COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 1.2.2006
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Recommendation for a

COUNCIL OPINION

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

On the updated stability programme of Luxembourg, 2005-2008

(presented by the Commission)

EXPLANATORY MEMORANDUM

Background

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. In 2005, the Pact was amended for the first time. The reform acknowledged the Pact's usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first stability programme of Luxembourg was submitted on 16 February 1999. In accordance with the Regulation, the Council delivered an opinion on it on 15 March 1999 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

In these programmes, Member States need to specify their medium-term objective for the budgetary position and set out the policy measures to achieve and maintain it, including the accompanying economic assumptions. Following the reform of the Pact, the medium-term objective should be differentiated for individual Member States in the light of the economic and budgetary heterogeneity in the Union, including as regards the fiscal risk to sustainability. Other elements of the reform are that a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in economic good times should be achieved, while "major structural reforms" with a verifiable impact on long-term sustainability should be taken into account for a temporary deviation from the medium-term objective or the adjustment path towards it.

Taking into account the Commission services' autumn 2005 forecast, the code of conduct[2], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008, the Commission has examined the recently submitted update of the stability programme of Luxembourg and, based on its assessment below, has adopted a recommendation for a Council opinion on it.

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

[2] "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

Assessment

(1) The 7th update of the convergence programme of Luxembourg was submitted to the Commission on 28 November 2005. It covers the period 2005-2008. The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct.[3]

(2) The economic performance of Luxembourg has been remarkably bright in the last 20 years, with real GDP growing at 5½% a year on average and domestic employment by 3¼%. Growth slowed down strongly in 2001 but recovered quickly, reaching 4.4% in 2004. The financial position of the Luxembourg government has traditionally been very sound, with recurrent surpluses since the beginning of the 1990's and a very low public debt. However, due to the very strong rise in expenditure, these surpluses rapidly declined since the beginning of this decade and turned into a deficit in 2004.

(3) According to the programme's macroeconomic scenario, real GDP growth should accelerate from an estimated 4.0% in 2005 to 4.4% in 2006 and to 4.9% in both 2007 and 2008. This growth scenario seems plausible, though slightly favourable in the outer years when compared with the Commission services' autumn 2005 forecasts and the estimates of potential output growth implied by the same forecasts. The inflation outlook presented in the programme seems plausible. It is significantly lower than the inflation projections from the Commission services' autumn 2005 forecasts but rests on different assumptions, especially a lower oil price. Oil products have an unusually large weight in the Luxembourg HICP due to the big purchases of car fuel by non-residents.

(4) In its opinion of 18 January 2005, the Council endorsed the budgetary strategy presented in the previous update of the stability programme, covering the period 2004-2007. As regards budgetary implementation in 2005, the general government deficit is currently estimated at -2.3% of GDP in the Commission services' autumn 2005 forecast as against a -1.0% of GDP target set in the previous update of the stability programme. While government revenues, which were projected by the previous update to increase by 1.2 percentage point of GDP, actually rose by only 0.2 percentage point of GDP, for a part due to large and unexpected VAT reimbursements, government expenditure increased by 1.4 percentage point of GDP (of which 0.8 accounted for by public investment) instead of 0.8 percentage point of GDP as planned.

(5) The programme aims at reducing the general government deficit from -2.3% of GDP in 2005 to -0.2% of GDP in 2008 in order to achieve a medium-term objective (hereafter MTO) of -0.8% of GDP in the same year. The time profile and the level of the primary balance are similar to those of the total balance, with an improvement from a -2.1% of GDP primary deficit in 2005 to a balanced budget at the end of the period. The budgetary strategy has been adapted since the submission of the previous programme, which was based on less optimistic, though still strong macroeconomic assumptions and projected the general government deficit to improve from -1.4% of GDP in 2004 to -1.0% in 2005 and then to remain broadly at the same level in 2006

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[3] It has gaps in the compulsory and optional data prescribed by the code of conduct.

and 2007. Although GDP growth in 2005 was even slightly stronger than expected, the deficit, instead of improving surged from a revised level of -1.2% of GDP in 2004 to -2.3% in 2005. The budgetary strategy has thus been adapted in the current programme in order to cope with this unexpectedly deteriorated situation. The budgetary adjustment planned by the programme is expenditure-based, as total government expenditure is projected to decline by 2.5 percentage points of GDP over the period while the revenue ratio should decrease by 0.4 percentage point of GDP. The reduction in the expenditure ratio should mostly occur in current expenditure, especially in collective government consumption and in social transfers. The adjustment effort is back-loaded since the projected reduction in both the nominal and the cyclically-adjusted deficits is planned to significantly accelerate in 2007.

(6) The cyclically-adjusted balance (as calculated by the Commission services using the commonly agreed methodology and based on the information provided in the programme) is projected to improve from a 1½% of GDP deficit in 2005 to a broadly balanced position in 2008. In the absence of one-off or other temporary measures, the structural balance follows the same path. The budgetary improvement takes place against the background of a negative but narrowing (from -1¾% of GDP in 2005 to -0.5% in 2008) output gap in the light of the very high potential output growth estimated for Luxembourg. The programme's MTO is a structural (i.e. cyclically-adjusted, net of one-off and other temporary measures) deficit of -0.8% of GDP, similar to the estimated minimum benchmark aiming at providing a sufficient safety margin in order to guarantee that the 3% threshold set for the general government deficit will not be breached. Hence, its achievement should fulfil the aim of providing this safety margin. Moreover, it can be considered as appropriate under the current assessment because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(7) There is some downside risk attached to the budgetary targets of the programme: first, the macroeconomic projections presented by the programme might be slightly optimistic in the last years of the period covered. Second, the expenditure reduction measures announced for 2007 and 2008 have not yet been specified. The respect of the budgetary projections of the programme thus depends on the condition that the measures to be taken for 2007 and 2008 are specified and properly implemented.

(8) Taking into account this risk assessment, the budgetary strategy outlined in the programme seems sufficient to ensure that the programme's MTO will be reached by the end of the programme period on the condition that the measures for 2007 and 2008 are specified and properly implemented. The risk of breaching the 3% of GDP threshold for the deficit cannot be excluded in 2006 since the cyclically adjusted deficit (as calculated by the Commission services on the basis of the programme and according to the commonly agreed methodology) will still amount to 1¼ % of GDP, which is higher than the minimum benchmark. Although from 2007 onwards the planned structural deficit is lower than the minimum benchmark, the safety margin may also not be sufficient unless the expenditure-reducing measures announced for that year are specified and implemented. Finally, the adjustment path (in structural terms) towards the programme's MTO is appropriate, except perhaps in 2006 when the reduction in the cyclically-adjusted deficit only amounts to 0.3% of GDP. This is less than the 0.5 percentage point of GDP average annual improvement in the

structural balance requested by the Pact while, in spite of a negative yet closing output gap, overall economic conditions may be regarded as good.

(9) The general government debt is estimated at 6.4% of GDP in 2005. It is projected in the programme to rise to 10.2% of GDP in 2008, with the main part of this increase occurring in 2006. The main factors behind this rise are the planned issue of new loans aiming at financing expenditure in road and railways infrastructure as well as some large investment projects based on a public-private partnership for which the Luxembourg government provides a financial guarantee to the promoter.

(10) With regard to the sustainability of public finances, Luxembourg appears to be at medium risk on grounds of the projected budgetary costs of ageing populations. The current level of debt is certainly very low and the planned consolidation over the medium term should contribute to partly alleviate the risk to public finances sustainability. However, Luxembourg has experienced, over the last two decades, a period of exceptionally strong employment growth which will progressively translate into a similar increase in the number of pensioners and into a large increase in pension expenditure. While it contributes significantly to public finances sustainability, the current size of pension fund assets will not be sufficient and, as recognised by the programme, some changes in the pensions schemes will prove necessary at some point to contain future increase in public expenditure and reduce the risk to long-term sustainability.

(11) The programme's strategy in the area of public finances is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. It is in particular in line with the integrated guideline on securing economic stability by maintaining the medium-term budgetary objective over the economic cycle and, as long as this objective has not yet been achieved, taking all the necessary corrective measures in line with the Stability and Growth Pact. It also complies with the integrated guideline on safeguarding economic sustainability in view of the projected costs of ageing population.

(12) The National Reform Programme of Luxembourg, submitted on 17 November 2005 in the context of the renewed Lisbon strategy for growth and jobs identifies securing economic stability and safeguarding economic sustainability as challenges with significant implications for public finances. It also identifies challenges in other areas that have a significant impact on public finances, especially the need to significantly increase public R&D. The budgetary implications of the actions outlined in the National Reform Programme are reflected in the budgetary projections of the stability programme and the measures in the area of public finances envisaged in the stability programme are in line with the actions foreseen in the National Reform Programme. The stability programme complements these measures with changes in the institutional features of the public finances, especially the postponement of the submission of the budget from August to October, in order to increase data availability and to improve the quality of budgetary projections. The programme also announces the introduction of a more in-depth analysis of the cost of investment projects, including the consideration of their operating costs from the first planning phase.

In view of this assessment, while the global strategy of deficit reduction through expenditure restraint presented in the programme is commendable, it would be appropriate for the Luxembourg authorities:

– to strengthen the effort of budgetary adjustment in 2006 and identify and implement the necessary measures for 2007 and 2008, and

– to address the long-term budgetary implications of ageing populations.

