DET KONGELIGE
FINANSDEPARTEMENT

Royal Ministry of Finance

National Budget 2013

A Summary

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National Budget 2013

1 Introduction

The Norwegian mainland economy has grown since late 2009. Employment has increased for the last eight quarters, and exceeded the top level from before the crisis about a year ago. Unemployment is currently well below the average over the last 25 years, and considerably lower than in most other industrialised countries.

Capacity constraints are getting evident despite weak developments in export markets. The strong economic performance is supported by high oil prices and low interest rates. Growth in the mainland economy for 2012 and 2013 as a whole is currently forecasted to be higher than the trend growth of the economy. The economy is expected to enter 2013 with less spare capacity than was envisaged six months ago.

The low interest rate level primarily benefits households and enterprises not exposed to competition from abroad. A strong Norwegian krone serves to alleviate some pressure in the economy. At the same time the strong currency is hurting industries exposed to international competition. High costs in Norway makes these enterprises more vulnerable to weak international growth, falling export prices and appreciation of the Norwegian krone exchange rate.

Fiscal policy is guided by the fiscal rule, stipulating a gradual phasing-in of oil revenues in the Norwegian economy in line with the expected real return on the Government Pension Fund Global, estimated at 4 pct. The fiscal rule permits spending more than the expected return on the Fund in a cyclical downturn, whilst the spending of petroleum revenues should be below the expected return when capacity utilisation in the economy is high. This room for manoeuvre was used in 2009 to mitigate the effects of the financial crisis on production and employment. In 2011 and 2012, the spending of petroleum revenues has returned to a level below the four-percent path.

In the current economic situation the Government emphasizes the need for fiscal constraints to support continued balanced developments of the economy and to reduce the pressure on exposed industries. Adding to the pressure would also risk further accelerating the growth in wages, as well as housing and real estate prices. The Government is therefore proposing a roughly neutral budget for 2013, i.e. a structural, non-oil deficit that grows more or less in line with Mainland Norway trend GDP. The budget for 2013 proposed by the Government implies a structural, non-oil budget deficit of about NOK 125 billion. This is NOK 26.4 billion below the 4-percent path. The difference is slightly smaller than in 2011, but larger than the estimate for 2012.

The budget proposal for 2013 is based on an unchanged level of taxation. The underlying real expenditure growth in the fiscal budget is 2.4 pct. from 2012 to 2013. Expenditures under the National Insurance Scheme account for about half of this.

2 Economic outlook

Norwegian economic growth looks set to continue apace this year and next year. Over the last 40 years, mainland economic growth has been lifted by high labour force participation and high productivity growth. In addition, large-scale oil and gas activities have been developed and resulted in considerable revenues for the State and an expanding supply industry in the mainland economy. After the turn of the millennium, the Norwegian economy has also benefited from China's entry onto the world economic stage, through higher prices for our exports and low prices for imported goods. This improvement in the terms of trade has resulted in Norway's disposable income growing more rapidly than its gross domestic product. The increased income has partly been saved in the form of financial assets and partly been devoted to higher consumption and investment.

Both employees, capital owners and the state have benefitted from the improving terms of trade. The apportionment of income from mainland economic activity between employees and capital owners has remained fairly stable, whilst Norwegian employees have experienced high real wage growth. The purchasing power of employees in Norway has expanded at twice the

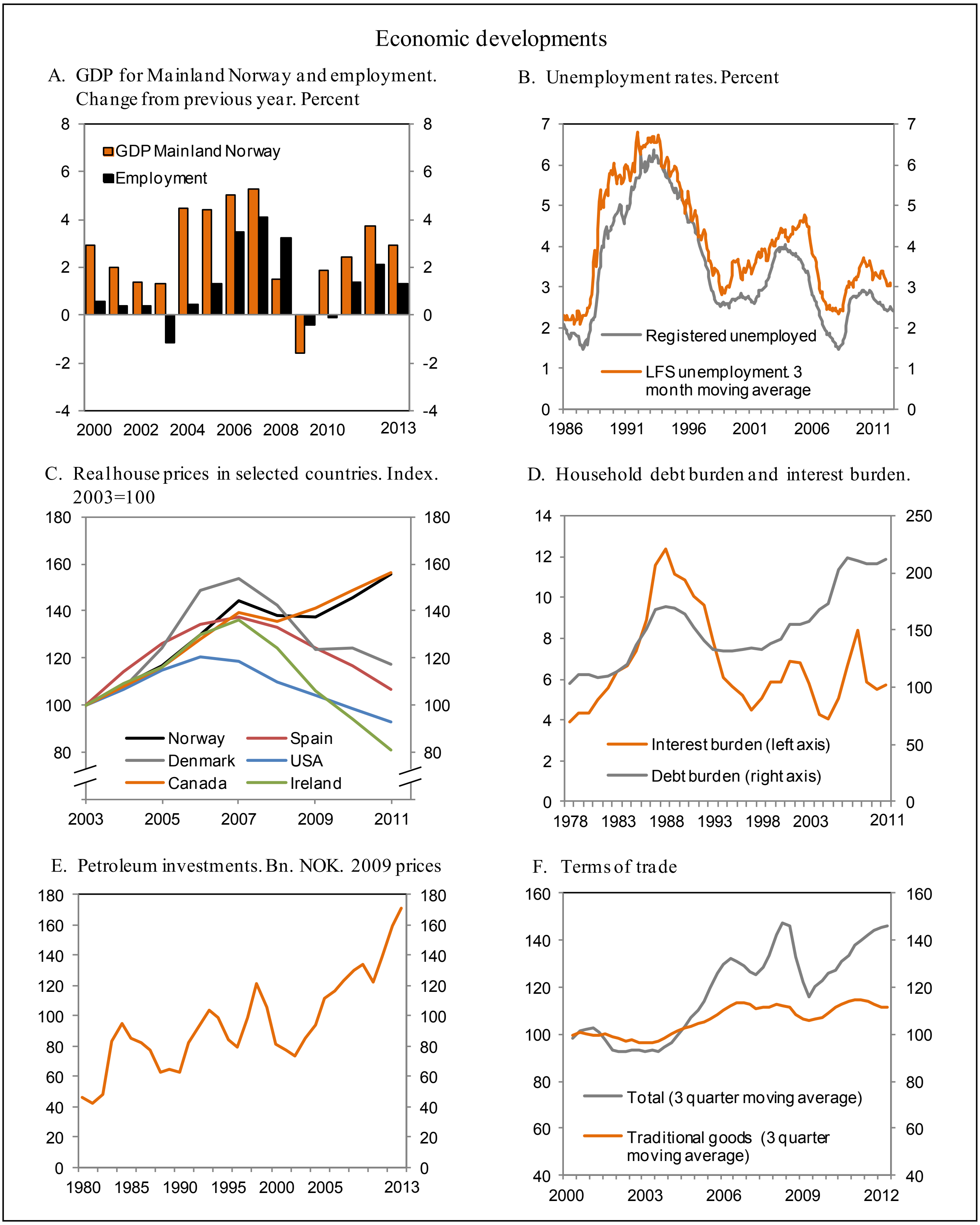

Figure 2.1 Economic developments

Sources: Statistics Norway, OECD and Ministry of Finance.

Table 2.1 Key figures for the Norwegian economy. Percentage change from previous year[1]

	Bn.NOK[2] 2011	2011	2012	2013
Private consumption	1 128.6	2.4	3.7	4.0
Public consumption	585.8	1.5	1.9	2.2
Gross fixed investments	549.9	6.4	7.7	5.8
Of which: Petroleum extraction and pipeline	144.6	13.4	15.0	7.0
Businesses in mainland Norway	179.7	2.6	4.9	5.1
Housing	124.2	22.0	9.0	8.0
Public sector	87.1	3.0	0.5	2.8
Demand from mainland Norway[3]	2 105.4	3.2	3.5	3.8
Exports	1 145.2	-1.4	1.6	1.4
Of which: Crude oil and natural gas	562.4	-6.2	1.0	-0.1
Traditional goods	316.4	-0.4	1.3	2.2
Imports	769.8	3.5	4.2	5.4
Of which: Traditional goods	470.1	5.3	4.3	5.6
Gross domestic product	2 720.5	1.4	3.1	2.5
Of which: Mainland Norway	2 085.0	2.4	3.7	2.9
Other key figures:				
Employment, persons		1.4	2.1	1.3
Unemployment rate. LFS (level)		3.3	3.1	3.2
Annual wage		4.2	4.1	4.0
Consumer price index (CPI)		1.2	0.8	1.9
CPI adjusted for tax changes and excluding energy products (CPI-ATE)		0.9	1.3	1.7
Oil price. NOK per barrel[4]		621	637	625
Current account balance (pct. of GDP)		14.5	13.3	11.4
Three-months money market interest rate[5]		2.9	2.2	2.0
Trade weighted index (TWI)		93.9	92.8	93.3
Household savings. pct. of disposable income		8.2	8.8	8.5

1 Calculated in constant 2009 prices unless otherwise noted.
2 Preliminary national account data in current prices.
3 Excluding changes in inventory.
4 Current prices.
5 Technical assumption based on forward rates in September.

Sources: Statistics Norway and Ministry of Finance.

speed of that in Sweden over the last decade. Although it is likely that wage growth has been held back by high labour immigration, wage costs in Norway have reached a high level by international standards. This represents a challenge for Norwegian enterprises that compete in the international market, and makes them vulnerable to changes in retail prices or further appreciation of the Norwegian krone.

The high income growth has, in combination with low interest rates and high population growth, resulted in strong growth in housing demand. Housing prices have increased considerably since the turn of the millennium. The steepest increase has been registered in the main urban centres. Housing investments are largely funded by borrowing, and household debts have increased in line with housing prices. Young households, in particular, are saddled with high debts, and these may experience uncomfortably high interest expenses when interest rates eventually increase towards a more normal level.

Thus far this year, Norwegian mainland economic growth has exceeded the average for the last 40 years. Low interest rates and high income growth have contributed to a sustained increase in household demand. The economy is, at the same time, stimulated by high oil prices. This is reflected in rapid growth in activity within the construction sector and amongst petroleum industry subcontractors. Employment is growing fast, and unemployment is low in historical terms as well as in comparison with the levels seen in other countries.

Strong growth in parts of the Norwegian economy is in stark contrast to the position of those parts of the economy that depend on demand in European export markets. Weak developments in Europe mean, in combination with high wage costs and a strong Norwegian krone exchange rate, that many exporters are facing a challenging situation. Although traditional goods exports have rebounded somewhat in the first half of this year, these still remain markedly lower than before the financial crisis. The prices of several important Norwegian export products have, at the same time, declined in recent quarters. Total forecasted *growth in Mainland Norway GDP* is 3.7 pct. in 2012 and 2.9 pct. in 2013, cf. Table 2.1.

The labour market is tightening. Unemployment has fallen somewhat over the last two years, and stands at about 3 pct. of the labour force currently. Employment growth is estimated to be 2.1 pct. from 2011 to 2012 and 1.3 pct. from 2012 to 2013. Unemployment is estimated at 3.1 pct. of the labour force in 2012 and 3.2 pct. in 2013.

Norges Bank reduced the *key policy rate* by a total of ¾ percentage points in the monetary policy meetings in December last year and March this year. The key policy rate is currently 1.5 pct. Norges Bank's interest rate estimates from June this year indicates that the key policy rate will remain at the present level until yearend, and subsequently be gradually increased to about 3¼ pct. towards the end of 2015.

Following weak developments last year, *private consumption* growth has rebounded distinctly in the first half of this year, and exceeded its historical average. Nevertheless, household consumption growth was less than income growth in the first half of the year, and *savings* have been further expanded. When measured as a percentage of income, savings in the 2nd quarter were more than twice the average for the last 30 years. Much of the savings are devoted housing investments, but recently there has also been an increase in bank deposits. The accumulation of financial buffers may be an indication that international uncertainty is also making Norwegian households somewhat more cautious. In addition, high savings may reflect a need for strengthening one's financial position. Many years of strong credit growth has brought household debts to a high level, when measured as a proportion of household income. Together with favourable prospects for income growth and a continuation of low interest rates, high savings give reason to expect further increases in household consumption ahead. Private consumption growth is estimated at 3¾ pct. in 2012 and 4 pct. in 2013. Consequently, the savings rate is expected to remain at a high level.

Since the housing market turnaround in late 2008, housing prices have increased by an average of ¾ pct. per month, and by 35 pct. for the whole period when adjusted for inflation.

Housing construction has recently picked up considerably, in the wake of weak developments last year and at the beginning of this year. The present report assumes that the number of new housing units entering construction will increase from about 27,500 in 2011 to 30,000 in 2012. Housing investment is expected to grow ahead.

