

## EXECUTIVE SUMMARY

### 1. Introduction

This assessment is the first that the National Council of Public Finance (CNFP) is carrying out under the regular annual budgetary procedure. The analysis is mainly based on the draft multi-annual financial programming law for the period 2015-2019 (hereinafter: LPFP 2015-2019), the draft budget for 2016 as well as a certain number of related documents and the most recent data available at the time of writing.

The preparation of this assessment of public finances is being done at a time where the functioning of CNFP remains hampered by resources inadequate to address the tasks it is legally in charge for. Recruiting staff is proving to be a particularly unwieldy process, despite the essential nature of this requisite for completing the institution's work. Over the past few months, progress has nonetheless been achieved, especially in the area of access to data as well as in terms of financial resources. Uncertainties concerning the scope of CNFP assessments have dissipated to some degree, though they are not fully eliminated. In accordance with the "comply-or-explain" principle, the Minister of Finance has indeed sent a letter to the CNFP on 14 October 2015 in which public responses were given to the main recommendations and requests formulated by the CNFP last June.

As the difficulties encountered are largely due to inaccuracies in the 12 July 2014 law on the coordination and governance of public finances, the CNFP has drafted various amendments to the aforementioned law with the aim of ensuring an efficient functioning of the CNFP and respecting its independence. The text of the proposed amendments was submitted to the Ministry of Finance and to the President of the Parliament on 29 September 2015. The CNFP hopes that these proposals will be timely translated into legislative proceedings.

### 2. Evaluation of formal rules applicable to the multi-annual financial programming draft law for the period 2015-2019 (LPFP 2015-2019)

In accordance with its monitoring tasks as defined by the 12 July 2014 law, the CNFP carried out a detailed assessment of the formal rules to be followed by the LPFP 2015-2019.

Of the 12 rules reviewed, it was determined that 5 fully comply with the law, 3 partially comply and 4 did not comply with the law (see the summary table on page 20 of the full text – available in French only).

In accordance with the "comply-or-explain" principle, the CNFP expects this assessment to be considered as part of the ongoing budgetary procedure or that the authorities explain publicly why CNFP recommendations would not be followed.

The following points have been deemed non-compliant with the 12 July 2014 law:

- Art. 3, paragraph 3 of the law dated 12 July 2014: The LPFP determines the *trajectories of annual nominal and structural balances* at the level of general government, *in accordance with the provisions of the European System of Accounts (ESA)*.

*The total cost for acquiring an A400M military aircraft, worth € 197 million, should be included in the 2019 fiscal year which therefore requires a downwards adjustment of budget balances indicated in articles 2 and 3 of the draft LPFP for 2015-2019.*

- Art. 3, paragraph 4 of the law dated 12 July 2014: The multi-annual objectives for public finances as determined by the LPFP include a **maximum amount of central government expenditures** for each of the years to which objectives relate.

*These maximum amounts or ceilings should be included in the text of the draft legislation, in accordance with the 12 July 2014 law. Furthermore, these ceilings should in principle remain fixed for the entire period of 2015-2019, to be rounded out at the next LPFP process by a supplementary ceiling for each additional year.*

- Art. 3, paragraph 5 of the law dated 12 July 2014: The LPFP contains an explanatory appendix that presents the **calculations used for the computation of structural balances**:

*Since Appendix 5 of the draft LPFP 2015-2019 provides only qualitative explanations, the CNFP requests that the Government adds the relevant calculations to the Appendix, as required by law.*

- Art. 3, paragraph 5 of the law dated 12 July 2014: The LPFP contains an explanatory appendix that presents an evaluation of **the impact that the policies under review could have on the long-term sustainability of public finances**.

*Given the legal requirement for such an Appendix and as the LPFP 2015 scarcely addresses spirit of the law, the CNFP hopes that future LPFPs will eliminate this shortcoming.*

The Minister of Finance, in his statement to Parliament when tabling the draft 2016 budget, suggested moving the submission of future draft LPFPs to the spring of each year, beginning with next LPFP covering the 2016-2020 period. In doing so, the Government would be implementing one of the principal recommendations put forth by the CNFP in its June 2015 evaluation. Relevant institutions and social partners would thus have the opportunity to engage in more detailed and freer discussions on a multi-year outlook of public finances detached from the annual budget cycle.

