

Highlights

Budget Proposal

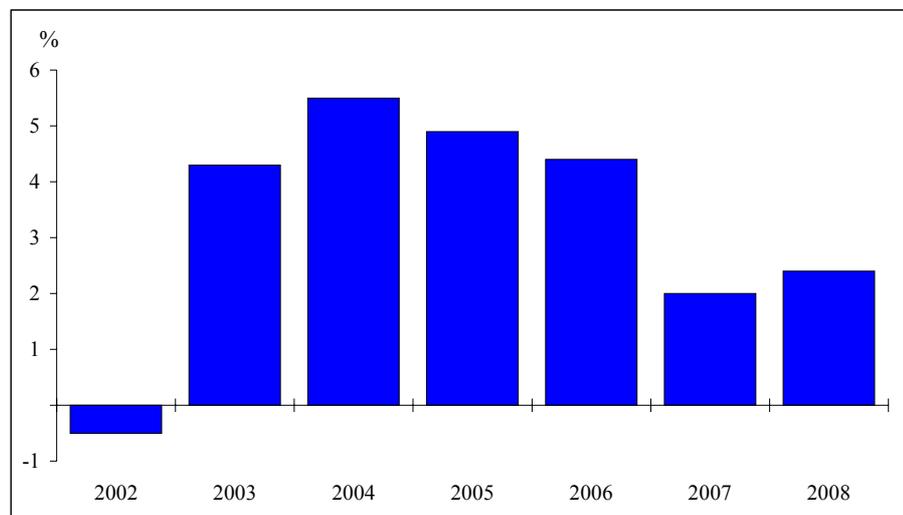
2005

Vigorous economic expansion

1 Economic policy objectives

A vigorous economic expansion is now underway in most sectors of the economy which is expected to continue for several years. The gross domestic product is forecast to increase by close to one-fourth over the years 2003-2007 and real disposable household income by 15 per cent. Inflation will be well within the limits aimed at by the Central Bank and the number of jobs will increase. The main forces behind the expansion are power project investments as well as increasing private consumption and residential construction. In these circumstances it will be important to follow a tight fiscal policy stance in order to restrain domestic demand over the next several years when investment activity is at its peak.

Economic growth



Tighter fiscal policy over the next several years

The 2005 fiscal budget proposal reflects this emphasis. It is presented with a revenue surplus exceeding 11 billion krónur, equivalent to 1¼ per cent of GDP. The surplus exceeds the 2004 estimate by 3.4 billion and the 2003 outcome by 17.4 billion which reflects a considerable tightening of fiscal policy in 2004 and 2005.

Medium-term fiscal policy objectives

For the second year, the four-year fiscal policy objectives of the Government are presented with the fiscal budget proposal. Such a policy objective strengthens economic policy and contributes to stability in the economy. The core of this policy is, as before, to use fiscal finances as a strong policy tool for restraining domestic demand during the period when power project investments are at their peak and to stimulate growth once they are completed. The main objectives of fiscal policy in 2005-2008 are as follows:

- A tight fiscal policy will be pursued. The annual growth in public consumption should not exceed 2 per cent in real terms. Central government wage costs should not increase in excess of wage costs

in the competitive sectors of the economy. Transfer payments should not increase by more than 2½ per cent a year in real terms.

- Central government investment will be cut by 2 billion krónur in 2005 and by another 2 billion in 2006. Investment will be increased again by 2 billion both 2007 and 2008.
- Comprehensive tax cuts will be implemented in 2005-2007 and priority given to certain expenditure areas, in accordance with the Policy Statement of the Government.

Utmost fiscal restraint...

These policy objectives call for the utmost restraint in current expenditures, both as regards wage costs as well as other current outlays. The same applies to transfer payments that have increased rapidly in recent years. Also, it will be necessary to cut government investment over the next two years when power project investments are at their peak. Government investment will be increased again in 2007 and 2008 when growth slows down.

...is one of the preconditions for tax cuts

A tight fiscal policy is not only an important precondition for economic stability but also for the implementation of the planned tax cuts. In view of the timing of the power project investments the main impact of the tax cuts will be felt in 2007. The first phase of the reduction in the personal income tax is scheduled to take place next year. The second phase will take place in 2006 and the personal and company net wealth tax will also be abolished that year. The final phase of the personal income tax reduction will take place in 2007, at which time the value added tax will be reviewed.

Structural reforms raise living standards, improve business environment...

The tax reductions are intended to improve the economic environment of households and businesses in this country and bring it on par or preferably above what is common in our principal trading countries so that people will not have to migrate to other countries to improve their living standards. The results of this policy can clearly be seen in the thriving economic activity in the country that is partly attributable to the changes in economic policies that the Government has implemented in recent years – in taxes and government finances, in financial markets and monetary policy, with the privatisation of government enterprises as well as in other areas. Household disposable income has increased sharply at the same time. The recent changes in housing mortgages, where favourable home mortgages have been made available by the banks, constitute an important addition to this market and a direct consequence of these policy changes, especially the fact that the banks were privatised.

The changed structure of the economy has not only increased household income and improved the business environment but also created conditions for a changed emphasis in economic policy. It is

**...and lay
ground for a
new economic
policy**

now generally recognised that a responsible fiscal policy and sound public finances are prerequisites for macroeconomic stability. The same applies to the importance of an independent monetary policy. These changes in the emphasis of economic policies have contributed to a more stable economic environment and will undoubtedly facilitate the task of economic policy making in the future.

The improvements in fiscal finances have also made it possible to increase payments to old-age and disability pensioners, to education and culture, to communications and to social assistance, including unemployment compensation, and to development aid.

**International
comparison**

Most economic criteria show Iceland's strength in international comparisons. Economic growth is higher than elsewhere. Unemployment is much less here than in neighbouring countries. Public finances are stronger and the same applies to government debt levels. Inflation is similar, although close to upper limits, which is wholly due to the fact that economic growth is higher here than elsewhere. In the long run, it is evident that Iceland's situation is better than that of most other countries. The pension system is much stronger since it is largely based on funding rather than on a pay-as-you-go basis. This means that special measures are not necessary to meet the relative increase in the number of old-age pensioners, neither through an increase in taxes nor through a cut in benefits.

