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## **Commission's assessment of the 2004 updated Stability Programme of Luxembourg<sup>1</sup>**

### **Background**

Council Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies<sup>2</sup> stipulates that participating Member States, that is, those which have adopted the single currency, had to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their stability programmes, which may also be examined by the Council in accordance with these same procedures.

Luxembourg's first stability programme covering the period 1998-2002, was submitted on 16 February 1999 and assessed by the Council on 15 March 1999<sup>3</sup>. Updates have been presented every subsequent year, the most recent having been submitted on 30 November 2004. The Commission services have carried out a technical evaluation of this update, taking into account their own autumn 2004 economic forecasts, and having regard to the code of conduct<sup>4</sup>, the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances, the recommendations in the broad economic policy guidelines for the period 2003-2005 and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the coordination of budgetary policies and endorsed by the Council<sup>5</sup>. Their evaluation is as follows.

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<sup>1</sup> Excerpt from the explanatory memorandum of the Commission recommendation for a Council opinion adopted by the Commission on 11.1.2005.

<sup>2</sup> OJ L209, 2.8.1997. All the documents referred to in this text can be found at the following website [http://europa.eu.int/comm/economy\\_finance/about/activities/sgp/main\\_en.htm](http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm)

<sup>3</sup> OJ C124, 5.5.1999.

<sup>4</sup> Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

<sup>5</sup> COM (2002) 668 final, 27.11.2002.

## **Commission's assessment**

The 2004 update of Luxembourg's stability programme, covering the period 2004-2007, was submitted on 30 November 2004 after its approval by the government on November 26. It partly complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes" because some compulsory data are missing.

The macroeconomic scenario presented in the update projects real GDP growth to slow from 4.4% in 2004 to 3.8% in 2005 and 3.3% in 2006 before reaccelerating to 4.3% in 2007. This scenario is plausible: for the period 2004-2006, it is reasonably close to the autumn 2004 forecasts by the Commission services. For the whole period, the real growth rates projected by the programme are consistent with the Commission services' estimates of potential growth.

The general government balance having gone from a 0.8% -of-GDP surplus in 2003 to an estimated 1.4%-of-GDP deficit in 2004, the programme aims to reduce the deficit to 1.0% in 2005 and to stabilise it at about the same level in 2006 and 2007. It thus does not envisage a continuation of the reduction in the deficit after 2005 but positively contrasts with the 2003 update, which was based on a significantly less optimistic growth outlook than that of 2004 and anticipated that the general government deficit would widen from 0.6% of GDP in 2003 to around 2% in the remainder of the programme period.

On the basis of calculations by the Commission services using the commonly agreed methodology, the cyclically-adjusted balance in the 2004 update is expected to post rising surpluses (from a deficit of less than 1% of GDP in 2003) for the rest of the period, reaching 2% of GDP in 2007. However, this dramatic improvement in the cyclically-adjusted balance seems to stem mostly from the unusual margin of uncertainty surrounding estimates of potential growth for Luxembourg rather than to reflect a genuine structural adjustment effort.

Developments in the general government balance as presented in the programme are significantly better than those projected in the Commission's autumn 2004 forecasts. This is because the latter were finalised before the 2005 budget was released and, consequently were based on a "no policy change" assumption and on the spending and revenues trends observed in previous years.

The risks to the budgetary targets of the programme are balanced. On the one hand, revenue estimates in Luxembourg are known to be cautious. On the other hand, however, the programme envisages a slowdown in expenditure growth, which has been very rapid in recent years, but without detailing the measures that should help achieve this. On balance, therefore, the objectives presented in the programme are plausible but hardly ambitious: they should not be difficult to achieve, provided that the authorities stick to their announced intention to rein in the rise in expenditure. In view of this risk assessment, the budgetary stance of the programme as expressed by the evolution of the cyclically-adjusted balance is sufficient to achieve the medium-term objective in the Stability and Growth Pact of a budgetary position close to balance within the programme period (from 2005 onwards). But in nominal terms, the programme does not envisage a continuation of the reduction in the headline deficit after 2005 and contains no commitment to move closer, at least in nominal terms, to a balanced position before the end of the period covered, since the headline deficit remains at around 1% of GDP.

However, from 2005 onwards, the budgetary stance in the programme seems to provide a sufficient safety margin within which normal cyclical fluctuations can occur without breaching the 3%-of-GDP deficit threshold.

The update estimates that the general government debt ratio will decrease from 5.3% of GDP in 2003 to 5.0% in 2004. About half of this debt comes from central government and the other half from local authorities, the debt of the social security institutions being negligible. The debt ratio is forecast to decline somewhat over the time horizon covered by the update, from 5.0% of GDP in 2004 to 4.5% of GDP in 2007. The total net asset position is even more favourable due to the substantial financial assets, estimated at about 50% of GDP, accumulated over past years with fiscal surpluses.

The programme refers to the measures recently taken in order to rein in the rise in health expenditure, especially the rise in contributions decided in November 2004. It announces additional measures aiming at moderating health expenditure which were incorporated into a bill passed by Parliament in December 2004. The programme also mentions the burden on the pension system that will arise in the coming years from the massive growth in employment in Luxembourg in the last two decades which increasingly comprises non-resident workers. While it does not yet include specific measures to tackle this problem, it announces that this issue will be debated in the course of 2005.

Due to its very low level of government debt and the considerable reserves that have been accumulated for more than two decades by the social security sector, Luxembourg appears to be in a favourable position with regard to the long-term sustainability of public finances, despite important projected budgetary costs of an ageing population. However, according to a tentative assessment made by the Commission services, on current expenditure projections, the budgetary strategy outlined in the programme would result in a “tax gap” of close to 2% of GDP which would need to be closed in order to fully ensure sustainability. The country has experienced about 20 years of exceptionally strong employment growth, which will progressively translate into a commensurate increase in the number of pensioners. The reserves could significantly contribute to easing the budgetary pressures of this situation and this policy of building up reserves should be continued, along with the adoption of measures aiming at raising the currently low employment rate of residents, especially older ones.

Comparison of key macroeconomic and budgetary projections

		<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Real GDP (% change)	<b>SP Nov 2004</b>	<b>4.4</b>	<b>3.8</b>	<b>3.3</b>	<b>4.3</b>
	COM	4.0	3.5	3.6	n.a.
	<i>SP Nov 2003</i>	2.0	3.0	3.8	<i>n.a.</i>
HICP inflation (%)	<b>SP Nov 2004</b>	<b>2.6</b>	<b>3.2</b>	<b>1.5</b>	<b>1.7</b>
	COM	3.0	2.3	1.6	n.a.
	<i>SP Nov 2003</i>	1.5	1.3	1.2	<i>n.a.</i>
General government balance (% of GDP)	<b>SP Nov 2004</b>	<b>-1.4</b>	<b>-1.0</b>	<b>-0.9</b>	<b>-1.0</b>
	COM <sup>2</sup>	-0.8	-1.6	-2.0	n.a.
	<i>SP Nov 2003</i>	-1.8	-2.3	-1.5	<i>n.a.</i>
Primary balance (% of GDP)	<b>SP Nov 2004</b>	<b>-1.2</b>	<b>-0.9</b>	<b>-0.8</b>	<b>-0.9</b>
	COM <sup>2</sup>	-0.6	-1.4	-1.8	n.a.
	<i>SP Nov 2003</i>	-1.6	-2.1	-1.5	<i>n.a.</i>
Cyclically-adjusted balance (% of GDP)	<b>SP Nov 2004<sup>1</sup></b>	<b>-0.7</b>	<b>0.3</b>	<b>1.4</b>	<b>2.0</b>
	COM <sup>2</sup>	0.4	0.3	0.7	n.a.
	<i>SP Nov 2003<sup>1</sup></i>	0.9	1.0	2.2	<i>n.a.</i>
Government gross debt (% of GDP)	<b>SP Nov 2004</b>	<b>5.0</b>	<b>5.0</b>	<b>4.6</b>	<b>4.5</b>
	COM <sup>2</sup>	4.9	4.8	4.7	n.a.
	<i>SP Nov 2003</i>	5.2	5.0	4.4	<i>n.a.</i>
<b>Note:</b>					
1 Commission services calculations on the basis of the information in the programme					
2 Finalised before the presentation of the 2005 budget					
<b>Sources:</b>					
<i>Stability programme (SP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations</i>					