

EXECUTIVE SUMMARY

Introduction

The law of 12 July 2014 on the coordination and governance of public finances transposes a series of measures into Luxembourg law that were decided on in the wake of the economic and financial crisis and that relate to the budgetary and economic architecture within the European Union. A new, independent fiscal council has been established under the name of the “National Council for Public Finances” (*Conseil national des finances publiques* - CNFP), whose task will be to monitor newly adopted fiscal rules and to assess economic and budgetary forecasts.

The members of the CNFP have been appointed by the Grand-Duke on 7 November 2014 and, beginning from early 2015, they have been supported by a secretary general.

The CNFP’s work programme for 2015 essentially includes two assessments: the first relates to the Stability and Growth Programme (SGP) for 2015-2019 as submitted by the Government to the European Commission on 30 April and which is the subject of this report; the second will be carried out in the autumn on the basis of the 2016 draft budget and the draft law on multi-annual financial programming. The CNFP will carry out more in-depth assessments of economic and budgetary forecasts as well as more specific audits once the necessary resources and procedures are in place.

Most of the challenges this newly established institution confronts are the result of deficiencies in the aforementioned 12 July 2014 law. These include notably the lack of an adequate legal basis for accessing information as well as fiscal and economic data, given that is an essential pre-requisite for achieving the Council's mandate. Another anomaly is that no explicit procedure has been set regarding the weight and scope of CNFP assessments, even though common principles laid out by the European Commission state that national budgetary authorities should be required to comply to the independent opinions of monitoring organisations such as the CNFP or would have to explain themselves if they digress from them (the so-called "*comply-or-explain*" principle). The CNFP expects the Government to respond to the conclusions and recommendations emerging from this assessment, even in the absence of a formal mechanism.

The CNFP’s work is carried out in accordance with best practices customarily seen in the international arena. To this end, it is participating in various international networks active in the fiscal sphere, primarily at the level of the EU and the OECD. The CNFP will use these experiences as a basis in their consultations with the Government and Parliament in order to overcome persisting operational challenges.

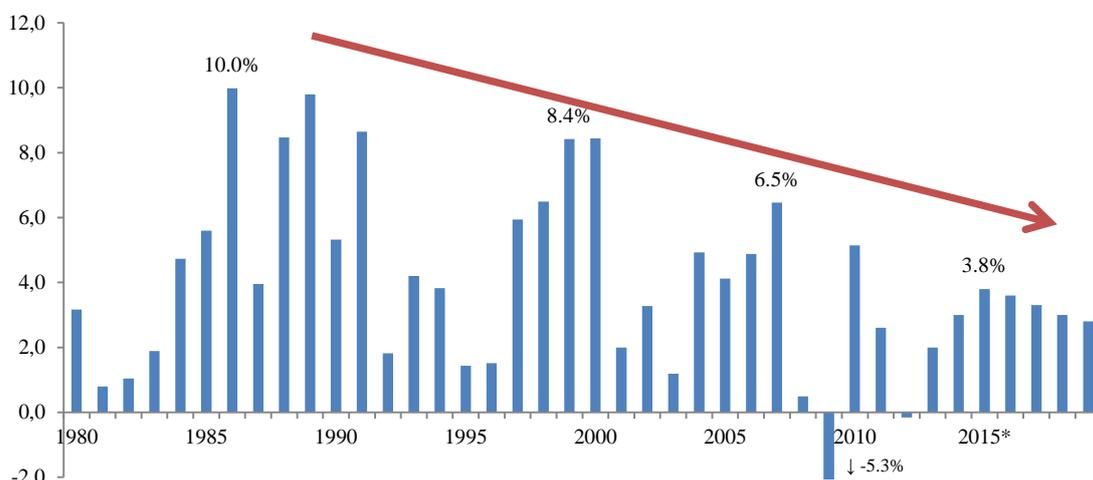
The economic backdrop

The international economic situation has gradually improved since 2013, however recovery in Europe remains weaker than elsewhere and was primarily triggered by external factors. The implementation of structural reforms supported by healthy public finances will be essential in ensuring enduring economic recovery. The 2015-2019 SGP is based on the assumption of 1.4% annual growth in the euro zone, with a peak in 2016 of 2.0%. This economic growth trajectory appears plausible in view of forecasts put forth by international organisations, but it is based on the assumption that the sovereign debt crisis in the euro zone is under control.

