POLICY BRIEF

OECD

March 2004

Economic Survey of Norway, 2004

Summary

The short-term outlook for Norway is good. Helped by global recovery, growth could proceed at above potential rates for a while, especially as inflation is well below target and there is some cyclical slack in the labour market. Interest rates are low, and fiscal stimulus needs to be withdrawn. Indeed, it will be important to rein back spending over the next few years in order to get back onto the self-imposed track of permissible spending of oil revenues that is consistent with notions of intergenerational fairness. In the longer term, the case for continuing fiscal restraint is even stronger. Reflecting both demographic factors and the maturing of the system, public spending on pensions will rise considerably over the next decades, even if the major reforms now under discussion are quickly implemented. In the future, growth of living standards will have to rely primarily on increases of productivity and employment in the non-oil private business sector. To maintain vigour in the non-oil economy, reforms in both labour and product markets, and in social policies and transfer programmes are called for. There are important interdependencies among policies in these areas and it is unlikely that success will be achieved without advancing with comprehensive reforms. More flexibility is desirable in wage setting, particularly in the public sector. Proposed changes in the fields of education and training will raise skill levels, but value for money needs to be an important criterion when prioritising the programmes. Competition should be strengthened through regulatory reform and a more active policy stance: proposed amendments to strengthen the enforcement framework are an opportunity to make

This Policy Brief presents the assessment and recommendations of the 2004 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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competition policy more central, and should include an independent appellate body. State ownership and subsidies to agriculture should be reduced. Norway's comprehensive social programmes ensure that poverty is virtually non-existent, and a strong work ethic and a high level of social trust led to comparatively little abuse in the past. However, the very rapid rises in numbers on disability pensions and on sick leave suggest that stricter controls are needed. Advancing the reform efforts suggested above will be necessary to harness the more efficient use of resources, thereby raising non-oil potential output and ensuring that Norway maintains a high standard of living in the years to come. ■

What are Norway's main economic policy accomplishments and challenges?

In recent decades, Norway has been in the forefront of OECD growth performance, and has managed to boost growth in the mainland over the last decade. Mounting oil wealth has contributed to Norway's per capita income being on a par with that of the United States, but this good performance also owes much to other factors: stability-oriented macroeconomic policies that have prevented oil wealth from being frittered away; efficiency gains from past liberalisations in a number of service sectors; direct impacts and spill-overs from the capital intensive, technologically sophisticated, and booming oil sector; a strong work ethic, as reflected in unusually high participation rates for men and women, old and young alike; and a high-performing labour market, in which a brisk rise in employment has accompanied strong growth of productivity. Norway's traditionally high social cohesiveness and solidarity have also ensured that the utilisation of the oil wealth benefits people at all levels of society, and will continue to benefit future generations well after the oil itself is depleted. The challenge will be to maintain this good performance going forward.

The first main challenge is to *manage monetary and fiscal policies*, and the balance between them, so as to strengthen policy credibility and thus provide a stable framework for growth. The second issue is the threat to long-term *fiscal sustainability* under current policies. A still-maturing yet demographically-challenged pension system faces a spending surge sharper than elsewhere in the OECD. The third major challenge is to arrest *declining labour utilisation* resulting from high and rising recourse to sick leave and disability pensions. The final issue, receiving special treatment in the Survey, is the *need to strengthen competition in product markets*. Despite its strong productivity performance, OECD indicators suggest that Norway possesses substantial scope for further gains from pro-competitive reforms, which will be critical in moving towards a post-oil economy. ■

How has implementation of the new macroeconomic policy framework proceeded?

For at least the last decade, a central policy concern for Norway has been to manage its rising oil wealth in an effective way. During most of the 1990s, the policy emphasis – embodied in the "Solidarity alternative" – was to preserve the competitiveness of the mainland economy, using monetary policy to stabilise the nominal exchange rate, incomes policy to deliver nominal wage growth in line with trading partners, and fiscal policy to keep aggregate demand in line with potential. Around the turn of the century, spending pressures arising from the mounting oil wealth called for a redesign of the policy framework. In 2001 monetary policy was formally shifted to a flexible inflation-targeting framework and the inflation target was set at 2½ per cent. Fiscal policy was also redefined by stipulating that the annual transfer of oil revenues to the state budget, to finance a structural non-oil deficit, should over time equal the "real return" on the Petroleum Fund, estimated at 4 per cent of the Fund value. While this rule "locked-in" a modest degree of fiscal expansion at a time when for cyclical reasons a fiscal tightening might have been more appropriate, it had the substantial advantage of setting out clearly a prudent long-term basis for the use of mounting Petroleum Fund assets – something that was lacking in the previous policy regime – while establishing the right of future generations to a share of the oil wealth.

