



The Fiscal Budget Proposal for 2014

Medium Term Outlook 2014-2017

October 1st 2013

2014



1. Fiscal outlook in 2013 and 2014

2014



Fiscal deficit 2013

The fiscal deficit in 2013 is estimated to be **ISK 31.1 bn.** In the final budget 2013 the deficit was assumed to be only **ISK 3.7 bn.**

The economic outlook is relatively weaker now than assumed in the 2013 budget when it was passed by Parliament last autumn.

Consequently the revenue forecast for this year is weaker than assumed in the 2013 budget and some weaknesses have appeared on the expenditure side.

2014



Fiscal deficit 2013

- Weaker economic outlook and lower economic growth (ISK 13.5 bn).
- Asset sales revenue (ISK 4 bn) and dividend payments (ISK 1 bn) did not turn out as expected.
- Expenditure weaknesses and new decisions made after the 2013 budget was passed by Parliament (ISK 5 bn).
- New decisions in last summer Parliament:
 - Fishing levy revenue is ISK 3.2 bn lower than expected and VAT on hotels is onward in the lowest bracket ISK which means 0.5 bn lower revenue.
 - New social security system legislation (ISK 1 bn).

2014



The 2014 outlook without fiscal measures

- Without any fiscal measures the year 2014 was estimated to end in a **ISK 27 bn** deficit.
 - A substantially weaker revenue forecast for 2013 affects the revenue outlook in 2014 and onwards. Also lower revenue from dividend payments and asset sales.
 - An increase in social security cost and health insurance, unfunded projects in the investment plan which was introduced in the 2013 budget, capital spending in relation to silica plant in Bakki and more.
- Without introducing revenue and expenditure measures the fiscal outlook would have been an ongoing budget deficit in coming years.

2014



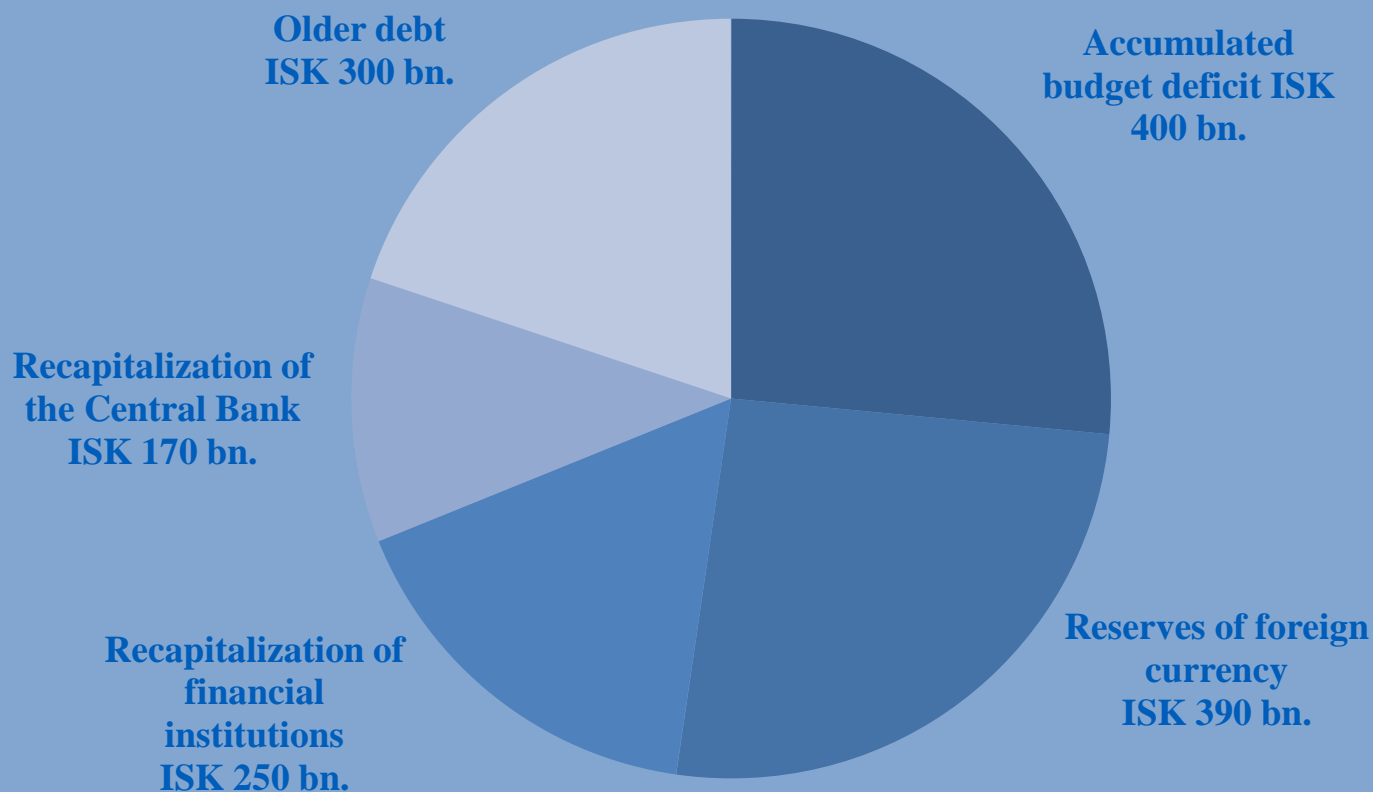
Debt level too high

- The accumulated budget deficit, and thereby debt accumulation, during last years will reach approximately **ISK 400 bn** in the end of this year.
- At the end of 2013 the total debt of the Treasury will amount to ISK 1.500 bn or approximately **85% of GDP**.

2014



Debt level is too high



2014



Interest cost is too high

- Interest expenditure in the 2013 budget was estimated to be approximately **ISK 85 bn.**
- The interest cost of bonds used to recapitalize Iceland's commercial banks is in total **ISK 50 bn** since 2010.
- The budget deficit of the last years has been capitalized with domestic bond issuance. Yearly interest cost as a result of this issuance amounts to around **ISK 30 bn.**

2014



Contingent liabilities are high

- In parallel with a plan of debt reduction, a strategy needs to be formed on how to meet liabilities of the Pension Funds for State Employees, LSR and LH (**ISK 390 bn**).
- Current outlook for the B-section of LSR is that it will be insolvent in 2027 and would then need up to **ISK 33 bn** contribution yearly, when all is included.
- State guarantees for the Housing Financing Fund (HFF) amount to ISK 940 bn.
 - Since 2009 HFF has received a contribution of total ISK 46 bn from the Treasury.

2014



Calls for responsible fiscal measures

- Stopping the debt accumulation and acquiring a positive total balance for the central government is a prerequisite of gaining a foothold.
- An indebted Treasury is vulnerable and has little capacity for stimulative action if needed.
- At the beginning of the recession in 2008, the favorable debt ratio of the central government was of vital importance.
- A revision of a strategy to sell state assets in the purpose of lowering debt is necessary.

2014



2. Sustainable fiscal policy

2014



Sustainable fiscal policy

- The goal of the 2014 Budget is a positive total balance of the central government and stopping the Treasury's debt accumulation.
 - Implement necessary restraint measures.
 - Broaden tax bases and implement tax reductions.
 - Increase the disposable household income.
 - Stimulate the economy.

2014



Restraint measures

- Turnover based restraint measures of ministries in 2014 – **ISK 3.6 bn.** That amounts to 0,8% of the budget turnover for 2013.
- Selective restraint measures will lower expenditure by **ISK 2.6 bn.**
- Cancelling new projects which haven't been started, **ISK 5.8 bn.**
- In total, this amounts to **ISK 12 bn** in lower expenditure for 2014.

2014



Restraint measures

ISK billions	Restraint measures	Turnover 2013	Change in percentage
Turnover based measures	-3.583	477.389	-0,8%
Selective measures	-2.595	477.389	-0,5%
Cancelling new projects	-5.790	477.389	-1,2%
Total	-11.968	477.389	-2,5%

2014



Broadening of tax bases

- **Bank levy:** base broadening and rate increase from 0.041% to 0.145%.
- Estimated bank levy revenue is **ISK 15.5 bn** (was ISK 1.1 bn in 2013).
 - Thereof **ISK 11.3 bn** from **broadening of the tax base.**
 - From beginning of 2014 the bank levy is also levied on **entities in wind-up proceedings.**

2014



FAT on financial institutions

- The general FAT (payroll tax on financial institutions) is lowered from 6.75% to 4.5% in 2014. This will increase revenue by **ISK 1.1 bn.**
- The net effect of the overall tax changes on financial institutions is an increase in revenue by **ISK 13.2 bn.**
- A transfer of tax burden from smaller financial institutions to larger ones.

2014



General tax system revision

- A general revision of the VAT tax system will take place with the aim of narrowing the gap between tax brackets, reduce exemptions and increase efficiency.
 - Emphasis on broad collaboration in the tax revision.
 - Excise duties revised.
- A general review of the **tax environment for households**.
 - Emphasis on simplicity and transparency.

2014



Disposable household income

- The PIT (Personal Income Tax) bracket lowered by **0.8 ppts**, from 25.8% to 25%.
- Extension of temporary increase in mortgage interest cost rebate and child benefits.
- Limit on tax exempt income for persons < 16 years of age raised from ISK 104,745 to ISK 180,000.
- Extension of full VAT refunding of expenses related to maintenance of residential properties.

2014



Diapers and higher parental leave payments

- VAT on disposable diapers lowered from 25.5% bracket to 7%.
 - Should bring down price of diapers by 14-15% and increase the disposable household income for families with children.
- Wage-cap on parental leave increased by ISK 20.000 to ISK 370.000 and minimum payments adjusted in correspondence to inflation.
 - Longer parental leave cancelled.

2014



Interest revenue and stamp duty

- Tax exemption limit for individuals' interest income increased from **ISK 100.000** to **ISK 125.000**.
 - The measure increases aggregate disposable household income by **ISK 200 million** each year.
- Stamp duty on loan agreements removed.
 - Makes refinancing of debt easier.
 - New and revised legislation on stamp duties.

2014



Positive effect on purchasing power

- In total, the changes to the PIT, capital income tax and VAT can increase purchasing power by 0.5-0.6%.
- **In total, the effect of the budget proposal on real disposable income is an increase of 0.3%.**
 - Includes the effect of inflation adjustment on excise taxes and duties.

2014



2014

Increased disbursement to social security

- Increased disbursements to recipients of old age and disability pensions and to social assistance programmes, **ISK 5 bn.**
- Social security system disbursements will increase by an additional **ISK 3.4 bn** next year because of an increased number of benefit recipients and indexation of benefits.
- **Spending in this category will therefore rise by a total of ISK 8.4 bn.**



Lower wage costs for companies

- SSC lowered from 7,34% to 7%.
 - 0,1% in 2014.
 - 0,1% in 2015.
 - 0,14% in 2016.
- Companies will enjoy direct cost reductions of **ISK 3.8 bn** once the measure has fully entered into force.

2014



Effects of tax changes on corporations

- Taxes are reduced on all firms except larger financial institutions.
- Positive impact on the economic environment, especially for labor-intensive industries.
- Creates a better environment for investment and a higher standard of living in the longer term.

2014



Other measures

- The covenants of the bond issued to refinance the Central Bank of Iceland (CBI) is to be revised – interest cost will be **ISK 10.7 bn** lower than assumed in the 2013 budget.
 - The captial ratio of the CBI is strong and earnings have been positive in recent years.
- A new Act on Public Finances will be presented to the Parliament in near future.

2014



3. Budget surplus in 2014

2014



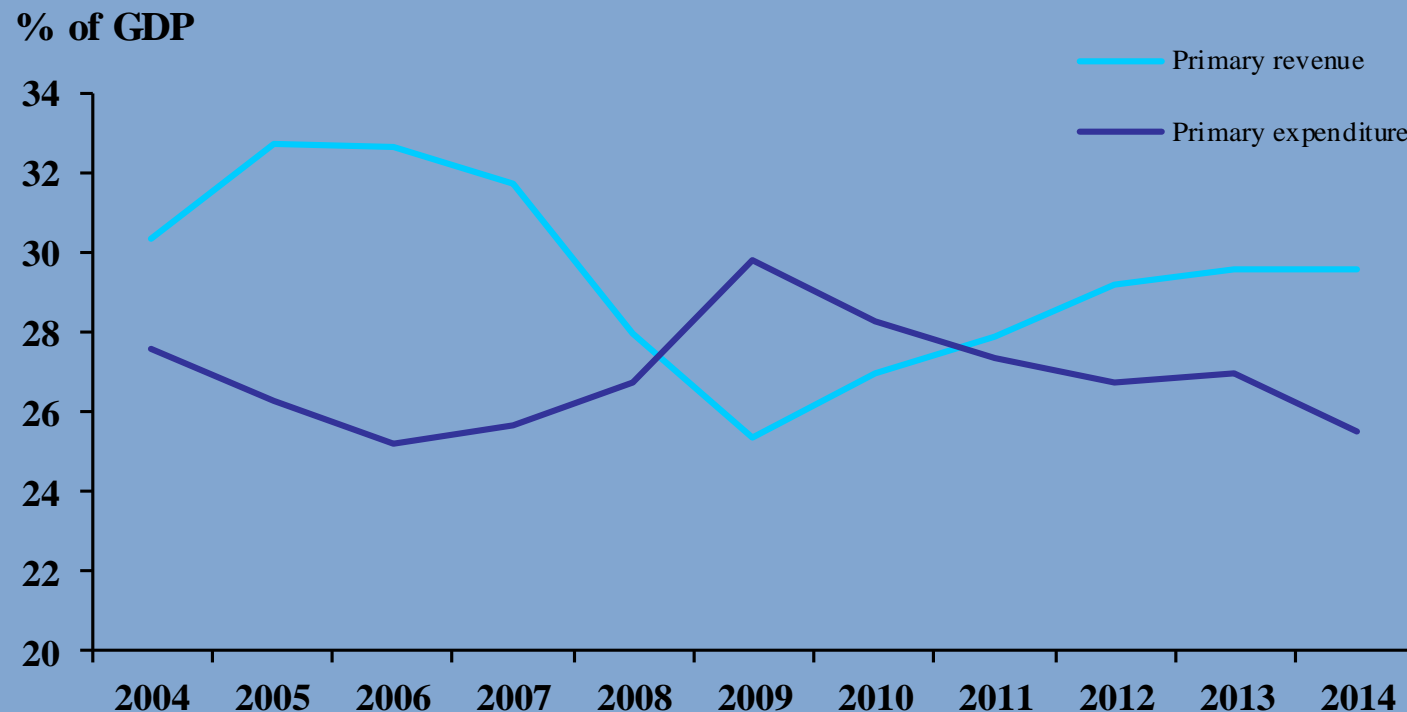
Positive total balance in 2014

- The total balance is assumed to be **ISK 0.5 bn** in 2014.
- The gross debt of the Treasury is assumed to be **80% of GDP** next year.
- The fiscal target concerning debt management is to keep lowering public debt as a ratio of GDP out the election term.

2014



Primary revenue and primary expenditure 2004-2014*

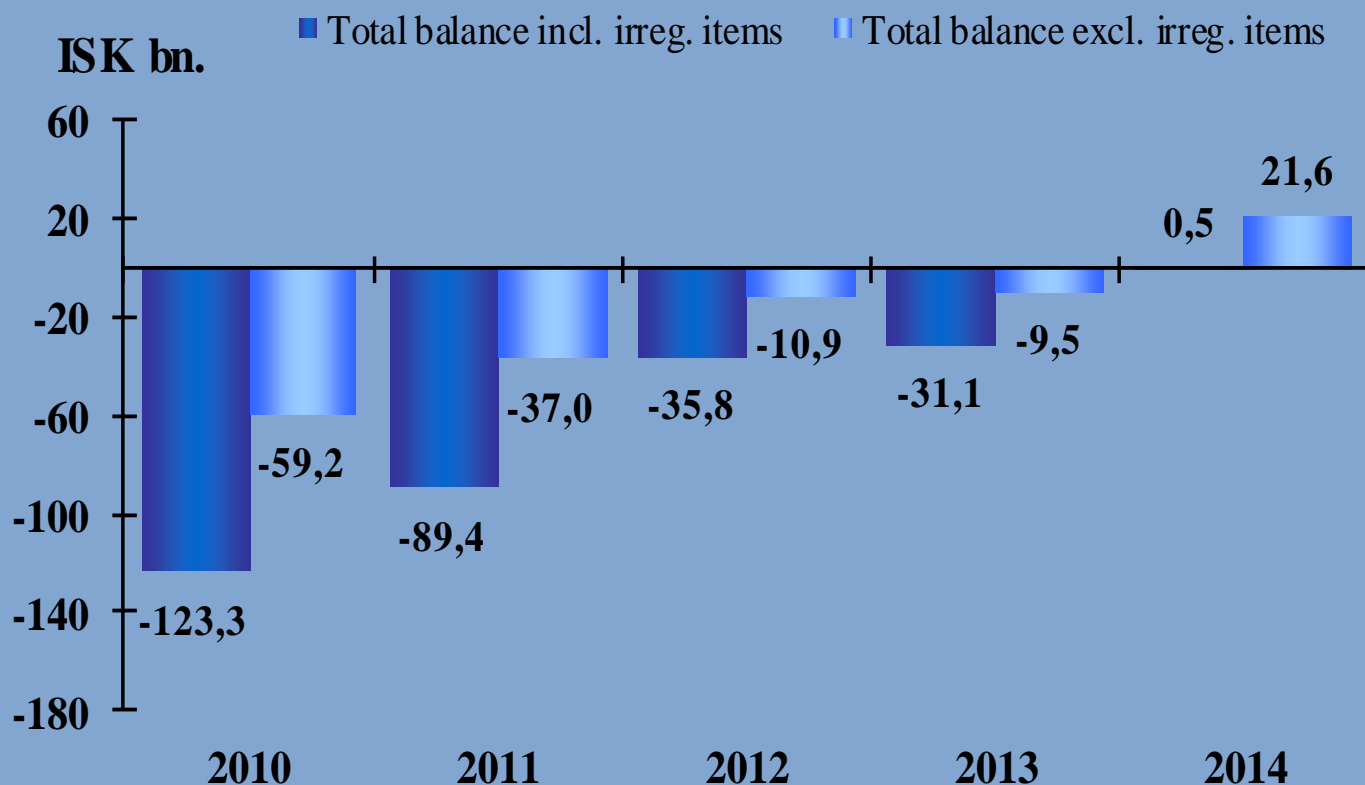


* Excluding irregular items and adjusted for the transfer of services for disabled people from the state to local governments.

2014



Total balance of the Treasury with and without irregular items 2010-2014*

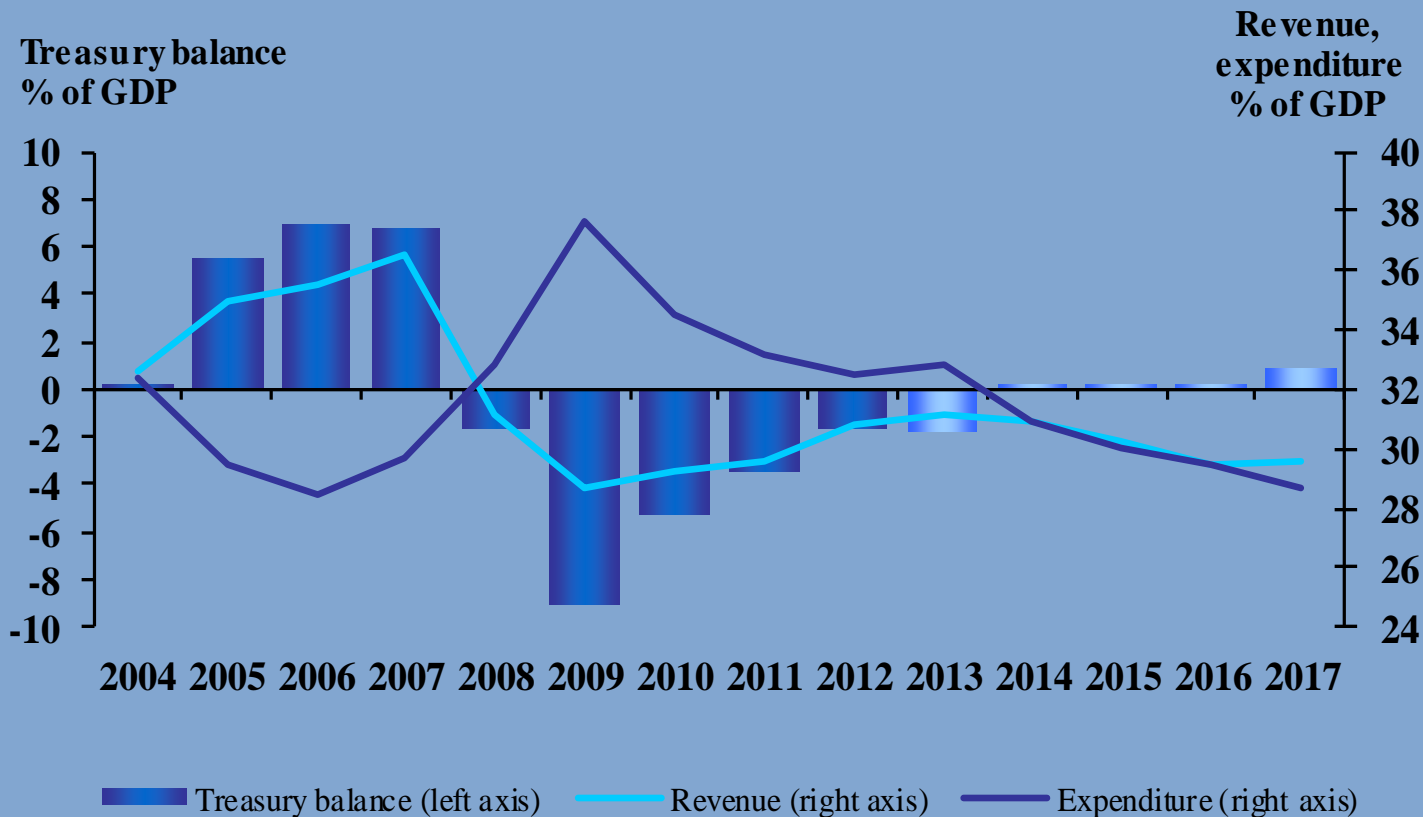


* Adjusted for the transfer of services for disabled people from the state to local governments.

2014



Treasury balance 2004-2017*



2014

2014

2014

* Irregular one-off items excluded



Conclusion

- The Treasury is returning a positive total balance in 2014 for the first time in six years.
 - Effective restraint measures.
 - Broadening of tax bases, higher bank levy.
 - Lower taxes on households and firms.
 - Stronger purchasing power.
 - Increase in disbursements to the social security system.

2014



I. Economic prospects

2014



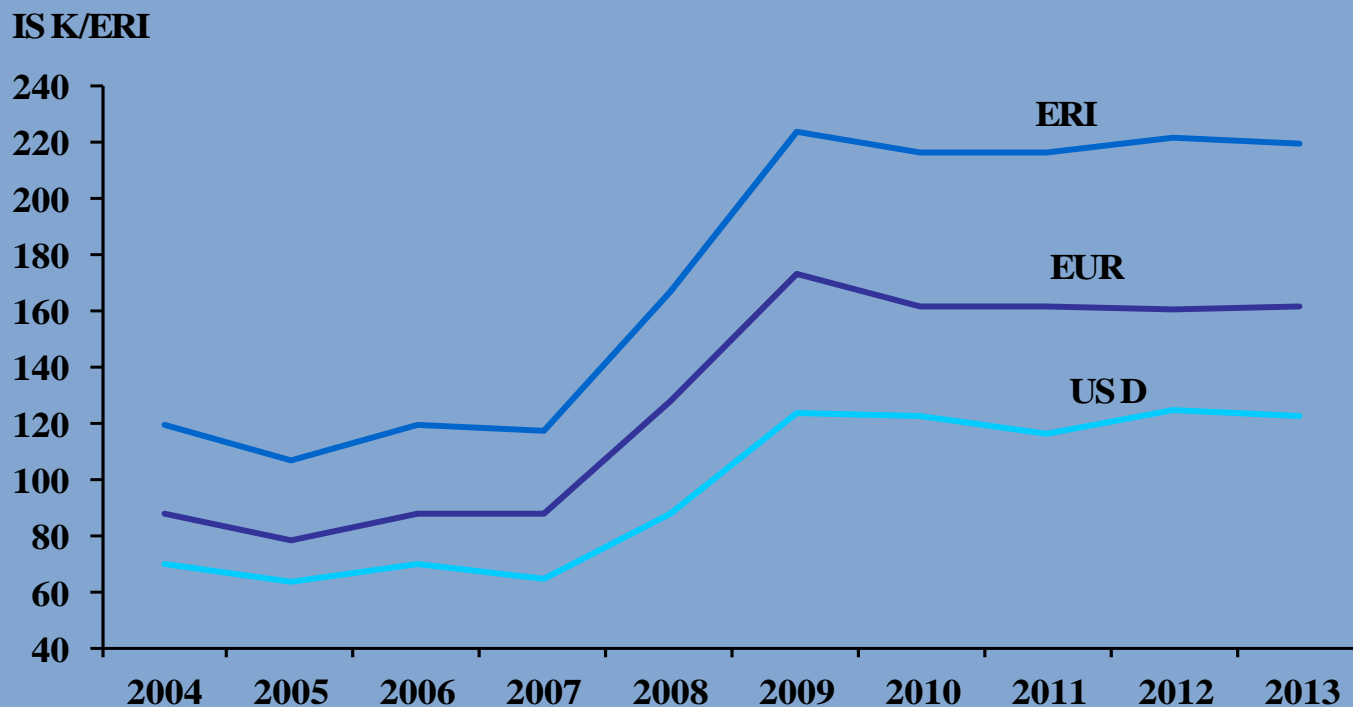
Economic assumptions for the Fiscal Budget Proposal

- Economic growth **2,7%**
- Inflation **3%**
- Unemployment **4,5%**
- Current account deficit **-3,5%** of GDP
- Increase in real wages by **2,6%**

2014



ISK exchange rates: ERI, EUR og USD

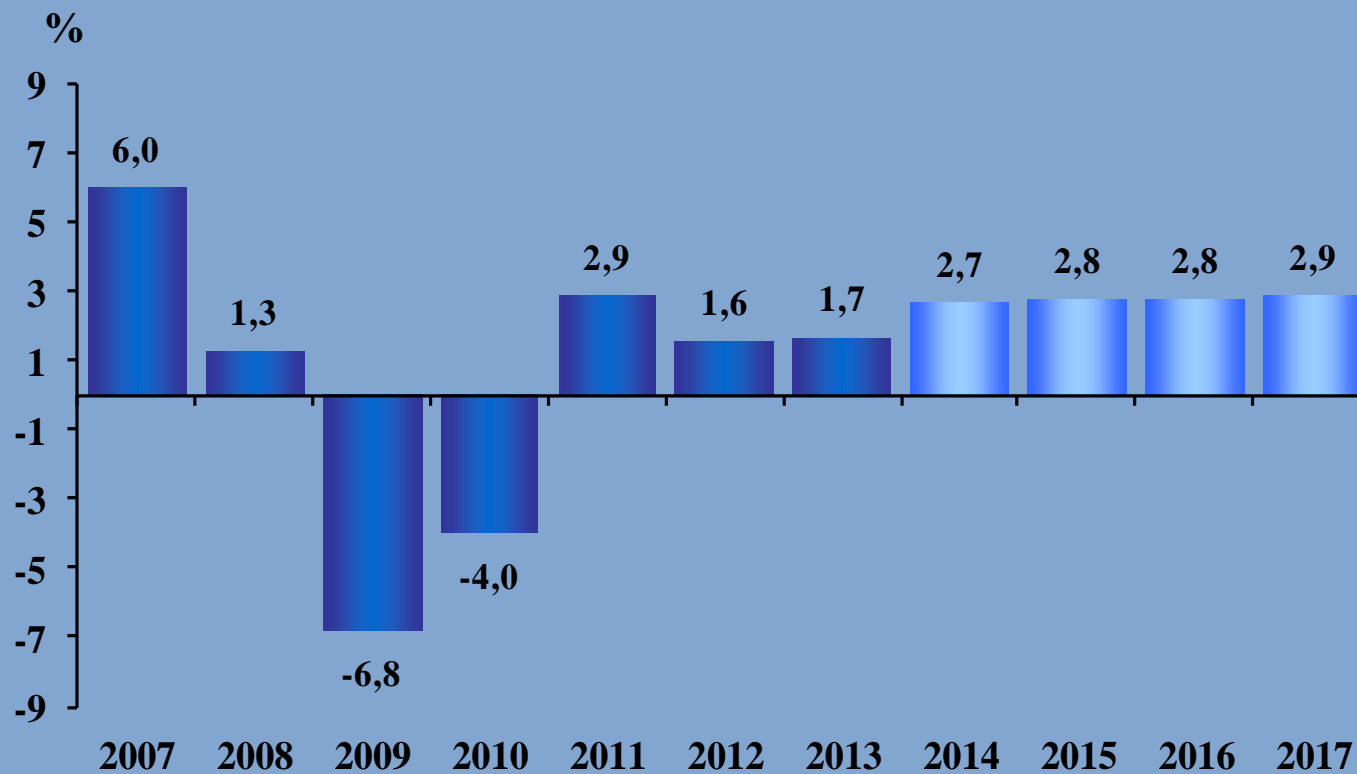


Average exchange rate 2004-2013
Source: The Central Bank of Iceland

2014

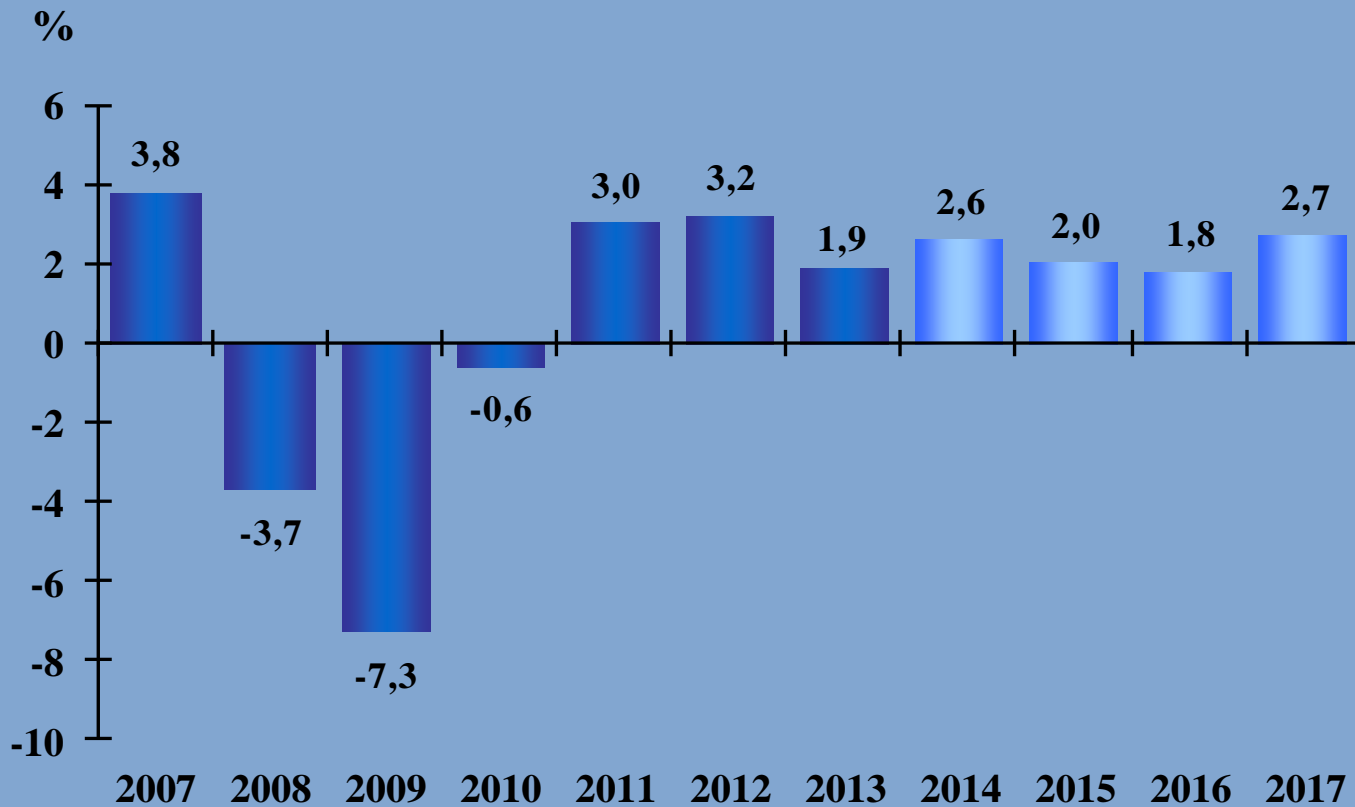


Economic growth



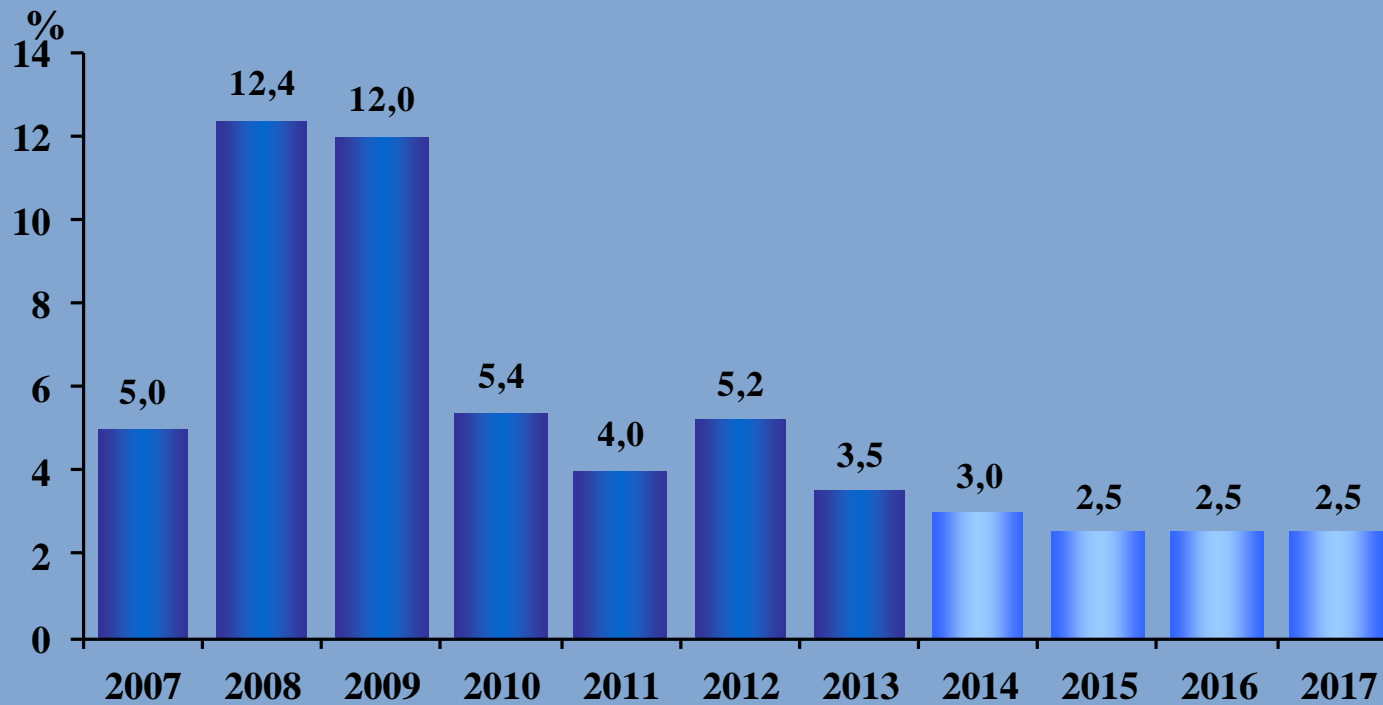


Real wages



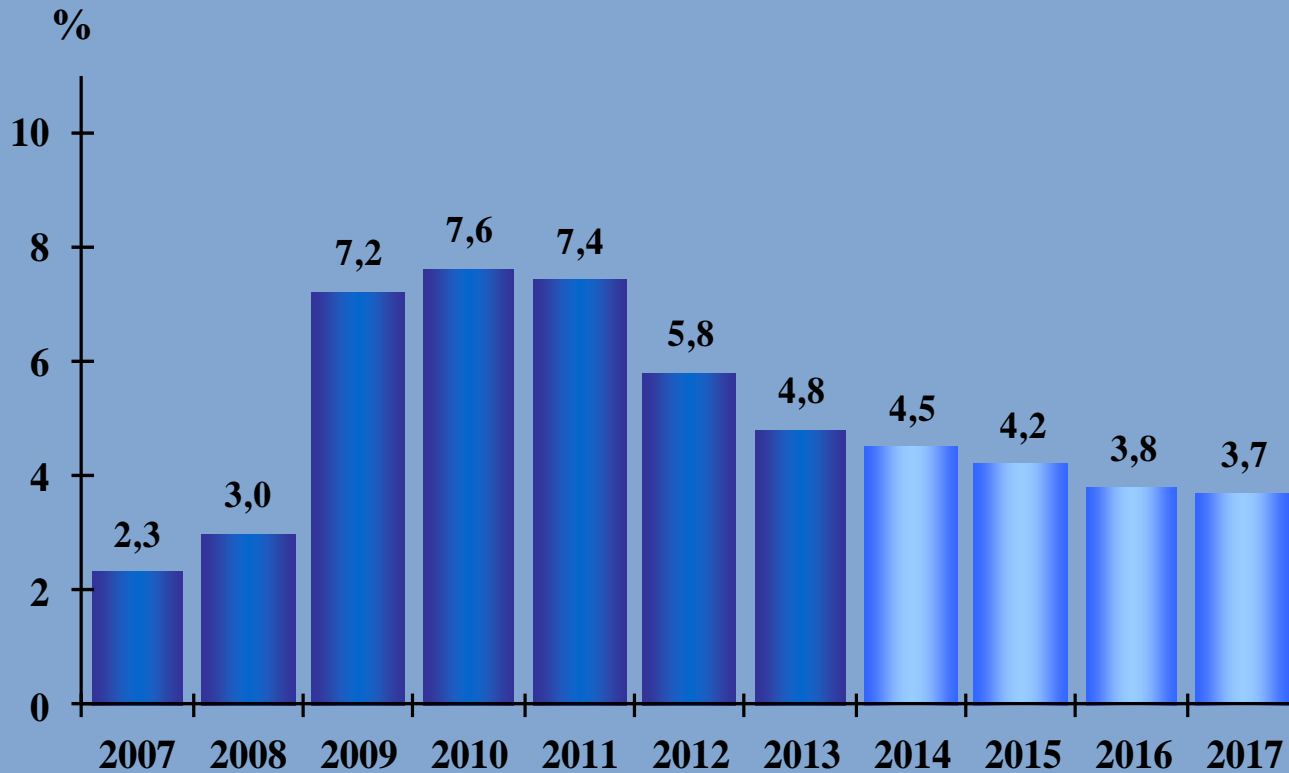


Inflation





Unemployment





II. Treasury balance in 2014

2014



Main results of the 2014 budget proposal

- In 2014 it is estimated that the total balance will be positive for the first time since 2007.
- A total surplus of **ISK 0.5 bn** is estimated in 2014 compared to **ISK 31.1 bn** deficit on the total balance in 2013.
- Excluding irregular items, the total balance for next year is estimated to be positive by **ISK 21.6 bn**.

2014



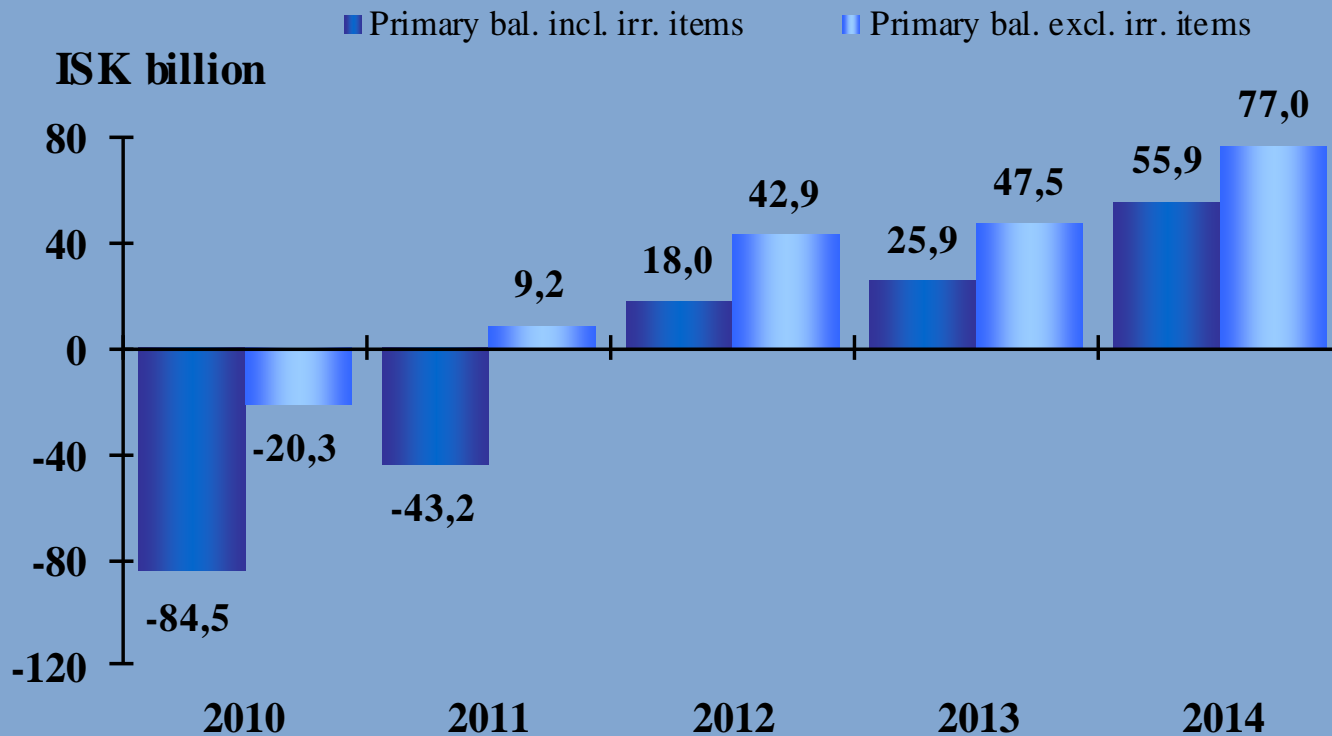
Main results of the 2014 budget proposal

- Next year the primary balance is expected to be positive by **ISK 55.9 bn**, which is an increase of **ISK 30 bn** from the estimate for 2013.
- Cash flow from operating activities will be negative by **ISK 10.6 bn** next year compared to **ISK 25.1 bn** in the 2013 budget.

2014



Primary balance with and without irregular items 2010-2014*



2014

* Adjusted for the transfer of services for disabled people from the state to local governments

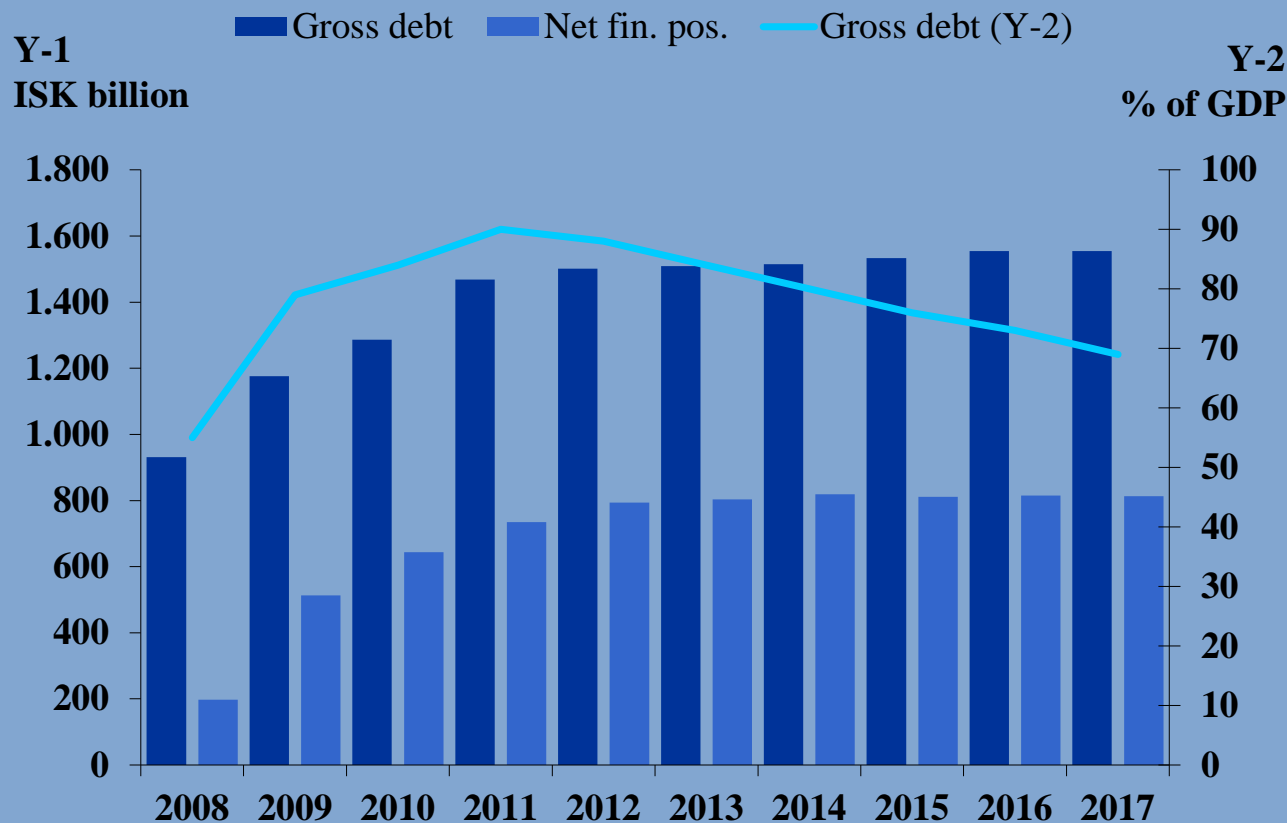
Appendix: General assumptions for the Budget Proposal

Total- and primary balance of the Treasury

	Accounts	Budget	Estimate	Proposal
In ISK billion nominal prices, accrual basis	2012	2013	2013	2014
Revenue	525,9	579,4	555,6	587,6
Expenditure	561,7	583,0	586,7	587,1
Total balance	-35,8	-3,6	-31,1	0,5
Total balance, percentage of GDP (%)	-2,1	-0,2	-1,7	0,0
Primary revenue	504,1	558,6	535,5	567,1
Primary expenditure	486,1	498,4	509,6	511,1
Primary balance	18,0	60,2	25,9	55,9
Primary balance, percentage of GDP (%)	1,1	3,4	1,5	2,9



Gross debt and net financial position



2014



III. Expenditure side 2014

2014



Main expenditure changes from 2013 estimate

- Primary expenditure are estimated at **ISK 511 bn** in 2014 and increase by **ISK 1.5 bn** from the estimate for 2013 in nominal prices.
- Total expenditure are expected to be **ISK 587.1 bn** next year and increase by **ISK 0.4 bn** from the estimate for 2013.
- Excluding projected wage and price changes in 2013, the primary expenditure will decrease by **ISK 9.1 bn**.

2014



Restraint measures 2014

- Turnover based restraint measures of ministries in 2014 – **ISK 3.6 bn.** That amounts to 0,8% of the budget turnover for 2013.
- Selective restraint measures will lower expenditure by **ISK 2.6 bn.**
- Cancelling new projects which haven't been started, **ISK 5.8 bn.**
- In total, this amounts to **ISK 12 bn** in lower expenditure for 2014.

2014

Restraint measures by economic category*

ISK million	Change ISK million	Turnover 2013	Change in percentage
Current expenditure	-3.128	220.144	-1,4%
Transfers	-4.856	229.459	-2,1%
Maintenance and investment	-3.983	27.785	-14,3%
Total	-11.968	477.389	-2,5%

* Changes from 2013 budget turnover excluding interest expenditure and irregular items in 2014 prices. A decrease in maintenance and investment is mainly caused by the restraint measures which focus on cancelling new projects, most of them are part of the investment plan 2013 to 2015.

Appendix: General assumptions for the Budget Proposal

Restraint measures by economic function*

ISK million	Change in ISK million	Turnover 2013	Change in percentages
Transport, economic and unempl. affairs	-637	88.958	-0,7%
Health	-1.143	126.075	-0,9%
Social security and welfare	-334	127.750	-0,3%
Education	-670	54.406	-1,2%
General public services	-395	32.356	-1,2%
Public order and safety	-207	23.939	-0,9%
Culture, sport and religion	-162	17.833	-0,9%
Housing and distribution system	-36	6.072	-0,6%
Total turnover based measures	-3.583	477.389	-0,8%
Selective measures	-2.595	477.389	-0,5%
Cancelling new projects	-5.790	477.389	-1,2%
Total	-11.968	477.389	-2,5%

* Changes from the 2013 budget excluding interest expenditure and irregular items.



Changes in expenditure*

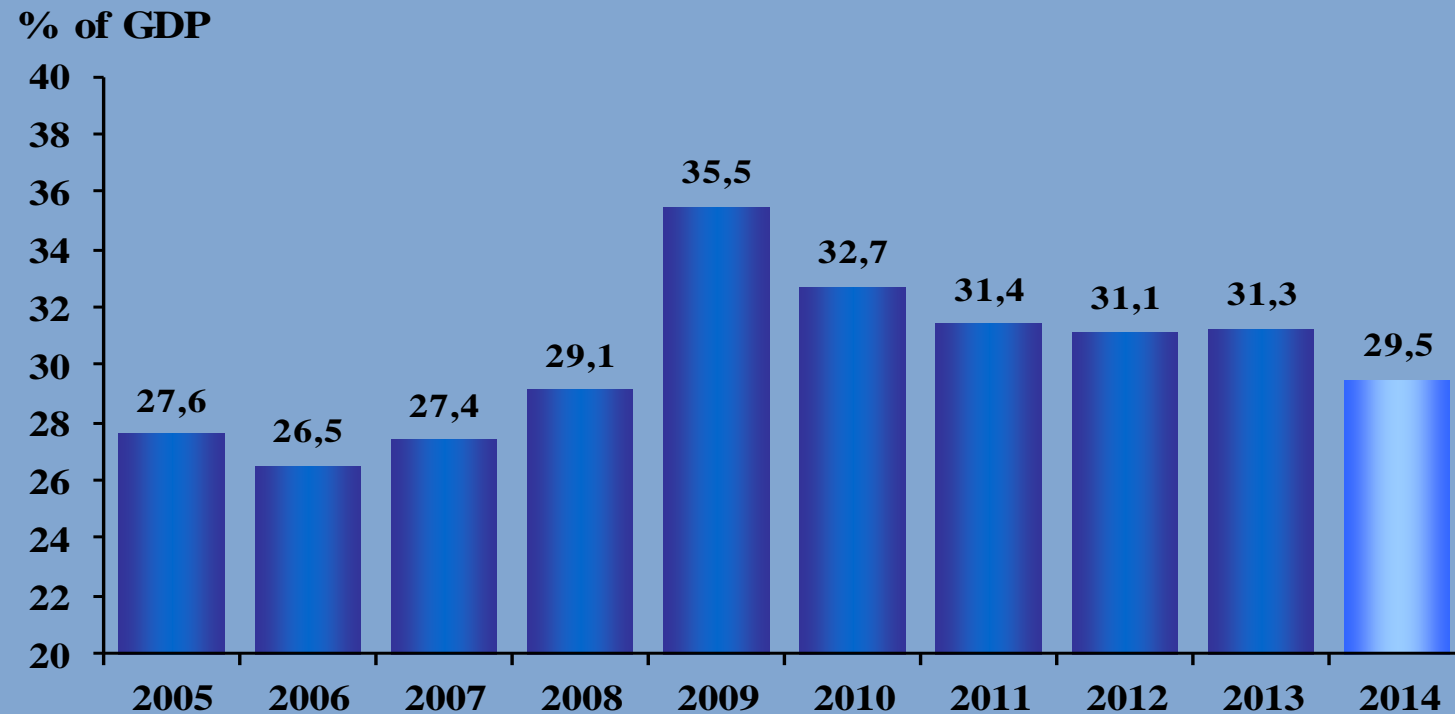
	ISK bn
Restraint measures	-12.0
Expenditure obligations	14.1
Increase in price levels 2014	10.6
Interest expenditure	-8.7
Total	4.1

* Changes from the 2013 budget.

2014



Decrease in total expenditure*

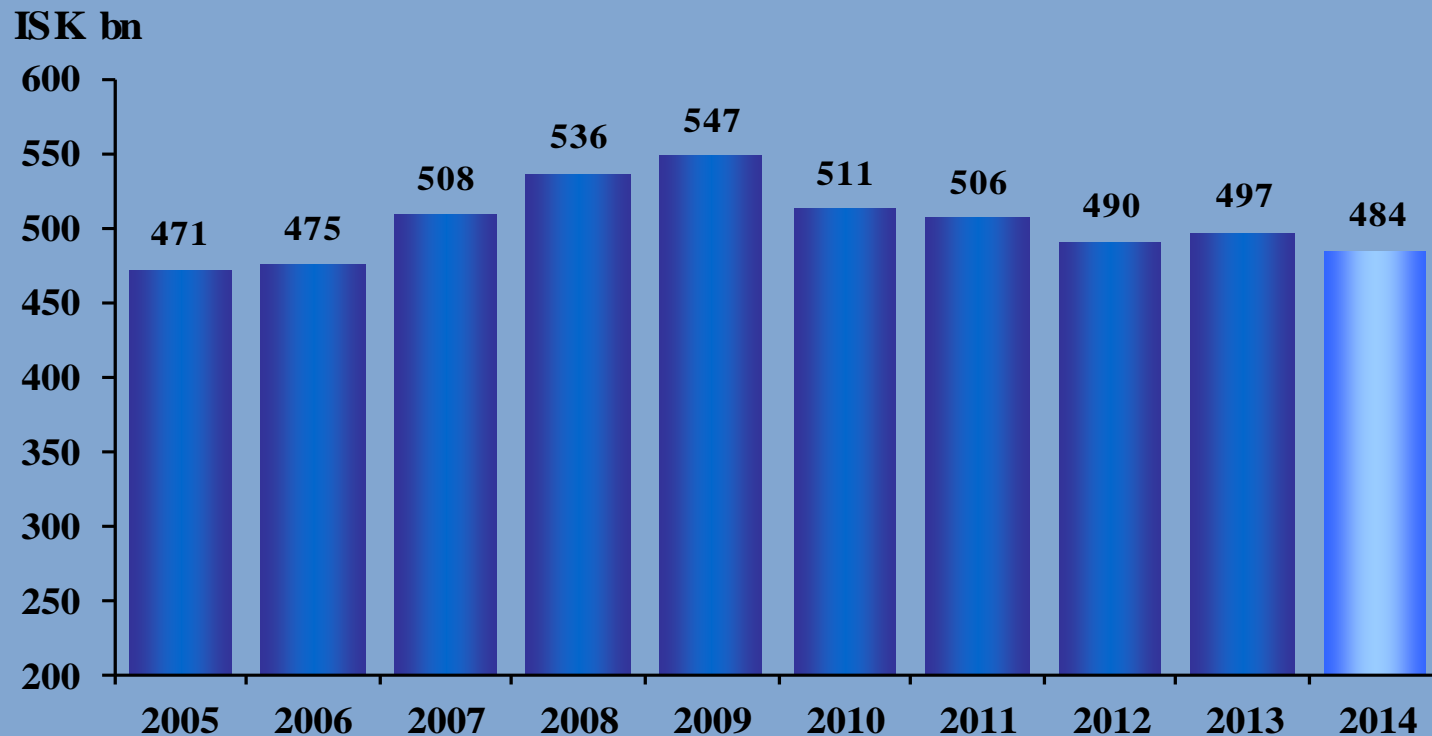


* In 2014 budget proposal prices, excluding interest expenditure and irregular items. Adjusted for the transfer of services for disabled people from the state to local governments.

2014



Primary expenditure in constant prices*



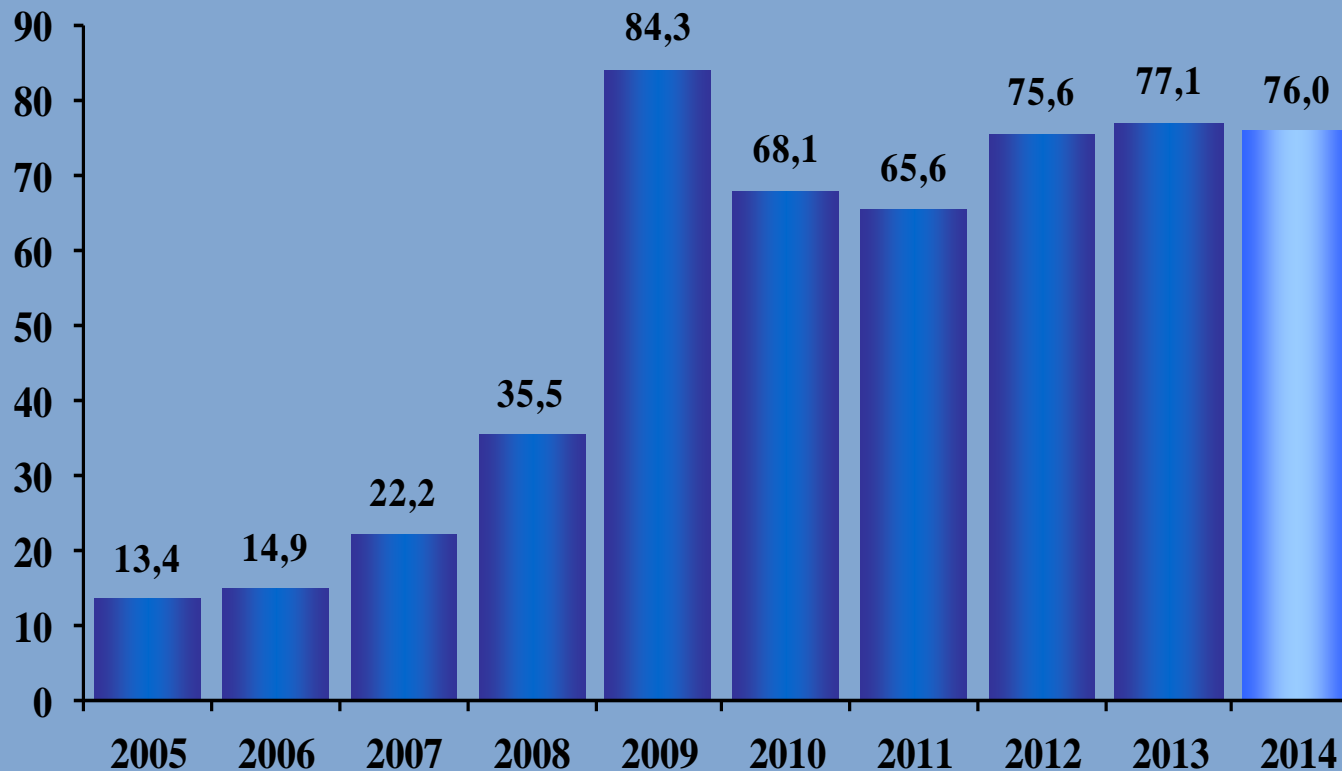
2014

* In 2014 budget proposal prices, excluding interest expenditure and irregular items. Adjusted for the transfer of services for disabled people from the state to local governments.



Interest expenditure

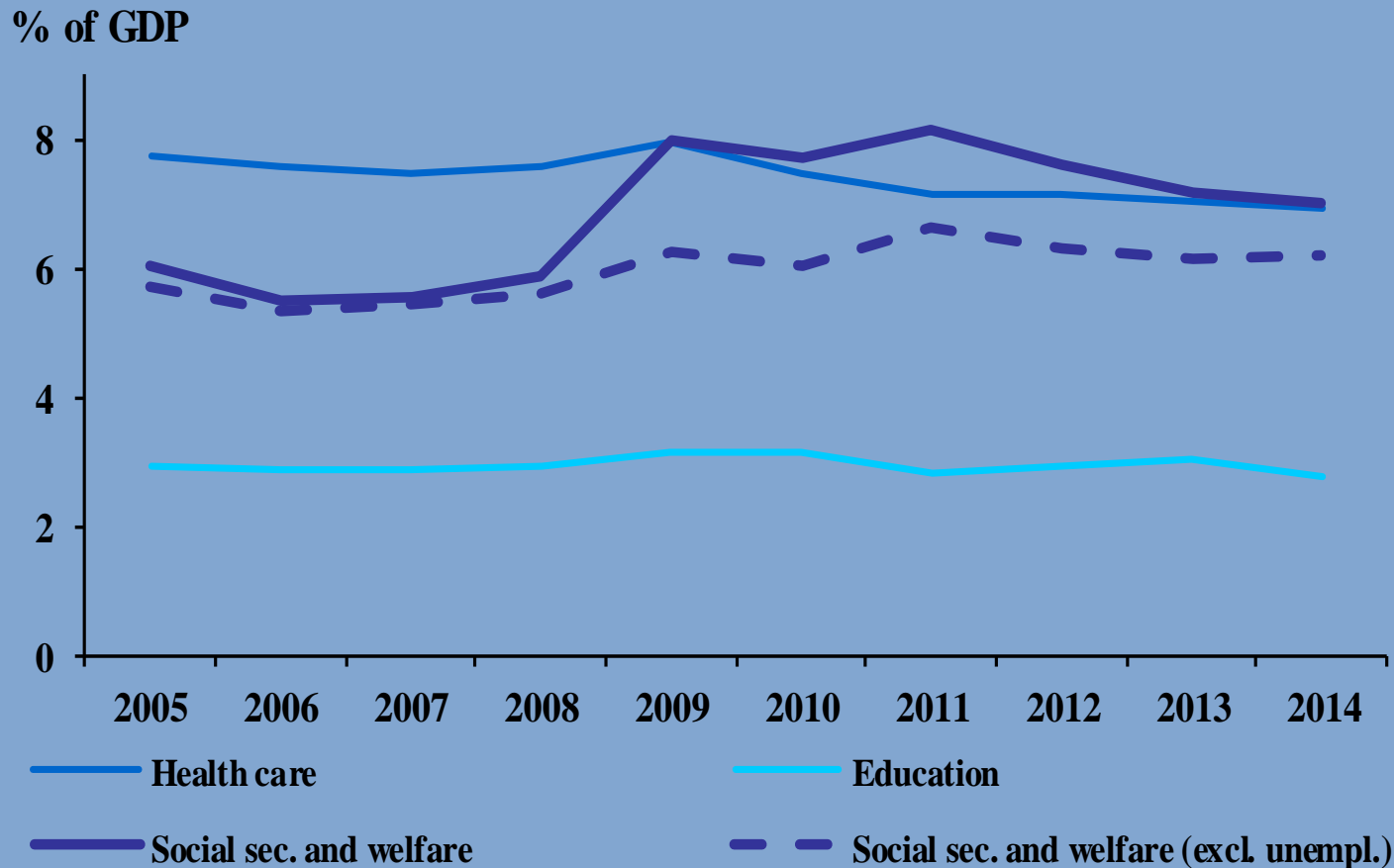
ISK billion



2014



Welfare expenditure 2005-2014



2014



IV. Revenue side 2014

2014



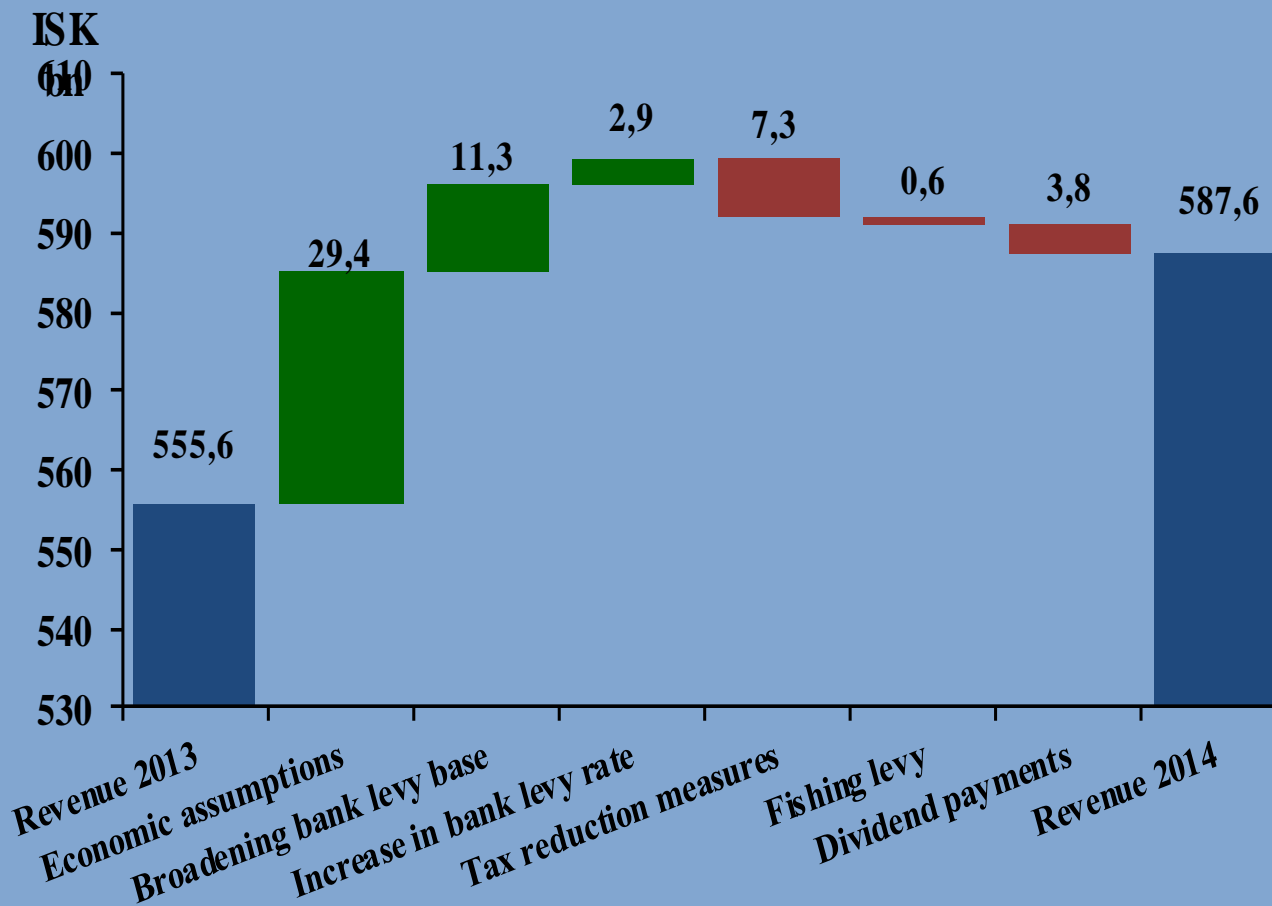
Main revenue changes from estimate for 2013

- Primary revenue is estimated **ISK 567.1 bn** and will increase by **ISK 31.5 bn** from the 2013 estimate.
- Total revenue is estimated **ISK 587.6 bn** and will increase by **ISK 31.9 bn** from the 2013 estimate.

2014



Revenue developments in 2014



2014



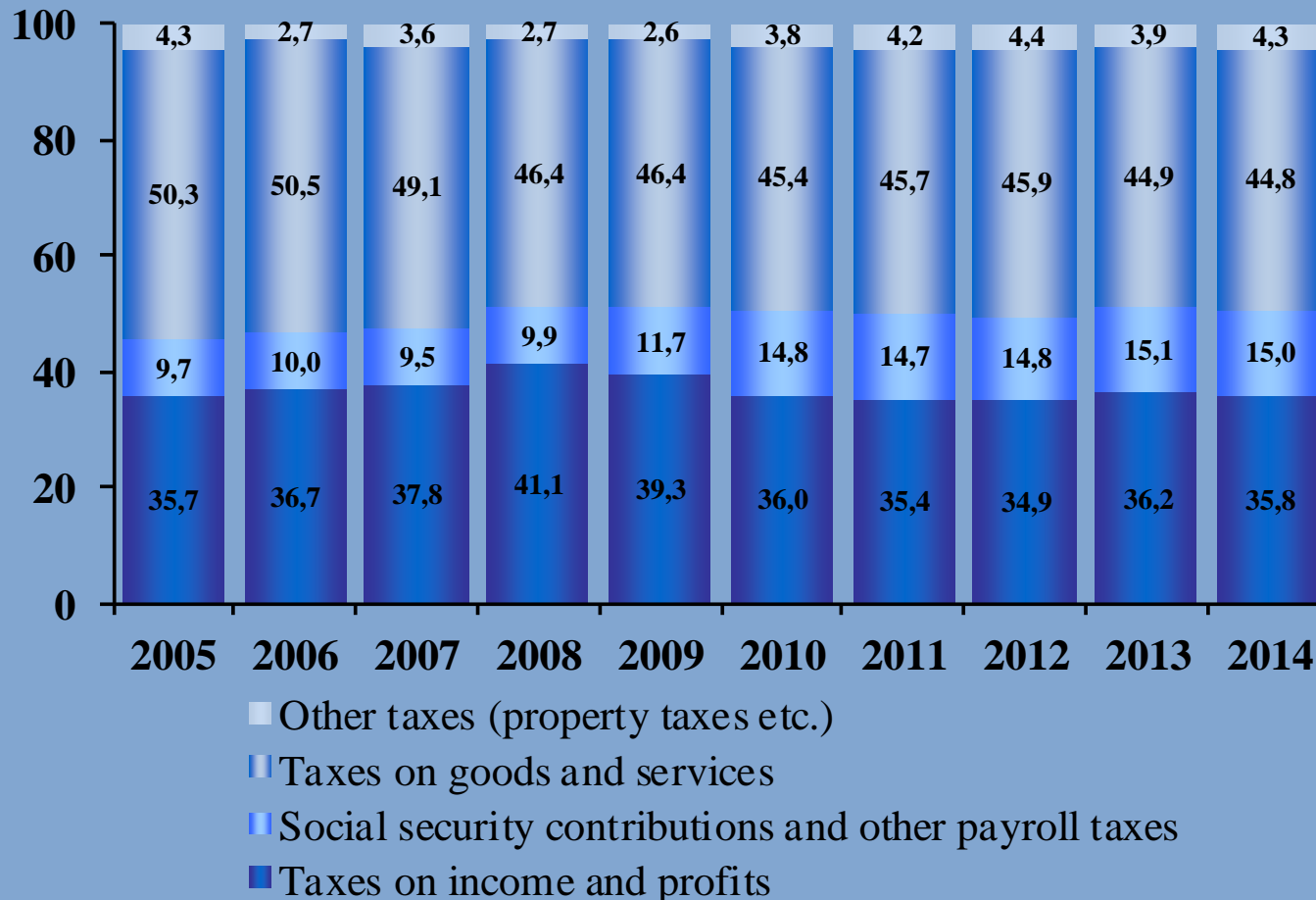
Special revenue measures in 2014

	ISK bn
Bank levy: base broadening and rate increase to 0.145%	14.3
The general FAT (payroll tax on financial sector) lowered to 4.5%	-1.1
Social security contributions lowered in total by 0.1 ppt	-1.0
Middle bracket of PIT lowered from 25.8% to 25.0%	-5.0
Tax exemption limit for individuals' interest income raised	-
Disposable baby diapers moved to lower VAT bracket	-0.2
Total revenue impact from tax measures in 2014	6.9

2014



Tax composition 2005-2014



2014