

One of the main objectives of the fiscal budget proposals for 2012 and 2013 was to achieve a surplus on the overall balance in the amount of 1% of GDP in 2014. According to the budget proposal for 2014, there will be an overall surplus during the year, but it will be much smaller, or just under 0.1% of GDP. The medium-term plan accompanying the budget proposal also deviates considerably from those accompanying the 2012 and 2013 budget proposals. The current medium-term plan does not include the Government's strategy for fiscal policy but is merely a simple extrapolation for the next few years. The proposal assumes that the primary balance will be positive by 56 b.kr., or 2.9% of GDP, in 2014, an improvement of 1.5 percentage points over the previous year. If this is borne out, the improvement in the primary balance from 2009 through 2014 will total 9.5% of GDP (see Section V).

#### **Overall balance slightly positive on an accrual basis but negative on a cash basis**

The budget proposal provides for an overall surplus amounting to 0.1% of GDP, measured on an accrual basis. On a cash basis, however, the balance will be negative by some 10 b.kr., which means that expenditures in excess of revenues must be funded. The deficit is small enough, however, that it can be funded with the Treasury's deposits in the Central Bank.

In order to achieve this year-on-year improvement, the Government aims, as it has in recent years, to pursue a mixed approach based on increased revenues and reduced expenditures. Special measures will total an estimated 1% of GDP. In krónur terms, measures aimed at improving Treasury performance total 19 b.kr., with 7 b.kr. in revenue-generating measures and 12 b.kr. in expenditure cuts.

#### **Box V-1**

### **National budget proposal for 2014**

**Table 1 Estimated Treasury performance 2014-2017 according to the 2014 medium-term budget plan**

B.kr.	2014	2015	2016	2017
Total revenues	587.6	606.1	624.6	663.7
Tax revenues	534.3	551.4	566.5	600.7
Total expenditures	587.1	603.5	624.3	644.7
Operating expenses	239.8	246	254.6	263.5
Cost of capital	76	80.2	86.1	89.3
Transfer outlays	241.4	248	255.2	264.6
Maintenance	8.7	8.8	9	9.3
Investment	21.2	20.6	19.4	18.1
Overall Treasury balance	0.5	2.6	0.3	19
as % of GDP	0	0.1	0	0.8
Improvement from prior year	1.8	0.1	-0.1	0.8
Primary revenues	567.1	584.6	600.4	635.1
Primary expenditures	511.1	523.4	538.3	555.4
Primary Treasury balance	55.9	61.2	62.2	79.7
as % of GDP	2.9	3.1	2.9	3.6
Improvement from prior year	1.5	0.1	-0.1	0.6

Source: Ministry of Finance and Economic Affairs.

#### **2014: the revenues side**

According to the budget proposal, increased taxes and excise taxes will generate 8.9 b.kr. in increased revenues, while lower dividend payments and fishing fees will reduce revenues by 4.4 b.kr. Revenues are estimated to increase by 27.4 b.kr. due to growth in nominal GDP during the year. As a result, revenues will increase by nearly 32 b.kr. from the year-2013 estimate.

It is assumed that tax bases such as individual income tax and investment tax will change but that the corporate tax rate will remain unchanged. It has also been proposed that changes be made in indirect taxes in coming years, but the budget proposal does not include any details. The payroll tax will continue to decline. The following tax changes are planned:

- The combined percentage of employers' payroll tax and Wage Guarantee Fund contributions will decline by 0.1 percentage points. The reduction specifies as follows: the employees' payroll tax will decline by 0.6 percentage points and the contribution paid to the Wage Guarantee Fund as a safeguard against bankruptcy will decline by 0.25 percentage points, while the general payroll tax will increase by 0.75 percentage points. Treasury revenues will decline by an estimated 1 b.kr. next year because of these changes. Furthermore, the payroll tax is to be reduced by an additional 0.24 percentage points in 2015 and 2016 combined, to 7%.
- The financial administration tax levied on financial and insurance firms' wage payments will be reduced from 6.75% to 4.5%, and revenues will decline by an estimated 1.1 b.kr. as a result.
- The so-called bank tax levied on credit institutions' and deposit institutions' total liabilities will increase from 0.041% to 0.145%. In addition, the legislation on this tax is to be amended so as to include legal entities in winding-up proceedings. Treasury revenues will increase by an estimated 14.3 b.kr. in 2014 as a result of these measures.
- The personal income tax is to be reduced by lowering the tax rate in the middle bracket by 0.8 percentage points, from 25.8% to 25%. This measure is estimated to reduce Treasury revenues by as much as 5 b.kr. in 2014.
- The tax-free threshold for financial income tax on individuals' investment income will be raised from 100,000 kr. to 125,000 kr., but the change will not affect revenues until 2015.
- Value-added tax on disposable paper diapers will be reduced to the lower rate. Value-added tax revenues will decline by an estimated 200 m.kr. as a result.
- Stamp fees on loan documents will be cancelled, and stamp fees on asset transfer agreements will rise. The impact on revenues is expected to be insignificant.

Table 2 Year-on-year revenue changes

	B.kr.
Estimated revenues 2013	555.6
<i>Year-on-year revenue changes</i>	
Increase in GDP between 2013 and 2014	27.4
Expansion of bank tax (financial entities in winding-up proceedings)	11.3
Increase in bank tax (from 0.041% to 0.145%)	2.9
Reduction in individual income tax; middle bracket lowered from 25.8% to 25%	-5.0
Reduction in financial administration tax from 6.75% to 4.5%	-1.1
Payroll tax reduced (from 7.34% to 7.24%)	-1.0
VAT on diapers reduced to lower tax bracket	-0.2
Excise taxes	2.0
Fishing fees	-0.6
Dividends	-3.8
Estimated year-2014 revenues according to budget proposal	587.6
Increase from 2013 estimates	31.9

Source: Ministry of Finance and Economic Affairs.

Table 2 gives a summary of year-on-year changes in revenues. Revenues from expected dividend payments decline by 3.8 b.kr., and revenues from fishing fees decline by roughly 600 m.kr. because of the changes made to the fee structure at the summer legislative session. Alcoholic beverage tax, motor vehicle tax, per-kilometre charges, and fuel taxes are expected to rise by about 3%, in line with the price level, and generate additional revenues in the amount of 2 m.kr.

#### 2014: the expenditures side

Treasury expenditures are expected to decline by 12 b.kr., or 0.6% of GDP, in 2014 as a result of special consolidation measures. The consolidation requirements equal 1.2% of turnover. In 2015-2017, consolidation is expected to be broadly similar, at around 1%, with the ministries expected to cut expenditures by about 5 b.kr. per year through special consolidation measures.

Of the 12 b.kr. expenditure reduction estimated for 2014, about 3.6 b.kr. are turnover-related consolidation measures and 2.6 b.kr. are special consolidation measures. The most important of these is the abandonment of plans for new road construction (0.8 b.kr.) to offset tunnel construction projects. Finally, a cutback of 5.8 b.kr. will be achieved by abandoning projects that are not yet underway or are in early stages and that the Government has not yet pledged to undertake. The lion's share of that reduction (4.5 b.kr.) is due to various projects included in the Investment Plan for 2013-2015, for which the previous Government provided budgetary allocations in the 2013 Budget but whose financing is no longer secure. An economic breakdown of the consolidation measures can be found in Table 3.

If these plans materialise, the scope of consolidation measures

**Table 3 Consolidation measures, economic breakdown**

<i>Accrual basis, b.kr.</i>	<i>Reduction 2014</i>	<i>Turnover 2013</i>	<i>Reduction %</i>
Operations	-3.1	220.1	-1.4
Transfers	-4.9	229.5	-2.1
Maintenance and investment	-4.0	27.8	-14.3
Total	-12.0	477.4	-2.5

Source: Ministry of Finance and Economic Affairs.

will be greater next year by 1 percentage point of turnover, according to the plans outlined in the budget proposal for this year. To place the proposed consolidation measures for 2014 into the context of the post-crisis period, consolidation peaked in 2010 at 3.6%, as opposed to the 0.6% estimated for next year.

The total increase in expenditures over the 2013 fiscal budget amounts to 4.1 b.kr., which stems primarily from changes in expenditure obligations for various Treasury-operated systems (14.1 b.kr.), whereas changes in wages, exchange rates, and prices since 2013 total 10.6 b.kr. Finally, the Treasury's interest expense is estimated to decline by about 8.7 b.kr., in part because it is assumed that the bond issued to the Central Bank of Iceland for its assumption of failed financial institutions' collateralised and overnight loans will be lengthened and the terms amended. If the amendments should take effect, the Treasury's interest expense would decline by about 10.7 b.kr. per year. The entire reduction does not show as a reduction of interest expense, as the plans set forth in the 2013 National Budget, to convert from indexed interest to non-indexed interest, did not materialise.<sup>1</sup> Increases on the expenditures side therefore

1. Interest on a non-indexed bond is recognised in the Treasury's profit and loss account, whereas if the loan is indexed, real interest is recognised in the profit and loss account and the indexation as revaluation in the balance sheet.

total 24.7 b.kr., but they are offset by the above-described consolidation measures amounting to 12 b.kr. and the 9 b.kr. reduction in interest expense, leaving a net increase of 4 b.kr. between years. Changes in expenditures from the 2013 National Budget to the 2014 budget proposal are itemised in Table 4.

**Table 4 Changes in expenditures between 2013 and 2014**

<i>Accrual basis</i>	<i>M.kr.</i>
Expenditures according to 2013 National Budget	583,028
<i>Year-on-year expenditure changes</i>	
Pension insurance and social assistance, statutory amendments and contractual expenditures	5,039
Housing Financing Fund, temporary yearly capital contribution 2013-2017	4,500
Health insurance (excess expenditures)	1,538
Contribution to wage equality campaign in 2014	1,490
Infrastructure development due to Bakki in Norðurþing	1,477
Pension insurance and social assistance, year-on-year increase in number of recipients and excess expenditures 2013	1,000
Increase in Iceland's contribution to the EFTA Development Fund	749
Increase in the Treasury contribution for Norðfjarðargöng tunnel	670
Reinforcement of general law enforcement	500
Mortgage interest subsidies, revised estimate based on 2012 and 2013 results	-2,000
Unemployment benefits, temporary campaigns conclude and unemployment reduced	-1,790
Child benefits	-393
Contribution to equalisation of moving costs expires in 2014	-197
Change in formulation of broadcasting fee delayed until 1 January 2016	-500
40 nursing home spaces at Vífilstaðir	350
Increased contributions to the University of Iceland Centennial Fund	300
Increase in ceiling on payments to parents on maternity/paternity leave	400
Other committed expenditures	9,807
Total expenditure increases	22,940
Cancelled capital contributions (e.g., equipment purchases for FSA and LSH, -700 m.kr.)	-7,863
Expenditures financed with State revenues	-951
Consolidation measures	-11,968
Primary expenditures 2014 at 2013 price level	500,510
Effects of 1 March 2013 wage increases that apply through 2014	863
Wage supplements due to 2011 wage agreement with medical transport workers	41
Wage, exchange rate, and price level changes in the 2014 budget proposal	9,719
Total wage, exchange rate, and price level changes	10,623
Primary expenditures 2014 at 2014 price level	511,133
Change in interest expense (including -10,700 m.kr. due to amendment of Central Bank bond)	-8,713
Total 2014 expenditures according to national budget proposal	587,096

Source: Ministry of Finance and Economic Affairs.

### **New fiscal framework expected in new legislation on public finances**

A bill of legislation intended to create a stronger foundation for fiscal policy is to be presented before Parliament in November. The bill was drafted following consultation with the International Monetary Fund (IMF) on possible ways to strengthen the fiscal framework. The main objective is to ensure Parliamentary involvement in setting government and public sector finance targets for use in budget preparation. With improved planning and increased discipline in budget implementation, the outcome of each year's national budget should be the same as that in the central government accounts. The possibility of adopting fiscal rules to anchor public sector finances five years ahead is under

consideration. It is assumed that fiscal policy will be defined in the discussions during the upcoming spring Parliamentary session and will be reflected in summer budget preparation work and autumn Parliamentary discussions on the fiscal budget. Also planned is the establishment of an independent three-member fiscal council that will supervise and give commentary on fiscal policy implementation.<sup>2</sup>

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2. Such fiscal councils have been established in numerous countries. Sweden, for instance, has operated a fiscal council for years with excellent results. See, for example, International Monetary Fund, *Case Studies of Fiscal Councils – Functions and Impact*, July 2013.