces new measures related to social payments or announces changes in pensions in each budget, which would not have been factored in this forecast round and time of year. Following 2023, a marginal decline of 0.4pp in the ratio to GDP is expected over the next three years, as the change in social payments is rather even compared to a larger change in GDP in relative terms.

Chart 5.12: Social payments



Source: MFE

5.3.4 Gross fixed capital formation

The government's expenditure on gross fixed capital formation (GFCF) is inherently subject to certain volatility, as new projects are discretionary. The profile for public investment growth over the forecast horizon is also volatile. GFCF is anticipated to grow strongly in 2023, up by 22.5% from the decline in 2022 of 2.1% (see Table 5.10). However, growth is projected to turn negative to -10.7% in 2024, mainly because of a large base effect from 2023. In absolute terms, the budget for public investment is forecast to rise by €126.9 million in 2023 over the prior year but then fall by €74.0 million in 2024. For the outer forecast years, 7.0% and 11.1% growth is projected for 2025 and 2026, respectively, thus offsetting the decline in 2024. Such developments are reflected in the public investment to GDP ratio, expected to rise to 3.8% in 2023 and decline to an average of 3.2% between 2024 and 2026 (see Chart 5.13).

Table 5.10: Gross fixed capital formation

	Yearly growth rate (%)	Yearly absolute change (EUR millions)
2021	3.7	20.8
2022	-2.1	-12.2
2023	22.5	126.9
2024	-10.7	-74.0
2025	7.0	43.4
2026	11.1	73.1

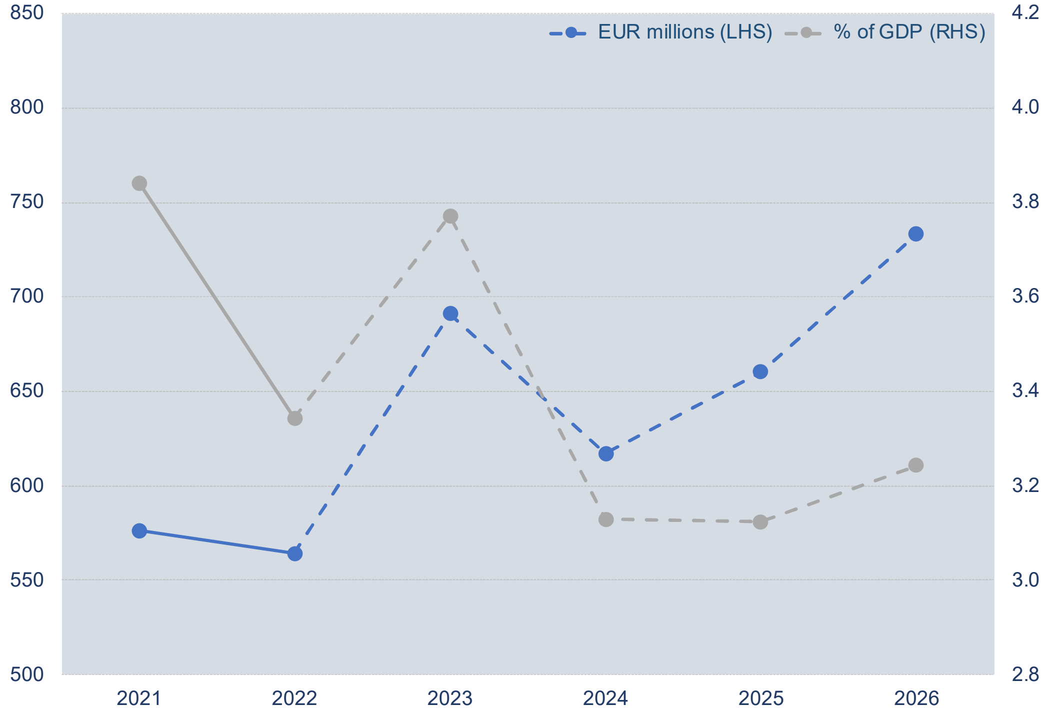
Source: MFE

2023's capital investment is expected to be supported by a substantial boost from EU-financed projects, in particular reflecting the completion of EU-funded projects financed from the programming period 2014-2020, the use of the RRF, as well as from the MFF for the period 2021-2027.[60,61] Indeed, investment expenditure matched by EU Funds is forecasted to rise to €134.6 million in 2023, from €32.1 million in 2022. This declines to €76.4 million in 2024 before stabilising at around €88.0 million in the following two years. Thus, although nationally financed capital expenditure is to remain high, most of the change in yearly investment is EU-funded. Another factor contributing to additional capital expenditure is from funding from the National Development and

[60] Further information on the MFF is available here.
[61] Further information on Malta's RRP is available here.

Social Fund (NDSF). Moreover, investment spending financed from RRF grants, as a proportion of GDP is estimated to amount to 0.5% in 2023, 0.6% in 2024, 0.4% in 2025 and 0.1% in 2026. The assumed rate of utilisation of RRF funds was kept similar to the previous forecast round. Such EU funds are specifically aimed to support the green transition, energy security and the digital transformation.[62]

Chart 5.13: Gross fixed capital formation



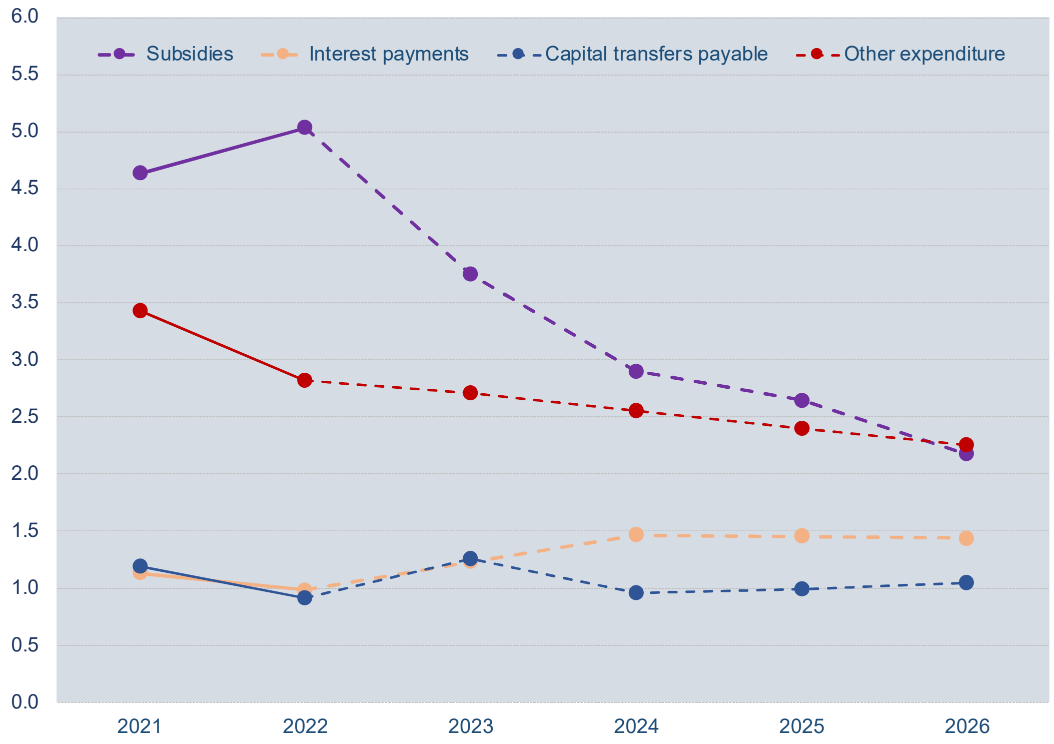
Source: MFE

[62] The European Council has recommended that Malta expands its public investment for the green and digital transitions, and for energy security taking into account the REPowerEU initiative. It encourages Malta to decrease its dependence on fossil fuels, by speeding up the implementation of renewable energy sources such as offshore wind and solar power. Additionally, it recommends that the country should also lower energy consumption by enhancing energy efficiency, particularly in residential buildings. To reduce emissions from road transport, the country should tackle traffic congestion by improving public transport services, implementing intelligent transport systems, and investing in infrastructure that promotes sustainable modes of transportation. Lastly, Malta needs to intensify policy initiatives focused on developing the necessary skills for a successful transition to a greener and digital future.