Business investments on the part of mainland economy expanded somewhat last year, and the moderate increase continued in the first half of this year. Experience suggests that these investments are highly sensitive to changes in the business cycle. Investment growth is assumed to pick up somewhat from last year to this year, with a further slight increase next year. The rather moderate growth in investments is probably a reflection of uncertainty as to future developments in the international economy.

Petroleum investments increased by just over 13 pct. last year, and were an important driver behind the upturn in the mainland economy. The Norges Bank's Regional network notes that the offshore supply industry is reporting strong production growth and expectations of further growth ahead. Prospects are for a further growth in petroleum investments of 15 pct. in 2012 and 7 pct. in 2013.

Exports of traditional goods rebounded slightly during the first half of this year, following a downturn in the second half of last year. Low growth prospects for many important trading partners give reason to expect weak developments in traditional goods exports ahead as well.

Imports of traditional goods picked up markedly in 2010 and 2011, in the wake of weak developments throughout 2008 and 2009. Imports have contracted again somewhat this year, although the level in the 2nd quarter of this year exceeded the average for the same period last year. Traditional goods imports are expected to undergo growth around the historical average both this year and next year.

Higher prices for Norwegian exports since the turn of the millennium have contributed to a significant improvement in *Norway's terms of trade*, as measured by the ratio between export and import prices. The improvement in the terms of trade has been reinforced by falling prices for imported consumer goods during the period. Following a decline in the wake of the international financial crisis in 2008 and 2009, the terms of trade for traditional goods improved considerably throughout 2010 and into 2011. However, a reduction in the prices of important exports like fish and metals since the summer of last year has contributed to renewed deterioration in the terms of trade for traditional goods. The Ministry of Finance assumes somewhat deteriorating terms of trade for traditional goods this year and next year. The increase in crude oil and natural gas prices means that the overall terms of trade will nonetheless remain fairly stable from last year to this year.

The favourable terms of trade developments have contributed to maintaining the profitability of Norwegian exporters despite the particularly high cost level in Norway. Norwegian wage growth has been high by international standards for a number of years. Last year, *hourly wage costs in manufacturing industry* in Norway exceeded those of our EU trading partners by more than 50 pct., measured in common currency. The high level of costs is making many export enterprises vulnerable to lower product prices and a strong Norwegian krone.

As measured by the *trade-weighted exchange rate index (TWI)*, the Norwegian krone has appreciated by about 3 pct. since the beginning of the year, and is now 2 pct. stronger than the average for last year and 5 pct. stronger than the average for the last five years.

In recent years, foreign trade developments and volatility in international equity and fixed-income markets, as well as in oil prices, have had a major impact on the *current account balance*. The surplus was almost NOK 400 billion kr. in 2011, or more than 14 pct. of GDP. This is still a lower level than in 2008, and further slight declines are anticipated this year and next year.

Consumer price growth adjusted for tax changes and excluding energy products (CPI-ATE) has remained fairly low and stable thus far this year. The Norwegian krone has appreciated through 2010 and 2011, and this has contributed to a reduction in the prices of imported consumer goods. Growth in the prices of goods and services produced in Norway has, at the same time, been moderate. The decline in the prices of imported consumer goods has petered out recently, and the growth in the prices of agricultural goods produced in Norway has picked up. The CPI-ATE growth estimate for 2012 is 1.3 pct., with the CPI estimate being 0.8 pct.

Average *annual wage growth* in 2012 is estimated to be 4.1 pct., based on the wage settlements completed and the economic outlook. For 2013, average annual wage growth is estimated at 4 pct.

As usual the forecasts in this report are subject to considerable uncertainty. There is a risk that the two-tier development of Norwegian industries may become even more pronounced. A significant slump in oil prices and weaker international development may have major negative effects on activity in the Norwegian mainland economy. On the other hand, low interest rates and strong income growth may give even stronger growth impulses to domestic demand than projected.

3 Economic policy

3.1 The fiscal policy guidelines

The Norwegian fiscal policy guidelines, introduced in 2001, plan for a smooth, gradually increase in the spending of petroleum revenues to a level that can be sustained over time. The rule states that the use of petroleum revenues, as measured by the structural non-oil budget deficit, should over time be in line with the expected real return on the Government Pension Fund Global, estimated at 4 per cent. At the same time, the spending of petroleum revenues *in each individual year* shall reflect business cycle fluctuations. Consequently, the framework facilitates using the budget to stabilise developments in the Norwegian economy, and enables the long-term management of the petroleum wealth, thus ensuring that it will also be of benefit to future generations, cf. Box 3.1.

The current high revenues from petroleum activities are mirrored by a corresponding reduction in the remaining petroleum resources. If Norway is to benefit from the petroleum revenues on a permanent basis, the spending of such revenues needs to be decoupled from the annual payments made to the State. The fiscal policy guidelines reflect this perspective. The net cash flow received by the State from petroleum activities is channelled into the Government Pension Fund Global in its entirety, whilst spending shall correspond to the expected real return on the Fund. This ensures that government expenditure developments are sheltered from the effects of volatile oil prices, whilst the State accumulates considerable financial wealth through the Fund.

The fiscal rule determines withdrawals from the Fund over time, but does not prescribe the level of expenditure or other revenues in the fis-

Box 3.1 Fiscal policy guidelines – the fiscal rule

In Report No. 29 (2000-2001) to the Storting, the first Stoltenberg Government proposed the following fiscal policy guidelines, which were endorsed by a majority in the Storting:

Petroleum revenues shall be gradually phased into the economy, in line with the expected real return on the Government Pension Fund Global, estimated at 4 pct. of the Fund capital.

An emphasis on dampening fluctuations in economic activity in order to ensure high capacity utilisation and low unemployment.

The fiscal rule facilitates stable development of the Norwegian economy in both the short and the long run:

- *The fiscal budget is sheltered from the effects of petroleum price volatility*. The cash flow from petroleum activities to the State are channelled into the Government Pension Fund Global, whilst spending is intended to reflect the expected real return over time. Hence, short-term fluctuations in oil and gas prices will have little impact on fiscal policy, whilst future generations will also benefit from the petroleum wealth.
- *The fiscal rule facilitates the gradual phasing-in of petroleum revenues, in step with growth in the Fund*. In case of major changes to the Fund capital, or in matters influencing the structural, non-oil deficit, the impact on the spending of petroleum revenues shall be smoothed out over several years. A gradual phasing-in of petroleum revenues serves to reduce the risk of sudden and large-scale realignments between those industries that are exposed to international competition and those that are not.
- *The automatic stabilisers in the budget are enabled to work*. The ongoing spending of petroleum revenues is measured by the structural, non-oil deficit, and not by the actual non-oil deficit. This implies that transfers from the Fund to the budget are allowed to increase when tax revenues decline in times of recession, whilst the reverse applies in times of strong economic expansion. Consequently, the expenditure side of the budget is sheltered from cyclical tax revenue fluctuations.
- *The fiscal rule facilitates the use of fiscal policy to stabilise production and employment*. In times of high unemployment, one may spend more than the expected real return on the Fund capital in order to stimulate production and employment. Conversely, it may be appropriate to tighten fiscal policy during periods of high economic activity.
- *The fiscal rule and the Fund construction contribute to stabilising the Norwegian krone market.* The Government Pension Fund Global serves to channel a large portion of the oil and gas revenues of the State into investments abroad. The investment of foreign exchange revenues abroad contributes to improved stability in the Norwegian krone market. This lessens the impact of oil price fluctuations on the Norwegian krone exchange rate.
- *The fiscal rule contributes to predictability concerning the use of petroleum revenues in the Norwegian economy.* The fiscal policy framework thus supports monetary policy and paves the way for stable expectations, amongst others in the foreign exchange market.

cal budget. The Government will keep an unchanged level of taxation, in keeping with its political platform. The tax level defines, together with the fiscal rule, a budget expenditure framework within which the Government makes its prioritisations.

Currently the Government Pension Fund Global is in a period of expected growth. This permits a gradual increase in the spending of petroleum revenues. At the same time, the Government attaches weight to the need for balanced economic development in its ongoing formulation of fiscal policy. Fiscal policy was given a highly expansive orientation in 2009 in order to dampen the effects of the financial crisis and the international economic slump on the Norwegian economy. The spending of petroleum revenues, as measured by the structural, non-oil deficit, was increased to a level in excess of the expected real return on the Fund. In 2011 and 2012, this deficit has been returned to a level well below the expected return on the Fund, whilst activity in the Norwegian economy has rebounded.

We are facing major fiscal policy challenges in

Table 3.1 Key figures for the fiscal budget and the Government Pension Fund. NOK billion

	Accounts		Estimates	
	2010	2011	2012	2013
Total revenues	1 064.8	1 223.5	1 278.0	1 314.4
1 Revenues from petroleum activities	296.1	372.2	412.8	401.2
1.1 Taxes and excise duties	159.2	209.7	229.0	229.9
1.2 Other petroleum revenues	136.9	162.6	183.8	171.3
2 Revenues other than petroleum revenues	768.7	851.3	865.2	913.2
2.1 Taxes and excise duties from Mainland Norway	713.5	777.5	807.9	855.9
2.2 Other revenues	55.1	73.7	57.3	57.3
Total expenditures	892.9	952.1	1 002.6	1 064.9
1 Expenditures on petroleum activities	20.1	21.4	26.0	28.0
2 Expenditures other than petroleum activities	872.7	930.7	976.6	1 036.9
Fiscal budget surplus before transfers to the Government Pension Fund Global	171.9	271.4	275.4	249.5
- Net cash flow from petroleum activities	276.0	350.8	386.8	373.2
= Non-oil surplus	-104.1	-79.4	-111.3	-123.7
+ Transfers from the Government Pension Fund Global	109.4	84.2	111.3	123.7
= Fiscal budget surplus	5.3	4.8	0.0	0.0
+ Net allocation to the Government Pension Fund Global	166.6	266.6	275.4	249.5
+ Interest earnings and dividends to the Government Pension Fund	90.5	103.0	108.8	130.6
= Surplus, fiscal budget and Government Pension Fund	262.4	374.4	384.2	380.1
Memo:				
Market value of the Government Pension Fund Global[1]	3 081	3 308	3 793	4 281
Market value of the Government Pension Fund[1]	3 216	3 437	3 931	4 426
as percentage of GDP	127.4	126.4	137.1	148.0
National insurance scheme – old-age pension liabilities[1]	4 881	5 181	5 474	5 797

1. At year-end.
Source: Ministry of Finance.

the longer run as the result of an ageing population. Population developments in Norway over the last few decades have been fairly favourable from a public finance perspective, with a slight decline in the proportion of older people. Such developments have now been reversed. Having fallen steadily since the early 1990s, the share of the population older than 67 years started growing in 2010. This trend will continue in coming decades and result in increased expenditure on, *inter alia*, pensions, health and care. The savings accumulated through the Government Pension Fund will help fund such expenditure. Nevertheless, long-term budget projections show that we will be faced with major fiscal policy challenges over time.

3.2 Fiscal policy in 2012 and 2013

Last autumn, the fiscal budget for 2012 signalled a weakly expansive budget impulse of about ¼ percentage point, as measured by the change in the structural, non-oil deficit as a portion of Mainland Norway trend GDP. This resulted in a fiscal budget deficit of NOK 122 billion, when adjusted for the petroleum revenues of the State and the impact of the business cycle.

The changes in connection with the Revised National Budget for 2012 reduced the structural, non-oil deficit for 2012 to NOK 116 billion NOK. The new information registered after the Revised National Budget does not, all in all, merit any change to the estimated structural, non-oil deficit in 2012. The structural, non-oil deficit for 2012 is estimated NOK 16 billion lower than the expected real return on the Government Pension Fund Global.

