



Highlights

Budget Proposal

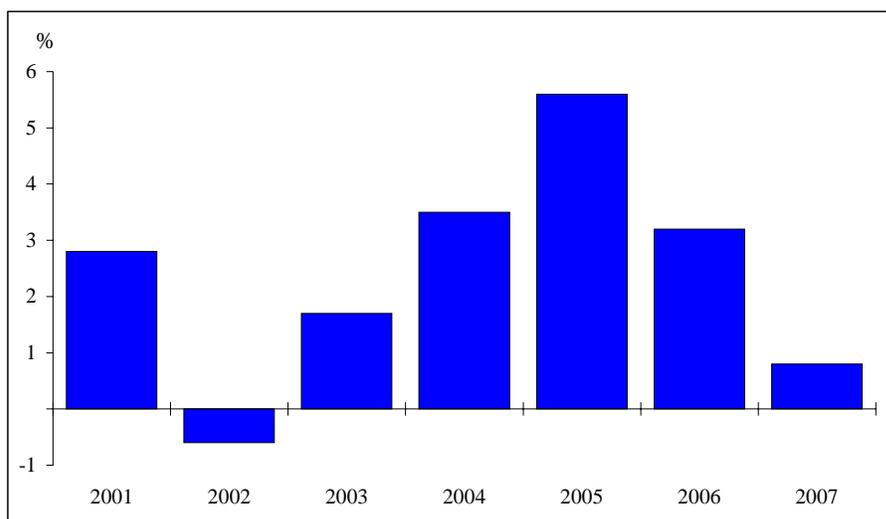
2004

1 Economic and fiscal policy

A new economic expansion has begun that could become one of the longest in Icelandic history. Construction of power projects and energy-intensive industry will dominate economic growth for the next several years, which will present a challenge to economic policy to maintain the stability that has been achieved in the Icelandic economy in recent years. The most important task is to apply fiscal policy in such a manner that it will restrain domestic demand at the peak of construction activity.

A new economic expansion has begun

Economic growth



These considerations have been paramount in the formulation of the 2004 budget, which is being presented with a revenue surplus of 6½ billion krónur, equivalent to ¾ per cent of GDP. No revenue from asset sales is foreseen, since the two commercial banks were fully privatised in 2003. The 2003 revenue balance excluding asset sales is estimated to be in deficit by about 6 billion krónur. The improvement in the revenue balance from 2003 to 2004 is thus estimated at 12½ billion, equivalent to about 1½ per cent of GDP, which reflects the tightening of fiscal policy between 2003 and 2004.

Fiscal tightening in 2004

Recent economic developments have shown that the Government's economic policy has been successful, both during the expansion that started around the middle of the past decade and culminated in 1999-

Successful economic policy

2000. Many observers predicted that the economy would experience a hard landing following the peak of the business cycle. These predictions have been proved wrong.

The explanations are clear

All economic experts, domestic and foreign, are in agreement on the reasons why. In the most recent report of the International Monetary Fund it is observed that the rapid adjustment of the economy to changed circumstances is primarily due to the fundamental structural reforms that this Government has implemented and its stability-oriented economic policy. Similar views have been expressed by other foreign observers, such as the OECD and the major credit rating agencies. The main elements of structural reforms have centred around liberalisation of the financial market, in addition to the abolition of restrictions on international capital movements in connection with Iceland's membership of the EEA-area. Furthermore, fiscal finances have been strengthened, government enterprises have been privatised and the economy as a whole has gradually become more competitive and market-oriented. Finally, the Central Bank has been vested with independent powers in pursuing monetary policy with an inflationary target along with a floating exchange rate.

Medium-term economic policy

In this budget the Government presents a well defined economic policy framework for the next four years. This represents a significant change in economic management in Iceland, facilitates a clearer perspective of medium-term economic prospects and contributes to a more credible stability-oriented economic policy.

Fiscal policy plays a key role

A tight fiscal policy will be followed in order to restrain domestic demand during the phase when construction of power and aluminium projects will peak while an easier policy will be pursued once the construction phase is over. Fiscal policy is therefore a key element in overall economic policy over the next few years. The Government has approved the following main objectives of fiscal policy:

- About 20 billion krónur will be used to cut taxes in 2005-2007 and up to 3 billion krónur for specific tasks, such as increasing child benefits.
- Central government investment will be cut by 3 billion krónur in 2005 and by a further 2 billion in 2006. Such investment will be

increased by 3 billion in 2007 and 2 billion in 2008.

- Fiscal policy will be tightened so as to limit the annual increase in public consumption to 2 per cent in real terms in 2005-2007. i.e. by ensuring that public sector wage increases do not exceed those of the exposed sectors of the economy. The annual increase in transfer payments should not exceed 2½ per cent in real terms in 2006-2007.
- The Treasury surplus should not fall below 1¾ per cent of GDP in 2005 and 1 per cent in 2006.

The growth in government current expenditure will be curtailed, both payroll costs and other current outlays. The government's contribution to public consumption should not increase by more than 2 per cent in real terms, 1 per cent less than the average rate of growth in recent years. This policy objective will be worked out more specifically with the formulation of the fiscal budget for each year.

The growth in public consumption will be reduced

Government investment must inevitably be cut over the next few years when other construction activity is at its peak. Investment will be accelerated once the peak has passed.

Government investment temporarily cut

Transfer payments are expected to increase over the next few years, i.e. because of an increasing number of pensioners. This should be offset by reduced unemployment, thus reducing unemployment compensation. The overall aim is to limit the increase in transfer payments to an annual growth of 2½ per cent in real terms.

Growth in transfer payments moderated

A tight fiscal policy will create room for reducing taxes and increasing expenditure in accordance with the Government's Policy Statement without endangering the main objective of economic policy to maintain stability. The tax reductions are in accordance with the Government's Policy Statement, with the aim of reducing the personal income tax, eliminating the net wealth tax and reducing the value added tax. Also, the child benefits will be increased.

Taxes will be reduced sharply

The main conclusion of the Government's medium-term programme is that economic stability can be ensured in spite of increased domestic demand following the build-up within the energy-intensive sector. One of the main assumptions is that a tight fiscal policy will be pursued as described above. Economic stability is also necessary to enable business

A responsible economic policy ensures economic stability

and industry to remain competitive with other countries, thus creating a basis for rising incomes and improved living standards. That is the main aim of this fiscal budget.

2 Overview of fiscal developments

2.1 Fiscal developments in 2003

The 2003 fiscal budget was passed with an 11.5 billion krónur revenue surplus. A supplementary budget was passed in March that reduced this surplus by 2.1 billion because of increased appropriations to regional development and road construction, thus reducing the budget surplus to 9.4 billion. Including the supplementary budget, the financial surplus was estimated at 19.8 billion, the bulk of which was derived from asset sales.

