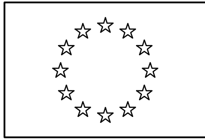

EUROPEAN COMMISSION

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REPORT FROM THE COMMISSION

Luxembourg

Report prepared in accordance with Article 126(3) of the Treaty

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1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn has brought about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to prepare a report such as the present one whenever an actual or planned deficit of a Member State exceeds the 3% of GDP reference value. This report, which represents the first step in the "excessive deficit procedure" (EDP), analyses the reasons for the breach of the reference value with due regard to the economic background and all other relevant factors. The amendments to the Stability and Growth Pact in 2005 aimed specifically at ensuring that in particular the economic and budgetary background was fully taken into account in all steps in the EDP. This means for instance that, if an "excessive deficit" is deemed to exist, adequate consideration needs to be paid to the economic background and outlook when making recommendations on the pace of the correction. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

2. LEGAL BACKGROUND

This report, which assesses recent and current budgetary developments in Luxembourg and reviews the short and medium-term prospects in the light of overall economic conditions and policy action taken by the government, is prepared according to Article 126(3) of the Treaty on the Functioning of the European Union (TFEU).

Article 126 TFEU lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the

implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. According to Article 126(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 126(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

According to data notified by the authorities in April 2010[2], validated by Eurostat[3] the general government deficit in Luxembourg is planned to reach 4.2% of GDP in 2010, thus exceeding the 3% of GDP reference value, while general government gross debt would be 19.3% of GDP, well below the 60% of GDP reference value even if on a rising trend since 2007.

The planned figure for the 2010 deficit provides *prima facie* evidence on the existence of an excessive deficit in Luxembourg in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore decided to initiate the excessive deficit procedure for Luxembourg with the adoption of this report. Section 3 of the report examines the deficit criterion. Section 4 deals with public investment and other relevant factors. The report takes into account the Commission services' spring 2010 forecast, which has been released on 5 May 2010.

Table 1: General government deficit and debt [a]

	2005	2006	2007	2008	2009	2010		2011
						COM	Apr 2010 notif.	COM
General government balance	0.0	1.4	3.6	2.9	-0.7	-3.5	-4.2	-3.9
General government gross debt	6.1	6.5	6.7	13.7	14.5	18.9	19.3	23.5

Note:
[a] In percent of GDP ;
Source: April 2010 EDP notification, Eurostat and Commission services' spring 2010 forecast (COM).

1 OJ L 209, 2.8.1997, p. 6. The report also takes into account the "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 10 November 2009, available at http://ec.europa.eu/economy_finance/sgp/legal_texts/index_en.htm.

2 According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Luxembourg can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/excessive_deficit/edp_notification_tables.

3 Eurostat news release No 55/2010 of 22 April 2010.

3. DEFICIT CRITERION

In 2010, the general government deficit is planned to reach 4.2% of GDP.

Well in excess of to the 3% of GDP, the planned deficit is not close to the Treaty reference value, but according to the Commission services' spring 2010 forecast the general government deficit would come out at 3.5% of GDP, which can still be considered as close. This divergence is mainly due to the fact that the Commission services forecast a lower rise in government expenditure (since they do not fully incorporate the 15% rise in public investment planned by the government) and expect that government revenues broadly stabilise in 2010 with respect to 2009, while the notification projects them to decline by 1.4%.

Table 2: Macroeconomic and budgetary developments [a]

	2005	2006	2007	2008	2009	2010		2011	
						COM	Feb 2010 SP	COM	Feb 2010 SP
Real GDP (% change)	5.4	5.6	6.5	0.0	-3.4	2.0	2.5	2.4	3.0
Potential GDP (% change)	3.9	3.5	3.8	3.5	2.3	2.1	2.2	2.5	2.1
Output gap (% of potential GDP)	+0.5	+2.5	+5.2	+1.7	-3.9	-4.1	-3.5	-4.1	-3.0
General government balance	0.0	1.4	3.6	2.9	-0.7	-3.5	-3.9 (c) -4.2 (d)	-3.9	-5.0 (e) -3.0 (f)
Primary balance	0.2	1.5	3.9	3.2	-0.2	-3.0	-3.3 (c) -3.5 (d)	-3.3	-4.3 (e) n.a. (f)
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Government gross fixed capital formation	4.5	3.6	3.3	3.2	3.6	3.7	3.9 (c) 4.0 (d)	3.5	3.9 (e) n.a. (f)
Cyclically-adjusted balance	-0.3	0.1	1.1	2.0	1.2	-1.4	-2.2	-1.9	-3.5
Cyclically-adjusted primary balance	-0.1	0.3	1.3	2.3	1.7	-1.0	-1.6	-1.3	-2.8
Structural balance [bc]	-0.3	0.1	1.1	2.0	1.2	-1.4	-2.2	-1.9	-3.5
Structural primary balance	-0.1	0.3	1.3	2.3	1.7	-1.0	-1.6	-1.3	-2.8

Notes:
[a] In percent of GDP unless specified otherwise.
[b] Cyclically-adjusted balance excluding one-off and other temporary measures.
[c] February 2010 update of the stability programme
[d] April 2010 notification
[e] February 2010 update of the stability programme : "unchanged policy" scenario
[f] February 2010 update of the stability programme : proposed adjustment path.
Source: Eurostat, Commission services' spring 2010 forecast and February 2010 update of the stability programme.

