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THE FISCAL RESPONSE TO THE COVID-19 PANDEMIC

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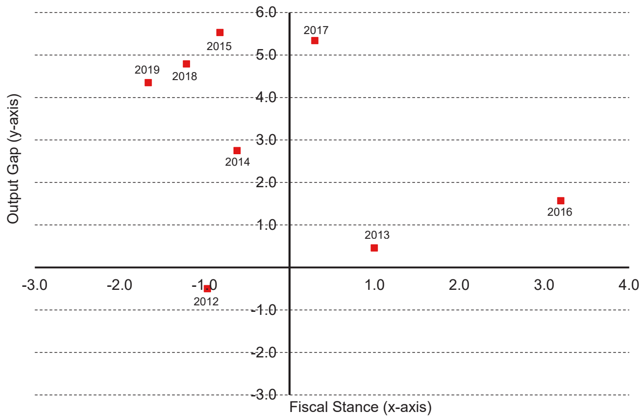
BOX 4: THE FISCAL RESPONSE TO THE COVID-19 PANDEMIC[1]

This analysis outlines the measures applied by the Maltese Government in response to the COVID-19 pandemic and assesses the impact of the pandemic on Malta's public finances.

Chart 1
FISCAL POLICY IN PRE-PANDEMIC TIMES



Sources: Authors' calculations.
Note: Markers in the bottom-left and top-right quadrants represent a countercyclical fiscal policy.

Fiscal policy before the pandemic

In the years prior to the pandemic, public finances improved significantly. Between 2012 and 2019, the headline balance-to-GDP ratio swung from a deficit to a surplus while the debt-to-GDP ratio declined by 25.9 percentage points to stand at its lowest since 1996. This was partly achieved on the back of strong economic growth, which boosted tax receipts. This period was also characterized by an element of expenditure restraint, as increases in the largest government expenditure items – compensation of employees and social benefits – were outpaced by growth in nominal GDP. Growth was supported by fiscal policy, which was expansionary in five out of the last eight years prior to the pandemic (see Chart 1).

In most years, the fiscal stance adopted by the Maltese government was quite significant as it amounted to at least one percentage point of GDP.[2] When accounting for the Bank's estimate of the output gap, fiscal policy was countercyclical in 2012, 2013, 2016 and 2017 as the fiscal stance acted counter to the output gap. By contrast, in 2014, 2015, 2018 and 2019 fiscal policy was pro-cyclical as the Government adopted an expansionary fiscal stance in these periods, even if economic activity was not subdued.

Fiscal policy after the pandemic

COVID-19 had a significant impact on public finances. The general government balance deteriorated from a surplus of 0.6% of GDP in 2019 to a deficit of 9.5% of GDP in 2020 and a deficit of 8.0% of GDP in 2021. Meanwhile, the debt-to-GDP ratio rose from 40.7% in 2019 to 53.4% in 2020 and 57.0% in 2021. This deterioration is due to a loss in tax revenue resulting

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[2] In this box, the fiscal stance represents the year-on-year change in the structural primary balance, i.e. the primary balance adjusted for the impact of the economic cycle and temporary government measures. The latter are defined as fiscal measures whose impact does not last for more than two years.

from lower economic activity and higher spending due to the introduction of pandemic-related support measures. These issues are discussed in detail below.

COVID-related support measures affecting the balance[3]

Government introduced several support measures to cushion the negative economic shock caused by the containment measures. These can be classified into four categories, depending on their stated function (see Table 1). This classification is in line with the definitions used by the Maltese Government in its Stability Programme and Draft Budget Plan. The first category consists of economic support measures, which aid households and firms

Table 1
COVID-19 FISCAL MEASURES AFFECTING THE BUDGET BALANCE
% of GDP [(1)]

