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Recommendation for a

COUNCIL RECOMMENDATION

on Luxembourg's 2014 national reform programme

and delivering a Council opinion on Luxembourg's 2014 stability programme

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Recommendation for a

COUNCIL RECOMMENDATION

on Luxembourg's 2014 national reform programme

and delivering a Council opinion on Luxembourg's 2014 stability programme

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[2],

Having regard to the resolutions of the European Parliament[3],

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 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, the Council, on the basis of the Commission's proposals, adopted a recommendation on the broad guidelines for the economic policies of the Member

[1] OJ L 209, 2.8.1997, p. 1.
[2] COM(2014) 417 final.
[3] P7_TA(2014)0128 and P7_TA(2014)0129.

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States and the Union (2010 to 2014) and, on 21 October 2010, adopted a decision on guidelines for the employment policies of the Member States, 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.

(4) On 9 July 2013, the Council adopted a recommendation on Luxembourg's national reform programme for 2013 and delivered its opinion on Luxembourg's updated stability programme for 2012-2016. On 15 November 2013, in line with Regulation (EU) No 473/2013[4], the Commission presented its opinion on Luxembourg's draft budgetary plan for 2014[5].

(5) On 13 November 2013, the Commission adopted the Annual Growth Survey[6], marking the start of the 2014 European Semester of economic policy coordination. On the same day on the basis of Regulation (EU) No 1176/2011, the Commission adopted the Alert Mechanism Report[7], in which it identified Luxembourg as one of the Member States for which an in-depth review would be carried out.

(6) On 20 December 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 5 March 2014, the Commission published the results of its in-depth review for Luxembourg[8], under Article 5 of Regulation (EU) No 1176/2011. The Commission's analysis leads it to conclude that Luxembourg is not experiencing macroeconomic imbalances in the sense of the Macroeconomic Imbalance Procedure. In particular, the analysis of the current account surplus shows that it does not stem from anaemic domestic demand, but is rather the result of Luxembourg's particular growth model, which is strongly based on financial services. Risks to the domestic financial stability stemming from the presence of a large financial sector exist but they are relatively contained as the sector is diversified and specialised at the same time. The high level of indebtedness in the private sector, in particular among the non-financial corporations mainly reflects the presence of a large number of multinational firms that use their branches or subsidiaries in Luxembourg for intra-group financing operations. Finally, the current favourable position of public finances is highly dependent on the

[4] OJ L 140, 27.5.2013, p.11.
[5] C(2013) 8006 final
[6] COM(2013) 800 final.
[7] COM(2013) 790 final.
[8] SWD(2014) 84 final.

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sustainability of a growth model based on a buoyant financial sector and presents a high sustainability risk in the long term.

(8) On 28 April 2014, Luxembourg submitted its 2014 national reform programme and on 25 April 2014 its 2014 stability programme. In order to take account of their interlinkages, the two programmes have been assessed at the same time.

(9) The objective of the medium-term budgetary strategy outlined in the 2014 Stability Programme is to return to the medium-term objective in 2016, after significantly deviating from it in 2015. The programme confirms the previous medium-term objective of a surplus of 0.5% of GDP, which reflects the requirements of the Stability and Growth Pact. The (recalculated) structural general government surplus is foreseen to decline from 1.4% of GDP in 2013 to 1.1% in 2014, before turning into a deficit of 0.1% of GDP in 2015. Thereafter, gradually increasing structural surpluses are planned to be achieved. Therefore, Luxembourg is expected to remain at its medium-term objective in 2014, but to significantly deviate from it in 2015. According to the programme, the growth rate of government expenditure, net of discretionary revenue measures, would be above the reference medium-term rate of potential GDP growth in 2015. Overall, the programme objectives are partly in line with the requirements of the preventive arm of the Stability and Growth Pact, with a deviation in particular in 2015. The debt ratio, which stood at 23.1% of GDP in 2013, well below the 60% of GDP reference value, is projected to further decline over the programme period. The macroeconomic scenario underpinning the budgetary projections in the programme, which has been prepared by an independent body (STATEC) is slightly optimistic for 2014 and 2015. The government projects a GDP growth rate of 3.2% in both 2014 and 2015, whereas the Commission 2014 spring forecast foresees 2.6% and 2.7%, respectively. Furthermore, the measures underpinning the fiscal trajectory for the period 2015-18 have not yet been fully specified by the authorities. According to the Commission forecast, which does not take into account the most recently announced measures, the structural surplus is estimated to decline to 0.6% of GDP in 2014 and turn to a deficit of 1.3% of GDP in 2015. The growth rate of government expenditure, net of discretionary revenue measures, is estimated to be above the reference medium-term rate of potential GDP in 2015, when a significant deviation is expected. Based on its assessment of the 2014 Stability Programme and the Commission forecast, pursuant to Council Regulation (EC) No 1466/97, the Council is of the opinion that there are risks to the achievement of the targets of the programme, which are only partly in line with the requirements preventive arm of the Stability and Growth Pact, in particular as of 2015.

