SUMMARY

Introduction

This assessment has been prepared by the National Council of Public Finance (CNFP) under the regular annual budgetary procedure. The analysis is mainly based on the draft law for multi-year financial programming for the period 2016-2020, hereinafter "2016-2020 LPFP", as well as on the draft budget for 2017, hereinafter "2017 DB", and on the most recent macroeconomic and budgetary data available to CNFP.

The national budgetary governance framework

CNFP was established following a series of reforms carried out in recent years on the European level to add a national dimension to the budgetary and economic governance. In view of the role accorded to it by European texts as well as by the law dated 12 July 2014 on the coordination and governance of public finances, hereinafter the "12 July 2014 law", CNFP continues to insist that its right of access to data and the "comply or explain" principle be at long last clarified via a "MoU" agreement to be concluded with the Ministry of Finance. With the Ministry's commitment expressed in its 11 October 2016 letter, CNFP hopes an agreement of this type is finalised rapidly.

CNFP has also proposed a modification to the 12 July 2014 law in order to ensure stronger legal footing for the independent nature of CNFP and of its operations. As the Government is proposing a one-off adaptation of this law in article 51 of the 2017 DB, CNFP would like that its proposals also be reviewed and, if appropriate, incorporated into the 2017 DB by government amendment.

The multi-year financial programming is a major innovation of the 12 July 2014 law. With the addition of a "National Appendix" to the Stability and Growth Pact for 2016-2020 (2016-2020 SGP) last April, a first significant step has been taken in segmenting the multi-term fiscal plan and the annual budget. CNFP wishes to stress the importance of completing this phase by moving the LPFP project forward to the spring of each year. More generally, the scope and end purpose of the LPFP as part of the multi-year programming of public finances should be clarified. Including each article of budgetary estimates in the LPFP appendix could seem excessive for a multi-annual financial programming process that is intended to determine the major guidelines of budgetary policy.

Evaluation of the formal rules for the 2016-2020 LPFP

Among the tasks assigned it by the 12 July 2014 law is CNFP's monitoring of compliance with the formal rules applicable to the 2016-2020 LPFP. As the Government did not follow CNFP's recommendations with regard to the national budgetary procedure last year, CNFP can only reiterate the evaluation of these rules that was performed a year ago. CNFP therefore would particularly emphasise that the non-conforming elements such as the coexistence of superimposed budgetary frameworks, the absence of maximum amounts for central government expenditures, the calculations used for the computation of structural balances or the lack of information concerning no-policy change forecasts and the impact that the policies under review could have on the long-term sustainability of public finances, all show that multi-year programming of public finances in Luxembourg is still a work in progress.

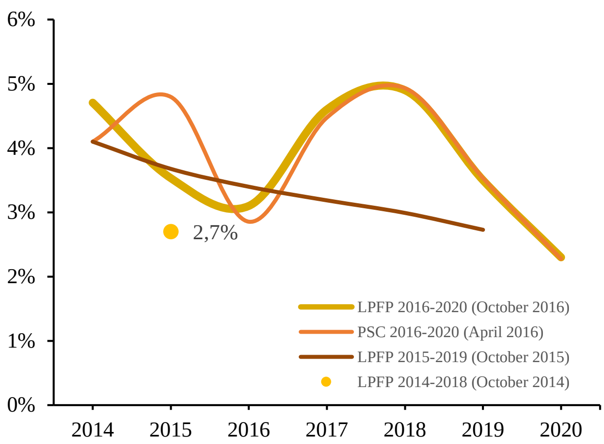
The bodies involved in the legislative process, i.e. Parliament and the Council of State, could effectively state their position regarding compliance or lack thereof with these formal rules that were entered into the 12 July 2014 law.

Macroeconomic forecasts

CNFP does not prepare its own macroeconomic forecasts, but rather analyses those prepared by the competent authorities under the 2016-2020 LPFP. CNFP confirms that these forecasts are based on a macroeconomic scenario for 2016 that is different from that of the period from 2017 to 2020. As such it regrets that the "interim" update for 2017 carried out by STATEC was not taken into full consideration. Indeed, for the 2017 to 2020 period, the economic scenario was established using growth rates retained under the 2016-2020 SGP. Furthermore, the detailed explanations do not cover the entire financial programming period. Finally, a more complete update of the forecasts for 2016 and 2017 will only be published towards the end of November. These overall considerations lead CNFP to insist on a better coordination of forecasting work, and they add further weight to its proposal for carrying out multi-annual financial programming in the spring of each year.

In its evaluation of the international economic context, CNFP starts by noting that exogenous assumptions were updated only for the years 2016 or 2017. The assumption chosen for growth in the euro zone is in line with that put forth by international organisations for 2016 and 2017. The scenario may be qualified as prudent for the medium term, as a gradual slowing of growth is forecasted at the end of the forecasting horizon of 2020. In as much as it is essential for a small, open economy to be able to assimilate the sensitiveness of the principal scenario with relation to accepted assumptions, a more detailed presentation of the main exogenous assumptions would be appropriate, especially for stock indices and oil prices.

Real GDP growth forecasts for Luxembourg.



Concerning the macroeconomic forecasts for Luxembourg, the real growth rate as a percentage of GDP in 2015 is +3.5%. This rate exceeds the assumption used in preparing the draft budget for 2015, which was +2.7% of GDP. It is nonetheless considerably less favourable than that estimated in the 2016-2020 SGP (+4.8% of GDP). The 2016-2020 LPFP gives no explanations for understanding the origins of this significant downward revision, which occurs within a mere five-month interval. Forecasts for 2016 are based on a slight decrease in growth to +3.1% of GDP. Under the assumption of a recovery in the financial markets as from 2017, the growth rate should rise to +4.6% in 2017, then to +4.9% in 2018, before plunging by over half at the end of the period, to +2.3% in 2020. With a projected average of +4.3%, changes in real growth for the years 2017 to 2019 used in the 2016-2020 LPFP are significantly higher than the average projected for the same period last autumn, which was +3.0%. CNFP believes that the forecasts for real growth for 2017 and 2018 could prove to be overly optimistic.

CNFP notes the Government's decision to use the harmonised method adopted by the European Commission, which STATEC used in simulations for the 2016-2020 LPFP (COM-LUX method) for determining potential GDP, and through it, the output gap, which are key concepts used in calculating the structural balance. However, CNFP wishes to draw the attention of budgetary authorities to the fact that the results obtained nationally through the COM-LUX method, and those obtained for Europe through the COM-COM method, produce divergent interpretations of the positioning of Luxembourg in the economic cycle. CNFP also confirms that the budgetary authorities updated neither potential GDP nor the output gap for the requirements of the 2016-2020 LPFP. In fact, the estimate of the output gap is still based on macroeconomic data in the 2016-2020 SGP. CNFP further maintains its reservations with regard to applying the Community method to Luxembourg's economy, in view of the specific nature of a small, open economy, and therefore continues to evaluate the structural balance using the two methods employed in the past, i.e. the HP filter and the COM-LUX method.

Public finances

In performance of the tasks given by the 12 July 2014 law and by the Treaty on Stability, Coordination and Governance (TSCG), CNFP is performing an overall evaluation of public finances on the basis of figures provided by the Government in the 2016-2020 LPFP, using the following as reference:

i) the **structural balance** of the general government and an analysis of its compliance with the Medium Term Objective (MTO).

(% of GDP)	2015	2016	2017	2018	2019	2020
	Ex-post evaluation	Intra-annual evaluation	Ex-ante evaluation			
Nominal balance of general government	+1.6%	+1.2%	+0.3%	+0.3%	+0.4%	+0.7%
STRUCTURAL BALANCE (*HP method*) -- according to CNFP calculations	**+2.0%**	**+1.7%**	**+0.2%**	**-0.4%**	**-0.4%**	**+0.3%**
STRUCTURAL BALANCE (*COM-LUX method*)- according to the 2016-2020 LPFP	**+2.5%**	**+2.3%**	**+0.8%**	**+0.2%**	**+0.2%**	**+0.9%**
Compliance with MTO: ***+0.5% of GDP for 2015 and 2016*** ***-+0.5% of GDP for 2017 to 2020***	**YES**	**YES**	**YES**	**YES**	**YES**	**YES**
Is there a significant deviation and should the correction mechanism be triggered?	**NO**	**NO**	**NO**	**NO**	**NO**	**NO**

i) **the Central government expenditure level** and an analysis of its compliance with the maximum amount for central government expenditures.

It is not possible to carry out the evaluation of the compliance with the central government expenditure level in as much as the legal provision pertaining to this is currently not in force. In particular, the 2016-2020 LPFP has omitted stating maximum amounts for central government expenditures.

in € millions	2015	2016	2017	2018	2019	2020
Maximum level determined by the 2016-2020 LPFP	**Fiscal rule currently not implemented**					
Central government expenditures according to the 2016-2020 LPFP	15,670	16,453	17,899*	18,447*	18,973*	18,988*
Central government expenditures according to the 2015-2019 LPFP	15,969	16,739	17,353	17,867	18,521	-
Central government expenditures according to the 2014-2018 LPFP	15,658	16,272	16,933	17,582	-	-

*These figures include taking into account a significant part, some 84%, of municipal business tax at the municipality level, which up until 2016 was allocated directly to municipalities and a large part of which will pass through the nation's budget beginning in 2017.

i) **The growth rate of general government expenditure** and an analysis of its compliance with the expenditure benchmark of the TSCG.

(% of GDP)	2015	2016	2017	2018	2019	2020
Annual change in adjusted public expenditures ***(in real terms, as a % with relation to the previous year)***	+0.1%	+1.9%	+5.5%	+2.7%	+1.8%	+2.1%
Applicable reference rate ***(in real terms, as a % with relation to the previous year)***	+2.9%	+3.1%	+3.2%	+3.3%	+3.4%	+3.5%
Difference (in % of GDP) over one year	1.1%	0.1%	-0.9%	0.2%	0.6%	0.5%
Compliance with expenditure benchmark	**YES**	**YES**	**RISK OF NON-COMPLIANCE**	**YES**	**YES**	**YES**
Procedural consequences under the TSCG	**NO**	**NO**	**NO**	**NO**	**NO**	**NO**

The Medium Term budgetary objective (MTO)

CNFP is evaluating the national budgetary rule pertaining to the structural balance and its respect of the MTO, with relation to a level of +0.5% of GDP for the years 2015 and 2016. Beginning in 2017, an ex-ante evaluation will be presented by reference to the new MTO of - 0.5% of GDP, as determined in the 2016-2020 LPFP.

The MTO of -0.5% of GDP is the result of a substantial upward revision of demographic projections (from 730,000 to 1.1 million new inhabitants in 2060), and of the subsequent concomitant downward revision for the ratio of expenditures due to the ageing of the population expressed as a percentage of GDP. This MTO is also based on a debt target of 60% of GDP, whereas the Government has set a more ambitious objective of 30% of GDP in its government programme.

CNFP regrets that the Government uses only the minimum required by European provisions, whereas the setting of a more ambitious MTO could have been considered in order to provide a degree of latitude in confronting the more complex and vaster challenges that will appear over the long term for Luxembourg.

Ex-post evaluation of budgetary rules for 2015

Luxembourg general government complied with the budgetary rule in the 12 July 2014 law concerning the structural balance adhering to the MTO of +0.5% of GDP. This is true regardless of the methodology used to compute the output gap. Based on this observation, the correction mechanism should not be triggered.

CNFP notes that as no ceiling for central government expenditures has been formally set in the LPFP, compliance with the relevant rule cannot currently be verified.

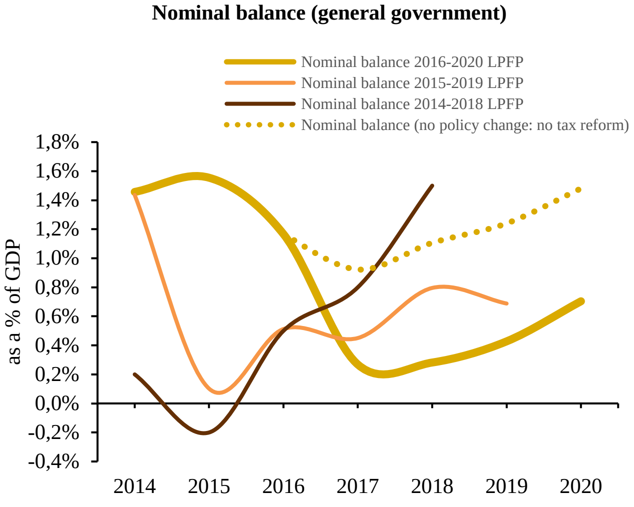
Intra-annual evaluation of budgetary rules for 2016

CNFP confirms that the budgetary rule regarding the structural balance should be complied with, regardless of the methodology used to compute the output gap, and the correction mechanism would not have to be triggered. This will be confirmed at the presentation of the next EDP notification on 1 April 2017.

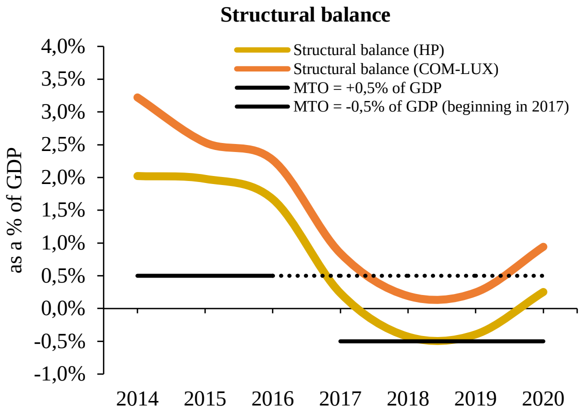
Ex-ante evaluation of budgetary rules for 2017-2020

According to 2016-2020 LPFP figures, the nominal balance of the general government will be +0.3% of GDP in 2017, compared to +1.2% of GDP in 2016. In the medium term, this balance should continue to show a surplus and progressively improve towards a balance of +0.7 of GDP at the end of the period.

This multi-year path is clearly less positive compared to those seen in the past, despite the supposed good health of the economy, featuring real GDP average growth of +3.8% per year from 2017 to 2020, and despite the markedly improved baseline situation in 2015 and 2016. This downward adjustment is primarily explained by taking into account the tax reform, which is non-neutral from a budgetary perspective. To this may be added the abolition of the temporary tax to balance the state budget (hereinafter the TTBSB) of 0.5% at the end of the current year.



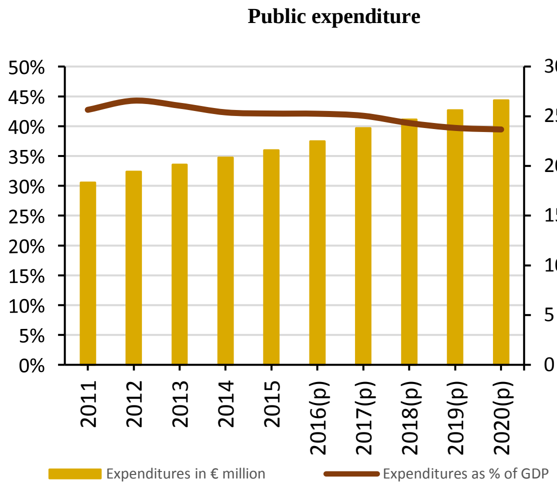
As experience in recent years has shown that initial budgetary estimates often subsequently undergo substantial revision, CNFP cannot exclude that the figures in the 2016-2020 LPFP may be once again changed over time. This will remain true for as long as potential systematic biases are not identified and corrected. CNFP estimates that the risk of upward or downward correction of the nominal balances will remain significant over the 2017 to 2020 period, because the basic assumptions are surrounded by much uncertainty and numerous risks were excluded in preparing budgetary forecasts.

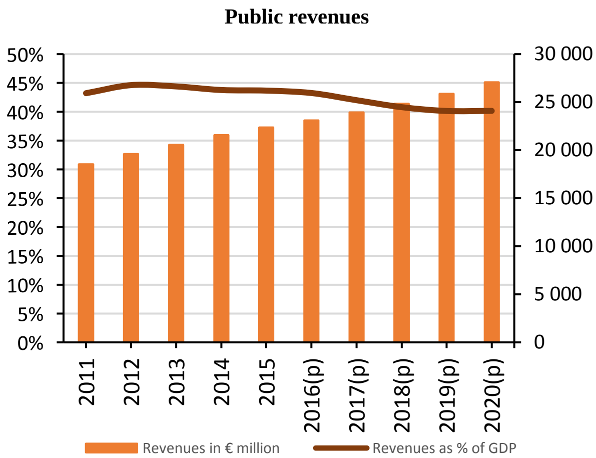


The structural balance for 2017 is estimated to be +0.2% of GDP according to the HP method and +0.8% of GDP according to the COM-LUX method. Compared with 2016, this would represent a substantial new deterioration of the underlying situation of public finances. The structural balance would worsen further in 2018 and 2019, hovering around -0.4% of GDP using the HP method and +0.2% of GDP using the COM-LUX method, before returning by 2020 to levels comparable to those forecasted for 2017.

Luxembourg general government are expected to comply with the budgetary rule in the 12 July 2014 law concerning the structural balance adhering to the MTO of -0.5% of GDP during the 2017-2020 period. Nonetheless, CNFP would suggest that the analysis shows that lowering the MTO to -0.5% of GDP, based on an assumption of demographics of 1.1 million in 2060 and excluding the objective of the government programme aimed at stabilising public debt by keeping it below 30% of GDP at all times, is decisive in arriving at this favourable result.

Public expenditures are gaining momentum, reaching a nominal growth rate of 5.9% in 2017. Compared to 2016, this is a renewed acceleration in expenditures growth, despite the supposed impact of the consolidation measures of the *Zukunftspak*. The Government is planning to later increase general government expenditures more slowly, with an annual level of +4.3% from 2017 to 2020 compared to an historic average of +6.2% over the period 2001-2015. However, achieving these forecasts is by no means automatic. The multi-year trajectory of expenditures in the 2016-2020 LPFP assumes continued and proactive action by the Government.

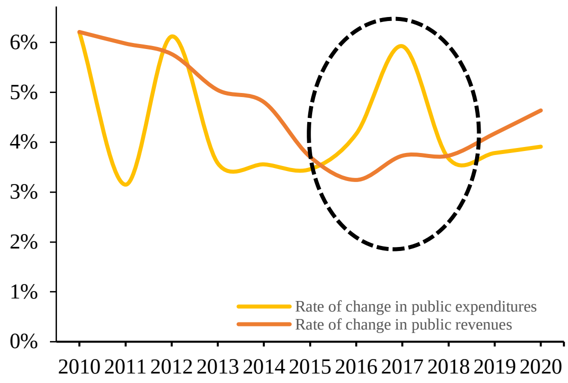




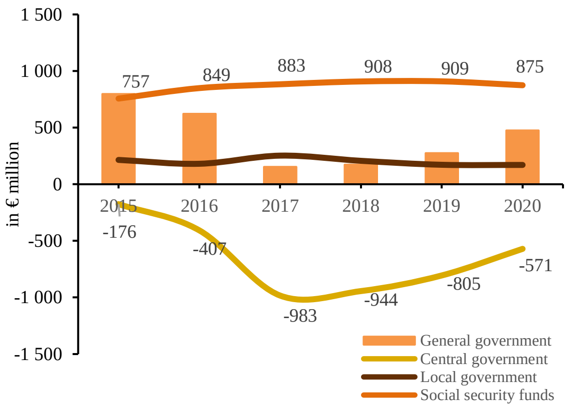
Public revenues would only advance by +3.7% in 2017, due to the impact of the tax reform, the abolition of the TTBSB and new revenue loss in the domain of VAT on e-commerce. For the period 2017-2020, it has been estimated that public revenues will grow significantly more slowly than in the past, with average growth of +4.1%, compared to an historic average of +5.5% between 2001 and 2015. With relation to GDP, public revenues will likely be significantly less in the medium term, moving from 43.7% in 2015 to 40.2% at the end of the period.

Estimated growth in public revenues is weaker than estimated growth of public expenditures in 2017 ("scissors effect"). The return of a reversed situation, as planned for by the Government beginning in 2018, assumes that no additional measure that tends to increase expenditures would be introduced during the period under review (apart from those already incorporated into the figures) or that any new measure would be offset by corresponding savings. Furthermore, changes in revenues are expected to gain momentum at the end of the period, simultaneous to a subsiding of the macroeconomic scenario.

Change in growth rate of public expenditures and revenues



Changes in the budget balance by sub-sector



The positive nominal balance for the general government continues to mask a very diverse situation at the level of the three sub sectors.

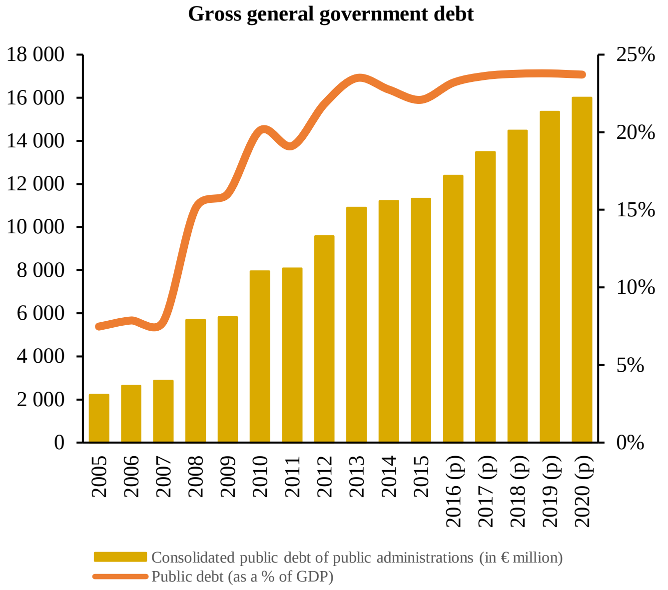
The central government will experience a considerably aggravated deficit beginning in 2017. CNFP observes that the tax reform is introduced during a period in which revenues continue to feel the effects of underlying structural trends, especially the gradual reduction of income from VAT on e-commerce and the abolition of the TTBSB. Furthermore, the reductions are being introduced at a time where the *Zukunftspak* was still expecting an increase in revenue of around €378 million. The tax reform substantially reduces available budgetary leeway to react to an economic shock or other unforeseen event. Local government in aggregate are expected to experience a slightly surplus balance throughout the entire period under review. Relevant forecasts are essentially based on an extrapolation of trends observed in the past. Social security funds will continue to exhibit major surpluses. This favourable financial situation is based on trends which risk to get reversed and therefore long-term sustainability of public finances is far from being certain.

Lastly, it should be noted that CNFP is still not in the position to evaluate compliance with the maximum amount of central government expenditures as long as such amounts are not set out in the LPFP, as stipulated by the 12 July 2014 law. It should however be noted that the central government expenditure amounts for 2017-2019 in the 2016-2020 LPFP substantially exceed the amounts in the 2015-2019 LPFP for the same years. If maximum amounts had been determined by the 2015-2019 LPFP, the budgetary rule would not have been complied with, or at least, the Government would have had to explain the upward revision of expenditures of the central government. As shown in the table below, the upward revision of expenditures of the central government can be explained by taking into account a significant part, some 84%, of municipal business tax at the municipality level, which up until 2016 was allocated directly to municipalities and a large part of which will pass through the state budget beginning of 2017.

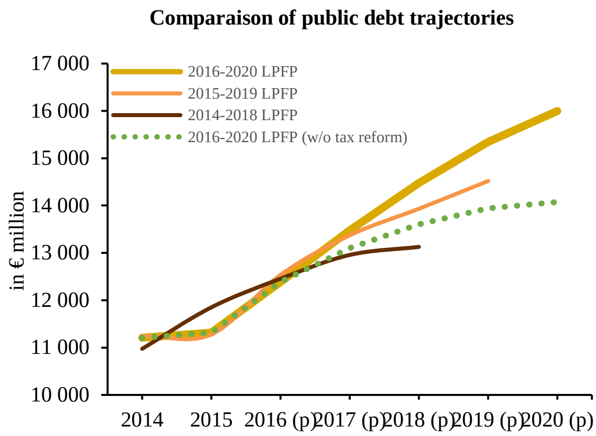
In € million	2017	2018	2019	2020
MAXIMUM AMOUNT OF CENTRAL GOVERNMENT EXPENDITURES				
Maximum amount determined by 2016-2020 LPFP	Budgetary rule not currently in force			
Central government expenditures according to 2016-2020 LPFP	17 899	18 447	18 973	18 988
--- corrected to include a large part of the municipal corporate tax in municipal funds	17 295 (-604)	17 820 (-627)	18 324 (-649)	18 315 (-673)
Central government expenditures according to 2015-2019 LPFP	17 353	17 867	18 521	-
Central government expenditures according to 2014-2018 LPFP	16 933	17 582	-	-

Public debt

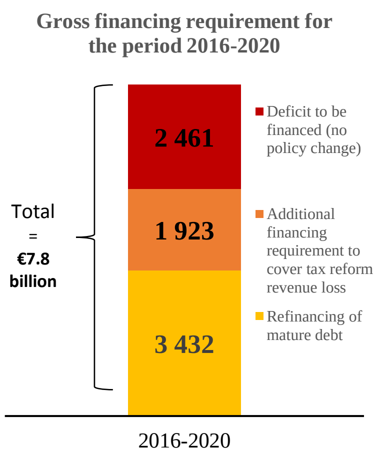
In 2015, the gross level of public debt amounted to €11 314 million, or 22.1% of GDP. The general government therefore kept spending beneath the 30% of GDP ceiling set by the Government in its government programme. The general government should also remain under the ceiling in 2016. Beginning in 2017, the public debt will follow an upward trajectory up till 2020. While increases in the public debt expressed as a percentage of GDP remain relatively low – from 23.2% in 2016 to 23.7% in 2020 – the net increase in indebtedness in absolute terms amounts to some €3.6 billion between 2017 and 2020, which corresponds to a rate of increase of 29%. The small increase in the ratio of public debt with respect to GDP is due to the fact that GDP is expected to increase by 26% over the same period.



Multi-year projections for public debt have been revised considerably upward compared to previous estimates. If no tax reform were to be implemented as from 1 January 2017, public debt would likely follow a slightly downward trajectory compared to GDP, at 20.9% of GDP in 2020 instead of the 23.7% figured in the 2016-2020 LPFP, and the absolute net increase in public debt would have been reduced by half.



CNFP further confirms that direct and indirect expenditures by the central government are not responsible for the deterioration of the central government's deficit, nor therefore of public debt, neither in 2017 nor over the medium term. Indeed, by keeping expenditures level throughout 2016 at € 2 259 million, adjusted forecasts for 2020 would result in public debt of €15 902 million and a debt-to-GDP ratio of 23.6%. This represents only a reduction of 0.1% compared to the trajectory of public debt as a percentage of GDP presented in the 2016-2020 LPFP.



As the central government remains in deficit over the entire period under review, any repayment of loans and bonds falling due will have to be financed entirely through the issuance of new loans or bonds. The gross financing requirement for the 2016-2020 period therefore totals €7 816 million.

Thanks to Luxemburg's AAA rating and due to relatively low interest rates projected over the forecast horizon, a net increase of public debt will not incur a significant increase in interest charges.