COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 23 January, 2008
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Recommendation for a

**COUNCIL OPINION**

**in accordance with the third paragraph of Art. 5 of Council Regulation (EC) No 1466/97 of 7 July 1997**

**On the updated stability programme of Luxembourg, 2007-2010**

(presented by the Commission)

# EXPLANATORY MEMORANDUM

## 1. GENERAL BACKGROUND

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes. The first stability programme of Luxembourg was submitted in February 1999. In accordance with the Regulation, the Council delivered an opinion on it on 15 March 1999 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the regulation foresees that they are assessed by the Commission and examined by the Committee and, if necessary and following the same procedure as set out above, that they may be examined by the Council.

## 2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Luxembourg, submitted on 27 October 2007, and is recommending a Council opinion on it (see box for the main points covered by the assessment).

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

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

(2) the orientations for budgetary policies adopted by the April 2007 Eurogroup

(3) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

(4) the Commission's assessment of the October 2007 implementation report of the national reform programme.

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[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

### 2.1. The assessment in the Council opinion on the previous update

In its opinion of 27 February 2007, the Council summarised its assessment of the previous update of the stability programme, covering the period 2006-2009, as follows :

"The Council welcomes that, in a context of strong growth prospects, the programme is making rapid progress towards the MTO, which should be achieved from 2007 onwards, and envisages a further narrowing of the deficit thereafter. However, most of the expenditure-curbing measures recently decided are only temporary (i.e. until 2009)." Taking into account its assessment and in view of the projected increase in age-related expenditure, the Council invited Luxembourg to "improve the long-term sustainability of public finances by implementing structural reform measures (especially in the area of pensions)".

### 2.2. Orientations for budgetary policies adopted by the Eurogroup in April 2007

On 20 April 2007, with a view to improving the coordination of fiscal policies in the euro area, Eurogroup ministers discussed national budgetary developments in 2007 and the preliminary policy outlook for 2008 and their implications for the euro area.

Reaffirming their adherence to the sound fiscal policy principles of the revised Stability and Growth Pact and to national fiscal rules, Ministers committed to (i) build on the better-than-expected budgetary outcomes in 2006 to pursue more ambitious budgetary targets than those set in the end-2006 updates of the stability programmes; (ii) implement their 2007 budgets as planned, avoiding expenditure overruns, and using unexpected extra revenues to reduce government deficit and debt; and (iii) carefully design fiscal policy plans for 2008 so as to accelerate the adjustment towards the MTO for Member States which have not reached it and for those which have reached it to avoid feeding macroeconomic imbalances overall[2].

### 2.3. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[3]. In the area of budgetary policies, Luxembourg was encouraged to focus on a detailed strategy aimed in particular at further reforming the current early retirement systems.

In addition, all euro area Member States were recommended to "make use of the favourable cyclical conditions to aim at or pursue ambitious budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment of at least 0.5 % of GDP as a benchmark" and "to improve the quality of public finance by reviewing public expenditures and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability".

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2 The entire statement can be found at: www.gouvernement.lu/salle_presse/actualite/2007/04/20pm_krecke_berlin/MTBR_EG_conclusions-finalCLEAN.rtf

3 OJ L 92, 3.4.2007, p. 23.

## 2.4. The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which included an assessment of the October 2007 implementation report of Luxembourg national reform programme[4]. This could be summarised as follows.

Luxembourg's national reform programme identified as key challenges a stable macro-economic framework, an economy integrated into the European and international context, an attractive economic environment, adherence to the principles of sustainable development, greater prominence given to older workers and a high-quality education and training system.

The Commission's assessment was that Luxemburg had made very good progress in implementing its national reform programme over the 2005-2007 period.

Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Luxembourg should be invited to focus on the areas of employment of older workers, the reform of its pension systems, the improvement of its education system, youth unemployment and the attractiveness of the economic environment.

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4 Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

**Box: Main points covered by the assessment**

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

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

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

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[5];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[6], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

[6] "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

Recommendation for a

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## in accordance with the third paragraph of Art. 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

## On the updated stability programme of Luxembourg, 2007-2010

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[7], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [12 February 2008] the Council examined the updated stability programme of Luxembourg, which covers the period 2007 to 2010.

(2) Since the end of the 2001-2003 slowdown, Luxembourg is experiencing a new period of strong growth. On average, real GDP grew by 5¼% and domestic employment by over 3% a year in 2004-2007. In this context, Luxembourg has been able to bring its public finances back to surplus. Growth should remain strong during the period covered, even if it is forecast to slow down slightly in the coming years. However, despite the currently good condition of the economy and especially of public finances, the problem of population ageing will be particularly severe in Luxembourg and long-term sustainability is therefore a serious challenge.

