



Ministry of Finance

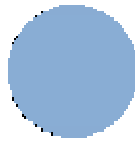
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Highlights

Budget Proposal

2002

Introduction

The 2002 Budget Proposal is presented by the Minister of Finance to the Althingi on October 1.

This report is a translation of the introductory text to the Budget Proposal where the fiscal stance is explained in detail along with a Statistical Appendix.

Chapter 1 reviews the main economic and fiscal policy emphasis of the Government.

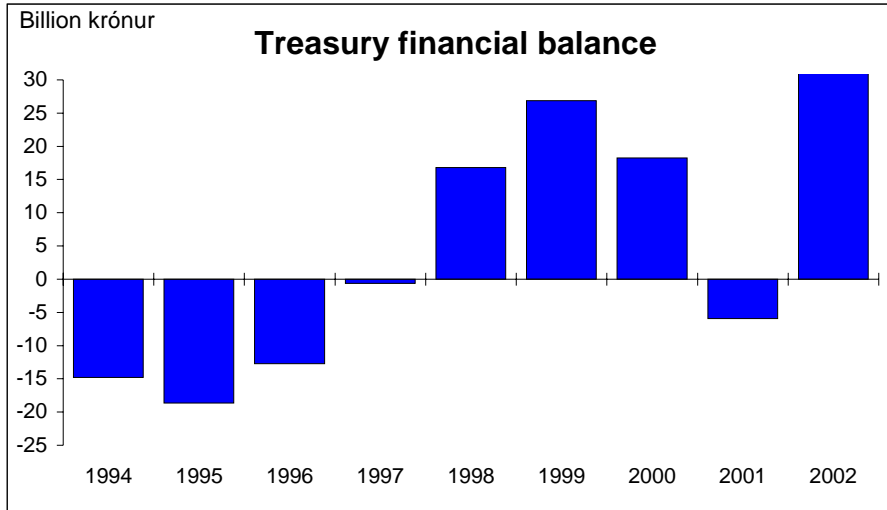
Chapter 2 outlines main revenue and expenditure trends of the budget proposal.

Chapter 3 focuses on economic developments and prospects with special emphasis on their fiscal context.

1 Economic and fiscal policy

In many respects, the 2002 budget proposal reflects the recently changed economic conditions. Following a vigorous upswing in recent years, the economy is again moving towards balance. Domestic demand has abated and the current account deficit is rapidly declining. Inflation is also expected to fall sharply in the next two years. As a result, economic growth is now lower which, in turn, will inevitably limit Treasury revenue growth. Given these circumstances it is not unreasonable that the Treasury surplus will be lower than in recent years. Nonetheless, it is important to pursue a tight fiscal policy in the coming years. The 2002 budget proposal projects a revenue surplus of 18.6 billion krónur, which is equivalent to 2½ per cent of GDP. This is fully in line with the Government's economic policy goal of reducing inflation and the current account deficit, to strengthen the foundations of economic activity and to ensure sustained stability.

A tight fiscal policy...



Under these circumstances, important arguments can be made for reducing taxes, both on enterprises and individuals. This issue has been under active consideration in recent months, including a reduction in the corporate income tax, net wealth tax and stamp duty and higher thresholds for the personal income surtax. Furthermore, the elimination of inflation accounting is under discussion as well as permitting the drawing up of company accounts in foreign currency terms.

...creates room for reducing taxes...

Such measures will improve the competitiveness of Icelandic companies and create a favourable tax environment in an international context. These factors will have a positive impact on the Icelandic economy. A reduction in the net wealth tax is also logical in the present circumstances and would encourage national saving.

...thus stimulating business environment and raising savings

The economic rationale for these changes is overwhelming. Nearly a decade has passed since a substantial reduction in corporate taxes took place in order to bring the economy out of several years of recession. The corporate tax environment thus created was unquestionably among the best in OECD-countries. Icelandic enterprises are in many respects at a disadvantage due to the small size of the market, the distance from foreign markets and substantial transport costs. It is therefore even more important for Iceland than many other countries to create not just comparable but more favourable circumstances for Icelandic enterprises than prevail in other countries.

