ASSESSMENT OF THE

ANNUAL REPORT 2022

MALTA FISCAL ADVISORY COUNCIL

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18 September 2023

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

Dear Minister,

OVERALL ASSESSMENT OF THE ANNUAL REPORT 2022

The Malta Fiscal Advisory Council is hereby presenting its assessment of the Annual Report 2022, in terms of the Fiscal Responsibility Act. The cut-off date for this report is 30 June 2023.

The Malta Fiscal Advisory Council notes that the Maltese economy's performance during 2022 was stronger than expected, which led to higher-than-expected tax revenue. However, this was more than offset by additional government expenditure, over and above what had previously been budgeted for. In particular, a number of fiscal measures to further support the economy's recovery from the pandemic continued during the first months of 2022 and furthermore, new measures were introduced to address the economic shocks created by the Russia-Ukraine war. There were also unplanned restructuring costs in relation to the national airline. These measures were possible due to the suspension of fiscal rules in the Stability and Growth Pact and in the Fiscal Responsibility Act and due to the fiscal space resulting from the surpluses registered in the years before the onset of the pandemic and the relatively low level of government debt. The Council positively notes that the fiscal support measures contributed to the buoyant performance of the Maltese economy. However, in view of the hefty cost of these measures, the Council emphasises that support should not be prolongated beyond what is necessary and should be targeted. Furthermore, the Council would like to highlight that if the current deficit levels are sustained, Malta risks being placed under the Excessive Deficit Procedure once fiscal rules become binding again. This is expected to happen in 2024 under a reformed EU economic governance framework.

Based on this assessment, the Council would like to highlight the following recommendations to Government:

- Prepare an adequate exit strategy in relation to the fixed-energy-price policy, adopt a more targeted approach and enhance incentives for energy savings.
- Rebuild fiscal buffers from any potential savings from energy subsidies or higher than projected revenue.
- Avoid curtailing planned productive capital expenditure especially to compensate for negative deviations from revenue and expenditure goals. On the contrary, further steps should be taken to preserve nationally financed public investment, improve its efficiency and effectiveness whilst ensuring the effective absorption of RRF grants and other EU funds, particularly to foster the green and digital transitions.
- MFE to continue allocating adequate resources and time for good quality macroeconomic and fiscal forecasts, as well as for their ex-post assessment, and to address any forecast biases. These are a pre-requisite for sound policymaking.
- Strive towards achieving a medium-term fiscal position combined with efforts to achieve sustainable growth.

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

Yours sincerely,

Moira Catania

Dr Moira Catania

Chairperson of the Malta Fiscal Advisory Council

INTRODUCTION

1. **Article 13(3)(e) of the Fiscal Responsibility Act prescribes that the Malta Fiscal Advisory Council (MFAC) shall "*analyse and issue an opinion and any recommendations pursuant to the Government's publication of the half-yearly and the annual report on the execution of the budget*".** On 27 June 2023, the Ministry for Finance and Employment (MFE) published the Annual Report for 2022, in line with the requirements stipulated under Article 41 of the Fiscal Responsibility Act, 2014 (Cap. 534). The Annual Report presents the fiscal turnout compiled on the basis of two different methodologies: on a cash basis, and on an ESA basis, according to the statistical guidelines of the European Union (EU). Any deviations from the previous estimates are identified and explained, thereby contributing to greater fiscal transparency. The MFE's Annual Report also evaluates the extent of compliance with the principles and numerical fiscal rules stipulated in the Fiscal Responsibility Act, which in turn are based on the requirements of the Stability and Growth Pact (SGP). Furthermore, it analyses whether the 2022 budgetary results were in line with the stipulated Medium-Term Objective (MTO).

