

## Economic Survey of Luxembourg, 2006

**What can be done to prepare the economy for lower growth in the long-term?**

**How should public finances be consolidated?**

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### Summary

The Luxembourg economy has regained its footing after the sharp slowdown at the start of the decade and is now growing at around its trend rate of 4-4½ per cent. The financial-services sector, which accounts for nearly one-third of economic activity, has benefited from the return of confidence in capital markets. Nonetheless, there are signs that the conditions for long-term economic growth are becoming less favourable. Output growth has not returned to the extraordinarily fast rates of the 1980s and 1990s, the dynamism of real incomes has declined, productivity growth has slowed, the fiscal situation has deteriorated and inflation has remained higher than in the main trading partners. This *Survey* analyses these challenges and outlines measures to prepare for changing times.

**A worrying sign of strain is the deterioration of the fiscal position, caused by the rapid growth in public expenditure.** The authorities have rightly announced that they will bring the budget back to balance by the end of the current legislature, i.e., in 2009 at the latest. To achieve this goal, it will be important to rein in the growth of public salaries and social benefits. This should start in earnest in the 2007 budget.

**Another source of concern is the weakening of the pension system, which appears unsustainable under present rules.** This results from the maturing of the system as well as the forthcoming increase in average effective replacement rates. The government should undertake reforms to put the pension system back on a sustainable path. These include indexing the age of retirement to life expectancy, reducing incentives for early retirement and pre-funding future pension promises by accumulating a large, actively-managed pension reserve.

**Despite strong employment growth, unemployment is rising.** Employers prefer to recruit cross-border workers, who accept lower salaries than residents. To reverse these trends, labour market institutions that drive up reservation wages should be reformed, in particular high unemployment

*This Policy Brief presents the assessment and recommendations of the 2006 OECD Economic Survey of Luxembourg. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.*

replacement incomes. In addition, activation measures are to be reinforced and a review of the public employment service (ADEM) has been commissioned with a view to restructuring it to match job-seekers and job vacancies more effectively.

**Enhanced human capital development would strengthen productivity growth and improve lower-skilled residents' employment prospects.** There is considerable scope to improve education achievement and attainment, which are below the OECD average, especially for children of immigrants and low socio-economic backgrounds. While much has been done to help these children cope with Luxembourg's trilingual education system, more could still be done. There are other reforms that would improve education outcomes, notably reducing selection at early ages and avoiding widespread recourse to grade repetition.

**Strengthening product market competition would also help to lift productivity growth.** Institutions to enforce competition were recently established, but they do not seem to have a sufficiently broad mandate to impose significant changes. Anti-competitive practices in professional services need to be tackled. In retail trade, barriers to entry should be eased and shop opening hours liberalised so as to reap the benefits of a potentially fast expanding sector. ■

### What can be done to prepare the economy for lower growth in the long-term?

The economy has regained its footing after the disruptive events at the start of the century, and is currently undergoing a sustained recovery. Output growth rose to around 4% in both 2004 and 2005, which is near the trend rate, and the short-term outlook is one of continued dynamic growth in 2006. The financial services sector (which represents around 30% of value-added) has recovered from the bursting of the stock market bubble, with investors regaining confidence in equity markets. The sector has also escaped unscathed from the introduction of a withholding tax on interest income, which does not appear to have deterred non-resident customers. Employment gains have been correspondingly robust (about 3% annually in the past two years) especially in financial institutions, but also in associated activities such as business services.

