POLICY BRIEF

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Economic Survey of Norway, 2002

Summary

While the oil wealth is benefiting the Norwegian population, it complicates the setting of macroeconomic policy and the implementation of structural reform. The rising assets of the Petroleum Fund lead to strong pressures from all quarters to raise public spending, stimulate rent seeking and encourage complacency on the need for structural adjustments. Both effective macroeconomic management and continued structural reforms to lift labour supply and productivity growth are essential to secure strong growth over the long term. The short-term outlook points to an acceleration in output growth while unemployment should remain low. Labour force growth has been negatively influenced by detrimental developments in early retirement, disability and sick leave. Labour shortages have led to strong wage increases, so that interest rates will need to stay high to comply with the inflation target of 2½ per cent. Fiscal policy should under no circumstance ease beyond the present fiscal rule, while additional government outlays should not take precedence over the tax cuts the government currently envisages. To ensure discipline on spending, the current fiscal rule should be supplemented by an explicit expenditure rule. Beyond the short term, if the planned public sector and pension reforms are not ambitious enough, a tighter fiscal rule will be needed. To improve public sector performance, the budget process should

This Policy Brief presents the assessment and recommendations of the 2002 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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switch to multi-annual budgeting, while the funding of public services should become more activity-based and public sector management more performance-oriented. Furthermore, there should be a better link between local taxation and spending. The private sector should play a larger role in the provision of public services and user charges should be introduced or raised to reduce excessive demand. Measures to lower the levels of sick leave and to reverse the fall in the effective retirement age are urgently needed. At the same time reducing state ownership further and, in several sectors, enhancing competition will improve productivity. Ensuring a stable macroeconomic environment and pursuing reforms of the public and private sector would improve labour productivity performance and raise the already high standard of living further. ■

What is the state of the Norwegian economy?

Strong growth through the five years to 1998 necessitated fiscal and monetary policy tightening which, together with a drop in oil investment, damped activity since then. However, the labour market has remained tight with tensions persisting in many sectors, even though the unemployment rate has risen slightly to 3.7 per cent in early 2002. Rapid wage gains have caused a sharp deterioration in competitiveness since the mid-1990s. On the other hand, inflation has remained under control, reflecting a squeeze in profit margins, cuts in indirect taxes and more recently the appreciation of the krone. As Norway is the world's third largest oil exporter behind Saudi Arabia and Russia, high oil prices since 2000 have led to an extremely large current account surplus which reached 15 per cent of GDP in 2001. ■

