

Box V-1

Bill of legislation on fiscal framework reform

The revision of the Government Financial Reporting Act, no. 88/1997, has been on the agenda for some time. During the implementation of the Government-IMF economic programme, it became evident that the statutory framework needed reform. The authorities approached the Fund in spring 2011 and requested a technical appraisal of Iceland's fiscal policy framework, together with comments and recommended improvements.

Before the Government Financial Reporting Act entered into force, legislation on the topic was fragmentary. The Act represented Iceland's first comprehensive legislation on Government finances, including budget preparation and implementation, central government accounts, Treasury borrowing, and financial reporting. For instance, major changes were made to the presentation of fiscal budget proposals, including the stipulation that the National Budget be presented on an accrual basis rather than on a cash basis.

The statutory framework for municipal finances has also been improved since the financial crisis struck. The new Local Government Act, no. 138/2011, which entered into force on 1 January 2012, provided for more stringent fiscal rules, cooperation on economic affairs, and supervision. That Act set forth two fiscal rules: combined revenues and expenditures in Parts A and B of the consolidated municipal accounts must balance during each three-year period, and consolidated liabilities and obligations are limited to 150% of revenues.

Comprehensive fiscal policy framework

The bill of legislation currently before Parliament entails a comprehensive framework for fiscal policy, which is broader in scope than the current Government Financial Reporting Act. The new legislation is to extend to the entire public sector, including all entities wielding State and municipal authority and all companies with State or municipal ownership of 50% or more. The Minister is entrusted with ensuring regular, formal consultation with the Association of Local Authorities in Iceland concerning the formulation of the fiscal policy and plan.

Enhanced clarity in fiscal policy

The fundamental values of policy formation are defined as sustainability, prudence, stability, steadfastness, and transparency. These basic values imply emphases and criteria that can easily become tenuous and overly generalised in practice, but they can nonetheless acquire legitimacy in legislative implementation – for instance, in the form of specific fiscal rules. Fiscal policy formation entails the creation, by the newly elected Government, of policy covering a period of at least five years and extending to both State and municipalities. The main emphasis in the fiscal policy shall be on the general government – that is, Part A of State and municipal accounts. Objectives shall also be set for the scope, performance, and evolution of the balance sheets of the public sector as a whole (Parts A, B, and C of the Treasury accounts and Parts A and B of the municipal accounts). Fiscal policy must take into account a far greater number of requirements than the medium-term plan according to the current legislation. The medium-term plan for central government finances covers a horizon of three years following the upcoming fiscal year. But the requirements are not clear, and they could entail a simple statistical extrapolation instead of a strategic fiscal path. On the other hand, the formulation of a strategic fiscal path is the cornerstone of the new bill of legislation and the main fiscal rule. The fiscal rule centres on procedures for the formulation of fiscal policy and entails the incorporation of a so-called procedural fiscal rule into the law. According to the procedural fiscal rule, the authorities shall follow a clear, legislated procedure when formulating fiscal policy;

for instance, by setting regular targets defining numerical fiscal rules concerning general government debt or permissible operational deficits as constraint when presenting the fiscal policy and plan.

As soon as possible after it has been formed, the Government must formulate a fiscal policy and submit it to Parliament as a proposed parliamentary resolution. The aim is to increase parliamentary monitoring of policy formulation and implementation. The fiscal plan, which must be based on an approved fiscal policy, is intended to explain the measures and channels through which fiscal policy objectives will be achieved. Each year, the Minister of Finance shall present a fiscal plan to Parliament at the spring legislative session in the form of a parliamentary resolution. A new, independent fiscal council (further described below) is then intended to appraise the implementation of the policy. The fiscal council's opinions must be made public.

New requirements for fiscal policy and plan

The fiscal rule in the bill of legislation is twofold. On the one hand, objectives for the evolution of public sector finances must be set in accordance with a predetermined procedure, and on the other, strict conditions entailing numerical targets for general government performance and debt must be adhered to. The fiscal policy conditions are set with the following three fiscal rules:

1. The overall result over a five-year period must always be positive, and the annual deficit may not exceed 2.5% of GDP.¹
2. Total debt, excluding pension obligations and accounts payable, but including cash balances and deposits, may not exceed 45% of GDP.²
3. If the debt ratio rises above 45%, the excess portion must decline by an average of at least 5% (1/20) per year in each three-year period.³

With these fiscal rules and the procedural fiscal rule, an attempt is made to lay the foundations for well-defined procedures for fiscal policy formulation. Clear debt and performance criteria are set on the basis of defined procedure and numerical targets, which should impose significant restraint on the legislative and executive authorities.

