Economic Perspectives

Annual address by Governor Kjell Storvik at the meeting of the Supervisory Council of Norges Bank on Thursday 15 February 1996

Over the past fifty years we have seen the emergence of the welfare state. In our country, there appears to be a broad consensus to preserve what we perceive to be the key elements of the welfare state. This seemed to be one of the conclusions of an interesting television debate between the current prime minister and three of her predecessors a few weeks ago.

By way of introduction, let me emphasise that I share the views of the prime ministers. I would, however, like to raise the question of whether, in our eagerness to improve and expand the welfare state, we are in fact eroding its foundations. Furthermore, it could be questioned whether the *overall* ambitions for the welfare state are unrealistic, when the full range of objectives and use of policy instruments are viewed in the light of economic constraints.

You may ask whether this is a suitable topic for a central bank, or whether it in fact is more suited to the political arena. The future of the welfare state largely depends on the fundamental elements of our economy; on whether we manage to maintain a sufficient level of economic growth which can finance the benefits of the welfare state. This in turn places demands on the stability and long-term orientation of economic policy. This brings us to an area for which the central bank has a responsibility.

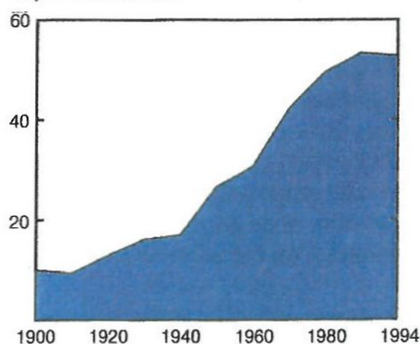
I will primarily concentrate on the constraints on increased welfare spending set by the economy. In the light of these constraints, I will outline some of the options and dilemmas we face when assigning priorities to the various objectives we have set.

By way of introduction, I will briefly outline the development of the welfare state and point to experiences of other countries which may be useful references for our own judgements.

Development of the welfare state

Historically, the public sector's role as a dominant operator in the economy is a relatively new phenomenon. For the first few decades of this century, the responsibilities of the public sector in most countries were largely restricted to law and order, defence and elementary education. For many people, the

Chart 1
Public expenditure
In per cent of GDP



Source: Statistics Norway

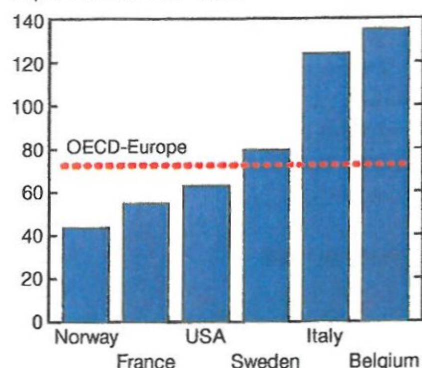
health care sector was, at best, synonymous with the local private physician. The public support schemes which were available (e.g. poor relief funds), only provided minimal benefits.

Following a period of social unrest and conflict prior to the Second World War, it was gradually recognised in many countries that, to a large extent, the state both could and should assume responsibility for the economic security of the individual, and for more equal opportunities for increased living standards. Such recognition appears to be based on fundamental concepts of community spirit and solidarity.

The public sector has now assumed considerable responsibility for important aspects of the economy. The financing of a number of services has been taken over by the government. The production of many of these services has also been organised by government bodies. We have built up a public education system, a government health sector and a social security system consisting of different transfer arrangements that provide us with a financial safeguard against illness, disabilities, unemployment and retirement. In addition to the tax system, these arrangements influence both income distribution and the functioning of the economy in general.

Norway is not the only country which has experienced a substantial increase in government services and benefits. Our public expenditure is not particularly high in a European context. Expenditure in Sweden and Denmark is considerably higher, and the average level in OECD Europe is on a par with Norway. On the other hand, there is a considerable difference between Western European countries and other OECD countries. It could perhaps be said that the emergence of the welfare state is a European phenomenon. In any event, European countries allocate more of society's general resources over government budgets than any other area.

Chart 2
Gross public debt
In per cent of GDP 1994



Source: OECD

Welfare state heading towards a crisis?

The trends which give most cause for concern are also to be found in Europe. Many European countries have substantial government budget deficits and high government debt levels. One typical characteristic is that even though government expenditure constitutes a relatively high share of GDP, a substantial amount of expenditure is used for interest payments on government debt, leaving a declining share for government services and benefits.

The squeeze on government finances is such that the future of the welfare system is now subject to intensive debate. France is a case in point, where the government recently announced a number of proposals to scale back social security and pension schemes. This gave rise to labour unrest and opposition involving industrial action which paralysed the entire country.

Another feature of developments in Europe is the dramatic rise in unemployment since the mid-1970s. At the moment, more than 20 million people are unemployed in Western

Europe. Labour force participation, the share of the working population which is seeking or which actually has work, is also consistently lower than in the US and Japan.

When the opportunity to earn an income is denied to so many, part of the basis for the welfare society is seriously eroded. In addition, unemployment has contributed to the deterioration in government finances through reduced tax revenues and increased unemployment benefit payments.

