

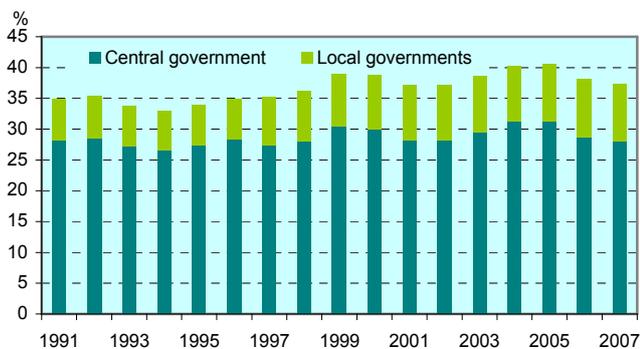


October 13, 2005

## The tax burden in Iceland and other OECD countries

The OECD has recently published data on general government taxation (central and local governments) in member countries. The OECD figures show Iceland's tax/GDP ratio at 41.9 per cent in 2004 which is quite high and the ratio has increased by 3 percentage points since 2002. Based on the newly revised GDP figures from Statistics Iceland the 2004 ratio is actually 40.2 per cent, or 1.7 percentage points lower than the previous estimate. By comparison the average for the nineteen European OECD-countries for which data was presented was 39.8 per cent for that year. The ratio was much higher in the other Nordic countries, 47.4 per cent of GDP. Taking into account the planned tax cuts in the years 2005-2007, the tax/GDP ratio is projected to decline to 37.3 per cent of GDP by 2007.

### The development of tax revenue in Iceland In per cent of GDP



As can be seen in the graph above, the general government tax/GDP ratio of Iceland has risen during the economic expansion due to the pro-cyclical impact of the expansion on tax revenues. The change is mostly felt in the tax revenue of the central government, whereas the ratio of local governments has remained relatively stable. In this connection it should be pointed out that public finances have become more restrictive in recent years, not least due to restraint in the growth of central government expenditure.

### Contributions to church congregations

According to Act no. 91/1987, concerning contributions to church congregations and other matters, the Treasury shall pay a monthly fee to congregations of the national church, registered religious organisations and to the University of Iceland. The contribution is based on a fee for each individual 16 years or older which amounts to 662 krónur in 2005. The Act also stipulates that the fee shall increase every year in concert with the increase in the average income tax base per person in the previous revenue year. In addition, a further 18.5 per cent of the total contribution to congregations of the national church shall be remitted to a fund that equalizes the income of individual congregations and another 11.3 per cent to a fund that finances certain church affairs. These contributions therefore increase each year due to the increase in the population of around 1-1.5 per cent on one hand, and due to the increase in the personal income tax base on the other, which has been about 5-9 per cent a year in recent years. As an example, the total 2005 increase was 8.7 per cent from the previous year. This arrangement of contributions to the national church congregations and other religious organizations has remained unchanged for a number of years and there are no parallels in

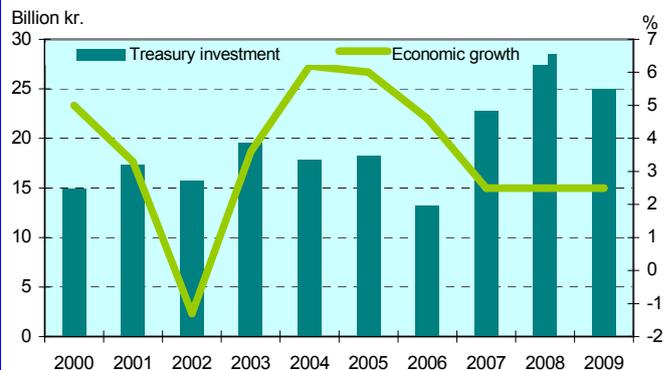
appropriations for other operational expenses in the state budget, with the possible exception of the Municipal Equalization Fund. Previously, the operation of graveyards was financed on the same basis by law. That legal provision was repealed at the beginning of this year when the government reached a new agreement with the Churchyard Council to the effect that appropriations will from now on be based on a simple model concerning the main operating premises.