The 2003 budget, including the supplementary budget, calls for a total revenue of 274.2 billion. The revenue estimate is based on the Ministry's forecast of the main economic aggregates for the current year as well as on the development of revenue collection in the course of 2002. A revised estimate for 2003 is primarily based on the development of revenue collection and the course of the economy in general. In spite of the fact that there are clear signs of a beginning economic upturn, government revenue is estimated to increase by only a small margin over 2003 budget estimates. Wage increases have been lower than assumed and unemployment higher than had been forecast; both factors affect revenue from the personal income tax and the social security tax. Indirect tax revenue has, however, increased by more than overall tax revenue, especially because of increasing dividends from government enterprises. All told, total Treasury revenue for 2003 is estimated at 277.2 billion, of which 237.8 billion is tax revenue.

**Increased
revenue from
indirect taxes**

The 2003 budget estimated expenditure at 260 billion krónur. The March supplementary budget increased appropriations by 4.7 billion krónur for public investment to stimulate employment and regional development. A revised estimate for 2003 puts expenditure at 6.2 billion over the sum of the fiscal budget and supplementary budget, including sums carried over from the previous year. Of this amount, 3.6 billion are attributable to current expenditure, mainly because of hospital cost overruns and higher school costs. Current transfer payments are estimated to exceed the budget by 4 billion, principally because of higher than estimated unemployment benefits and interest rebates. The health insurance system is expected to exceed its budget by 500 million krónur and emergency assistance to Iraq is going to amount to 300

**Regional and
employment
measures**

million. Finally, a recycling charge of 350 million krónur has been added to both revenue and expenditure since the passage of the budget.

Investment expenditure is expected to be somewhat under budget, particularly for road construction and the construction of cultural centres. All told, 2003 Treasury expenditure is estimated at 271 billion.

The revised fiscal estimate for 2003 puts the revenue balance at 6.2 billion, 3.2 billion less than in the fiscal and supplementary budgets. The change in the revenue balance has a direct impact on the financial balance, but a part thereof is offset by higher repayments to the Treasury of outstanding loans than had been estimated in the budget. The financial surplus is therefore estimated at 17.6 billion, some 2 billion less than budget estimates. The surplus will be used to repay outstanding Treasury debt of 9.1 billion and to prepay the future Treasury commitment to the Government Employees Pension Fund of 7.5 billion. The Treasury's balance with the Central Bank should thus improve by close to 1 billion.

2.2 The main elements of the 2004 budget proposal

The revenue surplus increases

The fiscal budget proposal calls for a 6.4 billion krónur revenue surplus, in spite of the fact that no revenue from asset sales are assumed. The revised estimate for 2003 projects a 12.4 billion surplus from asset sales and a total revenue surplus of 6.2 billion. The reasons why the revenue surplus is expected to increase, despite the absence of asset sales, are primarily twofold. First, expenditure restraint is applied to the utmost with a cut of 3.7 billion in expenditure so that total expenditure is scheduled to increase by only about 2 billion from the 2003 estimate. Second, the impact of the economic expansion in 2004 should increase turnover and purchasing power. Tax revenue is therefore expected to increase by 14½ billion and total revenue by 2.2 billion, despite the drop in revenue from asset sales. The financial surplus is estimated at 13.6 billion, a decline of close to 4 billion from this year. On one hand, this is due to the drop in asset sales, which on the other hand is offset by a 12 billion increase in the cash at hand from operations. Incoming repayments of outstanding loans extended by the Treasury will also increase, in particular because the Central Bank will make a repayment on a loan from the Treasury in 2001. The 2004 financial surplus will be used to repay 4 billion in debt, prepay future commitments of the

Treasury to the Government Employees Pension Fund of 7.5 billion and improve the Treasury's position with the Central Bank by 2 billion.

Treasury finances

	2002	Budget and supplem. budgets		Budget proposal
		2003	Estimate 2003	2004
Billions of krónur, current prices				
Revenue	259.2	274.2	277.2	279.4
Expenditure	267.3	264.8	271.0	273.0
Revenue surplus	-8.1	9.4	6.2	6.4
Non-financial current items.....	-4.2	-20.1	-20.1	-8.5
Cash from operations	-12.3	-10.7	-13.9	-2.1
Financial transactions.....	8.5	30.5	31.5	15.8
Net financial balance	-3.8	19.8	17.6	13.7

The revenue side of the 2004 fiscal budget proposal reflects the impact of the economic expansion, which is clearly under way and indicates that a substantial growth period is ahead. The Ministry's forecasts a 3½ per cent growth in 2004 and an inflation rate of 2½ per cent. Real disposable income per capita is expected to increase by 2½ per cent and private consumption by 3½ per cent. On this basis, it is estimated that total tax revenue of the Treasury will amount to 252.3 billion krónur, a nominal increase of 6 per cent from this year. The ratio of taxes to GDP would thereby remain broadly unchanged, increasing from 29.2 to 29.3 per cent. Total Treasury revenue is expected to amount to 279½ billion krónur. Total revenue will increase much less than tax revenue because no asset sales are assumed for 2004.

Total Treasury expenditure is estimated at 273 billion in 2004, an increase of 8.2 billion from the sum of the fiscal budget and the supplementary budget for 2003 and an increase of 2 billion over the estimated outcome for this year. Total expenditure would thus decline by 1.6 per cent in real terms from the 2003 estimate. Current expenditure is estimated to remain nearly unchanged and the same goes for current transfer payments in spite of increase expenditure on social security, in accordance with an agreement with associations of senior citizens and the disabled. There are two reasons why expenditure

increases little. Unemployment is forecast to decline and the Government has applied measures to cut current expenditure. Furthermore, investment and capital transfers are going to be cut by 20 per cent in all areas of government activity, except in nursing homes. Finally, interest costs are expected to remain unchanged.

Expenditure restraint

The fiscal budget proposals embodies expenditure cuts of 3.7 billion krónur. Current expenditure is cut by 700 million, transfer payments by 1,500 million and investment by 1,500 million. For current expenditure the intention is to abolish the reimbursement by the Treasury out of the social security tax to employers for their contribution to their employee supplementary pension savings. This reimbursement was originally intended as a temporary measure and is now seen as no longer being needed, since wage agreements now call for a higher employer contribution than in the beginning. Furthermore, the supplementary pension savings are tax-deductible. This measure is expected to reduce expenditure by more than half a billion. A 1 per cent cut in appropriations to administrative agencies is proposed, which must meet by increasing efficiency. This measure should yield a saving of 100 million. The cut in current transfers consists of a 740 million reduction in health insurance expenses, primarily by reducing co-payments for drugs, specialist physicians and assistive devices for the disabled. Expenditure on interest rebates declines by 600 million because the maximum rebate is expected to be cut from 7 per cent of debt due to a home purchase to 5.5 per cent. This is due to the fact that the real rate of interest has declined substantially since the 7 per cent ceiling was imposed. The expenditure of the Unemployment Insurance Fund is estimated to decline by 170 million on the assumption that no benefits will be paid for the first three days of registered unemployment instead of from the first day onwards. The cut in investment is mostly in road construction, where the appropriation declines by 1 billion krónur from 2003. Another 500 million is cut from various other investment expenditure programmes.

