

Report by the Minister of Finance to the 137th session of the Althingi

Measures to achieve a balance in fiscal finances 2009–2013 Stability, welfare and work

Revised July 2009

Introduction

With the collapse of the financial system last October, the foundations of the Icelandic economy were radically altered. Fiscal finances were imperiled and the finances of many businesses and households threatened. The collapse has caused the revenue of the Treasury to shrink, expenditure to increase, and the Treasury is currently run with a record deficit. Treasury debt will sharply increase and continue increasing for the next two years. This situation must inevitably be responded to with radical measures, placing limits on further indebtedness in order to restore a balance to Treasury finances within acceptable time limits.

In this report, the goals of the Government in fiscal finances for the next several years are summarised. These goals are in line with and are based on the economic program agreed to with the International Monetary Fund. Their aim is to restore fiscal finances and the economy as a whole and thereby create new foundations for the economy. The intention is to halt the debt accumulation of the Treasury and create a Treasury surplus by the year 2013.

The main goal of fiscal finances in these circumstances is a) to achieve a primary surplus by 2011, b) a total surplus by 2013 and c) that Treasury debt will be no more than 60 per cent of GDP in the long run.

On the basis of these principles, the Government has drawn up a plan for a balance in fiscal finances that charts its course in Treasury revenue procurement for the next several years and places a limit on its expenditure. In order to reach these targets, the Treasury primary balance is expected to be:

-7.7	per cent of GDP in 2009
-1.3	per cent of GDP in 2010
3.4	per cent of GDP in 2011
6.5	per cent of GDP in 2012
8.6	per cent of GDP in 2013

In these economic circumstances, it is evident that every effort must be made to resurrect the economy. It would be desirable that the goals of the recovery plan would enjoy a wide consensus, including the means that will have to be used to attain these goals. An emphasis will be placed on the following:

- **Cooperation with the labour market partners.** The authorities will endeavour to reach a far-reaching consensus regarding the goals of its plan in order to ensure its success. For this purpose, it seeks the cooperation of employers and unions. Discussions have been held regarding measures that can help attain stability and these discussions will continue.
- **Working with local governments.** Close cooperation between the central government and local governments plays an important role in the effort to reach economic stability. The plan is based on the premise that public finances be viewed as a whole. Local

governments must therefore contribute their share in order to attain the objectives of the plan.

- **Working with other interest groups.** The authorities will place emphasis on consulting and working with other interest groups, such as senior citizens, disabled persons, farmers etc. for the purpose of hearing their points of emphasis, before decisions are taken regarding their interests.
- **The economy and creating jobs.** The authorities will endeavour to create necessary conditions for the economy to protect and strengthen economic activity in the country. This will be done both with general and specific measures. The recapitalisation of the banks is about to be completed, making it possible for them to conduct normal business again and support households and businesses. In a few days, discussions will begin on the participation of pension funds in the financing of various investments in order to bring investment back to an acceptable level.

The authorities will make every effort to ensure that its measures of restraint, including cuts in public expenditure, will affect households and welfare services as little as possible, especially social services and health, and ensure the basic social welfare of all. They will also seek to protect basic public services, such as schools. In order to make this possible, it will be necessary to use public funds for its tasks and services in the most efficient manner possible. It is therefore inevitable that the arrangements and priorities in public operations will be carefully reviewed. All opportunities for rationalisation in government operations must be carefully considered.

Along with the above points of emphasis, the authorities intend to strengthen the frame of fiscal finances. In order to achieve results in the present pressing circumstances, fiscal policy must be pursued with great perseverance. This will have to be achieved with the following measures:

- **Improved fiscal budgeting.** Improvements will have to be made in the formulation of all expenditure goals and fiscal budgeting. Plans must be made for more than one year at a time. A four-year frame budget will be drawn up over the next several months, where the ground is laid for a revenue and expenditure policy in line with the program being introduced here.
- **Fiscal budget discipline will be strengthened.** In order to attain the objectives of the plan, it must be ensured that the expenditure limits under the plan, as expressed in the fiscal budget of future years, be respected. Restraint and savings in central government operations must be exercised everywhere. In order to attain these objectives, the authorities will increase the responsibility of ministries and agencies and increase the overall monitoring with current operations. The Althingi is also working on an effort to strengthen its role as an overseer of budget implementation.

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Determined measures to ensure a fiscal balance is one of the main prerequisites for regaining stability in the Icelandic economy. At the same time, a sound environment would be created for businesses and households to recover from the present difficulties, thus bringing the entire society back towards recovery and into a new phase of progress.

I. Economic developments and Treasury finances

The Ministry's economic forecast, published on May 12th, expects a major contraction in domestic demand this year followed by a slow recovery in 2010 and some economic growth in the years 2011–2013. The economy should gradually move towards a better equilibrium, low inflation, declining current account deficits and an improving employment outlook.

Table 1: Economic forecast 2009–2013 (this table will be revised)

	2009	2010	2011	2012	2013
Private consumption	-24.7	-2.6	4.1	3.8	4.0
Investment	-36.3	11.6	17.8	5.3	-5.6
Gross domestic product	-10.6	0.2	4.4	3.1	2.2
Current account in p.c. of GDP	-2.3	0.4	-0.3	-0.9	0.4
Consumer price index	10.2	1.5	1.7	2.1	2.1
Unemployment in p.c. of labour force	9.0	9.6	8.0	6.1	4.7

The bank collapse and the following downturn in the economy had a very substantial impact on Treasury finances. The Treasury had for a number of years been run with a sizeable surplus that overnight changed to a deficit estimated at 170 billion krónur or more than 10 per cent of GDP. Net Treasury debt was amongst the lowest known in Europe. This changed virtually overnight; the 2009 Treasury deficit is estimated at 170 billion krónur on a national accounts basis, equivalent to 12.2 per cent of GDP. The change is attributable both to increased expenditure and to the fact that the Treasury's revenue sources were unstable and declined with the downturn in the economy. In addition to increases in expenditure associated with the collapse, interest payments increased sharply on account of debt taken over by the Treasury. The main debt takeovers came from losses of the Central Bank on loans extended to the banking system that had to be written off when the banks collapsed as well as debt that was created for the refinancing of the banking system. The following table shows the development of Treasury expenditure from 2004 to the 2009 estimate in per cent of GDP each year.¹

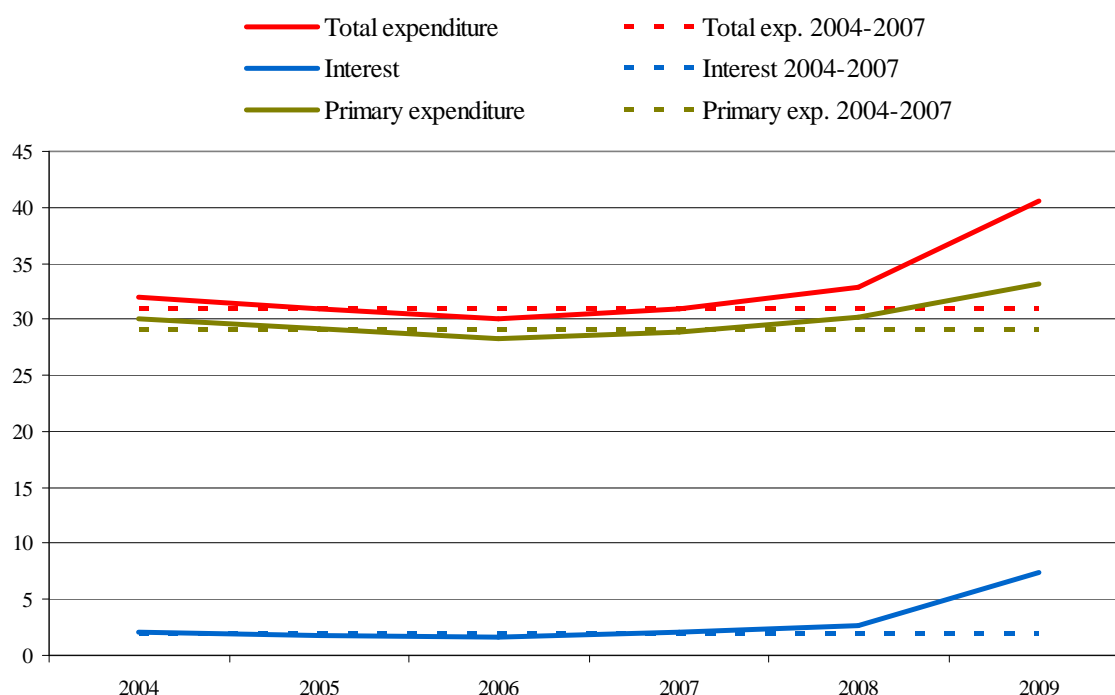
Table 2: Treasury expenditure 2004–2009 in per cent of GDP

	Primary expenditure	Interest	Total expenditure
2004	30.0	2.0	32.0
2005	29.1	1.8	30.9
2006	28.3	1.7	30.0
2007	28.8	2.1	31.0
2008	30.2	2.7	32.9
2009	33.1	7.4	40.5

¹ The discussion in this section is based on national accounts standards. Figures differ therefore from the fiscal budget and Treasury accounts, but show a similar development.

As shown in the table, Treasury primary expenditure, i.e. its expenditure excepting interest, rose sharply last year but particularly this year. It has increased from 29 per cent of GDP in the years 2004 to 2007 to more than 33 per cent in the 2009 projection. The increase in the ratio is due to the contraction in GDP as well as to rising expenditure, such as unemployment benefits. Moreover, interest expenditure is increasing from around 2 per cent of GDP to more than 7 per cent, bringing total expenditure from about 32 per cent of GDP to almost 41 per cent, an increase of 9 percentage points, based on this year's projection. GDP has declined sharply in 2009, which accounts for a part of the increase in the expenditure ratio. The increase in expenditure in real terms is accordingly lower. This is apparent in the following chart, where the solid lines show the development of expenditure and the dotted lines in the same colour the averages for the years 2004–2007:

Chart 1: Treasury expenditure in per cent of GDP



The revenue side of Treasury finances developed along similar lines. The sharp contraction in the economy has eroded the main tax sources of the Treasury. In addition, the built-in cyclical effect on fiscal finances of the personal income tax is causing a loss in excess thereof.

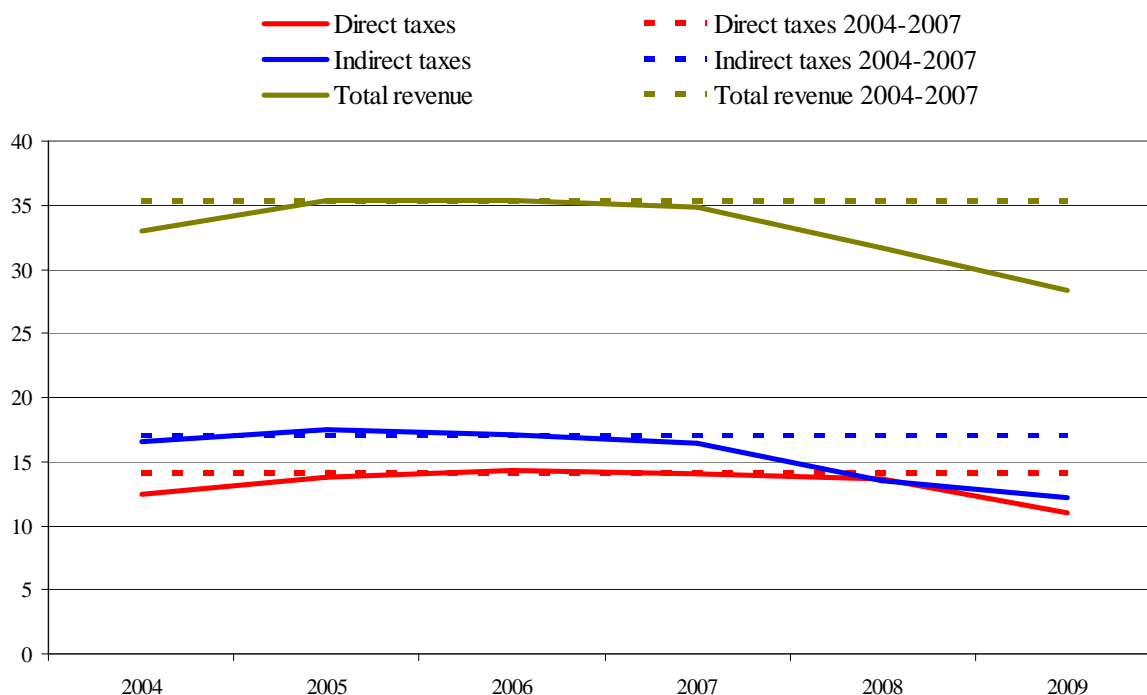
Table 3: Treasury revenue 2004–2009 in per cent of GDP

	Direct taxes	Indirect taxes	Other revenue	Interest	Total
2004	12.4	16.5	3.3	0.8	33.0
2005	13.8	17.5	3.3	0.7	35.3
2006	14.3	17.1	2.5	1.4	35.3
2007	14.1	16.4	2.6	1.8	34.9
2008	13.6	13.5	2.3	2.4	31.7
2009	11.0	12.2	2.3	2.8	28.3

Treasury revenue amounted to 35 per cent of GDP in the years before 2008 are currently estimated at about 28.3 per cent of GDP for 2009 and have thus declined by 6.7 percentage points of GDP. The loss is largest in indirect taxes; their ratio has fallen by 4–5 percentage

points on account of the sharp contraction in the economy. The revenue loss is also large in direct taxes, 2.6 per cent of GDP, but due to their elasticity, it falls faster than underlying tax sources. As in the case of expenditure, the decline in GDP has an impact on these ratios, but in this case the real decline in revenue is larger than corresponds to the nominal decline in the revenue/GDP ratio. The following chart illustrates this:

Chart 2: Treasury revenue in per cent of GDP



This development of expenditure and revenue of the Treasury led to a passage of the 2009 fiscal budget with a 153 billion krónur deficit that corresponds to about 170 billion on a national accounts basis.²

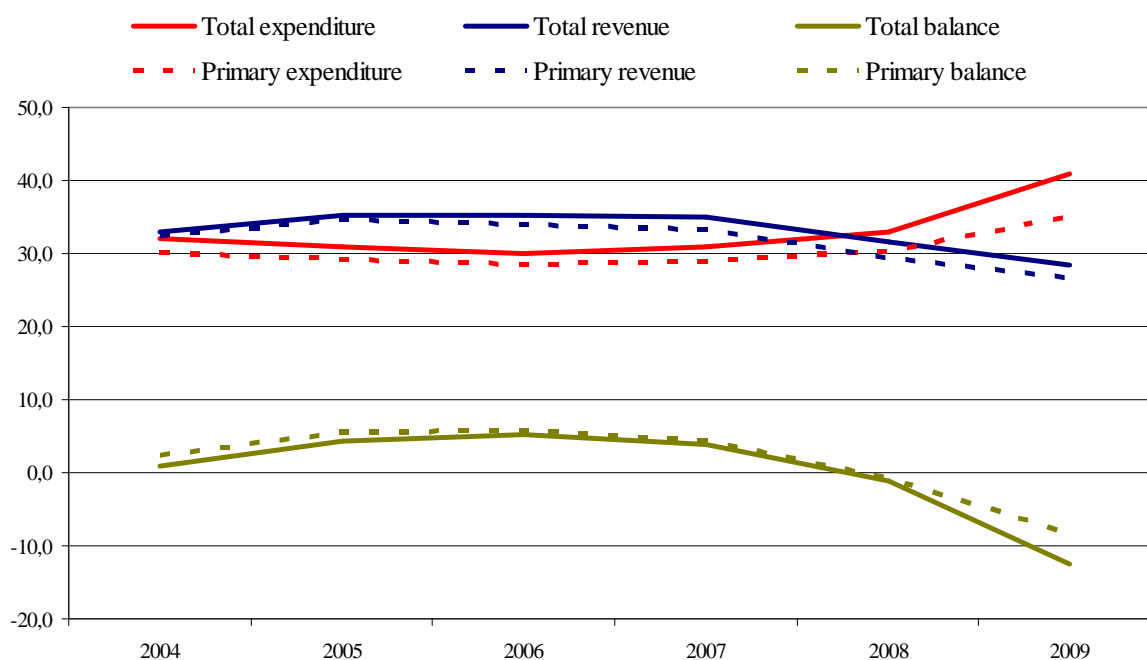
Table 4: Treasury balance 2004–2009 in per cent of GDP

	Primary expenditure	Total expenditure	Primary revenue	Total revenue	Primary balance	Total balance
2004	30.0	32.0	32.2	33.0	2.2	1.0
2005	29.1	30.9	34.6	35.3	5.5	4.4
2006	28.3	30.0	33.9	35.3	5.6	5.3
2007	28.8	31.0	33.1	34.9	4.3	3.9
2008	30.2	32.9	29.3	31.7	-0.9	-1.2
2009	33.1	40.4	25.5	28.2	-7.7	-12.2

As shown in the table, the Treasury surplus was sizeable, whether measured by the primary or the total balance but has turned into a large deficit, as is also shown in the following chart.

² The difference is primarily due to interest and price revaluation of Treasury loans with the Central Bank.

Chart 3: Treasury balance in per cent of GDP



The primary deficit is currently expected to amount to more than 8 per cent of GDP, which means that the amount equivalent to this ratio of GDP is needed to cover the shortfall in Treasury revenue, excepting interest payments and interest income. Including interest, the deficit is equivalent to 12.5 per cent of GDP.

In these difficult circumstances, it was decided to seek the assistance of the IMF for a Stand-By Arrangement to support the program for restoring the economy and its financial system. Such a program was drawn up in cooperation between the Icelandic authorities and the IMF and was passed by the IMF Board of Executive Directors in December 2008. The program outlines the main objectives for the years 2009–2011. In support of the program and in order to help restore stability in the country's foreign exchange transactions, the IMF lent Iceland more than 2 billion dollars. In addition, the Nordic countries, Russia and Poland pledged credits in excess of 3 billion dollars. The Faroe Islands had earlier promised a loan for this purpose.

The IMF Arrangement has three main objectives. First, to restore confidence in the Icelandic economy and stabilise the exchange rate. This would prevent household and business debt from increasing still further and thus deepen the recession already in evidence. Second, to restore the banking system and establish a sustainable financial system in order to meet the need of business and households for financial services. Third, to restore fiscal finances back to balance and maintain a surplus on the fiscal budget thereafter to make Treasury finances sustainable and bring Treasury debt down to an acceptable level over several years.

The following is a discussion of the role of fiscal finances in this program. The fiscal finances constitute one of the key issues in many ways. It is evident that other objectives, such as economic stability, an acceptable external debt level for the country and a balance in the foreign exchange market will not be achieved unless fiscal finances are brought onto a sound footing. Fiscal policy is one of the main tasks of the authorities at any given time. The confidence in the authorities is to a large extent based on their firm grip of fiscal finances. This applies especially in times of difficulty, as is the case now. The fiscal finances then become a measure of confidence in the Government's economic program that will be

scrutinised at home and abroad over the next several years. They form the basis for enabling our neighbouring countries to extend loans to Iceland in accordance with their commitments, based on their confidence that the Icelandic authorities will carry out the intentions as outlined in their economic program.

II. Fiscal policy in 2009–2013

The main goal of fiscal policy of the present Government in these circumstances is (a) to achieve a primary surplus by 2011, (b) a total surplus by 2013 and (c) a surplus on Treasury finances in the years thereafter, until Treasury debt will decline below 60 per cent of GDP.

On this basis, the Government has agreed to a program for the restoration of fiscal finances back to balance that is the foundation for its policy for the next several years in raising revenue for the Treasury and placing limits on its expenditure. In order to attain these principal objectives, it is assumed that the primary balance of the Treasury will be:

- 7.7 per cent of GDP in 2009
- 1.3 per cent of GDP in 2010
- 3.4 per cent of GDP in 2011
- 6.5 per cent of GDP in 2012
- 8.6 per cent of GDP in 2013

According to these objectives, the ratios of expenditure and revenue of the Treasury are estimated to stay within the limits below:

**Table 5: Estimates of revenue and expenditure ratios to GDP
(this table will be revised)**

Year	Primary expenditure	Primary revenue	Total expenditure	Total revenue
2010	31.0 – 32.0	28.0 – 29.0	37.0 – 38.0	29.5 – 30.5
2011	28.0 – 29.0	30.0 – 31.0	34.5 – 35.5	31.0 – 32.0
2012	26.5 – 27.5	32.0 – 33.0	33.0 – 34.0	33.0 – 34.0
2013	25.5 – 26.5	33.0 – 34.0	31.0 – 32.0	34.0 – 35.0

On February 24th, the Government agreed to a frame program for fiscal finances for the years 2009 to 2013. It was based on an assessment of prospects for fiscal finances as expressed in the projections underlying the Stand-By Arrangement of the IMF for Iceland. Treasury revenue, expenditure and balance are estimated as shown in the following table:

Table 6: Projections for fiscal finances 2009–2013

(Billion krónur, February 2009 calculations)

	2008	2009	2010	2011	2012	2013
Total revenue	463.0	408.4	447.4	500.4	550.0	603.5
Total expenditure	485.0	580.9	557.2	557.4	565.5	559.2
Revenue balance	-22.0	-172.5	-109.8	-57.0	-15.5	44.3
Financial revenue	37.9	23.0	13.4	15.3	21.3	27.0
Financial expenditure	41.0	101.2	100.3	95.6	94.8	86.1
Financial balance	-3.1	-78.2	-86.9	-80.3	-73.5	-59.1
Primary revenue	425.1	385.4	434.0	485.1	528.7	576.5
Primary expenditure	444.0	479.7	456.9	461.8	470.7	473.1
Primary balance	-18.9	-94.3	-22.9	23.3	58.0	103.4

At that time, the Treasury deficit was estimated at 170 billion krónur this year³ but is expected to decline year by year. At the time of the agreement behind the Stand-By Arrangement and at the time of the passage of the 2009 fiscal budget, it was assumed that these objectives could be attained without resorting to major fiscal measures this year, but it would be sufficient to rescind previous plans for expenditure increases. The intention, as expressed in the agreement, was that restraint measures would commence in 2010 that would include expenditure cuts and increases in Treasury revenue. By now, it is evident that the original projection of the agreement with the IMF and thereby the assumptions underlying the 2009 fiscal budget are not going to be realised without resorting to fiscal measures already this year. These projections must therefore be revised.

The first IMF review under the Stand-By Arrangement took place in March to May 2009. It revealed that the projections for Treasury finances called for revisions. Following these revisions, and on the basis of a new economic forecast⁴ the projection for fiscal finances is as follows:

Table 7. Fiscal finances 2008–2013 (this table will be revised)

Billion krónur

	2008	2009	2010	2011	2012	2013
Total revenue	472.8	397.7	433.6	481.7	532.0	571.8
Total expenditure	483.2	575.3	545.1	534.1	537.1	521.6
Revenue balance*	-10.4	-177.6	-111.5	-52.5	-5.1	50.1
Financial revenue	40.2	22.6	20.4	17.3	16.0	17.0
Financial expenditure	39.4	83.5	90.0	97.3	104.8	90.1
Financial balance	0.8	-60.9	-69.6	-80.0	-88.8	-73.1
Primary revenue	432.5	375.2	413.2	464.3	515.9	554.8
Primary expenditure	443.8	491.8	455.1	436.8	432.3	431.5
Primary balance	-11.2	-116.7	-41.9	27.5	83.7	123.3

* See footnote 3.

³ This figure includes the already incurred index compensation on Treasury debt with the Central Bank that is not entered as expenditure in the fiscal budget.

⁴ See Ministry of Finance: Spring 2009 Economic Forecast, May 2009.

The primary deficit, i.e. excepting capital revenue and expenditure, is currently estimated at close to 117 billion for the year and is projected to turn to a 27 billion surplus by 2011. It is also assumed that the total revenue balance, estimated at more than 177 billion this year, will improve rapidly, with a primary surplus and declining interest payments, leaving a revenue surplus of about 50 billion by 2013. These figures, as a ratio of GDP, are shown in the following table:

Table 8: Fiscal finances 2008–2013 (this table will be revised)

In per cent of GDP

	2008	2009	2010	2011	2012	2013
Total revenue	32.3	28.3	29.9	31.1	32.5	33.5
Total expenditure	33.0	40.9	37.5	34.5	32.8	30.6
Revenue balance*	-0.7	-12.6	-7.7	-3.4	-0.3	2.9
Interest income	2.7	1.6	1.4	1.1	1.0	1.0
Interest expenditure	2.7	5.9	6.2	6.3	6.4	5.3
Financial balance	0.1	-4.3	-4.8	-5.2	-5.4	-4.3
Primary revenue	29.5	26.7	28.4	30.0	31.5	32.5
Primary expenditure	30.3	35.0	31.3	28.2	26.4	25.3
Primary balance	-0.8	-8.3	-2.9	1.8	5.1	7.2

* See footnote 3.

In order to attain these objectives, it proves necessary to resort to restraint measures by cutting expenditure and raising revenue. The IMF experts and the staff of the Ministry of Finance have also revised the projections on the basis of such restraint measures for the years 2009–2013 that will prove necessary so that Treasury finances remain within frame limits. This increased need has emerged due to changed economic circumstances since the beginning of this year, in part because Treasury revenue is slacker, unemployment higher and some unexpected expenditure has become inevitable. The need for adjustment in Treasury finances is as follows⁵:

Table 9: The need for adjustment in Treasury finances 2009–2013

	Bn. kr.	P.c. of GDP
2009	-20	-1.4
2010	-56	-3.9
2011	-43	-2.8
2012	-36	-2.3
2013	-24	-1.4

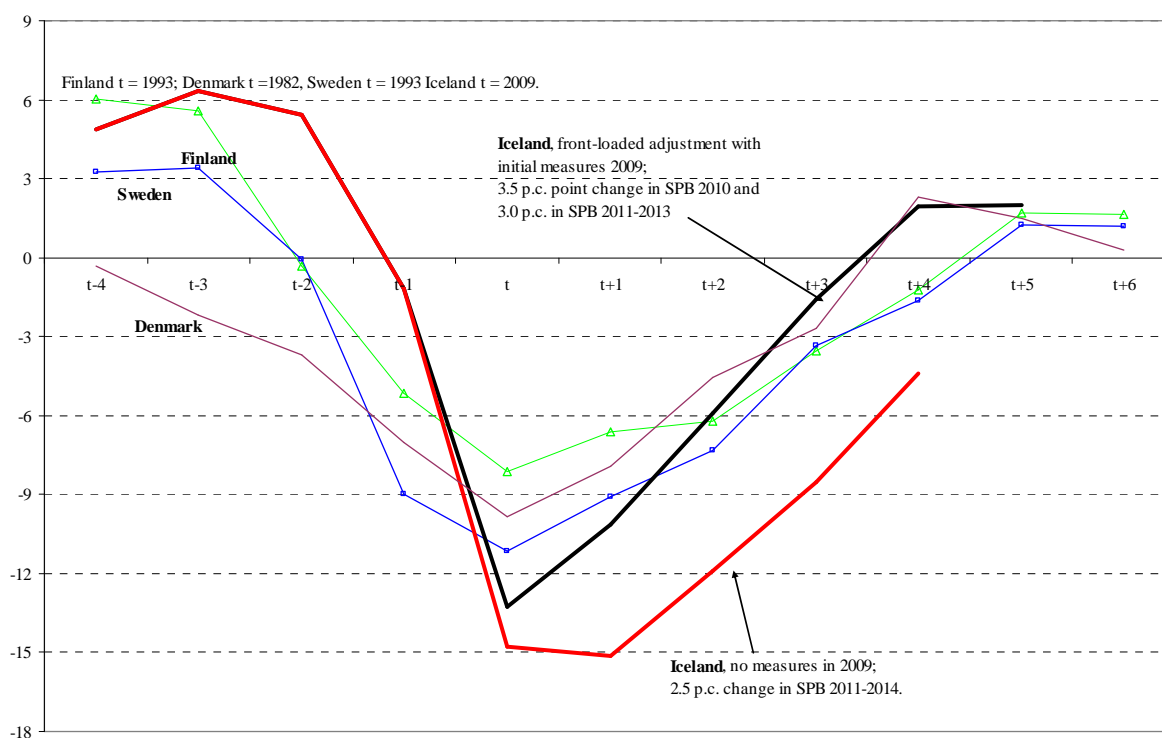
According to this assessment, the need for additional restraint is estimated at 20 billion krónur in 2009 and at 119 billion for the 2009–2011 period and 179 billion for the entire period up to 2013. These projections are subject to much uncertainty, especially for the longer term, and the need must be continuously revised in light of the stated objectives regarding the fiscal balance ratios to GDP.

⁵ Based on the June assessment of the IMF, excluding the creation of a reserve item on the fiscal budget.

The main purpose of the fiscal adjustment measures is to bring Treasury finances into balance and create conditions for the repayment of Treasury debt. The above projections are based on the objectives for fiscal finances, as has been discussed above. It is a matter of debate whether the adjustment measures are introduced too fast or perhaps too slowly. In this respect, the experience of other nations, which have gone through a similar process of adjustment, can be drawn upon, such as Finland, Sweden and Denmark in the last two decades of the previous century.

Chart 4: Comparison of adjustment paths

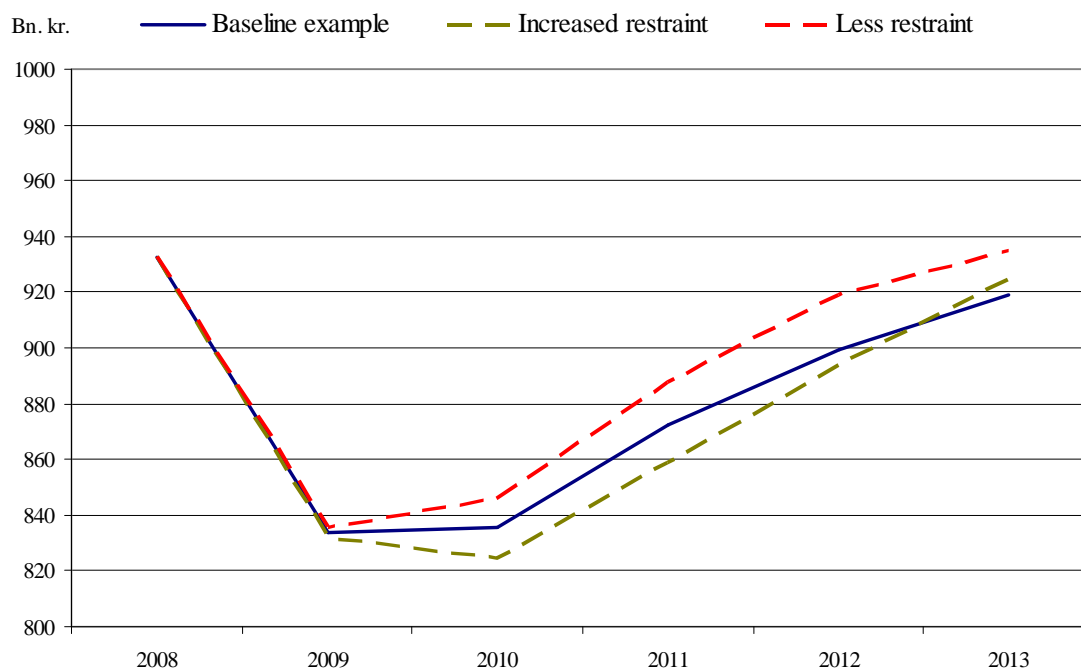
(Public sector balances in selected countries, from deficit to surplus in per cent of GDP; structural primary balances (SPB))



Source: IMF (WEO).

The chart shows the adjustment path for public sector balances in selected countries and two alternative paths for Iceland. One is based on the main points of the program proposed here, i.e. that measures would begin by the middle of 2009, an improvement in the fiscal balance by 3.5 per cent of GDP by 2010 and a 3 per cent improvement a year in 2011 to 2013. The other alternative path assumes that no measures will be implemented this year and that the fiscal balance will improve by 2.5 per cent a year in 2010–2013. In the case of weaker and less front-loaded measures, the adjustment path for fiscal finances will be slower, the deficit larger and more permanent and interest payment will be higher.

