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**Assessment of the 2015 Stability Programme for
LUXEMBOURG**

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses Luxembourg's April 2015 Stability Programme (hereafter called Stability Programme), which was submitted to the Commission on 30 April and covers the period 2014-2019. It was approved by the government and underwent an inclusive consultation process involving the national parliament.

Luxembourg is currently subject to the preventive arm of the the Stability and Growth Pact and should preserve a sound fiscal position which ensures compliance with the medium-term objective.

This document complements the Country Report published on 26 February 2015 and updates it with the information included in the Stability programme. Section 2 presents the macroeconomic outlook underlying the Stability Programme and provides an assessment based on the Commission 2015 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Stability Programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the Stability and Growth Pact, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 summarises the main conclusions.

2. MACROECONOMIC OUTLOOK

In 2014, real GDP growth reached 3.1%, accelerating from 2.0% in 2013. Specifically, during the second half of the year, the economy grew at a pace well above 3% in annual terms, compared to 1.9% in the first six months. According to the programme, GDP growth is projected to peak at 3.8% in 2015 and then gradually decelerate to 2.8% by 2019.¹

According to the authorities, growth in 2015 will be mostly driven by domestic demand, as a sharp increase in both private consumption and investment is forecast. Contribution to growth from net export is expected to be modest as import growth slightly outpaces that of export. In the outer years, contribution to growth is expected to become rather balanced, as domestic demand and net export will equally on average contribute to overall growth.

The outlook for GDP growth has been revised upwards substantially in the Stability Programme compared with the macro-economic scenario underpinning the 2015 Draft Budgetary Plan (DBP), where GDP in 2015 was projected to expand at 2.7%. Most recent soft and hard data confirm the acceleration in economic activity that started already in the second half of last year, even if anticipation effects associated with the VAT rates increase taking effect in January 2015 could have played a role and boosted household consumption and investment at the end of last year.

According to the programme, the output gap, as recalculated by the Commission based on the information in the programme and following the commonly agreed methodology, is projected to almost close already in 2016. It should then stabilise in the following years covered by the

¹ The external outlook underlying the macro-economic scenario in the Stability Programme is rather close to that in the Commission 2015 spring forecast. Euro area growth rate is projected at 1.4% and 2.0% for 2015 and 2016 respectively, compared to 1.5% and 1.9% in the Commission 2015 spring forecast.

programme, as the utilisation of production capacities approaches normal levels in 2016. Potential growth is projected to increase from 2.2% in 2015 to 3.0% in 2019².

Table 1: Comparison of macroeconomic developments and forecasts

	2014		2015		2016		2017	2018	2019
	COM	SP	COM	SP	COM	SP	SP	SP	SP
Real GDP (% change)	3.1	3.0	3.4	3.8	3.5	3.6	3.3	3.0	2.8
Private consumption (% change)	2.7	3.1	2.4	3.7	2.7	2.7	2.6	2.4	2.3
Gross fixed capital formation (% change)	2.4	5.4	2.4	6.7	3.0	-4.7	12.3	3.2	-0.7
Exports of goods and services (% change)	2.4	2.5	4.4	5.4	5.3	6.9	5.4	5.6	5.8
Imports of goods and services (% change)	2.1	2.8	4.3	5.9	5.5	6.1	6.6	5.9	5.8
<i>Contributions to real GDP growth:</i>									
- Final domestic demand	1.8	2.7	1.6	3.0	1.8	0.1	3.7	2.0	1.1
- Change in inventories	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	1.3	0.3	1.8	0.8	1.6	3.4	-0.3	1.0	1.7
Output gap ¹	-2.7	-3.0	-1.4	-1.5	-0.2	-0.2	0.1	0.1	0.0
Employment (% change)	2.4	2.4	2.5	2.7	2.3	2.3	2.2	1.9	1.8
Unemployment rate (%)	5.9	6.1	5.7	6.0	5.4	6.2	6.2	6.4	6.6
Labour productivity (% change)	0.7	0.5	0.9	0.9	1.1	1.1	0.9	0.9	0.9
HICP inflation (%)	0.7	0.7	0.8	-0.4	2.1	1.0	1.2	1.4	1.5
GDP deflator (% change)	0.9	1.5	0.2	-0.4	1.7	0.4	1.1	1.2	1.0
Comp. of employees (per head, % change)	2.3	1.9	1.7	1.0	2.3	1.8	1.9	2.3	2.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	5.4	n.a.	4.8	n.a.	4.9	n.a.	n.a.	n.a.	n.a.
<i>Note:</i>									
¹ In percent of potential GDP, with potential GDP growth recalculated by the Commission on the basis of the programme scenario using the commonly agreed methodology.									
<i>Source:</i>									
Commission 2015 spring forecast (COM); Stability Programme (SP).									

The expected 3.8% increase of GDP in 2015 in the programme compares with a projected 3.4% growth in the Commission 2015 spring forecast. The difference is mostly explained by a more dynamic development of private consumption in the authorities' scenario, at 3.7% while in the Commission projections the increase is limited to 2.4%. In the Commission's scenario, private consumption is expected to be dampened by the impact of the consolidation measures adopted in the 2015 budget and by the phasing out of the above-mentioned anticipation effect that took place in last part of 2014, in response to the announced increased of VAT rates from the beginning of 2015.

² The evolution of the recalculated output gap is close to the output gap presented in the programme itself up to 2016, however from 2017 up to the end of the period covered by the programme the two show divergent trends. The recalculated output gap stabilises around equilibrium as opposed to the output gap in programme that becomes increasingly positive. The difference is explained by the different estimation methods of potential growth underpinning the computation of the output gap.

In 2016, the programme projects a real GDP growth of 3.6%, very close to the 3.5% in the Commission 2015 spring forecast. However in the programme GDP growth is mostly driven by external demand, while in the Commission projections both domestic and external demand contribute to the expansion of economic activity in almost equal way.

A fall in its energy price component has driven down the headline inflation to 0.7% in 2014 compared with 1.7% in 2013. According to the programme, headline inflation would turn into a deflation in 2015, at a negative growth rate of 0.4%, before increasing to 1.0% in 2016. In the Commission 2015 spring forecast, inflation is projected to increase to 0.8% in 2015 and to be just above 2.0% in 2016. Hence, the Commission projects higher inflation rate. The different assumption about oil prices³ explains most of the difference between the two scenarios.

Overall, the macro-economic projections in the programme are favourable in 2015 and plausible thereafter.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2014

In 2014, the general government surplus declined from 0.9% of GDP to 0.6% of GDP. This position was mainly the result of a large surplus in the social security subsector (+1.5% of GDP), which compensated for the deficit of the central government subsector (-1.1% of GDP), while local governments recorded a small surplus (+0.2% of GDP).

In spite of the decline, the 2014 headline surplus represents a better than expected outcome compared to the 0.1% surplus projected in the 2014 Stability Programme and to the 0.2% surplus in the 2015 DBP. However, a base effect fully explains the difference as the final outcome for the general government balance in 2013 was 0.3% of GDP higher than expected in the 2015 DBP.

The 0.3% of GDP deterioration compared to 2013 is mainly explained by a sharp, 12.7% increase in gross fixed capital formation after a 0.7% drop in 2013, , mostly related to a surge in local government investment, whose surplus declined from 0.5% in 2013 to 0.2% of GDP in 2014. As to total expenditure, in spite of a package of measures worth around 0.4% of GDP in 2014 to curtail public expenditure, the latter increased by 5.2%, implying that the GDP share raised from 43.6% in 2013 to 44% of GDP. Revenues increased by 4.6% in 2014 less than the 5.2% in 2013; in particular revenues from current tax and wealth were lower than expected. The tax burden remained stable at 40.4% of GDP in 2014.

In structural terms, the surplus of the general government balance is estimated to decline from 2.5% of GDP in 2013 to 1.6% of GDP in 2014, still well above the country's medium-term objective (MTO).

³ The external outlook behind the Stability Programme's macroeconomic scenario is qualitatively broadly in line with the external outlook underlying the Commission forecast, although quantitative differences exist. Moreover, in contrast to the Commission forecast, the Stability Programme's constant oil price assumption for 2016 might partly explain its projection of a lower increase in consumer prices in 2016.

3.2. Target for 2015 and medium-term strategy

The target for 2015

In 2015, according to the programme, the general government surplus is expected to decline to 0.1% of GDP, mostly as a result of the expected decrease in e-VAT revenues stemming from the change in the e-commerce legislation (see Box 1). The underlying fiscal loss is estimated at €618 million (around 1.3% of GDP) and will be only partially compensated by the consolidation measures specified in the budget for 2015 for around 1.0% of GDP, including the increase in VAT rates. The planned small surplus for 2015 compares with the 0.2% of GDP deficit target mentioned in the 2015 DBP. The difference is largely explained by the upward revision of the macroeconomic scenario, with GDP growth for 2015 revised to 3.8% compared to 2.7% in the DBP. Higher growth is expected to have a positive impact on revenues, in particular those from the subscription tax⁴ and from taxes on current income and wealth. On the expenditure side, as the economic situation improves, savings will be realised on cyclical related spending (such as payments of unemployment benefits).

The Commission 2015 spring forecast projects a balanced budget in 2015. The 0.1% of GDP difference with the government forecast is largely due to a weaker underlying economic scenario.

The medium-term strategy

The multi-annual programming law, adopted at the end of last year, articulates the medium-term strategy in terms of budgetary targets up to 2018. The Stability Programme, beyond providing an update based of the latest macro-economic and budgetary developments, extends the period covered by the projections to 2019, one year more than in the multi-annual programming law.

The purpose of the programme is to respect the MTO throughout the programme period. The (re)calculated structural balance is projected indeed to post surpluses in the range between 0.6% and 0.9% of GDP over the period between 2016 and 2019, clearly above the country specific MTO of a surplus of 0.5% of GDP. To achieve this objective and counterbalance the loss of VAT revenues stemming from e-commerce, the government has adopted a consolidation package - covering the years from 2015 to 2018 - with an increasing effect from 1.0% of GDP in 2015 to 1.7% of GDP in 2018. As a consequence, the general government headline balance is expected to be comfortably in surplus, amounting to around ¾% of GDP throughout the programme horizon, apart from 2015 when only a small surplus of 0.1% of GDP is planned.

As to 2016, according to the programme the headline balance will record a surplus of 0.7% of GDP. This compares to a smaller surplus of 0.3% of GDP in the Commission 2015 spring forecast. In structural terms, a surplus of 0.8 % of GDP in the programme compares with a surplus of 0.4% of GDP in the Commission projections.

⁴ An annual subscription tax, at the rate of 0.05 percent per annum is levied on the net assets of investment funds on the last day of each quarter. A reduced rate of 0.01 percent per annum is levied on money market funds and special investment vehicles.

Box 1: VAT regime applicable to e-commerce (Directive 2006/112/EC as amended by Directive 2008/8/EC)

According to the aforementioned directive, from 1 January 2015, telecommunications, broadcasting and electronic services will **be taxed in the country where the customer comes from** – regardless of whether the customer is a business or consumer – regardless of whether the supplier is based in the EU or outside. This will apply to all electronically supplied services, notably including digital products (music, videos, games, etc.) and services consisting in providing or supporting businesses' presence in an electronic network such as a website or internet page.

From 1 October 2014, companies providing electronic services from Luxembourg are able to register for the Luxembourg "single window", that enable them to have all their declaration and payment obligations handled by the competent Luxembourg tax administration. As regards the VAT payments that have to be transferred to the member state where consumption takes place in accordance with the special regime provided by Directive 2006/112/EC, the member state in which the supplier is identified for VAT purposes retains:

- from 1 January 2015 to 31 December 2016: 30%;
- from 1 January 2017 to 31 December 2018: 15%;
- from 1 January 2019: 0%.

Consequently, if a company providing electronic services from Luxembourg chooses the Luxembourg "single window", Luxembourg will be able to retain 30% of the VAT revenue generated in this context in 2015 and 2016. For fiscal years 2017 and 2018 the retention rate falls to 15%. Fiscal revenues thus depend, from 2015, on the number and size of taxable companies providing electronic services and opting to sign up to the Luxembourg "single window". The forecast used in this SGP is based on the assumption that the majority of the companies concerned will remain registered in Luxembourg for all their services. Nevertheless, it should be stressed that this registration with the single window is not final. In other words, the company concerned may decide to leave, or may be forced to leave if it breaches applicable EU provisions.

The current programme is based on an assumed cumulative budgetary loss of €5.4 billion, of which EUR 618 million are assumed to relate to the fiscal year 2015, representing a less negative outlook compared with the loss of EUR 698 in the previous update of the Stability programme.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2014	2015		2016		2017	2018	2019	Change: 2014-2019
	COM	COM	SP	COM	SP	SP	SP	SP	SP
Revenue	44.7	44.4	44.4	44.1	44.7	44.5	44.5	44.4	-0.2
<i>of which:</i>									
- Taxes on production and imports	13.6	12.7	12.5	12.6	12.3	12.0	11.8	11.5	-2.1
- Current taxes on income, wealth, etc.	14.5	15.2	15.3	15.2	15.5	15.7	15.9	16.0	1.5
- Social contributions	12.4	12.4	12.4	12.3	12.5	12.5	12.5	12.6	0.2
- Other (residual)	4.2	4.0	4.1	4.0	4.3	4.3	4.4	4.4	0.2
Expenditure	44.0	44.4	44.3	43.8	44.0	43.9	43.6	43.7	-0.4
<i>of which:</i>									
- Primary expenditure	43.7	44.0	44.0	43.5	43.7	43.5	43.3	43.4	-0.3
<i>of which:</i>									
Compensation of employees	8.4	8.6	8.5	8.6	8.4	8.3	8.3	8.3	-0.1
Intermediate consumption	3.7	3.8	3.9	3.7	3.8	3.7	3.7	3.6	-0.1
Social payments	21.3	21.2	21.4	20.8	21.4	21.3	21.3	21.5	0.2
Subsidies	1.9	1.8	1.8	1.8	1.7	1.6	1.5	1.5	-0.4
Gross fixed capital formation	3.8	4.2	4.1	4.1	4.1	4.3	4.3	4.4	0.6
Other (residual)	4.6	4.5	4.2	4.5	4.3	4.2	4.2	4.2	-1.5
- Interest expenditure	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	-0.1
General government balance (GGB)	0.6	0.0	0.1	0.3	0.7	0.7	0.9	0.8	0.2
Primary balance	1.0	0.3	0.4	0.6	1.0	1.0	1.2	1.1	0.1
One-off and other temporary measures	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.2
GGB excl. one-offs	0.4	0.0	0.1	0.3	0.7	0.7	0.9	0.8	0.4
Output gap ¹	-2.7	-1.4	-1.5	-0.2	-0.2	0.1	0.1	0.0	2.6
Cyclically-adjusted balance ¹	1.8	0.6	0.7	0.4	0.8	0.6	0.9	0.8	-1.0
Structural balance (SB)²	1.6	0.6	0.7	0.4	0.8	0.6	0.9	0.8	-0.8
Structural primary balance ²	2.0	0.9	1.0	0.7	1.1	0.9	1.2	1.1	-0.9
<i>Notes:</i>									
¹ Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.									
² Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.									
<i>Source:</i>									
Stability Programme (SP); Commission 2015 spring forecasts (COM); Commission calculations.									

Measures underpinning the programme

The programme provides a sufficient description of the measures underpinning the envisaged budgetary trajectory throughout the programme period. It also provides a comparison with the development of budgetary targets at unchanged policies. The budgetary strategy, including the consolidation package, represents the action of the government to avoid the deterioration in public finances, which would occur at unchanged policies. In fact, according to the programme, the no-policy change headline deficit would amount to 1.0% of GDP in 2015, compared to a surplus of 0.1% of GDP currently planned.

The budgetary strategy consists in the frontloading of the already announced consolidation measures on the revenue side which, in 2015, constitute 70% of the overall consolidation effort. The share of the effort based on the revenue side is then planned to fall to 64% in 2016 and to further decline to 58% in 2019. Overall, the package focuses the efforts on the revenue side, while the expenditures side only accounts for 37% of the overall consolidation effort.

The consolidation package is expected to contribute to contain a further deterioration of the central government balance. In the wake of the change in e-VAT regime, the deficit of the central government would, according to the scenario at unchanged policies, surge from 1.1% of GDP in 2014 to 2.4% of GDP in 2015. Thanks to the measures adopted in the budget for 2015, the deficit of the central government will still worsen, but only to 1.5% of GDP. At the end of the programme period, the budget balance of the central government is expected to still be negative, at 0.6% of GDP.

The budgetary strategy envisaged in the programme is underpinned by the following measures:

- On the revenue side, the increase by 2 pps., with effect from 1st January 2015, of all VAT rates excluding the "super-reduced" rate of 3%. The standard rate increased from 15% to 17%, nevertheless remaining the lowest in the EU. In addition, the standard rate is since then applicable for all real estate investments, excluding the purchase of the first residence. The yield of this measure is estimated at around 0.5% of GDP in 2015 and to increase further in the years thereafter. In addition, a new tax, levied on personal income, is expected to yield 0.2% of GDP additional revenues as of 2015.
- On the expenditure side, the government last year carried out for the first time a comprehensive spending review, with the aim to increase the effectiveness of public spending. The results of this exercise were incorporated in the 2015 budget, which included a heterogeneous list of 258 measures, named 'ZukunftPak', which are expected to produce savings, worth around 0.3% of GDP in 2015, with an impact on both central government and the social security sector. The overall impact of these measures is projected to increase at 0.7% at the end of the programme period.

Main budgetary measures (cumulative impact)

Revenue	Expenditure
2015	
<ul style="list-style-type: none"> • VAT increase (0.5% of GDP) • New levy on personal income (0.2% of GDP) 	<ul style="list-style-type: none"> • ZukunftPak (0.3% of GDP)
2016	
<ul style="list-style-type: none"> • VAT increase (0.7% of GDP) • New levy on personal income (0.2% of GDP) 	<ul style="list-style-type: none"> • ZukunftPak (0.5% of GDP)
2017	
<ul style="list-style-type: none"> • VAT increase (0.8% of GDP) • New levy on personal income (0.2% of GDP) 	<ul style="list-style-type: none"> • ZukunftPak (0.6% of GDP)
2018	
<ul style="list-style-type: none"> • VAT increase (0.8% of GDP) • New levy on personal income (0.2% of GDP) 	<ul style="list-style-type: none"> • ZukunftPak (0.7% of GDP)

Revenue	Expenditure
2019	
<ul style="list-style-type: none"> • VAT increase (0.8% of GDP) • New levy on personal income (0.2% of GDP) 	<ul style="list-style-type: none"> • ZukunftsPak (0.7% of GDP)
<p><u>Note:</u> The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.</p>	

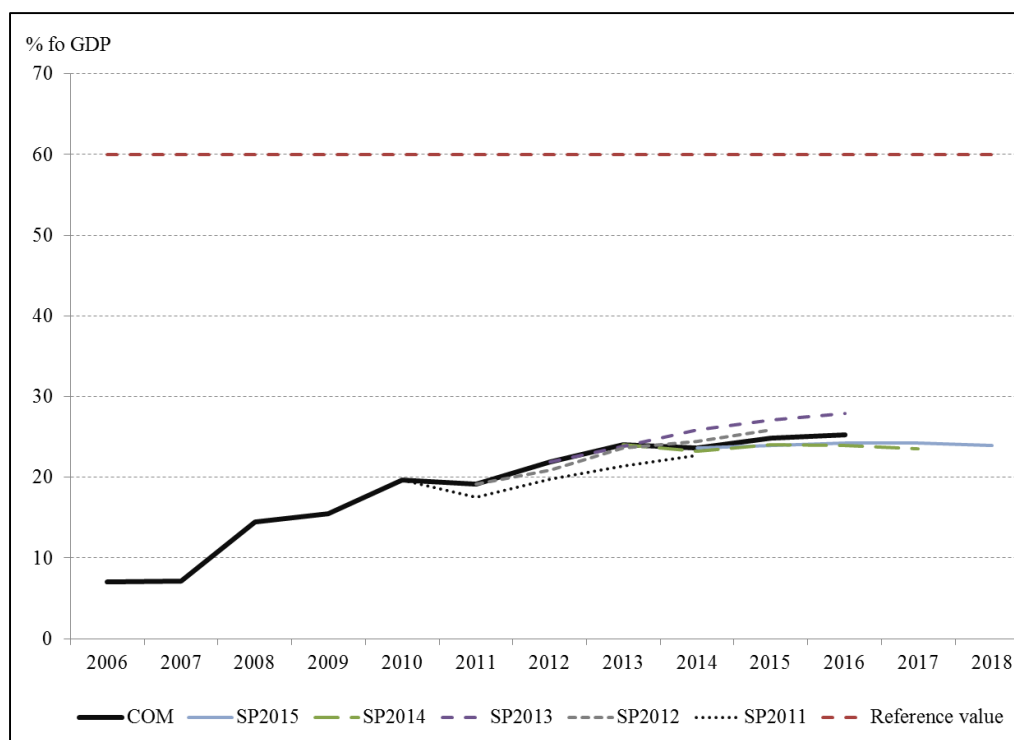
3.3. Debt developments

After increasing from 6½% of GDP in 2007 to 24% of GDP in 2013, mostly because of the support operations to the financial sector, the general government debt declined to 23.6% of GDP in 2014 (see Figure 1), and, according to the programme, it is projected to hover around that level throughout the programme period, peaking up at 24.2% of GDP in 2017, after which it is expected to gradually decline.

In the Commission 2015 spring forecast, public debt is projected to increase more strongly, reaching 25.3% of GDP in 2016. The different stock-flow adjustments in the Commission forecast reflect the foreseen higher borrowing requirement of the central government in the Commission forecast, which has to be financed through additional debt. In fact, the surplus of the social security cannot be used to finance the deficit of the central government as it is transferred to the pension reserve fund. Moreover, it is worth noting that, in addition to the reserves of the pension fund, the government owns stakes in commercial and non-commercial companies, valued at approximately 10% of GDP.

Finally, the cost of servicing public debt remains very low and stable at around 0.4% of GDP.

Figure 1: Government debt projections in successive programmes (% of GDP)



Source: Commission 2015 spring forecast, Stability Programmes

Table 3: Debt developments

(% of GDP)	Average 2009-2013	2014	2015		2016		2017	2018	2019
			COM	SP	COM	SP	SP	SP	SP
Gross debt ratio¹	20.0	23.6	24.9	23.9	25.3	24.2	24.2	24.0	23.8
Change in the ratio	1.9	-0.4	1.2	0.3	0.4	0.3	0.0	-0.3	-0.2
<i>Contributions²:</i>									
1. Primary balance	-0.5	-1.0	-0.3	-0.4	-0.6	-1.0	-1.0	-1.2	-1.1
2. "Snow-ball" effect	-0.3	-0.6	-0.5	-0.4	-0.9	-0.6	-0.7	-0.7	-0.6
<i>Of which:</i>									
Interest expenditure	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Growth effect	-0.2	-0.7	-0.8	-0.9	-0.8	-0.8	-0.8	-0.7	-0.6
Inflation effect	-0.5	-0.2	0.0	0.1	-0.4	-0.1	-0.3	-0.3	-0.2
3. Stock-flow adjustment	2.7	1.1	2.0	1.2	1.9	1.9	1.7	1.6	1.5
<i>Of which:</i>									
Cash/accruals diff.									
Acc. financial assets									
<i>Privatisation</i>									
Val. effect & residual									

Notes:
¹ End of period.
² The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:
Commission 2015 spring forecast (COM); Stability Programme (SP), Commission calculations.

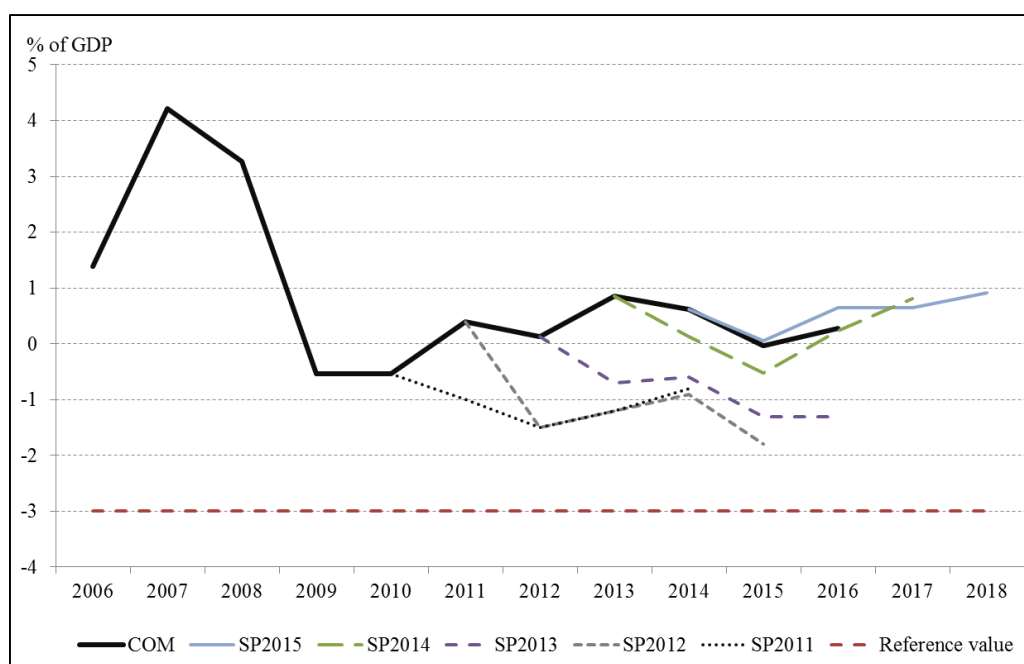
3.4. Risk assessment

Overall, the Stability Programme's headline (see Figure 2) and structural balance targets for 2015 are broadly in line with the Commission projection, while they appear slightly favourable as regard 2016. Both the programme and the Commission forecast project the debt to remain well below the threshold of 60% of GDP.

Risks to the above budgetary plans are related to the negative impact on Luxembourg's growth perspectives from undergoing international initiatives on tax harmonisation or on financial system regulation. Nevertheless, these risks are dependent on the external environment and on which the national authorities have limited possibility to exert an influence.

Risks to the budgetary targets also depend on a fully-fledged implementation of the measures identified by the government throughout the programme period. The programme contains a sensitivity analysis based on the non-implementation of some selected measures amongst those specified in the "Zukunftspak", notably those for which the related secondary regulation has still to be adopted or are still under discussion. According to the aforementioned sensitivity analysis, the non-implementation of those selected measures will lead to a deterioration of the general government balance by 0.6% of GDP in 2019, compared to a scenario of full implementation.

Figure 2: Government balance projections in successive programmes (% of GDP)



Source: Commission 2015 spring forecast, Stability Programmes

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Luxembourg is subject to the preventive arm of the Stability and Growth Pact. The general government balance was in surplus in 2014 and is planned to remain so in 2015 and 2016, which is confirmed by the Commission 2015 spring forecast. Luxembourg's general government debt stood at 23.6% of GDP in 2014, well below the 60% of GDP threshold from the Pact and it is expected to remain so throughout the programme period.

Luxembourg registered a structural surplus of 1.6% of GDP in 2014, well beyond its medium-term objective (MTO) of a structural surplus of 0.5% of GDP. According to the information provided in the Stability Programme, with a (recalculated) structural surplus of 0.7%, Luxembourg's structural balance is expected to continue to be above its MTO also in 2015, which is confirmed by the Commission 2015 spring forecast. In 2016, the recalculated structural balance is still estimated to remain above the MTO. According to the Commission 2015 spring forecast, the surplus will decline at 0.4% of GDP, which is considered to be broadly in line with the MTO.

Box 2. Council recommendations addressed to Luxembourg

On 8 July 2014, the Council addressed recommendations to Luxembourg in the context of the European Semester. In particular, in the area of public finances the Council recommended to Luxembourg to preserve a sound fiscal position in 2014; significantly strengthen the budgetary strategy in 2015 to ensure that the medium-term objective is achieved and remain at the medium-term objective thereafter, in order to protect the long-term sustainability of public finances, in particular by taking into account implicit liabilities related to ageing. Strengthen fiscal governance by speeding up the adoption of a medium-term budgetary framework covering the general government and including multi-annual expenditure ceilings, and by putting into place the independent monitoring of fiscal rules. Further broaden the tax base, in particular on consumption.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2014	2015		2016	
Initial position¹					
Medium-term objective (MTO)	0.5	0.5		0.5	
Structural balance ² (COM)	1.6	0.6		0.4	
Structural balance based on freezing (COM)	1.6	0.6		-	
Position vis-a -vis the MTO³	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	2014	2015		2016	
	COM	SP	COM	SP	COM
Structural balance pillar					
Required adjustment ⁴	0.0	0.0		0.0	
Required adjustment corrected ⁵	-2.0	-1.1		-0.1	
Change in structural balance ⁶	-0.9	-1.0	-1.0	0.1	-0.2
<i>One-year deviation from the required adjustment⁷</i>	1.1	0.1	0.1	0.1	-0.1
<i>Two-year average deviation from the required adjustment⁷</i>	1.0	0.6	0.6	0.1	0.0
Expenditure benchmark pillar					
Applicable reference rate ⁸	n.a. (Structural balance above MTO)				
<i>One-year deviation⁹</i>					
<i>Two-year average deviation⁹</i>					
Conclusion					
Conclusion over one year	Compliance				
Conclusion over two years					
Notes					
¹ The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points is allowed in order to be evaluated as having reached the MTO.					
² Structural balance = cyclically-adjusted government balance excluding one-off measures.					
³ Based on the relevant structural balance at year t-1.					
⁴ Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 28.).					
⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.					
⁶ Change in the structural balance compared to year t-1.					
⁷ The difference of the change in the structural balance and the required adjustment corrected.					
⁸ Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is not at its MTO.					
⁹ Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.					
<i>Source:</i>					
<i>Stability Programme (SP); Commission 2015 spring forecasts (COM); Commission calculations.</i>					

5. LONG-TERM SUSTAINABILITY

The analysis in this section includes the new long-term budgetary projections of age-related expenditure (pension, health care, long-term care, education and unemployment benefits) from the 2015 Ageing Report⁵ published on 12 May. It therefore updates the assessment made in the Country Reports⁶ published on 26 February.

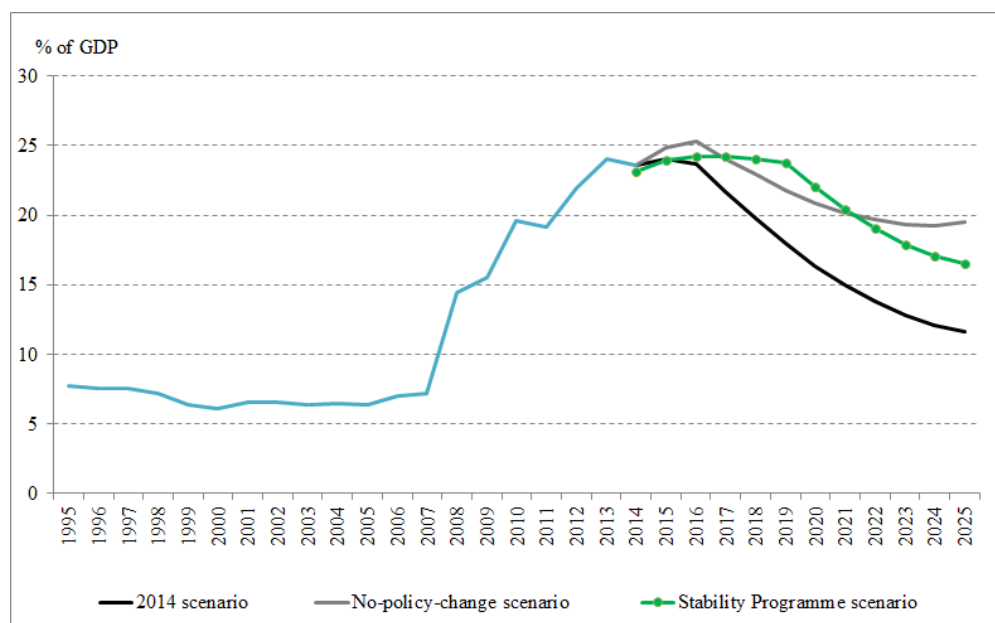
Government debt stood at 23.6% of GDP in 2014. It is expected to decrease (to 19.5% in 2025) remaining well below the 60% of GDP Treaty threshold. The full implementation of the programme would put debt on an even further decreasing path by 2025 (see Figure 3).

Luxembourg appears to face low fiscal sustainability risks in the medium-term. The medium-term sustainability gap, is at -3.2% of GDP, primarily related to the low level of government debt (25.3% of GDP in 2016) and the positive structural primary balance in 2016, indicating low risks. However, in the long-term, Luxembourg appears to face medium fiscal sustainability risks, related to the projected ageing costs over the very long run, in particular in the area of pensions (contributing with 3.1 pp. of GDP) and of long-term care. The long-term sustainability gap, which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path, is at 5.0% of GDP.

Risks would be lower in the event of the structural primary balance reverting to higher values observed in the past, such as the average for the period 2005-2014. It is therefore appropriate for Luxembourg to continue to implement measures that reduce risks to fiscal sustainability in the long-term, in particular by further containing age-related expenditure.

The projected ageing costs pose a challenge in Luxembourg. Especially, the contribution from pension expenditure is particularly high. The focus should therefore be on reducing the gap between statutory and effective retirement age and on reinforcing the link between the statutory retirement age and life expectancy.

Figure 3: Government debt projection scenarios



Source: Commission 2015 spring forecast, Stability Programme, Commission calculations

⁵ See http://ec.europa.eu/economy_finance/publications/european_economy/2015/ee3_en.htm

⁶ See http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm

Table 5: Sustainability indicators

	Luxembourg			European Union		
	2014 scenario	No-policy-change scenario	Stability Programme scenario	2014 scenario	No-policy-change scenario	Stability/Convergence Programme scenario
S2*	4.1	5.0	4.7	1.4	1.7	0.4
<i>of which:</i>						
Initial budgetary position (IBP)	-1.3	0.0	0.2	0.4	0.5	-0.7
Long-term cost of ageing (CoA)	5.4	4.9	4.6	1.0	1.1	1.1
<i>of which:</i>						
pensions	3.6	3.1	2.7	0.0	0.1	0.1
healthcare	0.4	0.4	0.4	0.8	0.7	0.6
long-term care	1.4	1.3	1.3	0.7	0.7	0.6
others	0.0	0.1	0.1	-0.4	-0.3	-0.2
S1**	-4.0	-3.2	-4.9	1.4	1.8	0.5
<i>of which:</i>						
Initial budgetary position (IBP)	-2.8	-1.5	-2.2	-0.4	-0.3	-1.6
Debt requirement (DR)	-2.7	-2.8	-3.7	1.7	1.9	1.8
Long-term cost of ageing (CoA)	1.5	1.2	0.9	0.1	0.3	0.4
S0 (risk for fiscal stress)***	0.13	:	:	:	:	:
<i>Fiscal subindex</i>	0.00	:	:	:	:	:
<i>Financial-competitiveness subindex</i>	0.18	:	:	:	:	:
Debt as % of GDP (2014)	23.6			88.6		
Age-related expenditure as % of GDP (2014)	19.6			25.6		
Source: Commission, 2015 Stability Programme						
Note: the '2014' scenario depicts the sustainability gap under the assumption that the structural primary balance position remains at the 2014 position according to the Commission 2015 spring forecast; the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commission 2015 spring forecast until 2016. The 'stability programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.						
* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.						
** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2016) is required (indicating a cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.						
*** The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indices, thresholds are respectively at 0.35 and 0.45.						

6. FISCAL FRAMEWORK⁷ AND QUALITY OF PUBLIC FINANCES

6.1. Fiscal framework

The fiscal framework of LU has been significantly strengthened in 2014, following the adoption of the Law of 12 July, with the introduction of a medium-term budgetary framework, a structural budget balance rule and the setting-up of the Fiscal Council.

The macroeconomic forecasts underlying the national medium-term budgetary plans have been produced by STATEC, the National Institute of statistics and economic studies of the Grand Duchy of Luxembourg, whose statute contains provisions supporting the independence of the institution as a body producing macroeconomic forecasts.

The programme clearly states, in accordance with the provisions of article 4.1 of the Two-Pack Regulation 472/2013 that the budgetary trajectory outlined in the document is to be considered as the national medium-term fiscal plan. However, neither the Stability Programme nor the National Reform Programme provide indications on the expected economic returns on non-defence public investment projects that have a significant budgetary impact.

6.2. Quality of public finances

Luxembourg presents a sound fiscal position, with the government accounts in balance or in surplus and the government debt amongst the lowest in the euro area. However, as stressed before, this favourable short-term position should not hide the sustainability problem resulting from the rise in public age-related expenditure.

General government expenditure increased from 36.4% of GDP in 2000 to 43.8% of GDP in 2014. In spite of this increase, expenditure remains low compared to most other Member States, even if this is for a part due to the high level of GDP, which is amplified by the very large number of non-resident workers in the country (about 40% of total labour force in 2014).

Public expenditure seems comparatively efficient: government consumption is low while public investment is among the highest in euro-area Member States. The Stability Programme also confirms the commitment of the government to maintain, in spite of consolidation needs, a high level of public investment. According to the programme, public investment increased by 12.4% in 2014 at 3.8% of GDP, well above the average 2.7% of GDP for the euro area. Public investment is projected to further increase, reaching 4.1% of GDP in 2015 and 4.4% of GDP in 2019, as the authorities confirm their commitment to increase the potential of the economy through sustained investment in public infrastructure, energy efficiency, IT infrastructure, climate protection and urban development.

In 2014, for the first time, the government carried out a comprehensive spending review, which was reflected in the 2015 budget. The programme confirms the intention of the authorities to proceed with a further reform of the budgetary procedure. The aim of this reform would be to improve the process of elaboration, implementation and evaluation of the budget with twofold objectives: the modernisation of the State and the effectiveness of public expenditure, in particular related to large investments in infrastructure projects.

⁷ This section complements the Country Report published on 26 February 2015 and updates it with the information included in the Stability Programme.

Similar to public expenditure, the overall tax burden is also low compared to most other Member States. However, comparisons with other countries are distorted by the high level of GDP in Luxembourg. Taxes on labour income, for instance, are comparatively low, being significantly lower than the EU average and much lower than in neighbouring countries.

7. CONCLUSIONS

In 2014, Luxembourg had a structural surplus well beyond its medium-term budgetary objective. According to the information provided in the Stability Programme, the structural balance will remain above the medium-term objective in 2015 and 2016. The Commission 2015 spring forecast confirms a structural surplus above the MTO in 2015, but projects a deterioration in the structural balance to 0.4% of GDP in 2016, which is broadly in line with the medium-term objective.

Moreover, Luxembourg general government debt stood at 23.6% of GDP in 2014, well below the 60% Treaty threshold and is also expected remain so in 2015 and 2016.

ANNEX

Table I. Macroeconomic indicators

	1997-2001	2002-2006	2007-2011	2012	2013	2014	2015	2016
Core indicators								
GDP growth rate	6.3	3.7	1.9	-0.2	2.0	3.1	3.4	3.5
Output gap ¹	2.0	0.6	-0.6	-3.8	-3.7	-2.7	-1.4	-0.2
HICP (annual % change)	1.9	2.9	2.7	2.9	1.7	0.7	0.8	2.1
Domestic demand (annual % change) ²	5.4	2.3	2.7	0.2	0.7	2.8	2.5	2.9
Unemployment rate (% of labour force) ³	2.4	4.1	4.7	5.1	5.9	5.9	5.7	5.4
Gross fixed capital formation (% of GDP)	20.8	19.6	18.0	18.4	17.1	16.8	16.8	16.8
Gross national saving (% of GDP)	32.3	29.8	25.6	23.5	21.3	21.8	21.0	21.1
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	4.4	0.7	1.4	0.1	0.9	0.6	0.0	0.3
Gross debt	6.8	6.6	15.2	21.9	24.0	23.6	24.9	25.3
Net financial assets	46.8	52.8	53.4	48.9	n.a	n.a	n.a	n.a
Total revenue	42.4	42.2	43.1	43.6	44.4	44.7	44.4	44.1
Total expenditure	38.0	41.6	41.8	43.5	43.6	44.0	44.4	43.8
<i>of which: Interest</i>	0.4	0.2	0.4	0.5	0.4	0.4	0.4	0.3
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	n.a	-0.5	-4.1	-10.0	-6.8	-5.7	-5.0	-4.4
Net financial assets; non-financial corporations	n.a	-124.5	-178.3	-190.5	n.a	n.a	n.a	n.a
Net financial assets; financial corporations	n.a	-534.9	-70.0	23.3	n.a	n.a	n.a	n.a
Gross capital formation	n.a	13.1	11.2	12.5	8.2	7.6	7.2	7.2
Gross operating surplus	26.0	29.5	30.8	28.5	27.2	26.8	27.1	27.4
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	3.1	1.0	2.0	3.3	0.7	-0.5	-1.0	-1.6
Net financial assets	n.a	77.6	81.7	72.4	n.a	n.a	n.a	n.a
Gross wages and salaries	29.8	28.4	26.5	26.3	28.7	28.8	28.9	28.8
Net property income	n.a	1.0	1.4	1.2	-3.1	-3.7	-3.8	-3.8
Current transfers received	n.a	13.2	14.7	15.6	15.9	16.1	16.2	15.8
Gross saving	n.a	3.8	6.7	7.7	5.6	4.7	4.2	3.7
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	10.1	9.8	6.9	4.8	3.4	5.4	4.8	4.9
Net financial assets	n.a	530.3	114.0	47.4	n.a	n.a	n.a	n.a
Net exports of goods and services	20.8	27.0	32.9	33.8	35.2	35.4	35.3	35.4
Net primary income from the rest of the world	-14.0	-19.3	-28.6	-35.3	-36.5	-37.4	-37.8	-37.7
Net capital transactions	-0.4	-0.1	-0.6	-0.9	-1.4	0.1	0.2	0.3
Tradable sector	33.5	30.4	27.9	27.9	26.4	n.a	n.a	n.a
Non tradable sector	56.6	59.3	62.1	61.9	62.9	n.a	n.a	n.a
<i>of which: Building and construction sector</i>	5.6	5.4	5.1	4.9	4.8	n.a	n.a	n.a
Real effective exchange rate (index, 2000=100)	82.5	89.4	99.1	101.7	105.6	106.6	103.2	103.3
Terms of trade goods and services (index, 2000=100)	98.4	97.4	99.3	101.2	101.2	101.0	100.5	100.4
Market performance of exports (index, 2000=100)	83.7	92.6	100.7	102.9	106.1	105.3	105.7	105.5
Notes:								
¹ The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
² The indicator on domestic demand includes stocks.								
³ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.								
Source:								
AMECO data, Commission 2015 spring forecast								