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**COMMISSION STAFF WORKING DOCUMENT**

**Analysis of the Draft Budgetary Plan of Luxembourg**

*Accompanying the document*

**COMMISSION OPINION**

**on the Draft Budgetary Plan of Luxembourg**

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## Analysis of the Draft Budgetary Plan of Luxembourg

### *Accompanying the document*

#### COMMISSION OPINION

#### on the Draft Budgetary Plan of Luxembourg

### 1. INTRODUCTION

Luxembourg submitted its Draft Budgetary Plan for 2020 on 14 October 2019 in compliance with Regulation (EU) No 473/2013.<sup>1</sup> Luxembourg is subject to the preventive arm of the Pact and should preserve a sound fiscal position which ensures compliance with the medium-term budgetary objective.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2019 autumn forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2019 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2019-2020 (also taking into account the risks to their achievement) 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 2019, 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 underlying the Draft Budgetary Plan is based on the ad hoc projections prepared by STATEC in September (see Box 1). This scenario takes into account the most recent revisions from the 2019 Q2 release of the quarterly national accounts, published on 9 October, where estimates of actual GDP growth were set at 3.1% for 2018; which is 0.5 percentage points higher compared with the previous estimate of 2.6%.

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

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.

The macroeconomic scenario underlying the Draft Budgetary Plan, which was submitted on 14 October, is based on ad-hoc projections updated for this particular purpose by the "Direction Etudes, Prévisions et Recherche" of the National Statistical Office, "STATEC", which also provides the

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<sup>1</sup> The English version of the Draft Budgetary Plan was submitted on 22 October 2019.

methodology for the calculation of the output gap. As stated in its Introduction, the Draft Budgetary Plan is based on the most recent macroeconomic forecasts independently produced by STATEC, as tabled to Parliament on 14 October 2019 by the Government, in line with article 6 of Regulation (EU) No 473/2013.

STATEC is an autonomous entity placed under the authority of the Ministry of Economy. Since 2018, STATEC has been involved in the process of adapting the public national accounts, which are presented in the Draft Budgetary Plan in accordance with the ESA2010 framework. The updated projections have been published only within the 2020 Draft Budgetary Plan. STATEC will publish the next forecast update on the forthcoming issue of its biannual forecast exercise, scheduled for December ("Note de Conjoncture, 2-2019" forthcoming). STATEC is also responsible for the preparation of the midterm projections<sup>2</sup> in the context of the Stability Program and the National Reform Plan.

The Draft Budgetary Plan projects real GDP to grow by 2.4% in both 2019 and 2020. Compared to the 2019 Stability Programme, where GDP growth was projected at 3.0% in 2019 and 3.8% in 2020, economic perspectives have been revised downwards by around half percentage point in 2019 and 1½ in 2020. The growth drivers in the Draft Budgetary Plan macroeconomic scenario reflect a more balanced composition of growth, compared to the 2019 Stability Programme scenario. In the Draft Budgetary Plan, the contribution of net exports has been revised upwards by 1.7 percentage points of GDP in both 2019 and 2020. In turn, the contribution from domestic demand has been revised downwards by 1.7 and 2.3 percentage points of GDP for 2019 and 2020, respectively. This is partly explained by the downward revision of gross fixed capital formation, which is fully debited from the external balance of goods. Compared to the 2019 Stability Programme scenario, the negative contribution from inventories projected in the macroeconomic scenario underlying the Draft Budgetary Plan, which is set at -0.7 percentage points of GDP for both 2019 and 2020, encloses most of the downward revision to GDP growth for 2019 and around one half of the revision for 2020. The macroeconomic scenario underlying the Draft Budgetary Plan assumes an increasing growth momentum for external trade, though less pronounced compared to the projections underlying the 2019 Stability Programme scenario. Overall, the deterioration in the external environment and increased uncertainty, which were pointed out as the main risks for the 2019 Stability Programme scenario going forward, appear to have been factored in, to a certain extent, by the macroeconomic scenario underpinning the Draft Budgetary Plan.

