

## Economic Survey of Norway, 2007

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### Summary

**The economy is experiencing a favourable period of robust growth, low unemployment and moderate underlying inflation.** This largely reflects the effects of globalisation, of which Norway has been a prime beneficiary, supplying energy and other commodities at high prices and increasingly importing products from low-cost countries. Sizeable labour migration inflows, together with sustained productivity growth, have kept cost inflation at a moderate pace. A tradition of foreign trade openness, domestic competition, a good policy framework and sound macroeconomic management have meant that Norway was well prepared to take advantage of these international trends.

**With underlying inflation well below its target, Norges Bank has raised the interest rate in small, not too frequent steps.** There are signs of tensions now emerging, notably in the labour market, which could lead to higher inflation expectations if interest rates remain below the neutral level for too long. The central bank has decided to edge up the pace of normalisation of interest rates; an even faster pace may become necessary if wage growth appears to accelerate more than expected.

**The fiscal rule has helped to limit the injection of oil revenue within the absorptive capacity of the economy.** The budget deficit was allowed to exceed the amount permitted by the rule in the past five years, in part to support the economy. But with the recovery well under way, the budget for 2007 reaffirms the political commitment to the rule, thus bolstering its credibility. An undershooting of the rule should now be envisaged, so as to compensate for past deviations and help cool the economy.

*This Policy Brief presents the assessment and recommendations of the 2007 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.*

**Even though the statutory retirement age is high by international norms, the pension system is not fully on a sustainable footing.** Perhaps because oil revenues have allowed distortions in the work-leisure choice, the effective age of retirement has trended down, suggesting that Norway may not in the end entirely escape the “resource curse”. The growing use of social benefit schemes – for the most part sickness and disability benefits and early-retirement – has depressed older-worker participation, lowered working time and brought labour utilisation towards the international average. Reforms are needed to correct such distortions. Norway must resist the temptation of finding in higher-than-expected oil revenues an excuse for delaying the adoption of necessary reforms.

**Future economic prosperity will also depend on the pace of technology-driven innovation, which at present remains low by cross-country standard indicators.** Although measurement is incomplete, R&D intensity appears weak, patenting is moderate and business surveys report a limited interest for innovative activity. Yet, the level of productivity is high in the mainland economy and its trend growth enviable, showing a capacity to absorb innovation spillovers and undertake organisational and managerial changes. Improving the framework conditions that stimulate innovation, such as strong product-market competition, would go a long way towards preparing Norway for its post-oil future, when revenues from natural resources will make a reduced contribution to fast-rising living standards. ■

**What are the main challenges?**

The economy is in the fourth year of a long cyclical upturn that has brought down unemployment, without so far rekindling underlying inflation. This reflects in large part the effects of globalisation, which have been more beneficial than in most other OECD countries. Norway has been supplying energy at prices driven up globally by the needs of buoyant emerging economies like China and India, and it has been increasingly importing low-cost consumer goods in return. The resulting terms of trade gains have been large both by international and historical standards. Sustained rises in oil prices induced record high petroleum investments, growing demand for business services and other significant spillovers into mainland production. Inflation and wage growth have nonetheless remained low, thanks to declining import prices and large migration inflows of labour. In turn, low inflation has allowed monetary policy to remain accommodative longer than would otherwise have been possible, adding to the forces of recovery and stimulating a housing boom. Natural endowment is not the only reason for this fine outcome. A tradition of trade openness (except for agriculture), a good policy framework and sound macroeconomic management have also meant that Norway adjusted its product specialisation to the challenges of globalisation early on.

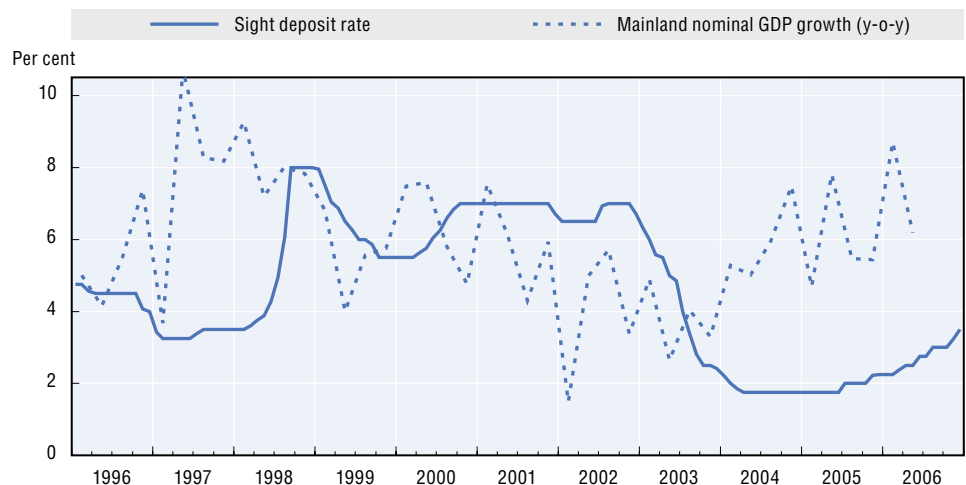
The central bank has kept interest rates low for an unusually long period as a result of muted inflation, but the short-term challenge will now be to reduce the risk of overheating. In the medium term, policies must remain vigilant to avoid possible perverse impacts of the oil wealth, notably an undue crowding out of market sectors by overextension of oil-financed public expenditure. The present fiscal rule has been helpful in this regard, but it nonetheless implies growing injections of oil money into the economy, the more so at the higher oil price. Buoyant petroleum revenues make it more difficult than otherwise to gather popular support for thorough-going reforms of early retirement, sickness absence and disability benefit programmes. Yet, such reforms are essential to bring pension and benefit promises into line with what is affordable over the long run, and thus need to be pursued vigorously. Such reforms can be absorbed more easily when growth is thriving, as at present. To secure Norway's longer term economic future, the economy needs to remain diversified and competitive, productivity gains need to stay robust and innovation will be critical to underpin them. Timely action is required, as petroleum production is expected to peak at the end of the present decade, at the same time that pension expenditures will start a rapid ascent. ■

**Should monetary policy tighten faster?**

Since 2003, underlying inflation has remained well below the target of Norges Bank of 2½ per cent. Worried that inflation expectations could become entrenched at a low level, the central bank kept its sight deposit rate at close to 2% from early-2004 to mid-2005. Thus, monetary conditions have remained quite easy for a long time. The central bank has cited various disinflationary forces to explain its policy stance – such as the increasing share of imports from low-cost countries, strong competition in product markets, high productivity growth and a hard-won anchoring of inflation expectations. Large migration inflows of labour may also have reduced the equilibrium unemployment rate because, in activities requiring a mix of skills (such as construction), the availability of skilled foreign workers has made it possible to employ low-skilled resident workers who would otherwise have remained unemployed. Thus, when the recovery started, Norgest Bank decided to tighten in small, not too frequent steps, even though the short-term interest rate was far from reaching its neutral rate interval of 5-6%, and got only about half way there by late 2006.

However, with growth having averaged 3¾ per cent annually since the recovery started, there are now signs that slack is fast disappearing. The unemployment rate seems headed for 3% – close to the historical danger zone for wage inflation. More industries are reporting hiring difficulties and there are signs that wage claims may grow at a faster pace. Capacity utilisation in the economy is also rising. Thus there are risks that inflation expectations might soon start rising. Meanwhile house prices have kept increasing and adjustable-rate household debts

**Figure 1.**  
**LATENT INFLATION PRESSURE**



Source: Norges Bank, OECD Economic Outlook 80 database.

have accumulated. In view of these developments, Norges Bank recently decided to quicken the pace of normalisation. It advanced the expected return to neutrality to 2008. Nonetheless, the new pace of normalisation remains quite gradual. During the last upswing, price and cost inflation surged suddenly at the peak of the cycle, and this feature of the Norwegian economy may well remain present. Whether the forces of globalisation have reduced this risk remains untested. *Hence, Norges Bank should stand ready to tighten faster than it currently envisages if wage growth picks up faster than expected, as could happen with the Spring 2007 wage rounds.* The OECD's latest economic projections suggest that such a faster tightening might indeed be necessary. ■

### Should fiscal policy undershoot the rule?

Conversely, fiscal policy has been running a larger deficit than targeted in each of the first five years of the fiscal rule's existence. This overshooting was initially justified by weak economic conditions and asset prices, thereby helping to stabilise the economy. Once the recovery started in 2004, however, there was no need for fiscal policy to continue providing stimulus, especially with the output gap turning positive in 2006. The spending of oil income in excess of the 4% expected real return on the Fund has gradually been reduced every year since 2003. The 2007 Budget reinstates a strict adherence to the fiscal rule. The structural non-oil deficit is estimated by the authorities at 4.6% of mainland trend-GDP, which is 0.3 percentage points higher than in 2006, suggesting a modest stimulus. Government expenditure is projected to grow by 3 per cent in real terms, with large increases going to primary education, foreign aid and infrastructure projects. *In view of the strong economic momentum, a slightly more ambitious budgetary stance would have been desirable. Therefore, any windfalls in 2007 should be used to strengthen the budget. Over the medium term, it will be important to undershoot the rule sufficiently to compensate for the cumulative overshooting to date, consistent with the symmetry enshrined in the fiscal rule.* The economic justification is threefold: *first*, a sharply expanding baseline for the rule, owing to high oil prices, could over-stimulate the already well-heated economy if strictly adhered to; *second*, there is a large fiscal gap after 2020 arising notably from steeply increasing ageing-related expenditure; and *third*, boosting spending now, i.e. on more generous welfare programmes, risks adding to the long-term challenges of fiscal policy. *In view of these fiscal challenges, the authorities might consider introducing an expenditure rule.*

In order to respect Norway's obligations *vis-à-vis* all generations, fiscal policy needs to be forward looking in not only a quantitative sense, i.e., by following the fiscal rule, but also qualitatively. This means, above all, using the oil money in ways that do not distort the work-leisure choice. Norway has so far been remarkable in providing incentives for older workers to remain in the labour market and in setting the retirement age at 67. Nonetheless, there are signs that the tradition of relatively late retirement is being increasingly undermined by policy settings. If exits through disability pensions for persons older than 50 years and AFP early-retirement pensions are included, the expected retirement age is now down to 63½, i.e., 3½ years less than the formal age of retirement. This is a sign that welfare policies have a large impact on the participation of older workers. *Thus, any reform of the pension system should restore later retirement incentives and close early exit routes.* ■

### How can the pension system be made more sustainable?

Norway should be no different from other OECD countries that have all instituted pension reforms. It is true that in Norway old-age pensions are partly pre-funded by the oil cushion. Nonetheless, even if the expected income from the oil fund were to be exclusively used to pay for future pensions, this would cover only about 40% of the pension funding gap. The pension system is still immature and the high female participation rate is recent, which obscures the underlying deficit. The combined effects of the retirement of baby boomers, longer life expectancy, maturation of the system and declining labour utilisation imply that the pension system is not on a sustainable footing.

A comprehensive pension reform proposal was formulated in 2004, and in May 2005 Parliament reached broad agreement on key elements of the reform, that are now being put into place. In January 2006, a new mandatory occupational pension scheme was introduced, with a minimum contribution rate, and employers have started to make contributions. The Petroleum Fund was also transformed into a "Global Pension Fund" and merged with the existing NIS fund; although largely symbolic, this step should help convince the public that oil revenues should be saved for future use. The pension agreement in Parliament also included the introduction of a life expectancy factor, benefits based on lifelong earnings and pension benefits indexed on an average of prices and wages after retirement.

A new White Paper on pension reform was presented to Parliament in October 2006. The new White Paper retained the proposal concerning the introduction of a flexible retirement age in the Social security system from 62 years based on actuarial principles. At the same time the government proposed somewhat higher pension credits to people with low to medium earnings than in the former White Paper, while preserving the long run fiscal saving envisaged earlier (3% of GDP). The government also stated its intention to negotiate changes in the present AFP early-retirement system with the social partners, in order to transform it to a supplementary benefit to the Social security old-age pension based on actuarial principles. In order to make this possible, the Government signalled its intention to increase its contribution to AFP in line with demographics. *Continuation of the state subsidies should be conditioned to the social partners reaching agreement on reforms coherent with the objective of securing actuarial neutrality in the overall pension system.*

In non-pension welfare areas, reforms are also essential. Health care and long-term care spending is a particular source of concern because its projected increase, some of which is due to ageing, nearly doubles the projected fiscal funding gap. Wide-ranging reforms were launched in the health sector to make greater use of quasi-market mechanisms, eliminate shortages, raise efficiency and improve citizen satisfaction. However, with the introduction of activity-based financing and other related measures, spending accelerated after the reform and, if current trends were to continue, they will substantially add to the required effort associated with ageing. ■

### How can labour market performance be improved?

The labour market is functioning well, with strong participation rates at all ages. Yet, labour utilisation is not as high as it looks, in part because of the short duration of working time. Annual working time is already one of the shortest among OECD countries. Hence, *the authorities should avoid making steps toward a general shortening of working time, which has led in other countries to lower labour utilisation, without obvious benefits for the workers.* In addition, labour utilisation is depressed by high entry into sickness and disability benefit schemes, which are poorly monitored and therefore popular. Attempts to reform the sickness and disability benefit schemes, including the tripartite agreement, have so far been unsuccessful. In order to curb sickness absences, the government proposed to introduce

an employer co-payment of benefits, but this was rejected on the grounds that it might have encouraged employers to screen applicants and discriminate against the less healthy. Likewise, an experiment to provide wage subsidies for the employment of disabled workers was not successful. New measures will be implemented in 2007 to curb the rise of sickness absences and a commission report on disability pensions will soon be released. *Indeed, Norway needs an ambitious rescaling of its sickness and disability assessment process, with a parallel reduction in these schemes' financial generosity and a tightening in eligibility criteria. Better control of sickness absences as carried out in most OECD countries is needed in Norway. Also, disability entitlements should be initially assessed and thereafter regularly reviewed by NIS doctors.* Thus, to have a real impact, the reform of the old-age pension and early retirement scheme should be complemented by reforms of the health-care system, as well as of the sickness and disability benefit schemes. With well-designed reforms in place, the welfare system would move onto a sustainable footing. It is therefore crucial that Norway resists the temptation of finding in higher-than-expected oil revenues a cause for delaying the necessary reforms.

Norway has developed a very strong activation strategy for people with low labour-market attachment. However, the process of vocational rehabilitation seems particularly long and outflows may be judged disappointing for specific groups. *These programmes should be aimed at speeding up the return of long-term sickness recipients back to work. In addition, in order to curb possible abuse, controls and sanctions to actively participate in job search should be enforced. The recent merger of the Public Employment Services with the National Insurance Administration should help fill this objective, provided that the culture of placing people into jobs takes precedence over the culture of distributing a multiplicity of assistance benefits.* In the medium term, such labour market reforms would halt the deteriorating trend in labour market participation, thereby helping safeguard the Norwegian welfare state itself. ■

### Is there a puzzle about innovation in Norway?

Future economic prosperity will depend not only on greater labour utilisation, but also on innovation-driven productivity growth. Innovative activity seems low by international standards, however, as suggested by below-average R&D intensity. The low level of R&D spending may in part reflect the incompleteness of measurements, which do not cover the oil sector very well, but weak patenting shows that there is less technological innovation activity than elsewhere. By contrast, there are clear signs of

intense non-technical innovation – such as process innovation, adoption of new technologies, engineering-based improvement – which goes a long way towards explaining why productivity growth has been satisfactorily high. The traditionally competitive product markets and high wage levels have meant that firms have been forced to adopt new technologies in order to beat rivals and survive. Although Norwegian firms only produce a small share of their technological innovation needs, they are very apt at taking advantage of existing technological opportunities and translating them into greater efficiency.

The government has set ambitious goals to promote innovation, hoping to raise the rate of R&D spending, especially in the private sector. It should however be careful as to how it spends public money. So far, the existing schemes to allocate public support to innovation through research grants and tax credits generally seem well designed and regularly evaluated. There have been benefits stemming not only from new technological developments, but also from improvements in traditional activities (such as engineering related to marine services and oil activities or aquaculture). But making an efficient use of additional fiscal support will be challenging. Because the private sector has been so far reluctant to allocate large resources to innovation, it is unlikely that increasing budgetary support alone will make a large difference. More public money may only end up raising the costs of producing research, without correspondingly larger benefits. Consequently,

**Figure 2.**  
**HOURS WORKED AND**  
**WORKING WEEKS LOST**  
**DUE TO SICK LEAVES**



Source: OECD, Going for Growth database.

measures should be carefully designed to increase the extent to which they generate additional R&D that would not have taken place in their absence. Furthermore, a higher degree of specialisation in technologically innovative sectors will not necessarily be rewarded; international prices of some of these products have fallen recently – as shown by computer prices – thus leading to deteriorating terms of trade for countries producing such equipment. ■

### How to promote innovation and entrepreneurship?

If the authorities want to ensure that the benefits of innovation spread further, they should continue to improve framework conditions. Most importantly, *competition policy and its implementation should be strengthened and product market regulations relaxed, together with a continuing reduction of state ownership in market-based production. In this respect, the independence of the competition authority should be upheld.* In the final analysis, firms must be subjected to more intensive competition to encourage them to look to innovation as an obvious way of staying in business profitably. As well, the spread of technological innovation requires adequately-educated workers and the present limited interest for tertiary studies in maths, science and technology is a concern in this respect. Efforts need to start at the level of secondary education, where PISA test scores in sciences are low by international standards. To raise the quality of teaching in maths and science, *salary differentials in favour of teachers of such subjects will need to widen in order to attract the qualified personnel.*

More public money will not achieve much in the absence of a greater innovation culture; in particular, businesses do need to perceive opportunities in boosting innovation. Several steps could improve the situation. The public research sector has long had a mission in knowledge transfers, but *private-public research links should be strengthened further, which could require additional mechanisms facilitating the commercialisation of university innovations, such as allowing public-sector employees to be seconded to the private sector without exposing them to financial risks, including erosion of pension rights.* The R&D funding programmes should also be clearly de-linked from the regional policy. The tax credits scheme (Skattefunn) seems to be sufficiently generous for SMEs. Raising the ceiling for larger firms could be considered if the evaluation exercise shows that additionality is significant. There are other steps that would facilitate the financing of innovative firms. *Financing of small innovative firms should be encouraged by lifting restrictions on classes of assets that can be invested by insurance companies and pension funds. At the same time,*

*there should be a relaxation of borrowing conditionality for the extension of seed capital while allocating more public funds to a variety of institutions currently channelling venture capital funds to private start-ups. ■*

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