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COMMISSION STAFF WORKING DOCUMENT

Analysis of the updated Draft Budgetary Plan of Luxembourg

Accompanying the document

COMMISSION OPINION

on the updated Draft Budgetary Plan of Luxembourg

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1. INTRODUCTION

Luxembourg submitted its updated Draft Budgetary Plan (hereafter: updated DBP) for 2019 on 5 March 2019. The DBP submitted on 15 October 2018 in compliance with Regulation (EU) No 473/2013 reflected budgetary projections for 2019 based on unchanged policies as the new government only took office on 5 December 2018, following national elections that took place on 14 October 2018. In comparison with the no-policy-change DBP submitted on 15 October 2018, the updated DBP includes measures that the new government has adopted or plans to adopt. Luxembourg is subject to the preventive arm of the Stability and Growth Pact and should preserve a sound fiscal position, which ensures compliance with the medium term budgetary objective (MTO).

Section 2 of this document presents the macroeconomic outlook underlying the updated Draft Budgetary Plan and provides an assessment based on the Commission ad-hoc forecast[1]. Section 3 presents the recent and planned fiscal developments, according to the updated Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2019 ad-hoc forecast. In particular, it also includes an assessment of the measures underpinning the updated Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2018-2019 against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations in the context of the European Semester adopted by the Council in July 2018[2], including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underpinning the updated DBP projects real GDP to grow by 3.0% in both 2018 and 2019. Compared to the no-policy-change DBP submitted on 15 October 2018, where GDP growth was projected at 3.9% for 2018 and by 4.0% for 2019,

[1] The Commission published its winter 2019 forecast (interim) on 7 February 2019. It only included projections for GDP growth and inflation. In order to assess the updated DBP, the Commission complemented its winter 2019 forecast for Luxembourg by a fully-fledged “ad-hoc” forecast, including in particular projections for the general government balance and the structural balance. The Commission ad-hoc forecast was finalised on 8 March 2019 and does not take into account developments known after this date.

[2] Council Recommendation of 13 July 2018 on the 2018 National Reform Programme of Luxembourg and delivering a Council opinion on the 2018 Stability Programme of Luxembourg, OJ C 320, 10.9.2018, p. 68.

respectively, economic perspectives have thus been revised downwards by around one percentage point each year.

The macroeconomic scenario underlying the updated DBP is based on the most recent projections produced by the STATEC (see Box 1). Specifically, the updated macroeconomic scenario factors in, compared to the most recent update of the Stability Programme, a lower contribution from domestic demand in 2018 and a lower contribution from external demand in 2019.

Compared to the Commission ad-hoc forecast, where real GDP growth is estimated to have reached 3.0% in 2018 and is set to decline to 2.5% in 2019, the macroeconomic scenario on which the updated DBP is based, seems plausible for 2018 and favourable for 2019. For 2019, the government expects real GDP growth to be around half a percentage point stronger than in the Commission services forecast. That difference is largely explained by a substantially higher forecast for domestic demand in the updated DBP – especially for gross fixed capital. In particular, the expansion in gross fixed capital formation projected by the STATEC for 2019 appears rather exceptional, especially when compared with the long-term trend levels of the quarterly national accounts-data. This is the case, even when considering that for Luxembourg the investment account is highly volatile and unpredictable, reflecting uneven, yet large, lump sum investments from the satellite and aircraft industry. Those investments are supposed to be rather neutral, in terms of GDP growth, as they are debited from the external balance of goods. Divergences in terms of growth of imports may appear, although they are wider in the macroeconomic scenario underlying the updated DBP compared to the Commission ad-hoc forecast. At the same time, the projected expansion in imports appears also less aligned with export growth than it was in recent years. Additionally, the rebound in investment in 2019 is reportedly due to a recovery in spending on machinery and equipment excluding aircraft and satellites, and underpinned by credit growth. Recent trends on credit growth to non-financial corporations resident in Luxembourg show stable growth rates, while their aggregate net debt has continued to increase.

Box 1: The macro economic forecast underpinning the budget in Luxembourg

The macroeconomic forecasts underlying the DBP have been prepared by the Direction "Etudes, prévisions et recherche" of the national statistical office STATEC[3], which also provided the methodology for the calculation of the output gap. STATEC is an autonomous entity placed under the authority of the Ministry of Economy.

In order to ensure compliance with the requirement of Regulation (EU) No 473/2013, the draft Budget Act to be transmitted to the national parliament should be based on an independently produced macroeconomic forecast.

