Assessment of the Draft Budgetary Plan 2025

MFAC
MALTA FISCAL ADVISORY COUNCIL

December 2024

ASSESSMENT OF THE DRAFT BUDGETARY PLAN 2025

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29 November 2024

Hon. Mr Clyde Caruana
Minister for Finance
30, Maison Demandols,
South Street,
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Honourable Minister,

ASSESSMENT OF THE DRAFT BUDGETARY PLAN 2025

As a follow-up to the letter of endorsement in relation to the macroeconomic forecasts, dated 14 October 2024, the Malta Fiscal Advisory Council (MFAC) is hereby presenting its full assessment report of the Draft Budgetary Plan 2025, in terms of the Fiscal Responsibility Act. The cut-off date for this report is 15 November 2024.

The MFAC notes that in view of the current circumstances in the global economy, the macroeconomic outlook remains subject to uncertainty and is very sensitive to the assumptions employed. Indeed, the global economic landscape has remained weak, with countries experiencing mixed economic performances. Moreover, the MFAC carried out its assessment within the context of a reformed EU economic governance framework and Malta's commitments presented in the Medium-Term Fiscal Structural Plan. It is also factoring in that Malta is currently under an Excessive Deficit Procedure (EDP).

According to the government's forecasts, the economy is expected to expand by 4.9% in 2024 and 4.3% in 2025. At the same time, the fiscal deficit ratio is expected to remain above the 3% benchmark in 2024 and 2025 but lower than in 2023. Indeed, the fiscal deficit ratio is expected at 4.0% and 3.5% of GDP in 2024 and 2025, respectively. Over the forecast horizon, the public debt-to-GDP ratio is expected to remain significantly below the 60% threshold, at 49.5% in 2024 and 50.1% in 2025.

Overall, the Council considers that the macroeconomic and fiscal projections for 2024 and 2025 prepared by the Ministry as part of the Draft Budgetary Plan 2025 lie within its endorsable range. Nonetheless, the Council's assessment points to possible risks to the projections by the Ministry.

Based on the information available by the cut-off date, the MFAC identified upside risks to real GDP growth in 2024 and 2025, which are more pronounced in 2024. The upside risks for 2024 are primarily due to developments in the year's first half, whereby economic growth stands higher (6.0%) than the overall projection (4.9%), mainly attributed to stronger private consumption expenditure and export growth. The implied notable slowdown in the year's second half in the Ministry's forecasts (3.8%) is not concomitant with the soft indicators data available by the cut-off date of this assessment. For 2025, the Council believes that economic growth could also turn out better than expected, especially from the domestic side.

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. Moreover, based on its assessment of each expenditure component, the Council considers the possibility that overall, government expenditure could turn out less than projected in 2024, particularly in compensation of employees and gross fixed capital formation, with possible spillovers over 2025. Combined with upside risks to GDP, these risks would translate into a smaller fiscal deficit than the MFIN projected in the DBP25 and a lower debt ratio in 2024 and 2025.

The Council notes that in both 2024 and 2025, Malta's headline and structural fiscal balances are projected to remain above the thresholds of 3% of GDP and potential GDP, respectively. Consequently, Malta is expected to remain subject to a deficit-based EDP during this period. In accordance with the applicable fiscal rules, an annual minimum fiscal adjustment of 0.5 pp of GDP is required. The Council notes that the government is targeting a structural effort of 0.7 pp in 2024 and of 0.8 pp in 2025, thus exceeding the prescribed minimum adjustment.

The Council also notes that the fiscal projections presented in the DBP imply compliance with the maximum growth in nationally financed net primary expenditure recommended by the European Commission, which constitutes the main fiscal surveillance indicator in the new economic governance framework. According to the DBP, net expenditure is projected to increase by 6.4% in 2024 and 5.6% in 2025. The Council underscores the potential challenges in achieving the 2025 targets for net nationally financed primary expenditure growth. These challenges arise when the 2025 targets are considered in the context of the 2024 outturn, historical expenditure patterns, and the discretionary measures outlined in the Government's Budget for the current fiscal year. Scrutiny of expenditure developments during the year is thus warranted as the margin between the DBP target for 2025 of 5.6%, and the 5.9% ceiling set in the MTFSP leaves limited space for expenditure slippages.

The Council also positively notes that Malta's debt-to-GDP ratio remains significantly below the EU average and is projected to stay well below the 60% threshold, maintaining a buffer of approximately 10 pp. This is contingent upon the realisation of the stock-flow adjustment (SFA) values, which have been volatile in recent years. At the same time, the positive risks identified by the Council for the fiscal deficit are expected to translate into debt dynamics.

Following this Assessment, the Council hereby recommends the following:

a. The need to transition from a reliance on domestic demand to export-led growth remains a pressing priority. Achieving productivity-driven growth will depend heavily on improvements in competitiveness, particularly through enhancements in labour productivity. Greater efforts are required to ensure Malta retains its capacity to expand export market shares across various economic sectors. Addressing skill gaps through education and training, fostering innovation and research, and advancing the twin transition towards digitalisation and environmentally sustainable business practices are critical enablers for improving organisational efficiency and labour productivity.

   The Council positively notes that initiatives to address these challenges have been announced, including the launch of a long-term economic vision. However, it cautions that these efforts should be expedited and implemented within the framework of a comprehensive strategy with concrete policy measures. Furthermore, budgetary measures, both as regards taxation and on the expenditure side, should be dove-tailed with this strategy to yield tangible policy outputs. Otherwise, Malta risks losing the competitive advantage it secured during the post-pandemic recovery period.

b. Given the expenditure path committed by the Government in the MTFSP, the Council emphasises the importance of prioritising expenditure policies that ensure the quality and sustainability of public finances. Specifically, it advocates for improving public spending efficiency and reallocating resources towards productive capital investment.

   In this context, the Council highlights that the current fixed energy price framework poses a significant risk to the attainment of the Government's fiscal targets and fails to incentivise energy efficiency habits. The Council recommends a more targeted approach that aligns with the Green Transition's overarching goals.

c. With Malta being subject to an excessive deficit procedure, the Council emphasises the importance of the Government adhering to its fiscal targets. Furthermore, it advises that any higher than projected revenue should be directed to accelerate fiscal consolidation and building fiscal space.

   Furthermore, the MFAC recommends that the government explores means of expenditure restraint and avoids inflating expenditure, particularly non-productive, to enable more space for fiscal adjustment in 2025.

Finally, the Council would like to express its sincere gratitude to the staff at the Ministry for Finance 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 European Union's (EU) 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 14 October 2024, the Chairperson of the Malta Fiscal Advisory Council (MFAC) addressed a letter to the Ministry for Finance (MFIN) confirming that the macroeconomic forecasts for 2024 and 2025 prepared by the MFIN as part of the DBP 2025 lie within its endorsable range. In its assessment, the Council considered that the balance of risk for both 2024 and 2025 is upside, though the upside risk is more pronounced in 2024 than it is for 2025.[2]

3. **The MFIN submitted the DBP 2025 to the COM on 15 October 2024**. **In this Report, the MFAC is presenting its assessment and endorsement of the official macroeconomic and fiscal projections within the DBP for the years 2024 and 2025.** The forecasts presented in the DBP update the vintages published in October 2023 as part of the DBP for 2024. It also follows the forecasts, trajectories and scenarios presented in the Medium-Term Fiscal Structural Plan (MTFSP) by the MFIN in September 2024. This plan constitutes a new report required under the revised EU economic governance framework.[3] The MTFSP establishes the minimum fiscal adjustment path necessary to ensure debt sustainability whilst delineating the reform and investment priorities for the period 2025–2028. The fiscal adjustment path presented in the MTFSP refers to a net expenditure path, which now constitutes the sole operational indicator for fiscal surveillance in the EU. It considers several elements, including the degree of public debt and the associated macroeconomic risks. The cut-off date of the DBP 2025 is 1 October 2024. This Report has a cut-off date of 15 November 2024.

4. **The methodology utilised by the MFIN to generate macroeconomic estimates and fiscal projections remained broadly unchanged from previous forecast rounds.** The MFIN relies primarily on STEMM (Short-Term Quarterly Economic Forecasting Model) to produce its macroeconomic projections.[4] The MFIN 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

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[1] The DBP for 2025 submitted by each country and the COM's opinion can be found here.

[2] The letter of endorsement can be found here.

[3] The MTFSP 2025-2028 and the COM's priori guidance for Malta can be found here.

[4] 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.

about the external economy produced by Consensus Economics and the European Central Bank (ECB).[5] 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 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. Bilateral meetings between individual Ministries and the MFIN are held to discuss their business plans. The forecasts are then finalised to be in line with ESA accrual-based standards.

5. **This assessment is being done within the context of a reformed EU economic governance framework and Malta's commitments presented in the MTFSP**. **It is also factoring in that Malta is currently under an Excessive Deficit Procedure (EDP).[6]** The MTFSP sets a limit on the growth of the nationally financed net primary expenditure indicator for the next four years.[7] The Council carried out this assessment with reference to the rules as adopted in the new EU economic governance framework.[8] The average net expenditure path presented in the MTFSP for the period 2025 until 2028 is 5.9%, which is equivalent to the reference trajectory transmitted by the European Commission. This assessment is also framed in a context whereby Malta is currently under an EDP and is required to reduce its budget deficit below 3% of the Gross Domestic Product (GDP) and its structural balance by 0.5 percentage points (pp) per year.

CONTEXT

6. **The global economic landscape has remained weak, with countries experiencing mixed economic performances.** Monetary policy tightening to address price hikes, particularly in the energy, food, and services components, mounting geopolitical tensions amid two ongoing wars leading to renewed supply bottlenecks, volatility in financial markets, climate change risks, and pronounced global declines in the manufacturing sector pose as the major short-term headwinds to international growth. Noting Malta's long-standing trading partners, apart from the United States, which registered a real GDP growth rate of 2.9% in 2023, both Germany (-0.3%) and the

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[5] The September 2024 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, real and nominal GDP growth of Malta's main trading partners. These assumptions are supplemented by data from the ECB (exchange rates & interest rates), COM (real and nominal GDP growth of Malta's main trading partners) and the US Energy Information Administration (oil prices).

[6] The Council Decision taken on the 26th of July 2024 on the existence of an excessive deficit for Malta can be accessed here.

[7] The nationally financed net primary expenditure indicator represents government expenditure net of interest expenditure, discretionary revenue measures, expenditure on Union programmes fully matched by revenue from Union funds, national expenditure on co-financing of programmes funded by the Union, as well as cyclical elements of unemployment benefit expenditure.

[8] The new economic governance framework is summarised here.

United Kingdom (-0.1%) fell into a mild recession while Italy and France registered a subdued growth rate of 0.7% and 0.9%, respectively.

Throughout the first half of 2024, economic activity within the EU accelerated marginally, achieving a real GDP growth rate of 0.7%. This remained considerably lower than the United States' growth rate, which stood at 2.3%. Italy and France experienced slight increases in real GDP growth in the first half of 2024 compared to their performance in the preceding year. However, provisional data suggest that Germany (-0.3%) is still struggling to return to positive growth. Conversely, outside the EU, the United Kingdom achieved an average real GDP growth of 0.6% during this period.

In its Autumn projections, the COM anticipates the EA's real GDP to expand by 0.8% in 2024 and 1.3% in 2025. At the same time, headline inflation in the EA is abating, down to 1.7% in September of this year, as financing conditions remain restrictive and economic activity is still weak, the latter reflecting private consumption expenditure and gross fixed capital formation. With strong balance sheets, abating incentives to save and improving credit conditions, households are projected to gradually lower their saving rate, accelerating consumption growth in 2025. Furthermore, strong corporate balance sheets, recovering profits, improving credit conditions and the impulse of the RRF set the stage for a robust rebound of investment, following the contraction in 2024.

7. **Within this international context, the MFIN incorporates specific exogenous assumptions into its modelling framework.**[9] For 2024, MFIN projects that real GDP growth among Malta's main trading partners will remain subdued at 0.8%, mirroring the growth rate observed in 2023. A modest increase to 1.0% is anticipated in 2025. The short-term interest rate is expected to drop in 2025 to 3.2% from 4.3% in 2024, reflecting easing monetary conditions. The long-term interest rate is expected to follow suit, dropping by 0.2 pp each year of the forecast, reaching 3.3% in 2025. The euro is forecasted to appreciate against the United States Dollar (USD) over 2024 and 2025, with a more pronounced appreciation expected in the latter year. In contrast, the euro–sterling exchange rate is projected to decline in 2024, stabilising at a similar level in 2025. At $82.4 per barrel, forecasts for oil prices in 2024 remain nearly unchanged from those of 2023. However, oil prices are anticipated to decline in 2025, to $79.8 per barrel.

8. **Against this unfavourable international scenario, Malta's economy demonstrated resilience throughout 2023. Data for the first half of 2024 indicates steady growth, with real GDP expanding by 6.0%.**[10] Real GDP expanded by 7.5% in 2023, primarily driven by a strong external sector (6.5 pp) and a positive, though more moderate, contribution from domestic demand (1.0 pp). Despite inflationary pressures, private consumption grew by 11.2% increase in 2023, and by a further 5.2% in the year's first half, mainly reflecting strong labour market developments and population growth. Government spending grew by 2.9% in 2023 but slowed down in the first six months to 0.3%. After recording significant increases in 2021 and 2022,

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

[10] The latest GDP release (NR159/2024) published by the National Statistics Office (NSO) can be found here.

gross fixed capital formation contracted sharply in 2023 by 18.2%. The decline in overall investment in 2023 can be attributed to a reduction in private investment, while public investment registered a substantial nominal increase of 21.0%. In the first half of the year, gross fixed capital formation increased by 4.9% on the back of increases in private investment, while public investment dragged overall growth. Exports rose by 4.7% in 2023 and continued to perform well in the year's first six months, increasing by 6.8%. Imports increased by 5.5% in the first half of the year following declines in 2023, reflecting domestic and external demand conditions.

9. **The tourism sector continued its post-pandemic upward trajectory, with total spending from international visitors growing by 32.7% in 2023 compared to 2022, underscoring the sector's importance to the Maltese economy.** Indeed, Cassar (2015) estimates that the tourism sector has a Type II multiplier of 17.7 in the Maltese economy.[11] Data from January to September 2024 indicates that 2.77 million tourists visited Malta, marking a 21.1% increase compared to the same period in 2023. This surge in visitors translated into a 23.4% increase in total spending during these months compared to 2023.

10. **Inflation moderated gradually throughout 2023, reaching 5.6% by year-end, although it remained high compared to historical norms.** The government's energy subsidies helped shield households and businesses from more severe inflationary impacts. Despite the tightness in the labour market, the increase in labour supply, mainly through migration, contributed to contain some wage pressures. In 2023, growth in compensation per employee has not kept abreast with inflationary developments, leading to a drop in households' purchasing power. Data for the first nine months of the year indicate that inflation decelerated to an average rate of 2.6%.

11. **Malta's fiscal position improved in 2023, with the deficit narrowing to 4.5% from 5.2% of GDP in 2022, while the debt-to-GDP ratio remained well below the 60.0% threshold.** The reduction in the fiscal deficit was driven by increased government revenues, supported by robust economic growth. This outpaced the rise in government spending. The government continued to channel fiscal support toward stabilising energy costs. Outlays in this regard have declined over the years, reflecting the stabilisation of international energy prices. Government debt reached 47.4% of GDP by year-end, a slight decline from 2022, primarily due to nominal GDP growth. In absolute terms, government debt stood close to €9.8 billion in 2023.

[11] For more information on tourism sector development in Malta, please refer to this Thematic Chapter published by the MFAC.

MACROECONOMIC ASSESSMENT

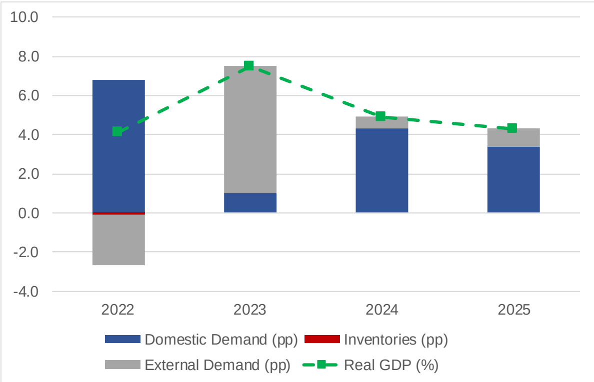
12. **Real GDP for 2024 is forecasted to moderate to 4.9%, following a 7.5% growth in 2023. The expansion in 2024 is expected to be driven primarily by domestic demand, with external demand contributing to a lesser extent. In 2025, real GDP is anticipated to increase by 4.3%, again predominantly supported by domestic economic activity.** The forecast for real GDP growth in 2024 has been revised upwards by 0.7 pp, while the 2025 forecast remains unchanged from the previous estimate submitted in last year's DBP.[12]

    In 2024, the MFIN expects domestic demand to be primarily driven by private consumption expenditure, although the other domestic expenditure components are also expected to contribute favourably to growth. Indeed, private consumption expenditure is expected to increase by 4.4%, driven by increases in compensation per employee and a buoyant labour market. Government final consumption expenditure is projected to increase by 8.6%, following an increase of 2.9% registered a year earlier. Gross fixed capital formation is expected to increase by 4.5%, following a marked decline of 18.2% experienced in 2023. On the other hand, exports of goods and services are projected to increase by 5.2% during the year, mainly driven by the services sector. Imports are expected to increase by 5.4%, reflecting domestic and external developments.

    The expected growth profile for 2025 is similar to that anticipated by the MFIN for 2024. Indeed, the Ministry expects the Maltese economy to expand by 4.3%, again predominantly supported by domestic demand (3.4 pp) and, to a lesser extent, by external demand (0.9 pp). Private consumption expenditure is expected to be the main driving force behind the contribution of domestic demand, increasing by 4.6%. Such an increase is on the back of an employment growth of 4.2%, an unemployment rate which remains hovering at low levels, an increase in compensation per employee of 4.2%, population growth, and an inflation rate expected to be closer to the 2.0% mark. The modification of income tax bands, proposed as part of the budgetary measures for 2025, is expected to enhance disposable income. Gross fixed capital formation is expected to increase by 5.5%, somewhat higher than in the previous year. On the other hand, growth in public consumption expenditure is expected to slow down considerably to 1.9%. Exports are projected to increase by 5.3%, again driven by the services sector. The other services sector, the other business services sector, and remote gaming are expected to contribute heavily to the increase in exports. Imports are projected to increase by 5.3%, reflecting the developments in the domestic and external side of the economy.

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

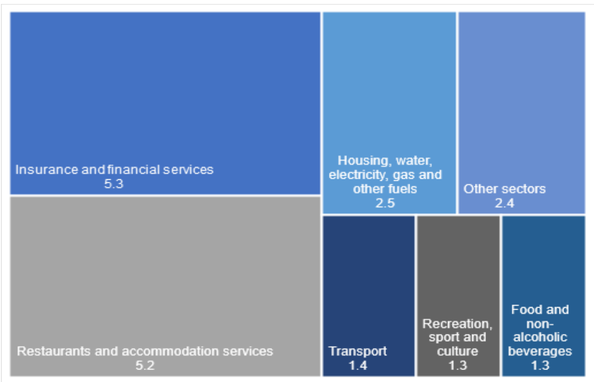
Real GDP growth and contributions to growth
(%, pp)



Source: MFIN

13. **In 2022, private consumption recorded a growth rate of 10.9% in real terms, followed by a stronger rate of 11.2% in 2023.** In nominal terms, data on the Classification of Individual Consumption by Purpose (COICOP) shows that household final domestic consumption expenditure increases in 2023 are attributed mainly to consumption in insurance and financial services (5.3 pp) and restaurants and accommodation services (5.2 pp). These were followed by housing, water, electricity, gas and other fuels (2.5 pp), transport (1.4 pp), recreation, sports and culture (1.3 pp) and food and non-alcoholic beverages (1.3 pp). Consumption in other sectors accounted for 2.4 pp.[13]

Contributions to nominal final consumption expenditure of households in 2023 (COICOP)
(Percentage points)



Source: NSO

[13] Other sectors include alcoholic beverages, tobacco and narcotics; clothing and footwear; furnishings, household equipment and routine household maintenance; health; information and communication; education; and personal care, social protection and miscellaneous goods and services.

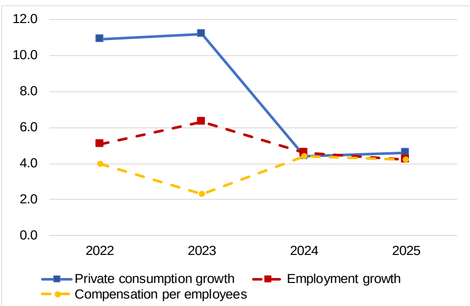
14. **Private final consumption expenditure is expected to grow by 4.4% in 2024 due to increases in households' purchasing power, strong labour market developments and migration flows. It is then expected to increase further by 4.6% in 2025.** In its previous assessment for the DBP 2024, the Council noted that it expected higher growth in 2023 and 2024 than anticipated by the MFIN.[14] Indeed, growth in 2023 turned out to be nearly two times higher (11.2%) than anticipated by the MFIN in the previous forecast vintage (6.1%).[15] Furthermore, growth in the first half of this year stood at 5.2%. As a result, with a projection of 4.4% for the year, the MFIN is expecting a slowdown in the second half of the year to 3.6%.

    Private consumption growth in 2024 and 2025 is expected to decelerate from the high rates observed post-pandemic, reflecting a normalisation in consumption growth. Accumulated savings and an element of pent-up demand sustained the growth in private consumption in the post-pandemic period. In the short term, the MFIN is expecting private consumption expenditure to be backed by a buoyant labour market and improving households' disposable income as compensation per employee is expected to accelerate relative to the growth observed in the past two years coupled with easing inflationary pressures. The expected slowdown in the year's second half reflects survey-based data which indicates weak consumer confidence.

    In 2025, the MFIN expects private consumption expenditure to accelerate slightly to 4.6%, underpinned by sustained employment growth and the ongoing recovery in real wages, which is expected to largely restore households' purchasing power by the end of the year. Growth in private consumption expenditure is also expected to be boosted with the Government's budgetary measures, particularly the revision of income tax bands, which should further boost disposable income and consumer confidence.

Growth in private consumption, employment, and compensation per employee

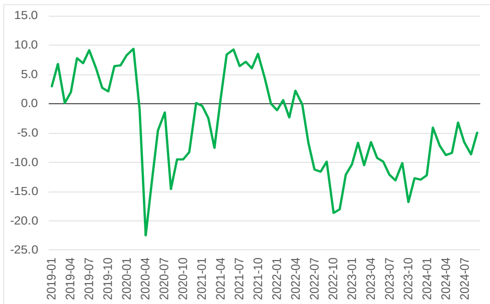
(%)



Source: MFIN

Malta's Consumer Confidence Indicator

(Index)



Source: DG ECFIN

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[14] The assessment of the MFAC for the DBP 2024 can be found here.
[15] Up to the cut-off date of last year's DBP, consumption growth stood at 7.0% in the first half of 2023. Growth in the first half of 2023 now stands at 11.3%. Thus, the forecast error noted for private consumption is influenced by statistical revisions (including the benchmark revision).

Risk Assessment

Over the past decade, except for 2020, private consumption expenditure has experienced strong growth, driven by robust labour market conditions, characterised by significant employment growth and historically low unemployment rates, migration flows and increases in compensation per employee. Additionally, pent-up demand from the pandemic year and accumulated savings have contributed to the substantial growth observed in the last three years. In fact, real growth over 2021-2023 averaged 11.3%, compared to a 10-year average growth rate of 5.5%.

In its previous assessment, the Council noted that the MFIN's forecast for private consumption growth, projected at 4.5% for 2024, was considered conservative, given the expectation of continued robust fundamentals. Recent updates have revised the private consumption growth forecast downwards by 0.1 pp, despite real growth of 5.2% in the first half of the year. This implies that MFIN expects growth in the year's second half to slow to 3.6%. The projected slowdown is attributed to survey-based data, which indicates weak consumer sentiment.

However, the Council holds a different view from that of the MFIN regarding expectations for the second half of the year. Soft indicator data does not point to weaker fundamentals compared to the year's first half; on the contrary, several indicators have shown improvement. For instance, the registered unemployment rate for July to September averaged 3.0%, compared to an average of 3.3% for the first half of the year, indicating a continued buoyant labour market and perhaps suggesting further tightening. Similarly, inflation has decelerated, with annual rates for July to September averaging 2.3%, down from 2.7% in the year's first half.

Furthermore, consolidated fund data also shows an acceleration in indirect tax growth during July and September compared to the year's first half. Additionally, it is worth noting that movements in the consumer sentiment indicator have not always aligned with trends in private consumption expenditure in Malta. A case in point is the past two years, where private consumption expenditure in Malta recorded double-digit growth rates in real terms despite the consumer sentiment index remaining in negative territory. The deterioration in sentiment was mainly a result of increased inflationary pressures which however did not have an impact on consumption growth given that this shock was in part absorbed by elevated savings accumulated during the pandemic.

Therefore, in view of the above considerations, the Council does not expect fundamentals to weaken in the second half of the year and consequently identifies an upside risk to MFIN's projected annual growth rate of 4.4% for 2024.

The MFIN is expecting private consumption growth to accelerate marginally in 2025 relative to 2024. Whilst growth in compensation per employee and employment are expected to moderate slightly, private consumption growth is expected to be underpinned by lower inflation and higher disposable income due to budgetary measures. Notwithstanding this, when compared to the long-term average growth rate of 5.5% over the past 10 years (including the COVID-19 pandemic), the expected growth rate for 2025 (4.6%) is nearly 1.0 pp lower. For 2025, the Council also appraises an upside risk for private consumption expenditure, the reasons for this are twofold. Firstly, real wages are expected to recover earlier than anticipated by the MFIN, and secondly, the proposed income tax cuts are expected to have a larger impetus on consumption than expected by the MFIN in their baseline projections, according to the Council.

15. **Government final consumption expenditure increased by 2.9% in real terms in 2023 and is expected to grow by 8.6% in 2024, before slowing down to 1.9% in 2025. The significant increase in 2024 is primarily attributable to very large increments in compensation of employees, followed by intermediate consumption.** In nominal terms, government consumption expenditure grew by 7.8% in 2023, with intermediate consumption being the largest contributor. For 2024, the MFIN projects a substantial nominal increase in government expenditure of 13.1%, markedly higher than the 4.7% growth projected in last year's DBP.[16] This growth is mainly being propelled by a large contribution of 9.3 pp from compensation of employees and a contribution of 5.6 pp from intermediate consumption. The negative contribution from market output marginally compensates for these increases.[17] In 2025, nominal growth in government consumption expenditure is expected to decelerate to 5.7%, with the largest contributor shifting back to intermediate consumption, as the growth in government wages slows down following the projected base effect of 2024.[18]

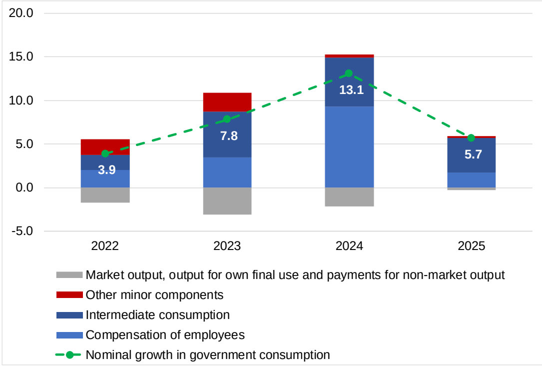
[16] In its Assessment of the DBP 2024, the Council highlighted that in last year's DBP, there was an inconsistency in the forecast for government consumption expenditure for 2024 between the macroeconomic and budgetary projections, due to slight timing differences of these two sets of forecasts. These discrepancies equate to around €71.5 million in 2024 or 0.9 pp difference between the two growth rates. Given that the budgetary projections are usually the latest projections finalised, the Council in its Report is referring to the forecast according to the fiscal projections. The macroeconomic projections indicated a forecast growth rate of 5.6% for this component in 2024.

[17] 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 2024 the total for these items will be higher than in 2023, this corresponds to a deduction of a larger value, thus explaining the downward push to government consumption resulting from these sources.

On another note, it is notable that the NSO has recently reclassified the receipts from the 'Citizenship by Investment Scheme', following Eurostat's recommendation published on 25th September 2024. These receipts have been reclassified from payments for other non-market output (P131) to Other current taxes (D59). This reclassification reflects a shift in the treatment of these receipts, which are now considered taxes, given that they are compulsory payments for obtaining citizenship, and the fees charged significantly exceed the costs associated with administering the scheme. Consequently, the elasticities published by the MFIN in previous publications may no longer produce similar projections when applied to the revised historical data as the impact of this reclassification on past revenue figures has altered the basis on which MFIN's projections were initially calculated.

[18] For 2025, there is an inconsistency in the DBP between the macroeconomic and fiscal forecasts for government consumption expenditure growth. The macroeconomic forecast shows a 5.1% increase, whilst the government consumption expenditure component computed by aggregating the fiscal components results in an increase of 5.7%. In absolute terms this translates to a €20.8 million difference. Assuming the same projections for the government consumption deflator, this is also expected to alter the projected growth rate in real terms for 2025.

Breakdown of nominal government consumption growth
(percentage points)



Source: MFIN

Risk Assessment

In view of the large increases projected for compensation of employees, and intermediate consumption, the Council is of the opinion that there is a downside risk to the government consumption expenditure growth in 2024. Government compensation of employees is projected to increase by €317.7 million, whereas the largest increase in compensation of employees recorded over the past decade was of €184.3 million. In percentage terms, the 16.3% increase is much higher than the average increase of 7.0% recorded over the past 10 years. Also, first half data for 2024 shows an increase of 6.8% in compensation of employees, significantly lower than the forecast. Even when taking into account that a number of sectoral collective agreements were concluded in 2024 and the high cost of living adjustment, the Council still opines that the projected increase involves a considerable downside risk. For intermediate consumption, the projected increase of 13.1% is marginally higher than the 12.9% recorded in 2023. This is however still high when juxtaposed against the growth in the first half of the year of 8.0%, though acknowledging that certain expenditure categories within the intermediate consumption bracket might intensify over the last six months of 2024.

On the other hand, for 2025, the MFAC opines that there could be some upside risk. The current forecast for 2025 is 1.9%, which seems quite low compared to the long-term average growth rate of 6.4% over the past 10 years (including the COVID-19 pandemic). There is also the possibility that expenditure in 2024 turns out as less and some expenditures could be shifted to next year. For a more detailed risk outlook of all components making up government consumption expenditure, refer to the fiscal assessment section of this Report.

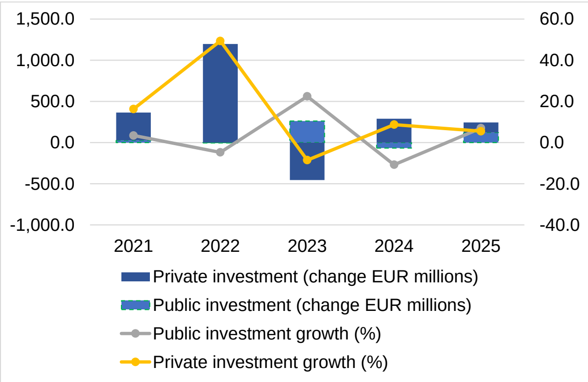
16. **In 2023, growth in gross fixed capital formation declined by 18.2% in real terms. A partial recovery is anticipated in the subsequent years, with projected expansions of 4.5% in 2024 and 5.5% in 2025.** In nominal terms, the overall reduction in total investment (-12.9%) in 2023 was primarily driven by a contraction in private sector investment (-18.2%), whereas public investment increased by 21.0%. The strong increase in public investment is mainly attributed to the closure of the 2014-2020 financial programmes in 2023**.** The surge observed in this final year had also occurred in previous programming periods under the EU multiannual financial frameworks.

In 2024, private investment is projected to grow modestly by 0.4%, with the primary impetus for investment growth anticipated to stem from public investment, which is expected to increase by 32.4%. The projected developments in public investment reflect anticipated increases in capital expenditure both by the central government and Extra Budgetary Units (EBUs). In contrast, in 2025, public investment growth is forecasted to decline slightly by 1.0%, while private investment is expected to expand significantly by 9.9%. Forecasts for gross fixed capital formation also account for projects funded through the RRF, projected to contribute 0.4% of GDP in 2024 and 0.3% of GDP in 2025.

Amongst the GDP expenditure components, gross fixed capital formation has exhibited the most volatility over the past years. Significant swings were recorded, with periods of extraordinary growth and others of negative growth, even pre-pandemic. Such inherent volatility makes producing accurate forecasts for this component more challenging.

Public and private sector investment in nominal terms

(EUR Millions, %)



Source: MFIN; MFAC Calculations

Risk Assessment

The Council supports the general investment trajectory projected by MFIN. In 2024, investment growth in the first half of the year shows a real increase of 4.9%, so that the Ministry's annual forecast implies a growth rate of 4.1% for the remainder of the year. Based on H1 data, the overall growth forecast for 2024 thus appears plausible, leading the Council to assess the risk for 2024 as neutral.

However, the Council has reservations about the balance between private and public investment. In 2023, the closure of the 2014–2020 Multiannual Financial Framework (MFF) contributed to substantial growth in public investment. It is also worth noting that ESA data shows a 2.2% decline in general government gross fixed capital formation in the first half of the year. To meet the annual target for public investment, a 54.7% growth rate would be required in the second half of 2024, equivalent to an increase of €237.3 million. Considering the high base of public investment in 2023 and the current trajectory of government investment in the first six months of 2024, the Council identifies a potential downside risk for public investment growth this year. However, this risk may be offset by an increase in private investment, given that historic trends show that underlying investment usually has a higher year-on-year growth than envisaged, supporting the Council's overall neutral risk assessment for 2024.

In 2025, growth is expected to be driven primarily by increased private sector investment. The Council notes that the modest growth projected for public investment in 2025 reflects the high base effect from the previous year, while the anticipated rise in private investment aligns with favourable economic prospects for the year, consistent with the Council's outlook. Consequently, the Council views the overall investment trajectory for 2025 as having a neutral risk profile.

17. **The MFIN is expecting export growth to pick up to 5.2% in 2024. For 2025, export growth is forecasted at a slightly higher rate of 5.3%, partly reflecting anticipated improvements in global economic conditions.** At 6.8%, the export performance observed in the first half of 2024 surpassed the expectations of the MFIN in last year's DBP, which projected a 3.9% increase in real exports for the year. Malta's strong export performance contrasts sharply with the prevailing international economic landscape, particularly that within the EU, where several advanced economies are grappling with challenges in maintaining their export market shares. Notably, the performance achieved during the first half of the year significantly exceeds the world GDP growth rate, weighted by Malta's principal trading partners, which is projected at a mere 0.8% for 2024.

For 2024, the MFIN has revised export growth upwards by 1.3 pp relative to the previous forecast vintage. This reflects better-than-expected performance in the tourism sector registered between January and September as well as positive developments in non-tourism services during the six months of the year. Indeed, Malta's current account balance for the first half of the year stood at 5.5% of GDP, with the negative balance in goods more than offset by the notable services balance. As regards the tourism sector, Malta attracted around 2.76 million tourists between January and September of this year, up by 21.1% over the same period in 2023, resulting in a 23.4% increase in total spending. Meanwhile, key non-tourism services which registered strong growth were the other business services sector and the personal, cultural and recreational services. On the other hand, goods exports are expected to remain weak due to subdued global demand for manufactured goods.

External demand is projected to strengthen in 2025, driven by more favourable global financing conditions, which are anticipated to support the expansion of global trade and enhance consumer demand. Although the strong momentum from the tourism sector in 2024 is likely to moderate, the MFIN anticipates that the ongoing recovery in global economic activity will bolster exports in non-tourism-related services and goods. Additionally, exports of manufactured goods are expected to benefit as excessive inventories accumulated in the global market are gradually reduced. As a result, export growth is forecasted to remain steady at 5.3%.

Risk Assessment

The Council foresees an upward risk to export growth projections for 2024. The implied growth rate of 3.6% for the latter half of the year appears conservative in light of the strong performance recorded in the first half of 2024. Furthermore, the higher export data for the first half of 2024, relative to the corresponding period in 2023, suggests the potential for enhanced growth in the second half, driven by the base effect established by the weaker performance in the second half of 2023.

When compared to the 10-year average, the projected export growth for 2025 is approximately half of the growth rate that Malta has typically achieved over the past decade. Consequently, the Council asserts that, *ceteris paribus*, there may be potential for upward risks to the baseline forecast.

18. **Imports are expected to increase by 5.4% in 2024 and by a similar 5.3% in 2025. These developments reflect broadly similar trajectories for private consumption, investment and exports over the two years.** The forecast for 2024 was revised upwards by 1.5 pp from the latest forecast vintage, mainly reflecting the upward forecast revisions in exports.[19] All import components are expected to register positive nominal increases, mainly from increases in other business services. Import growth in 2025 is set to remain robust, driven by strong domestic demand and a strengthened euro, as well as strong export activity.

Risk Assessment

Given the balance of risks identified for the other expenditure components which impact imports, the Council assesses an upside risk for import growth in 2024. For 2025, the Council also opines that the balance of risks for imports is on the upside given the upside risks identified in consumption expenditure and exports. Additionally, considering the long-term average growth of 8.8% over the past ten years (including the Covid-19 pandemic), the forecasts for both years seem low.

19. **Whilst following a downward trend, over the short-term, the inflation rate is expected to remain somewhat higher than the 2.0% ECB price stability threshold in 2024 and to fall further close to this threshold in the following year. Similar developments for inflation rates for the Euro Area in 2024 and 2025 are being forecasted by the European Commission in Spring.** Malta which is a highly open economy is vulnerable to international inflationary pressures, which increased considerably because of supply chain bottlenecks following the geopolitical conflicts between Russia and Ukraine and in the Middle East and the growing trade restrictions and protectionist measures on a global level. Indeed, inflation increased drastically from the low levels recorded in 2021 to 6.1% in 2022 and 5.6% in 2023. Yet, this was lower than the EU's average inflation rate, reflecting the subsidies provided by the government to maintain fixed energy prices. In contrast, the increase in energy prices in 2022 was the highest contributing factor for inflation in the EU and in the Euro Area (4.0 pp). Inflation in the Euro Area in 2023 stood lower than that in Malta mainly emanating from lower contributions in the services and energy components.

    Gradual declines in inflation characterised the first half of 2024. To contain inflation, the Government implemented the 'Stabbilta' Initiative on February 1st till the end of October. This initiative targeted the stabilisation of food prices and required major importers and retailers to reduce the recommended retail prices of staple foods by at

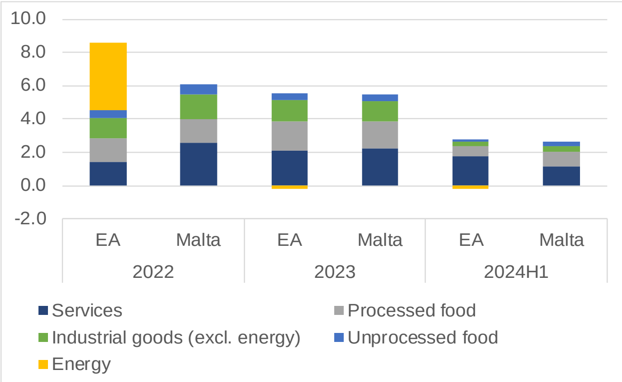
[19] For most of the one-off investment projects, the MFIN assumes an import content of between 75% and 95%, depending on the inputs required for that particular investment.

least 15% compared to the levels on October 31, 2023. Inflation in Malta, though standing marginally higher, has followed developments in other European countries, where inflation in the Euro Area stood at an annual average rate of 2.5% relative to 2.7% in Malta. Such declining trends have also been present in the third quarter of 2023 where inflation in Malta declined to an average rate of 2.3%.

In 2024, Malta's headline inflation is anticipated at 2.5%, core inflation marginally lower (2.3%), with further deceleration expected in the remaining months of the year.[20] Headline inflation in 2024 has been revised heavily downwards from the previous forecast vintage (3.7%). Such slow-down in inflationary pressures were primarily driven by services inflation which proved less sticky than anticipated in the previous forecast round as labour costs were relatively contained. Furthermore, the MFIN has revised downwards the contributions from the food and the non-energy industrial goods components relative to the previous forecast vintage.

Inflation decomposition at Main Industrial Groupings (MIG)

(pp, annual growth rate)



Source: NSO, MFAC Analysis

In 2025, inflation is anticipated to abate further, gradually return close to the 2.0% level, driven by an expected further decline in global commodity prices. Additionally, the strengthening of the euro is likely to reduce imported inflation. At the same time, the MFIN foresees that sustained domestic demand, particularly the rebound in consumer confidence, could generate demand-side price pressures. Consequently, inflation is projected to decrease at a moderate pace, reaching 2.1% in 2025.

Risk Assessment

Data from January to September 2024 indicates that the inflation rate, compared to the corresponding period last year, stands at an average of 2.6%. Given that the deceleration in inflation began markedly from July of last year, the Council anticipates that, due to base effects, it may be challenging to sustain the same rate of decline in the remaining months of this year. Nonetheless, inflation is still expected to be lower in the final months of the year compared to the same period in the previous year. As a result, the MFAC opines that the risk outlook for inflation in 2024 is neutral.

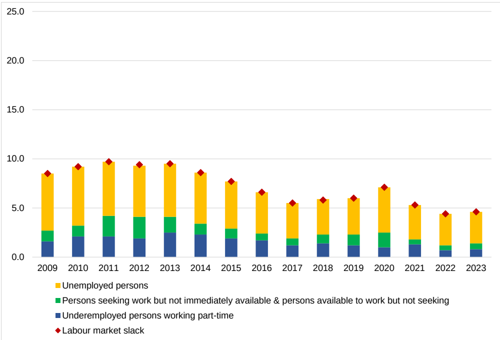
For 2025, the Council concurs with the MFIN's assessment that inflation is likely to gradually converge towards the 2.0% price stability threshold, though certain risks

[20] Core inflation excludes energy and seasonal food.

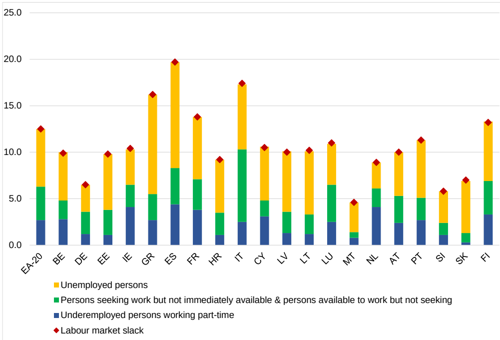
remain. Specifically, the Council notes that the potential escalation of geopolitical tensions and the proposed income tax cuts, which may lead to demand pressures, could hinder the downward inflation trend.

20. **The labour market is expected to remain buoyant over the short-term horizon, slightly moderating compared to 2023.** According to the national accounts definition, employment growth in terms of full-time equivalents (FTEs) was 6.3% in 2023. Employment is projected to grow at a slower rate of 4.6% in 2024 and 4.2% in 2025. The unemployment rate is anticipated to remain low relative to historical averages, at 3.2% for 2024 and 3.1% for 2025. Broader labour market indicators, such as the number of underemployed workers working part-time, persons seeking work but not immediately available and persons available but not seeking work, point to a continued reduction in the under-utilised portion of the labour force. In 2009, the labour market slack as a percentage of the extended labour force was 8.5%.[21] Over the years, this has registered a significant reduction, dropping to 4.6% by 2023. Notably, when comparing the labour market slack within the Euro Area (EA-20) for 2023, Malta had the lowest rate among its European counterparts.[22]

Maltese Labour Market Slack (2009-2023)
(% of extended labour force aged 20-64 years)



Labour Market Slack of the EA-20 countries in 2023
(% of extended labour force aged 20-64 years)



Source: Eurostat, MFAC Analysis

Risk Assessment

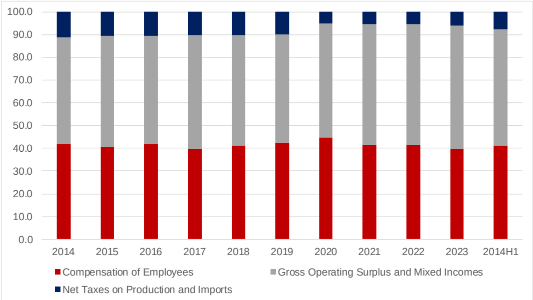
The labour market is anticipated to remain buoyant, with strong employment growth and low unemployment in line with recent trends. The Council assesses an upside risk to employment growth for 2024, supported by the latest employment statistics, while the risk for unemployment remains neutral. For 2025, the Council foresees a slight upside risk for employment growth, as the long-term average growth over the past ten years exceeds the growth rates projected by MFIN.

[21] Labour market slack refers to all unmet needs for employment. The labour market slack term includes unemployment according to the EU-LFS definition and three supplementary indicators: the underemployed part-time workers, people seeking a job but not immediately available to work, and people available to work but not seeking. The last two groups are jointly referred to as the potential additional labour force. The concept of 'extended labour force' is used to allow comparisons between these groups. It includes people in the labour force (unemployed and employed) and the potential additional labour force (the two categories outside the labour force, i.e. those available but not seeking, and those seeking but not available).

[22] List of country acronyms: AT- Austria, BE-Belgium, HR-Croatia, CY-Cyprus, EE-Estonia, FI-Finland, FR-France, DE-Germany, GR-Greece, IE-Ireland, IT-Italy, LV-Latvia, LT-Lithuania, LU-Luxembourg, MT-Malta, NL-Netherlands, PT-Portugal, ES-Spain, SI-Slovenia, SK-Slovakia.

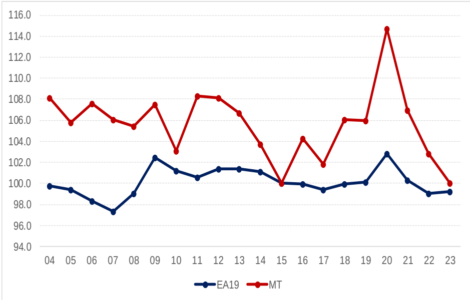
21. **The MFIN anticipates low labour productivity improvements in 2024 and 2025, in line with a moderation in real GDP growth and employment growth, which factors are exerting upward pressure on real unit labour costs.** In 2024, real GDP growth (4.9%) is slightly outpacing employment growth (4.6%), resulting in marginal labour productivity growth (0.3%). A similar outcome is expected in 2025, with a narrower gap between real GDP growth (4.3%) and employment growth (4.2%), leading to an even lower labour productivity growth per person employed of just 0.1%. Compensation per employee is projected to accelerate to 4.4% in 2024 and 4.2% in 2025, up from 1.7% in 2023. This trajectory contrasts with recent years in Malta, during which a greater proportion of income was allocated to profits rather than wages. Low labour productivity rates and rising compensation per employee are driving up nominal unit labour costs. These costs are forecasted to increase from 0.5% in 2023 to 4.0% in 2024 and 4.1% in 2025. Meanwhile, real unit labour costs are projected to rise by 1.0% in 2024 and 1.5% in 2025, marking a shift after three years of declining real costs.

Income Shares
(Per cent)



Source: NSO, MFAC Analysis

Real Unit Labour Costs
(Index)



Source: AMECO

Risk Assessment

The MFIN projects a 0.3% increase in labour productivity per person employed for 2024. However, the Council observes that this forecast is not aligned with the 1.2% increase in the first half of the year, suggesting a projected decline in labour productivity of 0.6% in the year's second half.

The Council identifies an upside risk for employment and GDP growth, with the latter expected to be more pronounced. It further contends that this may result in a more favourable forecast for labour productivity. This would moderate the projected growth in both nominal and real unit labour costs, thereby presenting a more positive outlook for Malta's capacity to retain export market shares and sustain its competitive position in international markets. Nonetheless, this scenario would still reflect real unit labour costs growth - a development which Malta has not observed over the past three years.

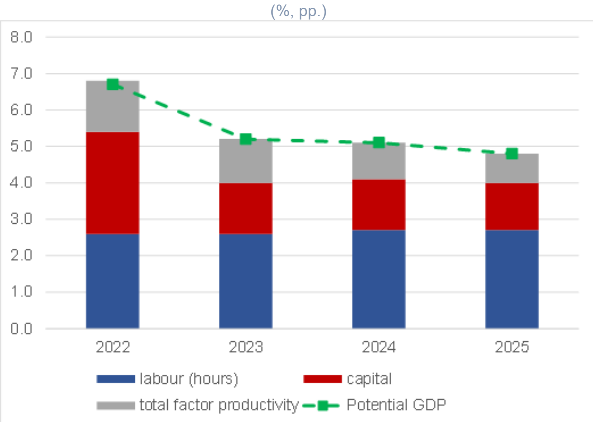
Similarly, for 2025, the Council anticipates that the upside risks identified in real GDP growth may contribute to higher labour productivity, which, in turn, would imply more positive developments for nominal unit labour costs in that year.

22. **The MFIN is anticipating a negative output gap across the forecast horizon as potential output growth is assumed to outpace expected real growth.** Potential output growth, as estimated using the EU's commonly agreed methodology, was 5.2% in 2023 and is projected at 5.1% in 2024, with a further moderation to 4.8% in 2025

(see Box B for MFAC's estimates of the potential output and output gap). This trajectory produced a neutral output gap of 0.0% in 2023, followed by a marginally negative output gap of 0.1% in 2024 and 0.5% in 2025. In 2022, capital accumulation served as the primary driver of potential output growth, contributing 2.8 percentage points (pp), with labour following closely at 2.6 pp. By contrast, in 2023, labour emerged as the main contributor to potential output growth, adding 2.6 pp, while the contributions from capital accumulation and total factor productivity (TFP) were positive, though to a lesser degree, at 1.4 pp and 1.2 pp, respectively. Looking forward to 2024 and 2025, labour is expected to remain the principal driver of potential output growth, contributing 2.7 pp in both years. The contribution of capital is projected to stay relatively low, at 1.4 pp in 2024 and 1.3 pp in 2025. Meanwhile, TFP is anticipated to make the smallest contribution to potential GDP growth over the forecast period, contributing 0.9 pp in 2024 and declining to 0.8 pp in 2025.

Sources of potential output growth

(%, pp.)



Source: MFIN

Risk Assessment

The Council observes a considerable upward revision in the estimated potential output growth for 2023 and 2024 compared to the projections included in the DBP of the previous year. Specifically, potential output growth was adjusted upward by 0.7 pp in both 2023 and 2024. The Council shares the MFIN's view that labour is expected to be the main contributor to potential output growth in 2024 and 2025, also due to an increasing population through inflows of foreign workers. At the same time, the Council considers that, the adjustment in potential output growth together with the relatively conservative approach taken in the macroeconomic forecasts, is resulting in a projected marginally negative output gap for 2024, which is anticipated to widen further in 2025. The Council asserts that, in the short term, this negative output gap contrasts with core inflation forecasts as well as the projected tight labour market.

23. **Based on alternative model forecasts and the Pearson skewness indicator, the MFIN considers upside risks to the baseline forecasts for real GDP in 2024 and 2025. However, the degree of upside risk for 2025 is more marginal compared to 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 MFIN included: (i) different rates for global economic growth; (ii) higher and lower interest rates; (iii) better outlook for the gaming

sector; (iv) stronger consumption; (v) more positive investment scenario; (vi) better tourism outlook; (vii) higher world oil prices; (viii) lower competitiveness; and (ix) lower inflow of foreign workers. These alternative model scenarios are used to assess the balance of risks based on the Pearson skewness indicator. Furthermore, the forecasts produced by the alternative models range from 4.2% to 6.0% in 2024 and from 3.7% to 4.8%, indicating an asymmetric distribution at the 90% confidence level, favouring positive skewness for 2024 and neutral skewness for 2025. It is also noteworthy that the past forecast error variance of GDP for the autumn round of forecasts leads to a standard deviation of 3.1 for the current year forecast and 4.1 for the one-year ahead forecast.

24. **In this context, earlier this year, the Council published a working paper evaluating the macroeconomic forecasting performance of the Ministry for Finance.** The findings indicated that the MFIN's one-year-ahead forecasts have exhibited a persistent downward bias. This bias may be partially influenced by statistical revisions, which have predominantly been upward in the national accounts data. While the Council acknowledges the importance of maintaining a prudent approach, particularly given that these forecasts form the basis for fiscal projections, it nonetheless encourages the MFIN to take the necessary corrective measures to address these biases and improve the reliability of its projections.

25. **The MFAC endorses the MFIN's macroeconomic forecasts presented in the DBP while identifying upside risk to real GDP growth in both 2024 and 2025, which is more pronounced in 2024.** The Council appraises that the macroeconomic projections for 2024 and 2025 prepared by the MFIN as part of the DBP 2025 lie within its endorsable range. According to its assessment, the upside risk for 2024 is primarily due to developments in the year's first half, whereby economic growth stands higher (6.0%) than the overall projection (4.9%). This implies that the Ministry's forecasts refer to relatively weak growth in the year's second half (3.8%). The notable slowdown in the year's second half is not concomitant with the soft indicators data available by the cut-off date of this assessment. On the other hand, for 2025, the Council believes that growth could turn out better than expected, especially from the domestic side. Furthermore, the Council notes that for 2024 and 2025, growth is mostly emanating from domestic demand increases. The Council would like to emphasise the importance of export-led growth and the need to improve competitiveness through labour productivity increases for sustainable medium-term economic growth.

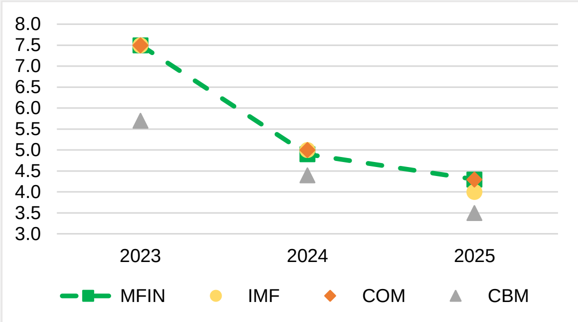
BOX A: A COMPARISON OF THE MFIN'S MACROECONOMIC FORECASTS WITH OTHER INSTITUTIONS

The MFAC also analyses the 2024 and 2025 forecasts issued by other reputable institutions, including the European Commission (COM), the International Monetary Fund (IMF), and the Central Bank of Malta (CBM). The most pertinent forecasts for this analysis are those published by the IMF in October 2024 and by the COM in November 2024, as these incorporate the latest benchmark revision in national accounts data released by the NSO on 28 August 2024.

Both, the IMF and the COM project a marginally higher real GDP growth rate of 5.0% for 2024 compared to the forecasts by the MFIN, which stand at 4.9%. However, for

2025, the IMF anticipates a lower real GDP growth rate of 4.0%, in contrast to the more optimistic projections of MFIN, which stands at 4.3%. For 2025, the COM is also expecting the same GDP growth rate as the MFIN. Conversely, the CBM, with forecasts based on data up to 19 August - thus not including the benchmark revision in the data released in late August - expects lower real GDP growth rates of 4.4% for 2024 and 3.5% for 2025. The real GDP forecasts published by MFIN are thus close to those provided by these institutions.

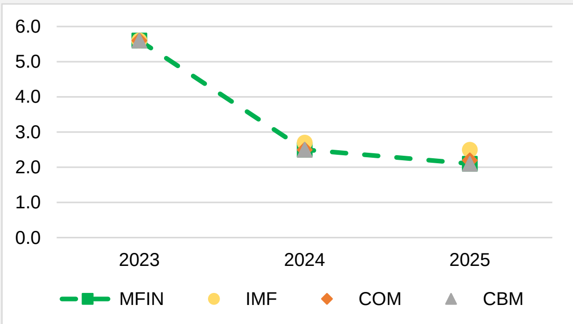
Real GDP Growth forecast by MFIN and other institutions
(%)



Source: MFIN, IMF, CBM, COM

All institutions project a decline in the inflation rate for 2024 and 2025, following the 5.6% rate recorded in 2023. In alignment with the MFIN, both the CBM and the COM forecast inflation rates of 2.5% for 2024. For 2025, the CBM is anticipating inflation to be at 2.1% as projected by the MFIN while the COM is projecting inflation to be 0.1 pp higher. The IMF, however, anticipates slightly higher inflation rates, projecting 2.7% for 2024 and 2.5% for 2025.

Inflation Growth forecast by MFIN and other institutions
(%)



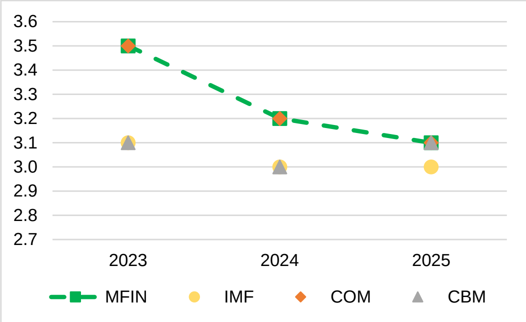
Source: MFIN, IMF, CBM, COM

The unemployment rate projected by the IMF and the CBM for 2024 is slightly lower than the 3.0% forecasted by both the MFIN and the COM. The IMF anticipates that the unemployment rate will remain at 3.0% in 2025, while the CBM aligns with the MFIN's forecast of 3.1%. Meanwhile, the employment growth projections provided by MFIN for both 2024 and 2025 exceed those of all other institutions.[23]

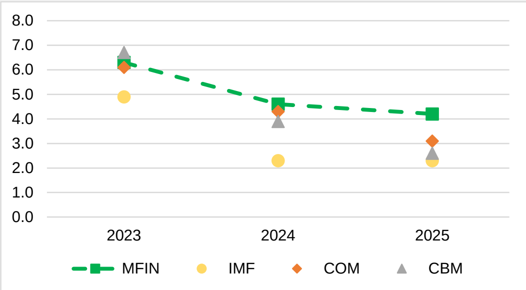
[23] The institutions (MFIN, IMF, CBM, COM) use different definitions for employment growth, thus figures for both actual data for 2023 and forecasts may be not directly comparable.

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

(%)



(a)



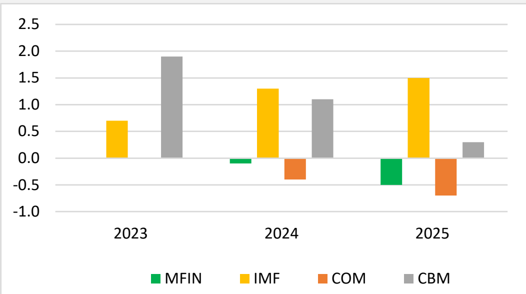
(b)

Source: MFIN, IMF, CBM, COM

Similar to the projections by the MFIN, the COM also expects that the output gap for 2024 and 2025 will be negative. However, the COM's projections are slightly more negative, at -0.4% for 2024 and -0.7% for 2025. In contrast, the IMF and the CBM anticipate a positive output gap for these years. Specifically, for 2024, the IMF expects the output gap to reach 1.3% of potential GDP, while the CBM forecasts it at 1.1%. In 2025, the IMF projects a further widening of the output gap to 1.5% of potential GDP, whereas the CBM estimates that the gap will remain positive, albeit to a lesser extent, at 0.3% of potential GDP.

Output Gap forecast by MFIN and other institutions

(%)



Source: MFIN, IMF, CBM, COM

Overall, the forecasts presented by the various institutions for real GDP growth, inflation rates, and unemployment rates appear to follow similar trajectories and are closely aligned. The fact that the MFIN forecasts fall within the range projected by other institutions further supports the Council's endorsement.

BOX B: MFAC'S POTENTIAL OUTPUT AND OUTPUT GAP ESTIMATES

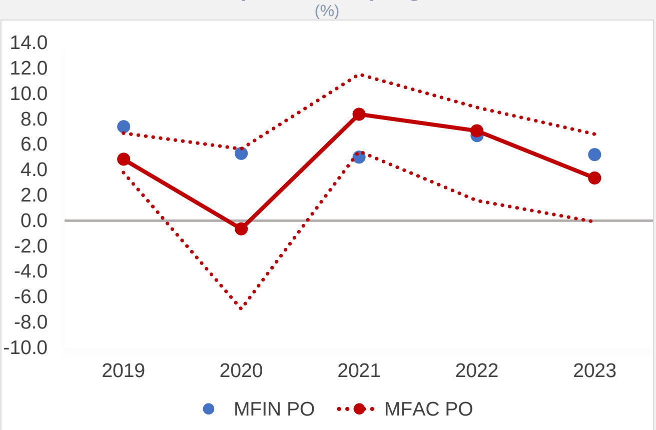
To support its assessment of potential output and output gap estimates produced by the MFIN using the EU Commonly Agreed Methodology (CAM), the MFAC has developed a suite of models approach (SOM). This approach estimates potential output using four univariate methods (the HP filter, Kalman filter, Baxter-King filter, Christiano-Fitzgerald Filter) and one multivariate method (Principal Components Analysis).[24] The output gap is calculated separately for each of these methods, using data spanning from 2001 to 2023.

The results obtained from the different methods are consolidated by calculating the mid-point of the full range of estimates. The dashed red lines in the following charts depict the range of estimates (i.e., the maximum and minimum bounds). The variances between the methods primarily stem from differences in the underlying assumptions, data inputs, and analytical frameworks inherent to each economic model. The mid-point estimate (illustrated by the dark red line) provides a measure, which mitigates the influence of extreme values from individual models.

Both the MFIN and the MFAC produce potential output growth estimates that generally exhibit similar trends, with a notable dip in 2020 due to the economic impact of the COVID-19 pandemic. This downturn is more pronounced in MFAC's estimates, which display slightly greater variability. The MFAC's estimates also indicate a sharper rebound in 2021.

The widening of MFAC's confidence interval for its potential output growth estimates around 2020 reflects the elevated uncertainty associated with this disruptive period. By 2023, the convergence between MFIN and MFAC estimates suggests a mutual view of stabilisation in potential output as the effects of the pandemic subside. The observed discrepancies, especially during periods of heightened volatility, underscore the influence of differing assumptions and modelling frameworks on the assessment of potential output.

MFIN and MFAC potential output growth estimates
(%)



Source: MFIN, MFAC

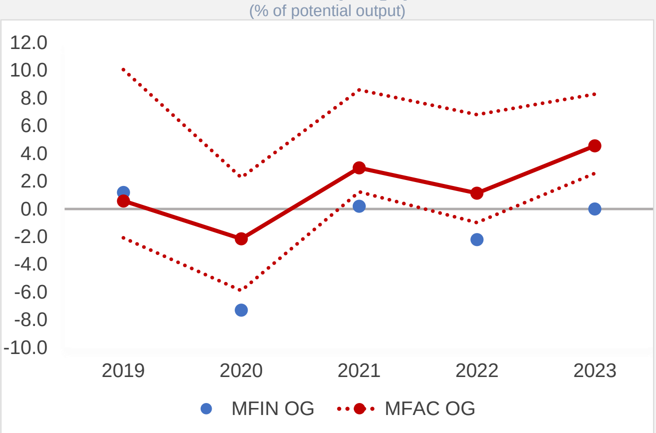
Regarding the output gap, MFIN's estimates display significant fluctuations, particularly in 2020. Indeed, the economy is estimated to have operated significantly below its potential. This reflects more stability in the potential output growth estimates by the MFIN during the pandemic's peak disruptions. In contrast, MFAC's output gap

[24] These methodologies are explained in more detail in Appendix 2 of the MFAC's assessment of the Annual report 2023, which can be accessed here.

estimates remain closer to zero, as its estimates show a larger decline in potential output growth during the COVID-19 period.

The narrowing of the Council's confidence interval for the output gap after 2021 indicates increased certainty and stability in its projections, suggesting a more predictable economic environment. The divergence between MFIN's and the Council's output gap estimates stems primarily from differing views on potential output in 2020. MFIN's lower potential output estimate for 2020 results in a larger output gap for that year, reflecting a more substantial deviation from potential economic activity. Furthermore, MFIN anticipates a slower recovery in potential output growth compared to the Council. This cautious recovery trajectory implies that MFIN projects a more prolonged period of subdued economic performance relative to potential, leading to consistently lower output gap estimates over the recovery period.

MFIN and MFAC output gap estimates
(% of potential output)



Source: MFIN, MFAC

The comparison between the potential output and output gap estimates produced by MFIN and MFAC reveals both areas of convergence and divergence in their assessment of economic performance and capacity. Notably, the differences are most pronounced during periods of economic disruption, such as the COVID-19 pandemic, highlighting the inherent challenges of estimating potential output and output gap under conditions of heightened uncertainty. The widening confidence intervals in MFAC's estimates during 2020–2021 reflect this volatility, emphasising the increased difficulty of providing accurate projections in such an unstable environment.

However, the gradual convergence of potential output estimates from both institutions in recent years, indicates a shared view of economic stabilisation and recovery. Moreover, the MFAC's output gap estimates suggest a quicker return to a positive output gap, in contrast to MFIN's persistent negative output gap. This divergence underscores the impact of differing methodologies and assumptions on fiscal and economic assessments, particularly in times of crisis.

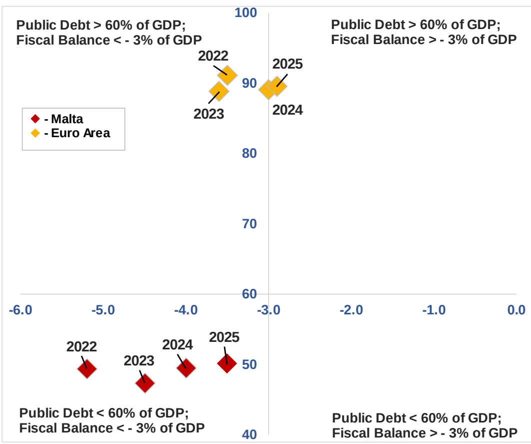
26. The fiscal deficit for 2023 amounted to 4.5% of GDP, compared to 5.0% in the DBP for 2024, mainly reflecting a stronger-than-expected GDP performance relative to projections made in the previous forecast vintage.[25] **The deficit is expected to remain above the 3% of GDP threshold, as the Government aims to achieve a gradual deficit reduction, adhering to the minimum required fiscal adjustment over 2024 and 2025. In terms of government debt, the ratio to GDP is projected to remain below the 60% benchmark.** The projected improvement in the headline fiscal balance is set at 0.5 pp of GDP in each forecast year, which would reduce the deficit to 3.5% of GDP by 2025. In structural terms, the planned fiscal adjustments are larger due to the MFIN's projection of a marginally negative output gap. Consequently, the structural deficit is projected to decline by 0.6 pp in 2024 and by 0.7 pp in 2025 to reach -3.3% of potential output.

Regarding government debt, the MFIN expects the public debt-to-GDP ratio to increase from 47.4% in 2023 to 49.5% in 2024 and further to 50.1% in 2025. This increase is attributed to positive contributions from the fiscal deficit and stock-flow adjustments (SFA), which are anticipated to outpace the impact of GDP growth. Despite these increases, debt is projected to remain well below the 60% threshold, maintaining a buffer of approximately 10.0 pp.

A comparative analysis of Malta's fiscal position with the Euro Area average indicates that Malta is likely to sustain a larger fiscal deficit than the Euro Area by 2025. The Euro Area average deficit is projected to fall below 3% by 2025, reflecting an improvement of 0.1 pp, compared to Malta's projected improvement of 0.5 pp. In terms of government debt, however, Malta's debt-to-GDP ratio remains significantly below the EU average. For both Malta and the EU, the debt ratio is expected to remain rather stable, albeit increasing slightly.

Fiscal balance and public debt dynamics – Malta and the EU[26]

(% of GDP)



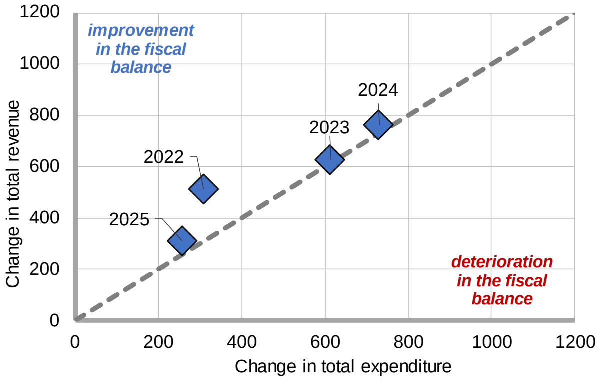
Source: MFIN, COM

[25] The benchmark revision in national accounts data resulted in a lowering of the deficit ratio to GDP by 0.3pp. The remaining 0.2pp improvements reflect better than expected fiscal outturn, as reported in the March and October 2024 fiscal notifications.
[26] 2022 and 2023 represent actual data. Figures for 2024 and 2025 for Malta represent the forecasts in the DBP by the MFIN, whilst the forecasts for the EU are those by the COM presented in the Autumn 2024 Economic Forecast.

27. **The anticipated decrease in the deficit ratio is primarily driven by GDP growth, as the total improvement in the fiscal balance is projected to be less than €100 million over the two forecast years.** According to the DBP, the deficit is expected to decrease from €938.9 million in 2023 to €847.4 million in 2025. The anticipated annual improvements are of €34.9 million in 2024 and €56.6 million in 2025. These projections indicate that the improvement in the deficit ratio will be driven more by GDP growth than by a substantial reduction in the deficit itself.

    The projections indicate that total revenue and total expenditure will grow almost proportionately, with government revenue expected to increase by €761.9 million (11.6%) and total expenditure anticipated to rise by €726.9 million (9.7%) in 2024 compared to 2023 levels. For 2025, both revenue and expenditure are projected to increase by considerably less than in 2024. Total revenue is forecast to increase by €311.7 million (4.3%), whilst total expenditure is forecast to increase by €255.1 million (3.1%). As shown in the chart below, the annual increments in revenue from 2023 onwards are almost matched by annual increments in expenditure, resulting in somewhat marginal yearly improvements in the fiscal balance.

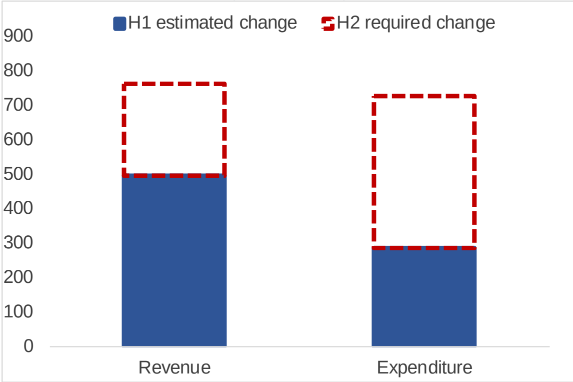
Annual changes in revenue and expenditure
(EUR millions)



Source: MFIN

28. **In absolute terms, the deficit target for 2024 has been maintained at a level closely aligned with the DBP24 submitted in October 2023, slightly above €900 million. However, mid-year developments indicate a fiscal position which is close to balance. The MFIN's estimates imply a substantial increase in expenditure relative to revenue in the latter half of the year.** Observations from the year's first half reveal that revenue rose by €494.1 million, or 15.5%, relative to the same period in 2023. In contrast, expenditure grew more moderately, with an increase of €286.2 million, or 8.3%. As shown in the chart below, whilst revenue has been performing well relative to the annual target, expenditure is lagging behind. Reaching the annual expenditure target requires an additional increase of €440.7 compared to the second half of 2023. Should government revenue continue to grow at the pace experienced in the first half, a further increase in expenditure would be necessary for the projected fiscal deficit of €904.0 million to materialise.

Mid-year required performance to meet the 2024 target changes set in the DBP 2025 when compared to 2023 actual data
(EUR Millions)



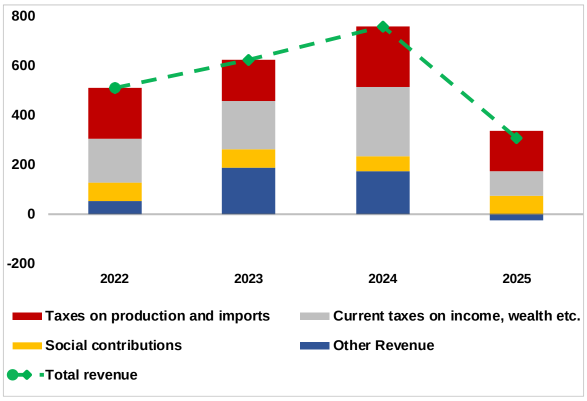
Source: NSO, MFIN, MFAC staff calculations

29. **In 2024, government revenue is anticipated to experience robust growth, surpassing the pace of expansion observed in 2023. The Government also plans a similar acceleration in public expenditure, with substantial increases forecasted across nearly all primary revenue and expenditure components. However, projections for 2025 indicate a more moderate growth rate in both revenue and expenditure.** For 2024, most of the revenue increase (68.9%) is expected to stem from substantial rises in current taxes on income and wealth and taxes on production and imports. In contrast, the projected revenue growth for 2025 is comparatively lower, largely due to reduced contributions from both direct taxes, because of income tax cuts, and indirect taxes, alongside a decrease in the 'other revenue' category. Taxes on production and imports are still projected to contribute the most to the increase in revenue next year, with the contribution accounting almost as that from direct taxes and social security contributions.

In 2024, the primary drivers of expenditure growth are projected to be compensation of employees and gross fixed capital formation. Additionally, intermediate consumption and social payments are also expected to make a notable contribution to the increase in expenditure. In 2025, compensation of employees, intermediate consumption and social payments are anticipated to continue to contribute positively to expenditure growth, but at a considerably reduced rate. On the other hand, a marginal decrease is projected for gross fixed capital formation. Subsidies represent the only expenditure category forecasted to decline in both 2024 and 2025, largely due to projected reductions in the cost of energy subsidies.

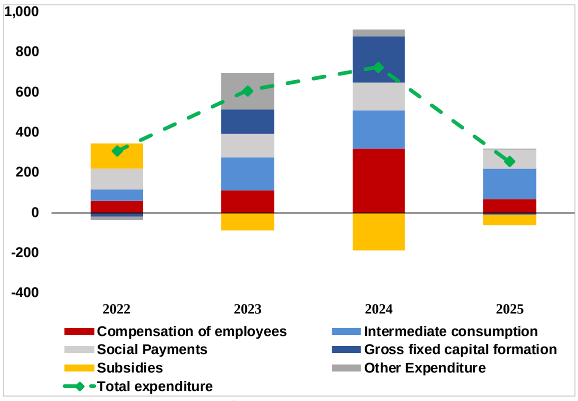
What follows is an assessment of the main revenue and expenditure components, analysed over both forecast years.

Contributions to changes in revenue
(EUR Millions)



Source: MFIN

Contributions to changes in expenditure
(EUR Millions)



Source: MFIN

BOX C: MFAC'S FISCAL REVENUE FORECASTS

The MFAC uses a fiscal model 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 gains a more nuanced understanding of the tax base and the sensitivity of revenue components to shifts in the tax base, thus enabling it to 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 MFIN [27]

	2023	2024	2025
Taxes on production and imports	0.4[28]	1.3	1.2
Current taxes on income and wealth	0.7	1.9	1.4
Net Social Security Contributions	0.9	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 MFIN. 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 identifies a slight element of upside risk in the projected total fiscal revenue as presented by the MFIN. Specifically, for the year 2024, the MFAC estimates an upward risk of €32.4 million in the fiscal revenue forecast. Similarly, for 2025, the MFAC identifies an upside risk in the fiscal revenue projection of €34.5 million. Notably, the MFAC projects lower fiscal revenue from Value Added Tax but higher revenue from direct taxes. Differences in net social security contributions receivables projections differ marginally.

Table 2C: MFAC Projections Assuming the same Macroeconomic Projections from the MFIN (EUR millions) [29]

	2024			2025			2025 - Incremental Risk
	MFIN	MFAC	MFAC-MFIN	MFIN	MFAC	MFAC-MFIN	
Taxes on production and imports	2,189.0	2,184.2	-4.8	2,353.1	2,343.8	-9.3	-4.5
of which Value Added Taxes	1,482.0	1,462.6	-19.4	1,607.0	1,581.9	-25.1	-5.7
Current taxes on income and wealth	2,793.4	2,821.80	28.4	2,892.40	2,930.90	38.5	10.1
of which taxes on individual or household income including holding gains	N/A	1,707.00		N/A	1,888.40		
of which Taxes on the Income or profits of Corporations	N/A	942.3		NA	993.9		

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

[28] If nominal GDP is used as the tax base, the elasticity estimate for 2023 would increase to 0.7.

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

including Holding Gains							
Net Social Security Contributions	1,129.20	1,138.00	8.8	1203.4	1,208.70	5.3	-3.5
(Downside) / Upside Risk on Government Revenue			**32.4**			**34.5**	**2.1**

Source: MFIN, 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 MFIN. 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 2024 by around €57.8 million, as an upside risk in all the primary revenue components is identified. Similarly, when incorporating the possible macroeconomic risks for 2025, and 2024 base effects, the MFAC assesses an upside risk to the total fiscal revenue projection of €76.0 million.

Table 3C: MFAC Projections incorporating changes in Macroeconomic Projections based on Expert Judgement (EUR millions)[30]

	2024			**2025**			**2025 - Incremental Risk**
	MFIN	**MFAC**	**MFAC-MFIN**	**MFIN**	**MFAC**	**MFAC-MFIN**	
Taxes on production and imports	2,189.0	2,199.4	10.4	2,353.1	2,369.6	16.5	6.1
of which Value Added Taxes	1,482.0	1,474.6	-7.4	1,607.0	1,602.5	-4.5	2.9
Current taxes on income and wealth	2,793.4	2,832.10	38.7	2,892.40	2,946.7	54.3	15.6
of which taxes on individual or household income including holding gains	N/A	1,707.00		N/A	1,888.40		
of which Taxes on the Income or profits of	N/A	950.6		N/A	1006.2		

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

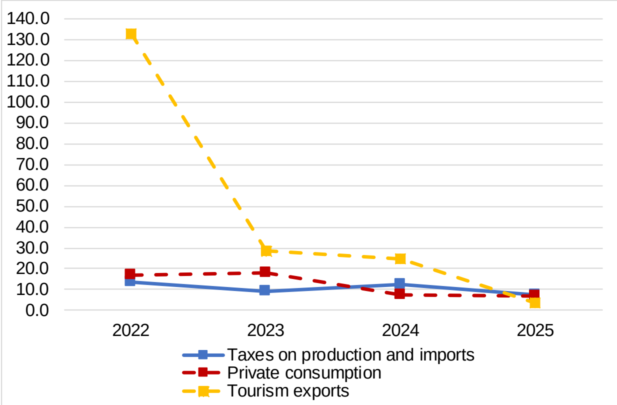
Corporations including Holding Gains							
Net Social Security Contributions	1,129.20	1,137.90	8.7	1203.4	1,208.60	5.2	-3.5
(Downside) / Upside on Government Revenue			**57.8**			**76.0**	**18.2**

Source: MFIN, MFAC Estimates

30. **The growth in taxes on production and imports is projected to remain strong throughout the forecast years. An acceleration is anticipated in 2024, with growth reaching 12.6%, up from 9.3% in 2023, followed by a projected increase of 7.5% in 2025.** In absolute terms, indirect taxes are forecasted to increase by €245.5 million in 2024 and by a further €164.1 million in 2025. Despite the projected slowdown in the two key proxy variables, being private consumption expenditure and tourism earnings, growth in taxes on production and imports is still projected to accelerate in 2024. This is attributed to an increase in the synthetic elasticity projected by the MFIN, which is expected to rebound from its relatively low value in 2023 to exceed unitary elasticity in 2024. Notably, the MFIN envisages higher levels of Value Added Tax (VAT), which are also reflecting increased efficiency in revenue collection. The data for the first half of the year suggests an increase of 14.9% in taxes on production and imports, when compared to the same period in the previous year, thus exceeding the annual projection of 12.6%.

    For 2025, the deceleration reflects a projected deceleration in nominal private consumption expenditure, but mostly in tourism exports. The very large increase in inbound tourists experienced over 2024 is projected to slow down in 2025. Indeed, the projected increase of 24.6% in tourism exports for 2024, is forecast to slow down to an increase of 3.5% in 2025. For 2025, growth in VAT is again projected, by the MFIN, to be higher, than for the other taxes making up this component. The synthetic elasticity of this tax component is also expected to decrease marginally, but to remain elastic.

Growth in taxes on production and imports and its main macro-proxy variables[31]
(%)



Source: MFIN

Risk Assessment

The data for the first half of the year indicates that out of the anticipated annual increase of €245.5 million, €136.0 million, therefore around 55% has been realised, indicative the possibility that the outturn could be higher than envisaged by the MFIN.

The baseline risks for taxes on production and imports, using the same macroeconomic forecasts by the MFIN, indicate downside risks of €4.8 million in 2024 and €9.3 million in 2025 (refer to Box C). Such downside risk emanates from the relatively higher assumed elasticity by MFIN, when compared to the MFAC estimate, particularly for VAT, which is the largest component in taxes on production and imports. The downside risk for VAT more than offsets any upside risks for other components within taxes on production and imports. On the other hand, upside risks emerge for both years when incorporating the Council's expert judgement on the macroeconomic forecasts. This involves upside risks in private consumption for both years, while keeping the tourism exports forecast unchanged. As a result, the Council's fiscal model projects an upside risk of €10.4 million in 2024, with a further incremental upside risk of €6.1 million in the following year, such that the total upside risk for 2025 amounts to €16.5 million.

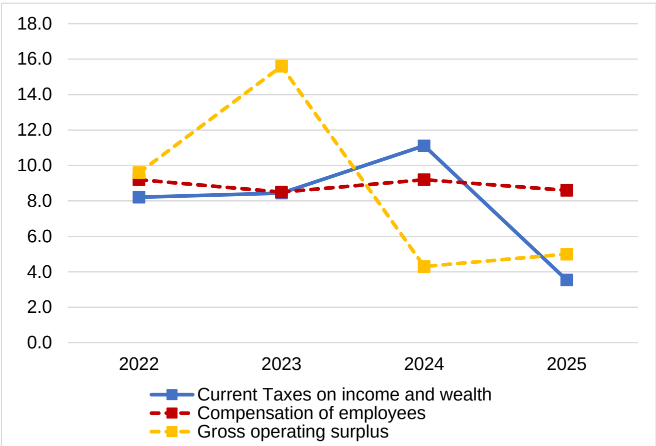
31. **In 2024, a significant increase of 11.1% in current taxes on income and wealth is anticipated, while for 2025 growth is expected to decelerate to 3.5%. This reflects the impact from the revision of the income tax bands that applies as from next year.** In absolute terms, direct taxes are forecasted to increase by €279.4 million in 2024 and by a further €98.9 million in 2025. The projection for 2024 was revised upward by €157.2 million when compared to the projection in the DBP 2024. The updated forecast for 2024 indeed reflects a more positive macroeconomic scenario, as well as continued improvements in tax collection efficiency. The growth expected in 2024 is also attributed to a higher estimated

[31] The growth rate for tourism exports in 2022 is notably significant compared to other years, as tourism was still recovering from the COVID-19 pandemic during this period.

elasticity, which is expected to be above one, compared to lower values observed over the previous two years.

The lower growth projected for 2025 partly reflects the discretionary measure announced in Budget 2025 that modifies income tax bands and involves an increase in the minimum taxable income. The fiscal cost of this measure is €140.0 million.[32] Excluding the impact of this measure, the growth in current taxes on income and wealth would have still been less than that in 2024, in line with the slight deceleration in growth of compensation of employees. On the other hand, growth in gross operating surplus is projected to be somewhat higher in 2025. In this context, it is relevant to note that, as regards the corporate tax system, the Government has deferred the implementation of the Pillar 2 minimum global tax rate beyond 2025 and discussions with the COM are still underway.

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



Source: MFIN

Risk Assessment

Over 55.3% of the amount of direct taxes projected for 2024 have been realised over the first half of the year (€1,545.1 million realised, out of the €2,793.4 million forecast for 2024). Indeed, over the first half of the year, current taxes on income and wealth increased significantly, up by €259.9 million. These developments indicate that the turnout for current taxes on income and wealth could be higher than envisaged by the Ministry. For 2025, it is plausible that the projected increase in direct taxes is considerably lower than that in 2024 because of the impact from the revenue-decreasing measure relating to the change in income tax bands.

The results obtained from the Council's fiscal revenue model (see Box C) corroborates this view and indeed indicates an upside risk for direct taxes in both 2024 and 2025, both in the model assuming the same macro projections as the MFIN's and the one incorporating expert judgement in the macroeconomic growth forecasts. In the latter model, the upside risk is larger in magnitude,

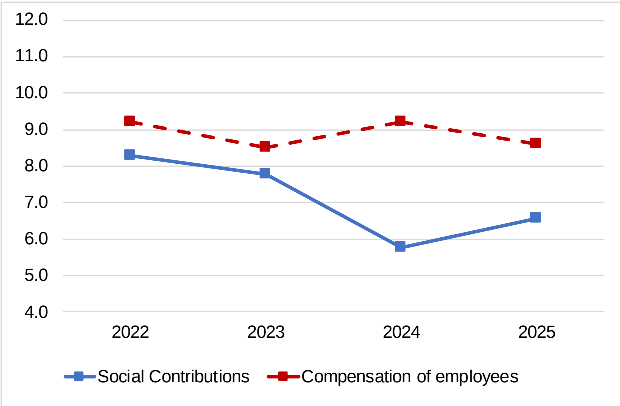
[32] The MFIN's methodology to estimate the cost of this measure involved using recent personal income tax micro data, calculating the difference between individual's tax with the current tax brackets and the new brackets to be introduced from 2025. The difference represented the amount that shall not be collected by the government under the new tax structure.

particularly because of higher expected positive developments in gross operating surplus. The Council's fiscal model points to an upside risk of €38.7 million in 2024. The total upside risk for 2025 is higher at €54.3 million. However, this incorporates the base effect of the previous year, meaning that the upside incremental risk in 2025 is less, at €15.6 million.

32. **The projected growth in social contributions indicates a moderate deceleration in 2024 and a partial rebound in 2025.** Social contributions are anticipated to increase by 5.8% in 2024 and 6.6% in 2025. The elasticity for this revenue component is expected to remain below unity, aligning with historical patterns and reflecting the statutory cap on annual social contribution payments.[33] The MFIN's forecast for 2024 anticipates a slightly lower elasticity relative to historical averages, but in 2025, the elasticity is expected to be more aligned with long-term trends.

Growth in social contributions and its macro-proxy variable

(%)



Source: MFIN

Risk Assessment

The Malta Fiscal Advisory Council (MFAC) considers the projected growth rate of 5.8% in social contributions for 2024 to be relatively modest when compared to the growth rates of approximately 8.0% recorded over the preceding two years and a ten-year average of 7.4%. This assessment is particularly noteworthy given that the increase in the macroeconomic proxy tax base is expected to surpass that of 2023. Furthermore, half-yearly data indicates a growth rate of 10.3% for social contributions, which further corroborates the views of the Council that the projected growth rate for 2024 may be conservative.

Looking ahead to 2025, the projected growth rate of 6.6%, corresponding to an increase of €74.2 million, appears more aligned with historical trends. Additionally, the Council estimates a slightly higher elasticity than the MFIN for both 2024 and 2025. The estimates from the MFAC's fiscal revenue model indicate a slight upside

[33] The cap implies that once the maximum national insurance contribution has been reached, additional income does not lead to additional social security payments.

risk in both years. Overall, while the risk outlook for 2024 is marginally tilted to the upside, the 2025 forecast appears more balanced.

33. **In 2024, other revenue is projected to grow by 16.9%, following an increase of 22.1% in 2023. However, this growth is expected to be followed by a slight contraction of 2.1% in 2025.** This projected volatility partially reflects expected EU funding flows. These include transfers receivable from the Recovery and Resilience Facility (RRF), the Multiannual Financial Programme 2021–2027, and the final disbursements from the 2014-2020 Programme. The MFIN's projections indicate that expenditure funded by transfers from the EU is expected to increase rather significantly, from 1.1% of GDP in 2023 to 1.5% of GDP in 2024, before moderating to 1.2% in 2025. However, in general, EU funding should have a broadly neutral impact on the fiscal deficit, as they involve corresponding expenditures.

    The other revenue category also includes proceeds from market output, which can be volatile due to its discretionary nature, as well as other minor components, namely revenue from capital taxes and property income, which includes contributions from the profits by the Central Bank of Malta.

Risk Assessment

The Council assesses an overall neutral risk for 'other revenue' in 2024 and 2025. Expected growth in both years largely reflects consistent trends, although some elements, such as revenue derived from market output, tend to be more volatile. Although both current and capital transfers are projected to be significantly higher than over the previous two years, which could suggest a downside risk particularly in 2024, the effect on the fiscal balance should be mitigated as they involve broadly matching expenditures.

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

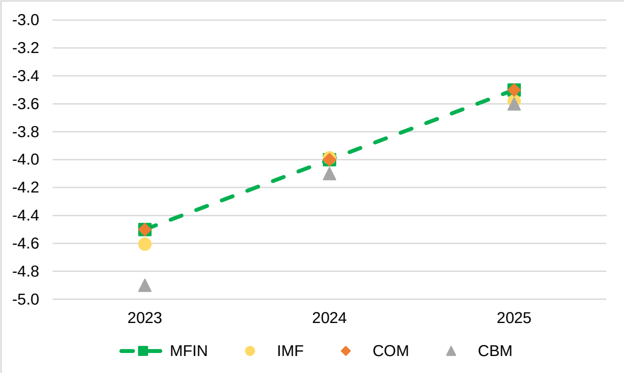
Part of the MFAC's endorsement function involves a comparison to the budgetary forecasts for 2024 and 2025 published by other reputable institutions, including the COM, the IMF and the CBM. The most relevant are those published by the IMF in October 2024 and the COM in November 2024, which incorporate the latest available data.

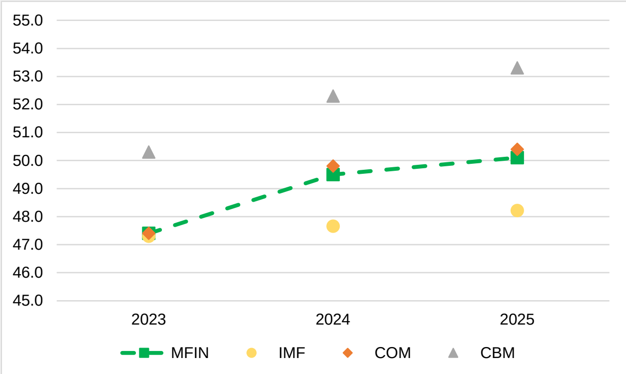
Whilst the forecast for the 2024 deficit ratio by the IMF and the COM is the same as that by the MFIN (-4.0%), the CBM expects a slightly higher deficit ratio (-4.1%). For 2025, all institutions expect an improvement in the deficit ratio relative to 2024. However, the deficit ratios projected by the CBM and the IMF are expected to be 0.1pp higher than those forecasted by the MFIN and the COM.

All institutions project an increase in the public debt-to-GDP ratio for 2024 and 2025, albeit to differing degrees. The COM anticipates a marginally higher debt ratio than the MFIN in both 2024 and 2025. On the other hand, the IMF anticipates a lower debt ratio, with 47.7% in 2024 and 48.2% in 2025. Conversely, the CBM forecasts a significantly higher debt ratio, exceeding both the MFIN and the COM projections, but its forecasts do not include the benchmark revision in the national accounts data, which resulted in a higher level of GDP and, thus, a lower debt to GDP ratio.

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

(a)





(b)

Source: MFIN, IMF, CBM, COM

The Council notes that the forecasts for the deficit ratio by these institutions are very close to those by the MFIN, and the debt trajectory is generally similar. The MFIN's debt ratio forecasts are considered to be within the range of estimates provided by these institutions.

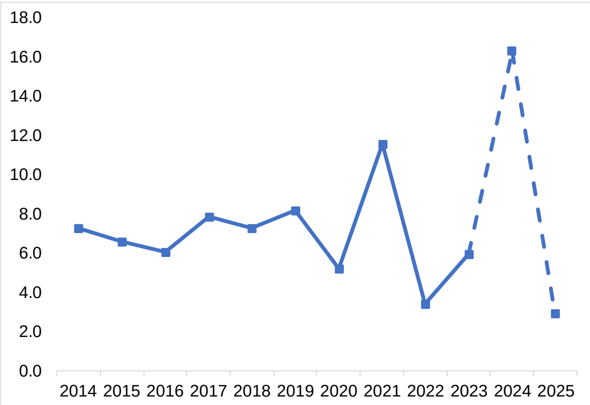
34. **The level of compensation of employees is expected to increase by €317.7 million in 2024, significantly more than increments observed in past years. For 2025, the projected increase is notably lower at €66.6 million. Changes in collective agreements and the settlement of outstanding arrears particularly impact the forecast for this expenditure component.** The absolute change in compensation of employees has been revised upwards by €124.1 million for 2024 when compared to the last forecast round. Over the first half of 2024, a growth of 6.8% was registered over the same period in 2023. The target for the year is for overall growth to be 16.3%, thus implying 25.6% growth in the second half of the year. Influencing this year's forecast is the finalisation of sectoral agreements, particularly that for the educational sector. This agreement was concluded on 15 July 2024, and therefore, its cost implications do not yet feature in the quarterly government accounts covering the first half of the year. The

agreement also includes provisions for the payment of arrears for 2023, which are reported in the year in which they are paid, that is, in the costings for 2024.

In terms of the forecast for 2025, the projected €66.6 million increase is more in line with historical standards. The major sectoral agreement next year will be that for public service workers, for which discussions have already been concluded. The increments, with an estimated additional cost of around €70.0 million should therefore start in due time next year. Offsetting, to an extent, this increase, is the non-recurrence of the payments in 2024 because of the 2023 arrears related to the educational sector. Apart from these developments, although still high, the COLA was reduced to €5.24 per week compared to €12.81 per week in 2024.

Growth in compensation of employees

(%)



Source: Eurostat, MFIN

Risk Assessment

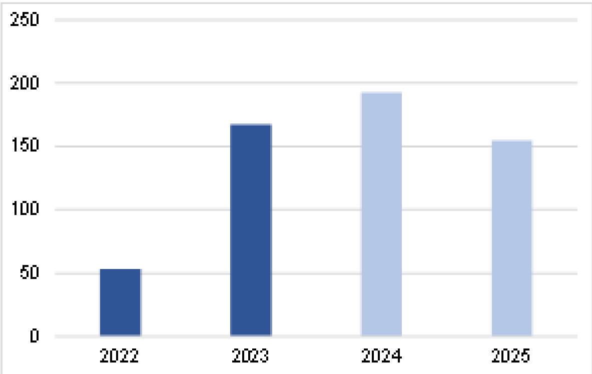
Reaching the €2,261.9 million annual figure for compensation of employees in 2024 implies a significant increase, well exceeding the average increase of 7.0% observed over the past 10 years. Corroborating this is the fact that a substantial increase in spending on compensation of employees shall be necessary in the second half of the year for the annual target to be reached. On the other hand, the Council recognises that the implications of the education sectoral agreement are still to feature in the statistical releases for government finances, since this was concluded during the second half of the year. This should prompt a higher increase than the 6.8% registered over the first six months. Nonetheless, the Council believes that, based on the developments described above and its implied assumptions for the rest of the year, there is still an element of downside risk to the level compensation of employee’s expenditure in 2024.

The savings which could potentially result in 2024 would automatically imply a larger increase in 2025. The Council views the current growth in 2025 as low, particularly when viewed against past tendencies and because of the new public sectoral agreement to feature next year. The possibility of attaining savings in 2024 would however put the targeted level of compensation of employees for 2025 as a plausible estimate.

35. **Growth in intermediate consumption is projected to continue to increase strongly by €192.6 million in 2024, following an increase of €167.3 million in 2023. In 2025, the projected increase is slightly more contained, at €154.8 million, reaching €1,816.4 million in total.** For 2024, the figures for intermediate consumption were revised upwards by €84.7 million when compared to the previous forecast round. Such revision is due to higher than estimated cost of contractual services, higher outlays in the health sector as well as higher than estimated capital expenditure classified under this category. These increases reflect a high inflationary environment which Malta was subject to in the recent past. The developments over the first half of the year indicate an increase of 8.0% over the same period in 2023, implying a growth rate of 17.7% in the second half of the year for the yearly target growth of 13.1% to be achieved. In terms of quarterly developments, the level of intermediate consumption is usually much higher in the last quarter of the year, and a similar pickup in expenditure is also being expected this year.

For 2025, the increase in spending on intermediate consumption is projected to be less, at 9.3%. This is linked, to an extent, to the lower rate of inflation. Outlays resulting from the high level of gross fixed capital formation envisaged for both years, as well as operational and maintenance expenses and programmes and initiatives are contributing to a large part of the increase projected for 2025.

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



Source: MFIN

Risk Assessment

The Council opines that the risk for intermediate consumption for 2024 is broadly neutral. The projected growth of slightly more than 13.0% is very similar to the growth in this component in 2023. On the other hand, the growth outturn for the first half of the year is lower than the projected annual increase. Nonetheless, the costs associated with this component are generally higher towards the end of the year when more finalisation of projects and payments occur. Turning on to 2025, the envisaged increase is forecast to be less than in the previous year. However, the slowdown is not as significant as that for other expenditure components and is backed by an element of continuity of contracts and other costs which consistently increase. Also, the level of inflation for 2025 is projected to decline, which supports the envisaged developments.

36. **New social measures, demographic pressures and inflationary developments underpin the increase in social payments of €140.3 million in 2024 and €94.3 million in 2025. The lower increase in 2025 is attributable, in large part, to the decline in inflation.** Social payments are projected to increase by 8.5% in 2024, which is broadly in line with the growth rate of 10.1% registered during the first half of the year. Inflationary pressures influence the forecast for social payments for 2025. Indeed, the COLA is notably lower, from €12.81 in 2024 to €5.24, and this is reflected in a smaller increase in pensions from €15 in 2024 to €8 in 2025.[34] The estimated cost of new social payments measures for 2025 is €70.5 million compared to €29.2 million in 2024. Ageing and other demographic pressures are also expected to lead to further increases in social payments. For instance, the number of individuals over 65 years of age is expected to increase from 102,000 in 2022 to 120,000 by 2030, inducing more expenditure on pensions.[35]

Risk Assessment

Demographic developments and the various social measures implemented in recent years and those announced in the Budget for 2025 contribute to the rising annual cost of social payments. For 2024, the progress observed in the year's first half broadly aligns with the projected increase in social payments. The MFAC further notes that past forecasts for this variable have been relatively accurate overall.

Looking ahead to 2025, the growth in social payments remains notable, although it is expected to be less pronounced than in 2024, primarily due to a significant reduction in inflationary compensation. Given these considerations, the trajectory for social payments is assessed as having an overall neutral risk.

