Luxembourg—2004 Article IV Consultation

Concluding Statement of the IMF Mission

January 25, 2004

1. A prolonged period of extraordinary economic growth and generally prudent policies leaves Luxembourg enviably well placed to address the challenges that have been brought to the fore by the recent global slowdown in activity. The most immediate among these is the need to adapt fiscal policy to a less buoyant medium-run growth outlook. In our view, the 2004 budget rises to this challenge but would not suffice to durably change the course of public spending over the medium run, as proposed in the latest Stability Program update. The ongoing efforts would thus have to be supplemented in future budgets, starting in 2005, with a consolidation strategy that is supported by further reforms to the social security system and factor markets. In the meantime, a tight hold should be kept on discretionary spending to ensure that the 2004 target for the general government deficit is broadly met. A proactive policy stance on the two fronts—fiscal consolidation and entitlement reform—is essential to preserve the country's virtuous circle of high productivity, strong employment growth, relatively low tax and contribution rates, and rapid output expansion.

Economic Outlook

2. Various indicators suggest that a recovery of activity should be in the offing. In 2004, the global recovery in demand and equity markets is likely to offset the effects of the recent strengthening of the euro on output and thus we project real GDP growth at about 2¼ percent. Inflation would slow, despite oil prices that are not forecast to fall, owing to the relatively more rapid passthrough of the euro appreciation to prices. However, the upturn of activity would not forestall a further increase in unemployment, as the recent declines in productivity and corporate profitability are likely to continue to weigh on firms' hiring.

3. The outlook for activity over the medium run is less certain, however. The appreciation of the euro will cause adjustments that could diminish output growth in the euro area before domestic demand has gained enough momentum. Also, some of the factors underlying Luxembourg's exceptional growth performance—notably that of its financial sector—might be fading. The economy's productivity trend growth rate appears to be already approaching those in neighboring countries. After a further acceleration in 2005 real GDP growth could thus settle well below the high average growth rate of the past two decades.

Fiscal Policy Requirements

4. Fiscal policy should target a balanced central government budget over the medium run—consistent with a modest general government surplus—and avoid a structural increase in the revenue burden. The reason is that structural deficits or tax increases would have deleterious effects on the country's highly mobile labor and capital. On the present medium-run projections for economic growth, such a policy would call for a tightening of public expenditure, which has recently been very expansionary, to maintain the general government

deficit within the 3 percent of GDP Maastricht ceiling and eliminate all deficits soon after the planning horizon of the latest Stability Program. In this regard, we are reassured that there are no plans to base policies on the recently-produced output gap estimates, which suggest that the emerging fiscal imbalances are self-correcting. Such estimates are too imprecise to guide policymaking in an economy with an exceptionally elastic labor supply.

5. The targets in the latest Stability Program for the general government balance—which foresee deficits during 2004-06—are not inconsistent with our policy advice. However, the fiscal effort that will be necessary to meet them is not as strong as that proposed by various euro-area partner countries. We agree that because of the public sector's favorable net asset position there is no compelling reason to resort to more drastic policy changes. Nonetheless, a faster pace of adjustment would safeguard the savings required to meet the rising demands of an aging population without unduly weakening activity, given the openness of the economy.

6. More important than the targets for the budgetary balance are the policies to achieve them. The latest Stability Program proposes to restrain spending on a range of budget categories—especially on public consumption—to limit nominal expenditure growth to an average annual rate of about 4½ percent over 2004-06. The emphasis on expenditure is well placed. However, in our view, the proposed slowdown would not be sufficient to achieve the Stability Program's path for the general government deficit because the revenue targets will be difficult to meet, notably those for the social security system. To achieve the deficit path and remain at a safe distance from the Maastricht deficit ceiling, nominal expenditure growth would have to be contained within about 3½ percent each year.

7. Slowing down spending in a sustainable manner will require a more strategic approach to consolidation. Public consumption alone cannot be reduced sufficiently to keep the public finances on a sound footing without denting the efficiency of government. More importantly, an approach with greater emphasis on cutbacks in subsidies and welfare reforms would contribute to strengthening the virtuous growth circle of the economy. The adjustment strategy should thus be reinforced—starting with the 2005 budget—and include: (i) a continued reprioritization and moderation of public investments, flanked by efficiency improvements through cost-benefit analysis and crossborder coordination; (ii) a cutback of the relatively high level of subsidies, linked also to accelerated restructuring of public transportation services; and (iii) further reforms to the entitlement programs, also to meet the targets for this category in the latest Stability Program, which envisage a considerable deceleration of expenditure. In the meantime, tight control of discretionary spending will be necessary to achieve a general government deficit in 2004 that is close to the 1.8 percent of GDP target proposed in the latest Stability Program.

Strengthening the Social Security System

8. Major progress has been made already in reforming the pension system but further measures are necessary, not only to achieve the medium-run budget targets but also to prepare for the demographic challenges that lie ahead. For old-age pensions, we recommend that a "solidarity factor" link the replacement rate to the contribution base and the statutory

retirement age to life expectancy. The introduction of such a factor would not reduce benefits but it would signal a determination to maintain the country's attractiveness as a place to work and invest in. This would foster a continued expansion of the revenue base that would forestall the need for more drastic entitlement cutbacks in the future, thereby leveraging the efficiency gains from the recent, impressive tax reforms. Furthermore, the "solidarity factor" could ensure a fair distribution across generations of the burden of adjusting to population aging or other economic shocks. Meanwhile, the credibility of the commitment to maintain low tax and contribution rates could be enhanced by a continued accumulation of public sector assets that might later also serve to sustain a minimum pension.

9. Regarding the health care system, further structural reforms are required soon, lest the ongoing accumulation of deficits trigger a potentially harmful hike of payroll taxes. Various measures should be considered, including: (i) raising copayments, which are low relative to neighboring countries; (ii) reducing reimbursements on pharmaceuticals, particularly when generic substitutes are available; (iii) narrowing down the list of eligible services; and (iv) better targeting sickness pay. Furthermore, any scope for rationalizing hospital services, including through greater crossborder cooperation, should be explored.

Reforming the Labor Market

10. High job growth testifies to generally employment-friendly wage setting but the ongoing increase in unemployment is a cause for concern. Many of our interlocutors do not foresee a large reduction in the unemployment rate through 2006, implying that the broad measure of this rate could stabilize near 6 percent. This calls for a renewal of wage moderation, notably in the public sector, where considerable wage hikes have given a fillip to private sector pay and where relatively high entry-level wages are apparently causing "wait unemployment" among young residents. Even more important is a further intensification of the efforts to implement strictly the existing laws governing the eligibility for unemployment benefits and the guaranteed minimum income. However, if these measures prove insufficient to return unemployment to a low level, a scenario that we consider likely, reforms will be necessary. Such reforms should include: (i) permanently limiting increases in the minimum income available to those who are able to work to the rate of inflation; (ii) fully aligning the eligibility requirements governing the unemployment benefits for the young with those of the regular unemployment benefit scheme—as is already the case in many euro-area countries—while possibly allowing young jobseekers to apply for minimum income; and (iii) tightening the criteria in unemployment benefit legislation that define an "appropriate" job.

11. Another important challenge is to raise the very low labor force participation of older workers, which has increasingly deleterious social and budgetary consequences. The recent steps to reform disability pensions go in the right direction and we understand that further refinements are under consideration. However, a more comprehensive approach seems necessary. Such an approach should be centered on a stronger program to foster on-the-job training, funded mainly by employers and workers. In addition, eligibility criteria for sickness pay and access to the employment fund need to be tightened; actuarial fairness should be introduced in the pension system to eliminate any financial incentives for early

retirement; and an unlimited rollover of temporary work contracts could be allowed for newly-hired, older workers. A further measure to consider would be to unify the duration of unemployment benefits at 12 months. This would foster a more rapid return of older job seekers to the labor market and thereby limit any atrophy of skills. In exchange, the benefit replacement rate for those who have contributed longer could be raised.

The financial sector and product markets

12. Banks and insurance companies have weathered well the recent global slowdown in activity and the bursting of the equity bubble, validating the FSAP assessment that the financial sector is robust, efficient, and well supervised. Various indicators suggest that business volume and profitability have already begun to recover. And the recent creation of the University of Luxembourg, notably the expansion of educational programs covering the financial sector, should help in building the country's know-how advantages. Nonetheless, a return to the growth rates of the end of the 1990s is not expected for several reasons: the imbalances created by the global equity bubble are taking time to unwind, global competition and consolidation are intensifying, and savings taxation is being harmonized.

13. As international competition intensifies, so will the challenges facing the supervisors. Since the 2002 FSAP, impressive steps have been taken to strengthen supervision further, notably through the hiring of more staff, more on-site inspections, and the increased use and refinement of stress tests. Given the importance of the reputation of the financial sector for the economy, this development should continue, particularly to support intensified supervision of the insurance and re-insurance sectors. One important challenge facing all supervisors is to combat money laundering and the financing of terrorism (AML/CFT). According to a recent AML/CFT assessment by Fund staff, a comprehensive legal and implementation structure is in place. As usual, such an assessment will include recommendations for further improvements and we understand that measures are already under discussion to that effect, including a new draft law. Given the relatively large scale of crossborder business, it would be important that the laws and requirements regarding AML/CFT continue to reflect the highest international standards.

14. A competitive environment for business has served the economy well. The ongoing efforts to reform the competition law and foster entrepreneurship are welcome. Also, we would encourage continued strong support for liberalizing trade and reforming agriculture.

Other issues

15. The statistical database has already been improved considerably and we welcome the progress toward subscribing to the IMF's Special Data Dissemination Standards.

16. The high level of support for official development assistance is commendable.

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We would like to thank all our interlocutors for the discussions and their warm hospitality.