The increasing growth momentum for external trade projected in the macroeconomic scenario underlying the Draft Budgetary Plan implies a contribution from exports of goods and services of around 7 and 11 percentage points to GDP growth in 2019 and 2020, respectively (compared with one percentage point of GDP in 2018). Growth of both exports and imports of goods and services is forecast to accelerate in 2019 and 2020, although their net contribution to growth is expected to be negative in 2019 compared with 2018, partly explained by the rebound in investment (which is recorded as imports in the external account). The robust labour market expansion is set to have reached a peak in 2019, including an expected decline in unemployment, of 0.4 percentage points of active population, for the same year.

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<sup>2</sup> See: <https://statistiques.public.lu/fr/actualites/economie-finances/conjoncture/2019/03/20190312/20190312.pdf>

**Table 1. Comparison of macroeconomic developments and forecasts**

	2018	2019			2020		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	3.1	3.0	2.4	2.6	3.8	2.4	2.6
Private consumption (% change)	3.3	4.3	3.0	3.1	3.6	2.2	2.7
Gross fixed capital formation (% change)	-5.9	15.7	6.7	4.5	13.6	3.7	2.9
Exports of goods and services (% change)	0.5	4.4	3.3	1.7	7.2	5.3	1.7
Imports of goods and services (% change)	-0.3	6.2	4.2	1.9	8.6	5.8	1.7
<i>Contributions to real GDP growth:</i>							
- Final domestic demand	0.5	5.0	3.3	2.2	4.7	2.4	1.8
- Change in inventories	0.9	0.0	-0.7	0.0	0.0	-0.7	0.0
- Net exports	1.6	-2.0	-0.3	0.3	-0.9	0.8	0.7
Output gap <sup>1</sup>	1.5	1.0	1.6	1.5	1.6	1.3	1.4
Employment (% change)	3.7	3.4	3.7	3.7	2.9	3.2	3.4
Unemployment rate (%)	5.5	4.7	5.1	5.3	4.5	5.2	5.3
Labour productivity (% change)	-0.6	-0.4	-1.3	-1.1	0.8	-0.7	-0.8
HICP inflation (%)	2.0	1.1	1.6	1.7	1.8	1.7	1.6
GDP deflator (% change)	2.5	1.1	1.4	2.2	1.9	2.3	1.9
Comp. of employees (per head, % change)	3.3	2.5	3.4	3.2	3.4	2.2	2.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-0.7			3.7			3.7

Note:

<sup>1</sup>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 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

In the Commission 2019 autumn forecast, economic activity is projected to grow by 2.6% in both 2019 and 2020. Thus, the Commission scenario points to a steady, though slightly higher growth trend compared to the macroeconomic scenario underlying the Draft Budgetary Plan, which appears to be plausible in both 2019 and 2020. The Commission projections for the external sector show relatively less dynamic components but a positive net contribution to growth in 2019. The difference is partly explained by lower investment expectations for 2019 by the Commission forecast. Furthermore, lower growth projections for the euro area and global trade, and the overall increased uncertainty at the current juncture, might suggest a lower expansion of exports and imports in 2019 and 2020, compared with the macroeconomic scenario underlying the Draft Budgetary Plan. However, other factors not specified in the Draft Budgetary Plan might also be underlying the projected composition of growth. Specifically, the sustained negative contribution from stock-building, projected at 0.7 percentage points of GDP in both 2019 and 2020, cannot be solely explained by the Draft Budgetary Plan macroeconomic projections on the expected increasing growth momentum for the external sector and the projected GDP growth, especially for 2020.

### **3. RECENT AND PLANNED FISCAL DEVELOPMENTS**

#### **3.1. Deficit developments**

The 2020 Draft Budgetary Plan projects a general government headline surplus of 2.0% of GDP in 2019. This is just the double of the headline surplus of 1.0% of GDP targeted for 2019 in the Stability Programme. The Draft Budgetary Plan projections for 2019 are more prudent than the Commission 2019 autumn forecast, which projects a headline surplus of 2.3% of GDP. The upward revision of the 2019 headline surplus compared to the Stability Programme is mostly due to lower-than-expected expenditure and to a lesser extent to higher-than-expected tax revenues. Total revenues have been revised up by 0.3 percentage points of GDP compared to the Stability Programme. Revenues from current taxes on income and wealth were revised up by 0.9 percentage points of GDP, partially counterbalanced by a downward revision of indirect taxes, social contributions and other revenue. The latest data on budget execution for the Central government<sup>3</sup> show that revenues increased on average by 13.4% in the first semester of 2019 compared to the same period of the previous year.