Partly reflecting international economic developments, but also domestic tensions, the implementation of the new framework faced challenges in its first two years. This was the case for both monetary and fiscal policies:

- The Central Bank was faced in early 2002 with wage increases that were clearly excessive relative to the inflation target and raised interest rates by ½ percentage point, thus maintaining a high differential with other countries. The krone appreciated further, reinforcing the cost competitiveness problems facing the exposed sector after several years of high wage growth, and subsequent job losses in manufacturing were high. Starting in mid-2002, falling import prices brought inflation down quickly to below the target. Moreover, lower domestic growth and moderate wage settlements in early 2003 pointed in the direction of more moderate inflationary pressures in the medium term than earlier envisaged. Starting at end-2002, the central bank cut interest rates, by a total of 5 percentage points by early 2004, and the real exchange rate (in relative consumer price terms) fell back to its long-term trend. Inflation has remained well below target.

- As regards fiscal policy, the guidelines for the use of oil money did allow in a general way for year-to-year deviations to smooth the market based swings in the value of Fund assets, and to accommodate cyclical fluctuations. In the event, the combination of falling asset prices internationally, sluggish growth in the Norwegian economy, tax cuts and increased spending, resulted in the use of oil money over the past two years exceeding the expected real return of the Fund by an average of one per cent of GDP per year. Moreover, current budget plans entail no correction for 2004, a year of economic recovery. Ministry of Finance projections are that even if use of oil money is frozen in real terms from now on – hence contracting relative to GDP – a return to the 4 per cent path would occur only towards the end of the decade. ■

How can monetary and fiscal policies be made more coherent and credible?

To underpin a balanced and sustainable recovery, monetary and fiscal policies will need to be coherent. Implementing monetary and fiscal policies to allow the underlying policy anchors – the inflation target and the fiscal rule – to acquire strengthened credibility, while still allowing appropriate flexibility, would reduce the risk of large swings in real and financial variables. As regards monetary policy, the Central Bank follows a flexible inflation targeting regime, meaning that a sufficiently long time horizon in pursuing its inflation target allows some weight to be put also on the output gap. Over time, a stable development in both employment and inflation can best be ensured when the social partners internalise the long-run relationship between real wages and productivity, as well as the nominal anchor provided by the inflation target. Arguably, the very moderate wage settlements in 2003 may be an indication that this is already occurring, although the real test will come with the next upturn. Monetary policy credibility will be critical. Regular hearings before Parliament with the Bank Governor have been introduced at end-2003, an essential step toward strengthened accountability, transparency and communication of the Bank's goals and strategies for achieving them. Recent moves to de-politicise the bank board selection process are also welcome.

The key requirement for fiscal policy is to establish and maintain credibility of the fiscal rule, faced with spending pressures that will intensify during this decade and onwards, because of rising health spending and public pension commitments, even with reforms to the calculations of benefits as recently proposed. A faster return to the 4 per cent spending rule path than currently envisaged is thus desirable, especially because if markets see that pressures to overspend are irresistible, the currency will tend to appreciate. A further delay of the return to the original oil-rule path would undermine the credibility of the fiscal guidelines. The adoption of a multi-year budget anchor could be a means of achieving fiscal objectives. ■

Is pension reform necessary?

Even if adhered to, the fiscal policy guideline will provide little in the way of additional budgetary resources to meet longer-term spending pressures from an ageing population. The use of oil money under the rule would increase by only about 1 percentage point of GDP by 2030 relative to its present rate. Gross spending on public pensions, if no reforms are put in place, would rise by some 10 percentage points of GDP. Spending on health is also likely to rise as the population ages. Long-term fiscal sustainability should thus be given more priority in policy-making, and room for manoeuvre in current fiscal policy should be decided within those lines. Norway's unusually large prospective increase in public pension spending reflects generous benefits, a still-maturing system, and (especially) marked expected increases in future life expectancy. Reforms in the old-age pension system are currently under discussion, and three of the suggested measures – to introduce a life expectancy factor which automatically reduces the pension level for an age group if life expectancy increases, to make pensions more actuarially fair, and not to index pensions fully to wages – would reduce the expected increase in spending by 4 percentage points of GDP. These changes should be phased in soon.