2. **The suspension of fiscal rules remained in place into 2022, but it is expected to be reactivated in 2024 under a reformed economic governance framework.** The exceptional circumstances and general escape clause of the domestic and EU fiscal rules were activated at the start of the COVID-19 pandemic in 2020 and remained in place into 2022. This allowed countries to temporarily deviate from the requirements under both the domestic and EU fiscal rules in these years. Heightened uncertainty, as well as downside risks created by the onset of the Russia-Ukraine war in February 2022 and the subsequent energy crises and supply-chain disruptions, led the European Commission to hold the general escape clause active for 2022 and 2023. Notwithstanding this, the European Commission has proposed a reformed economic governance framework, which is currently under discussion. The proposal involves shifting the fiscal rules towards a net spending rule with a debt anchor and away from reliance on the structural balance.[1] In addition, fiscal targets would be established at the country level. Such changes would require Malta to update domestic legislation governing how the fiscal rules operate at a national level.

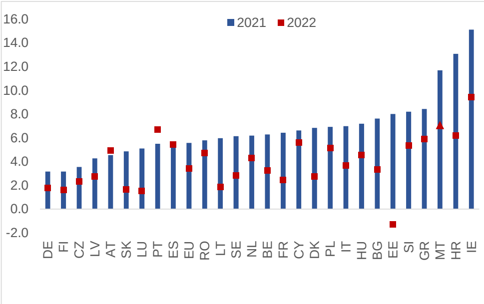
CONTEXT

3. **The Maltese economy outpaced the EU average in 2022, registering the second-highest real GDP growth rate.** Following the pandemic's adverse effects, Malta managed to recover strongly in 2021, surpassing the pre-pandemic GDP level. The strong economic recovery continued into 2022 and was even better than anticipated by the Government in the Medium-Term Fiscal Strategy (MTFS) 2021-2024 and the Draft Budgetary Plan (DBP) 2022. Supported by domestic demand

[1] Proposals on the reform of the EU's economic governance rules can be accessed here.

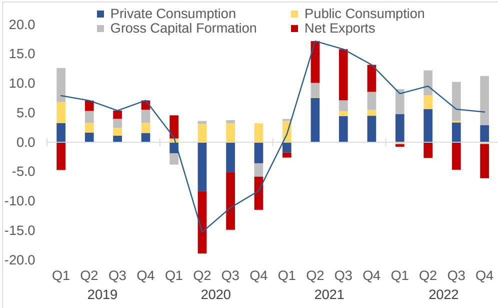
and export of services, particularly the stronger-than-anticipated recovery in tourism,[2] the Maltese economy expanded by 7.1% in 2022 (MTFS: +6.8%; DBP: +6.5%), twice the growth rate registered by the EU average during the same period.

2021 and 2022 Real GDP Growth
(Percent)



Sources: Eurostat and MFAC staff calculations

Contributions to GDP Growth
(Percentage points; year-on-year)



Source: MFAC staff calculations

4. **Russia's war in Ukraine stifled the global economic recovery from the COVID-19 pandemic, presenting new economic challenges for Malta and the European economy.** The immediate economic spillovers of Russia's war in Ukraine on Malta were limited due to Malta's negligible direct economic linkages (trade, energy, and financial) with these countries. However, Malta's high degree of openness exposed the economy to a number of shocks, namely rising import costs, high and volatile energy prices, supply-chain disruptions which led to inflationary pressures and abating external demand as a result of a stunted recovery in European economic growth.

5. **In response to these challenges, the Maltese Government opted to freeze retail electricity and fuel prices at a hefty fiscal cost.** In response to the pandemic, the SGP's general escape clause and the exceptional circumstances clause in the Fiscal Responsibility Act were activated, facilitating countercyclical expansionary fiscal policy, which temporarily deviates from the budgetary requirements that normally apply. The suspension of fiscal rules remained active during 2022 in view of the energy crisis and other economic disruptions brought about by the Russia-Ukraine war. This fiscal flexibility permitted the Maltese Government to shield the economy from international energy price increases by fully absorbing the increased costs from higher energy prices.[3] Indeed, the net budgetary impact of these energy measures in 2022 amounted to 2.9% of GDP, the largest relative support facilitated by any European government.