[3] Institut national de la statistique et des études économiques du Grand-Duché du Luxembourg.

Table 1. Comparison of macroeconomic developments and forecasts

	2017	2018			2019		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	1.5	4.6	3.0	3.0	4.6	3.0	2.5
Private consumption (% change)	3.0	3.5	5.0	4.7	3.8	4.3	3.2
Gross fixed capital formation (% change)	4.0	10.9	-3.8	-3.1	9.7	15.7	1.9
Exports of goods and services (% change)	-1.9	8.6	6.2	5.2	8.3	4.4	1.2
Imports of goods and services (% change)	-2.2	9.5	6.2	5.3	9.1	6.2	1.1
Contributions to real GDP growth:							
- Final domestic demand	2.2	3.4	1.5	1.4	3.5	5.0	1.8
- Change in inventories	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-0.1	1.2	1.6	1.6	1.2	-2.0	0.7
Output gap[1]	-0.7	0.3	0.0	0.0	1.3	0.3	0.3
Employment (% change)	3.4	3.5	3.7	3.7	3.4	3.4	3.1
Unemployment rate (%)	5.6	5.5	5.2	5.3	5.3	4.7	5.1
Labour productivity (% change)	-1.8	0.9	-0.7	-0.8	0.9	-0.4	-0.5
HICP inflation (%)	2.1	1.5	2.0	2.0	1.7	1.1	1.5
GDP deflator (% change)	2.2	1.0	3.2	2.2	1.5	1.1	1.9
Comp. of employees (per head, % change)	3.3	1.6	1.4	1.8	2.6	2.5	2.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	4.0			4.7			3.8

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2018 (SP); Updated Draft Budgetary Plan for 2019 (DBP); Commission ad-hoc forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The updated DBP projects a headline general government budget surplus of 2.6% of GDP in 2018. This is more than double the surplus of 1.1% of GDP targeted for 2018 in the last update of the Stability Programme. The updated DBP's projections for 2018 are broadly in line with the Commission ad-hoc forecast, which projects a headline budget surplus of 2.4% of GDP. The upward revision of the headline surplus is mostly due to higher-than-expected tax revenues. Total revenues have been revised up by 2 percentage points of GDP compared to the Stability Programme, with revenues from current taxes on income and wealth explaining a large part of the revision. The latest data on budget execution for the Central

government[4] show that revenues increased on average by around 10% in 2018 compared to the previous year. This evolution is remarkable in light of the already substantial increase of revenues recorded in 2017. The revenue increase in 2018 was broadly based. Direct taxes increased by 14.3% in 2018 supported by a strong collection in both personal (mirroring dynamic employment creation) and corporate taxes, while the increase in indirect taxes was less sizeable. The substantial but less pronounced increase in total expenditure only partially offset the increase in revenues. Public investment increased by 9.6%, to reach 4.2% of GDP, from 4.1% of GDP in 2017.

For 2019, the updated DBP projects the surplus of the headline balance to decline to 1.0% of GDP from 2.6% of GDP in 2018. This compares with an improvement of the surplus from 1.1% of GDP in 2018 to 1.4% in 2019 that was projected in the 2018 Stability Programme. The projected drop in the updated DBP cannot be fully explained by the deterioration of the macroeconomic scenario underpinning the budgetary trajectory, as the updated DBP still projects a steady growth of the economic output, as it was the case in the last update of the Stability Programme, even if at lower rates[5]. With discretionary measures estimated to have a negative impact amounting to 0.5% of GDP, it appears that the drop is mostly explained by the use of rather conservative assumptions about the elasticity of revenues. This entails that sizeable windfall gains have contributed to improve the budgetary outcome in 2018. In the updated DBP almost all revenues categories show, as a percent of GDP, a decline compared to their 2018 level, with the more sizeable drop projected for current taxes on income and wealth (a drop of 0.5 percentage points of GDP). Taxes on production and capital taxes are projected to drop as well, as percent of GDP, compared to their 2018 level. At the same time, total expenditure is estimated to increase by 0.6 percentage points to 43.9% of GDP. Gross fixed capital formation is projected to increase further to 4.3% of GDP.

Compared to the updated DBP projections for 2019, the Commission ad-hoc forecast projects a smaller drop in the headline surplus, with the latter expected to reach 1.5% of GDP. Total revenues are forecast to decrease by 0.3% of GDP compared to their 2018 level. With identical assumptions about the impact of the discretionary measures, the difference is mostly explained by the stronger elasticity of public revenues to GDP growth in the Commission ad-hoc forecast. This more than offsets the less favourable macro-economic scenario underpinning the Commission ad-hoc forecast (GDP growth at 2.5% in 2019 compared to 3.0% in the updated DBP). The total expenditure ratio is expected to increase by 0.6 percentage points of GDP as in the updated DBP.

