COUNCIL OPINION

of 14 February 2006

on the updated stability programme of Luxembourg, 2005-2008

(2006/C 55/08)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies [1], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On 14 February 2006 the Council examined the updated stability programme of Luxembourg, which covers the period 2005 to 2008.

(2) The economic performance of Luxembourg has been remarkably bright in the last 20 years, with real GDP growing at 5,5 % a year on average and domestic employment by 3,25 %. Growth slowed down strongly in 2001 but recovered quickly, reaching 4,4 % in 2004. The financial position of the Luxembourg government has traditionally been very sound, with recurrent surpluses since the beginning of the 1990s and a very low public debt. However, due to the very strong rise in expenditure, these surpluses rapidly declined since the beginning of this decade and turned into a deficit in 2004.

(3) In its opinion of 18 January 2005, the Council endorsed the budgetary strategy presented in the previous update of the stability programme, covering the period 2004-2007.

(4) As regards budgetary implementation in 2005, the general government deficit is currently estimated at -2,3 % of GDP in the Commission services' autumn 2005 forecast as against a -1,0 % of GDP target set in the previous update of the stability programme. Roughly half of the observed deterioration is explained by a statistical revision, following the implementation by the Luxembourg authorities of the Eurostat decision on the statistical treatment of projects financed by PPPs. While government revenues, which were projected by the previous update to increase by 1,2 percentage points of GDP, actually rose by only 0,2 of a percentage point of GDP, in part due to large and unexpected VAT reimbursements, government expenditure increased by 1,4 percentage points of GDP (of which 0,8 of a percentage point is accounted for by public investment) instead of 0,8 of a percentage point of GDP as planned.

(5) The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct [2].

(6) According to the programme's macroeconomic scenario, real GDP growth should accelerate from an estimated 4,0 % in 2005 to 4,4 % in 2006 and to 4,9 % in both 2007 and 2008. Assessed against currently available information, this scenario appears to be based on broadly plausible growth assumptions, although slightly favourable in the outer years. The programme's projections for inflation also appear realistic, taking into account that the HICP in Luxembourg is extremely sensitive to changes in oil prices.

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[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). 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

[2] It has gaps in the compulsory and optional data prescribed by the code.

(7) The programme aims at bringing the general government deficit close to balance by the end of the programme period and thereby achieving a medium-term objective of -0,8 % of GDP in the same year. The time profile and the level of the primary balance are similar to those of the total balance, with an improvement from a -2,1 % of GDP primary deficit in 2005 to a 0,1 % primary surplus at the end of the period. The deficit reduction is expenditure-based as total government expenditure is projected to decline by 2,5 percentage points over the period while the revenues ratio should decrease by 0,4 of a percentage point of GDP. In order to cope with the unexpected deterioration in the government balance in 2005, the budgetary strategy has been adapted since the submission of the previous update, which was based on a less optimistic macroeconomic scenario and where the general government deficit, after improving from an estimated -1,4 % of GDP in 2004 to a projected -1,0 % in 2005, was planned to remain broadly at the same level in 2006 and 2007.

(8) Over the programme period, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve on average by slightly more than 0,5 % of GDP per year. The adjustment is back-loaded, significantly increasing in 2007 in both nominal and structural terms. The programme sets the medium-term objective (MTO) for the budgetary position at a structural deficit of 0,8 % of GDP and aims at achieving this position by 2008. The programme's MTO is similar to the minimum benchmark aiming at providing a sufficient safety margin in order to guarantee that the 3 % threshold set for the general government deficit is not breached. Hence, its achievement should fulfil the aim of providing this safety margin. Moreover, the MTO can be considered as appropriate under the current assessment because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(9) The budgetary outcome could be worse than projected in the programme. First the macroeconomic projections presented by the programme might be slightly optimistic in the last years of the period covered. Moreover, the measures announced by the programme and aimed at continuing the adjustment effort in 2007 and 2008 are not yet specified. The achievement of the programme's budgetary objectives is conditional on the specification and proper implementation of these measures.

(10) In view of this risk assessment, the budgetary stance in the programme seems sufficient to ensure that the MTO is achieved at the latest by 2008, as envisaged in the programme, on the condition that the measures announced for 2007 and 2008 are specified and properly implemented. According to the Commission services' calculations, the risk of breaching the 3 % of GDP deficit threshold with normal macroeconomic fluctuations cannot be excluded in 2006. Although from 2007 onwards the planned structural deficit is lower than the minimum benchmark, the safety margin may also not be sufficient in 2007 unless the expenditure-reducing measures announced for that year are specified and implemented. The pace of the adjustment towards the MTO is broadly in line with the Stability and Growth Pact, which specifies that, for euro area and ERM II Member States, the annual improvement in the structural balance should be 0,5 % of GDP as a benchmark. However, the improvement in the structural deficit planned by the programme only amounts to 0,3 of a percentage point of GDP in 2006, despite favourable overall economic conditions.

(11) The general government debt is estimated at 6,4 % of GDP in 2005. It is projected in the programme to rise to 10,2 % of GDP in 2008, with the main part of this increase occurring in 2006.

(12) With regard to the sustainability of public finances, Luxembourg appears to be at medium risk on grounds of the projected budgetary costs of ageing populations [1]. The current level of debt is certainly very low and the planned consolidation over the medium term should contribute to partly alleviating the risk to public finance sustainability. However, Luxembourg has experienced, over the last two decades, a period of exceptionally strong employment growth which will progressively translate into a similar increase in the number of pensioners and into a large increase in pension expenditure. While it contributes significantly to public finance sustainability, the current size of pension fund assets will not be sufficient and, as recognised by the programme, some changes in the pension schemes will prove necessary at some point to contain future increase in public expenditure and reduce the risk to long-term sustainability.

[1] Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services
(http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm).

(13) The programme's strategy in the area of public finances is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008, in particular with the integrated guideline on securing economic stability by maintaining the medium-term budgetary objective over the economic cycle. As long as this objective has not been achieved, the government is committed to taking all the necessary corrective measures in line with the Stability and Growth Pact and the integrated guideline on safeguarding economic sustainability in view of the projected costs of ageing population.

(14) The National Reform Programme of Luxembourg, submitted on 17 November 2005, identifies the following challenges with significant implications for public finances: (i) securing economic stability, and (ii) safeguarding economic sustainability. It also identifies challenges in other areas that have a significant impact on public finances, especially the need to significantly increase public R&D. The budgetary implications of the actions outlined in the National Reform Programme are reflected in the budgetary projections of the stability programme and the measures in the area of public finances envisaged in the stability programme are in line with the actions foreseen in the National Reform Programme.

While the global strategy of deficit reduction through expenditure restraint presented in the programme is commendable, the Council is of the opinion that the Luxembourg authorities should:

— strengthen the effort of budgetary adjustment in 2006 and identify and implement the necessary measures for 2007 and 2008, and

— improve long-term sustainability, in particular by containing increases in public expenditure through reform in the pension system.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**SP Dec 2005**	**4,4**	**4,0**	**4,4**	**4,9**	**4,9**
	COM Nov 2005	4,5	4,2	4,4	4,5	n.a.
	SP Dec 2004	*4,4*	*3,8*	*3,3*	*4,3*	*n.a.*
HICP inflation (%)	**SP Dec 2005**	**3,2**	**3,7**	**2,6**	**2,0**	**1,8**
	COM Nov 2005	3,2	4,1	4,4	2,2	n.a.
	SP Dec 2004	*2,6*	*3,2*	*1,5*	*1,7*	*n.a.*
Output gap (% of potential GDP)	**SP Dec 2005** (1)	**– 1,7**	**– 1,7**	**– 1,3**	**– 0,7**	**– 0,6**
	COM Nov 2005 (2)	– 1,8	– 1,6	– 1,3	– 1,2	n.a.
	SP Dec 2004 (1)	*– 1,2*	*– 2,2*	*– 3,8*	*– 5,0*	*n.a.*
General government balance (% of GDP)	**SP Dec 2005**	**– 1,2**	**– 2,3**	**– 1,8**	**– 1,0**	**– 0,2**
	COM Nov 2005	– 1,2	– 2,3	– 2,0	– 2,2	n.a.
	SP Dec 2004	*– 1,4*	*– 1,0*	*– 0,9*	*– 1,0*	*n.a.*
Primary balance (% of GDP)	**SP Dec 2005**	**– 0,9**	**– 2,1**	**– 1,7**	**– 0,7**	**0,1**
	COM Nov 2005	– 0,9	– 2,1	– 1,8	– 2,0	n.a.
	SP Dec 2004	*– 1,2*	*– 0,9*	*– 0,8*	*– 0,9*	*n.a.*

		2004	2005	2006	2007	2008
Cyclically-adjusted balance= Structural balance (3) (% of GDP)	**SP Dec 2005** (1)	**– 0,3**	**– 1,5**	**– 1,2**	**– 0,6**	**0,1**
	COM Nov 2005	– 0,4	– 1,5	– 1,4	– 1,6	n.a.
	SP Dec 2004 (1)	*– 0,7*	*0,3*	*1,4*	*2,0*	*n.a.*
Government gross debt (% of GDP)	**SP Dec 2005**	**6,6**	**6,4**	**9,6**	**9,9**	**10,2**
	COM Nov 2005	6,6	6,8	7,1	7,3	n.a.
	SP Dec 2004	*5,0*	*5,0*	*4,6*	*4,5*	*n.a.*

Notes:

(1) Commission services' calculations on the basis of the information in the programme.

(2) Based on estimated potential growth of 4,1 %, 4,0 %, 4,1 % and 4,3 % respectively in the period 2004-2007.

(3) Since there are no one-off and other temporary measures specified in the programme, the cyclically-adjusted balance and the structural balance are identical.

Source:

Stability programme (SP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations.