Assessment of the Draft Budgetary Plan 2024

MFAC
MALTA FISCAL ADVISORY COUNCIL

December 2023

ASSESSMENT OF THE DRAFT BUDGETARY PLAN 2024

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18 December 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,

ASSESSMENT OF THE DRAFT BUDGETARY PLAN 2024

As a follow-up to the letter of endorsement in relation to the macroeconomic forecasts, dated 15 October 2023, the Malta Fiscal Advisory Council is hereby presenting its full assessment report of the Draft Budgetary Plan 2024, in terms of the Fiscal Responsibility Act. The cut-off date for this report is 24 November 2023.

The MFAC notes that in view of the current circumstances in the global economy, the macroeconomic outlook remains subject to considerable uncertainty and is very sensitive to the assumptions employed. The Council notes that the Ministry is projecting GDP to grow by 4.1% in 2023, and then by 4.2% in 2024. At the same time, the fiscal deficit ratio is projected to narrow down to 5.0% in 2023, before reducing by another 0.5 percentage points in 2024. **Overall, the Council considers that the macroeconomic and fiscal projections for 2023 and 2024 prepared by the Ministry as part of the Draft Budgetary Plan 2024 lie within its endorsable range.** Nonetheless, the Council's assessment points to possible risks to the projections by the Ministry.

According to its assessment, the Council considers that there is an upside risk for GDP growth in 2023, primarily due to data for the first half of the year, which stands higher than the overall projection for the year and the statistical base effect emanating from the second half of the year in 2022. The upside risk identified for 2023 mainly stems from the domestic side of the economy as the Council opines that there are upside risks to private consumption and government expenditure. These are expected to outweigh the downside risks identified from the external side as a result of higher than expected imports of goods and services. On the other hand, for 2024, the Council believes that growth could turn out weaker than projected, especially from the external side, as a result of lower than expected exports of goods and services.

Regarding the fiscal projections, the Council's assessment points to the possibility of achieving better fiscal deficit ratios than projected in the Draft Budgetary Plan. Indeed, the Council views positive risks for the government's revenue projections, mostly supported by the possibility of larger revenue from direct taxes. Combined with upside risks to GDP and the possibility of expenditure savings in 2023, these risks would translate into a larger improvement in the fiscal deficit, in the current year, than is projected by the Ministry. However, when removing the base effect of 2023, a downside risk is viewed for the fiscal outturn in 2024, which implies the possibility of a lower adjustment in the deficit than envisaged. Should the positive risk in 2023 materialise, a minimum structural effort of 0.5 pp in 2024 would still need to be registered, given that the fiscal deficit is projected to remain above the 3% of GDP benchmark.

The Council acknowledges that, although the debt ratio is projected to increase, it is still expected to remain below the 60% of GDP benchmark. Furthermore, the Council notes that the projections would respect the maximum growth in nationally financed net primary expenditure recommended by the European Commission.

Following this Assessment, the Council hereby recommends the following:

a. Economic growth should be more export-led, rather than being dependent on domestic demand, especially private consumption. This is particularly important in the context of the present high inflationary environment.

b. To achieve export-led growth, there is a significant need to improve competitiveness through labour productivity increases. Addressing skill gaps and implementing the twin transition towards more digital and environmentally sustainable business practices should enable organisations to operate more efficiently and sustainably, thus improving labour productivity. This will ensure sustainable medium-term economic growth, but since the effects of these investments take time to materialise, it is important to start implementing this reform agenda now.

c. Government should strive towards achieving a sound medium-term fiscal position by building fiscal buffers, combined with efforts to achieve sustainable growth.

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

e. Any potential expenditure savings or higher than projected revenue should be directed to build fiscal buffers.

f. Government should avoid inflating government spending, especially that which is not productive. Means of expenditure restraint should be explored in order to ensure that the minimum required fiscal effort is achieved.

g. Expenditure savings should not occur from curtailing planned productive capital expenditure. Further steps should be taken to preserve nationally financed public investment and meet the targets, also with respect to the absorption of RRF grants and other EU funds, especially in view of the closure of the 2014-2020 financial programmes in 2023. Furthermore, the Council encourages the government to accelerate the absorption of EU funds from the 2021-2027 programme and the remaining allocations from the RRF.

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. **Each year, countries that form part of the Euro Area (EA) must submit a Draft Budgetary Plan (DBP) to the European Commission (COM).** The COM assesses the plans to ensure that economic and fiscal policies among Member States sharing the euro as their currency are coordinated and that they all respect the EU's economic governance rules based on the requirements of the Stability and Growth Pact (SGP).[1]

2. **Article 16(3) of the Fiscal Responsibility Act (FRA) prescribes that "The Draft Budgetary Plan shall be submitted to the Fiscal Council for endorsement and shall thereafter be made public*".*** On 15 October 2023, the Chairperson of the Malta Fiscal Advisory Council (MFAC) addressed a letter to the Ministry for Finance and Employment (MFE) confirming that the macroeconomic forecasts for 2023 and 2024 prepared by the MFE as part of the DBP 2024 lie within its endorsable range. In its assessment, the Council considered that whilst the balance of risk for 2023 is on the upside, there are downside risks to the expected growth for 2024.

3. **The DBP was submitted to the COM on 16 October 2023**. The DBP for 2024 presents the updated official macroeconomic and fiscal forecasts prepared by the MFE for 2023 and 2024. The fiscal forecasts presented in the DBP also include projections for 2025 and 2026. The assessment and endorsement presented in this report by the MFAC cover 2023 and 2024 and should not be construed to include an endorsement of the outer years. Such a position is in view of the tight deadlines which the Council operates with to endorse the macroeconomic projections, given that the assessment and endorsement of the macroeconomic projections is conducted on an *ex-ante* basis. Since within these timeframes, the Council endorsed the macroeconomic forecasts for 2023 and 2024, the assessment and endorsement of the fiscal forecasts is also limited to these two years. The forecasts presented in the DBP update the vintages published in April 2022 as part of the Update of the Stability Programme (USP). The cut-off date of the DBP is 15 October 2023. This Report has a cut-off date of 24 November 2023.

4. **The methodology utilised by the MFE to generate macroeconomic estimates and fiscal projections remained broadly unchanged from previous forecast rounds.** The MFE relies primarily on STEMM (Short-Term Quarterly Economic Forecasting Model) to produce its macroeconomic projections.[2] 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 forecasts are based on several exogenous assumptions about the external economy produced by Consensus Economics and

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[1] The DBP for 2024 submitted by each country, together with the COM's opinion, can be found here.

[2] For further information regarding the methodology adopted in STEMM refer to the paper published by the Economic Policy Department on 'STEMM: Short-Term Quarterly Econometric Forecasting Model for Malta' on July 2019, available here.

the European Central Bank (ECB).[3] The model also enables expert judgement based on ad hoc data and routine discussions with key stakeholders, which are particularly useful when forecasting volatile economic drivers like gross fixed capital formation and specific industries such as tourism. On the fiscal side, the approach remained broadly the same, apart from a refinement in the estimation of gross fixed capital formation.[4] The approach adopted to generate the fiscal projections is based on the input provided by Government departments and entities through cash-based estimates of their anticipated revenues and expenditures. This is complemented by using estimated relationships of revenue items with their respective macroeconomic proxy bases. The forecasts are then finalised to be in line with ESA accrual-based standards.

5. **This assessment is being done within the context of an international economic environment which remains characterised by uncertainty. At the same time, although discussions on the reformed EU economic governance framework are still ongoing, the general escape clause of the Stability and Growth Pact will be de-activated at the end of the year**. In its assessment, the Council is following the fiscal policy guidance for 2024 issued by the COM on 8 March 2023.[5] In particular, the COM highlighted that in spring 2024, based on the outturn data for 2023, it will propose to the European Council to open deficit-based excessive deficit procedures in line with the prevailing legal provisions. As a result, the COM invited Member States to take this into account when preparing the budget for 2024. Consequently, the Council's assessment of the government's fiscal strategy for 2024, as outlined in the DBP, is framed within the context of the budgetary requirements as established in the current SGP, with particular emphasis on the net primary expenditure benchmark, since this is the proposed main operational fiscal indicator in the proposed reformed EU economic governance framework.

CONTEXT

6. **Since the last MFE's forecast round in spring 2023, the international environment has remained weak, characterised by a feeble short-term global growth outlook and inflation rates which remain high by historical standards**. Economic activity in the EA increased at a subdued pace in the first half of 2023 (0.7%) despite the unwinding of high energy prices and backlogs in manufacturing orders. The impact of tightening financing conditions and lower foreign demand for the EA's production in the context of a stronger euro, are dampening growth. At the

[3] The September 2023 edition of 'Consensus forecasts' was the main source of assumptions relating to the exchange rate of the euro with respect to the US dollar and the sterling, world prices, oil prices and real GDP growth of Malta's main trading partners. These assumptions are supplemented by data from the ECB (exchange rates & interest rates), COM (real & nominal GDP growth) and the US Energy Information Administration (oil prices).

[4] The change in the estimation of gross fixed capital formation is explained in the fiscal assessment section of this Report.

[5] The fiscal policy guidance for 2024 issued by the COM on 8 March 2023 can be found here.

same time, underlying inflation in the EA remained elevated (first half of 2023 – 7.2%). Overall, the COM is projecting real GDP growth in the EA to increase by 0.6% in 2023 and 1.2% in 2024. Economic growth in the EA is expected to remain constrained by monetary policy tightening, adverse credit supply conditions which feed through the real economy, and the gradual withdrawal of fiscal support. At the same time, there are a number of risks which would impinge more negatively on economic growth. Inflation could be higher than anticipated, triggering more restrictive monetary policy, if further shocks occur, including those from an intensification of the war in Ukraine as well as repercussions of the recent developments in Gaza, and from extreme weather-related events. Furthermore, financial sector turbulence created by the adaptation of further policy tightening by central banks is a possibility.

7. **Within this international context, the MFE uses certain exogenous assumptions within their modelling framework.**[6] As compared to the previous forecast round, the external assumptions taken by the MFE indicate higher short-term and long-term interest rates for both 2023 and 2024, reflecting the tightening in monetary conditions in recent months. At the same time, similar to the expectations in spring, the euro is anticipated to appreciate against the US Dollar (USD) in both 2023 and 2024, but the extent of appreciation between 2023 and 2024 is expected to be slightly lower compared to the appreciation between 2022 and 2023. Meanwhile, the euro–sterling exchange rate is expected to fall in 2023 and remain at a similar level in 2024. Real GDP growth in Malta's main trading partners is expected to remain weak and below 1.0%, with a slight revision upwards in growth in 2023 and a slight fall in expected growth for 2024 when compared to the USP projections, reflecting the increased uncertainty in the economic environment. On the other hand, forecasts for oil prices are similar to those in the spring forecasts and are expected to abate from the level recorded in 2022.

8. **Despite global uncertainty and significant inflationary pressures, the Maltese economy continued to expand strongly during 2022, with real GDP growing by 6.9%.** While the external side of the economy and inventories acted as a drag on economic growth, the domestic side of the economy, mainly on the back of growth in private consumption expenditure and investment, made a substantial contribution to growth. Private consumption expenditure surged by 9.5%, reflecting the strong labour market and substantial increases in compensation per employee, amidst high inflation. Government consumption expenditure increased by 2.3%, while gross fixed capital formation, primarily driven by investment in transport equipment, expanded by 31.2%. Exports increased by 6.8% in 2022, as the euro depreciated against both the US Dollar and the British Pound. In particular, the tourism industry registered a strong recovery from the pandemic levels. Indeed, inbound tourists' levels stood at 83.1% of 2019 levels in 2022, relative to 35.2% in 2021. On the other hand, imports, reflecting domestic and external developments, increased by 10.1%. The higher growth in imports as opposed to exports led to a

[6] See table A.1 in the Appendix.

negative contribution to growth from the external sector. The output side of GDP shows that growth was broad-based, with the services sector accounting for approximately 86% of Malta's Gross Value Added (GVA) level in 2022. The income side recorded increases in profits (15.5%) in 2022, on top of significant increases in 2021 and increases in compensation of employees (9.9%).

9. **Despite the global economic slowdown, the Maltese economy continued to register strong growth in the first half of 2023, increasing by 4.4% in real terms.** In the first half of 2023, the domestic side contributed adversely to real economic growth due to the large base effect experienced in 2022 in gross fixed capital formation. This is also reflected in developments in imports of goods and services, which partly explains the positive contribution from the external sector. Meanwhile, private final consumption expenditure increased by 7.0% while public consumption decreased by 1.0% over the same comparable period last year. Exports increased by 0.5%, while imports decreased by 3.3%. At a sectoral level, all sectors reported increases except for the construction sector, which declined by 0.9%. Several sectors registered an increase in growth in the double digits such as the manufacturing industry, the financial and insurance activities sector and wholesale and retail trade. In terms of the tourism sector, expenditure has increased by 33.9% between January and September, when compared to the same period last year. Meanwhile, Malta's inflation rate, as recorded by the HICP, has been gradually slowing down in 2023, reaching 4.9% in September. Nonetheless, when compared to historical averages, the inflation rate remains high, despite the government's subsidy on energy costs. The moderation of economic growth during 2023, combined with a buoyant labour market, resulted in declining labour productivity per person employed. At the same time, increases in compensation per employee are lagging the increases in inflation, resulting in a fall in real wages.

10. **Amidst this macroeconomic scenario, the government's fiscal balance was still high in 2022 but was reduced compared to 2021 as it declined to 5.7% of GDP, whilst the debt ratio was reduced to 52.3%, below the 60% benchmark.** In 2022, whilst the COVID-19 wage assistance scheme was terminated in May, the government introduced energy subsidies to shelter the Maltese economy from the effects of the high international energy prices, following Russia's invasion of Ukraine. Financial support for the restructuring of the national airline upscaled further the level of government expenditure. Notwithstanding this, as the strong macroeconomic performance increased the generation of tax revenue, there was an improvement in the general government's fiscal balance of €158.5 million compared to 2021's deficit figure, which translates to a reduction of 1.8 percentage points (pp) in the deficit-to-GDP ratio. Nonetheless, with the deficit for the year at €982.2 million, the level of government debt rose significantly from the previous year, surpassing the €9 billion mark. However, the debt-to-GDP ratio still decreased, as the upward contribution from the primary balance and interest expenditure were outweighed by negative contributions from the Stock-flow adjustments (SFA) and nominal GDP growth, leading to a net reduction of 1.7 pp over the previous year.

11. **As fiscal rules should become active again in 2024, consolidation efforts are necessary to reduce the budget deficit towards the 3% of GDP reference value.** The EU's general escape clause, which was activated in 2020 due to the COVID-19 pandemic and later maintained due to the economic effects of the Russia-Ukraine war, shall be revoked at the end of 2023. Currently, discussions are underway to enhance the EU's economic governance framework by improving national ownership, simplifying the framework, and moving towards a greater medium-term focus, combined with stronger and more coherent enforcement.[7] This assessment considers the fact that multi-year expenditure targets are being proposed as the single operational indicator for fiscal surveillance. However, countries are still required to have a budget deficit of less than 3% of GDP and maintain government debt below 60% of GDP. Apart from highlighting relevant risks to fiscal revenue and expenditure components, the Council's assessment also takes into account these criteria and put forth relevant recommendations to adhere to these rules.

