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Recommendation for a

COUNCIL RECOMMENDATION

on Luxembourg's 2013 national reform programme

and delivering a Council opinion on Luxembourg's stability programme for 2012-2016

{SWD(2013) 366 final}

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Articles 121(2) and 148(4) thereof,

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 policies¹, and in particular Article 5(2) thereof,

Having regard to the recommendation of the European Commission²,

Having regard to the resolutions of the European Parliament³,

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

After consulting the Economic and Financial Committee,

Whereas:

- (1) On 26 March 2010, the European Council agreed to the Commission's proposal to launch a new strategy for growth and jobs, Europe 2020, based on enhanced coordination of economic policies, which will focus on the key areas where action is needed to boost Europe's potential for sustainable growth and competitiveness.
- (2) On 13 July 2010, on the basis of the Commission's proposals, the Council adopted a recommendation on the broad guidelines for the economic policies of the Member States and the Union (2010 to 2014) and, on 21 October 2010, adopted a decision on guidelines for the employment policies of the Member States⁴, which together form the 'integrated guidelines'. Member States were invited to take the integrated guidelines into account in their national economic and employment policies.
- (3) On 29 June 2012, the Heads of State or Government decided on a Compact for Growth and Jobs, providing a coherent framework for action at national, EU and euro area levels using all possible levers, instruments and policies. They decided on action to be taken at the level of the Member States, in particular expressing full commitment to achieving the objectives of the Europe 2020 Strategy and to implementing the country-specific recommendations.

¹ OJ L 209, 2.8.1997, p. 1.

² COM(2013) 366 final.

³ P7_TA(2013)0052 and P7_TA(2013)0053.

⁴ Council Decision 2013/208/EU of 22 April 2013.

- (4) On 6 July 2012, the Council adopted a recommendation on Luxembourg's national reform programme for 2012 and delivered its opinion on Luxembourg's updated stability programme for 2011-2015.
- (5) On 28 November 2012, the Commission adopted the Annual Growth Survey⁵, marking the start of the 2013 European Semester for economic policy coordination. Also on 28 November 2012, the Commission, on the basis of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, adopted the Alert Mechanism Report⁶, in which it did not identify Luxembourg as one of the Member States for which an in-depth review would be carried out.
- (6) On 14 March 2013, the European Council endorsed the priorities for ensuring financial stability, fiscal consolidation and action to foster growth. It underscored the need to pursue differentiated, growth-friendly fiscal consolidation, to restore normal lending conditions to the economy, to promote growth and competitiveness, to tackle unemployment and the social consequences of the crisis, and to modernise public administration.
- (7) On 26 April 2013, Luxembourg submitted its 2013 stability programme covering the period 2012-2016 and its 2013 national reform programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time.
- (8) Based on the assessment of the 2013 stability programme pursuant to Council Regulation (EC) No 1466/97, the Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible. In particular, the programme scenario for 2013 is very close to the 2013 Commission spring forecast, while for 2014 it is slightly more optimistic. Medium-term deficit projections are made under a slightly optimistic growth scenario, above potential growth. The objective of the budgetary strategy outlined in the programme is to bring the deficit from 0.8% of GDP in 2012 to 0.6% of GDP in 2014. However in the outer years of the programme period, the deficit is forecast to deteriorate to 1.3% of GDP both in 2015 and 2016. This is the result of the introduction of the new VAT rules regarding electronic services, entering into force on 1 January 2015, which will bring Luxembourg into compliance with EU rules. According to these rules, the VAT revenues generated from e-commerce activities will be transferred from the country where the supplier is located to that of the residence of the customer. The impact of the new rules is estimated by the authorities to lower tax revenues from VAT by 1.4% of GDP. The government has already announced that the standard VAT rate will be increased, with a view to make up a part of the revenue loss. The 2013 Stability Programme confirms the previous medium-term budgetary objective (MTO) of a structural surplus of 0.5% of GDP. The MTO is in line with the requirements of the Stability and Growth Pact. Based on both the 2013 Commission spring forecast as well as on the (recalculated) structural budget balance in the programme, Luxembourg is expected to be at a structural surplus of 0.1% of GDP, which is below the MTO, in 2012, and is projected to achieve its MTO in 2013. However, Luxembourg is projected to depart again from its MTO starting from 2014 by 0.3% of GDP and even further in 2015 and 2016. The national authorities have reiterated their objective to return to the MTO at the latest in 2017 so as to provide greater room for manoeuvre. At 20.8% of GDP in 2012, gross government debt is well below the Treaty reference value.

⁵ COM(2012) 750 final.

⁶ COM(2012) 751 final.

- (9) Luxembourg has been able to keep its public deficit below the 3% of GDP threshold over the past years, therefore avoiding entering the excessive deficit procedure. This has been due more to buoyant revenues rather than to expenditure restraint. Specifically, in 2012, the growth rate of government expenditure, net of discretionary revenue measures, is estimated to have exceeded the expenditure benchmark as defined in the Stability and Growth Pact. The deviation of the growth rate of government expenditure from the expenditure benchmark is estimated to reach 1.3%pp of GDP, above the threshold of 0.5% of GDP defined in Regulation (EC) 1466/97. However, to qualify this deviation, an overall assessment needs to be conducted, taking into account other factors: (i) the deficit deteriorated in structural terms by only 0.2% of GDP in 2012; (ii) the economy of Luxembourg, given the small size of the country and its degree of openness is very volatile; and (iii) according to the Commission services' spring 2013 forecast, Luxembourg should attain its MTO already in 2013. All these elements point to a non-structural nature of the deviation. Still, the high volatility of the revenues collected by Luxembourg's general government, up to now resulting in higher-than-planned revenues, represents a risk for the sustainability of public finances. To better address these risks, both the debt and expenditure constraints, should be established in law. Moreover, there should be an identified monitoring body and predefined action in case of non-compliance. The entry into force on 1 January 2015 of the above-mentioned VAT package and its subsequent strong negative impact on tax collection illustrates the importance for Luxembourg to introduce a medium-term budgetary framework. Specifically, this would call for a particularly prudent fiscal stance in 2014.
- (10) Currently, less than a third of tax revenues are raised from consumption taxes, partially owing to moderate standard and reduced VAT rates. Luxembourg ranks first in the EU in terms of the number of categories of goods and services covered by reduced VAT rates. The presence of a large financial sector, exempted from VAT, also contributes to the low VAT to GDP ratio. Overall, Luxembourg has scope to raise revenue by extending the standard VAT rate. In addition, the corporate tax system in Luxembourg is characterised by a large tax bias towards indebtedness, which contributes to a high private debt to GDP ratio.
- (11) The Luxembourg pension reform adopted in December 2012 can only be considered a first step in the right direction. Even when taking into account most of the aspects of the adopted pension reform, Luxembourg would still need to implement long-term sustainability-enhancing policies equivalent to a permanent improvement of 8.6 percentage points of GDP in the primary balance to close the fiscal gap. Luxembourg therefore needs to go further in its pension reform. The introduction of a cap on pension adjustments based on real wage increases would increase pension reserves and linking the statutory retirement age to life expectancy would help ensure the long-term sustainability of the pension system. Moreover, the possibilities for early retirement should be reduced and it should be made more attractive to work longer than the minimum required. In addition, the impact on fiscal sustainability of long-term care expenditure is projected to contribute by 2.1 percentage points to Luxembourg's sustainability gap. The expected increase in both the number of elderly and the number of dependents in Luxembourg is high compared to the EU average.
- (12) Luxembourg's current productivity is rather high. However, the room for manoeuvre in terms of productivity gains is getting smaller. Therefore, the growth of unit labour costs should be limited by ensuring a better correlation between wages and productivity. Luxembourg has taken measures to moderate wage growth by

modulating the indexation system between 2012 and 2014. However, this reform is only temporary and does not guarantee that wages will over time evolve in line with productivity. Productivity is not the same across all economic sectors, and the level of productivity in the financial sector is almost twice as high as in the remaining part of the economy. There will be a significant risk to Luxembourg's competitiveness from 2015 onward, when the automatic indexation system will again be applied in the normal way. Additional measures should thus be taken to reform the wage setting system in a more permanent way to avoid a further deterioration of competitiveness in the future.

- (13) Luxembourg's economy is heavily dependent on its financial sector, which accounts for about 30% of total value added and 25% of collected fiscal revenues. To safeguard the country's future competitiveness, alternative "competence niches" would need to be developed. However, the Luxembourgish research and innovation system remains very weak and Luxembourg is not on track to reach its R&D intensity target for 2020. The performance of Luxembourg on the indicators on cooperation between public research institutions and firms is well below the EU average, reflecting the current disconnections between the private sector R&D and the public research system. Luxembourg should counteract the declining trend of its R&D intensity, notably by helping boost business R&D intensity. The development of a more targeted smart specialisation strategy could play a crucial role in maximising the economic impacts of public research funding, in particular through ensuring a leverage effect on private investments. Such a targeted approach should be complemented by a comprehensive horizontal policy focused on the development and growth of innovative firms.
- (14) Youth unemployment remains persistently high at 18% and depends heavily on the educational level. Young residents face intense competition for jobs from non-residents, who are often more skilled. While Luxembourg has demonstrated a strong commitment to combat youth unemployment, further efforts are needed. In order to maximise returns, measures taken should be made part of a comprehensive reform strategy, including enhanced activation policies to combat benefit dependency. Luxembourg's PISA performance testing on basic skills of young people is relatively weak. Further measures are needed to counteract the negative tendency in reading, mathematics and science observed since 2006. Further efforts should be made to improve and target education resources for schools with disadvantaged students and increase resources available for language support and remedial classes. The specific challenges faced by people with a migrant background on the labour market should be further examined and addressed by targeted measures, including in respect of language skills. Vocational education and training should be given particular attention in this context. Further measures should be taken to improve early childhood education and reduce early school leaving, in particular for the migrant population. The employability of older workers should be improved, including through skills upgrading.
- (15) Luxembourg is committed to reducing its greenhouse gas emissions in the non-ETS sectors by 20 % in 2020 compared to 2005 but is expected to fail to meet its target by 27 percentage points. The transport sector was responsible for 64% of non-ETS emissions in 2010 and represents a key challenge for Luxembourg. Measures currently in place would only contribute to approximately a third of the greenhouse gas emission reduction necessary to meet the target. Consequently, measures need to be significantly stepped up, notably by increasing fuel taxation so as to reduce the taxation gap with neighbouring countries. The vehicle tax reform should also be

accelerated. Luxembourg should continue with the implementation of projects which favour the use of public transport. It should introduce congestion charging on roads to encourage a shift towards public transport. Better public transport connections with neighbouring regions should be promoted.

- (16) In the context of the European Semester, the Commission has carried out a comprehensive analysis of Luxembourg's economic policy. It has assessed the stability programme and national reform programme. It has taken into account not only their relevance for sustainable fiscal and socio-economic policy in Luxembourg but also their compliance with EU rules and guidance, given the need to reinforce the overall economic governance of the European Union by providing EU-level input into future national decisions. Its recommendations under the European Semester are reflected in recommendations (1) to (6) below.
- (17) In the light of this assessment, the Council has examined Luxembourg's stability programme, and its opinion⁷ is reflected in particular in recommendation (1) below.
- (18) In the context of the European Semester the Commission has also carried out an analysis of the economic policy of the euro area as a whole. On this basis the Council has issued specific recommendations addressed to the Member States whose currency is the euro. Luxembourg also should ensure the full and timely implementation of these recommendations,

HEREBY RECOMMENDS that Luxembourg should take action within the period 2013-2014 to:

- 1. Preserve a sound fiscal position and remain at the medium-term objective so as to ensure the long-term sustainability of public finances, in particular by taking into account implicit liabilities related to ageing. Strengthen fiscal governance by adopting a medium-term budgetary framework covering the general government and including multi-annual expenditure ceilings, and by putting in place the independent monitoring of fiscal rules.
- 2. Take measures to address the debt-bias in corporate taxation and extend the application of the standard VAT rate.
- 3. Curb age-related expenditure by making long-term care more cost effective, in particular through a stronger focus on prevention, rehabilitation and independent living, strengthening the recently adopted pension reform, taking additional measures to curb early retirement and increasing the effective retirement age, including by linking the statutory retirement age to life expectancy.
- 4. Beyond the current freeze, take further structural measures, in consultation with the social partners and in accordance with national practices, to reform the wage setting system, including wage indexation, to improve its responsiveness to productivity and sectoral developments and labour market conditions and foster competitiveness. Step-up efforts to diversify the structure of the economy, fostering private investment in research, notably by developing cooperation between public research and firms.
- 5. Step up efforts to reduce youth unemployment by improving the design and monitoring of active labour market policies. Strengthen general and vocational education to better match young people's skills with labour demand, in particular for people with migrant background. Take resolute action to increase the participation

⁷ Under Article 5(2) of Council Regulation (EC) No 1466/97.

rate of older workers, including by improving their employability through lifelong learning.

6. Step up measures to meet the target for reducing non-ETS greenhouse gas emissions, in particular by increasing taxation on energy products for transport.

Done at Brussels,

For the Council
The President