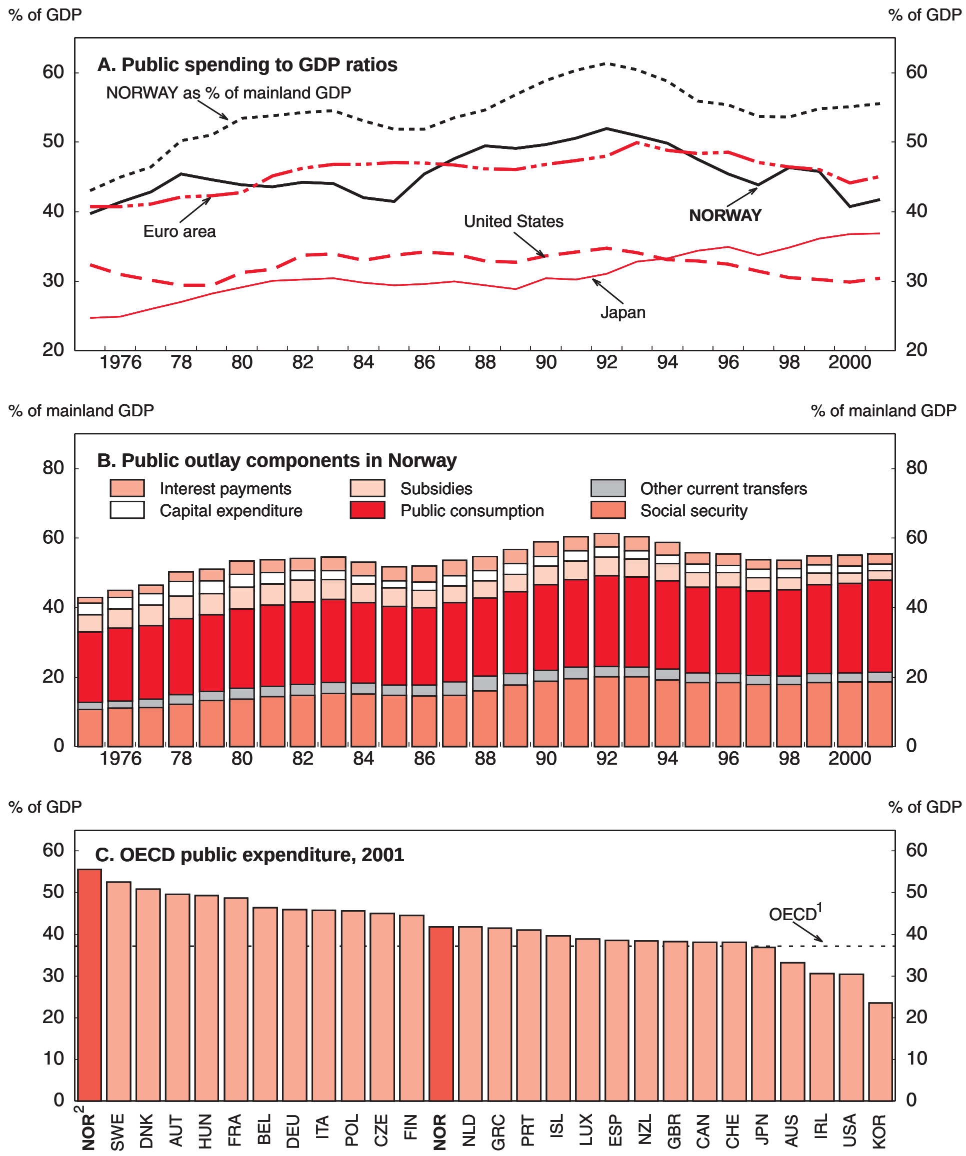
How about the near-term outlook?

With large oil revenues the general government surplus has become huge (14 per cent of GDP in 2001), creating strong pressure to ease fiscal policy. This prompted a reform of the macroeconomic policy framework that will lead to a persistent fiscal expansion from 2002 onwards. In 2002-03, this fiscal expansion will coincide with a healthy recovery abroad and a projected robust rise in oil investment, while consumer confidence is currently brimming and will probably be sustained by further hefty real wage gains. Export market losses caused by worsening competitiveness will dent output gains, but even so mainland GDP growth is projected to accelerate from 1¼ per cent in 2001 to 1¾ per cent in 2002 and 2½ per cent in 2003. Hence, unemployment is projected to remain low and a positive output gap to reappear. Nevertheless, because of cuts to indirect taxes and falling import prices due to the appreciation of the krone, headline inflation should be low (1¼ per cent) in 2002. The tight labour market is likely to keep wage gains strong so that interest rates will need to stay high – indeed some tightening may be needed – to comply with the inflation target of 2½ per cent, unless the krone appreciates further. With the oil price assumed to remain at USD 25 per barrel from the second quarter of 2002 onwards, the current account and the government budget are projected to continue to show very large surpluses. ■

What do the new macroeconomic guidelines mean?