Nonetheless, there are signs that long-term economic conditions are becoming less favourable. Real GDP growth has not returned to its previous brisk pace, the dynamism of real incomes has abated, trend productivity has decelerated, the fiscal situation is under strain and inflation has remained higher than in the main trading partners, with adverse consequences for competitiveness. The very high growth of the 1980s-90s was underpinned by specialisation in fast growing, high value added sectors, notably financial services. Financial market liberalisation in OECD countries and other factors came together to support expansion in the global financial services industry and Luxembourg offered regulatory and tax advantages that enabled its financial sector to grow particularly quickly. As the transition draws to a close, trend growth may slow further, bringing it closer to the European average. In view of these prospects, it would be prudent for the government, to prepare the economy for changing times, notably by investing in the human capital development of children, including those from immigrant and lower socio-economic backgrounds. ■

### How should public finances be consolidated?

An obvious sign of strain in the economy is the deterioration of public finances from comfortable budget surpluses during most of the 1990s to a deficit of 1.9% of GDP in 2005. This deterioration is largely of a structural nature, as shown by the failure of the deficit to fall during the current upswing. If it continued, this fiscal trend would risk undermining macroeconomic stability and low taxation of labour incomes, which has been so important in the past, notably in attracting foreign investors and workers. The authorities are committed to bringing the structural budget close to balance by 2009, which would imply an improvement of 0.5% of GDP on average every year until the end of the current legislature. To this end, the government and social partners have signed a tripartite agreement that aims to curb the growth of public expenditure, including by deferring (without catch-up) the indexation of salaries and benefits and reducing public investment programmes. Curbing spending growth is essential, in particular that of social benefits, which are the largest category of public expenditure and were boosted by the introduction of new entitlements (such as *congé parental*) and the widening of existing ones (such as the *Rentendösch* pension reform). Most benefits have very high replacement rates by international comparison. *Therefore, future budgets should avoid introducing new entitlements or expanding existing ones, and should temporarily suspend the adjustment of benefits to real wages.*

Among social entitlements, health care spending has been the most dynamic. Spending per capita has risen faster during 1997-2003 in Luxembourg than in any other OECD country (when converted at purchasing power parity). Pressure has emerged in the budget of the *Union des Caisses de Maladie* and contributions had to be hiked. This fast pace of growth is mainly explained by a fast expanding cross-border labour force covered by national social security institutions, by the introduction a long-term care scheme (*assurance dépendance*) and by the decision of the authorities to build new hospitals, which have provided expanded choice to patients but also permanently increased spending. *As an alternative to establishing additional in-patient institutions so as to cover the full range of medical treatments, the authorities should foster co-operation with healthcare suppliers in regions of neighbouring countries; this would help to reduce the duplication of hospital services.* As well, the number of doctors has risen rapidly, as have their fees, now that they are indexed to the economy's nominal wage rates. While controlling outpatient care expenditure is a problem across the OECD, *the authorities should consider introducing a gatekeeper system, entrusting general practitioners with the decision to refer to specialists; this may help to reduce future growth in ambulatory-care spending.*

Another reason behind the strong growth in public expenditure is the momentum of the government wage bill. The civil service is not oversized by international comparison, but individual wages are high and have strong dynamism partly reflecting automatic seniority-based increases. So as to slow this dynamism, the government has decided to freeze public sector pay scales in 2007 and 2008. Existing rules on the mobility of employees across government agencies are rigid, making it difficult to respond to the changing nature of demand for public services. *Hence, the management of the public service should be made more flexible, so as to facilitate the reallocation of human resources as well as to introduce elements of an incentive-based performance evaluation system.*

