



DET KONGELIGE
FINANSDEPARTEMENT

Royal Ministry of Finance

The National Budget 2015

A summary



Contents:	page
1. Introduction	2
2. The Norwegian economy	3
3. Economic policy	8
3.1 Fiscal policy	8
3.2 Tax policy	17
3.3 Monetary policy	18
3.4 Financial stability	19
4. Management of the Government Pension Fund.....	20
4.1 Introduction.....	20
4.2 Asset management performance.....	21
4.3 Current issues in the management of the Government Pension Fund	23
5. Policy measures for enhancing productivity and economic efficiency.	24
6. Efficient and effective government resource use.....	29
Appendix 1 Norway's fiscal framework.....	35
Appendix 2 Calculation of the structural, non-oil budget balance	37
Appendix 3 The role of the petroleum sector in the Norwegian economy	40

National Budget 2015

1. Introduction

The Norwegian economy is performing well. Unemployment is low both in historical terms and compared to other OECD countries. Employment and activity in the mainland economy are considerably higher than before the financial crisis. Several factors have spurred growth in the mainland economy over the past 10 years. Significant terms of trade gains since 2000 have contributed to a strong increase in Norway's real earnings. High demand from the petroleum sector has supported economic growth. Household demand has been bolstered by high growth in income, easy access to loans and low interest rates. Demand has also gone up because of rising use of oil revenues over the Fiscal Budget and high borrowing by municipalities.

Both this year and the next mainland GDP is expected to grow at about 2 per cent, on par with the 2013-result, but below the average for the last 40 years. Employment is expected to expand further, and unemployment to stay around 3½ per cent of the labour force. Purchases of goods and services by the petroleum industry are expected to flatten out this year and decline next year. In the long run, demand is expected to fall further, although it may first rebound for some years after 2015. Productivity in Norway is high, but growth has dropped compared to the mid-2000s. Some of the slowdown in productivity is linked to cyclical factors, but more permanent developments may also play a role.

Access to additional labour from the EU has helped to maintain economic growth despite lower productivity growth. A consequence is, however, that growth in mainland GDP is substantially lower on a per capita basis than in previous years. In the future, Norway's aging population will dampen growth in labour supply.

The Norwegian economy faces challenges stemming from imbalances that developed during the period of strong income growth in the early 2000s. Both house prices and household debt have come up at very high levels. House prices are now rising after a moderate decline last year. Household and municipal borrowing

continues to grow faster than income. In addition, wages have grown faster in Norway than in other countries for many years, leaving Norwegian businesses with higher wage costs than their foreign competitors.

Norway's high borrowing and cost levels render the economy vulnerable, and may slow activity in the short to medium term. Economic policy must support the development of a less oil-dependent mainland economy, whereby some resources currently employed with supplying the Norwegian oil sector gradually are transferred to the export sector. Furthermore, it appears that capacity utilisation in the Norwegian economy is close to normal. Lower growth prospects seem mainly linked to structural factors. These considerations suggest restraint in the setting of fiscal policy.

The Government's political platform emphasises that the use of oil revenues must be adjusted to the economic situation, within the confines of the fiscal policy framework. The fiscal rule specifies that the transfers from the Fund to the central government budget shall, over time, reflect the expected real return on the Fund, which is estimated at 4 per cent. The Government Pension Fund Global has experienced very rapid capital growth in recent years. In 2013 alone the Fund grew by NOK 1 200 billion, and its value is now twice that of Norway's mainland economy. As a result, fluctuations in the value of the Fund and in the Fund's expected real return can become large when compared to the size of the fiscal budget and the Norwegian economy, in particular when seen against the underlying growth in the mainland economy from one year to the next.

The Government propose to spend oil revenues of NOK 163.7 billion in the budget for 2015, measured by the structural, non-oil deficit. This equals 3.0 per cent of the Government Pension Fund Global at the beginning of the year, up from 2.8 per cent in 2013. The spending of oil revenues is estimated to increase by NOK 17 billion from 2014 to 2015. This implies budget impulse equivalent to ½ percentage points of trend-GDP for mainland Norway, as measured by the change in the structural, non-oil deficit. This is essentially the same impulse as proposed last autumn in the

Government's Amendment to the 2014 Fiscal Budget Proposal.

With a weakening potential for growth in the Norwegian economy, it is important to strengthen the production side of the economy. If Norway is to maintain the growth in living standards as enjoyed over the past 40 years, productivity growth must be lifted from its current level. Moreover, the use of public revenues must be prudent to ensure the sustainability of public finances over the long term. This requires targeted reforms in both the public administration and the rest of the economy. These efforts must be given high priority. Experience indicates that it will take time before reforms translate into higher productivity.

2. The Norwegian economy

Activity in the Norwegian mainland economy has rebounded swiftly after the downturn in 2009. However, last year growth in the mainland economy declined to a level below the average experienced over the past 40 years. The moderate growth continued in the 1st quarter this year, before picking up again in the 2nd quarter. Increased electricity generation alone accounted for close to half of the increase in growth from the 1st to the 2nd quarter, which may indicate that part of the upturn is temporary. Strong growth in the 2nd quarter does nevertheless point in the direction of higher growth in mainland GDP this year than in 2013, though statistics for the 3rd

Box 2.1 Mainland Norway and the total economy

Mainland Norway is defined as all economic activity in Norway, excluding petroleum activities and ocean transport. From a stabilisation policy point of view this is the most relevant sector definition.

Petroleum activities represent a major part of value added in the Norwegian economy. In 2013, about one fourth of total value added in Norway was accounted for by petroleum activities, while ocean transport accounted for only 1 per cent, cf. figure 2.1. Petroleum activities constitute an even larger portion if we look at exports; about half in 2013. The significance of the petroleum industry is less marked in terms of employment. The petroleum industry accounted for just over two per cent of total employment in 2013, whereas ocean transport accounted for just below two per cent. The combination of substantial value added and rather low employment in the petroleum sector reflects the high level of productivity and the resource rent in this sector. Since production in the petroleum industry and ocean transport have limited direct impact on the demand for labour in the Norwegian economy, these sectors are excluded from the analysis of cyclical developments.

Mainland Norway as a proportion of the total economy

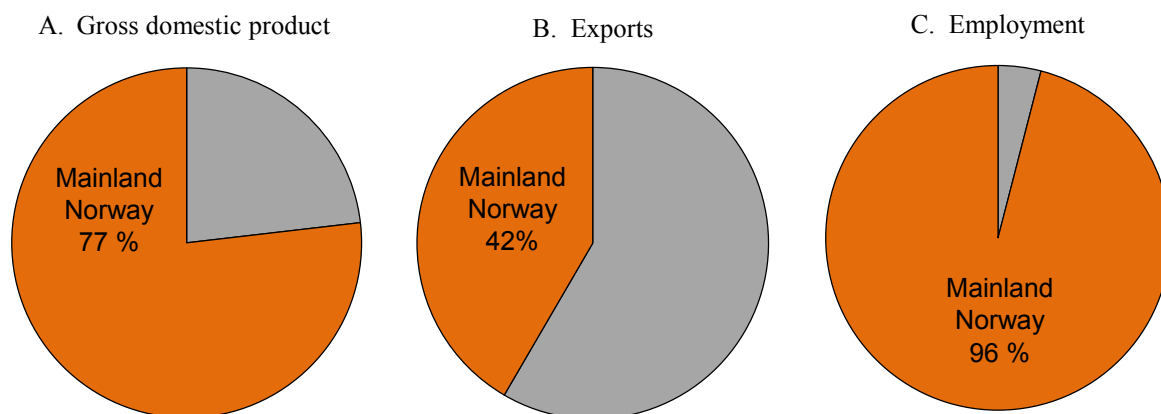


Figure 2.1 Mainland Norway as a proportion of the total economy
Sources: Statistics Norway and Ministry of Finance.

quarter show a somewhat divergent pattern. In 2015, a decline in petroleum investments is expected to curb mainland economic growth relative to 2014. However, higher growth in household demand and mainland exports may somewhat reduce the effect on mainland GDP.

Household consumption has in recent years grown more slowly than would be suggested by the low interest rate level and the high income growth. According to national accounts, this is mirrored in high savings. Disregarding large dividend distributions prior to the introduction of a tax on dividends in 2006, savings as a portion of disposable income are currently at a historically high level. A number of factors may have contributed to the increase in savings. The number of persons in the age group with the highest propensity to save has increased since the mid-1990s. Changes in the pension system that make it possible to combine drawing a pension with wage income may also have pushed up savings. Labour immigrants who are in Norway on a temporary basis may wish to save more of their income than others. At the same time, increased awareness amongst households of the risks associated with high debt and uncertainty about future developments in the international economy may have made them more cautious. This report assumes that private consumption growth will pick up from this year to next year. Consumption growth is nonetheless assumed to be lower than disposable income growth, and the savings rate is expected to increase further. This implies that household consumption developments will provide less of a demand growth impetus for the mainland economy than on average over the period 1974-2013.

Following a decline in the second half of last year, house prices have increased again this year. Adjusted for inflation, house prices are now almost back at their peak level from the beginning of last year. Higher house prices have been accompanied by higher debt in the household sector. Household debt is currently about twice as high as their disposable income. With a low interest rate level the interest burden of households is nonetheless low. However, high indebtedness and predominantly floating loan rates imply that even minor interest rate changes will reduce the purchasing power of households. High savings can help lessen such a reduction. However, a significant portion of household savings takes the form of investments in new housing, as well as renovation of existing housing. At the same time, debt and savings are unevenly distributed among households. Thus the vulnerability of the household sector when house prices fall is probably more acute than suggested by the

high savings rate.

Housing starts have picked up somewhat in recent months, but were still lower so far this year than during the corresponding period of last year. Weak sales and higher construction costs may have contributed to this. After several years of steep growth, housing investments are expected to decline somewhat this year, before increasing again next year.

Mainland business investments fell considerably in 2009 and 2010, and the decline was stronger in Norway than in other countries it is natural to compare with. However, accumulation of capital in the mainland business sector in the years prior to 2008 was also stronger than in most other countries. Investments as a share of GDP have nevertheless stayed at a relatively low level since the financial crisis. A number of factors have contributed to this. Strong investment growth in the years before the financial crisis may have lessened the need for new investments. Uncertainty about economic developments for key trading partners may have resulted in businesses putting investments on hold. At the same time, the high level of costs in Norway may have resulted in investment projects being implemented in countries with lower wage levels. Lower growth in demand from the petroleum sector may subdue investments ahead. On the other hand, growth in trading partner countries is expected to increase somewhat over the next few years. Along with the Norwegian krone depreciation, this may give incentives to parts of the business sector to expand their production capacity. In this report mainland business investments are estimated to be close to unchanged this year compared to last year, and to slightly expand next year.

Following three years of steep growth, there are now several indications that *petroleum investment* growth will abate. Surveys suggest that such investments will decline next year. Preliminary national accounts indicate that activity growth in petroleum-related industries has remained firm thus far this year. However, petroleum industry suppliers in Norges Bank's regional network report that the outlook ahead is for a decline in production.

Traditional goods exports declined steeply in the wake of the financial crisis and have since fluctuated somewhat from year to year. The overall volume of exports increased in the first half of this year and is now just below the level before the financial crisis. Developments have been weak within most categories of goods except export of fish. Demand growth from our trading partner countries and some improvement in the international cost competitiveness of Norway suggest that growth in traditional goods exports will

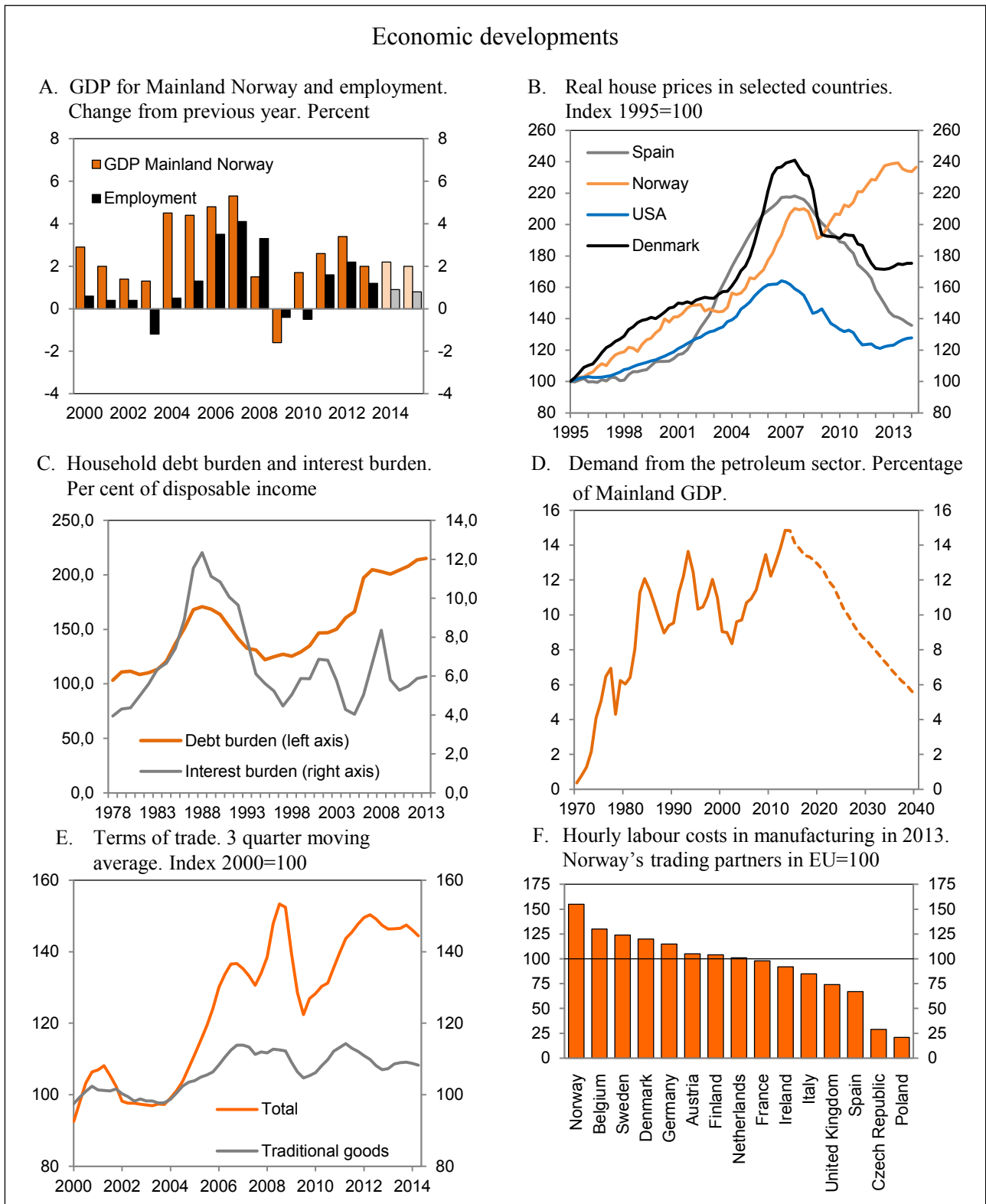


Figure 2.2 Economic developments

Sources: Statistics Norway, the Norwegian Technical Calculation Committee for Wage Settlements, Federal Reserve Bank of Dallas and Ministry of Finance

increase in 2015. Only a small fraction of mainland exports go to Russia. Hence, the direct effects on mainland exports of the restrictive economic measures vis-à-vis Russia will most likely be small. If the measures lead to lower growth in other trading partner countries the effects will be larger. Russia has been an important export market for some products, especially for Norwegian seafood. The restrictive economic measures are thereby a challenge for some producers.

Exports of services and petroleum are also expected to increase in 2014 and 2015. This contributes to an estimated increase in overall exports in both years.

Growth in the volume of *traditional goods imports* has been moderate in recent years. Weak growth towards the end of last year was followed by a decline in the volume of imports in the first half of this year. Growth is expected to pick up gradually in coming years. Nonetheless, the estimates imply that growth in traditional goods imports will remain below the average over the last 40 years in 2014 and 2015.

All in all, *mainland GDP growth* is estimated at about 2¼ per cent this year and 2 per cent next year, as shown in table 2.1. This is below the average of 2.6 per cent over the last four decades. Compared to the figures in the Revised National Budget 2014, these estimates represent an upward revision of ¼ percentage point for this year and a corresponding downwards revision for next year.

Employment increased at a lower rate last year than over the previous year, in line with the leveling-off in economic growth. At the same time, unemployment has remained low. The increase in employment is expected to continue at a moderate pace both this year and next year. Unemployment, as measured by the Statistics Norway Labour Force Survey (LFS), is expected to stay close to the outcome from last year.

Since early 2011, the *oil price* has fluctuated around 110 dollar per barrel. On the supply side, turbulence in important oil-producing countries in the Middle East and North Africa has served to keep prices high. At the same time, production shortfalls in Iran, Iraq and Libya during these years have been compensated by expanded production of shale oil in the US. Since June the price has generally fallen, and towards the end of September the oil price was under 100 dollar per barrel. This report assumes an average oil price per barrel of NOK 670 this year and NOK 650 next year (at 2015 prices). Further ahead, calculations are based on an oil price around 550 NOK (at 2015 prices). The gas price is expected to increase from NOK 2.15 per Sm³ this year to 2.30 per Sm³ next year (at 2015 prices).

Strong oil price growth has improved Norway's terms of trade since the turn of the millennium. Developments in the prices of traditional goods exports were also favourable prior to the financial crisis, but those prices have fluctuated considerably since 2008. Fish and metals prices have been especially volatile. In the 2nd quarter of this year, the terms of trade for traditional goods were 4¾ per cent weaker than in 2007, although still 5¼ per cent stronger than in 2000. It is anticipated that the terms of trade for traditional goods, as well as for all goods and services as a whole, will deteriorate somewhat this year and slightly increase next year.

Average annual wage growth was 3.9 per cent in 2013. Wage bargaining outcomes thus far this year are indicative of lower wage growth this year than last year. Based on these outcomes and economic outlook assessments, annual wage growth is estimated at 3¼ per cent for both 2014 and 2015. These estimates imply that wage costs in national currency are likely to continue to grow at a higher rate in Norway than amongst our trading partners as a whole. A depreciation of the Norwegian krone may nonetheless result in an improvement in cost competitiveness in both 2014 and 2015, as measured by relative wage costs per employee in common currency. The estimates still imply real wage growth this year and next year, although it is below the average over the last 10 years.

The Norwegian krone depreciation last year resulted in a considerable acceleration in *underlying consumer price growth*, as measured by consumer price growth adjusted for tax changes and excluding energy products (CPI-ATE), throughout last year. Price growth for imported consumer goods has increased further this year, and twelve-month growth in the underlying consumer price index has thus far been close to the 2.5 per cent inflation target. Annual CPI-ATE growth is estimated at 2.4 per cent this year and 2.1 per cent next year, up from 1.6 per cent last year. Electricity price developments thus far this year have contributed to twelve-month growth in the overall CPI lagging behind the corresponding CPI-ATE growth. Expectations of higher electricity prices next year will serve to push up the overall price growth. CPI growth is estimated, as an annual average, to remain unchanged both this year and next year.

Norges Bank swiftly reduced the *key policy rate* in the wake of the international financial crisis, and the rate has been kept at a generally low level ever since. Since March 2012, the key policy rate has remained unchanged at 1.5 per cent. The policy rate path in Norges Bank's monetary policy report from September 2014 implies that the key

policy rate will remain at the current level towards the end of 2015, following which it will be gradually increased to about 2 per cent in late 2017.

The *Norwegian krone* depreciated significantly through 2013 and for the first weeks of 2014. By early February this year, the Norwegian krone had depreciated by almost 14 per cent since the beginning of 2013, as measured by the trade-

weighted exchange rate index. The Norwegian krone has appreciated somewhat since then, but still remains considerably weaker than the average for last year. This report adopts the technical assumption that the Norwegian krone will depreciate along the lines of uncovered interest rate parity both this year and next year.

Table 2.1 Key figures for the Norwegian economy. Percentage change in volume from the previous year ¹

	NOK billion			
	2013	2013	2014	2015
Private consumption	1234.5	2.1	2.1	2.7
Public consumption	658.1	1.8	2.1	2.2
Gross fixed investments	681.9	8.4	1.0	-0.9
Of which: Petroleum extraction and pipeline transportation	208.3	17.1	0.0	-8.0
Businesses in Mainland Norway	185.6	0.2	0.1	1.2
Housing	147.0	6.4	-2.0	3.4
Public sector	108.0	9.9	9.4	3.2
Demand from Mainland Norway ³	2333.1	2.5	2.0	2.5
Exports	1170.8	-3.3	2.2	2.2
Of which: Crude oil and natural gas	570.4	-7.7	0.9	0.6
Traditional goods	322.1	0.4	3.1	3.6
Services excl. petroleum activities and international shipping	155.9	5.5	3.5	3.5
Imports	847.9	2.9	2.3	2.5
Of which: Traditional goods	508.1	2.5	1.4	3.6
Gross domestic product	3 011.4	0.6	1.8	1.6
Of which: Mainland Norway	2 314.0	2.0	2.2	2.0
Mainland Norway excl. electricity	2 259.7	2.2	2.2	2.1
Other key figures:				
Employment, persons		1.2	0.9	0.8
Unemployment, LFS (level)		3.5	3.4	3.6
Annual wage growth		3.9	3.3	3¼
Consumer price index (CPI)		2.1	2.1	2.1
CPI-ATE		1.6	2.4	2.1
Oil price, NOK per barrel ⁴		639	656	650
Current account balance (pct. of GDP)		11.1	11.6	11.7
Gross national income, NOK billion		3 060.2	3 193.7	3 318.2
Three-month money market interest rate, pct. ⁵		1.8	1.7	1.7
Trade-weighted exchange rate index, annual change in pct. ⁶		3.0	5.4	1.9
Household savings rate (level) ⁷		9.0	9.3	9.5

¹ Statistics Norway will publish new national account data on 20 November. Statistics Norway will in that context incorporate new international guidelines for national accounts and other information on economic developments. No attempt has been made at anticipating such changes in the estimates in this report.

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.

⁶ Positive figures indicate depreciation of the Norwegian krone.

⁷ Household savings as a percentage of disposable income.

Sources: Statistics Norway and the Ministry of Finance.

3. Economic policy

3.1 Fiscal policy

3.1.1 The role of fiscal policy

Fiscal policy governs the development of the state's net financial wealth and the size of the public sector. Accordingly, it also influences the composition and scale of overall demand for labour, goods and services. In Norway, government petroleum revenues allow tax revenues from the mainland economy to be kept below the level of public expenditure. At the same time, it makes it more challenging to support a stable development in the mainland economy. Oil and gas revenues are currently substantial, but fluctuate considerably and will eventually run out. Many countries have found that excessive use of the revenues from natural resources can lead to difficult adjustments when incomes subsequently decline (also known as Dutch disease). This underlines the need to phase in these revenues prudently. The additional resources should be spent to improve productivity growth and facilitate long-term growth and prosperity.

An important objective for the fiscal framework constituted by the Government Pension Fund and the fiscal rule for the use of oil revenues is to support a balanced development in the mainland economy. As part of this, the state's net revenues from the petroleum industry are transferred to the Government Pension Fund Global, which is invested abroad. Every year, an amount is transferred back into the fiscal budget to cover the non-oil deficit in the fiscal budget, after decision by the Storting. This mechanism delinks the earning and use of petroleum revenues. It promotes stability in the Norwegian exchange market and helps to insulate the fiscal budget from fluctuations in petroleum revenues and in the Fund's capital. The fiscal rule implies that the non-oil deficit over time shall follow the expected real return on the Government Pension Fund Global.

The Government is committed to a responsible economic policy based on the fiscal rule for the use of oil revenues. A larger share of the oil revenues that are phased into the budget will be spent on investments in knowledge and infrastructure, as well as in tax cuts that promote growth. The use of oil revenues will be adjusted to the economic situation within the fiscal policy framework. This will facilitate a gradual increase in the use of oil revenues over the medium term and reduce the risk of a sharp decline in indus-

tries exposed to international competition. When the spending of oil revenues does not exceed the real return of the Government Pension Fund Global, the oil and gas wealth will also benefit future generations.

The capital in the Government Pension Fund Global is now significantly larger than foreseen a few years ago. In 2013 alone the Fund grew by NOK 1 200 billion, and its value is now twice that of Norway's mainland economy. As a result, fluctuations in the value of the Fund and in the Fund's expected real return – estimated to be 4 per cent – can become large when compared to the size of the fiscal budget and Norwegian economy, in particular when seen against the underlying growth in the mainland economy from one year to the next. The market values of stocks, bonds, and foreign exchange can be highly volatile, due to the nature of financial markets, and they may not fluctuate in sync with Norway's business cycles. Potentially large fluctuations in the path for the expected real return from the Fund make it less adequate as an operational target for fiscal policy in the short term. The current situation is a case in point: a swift return to a level of spending corresponding to 4 per cent of the Fund's value would entail a large and unwarranted fiscal expansion. Against this background, the Government will appoint a commission to consider how to apply the fiscal rule.

Fiscal policy should have a margin for dealing with unforeseen events. In addition to fluctuations in the value of the Fund, there is uncertainty about the underlying development of the tax revenues from the mainland economy. In the event of an economic downturn, the estimates of these revenues may be reduced substantially, as seen in various countries after the financial crisis.

3.1.2 Fiscal policy in 2014

In the Adopted 2014 Fiscal Budget, the non-oil deficit was projected to NOK 137.5 billion. The structural, non-oil deficit was estimated to NOK 139.0 billion. Changes in connection with the Revised National Budget indicate, together with new information about the budget and the Norwegian economy, a somewhat weaker 2014 budget. The structural, non-oil deficit in 2014 is now estimated to NOK 142.2 billion.

The estimated *tax revenue from the mainland economy* in 2014 was reduced by NOK 9.2 billion in the Revised National Budget, compared to the Adopted Budget. New information on tax receipts and developments in the Norwegian economy indicate that the estimate must now be reduced by an additional NOK 4.8 billion. This reduction is linked to somewhat lower growth in the Norwe-

gian economy, including slightly lower estimated wage growth. The largest individual item is reduced value added tax receipts. Revenues from taxes on income, motor vehicles and other special duties have also been reduced.

The tax receipts of municipalities and counties also appear to be slightly lower this year – by approximately NOK 0.9 billion – than forecast in the Revised National Budget for 2014.

Calculations of the structural, non-oil budget balance utilise estimates of the *underlying or structural tax revenues* from mainland Norway, adjusting actual figures for effects of economic cycles and certain other factors. The estimated level of these structural tax revenues in 2014 was reduced by NOK 2.9 billion in the Revised National Budget, and is now being reduced by an additional NOK 2 billion. The primary reason is slightly weaker growth prospects for the Norwegian economy. A secondary reason is the reduction in estimated wage growth in the Revised National Budget. Lower wage growth also entails approximately equal savings on the expenditure side of the budget, and thus does not weaken the budget balance.

The estimated structural, non-oil deficit in 2014 equates to 5.8 per cent of mainland Norway trend GDP. The fiscal stance, measured by the change in the structural, non-oil deficit as a proportion of mainland Norway trend GDP, is estimated at 0.7 percentage point. This is 0.2 percentage point higher than anticipated last autumn. One reason for the increase is lower-than-expected use of oil revenues in 2013.

3.1.3 The fiscal budget and the Government Pension Fund in 2015

The budget for 2015 is based on a structural, non-oil deficit of NOK 163.7 billion. This is an increase from 2014 of NOK 17.3 billion at 2015 prices; see Figure 3.1A. About one in nine kroner spent via government budgets in 2015 will be taken from the Government Pension Fund Global. The withdrawal from the Fund equals about NOK 31,700 per capita.

The structural, non-oil deficit equates to 6.4 per cent of mainland Norway trend GDP, about ½ percentage point higher than in 2014.

The use of funds from the Government Pension Fund Global in 2015 is anticipated to equal 3.0 per cent of the Fund capital at the beginning of the year. This is approximately in line with the average interest and dividend revenues as a percentage of the Fund capital received over the past five years. The average annual real return on the Fund has been just under 4 per cent since 1997.

The spending of oil revenues in 2015 is forecast to be NOK 58 billion lower than the expected real return on the Fund (the 4 per cent path), compared to a difference of NOK 61 billion at 2015 prices in 2014. The difference compared to the 4 per cent path equals 2.3 per cent of mainland GDP, and provides an important fiscal policy buffer.

The Government’s budget proposal includes a further reduction in paid taxes and excises from 2014 to 2015 of about NOK 6.9 billion. This figure excludes the full-year effect of direct and indirect

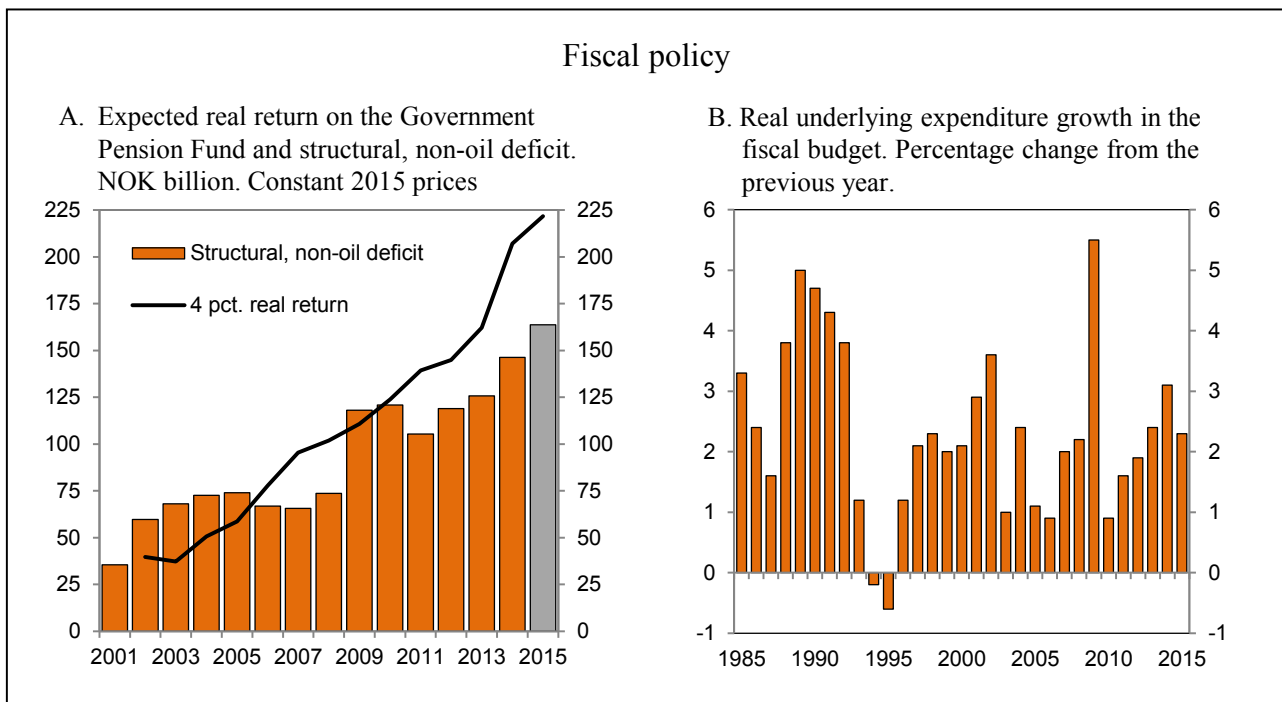


Figure 3.1 Fiscal policy
Source: Ministry of Finance.

tax relief in 2014 totalling NOK 3.1 billion. On accrued basis the tax relief in 2015 amounts to NOK 8.3 billion.

Real growth in the fiscal budget's underlying expenditure is estimated at NOK 25.4 billion at 2015 prices, or 2.3 per cent. This is approximately in line with the average for the years during which the fiscal rule has applied; see Figure 3.1B.

The change in the structural, non-oil deficit is often used as a simple indicator of the fiscal stance. To shed more light on how the budget impacts the economy, the Ministry of Finance supplements the budget indicator with calculations on the macroeconomic model MODAG. These simulations suggest that the proposed budget for 2015 may increase mainland GDP by slightly less than ¼ per cent in 2015, when taking into account the composition of general government revenues and expenditures.

Norway has solid public finances compared to most other OECD countries. The Government Pension Fund's capital is forecast to total close to 2.5 times mainland Norway GDP by the end of 2015, and is mostly invested abroad. The state also has assets and liabilities outside the pension fund. As measured in the state accounts, the central government's equity excluding the Govern-

ment Pension Fund is estimated at around 21 per cent of mainland Norway GDP. This proportion has been relatively stable in recent years, indicating that the savings in the Government Pension Fund are not being counteracted by reductions in other equity.

The state also has considerable, and growing, liabilities, not least in the form of pensions. Expenditure on national insurance pensions only becomes visible in the fiscal budget once pensions are paid. Furthermore, the state has commitments in the form of accrued rights under the Norwegian Public Service Pension Fund, The estimated total pension liability substantially exceeds the sum of the Government Pension Fund and the state's other net wealth.

The state's net cash flow from the petroleum industry is forecast to total NOK 304 billion in 2015, approximately the same amount as in 2014 but lower than in 2012 and 2013. The net allocation to the Government Pension Fund Global, which excludes the transfer to the fiscal budget, is estimated at approximately NOK 130 billion. The total surplus on the fiscal budget and the Government Pension Fund is expected to be around NOK 308 billion in 2015; see Table 3.1.

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

	Accounts		Estimates	
	2012	2013	2014	2015
Total revenues	1 290.7	1 291.8	1 272.2	1 328.9
1 Revenues from petroleum activities	421.1	378.7	335.2	342.0
1.1 Taxes and excise duties	232.7	206.4	178.3	173.6
1.2 Other petroleum revenues	188.4	172.3	156.9	168.4
2 Revenues other than petroleum revenues	869.6	913.1	937.1	987.0
2.1 Taxes and excise duties from Mainland Norway	807.4	849.0	879.0	919.8
2.2 Other revenues	62.2	64.0	58.1	67.2
Total expenditures	996.1	1 063.1	1 124.8	1 199.2
1 Expenditures on petroleum activities	25.6	33.6	38.0	38.0
2 Expenditures other than petroleum activities	970.5	1 029.5	1 086.8	1 161.2
Fiscal budget surplus before transfers to the Government Pension Fund Global	294.6	228.7	147.4	129.7
- Net cash flow from petroleum activities	395.5	345.2	297.2	304.0
= Non-oil surplus	-100.9	-116.5	-149.8	-174.2
+ Transfers from the Government Pension Fund Global	104.6	117.3	149.8	174.2
= Fiscal budget surplus	3.7	0.9	0.0	0.0
+ Net allocation to the Government Pension Fund Global	290.9	227.8	147.4	129.7
+ Interest earnings and dividends to the Government Pension Fund	115.3	131.1	161.7	178.3
= Surplus, fiscal budget and Government Pension Fund	409.9	359.8	309.1	308.0
Memo:				
Market value of the Government Pension Fund Global ¹	3 825	5 032	5 545	6 015
Market value of the Government Pension Fund ¹	3 970	5 200	5 724	6 206
National insurance scheme – old-age pension liabilities ¹	5 467	5 749	6 038	6 313

¹At year-end.

Source: Ministry of Finance.

3.1.4 General government fiscal position

Since the mid-1990s petroleum revenues have contributed to a substantial surplus to general government finances in Norway, whereas industrialised countries generally have posted deficits; see Figure 3.2A.

Norwegian general government net lending is estimated at NOK 306 billion in 2015, which corresponds to 9.5 per cent of GDP. This is slightly below the estimate for 2014. The general government surplus is due to high revenues from the petroleum activities; excluding oil revenues the central government budget has a large deficit; see Table 3.2. This deficit is covered by a transfer from the Government Pension Fund Global, in accordance with the Government Pension Fund Act. Local government net lending has been negative in recent year, partly because of a high level of gross fixed investment in local government.

High revenues from petroleum activities and large allocations to the Government Pension Fund Global have resulted in a steep increase in general government net financial assets since the mid 1990s; see Figure 3.2B. Developments in net financial assets are also influenced by changes in the market value of assets and liabilities including changes stemming from movements in the exchange rate. General government net financial assets are estimated at NOK 6,900 billion at the end of 2015, when including the capital of the Government Pension Fund and capital invested in government business operations. This corresponds to 214 per cent of GDP.

Total public expenditures are estimated at NOK 1,500 billion in 2015, corresponding to 59 per cent of GDP. Public expenditure as a share of mainland GDP is an indicator of the size of the public sector. Expenditures increased during the slump in 2009, but have subsequently remained fairly stable at close to the average for the last 25 years; see Figure 3.2C.

The composition of public expenditure has also changed somewhat during this period. Government transfers to the business sector, for example, have declined as a portion of mainland GDP, whereas public service provision expenditure has increased. General government gross fixed investment has increased in recent years. As a portion of mainland GDP, it is projected to be

higher in 2015 than the average for the past 25 years.

When measured as a share of mainland GDP, public expenditure appears to be relatively high in Norway compared to other OECD countries. When measured as a share of overall GDP instead, public expenditure is somewhat lower than the average for the euro zone. The strong contribution from petroleum production to GDP is based on the depletion of a non-renewable resource, and will decline over time. Public expenditure relative to overall GDP therefore underestimates the long-term challenges for fiscal policy. 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 production.

Government expenditure needs to be funded. The most important source of funding is revenues from taxes and excises. Other revenue sources are, inter alia, user fees and capital income. When measured as a portion of GDP¹, Denmark is one of few OECD countries with a higher tax level than the Norwegian mainland economy; see Figure 3.3D. Nonetheless, underlying growth in tax revenues has been good in Norway despite the relatively high tax level.

Differences in public expenditure and tax levels between countries 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 expenditures) as an alternative to government transfers. Such differences influence gross figures with regard to both public expenditure and revenues. In addition, a number of countries run fairly large structural budget deficits and have accumulated considerable government debt. Over time, these countries need to either reduce expenditure or increase revenues in order to strengthen public finances.

¹ Norway's industrial structure is characterised by considerable value added in the petroleum sector. For purpose of international comparisons, the tax level of the Norwegian mainland economy is the most relevant indicator. Although a major part of the revenues from petroleum activities accrue to the State, the tax level of the overall economy is somewhat below that of the mainland economy. This is because revenues from the State's Direct Financial Interest (SDFI) in the petroleum activities accrue directly to the State, and hence are not subject to taxation.

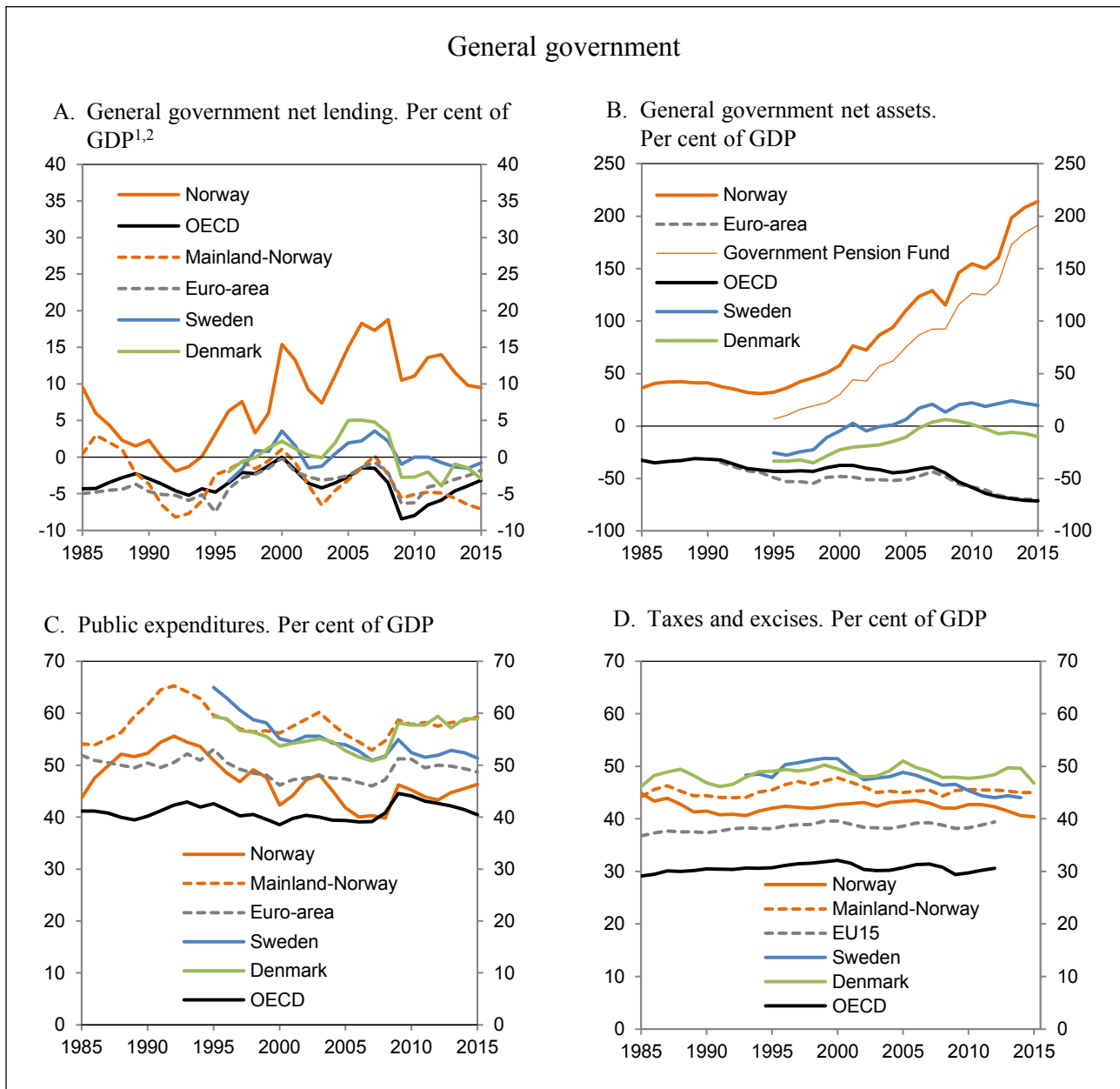


Figure 3.2 General government net lending, net assets, public expenditures, taxes and excises. NOK billion and per cent of GDP

¹ General government net lending is the surplus concept of the national accounts. General government net lending summarises the contribution made by financial transactions to changes in net financial assets. In addition, developments in net financial assets will depend on changes in asset valuations.

² Mainland Norway represents general government net lending, less net cash flows to the State from petroleum activities and the return on the Government Pension Fund.

Sources: Statistics Norway, OECD and Ministry of Finance

3.1.5 Fiscal policy in the medium run

The Government's economic policy is based on a generational perspective. Over the coming decades, expenditure on pensions, health and care services will increase as the population ages. At the same time, tax revenues from the mainland economy will remain the most important source of funding for the national insurance scheme. It is thus important to maintain an efficient tax system and a diverse business sector that is robust in the face of shifting international

market conditions. A more productive economy can make it easier to fund expenditure on an ageing population, particularly if productivity in the public sector also improves. The Government's economic policy is also designed to ensure that the return on the Government Pension Fund Global gives a lasting contribution to the funding of increasing public expenditure.

Over time, fiscal policy leeway is primarily determined by developments in mainland economy tax bases, by earlier expenditure and revenue

Tabell 3.2 Government Pension Fund Global, expected return on the Fund and the structural, non-oil budget deficit. NOK billion and per cent

	2013	2014	2015
A. Central government net lending, accrued value	378 432	334 955	333 889
Consolidated surplus in fiscal budget and Government Pension Fund	359 769	309 100	308 030
Non-oil fiscal budget surplus	-116 454	-149 753	-174 225
Net cash flow from petroleum activities	345 151	297 153	303 955
Interest and dividends on the Government Pension Fund	131 072	161 700	178 300
Surplus in other government and public pension accounts	7 207	3 736	4 122
Definitional discrepancies, central government accounts/national account ¹	11 456	22 119	21 736
B. Local government net lending, accrued value	-29 173	-29 063	-27 522
Local government surplus, book value	-23 412	-25 076	-24 107
Difference between accrued and book values, taxes	-5 761	-3 987	-3 415
C. General government net lending (A+B)	349 259	305 892	306 367
Measured as percentage of GDP	11.6	9.8	9.5

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: Statistics Norway and Ministry of Finance.

commitments, and by the development of the expected real return on the capital in the Government Pension Fund Global. The Government will give priority to measures towards quicker integration and greater labour force participation among immigrants. This is an important part of securing future welfare. Future leeway is also influenced by whether the structural, non-oil deficit currently deviates from the estimated expected return on the fund.

Despite a level of direct and indirect taxation that is relatively high from an international perspective, tax revenues from the mainland economy have grown healthily for many years. The Norwegian tax system is characterised by broad tax bases, low tax rates and symmetrical treatment of income and expenses. At the same time, the growth of the Norwegian economy has been helped by improvements in the terms of trade, increasing demand from the petroleum industry, generally expansive fiscal policy and periods with low interest rates. Norway's high immigration rate has helped to increase its productive capacity, but also put greater pressure on infrastructure and increased demand for public services.

The overall effect of immigration on public budgets and per capita value creation depends on both how flexibly the labour force moves across national borders and how successfully immigrants staying in Norway are integrated into the labour force. The Norwegian labour market has not suffered any major setbacks in the years since the expansion of the European Economic Area. Accordingly, not much is known about how an economic reversal would impact labour immigration and emigration.

For the coming years, the annual underlying real growth in direct and indirect tax revenue is estimated at NOK 18 billion at 2015 prices, or just below 2 per cent. Demographic trends will consume a considerable proportion of underlying tax revenue growth. In the immediate future, national insurance commitments are forecast to increase expenditure by approximately NOK 11 billion per year on average, at 2015 prices. Demographic trends will also increase municipal and health trust expenditure by around NOK 4 billion per year at 2015 prices if current standards and coverage are maintained. In view of these developments, it is important that public sector resources are used as efficiently as possible. The proportion of older people will continue to increase for many years. Improvements in public health and more efficient production of public services may reduce the expected expenditure increases.

Extensive investment plans for the transport sector and the purchase of defence materiel are also pushing budget commitments beyond the level implied by pension liabilities and demographic factors. The procurement of new jet fighters will require an increase in the defence budget in the years ahead, estimated at NOK 2.7 billion at 2015 prices in 2016 and a further NOK 0.5 billion at 2015 prices in 2017. In isolation, this increase equates to a budget impulse of 0.1 percentage point in 2016 and 0.02 percentage point in 2017.

The growth of the expected real return on the Fund as a proportion of GDP for mainland Norway will gradually fall; see Table 3.3. There will thus be less leeway to increase the structural,

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

Government Pension Fund Global at the beginning of the year ¹⁾	Current prices		Constant 2015-prices			Structural deficit	
	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
386.6	-	21.2	-	35.5	-	1.8	-
619.3	24.8	37.3	39.7	59.7	20.0	3.0	6.0
604.6	24.2	44.2	37.2	68.0	30.8	3.4	7.3
847.1	33.9	48.5	50.7	72.6	21.9	3.5	5.7
1 011.5	40.5	51.0	58.7	74.0	15.3	3.5	5.0
1 390.1	55.6	47.7	77.9	66.8	-11.1	3.0	3.4
1 782.8	71.3	49.1	95.4	65.6	-29.7	2.9	2.8
2 018.5	80.7	58.4	101.8	73.6	-28.2	3.3	2.9
2 279.6	91.2	97.1	110.7	118.0	7.2	5.2	4.3
2 642.0	105.7	103.2	123.8	120.9	-2.9	5.2	3.9
3 080.9	123.2	93.3	139.3	105.4	-33.9	4.5	3.0
3 307.9	132.3	108.7	144.9	119.0	-25.8	4.9	3.3
3 824.5	153.0	118.6	162.2	125.8	-36.4	5.1	3.1
5 032.4	201.3	142.2	207.1	146.3	-60.8	5.8	2.8
5 545.0	221.8	163.7	221.8	163.7	-58.1	6.4	3.0
6 015.4	240.6	-	232.6	-	-	-	-
6 392.3	255.7	-	238.9	-	-	-	-
6 759.4	270.4	-	244.2	-	-	-	-
7 140.4	285.6	-	249.3	-	-	-	-
7 532.7	301.3	-	254.2	-	-	-	-

¹ The estimate for 2014 is based on the actual market value of the Fund medio August, with the addition of estimated net transfers from the fiscal budget to the Fund and 4 pct. annual real return until the end of 2014. As for the years from 2016 onwards, the estimate is premised on the technical assumption that annual withdrawals from the Fund correspond to 4 pct. of the Fund capital as per beginning of the year.

Source: Ministry of Finance.

non-oil deficit from one budget to the next. The fund's contribution to the funding of the fiscal budget is estimated to increase from 6.4 per cent of mainland Norway GDP in 2015 to a peak of 9¼ per cent of mainland GDP around 2025; see Figure 3.4. Thereafter, the funding contribution as a proportion of mainland GDP will even out and gradually decline. Once the peak has passed, fiscal policy will on average have a restricting effect on demand for goods and services for many decades. By 2060, the financing contribution of the Fund measured as a proportion of mainland Norway GDP will have fallen approximately to current levels.

3.1.6 Fiscal policy challenges in the long run

Over the past two decades, several factors have contributed positively to public finances. Strong growth in demand from the petroleum industry and terms-of-trade gains have underpinned economic growth and tax revenues have increased. Over the same period, demographic developments have been relatively favourable to

public finances as the old age dependency ratio has declined. Furthermore, since 2001, the use of oil revenues has increased, creating fiscal space for higher public expenditures without a corresponding increase in tax levels. These trends will gradually reverse.

In June of this year, Statistics Norway published updated population projections for Norway. The projections show that the ratio of elderly persons (ages 67 and over) to persons of working age will double by 2060, compared to an all-time low in 2009; see Figure 3.3A. This is largely in line with the previous set of forecasts from 2011. Similar developments are expected in most other industrialised countries, with ageing populations putting pressure on public finances.

Public services are predominantly funded by direct and indirect taxes on the income generated by the working-age population, whereas children, young people and the elderly are net recipients; see Figure 3.3B. The changing age composition of the Norwegian population will thus weaken the fiscal base for public services and social transfers.

Ageing will reduce the total per capita labour

effort in the years ahead. If labour market participation by age, gender and immigration status 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, from around 750 man-hours per year per capita in 2015 to around 665 man-hours per year by 2060; see Figure 3.3C. Furthermore, the labour effort in the public sector will have to increase to meet increased demand for health and care services as the population ages.

An ageing population means higher public expenditure on retirement and disability pensions and nursing and care services. 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; see Figure 3.4. Although future returns on the Government Pension Fund Global will make an important contribution to the funding of public sector expenditure, it will gradually decline as a share of mainland GDP. Accordingly, if current welfare services are maintained, there will be a gradually increasing shortfall in public finances. The 2013 white paper on long-term perspectives for the Norwegian economy estimated that by 2060 the shortfall would be 6.1 per cent of mainland GDP, provided that the use of petroleum revenues follows the fiscal rule. These estimates have now been updated, and the revised estimates find the shortfall to be slightly lower, at 5.2 per cent of mainland GDP by 2060. To cover the shortfall in 2060, Norway must either increase public sector income or identify sufficient savings on the expenditure side.

Several factors lie behind the downward revision to the long-term need to strengthen public finances. The most important reason is that Statistics Norway has updated its estimates of how public service consumption is distributed among different age groups. The updated estimates show that persons of working age have a somewhat higher consumption of services than previously estimated, and that older persons have a corresponding lower consumption. Accordingly, the ageing of the population will have a slightly smaller impact on public expenditure. Furthermore, the Government Pension Fund Global has grown somewhat more rapidly than expected. As a result, the fund's long-term financial contribution will be a little larger, and the shortfall correspondingly smaller. Partly counteracting these two factors is the increase in the use of oil revenues via the fiscal budget since 2011, in accordance with the fiscal rule. This increase has provided fiscal space for both increased expenditure and lower direct and indirect taxes.

The estimates of the long-term fiscal position

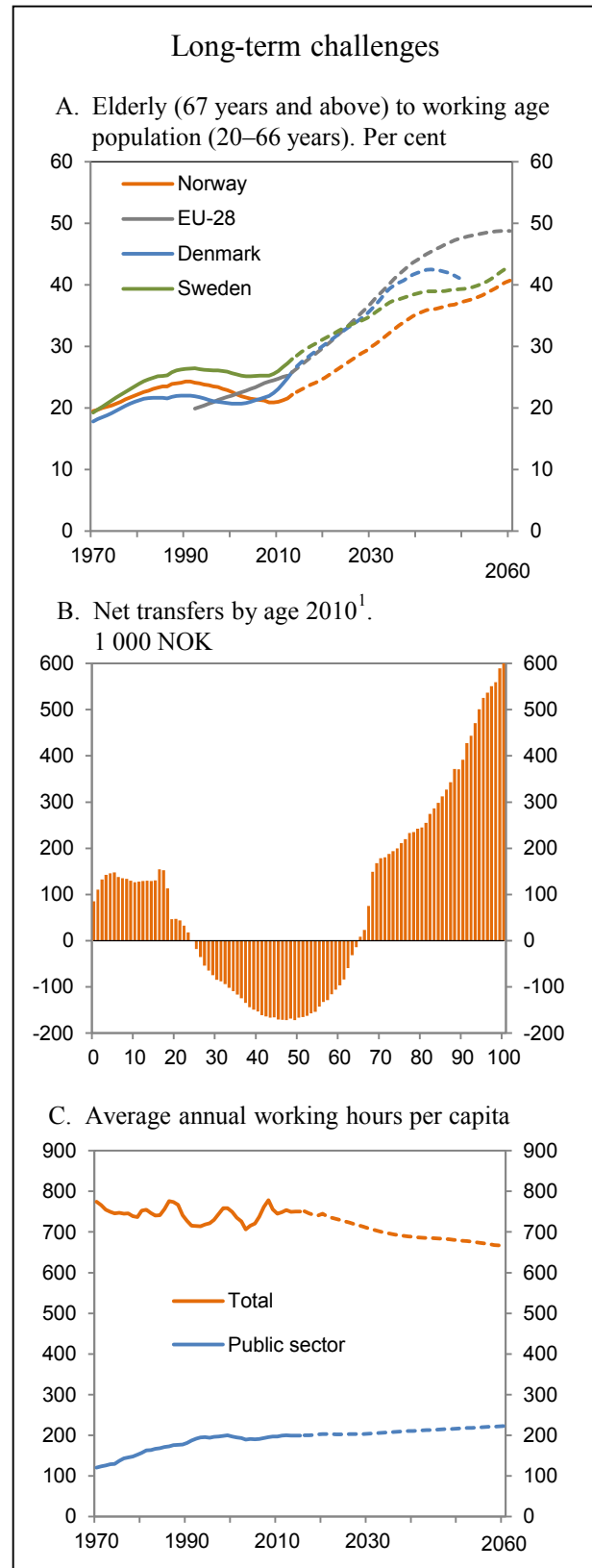


Figure 3.3 Long-term challenges

¹ Includes public expenditure on education, health, care and transfers to private individuals (including retirement pensions, sickness benefits and disability pensions), less personal taxes, value added tax and most other indirect taxes.

Sources: Ministry of Finance, Statistics Norway, Eurostat, Statistics Sweden and Statistics Denmark.

are uncertain and depend upon a number of underlying assumptions. Some of these concern circumstances beyond political control, such as oil and gas prices and the return on the Government Pension Fund Global's investments in the international stock and bond markets. Other assumptions concern factors that to some degree can be influenced by decisions in Norway, such as labour effort and welfare service standards. The importance of some of these assumptions is illustrated by estimates of how the 2060 shortfall changes when assumptions change; see Figure 3.5.