Luxembourg has also returned to more sustained growth since 2013. Under the 2015-2019 SGP, growth forecasts for 2015 have been significantly revised, to a rate of 3.8% in real terms. Subsequently, growth is expected to slow, lowering gradually toward a potential growth rate estimated by STATEC at 2.5%. Estimates

by international organisations remain more cautious. Furthermore, Luxembourg no longer appears to be able to return to historic growth levels. According to the medium-term forecasts sketched out in the 2015-2019 SGP, Luxembourg will very likely attain a high point in the economic cycle in 2015. Mirroring many other developed countries, this peak in growth is easily below levels observed historically, as is clearly indicated in the graph below.

Real growth in Luxembourg since 1980.



Source: STATEC, IMF, SGP 2015-2019. * = forecast.

Despite more sustained growth, the unemployment rate will likely continue to increase over the medium term, rising from 7.0 % in 2015 to 7.7% in 2019. Concerning inflation forecasts and the triggering of the automatic wage indexing system, figures contained in the 2015-2019 SGP seem to have been outdated already at the time of the publication of the SGP¹. The inflation rate is now expected to be 0.5% for 2015 and 1.5% in 2016 and the next wage indexation adjustment could be triggered in the first quarter of 2016. The CNFP is unable to assess the impact on public finances resulting from this upwards revision of inflation forecasts and would have wished that the most recent inflation information was considered in the SGP and that the impact on public finances be clarified.

With regard to economic forecasts, the CNFP asks the public authorities to:

- Systematically publish its key assumptions that are taken into account for budgetary programming;
- Make explicit the revisions from one forecast to another and the impact thereof on public finances;
- Ensure that future multiannual budgetary programming is, as with the SGP, based on updated and comprehensive macroeconomic scenarios.

¹ The 2015-2019 SGP is using an inflation forecast of 0.3% in 2015 and 1.1% in 2016. Under this scenario, the next wage index adjustment would not be triggered until July 2016.

Public finances

The **2014** fiscal year fared better than expected at the level of the general government as a whole, which includes the sub-sectors of central government, local government and Social security. However, the budgetary balance still remained below the level of 2013. In 2014, Luxembourg should nonetheless respect the fiscal rule based on the structural balance, which at +1.8% of GDP is significantly above the medium term objective (MTO) of +0.5% of GDP. Based on this observation, the CNFP believes that the correction mechanism will not be triggered. The CNFP underlines however the lack of continuity with regard to how the structural balance is estimated. It asks relevant authorities to choose a single approach and apply it consistently.

Positive figures at the level of the general government however conceal a much more nuanced situation in the sub-sectors, with the nominal balance of the central government still in deficit in 2014 and Social Security in surplus. A central government in deficit since 2002, except in 2007 and foreseeably through to 2019, will lead to a continued increase in Luxembourg's public debt. This evolution should be corrected in the medium term.

The implementation of the fiscal consolidation plan worth €230 million in 2014 at the level of central government unfortunately cannot be verified in detail, due to a lack of explanations and information in the 2015-2019 SGP. Consequently, the CNFP requests that the Government offer a more transparent *ex post* evaluation of the consolidation measures agreed upon under the 2014 budget.

Despite the negative impact from a new VAT scheme for electronic services, the **2015** fiscal year is expected to give rise to a slight nominal surplus of 0.1% of GDP. With a structural balance evaluated at +0.7% of GDP, Luxembourg should continue to respect its MTO. Under these conditions, the CNFP believes that the correction mechanism will continue not be triggered.

If the Government had used the same calculation method as in the context of the multiannual financial programming law for the 2014-2018 period (MFPL 2014-2018), the level of the structural balance would be estimated at +0.5% of GDP, i.e. exactly equal to the MTO. While welcoming the additional transparency in relation to the computation of structural balance, the CNFP reiterates its recommendation to adopt a single approach for the purposes of computing the structural balance for Luxembourg.

Despite the consolidation measures called for in the *Zukunftspak*, public expenditure should continue to increase in 2015 at a rate above the reference rate of the “expenditure benchmark” stated in the Stability and Growth Pact, with the deviation considered to be “significant”. The Government states that as long as the MTO is adhered to, no procedural consequences are to be expected. In view of the complexity of the issue and the underlying calculations, the CNFP will review this EU expenditure rule in an upcoming evaluation.

With regard to the second expenditure rule – a national rule this time – i.e. the “*maximum amount of expenditure of central government*”, CNFP calculations lead it to conclude that the rule will be adhered to in 2015. However, it cannot provide a definitive opinion on whether or not the national expenditure rule under the law dated 12 July 2014 is respected, given that the MFPL 2014-2018 has failed to specify such maximum annual amount. The CNFP requests that the Government and Parliament clarify the content of this rule and determine the maximum amounts when updating the multiannual financial programming in the autumn of 2015.

