

6. The public sector

The size and nature of the government sector

Compared to its neighbours, Iceland has a relatively small public sector, with expenditures around 42% of GDP. This is significantly lower than in the Nordic countries and the mainland countries of the European Union, higher than the US and Japan and close to the OECD average. An obvious reason for the modest size of the government sector is the absence of defence expenditures. However, what matters most are lower expenditures on social affairs in general. For this there are several explanations besides a difference in politics and tradition. Firstly, unemployment has been historically quite low in Iceland. Secondly, occupational fully funded pension funds have become the dominant pillar of the pension system, in contrast to public pay-as-you-go systems in many other OECD countries (See Chapter 4). The relatively young population and high retirement age also explain low overall pension expenditures.

General government sector finances

Iceland, like many other OECD countries, ran up a large public sector deficit in the late eighties and early nineties, with deficits averaging 3% of GDP in 1985 to the end of 1995 inclusive. To some extent the early 1990s deficit was the result of a prolonged slowdown

which depressed revenues and increased social spending.

General government finances consolidated after the mid 1990s and recorded healthy surpluses by the end of last decade after heavy deficit spending in the 1980s. Since the mid-1990s the public sector fiscal balance has been significantly above the OECD average.

With booming national expenditure and a growing wage share of GDP, public sector revenue shot up from 38% of GDP in 1996-98 to 42% in 1999, in spite of cuts in personal income tax rates. As private consumption and investment contracted in 2001-2, revenue fell to around 41% of GDP, while expenditures crept up, leading to an estimated deficit in 2002 of 1% of GDP.

General government debt rose significantly during the recession from the late 1980s to mid-1990s. Net debt peaked in 1995 at almost 40% but as economic growth gained momentum it declined and had come down by nearly a half by 2002.

Division of responsibilities

The government sector in Iceland is organised in two stages, the central government as described in the Treasury accounts, and municipal or local governments. In the last few years, local government expenditures have been

climbing from around 10% to around 11-12% of GDP as against a central government budget of around 30% of GDP. The central government regulates local governments, legislates their authority to collect revenue and actually collects more than 80% of local government tax revenues. It also administers and finances the bulk of the social security sector of government.

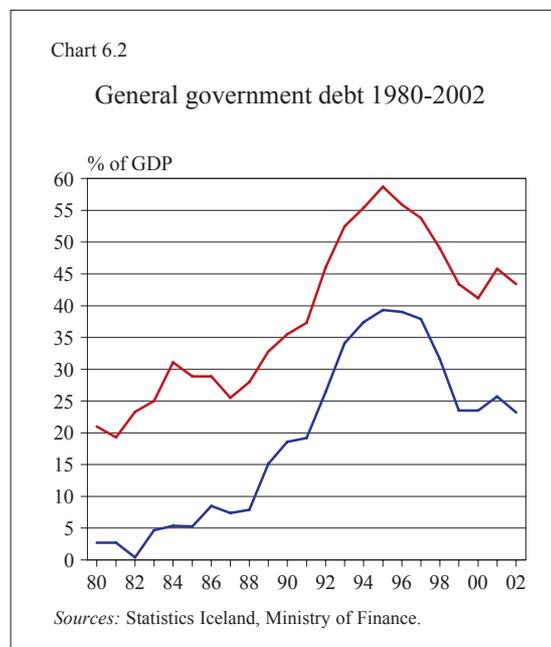
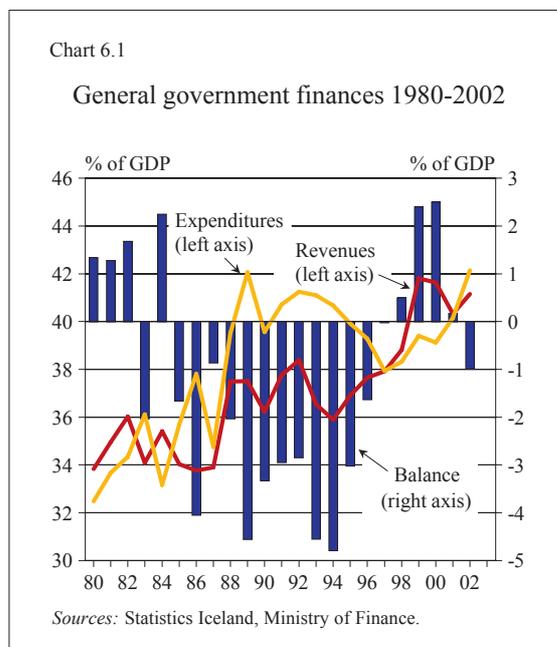
The central government is responsible for the police, courts and foreign affairs, upper secondary education, health services, institutional care for the disabled and elderly, general support and services for industry and most infrastructure construction and maintenance not obviously specific to individual municipalities. It administers basic benefit programmes for elderly and disabled persons and the bulk of supplementary old-age and disability pensions, rebates on interest payments on mortgages and benefits to families with dependent children. Most of these programmes are means-tested.

