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Budgeting in Norway

by

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Norway is a prosperous country with a healthy economy and a very high standard of living. Norway provides a truly unique example of long-term budgetary planning through its successful management of oil assets by means of the Government Pension Fund – Global. This article examines the annual budget process which is an important factor in the health of Norway's public finances. The cabinet has a central role in formulating the budget via the annual budget conferences. Parliament has a strong formal position, and the Ministry of Finance has a long tradition of providing objective and unbiased information to Parliament. The article also describes the high degree of managerial flexibility, the system of accountability for results, human resource management, financial management and reporting, the use of performance information, and the role of local and regional governments.

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Executive summary

Norway is a prosperous country with a healthy economy and a very high standard of living. This prosperity has been promoted by the presence of large oil reserves and Norway's very successful management of its oil assets. The budget process plays an important role in promoting healthy public finances. The Norwegian budget process has a number of distinctive features, listed below.

The fiscal rule has extensive political support. The fiscal guidelines imply that petroleum income should be phased into the economy on par with the expected real return of the Government Pension Fund – Global (previously known as the Government Petroleum Fund), estimated at 4%. Over the last four years, due to market forces and a slowdown in the economy, government deficits have exceeded this limit. There is widespread political consensus on this rule, and the government continues to support it. With an improved economy, the expectation is that further deviations from the rule can be avoided.

Norway has successfully managed its oil assets. It has avoided many of the mistakes of other oil-rich nations. Norway provides a truly unique example of long-term budgetary planning. In order to help pay for the costs of ageing, it transfers petroleum revenues to the Government Pension Fund – Global and seeks to anchor the public deficit to the expected real return on the Fund.

The cabinet plays a strong role in the budgetary process with a central role in formulating the budget via the annual budget conferences. Through extensive cabinet meetings, it is able to exert considerable influence on budget execution. The budget is settled by the cabinet in plenary meetings. In comparison with many OECD countries, the formal role of the Minister of Finance is weak. He/she does not negotiate directly with the individual ministers on budget proposals, and there are no spending reviews that allow him/her to propose medium-term policy reforms. The cabinet has more responsibilities and influence in the budget process than in most OECD countries.

Parliament has a strong formal position. The Storting has unlimited power to propose amendments to budgets and may approve them by a simple majority. In practice this power is curbed by party discipline and depends on the type of coalition government (minority or majority). The initial budget proposal of a minority government will always be changed to some extent due to the intervention of Parliament to ensure the passing of the budget proposal.

The Ministry of Finance has a long tradition of providing objective and unbiased information to Parliament. However, there are calls from some members of the opposition for Parliament to receive more independent information. Although Parliament has a wide range of powers, there is concern among some representatives of the opposition that it is too dependent on government information. This could hinder its ability to consider alternative proposals. Statistics Norway might be able to provide unbiased information, but building up the capacity of a research section of parliamentary staff may be a more practical way of balancing government information.

A more meaningful medium-term framework could be helpful. Similar to other OECD countries, Parliament appropriates expenditures for only one year. Although Norway's current system does take into account demographic changes and investment programmes, the figures for additional years are mostly mechanical extrapolations. A more meaningful medium-term framework – one done more on a programmatic basis and less using mechanical extrapolations – might help to control pressure for new mandatory spending programmes and otherwise maintain fiscal discipline. In the government's view this is unnecessary, as the fiscal rule constitutes a meaningful short-term, medium-term and long-term framework for budgeting.

Norway has a decentralised system of public administration in which ministries and agencies have a high degree of managerial flexibility. This removal of detailed input controls should give agencies the freedom to improve efficiency and performance. The control and monitoring of the spending activities of agencies is largely left to individual ministries. The Ministry of Finance has only a few formal controls over spending ministries. Thus, it has limited capacity to provide incentives or to put pressure on spending ministries to improve efficiency, make reforms, or implement government-wide initiatives.

There has been slow progress with a government-wide system of performance measures, especially with respect to developing and using performance information. Although the Ministry of Finance requires all ministries and agencies to set goals and monitor performance, many ministries and agencies seem to only talk about using performance information, without indicating full understanding of its importance and without showing real interest in promoting it. For real progress to take place, a stronger push is needed, either by the Minister of Finance or by Parliament.

There are limitations on the flexibility of local governments. The central government sets many standards for sub-national spending that limit the flexibility of local governments. All local revenues are subject to some form of central control: grants are set by the central government, fees and charges can only cover costs, and local taxes are subject to a maximum rate from which no local government deviates in practice. Sub-national governments frequently turn to the central government and Parliament to ask for additional funding.

1. Background

Norway is a large country with a small population of only 4.6 million inhabitants, who mainly live in the southern part of Norway. On average, there are 14 Norwegians per square kilometre. The distance from the most southern point to the most northern point of the country is comparable to the distance from Oslo to Rome. Norway is a relatively homogeneous society.

Norway became an independent nation in 1905 when it peacefully dissolved the union it had with Sweden. It is a constitutional monarchy and a unitary state. Norway is a member of several international organisations, including NATO. Norway rejected joining the European Union in referenda held in 1972 and in 1994. Since 1994, Norway has been a member of the European Economic Area and as such is included in the common market in the EU.

Norway has a bicameral Parliament elected by a system of proportional representation. There are a large number of political parties. In the 2005 parliamentary election, seven parties were elected to Parliament. The large number of parties makes it more difficult to find stable majorities. Since 1965 Norway has been mostly governed by minority governments. These governments have tended to foster consensus-style politics, and relatively strong party discipline has helped them to be generally stable. The government formed in 2005 is exceptional because it is a majority government made up of a coalition between the Labour Party, the Socialist Left Party and the Centre Party.

1.1. Norwegian economy

Norway is a very prosperous country. In 2004, its GDP per capita was USD 38 765, ranking third among OECD countries after Luxembourg and the United States. This prosperity could be linked to the petroleum reserves found in 1969. Since extraction began in 1971, Norway has grown into one of the world's largest oil producers. Norway has a relatively open economy: exports account for 44% of GDP, imports for 30% of GDP. The main export goods, besides oil and gas, are base metals, machinery, transport equipment, and fish.

Unlike other countries that derive substantial revenues from natural resources, Norway has managed to avoid the so-called Dutch disease: it prevented massive domestic public spending of petroleum revenues, avoiding periods of excess demand in the economy that could have resulted in exchange rate disadvantages and the crowding out of other productive economic sectors. An element in this success has been the establishment of the Petroleum Fund (renamed the Government Pension Fund – Global in 2006), to which the petroleum revenues are transferred. The investments for the fund are made by a separate unit within the Norwegian central bank that invests only outside Norway.

The peak in petroleum production will be reached by about 2010. The estimated depletion of oil fields will take place in ten to twenty years. After that the Norwegian energy resources will mainly consist of gas reserves which, according to estimates, will last well into the end of the 21st century.

Norway has a relatively large public sector: public sector expenditure makes up 41% of GDP (2005), which is in line with the average in OECD countries. Public sector performance is mixed: education results are average, while health care performance is good. According to the United Nations human development index, Norway was the most livable country in 2005. This indicator is based on real income, educational attainment and life expectancy.

2. Budget formulation process

This section examines the budget formulation process in Norway. It includes discussions on the legal framework for the budget process, the fiscal rule, the annual budget process, budget documentation, economic models, and fiscal risks.

2.1. The framework

2.1.1. The legal framework

The legal framework for the budgetary process is based on the budgetary regulations adopted by Parliament. In addition, there are budgetary rules decided by the administration within the legal framework of the budgetary regulations. The budgetary regulations in force today were adopted on 1st January 2006, replacing the regulations dating from 1959. The new regulations define the current one-year budgeting system and require that the budget be presented comprehensively, on a cash and gross terms basis.

Box 1. Investment strategies of the Government Pension Fund – Global

The Pension Fund plays an important role in the Norwegian economy. The Pension Fund Act defines the fund's objective as follows: the Government Pension Fund shall support central government saving to finance the National Insurance Scheme's expenditure on pensions and safeguard long-term interests through the use of the central government's petroleum revenues.

The Ministry of Finance is responsible for the management of the Fund. There has been a broad political consensus on the Fund's investment strategy. This requires the Pension Fund to be managed in a prudent manner with the aim of achieving high return subject to moderate risk. The operational management of the Fund has been given to Norges Bank (the central bank). A unit within the Norges Bank manages the Fund's capital in accordance with provisions laid down by the Ministry of Finance. This separate unit, Norges Bank Investment Management (NBIM), was established in 1998. There is no political involvement in the NBIM. There are institutional barriers that separate the NBIM from the rest of the central bank. The Fund manages around USD 210 billion in assets and employs 130 people in Oslo, London and New York.

The Ministry of Finance's choice of investment strategy is the key driver of the Fund's risk/return profile. The strategy is enshrined in a benchmark portfolio composed of equity and bond indices from the majority of countries in which the Fund is invested. The indices contain representative selections of securities, and movements in the indices reflect to a large extent market development in the countries in question. The regulations governing the management of the Pension Fund state where, and in what types of securities, the Fund can be invested. According to the regulations, 50-70% of the Fund's overall portfolio is to be invested in fixed income securities and 30-50% in equities. Where equities are concerned, 40-60% is to be invested in currencies and markets in Europe, the remainder in other regions. Where fixed income securities are concerned, 45-65% is to be invested in currencies and markets in Europe, 25-45% in the Americas and the Middle East/Africa, and 0-20% in Asia and Oceania.

There are only two limitations in terms of investments. First, certain companies are excluded because it is not considered ethical to invest in them. Second, the maximum share that can be taken in a company was fixed at 3%, although it was increased to 5% beginning in 2006. The Ministry of Finance reports to Parliament on the rates of return on investments of the Pension Fund.

2.1.2. The fiscal rule

The fiscal guidelines imply that petroleum income should be phased into the economy on par with the expected real return of the Government Pension Fund – Global, estimated at 4%. Considerable emphasis is also put on stabilising the economy, which permits the government to use this fiscal rule with some flexibility. In practice this means that there is a medium-term deficit rule, stating that the structural non-oil budget deficit should be kept at 4% of the assets in the Fund at the beginning of the budget year. As such the budget is prevented from being subject to fluctuations connected to short-term oil price changes. Moreover, the use of oil income is measured in terms of the structural non-oil budget deficit to avoid cyclicality.

The aim of this fiscal policy guideline was to provide a plan for the use of oil income in reaction to the rapid accumulation of petroleum revenues in the Fund. A 2001 White Paper prepared by the government showed that, beginning around 2010, the costs of ageing will push up public expenditures, while the petroleum revenues will start to decline. Norway's fiscal policy guidelines thus promote the smoothing of the growth in public expenditures over a long-term time period. Net petroleum revenues and return on investments are transferred to the Fund, but only the non-oil budget deficit is financed from it. The Pension Fund has grown steadily; in 2001 it contained almost NOK 20 billion. In the Revised National Budget 2006, the Pension Fund was estimated to contain NOK 3 000 billion in 2010. The deficit rule enjoys broad political support, although there are pressures to circumvent it.

In reality, the 4% path has never actually been adhered to. From its first year in operation in 2002 the level of spending has been higher than 4% of the capital in the Fund. Rationalisations for the initial deviations included a stock market crash, an economic downturn, and a revision of the national accounts, implying higher structural deficit. After the cyclical downturn in 2001-02 it was decided to use expansionary fiscal policy as a stabilisation tool, and the fiscal policy guidelines allow for this action. However, excess spending was considerably reduced in the 2006 budget. With restrictive use of oil income and a rapid increase in the Fund, the budget deficit is expected to be back on the 4% path in the near future.

The deviations from the fiscal rule do not necessarily indicate its inefficiency, since it is not known what the deficit would have been without the rule. It is important that Norway has a rule guiding the use of oil income. It stabilises market expectations and creates a budgetary framework comparable to other countries.

2.2. Annual budget process

Every new round of budget formulation starts with a circular letter from the Ministry of Finance to the line ministries. This letter is sent in December of year t-2 and aims at preparing for the budget conference that is held in March. In the circular letter the Minister of Finance asks line ministries to make proposals on expenditure projections for the following four years based on unchanged policy, and proposals for new policies. In January, ministries send suggestions to the Ministry of Finance on baseline projections for the next four years, and in February they provide their proposals for new policy initiatives. Although it is not part of the circular letter, in recent years line ministries have also been asked to produce proposals for 4% spending cuts to help the Ministry of Finance with suggested spending cuts for the budget conference.

Box 2. Budget formulation timetable

Fiscal year = calendar year

December in t-2	A circular letter from the Ministry of Finance is sent to line ministries requesting expenditure projections for four years based on unchanged policy (baseline projections) and proposals for new policy initiatives.
January in t-1	Ministry of Finance receives the different ministries' projections of baseline expenditures.
February in t-1	Ministry of Finance receives proposals for new policy initiatives.
March in t-1	The first budget conference decides on ceilings for each ministry and ceilings for new policy initiatives.
August in t-1	The second budget conference decides on new policy initiatives and the final allocation of the ministries' budgets. Tax policy is finalised.
October in t-1	The budget bill is presented to Parliament.

The first budget conference takes place in March of year t-1. This meeting decides on the total spending and revenue limits, the total limit for new policy initiatives, and the expenditure and revenue limits for each ministry. These ministerial limits are decided upon in a two-step process: technical baseline projections and specific spending cuts. The baseline projections of unchanged policy are taken as a starting point. In this projection, demographic changes and other information (such as developments in social security and investment projects) are taken into account. The baseline projections form a technical starting point for political discussions.

To adjust the ministries' budget ceilings to the recommended economic and fiscal policy and to make room for new policy initiatives, the Ministry of Finance proposes spending cuts for each ministry. The cabinet as a whole decides on the spending cuts for each ministry. The spending cuts, together with the baseline projection, form each ministry's budget ceiling. Between the two budget conferences, each ministry can reallocate money within its budget ceiling.

The second budget conference takes place in August of year t-1. At this meeting, new policy initiatives are decided and the final allocation of the ministries' budgets is made. In October, the budget bill is presented to Parliament.

2.2.1. Spending cuts

The Ministry of Finance proposes spending cuts in each ministry's budget for the cabinet. In recent years, in order to help with this exercise, ministries have been asked to present proposals for 4% spending cuts. The ministries usually adhere to the Ministry of Finance's request and provide these proposals. Most of the proposals offered, however, lack political feasibility, making it hard to actually pursue them. Moreover, ministries have an incentive to save feasible spending cuts for August instead of proposing them early in the process. The Ministry of Finance considers the suggested spending cuts from the line ministries and, if necessary, prepares other suggestions to the cabinet.

This type of exercise can help prompt ministries to prioritise within budget frames. However, after a few rounds, line ministries learn how the strategy works, and it becomes increasingly hard for the Ministry of Finance to find realistic spending cuts among the ministries' proposals.

2.2.2. The budget conference

During the budget conference in March, the whole cabinet meets for three consecutive days, usually outside Oslo. Senior civil servants from the Ministry of Finance and the Office of the Prime Minister also attend the conference. This is a closed meeting for ministers in which communications with the outside world are restricted. The Ministry of Finance prepares all the papers for the budget conferences. The line ministries receive the information five days in advance.

Budget negotiations do not take place bilaterally between the Minister of Finance and individual ministers. The main conflict resolution takes place in the cabinet. All decisions are made collectively. No formal voting takes place. In many other OECD countries, the negotiations on the budget as well as conflict resolution are the responsibility of the Minister of Finance. In Norway, the budget conference is an indication of the strong role that the cabinet plays in policy making and in budgetary policy.

Box 3. Decision making dominated by cabinet

The cabinet consists of 19 ministers, including the Prime Minister. There are frequent cabinet meetings every Monday and Thursday for around 3-4 hours. In addition the cabinet meets the King every Friday in a formal meeting (the King in Council). In the cabinet meetings, substantial political discussions take place, and the cabinet decides on all matters on the agenda (typically 10-30 matters in each meeting). Every cabinet proposal must be submitted with a summary of two pages maximum, accompanied by the opinions of the Ministry of Finance and other ministries that are considered to have an interest in the matter. The Prime Minister meets the Minister of Finance just before cabinet meetings in order for them to know their room for maneuver. This collective process of decision making is a means of ensuring that individual ministers feel responsible for the cabinet policies and decisions as a whole.

2.3. Budget documents

The budget documents that are normally submitted to Parliament are the national budget (White Paper), the budget proposal (called the "Yellow Book"), one budget document per ministry (presented as annexes to the Yellow Book), and the proposed tax bills. In the national budget the development of the economy is presented, including projections for the future. The Yellow Book includes the proposals for appropriations as well as a presentation of the main items in the new budget. On tax issues, there is one bill with the required changes in the tax laws and one proposal that addresses other tax issues, such as tax rates.

2.3.1. Multi-year budgeting

Similar to most OECD countries, Parliament appropriates budgets for one year. It is useful for policy makers to have information on multi-year budget consequences which provides insight into risks in the budget. The budget documents contain multi-annual projections for the following three years. Although these projections take into account expected budgetary consequences of demographic changes, investment programmes and new policy initiatives, they are usually based on relatively mechanical extrapolations.

Before a new government takes office, and after having finished the negotiations for forming a government, a political platform containing the main objectives of the new government is made public. In addition, upon taking office, the cabinet makes a declaration to Parliament on the issues that will be addressed in that cabinet period. This declaration is usually not specific on multi-year budgetary commitments, but can contain several explicit proposals with budgetary consequences.

In 2003 a government committee was asked to advise on multi-year budgeting. This committee pointed out that many plans and initiatives have a timeframe longer than four years, but at the same time it mentioned that there is considerable uncertainty connected with the projections when the timeframes are longer. The committee recommended not introducing a general multi-year budgeting system. The conclusions of the government were that the present fiscal policy guidelines form a good foundation for a balanced economic development and that it does not consider multi-year expenditure ceilings an appropriate tool.

2.4. Economic models

Macroeconomic forecasts on the basis of economic models are made three times a year. They feed into the budget process. The model simulations are conducted by the Ministry of Finance, on the basis of information from other ministries and directorates. The model of the Norwegian economy is called MODAG; it contains empirically based behavioral relations within a relatively detailed input-output framework. The overall properties of the model emphasise the importance of demand conditions in the short and medium term as well as the need to maintain profitability in sectors exposed to foreign competition in the longer term.

The model is developed and updated by Statistics Norway. There is no competition in economic modeling as provided by Statistics Norway. There is no debate on the economic model, although a debate could improve the transparency and the quality of the predictions. In the 1990s an investment bank tried to launch an alternative model, but it did not succeed.

However, the central bank, independent research institutes, private organisations and investment banks present independent analyses and forecasts for the economic outlook. In the budget documents to Parliament, central estimates concerning GDP growth, wage increases, prices and unemployment from different national and international institutions are presented along with the assumptions used by the Ministry of Finance. The Ministry of Finance and Statistics Norway also put great emphasis on maintaining comprehensive and accessible documentation in MODAG. This could facilitate an informed debate on the characteristics and the shortcomings of the analytical framework for baseline projections and policy analysis.

Box 4. Statistics Norway

The Research Department in Statistics Norway was founded in 1950. The intellectual basis for its econometric modeling was provided by Ragnar Frisch and Jan Tinbergen. Compared to most other statistical bureaus in the world, Statistics Norway is exceptional since it not only collects data, but also has a large economic research department that runs macro, micro, and tax models. As such, it is comparable to the French statistical bureau and the Dutch central planning bureau.

Statistics Norway is independent from the government. Some of its research is requested by the government, but most of it is done independently. Part of the research of Statistics Norway is funded by the Research Council where Statistics Norway competes with other research institutions for support. Another part is financed through general grants from the budget and from appropriations for research assignments by the Ministry of Finance. Since 1990, Statistics Norway is also obliged to serve political parties in Parliament, who can ask for calculations and model simulations of certain policy proposals.

A new project of Statistics Norway is the collection of performance data for the public sector. For local governments this is in the KOSTRA database. For the central government it is called Statres. Examples of the performance data published include the value added of an individual school and the efficiency of local courts.

Demographic data are important both for the economic models and for projections in the budget. A prognostication group, composed of civil servants from the different ministries concerned, is responsible for making prognoses of social security spending. Prognoses are usually decided upon in consensus and are not subject to political steering. Demographic issues, as well as issues related to managing the petroleum wealth, are also central in analysing long-term developments in government finances.

2.5. Fiscal risks

Several fiscal risks are reported in the budget documents such as public guarantees on loans, public-private partnerships (PPPs), and tax expenditures. Norway budgets for fiscal risks in a transparent manner. As a result, the losses to date from loan guarantees and PPPs have been small. However, recently the borrowing facility of state-owned hospitals and some use of PPPs in the road sector have been sources of concern.

All existing public guarantees on private loans are reported in an appendix to the government's annual financial statement. New guarantees are presented to and passed by the Storting. An overview of new guarantees is presented in the budget documents. In some cases the government has also given loan guarantees to government enterprises. From 1st July 2002, government enterprises with loan guarantees have been charged a fee by the government to compensate for the lower cost of borrowing. No new loan guarantees have been given to government enterprises since 31 December 2002. The government's annual financial statement currently lists 38 guarantees. Several of these refer to certain groups or specific "guarantee institutions". An example is the Norwegian Guarantee Institute for Export Credits, which manages about 400 individual guarantees.

Public loans are not included as expenditures under the fiscal rule. There are no comprehensive estimates of the annual expenditure flows resulting from the contingent liability of these loans. Loss on loans given by Innovation Norway to private companies is funded up front by funds for loan losses. However, estimated losses on loans made through the state banks (such as the State Educational Loan Fund and the State Housing Bank) are covered by appropriations in the budget, and interest subsidies on these loans are also normally reported as expenditures in the budget.

The Norwegian government engages in PPP projects on a trial basis, of limited scope and relatively recent. Three pilot PPP projects have so far been undertaken or planned, all in the transportation sector. The total cost of these three projects is estimated at approximately NOK 4.5-5 billion. There are no formal rules on the use of PPPs. The pilot projects undertaken are based on the principle that the agent (the private sector partner in the PPP) should bear all risks that the agent can influence (construction, financial risks). This implies that the risk undertaken by the Norwegian Public Road Administration is restricted to risks on planning and on traffic congestion.

Tax expenditures are reported to Parliament annually in the national budget. To identify the various tax expenditures, the existing tax system is evaluated against a reference system which is based on the assumption that similar taxpayers, activities, and commodities are taxed under the same principles and rates. Any deviation from this is seen as a tax expenditure.

Tax expenditures are calculated by a revenue loss method which implies that the tax expenditure is estimated as the revenue loss due to the diverging taxation. Tax expenditures are not subject to annual budgetary scrutiny.

2.6. Conclusion

The cabinet plays a central role in formulating the budget via the annual budget conferences. Through extensive cabinet meetings, it is able to exert considerable influence on budget execution. In comparison with many OECD countries, the formal role of the Minister of Finance is weak. He/she does not negotiate directly with individual ministers on budget proposals, and there are no spending reviews that allow him/her to propose medium-term policy reforms. A more meaningful medium-term framework might help to maintain fiscal discipline and prevent cost overruns. The effectiveness of the current system of requiring ministries to produce proposals for 4% spending cuts is questionable.

3. The role of Parliament in the budget process

This section outlines the parliamentary budget process addressing both the formal constitutional powers and the informal practices and operations, which are influenced by the underlying political context.

Norway has a history of minority governments. The proportional representation electoral system leads to a relatively large number of political parties in Parliament – seven after the last parliamentary election in 2005. The members of the Norwegian Parliament (Storting) are elected every four years. Parliament has 169 members. When the Storting first convenes following an election, it elects one-quarter of the representatives (42) to serve as members of the Lagting. The remaining three-quarters (127) become members of the Odelsting.

The Storting is only bicameral concerning matters of law. Since the budget is not formulated as a law in Norway, the budget is dealt with in plenary sessions and decided upon by plenary votes. Required changes in the tax laws are a matter of law and are therefore dealt with as a part of the bicameral system. The bill on changes in the tax law is handled by both chambers and is decided upon in the Lagting.

Most of the issues for the Storting are first prepared by a committee. Each representative in the Storting serves on one of the 13 permanent committees. The committees are the forum in which the real decisions are made on most matters. Parties are usually proportionally represented in the different committees. The committees vary in size, normally between 11 and 20 members.

For each item sent to a committee, the committee elects a spokesman who then assumes responsibility for presenting the matter to the committee, obtaining information and seeing the matter through the procedure in committee until a final recommendation has been adopted. The spokesman also formulates the recommendation in writing. Each committee has a permanent secretariat employed by the Storting to assist representatives in performing the work of the committee. In the course of its proceedings, a committee may invite individuals or representatives from ministries or organisations to hearings for the purpose of obtaining information. The parties will usually look for a compromise that will obtain a majority when the issue is submitted to a vote. For budgetary matters unanimous decisions are rare.

3.1. The parliamentary budget process

Parliament has the final authority in matters concerning state finances. It allocates funds and has the power to order expenditures. The budget proceedings are co-ordinated by the Standing Committee on Finance and Economic Affairs (finance committee). This committee consists of 18 members and is one the most important committees. It is responsible for both the expenditure and the revenue side of the budget, as well as economic and monetary policy.

After gathering extensive information, the finance committee presents its recommendations not later than 20 November, containing 22 spending limits and two revenue limits. Since the budget reform of 1997, Parliament sets these aggregate expenditure ceilings for all the standing committees.

During the annual budget debate, the government's economic policy is discussed and a vote is held on the proposals submitted in the recommendations from the finance committee. The amounts for all the separate spending ceilings are fixed collectively in a single resolution. In the following period, the different sectoral standing committees submit recommendations concerning appropriations within the spending programmes allocated to them.

The sectoral standing committees may only make reallocations within the limits that have been decided. This means that any increases in expenditure must be matched by equivalent decreases in expenditure under the same spending limit. The budget recommendations of the standing committees shall be considered by the Storting by 15 December at the latest.

The amounts for all the separate items within a sectoral spending programme are fixed collectively in a single resolution.

The recommendations of the individual committees are dealt with in plenary sessions. In debates on the individual budget recommendations, strict time limits are observed. The length of the debates varies from four to five hours for the shortest, to nine to ten hours for the longest.

Usually the Storting accepts the government's proposals, making only minor changes. The government's proposal and the Storting's resolution normally differ by less than one per cent. Examples of expenditure programmes that have been increased by Parliament include job training programmes, grants for local governments, and health care spending. The signals given by the Storting by means of its comments and priorities could be considered of greater political significance, since they may influence subsequent budgets. The Storting makes many of its appropriations in the form of block grants or "umbrella appropriations", so that it is up to the government to make the final decisions about how the funds are to be allocated.

Box 5. Parliamentary budget timetable

October	The budget bill is presented to Parliament. It goes first to the Standing Committee on Finance and Economic Affairs.
By 20 November	The finance committee presents recommendations on the 22 spending limits and two revenue limits to the general assembly. The amounts for the separate spending ceilings are fixed collectively in a single resolution.
By 15 December	Budget recommendations of the sectoral standing committees are considered by the general assembly.
1st January	Start of fiscal year.

Parliament enjoys extensive amendment rights. Budget rules can be changed by a normal majority. Parliament has relatively few restrictions on its ability to change the budget. Parliamentary committees do not usually play an independent role in the political process, but are a function of party discipline.

Although the process is meant to provide a structure for new spending proposals, effective consolidation of budgetary proposals does not take place. Many changes in budgets are proposed by Parliament outside the framework of the budget or the revised budget. On average five to ten changes per year are carried through in this way. The *ad hoc* nature of new proposals may be a result of the extensive rights of Parliament. More disciplinary power might result if a qualified majority vote were required for approving budgetary changes outside the framework of the budget and the supplemental budget.

3.2. Resources of Parliament

Parties in Parliament have their own political advisors, and each committee has a permanent secretariat. In addition, Parliament has a research section which was established in 1999 to provide more expert assistance to members. The section takes requests from members, from their political advisors, and from standing committees. Currently the seven researchers employed in the section respond to about 250 to 300 requests for information annually. The responses are only provided to the requestor, although the research section occasionally produces papers that are made generally available.

Having to answer 300 requests with a research staff of seven employees puts limits on the depth and rigor of the analysis that can be made. Although political parties can make use of Statistics Norway as an independent source of information, it is obvious that they cannot be used for all the requests from committees, members, or their staffs.

Other sources of information are available through the hearings that committees organise. The finance committee organises huge open hearings that last for days, in which 80 to 100 sessions are held. Speakers come from lobby groups, non-governmental organisations, and academic institutions. Sessions are clustered according to theme, and speakers are allowed to speak 15 minutes. Parliament and parties in Parliament also organise separate seminars and hearings on topics of interest where they invite external speakers such as non-governmental organisations, researchers and other institutions.

3.3. Conclusion

Parliament has a strong formal position; it has unlimited power to propose amendments to budgets and is able to decide on them with a simple majority. In practice this power is curbed by party discipline and depends on the type of coalition government (minority or majority). The initial budget proposal of a minority government is always changed to some extent to be able to guarantee passage of the budget bill. The Ministry of Finance has a long tradition of providing objective and unbiased information to Parliament. However, some members of the opposition have called for more independent information to be provided to Parliament.

Box 6. National Audit Office

The right of Parliament to elect auditors-general was established in the constitution of 1814. The first election of five auditors-general was in 1816. In 1822 the Audit Ministry was founded. The Office of the Auditor-General was established in 1918 when the five auditors-general and the Audit Ministry became one institution under the Act on the Auditing of Governmental Accounts. The Office of the Auditor-General currently has 500 employees. Audit reports are produced annually. The content is discussed with the responsible ministry before it is approved. Audit reports contain considerations and assessments, but no specific recommendations. Audit reports are sent to Parliament with the comments of the respective responsible minister. The audit reports are examined in Parliament by the Standing Committee on Scrutiny and Constitutional Affairs.

Besides the regular audit reports, performance audits are also carried out, on average eight per year. The topics of the performance audits are usually chosen by the Office of the Auditor-General, rarely by Parliament. The half-yearly reports made by agencies for the ministries are sent to the Office of the Auditor-General. The Auditor-General sends them to Parliament without any comments.

Three years after a report has been made on a certain topic, a follow-up report is made. The Auditor-General does not have the power to impose any sanctions, but new studies are done when things have not improved. In response to a report, Parliament usually asks for improvements, so an agency or a ministry frequently will have serious problems if it does not make efforts to improve matters.

The Norwegian budget process appears to provide systemic incentives to underestimate costs for capital multi-year projects. Project proponents frequently obtain first-year funding – often based on underestimates – with the goal of getting additional funding in subsequent years, since projects are typically not stopped because of cost overruns. Examples of cost overruns include roads, hospitals, restoration of the royal castle and the new Opera house. The Auditor-General has made reports on this, but underestimation of costs is difficult to prove. As a response to such overruns, the Ministry of Finance has initiated a new system for quality assurance for major investment projects. This scheme was introduced in 2000 and extended from 2005.

4. Managerial flexibility and accountability for results

This section reviews the budget implementation and management processes in Norway. It concentrates on examining the degree of flexibility given to agencies in implementing their budgets. The Norwegian system is characterised by a high degree of managerial flexibility and decentralisation to agencies. This is the result of a combination of factors including the institutional arrangement of public administration, the flexibility of appropriations, and the relaxation of input controls and central management rules in the areas of human resource management, procurement, and internal controls.

In a devolved environment, it is important to have an effective system of financial management and control and to hold agencies accountable for results. While Norway has a modern system of financial management, progress has been slow on developing accurate and meaningful performance measures and using them in decision making.

This section addresses five aspects of budget implementation and management: the organisational structure of government, budget appropriations, human resource management, financial management and reporting, and performance budgeting and management.

4.1. Ministries and agencies

4.1.1. Organisational structure

Similar to other Nordic countries, the Norwegian government is organised into ministries and agencies. There are 17 small central ministries mostly responsible for policy making, and a much larger number of agencies (180) that implement policies. Agencies vary widely in size from two employees in the Norwegian Culture Heritage Fund to thousands of employees. Over 97% of government employees work in agencies.

4.1.2. Roles and responsibilities

The 1986 budget reform called for a greater focus on results and efficiency and delegated extensive administrative authority to line ministries and agencies. This delegation took place in a framework in which ministries are accountable to Parliament for all the operations under their remit. Ministries are formally responsible for ensuring that agency operations are in line with decisions by Parliament, that resources are used effectively, and that agencies operate a sound system of internal control.

The central government has endorsed a Government Decree on Financial Management that regulates management of all administrative central government bodies, all activities in the administration, and all grant, contribution and guarantee schemes. The Ministry of Finance has issued Provision on Financial Management in accordance with the government decree. All together these are referred to as the Financial Management Regulations. The Regulations include measures designed to promote good governance and efficient use of government resources. The ministries' management of the agencies (subordinate bodies), internal management in the agencies, and internal control requirements are covered by the Regulations.

Within this general framework, individual line ministries have the flexibility to establish their own approach for overseeing and managing agencies. In practice most agencies have been given a high degree of autonomy in terms of how they run internal operations and implement their programmes and their budgets.

The letter of instruction (letter of allocation) is the main instrument used by ministries to implement the budget. The letter sets out the appropriations for the agency, the overall goals and steering parameters, the power of authority, reporting demands, and information requests on performance and indicators.

These letters will vary from agency to agency. The details of the letters are the result of a dialogue between the ministries and the agencies that takes place at various stages in the budget process, with agencies having considerable input in terms of budget proposals and performance indicators. The ministries reconcile the input from the agencies with their own strategy, and specify targets and requirements in accordance with the discussions and decisions in Parliament.

Ministries decide on the reporting requirements for individual agencies. For example, the Ministry of Justice and the Police requires a half-yearly report from its agencies detailing any difference between objectives in the letter of instruction and the current status. In addition, agencies are required to produce a special annual report and to inform the ministry of any essential derivation from the plans contained in the letter of instruction.

It is the responsibility of the individual line ministers to monitor and control spending at the agency level. The Ministry of Finance gives assistance by providing monthly reports to the line ministers on spending. It is the responsibility of the individual minister to take action to check overspending.

The Norwegian system entails extensive delegation to agencies. Ministries mainly manage agencies through a dialogue and discussion approach. However, due to the high degree of information asymmetry between ministries and agencies, the agencies will tend to have the upper hand in these discussions. Ministries' management and monitoring capacity will vary depending on size, expertise and experience of staff, and the monitoring systems established. This problem is especially acute for performance information.

4.2. Budget appropriations

The budget consists of lines and sub-lines, where the lines refer to specific purposes (*e.g.* health care, police or education) and the sub-lines refer to objects of expenses (operating expenses, investments, transfers and financial transactions). The budget is binding on the line and sub-line levels. Government agencies can have appropriations covering all types of expenses.

Each ministry and each agency receives one appropriation for all of its wages and operating expenditures. There are few restrictions on the choice of inputs. Agencies have considerable flexibility with regard to the appropriations at their disposal. Ministries only tend to highlight the actions and tasks they expect from each appropriation; they do not state in detail how the money should be spent or define salary ceilings or operating expenditures. Agencies have the flexibility to choose the appropriate mix of inputs to fulfil their mission.

4.2.1. Transfers and capacity to carry over funds

Transfers are possible with the permission of the Ministry of Finance; it can empower ministries and agencies to transfer funds from current expenditure appropriations to appropriations for investment purposes under the same chapter, limited to 5% of the appropriation for current expenses. However, the approval of Parliament is required to transfer appropriations between programmes.

It is possible for agencies to carry over funds. They can transfer up to 5% of an appropriation for current expenses to the following budget period. Exceptions above and beyond this are possible; however, they require special approval by Parliament. This is normally done only for appropriations for expenditures in building and capital, and the funds are only available for the next two budget periods only. In addition, this opportunity to carry over funds is accepted for appropriations where the timing of payments is uncertain.

With the permission of the Ministry of Finance, agencies can overrun operating expenses providing they have corresponding additional incomes. They can also exceed expenditure appropriations by up to 5% for investment purposes, subject to corresponding savings in the following three budget periods. This provision has however not been used in practice. There is no further borrowing against future appropriations.

4.3. Human resource management

Over the past ten years, human resource management in Norway has become more decentralised. In 1997, numerical restrictions on the number of permanent staff that ministries and agencies could employ were removed. There is now no maximum numerical ceiling; however, the budget imposes a *de facto* ceiling. Individual ministries and agencies have the flexibility to recruit and hire their own staff and to dismiss non-senior civil servants.

4.3.1. Recruitment

In the Norwegian government, there are only a small number of political appointees. For each ministry there is normally the minister, one or two under-secretaries, and one or two political advisers. Therefore, nearly all officials are members of the Norwegian civil service. The civil service in the ministries is divided into two levels: senior civil servant and civil servant. In total there are 850 senior civil servants and 3 450 civil servants.

Vacancies for both senior civil servants and civil servants are publicly advertised, and all posts are generally filled through a process of open competition. There are no entry exams. The Ministry of Government Administration and Reform sets central standards and guidelines for recruitment; however, all recruitment of civil servants, except for CEOs of agencies, takes place at the level of the individual ministry and agency. The Freedom of Information Act results in an open system in which the names of all the people that have applied for posts are generally available to the public on request.

4.3.2. Employment contracts

Across OECD countries, there is a trend towards employing civil servants on fixed-term contracts and moving away from jobs for life. In the case of Norway, most officials at both levels are permanent staff. Senior civil servants are officially appointed by the King; they are normally permanent employees who can only be dismissed by the King or by a court of justice.

For non-senior civil servants, while they are permanent, they are not guaranteed a job for life in the traditional sense. Ministries and agencies have the ability to dismiss civil servants if the post is abolished, if the work is discontinued, or if the persons are permanently unfit to carry out their duties (*i.e.* no longer have the qualifications that are necessary or prescribed for the post). The required notice period varies with the length of service. In practice, however, it is not common for agencies to dismiss staff, although the flexibility to do so is available should the need arise.

While most civil servants have permanent appointments, agencies and ministries also have the flexibility to make temporary appointments. It is up to the individual ministry to decide whether or not to use fixed-term contracts for its agency chief executives. Most CEOs are on fixed-term contracts.

4.3.3. Pay negotiations

Civil service pay negotiations take place through a process of collective bargaining between the civil service trade unions and the Ministry of Government Administration and Reform, after the cabinet has decided on a total limit for the wage increase. In Norway, trade union membership among civil servants is high: more than 75% of civil servants are members compared with 50% of the general working population.

The process of negotiation results in a basic collective agreement on pay, which is applied to nearly all civil servants including non-union members. Collective bargaining arrangements have traditionally been very centralised, with most negotiations taking place at the central government and union level. In 2002 and 2004 there has been an effort to introduce a degree of decentralisation into the process, with 20% of wages being set at local level.

Performance pay is not very widely used for civil servants in the central government in Norway; when it is used, it is only applied for top-level senior civil servants in managerial positions and for agency chief executives. Within central guidelines laid down by the Ministry of Government Administration and Reform, the approach varies from ministry to ministry. Top-level senior civil servants have individual contracts with their ministry that contain individual performance goals and the percentage of pay linked to performance. For these senior civil servants, up to 30% of their pay can be performance-related. If the ministry wishes to have more than 30% performance pay, it has to seek the permission of the Ministry of Government Administration and Reform. Performance pay is an established part of the pay package for agency chief executives, as well as for senior civil servants in managerial positions.

Individual ministries will set their own criteria for the evaluation of performance. Generally, pay will be linked to how chief executives perform in relation to the agency goals contained in the letter of instruction from the ministry.

In Norway, human resource management is decentralised, with ministries and agencies having the extensive flexibility to recruit, hire and – despite the permanent employment contract – dismiss non-senior staff under predefined conditions. However, with the possible exception of senior civil servants, there is less flexibility with regard to pay. Pay and pay-related issues remain largely centralised in Norway, notwithstanding recent attempts at decentralisation.

4.4. Financial management and reporting

Norway has a modern financial management system and reporting framework. This section examines cash management, the reporting framework, the administration of financial regulations and control, and the debate about introducing accruals.

Norway operates on a cash accounting and budgeting system. The Ministry of Finance is responsible for the cash system and the state accounts. In 2004, the Ministry created the Norwegian Government Agency for Financial Management to take over the tasks related to the state accounts and the governmental consolidated account systems. The agency also administers the Financial Management Regulations and the framework agreements for banking services, and delivers payroll and accounting services to the government administration.

4.4.1. Cash management

Participants in the bank account system include the different government ministries, the central bank (Norges Bank) and two private banks (DnB Nor and Nordea). The Ministry of Finance has agreements with the Norges Bank about the state account systems, and framework agreements for banking services in the commercial and savings banks.

There is a treasury single account structure in the Norges Bank for operating payment services related to state budget revenues and expenditures and state bond finance. All agencies have a number of sub-accounts at the Norges Bank. Payments are made by the responsible agency from its sub-accounts within the appropriation limits and financial limits authorised by the responsible line ministry. Budget credits are released only at a rate required for payment obligations. All liquidity is transferred daily to the Norges Bank and all the government cash reserves are placed here; interest is paid on the government's deposits. The rate is stipulated on the basis of the return on the bank's corresponding assets.

4.4.2. Financial reporting

Each agency accounts for its own transactions and reports electronically each month to the state accounts. All reporting to the state accounts is based on the cash principle. The Norwegian Government Agency for Financial Management provides accounting services for two-thirds of all state agencies and provides payroll administration for about three-quarters of all state agencies. This accounts for about 50% of all state employees (excluding the military).

Every month, the Norwegian Government Agency for Financial Management sends details to the Ministry of Finance on expenditures against each appropriation and produces and submits a monthly report showing the status of each ministry in relation to actual and planned spending. These reports are generally available between three to five weeks after the reported period. It is then the responsibility of the line ministry to analyse the figures and to take any future action that is needed to control the spending of its agencies.

All agencies are required to finalise their accounts by 15 January. Then the relevant line ministry is given one month to submit amendments to the accounts to the Norwegian Government Agency for Financial Management and another half month to confirm the accounts and comment on them to the Auditor-General. The Ministry of Finance is required to present its report on the state accounts to the Storting by 1st May. The Auditor-General reviews the accounts and sends letters to all ministries by July requesting comments on his/her findings. The Auditor-General sends a draft final report to all ministries by September. By November – nearly eleven months after the end of the fiscal year – the final audit report on the annual financial accounts is given to the Storting. In Parliament it is sent to the Standing Committee on Scrutiny and Constitutional Affairs which examines it and formulates a recommendation to Parliament. Parliament does not approve the audit report as such, but can ask the government to look closer into some issues of special concern.

4.4.3. Financial regulations and internal control and audit

The Norwegian Government Agency for Financial Management is responsible for the administration of regulations for financial management in central government. In 2004, revised general government financial regulations were put in place in order to reduce the number and detail of regulations and to move more towards an advisory and guidance role. Line ministries are responsible for ensuring that agencies perform a control of operations; however, agencies have the flexibility to establish their own systems of internal control and auditing. Indeed, many agencies do not have internal audit units, and the revised regulations of 2004 do not mention internal audit. The Norwegian Government Agency for Financial Management advises the central government agencies on internal control and has recently published a guidance document on risk management.

The Ministry of Finance and the Norwegian Government Agency for Financial Management are currently encouraging agencies to strengthen financial management and control, by issuing new sets of documents and recommendations on risk management, efficient management, grant transfers administration, evaluations and socio-economic analysis. Agencies, however, have the flexibility to decide if they wish to follow these recommendations. The Ministry of Finance has limited capacity to put pressure on agencies to implement these reforms.

4.4.4. Cash or accruals

In 2003, an expert committee appointed by the government recommended moving to full accrual accounting and budgeting. The former coalition government expressed strong concerns about moving from cash-based to accrual-based appropriations. In the budget proposal for 2004, the former government stated that appropriations should remain on a cash basis, arguing that this provides Parliament with more precise and unambiguous information and that the fiscal policy role of the budget is better served by cash-based appropriations. Furthermore, the former government argued that a cash system enables better control of entity investments and is more flexible in allowing government entities and organisations to adopt modified solutions. A majority in Parliament supported this view.

Plans for a pilot project to develop and test accrual accounting in the central government based on assessments of cost/benefits throughout the process was described in the budget proposition for 2004, and a majority in Parliament supported these plans. The first step has been to develop standards for accrual accounting and to test them in pilot agencies. In 2005, ten pilot agencies introduced accounting based on the accrual principles. This introduction of accrual accounting is only at the agency level, and all reporting to the state accounts is still in accordance with the cash principle.

This reform aims to provide better cost information and to help establish a baseline for benchmarking costs both between government agencies and between the government and the private sector. The reform also seeks to provide a more complete overview of the assets and liabilities of central government. In 2006, this pilot project will be evaluated and then the government and Parliament will decide on future steps.

Norway has a modern and efficient system of cash management and in-year reporting. There is, however, a significant time lag (eleven months) before the presentation of the final audit report on annual accounts to Parliament. This is not in keeping with the "OECD Best Practices for Budget Transparency" (OECD, 2002) that recommend the presentation of the government's audited annual financial accounts six months following the end of the fiscal year.

4.5. Performance information in the budget process

A common reform approach across OECD countries is to give ministries and agencies increased managerial flexibility in order to improve efficiency and performance and to hold them accountable for results measured in the form of outputs and outcomes. For twenty years, Norway has been applying this approach. Extensive improvements have been made in managerial flexibility. However the government-wide system of performance budgeting and management has developed slowly.

There are many government-wide requirements for the development of performance information. The appropriation regulations require that the budget proposal contain information on planned objectives and achieved results for the previous financial year together with financial information. The Financial Management Regulations require ministries to ensure that agencies report relevant and accurate performance information and that they commission evaluations. Performance information is requested by the different ministries in their letter of instruction to agencies. Agencies produce a special annual report.

Despite these formal requirements and processes, many ministries and agencies have made only limited progress in developing meaningful performance measures and using them in the budget process. There are of course exceptions, and progress does vary with individual ministries and agencies.

This slow progress can be attributed to a number of factors: the weak capacity of ministries in this area, poor quality information, and the lack of incentives or pressure for ministries to actively implement this approach.

It is mostly the agencies that decide on detailed goals, priorities, performance measures and targets. Even if there is interest, ministries in many cases do not have the expertise or knowledge to develop performance measures or even effectively monitor performance. Ministries do not tend to apply any financial rewards or sanctions to agencies that achieve or fail to achieve their goals and targets. In some ministries, failure to achieve a target can promote a discussion between the ministry and the agency, leading to questions about what steps can be taken to improve performance.

Similar to many OECD countries, Norway struggles with problems of defining goals and developing good quality performance measures and data. The character of performance information changes from agency to agency. Some agencies only define a few political goals; others define many goals. The development of output or outcome measurements has been slow, and generally the quality of the data is problematic. Sometimes far too many performance indicators have been developed: the police, for example, use as many as 300 performance indicators.

These problems are compounded by a decentralised system in which there are few incentives and little pressure on ministries to use performance information in the budget process. The Ministry of Finance is not putting pressure on ministries or agencies to actively implement these reforms. There is little systematic evaluation or monitoring by the Ministry of Finance of ministry or agency progress and activities in the area of performance. By 2007, Statistics Norway will develop an Internet-based system for communication of government services, quality, results and resources.

Similar to the majority of OECD legislatures, the Norwegian Parliament has shown only limited interest in performance information. This is despite receiving performance information in the annual budget bills from each ministry. In general, performance information is not used in the annual budget process to any meaningful degree. While there is some use of performance information by individual ministers, it appears sporadic; and they are heavily dependent on agencies for their information, the quality of which is variable. For real progress to take place, a stronger push is needed, either by the Minister of Finance or by Parliament.

4.5.1. Performance formula funding: directly linking performance to results

In some sectors, mainly education and health, funding is directly linked to results. In the area of education, where universities are paid according to the number of students who graduate, expenditures have increased every year after the introduction of performance-linked funding. There has also been some debate about the temptation for universities to let students pass who should have otherwise failed their exams, simply in order to get increased funding.

In the health sector, the performance-based funding has been controversial. In health care, part of the funding is based on Diagnosis Related Grouping (DRG), that is activity-based funding. Since the introduction of this funding system, there have been problems with cost controls, perverse incentives, and cheating.

While this system has resulted in a reduction in waiting lists, health expenditure has risen and a number of regional centres have exceeded spending limits. In one instance the system was manipulated as patients were re-diagnosed into categories that would bring more financial benefits. This incident received huge media coverage. Although no systemic changes have been put through, the media treatment may reduce the most blatant abuses of the system, but it was reported that there are still instances of projects to "improve" the patient categorisation in the system in order to increase income. The Office of the Auditor-General has recently published a critical report showing very poor categorisation of patients in the DRG system.

This system of direct performance funding is generally only suitable for certain functional areas and thus is not widely applied. In particular, care should be taken when adopting this type of performance funding as there can be dangers with perverse incentives and issues about the quality of the service delivered and the performance information itself.

4.6. Conclusion

Norway has a decentralised system of public administration in which ministries and agencies have a high degree of managerial flexibility. Changes over the past ten years in the area of human resource management and control systems have increased that flexibility, although a few areas stay centralised, such as pay negotiations, and certain restrictions remain – for example there is no borrowing against future appropriations.

For the governments of OECD countries, it is important to find an appropriate balance between delegating responsibilities and maintaining adequate systems of accountability and control. If this balance is not maintained, problems can arise with – depending on country context – management failures and financial irregularities, failure to control expenditure, and a lack of information and steering capacity at the centre to introduce change.

In the case of Norway, large-scale financial irregularities have not been an issue. Norway has developed a modern system of financial management and a system of control which permits extensive flexibilities to agencies in developing internal control systems appropriate for their needs.

Cost overruns have occurred occasionally in the past, for example in the Ministry of Defence and with hospital expenditure, especially after introducing activity-based financing. The Auditor-General has pointed out problems with the management of large multi-year capital projects. Generally, however, overspending on current expenditure is fairly rare in Norway.

Individual ministers rather than the Minister of Finance are responsible to cabinet and to Parliament for any spending overruns of their ministry. The fear of censure can act as an incentive for ministers to control spending. The Ministry of Finance has chosen to distance itself from the role of controlling the spending activities of agencies, preferring to leave the control to line ministries. Since there are not many formal controls, the system is predicated on a high degree of trust between the Ministry of Finance and spending ministries and between spending ministries and agencies, reflecting a unique set of contextual factors which appears to work in Norway.

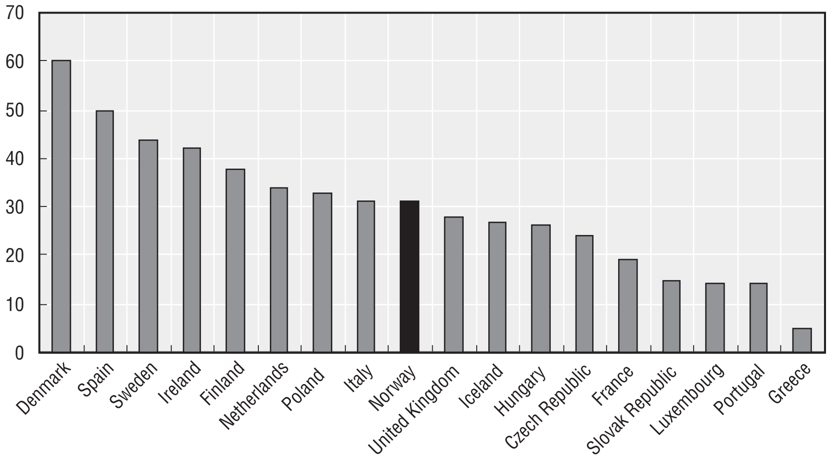
The oversight and steering capacity of the Ministry of Finance over line ministries is limited. While this has not recently posed problems in terms of spending controls, it does raise questions about the capacity to steer government-wide initiatives in relation to policies such as performance or risk management. It also limits the ability of the Ministry of Finance to put pressure on ministries to implement necessary changes.

5. The role of local and regional governments

Norway has three tiers of government: the central government, 19 counties, and 431 municipalities. Both the county level and the municipal level have direct elections with popular representatives responsible to their constituents. The municipal level of government is the more substantive level of sub-national government, both in terms of responsibilities and revenues. The budget of municipalities is more than five times bigger than that of the counties.

Local governments, including both the counties and the municipalities, are well-established institutions in Norway. The rights and responsibilities of local governments were first defined in 1837. Local government revenue amounted to 2% of GDP for most of the 19th century but expanded steadily during the 20th century, especially in the 1930s and the 1970s. Recent years have seen a reversal of that trend. At present, local government revenue accounts for around 13% of GDP. The amount of decentralised spending in Norway is comparable to many other OECD countries, but considerably less than in other Scandinavian countries (see Figure 1). About 20% of the labour force works in the local public sector, mainly teachers and nurses.

Figure 1. Sub-national expenditure as a percentage of total public spending (2003)



Source: OECD National Accounts statistics.

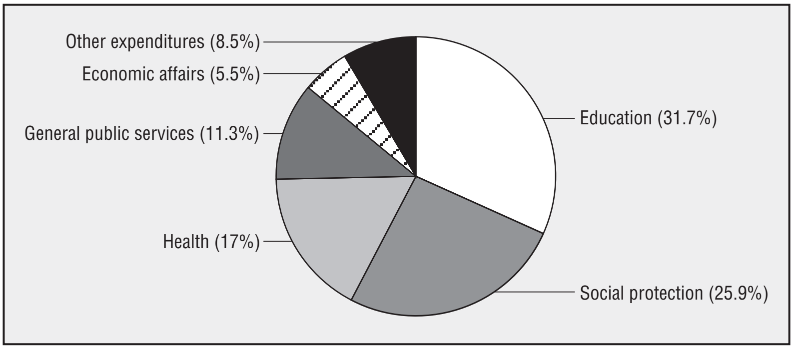
Eight Norwegian municipalities have more than 50 000 inhabitants. Oslo is the biggest municipality with half a million inhabitants. On average, a Norwegian municipality has 10 750 inhabitants. Over half of the Norwegian municipalities have less than 5 000 inhabitants.

5.1. Sub-national expenditure

Local governments play an important role in public service delivery. The counties are responsible for upper secondary education and regional development, including regional transport, business development, dental health service, and culture. Municipalities have responsibilities within the fields of primary and lower secondary education, kindergartens, and care for the elderly and disabled, as well as classic municipal functions such as fire prevention, local transport, waste collection, sanitation and water. More than half of the budget of sub-national governments is spent on education and social protection (see Figure 2).

The majority of sub-national spending relates to programmes for which the central government sets standards or guidelines. Within these fields, it could be argued that local governments act as an agent for central government more than as an independent actor. The mandated welfare services represent 70-80% of the budgets of municipalities and 80-90% of the budgets of the counties, while the rest covers local public goods. According to research carried out by the association of local governments, central government regulation hinders the effectiveness of local governments.

Figure 2. Sub-national expenditures by function (2003)



Source: Statistics Norway.

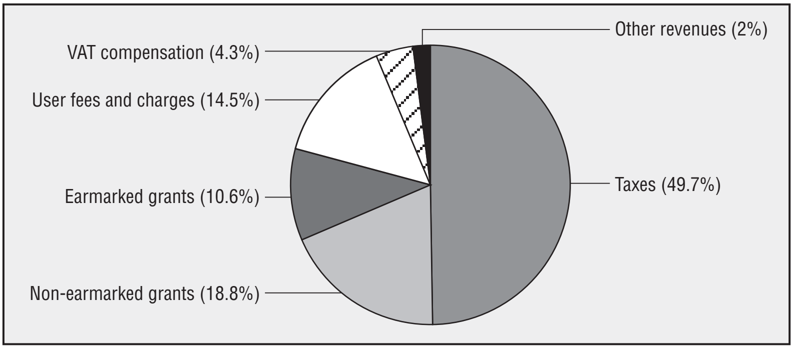
The last decade has seen mixed developments with respect to standardisation by the central government. On the one hand, Parliament has demanded more services from local governments on several issues. Examples are the decision to start education at the age of 6 instead of 7 (in 1997), the increased standards for elderly care, and the ambition to provide kindergarten to all children (in 2004). Furthermore, the central government has transferred the responsibility for hospitals from the county level and given it to five public enterprises (from 2002). On the other hand, there are other examples of increased autonomy for local governments, such as the abolition of regulations on maximum class size and, from 2004, the freedom of local governments to set the wages of their teachers.

5.2. Sub-national revenues

Almost half of the sub-national revenues come from taxes. Other large revenue sources are grants from central government (both earmarked and non-earmarked) and charges and fees (see Figure 3). The most important local tax is the personal income tax: it provides 42% of total municipal revenue. Other local taxes are the property tax and a corporation tax.

Municipalities are free to set their tax rates, but a maximum tax rate is set by Parliament. In practice all municipalities use this maximum rate. One explanation for this might be a fear at the sub-national level that setting a rate below the maximum will invite the central government to cut grants for this municipality. Such a policy has however never been announced by the central government. The central government does give out discretionary grants and can also influence local revenues through matching grants and funds channeled to promote new services. The local income tax can be considered as a tax share where the revenues from the 28% flat-rate tax on personal income are split between the three levels of government. The proposal for 2006 is 13.3% as a maximum tax rate for municipalities, 2.9% for the counties, and 11.8% for the central government. The progressive rate for higher income brackets is reserved to central government. Taxes are collected by the municipalities.

Figure 3. Sub-national revenues by type (2006 budget)



Source: Norwegian Ministry of Finance, 2005.

The property tax is restricted to urban areas and certain facilities, and thus not available to all municipalities. Around 230 of the 431 municipalities collect a property tax. In the revised budget for 2006, the cabinet has proposed changes in the property tax, making it available also for rural areas. If property tax related to electric power production is excluded, about 110 local governments collect property tax, mainly applied to residential property. In practice the number of local governments that collect property tax is quite stable over time and represents historical decisions. The property tax rate is restricted to a narrow band, between 0.2% and 0.7%. Most of the local governments collecting a property tax apply the maximum rate. In the local governments that collect residential property tax, it averages about NOK 1 300 (EUR 160) per standard house per year.

A relatively large part of the local revenues comes from charges and user fees. The most important charges are for utilities, care for the elderly and kindergartens. Charges and fees cannot exceed the production costs of the service. In some cases an additional limit is added by the central government, such as for child care, where the maximum fee is determined at NOK 2 250 per child per month from January 2006. Although user charges are regulated so that they cannot exceed total production costs, the share of costs covered may exceed 100% in a single year, as long as user charges do not exceed total production costs over a period of three to five years. It has been noted that local governments are, to some extent, able to circumvent the national regulation. It is claimed that user charges contribute to cost control in the Norwegian public sector: an increase in user charge financing of ten percentage points is predicted to reduce unit costs by up to 10%.

Most of the grants are distributed as general grants based on objective criteria, but a variety of matching grants and funds for new political initiatives are in place to promote the detailed ambitions of national politicians. The grant reform that took place in 1986 transformed most of the earmarked grants into one non-earmarked grant. The central government aims to minimise the use of earmarked grants.

Part of the sub-national revenues comes from the central government in the form of compensation for VAT that is being paid by sub-national governments for services that could have been provided in-house. The VAT compensation is paid to provide a level playing field to private enterprises for certain services that were formerly done by municipalities. In this way competition by private providers is enhanced.

5.3. Sub-national budget rules

In Norway the main central requirement for the budget of local governments is operational budget balance. Current revenue must be sufficient to cover current expenditures as well as the costs of servicing the local government debt (net interest payments and net instalments on debt). Borrowing can only be used for investment purposes.

The balanced budget rule is imposed *ex ante*, which means that actual deficits can be carried over. A deficit that is carried over has to be "repaid" within two years; that is, the surpluses in the following two years must be sufficient to cover the accrued deficit. Local governments are not subject to specific sanctions if the rule is broken, but budgets and borrowing must be approved by the regional commissioner (*fylkesmannen*), the central government's representative in the county. The regional commissioners will aim to restore economic balance by being reluctant to approve new borrowing. In extreme cases, not observed during the last decades, the central government may take control over local finances.

During the period 1991-99, more than two-thirds of the local governments had a net operating deficit at least one year, and nearly 30% had deficits at least three out of ten years. In two-thirds of the cases, the deficit was turned to a surplus after one year. In 80% of the cases there was a surplus after two years. In the period 1991-97, as much as 25% of the local governments violated the balanced budget rule at least once.

Current expenditures and revenues are only affected by deficit shocks to a small degree. The investment level is the main shock absorber. Overall the Norwegian local public sector has not experienced serious problems of deficits and debts since the Second World War. The application of the deficit rule seems to be efficient in keeping the local deficits under control.

5.4. Equalisation

Differences in both tax capacity and expenditure needs are equalised in Norway. There are differences in tax capacity since the tax bases per capita in municipalities differ. Rich municipalities have a tax base per capita that is two and a half times larger than poor municipalities. Expenditure needs differ because of the demographic composition of a municipality and other elements that determine the need and cost of certain services. Equalisation of expenditure needs is intended to provide the same service level in every municipality. Equalisation is provided regardless of the efficiency of service provision and local choices.

Equalisation of tax capacity takes place via the tax system. These differences are partly equalised. Since 2005, the differences between actual tax revenue in a municipality and average tax revenue for all municipalities are equalised at 55%. That means that a municipality with above-average tax revenue has to give away 55% of the above-average revenue. So a municipality with tax revenues of 130% of the average ends up with 116.5%, since 55% of the surplus of 30% is taken away. In the same vein, the municipalities with tax revenues below the average get 55% of the difference between their revenues and the average level.

The equalisation of expenditure needs takes place via allocation criteria of the general grant. These differences are fully equalised. Allocation criteria are manifold and include the number of elderly people, number of young children, number of inhabitants, and population density. Small and sparsely populated areas receive more expenditure needs equalisation than larger, more centrally-located municipalities.

In addition to the equalisation via tax revenues and general grants, regional disparities are also reduced by two earmarked grants: the grant for remote areas and the grant for northern Norway. These two categories can be but are not necessarily overlapping. A remote municipality is defined as a municipality with less than 3 200 inhabitants and tax revenue less than 110% of the national average. Northern Norway is defined as the three most northern provinces.

The comprehensive grant system has created new inequalities. Since regional policy aspects are built into the criteria, the periphery, and in particular small municipalities, have been overcompensated. The result is a divide where urban areas are relatively rich in private income and poor in public services, while the periphery is relatively poor in private income and rich in public services. Since the equalisation system compensates for the high costs associated with decentralised settlement patterns, it rewards cost-inefficient locations. Moreover, it may not give municipalities enough incentive to improve their tax base (municipalities with tax revenues that exceed the average are allowed to keep only 45% of the above-average revenues). It is assumed that the grant system altogether has lowered the emigration from the North. There is however no evaluation of what would have been the population in the north if there had been no equalisation transfers.

A recent report by a government committee suggests reforms of the equalisation system. It proposes simplification and reduction of the amount and weight of regional policy indicators that are currently used for allocating the general grant.

5.5. Sub-national governments and the budgetary process

In its annual budget, the central government presents in its annual budget the desired growth of total revenue of local governments, taking into account the overall economic situation. This is done by setting the level of the general grant and the maximum rate of the local income tax. The growth rate of tax revenues has not deviated much from grant revenues.

The association of local governments (KS) has the opportunity to influence the government's proposal on local finance in consultative meetings with the government. These meetings started in 2000 and take place four times a year at political level (between cabinet ministers and the central executive committee of KS). The meetings that took place in 2005 discussed the economic situations in municipalities and regions (February), the centrally initiated reforms and changes (April), results and productivity in 2004 (August), and a joint document with the effect of the government budget proposal for municipalities and counties (October). Due to the change of government, there was also a fifth meeting in December 2005. The meetings are not formally binding. KS would like the consultative meetings to develop in the direction of binding negotiations with the government on local government finance, such as those that take place in Denmark.

Local governments used to be subject to detailed reporting requirements on local spending. Currently a more general framework for reporting is used. Indicators on local government expenditure and performance are collected by Statistics Norway in their KOSTRA database. This information is used for both internal planning and external reporting.

5.6. Conclusion

Local government in Norway is characterised by limited autonomy. Most of the expenditure is mandated or subject to central guidelines; most of the revenue sources are determined by the central government. The only revenue sources over which local governments have relative freedom are charges and fees, but they are not allowed to exceed production costs. In addition the property tax has only been levied in some of the municipalities. It is not clear if a trend towards centralisation can be noted, since developments in both centralising and decentralising directions have been taking place.

Limited local autonomy leads to pressure from local governments on central government and Parliament to provide additional funding. Within a context of minority governments, additional funding to local governments has often proved a way of getting the government budget accepted by Parliament. Some argue that limited autonomy thus leads to local expenditure growth that is not efficient. Several OECD countries provide more local autonomy, with the belief that more local autonomy in setting tax rates can bring better incentives for efficiency.

Norway has an ambitious equalisation scheme that benefits remote regions and northern Norway. The scheme provides incentives for living in cost-inefficient locations but might not give municipalities enough incentives to improve their tax base and, thereby, economic growth. The extent to which this has reduced emigration from the North is unclear.

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Table of Contents