Recommendation for a

COUNCIL OPINION

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

On the updated stability programme of Luxembourg, 2005-2008

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 coordination of economic policies[4], 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:

(1) The economic performance of Luxembourg has been remarkably bright in the last 20 years, with real GDP growing at 5½% a year on average and domestic employment by 3¼%. Growth slowed down strongly in 2001 but recovered quickly, reaching 4.4% in 2004. The financial position of the Luxembourg government has traditionally been very sound, with recurrent surpluses since the beginning of the 1990's and a very low public debt. However, due to the very strong rise in expenditure, these surpluses rapidly declined since the beginning of this decade and turned into a deficit in 2004.

(2) In its opinion of 18 January 2005, the Council endorsed the budgetary strategy presented in the previous update of the stability programme, covering the period 2004-2007.

(3) As regards budgetary implementation in 2005, the general government deficit is currently estimated at -2.3% of GDP in the Commission services' autumn 2005 forecast as against a -1.0% of GDP target set in the previous update of the stability programme. While government revenues, which were projected by the previous update to increase by 1.2 percentage point of GDP, actually rose by only 0.2 percentage point of GDP, for a part due to large and unexpected VAT reimbursements, government

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4 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

expenditure increased by 1.4 percentage point of GDP (of which 0.8 accounted for by public investment) instead of 0.8 percentage point of GDP as planned.

(4) On [14 February 2006] the Council examined the updated stability programme of Luxembourg, which covers the period 2005 to 2008. The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct[5].

(5) According to the programme's macroeconomic scenario, real GDP growth should accelerate from an estimated 4.0% in 2005 to 4.4% in 2006 and to 4.9% in both 2007 and 2008. Assessed against currently available information, this scenario appears to be based on broadly plausible growth assumptions, although slightly favourable in the outer years. The programme's projections for inflation also appear realistic.

(6) The programme aims at bringing the general government deficit close to balance by the end of the programme period and thereby achieving a medium-term objective of -0.8% of GDP in the same year. The time profile and the level of the primary balance are similar to those of the total balance, with an improvement from a -2.1% of GDP primary deficit in 2005 to a 0.1% primary surplus at the end of the period. The deficit reduction is expenditure-based as total government expenditure is projected to decline by 2.5 percentage points over the period while the revenues ratio should decrease by 0.4 percentage point of GDP. In order to cope with the unexpected deterioration in the government balance in 2005, the budgetary strategy has been adapted since the submission of the previous update, which was based on a less optimistic macroeconomic scenario and where the general government deficit, after improving from an estimated -1.4% of GDP in 2004 to a projected -1.0% in 2005, was planned to remain broadly at the same level in 2006 and 2007.

(7) Over the programme period, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve on average by slightly more than 0.5% of GDP per year. The adjustment is back-loaded, significantly increasing in 2007 in both nominal and structural terms. The programme sets the medium-term objective (MTO) for the budgetary position at a structural deficit of 0.8% of GDP and aims at achieving this position by 2008. The programme's MTO is similar to the minimum benchmark aiming at providing a sufficient safety margin in order to guarantee that the 3% threshold set for the general government deficit is not breached. Hence, its achievement should fulfil the aim of providing this safety margin. Moreover, the MTO can be considered as appropriate under the current assessment because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(8) The budgetary outcome could be worse than projected in the programme. First the macroeconomic projections presented by the programme might be slightly optimistic in the last years of the period covered. Moreover, the measures announced by the programme and aiming at continuing the adjustment effort in 2007 and 2008 are not

[5] It has gaps in the compulsory and optional data prescribed by the code.

yet specified. The achievement of the programme's budgetary objectives is conditional on the specification and proper implementation of these measures.

(9) In view of this risk assessment, the budgetary stance in the programme seems sufficient to ensure that the MTO is achieved at the latest by 2008, as envisaged in the programme, on the condition that the measures announced for 2007 and 2008 are specified and properly implemented. According to the Commission services calculations, the risk of breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations cannot be excluded in 2006. Although from 2007 onwards the planned structural deficit is lower than the minimum benchmark, the safety margin may also not be sufficient in 2007 unless the expenditure-reducing measures announced for that year are specified and implemented. The pace of the adjustment towards the MTO is broadly in line with the Stability and Growth Pact, which specifies that, for euro area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark. However, the improvement in the structural deficit planned by the programme only amounts to 0.3 percentage point of GDP in 2006, when, in spite of a negative yet closing output gap, the overall economic conditions can be regarded as good.

(10) The general government debt is estimated at 6.4% of GDP in 2005. It is projected in the programme to rise to 10.2% of GDP in 2008, with the main part of this increase occurring in 2006.

(11) With regard to the sustainability of public finances, Luxembourg appears to be at medium risk on grounds of the projected budgetary costs of ageing populations. The current level of debt is certainly very low and the planned consolidation over the medium term should contribute to partly alleviate the risk to public finances sustainability. However, Luxembourg has experienced, over the last two decades, a period of exceptionally strong employment growth which will progressively translate into a similar increase in the number of pensioners and into a large increase in pension expenditure. While it contributes significantly to public finances sustainability, the current size of pension fund assets will not be sufficient and, as recognised by the programme, some changes in the pensions schemes will prove necessary at some point to contain future increase in public expenditure and reduce the risk to long-term sustainability.

(12) The programme's strategy in the area of public finances is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008, in particular with the integrated guideline on securing economic stability by maintaining the medium-term budgetary objective over the economic cycle and, as long as this objective has not yet been achieved, taking all the necessary corrective measures in line with the Stability and Growth Pact and the integrated guideline on safeguarding economic sustainability in view of the projected costs of ageing population.

(13) The National Reform Programme of Luxembourg, submitted on 17 November 2005, identifies the following challenges with significant implications for public finances: (i) securing economic stability and (ii) safeguarding economic sustainability. It also identifies challenges in other areas that have a significant impact on public finances, especially the need to significantly increase public R&D. The budgetary implications of the actions outlined in the National Reform Programme are reflected in the

budgetary projections of the stability programme and the measures in the area of public finances envisaged in the stability programme are in line with the actions foreseen in the National Reform Programme.

While the global strategy of deficit reduction through expenditure restraint presented in the programme is commendable, the Council is of the opinion that the Luxembourg authorities should:

– strengthen the effort of budgetary adjustment in 2006 and identify and implement the necessary measures for 2007 and 2008, and

– address the long-term budgetary implications of ageing populations.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**SP Dec 2005**	**4.4**	**4.0**	**4.4**	**4.9**	**4.9**
	COM Nov 2005	4.5	4.2	4.4	4.5	n.a.
	SP Dec 2004	*4.4*	*3.8*	*3.3*	*4.3*	*n.a.*
HICP inflation (%)	**SP Dec 2005**	**3.2**	**3.7**	**2.6**	**2.0**	**1.8**
	COM Nov 2005	3.2	4.1	4.4	2.2	n.a.
	SP Dec 2004	*2.6*	*3.2*	*1.5*	*1.7*	*n.a.*
Output gap (% of potential GDP)	**SP Dec 2005[1]**	**-1.7**	**-1.7**	**-1.3**	**-0.7**	**-0.6**
	COM Nov 2005[2]	-1.8	-1.6	-1.3	-1.2	n.a.
	SP Dec 2004[1]	*-1.2*	*-2.2*	*-3.8*	*-5.0*	*n.a.*
General government balance (% of GDP)	**SP Dec 2005**	**-1.2**	**-2.3**	**-1.8**	**-1.0**	**-0.2**
	COM Nov 2005	-1.2	-2.3	-2.0	-2.2	n.a.
	SP Dec 2004	*-1.4*	*-1.0*	*-0.9*	*-1.0*	*n.a.*
Primary balance (% of GDP)	**SP Dec 2005**	**-0.9**	**-2.1**	**-1.7**	**-0.7**	**0.1**
	COM Nov 2005	-0.9	-2.1	-1.8	-2.0	n.a.
	SP Dec 2004	*-1.2*	*-0.9*	*-0.8*	*-0.9*	*n.a.*
Cyclically-adjusted balance= Structural balance[3] (% of GDP)	**SP Dec 2005[1]**	**-0.3**	**-1.5**	**-1.2**	**-0.6**	**0.1**
	COM Nov 2005	-0.4	-1.5	-1.4	-1.6	n.a.
	SP Dec 2004[1]	*-0.7*	*0.3*	*1.4*	*2.0*	*n.a.*
Government gross debt (% of GDP)	**SP Dec 2005**	**6.6**	**6.4**	**9.6**	**9.9**	**10.2**
	COM Nov 2005	6.6	6.8	7.1	7.3	n.a.
	SP Dec 2004	*5.0*	*5.0*	*4.6*	*4.5*	*n.a.*

Notes:

[1] Commission services calculations on the basis of the information in the programme.

[2] Based on estimated potential growth of 4.1% 4.0%, 4.1% and 4.3% respectively in the period 2004-2007.

[3] Since there are no one-off and other temporary measures specified in the programme, the cyclically-adjusted balance and the structural balance are identical.

Source:

Stability programme (SP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations.