Rozprawy Ubezpieczeniowe. Konsument na rynku usług finansowych nr 25 (3/2017): 22-47
Journal of Insurance, Financial Markets and Consumer Protection No. 25 (3/2017): 22-47

Modelling pensions balance under macro-economic scenarios[1]

Marion LABOURÉ[2]
Harvard University

Received: 18 July 2017; Accepted: 11 August 2017; Published: 21 September 2017

Abstract. The pension system brings challenges in many developed countries. While the systems were set up at a time of economic growth, policymakers are facing both economic slowdown and an aging population. Moreover, there is an incentive mis-match between short to medium term popularity and re-election versus taking necessary decisions to affect long-term sustainability of the system.
In a small open economy, the situation is further accentuated by high volatility driven by migrations and cross-border workers. This paper aims to address the policymakers' challenges in these economies by providing both a highly innovative modelling that considers not only population aging but also the cohort of cross border workers and their entitlement to a partial pension in the future. It also provides an approach to analyse issues at stake and remove decision biases faced by politicians through policy options and their impact under various economic scenarios. We illustrate this approach through the case of Luxembourg and its pension challenge at horizon 2060 under three highly plausible scenarios: the "*Successful economic reorientation*", the "*Progressive convergence to normal*", and the "*Perfect storm*".

Keywords: pensions, ageing, population, small open economies, forecasting, decision planning, government strategy, optimism bias, planning fallacy, reference class problem.
JEL Codes: H55, J11, I18, I2.

1. Introduction

The sustainability of the pension system is being challenged in most developed countries. While the system was set up at a time of economic growth, policymakers are facing both economic slowdown and aging of the population. To correct for further long-term imbalances, policymakers can only take unpopular measures such

[1] The article was presented at the 5th international conference "*Social security systems in the light of demographic, economic and technological challenges*" hosted by the Poznań University of Technology in September 2017.
[2] Contact with author: Marion Labouré, Economics Department, Harvard University, Littauer Center 216, Cambridge, MA 02138, USA; e-mail: marion_laboure@fas.harvard.edu.

as increasing the retirement age, increasing contributions on the current working population or decreasing pensions.

The problem is further accentuated in a small open economy where the future is much harder to predict. Some economies benefited from a strong migration of young workers which helped to balance pensions, but this may not be replicated to the same magnitude in the future. Similarly, the size of the workforce and the age pyramid are moving targets, as the comparative attractiveness of the local economy and wages can create strong inflows of workers in both directions from larger neighbouring countries.

As a result, it is rather difficult for policymakers to first forecast the future and the magnitude of the challenges and then to decide which policy is currently the best to implement. The issues may look far away and less tangible, especially for social welfare and aging issues such as pensions with a twenty-thirty year horizon and a large time gap between decision making, policy implementation and observed outcomes.

There is an incentive mis-match between short to medium term popularity and re-election and taking necessary decisions to affect the long-term sustainability of the system. Besides, there are multiple theoretical political reasons explaining why it is difficult to influence policies and put in place reforms such as the fear or public opinion, the „*free rider theory*"[3] [Alesina, Drazen 1991; Velasco 2000], lobbyist activity [Tornell 1998], the "*pork barrel*"[4] problem or the "*optimism bias*"[5].

The "*Planning Fallacy*" theory first developed by Kahneman and Tversky [1979] underlines the phenomenon in which the predictions about how much time would be needed to complete a future task display an optimism bias and underestimate the time needed. This phenomenon occurs regardless of the individual's knowledge that similar previous tasks have taken longer to complete than generally planned [Buehler et al. 1994; Koole, van't Spijker 2000]. The bias only affects predictions about one's own tasks; when outside observers predict task completion times, they show a pessimistic bias, overestimating the time needed [Buehler et al. 1995; 2002]. Lovallo and Kahneman [2003] proposed an expanded definition as the tendency to underestimate the time, costs, and risks of the future actions and at the same time overestimate the benefits of the same actions. According to this definition, the planning fallacy results in not only time over-runs, but also cost over-runs and benefit shortfalls.

The theories behind "*reference class forecasting*" were developed by Kahneman and Tversky[6,7]. They found that human judgment is generally optimistic due to

[3] Emphasizing that while reforms are necessary for the collectivity, each group tries to avoid sharing the burden.

[4] Consisting in endless debates rather than action where everybody wants to prove they are right.

[5] Rejecting that when consensus expects a situation to improve naturally, reforms may appear less necessary.

[6] See Kahneman and Tversky [1982; 1979].

[7] Kahneman earned the Nobel Prize in 2012 "*for having integrated insights from psychological research into economic science, especially concerning human judgment and decision-making under uncertainty*".

overconfidence and insufficient consideration of distributional information about outcomes. Therefore, people tend to underestimate the costs, completion times, and risks of planned actions, whereas they tend to overestimate the benefits of those same actions. Such an error is caused by actors taking an "*inside view*", where the focus is on the constituents of the specific planned action instead of the actual outcomes of similar ventures that have already been completed.

Kahneman and Tversky concluded that regardless of the distributional information, risk is perhaps the major source of errors in forecasting. Based on this, they recommended that forecasters "*should, therefore, make every effort to frame the forecasting problem to facilitate utilizing all the distributional information that is available*" [Kahneman, Tversky 1982]. Using distributional information from previous ventures like the one being forecasted, is called taking an "*outside view*". Reference class forecasting is a method for taking an outside view on the planned actions.

In our paper, we use the "*reference class forecasting*" approach to study the evolution of a small open economy's pension's equilibrium between 2015 and 2060 to reduce the policy making biases. This involves the following three steps. First, we start by identifying a reference scenario of a past, similar, continuous and economically successful visible trend: the '*Successful economic reorientation*'. Then, we establish a probability distribution for our reference scenario and create two alternative scenarios: the '*Progressive convergence to normal*', and the '*Perfect storm*'. We then assess a set of policy actions and assess their impact in each of these scenarios. This leads to discussions on risk assessment under uncertain outcomes, where policymakers can have a rational debate about "*insuring*" for the future economic volatility.

This paper also addresses a modelling issue specific to small open economies: how to forecast and assess future contributions and liabilities when a large proportion of the workforce is made up of either cross-border workers or recent emigrants. These migrants or cross-border workers work for a short period of time, yet are entitled to receive pensions and other social benefits, at least partially. It is further challenging as the churn of cross-borders is very important. For example, assuming 100 cross-border workers in year N, and the same number in year $N+1$, a large proportion of the 100 workers in the two years will be different persons.

To address this challenge of forecasting future liabilities, we use a highly innovative modelling that considers not only population aging but also the yearly cohort of cross-border workers and their entitlement to a partial pension in the future. It not only allows us to assess state liabilities but also the evolution of the age pyramid with a significant portion of new migrants.

The purpose of this paper is to provide a unique modelling of pensions in a small open economy, using a process that leverages game theory to make decisions under high volatility and uncertainties.

The remainder of this paper is organized as follows. Section 2 describes the model. Section 3 takes the model and scenario-based approach to the applied case of the Luxembourg pension reform.

2. The model

2.1. The demographics

2.1.1. Total population

Total population P at year t is defined as the sum of the total population being aged from 0 to 95 years at year t.

$$P_t = \sum_{a=0}^{95} P_{a,t}$$

We assume a country with an open labour market economy. The population in this country is made up of residents and cross-borders. We call „*residents*" or "*home population*" citizens who officially live in the country. We call "*cross-borders*" citizens who live in the bordering countries and may supply the labour force in the home country. We denote residents and cross-borders by the superscripts r as resident and c as cross-border respectively hereafter.

2.1.2. Forecasting resident population

To determine the number of resident pensioners, we must know the structure of the total population in the home country, which is calculated from the survival probability rate, the fertility rate and the number of net migrations.

The resident population aged of r years at year c is forecast by

$$P^r_{a,t} = P^r_{a,t-1}\beta^r_{a,t}\,\varphi^r_{a,t} + B^r_{a,t} + X^r_{a,t}$$

where β is the survival probability rate, φ a coefficient reflecting the longer life expectancy, B the number of births, and X the number of net migrations[8]. The number of net migrations is split proportionally across the ages of 25-40 (15 years).

2.1.3. Structure of population

To determine the number of retired resident people, we must determine the structure of the population. We assume people aged less than 15 years do not work and people aged more than 65 years to be retired.

[8] By definition, the number of net migration is the number of people moving into a country less the number of people moving out of the same country.

We determine the number of people who contribute to financing the pension system with the participation rate. We take the participation rate as it refers to the number of people who are either employed or are actively looking for work and both workers and people benefiting from unemployment allowances contribute to financing the pension system.

2.1.4. Forecasting cross-border population

Cross-borders may come from several countries. For simplicity, we will consider that cross-borders come from a large closed economy.

Similarly, the cross-border population aged of *a* years at year *t* is forecast by

$$P^c_{a,t} = P^c_{a,t-1}\beta^c_{a,t}\,\varphi^c_{a,t} + B^c_{a,t}$$

where β is the survival probability rate, φ a coefficient reflecting the longer life expectancy and *B* the number of births.

2.2. The demographics

2.2.1. Key categories

There are three different type of agents:

1. people who neither contribute nor benefit from pension allowances such as individuals below 15, as they are either enrolled at school or nursery;
2. people in the labour force who contribute to financing the pension system (people aged from 15 to 65 who work or are unemployed);
3. people who benefit from a pension allowance, for example all individuals aged 65 or above are inactive, so that 65 is the legal and compulsory retirement age.

We assume the population aged from 55 to 65 can either contribute to the pension system or benefit from a pension allowance. As our objective is not to explain participation rates of individuals of working age across time or over the life cycle, we take the participation rate to be exogenous.

$$P_{a,t} = S_{a,t} + L_{a,t} + N_{a,t}$$

where $0 \leq a \leq 95$, *P* is the population, *S* the number of people enrolled at school (or nursery), *L* is the number of people in labor force, and *N* is the number of retired people.

$$L_{a,t} = U_{a,t} + E_{a,t}$$

where *U* is the number of unemployed people, and *E* is the number of employed people.

2.2.2. Resident population

The resident population is defined by

$$P^r_{a,t} = S^r_{a,t} + L^r_{a,t} + N^r_{a,t}$$

where $0 \leq a \leq 95$, P^r is the resident population, S^r is the number of people enrolled at school (or nursery), L^r is the number of people in the labour force, and N^r is the number of retired people.

$$L^r_{a,t} = U^r_{a,t} + E^r_{a,t}$$

where U^r is the number of unemployed people, and E^r is the number of employed people.

2.2.3. Cross-border population

The cross-border population is made of employed, unemployed and retired people only. There are no people in education, unlike in the resident population. The cross-border workers are defined by

$$P^c_{a,t} = E^c_{a,t} + U^c_{a,t} + N^c_{a,t}$$

where $0 \leq a \leq 95$, P^c is the total number of cross-borders employed, unemployed and retired, E^c is the number of employed people in the home country from another country, U^c is the number of unemployed people, and N^c is the number of retired people having worked in the home country and benefiting from a pension allowance.

2.3. Pension payments

2.3.1. Forecasting pensions quantum

The total number of pensions awarded by the home country government is the sum of the pensions of residents and the pensions of cross-borders.

$$N^{tot} = N^r + N^c$$

where N^{tot} is the total number of pensions granted, N^r is the number of pensions granted for residents and N^c is the number of cross borders pensions.

Primary spending is the sum of the number of retired residents by the average resident pension and the number of retired cross-borders[9] by the average cross-borders pensions.

[9] In most cases, the average pension for residents in the home country is higher than that of cross borders as most of cross borders only have a partial career in the home country and therefore do not benefit from a full pension allowance but only a partial one.

As a result, primary spending is defined as

$$S_t = (N_t^r W_t^r) + (N_t^c W_t^c)$$

where S stands for primary spending, N the number of pensions granted and W the average pension allocation. The subscripts r and c refer to the resident and the cross-border populations.

2.3.2. Forecasting resident pension

Pension Laws distinguish between, on the one hand, the adjustment of pensions to the cost of living, based on the evolution of the price index for domestic consumption (IPCN) and, on the other hand, the adjustment of pensions to the living standard, based on the increase in real wages (not indexed) due to productivity gains. To sum up, pension allowance is calculated as follows

$$b_t = b_{t-1} \tau_t t(SR_t) R_t$$

where b is the pension allowance, τ is the inflation growth rate, SR is the real wage growth rate and R is the impact of the 2013 pension reform.

To forecast pension allowance, we depart from the previous year's average pension allowance published. The forecast of the average pension is made from the average pension of the previous year, the expected real wage growth, the anticipated rate of inflation and a corrective factor taking the most recent reform into account. We assume the real wage growth to rise in line with the nominal Gross Domestic Product (GDP) and inflation growth rates.

2.3.3. Forecasting cross border pension

Most cross-border workers only work for a few years in the home country and hence are entitled to a partial pension when they retire. We model the yearly cohort of cross-border workers and the partial entitlement of each cohort when it retires after a few years, considering the high volatility of workers and this is the most suited model of the underlying future liability for the home country pension system.

For each year worked, the average pension as percentage of one year revenues is approximated by

$$\frac{Average\ pension}{Average\ revenue} * Average\ career\ length$$

2.4. Pension financing

2.4.1. Number of workforce population

The total number of the workforce in the home country is the sum of the resident workforce and the cross borders.

$$L^{tot} = L^r + L^c$$

where L^{tot} is the total labour force in the home country, L^r is the number of residents' workforce and L^c is the number of cross borders workers. Both workers and unemployed people contribute to the pension system.

2.4.2. Contribution per worker

Primary revenue is made up of pension contributions and excludes net assets. It is defined as

$$R_t = \delta_t \ (W_t^r L_t^r + W_t^c L_t^c)$$

where R stands for primary revenue and δ the pension contribution rate[10].

3. Illustration

3.1. Economic context in Luxembourg

Luxembourg is a wealthy country in Europe with a robust economy, which benefited from strong economic growth over the past twenty years. In 2015, Luxembourg was ranked as having the second[11] highest per capita GDP (after Qatar) in the world at $98,987 [International Monetary Fund (IMF) 2016]. Luxembourg developed as a banking and an administrative centre and is currently a key financial centre in Europe and globally with 46% of its GDP generated from financial services. Luxembourg also hosts the headquarters of several European institutions such as the European Investment Bank, the European Investment Fund, and the European Stability Mechanism, to name a few.

This economic success was due to its ability to rebalance the economy. In the 1970s, Luxembourg redirected its economy from an industrial focus and metallurgy towards

[10] The contribution rate, currently at 24%, is equally split between employees, employers and Government. If expenditure becomes higher than revenue, the contribution rate could be raised by 2pp for all contributors (so the contribution rate could increase to 30%).

[11] However, especially in the case of Luxembourg, GDP per capita is biased on the upside as it includes the significant contribution of cross borders to value added. For Luxembourg, Gross National Income (GNI) per capita would be a more appropriate indicator than GDP per capita (though Luxembourg's GNI per capita is also one of the highest in the world). However, we focus on GDP per capita to compare our results to those of other institutions (as for instance the Ageing Working Group).

administrative and financial services. This highly successful reconversion resulted in economic growth and has attracted new workers to Luxembourg. According to the World Bank, the population has nearly doubled in 35 years, from 364,150 in 1980 to 569,676 in 2015. The role played by the financial sector in the Luxembourg economy has kept growing since the 1980s to become the main driver. From 1986 to 2007, the average annual growth rate of GDP was 5.7%, more than twice the average growth recorded in the neighbouring countries. Financial activity resulted in migration and cross-border workers coming, especially from France, Belgium, and Germany. Currently, the employment market is competitive compared to the neighbouring countries (the unemployment rate stood at 7.1% in 2014). The public finance situation is in a strong shape with a net surplus (of 1.2% of GDP in 2015) and a low public debt (21.4% of GDP in 2015).

The economic growth is expected to slow down and with it the increase in the influx of younger workers. The global financial crisis of 2008, affected the Luxembourg economy and, primarily its financial sector as banks in Luxembourg were exposed to the performance of their parent banks abroad [IMF 2011]. At the beginning of the 21st century, Luxembourg was forced, with the end of the secret banking area, to redirect (again) its economy from financial services towards aeronautical and aerospace research and wealth management. Given the size of its small open economy, a strategic reorientation was possible and could significantly impact the economy.

With a slowdown in economic growth and an aging population, the implicit debt of Luxembourg may explode in the coming decades. This could affect the future capacity to pay generous pensions. Government has already started reforms. According to the Working Group of Aging set up by the European Commission [Directorate-General for Economic and Financial Affairs, 2015a], pension spending in Luxembourg is expected to record the strongest growth in the European Union from 9.4% of GDP in 2013 to 13.4% of GDP in 2060. This will pose some risk regarding the sustainability of the current system. It means that with unchanged policies, the active population will have to double every 30 to 40 years to keep the system viable.

The Luxembourg government introduced a pension reform in 2013, but limited the scope and did not substantially address the threat posed to the long-term sustainability of public finances. For instance, the reform only partially addressed the large gap between the statutory and the effective retirement age. Against the background of an effective-retirement age that stood at 58.9 in 2012 compared with the statutory retirement age fixed at 65, the reform still maintained the possibility of early retirement at 57 or 60.

We will study the potential economic scenarios on the Luxembourg pension system as an illustrative case study of public finance challenges faced by the small open economies. Between 2015 and 2060, we consider the evolution of four factors: (i) macroeconomics, (ii) demography of residents, (iii) cross-border inflows, and (iv) pension policies[12] (retirement age, pension levels, and pension financing).

[12] All the measures voted at the end of 2012 are effective over the considered horizon. The reform basically implies a progressively less generous pension system.

This paper incorporates three different scenarios.

– Scenario 1: '*Successful economic reorientation*', Luxembourg manages to succeed in its strategic business reorientation from financial services towards aeronautical and aerospace research and wealth management. This reorientation results in a sustained economic growth and a continued increase of net migrations from now until 2060.
– Scenario 2: '*Progressive convergence to normal*', Luxembourg's financial activities slow down due to the end of secret banking and firms relocate their businesses to other countries. Investments into new economic activities are not sufficient to maintain a strong economic outperformance.
– Scenario 3: '*Perfect storm*', Luxembourg's competitive advantage as a headquarters of banks and e-commerce companies is vanishing and no strong relay of growth is found. Not only does the economy converge to its neighbouring countries but it also suffers from a correction. This scenario strongly impacts the prospects of net migration and cross-border workers.

3.2. Calibration and data sources

Our aim is to use the model to (i) forecast expenditure and revenue of the pension system in Luxembourg; and (ii) to prescribe policy recommendations regarding the sustainability of the long-run pension system.

In this paper, we use a time series from 2001 to 2016 depending on availability from the Luxembourg National Statistical Office[13] (STATEC) and the European Commission database[14] (AMECO). Actual numbers for the total population by age and year and survival probability rates are from the STATEC; effective exit age is published by the General Inspectorate of Social Security (IGSS); average pension allowance is available in the 2015 IGSS General Report.

For the forecast, we take the following approach. First, we model the development of the economy such as economic growth, inflation, average gross income and real wage growth. Second, we set the demographics of the "*stable*" population: life expectancy, mortality and fertility rate per woman. Third, we model the broader exchanges (impacted by economic development): net migrations and cross-border workers. Finally, we model the policy in place: average effective departure age, pension contribution as a percentage of gross income and average level of pensions.

The model is highly innovative in the way it designs cross-border workers' contributions and impacts. Most cross-border workers only work for a few years in Luxembourg and hence are entitled to a partial pension when they retire. In this paper, we model the yearly cohort of cross-border workers and the partial entitlement of each cohort when it retires after a few years. This model considers the high volatility of workers and is the most suited model of the underlying future liability for the Luxembourg pension system.

[13] Le Portail des Statistiques [2014a; 2014b; 2014c; 2010].
[14] Directorate-General for Economic and Financial Affairs [2015a; 2015b; 2012].