MACROECONOMIC ASSESSMENT

12. **Real GDP for 2023 is forecasted to moderate to 4.1%, following a 6.9% growth in 2022. Growth in 2023 is expected to emanate from the external side of the economy, with the domestic side acting as a drag on economic growth. In 2024, real GDP is anticipated to grow by 4.2%, propelled mainly by the domestic side of the economy.** The forecast for real GDP growth in 2023 remained unchanged from the previous forecast round, while the forecast for 2024 was revised slightly downwards by 0.3 pp.[8]

    In 2023, the MFE is expecting external demand to be primarily driven by the services sector and, to a lesser extent, by the goods sector. The tourism sector is expected to contribute significantly to growth. The professional, scientific, and technical activities, administration and support services activities sector is also forecasted to contribute positively. Growth in the goods sector is mainly driven by the manufacturing sector. On the other hand, higher domestic demand mainly reflects increases in private final consumption expenditure. Government final consumption expenditure is expected to increase by 2.8%, while investment is expected to fall by 18.9% as a result of a base effect from 2022 due to a large one-off investment in transport equipment.

    In 2024, export growth has been revised downwards from 5.2% to 3.9%, partly on the back of updated exogenous assumptions reflecting weaker global economic growth and a stronger euro vis-à-vis the British Pound, relative to the previous year. At the same time, the upward revisions in unit labour costs and inflation in 2024

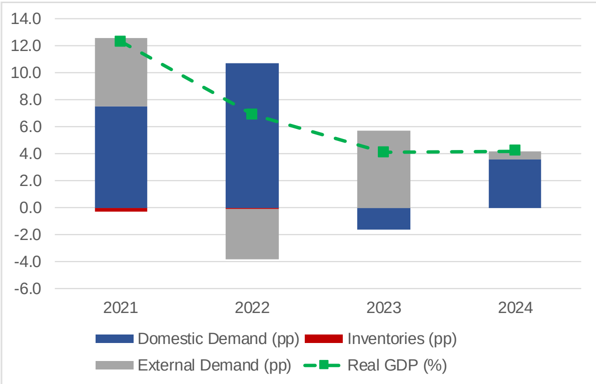
[7] The proposals by the COM are available here.

[8] See Table A.2 for details on the main macroeconomic variables referenced in this Report.

mean that Malta could potentially lose its competitive position over its European counterparts. On the other hand, the MFE is anticipating stronger increases in private final consumption expenditure in 2024 (from 3.9% to 4.5%) driven by stronger labour market developments (stronger employment growth and a lower unemployment rate) and higher wages per employee (from 3.9% to 4.3%) relative to the spring forecasts vintage. Investment is anticipated to increase by 5.5% in real terms, relative to the 3.8% growth anticipated in April, mainly due to revisions in the expected absorption of EU funds. Headline inflation in 2024 has been revised slightly upwards to 3.7%. Labour productivity has been revised downwards to negative territory, meaning that the MFE is anticipating labour productivity to record two years of declining rates. Unit labour costs are anticipated to increase by 4.6% in 2024.

Real GDP growth and contributions to growth

(%, Percentage points)

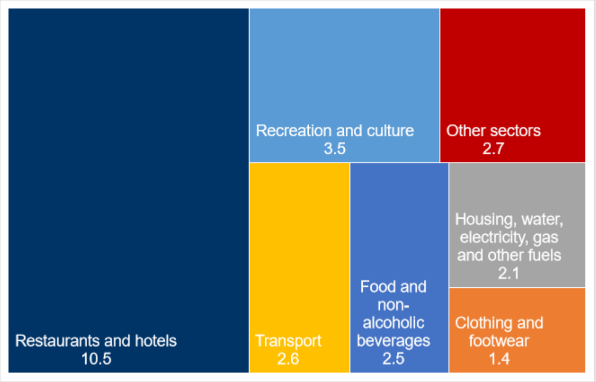


Source: MFE

13. **In 2021, private consumption recorded a growth rate of 8.3% in real terms, followed by a stronger rate of 9.5% in 2022.** In nominal terms, data on the Classification of Individual Consumption by Purpose (COICOP) shows that household final domestic consumption expenditure increases in 2022 are largely attributed to consumption in restaurants and hotels (10.5 pp). This was followed by recreation and culture (3.5 pp), transport (2.6 pp), food and non-alcoholic beverages (2.5 pp), housing, water, electricity, gas and other fuels (2.1 pp) and clothing and footwear (1.4 pp). Consumption in other sectors accounted for 2.7 pp.[9] The large growth of consumption in restaurant and hotels bodes well for its post-pandemic recovery, which in 2022 was the only consumption item which had not yet fully recovered from the 2019 levels (97.2% of 2019 levels).

[9] Other sectors include, alcoholic beverages, tobacco and narcotics; furnishing, household equipment and routine household maintenance; health; communications; education; and miscellaneous goods and services.

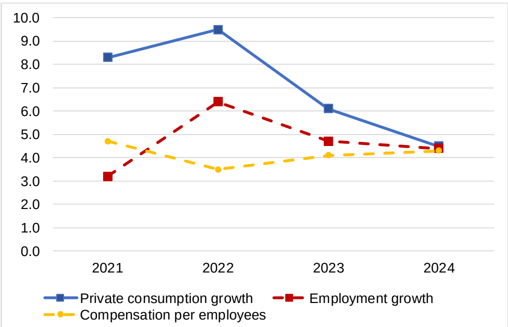
Contributions to nominal final consumption expenditure of households in 2022 (COICOP)
(Percentage points)



Source: NSO

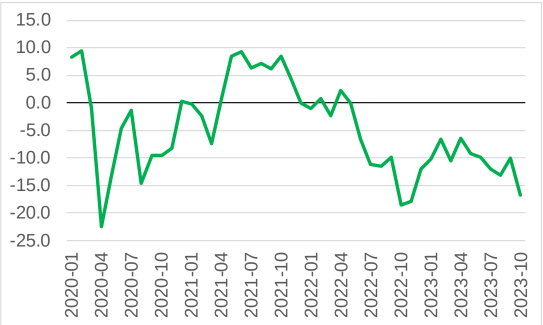
14. **Private final consumption expenditure is expected to grow by 6.1% in 2023 on the back of increases in compensation per employee, strong labour market developments and population growth. It is then expected to moderate to 4.5% in 2024.** From the previous forecast round, growth in both 2023 and 2024 was revised upwards by 2.3 pp and 0.6 pp, respectively. This is in line with the identified upside risks outlined by the MFAC in the spring forecast round. Actual data for the first half of 2023 shows that real private consumption exhibited a strong growth of 7.0%, implying an expected growth rate of 5.2% in the second half of the year. The lower growth anticipated for the second half of 2023 reflects a weakening of consumer confidence, as reflected in DG ECFIN's consumer confidence indicator, which was in negative territory between January and October 2023. In 2024, consumer demand is expected to fall slightly as the effect of pent-up demand accumulated during the pandemic subsides. However, the growth projected for 2024 is higher than that anticipated in the spring forecast round, driven by stronger employment growth, a lower unemployment rate and higher compensation per employee.

Private consumption, employment, and compensation per employee
(Percentage growth)



Source: MFE

Malta's Consumer Confidence Indicator
(Index)



Source: DG ECFIN

Risk Assessment

Private consumption expenditure has increased strongly in 2022 and in the first half of 2023. Buoyant labour market conditions (strong employment growth and a historically low unemployment rate), population growth, and strong increases in compensation per employee have fuelled private consumption expenditure. Furthermore, an element of pent-up demand from the pandemic years has also contributed to the strong growth observed over the last 18 months.

In 2023, reflecting declining consumer confidence and accelerating inflationary pressures, the Council corroborates the view of the MFE, that private final consumption expenditure growth is expected to decelerate relative to 2022. However, the Council expects higher growth in 2023 than that projected by the MFE due to a stronger expected employment growth. For 2024, the Council also opines that the balance of risk for private consumption growth lies on the upside since the fundamentals are expected to remain robust. Nonetheless, the Council agrees with the MFE that growth is expected to decelerate relative to 2023.

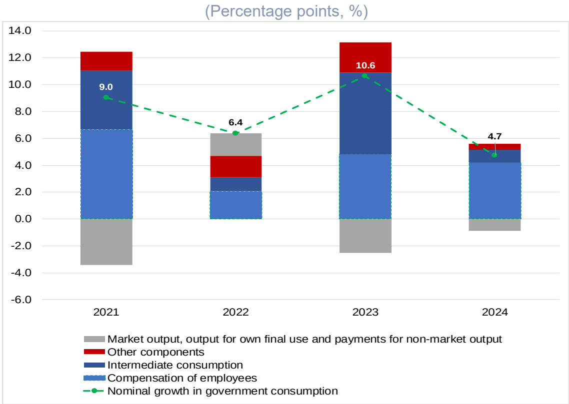
15. **Government final consumption expenditure is expected to grow by 2.8% in real terms in both 2023 and 2024, with increases in all its components.** This reflects a downward revision of 0.6 pp in 2023 and 0.4 pp in 2024 from the estimates of the previous forecast round. In nominal terms, government consumption is set to grow by 7.7% in 2023, slightly higher than the 6.2% growth recorded a year earlier, and by 5.6% in 2024.[10] In 2023, this growth mainly stems from increases in intermediate consumption and compensation of employees.[11] The growth projected for 2024 mainly relates to increases in compensation of employees with a 4.2 pp contribution to government consumption growth.

[10] For 2022 and the forecast years 2023 and 2024, there is inconsistency in the DBP between what is presented in the macroeconomic forecasts and the fiscal forecasts for this component, due to slight differences in the timing of these two sets of forecasts. Table 2.1 of the DBP (conveying the macroeconomic projections) quotes lower nominal growth rates for government consumption in 2022 and 2023 but higher growth rates in 2024. Indeed, the nominal growth rates in government consumption based on the fiscal projections are 6.4% in 2022, 10.6% in 2023, and 4.7% in 2024. . These discrepancies equate to around €4.0 million in 2022, €97.7 million in 2023, and €71.5 million in 2024.

[11] When estimating the value of government consumption, certain items (market output, output for own final use and payments for non-market output) are deducted from the other expenditure components. Since the DBP assumes that in 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 to government consumption resulting from these sources. This pattern contrasts with that recorded in 2022 when the reduced amount of market output increased the growth in nominal government consumption for that year.

Breakdown of nominal government consumption growth

(Percentage points, %)



Source: MFE

Risk Assessment

The fiscal forecasts presented in the DBP show higher government expenditure in 2023, but lower in 2024, when compared to those included in the macroeconomic forecasts. As a result, this could lead to an upside risk for government consumption growth in 2023. On the contrary, cash-based data between January and October 2023 indicates that public consumption expenditure could turn out lower than anticipated by the government. Consequently, the Council assesses a balanced risk outlook for public consumption expenditure in 2023. For 2024, a positive risk (lower expenditure level) is considered by the Council, given that the budgetary forecasts are lower than those presented for government consumption as part of the macroeconomic projections. For a more detailed risk outlook for this expenditure component, refer to the fiscal assessment section of this report.

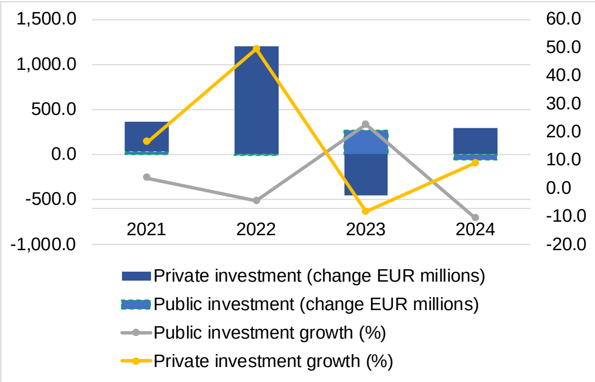
16. **Gross fixed capital formation is expected to fall by 18.9% in real terms in 2023, following a one-off investment in transport equipment in 2022 which substantially inflated growth for the year. Investment is then expected to grow by 5.5% in 2024.** Indeed, in nominal terms, the expected reduction in investment in 2023 is projected to stem from the private sector (-19.2%) while public investment is expected to grow by 20.6%.[12] In contrast, in 2024, public investment is expected to decline by 10.0% as the rise in investment growth is expected to be driven by private investment (11.2%). Developments in public investment reflect the closure of the 2014-2020 Multiannual Financial Framework (MFF) in 2023. Indeed, EU-funded projects accounted for around 0.2% of GDP in 2022 and are expected to account for 0.7% and 0.4% of GDP, respectively in 2023 and 2024. Forecasts for gross fixed capital formation include also projects financed from the Recovery and Resilience Facility (RRF) funds, which is projected at 0.4% of GDP in both 2023 and 2024.

    Amongst the GDP expenditure components, gross fixed capital formation has exhibited the most volatility over the past years. Significant swings were recorded,

[12] The inconsistency between the macroeconomic and fiscal forecasts presented in the DBP due to timing issues affects also public investment. Nominal public investment included in the fiscal forecasts denote higher growth rates for 2022 (-0.6%), 2023 (45.4%) and 2024 (-7.8%).

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.

Public and private sector investment in nominal terms
(pp, %)



Source: MFE ; MFAC Calculations

Risk Assessment

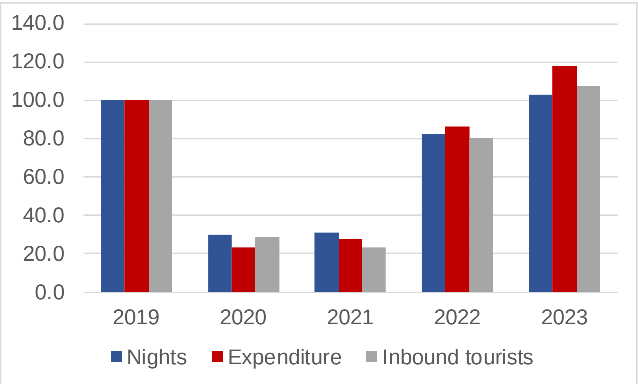
Due to timing issues, there are some inconsistencies between the public finance related inputs to investment used to produce the macroeconomic forecasts and those included in the fiscal forecasts as published in the DBP 2024. The macroeconomic forecasts show a lower public investment of around €143.6 million in 2023 and €148.2 million in 2024, than that included in the fiscal forecasts. Nonetheless, the Council expects the second half of 2023 to perform worse than the first half due to the base effect in the second half of 2022, which was larger than the first half of the year.

The Council agrees with the general trajectory for investment projected by the MFE. For 2023, whilst it considers the discrepancy between the macro and fiscal forecasts for public investment to constitute an upside risk, this is eroded by expectations for private investment in the second half of the year. For 2024, whilst there could be scope for upside risks, reflecting the discrepancy between the macroeconomic and fiscal projections in gross fixed capital formation, the Council assesses the balance of risks to also be neutral in 2024.

17. **During the first half of 2023, exports performed below what was expected in the spring forecast round, growing only by 0.5%. With a forecast for the year of 2.6%, the implied growth rate in the second half of the year is 4.7%.** The Russia and Ukraine conflict and the ensuing economic effects, which are resulting in increased world prices and a deteriorating economic outlook in Malta's main trading partners, are hindering export growth. Nevertheless, Malta's growth in exports is larger than the growth in world GDP as weighted by the country's main trading partners, suggesting that Malta has gained export market shares when

compared to its foreign counterparts.[13] For 2023, export growth has been revised downwards from 4.3% to 2.6% between the spring and the autumn vintages. The higher expected growth rate in the second half of the year is expected to be mainly driven by declining inflationary pressures, easing of supply disruptions, and further strengthening of tourism demand. January to September data on tourism show that inbound tourists reached 107% of 2019 levels, tourist expenditure reached 118.3% of 2019 levels, while nights spent reached 103.2% of 2019 levels. Furthermore, there was also robust growth recorded from the other services sector category. In 2024, export growth was also revised downwards from 5.2% to 3.9% in 2024, mainly on the back of updated exogenous assumptions reflecting weaker global economic growth and a stronger euro vis-à-vis the British Pound.

Index of inbound tourists, expenditure, and nights
(2019 = 100)



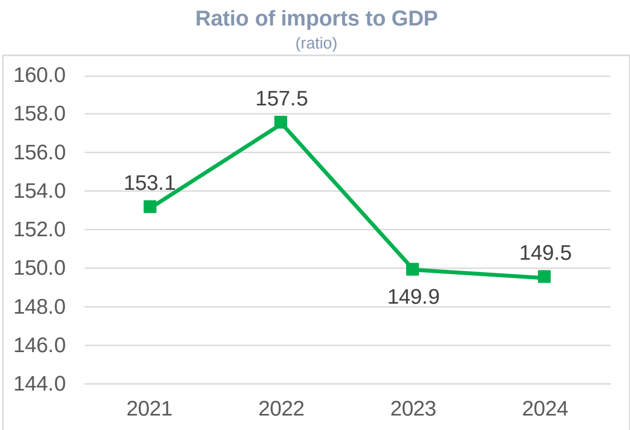
Source: NSO

Risk Assessment

The MFE anticipates better growth in the second half of 2023 compared to the first half of the year, which is possible given that 2022 was characterised by lower growth in the second half of the year as compared to the first half. As a result, the Council assesses neutral risks for 2023. Furthermore, the Council also corroborates the view of the MFE that growth is expected to moderate in 2024 when compared to the growth rates experienced in recent years. Indeed, when considering the increases in unit labour costs and the higher inflation rate projected by the Ministry relative to our European counterparts, this could impinge negatively on Malta's ability to continue gaining export market shares in the short-term. Concomitantly, some of the key services sectors in the economy may be reaching market saturation and the potential impact from the introduction of the global tax harmonisation on multinationals regime also constitutes a possible risk to export growth. As a result, the Council assesses that the balance of risks in 2024 tilts to the downside.

[13] This pattern is consistent with the export regression estimations in STEMM, which suggest that Malta's exports (for various categories) tend to have a higher than unitary elasticity with respect to real GDP developments in Malta's main trading partners.

18. **In line with the decline in investment which is relatively import-intensive in Malta coupled with the moderation in export growth, imports decreased by 3.3% in the first half of 2023.**[14] In 2023, imports of goods and services are projected to decline by 0.9%, reflecting primarily the base effect from the one-off investment in 2022, and then grow by 3.9% in 2024. In 2023, the implied second-half growth in imports is 1.5%. While declines in certain components of imports are expected in 2023 (mostly from lower capital goods and fuel), most components making up the value of imports are assumed to increase in nominal terms. It is also interesting to note that the ratio of imports to GDP is expected to fall in 2023 and remain at a similar level in 2024.



Source: MFE

Risk Assessment
In view of the balance of risks identified for the previous expenditure components which have an impact on imports, the Council assesses an upside risk for 2023 (mainly due to the upside risk for private consumption expenditure). For 2024, the Council opines that the balance of risks for imports is on the downside as the upside risk in private consumption expenditure is expected to be offset by the downside risks identified for public consumption expenditure and exports.

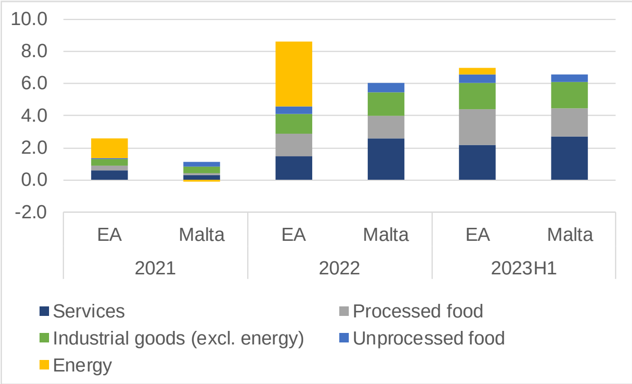
19. **The inflation rate is set to remain high in 2023, abating slightly in 2024.** Malta being an island, highly dependent on imports, is very vulnerable to international inflationary pressures, which increased considerably following the Russia – Ukraine war. Indeed, inflation increased drastically from the low levels recorded in 2021 to around 6.1% in 2022. Yet, this was lower than the EA's average inflation rate (8.4%), reflecting the subsidies provided by the government to maintain fixed energy prices. On the other hand, in the EA, the increase in energy prices was the highest contributing factor for inflation (4.0 pp). First half data for 2023 shows that the inflation rate in Malta remained high at 6.6%, still lower than the EA average, but with a narrowing gap. In 2023, Malta's headline inflation is anticipated to remain high (5.7%), core inflation even higher (6.0%), with some deceleration expected in

[14] For most of the one-off investment projects, the MFE assumes an import content of between 75% and 95%, depending on the inputs required in the particular investment.

the second half of the year (4.8%).[15] Headline inflation in 2024 has been revised slightly upwards from spring's forecast vintage to 3.7%. The MFE is expecting this slow-down in inflationary pressures as it is assuming that a wage-price spiral will not take place, with businesses expected to absorb any rise in wage costs by lowering their profit margins, given the accumulation of profit margins in the years following the pandemic.

Inflation decomposition at MIG

(Percentage points, annual growth rate)



Source: NSO, MFAC Analysis

Risk Assessment

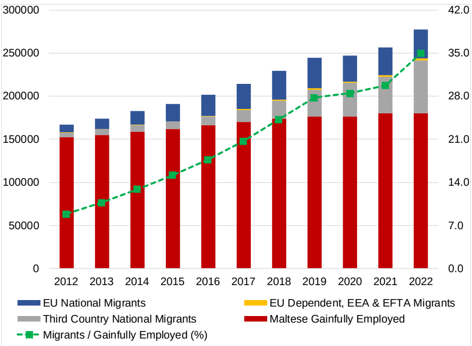
January – October data shows that the inflation rate, as compared to the first ten-month average of the previous year, is 6.0%. If inflation in the last two months of 2023 remains at the rate recorded in October, the inflation rate for the year would be 5.7%, as forecasted by the MFE. As a result, the MFAC opines that the risk outlook for inflation in 2023 is balanced. For 2024, the Council does not share the views of the MFE that further increases in costs will be absorbed from the firms' profit margins, especially in sectors where the market is highly concentrated. As a result, the Council expects that the wage-price spiral effects observed in 2022 and 2023 will remain prevalent in 2024, though less intensified as consumption behaviour adjusts to recent inflationary pressures. Furthermore, price developments in 2024 are also subject to further uncertainty from the risk of escalation in the Russia – Ukraine and Israeli – Palestinian conflicts, which may further impinge on global prices. Nonetheless, though the Council has different views as to how inflation is expected to affect the Maltese economy in 2024, it assesses a neutral risk to the forecast projection of the MFE.

20. **The labour market is expected to continue to perform buoyantly, albeit at a slightly slower pace over 2023 and 2024 by virtue of strong labour demand as economic growth is sustained.** Based on the national accounts definition, employment growth in terms of full-time equivalents (FTEs) stood at 6.4% in 2022. Employment growth is projected to be maintained, though at a slower pace of 4.7% in 2023 and 4.4% in 2024. The unemployment rate registered for 2022 stood at

[15] Core inflation excludes energy and seasonal food.

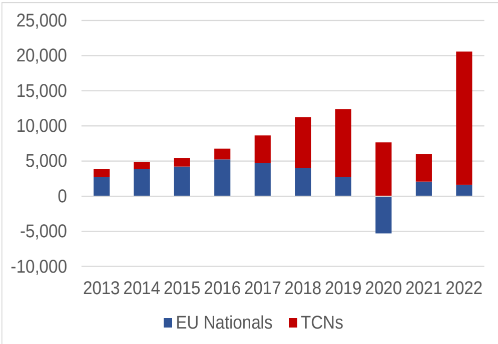
2.9%. In both 2023 and 2024, the unemployment rate is expected to remain low compared to historical averages and dip slightly further to 2.7% for both years. With steady labour demand, the labour market remains tight, putting even greater upward pressure on wages. The labour shortages and skill deficiencies in the Maltese labour market have made it increasingly reliant on immigration. In 2012, migrants made up only 9.0% of the labour force, with most of them being EU nationals, while in 2022, 35.0% of Malta's labour force were migrant workers, with the majority being third-country nationals. In 2018, the change in third-country nationals (TCNs) employees started to outpace the change in EU national employees and this has continued, with the biggest change occurring in 2022. When analysing sectoral data, this change can be attributed to a notable rise in TCN employment in elementary, service, and sales occupations.[16] Whilst the number of Maltese gainfully occupied increased slightly across the years, the labour market is expanding mainly due to the increase in migrant workers.

Share of workers in Malta by nationality
(Number of employees, %)



Sources: Jobsplus, MFAC Analysis [17]

Change in migrant workers year-on-year
(Number of migrant employees by type)



Sources: Jobsplus, MFAC Analysis

Risk Assessment

The labour market is expected to continue to grow buoyantly, with strong employment growth, while the unemployment rate is expected to remain low in line with recent trends. The Council corroborates the view of the MFE that the labour market in 2023 and 2024 will remain tight. The Council assesses the risk to employment growth to lie on the upside for 2023, in line with recent statistics, while the balance of risk of the unemployment is assessed to be neutral. With regards to 2024, the Council assesses the balance of risk on the labour market to be neutral, with labour demand supported by increased inflows of migrant workers.

21. **The moderation of economic growth, in combination with the resilient labour market performance, is resulting in declining labour productivity per person employed and rising unit labour costs.** Employment growth (4.7%) is expected to outpace the growth in real GDP (4.1%) in 2023, resulting in declining labour

[16] In 2022, 30.0% of the TCNs employed within the Maltese labour market worked in elementary jobs, while 21.9% worked in sales and services.

[17] Data on the amount and type of migrants working in the Maltese labor force can be found here, while data on the gainfully occupied population can be accessed from here. Those who work part-time as their primary activity have been converted to full-time equivalents using a factor of 2.3.

productivity per person employed (-0.5%). The MFE is expecting a similar outcome in 2024 though the gap between growth in employment and real GDP is expected to be narrower. Indeed, labour productivity per person employed is expected to decline by 0.2% in 2024. Compensation per employee is on a rising trajectory, with a 4.1% growth projected in 2023 and a 4.3% increase in 2024, reflecting the tight labour market as well as historically high cost of living adjustment. Nonetheless, increases in compensation per employee lag the increases in inflation, leading to a fall in real wages in 2023. Declining productivity rates and increasing compensation per employee coupled with high inflation are driving up nominal unit labour costs. Indeed, nominal unit labour costs are expected to rise from 3.0% in 2022 to 4.7% in 2023 and by 4.6% in 2024, thus denting any competitive edges.

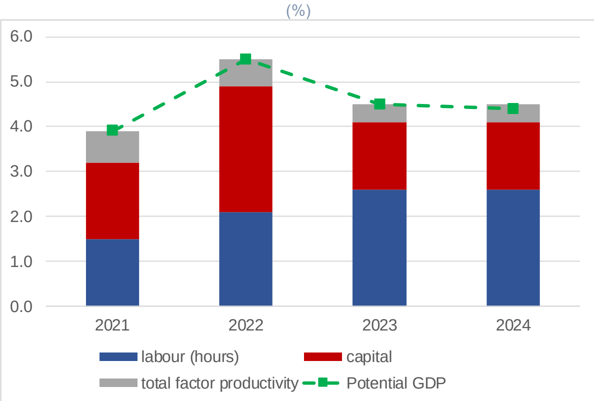
Risk Assessment

The Council assesses that real GDP and employment growth in 2023 could turn out better than expected by the MFE, with positive risks in the former component expected to be larger than the positive risks identified for the latter. As a result, the Council assesses upside risks for labour productivity per person employed in 2023. As a result, the increase in nominal unit labour costs may not be as significant as projected by the MFE. On the other hand, the Council assesses that the balance of risk for labour productivity per person employed to be on the downside in 2024 because of a downside risk in real GDP and a neutral risk for employment growth. The Council assesses the risk for compensation per employee to be neutral in 2024.

22. **The MFE is assuming a negative output gap across the forecast horizon.** Potential output growth, as estimated through the EU commonly agreed methodology, is expected to be 4.5% in 2023 and 4.4% in 2024.[18] This results in a negative output gap of 0.5% and 0.6% of potential output in 2023 and 2024, respectively. In 2022, capital accumulation was the main driver of potential output growth, contributing 2.8 pp, followed by labour contributing 2.1 pp. In both 2023 and 2024, labour is forecasted to be the main driver behind potential output, contributing 2.6 pp to potential GDP growth in both forecast years. On the other hand, capital is expected to contribute 1.5 pp in 2023 and 2024. Total factor productivity is anticipated to remain the least contributing factor in potential GDP growth throughout the projected horizon, with contributions of 0.4 pp in 2023 and 2024.

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

Sources of potential output growth
(%)



Source: MFE

Risk Assessment

The Council has reservations on the fact that the output gap for 2023 is projected to be negative especially since core inflation is expected to remain high. The fact that the Council assesses an upside risk for real GDP in 2023, potentially exceeding the potential output growth projected by the MFE in 2023, is more in line with the projections for core inflation. As a result, the Council expects the output gap to be positive in 2023 and not negative as projected by the MFE. Nonetheless, the Council shares the MFE's views that labour is expected to be the main contributor to potential output growth in 2023, also on the back of an increasing population through inflows of foreign workers.

With regards to 2024, the Council shares the MFE's views that the output gap is expected to be negative, though less accentuated relative to the MFE's projections. Indeed, the Council expects the output gap to be marginally negative in 2024. This is also in line with the MFE's forecasts that core inflation is expected to decelerate in 2024.