The Pension Commission also suggests replacing the Petroleum Fund and the National Insurance Fund with a new pension fund, supplementing the (reformed) pay-as-you-go system. How such a fund would operate, and indeed what liabilities it would actually fund, are issues still to be clarified. In any event, funding by itself would not solve the pension problem as the present value of pension liabilities substantially exceeds the combined expected assets of the Petroleum Fund and the National Insurance Fund. Reforms to curb future pension outlays of the sort described above are thus still imperative. One possible advantage to the course suggested by the Pension Commission is that it would be politically difficult to take resources out of a fund that was earmarked for pension payments and use them for other purposes. Pressures to increase public spending in other areas might then be easier to resist. It is important that if the new pension fund is adopted, revenues should be invested in line with the guidelines for the present Petroleum Fund. These would ensure that a large part of oil revenues are invested in foreign financial assets to neutralise pressure on the exchange rate. Safeguarding the capital value of the Fund over time would require fiscal policy to be conducted consistently with the fiscal rule. ■

Should sickness and disability schemes be tightened?

Health and long-term care expenditures will also put pressure on (especially local) budgets as the population ages, highlighting the need for higher revenues and lower spending elsewhere. A "modernisation" programme for the public sector was launched when the government came to office in 2001. This programme aims at better use of resources, for example by encouraging market solutions in the public sector, but needs to be pursued further. In particular, all for-profit contestable services could be privatised, while ensuring a level playing field between public and private providers of public services. To this end, the introduction of VAT compensation for all municipal purchases from private companies is a welcome step. Central government should decentralise responsibility to local governments and design appropriate incentives to encourage public entities to reach mutually-agreed performance targets. At the same time, the role of cost-benefit analysis in spending decisions should be strengthened.

While spending on old-age pensions will start accelerating in a decade, spending on sickness benefits and disability pensions is already mounting rapidly. The number of persons on long-term sickness and different disability schemes has increased dramatically since the mid-1990s. Measures to reduce the recourse to sick leave need to be taken. A 2001 agreement (without financial incentives) between the unions, employers and the government to cut the amount of sick leave by 20 per cent from mid-2001 to the end of 2005 will be difficult to fulfill as sick leave has already risen by more than 10 per cent since then. Hence, the authorities should explore other mechanisms to reduce absence rates, notably through a tightening of the sickness benefits or of their eligibility criteria. Also, enhanced monitoring of the working capabilities of beneficiaries should be further strengthened by the National Insurance Authority.

Despite above-average life expectancy, Norway has a higher share and a higher inflow of people on disability pensions than most other OECD countries, and so far, few of these eventually re-enter the work force. There is also a substantial flow out of long-term sick-leave into disability schemes. As a result, 10 per cent of the working population and a third of those over 55 are now on disability pensions. The corresponding expenditures put severe pressure on public finances: about 5 per cent of GDP per year is now being spent on disability, rehabilitation and sickness benefits. This disquieting development can partially be explained by Norway's high participation rate, which means that people more prone to fall sick or into disability nevertheless join the work force. Still, it is plausible that important causes are the overall generosity of the benefit system and inadequate monitoring. To reduce the inflow into permanent disability, a temporary disability benefit is now granted (for a period of between one to four years) when future work-capacity of the individual in question is uncertain; permanent disability pension will only be granted when the individual has no work-capacity. However, further efforts should be made to reduce attractiveness of the schemes and to counter abuses facilitated by complaisant doctors and weak controls. Moreover, independent audits of disability claims should be instituted. ■

Can reform of social benefits reverse the adverse trends in labour utilisation?

Norway has among the highest participation and employment ratios in the OECD, notably among women and older age groups, and one of the lowest structural unemployment rates. Yet, average hours worked are relatively low, probably reflecting the high participation rates among women, who typically demand part-time work. But average hours worked have also declined faster than in other OECD countries largely, but not only, because of rising recourse to sick leave, as noted above. Enhancing micro efficiency in the labour market is important in order for Norway to remain one of the best performing countries. Removing work disincentives from the benefit system, including those discussed above for sickness and disability, should remain the priority objective in this area. Recent measures reforming the unemployment benefit scheme – a reduction of the maximum duration and replacement rate for benefits, along with a tightening of eligibility requirements – are further steps in the right direction. Finally, a cash benefit, introduced in 1999 for parents not using the publicly-funded childcare centres, tends to reduce female participation in the labour force. Hence, the scheme could be substituted by a voucher system for families to be spent in formal private or public child-care centres, thereby reinforcing the current per-user public financing system. ■

What tax reforms are being proposed?

A tax reform is in the pipeline. Tight labour supply and a bias toward housing consumption can be traced in part to tax disincentives. Furthermore, the tax system creates both incentives and opportunities for classifying labour income as lower-taxed capital income. The tax reform proposed by the Skauge Committee makes a good start to correcting these distortions. Closing tax planning loopholes and increasing property taxes while phasing out the wealth tax as proposed by the Committee should be considered. Carefully planned and progressive tax reductions should also be envisaged, especially at the bottom and the top income brackets. ■

How can the labour market be made more flexible?

The generally good labour market performance in Norway suggests that the institutional framework in this area is in basically good shape, but improvements should still be sought to increase flexibility and improve work opportunities for marginal groups. A committee is currently reviewing the 1977 employment protection law and the regulations on overtime have recently been liberalised. It would be desirable to reconsider several aspects of issues concerning employment protection legislation, for example contract duration, and compensation for loss of employment that could be defined or modified by individual agreements – including in the public sector – rather than by law or collective agreements. Furthermore, public employment services and active labour market programmes remain important features of the Norwegian labour market. The current programme of service liberalisation should be continued in order to further increase workers' search opportunities and ensure the cost-effectiveness of training programmes.

In the medium term, a modification of the centralised and co-ordinated system of wage negotiations, encouraging a more disaggregated approach taking into account sectoral, skill and local labour market conditions, would be desirable. Such factors are hardly reflected in current pay awards in the public sector, leading to labour market inflexibility and suboptimal incentives to accumulate human capital or exert effort. Such a development need not preclude the continuation of some form of centralised bargaining, which has attractions for both employers and unions, as it reduces transaction costs and provides signals for more detailed negotiations elsewhere. A continued lead role by the exposed sector in the process of wage formation seems essential, as this sector has the strongest incentives to wage moderation. The ongoing expansion of the service sector and the increasing share of high-skill workers will probably result in market pressures for more flexibility in wage settlements at decentralised and individual levels, including in the public sector. This would increase returns from investing in human capital. At the same time, it is important that reform of the labour market be accompanied, or even preceded, by that of the product market: if the wage discipline currently afforded by centralised wage bargaining fails to be replaced by robust internal competition, decentralisation might make matters worse. ■

How to improve education quality?

Performance of Norwegian students in primary and secondary education has been disappointing compared with the high amount of spending per student. Measures recently put forward by the Ministry of Education are very comprehensive and would improve the quality of education, but all of them taken together would be very expensive. A priority list should accordingly be arranged, stating clearly the main objectives to be achieved, the costs of attaining them, and how each measure should be phased in. A systematic reform of tertiary education towards a performance-based financing system has been introduced, starting from the current academic year. The new system is likely to enhance teaching and research quality. The changes should be monitored in the coming years to make sure that the new financing system does not lead to an easing of requirements for students or an excessive attention by researchers to short-term results. ■

Why is competition reform so important?

Competition is key to raising living standards by making firms search for better ways to meet consumer tastes and for better means of production and organisation. Available OECD indicators point to weak competitive pressures in a number of areas in Norway. As a consequence, productivity growth has been slow in some sectors and prices are higher than in most other countries in Europe. Important network sectors are dominated by large publicly-owned incumbents. Agriculture and food processing enjoy extensive protection from foreign competition. A wave of acquisitions and mergers in the past has led to economies of scale but also a highly concentrated and vertically-integrated retail sector, notably in food. Looking forward, broad-based and sustained reform efforts to strengthen competition are needed, to stimulate growth of potential output, as oil resources are exhausted. OECD estimates suggest that such reforms might boost the level of potential output by at least 4 per cent.

The competition authority and the sector regulators should be given the necessary instruments and powers to prevent and deter anti-competitive behaviour, as has been proposed in the new competition law. Measures should be introduced to make enforcement more effective, such as increasing prosecution capacity, instituting powers to issue administrative fines, and making sanctions credible enough to deter. The introduction of leniency and whistleblower programmes would uncover and destabilise cartels. In addition, reform should include further strengthening the independence of sector regulators as well as establishing independent appellate bodies for both the competition authority and the sector regulators, which would separate more clearly the public sector's roles and functions as owner and regulator. Other measures to promote competitive markets would aim at increasing foreign competition by removing trade barriers, especially in agriculture, and remaining restrictions on inward FDI, especially in fisheries and power generation. Domestic competition should be enhanced through an expansion of the government's privatisation programme. Where there are demands for retaining public ownership, clear and transparent regulation should define and control acceptable public engagement in market activities. To prevent anti-competitive cross-subsidisation, a more rigorous approach to evaluating and financing the net cost of universal service obligations should be introduced. The current practice of only accounting separation between natural monopoly and contestable sectors of publicly-owned network companies should be replaced by formal separation requirements.

To underpin the effectiveness of such general measures, a number of sector specific measures are required, such as removing state monopolies and reviewing licence requirements for establishing large shopping centres outside densely populated areas to facilitate new entry in the retail sector. In the electricity sector, an expansion of national and international interconnection capacity could enhance competitive pressures. Private investment should be stimulated by removing the asymmetry in the concession rules that apply to private and public hydro-power plants. In telecommunication, the incumbent should divest its holdings of alternative networks, while interconnection and termination charges need close monitoring with a view to lowering them where justified. In domestic air transport, recent liberalisation measures should be underpinned by lowering entry cost via the introduction of cost-based user charges for airport handling services. Intermodal competition in land based passenger transport should be increased by ownership separation between the railway company's rail and long-distance bus activities, as well as reviewing local restrictions on the latter. Liberalisation of postal services should be accelerated. In the market for public procurement, clear dispute settlement facilities and sanctions for non-compliance or annulment of contracts should be introduced. The cost of regional policy should be made more visible and transparent by instituting a regional policy framework strategy. ■

How can sustainable development be better promoted?

Norway has committed itself to enlightened policies aimed at sustainable development for the welfare of present and future Norwegians with positive externalities in the rest of the world. Among these are: investment of government oil revenues to generate a steady income stream for Norwegian society for many years to come, as noted earlier; one of the highest OECD levels of carbon taxes to help curtail Norway's contribution to global warming; and one of the most generous OECD levels of overseas development aid to help address large and growing global income disparities. These policies display a willingness by Norwegian society to sacrifice near-term interests for the greater good. Yet, their effectiveness has often been undermined by inconsistencies, either within policy design itself or with other policy goals. Hence, a desirable next step would be to implement a higher degree of policy coherence, as in ways suggested below.

The carbon tax scheme has been inefficient because of high variability of tax rates across emission sources and exemptions. Its planned replacement by a broad emissions trading scheme to fulfil the Norwegian Kyoto obligations in 2008-2012 is welcome. The national scheme in fact goes beyond the EU counterpart because of its broader coverage of gases and sectors. The state of most commercially important fish stocks in Norwegian waters is at sustainable levels given current quotas, which are set in line with long-term management plans. Nevertheless, a further increase in stocks would be desirable as it would give long-term rewards in the form of higher sustainable quotas. The internationally negotiated total allowable catches for North Sea cod have been set above the scientifically recommended levels, resulting in a sharp decline in the stock to below precautionary levels. Norway has one of the highest rates of agricultural protection in the OECD, something that conflicts with the goals of development assistance by denying developing countries outside the LDC group access to the Norwegian market, where they could be very competitive (thereby also raising Norwegian consumer welfare). From 1 July 2002 all products from the LDCs have been accorded full duty and quota free access to the Norwegian market according to the GSP-scheme. Norway should consider granting more generous market access also for developing countries outside the LDC group, and also enhance the transparency of the safeguard mechanism in its system of trade preferences. Preferably, the whole system of output-based regional support should be replaced by a well-targeted transfer scheme and an alternative regional development philosophy which facilitates movement of resources to human capital-intensive activities where Norway is more likely to display a comparative advantage. ■

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Public Affairs and Communications Directorate.
They are published under the responsibility of the Secretary-General.

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