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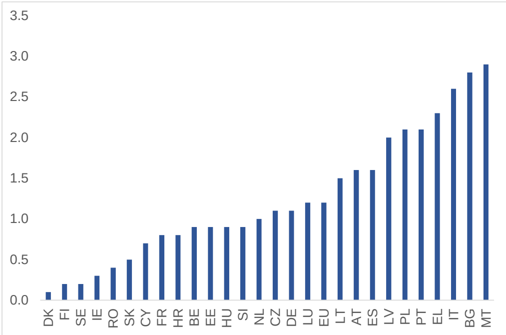
[2] For a detailed analysis of the tourism sector's developments in Malta, please see the following thematic chapter published by the Council in April 2023.

[3] For more information on the energy subsidies and how these were revised from one forecast vintage to another, please see Box C published in the Assessment of the Update of the Stability Programme 2023-2026 in June 2023 by the MFAC.

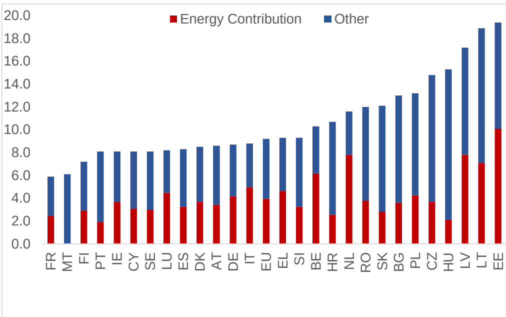
Net Budgetary Impact of Energy Measures in 2022
(Percent of GDP)



Sources: European Commission (March 2023 estimates)

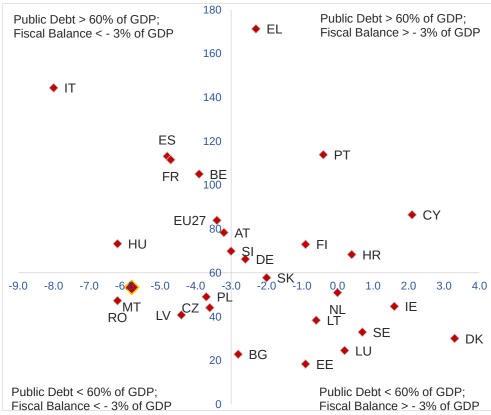
6. **The energy support measures retained the momentum of the economy by containing headline inflation but increased further fiscal pressures, as the deficit remained way above the SGP threshold.** Indeed, Malta's headline inflation rate stood at 6.1% relative to 9.2% in the EU,[4] primarily due to differences in the energy component. This however contributed towards a fiscal deficit that ranks among the highest in the EU, registering the fourth-highest deficit at 5.8% of GDP. On a more positive note, Malta's public debt-to-GDP ratio remains below the 60% benchmark (53.4%), favourably supported by economic growth.

Harmonised Index of Consumer Prices in 2022
(Year-on-year; percentage points)



Sources: European Commission

Cross Plot of Public Budget and Debt in 2022
(Percent of GDP)



Sources: Eurostat and MFAC staff calculations

MACRO ASSESSMENT[5]

7. **The macroeconomic projections in the MTFS and the DBP underestimated growth performance.[6]** Economic growth in nominal terms turned out much

[4] For a more detailed analysis of inflationary developments in 2022, please see the following MFAC's analysis published in the Assessment of the Update of the Stability Programme 2023-2026 in June 2023.
[5] The following assessment does not take into account the latest GDP release (NR158/2023) since it adopts the same cut-off date of the report published by the MFE.
[6] For a detailed analysis of the MFE's forecast performance of GDP, please consult the following thematic chapter prepared by the MFAC and published in March 2023.

stronger than expected by the Government of Malta in the MTFS and the DBP (+∆3.8 pp. and +∆4.1 pp.). This was attributed primarily to stronger domestic demand and, to a lesser extent, also higher external demand. Furthermore, an unforeseen one-off investment in machinery and equipment led to a growth of 38.5% in gross fixed capital formation in 2022 (MTFS projection: 13.9%; DBP projection: 10.2%). Similarly, private consumption was largely underestimated as it was expected to record growth rates less than half of the turnout increase of 15.8%. This reflected the labour market performance, which was much better than expected in both vintages (actual employment growth: 6.1%; MTFS projection: 3.5%; DBP projection: 2.2%), leading to a higher wage bill (actual compensation of employees registered growth: 9.6%; MTFS projection: 5.7%; DBP projection: 4.3%). Growth in compensation per employee also reflected this stronger-than-anticipated performance (actual compensation per employee growth: 3.5%; MTFS projection: 2.2%; DBP projection: 2.1%). On the other hand, inflation turned out much stronger than anticipated in the projections, at 6.1% (MTFS projection:1.5%; DBP projection: 1.7%). Public consumption has also surprised notably on the upside (6.5% compared with -0.7% in the MTFS and 5.3% in the DBP). Foreign demand has also turned out stronger than expected in the projections, increasing by 11.2% as opposed to projected growth rates of 8.5% and 8.9% in the MTFS and the DBP, respectively. This is partly attributed to a stronger-than-anticipated recovery in the tourism sector. Meanwhile, the underestimated domestic and external demand, in turn, led to a higher-than-projected increase in imports of 14.4% (MTFS projection: 7.0%; DBP projection: 7.5%). Reflecting these developments, gross operating surplus and mixed incomes increased by a significant rate of 16.6%, +6.1 pp and +12.5 pp higher than projected in the MTFS and the DBP, respectively.[7]

8. **In its assessment reports, the MFAC identified upside risks which materialised; the actual outturn was affected by unforeseen major revisions in historical data.** In its assessment of the MTFS, the Council highlighted the possibility of upside risks (i.e., macroeconomic data turning better than expected) for private and public consumption, downside risk for investment, and a neutral risk outlook for exports, imports, and GDP. Juxtaposing with the most recent data, the Council's assessment was appropriate in assessing upside risks for overall consumption. However, investment turned out better than expected by both the Council and the Government. This was due to an unforeseen sizeable one-off investment in machinery and equipment, which completely changed the landscape for this component. Notwithstanding this, the Council was correct in highlighting downside risks for non-cyclical underlying investment. This has also led to a corresponding increase in imports since the nature of the one-off investment was completely import-driven. The difference in export growth is primarily driven by statistical data revisions in the balance of payments. With regards to the Council's assessment of the DBP, the Council identified neutral risks for exports and investment, but actual data turned out better than expected by the Government for

[7] This description is based on the differences in nominal terms. The discrepancies between the actual turnout and the forecasts are, to a considerable extent, due to a large difference in expected inflation, which transposes onto all of the GDP expenditure components. Consequently, the differences in magnitude in real terms are much less.

the same reasons outlined earlier. In contrast, the Council's assessment was in line with the balance of risks assessment for the remaining components and concomitantly that of GDP.

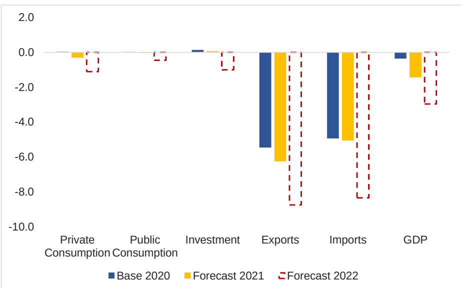
The Council's Assessment of the macroeconomic projections in the MTFS 21-24 and the DBP 22

	MTFS 21-24	DBP 22	Actual Data 22	MFAC's Assessment MTFS 21-24	MFAC's Assessment DBP 22
Private Consumption	7.1	5.7	15.8	↑	↑
Public Consumption	-0.7	5.3	6.5	↑	↑
Investment	13.9	10.2	38.5	↓	↔
Exports	8.5	8.9	11.2	↔	↔
Imports	7.0	7.5	14.4	↔	↑
GDP	8.9	8.6	12.7	↔	↑

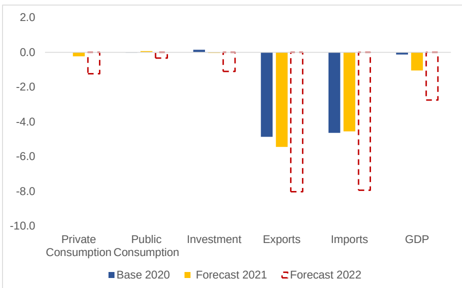
Note: Green arrows indicate that the Council's assessment of the MFE's projections materialised in actual data. Red arrows indicate discrepancies between the Council's assessment and actual data materialisation. An arrow pointing upwards indicates that the Council assessed stronger growth than projected by the MFE. A neutral arrow indicates that the Council supports the MFE's projections. An arrow pointing downwards indicates that the Council assessed lower growth relative to the MFE's projection.

9. **Forecast errors are partly attributed to base effects emanating from historical data revisions.** Focusing on the DBP 2022 projections, the MFAC notes that annual and quarterly statistical data has, in general, been revised upwards, meaning that when the Government of Malta was preparing its macroeconomic projections in September-October 2021, data for 2020 and the first half of 2021 was exhibited as being weaker than what recent data is showing. This has somewhat affected the macroeconomic and budgetary forecasts of the Government. For example, GDP was stated as being nearly €126.0 million (or 1.0%) lower when compared to the latest statistical data vintage in 2020. Similarly, exports were stated as being €4,857 million (or 20.7%) lower in 2020 when juxtaposed with recent data. Furthermore, the statistical data revisions implemented were not proportional in relative terms from one year to another, affecting the growth rates recorded at the expenditure component level. This has contributed to the underestimated macroeconomic projections of the Government of Malta.

MTFS 2021 – 2024: Revisions in Base Data and Forecast Errors
(Billions)



DBP 2022: Revisions in Base Data and Forecast Errors
(Billions)



Sources: NSO, MFE and MFAC staff calculations

FISCAL ASSESSMENT[8]

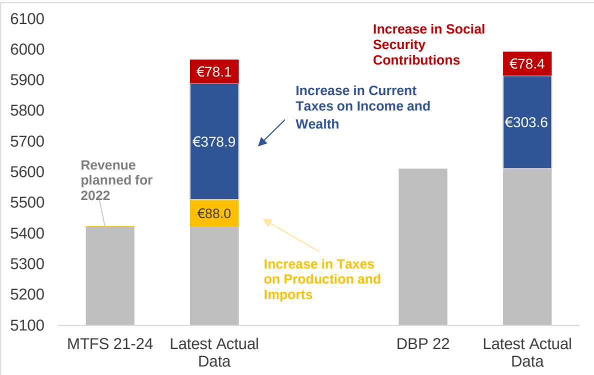
10. Stronger-than-anticipated macroeconomic performance led to higher revenue than projected by the MFE in the MTFS and the DBP.

Overall, total revenue turned out to be €491.6 million higher than expected by MFE in the MTFS and €302.6 million higher than expected in the DBP. Revenue increased by 9.1% in 2022 over 2021, with taxes on production and imports and current taxes on income and wealth increasing by 12.6% and 12.0%, respectively, largely on account of a stronger-than-expected rebound in tourism and more than anticipated increase in domestic demand brought about by sustained employment growth and pent-up demand.