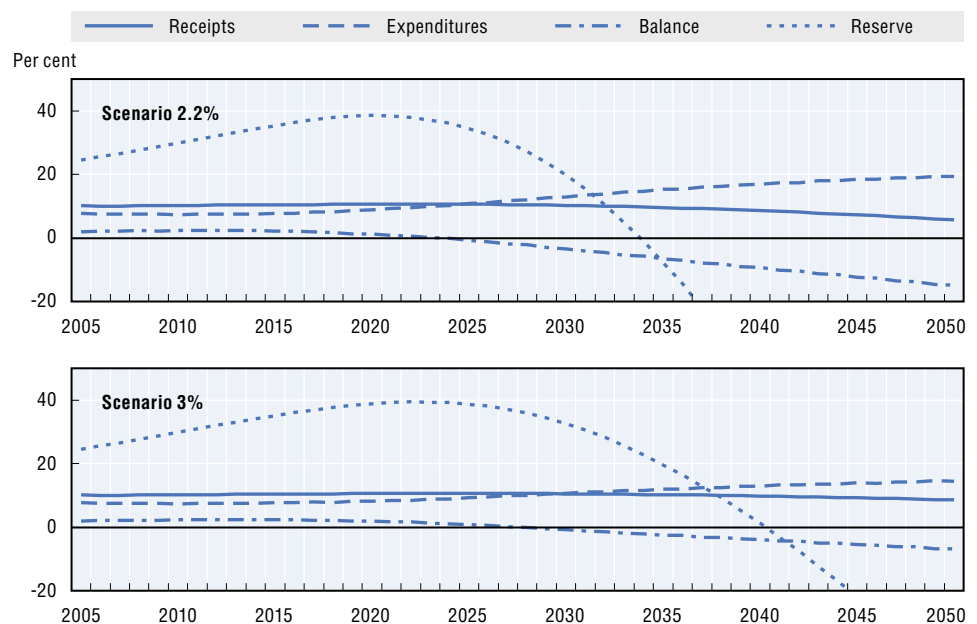
There are other budget management practices that could be made more efficient. First, the government continues to submit to Parliament a budget that is essentially limited to the revenues and spending of the central government during the next year; it thus fails to assess the medium-term trends of the budget and to present the financial interactions with the social security system, which are very intricate in the case of Luxembourg, in a fully transparent way. *The government should submit to Parliament a budget that assesses the medium-term trends of the general government and encompasses the social security system.* Second, the government continues to request authorisations for line-by-line credits, thus stressing the requested financial means rather than the ultimate policy objectives. *The budgetary framework should adopt an outcome-based approach, which focuses on final objectives and provides a fungible sum of money to budget managers, with responsibility to achieve these objectives.* Third, public investment projects are carried out by 29 "special funds" responsible for a large variety of tasks. A strength of these funds is that they can carry forward unused resources to the next year, thus avoiding end-of-year spending splurges. On the other hand, they lead to rigidity in budgetary execution because resources cannot be reallocated, if so needed. *The number of "special funds" should be reduced so as to foster fungibility of resources.* ■

**How can the pension system be made sustainable?**

Although the social security pension scheme appears to be in good financial shape for the time being, it is projected to mature progressively and incur large liabilities after 2030, when the ratio of contributors to beneficiaries will become much less favourable. Moreover, many current beneficiaries who now have incomplete contribution records – notably women, cross-border workers and migrants – will acquire rights to fuller pensions. As well, longer life expectancy means that pensions will be paid for a longer period than at present, thus increasing future spending. If nothing is done, liabilities could accumulate and reach between 49% and 151% of GDP by 2050, depending on the future rate of growth of real GDP. The financial position of the social security system will initially deteriorate at a gradual pace, providing breathing space for reform which, if implemented rapidly, could re-establish the long-term viability of the system without causing disruptive adjustments.

The bunching of pension promises after 2030 calls for pre-funding of future payments. In this regard, *pension replacement rates should be reduced so as to lower expenditure and accumulate financial assets equivalent to between 70% and 100% of GDP by 2030 (depending on future growth), from the present level of 24% of GDP.* Such a reduction in replacement rates would not unduly harm the welfare of pensioners as statutory pension replacement rates are very high at present – indeed they are among the highest in the OECD. Even though pre-funding would help to cope with the maturing of the system and the bunching of payments, it would not put it back on a sustainable footing. For this purpose, workers should be encouraged to devote a substantial part of their increased longevity to productive activities, rather than entirely to leisure. To this end, reforms should include: *indexing the legal early-retirement and pension ages to life expectancy; tightening access to pre-retirement schemes; reducing the eligibility to imputed pension rights for non-contributory periods; and putting the existing financial inducement to later retirement on an actuarially-neutral basis.* ■

**Figure 1.**  
**EVOLUTION OF THE FINANCIAL BALANCE AND NET ASSETS OF THE PENSION SYSTEM, 2005-2050**  
 In per cent of GDP



Source: IGSS (2006).

