

The medium-term fiscal plan included with the national budget proposal for 2015 assumes a balanced budget through 2018 and a stronger performance than was provided for in last year's budget proposal. The medium-term plan is summarised in Table 1. The budget proposal provides for an overall surplus amounting to 0.2% of GDP on an accrual basis in 2015. On a cash basis, however, the overall balance will be negative in the amount of 6.5 b.kr.

According to the assumptions underlying the budget proposal, the Treasury debt-to-GDP ratio will decline markedly in coming years, due primarily to growth in nominal GDP. According to the 2015 budget proposal, Treasury performance in 2014 will be much stronger than was assumed in the National Budget for the year. A surplus of 2% of GDP is now expected instead of the 0.1% provided for in the Budget. The budget proposals for 2012 and 2013 assumed a surplus of 1% of GDP in 2014. The reason for the considerable improvement is that dividend payments from the Central Bank of Iceland and Landsbankinn were much larger than previously estimated. In the budget proposal for 2015, the Treasury will still rely on dividends from these sources in order to generate a surplus, but the dividends will be considerably smaller, or about 15 b.kr., as opposed to this year's 57 b.kr.

Box 2

National budget proposal 2015

Table 1 Estimated central government performance through 2018

B.kr.	2015	2016	2017	2018
Total revenues	644.5	665.1	701.1	715.5
Tax revenues	591.1	609.2	644.2	656.7
Total expenditures	640.5	658.0	677.0	679.4
Operating expenses	258.0	269.2	280.1	290.4
Interest	84.2	84.3	83.8	86.7
Transfer outlays	249.8	259.0	268.8	278.1
Maintenance	9.2	9.4	9.7	9.9
Investment	39.3	36.1	34.7	14.4
Overall Treasury balance	4.1	7.1	24.1	36.0
as % of GDP	0.2	0.3	1.1	1.5
improvement from prior year	-1.8	0.1	0.7	0.4
Primary revenues	626.3	646.6	682.1	696.0
Primary expenditures	556.3	573.7	593.2	592.7
Primary Treasury balance	70.1	72.8	88.9	103.3
as % of GDP	3.5	3.4	3.9	4.3
improvement from prior year	-1.8	-0.1	0.5	0.4
Interest income	18.2	18.5	19.0	19.4
Interest expense	84.2	84.3	83.8	86.7
Financing balance	-66.0	-65.8	-64.8	-67.3
as % of GDP	-3.3	-3.1	-2.8	-2.8

Source: Ministry of Finance and Economic Affairs.

Economic developments year-to-date have been more favourable than was assumed in the 2014 National Budget. Domestic demand, both investment and consumption, is stronger than previously estimated. This has made a positive impact on Treasury revenue generation, but the reduction in revenues resulting from the tax system changes approved at the spring legislative session counteract this. The main economic assumptions underlying the new budget proposal are broadly in line with the baseline forecast in this *Monetary Bulletin*.

The estimates of Treasury debt contained in the budget proposal assume that developments will be more favourable than previous plans provided for, due in part to plans to sell a 30% stake in Landsbankinn in 2015 and 2016 and use the proceeds to pay down

debt. It is also assumed that only half of the Treasury's USD 1 billion bond maturing in 2016 will be refinanced and that the Central Bank's foreign exchange reserves will be used to pay the remainder. In addition, it is assumed that major steps will be taken to lift the capital controls in coming quarters and that it will therefore be possible to repay the loans from the International Monetary Fund (IMF) from the foreign reserves. If this assumption is not borne out, these obligations must be refinanced, which will increase Treasury debt. In nominal terms, gross debt at year-end 2018 is estimated at 1,418 b.kr., or 59% of GDP, as opposed to 1,489 b.kr. (79% of GDP) at the end of 2014.

The budget proposal assumes that domestic and foreign interest rates will rise somewhat and that the króna will depreciate, eroding the interest balance over the time horizon for the medium-term plan. The deficit is estimated to increase from 60 b.kr. this year to 65-67 b.kr. in 2015-2018. The increased deficit in the interest balance is due also to the conversion of the Treasury bond in the Central Bank from an indexed to a non-indexed bond. Furthermore, interest income on Treasury accounts with the Central Bank will decline 4-10 b.kr. per year in comparison with the previous estimate, owing to a revaluation of some of the accounts.¹ Paying half of the aforementioned loan in US dollars will save the Treasury about 1.6 b.kr. in interest expense in 2016 and 3.2 b.kr. per year in 2017 and 2018. Furthermore, the debt reduction achieved with the sale of the State's 30% holding in Landsbankinn will save the Treasury an estimated 3 b.kr. in interest expense in 2016 and just over 4.5 b.kr. [per year] in 2017 and 2018. However, dividends from Landsbankinn will decline as a result.