High petroleum prices and high returns in international capital markets increase Norway's disposable income, and also contribute positively to public finances. Petroleum prices directly affect the State's net cash flow from the petroleum sector which is set aside in the Government Pension Fund Global. The returns on the Fund are determined in international capital markets. Norway's current high level of oil and gas production, together with the size of the Fund, makes the prices on petroleum and return on capital highly significant for the development of the financial contributions from the Fund, and thus for future public finances. Figure 3.4 illustrates the effect of an increase or decrease in petroleum prices by NOK 100, relative to the baseline price of NOK 550 per barrel of oil, measured in 2015-

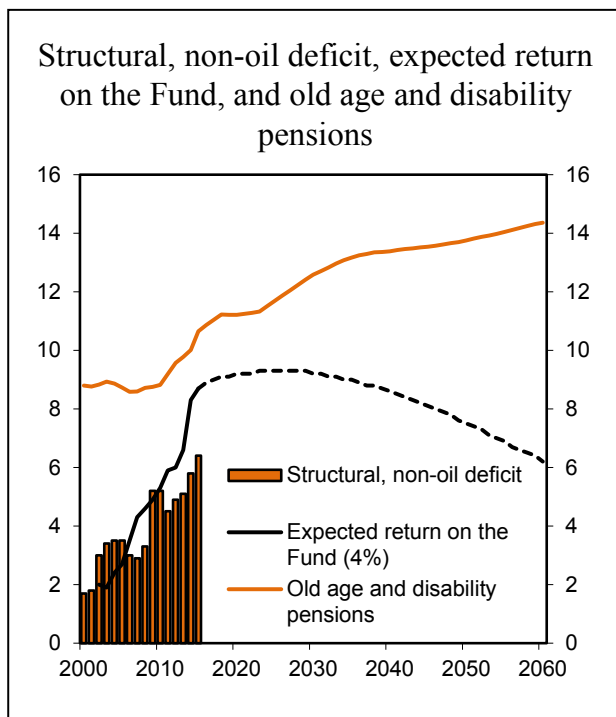


Figure 3.4 Structural, non-oil deficit, expected return on the Government Pension Fund Global, and old age and disability pensions. Per cent of mainland GDP

Sources: Ministry of Finance and Statistics Norway.

prices. The figure also illustrates a return on the Fund of one percentage point above or below the reference scenario, with a corresponding adjustment in the transfer from the Fund to the budget.

In the long run, productivity growth determines overall prosperity. However, it does not in itself contribute to better public finances. Higher productivity in the private sector results in a higher wage level. This raises tax revenues, but also entails higher expenditures on wages, pensions and other transfers. Furthermore, higher productivity growth gives a higher level of GDP, and a correspondingly lower contribution from the Government Pension Fund Global compared to mainland GDP. On balance, the effect of an increase in private sector annual productivity growth by $\frac{1}{4}$ percentage point is relatively small.

On the other hand, higher productivity growth in the public sector creates leeway that can be used to strengthen public finances. As an example, if resource utilisation in the public sector is improved by $\frac{1}{4}$ per cent per year, the fiscal shortfall in 2060 will be reduced by approximately $3\frac{3}{4}$ per cent of mainland GDP. An overview of the Government's work to increase efficiency in the public sector is found in chapter 6.

The forecasts assume that standards of public services – defined as expenditure per user – will not increase in real terms from current levels. It is also assumed that coverage, defined as the proportion of each birth cohort using the different public services, remain constant. Historically, this has not been the case. Both the proportion of those using public services and the expenditures per user have increased over time. This is consistent with a standard finding in many countries: demand for many types of public service increases as income levels in society rise. If it is assumed that the standard of public services will also rise in future, the shortfall increases. Given an annual increase in expenditure per user in public health and care services of $\frac{1}{2}$ per cent, the shortfall in 2060 increases by some 5 per cent of mainland GDP. By comparison, in recent decades the annual increase in expenditure on public health and care services has on average been close to $1\frac{1}{2}$ per cent higher than the estimated increase if expenditure per user had been constant.

Both prosperity levels in society and the sustainability of public finances depend on how much people work. Increased employment generates not only higher value creation, but also larger tax revenues for central and local government. The ageing of the population suggests fewer man-hours per capita, since older people normally work shorter hours and gradually retire. In addition, the average number of working hours has fallen as Norway has become richer. The fore-

casts assume working hours and labour market participation by age, gender and immigration status remain constant. If the number of average working hours develop in line with the fall observed between 1990 and 2013, the average number of annual working hours per capita will fall to 585 by 2060, compared to 650 hours if working hours remain unchanged. This would increase the shortfall in 2060 by some 5½ per cent of mainland GDP.

An important objective of the pension reform has been to encourage more people to remain economically active. The effect of the reform on labour force participation remains uncertain. While the consequences of lower pension payments have been incorporated into the forecasts, the potential effects of increased labour supply have not. Estimates from Statistics Norway indicate that the pension reform may lead to an increase in the annual number of man-hours worked in 2060 by around 8 per cent compared to if the reform had not been implemented. If the number of man-hours worked in 2060 is 8 per cent higher than assumed in the long-term forecasts, the shortfall in 2060 will be reduced by approximately 3½ per cent of mainland GDP.

The expected weakening of public finances in the decades ahead cannot be dealt with through tax increases. Higher taxes on labour may reduce labour supply, and higher taxes on capital returns may reduce the tax base by making investment in Norway less profitable. The link between tax rates and the size of the tax base has probably been reinforced by the internationalisation of the Norwegian economy. The openness of Norway's

economy limits the scope for tax rates in Norway to deviate from tax rates abroad. Norway's tax level is already high compared to most European countries. In its latest country report on Norway, the OECD recommended a cut in the tax level. The Government agrees that a lower tax level is an important step in promoting higher value creation.

3.2 Tax policy

The main tax policy objective of the Government is to fund public goods and services in the most efficient manner. A more efficient tax system can also make the economy more productive. The Government will make the tax system simpler and more conducive to growth. Working, saving and investing shall pay off, and the tax system shall stimulate more environmentally-friendly behaviour.

A tax policy in line with the Government's objective will have favourable dynamic impacts on the economy. Increased labour force participation and higher economic growth will increase the tax bases, and thus over time fund a part of the tax reductions. The most important tax changes in 2014 include a reduction of the tax rate on ordinary income and lower net wealth tax. These measures promote growth and employment. The 2015 budget takes further steps in the same direction.

The budget proposal for 2015 includes reductions in taxes totalling NOK 8.3 billion accrued and NOK 6.9 billion booked. Lower net wealth tax accounts for about half of the reductions. The net wealth tax rate will be reduced from 1 per cent to 0.75 per cent, and the basic allowance increased to NOK 1.2 million. The Government will, at the same time, reduce the valuation discount for commercial property and second dwellings in excess of the initial second dwelling from 40 to 20 per cent of market value. This will reduce the preferential tax treatment of such property as compared to listed shares and bank deposits. A more equal tax treatment may contribute to savings being invested, to a higher extent, where their returns for society are the highest.

Substantial income tax relief is also being granted. The basic allowance for wage income, benefits and pensions will be increased, and employee's social security contributions on wage income/social security benefits and on income from self-employment will be reduced. Fewer people will pay surtax, since the threshold is being increased. Hence, work will become more profitable. Moreover, the Government proposes that the phase-out of tax class 2 for married couples be completed in 2015. The proposal will

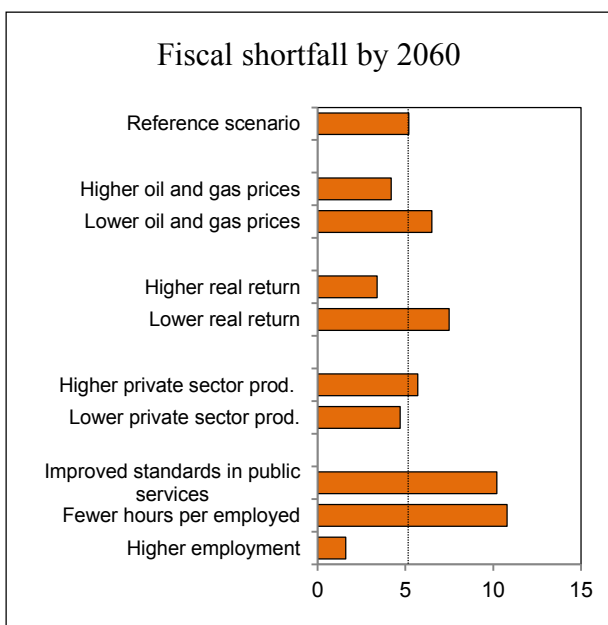


Figure 3.5 Fiscal shortfall by 2060 in different scenarios. Per cent of mainland Norway GDP

Sources: Ministry of Finance and Statistics Norway

strengthen work incentives, integration and equal opportunities, and result in more equal treatment of married couples and cohabitants.

The Government proposes significant motor vehicle tax reliefs: the motor vehicle re-registration tax will be reduced by an average of 35 per cent, while the annual weight-based tax for heavy vehicles will be more than halved. Road use taxes on fuel will fall in real terms, as the rates will not be adjusted for inflation. The motor vehicle registration tax for motorbikes and snowmobiles will be reduced by 30 per cent, and it is proposed that the annual motor vehicle tax on caravans be abolished.

Value added tax will be simplified and made more neutral, including by increasing the registration threshold. This represents a simplification for small businesses and will increase tax revenues. The Government also proposes an arrangement to neutralise value added tax for central government. This will make it easier for private service providers to compete for central government contracts and can lead to more efficient use of resources.

The Government proposes an increase in the tax collection threshold for low value imports from NOK 200 to NOK 500. Freight and insurance costs will, at the same time, be included in calculation of the threshold.

The Government will continue its efforts to achieve a more growth-oriented tax system, not least in response to feedback from the various public commissions that are currently in operation. The Scheel Commission, which is examining corporation tax in view of international developments, shall focus on proposals that contribute to efficient resource allocation and the best possible investment choice on the part of businesses. The Government has appointed a new Green Tax Commission to propose green tax changes that can shift taxation towards environmentally-harmful activities. The Government intends to present, in connection with the Revised National Budget for 2015, an overall review of motor vehicle taxes. Agricultural taxes will also be assessed with a view to simplifying the rules and bringing about a more efficient use of resources.

Further details of the tax programme can be found in the English translation of chapter 1 of the white paper on taxes and customs duties in 2015 (Prop. 1 LS (2014-2015)).

3.3 Monetary policy

The operational target of monetary policy is low and stable inflation, with annual consumer price inflation close to 2.5 per cent over time. In the short to medium term, monetary policy shall

weigh low and stable inflation against production and employment stability.

The key policy rate is Norges Bank's most important instrument, and can be adjusted quickly if the outlook for the economy indicates that this is necessary. Norges Bank has kept the key policy rate unchanged at 1.5 per cent since March 2012. The key policy rate will, according to the Norges Bank policy rate forecast per September of this year, remain unchanged until the end of 2015, after which it will be gradually raised to about 2 per cent towards the end of 2017. Many of Norway's trading partners have low key policy rates, and the market expects international rates to remain low for many years to come.

Throughout 2012 and 2013, falling risk premiums in the money and bond markets reduced the funding costs of Norwegian banks. However, the banks decided not to reduce their lending rates for households and businesses correspondingly, and their interest rate margins therefore reached all-time highs. The banks argued, among other things, that they needed to build up equity to meet new capital requirements set by the authorities. Nevertheless, several banks cut their lending rates before the summer. According to Statistics Norway's interest rate statistics, the average lending rate on a residential mortgage fell by around 0.15 percentage point from the first to the second quarter of this year. Also after the summer several banks have reduced their lending rates.

Monetary policy impacts the Norwegian economy through interest rates and, indirectly, through the krone exchange rate. Low interest rates abroad influence Norges Bank's interest-rate setting, since having a higher rate in Norway than in other countries can cause the krone to appreciate. Following appreciation over the past 10 years, the krone depreciated markedly last year, before recovering a little this year. Nevertheless, measured by the trade-weighted krone exchange rate (TWD), the Norwegian krone is still $4\frac{3}{4}$ per cent weaker now than its average for last year, and $2\frac{1}{2}$ per cent weaker than the average for the last 10 years. The krone's development influences both inflation and the real economy. The depreciation of the krone over the past year has contributed to higher consumer price inflation and improved the profitability of Norwegian businesses exposed to international competition. However, wage costs in Norwegian industry remain high compared to the trading partners.

In the National Budget 2015 it is assumed that the money market rates will develop as expected by market participants and expressed in the forward rates quoted in mid-September.

The interest rate on Norwegian 10-year government bonds has fallen over the past year, and

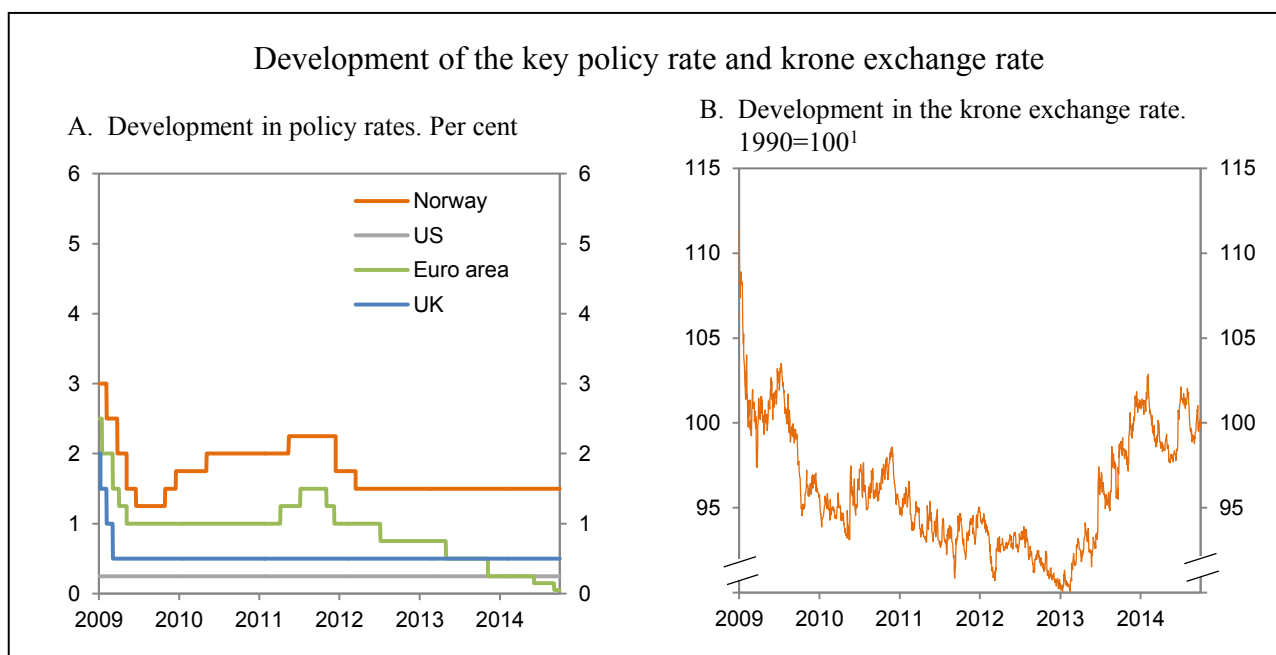


Figure 3.6 Development of the key policy rate and krone exchange rate

Source: Macrobond.

was 2.3 per cent in late September. This rate is low from a historical perspective, and must be viewed in the context of low long interest rates internationally.

3.4 Financial stability

3.4.1 General

The Norwegian authorities are committed to financial markets regulation that is uniform across the entire financial sector and that regulates the various parts of the financial market in a consistent and integrated manner. Norway also has a single supervisory authority for the entire financial industry. This promotes consistency in supervision across sectors, makes it easier to monitor financial industry development and provides a better basis for assessing risk in the financial industry as a whole. In the development of the regulatory framework, emphasis is also given to the consideration of competition between Norwegian and foreign banks.

3.4.2 Financial markets regulation

EU supervisory bodies

With effect from 1 January 2011, the EU established a new common supervisory structure for the financial markets area. Three micro-supervisory bodies were established for the banking sector (EBA), pensions and insurance sector (EIOPA) and securities sector (ESMA), respectively, in addition to a macro-supervisory body

(ESRB). The three micro-supervisory bodies have been given certain supranational powers, in that they may make decisions that are binding on national supervisory bodies and on individual institutions in member states in certain areas.

The Norwegian authorities emphasise maintaining well-functioning EEA cooperation in the financial services area. The regulations establishing the new supervisory structure may, however, not be included in the EEA Agreement until an acceptable EEA solution is found. The EEA/EFTA states and the European Commission have since 2010 been cooperating towards finding an acceptable EEA solution.

Until a solution is agreed upon, new acquis which make use of the supranational powers over market participants in the new supervisory system may not be taken into the EEA Agreement. The Norwegian authorities do, however, develop Norwegian legislation in line with developments in the EU framework.

Capital and liquidity requirements for banks and investment firms

The EU's new capital requirements regulations – referred to as CRR/CRD IV – entered into force on 1 January 2014. Although the new regulations have not yet been incorporated into the EEA Agreement (since these also give the supervisory bodies EU-wide jurisdiction), the Ministry of Finance has introduced new, stricter statutory requirements regarding the capital reserves of bank operating in Norway, based on the new EU rules.

Nordic cooperation

The cooperation between the Nordic countries encompasses, among other things, an agreement on the mutual recognition of risk weights for residential mortgages and counter-cyclical capital buffers. This is referred to as host state regulation.

On 16 January 2014, the Financial Supervisory Authority of Norway sent the supervisory authorities of Denmark and Sweden a letter discussing the planned introduction of stricter requirements for banks that use internal models to calculate capital requirements (IRB banks), including estimates of important parameters used to calculate capital requirements for residential mortgages in Norway. In a letter of 6 February 2014, the Danish Financial Supervisory Authority expressed strong support for Norway's proposal, and agreed that the requirements should apply to all IRB banks providing residential mortgages in Norway. In a letter dated 11 March 2014, the Swedish Financial Supervisory Authority also responded positively, expressing its intention to implement the same requirements for Swedish banks operating in the Norwegian market through pillar II when the Financial Supervisory Authority of Norway implements the notified restrictions. This is an important step forward in Nordic harmonisation efforts.

The Ministry of Finance also considers transparency about and simple comparability of the real risk levels of banks in different countries an important contribution to well-functioning financial markets and the efficient pricing of debt and equity costs. The Norwegian authorities wish to explore the possibility of requiring all Nordic authorities to specify their banks' capital ratios according to a common set of simplified risk weights. A simplified reporting standard of this type would allow the capital ratios of different Nordic banks to be compared independently of the national rules.

The Ministry of Finance has also informed its Nordic sister ministries of its decision not to incorporate the EU provisions on reduced capital requirements for small and medium-sized businesses – known as the SMB discount – into the Norwegian regulations. In Norway's view, it is important that home state authorities consider the macroeconomic situation and capital requirements in the host state when assessing the risk and capital levels of home-state banks with branches in the Nordic region.

4 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 expenditure and to support long-term considerations in the spending of government petroleum revenues. Sound long-term management of the Fund contributes to intergenerational equity, by allowing both current and future generations to benefit from the petroleum revenues.

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 carried out by Norges Bank and Folketrygdfondet, respectively, under mandates laid down by the Ministry of Finance.

The strategy of both the GPFG and the GPFN seeks to achieve the highest possible return over time, subject to a moderate level of risk. 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 professional analyses and thorough assessments. The Ministry will, in seeking to further develop the investment strategy, attach special weight to exploiting the special characteristics of the Fund, as a large investor with a long time horizon and limited liquidity needs. It will aim to further improve the ratio between expected risk and return.

The Government Pension Fund has a very long time horizon. The Fund does not have clearly defined liabilities, and it is unlikely that the State will be withdrawing large amounts from the Fund over a short period of time. These characteristics mean that the Fund is, generally speaking, better positioned to absorb risk than most other investors.

The Ministry emphasises the Fund's role as a responsible investor. Good long-term financial return is assumed to depend on sustainable development in economic, environmental and social terms, and on well-functioning, efficient and legitimate markets.

The Government aims for the Government Pension Fund to be the best managed fund in the world. This requires identifying and reaching for international best practice with regard to all aspects of fund management. Transparency is a prerequisite for securing widespread confidence in the management of the Fund. Operational management performance is reported by Norges

Bank and Folketrygdfondet on a regular basis. The Ministry reports on the management of the Fund in the National Budget and in an annual report to the Storting during its spring session, cf. Report No. 19 (2013 – 2014) to the Storting – The Management of the Government Pension Fund in 2013.

Chapter 4.2 discusses 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 Government Pension Fund.

4.2 Asset management performance

4.2.1 The market value of the Government Pension Fund

The total market value of the Government Pension Fund was NOK 5,661 billion as per the end of the first half of 2014. This represents an increase of NOK 456 billion on the value at the beginning of the year. The GPFG accounted for almost 97 per cent of total market value. Figure 4.1 shows developments in the market value of the Government Pension Fund over the period from May 1996 until June 2014.

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

The market value of the GPFG was NOK 5,478 billion as per the end of the first half of 2014. This represents an increase of NOK 440 billion since the beginning of the year. The inflow of new capital to the Fund during the first six months of the year was NOK 88 billion. The return over this period accounted for NOK 270 billion. Just under NOK 3 billion was used to cover Norges Bank's costs related to the management of the GPFG in 2013. Changes in the Norwegian krone exchange rate entailed, when taken in isolation, a NOK 85 billion increase in value. Asset management costs over the period were somewhat in excess of NOK 1 billion.

At the end of June, 61.3 per cent of the Fund was invested in equities, 37.6 per cent in bonds and 1.2 per cent in real estate.

The return on the GPFG during the first half of the year was 5.0 per cent, as measured in the currency basket of the Fund. When measured in Norwegian kroner, the return on the Fund was 7.0 per cent. The difference between the return in Norwegian kroner and in the currency basket of the Fund was caused by the Norwegian krone depreciating somewhat relative to the currency basket of the Fund over this period. However, the return in international currency is the relevant measure with regard to developments in the international purchasing power of the Fund over time.

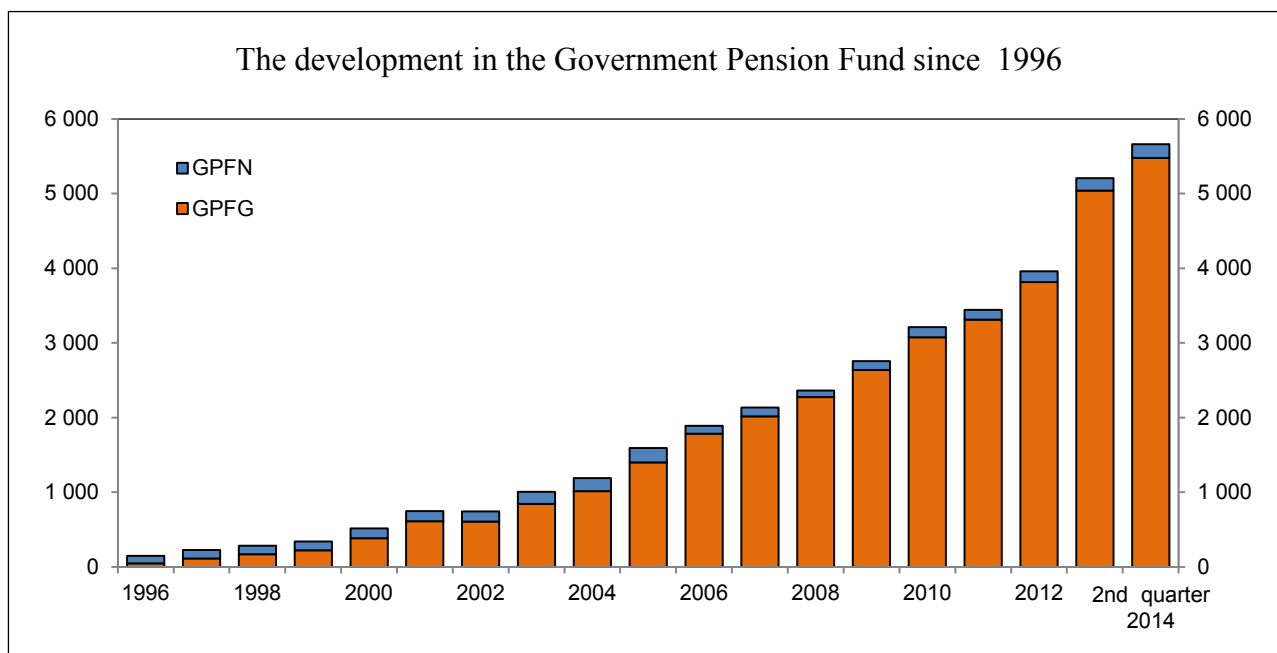


Figure 4.1 Developments in the market value of the Government Pension Fund since 1996. NOK billion¹
¹A major part of the GPFN assets was invested with the Treasury in the form of mandatory deposits until 2005. The mandatory deposits were discontinued in December 2006. This implied that the State redeemed deposits valued at NOK 101.8 billion, and that a corresponding amount was repaid to the State from fund assets.

Sources: Norges Bank, Folketrygdfondet and the Ministry of Finance.

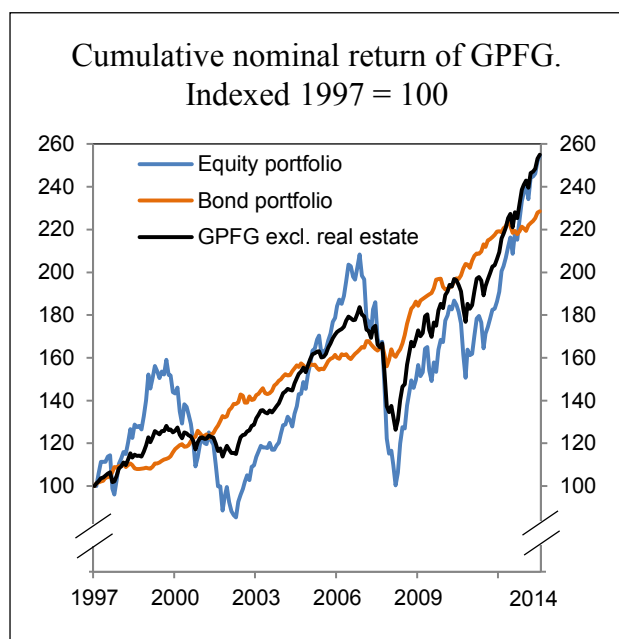


Figure 4.2 Developments in the nominal value of the sub-portfolios of the Government Pension Fund Global, as measured in the currency basket of the Fund. Index value as per yearend 1997 = 100.

Sources: Norges Bank and the Ministry of Finance.

The return on the equity portfolio was 5.5 per cent, the return on the bond portfolio was 4.1 per cent, and the return on the real estate portfolio was 5.1 per cent, as measured in the currency basket of the Fund. The establishment of the real estate portfolio is still in an early phase. The currency composition of the real estate portfolio deviates from the currency basket of the Fund and exchange rate fluctuations can, when taken in isolation, have a major impact on the measured return. For the first half of 2014 as a whole, exchange rate fluctuations reduced the measured return on the real estate portfolio by about 0.4

percentage point. Figure 4.2 shows developments in the value of the equity and bond portfolios since 1 January 1998.

The return on the equity and bond portfolios is evaluated against a benchmark index. All in all, Norges Bank achieved a return in the first half of 2014 that was 0.11 percentage point lower than the return on the benchmark index. Both the equity portfolio and the bond portfolio had lower return than the benchmark. Over the last three years, the management of the equity and bond portfolios generated an annual gross excess return of 0.23 percentage point. When measured since 1998, the corresponding annual gross excess return was 0.30 percentage point, cf. table 4.1.

The return on the real estate portfolio is compared to a return benchmark in the form of an index of unlisted real estate by IPD. The benchmark represents developments in the value of many properties across a number of countries. It will, as outlined in Report No. 10 (2009–2010) to the Storting, take a long time to develop the real estate portfolio. One should thus be cautious about evaluating the performance of Norges Bank against the real estate benchmark during the development phase of the real estate portfolio, and such performance should in any event be evaluated over several years. Each year, the Ministry receives a report prepared by IPD which includes analyses of the return on the real estate portfolio (www.government.no/gpf).

The average annual net real rate of return, i.e. the nominal rate of return net of asset management costs and inflation, is calculated to be 3.7 per cent, as measured in the currency basket of the Fund, from January 1998 until the first half 2014, inclusive. When measured from January 1997, the average annual net real rate of return is calculated to be 3.9 per cent.

Table 4.1 Key figures for the Government Pension Fund Global as at 30 June 2014. Annual data. Percent

Government Pension Fund Global (as measured in the currency basket of the Fund)	Last 12 months	Last 3 years	Last 5 years	Last 10 years	Since 1 January 1998
Nominal return.....	15.39	9.55	11.56	6.53	5.83
Inflation	1.83	1.86	2.11	2.13	1.92
Asset management costs.....	0.06	0.07	0.08	0.09	0.09
Net real rate of return	13.26	7.49	9.16	4.22	3.75
Excess return (gross)	0.15	0.23	0.80	0.20	0.30

Source: Norges Bank.

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

The market value of the GPFN was NOK 183.5 billion as per the end of the first half of 2014. This represents an increase of NOK 16 billion since the beginning of the year. At the end of June, 62.3 per cent of the Fund capital was invested in equities, whilst 37.7 per cent was invested in bonds.

The return on the GPFN in the first half of 2014 was 9.3 per cent, as measured in Norwegian kroner. The return on the equity portfolio was 12.2 per cent, whilst the return on the bond portfolio was 4.5 per cent. The Norwegian equity portfolio delivered a return of 12.6 per cent, whilst the return on the Nordic equity portfolio was 9.9 per cent. The return on the Norwegian and Nordic bond portfolios was 4.7 per cent and 3.5 per cent, respectively. A depreciation of the Norwegian krone over this period had a positive impact on the return on the Nordic bond portfolio.

In the first half of 2014, Folketrygdfondet generated a return on the GPFN that exceeded the return on the benchmark index stipulated by the Ministry of Finance by 0.27 percentage point. Both equity management and bond management generated a positive excess return. Over the last three years, the management of the fund generated an annual gross excess return of 0.03 percentage point, and 0.43 percentage point since 1998, cf. table 4.2. The annual nominal return over this period was 7.5 per cent.

4.3 Current issues in the management of the Government Pension Fund

4.3.1 Responsible investment in the Government Pension Fund Global

The report on the management of the Government Pension Fund in 2013 outlined the plans of

the Ministry for strengthening responsible investment in the GPF, cf. Report No. 19 (2013-2014) to the Storting. The changes were based on advice from the Strategy Council for the GPF. A majority in the Storting endorsed the strengthening of responsible investment by, inter alia, modifying the division of responsibilities between the Ministry of Finance, the Council on Ethics and Norges Bank with regard to the observation or exclusion of companies. The Ministry is currently redrafting relevant governance documents to reflect the input from the Storting. It is intended for the changes to enter into effect as from yearend. The Ministry will report the changes in the annual report on the Government Pension Fund, which will be submitted to the Storting in the spring of 2015.

4.3.2 The expert group on coal and petroleum investments in the Government Pension Fund Global

On 4 April 2014, the Ministry of Finance appointed, in line with the Storting's petition resolution of 20 March 2014 (Resolution No. 366 (2013-2014)) an expert group to evaluate whether the exclusion of coal and petroleum companies is a more effective strategy for addressing climate issues and promoting future change than the exercise of ownership rights and the exertion of influence. The expert group shall also advise on potential exclusion criteria for these types of companies. The group shall not advise on the general strategy for responsible investment practice or other aspects of the management strategy for the GPF. The mandate for the group is published in its entirety on the Ministry of Finance website (www.government.no/gpf).

The expert group has held a number of meetings with external stakeholders and researchers, including a feedback meeting with broad partici-

Table 4.2 Key figures for the Government Pension Fund Norway as at 30 June 2014. Annual data. Percent

Government Pension Fund Norway	Last 12 months	Last 3 years	Last 5 years	Last 10 years	Since 1 January 1998
Nominal return.....	21.51	11.20	13.21	8.20	7.49
Inflation	1.94	1.48	1.53	1.86	1.99
Asset management costs.....	0.09	0.09	0.09	0.07	0.05
Net real rate of return	19.10	9.48	11.41	6.15	5.34
Excess return (gross)	-0.12	0.03	0.33	0.53	0.43

Sources: Folketrygdfondet, Statistics Norway and the Ministry of Finance.

pation from non-governmental organisations at the University of Oslo on 18 June 2014.

The recommendations of the expert group will be presented in November 2014 and will thereafter be subjected to open discussion. The recommendations and feedback from the open discussion will form part of the basis for the report on the management of the Government Pension Fund in the spring of 2015.

5. Policy measures for enhancing productivity and economic efficiency

5.1 Key challenges and focal areas for the Government

Gross domestic product per capita in Norway has multiplied several times over in the last 150 years. The same developments have been witnessed in other countries taking part in the industrial revolution. Wealth has not expanded as the result of longer working hours, but because production per hour of work has multiplied several times over, cf. Figure 5.1.

The petroleum sector has contributed considerably to growth in the mainland economy over the last 45 years, but will not provide the same growth impetus for the mainland economy in coming years. It is estimated that demand from the petroleum sector will be halved over the period until 2030, from the current level of close to 14 per cent of Mainland Norway GDP. This makes it imperative for those currently supplying this sector to find new markets and/or refocus their production on other types of goods and services.

The Government's promotion of a more productive economy

The Government is highly committed to improving the use of resources and increasing the productivity of the Norwegian economy.

The Government has appointed a Productivity Commission to identify and analyse the causes of the slowdown in productivity growth since 2005. The Commission is called upon to submit specific proposals to strengthen productivity and growth in the Norwegian economy, in both the private and the public sector. The Government is addressing structural policy issues on an ongoing basis, in parallel with the activities of the Productivity Commission. The structural policy focus of the Government may be summarised under the following five headings:

Public sector reform: Public sector reform shall promote the most efficient use of society's resources. The public sector in Norway is large, with just over 30 per cent of all employees working in the public sector. Some major and many minor steps need to be taken to improve the use of resources. Improving the efficiency and effectiveness of the public sector is discussed in Chapter 6.

Promoting competition, deregulation and de-bureaucratisation: The Government will increase growth in the Norwegian economy by promoting competition, deregulation and de-bureaucratisation. The Government will pave the way for a free and independent business sector without special treatment or anti-competitive agreements, a free flow of goods and services and free access to markets.

An improved tax system: The main tax policy objective of the Government is to fund public

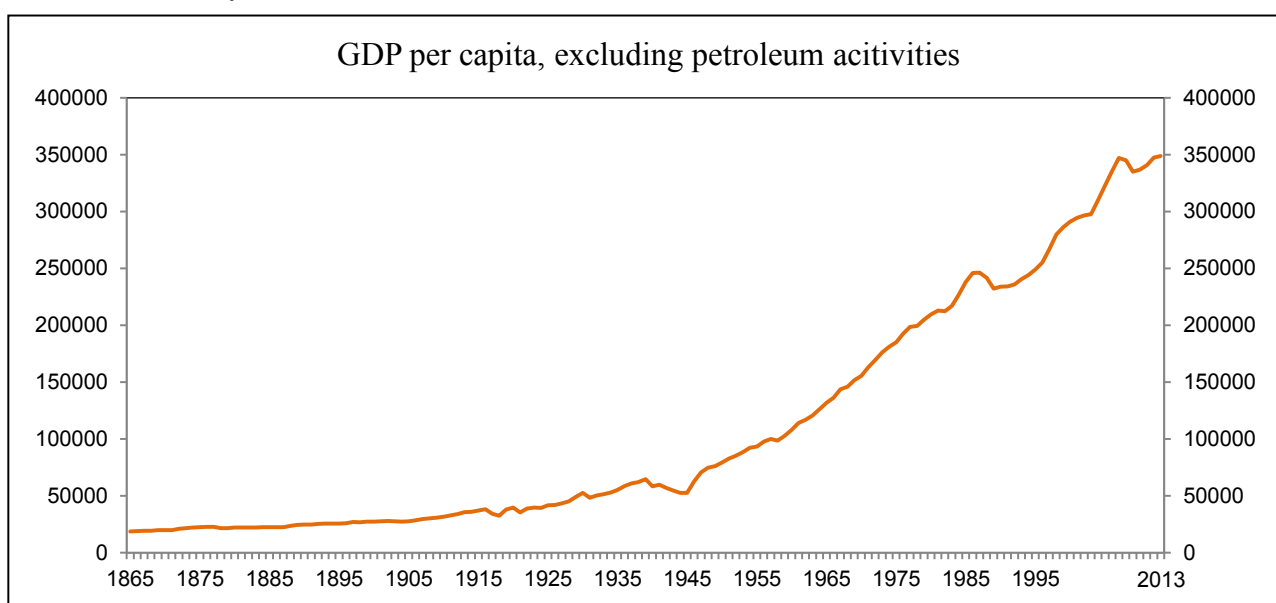


Figure 5.1 GDP per capita, excl. petroleum activities. NOK thousands at 2005 prices
Source: Statistics Norway.

goods and services in the most efficient manner. The Government will make the tax system simpler and more conducive to growth. Working, saving and investing shall pay off, and the tax system shall stimulate more environmentally-friendly behaviour. The Government will reduce the overall tax level to diffuse power, expand economic activity and provide more freedom for families and individuals. Further details on the tax proposal for 2015 may be found in the English summary of Chapter 1 of the bill and draft resolution on taxes.

More focus on outcomes: More focus on outcomes implies that prioritisations are also based on what outcomes can be realised. Good and relevant information is of key importance to this.

Clear budget priorities: Clear budget priorities are of important to achieve the objective of delivering the best possible services and the maximum welfare for the money spent via government budgets. The realisation of productivity gains in the public sector is of key importance in this regard. Effective and efficient use of resources is about doing the right things and doing them in the right manner. Consequently, prioritisation is also about curtailing resource inputs in less important areas.

5.2 Efficiency enhancement measures in product markets

5.2.1 More competition

Competition policy

The competition policy measures include the Competition Act for businesses, state aid regulations and regulations on public procurement. Competition policy is broad in scope and targets both anti-competitive conduct amongst players in the business sector and anti-competitive government initiatives.

Administrative appeals over the intervention decisions of the Competition Authority are today heard by the Ministry of Trade, Industry and Fisheries. The administrative appeals procedure of the Ministry does not allow for political considerations, but it is nonetheless a challenge that the proceedings may be perceived as politically influenced. The Government will strengthen the Competition Authority as an independent government body and abolish the role of the Government as an administrative appeal body for the Competition Authority. A government appointed committee is examining the organisation of a new, independent appeals tribunal for competition matters, which is intended to be established from 1 January 2016.

Network industries

Power grid: Power exchange with other countries serves to strengthen the security of supply and improve the utilisation of power resources. A new link to Denmark is under construction, and Statnett has applied for a licence to facilitate power exchange with Germany and the United Kingdom. The cost of constructing and operating such links needs to be balanced against the benefits from expanded exchange.

Railways: The Government wants to make the transport sector more efficient and economically profitable via organisational and structural improvements to the railway sector. The Government has embarked on a reform of the railway sector to bring about an appropriate management structure, a commercial organisational structure and clear objectives.

Airports: Norway has 52 airports with scheduled civil air traffic operations. The government-owned limited company Avinor is responsible for 46 airports, which account for the majority of passenger traffic in Norway. In June 2014, Avinor reorganised its air safety division into a wholly-owned subsidiary, Avinor flysikring AS. Such reorganisation facilitates the future exposure of air safety to competition.

Post: At present, Posten Norge AS has a monopoly on the distribution of sealed letters weighing less than 50 grams. The Government will incorporate the EU's Third Postal Directive into Norwegian law and abolish the monopoly. The Ministry of Transport and Communications is currently preparing a draft new Postal Services Act.

Neutral value added tax for central government and health trusts

The central government sector falls predominantly outside the scope of the value added tax system. The Government proposes the introduction of an arrangement under which value added tax is accounted for on a net basis by central government bodies as from 1 January 2015. This will result in value added tax no longer being recorded as a cost to such government bodies, thus putting an end to the current competitive disadvantage of private players. In addition, this facilitates more efficient resource use on the part of central government, since value added tax will no longer prevent the cheapest offer from being accepted. Moreover, the Government is examining an arrangement to neutralise value added tax for health trusts.

5.2.2 Deregulation and de-bureaucratisation

The Government wants to simplify everyday life for ordinary businesses and people. Renewing, simplifying and improving the public sector

are important aspects of this. The objective is to increase freedom in everyday life and to simplify interaction between the public sector and the population by way of simpler rules, less bureaucracy and more active use of ICT.

Simplifications for the business sector

The Government aims for the costs incurred by businesses in complying with government-imposed reporting requirements and regulations to be reduced by NOK 15 billion by yearend 2017, relative to the level of such costs in 2011. This will represent a 25 per cent reduction. The Government proposes the establishment of an *independent regulation council* to examine new proposed regulations and issue advisory statements. The council shall assess whether the implications of new regulations for the business sector have been adequately examined, as well as whether the regulations are drafted such as to realise the objective of a relatively low administrative cost to the business sector.

Altinn is an Internet portal providing information on starting and running a business in Norway, and is the point of access for digital services from the public sector. The infrastructure can provide services for both the business sector and private individuals. The Tax Administration, the Norwegian Labour and Welfare Administration and Statistics Norway have initiated pilot testing of a scheme for simplifying employment reporting for employers, offering potential annual savings of NOK 500 million for the business sector. The Brønnøysund Register Centre has also embarked on the development of a service for the electronic incorporation of limited companies, completion of which is planned for 2015. Altinn will thereby provide digital services from the start to the end of the lifecycle of a business, on one platform.

The report of the Simplification Committee was circulated for comments by the Ministry of Trade, Industry and Fisheries in June 2014. The report presents a proposal for new Norwegian public procurement regulations for those procurements falling outside the scope of the EU Procurement Directive. It is intended that the new regulations will enter into effect on 1 January 2016.

This year's *Agricultural Settlement* involves measures to expand the scope for individual solutions at the farm level and to increase the farmer's control of his or her own property. The objective is for such solutions to be determined by the resources available locally and the expertise and interests of farmers, rather than government restrictions and complex subsidy schemes.

Measured productivity developments in the

building and construction industry have been weak over the last 15-20 years. Productivity declined over the period from 1995 to 2005, but has increased somewhat in the last few years. These developments may be caused by various structural characteristics of the industry and the framework within which it operates. The Government has proposed a number of measures to simplify and improve the efficiency of planning and building permit processes, including a permit exemption for carports and similar buildings, abolishing the right of neighbours to object about matters previously resolved during the planning and building permit process, and stricter time limits for the completion of such processes. In addition, it is proposed that new area requirements and access requirements for homes be eased to make it easier to build homes with a good layout. The objectives are less bureaucracy, more equal treatment and more predictable processes.

Simplifications for the population

Although Norway has a well-functioning public sector, encounters with government bodies can be time consuming and complex. The Government is therefore strongly committed to improving services and speeding up administrative procedures, and a key objective is to eliminate unnecessary time use for people. Simplification of laws and regulations also makes it easier for people to understand and observe the rules. This may reduce the amount of resources devoted to regulatory compliance. Another form of simplification is to promote simpler language in letters and forms issued by government bodies, as well as in laws and regulations.

5.2.3 Government ownership

The State holds major ownership interests in Norway, and the ministries manage government ownership stakes in about 70 companies. The Government holds the facilitation of diverse and value-enhancing ownership and the strengthening of private ownership to be key features of its focus on improving Norwegian competitiveness. The Government is of the view that private ownership should be the main rule within the Norwegian business sector, and the objective over time is to reduce direct government ownership stakes in companies in which there are no special reasons for the State to retain holdings. The Government has therefore embarked on preparations for a gradual reduction in direct government ownership interests. At the same time the Government believes that there are sound reasons for the State to hold ownership stakes in certain companies.

5.2.4 Innovation policy

Innovation can enhance the competitiveness of the business sector via new or improved products and processes, or via organisations that work better and compete in new markets. Innovation is knowledge-intensive and is often based on research and development (R&D). In 2011, government-funded R&D accounted for about 47 per cent of total R&D expenditure. The budget proposal of the Government allocates about NOK 32.4 billion to research and development in 2015, including the Skattefunn R&D tax incentive scheme. This is estimated to represent an increase of about NOK 2.3 billion from 2014; corresponding to an increase of 4.2 per cent in real terms.

In Norway, most of the innovation policy measures at the enterprise level are under the administration of *Innovation Norway*. The Ministry of Trade, Industry and Fisheries has initiated a

review of the organisation of Innovation Norway with a view to achieve more effective operations and governance, an efficient office structure and a higher degree of goal attainment.

5.3 State aid

Government measures that give financial advantages to a business or a group of businesses may be defined as state aid. State aid may take many forms, from straightforward grants to protection from international competition. The state aid calculations of the Ministry of Finance include subsidy schemes on the expenditure side of the fiscal budget, i.e. grants, loans or guarantees granted on preferential terms, as well as the lack of a required rate of return for government-held ownership stakes. The net costs associated with preferential tax rules for certain parts of the business sector (tax expenditure) are not classi-

Table 5.1 breaks down total budgetary state aid by recipient industry. *Agricultural aid* accounted for two thirds of total state aid on the expenditure side of the budget in 2013. Most of the budgetary aid for agriculture is channelled through the Agricultural Agreement.

Budgetary state aid by object. Net costs. NOK million at 2013 prices¹

Object	2003	2008	2012	2013	Estimate 2014
<i>Horizontal aid</i> ²	3.4	3.7	5.2	4.3	5.0
Of which:					
R&D ³	0.7	1.2	1.2	1.3	1.3
Regional ⁴	1.5	1.5	1.4	1.4	1.2
SME ⁵	0.4	0.4	0.5	0.5	0.4
Environment and energy.....	0.4	0.5	1.8	1.0	1.7
<i>Industry-specific aid</i> ⁶	20.2	18.3	18.1	18.0	18.0
Of which:					
Agriculture.....	16.8	14.4	14.8	14.8	14.9
Fisheries and aquaculture	0.2	0.2	0.1	0.1	0.1
Shipbuilding ⁷	1.1	0.3	0.2	0.1	0.1
Shipping.....	0.9	2.1	1.7	1.7	1.7
Total	23.7	22.0	23.4	22.3	23.1

¹ Deflated by annual inflation for the gross domestic product of Mainland Norway.

² Includes aid for certain labour market measures (aid for intra-enterprise training and a portion of aid for temporary training positions).

³ Only includes aid for projects in which business-sector players are direct contracting parties, i.e. direct research aid at the enterprise level. Central government investments in the technology centre at Mongstad or planning expenditure relating to a full-scale facility are not included.

⁴ Includes aid for various regional development measures. Part of such aid is recorded for fiscal account purposes when transferred to the aid administrator.

⁵ Includes, inter alia, disbursements from Innovation Norway's country-wide development grants, guidance, entrepreneur grants, export program for small and medium-sized enterprises, as well as the seed capital funds.

⁶ Includes, inter alia, disbursements from the specific appropriations for project-oriented technology development within the petroleum sector.

⁷ Includes a portion of the government shortfall from the clearing account relating to the aid scheme for capital goods exports (the 108 scheme).

Source: Ministry of Finance.

fied as budgetary state aid. Industry-specific aid, regional aid and research aid at the enterprise level are all considerably higher when aid in the form of tax relief is taken into account.

Total state aid on the expenditure side of the budget was NOK 22.3 billion in 2013. Since 2005, budgetary state aid has increased by about NOK 1.3 billion in real terms. State aid measured as a portion of gross domestic product was 0.74 per cent in 2013.

State aid may also be granted in the form of schemes that are neither reflected on the expenditure side of the fiscal budget, nor classified as tax expenditure. Such aid may involve sheltering from international competition, licensing rules that increase barriers to entry within an industry or other regulations that confer advantages on specific businesses.

5.4 Policies for efficient use of labour

The Government wants a secure and flexible labour market that ensures high employment and low unemployment. A well-functioning labour market and a high skill level enable as many people as possible to realise their potential and enable businesses to get access to the knowhow they need. The scope for expanding total employment is limited by a large portion of the working-age population drawing various health-related benefits, as well as by the work effort, as measured in hours, not being particularly high in Norway. In order to ensure a large and efficient labour force, the regulatory framework, including tax and social security schemes, needs to be designed to make work profitable.

At the end of the first half of 2014, about 18 per cent of the working-age population was registered as recipients of health-related social security benefits. This share has remained fairly stable since the early 2000s, but there have been major differences in terms of gender and age group. Health-related benefits are received by a much larger number of older people than younger people. However, in recent years the disability rate has declined for those over the age of 50 years, whilst it has increased for those below the age of 50 years. If work assessment allowance recipients are included, the increase has been especially high for the youngest age groups.

Bringing sickness absences down, require a close cooperation between the social partners and the Government. The Inclusive Working Life Agreement (IA Agreement) was extended for another four-year period this spring. The overarching objectives and measures remain unchanged, including the goal of reducing sickness

absence by 20 per cent relative to the second quarter of 2001. The Government is now proposing two additional measures to reduce sickness absence; support for physicians (diagnose-based sickness benefit caps) and trials involving a new medical assessment after six months of sickness absence.

The Government intends to submit a report to the Parliament (Storting) this autumn on strategies to enable more people to participate in ordinary working life. Moreover, the Government has announced a number of knowledge and skill initiatives, inter alia in line with recommendations in a report from the OECD recently. The Government is also proposing some specific measures that will strengthen work incentives in particular for vulnerable groups. The budget proposal includes changes to the child supplement under the disability benefit scheme, abolition of the holiday allowance supplement for unemployment benefit recipients and a reduction in the maximum period for the payment of transitional benefits.

The Government is examining the regulatory framework governing working life, with a focus on simplification and increased flexibility. An expert committee shall review the operations of the Norwegian Labour and Welfare Administration over the course of the year. The objective is to make this service more transparent and user friendly, as well as to cut back on unnecessary bureaucracy. New regulations on the simplification of transitional and follow-up measures will enter into effect from 2015. This regulatory amendment will allow for increased competition in offering labour market measures.

Amendments to the provisions governing, inter alia, working hours in the Working Environment Act are circulated for comment. It is proposed that the provisions governing temporary employment, especially in the private and municipal sectors, be liberalised somewhat. Moreover, the Government has recently appointed a committee to examine working hours. The committee shall study different ways of organising work, as well as both statutory and contractual regulations. The Productivity Commission is also addressing these issues.

In Norway, *labour market measures* have long been used to reduce passivity and exclusion amongst the unemployed. The labour market measures are partly targeted at jobseekers, and partly at people with a reduced capacity for work. In 2015, the Government proposes on average 12,000 measures will be provided for jobseekers and 56,700 for people with an impaired work capacity.

6 Efficient and effective government

6.1 Norway's public sector

In Norway, the public sector fulfils a number of functions that in many other countries are the responsibilities of families or private institutions. This way of organising society gives Norway a large public sector. The state receives considerable revenues from the petroleum sector, and the general tax level is high compared with most other countries. The Government will manage the taxpayer's money carefully. This implies that the public sector must be efficient and effective. Results must be reviewed openly and frankly. Resources must be channelled to the most important tasks and to those measures that prove to work best.

Total general government outlays are estimated at around NOK 1,500 billion in 2015. This corresponds to around 59 per cent of mainland GDP. General government consumption corresponds to 28 per cent of mainland GDP and 22 per cent of total GDP. This is high compared both to the OECD average and the EU average, cf. Figure 6.1. Around 30 per cent of all employees work for the government, which is the highest share in any OECD country, cf. Box 6.1. The size of Norway's public sector underscores the importance of ensuring that the resources it deploys are used as efficiently as possible.

A well-organised public sector is also important for trust in government. The share of citizens that have confidence in the government is high in Norway, cf. Figure 6.1. In *Government at a Glance 2013*, the OECD points out that high trust in government may make it easier to mobilise support for necessary reforms, particularly where short-term sacrifices are involved and long-term gains might be less tangible.

6.2 Structural reforms in the central government

The need for better overall management of the public administration constituted the backdrop to the *creation of the Ministry of Local Government and Modernisation* from January 2014, with responsibility for both the central and local government administration. A unified ministry for central and local government administration provides a better basis for the coordination of central government policy implementation.

The Government has recently presented a reform to *modernise the administration of direct and indirect taxes*, and enhance its efficiency. The ad-

ministration of excise duties and value added tax on imports shall be transferred from the Customs and Excise Administration to the Tax Administration. The Norwegian National Collection Agency will, at the same time, be incorporated into the Tax Administration. It is also proposed that tax collection be transferred from the municipal tax collectors to the Tax Administration. Consequently, responsibility for assessing, collecting and checking direct and indirect taxes will be unified in one government body, whilst a reconstituted customs administration will be enabled to focus on its core duties. This can over time reduce the number of employees by 400-500 man-years and generate considerable savings. The objective is, at the same time, improved legal safeguards and simplification for the population and the business sector.

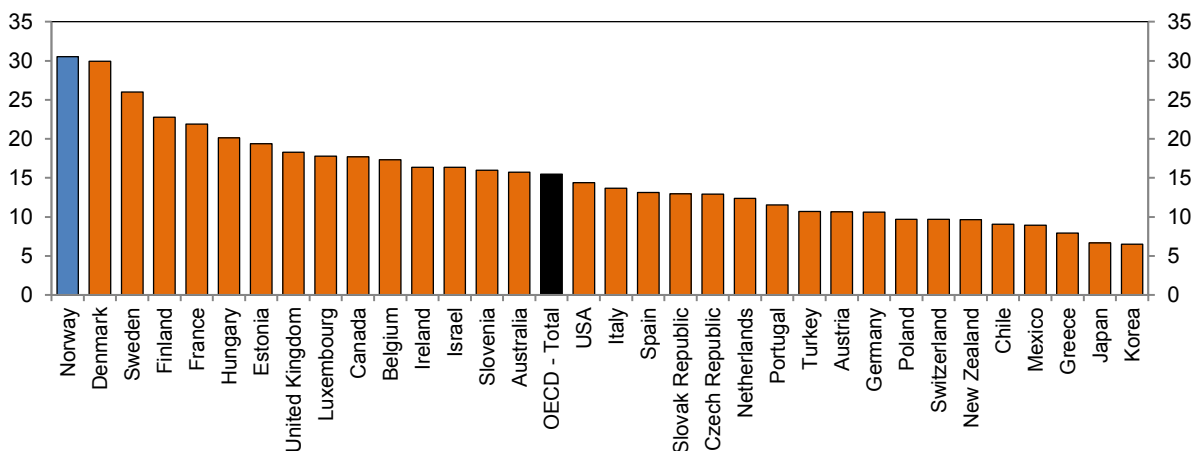
The NOU 2013: 9 Green Paper; *One Police Service – Prepared to Face Future Challenges (the Police Assessment)*, identifies developments in society that will subject a good police service to new requirements, whilst efficient execution of the core police duties necessitates a high level of specialisation, professional expertise, training and development in all parts of the police service. The committee proposed a structural and qualitative reform. The structural reform encompasses proposed changes to the portfolio of duties assigned to the police, as well as a new structure for the organisation of the police. The Government will revert to the Storting on the follow-up of this reform, including, inter alia, a new police district structure. The National Police Directorate is following up on the quality reform. It is intended to pave the way for improved management and operation of the police service, as well as increased quality in the delivery of police services. The Directorate is in the process of developing a unified structure for improved management and operation of the police service, with a view to assuming, inter alia, a more prominent role in change, service delivery and professional development within the police service.

The current *university college and university structure* is not in tune with the Government's ambition for Norway to be a leading knowledge nation contributing to the solution of global challenges. The Government will in 2015 submit a report to the Storting on structural changes to the university college and university sector. These changes shall provide a good framework for higher quality in education and research, by paving the way for more high-profile institutions, robust centres of expertise and a cost-effective sector.