37. **In 2024, the allocation towards public gross fixed capital formation is expected to increase significantly, by 32.4% over the previous year, reaching €943.7 million. This is expected to remain relatively stable in 2025, at €934.0 million. To achieve the 2024 annual target, substantial progress needs to be registered over the second half of the year**. In the first six months of 2024, only 28.9% of the government's projected investment for the year has been realised (€272.7 million). This figure is closely aligned with the investment level recorded during the same period in 2023. However, the updated annual forecast for 2024 is €231.2 million higher than the total investment that was realised in 2023. Compared to the previous forecast round, there have been significant revisions to the 2024 allocation for public gross fixed capital formation, up by €177.1 million. This revision primarily reflects higher expected capital expenditure by both the central government and EBUs, and particularly EU-funded investment. However, recent cash data reveals that while locally funded absorption is progressing well,

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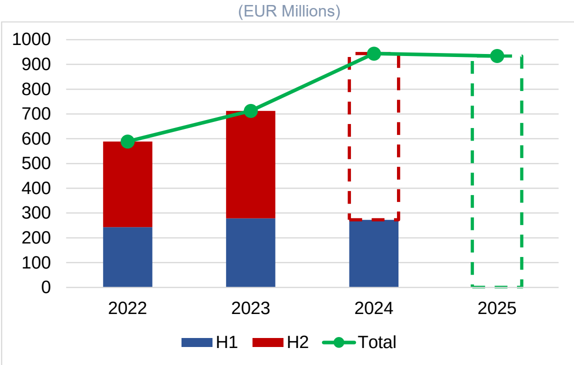
[34] The increments in pensions announced in the Budgets are inclusive of COLA.

[35] Sourced from the 2024 Ageing Report - Malta Country Fiche, which may be accessed here.

EU-funded absorption appears to be lagging behind the levels of absorption achieved in 2023.

For 2025, gross fixed capital formation is expected to decrease marginally by 1.0%, thus still remaining at a high level due to the substantial base from 2024. The Financial Estimates for 2025 indicate that, in comparison to 2024, the target for EU-funded investment will be lower, while nationally financed investment is expected to increase.

GFCF half-yearly and total developments
(EUR Millions)



Source: Actual Data – Eurostat, Forecast – MFIN

Risk Assessment

In 2024, the Council identifies potential downside risks to public investment growth. The high base of public investment in 2023 sets a challenging benchmark for growth in 2024. This is accentuated with the significant upward revision of €177.1 million in the investment forecast for 2024 compared to prior estimates, which could indicate an element of over-optimism in forecasting investment absorption. Indeed, the current trajectory of government investment in the first half of 2024 has been slower than expected, with only 28.9% of the projected annual investment materialising. This underperformance raises doubts about the pace of execution in the second half of the year, potentially hindering the achievement of the revised annual investment targets.

This was also the case last year, whereby with a similar first half outturn, the annual target in the DBP for 2024 was eventually not reached by €131.1 million. This heightens the downside risk to achieving the total investment target for 2024. For 2025, the Council also identifies possible downside risk, owing to the elevated level of gross fixed capital formation when compared to historical standards and the possibility of a lower turnout in 2024.

38. **Energy price support measures are being maintained, with no revisions being announced. Although the total level of subsidies is projected to decline consecutively, the blanket coverage of energy subsidies still poses fiscal risks because of uncertainties due to exogenous factors and possible volatilities in international prices.** Total subsidies have declined in 2023 and are

expected to continue on a downward trajectory in the coming years, from 3.6% of GDP in 2023, to 2.5% in 2024 and 2.1% in 2025. It is relevant to note that subsidies is the only main expenditure component which is projected to decline, thus offsetting some of the impact of the very high expenditure increments anticipated for the rest of the expenditure components in 2024. Lower international energy prices contributed to lower costs related to energy subsidies. Spending on energy subsidies and measures to ensure commodity price stability and supply security is expected to decline from just over €300 million in 2023 to €172 million in 2025, corresponding to 0.72% of GDP. In addition, the non-recurrence of COVID-19 assistance measures in 2023, and of subsidies to the national airline in 2024, also contributed to lower outlays on subsidies.[36]

Despite the expected decline in the cost of energy subsidies, these subsides continue to contribute towards the fiscal deficit. The Council still considers that the current structure of energy subsidies poses risks to the attainment of the fiscal deficit and expenditure trajectory targets, given the exogenous and volatile nature of energy prices. It thus maintains its recommendation for the government to develop a comprehensive exit strategy for the fixed-energy-price policy. Furthermore, this strategy should prioritise a more targeted approach while enhancing incentives for energy conservation.[37] The Council considers that the robust performance of the Maltese economy – significantly exceeding the EU average – along with the stabilisation of international oil and gas prices, provides a conducive environment for gradually revising these subsidies. Such a revision would allow for a more targeted framework, aligning with the overarching objectives of achieving a carbon-neutral economy and promoting the green transition.

Risk Assessment

Energy subsidies are inherently subject to volatility driven by developments in international markets, which could result in significant shifts in their fiscal trajectory. This volatility may lead to either cost savings or increased expenditure. Furthermore, given that these subsidies are neither capped nor targeted and are applied universally across all consumption levels, they fail to provide incentives for improving energy efficiency.

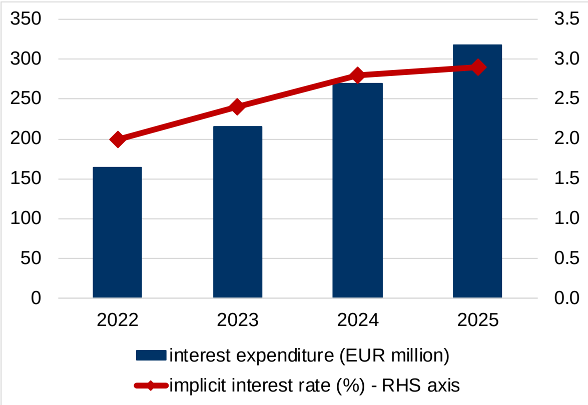
Consumption patterns and external factors, including weather conditions, population growth, and the increasing number of tourists, directly influence the level of subsidies. These factors introduce additional risks to the realisation of the projected reductions in subsidy expenditures over the near term.

[36] The operationalisation of the new airline, KM Malta Airlines, includes an equity acquisition of €215.0 million in 2024. This is included as a Stock-Flow Adjustment, impacting debt but not the government's fiscal balance.

[37] The MFAC first issued this recommendation in the Assessment of the Annual Report 2022, published in September 2023. The recommendation featured in the subsequent assessment reports of the Council.

39. **When aggregated, the remaining expenditure components are projected to remain rather stable over 2024-25 compared to the 2023 level. Nevertheless, notable shifts are expected across specific components.** The category of 'other expenditure' is projected to increase by €34.5 million in 2024 and €2.7 million in 2025. Among the underlying components, interest expenditure is projected to continue its year-on-year increase, underpinned by rising interest rates and a higher level of public debt. The implicit interest rate is expected at 2.8% in 2024, 0.4 pp higher than in 2023, and is projected to increase further to 2.9% in 2025.[38] Indeed, the projection in the DBP is that interest expenditure will rise to €270.0 million in 2024 and to €317.3 million in 2025, almost double the amount payable in 2022. Additional fluctuations in 2024 reflect changes in other current transfers payable and capital transfers payable. The former is expected to increase by €155.4 million, offset by a comparable decline in the latter. In 2025, current transfers are projected to increase by a much lower margin (€14.3 million), while capital transfers are expected to decrease further by €52.6 million.

Interest expenditure and the implicit interest rate
(LHS – EUR Millions, RHS - %)



Source: MFIN

Risk Assessment

The MFAC notes that the increased interest rates, coupled with higher gross debt levels, have resulted in higher borrowing costs for the government. The projected rise in interest expenditure, albeit with a slight deceleration in 2025, is considered plausible and consistent with prevailing interest rate expectations.

Changes within other expenditure components are largely offsetting and are not anticipated to significantly impact overall expenditure levels. Furthermore, these projections are partially contingent on the eventual level of EU funding. Consequently, the overall risks associated with the trajectory of the 'other expenditure' component are assessed as neutral.

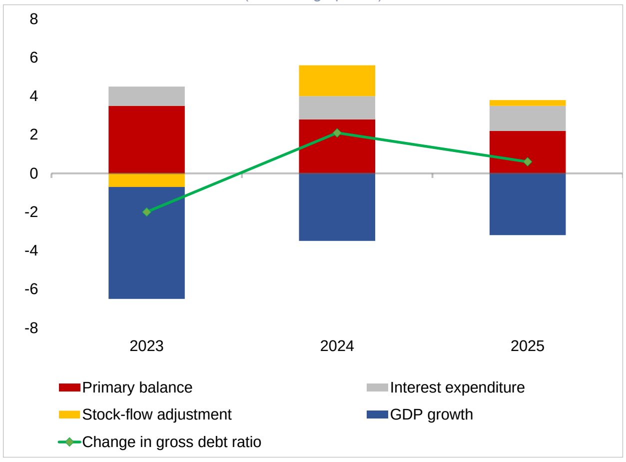
[38] The implicit interest rate is proxied by interest expenditure divided by the debt level of the previous year.

40. **Based on alternative model scenarios, in the DBP, the MFIN views the budget balance risk to be skewed towards the upside in 2024, that is towards a lower deficit, while for 2025 the risks are broadly balanced. Alternative output gap estimates yield mixed results, varying from positive to negative, posing an element of risk to the structural fiscal balance estimates.** The MFIN 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 for 2024 the confidence interval and thus the balance of risk is skewed towards a lower fiscal deficit. On the other hand, the risk is broadly balanced in 2025. In the worst-case scenario considered by the MFIN, the deficit increases by 0.1 and 0.3 percentage points in 2024 and 2025 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 -0.6 percent of potential output to 0.4 percent in 2024 and from -0.8 percent of potential output to 0.3 percent in 2025. The range of estimates is quite wide and the output gap estimates vary between positive and negative, which poses an element of risk to the structural balance fiscal forecasts.

41. **Despite the projected rise in the debt-to-GDP ratio by 2.1 pp in 2024 and by 0.6 pp in 2025, to 50.1%, it remains below the 60.0% threshold.** In absolute terms, public debt is expected to increase by €1,264.9 million to reach €11,056.2 million in 2024. This increase is primarily driven by the government's projected deficit of €904.0 million. The remaining €360.9 million increase in debt reflect a positive stock-flow adjustment (SFA). This contrasts with the 2023 outturn, when the SFA was negative. A large part of the adjustment in 2024 is due to an equity acquisition, amounting to €215.0 million, in respect of the new national airline. Additional SFA contributions are expected, mostly from changes in the government's cash balance. In 2025, debt is then estimated to increase by €911.8 million, to €11,968 million. The SFA's contribution is forecast to remain positive but to be much less, at €64.0 million. This reduction primarily reflects a much lower equity acquisition, and an assumed decrease in the cash balance.

The SFA's contribution to the change in the gross debt ratio is thus expected to decrease from 1.6 pp in 2024 to 0.3 pp in 2025. Meanwhile, the contribution to the change in gross debt from interest payments is expected to rise from 1.0 pp in 2023 to 1.2 pp in 2024 and 1.3 pp in 2025. However, these increases are offset by a declining primary balance contribution, projected to drop from 3.5 pp in 2023 to 2.8 pp in 2024 and further to 2.2 pp in 2025. Over both years, the projected contribution from growth in nominal GDP (reducing the debt ratio), does not exceed the combined debt-increasing contributions from the primary balance, interest expenditure and the SFA. As a result, the debt to GDP ratio follows a gradually increasing trend during the period.

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



Source: MFIN

Risk Assessment

Overall, the MFAC views the risks as skewed towards achieving a lower debt ratio in both 2024 and 2025. This optimism stems from upside risks to GDP growth outlined in this report, impacting the denominator of the ratio, and the potential for a better-than-expected fiscal deficit, especially in 2024. However, uncertainty remains regarding the eventual SFA outturn, which has historically been volatile.

Encouragingly, Malta's Debt Sustainability Analysis (DSA) risk scenarios, outlined in the MTFSP, indicate that the debt-to-GDP ratio will remain well below the 60.0% threshold with the trend expected to continue in the long term, extending up to 2038. Even under adverse scenarios, such as financial stress, lower structural primary balances, or a reduced interest rate-growth differential (r-g), the debt ratio is projected to remain well below 60.0%.

BOX E: THE NET EXPENDITURE PATH FOR MALTA - INSIGHTS FROM A HISTORICAL ANALYSIS

Overview of the new EU expenditure rule

In April 2024, the Council of the European Union approved substantial reforms to the EU fiscal framework, following extensive deliberations among Member States on optimising budgetary discipline and fostering greater compliance with fiscal regulations.[39] The primary objective of the revised fiscal rules is to ensure that a Member State's debt ratio follows a credibly declining trajectory or remains at sustainably low levels. To this end, the operational framework includes a multi-year net expenditure rule.

This rule refers to the annual maximum growth rate for nationally financed net primary expenditure, defined as general government expenditure excluding interest expenditure, one-offs, EU-funded spending, national spending on programmes co-

[39] More information on the new economic governance framework can be accessed here.

funded by the EU, and temporary spending on unemployment related to the cycle. It adjusts for the net impact of discretionary measures; for instance, tax-raising measures would allow for larger spending increases, whereas tax cuts would reduce the scope for spending increases.

Member States are required to submit MTFSPs covering either a period of four years or seven years, and commit to a set of reforms and investments. These plans establish an annual maximum growth rate for nationally financed net primary expenditure. Once approved by the Council of the European Union, this expenditure limit will become binding. The agreed net expenditure path will remain fixed for the duration of the plan unless a new government takes office, in which case the plan may, but is not required to, be revised.

Each spring, Member States are required to submit Annual Progress Reports, which the European Commission will use to evaluate compliance with the established maximum growth rate for net primary expenditure. As part of this process, the Commission will establish a *control account* to track cumulative deviations—both upward and downward—from the agreed expenditure path.

Under the new framework, Member States with debt ratios exceeding 60% of GDP or deficits above 3% of GDP will be subject to heightened scrutiny. For these countries, the European Commission will propose a reference adjustment path for net expenditure designed to ensure that debt follows a credibly declining trajectory, and that the deficit is brought below, or maintained under, the 3% threshold over the medium term. These reference paths were issued in June of this year.

Conversely, Member States with debt ratios below 60% of GDP and deficits under 3% of GDP will face less rigorous oversight. Such countries will not receive a reference adjustment path and will largely fall outside the scope of the stricter provisions. They may, however, request technical information from the Commission regarding the structural primary balance required to maintain deficits below 3% and debt ratios under 60% during the plan period and for the subsequent decade under a no-policy-change scenario. This request is optional and not mandated by the new framework.

The Net Nationally Financed Expenditure Path for Malta

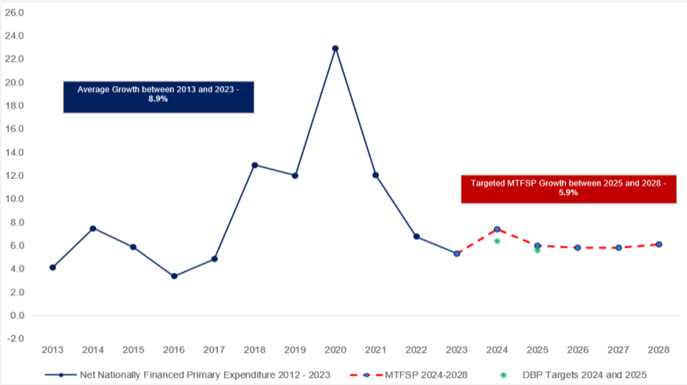
Since the budget deficit exceeds the 3.0% of GDP threshold, the European Commission issued a reference adjustment path for net expenditure for Malta in June, which set the maximum growth at 5.9% for 2025-28. This reference path was considered by Malta when formulating its MTFSP, which it submitted on 20th September of this year.

The growth trajectory for the net expenditure variable is outlined in Malta's MTFSP, with a maximum allowable annual average growth rate of 5.9% over the 2025 – 2028 period, thus similar to the Commission's reference trajectory. According to the DBP, net expenditure is projected to increase by 6.4% in 2024 and 5.6% in 2025. It is relevant to note that the new rules become binding on expenditure growth from 2025 onward.