### **3. Macroeconomic forecasts**

The CNFP notes that there is an apparent inconsistency between the short-term economic forecast for 2015 and 2016 and the medium-term forecasts for 2017 - 2019. Since the macroeconomic scenario appears to be based on a “hybrid approach”, consisting of a mix of outdated forecasts and partially updated data, the CNFP is requesting that details for all underlying assumptions be made public. The same is true for the sensitivity analysis, which appears to be based on alternative scenarios, but which cannot be found neither in the introductory explanations of the 2016 draft budget nor in those of the LPFP 2015-2019.

It is also regrettable that STATEC will not publish its more detailed update of macroeconomic forecasts for 2015 and 2016 until the end of November. However, the proposed change in the submission time for the 2016-2020 LPFP would provide the opportunity to review the approach with regard to preparing the macroeconomic scenario underpinning fiscal projections, primarily because it will be possible to better align budget-related working programmes with those of STATEC.

The international economic environment suggests that the timid recovery in economic activity within the Euro zone appears to be solidifying, even in the face of international organisations' projections that tend slightly downwards. For the Euro zone, STATEC assumes a real GDP growth of 1.6% in 2015, 1.9% in 2016 and an average of 1.4% from 2017 to 2019.

The macroeconomic forecasts for Luxembourg underpinning fiscal projections are as follows:

- a downward trend of real GDP growth rates for the entire period: 3.7% in 2015, 3.4% in 2016 and 3% on average between 2017 and 2019 ;
- a rising trend of nominal GDP growth rates: 3.2% in 2015, 3.9% in 2016 and 4.2% on the average between 2017 and 2019 ;
- a labour market that develops favourably in the short term, but features a slowdown in employment growth and an increase in unemployment in the medium term ;
- gradually rising inflation, approaching 2% towards the end of the planning period.

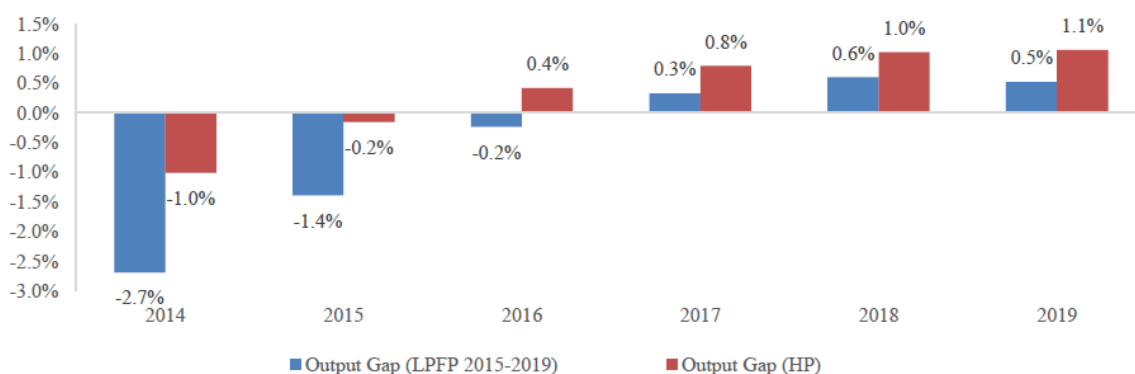
While the economy performed better in the short term compared to previous forecasts underlying the LPFP 2014-2018 presented in autumn 2014, the medium-term outlook seems to have worsened.

Given the importance of structural balances in the national fiscal framework as reformed by the 12 July 2014 law, the CNFP has examined the macroeconomic data used to determine structural balances, i.e. real GDP growth, potential output and the output gap, under the LPFP 2015-2019.

For the purposes of this assessment, the CNFP has chosen the Hodrick-Prescott (HP) filter method to determine output gaps. This methodology allows for a meaningful comparison of structural balances put forward by authorities since the LPFP 2014- 2018. As the Government has decided to move away from this methodology in the framework of the LPFP 2015-2019, despite its use as recently as in last year’s budgetary procedure (LPFP 2014-2018), without providing any explanations or justification, and given that the calculations underpinning the structural balances in the LPFP 2015-2019 are based on outdated data that differ from the macroeconomic scenario underlying the budget programme, the CNFP has had to recalculate structural balances. Nonetheless, results are to be interpreted with caution in the face of the methodological issues surrounding the computation of structural balances.

In light of the methodological issues and considering the increased volatility of forecasts for a small, open economy, the CNFP recommends that a working group be formed, composed of the main experts in the country, i.e. the Ministry of Finance, STATEC, BCL and CNFP, with the purpose of preparing a joint recommendation by April 2016 with regard to the methodological approach to be adopted going forward both by the Government in its budgetary work and by the CNFP in carrying out its monitoring task.

The following graph illustrates the differences between estimates for the output gap depending on the methodology used:



Source : CNFP calculations.

*LPFP 2015-2019 : output gap as calculated by authorities in the budget documents ;  
 HP : HP filter applied to most recent real GDP series following the 12 October 2015 update of national accounts.*

#### 4. Public finances

The CNFP carried out an overall assessment of public finances, on the basis of ESA2010 figures, using the following as references:

- Structural balances and their compliance with the medium-term objective (MTO) of 0.5% of GDP;
- Central government expenditure and whether or not they adhere to the relevant ceilings;
- Total expenditures in light of the expenditure benchmark of the Stability and Growth Pact.

For the purposes of its assessment, the CNFP has corrected fiscal projections presented in the 2015-2019 LPFP in two ways: first, by recognising the cost of the purchase of a military aircraft in the fiscal year 2019 and, second, by removing from the underlying projections any revenues from the 0.5% so-called “temporary budgetary equilibrium tax” (IEBT) from 2017 onwards, in accordance with the agreement between the Government and trade unions to abolish the IEBT by 2017. In contrast, no corrections were applied to take into account a “non-neutral” tax reform or the impact of a potentially incomplete implementation of the *Zukunftspak* consolidation package.

The summary table below gives an overall view of the figures and conclusions from the CNFP assessment :

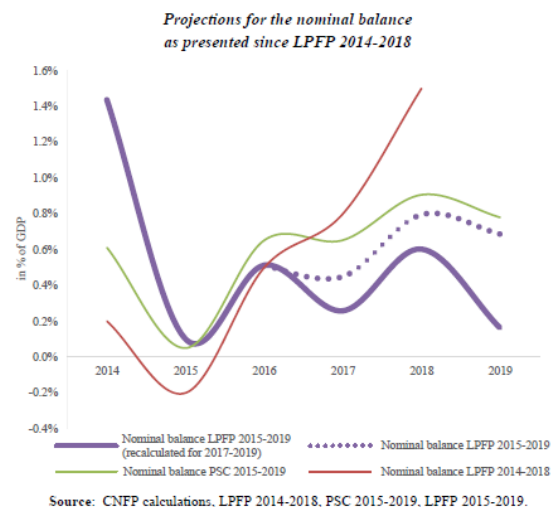
In % of GDP, unless stated otherwise	2014	2015	2016	2017	2018	2019
<b>STRUCTURAL BALANCE</b>						
Nominal general government balance <sup>1</sup> <i>(adjusted for 2017 to 2019 by the CNFP)</i>	1,4%	0,1%	0,5%	0,3%	0,6%	0,2%
Output Gap (in % of potential GDP) <sup>2</sup>	-1,0%	-0,2%	0,4%	0,8%	1,0%	1,1%
Cyclically-adjusted balance	1,9%	0,2%	0,3%	-0,1%	0,2%	-0,3%
One-off or temporary measures	0,2%	...	...	...	...	...
<b>STRUCTURAL BALANCE according to CNFP</b>	<b>+1,7%</b>	<b>+0,2%</b>	<b>+0,3%</b>	<b>-0,1%</b>	<b>+0,2%</b>	<b>-0,3%</b>
<i>Structural balance according to LPFP 2015-2019</i>		+0,7%	+0,6%	+0,3%	+0,5%	+0,5%
<b>Medium-term objective (MTO)</b>	<b>+0,5%</b>	<b>+0,5%</b>	<b>+0,5%</b>	<b>+0,5%</b>	<b>+0,5%</b>	<b>+0,5%</b>
<b>Compliance with the MTO</b>	<b>YES</b>	<b>RISK OF NON-COMPLIANCE</b>	<b>RISK OF NON-COMPLIANCE</b>	<b>RISK OF NON-COMPLIANCE</b>	<b>RISK OF NON-COMPLIANCE</b>	<b>RISK OF NON-COMPLIANCE</b>
Deviation from the MTO over 1 year <sup>3</sup>	+1,2%	-0,3%	-0,2%	-0,6%	-0,3%	-0,8%
Deviation from the MTO over 2 years <sup>3</sup>	n.a.	+0,4%	-0,25%	-0,4%	-0,5%	-0,6%
<b>Triggering of the correction mechanism according to the 12 July 2014 law</b>	<b>NO</b>	<b>NO</b>	<b>RISK</b>	<b>RISK</b>	<b>RISK</b>	<b>RISK</b>
<b>MAXIMUM AMOUNT OF CENTRAL GOVERNMENT EXPENDITURE<sup>4</sup></b>						
Maximum amount according to LPFP 2014-2018 <sup>4</sup>						
Central government expenditure according to the LPFP 2015-2019 <i>(in millions of euros)</i>	n.a.	15 967	16 739	17 353	17 867	18 718 <sup>5</sup>
<b>Compliance with the ceiling</b>	n.a.	?	?	?	?	n.a.
<b>EXPENDITURE BENCHMARK FROM THE STABILITY AND GROWTH PACT<sup>6</sup></b>						
Annual growth of adjusted public expenditure <i>(nominal, in %)</i>	+2,8%	+4,0%	+4,2%	+4,0%	+4,1%	+4,9%
Annual growth of adjusted public expenditure <i>(real, in %)</i>	+1,3%	+4,5%	+3,7%	+2,8%	+2,8%	+3,5%
Reference rate <i>(real terms, in %)</i>	+1,1%	+1,1%	-0,1%	+1,1%	-0,1%	-0,1%
Deviation (in % of GDP) over 1 year <sup>7</sup>	-0,1%	-1,4%	-1,6%	-0,7%	-1,2%	-1,5%
<b>Compliance with the benchmark</b>	<b>NO</b>	<b>RISK OF NON-COMPLIANCE</b>	<b>RISK OF NON-COMPLIANCE</b>	<b>RISK OF NON-COMPLIANCE</b>	<b>RISK OF NON-COMPLIANCE</b>	<b>RISK OF NON-COMPLIANCE</b>
<b>Procedural consequences under the SGP</b>	<b>NO</b>	<b>RISK</b>	<b>RISK</b>	<b>RISK</b>	<b>RISK</b>	<b>RISK</b>

Sources : Ministry of Finance, own calculations.

1 : abolition of 0.5% temporary tax from 2017 et military aircraft accounted for in 2019 ; 2 : calculated by taking into account the most recent real GDP data and potential GDP obtained through HP filtering of this latest data; 3 : a negative implies that the structural balance is below the MTO ; 4 : no maximum amounts have been fixed in the LPFP 2014-2018 ; 5 : military aircraft taken into account in 2019 ; 6 : based on ad hoc calculations, by taking into account structural balances as calculated by the CNFP; 7 : Deviation vis-à-vis the reference rate. A negative sign implies that expenditure growth is above the reference rate.

With regard to the general government nominal balance, as recalculated by the CNFP for 2017-2019, it is expected to remain in surplus over the entire period under review. Compared with the 2014 outcome of 1.4% of GDP, the surplus is however likely to be considerably smaller with balances varying between 0.1% and 0.6% of GDP.

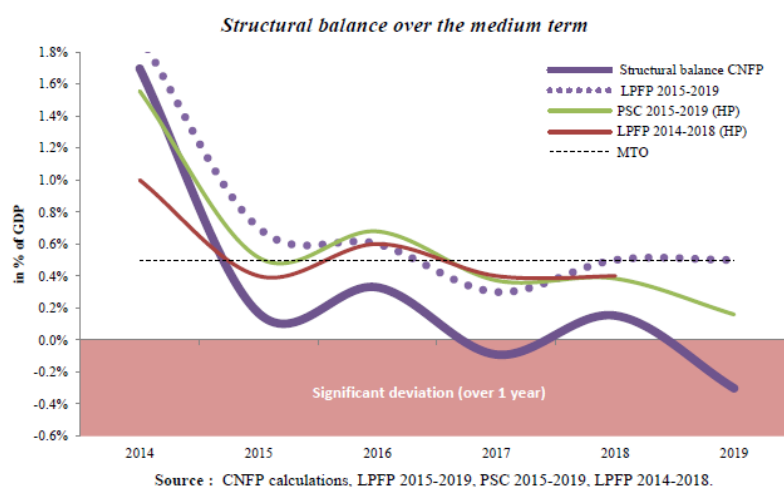
The deterioration of the nominal balance from 2014 to 2015 will likely be caused by a more rapid rise of 6.3% in expenditures, whilst revenues are projected to grow by 3.0% only. With an average growth rate of around 4.3% over 2016-2019, public expenditures should grow at a similar pace as revenues. This rate of growth, in both expenditures and revenues, is however considerably lower than their historic average of some 7% per year. The projected growth in economic activity is indeed implicitly expected to generate less revenues than in the past. As for the expenditure side, the rather positive projections are based on the assumption that no additional measure is introduced until 2019, that the “Zukunftspak” consolidation package is completely implemented and that operating costs (intermediary consumption) remain under control for the entire period under review.



The surplus at the level of the general government nonetheless continues to mask a much more diverse situation at the sub-sector level. The central government should remain largely in deficit for the entire period under review without showing any genuine trend toward a balanced account by 2019. This deficit will therefore have to be continually financed by issuing new debt.

According to CNFP calculations based on the method used by the Government in the preceding 2014-2018 LFPF, the structural balance is following an even more pronounced trajectory than the nominal balance. The structural balance should fall from its 2014 level of +1.7% of GDP to a slight surplus in 2015 and should hover around 0% of GDP in 2016.

Given that the calculation method used by the CNFP allows for a meaningful comparison with previous projections, the analysis indicates that changes compared to the 2014-2018 LFPF are essentially the result of revisions to nominal balances: nominal balances are revised up for 2014 and 2015 and down for 2016 to 2018. Revisions to GDP, more favourable at the beginning of the estimation period and less so at its end, only partially offset fluctuations. The annual deviation with respect to the MTO thus moves from a positive 1.2% of GDP in 2014 to negative figures for the entire period under review, in other words the structural balance would fall below the MTO threshold from 2015 onwards.



In 2014, the general government complied with the structural balance rule as defined by the 12 July 2014 law. The correction mechanism therefore does not have to be triggered.

In 2015, the general government may not comply with the fiscal rule set out in the 12 July 2014 law. However, this would not result in a triggering of the correction mechanism since the deviation with respect to the MTO is below the threshold of 0.5% of GDP over 1 year and below 0.25% over two years<sup>1</sup>.

In 2016, the structural balance rule would not be complied with. As the deviation will be an average of 0.25% of GDP for the years 2015 and 2016, the CNFP sees a risk for a “significant deviation” *vis-à-vis* the MTO to occur from 2016 onwards, potentially triggering the automatic correction mechanism.

In 2017, 2018 and 2019, the general government would continue not to comply with the structural balance rule as set out in the 12 July 2014 law. As the deviation with respect to the MTO could well be significant, i.e. higher than 0.5% in one year or higher 0.25% on average over two consecutive years, the correction mechanism may need to be triggered should no other correction be previously implemented.

If the planned tax reform were to be non-neutral from a budgetary point of view and at the same time not financed by a concurrent reduction in expenditure, budgetary balances would deteriorate further from 2017 onwards which increases the risk of a significant deviation *vis-à-vis* the MTO.

The CNFP would like to emphasize that its assessment of compliance with the structural balance rule depends to a large extent on the calculation method underpinning the estimation of such balances. This points indeed to the need to come to an agreement on a shared, consistent and stable methodological approach by all relevant parties in Luxembourg, i.e. the Government in its budgetary work and the CNFP in its monitoring tasks. As the risk of a slippage *vis-à-vis* the MTO seems to have increased, the CNFP wishes to underscore the urgency in this respect in order to avoid distorting further the question of a possible triggering of the correction mechanism under the 12 July 2014 law.

Regarding the fiscal rule calling for a maximum amount of central government expenditure (as foreseen by Article 3, Paragraph 4 of the law dated 12 July 2014), the CNFP is not in a position to assess its compliance given that the last year's LPFP 2014-2018 has not fixed any relevant expenditure ceilings. Moreover, this fiscal rule is still not being implemented under the new LPFP.

The assessment of the EU fiscal rule on total public expenditure, namely the expenditure benchmark which forms a second pillar of the Stability and Growth Pact, indicates a significant deviation, expressed in terms of % of GDP, for the entire period under review. Calculations by the Ministry of Finance, adjusted by the CNFP, show indeed that thresholds set under this rule are systematically exceeded. Since the structural balance may no longer be greater or equal to the MTO, there could be a risk that the both rules of the Stability and Growth Pact may be breached. This could trigger procedural consequences at the EU level; it should nonetheless be stressed that the European Commission conducts its own assessments on the basis of a common European methodology for estimating structural balances.

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<sup>1</sup> In accordance with Article 6, paragraph 1, of the law dated 12 July 2014, a deviation is considered "significant" when the structural balance measured shows a gap of 0.5% of GDP over one year with relation to the medium-term objective or when structural balances over two consecutive years show an average difference of 0.25% of GDP with relation to the medium-term objective.

### 3. Public Debt

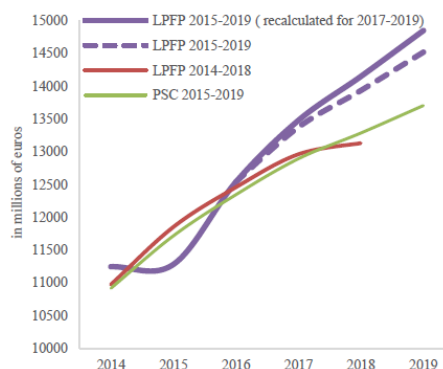
In 2015, current forecasts point to a stabilisation of public debt at € 11.3 billion and a drop in terms of % of GDP to 22.3%.

In the medium term, public debt should however increase, both in absolute terms and in terms of % of GDP, to € 14.8 billion or 25.1% of GDP in 2019. These latest forecasts for public debt are therefore significantly higher than previous estimates (see graph alongside), although debt would remain well under the 30% of GDP ceiling set out in the Government's programme.

The central government will potentially need to issue bonds for an amount of at least €1 billion each year over the entire 2016-2019 period to finance deficits and to refinance maturing debt.

In addition, the LPFP 2015-2019 doesn't specify whether financial transactions not recorded in deficit figures are now included in the debt projections.

Public debt projections presented since LPFP 2014-2018



Source: CNFP Calculations, LPFP 2014-2018, PSC 2015-2019, LPFP 2015-2019.

### General conclusions

While it remains true that Luxembourg still enjoys sound public finances compared to other countries, the figures stemming from the draft multi-annual financial programming law for the period 2015-2019 point to a deterioration that merits further analysis.

As an independent institution, the CNFP's task is to carry out as complete an assessment as possible, based on the most recent information. Despite the limited resources at its disposal and given the incomplete or outdated nature of some of the macroeconomic data underpinning the budgetary documentation, the CNFP has used updated figures to estimate structural balances through an output gap methodology which, while being different from that used this year by the Government, is better adapted for this assessment. As results vary considerably depending on the methodology, the CNFP's choice must be viewed in the light of the fact that the Government itself relied on this very same methodology as recently as last year and that it provided no explanation of its decision to move away from it in the context of the current budgetary procedure.

Compared to the conclusions drawn last June in the CNFP's assessment of the 2015-2019 Stability Programme, this new assessment points indeed to less favourable results. Just five months ago, the CNFP stated that compliance with fiscal rules would be far from certain in the medium and long term. It now has to conclude that the medium-term objective may not be achieved as of 2015 and that achieving this objective will become even more unlikely from 2016 onwards such that the correction mechanism under the 12 July 2014 law may have been triggered. The CNFP has come to these conclusions on the basis of the same methodology for estimating structural balances as the one used by the Government last year, which allows to assess more correctly the changes in the figures over time. The fact remains however that the underlying conclusions continue to depend strongly on major methodological parameters.

In view of the complexity of the issues at hand and the volatility of forecasts within a small and open economy such as Luxembourg, the CNFP suggests forming a working group composed of experts from relevant institutions to reach a common agreement on the methodology to be used by all parties in determining structural balances at a national level. The debate on public finances, and consequently also on the potential activation of the correction mechanism, is indeed far too important to depend solely on the choice of the relevant calculation methodology.