In the **medium term**, Luxembourg risks no longer respecting the fiscal rule concerning the structural balance by straying from the MTO. In application of the calculation method used in the 2015-2019 SGP, this risk may probably materialise by 2019, whereas under the MFPL 2014-2018 calculation method it could appear already by 2017. On the basis of these observations, which will be updated and further elaborated in the autumn of 2015, the correction mechanism should nonetheless not be triggered in as much as the deviation is not deemed “significant” within the meaning of the 12 July 2014 law.

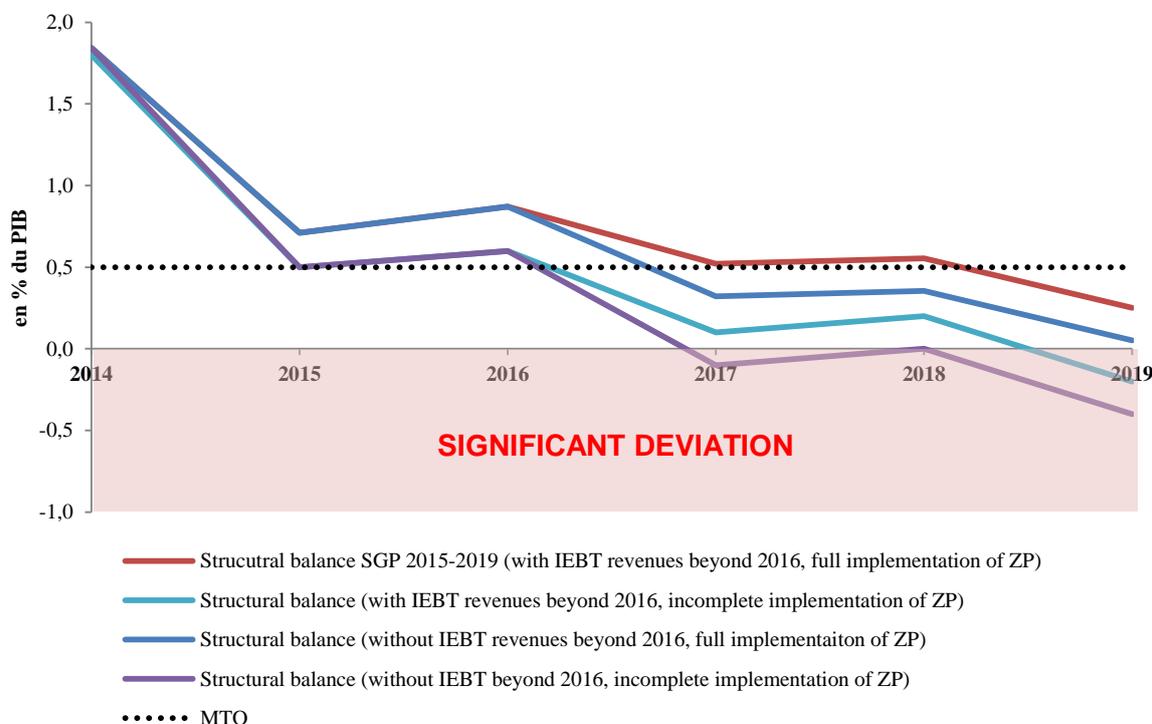
It should be noted that the results and observations stated above are based on a certain number of assumptions that may not necessarily be realised in the medium-term :

- Regarding public revenues, the 2015-2019 SGP is based on the assumption of "tax stability" over the entire period, which implies among other things (i) the absence of an unfavourable impact from changes in the international tax environment, (ii) the budgetary neutrality of the tax reform announced for 2017 and (iii) maintaining of revenues from 0,5% temporary tax beyond 2016.
- On the expenditure side, the 2015-2019 SGP is based on the assumption of full implementation of the *Zukunftspak* consolidation programme. Yet, according to figures provided by the Government, expenditure cuts worth € 288 million by 2019, i.e. 67% of a total target of € 427 million, have not been implemented so far and thus still need to be put into practice to achieve the budgetary targets.

Furthermore, it is unclear from the 2015-2019 SGP whether the budgetary figures take into account the impact of the Government's newly announced measures. This pertains for instance to the "Gäichel" agreement, the reforms under way regarding parental leave or the rent subsidisation programme. The CNFP requests that, whenever updates of the medium term fiscal trajectory are provided, new measures are all included and their impact clearly outlined, as they may have to be offset by other measures to ensure that the trajectory sketched out in the 2014-2019 MFPL is adhered to.

If one or several of the conditions described above are not to be achieved, for example through a partial implementation only of the *Zukunftspak* consolidation programme, the deviation from the MTO could become sufficiently wide to be deemed "significant", which could result in triggering the corrective mechanism under the 12 July 2014 law. If the general government simultaneously failed to adhere to the expenditure rule in the Stability and Growth Pact, there could also be procedural consequences at the European level in response to this.

Medium-term forecasts of the structural balance, under different assumptions



Source: 2015-2019 SGP, CNFP calculations. Method for determining output gap: Modux (STATEC).
 IEBT = Impôt d'équilibrage budgétaire temporaire (0.5% temporary tax), ZP = *Zukunftspak* (« future package » - consolidation plan).

In conclusion, the CNFP sees that in the shorter term, i.e. 2015 and 2016, the structural balance budget rule should be respected despite the continued rise in public expenditure. However, toward the end of the period under review, the structural balance will likely worsen progressively, although the deviation with regard to the MTO will not necessarily become "significant" in the meaning of the 12 July 2014 law. However, any drift with regard to either revenues or expenditures, could give rise to a potentially "significant" deviation, thus triggering the correction mechanism. Therefore, the CNFP recommends that the competent authorities ensure that the budget is implemented in line with the multiannual plan as currently set out in the MFPL 2014-2018.

Public debt

Over the review period, the level of gross public debt is projected to increase. However, the debt ratio should fluctuate around 24% of GDP, well below the Government's objective of keeping it under 30% of GDP throughout the entire legislative period of 2013-2018. Luxembourg's debt situation will therefore continue to compare favourably within the international and European context throughout this period.

With regard to multi-annual debt projections, the CNFP asks the Government to take into account all relevant financial transactions increasing the debt level over the medium term. This pertains especially to the planned increase in the central bank's capital base, the annual allocations to the newly created sovereign wealth fund and the recognition of CFL (the national railway company) liabilities. It would be equally important to take into account the debt issuance strategy in light of the upcoming gross financing needs of the treasury.

Long-term sustainability of public finances

The principal objective of fiscal rules should be to contribute to the long-term sustainability of public finances. As a result, the MTO is calculated explicitly by taking into account expenditure dynamics related to the ageing of the population in the long term. It is for this reason that the level of MTO – which is currently set at +0.5% of GDP in structural terms – will be re-evaluated in 2016 as a follow-on to the publication of the EU *Ageing Report* in 2015.

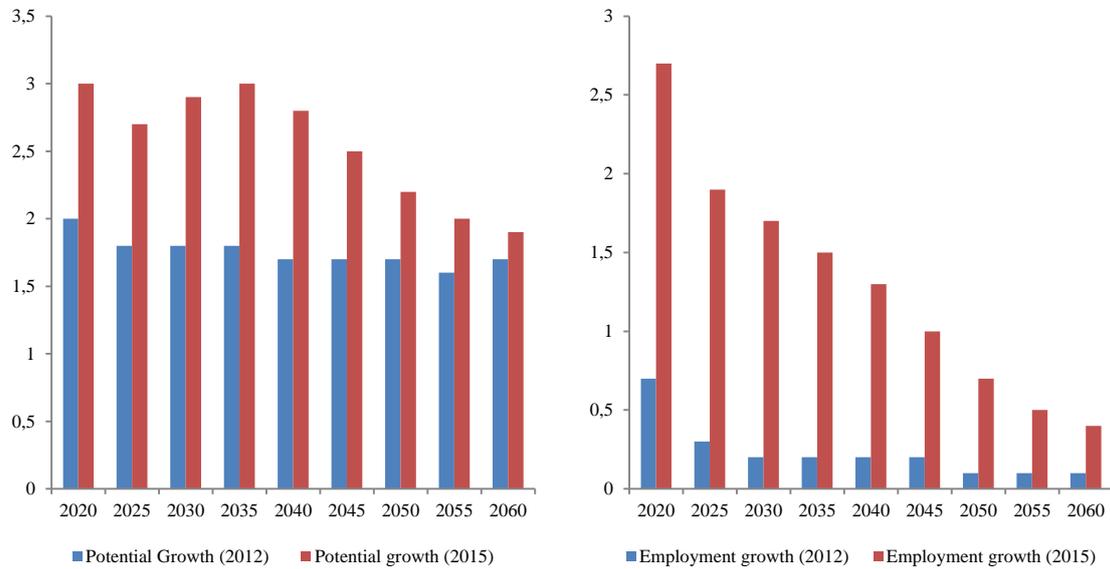
According to this recently published report, expenditure related to the ageing of the population will likely increase significantly in the future. These expenditures should increase from 19.5% of GDP in 2013 to 25.8% by 2060. This new estimate is still largely more favourable than projections made earlier. The less rapid increases in expenditure for ageing, as contrasted with the previous forecasts dating from 2012, seem to be due to a resolutely more optimistic macroeconomic scenario that uses a growth figure of around 3% per year on average between 2020 and 2040. This pace of growth would slacken progressively beginning in 2040, arriving at 1.9% by 2060. This evolution implies that Luxembourg would be capable of sustainably generating higher growth than the European average. The long-term macroeconomic scenario is also based on a very strong increase in jobs, such that the significant increase in contributions from a much larger pool of employed persons will help to partially counteract the long-term financing issues faced by social insurance institutions for pensions, illness and dependency.