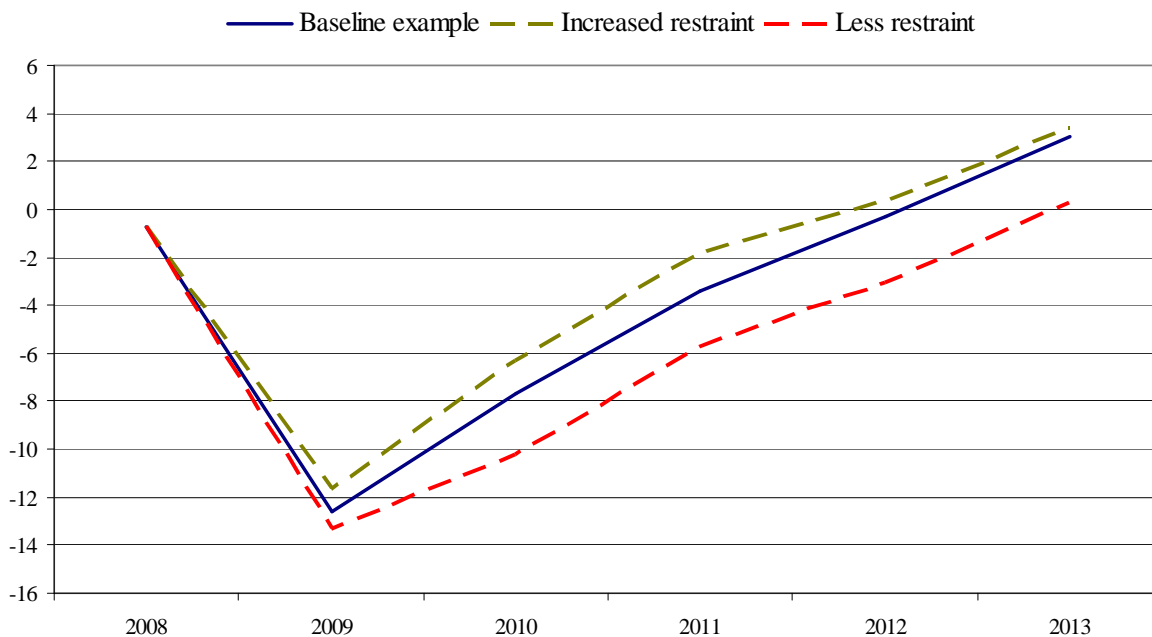
With the help of the Ministry's forecasting model, the speed of adjustment has been assessed for economic growth, the Treasury balance and Treasury debt. The increased-restraint alternative assumes that measures are taken earlier, and that the level of restraint would be raised by 50 per cent a year over and above the present projection until the 180 billion goal is reached and that revenue and expenditure will be kept at that level in subsequent years. In the easier alternative, the level of restraint would be reduced by 50 per cent over the next several years. The results can be viewed in charts 5–7.

Chart 5: GDP at constant prices

As is shown in the chart, economic growth would be stimulated by applying less restraint. The deficit would be greater and demand in the economy accordingly higher. Increased restraint slows down growth for several years, after which GDP turns back up, once the objective of restraint is reached. The positive effects of less restraint upon GDP will however lead to adverse effects in other areas that can prove disastrous in the longer run and could easily cancel the positive effects in a relatively short time.

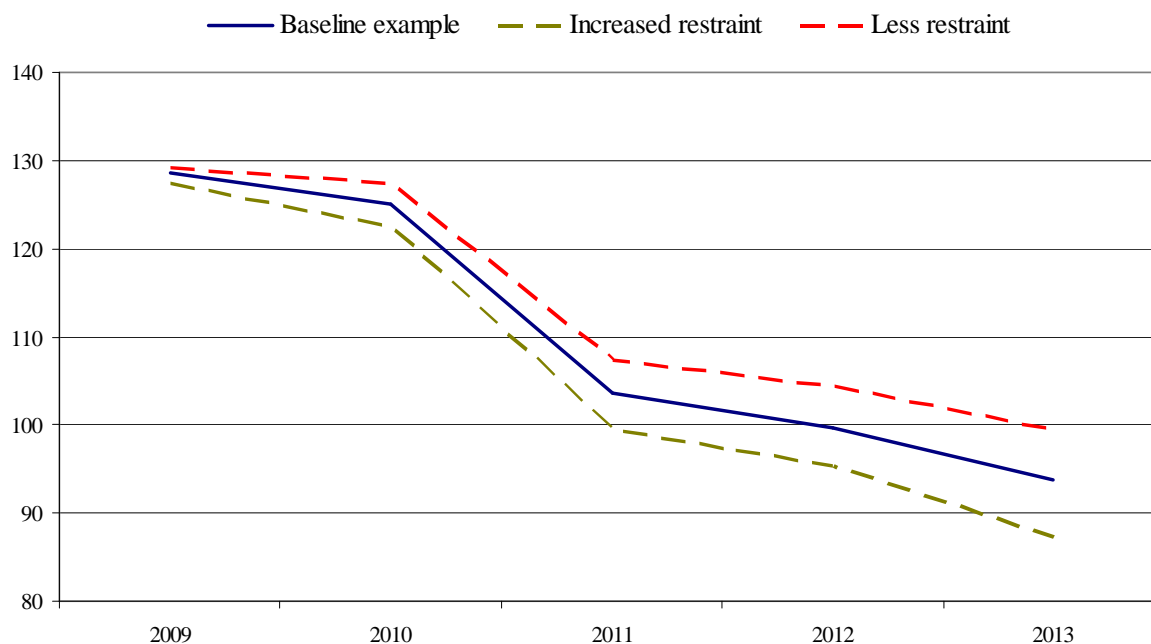
Chart 6 shows that the Treasury revenue balance will improve sooner with increased restraint, as can be expected, but will deteriorate significantly in the long term with less restraint. This will delay the return of the Treasury by at least one year in its effort to restore its balance in the lesser-restraint alternative.

Chart 6: Revenue balance, per cent of GDP



As can be seen in this example, if restraint is increased in excess of the baseline example, the forecasting model indicates that a higher tax rate and greater expenditure cuts will render lower tax revenue that in the long run will not improve the Treasury balance to any great extent over and above the baseline example.

Chart 7 shows that Treasury debt will evolve along significantly different paths, depending on the choice of alternatives. The lesser alternative path will produce a higher debt level, which will adversely affect the Treasury balance through higher interest payment and a higher level of interest rates. Such a path would also increase the uncertainty regarding the credibility of fiscal finances. Doubts would in turn arise under the increased restraint alternative that it would yield the intended results due to its adverse effect on growth and the fiscal balance.

Chart 7: Total Treasury debt, per cent of GDP

As these examples show, there is no simple answer to the question as to how fast to proceed along the adjustment path. This will in part be dictated by the economic situation at hand, especially the level of Treasury debt. In Iceland's case, the situation is quite difficult and that has prompted the choice of a fast path for adjustment measures as possible.

III. Ways and means of adjustment

The program for restoring Treasury finances in 2009–2013, as outlined above, means that stringent restraint must be applied that calls for determined measures by the authorities. As observed in the program accompanying the Stand-By Arrangement, such measures will include both expenditure cuts and an increase in Treasury revenue.

The extent of the adjustments necessary is such that an acceptable conclusion can not be reached by proceeding along one path or the other alone, i.e. only cutting expenditure or raising revenue. One must proceed along both paths simultaneously. The choice between the two will be dictated by several considerations. The contraction in the economy and increased Treasury debt following the bank collapse will inevitably reduce the living standards of the general public. The impact on living standards will be affected, depending on whether expenditure cuts or revenue increases are implemented.

Economic theory⁶ as well as the Ministry's research through its forecasting model⁷ both indicate that an increase in taxes and a cut in expenditure will have differing effects on the fiscal balance and economic growth. A cut in expenditure will do more to reduce the level of output and slow down economic growth than an increase in taxes would, at least in the short run. The reason is that an increase in expenditure of the Treasury increases demand in the economy by more than a tax change would, which would be reflected, among other things, in

⁶ The theories of J.M: Keynes represent a theoretical basis for such considerations on which many economists have based their work, such as Paul Krugman, the Nobel Prize laureate who has written a great deal on these issues in the wake of the international banking crisis and the world recession.

⁷ The Ministry of Finance has used its forecasting model to reach conclusions presented in this report.

public consumption and investment expenditure on the allocation side of the national accounts as well as in increased private consumption through a multiplier effect. For the longer run, the effect could be less pronounced and be more dictated by other aspects. In view of the fact that the Icelandic economy is in the middle of a recession, it seems more prudent to place emphasis on tax increases since they would reduce GDP and economic growth less in the short run.

A cut in expenditure is to some extent possible without causing a significant curtailment of important services or the continued build-up and maintenance of the country's infrastructure. Amongst those are the elimination of spending on projects that yield little and the reorganisation of public services. Aside from these options, that admittedly are minor in view of the adjustment need, it is inevitable that public services will have to be cut in some areas. Public services are primarily directed at those who need care, such as in the health or the benefit system, and constitutes an important part of their standard of living. Public services are also directed at important social services such as schools, education and research. Heavy cuts in these areas can impose undue weight on sensitive social groups and cause a relatively larger cut in their standard of living. It could also delay and obstruct possible ways of preparing for the future. It must also be borne in mind that a cut in labour-intensive services will lead to increased unemployment, both due to increased lay-offs but also because a decline in the demand by the public sector will have an impact on general economic activity and is therefore likely to exacerbate the downturn and lengthen the period until a trough is reached. It is therefore evident, both from a social and economic viewpoint, that cuts in expenditure must be made with care.

An increase in taxes is also difficult. It reduces disposable income of households and business and thus reduces their demand, even if such a contraction would be more than fully offset with increased demand from the public sector, inasmuch as the increased revenue is used to increase public sector demand. Increased taxes can also have an impact on private investment that in the long run could have an impact on economic growth. The impact on household private consumption can to some extent be directed by emphasising user charges that would offset market failures and negative environmental impacts.

It is difficult to find an ideal mix of expenditure cuts and tax increases. An inquiry by the Ministry of Finance directed at the choice between a 10 billion expenditure cut on one hand and an increase in taxes by the same amount indicated that the cut in expenditure for the full amount, rather than only increasing taxes, would reduce economic growth. This is not a surprising conclusion, since it is well in agreement with economic theory. It points to the conclusion that, as long as unemployment is high and there is great unused production capacity, it is not sensible to emphasise cuts in expenditure rather than increase taxes.

In light of the above, a mixture of measures that cut expenditure and increase revenue will be used to achieve a balance in fiscal finances, taking account of social as well as economic objectives in accordance with the considerations already discussed above and some that will be discussed below. Further decisions regarding measures will be taken later when further preparations have been worked out, and an analysis has been made of the impact and effectiveness of possible individual measures.

Treasury expenditure

Treasury current expenditure amounts to about 45 per cent of total expenditure, excluding irregular items, of which more than 65 per cent go towards wage costs of the central government. Current transfers also account for 45 per cent of expenditure, again excluding irregular items, and maintenance and investment for 10 per cent. Although some cuts can be

made without much damage, it must be expected that no significant cuts in spending can be achieved without directing cuts at all these categories. Even if an attempt is made to protect social-sensitive areas as well as labour-intensive activity, no significant results can be achieved without impacting social services such as pension benefits and health services to a substantial extent, reducing available education opportunities and cutting government staff.

Iceland has placed itself in the ranks of those nations that place a major emphasis on social welfare and the economic protection of its citizens. As is common in such countries, the standard of living has been high and comparable to the best in other countries. Although the economic impact of the bank collapse is very large and the living standard of the people has thus suffered, we are still amongst those nations that are best placed in this respect. The current setback should not prompt an occasion for deviating from the path of a welfare society by cutting living standards and services for those who are most vulnerable and at least not by more than the cut imposed on others. By the same token, it is maintained that there is an insufficient occasion to significantly reduce social services. It is therefore seen as a normal reference objective that these social objectives maintain their share in national expenditure and will not be cut by more than the relative contraction in the overall economy, i.e. expenditure on these objectives will maintain their ratio to GDP.

The share of the above in total Treasury expenditure is quite large. Most transfers are of this nature, and spending on health, social services and education constitutes a large part of the current expenditure of government agencies and transfers to individuals⁸. A significant cut in expenditure can therefore not take place unless these items are affected. In reaching such decisions, one must look further ahead and assess where we wish to stand at the end of the adjustment period, i.e. when a balance in fiscal finances has been achieved and a surplus has been created that is necessary to restore a fiscal balance.

As has already been observed, the primary expenditure of the Treasury in the years before the downturn, 2004–2007, was 29 per cent of GDP⁹. As the economy has contracted, this ratio has risen sharply, to an estimated 35 per cent this year. These public consumption expenditures will to some extent decline due to price increases that will not be compensated for over the budget, but in other respects, decisions must be taken regarding cuts to bring them to an acceptable level. By bringing the ratio of public consumption down to the previous ratio of 29 per cent of GDP, public consumption will have been cut by the same percentage as the rest of the economy, in addition to the fact that account must be taken of the increased interest burden of 4 per cent of GDP. If the share of public consumption is cut further, its share and that of those who depend on its services would inevitably be cut by more than elsewhere in the economy.

In order to adhere to the goals of the Government to maintain a high standard of welfare as in the past and endeavour to avoid letting the consequences of the economic collapse affect those who need the support of the welfare system most, at the same time as keeping up essential public services, it is necessary to decide the extent of the cut in Treasury expenditure with respect thereto. This is done in this program by projection that at the end of the adjustment period, in 2013, the primary expenditure of the Treasury will not be lower than they were before the collapse by more than 2 per cent, corresponding to one-third of the share in increased interest and surplus to reduce Treasury debt. This would mean that the primary expenditure of the Treasury would be 26 per cent of GDP, after a balance has been reached in total expenditure and some surplus has been created to repay debt.

⁸ Treasury spending on social security, welfare, health and education is close to 65 per cent of total expenditure, excluding interest and investment.

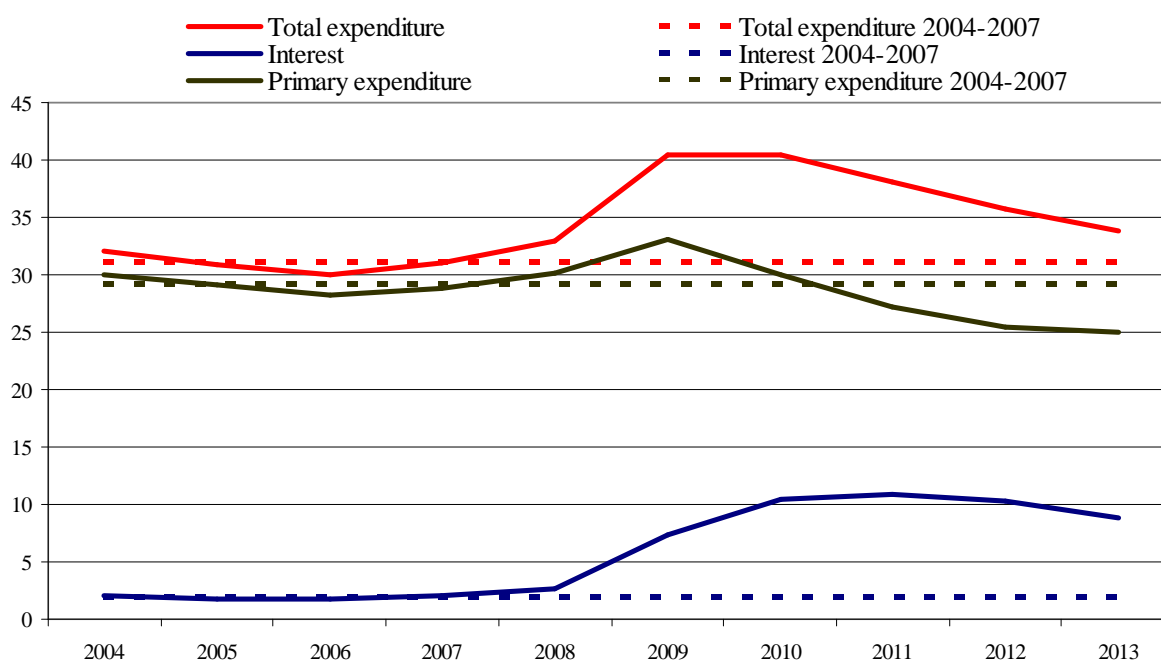
⁹ In addition, another 2 per cent was paid in interest for a total of 31 per cent of GDP.

Table 10. Treasury expenditure 2004–2013

In per cent of GDP

	Primary expenditure	Interest	Total expenditure
2004	30.0	2.0	32.0
2005	29.1	1.8	30.9
2006	28.3	1.7	30.0
2007	28.8	2.1	31.0
2008	30.2	2.7	32.9
2009	33.1	7.4	40.5
2010	30.0	10.4	40.4
2011	27.2	10.9	38.1
2012	25.5	10.3	35.8
2013	25.0	8.8	33.8

The changes planned on the expenditure side will lead to a cut in primary expenditure of the Treasury so that they will be 2–3 per cent lower than they have been as a ratio to GDP, i.e. the decline in public consumption will roughly correspond to the changes in GDP and create some room for debt servicing. Due to the increase in interest payments, the total expenditure of the Treasury will be a higher ratio of GDP than in the early years of the adjustment period but will approach the earlier ratio towards the end. The following chart shows the estimated development of primary expenditure, interest and total expenditure in accordance with the above.

Chart 8: Treasury expenditure in per cent of GDP

Treasury revenue

By using the same approach, i.e. by aiming at Treasury expenditure at the end of the adjustment period end up as a given ratio of GDP, and assuming that the total balance of the Treasury is given, the decision on Treasury revenue as a ratio of GDP can be derived as a

residual. It must be assessed that whether the revenue/GDP ratio is acceptable in foreseeable circumstances.

Revenue from taxes and charges constitute the largest part of Treasury revenue. Due to the expansion in most areas of the economy, Treasury revenue increased sharply because of automatic cyclical effects, even if marginal tax rates were reduced. In an economic downturn, the decline in Treasury revenue is faster than in the economy as a whole, thus reducing the ratio of taxes to GDP significantly.

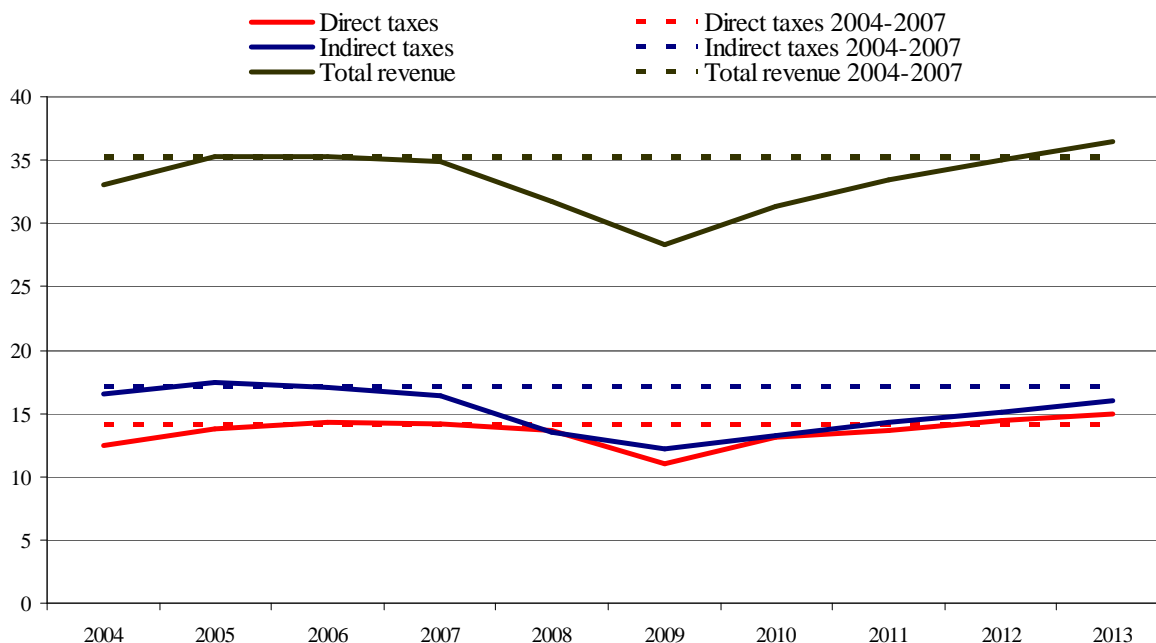
Table 11: Treasury revenue 2004–2013

In per cent of GDP

	Direct taxes	Indirect taxes	Other revenue	Interest	Total
2004	12.4	16.5	3.3	0.8	33.0
2005	13.8	17.5	3.3	0.7	35.3
2006	14.3	17.1	2.5	1.4	35.3
2007	14.1	16.4	2.6	1.8	34.9
2008	13.6	13.5	2.3	2.4	31.8
2009	11.0	12.2	2.3	2.8	28.3
2010	13.1	13.2	2.4	2.7	31.4
2011	13.7	14.3	2.6	2.9	33.5
2012	14.4	15.1	2.6	2.9	35.0
2013	15.0	16.0	2.6	2.8	36.4

In the years 2004–2007, total revenue amounted to 35 per cent of GDP. With the economic collapse, this ratio declined sharply, to 28.3 per cent, as projected for this year.¹⁰ The lower part of the table shows the estimated path of the total revenue ratio, based on the calculated adjustment need and the aforesaid objective regarding Treasury expenditure. According to this program, the total tax burden at the end of the adjustment period will still be lower than in the years 2004–2007. The burden of direct taxes will be slightly higher than before, due to the increase in the social security tax because of the financing need of the Unemployment Insurance Fund, an increase of about 0.8 per cent of GDP. This is shown in the following chart.

¹⁰ In this estimate, account has already been taken of the intention of the Treasury to increase its revenue by close to 10 billion krónur this year.

Chart 9: Treasury revenue, per cent of GDP

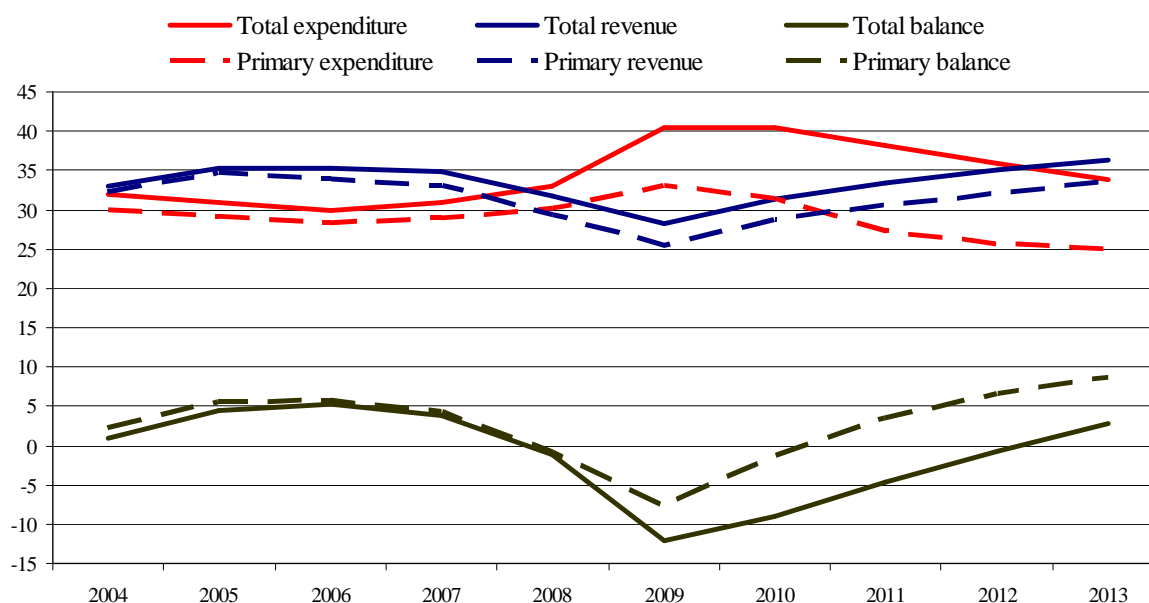
The chart shows that there is room for tax changes that fulfil a substantial part of the need for adjustment without an increase in the tax burden above what has previously been known in this country. It will still be lower than in those countries with which we compare ourselves. Although the total tax burden will not, according to this program, be higher than it was before, its distribution needs to be reviewed. The distribution of the tax burden favoured the better off at the time of the economic expansion. The reasons for this are many. The structure of the tax system led to such developments, if nothing was done, and the cut in tax rates and the abolition of some taxes at the time were such that it reinforced this trend. The role of the tax system in equalising incomes was thus reduced to the extent that there is good reason to review this aspect especially in the upcoming tax changes. This will be dealt with more closely below.

The following table and chart show the conclusions of the program to achieve a balance in fiscal finances as well as a comparison of the aggregates of expenditure, revenue and balance.

Table 12: Treasury finances 2004–2013

In per cent of GDP

P.c. of GDP	Primary expenditure	Total expenditure	Primary revenue	Total revenue	Primary balance	Total balance
2004	30.0	32.0	32.2	33.0	2.2	1.0
2005	29.1	30.9	34.6	35.3	5.5	4.4
2006	28.3	30.0	33.9	35.3	5.6	5.3
2007	28.8	31.0	33.1	34.9	4.3	3.9
2008	30.2	32.9	29.3	31.7	-0.9	-1.2
2009	33.1	40.5	25.4	28.3	-7.7	-12.2
2010	30.0	40.4	28.7	31.4	-1.3	-9.0
2011	27.2	38.1	30.6	33.5	3.4	-4.6
2012	25.5	35.8	32.0	35.0	6.5	-0.8
2013	25.0	33.8	33.6	36.4	8.6	2.7

Chart 10: Treasury finances, per cent of GDP

The table and the chart show the main objectives and characteristics of the program. A primary balance should be achieved in 2011 and a total balance by 2013. Treasury debt begins to decline thereafter. Public consumption as a ratio to GDP begins to decline from its peak in the wake of the collapse but adjusts to other economic aggregates over time. By the end of the adjustment period, 2013, it should be similar to the level before 2008. Total tax revenue as a ratio to GDP is expected to grow from their present trough and gradually adjust to its previous level over the adjustment period.

IV. Changes in taxes 2009–2013

The changes that have been made in the tax system over a long period of economic expansion have weakened the ability of the tax system to raise revenue for the level of social services

that has been developed in recent years. In addition, there is good reason to adjust the tax system to the need of increasing social equality.

In the process of raising revenue, the necessary changes must be designed to strengthen the tax system for the future and align it to the demands for an efficient and fair tax system, such as:

- that taxation becomes equitable
- that the tax burden is distributed as fairly as possible
- that the tax system is as neutral as possible with respect to decision-making in the economy, whether with respect to investment or consumption
- that the tax system is simple and transparent and is well aligned to the present tax administration.

In addition to fulfilling these demands as much as possible, it is desirable that the tax system serves other purposes such as:

- creating a more equal distribution of income
- contributing to social goals and social security
- ensuring that the nation receives as much of a share in the income from natural resources as possible
- adjusting for and countering market shortcomings, such as through the use of environmental taxes
- supporting the goals of the authorities in the fields of health, social welfare and culture.

The following ideas of a possible increase in revenue take account of the above requirements and objectives. The need for raising revenue in the next several years is very high and must be met by a contraction in expenditure as well as through increasing revenue. This is particularly the case because the flow of revenue to the Treasury has declined sharply in the economic downturn.

Direct taxes

Income taxes

Income taxes in this country consist of the personal income tax (including the local government income tax), the capital income tax and the corporate income tax. The personal income tax (including the local government income tax) has been the largest source of revenue for the public sector. Their share in Treasury revenue has increased to 38.5 per cent of the total in 2008. In per cent of GDP, the share of direct taxes of the Treasury averaged 14 per cent in 2005–2007. This ratio is expected to decline below 12 per cent in 2009, a decline of 2 percentage points of GDP. The social security tax is included in these figures, since it moves mostly in tandem with wages; most of the decline stems from the income tax on individuals and companies. The reasons are twofold. On one hand, nominal incomes have declined somewhat, but the main cause is that there is an automatic link between income and taxes so that a proportional change in taxes is far greater than in incomes. In the expansion of recent years, the revenue increment resulting from this link was only used for cyclical mitigation to a minor extent but instead used for tax cuts. The drop in the current downturn shows therefore up to a full extent in the decline in tax revenue. A change in income taxes by each one percentage point of GDP leads to a 14 billion impact on the Treasury. If the ratio of income taxes to GDP were increased to the 2005–2007 average, it would increase Treasury revenue by more than 30 billion krónur.

The personal income tax

Taxes on personal income consist of the personal income tax (including the local government income tax) that is imposed on wages, pensions etc. and the capital income tax. The changes in the personal income tax system, along with the development of incomes in recent decades has led to an increase in income taxation as measured in per cent of total incomes. This ratio has increased from more than 17 per cent to 21–22 per cent in the years 2001–2007 or by an average of 4–5 percentage points, as can be seen in the following table. It is notable that this increase in the tax burden has taken place despite the decline in tax rates and the abolition of the surtax on higher incomes.

Table 13: Income taxes as a ratio of total personal income 1993–2007 (assessment years), billion kr.

Assessment year	Wages	Capital income	Total income	General inc. tax	Surtax on income	Local govt. inc. tax	Capital inc. tax	Total inc. tax	Income tax in p.c. of total income
1993	226.9	6.3	233.2	24.1	0.0	16.0		40.1	17.2
1994	229.5	6.2	235.7	27.7	0.4	16.1		44.3	18.8
1995	239.7	4.8	244.5	26.0	0.5	20.4		46.9	19.2
1996	253.4	5.6	259.0	27.6	0.4	21.5		49.4	19.1
1997	276.2	7.6	283.8	32.3	0.4	23.1	0.1	56.0	19.7
1998	297.5	14.0	311.5	28.5	0.5	32.6	1.3	63.0	20.2
1999	339.2	14.9	354.1	33.9	0.9	37.3	1.4	73.6	20.8
2000	377.2	24.9	402.1	38.3	1.2	42.3	2.4	84.2	20.9
2001	419.9	32.9	452.8	44.7	1.5	47.1	3.2	96.5	21.3
2002	463.8	41.6	505.4	51.2	1.4	55.1	4.1	111.8	22.1
2003	495.7	45.9	541.6	54.4	1.7	59.0	4.5	119.6	22.1
2004	520.0	63.9	583.9	57.4	1.3	61.9	6.3	126.9	21.7
2005	565.9	74.6	640.5	65.8	1.4	67.6	7.4	142.1	22.2
2006	625.7	120.0	745.7	70.5	1.0	75.6	11.9	159.0	21.3
2007	705.2	159.8	865.0	81.9	0.0	88.8	16.3	187.0	21.6

Source: The Icelandic tax system, report to the Minister of Finance, September 2008 (in Icelandic only).

In addition to increasing the tax burden, this led to an erosion of the income-equalising role of the tax system, as it transferred the tax burden from higher-income earners to those with lower income. The main reason was that the standard income tax credit did not increase in line with wage developments, and a low tax on capital income (on dividends, sales profits, interest and rent) was adopted, which distorted the tax system in various ways and created an internal inconsistency where some tax bases were in nominal terms and others in real terms. The table shows the comparison of income, taxes and tax rates by income stages for the years 1993 and 2005. It clearly shows the great change in the tax burden over this period and how the burden has shifted.

One can read from the table that in 1993 about 15 per cent of married couples fell below the tax-free income threshold or received higher benefits from the tax system (child benefits, interest tax credits) than the amount of their tax liability. In 2005, only 5 per cent of married couples were below this threshold. The tax burden of the lowest quartile of married couples increased by more than 10 per cent between those years, whereas the tax burden of the

highest-income quartile rose by less than 2 per cent and in fact declined considerably for the highest-income decile¹¹.

Table 14: Average tax ratios of married or co-habiting couples in 1993 and 2005.

(Assessment years. Total income and wages for each income group, millions of krónur)

Income range					Tax ratio					
	1993		2005		Total wages		Total income		Change	
	Total wages	Total income	Total wages	Total income	1993	2005	1993	2005	Total wages	Total income
0-5	2.022	2.163	4.677	5.545	-7.8	-0.4	-12.5	-2.5	3.9	10.0
5-10	3.228	3.347	7.501	8.294	-5.3	6.5	-6.1	7.6	11.8	13.6
10-15	3.677	3.801	8.747	9.653	-3.3	10.1	-3.0	10.6	13.4	13.5
15-20	4.086	4.224	10.038	11.036	0.8	12.3	0.9	12.4	11.5	11.5
20-25	4.520	4.650	11.434	12.428	4.3	14.2	4.1	14.4	9.9	10.3
25-30	4.944	5.070	12.784	13.760	7.3	15.9	7.5	16.3	8.6	8.7
30-35	5.352	5.466	14.062	15.020	10.1	17.8	9.8	17.9	7.7	8.0
35-40	5.755	5.864	14.996	15.928	12.3	19.1	12.2	19.3	6.8	7.1
40-45	6.147	6.257	16.040	16.994	14.5	20.2	14.3	20.3	5.7	5.9
45-50	6.548	6.658	17.093	18.087	16.4	21.4	16.2	21.3	5.0	5.1
50-55	6.949	7.060	18.152	19.207	18.2	22.4	17.7	22.2	4.2	4.5
55-60	7.367	7.481	19.255	20.414	19.5	23.2	19.0	23.2	3.8	4.1
60-65	7.821	7.947	20.430	21.708	20.5	24.1	20.2	23.9	3.6	3.7
65-70	8.245	8.374	21.701	23.104	21.7	24.9	21.4	24.5	3.2	3.1
70-75	8.712	8.847	23.092	24.704	22.8	25.5	22.6	25.0	2.7	2.4
75-80	9.331	9.481	24.706	26.606	24.1	26.1	23.7	25.5	2.1	1.7
80-85	10.099	10.280	26.687	29.098	25.2	26.9	24.9	26.2	1.6	1.3
85-90	11.140	11.357	29.399	32.804	26.9	27.9	26.4	26.5	0.9	0.1
90-95	12.711	13.029	33.819	39.736	29.0	29.0	28.3	26.7	-0.1	-1.6
95-100	18.112	19.631	51.896	115.903	35.2	31.5	32.9	17.8	-3.7	-15.1
Total:	146.764	150.987	386.509	480.027	20.0	23.6	19.4	20.9	3.6	1.5

Source: The Icelandic tax system, report to the Minister of Finance, September 2008 (in Icelandic only).

