4 Public sector

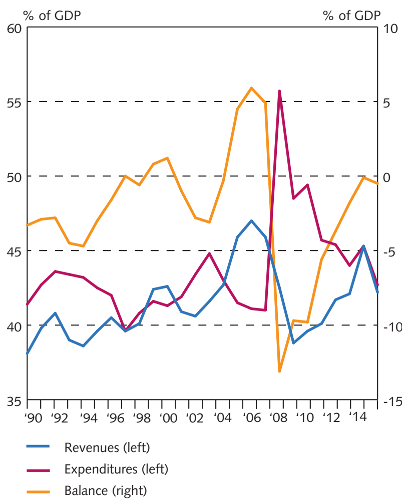
This chapter describes the public sector in Iceland, focusing on the division of responsibilities, central and local government finances, and the structure of the tax system. Recent developments in Iceland's sovereign credit ratings are discussed as well.

The size of the government sector

By 2015, Icelandic general government expenditure was back to the pre-crisis twenty-year average of 43% of GDP, after peaking at 56% of GDP in 2008, when the crisis struck. Iceland's expenditure ratio is at the lower end of the Nordic countries' range, together with Norway. It is at a level similar to that in the UK and Germany but higher than in Japan and the US, where levels are below 40%.

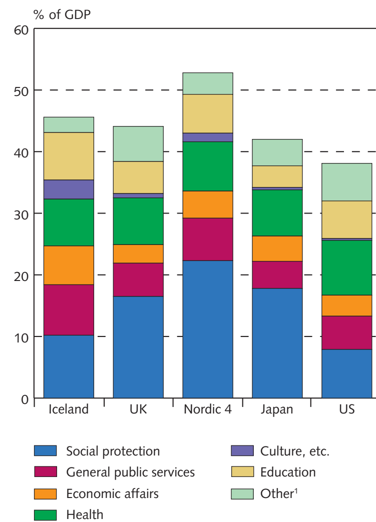
Several factors have allowed Iceland to function efficiently with a relatively small government sector: comparatively limited spending on social affairs, in part due to a relatively young population; historically low unemployment; and the historical absence of defence expenditure. Furthermore, fully funded private pension funds, organised by occupation, have overtaken the social security system's pay-as-you-go system in terms of benefit pay-outs, accounting for over

Chart 4.1
General government finances[1]



1. Revenues for 2013 adjusted for revaluation of the Treasury's share in Landsbankinn. The revaluation implies an increase in revenues of 1.4% of GDP.
Source: Statistics Iceland.

Chart 4.2
General government expenditures 2014



1. Public order and safety, defence, environment protection, and housing.
Source: OECD national accounts.

72% of pension payments in 2015, whereas public pensions are the dominant pillar in many other OECD countries (see Chapter 2). The relatively young population and high retirement age also help to lower overall pension expenditure.

On the revenues side, there was rapid growth during the pre-crisis upswing, bringing the revenue ratio up to the euro area average of around 45-47% of GDP. The ratio fell as low as 39% of GDP in the wake of the crisis but began to inch upwards after the economic recovery started to take hold, measuring 42% of GDP in 2015.

The composition of government revenues in Iceland differs noticeably from that in the other Nordic countries and the euro area. Social security contributions are low by international standards, partly because of the strength of the second-pillar pension system. Taxes on goods and services in Iceland have been similar in size to those in comparison groups, with value-added tax carrying most of the weight. Revenues from taxes on individual income rose throughout the 1990s, however, and are now approaching the rates in the Nordic countries.

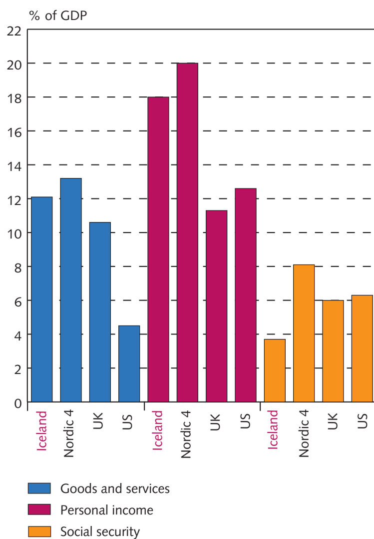
Division of responsibilities

Iceland's government sector is organised on two levels, central and local. Separate sets of social security accounts are maintained, but social security expenditures and revenues are authorised through the central government budget.

The central government regulates local governments and their authority to collect revenues, and it actually collects around two-thirds of local government revenues for municipalities, mostly through income taxes. It also administers and finances the social security sector of government.