**Continued
economic
stability**

The main conclusion of the fiscal budget proposal and the medium-term fiscal projection is that economic stability will be maintained in spite of the increase in economic activity due to power project investments and expanding domestic demand, partly due to changed terms in the home mortgage market. The tight fiscal policy of this budget proposal also makes it possible to cut taxes in accordance with the [Government's Policy Statement](#) without upsetting the main objective of economic policy of maintaining stability. A tight fiscal policy is a prerequisite to achieving these objectives.

2 Overview of fiscal finances

2.1. Fiscal developments in 2004

Rising revenue surplus

The revenue and expenditure of the Treasury have been revised in light of developments in the course of this year. Revenue is expected to exceed the budget by 8.2 billion and expenditure by 7.1 billion. The revenue surplus was estimated at 6.7 billion in the 2004 budget but has now been revised upwards to 7.8 billion. The financial surplus is estimated at 16.9 billion, compared to 14 billion in the budget. The surplus will be used to reduce Treasury debt and to prepay future pension obligations of the Government Employees Pension Fund.

Treasury revenue is increasing

Revenue was estimated at 282 billion krónur in the 2004 fiscal budget. The estimate was based on the 2002 Treasury accounts, the revenue trend in 2003 and a forecast of the main economic aggregates for 2004. In the revision of 2004 revenue, account has been taken of the revenue collection in the present year and general course of economic conditions. At present, it is estimated that Treasury revenue will amount to 290 billion for the year as a whole, 8 billion more than estimated in the budget. This increase can mostly be attributed to a more rapid economic expansion than had been originally assumed.

Welfare expenditure increases

Total Treasury expenditure was estimated at 275.3 billion in the budget for 2004. At present, expenditure is estimated to be 7 billion higher, of which 3.3 billion is current expenditure and 3.8 billion current transfer payments. The excess in current expenditure is mostly attributable to hospital cost overruns and an increase in the number of students in secondary schools and higher education. Law enforcement has also been increased and finally there has been a cost increase due to wage agreements in the general labour market during the year. The main reason for the excess in current transfer payments is that unemployment compensation exceeded budget estimates, due to an increase in benefits and more unemployment than had been forecast. Interest tax credits will exceed the budget by 600 million krónur and health insurance by 555 million, particularly due to higher drug costs. The expenditure of the Wage Settlement Fund – a government fund used to guarantee payment of outstanding wages of bankrupt companies - will exceed the budget by 300 million, and social security expenditures exceed budget estimates due to a greater increase in the number of disabled persons than had been assumed. The investment cost of the Road Authority rose by 375 million due to the construction of a road tunnel in the eastern part of the country, but this is offset by a cut in capital transfers of 460 million, since the payment to the Fisheries Development Fund has been abolished.

As noted above, the revenue surplus for 2004 is estimated at 7.8 billion. The financial surplus is larger, estimated at 16.9 billion. This is a slight improvement over the budget and is attributable to higher

Debt repayment increases

revenue on account of greater economic activity than had been assumed. The financial surplus will be used to repay 7 billion in debt, 3 billion more than had been assumed in the budget. The Treasury's balance with the Central Bank will improve by 700 million in excess of the amount that had been budgeted. The intention of prepaying 7 billion to the Government Employees Pension Fund to defray future pension obligations will remain unchanged from the budget.

2.2. The main elements of the 2005 budget

The revenue surplus increases in 2005

For 2005, the revenue surplus is estimated at 11.2 billion, 3½ billion higher than estimated for the present year and a significant improvement from the 2003 outcome. In the budget proposal, no assumption is made regarding profits from the sale of government enterprises, and on the revenue side, the collection of personal income tax is expected to decline due to the proposed cut in the tax. The improvement in the Treasury surplus is attributable to increased revenue associated with expanding economic activity at the same time as expenditure is restrained. Expenditure is being cut by 3 billion krónur from the baseline estimate. The financial surplus will not be strengthened as much, since cash from operations is lower in 2005 because large issues of savings bonds, including accumulated interest, will mature during the year. This will mean that interest expenditure on a cash basis will increase in excess of expensed interest on an accrual basis. The financial surplus is therefore expected to amount to 4 billion in 2005.

Treasury finances

Billions of krónur	Accounts 2003	Budget 2004	Estimate 2004	Budget proposal 2005
Revenue.....	273.9	282.0	290.2	305.8
Expenditure.....	280.0	275.3	282.4	294.6
Revenue surplus.....	-6.1	6.7	7.8	11.2
Non-financial curr. items.....	-10.8	-8.5	-5.5	-10.9
Cash from operations.....	-16.9	-1.8	2.3	0.3
Financial transactions.....	32.2	15.8	14.6	3.7
Net financial balance.....	15.3	14.0	16.9	4.0

Increasing revenue

The revenue estimate for the 2005 budget is based on the Ministry's forecast of continuing increases in economic activity and stable economic growth. Economic growth is forecast at 5 per cent and inflation at 3½ per cent. Private consumption is expected to increase by 5 per cent and real per capita disposable income by 3¼ per cent. On this basis, Treasury tax revenue is estimated to increase by over 6 per cent and amount to more than 280 billion krónur. Total Treasury revenue is estimated at close to 306 billion krónur.

Expenditure virtually unchanged

Total expenditure is estimated at 294.6 billion krónur and is expected to remain unchanged from this year's revised estimate. Current expenditure is expected to increase by a small margin in real terms, 0.5 per cent, mainly on account of increased expenditure for education, a shortening of the waiting list for communal living quarters for the disabled and an increased supply of nursing care spaces. The appropriation for development aid is increased by 500 million krónur. These increases are offset by a 1 per cent cost-efficiency demand upon most government agencies. Current transfers increase slightly in real terms, mostly on account of an increase in the number of disabled persons and higher appropriations for the Student Loan Fund on account of an increase in the number of students. Investment and maintenance expenditure declines by 9 per cent in real terms due to the 2 billion krónur postponement of investment projects.

Revision of the Medium Term Programme

In the Medium Term Programme of 2004 it was assumed that 3 billion krónur in investment would be postponed in 2005. This has now been revised down to 2 billion due to the state of employment in the economy. Other Treasury expenditure has instead been cut by 1 billion. Postponed investments consist of 1.9 billion in road construction and 100 million in cultural buildings. Other expenditure is cut by a 1 per cent cost-efficiency demand upon government agencies, other than the two major hospitals in Reykjavík and Akureyri and excluding the operation of nursing homes. This measure is expected to lead to an 800 million krónur cut in expenditure. Interest tax credits will be cut by 5 per cent for a saving of 200 million krónur.

