Box V-1

# National Budget 2011

The fiscal consolidation plan is one of the cornerstones of the Government-IMF economic programme. The 2011 National Budget, if passed, is an important step in that consolidation, as it enables the Government to achieve a surplus on the primary balance in 2011, the first important goal in the plan.[1] The second goal is to achieve a sizeable overall surplus by 2013.

**Strong improvement in primary balance**

On the basis of the plan, consolidation measures were adopted in the latter half of 2009, in response to a deteriorating outlook for Government operations. Thereafter, it was decided to take radical steps on both revenues and expenditures sides of the 2010 Budget. The turnaround in the primary balance from 2009 onwards could total 117 b.kr. in 2011, if the Budget is successful. It assumes that the primary balance will be about 17 b.kr. in 2011 on an accrual basis, or the

1. The primary balance is the difference between revenues and expenditures excluding financial income and expense. The overall balance is the difference between total revenues and total expenditures.

Table 1 Medium-term plan 2011-2014[1]

| *In ISK billions at current price levels* | *Accounts 2009* | *Budget 2010* | *Projection 2010* | *2011* | *2012* | *2013* | *2014* |
|---|---|---|---|---|---|---|---|
| Revenues | 439.5 | 461.9 | 470.8 | 477.4 | 533.2 | 599.4 | 629.3 |
| Expenditures | 578.8 | 560.7 | 545.3 | 513.8 | 526.8 | 550.5 | 579.9 |
| Overall balance | -139.3 | -98.8 | -74.5 | -36.4 | 6.4 | 48.9 | 49.4 |
| Overall balance, share of GDP (%) | -9.3 | -6.1 | -4.6 | -2.1 | 0.4 | 2.6 | 2.5 |
| Primary balance | -99.1 | -40.0 | -27.4 | 16.9 | 62.7 | 102.9 | 103.4 |
| Primary balance, share of GDP (%) | -6.6 | -2.5 | -1.7 | 1.0 | 3.4 | 5.4 | 5.2 |
| Capital and Financial Account | -40.1 | -58.9 | -47.1 | -53.3 | -56.4 | -54.1 | -54.0 |
| Capital and Financial Account, share of GDP (%) | -2.7 | -3.6 | -2.9 | -3.1 | -3.1 | -2.8 | -2.7 |

1. Excluding possible effects of Icesave accounts.
*Sources:* Ministry of Finance, State Accounting Office, Statistics Iceland.

equivalent of 1% of GDP. The original plan presented to Parliament in summer 2009 assumed that the primary balance would improve by just over 16% of GDP during the period 2009-2013. The current plan, on the other hand, aims at an improvement of up to 12% of GDP during the period; that is, the 2009 primary deficit of 6.7% will have become a 5.4% surplus by 2013. The need for consolidation is less acute primarily because economic developments are more favourable and public debt lower than original forecasts indicated.

**Overall balance on schedule**

According to the budget proposal, it is also estimated that the overall balance will improve by 56 b.kr. in 2011 and will be negative by 36 b.kr., or 2.1% of GDP. In order to achieve this, a mixed approach involving increased revenue generation and expenditure cuts will be adopted, but in this phase of the plan, the weight of the measures will be on the expenditures side. The proposal provides for direct measures to improve Treasury performance by 44 b.kr., including revenue-generating measures amounting to 11 b.kr. and expenditure cuts totalling 33 b.kr.

**The revenues side in 2011**

After sizeable tax increases in 2010, it is assumed that major tax categories will remain unchanged in 2011; therefore, such items as individual income tax, value-added tax, and payroll tax will not be raised. According to the budget proposal, tax hikes will deliver an estimated 8 b.kr. of the 11 b.kr. revenue target. The remaining 3 b.kr. will be obtained through an additional authorisation for third-pillar pension savings withdrawals. The taxes to be raised are listed in Table 2. Chief among them are financial income tax and corporate income tax, both of which rise from 18% to 20%; inheritance tax, which rises from 5% to 10%; and taxes on carbon, alcoholic beverages, and tobacco.

Table 2 Revenue-generating measures for 2011

| | *B.kr.* |
|---|---|
| Capital gains tax | 1.5 |
| Income tax on legal entities | 0.5 |
| Inheritance tax | 1.0 |
| Wealth tax | 1.5 |
| Alcohol and tobacco tax | 1.3 |
| Carbon tax | 1.0 |
| Motor vehicle tax | 0.2 |
| Tax on financial institutions | 1.0 |
| Total, excluding pension withdrawal authorisation | 8.0 |
| New authorisation for third-pillar pension withdrawal | 3.0 |
| Total, including pension withdrawal authorisation | 11.0 |

*Source:* Ministry of Finance.

**The expenditures side in 2011**

The majority of the 33 b.kr. contraction in expenditures, or 28 b.kr., is achieved through a direct cutback in allocations to Government ministries. The remaining 5 b.kr. is to be achieved by preventing Government salaries and guideline amounts for social welfare benefits from rising in excess of the increases approved in the 2009 wage settlements.

The 28 b.kr. savings to be achieved through direct cutbacks will be taken from operations, transfers, and investment. More specifically, operations are to be cut by 13 b.kr., transfers by 11 b.kr., and investment by 4 b.kr. (see Table 3). These cutbacks, if they are implemented successfully, total 6.3% of the nominal expenditure framework.

It is assumed that operational cutbacks will come from general administration (9%), social welfare services, upper secondary schools, and law enforcement (5% each), and medical insurance (3%). Transfers to the Unemployment Insurance Fund and the Childbirth Leave Fund are expected to decline by 10% each, or a total of nearly 2 b.kr.

Table 3 Restraint measures, economic breakdown

| *In ISK billions* | *Decrease, b.kr.* | *Total turnover* | *Reduction %* |
|---|---|---|---|
| Operations | -12.7 | 204.8 | -6.2 |
| Transfers | -11.4 | 211.5 | -5.4 |
| Maintenance and initial expenses | -3.9 | 30.1 | -13.0 |
| Total | -28.0 | 446.3 | -6.3 |

*Source:* Ministry of Finance.

The assumed inflationary impact of the budget proposal is negligible. The positive effects of exchange rate movements are estimated to offset almost entirely the negative effects of price changes in other operating expenses. The only remaining amount is a 500 m.kr. increase due to the 2009 wage settlements. No other indexation can be found in the proposal.

**New fiscal rule will promote economic stability in the long run**

Since 1992 the Government has used framework budgeting, which is based on an expenditure framework. The aim is that the Government sets overall policy and the ministries prioritise functions within the framework. The primary objective of preparing a budgetary framework is to enhance the Government's policy-making role and ensure that the defined policy is followed effectively. In 2003, budget preparation was improved still further with the adoption of a fiscal rule, according to which public consumption expenditures may not grow by more than 2% per year in volume terms and transfer may not rise by more than 2.5%. Also prepared was a four-year plan for revenues and expenditures, which was not binding, as it was not subjected to a vote in Parliament; it was merely a declaration of intent.

This budget preparation method was not sufficiently successful. During the pre-crisis period, real growth in public consumption and transfers almost always exceeded the amounts stipulated according to the fiscal rule, and cost overruns were seemingly tolerated without serious repercussions. Therefore, the base for the next year's allocations was often higher than long-term forecasts had provided for, and base creeping was evident in the development of the budgetary framework. In 2006, the Icelandic National Audit Office concluded that ⅔ of 300 budgetary items had exceeded the 4%

deviation limit.[2] The large Treasury surplus during the years before the crisis resulted not from restraint according to the 2003 fiscal rule but from unexpected and unusually sizeable tax revenues.

The main reason it proved so difficult to enforce the 2003 fiscal rule was a lack of transparency and credible follow-up. During a period of growing and uncertain inflation, it is difficult to use criteria on real changes when the nominal value of budgetary allocations is constantly changing. In recent years, international institutions such as the OECD and the IMF have recommended that the fiscal rule be changed so as to specify a permissible ceiling on nominal growth in the expenditure framework instead of specifying real growth targets. Surveillance of such a rule is much simpler because allocations are clear, established, and easy to communicate. Such a rule is also stricter because unexpected price rises must be met with cost-cutting measures, as indexation will not be a factor later on. This introduces a countercyclical policy role into the framework, as price increases automatically lead to a contraction in real public expenditure. In periods of high inflation, however, such a rule can cause cutbacks that do not have political support. The Government has now proposed to adopt a fiscal rule specifying nominal expenditure growth in order to enhance credibility in fiscal policy. In making this change, the Government has a vested interest in keeping inflation low, which should therefore lead to improved policy coordination with monetary policy than was the case, for example, during the run-up to the crisis.

The National Budget proposal for 2011 is the first to present a binding nominal expenditure framework for the next two years. Such a framework implies a resolution by the Government not to seek further financing from Parliament if they should exceed the targets. The expenditure framework for each year includes estimated changes in wages, exchange rate, and price levels. The plan is based on the strategy that for the first two years – 2011 and 2012 – the framework will be binding in nominal terms if prices deviate from assumptions by less than 1.5%; otherwise, the expenditure categories concerned can be revised. The plan also allows for an unallocated contingency fund of 5 b.kr. per year to meet unforeseen price deviations and obligations. In other respects, all decisions and deviations must be accommodated within the overall framework, which may not be changed at later stages, and all increases in expenditures for individual aspects of Government operations must be offset by decreases elsewhere.

The medium-term plan also includes guideline frameworks for 2013 and 2014. The guideline frameworks can be revised in the spring of 2012, during the preparation of the 2013 budget proposal, as regards wage and price assumptions and possible changes in conditions. However, there are certain irregular items that are not part of core operations and could fluctuate between years due to economic developments or assessment after reconciliation of accounts (for example, pension obligations related to Government employees). Such items are therefore extremely difficult to predict and do not fall under any direct Government decision-making associated with budget preparation. More specifically, the irregular items in question include expensed unfunded liabilities for the State employees' pension fund, financial income tax that is paid by the Treasury and also entered on the revenues side, write-offs of tax claims, Government guarantees of debts, lost claims, unemployment benefits, the statutory contribution to the Municipal Equalization Fund based on State tax revenues, and interest expense. Excluding these irregular items from total expenditures in the medium-term plan yields the overall

2. The deviation limit for budget results is 4%. If an institution is able to keep its expenditures within this limit, it is considered to be within the budget.

expenditure framework for each year, which is used as a reference during budget preparation. The overall expenditure framework for 2011 is 381.4 b.kr.

It is important to evaluate the success of the fiscal rule and publicise the findings. It is vital that there be a political cost associated with failure to enforce the rule and benefits associated with success. Increasing political responsibility for the rules is of paramount importance.