THE LUXEMBOURG STABILITY PROGRAMME

(February 1999)

I. Introduction

On 1 January 1999, 11 countries adopted the euro as the single currency under stage three of Economic and Monetary Union. In accordance with Council Regulation (EC) 1466/97 and pursuant to the declaration by the ECOFIN Council on 1 May 1998, Luxembourg and the other 10 Member States of the euro zone will each year go through the exercise of having their public finances monitored.

The first Luxembourg stability programme presented to the Commission and the Council is therefore part of this new environment. It represents the first of its kind, since Luxembourg has never had to submit a convergence report, because the convergence criteria have regularly been met.

The government, meeting in cabinet, has approved this stability programme and takes responsibility for it, even though the programme's time horizon goes beyond the present parliament which will come to an end in June 1999. The programme will be presented to the Chamber of Deputies and made public, inter alia on Internet site http://www.etat.lu/FI/.

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The stability programme, which forms part of the procedure of the surveillance of the budgetary positions of Member States and the surveillance and coordination of their economic policies, has to demonstrate that the budgetary policy of a Member State provides for a safety margin to ensure the avoidance of an excessive deficit, in accordance with the definitions of the Stability Pact. It must also facilitate the closer coordination of economic policies and be consistent with the broad economic policy guidelines.

The stability programme should not therefore be seen as an isolated document. Its natural complements are the reports on the reforms of the goods and services and capital markets ("Cardiff I"), for which the Luxembourg Government presented a national report in January 1999, and on structural reform ("Cardiff II"), which will follow. These reports together will form the basis for the broad economic policy guidelines.

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II. The broad lines of budgetary policy in a structural framework since 1994

In its government statement of 22 July 1994 to the Chamber of Deputies, the government stated its determination to pursue a prudent budgetary policy, more particularly by ensuring that increases in general government expenditure are linked to economic growth. To this end, increases in general government expenditure must be contained within the limits of the average growth of gross domestic product during the next five-year period.

The government's budgetary policy therefore essentially looks beyond the cyclical and is based essentially on structural aspects. The best way of ensuring public finance stability is to promote the good health of the national economy: in order to achieve this the government has conducted an active structural policy and continues to do so.

Accordingly, Luxembourg has been able to achieve a budget position "close to balance or in surplus" continuously throughout stage two of EMU. For the entire period, Luxembourg's public sector has actually generated net lending of more than 0.7% of GDP. The medium-term objective, for Luxembourg, is not therefore to achieve a position in balance or in surplus by programming the adjustment path towards this objective, but to ensure that the budget position required by the European Union and already attained by Luxembourg can also be maintained in the future.

In 1997, real GDP growth was 4.7%, inflation was held to 1.4%, and the unemployment rate was 3.6% (or 3.3% according to the revised series). Against this economic background the net lending of the public sector as a whole stood at 2.9% of GDP (+1.5% of GDP for central government, +1.1% of GDP for the social security system and +0.3% for local government).

As a result of this performance, it was possible, without any short-term risk for the net lending of the public sector, to introduce a number of tax cutting measures, the objective of which is to strengthen the growth potential of the Luxembourg economy in structural terms, and thereby to protect net lending in the long term.

As from 1996, therefore, legal persons have benefited from a consistent package of tax cuts aimed at making companies more competitive. More specifically, the measures in question were the abolition of the municipal trade tax on operating capital and the lowering of the rate of corporation tax from 33% to 32% from 1997; corporation tax was cut for a second time in 1998, a year earlier than originally planned, and now stands at 30%.

As regards debt, it is appropriate to outline the background to the evolution of central government debt. From 1989 to 1991, no debt was issued; the central government did not return to the capital market until economic activity turned down in 1992. From 1994 to 1997 successive budgets projected annual borrowing of LUF 4 billion, of which only LUF 1 billion related to the budget proper and LUF 3 billion was required to finance the investment expenditure of the Road Fund. This meant that debt worth LUF 3.8 billion was issued in

1997. The stock of outstanding public debt (combined debt of central government, social security funds and local government) stood at 6.7% of GDP in 1997.

