Policy Brief

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Economic Survey of Norway, 2005

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Summary

The Norwegian economy continues to recover strongly from its 2002-2003 slowdown. Low interest rates, competition-induced productivity gains, high investments by the booming oil sector, terms-of-trade gains and supportive macroeconomic policies are the main drivers. Inflation is low and labour inputs in terms of hours worked are rising briskly. Strong growth is likely for the remainder of this year and possibly during 2006.

Moving towards a neutral macro policy. Although inflation remains well under the target, and there is still a little slack in the economy, low inflation in part reflects low or falling import prices, not weak domestic demand. Robust growth could turn into overheating, especially if oil investments continue to rise strongly, though foreign demand presents a downside risk. It would therefore be appropriate for the Norges Bank to gradually move towards a more neutral stance. On the fiscal side, recent deviations from the 4% target of the fiscal rule are large. If the rule is to remain credible, and if the economy remains buoyant, transfers from the Petroleum Fund should not rise further in 2006, and could even fall.

This Policy Brief presents the assessment and recommendations of the 2005 OECD Economic Survey of Norway. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

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Encouraging greater work effort. Although participation rates are relatively high, the numbers of Norwegians on sick leave or drawing disability pensions is also high, and their evolution does not seem to be directly related to measures of overall health status. Reforms should continue to tighten eligibility criteria for entry into the schemes, to encourage timely return to the workplace from sick leave, and to focus rehabilitation programmes on faster reinsertion in the workforce. The private early retirement scheme, AFP, is also a powerful mechanism for encouraging early withdrawal from the labour force, and there is no reason why public subsidies to such a generous scheme should continue within a reformed pension system, except for those with long work histories in arduous jobs.

Implementing pension reforms and planning for emerging fiscal pressures in other areas. Spending on pensions in the National Insurance System (NIS) is currently equivalent to 9 per cent of GDP and this could double by the middle of the century. Reforms proposed by the government to link pension income after retirement more closely with incomes over working lives should encourage later retirement. Nevertheless, spending could still rise by 7 percentage points of GDP. Revenues from the Petroleum Fund will be sufficient to finance only a minor part of foreseeable increases in public spending even with higher oil prices and full implementation of pension reforms. Hence there is a need to rein back the growth of public spending in other areas, especially those which blunt work incentives, or eventually raise taxes.

The Norwegian health sector delivers better services but is expensive. Recent reforms have led to increased levels of treatment, and citizens agree that service has improved. But the volumes of services have risen more than expected, and salaries for some parts of the medical profession rose steeply in the aftermath of the reforms. Centralisation and rationalisation of hospital activities have not yet resulted in significant economies, and health system cost consciousness is still weak. Consideration should be given to reversing the recent decision to raise the proportion of DRG finance, raising the levels of co-payments by patients, and strengthening incentives for generalists to refrain from prescribing expensive treatments. ■

What are Norway's current strengths and challenges?

The Norwegian economy is in fine form at present. Per capita incomes are high, rising briskly, and evenly spread. Competition from abroad and at home is encouraging strong productivity gains and keeping inflation very low. The operations of the Petroleum Fund are insulating the exchange rate from swelling oil export revenues, and the associated fiscal rule is ensuring that most of them are saved. Although unemployment is falling only slowly from its comparatively low level, total hours worked have expanded.

Four concerns trouble this otherwise benign picture:

- Robust growth could turn into overheating, especially if oil investments continue to rise strongly, though foreign demand presents a downside risk;
- Oil euphoria and political pressures could result in fiscal policy becoming too expansionary in the near term and unsustainable in the long term;
- The numbers of people of working age on sick leave or receiving disability pensions have climbed to very high levels;
- The current public pension system is clearly unsustainable in the longer term, and even if proposed reforms are fully implemented, the increase in spending on pensions and health will outstrip any likely rise in revenue from the Petroleum Fund under the fiscal rule. ■

Should monetary policy tighten?

The current recovery from the 2002 slowdown is accelerating, fuelled by historically low nominal and real interest rates, a consequent private consumption and residential construction boom and rising house prices, a very rapid increase in oil investments, and high and rising spending by the oil sector on current goods and services produced by the mainland economy. Although nominal wage increases have been moderate, they have translated into substantial real increases because of unexpectedly low inflation; but profitability has not suffered overall because productivity and terms-of-trade gains have also been substantial. Hence both business and household incomes and sentiment are at high levels. Demand impulses from abroad are weak and the output growth has not been followed by a marked decline in unemployment. So far there are no signs of overheating in product or labour markets. A major uncertainty concerns oil investments, which could surprise on the upside, as has happened in the past. *It is thus appropriate that the monetary authorities have signaled their intention to move towards a more neutral stance — although gradually and in small, not too frequent steps – in order to reduce the risk of having to take potentially disruptive measures later on.* ■

Should slippage from the fiscal rule be reversed?

The fiscal rule states that only the real return on the Petroleum Fund, assumed to be 4% of its market value, can normally be used for general budgetary purposes. Deviations are permissible if, as in the past few years, the market value suffers or the economy hits a slow patch. But the deviations in 2002-2004 were substantial, and larger than initially projected, and the 2005 budget also implies a transfer considerably exceeding 4% of the end-2004 Fund value. If the transfers from the Fund remain constant from now on, return to the trajectory of the underlying fiscal rule would not occur until 2008. By then, the economy could well be moving into a slow-growth phase. *It is therefore essential that the 2006 budget eschews higher transfers from the Fund. If the economy remains very buoyant, full advantage should be taken of the automatic stabilisers to reduce such transfers. In addition, greater-than-expected tax revenues or other positive surprises in the budget should be used to reduce the deficit. Once return to the fiscal rule trajectory is achieved, it is important that the rule be applied symmetrically.*

Oil wealth in many other countries has been used to finance colossal fortunes for the few, or bread and circuses for the many. Norway has avoided both traps. The revenue from the Petroleum Fund could help to maintain Norwegian living standards long after the oil reserves are exhausted. In addition, macroeconomic and structural policies have been used to ensure that the non-oil economy, which accounts for most of the GDP and virtually all employment, remains as viable and prosperous as possible, including in the traded sectors. But pressures to spend more of the capital of the Fund straight away are strong. The consequences of uncoordinated and unplanned fiscal slippage are clear: squandering of the oil wealth, appreciation pressure on the Krone, and damage to the traded sector. *It is crucial that the Norwegian authorities explain clearly that while the Fund revenue can be spent indefinitely, its capital can be spent only once, and that its capital is being consumed every year that the fiscal rule is overridden. In order to shelter the non-oil tradable sector from the oil revenues and an appreciation of the Krone, it is also crucial to maintain the strategy of investing abroad the revenue from the petroleum sector.* ■

Are welfare programmes blunting the incentives to work?

Norwegians live comparatively long and healthy lives; the official retirement age for men and women is, at 67, above the OECD norm; and participation rates are very high at all ages for both sexes. Over their working lives, Norwegian citizens probably furnish on average at least as much work effort as the average OECD citizen. But on a typical working day, a well above average number of those of working age are on sick leave or claiming a disability pension, and around half of those over 62 have withdrawn from the labour force, often benefiting from subsidised early retirement on the AFP scheme. Trends in early retirement, disability, and (until very recently) sick leave, have been strongly upwards and levels are very high by international comparison. The cost to society of these schemes is also very high in terms of lost output. *New policies, or strengthened policies, are needed to arrest these upward trends in non-activity, and if possible reverse them. In addition, recent proposals that would shorten the standard working week, or make the labour market less flexible, should be resisted.*

Analysis shows that the economic incentives to reduce or curtail work effort through these schemes are substantial: eligibility criteria are not strict, replacement rates are high, and the impact on eventual public pension benefits of leaving the workforce to profit from one or other of these schemes can be quite small. It is revealing that a recent reform, by which doctors must assess capacity to work within 8 weeks on sick leave, was accompanied by a dramatic fall in total sick leave. This suggests that gate-keeping as well as economic incentives and health status are important drivers in this area, and probably also in the area of disability pensions. A reform of the disability pension scheme, splitting it into a permanent scheme and a temporary one entailing rehabilitation has not so far had much impact on either inflows into disability, or outflows into work. Indeed, there has been a marked inflow of younger workers into temporary disability. *If the results continue to disappoint, then more effort should be given to assessing work capacity at an early stage, and encouraging a timely return to the workplace, as work skills erode after prolonged absence. In the pension reform, incentives to move into disability rather than a flexible early retirement scheme should be removed, by adapting the disability scheme accordingly.*

The AFP scheme covering early retirement is a private agreement between employers and representatives of employees, financed entirely by the employer in the public sector, entirely by the employer before the age of 64 in the private sector, and 60/40 by employers and the government after that age. The scheme was introduced in 1989 in the private sector with the laudable aim of providing a decent retirement income as from age 65 for people who had left school comparatively young, and who had worked ever since, often in arduous jobs, and whose life expectancy at 65 was probably lower than the average. Over the years, though, its coverage has greatly expanded, and age at entry to the scheme is now down to 62 years. Around three-quarters of older workers now qualify for AFP pensions, and a large proportion of those who do qualify actually claim them. A particularity of the AFP is that entry to it has almost no impact on the size of the eventual public old-age pension at age 67. The average age at retirement has thus dropped precipitously, reducing output and tax revenues, and raising public spending. *The government should therefore curtail the inflow into such schemes by reducing its subsidies, and ensure that they are targeted at those groups for which they were originally intended.* ■

How important is pension reform?

The current Norwegian public pension system is still maturing, and together with the very high participation rates this means that most

Norwegians will be able to claim full pensions, that are indexed to wages and are taxed favourably. With life expectancy continuously increasing, spending could more than double as a percentage of mainland GDP by 2050 if a reform is not carried out. Public sector occupational pension schemes for central government employees (including teachers and some other groups) are unfunded and will also entail a significant rise in the future public spending burden, especially as the expansion of public sector employment is relatively recent.

Broad agreement was reached in the Norwegian Parliament on the proposed pension reforms in May 2005, but important elements are still under discussion. The Parliament supported the introduction of a benefit adjustment factor to account for changes in life expectancies at age of retirement. A minimum pension would be paid to those who had earned low incomes or with less than complete work histories, and there would be an effective ceiling on benefits for high earners. Benefits would be indexed to the average of wages and prices. It is officially estimated that the impact of less favourable indexation treatment, the benefit adjustment factor and the positive impact on labour supply of older workers of actuarial fairness would lead to savings of around 3% of GDP in public spending over the next few decades. However, these effects depend on the final design of the flexible retirement scheme and the link between pension earnings and pension benefits. The government was asked to submit new proposals incorporating a stronger redistribution element, which would weaken the link between lifetime earnings, and pension benefits, and hence also weaken work incentives. The government was also asked to submit an alternative proposal favouring early retirement. *It is very important that the authorities pursue a reform that strengthens work incentives and thus helps to ensure the sustainability of the scheme. Consideration should be given to a more direct and transparent linkage between actual contributions and actual benefits for those between the pension floor and ceiling whatever their age at retirement. The period of transition to the reformed system should be kept short.*

To top up NIS pension benefits many larger companies operate funded occupational pension schemes for their employees, mostly of the defined benefit type. They attract favourable tax treatment provided that the benefits cannot be claimed before 67. The schemes cover about one third of private-sector employees, they are firm-specific, and portability between different firms is complex. There is no portability into, or from, the public-sector pay-as-you-go (central administration) or funded (local government) occupational pension schemes which cover all employees there. Combined with the AFP scheme, the public-sector occupational schemes guarantee gross replacement of at least two-thirds of final pay at age 65. The 2004 White Paper proposed mandatory occupational pensions for all in the private sector, starting as early as January 2006, and coherence between the provisions of the public-sector schemes and the reformed NIS old-age pension system. *Because many complex issues of creating new schemes in the private sector remain to be resolved, and because operating such schemes may be very costly for small companies if introduced suddenly, their introduction on a mandatory basis should be phased in gradually. Rules allowing portability of occupational pensions between the public and private sectors should be considered, and the two-thirds guarantee in the public sector phased out over time.* ■

What are the key issues in health care?

