

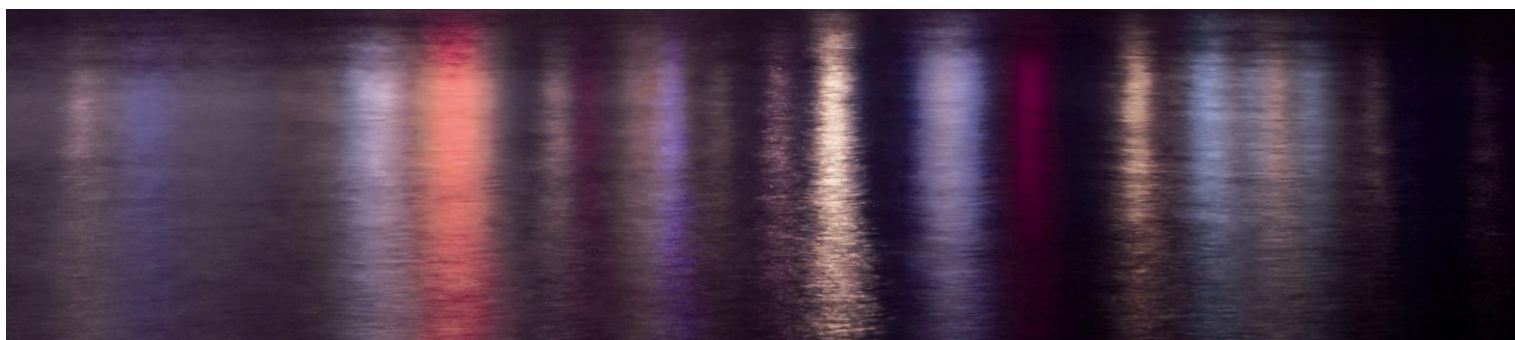


# OECD Economic Surveys

## NORWAY

FEBRUARY 2012

OVERVIEW



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# Summary

Norway continues to benefit from its well managed petroleum wealth and sound macroeconomic policies, achieving levels of well-being and social cohesion that have remained high by international standards. The strength of the economy and prudent supervision have helped the financial system to weather the financial crisis well, though high household debt and elevated house prices pose a risk. In the wake of the global slowdown and the euro area turmoil, the macroeconomic policy challenge has shifted towards preserving the momentum of growth in the context of the flexible inflation target and the well established fiscal framework. Public expenditure rose during the crisis and income redistribution remains extensive, in line with Norway's tradition. Ensuring that public spending is delivered in economically efficient ways remains a priority.

The **fiscal policy** stimulus was reined back a little in 2011 after the expansion in 2009-10. In 2012 the structural non-petroleum deficit, which is set to rise to just under 4% of the value of the Government Pension Fund Global, will have at most a small expansionary effect. There would be room within the fiscal guidelines to go for stronger expansion should economic activity turn out to be significantly weaker than projected. However, monetary policy should remain the first line of defence if the global outlook worsens, especially in the case of an intensification of the euro area crisis.

**Monetary policy** had begun to return to normality in the first half of 2011, as foreseen in the 2010 *Economic Survey*. Since then activity has slowed, international financial markets have again become turbulent, and annual consumer price inflation has remained well below the target of 2.5%. In these circumstances, the central bank was right to suspend the tightening cycle and then cut rates in December. It should resume tightening once there are risks of inflationary pressure, but there is also room for further easing in the event that economic conditions worsen.

**Labour market** performance is good overall with low unemployment and high participation. Average hours worked are low, due mainly to voluntary part-time work but also to high levels of sickness absence. The incidence of long-term sickness benefit and disability benefit to which it often leads may be reduced by measures taken in July 2011. Stronger steps to change incentives may well be needed. The recent private sector pension reforms need to be extended to the public sector.

**Public expenditure** occupies an important place in the economy, responding to Norwegians' desire for redistribution and a fair society through provision of public services. Careful attention to planning and efficiency is nonetheless required. An "efficiency unit" should be created to audit cost-benefit analyses and impact assessments carried out in spending ministries. A procedure for spending reviews, to assess the efficiency of major programmes and policies, should be established. Competitive outsourcing of the provision of public services to the private sector should be expanded where this improves cost-efficiency.

Norway's **tax system** achieves a high level of collection of receipts and revenue redistribution without overly undermining economic performance and while paying increasing attention to environmental externalities. The system is generally well structured with some innovative characteristics, but the taxation of capital still imposes distortions on savings. This is due to low taxation of residential property and uneven treatment of assets in the wealth tax, as theoretical calculations appear to show very high tax rates on some capital income. Greater tax neutrality could be achieved, equalising tax rates across different forms of capital income, while maintaining overall progressivity.

# Key recommendations

## Macroeconomic policies to support sustainable growth

1. Fiscal policy should continue to follow the longstanding guidelines. These allow for discretionary action to stabilise the economy if necessary.
2. Monetary policy should remain the first line of defence if the global outlook worsens, especially in the case of an intensification of the euro area crisis. There is room for further loosening if needed. Tightening should eventually resume if rising activity appears likely to bring annual consumer price inflation close to the target of 2.5%.
3. High household debt at floating interest rates and elevated house prices are vulnerabilities that macro-prudential policy and consumer protection should address. The strong financial supervision system should be maintained, including by ensuring that banks comply with higher capital requirements.

## Participation in an inclusive labour market

4. Align the rules for early retirement in the public sector with those in the private sector.
5. Tighten access to the sickness and disability schemes, with stronger enforcement of back-to-work plans and independent checks on GPs' sickness and disability assessments.
6. If even tighter gate-keeping does not reduce take-up, reduce the replacement rate for long-term sickness and shift more of the costs onto employers.
7. Make the work assessment system for recipients of disability benefits more rigorous. Use the disability benefit system to help people into employment when possible.

## Achieving high public spending efficiency

8. Increase the extent to which public expenditure and public administration and services are assessed on the basis of output indicators. Make greater and more consistent use of value-for-money analysis, with more transparent presentation of policy priorities.
9. Establish an "efficiency unit" with the power to audit cost-benefit and other assessment studies to ensure consistency across ministries.
10. Establish a system of independent spending reviews of specific public policy programmes.
11. Consider greater outsourcing of local and central government services to the private sector.

## Reform of capital taxation

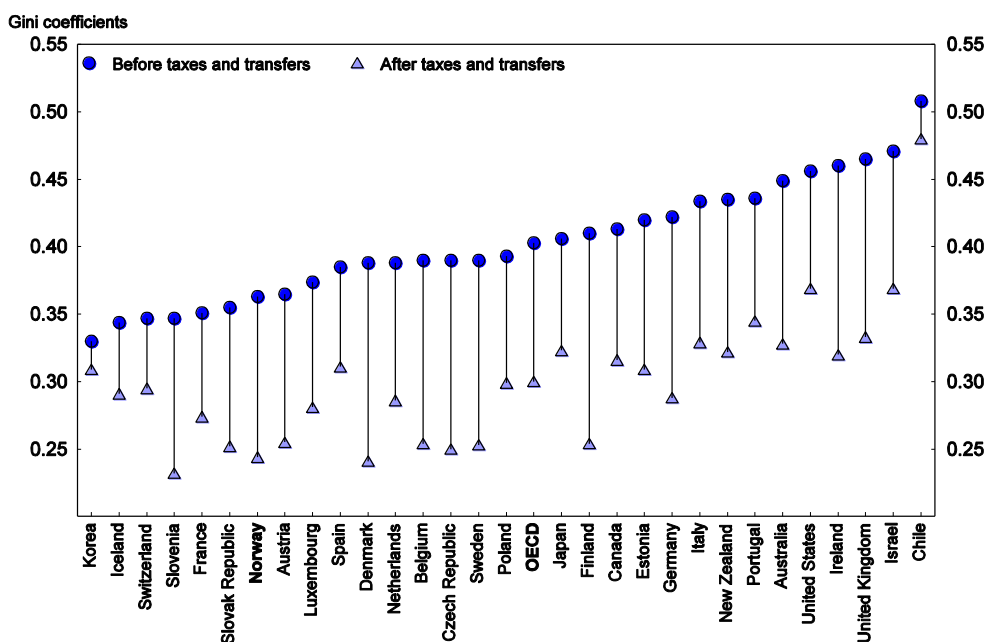
12. Improve capital taxation by aligning effective tax rates across assets. This should include reducing the implicit tax subsidy on owner-occupied housing, ideally by introducing tax on imputed rental income or a national property tax, otherwise - though less desirable - by phasing out mortgage interest deductibility.
13. Investigate the impact of the wealth tax on effective tax rates, on tax avoidance and on incentives to invest. Phase out or reduce the wealth tax if the growth-redistribution trade-off is too unfavourable to growth.
14. Abolish stamp duty on real-estate transactions so as to promote mobility. Due to the possible effect on house prices, the timing should be considered carefully.
15. Replace existing allowances by a donor-independent lifetime allowance, so as to restrain avoidance in the taxation of inheritances and gifts.

# Assessment and recommendations

## *Protected from the worst of the crisis by petroleum wealth and a sound macroeconomic policy framework, Norway continues to enjoy high levels of income and well-being*

Norway's economy was protected from the worst of the recession induced by the 2008-09 financial crisis and should escape relatively unscathed from the current euro area turmoil. This resilience owes a lot to the improvement of the terms of trade and the prudent management of petroleum wealth, which has led to a very strong fiscal position. Norway scores high in international comparisons of material well-being, but also shows up well in other comparisons such as community, environment and safety, and overall life satisfaction. These high scores may be related to the Norwegian model of a relatively egalitarian society, where social consensus and a high degree of inclusiveness are important. Indeed, not only is wage inequality relatively narrow in Norway, but the amount of redistribution through the tax and benefit system is large, so that the distribution of net income is even more egalitarian (Figure 1). The generous provision of public services, such as education and health, also has a major role in offering all Norwegians an opportunity to realise their full potential. High public spending and associated taxation potentially imply significant efficiency costs, however, as they tend to distort economic incentives. This *Survey* discusses the overall management and control of public spending across the economy and focuses on certain aspects of the tax system.

Figure 1. Gini coefficients before and after taxes and transfers  
In the late 2000s



Source: Joumard *et al.* (2012).

## I. Macroeconomic policies to support sustainable growth

### *The economy has been resilient despite the high level of uncertainty in the euro area*

The mainland economy maintained some momentum well into 2011, especially in sectors closely connected to the petroleum industry or to public-sector service provision, but also in certain other dynamic sectors – such as financial intermediation, retail distribution, fishing, and fish farming. Signs of slowdown appeared in the second half of 2011 and the economy seems set to grow more slowly in the short term. Unemployment is nonetheless expected to remain low by historical and international standards. This enviable economic situation owes a lot to the rapid accumulation of petroleum wealth in the Government Pension Fund Global (GPFG) and the terms of trade, but also to supportive macroeconomic policies. Norges Bank, Norway's central bank, has conducted monetary policy consistent with both low inflation and low unemployment, with interest rates well below the “normal” rate of some 4-5%. Flexibility in the design of the fiscal framework has allowed a broadly neutral fiscal stance, with the structural non-oil budget deficit kept at about 5½ per cent of mainland GDP from 2009 to 2012, and at about 3¼ per cent of the value of the GPFG in 2011.

