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COMMISSION OF THE EUROPEAN COMMUNITIES

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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, 2008-2010

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact 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 policies¹, which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme 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.

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 6 October 2008, and its addendum, presented on 2 February 2009, and has adopted a recommendation for a Council opinion on it.

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

- (1) the Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”);
- (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).

2.1. The Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”)

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan². The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to €200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of €170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of €30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term

¹ OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

² Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term is made in the opinions of stability or convergence programmes.

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

In its opinion of 12 February 2008, the Council summarised its assessment of the previous update of the stability programme, covering the period 2007-2010, as follows : “The overall conclusion is that public finances have gone back to surplus in a context of strong GDP and employment growth. Recently released revised data indicate that the deterioration in public finances has been significantly more limited than previously estimated. Consequently, Luxembourg has constantly achieved its MTO and the path for the general government balance in the programme is at least 1% of GDP better in each year than in the previous update. While tax cuts will result in a small decrease in the surplus in 2008, the programme aims at maintaining a surplus of 1% of GDP on average throughout the period. The macroeconomic scenario and budgetary targets of the programme seem plausible and budgetary outcomes might even be slightly better than planned. However, Luxembourg will have to support in the coming decades a particularly heavy burden resulting from population ageing and no corrective measures have been taken to date. This explains that the country is considered to be at medium risk as regards the long-term sustainability of its public finances, in spite of its currently sound budgetary position.” In the light of the projected increase in age-related expenditure, the Council invited Luxembourg to “improve the long-term sustainability of its public finances by implementing structural reform measures, in particular in the area of pensions”.

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**in accordance with the third paragraph of Article 5 of
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On the updated stability programme of Luxembourg, 2008-2010

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 policies³, 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 [10 March 2009] the Council examined the updated stability programme of Luxembourg, which covers the period 2008 to 2010⁴.
- (2) Economic activity slowed down considerably as a result of the global economic downturn and the financial crisis, with real GDP growth falling from 5.2% in 2007 to about 1% in 2008. In 2009, economic activity is expected to contract by 0.9% according to the Commission services' January 2009 interim forecast: the Luxembourgish economy, which is both very open and dependant on the performances of its financial sector, will be seriously hit by the projected fall in world trade and the financial crisis, while government spending and, to some extent, private consumption are expected to constitute the only support to growth. The main policy challenges in the downturn are related to the financial sector, whose activity is highly internationalised, and to the support of domestic demand. The downturn will have a significant impact on public finances as the large surplus projected for 2008 is expected to turn in 2009 into a deficit which will widen in 2010. This deterioration in

³ OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

⁴ The original October 2008 programme covered the period 2008-2011. However, the Luxembourgish authorities submitted on 2 February an addendum replacing the original macroeconomic and budgetary scenario by a fundamentally different one, but which only covers the period 2008-2010. The Commission services could therefore not assess the macroeconomic scenario and the budgetary targets in 2011.

the government balance also takes into account the effect of the support measures decided in recent months, which essentially include important tax cuts, especially in personal income tax, as well as a significant acceleration in the implementation of government investment projects. In view of the large available fiscal space created by the favourable starting budgetary position and the very low level of the public debt, these measures are appropriate and welcome.

- (3) The macroeconomic scenario underlying the programme, as amended by the addendum projects real GDP, after decelerating from 5.2% in 2007 to 1.0% in 2008, to contract by 0.9% in 2009 before recovering somewhat and rising by 1.4% in 2010. Assessed against currently available information⁵, this scenario appears to be based on plausible growth assumptions for 2008 to 2010. It is fully in line with the Commission services' January 2009 interim forecast. The programme's projections for inflation and wage developments also appear realistic.
- (4) For 2008, the general government surplus is estimated at 2.0% of GDP in the programme's addendum, which compares with a target of 0.8% of GDP set in the previous update of the stability programme. This much better than expected outcome compared to the previous update is for a large part due to the base effect associated to a revision of the general government surplus in 2007 from a previous estimate of 1% of GDP to 3.2%, mainly on account of revenue surprises. For 2008, these better than expected starting position was partly offset by higher than anticipated expenditure growth, in particular in government consumption and investment as well as social transfers. The faster than expected increase in government consumption is for a part explained by the hiring of new staff required by the development of the University of Luxembourg and other public research centres..
- (5) The programme projects the general government balance to deteriorate from a surplus of 2% of GDP in 2008 to a deficit of 0.6% of GDP in 2009. This can be explained in part by the impact of the economic slowdown and the associated normal functioning of automatic stabilisers, especially concerning tax revenue from the financial sector. The 2009 deficit will also result from discretionary measures adopted in the 2009 budget including those decided in response to the economic downturn and in line with the European Economic Recovery Plan. The 2009 budget foresees important tax cuts, especially in personal income tax, amounting ex ante to about 1¼% of GDP, while some government investment projects initially scheduled for 2010 are planned to be brought forward. Revenues are projected to decline by about ½ percentage point of GDP in 2009. This comprises a decrease by 1 percentage point of GDP in direct taxes resulting from the tax cuts and from the impact of the crisis, while social contributions and property income would increase by around ¼ percentage point of GDP each, thanks to the carry-over resulting from still buoyant employment growth until the end of 2008 and to the interests received on the loans granted in support of the financial sector. Simultaneously, in 2009 general government expenditure is planned to raise by 2¼ percentage point of GDP, mainly as a result of significant increases in government consumption and investment as well as in social transfers, the latter being partly the result of the

⁵ The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has become available since then.

replacement of the tax reduction for children by a system of tax credit and also of the increase in unemployment forecast for this year.

- (6) The programme projects the general government headline deficit to deteriorate further from 0.6% of GDP in 2009 to 1.5% of GDP in 2010, while the primary deficit would increase from 0.3% of GDP to 1.2%. Luxembourg's medium-term budgetary objective is a structural (that is cyclically-adjusted and net of one-off and other temporary measures) deficit of ¾% of GDP. Based on the programme's macroeconomic scenario and budgetary projections, this medium-term objective is planned to be fully respected throughout the period covered: the structural balance recalculated according to the commonly agreed methodology based on the information in the programme is projected to remain positive, slightly declining from a surplus of 0.6% of GDP in 2009 to a surplus of 0.4% of GDP in 2010. The gross public debt, which doubled from 7% of GDP in 2007 to 14.4% of GDP in 2008 as a result of the financing of the supporting loans to the Luxembourgish subsidiaries of relevant foreign banks, is projected to increase to 15% of GDP in 2009 and to 17% in 2010. However, despite its doubling in 2008, it will remain by far the lowest inside the euro area.
- (7) The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, some downside risks to the macroeconomic scenario could materialise. In particular, private consumption might prove less resilient than forecast. Moreover, the impact of the crisis on tax revenue, especially those from the financial sector, could be even larger than currently expected. On the other hand, the 2008 outcome might be better than projected in the programme (as was already the case in 2007) since budgetary projections in Luxembourg are traditionally renowned for being cautious.
- (8) The main concern for Luxembourg's public finance remains their long-term sustainability in view of the very large projected increase in age-related public expenditure and the fact that no measures have been taken to date in order to address this issue. : the long-term budgetary impact of ageing is among the highest in the EU, influenced notably by a very considerable projected increase in pension expenditure. The budgetary position in 2008 as estimated in the programme, which is better than the starting position of the previous programme, the low debt ratio, the significant assets accumulated in social security, and a structural primary surplus contribute to offsetting the projected long-term budgetary impact of ageing populations. However, this is not sufficient to cover the sizeable increase in age-related expenditure. Achieving high primary surpluses over the medium term and, as recognized by the authorities, implementing measures aimed at curbing the substantial increase in age-related expenditures would contribute to reducing the medium risk to the sustainability of public finances. The risks for sustainability stemming from the financial sector support operations performed in recent months do not seem considerable at the moment, despite the sizeable increase in public debt that these operations required, even though potential liabilities could be comparatively important due to the very large size of the financial sector. Moreover, a large part of the costs (or even all of them) generated by these support operations could be recouped in the future.
- (9) The structure of public finance seems comparatively favourable in Luxembourg: government expenditure and the tax burden are relatively low and expenditure as

well as revenue systems seem relatively efficient, compared with other Member States. In particular, government consumption and taxation of labour income are comparatively low while public investment is one of the highest in the whole EU.

- (10) With a view to stabilising the financial sector, the Luxembourgish government decided in September and October 2008 to grant a convertible loan to the local subsidiaries of two large foreign banks for a total amount of 2.776 billion euro (7.6% of GDP). In order to improve its access to finance, it was also decided to guarantee the new commitments contracted by one of these banks towards institutional investors and with a maximum maturity of three years. Finally, in order to restore depositors' confidence, the amount covered by the deposit guarantee scheme was raised from 20 000 EUR to 100 000 EUR per deposit. It should be noted that the general government holds large financial assets, accumulated from the recurrent surpluses recorded in the last decades and augmented by the loans granted to the local subsidiaries of two foreign banks at the end of 2008. These assets amounted to about 32% of GDP in 2008, of which about one third held by the central government and two thirds by the social security system. Consequently, the net financial position of the general government is widely positive.
- (11) Some fiscal support measures had already been decided in the 2009 budget, which was drafted before the aggravation in the financial crisis. They consisted for the most part of cuts in income tax, the cost of which is estimated by the programme at about 1.2% of GDP. The budget also foresaw a reduction of the corporate tax rate, which will affect revenues from 2010 onwards. In addition, in line with the European Economic Recovery Plan agreed in December by the European Council, Luxembourg has adopted other support measures, among which the most relevant refer to an acceleration in government investment as well as subsidies for the purchase of energy-efficient durables and for energy-saving investments. Furthermore, the employers' share of the unemployment benefit in case of part-time unemployment will be reimbursed by the government until the end of 2009. In total, these stimulus measures will amount to about 1¾% of GDP. Thanks to the non negligible surplus recorded in 2008 and to the very low level of the public debt, the available room for manoeuvre is especially large in Luxembourg. The fiscal stimulus package for 2009 and 2010 appears to constitute an adequate response to the current economic downturn, although a large part of the stimulus measures are not supposed to be temporary, in particular the cuts in income tax, which were primarily designed to compensate for the non-indexation of income tax brackets since 2001. Luxembourg also took several measures and will take additional ones in the coming years in order to create a more attractive economic environment and to implement the energy and climate-change package. These measures are related to the medium-term reform agenda proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs.
- (12) The structural balance calculated according to the commonly agreed methodology is projected to remain in surplus, declining from 1.5% of GDP in 2008 to 0.6% of GDP in 2009 and 0.4% of GDP in 2010. The overall fiscal stance as measured by changes in this structural balance thus appears to be expansionary in 2009, reflecting the response of the Luxembourgish government to the downturn, and mildly expansionary in 2010. Taking into account the risks to the budgetary projections, the MTO is projected to be respected over the period covered. The budgetary strategy is fully in line with the Stability and Growth Pact.

- (13) 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 data⁶. Moreover, the addendum to the programme, which replaces the original macroeconomic and budgetary scenario, does not provide projections for 2011⁷.

The overall conclusion is that, in view of the large available fiscal space, the measures decided in response to the downturn and presented in the addendum to the stability programme are appropriate and should be welcomed. They are generally in line with the principles (timely, targeted and temporary) of the European Economic Recovery Plan, even though the cuts in income tax, which were decided before the aggravation in the crisis, are not planned to be temporary. Due to the projected sharp economic downturn and to the measures decided in response to the downturn, the government balance will turn into a deficit in 2009, after several years in surplus, but it will remain far from the 3% reference value and the medium-term objective is planned to be respected throughout the programme period. Risks to the programme's budgetary targets seem broadly balanced. However, concerns remain about the long-term sustainability of public finance, which will have to bear a particularly heavy burden in the coming decades as the increase in age-related public expenditure, is projected to be among the strongest in the whole EU.

