DET KONGELIGE FINANSDEPARTEMENT

Royal Ministry of Finance

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Report to the Storting (White Paper)

Long-term Perspectives on the Norwegian Economy 2017

– A Summary of Main Points

1 Safeguarding the welfare of future generations

Norway is well equipped for the future. Employment is high, the country is endowed with vast natural resources, and public finances are on a solid footing. The labour force is highly skilled, due in large part to a strong education system. Income and wealth are evenly distributed.

Norway's good foundations are the result of both luck and wise decision making. The political choices in the coming years must help Norway remain a good country to live in for future generations. Significant challenges lie ahead, but also possibilities. The main message from this White Paper is that our ability to overcome the challenges and take advantage of the possibilities will depend on how successful we are in three main areas:

1. An inclusive labour market with high participation rates

A corner stone of Norwegian society is its high employment rate. For the individual, having a job means a stable income, personal development, and an arena for social inclusiveness. At the same time, a sustainable welfare state is dependent on maintaining a balance between the number of people financially contributing to the system and the number receiving benefits.

In the coming years, an ageing population means that a smaller share of the population will contribute to financing the welfare state unless the retirement age increases. If lack of relevant skills keep many outside the workforce, the fiscal strain on the working population will increase further. Higher immigration can amplify these challenges unless immigrants are well integrated in the labour market.

Rapid technological change is having a big impact on society. Broader and more efficient use of technology is crucial for raising productivity in the private sector. Automation and artificial intelligence renders some jobs superfluous, but at the same time creates large opportunities for the creation of new jobs, new investments, and innovation.

Education and skill enhancement are key to successfully addressing these challenges. More people need to take vocational training programs and higher education.

Additionally, increasing life expectancy means we have to work longer. The tax and welfare benefit system must strengthen the incentives to work. Health related problems, language difficulties, or a lack of a relevant and updated skillset must not prevent people from participating in the labour market. Tackling these challenges will help achieve a society that creates opportunities for all.

2. Rising living standards must benefit everyone in society

In many countries, the majority of the population has only to a limited extent benefitted from economic growth. The experience in Norway has been different. Economic growth has been inclusive and income inequality is low. Social mobility is high; the income of the next generation is less dependent on that of their parents than in many other countries.

3. Improved performance in the private and public sectors

After a long period of favourable economic conditions, in the coming decades the room for manoeuvre for fiscal policy will diminish considerably. The Government Pension Fund Global is expected to grow more slowly than in the past. Investment returns are anticipated to moderate, and the oil price is not expected to return to previous highs. At the same time, an ageing population will raise spending on pensions, health, and long-term care.

Norway has a good and far-reaching system of social welfare benefits and a well-functioning public sector. However, to deal with future challenges one must continuously ask whether things can be done better. Clear priorities and an active, systematic, and continuous process for improving efficiency in the public sector is necessary. Safeguarding our welfare state in the coming decades necessitates using public sector resources efficiently.

Improving living standards will require raising productivity growth in the private sector. Over the past decade, productivity has grown more slowly than before. To reverse this trend, as well as meeting the challenges associated with lower demand from oil and gas extraction, businesses and employees must adapt more quickly and smoothly to changing circumstances. The economy needs restructuring with stronger growth in the private non-oil sector.

More, and more efficient use of, technology is a prerequisite for raising productivity. Technological breakthroughs will be necessary to confront climate change. New technological solutions are also a precondition for better and more sustainable social services in the future. Welfare technology may make public health care more efficient and improve our ability to tackle the increased demand for social services from an aging population.

Sustaining our high level of welfare requires a commitment, and ability, to change. With a productive private sector, high employment, and strong public finances, Norway is well equipped to face the future. Our ability to create good jobs, further increase employment rates, and develop and make use of new technological solutions will have a decisive impact on our future standard of living and the level of welfare we can afford.

2 Main challenges

Despite a strong starting point, the Norwegian economy faces significant challenges that require wise choices. Some of the developments underlying these challenges are well known. In other areas, we are in the midst of transitions that were not clearly visible at the time of previous white papers on long-term perspectives on the Norwegian economy. The challenges relates in particular to:

1. Raising productivity growth

To ensure a continued increase in living standards we need to find ways to reverse the trend of low productivity growth. Although the level of productivity in Norway is high, like in many other countries productivity growth has been relatively weak for the past decade, see figure 1. The recent economic downturn can explain part of this development, but structural factors are also at play. The pace of structural reforms in the 2000s was lower than in the 1990s, and the rise in immigration from 2004 onwards has raised employment in low-productivity industries.

Raising productivity growth will depend on the smart and efficient use of our available resources. Economic policy should smooth ongoing transitions in the economy, facilitate greater innovation, and clear the way for capital and labour to move to new industries.

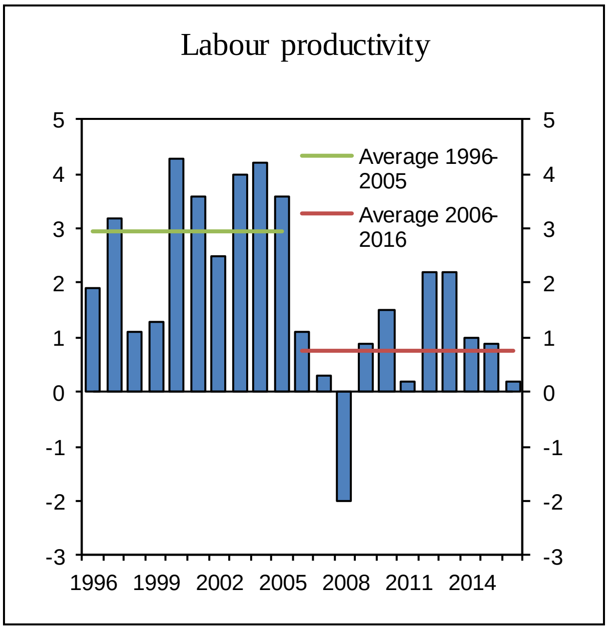

Figure 1: Annual growth in GDP per hours worked in market-oriented, mainland industries (ex. dwelling services). Percent

Source: Statistics Norway.

2. Transitioning to a new economic reality

The oil- and gas sector will no longer contribute to economic growth to the same extent as in the past. Between 2003-10 demand from the petroleum sector raised growth in the mainland economy by an average of 0,3 percentage points per year. In the years ahead, the sector is not expected to contribute to growth in other parts of the Norwegian economy, see figure 2. On the contrary, the petroleum sector's impact on the economy in the coming decades is expected to decline.

The oil sector will remain an important part of the economy. However, it is necessary to create more jobs in other knowledge-based industries. The challenge is to engineer a smooth transition of the Norwegian economy towards a state that more closely resembles that of western economies not endowed with oil-and gas resources.

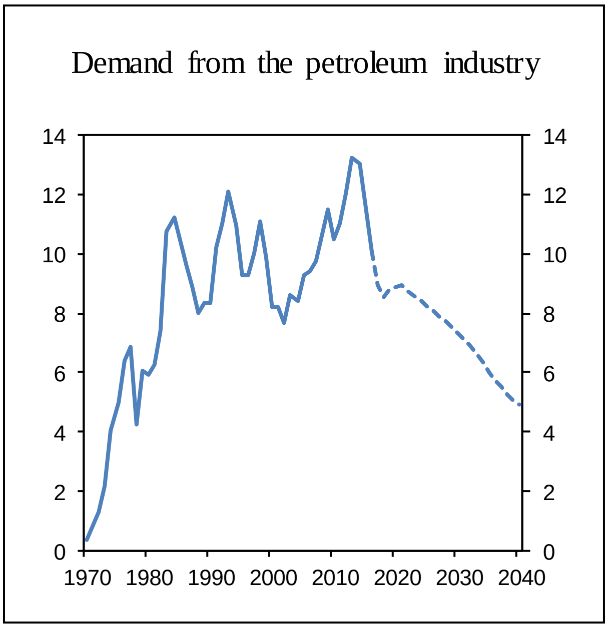

Figure 2: Demand from the petroleum sector. Share of Mainland GDP. Percent

Note: The demand components are investments, production inputs, and compensation per employee in the petroleum industry.

Sources: Norwegian Petroleum Directorate, Ministry of Petroleum and Energy, Statistics Norway and Ministry of Finance.

3. Combat rising protectionism

Few countries have benefitted more from cross-border trade and investments than Norway. Globalization facilitates access to financing, capital and labour inputs, export markets, technological transfers, and increases competition. The result is a more efficient use of available resources, which has contributed to a doubling of average global per capita purchasing power over the past 45 years. From the turn of the century until oil prices started falling in mid-2014, Norway also benefitted from rising export prices and falling import prices. Figure 3 illustrates how a large fall in the price of clothing and shoes relative to other prices coincided with a marked increase in the share of this category of goods imported from China.

The trend towards rising cross-border trade has been ongoing for a long time, but at an uneven pace and with significant setbacks. Technological innovations in transport and information sharing, and the development of tools that negate the need for personal interaction, have contributed to greater trade flows. Wars and periods of protectionism have interrupted these trends.

A small open economy like Norway is vulnerable to turmoil in the rest of the world. A well-defined legal framework and a predictable global trading environment is especially important for small countries. Rising protectionism and signs of a more isolationist posture in some large countries show that the trend towards greater economic integration among countries cannot be taken for granted. Rising protectionism may have strong negative consequences for small, open economies like Norway.

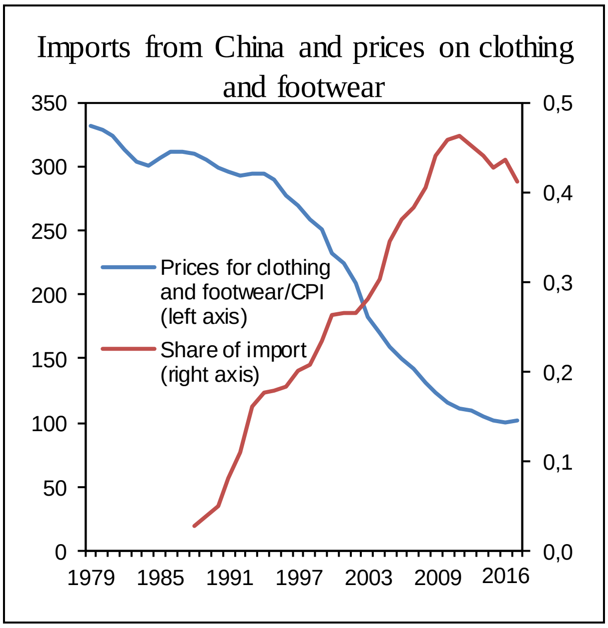

Figure 3: China's share of Norway's imports of clothing and footwear and the price index for clothing and footwear relative to CPI.

Sources: Statistics Norway and Ministry of Finance.

4. Maintaining an equal income distribution

Inclusive growth and an even income distribution are important components of overall welfare. Gains from economic growth must trickle down to the majority of the population. Most people consider a lack of income resulting from a troublesome family background, illness, or other events beyond ones control unfair. Large and persistent inequality can also contribute to social unrest, political instability, and a lack of trust in government.

In some OECD countries, the majority of the population has only to a limited extent benefitted from economic growth. In comparison, income in Norway has remained evenly distributed and inequality has not increased by much. Median income has broadly kept pace with Mainland GDP per capita, see figure 4. This contrasts to the United States, where median income has grown by only 10 percent in the past 30 years, while GDP per capita has grown by 60 percent.

One reason why inequality has increased less in Norway is an industrial structure less exposed to competition from China and other low-cost countries. A high degree of wage coordination also contributes towards an even income distribution between groups. Internationally, rising income inequality is related to technological change and increasing globalisation. When trade and technological change starts affecting new industries, greater cross-border competition could affect Norway to a greater extent than in the past. There is therefore no guarantee that Norway will continue to be able to combine low inequality with relatively high economic growth.

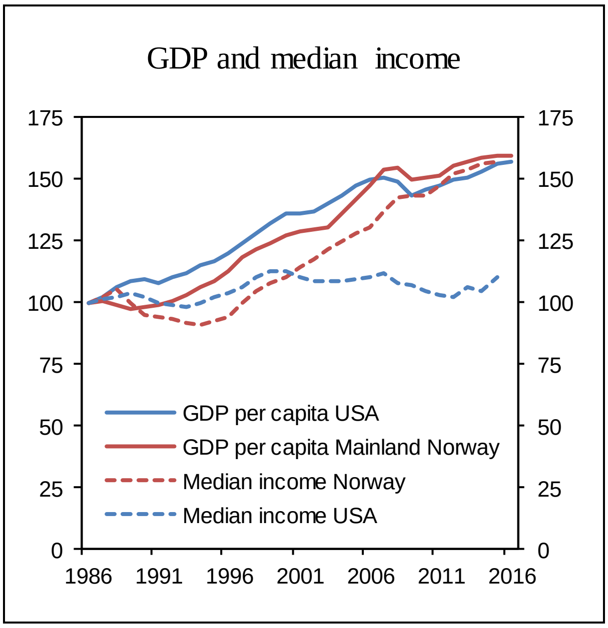

Figure 4: Growth in median income and GDP in the US and in mainland Norway, household pre-tax income. Index 1986=100

Sources: Statistics Norway and US Census Bureau.

5. Transitioning to a greener economy

Climate change will present significant challenges in the coming decades, and transitioning to a greener and more climate-friendly economy requires new ways of thinking, and will imply a new operating environment for the Norwegian private sector.

Tackling climate change requires extensive international cooperation. Achieving the two-degree target in the Paris agreement necessitates a rapid and significant reduction in emission of harmful greenhouse gases, see figure 5. The changes required to achieve this goal will require the involvement of all countries. A continuation of today's policies would imply about unchanged emissions from OECD countries, but a sharp increase in emissions from the rest of the world. The necessary reduction is so large that even if emissions from OECD countries fell to zero, global emissions would remain far above the level consistent with achieving the two-degree target. A broad range of countries must therefore share the responsibility of reducing global emissions. International cooperation is crucial.

Norway has committed as part of the Paris agreement to reduce emissions of harmful greenhouse gases by 40 percent in 2030 relative to a 1990 baseline. That is consistent with estimates of what is required to achieve the two-degree target made by the UN panel on climate change, and coincides with commitments made by the European Union. Norway is negotiating an agreement with the European Union that will entail a joint commitment to meet these targets. The Government has also set a target for Norway to become a low-emission country by 2050.

Transitioning to a greener economy will change the operating environment for the private sector, both in Norway and abroad, and will require a gradual change in production and consumption patterns. Polluting should be costly, and the cost of carbon pollution must therefore gradually increase. The definition of a successful green industry is one that is able to yield attractive returns within a strict climate change regulatory framework. That will require developing new products and production technologies, and will give new opportunities for Norwegian companies.

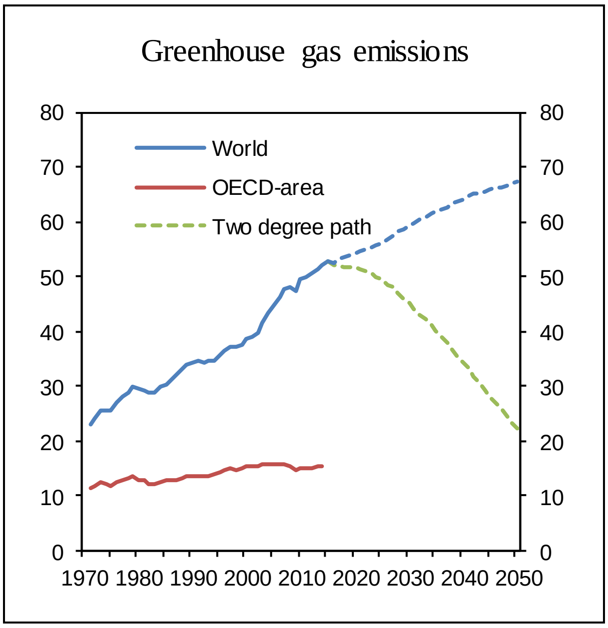

Figure 5: Emission of greenhouse gases. Billion tons CO_2-equivalents

Sources: Intergovernmental Panel on Climate Change, International Energy Agency and OECD.

6. A well-functioning public sector

A well-functioning public sector is one of the key attributes of the Norwegian welfare state. Norway has a good and far-reaching system of social benefits and a large public sector. To deal with future challenges one must continuously ask whether things can be done better and more efficient. Avoiding difficult but necessary choices will entail rapid growth in public expenditures that will prove challenging to finance in the future.

An ageing population will increase demand for health and long-term care services. Increased prosperity is also likely to increase demand for new and improved public services, many of which are labour intensive. These trends will strain our welfare model, which makes public services available at zero or no cost. The Norwegian public sector already employs around 30 percent of the workforce, see figure 6.

Efficient provision of welfare services requires clear prioritization combined with performance-based evaluation. A sensible sharing of responsibility among the different layers of government and an efficient allocation of municipal, regional, and governmental resources can make important contributions to efficiency. In some instances, greater private sector participation may be beneficial, resulting in greater competition and knowledge sharing. There is also significant scope to raise the quality and efficiency of public services through technological and organizational improvements.

An efficient use of resources also requires that the government provide the right kind of services. Societal change has resulted in an expansion in the number of services provided by the public sector. Norway’s strong fiscal situation has not required the phasing out of less critical services. New rules and guidelines has entailed administrative costs for both the government and the private sector. Such regulations need to be re-evaluated.

The coming decades must be accompanied by a continuous reassessment of the sharing of responsibility between the private and public sector in light of population change, welfare improvements, and a more challenging situation for the public finances.

Sensible reforms enhance the flexibility and adaptability of the welfare state. The pension reform is a good example. It did not reduce costs in the short run, but made future pensions costs less dependent on changes to life expectancy and made it more attractive to continue working. The recent efficiency reform in the central government that required public agencies to cut operating cost by ½ percent per year, will have positive long-term effects on resource utilization and public finances. Reforms often only deliver results over time, and thus early implementation is crucial. The process of evaluating and improving welfare services is a continuous process.

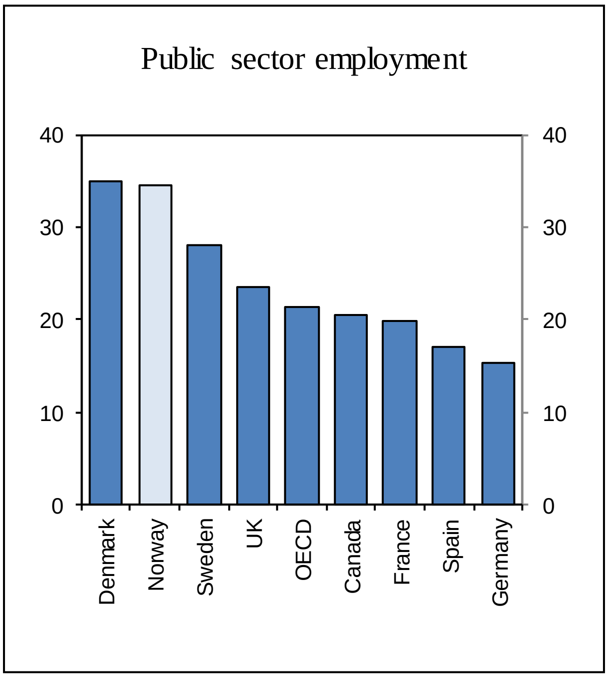

Figure 6: Employment in public sector in selected OECD countries. Share of total, 2014

Source: OECD.

