4 Public sector

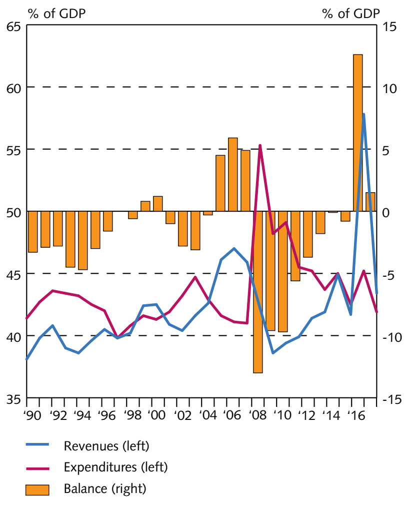
This chapter describes the public sector in Iceland, focusing on the division of responsibilities, central and local government finances, the structure of the tax system, and government balance sheets. Recent developments in Iceland's sovereign credit ratings are discussed as well.

The size of the government sector

By 2017, Icelandic general government expenditure was back to the 1998-2008 twenty-year average of 42% of GDP, after peaking at 55% of GDP in 2008. Iceland's expenditure ratio is somewhat below the Nordic countries' range of 47-52% of GDP. Iceland is at a level similar to that in Luxembourg, but slightly higher than in Japan, UK and the US, where levels are below 40%.

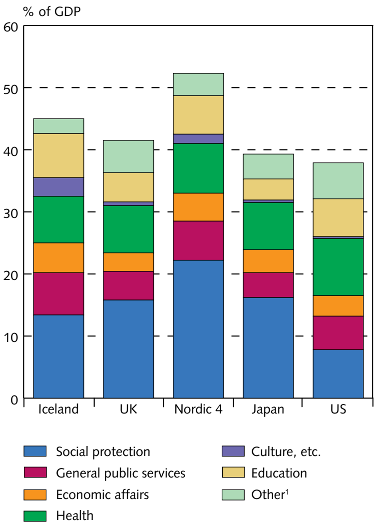
Several factors have allowed Iceland to function efficiently with a relatively small government sector: comparatively limited spending on social affairs, in part due to a relatively young population; historically low unemployment; and the historical absence of defence expenditure. Furthermore, fully funded private pension funds, organised by occupation, as opposed to a pay-as-you-go system in terms of benefit pay-outs, accounted for over 69% of pension payments in 2017, whereas public pensions are the dominant pillar in many other OECD countries (see

Chart 4.1
General government finances[1]



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

Chart 4.2
General government expenditures 2016



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

Chapter 2). The relatively young population and high retirement age also result in lower overall pension expenditure.

On the revenues side, there was rapid growth during the upswing prior to 2008, bringing the revenue ratio up to the euro area average of around 46% of GDP. The ratio fell as low as 39% of GDP in 2010 but began to inch upwards after the economic recovery started to take hold, measuring 43% of GDP in 2017.

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.

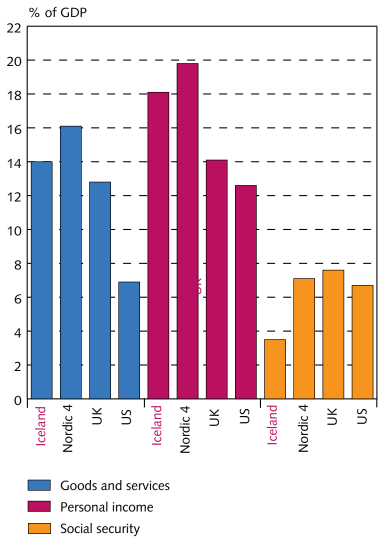
Division of responsibilities

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.

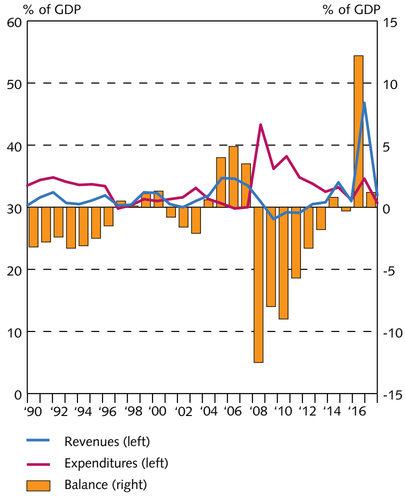
The central government is responsible for police, courts, foreign affairs, upper secondary and tertiary education, health services, institutional care for the elderly, general support and services

Chart 4.3
Importance of tax categories 2016



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.

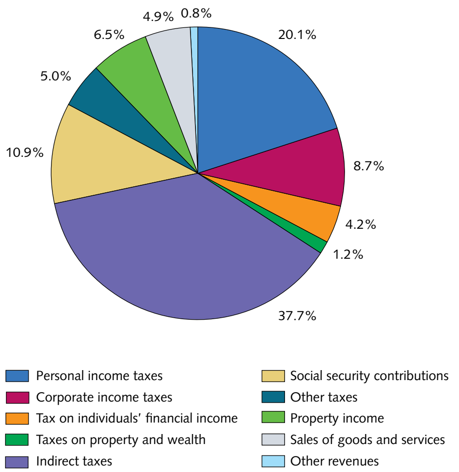
for industry, and most infrastructure construction and maintenance not obviously specific to particular municipalities. It administers benefit programmes for elderly and disabled persons, unemployment benefits, mortgage interest subsidy payments for owner-occupied housing, rent benefits for residential 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 meeting the housing needs of low-income households. Local governments provide supplementary assistance to general pensions and income support programmes 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

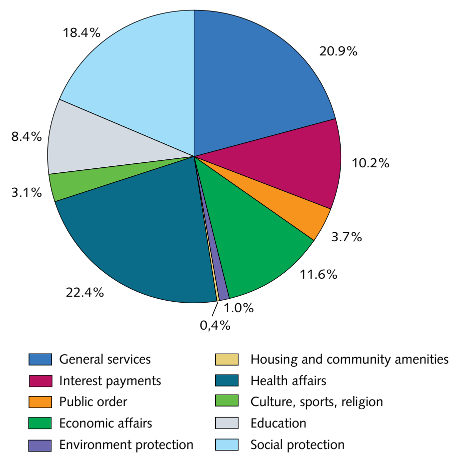
General government finances were in surplus in the period prior to the 2008 crisis. Gross general government debt, as defined by the Maastricht criteria, had fallen to 27% of GDP in 2007. In 2008, the Government assumed large liabilities and substantial consolidation became necessary. As a result, general government gross debt rose to 95% of GDP in 2011 but has fallen since, to 42% of GDP at the end of 2017. The outlook is for government debt to decline by a further 5% of GDP by 2020.

Chart 4.5
Composition of central government revenues in 2017



Source: Statistics Iceland.

Chart 4.6
Composition of central government expenditures in 2016



Source: Statistics Iceland.

Central government finances

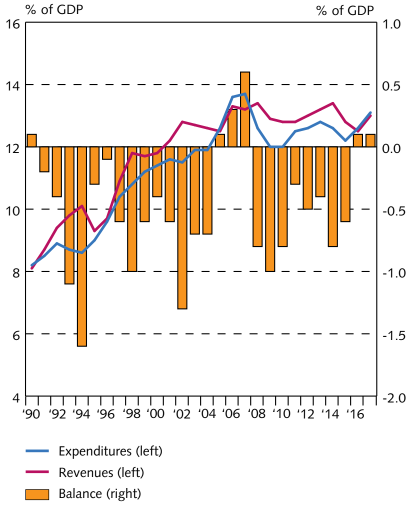
Since 1980, central government revenues have been fairly stable, fluctuating between 28% and 33% of GDP, in tandem with the business cycle. Only in the 2004-2007 upswing did they rise above that range.

The composition of central government revenues in 2017 is shown in Chart 4.5. Direct taxes generate almost half of total revenues, while indirect taxes constitute 38%. 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 (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, 38% of central government revenues come from taxes targeting consumption of 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 2% of GDP in 2003 to almost 5½% at the height of the

Chart 4.7
Procyclicality of indirect taxes

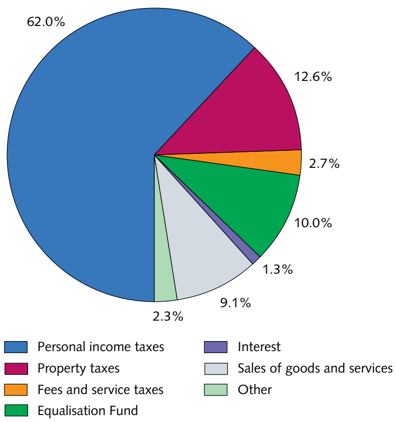
Source: Statistics Iceland.

Chart 4.8
Local government finances



Source: Statistics Iceland.

Chart 4.9
Composition of local government revenues in 2017



Source: Statistics Iceland.

upswing. In 2009-2013, they fell to below 3½% of GDP despite significantly increased tax rates, but then rose again to 4.1% of GDP in 2015. Combined central government revenues 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.

The composition of central government expenditures is shown in Chart 4.6. Health and social protection account for almost half of expenditures. The recession after 2008 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. Unemployment costs had fallen back to 0.4% by 2016.

Central government interest expense was around 2% of GDP in 2005-2007, in spite of steep increases in interest rates beginning in 2004. As a result of the debt burden imposed in 2008-2011, central government gross interest expense rose to 5.7% of GDP in 2009 but had fallen to 3.5% by 2016. 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. This was discontinued in the wake of the crisis but resumed in 2017. Adding pension liabilities and short-term payable accounts raises the debt figure by 28 percentage points, to 63% of GDP at the end of 2017.

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.

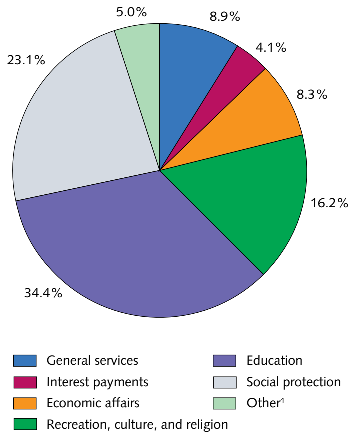
Local government finances

Local government expenditures amounted to 13% of GDP in 2017. This ratio has risen over the years as local governments have assumed increased responsibilities for education and care for the disabled in 2016. Education, from pre-school to age 16, accounts for 42% of expenditures, with culture and recreation and welfare expenditures accounting for about 20% each.

The local government sector broke a fourteen-year string of deficits in 2005 and remained in surplus in 2006 and 2007. After the crisis, another eight-year string of deficits ensued, followed by a slight surplus in 2016 and 2017. The two largest local government revenue sources, the flat municipal personal income tax contributing 61% of local government revenues (close to 8% of GDP) in 2017 and a property tax contributing 13% of revenues (1.6% of GDP), have remained stable.

The depreciation of the króna in 2008 led to an increase in local government debt from just under 5% of

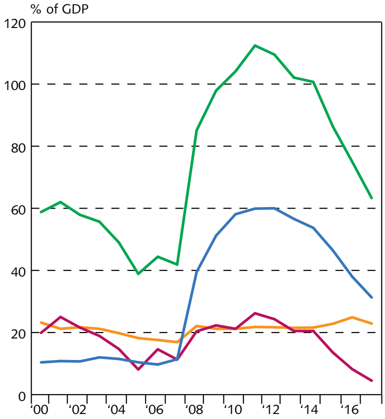
Chart 4.10
Composition of local government expenditures in 2016



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

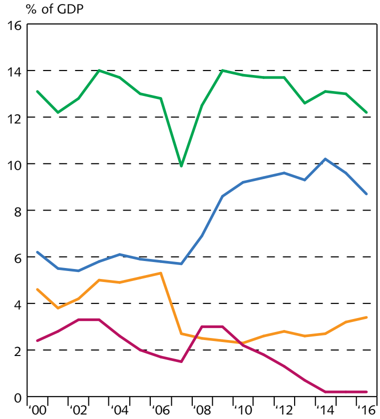
1. Debt as defined by the Maastricht criteria is total financial liabilities less insurance, technical reserves, and other accounts payable.

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.

GDP in 2007 to 9% of GDP in 2009. The debt level subsided to 6.6% of GDP in 2017.[1] Adding pension liabilities and short-term payable accounts raises the debt figure to just over 12% of GDP at the end of 2017.

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

Box 4.1
The tax system

In 2017, the central government derived around 86% of its revenues (27.6% of GDP) from taxes and social security contributions, while the comparable number for local government was 77.3% (10.1% 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 2017. 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 two-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 22.5% bracket of a lower-earning spouse.

The central government taxes individuals' financial income – dividends, rental income, interest, and capital gains – at a rate of 22%, with an exemption for interest income up to 1,200 euros per person per year (150 thousand kr.) and an exemption for 50% of rental income earned by individuals.

The corporate income tax is currently 20% of profits, after having been raised incrementally from a low of 15%. There is a payroll tax of 6.85% 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% between 2008 and 2011 in order to finance unemployment benefits, but was reduced to the current 6.85% in 2012.

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. This tax is scheduled to be lowered in four increments to 0.145% by 2023; 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. 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 2017, property taxes averaged 0.288% on residential property; 1.320% on schools, health care centres, and other like institutions; and 1.641% on commercial property; ii) A stamp tax collected by the central government, yielding around 0.2% of GDP. After a simplification in 2014, the stamp tax

Table 1 Main features of the Icelandic tax system in 2018

	2018[1]	*Revenue 2017 % of GDP*
Central government personal income tax[2]		6.4%
Lower bracket/starts at[3]	22.5%/14,120 euros (1.75 m.kr.)	
Higher bracket/starts at	31.8%/ 86,340 euros (10.7 m.kr.)	
Local government personal income tax		8.1%
min/average/max[4]	12.44%/14.44%/14.52%	
Zero bracket for combined income tax[3]	14,120 euros / 1.75 m.kr.	
Tax on individuals' financial income[5]	22.0%	1.3%
Payroll taxes	6.85%	3.6%
Corporate income (profit) tax	20.0%	2.8%
Property taxes		1.6%
Residential property, average/max	0.288%[6]/0.625%	
Hospitals, schools and related, avg./max	1.32%	
Commercial property, average/max	1.641%[6]/1.650%	
Value-added tax		8.5%
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 22.5% bracket up to a maximum of 22,590 euros (2.8 m.kr.). 3. The zero bracket is due to the 645 thousand kr. Treasury rebate against the combined income tax rate of 22.5% +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 1,200 euros (150 thousand kr.) and 50% of rental income from residential housing is exempt. 6. Average from 2017. 7. For items in the 11% 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.

applies only to transfer of deeds. It is set at 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 largest source of central government revenues is the value-added tax on domestic business, yielding 8.5% of GDP and 26.6% of revenues in 2017. 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/ministers 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. A general excise tax is levied on a range of goods at three rates – 15%, 20%, and 25% – while unit levies 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 2.9% of GDP and 8.4% of central government revenues in 2017.

In all, the central and local government taxes and social security contributions described above accounted for 85% of general government revenues and over 98% of tax revenues in 2017. As for the remaining 15% (6.4% of GDP), other taxes accounted for 1.5% of revenues, grants for 0.2%, property income for 5.8%, sales of goods and services for 6.5%, and miscellaneous income for the remaining 1%.

Government holdings in the business sector

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

After October 2008, the State recapitalised the banking system by establishing new banks. 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 6). In addition, through the stability conditions, the State received small shareholdings in various companies that are now in the process of being sold. By year-end 2017, the central government's business sector holdings were mainly in financial institutions, as a result of the settlement of the failed banks' estates.

Local government holdings are mainly in geothermal production of heat and electricity. Iceland's 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.

Table 4.1 Republic of Iceland foreign bond issues[1]

Type	*Issue date*	*Maturity*	*Currency*	*Loan facility amount*	*Outstanding amount*
US Dollar bond (MTN)	2012	2022	USD	1,000	92
Eurobond (MTN)	2014	2020	EUR	750	352
Eurobond (MTN)	2017	2022	EUR	500	500

1. Figures are as of 30 June 2018. Amount in millions.
Source: Central Bank of Iceland.

Government guarantees

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

As of year-end 2017, the central government's outstanding guarantees amounted to 39% of GDP. Some 82% of this represents Government backing of residential mortgages through the HFF, a State-owned investment fund with a sizable share of household mortgage lending in Iceland. Another 16% of the guarantees are for the debt of Landsvirkjun.

Treasury foreign debt

Since 2014, the Republic of Iceland has been a modest borrower in the international markets, as it was before the financial crisis. Loans taken in connection with the post-crisis recovery programme were repaid in full in 2015.

In 2017, the Treasury bought back its 2022 US dollar bond, in the nominal amount of 908 million US dollars. The original amount of the bond was USD 1 billion. At the end of 2017, a new eurobond was issued alongside the buyback of an existing 2.5% bond maturing in 2020. The buyback totalled just over 398 million euros, and the outstanding balance of that bond is now 352 million euros. The new bond, a five-year 500 million euro issue, bears 0.5% fixed interest and was issued at a yield of 0.56%.

At the end of June 2018, three foreign bond issues were outstanding, leaving the Treasury's foreign debt at 934 million euros (115.6 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

Iceland has received unsolicited credit ratings since 1986, but 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 range in late 2008. Although ratings were downgraded during the 2008 recession, investment-grade ratings were maintained throughout by both Moody's and Standard & Poor's (S&P Global). The Republic of Iceland's credit ratings have been on an upward trajectory in recent years. Iceland is currently rated A3 by Moody's and A by S&P Global and Fitch Ratings.

Table 4.2 Republic of Iceland credit ratings

		Foreign currency		*Domestic currency*		
	Affirmed	*Long-term*	*Short-term*	*Long-term*	*Short-term*	*Outlook*
Moody's	July 2018	A3	…	A3	…	Positive
Standard & Poor's	June 2018	A	A-1	A	A-1	Stable
Fitch	June 2018	A	F1	A	F1	Stable

Source: Central Bank of Iceland.

Fitch Ratings upgraded Iceland's long-term foreign and local currency issuer default ratings (IDR) from A- to A in December 2017, with a stable outlook. The agency cited the considerable reduction in the Icelandic economy's external vulnerability as a main rating driver, noting strong current account surpluses and the downward trajectory of public debt ratios. Fitch stated that evidence of overheating or a weakened commitment to fiscal consolidation in the medium term could put downward pressure on the ratings. On the other hand, continued balanced growth and reductions in the public debt ratio could lead to a positive rating action.

Moody's Investors Service has maintained an A3 rating on Iceland's Government bond and issuer ratings since September 2016. Moody's most recent rating action for Iceland was in July 2018, when the outlook was changed from stable to positive. The rating agency concurrently affirmed Iceland's long-term issuer rating at A3. The key drivers cited for the change in outlook were improving economic resilience due to a net external creditor position, more balanced growth, and an increasingly robust domestic banking system. Moody's also noted greater-than-expected improvements in the Government's debt metrics. In its most recent annual credit analysis, Moody's stated that deteriorating competitiveness represented the most significant threat to the sustainability of Iceland's external position.

S&P upgraded Iceland's long-term foreign and local currency sovereign credit ratings from A- to A in March 2017, noting that the recent liberalisation of most of the remaining capital controls and the conclusion of an agreement with the owners of offshore króna assets had strengthened Iceland's external profile. This entailed the likelihood that balance of payments stress due to liberalisation of capital controls had been reduced and that the removal of controls on residents could facilitate access to foreign capital markets as well as providing the Central Bank of Iceland with increased policy flexibility. In its most recent publication, from June 2018, the outlook remained stable, reflecting S&P's view that risks stemming from the domestic economy overheating are balanced against the potential for more rapid improvements in Government and external balance sheets over the next few years.

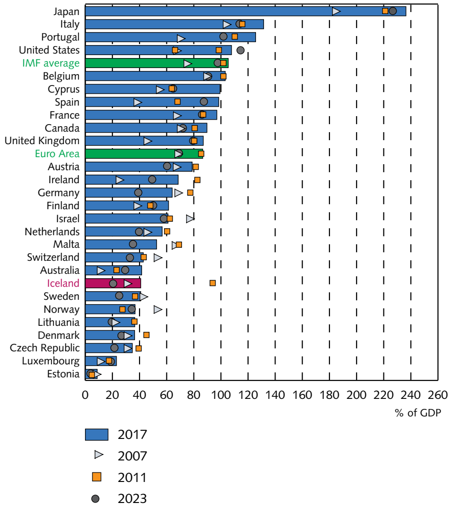
Government balance sheets

Iceland's general government gross debt was among the lowest in advanced IMF countries in 2007 (Chart 4.13). Gross debt rose substantially between 2008 and 2011, but it has fallen since then and was well below the average for IMF member countries in 2017. Furthermore, if projections of nominal GDP growth and a general government surplus are borne out, general government debt will be further reduced. According to a recent IMF forecast, by 2021 Iceland will again be among the advanced IMF countries with the lowest general government debt.[2]

2. International Monetary Fund (2018). *Fiscal Monitor*, April 2018.

The central government has by far the largest balance sheet, with assets and liabilities constituting almost 89% of the general government balance sheet, while the local government share is about 11%. Social security accounts constitute only a marginal share of general government accounts in comparison with central and local government. As a result, general government financial assets and liabilities are largely those of the central and local governments.

Chart 4.13
Gross general government debt in selected IMF countries



Source: IMF Fiscal Monitor April 2018.

Central government

The fiscal position of the central government was strong in 2007, as net financial assets became marginally positive. Net financial assets turned negative by 32.4% of GDP in 2009 and deteriorated further, bottoming out at -47.3% of GDP in 2012. Since then the position has improved, and in 2017 net financial assets stood at -26.1% of GDP.

After 2008, currency and deposits emerged as the central government's largest asset group, as foreign debt was used to build up the Central Bank's foreign exchange reserves. The second-largest asset group is shares and other equity holdings. Shares and equity held by the central government are still close to 20% of GDP, after the State received a 95% stake in Íslandsbanki in addition to its previous 5%, making it the sole owner of the bank. The increase in the two largest asset groups, plus the fact that the Treasury needed to hold more deposits to finance the deficit, explains why financial assets rose from 43% of GDP in 2007 to as high as 67% in 2011. They have since declined and stood at 37% of GDP in 2017.

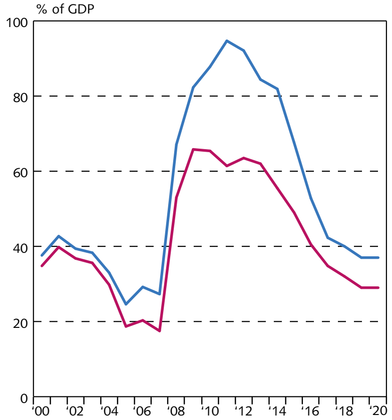
After bottoming out at 39% of GDP in 2005, central government financial liabilities soared, reaching a high of 112% of GDP in 2011; however, they had fallen to 63% by the end of 2017 and are projected to fall further still.

The depreciation of the króna in 2008 led to a rapid weakening of the gross debt position, as 33% of central government debt was denominated in foreign currency. The need to strengthen the Central Bank's foreign exchange reserves led to a further increase in the gross debt position. Consequently, central government gross foreign debt rose from 11.3% of GDP in 2007 to 26.2% of GDP in 2011. Gross debt has since declined, mainly because the loans from the IMF and the bilateral loans taken to strengthen the Central Bank's reserves have been paid in full. By 2017, gross debt had fallen to 4.5% of GDP.

As borrowed funds were used to acquire assets, net debt[3] increased less. While central government gross debt increased by 68% of GDP between 2007 and the 2011 peak, net debt

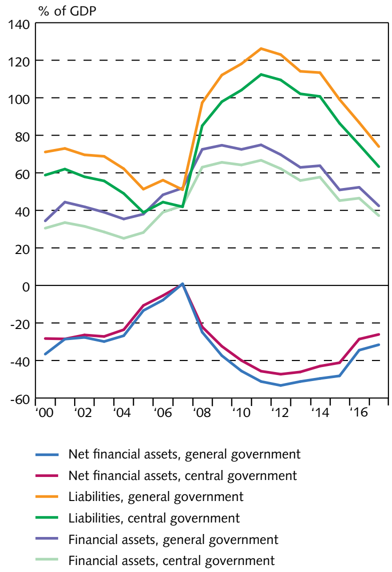
3. Net debt is defined here as gross debt less currency and deposits; i.e., readily available funds that can be used to pay down debt.

Chart 4.14
General government debt[1]



1. Central Bank baseline forecast 2018-2020 from *Monetary Bulletin* 2018/2. Gross debt according to Maastricht criteria and net debt according to the definition in the Act on Public Sector Finances.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4.15
Financial assets and liabilities



Source: Statistics Iceland.

increased by only 44% of GDP, to 66% of GDP. Net debt stood at just over 29% of GDP at year-end 2017.

Fiscal deficits were financed primarily in domestic financial markets following the financial crisis. Króna-denominated debt increased from 11.5% of GDP in 2007 to around 31% in 2017, after peaking in 2011 at 60%. At year-end 2017, króna-denominated liabilities, including pension liabilities, amounted to 59% of GDP, compared to 31% of GDP in 2007. Overall, total central government liabilities amounted to 63% of GDP in 2017 (36% according to the Maastricht criteria[4]), as opposed to 42% in 2007, after peaking at 112% in 2011.

Local government

Since 2009, local government gross debt has been on a declining path, helped by a new fiscal debt rule stipulating that debt may not exceed 150% of regular revenues (see Box 4.2). By 2016 it had fallen to 6.6% of GDP. To minimise risk, most of local governments' foreign debt has been refinanced; it amounted to only 0.2% of GDP at year-end 2017.

As is the case with the central government, local governments have financed their deficit spending primarily in the domestic credit market, increasing their króna-denominated debt from 3.2% of GDP in 2007 to 7.3% in 2017.

Local governments' financial assets were stable at approximately 8-9% of GDP from 2005 through 2012 but had fallen to 5.4% in 2017, due mostly to a decline in outstanding loans and other accounts receivable. Cash and deposits declined because of improved asset management,

4. Debt as defined by the Maastricht criteria.

while the nominal value of shares remained stable over the period but declined as a share of GDP because of a rise in nominal GDP. Therefore, all asset groups declined as a share of GDP from 2012 onwards.

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 were 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 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 MFOC has the authority to impose sanctions on municipalities that are in breach of the rules and to recommend to the Minister of Local Government 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 weakened fiscal discipline. 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

1. The IMF's Fiscal Affairs Department (FAD) played a key role in the process by providing numerous recommendations in the 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.
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.

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.

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 and Economic Affairs 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.

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