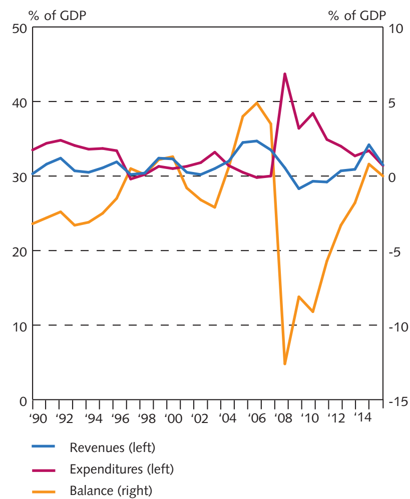
The central government is responsible for police, courts, foreign affairs, upper secondary and higher education, health services, institutional care for the elderly, general support and services

Chart 4.3
Importance of tax categories 2014



Sources: OECD, Central Bank of Iceland.

Chart 4.4
Central government finances[1]



1. Revenues for 2013 adjusted for revaluation of the Treasury's share in Landsbankinn. The revaluation implies an increase in revenues of 1.4% of GDP.
Source: Statistics Iceland.

for industry, and most infrastructure construction and maintenance not obviously specific to particular municipalities. It administers benefit programmes for elderly and disabled persons, unemployment benefits, mortgage interest subsidy payments for owner-occupied housing, child benefits, and parental leave at childbirth. The programmes are generally means-tested, although to varying degrees.

Local governments are responsible for local planning, most local infrastructure, day care and education from pre-school through the lower secondary level, care of disabled persons, and welfare services of various kinds, particularly to include services for the elderly apart from health care. They are also responsible for paying out rent benefits for residential housing and meeting the housing needs of low-income households. Local governments provide supplementary assistance to general programmes of pensions and income support run by the central government, notably by paying benefits to people who have exhausted their unemployment benefits or who for other reasons are ineligible for them.

General government finances

General government finances were in relatively good order between 2000 and 2007. Gross general government debt as a share of GDP, as defined by the Maastricht criteria, amounted to 27% in 2007. After the financial crisis struck in autumn 2008, the Government assumed large liabilities and substantial consolidation became necessary. As a result, general government gross debt rose to 95% of GDP in 2011 but has since fallen and was 69% of GDP in 2015. Government debt will decline still further in 2016, when the stability contributions are allocated towards payments of government debt (see Chapter 8).

Central government finances

Since 1980, central government revenues have been fairly stable, fluctuating between 28-33% of GDP, in tandem with the business cycle. Only in the pre-crisis upswing did they rise above that range.

The composition of central government revenues in 2015 is shown in Chart 4.5. Direct taxes generate almost half of total revenues, while indirect taxes constitute 36%. By design, Iceland's central government revenues are strongly cyclical for three main reasons. First, the state personal income tax, which accounts for some 20% of central government revenues, has a progressive predetermined bracket structure, including a sizable personal exemption, or zero bracket (see Box 4.1). This implies that greater-than-expected income growth translates into a higher-than-expected ratio of taxes to total income. Second, 40% of central government revenues come from taxes targeting consumption goods and services. These taxes fall most heavily on durables, most of which are imported. Such consumption has proven very sensitive to the business cycle, balance sheet effects, and the cyclical real exchange rate. Third, revenues from taxes on corporate profits, households' financial income, and certain financial transactions are by nature sensitive to the business cycle. These revenues grew from just under 4% of GDP in the pre-crisis years to almost 5½% at the height of the upswing and then fell to below 3½% of GDP in 2009-2013 despite significantly increased tax rates, but rose again to 4.1% of GDP in 2015. Combined central government revenue from taxes on consumption fell from 15½% in 2005-2007 to around 12% of GDP in 2009-2015. The payroll tax, or social security contribution, is far more stable,

except for the general understanding that it needed to rise to cover unemployment costs during the aftermath of the crisis. It has since been reduced somewhat.

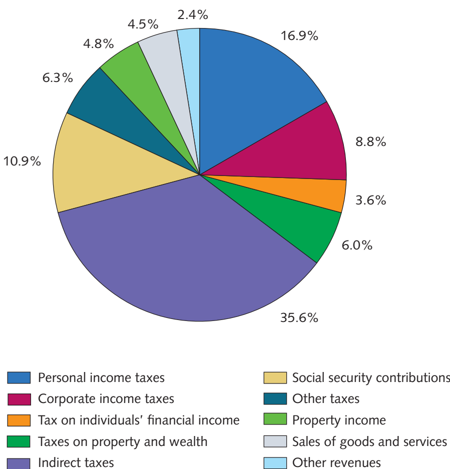
The composition of central government expenditures is shown in Chart 4.6. Health and social protection accounts for almost half of expenditures. The financial crisis increased social protection expenses, chiefly through unemployment costs, which rose from 0.4% of GDP in 2008 to 1.7% in 2009 before starting to taper off again. They were down to 0.5% in 2015.

With falling debt, central government interest expense fell from 3½% of GDP in the mid-1990s to around 2% in 2005-2007, in spite of steep increases in interest rates beginning in 2004. As a result of the debt burden imposed by the banking crisis, central government gross interest expense rose to 6% of GDP in 2009 but had fallen to 4.4% in 2015. The increased foreign debt was used primarily to build up the Central Bank's foreign exchange reserves, however. Government deposits in the Central Bank accrue interest income that must be deducted from interest expense in order to determine the net interest burden.

Beginning in 1997, the central government made an effort to pre-fund civil service pension liabilities, which are not classified as debt under the Maastricht definition, but this stopped in 2009, after the financial crisis. Pre-funding of pension liabilities is expected to resume again in 2017. Adding pension liabilities and short-term payable accounts raises the debt figure by 26 percentage points, to 87% of GDP as of 2015.

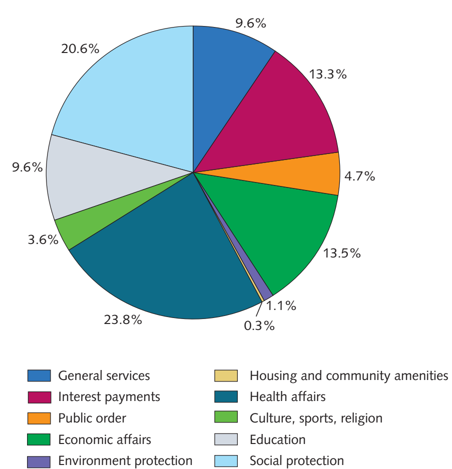
In December 2015, Parliament passed new legislation on public sector finances that imposes stringent rules on operational performance and developments in the debt level (see Box 4.2). The new medium-term fiscal framework is designed to address gaps in the previous legal framework from budget formulation to execution.

Chart 4.5
Composition of central government revenues in 2015



Source: Statistics Iceland.

Chart 4.6
Composition of central government expenditures in 2015



Source: Statistics Iceland.

Local government finances

Local government expenditures amounted to 13% of GDP in 2015. This ratio has risen over the years with increased responsibilities for education and care for the disabled. Education, from preschool to age 16, accounts for more than one-third of expenditures, with culture and recreation and welfare expenditures accounting for about 20% each.

The local government sector broke a 14-year string of deficits in 2005 and remained in surplus in 2006 and 2007, but has returned a slight deficit since then. With the 2008 crisis, local government revenue relative to GDP fell back to the 2005 level and has remained there since. The two largest local government revenue sources, the flat municipal personal income tax that contributed 61% of local government revenues (close to 8% of GDP) in 2015 and a property tax contributing 13% of revenues (1.6% of GDP), have remained stable, however.

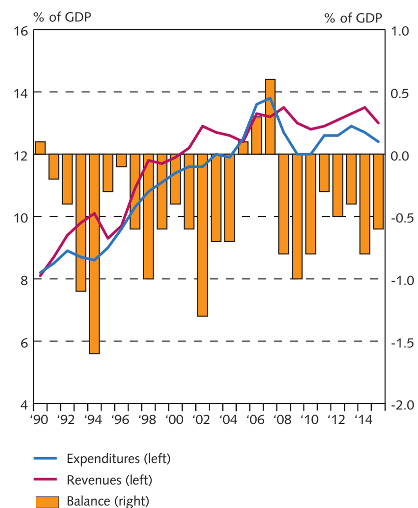
The financial crisis and the depreciation of the króna in 2008 led to an increase in local government debt from just under 5% of GDP in 2007 to 9% of GDP in 2009. The debt level subsided to 7.5% of GDP in 2015.[1] Adding pension liabilities and short-term payable accounts raises the debt figure to just over 13% of GDP as of 2015.

In addition to the direct effects of the crisis on local government balance sheets, several local governments operate utilities or other necessary infrastructure through separate corporations. Some of these accumulated significant foreign-denominated debt before the crisis, whereas their revenue base was domestic. In the most important cases, including Orkuveita Reykjavíkur (Reykjavik Energy), the shortfall has been covered through service charges. Orkuveita Reykjavíkur and other utility companies have managed to recover to a large extent from the 2008 financial crisis; for instance, Orkuveita Reykjavíkur's equity ratio has risen from 14% in 2009 to 37% as of 2015.

Chart 4.7
Procyclicality of indirect taxes

Sources: Statistics Iceland, Central Bank of Iceland.

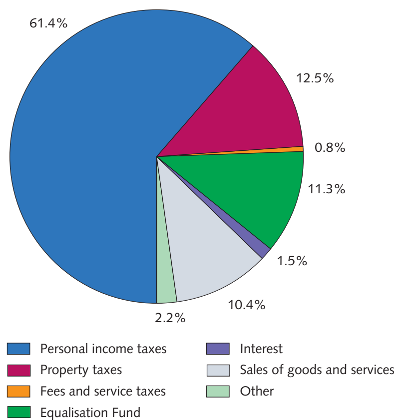
Chart 4.8
Local government finances



Source: Statistics Iceland.

1. Debt as defined by the Maastricht criteria.

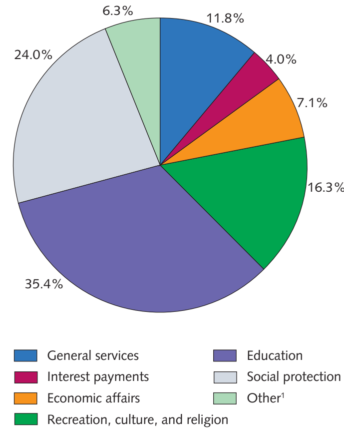
Chart 4.9
Composition of local government revenues in 2015



Personal income taxes
Property taxes
Fees and service taxes
Equalisation Fund
Interest
Sales of goods and services
Other

Source: Statistics Iceland.

Chart 4.10
Composition of local government expenditures in 2015



General services
Interest payments
Economic affairs
Recreation, culture, and religion
Education
Social protection
Other[1]

1. Health, housing, environment, public order.
Source: Statistics Iceland.

Parliament passed a new Local Government Act in September 2011 (see Box 4.2). Multi-year budgeting and two fiscal rules were introduced. The new Act tightened budget procedures and financial oversight considerably.

Box 4.1
The tax system

In 2015, the central government derived around 88% of its revenues (27.6% of GDP) from taxes and social security contributions, while the comparable number for local government was 74.7% (9.3% of GDP).

The personal income tax is levied jointly by the central and local governments. The local government tax, a flat percentage of total taxable income, varies slightly by municipality, averaging just below 14½% in 2015. It yielded 61.4% of local government revenue (7.6% of GDP) in 2015.

The central government tax is progressive, with a rising marginal rate and a zero tax bracket structured as a rebate on taxes due. The result is a four-bracket overall tax structure. The rates and thresholds are shown in Table 1.

In principle, taxes are levied on each individual, but a couple may share the rebate (i.e., the zero bracket) and a higher-earning spouse may utilise up to half of the unused part of the 23.9% bracket of a lower-earning spouse, subject to a maximum of 21,116 euros (2.8 m.kr.). The central government income tax yielded 5.8% of GDP and 17.8% of central government revenue in 2015.

The central government taxes individuals' financial income – dividends, rental income, interest, and capital gains – at a rate of 20%, with an exemption for interest income up to 943 euros per person per year (125 thousand kr.) and an exemption for 50% of rental income earned by individuals. The tax yielded 1.2% of GDP and 3.8% of central government revenue in 2015.

Table 1 Main features of the Icelandic tax system in 2016

	2016[1]	Revenue 2015 % of GDP
Central government personal income tax[2]		5.8%
Bottom bracket/starts at[3]	22.7%/12,450 euros (1.74 m.kr.)	
Middle bracket/starts at	23.9%/ 28,620 euros (4 m.kr.)	
Top bracket/starts at	31.8%/ 71,837 euros (10.04 m.kr.)	
Local government personal income tax		7.7%
min/average/max[4]	12.44%/14.45%/14.52%	
Zero bracket for combined income tax[3]	12,450 euros / 1.74 m.kr.	
Tax on individuals' financial income[5]	20.0%	1.2%
Payroll taxes	7.35%	3.6%
Corporate income (profit) tax	20.0%	2.9%
Property taxes		1.5%
Residential property, average/max	0.286%[6]/0.625%	
Hospitals, schools and related, avg./max	1.32%	
Commercial property, average/max	1.638%[6]/1.650%	
Value-added tax		8.3%
General rate	24.0%	
Reduced rate[7]	11.0%	

1. Based on average EURISK exchange rate year-to-date. 2. Couples are taxed individually, except that a) a couple may share their rebates or double zero brackets; and b) a person may utilise up to half of a spouse's unused 23.9% bracket up to a maximum of 21,116 euros (2.8 m.kr.). 3. The zero bracket is due to the 623 thousand kr. Treasury rebate against the combined income tax rate of 22.7% +14.44%. 4. Maximum rate 14.52% (temporary maximum 15.05% in 2016). Municipalities under financial duress may raise their rate by an extra 10%. 5. Interest income up to 943 euros (125 thousand kr.) and 50% of rental income from residential housing is exempt. 6. Average from 2014. 7. For items in the 7% category and items exempt from the tax, see main text.

Sources: Association of Local Authorities, Directorate of Internal Revenue, Parliament of Iceland website (www.althingi.is), Statistics Iceland.

The corporate income tax, currently 20% of profits, yielded 2.9% of GDP and 9.2% of revenues in 2015. There is a payroll tax of 7.35% of the applicable wage bill. The payroll tax is earmarked for financing unemployment benefits, maternity/paternity leave, and other similar expenses. It was raised in increments from 5.34% to 8.65% in the wake of the 2008 crisis in order to finance unemployment benefits, but has been reduced somewhat since 2012. Along with other taxes on payrolls, it yielded 3.6% of GDP and 11.5% of revenue in 2015.

Since the 2008 crisis, Parliament has introduced three measures of taxation on financial enterprises: i) A tax based on the debt of financial enterprises, introduced for 2011 at 0.041%. In 2014, the rate was raised to 0.376% and the tax was extended to include financial institutions in winding-up proceedings in order to finance the Government's household debt relief programme; ii) An additional payroll tax on financial enterprises, introduced for 2012 at 5.45%, now 5.5%; iii) An additional 6% charge on profits in excess of 1 b.kr., also introduced for 2012. Along with older taxes financing the Financial Supervisory Authority (FME) and the office of the Debtor's Ombudsman, special taxes on the financial sector yielded 1.8% of GDP and 5.8% of State revenues in 2015.

Taxation of property and financial transactions is in three main parts: i) Property taxes levied by local governments on the assessed value of real estate. In 2014, property taxes averaged 0.286% on residential property; 1.320% on schools, health care centres, and other like institutions; and 1.638% on commercial property. The combined yield was 1.5% of GDP in 2015 and

12.1% of local government revenue; ii) A stamp tax collected by the central government, yielding around 0.2% of GDP. After a simplification in 2014, it only applies to transfer of deeds and is 0.8% of the value if the deed holder is an individual, but 1.6% for corporations and other legal entities; and iii) An estate tax with a main rate of 10% (0.1% of GDP). The two state taxes yielded 0.3% of GDP in 2015 and 1.1% of central government revenue.

The largest source of central government revenue is the value-added tax on domestic business, yielding 8.1% of GDP and 25.8% of revenue in 2015. A rate of 24% is charged on most goods and services, while food, accommodation, road tolls, books, newspaper and media subscriptions, audio recordings, indoor heating, and selected services are taxed at 11%. Some categories of goods and services are exempt, including financial services, travel agencies, health services, daycare, education, cultural and athletic events and services, passenger transportation, postal services, the activities of writers and composers, and the services of priests and funeral parlours.

There are central government excise taxes and customs duties on imports of motor vehicles and on fuel (earmarked in part for road construction), as well as an annual licence tax on vehicles. In total, these levies yielded 1.97% of GDP in 2015. A general excise tax is levied on a range of goods at three rates of 15%, 20%, and 25%, while unit fees are charged on some goods. Alcoholic beverages and tobacco are also taxed. Customs duties range from 0% to 30% of the CIF value, although most imports from the EU as well as Iceland's EFTA partners (Norway, Liechtenstein, and Switzerland) are exempt under the EEA Agreement. Higher duties apply to various agricultural products. Central government excise taxes (including those on motor vehicles and fuel), tariffs, and user taxes accounted for around 3.6% of GDP and 11.3% of central government revenues in 2015.

In total, the central and local government taxes and social security contributions described above accounted for 83% of general government revenues and over 99% of tax revenues in 2015. As for the remaining 17% (7.64% of GDP), other taxes accounted for 1% of revenue, grants for 4.3%, property income for 4.5%, sales of goods and services for 6.5%, and miscellaneous income for the remaining 0.7%.

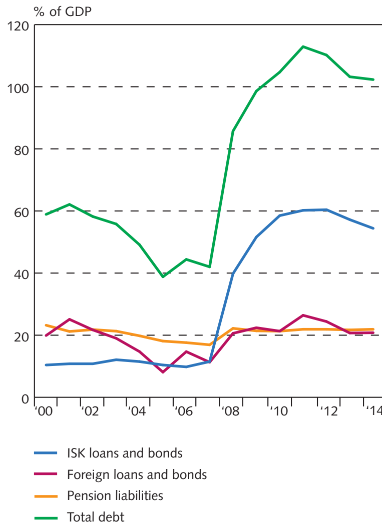
Government holdings in the business sector

In the period 1997-2007, the central government pursued an extensive programme of privatisation. After the privatisation process came to an end, the State's most important business holdings were in Landsvirkjun, the Housing Financing Fund (HFF), and a few smaller financial institutions.

After the financial collapse in October 2008, the State recapitalised the banking system by establishing new banks.[2] The original plan was that the new banks would initially be Government-owned, but according to agreements reached with the estates of the old banks, the estates took a significant equity stake in the new banks. Initially the State held 98% in Landsbankinn, 13% in Arion Bank, and 5% in Íslandsbanki, at a cost of 1.5 billion euros (196 b.kr.), or 12% of GDP. With the settlement of the Glitnir Bank estate through composition agreements based on stability conditions in late 2015, the State received a 95% stake in Íslandsbanki in addition to its previous 5%, making it the sole owner of the bank (see Chapter 8). In addition, through the stability conditions, the State received a small amount of shares in various companies that are now in the process of being sold.

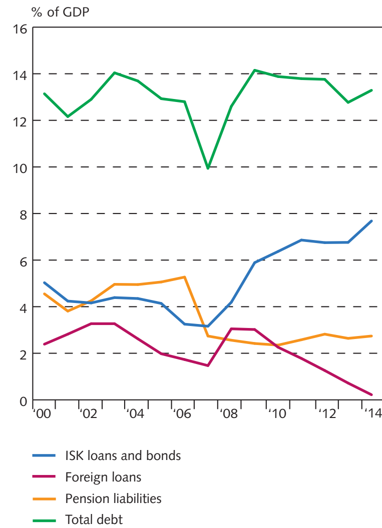
2. See Box 3.1 in the 2014 edition of *Economy of Iceland*.

Chart 4.11
Central government liabilities



Source: Statistics Iceland.

Chart 4.12
Local government liabilities[1]



1. The Maastricht definition of gross government debt does not include pension liabilities and is more akin to loans and bonds.
Source: Statistics Iceland.

Local government holdings are mainly in geothermal production of heating and electricity, as the municipalities own almost all of the geothermal power companies, which supply heating to most homes in Iceland and, on an increasing scale, provide electricity to the aluminium industry. Several local governments also own operating companies for harbours.

Government guarantees

State guarantees must be authorised explicitly in legislation and are generally confined to government enterprises and institutions related to government. Local governments, on the other hand, are prohibited by law from granting loan guarantees except to their own subsidiary institutions.

Central government accounts for 2015 show that the Government has outstanding guarantees equivalent to 51% of GDP. Some 75% of this represents Government backing of residential mortgages through the HFF, a State-owned investment fund with a considerable share of household mortgage lending in Iceland. Another 23% of the guarantees are for the debt of Landsvirkjun, the national power company.

Treasury foreign debt

The Republic of Iceland has been a modest borrower in the international markets since 2014, as it was before the financial crisis. As a result of the crisis, it became necessary to step up foreign borrowing. In 2008, the Government of Iceland negotiated a Stand-By Arrangement with the IMF, which provided Iceland with access to loan facilities from the IMF, the Nordic countries, and Poland. Bilateral loans from the treasuries of Denmark, the Faeroe Islands, Finland, Poland, and

Table 4.1 Republic of Iceland foreign bond issues[1]

Amount in millions	*Issue date*	*Maturity*	*Currency*	*Loan facility amount*	*Outstanding amount*
Eurobond (MTN)	2012	2022	USD	1,000	1,000
Eurobond (MTN)	2014	2020	EUR	750	750

1. Figures are as of 31 July 2016.
Source: Central Bank of Iceland.

Sweden were granted to the Treasury, whereas the loans from the IMF and Norway were granted to the Central Bank of Iceland. Furthermore, the Treasury launched three successful bond issues from 2011 to 2014 in order to rebuild confidence in foreign credit markets and used the proceeds to refinance other foreign debt. All the loans taken by the Treasury and the Central Bank, as well as two of the bond issues, have now been paid in full. At the end of July 2016, two foreign bonds were outstanding, leaving the Treasury's foreign debt at 1,654 million euros (219 b.kr.).

Under a special agreement with the Minister of Finance and Economic Affairs, the Central Bank is responsible for the implementation of both domestic and foreign borrowing for the Treasury. The Republic of Iceland has never failed to honour its financial obligations and has always paid when due the full amount of principal, interest, and sinking fund instalments for all internal and external obligations.

Republic of Iceland credit ratings

Although Iceland had unsolicited ratings beginning in 1986, the first formal long-term credit ratings for the Republic of Iceland were issued in 1994, in the single-A category. In the years that followed, Iceland's credit ratings steadily improved, reaching the AA - AAA categories prior to the financial crisis in late 2008. The ratings were lowered during the crisis, although investment-grade ratings were maintained by both Moody's and Standard & Poor's (S&P). The Republic of Iceland's credit ratings have been steadily recovering in recent years.

Fitch Ratings upgraded Iceland's long-term foreign issuer default rating to BBB+ in July 2015. Following Fitch's update of its general sovereign rating criteria in 2016, Iceland's long-term local currency rating stands at BBB+, the short-term foreign currency rating at F2, and the country ceiling at BBB+. The outlook was rated as stable. In its July 2016 report, Fitch stated that "[t]he main factors that, individually or collectively, could trigger positive rating action are: a track record of continued economic growth without excessive macroeconomic imbalances; continued improvements in debt dynamics, supported by prudent fiscal policy; and continued reductions in external vulnerability." On the other hand, factors that could trigger a negative rating action

Table 4.2 Republic of Iceland credit ratings

		Foreign currency		*Local currency*		
	Affirmed	*Long-term*	*Short-term*	*Long-term*	*Short-term*	*Outlook*
Moody's	September 2016	A-3	…	A-3	…	Stable
Standard & Poor's	July 2016	BBB+	A-2	BBB+	A-2	Stable
Fitch	July 2016	BBB+	F2	BBB+	F2	Stable

Source: Central Bank of Iceland.

included “evidence of overheating in the domestic economy; excessive capital outflows after the lifting of capital controls, leading to external imbalances and pressures on the exchange rate; and a weakened commitment to fiscal consolidation, for example through continued pro-cyclical fiscal policy that would reverse or stall the decline in the public debt ratio”.

In September 2016, Moody’s upgraded Iceland’s Government bond and issuer ratings by two notches, to A3 from Baa2, with a stable outlook. Moody’s also raised the ceilings on local currency debt and deposits to A1 from Baa1 and the ceilings on long-term foreign currency debt and deposits to A3 from Baa2. The ceilings on short-term foreign currency debt and deposits are unchanged at P-2. With this rating action, Moody’s concluded the review for upgrade which had commenced on 10 June 2016. In its press release, Moody’s identified the two main drivers as: (1) that further significant improvement in government debt metrics was expected, and (2) that event risk had been reduced due to the cautious liberalisation of capital controls. Moody’s further stated that the stable outlook balanced “… the positive impact of moderate but sustained growth and continued fiscal consolidation against, for example, the residual risks from capital account liberalization, the potential economic and financial pressures associated with substantial capital inflows and tight labour markets, and finally the evolving political dynamics.”

S&P upgraded Iceland’s long- and short-term foreign and local currency sovereign credit ratings from BBB-/A-3 to BBB/A-2 in July 2015 and again to BBB+/A-2 in January 2016. In its most recent credit report, published in July 2016, S&P affirmed Iceland’s long-term local and foreign currency rating of BBB+ and the local and foreign short-term rating of A-2, with a stable outlook. S&P stated that it “could raise the ratings if capital controls are fully lifted without putting the balance of payments or financial stability at risk. We could also raise the ratings if the ratio of net general government debt to GDP declines materially faster that we presently anticipate.” On the other hand, the credit rating could be lowered if the agency “perceived that the sizable wage hikes led to a significant overheating of the domestic economy with heightened risks for the country’s monetary, fiscal, or external stability. We could also lower the ratings if further liberalization of capital controls led to a significant decline in net reserves, placing renewed pressure on the Icelandic krona exchange rate and the financial system.”

Box 4.2
Iceland’s fiscal framework

The fiscal impact of the financial crisis and the extent of fiscal consolidation required thereafter helped to build the political consensus needed to implement reforms to the fiscal framework. Two new acts of law have been passed: the Local Government Act in September 2011 and the Act on Public Sector Finances in December 2015.[1]

The Local Government Act

Local government reforms are quite extensive. First, two numerical fiscal rules were adopted so as to provide a long-term anchor and a medium-term fiscal path that is quantified in a required

1. The IMF’s Fiscal Affairs Department (FAD) played a key role in the process by providing numerous recommendations in four reports prepared by technical advisory missions. The aim of the reports was to put Iceland's fiscal framework at the forefront of international budget practice.

multi-year budget. Second, municipalities are subjected to a three-tiered approach to external financial monitoring based on the principle of earned autonomy. Third, there are sanctions, ranging from mild to severe, for violating the fiscal rules. Fourth, local governments are monitored by an independent external body, the Municipal Fiscal Oversight Committee (MFOC).

The two numerical rules are a balanced budget rule and a debt ceiling rule, and both extend to Parts A and B[2] of the budget. The first rule prohibits municipalities from running operating deficits within a rolling period of three years. The second rule subjects municipalities to a maximum debt-to-revenue ratio of 150%. The definition of debt is broad and includes all liabilities and obligations.

The MFOC's task is to monitor local government finances, including accounting practices and budget proposals, and compare them to the criteria in the Local Government Act and any regulations deriving therefrom. The Committee subjects municipalities to three-tiered monitoring, which entails classifying the municipalities into one of three categories based on whether, and by how much, they are in breach of the rules. Both the autonomy and the degree of external monitoring to which a municipality is subjected vary depending on its category. The MOFC has the authority to impose sanctions on municipalities that are in breach of the rules and to recommend to the Minister of Local Governments that a municipality's fiscal powers be suspended and vested in a financial management board.

The Act on Public Sector Finances

The new Act on Public Sector Finances is a vast improvement over the previous legislation, as it addresses the gaps, loopholes, and inconsistencies in the old legal framework that helped contribute to lack of fiscal discipline before the crisis. Many features of the former Financial Reporting Act were preserved, and a number of processes and best practice guidelines have been elevated to the statutory level.[3] The scope of the Act has been expanded to include all sections of central and local government budgets and all public corporations. Ministerial responsibilities are also expanded considerably.

The main objective of the new legislation is to provide for sound macro-fiscal policy based on comprehensive medium-term budgeting and reporting. The new medium-term fiscal framework (MTFF), the cornerstone of the new Act, is designed to address gaps in the old legal framework from budget formulation to execution. The objective is to set up a transparent and credible MTFF that serves the purpose of mapping out macroeconomic and fiscal policy-making. The Act establishes a procedural fiscal rule that maps out a five-year general government fiscal path with the following three fiscal rules:

1. The overall result over a five-year period must always be positive, and the annual deficit may not exceed 2.5% of GDP.
2. Total debt, excluding pension obligations and accounts payable, but including cash balances and deposits, may not exceed 30% of GDP.[4]
3. If the net debt ratio rises above 30%, the excess portion must decline by an average of at least 5% (1⁄20) per year in each three-year period.

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2. Falling under Part A are activities operated directly through the Treasury or municipal account, while Part B includes the operations of Government-owned companies.
3. The FAD's third report contained 46 very specific recommendations. Most of the recommendations have been incorporated into the new Act on Public Sector Finances, some with variations.
4. This definition of debt is an approximation of the conventional definition of net debt, where all monetary assets are deducted from liabilities. Here, however, only cash and readily disposable monetary assets are deducted. This definition is used in part because the Treasury has taken account of loans taken, for example, to expand the Central Bank's foreign exchange reserves. Those funds have not been used for operations and are available for repayment of the loans. This definition gives a clearer picture of how much debt must be paid down with cash from operations.

Every new Government is obligated to formulate and submit to Parliament, as a proposed parliamentary resolution, a Statement of Fiscal Policy setting out the five-year fiscal path according to the procedural fiscal rule. Each year throughout the tenure of the five-year plan, the Minister of Finance shall present a fiscal plan or a medium-term fiscal strategy to Parliament.[5] An independent fiscal council assesses whether the fiscal policy and fiscal plan are in line with the fundamental values and fiscal rules in the legislation.

Parliament shall authorise budgetary allocations to various fields and functions, plus a contribution to a general contingency fund rather than to a large number of agencies. This will reduce budget items from approximately 900 items to 150-210.

When the fiscal budget is implemented, each minister must report to the Government and the Parliamentary Budget Committee on the implementation of the budget. Fiscal reporting is an important part of progressive fiscal responsibility laws. The scope of reporting is increased significantly with the new Act, and reports on budget outcome are moved forward so that the previous year's outcome is available well in advance of the fiscal plan.

5. This shall be done at the spring legislative session in the form of a parliamentary resolution.