The new set forecasts for ageing-related expenditure is also based on new demographic projections that assume a population of 1,1 million residents by 2060, i.e. a near doubling of the number from its current level. The symbolic threshold of one million inhabitants would be surpassed in 2046, although according to the previous set of forecasts, prepared three years ago, a total of only 730,000 inhabitants was assumed by 2060.

The CNFP takes note of this new demographic projection – which it views with caution – and asks that the Government present more prudent, alternative scenarios. In evaluating the long-term sustainability of public finances, it will be equally important to take into account the broader challenges that an unsustainable

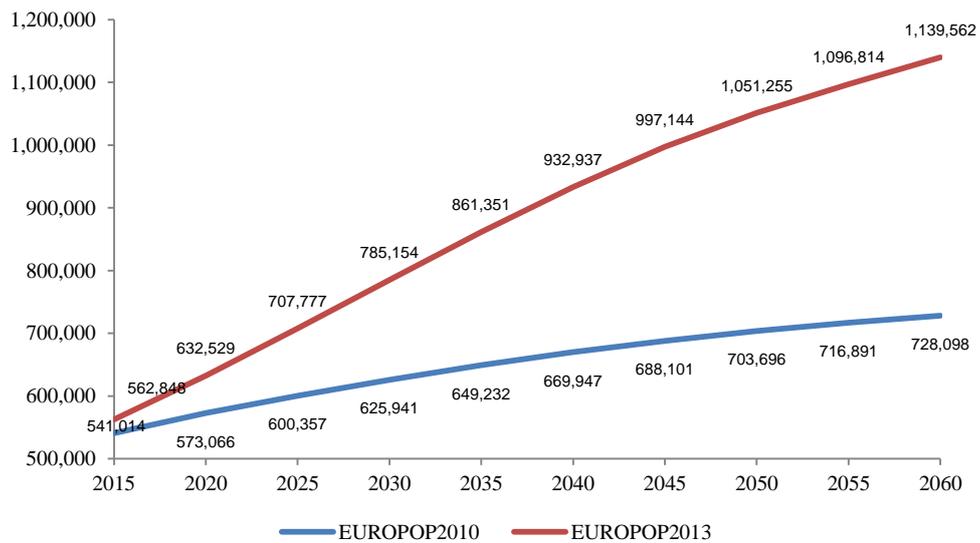
development of the Luxembourg economy would surely give rise to. The cost of investments for housing, infrastructure and utilities will engender an additional challenge to overcome among numerous others.

Long-term macroeconomic forecasts: Growth and employment (annual changes)
Comparison of forecasts in 2012 and 2015



Source: 2012 & 2015 Ageing Report: Underlying Assumptions and Projection Methodologies (ECFIN, EPC).

Major upward revision of long-term demographic projections.
Comparison of forecasts in 2010 and 2013



Source: Eurostat.

In its future assessments, the CNFP will examine the issue of long-term sustainability of public finances as well as related risks and opportunities at greater length with a view towards inter-generational equity. In 2016, CNFP will likely focus on the MTO revision procedure as well as the evaluation of assumptions in the context of the mid-term review of the pension insurance reform enacted in 2013.

General conclusions

Compared to other countries, Luxembourg continues to present a rather favourable fiscal position. Although fiscal rules will likely be respected in the short term, the sustained rate of increase in public expenditures and the progressive worsening of budgetary balance are posing a threat to continued adherence to these rules in the medium and long term. In addition, the automatic correction mechanism may potentially have to be activated prior to the end of the period under review. In the longer term, costs resulting from the ageing of the population should cause the public authorities to adopt an inter-generational approach that will allow them to anticipate and remedy a situation of potential imbalances in public finances.