This evolution is remarkable in light of the already substantial increase of revenues recorded in 2017 and 2018. These developments are, at least partially, explained by the introduction of the automatic tax declaration, which temporarily boosted the collection of tax revenues from firms. In 2020, the impact of the introduction of the automatic tax declaration is projected to fade away. Nevertheless, a less aggressive tax avoidance behaviour by multinationals linked to the international fight against tax avoidance is likely to have contributed as well to the buoyant evolution in recent years of taxes from corporations. 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.

On the expenditure side, expenditure has been revised downward in relation to compensation of employees, social payments, public investment, and other kind of expenditure. Public investment is expected to increase to 4.1% of GDP in 2019 from 3.9% in 2018.

For 2020, the Draft Budgetary Plan projects the headline surplus to decline to 1.2% of GDP. This compares with a headline surplus of 1.4% in 2020 that was projected in the 2019 Stability Programme. The macroeconomic scenario underpinning the budgetary strategy in the 2020 Draft Budgetary Plan projects a steady growth of the economic output compared to the sharp improvement factored in the last Stability Programme<sup>4</sup>. The decline in the 2020 headline surplus is then explained by a less favourable evolution of both revenues and expenditures compared to the Draft Budgetary Plan projections for 2019. Revenues are expected to shrink by 0.2 percentage points with a sizeable drop projected for current taxes on income and wealth (of 0.5 percentage points of GDP). At the same time, total expenditure is estimated to increase by 0.6 percentage points to 43.9% of GDP. In particular, compensation of employees is projected to increase by 0.2 percentage points, in line with the government efforts of reinforcing public services. Discretionary expenditure-increasing measures are

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<sup>3</sup> Note on the evolution of revenues and expenditure at 31 July 2019 for the Central Government, available at: <https://gouvernement.lu/dam-assets/documents/actualites/2019/07-juillet/Tableaux-Juin-2019.pdf>.

<sup>4</sup> According to the 2020 Draft Budgetary Plan, real GDP growth is forecast at 2.4% in both years 2019 and 2020, where the last Stability Programme projected real GDP growth to increase from 3.0% in 2019 to 3.8% in 2020.

estimated to amount to 0.2% of GDP. Gross fixed capital formation is projected to increase further to 4.3% of GDP, on the back of the purchase of military plane for an amount equivalent to EUR 200 million (around 0.3% of GDP).

Compared to the Draft Budgetary Plan projections for 2020, the Commission forecast projects the headline surplus to decline to 1.4% of GDP. Total revenues are forecast to decrease by 0.1% of GDP compared to their 2019 level. With identical assumptions about the impact of the discretionary measures, the difference is explained by the stronger elasticity of government revenues to GDP growth in the Commission 2019 autumn forecast and a more moderate evolution of government expenditure. The macroeconomic scenario underpinning the Commission forecast is broadly in line with that in the Draft Budgetary Plan (GDP growth at 2.6% in 2020 compared to 2.4% in the Draft Budgetary Plan). The total expenditure ratio is expected to increase by 0.8 percentage points of GDP as in the Draft Budgetary Plan.

In structural terms, the Draft Budgetary Plan projects the surplus of the recalculated structural balance<sup>5</sup> to decline to 1.3% in 2019 and to 0.6% of GDP in 2020. The Commission forecast also envisages a deterioration of the structural surplus to 1.6% of GDP in 2019, followed by a drop to 0.8% of GDP in 2020. In the light of the absence of one-offs and temporary measures, differences are explained by the different evolution in the headline surplus between the Commission forecast and the Draft Budgetary Plan and the estimation of the output gap.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Luxembourg currently standing at -0.5%.<sup>6</sup> 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 in 2018 and is projected to remain at 0.3% of GDP in 2019 and to fall to 0.2% of GDP in 2020. This compares to 1.8% 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 1.4% in 2020 compared to 1.8% for the euro area as a whole. This picture is broadly confirmed by the Commission 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 financial sector and overall growth prospects. Finally, the recurrent and sizeable revisions of national accounts risk undermining the reliability of the overall budgetary exercise.