The debt ratio has consistently been kept at a level well below that required by the needs of convergence. The objective systematically pursued by the government is not to deviate from this policy, since it is well aware that a heavier debt burden would be ill-suited to the size and structure of Luxembourg's economy.

Luxembourg's contribution to the Community budget, which, taking all types of resources together, totalled ECU 170.2 million for the 1997 financial year, is a significant burden for Luxembourg's public finances. Luxembourg's receipts from the Community budget during the same financial year, taking all types of operational expenditure together totalled ECU 106.1 million. According to the recent Court of Auditors report for the 1997 financial year, Luxembourg thus remains the leading per capita contributor.

As in the past, and although it has ample room for the "automatic stabilisers" to operate without any danger of overstepping the figures laid down in the Stability and Growth Pact, the government intends as far as necessary to pursue a proactive structural policy and to resort to discretionary measures to ensure the stability objective, if need be by counterbalancing the very marked sensitivity of an economy as small and as open to the outside world as Luxembourg, which is very heavily dependent on economic developments in its neighbouring countries and beyond in the European Union.[1]

III. 1998

1998 was marked by strong GDP growth which reached 5.7% in real terms. The steady expansion of economic activity was reflected in a 4.5% increase in payroll employment, bringing the unemployment rate down to 3.1% (compared with 3.3% in 1997). The inflation rate stood at 1%. Productivity increased by 1.2% and the real wage cost fell by 0.2%.

Starting in 1998, the government embarked on a new and significant round of tax cuts. As indicated above, the reduction in the rate of corporation tax was completed, with the rate now standing at 30%. The changes made are not limited to any particular area of taxation, but concern a range of provisions involving both adjustments to the level of personal taxation and corporation tax with in particular a reduction in the tax burden on companies, the objective still being to strengthen the structural bases of the Luxembourg economy so as to secure the financing of the public sector.

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[1] Because Luxembourg is so small, the economic forecasts may be subject to major variations. However, the statistical data as a whole conform to Community standards, in particular in the context of the ESA.

Despite the large number of taxation measures, the net lending of Luxembourg’s public sector thus remained completely intact (2.1% of GDP). Local government net lending reached 0.09% of GDP, the central government positive balance stood at 0.70% of GDP and the net lending of the social security funds increased to 1.33%.

With regard to central government debt, 1998 was marked by the total absence of borrowing and by the railways debt being taken over as part of the structural reform of that sector. Similarly the central government is not planning to issue any new debt for 1999. It should be noted that 50% of the central government debt, which in total represents 6.7% of GDP, is already covered by assets placed to reserve in the Special Debt Fund, so that the reimbursement of the stock of outstanding debt will not affect future budgets, even in a scenario of slower revenue growth.

IV. Macroeconomic scenario for the period 1999 to 2002

Because of the extreme openness of the Luxembourg economy and its specific structural features, it is relatively more difficult to produce economic projections for Luxembourg than for other (larger) countries. As in the past, it is right for the government in these circumstances to take a "conservative scenario" as its policy framework.

As regards financial year 1999 more particularly, because of the slowdown in the international economy forecast by all the international financial organisations, a certain contraction in Luxembourg’s economic activity is inevitable. The GDP growth forecast has therefore been revised downwards and the median scenario forecasts real GDP growth of 3.4%. The strongest component of growth is likely to be domestic private demand, whereas we see that external demand declines somewhat.

So as not to jeopardise the very healthy public finance situation, the government has revised downwards the draft budget for 1999 on the revenue side, and as an intentional consequence, on the expenditure side. The budget was therefore adopted with a slight revenue surplus, and without projected borrowing. It thus represents continuity, so that the government should be able to achieve its objective of cutting central government expenditure as a proportion of GDP. The proportion should come down to some 28.6%, compared with 31.8% in 1990.

This 1999 budget forms part of a medium-term perspective, as regards both the plan for the financial framework and the political emphasis intended. The main emphasis will focus on family and education policy, national and international solidarity and increasing the safety of citizens. Particular attention will be paid to employment policy by means of the national employment plan, which was voted into law by parliament in February 1999. The plan will place the emphasis of the government’s structural policy on:

- an active employment policy (including training the unemployed and integrating them into the workforce)

- introducing new working patterns and modernising work in general

- equality of opportunity

- developing an entrepreneurial spirit and vocational training.

Other priority areas are the stimulation of economic activity and the expansion of public investment. The 5.2% increase in public investment in 1998 and its faster growth in 1999 (+10%) bear witness to the government's determination to continue to develop and modernise public infrastructure, the prerequisite for continued economic growth.

In readiness for the ageing of the population and the burden this could impose on the public finances, structural reforms have been undertaken throughout the present parliament and will continue, the purpose being to guarantee pensions in the long term by increasing recourse to funded pension schemes and by stimulating pillar 2 and pillar 3 schemes. The entry into force of long-term care insurance, which will be neutral from an overall budget point of view, constitutes both a social and a structural reform intended to provide for the cost of the increased benefits which will become necessary, without undermining public finance stability.

In view of the revisions applied to the figures for 1999, any quantified projection beyond 1999 must, in order to respect the requirement of prudence, expect only a fairly slow recovery of economic growth. Accordingly, three scenarios have been developed for the period 1999-2002. The median scenario, based on conservative projections, forecasts real GDP growth of 3.7%. This figure is based on the most recent assumptions developed by the Commission (DG II) for its medium-term projections. On the basis of this median scenario, two other variants have been established: one is unfavourable, based on average growth of 3.0% and the other is favourable, with growth averaging 4.5% during the period concerned. Here it should be noted that during the period from 1985 to 1998, real GDP growth in Luxembourg was slightly over 5%, so that these three variants are still fairly cautious.

Any recovery should increasingly benefit once more from the support of improved external demand, with exports increasing slightly faster than imports.

Even a limited recovery in growth, coupled with the effects of the national employment plan, should permit the creation of new jobs to proceed steadily and lead to a gradual absorption of marginal unemployment, following the increase of over 4% in employment in 1998.

Implementation of the central government budgets over the projected period, established in accordance with the target-oriented guidelines described above, will make it possible to avoid an increase in public indebtedness as a proportion of GDP, thus respecting the government's policy of not imposing a mounting public debt burden on the Luxembourg economy.

V. General government net lending

Taking into account the macroeconomic forecasts, public sector net lending will range from 0.73% (low-growth scenario in 2001) to 2.48% (high-growth scenario in 2002). Thus throughout the forecast period Luxembourg's public sector will have a positive net lending capacity despite the initiation of major projects.

The median scenario

The median scenario is based on nominal GDP growth of 5% in 1999 and 5.5% a year for the period 2000 to 2002. After achieving public sector net lending of 2.12% in 1998, the percentage will fall in 1999 to 1.10% and then rise again to 1.66% of GDP in 2002.

Within the public sector, central government net lending in 2002 will be higher than in 1998. The fall in central government net lending from 0.70% to 0.04% in 1999 can be explained on the revenue side by the lower growth of tax revenue due to the decline in international, and even more so in national, economic activity and by the impact of the tax measures described above; and on the expenditure side chiefly by the introduction of long-term care insurance which will cost the central government an additional LUF 3 billion in terms of income transfers to the social security system. In addition, the growth of investment expenditure will remain strong (10% increase in the investment expenditure of the special funds in 1999).

The introduction of long-term care insurance will also have a temporary impact on the net lending of the social security funds. After reaching 1.33% of GDP in 1998, net lending will fall to 1.06% in 1999 and stabilise at that level thereafter. The expenditure on long-term care insurance benefits will reach LUF 6 billion and then grow at a rate of LUF 300 million a year.

Lastly, the local government sector will generate net lending of 0.09% of GDP in 1998. After falling to its minimum, namely 0.01% of GDP in 1999, net lending will again grow by 2 basis points a year over the period 2000 to 2002.

The variants of the median scenario

The variants for GDP will clearly also have an effect on the level of public sector net lending.

Thus, if we take nominal GDP growth rates, of the order of 5.5% for 1999 and averaging 6.4% from 2000 to 2002, public sector net lending will stand at 1.23% of GDP in 1999 and reach 2.48% in 2002.

For the subsectors, stronger growth will chiefly have an impact on central government revenue, which will see its net lending grow to over 1.47% of GDP in 2002.

Assuming a deterioration in the economic situation, public sector net lending will be 0.96% of GDP in 2002. With a nominal growth rate of 4.3% in 1999 and 4.9% in 2000 to 2002, central government net lending could become negative but the central government borrowing requirement will never exceed -0.18% of GDP. Even on this assumption of weak economic growth, the central government's borrowing requirement would be amply covered by its own reserves and the public sector as a whole would retain a positive net lending capacity for the whole of the forecast period.

So, even in a situation of low GDP growth, Luxembourg's public finances will remain sound and should continue to correspond to the European Commission's favourable prognosis in its most recent documents.

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Table 1

Public sector net lending

(LUF million)

	1998	1999	2000	2001	2002
High-growth scenario	**13 361**	**8 219**	**10 893**	**14 055**	**19 889**
Central government	4 417	1 029	3 238	6 816	11 755
Social security	8 379	6 991	7 034	6 155	6 504
Local government	565	199	621	1 084	1 630
Median scenario	**13 361**	**7 308**	**8 193**	**9 353**	**12 946**
Central government	4 417	254	947	2 833	5 885
Social security	8 379	6 991	7 034	6 155	6 504
Local government	565	63	212	365	557
Low-growth scenario	**13 361**	**6 031**	**5 604**	**5 311**	**7 306**
Central government	4 417	-832	-1 250	-588	1 121
Social security	8 379	6 991	7 034	6 155	6 504
Local government	565	-128	-180	-256	-319

(% of GDP)

High-growth scenario	**2.12%**	**1.23%**	**1.54%**	**1.86%**	**2.48%**
Central government	0.70%	0.15%	0.46%	0.90%	1.47%
Social security	1.33%	1.05%	0.99%	0.82%	0.81%
Local government	0.09%	0.03%	0.09%	0.14%	0.20%
Median scenario	**2.12%**	**1.10%**	**1.17%**	**1.27%**	**1.66%**
Central government	0.70%	0.04%	0.14%	0.38%	0.75%
Social security	1.33%	1.06%	1.01%	0.83%	0.83%
Local government	0.09%	0.01%	0.03%	0.05%	0.07%
Low-growth scenario	**2.12%**	**0.92%**	**0.81%**	**0.73%**	**0.96%**
Central government	0.70%	-0.13%	-0.18%	-0.08%	0.15%
Social security	1.33%	1.06%	1.02%	0.85%	0.86%
Local government	0.09%	-0.02%	-0.03%	-0.04%	-0.04%

(million)

GDP high-growth scenario	631 290	666 390 5.6%	708 912 6.4%	754 148 6.4%	802 270 6.4%
GDP median scenario	631 290	662 385 4.9%	699 595 5.6%	738 895 5.6%	780 402 5.6%
GDP low-growth scenario	631 290	658 381 4.3%	690 338 4.9%	723 847 4.9%	758 893 4.9%

Table 2

Macroeconomic scenario 1999-2002

Growth rate (excluding unemployment rate)

		1998	**1999**	**1999**	**1999**	**2000-2002**	**2000-2002**	**2000-2002**
		Actual figures or estimates	*Low-growth scenario*	*Median scenario*	*High-growth scenario*	*Low-growth scenario*	*Median scenario*	*High-growth scenario*
Real GDP (version ESA)	*1*	5.7	2.8	3.4	4.0	3.0	3.7	4.5
GDP deflator	*2*	1.7	1.5	1.5	1.5	1.8	1.8	1.8
Nominal GDP	*1'*	7.5	4.3	5.0	5.6	4.9	5.6	6.4
CPI (Consumer price index)	*3*	1.0	1.2	1.2	1.2	1.7	1.7	1.7
Nominal wage (average wage cost)	*4*	1.5	1.7	2.0	2.3	2.8	2.9	3.1
Payroll employment	*5*	4.5	1.8	2.4	3.0	1.5	2.2	3.0
Unemployment rate	*6*	3.1	3.2	3.1	3.0	3.4	3.1	2.9
Unemployment rate broadly defined	*7*	4.0	4.3	4.1	3.9	4.6	4.2	3.8
Total population	*8*	1.3	1.0	1.15	1.3	0.9	1.1	1.3
Productivity	*1/5*	1.2	1.0	1.0	1.0	1.5	1.5	1.5
Real wage cost	*4/2*	-0.2	0.2	0.5	0.8	1.0	1.1	1.3

Source: STATEC (January 1999)
6:official unemployment rate
7: unemployment rate broadly defined (total jobseekers), including employment measures

Table 3

Central government net borrowing or lending

(% of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
High-growth scenario	0.04%	-1.35%	0.03%	0.96%	-0.02%	1.27%	1.52%	0.70%	0.15%	0.46%	0.90%	1.47%
Median scenario	0.04%	-1.35%	0.03%	0.96%	-0.02%	1.27%	1.52%	0.70%	0.04%	0.14%	0.38%	0.75%
Low-growth scenario	0.04%	-1.35%	0.03%	0.96%	-0.02%	1.27%	1.52%	0.70%	-0.13%	-0.18%	-0.08%	0.15%

Social security funds' net borrowing or lending

(% of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
High-growth scenario	1.80%	2.62%	1.81%	1.57%	1.52%	1.05%	1.07%	1.33%	1.05%	0.99%	0.82%	0.81%
Median scenario	1.80%	2.62%	1.81%	1.57%	1.52%	1.05%	1.07%	1.33%	1.06%	1.01%	0.83%	0.83%
Low-growth scenario	1.80%	2.62%	1.81%	1.57%	1.52%	1.05%	1.07%	1.33%	1.06%	1.02%	0.85%	0.86%

Local government net borrowing or lending

(% of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
High-growth scenario	0.10%	-0.51%	-0.19%	0.20%	0.33%	0.49%	0.33%	0.09%	0.03%	0.09%	0.14%	0.20%
Median scenario	0.10%	-0.51%	-0.19%	0.20%	0.33%	0.49%	0.33%	0.09%	0.01%	0.03%	0.05%	0.07%
Low-growth scenario	0.10%	-0.51%	-0.19%	0.20%	0.33%	0.49%	0.33%	0.09%	-0.02%	-0.03%	-0.04%	-0.04%

Public sector net lending or borrowing

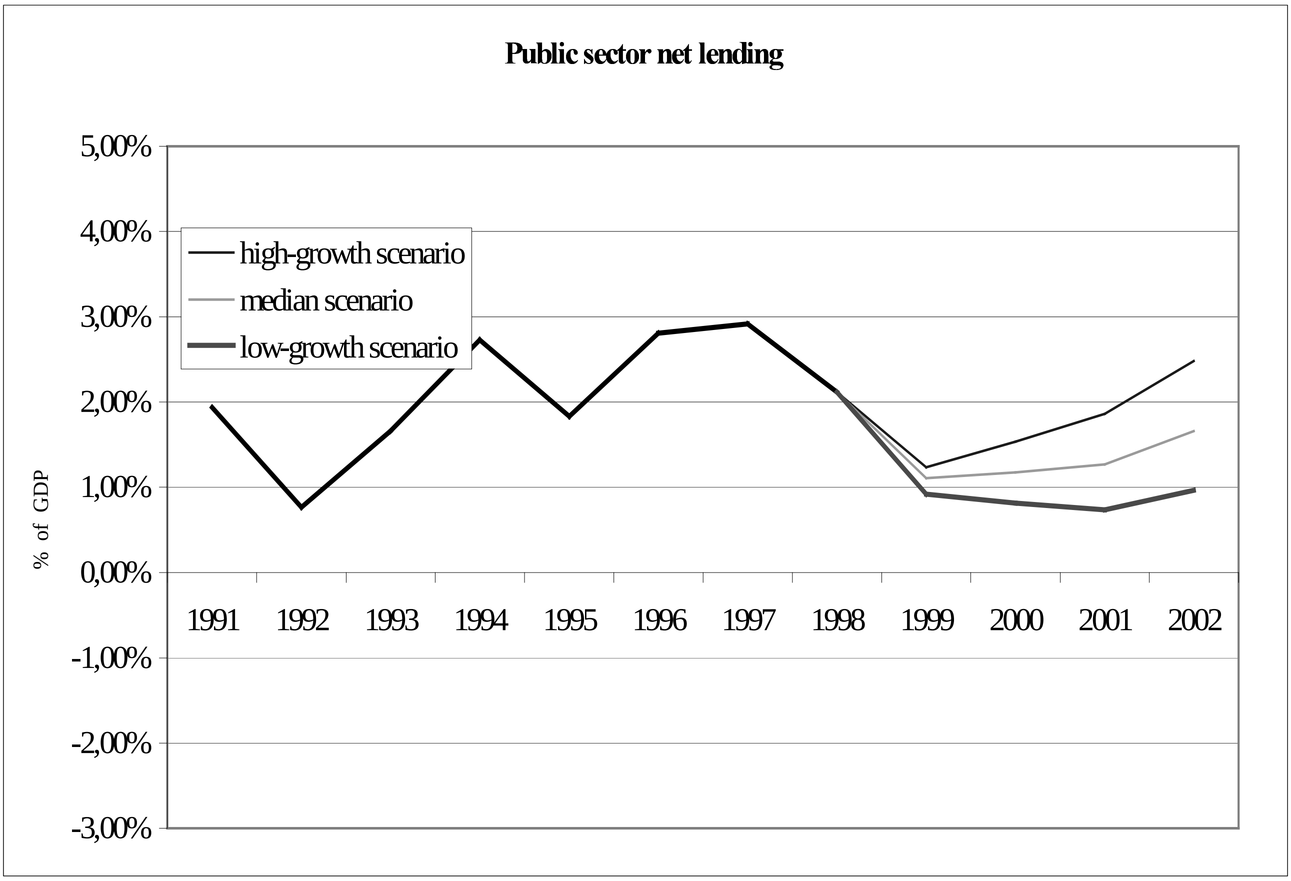
(% of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
High-growth scenario	1.94%	0.77%	1.66%	2.73%	1.83%	2.81%	2.92%	2.12%	1.23%	1.54%	1.86%	2.48%
Median scenario	1.94%	0.77%	1.66%	2.73%	1.83%	2.81%	2.92%	2.12%	1.10%	1.17%	1.27%	1.66%
Low-growth scenario	1.94%	0.77%	1.66%	2.73%	1.83%	2.81%	2.92%	2.12%	0.92%	0.81%	0.73%	0.96%

Table 4

Central government ordinary revenue and total expenditure as a proportion of GDP (%)

	Ordinary revenue/GDP	Total expenditure/GDP
1990	31.82	31.77
1991	30.48	30.85
1992	29.58	30.75
1993	29.49	29.75
1994	29.78	29.47
1995	29.06	29.37
1996	31.16	31.13
1997	28.92	29.07
1998	28.31	28.56


Public sector net lending
5,00%
4,00%
3,00%
2,00%
1,00%
0,00%
-1,00%
-2,00%
-3,00%
% of GDP
high-growth scenario
median scenario
low-growth scenario
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002