The revenues side

The changes from previous estimates on the revenues side are due to changes in the tax system and re-evaluation of tax revenues on the basis of the new macroeconomic forecast underlying the budget proposal. Estimated total revenues for 2015 increase by 38.5 b.kr. from the estimates in the 2014 fiscal budget proposal, to a total of 644.5 b.kr. The main sources of increased revenues are the changes in the bank levy, approved in December 2013 (23 b.kr.), re-evaluation of tax bases (18 b.kr.), and an increase in dividends on the State's holdings in the commercial banks (4.2 b.kr.). On the other hand, revenues decline by 1.7 b.kr. because of changes in the fishing fee system, the effects of measures related to household mortgage debt write-downs. Because of changed assumptions concerning interest income, revenues decline by 3.9 b.kr. Furthermore, revenues will decline by 3.7 b.kr. because of planned changes to the value-added tax system and the cancellation of general excise taxes. Other changes to the tax system will reduce revenues by another 0.9 b.kr. The general tax base increase according to the new assumptions in the macroeconomic forecasts contained in the budget proposal would have increased tax revenues by 33 b.kr., other things being equal, but because of the above-described measures, revenues will rise by only 17.3 b.kr. in nominal terms, or by 3% year-on-year. Tax revenues will shrink in real terms by 0.4% and will decline as a share of GDP from 30.5% to 29.2%. After adjusting for irregular items, total revenues increase by 4.5 b.kr. year-on-year but decline relative to GDP by 2 percentage points, to 31.6%. The revenue estimates are summarised in Table 2.

1. The financial interactions between the Central Bank and the Treasury are discussed in Section V of *Monetary Bulletin* 2014/2.

Table 2 Summary of Treasury revenue estimates on an accrual basis, 2014-2018

% of GDP	2014	2015	2016	2017	2018
Total revenues	35.5	31.9	30.9	30.7	29.6
Tax revenues	30.5	29.2	28.4	28.4	27.3
Primary revenues	34.6	31.0	30.0	29.9	28.8
Interest income	1.0	0.9	0.9	0.8	0.8
Revenues net of irregular items ¹					
Total revenues	33.6	31.6	30.6	30.4	29.3
Tax revenues	30.0	29.0	28.2	28.1	27.1
Primary revenues	32.7	30.7	29.7	29.6	28.5

1. Irregular items are the Treasury's investment income, revenues from asset sales, capital gains, and revaluation of ownership shares. Also classified as an irregular item in 2014 is the capitalisation of an estimated 26 b.kr. for the reduction of the Treasury's debt to the Central Bank, in connection with the amendment of the Central Bank Act and the changes in the financial interactions between the two institutions.

Source: Ministry of Finance and Economic Affairs.

The combined effect of the various tax cuts approved at the last legislative session will be to reduce revenues by 16.2 b.kr. once the cuts have taken full effect in 2016. The reduction in the fishing fee will first surface in full during fiscal year 2015, as will the 1% price list reductions passed at the spring 2014 legislative session. The estimated reduction in revenues from fishing fees from 2014 onwards will total just under 2 b.kr. The payroll tax will decline from 7.59% to 7.49% in 2015 and then to 7.35% in 2016. The effect of revoking the exemptions previously enjoyed by financial institutions in winding-up proceedings from 2014 onwards will taper off, thereby reducing revenues from the bank levy from 39 b.kr. this year to 4.5 b.kr. by 2018. Table 3 summarises the tax system changes since the autumn 2013 legislative session.

Table 3 Summary of revenue effects of tax system changes in autumn 2013 during the period 2015-2018

B.kr.	2015	2016	2017	2018
Tax changes from autumn 2013 legislative session	29.5	15.3	15.2	-7.9
– increase in bank levy	38.0	25.9	26.1	3.3
– various tax reductions	-8.6	-10.6	-10.9	-11.1
Tax reductions from spring 2014 legislative session	-5.5	-5.6	-4.6	-2.1
Tax changes in 2015 budget proposal	-0.5	0.7	0.2	-0.3
Total tax changes	23.5	10.4	10.8	-10.2
– increase in bank levy	38.0	25.9	26.1	3.3
– other	-14.6	-15.5	-15.3	-13.5
Previous measures				
Revocation of wealth tax and energy tax	-10.5	-12.7	-12.8	-12.9
Tax changes and tax revocation combined	13.0	-2.4	-2.0	-23.1
– other than bank levy	-25.1	-28.2	-28.0	-26.4

Source: Ministry of Finance and Economic Affairs.

The expenditures side

The austerity measures implemented in 2009-2013 required more operational streamlining than had been previously done based on the volume change in public consumption. The authorities have stated that they do not think it advisable to consolidate much further, as direct consolidation measures account for only 3.4 b.kr. according to the budget proposal, or 0.6% of primary expenditure, as opposed to 28 b.kr. in 2011. Central government debt remains the principal problem. Debt can be paid down with operating surpluses

and with asset sales, and the current Government has plans to sell assets to reduce debt.

