

English translation of the Weekly Web Release



MINISTRY OF FINANCE IN ICELAND

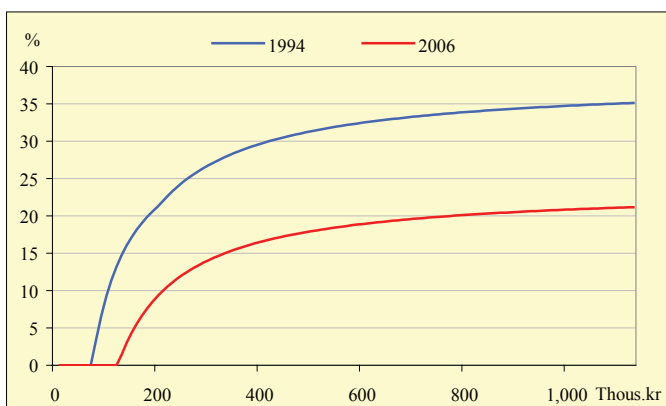
January 19th, 2006

Taxes have declined

A progressive tax system is in place in Iceland. It consists of a single personal income tax rate and a basic tax credit. Additionally, some taxpayers receive a children's allowance and an interest tax credit. A progressive tax system implies that people with higher incomes pay higher taxes, both in money terms and as a proportion of their tax base, compared to those with lower incomes. This also means that if incomes increase between years, the tax increases, assuming the tax rules remain unchanged.

Since the PAYE tax system was adopted in 1988, the tax system has undergone a number of revisions, but its main principles have remained unchanged. Tax rates, both of the central government and local governments have been amended. The local government tax rate has increased from 6.7 per cent in 1988 to 12.97 per cent today. The central government tax rate increased until 1996 but has since declined. The first central government tax cut was due to the transfer of elementary schools to the local governments, but the cuts have continued since then, and the central government tax rate presently stands at 23.75 per cent. It will decrease further, to 21.75 per cent next year. The personal tax credit has partially changed in concert with changes in the central government personal income tax rate. The personal tax credit was thus reduced in money terms from 1996 to 1999 at the same time as the personal tax rate was reduced. These factors, together with children's allowances and interest tax credits, yield the total of taxes paid. The changes in the interest tax credits have been particularly important, but both have a significant influence on the total tax ratio, especially for those with lowest incomes.

Graph 1. Central government tax ratio of monthly incomes

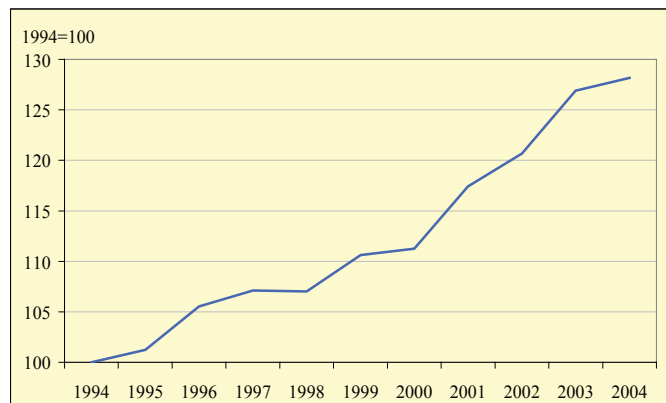


Although the personal tax credit covers both central and local government taxes, the Treasury pays the local government tax for those taxpayers whose income does not reach the income minimum to which the personal tax credit applies. The central government thus does not receive revenue until the taxpayer in question has reached the income level where the final tax ratio, based on the tax base, is higher than the local government tax rate. Graph 1 shows the central government tax ratio for individuals as it was in 1994 and as it applies according to present law. For reasons of simplicity, the graph shows the ratio for an individual and not a couple, since rules for couples have changed in the meantime as regards the transfer between spouses of the unused personal tax credit. The unused credit is fully transferable today, whereas in 1994 it was only 80 per cent transferable. As may be seen, the tax ratio is considerably lower today than in 1994. In 1994, an individual with a median income of 160,000 krónur a month paid 18.2 per cent in tax. Today, the tax rate is 5.6 per cent. Taking account of the transfer of elementary schools to the local level, the tax rate for the central government would have been 15.5 per cent. The tax cut thus amounts to 10 per cent of median individual income.

