INTERNATIONAL MONETARY FUND

LUXEMBOURG: Concluding Statement of the 2018 Article IV Mission

February 9, 2018

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Luxembourg's growth outlook remains favorable, as the ongoing global recovery boosts near-term activity. Economic, fiscal and financial sector policies are generally sound and unemployment is on a declining path. Risks arise from the possible impact on the economy and tax revenue of changing international tax rules; financial volatility, possibly triggered by increased risk perceptions and higher global interest rates, reduced cross-border integration and policy collaboration, or geopolitical events; and Brexit. Closer to home, continuously rising real estate prices pose affordability problems and could lead to excessive indebtedness of some households, while the longer-term sustainability of the pension system is not assured.

To contain these risks, policies should focus on continuing to adapt Luxembourg's business model to the changing global environment. A key plank in this effort is to continue implementing the EU and international tax transparency and anti-avoidance agenda. In view of related revenue risks and potential financial sector jitters, fiscal policy should remain prudent. To help shield Luxembourg's financial system from global financial-market shocks, and limit transmission to the rest of the world, the authorities should continue to enhance regulation and supervision, in line with the 2017 Financial Stability Assessment Program (FSAP) recommendations. Anti-money laundering challenges should continue to be addressed and risk monitoring of Fintech should be strengthened. Action should be taken to expand the housing supply and the authorities should stand ready to put in place measures to contain excessive household indebtedness. Targeted policies to reduce stubborn structural unemployment and increase labor market participation are important for inclusive growth. Reform of the pension system should continue in light of population ageing.

Fiscal policy

To bolster Luxembourg's reputation, the government should steadfastly continue to implement the EU and international tax transparency and anti-avoidance agenda. The authorities have taken welcome steps in this direction, including the EU-wide automatic exchange of tax rulings effective from 2017, and the submission to Parliament of a draft law to introduce a new (BEPS-compliant) IP Box regime. A key move forward will be the timely transposition of both EC Anti-Tax Avoidance Directives, including the establishment of best-practice rules for Controlled Foreign Corporations. Ensuring that special tax regimes and transfer pricing arrangements are aligned with evolving international and EU standards will widen the corporate tax base. This could create some room to further lower statutory corporate tax rates in a revenue neutral manner to safeguard competitiveness. With a more level playing field in international taxation, some firms could expand their local presence in view of the country's other competitive advantages such as its triple-AAA ratings and qualified labor force. Nevertheless, the changing international corporate tax rules together with uncertainties related to the U.S. tax reform could diminish incentives to conduct business through Luxembourg.

Current fiscal plans are appropriate in light of risks to tax revenue. Buoyant tax revenue, in part temporary, has resulted in a sizable fiscal surplus in 2017. Staff expects the surplus to largely disappear in the coming years because of the full impact of the recent tax reform and a continued need for high public investment in infrastructure, education, and healthcare. A broadly balanced budget over the medium term would keep the public debt ratio at its current low level, preserving room for maneuver in the event downside risks materialize–-particularly risks to tax revenues from the changing international tax environment. The government should also prepare contingency plans to address potentially sizable and permanent revenue losses. Increasing the very low real estate taxes and enhancing green taxation are possible instruments.

Further pension reform is needed to ensure the system's long-run viability and preserve fairness across generations. Population ageing is expected to significantly increase pension expenditures in the coming decades. The current surpluses in the system are projected to disappear in the medium term and reserves to progressively run out thereafter. This would deteriorate the fiscal position. Given the long lead time needed for meaningful reforms, the tripartite Working Group on Pensions should develop policy options ahead of this year's election. In view of the low effective retirement age in Luxembourg and rising life expectancy, priority should be given to reducing the generous incentives for early retirement.

Financial Sector Policies

Luxembourg's large financial sector is highly interconnected both domestically and internationally, and has benefitted from accommodative monetary policy. Abundant liquidity, expectations of sustained low interest rates, rich stock market valuations and demand for assets offering yields higher than traditional bank savings instruments, have boosted inflows into investment funds. This has generated income for the financial sector at large and stimulated ancillary service activities. Banks have preserved their profitability and have passed on low interest rates to borrowers, thus easing credit.

The authorities have been pursuing an ambitious regulatory and supervisory reform agenda and should take advantage of the current favorable environment to implement all 2017 FSAP recommendations:

- *In the banking sector, intensive supervision of banks' large cross-border exposures is essential.* Foreign bank subsidiaries in Luxembourg upstream liquidity to their parents abroad. The frequency of on-site inspections of the Luxembourg subsidiaries of significant institutions should continue to intensify, and rigorous supervision of the waivers for large exposure limits of internationally-oriented banks is important. The authorities should reinforce the oversight of non-bank holding companies of banks and continue to advocate for a European approach. Appropriate resolution plans for the most important banks established in Luxembourg should be finalized.

- *In the investment fund sector, risk monitoring and the supervisory regime should be further enhanced*. The authorities should continue to strengthen the inspection regime, develop close engagement with regulators in jurisdictions where delegated portfolio and risk management are prominent, and develop system-wide methodologies and guidance to the industry for liquidity stress-testing, while coordinating at the EU and international levels.

- *Macroprudential oversight appears to be working well but should be strengthened.* Legal steps taken to expand the toolkit to include borrower-based mortgage lending limits are welcome. The leading role of the *Banque centrale du Luxembourg* (BCL) in the *Comité du Risque Systémique* (CdRS) and BCL access to granular data should be enshrined into law, and the substance of the CdRS macro-financial risk analysis should be published.

- *Governance arrangements should be upgraded.* The recently revised code of conduct for non-executive members of the BCL Supervisory Board could be further aligned to best practices, and codes of conduct for the members of the non-executive boards of the *Commission de Surveillance du Secteur Financier* and the *Commissariat aux*

Assurances should be put in place. The relationship between the government and banks with state participation should be formalized on an arms-length basis.

- *The authorities should continue to address risks related to anti-money laundering and combating the financing of terrorism (AML/CFT).* The recent transposition into national law of the 4th EU AML/CFT Directive is an important step, to be followed by the establishment of registries of beneficial owners for firms, trusts, and other entities. The National Risk Assessment should focus on the specific AML/CFT risks related to tax evasion and activities of trust and company service providers, and develop remedial actions where needed.

Fintech risks to financial stability should be minimized. Luxembourg is actively engaged in Fintech developments which may impose changes in business models in the banking and asset management sectors, including by creating new opportunities. Adequate regulatory and supervisory arrangements should be put in place to safeguard financial stability.

Housing market policies

Demand for housing continues to exceed supply. House prices are in line with fundamentals. However, they have risen faster than disposable income for years, largely because of structural supply constraints in the context of strong demand, in part reflecting immigration of workers and their families. Rigid zoning and administrative rules together with land hoarding prevent sufficient construction, while tax incentives and subsidies fuel demand. Reduced affordability has driven up household indebtedness.

Containing house price pressures requires a strong effort to expand the stock of affordable housing. In addition to pruning excessive red tape, coordinating local zoning decisions with a national spatial development plan and imposing effective taxation on unused land would lift bottlenecks. The reform of the distribution of municipal business taxes among municipalities is a step in the right direction as it reduces incentives favoring commercial over residential real estate zoning decisions. There is also scope to increase the very low provision of social housing. Government benefits for house purchases should become more means-tested.

Risks in the real estate market should continue to be closely monitored, and further actions taken as needed. Recent measures have appropriately built capital buffers in the banking system while discouraging riskier lending. However, household debt is relatively high and limits to debt-service-to-income ratios should be set if house prices continue to outpace disposable incomes.

Labor market policies

Despite strong job creation, unemployment of young and low-skilled workers declines only gradually and activity rates of women and seniors remain low. While skills mismatches are a predominant factor in explaining structural unemployment, work disincentives inherent to the tax-benefits system are also important. High unemployment rates among the young and low-skilled reflect significant unemployment traps. The relatively low participation rate of women and the high gender-gap in part-time work mirror the high marginal effective tax rates for second-earners, especially at lower wages. Low participation of seniors is driven by inactivity traps generated by the generosity of the pension system.

Increasing the employment prospects for these groups requires further efforts to reduce skills mismatches and make work more rewarding. Education reform and further coordination between the national employment agency (ADEM), schools, and employers on training and apprenticeship programs would better align education outcomes with skills demanded in the labor market. Further adjustment of unemployment and welfare benefits to encourage job acceptance and a greater use of in-work tax credits could help reduce unemployment traps, especially for the low-skilled. The introduction of the *Revenu d'Inclusion Sociale* (REVIS) would go in this direction. The recently created option for individual income taxation and free multilingual childcare for 20 hours per week help to raise the labor participation of women. Consideration should also be given to increasing the second-earner income tax-deduction or to fully switching to individual income taxation. Raising the participation of seniors requires phasing out benefits for early retirement.

The mission team thanks the authorities and other interlocutors for constructive discussions.