Fiscal council

It is considered important to engage independent experts to conduct an impartial assessment of fiscal policy implementation. As a result, it is proposed that an independent fiscal council assess whether the fiscal policy and fiscal plan are in line with the fundamental values and fiscal rules in the bill of legislation. To enhance transparency, the

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1. Fiscal policy objectives and requirements shall only be revised under extraordinary circumstances, such as a national catastrophe or a severe economic shock.
 2. This definition of debt is an approximation of the conventional definition of net debt, where all monetary assets are deducted from liabilities. Here, however, only cash and readily disposable monetary assets are deducted. This definition is used in part because the Treasury has taken account of loans taken, for example, to expand the Central Bank's foreign exchange reserves. Those funds have not been used for operations and are available for repayment of the loans taken. This definition gives a clearer picture of how much debt must be paid down with cash from operations.
 3. Based on the current debt position and unchanged nominal GDP, nominal debt must be reduced by about 17 b.kr., or approximately 1% of GDP, per year. General government interest expense amounts to 5% of GDP, which requires a primary surplus of the same amount in order to ensure that the overall balance does not show a deficit. Assuming a 5% primary surplus and 5% growth in nominal GDP, the debt ratio will decline by 3.3% of GDP if the primary surplus is allocated to interest payments. In order to reduce the debt ratio according to the third item under conditions of 5% growth in nominal GDP, a primary surplus of 2.8% of GDP is sufficient.

results of this assessment shall be made public. Such fiscal councils can be found in many of Iceland's neighbouring countries, including Denmark, the Netherlands, and Sweden.⁴

Defining budgetary authorisations and reducing the number of budget items

If the bill is passed, fiscal budget proposals will be presented in a new way, based on Parliamentary authorisation of budgetary allocations to various fields and functions, plus a contribution to a general precautionary fund, instead of a large number of budget items. This is a fundamental change from previous practice. The bill assumes that Government ministers will be entrusted with defining the relevant ministries' fields and functions, upon receiving an opinion from a financial reporting council.⁵ Redefining budgetary authorisations aims to support substantive discussion of the Government and Parliament's policy on various fields and the total contribution to each of them, instead of a discussion of budgetary allocations to individual institutions and projects.

Roles and responsibilities for budget preparation and implementation

The purpose of the Act is to better define the roles and responsibilities of those involved in budget preparation and implementation. Since 1992, this work has been carried out according to a so-called fiscal budget framework. When the framework was introduced, the aim was that all participants in the budget process would base their efforts on Government policy, which entailed deciding the expenditure framework, and the ministries would be responsible for the necessary prioritisation and selection of tasks. These objectives have not been achieved in full. Under the proposed arrangement, Parliament shall take a binding position on budgetary allocations to various fields and functions, and instruct the relevant ministers to divide the allocations among individual institutions and tasks, budget items, in a separate appendix to the fiscal budget proposal. When the fiscal budget is implemented, each minister must report to the Government and the Parliamentary Budget Committee on the implementation of the budget and the financial performance of the Treasury as often as needed, and at least quarterly. The Parliamentary Budget Committee – and other committees, as appropriate – may request information from each minister concerning budget implementation within the scope of the minister's field.

Conclusion

The Icelandic authorities have often had difficulty with budget implementation and adherence to fiscal rules. The new bill of leg-

4. In general, a fiscal council is defined as an independent public agency whose purpose is to strengthen the Government's commitment to sustainable public sector finances through, for instance, appraisals of the fiscal policy and plan, with reference to official policy and its implementation. Furthermore, many fiscal councils issue opinions on macroeconomic assumptions in performance forecasts and the methodologies used for forecasting. The performance of such fiscal councils is discussed, for instance, in Debrun, Kinda, Curristine, Eyraud, Harris, and Seiwald (2013), "The functions and impact of fiscal councils", *IMF Policy Paper*, July 2013, Curristine, Harris, and Seiwald (2013), "Case studies of fiscal councils – Functions and impact," *IMF Policy Paper*, July 2013, and Debrun and Kinda (2014), "Strengthening post-crisis fiscal credibility – Fiscal councils on the rise. A new dataset", *IMF Working Paper*, no. 14/58.

5. A State Financial Reporting Council for Part A of Treasury accounts shall comprise six members appointed for a term of five years at a time. The Director of the Financial Management Authority (FJS), the Director of Statistics Iceland, and the Auditor General shall be members of the council by virtue of their positions. The other three members shall be appointed by the Minister, and one of them must be a chartered auditor. The role of the State Financial Reporting Council is to take decisions on the implementation of financial reporting standards and issues related to them, and other matters of importance for State accounting.

islation is intended to improve the statutory framework for public sector finances, as it draws on the lessons learnt in recent decades, both in Iceland and in other countries. In order to ensure that budget preparation was based on the best available information, the authorities consulted IMF experts with broad-based expertise and international experience of the topic. A mission from Sweden also provided valuable counsel. The new bill of legislation is a vast improvement over the current legislation. It assumes the use of a procedural fiscal rule that can be flexible within the limits of numerical fiscal rules. The change is also in line with points long emphasised by international institutions such as the OECD and the IMF: that under normal circumstances, changes in public sector performance aimed at affecting demand should primarily take the form of automatic fiscal stabilisers and should be within the scope of formal, well defined fiscal rules.⁶

In order for a formal fiscal rule to have the desired effect on the economy, it must be sufficiently credible and must be structured so as to promote disciplined fiscal policy. It must also be flexible enough to respond to unforeseen shocks. Furthermore, it should be borne in mind that, based on the experience gained from the current legislation, even though it is necessary to amend the letter of the law, amendment alone is not necessarily sufficient; it is also necessary to adopt new procedures and work habits in the spirit of the new legislation. If such changes are implemented successfully, however, they will represent a significant step forward in Iceland's fiscal policy, which could prove to be a cornerstone of disciplined, efficient economic policy.

6. See, for example, OECD (1999). "The size and role of automatic fiscal stabilisers", *OECD Economic Outlook* 66, 137-149. See also Central Bank of Iceland (2012). "Iceland's Currency and Exchange Rate Policy Options", *Special Publication* no. 7, Chapter 15.