As noted above, the Icelandic tax system is progressive. The higher the income, the higher is the tax. Taxes inevitably increase in periods of ex-

pansion. The tax burden in the lowest income brackets is far more dependent upon transfer item (interest tax credits and children's allowances) than in higher income brackets. Graph 2 shows that, in spite of the development in the personal tax credit, children's allowances and interest tax credits that so often is criticised, the income of couples in the lowest income decile have shown a steady increase and at the present time are 28 per cent higher than in 1994.

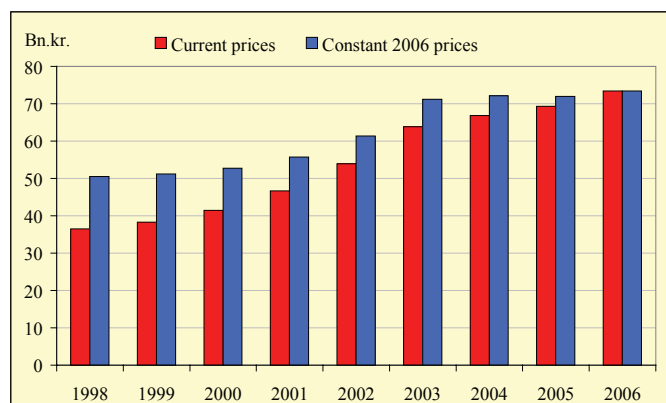
Graph 2. Real disposable income of the lowest income decile



Rising social expenditures

According to the 2006 fiscal budget, Treasury expenditure for social security and welfare will amount to just over 73 billion krónur. The items under this category cover old age and disability pensions, children's allowances, sickness compensation, childbirth allowances, support for the disabled, unemployment compensation and other social support. Expenditure in this category has more than doubled in money terms since 1998 up to the 2006 budget and by 45 per cent in constant price terms. Within this category, expenditure for old age, widows' and disability pensions weigh most heavily, having increased by 52 per cent. This is due to a sharp increase in the number of disabled persons and the rise in pensions. The sharpest increase was recorded for expenditures on sickness compensation, childbirth allowances and disability compensation, or 181 per cent since 1998. As before, a large increase in the number of disabled persons explains this increase. Expenditure on disabled persons has also increased sharply, or by 61 per cent during this period. Part of the increase is, however, due to population growth. Expenditure per capita has risen considerably, or by 33 per cent from 1998 to 2006, based on estimated constant 2006 prices.

Graph 3. Social expenditures



Treasury revenue, January-November	2003-2004	2004-2005
12 month changes (%)		
Total tax revenue	13.7	21.3
Income taxes	13.3	24.6
Social security taxes	10.3	16.4
Asset taxes	44.2	31.6
Indirect taxes	12.7	19.5
Total revenue	8.0	45.6

Treasury expenditure, January-November	2003-2004	2004-2005
12 month changes (%)		
Administration	8.2	4.8
Social affairs	9.2	6.4
Economic affairs	1.9	-2.0
Interest	-6.1	35.7
Other	6.0	63.4
Total expenditure	6.9	8.9

Treasury finances, January-November		
Million krónur	2004	2005
Cash from operations	-8,177	21,461
Net financial balance	9,557	70,420
Debt redemption	-32,321	-61,597
Gross borr. requirement	-29,639	3,691
Net borrowing	27,567	7,734
Overall cash balance	-2,072	11,425

Economic indicators		
12 month changes (%)	2004-2005	2005-2006
Inflation (Jan. '06)	4.0	4.4
Core inflation (Jan. '06)	4.0	4.3
Wage index (Nov. '05)	5.4	7.3
Total turnover (Jan. - Aug. '05)	9.6	9.2
Retail turnover (Jan. - Aug. '05)	4.3	6.3
Unemploy., % (Dec. '05)	2.7	1.5