Iceland - Fiscal Consolidation Plan
Ministry of Finance

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Policy Report: Fiscal Consolidation Plan

The financial crisis, October 2008

Banking crisis

Wipe-out of the worth of many of the largest corporations

Drastic fall of the Icelandic króna

Tight capital controls

The blows to the Treasury severely constrained the scope for fiscal policy to soften the economic adversities and to stimulate growth.

Blows to the Treasury due to the fall of the banks

- The heaviest blows to the Treasury (% of 2008 GDP):

  debt accumulation:
  - recapitalization of CBI, 170 bi.kr., 11% of GDP
  - recapitalization of banks, 187 bi.kr., 13% of GDP
  - loans for foreign reserves, 281 bi.kr., 18% of GDP
  - deficit 2009-2012, 400 bi.kr., 27% of GDP

  disrupted operational premises:
  - fall in revenue, 5% of GDP or 80 bi.kr.
  - interest cost from 4.5% of revenues up to 16%
  - unemployment costs from 3.6 up to 27 bi.kr.

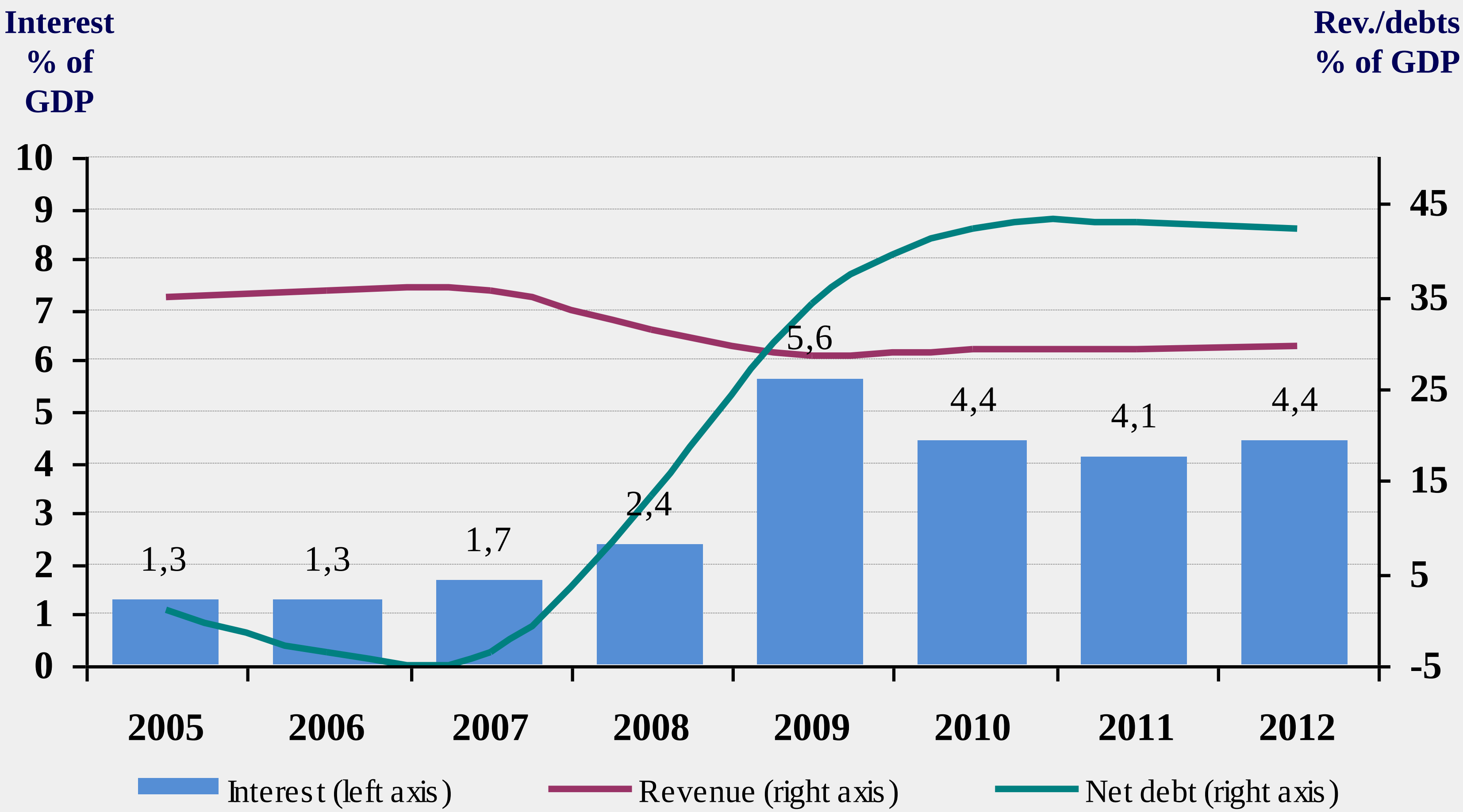
Strengths in the position of the Treasury

- The net debt of the Treasury (4% of GDP) was among the lowest in Europe due to sizeable surpluses for a number of years and the sale of assets.
- Treasury deposits with the Central Bank at the end of 2007 amounted 150 billion ISK, equivalent to 10% of GDP.
- The net financial position of the Treasury excluding financial assets had become positive by over 3% of GDP and the interest balance was positive as well.

Weaknesses in the position of the Treasury

- A large portion of revenues was based on:
  - oversized banking system
  - networks of leveraged holding corporations
  - huge current account deficit
  - bloated economy due to asset bubbles
- A series of tax cuts as well as various taxes and fees denominated in krónur that were allowed to be eroded by inflation weakened the revenue collection system.

Reversal in the fiscal finances*



***Excluding irregular and one-off revenues**

Policy response: Long term objectives

Main priority: make the public finances sustainable in order to lower the debt and interest burden of the Treasury

The long term objective is to reduce the public sector gross debt to less than 60% of GDP

Protect the welfare system

Increased equality in distribution of income

Policy response: The fiscal consolidation plan

- A report on the strategy for the fiscal consolidation plan 2009–2013 was presented to the parliament in June 2009.
- The main objectives in the Government's original fiscal consolidation plan were very simple and clear but quite ambitious given the circumstances:
  - A slight primary surplus, i.e. excluding interest revenue and expenditure, before the end of 2011.
  - Overall balance to yield a significant surplus by 2013.
  - Reduce the public sector gross debt to less than 60% of GDP in the long run.

Revision of the fiscal consolidation plan

- The fiscal strategy was re-evaluated in a report issued last fall.

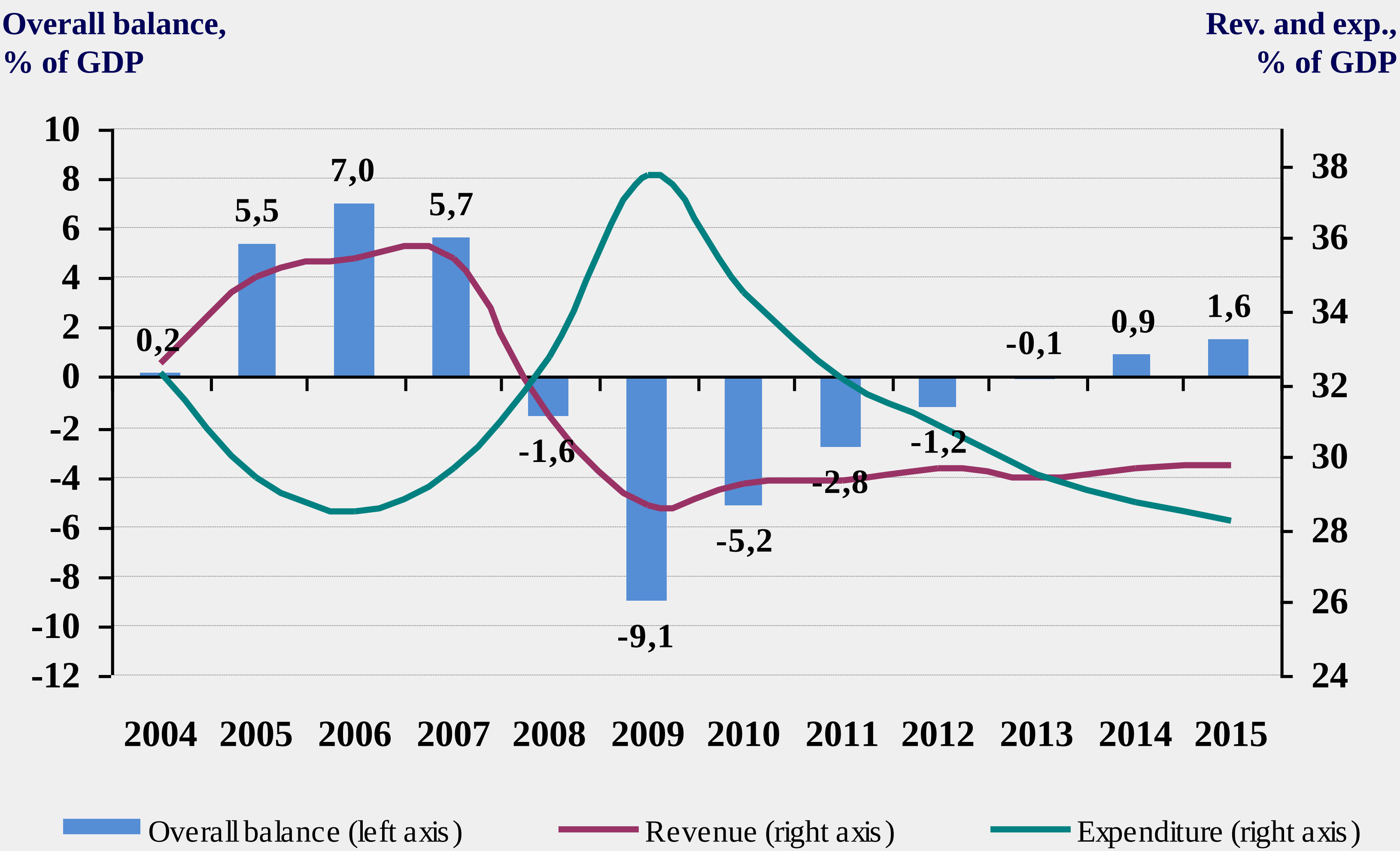
  conclusion:

- Fiscal readjustment need not be as extensive nor be concluded as rapidly as proposed when the programme was adopted in the summer of 2009.
- The objective of achieving a surplus on the overall balance is postponed until 2014, and a smaller surplus is targeted.
- The revised plan provides for a milder adjustment path, or an improvement in the primary balance by 10-11% of GDP.

Reasons for revision

- Lower debt than projected
- Favourable fiscal progress in 2009-2011
- Slower economic growth than projected
- Estimated tax revenue lower than previously projected
- Increased trust internationally
- Increased benefits and wages

Fiscal consolidation profile*



* Excluding irregular and one-off items on both revenue and expenditure side

Cumulative revenue- and restraint measures 2009-2012*

Accrual basis, in ISK billion	2009	2010	2011	2012
Revenue				
Changes in the tax system	23,7	68,7	83,0	95,0
Other revenue measures	0,0	6,1	7,0	13,1
Total	**23,7**	**74,8**	**90,0**	**108,0**
Total, % of GDP	**1,6**	**4,9**	**5,5**	**6,1**
Expenses				
Current expenditure	-13,5	-27,5	-38,7	-43,1
Transfers	-6,3	-22,2	-30,0	-34,0
Maintenance and investment	-13,3	-27,2	-31,1	-31,3
Freezing of wages and benefits	-5,5	-16,5	-16,5	-16,5
Total	**-38,6**	**-93,4**	**-116,3**	**-124,9**
Total, % of GDP	**-2,6**	**-6,1**	**-7,5**	**-8,0**

- **14% in fiscal measures over the period achieve a 11% adjustment in the total balance.**