7. More people have to work and for longer

High employment is one of the main reasons why income inequality is low in Norway. High employment also means that many people share the cost of financing public welfare services. In an international context, Norway already has a high labour force participation rate. More women, elderly people, and immigrants are part of the labour market than in most other OECD countries.

An ageing population means that in the future a smaller share of the population will finance the welfare state unless the retirement age also increases. The pressure on public finances will increase further if we fail to mobilize the work force potential in the remainder of the population. High immigration can further amplify these fiscal challenge unless immigrants are well integrated in the labour market.

A particular challenge in Norway is the number of people outside the labour force due to illness or disability, see figure 7. While many countries have been successful at reducing absenteeism, it has increased in Norway. This is despite improving health indicators, though the trend in mental health is worrying. It is not sustainable that an increasing share of the population relies on some form of disability benefit from the government.

The number of hours worked per employee is also relatively low in Norway compared to other countries. As a result, the number of hours worked per capita is close to the average among EU countries. The explanation lies in a relatively short workweek, generous leave benefits, high absenteeism, and widespread part-time employment.

A common trait among those left outside the labour market is a lack of skills, or a lack of the skills in demand in the workplace. A declining positive skill gap with the rest of the world amplifies these challenges. Various proficiency tests suggest that while older people in Norway are typically better educated than in other OECD countries, that is not the case for younger generations. Rapid technological change will make continuous skill upgrading even more important. It is therefore important to find ways to maintain and improve Norway's historically strong on-the-job training programs. In addition, the education system must be improved.

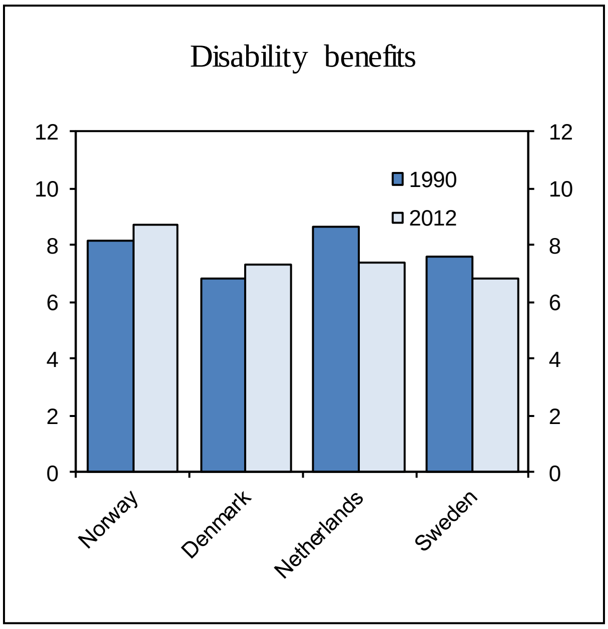

Figure 7: Disability beneficiaries in Norway and some other countries. Share of population between 20-64 years. Percent

Source: Statistics Norway, Norwegian Labour and Welfare Administration, OECD and The Swedish Social Insurance Agency.

The tax and welfare benefit system must strengthen incentives to work. The 2011 pension reform made it more attractive to continue working. We are now reaping the rewards of this reform, and the average private sector employment rate of those aged 62 years or above has increased. A similar reform of the pension system in the public sector would strengthen these effects.

8. Less room for maneuver in fiscal policy

While the last decades were characterized by very favourable conditions for the Norwegian economy and public finances, the future is likely to prove more challenging. The Government Pension Fund Global—and thus the amount the Government is able to draw from the Fund—is expected to grow more slowly than in the past, see box 1. Investment returns are anticipated to moderate, and the oil price is not expected to return to previous highs. At the same time, an ageing population will result in higher spending on pensions, health, and long-term care services. In the next 10-15 years, the room for manoeuvre in the budget will be far less than what we have become accustomed to, and beyond 2030 the pressure on public finances is only expected to increase. Government revenues must increase or expenditures fall.

Finding good solutions to these challenges will require progress on a number of fronts. Higher labour force participation—both by increasing the number of employed people and hours worked—has to be a key part of the solution. That will strengthen the public finances and give everybody the opportunity to raise their own income and welfare. We must also find ways to do things better in the public sector, including efficient provision of public service and being able to prioritize. Technological change will play a major role. If we do not make progress on these fronts, or if there is demand for a further expansion in public services, increased private sector participation or higher taxes may become necessary.

Chapter 3 elaborates further on ways to tackle the challenges facing the public finances and the welfare state.

Box 1 The Norwegian Fiscal Policy Framework

The Government Pension Fund Global and the fiscal rule have since 2001 set out the plan for the phasing-in of petroleum income and investment returns to the Norwegian economy. The Government Pension Fund Act stipulates that the State's net cash flow from the petroleum industry shall in its entirety be transferred to the Government Pension Fund Global, and that resources in the Fund can only be transferred to the budget pursuant to a decision by Parliament. Since 2001 the following rule has guided withdrawals from the Fund (handlingsregelen):

- Transfers from the Fund to the central government budget shall, over time, follow the expected real return on the Fund.
- Significant emphasis is placed on evening out economic fluctuations to contribute to sound capacity utilisation and low unemployment.

At the inception of the fiscal rule, the expected real rate of return of the Government Pension Fund Global was set at 4 percent. Based on analysis from the Thøgersen commission, the Mork commission, and Norges Bank, the expected real rate of return has now been reduced to 3 percent.

The fiscal policy framework ensures preserving the real value of the Fund for the benefit of future generations. At the same time, the Fund and the fiscal rule insulates the budget from short-term fluctuations in petroleum revenue, and leaves space for fiscal policy to counteract economic downturns. In the event of large movements in the value of the Fund or in factors that affect the structural non-oil fiscal deficit, the change in the use of petroleum revenue shall be smoothed over several years, based on an assessment of the real rate of return of the Fund a few years ahead.

Even though the fiscal policy framework is especially well-suited to the particular challenges Norway faces in managing its large petroleum wealth, the fiscal rule resembles that in use in other European countries. The rule stipulates that the government expenditure shall, over time, equal government revenues from the mainland economy and the expected future real return from the Fund. Several countries, including countries in the EU, have fiscal rules that imposes limits on the budget balance.

3 The future welfare state

3.1 Public finances in the longer term

Since the turn of the century, Norway has experienced a near unprecedented period of economic growth and strengthening public finances. However, fiscal space in the next 10-15 years is likely to be more constrained than we have become accustomed to. After 2030, the challenges will increase further as the share of persons aged 80 years or over increases while the share of public expenditures financed by the Government Pension Fund Global falls.

Absent reforms, a funding requirement will emerge, which will prove even more challenging to meet if the welfare state continues to expand.

Notwithstanding the recent pension reform, pension expenditures are set to rise, see figure 8, although not so much as without a reform. After a temporary reversal, the unusually large cohorts born in the years after World War II are now increasing the demographic dependency ratio. In addition to rising pension expenditures, this also puts upward pressure on public expenditures on health and long-term care.

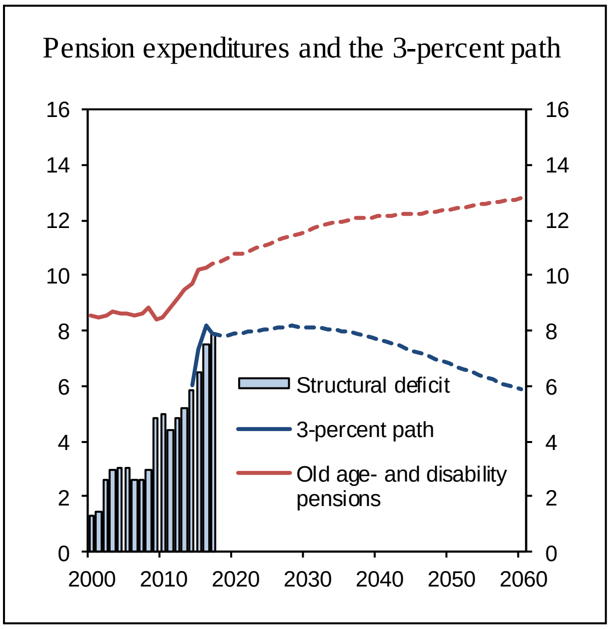

Figure 8: Structural, non-oil deficit, 3 percent path and old age- and disability pensions in the National Insurance Scheme. Per cent of trend-GDP for Mainland Norway

Sources: Ministry of Finance and Statistics Norway.

Increasing life expectancy is the main driver behind population aging. The increase in life expectancy mirrors the improvements in the individual work environment, housing conditions, and access to welfare services. If accompanied by an overall improvement in health, older people will be able to work longer and require less access to health and long-term care services. Healthy aging will therefore mitigate the challenges increased longevity poses for public finances. This report's baseline scenario takes this into account, but at the same time assumes that the government increases the standards of health care services, see box 2.

In the baseline scenario, the growth of public expenditure outpaces that of public revenues between 2030 and 2060, resulting in an average financing requirement per decade of 1.7 percent of Mainland GDP. Based on today's level of Mainland GDP, this amounts to almost NOK 50 billion per decade, or NOK 5 billion per year. If the financing requirement is met by raising taxes, it will adversely affect labour supply and capital accumulation by negative incentive effects, thus weakening the economy and making it more difficult to balance public finances.

Box 2 Assumptions in the long-term projections

The long-term projections have been prepared by means of the computable general equilibrium model DEMEC, developed by Statistics Norway. Key assumptions in the projections are:

Statistics Norway's main alternative from 2016 decides the development of the population's size and composition. The *demography scenario* assumes maintaining today's labour market pattern with respect to age, gender and country background. An increasing share of the elderly and immigrants from less developed countries, who both generally have lower participation rates than the main population, contribute to employment (hours worked per capita) decreasing by 9.5 percent between 2017 and 2060. In the *baseline scenario*, increased longevity is assumed to contribute to higher participation among persons aged above 62 years. This contributes to a less pronounced 7.7 pct. decrease in employment (hours worked per capita) between 2017 and 2060.

The projections are based on the productivity in the mainland economy (GDP per hours worked) growing by an average of 1.5 percent per year. Real wages grow in line with productivity growth in private mainland sectors, estimated to be 1.7 percent per year.

Production of oil and gas gradually decreases, assumingly to a level in 2060 that equals about a quarter of 2015 production. Long-term oil and gas prices are set at NOK 510 per barrel and 1.85 per sm^3, measured in fixed 2017-prices. The real return on the Government Pension Fund Global is 3 percent, which again equals the withdrawal from the fund.

As regards public consumption, the demography scenario assumes maintaining the current pattern, in terms of hours worked per service user after age and gender. This means for example that the hours spent on health care for an 80-year-old man in 2060 will be the same as in 2017. Consequently, increased public service productivity means more room for improving the services, rather than increasing savings.

The baseline scenario differs from the demography scenario by assuming that a 5-year increase in longevity translates into 3 extra healthy years of living. This assumption reduces the growth in public consumption. A yearly increase of 0.5 percent in per capita resources allocated to hospitals in the period to 2060 will on the other hand push public consumption growth upwards. These adjustments will overall reduce public expenditures growth in the baseline scenario compared with the demography scenario. The projected old age and disability pensions are based on the current pension system. Table 1 shows the estimated funding requirement in the two scenarios.

Table 1 Funding requirement in public finances. Percent of Mainland GDP

	2060	2100
Financing gap demography scenario	6.0	11.3
- Healthy aging	-1.5	-1.6
- Increased standard in health services..	+1.6	+1.4
- Increased employment among the elderly	-0.9	-1.6
= Financing gap baseline scenario..	5.3	9.5
Per decade from 2030...	1.7	1.3

Source: Ministry of Finance.

Figure 9 illustrates how the estimated baseline financing requirement depends on the underlying assumptions.

Although productivity growth is decisive for increased prosperity over time, figure 9 shows that private sector productivity growth on its own has no significant impact on the public sector financing requirement. This is because increased private sector productivity growth tends also to raise wages and therefore public expenditures on wages, pensions, and other transfers.