23. **Based on alternative model forecasts and the Pearson skewness indicator, the MFE considers upside risks to real GDP in 2023, while risks are broadly balanced for 2024.** The DBP presents a range of real GDP growth and fiscal balance outcomes that could arise based on alternative scenarios that are more positive or negative than the baseline. The scenarios considered by MFE included: (i) different rates for global economic growth; (ii) higher interest rates; (iii) downside tourism forecasts; (iv) strengthening of the euro exchange rate; (v) lower competitiveness; (vi) higher private consumption; and (vii) faster decline in inflation. In general, the MFE indicate that all scenarios point to positive real GDP growth in 2023 at all confidence levels. On the other hand, the wider range of estimates calculated for 2024 portrays real GDP growth rates which are mostly positive but also include negative growth rates at the 90.0% confidence levels. The MFAC opines that this risk assessment would have benefitted from the inclusion of scenarios which relate to the possibility of higher oil prices. This is particularly relevant since the latest spot price has already exceeded the forecasts assumed

in the external assumptions and may rise further in view of a possible escalation of the Israel – Palestinian conflict.

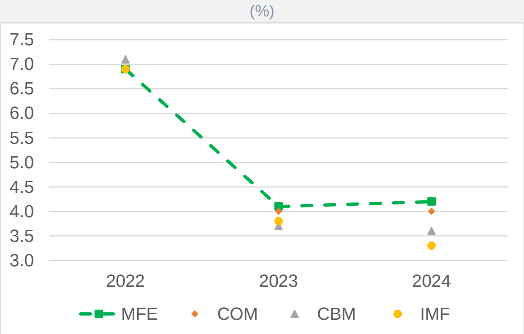
24. **The MFAC endorses the macroeconomic forecasts while identifying upside risk to real GDP growth in 2023 and a downside risk in 2024.** The Council considers that the macroeconomic projections for 2023 and 2024 prepared by the MFE as part of the DBP 2024 lie within its endorsable range. According to its assessment, the upside risk for 2023 is primarily due to data for the first half of the year, which stands higher than the overall projection for the year and the statistical base effect emanating from the second half of the year in 2022. On the other hand, for 2024, the Council believes that growth could turn out weaker than expected, especially from the external side. Furthermore, the Council notes that for 2024, growth is mostly emanating from domestic demand increases, mainly from private consumption expenditure. The Council would like to emphasize the importance of export-led growth and the need to improve competitiveness through labour productivity increases for sustainable medium-term economic growth.

BOX A: A COMPARISON OF MFE'S MACROECONOMIC FORECASTS WITH OTHER INSTITUTIONS

To enhance its endorsement function, the MFAC also analyses the forecasts for 2023 and 2024 published by other reputable institutions, including the COM, the International Monetary Fund (IMF) and the Central Bank of Malta (CBM). The most relevant are those published by the IMF in October 2023 and the COM in November 2023, which incorporate the latest available data. The IMF expect lower real GDP in both 2023 (3.8%) and 2024 (3.3%), while the COM's expectations are for real GDP to grow by 4.0% in both forecast years, very similar to what the MFE is projecting. On the other hand, the CBM forecasts, which were published with a cut-off date in August, expect real GDP to grow by 3.7% in 2023 and 3.6% in 2024. The MFE forecasts for real GDP do lie within the range of forecasts available by the other institutions, however, are slightly on the high side.

Real GDP growth forecast by the MFE and other institutions

(%)

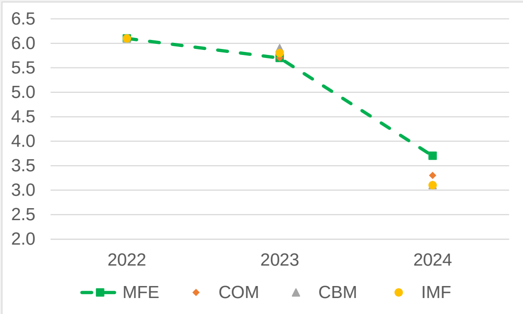


Source: MFE, COM, CBM, IMF

With regards to the inflation rate, both the MFE and the COM anticipate a rate of 5.7% in 2023, while for 2024, the COM expects inflation to be lower than anticipated by the MFE by 0.4 pp. The IMF and the CBM also indicate similar inflation forecasts for 2023 at 5.8% and 5.9%, respectively, while for 2024 both institutions expect inflation to be 0.6 pp lower than forecasted by the MFE.

Inflation rate growth forecast by MFE and other institutions

(%)

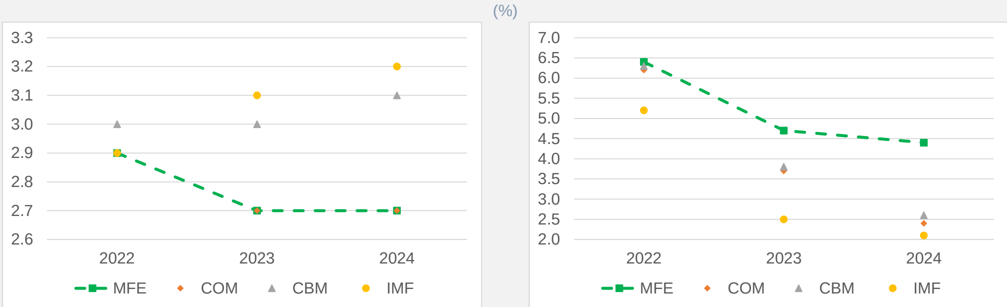


Source: MFE, COM, CBM, IMF

All institutions are expecting labour market fundamentals to remain strong in the short-term. The unemployment rate forecasted by the COM corroborates with that of the MFE for both years, at 2.7%. Both the IMF and the CBM are anticipating somewhat higher unemployment rates for both 2023 and 2024. At the same time, the forecasts for employment growth, as indicated by the MFE for both 2023 and 2024, are higher relative to all the other institutions.[19]

Unemployment rate forecast (a) and employment growth forecast (b) by MFE and other institutions

(%)



(a) (b)

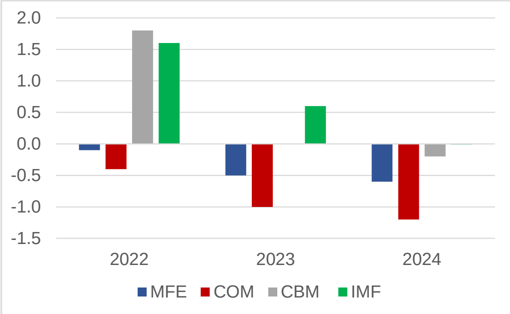
Source: MFE, COM, CBM, IMF

The COM is expecting the output gap to be even more negative than indicated by the MFE for both 2023 (-1.0% of potential GDP relative to -0.5% of potential GDP) and 2024 (-1.2% of potential GDP relative to -0.6% of potential GDP), with the commonality is that both are expecting the output gap to open across the forecast period. On the other hand, for 2023, the CBM is expecting the output gap to close but turn slightly negative (-0.2% of potential GDP) in 2024. Contrasting the forecasts for the output gap, as presented by the MFE, are those indicated by the IMF, which for 2023 are expecting the output gap to be positive (0.6% of potential GDP) and to close by the outer forecast year.

[19] The institutions (MFE, COM, CBM & IMF) use different definitions for employment growth, thus figures may not be directly comparable.

Output gap forecast by MFE and other institutions

(%)



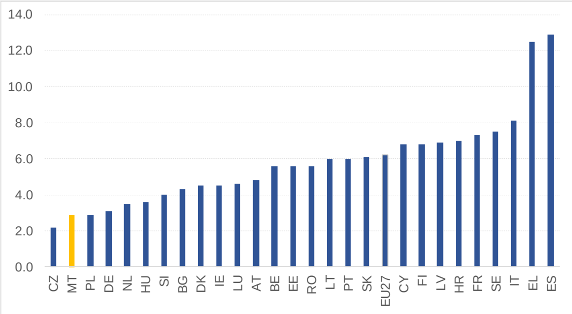
Source: MFE, COM, CBM, IMF

Overall, the forecasts presented by the other institutions for real GDP, inflation rate, and employment growth seem to follow similar trajectories and are quite close. The fact that MFE forecasts lie within a range of forecasts as presented by the other institutions, substantiates the endorsement of the Council. In terms of the output gap, the Council's views tend to incline more towards the forecasts as presented by the IMF for 2023 as indicated in the risk assessment presented for potential output and the output gap.

BOX B: UNEMPLOYMENT AND OUTPUT NEXUS: TESTING OKUN'S LAW FOR MALTA

The last twenty years or so have been marked by notable periods of economic uncertainty, global instability and international upheavals. Events such as the dot-com crash and the terrorist attacks of 9/11 in 2001, the economic and financial crisis of 2008–2009 and the sovereign debt crisis that followed, the Covid-19 pandemic that started in early 2020, and Russia's invasion of Ukraine in February 2022, have all had a negative impact on the global economy and consequently also on labour markets, albeit to varying degrees across countries. This is best exemplified by the differences in unemployment rates amongst EU member states. For example, in 2022, Czechia had the lowest unemployment rate in the EU, at 2.2%, while Spain had the highest rate, at 12.9%. The unemployment rate in Malta is 2.9%, which is the second lowest rate in the European Union. The disparity in unemployment rates across EU countries is largely attributed, though not limited, to differences in labour market regulations and policies, differences in the industrial structures composing the economy and the extent of labour intensity in key sectors and the economy, and variations in policy initiatives designed to counter effect negative economic shocks and firms' response to such policies.

Unemployment Rate in EU Countries in 2022
(Percentage of the labour force)



Source: Eurostat

The link between output and unemployment, known as Okun's law, was originally studied and published in economic literature in the early 1960s using post-second World War US data, revealing a negative relationship between the two.[20] Indeed, Okun found that a drop of 1 percentage point in output increased the unemployment rate by around 0.3 percentage points.

More recent estimates for the EA reveal that from 1996 to the beginning of the 2008-09 recession, typical Okun coefficient estimates were close to -0.4.[21] However, studies based on data samples, which include the financial crisis of 2008-2009, find that the unemployment rate became less responsive to changes in output. This could be partly explained by the principle of labour hoarding, which, during the 2008-2009 subprime mortgage crisis, was further supported by short-time working arrangements Such policies have, to some extent, distorted the unemployment-output relationship.

During the COVID-19 pandemic, a similar distortion was seen in 2020 and 2021. The COM had urged Member states to adopt countercyclical fiscal policies to strengthen their economies and help them endure the harsh consequences of COVID-19. This has been accomplished by activating the general escape clause in the SGP. It also provided financing for short-time work schemes and similar measures, through the temporary SURE (Support to mitigate Unemployment Risks in an Emergency) instrument. Focusing on Malta, the labour market remained strong in 2020 despite an 8.1% fall in the country's real GDP, with the unemployment rate rising very little during that time. This was mainly because of the significant assistance provided by the Maltese government to safeguard employment through various initiatives, such as the COVID wage support scheme, which allowed most Maltese firms to retain their existing workforce.

Okun's law has fluctuated in popularity as a tool in the macroeconomics toolbox. Even while it is often acknowledged that this "law" is merely a statistical link and not

[20] See Okun, A.M., "Potential GNP: Its Measurement and Significance", Proceedings of the Business and Economic Statistics Section, American Statistical Association, 1962, pp. 98 – 104.

[21] See box entitled "Back to Okun's Law? Recent developments in EA output and unemployment", ECB Monthly Bulletin, June 2011.

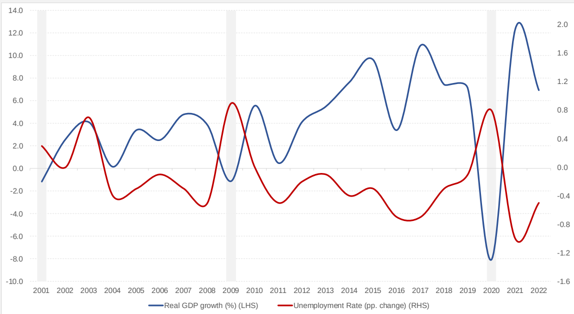
always a structural aspect of an economy, part of its attraction is still its simplicity. This suggests that this association might not hold up over time, particularly if the economy experiences significant structural changes. In fact, new research indicates that this association varies greatly between countries, especially following periods of severe economic distress.[22] Additionally, research suggests that Okun's relationship has asymmetries, with unemployment tending to increase more during recessions than to decline during periods of growth.[23]

Against this background, this box presents empirical estimates of the link between output and the unemployment rate in Malta during 2001-22 based on Okun’s law. It also compares the strength of this relationship in other EU nations.

ESTIMATING OKUN’S LAW FOR MALTA

According to GDP data, there were three recessions (grey columns) over the time under consideration, with the most recent one being the most significant in terms of the recorded contraction in real GDP. Malta saw strong rates of real GDP growth in most of the remaining years of the study period. The data also points to the possibility of a negative correlation between changes in GDP growth and changes in unemployment rates; that is, when real GDP growth accelerates, the unemployment rate typically declines and vice-versa. Therefore, a priori, it is expected that the Okun coefficient will be negative and statistically significant.

GDP growth and changes in the unemployment rate
(annual series)



Source: Eurostat

Indeed, when regressing the changes in the unemployment rate against real GDP growth using annual data from 2001 to 2022, the coefficient values obtained are 0.13 for the y-intercept and -0.07 for the Okun coefficient. This confirms a negative relationship between output and unemployment. The rate of output growth consistent with a stable unemployment rate is estimated at 1.8%. This means that a 1.0 percentage point increase in real GDP growth in excess of 1.8% lowers the unemployment rate by around 0.07 percentage points.

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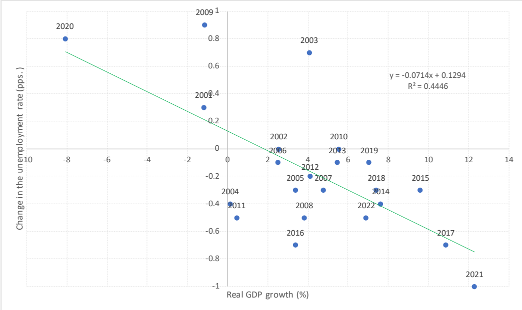
[22] See Pizzo, A., “Literature Review of Empirical Studies on Okun’s Law in Latin America and the Caribbean”, EMPLOYMENT Working Paper, Employment Policy Department, International Labour Organisation, Working Paper No. 252, 2019.

[23] See Harris, R. and Silverstone, B., “Testing for asymmetry in Okun’s Law: a cross-country comparison”, Economic Bulletin, 2001, 5, pp. 1 – 13.

Okun's Relationship in Malta
(annual data)



Source: Eurostat; Author's calculations

The difference version of Okun's law for Malta has also been undertaken as shown in the following table, which makes use of quarterly data spanning from the first quarter of 2001 to the second quarter of 2023.[24] The GDP growth rate that is consistent with a stable unemployment rate is estimated to be 1.6%, whereas the first equation, called static, indicates an Okun's coefficient of -0.07. The value of the Okun coefficient is very similar to the estimates obtained in a similar study by the Central Bank of Malta (CBM).[25] The intercept is not statistically different from zero at standard significance levels, though, and this is important to note. Even after accounting for lags in the dependent and explanatory variables, the results hold steady, showing that changes in domestic economic activity have little impact on the labour market while being statistically significant. The dynamic specification, including lags both for the dependent and the explanatory variables, indicates that the long-run Okun's coefficient is close to zero.