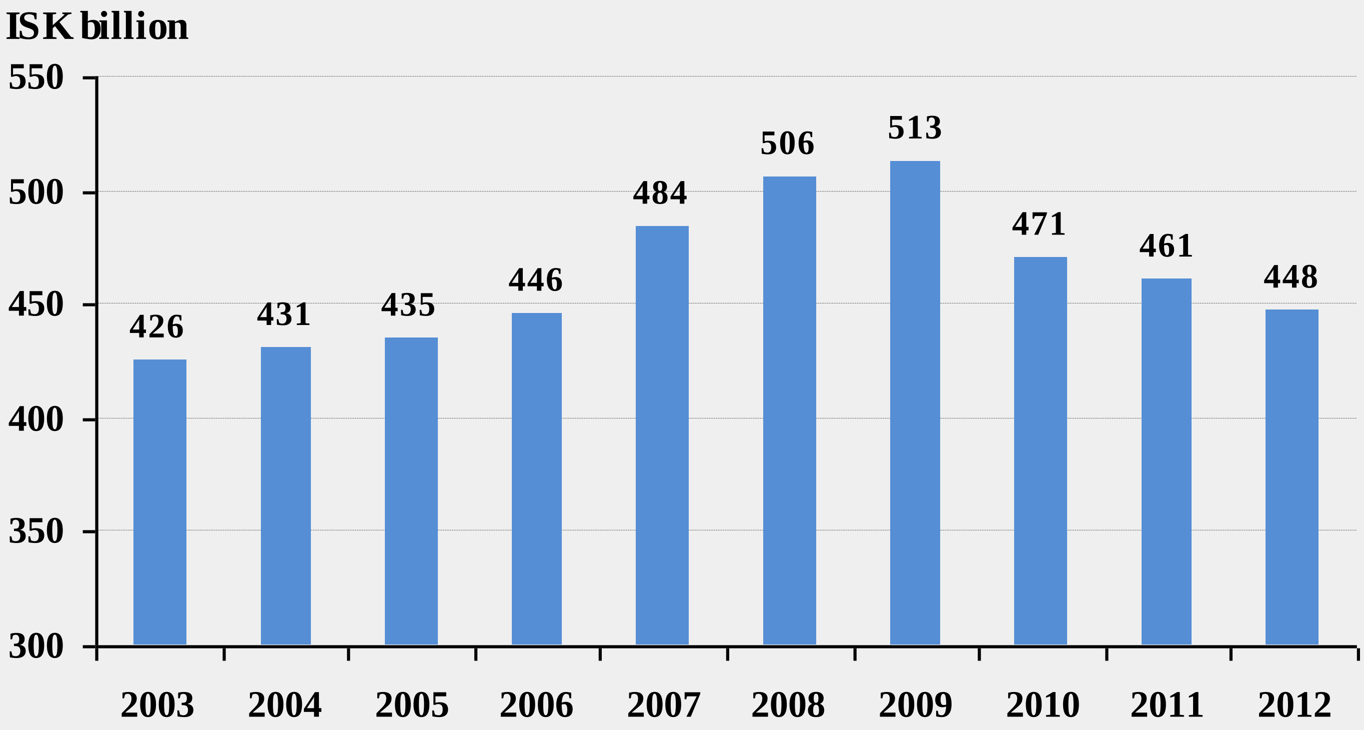
Main revenue measures 2009-2012

2009	2010	2011	2012
Excises raised	PIT reform to triple-rate system	Capital income tax 18% to 20%	Carbon tax raised
PIT raised by 1.25%	Capital income tax 10% to 18%	CIT 18% to 20%	FAT 10.5% payroll tax
Temporary surtax rates in PIT	CIT 15% to 18%	Inheritance tax 5% to 10%	Fisheries levy raised
Temporary surtax rates in capital income tax	New temporary net wealth tax 1.25%	Net wealth tax 1.25% to 1.5%	Proceeds from asset sales
10% withholding tax on interest payments	SSC 7% to 8,65%	New bank tax	Net wealth tax, 2nd tier
SSC 5.34% to 7%	VAT 24.5% to 25.5%	Carbon tax 50% to 75% of ETS	Dividend payments
	Other measures	Other measures	Other measures

