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Recommendation for a

COUNCIL RECOMMENDATION

on the 2019 National Reform Programme of Luxembourg and delivering a Council opinion on the 2019 Stability Programme of Luxembourg

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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 policies[1], and in particular Article 5(2) thereof,

Having regard to the recommendation of the European Commission,

Having regard to the resolutions of the European Parliament,

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

Having regard to the opinion of the Economic and Financial Committee,

Having regard to the opinion of the Social Protection Committee,

Having regard to the opinion of the Economic Policy Committee,

Whereas:

(1) On 21 November 2018, the Commission adopted the Annual Growth Survey, marking the start of the 2019 European Semester for economic policy coordination. It took due account of the European Pillar of Social Rights, proclaimed by the European Parliament, the Council and the Commission on 17 November 2017. The priorities of the Annual Growth Survey were endorsed by the European Council on 21 March 2019. On 21 November 2018, on the basis of Regulation (EU) No 1176/2011, the Commission also adopted the Alert Mechanism Report, in which it did not identify Luxembourg as one of the Member States for which an in-depth review would be carried out. On the same date, the Commission also adopted a recommendation for a Council recommendation on the economic policy of the euro area, which was endorsed by the European Council on 21 March 2019. On 9 April 2019, the Council adopted the recommendation on the economic policy of the euro area ('Recommendation for the euro area').

(2) As a Member State whose currency is the euro and in view of the close interlinkages between the economies in the economic and monetary union, Luxembourg should

[1] OJ L 209, 2.8.1997, p. 1.

ensure the full and timely implementation of the Recommendation for the euro area, as reflected in recommendations (1) to (4) below.

(3) The 2019 country report for Luxembourg[2] was published on 27 February 2019. It assessed Luxembourg's progress in addressing the country-specific recommendations adopted by the Council on 13 July 2018, the follow-up given to the recommendations adopted in previous years and Luxembourg's progress towards its national Europe 2020 targets.

(4) On 30 April 2019, Luxembourg submitted its 2019 National Reform Programme and its 2019 Stability Programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time.

(5) Relevant country-specific recommendations have been addressed in the programming of the European Structural and Investment Funds ('ESI Funds') for the 2014-2020 period. As provided for in Article 23 of Regulation (EU) No 1303/2013 of the European Parliament and of the Council[3], where it is necessary to support the implementation of relevant Council recommendations, the Commission may request a Member State to review and propose amendments to its Partnership Agreement and relevant programmes. The Commission has provided further details on how it would make use of that provision in guidelines on the application of the measures linking the effectiveness of the ESI Funds to sound economic governance[4].

(6) Luxembourg is currently in the preventive arm of the Stability and Growth Pact. In its 2019 Stability Programme, the government plans a decrease in the headline surplus from 2.4% of GDP in 2018 to 1.0% of GDP in 2019, followed by an almost steady increase thereafter, reaching a surplus of 2.2% of GDP in 2023. Based on the recalculated structural balance[5], the medium-term budgetary objective – which has been changed from a structural deficit of 0.5% of GDP in 2019 to a surplus, in structural terms, of 0.5% of GDP as of 2020 – is overachieved throughout the programme period. According to the 2019 Stability Programme, the government debt-to-GDP ratio is expected to remain well below the 60% of GDP Treaty reference value. The macroeconomic scenario underpinning those budgetary projections is favourable throughout the period covered by the programme, except for 2023 when it is plausible. Based on the Commission 2019 spring forecast, the structural balance is forecast to register a surplus of 0.9% of GDP in 2019 and 0.5% of GDP in 2020, lower, in particular for 2020, than in the 2019 Stability Programme, but still above or in line with the medium-term budgetary objective. At the same time, expenditure developments should be monitored carefully in the short and the medium term, especially in light of possible future risks to the robustness of revenues. Overall, the Council is of the opinion that Luxembourg is projected to comply with the provisions of the Stability and Growth Pact in 2019 and 2020.

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2 SWD(2019) 1015 final.

3 Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 (OJ L 347, 20.12.2013, p. 320).

4 COM(2014) 494 final.

5 Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

(7) In spite of recent reforms, Luxembourg's age-related spending (pension-related, healthcare and long-term care costs) is expected to increase markedly in the long term. Assuming no policy changes are made to the current system, this could put at risk the sustainability of public finances in the long term. This is despite the current low level of public debt and the accumulated reserves of the social security system, which are expected to ensure the system's viability until 2041. Recommendations on this challenge have been addressed to Luxembourg since 2011 but limited progress has been made to date. In its 2018 report, the government's pensions working group discussed various ways to improve the long-term sustainability of the pensions system, including gradually increasing the contribution rate, raising the pensionable age to take account of longer life expectancy and encouraging phased retirement. The report suggests a multi-pronged strategy of calibrated reforms to guarantee the long-term sustainability of the system while minimising the impacts on both the economy and pensioners. Projected increases in age-related expenditure also threaten the long-term sustainability of the healthcare and long-term care systems. More than three quarters of long-term care expenditure comes from public sources. The 2018 reform is expected to ensure financial viability until 2030, by allowing to gradually increase workers' contributions to the healthcare system from 1.4% of the wage base to 1.7%, in order to keep costs in line with the proportion of dependent people. However, the impacts in terms of long-term fiscal sustainability are not yet clear. To sustain social cohesion and public finances in the long term, demographic policies would need to concur with education and training policies, taking a holistic approach to considering both the challenges and opportunities of changes in demography as well as in the digital economy, given the expected impact of population ageing on labour supply in the near future. Labour shortages have recently emerged in certain sectors, which could hinder productivity growth and reduce the long-term growth potential.

(8) Despite an overall good labour market performance, the employment rate is stagnating and specific groups still face particular difficulties on the labour market. In particular, the employment rate of older people remains particularly low, and further measures are needed to improve their participation to the labour market. Early retirement schemes encouraging workers to leave employment remain widespread, with 57.5% of newly attributed pensions being early old-age pensions in 2017. In 2018, the government abrogated one of the pre-retirement schemes allowing people to retire from the age of 57, but the effect of this reform was weakened by relieving restrictions on other pre-retirement schemes. Low old-age activity rates also largely result from financial disincentives to work stemming from the tax-benefit system which are comparatively high for this age group. Encouraging the employment of older workers requires a comprehensive strategy including measures to help them remain in active employment for longer. The 'Age Pact', a draft law submitted to Parliament in April 2014, which aims to encourage firms with more than 150 employees to hire and retain older workers through age management measures, is still pending in Parliament.

(9) While Luxembourg remains committed to improving the regulatory environment for the business services sector, regulatory barriers are still high in several sectors, such as legal, accounting, architecture and engineering services, according to the European Commission's restrictiveness indicator[6]. The OECD's intra-EEA Services Trade Restrictiveness Index published in December 2018 also confirmed that Luxembourg's level of regulatory restrictiveness vis-à-vis other EU Member States is higher than the Single Market average for these sectors.

[6] SWD(2016) 436 final

(10) Luxembourg’s economic model features strong performances consistent with robust and sustained creation of qualified employment. This is supported by high productivity levels, largely reflecting efficiency gains from participation in global markets, in particular in the financial sector. However, productivity growth has stagnated in recent years, hampered by low levels of business investment in innovation and digital integration. Luxembourg’s strategy to diversify its economy, by developing key knowledge-intensive sectors in a transition to a data-driven economy, exhibits strong potential to stimulate high value-added investment and boost productivity growth. In that context, public investment remains high and focused on those sectors, including a strong Information and Communication Technology sector. However, this significant public investment has not spilled over, nor has it helped to stimulate private investment in innovation and digitalisation. Increased investment in research and innovation, as well as in digital integration, especially in firms and specifically in small and medium-sized enterprises, is important for improving productivity growth and further diversifying Luxembourg’s economy. Developing a coherent and integrated national framework for research and innovation policies and support instruments, including prioritisation based on robust assessment of expected economic impacts, is essential to enabling Luxembourg to exploit the full potential of its innovation eco-system.

(11) Increased investment in skills, in particular information and communications technology skills, employability, education and training, including a better alignment of education curricula to labour market needs and fostering technological and digital transformations, is important for improving Luxembourg’s productivity, employment and long-term growth potential, and for fostering equal opportunities.

(12) Air pollution and traffic congestion at peak times still constitute major problems for Luxembourg, from both a competitiveness and environmental point of view. In addition, the CO_2 emissions from road transport contribute to climate change. According to the 2017 national projections submitted to the Commission, it is expected that in the absence of additional measures, Luxembourg will miss its 2020 greenhouse gas emission reduction target by 3 percentage points and its 2030 target by 20 percentage points. The number of cross-border workers, who currently represent about 45% of Luxembourg’s labour force, the low taxation of transport fuel and high house prices stimulate increased car use and are an obstacle to improving air quality and traffic conditions. Meanwhile, the use of alternative fuels in new passenger cars sold in Luxembourg has increased over the past few years.

(13) Insufficient housing supply may negatively affect Luxembourg’s attractiveness. Its strong housing demand remains driven by population growth, favourable financing conditions and a large cross-border workforce. Housing supply and investment appear insufficient, constrained by insufficient land availability and low housing density, largely due to a lack of incentives for landowners to build new housing or to sell. The supply of social housing also appears insufficient and points to a need for significant investment to alleviate rising tensions in the housing market.

(14) The fight against aggressive tax planning is essential to make tax systems more efficient and fair as acknowledged in the 2019 euro area recommendation. Spillover effects of taxpayers’ aggressive tax planning strategies between Member States call for a coordinated action of national policies to complement EU legislation. Luxembourg has taken measures against aggressive tax planning, but the high level of dividend, interest and royalty payments as a percentage of GDP suggests that the country’s tax rules are used by companies that engage in aggressive tax planning. The majority of

foreign direct investment is held by 'special purpose entities'. The absence of withholding taxes on outbound (i.e. from EU residents to third country residents) interest and royalty payments and the exemption from withholding taxes on dividend payments under certain circumstances may lead to those payments escaping tax altogether, if they are also not subject to tax in the recipient jurisdiction.

(15) The programming of EU funds for the period 2021-2027 could help address some of the gaps identified in the recommendations, in particular in the areas covered by Annex D to the country report[7]. This would allow Luxembourg to make the best use of those funds in respect of the identified sectors.

(16) In the context of the 2019 European Semester, the Commission has carried out a comprehensive analysis of Luxembourg's economic policy and published it in the 2019 country report. It has also assessed the 2019 Stability Programme and the 2019 National Reform Programme and the follow-up given to the recommendations addressed to Luxembourg in previous years. It has taken into account not only their relevance for sustainable fiscal and socioeconomic policy in Luxembourg, but also their compliance with Union rules and guidance, given the need to strengthen the Union's overall economic governance by providing Union-level input into future national decisions.

(17) In the light of this assessment, the Council has examined the 2019 Stability Programme and is of the opinion that Luxembourg is expected to comply with the Stability and Growth Pact.

HEREBY RECOMMENDS that Luxembourg take action in 2019 and 2020 to:

1. Increase the employment rate of older workers by enhancing their employment opportunities and employability. Improve the long-term sustainability of the pension system, including by further limiting early retirement.
2. Reduce barriers to competition in regulated professional business services.
3. Focus economic policy related to investment on fostering digitalisation and innovation, stimulating skills development, improving sustainable transport, and increasing housing supply, including by increasing incentives and lifting barriers to build.
4. Address features of the tax system that may facilitate aggressive tax planning, in particular by means of outbound payments.

Done at Brussels,

For the Council
The President

7 SWD(2019) 1015 final.