### What can be done to increase employment rates?

Despite employment growing at a strong pace, unemployment has risen since the start of the decade. The increase in unemployment partly results from an administrative reform that shifted the disabled and partially disabled job-seekers to the unemployment insurance scheme. However, there has also been an increase in the number of regular residents unemployed. The fact that a growing proportion of residents fail to find a job seems to result from their having high reservation wages, reflecting the high levels of replacement incomes. During the first year of unemployment, benefits are as high as 90% of prior earnings on a net basis for the average worker. Although this runs out after 12 months, the minimum guaranteed income (RMG) then keeps the replacement rate at close to 80% for someone who had average earnings and has a dependent spouse. *The authorities should therefore consider lowering existing unemployment replacement rates, after an initial period of three months of unemployment.* The fact that the RMG is conditioned on the level of the spouse's income may also create significant inactivity traps for dependent partners. *The rate at which the RMG declines when the dependent partner finds a job should be made more gradual, so as to strengthen work incentives.*

The rise of unemployment makes it all the more important for the public employment service (ADEM) to ensure a better match between job seekers and jobs. Activation measures undertaken by ADEM have become inadequate, in particular because the agency is no longer adequately funded and equipped to deal with the large number of job-seekers. The recent tripartite agreement reinforces activation measures. In addition, the authorities have commissioned a special OECD Review of ADEM to help guide reforms to improve the effectiveness of the system.

The existing panoply of pre-retirement schemes has helped to depress the employment rate of older workers to one of the lowest levels in the OECD. These schemes were created in the past to respond to special events (notably the sharp decline of steel production), but no longer appear justified. *This is notably the case of the "préretraite d'ajustement", which should be phased out.* Workers can obtain an early-retirement pension at age 60 provided that they contributed to the pension system during at least 40 years, including imputed credits for non-contributory periods, such as periods of tertiary education or child rearing. Such imputed credits are not only high by international comparison, but are likely to contribute to an inefficient lengthening of periods of tertiary education and to excessive labour-market withdrawal of women after childbirth. *The authorities should reconsider the arrangements for imputing non-contributory periods to pension rights, so as to strengthen work incentives.* ■

### How could education outcomes be improved?

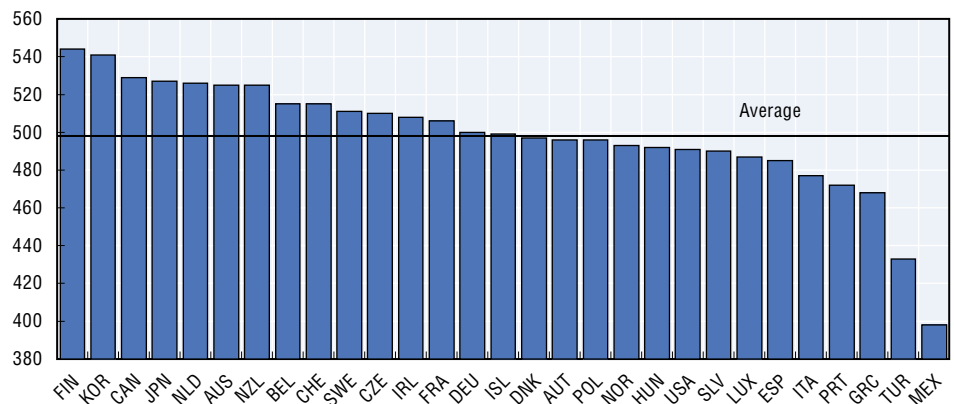
Weak education outcomes will become a rising hurdle for the government strategy to build a knowledge-based economy unless reforms are instituted. Student achievement is below the OECD average, according to the 2003 PISA study, with the gap in achievement between immigrant students, most of whom come from EU-member countries in which Romance languages are spoken, and native students being above average. Partly reflecting this,

attainment is also below the OECD average. Correcting these weak outcomes does not necessarily mean spending more, but it certainly implies spending more effectively.