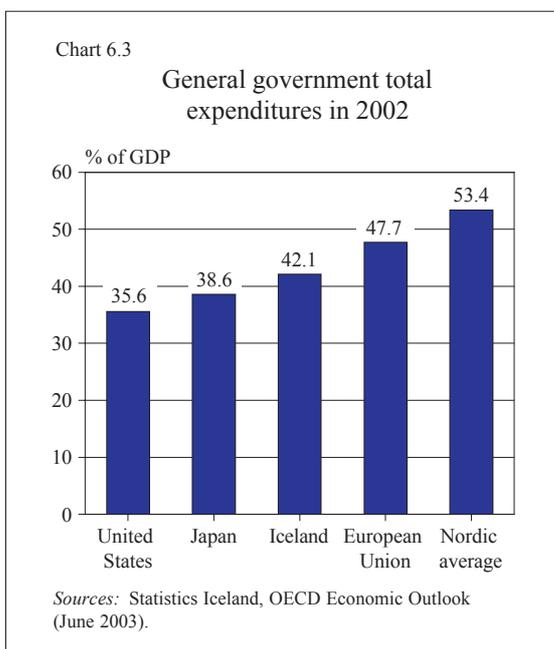
Local governments are responsible for local planning, most local infrastructure, day care and education from pre-school to the end of lower secondary level, and welfare services of various kinds, in particular services for the elderly except for health care. They are also responsible for solving the housing needs of low-income households. This is done via rent support, partially financed by the central government, and by providing rental housing for those who cannot find housing on their own. Local governments provide supplementary assistance to general programmes of pensions otherwise run by the central government.

Central government finances

Central government revenues as presented in the Treasury's accounts amounted to around 33% of GDP in 2002. The composition of Treasury revenues is shown in Chart 6.4.

In 2002, expenditures by the Treasury, as presented in its accounts, amounted to around 34% of GDP. By far the largest part of central

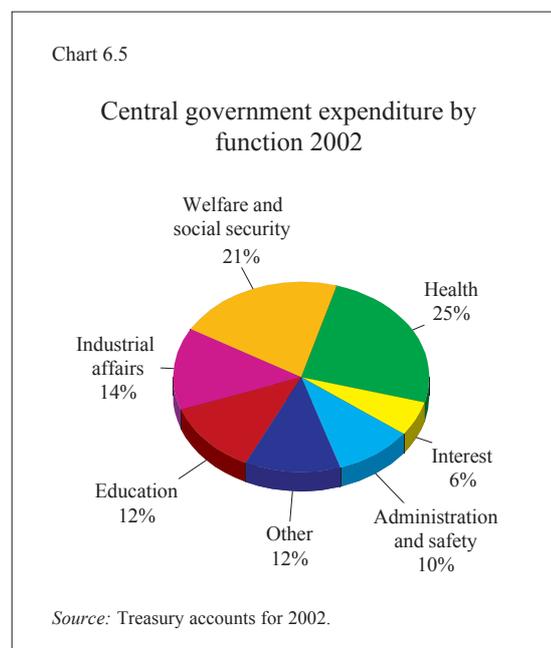
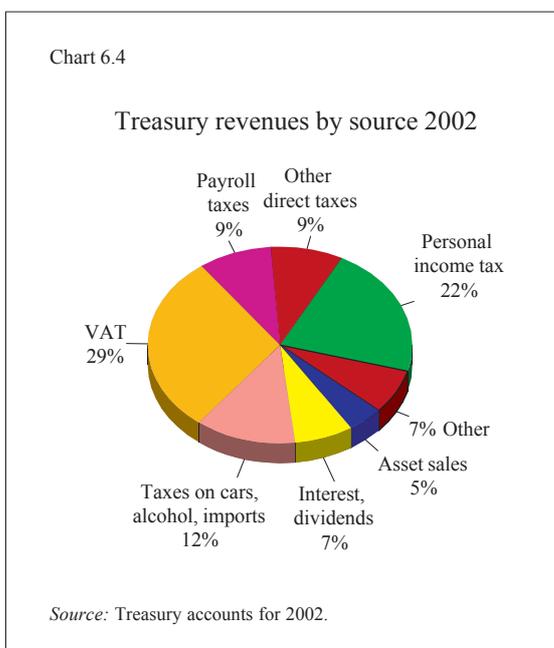


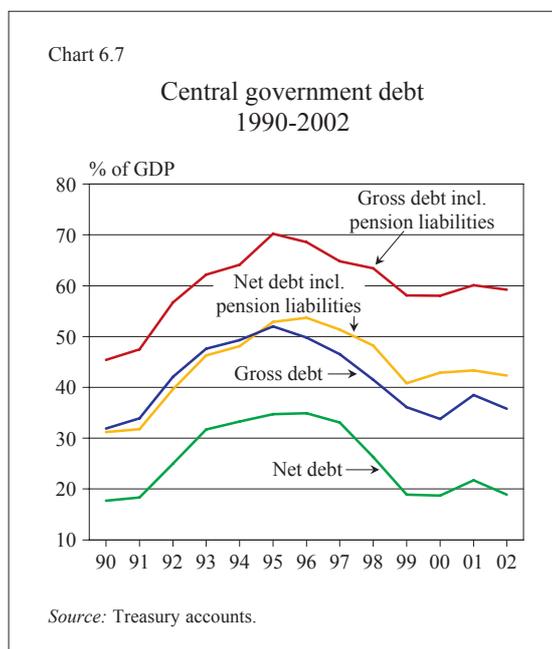
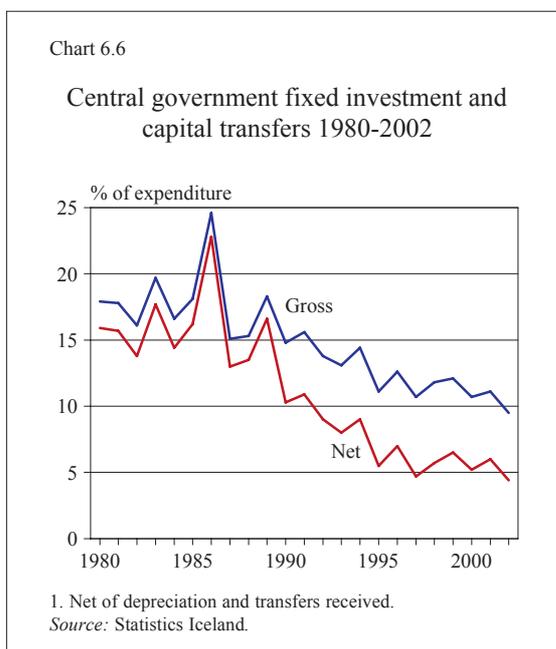


government expenditure goes to social security, welfare and health. A quarter was spent on health and about the same on social security and welfare. Chart 6.5 shows the functional

breakdown of central government expenditure according to the Treasury accounts. A final detail to note is that the discretionary part of Treasury expenditures is quite low and has been falling. In particular, expenditure on fixed capital and capital transfers has fallen considerably in recent years, as is evident from Chart 6.6.

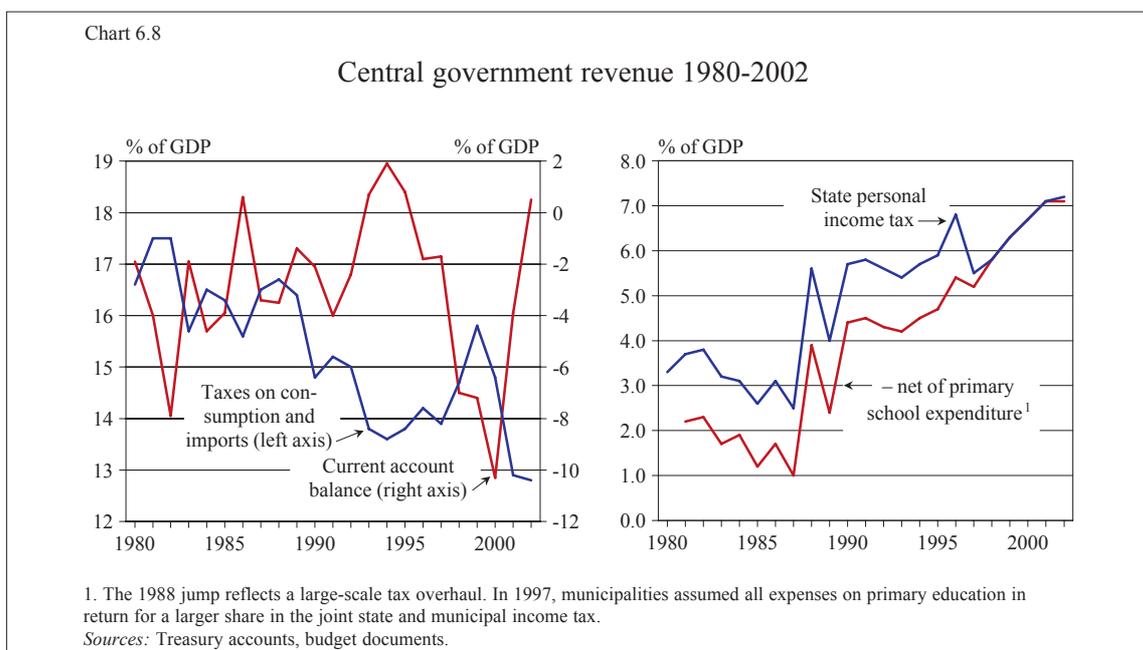
An interesting aspect of Treasury finances concerns the cyclical properties of the budget, especially revenues. The improvement in the budget in the mid- to late 1990s is largely explained by the sensitivity of Treasury revenues to the business cycle and associated swings in the current account. Firstly, the upswing in the economy and the associated consumption boom expanded revenue from expenditure taxes from 14% of GDP in 1995 to 17% in 1999 and 16% in 2000, after which the expenditure-led contraction in 2001-2 took this ratio down to 13% of GDP. Secondly, incomes below a threshold (around €9.7 thousand, 835 t.kr., in 2002 are exempt from the combined





state and local income taxes. This in itself makes revenue from combined income taxes rise during booms and fall during contractions, assuming that the threshold follows, say, a

longer-term trend of income. However, the peculiarity in the Icelandic taxation system is that the Treasury assumes all of this variability, by paying local governments their share of



the combined tax as a flat rate on total taxpayers' income rather than as a proportion of the revenues actually earned from it. In recent years, the threshold has lagged behind income trends, so the contraction in 2001-2 shows up as a flattening of income tax revenues relative to GDP and income. Thirdly, the upswing, along with policy changes, lowered expenses on unemployment benefits, child benefits and interest rebates to homeowners from a total of 2.6% of GDP in 1995 to 1.6% in 2002.

These factors, along with a smaller boost from corporate income and payroll taxes and the introduction of a tax on personal capital income in 1997, helped transform the Treasury balance from -2.6% of GDP in 1995 to +2.5% in 2000. When the boom turned into a mild contraction and the current account deficit began to dwindle, this surplus withered away.