(3) The programme contains two different scenarios for the macroeconomic and budgetary projections: a "central" scenario and a "variant". The "central" scenario is presented by the programme as the reference scenario, on which its budgetary projections are based. Assessed against currently available information[8], it appears to be based on plausible growth assumptions. It envisages that real GDP growth will decrease from 6% in 2007 to 4.5% on average over the period 2008-2010. The

[7] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

[8] The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

programme's projections for inflation in 2008 appear to be on the low side, in view of the acceleration in consumer prices at the end of 2007 and of the recent hike in energy prices. The rise in labour costs in Luxembourg has significantly exceeded the EU average since the early 2000's and the programme projects it to remain rather strong over the period covered, which might progressively weaken the country's competitiveness.

(4) For 2007, the general government surplus is estimated at 1.2% of GDP in the Commission services' autumn 2007 forecast and at 1.0% of GDP in the 2007 update of the stability programme, against a deficit of 0.9% of GDP targeted in the previous update. The main reason for this large divergence with the target is a strong revision of public finance data in recent years, which resulted in a large upward shift of the series of government balances since 2005. This shift implies that Luxembourg has in recent years constantly been at its medium-term objective (MTO) for the budgetary position, which is an estimated structural deficit (i.e. a cyclically-adjusted deficit net of one-off and other temporary measures) of ¾% of GDP. This is a much better outcome than the plan in the 2006 update to achieve the MTO from 2007 onwards. Although the improvement in the general government balance in 2007 was half of what was planned in the 2006 update and the better-than-expected outcome is almost entirely due to the large revision in public finance data, the budgetary implementation in 2007 has thus achieved the objectives endorsed by the Council opinion of 27 February 2007 on the 2006 update (OJ C 70, 27.3.2007). It has also been in line with the April 2007 Eurogroup orientations for budgetary policies.

(5) In view of these revised data, the current programme no longer envisages a budgetary consolidation like the previous one. The main goal of its medium-term budgetary strategy is now to maintain a nominal surplus of about 1% of GDP on average and to continue to respect the MTO with a comfortable margin throughout the programme period. The headline surplus is projected to decrease from 1.0% of GDP in 2007 to 0.8% in 2008 as a result of cuts in personal income tax before gradually increasing thereafter. The primary surplus would follow a similar path. The increase in the surplus from 2007 to 2010 is planned to be achieved through a decrease by 0.9 p.p. of GDP in the expenditure ratio, more than compensating a decline by 0.7 p.p. of GDP in the revenue ratio. With the exception of 2008 for which they reflect the measures contained in the budget, these figures represent no-policy change projections rather than targets reflecting the implementation of policy measures.

(6) The risks to the budgetary projections in the programme appear broadly balanced. They are based on a plausible macroeconomic scenario and seem attainable. In fact, outcomes could even be slightly better than projected in the programme due in particular to the prudence of revenue projections and the country's good track record in budgetary performance.

(7) In view of this risk assessment, the budgetary stance in the programme seems sufficient to maintain the MTO by a large margin throughout the period covered, as envisaged in the programme. The fiscal policy stance implied by the programme is in line with the Stability and Growth Pact throughout the period and with the April 2007 Eurogroup orientations.

(8) Luxembourg appears to be at medium risk with regard to the sustainability of its public finances. The long-term budgetary impact of ageing is among the highest in the

EU, influenced notably by a very considerable projected increase in pension expenditure. The budgetary position in 2007 as estimated in the programme, which is better than the starting position of the previous programme, the low debt ratio, the significant assets accumulated in social security, and a structural primary surplus contribute to offsetting the projected long-term budgetary impact of ageing populations. However, this is not sufficient to cover the sizeable increase in age-related expenditure. Achieving high primary surpluses over the medium term and, as recognized by the authorities, implementing measures aimed at curbing the substantial increase in age-related expenditures would contribute to reducing risks to the sustainability of public finances.

(9) The stability programme seems to be consistent to some extent with the October 2007 implementation report of the national reform programme. In particular, the measures in the stability programme are in line with the 2005 national reform programme and its October 2007 implementation report, for instance the projected increase in R&D expenditure and the new investment projects in rail and road infrastructures. The budgetary implications of those NRP reforms that have a direct budgetary impact are reflected in the stability programme's budgetary projections.

(10) The budgetary strategy in the programme is partly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines and with the guidelines for euro area Member States in the area of budgetary policies issued in the context of the Lisbon strategy. In particular, no reform of the pension system has been initiated to date in order to enhance the sustainability of public finances.

(11) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data [9].