The 2006 fiscal budget proposal provides for a total of 2.4 billion krónur in Treasury expenditure on congregation contributions, an increase of 45 per cent in the period 1996-2006 in real terms, after being deflated by the consumer price index. This increase is somewhat higher in real terms than has been the case for many general administrative expenditure items, such as for running tax offices.

### Treasury investment expenditure and economic growth

The 2006 fiscal budget proposal provides for an investment expenditure of 13.2 billion krónur, declining by 5 billion krónur from the 2005-estimate. Treasury investment expenditure covers the direct investment of the central government, mainly roads and buildings, as well as capital contributions to, for example, harbours. In the years 2000 up to the 2006 budget proposal, the average investment expenditure has amounted to 17.3 billion a year, reaching a high of 19.6 billion in 2003. During the same period, the annual average GDP growth has been 3.8 per cent. The national economic forecast anticipates a 4.6 per cent growth in 2006 compared to an estimated 6 per cent growth rate in 2005. This is reflected in a low rate of unemployment, estimated at 2.2 per cent in 2005 and only 1.8 per cent in 2006.

### Treasury investment expenditure and economic growth



In the graph above, the green line shows the development of economic growth in Iceland and the columns show the Treasury investment expenditure in billions of krónur. Investment expenditure declines in 2004-2006 when economic growth is at its peak. Investment expenditure will be at a minimum in 2006, reflecting a tight fiscal policy. The Ministry's economic forecast projects reduced economic growth in 2007-2009 when the large scale investments in the eastern part of the country are completed. In order to offset some of the decline in private sector investment, Treasury investment is expected to increase by 9.6 billion in 2007 and further by 5.7 billion in 2008. The government's medium-term programme projects a Treasury investment of 22.8 billion in 2007, 28.5 billion in 2008 and 25 billion in 2009. Treasury investment expenditure will thus be counter-cyclical.

| Treasury revenue, January-August |           |           |
|----------------------------------|-----------|-----------|
| 12-month changes %               | 2003-2004 | 2004-2005 |
| Total tax revenue                | 15.3      | 18.5      |
| Income taxes                     | 20.5      | 15.5      |
| Social security taxes            | 10.3      | 16.6      |
| Asset taxes                      | 18.3      | 50.3      |
| Indirect taxes                   | 13.6      | 18.4      |
| Total revenue                    | 6.1       | 21.1      |

| Treasury expenditure, January-August |           |           |
|--------------------------------------|-----------|-----------|
| 12-month changes %                   | 2003-2004 | 2004-2005 |
| Administration                       | 8.7       | 2.4       |
| Social affairs                       | 9.8       | 6.7       |
| Economic affairs                     | 5.9       | -3.4      |
| Interest                             | -13.5     | 52.9      |
| Other                                | -0.4      | 15.0      |
| Total expenditure                    | 7.0       | 7.6       |

| Treasury finances, January-August |         |         |
|-----------------------------------|---------|---------|
| Million krónur                    | 2004    | 2005    |
| Cash from operations              | -6,761  | 16,298  |
| Net financial balance             | 1,068   | 27,558  |
| Debt redemption                   | -29,593 | -33,363 |
| Gross borrowing requirem.         | -33,525 | -8,406  |
| New borrowing                     | 40,177  | 15,832  |
| Overall cash balance              | 6,652   | 7,426   |

| Economic indicators      |      |      |
|--------------------------|------|------|
| 12-month changes, %      | 2004 | 2005 |
| Inflation - October      | 3.7  | 4.6  |
| Core inflation - October | 3.1  | 4.8  |
| Wage index - August      | 5.2  | 6.7  |
| Tot. turnov. Jan-June    | 9.8  | 8.7  |
| Ret. turnov. Jan-June    | 5.3  | 9.0  |
| Unemploy. in % August    | 2.9  | 1.8  |