The fiscal impulse, measured by changes in the structural, non-oil deficit as a proportion of Mainland Norway trend GDP, is now estimated at 0.8 percentage points. This exceeds the estimate in the National Budget for 2012, and this is due to the estimated structural, non-oil deficit having been revised further downwards for 2011 than for

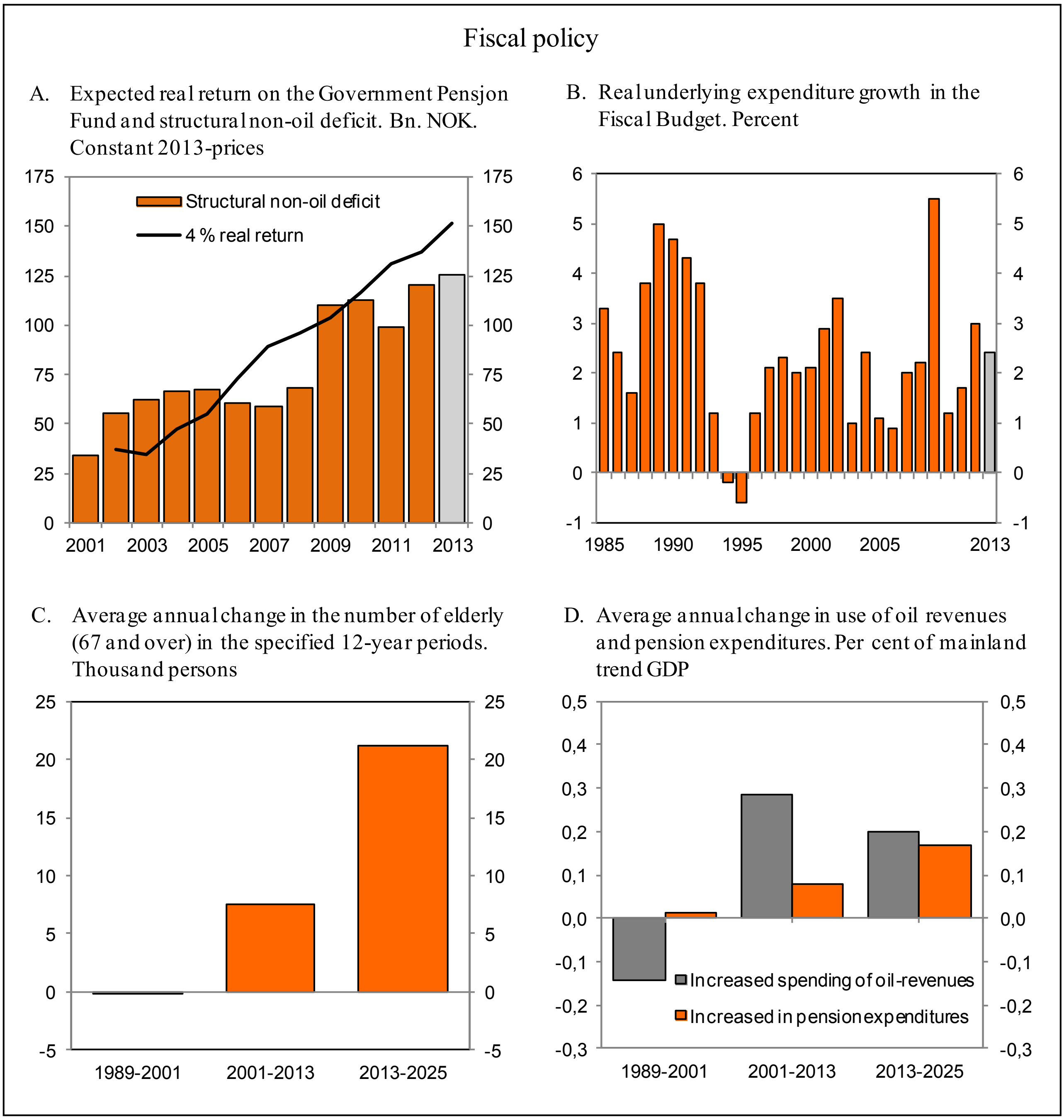

Figure 3.1 Fiscal policy.

Source: Ministry of Finance and Statistics Norway

2012. For these two years as a whole, the estimated budget impulse remains about the same as in the National Budget for 2012.

The Government proposes a roughly neutral budget for 2013, i.e. that the structural, non-oil deficit increases more or less in line with the growth in Mainland Norway trend GDP, cf. Figure 3.1A. The structural, non-oil deficit is estimated to be NOK 125 billion. This is NOK 26 billion less than the expected real return on the Government Pension Fund Global, computed as 4 pct. of the estimated Fund capital at the beginning of this year.

The change in the structural, non-oil budget balance is used as a summary indicator of the effect of the budget on the economy. However, this budget - indicator does not take into account the fact that different revenue and expenditure items may have different effects on the Norwegian economy. Macroeconomic model simulations indicate that the overall effect of the Government's budget proposal for 2013 on the economy is about neutral, also when taking into consideration the composition of revenues and expenditures.

The real underlying expenditure growth of the 2013 fiscal budget is estimated to be slightly higher than the average for the period during which the fiscal rule has guided fiscal policy, cf. Figure 3.1B. The last few decades have seen favourable demographic developments, which have made it possible to fund comprehensive expansion of social security schemes without a matching increase in the level of taxes. Said development has now been reversed. Government pension expenditure is expected to increase steeply because the proportion of older people in the population is now growing swiftly, cf. Figure 3.1C. Such growth will continue for many decades to come.

This will be accompanied by a gradual reduction in the growth in the expected real return on the Fund, relative to mainland economy GDP. Given that transfers from the Fund move in line with the expected real return, the Fund's contribution to the financing of the fiscal budget will increase from 5.3 pct. of Mainland Norway GDP in 2013 to just short of 8 pct. in 2025. This is less than the increase in such funding contribution from 2001 to 2013, cf. Figure 3.1D.

The main features of the budget proposal for 2013 are as follows:

- The spending of petroleum revenues, as measured by the structural, non-oil deficit, is estimated at NOK 125 billion. This is NOK 26 billion less than the expected real return on the Government Pension Fund Global, computed as 4 pct. of the estimated Fund capital at the beginning of 2013.
- The increase in the structural, non-oil budget deficit from 2012 to 2013 corresponds to 0.1 percent of Mainland Norway trend GDP. The budget proposal is estimated to be roughly neutral.
- The real growth in the underlying expenditure of the fiscal budget from 2012 to 2013 is estimated to be about NOK 23 billion at 2013 prices, or 2.4 pct. This is slightly higher than the average for the period during which the fiscal rule has guided fiscal policy.
- The non-oil budget deficit is estimated at about NOK 124 billion. This deficit is covered through transfers from the Government Pension Fund Global.
- The central government net cash flow from petroleum activities is estimated at about NOK 373 billion.
- The consolidated surplus in the fiscal budget and the Government Pension Fund, inclusive of interest and dividend revenues, is estimated at NOK 380 billion.
- The market value of the Government Pension Fund is estimated to be NOK 4,426 billion as per yearend 2013, of which the Government Pension Fund Global accounts for NOK 4,281 billion. The old-age pension liabilities under the National Insurance Scheme are estimated at close to NOK 5,800 billion as per yearend 2013.
- The Government's budget proposal is based on the overall level of direct and indirect taxes remaining unchanged from 2012 to 2013.

3.3 The Government's tax profile

Total accrued tax revenues in Norway will amount to about NOK 1 247 billion in 2012. Of this, about 88 pct. is paid to the central government, while local government (municipalities and counties) receives 12 pct.

The Norwegian tax system is characterised by a relatively high share of indirect taxes. Value-added tax (VAT), excise duties and custom duties represent about 29 pct. of the central government's tax revenue. Personal income tax and the tax on net wealth levied on individuals represent about 24 pct. Corporate tax, including employers' social security contributions, amounts to approximately 21 pct. Taxes levied on petroleum activities (ordinary tax, special tax and environmental taxes) represent about 23 pct. of the central government's tax revenue.

The Government's objectives for its tax and fiscal policies are to ensure public revenue, contribute to a fair income distribution and a better environment, promote economic growth and employment in the entire country and improve the functioning of the economy. The Government has stated that the level of taxation should be kept stable to ensure a good economic foundation for maintaining the welfare state.

The Government have strengthened the redistributive aspect of the tax system through more stringent taxes on dividends and gains on equity investments, a fairer net wealth tax and inheritance tax and higher minimum deductions in both of these taxes. In addition, the tax system more clearly addresses environmental concerns. By continuing the systemic changes in the tax system within a stable tax level, the Government is ensuring a predictable tax system, making it attractive to invest and do business in Norway.

In April last year, the Minister of Finance submitted a White Paper on the evaluation of the 2006 tax reform; see Report no. 11 (2010-2011) to the Parliament. The evaluation shows overall positive effects of the reform. The problems of income shifting inherent in the tax system have been largely eliminated. Payable taxes are now far less dependent upon how labour income is

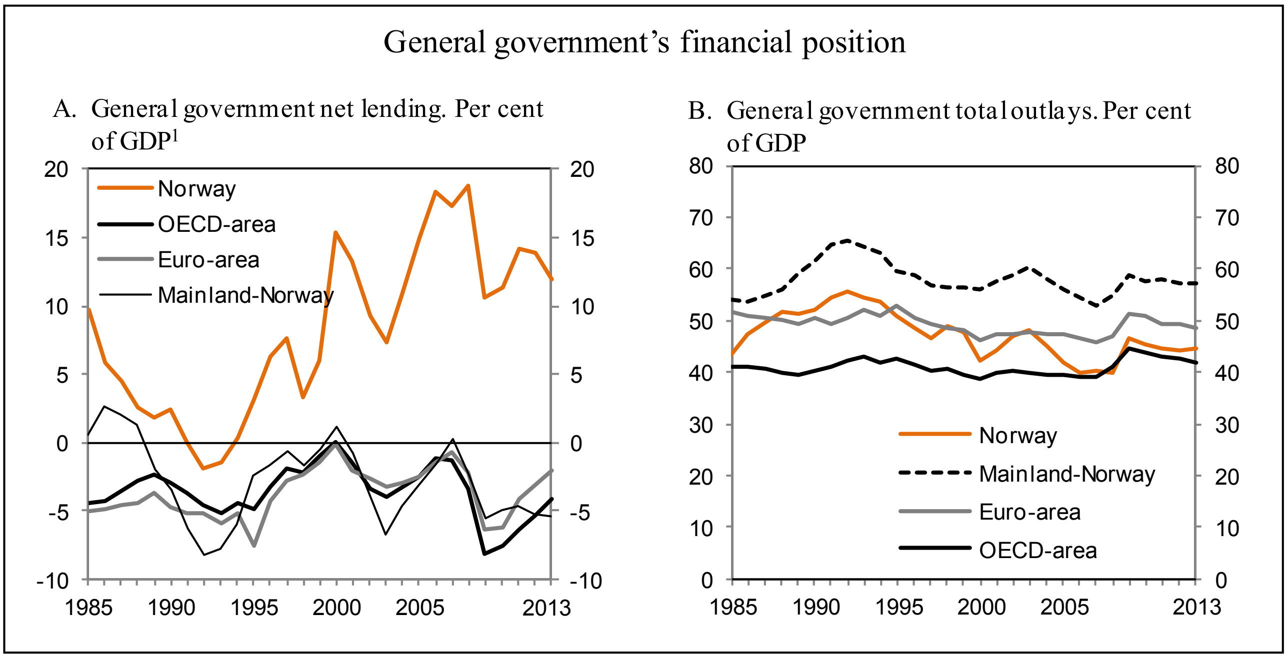

Figure 3.2 General government's financial position

1. Mainland Norway: General government net lending excluding net oil revenues and return on capital in the Government Pension Fund Global.

Source: Ministry of Finance and Statistics Norway.

earned or how businesses are organised. The combination of dividend tax and wealth tax ensures that taxes levied on the most affluent have increased considerably. In addition, lower tax on labour has led to productivity gains through increased labour supply. The administrative costs due to the 2006-reform are moderate, and the dividend tax does not appear to have had a negative effect on the supply of capital. The tax system appears more uniform than before the reform. However, some room for improvement was identified in the evaluation, first and foremost to prevent tax avoidance and to simplify the rules. Some changes in the corporate tax were made in the budget for 2012 as a follow-up of the evaluation.

In the budget for 2013, the Government propose minor amendments in the tax system. The income tax for personal tax payers is kept mainly unchanged in real terms, whereas broadening the tax base makes room for an increase in the basic allowance in the net wealth tax. The Government proposes a further improvement of the environmental profile of the tax system. An increase of the CO_2 tax in the offshore petroleum sector is proposed, as previously announced in the Government's white paper on climate policy. Further, the CO_2 tax base will expand to include fisheries. The government also put more emphasis on emissions of CO_2 and NO_x in the registration tax on vehicles. For further details on the tax proposal for 2013, see English summary of Chapter 1 of the bill and draft resolution on taxes 2012.

3.4 The fiscal position of general government

In addition to the fiscal budget and the Government Pension Fund, the general government includes other central government and national insurance accounts and local government administrations. General government net lending is the surplus concept of the national accounts and is computed in a way that enables meaningful comparisons of public sector figures across countries. Since the mid-1990s, petroleum revenues have contributed a substantial surplus to general government finances in Norway, whereas the euro zone and industrialised countries as a whole have generally posted deficits, cf. Figure 3.2A. Both in the euro zone and in Norway general government net lending decreased substantially from 2008 to 2009. This must be viewed in the context of lower tax revenues in the wake of the global downturn, along with extensive fiscal policy measures to dampen the rise in unemployment.

Deficits have been reduced again somewhat since 2009. Norwegian general government net lending is estimated at NOK 358 billion in 2013, which corresponds to 12.0 pct. of GDP. This is

Table 3.2 General government net lending. NOK billion

	2011	2012	2013
A. Central government net lending, accrued value	408 830	423 363	381 172
Consolidated surplus in fiscal budget and Government Pension Fund	374 408	384 244	380 122
Non-oil fiscal budget surplus	-79 399	-111 346	-123 663
Net cash flow from petroleum activities	350 804	386 790	373 185
Interest and dividends on the Government Pension Fund	103 004	108 800	130 600
Surplus in other government and public pension accounts	-866	-1 080	-29
Definitional discrepancies, central government accounts/national account[1)]	35 287	40 199	1 079
B. Local government net lending, accrued value	-22 196	-24 309	-23 522
Local government surplus, book value	-18 193	-22 125	-21 678
Difference between accrued and book values, taxes	-4 003	-2 184	-1 844
C. General government net lending (A+B)	386 634	399 054	357 650
Measured as percentage of GDP	14.2	13.9	12.0

1) Includes central government taxes accrued, but not booked, incl. tax revenue from the petroleum sector. Adjustments are made to address that capital contributed to state-run enterprises, including central government petroleum activities, are classified as net lending in the national accounts.
Sources: Ministry of Finance and Statistics Norway.

slightly less than the estimate for 2012. The reduction in net financial investments from 2012 to 2013 is caused by lower accrued tax revenues from petroleum activities, cf. The assumption that average oil prices will be lower in 2013 than in 2012. The general government surpluses are caused by large central government surpluses, cf. Table 3.2.

High revenues from petroleum activities and large allocations for the Government Pension Fund Global have resulted in a steep increase in general government net financial assets in recent years. General government net financial assets is estimated to be NOK 5,200 billion as per yearend 2013, including the assets of the Government Pension Fund and the capital tied up in government-owned business operations. This corresponds to 175 pct. of GDP.

Public expenditure as a share of GDP is used as an indicator of the size of the public sector. According to this indicator the size of government increased during the slump in 2009, but has subsequently remained fairly stable at close to the average for the last 25 years. However, the level is lower than during the recessions in the early 1990s and in 2003, cf. Figure 3.2B.

When measured as a share of mainland GDP, public expenditure appears to be fairly high in Norway in comparison with levels in other countries. When measured as a share of overall GDP, public expenditure is somewhat lower than the average for the euro zone. This has to do with the extraordinary contribution made to GDP in Norway by the petroleum revenues, with the expenditure ratio being correspondingly low. The high current petroleum revenues are based on the depletion of a non-renewable resource, whilst prices are high in historical terms. The revenues of the State from petroleum activities will decline over time. Public expenditure relative to overall GDP therefore underestimates the long-term financing burden. Public expenditure as a share of Mainland Norway GDP will, on the other hand, overestimate the financing burden. This is partly because it disregards the funding contribution from the Government Pension Fund, and partly because it disregards the potential alternative use of the resources currently devoted to petroleum activities.

Differences in public expenditure ratios between countries also reflect differences in the division of labour between the public and the private sector. Public sector responsibility for retirement pensions does, for example, vary from country to country. Moreover, different countries tax pensions and other transfers differently. Countries also make varying use of tax deductions (tax expenditure) as an alternative to government transfers. Such differences influence gross figures with regard to both public expenditure and revenues. In addition to the problems associated with comparing expenditure ratios between countries, a description of the current situation does not bring out the fact that the ageing of the population will be increasing expenditure for several decades to come.

3.5 Fiscal policy in the medium and long term

Over time, the leeway in fiscal policy is primarily determined by developments in the mainland economy tax bases, by developments in the expected real return on the capital of the Government Pension Fund Global, as well as by expenditure and revenue commitments resulting from earlier decisions, including the growth in the expenditure under the National Insurance Scheme.

For the next few years, it is estimated that the underlying real growth in revenues from direct and indirect taxes will be about NOK 18 billion per year at 2013 prices. However, commitments under the National Insurance Scheme is estimated to increase expenditure by close to NOK 11 billion per year at 2013 prices, when calculated as an average for the three-year period from 2014 to 2016. Retirement pension expenditure, in particular, is expected to increase steeply because the proportion of seniors in the population is now growing rapidly. Such growth will continue for many years to come. Growth in the expected real return on the Fund will, at the same time, gradually decline in coming years, cf. Table 3.3.

Public social security provision in Norway is predominantly funded by taxes on the income generated by the working-age population, whilst children, youth and the elderly are net recipients of publicly-funded benefits, cf. Figure 3.3A. Funding of the social security schemes is critically dependent on high employment to give sufficiently high tax revenues. Increased labour force participation amongst women and an almost stable proportion of older people in the population have for several decades made it easier to fund such social security schemes. In addition, the increase in the

Table 3.3 Government Pension Fund Global, expected real return on the Fund and structural non-oil budget deficit. NOK billion and per cent

	Current prices			Constant 2013 prices			Structural deficit	
	Government Pension Fund Global at the beginning of the year[1)]	Expected return (4 pct. on the Fund capital)	Structural, non-oil budget deficit	Expected return (4 pct. on the Fund capital)	Structural, non-oil budget deficit	Deviation from the 4 pct. trajectory	As pct. of Mainland Norway trend-GDP	As pct. of the Fund capital
2001	386.6	-	21.7	-	34.1	-	1.9	-
2002	619.3	24.8	36.7	37.3	55.3	17.9	3.0	5.9
2003	604.6	24.2	43.2	35.0	62.5	27.5	3.3	7.1
2004	847.1	33.9	47.1	47.7	66.3	18.7	3.4	5.6
2005	1 011.5	40.5	49.3	55.2	67.3	12.1	3.3	4.9
2006	1 390.1	55.6	45.7	73.2	60.2	-13.0	2.9	3.3
2007	1 782.8	71.3	46.9	89.6	59.0	-30.7	2.8	2.6
2008	2 018.5	80.7	57.3	95.7	67.9	-27.7	3.2	2.8
2009	2 279.6	91.2	96.1	104.1	109.7	5.6	5.1	4.2
2010	2 642.0	105.7	102.4	116.6	113.0	-3.6	5.1	3.9
2011	3 080.9	123.2	92.6	131.2	98.6	-32.6	4.4	3.0
2012	3 307.9	132.3	116.2	136.6	120.0	-16.6	5.2	3.5
2013	3 793.1	151.7	125.3	151.7	125.3	-26.4	5.3	3.3
2014	4 280.7	171.2	-	165.8	-		-	-
2015	4 641.4	185.7	-	174.1	-	-	-	-
2016	4 954.6	198.2	-	179.9	-	-	-	-
2017	5 275.2	211.0	-	185.4	-	-	-	-
2018	5 600.2	224.0	-	190.5	-	-	-	-
2019	5 926.9	237.1	-	195.2	-	-	-	-
2020	6 262.3	250.5	-	199.6	-	-	-	-

1) When projecting the Fund capital from 2014 and onward it is technically assumed that annual withdrawal from the Fund equals 4 pct. of the capital at the beginning of the year.

Source: Ministry of Finance.

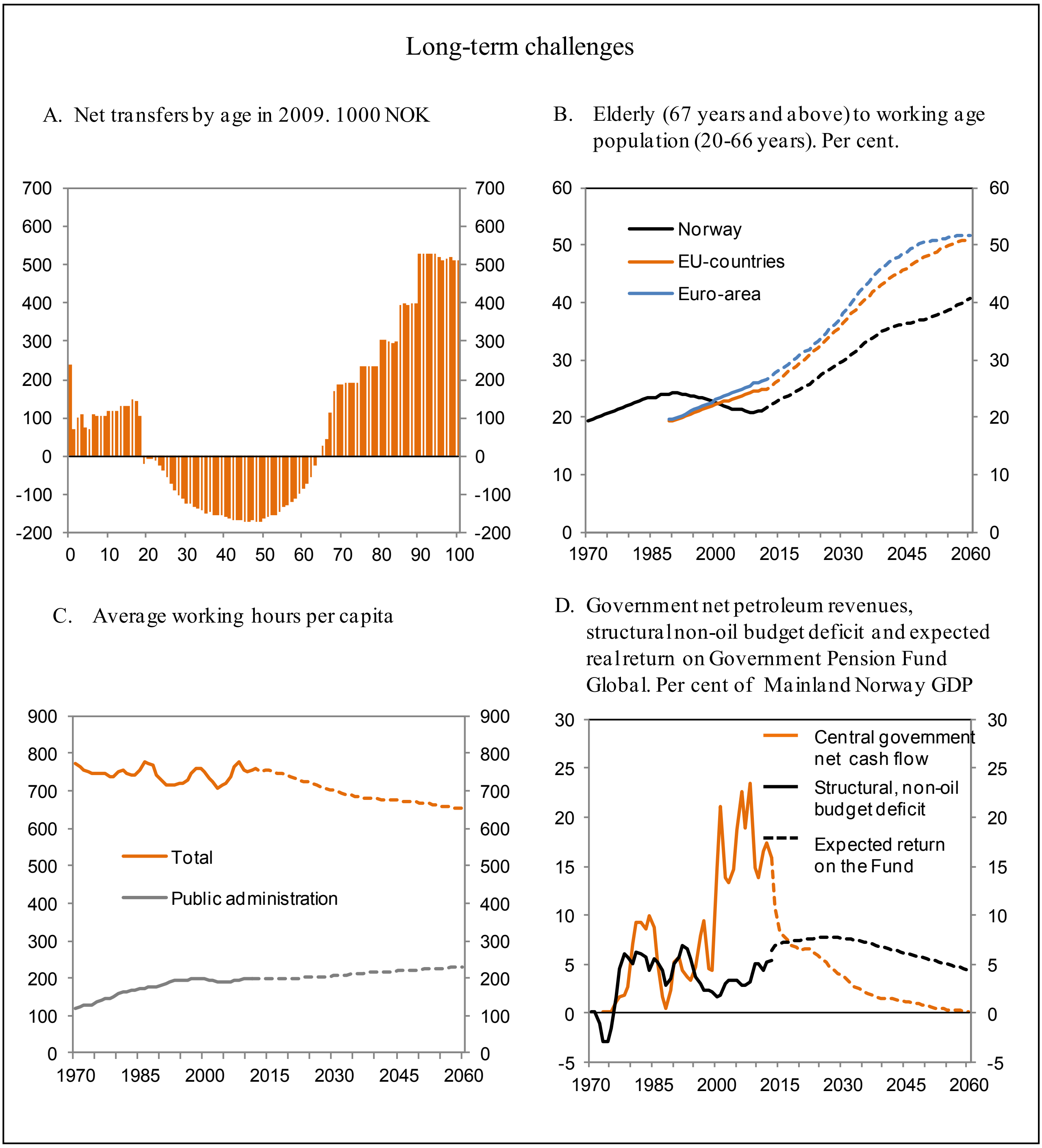

Figure 3.3 Long-term challenges

[1] The Ministry of Finance estimates for Norway.

Sources: Ministry of Finance and OECD.

spending of petroleum revenues has enabled the funding of social security scheme expansions without a corresponding increase in the tax level.

The proportion of older people (67 years and above) is estimated to increase from in excess of 20 per 100 persons of working age at present, to more than 25 in 2020 and then to over 40 in 2060, cf. Figure 3.3B. Although the high birth rates in the post-WWII years will contribute to considerable growth in the number of persons above the age of 67 years over the next few years, it is the increase in life expectancy that is the main driver behind the increase in the proportion of older people in the population over time. Life expectancy at birth has increased by more than 7 years in Norway since the adoption of the Norwegian National Insurance Act in 1967. Both the formal and the actual retirement age have declined over the same period. The population projections assume that life expectancy at birth will increase by about 6½ years between now and 2060.

If labour market participation by group remains the same as at present, the changes in the composition of the population will result in a reduction in total labour effort per capita in coming years, cf. Figure 3.3C. Such reduction will be reinforced unless the decline in average working hours observed over the last 40 years does not come to an end. At the same time, the public sector labour effort will have to increase considerably in coming years in order to meet the growing need for health and care services resulting from the ageing of the population.

In coming decades, the ageing of the population will contribute to public expenditure growth outpacing the growth in revenues from direct and indirect taxes on the mainland economy. Although future returns on the Government Pension Fund in line with Figure 3.3D will make an important contribution to the funding of public sector expenditure, these will not be able to make up the growing shortfall. Continued expansion of public social security schemes in step with general income growth will further exacerbate the fiscal policy challenges.

The National Budget for 2011 presented projections for long-term general government funding needs. For 2060, the projections indicated an unmet funding gap related to a continuation of the current programs corresponding to 7¼ pct. of mainland economy GDP Long-term projections for general government funding needs are uncertain. The estimated structural, non-oil budget deficit has been reduced by 1 pct. of mainland GDP since the National Budget for 2011, whilst the base level of the Government Pension Fund Global has been increased. When taken in isolation, both changes would indicate a reduction in long-term funding needs. The Government will present new long-term projections in early 2013 in a White Paper on long term perspectives.

High labour effort is absolutely crucial for ensuring the sustainability of public social security schemes. An increase in labour effort per capita will expand tax revenues. Moreover, social security expenditure will be reduced if this is accompanied by a simultaneous decline in the number of people outside the labour force. The pension reform is highly important in this context.

3.6 Monetary policy

The 2001 monetary policy guidelines established flexible inflation targeting as the guide for interest rate setting by Norges Bank. Norges Bank's operational implementation of monetary policy shall be aimed at low and stable inflation, defined as an annual increase in consumer prices that remains close to 2.5 pct. over time. In the short and medium term, monetary policy shall weigh low and stable inflation against production and employment stability.

Norges Bank reduced the key policy rate by 0.5 percentage point in the monetary policy meeting in December last year and by a further 0.25 percentage point in the monetary policy meeting in March this year. The key policy rate cuts were explained by deteriorating growth prospects for our trading partners, lower interest rates abroad than previously assumed, a strong Norwegian krone exchange rate and lower inflation in Norway. The key policy rate has since then remained unchanged at 1.5 pct. Monetary Policy Report 2/12, which Norges Bank published in June, offers the following policy outlook: "*Should the uncertainty abate and growth and inflation pick up, the key policy rate may be raised. If the international turbulence increases and domestic growth and inflation prospects weaken, the key policy rate may be reduced*". The Norges Bank rate forecast from June indicates that the key policy rate will remain unchanged at 1.5 pct. until yearend, and subsequently be gradually increased to about 3¼ pct. towards the end of 2015.

The difference between the three-month money market rate and the market's key policy rate expectations for the same period provides an indication of the risk premium banks will require when extending unsecured loans to each other. Mounting turbulence in international financial markets as the result of uncertainty about government finances in several European countries contributed to escalating money market risk premiums in the autumn of 2011. By December last year, the premium embedded in the Norwegian three-month money market rate had increased to 1¼ percentage point, up from about ½ percentage point in the first half of 2011. The premium has subsequently declined, to just over 0.6 percentage points by mid-August.

Norges Bank's reduction of the key policy rate and the declining risk premium have contributed to a lower money market rate level. Recently, the Norwegian three-month money market rate has been in the region of 2 pct., down from more than 3 pct. in December of last year. Fixed-income market pricing suggests that market participants are expecting interest rates to remain below 2 pct. until the spring of 2014.

The key policy rates in other countries are expected to remain low for a long time to come. Interest rate developments abroad influence the trade-off for Norges Bank when deciding on the key policy rate, inasmuch as higher interest rates in Norway than in other countries may results in the appreciation of the Norwegian krone. At present, the Norwegian krone is about 2¼ pct. stronger than the average level for last year and 6½ pct. stronger than the average for the last ten years.

3.7 Financial stability

The costs associated with financial crises are large and of a long-term nature. This is confirmed by developments in the international economy over the last four years. Norway experienced the same during the domestic banking crisis just over 20 years ago. Financial imbalances tend to accumulate over a long period of time, before triggering a crisis. In order to reduce the risk of financial imbalances, financial market regulation and supervision must promote solvency, liquidity and sound conduct.

European financial markets have experienced particularly high turbulence in recent years. Norwegian banks are less affected by the volatility in Europe than are other European banks. Norwegian banks have not been lending large amounts to businesses or governments in exposed euro zone countries. At the same time activity in the Norwegian economy has kept up well. Banks have therefore slightly improved their solvency and established somewhat more robust funding over the last couple of years. The outlook ahead suggests that banks will be well placed to further strengthen their solvency. However, Norwegian banks have borrowed extensively abroad, and this makes them vulnerable. Banks shall be prepared to deal with turbulence. The solvency and liquidity of banks themselves shall constitute the first line of defence in this respect.

The regulatory framework stipulating capital adequacy and liquidity requirements for banks is changing. The Basel Committee has recommended new and stricter capital adequacy and liquidity requirements for banks; the so-called Basel III standards. These are now in the process of being implemented in the EU. Financial stability considerations suggest that it would be favourable to implement these requirements more swiftly in Norway than in other countries. The Ministry of Finance aims to propose statutory provisions corresponding to the new EU provisions in early 2013.

3.8 Employment policy

In comparison with other countries, Norway enjoys high labour force participation and low unemployment. At present, employment growth is robust, and the Labour Force Survey puts unemployment at one percentage point below the average for the last 25 years. At the same time, transitions from working life to various social security schemes are high. The sustainability of publicly-funded welfare schemes is predicated on keeping people in work. This will become ever more important as the population ages.

In coming years, the ageing of the population will reduce the ratio between the number of people of working age and the number of older people. In addition, it must be expected that growing economic prosperity will to some extent be enjoyed in the form of leisure in coming years as well, reflecting the developments seen over the last few decades. It becomes challenging, but also highly important, to maintain high labour force participation. It is important both to keep more people in work for a longer time and to facilitate the entry of more people into working life, for example through effective integration of immigrants into the labour market.

When we live longer lives, it stands to reason that we also need to remain longer in work. A pension reform was implemented gradually from 2011. Actuarial elements combined with flexible retirement age imply much stronger incentives to stay in the labour force, and that pensioners can be allowed to continue working full or part time with no reduction in pension benefits. Calculations from Statistics Norway show that pension reform may have significant positive employment effects in the long run. It is nonetheless too early to say to what extent the pension reform will contribute to increased employment amongst seniors. That will depend on a number of factors. The design of occupational pensions and other social security schemes will, for example, impact on the motivation to stay in work.

Although labour force participation in Norway is high, there is also a large portion of people who are outside working life as the result of disease and other health problems. About 17 pct. of total man-years in 2011 were lost due to reduced work capability and the receipt of health-related social security benefits according to estimates. In addition to reducing our total work output, this curtails freedom of action in fiscal policy. OECD figures for 2009 show that Norway's expenditure on sickness absence and disability pensions as a percentage of GDP is the highest in the OECD area.

The Government is pursuing an active labour market policy, with an emphasis on close follow-up, the encouragement of activity and the use of labour market measures to facilitate transition into jobs. The facilitation of job search and job transition is of particular importance now that labour demand is on the increase. Participation in labour market measures may discourage job searching amongst the unemployed. Such measures must therefore be structured to enable a swift transition into the ordinary labour market for the unemployed, thus preventing labour resources from being unnecessarily tied up in these measures. The Government is planning to offer participation in such measures for up to 16,000 unemployed persons in 2013.

Groups that are at risk of involuntary exit from the labour market need extra assistance. This applies, in particular, to people with reduced work capability. Measures targeting this category are planned for 54,700 people in 2013, i.e. 500 more than this year.

In aggregate, this offers scope for 70,700 people to join labour market measures in 2013. In addition, a new trial will be launched to offer grants to employers for employing people who receive work assessment allowance. The trial commences on 1 January 2013 and will run for five years. 150 placements are being planned for 2013. Young people shall be accorded priority.

At the same time, the Government will reinforce efforts targeting young people not in work, education or training. The young person guarantees applicable to the age bracket 20-24 years shall be improved and refined. In addition, designated points of contact for work with young people shall be established at the largest NAV offices. It is of special concern if young people are unable to gain a foothold in working life. Although unemployment amongst young people is low in Norway when compared to other countries, it is higher than for other age groups in our country as well.

4 The management of the Government Pension Fund

4.1 Introduction

The purpose of the Government Pension Fund is to facilitate government savings to finance rising public pension expenditures and to support long-term considerations in the spending of government petroleum revenues. A sound long-term management of the Fund contributes to ensuring that the petroleum wealth will benefit both current and future generations.

The Government Pension Fund comprises the Government Pension Fund Global (GPFG) and the Government Pension Fund Norway (GPFN). The operational management of the two parts of the Fund is delegated to Norges Bank and Folketrygdfondet, respectively, under mandates set by the Ministry of Finance.

The Government aims for the Government Pension Fund to be the best managed fund in the world. This requires identifying international best practice with regard to all aspects of fund management, and reaching for this.

Transparency is a prerequisite for securing widespread confidence in the management of the Fund. Operative management performance is reported by Norges Bank and Folketrygdfondet on a regular basis. The Ministry accounts for the management of the Fund in an annual report to the Storting, cf. Report No. 17 (2011-2012) to the Storting *The Management of the Government Pension Fund in 2011*, as well as in the National Budget.

The Government Pension Fund is managed with a view to achieving the highest possible return over time, subject to a moderate level of risk. The time horizon of the Fund investments is very long. The investment strategy is therefore based on assessments of expected risk and return in the long run. Moreover, it is based on assumptions regarding the functioning of financial markets, as well as the Fund's special characteristics. There are distinct differences between the two parts of the Fund in this respect. The GPFN is a relatively large investor in a small capital market, whilst the GPFG is, in relative terms, a smaller investor in large international markets.

The investments are spread across different asset classes and a broad range of countries, sectors and companies. The investment strategy has been developed over time, on the basis of comprehensive professional assessments.

One has to be prepared for significant variations in the value of the Government Pension Fund from one year to the next. The Fund is highly resilient to such volatility. One reason for this is the low risk that the owner will need to make large withdrawals on short notice. Consequently, the investment strategy does not aim to minimise short-term fluctuations in the value of the Fund. A strategy with this objective would have offered a significantly lower expected return over time. It is important to stick to a long-term investment strategy also during periods of financial market turbulence. Broad support for how the Government Pension Fund is managed provides a solid foundation for long-term management.

Experience with the investment strategy is favourable. The Ministry will, in its further effort to evolve the investment strategy, attach special weight to exploiting the special characteristics of the Fund, as a large investor with a long time horizon and a limited liquidity need. The objective is to further improve the ratio between expected risk and return.

Through our long-term investments in a large number of companies worldwide, we both carry a responsibility for, and a self interest in, contributing to good governance and attending to environmental and social considerations. Work relating to responsible investment practice, including the exclusion mechanism of the Fund and the exercise of ownership rights on the part of Norges Bank and Folketrygdfondet, form an integrated part of the asset management effort. However, the Government Pension Fund is not suited for safeguarding all types of obligations, and the Fund shall not serve as a foreign policy tool.

Chapter 4.2 discusses financial market developments and the performance of the GPFG and the GPFN during the first half of this year. Chapter 4.3 discusses certain current issues relating to the management of the GPFG.

4.2 Asset management performance

4.2.1 The financial markets

Uncertainty with regard to economic developments and government finances in a number of countries has given rise to considerable financial market volatility over the last years. The stock market rose at the beginning of this year, but prices fell back somewhat during the second quarter. Recent months have seen a significant rebound in global stock markets, partly because of measures announced by European authorities and the ECB. At the end of September, the global stock index FTSE All-World, as measured in local currency, was up by a total of about 13 pct. for the year. The main index of the Oslo Stock Exchange has gained about 16 pct. over the same period.

The financial market turbulence has made investors move into safe haven investments, including US and German government bonds. Interest rates on government bonds from countries considered to be safe havens, have fallen to historically low levels. The low interest rates probably also reflect expectations of low inflation and weak economic growth ahead. Highly indebted countries in Europe experienced a significant increase in interest rates over the summer, but these fell back after the ECB announced new measures. All in all, falling interest rates have resulted in increased bond prices and high returns on bonds thus far this year.

4.2.2 The return on the Government Pension Fund Global (GPFG)

The market value of the GPFG was NOK 3,561 billion as per the end of the first half of 2012. This represents an increase of NOK 249 billion since the beginning of 2012. At the end of June, 59.6 pct. of the Fund was invested in equities, 40.1 pct. in fixed-income securities and 0.3 pct. in real estate. The inflow of new capital during the first six months of the year amounted to a total of NOK 134.6 billion.

The return on the GPFG during the first half of the year was 4.8 pct., as measured in the currency basket of the Fund. The return on the equity portfolio was 5.9 pct.; the return on the fixed-income portfolio was 3.1 pct., whilst the return on the real estate portfolio was 2.5 pct. Figure 4.1 shows the accumulated return of the equity and fixed-income portfolios since 1998.

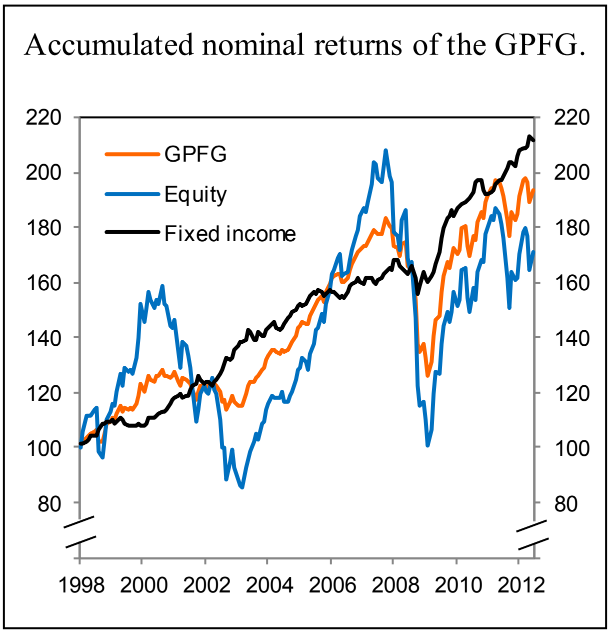

Figure 4.1 Accumulated nominal returns of the Government Pension Fund Global and sub portfolios, as measured in the currency basket of the Fund. Index, December 31, 1997 = 100

Sources: Norges Bank and Ministry of Finance.

Table 4.1 Key figures for the GFPG and GPFN as at June 30, 2012. Annual geometric averages. Percent.

	Last 12 months.	Last 3 years	Last 5 years	Last 10 years	Since Jan. 1, 1998
GPFG					
(as measured in the currency basket of the Fund)					
Nominal return	-0.24	9.45	1.62	4.90	4.65
Inflation	2.00	2.33	2.17	2.16	1.94
Management costs	0.07	0.10	0.10	0.10	0.09
Net real rate of return	-2.27	6.85	-0.63	2.58	2.57
GPFN					
(as measured in Norwegian kroner)					
Nominal return	1.43	11.12	2.94	7.33	6.39
Management costs	0.08	0.09	0.07	0.05	0.04

Sources: Norges Bank and Folketrygdfondet.

When measured in Norwegian kroner, the return on the GPFG during the first half of the year was 3.5 pct. The difference between the returns in Norwegian kroner and in the currency basket of the Fund was caused by appreciation of the Norwegian krone relative to the currency basket of the Fund. However, the return in international currency is the relevant measure for the developments in the international purchasing power of the Fund. The average annual net return (i.e. after the deduction of asset management costs) since 1998 is calculated at 4.6 pct., as measured in the currency basket of the Fund. When adjusted for inflation, the annual net return has been about 2.6 pct. As measured from 1997, the net average annual real rate of return is 2.9 pct.

4.2.3 The return on the Government Pension Fund Norway (GPFN)

The market value of the GPFN was NOK 135.5 billion as per the end of the first half of 2012. This represents an increase of NOK 6.0 billion since the beginning of 2012. A total of 60.7 pct. of the market value of the Fund was invested in equities, whilst 39.3 pct. was invested in fixed-income securities.

The return on the GPFN in the first half of 2012 was 4.7 pct. The return was 5.2 pct. for the Norwegian equity portfolio and 4.8 pct. for the Nordic equity portfolio. The Norwegian fixed-income portfolio registered a return of 4.5 pct., whilst the Nordic fixed-income portfolio delivered a return of 1.1 pct.

4.3 Current issues in the management of the Government Pension Fund Global

4.3.1 GPFG's fixed-income benchmark

Report No. 17 (2011-2012) to the Storting *The Management of the Government Pension Fund in 2011*, discussed the new benchmark for the fixed-income portfolio of the GPFG. The Ministry has attached weight to highlighting the purpose of the various parts of the fixed-income portfolio. The benchmark has, in view of this, been split into a government sub-index and a corporate sub-index. The main role of the government sub-index is to reduce volatility in total fund returns. Corporate bonds contribute somewhat to the expected return on the Fund, *inter alia* due to the inherent credit risk of such investments. The corporate sub-index comprises corporate bonds and covered bonds. Compared to the previous benchmark, certain segments have been eliminated from the index. In the Report, the Ministry proposed that the government sub-index be expanded to include all currencies approved by the index provider Barclays. This was supported by the Storting, cf. Recommendation No. 361 (2011-2012).

The Ministry wrote in Report No. 17 (2011-2012) to the Storting that the fixed-income benchmark had been changed to a benchmark comprising a government part of 70 pct. and a corporate part of 30 pct. The Ministry further wrote that it had initiated a shift in the currency composition of the benchmark. The deliberation of Report No. 17

Boks 4.1 The fixed-income benchmark

The new fixed-income benchmark of the GPFG comprises two parts: 70 pct. issued by governments and 30 pct. issued by corporations. The two sub-indices feature fixed weights with full monthly rebalancing.

The government sub-index includes nominal and inflation-linked government bonds issued in national currency, as well as bonds issued by international organisations. GDP weights are used to determine the country composition. The GDP weights are calculated as three-year weighted averages and are updated once a year. Monthly full rebalancing to the weights takes place throughout the year. Bonds issued by international organisations are allocated to countries according to underlying currency denomination. Since several countries use the euro as their currency, an annual fixed weight for such euro-denominated bonds is applied. The GDP weights of euro zone countries are reduced correspondingly. The government sub-index is currently based on 21 approved currencies. The currency composition of the government sub-index will change over time in line with changes to the index from the index provider Barclays.

The corporate sub-index includes corporate bonds and covered bonds. Global market weights are applied to this part of the benchmark. The corporate sub-index features seven approved currencies.

(2011-2012) by the Storting resulted in the government sub-index being expanded to include new emerging market currencies.

The adaptation to the new currency composition of the fixed-income benchmark will take place over time. In the first half of 2012, the European part of the fixed-income benchmark was reduced from 58 pct. to 47 pct.

Inflation-linked bonds

Inflation-linked bonds offer investors protection against changes in the purchasing power of invested capital. Investors achieve a real return, in addition to a compensation for developments in a price index agreed on beforehand.

Inflation-linked bonds currently form part of the government sub-index alongside nominal government bonds, cf. Box 5.1. These bonds accounted for 2 pct. of the total fund benchmark as of end-June 2012. The main issuers of real interest rate bonds in the current benchmark are the United States, the United Kingdom, France, Canada and Italy.

In a letter of 9 August 2012, Norges Bank has rendered advice as to the role inflation-linked bonds should play in the benchmark of the GPFG. The letter is published on the Ministry's webpage. Norges Bank writes that inflation-linked bonds should be omitted from the strategic fixed-income benchmark. The reason given by the Bank is that inflation-linked and nominal bonds have different, and in some cases conflicting, characteristics during periods of real interest rate variations and inflation risk. The Bank is of the view that the market for inflation-linked bonds is not sufficiently broad, deep and uniform to enable diversification of the risk of the GPFG in the event of a swift and unexpected increase in inflation. Consequently, no specific strategic allocation should be established for inflation-linked bonds.

The Ministry will revert with an evaluation of the advice from Norges Bank that inflation-linked bonds be omitted from the fixed-income benchmark of the GPFG. It is particularly relevant to examine whether the long time horizon of the GPFG and its ability to withstand return variations over time mean that the Fund is better placed than many other investors to absorb inflation risk. In addition, the Ministry will weigh the arguments of the Bank in favour of further simplifying the benchmark against the need for diversification.

4.3.2 New geographical distribution of equities in the GPFG

Report No. 17 (2011-2012) to the Storting *The Management of the Government Pension Fund in 2011*, presented plans for a new geographical distribution of the equity benchmark of the GPFG. These plans were supported by the Storting, cf. Recommendation No. 361 (2011-2012). After the deliberations in the Storting, the Ministry has decided on a new geographical distribution of the equity benchmark. Adaptation to the new distribution will take place over time.

Previously, the equity benchmark featured a fixed geographical distribution: 50 pct. Europe, 35 pct. Americas and Africa and 15 pct. Asia and Oceania. The allocation between companies within each geographical region was based on the market value of such companies.

The new geographical distribution does not feature fixed regional weights. The distribution will instead adjust according to developments in the size of the world's equity markets (global market weights). The rule is formulated, in line with the discussion in Report No. 17 (2011-2012) to the Storting, such as to ensure that the weight attached to developed European stock markets in the benchmark will remain somewhat higher than would be implied by global market weights. The weight attached to developed markets in North America will still remain somewhat lower. Emerging markets in all regions and developed markets in Asia and Oceania carry weights in line with their global market weights.

The new geographical distribution of the equity benchmark will result in a broader geographical spread of the equity investments than is currently the case. The number of markets and the types of companies included in the benchmark remain the same. The specific rule for the calculation of the country and regional allocations of the benchmark is set out in the mandate for the management of the GPFG, which is available at www.government.no/gpf.

4.3.3 Rebalancing

The long-term investment strategy for the GPFG pursued by the Ministry of Finance specifies a fixed allocation between equities (60 pct.), fixed-income securities (35 pct.) and real estate (5 pct.). The real estate investments of the Fund are currently in an establishment phase, and represented 0.3 pct. of the Fund capital as per the end of the second quarter of this year. The increase in real estate investments will result in a corresponding reduction of the portion invested in fixed-income instruments.

Market fluctuations will result in the actual allocations moving away from the strategic weights. Rebalancing brings the weights of the Fund back towards the strategic weights.

Report No. 17 (2011-2012) to the Storting *The Management of the Government Pension Fund in 2011*, provided a detailed account of the background to, and experience from, the rebalancing of the GPFG. Advice from Norges Bank concerning changes to the rebalancing rules was also discussed. The Ministry emphasised that the rebalancing rules have formed an important part of the investment strategy of the Fund and that experience with the rebalancing of the GPFG has been favourable. The Ministry proposed, against this background, that systematic reversion of the equity portion to the strategic weight of 60 pct. through rebalancing should be continued, as also recommended by Norges Bank. It was also emphasised that a rebalancing rule in the public domain will contribute to increased transparency in the management of the Fund. The Storting agreed with these assessments, cf. Recommendation No. 361 (2011-2012).

The Ministry said, at the same time, that one would continue to explore the detailed formulation of the rebalancing rules, including the matter of how to ensure increased transparency surrounding the rebalancing rules, the width of the range of permitted deviations from the strategic equity portion of 60 pct., as well as the partial rebalancing system. It was signalled that the Ministry would provide information about the new rebalancing rules in the National Budget for 2013.

Norges Bank has proposed, in a letter of 26 January 2012, that the portfolio be permitted to deviate by three percentage points from the strategic weight equities carry in the benchmark before any rebalancing is triggered. This implies that rebalancing commences if the equity portion falls below 57 pct. or exceeds 63 pct. The Bank has also proposed that the equity portion be rebalanced to the fixed weight of 60 pct. on the first quarter end date if the equity portion falls outside these limits on any one day during such quarter. This means that rebalancing is triggered on the basis of one signal.

The proposal implies a certain increase in the number of expected rebalancings, when compared to the present rebalancing rules. At the same time, the magnitude of each rebalancing will decrease. This will contribute to a reduction in market impact and transaction costs per rebalancing. Norges Bank has also proposed the abolition of partial rebalancing. The Bank notes that it is uncertain what effect partial rebalancing has on the overall return on the Fund over time. It is also noted that the abolition of partial rebalancing will make the calculation of the benchmark less complex.

The Ministry emphasises that the purpose of rebalancing is to ensure that the benchmark does not deviate materially from the strategic allocation across various asset classes over time. The Ministry also attaches weight to the consideration that rebalancing may contribute to an increase in the return on the Fund through the exploitation of any variations in the equity risk premium over time (sell equities when market prices are high and purchase them when prices are low). However, these considerations must be balanced against the need to save transaction costs, since rebalancing results in the purchase and sale of securities. Accumulated transaction costs will, in general, increase with the number of rebalancings. Large transactions within a short period of time may, at the same time, influence rebalancing costs, because such transactions influence market prices. The Ministry has analysed the effects of different rebalancing rules on this basis.

Norges Bank writes that the appropriate level of deviations from fixed weights for purposes of triggering rebalancing cannot be determined with any certainty on the basis of historical data. The calculations of the Ministry indicate that increasing the range of permitted deviations to four percentage points will result in fewer rebalancings and somewhat lower expected transaction costs than would a three-percentage point range. On the other hand, there will be somewhat larger deviations from the strategic equity portion and a higher average trading volume. The Ministry is of the view that a somewhat larger average deviation from the strategic equity portion of 60 pct. is of minor concern to a long-term investor like the GPFG. The Ministry is therefore of the view that the advantages of lower rebalancing frequency and transaction costs should be accorded somewhat more weight.

The Ministry is of the view that a public rebalancing rule will contribute to increased transparency in the management of the GPFG, and has noted that Norges Bank recommends that the rule be made public. The Ministry agrees with this. The Ministry has adopted new rebalancing rules for the GPFG with effect from 8 October 2012, which imply the following:

- The equity portion shall be rebalanced back to the strategic weight of 60 pct.
- Rebalancing is triggered if the equity weight of the benchmark deviates by more than four percentage points from the equity weight of the strategic benchmark at the end of the month. Rebalancing of the benchmark shall be executed at the end of the subsequent month.
- The partial rebalancing system is abolished.
- Some procedures for the execution of rebalancing will be simplified.
- Norges Bank is required to report on the execution of rebalancings.

The new rebalancing rules are expected to result in about the same number of rebalancings as under the previous rules, i.e. approximately one rebalancing every other year on average. Transaction costs and volumes (purchases and sales) associated with rebalancing are expected to be somewhat lower. This has to do with only the total equity portion being rebalanced under the new rules. The previous rules triggered rebalancing of the equity and fixed-income weights within three geographical regions, which resulted in higher transaction costs and volumes.

The Ministry wrote in Report No. 10 (2009-2010) to the Storting *The Management of the Government Pension Fund in 2009*, that the Ministry would calculate the benchmark independently of Norges Bank, and compare the result with the Bank's own calculations. This procedure will be continued under the new rebalancing regime.

4.3.4 Revised expectation document from Norges Bank concerning climate risk

The Ministry assumes that favourable long-term returns depend on sustainable economic, environmental and social development, as well as on well-functioning, legitimate and efficient markets. The responsible investment activities cover several areas:

- international cooperation and contribution to
- the development of best practices;
- environment-related investments;
- research and analysis;
- active ownership; and
- observation and exclusion of companies.

Responsibility for exercising the ownership rights associated with the investments of the Fund lies with Norges Bank. It follows from the mandate given by the Ministry of Finance to Norges Bank that the overarching objective of the exercise of ownership rights is to safeguard the financial interests of the GPFG. Moreover, the Bank shall integrate good governance, environmental and social considerations in all of its investment activities, in line with internationally recognised principles for responsible investment activities.

Norges Bank has in recent years developed and strengthened its exercise of ownership rights. These efforts operate on the premise that acting predictably and with a long-term perspective within areas of financial relevance to the Fund and other investors offers the best scope for having an impact. Norges Bank has selected the following strategic focus areas:

- equal treatment of shareholders;
- shareholder influence and board accountability;
- well-functioning, legitimate and efficient markets;
- climate change risk management;
- water management; and
- children's rights.

The Bank has several tools at its disposal in exercising its ownership rights, including, *inter alia*, voting in general meetings, proposals submitted to general meetings, contact with companies and collaboration with other investors.

As far as the focus areas children's rights, climate change and water management are concerned, Norges Bank has expressed what it expects from companies in designated expectation documents. The Bank describes, in these documents, how the companies should handle risk within each area. The documents are used both as a starting point for examining and analysing the risk in various sectors and companies, and as a basis for feedback and contact with individual companies.

The expectation document concerning climate change risk management was published in 2009. Climate change is expected to have potentially large economic consequences, both as a result of physical implications of such changes and as a result of regulatory measures that may cause a different carbon price from what we have at present. As a long-term investor with a broad portfolio, the GPFG will be exposed to risk resulting from such developments.

On 5 October 2012, Norges Bank published a revised expectation document concerning climate. The document now also includes expectations as to companies' handling of tropical deforestation. Such deforestation results in the carbon stored in tropical forests being released into the atmosphere, and influences climate change. The Bank writes that a main cause of tropical deforestation is the growth in global demand for commodities that are produced through the clearing of tropical forest. In order to achieve reduced tropical deforestation or new growth of tropical forests, one needs to pave the way for the sustainable production and sale of such raw materials.

The Ministry is of the view that the expectation documents published by Norges Bank form an important part of the Bank's ownership efforts. Issues related to tropical deforestation may constitute a business risk for companies, and a long-term risk for the GPFG. By expressing clear expectations to companies in which the Fund is invested, one is perceived as a clear and predictable owner. This may contribute to safeguarding the financial return on the Fund in the long run.

Appendix 1

The structural, non-oil budget surplus

The overall public sector budget surplus may change significantly from year to year without reflecting any fiscal policy changes. In order to form the best possible impression of the underlying fiscal stance, it is appropriate to study developments in the budget balance exclusive of revenues and expenditure associated with petroleum activities, i.e. the non-oil budget balance. In addition, it is appropriate to make corrections for, *inter alia*, cyclical fluctuations in direct and indirect taxes and employment benefits.

As from the National Budget of 1987, the Ministry of Finance has used an indicator of changes in the structural, non-oil budget balance to assess the fiscal stance. In addition, following the introduction of the fiscal rule in 2001, the *level* of the structural, non-oil deficit has been used as a measure of the underlying use of petroleum revenues via the fiscal budget. Using this measure to direct policy means that one aims to ensure that actual transfers from the Government Pension Fund Global will on average, over time, trace the expected real return on the Fund. A number of other countries, including the EU countries, also attach key importance to structural budget balance indicators in their fiscal policy frameworks.

The following corrections are made to get from the *non-oil* to the *structural, non-oil* budget balance:

– The budgetary consequences of various revenues from direct and indirect taxes deviating from their trend values are calculated in order to adjust the non-oil budget balance for the effects of business cycle fluctuations. Moreover, account is taken of the fact that the payment of unemployment benefits also depends on the business cycle. The estimated corrections for 2012 and 2013 in Table A.1 reflect the fact that the tax revenues from the mainland economy (less unemployment benefits) are assumed to be close to trend. The estimated corrections for 2011 reflect the fact that taxes paid by mainland corporations reached a record high, which has not been extended into the projections.
– Corrections are made for the difference between the actual levels and estimated normal levels of central government interest revenues and interest expenditure and transfers from Norges Bank.
– Corrections are made for accounting changes and for changes to the distribution of functions between central and local government that do not affect underlying budget balance developments. In 2013, a correction is made in relation to a proposal for abolishing the VAT exemption applicable to the sale of services for the construction and maintenance of public road facilities. The change results in increased central government VAT revenues, and in increased appropriations from central government to cover the increased VAT costs incurred by the government bodies responsible for the construction and operation of roads. For central government, higher appropriations will be mirrored by higher VAT revenues dur-

Table A.1 The structural non-oil budget surplus. NOK billion

	2010	2011	2012	2013
Non-oil budget surplus	-104 070	-79 399	-111 346	-123 663
- Net interest payments and transfers from Norges Bank. Deviations from estimated trend level	-402	3 544	2 283	1 220
- Accounting technicalities	-1 364	3 480	0	-400
- Taxes and unemployment benefits. Deviations from trend	70	6 202	2 597	813
= Structural non-oil budget surplus	-102 374	-92 625	-116 226	-125 297
Measured in pct. of Mainland Norway trend GDP	-5,1	-4,4	-5,2	-5,3
Change from previous year in percentage points[1)]	0,0	0,7	-0,8	-0,1

1) The change in the structural, non-oil budget surplus as a percentage of the trend GDP for Mainland Norway is used as a rough indicator of the budget's impact on the economy. Negative figures indicate that the budget has an expansionary impact. Unlike the model computations presented in the National Budget, this indicator does not take account of the fact that different revenue and expenditure items may have different effects on the economic activity.
Sources: Ministry of Finance and Statistics Norway.

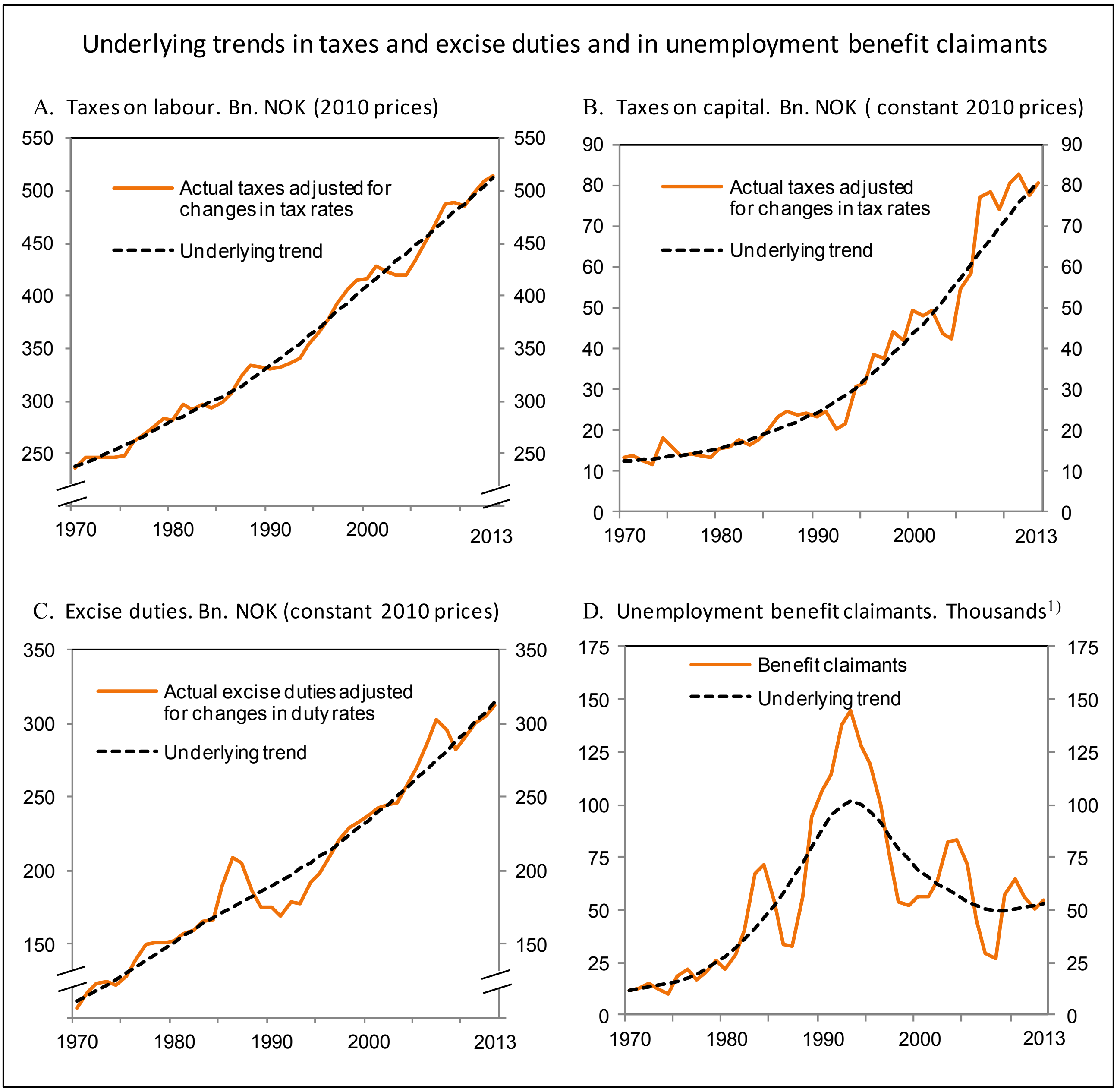

Figure A.1.1 Underlying trends in taxes and excise duties and in unemployment benefit claimants

1) Correction is made for unemployment benefit recipients who may be partly unemployed by converting the number of recipients into full-time equivalents.

Sources: Ministry of Finance and the Norwegian Labour and Welfare Administration (NAV).

ing the course of 2013 and 2014, although a certain time lag in VAT payments will result in an accrual discrepancy estimated at about NOK 0.4 billion in 2013. The structural budget balance is corrected for such accrual discrepancy.

The classification of public revenues and expenditure into a cyclical and a structural part cannot be based on direct observations, but needs to be estimated on the basis of analysis of accounting figures, economic statistics and forecasts for coming years. The distinction between cyclical and structural changes is usually made on the basis of estimated trend levels for the relevant variables. The findings may be influenced by new figures for economic developments, also subsequent to the publication of the central government accounts for each year.

The calculation of structural direct and indirect taxes is based on data on actual revenues recognised in the central government accounts, as well as forecasts for the projection period. The calculations also include taxes on income and wealth that accrue to local government, and cover the period 1960-2020. The data for the pro-

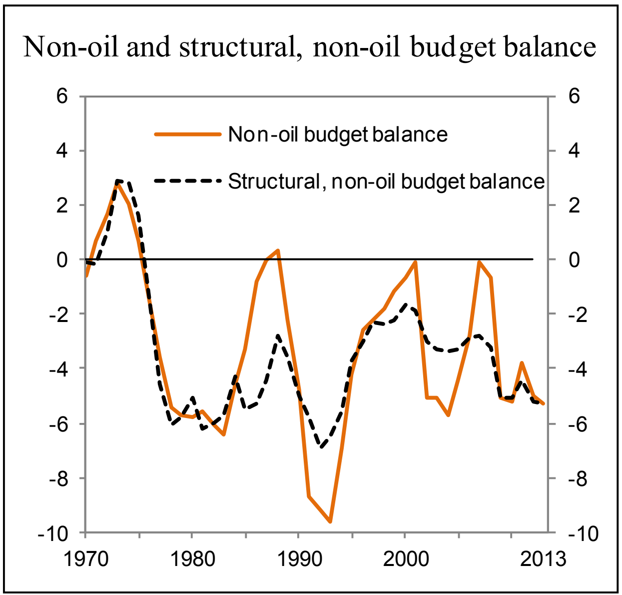

Figure A.1.2 Non-oil and structural, non-oil budget balance. Percent of trend-GDP Mainland Norway
Source: Ministry of Finance.

jection period are based on the medium-term projections of the Ministry of Finance, cf. Box A.1.

