THE GOVERNMENT
OF THE GRAND-DUCHY OF LUXEMBOURG
Ministry of Finance

14th UPDATE OF THE LUXEMBOURG STABILITY AND GROWTH PROGRAMME 2013-2016

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I. OVERALL POLICY FRAMEWORK AND OBJECTIVES

The 14th update of the stability programme (SGP) has been drawn up for the 2013-2016 period. It falls within a difficult macroeconomic context. The economy of the eurozone remains mired in a recession in 2013. The financial crisis and the sovereign debt crisis have been contained by the determined implementation of stabilisation policies whilst the materialisation of a “catastrophic” scenario, such as a collapse of the eurozone has been averted. Nevertheless, the crisis will have significant ramifications on the functioning of our economies and in particular on the functioning of financial markets, of which the effects on long-term growth remain uncertain at this stage.

In Luxembourg, the crisis has reduced the growth potential by half. Weak growth and the rise in unemployment have reduced the budgetary margin of manoeuvre. The financial sector, the “engine” of Luxembourg growth, has proven to be very resilient in response to the crisis. Nevertheless, numerous stabilisation measures undertaken since 2008 and the international reforms of the financial architecture have and will continue in the future to have wider consequences for the development of the financial industry on a global scale and hence the Luxembourg financial sector, which consequently has to continue to adapt to this new environment.

In 2009-2010, the Government used its budgetary margin of manoeuvre to implement a fiscal policy rigorously targeting macroeconomic stabilisation and protecting the vulnerable segments of the population against the negative effects of growth. Confronted with a sustained economic crisis and keen to avoid an excessive structural deterioration of public finances, the Government has been implementing a prudent budgetary consolidation policy since 2011.

In 2013, the general government budgetary balance is estimated at -341 million euros, i.e. -0.7% of GDP. The structural balance amounts to +0.7% of GDP, i.e. an improvement of 0.3 percentage points in relation to 2012. It is therefore foreseen that Luxembourg will - in 2013 - meet its medium-term objective of a structural balance of +0.5% of GDP. The stabilisation of the nominal budgetary balance and the underlying improvement of the structural balance particularly reflect the implementation of a package of consolidation measures, the impact of which is estimated at 952 million euros (2.1% of GDP) compared to a scenario at unchanged policies.

In 2014, it is foreseen that the general government budgetary balance will reach -270 million euros, i.e. -0.6% of GDP. The structural balance will slightly deteriorate and reach +0.6% of GDP. Despite this slight deterioration, Luxembourg will continue to adhere to its medium-term objective. The stabilisation of the budgetary situation from both a nominal and a structural point of view reflects, on the one hand, the improvement of the economic scenario and, on the other hand, confirms the lasting effects of the budgetary consolidation measures decided in 2012 and 2013.

However, from 2015 onwards, the trend towards the stabilisation of the fiscal situation will be reversed by the entry into force of a change in VAT taxation on telecommunications, broadcasting and electronic services . From 2015, these VAT revenues will be assigned to the Member States' budgets in accordance with the principle of residence of consumers, whereas until 2015, the rule is based on the location of the service provider. The negative impact of this change on public revenues is estimated at 700 million euros (1.4% of GDP) based on a scenario at unchanged policies. In a bid to partially offset this shortfall and in order to mitigate the negative consequences on the budgetary balance, the Government has already announced an increase in VAT with effect from 1 January 2015, as part of a broader fiscal reform.

Consequently, the SGP foresees a general government deficit amounting to 650-680 million euros or -1.3% of GDP in 2015-2016. The corresponding structural balance will amount to -1.1% of GDP in 2016, i.e. a difference of 1.5 percentage points in relation to the medium-term fiscal objective. In addition to the VAT increase in 2015, the Government will also have to specify additional budgetary consolidation measures with a structural impact of 1.5% of GDP on the general government budgetary balance in order to return to an adjustment path compatible with the provisions of the Stability and Growth Pact and in order to ensure a rapid return to its medium-term objective in 2016 or at the latest in 2017.

In this context, it should also be noted that the Government has furthermore announced a reform of the budgetary framework. This reform will be implemented in different stages. The first stage, which aims in particular to transpose into Luxembourg law the "Fiscal Compact" as well as a number of elements of the "six-pack", will enter into force on 1 January 2014.

In 2013, public debt will amount to 10.9 billion euros, i.e. 23.8% of GDP. It will increase over the course of the 2014-2016 period to reach 27.9% of GDP in 2016. In April 2013, the Government announced its intention to sell its equity stake in BGL BNP Paribas in the short to medium term, provided the conditions under which such a possible disposal may take place are acceptable to the Government. In the event of a successful disposal of this stake, the debt incurred to finance the acquisition of the stake in 2008 can be repaid, reducing public debt by 4.5% of GDP. In this context, it should be recalled that the Luxembourg State also has stakes in commercial and non-commercial entities valued at approximately 10% of GDP.It should also be pointed out that the social security surpluses are transferred to a reserve fund which currently amounts to 27.5% of GDP.

It should be noted that the reform of the pension system, which entered into force on 1 January 2013, contributes to the viability of public finances by significantly reducing public expenditure in relation to ageing and, hence, also reducing implicit liabilities compared to a scenario at unchanged policies.

The Government has furthermore undertaken additional reforms with a positive impact on public finances which notably include a modification of the automatic wage indexation mechanism as well as a reform of the civil service and of the early retirement-solidarity scheme.

PUBLIC FINANCES	2012			2013			2014			2015			2016		
	bln euros	% of GDP	rate of change, %	bln euros	% of GDP	rate of change, %	bln euros	% of GDP	rate of change, %	bln euros	% of GDP	rate of change, %	bln euros	% of GDP	rate of change, %
TOTAL REVENUES	**18,725**	**42,1**	**5,7**	**19,520**	**42,6**	**4,2**	**20,430**	**42,7**	**4,7**	**21,051**	**42,5**	**3,0**	**22,099**	**42,8**	**5,0**
of which:															
Taxes on production and imports ("indirect" taxes)	5,512	12,4	9,5	5,791	12,6	5,1	6,034	12,6	4,2	5,937	12,0	-1,6	6,163	11,9	3,8
of which : VAT e-commerce	0,719	1,6	31,7	0,810	1,8	12,7	0,860	1,8	6,2	0,214	0,4	-75,1	0,226	0,4	5,6
Current taxes on income, wealth, etc ("direct" taxes)	6,280	14,1	4,6	6,638	14,5	5,7	6,966	14,6	4,9	7,331	14,8	5,3	7,726	14,9	5,4
Social contributions	5,318	12,0	4,6	5,503	12,0	3,5	5,764	12,1	4,7	6,033	12,2	4,7	6,358	12,3	5,4
TOTAL EXPENSES	**19,082**	**43,0**	**7,2**	**19,861**	**43,3**	**4,2**	**20,700**	**43,3**	**4,2**	**21,705**	**43,8**	**4,9**	**22,783**	**44,1**	**5,0**
of which:															
Public investment	1,721	3,9	8,7	1,555	3,4	-9,6	1,585	3,3	1,9	1,659	3,4	4,7	1,686	3,3	1,6
Social payments	9,007	20,3	6,6	9,495	20,7	5,4	9,974	20,9	5,0	10,420	21,0	4,5	10,987	21,3	5,4
Intermediate consumption	1,726	3,9	13,0	1,767	3,9	2,4	1,817	3,8	2,9	1,900	3,8	4,5	2,000	3,9	5,3
Compensation of employess	3,591	8,1	5,6	3,775	8,2	5,1	3,986	8,3	5,6	4,192	8,5	5,2	4,364	8,4	4,1
GENERAL GOVERNMENT BALANCE	**-0,357**	**-0,8**		**-0,341**	**-0,7**		**-0,270**	**-0,6**		**-0,654**	**-1,3**		**-0,684**	**-1,3**	
Central government balance	-1,155	-2,6		-1,024	-2,2		-0,875	-1,8		-1,181	-2,4		-1,136	-2,2	
Local government balance	0,041	0,1		-0,002	0,0		0,008	0,0		-0,009	0,0		-0,008	0,0	
Social government balance	0,757	1,7		0,687	1,5		0,597	1,2		0,537	1,1		0,459	0,9	
STRUCTURAL BALANCE		**0,4**			**0,7**			**0,6**			**-0,3**			**-1,1**	
GROSS DEBT	**9,231**	**20,8**		**10,903**	**23,8**		**12,403**	**25,9**		**13,403**	**27,1**		**14,403**	**27,9**	

MAIN MACROECONOMIC INDICATORS	2012	2013	2014	2015	2016
GROWTH					
Real GDP (in %)	0,3	1,0	2,2	1,7	3,4
Nominal GDP (in %)	4,2	3,2	4,4	3,5	4,4
Nominal GDP (level, in bln euros)	44,426	45,831	48,828	49,502	51,682
PRICE DEVELOPMENTS					
Inflation NICP (in %)	2,7	1,9	1,8	2,8	2,1
LABOUR MARKET DEVELOPMENTS					
Employment (growth, in %)	2,1	1,7	1,3	2,3	1,9
Unemployment rate (ADEM definition, in %)	6,1	6,7	6,8	6,6	6,5

***Note**: The Government maintains its commitment to reach its medium-term fiscal objective of a structural surplus of 0.5% of GDP in 2016 or, at the latest, 2017. Besides the measures announced in the present programme, additional budgetary consolidation measures will be specified by the Government emerging from the May 2014 general elections in order to reach this objective.*

II. ECONOMIC OUTLOOK AND MACROECONOMIC FORECASTS

II.1. The economic outlook in 2013

Following real GDP growth of 0.3% in 2012, economic prospects remain sluggish in 2013 with an estimated real GDP growth of 1.0%. This growth rate remains well below the levels observed before the outbreak of the crisis in 2008 (+5.0% on average between 1995 and 2007). The persistence of this trend is due to several factors, in particular:

- global economic growth which is less dynamic than foreseen;
- uncertainties surrounding growth outlook in Europe (the European Commission is foreseeing a growth rate of -0.3% in the eurozone in 2013);
- uncertainties linked to the effects on the real economy of the restructuring of the financial architecture in Europe.