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<sup>5</sup> Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

<sup>6</sup> 10-year bond yields as of 6 November 2019. Source: ESTAT.

**Table 2. Composition of the budgetary adjustment**

(% of GDP)	2018	2019			2020			Change: 2018-2020
	COM	SP	DBP	COM	SP	DBP	COM	DBP
<b>Revenue</b>	<b>44.6</b>	<b>45.0</b>	<b>45.3</b>	<b>45.4</b>	<b>45.0</b>	<b>45.1</b>	<b>45.3</b>	<b>0.5</b>
<i>of which:</i>								
- Taxes on production and imports	11.8	11.8	11.7	11.7	11.8	11.7	11.8	-0.1
- Current taxes on income, wealth,	16.4	16.3	17.2	17.3	16.3	16.6	16.9	0.2
- Capital taxes	0.2	0.2	0.2	0.2	0.3	0.2	0.2	0.0
- Social contributions	12.2	12.5	12.4	12.3	12.5	12.5	12.4	0.3
- Other (residual)	4.1	4.2	3.8	4.0	4.1	4.1	4.0	0.0
<b>Expenditure</b>	<b>41.9</b>	<b>43.9</b>	<b>43.3</b>	<b>43.1</b>	<b>43.6</b>	<b>43.9</b>	<b>43.9</b>	<b>2.0</b>
<i>of which:</i>								
- Primary expenditure	41.6	43.7	43.0	42.8	43.4	43.7	43.6	2.1
<i>of which:</i>								
Compensation of employees	8.9	9.4	9.2	9.2	9.4	9.4	9.4	0.5
Intermediate consumption	3.6	3.8	3.8	3.7	3.7	3.9	3.8	0.3
Social payments	19.6	20.2	19.9	19.8	20.1	20.1	20.0	0.5
Subsidies	1.2	1.2	1.2	1.2	1.2	1.2	1.2	0.0
Gross fixed capital formation	3.9	4.3	4.2	4.1	4.2	4.4	4.3	0.5
Other (residual)	4.5	4.8	4.7	4.8	4.8	4.7	4.8	0.2
- Interest expenditure	0.3	0.3	0.3	0.3	0.2	0.2	0.3	-0.1
<b>General government balance (GGB)</b>	<b>2.7</b>	<b>1.0</b>	<b>2.0</b>	<b>2.3</b>	<b>1.4</b>	<b>1.2</b>	<b>1.4</b>	<b>-1.5</b>
<b>Primary balance</b>	<b>3.0</b>	<b>1.3</b>	<b>2.3</b>	<b>2.6</b>	<b>1.6</b>	<b>1.4</b>	<b>1.7</b>	<b>-1.6</b>
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>GGB excl. one-offs</b>	<b>2.7</b>	<b>1.0</b>	<b>2.0</b>	<b>2.3</b>	<b>1.4</b>	<b>1.2</b>	<b>1.4</b>	<b>-1.5</b>
Output gap <sup>1</sup>	1.5	1.0	1.6	1.5	1.6	1.3	1.4	-0.4
Cyclically-adjusted balance <sup>1</sup>	2.0	0.6	1.3	1.6	0.6	0.6	0.8	-1.3
<b>Structural balance (SB)<sup>2</sup></b>	<b>2.0</b>	<b>0.6</b>	<b>1.3</b>	<b>1.6</b>	<b>0.7</b>	<b>0.6</b>	<b>0.8</b>	<b>-1.3</b>
Structural primary balance <sup>2</sup>	2.3	0.8	1.6	1.9	0.9	0.8	1.0	-1.4

Notes:

<sup>1</sup> 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.

<sup>2</sup> Structural (primary) balance corresponds to cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

### 3.2. Debt developments

In the Draft Budgetary Plan, the public debt-to-GDP ratio is projected to decrease from 21.0% in 2018 to 20.0% in 2019 and to 19.8% of GDP in 2020, well below the Treaty threshold of 60% and under the 30% threshold set by government. This projection is broadly confirmed by the Commission forecast that projects the government debt to decline to 19.6% of GDP and 19.2% of GDP in 2019 and 2020, respectively. The decrease in government debt is not as large 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 and they cannot be used to finance the needs of the central government. The differences compared to the evolution of the government debt in the Draft

Budgetary Plan are mostly due to different assumptions about the stock-flow adjustment, where the Draft Budgetary Plan projects an active management of the existing stock of debt.

**Table 3. Debt developments**

(% of GDP)	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
<b>Gross debt ratio<sup>1</sup></b>	<b>21.0</b>	<b>20.2</b>	<b>20.0</b>	<b>19.6</b>	<b>19.9</b>	<b>19.8</b>	<b>19.2</b>
Change in the ratio	-1.3	-0.8	-1.0	-1.4	-0.3	-0.2	-0.4
Contributions <sup>2</sup> :							
<b>1. Primary balance</b>	<b>-3.0</b>	<b>-1.3</b>	<b>-2.3</b>	<b>-2.6</b>	<b>-1.6</b>	<b>-1.4</b>	<b>-1.7</b>
<b>2. “Snow-ball” effect</b>	<b>-0.9</b>	<b>-0.6</b>	<b>-0.5</b>	<b>-0.7</b>	<b>-0.8</b>	<b>-0.7</b>	<b>-0.6</b>
<i>Of which:</i>							
Interest expenditure	0.3	0.3	0.3	0.3	0.2	0.2	0.3
Real growth effect	-0.7	-0.6	-0.5	-0.5	-0.7	-0.5	-0.5
Inflation effect	-0.5	-0.2	-0.3	-0.4	-0.4	-0.4	-0.4
<b>3. Stock-flow adjustment</b>	<b>2.5</b>	<b>1.1</b>	<b>1.8</b>	<b>1.9</b>	<b>2.1</b>	<b>1.9</b>	<b>1.8</b>

Notes:

<sup>1</sup>End of period.

<sup>2</sup>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:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

### 3.3. Measures underpinning the draft budgetary plan

The Draft Budgetary Plan reports on a number of new measures, which have been enacted or are planned. Since 2019 several flagship measures have been implemented, in particular the net increase in the minimum social wage by EUR 100 per month since the start of 2019 and a significant increase in investments in areas such as housing, education, research, digitalisation, transportation infrastructure, sustainable energy, culture and social structures. Other measures are aimed at strengthening the competitiveness of the tax framework by lowering the Luxembourg corporate income tax rate by one percentage point to 17% and widening the income bracket to which the reduced rate for corporate income tax applies. To keep up with the fight against global warming, an increase in excise duties on diesel and gasoline is also included. These measures combined are expected to lead to a budgetary cost of 0.5% of GDP in 2019.

Additional measures are planned in 2020 expected to cost an additional 0.2% of GDP. Measures on the revenue side account for a negative impact of less than 0.1% of GDP in 2020, pertaining to the adjustment of the VAT rate for some professional services. On the expenditure side, measures enacted or planned are estimated to increase expenditure by more than 0.1% of GDP in 2020. The main measures relate to the increase in compensation of employees related to the reinforcement of public administration services and in subsidies to private companies providing transportation services in relation with the reorganisation of the bus network. The Commission 2019 autumn forecast factored in similar estimates for these discretionary measures.



**Table 4. Main discretionary measures reported in the Draft Budgetary Plan****A. Discretionary measures taken by General Government - revenue side**

Components	Budgetary impact (% GDP)
	<b>2020</b>
Taxes on production and imports	0.0
Current taxes on income, wealth, etc.	0.0
Capital taxes	0.0
Social contributions	0.0
Property Income	0.0
Other	0.0
<b>Total</b>	<b>0.0</b>
<u>Note:</u> The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure. <i>Source: Draft Budgetary Plan for 2020</i>	

**B. Discretionary measures taken by general Government- expenditure side**

Components	Budgetary impact (% GDP)
	<b>2020</b>
Compensation of employees	0.1
Intermediate consumption	0.0
Social payments	0.0
Interest Expenditure	0.0
Subsidies	0.0
Gross fixed capital formation	0.0
Capital transfers	0.0
Other	0.0
<b>Total</b>	<b>0.2</b>
<u>Note:</u> 1) The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure. 2) Inconsistencies between the total and the sum of single measures is explained by rounding effects. <i>Source: Draft Budgetary Plan for 2020</i>	

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

##### **4.1. Compliance with the medium-term budgetary objective**

Luxembourg is subject to the preventive arm of the Pact and should ensure compliance with its medium-term budgetary objective.

According to the information provided in the Draft Budgetary Plan, Luxembourg is expected to achieve a recalculated structural surplus of 1.3% of GDP in 2019. This is above its medium-term budgetary objective of a deficit of 0.5% of GDP.<sup>7</sup> For 2020, based on the information in the Draft Budgetary Plan, the recalculated structural balance is expected to decline to a surplus of 0.6% of GDP, above the medium-term budgetary objective of a surplus of 0.5% of GDP. This is confirmed by the Commission 2019 autumn forecast, which estimates the structural surplus to reach 1.6% of GDP and 0.8% of GDP in 2019 and 2020, respectively.

Luxembourg is therefore expected to be compliant with the requirements of the preventive arm of the Stability and Growth Pact both in 2019 and 2020.

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<sup>7</sup> Medium-term budgetary objectives are to be revised every three years. Based on an agreed methodology, the Commission computes a minimum medium-term budgetary objective for each country. The minimum medium-term budgetary objectives 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 less favourable estimation in the 2018 Ageing report of its sustainability components (age-related expenditure, debt) the new minimum medium-term budgetary objective for Luxembourg increased significantly, from a structural balance deficit of 0.5% of GDP to a surplus of 0.5% of GDP. With the 2019 Stability Programme Luxembourg decided to revise its medium-term budgetary objective to a surplus of 0.5% of GDP for the period 2020-2022 from a deficit of 0.5% of GDP.

**Table 5. Compliance with the requirements of the preventive arm**

(% of GDP)	2018	2019		2020	
<b>Initial position<sup>1</sup></b>					
Medium-term budgetary objective (MTO)	-0.5	-0.5		0.5	
Structural balance <sup>2</sup> (COM)	2.0	1.6		0.8	
Structural balance based on freezing (COM)	2.4	1.6		-	
Position vis-a-vis the MTO <sup>3</sup>	the MTO	At or above the MTO		At or above the MTO	
	<b>2018</b>	<b>2019</b>		<b>2020</b>	
(% of GDP)	<b>COM</b>	<b>DBP</b>	<b>COM</b>	<b>DBP</b>	<b>COM</b>
<b>Structural balance pillar</b>					
Required adjustment <sup>4</sup>	Compliant				
Required adjustment corrected <sup>5</sup>					
Change in structural balance <sup>6</sup>					
One-year deviation from the required adjustment <sup>7</sup> adjustment <sup>7</sup>					
<b>Expenditure benchmark pillar</b>					
Applicable reference rate <sup>8</sup>	Compliant				
One-year deviation adjusted for one-offs <sup>9</sup>					
Two-year average deviation adjusted for one-offs <sup>9</sup>					
<i>Notes</i>					
<sup>1</sup> 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.					
<sup>2</sup> Structural balance corresponds to cyclically-adjusted government balance excluding one-off measures.					
<sup>3</sup> Based on the relevant structural balance at year t-1.					
<sup>4</sup> 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 ed. 2018, page 38.).					
<sup>5</sup> Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.					
<sup>6</sup> Change in the structural balance compared to year t-1. Ex post assessment (for 2018) was carried out on the basis of Commission 2019 spring forecast.					
<sup>7</sup> The difference of the change in the structural balance and the corrected required adjustment.					
<sup>8</sup> 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.					
<sup>9</sup> 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.					
<i>Source:</i> Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations.					

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

In 2020, the fiscal stance is expected to be expansionary, based on the structural balance estimates, according to both the Draft Budgetary Plan and the Commission 2019 autumn forecast.