Current taxes on income and wealth, which happens to be the largest revenue component, was the main contributor to the forecast error, accounting for around three-fourths of the difference from the MTFS and practically all the difference from the DBP. Focusing on the MTFS, the largest contribution to this error is emanating from statistical data revisions in the tax base, contributing to over €300.0 million. Errors arising from the tax base and the elasticity, collectively contributed to the remaining difference, arising from the fact that the MFE underestimated the growth in the tax base (Compensation of Employees (∆3.9pps.) and Operating Surplus and Mixed Income (∆6.1pps.)). Similarly, taxes on production and imports, accounting for over 30% of total revenue, was also under-projected by €88.0 million, while social security contributions were underestimated by €78.1 million. Collectively, these three components account for over 85% of total revenue.

Evolution of Revenue: Deviations in MTFS and DBP Projections[9]

(Millions)



Sources: NSO, MFE and MFAC staff calculations

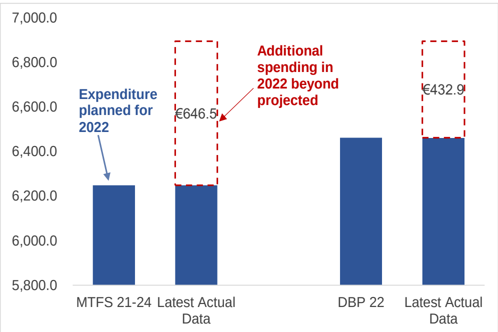
[8] The following assessment does not take into account the statistical data revisions featured in NR116/2023 Quarterly Accounts for General Government: Q1/2023 since it adopts the same cut-off date of the report published by the MFE. Notwithstanding this, it is worth mentioning that the statistical data revisions in total revenue, total expenditure, and the fiscal deficit between the latest two releases are minimal and, consequently, should not materially affect the overall fiscal assessment provided hereunder by the MFAC.

[9] Negatively contributing components are omitted from this chart.

11. **Compared to the expenditure target as set out in the MTFS and the DBP, expenditure turned out higher than expected, primarily attributed to the Government's commitment to fully shoulder the increase in energy prices as a result of the Russia-Ukraine war, unplanned restructuring costs in relation to the national airline and continuation of the Covid-19 assistance for the first five months of the year.** Compared to the DBP, higher than targeted expenditure was mainly attributed to subsidies (+€594.6 million) and other expenditure (+€138.2 million), but partly offset by lower expenditure on compensation of employees (-€25.5 million), intermediate consumption (-€55.7 million), social payments (-€32.2 million) and investment (-€178.5 million). On the other hand, when compared to the MTFS, higher-than-projected expenditures were more widespread, being recorded in every expenditure component save for investment and capital transfer payable.

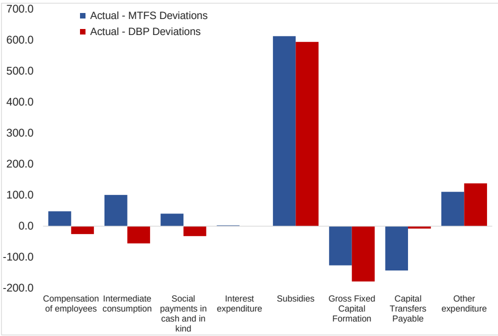
Expenditure on subsidies was higher than targeted in the DBP on account of the cost of energy support measures and Air Malta restructuring costs, in part offset by lower expenditure on the wage supplement scheme. At the same time, public investment has been revised downwards by nearly €180 million when compared to that projected in the DBP, with more than €40 million attributed to lower actual expenditure from the government's end while around €135 million are due to lower than anticipated investment financing by EU funds.

Evolution of General Government Expenditure: Deviations in MTFS and DBP Projections
(Millions)



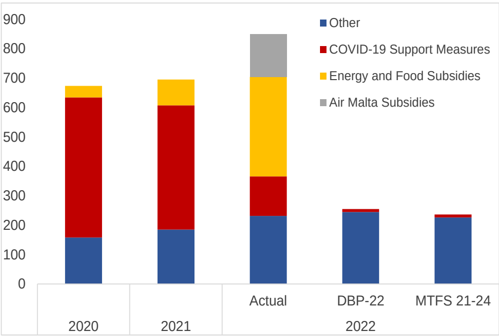
Sources: NSO, MFE and MFAC staff calculations

Evolution of Expenditure by Component: Deviations in MTFS and DBP Projections
(Millions)



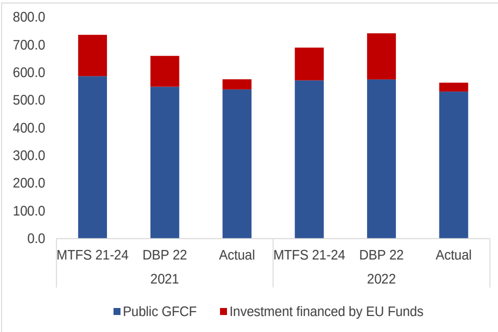
Sources: NSO, MFE and MFAC staff calculations

Evolution of Subsidies: Deviations in MTFS and DBP Projections
(Millions)



Sources: NSO and MFE

Evolution of Public Investment: Deviations in MTFS and DBP Projections
(Millions)



Source: MFE

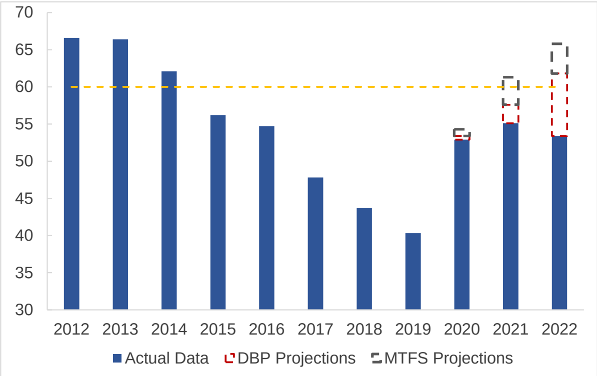
12. **The higher-than-expected increase in expenditure, which more than offset higher revenue derived from better economic performance, led to a deterioration in the general government balance of over €150 million when compared to the MTFS projections and €130 million relative to the DBP.** However, the fiscal deficit as a percentage of GDP stood at 5.8%, only 0.2 percentage points higher than projected in the MTFS and the DBP due to the stronger growth in nominal economic activity (actual nominal GDP growth: 12.7%; MTFS projection: 8.9%; DBP projection: 8.6%) which resulted in lowering the targeted fiscal deficit by 0.6 and 0.7 percentage points respectively. It is notable that the Air Malta restructuring costs contributed around 0.9 percentage points to the fiscal deficit recorded in 2022, while the energy subsidies accounted for 2.0 percentage points.

13. **Large deviations in output gap estimates impacted the structural balance projections.** In the MTFS and the DBP, the MFE projected the output gap at -2.4% and -2.5% for 2022; however, it turned out positive 0.5%. Inconsequently, the structural balance turned out to be 1.6 percentage points worse than projected in the MTFS (-4.5%) and the DBP (-4.5%). The structural adjustment reflected such gap (actual: 0.9 pps; MTFS projection: 5.2 pps.; DBP projection: 4.2 pps.).

14. **In contrast to what was projected in the MTFS and the DBP, the public debt ratio remained below 60% of GDP, reflecting both the snowball effect and the stock-flow adjustment.** Both the MTFS and the DBP were projecting public debt to increase in absolute terms in 2022. However, public debt turned out €370.4 million lower than projected, mainly due to lower-than-projected Malta Government Stocks (Δ€502.5 million), partly offset by higher treasury bills (Δ€161.9 million). As a percentage of GDP, lower-than-projected public debt was mainly due to the snowball effect, comprising the real GDP and inflation effect, contributing to a decline of 5.1 percentage points and the stock-flow adjustment, which in the MTFS was expected to contribute positively by 0.5 but actual data revealed a negative contribution of 1.4 percentage points. These were compensated for by a positive contribution from the primary balance (4.8 percentage points) and interest expenditure (1.0 percentage points).

Evolution of Public Debt: Deviations in MTFS and DBP Projections

(Percent of GDP)



Sources: Eurostat and MFE

COUNCIL'S APPRAISAL

15. **Stronger-than-expected macroeconomic economic performance led to higher-than-expected fiscal revenue, which was more than offset by additional fiscal expenditure not previously budgeted for.** In 2022, a number of fiscal measures earmarked by the Government to further support the economy in its recovery from the pandemic were continued in the first months of 2022, whilst new measures were introduced to withstand the exogenous shocks created by the Russia-Ukraine war. This has, in itself, led the Maltese economy to remain buoyant and reach the second-highest real GDP growth rate in the EU. Particularly, such unprecedented initiatives were possible due to the suspension of fiscal rules in the Stability and Growth Pact and in the Fiscal Responsibility Act, and also due to the fiscal space, which was available pre-pandemic because of the stream of fiscal surpluses registered between 2016 and 2019 and the relatively low level of public debt. While the Council fully supports these fiscal initiatives, the Council would like to emphasize that support should not be prolongated beyond what is necessary and should be targeted, as this has negative implications on (i) the medium-term fiscal position, (ii) risks of productivity crowding-out effects, and (iii) making the economy dependable on such measures. Furthermore, the Government should be aware that if the current deficit levels are sustained, Malta risks being placed under an 'Excessive Deficit Procedure' once fiscal rules become binding again.

COUNCIL'S RECOMMENDATIONS

16. Based on the above assessment, the Council hereby highlights the following recommendations to Government:

a. Prepare an adequate exit strategy in relation to the fixed-energy-price policy, adopt a more targeted approach and enhance incentives for energy savings.

b. Rebuild fiscal buffers from any potential savings from energy subsidies or higher than projected revenue.

c. Avoid curtailing planned productive capital expenditure especially to compensate for negative deviations from revenue and expenditure goals. On the contrary, further steps should be taken to preserve nationally financed public investment, improve its efficiency and effectiveness whilst ensuring the effective absorption of RRF grants and other EU funds, particularly to foster the green and digital transitions.

d. MFE to continue allocating adequate resources and time for good quality macroeconomic and fiscal forecasts, as well as for their ex-post assessment, and to address any forecast biases. These are a pre-requisite for sound policymaking.

e. Strive towards achieving a medium-term fiscal position combined with efforts to achieve sustainable growth.

Appendix A

Summary Table of the Economic and Budgetary Position of the Maltese Economy in 2022 and the Deviations from the Medium-Term Fiscal Strategy 2021-2024 and the Draft Budget Plan 2022.

	Medium-Term Fiscal Strategy 2021-2024	Draft Budget Plan 2022	Actual 2022
Macro Forecasts (% unless otherwise stated)			
Gross Domestic Product (Nominal Terms)	8.9	8.6	12.7
Private Final Consumption Expenditure	7.1	5.7	15.8
Public Consumption Expenditure	-0.7	5.3	6.5
Gross Fixed Capital Formation	13.9	10.2	38.5
Exports of Goods and Services	8.5	8.9	11.2
Imports of Goods and Services	7.0	7.5	14.4
Employment	3.5	2.2	6.1
Inflation	1.5	1.7	6.1
Output Gap (% of potential output)	-2.4	-2.5	0.5
Budgetary Forecasts (% of GDP unless otherwise stated)			
Revenue	36.6	37.0	35.1
Expenditure	42.2	42.6	40.9
General Government Balance	-5.6	-5.6	-5.8
Primary Balance	-4.5	-4.5	-4.8
Cyclically adjusted Budget Balance	-4.4	-4.4	-6.1
Structural Balance	-4.5	-4.5	-6.1
Gross Debt	65.8	61.8	53.4