COMMISSION OF THE EUROPEAN COMMUNITIES

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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, 2001-2005

(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 this Council and the Commission by 1 March 1999. In accordance with Article 5 of the 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 1998-2002 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 of the stability programme of Luxembourg were assessed by the Council on 13 March 2000 and 12 March 2001 respectively. The 2001 update covered the period 2000-2004 and was examined by the Council on 15 January 2002[3]. The 2002 update of the stability programme of the Luxembourg, which covers the period 2001-2005, was submitted on 17 January 2003. The Commission services have carried out a technical evaluation of this updated programme, namely taking into account the Communication from the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[4]. This evaluation warrants the following assessment.

> The 2002 update of the stability programme of Luxembourg incorporates the 2003 budget law that was approved by Parliament on 17 December 2002. The update does not fully comply with the Code of Conduct in a number of respects, in particular as regards the lack of a detailed breakdown of revenue and expenditure of general government and the absence of a sensitivity analysis. The update confirms that a sound management of public finance has the highest priority; the budgetary strategy is based on three major principles: the general government balance should be in a net lending position, the central government budget should remain in balance, while the growth of current expenditure should not exceed the growth of total expenditure. Adherence to these principles should ensure that the growth of government spending in the medium term would be compatible with the rate of economic growth.
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> Real GDP growth was particularly strong in 2000, reaching 8.9%, driven by dynamic domestic demand and by buoyant exports. In 2001, real GDP growth slowed down considerably to 1%, primarily due to weak export growth. The negative impact of external trade was cushioned by still buoyant domestic demand. Real GDP growth is expected to slow down further to no more than 0.5% in 2002 reflecting continued weakness of exposed sectors as well as a slowdown in domestic demand. According to the cautious macro-economic scenario underlying the stability programme update, which assumes a somewhat more muted recovery of real GDP growth than in the

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[1] OJ L 209, 2.8.1997
[2] OJ L 209, 5.5.1999
[3] OJ.2002/C/33 22.1.2002
[4] COM (2002) 668 final, 27.11.2002.

Commission Autumn 2002 forecast, economic growth is expected to pick up only gradually to around 3% in 2005, reflecting among other things a muted projected upturn in the financial services sector, which accounts for around a quarter of total value added. In 2003 and 2004, real GDP growth in the stability programme projections is somewhat weaker than in the Commission forecast, reflecting the use of cautious assumptions on the strength of the expected economic recovery. Employment growth is expected to slow down significantly as well, following movements in activity with a lag, while CPI is expected to moderate in response to weak activity, averaging slightly below 2% in 2003-2005.

The stability programme envisages the nominal general government budget balance to have deteriorated dramatically in 2002, by no less than 6.4 percentage point of GDP to a deficit of 0.3% of GDP. This sharp deterioration is the result of a slight reduction in the revenue ratio, largely due to the effects of the tax reform coinciding with a sharp economic slowdown, coupled with a substantial increase in the expenditure ratio. It is estimated that in 2002 the tax reform resulted in a combined reduction of taxes on households and businesses of approximately € 510 million (around 2½% of GDP) compared to the previous year. According to the stability programme the ratio of total expenditure to GDP will increase from 40.9% to 47.0% in 2002. Around 2 percentage points of the total increase in the expenditure ratio by around 6 percentage points in 2002 is a base effect reflecting the one-off impact of a net purchase of non-produced non-financial assets in 2001. However, the remainder of the substantial increase in the expenditure ratio in 2002 is due to a high growth rate of total general government expenditure, estimated at around 11%, reflecting both strong public investment, substantial increases in family allowances and pensions, and an estimated increase in nominal government consumption by around 9%.

The general government deficit is expected to remain at 0.3% of GDP in 2003, before deteriorating slightly in 2004 to a deficit of 0.7% of GDP and then to improve somewhat in 2005 to a position close to balance. In the period 2003 to 2005 the income and expenditure ratios are expected to first stabilise and then decline slightly. Over the same period, the growth rate of total general government nominal expenditure would moderate substantially, to around 4% in 2003 and 2½% in 2005. However, the stability programme is not very explicit on how the deceleration of current expenditure would be achieved. In principle, the availability of substantial reserves could help mitigate increases in the expenditure ratio, but the programme does not provide details on possible relevant operations of special funds over the forecast horizon.

The deterioration of the general government balance is for the largest part accounted for by central government. Central government is expected to register a deficit of around 2% of GDP in 2002 and 2003, a very marked deterioration vis-à-vis the surplus of 2.6% of GDP attained in 2000. This is to a large extent due to the substantial reduction of tax revenue in the wake of the tax reform, as well as lower tax revenues due to the lagged impact of the marked slowdown in activity. The central government deficit is even expected to widen further to 2.8% of GDP in 2004 and 2005. The budget balance of local government is projected to have a slight deficit in 2002-2005, while surpluses in social security would compensate for the largest part of the deficit in the other two sectors of general government. However, the expected relatively favourable development in the surplus of social security funds seems somewhat at odds with the projected continued weakening of employment growth. The cyclically adjusted general government balance is also expected to deteriorate markedly in 2002, but to remain in surplus over the remainder of the projection horizon.