The rationale for making these changes is overwhelming...

There are, however, clear signs that Icelandic enterprises no longer enjoy the tax advantage over competitor countries that was evident a few years ago. This applies both to the income tax ratio, which today is just about the average for the OECD as a whole, while it was well below average nearly a decade ago. It should also be kept in mind that when the corporate income tax was reduced, the tax base was broadened by eliminating a large number of previously permitted deductions. This makes the tax base considerably broader in this country than in most others. Also, the imposition of a net wealth tax on corporations, which still exists in this country, is about to disappear amongst other Western countries, since most countries that still had such taxes a decade ago have eliminated them by now. The same may be said for the stamp duty. The recommendations of the OECD in its recent overview of the Icelandic tax system go along similar lines.

The tax advantage of earlier years has disappeared...

The profitability of Icelandic enterprises has also declined in recent months due to declining demand at home and abroad. Although the economy is basically sound, economic activity has recently shown signs of a slowdown. This is partially due to the fact that nearly all major countries of the world are experiencing an economic slowdown. Economic growth has slowed in the United States and Europe and Japan's economic difficulties are continuing. The same may be said for many developing countries and countries in Asia and Latin America. The impact is felt in this country since many of these countries are important trading partners of Iceland. Domestic demand has also slowed after a major expansion in recent years in concert with a rise in household and business expenditures. Both have eventually led to a deteriorating position of enterprises and even some staff layoffs.

...and the situation of enterprises is more difficult than often before

All in all, there are ample reasons for reducing taxes at this time. The initial impact of such measures would quickly be transposed into increased economic activity, for example through increased investment, which, in turn, would increase employment, personal income and corporate revenues.

A tax reduction will quickly be felt by households and enterprises...

Increased economic growth will, in turn, boost Treasury revenue. The implementation of such tax changes in stages will positively affect business environment as well as the overall situation of the labour market and personal savings.

...thus increasing Treasury revenue

In addition, several other tax reforms are being prepared. First, the Government intends to see to it that the increase in assessed real property values stemming from the comprehensive property assessment review for the country as a whole will not lead to a rise in net wealth taxes in 2002. The minimum tax-free threshold for net wealth tax as well as the tax rate are both under review. The personal income tax rate will be reduced by 0.33 per cent at the beginning of 2002, thus implementing the Government's decision following the review of general wage agreements last winter. The third stage, out of four, of the transferability between spouses of the tax-free exemption from the personal income tax, from 80 per cent to 100 per cent, becomes effective at the beginning of 2002. The inheritance tax is also being reviewed and the adoption of a diesel fuel tax in place of the weight tax on diesel vehicles is again under review.

Further tax reforms are underway...

The second stage of three in increasing child benefits takes place at the beginning of next year. This is in accordance with the Government's Policy Statement and its statement of October 27, 2000 which stated that child benefits would increase by more than a third in the years 2001-2003, or by some 2 billion krónur. The first stage took effect in 2001. The main element of the changes is that child benefits not tied to income have been reintroduced while the means-tested part is being reduced and the curtailment due to net wealth is being abolished. These changes will lead to a considerable increase in the disposable income of families with children, particularly those with low incomes.

...and the second stage of increasing child benefits comes into effect

Significant steps in privatisation will be taken this year and next, as major stakes of the central government in Landssiminn, the telephone company, as well as in Landsbanki and Bunadarbanki, the two majority-government-owned commercial banks will be sold. These sales are expected to yield substantial revenue to the Treasury and make it possible to reduce Treasury debt by a considerable margin.

Significant steps in privatisation...

This will markedly reduce the central government's involvement in economic activity and strengthen the ability of the private sector to compete in international markets. This could also give a significant boost to the stock market and thus to the economy as a whole.

...will reduce government involvement and strengthen the private sector

The economy has now reached a watershed. Economic growth and domestic demand has slowed, following an unusually sharp upswing in recent years. This slowdown means that the economy is in many respects more balanced than before. The current account deficit that emerged in the upswing is declining rapidly and heading for around 3 per cent of GDP in 2003-2004. Inflation is also expected to decline sharply over the next several months and should be back on par with neighbouring countries in the next two years.

The economy has reached a turning point...

Although decelerating inflation and a decreasing current account deficit are a welcome result of slower economic activity, certain signs of recession loom ahead. If the economy cools too quickly, it could lead to a recession that may be difficult to reverse in the short run. Recent economic indicators show that economic growth has slowed down considerably and a decline in GDP may possibly be ahead. New investment in the energy sector and implementation of major tax reforms may, however, radically change this outlook.

...but certain warning signs lie ahead

Under these circumstances, the main emphasis of economic policy, both fiscal and monetary, must be on improving the competitiveness of enterprises, reducing inflation and thereby fostering economic growth. The measures outlined in this budget proposal are based on this view. A significant lowering of taxes and the Government's emphasis on privatisation constitute an important contribution towards strengthening the economy and ensuring full employment and a good standard of living. This is the main goal of the budget proposal.

The main policy emphasis is to ensure continued growth

2 Fiscal developments

2.1 Fiscal prospects for 2001

The 2001 fiscal budget was passed with a 33.9 billion krónur revenue surplus. Total revenue was estimated at 253 billion and expenditure at 219.2 billion. The financial surplus was projected at 38.7 billion, being partially based on 18 billion in proceeds from government asset sales. Projections for revenue and expenditure have now been revised in light of economic developments, exchange rate changes and new wage agreements for public employees.

Total revenue of the Treasury was estimated at 253 billion in the 2001 fiscal budget. This was based on the provisional fiscal accounts for 2000 and the National Economic Institute forecast for the economy for 2001. These assumptions have, however, changed significantly. The final Treasury accounts for the year 2000 differ from the provisional figures in several important respects, although the end result is similar. Most importantly, tax claims written off nearly tripled in the year 2000, mainly due to revised standards and procedures. Furthermore, economic developments have turned out to be somewhat different from the assumptions on which the budget was based. Domestic demand has contracted faster than expected, mainly through reduced household demand which is reflected in declining imports. Investment has also declined more than had been forecast. This is mitigated by increased exports. Revised revenue estimates show that GDP growth may turn out to be in the area of 1-2 per cent in 2001.

Revenue prospects have deteriorated from budget estimates...

These factors have all contributed to a less favourable revenue outlook, as tax revenue is expected to fall short of the budget by 5 billion krónur. There are two separate developments at work here. Indirect taxes are declining significantly, particularly the value added tax, whereas taxes on personal income and net wealth appear to exceed projections, which is attributable to larger increases in income and net wealth than had been assumed. Revenue from the corporate income tax is expected to fall short of projections due to less favourable profit prospects. The shortfall in tax revenue is, however, outweighed by the fact that proceeds from government asset sales are expected to exceed budget estimates. All told, total 2001 Treasury revenue is estimated to amount to 253 billion, an amount close to the budget total.

... and tax revenue falls short of projections

Revised Treasury expenditure amounts to an estimated 232 billion in 2001, 13 billion above the budget. Of this amount, 3 billion is attributable to pension fund liabilities,

Treasury expenditure exceeds the budget...

particularly because of police pensions, 700 million go to increased capital income tax paid by the government on profits from asset sales and 500 million is due to a higher tax claims write-off in accordance with one-time changes made in drawing up the 2000 Treasury accounts. Changes in wages, prices and exchange rates are estimated to exceed the budget by 3 billion krónur. New pay agreements were concluded with government employees in the course of the year. The decline in the exchange rate directly affects the cost of the foreign service, expenditure on pharmaceuticals and other foreign currency-related items. Furthermore, social security benefits were increased in course of the year for the benefit of lower income groups. Total old age and disability benefits are expected to exceed the budget by 1.2 billion. Finally, interest expenditure is expected to exceed budget by 600 million.

All told, the revenue surplus is expected to fall short of budget by 12.9 billion and amount to 21 billion in 2001. The financial balance, excluding the contribution to the Government Employees Pension Fund, is expected to be in deficit by 6 billion. In addition to a lower revenue surplus, which leads to less cash at hand from operations, a 9 billion capital contribution to the Central Bank and a 2.8 billion purchase by the Treasury of the municipal share in the Westfjord Power Company will take place, which explains the reduced financial balance. Furthermore, the 8 billion incoming repayment of credits on account of the Leif Ericsson Airport Terminal will not take place as expected. The redemption of domestic government debt exceeds projections. Excluding these items, the financial surplus would have exceeded the budget by 20 billion. Government asset sales are taking place late in the year with the result that more than 21 billion of total sales proceeds will be transferred to 2002 and are incorporated into the financial budget surplus for that year. In assessing Treasury finances, it is therefore insufficient to view only one year; the two years, 2001 and 2002 must be viewed together.

...and the
revenue surplus
will fall below
budget

2.1 Highlights of the 2002 budget proposal

The revenue surplus in the 2002 budget proposal is projected at 18.6 billion, compared to present estimates of 21 billion for 2001. The lower revenue surplus is primarily due to reduced asset sales which are expected to be 6 billion less than estimated for 2001. As noted above, the sales proceeds from asset sales in 2001 are for the most part expected to be reflected in the 2002 cash flow. The financial surplus for 2002 is therefore expected to amount to 41 billion, compared with a financial deficit estimated at 6 billion in 2001. For the two years together, the financial surplus is expected to amount to 35 billion, should asset sales proceed as planned.

Treasury finances 2000-2002

Billion krónur	Accounts	Budget	Estimate	Budget
	2000	2001	2001	Proposal 2002
Revenue.....	224.7	253.0	253.0	257.9
Expenditure.....	229.0	219.2	232.0	239.3
Revenue balance.....	-4.3	33.8	21.0	18.6
Non-financial current items...	21.8	-24.7	-23.4	-17.7
Cash from operations.....	17.5	9.1	-2.4	0.9
Financial transactions	0.7	29.6	-3.6	40.3
Net financial balance.....	18.2	38.7	-6.0	41.2

One of the main assumptions behind the 2002 budget proposal is that the downturn will soon bottom out and that economic growth will gradually resume in the course of the next few years. Inflation is expected to abate significantly in 2002, being close to 3 per cent from the beginning to the end of the year. Per capita purchasing power is expected to remain broadly unchanged. Private consumption per capita is, however, expected to contract slightly and household saving therefore increase. All told, economic growth is forecast to be slightly below 2001, around 1 per cent. It is also assumed that the exchange rate will slightly strengthen in 2002.

The downturn
will soon bottom
out...

Based on these assumptions, Treasury tax revenue is projected to amount to 222 billion and total revenue to 258 billion. The increase from 2001 is primarily attributable to higher receipts from the personal income tax and the social security tax, largely reflecting higher wage incomes, and from the value added tax. The corporate income tax and the capital income tax are expected to yield less due to declining corporate profits and reduced activity in financial markets. Revenue from asset sales is also expected to be lower than in 2001.

...and Treasury
revenue
increase

Total Treasury expenditure is estimated at 239 billion in 2002, increasing by 3.1 per cent from the 2001 estimate. In real terms, total expenditure is forecast to decline by ½ per cent from the 2001 estimate, after having been adjusted for prepayments of pension fund liabilities. Measured as a proportion of GDP, expenditure is projected to decline by 1 per cent from the 2001 estimate, in line with the Government's economic policy. Operational expenditures is expected to decline by 1.4 per cent in real terms, whereas transfer payments increase by an estimated 2.3 per cent.

Expenditure
expected to
decline in real
terms

Following expenditure increases in 2001 in excess of budget, the Government decided that operational expenditure in budget frames should be reduced by 2 per cent from baseline levels. This has been carried out in the budget proposal. Taking into account new operational tasks, such as new nursing homes and an increase in the number of pupils, the operational expenditure is budgeted to decline from the 2001-level. The budget implementation process will be strengthened, and new expenditures will be met by reducing existing ones as much as possible.

Operational expenditure is being curtailed...

Transfer payments to households are expected to increase in real terms from the estimate for 2001. Social security increases to benefit the lowest paid that were implemented during 2001 will now come on stream for the full year in 2002. Secondly, child benefits will rise by 0.5 billion as a result of the Government's policy of reducing the income-linkage effects of benefits and raising benefits not linked to income. Thirdly, the Parental Leave Fund will be operating for a full year for the first time, and one month will be added to the right of fathers to take leave on account of childbirth.