There is universal access to publicly-provided health care at all ages and for a very wide variety of treatments. It is not very surprising, therefore, that public spending on health is high. But relative to mainland GDP, spending is also high compared with similar countries, especially after large

salary increases were granted to many health-care professionals in 2002. This is the case despite a series of wide-ranging reforms designed to make greater use of market mechanisms instituted in recent years, a purchase system for patented drugs that results in low prices for them, and a system for encouraging use of generics where available. The reforms have succeeded in eliminating shortages, raising efficiency and improving citizen satisfaction. Nevertheless, spending accelerated after the reforms. Centralisation of hospital ownership may have increased political influence, encouraging spending that cannot be justified on cost-benefit grounds. Although hospitals in principle must repay debts incurred by them in the short-term, there are no adequate sanction mechanisms to force them to do so. Co-payments by patients are modest, and the background of swelling oil wealth may have sapped willingness to control costs. Diagnosis related groups (DRG) procedures are arguably too well-remunerated in some areas, leading to supply-driven interventions, while their absence in others (*e.g.* psychiatry) may have resulted in sub-optimal supply. Generalist doctors have a gatekeeper role, but are said to over-refer patients to hospitals.

Controlling costs in health care can be time-consuming, entailing studies and cost-benefit analyses to establish the suitability of new drugs and treatments, and the efficacy of existing ones. In principle, though, such mechanisms exist in Norway, but they are too often sidestepped by pressure by citizens on politicians to approve new drugs and treatments. *Even if it is not always possible to resist such pressures, the normal certification procedures should be followed subsequently. In a related area, the recent political decision to raise the proportion of DRG finance to 60%, instead of lowering it, was an expensive one that should be reconsidered soon. In this context, greater reliance on regularly updated international benchmarking should be considered. Spending overshoots by hospitals should be only partially reimbursed, and the possibility to replace the management of hospitals in chronic deficit should be used more actively*. Market forces to rein in spending would arguably be more effective if they acted more intensively at the interface between the patient and the health service supplier. Co-payments are comparatively low, blunting the incentive of patients to demand cheaper treatments, even if the incentives to suppliers to give them are in place. *It would therefore be desirable to gradually introduce co-payments where they do not already exist (e.g. hotel-type services in hospitals) and raise them where they already exist. As in many other countries, exceptions can be made for those on low incomes or the chronically sick.* ■

How can fiscal sustainability be assured?

The oil wealth and the sensible proposals for pension reform should not be allowed to obscure the basic fact that neither the one nor the other, nor even both in combination, will obviate the need for hard choices for public spending in the years to come. The latest OECD estimates suggest that total old-age-related public spending (on both pensions and health) could rise by around 13 percentage points of GDP over the next few decades, assuming that the pension reform proposals are accepted as they stand and that they have their officially-estimated impact. Most of the increase would still be on public pensions, and it would come about as a result of demographic developments and because the system is still maturing, not because its generosity is excessive. Indeed, if the old-age pension "accounts" were separated out from the general budget, they would certainly show that the system would be in surplus at present at a notional contribution rate of 17½ per cent of salaries, as proposed in the reform package. Spending of oil revenue is currently about 5% of mainland GDP and it could rise to 7-8% at its peak given adherence to the fiscal rule, and gradually

shrinking thereafter. Even with an early return to the strict fiscal rule, it is clear that rising oil-related fiscal revenues would be quite insufficient to finance foreseeable spending increases. Spending the capital of the Fund to close the gap would merely pass on the problem in magnified form to the children of the current working generation. The inevitable conclusion is that there will have to be substantial public spending cuts relative to GDP in other areas and/or a rise in the tax burden. *Spending cuts and/or tax increases should preferably be designed to encourage work effort.* It would be as well to prepare suitable measures while income from oil-related activities remains high, so that they can be phased in gradually, reducing pressure on the exchange rate during a period when the economy is still likely to be prospering. This would guard against the need to take disruptive measures at a later stage that would threaten the sustained growth of national income. ■

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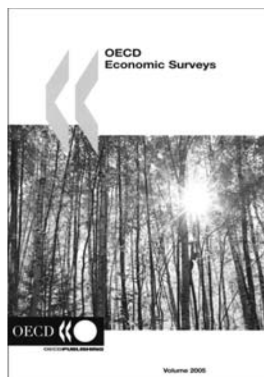

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- **Economic Outlook No. 77,** June 2005. More information about this publication can be found on the OECD's Web site at *www.oecd.org/eco/Economic_Outlook*.

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