

On 1 October 2020, the fiscal budget proposal for 2021 and the Parliamentary Resolution for the 2021-2025 fiscal plan were introduced in Parliament. The macroeconomic assumptions underlying both are therefore identical.

Table 1 compares Statistics Iceland's forecast from 1 October (on which Parliamentary estimates are based) and the forecast in *Monetary Bulletin* 2020/3, published in August. As can be seen, the fiscal budget proposal is based on a more optimistic economic outlook than presented in the Bank's August forecast. The outlook has worsened since then, according to the Bank's new baseline forecast, included in this *Monetary Bulletin*.

**Table 1 Macroeconomic assumptions in the 2021 fiscal budget proposal (%)**

	<i>Statistics Iceland forecast</i>	<i>MB 2020/3</i>
Private consumption	4.2	3.8
Public consumption	1.8	1.2
Gross capital formation	5.5	2.4
Exports of goods and services	17.1	19.8
Imports of goods and services	17.4	17.4
GDP growth	3.9	3.4
Inflation	2.7	2.4
Unemployment	6.8	7.9

Sources: Statistics Iceland, Central Bank of Iceland.

### Key assumptions in the 2021 fiscal budget proposal

**Wage assumptions:** The 2020 National Budget assumed a weighted average wage increase of 3%. According to the Ministry of Finance and Economic Affairs' reassessment of wage premises in the Budgets for 2019 and 2020, wage expense in 2021 will be 400 m.kr. lower than previously assumed. The budget proposal assumes an average wage rise of 3.6% in 2021, but the pay rises vary, as they involve fixed amounts rather than percentage increases. In addition to general wage rises are changes in vacation rights, which increase the annual rise in wage costs to 4%, or 13.8 b.kr. As a result, the net rise in wage costs in 2021 is estimated at 13.4 b.kr.

**Price assumptions:** In the premises for the 2020 National Budget, it was assumed that inflation would measure 3.2% that year, and in the 2021 budget proposal, this is assumed to materialise; therefore, there is no need to adjust year-2021 indexation in either direction. According to Statistics Iceland's forecast, the price level revision for other operating expenditures amounts to 2.7% for 2021, with expenses totalling 3.9 b.kr.

**Table 2 Changes in wages, benefits, prices, and exchange rate in 2021**

<i>Accrual basis</i>	<i>Expenditures, b.kr.</i>
<b>Wage assumptions</b>	
Reassessment of wage increases 2019 and 2020	-0.4
Estimated wage increases 2021	13.8
Total wage increases	13.4
Unemployment and social security benefits	7.8
General price level assumptions	3.9
Exchange rate assumptions	6.1
Changes in wages, benefits, prices, and exchange rate	31.2

Source: Fiscal budget proposal 2021.

## Box 3

### Fiscal budget proposal for 2021

*Exchange rate assumptions:* The exchange rate assumptions are based on the average exchange rate in August, when the króna was 13% weaker than had been assumed in the 2020 National Budget. Budgetary authorisations will rise by 6.1 b.kr. as a result, owing mainly to foreign policy expenses and drug costs.

*Unemployment and social security benefits:* The budget proposal assumes that benefits will rise by 3.6% on 1 January 2021, with an estimated associated cost of 7.8 b.kr.

In all, the above-specified changes to budgetary authorisations in the 2021 budget proposal – changes in wages, prices, and exchange rates, including increased unemployment and social security benefits – amount to just over 31 b.kr. (see Table 2).

Furthermore, it is assumed that changes in the tax system, both statutory and non-statutory (not yet passed into law), will reduce next year's Treasury revenues by nearly 38 b.kr. (Table 3).

**Table 3 Impact of tax changes on Treasury revenues in 2021**

<i>Accrual basis</i>	<i>B.kr.</i>
<i>Statutory changes</i>	
Last phase, changes in personal income tax	-14.3
Last phase, introduction of tax on F gases	0.2
First phase, reduction in bank tax	-1.7
Cancellation of transport equalisation tax on petrol products	-0.4
COVID-19 measures	-9.4
Total statutory changes	-25.6
<i>Non-statutory changes</i>	
Increase in tax-free inheritance tax threshold	-0.5
Changes in investment tax	-2.1
Support for third-sector organisations	-2.1
Extension of VAT reimbursements due to COVID-19	-8.0
Staff deployed (chain responsibility for PAYE tax)	0.3
Increase in carbon tax	0.2
Total non-statutory changes	-12.2
Total changes, statutory and non-statutory	-37.8

Source: Fiscal budget proposal 2021.