...but transfer payments to households continue to increase

The 2002 revenue surplus is estimated at 18.6 billion krónur. Excluding profits from asset sales the surplus amounts to 3 billion. The reduced revenue surplus, as compared to earlier goals, is attributable to a more gloomier economic outlook and the consequent negative impact on revenues. This is primarily reflected in indirect taxes, following the forecast for virtually stagnant private consumption. In order to analyse the fiscal stance more clearly it is useful to view the Treasury current balance excluding extraordinary items.

Future liabilities further reduced

Treasury surplus excluding extraordinary items

Million krónur	Accounts 1999	Accounts 2000	Budget 2000	Budget 2001	Estimate 2001	Budget Proposal 2002
Revenue surplus	23,631	-4,286	16,741	33,899	21,063	18,560
Extraordinary expenditure ..	19,000	37,600	11,400	10,535	14,035	10,205
Extraordinary revenue	16,000	3,800	4,200	15,500	21,500	15,500
Adjusted revenue surplus	26,631	29,514	23,941	28,934	13,598	13,265

The table shows the revenue surplus as it appears in the Treasury accounts and the fiscal budget. When the accounts have been adjusted for non-recurring items, such as profits from asset sales, prepayments of pension fund liabilities and tax claims write-offs, another picture emerges. The revenue surplus develops more evenly with the surplus declining in 2001, following the peak of the business cycle in 2000. The table

also reflects the continued sound finances of the Treasury, once the Treasury balance has been adjusted for cyclical effects. The structural surplus reached a peak of 3½ per cent of GDP in 1999 and 2000, both years of rapid expansion. The structural surplus will be lower in 2001 but is expected to increase again in 2001, to about 2½ per cent of GDP.

The net financial surplus, however, is expected to reach 41 billion in 2002. Cash from operations is projected at close to a billion and other financial transactions are expected to yield 40 billion. Of this last amount, 21 billion constitutes profits from asset sales in 2001, 20 billion are projected asset sales in 2002 and 8.5 billion are incoming repayments of outstanding loans in excess of new borrowing. New lending is expected to amount to 4.9 billion and a capital contribution to the Central Bank is projected at 4.5 billion. The intention is to apply 25 billion of the revenue surplus to a net repayment of outstanding debt, 9 billion will be used to prepay future pension liabilities to the Government Employees Pension Fund and the overall balance, reflected in the Treasury's balances with the Central Bank, will be in surplus by 7.5 billion. These intentions will be under review in course of 2002 as circumstances dictate.

3 Economic developments and prospects

3.1 International developments

The economic outlook for the world is unusually uncertain at this point due to the recent terrorist attacks in the United States. It is very difficult to forecast what effect this attack will have on economic developments. On one hand, these events will undoubtedly have a negative effect on consumer and business confidence and not least, as already seen, on the income of certain sectors, such as airlines and insurance companies. The effect on oil prices is also still uncertain. On the other hand, the first reaction of governments, with the lowering of interest rates and increased spending, will certainly give rise to the belief that the economic effects of these events will be reduced. All things considered, however, the economic forecast of the IMF is more likely to be revised downwards than upwards and this should be kept in mind in the chapters that follow that are based on IMF forecasts before the terrorist attacks.

Uncertainty in the wake of the terrorist attacks on the USA

Global growth has declined but is expected to increase again next year. The IMF forecasts that global growth will be lower this year than last year, or about 2.7 per cent, but that it will increase to 3.6 per cent next year. Due to globalisation the current downturn is more general than has been the case before, i.e. even if the current downturn is not as steep as previously has occurred it is now affecting most countries of the world. The economic downturn that started in the US about a year ago is very influential in this respect and has negatively affected growth in other countries. Among factors driving the global slowdown is the tightening of monetary policy in 1999 and 2000 in the US and Europe in response to growing demand pressures, a rise in energy prices and a decline in stock prices – especially in information technology sectors.