The planned excess over the 3% of GDP reference value is exceptional. In particular, it essentially results from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact, namely the recession in the context of the global financial crisis. According to the Commission services' Spring 2010 forecast, real GDP dropped by 3.4% in 2009 and is forecast to recover to 2% in 2010.

The excess over the 3% of GDP reference value can be regarded as temporary in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services' spring 2010 forecast, which was based on the no policy change assumption for 2011, the general government deficit would rise from 3.5% of GDP in 2010 to 3.9% of GDP in 2011 essentially because the rise in revenues, though larger than in 2010, is expected to fall short of the increase in expenditure. However, on 5 May 2010, after the cut-off date of the forecast the Prime Minister announced consolidation measures that would amount, according to

information provided to the Commission on 7 May, to 1.6% of GDP in 2011 and another 1.7% of GDP in 2012; they include a series of expenditure cuts , in particular in public investment as well as an increase in revenues. Given that the Commission forecast of 3.9% of GDP already anticipated a somewhat lower investment growth, the part of this consolidation package that can be taken into account for 2011 is estimated at about 1.2% of GDP and would reduce next year's deficit to around 2¾%, thus below the 3% of GDP threshold.

In sum, the planned deficit for 2010 can be regarded as exceptional, close to the 3% of GDP reference value and temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis suggests that the deficit criterion in the Treaty is fulfilled.

4. RELEVANT FACTORS

Article 126(3) of the Treaty provides that the Commission report "shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of the Member State". These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that "any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council" need to be given due consideration.

In view of the above provisions, the following four subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) other factors put forward by the Member State and (4) other factors considered relevant by the Commission.

4.1. Medium-term economic position

Cyclical conditions and potential growth

After having recorded an average annual growth of 5.5% over the years 2004-2007 (slightly above the long-term 5.2% average growth recorded from 1983 to 2007), the Luxembourgish economy stagnated in 2008 and contracted by 3.4% in 2009. It is projected to grow by 2.0% in 2010 and 2.4% in 2011 in the Commission services' spring 2010 forecast. The output gap, which was substantially positive in the years before the crisis, reaching a peak of 5.2% in 2007, became widely negative in 2009 (-3.9%). It is projected to slightly increase to -4.1% in 2010 and to remain at that level in 2011.

Recent structural reforms

The structural reforms launched within the Lisbon process comprise a significant increase in public R&D expenditure, which were/are planned to be brought from about ¼% of GDP in 2005 to 0.6% in 2010 and eventually to 1% of GDP, in particular through the creation and development of the University of Luxembourg. At the same time, there have been efforts to improve R&D governance, in particular through the entry into force of a law on research and innovation (*loi du 5 juin 2009 relative à la promotion de la recherche, du développement et de l'innovation*). New projects have been identified in the field of transport and telecoms infrastructures that should support the country's competitiveness and keep the investment activity at a high level/further increase the country's investment activity.

4.2. *Medium-term budgetary position*

Structural deficit and fiscal consolidation in good times

The strong growth recorded between 2004 and 2007 was used to convert the deficit of 1.1% of GDP observed in 2004 to an average surplus of 2.6% from 2006 to 2008. The fiscal stance, which was strongly expansionary in 2002-2004, turned moderately and then more openly restrictive, with the structural balance improving by about 0.4 percentage point of GDP in 2005 and 2006 and by about 1 percentage point of GDP in 2007 and 2008. It peaked at a surplus of 2.0% of GDP in 2008 before decreasing to 1.2% in 2009 against the background of the sharp economic decline. Thanks to this fiscal policy stance as well as surpluses accumulated during the 1990s[4], the debt stock stood at 13.7% of GDP at the end of 2008.

Public investment

At 3.9% of GDP in 2010 according to the February stability programme, public investment would be more or less of the same magnitude as the deficit projected in the programme and the April EDP reporting. It amounted to 4.1% of GDP on average from 2001 to 2009, which is one of the highest figures among the EU15. The Luxembourgish stimulus programme comprised a substantial increase in public investment, which rose from 3.2% of GDP in 2008 to 3.6% in 2009.

Quality of public finances

Despite its sizeable increase resulting from the crisis, general government expenditure (42% of GDP in 2009) remains low compared to most other Member States and public investment in percent of GDP is amongst the highest among the EU15. The government, especially the social security system, holds sizeable assets, which are the result of the recurrent surpluses recorded in the last decades. According to most estimates, these assets amount to more than 30% of GDP, compared to a debt-to-GDP ratio of just below 20% in 2010. The net financial position of the government is thus positive. The support operation to the financial sector launched at the end of 2008, which caused the doubling of the gross debt in that year, also resulted in a corresponding increase in government assets. The increase in the gross debt ratio projected for 2010 and 2011, triggered by the large deficits of the central government, will also go together with a rise in government assets, mainly accumulated from the surpluses of the social security system (about 1¾% of GDP in both years).