The overall conclusion is that public finances have gone back to surplus in a context of strong GDP and employment growth. Recently released revised data indicate that the deterioration in public finances has been significantly more limited than previously estimated. Consequently, Luxembourg has constantly achieved its MTO and the path for the general government balance in the programme is at least 1% of GDP better in each year than in the previous update. While tax cuts will result in a small decrease in the surplus in 2008, the programme aims at maintaining a surplus of 1% of GDP on average throughout the period. The macroeconomic scenario and budgetary targets of the programme seem plausible and budgetary outcomes might even be slightly better than planned. However, Luxembourg will have to support in the coming decades a particularly heavy burden resulting from population ageing and no corrective measures have been taken to date. This explains that the country is considered to be at medium risk as regards the long-term sustainability of its public finances, in spite of its currently sound budgetary position.

In view of the above assessment and of the very strong increase in age-related expenditure forecast for the coming decades, Luxembourg is invited to improve the long-term sustainability of its public finances by implementing structural reform measures, in particular in the area of pensions.

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

**Comparison of key macroeconomic and budgetary projections**

| | | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|
| Real GDP (% change) | **SP Nov 2007** | **6.1** | **6.0** | **4.5** | **5.0** | **4.0** |
| | COM Nov 2007 | 6.1 | 5.2 | 4.7 | 4.5 | n.a. |
| | *SP Nov 2006* | *5.5* | *4.0* | *5.0* | *4.0* | *n.a.* |
| HICP inflation (%) | **SP Nov 2007** | **3.0** | **2.3** | **2.0** | **2.1** | **2.1** |
| | COM Nov 2007 | 3.0 | 2.5 | 2.8 | 2.3 | n.a. |
| | *SP Nov 2006* | *2.9* | *1.4* | *2.0* | *2.0* | *n.a.* |
| Output gap[1] (% of potential GDP) | **SP Nov 2007** | **-0.4** | **0.5** | **0.1** | **0.2** | **-0.8** |
| | COM Nov 2007[2] | -0.2 | 0.0 | -0.2 | -0.6 | n.a. |
| | *SP Nov 2006* | *-0.3* | *-0.8* | *-0.5* | *-1.6* | *n.a.* |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | **SP Nov 2007** | **n.a.** | **n.a.** | **n.a.** | **n.a.** | **n.a.** |
| | COM Nov 2007 | n.a. | n.a. | n.a. | n.a. | n.a. |
| | *SP Nov 2006* | *n.a.* | *n.a.* | *n.a.* | *n.a.* | *n.a.* |
| General government balance (% of GDP) | **SP Nov 2007** | **0.7** | **1.0** | **0.8** | **1.0** | **1.2** |
| | COM Nov 2007 | 0.7 | 1.2 | 1.0 | 1.4 | n.a. |
| | *SP Nov 2006* | *-1.5* | *-0.9* | *-0.4* | *0.1* | *n.a.* |
| Primary balance (% of GDP) | **SP Nov 2007** | **0.9** | **1.2** | **1.1** | **1.2** | **1.5** |
| | COM Nov 2007 | 0.9 | 1.3 | 1.2 | 1.5 | n.a. |
| | *SP Nov 2006* | *-1.3* | *-0.8* | *-0.2* | *0.3* | *n.a.* |
| Cyclically-adjusted balance[1] (% of GDP) | **SP Nov 2007** | **0.9** | **0.7** | **0.8** | **0.9** | **1.6** |
| | COM Nov 2007 | 0.8 | 1.2 | 1.2 | 1.7 | n.a. |
| | *SP Nov 2006* | *-1.3* | *-0.5* | *-0.1* | *0.9* | *n.a.* |
| Structural balance[3] (% of GDP) | **SP Nov 2007** | **0.6** | **0.7** | **0.8** | **0.9** | **1.6** |
| | COM Nov 2007 | 0.8 | 1.2 | 1.2 | 1.7 | n.a. |
| | *SP Nov 2006* | *-1.3* | *-0.5* | *-0.1* | *0.9* | *n.a.* |
| Government gross debt (% of GDP) | **SP Nov 2007** | **6.6** | **6.9** | **7.1** | **7.2** | **7.0** |
| | COM Nov 2007 | 6.6 | 6.6 | 6.0 | 5.4 | n.a. |
| | *SP Nov 2006* | *7.5* | *8.2* | *8.5* | *8.5* | *n.a.* |

Notes:

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

[2]Based on estimated potential growth of 4.8%, 5.0%, 5.0% and 4.9% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off or other temporary measures for the period 2007-2010 in the most recent programme and in the Commission services' autumn forecast.

*Source:*

*Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations*