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COMMISSION STAFF WORKING DOCUMENT

Analysis of the Draft Budgetary Plan of LUXEMBOURG

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of LUXEMBOURG

{C(2013) 8006 final}

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1. INTRODUCTION

Luxembourg has submitted its Draft Budgetary Plan for 2014 on 15 October 2013 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. The Draft Budgetary Plan was submitted by the outgoing government based on a no-policy change scenario, due to general elections that took place just after the submission of the DBP. Luxembourg is subject to the preventive arm of the Pact and should preserve a sound fiscal position which ensures compliance with the medium term objective.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission Forecast. The following section presents recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission Forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses recent and planned fiscal developments in 2013-2014 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underlying the Draft Budgetary Plan is almost unchanged compared to that underpinning the 2013 Stability Programme. Only some marginal adjustments have been introduced, such a small upward revision of GDP growth in 2014 from 2.2% to 2.3%.

According to the most recent estimates for 2012, output contracted by 0.2% compared to an already subdued expansion of 0.3% projected initially, representing therefore the third year of negative growth in Luxembourg since the onset of the financial crisis. Output and gross value added diminished in 2012 in the two main pillars of the economy, the steel industry and the financial sector.

According to the projections in the Draft Budgetary Plan, economic prospects would remain sluggish in 2013 with real GDP growth estimated at 1.0%. The macroeconomic scenario underlying the Draft Budgetary Plan was established before the national account data for the second quarter of 2013 were released, which point to a sharp improvement of output in the second quarter of 2013.

Table 1. Comparison of macroeconomic developments and forecasts

	2012	2013			2014		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	-0.2	1.0	1.0	1.9	2.2	2.3	1.8
Private consumption (% change)	2.2	-0.8	n.a.	1.2	1.9	n.a.	1.5
Gross fixed capital formation (% change)	3.5	-0.2	n.a.	1.1	-3.3	n.a.	2.7
Exports of goods and services (% change)	-1.9	0.1	0.2	2.7	4.8	4.8	4.0
Imports of goods and services (% change)	-1.0	-0.3	-0.2	2.7	4.2	4.3	4.6
<i>Contributions to real GDP growth:</i>							
- Final domestic demand	2.2	0.4	0.5	1.2	0.5	0.6	1.5
- Change in inventories	-0.4	0.6	-0.1	0.0	1.7	0.0	0.0
- Net exports	-1.9	0.0	0.6	0.7	0.1	1.7	0.3
Output gap ¹	-2.8	-2.2	-2.4	-2.2	-1.3	-0.2	-1.2
Employment (% change)	2.5	1.7	1.7	1.7	1.3	1.3	1.5
Unemployment rate (%)	5.1	5.9	5.9	5.7	6.1	6.1	6.4
Labour productivity (% change)	-2.6	-0.8	-0.8	0.2	0.7	0.8	0.3
HICP inflation (%)	2.9	2.1	n.a.	1.8	1.8	n.a.	1.7
GDP deflator (% change)	3.0	2.1	2.1	3.6	2.1	2.1	2.7
Comp. of employees (per head, % change)	2.0	1.5	1.5	0.8	2.7	2.7	2.9
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	5.4	n.a.	n.a.	7.0	n.a.	n.a.	7.1
<p>Note:</p> <p>¹In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.</p> <p>Source:</p> <p>Stability programme (SP); Draft Budgetary Plan (DBP); Commission services' 2013 Autumn Forecast (COM); Commission services' calculations.</p>							

In contrast, the Commission 2013 Autumn Forecast does incorporate that strong rebound and, therefore, projects economic activity to expand by 1.9%, around double the Draft Budgetary Plan projection. Net exports represent again an important growth driver (0.7 pp.). Also related to the most recent information about the second quarter of 2013, the GDP deflator is higher in the Commission forecast than in the Draft Budgetary Plan. The Commission thus projects much higher nominal GDP growth compared to the macroeconomic scenario underpinning the Draft Budgetary Plan, which impacts budgetary ratios to GDP.