Classification	Measures impacting budget balance	ESA Classification	Budgetary Impact 2020	Budgetary Impact 2021
Economic Support Measures	Wage supplement scheme, support to workers in quarantine, distribution of vouchers to households, reduction of stamp duty on property purchases and schemes to facilitate investment in teleworking systems.	Subsidies, indirect taxes	3.6	3.1
Social Measures	Additional social benefits to help working parents, the unemployed, persons with disabilities and persons classified as 'vulnerable' by the Superintendent of Public Health, extension of the In-work Benefit and a top-up of rent subsidies for low-income households.	Social Benefits other than in kind	0.1	0.0
Liquidity Support Measures	Interest rate subsidy on CGS loans, subsidised commercial electricity bills for firms and a scheme to support business undertakings to provide training and development of their workforce.	Subsidies	0.0	0.2
Health-related Measures	Cost associated with containment and treatment of the virus, testing, purchase of additional equipment, cleaning, cargo transportation, purchase and distribution of vaccines, other repatriation costs and the safe re-opening of schools.	Intermediate consumption, Social benefits in kind, Compensation of employees	1.2	0.9
Total Impact			**5.0**	**4.2**

Source: Authors' calculations.

(1) Calculations based on NSO *News Release* 037/2022 (published on 1 March 2022).

Note: Figures may not add up due to rounding.

3 The tax deferral scheme and the CGS are not covered in this assessment as these measures do not affect the budget balance. The former does not have an impact on the budget balance as the general government accounts are adjusted for accruals and hence consider deferred taxes as part of tax revenue earned in 2020 and 2021. Meanwhile, government guarantees do not affect the general government deficit unless they are called.

to minimise the impact of COVID-19 on industries and employment. The second category refers to social measures which are intended to provide additional assistance to vulnerable households. A third category of measures includes liquidity support to firms to bolster their working capital. The final set of measures reflects health-related expenditure.

Overall, measures amounted around 5.0% of GDP in 2020 and 4.2% of GDP in 2021. In both years, more than 70% of these measures were in the form of economic support measures, particularly through the wage supplement scheme. In fact, outlays on the latter amounted to around 3.0% of GDP in 2020 and to 2.3% of GDP in 2021. The scheme cost less in 2021 as for most of the year, support was determined by the declared loss in turnover compared with pre-pandemic times. By contrast, in 2020, the level of support was the same for each firm within the same industry. Other significant economic support measures include the vouchers issued to households and the temporary reduction in stamp duty on property purchases.

Health-related spending represents the second largest form of COVID-related spending, amounting to around 1.2% of GDP in 2020 and 0.9% of GDP in 2021. Outlays were higher in 2020, when large orders for testing and protective equipment were made. At the time, Government also incurred significant costs related to repatriation of travellers and the safe reopening of schools once containment measures were eased later on.

Increased spending on social measures amounted to around 0.1% of GDP in total, with most of these outlays incurred in 2020. This spending was largely attributed to the introduction of benefits to parents who stopped working while their children were taught from home. Meanwhile, overall spending on liquidity measures amounted to around 0.2% of GDP, with most spending taking place in 2021. This mainly reflects refunds to commercial rents and electricity bills and subsidised interest on CGS loans.

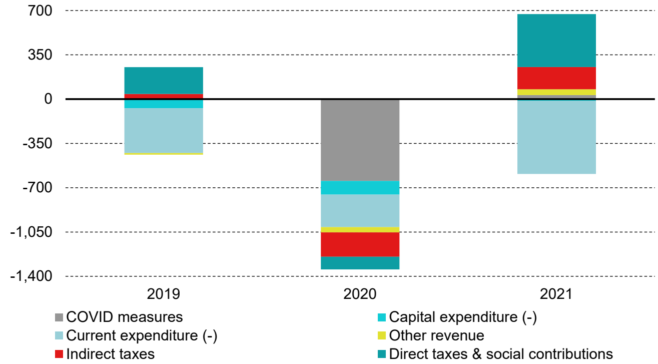
According to the European System of Accounts (ESA) methodology, the fiscal measures introduced are mainly classified as subsidies, social benefits and intermediate consumption. The largest category of expenditure is subsidies and mainly reflects the wage supplement scheme and the introduction of household vouchers. The second largest expenditure component is intermediate consumption, which includes most health-related spending. Spending on social benefits reflects outlays on social measures and some health-related expenditure classified as social benefits in kind. On the revenue side, the main measures are classified as indirect taxes and largely reflect the reduction in stamp duty on property purchases.

In 2020, the introduction of the abovementioned measures led to a €646.5 million deterioration in the public finances (see Chart 2). COVID-related measures continued to exert a deficit-increasing impact in 2021, albeit by slightly less than the previous year.

The impact of COVID-19 on tax revenue

Measures that restricted mobility led to a significant decline in economic activity that was especially pronounced in contact-intensive services industries such as tourism and retail. The contraction in economic activity resulted in lower inflows from indirect taxes, namely VAT, and taxes on corporations. When excluding the impact of COVID-19 measures, tax revenue in 2020 declined by €292.5 million (2.2% of GDP) compared with 2019 (see Chart 2). In 2021, this decline was completely reversed as a recovery in economic activity brought about a significant increase in direct taxes. Indirect taxes also increased, but remained below their pre-pandemic level, reflecting the partial recovery of tourist activity.

Chart 2
ANNUAL CHANGE IN FISCAL ITEMS
(year-on-year absolute changes in EUR)



Sources: National Statistics Office; Central Bank of Malta.
Notes:
- Revenue and expenditure items exclude the impact of COVID measures (which is shown separately).
- Expenditure items shown with negative values.
- 'Other revenue' includes recurrent revenue (namely sales and property income) and capital revenue.
- Data on COVID measures are accruals-adjusted and hence do not reflect the impact of tax deferrals.

Other issues affecting public finances

During 2020 and 2021, government expenditure not related to COVID measures also exerted a deficit-increasing impact. This is mainly due to higher current expenditure, and partly reflects spending on budget measures such as an increase in retirement pensions, the extension of school transport to households and additional outlays on cancer treatment. Outlays in heath treatment excluding COVID also increased. The increase in costs in 2021 also reflects one-off payments to the EU budget and backdated payments following the signing of collective agreements.

Capital spending also increased between 2020 and 2021, driven by outlays on domestically-financed infrastructural projects.

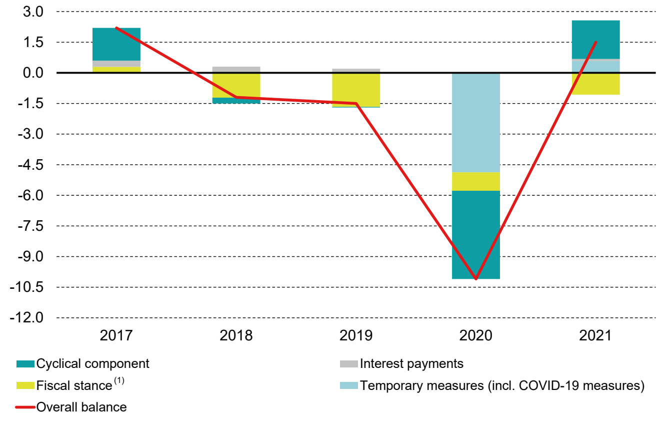
Overall impact on deficit and debt ratios

Chart 3 shows that changes in the fiscal balance in 2020 and 2021 were mostly driven by the implementation of support measures and cyclical developments. In 2020, extraordinary measures introduced during the pandemic account for around half of the deterioration in the deficit ratio. Another 40% of the change in the ratio was attributable to loss of revenue, through the cyclical impact, arising from the effects of COVID on economic activity.

In 2021, the decline in COVID-related measures as a share in GDP contributes around 40% of the narrowing of the deficit ratio. The cyclical component improved in 2021, owing to the partial closure of the negative output gap. Overall, however, it remained negative.

In the years prior to the pandemic, a declining share of interest payments in GDP contributed towards an improvement in the public finances. This trend was interrupted in 2020 as interest payments had a neutral impact. In 2021, interest payments exerted a small deficit decreasing impact.