Long-term sustainability of public finances

In its opinion of 26 April 2010 on the most recent stability programme, the Council assessed the long-term sustainability of Luxembourg's public finances as follows. The long-term budgetary impact of ageing projected for Luxembourg is significantly above the EU average due in particular to a very considerable projected increase in pension expenditure. The significant assets accumulated by the social security system will contribute to offsetting the projected long-term budgetary impact of ageing but this will not be sufficient to cover the sizeable increase in age-related expenditure. Achieving high primary surpluses over the medium term and implementing measures aimed at curbing the substantial increase in age-related expenditure would contribute to reducing the risk to the sustainability of public finances, which were assessed in the Commission 2009 Sustainability Report as medium.

[4] There are no complete accounts for general government in Luxembourg before 1990.

Against this background, Luxembourg was invited to improve the long-term sustainability of public finances by reforming the pension system and to set a MTO that takes sufficiently into account the implicit liabilities related to ageing.

4.3. Other factors put forward by the Member State

In reply to a request addressed by the Commission to the authorities of Luxembourg regarding relevant factors in accordance with Article 2(3) of Council Regulation (EC) No 1467/97, they confirmed on 3 May 2010 that according to their latest estimations, Luxembourg's 2010 public deficit is likely to exceed the 3% of GDP threshold. As regards the closeness to the reference value, the authorities acknowledged that their latest estimate of a deficit of 4.2% of GDP in 2010 could under no circumstances be qualified as "close" to the reference value, while pointing out that it was made before receiving revenue data for the first quarter and an upward revision of the GDP growth forecasts for 2010. This better performance had been to some extent already anticipated in the Commission services Spring 2010 forecast. Moreover, following discussions in Parliament on 6 and 7 May, the authorities provided information to the Commission on 7 May regarding the consolidation measures that Prime Minister Juncker had announced during his speech to Parliament on 5 May.

4.4. Other factors considered relevant by the Commission

Apart from the impact of the economic downturn, the excess above the reference value also results from the stimulus package decided by the Luxembourgish government as part of the European Economic Recovery Plan (EERP): as a response to the economic crisis, the Luxembourgish government adopted a recovery package, which (together with other measures which were taken before the aggravation of the crisis but have also the effect to support the economy) amounted in 2009 to over 3% of GDP.

To stabilise the financial system, the Luxembourgish authorities granted a loan to the Luxembourgish subsidiaries of Fortis and Dexia. These loans amounted together to about EUR 2.8 billion (7% of GDP). The loan to Fortis, which amounted to EUR 2.4 billion, was subsequently converted into capital. The financing of these loans resulted in a doubling of the general government gross debt by the end of 2008, from 7.0% of GDP in 2007 to 14.4% of GDP (although it also increased the government's assets to the same extent). The Luxembourgish authorities also decided together with the Belgian and French governments to guarantee Dexia's liabilities towards credit institutions and institutional counterparties for a total of EUR 150 billion, of which 3% or EUR 4.5 billion for the Luxembourgish government (about 12½% of Luxembourg's GDP). This guarantee has not led to any disbursement up to now.

In its opinion of 26 April 2010 on the most recent update of the stability programme, the Council considered that, in view of the downturn and the sound budgetary starting position of Luxembourg the temporary deterioration in the general government balance in 2009 and 2010 partly reflecting the adoption of stimulus measures is appropriate. However, from 2011 onwards, the Council also noted that the fiscal stance as shown in the programme's "unchanged policy scenario" cannot be considered in line with the requirements of the Pact, as the government deficit would remain above 3% of GDP until 2014 and there would be no consolidation effort to ensure that the deficit is brought below the threshold. The Council also stated that, while the authorities indicated their intention to follow a more ambitious consolidation path with a view to bringing public finances back to balance in 2014 and to achieve the medium-term objective in the following years, this adjustment path could not be

properly assessed in the absence of any information including the underlying measures. It thus indicated that more information on these measures would be welcome.

The Council, therefore, invited Luxembourg to start fiscal consolidation as from 2011 with a view to bringing the deficit below the 3% of GDP threshold and thereafter progressing towards the MTO. It also invited Luxembourg to specify the measures that would be needed to achieve this consolidation.

5. CONCLUSIONS

Whereas the general government deficit in Luxembourg is planned to reach 4.2% of GDP in 2010, which is above and not close to the 3% of GDP reference value of the Treaty, the Commission services' 2010 spring forecast projects a deficit of 3.5% of GDP which can be considered as close. The excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. Taking into account the latest consolidation measures announced by the Luxembourg government, this excess can be regarded as temporary. This suggests that the deficit criterion in the Treaty is fulfilled.

The general government gross debt remains well below the 60% of GDP reference value. This suggests that the debt criterion in the Treaty is fulfilled.

In line with the Treaty, this report has also examined “relevant factors”, which, according to the Stability and Growth Pact, can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. Considered on their own merit, the relevant factors in the current case on balance seem to be favourable.