REGRESSION COEFFICIENTS FOR OKUN'S LAW

Table 1B: ***Dependent variable: $\Delta(UR_t)$ Sample: 2001Q1 – 2023Q2***

		Explanatory Variables			
Specification	**Intercept**	**$\Delta(Y_t)$**	**$\Delta(Y_{t-1})$**	**$\Delta(UR_{t-1})$**	**Adjusted R2**
Static	0.11	-0.07***			26%
Dynamic (a)	0.11	-0.07***	-0.00*		24%
Dynamic (b)	0.11	-0.07***	-0.02*	-0.32***	41%

Statistical significance: * at 90% confidence interval, ** at 95% confidence interval, *** at 99% confidence interval

Source: Author's calculations

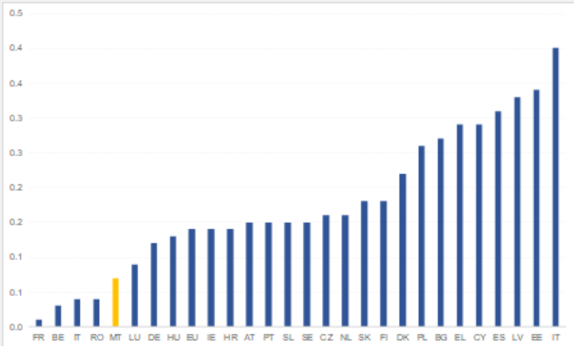
[24] The first four observations are lost when calculating the yearly growth rate of GDP and the change in the unemployment rate because quarterly data only goes back to 2000. The National Accounts and the Labour Force Survey are the sources of the GDP and unemployment figures, respectively.

[25] See box entitled "*Estimating Okun's Law for Malta", Central Bank of Malta Quarterly Review,* 2013:3.

COMPARISON WITH EU COUNTRIES

Using the static specification and the same sample of quarterly data, the following chart plots the Okun's coefficient for EU countries. In comparison, Malta's Okun's coefficient is one of the lowest in the European Union.

Comparison of Malta's Okun's Coefficient with EU countries
(estimates based on quarterly data, static equation, negative values)



Source: Author's calculations

The cross-country comparison shows a considerable degree of heterogeneity in Okun's coefficient. This heterogeneity is due to a number of factors, such as the degree of labour market flexibility, including the ease with which firms can fire and hire workers and the extent to which firms can adjust wages, the power of trade unionism and collective bargaining, including the firm's ability to reduce employees' working hours, employment protection legislation, the magnitude and type of shocks hitting the economy, and the degree of tightness in the labour market. For instance, the high Okun coefficient in the case of Spain could be related to the elevated incidence of temporary contracts.[25]

In the case of Malta, an important reason for the relatively low Okun coefficient is labour hoarding. Hoarding labour would be the best course of action if businesses anticipate that the decline in demand will only be temporary. This is because doing so would prevent them from having to pay more expenses should they need to hire new workers in the future. This is at times complemented by government support to firms to retain workers during periods of deficient demand. A perfect example of this is the unprecedented government support in wage assistance schemes during the Covid-19 pandemic.

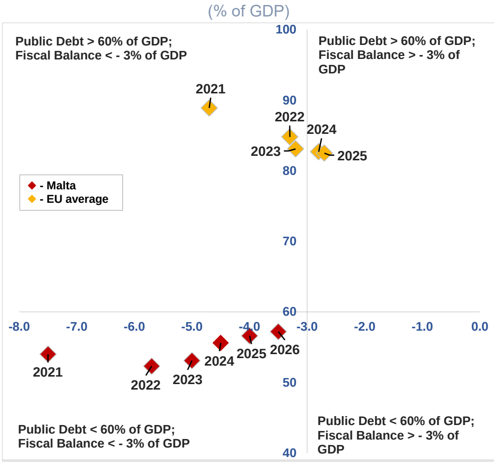
FISCAL ASSESSMENT

25. At the time of the USP, the MFE had projected that the fiscal deficit ratio would fall beneath the 3% threshold by 2026, but in the DBP, this target has now been deferred to 2027. Meanwhile, the debt-to-GDP ratio is anticipated to rise consecutively over the forecast period, albeit remaining below, but

close to, the 60% criteria. The fiscal deficit is projected to diminish by 0.7 pp in 2023, followed by an annual reduction of 0.5 pp in subsequent years, such that by 2026, the balance would still be at -3.5% of GDP.[26]

In structural terms, the balance will narrow from -4.8% in 2023 to -3.0% by 2026. However, these projections need to be viewed within the context of a negative output gap, which widens further over the forecast horizon.[27] As highlighted in the macroeconomic risk assessment, the Council considers that these projections for the output gap are not consonant with the current high core inflation and the buoyant labour market, which is expected to persist over the forecast period. This implies that the structural balance could, *ceteris paribus*, be worse than projected in the DBP. On the other hand, Malta's government debt-to-GDP ratio, though remaining below 60%, is projected to increase by an average of 1.2 pp per year, reaching a ten-year high of 57.2% by 2026. A comparison of Malta's fiscal position to the average across the EU shows a similar declining trend for the fiscal balance, but whereas for the EU average the deficit falls below 3% of GDP by 2024, the excess over this threshold persists for longer for Malta. As regards government debt, whilst Malta's ratio is considerably lower than the EU average, the upward trajectory contrasts with the declining trend for the EU.

Fiscal balance and public debt dynamics – Malta and the EU[28]
(% of GDP)



Source: MFE, COM

26. **Despite the fact that the minimum consolidation effort, required by the SGP and the FRA is projected to be attained, the deficit in absolute terms is projected to remain rather close to current levels.** Throughout the period under review, the deficit will persist at a level close to €900 million (estimated at €935.7

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[26] See Table A.3 in the Appendix for more fiscal ratios data.

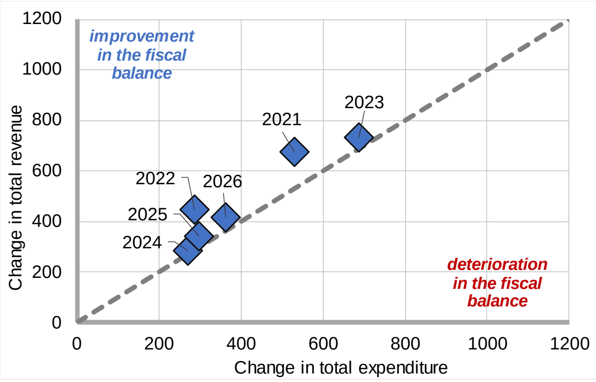
[27] The output gap (as % of potential GDP) in the DBP is as follows: 2022; -0.1 2023; -0.5, 2024; -0.6 2025; -0.8 2026; -1.3.

[28] 2021 and 2022 represent actual data. Figures for 2023 and 2024 for Malta represent the forecasts in the DBP by the MFE, whilst the forecasts for the EU are those by the COM presented in the Autumn 2023 Economic Forecast. The COM publishes forecasts until 2025.

million in 2023 and €919.7 million in 2024).[29] The consolidation of the deficit ratio is thus primarily derived from GDP growth.

27. **If the forecast for 2023 materialises, total revenue will register the highest historical increase in absolute terms, up by €732.3 million.** As a percent of GDP, total revenue would increase to 35.0% in 2023, but it is expected to decline thereafter by an average of 0.6 pp yearly, reaching 33.3% in 2026. Meanwhile, the increase in total expenditure in 2023 is the second highest on record, following the record increase in 2020 on account of the COVID-19 pandemic. The expenditure-to-GDP ratio is also forecasted to peak in 2023, reaching 40.0% and declining by an average of 1.0 pp, until it reaches 36.9% in 2026.

Annual changes in revenue and expenditure
(EUR millions)



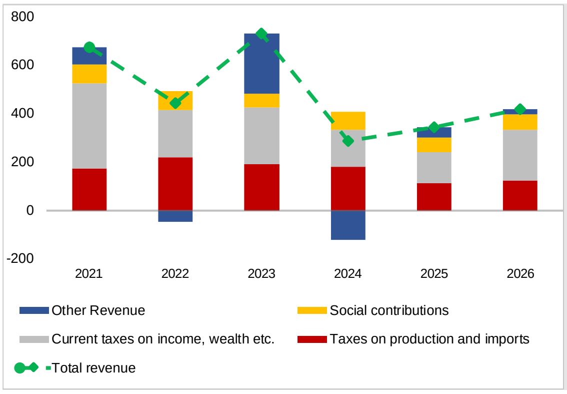
Source: MFE

28. **All revenue components are projected to increase in 2023 when compared to 2022 but the extent of the contribution towards the increase in revenue is expected to decline thereafter. More volatility is exhibited across the various expenditure components, with some large increments in 2023 which are then lowered in 2024.** For 2023, all the main revenue components are to contribute positively to the significant increase in total revenue. In particular, 'other revenue' is projected to increase considerably, reflecting the closure of the EU's 2014-2020 multiannual financial framework. In 2024, the projected increase across revenue components is more subdued, in line with a moderation in the relevant macro proxy bases, and in the case of 'other revenue', due to a base effect primarily related to EU funding in 2023. Developments in EU-funded projects are also reflected in the trajectory for gross fixed capital formation, with significant growth envisaged for 2023, but a lower level of government investment in 2024. On the other hand, subsidies in absolute terms are assumed to continue contracting, whilst the yearly increase in intermediate consumption is set to be marginal as from 2024. The rest of the expenditure components will exhibit a more stable increase in absolute terms

[29] In 2025 the deficit is projected to reach €872.5 million, and in 2026, €815.5 million.

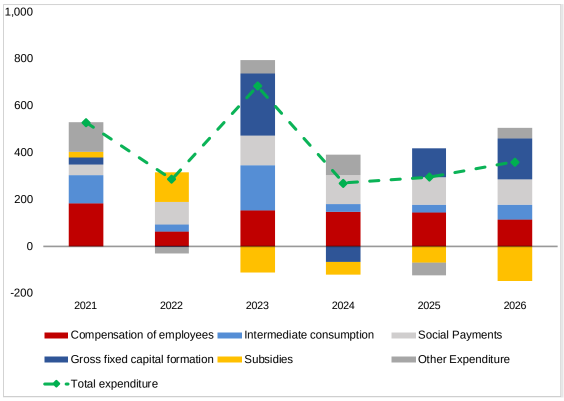
over the forecast years. What follows is an assessment of the main revenue and expenditure components, analysed separately, focusing on 2023 and 2024.[30,31,32]

Contributions to changes in revenue
(EUR millions)



Source: MFE

Contributions to changes in expenditure
(EUR millions)



Source: MFE

[30] The government is required to publish forecasts for years 't' and 't+1' in the October forecast round. Similar to the DBP for 2023, the MFE has also published fiscal targets for 't+2' and 't+3' in the DBP for 2024. The MFAC's assessment will primarily focus on the years 2023 and 2024 in its assessment of each component, given that macroeconomic forecasts for 't+2' and 't+3' are not included in the DBP.

[31] Following the publication of the DBP on 16 October 2023, some changes were implemented across expenditure components for 2024, in view of measures announced in the Budget Speech on 30 October 2023. The assessment presented in this report is based on the figures presented in the DBP. However, it was noted that the changes in the expenditure components for 2024 were minimal, and an increase in one expenditure item, such as social payments, was offset through a reduction in other line items, resulting in practically no impact on the overall deficit figure.

[32] See Table A.4 in the Appendix for a list of the main fiscal components in absolute terms.

BOX C: MFAC'S FISCAL REVENUE FORECASTS

The MFAC uses a fiscal model that is based on the standard ESA 2010 framework. This model allows for a detailed examination of the core components of government tax revenue: 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 this model, the Council can gain a more nuanced understanding of the tax base, and the sensitivity of revenue components to shifts in the tax base and refine its risk assessment capabilities.

Revenue collection is driven by two main elements: the tax base and discretionary fiscal policy. Tax revenue elasticity focuses on the former, as it involves the estimated impact of the macroeconomic environment on revenue, assuming fiscal policy remains unchanged. By using this model, a relationship between revenue collected and its respective tax base can be deduced.

Table 1C: MFAC's Elasticity Estimates for the Main Revenue Components assuming the same macroeconomic projections of MFE [33]

	2022	2023	2024
Taxes on production and imports	0.4[34]	0.8	0.9
Current taxes on income and wealth	0.7	1.2	1.1
Net Social Security Contributions	0.8	0.8	0.9

Source: MFAC Estimates

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 of tax revenue, so that variances are attributed solely to different tax elasticities. In this scenario, the MFAC assesses an element of upside risk in 2023 in the total fiscal revenue projection as presented by MFE of €8.8 million, but a downside risk to the total fiscal revenue projection for 2024 of €46.1 million. Notably, the MFAC projects lower fiscal revenue from indirect taxes but higher revenue from direct taxes. Differences in net social security contributions receivables projections differ marginally.

[33] The elasticity provided here is worked on a synthetic tax base.

[34] If nominal GDP is used as the tax base, the elasticity estimate for 2022 would increase to 1.1.

Table 2C: MFAC Projections Assuming the same Macroeconomic Projections from the MFE (EUR millions) [35]

	2023			2024			2024 - Incremental Risk
	MFE	**MFAC**	**MFE-MFAC**	**MFE**	**MFAC**	**MFE-MFAC**	
Taxes on production and imports	1,981.4	1,928.4	53.0	2,161.1	2,041.4	119.7	66.7
of which Value Added Taxes	1,315.0	1,298.7	16.3	1,450.0	1,382.3	67.7	51.4
Current taxes on income and wealth	2,483.7	2,538.8	(55.1)	2,636.2	2,713.4	(77.2)	(22.1)
of which taxes on individual or household income including holding gains	N/A	1,656.1		N/A	1,849.7		
of which Taxes on the Income or profits of Corporations including Holding Gains	N/A	779.8		N/A	790.8		
Net Social Security Contributions	1,046.9	1,053.6	(6.7)	1,124.4	1,120.8	3.6	10.3
Downside / (Upside) on Government Revenue			**(8.8)**			**46.1**	**54.9**

Source: MFE, MFAC Estimates

The second scenario incorporates changes in the macroeconomic projections based on the expert judgment of MFAC, reflecting the macroeconomic risks highlighted earlier in the 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 revenue outcomes. This approach allows the Council to incorporate its 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 macroeconomic projections.