The effects of weakened confidence in the wake of the most recent global downturn are projected to restrain growth into 2012. The mainland economy should then regain momentum, and accelerate further in 2013 (Table 1). Norway has little trade exposure to troubled peripheral euro area countries, with its exports concentrated on relatively strong economies in Europe and, increasingly, Asia. Thus, the slowdown will be less pronounced than in many other OECD countries and the government, under current projections for the value of the GPFG, should keep the structural non-oil deficit somewhat below the level defined by the “4%” guideline. If, however, the financial turmoil worsens in the euro area and has negative global repercussions, the outcome could be much less favourable. In such a case monetary policy action should be taken, and if necessary the government could take discretionary fiscal measures to sustain demand, as foreseen under the macroeconomic framework (Box 1).

#### Box 1. The Norwegian macroeconomic policy framework

**Fiscal policy** works within a set of guidelines, agreed across all but one of the main political parties, on the use of revenue from oil and gas production. The current government augments these guidelines with self-imposed restrictions on tax changes.

The fiscal framework has two parts, a rule on the management of annual petroleum revenues and a rule on the management of the accumulated stock of revenue:

- All government revenues from oil and gas production, whether through taxation or ownership, less investment costs, are paid into the Government Pension Fund Global (GPFG). The GPFG invests exclusively in assets outside Norway.
- The so-called 4% rule stipulates that the central government deficit excluding petroleum revenues and adjusted for the cyclical position of the mainland economy should, over time, equal 4% of the value of the GPFG at the end of the year prior to the budget year.

The figure of 4% was chosen because it was estimated that this was the long-run real rate of return the fund could expect. In this case, the rule amounts to preserving the real capital value of the GPFG. For the first decade or so, it achieved almost a 4% real return, but after stock market declines since the crisis and up to September 2011, the average return since the inception of the fund has been only 2.2%.

A non-petroleum structural deficit equal to 4% of the GPFG is not a binding target for any particular year, the government is free to deviate from it in various circumstances, notably when discretionary fiscal action seems necessary to stabilise the economy, or when the value of the GPFG changes erratically. Although one of the aims of the GPFG is to preserve petroleum wealth for future generations, the guidelines do not explicitly require that cumulated deviations of the structural deficit from the 4% value should be zero. Use of the phrase “the 4% rule” or “4% guideline” in the text of this report encompasses both the 4% rule as outlined above and the underlying rule allocating all current petroleum revenue to the GPFG.

The current government has operated since 2006 with a rule that any changes in the tax system should be calculated to be revenue neutral. If one tax is increased, another must be reduced to offset the estimated impact of the increase. In effect this should lead to a broadly constant share of mainland tax revenue in mainland GDP.

**Monetary policy** is operated according to a flexible inflation target oriented toward low and stable inflation. The operational target is for consumer price inflation to be close to 2.5% over time. In aiming for this target, monetary policy is also to contribute to stabilising output and employment. The main policy instrument is the interest rate paid on banks' deposits in the central bank.

Table 1. Main macroeconomic and financial indicators

	2008	2009	2010	2011	2012	2013
	Current prices NOK billion	Percentage changes, volume (2007 prices)				
Real GDP	2 510.9	-1.7	0.3	1.5	2.0	2.7
Private consumption	988.8	0.2	3.7	2.8	2.7	3.9
Government consumption	491.9	4.8	2.2	2.4	1.5	1.7
Gross fixed capital formation	548.0	-6.8	-7.4	6.0	5.0	4.8
Final domestic demand	2 028.7	-0.6	0.5	3.5	3.0	3.6
Stockbuilding <sup>1</sup>	7.0	-2.9	3.4	1.4	-0.8	0.0
Total domestic demand	2 035.7	-4.2	4.4	5.1	2.0	3.6
Exports of goods and services	1 218.0	-3.9	-1.7	-2.2	1.9	2.2
Imports of goods and services	742.8	-11.7	9.0	5.8	1.9	4.4
Net exports <sup>1</sup>	475.2	1.6	-3.2	-2.6	0.3	-0.3
Mainland GDP <sup>2</sup>	1 812.2	-1.8	2.1	2.6	2.7	3.6
Terms of trade		5.7	-4.2	-2.3	0.6	0.4
Consumer price index	–	2.2	2.4	1.5	1.9	1.8
Private consumption deflator	–	2.5	2.0	1.2	2.0	2.0
Unemployment rate	–	3.2	3.6	3.2	3.2	3.2
Household saving ratio <sup>3</sup>	–	7.3	7.4	8.7	8.5	7.7
General government financial balance <sup>4</sup>	–	10.7	10.6	12.5	11.5	10.7
General government gross debt <sup>4</sup>	–	49.1	49.7	56.5	51.3	48.6
Current account balance <sup>4</sup>	–	11.8	12.6	16.4	16.4	15.6
Value of GPFG, % mainland GDP <sup>5</sup>		150	166	160	172	
Structural non-petroleum budget balance, per cent of trend mainland GDP <sup>5</sup>		-5.4	-5.5	-5.3	-5.6	

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see OECD Economic Outlook Sources and Methods ([www.oecd.org/eco/sources-and-methods](http://www.oecd.org/eco/sources-and-methods)).

- Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
- GDP excluding petroleum and shipping.
- As a percentage of disposable income.
- As a percentage of GDP.
- 2012 National Budget (October 2011). The estimated structural non-oil deficit in 2011 was revised down to 4.8 per cent of trend mainland GDP in the Final Budget Revision for 2011 (December 2011). Updated figures for 2012 will be published in the Revised National Budget in May 2012.

Source: OECD Economic Outlook, November 2011.

## *Fiscal policy continues to benefit from prudent management of petroleum revenues*

Petroleum revenues continue to contribute to high national saving. Petroleum revenues are accumulated in the GPFG, which was worth over 160% of mainland GDP at the end of 2010, but rather less in late 2011 owing to equity market declines. A key contribution of the GPFG is to insulate the budget and the mainland economy from the immediate effect of swings in oil and gas prices, allowing the adjustment to take place over a longer period. The discretion allowed by the guidelines has some advantages, as the fluctuations in the value of the fund are increasingly due to financial markets rather than petroleum revenue, so the growth in the non-petroleum structural deficit as a share of mainland GDP has been quite rapid but not steady (Table 2).

Table 2. Budget deficits 2001-12

	Central government structural non-petroleum deficit	
	as % of the GPFG	as % of mainland GDP
2001	5.5	1.8
2002	5.9	3.0
2003	7.1	3.4
2004	5.6	3.5
2005	4.9	3.4
2006	3.4	2.9
2007	2.7	2.8
2008	3.0	3.3
2009	4.4	5.4
2010	4.1	5.5
2011 <sup>1</sup>	3.5	5.3
2012 <sup>2</sup>	3.9	5.6

1. The estimated structural non-oil deficit in 2011 was revised down to 3.2% of the GPFG in the Final Budget Revision for 2011 (December 2011), corresponding to 4.8% of trend mainland GDP. Updated figures for 2012 will be published in the Revised National Budget in May 2012.

2. Projected.

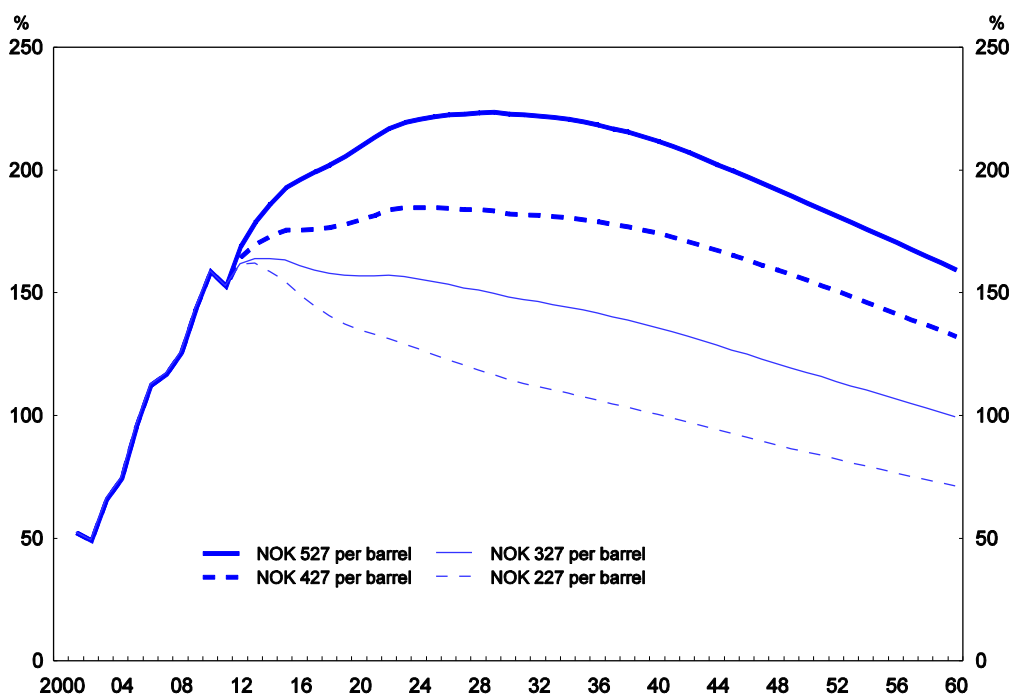
Source: Ministry of Finance and *OECD Economic Outlook database*.

The Ministry of Finance currently projects the value of the GPFG to increase from about 160% of mainland GDP at the end of 2011 to about 185% by 2025, assuming an oil price of NOK 427 (corresponding to about USD 72) per barrel (Figure 2). An oil price of USD 85 per barrel would imply a higher fund value, around 220% of mainland GDP. On the central projection, the 4% rule would result in a non-oil structural deficit of 7% of mainland GDP in 2025. Though substantial, this would be insufficient to cover the potential longer-term gap in public finances due to higher age-related spending on pension and health. In addition, the annual real return on the assets of the GPFG between 1998 and late 2011 was only 2.2%, below the envisaged 4%. Although this is not a certain guide to future rates of return, together with the expected longer-term fiscal gap, it suggests that fiscal policy should aim at staying below the 4% path.



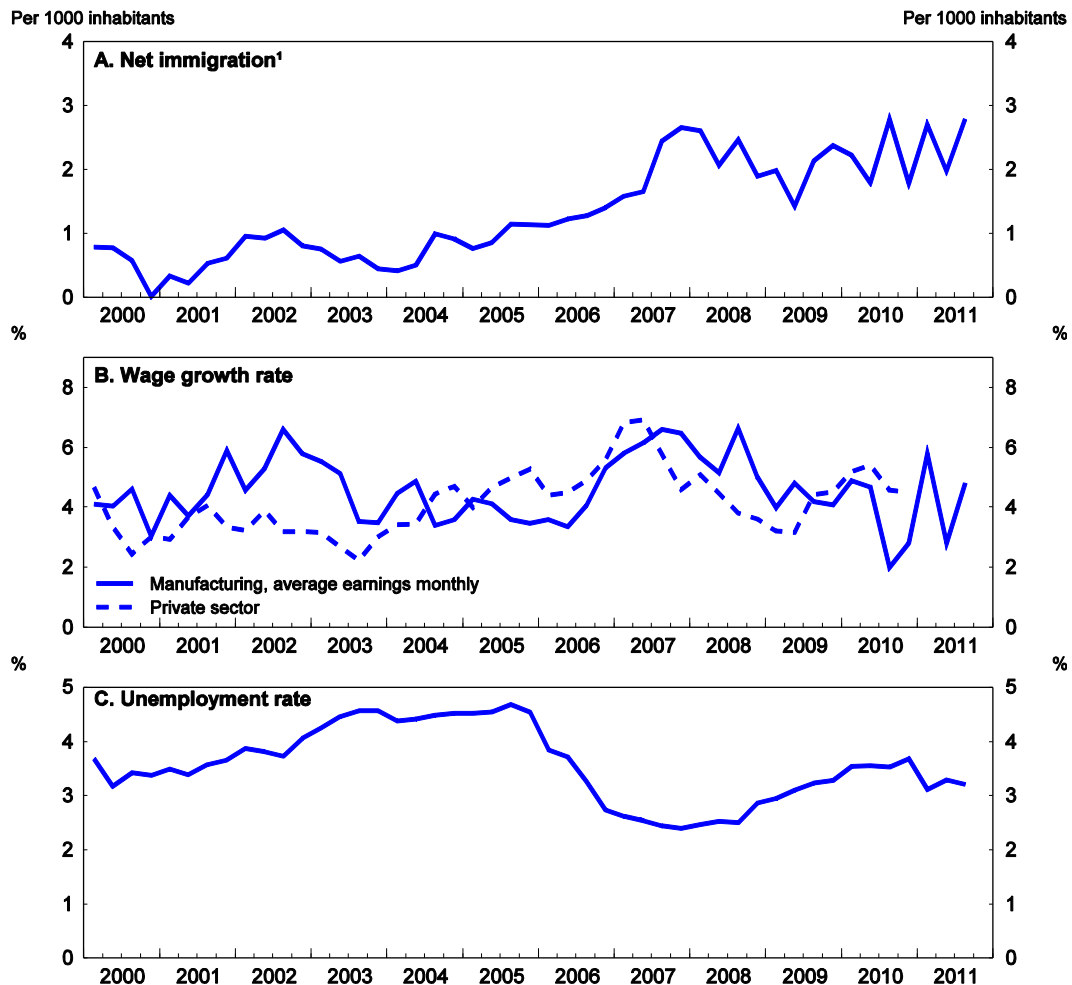
While the 4% rule dampens the “Dutch disease” effect, it cannot eliminate it altogether and the so-called traditional sector (non-oil traded goods) has been diminishing in importance. Despite this, it is important in setting wages. Rather than wages being determined by the relative bargaining strengths of different sectors, the general level of wage settlements is set by the social partners first considering the wage increase that the traditional sector can “afford”. This tends to mean that in times of high demand pressure the acceleration of overall unit labour costs is attenuated. To some extent the pressure has, in recent years, been reflected instead in very high rates of net labour immigration (Figure 3).

Figure 2. Value of the Government Pension Fund Global  
As a percentage of mainland GDP



Source: Statistics Norway and Ministry of Finance.

Figure 3. Immigration, wages and unemployment



1. Net immigration is total population inflow minus total population outflow.  
Source: Statistics Norway and OECD Economic Outlook database.

### *Public accountability in fiscal policy*

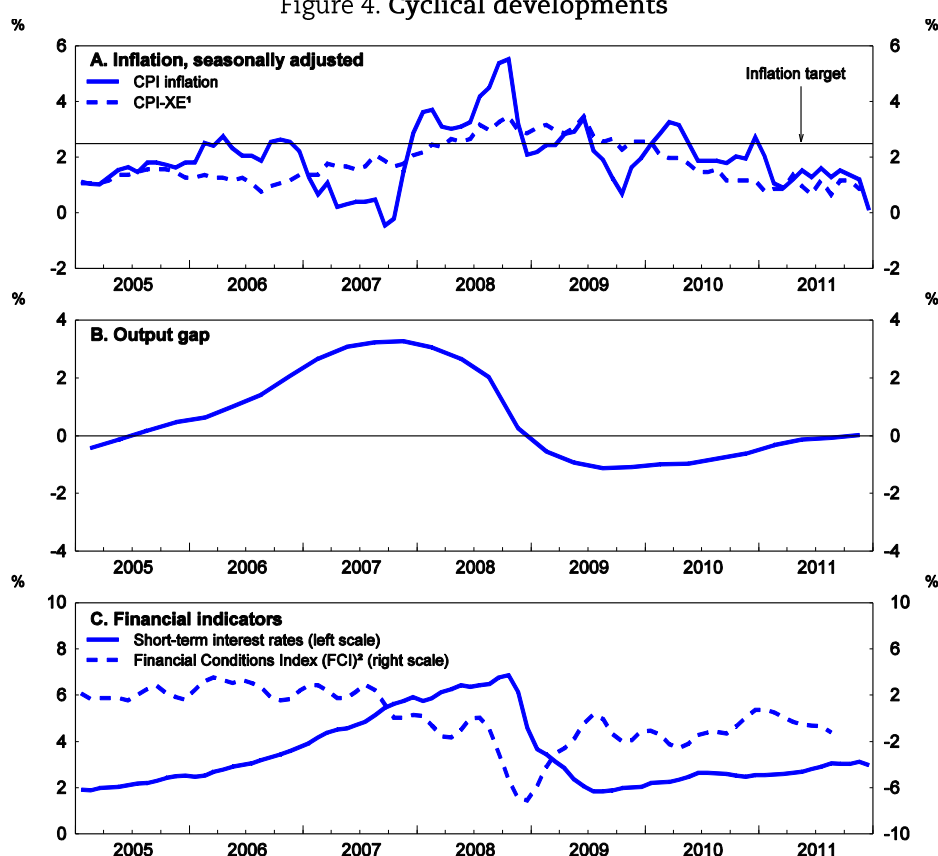
An increasing number of countries have recently set up independent fiscal councils to report on budgetary policy, as recommended by the OECD and others (Hagemann, 2010; Calmfors, 2010). As suggested in the 2010 *Economic Survey*, Norway has set up an Advisory Panel, which gives “expert judgment and advice” on modelling and long-term simulation issues, as well as on analyses reported to parliament in budget reports and the regular white papers on long-term perspectives. Two out of ten members are officials from the Ministry of Finance. The role of the panel should be kept under review, to see if its mandate could usefully be broadened in the future.

### *Monetary policy credibility allows interest rates to be kept low*

Norway’s flexible inflation targeting approach to monetary policy can present the authorities with a challenge, as domestic interest rates can have an uncertain effect on the exchange rate, depending on external factors - notably petroleum prices and interest rates in other countries. Although the annual consumer price inflation target of “close to 2½ per cent over time” has not always been met over the last 6 years, the shortfall has been mostly on the downward side, so expectations of low inflation are likely to

be well-anchored (Figure 4). Keeping policy interest rates low, as the current uncertain situation requires, thus poses little risk to inflation. Low interest rates may have been encouraging the real-estate boom, which calls for a tightening of macro-prudential measures. Other indicators, such as banks' lending conditions and interest rates spreads, suggest that financial conditions are tighter than policy interest rates alone would suggest. In December 2011 the central bank lowered its key policy rate by 50 basis points to 1.75%, citing weaker prospects abroad, lower than expected domestic inflation and tightening conditions on financial markets. If the global and domestic economy turn out to be weaker than projected, the central bank should reduce the policy rate further and maintain it at a very low level for an extended period.

Figure 4. Cyclical developments



1. CPI-XE, calculated by Norges Bank, is the consumer price index adjusted for tax changes and excluding temporary fluctuations in energy prices.
2. Financial Conditions Index (FCI) includes 13 different indicators of financial conditions, such as share prices, credit supply and exchange rates ([http://www.norges-bank.no/Upload/Publikasjoner/Staff%20Memo/2011/StaffMemo\\_0711.pdf](http://www.norges-bank.no/Upload/Publikasjoner/Staff%20Memo/2011/StaffMemo_0711.pdf)).

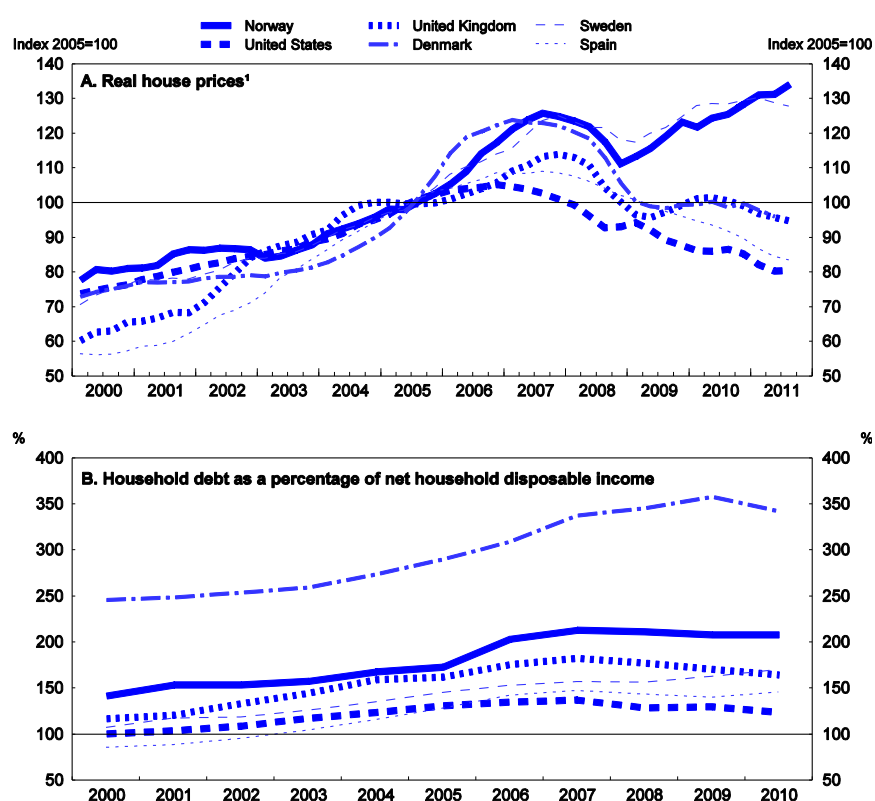
Source: Statistics Norway and Norges Bank.

### *Real estate prices have continued to grow strongly*

Property prices have renewed their upward path (Figure 5), growing at an annual rate of almost 10% for most of 2010 and into 2011. Credit to households has also been growing strongly, at around 6 to 7% a year, but this has been broadly matched by household income growth since 2007. Norges Bank has developed a tool to assess the resilience of the financial system, which considers internal vulnerabilities in the banking sector as well as external sources of risk (Figure 6). The greatest risks seem to stem from the household sector, reflecting historically high house prices and household debt, which is twice disposable income on average and almost exclusively at floating interest rates, an unusual situation in

international comparison. In addition, the banking sector is subject to some funding risks which are primarily related to its significant reliance on foreign wholesale funds, while banks are little exposed to sovereign bonds in distressed euro area countries. Norges Bank's stress testing shows that banks' capitalisation would fall below required levels in a scenario where trading partner economies' suffer a downturn more severe than during the financial crisis of 2008-09, combined with a significant deterioration in international financial markets. These potential vulnerabilities of the banking system argue for maintaining high standards of financial supervision, in particular by ensuring that the banks are well capitalized with respect to the international Basel III norms and EU directives.

Figure 5. House prices and household debt in selected OECD countries



1. Deflated by private consumption prices.

Source: OECD Economic Outlook database.

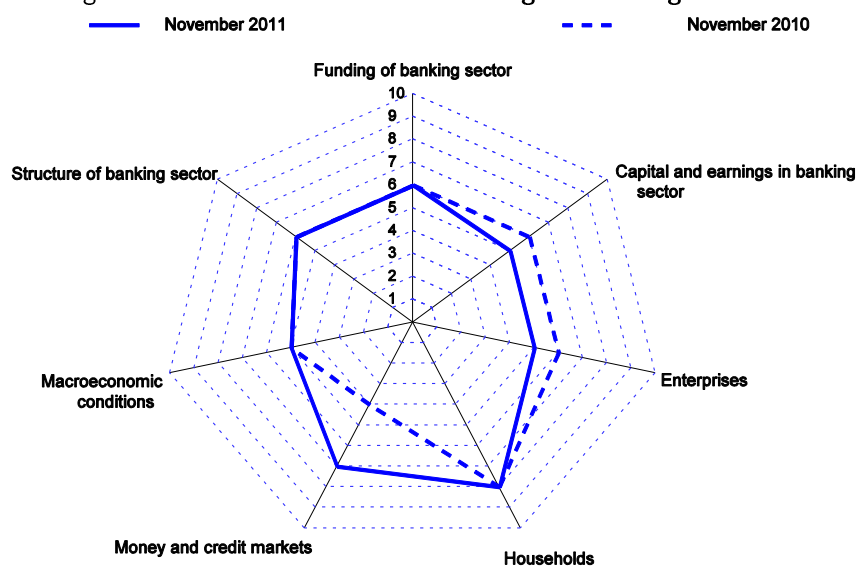
These potential vulnerabilities also suggest tighter macro-prudential policies are warranted. The authorities are constrained in regulating banks by EU rules and their application to EEA countries. Finanstilsynet (The Financial Supervisory Authority of Norway) advised banks in 2010 to apply stricter standards on mortgage loans where the loan-to-value ratio exceeded 90%. The guidance applies to both domestic banks and branches of foreign banks. Finanstilsynet tightened these guidelines in December 2011 due to continued high growth in house prices and household debt. The revised guidelines advise banks to lower the general loan-to-value ratio limit to 85% and to make allowance for a 5 percentage point increase in interest rates when assessing a loan applicants' debt-servicing ability. Finanstilsynet has stated that it may impose higher capital requirements if these guidelines are breached.

As in most countries, the low risk weights on mortgage lending encourage banks to expand in this market. Norway is also constrained because it cannot regulate Norwegian branches of foreign (mainly Nordic) banks, and stricter limits on domestic banks might cause many households to turn to branches

of overseas banks, potentially inducing Norwegian subsidiaries of foreign banks (regulated in Norway) to turn themselves into branches (which would be regulated by the regulator of the parent bank). This could potentially leave much of the financial system outside the reach of the Norwegian regulator. Nordic cooperation on stricter capital requirements for housing loans would be a step in the right direction, but it is not clear what room Norway has to act on its own. There may be a further role for consumer protection legislation – which would apply to all borrowers and therefore to both banks and branches. Variable interest rate loans are the norm in Norway, and such borrowers are potentially very vulnerable to increases in interest rates. Such action could contribute to financial stability. Principles on financial consumer protection developed by the OECD were endorsed by the G20 heads of government in November 2011. They place particular emphasis on the need for financial consumer protection to be an integral part of the legal and regulatory framework. Financial service providers should provide clear information on possible risks, and financial education should be promoted. Norway is generally in line with international good practice in these areas, though improvements are needed in most countries.

In the Norwegian banking crisis of the early 1990s, bank losses on commercial property - rather than household mortgage debt - precipitated the crisis. Having fallen more sharply than housing prices in 2009, commercial property prices have bounced back more rapidly, growing at annual rates of 30% in 2011. Although growth in credit to companies has been low, the regulator should also continue to pay attention to banks' exposure to commercial property loans. Despite high property prices, the economy has been less unbalanced than some countries were in the pre-crisis boom: output of the construction sector remained between 4 and 4½ per cent of GDP for the last decade, though it did rise to close to 5% in the boom years.

Figure 6. Vulnerabilities in the Norwegian banking sector



Note: A value of 0, i.e. the origin, denotes the lowest level of risk or vulnerability. A value of 10 denotes the highest level of risk or vulnerability.

Source: Norges Bank, Dahl *et al.* (2011).

While in some areas, such as the regulation of financial markets, progress has been made, in others the implementation of structural reforms recommended in past *Surveys* has been rather slow, in a few cases even backward (Annex A1). For example, since the last *Survey*, no significant measures have been taken to reduce tariffs and increase import quotas in the agriculture market. Similarly, no significant action has been taken to promote competition across a range of sectors, including the retail sector and postal services. Structural reforms should be implemented to address these weaknesses. In the labour markets, while the merger of the Public Employment Services and the National Insurance Services was

completed, there is a need for increasing the flexibility in wage setting and a modernisation of the employment protection legislation. Other labour market reforms to promote job creation are discussed below.

#### Box 2. Summary of recommendations on macroeconomic policy

- Continue to manage fiscal policy within the established framework.
- Aim to keep the structural non-oil deficit below the 4% rule, although there is room for discretionary action to sustain domestic demand in the event of a significant worsening of the euro area financial turmoil.
- The stance of the central bank is appropriate. There is room for further loosening if needed. Tightening should eventually resume, once rising activity appears likely to bring annual consumer price inflation close to the target of 2.5%.
- The good performance of the financial supervision system should be maintained, especially by ensuring that banks are well capitalized with respect to Basel III norms and EU directives.
- The financial vulnerabilities resulting from high household indebtedness at floating interest rates may need to be addressed by further action on macro-prudential policy and consumer protection.

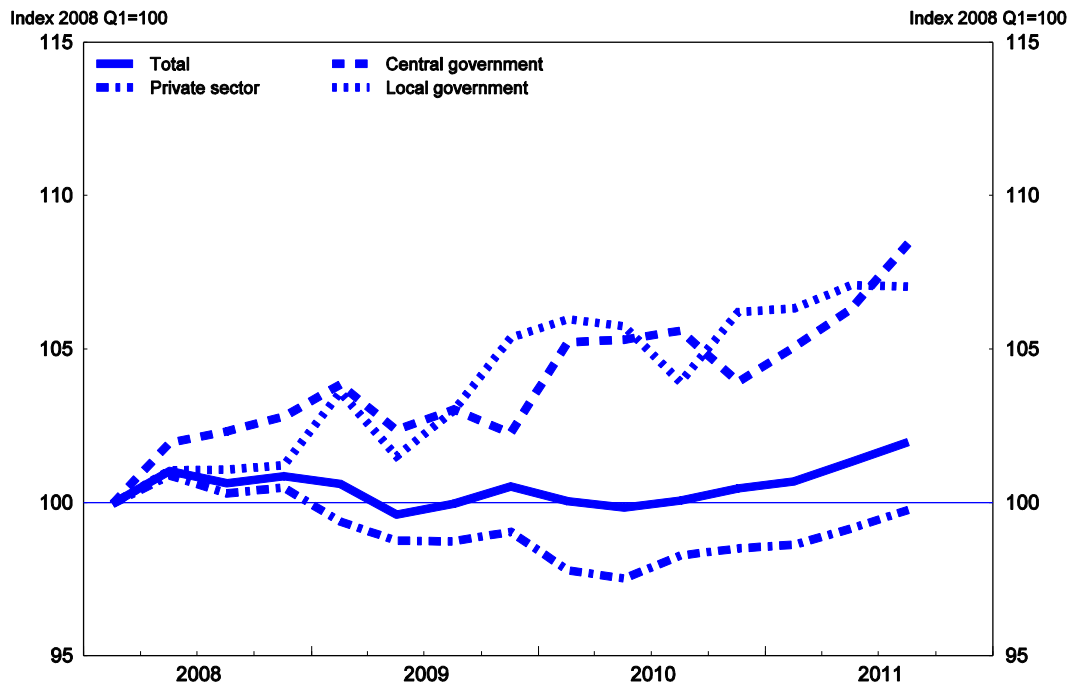
## II. Labour market policies

### *Public sector employment helped to sustain the labour market through the recession*

The labour market is characterised by low unemployment and high participation. Labour utilisation measured in terms of hours worked per working-age person is not high by international comparison, at least partly due to high levels of voluntary part-time working and sickness absence. High participation but short average working hours are probably a key contributor to Norway's high rating on subjective assessments of work-life balance. The dispersion of wages is also low; the ratio of the earnings of the highest decile of workers to that of the lowest is below that of all OECD countries except the other Scandinavian countries.

The fiscal expansion that was a response to the 2008-09 recession has been accompanied by increased public sector employment (Figure 7). This increase was small compared with the large increase in public sector employment that took place in the 1990s. It may be difficult to reverse because of the strong *de facto* security of employment in the public sector (although public sector labour contracts allow workers to be made redundant if the role defined in their job description is no longer needed). Over the past 20 years, public sector employment as a share of total employment in the mainland economy has been fairly stable.

Figure 7. Employment in the private and public sector  
Seasonally adjusted

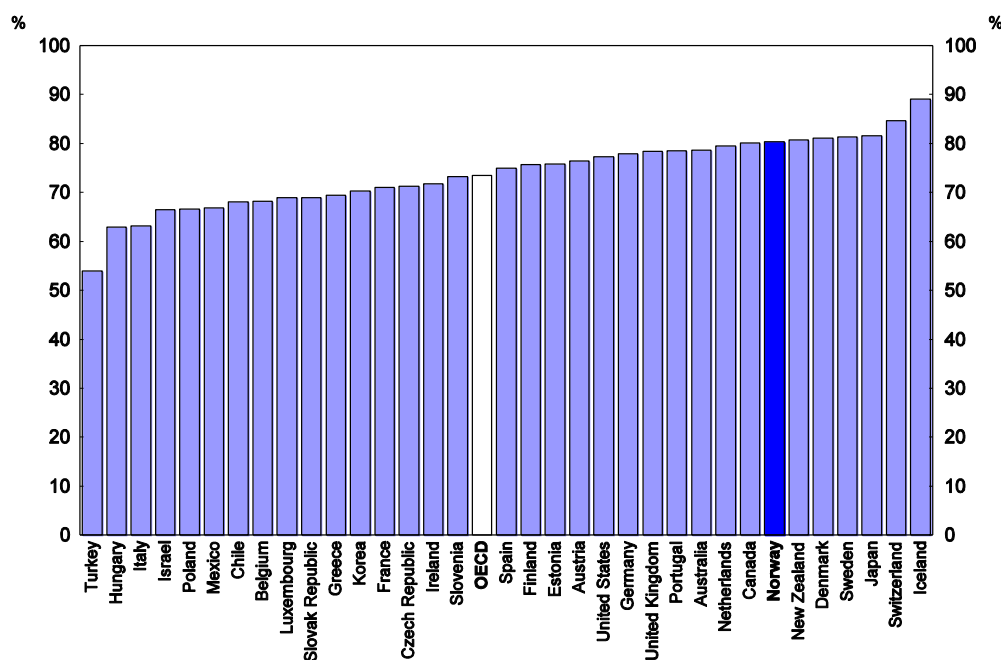


Source: Statistics Norway.

The recent rise in local government employment has in fact been primarily due to higher employment in kindergartens and health and social services. The higher employment in kindergartens is partly accounted for by the newly introduced kindergarten promotion of the current government (“Kindergarten places for all children whose parents so wish”). About half of all kindergartens are privately run, not so much because of a policy choice by the local governments responsible but because they found it difficult to expand provision in the public sector in time to meet the objectives of the law. In other areas, the use of contracting out is more limited, but in many cases policy aims could be better served by wider use of contracting out to the private sector.

Participation rates are comparatively high in Norway, including quite a high share of part-time employment (Figure 8), while the employment rate was 77.5% in 2010, the third highest among all OECD countries. Participation rates for the young, though still somewhat higher than elsewhere, fell in 2009 and 2010, seemingly as many chose higher education as an alternative to employment. Participation of older workers is also relatively high, despite high take-up of early retirement and disability pensions. It is likely to increase in the future following pension reforms which reduced the disincentive to continue working in the private sector, though strong disincentives still exist in the unreformed public sector scheme.

Figure 8. Labour force participation rates<sup>1</sup> in 2010: an international comparison



1. Women and men aged 15 and over.

Source: OECD, Labour Force Statistics database.

Norway's growing economy and high living standards attract large inflows of migrants, which are now 10% of the population. Despite high labour demand, employment rates for certain groups are relatively low, particularly among those with an Eastern European (outside the European Union), African, Asian and Latin American background (which together make up about half of all employed immigrants).

For unemployed immigrants as for many other unemployed individuals, Norway makes extensive use of active labour market programmes (ALMPs, such as public employment services, training schemes, employment subsidies). Experience in many countries suggests that not all forms of ALMPs are effective, and studies have shown this for Norway too (see e.g. Lorentzen and Dahl, 2006; and Rønsen and Skarohamar, 2009). The government should extend these studies to identify which ALMP programmes and which methods of delivery yield the best value for money, as well as to assess the relative efficiency of public and privately-run schemes. Resources should be concentrated on the most cost-effective methods.

***Reforms in the sickness and disability schemes, and in public sector pensions, still fall short of what is needed***

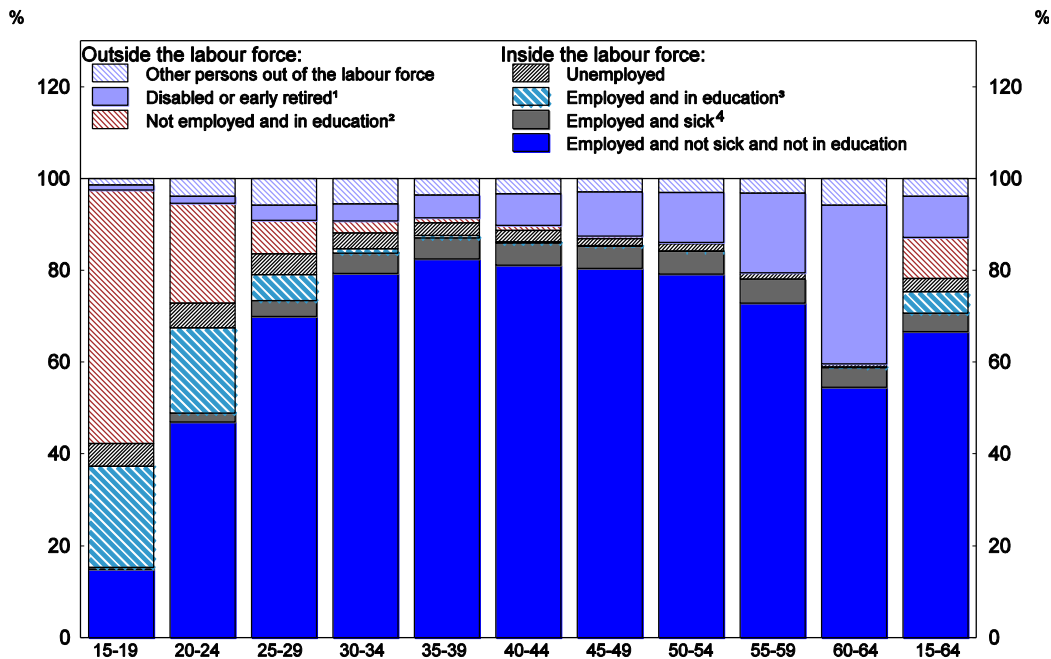
In the public-sector early-retirement schemes, people can receive an early-retirement pension at age 62, and from age 65 at the same level as if they retire later, creating a very high “implicit tax” on continued employment and a strong incentive to retire early. In the private sector, a similar scheme (AFP) used to operate but a recent reform, discussed in the 2010 *Economic Survey*, took effect for new pensioners from 2011. This reform has removed the strong disincentive to continue working, although the remaining subsidy due to partial state financing should be removed. Negotiations between public sector employers and unions should seek to reform the public sector scheme so as to fully align it with the principles of the reformed private sector system. It also is important to ensure that employees who transfer between the public and private schemes do not have their pension entitlements affected, so



that the choice between public provision and contracting out of public services, discussed below, is neutral as far as workers' pension rights are concerned.

As discussed in previous *Economic Surveys* (in particular in 2005, 2007 and 2010) and the Disability Study (OECD, 2010b), Norway's high participation rates are undermined by its sickness and disability schemes. No other OECD country has such a high level of sickness absence and such a generous sickness benefit scheme (Figure 9). Around 5½ per cent of the employed are absent from work on a sick leave certificate. As a share of the population the number of employed-and-sick is fairly constant for those over 30 but, since the employment rate declines with age, the number of sick as a proportion of the employed increases, reaching 8% for the 60-64 year-olds. Norway spends a higher share of GDP (4.8% in 2007) on sickness and disability programmes than any other OECD country and more than twice the OECD average of 1.9% (OECD, 2010b, Table 2.1). Sickness benefits are paid at 100% of the past wage for a whole year, for the initial 16 working days by the employer, then by the state. The scheme provides valuable insurance against a genuine long-lasting sickness, but it seems unlikely that genuine incapacitating sickness is so prevalent where other health indicators are good.

Figure 9. Population structure, 2010



Note: This chart is based on a mixture of administrative data and survey data which may not be strictly comparable. "Employed and in education", "Not employed and in education", "Disabled or early retired" use self-reported data on main activity; according to Statistics Norway and Ministry of Finance, no factual data on the labour market status of persons in education and persons receiving disability or early retirement benefits are available.

1. This is an estimate based on the Labour Force Survey of the number of persons who are outside the labour force and self-report "Disability or early retirement" as their main activity. It is assumed that no person inside the labour force is disabled or early retired.
2. This is an estimate based on the Labour Force Survey of the number of persons who are outside the labour force and self-report "In education" as their main activity.
3. This is an estimate based on the Labour Force Survey of the number of persons who work part-time and self-report "In education" as their main activity. It is assumed that no such person is sick.
4. This is the number of employees who are on sick leave that is certified by a doctor.

Source: Statistics Norway.

Governments have tried to improve gate-keeping, as documented in the 2010 *Economic Survey*, but the level of sickness absence remains very high. A further tightening was introduced in July 2011 in measures to provide for earlier and closer monitoring of sick leave, with provision for sanctions against the employee, employer and doctor for failure to follow up. Without strong sanctions and independent audits (which might be on a random selection basis) of doctors' assessments, there is a risk that this tightening will fail as in the past. The sanctions on employers and doctors who do not respect the tightened procedures should be strong. The new information system that allows doctors to benchmark their own diagnostic practices should be used to improve diagnosis, not to lead to a weakening of vigilance by those doctors who are currently relatively strict. Success in reducing unjustified sick leave would allow for an accompanying reduction in social security contributions. If the 2011 measures fail to cut entry into sickness benefit significantly, the government should introduce much stronger checks on doctors' assessments and/or increase work incentives by reducing replacement rates (as recommended in OECD, 2010b) to, say, 75-80% of the previous wage. A higher share of costs (beyond the current 16-day period) could also be shifted onto employers.

High levels of disability in Norway (9% of the population aged 15-64 receive a disability pension) also call for reform, linked with reform of sickness benefit, because many people on long-term sickness move onto disability benefits. As a fraction of GDP, expenditure on disability insurance in Norway is the highest across all OECD countries and the OECD indicator of disability compensation policy suggests that the Norwegian system is more generous overall than any other except that in Sweden (OECD, 2010b, Table 3.A2.1). To a considerable extent, disability benefit operates partly as a form of early retirement benefit – take-up rises strongly with age, but growing take-up among people under 35 (with a higher than average share of people assessed with a mentally-related disability) is an increasing problem.

A reform of the disability scheme was announced in mid-2011, to align the disability pension scheme with the reformed old-age pension scheme, but it did not address the existing problems of the high level of disability pension recipients. The government needs to provide clear guidelines to general practitioners in their role as gatekeepers to disability benefit, along the lines of the July 2011 measures for sickness benefit. But while sickness benefit is of limited duration, assignment to disability is effectively permanent, so gate-keeping must be even stronger. GPs' decisions should be subject to randomised but not infrequent checks. Those whose decisions reveal a strong bias towards leniency should have their authority to certify people for sickness or disability benefit withdrawn. In addition, the time on work assessment benefit (which covers the transition between sickness and disability schemes) must be better used to fit people for some work, and help to do more to facilitate the use of partial disability awards which act as income support while encouraging and, in part, enabling people to continue working; at the moment, more than 80% of disability benefit recipients receive full benefits.

### Box 3. Summary of recommendations on labour-market policy

- Conduct credible statistical or other forms of testing to see which kinds of active labour market programmes give the best value for money and concentrate resources on these.
- Fully align the rules for public sector pensions with the principles of the reformed system in the private sector, to avoid encouraging early withdrawal from the labour market.
- Ensure the July 2011 revisions to guidelines on sickness benefit are fully implemented, with clear assessment guidelines to general practitioners and effective compliance monitoring. Extend a similar system to disability benefit and make more extensive use of partial disability benefit awards.
- If access rates to sickness benefits do not fall significantly, further tighten gate-keeping, lower the replacement rate for long-term sickness absence and shift a greater part of the associated costs onto employers.

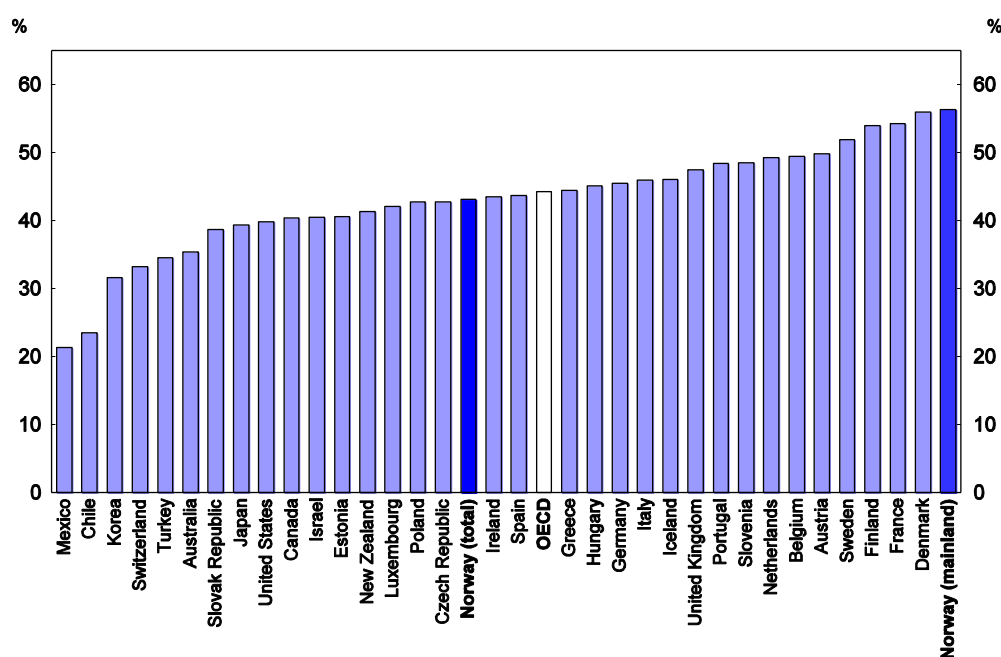
### III. Raising public spending efficiency

#### *Petroleum wealth allows high public expenditure*

Norway's petroleum wealth provides the means to finance very high levels of public spending. The self-imposed restraint of the fiscal guidelines has been very effective in managing petroleum wealth and preventing too-rapid spending growth. Nevertheless spending has reached high levels and as a share of mainland GDP is the highest in the OECD (Figure 10). With such a large share of economic activity being influenced by public spending good mechanisms for ensuring money is spent wisely are important.

For example, there is evidence of overall inefficiency in the large compulsory education sector (see *Economic Surveys* of 2008 and 2010), and a number of areas of inefficiency in health spending (*Economic Surveys* of 2005 and 2010). Another example is regional policy, part of which is financed by the education, agriculture and public investment budgets, and thus cannot be easily evaluated. In addition to measures that can improve efficiency in specific areas, there is room to consider better ways to plan overall spending priorities, to assess policy efficiency and to ensure value for money in both small and large-scale spending decisions.

Figure 10. General government total outlays<sup>1</sup> in 2010 or latest year available  
As a percentage of GDP



Note: Norway (total) divides total outlays by total GDP, and Norway (mainland) divides total outlays by mainland GDP. OECD area is the simple average of countries for which data are available (using Norway mainland). The figure for Ireland excludes the one-off impact of recapitalisation in the banking sector (EUR 31.575 billion in 2010).

1. Excluding interest payments.

Source: OECD, National Accounts and OECD Economic Outlook database.

#### *The budgetary planning horizon*

Detailed spending allocations across ministries are carried out on a one-year cycle, as in most OECD countries, though there is also a revised budget in the spring that sometimes modifies allocations. Medium and long-term projections of spending by the Ministry of Finance are important tools for

managing total spending. But, being based on the spending implications of existing policy settings, they may not be best suited for forward planning of policy changes, especially if they may involve switching spending between ministries. The one-year horizon at the central level contrasts with longer horizons elsewhere: transport spending is based on detailed 4-year rolling plans derived from a 10-year national transport strategy and local governments work on 4-year plans, for example.

While maintaining the one-year cycle of parliamentary debate and budget approval, a number of OECD countries have moved towards a longer period for planning expenditure, notably France, Italy, the Netherlands, Sweden and the United Kingdom. This is typically in the form of a multi-year plan (often 3 years) or framework that is rolled forward each year. In most cases a flexible form of multi-annual framework is used, in which the annual budget process can revise the whole framework. However, certain countries, including France, Sweden and the Netherlands (where significant proportions of spending are fixed for a full four-year period) have adopted a more fixed approach, in which the annual process adds an extra year but does not normally change the spending ceilings for years already planned.

Norway has considered multi-year budgeting in the past and rejected it. Some policymakers are concerned that such plans would set a floor on expenditure, with political pressure each year leading to upward creep. An implicit political commitment not to re-open the short-term debate each year would be necessary, leading to a better focus on efficiency and longer-term planning. Multi-year budgeting could facilitate planning within spending ministries, rather than achieve any particular level of spending, which is governed by the current fiscal guidelines. This need not jeopardise the existing system of effective control of total spending and the fiscal stance. The current fiscal framework enjoys strong political support and its key elements must be conserved, but a re-examination of the pros and cons of multi-year budgeting may be timely.

### ***Monitoring of public expenditure “output” has improved***

Norwegian public expenditure management has been moving for several years towards an output-based system where the allocation of resources is tied to policy objectives, thereby allowing policy makers and expenditure managers to compare performance across different areas. In local government, the relevant information system – known as KOSTRA – seems effective, as municipalities can compare their own spending patterns with those of others; at least some municipalities are doing this actively. The corresponding information system for central government functions is not yet being effectively used in this way, perhaps because a clear definition of output in many functions is more difficult.

In some cases information that is already available, or could be made available, may not be being used as effectively as it could be. In education, previous *Economic Surveys* noted the under-performance of the education system given the amount of resources devoted to it (OECD, 2008; Boarini, 2009); the latest (2009) PISA results show some improvement, with performance generally slightly above the OECD average, but still not commensurate with the well above-average level of resource-use. There are legitimate worries about using test results to improve performance, for example excessive testing, teaching to tests, taking proper account of students’ backgrounds. But effective accountability requires better use of such information. In Oslo, such performance information is used to some extent to reward school principals and teachers, suggesting that it can be useful. Earlier OECD recommendations that the Ministry of Education at least conduct a comparative study to see whether the Oslo experience could be used more widely have not yet been followed up. Nevertheless, policy has moved towards improving teacher qualifications, focusing more on core competencies in maths and reading/writing, in line with OECD recommendations in these areas.

### ***Regional policy is popular, but output is hard to measure, although its cost is becoming easier to identify***

Regional subsidies command a high degree of popular support in Norway and may provide public goods, for example by reducing congestion in larger cities. But this support may be partly because the costs are not explicit. The main explicit instrument is social insurance charges which are lower than the

standard rate, even zero, in the most remote areas, but almost every spending department in Norway has extra costs associated with the difficulties of providing public services to a geographically low density population. To a considerable extent the low density is actively encouraged by deliberate policy to lower the cost of living in certain areas.

Some improvement in transparency is, however, apparent in the budgetary treatment of regional policy. The cost of social insurance reductions is some NOK 11 billion or about ½ per cent of GDP. Furthermore, a table in the 2011 budget documentation shows that a number of other measures address regional policy objectives, although many are classified under agriculture or fisheries policy. Together with the social insurance measures, identified budgetary measures add up to over 1% of GDP (Table 3). The information in the budget documentation covers only current expenditure, and no corresponding figures are presented for investment spending.

Although helpful, the information now published is incomplete. Some implicit costs, admittedly rather hard to evaluate, such as those of keeping larger numbers of small schools or maintaining and building roads, are missing, as well as the non-budgetary costs of agricultural policy. The latter, measured by the Producer Support Estimate (PSE) calculated by the OECD, could reasonably be understood as partially motivated by regional policy for agricultural support and are large. As Table 3 shows, when estimates of the implicit cost of these items are included, the total resources devoted to broadly-defined regional policy may be over 2% of GDP, equivalent to around one third of the education budget, and a multiple of the cost of the labour cost subsidies, the main explicit policy instrument.

Table 3. Budgeting for regional policy

Item	2011 budget allocation or estimated implicit cost	
	NOK billion	% mainland GDP
Budget figure for the cost of regional policy	34.4	1.7
of which:		
Reduced social contributions		
Private sector	7.0	0.4
Public sector	5.2	0.3
Reduced income tax and other measures for Finnmark and North Troms	1.2	0.1
Reduced tax on energy, district and other grants in northern Norway	3.9	0.2
Direct subsidies to agriculture	11.5	0.6
Transport and other infrastructure subsidies	2.6	0.1
Public services, environment	2.2	0.1
Capital costs of road and other infrastructure investment	n.a.	n.a.
Other implicit costs: <sup>1</sup>		
Subsidies to agriculture via Producer Support Estimate	4.5	0.3
Education	2.0	0.1
<b>Total</b>	<b>40.9</b>	<b>2.1</b>

1. Implicit costs are based on illustrative assumptions: half the market price support component of the PSE for agriculture; one fifth of the possible gains from increasing school size in education.

Source: Ministry of Local Government and Regional Development and OECD estimates; see chapter 1, Table 1.1.

## *An array of good public expenditure assessment tools could be used more coherently*

Such aggregate information can be used as part of an assessment of overall spending priorities, while at a more detailed level cost-benefit analysis (CBA) is an important tool. More consistent use of CBA is needed, and some paradoxes need addressing. It is fairly easy, for example, to find the guidelines for CBA of road projects (though not for rail projects) on ministry websites, but not the analyses themselves. Indeed, almost no road projects that are actually implemented show an *ex ante* excess of benefit over cost. This is not necessarily inconsistent with good use of CBA. Benefits that cannot be quantified in monetary terms can legitimately be sufficient to justify carrying out such a project, and research has shown that some components of CBA or impact assessments do influence Norwegian decision makers' priorities. However, when decisions are taken that overrule the conclusions of CBA or other impact assessment procedures, the responsible ministry should make clear the grounds on which such decisions are made. This is useful both on grounds of transparency but also to develop consistent practices in the face of particular but recurring circumstances.

Other systems for ensuring that public spending is used in a cost-efficient way also exist in Norway, notably a "quality assurance system" for large public projects. In this system evaluation is carried out by outside consultants rather than within the public administration, ensuring a degree of independence. Procedures are quite long and thorough, requiring an initial investigation of at least two alternative ways of meeting a project's objectives as well as an analysis of the relative costs and benefits of doing nothing. This independence is illustrated by the fact that the system has recently called into question a major public investment in a carbon capture and storage scheme, to which the government had attached high priority. The investment has been postponed. The cancellation of a bid for the Winter Olympic Games is another example. The National Audit Office, which reports to parliament but has a large degree of independence, can also investigate spending efficiency, but (in common with parliamentary audit offices generally) it is largely constrained to judge policy against the objectives set by parliament. Finally, guidelines for Regulatory Impact Assessment (RIA) have been in place for some time, but according to the Ministry for Government Administration, Reform and Church Affairs they are not consistently followed in some ministries, despite the existence of a new panel established to ensure better use of RIA. The Budget Department in the Ministry of Finance monitors whether ministries spend money according to plans, and examines new policy initiatives, but has only a limited role in assessing value for money in ministries' implementation of agreed policies.

Ensuring that CBA is applied consistently across all projects and ministries should be a priority. A commission on the revision of the CBA guidelines is due to report in 2012. One way to get more coherent use of value for money tools would be to assign responsibility, with strong political backing, to an "efficiency unit" which would monitor analysis and decision making in all ministries and report publicly where required procedures are not followed effectively. To contain costs, this oversight should take the form of random but in-depth checks of CBA (and RIA and other assessments) rather than systematic monitoring of all of them. The efficiency unit could be under the responsibility of the Ministry for Government Administration or the Ministry of Finance. Once in place, additional force could be given to the unit by the Audit Office, which could, under its own mandate, report on whether the efficiency unit was effectively improving compliance with assessment guidelines and, if not, insist on better enforcement.

In order to redirect expenditure over time to more cost-effective areas, a system of "efficiency dividends" could be envisaged. Under such a system, all ministries would have their budgetary allocations reduced by, say, 1% each year. The resulting "pool" would be allocated across ministries according to priorities decided by the government as a whole.

An additional measure would be to set up a spending review system that could take major policy areas one at a time and conduct in-depth reviews of policy aims and effectiveness. Investigating panels should have independent chairpersons and could use both experts from ministries and outside experts, including from other countries, with a remit both to assess existing policies and to propose modifications that would meet policy objectives more cost-effectively. One of the purposes of such a

system would be to provide background information for the multi-annual spending framework discussed earlier, as it does in the United Kingdom, for example.

Private sector involvement in delivering public services through contracting out via competitive tenders can help to improve efficiency in public expenditure. Local government in particular has done this on some occasions. The recent rapid expansion in kindergarten provision, following a change in the law, was achieved largely through private provision. Private provision is almost non-existent in the rest of the education system, however. Under the new approach to output-based budgeting, project managers, even in central government, are in principle free to choose whether to use public or private sector providers to meet their targets but little use is made of this possibility. Public-Private Partnerships (PPPs), favoured in some OECD countries, are little used in Norway. They can be misused, for example if they serve mainly to by-pass ceilings on public expenditure by substituting private funds, and the government may not be well-placed to assess some of the risks involved. The benefits of private sector expertise in management and cost-reduction are achievable through outsourcing with the careful definition of contractual terms. The financing side of all projects should remain fully accounted for in public budgets. Guidelines on PPPs are currently being discussed by the OECD's Public Management Committee.

However, as mentioned earlier, since 2008 employment in the public sector has been rising even while private sector employment has declined. Although public sector employees can legally be made redundant if their job disappears, in practice this rise in public sector employment cannot easily be reversed. Many government functions are close to policy-making and require specialised knowledge, long-term accountability and confidentiality. These are good reasons for excluding the possibility of private sector involvement. But encouraging the consideration of its use in other areas, especially for simple service delivery, while meeting at least as good standards as public sector providers, could give efficiency gains that release public resources for other uses.

#### Box 4. Summary of recommendations on value for money and public spending

- Establish a procedure for independent “spending reviews” - evidence-based assessment of specific policies or programmes - as a counterpart to internal assessment. A unit to support them could be located in the Ministry of Finance but the chair should be independent and with the power to recruit key outside experts.
- Further increase the extent to which expenditure is assessed on the basis of output indicators.
- Explore the possibility for greater use of private sector out-sourcing in provision of local and central government services.
- For cross-cutting issues, especially regional policy, place more emphasis on publishing estimates of overall spending, including implicit spending through methods such as market price support and cross-subsidisation, and assessing this overall spending against policy objectives.
- Explore the possibility for greater use of performance-based information and incentives for public sector workers to increase efficiency.
- Ensure that the implementation of Regulatory and Environmental Impact Assessment, cost-benefit analysis and other policy assessment tools is consistent across ministries. Establish an “efficiency” unit, with the responsibility of auditing the use of these tools to ensure this consistency, publishing its reports. Such a unit should be subject to performance auditing by the National Audit Office.
- Consider the introduction of an “efficiency dividend” system in which mandatory across-the-board cuts in ministerial budgetary allocations are redistributed annually to priority areas.
- Require a reasoned justification for decisions which do not respect the conclusions of cost-benefit analyses or impact assessments.

- Assess the pros and cons of adopting multi-year budgeting, for example in which spending ceilings for the main spending lines in each ministry are fixed for the next three years, consistent with expected returns on the GPFG and other revenues.

#### IV. Reform of capital taxation

##### ***Progressive, broadly-based labour income taxation is a feature of Norway's dual income tax system***

Norway's egalitarian income distribution and high level of social cohesion is achieved not only through low wage inequality (see Figure 1), but also through significant redistribution of income through the benefit system (*i.e.* cash transfers) and public expenditure (*i.e.* transfers in kind). In addition, some reduction in income inequality can also be attributed to the overall progressivity of the tax system. Since in aggregate labour income far exceeds capital income, the bigger contribution to income redistribution within the tax system is through labour income. The current design of the tax system ensures that it raises a lot of revenue, and it generally does so without harming incentives disproportionately, as is evidenced by strong economic performance. Norway has pioneered a number of new instruments in environmental taxation whose level is one of the highest in the OECD area. Furthermore corporate income taxation represents an unusually large component of tax revenue reflecting the large amounts of tax payments from petroleum companies.

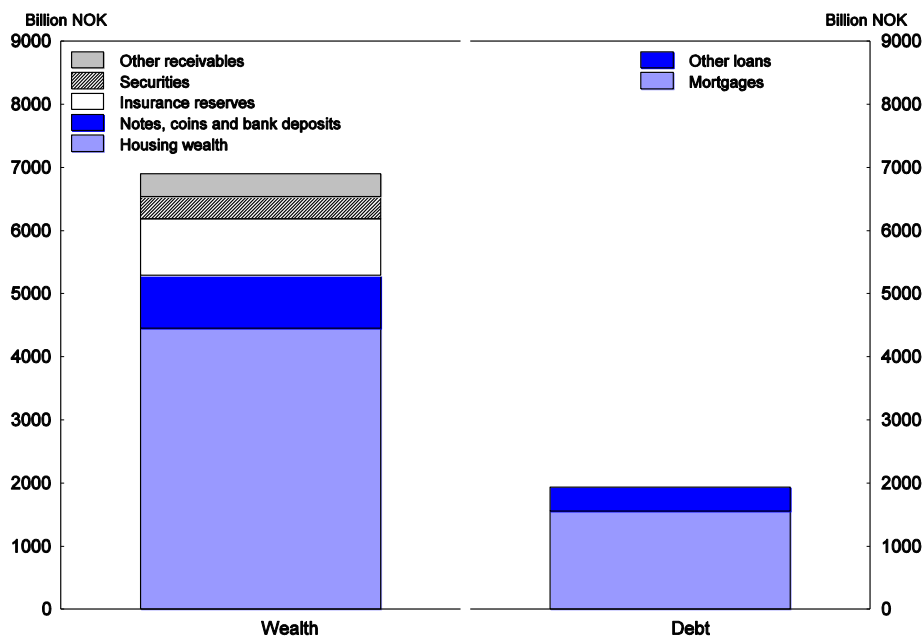
Like Denmark, Finland and Sweden, Norway has a dual income tax system which treats the taxation of capital income separately from the taxation of labour income. Capital income is taxed at a low proportional rate, while labour income is taxed at progressive rates. This approach seeks to limit the type of distortion induced by the traditional comprehensive income tax system, which taxes capital and labour in the same way and results in double taxation of earned labour income and high tax rates on real returns. The dual approach was however not perfect, and Norway had to make adjustments to its initial system in reaction to personal business owners evading taxation by reporting labour income as capital income and incorporating solely for tax purposes. These loopholes were successfully closed in a reform in 2006. This introduced the innovative concept of a rate of return allowance that raised the statutory tax rate on capital income above the "normal" (or risk-free) return to that on labour income but did not increase the taxation of the normal return. This way, the reform decreased the scope for the type of tax avoidance that reduced the progressivity of the tax system, while limiting the negative effects on investment incentives.

##### ***Taxation of savings and wealth pursues many aims, often ineffectively***

Some problems remain, however. Taxation varies widely across asset classes. Ministry of Finance calculations suggest that taxation of real returns can be over 100% for fixed-income assets and equity shares and as low as 0% for owner-occupied housing. This is likely to result in significant distortions to saving and investment behaviour and also to affect income distribution. The harsh tax treatment of interest on bank deposits, through the taxation of purely inflationary gains, especially affects households at the lower end of the income distribution for whom this type of savings instrument is likely to be relatively important. The high taxation of equity income, caused by insufficient inflation adjustment of depreciation allowances and cumulative taxation of capital incomes through the wealth tax, may lower economic growth. The extraordinary tax advantages to housing investment are likely to influence the way in which households hold their overall wealth, favouring residential investment at the expense of more productive categories of investment (Figure 11). They also raise the vulnerability of the financial system to macroeconomic shocks. House prices have risen to new historic highs and household debt is also high (see Figure 5). The government should design a package to reform the taxation of capital that, when accounting for purely inflationary gains and the wealth tax, would align a household's capital income tax rates across all asset classes at a level close to its labour income tax rate.



Figure 11. Household wealth and debt, second quarter 2009



Source: Statistics Norway and Norges Bank.

The current system taxes savings and wealth in many forms: through the personal income tax (on interest, rents, dividends and capital gains) and the corporate income tax; through the wealth tax and the local property tax; and through the stamp duty on property transactions and the gift and inheritance tax. The wealth tax is due at a rate of 1.1% on assessed wealth in excess of NOK 750 000 and is currently paid by 17% of the adult population.

To illustrate the effective tax on each asset class, an overall tax rate (subsuming personal income tax, corporate income tax and the wealth tax) applying to each asset can be calculated. Table 4 presents effective tax rate (ETR) calculations by the Ministry of Finance. The ETR is defined as the percentage reduction in the annual real rate of return caused by the tax system and is shown for four investment classes: interest-bearing accounts, shares, owner-occupied housing and rental housing. The calculations are done for a nominal rate of return of 4% and an inflation rate of 2%. These approximate the nominal rate of return to government bonds and consumer price inflation in Norway since 2000; a similar pattern emerges for different choice of these values. The left column applies to citizens who do not pay the wealth tax, the one on the right to those who do.

The table illustrates the wide variation in tax rates across asset classes and the high ETR, well above that on labour income, on the capital income of wealth tax payers unless there are ways to avoid these taxes. The statutory capital income tax rate is 28%. Since this is applied to the nominal return, the ETR – when the nominal rate of return is twice the inflation rate – amounts to 56% (or twice 28%). For people not paying the wealth tax, the income from interest-bearing accounts, shares and rental housing is taxed in full, while nothing is due on owner-occupied properties. The discrepancies are even more pronounced for people paying the wealth tax. Since owner-occupied housing and rental housing are given reductions in the base of the wealth tax, interest-bearing accounts and shares are taxed 8 times as much as owner-occupied housing and 1.5 times as much as rental housing.

Table 4. Effective tax rates on the real income from different assets

	Without wealth tax	With wealth tax
Interest-bearing accounts	56%	113%
Shares	56%	113%
Owner-occupied housing	0%	14%
Rental housing	56%	79%

Note: The calculations are done for a nominal rate of return of 4% and an inflation rate of 2%, which correspond closely to the nominal rate of return to government bonds and consumer price inflation in Norway since 2000. The effective tax rates (ETRs) apply to an extra NOK of saving by a Norwegian resident investing in a Norwegian asset. The ETRs for shares are based on nominal depreciation rates which are a reasonable approximation to how the Norwegian tax system functions as tax depreciation depends on the cost price (not the repurchase price) and the expected life span of the asset. The ETRs for owner-occupied housing and rental housing are independent of the degree of debt finance versus self-finance when assuming that mortgage interest rates equal savings interest rates. See chapter 2.

Source: Ministry of Finance.

### ***Re-alignment of effective tax rates is feasible***

ETRs should be aligned across all asset classes to reduce distortions in the allocation of savings and capital. Taxation of owner-occupied housing would be put on the same basis as for other capital by re-introducing the taxation of imputed rents and capital gains at the current statutory capital income tax rate of 28%, while retaining the deductibility of mortgage interest and other expenses. Such a reform would need to be phased in gradually to alleviate the economic impact on current owners who would experience windfall losses as a result. In most regions, the rental market would be sufficiently large to enable reliable estimation of the unobserved rents to owner occupation. Elsewhere, house prices and average price/rent ratios could be used as an indirect means to derive the imputed rents. An alternative to taxing imputed rent would be a national tax on the market value of owner-occupied property, which would be quite similar. Either of these reforms would be largely pointless unless the tax base were regularly revalued, so a strong political commitment would be necessary. Taxing owner occupation would also eliminate the current tax discrimination against the less well-off who tend to rent and hence on whom a significant fraction of the tax due on rental housing is likely shifted.

Given the political and practical difficulties of taxing imputed rents or property values experienced in many OECD countries, an alternative – though less desirable – option is to phase out mortgage interest relief. It would raise the ETR on the debt-financed part of owner-occupied housing towards those on other asset classes, while leaving the returns to the self-financed part untaxed. However, because of the difficulties ring-fencing interest related to mortgages on owner-occupied houses, an abolition of mortgage interest relief would probably introduce some debt shifting in the personal income tax and thereby undermine the uniform treatment of different sources of capital income.

Taxing the imputed rents and capital gains from owner occupation would align tax rates across asset classes under the capital income tax, but would not remove the distortions due to the current undervaluation of owner-occupied housing, rental housing and business property in the base of the wealth tax. To remove this distortion to capital allocation, the base of the wealth tax should include all assets at full value. However, if this were done, at current tax rates the theoretical ETR for people paying the wealth tax would rise to 113% for all asset classes. These very high ETRs could be reduced either through the capital income tax or the wealth tax. However, any significant reduction in the capital income tax rate would reduce the tax rates on above-normal returns below the one on labour income, providing individuals with incentives to declare labour as capital income. It would also bring capital income taxes on the personal and corporate level out of line. It would therefore have to involve a rather substantial reform of the entire tax system.

### ***Norway's wealth tax raises little revenue, but imposes very high marginal effective tax rates on capital income***

The revenue from the wealth tax is small, only about 0.2% of all household wealth or around 0.8% of mainland GDP. Evidence suggests that wealth taxation is subject to avoidance and evasion behaviour. The cumulation of the capital income tax and the wealth tax, which both effectively tax the same base, results in ETRs of above 100%. Such a high rate should be a strong disincentive to investment and indeed the ratio of mainland investment to GDP is relatively low. The fact that investment nevertheless continues suggests that there are ways to avoid one or more of the taxes, that many wealth tax payers have a strong desire to build up their wealth even though this does not increase their lifetime consumption, or that investment is increasingly undertaken by foreigners (who are not subject to the wealth tax), or maybe that taxpayers are not aware of the ETR. Given the potential long-run consequences of penalising saving and investment, the Norwegian authorities should investigate this issue.

Rather few countries in the OECD levy a wealth tax. Sweden abolished its wealth tax in 2007, to avoid cumulative taxation and because, as in Norway, it suffered from exceptions that created loopholes and encouraged tax planning. The wealth tax is controversial in Norway and has been much in the public debate. This controversy is reflected by the leader of the Confederation of Trade Unions (LO), the main workers' organisation in Norway, arguing for an evaluation of the wealth tax, on the ground that it hinders investment. Phasing out the wealth tax would reduce the ETR on all assets (if imputed rents and capital gains on housing were taxed) to 56% in Table 4, close to the top marginal tax rate on labour income (including social security contributions) of 54%. However, phasing out the wealth tax might be politically difficult because of its association with redistribution. A less complete reform should at least remove the undervaluation of housing and business property, while at the same time lowering the 1.1% statutory rate of the wealth tax. Raising the current threshold of NOK 750 000 would reduce the number of people paying the wealth tax, but not solve the underlying problem of high marginal effective tax rates.

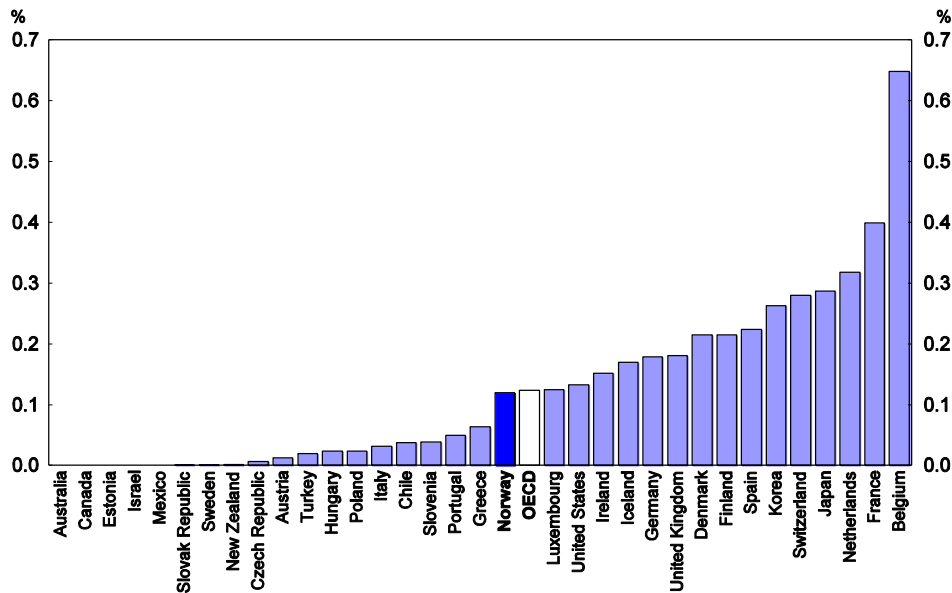
If the wealth tax were removed, the ETR on interest-bearing accounts and shares would be 56%. This is above the top marginal tax rate on labour income and considerably higher than the lowest rate. Small savers would thus pay a higher rate on income from their savings than on their labour income, while richer people would pay roughly similar rates. To reduce this effect, the government could introduce a personal allowance on capital income of a certain amount per year (say, NOK 10 000) for each citizen. Variants of such an allowance are in place in several OECD countries, such as Germany. Such an allowance would enable households to transfer some of their labour income to later in life without incurring taxes on the income earned. An ETR of 0% (up to the allowance) would particularly benefit poorer households for whom bank deposits (which currently attract an ETR of 56%) are likely the most important type of investment. Since for rich households the ETR would be unchanged at the margin, the allowance would strengthen the overall progressivity of the tax system, counterbalancing some of the effects from phasing out the wealth tax. There is, however, a risk that such an allowance would inflate over time due to lobbying activity and also set a precedent which might lead to public demands for allowances elsewhere in the system.

### ***The tax base of the gift and inheritance tax should be broadened***

In Norway, gift and inheritance taxation generates little revenue. Generous annual and lifetime allowances provide the wealthy with many tax avoidance possibilities, thus undermining redistribution policy. Gifts to a taxpayer's children are taxed to avoid erosion of the inheritance tax base. By contrast, gifts to others remain untaxed, while children's inheritances are tax-advantaged. Farms, non-listed shares and partnerships enjoy preferential rules. To broaden the base of the gift and inheritance tax, current allowances and preferential rules could be replaced with a single allowance for each individual that applies to the total lifetime amount of taxable gifts and inheritances received from all donors. Currently, the revenue from gift and inheritance taxation is small (Figure 12), less than half the revenue from the stamp duty on property transactions. For its part, the stamp duty distorts the allocation of

residential property and reduces residential and labour mobility. It should thus be phased out over time - due to the possible effect on house prices, the timing should be considered carefully.

Figure 12. Revenue from gift and inheritance taxation, 2010<sup>1</sup>  
As a percentage of GDP



Note: Data from Norway refer to mainland. OECD area is the simple average of OECD countries for which data are available. The figures of GDP used for the calculations are those of the latest update available.

1. Or latest year available.

Source: OECD, Revenue Statistics database and National Accounts database.

Tax reform should promote growth through improvements to the allocation of capital and work and investment incentives. It could be designed to be broadly neutral with respect to revenue and income redistribution. Subjecting owner occupation to taxation and increasing gift and inheritance taxation would offset revenue losses from the proposed annual allowance on capital income and abolition of the stamp duty as well as from possible reductions in the wealth tax. The introduction of the taxation of owner-occupied housing, the annual allowance on capital income and the increase in gift and inheritance taxation would reinforce redistribution through the tax system, while reducing the wealth tax and stamp duty would have opposite effects.

#### Box 5. Summary of recommendations on the taxation of savings and wealth

- Align the taxation of different asset classes.
- For housing this should include reducing the implicit tax subsidy of owner-occupied housing and removing the special treatment of real estate in the wealth tax.
- Ideally, imputed rents and capital gains from owner-occupied property should be taxed at the same rate as other capital income. An alternative would be a national tax on the market value of owner-occupied property. A third possibility would be to eliminate mortgage interest deductibility on owner-occupied property, although this would still leave distortions in place.
- To promote mobility, abolish stamp duty on property transactions. Due to the possible effect on house prices, the timing should be considered carefully.
- To restrain avoidance by the wealthy in the taxation of inheritances and gifts, replace all existing allowances and preferential rules with a donor-independent lifetime allowance.
- Investigate the impact of the combination of wealth and capital income taxes on effective tax rates, on tax avoidance and on incentives to save and invest. If the growth-redistribution trade-off is too unfavourable to growth, phase out or reduce the wealth tax. If the wealth tax is phased out, consider introducing a personal allowance on capital income.

# Chapter summaries

## Chapter 1. Value for money and public spending

Norway attaches importance to efficiency and value for money in public spending, especially because of its high overall level. Reasonable guidelines for pursuing efficiency are in place and in some areas, for example tax collection, measures of efficiency show good performance. Information systems are increasingly in place that allow benchmarking of performance, especially across local government, but increased attention to outcome indicators is required as well. But the guidelines are not always followed in practice and the traditional Norwegian reliance on good sense and trust needs to be reinforced with strengthened arrangements for formal evaluation of projects and policies. Lengthening the time horizon for overall budgetary planning could help to improve the longer-term focus on value for money.

## Chapter 2. Tax reform in Norway: A focus on capital taxation

Norway's dual income tax system achieves high levels of revenue collection and income redistribution, without overly undermining economic performance and while paying attention to environmental externalities. It treats capital and labour income in different ways: capital income is taxed at a single low rate, while labour income is taxed at progressive rates. However, effective tax rates on savings vary widely across asset classes. The favourable treatment of owner-occupied housing relative to financial savings should be reduced, preferably by taxing imputed rents at the standard 28% statutory rate. The wealth tax implies very high effective tax rates on savings, indicating that it either gives rise to tax avoidance or significantly inhibits growth. The government should investigate the issue and, if the growth-equity trade-off is too unfavourable to growth, phase out or lower the wealth tax. To restrain tax avoidance by the wealthy, the base of the gift and inheritance tax should be broadened. Overall, the reform package recommended in this chapter would improve the allocation of capital and increase work and investment incentives. It could be designed to be broadly neutral in regard to income redistribution and public revenue.

*This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.*

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