### Further changes on the revenues side

On 29 September, it was decided to lower the payroll tax by 0.25 percentage points for 2021 in order to mitigate the impact of the wage rises negotiated in the last wage settlements and scheduled to take effect at the beginning of 2021.

### Revision of 2020 revenue estimates

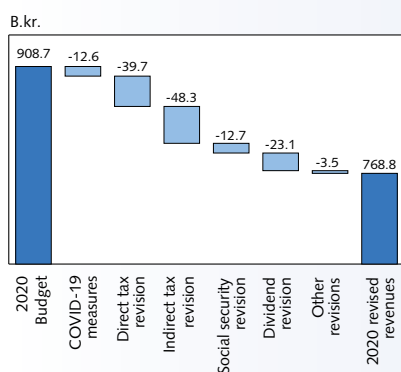
In the 2020 National Budget, revenues were estimated at just under 909 b.kr., whereas now they are assumed to total just under 769 b.kr. (Chart 1). The difference relative to the Budget as passed, 140 b.kr., is due both to automatic stabilisation of the tax system in connection with the economic recession and to the Government's pandemic response measures (further discussion below).

According to the fiscal budget proposal, the ratio of total Treasury revenues to GDP will decline by 2.7 percentage points relative to 2019, as can be seen in the breakdown in Table 4.

### Changes on the expenditures side

The main changes in 2020 expenditures from the 2020 National Budget to the 2021 budget proposal can be seen in Chart 2. Three items contribute most to the increase in expenditures. The first is the automatic stabilisation of unemployment benefits, totalling nearly

Chart 1  
2020 revenue revisions



Source: 2021 fiscal budget proposal.

Table 4 Breakdown of total Part A Treasury revenues

% of GDP	Accounts 2019	Reassessment 2020	Budget proposal 2021
Tax revenues	22.0	21.1	20.0
Taxes on revenues and profits	9.7	9.2	8.6
Taxes on payroll and workforce	0.3	0.3	0.3
Taxes on property	0.4	0.3	0.3
Taxes on goods and services	10.7	10.6	10.5
Taxes on international trade	0.1	0.1	0.1
Other taxes	0.8	0.7	0.4
Social contributions	3.3	3.1	3.1
Grants	0.1	0.2	0.2
Other revenues	2.6	2.5	1.9
Investment income	1.3	1.0	0.6
Interest income	0.3	0.2	0.2
Dividends, etc.	0.7	0.6	0.2
Fishing fees	0.2	0.2	0.2
Other investment income	0.0	0.0	0.0
Sales of goods and services	1.0	1.1	1.0
Miscellaneous revenues	0.3	0.4	0.2
Total revenues	27.9	26.9	25.2

Source: Fiscal budget proposal 2021.

30 b.kr. The second is the estimated 85 b.kr. due to mitigating measures in response to the pandemic, and the third is 5 b.kr. due to extra expenditures over and above the budgetary reserve fund. In all, expenditures in these three categories come to nearly 120 b.kr. over and above the assumptions underlying the 2020 National Budget.

According to the fiscal budget proposal, the ratio of total Treasury expenditures to GDP will rise by 3 percentage points relative to the 2020 Budget, as can be seen in the breakdown in Table 5.

Table 5 Breakdown of total Part A Treasury expenditures

Accrual basis, b.kr	Budget 2020	Budget proposal 2021 <sup>1</sup>	Change	
			% of GDP	%
Secondary income	438.7	446.9	0.3	1.9
Operational transfers	325.4	341.4	0.5	4.9
Capital transfers	223.1	339.8	0.4	52.3
Investment contribution <sup>2</sup>	519.1	758.8	0.8	46.2
Expenditure framework	838.3	898.2	1.9	7.1
Interest expense	432.3	460.1	0.1	6.4
Other non-framework items	122.7	153.2	1.0	24.9
Total expenditures	1,004.2	1,097.4	3.0	9.3

1. Excluding price increases. 2. Investment allocations are depreciated over the lifetime of the asset.  
Source: Fiscal budget proposal 2021.