The projections derived from this scenario convey positively for the government's total revenue for 2023 by around €128.9 million, as an upside risk in all the primary revenue components is identified, save for taxes on production and imports. Similarly, when incorporating the possible macroeconomic risks for 2024, and 2023 base effects, the MFAC assesses an upside risk to the total fiscal revenue projection of €102.0 million. However, when removing the €128.9 million base effect, the

[35] A negative balance in Tables 2C and 3C reflects an upside risk (green) to the projections by the MFE, whilst a positive balance indicates a downside risk (red).

incremental risk in 2024 turns on the downside, amounting to €26.9 million, derived from taxes on production and imports and, to a lesser extent, from social contributions.

Table 3C: MFAC Projections incorporating changes in Macroeconomic Projections based on Expert Judgement (EUR millions) [0]

	2023			2024			2024 - Incremental Risk
	MFE	MFAC	MFE-MFAC	MFE	MFAC	MFE-MFAC	
Taxes on production and imports	1,981.4	1,956.5	24.9	2,161.1	2,083.3	77.8	52.9
of which Value Added Taxes	1,315.0	1,321.4	(6.4)	1,450.0	1,418.6	31.4	37.8
Current taxes on income and wealth	2,483.7	2,613.2	(129.5)	2,636.2	2,800.8	(164.6)	(35.1)
of which taxes on individual or household income including holding gains	N/A	1,715.9	N/A	N/A	1,915.5		
of which Taxes on the Income or profits of Corporations including Holding Gains	N/A	793.9		N/A	812.1		
Net Social Security Contributions	1,046.9	1,071.2	(24.3)	1,124.4	1,139.6	(15.2)	9.1
Downside / (Upside) on Government Revenue			**(128.9)**			**(102.0)**	**26.9**

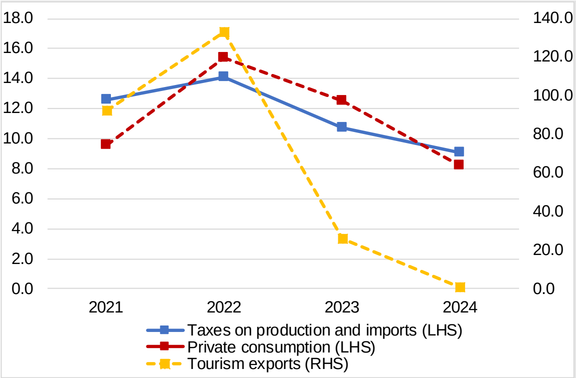
Source: MFE, MFAC Estimates

29. **Although decelerating, growth in taxes on production and imports is still projected to be strong throughout the forecast years, close to 10%. The synthetic elasticity is projected to increase progressively from its low value in 2022, turning elastic in 2024 according to the MFE.** In 2023, indirect taxes are forecasted to increase by €192.0 million, followed by a €179.8 million increase in 2024. The deceleration in growth in 2023 to 10.7%, from 14.1% in 2022, follows similar developments in private consumption expenditure and tourism earnings which act as proxy bases. Although remaining below unitary, the elasticity in 2023 is higher than the low elasticity experienced in 2022. On the other hand, in 2024, the higher growth in indirect taxes compared to the proxy bases indicates an elasticity greater than unitary. Particularly, the MFE is envisaging a relatively high elasticity for Value-Added Taxation (VAT). This also reflects an assumed improvement in tax collection efficiency. Such higher elasticities for 2024 have contributed to the upward revision of €125.4 million, in absolute terms, compared

to the previous forecast round. As a result, the ratio of indirect taxes to GDP is expected to increase by 0.1 pp to 10.5% in 2023 and to rise further to 10.7% in 2024.

Growth in taxes on production and imports and its main macro-proxy variables

(pp, %)



Source: MFE

Risk Assessment

The decelerations in taxes on production and imports in 2023 and 2024 are consistent with the trajectory for private consumption expenditure and nominal GDP. The developments up till the first half of 2023 suggest that from a €192.0 million increase projected for the year, €67.2 million have already been realised (year-on-year difference to the first half of 2022). This suggests that significant progress is required over the second half of the year for the target to be realised.

The Council's fiscal revenue model supports the risk assessment of the main revenue components (see Box C). The risks for taxes on production and imports based on the macroeconomic projections of the MFE, and also when including the Council's expert judgement on the macroeconomic forecast, are on the downside for both 2023 and 2024. However, the risks, particularly for 2023, are lower when the macroeconomic projections reflect the Council's expert judgement. Particularly, for VAT, risks turn slightly positive in 2023 when using the latter model. On the other hand, the risk for 2024 is more significant, due to a lower elasticity projected by the MFAC than that of the MFE.

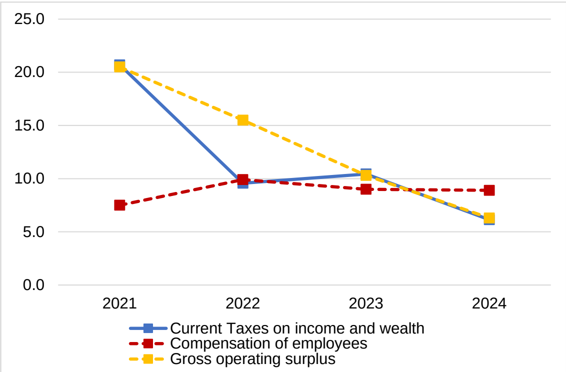
30. **In 2023, a strong increase in current taxes on income and wealth is expected, up by 10.4%. The MFE's projections show that this growth decelerates to 6.1% in 2024, being underpinned by an assumed prudent elasticity.** Direct taxes are projected to increase by €234.7 million in 2023 and €152.5 million in 2024. The growth in 2023 outpaces that of the two key proxy tax bases: compensation of employees, and gross operating surplus, projected to grow by 9.0% and 10.3%, respectively. Indeed, the MFE's elasticity for this variable is projected to be slightly higher than unitary, compared to a below unitary elasticity in 2022. Meanwhile, a weaker elasticity is being projected for 2024, as growth in

compensation of employees and gross operating surplus (8.9% and 6.3%, respectively) exceeds that in revenue from this tax component.

The proportion of direct taxes in relation to GDP is expected to be maintained at 13.1% in 2023, and then decrease by 0.1 pp in 2024. The forecast does not incorporate any new discretionary measures. In terms of tax on corporate profits, the MFAC notes that the tax system is planned to remain unchanged, with the government's decision not to introduce the OECD's 15% minimum tax Pillar Two regulation in 2024.

Growth in current taxes on income and wealth and its macro-proxy variables

(Percentage points, %)



Source: MFE

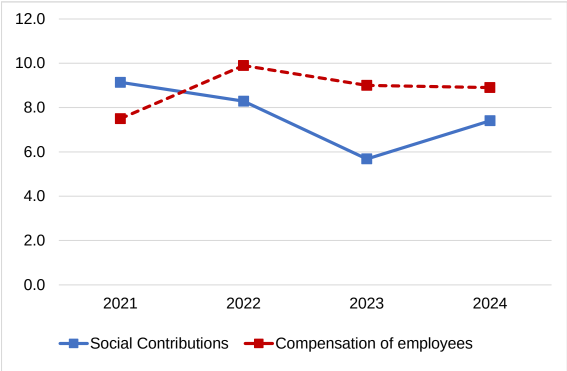
> **Risk Assessment**
>
> Over 72.0% of the envisaged growth in the direct tax component has been realised over the first half of 2023 (€170.6 million, out of the €234.7 million targeted annual increase). Specifically, the development in revenue from international companies was higher than estimated. Despite this, the MFE's elasticities remained rather prudent. Similar results are obtained from the Council's fiscal revenue model (see Box C). Both the model assuming the same macroeconomic projections as the MFE's and the one incorporating changes in macroeconomic projections based on expert judgement point to an upside risk to current taxes on income and wealth over both forecast years. When incorporating the Council's expert judgement, the upside risk is, in magnitude, higher than that assuming the same macroeconomic forecasts as the MFE's. The former model points to an upside risk of close to €130 million in 2023. The total upside risk for 2024 is €164.6 million, however, this incorporates the base effect from the previous year, meaning that the upside incremental risk in 2024 is lower at around €35 million.

31. **The rather stable absolute incremental growth observed in social contributions is projected to be maintained across both forecast years, though growth dips marginally in 2023.** Social contributions are projected to continue to increase over the forecast period, albeit at a slightly lower rate in 2023. The growth rates of 5.7% in 2023 and 7.4% in 2024 are lower than the component's macro-proxy variable, compensation of employees, which is expected to increase

by 9.0% and 8.9%. This suggests that the elasticity is poised to remain below unitary, consistent with past patterns and reflecting the established cap on annual social contribution payments.[36] However, the MFE's forecast for 2023 represents a slightly lower elasticity than historical tendencies, which poses an upside risk. Indeed in 2024 the elasticity is expected to rebound to previous values.

Growth in social contributions and its macro-proxy variable

(Percentage points, %)



Source: MFE

Risk Assessment

The MFAC is of the opinion that, overall, the level of social contributions is in line with the observed trends in its macro-proxy tax base. Particularly for 2023, the half-yearly developments indicate progress in line with the yearly target. However, the risk is slightly on the upside because of a slightly more prudent elasticity than envisaged by the MFE. This is supported by a positive risk when estimated via the Council's fiscal revenue model (see Box C). On the other hand, for 2024, the risk turns to marginally downside, but only when using the same macro projections as the MFE, and not when incorporating changes in macroeconomic projections based on expert judgement.

32. **In 2023, revenue from the remaining components is anticipated to be 29.2% higher than that registered in 2022, reflecting elevated EU funding. Consequently, this high base effect results in a decline of 11.1% in 2024.** In absolute terms, other revenue is expected to increase sharply by €249.3 million in 2023, before decreasing by €122.7 million in 2024. This volatility is mainly explained by the realisation of EU-funded revenue from the 2014–2020 Programming period, for which funds are available until 2023. This surge to tap into the remaining funds in this final year for which claims can be made, had also occurred in previous programming periods under the EU multiannual financial frameworks. Indeed, capital transfers receivable is projected to increase by a substantial rate of 85.4% to €366.1 million before going back to levels similar to those in 2022, close to €200 million. This includes receipts of EU funds from the

[36] The cap implies that once the maximum national insurance contribution has been reached, additional income does not lead to additional social security payments, hence producing a stable elasticity, unless there are ad-hoc factors or permanent changes in the contributory system.

RRF and the Multiannual Financial Programme 2021–2027. In general, though, EU funds should exert a broadly neutral impact on the deficit, as this is then matched by the relevant expenditure to which the funds are assigned.[37] Other revenue also includes proceeds from market output, which includes proceeds derived from the permanent residency programme. Potential variances may arise due to the nature of this programme as well as the discretionary nature of certain sales listed as market output. Other revenue also constitutes revenue from capital taxes, which is projected to remain low at close to 0.1% of GDP and that from property income, which is projected to be slightly lower than over the past years, to settle at 0.3% of GDP over both forecast years.

Risk Assessment

The projected trajectory for other revenue is backed by the forecasted implementation of projects financed from EU funding, whilst no particular risk is viewed in terms of the other elements making up the rest of the other revenue component. The materialisation of the projection, however, hinges on the successful absorption of the available EU funding, while other potential variances could arise because of changes in market output.

33. **Growth in compensation of employees is expected to increase by around €150 million annually over both forecast years. Changes in collective agreements and the Cost-of-Living Adjustment (COLA) particularly impact the forecast.** The absolute change in compensation of employees has been revised upwards for both 2023 and 2024 when compared to the USP, by around €27 million and €51 million, respectively, reflecting updated wage cost information. As a result, the projected annual increases presented in the DBP are considerably higher than the increase of €62.0 million in 2022.[38] Some public service sectoral agreements were negotiated in 2023, particularly in the health sector and the police force pushing up public wages, whilst negotiations on other agreements are currently underway, most notably in the education sector. In 2024, the incremental expenditure impact of revised contractual agreements is not expected to be as significant as that estimated for 2023. Compensating for this is the increased COLA for 2024 of €12.81 per week compared to that of €9.90 in 2023, pushing up wage costs.

Risk Assessment

Government compensation of employees is projected to maintain an overall stable ratio as a percent of GDP over the forecast horizon, of around 10.5%. This stability and the noted additional costs related to contractual agreements and COLA

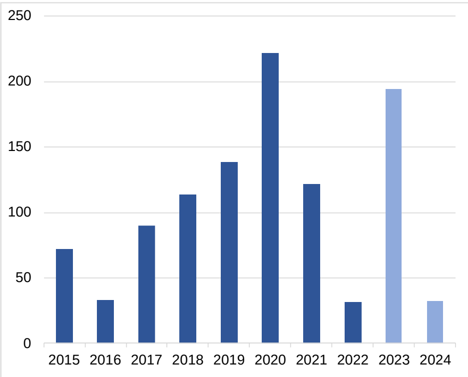
[37] The only impact on the fiscal balance stems from the national co-financing element and expenditure which is ineligible for EU funding.

[38] Based on Registered Employment NSO News Release NR204/2023, total gainfully occupied public sector employment stood at 51,213 in June 2023, compared to 51,132 in June 2022. The Full-Time Equivalent (FTE) for June 2023 was calculated at 47,730. Source: here.

indicate an overall neutral risk to this component. However, some savings could materialise when considering actual developments in this expenditure component in the first half of 2023 against the annual fiscal target. On the other hand, a higher minimum wage from 2024 could pose upward wage pressures thereon.

34. **Intermediate consumption is projected to exceed €1.5 billion in 2023, underpinned by high inflationary pressures. Thereafter, the increment in this line item is relatively minimal.** The trajectory of intermediate consumption remained similar to that in the USP, though absolute figures are now lower. In 2023, intermediate consumption is set to increase by €194.0 million, or 14.5%, from €1,342.7 million in 2022. For the current year, the forecast is impinged by inflationary pressures affecting contractual commitments, particularly in the health sector, increasing the cost of intermediate goods and services. The very high level of EU-funded investment projects envisaged for 2023, for which a certain element of intermediate consumption is necessary, further pushes up this expenditure component. Spending on intermediate consumption is then projected to only increase by €32.2 million in 2024. The assumption is that price increments abate, and so should the costs of intermediate goods and services. Compared to the USP, the downward revision of €41.6 million in 2024 is due to updated lower increases related to Programmes and Initiatives and partly due to the methodological change in compiling capital expenditure projections.[39]

Year-on-year increments in intermediate consumption
(EUR millions)



Source: MFE

Risk Assessment

The dynamics of this component remained similar to those portrayed in the USP. The assessment indicates no particular risks for 2023. It is also acknowledged that additional capital projects and other EU-funded programmes in 2023, which include an element of intermediate consumption, pose a base effect with respect to 2024, which explains why the increment envisaged for 2024 of 2.1% is low.