One of the main causes of this development, in addition to relatively small changes in the standard personal tax credit, is the low taxation of capital income, the share of which in personal income has steadily increased from less than 5 per cent of total income in 2000 to nearly 20 per cent in recent years. The reason is that financial assets have greatly increased and become concentrated in few hands. A shift in income from wages to capital income has also taken place, for tax reasons. The low taxation of capital income, coupled with the low corporate tax rate, has led to a disparity of up to 15 per cent in the taxation of income that many people have taken advantage of by establishing private limited companies that do little but sell the labour of their owners.

It is possible to increase personal taxation by more than 2 per cent of GDP without exceeding previously known limits that have been considered acceptable. This could yield 30–35 billion krónur in extra revenue. The elimination of tax disparities due to capital income and private limited companies, along with the elimination of credits and deductible items could yield an additional 5 billion for a total of 35–40 billion krónur.

¹¹ An increase in the tax burden over this period did not mean that living standards decline, since there was a sharp overall increase in income over the period.

The review of the personal income tax system calls for some preparation and can for practical reasons only be made at the turn of the year. The aim is to let such a revision, or a phase thereof, take effect at the beginning of January 2010. A temporary measure is planned for 2009 with surtax rates on high general income and high capital income that together could yield an additional 3 billion krónur¹².

The corporate income tax

The present system of taxing corporate profits embodies a number of problems. The first is the disparity vis-à-vis other taxpayers, since the corporate tax rate plus the taxation of dividends gives a total tax rate of at most 23.5 per cent, compared to up to 36 per cent on wage income. This disparity has led to a considerable shift in income, as noted above. By increasing the taxation of dividends, this disparity can be reduced. To eliminate it altogether, the corporate tax rate must also be raised. There are other reasons in favour of such an increase.

Table 15: The taxation of profits and dividends

	Corporate income tax	Dividends	Total
Iceland	18.0	10.0	26.2
Denmark	28.0	43.0	59.0
Finland	26.0	28.0	40.5
Norway	28.0	28.0	48.2
Sweden	28.0	30.0	49.6
UK	30.0	32.5	47.5
OECD avg.	28.4	30.5	43.8

Source: The Icelandic tax system, report to the Minister of Finance, September 2008 (in Icelandic only).

This table shows that Iceland taxes profits of enterprises far more lightly than comparable countries. The total taxation of corporate profits, after the payment of dividends, reaches a maximum of 23.5 per cent compared with an average of 44 per cent in the OECD countries and between 40 and 50 per cent in the other Nordic countries. One of the reasons given for the cut in the corporate tax rate has been that they would probably increase the inflow of foreign investment. This has not turned out to be the case. Foreign investment, other than in aluminium smelters due to the intermediation of the Government, has been scant, whereas Icelandic investment abroad has increased.

The low taxation of companies has an impact on the operations of foreign-owned companies in this country. The corporate tax revenue from such companies is constitutes a large part of the yield of the country from direct foreign investment, especially in activity that is not labour-intensive, such as aluminium production and other energy-intensive activity. A low income tax rate on such companies means that the country divests itself of its share in the profits and the value added created in this country and probably also its share in the yield from the country's natural resources.

¹² A bill has been presented to the Althingi with proposals for a temporary surcharge on top of the tax on high personal income and high capital incomes. It is assumed that these changes will be integrated into the coming revision.

Table 16: Corporate tax assessments

Assessment year Million krónur	2000	2002	2004	2006	2007	2008
Agriculture, hunting and forestry	59	69	113	179	289	248
Fisheries	418	696	882	1,176	1,064	1,331
Manufacturing	1,382	1,340	1,615	2,061	2,371	4,236
Distribution systems	2	2	2	37	35	207
Building and construction	768	1,066	1,185	3,496	3,877	5,292
Commerce and repair services	3,346	2,057	2,559	4,613	4,830	4,376
Hotels and restaurants	167	299	353	635	559	862
Communications and transport	628	224	719	1,507	870	908
Maritime transportation	85	13	34	29	35	39
Financial services, pension funds, insurance	1,106	1,520	2,079	13,045	18,260	18,208
Real property transactions, rental services	1,568	1,833	2,820	6,086	8,459	10,148
Education	10	23	27	77	58	74
Health and social services	151	276	401	646	735	868
Other social and cultural services etc.	118	215	313	703	941	722
Other, unclassified	530	520	526	379	283	222
Total:	10,318	10,186	13,622	34,669	42,717	47,761

A raise in the corporate tax rate towards levels more in line with most European countries is being considered. The aim is to adjust the sum of tax on company profits and dividends to be about the same as the tax on wages of individuals. Furthermore, several deduction items will be revised and allowances for a tax-free collection of dividends and capital gains etc. will be narrowed.

The rate of withholding taxes on revenue to foreign parties could be raised in parallel with the aforementioned changes, and interest payments to foreigners would be taxed like other income of foreign nationals. That, and the change in corporate tax rate, would significantly increase the country's revenue from power-related industry and other business activity of foreign nationals.

Due to the probability that most companies in Iceland will have weak profits over the next several years, a raise in the corporate tax ratio can not be expected to generate much revenue. Still, it is evident that some increase can be derived from private limited companies and companies in sectors benefitting from the weak currency. The corporate income tax is estimated to yield 22 billion krónur in the 2009 fiscal budget. Based on this estimate, a one per cent increase in the corporate tax rate would yield close to 1.5 billion. Due to the uncertainty over the next several years, it would be prudent to assume that each percentage point would yield only 1 billion.

The social security tax

The social security tax is by its nature a tax on personal wage incomes. This tax is significantly lower in this country than in most other countries but this is offset by the fact that the compulsory premium payment to pension funds is relatively high. A part of the tax (0.65 per cent) goes to the Unemployment Insurance Fund and it has been changeable according to need. It is evident that the current rate is insufficient and it will be necessary to raise it, at least temporarily to finance unemployment benefits in the current downturn when unemployment is expected to be of the order of 5–9 per cent for several years.

The current social security tax is 5.34 per cent and the tax base, i.e. wages, amounted to close to 750 billion krónur at the 2008 assessment. A 1 per cent increase would yield about 7.5

billion in revenue and an increase to 7 per cent would yield 12.5 billion. About 0.1 per cent thereof will probably have to be channelled to the Wage Guarantee Fund and a 1.66 per cent increase would go to the Unemployment Insurance Fund.¹³

Other taxes

In addition to changes in income taxes, changes in taxes on net wealth and inheritance could also be considered. In the case of the net wealth tax, the tax would only be imposed on large estates, a sort of a large-estate tax on income-producing assets. The tax ratio and arrangement of the inheritance tax could also be reviewed. No concrete ideas have been formulated yet regarding these types of taxes.

General taxes on goods and services

The value added tax

The value added tax is currently imposed at two rates, a general rate of 24.5 per cent and a lower rate of 7 per cent that applies to food and several types of other goods and services. Exceptions are few. Although the VAT is high in this country, there are higher rates, such as 25 per cent in Denmark that imposes VAT on all taxable sales of goods and services. A number of revisions could come up for review.

Raising the lower VAT rate

From a taxation viewpoint, whether from tax theory or tax administration, the most beneficial change is to reduce the disparity between tax rates. The disadvantage is that it could lead to some increases in food prices and thus weigh heavily on lower-income earners who generally devote a higher portion of their income to food. The experience of such a difference only supports such a view to a small extent. The recent debate on whether the cut in the lower rate has turned up in lower prices is still fresh in memory. Data from Statistics Iceland also indicate that the share of consumption expenditure that is spent on food differs little across the income scale and the impact of such a rate disparity upon income distribution is therefore scant¹⁴. An increase in the lower tax rate from 7 per cent to 12 per cent, as is common amongst nations with two tax rates, could lead to a tax increase of 7 billion, and an increase to 14 per cent could yield 10 billion.

The increase in the general rate

The increase in the general VAT rate from 24.5 per cent to 25 per cent would yield about 2 billion in increased income. The main disadvantage has to do with the impact on prices, but these are uncertain in current circumstances.

The transfer of individual goods categories between tax rates

Some revenue increase can be generated, and other objectives achieved, by transferring goods between categories. This change can be considered as an addition to some increase in the lower rate. The main goods under consideration are unhealthy foods, such as candy and sugar-based beverages. Such goods were moved to the lower rate not long ago. This change would support the ideas recently under discussion for the need of reducing the sugar consumption of children, a matter that would apply to all age brackets. It is debatable whether such a change

¹³ An increase in the social security tax to 7 per cent is already included in a bill before the Althingi .

¹⁴ This is also in accordance with the investigation of the State Auditor when the original lower tax rate was introduced in 1993.

would have an effect on prices in line with increased tax collection. For example, the price of soft drinks is probably more associated with market share than production cost.¹⁵

General excise taxes

Excise taxes on candy, soft drinks and other sugar-based foods could be considerably increased without substantial adverse effects. A temporary excise tax on luxury goods could also be considered.

Special excise taxes

This group covers environmental taxes and special consumption taxes. Most are decided in krónur and leave therefore some room for increase due to price increases. Furthermore, environmental viewpoints and negative externalities also support revisions. The following could be considered.

An alcohol tax

An alcohol tax is level on each centilitre of pure alcohol, close to 60 krónur for wine, 66 krónur for beer and close to 80 krónur on liquor. If these charges had followed the consumer price index from the beginning, they would all amount to about 113 krónur. Revenue from the alcohol tax in 2008 is estimated at 8 billion krónur.

The alcohol tax could be increased by 30–40 per cent over the next several years, for example in three 10 per cent stages, July 1st, January 1st 2010 and January 1st 2011.¹⁶

Tobacco levy

Tobacco is currently taxed at 257 krónur a unit (20 pieces). It has increased in line with prices from the beginning. Cigarettes are still cheaper than in most other countries of Western Europe. Revenue from the levy amounted to 3.9 billion krónur in 2008. One could consider increasing the charge by 30 to 40 per cent in two stages in 2009 and 2010¹⁷.

Taxes on arriving passengers and hotel stays

A special hotel tax is common and could be considered here. There is a shortage of funds for national parks and other tourist spots. Such a tax could be used to pay such costs. In order to equalise to some extent between the different types of accommodation, a part of this revenue could be collected through a tax on air tickets to the country. Overnight stays at hotels are currently 1.5 million a year. A 500 krónur average charge a night would yield 750 million a year. The same amount on each ticket would yield 250 million, based on 500 thousand arrivals, a total of 1000 million. It would be possible to allocate one-fourth of this amount to national parks and tourist-related projects. This share could increase as the finances of the Treasury improve.

Environmental and natural resource taxes

Taxes on petrol and oil could be classified as environmental taxes, as well as a general carbon tax that has been under consideration for some time.

¹⁵ The transfer of candy, soft drinks and other sugar-based foods into the upper VAT bracket is being proposed in a bill currently before the Althingi.

¹⁶ The alcohol tax was increased by 15 per cent last May.

¹⁷ The tobacco tax was increased by 15 per cent last May.

A petrol and diesel fuel tax

The current petrol tax (general and special) amounts to 47.5 krónur per litre of petrol and 46.12 krónur per litre of diesel oil. Still, the price of diesel is slightly higher than of petrol, a difference of about 7 krónur in recent weeks. These taxes could be increased. The impact on transport costs could be mitigated by reducing the weight-distance tax on trucks and increasing the rebate for public transportation. The petrol tax could increase by 10 krónur a litre at the middle of 2009 and 2010 and the diesel tax by 5 krónur, but that the increase would not impact trucks and lorries or public transportation¹⁸.

A carbon tax

A tax on carbon emissions from all use of goods and raw materials has been under consideration. This applies to coal, coke, petrol, aviation fuel, diesel fuel and anodes. The total of carbon emissions from these substances is estimated at 1 million tonnes a year. The trading price on carbon emissions in the EU is currently about 14 euros a tonne of carbon dioxide, corresponding to about 46 euros per tonne of carbon. A carbon tax corresponding to this price would be about 7,700 krónur a tonne of carbon. Revenue from such a tax would amount to 7.7 billion krónur a year. If brought about, the tax could be lower in the beginning, e.g. 2,500 krónur a tonne in three stages, yielding an estimated 2.5 billion krónur a year for a total of 7.5 billion, where some part of the sale of diesel fuel and aviation fuel would be to foreign ships and aircraft that would normally be tax-exempt.

Since the carbon tax would also apply to the anodes used in aluminium smelters, they could have an impact on potential investors in that sector. First, such a tax is only being considered in cases where no payment for emissions are in effect and the amount of the charge is based on the premise that the sum of the tax burden does not exceed the emission charge. Second, it should be borne in mind that foreign energy-intensive industry enjoys great tax benefits in comparison with other countries and other economic activity and that only a small part of its value added remains in the country and could usefully be increased.

A natural resource tax

There are no actual taxes on natural resources, except for the so-called fishing licence charge that will be reinstated this autumn, unless the law to that effect is amended. There is every reason to consider such a general tax. Limited natural resources or limits on the access to resources creates a resource yield for the owner. In cases where the state is the owner, the principal means of ensuring that the resource creates a yield for the state is for the state itself to use the resource or allocate it to others in return for a user charge. If neither approach used, the yield from the resource accrues to the designated user or the one with access to it.

V. Cuts in Treasury expenditure 2009–2013

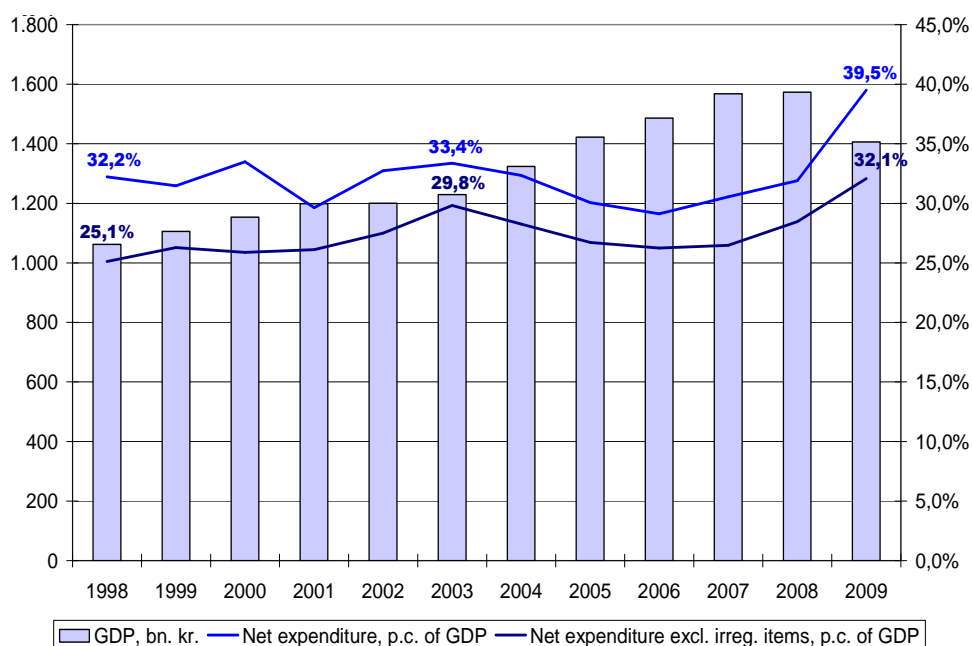
The first step taken to meet the impact of the bank collapse on the Treasury was taken in the fiscal budget for this year where measures were implemented to reduce the Treasury deficit by 45 billion krónur from original intentions. The Government's intention is to reach a balance in fiscal finances over the 2009–2013 period, where the aim is to reduce spending still further, probably through annual measures that must offset built-in spending growth, such as

¹⁸ A recent change in the law increased the petrol tax by 10 krónur per litre and the diesel fuel tax by 5 krónur per litre as of the middle of 2009. The increase was not made applicable to passenger buses and public transportation.

through the increase in the number of students, older persons, benefit recipients and other demographic changes.

The state of fiscal finances has been radically altered. Treasury debt, which before the bank collapse was amongst the lowest in OECD countries, has increased to a very high ratio, 125 per cent of GDP at the end of this year. This inevitably leads to a very high interest cost of the Treasury, a cost that could exceed the combined cost of running hospitals, nursing homes, rehabilitation centres and the rest of the country's health system. It is therefore very important that the authorities succeed in closing the deficit as soon as possible so the interest cost will not continue to exacerbate problems and to prevent the debt situation from becoming unmanageable.

Chart 11: The development of total expenditure and GDP, 2009 prices¹⁹



As has been observed earlier, the difficult state of the economy, unemployment and household finances place a limit on the room for increasing Treasury revenue, at least for the near future. In these circumstances, it is evident that measures must be taken to cut services, reduce benefits and other support payments to individuals and households. By distributing the burden that has been created by the increased financing needs of the Treasury in a fair manner and by protecting those socio-economic groups and expenditure categories that are vulnerable to reductions, the frame for government operations will eventually be aligned to changed circumstances so that the basic services will remain broadly intact, and so that it can be restored on a sounder footing. The underlying assumption is that the basic services system of the state will be safeguarded. Benefits will mostly be reduced to those with better incomes and assets. Costly investments will be postponed and labour-intensive investments will increasingly be emphasised, such as the maintenance of housing and government structures.

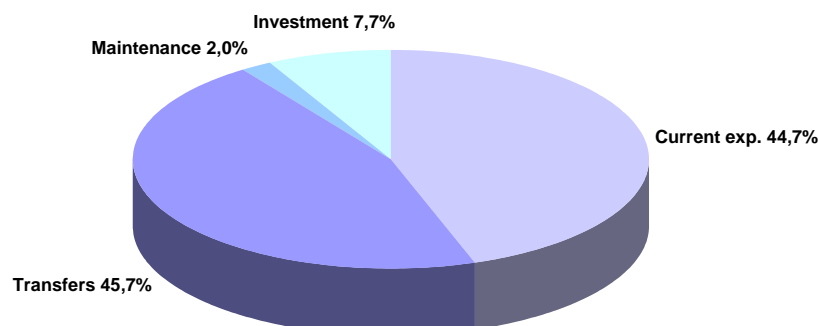
In chapter II above, the goals for fiscal finances were outlined for the major revenue and expenditure categories along with the probable size of necessary measures. In order to ensure

¹⁹ The lower line shows the expenditure/GDP ratio, excluding interest and irregular items such as pension commitments and tax claims written off. This ratio is most indicative of the size of expenditure that is subject to the direct decision-making of the authorities at each time.

that the program will be carried out, the authorities have recently been developing more precise proposals, choosing among alternatives and preparing for their implementation. The bargaining partners in the labour market have been consulted and the state of Treasury finances has been explained to the main interest groups. A special working party on the implementation of savings measures, composed of representatives of the majority parties in the Althingi's finance and economic committees and a representative of the Minister of Finance, has also participated in the process. On the basis of a plan for reducing Treasury expenditure and the priorities contained therein, work has begun on a frame budget for the next four years. The intention is that a frame budget for the next four years will be published and introduced with the fiscal budget proposal for 2010 this autumn, where a further division by ministry and expenditure categories will appear.

The following account deals with the main intentions of reducing expenditure over the program period. Decisions have already been taken for this year and next, as broadly described above. The first measures will be taken this year. A part thereof necessitates changes in law, some of which have already been proposed to the Althingi in the fiscal measures bill currently under deliberation. The main lines of emphasis in expenditure reductions have already been prepared for the years 2011 to 2013. Certain upper and lower limits have been presented for expenditures in view of the main intended measures and also in view of the size of measures to raise more revenue associated therewith. Further decisions for this part of the program period will be made later, and they will therefore only be discussed here in general terms. It should be noted that in this discussion, the fiscal budget accounting basis and that of the government accounts is used, not the national accounting standard.

It should be noted, that present economic forecasts are subject to much uncertainty, including their impact on fiscal finances. It should also be noted that the need for adjustment has been assessed on the basis of extrapolations from the Ministry's forecasting model, which is a much less detailed approach than must be applied in the drafting of the fiscal budget, where measures have been aligned more closely with information on the expenditure commitments of individual ministries. It must be assumed that in the coming weeks and months, a number of new issues will arise that must be dealt with. The authorities are determined to continue working on these issues and respond to changed circumstances with measures necessary to restore fiscal finances.

Chart 12: Composition of expenditure, excl. irregular items in 2009

The discussion on plans to reduce expenditure is based on the so-called economic categories, i.e., current expenditure, transfer payments and capital investments. The table below shows the expenditure side of the plan, with a summary of measures already decided for the years 2009 and 2010, followed by the sum of changes for the years 2011 to 2013, and their realistic range in view of the alternatives under review.

Table 17: Plans for cutting expenditure 2009–2013, in billion kr.

	2009	2010	2011	2012	2013
Current exp.	1,800	14,250			
Transfers	3,135	11,113			
Investment	4,425	10,000			
Total	9,360	35,363	16,000–26,000	12,000–20,000	8,000–14,000

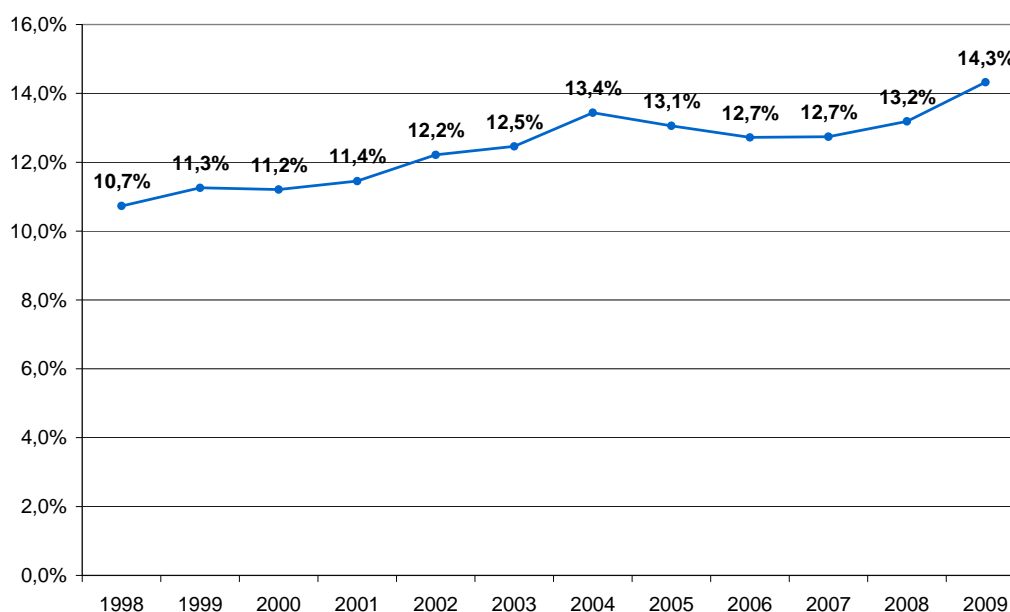
The table shows a summary of expenditure cuts that must be implemented each year in order to restore a balance to Treasury finances. Measures for each year must come in addition to those already implemented. The cumulative impact of the measures could be in the range of 75 to 95 billion krónur at the end of the period. At the upper end of the range, cuts in expenditure will bear the brunt of the adjustment. If the result will be in the middle of the range, it will yield about half of the adjustment need. This corresponds to about 17 per cent of the part of Treasury expenditure that such direct interventions can apply to, excepting such items as interest payments and ultimate accounting entries such as expensed pension commitments and tax claims written off. As is evident from this plan, most of the measures will be implemented this year and next, thus ensuring a maximum success in one concerted effort, thus reducing debt accumulation as soon as possible as well as the rise in interest cost. It is clear that the longer one waits before the Treasury's finances improve and balance is restored, the heavier the debt and interest burden becomes and subsequent measures must therefore be larger in scope. In addition, it is inevitably important that wage and price changes be kept to a minimum, so that they will remain below the general inflation influence on the

revenue side and will offset the built-in increase on the expenditure side, such as through the increase in the population and a change in the demographic composition.

Current expenditure

The Treasury's current expenditure, net of user charges, amounts to about 200 billion krónur, excluding capital income tax on the Treasury's interest income and future pension commitments. This is equivalent to 45 per cent of government expenditure, excluding other irregular items and interest payments. About 65 per cent of this amount goes to wage costs. Current expenditure has been increasing as a ratio of GDP in the past decade, or by 2.5 per cent over the past decade, from 10.7 per cent in 1998 to 13.2 per cent in 2008. This year, the ratio will be still higher, 14.3 per cent, based on the fiscal budget and due to the fall in GDP.

Chart 13: Treasury current expenditure, excl. irregular items, in per cent of GDP



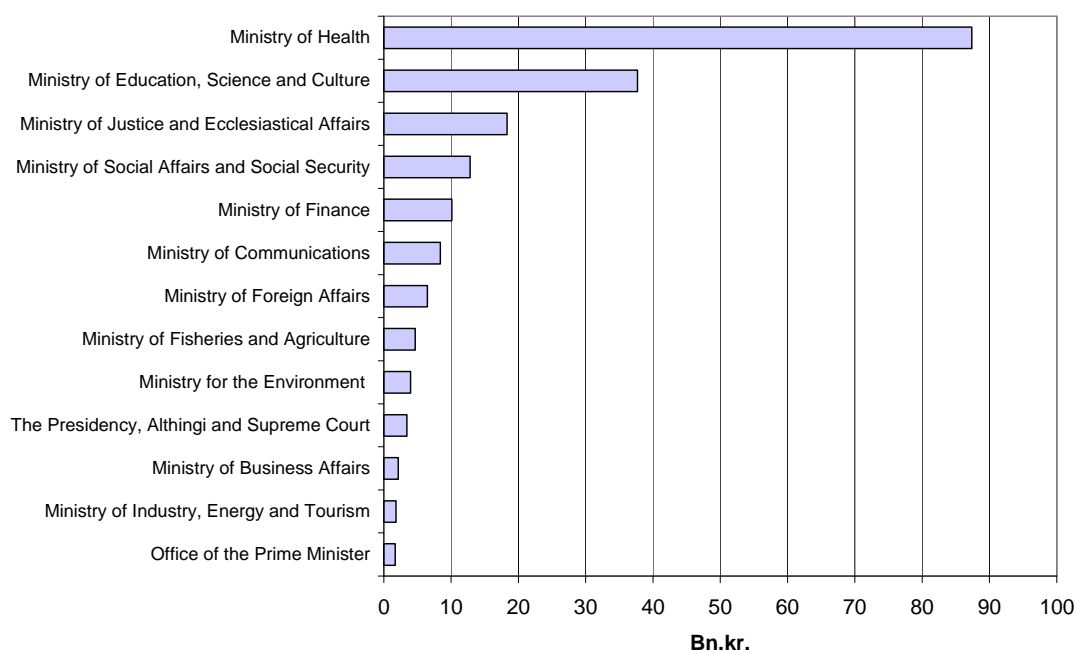
The measures needed to cut current expenditure generally need some time to be fully implemented and their impact will not be immediately felt. It is therefore not anticipated that such measures will yield further results this year in excess of what was assumed in the budget. Nevertheless, it will be feasible to achieve some savings in the latter half of the year with appropriate measures taken this summer, which in some cases can yield immediate results, such as in travel costs and purchased services. In other cases, it will take some months, such as amending work arrangements and associated wage costs. In light of the needed size in cuts of current expenditure next year, the authorities consider it important to begin immediately to implement measures, so that they will yield results for all of next year. It is also evident that the central government's wage policy must take account of the fact that total wage costs much decline. This can only take place through a cut in wages or in staff. Changing the separation pay of government employees should also be considered.

Appropriations to government agencies in most areas have been substantially increased in recent years on the basis of rising revenue. This sharp increase has meant that there is room in many expenditure categories for reduction without endangering the level of service that the nation was used to five years ago before the recent expansion began. The Government has now decided on a goal for current expenditure of all ministries, government agencies and other activity financed by the Treasury. The goal means that expenditure must already be

reduced this year and that a significant result will be achieved next year. In general terms, ministries and agencies are expected to implement measures already this year in order to have some impact this year. The Government emphasises that ministries and agencies must implement spending cuts themselves in accordance with its guidelines, rather than accepting top-down orders regarding individual spending items. The ministries know best of their areas of expertise and are best situated to find effective ways of spending cuts. The responsibility for expenditure will thus be delegated in accordance with the work methods of the frame budget in order to achieve the intended results by using the know-how of managers and staff in their daily work.

The expenditure reduction goals are decided in proportion to the current expenditure of ministries when irregular items and items not directly related to current operations are excluded, such as for example pension commitments that are transferred from the Ministry of Finance. In setting such goals, a more lenient demand is imposed upon agencies engaged in welfare services and the basic services of the education system than upon public administration and monitoring agencies. This reflects the prioritisation of the Government. Although the savings goals are decided upon in proportion to the current spending of each ministry, this does not mean that a flat spending cut should be applied. It is assumed that ministries and their ministers will prioritise in their decisions on appropriation cuts and by how much. Such priorities could mean that some tasks in, say, health services would be abolished altogether or drastically reduced when other tasks would be left untouched. It should also be noted that, although a more lenient approach will be applied to the operation of welfare services, it is nevertheless possible to substantially reduce expenditure in some areas, such as in travel and pharmaceutical purchases.

Chart 14: Current expenditures (net) by ministry, excl. irregular items, 2009



The year 2009

The goal for additional cuts in current expenditure in the latter half of this year is based on 2 per cent of the annual turnover of public administration, 1.6 per cent for schools and 1 per cent for agencies supplying health and disability services. Since the cut must be achieved in the second half of the year, these percentages would be double on a full-year basis. These

goals would lead to a 3 billion cut in expenditure. Ministries will have much flexibility in implementing these goals for this year by other means, such as rescinding plans for disbursing transfer support payments or abandoning plans for purchasing equipment or investing. The approach will differ between ministries and to what extent the cuts will be in current operations. The final plans for implementation have been completed in all ministries. For example, the Ministry of Health intends to achieve the largest share of savings in transfer payments under the health insurance system so that more time will be available to prepare reductions in expenditure for next year. The plans of ministries mean that current expenditure will be reduced by 1.8 billion krónur, transfer payments by close to 1 billion and investments by about 300 million. The cuts in current spending by ministry are shown in the table below.

Table 18: Extra cut in current expenditure by ministry in 2009

	Cut, million krónur
The Presidency, Althingi and Supreme Court.....	-44
Office of the Prime Minister.....	-22
Ministry of Education, Science and Culture.....	-355
Ministry of Foreign Affairs.....	-80
Ministry of Fisheries and Agriculture.....	-84
Ministry of Justice and Ecclesiastical Affairs.....	-329
Ministry of Social Affairs and Social Security.....	-130
Ministry of Health.....	-250
Ministry of Finance.....	-157
Ministry of Communications.....	-197
Ministry of Industry, Energy and Tourism.....	-69
Ministry of Business Affairs.....	-21
Ministry for the Environment.....	-64
Total.....	-1.802

The year 2010

The goal for reducing current expenditure in 2010 is based on 10 per cent of the annual turnover of public administration agencies, 7 per cent for education and 5 per cent for welfare, for a total of 14.3 billion krónur in cuts.

Table 19: Cuts in current expenditure by ministry in 2010

	Cut, m.kr.	Current exp.	Cut in p.c.
The Presidency, Althingi and Supreme Court.....	-221	3.427	-6.4
Office of the Prime Minister.....	-170	1.699	-10.0
Ministry of Education, Science and Culture.....	-2.835	37.692	-7.5
Ministry of Foreign Affairs.....	-648	6.485	-10.0
Ministry of Fisheries and Agriculture.....	-473	4.652	-10.2
Ministry of Justice and Ecclesiastical Affairs.....	-1.834	18.302	-10.0
Ministry of Social Affairs and Social Security.....	-881	12.827	-6.9
Ministry of Health.....	-4.753	87.367	-5.4
Ministry of Finance.....	-863	10.096	-8.5
Ministry of Communications.....	-830	8.386	-9.9
Ministry of Industry, Energy and Tourism.....	-180	1.801	-10.0
Ministry of Business Affairs.....	-216	2.163	-10.0
Ministry for the Environment.....	-345	3.978	-8.7
Total.....	-14.249	198.874	-7.2

As can be seen in the last column of the table, the proportional cut in current expenditure is not exactly in line with the above goals in some ministries. This is due to the fact that the activity of ministries is divided into sub-categories that are subject to different demands for cuts, depending on their nature. For example, in the Ministry of Social Affairs, the appropriations for agencies serving the disabled, a 5 per cent cut is applied, whereas the cut in public administration is 10 per cent. Secondly, some current expenditure items may be exempt from cuts, leaving a lower average cut, even if all agencies were cut by 10 per cent. This applies in particular to the Ministry of Finance, where revenue collection costs, costs of court verdicts and accident compensation pursuant to wage agreements are exempted.

Last spring, ministries were asked to prepare alternatives and proposals for expenditure reductions of 10 per cent of turnover. In some ministries, particularly the larger ones, these preparations took place in special working groups, and the ministries have also solicited ideas from agencies under their auspices. The ministries have worked on the priorities this past spring and summer and drawn up concrete proposals for current expenditures in all main aspects. Some ministries have completed their proposals, but in some ministries it will take another two weeks to complete a proposal in detail and align measures to other expenditure plans for next year in time for the 2010 fiscal budget.

As noted earlier, ministries and their agencies will mostly be entrusted with the task of implementing plans for cuts in current expenditure in accordance with their tasks as described by law and the work methods of frame budgeting. The Government will also take part in various measures to facilitate and support such implementation, such as proposing legislative amendments where needed and by consulting labour market partners and other interest groups, public employee unions and local governments. The Government has also decided to present *reference guidelines* to all ministries and agencies that shall be used in decisions and their implementation in the extensive measures ahead to reduce Treasury expenditure. These reference guidelines are largely directed to current operation and are as follows:

Reference guidelines

- Flat expenditure cuts should be avoided, using instead priorities and expert assessments on the basis of the reference guidelines presented by the Government.
- All tasks and operations of agencies should be reassessed from the point of view whether it is equally important that the government would provide such services as well as others that must be included in basic services. The aim is to reduce or abolish tasks with a low priority.
- Basic welfare services should be protected, and all ways and means need to be sought to achieve greater efficiency and savings within the welfare sector, as in other basic services where necessary services can be provided in a more efficient manner.
- When reducing wage costs, jobs should be protected as much as possible, lowest wages should not be cut, but higher pay grades should bear the brunt of the cuts. Overtime pay should be reduced as much as possible and reduce work proportions rather than let staff go. Employees who have gained the right to a pension shall be offered flexible separation terms.
- The pay of employees making more than 400,000 krónur á month shall be reviewed, in consultation with the ministry and the agency concerned, with the aim of reducing total emoluments and revising work arrangements so that the pay of the highest paid will decline proportionately more than those with lower pay. Such a review shall take into

account the cuts in staff salaries that already have occurred within ministries and agencies.

- The pay of senior managers in the central government shall be cut so that it will not exceed that of the Prime Minister.
- In cases where government employees receive monthly pay that is higher than that of the Prime Minister, the total emoluments and work arrangements shall be reviewed in consultation with the ministry and agency concerned with the aim of cutting their pay in line with the pay cuts of senior government managers.
- The pay of managers of companies, institutions and limited liability companies that are majority-owned by the Treasury shall be placed under the jurisdiction of the Wage Council.
- Gender equality shall be borne in mind in changing pay arrangements.
- Vacant posts in ministries or agencies shall not be refilled unless absolutely necessary.
- Human resources and expertise within the central government shall be used by transferring staff between posts as needed.
- Outside consultants shall not be hired by ministries or agencies unless absolutely necessary and the relevant expertise is not at hand amongst government employees.
- Ministries and agencies shall immediately review extra emoluments to staff on permanent pay, such as for being on committees, councils, management boards, car reimbursements and other such payments. Measures need also be taken to reduce travel and representation costs appreciably from the level of recent years.
- Government operations must be run with the utmost frugality. All operations and purchases must be revised and existing contracts brought up for review.
- All contracts containing automatic index or exchange rate increases must be reviewed, such as service contracts or space leases. This applies also to space leasing from the Government Real Property Agency. Service or work contracts with other price clauses than are embodied in the fiscal budget are not allowed without a prior assessment of the budget department of the Ministry of Finance.
- Ministries, agencies and companies owned by the central government, including banks, shall adhere to rules on public purchasing in order to ensure market equality and achieve cost-effective purchasing. This means that tenders shall be used in all instances possible and joint purchases shall be made under frame contracts through the Government Purchasing Agency. Electronic purchasing shall be introduced as widely as possible, and a policy must be formulated for environmentally benign purchasing.
- The planned merger of ministries and agencies shall be based on the achievement of significant rationalisation, thus increasing the synergy of related activity and better cost effectiveness for the Treasury. Electronic services and efficiency must be emphasised as well as the flexibility of using government employees so that ministries and agencies can cooperate as one whole in a changing economic environment.
- Investment projects and tasks not yet begun shall be reviewed for the purpose of their postponement or abandonment. Ministries must report all new current operation tasks and work contracts exceeding 50 million krónur to the budget department of the Ministry of Finance that are planned or scheduled to commence after July 1st. The report

must explain why the task or contract is necessary, and authorisation must be sought for its start.

- Payments from various funds for specific tasks/areas shall be halted, at least temporarily, where possible or feasible and assess whether such payments should be abolished altogether. Funds that support new business opportunities or new enterprises shall not be abolished.
- Ministries and agencies shall keep their operations within budget limits of the existing fiscal budget, taking the demand for efficiency savings and deficits brought over from previous years into account, where applicable. The current expenditure plans for 2009 shall not take account of unused budget appropriations from earlier years, since the Treasury deficit would thereby increase accordingly.
- Major appropriations left over from previous years under several specific items, such as for investment projects not carried out, as well as for current operations of agencies that have been left unused and are in excess of a given proportion of turnover in the 2009 fiscal budget shall be rescinded.

A reorganisation of the agency system

A large part of the cut in Treasury expenditure next year must be achieved through increased efficiency by reorganising the agency system, transferring tasks, merging ministries and agencies and reviewing existing tasks. A careful review must take place of the urgency of tasks currently performed by the central government and how all related public services have been aligned to such tasks. A review of the transfer of tasks between ministries is already under way, and all ministries are currently reviewing possible changes in tasks and agencies with the intention of creating savings in current operations in future years. Agencies must be merged to create larger and more efficient units that at the same time will become more able to provide good service. It must be ensured that no changes will take place until it has been demonstrated that such changes will be cost-effective and that opportunities for rationalisation will not be lost. Such mergers must have the goal of producing a certain measure of results in current operation savings, e.g. 5–10 per cent of turnover, through synergy and efficiency of size, e.g. through a reduction in the number of managers and support services, more efficient premises etc. Tasks will not be transferred to local governments until a reorganisation plan for cost savings has been drawn up. It must also be ensured that basic government services on which there is a consensus that the central government must provide for the benefit of society will be cut as little as possible. Bearing this in mind, ways and means must be sought to increase cooperation with local government regarding individual tasks of public service, such as in areas where central government staff is reduced or services are deteriorating. In addition, all agencies must have general goals of continuing cost efficiency in their operations.

The aim is to achieve a reduction in current expenditure of 3–4 billion through government reorganisation over the next several years. In order to achieve this result, the Government has adopted the goal that contemplated agency mergers will yield a 5–10 per cent savings out of their turnover, primarily through synergy effects and size efficiency. This should ensure that changes will not be embarked upon until it has been demonstrated that they will lead to cost efficiencies. If synergy effects, for example, can be shown to yield 5 per cent savings, a cut in current spending of 3 billion can be counted upon. For example, a merger of universities and other higher education establishments could yield substantial cost savings. The same applies to a reorganisation of health service agencies, both in the regions and near the capital area. Mergers in many smaller areas can also yield considerable results, such as mergers of district magistrates, tax office, fewer embassies etc. The first changes in the agency system are

planned to take effect at the beginning of next year, except for those that already have been decided with amendments to the Administration Act.

Other plans for savings in current operations of ministries

In addition to plans under consideration and in preparation regarding agency mergers and the reorganisation of tasks, general measures are planned for reducing the current operating cost of all ministries. It will prove important to cut pay costs with general methods, having regard to the reference guidelines listed above, such as through the reduction in overtime, the reorganisation of shift plans, by abolishing extra emoluments, negotiating salary cuts for those higher paid and by not filling vacancies. Results can also be achieved by other general measures such by reducing travel abroad, increase purchasing efficiency through tenders, renegotiating leases and the purchase of outside services and similar things. As noted earlier, ministries and agencies have already embarked on such measures this summer to achieve cost savings this year. A number of other measures are under consideration in ministries that can not be disclosed until budget limits in the budget proposal have been set up. Some of these measures can not be fully prepared until towards the end of the year.

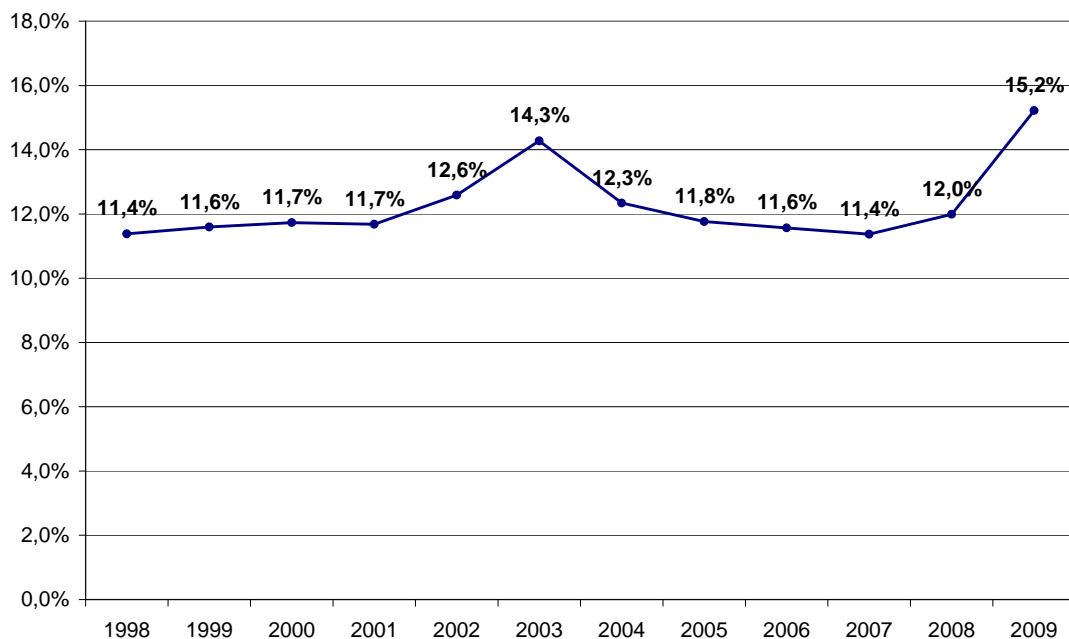
Due to changed economic circumstances it was evident that government agencies were compelled to cut their operating costs. Since wages are in many instances a large part of current costs, many managers have responded by amending work arrangements or changing the composition of total emoluments. The impact has not fully emerged, but data from the Treasury's Central Pay Office shows that managers have responded swiftly with measures that already are producing results.

Data from the Central Pay Office show that total wage costs have declined since last autumn. The average emoluments of government employees have declined from September 2008 to March 2009, especially at the upper end of the income scale. The increase is largest in overtime and cost reimbursement pay. Total hours worked have also declined, as overtime has been reduced by one-fifth. The total wage cost has declined between the above months by 4.3 per cent or 446 million. On a full-year basis, this reduction could amount to 5 billion, but this is difficult to assert due to seasonal changes. Changes in pay terms are not immediately reflected in the aggregate data due to provisions on contract notices.

It is assumed that the impact of changes already decided upon is not fully reflected in available data. It is evident that most agency managers have, on their own initiative, responded to the change in economic conditions, as is intended in the Government's plans for a distribution of responsibility and frame budgeting.

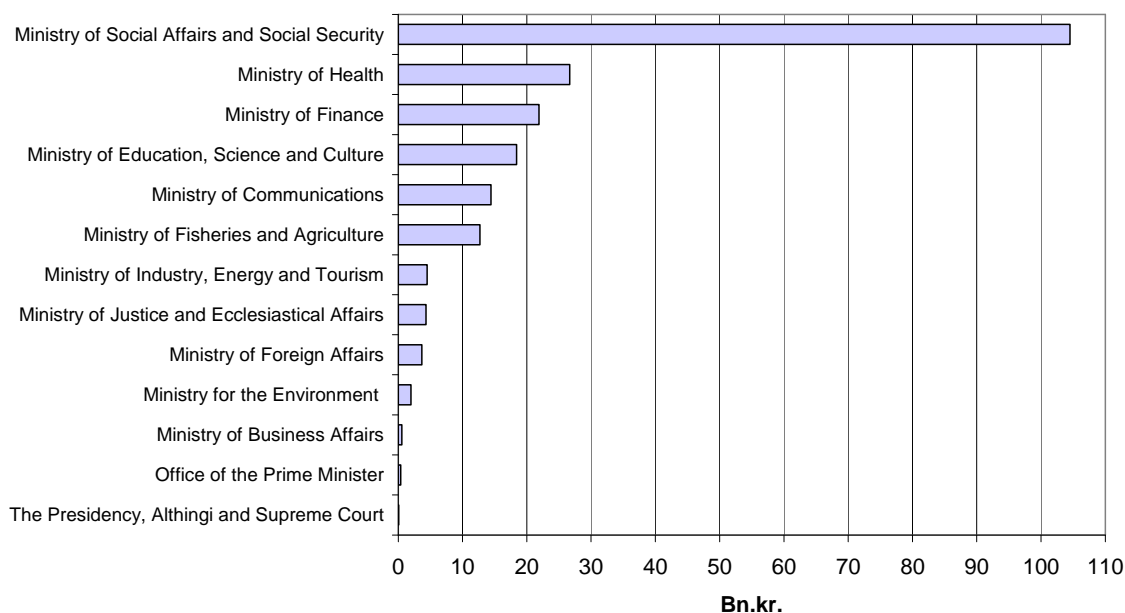
Transfer payments

Current transfer payments amount to 206 billion, excluding the write-off of tax claims. Transfer payments account for 46 per cent of Treasury expenditure, other than irregular items and interest payments. Current operating transfers amount to 18 billion, e.g. agricultural support payments, but the largest amounts go to the social security system, 145 billion according to the current fiscal budget. Such payments go to pensions, unemployment compensation, childbirth leave payments, child benefits, interest tax credits etc. Transfer payments have roughly increased in line with the growth in GDP in the past decade, in the range of 11.5 to 12 per cent in most years. Since unemployment compensation is determined by the business cycle, this ratio can fluctuate in line with economic conditions. As can be seen in the chart below, this applies to the recession in 2002–2003. Due to conditions in the labour market this year, the ratio may be expected to rise to more than 15 per cent.

Chart 15: Transfer payments, excl. irregular items, in per cent of GDP

Benefit amounts have been substantially increased in recent years and income and asset linkages reduced in most benefit systems, such as in social security, child benefits and interest tax credits. Benefits paid through the Social Security Institute have increased by 23 billion in real terms since 1999, equivalent to a 55 per cent increase, both due to an increase in the number of beneficiaries and through special increases in benefits. Unemployment compensation amounts change, as noted before, in line with the business cycle and are estimated to amount to 25 billion this year.

Many of the changes currently contemplated in the benefit system are such that they need not be made with much advance notice. This applies especially to old age and disability benefits, whereas changes in interest tax credits and child benefits need longer advance notice, since they are calculated at the time of the annual final tax assessment. The Government has already decided on considerable cuts in transfer payments that take effect at the middle of this year and will continue to produce reductions at a full-year rate next year. The largest single measures already decided upon relate to old age and disability benefits, health insurance and child benefits. They are intended to reduce expenditure by a total of 2.3 billion this year and by 7.6 billion next year. Other transfer payments to selected tasks have been cut from 100 to 700 million for a total of 1.8 billion in 2010 but only 0.5 billion this year. In addition, the ministries will substantially cut many smaller transfer items and set up comparable cost efficiency goals as apply to the operation of government agencies. This applies to a number of fairly large transfer payments to cover operating costs, which are booked under transfers in the Treasury accounts. Appropriations for these items will be reduced by 350 million krónur this year and by 1.7 billion next year. Decisions have thus already been made for a reduction in transfer payments by a total of 3.1 billion this year and by 11.1 billion next year.

Chart 16: Transfer payments by ministry, excl. irregular items, 2009

A bill has been presented to the Althingi on fiscal measures, where the cut in transfer payments is being passed into law. This applies in particular to the benefit system of the Social Security Institute and to several special tasks under the Ministry of Justice. The changes in the benefit system take effect on July 1st and are intended to yield savings of 3.7 billion krónur on a full-year basis, equivalent to 5.7 per cent of their appropriations, of which 1.8 billion should be achieved this year. In 2008, extensive changes took place in the benefit system of the Social Security Institute that considerably improved the benefits of older people and disable persons. Spouse linkages were abolished, benefits increased, the linkage to employment income increased, a special exemption on pension benefits for disable persons was introduced as well as for capital income, and the income curtailment linkage for old-age beneficiaries was reduced. Due to difficulties in the economy, a step backward in this respect can not be avoided. These measures are temporary and take account of current economic circumstances. The entire social benefit system will be under continued review. Emphasis will be placed on minimising the adverse effects of these savings measures. A minimum cost-of-living floor will continue in effect for pension beneficiaries. Old-age pensioners will receive a special 10,000 krónur income limit from pension funds.

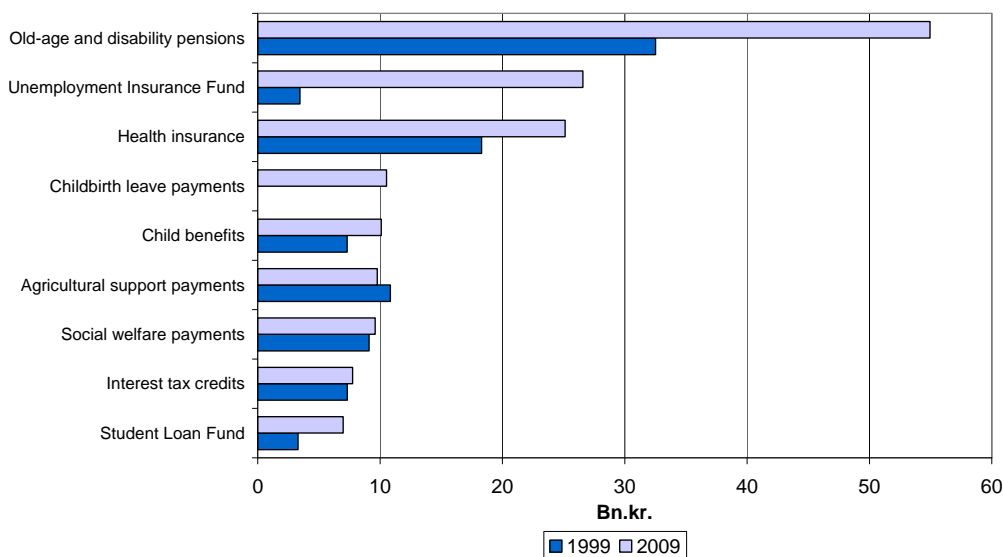
Decisions on changes in the social security benefit system have been designed to protect to conditions of the lowest-income pensioners. The minimum cost-of-living payment to pensioners decided last year currently amounts to 180,000 krónur a month for pensioners living alone and to 153,500 krónur a month for pensioners that do not receive a household supplement.

The proposed changes in the social security benefit system will thus not cut minimum benefits. The changes will affect those who receive benefits from pension funds or from employment in addition to social security benefits. Their benefits will be reduced with growing income and be abolished altogether when income reaches close to four million krónur a year.

The following amendments to the Social Security Act are being proposed:

- A reduction in the curtailment linkage to employment income for old-age pensioners for purposes of calculating old-age benefits. The curtailment linkage for disabled person remains unchanged.
- The option of choosing between the curtailment linkage and counting 60 per cent of income from employment will be abolished.
- The savings from the above two measures are estimated at 275 million krónur a year.
- Income from pension funds will have an effect on the basic pension.
- The age-related disability pension will be cut with respect to outside income.
- The savings from the two above points are estimated at 1,575 million krónur.
- The income curtailment linkage for pension benefits is increased from 38.35 per cent to 45 per cent. This change is temporary and will be effect until December 31st 2013.
- The savings from this measure is estimated at 2.5 billion at an annual rate.
- The first 10,000 krónur in income from pension funds to old-age pensioners will not be included in the calculation of minimum old-age benefits.
- Treasury expenditure resulting from this measure is estimated to increase by 700 million krónur at an annual rate.

Amongst other measures to reduce transfer payments under the Ministry of Social Affairs is the proposed reduction in childbirth benefits from a maximum of 400,000 to 350,000 krónur a month. This means that the maximum payments from the Childbirth Leave Fund will be 80 per cent of 437,500 krónur a month average income instead of 500,000 krónur before. Payments to parents with average monthly income below 437,500 krónur will remain unchanged at 80 per cent of the average. About 15 per cent of parents will be affected by this cut, based on the experience of the childbirth benefit system in recent months. About 30 per cent of men will be affected and 10 per cent of women. The savings generated from this measure are estimated to 70 million krónur this year and 350 million at an annual rate next year. This corresponds to 3.3 per cent of estimated expenditure of the Childbirth Leave Fund according to the 2009 fiscal budget.

Chart 17: Major transfer payments, 2009 prices

The above-mentioned bill before the Althingi also proposes an amendment in several laws in the area of the Ministry of Justice that are intended to reduce expenditure by 205 million this year and 430 million next year. First, the so-called congregation payments to churches and religious organisations will be reduced. Second, a maximum limit on amounts in private law suits, the legal cost of which is paid by the Treasury, will be set. Third, the reference amounts on legal fees paid by the Treasury to defence counsel for indigent defendants will be transferred from the Courts Council to the Minister of Justice and the fee amounts will be cut. Fourth, the minimum reference amounts for damage claims by crime victims paid by the Treasury will be increased.

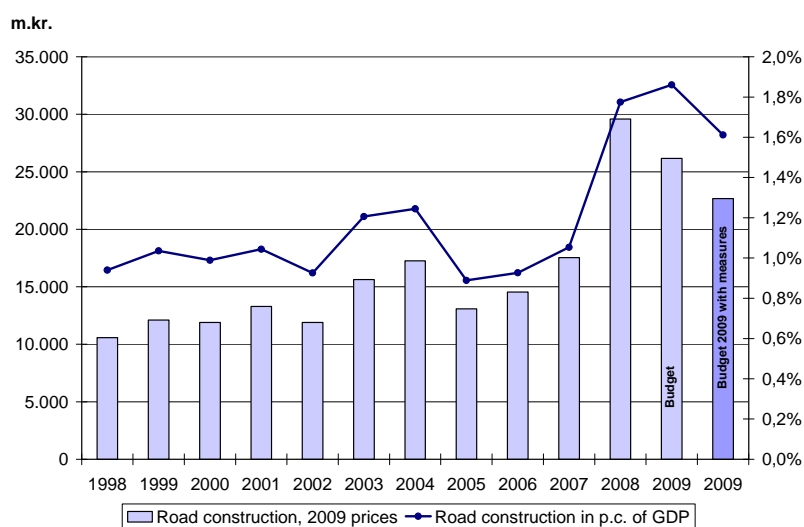
The decision of the Government to reduce transfer payments next year also includes measures to reduce health insurance payments by at least 10 per cent next year, by a total of at least 2.6 billion. The estimate for changes under the Ministry of Health should actually yield 3 billion krónur savings on a full-year basis and 440 million this year. Substantial success has been achieved in recent years in the containment of drug costs, calculated at constant prices. The intention is to increase the co-payment for an increasing number of drug classes, based on the cheapest drug in each class with a similar effect. The maximum and minimum amounts of co-payments for drugs will also be amended to encourage patients to direct their demand to generic drugs. The cost of drug expenditure is also contemplated due to the general review of drug prices that will be reviewed class by class after the inclusion of Finland in the country comparison for the Pharmaceutical Price Registry. The intention is to reduce payments to specialist physicians by 1.5 billion with renegotiated agreements that would reduce the services purchased from such physicians and paid for by the Treasury.

The Ministry of Finance intends to amend the child benefit system, leading to an expenditure reduction of 1 billion next year. Benefits currently not related to income for children under the age of seven are being considered for an income linkage in part or in full, but the move would be partially offset by increasing the rate of income curtailment in order to achieve the savings goal.

Investment expenditure

Treasury appropriations for maintenance and investment have since 1998 averaged 2.6 per cent of GDP. The average for 1998–2004 was 2.7 per cent, declining to 2.1 per cent in 2005–2007 due to the high level of power-intensive construction and the expansion of the financial system. At that time, the central government reduced its investment. These appropriations were substantially increased in 2008, in par to offset the expected sharp contraction in private investment, bringing the ratio up to 3.3 per cent. The 2009 fiscal budget contained further increases for maintenance and investment, but due to the economic collapse and the financial difficulties of the Treasury, investment plans have been cut. Despite these cuts, appropriations are at a record level, about 3.1 per cent of GDP.

Chart 18: Road construction 1998–2009



Most of Treasury spending on maintenance and investment goes to communications. In the 2009 budget, 8.9 billion are appropriated for maintenance and 34.8 billion to investment, including capital transfers, for a total of 43.7 billion. Of this amount, 27.6 billion or 63 per cent go to communications, mostly road construction. Over the ten-year period from 1998 to 2007, appropriations to maintenance and new road construction ranged from 7 to 17 billion, averaging nearly 14 billion a year at present prices. These appropriations were increased to almost 30 billion in 2008 but are slightly reduced in 2009, to 26 billion. In the decision to reduce appropriations to road construction in the 2009 fiscal budget, account was taken of the possibility of postponing the purchase of a new aircraft for the Coast Guard by one year and that it would even be leased. This did not turn out to be possible and the Treasury will have to pay 3 billion in investment costs this year for this reason, an amount that was not anticipated in the fiscal budget.

The Government has decided that investment will be reduced by 4.4 billion from the 2009 fiscal budget, of which 3.5 billion will fall on road construction. The decision also means that amounts carried over from previous years will not be put to use, since that would increase Treasury spending by an equivalent amount. Road construction is therefore estimated to amount to 1.6 per cent of GDP this year instead of 1.9 per cent. In the years 1998–2007, this ratio averaged about 1 per cent which means that in spite of the cuts, appropriations for road construction will be more than 50 per cent above average and do much to offset the contraction in private investment, including the construction of the Concert Hall, maintenance

of government buildings, increased spending on avalanche protection, increased reimbursements of VAT on construction work, etc. In this regard, there is also reason to take into account the outcome from tenders of the Road Construction Authority so far this year. Savings of 2 billion have already been achieved through more favourable offers than expected in cost estimates, thus creating increased flexibility in reducing budget limits without cutting the volume of investments to the same extent.

In addition, the Government has decided that appropriations for investment will be reduced by 10 billion krónur next year because the Treasury does not for the time being have the financial capacity to emphasise improvements in transport systems and infrastructure as in previous years. The alternative would be to irresponsibly increase Treasury debt. During the next several years when the economy is being restored and Treasury finances strengthened, it becomes inevitable that appropriations for new investment will be reduced. Efforts will be made to pay for the maintenance of public buildings and construction and infrastructure investments. The authorities have been exploring ideas in consultation with labour market partners and pension fund that they will finance large investment projects, as long as they can be paid for by user charges. Efforts are also being made to attract foreign investment to the country. If such projects come to pass, they could do more than offset the lower level of Treasury investment.

VI. The framework for the fiscal budgeting process and fiscal policy

According to article 27 of the Financial Reporting Act, the annual fiscal budget should contain a fiscal programme for the next four years, presenting an outline for the prospects of fiscal finances in light of overall economic prospects on one hand and the fiscal policy and priorities of the government on the other hand. In recent years, these medium-term programs have mainly consisted in projections of revenue prospects and expenditure commitments, based on current law and policies, in order to highlight the overall impact of fiscal finances over the next four years. However, it has been criticised, amongst others by international analysts, that these projections have focused too much on fiscal aggregates, that they have been based on rather general assumptions regarding the real growth of current operating costs and transfer payments as a whole, while not providing a sufficiently clear connection to a direct order of priorities in the expenditure paths of individual categories and projects. In recent years, when revenues were swelling rapidly, there was also a tendency to expand expenditure frames in annual reviews, with the result that the expenditure policy strayed off course. The programme included in the 2009 fiscal budget proposal placed greater emphasis on prioritising the developments of individual spending categories; in addition, expenditure frames for individual ministries were for the first time presented for the next four-years on that basis. As is well known, the entire set of premises underpinning the four-year budget frames was ruptured by the collapse of the financial system and the foreign exchange market this past autumn.

In order to achieve some success under the current demanding circumstances, it is self-evident that the public finances must be guided with a firm hand. The authorities can not permit themselves to pursue fiscal policy with as much ease as in times when revenue was growing rapidly. In addition, a range of unforeseen expenditures may arise and will have to be dealt with. For this purpose, the medium-term fiscal programme needs be strengthened considerably, both by means of greater political commitment and more effective pursuance of fiscal targets, so that the programme will serve genuinely as a firm framework for the annual budget frames for the ministries. The Ministry of Finance has sought technical assistance from the IMF in this respect and an expert mission team from the fund made a careful analysis

of the budgeting process and the fiscal framework last January. A draft advisory report was prepared on which the following proposals are based.

The Government is preparing the following reforms in order to strengthen the framework of the fiscal finances and of the medium-term fiscal programme. A further elaboration of the framework will be under consideration during the preparation of the budget proposal.

Measures to strengthen the fiscal budget process

The Government and a ministerial committee on its behalf assumes political responsibility for the main goals of the public finances, particularly regarding policies on revenue and expenditure, the Treasury balance and debt position as well as on the impact on the general economy. The policy will be discussed in the spring session of the Althingi. The main features of the fiscal policy for the next four years were already outlined above but the following points of emphasis relate to the main elements of the framework:

- In the long term, the main goal of fiscal finances is to reduce net Treasury debt, excluding state guarantees and other similar obligations to 60 per cent of GDP.
- The Treasury will not take on further commitments arising from the bank collapse than those already assumed under the Government's agreement with the IMF.
- Revenue, including irregular revenue, over the period in excess of the projection will be used to improve the Treasury balance, unless it proves unavoidable to use a part thereof for unforeseen expenditure, such as due to unemployment.
- During the next weeks and months, a four-year frame budget will be drawn up, on the basis of a prioritised revenue and expenditure policy in accordance with the plan to restore balance to Treasury finances, as outlined in this report.
- The four-year total expenditure frame shall be binding and include projected wage-, exchange rate- and price changes. The price assumptions incorporated into the total frame shall not be deviated from for the first two years after they have been set. Such deviations will have to be met with countermeasures. However, the relevant expenditure items may come up for revision if prospective price deviations will be in excess of 1.5 per cent. Wage-, exchange rate- and price assumptions of the plan will be revised for the third and fourth year of the expenditure frame.
- Only certain irregular items, such as interest payments, unemployment compensation, the Municipal Equalisation Fund, tax claims written off, public employee pension fund commitments and capital income tax paid by the Treasury, will be exempted from the frames. Some flexibility will have to be incorporated into the frames, in the form of an unallocated contingency fund, to meet unforeseen expenditure, amounting to about 1-2 per cent of spending in years 1 to 4. In other instances, all decisions and deviations will have to be accommodated within the budget frames.
- The expenditure frames of ministries will be binding and can not be revised retroactively, such as by bringing bills or other issues to the Cabinet, unless they are offset by an equivalent spending cut in other categories.
- In accordance with the limited role of supplementary budget stipulated in the Financial Reporting Act, it will not allow for appropriations to new initiatives, increased activities or operating deficits of agencies in excess of frames already set.

- The implementation of the budget will be strengthened considerably . Drawing on future appropriations will not be permitted. Offsetting measures will be required in all such instances.
- The minister in question is responsible for reporting and explaining to the budget committee of Althingi if deviations from the budget arise.
- The authority to carry over unused appropriations from previous years will be curtailed. Certain large accumulated surpluses carried forward between years will be rescinded. In general current operations, the unspent surpluses of agencies that can be carried over will be limited to 4 per cent of their turnover of the previous year, as of and including 2008. A 10 per cent ceiling will also be placed on unspent appropriations accumulated and carried over in current operations for the longer term.
- The extensive earmarking of government revenue for particular projects and agencies shall be abolished. Such earmarking has been subject to increasing criticism, including from the Althingi budget committee. The aim thereby is to better ensure the fiscal legislative powers of the Althingi, strengthen the fiscal management of ministries, prevent automatic expenditure changes and thereby reduce expenditure laxity and fluctuations in the finances of agencies receiving such earmarked revenue. This arrangement has been in direct conflict with the fiscal management by means of budget frames that aims at keeping expenditure within pre-determined expenditure frames, in cases when fiscal budget spending limits of agencies are amended *ex post* in the final budget accounts in accordance with the final accounting of earmarked revenue for the past year.
- All legislative proposals and regulations that can affect Treasury expenditure must be cost-assessed by the budget department of the Ministry of Finance before being introduced to the Government and proposed to the Althingi, or before a regulation is published in the Government Gazette.
- All contracts on the purchase of services or operating tasks according to the authorisation in Article 30 of the Financial Reporting Act shall be drawn up in accordance with Regulation no. 343/2006 regarding contracts on operating tasks concluded by ministries and agencies for a longer period than one year. This means that a preliminary assessment must be made for the purpose and efficacy of the task before preparations for the contract are made. The assessment must be reviewed by the budget department of the Ministry of Finance that will also review the draft contract at a later stage before signature.
- Individual ministers may not conclude agreements or issue statements that include expenditure commitments unless they have been especially incorporated in appropriations of the existing fiscal budget and that the Minister of Finance has agreed to the commitment.
- The National Audit Office will be asked to report on whether the fiscal policy targets were achieved after each budget year.
- Proposals will be drafted in cooperation with the budget committee of the Althingi to the effect that debates and votes on the fiscal budget will be amended in line with frame budgeting: the first debate should be confined to the goals of fiscal policy and the main aggregates, and be followed by a vote on the budget frames for the ministries. After that there will be debates concerning the appropriation of funds for individual spending categories and projects.

- Local governments are committed to ensuring that their financial balance, on the whole, will progress in accordance with this plan to achieve a surplus in the public finances during the period that it covers. In this way, it will be ensured that the current operation of the local government will be in balance at the end of the period and that they adopt fiscal rules aimed at achieving appropriate targets for their fiscal position and prevents further debt accumulation in accordance with the objectives of the plan.
- The budgeting process will adhere more detailed procedural rules that will be adopted this coming August in order to prevent fiscal finances from deviating from their intended course. The guidelines will, firstly, be intended to reinforce the organisation and procedures of frame budgeting and, secondly, to induce expenditure restraint by stipulating in advance how deviations from projections and expenditure frames will be dealt with.