NORWEGIAN MINISTRY OF FINANCE

The Revised National Budget 2008

A summary

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Contents

This publication is based on information in the period until 14 May 2008.

1 The Norwegian Economy

1.1 General

Norway forms the western and northern part of the Scandinavian Peninsula and has common borders with Sweden, Finland and Russia. Norway's area is 323,802 square kilometers (approximately 125,100 square miles), excluding the Svalbard Island group in the Arctic Ocean and other overseas territories. The population of Norway was estimated at 4,737,200 as of January 1, 2008. Oslo, the capital and largest city of Norway, had a population of 560,484 as of January 1, 2008.

Norway is a constitutional monarchy, with the conistitution dating back to 1814. The power is divided between a legislative branch, the Storting, which is also responsible for appropriations; an executive branch, the Government; and a judicial branch, the courts.The Storting has 169 members and cannot be dissolved by the King or otherwise during its four-year term. Parlamentarianism was introduced in 1884.

1.2 Economic sectors

Norway is a diverse industrial society with a free market economy and generally low trade barriers. A significant share of the Norwegian economy consists of service industries, including wholesale and retail trade, banking, insurance, engineering, transport and communications and public services. In 2007, the service sector as a whole accounted for approximately 46.9 per cent of GDP. Norway's petroleum industries, including exploration and extraction, accounted for 23.7 per cent of GDP and about 47.9 per cent of exports. Manufacturing accounted for approximately 8.8 per cent of GDP.

The major manufacturing industries are machinery, construction of oil platforms and ships, paper products, metal products, basic chemicals and electrical and electronic equipment. All of these industries are highly export oriented. The paper industry, the metal industry and the chemical industry have benefited from the availability of hydroelectric power and to some extent also of raw materials.

Following the discovery of substantial petroleum deposits in the Norwegian sector of the North Sea in the late 1960's, and the commencement of North Sea oil production in 1971, a substantial petroleum related sector was developed in Norway. From the beginning of the 1970's, this sector has been the predominant growth sector in the Norwegian economy.

The exploration and production of petroleum resources on the Norwegian continental shelf has had a major impact on the Norwegian economy. In 2007, Norwegian petroleum production totaled approximately 238 million standard cubic meters of oil equivalents (scm oe.). Norway ranks as the world's fifth largest oil exporter, and the third largest gas exporter.

1.3 Memberships in International Organisations

Norway is a party to the Agreement on the European Economic Area (EEA), which generally includes Norway in the internal market of the European Union (EU). Norway is a founding member of the United Nations and its affiliate organizations and has been a member of the North Atlantic Treaty Organisation (NATO) since 1949. Norway is a member of the European Free Trade Association (EFTA), an international free trade partnership.

Norway is a member of a number of other international organizations, including the International Monetary Fund (IMF), Organisation for Economic Cooperation and Development (OECD), International Bank for Reconstruction and Development (World Bank) and the World Trade Organisation (WTO). Norway is also a member of the Inter-American Development Bank (IADB), African Development Bank (AfDB), Asian Development Bank (ADB), European Bank for Reconstruction and Development (EBRD), Council of Europe Development Bank (CEB), Nordic Investment

Bank (NIB), Nordic Development Fund (NDF), Nordic Council, Nordic Project Fund (Nopef) and Nordic Environment Finance Corporation (NEFCO).

2 Economic Developments and Prospects

Since 1970 yearly economic growth has averaged 3.4 pct., or 3 pct. if we exclude petroleum activities and ocean transport. Actual growth fluctuates around these long run averages, and over the past four years growth in Mainland GDP has averaged close to 5 pct. This is the highest economic growth over any four-year period since the 1960s. The high growth since the turnaround in the Norwegian economy in 2003 can be traced back to the interplay of several factors. Strong income growth and several years of low interest rates have fuelled a significant increase in household demand. Sound profitability and high capacity utilisation has contributed to a significant increase in investments on the part of mainland businesses. A steep increase in petroleum investments has also boosted domestic demand. The expansion in the mainland economy has caused record-strong employment growth, with the unemployment rate reaching a 20-year low. The tightening labour market has caused mounting cost increases, and the outcomes of wage settlements thus far this year indicate that wage growth will continue to accelerate somewhat from 2007 to 2008. Moreover, inflation has increased as far as domestically produced goods and services are concerned, also when energy goods are excluded.

Growth in the mainland economy reached 6 pct. in 2007 according to preliminary national accounts figures. Growth was sustained throughout the year, with somewhat weaker developments in the manufacturing industry than in the rest of the economy. The Statistics Norway's business tendency survey and production index for manufacturing industry indicate that growth within that sector continues to decline. Furthermore, it appears that growth in the demand facing the mainland economy may be levelling off. Residential construction

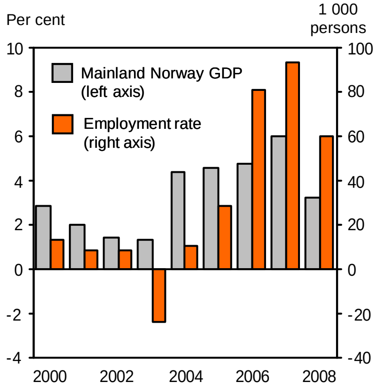

Chart 2.1 Mainland Norway GDP and employment. Change from previous year

Sources: Statistics Norway and Ministry of Finance.

has decreased in recent months, and household consumption of goods in the 1st quarter of this year was about 0.6 pct. lower than in the 4th quarter of last year. There are also indications of a slowdown in the exports of traditional goods. However, the strong increase in petroleum sector investments appears to hold up, and the order situation within petroleum-related industries remains very favourable. Growth in the Norwegian economy for 2008 as a whole is likely to be well above the estimated trend growth, but a distinct levelling off is expected over the year. All in all, Mainland Norway GDP is estimated to grow by 3¼ pct. this year.

The international economic outlook has recently deteriorated considerably, cf. Chart 2.2. The major underlying problems in the financial markets, which surfaced last summer, have developed into one of the main financial upheavals since World War II. The disturbances were triggered by problems in the US market for housing mortgages, but spread rapidly to other market segments, resulting in tightening credit markets and stock market downturns throughout the world.

The US Federal Reserve has effected a drastic reduction in the federal funds rate as the result of the financial turmoil and weaker economic prospects. The situation in the financial markets and the cooling down of the housing market are severely curtailing growth in the US economy, despite the steep reductions in interest rates and the depreciation of the US dollar. Consumption and investment growth are in decline, and employment is falling. Growth prospects also look weaker in the Eurozone, the UK and emerging economies. The financial market disturbances have, *inter alia*, increased the cost of borrowing and restricted access to external funding, also for consumers and businesses outside the US. In addition, the outlook for export-oriented businesses looks less attractive as the result of lower demand from the US.

The Ministry of Finance estimates a GDP growth of 2 pct. this year for our main trading partners as a whole.

Steep increases in food prices contribute to growing uncertainty as to future economic developments in several low-income countries. This trend has, together

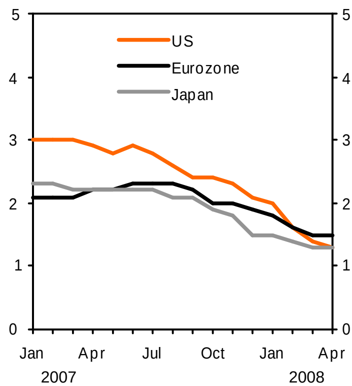

Chart 2.2 GDP estimates for 2008, as made at different dates. Change from previous year. Percent

Source: Concensus Forecasts.

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

	NOK billion 2007[2]	2007	2008
Private consumption	946.4	6.4	3.7
Public consumption	447.1	3.2	3.2
Gross fixed investments	474.3	9.6	4.8
Petroleum extraction and pipeline transportation	109.0	6.6	10.0
Businesses in Mainland Norway	169.2	13.2	7.0
Housing investments	105.9	6.3	-4.0
Demand from Mainland Norway[3]	1,735.4	6.1	3.5
Exports	1,062.7	3.2	2.4
Of which: Crude oil and natural gas	498.0	-2.4	-0.2
Traditional goods	303.0	9.0	4.3
Imports	685.5	8.6	6.0
Of which: Traditional goods	451.4	8.2	6.1
Gross domestic product	2,288.7	3.5	2.4
Of which: Mainland Norway	1,708.7	6.0	3.2
Mainland Norway without el.	1,662.7	5.9	3.3
Other key figures:			
Employment, persons	..	3.8	2.4
Unemployment rate, LFS (level)	..	2.5	2.4
Annual wage growth	..	5.4	5½
Growth in consumer price index (CPI)	..	0.8	3.2
CPI adjusted for tax changes and excluding energy products (CPI-ATE)	..	1.4	2.4
Oil price, NOK per barrel	..	423	500
Current account balance (pct. of GDP)	..	16.3	17.2
Household savings, pct. of disposable income	..	-1.2	0.3

1 Calculated in constant 2005 prices unless otherwise indicated.

2 Preliminary National Accounts figures in current prices.

3 Excepting inventory changes.

Sources: Statistics Norway and Ministry of Finance.

with high price growth for energy goods, contributed to accelerating inflation in both industrialised countries and emerging economies. An average CPI growth of 2¾ pct. is assumed this year for our most important trading partners.

The international financial market disturbances have also influenced developments in Norway, and there have been large fluctuations in the Norwegian krone exchange rate, in credit market risk premiums and in the stock markets. As of yet there are no indications that Norwegian banks have been directly exposed to subprime mortgages or structured products containing subprime mortgages. Losses in securities markets have also been limited, due to relatively small exposures in the financial markets affected by the turmoil.

The main index of the Oslo Stock Exchange lost a total of 28 pct. from its highest level last summer until it bottomed out in January this year, but it has since increased to a level 7 pct. below that of last summer. The financial market turbulence has increased the funding costs of businesses, and there has been limited equity offering activity on the Oslo Stock Exchange this year.

The oil price is very high. Thus far this year, the price of North Sea oil has been about NOK 530 per barrel on average. At the beginning of May, North Sea oil was traded at more than NOK 600 per barrel in the spot market. The high oil price has to do with strong growth in the demand from, *inter alia*, China, limited spare production capacity outside OPEC and uncertainty as to future deliveries from important producing countries like Iran, Iraq, Venezuela and Nigeria. Prices of oil for delivery in December this year are in excess of USD 120 per barrel, which may indicate that the oil price is expected to remain high for the rest of 2008 as well. The Revised National Budget assumes an average oil price of NOK 500 per barrel for this year.

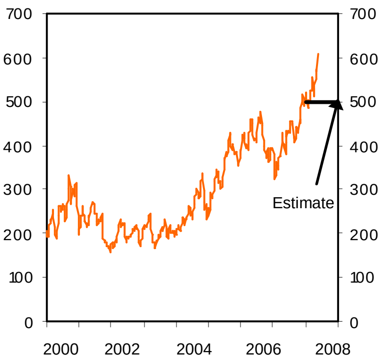

Chart 2.3 Brent Blend spot price. NOK per barrel

Sources: Reuters EcoWin and Ministry of Finance.

The strong economic expansion has resulted in steep growth in labour demand. Employment has increased by 250,000 persons since the turnaround in spring 2003, and unemployment is at a 20-year low. Many businesses report having problems recruiting qualified manpower, despite high labour immigration, primarily from the new EEA countries.

The strong growth in employment and the labour force has continued into 2008. Seasonally adjusted employment increased by 22,000 persons from the 4th quarter of last year to the 1st quarter of this year, and by close to 100,000 persons when compared to the same period one year earlier, according to the Statistics Norway's labour force survey (LFS). The strong growth can be attributed to both higher labour force participation amongst Norwegians and continued high labour immigration, especially from Poland and other Nordic countries. Employment growth is expected to level off ahead, in line with the lower rate of economic growth. Employment is estimated to increase by 60,000 persons, or 2½ pct., from 2007 to 2008.

There has, in parallel with the strong employment growth, been a significant reduction in unemployment. In the 1st quarter of this year, LFS unemployment was 2.4 pct. of the labour force. This is almost down to half the level of the summer of 2005. Developments in recent months indicate that LFS unemployment is levelling off at just below 2½ pct. There are also clear indications that registered unemployment is levelling off. As per the end of April this year, registered unemployment was 1.5 pct. of the labour force, seasonally adjusted. A slowdown in economic growth ahead suggests that labour demand will ease. LFS unemployment is estimated at 2½ pct. on average for 2008.

The tightening labour market is reflected in increased competition for manpower and a clear acceleration of wage growth. The Norwegian Technical Calculation Committee for Wage Settlements (TBU) estimates average annual wage growth to have been 5.4 pct. in 2007, up from 4.1 pct. in 2006. Wage growth last year was the highest since 2002. In this year's wage settlements, agreement has thus far been reached between the Confederation of Norwegian Enterprise (NHO) and the Norwegian Confederation of Trade Unions/Confederation of Vocational Unions (LO/YS) and between the Federation of Norwegian Commercial and Service Enterprises (HSH) and LO/YS based on estimated annual wage growth of 5.6 pct. in 2008. The

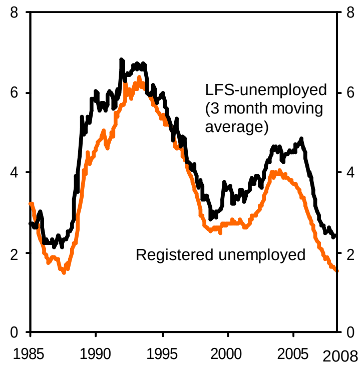

Chart 2.4 Unemployment. Seasonally adjusted monthly figures. Percent of labour force

Sources: Norwegian Labour and Welfare Administration and Statistics Norway.

Ministry of Finance assumes, in line with these outcomes, that wage growth in the Norwegian economy as a whole will amount to 5½ pct. this year.[1] This is ½ percentage point more than assumed in the National Budget 2008. Wage growth on the part of our main trading partners is estimated at 3½ pct. this year. Consequently, the wage estimates imply a continued deterioration in the cost-based competitiveness of the business sector.

Consumer prices (CPI) increased by 0.8 pct. from 2006 to 2007. Consumer price growth has in recent years been strongly influenced by fluctuating energy prices. Higher energy prices have contributed to a significant increase in twelve-month CPI growth. Consumer prices were 3.5 pct. higher in the first four months of this year than in the same period last year. Adjusted for taxes, and excepting energy goods, average growth in consumer prices (CPI-ATE) was just under 1 pct. per year over the period 2003 – 2006. Higher growth in the prices of domestically produced goods and services boosted CPI-ATE growth last year, and the annual increase was 1.4 pct. Twelve-month CPI-ATE growth has accelerated further this year, and this index was 2.1 pct. higher in the first four months of the year than in the same period last year. The Ministry of Finance assumes that CPI and CPI-ATE will increase by 3.2 and 2.4 pct., respectively, in 2008, up from 2½ and 2 pct. in the National Budget 2008. The upwards adjustments have to do with, *inter alia*, higher estimates for oil prices, wage costs and rents, as well as the increase in world market food prices.

The Norges Bank key policy rate has been increased by a total of 3¾ percentage points, to 5½ pct., since summer 2005. The international financial market uncertainty has in recent months resulted in increases in money market rates, and banks' deposit and lending rates have outweighed those in the Norges Bank key

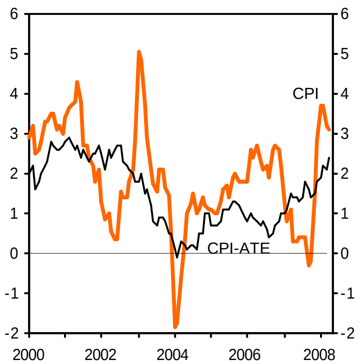

Chart 2.5 Overall consumer price inflation (CPI), as well as adjusted for tax changes and excepting energy goods (CPI-ATE). Percentage change from same month of previous year

Sources: Statistics Norway and Ministry of Finance.

1 After the finalisation of the Revised National Budget, agreements have been reached for major parts of the public sector. The agreements imply an annual wage growth of 6.3 pct. in the municipal sector and 6.1 pct. in the central government sector.

policy rate. Norges Bank estimates, in its monetary policy report from March this year, that the key policy rate will be in the region of 5½ to 5¾ pct. in the 4th quarter of this year, and thereafter be reduced to about 5 pct. in the 4th quarter of next year. The Ministry of Finance assumes in the Revised National Budget that money market rates will evolve in line with the expectations of market participants, as reflected in forward interest rates at the beginning of May.

The Norwegian krone was as per 9 May about 5 pct. stronger than the average exchange rate last year, and 9 pct. stronger than the average over the last decade, as measured by the effective krone exchange rate (TWI). The Ministry of Finance assumes in the Revised National Budget that the effective Norwegian krone exchange rate will develop in line with exchange rates as priced in the forward market at the beginning of May. This implies that Norwegian kroner, as measured by TWI, are assumed to appreciate by about 3¼ pct. from 2007 to 2008. The Norwegian krone exchange rate is influenced by a number of factors, and experience suggests that there is considerable uncertainty associated with estimates as to future developments in exchange rates.

Private consumption increased by 6.4 pct. in 2007, following several years of high growth. The strong growth in recent years has to do with steep increases in employment and relatively low inflation having resulted in considerable growth in the disposable real incomes of households. Nevertheless, consumption has increased more sharply than have incomes, and the saving rate has declined to a very low level. Developments in the saving rate in recent years are influenced by large fluctuations in dividend payments in connection with the introduction of dividend taxation. Savings as a percentage of incomes have contracted in recent years, also when dividends are disregarded. It would seem reasonable to assume that this decline has to do with the long period of relatively low interest rates, whilst improvements in the labour market may have influenced household perceptions as far as the need for holding financial reserves is concerned. In addition, new and more flexible lending products may have

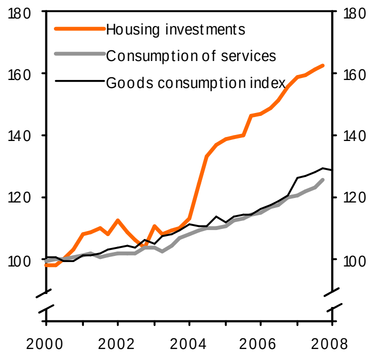

Chart 2.6 Household demand. Seasonally adjusted volume indices. 2000=100

Sources: Statistics Norway and Ministry of Finance.

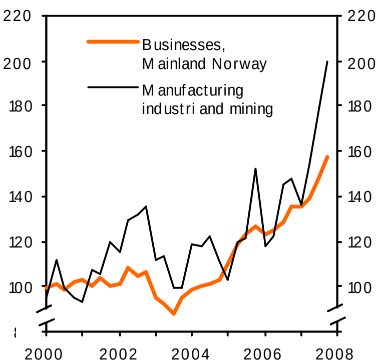

Chart 2.7 Gross investments. Seasonally adjusted volume indices. 2000=100

Sources: Statistics Norway and Ministry of Finance.

contributed to increased borrowing amongst households for a period of time.

Growth in the consumption of goods slowed down gradually last year. The slowdown has continued this year, and goods consumption was about 0.6 pct. lower in the 1st quarter of this year than in the 4th quarter of last year. It is expected that the low savings amongst households and the increases in interest rates will contribute to consumption growth continuing to be significantly lower than last year. More moderate growth in the purchasing power of households as a result of higher consumer price inflation suggests the same. Private consumption is estimated to increase by 3.7 pct. in 2008.

The housing investments of households would appear to be declining, from a high level. Construction of 32,500 new homes was initiated last year, as compared to 33,300 in 2006. The number of home constructions initiated declined markedly throughout last year, and this reduction has continued into 2008. Construction of a total of just over 6,300 new homes was initiated in the 1st quarter of this year, which is a reduction of no less than 23 pct. from the same period last year. However, the average size of the homes increased somewhat, and the reduction in initiated home floorage construction was 19 pct. over the same period. Strong growth in building costs, higher interest rates, a declining order intake for housing and lower growth in housing prices suggest that housing construction will continue to slow down. In total, housing investments are estimated to decline by 4 pct. in 2008.

Investments in petroleum extraction and pipeline transportation have on average increased by almost 11 pct. per year over the last five years, and have contributed considerably to the expansion of the mainland economy. These investments increased by 6.6 pct. from 2006 to 2007 according to preliminary national accounts figures. The Ministry of Finance assumes a 10 pct. growth in petroleum sector investments this year, based on, *inter alia*, information reported by the companies.

High and growing capacity utilisation, good profitability and relatively low funding costs have contributed to a steep upsurge in investments on the part of mainland businesses over the last few years. Last year the growth was in excess of 13 pct. Data for building starts suggest that growth in commercial property investments has continued into 2008. Statistics Norway's investment count for the 1st quarter this year may suggest a growth in manufacturing industry and mining investments of about 20 pct. this year, whilst investments within electricity supply continue to increase. Statistics Norway's accounts statistics show that the profitability of Norwegian-registered non-financial enterprises listed on the Oslo Stock Exchange weakened during the course of last year, but from a high level. At the same time, the financial market turbulence has contributed to increasing the funding costs of businesses, and there has been limited new equity offerings on the Oslo Stock Exchange this year. However, growth in corporate borrowing remains very high, which may indicate that businesses are continuing to borrow to fund new investments. In the Revised National Budget it is assumed that growth in corporate investments will be reduced to 7 pct. this year. Growth is estimated to be 17 pct. for manufacturing industry and mining.

The strong expansion of the world economy has contributed to high growth in the exports of services and traditional goods in recent years. Growth in aggregate exports has been more moderate as the result of reduced extraction of crude oil and natural gas. Strong growth in the exports of engineering products were an important reason why exports of traditional goods increased by as much as 9 pct. from 2006 to 2007. There were also steep increases in the exports of metals and chemical products. Thus far this year, exports have shown signs of slowing down. The value of traditional goods exports declined by 1.6 pct. from the 4th quarter of last year to the 1st quarter of this year. The Ministry of Finance assumes in the Revised National Budget that growth in export demand levels off, whilst the cost-based competitiveness of export businesses deteriorates further as the result of high cost growth and an appreciating Norwegian krone exchange rate. Both factors suggest that export growth will ease

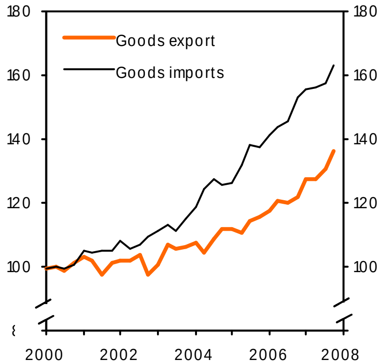

Chart 2.8 Exports and imports of traditional goods. Seasonally adjusted volume indices. 2000=100

Sources: Statistics Norway and Ministry of Finance.

off ahead. In total, the Ministry of Finance assumes that growth in traditional goods exports will be 4.3 pct. in 2008. Aggregate exports are expected to grow by 2.4 pct.

The import volume for traditional goods increased by as much as 8.2 pct. from 2006 to 2007. This was the fifth year in a row of very high growth in traditional goods imports. Aggregate imports increased by 8.6 pct. last year. The import expansion over the last few years is related to strong domestic demand growth and very high petroleum investments, which feature a large element of import contents on average. The Ministry of Finance assumes that traditional goods imports will grow by 6.1 pct. from 2007 to 2008.

Norwegian terms of trade – as measured by the ratio between export and import prices – improved markedly over the period 2004-2006. The strong growth in China and other emerging economies has contributed to strong price growth for metals, crude oil and other intermediate goods in recent years, whilst the prices of some of the goods and services that we import have declined. The increase in the prices of Norwegian export products continued in 2007. High price growth for certain imports, especially metals, meant that the terms of trade nevertheless deteriorated by 0.7 pct. The large price fluctuations in commodities markets over the last six months fuel uncertainty as to future developments in the terms of trade. All in all, it is estimated that the terms of trade, excluding crude oil and natural gas, etc., will deteriorate by close to 2 pct. from 2007 to 2008. High growth in the prices of crude oil and natural gas implies that the total terms of trade are expected to improve by almost 7 pct. in total.

High revenues from the petroleum sector have contributed to large current account surpluses in recent years. In 2007, the surplus was as much as NOK 372 billion, corresponding to 16.3 pct. of GDP. The surplus for this year is estimated to be NOK 429 billion, corresponding to 17.2 pct. of GDP.

The estimates in the Revised National Budget imply that capacity utilisation in the Norwegian economy will remain at a high level throughout 2008, whilst employment will increase by 60,000 persons. However, the combination of continued strong pressure in the Norwegian economy and a danger of a significant downturn in the international economy means that the risk of a less balanced development is high. Nevertheless, this will primarily have an effect on output growth and the labour market from 2009 onwards. A high or increasing interest rate in a situation where foreign central banks are cutting their key policy rates may create pressure towards a further appreciation of the Norwegian krone exchange rate. This may, in combination with a Norwegian cost level that is already high, and a possible decline in Norwegian export prices, result in a rapid deterioration of profitability in parts of the business sector exposed to international competition, with negative consequences in terms of output and employment. In addition, several years of high debt accumulation and low savings mean that parts of the household sector are vulnerable to further interest rate increases. This contributes to additional uncertainty as to the effect of a further increase in borrowing rates on household choices.

3 Economic Policy

3.1 Budget Policy

3.1.1 Guidelines and challenges

The Government will conduct an economic policy that facilitates high employment and stable economic development, and ensures that public welfare schemes are sustainable. The various aspects of economic policy need to work in unison to realise these objectives.

In 2001, fiscal policy guidelines were introduced to handle rapidly increasing petroleum revenues, cf. Box 3.1.

The fiscal policy guidelines decouple the spending of revenues from the extraction of non-renewable oil and gas resources from the earning of the revenues. The various revenues earned by central government from petroleum activities are allocated to the Government Pension Fund – Global in their entirety, whilst withdrawals over time shall correspond to the expected real return on the Fund, estimated at 4 pct.

Actual return on the Government Pension Fund – Global was 4.3 pct. in 2007, as measured in foreign currency. The average annual return is 8.9 pct. over the last five years and 6.0 pct. over the last decade. The average real return over the last decade is 4.3 pct.

The fiscal policy guidelines advocate a steady and gradual increase in the spending of petroleum revenues, to a level that can be sustained over time. At the same time, the spending of petroleum revenues in any given year shall be adapted to the relevant stage of the business cycle. This enables fiscal policy to contribute to predictability, support monetary policy and facilitate stable development in the Norwegian economy.

For the first few years after the fiscal policy guidelines were introduced in 2001, the spending of petroleum revenues, as measured by the structural, non-oil budget deficit, was markedly higher than the expected real return on the global part of the Government Pension Fund. This has to do with the fact that the Fund was for a few years growing more slowly than expected, whilst both the international and the Norwegian economy went into recession in 2001. It was hardly appropriate to tighten budget policy in such a situation. Activity in the Norwegian economy has picked up significantly since 2003, whilst the Fund has undergone strong growth. The spending of petroleum revenues has during this period increased less than expected return on the Fund, and has since 2006 been less than 4 pct. of the Fund capital.

There is still high capacity utilisation in the Norwegian economy, and preliminary figures from Statistics Norway estimate economic growth in Mainland Norway in 2007 at 6 pct., the strongest growth since 1971. The Norges Bank key policy rate has been increased to 5½ pct., and money market rates has recently increased by more than has the key policy rate. The differential between Norwegian and international interest rates has increased to about 1¾ percentage point, whilst the outlook for the international economy has deteriorated.

Box 3.1 Budget policy guidelines

The Stoltenberg I Government presented, in Report No. 29 (2000-2001) to the Storting, the following budget policy guidelines, which were supported by a large majority in the Storting:

> Petroleum revenues shall be phased gradually into the economy, more or less in line with developments in the expected real return on the Government Pension Fund – Global.[1]
>
> Weight is attached to smoothing out fluctuations in the economy to ensure good capacity utilisation and low unemployment.

The fiscal policy guidelines facilitate stable development in the Norwegian economy in both the short and long run:

> *The Fiscal Budget is sheltered from the effects of volatility in petroleum prices*. The cash flow received by central government from petroleum activities is allocated to the Government Pension Fund – Global, whilst it is the expected real return – estimated at 4 pct. – on the Fund as per the beginning of the fiscal year that is to be spent over time. This means that short-term changes in oil and gas prices will have limited impact on budget policy, whilst the petroleum wealth will also be benefiting future generations.
>
> *The guidelines facilitate the balanced phase-in of petroleum revenues over time*. The spending of petroleum revenues is measured by the structural, non-oil budget deficit, i.e. the non-oil deficit adjusted for, *inter alia*, the effects of changes in the business cycle. This reduces the risk that budget policy will serve to amplify cyclical fluctuations in the Norwegian economy. In case of major changes to the Fund capital, or circumstances that influence the structural, non-oil deficit, the consequences for the spending of petroleum revenues shall be evened out over several years. A smooth phase-in of petroleum revenues serves to reduce the risk of sudden and major restructurings between those industries that are exposed to international competition and those that are not.
>
> *The fiscal policy guidelines enable budget policy to be used for purposes of stabilising production and employment*. During periods of high unemployment one can spend more than the expected real return on the Fund capital to stimulate production and employment. Correspondingly, there will be a need for reigning in fiscal policy during periods of high activity in the economy.
>
> *The fiscal policy guidelines contribute to predictability concerning the spending of petroleum revenues in the Norwegian economy*. The fiscal policy framework thereby supports monetary policy, and lays the foundations for stable expectations as to the phase-in of oil revenues, hereunder in the foreign exchange market.

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1 The Government Petroleum Fund changed its name to the Government Pension Fund – Global on 1 January 2006.

In a situation where growth in the mainland economy looks set to remain well above trend growth, it will be consistent with the fiscal policy guidelines for the spending of petroleum revenues to remain well below the expected return on the Fund.

Long-term considerations also suggest that the spending of petroleum revenues should not be expanded too rapidly. Norway is in a period when demographic developments are relatively favourable from a government budget perspective. A high oil price and strong growth in the Fund capital means that a budget policy that adhered mechanically to the 4-percent trajectory would result in a steep increase in the spending of petroleum revenues over the next few years. The favourable demographic developments will soon be reversed, and the proportion of elderly people in the population will be increasing rapidly in the longer run. Long-term budget projections show that we will eventually be facing major fiscal policy challenges, even with a relatively high oil price and a pension reform in line with the framework defined by the pension agreement. Consequently, the return on the extra savings retained in the Government Pension Fund – Global will be put to good use when the growth in expenditure associated with an aging population starts to accelerate.

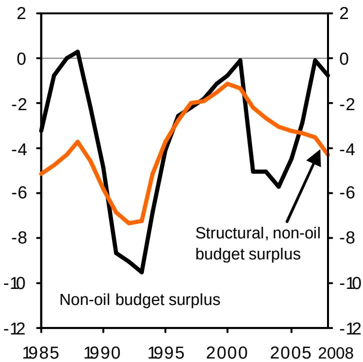

Chart 3.1 Non-oil budget surplus and structural, non-oil budget surplus. Percent of Mainland Norway trend GDP

Sources:Statistics Norway and Ministry of Finance.

3.1.2 The implementation of budget policy in 2007

The central government accounts for 2007, which were submitted to the Storting on 25 April, estimates the structural, non-oil deficit for 2007 at NOK 57.8 billion. The expected real return on the Government Pension Fund – Global in 2007, 4 pct. of the Fund capital as per the beginning of 2007, is estimated at NOK 71.3 billion. Consequently, the spending of petroleum revenues in 2007 is estimated to be NOK 13.5 billion less than the expected return on the Fund.

Whilst the structural, non-oil deficit provides a measure of the underlying spending of petroleum revenues, cf. Box 3.2, the non-oil deficit (as estimated in the final revised Budget) determines how much money should be transferred from the Government Pension Fund - Global to the Fiscal Budget in any given year. The central government accounts for 2007 show a non-oil deficit of NOK 1.3 billion. This is NOK 1.5 billion less than estimated in the final revised Budget, mainly due to higher revenues from direct and indirect taxes. Consequently, the central government accounts for 2007 will be closed with a NOK 1.5 billion surplus, cf. Table 3.2.

The estimated structural, non-oil deficit for 2007 has been reduced by NOK 10.7 billion relative to the National Budget 2008. The estimated central government structural tax revenues for 2007 have been increased by NOK 3.6 billion, whilst changes in expenditure and other revenues than direct and indirect taxes have served to reduce the structural, non-oil deficit for 2007 by NOK 7.1 billion. The lower structural deficit for 2007 implies that budget policy in 2007 is perceived to have been significantly less expansive than previously estimated.

The estimated structural, non-oil deficit for 2007 has been reduced by NOK 13.2 billion relative to the original estimate in the adopted Budget for 2007. However, the non-oil deficit was NOK 52.8 billion less than originally estimated in the adopted Budget for 2007. The non-oil deficit having shrunk by more than has the structural, non-oil deficit is explained by changes in the business cycle contributing to a steep increase in direct and indirect tax revenues from the mainland economy in 2007. Direct taxes on the business sector have, in particular, boosted tax revenues, as the result of high output growth and improved profitability on the part of businesses.

Real, underlying expenditure growth in central government accounts is estimated at just over 2½ pct. for 2007, cf. Chart 3.2. This is about ½ percentage point less than in the adopted Budget. The reduction is primarily the result of wage growth and growth in the prices of procured goods and services being somewhat higher than previously assumed.

Net central government cash flow from petroleum activities was NOK 316.4 billion in 2007, which is

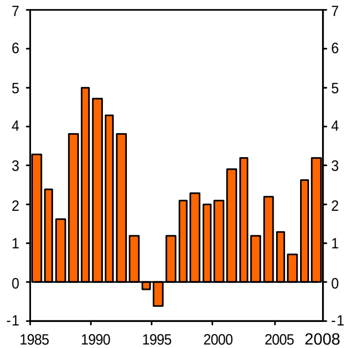

Chart 3.2 Real underlying expenditure growth in the Fiscal Budget. Percent

Sources: Statistics Norway and Ministry of Finance.

Box 3.2 The structural, non-oil budget deficit

The non-oil budget deficit is not only influenced by budget policy, but also by changes in the business cycle and certain other factors. In a recession, tax revenues are temporarily low, whilst expenditure on unemployment benefits is high. The situation is the opposite during a period of expansion. Other revenue and expenditure items may also vary considerably from one year to another, without reflecting structural changes to the Budget. This pertains to, *inter alia*, the transfers from Norges Bank as well as central government interest revenues and expenditure. In addition, the non-oil deficit may be influenced by accounting technicalities.

The fiscal policy guidelines relate changes in the expected real return on the Government Pension Fund – Global to the structural, non-oil budget deficit. Said deficit provides a measure of the underlying use of petroleum revenues over the Fiscal Budget, which is adjusted for, *inter alia*, effects of changes in the business cycle. The following adjustments are required to get from the non-oil to the structural, non-oil budget deficit:

Adjustments are made to cater for cyclical discrepancies from a normal situation by computing the budgetary effects of tax bases deviating from their trend levels. Furthermore, it is taken into consideration that the payment of unemployment benefits depends on the stage of the business cycle.

Adjustments are made to cater for the difference between the estimated normal levels of transfers from Norges Bank and central government interest revenues and expenditure, on the one hand, and actual transfer and interest flows, on the other hand.

Adjustments are made to cater for technical accounting changes and for changes in the division of responsibilities between central and local government that do not influence underlying budgetary balance developments.

Table 3.1 The structural, non-oil budget deficit. NOK million

	2005	2006	2007	2008
Non-oil Fiscal Budget deficit	64,763	44,002	1,342	13,049
- Transfers from Norges Bank. Deviations from estimated trend level	5,080	5,280	5,640	6,010
- Net interest revenues. Deviations from estimated trend level	2,425	7,953	-5,083	-7,782
- Special accounting technicalities	-2,965	-4,698	-2,096	747
- Output adjustments	12,551	-16,086	-54,904	-59,780
= Structural, non-oil budget deficit	47,672	51,553	57,785	73,855
Measured in percent of Mainland Norway trend GDP	3.3	3.4	3.6	4.3
Change from previous year in percentage points [1]	0.3	0.1	0.2	0.7

1 The change in the structural, non-oil deficit as a percentage of Mainland Norway trend GDP is used as a brief indicator of the effect of the Budget on the economy. Positive figures indicate that the Budget has an expansionary effect. This indicator does not, unlike the model computations presented in the National Budgets, take into consideration the fact that different revenue and expenditure items may have different effects on economic activity.

Sources: Statistics Norway and Ministry of Finance.

Table 3.2 Key figures for the Fiscal Budget and the Government Pension Fund. NOK billion[1]

	Accounts		Budget
	2006	2007	2008
Total revenues	994.9	1,030.1	1,119.5
1 Revenues from petroleum activities	376.6	337.4	381.4
1.1 Direct and indirect taxes	217.3	191.2	215.9
1.2 Other petroleum revenues	159.3	146.3	165.5
2 Revenues other than petroleum revenues	618.3	692.7	738.1
2.1 Direct and indirect taxes from Mainland Norway	562.5	632.9	676.7
2.2 Other revenues	55.9	59.8	61.4
Total expenditures	683.5	715.1	776.9
1 Expenditures on petroleum activities	21.2	21.1	25.7
2 Expenditures other than petroleum activities	662.3	694.0	751.1
Fiscal Budget surplus before transfers to the Government Pension Fund – Global	311.4	315.0	342.6
- Net cash flow from petroleum activities	355.4	316.4	355.7
= Non-oil surplus	-44.0	-1.3	-13.0
+ Transfers from the Government Pension Fund – Global	57.4	2.8	13.0
= Fiscal Budget surplus	13.4	1.5	0.0
+ Net allocated to the Government Pension Fund – Global	298.0	313.6	342.6
+ Interest and dividend income, etc., on the part of Government Pension Fund[1]	64.1	78.4	81.6
= Consolidated Fiscal Budget surplus and Government Pension Fund surplus	375.5	393.5	424.2
Memo:			
Market value of the Government Pension Fund – Global[2]	1,783	2,018	2,316
Market value of the Government Pension Fund[2]	1,890	2,136	2,427

1 The Government Pension Fund was established on 1 January 2006 as a superstructure encompassing the Government Petroleum Fund and the National Insurance Fund.
2 As per the end of the year.
Sources: Statistics Norway and Ministry of Finance.

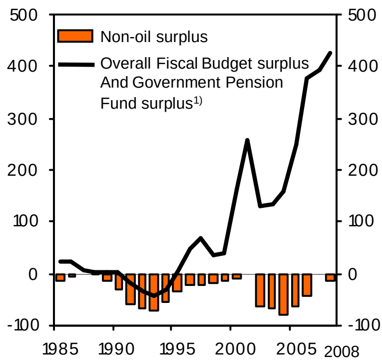

Chart 3.3 Fiscal Budget surplus and Government Pension Fund surplus[1]. NOK billion

1 Fiscal Budget surplus and Government Petroleum Fund surplus prior to 2006.

Sources: Ministry of Finance and Statistics Norway.

NOK 3.3 billion less than estimated in the newly balanced Budget. This resulted, when taken together with a non-oil deficit of NOK 1.3 billion in the central government accounts as well as interest and dividend income of NOK 78.4 billion in the Government Pension Fund, in a consolidated surplus in the central government accounts and the Government Pension Fund of NOK 393.5 billion in 2007, cf. Table 3.2.

The capital held in the Government Pension Fund – Global was NOK 2,018.5 billion as per the end of last year. This is NOK 75 billion less than estimated in the National Budget 2008. The reduction was caused by weak performance in international financial markets, a slight appreciation of the Norwegian krone exchange rate and somewhat lower cash flow from petroleum activities than previously estimated. Expected real return on the Government Pension Fund – Global for 2008 is computed at just under NOK 81 billion, about NOK 3 billion less than estimated in the National Budget 2008. The overall capital held by the Government Pension Fund, including the capital of the Government Pension Fund – Norway, was NOK 2,135.8 billion as per yearend 2007.

3.1.3 The Fiscal Budget and the Government Pension Fund in 2008

The Fiscal Budget originally proposed by the Government for 2008 implied a structural, non-oil deficit of NOK 76.8 billion, an estimated increase of 5.4 billion 2008 kroner from 2007. This implied an increase in the structural, non-oil deficit of about 0.3 percentage point when measured as a proportion of output in the mainland economy. The domestic demand stimulus was considered to be of the same order of magnitude. The estimated structural, non-oil deficit for 2008 was not changed upon adopting the Budget for 2008.

New information relating to developments in the Norwegian economy and tax inflows thus far this year suggest, all in all, that estimated structural direct and indirect tax revenues, etc., for 2008 should be increased by NOK 5.9 billion relative to the estimates in the

Table 3.3 Fiscal Budget revenues and expenditures in 2007. Changes from the adopted Budget to the accounts. NOK million

		1 Adopted Budget	2 Change	3=1+2 Final revised Budget	4 Change	5=3+4 Accounts	6=5-1 Memo: Change from adopted Budget
A	Revenues other than petroleum revenues	641,651	45,500	687,151	5,527	692,678	51,027
	Direct and indirect taxes from Mainland Norway	589,624	41,765	631,389	1,466	632,855	43,231
	Interest revenues	17,183	638	17,821	50	17,871	688
	Transfers from Norges Bank	0	0	0	0	0	0
	Other revenues	34,844	3,097	37,941	4,012	41,952	7,108
B	Expenditures other than petroleum activities	695,793	-5,832	689,961	4,060	694,021	-1,773
	Interest expenditures	16,064	9	16,073	-17	16,056	-8
	Unemployment benefits	6,877	-2,437	4,440	-16	4,424	-2,453
	Other expenditures	672,852	-3,404	669,448	4,093	673,540	688
C	Non-oil surplus (A-B)	-54,142	51,332	-2,810	1,468	-1,342	52,800
D	Cash flow from petroleum activities	364,893	-45,139	319,700	-3,311	316,389	-48,504
E	Allocations to the Government Pension Fund - Global	310,751	6,139	316,890	-3,311	313,579	2,828
F	Surplus prior to loan transactions (C+D-E)	0	0	0	1,468	1,468	1,468
G	Interest and dividend income on the part of the Government Pension Fund	78,700	1,700	80,400	-1,991	78,409	-291
H	Consolidated Fiscal Budget surplus and Government Pension Fund surplus (E+F+G)	389,451	7,839	397,290	-3,835	393,456	4,005

Source: Ministry of Finance.

National Budget 2008. This has to do with, *inter alia*, higher wage growth in the economy. Estimated other revenues in this year's Fiscal Budget have been increased by NOK 3.8 billion, primarily as the result of higher dividend revenues. Follow-up of an environmental agreement respecting the NOx tax for certain industries, as well as other changes to direct and indirect taxes, represent a reduction in booked direct and indirect tax revenues of just below NOK 0.5 billion.

In historical terms, the Norwegian economy finds itself in a strong expansionary phase. Output in the mainland economy has expanded by close to 5 pct. per year on average over the last four years, and capacity utilisation is high. The Government has in this situation chosen to reduce the structural, non-oil deficit in 2008. The proposed revision to the Budget implies that the structural deficit will be reduced from NOK 76.8 billion in the adopted Budget to NOK 73.9 billion. Consequently, the spending of petroleum revenues in 2008 will be about NOK 7 billion below the expected real return on the Government Pension Fund – Global.

Fiscal Budget expenditure has been increased, within this framework, by NOK 6.3 billion relative to the adopted Budget, including NOK 0.3 billion in increased expenditure that has already been submitted to the Storting. Increased pension expenditure in health authorities represents about NOK 3.5 billion, whilst expenditure increases in connection with the wage and pension settlement represent NOK 2.1 billion. Other increases in expenditure represent a total of about NOK 0.4 billion.

The main features of the revised Budget proposed by the Government for 2008 are:

- A structural, non-oil budget deficit of NOK 73.9 billion. This is about NOK 7 billion lower than the expected return on the Government Pension Fund - Global. Petroleum revenue spending represents about 3.7 pct. of the Fund capital as per the beginning of the year.
- The structural deficit increases by 0.7 percentage point from 2007 to 2008 as measured relative to output in the mainland economy. The revised

Budget for 2008 therefore appears, according to that budgetary indicator, to be somewhat more expansionary than was the original budget proposal. The structural deficit is estimated to increase by 0.9 percentage point when measured over the two years 2007 and 2008 as a whole, which is the same as was estimated in the National Budget 2008.

Real, underlying growth in Fiscal Budget expenditure is estimated at 3¼ pct. from 2007 to 2008. The estimate has been increased by about 1 percentage point when compared to the National Budget 2008. The increase in expenditure growth reflects both higher expenditure in 2008 and lower expenditure in 2007.

The non-oil budget deficit in 2008 is estimated at NOK 13 billion, cf. Table 3.4. A net cash flow from petroleum activities of close to NOK 356 billion implies a net allocation to the Government Pension Fund – Global of almost NOK 343 billion. The estimated net central government cash flow from petroleum activities has been increased by nearly NOK 54 billion when compared to the adopted Budget. An increase in the oil price estimate of NOK 140 per barrel contributes to a higher estimate, whilst a reduction in the production estimates has the opposite effect. Consolidated Fiscal Budget surplus and Government Pension Fund surplus is estimated at just over NOK 424 billion for 2008. The market value of the aggregate capital of the Government Pension Fund is estimated at NOK 2,427 billion as per yearend 2008, of which about NOK 2,316 billion in the Government Pension Fund – Global.

The pensions under the National Insurance system are funded on an ongoing basis over the Fiscal Budget as these fall due for payment (so-called ”pay-as-you-go”). The value of already accrued rights to future old-age pensions from the National Insurance system is estimated at about NOK 4,180 billion as per yearend 2007. The liabilities are estimated to increase by almost NOK 370 billion, to just over NOK 4,550 billion by yearend 2008, cf. Table 3.5. This is NOK 40 billion higher than the estimate in the National Budget 2008,

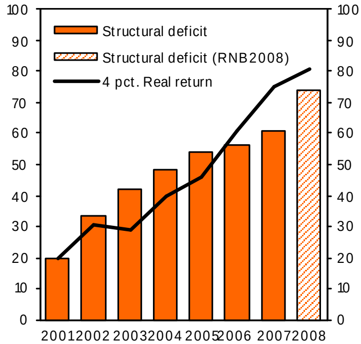

Chart 3.4 Expected real return on the Government Pension Fund and structural, non-oil deficit. Billion 2008 kroner

Source: Ministry of Finance.

which has to do with higher wage growth in 2007 and 2008. Central government liabilities in respect of disability benefits and dependents' pensions under the National Insurance system are additional thereto, and are estimated at just over NOK 1,050 billion as per yearend 2008. The estimates are based on the current pension system and the medium alternative from Statistics Norway's population projections from 2005.
High petroleum revenues mean that the capital of the Government Pension Fund is currently growing more rapidly than are the old-age pension liabilities under the National Insurance systems. Nevertheless, the accrued old-age pension rights remain much larger than the capital of the Government Pension Fund. Revenues

Table 3.4 Fiscal Budget revenues and expenditures in 2008. Changes from the National Budget/adopted Budget and Revised National Budget. NOK million

		1 National Budget/ adopted Budget	2 Change	3=1+2 Revised National Budget
A	Revenues other than petroleum revenues......	708,686	29,407	738,093
	Direct and indirect taxes from Mainland Norway...	650,372	26,369	676,741
	Interest revenues	21,897	-730	21,166
	Transfers from Norges Bank......................	0	0	0
	Other revenues	36,417	3,768	40,186
B	Expenditures other than petroleum activities..	745,104	6,038	751,142
	Interest expenditures..................................	17,330	102	17,432
	Unemployment benefits..............................	4,821	-696	4,125
	Other expenditures.....................................	722,952	6,632	729,585
C	Non-oil surplus (A-B)..................................	-36,418	23,369	-13,049
D	Cash flow from petroleum activities	301,773	53,926	355,699
E	Allocation for the Government Pension Fund – Global..	265,355	77,295	342,650
F	Interest and dividend income, etc., in the Government Pension Fund............................	78,600	3,000	81,600
G	Consolidated Fiscal Budget surplus and Government Pension Fund surplus	343,955	80,295	424,250

Source: Ministry of Finance.

from petroleum activities will decline over time, which will reduce growth in the Fund capital. Pension liabilities, however, will continue to increase in coming years, even with a pension reform in line with the pension agreement.

3.1.4 Developments in public finances in recent years

High petroleum revenues have contributed to large surpluses in public finances in Norway over the last 10-15 years. Net public sector financial investments for 2008 are estimated at close to NOK 446 billion, as compared to NOK 394 billion in 2007, cf. Table 3.6.

Table 3.5 The Government Pension Fund and central government liabilities in respect of old-age pensions under the National Insurance system. NOK billion and percent of GDP Mainland Norway as per yearend

	2006	2007	2008
NOK billion			
Central government liabilities in respect of old-age pensions under the National Insurance system[1]	3,874	4,184	4,551
The market value of the Government Pension Fund[2]	1,890	2,136	2,427
Percent of Mainland GDP			
Central government liabilities in respect of old-age pensions under the National Insurance system[1]	245.8	244.9	250.3
The market value of the Government Pension Fund[2]	119.9	125.0	133.4
Memo			
The Government Pension Fund as a proportion of central government liabilities in respect of old-age pensions under the National Insurance system (percent)	48.8	51.0	53.3

1 Net present value of accrued rights to future old-age pension payments from the National Insurance system. An average annual real wage growth of 2 pct. and a real interest rate of 4 pct. have been assumed. Higher real wage growth or a lower real interest rate will imply higher pension liabilities. The estimate does not include old-age pensioners who are resident abroad, or the National Insurance system's liabilities in respect of disability benefits and dependents' pensions.

2 The Government Pension Fund was established on 1 January 2006 as a superstructure encompassing the Government Petroleum Fund and the National Insurance Fund.

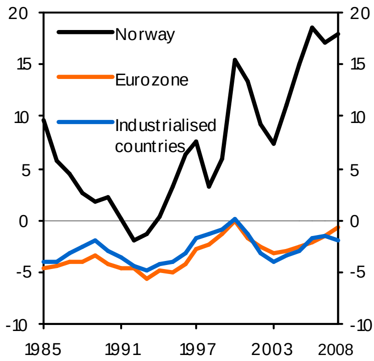

Chart 3.5 Net public sector financial investments. Percentage of GDP
Sources: OECD, Statistics Norway and Ministry of Finance.

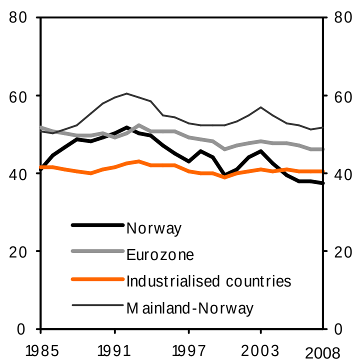

Chart 3.6 Public sector expenditure. Percentage of GDP
Sources: OECD, Statistics Norway and Ministry of Finance.

Net public sector financial investments for 2008 measured as a proportion of GDP are estimated at 17.9 pct. for 2008. This is markedly higher than the average over the last 20 years, cf. Chart 3.5. The high level of net financial investments in recent years has to do with the rapid extraction of oil and gas resources, as well as high oil prices.

Net public sector financial assets, including the capital of the Pension Fund and capital contributed to government-held commercial enterprises, is estimated at about NOK 2,630 billion as per yearend 2008, which is equivalent to just over 105 pct. of GDP. This percentage has increased rapidly in recent years as a result of the high level of net central government cash flow from petroleum activities.

Most of the public sector surplus can be attributed to developments on the part of central government, where high oil prices result in large gains in the value of the Government Pension Fund. As far as the local government sector is concerned, high growth in expenditure, in terms of both operational expenditure and gross investments, resulted in net financial investments declining from NOK 0.7 billion in 2006 to minus NOK 12 billion in 2007. Net financial investments in local government are estimated at minus NOK 14.5 billion for 2008.

Public expenditure in Norway is relatively high, in an international perspective, when measured as a percentage of Mainland GDP. When measured as a percentage of GDP, on the other hand, expenditure is more or less in line with the average amongst industrialised countries, and well below the expenditure level of the Eurozone.

Direct comparisons of the levels of public expenditure in different countries can be problematic. This is, *inter alia*, because different countries have different practises when it comes to the taxation of pensions and other publicly-funded benefits. Countries also differ in the extent to which they make use of tax credits (tax expenditure) as an alternative to publicly-funded benefits. Such differences have an effect on gross figures for both public expenditure and public revenues. Moreover, any differences need to be analysed from the perspective that the division of responsibilities between the public and private sector varies from country to country.

As far as Norway is concerned, petroleum activities make an extraordinary contribution to GDP, thus making public expenditure as a percentage of GDP correspondingly lower. However, the current high revenues from petroleum activities are based on the extraction of a non-renewable natural resource. These revenues will decline overt time, and eventually cease altogether. On the other hand, public expenditure measured as a percentage of Mainland GDP exaggerates the financial burden associated with public expenditures in Norway. This is partly because the resources currently allocated to petroleum activities have an alternative use in the Norwegian mainland economy. In addition, the accumulation of capital in the Government Pension Fund represents a long-term contribution to the funding of public expenditure on top of revenues from the mainland economy.

Table 3.6 Net public sector financial investments. NOK million and percentage of GDP

	2006	2007	2008
A. Net central government financial investments, accrued value	398,462	405,772	458,330
Fiscal Budget surplus	13,370	1,468	0
Government Pension Fund surplus	362,144	391,988	424,250
Surplus in other central government and public pension accounts	-10,730	-5,760	2,604
Definitional discrepancies central government accounts/national accounts[1]	28,210	13,963	23,479
Capital contributed to commercial enterprises[2]	5,469	4,114	7,997
B. Net local government financial investments, accrued value	445	-11,678	-12,590
Local government surplus, book value	700	-12,044	-14,523
Local taxes accrued, but not booked	-255	366	1,933
C. Public sectors financial investments (A+B)	398,907	394,094	445,740
Measured as a percentage of GDP	18.5	17.2	17.9

1 Includes central government taxes accrued, but not booked.
2 Capital contributed to commercial enterprises, hereunder central government petroleum activities, are classified as financial investments in the national accounts.
Sources: Statistics Norway and the Ministry of Finance.

3.1.5 Budget policy in the intermediate run

The room for manoeuvre in budget policy over time is primarily determined by developments in the mainland economy tax bases, by expenditure and revenue commitments resulting from past decisions and by developments in the expected real return on the capital of the Government Pension Fund – Global.

The spending of petroleum revenues over time shall, according to the budget policy guidelines, be tuned to developments in the expected real return on the capital of the Government Pension Fund – Global. The estimates in this Report indicate that the steep growth in the Fund capital in recent years will continue for the next few years, cf. Table 3.7. More specifically, the expected real return on the Government Pension Fund – Global is estimated to increase by about 10 billion

Table 3.7 Government Pension Fund – Global, expected real return, and structural non-oil budget deficit. NOK billion and percentage of Mainland Norway trend GDP

	Current prices			Constant 2008 prices			Structural deficit	
	Government Pension Fund – Global as per the beginning of the year[1]	Expected return (4 pct. on the Fund capital)	Structural, non-oil budget deficit	Expected return (4 pct. on the Fund capital)	Structural, non-oil budget deficit	Deviation from the 4 pct. trajectory	As pct. of Mainland Norway trend GDP	As pct. of the Fund capital
2001....	386.6	-	15.3	-	19.9	-	1.3	3.9
2002....	619.3	24.8	27.0	31.0	33.7	2.8	2.2	4.4
2003....	604.6	24.2	34.8	29.1	41.9	12.8	2.7	5.8
2004....	847.1	33.9	41.4	39.5	48.3	8.8	3.0	4.9
2005....	1,011.5	40.5	47.7	45.8	54.0	8.2	3.3	4.7
2006....	1,390.1	55.6	51.6	60.8	56.4	-4.4	3.4	3.7
2007....	1,782.8	71.3	57.8	74.8	60.6	-14.2	3.6	3.2
2008....	2,018.5	80.7	73.9	80.7	73.9	-6.9	4.3	3.7
2009....	2,316.4	92.7	-	88.9	-	-	-	-
2010....	2,754.3	110.2	-	102.1	-	-	-	-

1 The projections for the Fund capital assume, for technical computation purposes, that annual withdrawals from the Fund will correspond to 4 pct. of the Fund capital as per the beginning of each year.

Source: Ministry of Finance.

2008-kroner on average per year over the four-year period from 2009 to 2012. The estimates as to developments in the Fund capital in coming years are uncertain, and depend, *inter alia*, on developments in petroleum prices, the actual return on the Fund capital abroad and exchange rates.

The actual spending of petroleum revenues needs to be adapted to changes in the business cycle, and take into account the significant long-term challenges facing public finances. With continued strong growth in the Fund capital and high activity in the Norwegian economy, it will be consistent with the fiscal policy guidelines for the spending of petroleum revenues to grow, for a few years, more slowly than does the expected real return on the Government Pension Fund – Global. This will also reduce the need for difficult reallocations once growth in age-related expenditures picks up in the near future.

3.1.6 Long-term fiscal policy challenges

Norway currently has one of the highest standards of living in the world, and continued growth is expected in coming years. If productivity growth within mainland industries remains in line with historical experience, income per capita may be more than doubled by 2060. This projection takes into consideration the fact that aging of the population will, when taken in isolation, curb growth in employment and output per capita.

Nevertheless, the aging of the population will present considerable challenges to the implementation of budget policy as growth in age-related expenditure accelerates in coming decades. The National Budget 2007 presented computations showing that the level of direct and indirect taxes would have to be increased by an amount corresponding to about 7 pct. of Mainland Norway GDP by 2060 in order to balance government budgets. These computations assumed, *inter alia*, that the spending of petroleum revenues is in conformity with the budget policy guidelines, that average working hours and employment frequencies remain constant over time for different population groups, and that current coverage ratios and resource use per user of publicly-funded services are upheld.

Productivity growth is of decisive importance to growth in material wealth, but is of lesser importance to developments in public finances. When quantifying future funding gaps, one takes into consideration the fact that continued productivity growth in mainland industries will contribute to expanding the tax bases available for the funding of public welfare schemes. However, higher productivity and higher wages within the private sector will also result in higher wage costs and increases on other wage-related expenditure on the part of the public sector. All in all, productivity growth will therefore have a limited impact on any future funding gaps.

On average, income security schemes and the provision of public services for young and old people are funded by the economically active population. The sustainability of the schemes is dependent on high labour force participation contributing to curtailment of the tax level and the dependency ratio. Chart 3.7 shows how net public expenditure was allocated between various age groups in 2004. Pensions and various benefit schemes, as well as public expenditure relating to the provision of individually-oriented services (teaching, health, nursing and care, etc.), represent positive contributions to the age-differentiated net transfers, whilst direct and indirect taxes represent negative entries. Public expenditure on public goods like the police, the judicial system and defence is not included in the individually-allocated net transfers in the Chart.

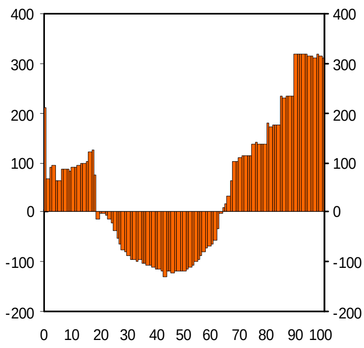

Chart 3.7 Net transfers by age in 2004. NOK 1,000

Sources: Statistics Norway and Ministry of Finance.

The funding gap computations in the National Budget 2007 were based on the medium alternative under Statistics Norway's population projections from 2005. Chart 3.8 shows that new population projections presented by Statistics Norway on 8 May imply more or less the same developments in the number of older people (67 years and above) relative to the number of people of working age, as did the projections from 2005. The medium alternative represents an increase in the number of older persons from just over 20 per 100 persons aged 20 – 66 years at present, to 40 in 2060, i.e. a doubling of the number of older persons per person of working age when compared to the current level. If the publicly-funded benefit pattern from 2004 is upheld, the changes in the population composition will contribute to a considerable weakening of public finances.

Over the last 30 – 40 years, the increase in the economically active part of the population, as well as higher spending of petroleum revenues, have meant that is has been possible to expand the scope of welfare schemes without a corresponding increase in the level of direct and indirect taxes. The future increase in the dependency ratio, representing the number of young and old persons relative to the number of persons of working age, means that growth in public expenditure, if current welfare schemes are upheld, will be higher than growth in output, revenues and tax bases. The ageing of the population will result in higher expenditure on old-age pensions and higher expenditure on health and care. A gradually older labour force would also suggest a continued increase in the number of recipients of disability benefits. At the same time, the ageing of the population will curtail growth in labour supply, and thereby growth in the tax bases for the funding of public welfare schemes.

The budget policy guidelines imply that the petroleum revenues will make a long-term contribution to the funding of public welfare schemes. However, future growth in this contribution is relatively limited, and the financial contribution will eventually decline both as a share of public expenditure and as a share of Mainland GDP. The assumptions pertaining to petroleum prices and the return on the capital of the Government Pension Fund – Global influence how soon this will happen. However, impact assessments presented in the National Budget 2008 illustrate that the consequences, in terms of the funding gap, of relatively large changes to the long-term oil price level are of the same order of magnitude as those of relatively moderate changes to labour supply.

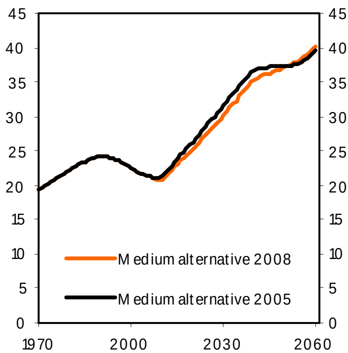

Chart 3.8 Ratio of older persons to persons aged 20-66 years. Percent

Sources: Statistics Norway and Ministry of Finance.

Box 3.3. Regulation on Monetary Policy

Established by Royal Decree of 29 March 2001 pursuant to Section 2, third paragraph, and Section 4, second paragraph, of the Act of 24 May 1985 no 28 on Norges Bank and the Monetary System

I

§ 1.

Monetary policy shall be aimed at stability in the Norwegian krone's national and international value, contributing to stable expectations concerning exchange rate developments. At the same time, monetary policy shall underpin fiscal policy by contributing to stable developments in output and employment.

Norges Bank is responsible for the implementation of monetary policy.

Norges Bank's implementation of monetary policy shall, in accordance with the first paragraph, be oriented towards low and stable inflation. The operational target of monetary policy shall be annual consumer price inflation of approximately 2.5 per cent over time.

In general, the direct effects on consumer prices resulting from changes in interest rates, taxes, excise duties and extraordinary temporary disturbances shall not be taken into account.

§ 2.

Norges Bank shall regularly publish the assessments that form the basis for the implementation of monetary policy.

§ 3.

The international value of the Norwegian krone is determined by the exchange rates in the foreign exchange market.

§ 4.

On behalf of the State, Norges Bank communicates the information concerning the exchange rate system ensuing from its participation in the International Monetary Fund, cf. Section 25, first paragraph, of the Act on Norges Bank and the Monetary System.

II

This regulation comes into force immediately. Regulation no. 0331 of 6 May 1994 on the exchange rate system for the Norwegian krone is repealed from the same date.

3.2 Monetary policy

A new regulation on monetary policy was established 29 March 2001 in a white paper to the parliament (Report No. 29 (2000-2001)). The regulation stipulates that monetary policy shall aim for stability in the domestic and international value of the Norwegian krone. Norges Bank's operational implementation of monetary policy shall be aimed at low and stable inflation, defined as an annual increase in consumer prices that remains close to 2.5 pct. over time, cf. Box 3.3.

It follows from the regulations that monetary policy shall contribute to stabilising output and employment developments, and to creating stable expectations as to exchange rate developments. As a general rule, it is expected that consumer price increases will fall within an interval of +/– 1 percentage point from the inflation target. Furthermore, it is stated in Report 29 to the Storting that the interest rate decisions of Norges Bank shall be forward-looking, and pay due heed to the uncertainty attaching to macroeconomic estimates and assessments. It shall take into consideration that it may take time for policy changes to affect the economy, and it should disregard disturbances of a temporary nature that are not deemed to affect underlying price and cost increases.

The long-term role of monetary policy is to provide the economy with a nominal anchor. Over time, low and stable inflation is an important prerequisite for growth and welfare. The regulation establishes a flexible inflation targeting regime for monetary policy. In the short and medium run, monetary policy shall balance the need for low and stable inflation, on the one hand, against the need for output and employment stability, on the other hand.

The monetary policy guideline prescribes that Norges Bank shall aim at low and stable inflation, but at the same time monetary policy shall contribute to stabilising output and employment developments. In most situations the need for stabilising inflation will be in accordance with the need for stable output and employment developments. In case of conflict, the discretionary monetary policy element will have to balance these needs against each other.

In the Report on Financial Markets 2007, which was presented on 18 April 2008, the Ministry of Finance stated, *inter alia*, the following:

"Underlying price growth in 2007 was low, and below the inflation target. The low inflation was not an indication of weak economic development, but especially the result of price reductions on imported consumer goods and increased competition within certain product markets. There has been a weak increase in underlying inflation since autumn 2006."

The Norges Bank key policy rate was reduced by a total of 5¼ percentage points, to 1¾ pct., from December 2002 to March 2004. The interest rate stayed at this low level up to and including June 2005, and has thereafter been gradually increased. The key policy rate is currently 5½ pct., after having been increased by ¼ percentage point in the monetary policy meeting on 23 April. The low interest level has contributed to the strong expansion in the Norwegian economy over the last few years. Capacity utilisation in the Norwegian economy is very high at present, and unemployment has been reduced to a low level. Underlying consumer price inflation remained low for a long period of time, but accelerating wage growth is now contributing to higher price growth as far as domestically produced goods and services are concerned.

The Norges Bank interest rate forecast in Monetary Policy Report 1/08 from March suggests that the key policy rate may peak at between 5½ and 5¾ pct. in the 4th quarter of this year, and that the key policy rate will thereafter be reduced to about 5 pct. in the 4th quarter of next year. In its presentation of monetary policy strategy for the subsequent four-month period, the Executive Board wrote, *inter alia*, the following on the same occasion:

"The key policy rate should be in the interval 5% – 6% in the period to the publication of the next Monetary Policy Report on 25 June, unless the Norwegian economy is exposed to major shocks."

The interest rate estimates in the Revised National Budget are based on forward interest rates from the beginning of May, which are somewhat higher than the

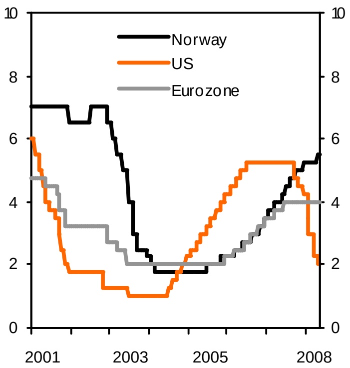

Chart 3.9 Key policy rates. Percent

Sources: Norges Bank, ECB and the Federal Reserve.

Norges Bank interest rate forecast for the coming year. The turmoil in international financial markets has resulted in unusually high risk premiums in money market rates both abroad and in Norway. This higher premium has also contributed to bank's deposit and lending rates having increased more rapidly than has the key policy rate over the last few months. The Norwegian interest rate level has since the beginning of 2007 been higher than the average interest rate level on the part of our most important trading partners. Market pricing indicates that the interest rate differential between Norwegian and international markets will be further increased this year, and then reduced next year.

The Norwegian krone exchange rate has appreciated over the last year. As per 9 May, Norwegian kroner, as measured by the effective krone exchange rate (TWI), were about 5 pct. stronger than the average exchange rate for last year and 9 pct. stronger than the average exchange rate for the last decade. Developments in the Norwegian krone exchange rate have partly to do with a general depreciation of the US dollar and of pound sterling recently, but the krone is also relatively strong in relation to several other currencies. The Ministry of Finance assumes that the effective Norwegian krone exchange rate will develop in line with exchange rates as priced in the forward market at the beginning of May. This assumption implies that the Norwegian krone exchange rate will on average be about 3¼ pct. stronger in 2008 than in 2007, and 1¼ pct. weaker in 2009 than in 2008.

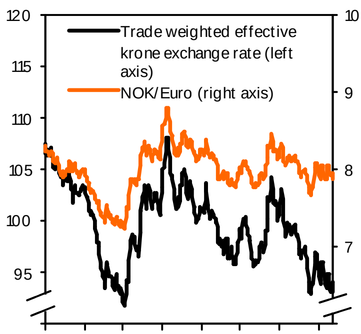

Chart 3.10 Norwegian krone exchange rate

Source: Norges Bank.

3.3 Main Aspects of the Management of the Government Pension Fund

3.3.1 Background

The Government Pension Fund was established in 2006, encompassing the former Government Petroleum Fund and National Insurance Scheme Fund. The purpose of

the Pension Fund is to support government savings to finance the pension expenditure of the National Insurance Scheme and long-term considerations in the spending of government petroleum revenues. To ensure that the petroleum revenues are contributing to the stable development of the Norwegian economy, the revenues shall be phased into the economy gradually, whilst the savings shall be invested outside Norway. The Government Pension Fund – Global contributes, by investing a significant part of the petroleum revenues abroad, to a capital outflow that offsets the impact on the Norwegian krone exchange rate of large and varying foreign exchange inflows from the petroleum sector.
The savings of the Pension Fund take the form of general fund accumulation. The Fund is fully integrated with the Fiscal Budget, in order to facilitate growth in the Fund being a reflection of the State's actual

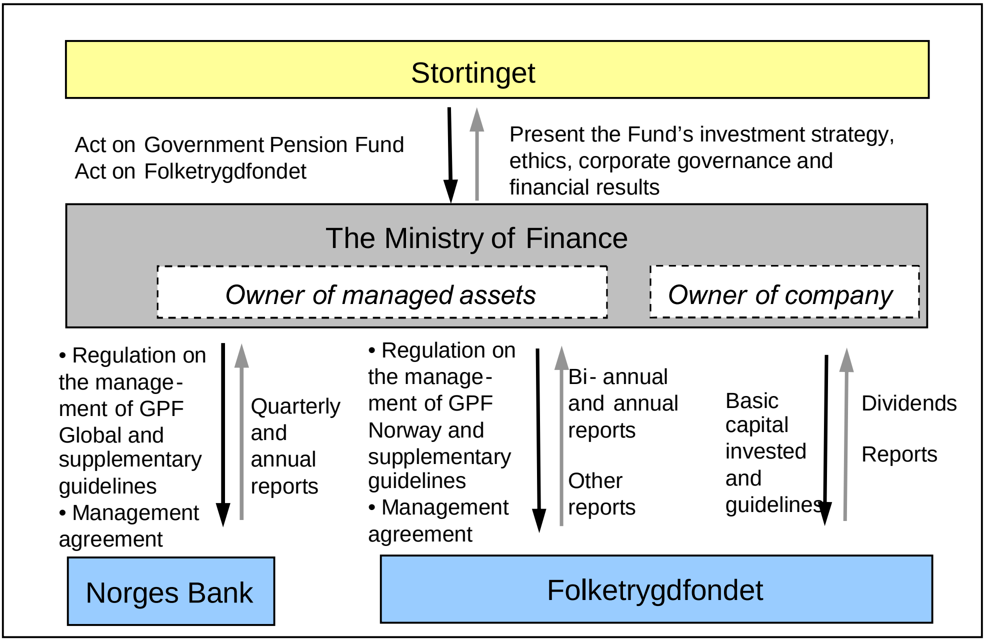

Chart 3.11 The main aspects of the distribution of responsibilities between the Storting, the Ministry of Finance, Norges Bank and Folketrygdfondet
Source: Ministry of Finance.

accumulation of financial assets. Consequently, there is no requirement that the assets of the Pension Fund shall at all times represent a certain share of the pension liabilities of the State under the National Insurance Scheme.

Under the Pension Fund Act, the Ministry of Finance has been charged with managing the Fund. The Ministry determines the general investment strategy of the Pension Fund, as well as its ethical and corporate governance principles, and follows up on its operational management. The task of carrying out the operational management of the Government Pension Fund has been delegated to Norges Bank and Folketrygdfondet, which manage the Government Pension Fund – Global and the Government Pension Fund – Norway, respectively. Both the Government Pension Fund – Global and the Government Pension Fund – Norway are subject to ethical guidelines. The main aspects of the division of responsibilities between the Storting, the Ministry of Finance, Norges Bank and Folketrygdfondet are described in Chart 3.11, illustrating, inter alia, the different roles of the Ministry. The Government Pension Fund does not have its own Executive Board or administrative staff.

The Government Pension Fund is one of the largest funds in the world, and its assets are growing rapidly. The Fund is large relative to the size of the Norwegian economy, and the return on the Fund will make considerable contributions to the funding of State expenditure in coming years. This underscores the importance of ensuring that the investment strategy of the Pension Fund, and its ethical guidelines, have the firm backing of the Storting. The Ministry emphasises a high degree of openness for purposes of strengthening the credibility of, and confidence in, the Fund and the fund structure. The Storting is consulted, inter alia, through an annual report on the management of the Pension Fund, which is submitted in the spring session, cf. Report No. 16 (2007-2008) to the Storting. Operational management performance is also reported by Norges Bank and Folketrygdfondet on a regular basis.

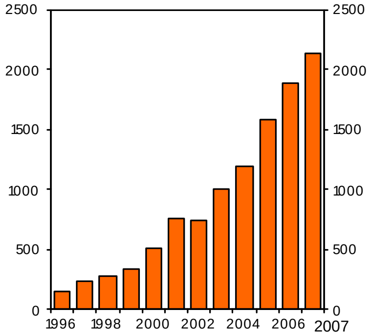

Chart 3.12 The market value of the Government Pension Fund[1]. 1996-2007.[2] NOK billions.

[1] The Government Pension Fund was created in 2006 as a general framework encompassing the Government Petroleum Fund and the National Insurance Scheme Fund. The value of the two Funds has, for purposes of illustration, been aggregated for previous years as well.

[2] The value of the Government Pension Fund – Global has been calculated prior to the deduction of management costs. The management costs amounted to just under NOK 1.8 billion in 2007, and are credited to Norges Bank during the 1st quarter of 2008.

Source: Ministry of Finance.

3.3.2 Management performance

The total market value of the Government Pension Fund was NOK 2,136.0 billion as per yearend 2007. This represents an increase of NOK 245,4 billion in total, when compared to yearend 2006, which was caused by the inflow of new funds (313.6 NOK billion) and the return on the Fund's investments (NOK 86.1 billion when measured in kroner). An appreciation of the Norwegian krone, as measured against the currency basket of the Government Pension Fund – Global, entailed, when taken in isolation, a reduction in the market value of the Fund (NOK 154.3 billion), but changes to the Norwegian krone exchange rate are not relevant as far as developments in terms of international purchasing power are concerned.

The assets of the Government Pension Fund have, as illustrated in Chart 3.12, grown rapidly since the mid-1990s. The value of the Pension Fund as per yearend 2007 represented approximately NOK 1 million per household in Norway.

The real return measured in foreign currency on the Government Pension Fund is relevant for purposes of

Table 3.8 Annual real returns on the Government Pension Fund – Global[1] and the Government Pension Fund – Norway[2], less management costs. 1997–2007. Per cent

Net real return	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997-2007
Pension Fund – Global	7.15	8.20	10.93	0.35	-3.66	-6.62	10.75	6.30	8.46	5.57	1.05	4.25
Pension Fund – Norway	5.60	-2.29	6.24	3.08	0.97	0.49	13.31	10.12	7.28	8.55	8.43	5.52

[1] Geometric real return in international currency calculated on the basis of a weighted average of retail price growth in the countries included in the benchmark portfolio of the Fund. Average annual management costs were 0.09 pct. of the assets under management over this period.

[2] Geometric real return in Norwegian kroner. Management costs are assumed, for technical calculation purposes, to have been 0.05 pct. of assets under management, which is higher than historical management costs because a significant portion of the assets managed by Folketrygdfondet was under December 2006 held in the form of sight deposits with the State. The sight deposit arrangement was abolished in December 2006.

Sources: Norges Bank, Folketrygdfondet and Ministry of Finance.

measuring developments in the international purchasing power of the Fund. The real return (after the deduction of management costs) on the Government Pension Fund – Global was 1.05 pct. in 2007 when measured in foreign currency, as can be seen from Table 3.8, which is significantly less than the average for the period 1997-2007. The Government Pension Fund – Norway achieved a real return of 8.43 pct., which is significantly more than the average annual real return for the period 1997-2007 as a whole.

3.3.3 Investment strategy

The Ministry of Finance has formulated a long-term investment strategy which implies that the portions to be invested in various asset classes and geographical regions can be determined on the basis of assessments of expected long-term returns and risks. The investment strategy is based on the premise that contributions to the diversification of the risk associated with the investments improve the risk-adjusted return. The Ministry of Finance has therefore emphasised a broad representation of the world’s stock and bond markets in the benchmark portfolio it has stipulated for the Government Pension Fund. The indices making up the benchmark portfolio of the Fund include representative security samples, and developments in these reflect, in large part, market developments in the relevant countries. The benchmark index for equities of the Government Pension Fund – Global comprises almost 7,000 companies across 27 countries, whilst the benchmark index for bonds comprises more than 9,800 bonds across the currencies of 21 countries.

It follows from guidelines laid down by the Ministry of Finance that Norges Bank and Folketrygdfondet may also invest in other securities and instruments than those included in the benchmark portfolio for the Fund. At the same time, there is an upper limit on the permitted tracking error in active management. By making investments in securities and instruments that fall outside the scope of the benchmark portfolio, and by investing other portions of the Fund in certain securities than are implied by the benchmark portfolio, Norges Bank and Folketrygdfondet are exploiting their permitted tracking error for purposes of achieving an excess return.

Calculations in Report No. 16 (2007-2008) show that 90-95 pct. of the return on the Government Pension Fund – Global may be attributed to the choices made by the Ministry in designing the benchmark portfolio, whilst the remaining 5-10 pct. may be attributed to the investment choices made by Norges Bank within the guidelines laid down by the Ministry. These calculations also show that about 99 pct. of the fluctuations in the return on the Government Pension Fund – Global may be attributed to the chosen benchmark portfolio, thus implying that the investment decisions of Norges Bank have hardly contributed to increasing the overall risk associated with the Fund.

There has been a gradual evolvement in the investment strategy of the Government Pension Fund – Global. The

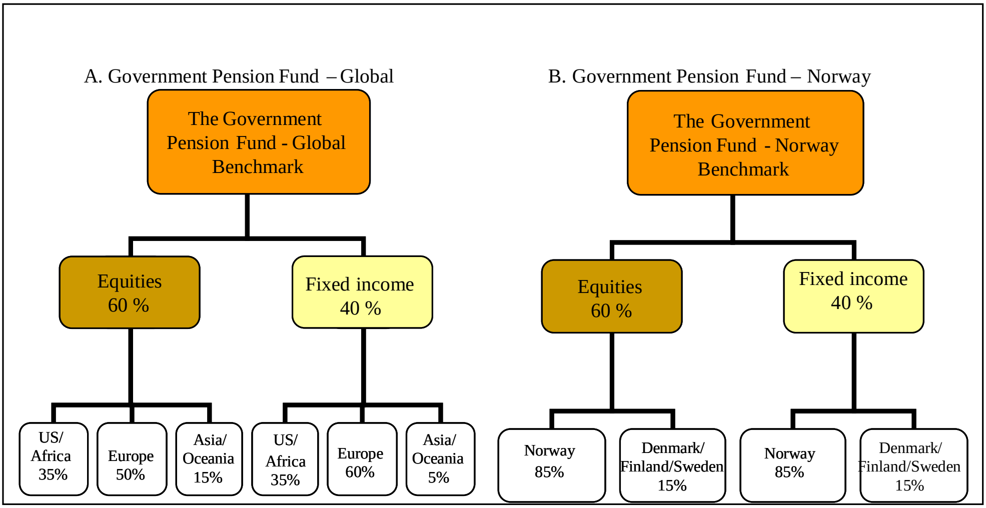

Chart 3.13 Strategic benchmark portfolio for the Government Pension Fund[1]

1 It has been resolved to increase the equity portion of the Pension Fund – Global to 60 pct., and it is currently being increased to that level.

Source: Ministry of Finance.

Fund has invested in equities since 1998. In 2000, emerging markets were included in the benchmark portfolio for equities, whilst in 2002 the benchmark portfolio for bonds was expanded through the inclusion of non-government-guaranteed bonds (i.e. corporate bonds and mortgage-backed bonds). In 2004, new ethical guidelines were laid down for the Government Pension Fund – Global. In 2006, the investment universe was further expanded. It was decided, following the Storting's deliberation of Report No. 24 (2006-2007) to the Storting, to include the small-cap segment in the benchmark portfolio for equities, and to increase the equity portion of the benchmark portfolio from 40 pct. to 60 pct.

In Report No. 16 (2007-2008) the Ministry presented intentions to change the investment strategy of the Government Pension Fund – Global by including real estate investments, expanding into more emerging markets and increasing the limit on ownership stakes.

3.3.4 Ethics and the exercise of ownership rights

It is an overarching objective for the management of the Government Pension Fund to achieve a high return on the Fund's investments over time. The capital of the Government Pension Fund – Global originates from the oil and gas revenues of the State. It would not be fair if the wealth from the oil and gas reserves only were to benefit those few generations that happen to experience the extraction thereof. The wealth needs to be safeguarded for posterity. This is an ethical obligation in itself. As an investor we share, at the same time, ethical responsibility for how the companies in which the Fund invests are conducting themselves, for what they are producing and for how they are treating their environment. The managers of the Pension Fund can exercise, through their active ownership effort, influence over companies on matters relating to good corporate management, as well as in relation to social and environmental issues. The production or activities of a company will in some cases be of such a grossly unethical nature that the Fund cannot run the risk of contributing thereto through its investments. The Ministry of Finance will in such cases determine that the Fund should divest its holdings in the relevant company.

Both the Government Pension Fund – Global and the Government Pension Fund – Norway are governed by ethical guidelines. The Ministry of Finance laid down ethical guidelines for the Global part of the Pension Fund on 19 November 2004, based on the report and proposal of the Government-appointed Graver Committee (NOU 2003:22 Green Paper). The same year, the Executive Board of Folketrygdfondet introduced ethical guidelines for the management of the Government Pension Fund – Norway. The guidelines for the two parts of the Government Pension Fund may to a large extent be characterised as founded on a joint ethical platform.

The principles governing the exercise of the ownership rights of the Government Pension Fund are based on the UN Global Compact, the OECD Principles of Corporate Governance and the OECD Guidelines for Multinational Enterprises.

The Government announced, in Report No. 24 (2006-2007) to the Storting, that it would undertake an evaluation of the ethical guidelines for the Government Pension Fund – Global. This process has now been commenced, and will continue until the end of 2008. The findings from the evaluation will be presented to the Storting in the report on the management of the Government Pension Fund in the spring of 2009.

3.3.5 Development and supervision of the management framework

The capital of the Government Pension Fund is growing rapidly. At the same time, the investment strategy of the Fund is undergoing continuous development. This is taking place alongside major changes to the supervision of risk management in financial institutions as a result of new rules both in Europe (EU Directive) and globally (Basel II). The Ministry deems it important to ensure that the framework for the management of the Government Pension Fund is adapted to these developments on an ongoing basis.

In Report No. 16 (2007-2008), the Ministry presented the results from a review of the risk management and control procedures of Norges Bank carried out by an international team from Ernst & Young LLP. The Report also presented main aspects of a proposal for amendments to the Central Bank Act, thus facilitating the further strengthening of the control and monitoring arrangements related to Norges Bank's asset management.

3.4 Central Government Debt

The central government debt consists of government bonds, treasury bills and deposits with the Treasury by other state institutions.

The non-oil fiscal budget deficit is financed by transfers from the Government Pension Fund - Global. Capital transactions, including debt amortisation, net lending to state entities and net equity investments, are covered by borrowing and/or a reduction in the Treasury's cash reserves. The main objective for central government debt management is to cover the central government borrowing requirement at the lowest possible cost, risks taken into account. Government borrowing shall also contribute to maintaining and developing well-functioning and efficient financial markets in Norway.

The domestic borrowing requirement is relatively small and the government therefore concentrates its borrowing on a limited number of loans with maturity up to 10-11 years. Each loan is gradually built up to a substantial volume in order to maintain a liquid and well-functioning secondary market.

The Storting authorizes the Ministry of Finance to borrow based on an annual proposition to the Storting. For 2008, the Ministry is authorized to borrow up to NOK 40 billion in long term loans and to have up to NOK 80 billion in outstanding short term market loans.

On March 31, central government debt amounted to NOK 320 billion, of which NOK 235 billion was marketable debt (bonds and T-bills).

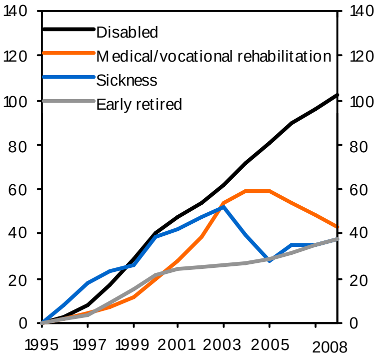

Chart 3.14 Number of persons (16-66) drawing benefits under social security schemes since 1995. 1,000 persons

Sources: Statistics Norway, Directorate of Labour and Welfare and the Ministry of Finance.

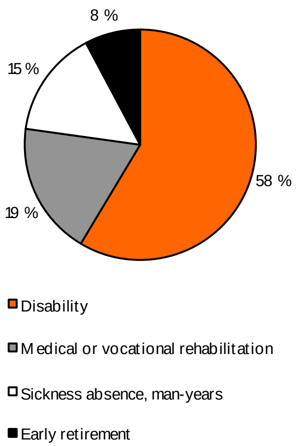

Chart 3.15 Distribution of recipients by type of benefits 2007. Percent

Sources: Statistics Norway and Directorate of Labour.

3.5 Employment and Income Policy

Employment policy is aimed at facilitating good availability of manpower, low unemployment and the inclusion of groups characterised by low labour force participation. A comprehensive safety net and good public services in day-care centres, education and health contribute to a well-functioning labour market and high labour force participation. A pension reform in line with the resolution passed by the Storting in spring 2007 entails good work incentives.

The steep increase in labour demand in recent years has resulted in a significant reduction in unemployment and strong labour force growth. The labour force has grown as a result of both higher labour force participation amongst Norwegians and extensive labour immigration. Labour force participation in Norway has never been higher and it is also high by international standards. However, the overall amount of work performed is reduced by relatively short working hours per employee. The shorter working hours in Norway have to do with, *inter alia*, a high proportion of part-time work amongst women, and high absence due to sickness. At the same time, the manpower potential is curtailed by the fact that an ever-increasing number of people draw benefits under various health-related benefit schemes. Reversing this trend is a challenge.

Exits from working life onto health-related benefit schemes and collectively-agreed early retirement pension schemes (AFP) have increased considerably since the mid-1990s, cf. Chart 3.14. About 480,000 individuals received disability benefits, medical or vocational rehabilitation benefits or AFP as per the end of the 1st quarter of 2008. This is moderately higher than at the same time last year, and about 180,000 more than in 1995. In addition, it is estimated that publicly-funded sickness absence has increased by more than 35,000 man-years since 1995.

The largest group of benefit recipients are those who draw disability benefits, cf. Chart 3.15, although percentage growth has been even higher for the other groups since 1995. Disability benefit developments need to be examined in relation to the evolution in health-related short-term benefits. About 30 pct. of those who completed a period of medical or vocational rehabilitation in 2007 received a disability benefit after a short period of time, and close to 20 pct. of those who had exhausted their sickness benefit allowance were switched straight over to disability benefits, cf. Chart 3.17. The share of older people in the population will increase in coming years, which will, all else equal, increase the number of individuals drawing disability benefits. As per the end of the 1st quarter of 2008, recipients of disability benefits numbered 335,200 persons, which is 5,200 more than at the same time last year. 101,500 persons received medical or vocational rehabilitation benefits. The number of recipients of these short-term benefits has been reduced over the last few years. This has to do with the favourable labour market conditions which have contributed to more recipients of medical or vocational rehabilitation benefits finding a job, whilst fewer people have joined the scheme.

45,700 individuals were registered as receiving the early retirement scheme AFP as per the end of the 1st quarter of 2008, or 3,300 more than a year earlier. The number of people drawing AFP has increased steeply for many years. Developments in the 1990s were influenced by the fact that the retirement age under the scheme was reduced in several steps, and that new groups were admitted into the scheme. The number of people receiving AFP increased by no less than 70 pct. from the beginning of 2000 until the end of 2007. The growth has to do with demographics and an ever-growing number of adult women who have accrued an entitlement to collectively-agreed early retirement pension. Projections based on Statistics Norway's population forecast indicate continued strong growth in the number of people drawing collectively-agreed early retirement pension over the next few years. As a part of the wage negotiations in April 2008, unions agreed to convert the scheme in line with the outline presented by the Government in the Pension Report; Report No. 5

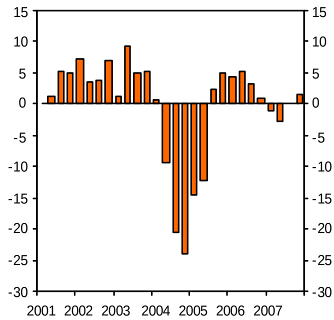

Chart 3.16 Sickness absence as a percentage of agreed man-days. Percentage change from the same quarter of the preceding year
Source: Statistics Norway.

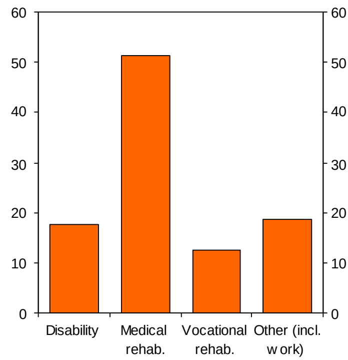

Chart 3.17 Status for persons who have exhausted their sickness benefit allowance, three months later. 2007. Percent
Source: Directorate of Labour and Welfare.

(2006-2007) to the Storting. The new scheme provides an incentive to increased participation.

A moderate reduction in sickness absence in the first half of last year was followed by a new increase in the second half of the year, and sickness absence in the 4th quarter was in excess of 1½ pct. higher than at the same time the previous year. Nevertheless, sickness absence was reduced by ½ pct. on an annual basis, and thereby represented just below 7 pct. of all agreed man-days in 2007. This corresponds to more than 135,000 man-years. This Report assumes a 1 pct. increase in sickness absence from 2007 to 2008.

In 2007, the scale of implemented labour market measures was close to 40,000 positions. The labour market has tightened considerably over the course of the last year. Thus far this year, employment has increased by more than what was assumed in the National Budget 2008, whilst unemployment and the number of occupationally disabled have declined more. The Government attaches considerable weight to an active effort aimed at individuals at the periphery of the labour market. New measures like, *inter alia*, permanent wage subsidies and the qualification programme, contribute to including more people in working life. The measures aimed at priority groups like youth, immigrants, long-term unemployed and occupationally disabled have been stepped up significantly in recent years, and unemployment amongst these groups has declined. It is in this report proposed that the scale of labour market measures be maintained at the same level as proposed in the National Budget 2008, i.e. 40,000 positions on an annual basis for 2008.

Labour immigration, in particular from the new EEA countries, has increased steeply in recent years. This has contributed to relieving mounting pressure in the labour market. The Government has implemented a number of simplifications to the regulatory framework governing immigration, with a view to improving access to manpower from abroad. Further measures that will contribute to facilitating labour immigration, both from the EEA area and from countries outside the EEA area, have been proposed in a recently submitted report to the Storting on labour immigration. The proposed measures will contribute to a simpler and more user-friendly regulatory framework, better information and simplified application procedures. However, labour immigration also presents challenges in terms of upholding the Norwegian labour market model, characterised by well-structured remuneration and working conditions, as well as a fair distribution of income. The Report announces that the effort to combat social dumping will be reinforced.

Income policy cooperation is a key feature of economic policy in Norway, and is one of the reasons why Norway has had lower unemployment than most other OECD countries over the last 30 years. The Norwegian wage bargaining model is based on the premise that wage growth must over time be kept within limits that can be accommodated by the sector exposed to international competition.

Like the other Nordic countries, Norway has a comprehensive social safety net, a high degree of unionisation and relatively coordinated wage formation. The social safety net provides economic security for employees, and thereby lays the foundations for flexibility and adaptability in the Norwegian economy. Coordinated wage formation has contributed to an even distribution of income and a low unemployment rate.

The Nordic countries have a tradition for a broad-based social dialogue and participation from the social partners. This contributes to a joint understanding when it comes to economic policy and the importance of wage formation for the situation in the Norwegian economy.

The Norwegian Technical Calculation Committee for Wage Settlements (TBU) estimates growth in average annual wages to have been 5.4 pct. in 2007, up from 4.1 pct. in 2006. Wage growth last year was the highest since 2002, and well above the average of 4.7 pct. over the last decade.

In this year’s wage settlements, agreement has thus far been reached between the Confederation of Norwegian Enterprise (NHO) and the Norwegian Confederation of Trade Unions/Confederation of Vocational Unions (LO/YS) and between the Federation of Norwegian

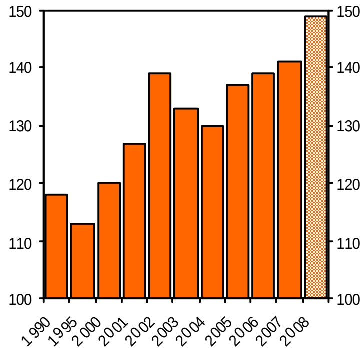

Chart 3.18 Wage costs for manufacturing industry workers in Norway relative to those of EU trading partners[1]. Common currency. Index. EU trading partners = 100

1 Trade-weighted average

Sources: Norwegian Technical Calculation Committee for Wage Settlements, Statistics Norway and Ministry of Finance.

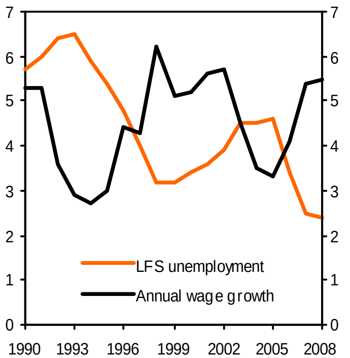

Chart 3.19 Annual wage growth[1] for all groups, and number of unemployed (LFS) as a percentage of the labour force. Annual average

1 Incl. costs associated with the introduction of longer holidays in 2000 and 2001.

Sources: Norwegian Technical Calculation Committee for Wage Settlements, Statistics Norway and Ministry of Finance.

Commercial and Service Enterprises (HSH) and LO/YS. Both settlements have adopted an estimated annual wage growth in 2008 of 5.6 pct. The central and local government sector settlement processes have been submitted for mediation. The Revised National Budget assumes, based on the settlements completed thus far, that wage growth in the Norwegian economy as a whole will amount to 5½ pct. this year.

Hourly wage costs in Norway, when compared to international wage costs, have never been higher than at present. In 2007, hourly wage costs for manufacturing industry employees were about 25 pct. higher in Norway than on the part of our main European trading partners, after conversion into a common currency. If one looks at blue-collar workers within manufacturing industry, Norwegian costs were as much as 40 pct. higher, cf. Chart 3.18. High prices for important Norwegian export prices have meant that profitability has still been good when looking at industries exposed to international competition as a whole. However, a reduction in the prices of Norwegian export goods, as has often been experienced during international recessions, may change this situation rapidly.

Wage growth on the part of our trading partners is estimated at about 3½ pct. this year. This implies, if the Norwegian krone exchange rate appreciates in line with the estimates in the Revised National Budget, that cost-based competitiveness will be weakened by 5½ pct. from 2007 to 2008.

3.6 Tax Policy

Total accrued tax revenues in Norway will accumulate to about NOK 960 billion in 2007. Of this, about 87 pct. were paid to the central government, while local government (municipalities and counties) received 13 pct. The Norwegian tax system is characterised by a relatively high share of indirect taxes, cf. Chart 3.20. The value-added tax (VAT) and excise duties represent about 27 pct. of the total tax revenue. The personal income tax and tax on net wealth levied on individuals represent about 29 pct. of the total tax revenue. The corporate tax, including employers' social security contributions, amounts to approximately 16 pct. Taxes levied on the petroleum activity represent about 26 pct. of the total tax revenue.

Total taxes as a percentage of the gross domestic product (GDP) can give a rough impression of the general tax level, cf. Chart 3.21. Total accrued taxes as a percentage of GDP is estimated to 43.9 for 2006. Adjusted for the petroleum activity, the tax level is estimated to 41.3 pct.

The main goals of the tax system are to provide revenue for public services and to redistribute income between citizens. The tax system should raise revenue by means that allow labour, capital and natural resources to be used as efficiently as possible.

In 1992 Norway implemented a broad tax reform. Both the personal income taxation and the corporate taxation were reformed. The main goal was to reduce tax-induced distortions to a minimum by lowering the tax rates and broadening the tax base. The reform also involved a significant step towards a more neutral tax system with respect to type of economic activity and the organisational and financial structure of such activity.

Until 2005 capital income of individuals and businesses was taxed at a uniform rate of 28 pct. As opposed to this, wage income is taxed by a progressive rate structure. This is the main feature of a dual income tax system. In 2005 the maximum marginal tax rate on wage income was 51.3 pct. exclusive of employers' social security contributions (61.5 pct. including employers' social security contributions). The difference in the maximum marginal tax rates between wage and capital income created tensions in the tax system, i.e. by increasing the incentives for tax planning. This was a main reason for initiating a new tax reform in 2004-2006. In 2006 the maximum marginal tax rate (including employers' social security contribution) was reduced to 54.3 pct. Combined with the tax on returns on shares above the risk-free interest rate and on corresponding income for self-employed, which implies a 48.2 pct. marginal tax rate on returns to individuals, it was possible to abolish the prevailing splitting of business income of self-employed into capital and labour income (the split model). It is important to keep this difference in maximum marginal tax rates at a low level.

The objectives of the Government's tax policy are to safeguard revenue for public purposes, contribute to fairness in distribution and an improved environment, promote employment throughout the country and enhance the efficiency of the economy. By reverting aggregate direct and indirect taxes to the 2004 level, in total about NOK 5.1 billion, the Government has made it possible to strengthen welfare schemes and public benefits. At the same time, the distributional profile of the tax system has been improved as a consequence of the introduction of dividend tax, an increase in the basic

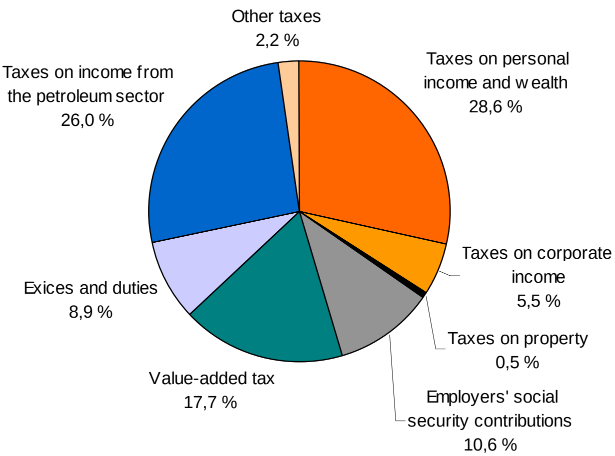

Chart 3.20 Taxes as a percentage of total tax revenue for Norway in 2007
Source: Ministry of Finance.

allowance, as well as a fairer and higher wealth tax.
Norway has a long experience with environmental taxation. Taxes have been introduced to reduce environmentally harmful emissions to air and water, and to reduce the amount of waste generated. The political authorities in Norway have defined an ambitious climate policy. The Government emphasizes the use of cross-sectoral, cost-effective measures like taxes and quotas. Norway will be a part of the EU Emission Trading Scheme. In Norway, approximately 75 pct. of national greenhouse gas emissions are covered by the CO_2-tax, the Emission trading scheme or taxes on other climate gases. Chart 3.22 shows the distribution of

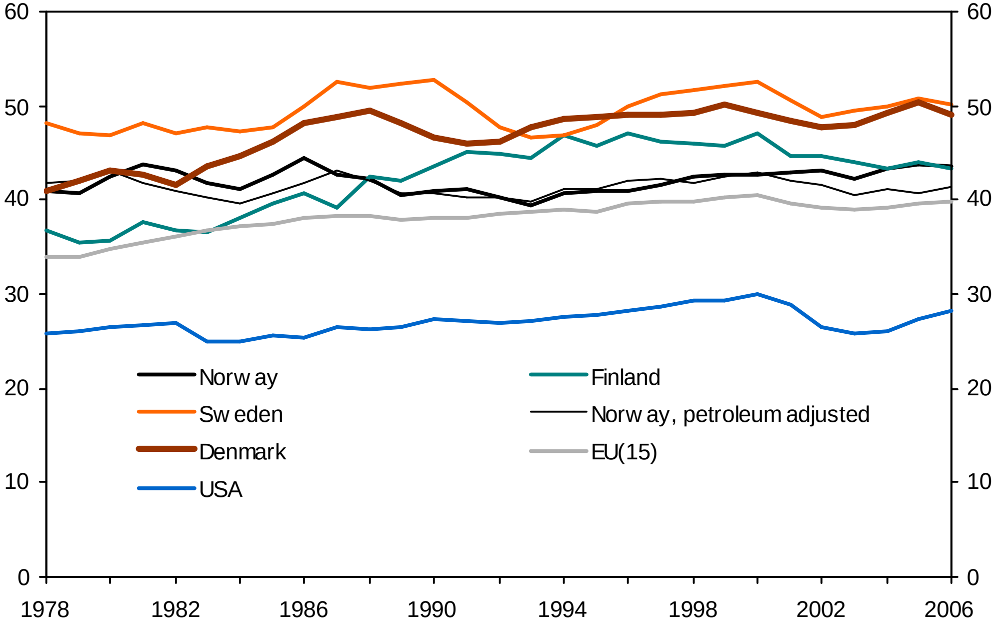

Chart 3.21 Tax revenues as a percentage of GDP
Sources: OECD and Ministry of Finance.

climate gas measures by source.

It was announced in the Climate Report that the Government will increase environmental and climate taxes, and offset this by corresponding reductions in other direct and indirect taxes.

The Government proposes, in connection with the Revised National Budget 2008, inter alia the following changes within the area of direct and indirect taxes:

- Central government and 14 business organisations have concluded an environmental agreement concerning measures to reduce NO_X emissions. The environmental agreement grants exemptions from NO_X tax, thus eliminating the basis for tax compensation to industries. Formation of the environmental agreement and cutbacks in the compensation schemes will entail an overall loss of proceeds in the approximate amount of NOK 650 million accrued and NOK 470 million booked in 2008.
- On 17 January 2008, the government parties reached agreement with the Conservative Party, the Christian Democratic Party and the Liberal Party about a comprehensive climate policy compromise. The Government proposes an early introduction of the item under the climate compromise that concerns fuel tax increases, by increasing the auto diesel tax by 0.10 NOK per litre and the petrol tax by 0.05 NOK per litre with effect from 1 July 2008.
- The Government presents, in line with a request from the Standing Committee on Finance and Economic Affairs in the Storting, a comprehensive evaluation of incentives for the expanded development of hydropower and other renewable energy. Furthermore, some changes in the taxation of hydro power are proposed

The proposed changes imply an aggregate loss of proceeds in the approximate amount of NOK 540 million accrued and NOK 370 million booked.

Furthermore, the Government will consider the abolition of the tax exemption for mutual fire and livestock insurance companies with effect from the

2008 financial year, in connection with the Budget for 2009. There is no real justification for such a tax exemption, and it distorts competition and may be problematic from the perspective of the state aid rules under the EEA Agreement.

By a letter of 13 June 2007, the EFTA Surveillance Authority (ESA) initiated formal proceedings against Norway, contending that the base tax on disposable packaging is in violation of Article 14 of the EEA Agreement. In a letter of 16 April 2008, the Ministry of Finance received a reasoned opinion from the ESA to the effect that the base tax represents a violation of the EEA Agreement. The time limit for furnishing a reply in respect of the reasoned opinion from the ESA is 16 June 2008. The Government will give the opinion its due attention, and respond to the ESA within the time limit.

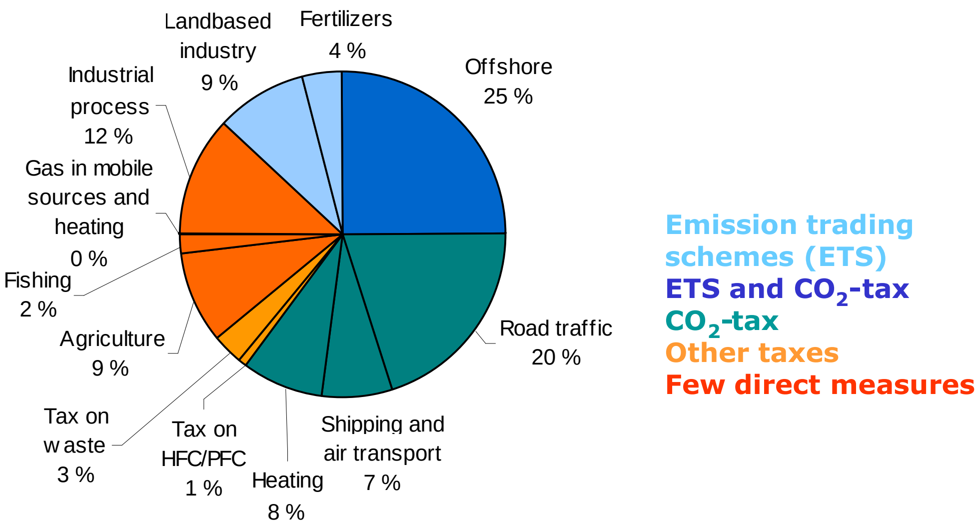

Chart 3.22 Climate measures in Norway by sources

Sources: Statistics Norway, Norwegian Pollution Control Authority and Ministry of Finance.

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