



EFTA SURVEILLANCE AUTHORITY

Doc. No. 97-6176-I
Dec. No. 246/97/COL

EFTA SURVEILLANCE AUTHORITY DECISION

OF 19 NOVEMBER 1997

TO OPEN THE FORMAL INVESTIGATION PROCEDURE PROVIDED FOR IN ARTICLE 1(2) OF
PROTOCOL 3 TO THE SURVEILLANCE AND COURT AGREEMENT WITH REGARD TO
STATE AID IN THE FORM OF REGIONALLY DIFFERENTIATED SOCIAL SECURITY TAXATION
(NORWAY) (AID No. 95-010)

THE EFTA SURVEILLANCE AUTHORITY,

Having regard to the Agreement on the European Economic Area¹, in particular to
Articles 61 to 63 and to Protocol 26 of the Agreement,

Having regard to the Agreement between the EFTA States on the establishment of a
Surveillance Authority and a Court of Justice², in particular to Article 24 and Article 1
of Protocol 3 thereof,

WHEREAS:

I. INTRODUCTION

Investigation procedure

Article 1(1) of Protocol 3 to the Surveillance and Court Agreement provides that "*the EFTA Surveillance Authority shall, in co-operation with the EFTA States, keep under constant review all systems of aid existing in those States. It shall propose to the latter any appropriate measures required by the progressive development or by the functioning of the EEA Agreement.*"

Article 1(2) of Protocol 3 to the Surveillance and Court Agreement provides that "*If, after giving notice to the parties concerned to submit their comments, the EFTA Surveillance Authority finds that aid granted by an EFTA State or through EFTA State resources is not compatible with the functioning of the EEA Agreement having regard to Article 61 of the EEA Agreement, or that such aid is being misused, it shall decide that the EFTA State concerned shall abolish or alter such aid within a period of time to be determined by the Authority.*"

¹ Hereinafter referred to as the EEA Agreement.

² Hereinafter referred to as the Surveillance and Court Agreement.

The EFTA Surveillance Authority is obliged to open the procedure provided for in Article 1(2) of Protocol 3 to the Surveillance and Court Agreement whenever it is in any doubt about the compatibility of the aid with the functioning of the EEA Agreement. The procedure is applicable in all types of cases, whether of notified, unnotified or existing aid, although in the latter case it must be preceded by the proposal of "*appropriate measures*".

The decision to open proceedings is without prejudice to the final decision, which may still be to find that the aid is compatible with the functioning of the EEA Agreement. The purpose of proceedings under Article 1(2) of Protocol 3 to the Surveillance and Court Agreement is to ensure a comprehensive examination of the case by giving all parties concerned the right to be heard.

Procedural background

The Authority requested the Norwegian authorities by letters of 16 June 1995 and 30 August 1995, to submit full details on the existing system of social security taxation. The request concerned in particular the system of regionally differentiated social security contributions paid by employers, in order to examine whether this system might constitute State aid in the meaning of Article 61(1) of the EEA Agreement and if so, to what extent any of the derogations according to Article 61(3) might be applicable.

The Norwegian authorities responded to the Authority's requests by letters dated 5 and 19 September 1995. The Authority had several informal and technical meetings with the Norwegian authorities between the Spring of 1995 and March 1997 on the scheme under consideration. The Norwegian authorities submitted, i.a. in relation to the above-mentioned meetings, further information relevant to the Authority's examination.

The Authority informed the Commission's services of its examination, in accordance with Protocol 27 (f) of the EEA Agreement and it received their comments³ to the initial assessment of Authority's Competition and State Aid Directorate.

The Authority concluded in its decision⁴ of 14 May 1997, that the lower tax rates in tax zones 2-5 of the Norwegian system of regionally differentiated social security contributions from employers lead to disbursements of State aid in the meaning of Article 61(1) and it proposed in the same decision, on the basis of Article 1(1) of Protocol 3 to the Surveillance and Court Agreement, a number of conditions as "appropriate measures" for the system of regionally differentiated rates of employers' social security contributions⁵ to be compatible with the EEA Agreement, ref. section III.1. of this decision.

³ Letter from European Commission, Directorate General IV- Competition State Aids of 28 March 1997 (ref. Doc. No. 97-1924 A).

⁴ Dec. No. 145/97/COL

⁵ Hereinafter also referred to as tax rates

The Authority requested the Norwegian Government to signify its agreement to the proposal for appropriate measures, or otherwise submit its observations within two months from the receipt of the decision.

As referred to in section III.2 of this decision, the Norwegian authorities responded that they could not comply with the proposed appropriate measures.

The Authority's assessment of the case at hand is presented in section III of this decision.

II. FACTS

1. **Basic features of the Norwegian national insurance scheme and its financing**

1.1 The Norwegian national insurance scheme ("Folketrygden")

Compulsory insurance applies to all persons residing or working in Norway according to the National Insurance Act of 17 June 1966. Persons covered by the scheme are entitled to a wide range of benefits including i.a. old age pension, benefits for survivors, disability, rehabilitation, medical care and occupational injury, wage compensation in cases of illness and maternity leave, and daily cash payments during unemployment. Total expenditure for the national insurance scheme amounted to NOK 125 billion in 1995.

When the Norwegian national insurance scheme was established, it was financed from four sources of revenue, namely;

- social security contributions from employees,
- social security contributions from employers,
- grants from central government and
- grants from local government.⁶

The national insurance scheme's historical sources of financing have for a number of reasons become grossly insufficient. The estimated total revenue from the specific insurance levies amounted in 1995 to approximately NOK 86 billion. The national insurance scheme has therefore been gradually developed from a more traditional "insurance" scheme, to a fully integrated part of central government finances. There is no earmarking of revenues, and both revenues and expenditure items are fully integrated into the Fiscal Budget.

1.2. Regionally differentiated social security contributions paid by employers

The social security contributions paid by employers are, after VAT, the single most important source of income for the central government. For 1995, the tax revenue stemming from the employers' social security contributions was estimated at approximately NOK 47 billion, which represents 11 per cent of revenue in the Fiscal Budget. The respective social security contribution rates are, together with other taxes

⁶ Abolished from 1992 onwards

and duties, decided annually by the Norwegian Parliament as part of the Fiscal Budget.

The taxes are calculated on the basis of the individual employee's gross salary income. The tax rates vary between 0.0 per cent and 14.1, depending on the tax zone where the employee has his registered permanent residence. The differences in tax rates between the respective tax zones do not, however, in any way impinge on the acquisition of individual rights within the national insurance scheme.

The system of regionally differentiated tax rates was introduced in 1975⁷ for reasons of regional policy. The country was then divided into three tax zones. Three tax rates of respectively 17, 16 and 14 per cent replaced the previous single rate of 16.7 per cent. Several adjustments to the system affecting both the geographical scope and the levels of taxation according to zone, have been introduced over time. Table 1 below shows the tax rates applicable from 1 January 1995 and the share of population according to tax zones. An average tax rate can be calculated to 12.6 per cent.

Table 1 Employers' social security contributions (1995).

Tax zone	Area	Tax rates in %	Share of population ⁸ in % of total
1	Central regions Southern Norway	14.1	73.0
2	Other regions Southern Norway	10.6	14.8
3	Coastal area Mid-Norway	6.4	0.4
4	Northern Norway (except zone 5)	5.1	9.5
5	Finnmark/Northern part of Troms	0.0	2.3

The tax zones were last revised in 1988. Only minor adjustments have been made to the scheme since then.

The main features in the system of differentiated employers' social security contributions are described by the Norwegian authorities as follows:

- The respective contribution rates are related to the registered permanent residence (municipality)⁹ for each employee and not the location of the enterprise.
- The system is automatically applied on the basis of objective criteria and is not limited in time.
- The system is neutral with respect to industry, company size, occupation/economic activity, form of ownership etc.
- The system applies to all employees in both the private and the public sector except for central government which has to pay the maximum rate regardless of the residence of the employee.
- The system applies to foreign employees residing in Norway if they are covered by the national social security system.
- The employers' social security contributions are neutral with respect to the nationality of the employer.

⁷ Bill to the Norwegian Parliament, Ot prp nr 12 1974-75

⁸ By 1 January 1995

⁹As defined in Act No 1 of 16 January 1970 "Lov om folkeregistrering"

2. Tax zones 2-5 - Demographic situation

Tax zones 2-5 account for 27 per cent of the total population. According to section 28.2.3 of the Authority's Procedural and Substantive Rules in the Field of State Aid¹⁰ (State Aid Guidelines), regions corresponding to NUTS III Level regions with a population density below 12.5 inhabitants per square kilometre may qualify for the exemption regarding regional aid laid down in Article 61(3)(c) EEA.

Table 2 below, shows the population density of each county (NUTS III Level regions), and of those parts of each county which are covered by tax zones 2-5. Each of the nine counties listed in the upper part of table 2 has as a whole an average population density of less than 12.5 inhabitants per square kilometre, while those listed in the lower part have an average population density above that threshold. The nine counties listed in the upper part of table 2 cover a wider area in terms of population coverage than tax zones 2-5 and account for 31 per cent of the total Norwegian population.

Table 2 Population density, population and tax zones (1995)

Counties/Nuts III	Whole county		Part covered by tax zones 2-5		Tax zone
	Inhabitants	inh/km ²	Inhabitants	inh/km ²	
Counties with < 12.5 inh/km²					
Finnmark	76'629	1.7	76'629	1.7	zone 5
Troms	150'636	6.0	150'636	6.0	zones 4 and 5
Nordland	241'426	6.6	241'426	6.6	zone 4
Nord-Trøndelag	127'537	6.1	52'621	3.2	zones 1, 2 and 4
Sogn og Fjordane	107'609	6.0	107'609	6.0	zone 2
Aust-Agder	99'615	11.7	14'426	2.3	zones 1 and 2
Telemark	163'141	11.5	46'830	3.9	zones 1 and 2
Oppland	183'301	7.6	73'769	3.6	zones 1 and 2
Hedmark	186'593	7.2	62'198	3.0	zones 1 and 2
Sum:	1'336'487		826'144		
Counties with ≥ 12.5 inh/km²					
Oslo	483'401	1'133.2	0	-	zone 1
Akershus	434'451	94.7	0	-	zone 1
Østfold	239'382	61.6	0	-	zone 1
Vestfold	203'240	95.0	0	-	zone 1
Buskerud	228'498	16.4	24'443	3.0	zones 1 and 2
Vest-Agder	149'500	21.8	5'681	1.9	zones 1 and 2
Rogaland	354'447	41.0	22'332	5.0	zones 1 and 2
Hordaland	422'554	28.1	107'249	9.1	zones 1 and 2
Møre og Romsdal	240'146	16.4	101'087	8.2	zones 1, 2 and 3
Sør-Trøndelag	256'304	14.3	69'750	4.4	zones 1, 2 and 3
Sum	3'011'923		330'542		

¹⁰ Adopted and issued by the Authority on 19 January 1994, ref. OJ No L 231, 3.9.1994. Chapter 28 of the State Aid Guidelines was amended on 20 July 1994, ref. OJ No L 240, 15.9.1994

Total	4'348'41 0		1'156'686		
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Source: Ministry of Local Government and Labour

3. Economic effects of the scheme

3.1 Estimated benefits of lower tax rates in zones 2-5

The Authority has commissioned a study¹¹ on the scheme's economic effects by an independent consultant. The consultant's report describes the estimated benefits derived from the differentiated tax rates by industrial sector, size of firm, tax zone, and region. The estimated benefits are, in this context, defined as the difference between the estimated revenue that would have been obtained if the highest tax rate (of tax zone 1) had been generally applicable¹² and the actual revenue from the employers' social security contributions for enterprises in tax zones 2-5.

Table 3 below, shows the 1994 figures¹³ for the estimated volume and distribution of benefits by tax zone and industrial classification. The total benefits calculated in accordance with the above definition are estimated at NOK 4,473 million. 3,102 million NOK, or close to 70 per cent of the total amount, may be attributed to Northern Norway (tax zones 4-5).

Table 3 Estimated benefits by zone and industrial classification. NOK million (1994)

Industrial classification (ISIC)	Zone 5	Zone 4	Zone 3	Zone 2	Group total	% of total
Primary industry	12.9	48.6	6.2	46.5	114.2	2.6 %
Oil extraction, mining and quarrying	38.1	28.6	0.4	22.6	89.7	2.0 %
Manufacturing	118.9	312.2	12.7	324.1	767.9	17.2 %
Electricity, gas and water supply	20.7	45.3	1.4	37.6	105.0	2.3 %
Construction	47.1	146.2	5.9	99.3	298.5	6.7 %
Wholesale/retail trade, restaurants, hotels	121.6	338.2	5.6	150.7	616.1	13.8 %
Transport, storage and communication	55.6	175.4	6.2	79.1	316.3	7.1 %
Financing, insurance, etc.	39.5	150.3	2.8	64.4	257.0	5.7 %
Other community and personal services	79.2	146.7	5.2	81.1	312.2	7.0 %
Municipalities and counties	312.0	812.9	19.9	374.5	1,519.3	34.0 %
Not stated	16.5	35.6	1.6	23.3	77.0	1.7 %
Group total	862.1	2,240.0	67.9	1,303.2	4,473.2	100 %
% of total	19.3 %	50.1 %	1.5 %	29.1 %	100.0%	

Source: Hervik, "Benefits from reduced pay-roll taxes in Norway"

The consultant's report shows that in 1994 1,519 million NOK, corresponding to about one third of the total benefits, could be attributed to the public sector

¹¹ "Benefits from reduced pay-roll taxes in Norway" by Arild Hervik, Norwegian School of Management, BI (1996)

¹² It is implicitly assumed that neither the wage and activity levels nor the distribution of economic activities according to sector and region are affected by the level of taxation. The assumption implies that the amount of benefits to enterprises in zone 2-5 will tend to be overestimated.

¹³ The general tax level was adjusted marginally downwards, by 0.2 percentage points, in tax zones 1-4 with effect from 1 January 1995. The adjustment implied therefore that i.a. the rate in tax zone 1 was lowered from 14.3 per cent to 14.1 per cent.

(municipalities and counties), while manufacturing industries accounted for some 17 per cent of the total amount.

Approximately 23 per cent of the Norwegian manufacturing industry with a combined turnover of NOK 79 billion in 1994 was located in tax zones 2-5¹⁴. The estimated benefits for manufacturing enterprises in the same area amounted to NOK 767.9 million, corresponding to approximately 1 per cent of their turnover. 16 per cent of that amount, NOK 124.9 million, could be attributed to large firms with more than 250 employees according to the estimates presented by the Authority's consultant.

The Authority's consultant has estimated the benefits for the manufacturing industries, per employee, in 1994, at NOK 7 000 in zone 2, NOK 19 000 in zone 4 and NOK 29 000 in zone 5, respectively.

As explained above, the employers' social security contributions are calculated as a percentage of the gross salary income of each employee. The actual rate applied is dependent on the registered residence of the employee. As most employees have their place of work in the vicinity of where they reside, it is to be expected that the social security contributions from employers in a given tax zone usually relate to employees resident in the same zone. This is confirmed by table 4. The intra-regional observations presented diagonally and in bold in table 4, show that most of the tax revenue may be associated with employees residing in the same tax zone as their place of work. (This may of course not be seen in the case of tax zone 5 where the tax rate is zero and no revenue is collected.)

Table 4 Revenue from employers social security tax by tax zones. NOK Million (1994)

		Employees' zone of residence					Total
		Zone 1	Zone 2	Zone 3	Zone 4	Zone 5	
Location of employers	Zone 1	33916	750	8	73	0	34747
	Zone 2	322	3209	1	4	0	3537
	Zone 3	4	2	47	0	0	53
	Zone 4	71	11	1	1219	0	1302
	Zone 5	14	2	0	5	0	20
	Not stated	666	48	1	17	0	732
	Total	34993	4022	58	1318	0	40391

Source: Hervik, "Benefits from reduced pay-roll taxes in Norway"

3.2. Effects on wage formation

The immediate effect of a reduction in employers' social security contributions will be a reduction in the employers' total wage costs. If such a reduction, on the other hand induces an increase in wages, parts of the benefits will be passed over to the wage earners (carry-over effects). The possible existence of carry-over effects implies that the net benefits to enterprises may be smaller than total benefits associated with the lower tax rates.

¹⁴ Measured in terms of turnover.

The Authority's consultant evaluated whether it may be relevant to take into account possible carry-over effects. The Norwegian authorities have commissioned a separate study¹⁵, on the same subject.

The conclusions of the above studies were in short that:

- No empirical studies provide precise answers to how the wage formation process is influenced by changes in the level of pay-roll taxation. Empirical studies based on national data contain estimates of carry-over effects ranging between 20 per cent and 80 per cent.
- All empirical studies based on national data indicate that reductions in employers' social security contributions lead to reduced wage costs for the enterprises in the short run. A majority of studies indicate that the enterprises' wage related costs are also influenced in the longer run, but to a lesser degree. In other words, a majority of the studies indicate that the economic benefits related to a reduction in pay-roll taxes, in the long run, are to a certain extent passed over to wage earners in the form of higher wages.
- Studies based on regional data indicate that the carry-over effects related to a regional reduction in pay-roll taxes may be more limited compared to a general reduction, implying that a lesser part of the benefits are likely to be passed over to the employees when a reduction in pay-roll taxes is introduced only for certain regions.

4. Additional transport costs

In addition to the low population density as referred to above, there are regional handicaps specific to the Nordic countries, "namely the extra costs to firms occasioned by very long distances and harsh weather conditions¹⁶". Against this background the State Aid Guidelines foresee that operating aid aimed at providing for "partial compensation for the additional cost of transport¹⁷" may be justified in accordance with Article 61(3)(c) if certain conditions laid down in section 28.2.3.2 of the State Aid Guidelines are met.

The Authority's services examined, in co-operation with the Norwegian authorities, the potential for identifying additional costs of transport based on existing statistical data. The Norwegian authorities presented various estimates. Calculations were carried out at an aggregate level of industry and, to various degrees, using average values of i.a. prices and quantities. The different calculations based on existing statistics showed invariably that the sum of additional transport costs estimated for each tax zone exceeded by a good margin the benefits related to the lower tax rates.

Although aggregate figures derived from existing statistics provided useful background information for establishing a general picture of the relative transport cost disadvantages facing enterprises located in tax zones 2-5, the Authority came to the conclusion that more detailed enterprise specific information would be necessary for

¹⁵ "Effects on wages from changes in pay-roll taxes in Norway" by Dr. oecon. Nils Martin Stølen, Statistics Norway

¹⁶ Para 28.2.3.2 (1) of the State Aid Guidelines

¹⁷ Para 28.2.3.2 (2) of the State Aid Guidelines

its assessment. Against this background the Norwegian authorities agreed to commission a special study on the relations between additional transport costs and the lower social security contributions in tax zones 2-5 for individual export and import competing enterprises in the manufacturing and mining industries.

The special study covered a representative sample of enterprises reflecting the existing pattern of industrial activities in the manufacturing industry in tax zones 2-5. Statistics Norway identified the total number of enterprises in mining and manufacturing, classified by Statistics Norway as export or import competing, located in tax zones 2-5 and having more than 50 employees. Some 180 such enterprises were identified. The selection of individual enterprises for further examination, out of the some 180 referred to, was carried out by Statistics Norway and the Institute on Transport Economics (TØI) to attain a representative sample which would reflect the actual pattern of industrial activities in the manufacturing industry in tax zones 2-5. 36 firms were finally selected for examination. For each selected enterprise a detailed examination of the additional transport costs was carried out i.a. based on the accounts of the firm in question. The estimates of additional transport costs were referred to costs related to inward and outward transport of goods within national borders. Additional domestic travel costs for certain categories of personnel were included. Enterprises covered by specific sectoral rules on State aid, e.g. shipbuilding, were not included. Typical Norwegian export products such as metals (including aluminium and ferro-alloys), wood and wooden products, furniture, textiles, plastic products, fabricated metal products and equipment, processed fish products, and mining and quarrying products were covered by the study.

The general findings of the study are illustrated in table 5 below. In aggregate terms, additional transport costs exceeded by far the estimated benefits to the enterprises of lower social security contributions. For each individual firm that was covered by the study, the additional transport costs exceeded the estimated benefit. The estimated benefits of the lower tax rates were calculated according to the method applied by the Authority's consultant, ref. section II.3.1 above. The impact of possible carry-over effects was not taken into account in the calculations.

Table 5 Comparison of additional transport costs and benefits from lower social security contribution rates for selected enterprises. NOK mill. (1995)

Zone ¹⁸	Additional transport costs				Estimated benefits of reduced social security contributions	Ratio between additional transport costs and estimated benefits
	Inward transport of goods	Outward transport of goods	Transport of key personnel	Total transport costs		
2	94	110	27	231	50	4.6
4	41	48	4	93	25	3.7
5	1	49	1	51	17	3.0

Source: TØI and Ministry of Local Government and Labour

¹⁸ There were no observations for zone 3.

III. APPROPRIATE MEASURES

1. The Authority's proposal

Having received the information as referred to above, the Authority assessed the Norwegian scheme of regionally differentiated social security contributions, and came to the conclusion that it represented a form of operating aid that implied allocation of state aid in the meaning of Article 61(1) EEA. It, furthermore, concluded that the scheme in its entirety could not be subject to any of the exemptions provided for by the EEA Agreement.

However, the Authority took note of the fact that benefits of the lower rates applied in tax zones 2-5 accrue not only to employers engaged in activities exposed to international trade and competition. Benefits also accrue to employers in sectors where international trade is not in any discernable way affected, like in many private and public services of a local nature. Aid which does not affect trade between the Contracting Parties falls outside the scope of Article 61 (EEA). The Authority also noted that many service or non-manufacturing sectors are important from an employment point of view and that lower charges in tax zones 2-5 contribute to improving the employment situation in these areas by lowering the costs of labour.

Looking at typical export and import competing enterprises within mining and manufacturing, the Authority recognized that transport costs for such firms within tax zones 2-5 are high compared to enterprises located in tax zone 1. It was in particular noted that in a representative sample of export and import competing firms within tax zones 2-5, the calculated additional transport costs for each individual firm exceeded the estimated benefits received from reduced social security contributions, see Section II.4 above.

According to the State Aid Guidelines, and as mentioned in Section II.4 above, operating aid to compensate for additional costs of transport may be justified on certain conditions. One of the conditions is that enterprises receiving such aid are located in thinly populated areas, i.e. areas with a population density below 12.5 inhabitants per km². Areas within tax zones 2-5 fulfil that criterion, see Table 2 above.

The Authority also considered that other criteria stipulated in Section 28.2.3.2 of the State Aid Guidelines were complied with. Therefore, the Authority considered that a general reduction was not called for in the current level of indirect compensation for additional transport costs for enterprises within mining and manufacturing. Hence, a general reduction in the current regional differentiation of social security contributions was not deemed necessary.

On the other hand, the Authority also pointed out that Section 28.2.3.2 of the State Aid Guidelines explicitly states:

“No aid may be given towards the transport or transmission of the products of enterprises without an alternative location (products of the extractive industries, hydro electric power stations, etc.).”

“Transport aid given to firms in industries which the EFTA Surveillance Authority considers sensitive sectors (motor vehicles, textiles, synthetic fibres, ECSC products and non-ECSC steel) are subject to the sectoral rules for the industry concerned ...”

According to the view of the Authority these provisions would call for amendments in the current scheme for employers’ social security contributions, most notably that firms in certain sectors of the economy would have to be subject to the tax rate applied in zone 1, irrespective of the location of the enterprise or more precisely, the residence of their employees.

Finally, the Authority found that for some service sectors exposed to international competition, the benefits of lower social security charges in tax zones 2-5 could not be justified. This related to financial services, telecommunications and parts of the transport sector.

With reference to the facts and assessments presented above, the Authority proposed in its decision of 14 May 1997 the following appropriate measures to Norway:

- i) The Norwegian Government must submit a detailed proposal for a general map of assisted areas by 15 October 1997. The proposal must indicate the areas to be designated for regional transport aid and regional investment aid, respectively.*
- ii) As concerns economic activities not referred to in point iii) below, the Norwegian Government shall take the necessary measures to ensure that the application of the system of lower social security contribution rates, such as the one presently applied in tax zones 2-5, is confined to an area that is authorized for regional transport aid.*
- iii) The Norwegian Government shall, in addition, take the necessary steps to effect adjustment of the relevant provisions of the tax legislation on the employers’ social security contributions in such a manner as to :*
 - a) Ensure that the following activities are subject to the tax rate applied in tax zone 1 for all employees:*
 - Production and distribution of electricity (NACE 40.1)*
 - Extraction of crude petroleum and gas (NACE 11.10)*
 - Service activities incidental to oil and gas extraction excluding surveying (NACE 11.20)*
 - mining of metal ores (NACE 13),*
 - activities related to the extraction of the industrial minerals nefeline syenite (HS 2529.3000) and olivine (HS 2517.49100)*
 - b) Ensure that enterprises with more than 50 employees engaged in freight transport by road (NACE 60.24) are subject to the tax rate applied in tax zone 1 for all employees.*
 - c) Ensure that enterprises in the telecommunications (NACE 64.20) sector are subject to the tax rate applied in tax zone 1 for all employees.*

- d) *Ensure that enterprises having branch offices established abroad or otherwise being engaged in cross-border activities in the following sectors, with the exception of branch offices only providing local services, are subject to the tax rate applied in tax zone 1 for all employees:*
- *Financial intermediation (NACE 65),*
 - *Insurance and pension funding (NACE 66) and*
 - *Services auxiliary to financial intermediation (NACE 67)*
- e) *Ensure that the discipline on aid to industries covered by specific sectoral rules is respected by*
- *applying the tax rate in zone 1 to all employees of producers of ECSC steel,*
 - *applying the tax rate of zone 1 to all employees of enterprises covered by the act referred to in point 1b of Annex XV to the EEA Agreement (Council Directive 90/684/EEC on aid to shipbuilding) and*
 - *implementing, in the present context, the special notification requirements in the specific rules on State aid to the motor vehicle industry, the synthetic fibres industry and the non-ECSC steel industry by notifying the Authority of all existing and future recipients benefiting from lower social security contribution rates.*
- (iv) *Detailed annual reports must be submitted on the system of regionally differentiated rates of employers' social security contributions in accordance with the format indicated in Annex III of the State Aid Guidelines. The annual reports must show the operation of an aid-per-kilometre ratio or of an aid-per-kilometre and an aid-per-unit-weight ratio. The reports must contain as separate items, the estimated amounts of indirect compensation for additional transport costs in the form of lower social security contributions foreseen and of any direct transport aid received by enterprises in the sectors covered by special notification requirements (motor vehicle industry, synthetic fibres industry and non-ECSC steel industry). The annual reports must, as foreseen in Chapter 32 of the State Aid Guidelines, cover two financial years and be submitted to the Authority not later than six months after the end of the financial year, starting with the annual report for 1997.*
- (v) *The system of lower social security contributions must be re-examined periodically. The review periods should normally not exceed four years and be carried out in connection with the general reviews of the maps of areas eligible for regional investment aid and regional transport aid.*

2. The response from the Norwegian Government

The Norwegian Government replied in response to the Authority's proposal for appropriate measures that it "*disagrees with the legal interpretation put forward by [the Authority] in its decision of 14 May 1997 and thus cannot accept and comply with the proposed appropriate measures.*¹⁹"

¹⁹ Letter from the Ministry of Finance dated 11 July 1997 received by the Authority on 24 July 1997 (ref. 97-5170 A)

The Norwegian Government expressed that the social security contribution scheme for employers is an integral part of the overall taxation system in Norway. In its response the Government raised the question whether the differentiated social security contribution scheme is a general tax measure or State aid and held forth in this connection i.a.:

“The differentiated employers’ social security tax is an integral part of the Norwegian taxation system, safeguarding both fiscal considerations and considerations of income equalization. In the present case, these considerations are not in conflict with the State aid provision in Article 61(1) of the EEA Agreement.”

The main features of the Norwegian differentiated employers’ social security tax scheme are in keeping with those of a general tax system. The scheme is applied automatically on the basis of precise and objective eligibility criteria. No undertakings are excluded from the scheme. Thus, there is no discrimination which would bring it into conflict with the State aid provisions of the EEA Agreement.”

The Norwegian Government moreover, stated that:

“The differentiating element in the scheme is that undertakings pay different rates of tax depending on where their employees live. This gives employees from low-rate zones an advantage in the labour market and, in combination with the income tax and transfers system in general, contributes to keep up employment in the districts and to promote income equalization among the population. The Norwegian Government holds the view that when a taxation measure has general features and effects of this kind, it cannot be regarded as State aid within the meaning of the EEA Agreement. The scheme promotes income equalization among the population in the same way as other personal tax measures, by strengthening employment in parts of the country having a weak economic basis.

The advantages of a low social security tax rate may in principle be reaped by any undertaking in whatever part of the country it may be located and irrespective of the type of goods it produces. The criteria for the application of the differentiated rates are determined objectively, and are not a matter of discretion. There is no discrimination of employers. Thus a geographical differentiation of taxation rates of this kind cannot be seen as favouring “certain undertakings or the production of certain goods”, cf. Article 61(1) of the EEA Agreement.”

The opinion of the Norwegian Government, as expressed in its concluding remarks, is “that the regionally differentiated social security tax system does not fall within the scope of Article 61(1) of the EEA Agreement”. The Norwegian Government did not address the question of possible exemptions in case the scheme should be considered as State aid within the meaning of Article 61(1) EEA.

IV. ASSESSMENT

1. Applicability of Article 61(1)

The Authority's assessment of the applicability of Article 61(1) EEA is based on the considerations presented below.

Article 61(1) of the EEA Agreement provides that

"Save as otherwise provided in this Agreement, any aid granted by EC Member States, EFTA States or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Contracting Parties, be incompatible with the functioning of this Agreement."

The measure under consideration is the system of lower social security contributions paid by employers in tax zones 2-5 resulting from the differentiation of the rates applied in calculating the contributions. The employers' social security contributions are compulsory payments from employers to the State.

One effect of the system of the lower tax rates in tax zones 2-5 is that certain enterprises, capable of benefiting from the lower tax rates in tax zones 2-5, are relieved from a tax burden compared to enterprises not capable of doing so. The benefits resulting from a relief in tax burden will depend on the number of employees, their salaries and in particular their residence, as this latter factor determines an enterprise's capability of taking advantage of the lower tax rates in zones 2-5.

The provision that the lower tax rates depend on the registered residence of the employee and not technically on the location of the enterprise, must be examined according to its effects. The Authority has found, with reference to the size, topographical and geographical circumstances of the area covered by tax zones 2-5, that there is a high level of correlation between the zone of location of an enterprise and the zone of permanent residence of its work force, ref. table 4 above.

Therefore, the effect of the scheme is to favour specific enterprises, namely enterprises which are situated so that, as a rule, a significant part of their workforce has a permanent residence in municipalities covered by tax zones 2-5. The enterprises which are capable of benefiting from the lower tax rates are typically enterprises located in municipalities covered by tax zones 2-5, while enterprises located in tax zone 1 are, normally, not capable of doing so or only to a very limited extent, ref. table 4 above.

The enterprises benefiting from the lower social security contribution rates, experience a competitive advantage by being relieved from part of their tax burden through State measures which directly contribute to a reduction in their wage and production costs. As the relief in the tax burden benefiting certain enterprises is established through State legislation, such aid is granted through State resources within the meaning of Article 61 of the EEA Agreement.

Article 61(1) prohibits measures which favour certain enterprises or the production of certain goods. The main criterion for distinguishing a measure constituting State aid for the purpose of Article 61(1) from a general economic measure not covered by the prohibition is, in other words, whether or not the measure is selective in nature. The Authority considers that the selectivity criterion is fulfilled i.a. when the effect of a measure is to favour enterprises located in certain regions as opposed to enterprises in other regions which are not capable of benefiting from the measure.

As referred to in section III.2 above, the Norwegian Government put forward that the objectives of the scheme (i.a. promotion of regional employment, income equalization, fiscal considerations) imply that it should not be considered as State aid within the meaning of the EEA Agreement. In this context the Authority considers it to be of relevance to refer to the European Court of Justice's ruling in the Family Allowance case²⁰:

“The aim of Article 92 is to prevent trade between the Member States from being affected by benefits granted by public authorities which in various forms, distort or threaten to distort competition by favouring certain undertakings or the production of certain goods.

Accordingly, Article 92 does not distinguish between the measures of State intervention concerned with reference to their causes or aims but defines them in relation to their effects.

Consequently the alleged fiscal nature or social aim of the measure in issue cannot suffice to shield it from the application of Article 92”

A measure, such as the one under consideration which favours enterprises located in certain regions, must be regarded as constituting State aid unless the lower rates are justified by the nature and general scheme of the system²¹. That might have been considered to be the case if, for example, the lower tax rates were linked to the rights accrued. The Norwegian authorities have not supplied any evidence indicating that the lower tax rates under consideration are linked to other properties of the tax system or the social security system to which they belong. In fact, the Authority has observed that the lower rates do not impinge on the rights acquired under the National insurance system.

It could be argued that reduced social security contributions may have an effect on the wage formation process as referred to in point II.3.2 of this decision and that the enterprises are not receiving the full benefits of the measures under consideration. On this point the Authority notes that the reduced rates obviously constitute a benefit. The studies referred to in point II.3.2. of this decision confirm that this benefit results in reduced wage costs. This being so, the observation that, over time, the benefits may to some extent be shared with employees, does not alter the fact that the enterprises

²⁰ Ref. para 13, Judgement of the Court of 2 July 1974, *Italy v Commission* Case 173/73 [1974-5] ECR 631 - 892 at pages 718-719

²¹ See paragraph 15, Judgement of the Court of 2 July 1974, *Italy v Commission* Case 173/73 [1974-5] ECR 631 - 892 at page 719

enjoying these benefits are in effect given a competitive advantage as compared to those being subject to paying social security contributions according to the highest rate.

The lower tax rates in zones 2-5 apply to all undertakings employing persons residing in these zones. Therefore they apply to all undertakings engaged in export and import competing activities which make use of such labour, consequently affecting trade between the Contracting Parties to the EEA Agreement. This observation may be illustrated by the fact that undertakings which are clearly in competition with undertakings in other EEA States, e.g. producers of aluminium, ferro-alloys, steel and shipyards, to mention some, located in or close to tax zone 2-5, currently benefit from lower labour costs due to the lower tax rates in zones 2-5. The relevant test concerning effects on trade is therefore satisfied²². The fact that the lower rates also apply to economic activities sheltered from international competition does not eliminate this effect. Furthermore, the Authority has not raised any objections to the fact that the lower rates also apply to such activities.

Against the points discussed above, the Authority must conclude that the lower tax rates in tax zones 2-5 of the Norwegian system of regionally differentiated social security contributions from employers constitute State aid in the meaning of Article 61(1) of the EEA Agreement.

2. Articles 61(2) and 61(3)

Concerning possibilities for exemptions according to Articles 61(2) or 61(3) EEA, the Authority has not found reason to alter the view it took when it proposed appropriate measures to Norway by its decision of 14 May 1997, ref. section III.1. above.

Accordingly, benefits to compensate for additional transport costs in sparsely populated areas could be justified under Article 61(3)(c), for a wide number of economic activities. However, for certain sectors of the economy, as specified in the Authority's decision on appropriate measures, it is the Authority's view that there is no room for granting exemptions under Articles 61(2) or 61(3). Consequently, enterprises in these sectors would have to be subject to the tax rate in zone 1 irrespective of the residence of their employees.

Conclusion

Without prejudice to its final view, the Authority maintains that the system of regional differentiation of employers' social security contributions in Norway should be regarded as State aid within the ambit of Article 61(1) of the EEA Agreement. Furthermore, the Authority does not consider that the system as such, without any modifications, merits exemptions according to Articles 61(2) or 61(3) of the EEA Agreement.

²² Ref. para 19, Judgement of the Court of 2 July 1974, *Italy v Commission* Case 173/73 [1974-5]

HAS ADOPTED THIS DECISION:

1. The procedure provided for in Article 1 (2) of Protocol 3 to the Surveillance and Court Agreement is opened with regard to Norway's system of regionally differentiated social security taxation.
2. The Norwegian Government shall be informed by means of a letter containing a copy of this decision, whereby it is invited to submit its comments and any other information relevant to the assessment of this case within a period of one month from the receipt of the letter.
3. The EC Commission shall be informed, in accordance with Protocol 27(d), by a copy of this decision.
4. Other EFTA States, EC Member States, and interested parties shall be informed by the publishing of the attached notice in the EEA Section of the Official Journal of the European Communities and the EEA Supplement thereto, inviting them to submit comments within one month from the date of the publication.
5. This decision is authentic in the English language.

Done at Brussels, 19 November 1997

For the EFTA Surveillance Authority

Knut Almestad
President

Hannes Hafstein
College Member