A factor that makes learning especially challenging for children from immigrant and/or lower socio-economic backgrounds is that Luxembourg has a trilingual education system (*Lëtzebuergesch*, German and French are used as languages of instruction). The ability to speak fluently each of the three official languages is considered an objective because it fosters social unity in a country that could otherwise divide into two distinct linguistic communities (German- and French-speaking). Trilingual education is also considered essential to integrate the children of immigrant families, who otherwise may stay at the margin of society.

The authorities have worked hard to overcome learning difficulties in a trilingual education system. Pre-school has been extended to 3-year olds on a voluntary basis, so that children of immigrant origin have more time to learn *Lëtzebuergesch* before joining primary school. Supplementary courses in German are also offered at the primary-school level to improve the German-language competence of immigrant children. There are special classes for immigrant children who did not start their education in Luxembourg in which German and/or French are taught intensively with a view to enabling them to join regular education as soon as possible. New empirical evidence based on the PISA tests suggests that Luxembourg has had considerable success in meeting this challenge: the adverse impact of immigrant status on PISA test scores is around the OECD average. Less support and flexibility is available, however, at the level of vocational courses, which are predominantly taught in German, although this is the track that many immigrant children find themselves in after having done poorly at primary school, resulting in a high rate of dropouts. *The authorities should thus continue to exercise flexibility and seek innovative solutions in the implementation of the trilingual system, notably by encouraging the participation of immigrant children in supplementary German-language classes, as well as by increasing the proportion of courses in the vocational track of secondary education that are taught in French.*

**Figure 2.**  
**AVERAGE OF STUDENT PERFORMANCE IN MATHEMATICS, READING, SCIENCE, AND PROBLEM SOLVING**  
 In the 2003 OECD PISA study



Source: OECD, PISA 2003.

Another specific feature of the Luxembourg education system is that it is very stratified. Children are sorted into a large number of parallel tracks at an early stage, with little opportunity to get into a higher track at a later stage. There are three main tracks, with academic and vocational programmes separately provided; the academic (*enseignement secondaire*, representing about 30% of students) and technical vocational (*Régime technique*, representing about 25% of students) tracks lead to qualifications that have the same legal standing in the labour market and for access to university studies. Students are also sorted within tracks according to performance. International evidence suggests that the impact of socio-economic background on student performance is large in countries with more differentiated systems. This implies that education may not be able to offer children from low socio-economic background and/or immigrant origin a chance to do better than their parents.

So as to enhance permeability between the different tracks and increase social diversity, the government decided ten years ago that all new secondary schools would offer all three tracks (general academic, technical vocational and ordinary vocational) in lower secondary education. However, already established secondary schools have refused to do so. *All secondary schools should be compelled to offer all three education tracks in the first years.* In a further move to increase permeability, the authorities are considering introducing a module corresponding to the first two years of secondary school during which the general and technical vocational programmes would develop in parallel. This would facilitate entry into the more prestigious general programme for some children who were oriented to the technical programme from the beginning of secondary school. The authorities are also considering offering exams that would enable students having gained a certificate at the end of ordinary vocational secondary education (*Régime professionnel*) to do extra exams and gain access to tertiary education. *Overall, there should be a greater degree of permeability between tracks so as to give students selected for vocational programmes a second chance. The authorities should also reflect on whether it makes sense to continue to direct such a large proportion (45 per cent) of students into the vocational tracks (Régime de technicien and Régime professionnel) that lead to particular occupations or trades given that a good general education may be more appropriate for the jobs available in Luxembourg.*

Luxembourg has a high rate of grade repetition, which is recognised as bad educational practice since it does not improve performance, is expensive and tends to increase the impact of socio-economic background on performance. The authorities aim to reduce this practice and have, to this end, recently introduced remedial measures for all children falling behind. Grade failure has also been reduced by allowing some averaging of results across subjects – previously children were required to pass in every subject or repeat them all – and should fall further with new, less restrictive rules for averaging results across subjects. The authorities are considering reorganising the six-year primary education programmes into three two-year modules with defined competences to be achieved at the end of each module. The curricula in these modules would be pared back, leaving an extra margin of 30%

of course time for getting to the required level. Children not meeting the required standards in the first or second modules would at most be required to repeat one year while failure in the third cycle would result in children going into the vocational education track (*régime préparatoire*) that leads to apprenticeship training during the upper secondary years. *The authorities should continue implementing the reforms being considered to reduce grade repetition, notably the reorganisation of primary education into three two-year modules with defined competences to be achieved.*

Approximately one quarter of teachers are not certified, having failed to pass the final exams or to successfully complete the training period. This is a cause for concern because empirical evidence suggests that uncertified teachers have an adverse impact on achievement. *The government should enhance access to second-chance opportunities through continuing education to enable more uncertified teachers to certify.* With almost all teachers being natives of Luxembourg, mostly from middle-class households, there is much room for misunderstanding between teachers and students from immigrant households, resulting in poor communication and undermining the effectiveness of teaching. *Teachers should be given more training to overcome cultural differences that could otherwise stand in the way of effective learning. Moreover, greater efforts should be made to overcome these differences directly by recruiting more students from immigrant backgrounds into the profession.* This would also provide such students with positive role models. ■

### How could product-market competition be strengthened?

Being a small economy with open borders and small travelling distances to neighbouring countries, Luxembourg already enjoys many of the gains coming with competitive pressures on product markets. Nevertheless, regulatory barriers to product market competition remain, the removal of which would have a beneficial effect on productivity growth. The authorities have taken an important step in this direction by bringing the competition policy framework into line with that prescribed by the articles of the European Union Treaty. They created a Competition Council and a Competition Inspectorate *These institutions should expedite the reviews they have been mandated to do, outsourcing if necessary.* The field of competences of the Council is restricted by law to sanctioning the abuse of dominance and restrictive agreements. *It should be widened to include competition advocacy and the examination of laws and regulations issued by legislative and administrative bodies.*

Important regulatory barriers to competition remain in professional services provided by lawyers, notaries, architects and accountants. In these professions, the economic rationale for regulation is to alleviate significant market failures, notably information asymmetry. However, it has been found that professional services are often subject to pervasive regulation that hinders competition, thereby reducing incentives to lower prices, increase quality and offer innovative services. The OECD summary indicator on regulation of professional services ranks Luxembourg as the third strictest in a cross-country comparison. This suggests that consumers are deprived of many of the benefits associated with strong competitive pressure among providers of professional services. In particular, the

access of new entrants is restrained by very strict licensing and education requirements, with negative consequences for competition. *The authorities should consider ways to ease the stance of policies regulating professional services, notably by opening access to the market to new entrants, as well as by curbing excessively strict conduct regulation.*

The retail trade sector has been an important driver of productivity growth and employment in many countries over the past decade. Where competitive pressures have been at work, the sector has found ways to benefit from progress in new information technology, logistics and managerial techniques. In Luxembourg, these developments have been hampered by the introduction in 1997 of a moratorium on authorisations for large new retail outlets, which was extended to 2005. The moratorium was allowed to lapse at the beginning of this year, but government authorisation is still subject to a test of whether a new outlet is likely to induce an economic imbalance. Furthermore, granting planning permission for large retail outlets may suffer from the fact that municipalities have to draw up zoning plans and that these are subject to pressure from incumbents; in fact, zoning policies are in general very tight for all economic activities, notably road and telecommunications infrastructure and office buildings. New retail outlets have therefore been established in neighbouring countries, causing some inconvenience for consumers and depriving the economy of employment gains as well as tax revenues. Entry of large retail outlets is also discouraged by stricter regulations on shop opening hours than in neighbouring countries. *Thus, zoning policies should be reviewed to determine whether they unnecessarily hinder economic development; shop opening hours should be liberalised, for example by aligning them with those in France.* ■

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