Revenue surplus, excluding irregular items

Billion krónur	Accounts			Budget 2004	Estimate 2004	Budget
	2001	2002	2003			proposal 2005
Revenue surplus.....	8.6	-8.1	-6.1	6.7	7.8	11.2
Irregular expenditure.....	9.0	26.3	14.4	8.7	8.7	8.8
Irregular revenue.....	1.1	11.7	9.9	0.1	0.1	0.1
Revenue surplus, excl. irr. items	16.5	6.5	-1.6	15.3	16.4	19.9

Tighter fiscal policy

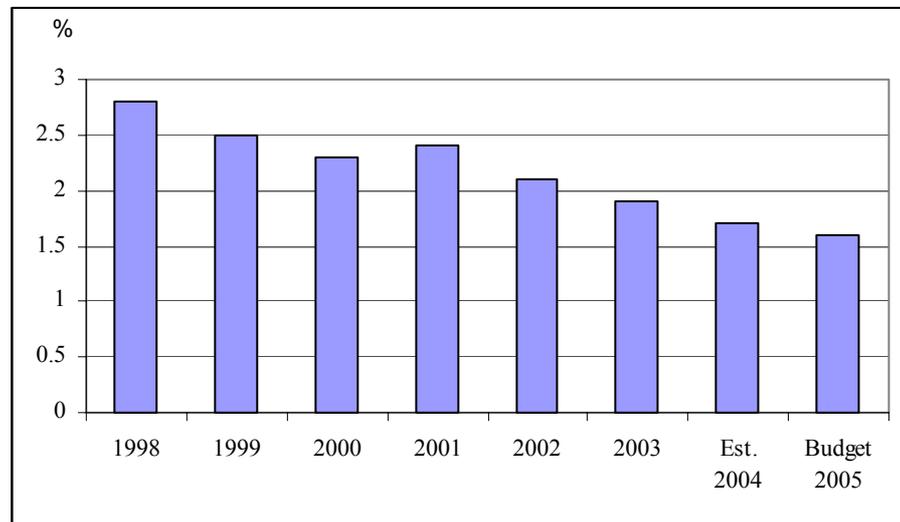
The above table shows Treasury finances excluding so-called irregular items. Irregular revenue includes profit from the sale of government assets and revaluation of assets entries on the revenue side. Irregular expenditure includes expensed pension obligations and tax claims written off. By this measure, the impact of the Treasury's normal operations are shown more clearly, and the effect of the business cycle is made more transparent. In 2003, there was a temporary revenue deficit due to the special measure of increasing expenditure to support employment and regional development in that year. In 2004, fiscal policy is tightened at a time when the economy is expanding rapidly, a situation which is expected to continue in 2005. By this measure, the revenue surplus increases by more than 20 billion from 2003 to 2005,

which is an indicator of fiscal tightening during the period of power project investment activity.

**Stronger
Treasury
debt
position**

If these intentions are all realised, the total Treasury financial surplus from 1998 to 2005 will amount to 68 billion krónur. It is being used to prepay future obligations of the Government Employees Pension Fund, to strengthen the Treasury's balance with the Central Bank and to repay general Treasury debt. Treasury debt should thus decline from 41.5 per cent of GDP in 1998 to 27.6 per cent in 2005. Net Treasury debt, i.e. total debt less funds relent and claims on others, is estimated to decline from 26.5 per cent to 17.2 per cent. Should Iceland Telecom be sold, debt will decline still further. The following chart show Treasury interest payments in per cent of GDP.

Treasury interest payments in per cent of GDP



The interest payment ratio has declined from 2.8 per cent of GDP in 1998 to 1.9 per cent in 2003 and is projected to decline to 1.6 per cent in 2005. If the ratio had remained unchanged from 1998, interest payments would be more than 11 billion krónur higher than estimated in the 2005 budget.

3 Medium-Term Programme

3.1 Introduction

The Government has increasingly adopted the practice of drafting economic policy for a period of more than one year. This tends to strengthen its policy objectives and contribute to stability in the economy. The drafting of such policy objectives are laid out in the Government Financial Reporting Act of 1997 where it says in Article 28:

“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 medium-term projection shall be reviewed and placed before the Althingi if significant changes have taken place in its premises.”

This provision of the law was followed up with a special section in the fiscal budget proposals in 1998-2003. The discussion was in general terms rather than a detailed outline of the Government's policies. An important step was taken last autumn when the Government passed a formal resolution on a Medium Term Programme for the years 2004-2007, i.e. the 2004 fiscal year and the three following years. This Programme was based on the [Government's Policy Statement](#) where the principal objectives of its economic policy are defined 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 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.”

Clear objectives of fiscal policy

In order to implement its fiscal policy objectives, the Government has agreed to the following goals for fiscal policy for the years 2005-2008:

- A policy of fiscal restraint will be pursued. The annual growth in public consumption shall not exceed 2 per cent in real terms. The wage cost of the central government should not increase by more than in

competitive sectors. The annual growth in transfer payments should not exceed 2½ per cent.

- Government investment will be cut by 2 billion krónur in 2005 and another 2 billion in 2006. This will be followed by an increase in investment of 2 billion in 2007 and again by 2 billion in 2008.
- Comprehensive tax cuts will be implemented in 2005-2007 and priority given to certain expenditure areas, in accordance with the Policy Statement of the Government.

3.3. Main assumptions of the Medium-Term Programme

The Ministry of Finance has assessed economic prospects for the years 2005-2008 on the basis of the Government's policy objectives.

Substantial tax cuts

On the revenue side, substantial tax cuts will be implemented in 2005-2007. This extends primarily to cuts in the personal income tax, the abolition of the net wealth tax and a review of the value added tax. In light of economic prospects and the timing of power project investment, the main tax cuts will take place in 2007. The first phase of the cut in the personal income tax will take place in 2005. The second phase will be implemented in 2006 in addition to the abolition of the net wealth tax on individuals and companies. The final phase is scheduled for 2007 at which time the value added tax will be reviewed. In addition, a 50% cut in inheritance tax has already been legalised.

Increased expenditure restraint

The main premise on the expenditure side is that current expenditure is restrained, and that measures are taken in cases where actual expenditures deviate from their designated course. It is also seen as important that the wage and salary changes of public employees will not exceed those of competitive sectors. Public employee pay agreements will expire at the end of November 2004.

Slower growth of public consumption

The Medium-Term Programme assumes that the growth in the central government's public consumption will slow down to an annual growth rate of 2 per cent in real terms, 1 per cent less than the average rate of recent years. In the 2005 fiscal budget proposal, a 1 per cent cost-efficiency demand is imposed upon government agencies. The largest growth in current expenditure is towards education in accordance with the Government's policy, and health expenditure is increased as well. Government investment will be cut by 2 billion krónur in 2005 and again by 2 billion

in 2006. Investment will be increased by 2 billion in 2007 and again by 2 billion in 2008. Transfer expenditures will increase over the next several years on the basis of presently existing legislation, partly because of an increase in the number of pensioners. This is offset by an expected decline in unemployment. Appropriations for development aid will increase substantially over the next several years. All told, transfer payments should not increase by more than 2½ per cent a year. No costly changes will be initiated unless they will be met with restraint in other areas.

The main elements of fiscal finances

Billion krónur	Budget	Projection		
	proposal	2006	2007	2008
Total revenue.....	305.8	319.4	316.5	328.1
Of which: Tax revenue.....	280.6	292.1	288.3	298.7
Total expenditure.....	294.6	308.4	328.4	345.4
Current expenditure.....	137.7	145.7	152.9	160.4
Interest payments.....	15.5	15.6	15.9	17.0
Transfer payments.....	122.3	128.7	138.0	146.0
Maintenance.....	4.6	4.8	5.0	5.1
Investment.....	14.5	13.6	16.6	16.9
Revenue balance.....	11.2	11.0	-11.9	-17.3
Financial balance.....	4.0	11.2	-10.9	-18.2
Net Treasury debt.....	166.7	162.5	179.5	202.6
In per cent of GDP				
Total revenue.....	32.0	30.9	29.6	29.7
Of which: Tax revenue.....	29.4	28.2	27.0	27.1
Total expenditure.....	30.8	29.8	30.7	31.3
Revenue balance.....	1.2	1.1	-1.1	-1.6
Financial balance.....	0.4	1.1	-1.0	-1.6
Net Treasury debt.....	17.5	15.7	16.8	18.4

Expenditure on education and health continues to grow

The projection of expenditure is generally based on existing legislation and the present volume of services. On one hand, a general assumption regarding the development of expenditure is made. For example, expenditure of general administration is expected to grow by 1 per cent a year. On the other hand, forecasts on the number of older persons, the number of students in secondary schools and higher education are incorporated into the projections. Expenditure on education and health are therefore expected to rise by 2-4 per cent a year over the projection period. It is assumed that during the period of power project investments, restraint will be exercised in the growth of public consumption through an active expenditure management, and the automatic growth of expenditure will be slowed down.

The economic assumptions underlying the Medium-Term Programme are in part based upon forecasts of international

agencies regarding economic developments in the major trading countries. Forecasts on the growth in population and the labour force are prepared by the Ministry, taking account of power project investments. Finally, an assumption is made regarding export production and the fish catch over the next several years.

In the Programme, certain assumptions are also made on the monetary side in accordance with its core objectives. It is thereby assumed that the Central Bank will continue to raise its base rate to a peak in 2006. Increased fiscal restraint will however help keep the rise in interest rates at a minimum.

3.4. Conclusions of the Medium-Term Programme

The main conclusion of the Medium-Term Programme is that economic stability will be maintained in spite of increased power project investment activity and rising domestic demand, partly because of changed circumstances in the housing market. A strong economic growth is expected in 2005 and 2006 followed by a slowdown in 2007 and 2008. A surge in imports during the investment period will inevitably lead to a widening current account deficit, followed by a sharp decline once the investment period ends and the exports of the new plant will be felt. Inflation may ease upwards during the peak of investment activity but decline thereafter. Real incomes will increase substantially and unemployment will decline during the first half of this period. The rise in real incomes will slow down in the latter half of the period and unemployment may increase.

Real incomes increase

Main economic aggregates

Volume changes in p.c.	Est. 2004	Budget 2005	Forec. 2006	Forec. 2007	Forec. 2008
Private consumption.....	7	5	5	1¼	1¾
Public consumption.....	1½	2	2	2	2
Investment.....	17¼	18	9¼	-19¾	-18¾
Total national expenditure.....	8¼	7½	5½	-4¼	-2¾
Exports of goods and services.....	6	4	5¾	12½	9¼
Imports of goods and services.....	12¾	10½	8½	-3¾	-3
Gross domestic production.....	5½	5	4½	2	2½
Current account in p.c. of GDP.....	-7¼	-11	-13½	-8½	-4½
Changes in incomes and prices, p.c.					
Disp. income per capita.....	4½	6¾	7¼	4	3½
Wages.....	4¾	5¼	4½	3	3
Real disp. income per capita.....	1½	3¼	4	1¾	1½
Consumer price index.....	3	3½	3¼	2¼	2
Exchange rate index, points.....	122	125	128	129	130
Unemployment in p.c. of labour force..	3	2¾	2¼	3¾	3¼

**Fiscal finances
used to mitigate
fluctuations**

The tight fiscal policy makes it possible to reduce taxes without upsetting the principal goal of maintaining economic stability. The Treasury is expected to yield a significant revenue surplus at the peak of investment activity in 2005-2006, equivalent to 1¼ per cent of GDP. Treasury debt will decline commensurably. The projections also imply that the Treasury will incur a deficit in 2007 and 2008 when total national expenditure will actually decline and economic growth will slow down.

It should be kept in mind that this is a four-year forecast based on a large number of uncertain assumptions, both at home and abroad. The figures shown here should therefore be viewed with the caveat that they can at best represent an indication of the direction of the economy and public finances. The tax changes represent a particular element of uncertainty. This applies to the impact of the cut in the personal income tax rate which could lead to a higher participation rate in the labour market, in turn reducing demand pressures and unemployment compensation expenditure. That would lead to increased tax revenue and a better revenue balance. The most likely effect of the abolition of the net wealth tax is that saving would increase which in turn would reduce demand pressures as well as inflation and the current account deficit. A cut in the value added tax would help in reducing prices and thus increase real incomes. These effects would be partly offset by the increase in demand.

**Revenue from
asset sales**

In this context, it should also be kept in mind that no assumption is made regarding revenue from the sale of Iceland Telecom. This is done in order to err on the side of caution, as should be standard practice in projections of this kind. It is however likely that Iceland Telecom will be privatised during the present term of office. That would yield considerable revenue to the Treasury and provide an opportunity to reduce debt in excess of what already is projected. The annual interest payments of the Treasury could thereby decline considerably, thus improving the revenue balance. All told, it appears likely that the Treasury's revenue balance will exceed the projection for the Programme period.

Treasury expenditure by category

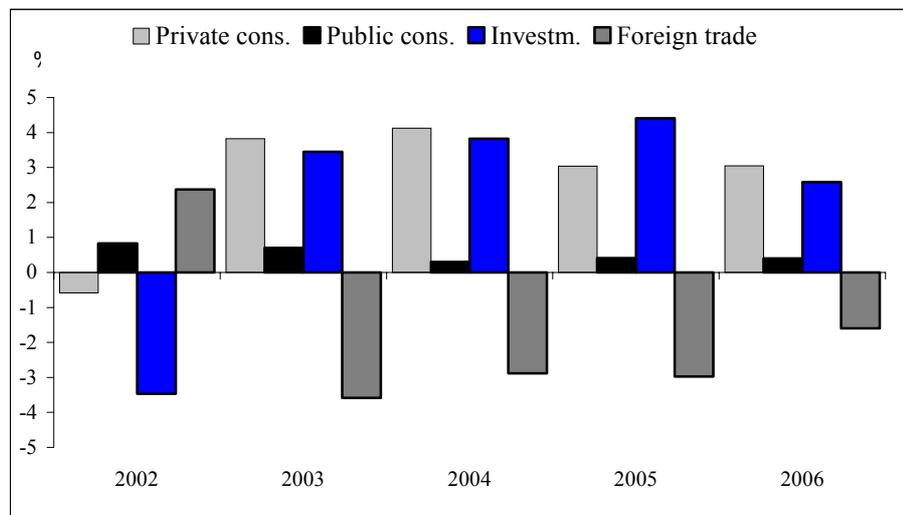
Million krónur, accrual basis	Budget 2005	Forec. 2006	Forec. 2007	Forec. 2008
General administration	15,970	16,160	16,644	16,768
Police and security	12,385	12,316	12,451	12,516
Education	28,624	29,623	30,432	31,259
Health	79,168	80,906	83,092	85,489
Social services and welfare	67,674	68,603	72,265	73,500
Housing, zoning and environment..	3,549	3,708	3,456	3,563
Culture and church	11,332	11,236	11,249	11,291
Fuel and energy	2,219	2,194	2,201	2,213
Agriculture and fisheries	14,076	14,150	14,230	14,283
Industry	1,272	1,396	1,445	1,452
Transport and communications	20,378	19,725	19,201	19,321
Other economic affairs.....	4,763	4,687	4,724	4,765
Other expenditure	35,181	36,821	37,046	38,899
Postponed investment	-2,000	-2,000	2,000	2,000
Change in wages, prices and interest		8,790	18,031	28,029
Total	294,591	308,315	328,467	345,348

4 Economic developments and prospects

A new economic expansion is underway

The latest economic data confirm earlier forecasts of the Ministry that a new economic upswing started in 2003 when a growth of more than 4 per cent was recorded. The new forecast implies a continuation of this trend with an estimated 5½ per cent growth expected for 2004, slowing down to 5 per cent in 2005 and to 4½ per cent in 2006. Although a significantly lower growth rate is expected in 2007-2010, it is nevertheless forecast to average 2½ per cent a year. If this forecast is realised, this will be one of the longest economic expansions on record in Iceland.

Components of economic growth



Extensive investment projects

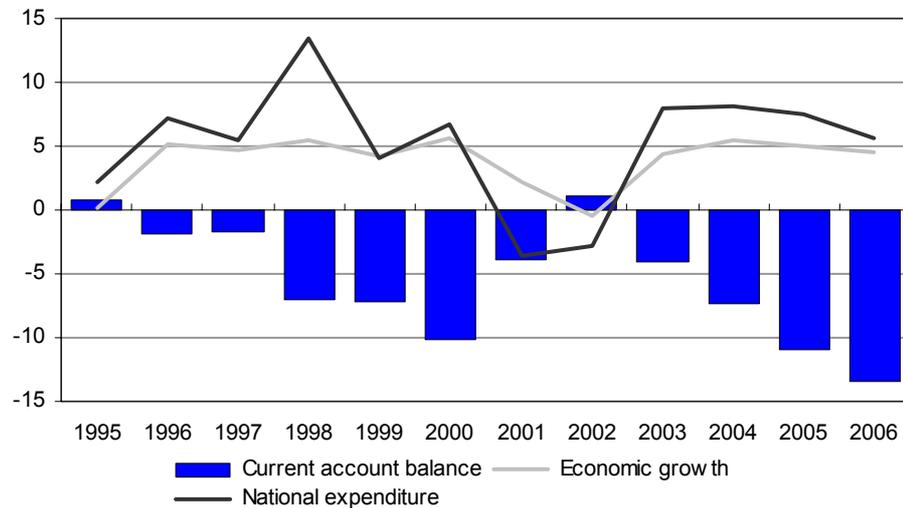
The construction schedule for power-intensive investments for the next several years has changed little since May. The total cost of these projects is estimated at 235 billion krónur at 2003-prices. The foreign share of the investment cost is estimated at 55 per cent in power projects and 62 per cent in the construction of aluminium plants. The share of foreign labour in power projects and plant construction together is expected to amount to 50 per cent over the construction period, a slightly higher proportion than in the last forecast. The number of man-years used in the construction of these projects is estimated at 7,000 and that 1½ per cent of the labour force will be engaged in this construction activity when it peaks in 2005 and 2006. At this point, the forecast has not included a possible second phase of the Norðurál plant expansion or a construction of an anode plant at Katanes.

Moderate wage increases ensure stability

One of the assumptions behind the forecast is that the average exchange rate index will be about unchanged from its present level of 122 in 2004, rising to 125 in 2005 and 128 in 2006. The assumption is that the króna will gradually weaken, taking into account the reduced inflow of foreign exchange over the next few years. A growing current account deficit will also place pressure on the exchange rate. Another

account deficit will also place pressure on the exchange rate. Another important assumption is that the newly concluded wage agreements will more or less apply to those unions that have yet to renew their wage agreements. On this basis, a continued increase in real wages and moderate price increases are forecast.

Economic growth and trade balance



Counter-cyclical fiscal and monetary policy measures

Furthermore, it is assumed that both monetary and fiscal policy will be tightened in order to promote price stability. In the forecast, it is assumed that the Central Bank base rate will gradually rise to 8 per cent until 2006 after which it will start to decline. On the fiscal front, the tightening of fiscal policy began already with the 2004 budget where the growth in public consumption and transfer payments is restricted and public investment is substantially cut. These developments are expected to continue throughout the forecast period.

Widening current account deficit because of power projects

Total expenditure is forecast to increase by 8 per cent in real terms in 2004. The prime cause of the increase lies in a 17% increase in investment, which includes a 30 per cent increase in business investment and a 12½ per cent increase in residential construction. This is in part offset by an 18 per cent cut in public investment. Private consumption is forecast to rise by 7 per cent and public consumption by 1½ per cent. The current account deficit is assessed at 7¼ per cent of GDP for 2004, growing rapidly to a peak of 13½ per cent in 2006. A widening current account deficit is to a considerable extent attributable to the power-intensive construction projects. Their direct impact is estimated to account for just under 40 per cent of the current account deficit at the peak of construction activity in 2005 and 2006. Business investment will thereby increase by 130 per cent in real terms in the period 2003-2006.

Moderate inflation and

Unemployment is expected to average 3 per cent of the labour force in 2004 but gradually decrease in the next two years. The output gap is expected to disappear in the course of this year. The slack in the labour

**declining
unemployment**

expected to disappear in the course of this year. The slack in the labour market, as measured by the difference between measured unemployment as a percentage of the labour force and an estimate of the equilibrium unemployment, however, is forecast to continue. Increased economic activity is expected to reduce unemployment this year and next, from 3 per cent in 2004 to $2\frac{3}{4}$ per cent in 2005 and $2\frac{1}{4}$ per cent in 2006. Should this scenario be realised, the negative output gap will revert to a positive gap and unemployment will be close to equilibrium in 2005. A corollary to these developments is that inflation is expected to edge up, to $3\frac{1}{2}$ per cent in 2005 and $3\frac{1}{4}$ per cent in 2006.

Table 1

Treasury finances

Million krónur, accrual basis	Accounts 2002	Accounts 2003	Budget 2004	Estimate 2004	Budget proposal 2005
Tax revenue.....	220,510	238,859	254,617	264,335	280,557
Personal income tax.....	61,290	65,222	72,900	75,000	75,700
Corporate income tax.....	8,807	12,212	8,900	11,300	13,500
Social security taxes.....	23,397	26,315	29,007	29,707	31,724
Net wealth taxes.....	11,001	8,666	8,710	9,208	8,970
Value added tax.....	76,271	80,940	88,021	91,521	101,400
Other taxes on goods and services.....	37,469	42,147	44,839	45,379	46,967
Other taxes	2,275	3,357	2,241	2,221	2,296
Other current revenue.....	25,782	20,741	25,721	24,221	23,704
Dividend income.....	3,095	3,382	3,726	4,165	3,457
Interest income.....	15,629	10,352	15,121	12,921	12,452
Other.....	7,058	7,007	6,874	7,135	7,795
Revenue from sales of assets.....	11,722	11,954	540	540	540
Revenue and cost sharing transfers.....	1,196	2,322	1,143	1,143	1,006
Revaluation of state enterprise assets.....	0	0	0	0	0
Total revenue.....	259,210	273,876	282,021	290,240	305,807
The Presidency, Althingi and Supreme Court.....	2,596	2,490	2,468	2,536	2,642
Office of the Prime Minister.....	1,444	1,445	1,176	1,301	1,134
Ministry of Education, Science and Culture.....	30,173	32,835	33,326	34,030	35,950
Ministry for Foreign Affairs.....	5,489	5,335	5,526	5,823	6,668
Ministry of Agriculture.....	11,610	12,096	11,713	11,908	12,240
Ministry of Fisheries.....	2,883	3,292	3,104	2,645	2,512
Ministry of Justice and Church.....	13,883	14,723	15,051	15,267	15,841
Ministry of Social Affairs.....	20,695	24,832	23,376	25,487	26,099
Ministry of Health and Social Security.....	96,361	105,818	110,543	113,101	119,031
Ministry of Finance.....	41,963	32,486	26,240	27,178	28,980
Ministry of Communications.....	15,902	18,411	18,274	18,685	17,936
Ministry of Industry.....	2,891	4,732	3,460	3,467	3,733
Ministry of Commerce.....	1,468	1,419	1,459	1,368	1,342
Statistics Iceland.....	500	649	542	556	601
Ministry for the Environment	3,469	4,198	3,899	3,949	4,429
Interest expenditure.....	16,005	15,256	15,140	15,140	15,450
Total expenditure.....	267,332	280,015	275,296	282,441	294,586
Revenue balance.....	-8,122	-6,139	6,726	7,798	11,221

Table 2**Treasury cash flows**

Billion krónur, cash basis	Accounts 2002	Accounts 2003	Budget 2004	Estimate 2004	Budget proposal 2005
Cash flow from operating activities.....	-12.3	-16.9	-1.8	2.3	0.3
Capital transactions					
Credit extended, net.....	12.0	5.7	15.7	14.5	3.6
Rev. from sales of assets and other capital transact.....	0.0	26.5	0.1	0.1	0.1
Capital transactions, total.....	12.0	32.2	15.8	14.6	3.7
Discounts on borrowings.....	3.5				
Net financial balance (before contrib. to GEPP).....	-3.8	15.3	14.0	16.9	4.0
Contrib. to Gov. Employees Pension Fund.....	-10.9	-8.6	-7.5	-7.5	-4.0
Net financial balance (after contrib. to GEPP).....	-14.7	6.7	6.5	9.4	0.0
Credit transactions, net.....	13.5	-6.3	-4.0	-7.0	-3.7
Cash balance.....	-1.2	0.4	2.5	2.4	-3.7
Per cent of GDP					
Cash flow from operating activities.....	-1.6	-2.1	-0.2	0.3	0.0
Net financial balance.....	-0.5	1.9	1.6	1.9	0.4
Cash balance.....	-0.2	0.0	0.3	0.3	-0.4

Table 3

Treasury revenue

Million krónur, accrual basis	Accounts 2002	Accounts 2003	Budget 2004	Estimate 2004	Budget proposal 2005
I Tax revenue	220,510	238,859	254,617	264,335	280,557
Taxes on income and profits	71,569	80,141	83,220	87,695	90,620
Individuals	61,290	65,222	72,900	75,000	75,700
Personal income tax	53,976	56,518	65,900	65,900	66,700
Personal income surtax	1,077	1,480	1,400	1,400	1,200
Other taxes on income and profits	6,237	7,224	5,600	7,700	7,800
Corporations	8,807	12,212	8,900	11,300	13,500
Other	1,472	2,707	1,420	1,395	1,420
Tax on central gov't capital gains	721	1,860	500	500	500
Tax for the Nursing Home Constr. Fund	751	847	920	895	920
Social security taxes	23,397	26,315	29,007	29,707	31,724
Net wealth taxes	11,001	8,666	8,710	9,208	8,970
Taxes on goods and services	113,740	123,087	132,860	136,900	148,367
Value added taxes	76,271	80,940	88,021	91,521	101,400
General excise taxes	11,461	12,496	16,622	16,527	19,208
Excise tax on motor vehicles	2,804	4,525	4,540	5,540	5,587
General excise tax on petrol	1,890	1,924	2,157	2,157	2,040
Special excise tax on petrol	5,493	5,540	5,871	5,871	6,289
Other turnover taxes	6,700	7,946	4,581	4,612	5,062
Motor vehicle tax	2,916	3,003	3,060	3,160	3,222
Diesel weight tax	4,704	5,042	5,573	5,573	3,323
Misc. charges	1,501	1,671	2,434	1,939	2,236
Other taxes	803	650	821	826	876
II Other current revenue	25,782	20,741	25,721	24,221	23,704
Dividends and rental income	3,095	3,382	3,726	4,165	3,457
Interest income and other property income	15,629	10,352	15,121	12,921	12,452
Charges and licences.....	6,313	5,967	5,912	6,173	6,784
Other.....	745	1,040	962	962	1,011
III Revenue from sales of assets.....	11,722	11,954	540	540	540
IV Cost sharing transfers.....	1,196	2,322	1,143	1,143	1,006
Total revenue, accrual basis	259,210	273,876	282,021	290,240	305,807
Total revenue, cash basis	244,338	265,137	267,140	278,357	293,411

Table 4**Treasury expenditure by economic category**

Million krónur, accrual basis	Accounts 2002	Accounts 2003	Budget 2004	Estimate 2004	Budget proposal 2005
Current expenditure					
Wages.....	71,456	78,160	78,027	79,986	84,579
Pension fund contributions.....	16,321	3,395	4,704	4,704	4,798
Other current expenditure	50,038	48,142	62,273	63,356	68,452
Service charges	-21,040	-19,628	-18,902	-18,601	-20,091
Total current expenditure	116,775	110,070	126,102	129,445	137,737
Interest	16,005	15,256	15,140	15,140	15,450
Transfer payments					
Old age and disability insurance	22,190	26,122	28,939	29,236	31,397
Health insurance	12,695	13,926	14,452	15,007	15,584
Agricultural support payments	7,718	7,261	7,310	7,450	7,726
Municipal Equalisation Fund	5,800	6,553	6,427	6,676	7,100
Welfare support payments	6,240	7,057	5,865	6,211	6,577
Parental Leave Fund	4,654	5,580	5,826	5,826	5,967
Child benefits	4,756	5,357	5,430	5,430	5,430
Interest cost rebates	5,117	5,756	4,505	5,105	4,900
Unemployment Insurance Fund	3,002	4,286	3,420	4,470	4,171
Tax write-offs	9,811	8,696	4,000	4,000	4,000
Student Loan Fund	2,645	2,951	3,412	3,412	3,750
Parishes and churchyards	2,426	2,620	2,739	2,739	2,863
National Broadcasting Service	2,248	1,854	2,298	2,405	2,516
Other transfer payments	23,312	30,777	19,213	19,707	20,349
Total transfer payments	112,614	128,796	113,835	117,674	122,329
Maintenance					
Maintenance of roads	4,399	4,248	2,307	2,307	2,625
Other	1,737	2,018	1,813	1,863	1,968
Total maintenance	6,136	6,266	4,120	4,170	4,593
Capital expenditure					
Road construction	5,354	8,404	7,220	7,595	6,318
Hospitals and health centres	1,159	1,565	1,896	1,896	1,905
Harbour construction	1,586	466	1,072	1,072	1,138
Universities and higher education	1,130	2,154	1,062	1,062	1,247
Airfields	455	396	287	287	336
Other capital expenditure	6,119	6,644	4,562	4,101	3,532
Total capital expenditure	15,803	19,627	16,099	16,013	14,476
Total expenditure	267,333	280,015	275,296	282,441	294,586

Table 5**Treasury expenditure by function¹**

Million krónur, accrual basis	Accounts 2002	Accounts 2003	Budget 2004	Estimate 2004	Budget proposal 2005
General public services	15,092	15,439	14,851	15,269	15,970
Public order and safety	11,513	12,521	11,599	11,755	12,384
Education	22,652	25,639	25,833	26,298	28,624
Health services	66,242	69,868	73,868	75,815	79,168
Social security and welfare services	53,896	63,873	62,364	65,120	67,673
Housing and community amenities	2,228	2,858	3,263	3,279	3,549
Recreation, culture, and religion	9,951	10,511	11,031	11,290	11,232
Fuel and energy	1,959	2,187	2,170	2,170	2,219
Agriculture, forestry, fishing, and hunting	14,040	14,873	14,353	14,090	14,076
Mining, manufacturing and construction	1,039	1,751	1,067	1,074	1,272
Transportation and communication	16,091	18,340	18,497	19,097	18,477
Other industries	4,789	5,616	4,485	4,723	4,764
Expenditures not classified by major group	47,842	36,540	31,914	32,463	35,181
Samtals	267,332	280,015	275,296	282,441	294,586

¹ According to the Classification of the Functions of Government standard published by the United Nations.

Table 6**Central government debt and claims**

Million krónur, year-end	1995	1996	1997	1998	1999	2000	2001	2002	2003	Estimate 2004	Budget proposal 2005
Gross debt.....	232,585	239,246	241,566	237,764	225,968	227,957	296,461	279,583	275,838	269,600	266,700
Central Bank.....	-	-	-	-	-	-	-	-	-	-	-
Treasury bonds.....	74,140	73,889	84,424	82,865	82,618	68,898	64,243	50,818	47,400	43,400	24,400
Treasury notes.....	5,768	8,366	11,258	15,846	11,018	11,430	19,588	32,482	41,705	50,300	62,600
Treasury bills.....	16,406	15,811	12,296	15,209	9,899	5,970	12,003	12,004	20,463	17,500	17,500
Other domestic liabilities.....	9,010	8,962	6,960	6,526	4,297	2,334	2,338	2,274	2,271	2,300	2,200
Foreign debt.....	127,261	132,218	126,628	117,318	118,136	139,325	198,289	182,005	163,999	156,100	160,000
Total claims.....	77,266	71,023	69,309	86,496	107,152	100,463	126,893	129,512	118,259	101,800	100,000
Long term credit.....	64,134	63,663	65,278	64,739	69,347	70,210	90,381	78,785	76,617	58,500	54,800
Indexed to domestic prices.....	45,176	50,565	52,885	53,215	57,699	58,556	78,896	71,710	71,145	-	-
In foreign currency.....	18,958	13,098	12,393	11,524	11,648	11,654	11,485	7,075	5,472	-	-
Taxes due and short-term claims.....	13,132	7,360	4,031	21,757	37,805	30,253	36,512	50,727	41,642	43,300	45,200
Net debt.....	155,319	168,223	172,257	151,268	118,816	127,494	169,568	150,071	157,579	167,800	166,700
Claims in per cent of debt.....	33.2	29.7	28.7	36.4	47.4	44.1	42.8	46.3	46.7	44.9	44.9
Percentage of GDP											
Gross debt.....	51.2	49.1	46.5	41.5	36.1	33.7	38.3	35.6	33.6	30.4	27.6
Of which: foreign debt.....	28.1	27.3	24.6	20.6	19.4	21.0	26.6	23.4	20.2	-	-
Total claims.....	14.1	14.6	13.5	15.2	17.6	15.2	17.1	16.6	14.6	11.6	10.5
Of which: In foreign currency....	4.2	2.7	2.4	2.0	1.9	1.8	1.5	0.9	0.7	-	-
Short term credit, net....	2.9	1.5	0.8	3.8	6.0	4.5	4.7	6.5	5.1	-	-
Net debt.....	34.3	34.6	33.5	26.5	19.4	19.2	22.9	19.1	19.2	18.9	17.2

Table 7

General government debt and claims ¹

Million krónur, year-end	1995	1996	1997	1998	1999	2000	2001	2002	2003	Estimate 2004	Budget proposal 2005
Total debt.....	267,540	274,447	279,351	280,431	271,537	277,415	352,881	339,643	335,718	330,818	327,473
Domestic.....	135,881	138,088	145,149	153,144	142,048	124,861	136,747	145,182	159,295	-	-
Foreign.....	131,730	136,359	134,202	127,316	129,983	152,903	216,336	194,605	176,560	-	-
Total claims.....	88,313	82,925	82,820	99,746	124,552	118,617	152,804	156,926	145,673	129,214	127,414
Credit extended.....	70,760	71,249	74,449	74,482	79,505	80,336	110,880	100,199	98,031	79,914	76,214
Short-term credits and tax claims....	17,553	11,676	8,371	25,264	45,047	38,281	41,924	56,727	47,642	49,300	51,200
Net debt.....	179,227	191,522	196,531	180,685	146,985	158,798	200,077	182,717	190,045	201,474	199,936
Treasury.....	155,319	168,224	172,256	151,268	118,816	127,494	169,568	150,071	157,579	167,800	166,700
Local government.....	25,130	24,190	25,038	30,089	28,663	31,653	30,711	32,790	32,603	33,804	33,359
Social security.....	-1,222	-892	-763	-672	-494	-349	-202	-144	-137	-130	-123
General gov't debt at 1998-prices²											
Total debt.....	279,595	280,731	282,828	280,460	263,872	259,561	317,234	294,902	283,652	273,184	263,847
Net debt.....	187,215	195,893	198,944	180,685	142,599	148,190	178,457	157,549	160,571	166,374	161,089
In per cent of GDP											
Total debt.....	59.2	56.6	54.4	49.3	44.5	41.9	47.4	43.6	41.4	37.7	34.3
Domestic.....	30.1	28.5	28.3	26.9	23.3	18.8	18.4	18.6	19.6	-	-
Foreign.....	29.1	28.1	26.1	22.4	21.3	23.1	29.1	25.0	21.8	-	-
Total claims.....	19.5	17.1	16.1	17.5	20.4	17.9	20.5	20.1	18.0	14.7	13.3
Net debt.....	39.6	39.5	38.3	31.7	24.1	24.0	26.9	23.4	23.4	23.0	20.9

1) The definition of general government is based on Standard National Accounts (SNA) and covers the Treasury, local governments and the social security system.

2) Domestic debt is deflated by the consumer price index; foreign debt with foreign prices and the average exchange rate.

Table 8**Main economic aggregates**

	Budget 2004	Estimate 2004	Budget proposal 2005
I. Main economic aggregates, volume changes in per cent			
Private consumption	3½	7	5
Public consumption	1	1½	2
Investment	8½	17¼	18
Total national expenditure	4	8	7½
Exports of goods and services	4½	6	4
Imports of goods and services	5¾	12¾	10½
Gross domestic product	3½	5½	5
Current account balance, p.c. of GDP	-3¼	-7¼	-11
II. Wages and prices, changes in per cent			
Disposable income per capita	5	4½	6¾
Real disposable income per capita	2½	1½	3¼
Consumer prices	2½	3	3½
Exchange rate index	1	-1	2½
Unemployment in per cent of the labour force	2½	3	2¾