Treasury surpluses since 1997, asset sales, reduced lending activity and strong economic growth contributed to a fall in gross Treasury debt from 52% of GDP in 1995 to 34% in 2000, while net debt fell from 34% to 19% of GDP. Since 2000, gross debt has rebounded to 36%, mostly because the Treasury borrowed funds to replenish the foreign exchange reserves of the Central Bank. The Treasury has also started to pre-fund civil service pension liabilities, which are not classified as debt in international comparisons. The evolution of Treasury debt, with and without pension liabilities, is shown in Chart 6.7.

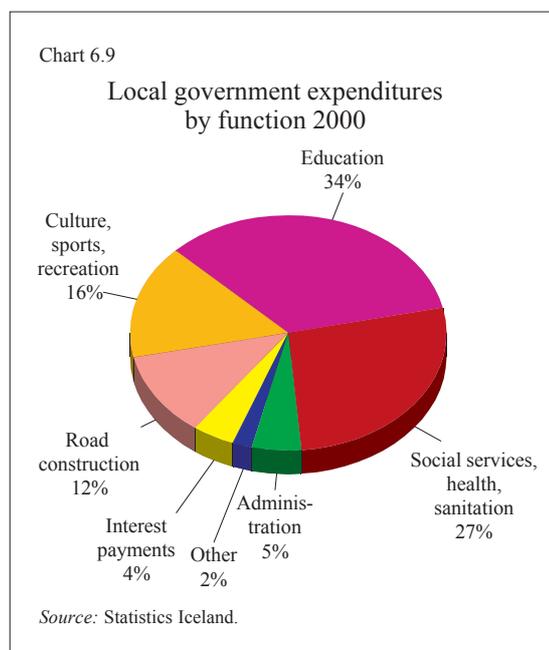
Local government finances

According to preliminary figures for 2002, local governments ran a deficit of around €70 million (6 b.kr.) or 7% of revenues. Local government revenues were approximately 11% of GDP, as measured by Statistics Iceland national accounts figures, while expenditures were

around 12% of GDP. The size of local government budgets has grown in recent years from an average of 6½% of GDP in the early eighties to the current 12% in 2002, mainly because of new and expanded tasks in the area of primary education.

In 2000, education accounted for 34% of local government expenditures, followed by 27% for various social services, around 15% for culture and recreation and 12% for roadwork and traffic. On the revenue side, approximately 52% of revenues came from municipal income tax, another 10% from taxes on real estate, 5% from the Municipal Equalisation Fund and 20% and 12% respectively from service fees and capital-related items such as fees on building permits and asset sales.

Local governments ran deficits averaging 7% of revenue from 1990-2002, reaching 20% of revenue at the bottom of the recession in 1992-95. In spite of these persistent deficits, gross local government debt has hovered



around 7% of GDP and net debt around 5% in the period 1994-2000, actually falling to around 4% in 2002, as asset sales and economic growth have helped municipalities hold ground on the debt front.

The response of local government budgets to the business cycle is quite different from that of the Treasury budget. The municipal income tax is a fixed percentage of an individual's gross income with minimal exemptions and is much more stable than the Treasury's share of income taxes. However, there are considerable pressures on the expenditure side, since local governments run means-tested social assistance programmes and the pressure on local authorities to stimulate job creation in downturns proved quite strong in the early nineties. This may to some extent be due to the fact that the discretionary factor in local budgets is considerably larger than that of the central government. In particular, gross investment accounts for upwards of 20% of local government budgets compared to less than 10% for central government.

The tax system

The central government or Treasury derived around 93% of its revenue from taxes in 2002, while at the local government level the tax-dependency ratio was 86%. Of Treasury revenue, 30% came from direct taxes on income and wealth, 29% from a value-added tax, 9% from payroll taxes and 14% from various excise taxes on imports, production and consumption.

