COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.2.2007
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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, 2006-2009

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL 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. The 2005 reform of the Pact acknowledged its 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 Stability and Growth 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 in 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.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Luxembourg, submitted on 24 November 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated stability programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme), and

(3) the Commission's assessment of the October 2006 national reform programme.

2.1. Recent economic and budgetary performance

The macroeconomic performance of Luxembourg in the last 25 years has been impressive both in terms of output and employment growth. Even if Luxembourg experienced small

[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

deficits in recent years, the situation of public finance remains fundamentally sound, with a very low government debt and sizeable reserves held by the public sector. However, despite the strong job creation, the labour market situation is less favourable than appears at first sight. Unemployment, though still rather low, has been on the rise since 2002, with residents facing intense competition from non-residents. Moreover, the employment rate of older residents, although it rose in recent years, remains one of the lowest in the EU. The burden on public finances constituted by these unemployed and additional retirees has so far been easily sustained thanks to the buoyancy in revenues but it should nevertheless not be understated. Moreover, the large projected increase in ageing-related expenditure over the coming decades is a source of concern for the long-term sustainability of public finance.

2.2. The assessment in the Council opinion on the previous programme

On 14 February 2006, the Council adopted its opinion on the previous update of the stability programme, covering the period 2005-2008. The Council was of the opinion that "*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 improve long-term sustainability, in particular by containing increases in public expenditure through reform in the pension system*".

2.3. The Commission assessment of the October 2006 national reform programme

The implementation report of the national reform programme of Luxembourg, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 27 October 2006. Luxembourg's national reform programme identifies as key challenges: a high quality education and learning system, an economy integrated in the European and international context, an attractive economic environment, a stable macro-economic framework and the respect of the principles of durable development.

The Commission’s assessment of this programme (adopted as part of its December 2006 Annual Progress Report[2]) showed that Luxembourg is making very good progress on implementation of its National Reform Programme and of the actions agreed by the 2006 Spring European Council, but that there is still room for improvement regarding the weaknesses identified in 2005. The macro-economic measures adopted hold out the prospect of fiscal consolidation and lower inflation. A promising set of measures are now being implemented at the micro-economic level. Greater efforts are required, however, to implement a system to monitor and assess annual progress, and a number of measures need to be introduced, for instance to assist business start-ups and SMEs. Despite encouraging reforms on the employment front, no new initiative has been announced to raise the level of employment among older workers, and major reforms to improve the education system have yet to materialise.

Against the background of progress made, Luxembourg was encouraged to focus on the areas of: strategies for further increasing the employment rate among older workers and reforming current early-retirement systems; further efforts to reduce drop-out rates and to remove the artificial barriers between different types of education; close monitoring of the impact on youth unemployment of the measures recently adopted for young; as well as greater support for competitive markets, for the transposition of EU directives and for SMEs.

[2] Communication from the Commission to the Spring European Council, “Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery” - COM(2006) 816, 12.12.2006.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[3];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[4], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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[3] Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

[4] "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.

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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, 2006-2009

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[5], 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) On [27 February 2007] the Council examined the updated stability programme of Luxembourg, which covers the period 2006 to 2009.

(2) The macroeconomic scenario underlying the programme envisages that real GDP growth will decelerate from 5.5% in 2006 to 4.3% on average over the rest of the programme period. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions. The programme's projections for inflation also appear realistic.

(3) For 2006, the general government deficit is estimated at 1.0% of GDP in the Commission services' autumn 2006 forecast, against a target of 1.8% of GDP set in the previous update of the stability programme. This is partly explained by the downward revision of the 2005 deficit outcome, from 2.3% of GDP in the previous programme to 1.0% according to the most recent data. The 2006 deficit outturn may also be better than estimated in the new programme (1.5% of GDP) as tax revenues are likely to be underestimated.

[5] 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

(4) The main goal of the programme's medium-term budgetary strategy is to regain a balanced position within the programme horizon. This is to be achieved through a progressive improvement of the general government balance from an estimated deficit of 1.5% of GDP to a small surplus in 2009 (0.1% of GDP). The reduction in the primary balance would be parallel to the decrease in the headline deficit. The adjustment relies on a reduction in the expenditure ratio amounting to 3.8 percentage points of GDP, which would more than compensate for a 2.1 point of GDP decrease in the revenue ratio. This strategy is similar to that described in the 2005 programme, which, against the background of a broadly similar macroeconomic outlook, projected the deficit to reach its peak in 2005 rather than 2006 and a broadly balanced position to be achieved in 2008 instead of 2009.

(5) 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 from a deficit of around 1¼% of GDP in 2006 to a surplus of about 1% at the end of the programme period. As in the previous update of the stability programme, the medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of 0.8% of GDP. The programme aims to achieve the MTO by 2007, one year earlier than in the previous update. As the MTO is (slightly) more demanding than the minimum benchmark (estimated at a deficit of around 1% of GDP, achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO 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.

(6) The budgetary outcomes could be better than projected in the programme. In particular, tax projections seem rather cautious, especially for 2007. Indeed, budgetary outcomes have very often been better than projected in Luxembourg in recent years, generally because of significantly higher-than-expected revenues.

(7) In view of this risk assessment, the budgetary stance in the programme seems sufficient to ensure that the MTO is achieved by 2007, as envisaged in the programme. In addition, it seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations from 2007 onwards. The pace of the adjustment towards the MTO implied by the programme is fully 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 and that the adjustment should be higher in good economic times and could be lower in bad economic times. After the achievement of the MTO, the fiscal policy stance implied by the programme is also fully in line with the Pact.

