COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.1.2004
SEC(2004) 87 final

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Luxembourg, 2002-2006

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 (formerly 109c) of the Treaty (from 1 January 1999, the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme.

The first stability programme of Luxembourg covering the period 1998-2002 was submitted on 16 February 1999 and assessed by the Council on 15 March 1999[2].

Luxembourg submitted its fifth and most recent update of the stability programme, covering the period 2002-2006, on 28 November 2003. The Commission services have carried out a technical evaluation of this updated programme, taking into account the information provided in accordance with the Code of Conduct[3], the Autumn forecasts as well as subsequent evaluations, the commonly agreed methodology for the estimation of cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines and the principles laid down in the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[4]. This evaluation warrants the following assessment:

> The 2003 update of the stability programme of Luxembourg incorporates the 2004 budget law that was approved by Parliament on 16 December 2003. The update complies with the Code of Conduct on the content and format of the programmes. However, a few non-compulsory variables which are valuable inputs to compute cyclically adjusted balances using the common production function method were not included.
>
> Real GDP growth in 2002 remained very weak by historical standards, at slightly above 1%, like in the year before. Real GDP growth is expected to have remained weak as well in 2003, at 1.2%. According to the central macroeconomic scenario underlying the update, which appears plausible and is quite close to the Commission Autumn 2003 forecast, economic growth is expected to pick up gradually to 2% in 2004. A further pick-up is forecast in the next two years and real GDP growth would be close to 4% in 2006. This is still below the estimated rate of potential growth on the basis of the common production function method. However, in the case of Luxembourg estimates of potential growth and the output gap should be treated with due caution, because of difficulties in extrapolating past productivity trends and in estimating the impact of cross-border employment. Employment growth is expected

---

1 OJ L 209, 2.8.1997. The documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2 OJ L 209, 5.5.1999.

3 Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

4 COM(2002) 668 final, 27.11.2002

to slow down significantly compared to 2002 and the years before, following movements in activity with a lag, while HICP inflation is expected to moderate gradually from 2.5% in 2003 to 1.2% by 2.6 in response to weak activity and muted import prices.

According to the update the general government budget balance deteriorated markedly in 2003, by no less than 3 percentage point of GDP to a deficit of 0.6% of GDP. This sharp deterioration mainly reflects the effects of the tax reform coinciding with a sharp economic slowdown, coupled with continued substantial growth in public expenditure and a deceleration in the collection of back taxes that had boosted revenue in 2002. The deficit is expected to worsen further to 1.8 and 2.3% of GDP in 2004 and 2005 respectively, as the expected economic recovery would be rather gradual, while the full impact of the earlier economic slowdown on revenue would be felt only with a substantial lag. The deficit would improve somewhat in 2006, to 1.5% of GDP, in response to the expected economic upturn and a deceleration in expenditure. The cyclically-adjusted budget balance, computed using the common production function method, is expected to remain positive over the horizon covered by the update, even though this assumes a potential growth rate that may be on the high end of plausible outcomes.

The deterioration of the general government balance is for the largest part accounted for by central government. In the period 2004-2006, the deficit of central government is expected to widen to above 3% of GDP. The balance of local government is projected to have a slight deficit, largely due to the importance of lacklustre municipal corporate tax receipts as a source of revenue. By contrast, social security would offset part of the projected deficit in the other two sub-sectors of general government. However, surpluses in social security would be considerably smaller than in the past, largely reflecting expected weaker employment growth.

Risks to the outlook for public finances appear skewed to the downside. If such risks materialise, it cannot be entirely ruled out that the deficit could rise to above 3% of GDP at some point in the period covered by the update. While recognising the sound starting position of public finances in Luxembourg, the March 2003 Council opinion on the previous stability programme update[5] highlighted the necessity to monitor closely fast growing current expenditure, in particular of central government. The update expects the growth rate of general government nominal expenditure to moderate substantially in the period 2004-2006, to around 4½% on average, down from around 8% in the previous decade. However, apart from an assumed decrease in the public investment ratio, the stability programme is not very explicit on how this deceleration of current expenditure would be achieved, other than by an expected decrease of public investment in the period 2004-2006. Should economic growth and thus tax revenue fall to rates below what is currently envisaged, additional measures might be needed to adjust expenditure levels. This may be necessary to prevent the nominal deficit from breaching the 3% of GDP threshold and to ensure that a budgetary position close to balance or in surplus would be maintained in the medium to long run.

[5] OJ C 64 18.3.2002

Luxembourg is in a good position to meet the budgetary consequences of the ageing population. There are no risks of unsustainable public finances in the long term. The debt to GDP ratio will remain very low and is expected to decrease to below 5% of GDP over the projection period. Moreover, substantial additional financial assets have been accumulated that could help bridge a spell of weak economic growth. Some uncertainties remain on long term trends in Luxembourg due to the lack of complete information on age-related expenditures and the key role that cross-borders workers play in the national labour market.

The update is broadly consistent with the 2003 Broad Economic Policy Guidelines, in particular those with budgetary implications.

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

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Luxembourg, 2002-2006

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[6], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission, after consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [10 February 2004] the Council examined the 2003 update of the stability programme of Luxembourg, which covers the period 2002 to 2006. The updated programme complies with the data requirements of the revised "code of conduct" on the content and format of stability and convergence programmes.

The budgetary strategy underlying the update is based on maintaining balanced public finances in the medium term. While the government intends not to cut public spending drastically in the present period of weak economic growth, measures have been taken to limit the growth rate of public expenditure.

The update projects real GDP growth at 1.2% in 2003, from 1.3% in 2002. In 2004 growth is estimated to pick up to 2%, increasing to 3.8% in 2006. Employment growth is expected to decelerate to around 1% in 2004 and to increase to slightly above 2% by 2006. HICP inflation is forecast to decrease gradually to around 1.3% in 2006. On the basis of currently available information, the macro-economic scenario underlying the programme seems plausible for 2004 and 2005. However, the growth projection for 2006 may be on the high side.

The update targets a general government deficit of 1.5% of GDP in 2004, a marked deterioration from the 0.6% of GDP deficit foreseen for 2003. This deterioration to a large extent seems to reflect the lagged impact of the economic slowdown on public finances. In cyclically adjusted terms, based on Commission calculations according to the commonly agreed methodology, there would be a stable surplus. In 2005, the deficit would rise further to 2.3% of GDP, and it would decrease again to 1.5% of GDP in 2006. In cyclically-adjusted

[6] OJ L 209, 2.8.1997

terms, a surplus would be maintained. The debt ratio is forecast to decline somewhat over the time horizon covered by the update, 5.2% of GDP in 2004 to 4.4% of GDP in 2006.

The balance of risks to the budgetary projections seems skewed to the downside. This regards in particular the strength of the expected cyclical upturn, and the feasibility of the planned slowdown in expenditure in the baseline projection of the update. The budgetary stance in the programme does not seem to provide a sufficient safety margin under normal macroeconomic fluctuations to rule out a breaching of the 3% of GDP deficit threshold at some point over the programme horizon, in particular in 2005. On the other hand, the changes in the cyclically adjusted balance indicate that the maintenance of a budgetary position close to balance seems sufficiently established by the programme.

However, the estimate of the output gap and hence the cyclically-adjusted balance present unusual margins of uncertainty due to the special features of the economy of Luxembourg. In particular, current estimates of the rate of potential growth in the medium term may be on the high end of plausible outcomes. Although the starting position of public finances is very sound, some expenditure restraint may be in order to ensure that public expenditure remains in line with the revenue base in the medium term. Further, it has to be noted that the ratio of public investment to GDP would decline somewhat over the time horizon covered, but would remain well above the EU average at more than 4% of GDP.

Luxembourg presents no risks of unsustainable public finances in the long term. The debt to GDP ratio will remain very low over the projection period, and the total net asset position is even more favourable in view of the substantial financial assets accumulated over past years with fiscal surpluses.

The economic policies as reflected in the updated programme are broadly consistent with the recommendations in the Broad Economic Policy Guidelines, specifically those with budgetary implications.