A 25.75% tax is levied on personal income up to €47 thousand (4.1 m.kr) for individuals, while an additional 5% is charged on higher income. In addition a municipal income tax, ranging from 11.2 to 13% depending on locality, is levied on personal income. Incomes up to

€9.7 thousand (835 t.kr.) per person per year are exempt from the combined state and municipal income taxes, as are pension contributions.

Interest, dividends, rental income and personal capital gains are taxed at a lower rate of 10%.

The corporate income tax has been lowered significantly in the last 12 years, from 50% in 1991 to 18% in 2002. Capital income of corporations is treated like other revenue for tax purposes. A payroll tax of 5.73% is charged on wages.

A net wealth tax of 0.6% is assessed on net assets exceeding €54 thousand (4.7 m.kr.) for individuals as well as on the net value of corporations. These rates have been cut significantly in the last 10 years, with a large step being taken at the beginning of 2003. There is

Table 6.1 Main features of the tax system in Iceland

State income tax ¹	25.75%
on incomes > €47 thousand (4.1 m.kr.).....	30.75%
Municipal income tax ¹	11.2% to 13% by locality
State tax on financial income ²	10%
Corporate income tax	18%
Taxes on net worth	
Persons	0.6%
Corporations	0.6%
Payroll taxes	5.73%
Value-added tax	
General rate	24.5%
Low rate ³	14.0%

1. Incomes up to €9.7 thousand per person are exempt from income taxes, but the Treasury pays municipalities the tax for persons below the exemption level. Pension fund contributions of persons are exempt up to a point.

2. Interest, dividends, realised capital gains and rental income of persons.

3. Food, hotel rooms, heating, books, newsprint, television and radio subscriptions.

Sources: Internal Revenue Directorate, Association of Local Authorities.

a 1.5% stamp duty on most debt instruments, a 0.25% duty on bills of exchange and 0.5% on the issue of equity shares.

The largest single source of Treasury revenue is value-added tax, which is levied at 24.5% on most goods and services. Food, heating fuel and some services are taxed at 14%, while a few specific sectors are exempt, notably financial services, education, health services and passenger transportation.

A general excise tax is levied on a range of goods at three rates; while unit fees are charged on some goods. Customs duties range from 0 to 30% of cif value; most imports from EFTA and EU countries are exempt. Revenue from general excise taxes and import duties has fallen from around 2% and 3% of GDP respectively in the early 1980s to a total of less than 1% in 2002.

Taxes on imports and ownership of motor vehicles, and excise taxes on motor fuel, made up 8% of Treasury revenue in 2002, while 4% derived from charges on the sale of alcohol and tobacco. In total, the taxes described above accounted for 84% of Treasury revenues and 98% of tax revenues in 2002. Non-tax income accounted for 15% of Treasury revenue in 2002, an unusually high figure due to gains on the sale of the two banks mentioned above. Besides this, non-tax revenue consists mostly of service charges, interest income and dividends.

Tax-to-GDP ratio was 37.3% in 2000, the same as the OECD average but well below that in the EU.

Divesting government holdings in the business sector

In Iceland, both central and local government have traditionally been heavily involved in the business sector, notably in the operation of utilities and banking institutions.

This has been especially true of the central government, whose involvement was considered necessary because of the small size of the economy. At the end of the 1980s, it ran a shipping company and owned factories producing fertiliser, cement, ferrosilicon and pharmaceuticals. Furthermore, the central government held shares in the largest airline, owned a majority share in the dominant electricity producer, most of the power grid and electricity distribution networks outside the Reykjavik area. It owned the sole operator of telephone services and postal services and the dominant broadcasting service, as well as financial institutions responsible for more than 60% of domestic credit.

Over the last 10 years the central government has embarked upon an extensive plan of privatisation. Ships, a fertiliser plant, a pharmaceuticals company, airline shares and the ferrosilicon plant have been sold, as well as sizeable chunks of the financial institutions and sundry other holdings. At the beginning of 1998, the government created an investment bank by merging four government investment credit funds which specialised in fisheries and manufacturing. The new bank was privatised in 1998 and 1999 and merged into a private bank in 2000. The two remaining government banks, Landsbanki and Búnaðarbanki, were sold in steps in 1999-2003.