5.3.5 Subsidies and other expenditure components

The share of subsidies and the other components in total expenditure has increased during the years of the pandemic. Subsidies increased to more than 5.0% of nominal GDP in 2020 and remained elevated at 4.6% in 2021 (see Chart 5.14). This surge mainly reflected the assistance provided by the government to support employment, which was hampered because of COVID-19 restrictions, through various initiatives, but mainly through the wage supplement scheme administered by Malta Enterprise. By May 2022, the latter scheme was terminated. However, the onset of the war between Russia and Ukraine brought about inflationary pressures, particularly in energy prices, which the government deemed a priority to keep under control. In fact, domestic energy prices remained constant. There were also additional subsidies allocated towards the national airline's restructuring assistance because of higher costs due to inflation (fuel prices), and the airline's early retirement schemes. This led to subsidies increasing as a percentage of GDP, to 5.0% in 2022.

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



Source: MFE

The estimates produced at the time of the DBP, thus in October of 2022, showed a much higher allocation for energy subsidies than the eventual turnout for 2022 and the planned allocations for 2023 and onwards (see Box C). However, the savings from lower estimates on subsidies were redirected towards other expenditure items, rather than being used for deficit reduction.

The fiscal projections for 2023 suggest that the budgetary impact of energy-price measures, mainly 'compensation for higher imported electricity prices', the 'Gas Stabilisation Fund', and 'subsidies on petroleum products' is reduced to €262.0 million from €305.0 million in the previous year (see table 5.11).[63] The estimates for energy subsidies remain relatively similar over the forecast years, except for a slowdown in subsidies on petroleum products. The cost of energy subsidies shown in the government's official forecasts is based on estimates provided by Enemalta plc. Such calculations are subject to revisions, also given that these critically depend on exogenous factors and external developments relating to the conflict in Ukraine, the supply of energy from abroad and the energy mix utilised by the operator and effectively, the price of oil, energy, gas and other related products. The estimated cost of these subsidies contributes to an additional expenditure of 1.4 pp of GDP in 2023, declining marginally each year to 1.1 pp in 2025. In terms of energy subsidies, the European Commission has, in its Country-Specific Recommendations (CSRs) recommended that the government winds down the energy support measures in force by the end of 2023, using the related savings to reduce the government deficit.[64]

In terms of the national airline, the MFE quotes spending on its restructuring. Particularly, €60.7 million were spent in early retirement schemes. The government has made provisions for the possibility of more early retirements to be realised in 2023. The Council identifies the future of Air Malta and potential associated costs as an important fiscal risk also given the ongoing discussions with the COM.

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[63] A Gas Stabilisation Fund was also created in 2022 to pay operators, being authorised importers and sellers in bulk or in gas cylinders, to stabilise the price and secure the supply of gas.
[64] The Country-Specific Recommendations are available here.

Box C: Energy subsidies - revisions across forecast rounds

The revisions between the estimates for energy subsidies conducted at the time of the DBP and in this forecast round are significant (see Table 5.11). The allocations towards energy price subsidies reflect in particular developments in international markets, and thus, changes in the prices at which electricity and other inputs needed to produce electricity are bought, can significantly influence the government's forecasts.

Table 5.11: Potential savings from lower allocations towards energy subsidies

Update of Stability Programme 2023 - 2026	**2022**	**2023**	**2024**	**2025**
Compensation for higher imported electricity prices	-221	-200	-200	-200
Gas Stabilisation Fund	-16	-15	-15	-15
Subsidies on petroleum products	-68	-47	-37	-27
Total	-305	-262	-252	-242
Draft Budgetary Plan 2023	**2022**	**2023**	**2024**	**2025**
Compensation for higher imported electricity prices	-248	-500	-430	-305
Gas Stabilisation Fund	-15	-15	-15	-15
Subsidies on petroleum products	-96	-80	-60	-60
Total	-359	-595	-505	-380
	2022	**2023**	**2024**	**2025**
Difference USP - DBP	54	333	253	138
GDP	16,870	18,321	19,732	21,153
Potential savings as % of GDP	0.3	1.8	1.3	0.7

Note: The USP also includes the estimates for 2026, but these were not included in the DBP for 2023.

When combined, the revisions for 2022 resulted in lower spending for the three main components of €54 million. The largest change is portrayed in 2023. For this forecast year, a higher allocation was made in the DBP, close to €600 million. However, the estimates in the USP show that the three energy subsidies are to exert a lower total expenditure than that in 2022, when opposed to an increase of more than €230 million allocated in the DBP. If calculated as a percentage of the updated nominal GDP forecast, this would translate into savings of 1.8% of GDP. However, total expenditure, as a ratio to GDP was kept almost constant in 2023, as the lower estimated outlays on energy measures were directed towards other expenditure items, instead of contributing towards a larger fiscal consolidation. This large difference translates onto the other forecast years, with a further accumulated impact of 1.3 pp in 2024 and 0.7 pp in 2025.

Spending on interest payments remained relatively similar in 2022 to that spent in 2021, marginally declining by €4.0 million to €166.0 million. This resulted in a decline in the ratio of interest payments to GDP. It is expected that in 2023 and 2024, interest payments start increasing and will rise by 35.9% (+€59.6 million) in 2023 and by another 27.9% (+€63.0 million) in 2024, according to the MFE. This is partly due to the estimated considerable increases in total outstanding government debt and may also reflect different methodologies between actual and forecast data when it comes to interest payments. Government debt started to increase significantly since the COVID-19 pandemic in 2020. However, in the case of interest expenditure, the full impact of new debt is reflected in subsequent years. Apart from the increase in debt, increases in the implicit interest rate on debt are another factor that pushes interest payments upward. This rate is proxied by the interest expenditure divided by the debt level of the previous year. It is projected that the implicit interest rate shall increase to 2.5% in the current year, an increase of 0.5 pp compared to 2022. This is followed by a further 0.4 pp increment in 2024, to 2.9%. In the outer years, the rate declines by 0.1 pp consecutively. The profile for interest expenditure as a ratio-to-GDP increases over the first two forecast years but then remains stable in 2025 and 2026, as the increments in interest expenditure are assumed to be much lower over these two latter years (+€18.0 million in each year). Risks to this variable relate to further increments in international interest rates and the extent to which the government adheres to its primary balance targets, and thus whether the issuance of more or less debt than envisaged would have to be resorted to.[65]

In 2023, capital transfers are expected to spike to €229.5 million from €154.2 million in 2022. The increase is mainly due to higher capital expenditure classified under this component, to which an element of higher EU Funding is ascribed for 2023. The disaggregated data of government capital expenditure is partially apportioned to this component, primarily based on the average of the previous three years' ratios. Errors in the forecast of this component may thus be due to classification errors. Capital transfers are assumed to scale down in 2024, though still higher than in prior years (excluding 2023). For the outer years, the target increases slightly above €235.0 million in 2026.

[65] Refer to section 5.5 for more details on debt developments.

Regarding the ‘other expenditure components’, the MFE assumes that the ratio to nominal GDP will fall consecutively to 2.3% in 2026 from 2.8% in 2022. The decline is relatively constant, between 0.1 pp and 0.2 pp. Most of the ‘other expenditure’ developments reflect other current transfers, mainly the contributions to various government entities and EU Own Resource payments.

5.4 Fiscal risk outlook

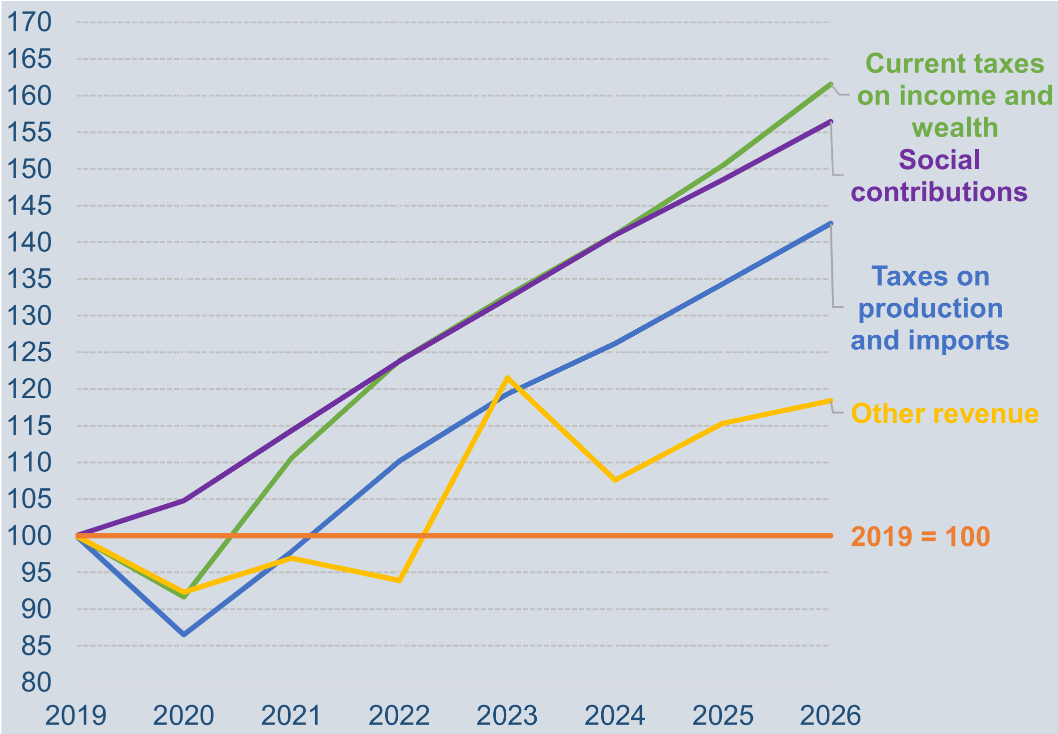
The MFAC’s risk opinion focuses on each revenue and expenditure component from 2023 to 2026. The forecasts presented in the USP hinge on several exogenous factors, mainly on the extent to which the Russia-Ukraine conflict continues to ensue and its repercussion on international energy and commodity prices, how domestic inflationary pressures develop, and government’s energy support measures.

Under the baseline scenario, all the main revenue components are projected to have recovered from the declines experienced in 2020 by 2023 (see Chart 5.15). Over the forecast horizon, the component expected to increase the most is current taxes on income and wealth. This revenue component is expected to increase in 2023 to 132.7% of the level in 2019. The expected trajectory of social contributions is rather stable, growing at relatively similar growth rates over the forecast horizon. Taxes on production and imports recovered above the levels of 2019 in 2022 and shall continue its upward trajectory for the rest of the forecast years. On the other hand, a less stable pattern is projected for ‘other revenue’, increasing above 2019 levels in 2023, but then exhibiting a V-shaped trajectory over the next two years.

The risk profile of the three main revenue components is determined via examining both risks stemming from macroeconomic underpinnings, estimates by the MFAC on the respective elasticities (see Box D) and other known uncertainties or risks. The upside risk identified by the MFAC vis-à-vis the profile for real GDP for 2023 is considered for assessing the individual fiscal components.[66]

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

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



Source: MFE

The profile for the growth in taxes on production and imports is that an 8.3% increment in 2023 is followed by slower growth of 5.8% in 2024, before increasing by 6.4% and 6.1% in 2025 and 2026. The Council's opinion is that revenue from this component could be higher than anticipated. This reflects the possibility of a larger tax base for taxes on production and imports, both from private consumption expenditure and tourism exports. Regarding tourism exports, the risk is higher, particularly for 2024, where the MFE assumes no growth. The data for 2023 that is available until the cut-off date of this report also shows that tourism numbers could be higher than assumed by the MFE. The elasticity of indirect taxes is projected to be higher than that in 2022, where this was below unitary (see Box D). The elasticities assumed in this forecast round are around the unitary value. The MFAC concurs with a similar estimate. Risks could stem should the elasticity change from last year be more of a structural rather than a temporary nature. However, risks are most pertinent in the case of a more positive tax base rather than differences calculated by the MFAC in terms of elasticity.

The growth in current taxes on income and wealth is relatively stable. Its growth profile is 7.1% in 2023, then decelerating marginally to 6.3% in 2024, and then accelerating consecutively with growth rates of 6.7% in 2025 and 7.4% in 2026. This follows the developments in the component's proxy bases, namely compensation of employees and gross operating surplus. These are also assumed to decelerate following the high growth rates in 2022. However, the deceleration could be less strong, particularly in the case of gross operating surplus. These risks translate into a possibility of an upside risk to the government's forecast. Other risks stem from inflationary pressures, should these continue to increase wage pressures leading to higher wages and direct taxes. Additional COLA than forecasted for 2024 and the other forecast years could also boost additional direct taxes, although, in terms of the fiscal balance, these would be countered by higher compensation of employees and social payments. Higher inflation than that projected in the USP would also pose an upside risk to other expenditure categories, including intermediate consumption. As outlined in section 5.2, the elasticity for current taxes on income and wealth is projected to increase and turn above unitary by the end of the projection period. However, applied elasticities are still assumed to remain below historical standards. The MFAC consider that, based on its estimates, marginally higher elasticities can be realised, particularly from corporate taxes. Combined, the higher tax base and elasticity suggest a possibly higher level of direct taxes over the forecast years.

On the other hand, the MFAC views the forecast for social contributions as reflecting the developments in compensation of employees, as both are forecasted to decelerate over the forecast years. Indeed, in absolute terms, social contributions are estimated to rise by very similar amounts each year, between €60.0 million and €70.0 million. The MFAC concurs with the elasticities of the MFE for this variable. The capping of social contributions beyond a set wage bracket limits the extent to which changes in additional wages impact this variable.

Regarding the other revenue components, the significant increase projected for 2023 relates to EU Funds, with the government aiming to ensure that available funds are fully utilised towards the end of their Programme period through realised investment. Other sources relate to the RRF and the MFF 2021-2027. Deviances from the targets related to these funds can influence this source of revenue. Revenue from the residency programme is projected to be larger than in 2022 but still much lower than in the first years when the scheme was in place. As such, the risks surrounding this source of revenue are thus rather limited. Overall, no particular upside or downside risks are identified for the other revenue components.

Considering the description and analysis provided for each revenue component in section 5.2 and the summary of risks provided above, the overall risk outlook of the MFAC in relation to total revenue is on the upside. An ad-hoc risk to the revenue projections relates to the extent to which the introduction of global tax harmonisation has an impact on the country's business. The global minimum level of taxation rules applicable to the multinational investor market could affect Malta's ability to retain its competitive position relative to our foreign counterparts and may also potentially lead to deviations in the fiscal revenue targets during the Programme period.

Box D: Fiscal revenue model developed by MFAC

The MFAC has recently developed a new fiscal model, based on the standardised ESA 2010 framework, to enable a more granular analysis of the primary revenue components, i.e., taxes on production and imports, current taxes on income and wealth, and social security contributions. These three revenue components account for more than four-fifths of total government revenue. The analysis was carried out at the sub-component level, thus, the individual elements contributing to the total revenue were examined. Through its model, the MFAC can perform a deeper analysis and obtain a better understanding of the tax base, the responsiveness of the revenue component to changes in the tax base and, accordingly, improve its risk assessment.

The development of the new fiscal model involved studying the various sources of revenue, such as taxes, fees, and other income streams, and examining their historical patterns and relationships. This data-driven approach allowed the MFAC to identify key factors influencing each revenue sub-component and establish econometric models to capture their dynamics.

The amount of revenue collected is driven by two main factors, the tax base and taxation policy. The tax revenue elasticity focuses on the impact of the macroeconomic environment alone on receipts, with tax policy held constant. Through this model, the MFAC was able to derive the relationship between the revenue collected and its respective tax base (see Table 5.12).

Using the above elasticity estimates, the Council considered two scenarios. The first scenario maintains the macroeconomic projections provided by the MFE. In this case, the MFAC employs its model-driven elasticities and produces a forecast. In this scenario, the MFAC assesses an element of upside risk in the budgetary projections as presented by the MFE, save for 2026. Overall, the magnitude of this upside risk decreases over time. Interestingly, the MFAC assesses a downside risk in taxes on production and imports and net social contributions, but upside risks in current taxes on income and wealth (see Table 5.13). In 2023, the MFAC foresees an upside risk of around €40.0 million in total revenue. For 2024 and 2025, the Council also projects an upside risk albeit not as significant as that in 2023.

Conversely, in 2026, a marginal downside risk of approximately €14.0 million is estimated.

Table 5.12: MFAC's estimate of elasticities for the main revenue components

	2023	2024	2025	2026
Taxes on production and imports	1.1	1.1	1.0	1.1
of which Value Added Taxes	0.9	1.0	1.2	1.2
Current taxes on income and wealth	1.0	1.0	1.1	1.2
of which taxes on individual or household income including holding gains	1.3	1.3	1.3	1.3
of which Taxes on the Income or profits of Corporations including Holding Gains	0.3	0.3	0.4	0.8
Net Social Security Contributions	1.0	1.0	1.0	1.0

Source: MFAC Estimates

The second scenario incorporates changes in the macroeconomic projections based on the expert judgment of MFAC, reflecting the macroeconomic risks highlighted in Section 3.11 of this Report. The MFAC considers various factors, such as changes in global economic conditions, domestic policies, emerging trends, and other relevant factors that may impact the baseline macroeconomic outlook of the MFE. By introducing changes to the macroeconomic projections in the second scenario, the MFAC aims to provide a more encompassing risk assessment of the Government's revenue outcomes, assuming the same discretionary measures as outlined by the MFE in the USP. This approach allows the Council to incorporate their expert judgment and insights into the forecasting process, which can be particularly valuable in situations where the Council identifies significant deviations or risks compared to the initial projections.

The projections derived from this scenario convey positively for the government's total revenue for 2023 by around €70.0 million, as an upside risk in all the primary revenue components, save for net social security contributions is estimated (see Table 5.14). Similarly, when incorporating the possible macroeconomic risks for 2024 and 2025, the MFAC assesses larger upside risks of close to €20.0 million, relative to the scenario when incorporating the same macroeconomic projections. In 2026, a downside risk is once again foreseen, yet to a lesser extent than that estimated in the first scenario.

Table 5.13: MFAC Projections Assuming the same Macroeconomic Projections from the MFE (EUR millions)[67]

	2023			2024			2025			2026		
	MFE	MFAC	MFE-MFAC	MFE	MFAC	MFE-MFAC	MFE	MFAC	MFE-MFAC	MFE	MFAC	MFE-MFAC
Taxes on production and imports	1,924.7	1,923.3	1.4	2,035.7	2,022.6	13.1	2,166.6	2,149.1	17.5	2,299.6	2,280.9	18.7
of which Value Added Taxes	1,300.0	1,295.7	4.3	1,376.0	1,369.9	6.1	1,469.0	1,463.3	5.7	1,568.0	1,561.6	6.4
Current taxes on income and wealth	2,463.1	2,508.7	-45.6	2,617.2	2,649.0	-31.8	2,792.6	2,837.5	-44.9	2,998.2	3,034.5	-36.3
of which taxes on individual or household income incl. holding gains	N/A	1,596.2	-	N/A	1,760.3	-	N/A	1,916.7	-	N/A	2,081.9	-
of which Taxes on the Income or profits of Corporations incl. Holding Gains	N/A	811.5	-	N/A	817.4	-	N/A	847.1	-	N/A	876.9	-
Net Social Security Contributions	1,059.0	1,053.7	5.3	1,128.0	1,112.3	15.7	1,188.5	1,165.8	22.7	1,251.9	1,220.6	31.3
Downside / (Upside) on Government Revenue			**-38.9**			**-3.0**			**-4.7**			**13.7**

Source: MFE, MFAC Estimates

Table 5.14: MFAC Projections incorporating changes in Macroeconomic Projections based on MFAC Expert Judgment (EUR millions)

	2023			2024			2025			2026		
	MFE	MFAC	MFE-MFAC	MFE	MFAC	MFE-MFAC	MFE	MFAC	MFE-MFAC	MFE	MFAC	MFE-MFAC
Taxes on production and imports	1,924.7	1,943.7	-19.0	2,035.7	2,054.4	-18.7	2,166.6	2,180.5	-13.9	2,299.6	2,309.9	-10.3
of which Value Added Taxes	1,300.0	1,313.1	-13.1	1,376.0	1,397.4	-21.4	1,469.0	1,490.3	-21.3	1,568.0	1,585.8	-17.8
Current taxes on income and wealth	2,463.1	2,521.3	-58.2	2,617.2	2,646.7	-29.5	2,792.6	2,829.7	-37.1	2,998.2	3,025.2	-27.0
of which taxes on individual or household income incl. holding gains	N/A	1,596.9	-	N/A	1,735.7	-	N/A	1,896.0	-	N/A	2,047.6	-
of which Taxes on the Income or profits of Corporations incl. Holding Gains	/NA	823.1	-	N/A	839.3	-	N/A	859.6	-	N/A	901.6	-
Net Social Security Contributions	1,059.0	1,053.6	5.4	1,128.0	1,102.3	25.7	1,188.5	1,157.7	30.8	1,251.9	1,207.8	44.1
Total Effect on Gov. Revenue			**-71.8**			**-22.5**			**-20.2**			**6.8**

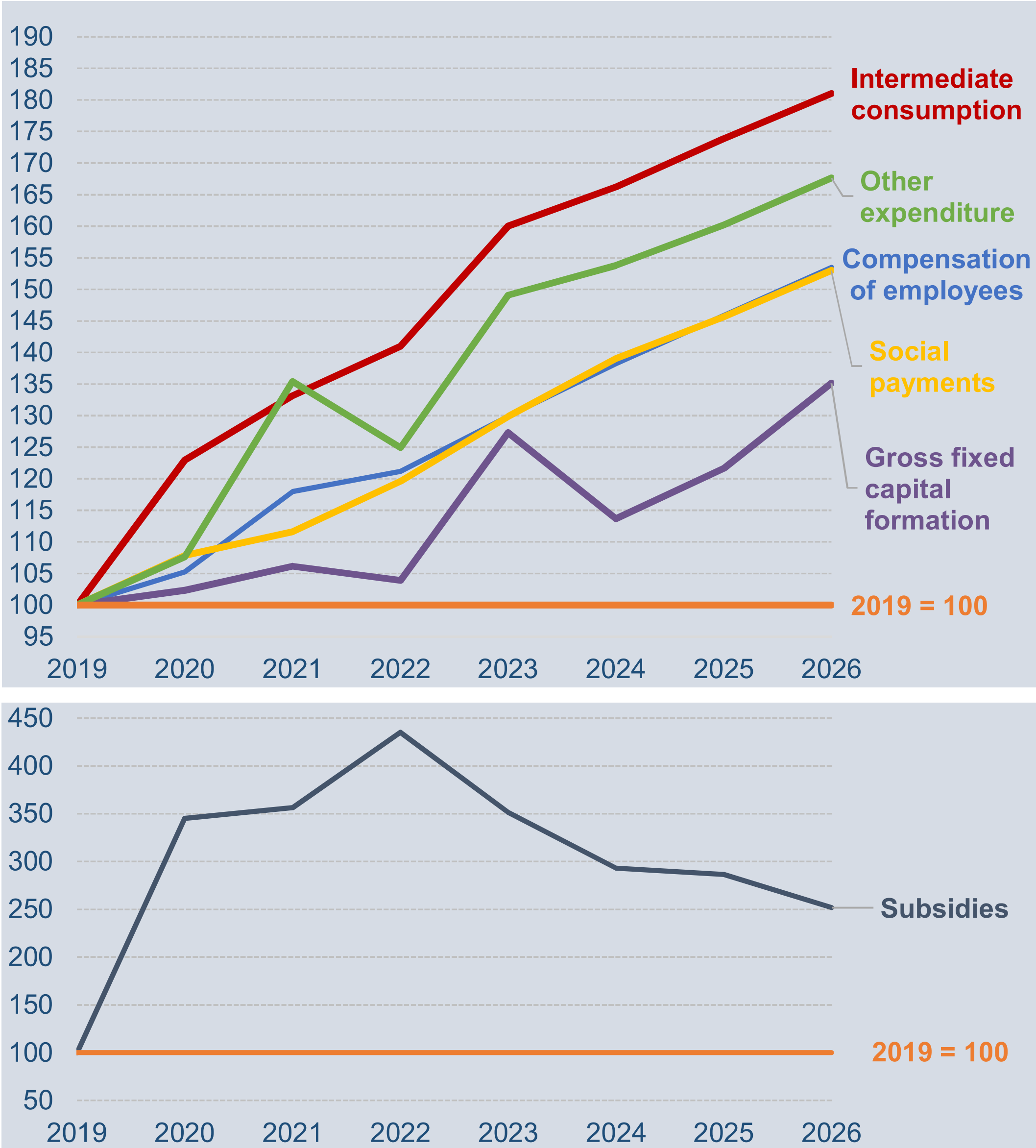
Source: MFE, MFAC Estimates

[67] A negative balance in Tables D.2 and D.3 reflects an upside risk to the projections by the MFE, whilst a positive balance indicates a downside risk.

On the expenditure front, patterns amongst the individual components are varied (see Chart 5.16). Intermediate consumption, gross fixed capital formation and 'other expenditure' are projected to increase significantly in 2023. On the other hand, subsidies are projected to fall, as energy prices have abated, impacting the level of energy subsidies when compared to previous forecast rounds. Further declines are assumed for the rest of the forecast years. Compensation of employees and social payments, and to an extent gross fixed capital formation, are characterised by a close to linear upward trend throughout the forecast horizon. Compensation of employees and social payments continue to rise at a similar pace when indexed to their level in 2019 over all the forecast years. Gross fixed capital formation is projected to decline in 2024, following the large increment in 2023, but then rise again to higher levels, aided by funds from the RRF and the MFF 2021 – 2027 over the outer forecast years.

Turning to risks, starting with compensation of employees, the MFE is assuming a deceleration over the forecast years, which is backed up by the lower inflation costs linked to COLA and the government's aim to contain recruitment. The MFAC considers that some upside risks, thus the possibility of higher spending, exist particularly for the outer forecast years when the new government collective agreement is initiated. Other risks relate to the extent to which the estimated rates of inflation materialise or not, which in turn, would translate into a higher or lower COLA over the next years. Turning to intermediate consumption, a 13.5% growth rate is envisaged for 2023, which is relatively high, especially when compared to the almost no growth presented in the DBP for 2023. Higher costs are mostly due to increments in prices related to certain intermediate goods and contractual agreements, such as those related to healthcare. Following 2023, growth in intermediate consumption is expected to slow down, to around 4.0%. These are low growth rates when compared to historical data. The assumption is that increments in prices abate, and so should the cost of intermediate goods and services. The MFAC, however, views that higher growth rates could be possible in the outer forecast years.

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



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

Source: MFE

Concerning social payments, the main developments for 2023 relate to the inclusion of new measures in the Budget for 2023, which are considered in this forecast round. The assumed acceleration in expenditure relating to social payments for 2023 is viewed as plausible. This also applies to the rest of the forecast period, assuming no new measures. The Council, however, acknowledges that there has been a consistent trend over the years whereby the government announces new measures related to social payments or announces changes in pensions in each budget. Such discretionary measures are not factored in the projections. The profile of government investment is more volatile, partly underpinned by changes in the absorption of EU Funds. The forecast, particularly for 2023, is underpinned by the extent to which the large increase in investment is indeed realised within the set timeframe. Risks can emanate from delays in project implementation or the limited availability of resources to conduct certain investments, amongst others.

In turn, the risk outlook for subsidies still remains highly uncertain, particularly for the energy support measures. The Council notes that the commitment by the government to continue offering energy price subsidies to all households and businesses is still in place. At the same time, the risk outlook for the cost of energy subsidies still remains highly uncertain, in view of the ongoing war between Russia and Ukraine and its effect on international energy prices. Furthermore, changes in the attitude of households towards energy-saving, the usage of energy, and the employed energy mix, amongst other factors, could all influence the level of subsidies required to be paid by the government, either more positively or negatively. The Council considers that the uncertainty surrounding this expenditure component, together with its notable magnitude, constitute an important risk element to the fiscal projections. Another risk related to subsidies involves the financial assistance to the national airline. Discussions with the European Commission are ongoing and potential additional subsidies to the company or outlays related to the set-up of a new airline imply further risks associated with the ‘subsidies’ expenditure component. The amount of government borrowing over the forecast period is high by historical standards affecting the cost of government borrowing. Risks to interest expenditure relate to further increments in interest rates and the extent to which the government adheres to its primary balance targets, and thus whether there would be the need for more or less borrowing than envisaged. No particular risks are viewed in terms of the other expenditure items.

The assessment carried out by the MFAC on the expenditure components suggests that risks to total expenditure tilt more on the upside (possibly higher expenditure), particularly for the outer forecast years, assuming unchanged MFE projections relating to the energy subsidies. The upside risks noted for total revenue, specifically for current taxes on income and wealth and taxes on production and imports, are considered to be compensated by the possibilities of higher expenditures in certain line items. However, the risk of a higher fiscal deficit is more pertinent over the outer forecast years. Nonetheless, the fiscal balance as a percentage of GDP is supported by the upside risks to GDP, which is the denominator in this ratio. Various factors could underpin the trajectory of the fiscal balance, and any changes in government policy, or the materialisation of certain ad-hoc risks listed above could result in deviations from the deficit targets. The risks are higher given that any deviances that worsen the fiscal deficit ratio would have to be adjusted for, given the fact that the 3% deficit benchmark is only set to be adhered to by 2026. The fact that the budget deficit target for 2026 is only 0.1 pp below the 3% threshold, leaves little to no room for manoeuvre in the budgetary targets set out in this year's USP, which may become necessary in case of any unforeseen shocks which may require the Government's support through countercyclical fiscal policy.

5.5 Assessment of the public debt projections

In 2023, the outstanding level of public debt is expected to rise by €976.9 million, from €9,003.4 million to €9,980.3 million. The majority of the increase reflects the financing of the government's deficit for the year, which is projected to amount to €913.3 million. The rest of the difference is made up of the estimated level of SFA.[68] The latter is expected to push up debt by €63.6 million in 2023.[69] These estimations follow a large negative SFA reported for 2022, of €241.6 million, which offset, in part, the negative contribution from the government's net borrowing figure of €981.1 million.[70]

From 2024 onwards, the MFE is projecting an increase in the SFA, to levels which hover around €120.0 million. For 2024, this would mean a higher increment in debt than that of 2023. On the other hand, as the projected deficits decline and SFAs remain stable, the yearly increase in debt at the end of the forecast period is forecast to slow down to €776.1 million (see Table 5.15).

In terms of SFA, a main change from 2022 reflect those assumed for ESA adjustments, turning from negative to positive. The estimated ESA adjustments increase year-on-year until 2026. Also, no movement in the government's bank account to fund additional debt is projected, compared to a significant movement in 2022.[71] In line with

[68] 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 the stock of debt.
[69] The SFA's listed in this section are different than the ones portrayed in the USP. The Medium-Term Fiscal Strategy will include the revised SFAs.
[70] The reported SFA for 2022 varies significantly from the estimated SFA in the DBP for 2023. In the latter, the estimate was that the SFA would be positive.
[71] Movements in bank account are discretionary and only used post end-year should this be necessary.

this, equity acquisitions are projected to decline in 2023, and thereafter be almost negligible, whilst total consolidation is set to shift to positive as of 2024, following a less negative figure in 2023 when compared to 2022.

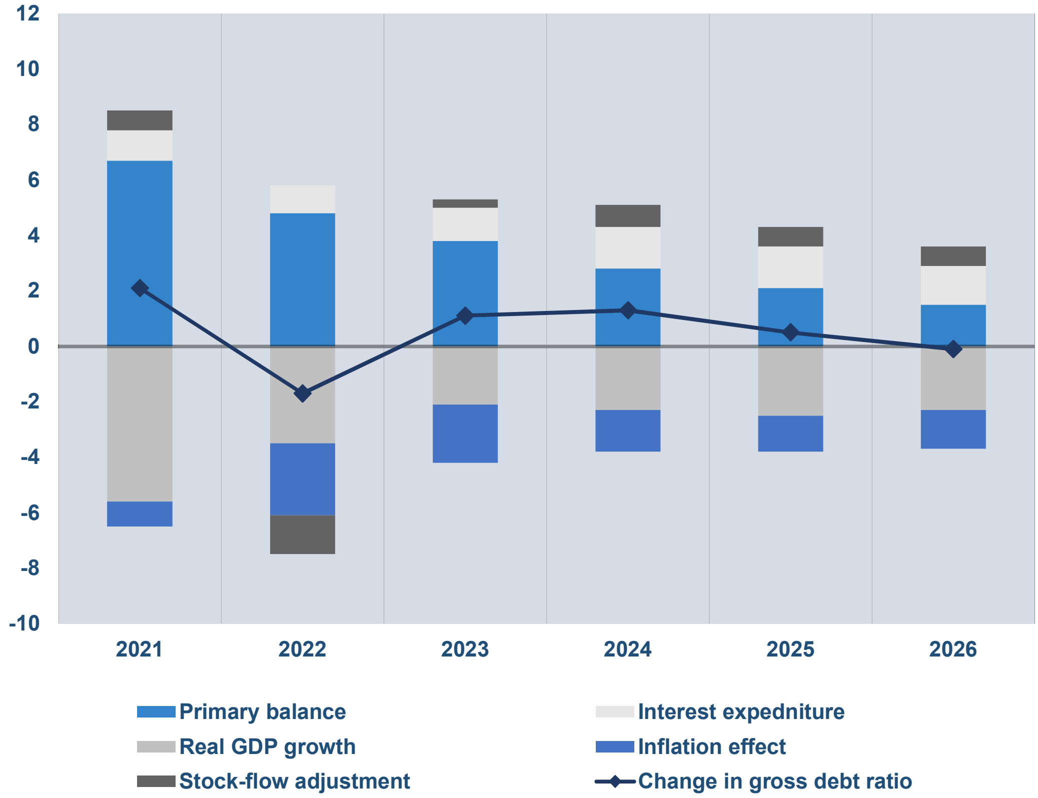
The proposed EU legislation on fiscal rules still maintains the 60% benchmark as a threshold, meaning countries that fall below the 60% threshold are considered as low-debt countries. In this respect, the government's aim is to keep below this benchmark. The debt ratio is portrayed to increase by 1.1pp in 2023 (see Chart 5.17). The change in the debt ratio is slightly higher for 2024, at 1.3 pp, before slowing down to 0.5 pp in 2025 and then declining by 0.1 pp in 2026. These developments translate into a gross debt ratio that increases to 56.1% from 53.4% in 2022, thus remaining below the 60% benchmark.

Table 5.15: Stock-flow adjustments (EUR millions)

	2022	**2023**	**2024**	**2025**	**2026**
ESA adjustments	-131.1	29.1	85.6	99.4	99.4
Total changes in Sinking Fund balances and MGS holdings	25.1	30.1	30.0	30.0	30.0
Equity acquisitions	45.0	12.5	0.1	0.1	0.0
Currency	12.5	6.1	6.7	7.4	8.1
ESA re-routed debt	18.1	20.0	20.0	5.0	0.0
Total consolidation	-96.4	-33.4	25.6	1.5	18.2
Movement in Bank Account	-94.9	-	-	-	-
Other adjustments	-19.9	-0.8	-3.5	-3.4	-3.4
Total stock-flow adjustment	**-241.6**	**63.6**	**164.5**	**140.0**	**152.3**

Source: MFE

Chart 5.17: Contributions to changes in gross debt ratio (pp)



Source: MFE

The primary balance is to contribute 3.8 pp to the change in the gross debt ratio as a percentage of GDP. On the contrary, the snowball effect has a negative effect of 3.0 pp. The snowball effect is composed of the contribution from real GDP growth and the impact of inflation (each contributing 2.1 pp to lower debt ratio) and also includes interest expenditure, which has a positive effect of 1.2 pp. The effect from SFAs is low but would still contribute an additional 0.3 pp to the change in the debt ratio.[72]

Between 2024 and 2026, the contribution from the primary deficit reduces year-on-year, though remaining positive at 1.5 pp in 2026. On the other hand, the snowball effect has a lower negative value over the rest of the forecast years, thus contributing less to the reduction in the debt ratio. This is due to a lower debt ratio reducing effect from the combined impact of real GDP growth and the inflationary element, whilst interest expenditure is set to be higher. With respect to the latter, the MFE is projecting an implicit interest rate on debt that peaks and increases to 2.9% in 2024, which follows

[72] In light of an inconsistency in the SFAs (which was referred to in a footnote above), the contributions which are depicted in Chart 5.17, may marginally change in the MFE's forthcoming publication (the Medium-Term Fiscal Strategy).

an implicit interest rate of 2.0% in 2022 and 2.4% in 2021. The impact from SFAs is slightly higher in the outer forecast years.

5.5.1 Assessment

In terms of the overall debt ratio, the overall upside risk identified for the profile for real GDP (i.e., higher economic activity than anticipated in the baseline scenario) over the forecast horizon can lead to a higher debt-decreasing impact from the interest-growth differential (snowball effect). On the other hand, there is some risk relating to the extent to which the primary deficit is larger, or smaller than projected by the MFE. These risks were discussed in section 5.4. The Council's assessment is that the risk that a higher fiscal deficit materialises is more pertinent over the outer forecast years, which risk could push gross debt in absolute terms, upwards. The MFAC however views that the overall profile for the debt-to-GDP ratio could potentially turn out better than the MFE's targets. This would widen the gap away from the 60% debt benchmark. Also, the recommended nationally financed net primary expenditure growth figure of 5.9% by the COM is considerably above the figure of 3.9% quoted by the MFE in the USP, which would mean that debt remains at plausibly sustainable levels and below 60%.

Chapter 6
Comparison of different fiscal forecasts

6.1 Introduction

The USP 2023–2026 fiscal projections can be further assessed by noting the similarity, or otherwise, to the forecasts produced by other reputable institutions. The caveat remains that these forecasts are not necessarily prepared simultaneously and thus would not include the same data sets and information. Moreover, given the current degree of uncertainty, such differences may play a more significant role than in regular times. Nevertheless, the MFAC views this comparison as a reliable standard for validating the qualitative evaluation of the financial estimates in Chapter 5. To track the revisions in the main revenue and expenditure components, the fiscal outlook provided in the USP is also compared to the previous round of fiscal estimates released by the MFE in the DBP.

6.2 Comparison with DBP 2023

The targets specified in the USP reflect a slightly better fiscal balance position for 2023 than that specified in the DBP, as the deficit is projected to be lower by €58.7 million (see Table 6.1). The USP's updated forecast for total revenue is higher than that estimated at the time of the DBP, even though total revenue turned out lower in 2022 than estimated in October. On the other hand, the estimated total expenditure is also higher, but to a lesser extent than revenue. Although the changes in aggregate revenue and expenditure are not large, some significant revisions were implemented in terms of some sub-components.

The most significant revisions were undertaken on the expenditure side of the budget. The largest change was with respect to the downward revision in subsidies. As already reviewed in Chapter 5, the estimated cost of energy subsidies, which, in 2022, turned out lower than had previously been projected, was significantly revised down for 2023. Indeed, this is the primary contributor to the €173.2 million reduction in total subsidies for the latter year. On the other hand, additional national airline restructuring assistance offsets some of this downward revision.

Counteracting this revision is an increase in the estimated expenditure on intermediate consumption of €141.5 million compared to the DBP's targets. This mainly reflects updated prices and high inflationary impacts, particularly in the health sector. The other expenditure components were, on the whole, kept on a more similar level to the estimate in October.

The upward revision in total revenue was broad-based across all components, except for taxes on production and imports, which in absolute terms, is expected to turn out €61.0 million less than the DBP's target for 2023. The elasticity for this component turned out lower than projected in the DBP for 2022. For 2023, a higher elasticity than that registered in the previous year was assumed but still below historical averages. Meanwhile, current taxes on income and wealth were revised upwards by €40.0 million, based on a slightly higher elasticity and a higher growth in compensation of employees (marginally compensated for by a lower growth rate in gross operating surplus). A similar change is projected for social contributions, primarily due to a larger tax base (€37.2 million). The 'other revenue' component was revised upwards by €50.0 million, mostly due to more market output.

The forecasted debt target for 2023 has been revised downwards by 3.8%, between the DBP and the USP. The forecast is heavily influenced by the outturn in 2022 whereby debt turned out to be €303.3 million less than estimated at the time of the DBP. This was the result of a very big difference in the estimate of the SFA, which turned from a positive balance to a negative one of €241.6 million. The main changes in the estimated level of SFA were in terms of ESA adjustments, movement in the government's bank account and 'total consolidation'. These all contributed towards a lower debt level. SFA developments and adjustments are considerably volatile and further information included in their estimation is generally available after the end of the year. This uncertainty and volatility in the SFA also surround the debt projections for the outer forecast years. For 2023, apart from the base effect of 2022, the difference in the change in gross debt is €88.7 million. This reflects the better fiscal balance (€58.7 million) projected for 2023, which is supplemented by a lower (though also positive) SFA for 2023 (€30.0 million) in the USP when compared to the DBP.

Table 6.1: Difference between USP 2023 – 2026 and DBP 2023 (EUR millions)[73]

	2022	2023	2024	2025
Total revenue	**- 120.4**	**66.9**	**131.4**	**188.3**
Taxes on production and imports	- 53.7	- 61.0	- 78.6	- 81.7
Current taxes on income and wealth	- 27.3	40.0	97.0	133.0
Social contributions	21.1	37.2	49.3	55.3
Other revenue*	-60.5	50.7	63.7	81.8
Total expenditure	**- 87.4**	**8.3**	**185.6**	**379.1**
Compensation of employees	- 32.2	9.9	42.4	60.7
Intermediate consumption	- 41.2	141.5	183.8	204.7
Social payments	5.6	- 5.0	41.3	42.4
Gross fixed capital formation	- 83.8	9.2	54.9	82.0
Subsidies	83.2	- 173.2	- 183.6	- 66.6
Other expenditure**	- 19.1	25.9	46.9	55.9
Fiscal balance	**- 33.1**	**58.7**	**- 54.2**	**- 190.8**
Gross debt	**- 303.3**	**- 392.0**	**- 272.4**	**- 16.1**
Nominal GDP	194.6	422.5	804.8	1,282.6

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

Source: MFE

[73] Figures for 2022 in the USP refer to actual data, whilst figures for 2022 in the DBP are forecasts. Forecasts for 2026 were not published in the DBP, as the MFE's forecasts cover until year t+3.

Most of the variances for 2023 across the revenue and expenditure components are also translated on to those for 2024 and 2025. However, the magnitude of the change in total revenue is lower than the changes in total expenditure between the two forecast rounds. This translates into a worse fiscal balance for the outer years in the USP. Indeed, the latter projects a slower consolidation towards the 3% benchmark as such target is now projected to be reached in 2026, as opposed to the previous target of 2025 outlined in the DBP. This contributes to a lower difference in the public debt figures between the two publications in 2024 and 2025 than in 2023.

6.3 Comparison with forecast produced by other institutions

All institutions considered in this Chapter forecast that the government's fiscal position will remain in deficit from 2023 to 2026 (see Chart 6.1).[74] All institutions also project that the fiscal deficit shall improve year-on-year in all forecast years. For 2023, most institutions anticipate that the deficit should be close to the MFE's target, with most projections being at or close to the 5.0% mark. The fiscal deficit-to-GDP ratio lies within a range of 0.5 pp for 2023 across all the institutions, with the range of estimates widening to 1.3 pp in 2024

The CBM and S&P estimate the lowest deficit of 4.9% in 2023, while Fitch and Moody's forecasts are the highest at 5.4%. S&P again estimate the lowest deficit for 2024, at 3.2%, while Moody's and the COM estimate the highest deficit at 4.5%. It is expected that the variation in the estimates increases in more distant years. Furthermore, these variances are partly attributed to the fact that certain institutions still need to update their forecast with the most recent data.

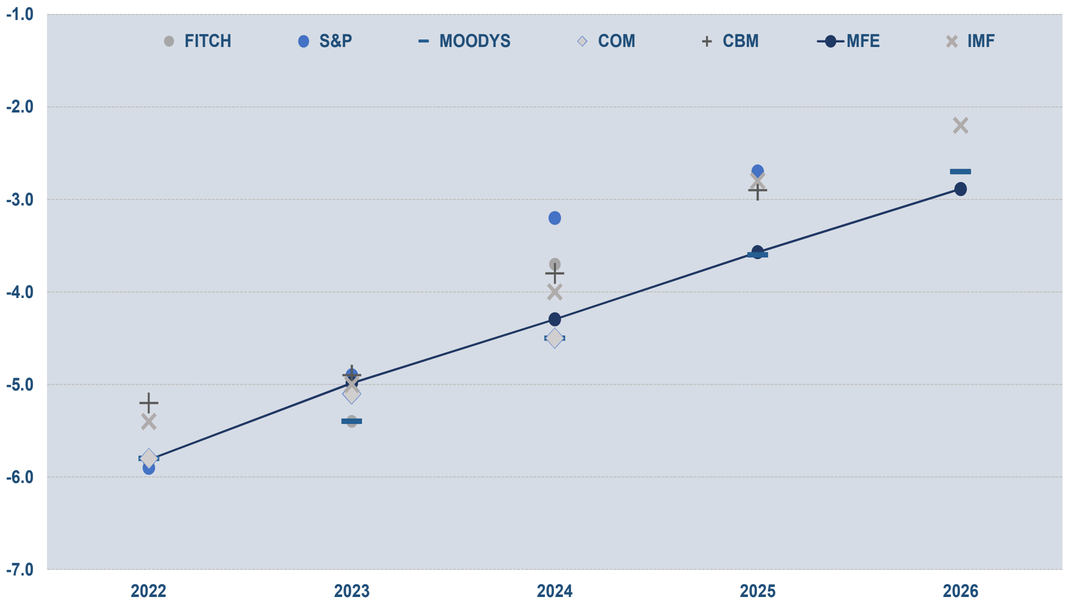
Information on policy changes and the stance on certain measures announced by the government is another important factor influencing the fiscal projections. This has become more important especially since 2020, due to the magnitude of government's budgetary response, first to the effects of the COVID-19 pandemic and more recently in relation to the energy support measures.[75]

[74] Forecasts referred to in this Chapter are the same as those used in Chapter 4.
[75] Indeed, an important input in the fiscal forecasts is the availability of information on the cost of the energy-price subsidies. The first estimates of the energy price subsidies were published in April 2022, at the time of the previous USP. However, the costs were updated, on 16 September 2022 and re-updated with the publication of the latest forecast figures in the USP.

The number of institutions producing forecasts beyond 2024 is more limited. These institutions project that Malta's fiscal deficit will drop below 3% by 2025, comparable to the target previously set by the MFE in the DBP forecast round. However, the MFE currently envisages a more gradual decline in its deficit, reaching a lower value falling below the EU's Maastricht benchmark of 3% of GDP in 2026.

The expected deficit improvement is projected to happen at a comparatively constant rate across all institutions. These projections indicate that Malta's fiscal deficit would decrease by an average of 0.6 pp between 2022 and 2023 and a further 1.1 pp between 2023 and 2024. It is noted that for 2023, most institutions are envisaging an equivalent or worse deficit ratio to the MFE's projection, whilst from 2024 onwards, most institutions anticipate a better fiscal balance than that foreseen by MFE.

Chart 6.1: Fiscal balance estimates by institution (% of GDP) [76]



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

The MFE's forecasts can also be compared, at component level, to the fiscal projections produced by the COM and the CBM (see Table 6.2). Compared to the MFE's targets, the COM's estimates for 2023 are relatively close. Both the level of revenue and expenditure are forecasted as slightly less by the COM. The €36.1 million

[76] Some marginal differences also exist for 2022 as data is revised from one ESA data release to another, either through a new general government accounts data, or a new GDP release which influences the ratio's denominator. Due to the different cut-off dates employed, some institutions would not have had the latest statistical data release available as that used by the MFE.

lower revenue is partially mitigated by the €14.4 million lower projection for expenditure, which leads to a marginally more negative fiscal balance than the MFE's. In terms of revenue, the variance for 2023 is broad-based, with the COM being marginally less optimistic on the outturn of all the revenue components. Indeed, both private consumption expenditure and compensation of employees (the main macro-economic proxy bases) are higher in the case of the MFE.

Turning to 2024, the COM's forecast is also quite close to the MFE's, but the difference is larger than in the previous year, with a €40.4 million higher deficit in the case of the COM. This time, both revenue and expenditure contribute towards the variance in the deficit, as expenditure is higher by €10.7 million, whilst revenue is lower by €29.7 million. Again, the COM is slightly more conservative on the main revenue components, also reflecting a lower tax base. The COM is projecting higher expenditure particularly for intermediate consumption and social payments, but notably lower expenditure in 'other expenditure' relative to the MFE.

Concerning the CBM's forecast, the caveat is that these were produced earlier than the forecast by the MFE and the COM. The CBM's forecast portrays a better fiscal balance than that of the other two institutions (the difference to the MFE's forecast amounts to €43.5 million in 2023 and €129.5 million in 2024). The estimate by the CBM for subsidies is higher than that of the MFE, whilst the estimates for all the other expenditure components were lower, particularly for intermediate consumption and the 'other expenditure' component. This applies for both 2023 and 2024. On the other hand, lower revenue is estimated by the CBM, though not to the same extent and magnitude as the divergence in expenditure. Particularly, the better estimate envisaged for taxes on production and imports is offset by the lower estimate for current taxes on income and wealth. This may, in part be underpinned by updated government accounts data for 2022 and the more recent macroeconomic forecast included in the Ministry's fiscal forecasts. Other changes reflect different methodologies used by the two institutions to produce the fiscal forecasts.

Table 6.2: Fiscal balance forecasts by institution (EUR millions) [77]

	2023			2024		
	MFE USP	COM SPR	CBM AR	MFE USP	COM SPR	CBM AR
Total Revenue	**6,542.7**	**6,506.6**	**6,452.4**	**6,751.2**	**6,721.5**	**6,708.1**
Taxes on production & imports	1,924.7	1,906.7	1,987.8	2,035.7	2,019.6	2,128.2
Current taxes on income & wealth	2,463.1	2,451.1	2,386.9	2,617.2	2,610.3	2,517.7
Social contributions	1,059.0	1,058.4	1,039.1	1,128.0	1,129.4	1,092.6
Other *	1,095.9	1,090.4	1,038.6	970.3	962.2	969.6
Total expenditure	**7,456.1**	**7,441.7**	**7,322.1**	**7,598.4**	**7,609.1**	**7,425.8**
Compensation of employees	1,962.0	1,967.5	1,947.4	2,087.5	2,085.6	2,062.5
Intermediate consumption	1,550.3	1,559.5	1,489.5	1,610.5	1,629.0	1,561.5
Social payments	1,616.5	1,627.3	1,614.2	1,730.9	1,740.7	1,704.9
Gross fixed capital formation	690.8	697.0	668.1	616.8	617.3	584.9
Subsidies	685.9	692.4	712.7	572.1	574.6	590.0
Other **	950.6	898.0	890.3	980.6	962.0	922.1
Fiscal balance	**-913.3**	**-935.1**	**-869.8**	**-847.2**	**-887.6**	**-717.7**
Gross debt	**9,980.3**	**10,010.0**	**10,176.7**	**10,992.0**	**10,990.0**	**10,967.3**

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

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

Source: MFE, COM (AMECO), CBM

[77] The absolute figures for the COM's forecasts are sourced from the AMECO database, available here. The absolute figures by the CBM were provided to the MFAC following the publication of the economic projection release. The CBM's figures, as % of GDP are available here.

Turning to the debt projections by other institutions, the COM's position is projecting an increase of slightly more than €1.0 billion between 2022 and 2023, whilst the MFE anticipates a €976.9 million increase. The somewhat higher borrowing requirements expected by the COM mainly reflect its slightly larger budget deficit for 2023. On the other hand, the COM's and MFE's debt projections for 2024 are very similar, despite the larger imbalance expected by the COM. Meanwhile, although the CBM projects a smaller budget deficit in both 2023 and 2024, it forecasts a higher debt level in 2023, and a similar debt level to the MFE's for 2024.

In terms of the public debt-to-GDP ratio, a similar analysis to the one done in the previous section is performed (compared to the COM, CBM and credit rating agencies). The same caveat of having different times of publication applies. All institutions project that the debt ratio will increase in 2023 compared to 2022, with the MFE estimating the lowest ratio (54.5%) whilst the IMF and S&P indicate the highest ratio (58.5%) (see Chart 6.2). When factoring in the various estimates made for 2022, all institutions broadly accord on the annual change (in pp) in the debt ratio in 2023. The institutions' debt-to-GDP ratios rise on average by 1.8 pp in 2023, while the MFE's rises by 1.1 pp. Although all the institutions' estimates are relatively close, the MFE is projecting the lowest debt ratio throughout the forecast period.

An additional rise is anticipated by almost all institutions in 2024, save for S&P, with forecasts ranging from 55.7% (MFE) to 59.6% (IMF). Nearly all institutions anticipate a peak in the debt-to-GDP ratio between 2024 and 2025 and a decrease thereafter. Nonetheless, most institutions expect that Malta's debt-to-GDP ratio shall remain under the 60% benchmark over the forecast horizon

Chart 6.2: Public debt estimates by institution (% of GDP)[78]

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

6.4 Assessment

The variation in the fiscal balance, coupled with higher nominal GDP forecast, contribute to a lower fiscal balance-to-GDP ratio (5.0%) when compared to the DBP's estimate of 5.5%. On the other hand, the DBP had indicated that the fiscal consolidation towards the 3% benchmark would be reached by 2025, whereas in this forecast round, the aim is to reach a level below 3% in 2026.

On the other hand, the Council acknowledges that when compared to other institutions, the fiscal estimates produced by the MFE fit within a plausible range. This applies to both the fiscal balance and the public debt trajectories over the forecast period. Such comparability adds to the forecasts' plausibility, albeit the risks identified in the previous Chapter of this Report. At component level the fiscal revenue and expenditure forecasts are also close to those published more recently by the COM.

[78] Moody's forecasts were available for 2023, 2024 and 2026, hence for 2025, the mid-point between 2024 and 2026 was assumed.

Chapter 7
Conclusion

The USP projects that in 2023 Malta's real GDP will continue building momentum and increase by 4.1%. Moderate growth is anticipated in 2024 and 2025 at 4.5% and 4.6%, respectively, before easing to 4.2% in 2026. At the same time, the fiscal balance is anticipated to remain above the 3% threshold over the forecast horizon, slightly dipping under it in 2026. On the other hand, the public debt to GDP ratio is expected to remain below the 60% mark over the Programme period but to increase slightly from 55.7% at the end of 2024 to 56.1% by the end of 2026.

The context of this year's USP is different to the previous few years as the COM is currently leading efforts towards transitioning to a new framework of fiscal governance. In fact, despite maintaining the general escape clause active for this year, the COM, in its guidelines of fiscal policy, recommended that the Stability or Convergence Programmes for the period 2023-2026 should already include medium-term budgetary and structural plans as required by the new governance framework, i.e., (a) to be in line with the SGP's reference value of 3% of GDP deficit and that this remains below this threshold value at constant policies in the medium-term, and (b) ensure a plausible and continuously declining rate of public debt to sustainable levels through the reference period.

The Council notes that the USP is anticipating a fiscal deficit of 5.0% of GDP in 2023. Based on the projected fiscal balance for 2023, the USP proposes an adjustment of 0.7% of GDP in structural terms, exceeding the minimum required efforts by 0.2 pp. This is expected to bring the deficit down to 4.5% of GDP in 2024. This adjustment also means that the structural primary balance will be reduced to 1.0% of GDP. The Council deems this adjustment to be satisfactory in maintaining the debt-to-GDP ratio at prudent levels below the 60% mark. Furthermore, the USP aims to correct the excessive deficit by 2026 in line with the Commission's fiscal policy guidelines for 2024, which recommends a correction of the excessive deficit within the period covered by the Programme. This implies an annual average structural effort of 0.7% of GDP and an average annual reduction of the structural primary deficit of 0.9% of GDP over the Programme horizon. Being more ambitious than what is required by the present fiscal framework and the proposed Governance framework, the Council assesses this year's

USP to be compliant with the COM's guidelines of fiscal policy communicated in March 2023.

The Council considers the macroeconomic and budgetary forecasts to lie within the endorsable range identified by the Council. Notwithstanding this, the Council identified a number of risks which could impinge positively or negatively on the baseline projections in the USP. Overall, the Council opines that the balance of short-term risks associated with economic growth tilts slightly on the upside for 2023, mainly on the back of stronger domestic developments. For the outer years, the Fiscal Council opines that stronger expected consumption growth, mainly emanating from easing price pressures and a stronger external trade balance, could pose upside risks for the medium term. Nonetheless, the Council notes that the output gap is projected to remain negative over the forecast horizon despite core inflation remaining above the 2% threshold of price stability. The Council considers that this may be the result of some underestimation of actual economic growth coupled with an overestimation of potential output growth.

With regards to public finances, the Council opines that over the short term, total revenue could turn out to be stronger than projected by the Ministry for Finance and Employment, specifically current taxes on income and wealth and taxes on production and imports. However, the Council also views the risk that expenditure growth could turn out stronger than anticipated in the USP, particularly for the outer forecast years. Indeed, the Council assesses the risk that a higher fiscal deficit materialises to be more pertinent over the outer forecast years. Various factors could underpin the trajectory of the fiscal balance, and any changes in government policy, or the materialisation of certain ad-hoc risks identified in this Report could result in deviations from the deficit targets. Such risks are particularly relevant since any deviances that worsen the fiscal deficit ratio may result in the 3% deficit benchmark not being adhered to by 2026. The fact that the Government is targeting to reach this threshold in the final year of the Programming period and just slightly under it, leaves little to no room for manoeuvre for the Government to provide support through countercyclical fiscal policy in case of any unforeseen shocks.

The Council views that its risk assessment largely hinges on the Government's planned expenditure on energy subsidies. In particular, it notes the material deviation in the estimates for this expenditure component submitted by the Ministry for Finance and Employment in the USP for 2023 relative to those set in the Draft Budgetary Plan.

The risk outlook for the cost of energy subsidies remains highly uncertain, given the ongoing war between Russia and Ukraine and its effect on international energy price levels. Furthermore, changes in the attitude of households and enterprises towards energy-saving, the usage of energy and the employed energy mix, amongst other factors, could all influence the level of subsidies required to be paid by the government, either more positively or negatively. The Council thus considers that this uncertainty surrounding the energy subsidies constitute an important risk element to the fiscal projections.

The Fiscal Council notes that the activation of the general escape clause in the Stability and Growth Pact and in the Fiscal Responsibility Act permitted the Government to take all the initiatives deemed necessary to mitigate the adverse effects created by the pandemic and ensuing supply-chain disruptions and the subsequent Russia-Ukraine war. However, following the de-activation of the general escape clause in 2024, the Council would again like to emphasize the importance of achieving a prudent medium-term fiscal position. The Council recommends that any potential savings from energy subsidies or higher than projected revenue should be used to rebuild fiscal buffers. Furthermore, any deviations from the revenue and expenditure targets should not be compensated for by curtailing planned productive capital expenditure.

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