In view of the severity of the economic slowdown and given the fact that the nominal general government balance is expected to reach a position close to balance in 2005, while the underlying budget balance is expected to remain positive over the horizon covered by the stability programme, Luxembourg complies with the provisions of the stability and growth Pact.

However, risks to the outlook for economic growth and public finances appear skewed to the downside. This underlines the desirability of a cautious approach. The January 2002 Council opinion[5] as well as the Broad Economic Policy Guidelines highlighted the necessity for Luxembourg to monitor closely fast growing current expenditure, in particular of central government, in the event that economic activity should moderate. The stability programme update expects current expenditure to decelerate over the horizon covered by the programme. However, since total nominal general government expenditure growth in 2002 is estimated to have grown very rapidly (at slightly more than 11%), while the ratio of total general government expenditure to GDP rose markedly in that year and is forecast to decline only moderately in the period 2003-2005, the projections in the stability programme seems to encompass only partially the recommendation of expenditure restraint in the Broad Economic Policy Guidelines. Should economic growth slow down to a rate below what is currently envisaged, additional measures might be needed to adjust spending levels and thus ensure that a budgetary position close to balance or in surplus would be achieved and maintained in the medium term.

The stability programme gives information concerning the government debt, which is expected to gradually decline from the already very low level of 5.1% of GDP in 2002 to 2.9% of GPD in 2005. Some further clarification would be welcome concerning accumulated reserves generated by the surpluses achieved in previous years, the dotations to special funds and the way these relate to changes in the level of the debt.

Luxembourg is in a good position to meet the budgetary consequences of the ageing population. However, the sustainability of public finances is very sensitive to developments as regards the number of cross-border workers and rates of real GDP growth. The programme recognises the need for corrective measures in the event of a less favourable scenario, and also draws attention to efforts to reform the tax system with a view to enhancing the attractiveness of third pillar pension schemes.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the updated stability programme of Luxembourg and is forwarding it to the Council.

[5] OJ.2002/C/33 22.1.2002

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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, 2001-2005

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[6], 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 [7 March 2003] the Council examined the updated stability programme of Luxembourg, which covers the period 2001-2005. The programme does not fully comply with the requirements of the Code of Conduct on the content and format of the programmes endorsed by the ECOFIN Council on 10 July 2001. The programme partly conforms with the recommendations of the BEPGs.

In 2002, real GDP growth decelerated markedly to an estimated 0.5%, from 1.0% in 2001, which is well below the forecast included in the 2001 stability programme. The slowdown is to a large extent due to adverse developments in financial services, which accounts for around a quarter of total value added. On the basis of a cautious macro-economic scenario, which assumes a somewhat more muted recovery of economic activity than in the Commission Autumn 2002 forecast, real GDP growth is expected to pick up only gradually, to around 3% in 2005.

The Council notes that government finances deteriorated markedly in 2002 as revenues decelerated in response to the combined impact of the tax reform and the economic slowdown, while expenditure growth remained very strong. Consequently, the general government budget balance is expected to show a deficit of 0.3% of GDP in 2002, a sharp deterioration compared to the large surplus of 6.1% of GDP in 2001. The general government balance is projected to remain in deficit by 0.3% of GDP in 2003, to deteriorate slightly further in 2004 to a deficit of 0.7% of GDP, and to reach a position close to balance in 2005, with a slight nominal deficit of 0.1% of GDP. The underlying general government balance is expected to remain positive over the horizon covered by the stability programme. Consequently, the Council considers that Luxembourg continues to be in conformity with the requirement of the stability and growth pact to reach a budgetary position ~~of close to~~ balance or in surplus in the medium term.

[6] OJ L 209, 2.8.1997

The Council notes that sound management of public finances continues to be the guiding principle of the 2002 update; the Council welcomes the main elements of the budgetary framework currently in place, which inter alia encompasses the use of cautious macro-economic projections as the basis for budgetary policy, as well as the principle to let net public sector lending be positive, to achieve a balanced budget for central government, and not to let the rise in current expenditure exceed the growth of total expenditure. The Council welcomes the reduction of the tax burden through the implementation of tax reform while aiming for a sound budgetary position in the medium term; in this context it encourages a future government to adhere to real expenditure ceilings that are compatible with achieving a budgetary position close to balance or in surplus in the medium term.

However, the Council expresses some concern over the rapid deterioration of the budget balance of the central government, which only accounts for part of the general government sector. The balance of central government still was in surplus by 2.6% of GDP in 2001 but is projected to register a deficit of 2.2% of GDP in 2002 and of 2.1% of GDP in 2003, while the central government deficit is expected to deteriorate further to 2.8% of GDP in 2004 and 2005. The Council notes that this is partly due to revenue shortfalls in response to the economic slowdown, while central government expenditure is projected to increase rapidly; although the starting position of public finances in Luxembourg is extremely sound, a continued fast increase of current expenditure might become a factor of risk should economic growth in the medium term slow significantly.

On the basis of current policies, the Council considers that public finances in Luxembourg are in a good position to meet the projected costs of ageing population. However, the Council notes that the assessment of the sustainability of public finances in Luxembourg is very sensitive to developments as regards the number of cross-border workers. The Council considers that the commitment to sustain a balanced budget position in coming years is broadly appropriate in light of the projected budgetary impact of ageing populations, and welcomes measures to improve the attractiveness of third pillar private pensions.