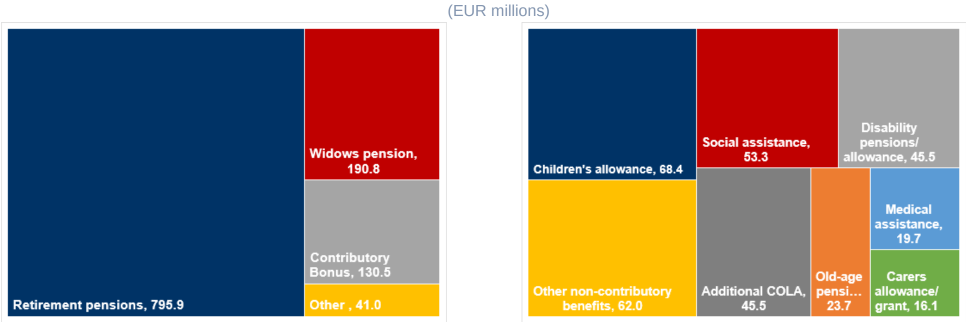
[39] The change in methodology in estimating the costs of capital projects is described in paragraph 36.

However, there is still a possibility of upside risk in 2024, particularly when juxtaposed against historically larger increments.

35. **The inclusion of the new social budget measures alongside increments to pensions and compensation for inflation shall elevate the level of social payments over both forecast years compared to the past years.** In 2023, social payments are projected to amount to €1,612.8 million, thus €126.1 million more than registered in 2022. Actual developments in the year's first half (+€67.0 million) are in line with this projected annual increase. For 2024, an allocation of €27.2 million has been factored into the forecasts to account for Budget 2024 social measures. Among others, these include measures related to children's allowance, pension and other social benefits adjustments. The MFE expects social payments to reach €1,736.8 million in 2024.[40] This represents an increase of €124.0 million, similar to the projected increase for 2023, maintaining the ratio-to-GDP at around 8.5%. In 2024, 'social benefits other than social transfers in kind', is split between 77.6% in contributory benefits and 22.4% in non-contributory benefits. Retirement pensions (included as part of contributory benefits) account for 53.3% of all 'social benefits other than social transfers in kind'. An ageing population is putting further pressure on this notable expenditure component. Indeed, the number of retirement beneficiaries is projected to continue increasing over the years, from 64,745 in 2017 to 76,100 in 2024.

Contributory benefits (€1,158.2 million) and Non-Contributory benefits (€334.2 million) in 2024

(EUR millions)



Source: MFE

Risk Assessment

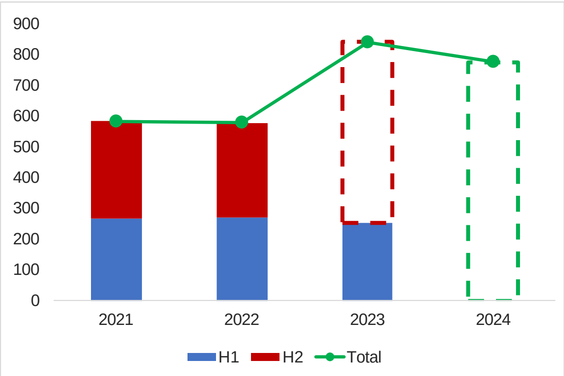
The various social measures announced in the Budget for 2023 and those in the Budget for 2024 explain the increments of around €125.0 million in each year. In terms of 2023, the progress over the first half of the year is in line with the yearly target. The MFAC also notes that the forecast for this variable over the past years was relatively accurate overall. In view of these factors, the overall trajectory for social payments is viewed as having neutral risk.

[40] Social payments is split between social benefits other than social transfers in kind, and social transfers in kind – purchased market production. The former includes a major part of the cost, projected at €1,528.2 million, whilst the latter is projected to amount to €208.6 million.

36. **In 2023, a record allocation towards public gross fixed capital formation has been made, exceeding the investment level of the previous year by 45.3%.** A significant upward revision to government gross fixed capital formation (investment / GFCF) expenditure was implemented between the USP and this forecast round, from €690.8 million to €843.6 million. The level of EU-funded investment in 2023 is elevated compared to other years, reflecting the fact that 2023 is the final year for the absorption of EU funding related to the 2014 – 2020 multiannual financial framework. This component of investment was revised upward further in the DBP when compared to the USP. Furthermore, in this forecast round, the MFE implemented a change in the methodology used to forecast gross fixed capital formation, which resulted in a marginal upward revision to the forecast for 2023. The change reflects a shift from splitting the total cost of investment projects to each fiscal expenditure category by set historical ratios to one whereby investment projects are analysed separately to portray more accurate figures across the various expenditure components.[41]

Only around 30% of the total projected annual government investment had materialised during the first half of the year. The January – June 2023 investment figure was also marginally less than that over the same period of 2022. However, more EU-funded investment is expected to materialise over the year's second half, with investment picking up pace, as has happened in the past with the final year of absorption of EU-funded programmes.

GFCF half-yearly and total developments [42]
(EUR millions)



Sources: Eurostat -actual data, MFE - forecast

Risk Assessment

Overall, for 2023, there is the possibility of slower progress than anticipated for some investment projects, with the possibility of postponement of some of the allocated GFCF expenditure to 2024. This possibility, alongside the fact that the

[41] This change in methodology has also affected other components since expenditure on an investment project does not only include costs related to gross fixed capital formation, but involves other costs, for instance, related to intermediate consumption.

[42] For 2023, the dotted area represents the required level of investment in H2 to meet the yearly forecast, whilst for 2024 this represents the total forecast for the year by the MFE.

upward revision in investment since the USP is considerable poses some downside risk to total investment in 2023. Although GFCF is projected to be lower in 2024 (by €65.4 million), the level of investment is still projected to be high by historical standards. Nonetheless, the MFAC commends a high level of productive public investment, especially that targeting capacity constraints and ensuring sustainable economic growth. It also advises that should there be the need for more fiscal consolidation effort than envisaged, this does not come at the expense of rescinding investment plans.

37. **Energy subsidies are being maintained over the forecast period. The blanket coverage elevates the level of uncertainty related to fiscal expenditure because of volatility in international prices and exogenous elements. At the same time, total subsidies are to decrease over the forecast years due to the non-recurrence of COVID-19 assistance in 2023, and the costs associated with the restructuring of the national airline in 2024.** In the Assessment of the Annual Report 2022 and the Assessment of the Half-yearly Report 2023, the MFAC made the following recommendation: "to prepare an adequate exit strategy in relation to the fixed-energy-price policy, adopt a more targeted approach and enhance incentives for energy savings."[43] This recommendation still stands. The forecast for this expenditure component is susceptible to the uncertainty related to international energy prices as well as other exogenous factors affecting energy demand, and thus the difficulty in forecasting energy subsidies, remains. The estimated cost of the two main energy subsidies, i.e., compensation for higher imported electricity prices and subsidies on petroleum products, amounted to €288.7 million, or 1.7% of GDP in 2022. For the current year, these measures are projected to amount to €246.0 million or 1.3% of GDP, whilst for 2024, an allocation of €320.0 million, or 1.6% of GDP has been made.

In terms of other subsidies, those linked with the national airline amounted to €144.7 million in 2022, split between early retirement schemes and other restructuring assistance. In 2023, an allocation of €105 million has been made in this respect. On the other hand, COVID-19 wage subsidies were maintained for the first five months of 2022, costing €124.7 million. This figure translates into savings in 2023 compared to 2022 because of the non-repetition of this measure.

Risk Assessment

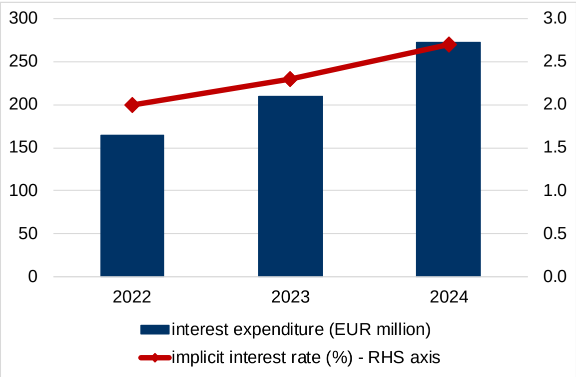
The risks in terms of subsidies reflect their exogenous nature. As regards the energy subsidies, these are subject to volatility arising from developments in the international market. This could significantly shift the trajectory of subsidies, in either direction, that is, there could be either cost savings or higher outlays. The fact that energy subsidies are not capped, but apply to all levels of usage, implies that energy efficiency is not incentivised. This also creates additional risk, more so since energy consumption depends on exogenous factors such as weather

[43] Both reports are available on the MFAC's website, here. Similar recommendations were also put forward by the IMF and the COM.

conditions, tourism inflows and changes in the population. This is compounded by the fact that these subsidies are not targeted.

38. **When combining the other expenditure elements, an increase in both 2023 and 2024 is expected of an annual average of €73 million. This mainly reflects interest expenditure increases due to higher interest rates and large borrowing requirements.** Interest expenditure is projected to increase by €45.1 million in 2023 and by a further €63.8 million in 2024. Higher market borrowing rates inevitably lead to refinancing and funding the public sector's borrowing requirement at higher coupon rates. Annual funding needs are relatively high, reflecting the projected level of fiscal deficits. 'Other' expenditure also comprises current and capital transfers payable. In the DBP, capital transfers are projected to increase by €34.0 million in 2023 before declining by €50.1 million in 2024 in part, reflecting the trajectory for EU funding. On the other hand, developments in current transfers partly offset the developments in capital transfers, by a marginal decline of €5.3 million in 2023 and then an increase of €84.6 million in 2024. Additional current transfers are mainly on account of first-time buyers grants and planned expenditure from the Individual Investor Programme (IIP).

Interest expenditure and the implicit interest rate[44]
(LHS – EUR millions, RHS - %)



Source: MFE

Risk Assessment

The MFAC notes that the current inflationary scenario, which is leading to higher interest rates, has started to negatively affect fiscal refinancing. This, coupled with the relatively high public borrowing requirements, is resulting in the projected upward trajectory for interest expenditure. However, overall, no upside or downside risk is viewed in the 'other expenditure' category.

39. **In the revised EU economic governance framework, net nationally financed primary expenditure growth is proposed to be the main indicator to be used to assess a country's fiscal trajectory. The MFE's forecasted expenditure**

[44] The implicit interest rate is proxied by interest expenditure divided by the debt level of the previous year.

developments suggest compliance with the growth trajectory recommended by the COM. In its assessment of the DBP, the COM has recommended that the net nationally financed primary expenditure should grow at a maximum rate of 5.9%.[45] This expenditure path is proposed to ensure a fiscal adjustment that complies with the requirements in terms of debt sustainability, as established by the Debt Sustainability Analysis (DSA) methodology by the COM. According to the fiscal forecasts presented in the DBP, the growth in this indicator is estimated at 4.9% in 2023, 1.0 pp less than the benchmark. On the other hand, albeit still lower than the benchmark, the indicator's growth is larger in 2024, when fiscal rules should become binding again, at 5.4%.

40. **Based on alternative model scenarios, in the DBP the MFE views the budget balance risk to be skewed towards the upside in both forecast years but to a lesser extent in 2024.** The MFE uses the same alternative macroeconomic scenarios detailed in paragraph 23 of this Report to evaluate risks to fiscal targets. The evaluation also incorporates the variance resulting from the past forecast error of fiscal projections, and the results are shown by means of a probabilistic fan chart. The latter indicates that the balance of risk is skewed towards a lower fiscal deficit (i.e., upside risk), particularly in 2023. Out of the scenarios considered, the worst-case scenario suggests a downward revision of 0.1 and 0.5 percentage points in 2023 and 2024 respectively, when compared to the baseline projection. The assessment extends to the risks associated with the output gap, which could subsequently affect structural fiscal targets. Alternative output gap forecasts vary from -0.5 percent of potential output to 0.6 percent in 2023 and from -1.1 percent of potential output to 0.9 percent in 2024. The range of estimates is quite wide and varies between positive and negative, which poses an element of risk to the structural balance forecasts.

41. **The MFAC is of the opinion that the fiscal trajectories for Malta prepared by the government fit within its plausible range when noted against the government's policies and other observed macro and fiscal dynamics. The assessment however points to a possibly better fiscal deficit ratio in 2023, with risks turning more on the downside in 2024 when removing the base effect of 2023**. The assessment for each revenue component, which is substantiated by means of the MFAC's fiscal modelling framework, suggests that on aggregate, total revenue could turn out better in 2023. The possibly larger level of direct taxes compared to that of the MFE, compounded by slightly higher social contributions, outweighs the lower downside risk viewed for indirect taxes. This base effect, and thus upside risk in total revenue is transposed onto 2024, leading to total revenue possibly turning out better than targeted. However, when removing 2023's positive base effect on the revenue side, the incremental risk is on the downside in 2024, as the upside risk for total revenue, in absolute terms, is lower than that in 2023. This time, the level of downside risk is larger for indirect taxes and net social contributions, outweighing the upside incremental risk envisaged for

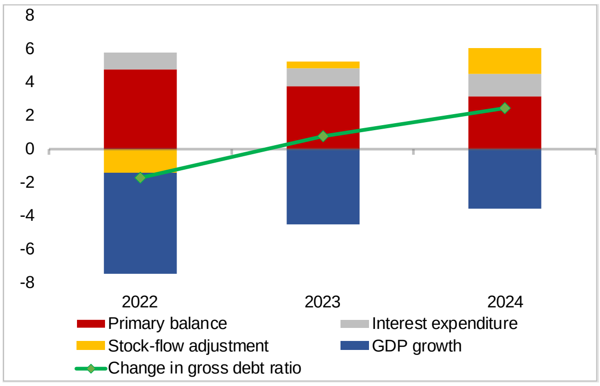
[45] Net nationally financed primary expenditure represents the general government primary expenditure, net of the incremental budgetary impact of discretionary revenue measures (and COVID-19 pandemic-related temporary emergency measures), excluding one-off and cyclical unemployment expenditure, as well as expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds.

direct taxes. Concomitantly, the noted progress over 2023 for specific expenditure components, compounded with other observed risks, indicates the possibility of expenditure savings when compared to the aggregate target. For 2024, risks to developments in expenditure are close to neutral, but could possibly turn out marginally on the upside.

The MFE's projected deficit ratios for both forecast years are relatively close to those produced by other reputable institutions, and the MFAC views the estimates as fitting within a plausible range. This is supported by the fact that the envisaged fiscal risks, along with those with respect to GDP, suggest that a lower fiscal deficit-to-GDP ratio than projected by the MFE could be achieved in both 2023 and 2024. Notably, should the positive risk in 2023 materialise, a minimum structural effort of 0.5 pp in 2024 would still need to be registered, given that the fiscal deficit is projected to remain above the 3% benchmark. On this basis, the Council recommends that the government should still not inflate expenditure, particularly the non-productive type, to enable space for fiscal adjustment in 2024.