The slight recovery in growth in Luxembourg in 2013 can thus be explained mainly through domestic demand and a positive change in inventories.

Furthermore, the central scenario of the SGP is based on the assumption of an orderly resolution of the European sovereign debt crisis as well as a stabilisation of the economic and financial situation of the “peripheral” countries.

Inflation (national price index, NICP) will level off in 2013, dropping from 2.7% in 2012 to 1.9% in 2013, due in particular to the dampening effect of a modification to the automatic wage indexation mechanism introduced in 2012 and a moderation in administered prices. The less economic recovery and a less pronounced upward trend of oil prices have also contributed to this drop.

As a result of a dynamic domestic financial sector (despite contrary trends elsewhere in Europe), job creation continues to show a positive trend with a total domestic employment growth rate of 1.7% in 2013 following an increase of 2.1% in 2012. However, the unemployment rate continues to increase, going from 5.4% in 2012 to 5.9% in 2013, according to the Eurostat harmonised definition. The rise in unemployment despite a relatively strong growth in domestic employment suggests that the labour market is characterised, at least partially, by a mismatch between labour supply and demand.

II.2. Macroeconomic forecasts: international environment

The present SGP update is based on the common external assumptions published in the European Commission’s winter forecast of 22 February 2013. In 2013, economic growth in the EU reaches 0.1% while the eurozone remains in recession (-0.3%). In 2014, both the EU and the eurozone will return to growth: 1.6% for the EU and 1.4% for the eurozone. At the end of the 2015-2016 period, it is assumed that the eurozone will peak with a growth rate of 2.0% in 2015, followed by a slight drop in 2016 with a growth of 1.6%.

Furthermore, the SGP is based on the assumption of easing conditions in international financial markets, developing along a positive trajectory under the assumption of the peak of the business cycle being reached at the end of the forecast period.

Oil prices and euro/US dollar exchange rate developments are subject to a high level of uncertainty. For the purposes of the SGP, the following technical assumptions have been adopted: oil prices have been fixed at USD 108.6/barrel for “Brent” crude and the euro/US dollar exchange rate varies between 1.28 and 1.30 over 2014-2016.

Taking into account subdued macroeconomic conditions and limited risks of short-term inflation, interest rates will gradually increase only from 2015 onwards with short-term interest rates reaching 2.0% in 2016 (from 0.2% in 2013-2014) and long-term interest rates reaching 3.5% in 2016 (from 3.0% in 2013-2014).

II.3. Medium-term macroeconomic forecasts 2014-2016

Taking into account international assumptions outlined above, growth in Luxembourg is gradually improving: 2.2% in 2014, 1.7% in 2015 and 3.4% in 2016. The corresponding nominal growth rate will reach 4.4% in 2014, 3.5% in 2015 and 4.4% in 2016.

The potential growth of the Luxembourg economy is estimated at 1.6% while during the early 2000s it was still estimated at 3.5-4%. This implies that the SGP is based on a scenario that is characterised, like the economy of the eurozone, by a return to a cycle peak at the end of the forecast period (on the technical assumption of a rapid closing of the output gap). The slight drop in growth occurring in 2015 is due to the inclusion of the change in regime of vVAT on telecommunications, broadcasting and electronic services.

The growth is fuelled by a strong rebound in exports (from 4.8% in 2014 to 6.3% in 2016) and by internal consumption, including public consumption.

Employment will grow by 1.3% in 2014, 2.3% in 2015 and 1.9% in 2016. Following a peak of 6.1% in 2014, the unemployment rate should gradually drop to reach 5.8% in 2016.

Over 2014-2016, inflation will show a slight downward trend in 2014 before rebounding to 2.8% in 2015 as a result of the increase in value-added tax rates. Inflation is expected to revert to a level of 2.1% in 2016.

It should be noted that pursuant to the legal provisions in force and in accordance with the Government decision of December 2011, an index adjustment of wages will be applied in October 2014 before a return to the usual system from 1 January 2015 onwards. According to the central scenario adopted in the SGP, the following index adjustment should become due in February 2016.

It should also be noted that the medium-term forecast is based on the assumption of an absence of a structural shock in the financial sector and of a stabilisation of the sovereign debt crisis. In addition, the forecast is based on the the absence of a significant drop in financial activity. Employment in the financial sector is thus assumed, after a weak growth in recent years (-0.7% in 2010, 1.5% in 2011, 1.7% in 2012 and 2013), to regain more sustained growth rates (1.9% in 2014, 2.7% in 2015, 3.4% in 2016).

III. GENERAL GOVERNMENT BALANCE AND PUBLIC DEBT

III.1. Policy strategy

The economic and financial crisis has led to a deterioration of public finances in Luxembourg. Despite this deterioration, Luxembourg has maintained a budgetary safety margin in relation to the reference value of 3% of GDP foreseen in Article 126 of the TFEU, and it has also maintained its public debt at a relatively low level in absolute terms well below the maximum debt threshold of 60% of GDP, asforeseen by the Stability and Growth Pact.

In 2012 and 2013, the implementation of a series of budgetary consolidation measures has contributed to stabilise the nominal deficit of general government and to improve the underlying structural deficit. The impact of the measures adopted in 2013 amount to 2.1% of GDP in relation to a scenario at unchanged policies, enabling Luxembourg to reach its medium-term fiscal objective from 2013 onwards. Despite a slight deterioration of the structural balance in 2014, it is foreseen that Luxembourg will also reach its medium-term fiscal objective in 2014.

Nevertheless, the economic and financial crisis has weakened the state of public finances and Luxembourg is facing a series of challenges of a structural nature:

- the decrease in potential growth in the wake of the economic and financial crisis implies a structural reduction in the growth rate of public revenues;
- moreover, the high degree of openness of the Luxembourg economy and its specialisation in financial services implies that public revenues are subject to very high volatility;
- public expenditure is sticky downwards and a significant part of public expenditure is characterised by “autonomous” growth irrespective of the business cycle;

- despite the implementation of a significant reform of the pension system, ageing of the population will cause strong upward pressure on public expenditure and implicit liabilities remain high in terms of absolute value and by international comparison.

In addition to these structural elements, Luxembourg's public finances will be negatively impacted from 2015 onwards by a change in the VAT regime applied to telecommunications, broadcasting and electronic services.

Despite the VAT increase with effect from 1 January 2015, as already announced by the Government, this implies that in 2015-2016 Luxembourg will deviate from its medium-term objective and will consequently have to specify additional budgetary consolidation measures that will allow it to return to an adjustment path so that its medium-term fiscal objective may be achieved in 2016 or at the lastest in 2017.

In terms of the sustainability of public finances, in addition to the positive effects of the pension reform which entered into force on 1 January 2013, it should be noted that gross public debt remains at a low level in absolute terms by international comparison and that the State and social security hold financial assets valued at > 35% of GDP.

III.2. Medium-term objective

In accordance with the conclusions of the European Council of March 2005, the medium-term objective is differentiated according to Member States so as to take into account the differences in economic and budgetary positions and developments as well as the various degrees of budgetary risk in terms of the sustainability of public finances, while also considering foreseeable demographic changes.

The criteria and methods for taking into account foreseeable demographic changes were approved by the Ecofin Council in July 2009.

Following the reform of the pension system, which entered into force on 1 January 2013, public expenditure linked to demographic ageing will increase less strongly from 2020 and the impact of the reform will significantly reduce the implicit liabilities linked to demographic ageing. Nevertheless, the issue of the long-term financing of the implicit liabilities is not definitively resolved by the reform and, consequently, in determining the medium-term objective, an ambitious budgetary balance will thus continue to impose itself in order to prefinance the future budgetary commitments that remain despite the reform.

Thus, achieving the medium-term fiscal objective of +0.5% of GDP in structural terms and using the ensuing budget surpluses to build up reserves should allow the additional expenditure caused by demographic ageing to be covered until 2040.

Following the entry into force at the end of 2011 of the rules of the new economic governance, in particular the rules known collectively as the "six-pack", medium-term objectives will be revised every three years.

The last revision having taken place in 2009, a revision procedure of medium-term fiscal objectives was launched in 2012 on the basis of the new long-term projections that were endorsed by the Ecofin Council in May 2012.

In accordance with the new revision cycle of medium-term fiscal objectives, the present SGP update sets the medium-term objective for Luxembourg for the following three years at the current level, i.e. a surplus of 0.5% of GDP in structural terms. Maintaining the medium-term objective level following the implementation of a significant reform of the pension system is explained by the following reasons:

- according to the Council, the medium-term objective of a surplus of 0.5% of GDP as set out prior to the reform was not ambitious enough, as noted by the Council of the EU in its opinion of June 2012 on the 13th SGP update. The medium-term objective set by Luxembourg was indeed below the minimum required that the European Commission had established for Luxembourg, i.e. a surplus of 0.75% of GDP in structural terms;
- taking into account the last update's expenditure projections of the pension system following the entry into force of the reform led the European Commission to a downward revision of the necessary minimum from a surplus of 0.75% of GDP to a surplus of 0.5% of GDP.