The challenges associated with employment and unemployment are in themselves worthy of an annual address. However, tonight I will concentrate on the financing of the welfare state.

Norway has also felt the squeeze on public finances during the recent cyclical slump. The deterioration in public finances has run parallel to a sharp increase in oil production. Using the oil revenues has made us vulnerable to and increasingly dependent on the international economic and political developments far beyond our control. Oil revenues could peak within the next decade.

This raises the question of whether we have established a system that provides a fair economic distribution among generations. In other words, there may be a generational problem associated with how we manage the country's wealth and with the burdens we impose on our descendants in the form of constraints on government spending - primarily on old-age pensions provided by the National Insurance Scheme.

Moreover, the experience of the past few years seems to indicate that the welfare state cannot continue to grow at the same rate as previously, because there are limits to the tax burden that the economy can tolerate, and that the population is willing to accept. When we then take into account that any expansion of the welfare system partly depends on oil revenues, which we know will start to fall some time after the turn of the century, we may be facing a financing problem.

The question is how we best can act to preserve what we regard as the main content of the welfare state, within existing financial constraints and faced with persistent pressure on the use of public resources. This represents a problem of priorities: it will be necessary to define more clearly the public sector's responsibility to provide and finance welfare services and benefits, and assign priority to the most important needs in order to cover them satisfactorily.

Distribution among generations

In the long run, we can only finance the welfare state through tax revenues. We can either fully finance expenditure through current tax revenues, or defer parts of the tax burden to a later date by means of deficits and borrowing.

It will come as no surprise to you all that a central bank would advise strongly against persistent budget deficits. As we have seen, this is exactly what has happened in a number of countries in Europe.

A persistent deficit would result in increasing government debt and larger interest payments for the public sector. A larger share of government expenditure would be used for interest payments. To put it simply, financing government expenditure through borrowing today will entail a lower level of services and benefits in the future. Sooner or later the budget will have to be balanced, and interest payments will have to be financed through taxation.

This also implies that deficit financing is in fact a tax burden on our descendants. One feature of such future taxes is that those who will have to pay them do not have voting rights when the decision is taken.

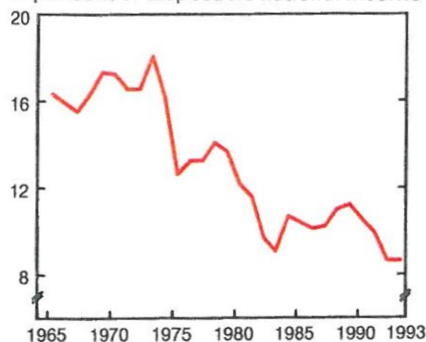
The problems associated with deficit financing and an increased interest burden are particularly relevant if the deficit persists over many years, entailing a build-up in the interest burden which continually supersedes other objectives. There is less cause for concern if we only have limited deficits for a short period, which are swiftly reversed into surpluses.

If it is of appropriate proportions and is managed with the necessary discipline and moderation, such budgetary policy can, over time, contribute to more stable economic developments, and a permanently higher level of employment. In this context, the role of monetary policy is to contribute to stable growth through low inflation and a stable currency. I will discuss this in more detail later.

Generally, the income that Norwegians will live off in the future will, to a large extent, be determined by how much we leave behind us - in other words, our total savings. In the same way that our welfare depends on the investments and human capital that have been accumulated in the past, we must also set aside the necessary resources to create the foundations for a high level of welfare in the future. Today's level of income is based on production equipment and know-how which will not last forever. This means that we must replace the equipment and know-how with something new - and we cannot do that without saving. Furthermore, we must save in order to *increase* our total capital if we are to ensure continued economic growth.

In this connection, it is of particular concern that total saving has fallen markedly both in Norway and in other countries over the past 25 years.

Chart 3
Saving in OECD countries
In per cent of disposable national income

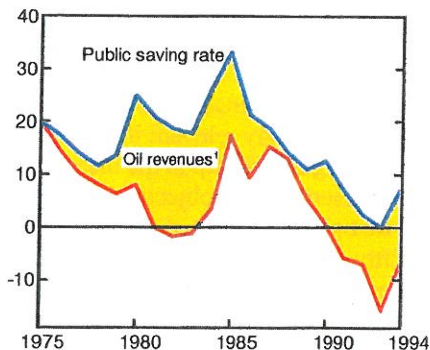


Source: OECD

The decline in saving ratios in industrial countries has reduced the global access to capital for financing fixed investment. Substantial government budget deficits - which to a large extent reflect high government consumption - may have contributed considerably to this trend. The deficits have absorbed a large part of private saving, and there is reason to believe that this, in turn, has contributed to the rise in real interest rates[1]. Real interest rates have risen considerably since the start of the 1970s, and this has constrained fixed investment, resulting in weaker fixed capital formation than previously. Thus, the fall in government saving has probably served to reduce opportunities for growth in income and welfare in the long term.

[1] Cf. IMF's World Economic Outlook, May 1995.

Chart 4
Public saving
In per cent of public disposable income



[1] Government's net cash flow from petroleum activities in per cent of public disposable income.

Source: Statistics Norway and the Ministry of Industry and Energy

A decline in the aggregate saving ratio, which has coincided with a fall in public saving, has also been registered in Norway. Looking at the period as a whole, the public saving ratio is now considerably lower than before oil revenues became an important element of our economy. In other words, the decline in saving coincided with, and in spite of, the draining of oil resources.

It must be assumed that the fall in government saving will weaken the long-term basis for the Norwegian welfare state.

How our savings should be used, however, is another question. We could invest in infrastructure, in better or more machinery, or we could save through financial investment abroad. From a broader perspective, we could also safeguard our total capital in other ways: our knowledge and skills, our natural resources and environment are elements of this broader concept of capital. What we do need to ensure, is that our savings are used for investments which provide high social returns. Moreover, we should spread the risk on our investments, so that we are less exposed to income fluctuations. As the Norwegian economy is so dependent on developments in oil revenues, it may, for this reason alone, be sensible to invest some of our wealth in foreign assets.

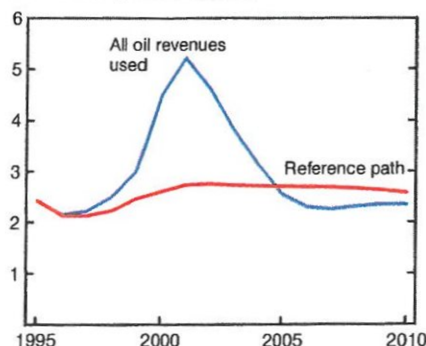
An inappropriate use of oil revenues

In our particular situation, with substantial oil revenues accruing to the government in the years to come, there is, nevertheless, a widespread belief that we can afford to expand the welfare state further. If we use the increase in oil revenues to finance the costs of such measures, there is, furthermore, no need to raise taxes - at least, not until oil revenues fall again. I will now attempt to illustrate the consequences of such an approach.

We have used our macroeconomic model to illustrate the effect of using all the oil revenues in Norway over the next few years. Obviously there is considerable uncertainty attached to such calculations. The results will partly depend on the anticipated effect on exchange and interest rates of using oil revenues over the budget. The calculations are based on the assumption that real annual growth in government expenditure will be 2 1/2 per cent to the turn of the millennium, which is more or less in line with the average growth in government expenditure over the past 10 years. This spending growth would mean that the Petroleum Fund will still be empty when we enter the next century. This entails a more expansionary fiscal policy than assumed in the official budget documents, which project annual real growth in government expenditure at 1 1/2 per cent to the end of the century.

In the first instance, such a policy would result in stronger growth in domestic demand, higher price and wage inflation, and a corresponding deterioration in profitability in exposed industries. Furthermore, there would be fewer resources avai-

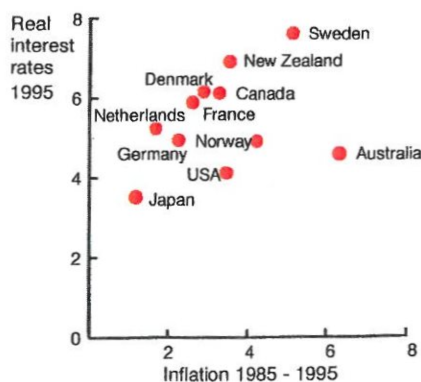
Chart 5
Consumer price inflation



The reference path shows a development with stable, moderate growth and falling unemployment. It is based on annual public spending growth of 1½ per cent. The reference path to the end of the century is identical to Norges Bank's projections in Economic Bulletin 1995/4. Projections up to 2010 are based on a continuation of assumptions regarding growth in the international economy and public spending to the end of the century. Public budgets will run a surplus through the period, allowing for the accumulation of resources in the Petroleum Fund. «All oil revenues used» shows the effects of including oil revenues in the economy, with the result that the Petroleum Fund is empty around the year 2000. Developments in this path at the start of the new century are based on the assumption that fiscal policy will be tighter and interest rates will be higher.

Source: Norges Bank

Chart 6
Inflation record and long-term real interest rates
Per cent



Countries which have recorded high inflation over the past ten years have consistently higher real interest rates than countries which recorded low inflation. Real interest rates for 1995 are calculated as an average of 10-year bond yields in each country deflated by consumer price inflation for 1995.

Source: Norges Bank and OECD

lable if oil revenues were to fall. Overall, Norway's oil dependency will have grown by a substantial margin.

It is possible that this development would not result in pressure on the krone initially, as large current account surpluses could still be expected. Experience in Norway and in other countries indicates that such pressures arise only when it becomes apparent that confidence in economic policy in general has been weakened. However, it is inevitable that a higher level of inflation combined with the full use of oil revenues will sooner or later lead to weakened confidence in the krone. By then it will be very difficult to prevent a fall in the value of the krone. In the calculations, this is illustrated by a fall in the value of the krone at the turn of the century, which, in turn, results in accelerating price and wage inflation.

Norway's oil revenues will start to decline at the start of the next century. In order to restore confidence and to avoid a persistent budget deficit, it would be necessary to tighten fiscal policy substantially. Moreover, it has been assumed that imbalances in the economy will inevitably lead to a rise in real interest rates, which will probably remain at a higher level for a few years. This assumption is primarily based on our own experience with ten years of fairly frequent devaluations in the period up to 1986, as well as similar experiences in other countries.

It seems that real interest rates are higher in countries which traditionally have relatively high inflation than in other countries. We have also seen that the rise in interest rates that occurs during periods of turbulence when the markets are characterised by uncertainty and reduced liquidity, will be highest in those countries which have a track record of high inflation.

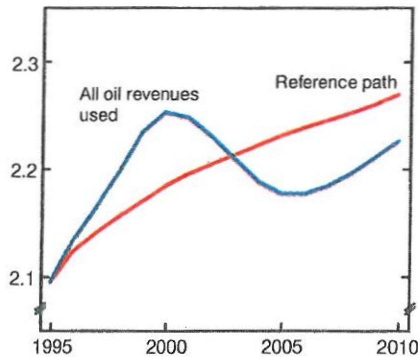
In this scenario, the increase in real interest rates leads to a reduction in household consumption and housing investment. Business fixed investment and production will be adversely affected by the accumulated effects of higher interest rates, higher production costs and lower domestic demand.

Against such a background, the economy would experience a sharp cyclical downturn with ebbing growth over several years. The cyclical slump would lead to a twofold increase in the number of unemployed over three years, and our estimations indicate that unemployment could remain at a persistently higher level.

This illustrates how an increase in the use of oil revenues domestically to finance high growth in government expenditure later may lead to social costs, in the form of reduced growth and employment. It may be uncertain how long it is possible to stretch the limits of a sound fiscal policy and the effect on interest and exchange rates may be difficult to predict. But there is every indication that a lack of prudence in the use of oil revenues may have the dire consequences I have just indicated.

Moreover, the use of oil revenues domestically will make the Norwegian economy even more vulnerable and dependent

Chart 7
Employment
In millions of persons



Cf. note to Chart 5.

Source: Norges Bank

on oil. This vulnerability may in itself result in wide fluctuations in the economy, as was the case after the fall in oil prices in 1986.

The important role of oil Norway's economy is not only related to public demand by the use of oil revenues, but is also related to the direct demand from the petroleum sector. The structure of our industry is considerably influenced by activity on the Norwegian shelf and has become increasingly dependent on oil operations. What could be called the supplier industry currently employs some 50 000 people and is in possession of spearhead technology in several fields connected to oil operations. This sector is heavily dependent on the activity level on the Norwegian shelf. Deliveries to the oil sector will decline long before the oil age draws to a close. If this sector does not make inroads into other international markets, this industry will probably have to be phased out. Hopefully it will then be possible to transfer the production resources to other activities, but that will depend on competitiveness and profitability in other sectors at that time. Also in this context, we would be better equipped if we could reduce our vulnerability by means of a petroleum fund, which could act as a buffer against external shocks.

On a more general level, we know that oil revenues will sooner or later come to an end, even though for a short period we will record even higher revenues than at present. The rise in oil revenues in the years ahead should not be used domestically as we would then become used to a high expenditure level that cannot be sustained once the oil revenues start to decline and gradually peter out. The adjustments which will have to be made will then be more painful. New exposed industries cannot be built up overnight. Nor can we expect industries that die out to start up without any difficulty, even if we improve our competitiveness.

By setting some of the oil revenues aside we can help to create the conditions necessary for a larger and more competitive non-oil industry, and thereby preserve and develop the expertise we need for the future. Furthermore, we would be in a better financial position to deal with the decline in oil revenues by means of a gradual transition, as opposed to the shock therapy which I have just illustrated.

The limitations of tax financing

Having attempted to dismiss increased use of oil revenues as a viable means to solve the financial problems of the welfare state, we once again return to tax revenues as the actual source of its financing.

It is well known that taxes can entail substantial efficiency losses if it is not ensured that they are as neutral as possible - in other words, that all economic agents should, as far as possible, be subject to the same tax rates, and that each individual should be subject to the same tax rate, irrespective of how we choose to use our resources and income.

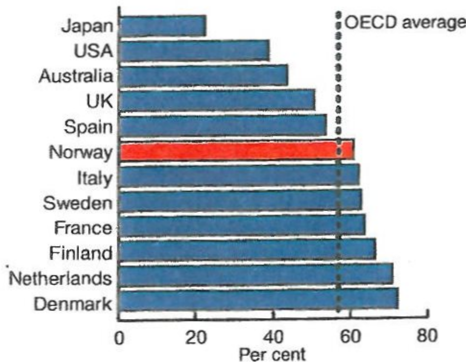
Furthermore, a high *level* of taxation will have negative consequences for value added in the economy's private sector - regardless of how we structure the tax system and how efficiently it is organised. In my predecessor's annual address last year, reference was made to surveys which indicate that taxes result in efficiency losses at the margin of around 50 per cent. Or, in other words: for this loss of efficiency in the private sector to be acceptable, an additional NOK 100 in taxes must generate social gains of NOK 150 through their use over public budgets.

By this I do not mean to imply that the welfare obtained through equality, security and more public services and benefits cannot be worth the costs of taxation. It is difficult to measure the economic gains of welfare state services, and there may be some people who, literally, value these benefits more than others. But, irrespective of our personal opinions, it is important to be aware that taxes entail efficiency losses, and thereby a lower average income level in the population at large.

Let me try to provide a concrete example: perhaps the most obvious is the effect of taxing labour.

The differential between the costs of employing someone and the service provider's disposable income after tax represents the total tax wedge on employment. This concept can be illustrated and demystified by means of a familiar figure - the self-employed plumber. For a couple of hours of plumbing services, we would be prepared for a bill of around NOK 700. This amount includes a number of taxes and social security contributions: VAT accounts for NOK 130 and income tax for about NOK 300. After taxes the plumber is left with NOK 270, whereas the user of the service has paid NOK 700. The central government receives the difference of NOK 430, in the form of taxes and social security contributions. So, in this example, the tax wedge accounts for around 60 per cent of the amount paid to the plumber.

Chart 8
Total tax wedge
1991/1992



The tax wedge includes employer and employee social security contributions, personal income taxes and indirect taxes. The rates are calculated for an average wage earner.

Source: OECD Jobs Study

Norway's tax wedge is on a par with that of some European countries with high government debt levels, and higher than the average for OECD countries. It may be argued that a tax wedge of about 60 per cent is an indication of a generally high tax burden throughout Europe. In Norway, we have relatively low tax rates for some sources of taxation. Compared with other European countries, for example, we have almost no property tax. A substantial share of our tax revenues are derived from taxes which either directly or indirectly influence the use of labour.

It goes without saying that the production of services - for which labour costs account for a particularly high share of total costs - would be higher if the tax wedge had been lower. True, not all services are subject to VAT, and the tax system itself provides for a more limited taxation of income from some services, so that the tax wedge may be slightly lower for these services. The tax wedge will nevertheless contribute to reducing private market turnover of typical welfare goods, such as care and household services. If the total costs, inclu-

ding taxes and social security contributions, are too high, most people will either decide to do the work themselves or the work will simply not be done. This results in a less efficient use of time and resources and lower welfare for the individual. This may in turn add to the pressure on the public sector to introduce or expand existing services with public financing arrangements.

What may then be said of the taxation of wealth and capital income?

This type of taxation influences households' and enterprises' choice between saving and consumption in such a way that it reduces the motivation to save. In particular, a high wealth tax can have a negative effect on saving, and thereby result in reduced fixed investment and lower growth in the long run. In addition, state aid to industries, subsidies and other features of the tax system which impair fiscal neutrality influence the ranking of the various investment projects' profitability.

The main principle must be that business enterprises, with Norway as a base and subject to the Norwegian tax regime and legislation, should as far as possible operate under the same formal and effective tax rules. Any departure from this regime, for example through exemption arrangements and special rules serving special interests, will channel capital to investments favouring private economic profitability, but which may be unprofitable for society. This may thus lead to an allocation of our savings to investments which yield a low social return and tie up fixed capital in production that does not benefit society as a whole.

Even though some calculations and estimates have been made of the costs of taxation, it should be pointed out that these estimates are uncertain, particularly as regards the taxation of capital. In this area, however, there is another phenomenon which has become increasingly apparent in the last few years, and which in the long run will impose stricter constraints on the tax level.

Although the authorities can continue to influence the country's total saving, the possibilities for influencing where the saving is allocated will be reduced in a world with free cross-border capital movements. If there are no specific natural advantages, the enterprises' costs, including taxes, will be crucial in determining whether they can compete with enterprises from other countries. The tax level may thus also have an influence on the location of enterprises.

This argument, however, should not be carried too far. There will always be some advantages and preferences in enterprises for maintaining their ties to the home country. It is equally clear, however, that there are limits as to the maximum level of tax revenues that can be generated before having serious consequences for the income base in exposed sectors.

My main point is that a high tax level involves costs for society, which are expressed in the form of lower value added,

a less efficient division of labour and a lower consumption of services. These costs impose limits on both the individual's willingness to pay taxes and on the economy's ability to sustain the tax burden in the long run. Furthermore, higher taxation can result in a lower level of welfare for the individual if the costs of higher taxation exceed the benefits from using these resources over public sector budgets.

Let me summarise before continuing:

In order to safeguard economic growth and government finances in the longer run, it is necessary to set aside a higher share of government revenues as saving than has been the case in recent years. There are also strong arguments for limiting the use of oil revenues domestically if we are to achieve balanced economic growth and an industrial base when oil revenues decline. It is also clear that we can hardly base higher spending growth on a increase in the overall tax level. In the long run this would erode the basis for economic growth. Higher public sector expenditure may also reduce the individual's welfare instead of enhancing it, when it is taken into account that higher expenditure must be financed by higher taxes.

There is thus no basis for increasing public expenditure's share of GDP in the years ahead. On the contrary, it is desirable to reduce spending and increase public saving.

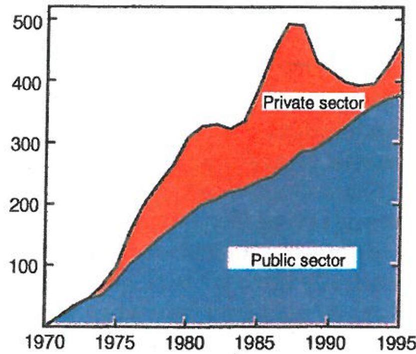
Priorities and choices

Demand for the services and benefits offered by the welfare state will expand rapidly in coming years as a result of both technological and economic developments. Moreover, the political parties have had a pronounced tendency to contribute to raising people's expectations of what can, should and must be covered by the welfare state. This may generate tensions between expectations of services and benefits provided by the welfare state on the one hand and the actual possibilities for providing them on the other. When the welfare state fails to keep its promises, it arouses growing public concern and leads to mounting pressures for greater government involvement.

As I said, the demand for public sector services may also be related to unfavourable conditions in the market for services in an economy with high tax wedges. This may result in lower employment in the private segment of this sector, which in turn may add to the pressure on the public sector to develop arrangements and public services which cover the demand for these services. Strong demand for public services must also be seen in conjunction with the fact that these services are financed through taxes and only to a limited extent by those using the services. In addition, changes in technology, income levels and the population structure have contributed to increasing demand for public services.

The fact that the public sector accounts for most of the employment growth which has taken place in Norway in the last 25 years reflects the strong underlying demand for the services offered by the public sector.

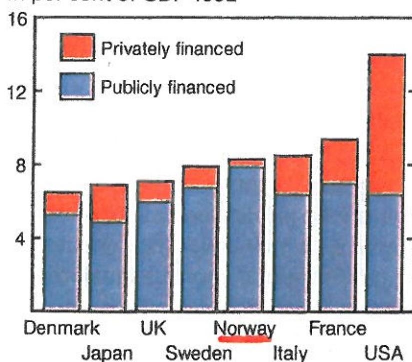
Chart 9
Accumulated growth in employment from 1970
In thousands of persons



Employment in the public sector has increased steadily over the past 25 years. There are currently nearly 400 thousand more people employed by the central and local government than in 1970. Employment in the private sector has varied in relation to the business cycle, and there are currently around 90 thousand more people employed in private industries than in 1970.

Source: Statistics Norway

Chart 10
Health care expenditure
In per cent of GDP 1992



Source: OECD

The trend growth in some major spending items, for which we know that demand will rise sharply, will probably continue in the years ahead. There is reason to believe that, based on the current system, it will be necessary - just to maintain the availability of health services and thus avoid longer queues - to increase this expenditure at least in step with the growth we have witnessed over the past decade. We also know that changes in the age composition of the population will lead to a sharp rise in old-age pensions in the next century.

In view of the existing problems related to establishing our current priorities, it is clear that such substantial growth in some components of the budget will entail increasingly difficult choices. If the ceiling for total expenditure is given as a constant share of total GDP, a steadily declining share of the budget will be available for other purposes. The inevitable implication is that the problems of establishing priorities will be exacerbated in the years ahead unless the welfare state's area of responsibility is more clearly delineated.

By way of conclusion, allow me to look more closely at two of the most important areas, notably health and care services and old-age pensions, and attempt to indicate some of the dilemmas we are facing.

Health and care services: limitations of public responsibility

Adjusted for inflation, health care expenditure has risen by 4 per cent annually since 1980. The rising percentage of elderly in the population will add to the pressures on demand for health and care services in coming years. Advances in the field of medicine have provided new forms of medical treatment, and our life expectancy has increased. This also means that each of us will use a greater number of and more expensive health services throughout our lives.

Norway does not use more resources on health care, measured as a percentage of GDP, than the average of the OECD countries. However, we finance a far greater share over public budgets. As much as 95 per cent of Norway's health care expenditure is financed by the public sector. If services in these sectors are mainly to be produced in the public sector and financed through taxes, we will probably not succeed in satisfying the higher demand, with the result that health queues will increase in the years ahead.

Health queues would be quickly eliminated if health services were offered in a market at non-fictitious prices. Nevertheless, there are a number of reasons why this is not a preferred option. Since health services can be a question of life and death, the willingness to pay will be very high in some cases. This can obviously result in ethical dilemmas because most of us will consider it immoral if such questions were to be decided by our financial situation.

An insurance market would quickly be established to reveal the risk of illnesses which require expensive treatment. The

experience of some countries shows that a private health insurance market does not always function satisfactorily, partly because it is sometimes not even possible for high-risk groups to buy insurance.

In other words, there are many indications that the financing of what we can call «basic» health services must on the whole continue to be a public sector responsibility. I interpret this to mean that a health service primarily financed by the government is one of the pillars of the welfare state.

We should also bear in mind, however, that a universal public health sector, which shall offer services to everyone at prices that do not cover the costs of performing the services, reflects a particularly high level of ambition. If we are to succeed in resolving the conflict between limited financing on the one hand and rising demand for these services on the other, it is necessary to delimit what should be the public sector's responsibility so that the functions allocated to government institutions can actually be executed.

Such a delimitation will probably also be forced upon other public services, including the care sector. This has also been brought up in the White Paper on welfare now being debated in the Storting. For some care services, e.g. home-help arrangements and other more service-oriented activities, one may ask whether there is actually a significant difference between these services and other services which are usually bought by individuals in a market.

It should be possible to deal with those tasks that can no longer be given priority within appropriate budgetary constraints by establishing supplementary services in the private market. It is not my job to offer advice about priorities and choices that must be made in this connection. This difficult task is, and probably has to be, the responsibility of the politicians. In my view, however, there is every indication that the establishment of priorities between publicly-financed and privately-financed services will be unavoidable.

In this connection it is not necessary to take a standpoint on whether public services should be privatised. This is actually a subordinate issue. It is fully possible to finance public service producers through user fees, even in competition with others. This is quite common in many segments of the care services sector. The point must be to provide an efficient production of services within a sound budget.

National Insurance Scheme: Pension scheme without saving

The sharp rise in old-age pensions that is expected in the next decades will be the greatest challenge our welfare system has ever had to address. This is above all due to the ageing of the large cohorts of the post-war generation, but also to the high supplementary pension benefits to which many of them will be entitled.

We also know that the growth in the labour force will slow

after 2010, while oil revenues will decline. The National Insurance Scheme's benefits are not based on accumulated funds but on financing through current tax revenues, the pay-as-you-go system. When the share of elderly in the population increases, with a rise in the ratio of pensioners to workers, the system will lead to an unintentional redistribution of income between generations.

As I demonstrated earlier, saving in this country has been sharply reduced in the last twenty years. This may seem somewhat strange in the light of the steady rise in the government's future pension obligations.

Inasmuch as the government is guarantor for the payments of the National Insurance Scheme, it is only natural that most people do not feel the need to set aside substantial funds for their own retirement. Most people would probably have decided to save much more, either by paying into private pension funds or by accumulating a higher level of wealth if they had not based their choices on the National Insurance Scheme. The establishment of the old-age pension has thus most probably resulted in lower private saving than would have been the case if the pension system had been wholly or partly financed in the private sector.

As the National Insurance Scheme has not used premium payments to build up funds, but has based social security benefits on current tax payments, the introduction of the old-age pension in the National Insurance Scheme has not contributed to increasing public saving either. The result is a fairly paradoxical situation whereby even though everyone recognises that the country must save more in the years ahead, both private and public saving has declined through time.

One way out of this dilemma is setting aside a larger share of the oil revenues, as I have already noted. Our natural resources actually provide us with a unique basis for strengthening our position to meet this challenge. While other countries are grappling with substantial public sector deficits and a heavy government debt burden, we still have the opportunity to build up government assets in order to enable the government to honour its pension obligations.

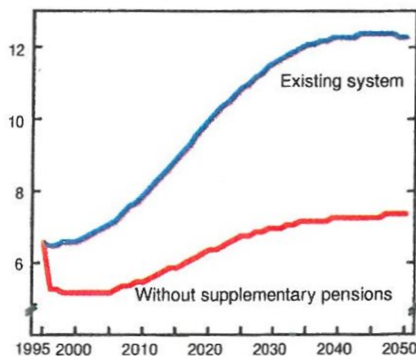
In the light of the pressure that will come to bear on other public expenditure items - not least the expansion of the range of services - a more fundamental question comes to mind, however: Are old-age pensions a more important part of the welfare state than, for example, the development of public health services? Or to take it one step further: Are we certain that today's working population would in fact choose - if they had the choice - to give higher priority to public old-age pensions than a strengthening of health services?

It may also prove difficult to motivate the *next* generation of workers to pay higher taxes in order to maintain a high income level for pensioners who will in any case have a far higher level of wealth and living standards than the working population. There is no particular reason why policy decisions in the future should not take a different course than we now antici-

pate. Future generations may decide that the large elderly segment of the population must resign itself to lower benefits, a higher retirement age and a higher level of taxation of pensioners' incomes. Future wage-earners may not necessarily have the opportunity, or feel the obligation, to provide for the older generation who they might blame - probably with some justification - for having squandered their inheritance.

This leads to the question of whether it is a public sector task to offer insurance to high-income groups in the form of supplementary benefits in the National Insurance Scheme. In many other countries, the government confines its role to providing a basic pension, and it is up to the individual to contribute to any supplementary pensions in the private insurance sector.

Chart 11
Government net pension expenditure
In per cent of GDP



The current system will entail a rise in the National Insurance Scheme's net pension expenditure (pension expenditure less income taxes paid by pensioners) from 6½ per cent of GDP in 1996 to over 12 per cent in 2050. If social security contributions were halved and there were no supplementary pensions, the National Insurance Scheme's net expenditure would be lower and rise more slowly than in the existing system.

Source: Norges Bank, Statistics Norway and the Ministry of Finance

In principle, this is also the system in Norway. It is fully possible to take out supplementary insurance which in practice will yield higher pension income. However, as mentioned, the problem is that such private pension schemes do not attract many subscribers as long as people rely on the compulsory public supplementary pension scheme.

Allow me to illustrate this dilemma further. Let us assume that the public supplementary pension scheme is discontinued. It would then also be reasonable to reduce social security payments commensurate with the reduction in expenditure for supplementary pensions, so that these funds would be made available for individual savings. In our example this would entail close to a 50 per cent reduction in National Insurance contributions.

To all appearances, this measure would solve the National Insurance Scheme's financing problems in the sense that total expenditure for old-age pensions would, in the long run, be equivalent to about the same percentage of GDP as today.

However, we then forget the obligations for supplementary pensions that have already accrued through pension points. It would hardly be considered acceptable to deny pensioners who have earned these points supplementary pensions in the future. There would at least be a need for transitional arrangements for those who are pensioners today.

One option could be that the government pays out the supplementary benefits once and for all, or that these financial resources were placed in a fund to be paid out in accordance with the original system, in other words under current rules. The financial burden would then have to be borne by the current budget, but supplementary entitlements could not be accrued in the future.

The problem is that we are not talking about a negligible sum. Allowing for some uncertainty, the present value of already accrued supplementary pension obligations may be estimated at NOK 450 billion. If the state were to disburse or allocate these resources to a fund today, this fund would thus amount to twice the current level of general government net assets.

Let me emphasise that this is not a proposal, but is an illu-

stration of the enormous sums and tied commitments that are inherent in the obligations of the public pension system. It is thought-provoking to note that if the government's asset position is adjusted solely for supplementary pension obligations as a result of already accrued pension points, the government is in a net debt position equivalent to about 25 per cent of GDP.

No matter what solutions are found to this problem, it is clear that we cannot allow expenditure to increase at the expense of total saving.

As I noted early, it is not my role to indicate the priorities which should be established in order to maintain the welfare state. But it is clear that we cannot simply turn our back to these problems. There is no way to avoid facing the problem of establishing which objectives should be given priority if we are to successfully address the challenges confronting the welfare state.

A policy for stable growth

The White Paper on welfare, which is now being deliberated in the Storting, states that welfare policy "must impose strict requirements as to the efficient use of resources and the prioritisation of tasks. Caution should be exercised with regard to introducing new, costly pension reforms".

This may also be an appropriate conclusion to the issues that I have outlined here: the choices we face in welfare policy imply that it is necessary to reach a better understanding of the main elements of the welfare state and that priorities must be clearly delineated with respect to the government's tasks and responsibilities.

It cannot be emphasised too strongly that the welfare state can only survive in the long run if its economic basis is expanded. Economic policy should therefore, as far as possible, promote stable and sustainable economic growth. Important elements of such a long-term policy are high public saving, sound public finances and a prudent domestic use of the country's oil revenues.

The need for long-term stability also has implications for monetary policy. As mentioned, our own and others' experience illustrates that uncertainty surrounding exchange rates and inflation may lead to considerable fluctuations in the economy and costs in the form of persistently higher real interest rates. Provided that there is general confidence in the economic policy being conducted, monetary and exchange rate policy can best serve the objective of stable economic growth by being geared to low price and wage inflation and a stable currency.

In Norway, the operational objective of monetary policy is to maintain a stable exchange rate against European currencies. By linking the krone's value to countries with low and stable price inflation, monetary and exchange rate policy will in the long run also contribute to low price and wage inflation.

A long-term orientation of monetary policy offers nume-

rous advantages. However, a strong focus on the exchange rate entails problems for an active use of monetary policy for short-term stabilisation objectives, which could prove desirable when Norway is at a stage of the business cycle that is not synchronised with the countries whose currencies are used to define the exchange rate. Norges Bank does try to use the limited leeway that exists, but the exchange rate regulation sets constraints on how actively monetary policy instruments can be used for stabilisation purposes.

When monetary policy is thereby constrained by the concern for exchange rate stability, fiscal policy is the primary instrument for stabilising the economy. As I mentioned earlier, the use of fiscal policy in cyclical management can contribute to strengthening employment also in the long run, given that fiscal policy otherwise abides by the long-term constraints imposed on public spending growth.

This brings us to a core problem. As fiscal policy and public finances are also the basis for financing the welfare state, the long-term objective of maintaining sound government finances implies a large degree of moderation in fiscal policy. As we have seen, large public deficits quickly lead to substantial increases in interest expenditure, which reduce the scope for financing a further expansion of government services and benefits. If this is accompanied by heavy pressure on the welfare schemes in the general direction of higher expenditure, a conflict may easily arise between short-term welfare policy objectives on the one hand and concern for the long-term financial basis for the welfare state on the other.

The problems facing other European countries may serve to illustrate this. Some countries' spending on interest payments and the unemployed are equivalent to more than 10 per cent of GDP, money which in the long run could have been used for other purposes if employment had been higher and the government debt lower.

This is a double-edged sword, where we are balancing on a thin line between different concerns: if stabilisation policy fails, imbalances in government finances quickly arise, making it extraordinarily difficult to maintain the existing welfare arrangements at the current level, and even more difficult to develop and expand these schemes further. The result is just as negative if we are unable to establish priorities and delimit the tasks of the welfare state, as this would lead to a permanent deterioration in public finances. This means that both the welfare state's economic basis and margin of manoeuvre to stabilise the economy would be impaired. The consequence may easily be higher interest expenditure and rising unemployment.

A former minister of finance and central bank governor reportedly said something along the lines of "it is unbelievable how much tax people are willing to pay once they get used to it". In the 1990s the problem appears to be the following: it is unbelievable how much tax future generations will have to pay if we don't get used to establishing priorities.