Revenue surplus excluding irregular items

Billion krónur	Budget ¹			Budget proposal
	2002	2003	Estimate 2003	2004
Revenue surplus	-8.1	9.4	6.2	6.4
Irregular expenditure	26.3	8.5	8.5	8.7
Irregular revenue	11.7	12.9	13.0	0.5
Revenue surplus, excl. irr. items	6.5	5.0	1.7	14.6

¹ Including the March supplementary budget.

The above table shows the development of Treasury finances after adjustment for irregular items. Irregular revenue includes the profit from the sale of assets and the revaluation of assets in government agencies that are entered over the revenue account. Irregular expenditure includes the expensing of pension commitments and tax claims written off. By this measure, the impact of the business cycle upon Treasury finances is clearly visible. There is only a marginal revenue surplus in 2003, partly because fiscal measures were applied to stimulate the economy in the course of the year. The change from 2003 to 2004 is quite significant, an improvement from a surplus of 1.7 billion in 2003 to 14.6 billion in 2004 due to an expected expansion in the economy in 2004, as noted earlier, and a cut in expenditure as discussed above.

**Increasing
revenue
surplus**

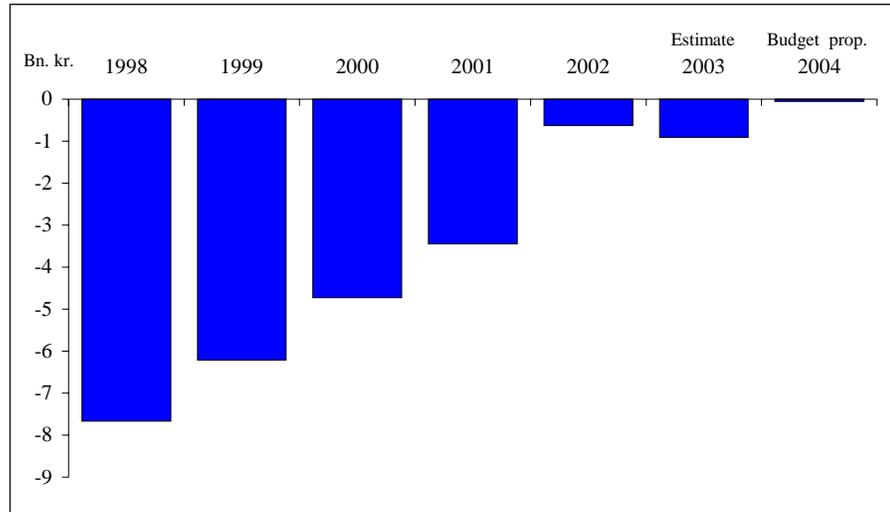
Except in two years, the Treasury has yielded a financial surplus in all years since 1998. The combined financial surplus for the years 1998-2004 is estimated to amount to 63.5 billion krónur at the current values for each year. The surplus has been used to prepay future commitments of the Treasury to the Government Employees Pension Fund, to repay general Treasury debt and to improve the Treasury's position with the Central Bank. As is observed in the 2002 Treasury accounts, the Treasury's prepayment of future pension commitments means that the projected cash exhaustion of the Government Employees Pension Fund has thereby been postponed from 2014 to 2025 and will be permanently avoided after several further years of such prepayments.

**Debt is
expected
to decline**

Repayment of Treasury debt has taken account of the state of the financial market at each and every time and the room for manoeuvre in repaying foreign debt. The following chart shows the interest balance of the Treasury, where interest income is subtracted from payments.

As is shown in the chart, the interest balance was in deficit by 7.7 billion in 1998, declining to 0.6 billion in 2002 and is expected to be close to equilibrium in the fiscal budget for 2004.

Interest balance of the Treasury



3 Medium-term fiscal projection

3.1 Introduction

The Government's economic policy has in recent years increasingly been formulated with a medium-term perspective. Such a policy framework facilitates a clearer perspective of future economic prospects and creates a more solid foundation for economic policy. This is spelled out in the 1997 Financial Reporting Act:

“Long term projection. A projection of government finances for the next three years following the next fiscal year shall accompany the fiscal budget bill each year. It shall outline the prospects for government finances with a view towards general economic conditions on one hand and the policy of the government with respect to fiscal finances on the other. The projection shall include an assessment of the fiscal impact on the economy and employment, intentions for the procurement of revenue and the division of expenditure, appropriations for investment and a summary of the government's debt operations and debt service. Once the fiscal budget bill has been passed into law the long term projection shall be reviewed and placed before the Althingi if significant changes have taken place in its premises.”

This has been followed up in the fiscal budget proposals of recent years, where a three-year expenditure projection by ministry has been presented along with a medium-term forecast for the economy and fiscal finances. This discussion has been in general terms without getting into specifics on the basis of the Government's economic policy declaration. Nonetheless, this exercise has been useful as an indicator of the fiscal stance and the necessary fiscal policy objectives seen in the context of overall economic policy.

The formulation of the Government's economic policy for the medium term enhances the credibility of economic policy and thus contributes to economic stability. The construction of the power and aluminium projects in the eastern part of the country presents a major challenge to economic policy and calls for a restrictive fiscal policy stance to restrain domestic demand at the peak of construction activity.

The Government's Policy Statement reflects these views, where the economic policy objectives are outlined as follows:

“Ensuring a balanced and stable economy. This will create conditions for even further growth in national income and higher real wages for the public at large. Economic stability is also a precondition for the improved competitiveness of Icelandic businesses.

Maintaining fiscal balance. Fiscal policy will play a key role in economic policy implementation over the coming years and needs to be flexible towards economic developments. Reforms aimed at cutting costs in central government operations will

**Economic
policy
challenges**

continue and procedures will be evolved further for more efficient handling and implementation of the Treasury budget. In this respect it is important to take a longer-term view than one year at a time.

Taking advantage of the Treasury's improved scope for securing higher real wages, through systematic tax policy measures. Action to be taken during the Government's term of office will include a reduction in personal income tax by up to 4%, the abolition of wealth tax, harmonisation and reduction of inheritance tax and a review of the VAT system aimed at benefiting the public at large. Furthermore, wider opportunities for tax-free supplementary pension savings schemes are planned. Tax cuts will be decided in more detail in connection with wage settlements."

Tax reductions

3.2. Main elements of fiscal policy

On the basis of its Policy declaration, the Government has approved to the following fiscal policy objectives during its term of office:

- About 20 billion krónur will be used to cut taxes in 2005-2007 and up to 3 billion krónur for specific tasks, such as increasing child benefits.
- Central government investment will be cut by 3 billion krónur in 2005 and by a further 2 billion in 2006. Such investment will be increased by 3 billion in 2007 and 2 billion in 2008.
- Fiscal policy will be tightened so as to limit the annual increase in public consumption to 2 per cent in real terms in 2005-2007. i.e. by ensuring that public sector wage increases do not exceed those of the exposed sectors of the economy. The annual increase in transfer payments should not exceed 2½ per cent in real terms in 2006-2007.
- The Treasury surplus should not fall below 1¾ per cent of GDP in 2005 and 1 per cent in 2006.

3.3 Assumptions underlying the medium-term forecast

As noted before, about a 20 billion krónur tax cut will take place in the years 2005-2007. The objective is to reduce the personal income tax, eliminate the net wealth tax and reduce the value added tax. The implementation will be brought about in connection with the general wage agreements in 2004.

The reduction in the personal income tax will contribute to increased labour market participation, which is especially important in light of the fact that the large construction projects envisaged will call for a substantial increase in the supply of labour. Although labour market participation is fairly high in Iceland, it is assumed that such a cut may

stimulate labour supply even further.

The abolition of the net wealth tax is seen as a logical step in light of the fact that all income capited is now taxed on a uniform basis. The bulk of the net wealth tax is borne by persons of middle age and older and, therefore, an abolition of the tax may stimulate saving rather than consumption. A net wealth tax on business is today nearly unknown in major competitor countries, thus placing Icelandic businesses at a clear disadvantage.

The value added tax is due for a revision, since the tax rate is one of the highest known. The different excise taxes on various goods must also be reviewed in order to further remove any distortive elements in taxation of consumer goods. All these aspects must come under scrutiny, taking account of income distributive effects, tax incidence and fiscal collection efficacy.

On the expenditure side, the main assumption is that current expenditure will be managed with utmost restraint. Special measures will be used to meet with deviations from budget plans. It is seen as important that wage increases of public employees will not exceed those of the exposed sectors of the economy. The medium-term programme assumes that the growth in public consumption will be reduced to 2 per cent a year in real terms, 1 per cent below the average growth in recent years. Government investment will be sharply cut over the next few years, followed by an increase in the years when the construction of the aluminium plant and the power project in the eastern part of the country is completed.

**Slower growth of
public
consumption**

Transfer payments are expected to increase over the next several years on the basis of existing legislation, partly because of an increasing number of pensioners. The increase in the number of disabled persons is expected to level off due to changed circumstances in the labour market. Unemployment is expected to decline, thus reducing unemployment compensation. All told, transfer payments are expected to increase by an average of 2½ per cent a year in real terms. This calls for substantial restraint and implies that no important additions to the transfer payments system will be undertaken without commensurate expenditure cuts in other areas.

The medium-term projection of fiscal finances generally assumes that expenditure will continue on the basis of existing legislation and the present level of services. It is assumed that expenditure for general government administration will increase by 1 per cent a year in real terms. Transfer payments and education expenditure are projected on the basis of forecasts of the number of older persons, the disabled, the number of pupils in schools and other important parameters that determine government expenditure. It is assumed that restraint will be applied to government expenditure through a more effective expenditure management and that the built-in automaticity of expenditure increases will be carefully scrutinised.

One billion krónur a year will be used for the Government's priority projects in 2005-2007. These projects will be implemented by rearranging the priorities of individual projects, taking into account longer-term commitments and plans for investment in roads, harbours and airfields.

The medium-term programme is i.a based on forecasts of major international institutions on economic developments in Iceland's major trading countries. Forecasts on population growth and the labour force are based on the Ministry's projections with regard to power project and aluminium plant construction activity. An assessment of export production is also taken into consideration, based on specific assumptions with regard to the fish catch over the next several years. Furthermore, it is assumed that upcoming wage negotiations in 2004-2005 will be based on the economic circumstances ahead so as not to upset the objectives of economic stability, low inflation and full employment.

In the medium-term forecast, it is also assumed that certain monetary policy measures will be implemented in accordance with the main goals on which the forecast is based. It is expected that interest rates will rise temporarily during the peak of construction activity. Fiscal restraint will help in keeping the rise in interest rates to a minimum.

3.4 Conclusions of the medium-term forecast

The main conclusion of the medium-term forecast is that economic stability can be maintained in spite of increased domestic demand.

**Pronounced
economic growth**

Economic growth will be quite pronounced in 2004-2006, followed by a slowdown in 2007 which will in part be offset by increased public investment. The power project and aluminium plant construction inevitably leads to an increase in imports and consequently to a deficit on the current account which will shrink substantially upon the completion of construction when aluminium exports of the new plant come on stream. Inflation may be expected to increase temporarily at the peak of construction activity and decline thereafter. Real wages will increase substantially while unemployment will be low throughout the period.

Main economic aggregates

Volume changes in per cent	Budget	Medium-term projection		
	2004	2005	2006	2007
Private consumption.....	3½	5	3¾	3
Public consumption.....	1	2	2	2
Investment.....	8½	16½	6	-19¾
National expenditure, total.....	4	7	4	-2¾
Exports of goods and services.....	4½	3	2½	11½
Imports of goods and services.....	5¾	6¼	4¼	1¾
Gross domestic product.....	3½	5½	3¼	¾
Curr. account balance, p.c. of GDP.....	-3¼	-4¾	-5¾	-3¼
Wages and prices, change in p.c.				
Disposable income per capita.....	5	7	6	4½
Wage increases.....	5	7	4½	3½
Real disposable income per capita.....	2½	4	2¾	1¾
Consumer price index.....	2½	3	3	2½
Exchange rate index numbers.....	125	127	128	129
Unemployment, p.c. of labour force.....	2½	2	2½	3

A tight fiscal policy will create room for reducing taxes and increasing expenditure in accordance with the Government Policy Statement without upsetting the main objectives of economic policy of maintaining economic stability. Fiscal finances yield a substantial surplus at the time when construction activity is at its peak. Treasury debt should at the same time decline.

**Maintaining
economic
stability**

Fiscal finances will inevitably revert to deficit, once the power project and the aluminium plant in eastern Iceland are completed, since economic growth will slow down. In the circumstances, the Government will increase public investment, and tax cuts will help in promoting growth.

Main elements of fiscal finances

<i>Bn.krónur, accrual basis</i>	Budget	Medium-term projection		
	2004	2005	2006	2007
Total revenue.....	279.4	300	313	320
Of which: Tax revenue.....	252.3	270	281	286
Total expenditure.....	273.0	285	303	325
Current expenditure.....	124.3	131	139	147
Interest expense.....	15.1	15	15	15
Transfer payments.....	112.9	121	129	138
Maintenance.....	4.0	5	5	5
Investment.....	16.7	13	15	20
Revenue balance.....	6.4	15	10	-6
Financial balance.....	13.7	7	8	-8
Net Treasury debt.....	155.0	155	149	160
in p.c. of GDP				
Total revenue.....	32.4	32	31¼	31
Of which: Tax revenue.....	29.3	29	28	27¾
Total expenditure.....	31.7	30½	30½	31½
Revenue balance.....	0.7	1¾	1	-½
Financial balance.....	1.6	¾	¾	-¾
Net Treasury debt.....	18.0	16½	15	15½

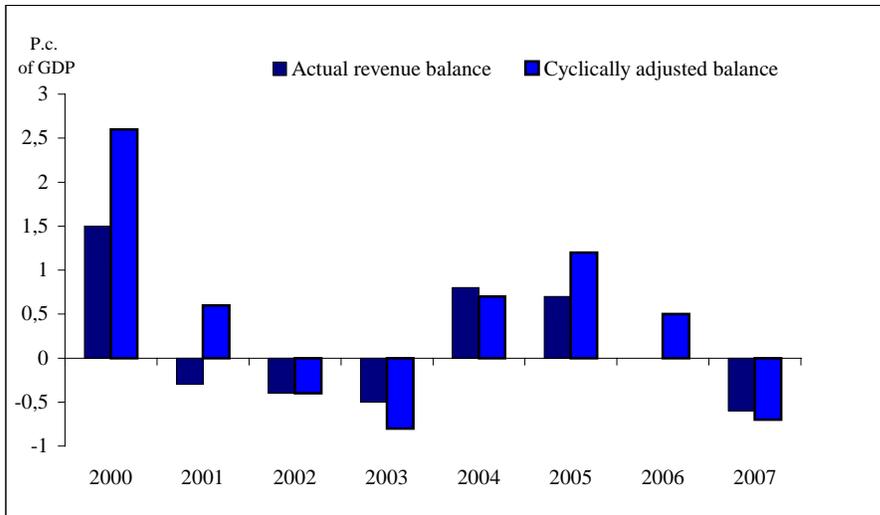
It should be remembered that in this medium-term projection no assumption is made about construction activity in connection with the expansion of the Nordural aluminium plant. Nor is it assumed that fiscal revenue will be incurred from the sale of Landssími, the government-owned telephone company. These possibilities are excluded for cautionary reasons.

Nonetheless, it is thought likely that Landssími will be sold during the next four years, fully or in part. This would mean that the Treasury would receive considerable revenue from asset sales and provide an opportunity for reducing debt over and above what has already been assumed. The Treasury's interest cost could thereby be reduced, thus improving fiscal finances. The expansion of the Nordural plant will also have a significant economic impact, which will both be reflected in increased growth and stronger fiscal finances.

All in all, it is likely that fiscal finances will actually exceed the projections presented here and that a fiscal deficit will be avoided in 2007.

Fiscal policy aims at mitigating the upswing in 2004-2006 and the slowdown in 2007. These mitigating influences can be clearly seen in the chart below which shows the actual Treasury revenue balance on a national accounts basis on one hand and the cyclically adjusted balance on the other. Fiscal restraint increases during the cyclical upswing when the cyclically adjusted balance is in surplus, reverting to a deficit during the slowdown in 2007.

Treasury finances



The following table shows a projection of Treasury expenditure by category, based on the above assumptions of present legislation, a forecast of the number of older persons, pupils in school and other determining factors.

Treasury expenditure by category

Million krónur, accrual basis	Budget	Forecast		
	2004	2005	2006	2007
General administration	14 598	14 727	14 843	14 974
Police and security	11 834	11 937	12 060	12 204
Education	25 147	26 105	26 985	27 761
Health	73 578	75 526	77 642	79 838
Social services and welfare	61 860	62 706	64 482	66 513
Housing, zoning and environm.	3 554	3 643	3 682	3 451
Culture and church	10 603	10 644	10 603	10 677
Fuel and energy	2 170	2 177	1 984	1 958
Agriculture and fisheries	14 366	14 410	14 482	14 579
Industry	1 064	1 206	1 333	1 380
Transport and communications	18 106	16 778	17 776	17 358
Other economic affairs	4 460	4 296	4 274	4 310
Other expenditure	31 694	31 917	32 144	32 376
Postponed investment		-3 000	-2 000	3 000
Change in wages, prices and interest		11 604	22 936	35 018
Total	273 034	284 676	303 226	325 397

Figures for individual items are at 2004-prices. The impact of wage-, price- and interest increases is presented as a separate item. The total is therefore at the estimated current prices of each year.

4 Economic developments and prospects

Considerable economic growth ahead

4.1 Main conclusions

There will be substantial economic growth over the next several years, although lower than in the April forecast due to the fact that the expansion of the Nordural plant at Grundartangi has been postponed. A stricter fiscal policy will lead to lower interest rates than otherwise would have been the case, create room for tax cuts and ensure continued economic stability.

The main sources of growth will be the power construction projects in the eastern part of the country and a substantial increase in household purchasing power, leading to increased consumption and investment. This is in part offset by the fact that a substantial part of the increase in national expenditure will be met by imports and an increased deficit on the current account over the next several years. Economic growth will slow down considerably once the construction projects are completed, but this slowdown will be mitigated by the impact of tax cuts and increased public investment.

In spite of a considerable increase in economic activity, it is forecast that inflation will be stable over the next several years, although a temporary rise may be expected at the peak of construction activity. A tight monetary and fiscal policy will play an important role in this respect.

The impact of the expansion in the economy, particularly that of the energy construction projects, will be reflected in general wage increases which may be expected to be greater when construction activity will be at its peak. At the same time, unemployment will decline to negligible levels. Household purchasing power will therefore continue to grow over the next several years.

Fiscal finances will strengthen in line with expanding economic activity. The Treasury's revenue surplus will rise substantially at the peak of construction activity in spite of the planned tax cuts. Once the construction period is over, a deficit may be expected, partly because of increased outlays for public investment. The expansion of the Nordural plant would however change these prospects considerably.

The most important task of economic policy over the next several years is to pursue a tight fiscal policy in order to manage domestic demand, particularly due to the construction activity in the eastern part of the country. A delay of public investments is of importance here as well as a general restraint on public expenditure, particularly on wages and salaries.

4.2 Economic developments in 2003

The main conclusion of the Ministry's April forecast was that a new economic upturn had started with considerable growth in output and expenditure this year. Economic developments since then have confirmed this expectation.

Economic growth in 2003 is forecast at 1¾ per cent, 1 per cent less than forecast this spring. The most important change here is that it is no longer assumed that the expansion of the Nordural plant in Hvalfjörður will take place along with congruent power construction activity. Imports of goods and services have increased more than previously assumed and the current account deficit has widened.

**Growing
national
expenditure**

Despite lower growth than earlier forecast, national expenditure is expected to increase more, by 4¼ per cent in real terms, compared with a projection of 3½ per cent this past spring; the difference being due to higher private and public consumption. Investment is expected to increase by 7¾ per cent in real terms this year, of which business investment is expected to increase by 14½ per cent. This is a sharp turnaround from the declines in 2001 and 2002. Subsequently, imports of goods and services are expected to increase substantially this year. Total exports, however, are expected to decline by half a per cent, which to a considerable extent is due to a 2 per cent decline in marine export production as a result of a declining fish catch. All told, the current account deficit will be larger in 2003 than previously estimated, about 2½ per cent of GDP.

Inflation has declined rapidly in recent months and the 2.5 per cent inflation target of the Central Bank was attained in November 2002. Inflation has further abated since then due to the considerably stronger exchange rate; the real exchange rate is expected to rise by 7 per cent, as measured by relative prices, in the course of 2003. In addition, there is

**Inflation is
declining**

the influence of continued excess capacity in the economy and a relatively high rate of unemployment in recent months. A 2 per cent inflation rate is forecast between the averages of 2002 and 2003, and the unemployment rate for 2003 is expected to average 3¼ per cent. The latest unemployment figures indicate that the employment situation is rapidly improving. The wage cost per man-year is expected to increase by 5 per cent in 2003. Real disposable income per capita is expected to increase by 1½ per cent this year.

4.3 Economic prospects 2004-2005

The construction of the power project and an aluminium plant in eastern Iceland will have a profound impact on economic developments up to 2007. The Ministry's national economic forecast projects economic growth at 3½ per cent in 2004, accelerating to 5½ per cent in 2005.

Economic forecast

	Bn.kr. 2002	Volume changes in per cent			
		Prov. 2002	Forecast		
			2003	2004	2005
Private consumption	418.3	-1.1	3¼	3½	5
Public consumption	198.8	4.0	3½	1	2
Investment	146.8	-14.8	7¾	8½	16½
Change in stocks ¹	-0.2	0.4	0	0	0
National expenditure, total	763.6	-2.9	4¼	4	7
Exports of goods and services	309.0	3.7	-½	4½	3
Imports of goods and services	293.7	-2.3	5¾	5¾	6¼
Gross domestic product	779.0	-0.6	1¾	3½	5½
Gross national income	762.0	0.6	2¼	3½	5¼
Terms of trade effect ²		0.2	-¼	-½	0
Nat'l inc., incl. terms of trade effect		0.8	2	3	5¼
Current acc. balance, p.c. of GDP	-0.5	-0.1	-2½	-3¼	-4¾
P.c. change in per cap. real disp. income		-0.2	1½	2½	4
P.c. change in consumer prices		4.8	2	2½	3

¹ Volume changes in per cent of GDP of the previous year.

² Volume changes in per cent of GNI of the previous year.

National expenditure is expected to increase by 4 per cent in real terms in 2004, in large part due to an 8½ per cent increase in investment, where business investment is expected to be up by 15 per cent and housing by 4 per cent, whereas public investment is expected to decline by 8 per cent. Private and public consumption together is forecast to increase by 4½ per cent in 2004. The current account deficit is expected to widen in spite of a 6 per cent increase in marine production; it is

forecast to reach $3\frac{1}{4}$ per cent of GDP in that year. The wider deficit is due to rising national expenditure, particularly on account of the construction activity in the eastern part of the country.

As the economy goes into an upturn, demand for labour increases and unemployment declines. The average increase in prices is forecast at $2\frac{1}{2}$ per cent between 2003 and 2004. The negative output gap in the economy is expected to recede but will to some extent exist into 2004. However, the employment situation is expected to be in balance.

Unemployment is declining

The Ministry forecasts a $5\frac{1}{2}$ per cent growth rate in 2005, at which time construction activity in the East will be at its peak. Business investment is expected to increase by more than one-fourth in real terms in 2005 and private consumption by 5 per cent. National expenditure is expected to increase by 7 per cent in 2005 and the current account deficit is forecast to reach $4\frac{3}{4}$ of GDP.

As construction activity in eastern Iceland increases, unemployment is expected to decline and reach 2 per cent in 2005. Should this be realised, it would mean that considerable demand pressures would emerge and actual output would exceed potential output by a significant margin. This turnaround would also mean that inflation could exceed the Central Bank's inflation target in 2005 by $\frac{1}{2}$ per cent, according to the Ministry's projection. The Ministry expects that the Bank's base rate will increase at the peak of construction activity by up to $2\frac{1}{2}$ per cent over the present level. However, this projection is uncertain and will be dictated by the course of the economy at that time.

Table 1**Treasury revenue and expenditure**

In billions of krónur	2001	2002	Budget ¹ 2003	Estimate 2003	Budget proposal 2004
Tax revenue.....	211 729	220 510	237 001	237 776	252 273
Personal income tax.....	58 676	61 290	69 140	68 580	73 900
Corporate income tax.....	9 551	8 807	8 250	7 900	7 900
Social security taxes.....	21 909	23 397	27 744	27 122	29 007
Net wealth taxes.....	10 596	11 001	7 954	7 954	8 260
Value added tax.....	72 147	76 271	79 700	81 400	86 021
Other taxes on goods and services.....	37 467	37 469	40 333	41 379	44 944
Other taxes	1 383	2 275	3 881	3 442	2 241
Other current revenue.....	23 274	25 782	22 409	24 681	25 470
Dividends income.....	1 917	3 095	2 537	4 101	3 726
Interest income.....	14 727	15 629	13 523	14 173	15 121
Other.....	6 630	7 058	6 349	6 407	6 623
Revenue from sales of assets.....	1 065	11 722	12 940	12 940	540
Revenue and cost sharing transfers.....	1 288	1 196	1 850	1 850	1 143
Revaluation of state enterprise assets.....	-	-	-	-	-
Total revenue.....	237 356	259 210	274 200	277 246	279 425
The Presidency, Althingi and Supreme Court.....	2 111	2 596	2 299	2 310	2 390
Office of the Prime Minister.....	1 146	1 444	1 031	1 150	1 130
Ministry of Education, Science and Culture.....	26 803	30 173	32 271	33 100	32 250
Ministry for Foreign Affairs.....	4 965	5 489	5 292	5 648	5 457
Ministry of Agriculture.....	11 039	11 610	11 465	11 665	11 743
Ministry of Fisheries.....	2 813	2 883	2 933	2 983	3 071
Ministry of Justice and Church.....	12 901	13 883	14 367	14 557	15 176
Ministry of Social Affairs.....	16 767	20 695	21 558	23 182	22 944
Ministry of Health and Social Security.....	84 559	96 361	100 742	103 632	110 181
Ministry of Finance.....	23 706	41 963	27 653	28 100	26 000
Ministry of Communications.....	15 869	15 902	20 569	19 529	17 982
Ministry of Industry.....	2 972	2 891	3 905	3 955	3 442
Ministry of Commerce.....	1 450	1 468	1 446	1 446	1 467
Statistics Iceland.....	399	500	539	550	514
Ministry for the Environment	3 290	3 469	3 273	4 163	4 149
Interest expenditure.....	17 923	16 005	15 500	15 030	15 140
Total expenditure.....	228 713	267 332	264 842	271 000	273 035
Revenue balance.....	8 643	-8 122	9 358	6 246	6 390

¹ Budget plus the March supplementary budget.

Table 2**Treasury cash flow and capital transaction**

In billions of krónur	2001	2002	Budget ¹ 2003	Estimate 2003	Budget proposal 2004
Cash flow from operating activities.....	0.5	-12.3	-10.7	-13.9	-2.1
Capital transactions					
Credit transactions, net.....	-12.5	12.0	14.7	15.9	15.7
Rev. from sales of assets and other capital transact.....	-11.3	0.0	15.8	15.6	0.1
Capital transactions, total.....	-23.8	12.0	30.5	31.5	15.8
Discounts on borrowings.....	2.7	3.5			
Net financial balance (before contrib. to GEPF).....	-26.0	-3.8	19.8	17.6	13.7
Contrib. to Gov. Employees Pension Fund.....	-14.3	-10.9	-7.5	-7.5	-7.5
Net financial balance (after contrib. to GEPF).....	-40.3	-14.7	12.3	10.1	6.2
Changes in credit transactions.....	41.6	13.5	-11.1	-9.1	-4.0
Cash balance.....	1.3	-1.2	1.2	1.0	2.2
Per cent of GDP					
Cash flow from operating activities.....	0.1	-1.6	-1.3	-1.7	-0.2
Net financial balance.....	-3.5	-0.5	2.4	2.2	1.6
Cash balance.....	0.2	-0.2	0.1	0.1	0.3

¹ Budget plus supplementary budget.

Table 3**Treasury revenue**

Accrual basis, millions of krónur	2001	2002	Budget ¹ 2003	Estimate 2003	Budget proposal 2004
I Tax revenue	211 729	220 510	237 001	237 776	252 273
Taxes on income and profits	68 896	71 569	79 790	79 140	83 220
Individuals	58 676	61 290	69 140	68 580	73 900
Personal income tax	50 862	53 976	62 600	61 600	66 900
Personal income surtax	1 644	1 077	1 540	1 480	1 400
Other taxes on income and profits	6 170	6 237	5 000	5 500	5 600
Corporations	9 551	8 807	8 250	7 900	7 900
Other	669	1 472	2 400	2 660	1 420
Tax on central gov't capital gains	56	721	1 500	1 760	500
Tax for the Nursing Home Constr. Fund	613	751	900	900	920
Social security taxes	21 909	23 397	27 744	27 122	29 007
Net wealth taxes	10 596	11 001	7 954	7 954	8 260
Taxes on goods and services	109 614	113 740	120 033	122 779	130 965
Value added taxes	72 147	76 271	79 700	81 400	86 021
General excise taxes	11 161	11 461	16 232	16 142	16 978
Excise tax on motor vehicles	2 853	2 804	3 200	4 000	4 290
General excise tax on petrol	1 981	1 890	1 995	2 008	2 157
Special excise tax on petrol	5 447	5 493	5 434	5 470	5 871
Other turnover taxes	7 468	6 700	3 950	4 170	4 581
Motor vehicle tax	2 628	2 916	2 975	3 030	3 060
Diesel weight tax	4 894	4 704	5 088	5 088	5 573
Misc. charges	1 035	1 501	1 459	1 471	2 434
Other taxes	714	803	1 481	782	821
II Other current revenue	23 274	25 782	22 409	24 681	25 470
Dividends and rental income	1 917	3 095	2 537	4 101	3 726
Interest income and other property income	14 727	15 629	13 523	14 173	15 121
Charges and licences.....	5 782	6 313	5 582	5 640	5 811
Other.....	848	745	767	767	812
III Revenue from sales of assets.....	1 065	11 722	12 940	12 940	540
IV Capital transactions.....	-	-	-	-	-
V Cost sharing transfers.....	1 288	1 196	1 850	1 850	1 143
VI Revaluation of government assets.....	-	-	-	-	-
Total revenue, accruals basis	237 356	259 210	274 200	277 246	279 425
Total revenue, cash basis	224 042	244 338	261 280	263 209	264 544

¹ Budget plus supplementary budget.

Table 4

Treasury expenditure by economic activity

Accrual basis, millions of krónur	2001	2002	Budget ¹ 2003	Estimate 2003	Budget proposal 2004
Current expenditure					
Wages.....	62 279	71 456	73 161	75 360	77 192
Government employee's pension fund liabilities.....	2 612	16 321	4 555	4 555	4 704
Other current expenditure	43 201	55 155	53 502	54 910	61 011
Service charges	-16 414	-21 040	-17 116	-17 116	-18 613
Total current expenditure	91 678	121 892	114 101	117 708	124 294
Interest	17 923	16 005	15 500	15 030	15 140
Transfer payments					
Old age and disability insurance	19 944	22 190	25 326	25 326	28 939
Health insurance	11 663	12 695	13 627	14 057	14 216
Agricultural support payments	7 295	7 718	7 324	7 500	7 310
Municipal Equalisation Fund	5 763	5 800	5 966	6 000	6 427
Welfare support payments	5 823	6 240	7 109	7 109	5 793
Child benefits	4 559	4 756	5 430	5 430	5 430
Parental Leave Fund	2 853	4 654	5 292	5 292	5 546
Interest cost rebates	4 721	5 117	4 605	5 205	4 505
Tax write-offs	5 944	9 811	4 000	4 000	4 000
Student Loan Fund	2 420	2 645	3 028	3 028	3 412
Unemployment Insurance Fund	1 592	3 002	3 163	4 268	3 314
Parishes and churchyards	2 473	2 426	2 620	2 640	2 739
National Broadcasting Service	1 938	2 248	2 171	2 171	2 188
Other transfer payments	19 119	18 195	17 592	19 195	19 126
Total transfer payments	96 107	107 497	107 252	111 220	112 945
Maintenance					
Maintenance of roads	4 187	4 399	4 327	4 327	2 085
Other	1 491	1 737	1 725	1 725	1 868
Total maintenance	5 678	6 136	6 052	6 052	3 953
Capital expenditure					
Road construction	6 067	5 354	10 573	9 070	8 070
Universities and higher education	1 014	1 130	2 236	2 396	1 818
Harbour construction	888	1 586	1 202	1 201	1 072
Hospitals and health centres	1 072	1 159	1 260	1 260	1 062
Airfields	1 072	455	693	693	287
Other capital expenditure	7 213	6 119	5 973	6 370	4 394
Total capital expenditure	17 326	15 803	21 937	20 990	16 703
Total expenditure	228 712	267 333	264 842	271 000	273 035

¹ Budget plus supplementary budget.

² In the budget for 2003 transfers decrease by 3.856 m.kr. and other current expenditure increases by the same amount due to a change in the presentation of payments to non-profit institutions for the elderly and to private universities.

Table 5**Treasury expenditure**

Accrual basis, millions of krónur	2001	2002	Budget ¹ 2003	Budget proposal 2004
General public services	13 430	15 092	14 190	14 599
Public order and safety	10 811	11 513	11 367	11 835
Education	20 611	22 652	23 925	25 146
Health services	57 236	66 242	66 487	73 578
Social security and welfare services	46 707	53 896	58 886	61 860
Housing and community amenities	2 011	2 228	2 458	3 554
Recreation, culture, and religion	9 139	9 951	11 514	10 603
Fuel and energy	1 855	1 959	2 149	2 170
Agriculture, forestry, fishing, and hunting	13 469	14 040	13 931	14 365
Mining, manufacturing and construction	783	1 039	848	1 064
Transportation and communication	15 908	16 091	20 710	18 107
Other industries	5 049	4 789	4 438	4 461
Expenditures not classified by major group	31 705	47 842	33 939	31 694
Total expenditure	228 714	267 332	264 842	273 035

¹ Budget plus the March supplementary budget.

Table 6

Central government debt and claims ¹

Stock figures in millions of krónur, year-end values	1994	1995	1996	1997	1998	1999	2000	2001	2002	Estimate 2003	Budget proposal 2004
Gross debt.....	213 924	232 585	239 246	241 566	237 764	225 968	227 908	296 480	279 583	276 100	273 800
Central Bank.....	-	-	-	-	-	-	-	-	-	-	-
Treasury bonds.....	69 008	74 140	73 889	84 424	82 865	82 618	68 898	64 243	50 818	45 000	43 500
Treasury notes.....	5 563	5 768	8 366	11 258	15 846	11 018	11 430	19 588	32 482	41 100	45 400
Treasury bills.....	14 630	16 406	15 811	12 296	15 209	9 899	5 970	12 003	12 004	21 000	18 000
Other domestic liabilities.....	11 090	9 010	8 962	6 960	6 526	4 297	2 285	2 357	2 274	2 200	2 100
Foreign debt.....	113 633	127 261	132 218	126 628	117 318	118 136	139 325	198 289	182 005	166 800	164 800
Total claims.....	69 066	77 266	71 023	69 309	86 496	107 152	100 696	126 760	129 512	126 500	118 800
Long term credit.....	55 469	64 134	63 663	65 278	64 739	69 347	70 443	90 248	78 785	75 600	56 800
Indexed to domestic prices.....	36 965	45 176	50 565	52 885	53 215	57 699	58 786	76 828	71 710	-	-
In foreign currency.....	18 504	18 958	13 098	12 393	11 524	11 648	11 657	13 420	7 075	-	-
Taxes due and short-term claims.....	13 597	13 132	7 360	4 031	21 757	37 805	30 253	36 512	50 727	50 900	62 000
Net debt.....	144 858	155 319	168 223	172 257	151 268	118 816	127 212	169 720	150 071	149 600	155 000
Claims as a percentage of debt.....	32,3	33,2	29,7	28,7	36,4	47,4	44,2	42,8	46,3	45,8	43,4
Percentage of GDP											
Gross debt.....	48.6	51.3	49.1	46.8	41.7	36.6	34.1	39.3	35.8	35.1	31.5
Of which: foreign debt.....	25.9	28.2	27.3	24.6	20.6	19.4	21.0	26.6	23.4	-	-
Total claims.....	12.6	14.1	13.0	12.6	11.3	11.1	10.5	11.7	10.0	15.5	13.8
Of which: In foreign currency.....	4.2	4.2	2.7	2.4	2.0	1.9	1.8	1.8	0.9	-	-
Short term credit, net.....	3.1	2.9	1.5	0.8	3.8	6.0	4.5	4.7	6.5	-	-
Net debt.....	32.9	34.3	34.6	33.4	26.5	19.4	19.2	22.9	19.3	19.0	17.8

¹ Including accrued interest liabilities.

Table 7

General government debt and claims ¹

Millions of krónur, nominal values	1994	1995	1996	1997	1998	1999	2000	2001	2002	Esimate 2003	Budget proposal 2004
General government gross debt.....	245 071	267 611	274 447	279 351	280 460	272 031	277 715	346 170	343 627	344 697	346 482
Domestic debt	126 467	135 881	138 088	145 149	153 144	142 048	124 812	129 834	134 799	-	-
Foreign debt.....	118 604	131 730	136 359	134 202	127 316	129 983	152 903	216 336	208 828	-	-
General government total claims.....	79 577	88 313	82 925	82 820	99 746	124 552	118 850	152 671	148 259	142 945	134 244
Long-term claims.....	61 559	70 760	71 249	74 449	74 482	79 505	80 569	110 747	93 616	88 610	69 018
Taxes outstanding and other short-term claims	18 018	17 553	11 676	8 371	25 264	45 047	38 281	41 924	54 643	54 335	65 226
General government net debt.....	165 494	179 227	191 522	196 531	180 685	146 985	158 516	193 297	195 176	201 570	212 065
Central government.....	144 858	155 319	168 224	172 256	151 268	118 816	127 212	162 788	150 071	149 600	155 000
Local governments.....	22 185	25 130	24 190	25 038	30 089	28 663	31 653	30 711	45 297	52 152	57 238
Social security system.....	-1 549	-1 222	- 892	- 763	- 672	- 494	- 349	- 202	- 192	- 182	- 173
Percentage of GDP											
General government gross debt.....	55.8	59.2	56.6	54.4	49.3	44.6	41.9	46.5	44.1	42.3	40.2
Domestic debt.....	28.8	30.1	28.5	28.3	26.9	23.3	18.8	17.4	17.3	-	-
Foreign debt.....	27.0	29.1	28.1	26.1	22.4	21.3	23.1	29.0	26.8	-	-
General government total claims.....	18.1	19.5	17.1	16.1	17.5	20.4	17.9	20.5	19.0	17.5	15.6
General government net debt.....	37.7	39.6	39.5	38.3	31.8	24.1	23.9	25.9	25.1	24.7	24.6

1) The general government is defined according to the SNA-definition. Government enterprises and financial institutions are excluded.

Table 8

	Budget 2003	Estimate 2003	Budget proposal 2004
I. Key economic aggregates, volume changes, p.c.			
Private consumption	1¼	3¼	3½
Public consumption	2¼	3½	1
Investment	2	7¾	8½
Total national expenditure	1¾	4¼	4
Exports of goods and services	3	-½	4½
Imports of goods and services	3	5¾	5¾
Gross domestic product	1¾	1¾	3½
Current account balance, % of GDP	-½	-2½	-3¼
II. Wages and prices, change in per cent			
Disposable household income per capita	5	3½	5
Real disposable income per capita	2½	1½	2½
Consumer price	2¼	2	2½
Exchange rate index	-1½	-6	1
Unemployment, per cent of labour force	2¾	3¼	2½