A key role of the MFAC is to monitor the Government's compliance with fiscal rules. Accordingly, this analysis aims to evaluate the effort the Maltese Government requires to comply with the expenditure path outlined in the MTFSP, drawing on historical expenditure trends for context. Specifically, the growth in net expenditure set in the MTFSP for 2025-28 and the DBP targets for 2024 and 2025 are compared to the actual growth in this fiscal indicator during the previous ten years. The Council acknowledges that the two periods may not be entirely comparable since a budget surplus was recorded between 2015 and 2019 negating the need for expenditure limits and additionally, fiscal rules were suspended between 2020 and 2023, further distinguishing the fiscal environment of that period from the current framework. Nonetheless, the Council considers that past expenditure trajectories can still shed light on the degree of effort required to keep expenditure growth within the limit allowed by the new expenditure rule.

Growth in the Net Nationally Financed Primary Expenditure

(y-o-y % change)



Source: Eurostat, AMECO, NSO, Author's Calculations

The average growth rate of net nationally financed primary expenditure between 2013 and 2023 was 8.9%. Excluding the impact of the COVID-19 pandemic year, this average declines to 7.5%. Consequently, attaining the targeted growth rates of 6.4% in 2024 and 5.6% in 2025 is likely to present a significant challenge, particularly when viewed against historical trends and the context of an expanding economy with a growing population. Scrutiny of expenditure developments during the year is thus warranted as the margin between the DBP target for 2025 of 5.6%, and the 5.9% ceiling set in the MTFSP leaves limited space for expenditure slippages.

This is particularly important since the reduction in personal income tax announced in the Budget for 2025 constitutes a discretionary revenue measure which is included in the allowable nominal growth in net nationally financed primary expenditure.

The Council emphasises that assessing compliance with the target net primary expenditure growth applicable for 2025-2027 may not be entirely comparable with the nominal growth in net nationally financed primary expenditure over the 2012-2023 period. Notably, actual potential growth was higher during this earlier period, which would likely have permitted a greater increase in expenditure. Furthermore, between 2015 and 2019, a surplus was recorded in the general government accounts, negating the need for expenditure limits. Additionally, fiscal rules were suspended between 2020 and 2023, further distinguishing the fiscal environment of that period from the current framework.

BOX F: COMPLIANCE WITH FISCAL RULES

A key role of the Fiscal Council is to monitor the Government's compliance with fiscal rules. A new economic governance framework came into force at the EU level on 30 April 2024.[40] The framework aims to streamline oversight by Member States through focusing on a single indicator: the net nationally financed primary expenditure. However, additional requirements remain applicable alongside this indicator.

The growth trajectory for this expenditure variable is outlined in Malta's MTFSP, with a maximum allowable annual average growth rate of 5.9% over the 2025 – 2028 period. According to the DBP, net expenditure is projected to increase by 6.4% in 2024 and 5.6% in 2025. It is relevant to note that the new rules become binding on expenditure growth from 2025 onward.

In addition to this new expenditure rule, the deficit and debt rules established in the Maastricht Treaty of 1992 remain in force. These rules mandate that budget deficits must not exceed 3% of GDP, and public debt must remain below 60% of GDP. As Malta's budget deficit currently exceeds the 3% threshold, the country is subject to a deficit-based EDP.[41] The requirements for addressing the EDP remain largely unchanged from the previous framework, necessitating a minimum annual structural improvement of at least 0.5% of GDP.

Adhering to the prescribed expenditure path is expected to ensure compliance with the adjustment required to achieve a deficit of 3% of GDP. Indeed, projections indicate that both the headline and structural deficit will align with the respective obligations. Given the prevailing high interest rate environment the required fiscal effort is currently being viewed in terms of the structural primary balance. Accordingly, the structural primary deficit is projected to decline by 0.7 pp in 2024 and 0.8 pp in 2025, again exceeding 0.5 pp.

Regarding the debt ratio, Malta's obligations remain well within the 60% of GDP ceiling. While the debt ratio is expected to increase from its 2023 level, projections show a buffer of approximately 10 pp below the 60% threshold by 2025.

The above provisions refer to the current EU fiscal rules. Additionally, Malta's fiscal policy is also subject to the provisions of the FRA, which requires that the general government's budgetary position must be in balance or surplus. Whilst the government's projections do not anticipate achieving this target in the near term, the FRA also provides that the budgetary rule is considered as respected if there is an annual adjustment in the structural budget balance of at least 0.5pp of GDP. The planned fiscal adjustments are consistent with this requirement. The FRA also provides

[40] More information on the new economic governance framework can be accessed here.

[41] The decision establishing that Malta is subject to an EDP can be accessed here.

for a debt rule, which requires the debt ratio to be below 60% of GDP or if it is higher, that it is being reduced towards this benchmark. With a debt ratio of around 50% over the forecast period, this requirement is being fulfilled.

The current period is one of transition, as fiscal planning shifts to align with the new framework's emphasis on expenditure control. EU Directive 2024/1265 on the requirements of national budgetary frameworks prescribes that Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with the same Directive by 31 December 2025.[42] Consequently, the FRA will need to be amended to incorporate the new framework into national legislation by the end of next year.

Fiscal Rules and Government Targets

DBP projections	2024	2025
Headline balance below 3% of GDP	4.0	3.5
Structural balance below 3% of potential GDP	4.0	3.3
Fiscal balance adjustment ≥ 0.5 pp of GDP	0.5	0.5
Structural primary balance adjustment ≥ 0.5 pp of GDP	0.7	0.8
Structural balance adjustment ≥ 0.5 pp of GDP	0.6	0.7
Net expenditure growth averaging ≤ 5.9%	6.4*	5.6
Debt ratio < 60% of GDP	49.5	50.1

Note: Green boxes mean adherence to the rules, whilst red means non-adherence to the fiscal rule.
* Not binding in 2024, but the Council Recommendation of 14 July 2023 on the 2023 National Reform Programme of Malta recommended that the nominal increase in net nationally financed primary expenditure in 2024 is limited to 5.9%.

COUNCIL'S CONCLUSIONS

42. **The MFAC endorses the MFIN's macroeconomic forecasts presented in the DBP while identifying upside risks to real GDP growth in 2024 and 2025, which are more pronounced in 2024.** The Council appraises that the macroeconomic projections for 2024 and 2025 prepared by the MFIN as part of the DBP 2025 lie within its endorsable range. According to its assessment, the upside risk for 2024 is primarily due to developments in the year's first half, whereby economic growth stands higher (6.0%) than the overall projection (4.9%). The implied notable slowdown in the year's second half in the Ministry's forecasts (3.8%) is not concomitant with the soft indicators data available by the cut-off date of this assessment. For 2025, the Council believes that economic growth could also turn out better than expected, especially from the domestic side.

43. **Regarding public finances, the Council notes that the fiscal trajectories for Malta as presented by the Government in the DBP are considered plausible and fall within the Council's endorsable range both when evaluated against**

[42] The Directive can be accessed here.

the Government's policies and the prevailing macroeconomic and fiscal 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 2024, particularly in compensation of employees and gross fixed capital formation, with possible spillovers over 2025. At the same time, the Council views positive risks for the government's revenue projections, supported mainly by the possibility of larger revenue from direct taxes. Combined with upside risks to GDP, these risks would translate into a smaller fiscal deficit than the MFIN projected in the DBP25 and a lower debt ratio in 2024 and 2025.

44. **In both 2024 and 2025, Malta's headline and structural fiscal balances are projected to remain above the thresholds of 3% of GDP and potential GDP, respectively. Consequently, Malta is expected to remain subject to a deficit-based EDP during this period. In accordance with the applicable fiscal rules, an annual minimum fiscal adjustment of 0.5 pp of GDP is required.** However, the government is targeting a structural effort of 0.7 pp in 2024 and 0.8 pp in 2025, thereby exceeding the prescribed minimum adjustment. It is important to note that the fiscal framework does not allow for compensatory adjustments across years; achieving a higher fiscal effort in one year does not permit a lower effort in subsequent years. As such, even if positive risks materialise in 2024, a minimum structural effort of 0.5 pp would still need to be achieved in 2025, given that the fiscal deficit is projected to remain above the 3% benchmark. This adherence is essential to comply with the EDP requirements. Adhering to these targets is critical for demonstrating a credible commitment to fiscal consolidation and ensuring progress toward correcting the excessive deficit within the stipulated timeframe.

45. **The Council also notes that the fiscal projections presented in the DBP imply compliance with the maximum growth in nationally financed net primary expenditure recommended by the COM, which constitutes the main fiscal surveillance indicator in the new economic governance framework.** According to the DBP, net expenditure is projected to increase by 6.4% in 2024 and 5.6% in 2025. The Council underscores the potential challenges in achieving the 2025 targets for net nationally financed primary expenditure growth. These challenges arise when the 2025 targets are considered in the context of the 2024 outturn, historical expenditure patterns, and the discretionary measures outlined in the Government's Budget for the current fiscal year. Scrutiny of expenditure developments during the year is thus warranted as the margin between the DBP target for 2025 of 5.6%, and the 5.9% ceiling set in the MTFSP leaves limited space for expenditure slippages.

46. **The Council also positively notes that Malta's debt-to-GDP ratio remains significantly below the EU average and is projected to stay well below the 60% threshold, maintaining a buffer of approximately 10 pp. This is contingent upon the realisation of the stock-flow adjustment (SFA) values, which have been volatile in recent years. At the same time, the positive risks identified by the Council for the fiscal deficit are expected to translate into debt dynamics.** Malta's relatively low debt ratio and its debt trajectory contribute positively to the sustainability of its fiscal position. From a long-term fiscal

sustainability point of view, in the context of demographic projections and their impact on the pension system, the Council commends the Government's Budget measure to increase the years of social security contributions, required to qualify for a full pension, from 41 to 42 for those born in 1976 or later.

COUNCIL'S RECOMMENDATIONS

47. Following this Assessment of the DBP 2025, the Council hereby recommends the following:

a. The need to transition from a reliance on domestic demand to export-led growth remains a pressing priority. Achieving productivity-driven growth will depend heavily on improvements in competitiveness, particularly through enhancements in labour productivity. Greater efforts are required to ensure Malta retains its capacity to expand export market shares across various economic sectors. Addressing skill gaps through education and training, fostering innovation and research, and advancing the twin transition towards digitalisation and environmentally sustainable business practices are critical enablers for improving organisational efficiency and labour productivity.

   The Council positively notes that initiatives to address these challenges have been announced, including the launch of a long-term economic vision. However, it cautions that these efforts should be expedited and implemented within the framework of a comprehensive strategy with concrete policy measures. Furthermore, budgetary measures, both as regards taxation and on the expenditure side, should be dove-tailed with this strategy to yield tangible policy outputs. Otherwise, Malta risks losing the competitive advantage it secured during the post-pandemic recovery period.

b. Given the expenditure path committed by the Government in the MTFSP, the Council emphasises the importance of prioritising expenditure policies that ensure the quality and sustainability of public finances. Specifically, it advocates for improving public spending efficiency and reallocating resources towards productive capital investment.

   In this context, the Council highlights that the current fixed energy price framework poses a significant risk to the attainment of the Government's fiscal targets and fails to incentivise energy efficiency habits. The Council recommends a more targeted approach that aligns with the Green Transition's overarching goals.

c. With Malta being subject to an excessive deficit procedure, the Council emphasises the importance of the Government adhering to its fiscal targets. Furthermore, it advises that any higher than projected revenue should be directed to accelerate fiscal consolidation and building fiscal space.

   Furthermore, the MFAC recommends that the government explores means of expenditure restraint and avoids inflating expenditure, particularly non-productive, to enable more space for fiscal adjustment in 2025.

APPENDIX

Table A.1: Exogenous assumptions

	Source	Publication	2023	2024	2025
Short-term interest rate (annual average)	**ECB**	**DBP25**	3.8	4.3	3.2
		DBP24	3.7	4.1	
Long-term interest rate (annual average)	**ECB**	**DBP25**	**3.7**	**3.5**	**3.3**
		DBP24	3.7	3.9	
USD/€ exchange rate (annual average)	**ECB & Consensus Economics**	**DBP25**	**1.081**	**1.087**	**1.109**
		DBP24	1.084	1.108	
STG/€ exchange rate (annual average)	**ECB & Consensus Economics**	**DBP25**	**0.87**	**0.855**	**0.855**
		DBP24	0.866	0.868	
Real GDP growth of main trading partners	**Eurostat & Consensus Economics**	**DBP25**	**0.8**	**0.8**	**1.0**
		DBP24	0.5	0.7	
Oil prices (Brent, USD/barrel)	**US Energy Information Administration (EIA) + Consensus Economics**	**DBP25**	**82.47**	**82.37**	**79.83**
		DBP24	84.27	84.18	

Source: MFIN

Table A.2: Macroeconomic variables 2022 – 2025 (%)

	Actual		Forecast		
	2022	2023	2024		2025
			DBP24	DBP25	DBP25
Real GDP components					
Private final consumption expenditure*	10.9	11.2	4.5	4.4	4.6
General government final consumption expenditure	0.4	2.9	2.8	8.6	1.9
Gross fixed capital formation	9.7	-18.2	5.5	4.5	5.5
Exports of goods and services	13.7	4.7	3.9	5.2	5.3
Imports of goods and services	18.5	-0.4	3.9	5.4	5.3
Real GDP	4.1	7.5	4.2	4.9	4.3
Contribution to real GDP growth					
Domestic demand (pp)	6.8	1.0	3.6	4.3	3.4
Inventories (pp)	-0.1	0.0	0.0	0.0	0.0
Net exports (pp)	-2.6	6.5	0.6	0.6	0.9
Deflators					
Private final consumption expenditure	5.3	6.1	3.5	3.0	2.2
General government final consumption expenditure	3.5	4.7	2.7	4.1	3.2
Gross fixed capital formation	5.4	6.4	1.6	1.6	1.9
Exports of goods and services	4.3	3.3	2.9	2.8	2.2
Imports of goods and services	4.2	3.4	2.7	2.7	2.0
GDP deflator	5.1	5.3	3.1	3.0	2.6
Labour market					
Employment (National Accounts definition -FTEs)	5.1	6.3	4.4	4.6	4.2
Unemployment rate (%) (LFS definition)	3.5	3.5	2.7	3.2	3.1
Nominal compensation of employees	9.2	8.5	8.9	9.2	8.6
Nominal compensation per employee	3.8	1.7	4.3	4.4	4.2
Labour productivity (real GDP per person employed)	-0.9	1.1	-0.2	0.3	0.1
Unit labour costs	4.8	0.5	4.6	4.0	4.1
Other macroeconomic variables					
Inflation rate (%) (based on the HICP)	6.1	5.6	3.7	2.5	2.1
Nominal GDP	9.4	13.2	7.4	8.1	7.0
Potential GDP	6.7	5.2	4.4	5.1	4.8
Output Gap	-2.2	0.0	-0.6	-0.1	-0.5

Note: Figures for 2022 and 2023 are actual, while figures for 2024 and 2025 are forecasts.
*Includes Non-Profit Institutions Serving Households (NPISH).

Source: MFIN and NSO

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

	Total Revenue	Total Expenditure	Fiscal Balance	Structural Balance	Gross Debt
2023	31.8	36.3	-4.5	-4.6	47.4
2024	32.8	36.9	-4.0	-4.0	49.5
2025	32.0	35.5	-3.5	-3.3	50.1

Source: MFIN and NSO

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

	Actual		Forecasts		
	2022	2023	2024		2025
			DBP24	DBP25	DBP25
Total revenue	**5,935.2**	**6,561.3**	**6,901.9**	**7,323.2**	**7,634.9**
Taxes on production and imports	1,778.1	1,943.5	2,161.1	2,189.0	2,353.1
Current taxes on income and wealth	2,318.3	2,514.0	2,636.2	2,793.4	2,892.4
Social contributions	990.6	1,067.7	1,124.4	1,129.2	1,203.4
Other revenue*	848.1	1,036.1	980.2	1,211.5	1,186.0
Total expenditure	**6,889.7**	**7,500.2**	**7,820.7**	**8,227.1**	**8,482.3**
Compensation of employees	1,834.7	1,944.2	2,137.8	2,261.9	2,328.5
Intermediate consumption	1,301.7	1,469.0	1,576.9	1,661.6	1,816.4
Social payments	1,539.0	1,654.4	1,749.2	1,794.8	1,889.0
Gross fixed capital formation	589.0	712.5	766.6	943.7	934.0
Subsidies	833.8	745.5	666.8	556.1	502.5
Other expenditure**	791.5	974.5	923.5	1,009.1	1,011.8
Fiscal balance	**-954.5**	**-938.9**	**-918.8**	**-904.0**	**-847.4**
Gross debt	**9,010.9**	**9,791.4**	**11,273.9**	**11,056.2**	**11,968.0**
Nominal GDP	**18,242.3**	**20,650.4**	**20,286.2**	**22,323.1**	**23,885.7**

Note: Figures for 2022 and 2023 are actual, while figures for 2024 and 2025 are forecasts.

Source: MFIN and NSO

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