(10) The government submitted to Parliament in July 2013 a draft bill on the transposition of the provisions of the Council Directive 85/2011 on budgetary frameworks and the Treaty on Stability, Coordination and Governance. While the draft law was expected to enter into force on 1 January 2014, its adoption was delayed by the resignation of the government in July. According to the draft bill, a new Multiannual Finance Programme Law is introduced covering the same time horizon as the forthcoming update of the Stability programme. The Multiannual Finance Programme Law would be updated annually on a rolling basis, together with the annual budget. It would detail plans to achieve the medium-term budgetary objective at the level of the general government. The draft bill introduces multi-annual ceilings in the Multiannual Finance Programme Law that would cover the

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central government sector only, but there is no specification on the consequences in case ceilings are exceeded. The draft bill does not foresee a national expenditure rule that would guide the setting of multi-annual expenditure targets. However, it contains provisions for the adjustment path to the medium-term objective to be respected. A revised draft of the law was submitted to the Parliament in March 2014, and amongst else provides for the allocation of the task for the independent monitoring of fiscal rules to a newly created institution, the "Conseil National des Finances Publiques".

(11) In addition, tax revenues from VAT will be hit by the new rules on VAT revenues generated from e-commerce activities. As from 2015, such revenues will be transferred from the country where the supplier is located to that of the residence of the customer. The government has announced that the VAT rates will be increased by 2pps, which should partially compensate for the revenue loss. However, given the widespread use of reduced and super reduced rates, additional revenue can be raised by extending the application of the standard rate and thereby compensate more largely for the above-mentioned losses.

(12) Gross public pension expenditure as a proportion of GDP in Luxembourg is to increase, according to figures of the 2012 Commission's Ageing Report, from 9.2% of GDP to 18.6% in 2060. This is mostly due to age-related spending and in particular to pensions. The 2012 pension reform was limited in scope and did not substantially address the threat posed to the long-term sustainability of the public finances. Short-term financing of the pension system is currently guaranteed by a low old-age dependency ratio and relies on the contributions paid by the relatively young population of cross-border workers. In the future, this trend is expected to reverse and pension costs, as well as long-term care costs, will probably increase substantially. In order to guarantee the viability of the pension system, a substantial increase in the contribution rate would be necessary after 2020, in addition to the built-in moderation of the adaptation of pensions to the standard of living. This would entail a significant increase in the burden on labour supported by the future active population and consequently a loss of cost competitiveness. Given the currently high level of the replacement rate, some different measures could have been taken so as to ensure a fairer distribution of the burden across generations. The introduction of a cap on pension adjustments based on real wage increases would increase pension reserves. In addition, increasing the effective retirement age, currently situated at the age of 59, by aligning it to change in life expectancy would help to ensure the long-term sustainability of the pension system. Also, the possibilities for early retirement should be reduced. Financial incentives to prolong working careers, as provided for in the pension reform, may contribute to the sustainability of the pension system, but the employability of older workers should be further improved by reinforcing vocational education and lifelong learning. Luxembourg needs to curb the future need for and related costs of, long-term care to ensure its sustainability. Long-term care services could also be made more cost-effective by strengthening coordination between healthcare and social care, improving service delivery and better supporting family carers.

(13) Luxembourg's large current account surplus is driven by financial services and masks a persistent and gradually increasing deficit in the trade balance for goods, which stems from slow export growth. While this trend reflects the increasing importance of the service sector in the economy, it is also due to a more structural

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loss of cost-competitiveness. The recent steady increase in the unit labour cost has undermined the competitiveness of Luxembourg's industrial fabric. The modulation of the wage indexation mechanism adopted by the government in 2012 will be terminated by the end of 2014. While different avenues could be explored, it is important that wages are more closely tied to productivity by means of a reform of the wage indexation system, allowing for sectoral differentiation. The heavy dependence on the financial sector represents a structural risk for the Luxembourg economy. Therefore, Luxembourg needs to focus on the development of highly specialised firms as a springboard for innovation-driven growth. While the quadrupling of public sector R&D intensity since 2000 reflects the resolve to build up public research capacities, Luxembourg is not on track to reach its 2020 R&D intensity target of 2.3-2.6% of GDP, due to the sharp decrease in business R&D intensity (from 1.53% of GDP in 2000 to 1% in 2012). Its performance on the indicators on cooperation between public research institutions and firms should be further improved. The reform launched in 2013 on the reinforcement of innovative clusters should be pursued.

(14) Although various measures have been adopted, youth unemployment is persistently high, at 17.4% of the active population in 2013, albeit decreasing from 18% in 2012. It depends heavily on educational level and is lower among those with a higher educational attainment. Luxembourg's education system faces a number of specific challenges, such as multilingualism and the specific skills required by a highly specialised labour market with a big financial sector. The results of the OECD's 2012 students' skills survey confirmed that further measures are needed to counteract young people's relatively weak performance in basic skills, as observed since 2006. In this respect, the primary and secondary school reforms should be pursued. In addition, the quality and attractiveness of vocational and educational training should be further improved in order to provide the labour market with a qualified workforce, including in particular people with a migrant background. The design of the tax and benefit system is at the origin of very high labour-market traps, among the highest in the EU, for all wage levels and family compositions. Also, despite recent reform efforts, activation policies remain weak; participation in active labour market policies is not compulsory at any point during the period of unemployment, and there is no requirement to continue job-seeking while participating in active labour market policies.

(15) Luxembourg is committed to reducing its greenhouse gas emissions in the non-ETS sectors by 20% in 2020, but is expected to miss this target by 23 percentage points. In addition, 2013 emissions are expected to be 1% higher than the target set for 2013 in the Effort Sharing Decision. Around 70% of transport-related emissions are connected to fuel exports, inter alia as a result of very low excise duties on fuels. The recognition of fuel export as a key challenge in the second National Climate Action Plan adopted in May 2013 is a step forward. However, more specific and long-term measures are needed to address this issue. Environmental taxation accounted for 2.4% of GDP in 2012, whereas in 2004 it accounted for 3.1 %. This drop is driven in particular by lower energy tax revenues influenced by the absence of indexation on energy taxes. Transport taxes, excluding fuels, represented 0.2% of GDP in 2012. Taxes on fuel used for transport are high at 2.2% of GDP, in spite of the preferential tax treatment of diesel, mostly owing to 'fuel-pump tourism'. With environmental taxation accounting for a below-average proportion of total tax

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revenue, the design of its environmental taxes can be improved, in particular by increasing taxation on energy products for transport.

(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 the 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 (5) below.

(17) In the light of this assessment, the Council has examined Luxembourg's stability programme, and its opinion[9] 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 the basis of this analysis the Council has issued specific recommendations for the Member States whose currency is the euro. Luxembourg should also ensure the full and timely implementation of these recommendations.

HEREBY RECOMMENDS that Luxembourg take action within the period 2014-2015 to:

1. Preserve a sound fiscal position in 2014; significantly strengthen the budgetary strategy in 2015 to ensure that the medium-term objective is achieved and remain at the medium-term objective thereafter, in order to protect the long-term sustainability of public finances, in particular by taking into account implicit liabilities related to ageing. Strengthen fiscal governance by speeding up the adoption of a medium-term budgetary framework covering the general government and including multi-annual expenditure ceilings, and by putting into place the independent monitoring of fiscal rules. Further broaden the tax base, notably on consumption.

2. In view of ensuring fiscal sustainability, curb age-related expenditure by making long-term care more cost-effective, pursue the pension reform so as to increase the effective retirement age, including by limiting early retirement and linking the statutory retirement age to life expectancy. Reinforce efforts to increase the participation rate of older workers, including by improving their employability through lifelong learning.

3. Speed up the adoption of structural measures, in consultation with the social partners and in accordance with national practices, to reform the wage indexation system with a view to improving the responsiveness of wages to productivity developments, notably at sectoral level. Pursue the diversification of the structure of the economy, including by fostering private investment in research and further developing cooperation between public research and firms.

4. Pursue efforts to reduce youth unemployment for low-skilled jobs seekers with a migrant background, through a coherent strategy, including by further improving the design and monitoring of active labour market policies, addressing skills mismatches, and reducing financial disincentives to work. To that effect, accelerate

[9] Under Article 5(2) of Council Regulation (EC) No 1466/97.

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the implementation of the reform of general and vocational education and training to better match young people's skills with labour demand.

5. Develop a comprehensive framework and take concrete measures to meet the 2020 target for reducing greenhouse gas emissions from non-ETS activities, especially through the taxation of energy products for transports.

Done at Brussels,

For the Council
The President

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