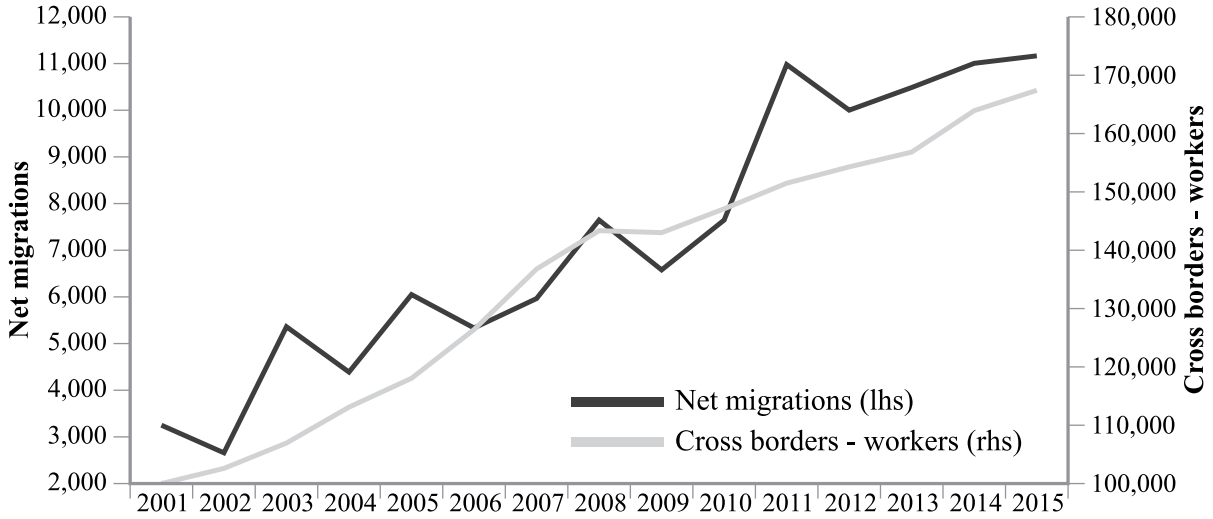
3.3. Baseline assumptions on the future

Luxembourg's pay-as-you-go pension system is generous and currently generating surpluses. Its effective retirement age is low (Figure 4) while its replacement rate (average pension benefit as a share of average wage at retirement) is amongst the highest in Europe. This system is at equilibrium because the population has nearly doubled in the past forty years, with new population inflows coming as contributors and not beneficiaries.

However, pension expenditures are expected to increase significantly over time as the recent migrants are retiring. The population growth may also slow down. The core value of this model is to assess the potential future scenarios for the economy and its impact on pension sustainability. The most impactful variables (that are also correlated) are (i) demography (residents); (ii) cross-border workers (non-residents working in Luxembourg); and (iii) economic activity. We briefly describe these different assumptions below.

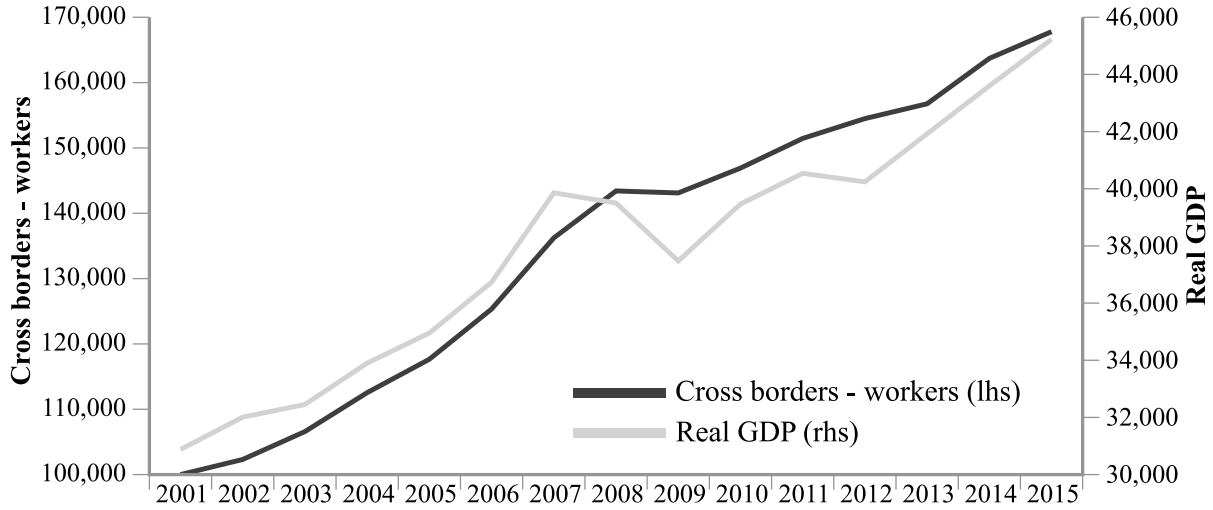
First, demography is hard to predict and differs significantly across institutes. Population ranges from 700,000 inhabitants in 2060 according to the 2012 Working Group on Ageing Populations and Sustainability to 1,100,000 inhabitants in 2060 according to the 2015 Working Group on Ageing Populations and Sustainability. Most institutes forecast a total population of around 700,000 inhabitants by 2060 and use a linear forecast extension to come to a continued growth. This, of course, makes the underlying assumptions of a continued economic outperformance and with it the capacity to attract new workers. Migrations, cross-border workers and economic growth are closely correlated as shown in Figures 1, 2 and 3.

Figure 1. Net migrations & cross borders - workers



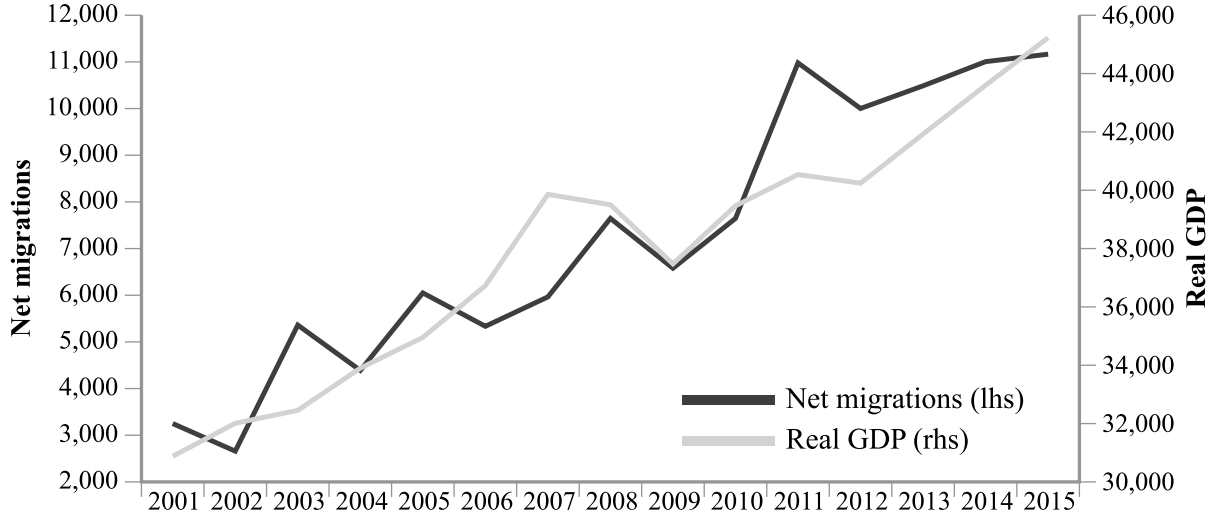
Source: STATEC, author's own calculations.

Figure 2. Cross borders - workers & GDP



Source: STATEC, author's own calculations.

Figure 3. Net migrations & GDP



Source: STATEC, author's own calculations.

Economic growth drives activity and migration and the other way around holds true, too. Potential GDP depends on two components, namely, demography and activity. While it is relatively acknowledged that with the aging of population, the operative share of the working population will decrease; the total population is expected to rise until 2060 due to the expected increase in economic growth. Projecting these subcomponents is possible and necessitates taking a view on the activity and the success of the country to make the strategic business reorientation. The 2015 European Commission Pensions Group (AWG2015) forecasts potential GDP growth from 1.4% y/y in 2013 to 3% in 2035 and then to slow to 1.9% in 2060. In contrast, the OECD [OECD 2015] forecasts a real GDP growth of 1.4% in 2060.

We do a bottom-up forecast with three main components determining demography (i) organic growth of the current population (driven by fertility rate and life expectancy), (ii) net migrations and (iii) cross-border inflows. While the first is relatively predictable, the second and the third are less so and are highly volatile and correlated with economic activity.

We take the following approach for each of the components:

1. Organic growth of the current population: life expectancy and fertility rate are relatively stable across statistical agencies. They are in line with forecasts of other countries and fluctuate relatively little over the years. For instance, the STATEC forecast Les Portail des Statistiques [2014b], in Bulletin No. 5 published in 2010, life expectancy at birth to be 84.5 (vs. 84.9 in the AWG2015) for men and 88.5 (vs. 89.5 in the AWG2015) years for women and a fertility rate of 1.72 (vs. 1.68 in the AWG2015) in 2060. We make similar assumptions to the European Commission Pensions Group.

2. Net migrations: net migrations strongly differ across statistical agencies and are responsible for the sharp revision of population from the AWG2012 to the AWG2015. The AWG2015 forecasts 10,800 net arrivals per year on an average from 2015 to 2040. STATEC forecasts that the net migrations are expected to be around 3,370 people per year on an average between 2020 and 2060. We take three scenarios with net migration growing at 8,500 per year in case of continued economic outperformance, 3,500 per year in case of convergence to normal and 300 in case of the perfect storm.

3. Cross-border inflows: in the case of Luxembourg, the evolution of cross-border worker inflows is a key, with direct effects on the labour supply in the model. According to the National Statistic Agency in Luxembourg Le Portail des Statistiques [2014b], the median scenario foresees a rise in cross-border workers, reaching an employment share of 52% by 2060. We take three scenarios with cross-border inflows increasing to 327,824 in 2060 in the most optimistic economic scenario, only increasing to 160,000 in the median scenario, and decreasing to 130,000 in the perfect storm scenario.

3.4. Three alternative scenarios

The three scenarios are summarized in Table 1. The key differentiator between them is the level of economic success and the impact it has on migration and cross-border workers.

Scenario 1 'Successful economic reorientation'

Luxembourg manages to succeed its strategic business reorientation from financial services towards innovation, research and wealth management. This reorientation will result in sustained economic growth and a continued increase of net migrations until 2060.

This scenario forecasts a resident population of 1,045,000 inhabitants including 8,600 net migrations per year on an average between 2015 and 2060, 259,000 cross-

border workers, and a potential GDP growth (2.0% on average over the period 2015-2060). The assumptions of this scenario are summarized in Table 2.

Table 1. The three assumptions on the future (in the three scenarios)

Assumptions		**Scenario 1: '*Successful economic reorientation*'**	**Scenario 2: '*Progressive convergence to normal*'**	**Scenario 3: '*Perfect storm*'**
(I) Macroeconomics	Economic growth	2.0%	1.0%	0.0%
	Inflation rate	1.5%	1.0%	0.5%
(II) Demography	Total population in 2060	1,045,000	718,000	529,000
	Net migrations	8,600	3,100	-500
(III) Cross-border workers	Cross-border workers	259,000	171,000	144,000

Source: Author's own calculations.
Note: The numbers are average per year over the period 2015-2060 unless specified.

Table 2. Assumptions in Scenario 1 'Successful economic reorientation'

	2020	**2030**	**2040**	**2050**	**2060**
Macroeconomic assumptions					
Nominal GDP (EUR mn)	66,151	101,460	153,539	221,869	309,657
Nominal GDP (per capita)	105,372	132,307	171,478	224,366	296,425
Real GDP (EUR mn)	52,949	70,265	91,984	114,905	138,565
Real GDP (per capita)	84,341	91,628	102,731	116,198	132,644
Demography (residents) assumptions					
Total population	627,792	766,857	895,387	988,872	1,044,638
Fertility rate (per women)	1.6	1.7	1.7	1.8	1.8
Life expectancy at 65 years	21.0	21.9	22.8	23.7	24.5
Net migrations	11,748	11,245	9,145	5,495	4,945
Share of population 64+ as % of total population	0.14	0.15	0.15	0.17	0.23
Demography (crossborders) assumptions					
Total number of cross-border workers	185,767	222,192	258,617	295,042	327,824

Source: Author's own calculations.

Scenario 2 'Progressive convergence to normal'

Financial activities slow down due to the end of secret banking and firms relocate their businesses to other countries. Investments into new economic activities are not sufficient to maintain strong economic outperformance. Luxembourg's competitive advantage erodes due to an expensive labour market which is no longer competitive, leading to an increase in unemployment and a low working force. This scenario is an extension of the actual visible trend with a slower economic growth than before the previous crisis level and slow net migration.

This scenario forecasts a resident population of 718,000 inhabitants including 3,100 net migrations per year on an average between 2015 and 2060, 171,000 cross-border workers on average and a potential GDP growth (1.0% on average over the period 2015-2060). The assumptions of this scenario are summarized in Table 3.

Table 3. Assumptions in Scenario 2 'Progressive convergence to normal'

	2020	**2030**	**2040**	**2050**	**2060**
Macroeconomic assumptions					
Nominal GDP (EUR mn)	64,117	81,275	96,671	112,191	130,202
Nominal GDP (per capita)	106,757	125,095	140,576	157,864	181,335
Real GDP (EUR mn)	51,425	59,094	63,678	66,934	70,357
Real GDP (per capita)	85,625	85,625	90,954	94,183	97,988
Demography (residents) assumptions					
Total population	600,590	649,706	687,679	710,679	718,021
Fertility rate (per women)	1.6	1.7	1.7	1.8	1.8
Life expectancy at 65 years	21.0	21.9	22.8	23.7	24.5
Net migrations	3,700	3,400	3,100	2,800	2,600
Share of population 64+ as % of total population	0.15	0.17	0.20	0.22	0.24
Demography (crossborders) assumptions					
Total number of crossborders workers	167,554	180,000	176,770	165,590	160,000

Source: Author's own calculations.

Scenario 3 'Perfect storm'

Luxembourg's competitive advantage as a headquarters of banks and e-commerce companies is vanishing and no strong relay of growth is found. Not only does the economy converge with its neighbouring countries but it also suffers from a correction. This scenario also strongly impacts the prospects of net migration and

cross-border workers as banking activity ceases and few highly-specialized jobs are created in the aerospace industry.

This scenario forecasts a resident population of 529,000 inhabitants, lower than the previous two scenarios. This includes -500 net migrations per year on an average between 2015, 144,000 cross-border workers per year on an average and a lower potential GDP growth (0% on average over the period 2015-2060). The assumptions of this scenario are summarized in Table 4.

Table 4. Assumptions in Scenario 3 'Perfect storm'

	2020	**2030**	**2040**	**2050**	**2060**
Macroeconomic assumptions					
Nominal GDP (EUR mn)	61,398	70,541	73,048	68,917	63,598
Nominal GDP (per capita)	103,217	114,112	118,541	117,499	120,250
Real GDP (EUR mn)	50,676	54,332	53,522	48,895	44,220
Real GDP (per capita)	85,193	87,892	86,854	83,362	83,610
Demography (residents) assumptions					
Total population	594,844	618,172	616,228	586,539	528,885
Fertility rate (per women)	1.6	1.7	1.7	1.8	1.8
Life expectancy at 65 years	21.0	21.9	22.8	23.7	24.5
Net migrations	2,000	500	-500	-1,500	-3,000
Share of population 64+ as % of total population	0.15	0.18	0.22	0.26	0.30
Demography (crossborders) assumptions					
Total number of cross-borders workers	159,390	150,000	142,464	137,000	130,000

Source: Author's own calculations.

3.5. Results

Overall, the three scenarios result in a significant imbalance of the pension system over time, the worst being scenario 3, '*Perfect storm*'.

The first scenario, '*Successful economic reorientation*', presented in Table 5, is by far the best economic outcome in terms of public finance, with the pension deficit limited to 3.8% of GDP in 2060. This outcome is in line with current equilibrium and results from robust economic growth and a record high number of cross-border workers.

Table 5. Results in Scenario 1 'Successful economic reorientation'

		2020	2030	2040	2050	2060
Residents						
Contributors	Number of pension contributing workers	309,385	380,072	436,363	456,731	436,943
	Average gross income per contributor (EUR)	61,293	78,575	100,729	129,131	165,541
	Total pension revenue (EUR mn)	4,575	7,400	10,739	13,241	15,995
Beneficiaries	Population 64+	87,123	112,641	135,579	171,960	239,468
	Average pension (EUR)	47,192	56,198	68,879	86,321	110,200
	Total pension spending (EUR mn)	-5,713	-8,679	-12,533	-21,614	-35,126
Deficit /surplus	Primary deficit/surplus (EUR mn)	10,287	16,079	23,272	34,854	51,121
	Primary deficit/surplus (% of GDP)	-1.7%	-1.3%	-1.2%	-3.8%	-6.2%
	Pensions paid as % of contribution	-1.2	-1.2	-1.2	-1.6	-2.2
Cross-border workers						
Contributors	Number of cross borders	185,767	222,192	258,617	295,042	327,824
	Average gross income per contributor (EUR)	55,866	61,711	68,168	75,299	83,177
	Share of gross income to pension (%)	24%	24%	24%	24%	24%
	Total pension revenue (EUR mn)	2,612	4,004	5,975	8,738	12,447
Beneficiaries	Total pension spending (EUR mn)	-337	-667	-1,253	-2,806	-5,096
Deficit /surplus	Primary deficit/surplus (EUR mn)	2,275	3,337	4,722	5,933	7,351
	Primary deficit/surplus (% of GDP)	3.4%	3.3%	3.1%	2.7%	2.4%
	Pensions paid as % of contribution	0.129	0.167	0.210	0.321	0.409
Total (residents and cross-borders)						
Deficit /surplus	Primary deficit/surplus (% of GDP)	1.7%	2.0%	1.9%	-1.1%	-3.8%

Source: Author's own calculations.

The second scenario, '*Progressive convergence to normal*', presented in Table 6, is more negative and the pension deficit is expected to reach 5.6% of GDP in 2060. This scenario reflects an extension of the visible trend and forecasts a slowdown in the activity with a more modest economic growth, lower inflation, and net migrations.

Table 6. Results in Scenario 2 'Progressive convergence to normal'

		2020	2030	2040	2050	2060
Residents						
Contributors	Number of pension contributing workers	290,683	304,633	310,738	305,799	295,270
	Average gross income per contributor (EUR)	58,458	64,574	71,330	78,793	87,036
	Total pension revenue (EUR mn)	4,031	4,603	5,061	5,326	5,863
Beneficiaries	Population 64+	87,123	112,641	135,579	157,526	174,497
	Average pension (EUR)	45,010	46,185	48,776	52,671	57,940
	Total pension spending (EUR mn)	-5,449	-7,133	-8,752	-11,106	-12,710
Deficit/ surplus	Primary deficit/surplus (EUR mn)	9,480	11,736	13,813	16,431	18,573
	Primary deficit/surplus (% of GDP)	-2.2%	-3.1%	-3.8%	-5.2%	-5.3%
	Pensions paid as % of contribution	-1.4	-1.5	-1.7	-2.1	-2.2
Cross-border workers						
Contributors	Number of cross borders	180,000	176,770	171,180	165,590	160,00
	Average gross income per contributor (EUR)	55,866	61,711	68,168	75,299	83,177
	Share of gross income to pension (%)	24%	24%	24%	24%	24%
	Total pension revenue (EUR mn)	2,413	2,618	2,801	2,993	3,194
Beneficiaries	Total pension spending (EUR mn)	-337	-667	-1,250	-2,495	-3,616
Deficit/ surplus	Primary deficit/surplus (EUR mn)	2,077	1,951	1,550	497	-422
	Primary deficit/surplus (% of GDP)	3.2%	2.4%	1.6%	0.4%	-0.3%
	Pensions paid as % of contribution	0.140	0.255	0.446	0.834	1.132
Total (residents and cross-borders)						
Deficit/ surplus	Primary deficit/surplus (% of GDP)	1.0%	-0.7%	-2.2%	-4.7%	-5.6%

Source: Author's own calculations.

The third scenario, '*Perfect storm*', presented in Table 7, is by far the worst scenario and the pension deficit is expected to reach 10.3% of GDP in 2060. This scenario mirrors a worsening of the economic situation with job destruction and economic growth drop impacting net migrations and cross-borders.

Table 7. Results in Scenario 3 'Perfect storm'

		2020	2030	2040	2050	2060
Residents						
Contributors	Number of pension contributing workers	286,732	284,089	266,432	233,732	196,385
	Average gross income per contributor (EUR)	56,473	60,551	63,648	65,714	67,040
	Total pension revenue (EUR mn)	3,827	3,939	3,695	3,194	2,849
Beneficiaries	Population 64+	87,123	112,641	135,579	154,355	157,106
	Average pension (EUR)	43,482	43,308	43,523	43,928	44,628
	Total pension spending (EUR mn)	-5,264	-6,688	-7,786	-8,846	-8,445
Deficit /surplus	Primary deficit/surplus (EUR mn)	9,090	10,627	11,482	12,040	11,294
	Primary deficit/surplus (% of GDP)	-2.3%	-3.9%	-5.6%	-8.2%	-8.8%
	Pensions paid as % of contribution	-1.4	-1.7	-2.1	-2.8	-3.0
Cross-border workers						
Contributors	Number of cross borders	159,390	150,000	142,464	137,000	130,000
	Average gross income per contributor (EUR)	55,866	61,711	68,168	75,299	83,177
	Share of gross income to pension (%)	24%	24%	24%	24%	24%
	Total pension revenue (EUR mn)	2,065	2,083	2,080	2,065	1,999
Benefi-ciaries	Total pension spending (EUR mn)	-337	-667	-1,226	-2,227	-2,977
Deficit /surplus	Primary deficit/surplus (EUR mn)	1,728	1,416	854	-163	-978
	Primary deficit/surplus (% of GDP)	2.8%	2.0%	1.2%	-0.2%	-1.5%
	Pensions paid as % of contribution	0.163	0.320	0.589	1.079	1.489
Total (residents and cross-borders)						
Deficit/ surplus	Primary deficit/surplus (% of GDP)	0.5%	-1.9%	-4.4%	-8.4%	-10.3%

Source: Author's own calculations.

3.6. Potential policy actions and impact

Continued reform of the pension system is advisable. The very strong population growth projection, through long-term net migration, should be treated with caution. Additional pension reforms should be considered, as the reforms of 2013 are not sufficient for system equilibrium if economic outperformance is not sustained. We present several sets of reforms for the three scenarios in Table 8.

Table 8. Policy readjustment in the three scenarios (in % of GDP)

Policy readjustment	**Scenario 1: '*Successful economic reorientation*'**	**Scenario 2: '*Progressive convergence to normal*'**	**Scenario 3: '*Perfect storm*'**
Nothing	- 6.2	- 6.7	- 10.9
+ Increase in contribution (+4pp from 2015 to 2060)	- 4.7	- 5.6	- 9.7
+ Increase in the effective exit age (+4pp years from 2015 to 2060)	- 2.1	- 3.8	- 7.7
+ Increase in contribution (+8pp from 2015 to 2060)	- 0.7	- 2.9	- 6.8
+ Increase in the effective exit age (+8pp years from 2015 to 2060)	+ 1.9	- 1.0	- 4.6
+ Inflation freeze of pension allowance	+ 2.1	- 0.8	- 4.3

Source: Author's own calculations.
Notes: The numbers in this table relate to the pension deficit/surplus as % of GDP, pp stands for percentage point.

Potential reform levers include an increase in contributions, re-indexation of pension benefits and postponing of the retirement age. Each of these policy actions has a different level of impact and implementation time.

The increase in contributions is the fastest policy to implement, and probably the most likely given that citizen protests against this measure are assumed to be low compared to reduction in the level of pension or an extension of the retirement age, as it can be implemented almost immediately. However, there is a natural cap to how much it can be increased to maintain the competitiveness of the local workplace (gross to net income ratio).

Indexation of pension benefits will take time if policymakers wish to avoid giving a straight haircut (in this case it will re-adjust over time by freezing pension indexation vs. inflation). In extreme cases of deficit, it can be implemented quickly and significantly re-adjust the deficit.

Postponing the retirement age has a large impact, as it theoretically increases the number of contributors while decreasing the number of pensioners. However, implementing the policy does not immediately solve the issue of the senior employment rate, as it takes time to implement on a cohort-by-cohort basis.

We have modelled a set of policy readjustments from mild to substantial, from the easiest to implement for policy makers to the most difficult one, and tested it against each scenario. We have analysed the impact of each reform-set on current scenarios.

To sum up, without any policy reform, pension budget in 2060 is expected to reach:

– Scenario 1 '*Successful Economic Reorientation*': -3.8% of GDP;
– Scenario 2 '*Progressive Convergence to Normal*': -5.6% of GDP;
– Scenario 3 '*Perfect Storm*': -10.3% of GDP.

First, the mildest and easiest reform for policymakers to implement would probably be to slightly and gradually increase the contribution rate[15]. This measure could also pass with little protest from citizens. Taking into consideration a gradual rise of 4pp in the contribution rate to 2060, the pension budget in 2060 is expected to decrease in all the three scenarios to:

– Scenario 1 '*Successful Economic Reorientation*': -2.4% of GDP;
– Scenario 2 '*Progressive Convergence to Normal*': -4.5% of GDP;
– Scenario 3 '*Perfect Storm*': -9.3% of GDP.

Second, other measures will be enacted once the contribution rate has been raised. The second most likely measure will probably be to raise the effective exit age. With an aging population, it would be rational to align the effective exit age to lifespan, or at least postpone the exit age. Adding these two policy reforms, the pension budget is expected to reach:

– Scenario 1 '*Successful Economic Reorientation*': +0.3% of GDP;
– Scenario 2 '*Progressive Convergence to Normal*': -2.6% of GDP;
– Scenario 3 '*Perfect Storm*': -7.1% of GDP.

Third, the next policy reform likely to be implemented would be another increase in the contribution rate, but at a higher level, than the one implemented previously. Instead of +4pp, it would be +8pp to 2060. Taking the two measures into consideration (increase of the effective exit age by four years associated with an increase in the contribution rate by 8pp) would yield a pension budget of:

– Scenario 1 '*Successful Economic Reorientation*': +1.9% of GDP;
– Scenario 2 '*Progressive Convergence to Normal*': -1.5% of GDP;
– Scenario 3 '*Perfect Storm*': -6% of GDP.

Fourth, the next policy reform likely to be implemented would be another increase in the effective exit age, but at a higher level than the one previously implemented. Instead of four years, the effective exit age will rise by eight years by 2060. Taking the two measures into consideration (the increase of the effective exit age by eight years associated with an increase in the contribution rate by 8pp) would yield a pension budget of:

– Scenario 1 '*Successful Economic Reorientation*': +4.6% of GDP;
– Scenario 2 '*Progressive Convergence to Normal*': +0.4% of GDP;
– Scenario 3 '*Perfect Storm*': -3.6% of GDP.

[15] This reform has been enacted by the government. The contribution rate, currently at 24%, is equally split between employees, employers and Government. If expenditure becomes higher than revenue, the contribution rate could be raised by 2pp for all contributors (so the contribution rate could increase to 30%).

Fifth, the last and least popular pension measure is likely to be a reduction in pension benefits for all pensioners. As this measure is rather unpopular, the likely way to implement it would be to freeze pension benefits against inflation and to stop automatically adjusting pension benefit levels taking the inflation rate into consideration. Given that the inflation rate is the highest in the first scenario and the lowest in the third scenario, we can expect this measure to have a wider impact in the first scenario than in the last one. Considering the three measures (inflation freeze of pension benefits, increase of the effective exit age by eight years associated with an increase in the contribution rate by 8pp) would yield a pension budget of:

– Scenario 1 '*Successful Economic Reorientation*': +9.1% of GDP
– Scenario 2 '*Progressive Convergence to Normal*': +4.3% of GDP
– Scenario 3 '*Perfect Storm*': -0.1% of GDP

Obviously, policy makers are reticent to make unpopular reforms, given their interest in being (re)elected.

4. Conclusion

In our paper, we use the "*reference class forecasting*" approach to study the evolution of a small open economy's pension's equilibrium between 2015 and 2060 to reduce policy making biases and gut feeling. We assess a set of policy actions and their impact in three different scenarios: the '*Successful economic reorientation*', the '*Progressive convergence to normal*', and the '*Perfect storm*'. It leads to a risk assessment discussion under uncertain outcomes, where policymakers can have a rational debate about "*insuring*" for the future economic volatility.

This paper addresses a modelling issue specific to small open economies – how to forecast and assess future contributions and liabilities when a large proportion of the workforce is made up of either cross-border workers or recent emigrants.

To overcome these challenges, we built a highly innovative model in the way it models cross-border workers' contributions and impact. Most cross-border workers only work a few years in Luxembourg and hence are entitled to a partial pension when they retire. It is further challenging as the churn of cross-border workers is very important and varies strongly over the years. We model the yearly cohort of cross-border workers and the partial entitlement of each cohort when it retires after a few years. This allows us to not only assess the state liabilities but also the evolution of age pyramid with a significant portion of new migrants. This considers the high volatility of workers and is the most suited model of the underlying future liability for a small open economy's pension system.

As a result, we built a model allowing policymakers to navigate in a highly volatile and an open small economy. Also, we paved the way for healthy debate between policymakers and on how to present the challenges to the population with a collective "*call for action*" with several economic and policy reform scenarios.

Although we focus in this paper on pensions in a small open economy, our approach is highly relevant and can be easily tailored to model other areas that

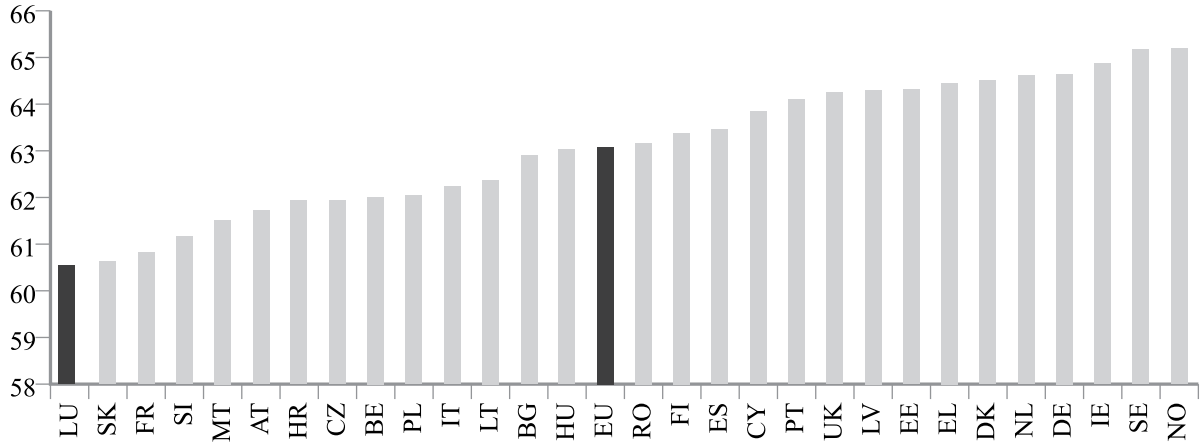
are highly impacted by employment migration and demographic balance such as unemployment benefits or social welfare. The model can also be used to reflect any country's pension reforms, assess the need for reforms, and provide an update with several economic scenarios depending on the cyclicality.

A. Annex

A.1. Statutory and average retirement age

The statutory retirement age is 65 and the early retirement age is 57. The effective exit age in 2014 was 60.2 for men and 60.9 for women as shown in Figure 4, the lowest in the European Union. We expect the effective retirement age to remain unchanged for men and women until 2060 (in line with the AWG2015), despite the Pension reform and the incentives to work longer to keep the same benefit as before the reform. The incentives to work longer are rather low as there are neither penalties nor bonuses to working longer (AWG2015).

Figure 4. Average Effective Exit Age from Labour Market, 2014



Source: The 2015 Ageing Report, European Commission and Fund staff calculations.

A.2. The 2013 Luxembourg pension reform

The pension allowance is made of three components. First are the fixed additional charges ("*majorations fixes*") which are the fixed additional charges, depending on the insurance increase. Second are the accrued charges ("*majorations proportionnelles*") which depend on the earnings contributions. Third are the increase of accrued instalments charges ("*majorations proportionnelles échelonnées*"). Fourth is an end-year-allowance, which is allocated to those entitled to a pension by December 1st.

A pension reform came into force in 2013, which is reflected in this model. The fixed additional charges (depending on the insurance period) increase from

23.5% to 28.0% of the social minimum wage over the next 40 years. The accrued charges decrease from 1.85% in 2013 to 1.60% in 2052, representing a decrease in pensions of around 10%. The weighting of these two effects gradually reduced the pension allowance by 7.7% from 2013 to 2052.

The increase of accrued instalment charges also changed. To benefit from an increase of accrued instalment charges, before the reform there were two thresholds, both in terms of age (55 years) and of career length (38 years). Both criteria had to be respected. The Pension Law sets a new single minimum threshold for the sum of both of age (60 years) and of career length (40 years). According to the reform, only one of these criteria needs to be respected to grant rights to accrued instalment charges.

The end-of-year allowance would be withdrawn if expenditures were higher than revenue. Cutting the allocation at year-end, which represents 2% of all paid pensions, occurs when pension expenditures exceed revenues.

The ages of retirement and early retirement remain unchanged and the contribution rate of 24% (8% employees, 8% employers and 8% Government) to the pension system is similar. If expenditures are higher than revenue, the contribution rate could be raised by 2pp for all contributors so that the contribution could reach 30%.

The adjustment to real wage developments will be no longer automatic as had been the case before the reform. Indeed, pensions are now adjusted to actual salaries every two years (odd years) based on a reference series compiled by the IGSS after elimination of the most extreme incomes. However, if spending becomes higher than revenue, there is a compensation mechanism that would be triggered, limiting to half of wage increases of what was granted.

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Abbreviations

AWG – Ageing Working Group, GDP – Gross Domestic Product, GNI – Gross National Income, IGSS – General Inspectorate of Social Security, IMF – International Monetary Fund, IPCN – price index for domestic consumption, STATEC – Luxembourg National Statistical Office.