According to the budget proposal for 2015 and the revised estimates for 2014, primary expenditures will total 556 b.kr. in 2015, an increase of less than 1% year-on-year in nominal terms and a contraction of 2% in real terms, excluding wage and price increases. They are projected to increase by 3% per year in 2016 and 2017 and remain unchanged in 2018, as the 20 b.kr. in expenditures due to mortgage debt write-downs will expire that year. The small year-on-year change is due in part to the fact that primary expenditures are higher this year than was assumed in the 2014 Budget. Estimated primary expenditures therefore increase in 2015 by 13 b.kr. from the estimate in the 2014 budget proposal. In 2015, it is assumed that expenditures for social assistance and payments to old-age and disability pensioners will rise by 2.4 b.kr. over and above price increases, or a total of 5.4 b.kr. To offset the effects that changes in the lower value-added tax bracket will have on prices and living expenses, it is

Table 4 Changes in 2015 performance between last year's and this year's budget proposals

<i>Accrual basis</i>	<i>B.kr.</i>
<i>Treasury performance in 2015 according to budget proposal plan autumn 2013</i>	
Primary balance	61.2
Interest balance	-58.7
Overall balance	2.6
<i>Changes in Treasury performance in 2015 from budget proposal plan autumn 2013</i>	
1. Changes in primary income	
Tax base re-evaluation	14.9
Dividend payments	3.9
Fishing fee reduction	-1.8
System changes	2.2
Other	2.8
Total changes in primary income	22.0
2. Changes in primary expenditure	
Increased contributions to healthcare, esp. LSH and FSA hospitals	4.6
Changed price level assumptions (employee compensation and Social Security benefits increase by 0.9 percentage points)	2.4
Real growth in functions in excess of assumptions in previous fiscal plan	1.0
Cancellation of contribution to VIRK occupational rehabilitation fund	-1.3
Reduction of contribution to Housing Financing Fund for changes in Fund operations	-2.5
Treasury pension obligations	2.5
Write-offs of tax claims and unforeseen expenditure	2.6
Increased real growth and other changes	3.8
Total changes in primary expenditure	13.1
3. Changes in interest balance	
Amendment of Central Bank bond (non-indexed interest, etc.)	8.1
Other changes in interest expense (retirement of foreign loan and smaller debts)	-4.1
Reduced interest income on FX accounts with Central Bank	3.4
Other changes in interest income	-0.1
Total changes in interest balance	7.3
4. Adjustment of indexed household mortgage debt	
Increase in bank levy and side-effects of income tax and payroll tax	19.7
Net expenditure due to adjustment of indexed household mortgage debt	19.8
Total adjustment of indexed household mortgage debt	-0.1
Total changes in overall balance	1.5
<i>Treasury performance in 2015 according to fiscal plan autumn 2014</i>	
Primary balance	70.1
Interest balance	-66.0
Overall balance	4.1

Source: Ministry of Finance and Economic Affairs.

assumed that mitigating measures will be applied through individual income taxes, costing the Treasury about 1 b.kr. in 2015. The wage and price increases provided for in the 2015 budget proposal total 15.3 b.kr, including 2.4 b.kr. due to a higher inflation forecast than before. To counteract this, expenditures will be cut by reducing contributions to the Housing Financing Fund (HFF) during 2015-2018. Next year's HFF contribution is estimated at 2.5 b.kr., whereas previous plans had provided for an annual contribution of 4.5 b.kr. during the 2015-2018 period. Furthermore, the budget proposal assumes that plans for a 1.3 b.kr. contribution to occupational rehabilitation funds in 2015 will be abandoned. Primary expenditures net of expenditures for household mortgage write-downs are estimated to decline from 25.1% of GDP in 2015 to 23.2% by 2018, or nearly 2 percentage points.

The budget proposal assumes that central government wages will increase by 3.5% in 2015 and by 3.6-4.4% per year in 2016-2018. This is an increase of about 1% over and above the inflation forecast for the 2016-2018 period. The results of upcoming wage negotiations are highly uncertain. This is why a new budgetary allocation has been created so as to provide the scope to absorb deviations – particularly in wage, exchange rate, and price assumptions – and fulfil unforeseen obligations that may accrue each year. This allocation amounts to 6 b.kr. each for 2015 and 2016. It then increases by 0.5 b.kr. per year in 2017 and 2018, when it will total 7 b.kr. Irregular items in the budget proposal are estimated at 165 b.kr. Table 4 shows the changes in year-2015 performance according to the budget proposals for 2014 and 2015.

Legislative bill for new law on public sector finances submitted again

The Minister of Finance has submitted a bill of legislation on public sector finances. The aim of the proposed legislation is to enhance enforcement of budget execution by adopting fiscal rules providing for performance targets and reference debt levels. The bill also states that, after a Government is appointed, it shall issue a five-year fiscal policy for the entire public sector, plus a fiscal plan to be presented at the legislative session each spring. An independent fiscal council is to provide commentary on whether the budget and overall fiscal policy are being implemented in accordance with fiscal policy as issued. Further discussion of these changes can be found in Box V-1 in *Monetary Bulletin* 2014/2.