In structural terms, the updated DBP estimates the surplus of the structural balance[6] to have increased from 1.7% of GDP in 2017 to 2.6% in 2018 and projects a decline to 0.9% of GDP in 2019. The Commission ad-hoc forecast envisages a structural improvement to 2.4% of GDP in 2018, followed by a drop to 1.4% of GDP in 2019. In the light of the absence of one-

[4] Note on the evolution of revenues and expenditure at 31 December 2018 for the Central Government, available at: https://gouvernement.lu/dam-assets/documents/actualites/2019/02-fevrier/Tableaux-Dec18.pdf .

[5] According to the 2018 Stability Programme, real GDP growth was forecast at 4.6% in both years 2018 and 2019, whereas the updated DBP forecast real GDP growth at 3.0% in both years.

[6] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

offs and temporary measures differences are explained by the different evolution in the headline balance between the Commission ad-hoc forecast and the updated DBP.

Euro area sovereign bond yields remain at historically low levels. Consequently, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the Draft Budgetary Plan, in line with the low level of government debt Luxembourg's interest expenditure has remained modest at 0.3% of GDP. This compares to 1.9% of GDP on average for the euro area as a whole and it is below the 0.5% recorded back in 2013 at the peak of the euro area sovereign debt crisis. In addition, over recent years Luxembourg has benefitted from stable and favourable financing conditions. The implicit interest rate of government debt is estimated at 1.7% in 2019 compared to 2.2% for the euro area as a whole. This picture is broadly confirmed by the Commission ad-hoc forecast.

Risks to that fiscal outlook are mainly related to the macroeconomic outlook and, in particular, to the financial sector remaining the main engine of the domestic economy. Regulatory and external risks remain and could adversely affect the sector and overall growth prospects. Finally, the recurrent and sizeable revisions of national accounts risk undermining the reliability of the overall budgetary exercise.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2017	2018			2019			Change: 2017-2019
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**44.5**	**43.9**	***45.9***	**45.9**	**43.6**	***45.0***	**45.6**	**0.5**
of which:								
- Taxes on production and imports	11.9	11.9	*12.1*	12.2	11.7	*11.8*	12.1	-0.1
- Current taxes on income, wealth, etc.	15.4	15.3	*16.8*	16.5	15.3	*16.3*	16.3	0.9
- Capital taxes	0.2	0.1	*0.4*	0.2	0.1	*0.2*	0.2	0.0
- Social contributions	12.5	12.4	*12.4*	12.5	12.4	*12.5*	12.6	0.0
- Other (residual)	4.4	4.2	*4.2*	4.4	4.1	*4.2*	4.4	-0.3
Expenditure	**43.1**	**42.8**	**43.3**	**43.5**	**42.3**	**43.9**	**44.1**	**0.8**
of which:								
- Primary expenditure	42.7	42.5	43.0	43.1	42.0	43.6	43.8	0.9
of which:								
Compensation of employees	9.0	9.0	9.2	9.1	8.9	9.4	9.3	0.4
Intermediate consumption	3.7	3.6	3.7	3.7	3.5	3.8	3.8	0.1
Social payments	20.2	20.1	19.9	20.0	19.7	20.2	20.1	0.0
Subsidies	1.3	1.4	1.3	1.3	1.3	1.2	1.3	-0.1
Gross fixed capital formation	4.1	4.1	4.2	4.2	4.0	4.3	4.3	0.2
Other (residual)	4.5	4.3	4.7	4.8	4.6	4.7	5.1	0.2
- Interest expenditure	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.0
General government balance (GGB)	**1.4**	**1.1**	**2.6**	**2.4**	**1.4**	**1.0**	**1.5**	**-0.4**
Primary balance	**1.7**	**1.4**	**2.9**	**2.7**	**1.6**	**1.3**	**1.8**	**-0.4**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**1.4**	**1.1**	**2.6**	**2.4**	**1.4**	**1.0**	**1.5**	**-0.4**
Output gap[1]	-0.7	0.3	0.0	0.0	1.3	0.3	0.3	0.9
Cyclically-adjusted balance[1]	1.7	1.0	2.6	2.4	0.8	0.9	1.4	-0.8
Structural balance (SB)[2]	**1.7**	**1.0**	**2.6**	**2.4**	**0.8**	**0.9**	**1.4**	**-0.8**
Structural primary balance[2]	2.0	1.3	2.9	2.7	1.1	1.2	1.6	-0.8

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2018 (SP); updated Draft Budgetary Plan for 2019 (DBP); Commission ad-hoc forecast (COM); Commission calculations

3.2. Debt developments

In the updated Draft Budgetary Plan, the public debt-to-GDP ratio is projected to decrease from 23.0% in 2017 to 21.4% in 2018 and to increase to 20.2% of GDP in 2019, still well below the Treaty threshold of 60% and under the 30% threshold set by government. That projection is broadly confirmed by the ad-hoc Commission forecast that projects the

government debt to decline to 21.1% of GDP and 20.4% of GDP in 2018 and 2019, respectively. The decrease in government debt is not as great as what would be expected in light of the surplus of the primary government balance. According to the national law, the surpluses of the social security sector are allocated to a reserve fund ("Fonds de compensation commun au régime général de pension") so as to cover future pension expenditure. They cannot be used to finance the needs of the central government. The differences compared to the evolution of the government debt sketched out in the updated DBP is mostly due to different assumptions about the stock-flow adjustment, where the Commission ad-hoc forecast assumes a steady access to the market throughout the period covered by the forecast.

Table 3. Debt developments

(% of GDP)	2017	2018			2019		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**23.0**	**22.7**	**21.4**	**21.1**	**22.1**	**20.2**	**20.4**
Change in the ratio	2.3	-0.3	-1.6	-1.8	-0.6	-1.2	-0.8
Contributions[2] :							
1. Primary balance	**-1.7**	**-1.4**	**-2.9**	**-2.7**	**-1.6**	**-1.3**	**-1.8**
2. "Snow-ball" effect	**-0.4**	**-0.9**	**-1.0**	**-0.8**	**-1.1**	**-0.5**	**-0.6**
Of which:							
Interest expenditure	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Growth effect	-0.3	-1.0	-0.6	-0.6	-1.0	-0.6	-0.5
Inflation effect	-0.4	-0.2	-0.7	-0.5	-0.3	-0.2	-0.4
3. Stock-flow adjustment	**4.4**	**2.1**	**2.4**	**1.7**	**2.1**	**0.6**	**1.6**

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

Source:

Stability Programme 2018 (SP); Updated Draft Budgetary Plan for 2019 (DBP); Commission ad-hoc forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The updated Draft Budgetary Plan reports on a number of new measures, which have been enacted or are planned by the newly appointed government. The overall surplus-reducing impact of those measures is estimated at 0.5% of GDP in 2019. Measures on the revenue side account for a negative impact of around 0.1% of GDP in 2019, mostly due to the decision to increase the minimum social wage, which will be implemented retroactively from the start of 2019 through tax credits. On the expenditure side, measures enacted or planned are estimated to increase expenditure by 0.4% of GDP in 2019.

Table 4. Main discretionary measures reported in the updated DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% of GDP) (as reported by the authorities)
	2019
Taxes on production and imports	0.0
Current taxes on income, wealth, etc.	-0.1
Capital taxes	0.0
Social contributions	0.0
Property Income	0.0
Other	0.0
Total	-0.1

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the updated DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source: Updated Draft Budgetary Plan for 2019

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% of GDP) (as reported by the authorities)
	2019
Compensation of employees	0.1
Intermediate consumption	0.1
Social payments	0.0
Interest Expenditure	0.0
Subsidies	0.0
Gross fixed capital formation	0.1
Social benefits	0.0
Current transfers	0.1
Total	0.4

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the updated DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2019

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

Luxembourg is subject to the preventive arm of the Stability and Growth Pact.

According to the information provided in the updated Draft Budgetary Plan, Luxembourg is expected to have achieved a (recalculated) structural surplus of 2.6% of GDP in 2018. This is well above its MTO of a deficit of 0.5% of GDP.[7] For 2019, based on the information in the updated Draft Budgetary Plan, the (recalculated) structural balance is expected to decline to a surplus of 0.9% of GDP, still above the MTO. In that regard, it is worth noting that revenues from direct taxation surprised on the upside in 2018. Those developments could be related to less aggressive tax avoidance behaviour by multinationals linked to the international fight against tax avoidance. Furthermore, in the wake of the United Kingdom's decision to withdraw from the European Union, Luxembourg has been able to attract a number of firms that have decided to locate their headquarters in that Member State.

Those conclusions are confirmed by the Commission ad-hoc forecast.

[7] MTOs are to be revised every three years. Based on a agreed methodology, the Commission computes a minimum MTO for each country. The minimum MTOs a provide a lower bound for the national structural balance targets, which ensure the sustainability of the public finances, including the projected impact of ageing, or rapid progress towards sustainability, while providing a safety margin with respect to the 3% of GDP Treaty reference value. Due to the more favourable estimation in the 2015 Ageing report of its sustainability components (age-relate expenditure, debt) the new minimum MTO for Luxembourg declined significantly, from a structural balance surplus of 0.5% of GDP to a deficit of 1% of GDP. However, given that Luxembourg is bound by the provisions of the Fiscal Compact a deficit of 0.5% of GDP is considered as a general minimum MTO requirement. With the 2016 Stability Programme Luxembourg decided to revise its MTO to a deficit of 0.5% of GDP for the period 2017-2019 from a surplus of 0.5% of GDP.

Table 5. Compliance with the requirements of the preventive arm

(% of GDP)	2017	2018		2019	
Initial position[1]					
Medium-term objective (MTO)	-0.5	-0.5		-0.5	
Structural balance[2] (COM)	1.7	2.4		1.4	
Structural balance based on freezing (COM)	0.6	2.4		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	**2017**	**2018**		**2019**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.0	
Required adjustment corrected[5]	-2.7	-1.1		-2.9	
Change in structural balance[6]	0.0	0.9	0.7	-1.7	-1.0
One-year deviation from the required adjustment [7]	2.7	2.0	1.8	1.1	1.9
Two-year average deviation from the required adjustment [7]	2.2	2.4	2.3	1.6	1.8
Expenditure benchmark pillar					
Applicable reference rate[8]	9.6	8.6		11.1	
One-year deviation adjusted for one-offs [9]	0.8	1.8	0.7	1.9	1.7
Two-year average deviation adjusted for one-offs [9]	1.4	1.3	0.8	1.8	1.2

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 (p.p.) 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 38.).

[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. Ex post assessment (for 20XX-1) was carried out on the basis of Commission 20XX spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[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 adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs 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.

Source :

Updated Draft Budgetary Plan for 2019 (DBP); Commission ad-hoc forecast (COM); Commission calculations.

5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The updated DBP projects an increase in total revenues in 2018 compared to 2017, when total revenues stood at 44.5% of GDP. They are expected to increase to 45.9% of GDP over 2018 and to decline from there to 45.0% of GDP in 2019. In 2017, revenue growth was affected by the tax reform that took effect at the start of 2017. The reform introduced changes mostly in the area of direct taxation, both for individuals and corporations, aiming at a gradual reduction in the corporate income tax rate (with the aim of increasing competitiveness) and increased progressivity of the personal income tax (with the aim to increase fairness). It is estimated to have cut revenues by 0.7% of GDP in 2017. Its impact is projected to become larger in the following years, reducing revenues annually by about 0.8% of GDP on average over the period 2018-2022. However, in spite of the impact of that reform, current taxes on income and wealth increased substantially already in 2017 and further in 2018, with that increase partly explained by the improvement in the labour market.

In 2017, total revenues were also affected by the change in VAT legislation[8] with regard to the place of taxation for activities related to e-commerce. A transitional rule covering the period from 2015-2019 was put in place. Accordingly, Luxembourg has been able to retain 30% of VAT revenues generated by those activities between 2015 and 2016. The loss of e-VAT revenues between 2015 and 2016 has been estimated at around EUR 600 million (equivalent to 1.2% of GDP), partially compensated by the increase, which took effect at the start of 2015, by 2 percentage points of all VAT rates, excluding the super-reduced rate of 3%. The retained share of e-VAT is then reduced to 15% for the period 2017-2018. In 2017, a loss of around EUR 300 million (0.5% of GDP) was recorded. The rate is finally reduced to 0% from 2019 onwards. The potential loss in 2019 is estimated at around at around 0.1% of GDP.

Total expenditure in 2018 and 2019 is expected to increase to 43.3% and 43.9% of GDP, respectively, compared to 43.1% of GDP in 2017. In real terms, after a period of relative containment between 2013 and 2016 when it increased on average by 2.3% annually, total expenditure has returned to grow at around 4% per year, broadly the same rate it experienced between 2000 and 2012.

Public investment is projected to increase gradually at 4.3% of GDP in 2019. While it stands at a level well above the euro-area average (2.6% of GDP in 2017), it remains below its level before the financial crisis, in spite of recent government efforts to increase investment in Luxembourg's infrastructure.

The updated Draft Budgetary Plan provides a list of measures in order to ensure an adequate follow-up of the 2018 Country-Specific Recommendations.

On 13 July 2018, the Council recommended to Luxembourg[9] an increase of the employment rate of older people with a view to improving the long-term sustainability of the pension system. In order to increase the employment rate of older people, the Council

[8] From 1 January 2015, telecommunications, broadcasting and electronic services will always be taxed in the country where the customer belongs – regardless of whether the customer is a business or consumer – regardless of whether the supplier is based in the EU or outside.

[9] Council Recommendation of 13 July 2018 on the 2018 National Reform Programme of Luxembourg and delivering a Council opinion on the 2018 Stability Programme of Luxembourg, OJ C 320, 10.9.2018, p. 68.

recommendation suggests to enhance their employment opportunities and employability and to further limiting early retirement. In that regard, the updated Draft Budgetary Plan reports on (i) the adopted reform of the long-term care insurance scheme, which will be effective from the start of 2018; (ii) the new measures to help people in long-term unemployment, which entered into effect in August 2017; and (iii) the reform of early retirement schemes[10]. It also recalls previously reported measures such as the adopted reform of the professional classification scheme for persons with partial incapacity. Nevertheless, in 2018, the working group on pensions mandated by the Government concluded that the pension system appears to be not sustainable, amid high uncertainty levels in the long-term projections at unchanged policies.

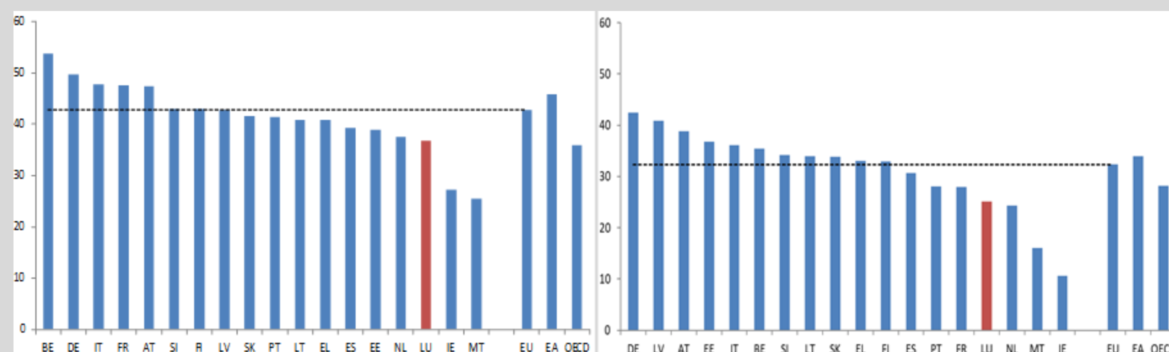
A comprehensive description of progress made with the implementation of the country-specific recommendations is presented in the 2019 Country Report and the Commission will assess that progress in the context of the country-specific recommendations it will propose in June 2019.

Box 2 – Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against that background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euroarea Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate those numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Luxembourg for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the Union average.

The tax burden on labour in Luxembourg at the average wage and at low wage (2017)



Notes: No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.
Source: European Commission Tax and Benefit Indicator database based on OECD data.

[10] Law dated 30 November 2017. A special scheme allowing people to retire from the age of 57 was abrogated in 2018, but its impact on the average effective retirement age and on expenditure is difficult to assess due an easing of restrictions on other kinds of early-retirement schemes.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific, analysis is necessary before drawing policy conclusions.

The reform of the tax code, which took effect as of 1 January 2017, introduced measures lowering the tax wedge on labour. The reform has made the system more progressive for lower incomes while introducing two new marginal tax rates for the highest incomes. Tax credits for employees and pensioners have been increased. The tax measures are expected to preserve the competitiveness of its economy and increase households' disposable income and have a positive effect on employment and on growth through higher private consumption. The updated Draft Budgetary Plan factors in the decision to increase retroactively from the start of 2019 the minimum social wage by EUR 100 through tax credits, which is expected to have an impact on the labour tax wedge.

6. OVERALL CONCLUSION

According to both the information provided in the updated Draft Budgetary Plan and the Commission ad-hoc forecast, the structural balance is expected to remain well above the medium-term budgetary objective in 2018 and 2019.