The previous government presented new guidelines for fiscal and monetary policy in March 2001 that were approved by Parliament shortly thereafter. The new fiscal policy rule sets the structural non-oil central-government deficit equal to the expected 4 per cent real rate of return on the Government Petroleum Fund. However, as expressed in the government report on the new guidelines, fiscal policy has a counter-cyclical role to play and deviations from this deficit target are thus allowed in the case of excess demand or supply. Moreover, the guideline foresees that in the event of extraordinary changes in the Petroleum Fund's capital or in the structural deficit, corrective action will be spread over several years. With the presumption that tight monetary policy might well be necessary to offset this steady fiscal expansion,

Public spending in international perspective



1. Weighted average.
2. Norway as a percentage of mainland GDP.

Source: OECD, *OECD Economic Outlook,* No. 71, June 2002, finalised in April 2002.

the government set an inflation target of 2½ per cent over time for the central bank. Based on the new fiscal rule, the structural non-oil central-government deficit is currently projected to rise gradually from 1½ per cent of mainland GDP in 2001 to 4½ per cent in 2010, with the strongest rises in the initial years. The total government surplus would fall to 10 per cent of GDP in 2010, while the Government Petroleum Fund assets would increase to 116 per cent of GDP.

With the economy close to full capacity, the intended fiscal expansion will lead to tight monetary conditions. More public spending or higher private outlays induced by tax cuts will need to be offset either by the negative impact of high interest rates on interest-rate sensitive expenditure or the negative effect of a strong exchange rate on exports. In any case, labour demand in the public and private service sectors will increase, requiring a shift of employees from exposed to sheltered activities. ■

Is the new monetary policy guideline an improvement?

Although the introduction of the inflation target largely represents a formalisation of operational procedures which had been in place since 1999, it is welcome as it has increased transparency. As the monetary policy framework is now in line with current practice of many other central banks, it is now easier to communicate policy decisions. With the manufacturing sector squeezed by strongly rising labour costs and the appreciation of the krone, pressure on the monetary authorities to soften the policy stance is likely to increase, but should be strongly resisted. ■

Has fiscal policy a counter-cyclical role to play?

According to the guidelines, fiscal policy should still play an important role in stabilising output fluctuations while inflation targeting by the monetary authorities will have the same impact. In a welcome development, the authorities' attitude towards fiscal activism has recently evolved in the direction of giving the principal demand-management role to monetary policy. Monetary policy is a much more flexible instrument and fiscal activism could divert the authorities' attention from medium-term issues. Moreover, an active fiscal policy risks to be asymmetric over the cycle pushing up outlays. Fiscal policy should therefore not go beyond letting the automatic stabilisers work fully around the expansionary path set by the fiscal rule and active stabilisation policy should be left to the central bank. It is important that the authorities continue to communicate that monetary policy is the primary instrument of stabilisation policy.

The introduction of an operational inflation target requires a new approach to the wage negotiations and incomes policy co-operation, the traditional third pillar of the Norwegian macroeconomic policy framework, the so-called *Solidarity Alternative*. Excessive labour cost increases will lead to monetary tightening and the social partners should shift focus from wage developments relative to the trading partners towards wage increases relative to productivity developments. To reduce labour market imbalances, greater room for negotiations at the local level is also required while policy concessions, such as the introduction in the past of financial support for early-retirement schemes, should no longer be made. ■

Is the new fiscal rule sustainable?

In principle, the new fiscal rule, while looser than the earlier framework, will still just about ensure broad generational fairness, as the ongoing reduction in petroleum reserves is matched by a corresponding increase in the assets of the Petroleum Fund. However, the official long-term scenario implicitly assumes a substantial improvement in public sector efficiency and a far-reaching pension reform. If these are not forthcoming the new fiscal rule will lead to an unsustainable budgetary situation in the long term. Given this, the authorities should under no circumstance ease beyond the current deficit rule. Moreover, if the current public sector reform programme does not rein in spending soon or if a pension reform is agreed in 2004 that is not ambitious enough, the current framework will be too loose and policy will have to be reversed to ensure long-term fiscal sustainability. ■

How can the budget process be improved?

Concerning the budget process, the authorities should introduce multi-annual budgeting as this would underscore that the room for additional spending is limited in the medium term. Furthermore, the deficit rule should be supplemented by an explicit expenditure rule. This would reduce the risk that spending pressure will crowd out the tax cuts currently envisaged or, as in the case of the revised 2002 national budget, that a tax windfall is immediately used for additional outlays. It would also be helpful to supplement the current Long-Term Programmes, presented by the government before elections, with a detailed fiscal strategy statement of the new government soon after the elections. To improve transparency, a move from cash to accrual accounting is also desirable. It would give better information on costs and may therefore improve cost effectiveness. Moreover, the budget papers should present comprehensive estimates of the cost of regional policy to enhance transparency in an area where there is currently little information despite its importance. ■

What public sector reforms are needed?

Public sector reform should focus on moving further towards a budget and management approach geared towards outcomes, in order to improve cost-efficiency. Activity-based funding schemes, similar to that for hospitals, should be extended to other public services, but at the same time price signals, should be used more frequently to avoid excessive demand and hence public spending. In the aftermath of the hospital reform, the problems of cost control may be a particular source of concern. To enhance public sector efficiency, more flexible personnel management practices are also required. Public bodies should be given more freedom to set employment and employees' wages, with the possibility to use efficiency gains to reward good performance. At the moment, the public-sector wage system is too rigid and the remuneration schemes are not sufficiently performance-based.

To encourage efficiency gains, mergers of and co-operation between municipalities should be stimulated, so as to reap scale economies. Furthermore, citizens should be allowed to use the services of other municipalities to increase user choice and raise competition within the public sector. Better cost-accounting and a consistent application of the "money follows the user" principle are prerequisites for better co-operation and increased user choice. Local-government funding arrangements fail to provide sufficient incentives to contain local spending and should therefore be reformed. Currently, all municipalities apply the maximum local income tax rate partly because they fear that lowering the rate will be met by a cut in discretionary central government grants. These discretionary grants should therefore be sharply reduced. Moreover, property taxes should be given more prominence in local government revenues. These are less volatile than income taxes and, as revenues are not shared with central government, they are more transparent for citizens and thus are likely to help to contain local spending. A sharing arrangement between local governments and the state for the corporate income tax, which is currently discussed by the government, should not be reintroduced as the tax base is very volatile. It can also lead to excessive spending to attract businesses, as local governments do not have the power to set the rate.

To provide public services in a more cost-efficient way, more competition between public and private sector providers is also required. In this context, equal funding of public and private providers is crucial. The recent government objective to equalise funding for early childhood educational and care facilities is thus commendable and should be extended to other public services. However, the application of the "money follows the user" principle to other childcare arrangements (parental care and private child-minders) through the existing childcare cash benefit should be reconsidered. This does not bring the same economic and social benefits, in particular concerning labour supply as well as the cognitive development and social integration of children. Furthermore, the current tight regulations on the establishment of private providers should be liberalised, especially in the hospital and education sectors. In this context the recent government proposal to facilitate the founding of private schools is welcome. More user choice is likely to promote better outcomes in the education system, which have recently been shown as being only average in the OECD PISA study despite the high government outlays. Finally, increased recourse to outsourcing and competitive tendering would contribute to a better delivery of services, requiring a reform of the special VAT treatment for public bodies because the current system favours in-house production.

Increases in user charges should be considered as a means to reduce excessive demand for public services. Several OECD countries have better targeted support for higher education through fees, loans and grants schemes which include provisions of the less well-off, and the Norwegian authorities should envisage similar measures. The introduction of such schemes would strengthen incentives for students to complete studies in a reasonable time. In the elderly care sector, there is also scope to raise user charges, as recommended in the previous *Survey*. However, in increasing the role of user fees, equity considerations should be taken into account and mechanisms need to be introduced to avoid “cream skimming”. Therefore, the commendable government proposal to increase user choice in primary education should be supplemented by measures to avoid social segregation.

In addition to public sector reform, other measures are needed to boost potential output growth. Spurred by petroleum revenues, national income per capita is among the highest in the OECD but the oil wealth masks the need for structural reforms and makes implementation more difficult. Besides the attention required to growth issues explored in the recent *OECD Growth Study* – such as the need to encourage an appropriate mix of private and public research and the need to enhance the capacity for adopting new technologies – there are specific labour market and product market problems that have to be solved. ■

What sick leave and pension reforms are needed?

Norway’s commendable tradition of work-oriented social inclusion has led to one of the highest employment rates in the OECD area but, at 26½ hours per week, average working hours are relatively low, partly due to high part-time employment. This reflects individual preferences but also the impact of the tax and social security systems and of labour market regulation. In this context, the October 2001 agreement on sick leave between the government and social partners is disappointing. It is highly unlikely that the goal of reducing sickness absence by 20 per cent in four years will be reached by the voluntary company-level approach. With sick leave continuing to rise, the re-evaluation agreed for mid-2003 should be advanced and the recommendations of the recent *Sandman Committee* to lengthen the duration of the employer’s contribution and to reduce benefits should be implemented.

Another major labour market issue is the worrying drop in the effective retirement age, although it is still high in international comparison. Withdrawal from the labour force before the standard pensionable age of 67 years via the disability pension and early retirement schemes has become increasingly common. Spending on disability pensions is around 2½ per cent of GDP, one of the highest levels in the OECD. The introduction in 2001 of the assessment of each disability pensioner’s potential to return to work is a positive step but as participation in rehabilitation programmes is voluntary, the measure has to be strengthened and additional measures to stop the use of the scheme for early retirement are needed. As recommended in the previous *Survey*, the current early retirement schemes should be replaced by a system of flexible retirement with actuarially-adjusted benefits. It remains to be seen whether the latest pension committee – the third one in six years – will come up with such a recommendation. This committee will provide a comprehensive review of the Norwegian system, including the possible use of the Government Petroleum Fund for funding pensions. Such earmarking may help to reduce the pressure to raise other government outlays in the future but may have consequences for the formulation of the fiscal framework. However, to avoid an unsustainable budgetary development, supplementary measures to make the pension system less generous are also needed. ■

How is privatisation progressing?

To spur potential output growth, product market reforms are needed as well. Norway has made a relatively late start compared with most OECD countries in relying more on market forces and less on the state in the provision of goods and services, the main exception being the reform of the electricity market in the early 1990s. Since 1994, Norway has been a member of the European Economic Area, and as such has been committed to deregulation of product markets in line with developments inside the European Union. Given the high share of public ownership, privatisation should be more rapid, especially in the banking, telecommunications and electricity sectors. Thus the proposals made in the April 2002 White Paper to reduce state stakes in enterprises are welcome. However, important elements were not endorsed by Parliament. In the electricity sector, competition is currently insufficient and the recent blocking of further concentration by the Norwegian Competition Authority is welcome. The same holds for its efforts to instill greater competition in the domestic airline industry, for instance by its decision to halt airline bonus programmes that were seen as unduly strengthening the position of the incumbent. ■

Is it necessary for consumers to bear the burden of agricultural support?

Norway has not significantly reduced its heavy agricultural support in recent years. Two-thirds of Norwegian farm revenue is government aid, while consumers pay twice the world price for agricultural products and considerably more than in neighboring countries, causing substantial cross-border shopping. Support should become less linked to output and better targeted so as to reduce the high costs to consumers and taxpayers while its regional policy goals should be pursued by other means. Furthermore, lower agricultural support and fewer restrictions on agricultural trade might lead to a valuable improvement in trade arrangements for fish products with the European Union. ■

For further information

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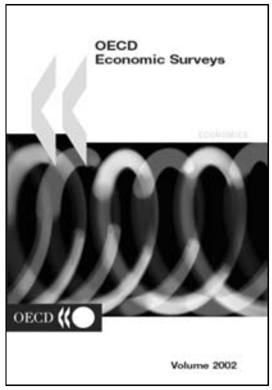
For further reading

- **OECD Economic Surveys:** *Economic Surveys* review the economies of member countries and, from time to time, selected non-members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at *www.oecd.org/bookshop*.



- **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 Web site at *www.oecd.org/eco*.

- **Economic Outlook No. 71,** June 2002. More information about this publication can be found on the OECD's Web site at *www.oecd.org/eco/Economic_Outlook*.

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