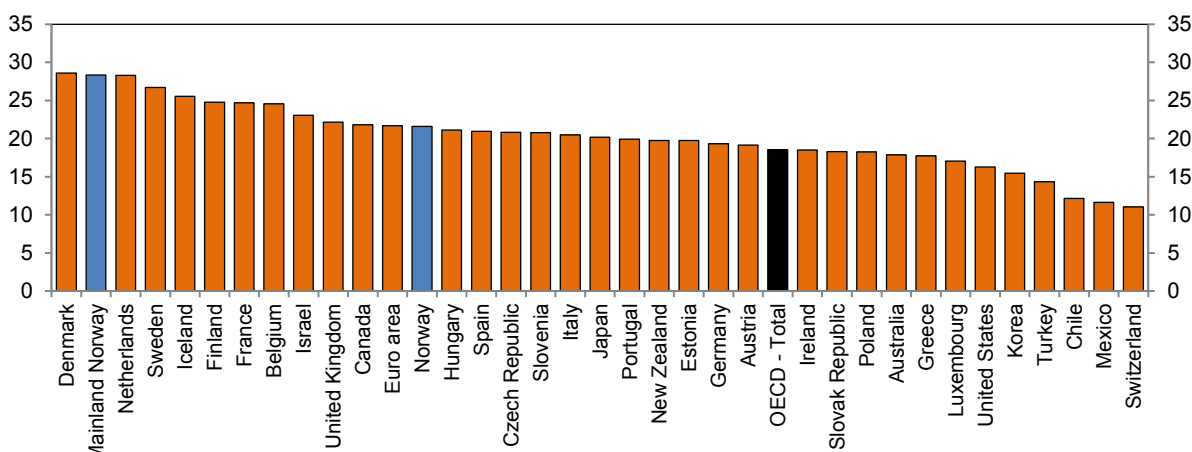
A partly performance-based system for the *funding of the university college and university sec-*

The size of the public sector and citizens' trust in government

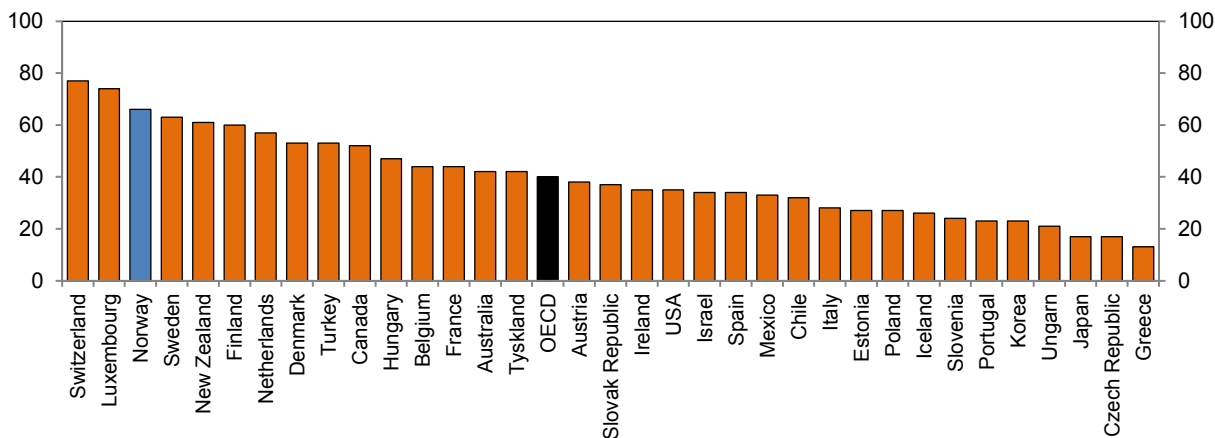
A. General government employment. Per cent of total employment. 2011



B. General government consumption expenditure. Per cent of GDP. Average 2010-2012



C. Per cent of citizens who have confidence in their national government. 2012



Figur 6.1 The size of the public sector and citizens' trust in government
Source: OECD.

Boks 6.1 Public sector employment

Public sector employment as a portion of total employment increased steeply from 1970 until about 1990, cf. Figure 6.2A. This has to do with, inter alia, the expansion of the Norwegian welfare state and the introduction of welfare schemes in step with the phase-in of oil revenues into the economy. The increased need for manpower was to a large extent met by growth in female labour force participation. Since the early 1990s, public sector employment has increased more or less in line with private sector employment.

Expansion of the health and care sector has been a particularly important driver behind the increase in public sector employment, and growth within this area has continued also after 1990. The health and care sector has increased its share of total employment from 15 to 20 per cent over the last 25 years. Demand for health, care and education services will depend on the size and composition of the population. However, calculations show that population developments only explain about one third of the health and care sector growth since 1990. Most of the growth is caused by ever more extensive services being provided to ever larger groups of the population (higher standard and expanded coverage).

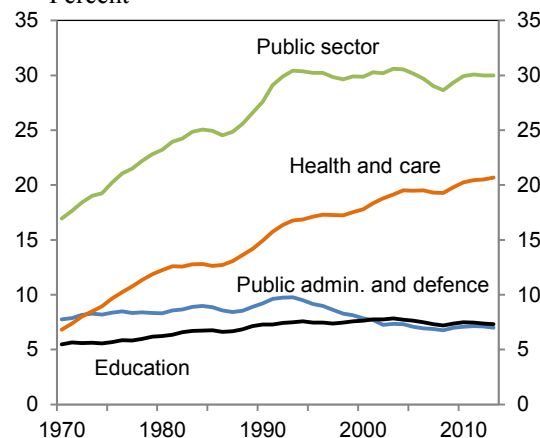
The StatRes database enables central government employment developments to be traced in more detail for the years after 2006. Central government employment increased by about 36,000 man-years from 2006 until 2013 according to the StatRes figures. About two thirds of this growth took place within health, care, defence and public order, cf. Figure 6.2B. Close to half of central government employees worked in the health and care sector in 2013, just over 20 per cent within defence, public order and security, and well below 10 per cent in administration etc. There is, according to ILO figures, fairly limited variation between countries in the portion of the working population employed in public administration, defence and mandatory social insurance. In 2012, the percentage of the working population employed in public administration was about the same in Norway as in the euro zone.

The central public administration (ministries, directorates, inspectorates, etc.) had just over 22,000 employees as of 1 March 2014, according to the State Central Register of Government Employees. This represents an increase of close to 4,000 persons from the same date in 2006. The directorates have grown the most over this period, cf. Figure 6.2C, which shows the developments in selected parts of the central public administration. This has partly to do with the reassignment of duties from ministries to directorates. The fastest growing central government bodies include, inter alia, the Norwegian Directorate of Immigration, the Norwegian Directorate of Health and the Norwegian Institute of Public Health.

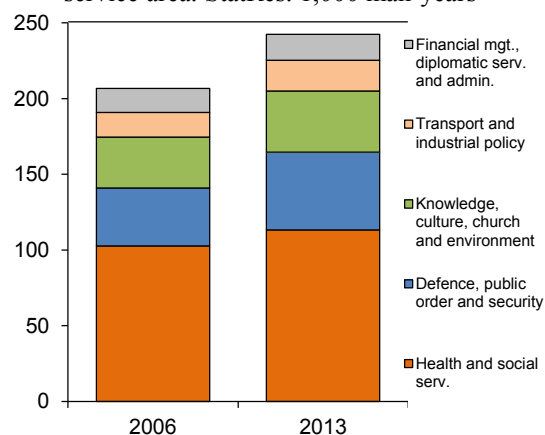
New technology opens opportunities for a more efficient central public administration. This is illustrated by the reorganisation of the Customs and Excise Administration and the Tax Administration, which over time may lead to a reduction in the number of employees by 400-500 man-years and generate considerable savings. A de-bureaucratisation and efficiency enhancement reform is carried out to provide incentives for more efficient central government operations and allow scope for prioritisation.

Public sector employment

A. Employees in the public sector and selected sub-sectors as a portion of total employment. Percent



B. Central government man-years, by public service area. StatRes. 1,000 man-years



C. Ministry, directorate and county governor man-years compared to the level of 2006

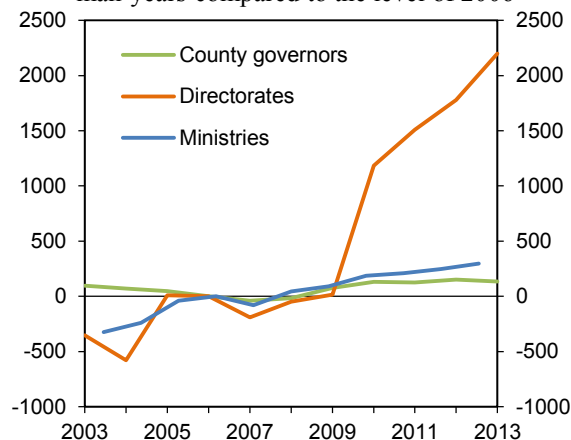


Figure 6.2 Public sector employment developments

Sources: Statistics Norway and the Agency for Public Management and eGovernment (Difi).

tor was introduced as part of the Quality Reform of 2003. This funding system has, together with other policy measures, contributed to the realisation of many of the reform objectives. There is nonetheless a need for examining whether the funding of these institutions makes enough of a contribution to high quality in education and research. The Government has ambitious goals for higher education and research, and funding is one of the key tools for the attainment of these goals. The Government has appointed a public committee to present assessments and specific recommendations as to how public and private university colleges and universities should be funded in future to realise the objectives for this sector. The committee shall submit its final report by yearend 2014.

An *efficient transport system* will strengthen the competitiveness of the business sector. The Government is currently in the process of, inter alia, simplifying the planning of new road construction and establishing a development company for constructing more roads in a more integrated manner.

6.3 More competition

Competition between providers is a key driver for efficiency enhancement in the private sector. The Government wishes to facilitate the use of competition as a tool for promoting efficient resource use in the public sector.

The Government will introduce *free treatment choice within the specialist health service*. This represents an expansion of the right of patients to choose their treatment provider, and expands the scope of private businesses for providing their services. A proposal for free treatment choice was circulated for consultation in June 2014, and the Government intends to introduce the reform during the course of 2015.

The Government will also facilitate more competition in the *transport and communications sectors*. Important measures are a new Postal Services Act, which scales back the monopoly of Norway Post on certain postal services, railway reform, and the ongoing work on assessing the possibilities for air safety service competition.

The Government also proposes the introduction of an arrangement under which *value added tax is accounted for on a net basis* by central government bodies as from 2015. This will result in value added tax no longer being recorded as a cost to such government bodies, thus putting an end to the current competitive disadvantage of private players. This facilitates more efficient resource use on the part of central government, since value added tax will no longer prevent the

cheapest alternative from being chosen. In addition, central government bodies are exposed to increased competition from private providers. The proposals for increased competition in the transport and communications sectors, as well as value added tax accounting on a net basis, are discussed in more detail in Chapter 5.2.

6.4 More focus on outcomes

6.4.1 Knowledge gathering and utilisation

The Government will attach more weight to outcomes than to the amount of appropriations for various causes. This requires a solid basis for decision-making and thorough pre-implementation studies and reports, good management and control during implementation, and robust post-implementation evaluation to establish what worked. Knowledge about the public sector is available from numerous sources including, inter alia, performance reporting from government directorates, agencies and other entities, as well as research and reports from universities and research institutes. The Statistics Norway systems *KOSTRA* and *StatRes* are important tools for shedding light on public sector performance and expenditure.

6.4.2 Thorough pre-implementation studies and reports

Central government initiatives shall be well founded and thought through. Good and relevant information is of key importance in this regard. Incomplete or inadequate pre-implementation studies and reports may result in initiatives having unintended consequences, involving cost overruns or failing to deliver the desired effect. Good methods for evaluating the actual effect of reforms and government policies are important, and new initiatives need to pay heed to past experience. Various alternatives should be examined before decisions are made in important cases, and in some cases it is preferable to try out different solutions, cf. the below discussion of evaluations.

A study by the Agency for Public Management and eGovernment (Difi) has demonstrated that compliance with the current Instructions for Official Studies and Reports from 2005 has been inadequate. The Instructions for Official Studies and Reports are now being reviewed and revised with a view to improving the basis for decision-making. Such review also includes an assessment of how to ensure improved compliance with the Instructions.

Furthermore, the Government will consider the establishment of a function relating to the

quality assurance/quality control of the documentation prepared as a basis for decision-making, for example in the form of an independent public sector efficiency and effectiveness unit charged with examining, inter alia, cost-benefit analyses in various fields. This is considered in the context of the proposal for the establishment of a regulation council to examine the burdens imposed on the business sector by new proposed regulations.

Economic analyses provide a basis for ranking and prioritising various government initiatives, thus enabling society's resources to be used more efficiently and effectively. The Office of the Auditor General and Difi have highlighted the need for improving the quality of economic analyses. The Ministry of Finance has prepared a new circular on how to conduct economic analyses and other economic studies of central government initiatives. This is supplemented by a new cross-sectoral guide from the Norwegian Government Agency for Financial Management (DFØ), which can be used in the examination of all types of government initiatives.

The quality assurance regime for large central government projects encompasses all central government projects in excess of NOK 750 million. The regime is based on two milestones, upon which external consultancy firms review the documentation prepared as a basis for decision-making, normally by a ministry or an underlying agency. At the first milestone; QA1, the purpose is to establish a basis for choosing which concept (project alternative) merits the preparation of a detailed plan. Key elements are a needs analysis, a feasibility study and an economic analysis of relevant concepts. The second milestone; QA2, involves quality assurance of the extent to which a project is ready for a final implementation decision. QA2 is carried out before presenting any initial appropriation and cost budget proposal to the Storting. Key elements of QA2 are assessments of uncertainty, cost estimates and contract strategy. The Ministry of Finance intends to conclude a new framework agreement on external quality assurance with effect from 2015.

6.4.3 Performance evaluation and reporting

It is often difficult to know whether or not a public sector reform has a positive effect, and how strong any such effect is. More strategic and systematic use of evaluations may improve decision-making and identify potential improvements.

DFØ provides guidance and support for central government bodies in their development of good evaluation practices. Methods and tools for measuring and evaluating goal attainment and performance, both during and after implementa-

tion, need to be tailored to each activity/initiative. The Evaluation Portal has been created to gather all central government evaluations and make these readily available to ministries, agencies and the general public.

The Government believes that reforms should be planned with a view to also ensuring that lessons can be drawn from them. The Government will, for example, initiate trials involving a new medical assessment after six months of sickness absence, with a view to establishing whether this may serve to reduce sickness absence. Research expertise will be mobilised, both to assist in designing such trials and to evaluate these retrospectively.

6.5 Clear budget priorities

It must be assumed that the public sector, like the business sector, offers a potential for productivity growth over time. Such a potential is more readily realised when the public administration is faced with a clear requirement for more efficient operations. A de-bureaucratisation and efficiency enhancement reform is carried out to provide incentives for more efficient central government operations and allow scope for prioritisations. Part of the gains from reduced bureaucracy and more effective spending of money are transferred to society in the annual budgets. The expenditure reduction needs to form part of a planned process in order for permanent savings to be realised. The said transfer is therefore introduced as a permanent feature of the budgetary process. The savings are put at 0.5 per cent per year. This is less than is recouped in a corresponding manner in Denmark and Sweden. A saving of 0.5 per cent on central government operational budget items will deliver savings of NOK 1.4 billion in the budget for 2015. The proposal for an annual arrangement to recoup gains from the more efficient operation of the central government administration is in line with recommendations from the OECD.

6.6 The local government reform and ongoing local government development efforts

6.6.1 The local government reform

It is now fifty years since the last major change in the local government structure. More duties and responsibilities have been assigned to local government over this period. Population patterns have changed over these years as well. If we look at the last 30 years, the largest municipal-

ities, in particular, have seen their populations grow, whilst many small municipalities have registered a population decline. The share of the population above the age of 67 years has increased in the smallest municipalities, whilst it has declined in the very largest municipalities. The proportion of older people will increase over the coming years, and population growth, especially in central urban areas, is expected to remain high.

On 3 January 2014, the Ministry of Local Government and Modernisation appointed an expert committee to examine criteria for a good local government structure. The committee made three main recommendations in a sub-report submitted on 31 March 2014. Firstly, a municipality should have a population of at least 15,000-20,000 to ensure that duties are performed well. Professional resources in the smallest municipalities need to be strengthened in order to achieve an adequate and consistent quality of services. Secondly, the committee recommended that the local government structure become more aligned with functional development areas in society. Thirdly, the committee recommended to cut back on detailed central government controls, and that good political participation solutions be developed to ensure vigorous and effective democratic arenas.

The local government reform shall facilitate the consolidation of municipalities. Sustainable and financially robust municipalities can deliver more efficient resource use within the applicable financial framework. The reform will offer scope for more efficient administration and management, and can free up resources to strengthen the performance of the core duties of local government. More professional administration and management may also pave the way for innovation in the provision of services.

Central government has a responsibility for enabling local government to have sufficient freedom of action to make necessary adaptations in service production to match local circumstances and needs, in order for the benefits from decentralisation to be realised. Fewer and larger municipalities, with generally high capacity and

knowhow, will be in a position to implement a welfare policy in conformity with national objectives. The need for detailed central government intervention may therefore be reduced. A modified local government structure with larger municipalities will facilitate the transfer of more duties from regional government, county governors and central government in general. This may strengthen municipal administrations as important locally-based democratic bodies for their local populations.

6.6.2 Ongoing development efforts

Local government holds principal responsibility for welfare services like schools and kindergartens, nursing and care services and social services, as well as for certain technical services. The local government sector is predominantly funded by general appropriations, and about three fourths of its revenues are unrestricted revenues. The unrestricted revenues are in the form of tax revenues and general appropriations. Funding by general appropriations implies that local government retains the entire gain from its own efficiency enhancement measures. This entails strong incentives for cost control and efficient resource use. Funding by general appropriations is also less administratively challenging for both central and local government than using earmarked appropriations.

Tax revenues account for about 40 per cent of local government revenues. Tax revenues collected from the population and business sector in the relevant municipality highlight the link between local government revenues and local government services. The Government wants local government to retain more of the tax revenues than at present. The Government has announced that it will present a comprehensive review of the local government revenue system in the local government proposition for 2017, in the spring of 2016. All the elements in the revenue system shall be addressed in that context. The Government has also announced that it will consider various models for rechanneling part of the corporation tax back to local government and report on this in the local government proposition for 2016.

Appendix 1

Norway's fiscal framework

Norway's petroleum industry presents particular challenges for fiscal policy in ensuring a stable economic development. The public revenues from petroleum are large, vary considerably from year to year, and will be depleted over time. Many countries have found that temporary large revenues from natural resource exploitation produce relatively short-lived booms that are followed by difficult adjustments as production and revenues diminish. Moreover, income from non-renewable resources like oil and gas should also benefit future generations.

The Government Pension Fund Global and the fiscal rule for the use of oil revenue address these challenges, and are designed to support a stable development of the Norwegian economy in both the short and long term. The Government Pension Fund Act stipulates the transfer of the State's net cash flow from the petroleum industry to the Government Pension Fund Global. The fiscal rule specifies that the transfers from the Fund to the central government budget shall, over time, reflect the expected real return on the Fund, which is estimated at 4 per cent. This framework delinks the earning and use of petroleum revenue, reducing the costs of future restructuring and the risk of a sharp decline in industries exposed to international competition.

The fiscal rule was presented in the White Paper Guidelines for Economic Policy (Report No. 29 (2000–2001) to the Storting), and received the support of a broad parliamentary majority. The White Paper pointed out that the question was not whether more petroleum revenue should be used in public budgets, but rather when and how quickly this should happen. The fiscal rule envisages a gradual increase in the use of this revenue, but also ensures that it will benefit future generations.

The fiscal rule is a long-term guide for the use of the money in the Government Pension Fund Global. It also puts emphasis on evening out economic fluctuations to contribute to good capacity utilisation and low unemployment. Several mechanisms have an effect in this regard.

The fiscal rule allows automatic stabilisers to play out fully. Accordingly, the yearly use of petroleum revenue is measured using the structural non-oil deficit, not the actual non-oil deficit. The

structural non-oil deficit is corrected for fluctuations in the business cycle and other temporary changes in public expenditure and income. This means that the transfers from the Fund to the budget may be higher than the expected return on the Fund during a downturn, and lower during an upturn. The automatic stabilisers in the budget are estimated to be stronger in Norway than in many other countries due to Norway's well-developed welfare systems.

The spending rule also allows budget policy to be used actively to stabilise production and employment. However, experience indicates that fiscal policy has a limited capacity for fine-tuning of the business cycle. Since 2001, monetary policy has been the first line of defence in the policies for economic stabilisation.

Together, the fiscal rule and the Government Pension Fund Global comprise a fiscal framework that insulates the fiscal budget from fluctuations in petroleum revenue, stemming either from volatile oil and gas prices or from changing

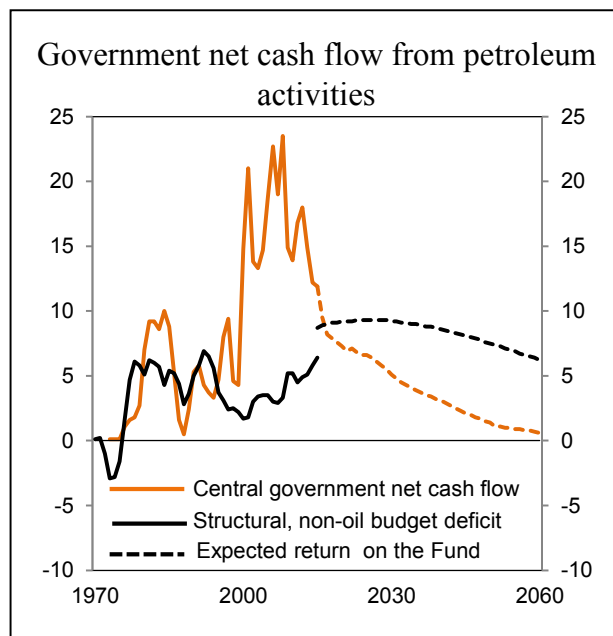


Figure A1 The State's net cash flow from the petroleum sector, the structural, non-oil deficit and expected real return from the Government Pension Fund Global. Per cent of trend-GDP for Mainland Norway

Source Ministry of Finance and Statistics Norway.

production or investments in the petroleum sector. Through the Fund, a large proportion of the State's oil and gas income is invested in other countries. Investing foreign exchange earnings abroad protects the krone against the large, varying foreign exchange earnings generated by the petroleum industry. The fiscal policy framework thus supports Norway's monetary policy, and lays a foundation for more stable expectations in the currency market.

Following a decline in the second half of the 1990s, the use of petroleum revenue has increased again since 2001; see figure A.1. Nevertheless, measured as a share of trend-GDP for

Mainland Norway, the level is not higher now than in the 1980s and early 1990s. The figure also shows how the spending rule helps Norway to convert substantial, yet temporary and fluctuating income from the petroleum industry into more stable spending over public budgets. Norway has managed the most intensive harvesting phase fairly successfully. The contribution of Fund returns to the national budget as a proportion of mainland GDP is expected to increase slightly over the next 10-15 years. The proportion will then fall gradually as flows into the Fund diminish and the mainland economy continues to grow.

Appendix 2

Calculation of the structural, non-oil budget balance

The total public budget surplus can vary considerably from year to year without this being the result of changes in budget policy. In order to form the best possible impression, of the underlying fiscal stance, it is appropriate to examine the development of the budget balance excluding petroleum related revenues and expenditures. It is also appropriate to correct for factors such as the effects of economic fluctuations on direct and indirect taxes and unemployment benefit.

Since the National Budget of 1987, the Ministry of Finance has used the change in the structural, non-oil budget balance as an indicator of the fiscal stance. In addition, with the introduction of the fiscal rule in 2001, the *level* of the structural, non-oil deficit has become a measure of the underlying use of petroleum revenues over the fiscal budget. It is this deficit measure that over time shall equal the expected real return on the Government Pension Fund Global.

Automatic stabilisers are allowed to operate fully when the fiscal stance is measured against the structural, non-oil deficit. This benchmark also helps maintain net public wealth over the business cycle. Structural budget balance indicators also play a key role in the fiscal policy frameworks of a number of other countries, including the EU countries.

The non-oil budget deficit excludes revenues and expenditures linked to petroleum activities. The following adjustments are made to get from the non-oil budget deficit to the structural, non-oil budget deficit:

- The deviations of various tax revenues from trend levels are calculated and corrected for. Moreover, the cyclical component of unemployment benefits is taken into account. The estimated adjustments for 2014 and 2015 in Table A.1 reflect the fact that tax revenues from the Mainland economy are estimated to be somewhat below trend.
- The difference between the actual levels and the estimated normal levels of interest rates and transfers from the central bank (Norges Bank) is adjusted for. As part of the strengthening of the equity of Norges Bank, no capital was transferred from the Bank to the fiscal budget for a period from 2002 onwards. This is about to change in 2015. An adjustment for the

discontinuation of Folketrygdfondet's mandatory deposits with the State from 2007 onwards has the opposite effect.

- Adjustments are made for accounting changes and for changes to the distribution of functions between central and local government that do not affect the underlying budget balance developments. The adjustment for 2015 relates to the introduction of the new disability pension scheme, where benefits as from 2015 are taxed as wages.

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 analyses of accounting figures, economic statistics and projections 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 economic developments, and are subject to revision even after the national accounts for each year have been finalised.

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 payable to municipalities, and essentially cover the period 1960–2013, extended to 2025 using forecasts. The projection period is based on the Ministry of Finance's medium-term projections and the continuation of the proposed tax programme for 2015. The assumptions may be summarised as follows:

- *Taxes on labour.* This category includes employers' national insurance contributions and personal taxes, including net wealth tax levied on individuals. The development in the number of normal man-years employed is an important indicator of developments in employers' national insurance contributions and total personal taxes. The projections assume that growth in the number of normal man-years will gradually decline from about 1 per cent in the next few years to around $\frac{3}{4}$ per cent on average per year by 2025. The estimates are based on population projections from Statistics Norway, which among other things as-

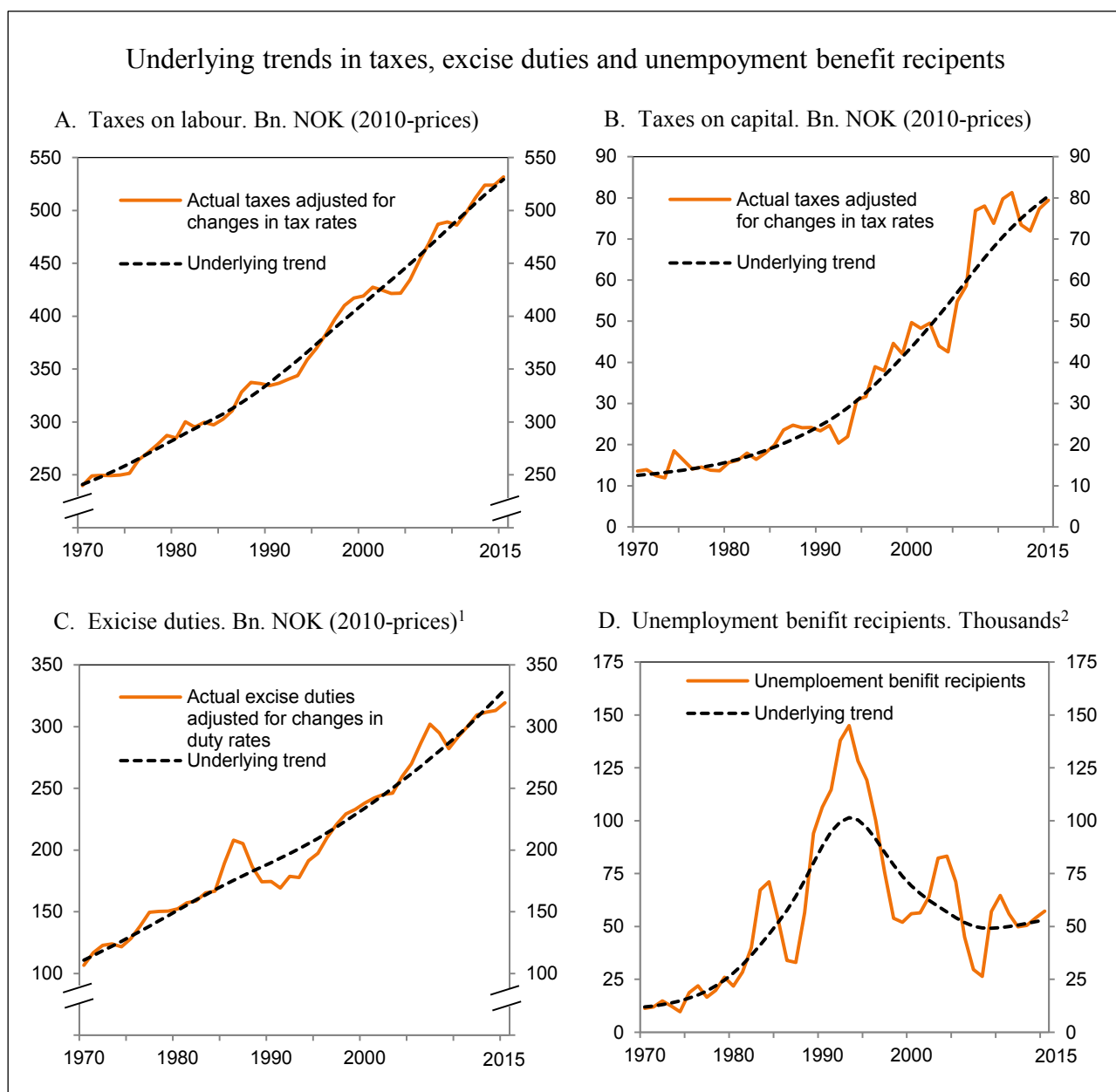


Figure A.2

Source: NAV and Ministry of Finance.

sume high immigration from the EEA. In the case of net wealth tax levied on individuals, average nominal growth of approximately 5 per cent annually from 2015 to 2025 has been assumed in the absence of regulatory changes.

- *Taxes on capital.* This category includes taxes paid in arrears by companies and other non-individual taxpayers outside the petroleum industry, withholding tax and inheritance tax (until its abolition as of 2015). It has been assumed that taxes from enterprises outside the petroleum industry will remain approximately unchanged as a proportion of mainland Nor-

way GDP after 2015. This corresponds to an average nominal growth rate of around 5 per cent per year.

- *Indirect taxes.* This category includes value added tax, motor vehicle registration tax and other excise duties, and other indirect taxes including stamp duty and miscellaneous sectoral duties. It also includes the investment tax until its abolition in 2002. Private consumption developments are an important influence on indirect taxes, and it has been assumed that consumption growth will average some 3½ per cent per year from 2015 to 2025.

Table A.1 The structural, non-oil budget deficit. NOK Million

	2012	2013	2014	2015
Non-oil budget deficit	100 898	116 454	149 753	174 225
+ Net interest payments and transfers from Norges Bank.				
Deviations from estimated trend level ²	1 526	80	2 046	2 872
+ Accounting technicalities	0	0	0	-2 275
+ Taxes and unemployment benefits. Deviations from trend	6 303	2 103	-9 614	-11 157
= Structural non-oil budget deficit	108 727	118 638	142 185	163 664
Measured in pct. of Mainland Norway trend GDP	4.9	5.1	5.8	6.4
Change from previous year in percentage points ^{1, 2}	0.5	0.2	0.7	½

¹ Changes in the structural, non-oil budget deficit as a proportion of trend GDP for mainland Norway are used as a rough indicator of the budget's impact on the economy. Positive figures indicate that the budget has an expansionary impact.

Sources: Ministry of Finance and Statistics Norway.

On the expenditure side of the budget, a cyclical correction is made to unemployment benefit expenditure based on estimated trend deviations for the number of unemployment benefit recipients.

Developments in the three main groups of direct and indirect taxes and the number of unemployment benefit recipients are shown in Figures A2.A to A2.D.

Developments in the non-oil and the structural, non-oil fiscal budget surplus are shown in Figure A.3. As regards the surpluses in the years 1987–1988 and the small deficits in 2001 and 2007, it is important to note that these years marked the ends of lengthy, strong cyclical upturns. With the exception of these years, fiscal budgets since 1975 have generally registered significant running deficits when revenues and

expenditure relating to the petroleum industry are excluded, although there have been major variations during the period. This is linked to the rapid escalation of petroleum revenue use in 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 per cent of mainland Norway GDP.

The fluctuations in the structural, non-oil deficit are related to the fact that the budget has 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 due to the objective of allowing the automatic stabilisers in the budget to function so that cyclical fluctuations in tax revenues is prevented from triggering fluctuations on the expenditure side of the budget.

Experience shows that it is difficult to distinguish the impact of economic cycles from the underlying tax revenue trend. The estimated structural, non-oil deficit may thus be revised considerably if new information emerges. Table 1.2 provides an overview of revised budget position estimates since 2002. The Ministry of Finance's method for calculating the structural, non-oil budget balance is explained further in a working paper which can be downloaded from the Ministry's website (www.regjeringen.no/fin).

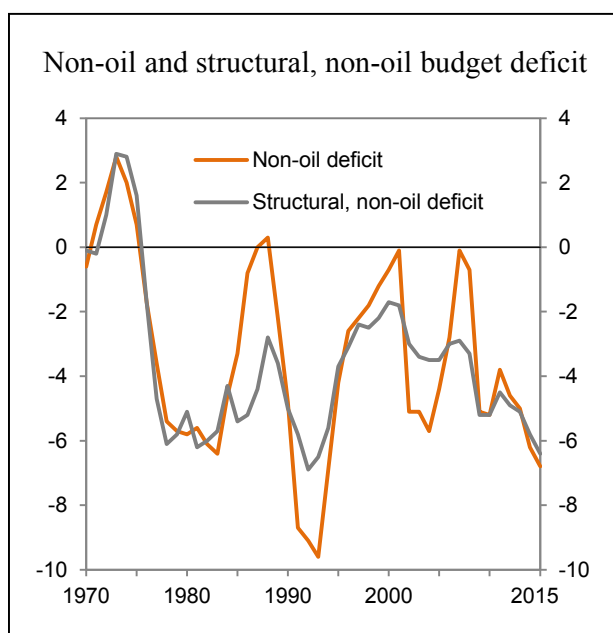


Figure A.3 Non-oil and structural, non-oil budget balance. Per cent of Mainland Norway trend-GDP

Source: Ministry of Finance.

Appendix 3

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 per cent of Mainland GDP. The petroleum industry contributes, through its demand for goods and services, to considerable activity and to a range of 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 30 per cent of the State's total income since 2000. How the petroleum revenues are handled in fiscal policy is discussed in Appendix 1. This appendix covers the more direct effects of the oil and gas activity.

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

- investments
- intermediate inputs, which include all mainland deliveries to petroleum sector operations,

from repairs and maintenance to catering

- wage costs

Growth in aggregate demand from the petroleum sector was particularly steep from the mid-1970s to the mid-1980s, cf. Figure A.4A. 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 2005-2013.

Investments corresponded to 9 per cent of mainland economy value added in 2013. Whereas investments in the beginning of the Norwegian oil and gas era were 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.4B.

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

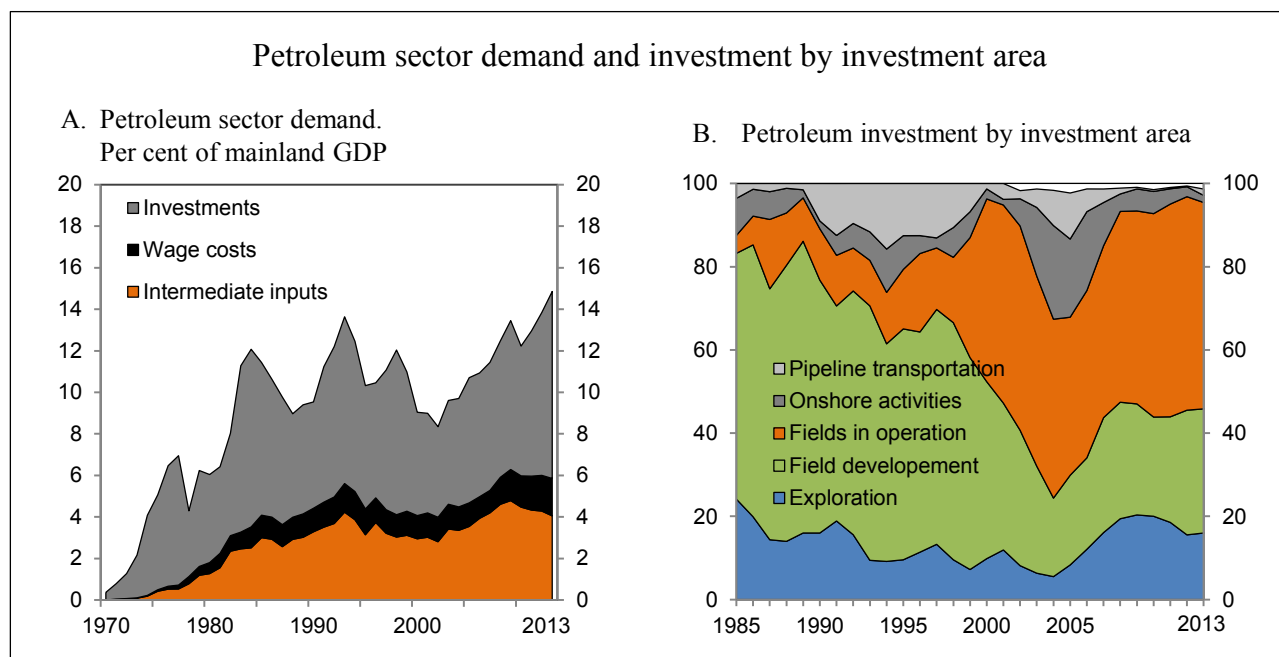


Figure A.4 Petroleum sector demand and investment by investment area

Source: Statistics Norway and Ministry of Finance.

about 1 per cent of overall employment in Norway. Consequently, *wage costs* are low relative to the costs associated with investments and intermediate inputs. Yet the wage level is distinctly higher than the average level within the mainland economy.

Development of the petroleum activities has given rise to a large Norwegian supply industry. Calculations made by Statistics Norway researchers indicate that in 2009 the sector accounted, directly and indirectly, for about 8 per cent 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 higher activity in the mainland economy.

Thus far, petroleum industry demand has largely correlated with the mainland economy business cycle. This tendency is especially notable in investments, which are significantly more volatile than intermediate inputs. Nonetheless, certain periods have deviated from this pattern. Investments have, for example, grown also 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 do, however, still account for a considerable share of petroleum sector investments and intermediate inputs.