As a result, maintaining the medium-term fiscal objective at +0.5% for the next three-year period will enable a convergence of the objective set by Luxembourg and the objective resulting from the estimates drawn up by the European Commission.

III.3. Budgetary situation in 2012 and in 2013

On 1 April 2013, Luxembourg notified the European Commission of a general government deficit of -357 million euros or -0.8% of GDP in 2012 and -341 million euros or -0.7% of GDP in 2013.

In 2012, the general government budgetary balance deteriorated by 261 million euros or 0.6% of GDP in relation to 2011 when the balance stood at a deficit of 98 million or -0.2% of GDP. Despite this nominal deterioration, the structural balance remained unchanged in 2012 in relation to 2011, i.e. at a surplus of 0.4% of GDP in structural terms, which is close to the medium-term objective of +0.5% of GDP. The adjusted general government expenditure[1] showed a real growth of 4.4%, thus exceeding the reference rate of 1.8% computed by Commission services. It should be noted that the budgetary balance for 2012 also reflects the consolidation package adopted by the Government in 2010 for the 2011-2012 period as described in the 12th SGP update, the impact of which amounted to 1.4% of GDP in 2012 in relation to a scenario at unchanged policies.

At the level of sub-sectors, the central government balance in 2012 shows a deficit of 1,155 million euros (2.6% of GDP). The combined local government budgetary situation is close to balance (+41 million euros or +0.1% of GDP) while social security shows a surplus of 757 million euro (1.7% of GDP).

Total general government revenue amounts to 18,725 million euros (42.1% of GDP), up by 5.7% in relation to the previous year. Total expenditure amounts to 19,082 million euros (43.0% of GDP), up by 7.2% in relation to the previous year.

It is thus the gap of 1.5 percentage points between the expenditure growth rate and the revenue growth rate that is at the origin of the rise in public deficit in 2012, while the nominal growth rate of GDP amounts to 4.2%. The expenditure categories that experience the most significant growth rates are the following: intermediate consumption (+13%), capital formation (+8.7%), other current transfers (+9.6%), subsidies (+11%), social transfers in kind (+7.2%).

In 2013, the forecast general government balance amounts to -341 million euros, i.e. -0.7% of GDP. Thus, the budgetary deficit is reduced by 16 million euros or by 0.1% of GDP in relation to 2012. Despite the drop in growth in public revenues (4.2% in 2013 versus 5.7% in 2012), a deterioration of the budgetary situation has been avoided given the growth of total public expenditure (i.e. non-adjusted) was able to be reduced from 7.2% in 2012 to 4.2% in 2013. Thus, the real growth rate *adjusted* expenditure is brought from 4.4% in 2012 to -0.2% in 2013 in accordance with the reference rate of 1.8% for 2013. An improvement of the structural balance, which went from a surplus of 0.4% in 2012 to 0.7% in 2013 results in the adherence of the medium-term objective of a surplus of 0.5% of GDP.

In this context, it should be recalled that the stabilisation of general government budgetary balance and the reduction of the central government deficit within a difficult macroeconomic context were achieved only following the adoption of a package of budgetary consolidation measures in the 2013 budget framework, the global effect of which is estimated at 952 million euros (2.1% of GDP). It should furthermore be recalled that in 2013, the dynamics of public expenditure were also positively impacted by the Government decision in 2012 to modify the automatic wage indexation mechanism. Thus, the application of the index adjustment due in February 2013 shall be postponed to October of the same year.

[1] Expenditure adjusted and modified according to the Commission proposal for the expenditure rule .

Budgetary consolidation measures adopted within the 2013 budget framework

EXPENDITURE	*Share in total effort*
Intermediate consumption	6%
Investment expenditure	30%
Compensation of employees	7%
Subsidies	1%
Social payments	11%
Measures with regard to labour market policies (employment fund)	2%
Total expenditure	**57%**
REVENUES	
Corporate income tax	
- Soparfi	5%
- Reduction of tax expenditure for investment (+20 mio from2014)	
- Introduction of new minimal tax	5%
Personal income tax	
- Introduction of a new bracket at 40%	2%
- Change in stock option regime	5%
- Reduced deductibility of interest on consumption loans	1%
- Reduction of tax expenditure on commuting	4%
Tax on cars	1%
Solidarity tax	
- 2 percentage point increase (households and companies)	11%
- additional 1 percentage increase (households)	5%
VAT on housing (reduction of tax expenditure)	2%
Tax on fuel and tabacco	4%
Total revenues	**43%**
TOTAL IMPACT ON BALANCE OF GENERAL GOVERNMENT IN 2013	952

The central government balance amounts to -1,024 million euros (-2.2% of GDP), i.e. an improvement of 131 million euro in relation to the previous financial year. The improvement of the budgetary balance in 2013 at general government level as a whole is less significant than the improvement at central government level given the deterioration of the local government balance (-43 million euros in relation to 2012) and the social security balance (-70 million euros in relation to 2012).

III.4. Budgetary situation of general government in 2014-2016

The medium-term development of public finances is strongly marked by the change in regime, with effect from 1 January 2015, of the value-added taxation in matters of e-commerce. From 1 January 2015, VAT revenue on telecommunications, broadcasting and electronic services will no longer be assigned to the public budgets in accordance with the principle of residence of the service provider, but rather in accordance with the principle of residence of the consumer. This change will have a considerable impact on public revenues, such that, beyond the general situation of the general government balance prior to this change, it raises specific issues in terms of fiscal policy.

In 2014, the SGP update foresees a slight improvement of the nominal balance of general government, from -0.7% of GDP or -341 million euros in 2013 to -0.6% of GDP or -270 million euros in 2014. This improvement is due essentially to the two following elements:

- increasingly dynamic public revenues in relation to 2013 as a result of the improvement of the macroeconomic scenario in 2014: as a result of a nominal growth rate of GDP, which goes from 3.2% in 2013 to 4.4% in 2014, the ratio between public revenues and GDP shows a slight increase, from 42.6% in 2013 to 42.7% in 2014;
- a growth rate of public expenditure remaining at the level of 2013, i.e. 4.2%, which enables a stabilisation of the ratio between public expenditure and GDP at a level of 43%. The measures to reduce the dynamics of public expenditure revolve around the following elements: a high absolute level of public investment (3.3% of GDP), the dynamics of which are nonetheless curbed in 2014 with a nominal growth rate of 1.9% and a moderate growth rate of 2.9% of intermediate consumption.

In structural terms, the budgetary balance shows a slight deterioration by going from a surplus of 0.7% of GDP in 2013 to a surplus of 0.6% of GDP in 2014, which nonetheless still enables the medium-term objective to be adhered to. Total adjusted general government expenditure shows an increase in real growth rate, going from -0.2% in 2013 to 2.3% in 2014. Despite this growth being superior to the reference rate of 1.1% for 2014, the adherence to the medium-term objective in 2014 ensures the compliance of the fiscal path with the provisions of the preventive arm of the Stability and Growth Pact.

At the level of the general government sub-sectors, the central government balance improves by going from a deficit of 2.2% of GDP or 1,024 million euro in 2013 to a deficit of 1.8% of GDP or 875 million euro in 2014. At local government level, the budget remains in balance and at the level of social security, the budget shows a surplus but deteriorates by going from 1.5% of GDP or 687 million euros in 2013 to 1.2% of GDP or 597 million euros in 2014.

The forecast then projects a significant deterioration of the general government balance in 2015. Indeed, the nominal general government balance goes from -0.6% of GDP or -270 million euros in 2014 to -1.3% of GDP or -654 million euros in 2015. This situation continues to prevail in 2016 with a deficit of 1.3% of GDP or 684 million euros. As for the structural balance, a significant deterioration is foreseen over these two consecutive years 2015-2016. Consequently, with a deterioration of 0.9% of GDP in structural terms in 2015 (going from a surplus of 0.6% of GDP in 2014 to a deficit of -0.3% of GDP in 2015) and with an additional deterioration estimated at 0.8% of GDP in 2016 in structural terms (going from a deficit of -0.3% of GDP in 2015 to a deficit of -1.1% of GDP in 2016), the structural balance will during these two years exhibit a significant deviation from the rules of the Stability and Growth Pact, i.e. an annual deviation higher than 0.5% of GDP in structural terms with regard to maintaining the adherence to the medium-term objective in 2015 or with regard to an adjustment path foreseeing an improvement of the structural balance of 0.5% of GDP in 2016. With regard to general government expenditure, the respective reference rate of -0.1% is exceeded in 2015 with a real growth rate of expenditure estimated at 1.7% as well as in 2016 with a real growth rate estimated at 3.4%. The expenditure rule as defined in the preventive arm of the Stability and Growth Pact would thus not be adhered to during the years 2015 and 2016, since the impact of the non-adherence to the expenditure rule is estimated at 0.8% of GDP in 2015, respectively 1.5% of GDP in 2016.

At the level of the sub-sectors, the central government is most strongly impacted by this deterioration of the general government balance, its balance exceeding the 1 billion euro threshold (deficit of 1,181 million euros or 2.4% of GDP in 2015), whereas the local government balance remains in balance and the social security balance shows a slight drop from 1.2% to 1.1% of GDP.

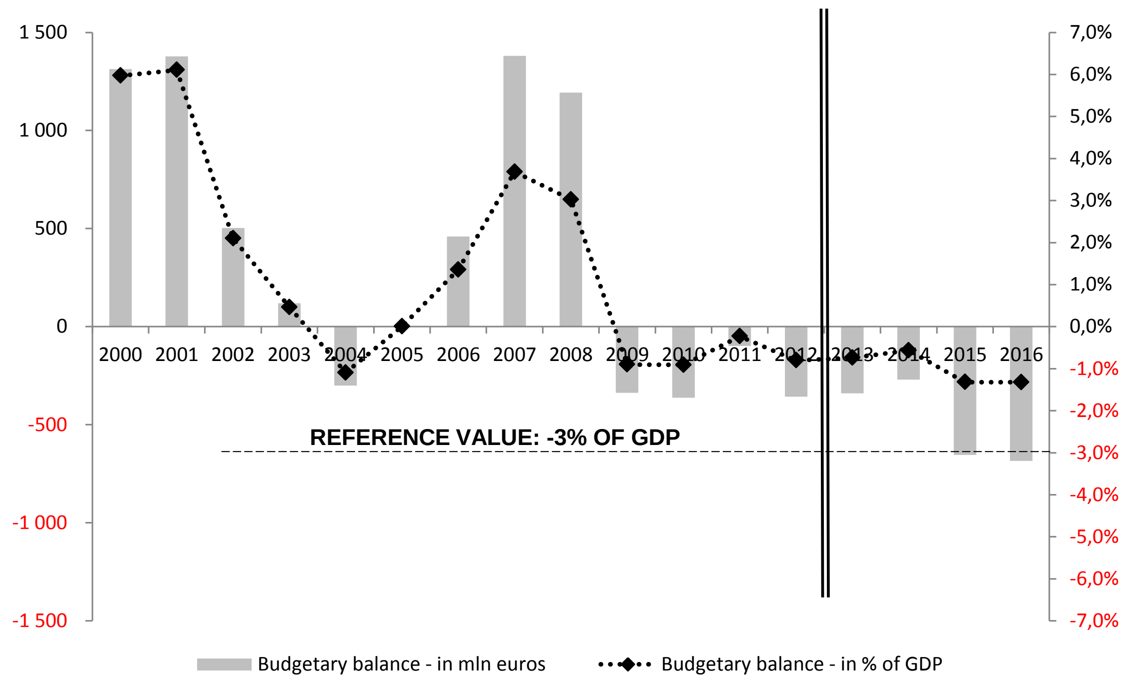
The change in regime of value-added taxation in matters of telecommunications, broadcasting and electronic services will have a negative structural effect on revenues from 2015. The SGP forecast is based on a central hypothesis, i.e. an estimate of the losses linked to the change in regime lying halfway between the estimates of minimum and maximum losses for 2015 and 2016. The negative impact considered is thus that of a loss in revenue amounting to 1.4% of GDP (700 million euros) per annum on average, while the range of minimum and maximum losses amounts to 1% of GDP, respectively 2% of GDP in 2015 and 2016. These loss estimates are calculated on the basis of a scenario based on acontinued dynamism of the relevant sectors, on the one hand, and on maintaining the current taxation regime, on the other hand.

To the extent that such a shock on the budget can be absorbed only gradually, the Government has announced a strategy to partially counter-finance this revenue shortfall from 2015 onwards which is also included in the present SGP update.

In this case, the planned partial counter-financing will be carried out in particular by an increase in value-added tax from 1 January 2015 onwards with the exact parameters to be specified at a later stage. It is currently foreseen that this fiscal reform will compensate the loss in revenue resulting from telecommunications, broadcasting and electronic services to the tune of 400 million euros in 2015 and 450 million euros in 2016.

However, in view of a public deficit amounting to 1.3% of GDP in 2015 and 2016, the Government emerging from the May 2014 general elections will have to identify and implement additional budgetary consolidation measures to specify an adjustment path enabling a return to a balanced budget and a return to the medium-term objective by 2016 or, at the latest, 2017.

GENERAL GOVERNMENT BUDGETARY BALANCE



The reasons why the budgetary consolidation measures aiming to restore the convergence towards the medium-term fiscal objective are not already specified in this programme are manifold. In the first instance, significant uncertainties are linked to the development of the macroeconomic conditions that can influence the development of net borrowing requirements. In the second instance, the uncertainties surrounding the estimation of the impact of the change in regime in telecommunications, broadcasting and electronic services from 2015 are especially high. Finally, general elections will be held in May 2014, and the Government emerging from these general elections should have a sufficient margin of manoeuvre to be able to specify the exact measures for restoring a balanced budget without undermining the commitment of Luxembourg to return to its medium-term objective by 2016 or, at the latest, 2017.

III.5. Public debt

In 2012, gross public debt amounted to 9,231 million euros, i.e. 20.8% of GDP. Luxembourg's public debt thus continues to be well below the reference value of 60% of GDP. ThusLuxembourg ranks among those Member States with the lowest level of debt in the eurozone.

To cover central government net borrowing requirements throughout 2010 to 2012, the Governmentissued a bond amounting to 2 billion euros in May 2010 and maturing on 18 May

2020. In March 2012, it issued a bond amounting to 1 billion euros maturing on 21 March 2022 and in March 2013 it issued a bond amounting to 750 million euro maturing on 19 March 2028.

For the year 2013, the SGP is based on the assumption of the use of debt financing to a global amount of 3.5 billion euros (including the bond already issued in March 2013 and a full refinancing of a bond due to mature in December 2013). For the 2014-2016 period, it is foreseen that the central government net borrowing requirements in 2014-2016 are covered by the issue of new bonds amounting to 1 billion euro per annum.

On this basis, the general government consolidated debt will increase from 23.8% of GDP in 2013 to 27.9% of GDP in 2016. The servicing of the public debt will nevertheless remain relatively low (amounting to roughly 0.6% of GDP per annum) due in particular to Luxembourg's AAA rating that allows a financing of public debt at low absolute rates.

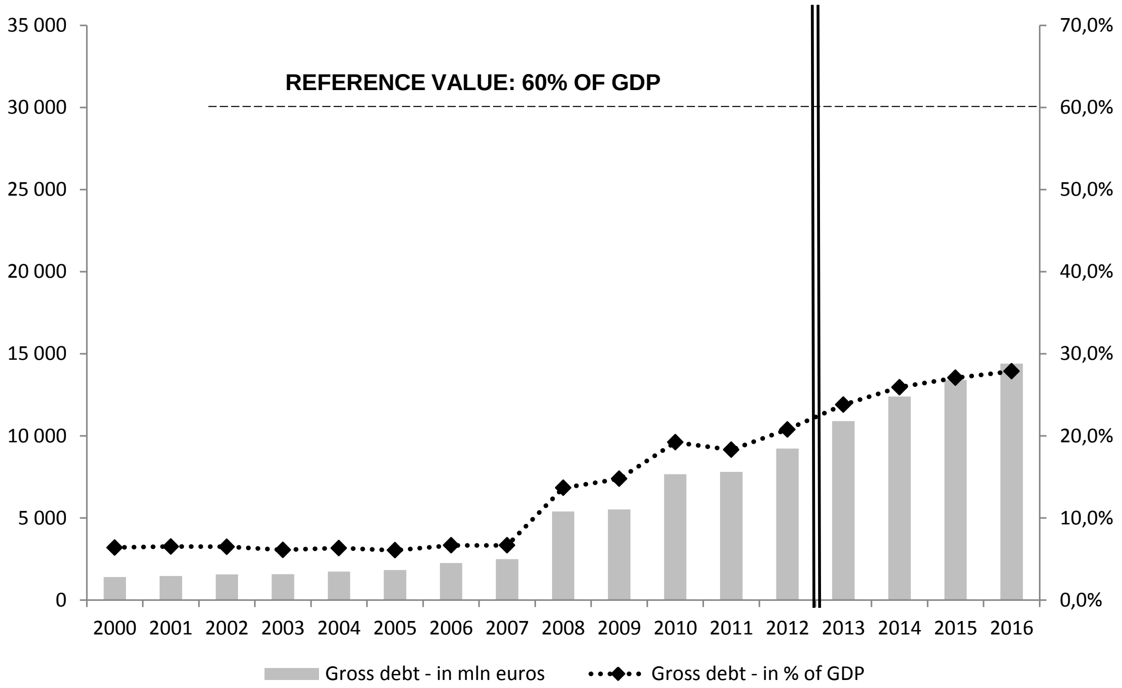
The dynamics of public debt are determined almost exclusively by the dynamics of central government net borrowing requirements (and to a limited extent by the net borrowing requirements of local government which are however heavily constrained by law).

It should be therefore noted that public debt is principally composed of central government debt and local government debt. Social security shows a structural surplus for the period considered in the present SGP update. Its surpluses are transferred to a reserve fund in order to secure future financing needs of social transfers (in particular pensions). This fund currently contains reserves amounting currently to 27.5% of GDP. In order to fully appreciate the financial position of Luxembourg, it should also be recalled that in addition to largepension reserves, the Luxembourg State also has numerous stakes in commercial and non-commercial entities valued at approximately 10% of GDPimplying that the Government holds assets worth approximately 37.5% of GDP which should be seen in comparison with the public debt ratio of 20.8% of GDP at the end of 2012.

It should also be noted that in addition to the debt issued by the Treasury, the public debt includes the debt of public institutions ("établissements publics") as well as financial guarantees granted by the Government in the context of PPP contracts (*Loi de garantie*) that, according to a Eurostat decision, are recorded as loans in the general government accounts. Over the course of the 2013-2016 period, the impact of this classification on the ratio between gross debt and GDP will vary between 1.5% and 2.0% per annum.

In addition, the public debt level also reflects the Eurostat decision to include debt issued by the European Financial Stability Facility (EFSF) into the computation of public debt of the Member States. The impact increases the level of gross public debt by 1% of GDP, but has no impact on the Government's net borrowing requirements or debt servicing costs.

GROSS PUBLIC DEBT EVOLUTION



In the context of the financial crisis, the Luxembourg State issued a bond worth 2 billion euros in 2008 to lend its support to a systemically relevant bank by entering its capital. This bond matures on 4 December 2013 and the SGP is based on the assumption of a full refinancing of this bond. However, the Government recently expressed its intention, under certain conditions, to sell of this equity stake acquired over the course of this crisis operation. Following a potential sale, the public debt ratio would be reduced by approximately 4.5%.

III.6. Sensitivity analysis

The sensitivity analysis is based on the simulation of two symmetrical shocks, a negative shock and a positive shock, measuring 1% of the growth rate in the eurozone from 2013.

Negative shock on the eurozone growth rate

The alternative scenario resulting from this external negative shock implies a real growth rate in Luxembourg of 1% on average during the 2013-2016 period, compared with 2.1% on average during the same period in the central scenario. This shock thus has significant repercussions for the growth of Luxembourg during the projection period.

The drop in growth rate in the eurozone impacts on growth essentially through three aggregates: a less favourable stock index, a drop in the growth rate of investment levels and a reduction in external trade.

Consequently, the inflation path edges down, remaining below 2% from 2013 onwards, which implies that a living cost adjustment will not be paid until October 2014 and that no additional living cost adjustment will fall due in 2015 and in 2016.

Compared with the central scenario and as a result of a weaker growth in employment, the unemployment rate exhibits a higher level from 2014 onwards: +0.2% in 2014 and +0.5% for 2015/2016.

This negative shock also impacts public finances and more particularly the level of public revenues compared with the central scenario until 2016. The general government deficit in this alternative scenario amounts to 1% of GDP in 2013, in comparison with 0.7% of GDP in the central scenario. The cumulative nature of this negative shock implies that the deficit will amount to 3% of GDP in 2016 against 1.3% of GDP in the central scenario. As a result, in the event of a negative external shock on growth, Luxembourg risks finding itself in a potential situation of excessive deficit in 2016.

Positive shock on the eurozone growth rate

A positive shock of the same magnitude as the negative shock on growth rate in the eurozone results in higher economic growth in Luxembourg by bringing about a macroeconomic context that is, generally speaking, more conducive to budgetary consolidation. This positive effect amounts to a growth rate of 3.4% on average over the course of the 2013-2016 period, against 2.1% in the central scenario. The higher growth has an impact on employment, the growth rate of which amounts to 2.5% on average, against 1.8% in the central scenario. In contrast to the negative shock, the positive shock allows the economy to be more dynamic, resulting in an increase in inflation rate, which will exceed 2% over the course of the 2013-2016 period.

This positive growth shock in the eurozone has an effect on public expenditure and in particular public revenues and impacts through the same aggregates as mentioned for the negative impact. The effect on the general government budgetary balance is largely positive, with the deficit going from 0.7% of GDP in the central scenario to 0.5% of GDP in 2013. The general government balance consequently improves by going from -0.6% of GDP to +0.2% of GDP in 2014, from -1.3% of GDP to -0.1% of GDP in 2015 and from -1.3% of GDP to +0.2% of GDP in 2016. It should be noted that these balances, while significantly improved compared with the central scenario, are not compatible with a return to the medium-term fiscal objective of +0.5% of GDP in structural terms.

	2012	2013			2014			2015			2016		
	central	low	central	high	low	central	high	low	central	high	low	central	high
Altered exogenous variables													
Euro area GDP	-0,4	-1,3	-0,3	+0,7	+0,4	+1,4	+2,4	+1,0	+2,0	+3,0	+0,6	+1,6	+2,6
World demand - goods	+1,8	+0,4	+3,0	+5,8	+3,5	+6,3	+9,1	+3,8	+6,5	+9,3	+2,6	+5,2	+8,0
World demand - services	+2,0	+0,7	+2,3	+3,9	+3,8	+5,5	+7,2	+1,9	+3,7	+5,5	+1,1	+3,0	+4,9
European stock index	-8,1	+4,5	+10,5	+16,9	-0,2	+4,7	+9,8	+10,0	+12,9	+15,9	+8,5	+9,8	+11,1
Main endogenous variables													
Nominal GDP	+0,3	+0,2	+1,0	+1,8	+0,9	+2,2	+3,6	+0,5	+1,7	+3,2	+2,4	+3,4	+4,8
Real GDP	+4,2	+1,9	+3,2	+4,4	+2,3	+4,4	+6,5	+0,6	+3,5	+5,4	+2,0	+4,4	+7,2
Employment	+2,1	+1,6	+1,7	+1,8	+0,9	+1,3	+1,9	+1,5	+2,3	+3,2	+1,3	+1,9	+3,1
Unemployment rate	+6,1	+6,6	+6,6	+6,5	+7,0	+6,8	+6,5	+7,0	+6,6	+6,1	+6,9	+6,5	+5,8
Inflation, NICP	+2,7	+1,8	+1,9	+2,0	+1,5	+1,8	+2,2	+1,3	+2,8	+2,6	+1,2	+2,1	+2,9
General government budgetary balance (% of GDP)	**-0,8**	**-1,0**	**-0,7**	**-0,5**	**-1,3**	**-0,6**	**+0,2**	**-2,8**	**-1,3**	**-0,1**	**-2,9**	**-1,3**	**+0,2**

III.7. Comparison with previous stability programme

The development of the economic situation has been subject to uncertainties linked to the sovereign debt crisis which continues to persist in the eurozone.

Consequently, for 2012, the forecasts of macroeconomic conditions in recession for the eurozone with a growth rate of -0.3% of GDP are confirmed in the 14th update with a growth rate of -0.4% of GDP. This slight deterioration has led to real growth of GDP being revised downwards, from 1.0% to 0.3%. This drop can be explained in particular by a general drop in the global demand for goods, the growth rate of which is revised downwards by 1% as well as by a less favourable development of the European stock index, the growth rate of which is revised from -2.7% to -8.1%, a factor not to be underestimated in the economic context of Luxembourg, given the weight of the financial sector. The inflation rate (NICP) and the unemployment rate remain unchanged.

Nevertheless, this downwards revision of the macroeconomic scenario does not impact public finances: the 14th SGP update, based on the notification of April 2013, counts on a general government balance of -0.8% of GDP, which represents an improvement in relation to that of the 13th update, i.e. -1.5% of GDP. The absence of a deterioration can be explained by several factors: (i) a nominal growth in 2012 that was more significant than anticipated, i.e. 4.2% instead of 3.2%, which has an impact in particular on revenue dynamics, (ii) sustainted employment growth with agrowth rate remaining at 2.1%.

For 2013, the 14th update also foresees an improvement in public finances in comparison with the 13th update: the general government balance is thus expected to improve to -0.7% of GDP instead of -1.2% of GDP. This development is the result of several contradictory factors:

- on the one hand, a downwards revision of the macroeconomic conditions, which has a negative impact on the development of public finances: the eurozone thus remains in recession with a growth rate of -0.3% instead of a growth rate of 1.3% as foreseen in the 13th update; the main macroeconomic variables (growth rate of real and nominal GDP) of the national economy are thus revised downwards, apart from employment, the growth rate of which is revised upwards (1.7% instead of 1.4%), while the unemployment rate and the inflation rate (NICP) are changed only slightly;

- on the other hand, the situation of public finances is improved by several specific factors: i) the positive base effect of 2012, ii) the package of measures adopted by the Government at the end of 2012 amounting to 952 million euro, iii) the improvement of the European stock index, the growth rate of which is revised upwards from 4.5% to 10.5%, resulting in a positive impact on certain revenue categories that heavily depend on it.

Without the above elements and given the revised macroeconomic conditions, the situation of public finances in 2013 would have been much less favourable.

For the 2014-2015 period, in line with the general downwards revision of the macroeconomic conditions, the principal macroeconomic variables are revised downwards between the two SGP updates: the growth rate of the eurozone is thus revised downwards by -0.6% to 1.4% in 2014 and by -0.4% to 2.0% in 2015. This revision results in a less strong national economic growth: the real and nominal growth rates are revised downwards by -1.1%, respectively -1.1% in 2014 and by -2.4%, respectively -3.0% in 2015. The significant deviation of this revision for 2015 is explained by the fact that the 13th update was based on an assumed convergence of real growth at the end of the period to the historical average of potential growth. The employment profile follows that of economic growth with a slight delay: the employment rate is thus revised downwards in 2014 from 1.6% to 1.3%, where it will reach a low before once again showing stronger dynamism in 2015. It should in particular be noted that the inflation rate, revised slightly downwards in 2014 (-0.2%) is revised upwards by 0.6% from 2.2% to 2.8% in 2015: this revision takes into account the strategy announced by the Government for the counter-financing of the impact of the change in taxation on, telecommunications, broadcasting and electronic services in particular through indirect taxation (VAT) measures.

For 2014-2015, the situation of public finances improves due to the following elements:

- 2014: the general government balance goes from -0.9% of GDP to -0.6% of GDP: this is essentially due to the positive base effect of 2013;
- 2015: the general government balance goes from -1.8% of GDP to -1.3% of GDP: this is due to the base effect and the inclusion of the counter-financing strategy, which was not part of the 13th update for 2015.

IV. QUALITY OF PUBLIC FINANCES

During the 2005-2008 period, the general government budgetary balance showed surpluses. Following the economic downturn of 2008-2009 and the implementation of exceptional measures aimed at stabilising economic activity and employment and the relatively weak economic growth in 2010-2011, the general government budgetary situation reached a deficit in 2009 (-1.1% of GDP). Thus, since 2009, the general government budgetary balance is in deficit and will remain so, despite changed policies, over the course of the period covered by the current programme.

While the Government took advantage of the period of favourable economic growth of 2005-2007 to consolidate public finances and to transfer the surpluses of 2005-2008 to reserves, which allowed budgetary margins of manoeuvre to be created for the financing of counter-cyclical policies during economic downturns, it must nevertheless be stated that the persistence of deficits at general government level since 2009, and in particular of the higher deficits at central government level, has resulted in a reduction of reserves at central government level. This led the Government in May 2010 to call upon the financial markets for the first time in a long time by issuing a bond to finance its budget deficit, a move it repeated in March 2012. Henceforth Luxembourg will be obliged to call upon the financial markets at regular intervals to finance its deficits and will for the first time in a long time enter a debt rollover cycle through the issue of new bonds.

Nevertheless, the Government maintains its objective to restore general government budgetary balance on a path that guarantees healthy and sustainable public finances in the medium and long term. This effort translates in particular to the consolidation packages that the Government has adopted on several occasions since 2010: these packages aim to avoid too significant a deterioration of public finances in a context of years of weak macroeconomic conditions in the EU and the eurozone while ensuring no significant harm is caused to economic activity.

In particular, the Government also aims to ensure that the level of public debt remains as low as possible and well below the upper limit laid down by the Maastricht criteria (60% of GDP).

With regard to public expenditure, the Government has succeeded and continues its efforts to favour a level and composition of expenditure most likely to sustain the long-term growth of Luxembourg’s economy while at the same time ensuring the cohesion of society.

The quality of public expenditure can thus be analysed via the following elements:

- with regard to the level of public expenditure in relation to GDP, it can be noted that, despite the increase of the expenditure proportion of GDP, in particular since the outbreak of the financial and economic crisis in 2008, Luxembourg still remains below the European average: thus, the public expenditure proportion in relation to GDP amounted to 42% in 2011 against 49.5% on average in the eurozone;
- in terms of structure, the public expenditure in Luxembourg can be characterised by the following points:
    - with regard to public investment, the public investment proportion in relation to total expenditure is twice as high in Luxembourg than on average in the eurozone: on average, over the 1995-2011 period, this proportion amounted to 10% in Luxembourg, against 5.3% in the eurozone. This concern for a high level of investment reflects the continued effort by the Government to invest in the economic growth potential;
    - with regard to operating expenses, i.e. intermediate consumption expenses and civil servants' compensation, which are sometimes seen as expenses that contribute less to the long-term growth of an economy, it can be seen that the proportion of these expenses in Luxembourg remains below the European average: in 2011, this proportion amounted to 9% of total public expenditure in Luxembourg, against 11.1% on average in the eurozone;
    - with regard to social transfers, which are often represented as expenses reflecting the redistribution efforts in a society, the crisis has led to an increase in the proportion of these expenses in Luxembourg and in Europe in general: with a proportion of 47.3% of total public expenditure in 2011, Luxembourg was above the eurozone average, which amounted to 46.8%;
    - with regard to property income on the expenditure side, i.e. debt servicing costs: given that Luxembourg benefits from both a relatively weak debt stock and enjoys relatively low interest rates, the expenditure linked to the financing of the debt is well below that of the eurozone average: in 2011, the debt servicing costs represented 1.1% of the total expenditure in Luxembourg, against 6.1% on average in the eurozone.

All these elements allow the quality of public expenditure in Luxembourg to be measured in comparison with the eurozone. Nevertheless, the quality of a public expense is measured not only in quantitative terms, i.e. the expenses incurred in a given area, but also in more qualitative terms. In this sense, Luxembourg foresees to develop its budgetary framework in such a manner as to create more incentives for public expenditure managers to increase the quality of public expenditure. This issue will arise in particular in those areas for which expenses incurred are significant, such as public investment, notably in its form of gross fixed capital formation.

V. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

In 2012, Luxembourg implemented a reform of its pension system (general scheme and special schemes), the details of which can be found in the National Reform Programme. The reform, which entered into force on 1 January 2013, focuses on three dimensions, namely an alignment of the effective retirement age with life expectancy changes, an adaptation of pensions to the budgetary situation of the pension scheme and an allocation of additional financial resources to ensure long-term financial balance.

In the 13th SGP update, the Government outlined the estimated financial impact of the reform: thus, in relation to the last long-term forecasts of expenditure linked to ageing with unchanged policies of 2012, endorsed by the Ecofin Council of 15 May 2012, the budgetary impact estimated for the considered period up to 2060 amounts to a significant reduction in expenditure linked to ageing of the pension system amounting to approximately 7% of GDP, dropping from a level of 17.1% of GDP in 2060 in a scenario at unchanged policies to a level of 10.5% of GDP in 2060 in a scenario at changed policies that include the proposed reform. In the current SGP update, the estimated budgetary impact of the reform remains unchanged, i.e. approximately 7% of GDP in 2060. This significant reduction of the cumulative cost through the pension system has also been estimated by the Banque centrale du Luxembourg (BCL) in its opinion on the draft budget for 2013. In particular, the BCL presented simulations of the financial impact of the pension reform and specified that: *"The adjustment to real wages would be removed altogether (…). This removal, however, would have no impact on the initial pension of each retiree, regardless of the year of retirement, the initial pension being fully adjusted to real wage developments. This scenario enables the scale of the fiscal challenge to be approximately cut in half in comparison with a scenario with noreform"*[2].

The strategy implemented in relation to the retirement ageis based on flexibility: the beneficiary chooses either to prolong his service life or else he accepts a corresponding review of his retirement level.

As of now, the adaptation of pensions is conditioned by the revenues of the scheme's contributions. If the latter prove insufficient, and if the pension scheme reserves need to be accessed, the adaptation of the pensions of the general scheme and the special schemes to wage developments (wage indexation) shall be reduced, either partially or fully, and will be

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[2] For more details (page 35):
http://www.bcl.lu/fr/publications/avis/Avis_de_la_BCL_sur_le_projet_de_Budget_2013__web1.pdf

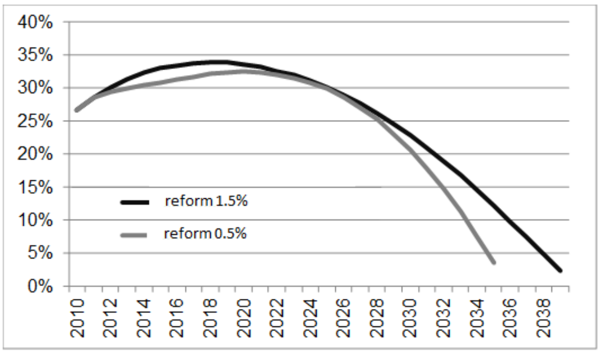
restricted to living cost developments (COLA). Already for 2013, a transitional measure restricts the adaption of the pensions to the COLA index only.

The general scheme currently has financial reserves amounting to 27.5% of GDP (12.2 billion euros). With contribution rates unchanged, this financial reserve will be available in the event of contribution revenues becoming insufficient to cover social transfer expenditure. In addition, the use of this additional financing will be able to be diminished, delayed even, on the one hand by a possible revision of the social transfers and/or on the other hand by a gradual increase in contribution rate. The special schemes will for the most part be charged to the Government budget. In the event of an increase in contribution rate, its financial participation in the special schemes will consequently be reduced.

The reform scenario counts on an employment growth of 1.5% in the medium and in the long term, close to the average employment growth over the 2009-2011 period, i.e. two percentage points less than the country's average growth before the crisis (average growth of 3.8% over the 1997-2007 period) and one percentage point above the long-term growth retained by the services of the European Commission. Independently of the chosen growth scenario, the reform enables social transfers to be financed on the basis of accumulated funds in the pension scheme reserves, even without an increase in contributions, beyond the 2030 horizon (see graph below).

The reform foresees that, every five years, by means of an actuarial study, the monitoring institution, i.e. the *Inspection générale de la sécurité sociale* (IGSS), verifies the consistency between the assumptions underlying the reform and the updated financial trajectory of the scheme. In the event of significant deviations from the equilibrium trajectory, several expenditure alignment measures are foreseen in the context of the new provisions. The COLA adaptation may be implemented earlier and the end-of-year allowance, introduced in 2002, may be suspended.

Development of the general pension scheme reserve, with unchanged contribution rate, according to the employment growth scenario



The reform offsets an increase in life expectancy of three years over the 2013-2053 period. In the event of a rapid increase in longevity, the related parameters can be consequently adapted. The Government thus plans the implementation of a specific "Pensions Group", as seen in other Member States of the EU, composed of the main,stakeholders which would be mandated to verify, every five years, on the basis of the actuarial opinion issued by the IGSS, the consistency of the corresponding provisions with the developments observed in terms of life expectancy and to present, if applicable, corresponding adaptations.

VI. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

The national legal framework in relation to the institutional setup of public finances has not changed since the previous SGP update. Nevertheless, this framework is evolving to take into account two factors: i) the implementation on a national level of a certain number of obligations arising from the new economic and fiscal governance that is being gradually implemented throughout the EU and the eurozone over recent years, including the transposition of the "Fiscal Compact"; ii) the needs to reform the national budgetary procedure in accordance with the governmental declaration in 2009 in which the Government stated its commitment to "*examine the means to improve the procedure for the preparation, implementation and evaluation of the budget with the twofold intention of modernising the State and the effectiveness of public expenditure*".

Economic and fiscal governance in the EU has evolved in recent years essentially as a result of the following decisions:

- the introduction in 2010, by the European Council, of the European semester from 2011;
- the entry into force on 13 December 2011 of the "Six-pack" reforms. Composed of five regulations and one directive, it includes the following changes: i) a revision of the Stability and Growth Pact; ii) the introduction of a new sanction regime linked to the Stability and Growth Pact for the eurozone; iii) the introduction of a new procedure on the prevention and correction of macroeconomic imbalances; iv) a new sanction regime linked to this new procedure for the eurozone; v) a Directive laying out requirements for national budgetary frameworks;
- the entry into force, on 1 January 2013, of the intergovernmental Treaty on Stability, Coordination and Governance ("Fiscal Compact") signed by 25 of the 27 EU Member States, which provides a transposition period until the end of 2013 for a certain number of provisions;

- the political agreement between the Council and European Parliament in March 2013 and the entry into force of the "two-pack" regulations in a way that the regulations will be applicable for the fiscal cycle leading up to the preparation of the 2014 budget. It comprises two regulations: the first regulation "establishing common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States of the eurozone" and the second regulation "relating to the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the eurozone".

Recent years have witnessed the gradual implementation of these changes on a national level and a certain number of changes of an essentially informal nature have been carried out on a procedural and practical level of budgetary policy and of public finances. The most significant informal changes can be summarised as follows:

- the reinforced inclusion of the multi-annual dimension of public finances: even if the budgetary framework in Luxembourg does not have a medium-term budgetary framework[3], the medium-term multi-annual dimension of public finances has gained in significance in the discussions and preparatory work surrounding public finances. Indeed, the *comité de prévision* provides the Government with medium-term macroeconomic and budgetary forecasts based on the technical assumption of an "unchanged policy". This projection must allow the Government to determine its budgetary orientations in terms of objectives and, if applicable, to take discretionary measures if the scenario of "unchanged policies" does not allow the fiscal objectives to be achieved. The projection and the policy directions resulting from these discussions will then serve as the basis for drawing up the SGP in April;
- the reinforced involvement of Parliament earlier in the annual budgetary procedure as a result of the European semester: the organisation of policy debates and regular communication between the Minister of Finance and the parliamentary commission on finances and the budget;
- the search for a coherent and integrated approach between the two procedures with regard to monitoring budgetary policies (stability and growth programme) and structural reform policies (national reform programme).

The new governance has thus brought about a certain number of informal changes on the level of budgetary policy until now, but additional informal changes will no doubt be necessary, in particular to enable Luxembourg to comply with the directive on the requirements for national

[3] This statement was made in the "Peer review of national fiscal frameworks", which was carried out during 2011

budgetary frameworks and with the “two-pack”. The latter in particular requires Member States to send a draft budgetary plan to the European Commission in October, a “type” of annual SGP based on the Government’s draft budget for the following year, which also contains a certain amount of information on the situation of public finances at the level of general government, comprising all the sub-sectors: central government, local government and social security.

In addition to these informal changes, the new governance also implies changes of a regulatory or legislative nature. These changes will be integrated in a draft reform of the current legal framework, for which preparatory work is already underway and which will go to vote before the end of 2013.

In this context, particular work will be carried out for the implementation of the following elements[4]:

- establishment of a medium-term budgetary framework;
- adoption of fiscal rules covering the scope of general government according to the ESA95, i.e. including the three sub-sectors of central government, local government and social security;
- the creation of an authority in charge of monitoring compliance with fiscal rules.

Within this work, a particular problematic issue will be addressed, namely that of the methodology to use to establish a budgetary rule based on the concept of “structural balance” as imposed by the “Fiscal Compact”. It should thus be noted that the structural balance is not observable but must be estimated on the basis of the “nominal” budgetary balance (observed/measured) and the output gap, with the output gap being a non-observable input. Thus, the transition of the “nominal” balance to the “structural” balance is dependent on the methodology used for calculating the output gap.

On the one hand, a method has been approved by the Ecofin Council in 2002 to calculate the output gap and thus the structural balance. This methodology, like any methodology, contains imperfections since it is the result of a political compromise between the double requirement of methodological uniformity across the EU and the particularities of the various countries, and will be used by the European Commission for budgetary surveillance and compliance control of the budgetary situation of a Member State with “Fiscal Compact” obligations.

Today, the methodology used in the SGP for calculating the structural balance is based on a STATEC (*Institut national de la statistique et des études économiques*) methodology that was developed well before the adoption of the “Fiscal Compact”. This methodology uses parameters slightly different to the common methodology implemented by the European Commission.

[4] Non-priority list and non-exhaustive list

In addition, it is important to note that, regardless of the methodology used, the forecasts are often subject to strong variations and frequently undergo significant revisions between two successive forecasts. It is also useful to add that the "Fiscal Compact" does not impose upon Member States the use of an exact methodology, nor the methodology approved by the Ecofin Council.

Consequently, in view of the implementation of the "Fiscal Compact" at national level, a solution in terms of methodology will have to be found that respects a certain number of criteria: i) the methodology must be statistically robust and not be subject to ex-post variations that are too strong, so as to minimise the risks of a budgetary policy that is inadequate for the economic cycle, ii) it must be transparent, iii) it must not deviate too much in terms of results and in terms of the consistent analysis from the approach used by the European Commission in its budgetary surveillance.

In addition to the modifications implied by the changes in economic and fiscal governance in the EU, in accordance with the governmental programme of 2009, the Government also plans to review the national budgetary policy according to a number of guidelines:

- to adapt the existing instruments and to design new ones to give a more strategic direction to the budgetary procedure by placing more emphasis on the policy action priorities of the Government whilst still meeting the new obligations, which are being established at European Union level;
- to improve the control of the budget at general government level by reinforcing short-term, medium-term and long-term planning;
- to place greater significance on the quality of public expenditure through reinforcing the transparency and accountability of policy products and results, to simplify the structure of the budget and to focus more on policy evaluation.

Within the context of the preparatory work, the Minister of Finance has requested that the Organisation for Economic Cooperation and Development (OECD) carry out an analysis of the budgetary procedure in Luxembourg. This analysis, which was published on 27 November 2011[5], also includes a chapter on the new requirements of economic governance, which are in the process of being implemented within the EU.

[5] http://www.mf.public.lu/actualites/2011/11/ocde_progr_budget_251111/index.html

STATISTICAL ANNEX

Table 1a. Macroeconomic prospects

	ESA Code	Year 2012	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	33 943	0,3	1,0	2,2	1,7	3,4
2. Nominal GDP	B1*g	44 426	4,2	3,2	4,4	3,5	4,4
Components of real GDP							
3. Private consumption expenditure	P.3	11 872	1,5	-0,8	1,9	4,4	2,3
4. Government consumption expenditure	P.3	6 049	4,4	3,1	2,4	2,5	2,8
5. Gross fixed capital formation	P.51	8 271	7,0	-0,2	-3,3	1,0	-0,3
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53		3,9	3,8	3,7	3,6	3,5
7. Exports of goods and services	P.6	59 662	-3,2	0,1	4,8	5,8	6,3
8. Imports of goods and services	P.7	53 231	-2,6	-0,3	4,2	6,7	5,7
Contributions to real GDP growth							
9. Final domestic demand		-	0,8	0,4	0,5	1,3	1,0
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	-1,6	0,6	1,7	0,3	2,3
11. External balance of goods and services	B.11	-	1,1	0,0	0,1	0,2	0,1

Table 1b. Price developments

	ESA Code	Year 2012	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		1,26	3,9	2,1	2,1	1,7	0,9
2. Private consumption deflator		1,14	2,2	1,6	1,6	2,4	2,0
3a. HICP		117,32	2,9	2,1	1,8	2,8	1,8
3b. NICP		137,76	2,7	1,9	1,8	2,8	2,1
4. Public consumption deflator		1,21	2,8	2,6	3,1	2,8	2,1
5. Investment deflator		1,05	3,9	2,5	1,6	1,9	1,4
6. Export price deflator (goods and services)		1,22	4,3	3,9	3,1	3,0	2,6
7. Import price deflator (goods and services)		1,13	3,5	3,8	3,9	4,5	3,8

Table 1c. Labour market developments

	ESA Code	Year 2012	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		377,3	2,1	1,7	1,3	2,3	1,9
2. Employment, hours worked[2]		363,3	1,3	0,4	1,1	2,0	1,7
3. Unemployment rate (%)[3]		…	5,4	5,9	6,1	5,9	5,8
4. Labour productivity, persons[4]		…	-2,2	-0,8	0,7	1,0	1,6
5. Labour productivity, hours worked[5]		…	-1,5	0,5	1,0	1,2	1,8
6. Compensation of employees	D.1	…	3,6	3,5	4,3	4,6	4,6
7. Compensation per employee		…	1,2	1,5	2,7	2,1	2,5

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-	-	-	-	-
of which :						
- Balance on goods and services						
- Balance of primary incomes and transfers						
- Capital account						
2. Net lending/borrowing of the private sector	B.9					
3. Net lending/borrowing of general government	EDP B.9	-0,8	-0,7	-0,6	-1,3	-1,3
4. Statistical discrepancy		-	-	-	-	-

Table 2a. General government budgetary prospects

	ESA Code	Year 2012	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-357	-0,8	-0,7	-0,6	-1,3	-1,3
2. Central government	S.1311	-1155	-2,6	-2,2	-1,8	-2,4	-2,2
3. State government	S.1312	…	…	…	…	…	…
4. Local government	S.1313	41	0,1	0,0	0,0	0,0	0,0
5. Social security funds	S.1314	757	1,7	1,5	1,2	1,1	0,9
General government (S13)							
6. Total revenue	TR	18 725	42,1	42,6	42,7	42,5	42,8
7. Total expenditure	TE[1]	19 082	43,0	43,3	43,3	43,8	44,1
8. Net lending/borrowing	EDP B.9	-357	-0,8	-0,7	-0,6	-1,3	-1,3
9. Interest expenditure	EDP D.41	175	0,4	0,5	0,4	0,4	0,4
10. Primary balance[2]		-182	-0,4	-0,3	-0,1	-0,9	-0,9
11. One-off and other temporary measures[3]		…	…	…	…	…	…
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		11 844	26,6	27,2	27,3	26,9	27,0
12a. Taxes on production and imports	D.2	5 512	12,4	12,6	12,6	12,0	11,9
12b. Current taxes on income, wealth, etc	D.5	6 280	14,1	14,5	14,6	14,8	14,9
12c. Capital taxes	D.91	52	0,1	0,1	0,1	0,1	0,1
13. Social contributions	D.61	5 318	12,0	12,0	12,1	12,2	12,3
14. Property income	D.4	663	1,5	1,5	1,5	1,6	1,6
15. Other[4]		900	2,0	1,8	1,9	1,9	1,9
16=6. Total revenue	TR	18 725	42,1	42,6	42,7	42,5	42,8
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]		17 162	38,6	39,2	39,3	39,1	39,3
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	5 317	16,2	16,5	16,7	16,9	16,9
17a. Compensation of employees	D.1	3 591	8,1	8,2	8,3	8,5	8,4
17b. Intermediate consumption	P.2	1 726	3,9	3,9	3,8	3,8	3,9
18. Social payments (18=18a+18b)		9 007	20,3	20,7	20,8	21,0	21,2
***of which* Unemployment benefits**[6]		416	0,9	1,0	1,0	0,9	0,8
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	2 175	4,9	5,0	5,1	5,2	5,3
18b. Social transfers other than in kind	D.62	6 832	15,4	15,7	15,7	15,8	16,0
19=9. Interest expenditure	EDP D.41	175	0,4	0,5	0,4	0,4	0,4
20. Subsidies	D.3	762	1,7	1,8	1,8	1,9	1,9
21. Gross fixed capital formation	P.51	1 721	3,9	3,4	3,3	3,4	3,3
22. Capital transfers	D.9	557	1,3	1,2	1,3	1,4	1,4
23. Other[7]		1 543	3,5	3,6	3,5	3,5	3,5
24=7. Total expenditure	TE[1]	19 082	43,0	43,3	43,3	43,8	44,1
p.m.: Government consumption (nominal)	P.3	7506	16,9	17,3	17,5	17,8	17,9

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

[5]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[6] Includes cash benefits (D.621 and D.624) and in kind benefits (D.631) related to unemployment benefits.

[7] D.29+D4 (other than D.41) + D.5+D.7+P.52+P.53+K.2+D.8.

Table 2b. No-policy change projections

		Year 2012	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1. Total revenue at unchanged policies		18 725	42,1	42,6	42,7	41,7	41,9
2. Total expenditure at unchanged policies		19 082	43,0	43,3	43,3	44,2	44,3

Tableau 2c. Amounts to be excluded from the expenditure benchmark

		Year 2012	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue		71	0,2	0,2	0,2	0,2	0,2
2. Cyclical unemployment benefit expenditure[1]		416	0,9	1,0	1,0	0,9	0,8
3. Effect of discretionary revenue measures		28	0,1	0,9	0,0	0,8	0,1
4. Revenue increases mandated by law		…	…	…	…	…	…

[1]Absolute level of unemployment expenditure, based on COFOG 10.50

Table 3. General government expenditure by function

% of GDP	Code COFOG	Année 2011	Année 2016
1. General public services	1	4,7	
2. Defence	2	0,4	
3. Public order and safety	3	1,0	
4. Economic affairs	4	4,2	
5. Environmental protection	5	1,1	
6. Housing and community amenities	6	0,8	
7. Health	7	4,8	
8. Recreation, culture and religion	8	1,7	
9. Education	9	5,0	
10. Social protection	10	18,1	
11. Total expenditure	TE	41,8	

Table 4. General government debt developments

% of GDP	ESA Code	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
1. Gross debt[1]		20,8	23,8	25,9	27,1	27,9
2. Change in gross debt ratio		2,5	3,0	2,1	1,1	0,8
Contributions to changes in gross debt						
3. Primary balance[2]		-0,4	-0,3	-0,1	-0,9	-0,9
4. Interest expenditure[3]		0,4	0,5	0,4	0,4	0,4
5. Stock-flow adjustment		1,7	2,3	1,6	-0,2	-0,5
p.m.: Implicit interest rate on debt[4]		2,2	2,4	1,8	1,8	1,7

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

[4]Proxied by interest expenditure divided by the debt level of the previous year.

Table 5. Cyclical developments

% of GDP	ESA Code	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
1. Real GDP growth (%)		0,3	1,0	2,2	1,7	3,4
2. Net lending of general government	EDP B.9	-0,8	-0,7	-0,6	-1,3	-1,3
3. Interest expenditure	EDP D.41	0,4	0,5	0,4	0,4	0,4
4. One-off and other temporary measures[1]		….	…	…	…	…
5. Potential GDP growth (%)		1,6	1,6	1,6	1,6	1,6
6. Output gap		-2,6	-3,2	-2,6	-2,4	-0,6
7. Cyclical budgetary component		-1,2	-1,4	-1,1	-1,0	-0,3
8. Cyclically-adjusted balance (2 - 7)		0,4	0,7	0,6	-0,3	-1,1
9. Cyclically-adjusted primary balance (8 + 3)		0,7	1,1	1,0	0,2	-0,6
10. Structural balance (8 - 4)		0,4	0,7	0,6	-0,3	-1,1

[1] A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

	ESA Code	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
Real GDP growth (%)						
Previous update		1,0	2,1	3,3	4,1	…
Current update		0,3	1,0	2,2	1,7	3,4
Difference		*-0,7*	*-1,1*	*-1,1*	*-2,4*	…
Nominal GDP growth (%)						
Previous update		3,2	3,7	5,5	6,5	…
Current update		4,2	3,2	4,4	3,5	4,4
Difference		*1,1*	*-0,5*	*-1,2*	*-3,0*	…
General government net lending (% of GDP)	EDP B.9					
Previous update		-1,5	-1,2	-0,9	-1,8	…
Current update		-0,8	-0,7	-0,6	-1,3	-1,3
Difference		*0,7*	*0,5*	*0,3*	*0,5*	…
General government gross debt (% of GDP)						
Previous update		20,9	23,6	24,4	25,9	…
Current update		20,8	23,8	25,9	27,1	27,9
Difference		*-0,2*	*0,2*	*1,5*	*1,2*	...

Table 7. Long-term sustainability of public finances

% of GDP	AR 2012 *)					REFORM ***)			AR 2009 ****)		
	2010	2060	2060-2010	2060bis **)	2060bis-2010	2010	2060	2060-2010	2010	2060	2060-2010
Age-related expenditures	**17,8**	**29,8**	**12,0**	**37,5**	**19,7**	**17,8**	**30,9**	**13,1**	**19,9**	**38**	**18,1**
Pension expenditure	9,2	18,6	9,4	26,3	17,1	9,2	19,7	10,5	8,6	23,9	15,3
Health care expenditure	3,8	4,5	0,7	4,5	0,7	3,8	4,5	0,7	5,9	7	1,1
Long-term care expenditure	1,0	3,1	2,1	3,1	2,1	1,0	3,1	2,1	1,4	3,4	2
Education expenditure	3,2	3,1	-0,1	3,1	-0,1	3,2	3,1	-0,1	3,6	3,3	-0,3
Unemployment expenditure	0,6	0,5	-0,1	0,5	-0,1	0,6	0,5	-0,1	0,4	0,4	0
Reserve pension fund ("fonds de compensation")	*25,4*	*0*		*0*		*25,4*	*0*		*28*	*0*	
Assumptions	AR 2012 *)					REFORM ***)			AR 2009 ****)		
Labour productivity growth	2	1,5				2	1,5		1,4	1,7	
Real GDP growth	3,5	1,7				3,5	1,7		5	2	
Participation rates (men, aged 15-64)	75,6	71,6				75,6	71,6		74,4	72,1	
Participation rates (women, aged 15-64)	60	63,3				60	63,3		59,5	61,4	
Total participation rate (aged 15-64)	67,9	67,5				67,9	67,5		67	66,8	
Population (in million)	0,5	0,7				0,5	0,7		0,5	0,7	
Working-age population (15-64/total)	68,4	58,5				68,4	58,5		67,8	60,3	
Ratio non-active/active (65+/15-64)	20,4	45,2				20,4	45,2		21,1	39,1	
Ratio elderly active/active (55-64/15-64)	16	20				16	20		16,3	19,5	
Unemployment rate (15-64)	6	4,8				6	4,8		4,5	4,5	

Sources:

*) 2012 Ageing report (AR) baseline scenario, 2012 constant policy scenario

**) 2012 Ageing report baseline scenario, excl. pension expenditure: 2009

***) 2012 Ageing report baseline scenario, excl. pension expenditure: reform

****) 2009 Ageing report baseline scenario, 2009 constant policy scenario

Table 7a. Contingent liabilities

% of GDP	Year 2012	Year 2013
Public guarantees	8,4	…
Of which: linked to the financial sector	5,0	…

Table 8. Basic assumptions

	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016
Short-term interest rate (annual average)	0,6	0,2	0,1	1,3	2,0
Long-term interest rate (annual average)	3,6	3,0	3,0	3,3	3,5
USD/€ exchange rate (annual average)	1,29	1,29	1,28	1,28	1,3
Euro area GDP growth	-0,4	-0,3	1,4	2,0	1,6
EU GDP growth	-0,3	0,1	1,6	2,2	1,8
Growth of relevant foreign markets	1,9	2,7	5,9	5,1	4,1
Oil prices (Brent, USD/barrel)	111,7	109,5	108,6	108,6	108,6