COMMISSION OF THE EUROPEAN COMMUNITIES

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RESTRICTED

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997 on the updated stability programme of Luxembourg, 2000-2004

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Committee set up by Article 114, the Council delivered an opinion, following its examination of the programme.

The first stability programme of Luxembourg covering the period 1999-2002 was submitted on 16 February 1999 and assessed by the Council on 15 March 1999[2]. According to the Regulation, the updated stability programmes, to be presented annually, may be examined by the Council in accordance with these same procedures. The first and second updates to the stability programme of Luxembourg were assessed by the Council on 13 March 2000 and 12 March 2001 respectively. The third update was submitted on 5 December 2001. The Commission services have carried out a technical evaluation of this updated programme, which warrants the following assessment:

> The 2001 update of the stability programme of Luxembourg covers the period 2000-2004. The update confirms that a sound management of public finance is the highest priority for the government; the budgetary strategy is based on three major principles enacted in the coalition agreement: the general government balance should continue to be in net lending position, the central government budget should remain in balance while the central government ordinary expenditure should increase less than the overall budget.
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> Real GDP growth was particularly strong in 2000, reaching 8.5%, driven by dynamic domestic demand and by buoyant exports. From early 2001, a slow down in activity was entailed by external developments; however, the negative impact of external trade on activity was buffered by domestic demand, still dynamic partly as a result of the effects on private consumption of the fiscal reform which entered into force from 1 January 2001; real GDP growth is expected to decelerate to 3.9% in 2001. For 2002, the 2001 update expects an acceleration in real GDP growth, to 5.3%, well above the projection included in the Commission Autumn forecasts, mainly resulting from an assumption of faster export performance. Employment, which has been increasing significantly until the second half of 2001, is expected to decelerate afterwards, with limited effects on the unemployment rate, but reducing the inflow of frontier workers. Inflation surged in 2000 under the impact of rising oil prices; it has been decelerating throughout 2001, the rise in the HICP slowing from 4% at the end of 2000 to 1.4% in November 2001. However, wages have accelerated significantly, partly due to the indexation process; they are expected to moderate somewhat in the coming months. Practically no difference exists between the forecasts for 2003 and 2004, as real GDP growth is generally expected to resume rates around 5%.

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1 OJ L 209, 2.8.1997
2 OJ C 124, 5.5.1999

The general government balance was in comfortable surplus for years in Luxembourg and reached 6.2% of GDP in 2000, 3.2 percentage points above the projections of the 2000 update of the stability programme. Buoyancy in tax revenues originated the surplus, more than compensating significant increases in expenditure. A slowdown in tax revenues, entailed by decelerating activity as well as by the effects of the fiscal reform, is expected to contribute to lower the government surplus to 4.1% of GDP in 2001, and 2.8% of GDP in 2002; it should resume a level over 3% of GDP in 2003 and 2004. Given that a comfortable budgetary surplus is secured throughout the whole period covered by the update, Luxembourg fully complies with the provisions of the Stability and Growth Pact. Moreover, the budgetary projections included in the 2001 updated stability programme provide a comfortable margin for not breaching the 3% of GDP deficit threshold in the period 2000 to 2004.

The tax reform is meant to implement cuts in the personal income tax in two steps, at the beginning of 2001 and 2002, as well as cuts in the corporate tax in 2002, for a total ex ante cost amounting to 3.1% of GDP. However, the decline in the government surplus in 2001 and 2002 is expected to be to a large extent due to strong growth in central government expenditure, including an important increase in public investment. A specific feature to Luxembourg is the financing of such important investments through special investments funds to a share around 70%.

While the March 2001 Council recommendation as well as the Broad economic policy guidelines both highlighted the necessity for Luxembourg to monitor closely fast growing current expenditure, central government current expenditure continued to grow rapidly in 2001 and is expected to accelerate to 10.5% in 2002, faster than total budget expenditure (9 ½%), which, moreover, does not seem to be totally consistent with the third main principle ruling the budgetary strategy of Luxembourg. Changed cyclical conditions and less pressing inflationary risks seem to have lessened to some extent the short-term necessity of budgetary restraint. However, as underlying inflation has been accelerating throughout 2001, a more cautious approach would still be advisable. Moreover, in a longer term perspective and despite a practically non-existing government debt, monitoring expenditure might be commended in the event that strong activity in main sectors should moderate.

Luxembourg is in a good position to meet the budgetary consequences of the ageing population. However, this favourable assessment is based upon a large increase in the number of cross-border workers and high rates of real GDP growth up to 2050.

For the first time, the 2001 updated stability programme gives information concerning the government debt, which is at a very low level. Some clarification concerning the importance of the accumulated reserves generated by the recurrent surpluses recorded for many years would be welcome.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the Stability Programme update of Luxembourg and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997 on the updated stability programme of Luxembourg, 2000-2004

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[3], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION :

On [22 January 2002] the Council examined the 2001 update of the stability programme of Luxembourg, which covers the period 2001-2004.

The Council notes that sound management of public finances continues to be the guiding principle of the 2001 update; the budgetary strategy of the updated programme is based on continued net lending position of general government, a balanced budgetary position of central government and rise in ordinary expenditures lower than the overall budget.

In 2000, real GDP growth was particularly strong, at 8.5%, driven by dynamic domestic demand and buoyant exports; in 2001, despite the general economic slowdown entailed by external factors, economic growth in Luxembourg remained relatively robust at around 4%; real GDP growth is projected to accelerate in 2002 and remain strong in the following two years covered by the programme.

The Council notes that the general government surplus reached 6.2% of GDP in 2000, clearly above that projected in the 2000 update, resulting from buoyant tax revenues which more than compensated significant increases in expenditure; decelerating activity and the effects of the tax reform are expected to lower the government surplus in 2001; overall, the projected budgetary surplus over the period of the programme is somewhat higher than in the 2000 update, due to better initial conditions and improved growth prospects from 2003 onwards. The public finance projections presented in the 2001 update to the stability programme of Luxembourg are thus in compliance with the requirements of the Stability and Growth Pact as

3 OJ L 209, 2.8.1997

the government's budgetary position remains close to balance or in surplus all along the period covered.

The Council notes that current expenditures of central government continued to grow rapidly in 2001 and are expected to accelerate to 10.5% in 2002, faster than the total budget expenditure; although the situation of public finance in Luxembourg is extremely sound, the rigidity of current expenditure acknowledged by the update itself might become a factor of risk should growth slow significantly in the medium term.

The Council commends the continued orientation of government expenditure towards investment spending aimed at improving infrastructure, the technological level of activities and human capital; it welcomes the reduction of the tax burden through the implementation of tax reform while maintaining sound budgetary position.

The Council notes that Luxembourg is in a good position to meet the budgetary consequences of ageing population; however, readiness to adapt policy in case of adverse developments is required. The Council notes the very low level of government debt ratio in Luxembourg, resulting from healthy public finances and budgetary surpluses over a number of years.