The Draft Budgetary Plan projects a sharp improvement of GDP growth in 2014. Overall economic activity is expected to expand by 2.3%, well above its potential, albeit still below the growth rates recorded before the onset of the financial crisis. The GDP growth is forecast to be driven by an upturn in external demand, with the contribution of net exports to growth expected to amount to 1.7 pp. of GDP. According to the Commission 2013 Autumn Forecast, economic activity is projected to grow by 1.8% next year. Contrary to the Draft Budgetary Plan macroeconomic scenario, the main contribution is projected to stem from domestic demand backed by improving confidence. As a result, the contribution from exports is expected to remain positive but partly offset by more dynamic import growth, once domestic demand gains momentum. Overall, the macroeconomic scenario depicted in the Draft Budgetary Plan can be considered as pessimistic in 2013 and slightly optimistic in 2014.

The labour market developments as projected in the Draft Budgetary Plan are identical to the Stability Programme and in line with the Commission forecast, with employment growth estimated to slow-down to 1.7% in 2013, while in 2014 the further slow-down in labour

creation is sharper in the Draft Budgetary Plan and in the Stability programme, both project employment to grow by 1.3%, compared 1.5% in the Commission forecast.

Box 1: The macro economic forecast underpinning the budget in Luxembourg

The macroeconomic forecasts underlying the draft budgetary plan have been prepared by the national statistical office STATEC¹, which also provided the methodology for output gap calculation. STATEC is an autonomous administration placed under the authority of the Ministry of Economy and External Trade. Based on the information available to the Commission at this stage, the statutes of STATEC contain provisions supporting independence of the institution as a body producing macroeconomic forecasts.

Its mandate and organisation were reformed by the law of July 10th 2011², which explicitly highlights its scientific and administrative independence, ability to access to appropriate information to carry out its mandate and capacity to communicate freely. Its director is appointed by the Government.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

According to the October 2013 EDP notification, the general government deficit in 2012 was corrected to 0.6% of GDP, slightly better than initially estimated in the most recent update of the Stability Programme (0.8% of GDP). The better outcome is almost equally due to higher revenue and lower expenditure. On the revenue side, social contributions have been more dynamic than initially estimated, while on the expenditure side, the reduction is primarily due to an even stronger decrease in public investment by the central government.

According to the Draft Budgetary Plan, the general government deficit is projected to deteriorate to 0.9% of GDP in 2013, in spite of the implementation of the consolidation package adopted by the government with the 2013 budget. This represents a worse outcome than the target of 0.7% of GDP set in the Stability Programme. This is mostly due to expenditure overruns of around 0.2% of GDP, mostly on account of expenditure to combat unemployment, financial aid for higher education and government consumption. At the same time, revenue windfalls of around 0.1% of GDP compared to the Stability programme are expected to provide a small offset, although not sufficient to fully counterbalance the expenditure overruns. The upward revision of revenues is explained by a higher projection for taxes on production, mostly the result of buoyant revenues from the VAT from e-commerce and the subscription tax associated with investment funds, whereas the estimated amount of taxes stemming from corporates and the municipal business tax has been revised downwards. The revised outcome for the 2013 deficit is in line with the outcome projected in the Commission 2013 Autumn Forecast.

Instead of setting an explicit target for the general government balance in 2014, the Draft Budgetary Plan presents a no-policy change scenario, prepared in the form of a technical update of the medium-term forecast provided in the most recent update of the Stability

¹ Institut national de la statistique et des études économiques du Grand-Duché du Luxembourg.

² Loi du 10 juillet 2011 portant organisation de l'Institut national de la statistique et des études économiques et modifiant la loi modifiée du 22 juin 1963 fixant le régime des traitements des fonctionnaires de l'Etat

Programme. Due to general elections, which took place on 20 October, just a few days after the deadline for submission of the DBP to the Commission, the incumbent government decided to leave the preparation of the 2014 budget to its successor.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2012	2013			2014			Change: 2012-2014
	COM	SP	DBP	COM	SP	DBP ⁵	COM	DBP
Revenue	43.7	42.6	44.2	43.2	42.7	44.1	43.0	0.4
<i>of which:</i>								
- Taxes on production and imports	12.8	12.6	13.4	13.1	12.6	13.5	13.1	0.7
- Current taxes on income, wealth, etc.	14.6	14.5	14.7	14.4	14.6	14.7	14.3	0.1
- Capital taxes	0.2	0.1	0.2	0.2	0.1	0.2	0.2	0.0
- Social contributions	12.5	12.0	12.4	12.2	12.1	12.4	12.1	-0.1
- Other (residual)	3.6	3.4	3.5	3.3	3.3	3.3	3.3	-0.3
Expenditure	44.3	43.3	45.1	44.0	43.3	44.6	44.0	0.3
<i>of which:</i>								
- Primary expenditure	43.8	42.8	44.5	43.4	42.9	44.1	43.5	0.3
<i>of which:</i>								
Compensation of employees	8.4	8.2	8.5	8.4	8.3	8.5	8.5	n.a.
Intermediate consumption	3.9	3.9	3.8	3.7	3.8	3.9	3.8	0.0
Social payments	21.0	20.7	21.5	21.0	20.8	21.5	21.0	0.5
Subsidies	1.8	1.8	1.9	1.9	1.8	1.9	1.9	0.1
Gross fixed capital formation	3.8	3.4	3.5	3.5	3.3	3.4	3.5	-0.4
Other (residual)	4.9	4.8	5.3	5.0	4.9	4.9	4.9	8.5
- Interest expenditure	0.5	0.5	0.6	0.6	0.4	0.5	0.5	0.0
General government balance (GGB)	-0.6	-0.7	-0.9	-0.9	-0.6	-0.5	-1.0	0.1
Primary balance	-0.1	-0.3	-0.3	-0.3	-0.1	0.0	-0.5	0.1
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	-0.6	-0.7	-0.9	-0.9	-0.6	-0.5	-1.0	0.1
Output gap ¹	-2.8	-2.2	-2.4	-2.2	-1.3	-0.2	-1.2	2.6
Cyclically-adjusted balance ¹	0.8	0.3	0.2	0.2	0.0	-0.4	-0.4	-1.1
Structural balance (SB)²	0.8	0.3	0.2	0.2	0.0	-0.4	-0.4	-1.1
<i>Change in SB</i>	<i>0.1</i>	<i>0.2</i>	<i>-0.5</i>	<i>-0.6</i>	<i>-0.3</i>	<i>-0.6</i>	<i>-0.6</i>	<i>-</i>
<i>Two year average change in SB</i>	<i>0.3</i>	<i>0.0</i>	<i>-0.2</i>	<i>-0.3</i>	<i>-0.1</i>	<i>-0.5</i>	<i>-0.6</i>	<i>-</i>
Structural primary balance ²	1.2	0.8	0.8	0.7	0.4	0.1	0.1	-1.1
<i>Change in structural primary balance</i>		<i>0.3</i>	<i>-0.3</i>	<i>-0.5</i>	<i>-0.4</i>	<i>-0.7</i>	<i>-0.6</i>	<i>-</i>
Expenditure benchmark								
Applicable reference rate ³	1.76	0.6	1.8	1.8	1.08	-0.07	-0.07	-
Deviation ⁴ (% GDP)	1.3	-1.3	-0.7	-0.8	-0.5	0.7	0.7	-
Two-year average deviation (% GDP)	0.9	-0.9	0.4	0.2	-0.9	0.0	-0.1	-

Notes:

¹Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

²Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

³Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A lower rate applies as long as the country is adjusting towards its MTO, including in year t. The reference rates applicable to 2014 onwards have been updated in 2013.

⁴Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A positive sign implies that expenditure growth exceeds the applicable reference rate.

⁵ The Draft Budgetary Plan is drafted at no-policy change scenario and does not provide for explicit budgetary targets for 2014. The figures reported in the column come from Table 2 of the annex to the DBP and reflect, as highlighted in the DBP, the technical consequence of the assumptions retained.

Source:

Stability programme (SP); Draft Budgetary Plan (DBP); Commission services' 2013 Autumn Forecast (COM); Commission services' calculations.

The assumed no-policy change scenario points to a general government deficit of 0.5% of GDP in 2014, compared with 0.6% of GDP in the Stability Programme. According to the Commission 2013 autumn forecast, the general government deficit is expected, on no-policy change basis, to deteriorate to 1.0% of GDP in 2014. The divergence with the Draft Budgetary Plan is explained by the different underlying assumptions about the evolution of certain expenditure items. For instance the DBP projects an almost stagnating public investment in 2014, whereas the Commission forecast projects a more sustained increase, in line with past trends.

On this basis, the recalculated structural balance³ is expected to move from a small surplus in 2013 to a deficit of 0.4 % of GDP in 2014, in both the Draft Budgetary Plan and the Commission 2013 autumn forecast.

3.2. Debt developments

In the October 2013 EDP notification the general government gross debt ratio-to-GDP in 2012 has been revised upwards from 20.8% of GDP to 21.7%, mostly due to a downward revision in the level of the nominal GDP. In the Draft Budgetary Plan the general government debt for 2013 is estimated at 24.9% of GDP compared to 23.8% in the Stability Programme. The difference is explained by (i) a base effect from 2012 from a statistical downward revision in the level of the nominal GDP and (ii) the upward revision in the general government deficit. In the Commission 2013 Autumn Forecast the general government debt is estimated to be lower, at 24.5% of GDP, which is largely explained by a significant higher nominal GDP projection (see section 2).

The general government debt is projected to increase to 26.1% of GDP in 2014 in the Draft Budgetary Plan, compared to 25.9% in the Stability programme and 25.7% in the Commission 2013 Autumn Forecasts. The difference compared to the Stability programme is mostly due to a revision in the figures for the stock-flow adjustment, whereas the divergence with the Commission forecast is explained by the denominator effect as mentioned before.

Despite the upward revision and its increasing trend, the level of the general government gross debt remains low, especially when compared with the euro area average, which is projected at around 96% of GDP in 2014.

Finally the Draft Budgetary Plan reports on the impact of the financial crisis on Luxembourg's public finances. Outstanding public guarantees are equal to 8.8% of GDP, of which 4.9% are related to the financial sector.

³ Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission services on the basis of the information provided in the Draft Budgetary Plan, using the commonly agreed methodology.

Table 3. Debt developments

(% of GDP)	2012	2013			2014		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio¹	21.7	23.8	24.9	24.5	25.9	26.1	25.7
Change in the ratio	3.0	2.1	3.2	2.8	2.1	1.2	1.2
<i>Contributions² :</i>							
1. Primary balance	0.1	0.3	0.3	0.3	0.1	n.a.	0.5
2. “Snow-ball” effect	0.0	-0.3	0.0	-0.5	-0.5	n.a.	-0.6
<i>Of which:</i>							
Interest expenditure	0.5	0.4	0.6	0.6	0.5	n.a.	0.5
Growth effect	0.0	-0.2	-0.2	-0.4	-0.5	-0.5	-0.4
Inflation effect	-0.6	-0.5	-0.5	-0.7	-0.5	-0.5	-0.6
3. Stock-flow adjustment	3.0	2.1	2.9	3.1	2.5	1.7	1.3
<i>Of which:</i>							
Cash/accruals difference		n.a.	n.a.		n.a.	n.a.	
Net accumulation of financial		n.a.	n.a.		n.a.	n.a.	
<i>of which privatisation</i>							
<i>proceeds</i>		n.a.	n.a.		n.a.	n.a.	
Valuation effect & residual		n.a.	n.a.		n.a.	n.a.	

Notes:¹ End of period.² The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.**Source:***Stability programme (SP); Draft Budgetary Plan (DBP); Commission services' 2013 Autumn Forecast (COM); Commission services' calculations.***3.3. Measures underpinning the Draft Budgetary Plan**

As the Draft Budgetary Plan is based on a no-policy-change scenario, it does not contain any information on new measures to achieve the budgetary targets. The budgetary projections presented in the Draft Budgetary Plan should thus be interpreted with caution, given that they do not represent a budgetary policy target. They rather result from a mechanical implementation of the specific assumptions retained.

However, some of these assumptions have not been sufficiently specified and therefore have not been included in the Commission 2013 autumn forecast. As mentioned above, whereas the Draft Budgetary Plan projects an almost stagnating public investment in 2014, the Commission forecast projected a more sustained increase, in line with past trends.

Finally, the Draft Budgetary Plan identifies a one-off measure related to the implementation of the public service wage agreement, according to which a lump sum payment of 0.9% of gross wages would be paid in mid-2014. According to the criteria used by the Commission, however, the lump sum payment is assimilated to a wage increase and as such cannot be classified as a one-off.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Box 2. Council recommendations addressed to Luxembourg

On 9 July 2013, the Council addressed recommendations to Luxembourg in the context of the European Semester. In particular, in the area of public finances the Council recommended to Luxembourg to 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.

4.1. Compliance with the MTO

Taking into account the most recent national accounts and budgetary data, Luxembourg had a structural surplus of 0.8% of GDP in 2012. Luxembourg thus achieved its medium-term objective (MTO) for the budgetary position, a structural surplus of 0.5% of GDP, already in 2012. At the time of the European semester recommendations, the 2012 structural surplus was estimated at 0.1% of GDP, below the MTO.

In 2013 the recalculated structural balance is projected to deteriorate from 0.8% of GDP to 0.2%, according to both the Draft Budgetary Plan and the Commission forecast, below the MTO. The risks for Luxembourg to depart from the MTO are thus confirmed by the Commission 2013 Autumn Forecast.

In 2014, the recalculated structural balance based on the Draft Budgetary Plan is expected to deviate further from the MTO according to both the Draft Budgetary Plan and the Commission forecast namely to a deficit of 0.4% of GDP, implying a gap of almost 1% with the MTO. It should be borne in mind that both sets of projections are made under an unchanged policy assumption, i.e. without a 2014 budget.

According to the information provided in the Draft Budgetary Plan, thanks to the consolidation measures adopted by the government in the 2013 budget, general government expenditure, net of discretionary revenue measures, in 2013 is expected to increase at a slower pace than the reference rate that ensures compliance with the MTO. However, this expenditure restraint will not be enough to compensate for the 2012 deviation from the expenditure benchmark, i.e. to avoid the risk of a significant deviation on average over 2012-2013. Specifically, the two-year average deviation over this period is estimated at 0.4% of GDP when estimated on the basis on information contained in the Draft Budgetary Plan. According to the Commission 2013 autumn forecast the deviation it is estimated at 0.3%.

In 2014 and according to the information provided in the Draft Budgetary Plan, the growth rate of government expenditure net of discretionary revenue measures is not expected to contribute to an annual structural adjustment towards the MTO by 0.5% of GDP. This is because the expenditure growth rate is above -0.07% calculated as the maximum under the expenditure benchmark. The deviation is estimated at 0.7% of GDP and can be considered as significant since it is above 0.5%. This conclusion is confirmed by the Commission 2013 autumn forecast. Again, it should be borne in mind that both sets of projections are pre-budget and rest on a no-policy-change evolution of expenditure.

Following an overall assessment of Luxembourg's Draft Budgetary Plan, with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, there are risks regarding the continued compliance with the MTO as signalled by the drop in the structural balance. For 2014, a significant deviation from the adjustment path towards the MTO can be expected, putting at risk compliance with the requirements of the preventive arm of the Pact, and which would result both from the deterioration in the structural balance (showing a gap of almost 1% of GDP with the MTO) and the non-compliance with the expenditure benchmark rule.

4.2. Other considerations

The Draft Budgetary Plan provides a list of measures that have been already adopted or are planned to be adopted in order to ensure an adequate follow-up of the 2013 country-specific recommendations (CSRs). In order to ensure a full follow-up of the fiscal recommendation (see Box 2), that called for a strengthening of Luxembourg's fiscal governance through the adoption of a medium-term budgetary framework covering the general government, the Draft Budgetary Plan indicates that a draft bill has been tabled in Parliament just before the summer. The adoption of the draft bill, also designed to transpose the provisions of the Fiscal compact, is planned for the end of 2013.

Several measures with regard to other recommendations issued under the European Semester have been adopted in previous years or their adoption has been planned. However, so far no measures have been reported to address the debt-bias in corporate taxation and the widespread application of reduced VAT rate. Still, the political standstill due to the government resignation and anticipative elections blocked the reform process.

5. SUMMARY

Overall, Luxembourg submitted on 15 October a Draft Budgetary Plan based on a no-policy change scenario, due to general elections that took place just after the submission of the DBP. As a result, the budgetary targets contained in the document have to be interpreted more as the result of the implementation of technical assumptions rather than as real fiscal policy targets. According to both the information provided in the Draft Budgetary Plan and to the Commission services' 2013 Autumn Forecast, in the absence of new budgetary measures, Luxembourg is projected to deviate significantly from its MTO in 2014. In addition, there is a high risk that the expenditure benchmark will not be respected.