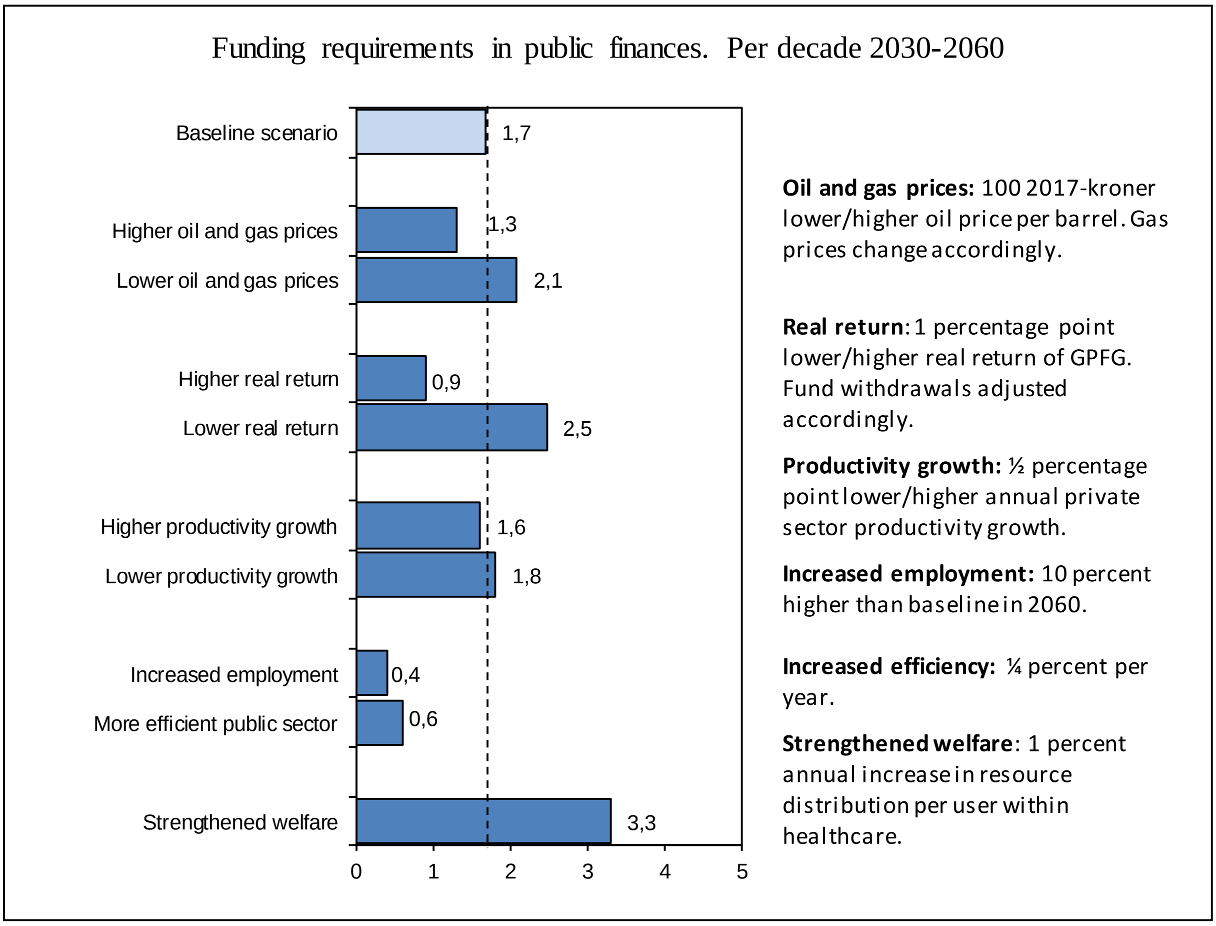

Figure 9: Long-term funding requirement in public finances per decade, 2030-2060. Percent of Mainland GDP

Source: Ministry of Finance.

However, higher productivity in the public sector will have a major positive impact on the sustainability of public finances. The same is true for increased labour utilisation, see figure 9. These are also areas where public policy can play an important role. The Government has placed policies to improve public sector efficiency and increase labour force participation at the forefront of its strategy to safeguard the future welfare state, see further discussion in chapter 3.2 below.

3.2 Alternative ways to ensure high welfare and sustainable public finances

The discussion above shows that the room for manoeuvre in fiscal policy is likely to be much smaller in the coming years than what we have become accustomed to, and will decline even further after 2030. In order to maintain and improve our welfare model with good common-funded soulutions, it is necessary to strengthen their funding and curb their expenditure growth. These challenges cannot all be solved today, but must be solved by making the right choices along the way. In the section below, four alternative courses of action are discussed, each of which cannot alone represent the key, but which together can lay the foundation for the future welfare society.

A. The work alternative – a large and well-qualified workforce

A large and well-qualified workforce is essential for both private and public welfare. If the estimated future baseline financing requirement is only to be met by increasing labour utilisation (and thus tax revenues), the number of hours worked per capita must increase by 13 percent between today and 2060, see the green curve in figure 10. Labour utilisation would then reach a level far above what we have seen in recent times.

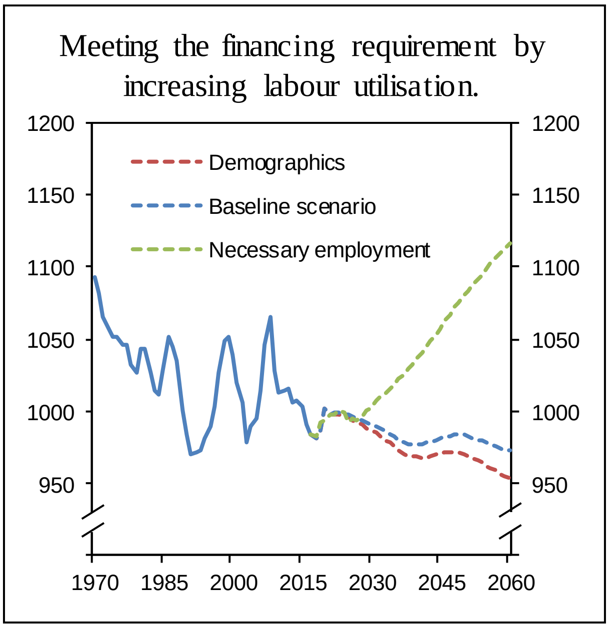

Figure 10: Hours worked per capita, age group 15-74 years. Actual development and different future scenarios

Sources: Statistics Norway and Ministry of Finance.

A good labour strategy should aim at increasing both average working hours and labour force participation. One in three women work part-time. If they instead worked full time, the overall number of hours worked in 2016 would increase by more than 8 per cent. An increasing proportion of women take higher education, and the highly educated tends to work full-time. This may decrease the share of women on part-time. Increased need for employment in the health care sector, which has high part-time share today, may have the opposite effect.

Immigrants from Africa, Asia and Latin America participate less in the labour market than the general population. If the participation rate in this group were equal to the participation rate of the majority population, this would increase the number of hours worked by 3 percent in 2016 and almost 7 percent in 2060, suggesting the importance of successful integration over time. Refugees and other immigrants must to a larger extent become part of the labour market.

Although higher labour utilisation is a natural response to increasing life expectancy, figure 10 illustrates that there are limits to what can be accomplished by increased employment alone, especially considering that demographic trends point to lower employment ahead. While the baseline scenario assumes a positive effect on the elderly's labour force participation, figure 10 shows that this is not enough to stop the negative trend. Rising income levels over time could strengthen the preferences for leisure, which would have an adverse effect on work effort.

If we succeed in raising the overall labour utilisation by 10 percent above the baseline scenario in 2060, employment will reach the levels of previous economic booms. The expected financing requirement per decade, measured as a share of mainland GDP, would then be 1¼ percentage points lower than in the baseline scenario, see figure 9. This corresponds to about NOK 3 billion per year, measured as a share of today's Mainland GDP. If more people enter work rather than receiving benefits, the fiscal benefits will increase further, due to an additional effect from reduced public expenses. Increased labour is thus essential to support the sustainability of the welfare system.

More healthy years will probably lead to higher employment among elderly workers. The financial incentives to stay in work longer are strong in the private sector. These must be continued. While formal obstacles to a postponed retirementare are reduced, various informal obstacles remain. Labor force participation among the elderly has increased significantly after the pension reform, especially in the private sector. Meanwhile, incentives are weaker in the public sector. A public sector pension reform would further rise employment among elderly workers. In addition, fewer people should be left outside the labor market for health or other reasons.

B. The efficiency alternative – a more efficient public sector

Technological innovations, changing work methods and clearer priorities give significant opportunities to the efficient provision of public services. Still, increasing standards, on top of demographic drivers, suggest increasing strain on public finances in the coming decades.

Being able to reduce the number of hours used in providing public services by ¼ percent compared to baseline, would reduce the ten-year funding requirement by about 1 percentage point, see figure 9. This equals to just under NOK 3 billion per year in today's money. To meet the full estimated financing requirement, the yearly need for efficiency improvement doubles to ½ percent. Hours worked (per capita) in the public sector would then fall back towards the levels in the early 1990s, see figure 11, while ageing suggests a development in the opposite direction.

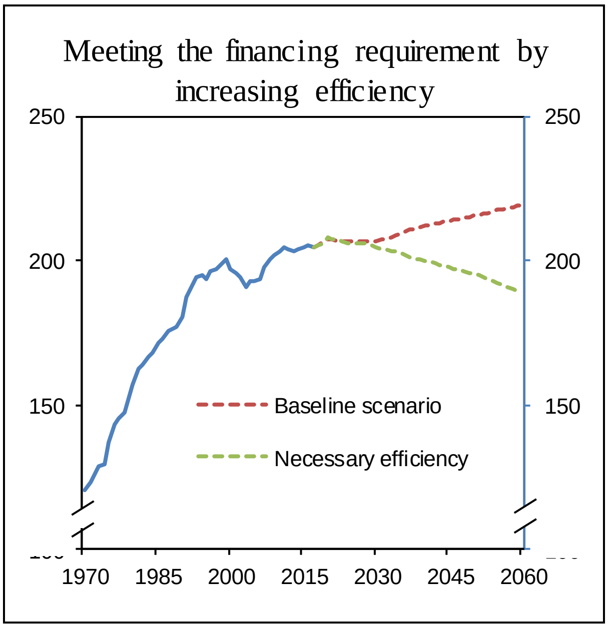

Figure 11: Employment in the general government sector (excl. defence) measured in hours worked per capita. Actual development and different future scenarios

Sources: Statistics Norway and Ministry of Finance

Through reforms and clear priorities, it is also possible to reduce government transfers to households and businesses, which account for over 40 percent of the total public expenditure. For example, support schemes for businesses have been reduced to about half of the level in 1990, measured as a percentage of the value added in the mainland economy. The pension reform is an example of a reform that has strengthened the sustainability of social security schemes.

The recent efficiency reform in the central government sector, requiring every public agency to cut operating cost by ½ percent every year, will have positive long-term effects on resource utilization and public finances. However, further steps are necessary, both at the local and at the central level of the public sector.

C. The co-financing alternative – more private responsibility

Private co-financing, or transferring certain services to the private sector, will ease the pressure on public finances. Assuming incomes continue to increase, households may be prepared to bear some of the costs related to their use of welfare services. This may be especially true when it comes to services with a high private return. User fees are now about the same level as in the early 1990s, measured as a share of share of Mainland GDP, after a rapid increase towards the end of the 1980s, see figure 12. Private co-financing amounts to some 8 percent of public revenues from the mainland economy, which is 4-6 percentage points less than in countries such as the US, Finland and Switzerland. Health and long-term care services are areas where private co-financing is widespread in many other OECD-countries.

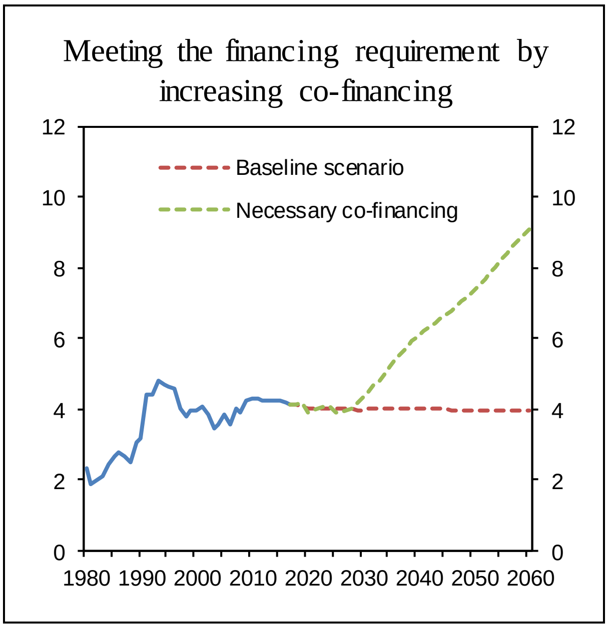

Figure 12: Private co-financing. User fees as a share of Mainland GDP. Actual development and different future scenarios.

Source: Ministry of Finance and Statistics Norway.

In addition to increasing public revenues, more private co-financing may help better dimension the demand for public services. The demand for heavily subsidised services may not correctly reflect their benefit. More private co-financing may also create welfare services that better suit individual wishes and needs. Still, delivering high quality and cost-effective universal services on prioritised areas will continue to be an important part of the Norwegian welfare model.

A wider definition of private co-financing or greater private responsibilities could include measures that both reduces the level of benefits and tightens the eligibility of benefits. This is especially relevant when such measures could have positive effects on the labour supply.

Figure 12 shows that meeting the estimated baseline financing requirement by increasing the private co-financing alone, would require a doubling of user fees from the current level, measured as a share of Mainland GDP. This calculation is mainly an illustration of how important it is to succeed on the other two strategies – increasing employment and efficiency as well as better target public welfare services.