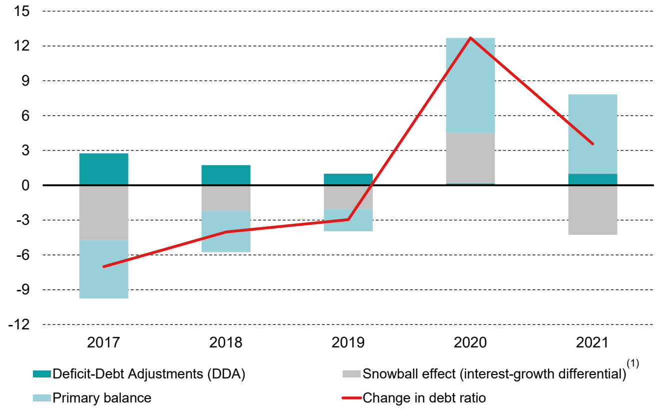
Chart 3
CONTRIBUTIONS TO CHANGE IN FISCAL BALANCE
(% of GDP; year-on-year changes)



Source: Authors' calculations.
(1) Fiscal stance excludes the impact of COVID measures in 2020 and 2021.

The underlying fiscal stance remained expansionary in 2020 and 2021, equivalent to around 1.0% of GDP in each year. This reflects the abovementioned increases in current and capital outlays. Fiscal policy thus remained countercyclical even after excluding COVID-related measures.

Chart 4
CONTRIBUTION TO CHANGE IN DEBT
(percentage points)



Sources: NSO; Central Bank of Malta.
(1) Difference between effective interest rate (interest payments at year t relative to debt outstanding at year t-1) and GDP growth.

In level terms, the stock of general government debt rose from €5,720.2 million in 2019 to €8,284.4 million by end-2021. Its ratio in GDP rose by 16.3 percentage points over this period (see Chart 4). This mainly reflects additional borrowing to finance the shortfall in public finances. Debt-increasing deficit-debt adjustments also contributed slightly to the increase in the ratio. Although the interest-growth differential contributed to an increase in the debt ratio in 2020, this was reversed in 2021 once economic activity recovered.

Comparison with COVID-19 support measures in the euro area

The size and composition of pandemic-related fiscal support measures was heterogeneous across euro area countries. In general, however, most countries introduced COVID-related measures in the form of subsidies to business in designated industries, job retention schemes, welfare payments to individuals and tax relief measures. Other measures include emergency spending to increase the capacity of health systems, the purchase of protective equipment and setting up testing and tracing systems.[4]

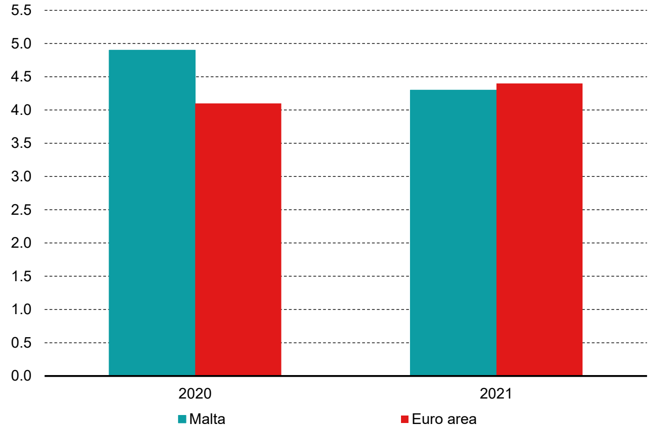


Chart 5
FISCAL MEASURES IN RESPONSE TO COVID-19 PANDEMIC
(% of GDP)

Sources: ESCB; authors' calculations.

Available estimates from the European System of Central Banks (ESCB) put the direct budgetary impact of COVID-19 measures in 2020 and 2021 at around 4.1% and 4.4% of GDP, respectively. Chart 5 compares own estimates for budgetary impact of COVID measures in Malta, with ESCB estimates for the euro area. Overall, the fiscal response to the pandemic in Malta was higher than the EA average. This is partly due to more generous assistance schemes. For instance, the level of assistance given out in Germany's "Kurzarbeit" short-term employment scheme was based on the reduction on employees' working hours. In contrast, the Wage Supplement Scheme in Malta gave out a flat benefit to applicants.

In the euro area, revenue-reducing measures (excluding tax deferrals) had a comparatively broader scope and included measures such as cuts in the standard VAT rate. In contrast, the Maltese Government sought to boost domestic consumption by expenditure-based measures, notably the voucher scheme.

[4] Several euro area countries also offered liquidity assistance to firms in the form of tax deferrals and state guaranteed schemes.