

Public Finance assessment of the 2023 Stability and Convergence Programme

Spring 2023

The macroeconomic and budgetary figures presented in the 2023 Stability and Convergence Programme ("SCP") can be summarized as follows:

- The Luxembourg economy is expected to grow by 2.4% in 2023 and 3.8% in 2024, following an economic growth rate of 1.5% in 2022. This economic trend in Luxembourg compares favorably with the economic trend in the euro area, where the economy is expected to stagnate in 2023 and to grow by 1.8% in 2024, following an economic growth rate of 3.3% in 2022. With regard to inflation, under the effect of the measures decided at the "tripartite" meeting of March 3rd, 2023, the 2023 SCP forecasts a clear slowdown in inflation in 2023 (3.4%) and 2024 (2.8%), after very high inflation observed in 2022 (6.3%, the highest rate since 1983). In 2025, inflation should rebound slightly (3.4%), before falling back below the 2.0% mark in 2026 and 2027. On the labor market, the 2023 SCP forecasts a slowdown in job creation (from 2.7% in 2023 to 2.2% in 2027) and a rise in unemployment rate (from 4.9% in 2023 to 5.7% in 2027).
- With regard to budgetary forecasts, the nominal balance (i.e. the difference between budgetary revenues and expenditures) is expected to reach -1.5% of GDP in 2023 and -1.7% of GDP in 2024, i.e. an estimated deficit of 1 224 and 1 517 million euros respectively. In the medium term (2025-2027), the nominal balance would improve only slowly towards -0.9% of GDP or -887 million euros in 2027. In addition to the fact that the deficit of the central government would still remain in 2027 (-1 613 million euros vs -2 351 million euros in 2023), the surplus of the social security is set to fall almost continuously from 1 097 million euros in 2023 to 573 million euros in 2027. Nevertheless, the social security surplus is more favorable than forecasted a year ago.
- Public debt should continue to rise in absolute terms over the medium term, reaching 29 007 million euros, or 29.0% of GDP in 2027.

The CNFP made some observations (which are explained in detail in the respective sections of the assessment) concerning the macroeconomic and budgetary forecasts.

On the **macroeconomic** side:

- The 2023 SCP forecasts a significantly more favorable economic trend for Luxembourg (2023: 2.4% and 2024: 3.8%) than the International Monetary Fund ("IMF") in April (2023: 1.1% and 2024: 1.7%) and the European Commission ("EC") in May this year (2023: 1.6% and

2024: 2.4%). In its recent Economic Outlook (“Note de conjuncture 1-2023”), STATEC also revised its growth forecasts downwards (1.5% in 2023 and 2.5% in 2024). In addition, the growth of the Luxembourg economy in 2022 has been revised downwards in the SCP 2023 compared with the forecasts made by STATEC in its Medium-Term Projections 2023-2027 in February (1.5% vs. 2.5%).

- The international scenario on which the 2023 SCP is based also deviates from the forecasts of other international institutions (IMF, EC, European Central Bank “ECB”). This is particularly true in 2023, when the 2023 SCP forecasts a stagnation of activity in the euro area, while the other international institutions are forecasting weak growth of around 1%.

The CNFP must point out that the economic growth forecasts for Luxembourg published in the 2023 SCP are likely to be over-optimistic in the light of the most recent forecasts published by other international institutions and STATEC, considering the risks and uncertainties surrounding the economic environment.

On the **budgetary** side:

- In 2022, the central government balance (-723 million euros) shows an improvement of 636 million euros compared with the forecast made in the multiannual financial programming law for the years 2022-2026 (“LPFP 2022-2026”). This seems to confirm the result of the *Evaluation de la fiabilité des prévisions macroéconomiques et budgétaires* published by the CNFP in May 2023. This analysis highlighted a significant distortion in the forecasts of the nominal balance of the central government over the period 2007 to 2021, this in form of an underestimation of around 500 million euros on average per year for the forecasts of one fiscal year compared with the observations made a year later for the same period.
- In 2023, the CNFP notes the sustained growth in direct and indirect investments (+22.1%) of the central government. These investments risk however to be overestimated and CNFP refers again to its analysis from May 2023, in which it found a statistically significant overestimation of investments over the period 2007 to 2021.
- In 2024, the central government deficit is expected to reach 2 457 million euros, corresponding to a further deterioration in the balance compared to 2023 (amounting to 106 million euros), despite a reduction in the budgetary impact of the measures decided at the “tripartite” meetings in the amount of 709 million euros. The CNFP considers that revenues could be underestimated (in particular, current taxes on income, wealth, etc., which would only increase by 4.2% if the

measures were deducted), while direct and indirect investment could be overestimated, which would hence lead to a smaller deficit balance.

- The budgetary envelope for the packages of measures agreed on during the “tripartite” meetings is likely to be overestimated, what could have a positive impact (i.e. an improvement) on the budget balance.
- In the medium term (2025-2027), the central government deficit is expected to reach 1 722 million euros on an annual average basis. Hence, the medium-term revenue growth rates (5.3% annual average) forecasted in the SCP 2023 would not be able to offset the substantial growth rates of expenditures over the 2022-2024 period (8.9% annual average), even if the latter are expected to grow at an average rate of 3.9% over the medium term.

Given the public deficit forecasts for the entire period under review (2023-2027), the CNFP must point out that the evolution of public finances risks jeopardizing the budgetary room for manoeuvre in the event of a worsening of the macroeconomic conditions or in the event of a subsequent crisis. This is particularly true given the downward rigidity of a large proportion of expenditures and an increasing debt and its financing costs. In the long term, public finances are challenged by future spending related to an ageing population but also by the additional costs required for housing, energy transition, mobility and defense, among others.

With regard to the budgetary governance rule, the CNFP takes note of the Government's use of the “exceptional circumstances” clause for the year 2023 provided for in Article 6, Paragraph 1 of the amended law of July 12th, 2014, on the coordination and governance of public finances. The structural balance (i.e. the cyclically adjusted nominal balance corrected for one-off and temporary measures) of the general government, which is expected at -0.80% of GDP in the SCP 2023, may therefore diverge from the medium-term budgetary objective (“MTO”) of 0.00% of GDP in 2023.

By 2024, Luxembourg's public finances would no longer be in line with the legal provisions currently applicable at national level. In fact, the structural balance is projected at -1.60% of GDP, well below the MTO of 0.00% of GDP. The same conclusion can be drawn for subsequent years (2025-2027) considering the current forecasts. It should be emphasized, however, that this is only a preliminary finding which 1) would only become definitive in October 2025 for the year 2024 (and in October 2026 for the year 2025 and so on) and which 2) is based on the currently applicable legislative framework. However, this framework is currently being reformed and on April 26th, 2023, the European Commission presented legislative proposals for the reform of economic governance rules. According to these proposals, the

current rules (based on the MTO and structural balance) would be replaced by a single operational indicator anchored on public debt sustainability, notably through a medium-term adjustment path for primary public spending (i.e. excluding public spending on interest payments on public debt).

Notwithstanding the uncertainty of the fiscal governance framework that would apply from 2024 onwards, and given the plurality of challenges for public finances mentioned above, the CNFP expresses the opinion that the competent budgetary authorities must monitor the evolution of public finances, which are characterized by a downward rigidity in current expenditures and a rising public debt.