42. **The debt-to-GDP ratio is anticipated to increase by 0.8 pp in 2023 and by 2.5 pp in 2024 to reach 55.6%. The larger increase in 2024 reflects the planned assistance to the national airline through a positive stock-flow adjustment (SFA), increasing debt. Overall, the MFAC's macroeconomic and fiscal risk assessments suggest possibly better debt ratios in 2023 and in 2024, with the upside risk in 2023 being more pronounced than that in 2024.** In 2023, public debt is anticipated to increase by €1,021.1 million from €9,003.4 million in 2022, thus exceeding €10 billion, with the change mainly reflecting the financing of the government's projected deficit for the year. Contrary to 2022, the SFA is projected to shift to positive, increasing debt by €85.4 million or contributing 0.4 pp to the change in the gross debt ratio. This contribution is set to be higher in 2024, at 1.6 pp, mostly because of the planned assistance to the national airline, which is not projected to affect the general government balance but increases debt through an equity acquisition of €215.0 million. Other SFA line items are projected to contribute to a total SFA of €329.7 million in 2024. Along with the projected SFA, the contribution to debt from interest payments is also set to increase (up to 1.1 pp in 2023 and 1.3 pp in 2024), though these are offset by a lower contribution from the primary balance from one year to the next (from 4.8 pp in 2022 to 3.8 pp in 2023 and 3.2 pp in 2024). The developments in these three variables are anticipated to offset the favourable reducing impact of nominal GDP growth on the debt ratio.

Contributions to changes in the gross debt ratio
(Percentage points)



Source: MFE

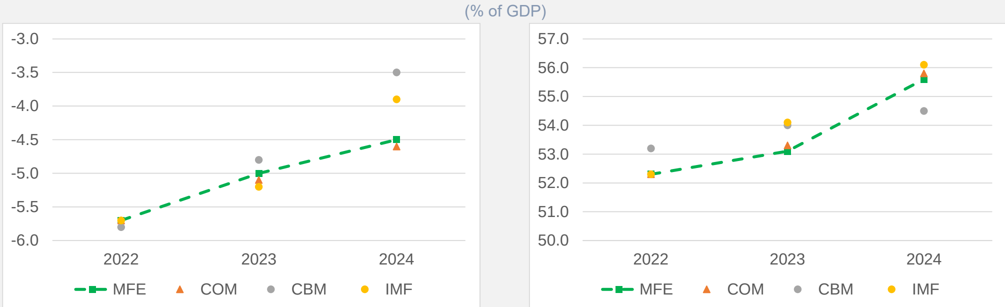
Risk Assessment

Overall, the MFAC is of the opinion that risks are skewed towards achieving a lower debt ratio in 2023 and possibly also in 2024. This is in view of the upside risks associated with GDP growth in 2023, which acts as the denominator in the ratio, and the possibility that the fiscal deficit also turns out slightly better than projected. In 2024, the base effects in nominal GDP growth and in the fiscal deficit ratio arising from 2023 could possibly offset the downside risks identified for economic activity in 2024, leading to a more favourable debt ratio in 2024. An added element of uncertainty also relates to the eventual outturn of the SFA, which, exhibits considerable volatility and over the past years has turned out rather different than what was forecasted.

BOX D: A COMPARISON OF MFE'S BUDGETARY FORECASTS WITH OTHER INSTITUTIONS

To enhance its endorsement function, the MFAC also analyses the budgetary forecasts for 2023 and 2024 published by other reputable institutions, including the COM, the IMF and the CBM. The most relevant are those published by the IMF in October 2023 and the COM in November 2023, which incorporate the latest available data.

Deficit ratio forecast (a) and Debt ratio forecast (b) by MFE and other institutions
(% of GDP)



(a) (b)

Source: MFE, COM, CBM, IMF

The IMF (-5.2%) and the COM (-5.1%) expect a higher deficit ratio when compared to the MFE (-5.0%) in 2023. On the contrary, the CBM expects a more favourable deficit ratio of 0.2 pp and 1.0 pp in 2023 and 2024, respectively, when compared to the MFE's forecast. Both the COM (-4.6%) and the IMF (-3.9%) expect the deficit ratio in 2024 to improve relative to 2024, though the COM's forecast of the deficit ratio is 0.1 pp worse than that expected by the MFE. The Council assesses the MFE forecasts of the deficit ratio to lie within the range of forecasts available by the other institutions, though confirming the Council's assessment that the deficit ratio in 2023 and in 2024 could turn out better than anticipated by the MFE in the DBP.

All institutions are expecting the public debt ratio to increase in 2023 and in 2024, though to varying degrees. Only the CBM (54.5%) expects a lower public debt ratio in 2024 relative to the forecasts of the MFE (55.6%). Both the COM and the IMF anticipate the public debt ratio to be higher than that forecasted by the MFE in 2024, by 0.2 pp and 0.5 pp, respectively. The Council assesses the MFE forecasts of the debt ratio to lie within the range of forecasts available by the other institutions.

COUNCIL'S CONCLUSIONS

43. **The MFAC endorses the macroeconomic forecasts as prepared by the government. The Council is of the opinion that there may be elements of upside risks to real GDP growth in 2023 and downside risks in 2024.** The MFAC notes that in view of the current circumstances in the global economy, the macroeconomic outlook remains subject to considerable uncertainty and very sensitive to the assumptions employed. Within this context, the Council considers that the macroeconomic projections for 2023 and 2024 prepared by the MFE as part of the DBP 2024 lie within its endorsable range. According to its assessment, the upside risk for 2023 is primarily due to data for GDP growth for the first half of the year, which stands higher than the overall projection for the year and the statistical base effect emanating from the second half of the year in 2022. The upside risk identified for 2023 mainly stems from the domestic side of the economy as the Council opines that there are upside risks to private consumption and government expenditure, which are expected to outweigh the downside risks identified from the external side as a result of higher expected imports of goods and services. On the other hand, for 2024, the Council believes that growth could turn out weaker than expected, especially from the external side, as a result of lower expected exports of goods and services.

44. **The MFAC is of the opinion that the fiscal trajectories for Malta prepared by the government fit within its endorsable range when noted against the government's policies and other observed macro and fiscal dynamics. The MFAC's assessment, however, points to the possibility of achieving better fiscal deficit ratios over both forecast years, although in 2024, the adjustment in the deficit ratio could prove more difficult to achieve. Such risks translate**

onto debt dynamics. Based on its assessment of each expenditure component, the Council considers the possibility that overall, government expenditure could turn out less than projected in 2023. At the same time, the Council views positive risks for the government's revenue projections, mostly supported by the possibility of larger revenue from direct taxes. Combined with upside risks to GDP, these risks would translate into a larger improvement in the fiscal deficit than is projected by the MFE. Due to the base effect in 2023, the fiscal deficit ratio in 2024 is viewed as also turning out better than the 4.5% forecast of the MFE. However, when removing the base effect, a downside risk is viewed for the ratio in 2024, which implies the possibility of a smaller adjustment in the deficit than envisaged by the MFE.

Should the positive risk in 2023 materialise, a minimum structural effort of 0.5 pp in 2024 would still need to be registered, given that the fiscal deficit is projected to remain above the 3% benchmark, to adhere with excessive deficit procedures. On this basis, the Council still recommends that the government should explore means of expenditure restraint and should not inflate expenditure particularly that which is non-productive to enable more space (which is limited) for fiscal adjustment in 2024. Another potential risk relates to the estimate of the structural balance and in turn, the structural effort, as this depends on possible revisions in the output gap estimate. The Council notes that the debt ratio is projected to remain below the 60% of GDP benchmark. Although the MFE projects the debt ratio to increase closer to 60%, the fiscal risks identified in the assessment translate onto the possibility that the debt ratios turn out lower than projected, unless changes to stock-flow adjustments occur. The Council also notes that the current projections imply compliance with the maximum growth in nationally financed net primary expenditure recommended by the COM, as this is proposed to be the main fiscal surveillance indicator in the new economic governance framework.

COUNCIL'S RECOMMENDATIONS

45. Following this Assessment of the DBP 2024, the Council hereby recommends the following:

a. Economic growth should be more export-led, rather than being dependent on domestic demand, especially private consumption. This is particularly important in the context of the present high inflationary environment.

b. To achieve export-led growth, there is a significant need to improve competitiveness through labour productivity increases. Addressing skill gaps and implementing the twin transition towards more digital and environmentally sustainable business practices should enable organisations to operate more efficiently and sustainably, thus improving labour productivity. This will ensure sustainable medium-term economic growth, but since the effects of these investments take time to materialise, it is important to start implementing this reform agenda now.

c. Government should strive towards achieving a sound medium-term fiscal position by building fiscal buffers, combined with efforts to achieve sustainable growth.

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

e. Any potential expenditure savings or higher than projected revenue should be directed to build fiscal buffers.

f. Government should avoid inflating government spending, especially that which is not productive. Means of expenditure restraint should be explored in order to ensure that the minimum required fiscal effort is achieved.

g. Expenditure savings should not occur from curtailing planned productive capital expenditure. Further steps should be taken to preserve nationally financed public investment and meet the targets, also with respect to the absorption of RRF grants and other EU funds, especially in view of the closure of the 2014-2020 financial programmes in 2023. Furthermore, the Council encourages the government to accelerate the absorption of EU funds from the 2021-2027 programme and the remaining allocations from the RRF.

APPENDIX

Table A.1: Exogenous assumptions

	Source	Publication	2022	2023	2024
Short-term interest rate (annual average)	**ECB**	**DBP 2024**	**0.5**	**3.7**	**4.1**
		USP 2023 - 2026	1.0	1.3	1.5
Long-term interest rate (annual average)	**ECB**	**DBP 2024**	**2.4**	**3.7**	**3.9**
		USP 2023 - 2026	2.4	3.1	3.1
USD/€ exchange rate (annual average)	**ECB & Consensus Economics**	**DBP 2024**	**1.048**	**1.084**	**1.108**
		USP 2023 - 2026	1.048	1.090	1.125
STG/€ exchange rate (annual average)	**ECB & Consensus Economics**	**DBP 2024**	**0.869**	**0.866**	**0.868**
		USP 2023 - 2026	0.869	0.892	0.887
Real GDP growth of main trading partners*	**Eurostat & Consensus Economics**	**DBP 2024**	**1.8**	**0.5**	**0.7**
		USP 2023 - 2026	11.7	0.2	1.1
Oil prices (Brent, USD/barrel)	**US Energy Information Administration (EIA) + Consensus Economics**	**DBP 2024**	**100.78**	**84.27**	**84.18**
		USP 2023 - 2026	100.78	85.00	84.80

* Real GDP growth of main trading partners in 2022 as recorded in the USP 2023 – 2026 is erroneous. From calculations carried out by the MFAC, this should have been closer to 2.5% instead of 11.7%.

Source: MFE

Table A.2: Macroeconomic variables 2021 – 2024 (%)

	Actual		Forecasts			
	2021	2022	2023		2024	
			USP	DBP	USP	DBP
Real GDP components						
Private final consumption expenditure*	8.3	9.5	3.8	6.1	3.9	4.5
General government final consumption expenditure	6.5	2.3	3.4	2.8	3.2	2.8
Gross fixed capital formation	12.7	31.2	-6.8	-18.9	3.8	5.5
Exports of goods and services	7.5	6.8	4.3	2.6	5.2	3.9
Imports of goods and services	5.0	10.1	2.4	-0.9	4.8	3.9
Real GDP	12.3	6.9	4.1	4.1	4.5	4.2
Contribution to real GDP growth						
Domestic demand (pp)	7.5	10.7	0.6	-1.6	3.2	3.6
Inventories (pp)	-0.3	-0.1	0.0	0.0	0.0	0.0
Net exports (pp)	5.1	-3.7	3.5	5.7	1.2	0.6
Deflators						
Private final consumption expenditure	1.2	5.4	5.3	6.0	3.3	3.5
General government final consumption expenditure	2.3	3.8	2.3	4.7	2.4	2.7
Gross fixed capital formation	2.4	6.7	2.7	6.3	1.7	1.6
Exports of goods and services	2.0	4.7	3.3	3.5	2.8	2.9
Imports of goods and services	1.9	4.7	2.9	3.4	2.5	2.7
GDP deflator	2.0	5.3	4.9	5.4	3.0	3.1
Labour market						
Employment (National Accounts definition)	3.2	6.4	3.5	4.7	3.7	4.4
Unemployment rate (%) (LFS definition)	3.4	2.9	3.0	2.7	3.1	2.7
Nominal compensation of employees	7.5	9.9	9.0	9.0	7.8	8.9
Nominal compensation per employee	4.7	3.5	5.3	4.1	3.9	4.3
Labour productivity (real GDP per person employed)	8.8	0.5	0.6	-0.5	0.7	-0.2
Unit labour costs	-3.7	3.0	4.7	4.7	3.2	4.6
Other macroeconomic variables						
Inflation rate (%) (based on the HICP)	0.7	6.1	5.7	5.7	3.5	3.7
Nominal GDP	14.5	12.6	8.6	9.7	7.7	7.4
Potential GDP	3.9	5.5	4.8	4.5	4.7	4.4
Output Gap	-1.5	-0.1	-0.1	-0.5	-0.4	-0.6

Note: Figures for 2021 and 2022 are actual, while figures for 2023 and 2024 are forecasts. *Includes Non-Profit Institutions Serving Households (NPISH).

Source: MFE and NSO

Table A.3: Main fiscal developments (% of nominal GDP)

	Total Revenue	Total Expenditure	Fiscal Balance	Structural Balance	Gross Debt
2021	35.6	43.0	-7.5	-6.8	54.0
2022	34.2	39.9	-5.7	-5.7	52.3
2023	35.0	40.0	-5.0	-4.8	53.1
2024	34.0	38.6	-4.5	-4.3	55.6

Source: MFE and NSO

Table A.4: Fiscal Developments in absolute terms (EUR million)

	Actual		Forecasts			
	2021	2022	2023		2024	
			USP	DBP	USP	DBP
Total revenue	5,436.8	5,882.6	6,542.7	6,614.9	6,751.2	6,901.9
Taxes on production and imports	1,568.4	1,789.4	1,924.7	1,981.4	2,035.7	2,161.1
Current taxes on income and wealth	2,052.7	2,249.1	2,463.1	2,483.7	2,617.2	2,636.2
Social contributions	914.8	990.6	1,059.0	1,046.9	1,128.0	1,124.4
Other revenue*	900.9	853.5	1,095.9	1,102.8	970	980.1
Total expenditure	6,577.5	6,864.8	7,456.1	7,550.6	7,598.4	7,821.6
Compensation of employees	1,772.5	1,834.5	1,962.0	1,988.8	2,087.5	2,138.1
Intermediate consumption	1,311.0	1,342.7	1,550.3	1,536.7	1,610.5	1,568.9
Social payments	1,389.1	1,486.7	1,616.5	1,612.8	1,730.9	1,736.8
Gross fixed capital formation	584.2	580.4	690.8	843.6	616.8	778.2
Subsidies	707.4	833.0	685.9	721.4	572.1	666.6
Other expenditure**	813.4	787.5	950.6	847.3	980.6	933.1
Fiscal balance	-1,140.7	-982.2	-913.3	-935.7	-847.2	-919.7
Gross debt	8,263.9	9,003.4	9,980.3	10,024.5	10,992.0	11,273.9
Nominal GDP	15,292.6	17,212.5	18,315.6	18,889.8	19,717.8	20,286.2

Note: Figures for 2021 and 2022 are actual, while figures for 2023 and 2024 are forecasts.
Source: MFE and NSO

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