SGI Sustainable Governance Indicators

2014 Luxembourg Report

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Executive Summary

For more than three decades, Luxembourg's GDP growth rate as well as rate of job creation was ranked among the top performers in the European Union. Yet both have since decreased considerably and during the review period, a key theme was concerns over the competitiveness of Luxembourg's economy.

Since 2010, tripartite negotiations – between the government, employers' organizations and trade unions – failed to produce desired compromises. The government in response replaced these talks with bilateral consultations. While the country's traditional collaboration between social partners and the government had proven itself effective during times of growing prosperity, in times of crisis and austerity, such tripartite talks have not proven to be an efficient basis for determining future policy.

Luxembourg's strong economic performance over years gave authorities the means to build an outstanding welfare system with generous insurance plans, benefit schemes and services, such as the recently expanded health care sector. Levels of replacement revenues exceed Scandinavian standards, and could easily be seen as an incentive to leave professional activity. In recent years Luxembourg's traditional corporatist philosophy has become more and more universal, with liberal views increasingly rare. The welfare state has expanded over the past two decades, while at the same time neighboring countries were cutting back benefits. Luxembourg has not yet enacted any rigorous austerity policies (leading up to elections scheduled for May 2014) but has adopted only minor changes to the country's pension regime and general employment rules.

The financial crisis hit Luxembourg later than in other European countries. Since 2009, certain marginal-employment groups suffered some job losses, but these numbers didn't immediately affect national employment statistics. The most seriously affected were workers with interim agencies (mainly cross-border commuters) and cross-border commuters in regular employment. Some companies closed as a result of the crisis and the financial sector came under pressure but still continued to generate positive results while cutting back higher-paid staff.

Legislation regarding the automatic exchange of information in banking however poses an interesting challenge for this sector. Authorities have pretended that banks are prepared for the end of banking secrecy, while the bankers' association (Association des Banques et Banquiers, Luxembourg, ABBL) has highlighted future opportunities, in an attempt to minimize the expected impact of the automatic exchange of information on their businesses.

Democratic representation is low among Luxembourg's resident population, 45% of which are foreigners; the economy is essentially supported by this group, which includes commuters and resident migrants at all levels. Employers and non-governmental organizations (NGOs) have made a plea to the government to allow resident migrants to vote in national elections, with the aim of reconciling the "pays réel" with the "pays legal." Luxembourg may be the only country in Europe to attempt such a widening of the electoral population. While Luxembourg cannot claim a large cache of internal expertise, the government, social partners and civil society organizations do seek on important issues expertise from abroad.

A number of groups within Luxembourg are working to formulate a plan for the country's future, as general information about how well or poorly Luxembourg fares on many issues is surprisingly lacking. Issues concerning welfare, technological expertise, the country's ratio of professionals to general population need further research. Interestingly, Luxembourg's existing purchasing power exceeds even Scandinavian countries; yet poverty levels are high before social transfers. After transfers, however, Luxembourg performs better yet not perhaps as well as one would imagine, given its strong welfare state. In terms of Gini scores, Scandinavian countries score better.

Key Challenges

Isolating the effects of the global financial crisis, a small country such as Luxembourg will face a number of specific challenges in the near future. The competitiveness of Luxembourg's economy is a key concern. Internal issues include high wages that are linked to the country's salary index mechanism (similar to other automatic financial adaptations); generous welfare provisions; and failed tripartite negotiations during the review period. External issues include the change to VAT rules for e-commerce and the implementation of the automatic information exchange on capital income for the banking sector.

These issues have during the period inspired the need to discover new economic niches to help replace the considerable contribution of these sectors to the public budget. The Luxembourg Cluster Initiative, powered by the national research agency, Luxinnovation, identified several sectors as important for the future sustainable development of Luxembourg's economy: health care and biotechnology, information and communication technology, materials technology, space technology, logistics, maritime activities and the establishment of alternative investment funds, including private equity funds.

Luxembourg's domestic labor market is the most transnational among OECD states; yet it is also highly segmented, as the private sector is run by foreigners (80%) and the public sector is run by nationals (90%). The European Court of Justice has required that Luxembourg open up employment in the public sector to address the discrimination of EU citizens. This could also improve the performance (be it analysis, planning or management) of public administration.

Including non-nationals in the democratic process would improve parliament's representative mix and would strengthen non-nationals' identification with "their" country. Citizenship is obviously not the only tool to foster inclusivity. The wish of non-nationals to participate has been evident with the launch of civil society initiatives that concern the country's future.

Luxembourg's outstanding yet overly generous welfare provisions – mainly pensions but also in health care – need to be revised as well as reduced through a package of retrenchment policies. For years now the OECD and the European Commission have criticized Luxembourg's pension system, as it is founded on overly optimistic economic growth projections and the rejuvenating effect of migration inflows, which Luxembourg did enjoy for decades, avoiding the pressures of an aging population like in other European countries. Numerous incentives for early retirement also need to be tackled; in general, the populace needs to come to terms with full and longer participation in the labor market.

But the overall mentality in Luxembourg remains corporatist. Before scheduled elections in June 2014, the government will probably not pursue bold reforms in these areas. Additionally, schools reform is badly needed to provide Luxembourg's youth with the necessary skills to enter the country's highly competitive labor market. For years nationals have lost out as cross-border commuters and migrants accept lower wages, offer higher flexibility and have often higher levels of education. As more migrants and commuters are hired in private firms, this leads to the recruitment of more of the same, and nationals lose out. Thus, the schools reform needs to be implemented.

Policy Performance

I. Economic Policies

Economy

Economic Policy
Score: 7

Luxembourg has been for some time ranked highly on international competitiveness indices, but during the review period its position has slipped. The International Institute for Management Development's (IMD) index from position 11 (2011) to 13 (2013). The country's scored positively on policy stability and predictability, a competitive tax regime, a skilled labor force, a predictable legal framework and a business-friendly environment. Yet the automatic information exchange on capital income will be implemented in January 2015 and is expected to impact the financial sector, which provides a third of Luxembourg's GDP. The European Union is also in the process of modifying the VAT regime for electronic commerce to the detriment of Luxembourg, which is home to many e-commerce companies because of its favorable tax rates. This will lead to a loss of tax revenue, obliging the government to increase its general VAT rates. New hubs and clusters have been created in an effort to add new revenue sources as the financial sector's power diminishes. The Luxembourg Cluster Initiative covers priority sectors for the Luxembourg economy: life sciences, eco-technology, information and communication technology, materials and production technologies, space technology, logistics and maritime activities.

To grow, Luxembourg needs to increase its labor force with highly skilled workers. According to employers' organizations, the government needs to focus policy on accelerating administrative work and procedures as well as tackling the country's excessive inflation rate through the abolishing of the automatic salary index mechanism, which raises wages automatically according to inflation rates. This would also help the unemployed get back to work as well as encourage other reforms of the education system and of pensions.

The country’s generous welfare model has to be reformed to adapt to a reality of more modest public resources and budgets. While the European Commission in its evaluation of Luxembourg’s Stability Program 2012 – 2015 agreed with this macroeconomic scenario, it highlighted concerns over the country’s overly optimistic economic growth outlook and its inability to address early retirement and pension reform, not to mention for more in terms of the limited application of the country’s salary index mechanism.

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Labor Markets

Labor Market Policy
Score: 7

The gradual loss of industrial jobs in Luxembourg was more than compensated over time by a gain in services. More moderate wage development has been made possible by the postponing of a new index tranche (January 2012). Luxembourg’s labor market is highly regulated, yet too many incentives in the marketplace result in high early exit rates. Only 29% of the workforce is Luxembourg nationals, while more than 43% is so-called transborder commuters (frontaliers), a circumstance that guarantees high flexibility and short-term fluctuation in the labor market. Because of the steady growth of the resident population via a high inflow of economic migrants and corresponding national employment, the unemployment rate has increased only moderately to 6.7% as of May 2013.

After three decades of strong economic growth and modest GDP growth, the period under review saw even qualified workers losing their jobs. Those who suffered first as a result of the global crisis were workers with limited employment contracts and those with the shortest work records at a firm, such as those who worked for interim agencies and cross-border commuters. Luxembourg employment protections are significant for full-time employees. For the cross-border labor market, commuter transfers from the units of the Greater Region – which includes aside from Luxembourg the adjacent regions of Belgium, Germany and France – are crucial, as these groups do not necessarily show up in unemployment statistics. As part of EU regulation 883/2004, which covers the coordination of social security systems within the European Union, Luxembourg has to reimburse the member state for the first three months' payments of unemployment benefits (which is handled by and paid according to the laws of the country in question).

Luxembourg's youth unemployment levels are low compared with the rest of the European Union (18.2% as of April 2013), yet the government has still enacted a plan to help boost youth employment (Plan d'action en faveur de l'emploi des jeunes) to especially assist young graduates having trouble adjusting to working life. The state Employment Agency has also responded with new measures for young university graduates. Other initiatives include a youth-employment center (established in 2012), strategic plans to push lifelong learning programs and regional employment services.

Because of a significant expansion in social care services for children and the elderly as well as the implementation of the European Employment Strategy, more women have entered the workforce during the period. The employment rate of workers 50 years old or older, however, is 40%, which is far below the EU average and national goals – a situation that is maintained by the many incentives for older workers to leave the labor market.

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Taxes

Tax Policy
Score: 7

Luxembourg was particularly affected by the financial crisis and its public deficit has grown. From 2011 to 2013, the deficit rose from 18.2% to 23.6% of GDP. GDP growth in 2012 was 1%, from 3.5% in 2010. Luxembourg responded to the crisis with fiscal adjustments, including increasing the withholding tax to 35% in 2011, and in 2013, increasing a special solidarity tax, which is paid on income tax liability, from 5% to 7% (or to 9% for high-income earners and commercial entities). In December 2011, the government decided to suspend the automatic wage indexation mechanism and to allow for only one annual increase. Furthermore, the composition of the index will be changed. In 2011, the top tax rate was increased by 1% to 40%.

A PriceWaterhouseCoopers (PWC) 2012 business report ranked Luxembourg favorably. At 21%, the total tax rate (after deductions and exemptions) is the lowest among European and European Free Trade Association countries. Luxembourg's taxation system is still attractive for businesses, and only some 20% of companies actually pay business tax. To maintain the competitiveness of the financial sector, the government decided not to introduce a tax on financial transactions (the Tobin tax). At 15%, Luxembourg offers the lowest VAT in Europe; supported by the consumption of cross-border commuters, around 24% of the state budget comes from VAT revenue.

The government has also taken some restructuring measures to improve the country's economic attractiveness to foreign investors. Luxembourg extended an exceptional tax deduction for eligible costs of highly skilled migrant workers. International companies can deduct expenses over a period of five years. Furthermore, in 2013 VAT declarations will be simplified by an electronic information system (eVAT).