The activity correction at the expenditure side of the budget relates to unemployment benefit expenditure. The cyclical correction of the unemployment benefit expenditure is based on estimated trend deviations for the number of unemployment benefit claimants.

Developments in the main three groups of direct and indirect taxes, as well as the number of unemployment benefit claimants, are shown in Figure A.1.1.

Developments in the non-oil and the structural, non-oil fiscal budget surplus are shown in Figure A.1.2. With the exception of the years 1987-1988, 2001 and 2007, all of which came at the end of lengthy and robust cyclical upturns, the fiscal budget after 1975 has generally registered a significant actual deficit when excluding revenues and expenditure relating to the petroleum activities, although with major variations over this period. This has to do with the spending of petroleum revenues being expanded rapidly during the first half of the 1970s. Since then, both the non-oil and the structural, non-oil deficit have fluctuated around a level corresponding to about 4 pct. of Mainland Norway GDP. The fluctuations in the structural, non-oil deficit have to do with the budget having at times been used actively to stabilise production and employment developments. The figure shows that the fluctuations in the non-oil deficit are considerably larger than the fluctuations in the structural, non-oil deficit. This is because one has sought to allow the so-called automatic stabilisers in the budget to operate fully.

The spending of petroleum revenues has increased since 2001, in line with the fiscal rule. The escalation was particularly pronounced in 2009 due to the special measures to dampen the effects of the international financial crisis. The calculations of the structural, non-oil deficit register an increase in the underlying spending of petroleum revenues in the amount of NOK 91 billion, at 2013 prices, from 2001 to 2013, to reach NOK 125 billion.

Box A.1 Medium-term projections of direct and indirect taxes

The projections for direct and indirect taxes for the coming years are based on the continuation of the tax proposals for 2013. The following assumptions have been adopted, based on the macroeconomic projections of the Ministry of Finance:

Direct taxes on labour. This category includes employers' contributions to the National Insurance Scheme and personal taxes, inclusive of wealth tax levied on individuals. Developments in the number of normal man-years employed are an important indicator of developments in employers' contributions to the National Insurance Scheme and in total personal taxes. The projections assume an average annual growth in the number of normal man-years of 1¼ pct. from 2012 to 2015 and 1 pct. over the period 2015-2020. The estimates are based on population projections from Statistics Norway, which assume, inter alia, high immigration from the EEA area. As far as wealth tax levied on individuals is concerned, the assumption is an average nominal increase of about 5 pct. per year throughout the projection period.

Direct taxes on capital. This category includes taxes paid in arrears by corporations and other non-physical taxpayers outside the petroleum sector, as well as withholding tax and inheritance tax. It has been assumed that taxes from enterprises outside the petroleum sector will remain more or less unchanged as a portion of Mainland Norway GDP after 2012. This corresponds to an average nominal growth rate of just below 6 pct. per year. As far as inheritance tax is concerned, the assumption is an average nominal increase of about 8 pct. per year until 2020.

Indirect taxes. This category includes value added tax, motor vehicle excise duties and other indirect taxes, including stamp duties and miscellaneous sectoral duties. It also included the investment tax until it was abolished in 2002. Private consumption developments are an important influence on indirect taxes, and it has been assumed that the average consumption growth will be 3¾ pct. per year from 2012 to 2015, and 3 pct. per year thereafter.

Appendix 2

The role of the petroleum sector in the Norwegian economy

The petroleum sector generates large, but fluctuating, revenues for Norway. From 1970 until the present day, an industry has been developed whose production value has only in the last decade varied between 25 and 40 pct. of Mainland GDP. The petroleum industry contributes, through its demand for goods and services, to considerable activity and many jobs in the remainder of the Norwegian economy as well. The tax system and the State's Direct Financial Interest (SDØE) ensure that most of the extraction revenues accrue to the State. Such revenues make a major contribution to the funding of the welfare state and the strengthening of public finances. The State's net cash flow from petroleum activities has represented about 37 pct. of mainland economy tax revenues over the last decade. The phasing-in of revenues from the Government Pension Fund Global for purposes of funding the structural, non-oil budget deficit corresponded, during the same period, to about 9 pct. of the revenues from direct and indirect taxes in the mainland economy.

Petroleum is a non-renewable resource. The economic policy framework is designed to ensure that the value of these resources is of lasting benefit to Norway. State revenues from the petroleum activities are channelled into the Government Pension Fund Global on an ongoing basis, whilst the phasing-in of revenues into the fiscal budget over time shall correspond to the expected real return on the Fund. By investing the Fund in international currencies, we shelter the mainland economy and the Norwegian krone exchange rate from the large and variable cash flows from the petroleum sector. This contributes to preventing the petroleum sector from causing the excessive displacement of mainland export-oriented industries. By limiting the phasing of revenues from the Government Pension Fund Global into the fiscal budget to the expected return on the Fund, we achieve a cautious and gradual increase in the use of such revenues, whilst at the same time ensuring long-term sustainability. The phasing-in of revenues increased the structural, non-oil deficit, measured as a percentage of Mainland GDP, with particular rapidity in the 1970s. The deficit has since then fluctuated around a level corresponding to about 4 ¼ pct. of mainland economy value added, cf. Figure A.2.1 A.

Direct mainland economy demand from the petroleum sector may be grouped into two elements:

– investments
– intermediate inputs, which include all

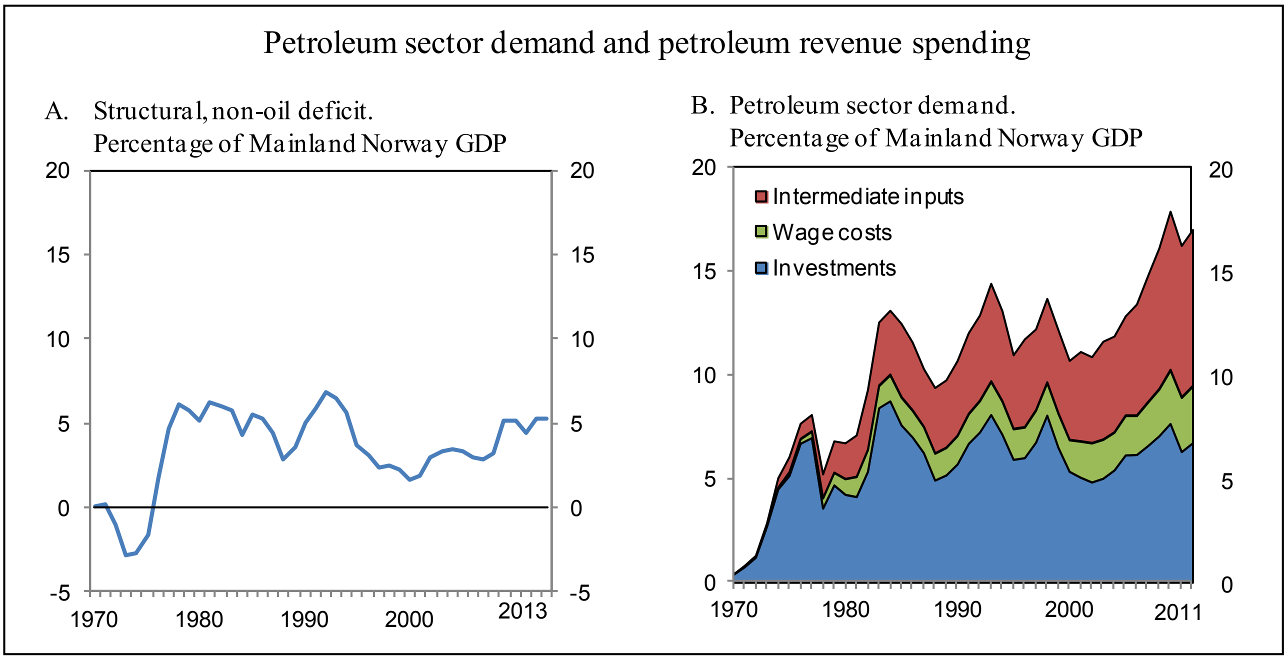

Figure A.2.1 Petroleum sector demand and petroleum revenue spending
Source: Ministry of Finance and Statistics Norway

mainland deliveries to petroleum sector operations, from repairs and maintenance to catering

Growth in aggregate demand from the petroleum sector was particularly steep from the mid-1970s to the mid-1980s, cf. Figure A.2.1 B. Subsequently, demand from the sector fluctuated around a fairly stable level as a percentage of Mainland Norway GDP, before picking up significantly again over the period 2005-2010.

Investments accounted for just below 7 pct. of mainland economy value added in 2011. Indications are that these will increase further this year and next year. Nevertheless, it is estimated that the investment portion will be lower in 2013 than it was in 1983-1984, 1993 and 1998. Whilst investments were at the beginning principally devoted to the development of new production fields, investments in fields that are already in operation have become more dominant over time, cf. Figure A.2.2.

Intermediate inputs have increased gradually. This partly reflects the fact that offshore production has increased over time relative to mainland economy production, and partly that it becomes more difficult to extract oil and gas from the fields as these mature.

High productivity in the extraction of oil and gas results in the sector generating large profits without having to employ a lot of people. Direct petroleum industry employment accounts for about 2 pct. of overall employment in Norway. Consequently, *wage costs* are low relative to the costs associated with investments and intermediate inputs. Wages within the sector have increased over time, and the wage level is distinctly higher than the average level within the mainland economy. It is likely that high wages within the petroleum sector have also contributed to raising the wage level in the remainder of the economy. Development of the petroleum activities has given rise to a large Norwegian supply industry. Calculations made by Statistics Norway researchers indicate that the sector accounts, directly and indirectly, for about 8 pct. of employment within the Norwegian economy. The highest concentration of such employment is likely to be found in coastal areas, but supply enterprises are found in large parts of the country. Moreover, petroleum revenue spending via the fiscal budget results in a higher level of public sector employment.

Thus far, petroleum industry demand has largely moved in tandem with the mainland economy business cycle. This tendency is especially notable in investments, which are significantly more volatile than intermediate inputs. Nonetheless, some periods have deviated from this pattern. Investments have, for example, grown steeply in the wake of the financial crisis, which has resulted in favourable mainland economy developments despite weak export market performance. A larger Norwegian supply industry means that mainland economy activity is more sensitive to offshore demand fluctuations than was previously the case. A reduction in the proportion of petroleum sector supplies accounted for by imports has the same effect. Imports account, directly and indirectly, for about 40 pct. of petroleum sector investments on average. The import content of intermediate inputs is somewhat lower than this.

The authorities award exploration licences for defined areas to the oil companies. What discoveries will be made, and when any discoveries may be developed, is subject to considerable uncertainty. Experience suggests that a long period of time may elapse between the awarding of exploration licences to oil companies and production. The long planning horizon means that the regulation of new development projects does not offer much scope for curbing fluctuations in economic activity.

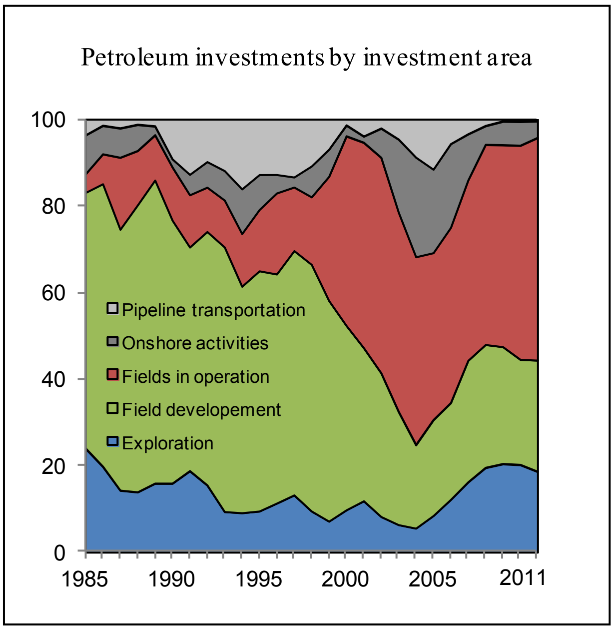

Figure A.2.2 Petroleum investment by investment area
Source: Statistics Norway