(8) Government gross debt is estimated to have reached 7.5% of GDP in 2006, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to rise slightly to 8.5% of GDP by the end of the programme period.

(9) The long-term budgetary impact of ageing in Luxembourg is among the highest in the EU, influenced notably by a very considerable increase in pension expenditure, by 7½ percentage points of GDP, and in total age-related public spending, by 8¼ points, from 2004 to 2050 (compared to EU average increases of 2¼ and 3½ percentage points of GDP, respectively). The current level of gross debt is very low and considerable assets

have been accumulated by the social security system. However, while the current size of these assets (estimated at around 25% of GDP) contributes significantly to public finance sustainability, it will not be sufficient to offset the impact on the debt ratio in the long term resulting from the sizeable increase in age-related expenditure. Therefore, while keeping a strong budgetary position will help to alleviate part of the cost of ageing, as recognised by the authorities, some changes to the pension scheme are necessary so as to contain the future increase in public expenditure and reduce the risks to the long-term sustainability of public finances. Overall, Luxembourg appears to be at medium risk with regard to the sustainability of its public finances.

(10) The stability programme contains a qualitative assessment of the overall impact of the October 2006 implementation report of the national reform programme within the medium-term fiscal strategy. In addition, it provides some information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme and its budgetary projections seem to take into account the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the stability programme seem consistent with those foreseen in the national reform programme. In particular, the government's intention, confirmed by the programme, to keep public investment at a high level seems to reflect the identification as priority actions by the NRP of the increase in R&D, the encouragement of the sustainable use of resources and the improvement of the rail connections with neighbouring countries.

(11) The budgetary strategy outlined in the programme is partly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, no significant pension reforms have been undertaken to date.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data[6]. In addition, it deviates on some material points from the model structure specified in the code of conduct[7].

The overall conclusion is that, in a context of strong growth prospects, the programme is making rapid progress towards the MTO, which should be achieved from 2007 onwards, and envisages a further narrowing of the deficit thereafter. However, the expenditure-curbing measures recently decided are only temporary (i.e. until 2009).

Taking into account the above assessment and in view of the projected increase in age-related expenditure, Luxembourg is invited to improve the long-term sustainability of public finances by implementing structural reform measures (especially in the area of pensions).

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[6] In particular, the data on sectoral balances are missing (except for the general government).

[7] The section on the institutional features of public finance is missing.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009
Real GDP (% change)	**SP Nov 2006**	**4.0**	**5.5**	**4.0**	**5.0**	**4.0**
	COM Nov 2006	4.0	5.5	4.5	4.2	n.a.
	SP Nov 2005	*4.0*	*4.4*	*4.9*	*4.9*	*n.a.*
HICP inflation (%)	**SP Nov 2006**	**3.8**	**2.9**	**1.4**	**2.0**	**2.0**
	COM Nov 2006	3.8	3.2	2.2	1.8	n.a.
	SP Nov 2005	*3.7*	*2.6*	*2.0*	*1.8*	*n.a.*
Output gap (% of potential GDP)	**SP Nov 2006**[1]	**-1.6**	**-0.3**	**-0.8**	**-0.5**	**-1.6**
	COM Nov 2006[5]	-2.2	-0.9	-0.7	-0.9	n.a.
	SP Nov 2005[1]	*-1.7*	*-1.3*	*-0.7*	*-0.6*	*n.a.*
General government balance (% of GDP)	**SP Nov 2006**	**-1.0**	**-1.5**	**-0.9**	**-0.4**	**0.1**
	COM Nov 2006	-1.0	-1.0	-0.5	-0.3	n.a.
	SP Nov 2005	*-2.3*	*-1.8*	*-1.0*	*-0.2*	*n.a.*
Primary balance (% of GDP)	**SP Nov 2006**	**-0.8**	**-1.3**	**-0.8**	**-0.2**	**0.3**
	COM Nov 2006	-0.8	-0.8	-0.3	-0.1	n.a.
	SP Nov 2005	*-2.1*	*-1.7*	*-0.7*	*0.1*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**SP Nov 2006**[1]	**-0.2**	**-1.3**	**-0.5**	**-0.1**	**0.9**
	COM Nov 2006	0.0	-1.1	-0.2	0.1	n.a.
	SP Nov 2005[1]	*-1.5*	*-1.2*	*-0.6*	*0.1*	*n.a.*
Structural balance[2] (% of GDP)	**SP Nov 2006**[3]	**-0.2**	**-1.3**	**-0.5**	**-0.1**	**0.9**
	COM Nov 2006[4]	0.0	-1.1	-0.2	0.1	n.a.
	SP Nov 2005	*-1.5*	*-1.2*	*-0.6*	*0.1*	*n.a.*
Government gross debt (% of GDP)	**SP Nov 2006**	**6.1**	**7.5**	**8.2**	**8.5**	**8.5**
	COM Nov 2006	6.0	7.4	7.3	7.1	n.a.
	SP Nov 2005	*6.4*	*9.6*	*9.9*	*10.2*	*n.a.*

Notes:
[1] Commission services calculations on the basis of the information in the programme.
[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[3] There are no one-off and other temporary measures in the programme.
[4] There are no one-off and other temporary measures in the Commission services' autumn 2006 forecast.
[5] Based on estimated potential growth of 4.1%, 4.1%, 4.4% and 4.7% respectively in the period 2005-2008.
Source:
Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations