

Economic Survey of Norway, 2001

Summary

Norway is currently benefiting tremendously from the high oil price. At the same time, however, this has complicated the pursuit of a sound macroeconomic policy stance. Looking ahead, given the tight labour market situation, a major challenge in securing a stable economic development with robust growth will be to contain inflation. In this context, the monetary authorities should be commended for their swift reaction to the mounting inflationary pressures while the fiscal authorities should, at a minimum, resist the temptation to fuel demand further. A change in the policy mix, including fiscal tightening, would be appropriate, especially if upside risks materialise. It will also be essential that the authorities continue to save the major part of oil revenues. This will reduce the need to increase the tax burden in coming decades when ageing will push up expenditure and oil revenues will fall. In this context, the use of the Government Petroleum Fund for developing a funded pension system should be assessed. It will also be crucial for the government to end the rapid rise in early retirement, sick leave and disability pensions. This would also boost labour supply and prevent the crowding out of private sector labour demand due to the projected strong increase in government employment. At the same time, efficiency-enhancing measures are needed to prevent such a strong rise in government employment. The pace of structural reform has been slow. Concerning product and financial markets, the recent privatisations are a step in the right direction but more remains to be done. The standard of living could be improved further by taking measures that would help to increase productivity growth in the future. Obtaining the major benefits of the rapid development of information and communication technology, and of the new economy, will depend on putting the proper policy conditions in place. To take advantage of policy complementarities, reforms should be comprehensive, covering a wide range of structural policies. This would help to increase living standards and to maintain prosperity in an ageing society. ■

This Policy Brief presents the assessment and recommendations of the 2001 OECD Economic Survey of Norway. 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.

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How has the economy performed recently?

The Norwegian economy has rebounded from a short and benign growth pause that ended in mid-1999 largely due to an easing in monetary policy and strong external demand. Growth of mainland Gross Domestic Product (GDP) (*i.e.* excluding shipping and petroleum extraction activities) picked up from $\frac{3}{4}$ per cent in 1999 to an estimated $2\frac{1}{4}$ per cent in 2000. While growth has remained clearly below its strong performance in 1994-98, in large part because investment in the offshore petroleum sector has continued to contract sharply, capacity constraints remain. The rebound in activity has kept the labour market tight, with vacancies at a high level while the unemployment rate, at 3.4 per cent, has remained very low. As a consequence, wages have risen faster than in the euro area, adding to the cost pressures prompted by the oil price hike and inflation accelerated from 2.3 per cent in 1999 to 3.1 per cent in 2000. The central bank reacted swiftly to rising inflation pressures and raised its key deposit rate. ■

Is there a downside to the high oil price?

As the world's second-biggest net oil exporter, Norway has benefited tremendously from the sharp rise in oil prices since early 1999. The major improvement in the terms of trade led to an increase in national income by an estimated 17 per cent in 2000 and to double-digit current account and government budget surpluses as a share of GDP. At the same time, the task for the authori-

ties to steer a sound macroeconomic policy became more complicated, especially due to the mounting pressures to spend more of the oil wealth now. ■

What is the near term outlook?

Mainland GDP growth is projected to slow down somewhat to slightly below 2 per cent in 2001 and 2002, reflecting the recent monetary tightening, the tapering-off of world trade and the return to a normal level of electricity production, which will only be partly offset by a less negative development of petroleum-sector investment. The output gap, however, is likely to remain positive and the labour market tight. As a result, the rise in labour costs will remain strong and core inflation (*i.e.* excluding energy) could drift up. The risks to the growth and inflation outlook appear to be more balanced in the light of weak activity in recent months. Demand could be boosted, if the tight labour market induces stronger than projected wage gains in 2002 after the expiration of the current two-year wage settlements. The high oil price may also imply stronger oil investments than projected. Moreover, slippage on public outlays, as has occurred in recent years, could also fuel domestic demand. On the other hand, weak demand in the second half of 2000 may indicate that interest rate changes are influencing private consumption more strongly than in the past. ■

Is the policy framework delivering?

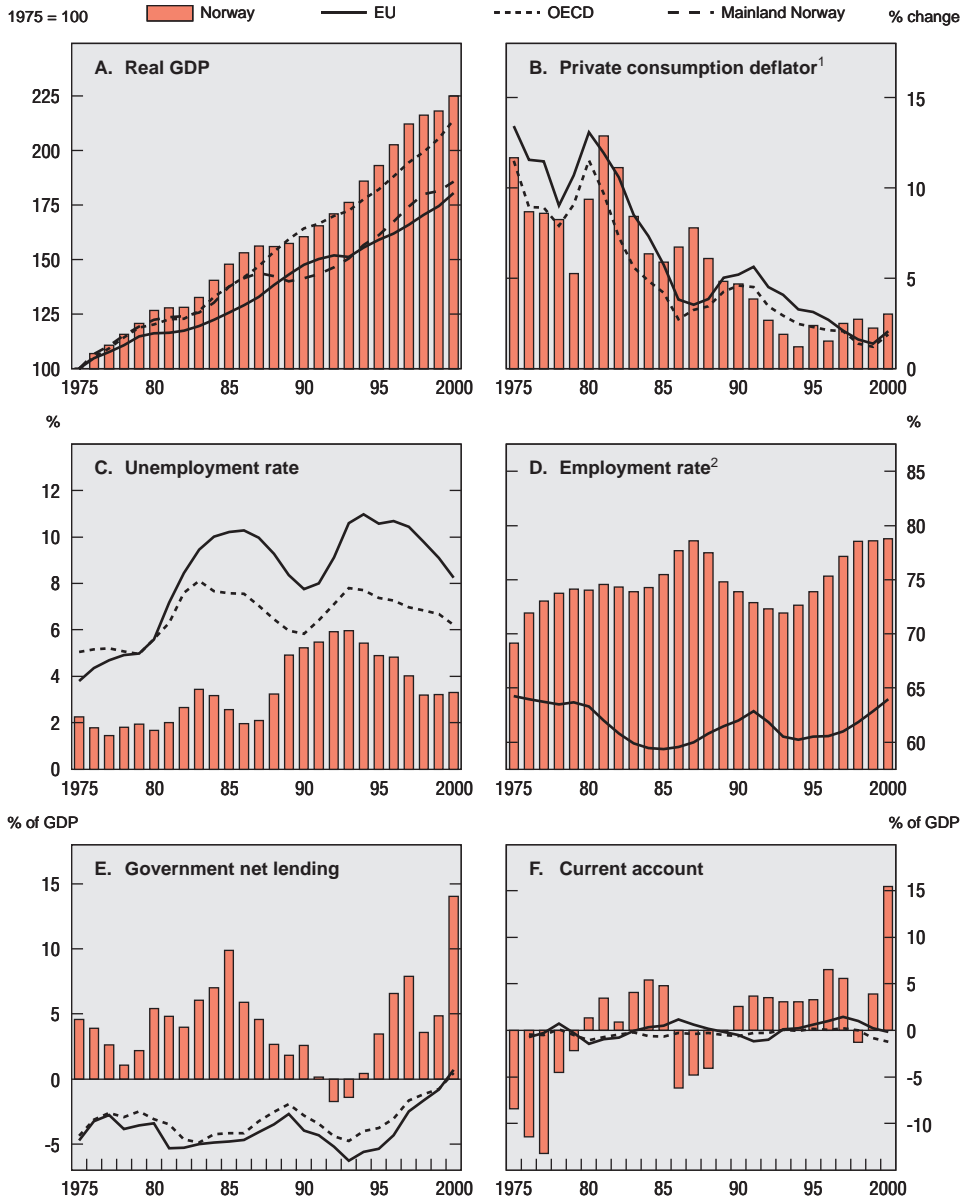
The current macroeconomic policy framework, the so-called *Solidarity Alternative*, has three pillars:

i) monetary policy, which aims at maintaining a stable exchange rate against the European currencies (the euro since 1999); ii) fiscal policy, which aims at stabilising the economy, with budget surpluses generated by the government's petroleum revenues reinvested in financial assets abroad; and iii) incomes policy, *i.e.* co-operation between the government and the social partners, which aims at moderate wage settlements to ensure full employment and to prevent an erosion of the traditional exposed sector. Monetary policy is the pillar that has evolved most, which should prevent a pro-cyclical monetary policy stance that on occasions occurred in the past. However, influenced by mounting labour market tensions and the high oil revenues, neither fiscal nor incomes policy have fully fulfilled their objectives, placing a heavier burden on monetary policy. ■

Should the policy mix be adjusted?

Since early 1999, operational procedures of monetary policy have evolved and the monetary authorities are emphasising now the need to bring price and cost inflation down towards the European Central Bank's (ECB) price stability objective as a fundamental precondition for exchange rate stability *vis-à-vis* the euro. Accordingly, the Norges Bank moved quickly and raised the key deposit rate by $1\frac{1}{2}$ percentage points to 7 per cent when inflationary pressures rose during 2000. This has undoubtedly increased the credibility of the new approach and avoided imbalances from building up even further. If, as projected, demand slows down and inflationary pressures abate, monetary policy could

Key indicators in long-term and international perspective



1. OECD excludes high inflation countries.
 2. Total employment as a per cent of working age population (aged 16-64).
 Source: OECD (2000), Economic Outlook No. 68, December.

be eased somewhat during the projection period. However, if the upside risks to the projection materialise, the monetary authorities

may need to tighten further. Since possibilities to adjust the budget during the budget year to offset unexpected changes in demand are

limited, fiscal policy is not a very flexible demand-management instrument. The fact that monetary policy, rather than fiscal policy,

reacted to signs of overheating in 2000 would thus appear appropriate. However, the fiscal authorities should have tightened the fiscal stance for 2001 to reduce the burden on monetary policy, thus ensuring a more balanced policy mix. They decided, however, to maintain the neutral stance and fiscal policy will therefore neither cool nor boost the economy in 2001. The current mix of a neutral fiscal stance and a tight monetary policy means interest rates are higher than they otherwise need to be which could put the exchange rate under upward pressure and could lead to a crowding out of the exposed sector. Such a crowding out might also take place if continuing increases in public expenditure, that might seem affordable in view of Norway's oil wealth and the assets accumulated in the Petroleum Fund, compete away scarce labour resources from the private sector. ■

How can fiscal discipline be reinforced?

To cover rising public expenditure and ensure a neutral fiscal stance, taxes will increase in 2001 by even more than in the previous year. This is in sharp contrast with the trend in other European countries. A dividend tax has been introduced, increasing the tax on capital income, and the VAT (value-added tax) rate will rise by 1 percentage point to 24 per cent, only partly offset by the halving of the VAT on food. The rise in the tax burden is likely to have a negative impact on potential output. In this context, it is a handicap that there is no clear medium-term budgetary framework, comparable with the Stability Programmes of the euro area countries. Such a programme would provide

an anchor to the budget deliberations and could help contain the upward trend in government outlays and taxes. It would also bring to the fore the long-term consequences of fiscal policy as regards issues such as the distribution of real resources between the public and private sector.

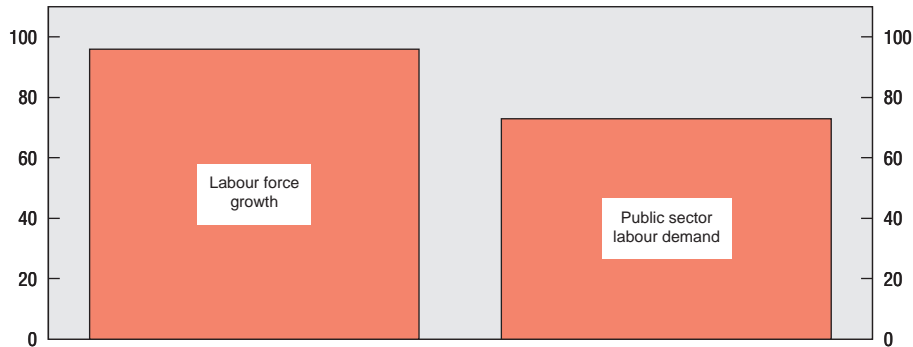
The government has recently stressed the need to improve public sector efficiency. It is crucial that concrete measures be taken soon to attain this goal. If not, practically the complete rise in labour supply in the coming decade will be absorbed by the public sector, the rise in public expenditure will be substantial and the tradeables sector will inevitably be squeezed. There is plenty of room for increased outsourcing of auxiliary services, especially by local governments. More fundamentally, collective provision of goods does not necessarily imply production by the public sector and a shift of production to the private sector could lead to efficiency gains. ■

Is incomes policy working?

The performance of incomes policy, the third pillar of the macroeconomic policy framework, has been mixed. The rather centralised wage negotiation system has probably contributed to dampen wage growth, in particular in the first half of the 1990s, when unemployment was still high by Norwegian standards. However, it did not prevent the excessive rise in earnings in 1998, although it contributed in avoiding an escalating wage-price spiral thereafter. Since 1995 Norwegian labour costs have risen consistently by more than among its trading partners, leading to a deterioration in

competitiveness. Moreover, the highly-centralised wage negotiations have reduced flexibility at the micro level, especially in the public sector, and have induced policy concessions such as the early retirement schemes with clearly negative long-run consequences. After the expiration of the current wage settlements in early 2002, income policy will face another crucial test. The tight labour market could lead to wage gains outstripping that of trading partners for the eighth successive year. Strong wage gains would necessitate a tightening of the macroeconomic policy stance and could undermine the credibility of the current policy framework. In 2000, a government committee concluded that the current policy framework has contributed to the sound and balanced economic development, especially the favourable labour market situation, but acknowledged explicitly at the same time certain weaknesses of the current centralised wage negotiations. Its recommendation to allow greater room for negotiations at the local level within the centralised framework should be taken up as it would make wage setting more flexible, particularly in the public sector. Furthermore, the liberalisation of the strict rules on labour contracts and overtime should be seriously considered. It remains to be seen, however, whether the implementation of these recommendations would lead to incomes policy fulfilling its objective of moderating wage growth better than in recent years and whether it would reduce markedly the costs of the centralised approach. Despite strong wage rises in recent years, Norwegian employment performance is outstanding in a number

Future labour force and public sector labour demand¹
2000-2010, thousand persons



1. The rise in public labour demand is based on demographic developments leading to an increase in health and care labour demand, on constant man-hours per user (after taking into account the upward impact of policy measures already taken), on the shortening of working days due to the 2000-01 wage agreement and on no shift of services to the private sector. The rise in labour force growth is based on constant participation rates by age cohort. Two-thirds of the rise in the working-age population and the labour force is due to net immigration.

Source: Ministry of Finance.

of respects: the employment rate is one of the highest in the OECD, while the unemployment rate is among the lowest. But measures are needed to reverse some worrying trends such as the rapid rise in early retirement, sick leave and disability pensions. A drop in the labour force participation rate should be avoided as labour market bottlenecks are already substantial and as it would make it more difficult to cope with the ageing of the population in the coming decades. Concerning sick leave, the recent proposals by an official committee to tackle the sharp rise in absenteeism should be implemented rapidly. The committee suggested that employers should start to pay 20 per cent of the sickness payments from the 16th day of absence onwards and that these

payments should be reduced from 100 to 80 per cent of earnings in the first 16 days of sick leave. Implementing these measures would still leave sickness benefits which are generous by international comparison, so that they may have to be complemented by a tighter follow-up of those on sick leave. ■

Should telecom and energy markets be opened further?

Not only labour market reform but also product market reform is needed to underpin solid, non-inflationary growth in the longer run. Product markets are still characterised by substantial state ownership and by high government

support, especially to the agricultural sector. In the 1990s, deregulation has been carried out to improve competition, while so far not much emphasis has been put on privatisation of public enterprises. The partial privatisation of the public telecommunications operator at the end of 2000 is, therefore, a welcome step and is likely to improve competition and efficiency further. However, the authorities intend to keep a stake of 51 per cent in the long term while many other countries have opted for complete privatisation. Government involvement should be reduced further. Strict regulatory supervision of the incumbent will be indispensable to prevent an abuse of its dominant market position. Norway could also benefit from increasing competition in the electricity sector. A further unbundling

of production and distribution of local government electricity utilities would enhance competition and improve efficiency. Furthermore, ownership of such utilities by municipalities should be reconsidered as they may not be sufficiently professional owners in an electricity market that is becoming more complex and sophisticated. As for the oil sector, the recent decision to create room for more players in the exploration market is welcome. But this needs to be amplified, as proposed by the government, by privatisation of the state-owned oil company so as to improve efficiency. While recognising that there are difficult issues in assuring that the state effectively keeps the resource rent, the government proposal of a somewhat smaller involvement of the government through the *State Direct Financial Interest* is also welcome.

Because of participation in the European Economic Area (EEA), structural reforms have been fastest and deepest in sectors benefiting from the EU's liberalisation agenda. This will continue in the future. The government should therefore pay great attention to sectors that are not directly influenced by the EEA agreement, such as agriculture. Support to the agricultural sector, which is among the highest in the OECD, should be scaled back and regional policy goals pursued by other means. Specifically, agricultural support should be less linked to output and better targeted to reduce the high costs to consumers and taxpayers. In this context, the reduction of VAT on food in 2001 may limit tax evasion through cross-border shopping slightly, but it could even increase the overall burden of agricultural protection on the rest of the economy.

With respect to structural reform of financial markets, the Norwegian

authorities have recently sold their one-third stake in the second-largest bank. There is also a decision to reduce the state stake in the largest bank, but only from 60 per cent to a third. In this context, it is relevant that economies of scale and scope may exist in the banking sector and that the international trend is towards greater size, while Norwegian banks are small, even in a regional context. However, further concentration around this partially state-owned bank may affect competition negatively for some banking and insurance services. ■

How will ageing affect public finances?

The special chapter of this *Survey* reviews the impact of ageing on the Norwegian economy and the scope for reform. Norway, like most OECD countries, will experience a significant ageing of its population. It starts, however, from an enviable position. The employment rate of older people is among the highest in the OECD, pension outlays are currently relatively low and substantial financial assets have been accumulated in the Government Petroleum Fund. However, without reform, due to the maturing of the pension system, the ageing of the population will lead to a bigger run-up in spending than in most other OECD countries over the next 50 years despite a somewhat less rapid ageing process. ■

What pension reforms are needed?

A key problem over the past decade has been a fall in the effective age of retirement. This has been encouraged by the implementation of the

early retirement scheme (AFP), which provides fairly generous benefits and strongly encourages retirement before 67. And, since it allows individuals to accrue old-age pension rights while receiving AFP benefits, it reduces the tax base while keeping old-age pension outlays unchanged. This scheme should be abolished and replaced by a system of flexible retirement where benefits would be actuarially adjusted. Finally, changes in the tax code to remove incentives to retire early would be welcome. Measures are also needed to contain the inflow into disability pension schemes. Implementing the recent proposal of an official committee to introduce temporary disability pensions, which are automatically reassessed after a couple of years would improve screening. Meanwhile, the programme to re-examine eligibility for receiving a disability pension, which will be implemented in 2001, is a step in the right direction. Reforms within the current public old-age pension system should also be on the agenda. Future spending pressures could be reduced by shifting the indexation of pension benefits partly from wages to prices, as many OECD countries already have done, and by calculating pension rights over the entire work history instead of the best twenty years. The fact that not all individuals are covered by the occupational schemes makes the system unequal, although recent legislation on private sector occupational schemes is likely to increase their coverage. The authorities should assess the desirability of merging the two types of earnings-related pension schemes (the supplementary pension scheme within the public *National Insurance Scheme* and occupational schemes) to ensure full coverage of the retired population and to streamline the

pension system. However, such a merger should be carefully designed to avoid a sharp rise in overall pension expenditure. ■

Should oil wealth fund retirement?

The use of the Government Petroleum Fund for funding pensions should be assessed. The Fund is not sufficiently large to fund all pension liabilities. However, one option is to earmark part of the Government Petroleum Fund for new pension rights. This could also facilitate reforms of the current pension system and might help to contain the pressure to raise other government outlays in the future. On the other hand, earmarking would also pre-empt alternative uses of the assets accumulated in the Fund and risk locking in social security entitlements. More radical options should also be considered when redesigning the earnings-related component of the pension system. A first option would be to move to a “virtual” defined-contribution arrangement, as in Sweden and Italy. Under this system, individuals accumulate “contributions” in fictive accounts over their working lives with the individual receiving an “annuity” based on the cumulated

contributions on retirement. The Petroleum Fund could be used to pre-fund this system. A second option could be a mandatory system outside the public sector with individual accounts. In this case, the Petroleum Fund could be allocated to individual accounts on the basis of previous lifetime earnings. In this approach, saving through individual accounts would replace taxation for the pay-as-you-go system, which could well strengthen incentives to work, save and invest. The financial burden of the health and old-age care systems could rise rapidly in the coming decades given current use patterns – with an extensive use of some high cost services – and the low level of user charges paid by the beneficiary. Some containment of the ageing-induced rise in health and care expenditure seems possible through improvements in health care system efficiency, for instance through a better consolidation of supply across municipalities. While there are distinct advantages to having responsibility for some welfare services at different government levels, the present arrangements could encourage municipalities and counties to shift part of the burden onto each other. Arrangements should be changed to remove these incentives. More generally, charges for health care may need to be

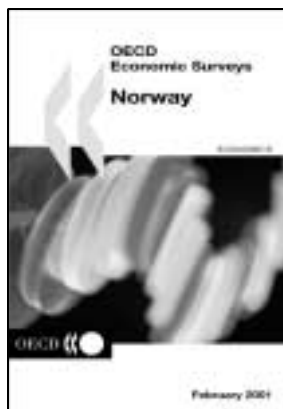
increased to better reflect overall resource costs. Public spending on long-term care in Norway is particularly high by international standards and with the number of the very old tending to increase more rapidly than the total number of individuals of retirement age, these costs could continue to increase. To ease the financing of the costs, the government could consider requiring a larger share of the overall cost to be paid for by beneficiaries. Introducing such measures is often politically contentious because they can require individuals to sell off assets such as housing. But with careful design, such measures can circumvent such problems while avoiding distorting effects on the volume and allocation of savings. ■

For further information

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For further reading

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- **Additional Information:** More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Website at www.oecd.org/eco/eco/.
- **Economic Outlook No. 68,** December 2000. A preliminary edition is published on the OECD Website approximately one month prior to the publication of the book: www.oecd.org/eco/out/Eo.htm.

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The OECD Policy Briefs are prepared by the Public Affairs Division,
Public Affairs and Communications Directorate.
They are published under the responsibility of the Secretary-General.

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