D. The Tax alternative

There is a connection between Norway's comparatively high tax level and the comprehensiveness of the welfare schemes. There is however a limit to how high the tax level can be. Sizable tax increases may increase the likelihood of tax evasion and adjustments that reduces the tax base. High income tax can reduce labour supply, while high capital tax can weaken the incentives to invest and do business in Norway. Other traits also challenge the tax base, such as globalisation, digitalisation and increased tax competition between countries.

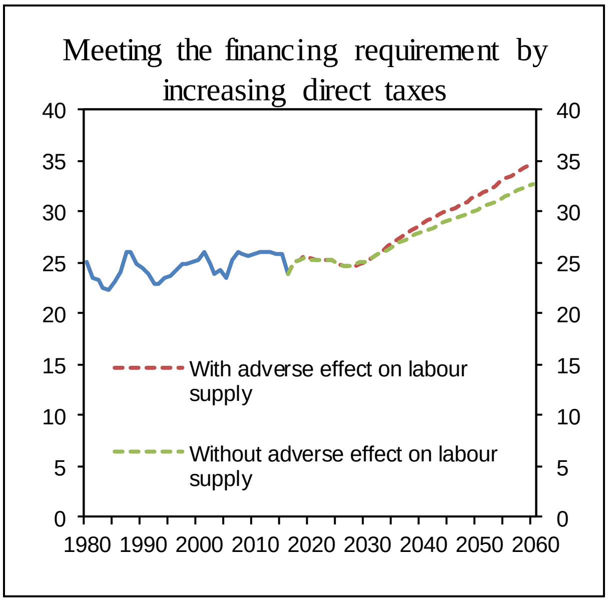

Figure 13: Direct taxes paid by households as a share of pre-tax income. Actual development and scenario where the tax share meets the baseline financing requirement with and without negative effects on the labour supply

Sources: Statistics Norway and Ministry of Finance

Meeting the baseline financing requirement only by increasing taxes would make it difficult to avoid distortionary taxes with adverse consequences on labour supply and investments. Income tax amounts to over half of total mainland taxes and levies. Figure 13 shows the necessary development in direct taxes and national insurance contributions paid by households to meet the estimated baseline financing requirement towards 2060. Disregarding potential negative effects from taxes to the supply of labour, these taxes must increase by 7 percentage points (27 percent) by 2060 in order to balance public budgets. This would weaken the incentive to work, reduce the tax base and make it necessary to increase the tax level further. The red line in the chart illustrates this mechanism, where the assumption is that increasing the tax level by 1 percent reduces the labour supply by 0.1 percent. This increases the financing requirement by almost 0.4 percentage points per decade compared with means of financing without adverse effects on labour and investments.

The tax alternative is clearly not the preferred strategy to deal with the long term challenges.

Summing up

The welfare state has expanded significantly over the last decades. Public employment has risen sharply, also when measured per capita. This development reflects broader and improved public welfare services. If this continues, it will add to the aging-related strain on public finances.

Which welfare state we can afford in the face of demographic and non-demographic challenges will depend on the total state of the economy. Being able to contribute and utilise the possibilities of new technology will play an important part when pursuing an affordable level of public welfare services. Political priorities will affect economic growth and decide how to balance public finances.

Good solutions will require effort in many areas. Increased labour participation – both by postponing retirement and by mobilising the population's full labour potential – should be a central part of the strategy. This will strengthen public finances and give the individual citizen the possibility to increase his or her income and standard of living, but it will hardly suffice. Better public sector solutions are also necessary. That requires clear priorities and well-organized and efficient services. Failing to succeed in these two areas, or if one wishes to further expand the provision of public services, could make less attractive alternatives such as private co-financing and taxes become relevant tools.

Figure 14 illustrates these challenges and possibilities by depicting alternative welfare state scenarios in the coming decades. Merely maintaining the current level of welfare services another decade or so does not require any specific revenue-increasing or expenditure-constraining measures (the left dark blue column). Improved public services in some areas (the left light blue column), however, will require some combined efforts of increased effectiveness elsewhere in the public sector and better utilising the labour force.

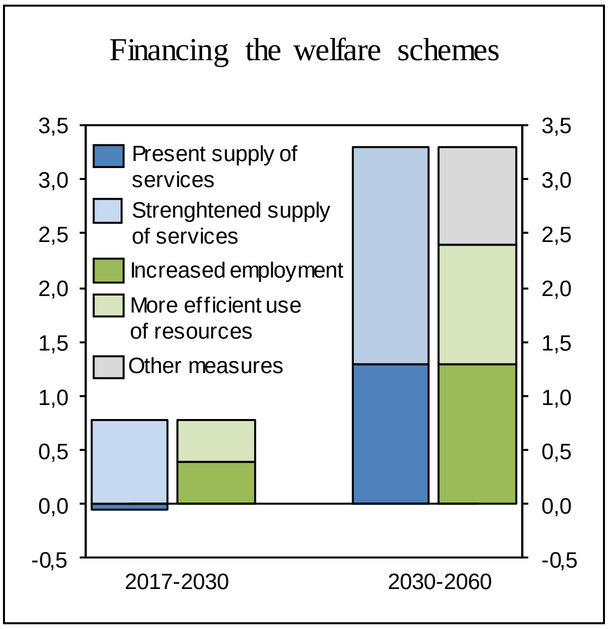

Figure 14: Financing the welfare schemes. Need for increased financing (blue columns) and means of coverage (green columns) measured per decade. Percent of Mainland GDP

Sources: Ministry of Finance and Statistics Norway.

The challenges increase after 2030 and towards the end of the end of the projection horizon in 2060. The right-hand pair of columns illustrates a scenario where employment successfully is brought up to the levels of previous booms, generating more tax income (despite demography would rather suggest employment to ebb). The scenario also assumes the ability to reprioritize and realise savings within public services and transfers. The figure suggests that successful labour and public sector policies would be more than enough to secure the financing of the current welfare state towards 2060.

If ambitions are higher, and the welfare state continues to expand and improve, almost at the pace seen so far, further measures are required. That could be having even more successful labour and public sector policies than assumed in the figure. If that proves difficult, increased private responsibility could enter the agenda, either in terms of user fees or in terms of leaving some services to the private market. Alternatively, taxes need to go up.

The better we succeed in increasing employment, the more room to strengthen the provision of public services – or to avoid austerity measures. The better we succeed in allocating public resources efficiently and target our efforts, the more room for improved services in the areas we prioritise. Ensuring a continued safe voyage for the Norwegian welfare means being open for new and better solutions. With our state finances in order, a productive private sector and a highly educated labour force, Norway should be well prepared to meet the future.