The Draft Budgetary Plan projects an increase in total revenues in 2019 compared to 2018, when total revenues stood at 44.6% of GDP. They are expected to increase to 45.3% of GDP in 2019 and to decline from there to 45.1% of GDP in 2020. In 2019, revenue growth is still expected to be 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 an increase in progressivity of the personal income tax (with the aim to

increase fairness). After reducing revenues by 0.7% of GDP in 2017, the reform 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 since 2017 due to the impact of a number of specific elements, including the improvement in the labour market.

VAT revenues in 2019 are expected to be affected by the residual impact of the change in VAT legislation with regard to the place of taxation for activities related to e-commerce that took effect in 2015. 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 less than 0.1% of GDP.

According to the Draft Budgetary Plan, total expenditure in 2019 and 2020 is expected to increase to 43.3% and 43.9% of GDP, respectively, compared to 41.9% of GDP in 2018. 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 4.4% of GDP in 2020. The peak in 2020 is explained by the one-off impact of the purchase of a military plane (around EUR 200 million, equivalent to 0.3% of GDP). While it stands at a level well above the euro-area average (2.6% of GDP in 2018), it remains below its level before the financial crisis, in spite of recent government efforts to increase investment in Luxembourg's infrastructure. Overall, the tax structure remains rather growth-friendly.

The Draft Budgetary Plan provides a list of measures in order to ensure an adequate follow-up of the 2019 country-specific recommendations.

On 9 July 2019, the Council recommended to Luxembourg an increase of the employment rate of older people with a view to improving the long-term sustainability of the pension system.<sup>8</sup> In order to increase the employment rate of older people, the Council recommendation suggests to enhance their employment opportunities and employability and to further limiting early retirement. In this regard, the Draft Budgetary Plan does not report about new measures compared to those already enumerated in the former Draft Budgetary Plan. The following measures are listed: (i) the adopted reform of the long-term care insurance scheme, which was 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. It also recalls previously reported measures such as the adopted reform of the professional classification scheme for persons with partial incapacity. Nevertheless, it is worth noting that in 2018, the working group on pensions mandated by the

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<sup>8</sup> Council Recommendation of 9 July 2019 on the 2019 National Reform Programme of Luxembourg and delivering a Council opinion on the 2019 Stability Programme of Luxembourg (OJ C 301, 5.9.2019, p. 97).

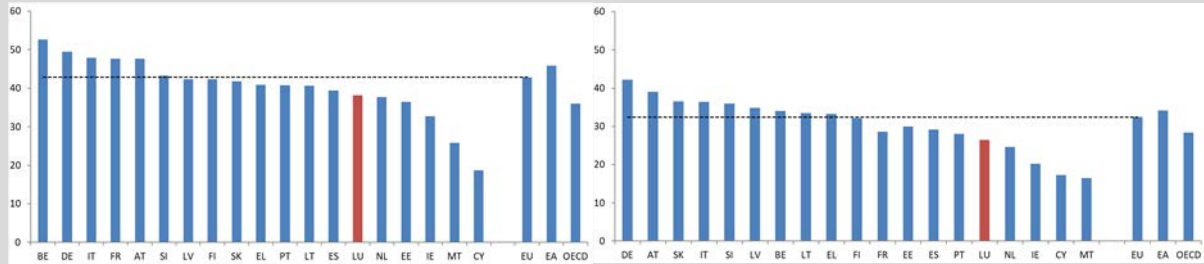
government concluded that the pension system in Luxembourg appears to be not sustainable, amid high uncertainty levels in the long-term projections at unchanged policies.

**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 this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area 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 these 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 EU 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.

Notes: 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.

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.

Luxembourg's Draft Budgetary Plan does not include any new measures affecting the tax wedge on labour. 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. Since the start of 2019 the minimum social wage has been increased by EUR 100 through tax credits, which is expected to have an impact on the labour tax wedge. This measure is estimated to have a revenue-decreasing impact of around 0.1% of GDP.

## **6. OVERALL CONCLUSION**

According to both the information provided in the Draft Budgetary Plan and the Commission 2019 autumn forecast, the structural balance is expected to remain above the medium-term budgetary objective in 2019 and 2020. Therefore, Luxembourg is projected to meet the requirements under the preventive arm of the Stability and Growth Pact both in 2019 and 2020.