In view of the above assessment and of the very strong increase in age-related expenditure forecast for the coming decades, Luxembourg is invited to

- i) implement in 2009 the measures in line with the EERP as planned and
- ii) improve the long-term sustainability of its public finances by implementing structural reform measures, in particular in the area of pensions.

Luxembourg is also invited to improve compliance with the requirements of the code of conduct.

⁶ In particular, there are no data on sectoral balances with the exception of the general government.

⁷ Article 3(3) of Council Regulation (EC) No 1466/97 foresees that *'The information about the paths for the general government deficit ratio and debt ratio and the main economic assumptions (...) shall cover, as well as the current and the preceding year, at least the following three years'*.

Comparison of key macro economic and budgetary projections

		2007	2008	2009	2010
Real GDP (% change)	SP Oct 2008	5.2	1.0	-0.9	1.4
	COM Jan 2009	5.2	1.0	-0.9	1.4
	SP Nov 2007	6.0	4.5	5.0	4.0
HICP inflation (%)	SP Oct 2008	2.7	4.1	0.6	2.5
	COM Jan 2009	2.7	4.1	0.6	2.5
	SP Nov 2007	2.3	2.0	2.1	2.1
Output gap ¹ (% of potential GDP)	SP Oct 2008	3.2	1.1	-2.5	-3.8
	COM Jan 2009 ²	3.2	1.1	-2.3	-3.5
	SP Nov 2007	0.5	0.1	0.2	-0.8
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	SP Oct 2008	n.a.	n.a.	n.a.	n.a.
	COM Jan 2009	n.a.	n.a.	n.a.	n.a.
	SP Nov 2007	n.a.	n.a.	n.a.	n.a.
General government revenue (% of GDP)	SP Oct 2008	41.0	43.2	42.8	42.8
	COM Jan 2009	41.0	43.6	44.0	42.9
	SP Nov 2007	38.5	37.8	37.9	37.8
General government expenditure (% of GDP)	SP Oct 2008	37.8	41.2	43.4	44.3
	COM Jan 2009	37.8	40.6	43.5	44.3
	SP Nov 2007	37.5	36.9	36.9	36.6
General government balance (% of GDP)	SP Oct 2008	3.2	2.0	-0.6	-1.5
	COM Jan 2009	3.2	3.0	0.4	-1.4
	SP Nov 2007	1.0	0.8	1.0	1.2
Primary balance (% of GDP)	SP Oct 2008	3.5	2.3	-0.3	-1.2
	COM Jan 2009	3.5	3.3	1.0	-0.9
	SP Nov 2007	1.2	1.1	1.2	1.5
Cyclically-adjusted balance ¹ (% of GDP)	SP Oct 2008	1.6	1.5	0.6	0.4
	COM Jan 2009	1.6	2.4	1.6	0.3
	SP Nov 2007	0.7	0.8	0.9	1.6
Structural balance ³ (% of GDP)	SP Oct 2008	1.6	1.5	0.6	0.4
	COM Jan 2009	1.6	2.4	1.6	0.3
	SP Nov 2007	0.7	0.8	0.9	1.6
Government gross debt (% of GDP)	SP Oct 2008	7.0	14.4	14.9	17.0
	COM Jan 2009	7.0	14.4	15.0	15.1
	SP Nov 2007	6.9	7.1	7.2	7.0

Notes :

¹ Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

² Based on estimated potential growth of 4.2%, 3.2%, 2.7% and 2.8% respectively in the period 2007-2010.

³ Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0% of GDP in 2009, 2010 and 2011 according to the most recent programme and in the Commission services' January interim forecast.

Source: Stability programme (SP), Commission services' January 2009 interim forecasts (COM); Commission services' calculations.