General criteria for restraint measures

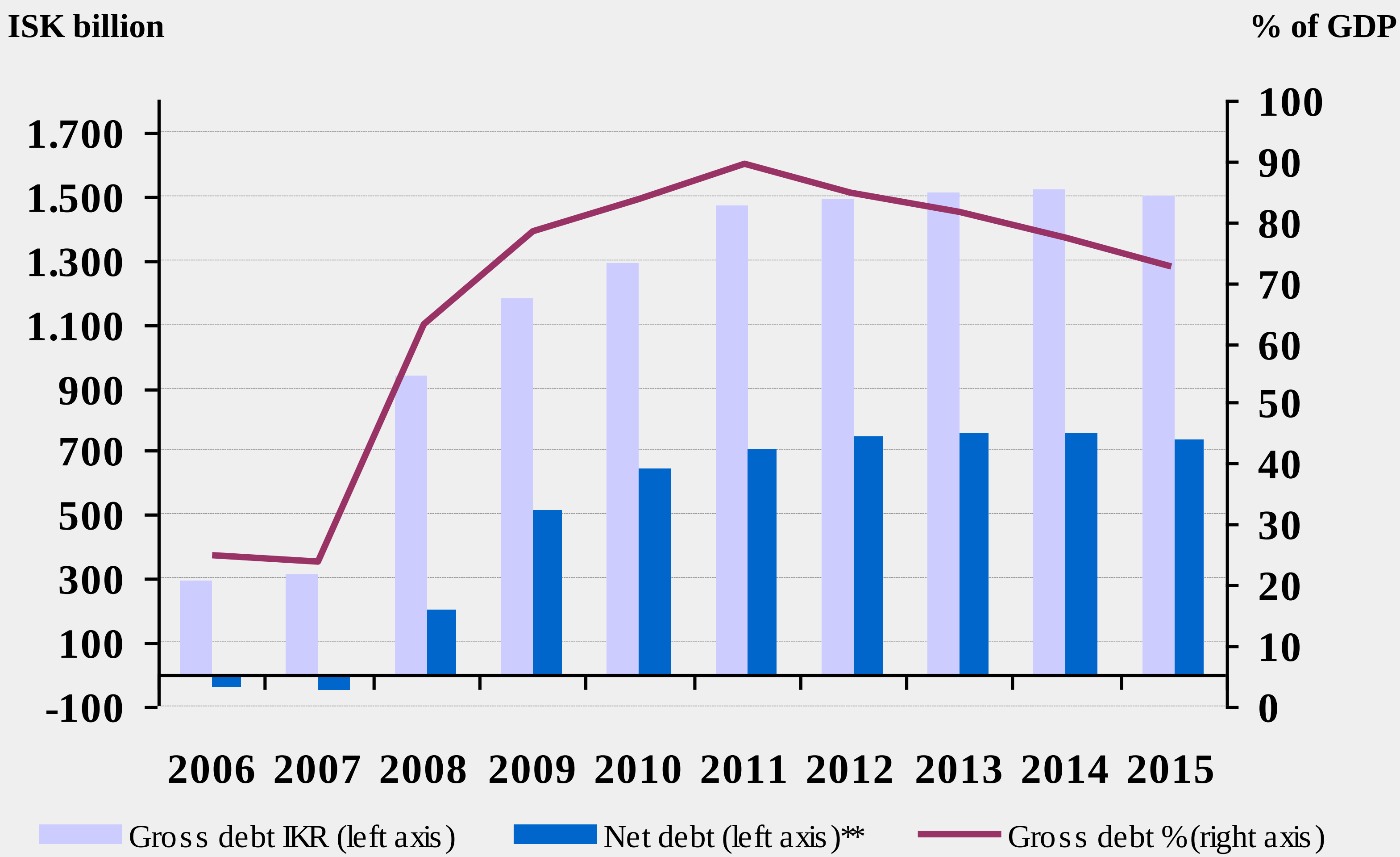
Cuts as % of current budget's turnover	Budget 2009	S. budget 2009	Budget 2010	Budget 2011	Budget 2012
Current expenditure					
Governmental institutions ministries etc.	5,0%	2,0%	10,0%	9,0%	3,0%
Welfare institutions	3,0%	1,0%	5,0%	5,0%	1,5%
Educational institutions	3,0%	1,6%	7,0%	7-7,5%	1,5%
Public order and safety	3,0%	1,0%	5,0%	5,0%	1,5%
Transfers	Selective	Selective	Selective	Selective	Selective
Maintenance and investments	Selective	Selective	Selective	Selective	Selective

Primary expenditure in real terms declines to 2006 level



*** In 2012 prices. Excluding irregular and one-off items.**

Gross debt and net debt*



* In 2011 year-end, gross debt is 7% of GDP higher than published in the 2012 budget due to a temporary drawdown in December on Nordic loans in excess of budget plan. The excess drawdown was used to prepay debt in early 2012, thereby reducing the debt level again.

** Including CBI deposits