

Assessment of long-term fiscal sustainability

In May 2021, the Working Group on Ageing Populations and Sustainability (AWG) of the European Commission (EC) has published updated demographic, economic and budgetary projections for EU member states within the framework of the Ageing Report (AR) 2021. In this context, the Luxembourg National Council of Public Finance (CNFP) has just published an **Assessment of long-term fiscal sustainability**, its third evaluation of this kind and that follows two earlier evaluations from October 2017 and June 2018. The CNFP analyzes the impact of these new projections on long-term fiscal sustainability in Luxembourg as well as on the level of the medium-term budgetary objective (MTO).

Regarding fiscal sustainability, long-term challenges arise in particular due to the projected evolution of age-related spending. Indeed, these expenditures are expected to rise from 16.1% of GDP in 2021 to 24.6% of GDP in 2070, which represents an increase of around one third (8.6 % pts of GDP). Compared to the AR 2018 projections, which predicted an increase of 11.8 % pts of GDP, these updated projections are lower although still significantly on the rise. In an unchanged policy scenario and under the assumptions of the AR 2021, the public debt ratio would exceed the threshold of 30% of GDP in 2047 while the “Maastricht” threshold of 60% of GDP would be exceeded in 2055. Thereafter, the ratio would increase sharply to reach 168% of GDP in 2070. In order to stabilize the public debt ratio (sustainability indicator “S2”, fully explained in the assessment), a lasting improvement in the primary structural balance¹ of +7.0 % pts of GDP would be necessary (knowing that the latter is already supposed to reach +1.3% of GDP over the whole period). According to the criteria of the EC (the critical threshold being fixed at 6 % pts of GDP), Luxembourg is exposed to a high risk for long-term fiscal sustainability, while the risk is non-significant in the short and medium term.

The CNFP points out that the results of the analysis of long-term fiscal sustainability should be interpreted with caution and should be considered as a trend or an order of magnitude, rather than forecasts. The projections of the AR 2021 are established under the hypothesis of constant legislation and hence bypass the fact that various social security schemes - pensions, health care, long-term care - provide for the application of automatic stabilizers intervening at specific times that might mitigate the increase in related costs. This includes, among others, the submission of a special law that allows increasing the contribution rates as soon as the pension reserves fall below a certain threshold. In addition, the pension reserves in the *Fonds de Compensation*² (currently representing 35.7% of GDP) are not considered in the projections of the AR 2021.

Furthermore, several assumptions made in the projections of the AR 2021 are subject to a high level of uncertainty. This includes, among others, the demographic hypothesis of a lower migration (resulting in 788,000 inhabitants in 2070 instead of 1,035,000 inhabitants as projected in the previous AR, dating from 2018) combined with the hypothesis of a strong increase in cross-border employment (rising above 50% of total employment³ from 2031 onwards) and a downward adjustment of the coefficient of the readjustment mechanism of pensions (0.25 instead of 0.5 in the AR 2018). The latter is the rate of adaptation of pensions to the real evolution of wages, which is, even though incorporated in the projections, not yet decided at the political level. In addition, the AR 2021 projections include methodological revisions leading to a reduction in ageing costs (in particular, the revision of the System

¹ Primary structural balance = nominal general government fiscal balance (i.e. the difference between government revenue and expenditure) corrected for the effects of fluctuations in economic conditions and corrected for one-off and temporary measures and excluding interest payments on public debt.

² Created in 2014, the *Fonds de Compensation commun au régime général de pension* manages the compensation reserves through a diversified portfolio that is subject to return and risk criteria in order to guarantee the long-term viability of the general pension insurance scheme of the Grand Duchy of Luxembourg.

³ Considered in full-time equivalents.

of Health Accounts that allowed the elimination of double counting and overestimation as well as the fact that unemployment expenditure is not anymore considered as ageing costs).

These considerations led the CNFP to simulate several alternative scenarios, in particular one which is based on the long-term macroeconomic and demographic projections of STATEC (and not of the EC). In this scenario, projections are established with a methodology that establishes a link between economic growth and population growth. In this scenario, the S2 sustainability indicator would pass from 7 to 5 % pts of GDP, and hence below the critical threshold of 6 % pts.

Bearing in mind all these clarifications, the CNFP reminds that the minimum MTO for the EU member states for the period from 2023 to 2025 will be set by the EC in spring 2022 and will be determined in particular on the basis of the projections of the AR 2021. The Luxembourg Government needs to take the suggested minimum level into account while setting its own MTO as part of the update of the SGP in April 2022. According to the 12th July 2014 law on the coordination and governance of public finances, the monitoring of the achievement of the MTO set at the national level underlies the CNFP.

According to a preliminary estimate by the CNFP, based on today's available macroeconomic information and the underlying assumptions of the AR21, the minimum MTO would be 0.0% of GDP for the period from 2023 to 2025, and therefore at a level lower than the current MTO of +0.5% of GDP (2020-2022). However, it must be clearly pointed out that this estimate does not have universal validity and does not appear as a reference value put forward by the CNFP for a future fiscal policy.