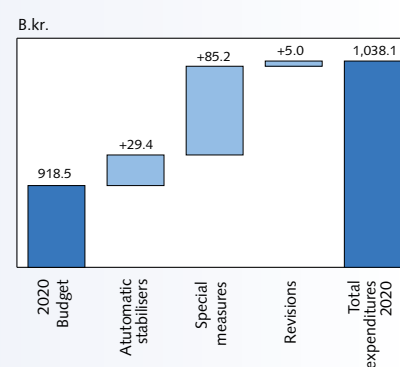
### Pandemic-related fiscal response measures

The COVID-19 pandemic has made a major impact on economic activity and on State and municipal finances. As is discussed in Box 2 in *Monetary Bulletin 2020/2*, the authorities have adopted a wide range of fiscal measures designed to mitigate the shock to the households and businesses most vulnerable to the effects of the pandemic, and to protect jobs and companies.

Tables 6 and 7 provide an updated summary of the pandemic-related fiscal response measures the Government plans to put in place in 2020 and 2021, together with their impact on the Treasury outcome. These include revenue loss subsidies for this year, which

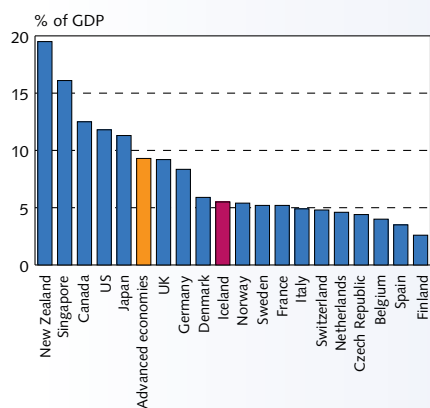
Chart 2

Revision of total expenditures in 2020



Source: 2021 fiscal budget proposal.

Chart 3  
Direct COVID-19 fiscal measures<sup>1</sup>



1. Announced measures as of mid-September 2020. The timeframe of the measures varies by country, but most will be implemented in 2020-2021.

Sources: IMF, Ministry of Finance and Economic Affairs, Central Bank of Iceland.

were approved by the Government on 16 October, after the fiscal budget proposal was introduced in Parliament. In all, the cost to the Treasury for these measures amounts to an estimated 174 b.kr., or 5¾% of year-2019 GDP. As Chart 3 shows, the direct measures are smaller, on average, than in other advanced economies but similar in scope to those put in place in the other Nordic countries, apart from Finland.

In addition to these are various fiscal measures that do not have the same direct impact on the Treasury outcome, even though their economic scope could be considerable. For example, bridge loans and support loans have been granted, in addition to subordinated loans totalling 23 b.kr., with the Treasury guaranteeing a large share

Table 6 Fiscal measures in response to COVID-19

Measure	Scope (b.kr.)
Unemployment benefits for reduced employment percentage	22.0
Partial wage payments during termination notice period	21.1
Acceleration of construction projects	17.9
Revenue loss subsidies	23.3
Loss carry-back for legal entities	12.0
Miscellaneous social and healthcare measures	5.4
Educational and job measures	5.0
Increased VAT reimbursement for maintenance, etc.	4.7
Tax revenue from special payouts of third-pillar pension savings	-4.6
Supplemental child benefit	3.1
Domestic and foreign marketing campaign	3.0
Business closure subsidies	2.5
Reimbursements for film production	2.1
Extended income linkage of entitlement to unemployment benefits	1.5
Support for innovation and development	1.4
Wage payments during quarantine	0.3
Cancellation of bed-night tax	0.3
Cancellation of customs processing fees	0.2
<b>Total cost</b>	<b>121.3</b>

Source: Fiscal budget proposal 2021.