In 2001, an attempt to sell 24% of the national telecom company was not successful, with subscriptions reaching only a tenth of the proposed sale. The sale was put on hold, but recent indications are that the sales process will be resumed in 2004. Meanwhile, the government's monopoly on telephone services has been diluted by competition from new entrants. The postal service remains in government hands. It too faces competition in spe-

Table 6.2 Highlights of recent and prospective privatisation

<i>Year</i>	<i>Company sold</i>	<i>Share sold</i>	<i>EUR millions</i>
1998	Icelandic Alloys Ltd. (ferrosilicon plant)	26.5%	13
	FBA Ltd. (investment bank)	49%	58
1999	FBA Ltd. (investment bank)	remaining 51%	126
	Búnaðarbanki (commercial bank)	13%	29
	Landsbanki (commercial bank)	13%	43
2001	Iceland Telecom	2.7%	11
2002	Landsbanki (commercial bank)	20% and 45.8%	200
2003	Búnaðarbanki (commercial bank)	45.8% and remaining 9.1%	170
	Landsbanki (commercial bank)	remaining 2.5%	8
	IAV (contractors)	remaining 40%	24
<i>Dilution of ownership through stock issue</i>			
1998	Landsbanki (commercial bank)	15%	21
1998	Búnaðarbanki (commercial bank)	15%	14

Prospective privatisation

The sale of Iceland Telecom has been authorised.

Source: Executive Committee on Privatisation.

cialised postal delivery. After pending sales, the state's most important business holdings will be large stakes in the production and distribution of electricity, as well as the Housing Finance Fund, the Student Loan Fund and a few smaller financial institutions, altogether responsible for almost 25% of credit in the economy.

The current wave of privatisation actually started at the local government level in 1985, when the townships of Reykjavík and Hafnarfjörður sold their respective municipal trawler operations. Historically, local governments tended to be deeply involved in the fisheries sector, but most of those holdings have been divested in the last 15 years. Local governments, however, still own more than half of all

electricity production capacity in Iceland, notably through holdings in the national power company, Landsvirkjun. They almost invariably own geothermal power companies responsible for central heating for most homes. Many own their local distributor of electricity and they generally own operating companies for the harbours. In 1998, local governments were barred from providing loan guarantees for non-governmental businesses, a practice which in the past had led to significant municipal involvement and ownership in troubled enterprises.

Government guarantees

Besides debt on the books of government entities, the state and local governments guarantee

Table 6.3 Treasury guarantees
at the end of 2002

	<i>EUR millions</i>	<i>% of total</i>
Total Treasury guarantees.....	5,406	100.0
Housing Financing Fund	4,285	79.3
National Power Company.....	447	8.3
Agricultural Loan Fund	166	3.1
Regional Development Fund.....	124	2.3
Privatisation financing.....	152	2.8
Utilities	150	2.8
State enterprises.....	33	0.6
Other credit funds	18	0.3
Othe.....	31	0.6

Sources: Treasury Accounts 2002.

certain debts of various enterprises. Even though state guarantees must be authorised explicitly in budget legislation, historically they were granted to private as well as public enterprises in order to facilitate their borrowing. In recent years, guarantees have mostly

been confined to government enterprises and institutions related to government. In 1998, local governments were legally prohibited from granting loan guarantees except to their own subsidiary institutions.

Treasury accounts for 2002 show that it has granted guarantees of around €5.3 billion (457 b.kr.), or 58% of GDP. Of this, 80% represents government backing of residential mortgages. Another 8% represents its guarantees for the debt of the national power company Landsvirkjun, in which the Treasury is a 50% partner and whose debt is guaranteed *in solidum* by the Treasury and the townships of Reykjavík and Akureyri. Landsvirkjun's total debt stood at €956 thousand (81 b.kr.) at the end of 2002, or 10% of GDP. Both the company's debt and the guarantees will rise significantly with the construction of large new power plants in east Iceland.