Table 7 Fiscal measures for 2021 in response to COVID-19

Measure	Scope (b.kr.)
Investment and construction initiative	27.2
Extension of VAT reimbursement	8.0
Expedited reduction of bank tax	4.9
Increased VAT reimbursement from 60% to 100%	3.9
Support for innovation	2.5
Extended income linkage of entitlement to unemployment benefits	1.5
Education	1.0
Cancellation of bed-night tax	0.8
Services for job-seekers	0.7
Labour market initiatives	0.6
Family affairs	0.5
Tax revenue from special payouts of third-pillar pension savings	-0.6
Mental health	0.6
Tax, special revenues	0.5
Cancellation of customs processing fees	0.4
Wage payments during quarantine	0.2
<b>Total cost</b>	<b>53</b>

Source: Fiscal budget proposal 2021.

of commercial bank loans to businesses. Furthermore, tax payment deferrals have been granted for some 20 b.kr., and in June, Parliament passed legislation on debt moratoria of up to one year for companies (for further information, see Box 2 in *Monetary Bulletin* 2020/2).

### Treasury debt ratio rising sharply

In order for Treasury finances to be sustainable, the debt-to-GDP ratio must remain stable or be on a declining trend. According to the fiscal plan presented for 2021-2025, the debt ratio will rise from 30% of GDP in 2019 to a peak of 50% of GDP in 2025. The debt ratio therefore increases sharply in the next few years, albeit less than in the wake of the financial crisis just over a decade ago (Chart 4).

Although the debt-to-GDP ratio is expected to peak in 2025, this does not mean that nominal Treasury debt will then be stable or declining, as Treasury cash flows indicate that cash flows from operations will still be negative by 62 b.kr. in 2025 and the net financing need will be around 100 b.kr. (Table 8).

Table 8 Treasury cash flows 2021-2025

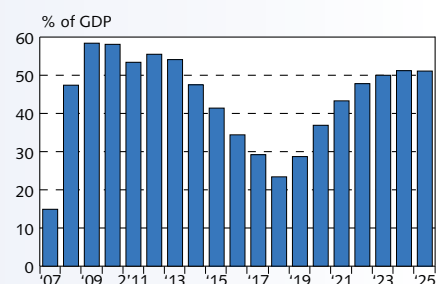
	Budget proposal	Estimate	Estimate	Estimate	Estimate
Payments basis, b.kr.	2021	2022	2023	2024	2025
Net cash from operating activities	-182	-175.1	-127.2	-93.4	-62
Total investment activities	-97.1	-62.8	-37.1	-40.3	-38.8
Net financing balance	-279	-237.9	-164.3	-133.7	-100.8
Financing activities, total	277.4	225.2	164.3	133.7	100.8

Source: Fiscal budget proposal 2021.

This increase in the debt ratio due to deficit operations reflects the Government's policy responses to the pandemic and the ensuing economic shock. Discretionary measures are applied, as is discussed above, and automatic stabilisers are allowed to work fully.

When the pandemic has receded and economic activity picks up again, however, it will be necessary to unwind these measures so as to avoid posing a risk to fiscal sustainability. In assessing whether the Treasury's debt level can be deemed sustainable, it is necessary to bear two things in mind: the interest burden on Treasury debt, and the cyclically adjusted primary balance on Treasury operations (both relative to GDP). The change in the Treasury debt ratio is equal to the real interest burden in excess of GDP growth, less the primary surplus relative to GDP. In order to prevent the debt ratio from rising, the cyclically adjusted primary surplus relative to GDP must be at least equal to the real interest burden over and above output growth. If the objective is to reduce the debt ratio, the primary surplus must therefore be greater than the real interest expense burden over and above output growth. As debt and interest rise and GDP growth declines, the Treasury must rely more on tax increases or expenditure cuts, either now or in the future. As a result, the decisions the Treasury must take depend greatly on the GDP growth path. Although the debt ratio the Treasury faces for 2025 is only  $\frac{3}{4}$  of the 2011 peak, it must also be remembered that there is no foreseeable one-off windfall like the one the Treasury received in 2016 in the form of stability contributions from the failed banks' estates, which totalled more than 15% of GDP in 2016. Furthermore, the premises for the medium-term economic outlook are highly uncertain.

Chart 4  
Treasury debt according to debt rule<sup>1, 2</sup>



1. Total liabilities net of pension obligations and accounts payable and net of cash and bank deposits; cf. Article 7 of the Act on Public Finances, no. 123/2015. 2. Ministry of Finance and Economic Affairs forecast 2020-2025.

Sources: Ministry of Finance and Economic Affairs, Statistics Iceland, Central Bank of Iceland.