Economic growth has declined...

Due to various factors, including the lowering of interest rates in the US, the current downturn is not expected to last long. Oil and food price increases have also to some extent been reversed, over-investment has been reduced, inventory adjustments have been rapid and the IT sector is gradually recovering. This development will also have a positive effect on economic developments in many transition economies.

...but the downturn is not expected to last

The slowdown that started in the US in the latter half of 2000 was not altogether unexpected and many had predicted that the long period of relatively high growth rates in the US was unsustainable and bound to end. What was unexpected, however, was how rapid the downturn has been and to some degree how widespread it has become in such a short timespan. Declining business investments is what has mostly driven the downturn, especially in equipment and software. Both exports and imports have declined, but exports have declined more than imports since domestic demand is still

Declining business investments have driven the downturn in the United States

relatively strong. The current account deficit has thus increased further. In contrast, growth in residential construction has remained strong, aided by the reduction in long-term interest rates since mid-2000.

The IMF forecasts that economic growth in the US will be 1.5 per cent this year and increase to 2.5 per cent next year. Increased activity is expected already at the end of this year when the effects of interest rate and tax cuts will be felt. The US has responded rapidly to the downturn and interest rates have been cut by 3.25 per cent since the slowdown began last year. Tax cuts were also enacted this year and the effects of these policies should be felt towards the end of the year. The continuing strength of the US dollar, however, partly offsets the intended effects.

Interest rate reductions and tax cuts meant to counter the slowdown

Economic growth has declined in the euro area from last year and is now expected to be 1.9 per cent this year and 2.3 per cent next year. Higher oil prices and food price increases due to animal diseases have negatively affected demand, but there has also been a downturn in the stock markets and in technology sectors. Exports have declined since external demand has decreased, but imports have declined even more so the effects on the current account have not been negative. The euro exchange rate declined in the beginning of the year – particularly against the dollar. Inflation increased a little and reached 3.4 per cent in May, but given that the food price increases will be reversed and that oil prices will not go up, inflation is expected to be under 2 per cent in the euro area next year. Minor tax and interest rate cuts have been made in the euro area and food prices have decreased and this should lead to an increase in demand. The development in oil prices is, however, uncertain, which could affect both demand and inflation.

Slower growth in Europe

The economic outlook has deteriorated in Japan and it is now likely that the economy is headed for the fourth recession in 10 years. Economic growth was 1.5 per cent last year and prospects seemed hopeful especially due to increased investments, more exports and growth in the high technology sector. In mid-2000 the economy started to slow due to a contraction in external demand – especially for various electronics. Demand continued to decline in the first half of this year and the IMF now forecasts that GDP will decline by 0.2 per cent in 2001. The fact that the pace of corporate restructuring has been slow has not aided the situation. This is evident from the decline in stock prices and the yen exchange rate. The economy is expected to recover slowly next year and the IMF forecasts 0.5 per cent growth in Japan in 2002.

Continuing economic difficulties in Japan

The role of the IMF

The International Monetary Fund was established at the end of World War II, Iceland being amongst its charter members. At first, the main role of the Fund was to contribute to the economic reconstruction of the member countries through a wide array of support measures in order to ensure financial stability. Initially, most of the Fund's efforts were directed at the industrial countries, but its focus gradually shifted towards other countries, first to the developing countries in Africa, Asia and Latin America and later to the countries of Central and Eastern Europe. The Fund played a central role in the economic development of many of these countries, and the three Baltic countries are probably one of the best examples thereof.

The role and operation of the Fund – as well as the World Bank – have been subject to increasing scrutiny in recent years. This is partially due to economic turbulence, e.g. in Mexico, South East Asia, Russia and lately in Turkey and Argentina. All of these countries have received Fund assistance to a greater or lesser extent. Critics have contended that assistance extended by the Fund has not been as successful in the recipient countries as could have been expected.

These events, along with the obvious need for a change in emphasis in the Fund's operations led to the decision that Nordic-Baltic co-operation would be strengthened in preparation for meetings under the Fund's auspices. The Nordic and Baltic countries form a constituency within the Fund and jointly elect an Executive Director to the Executive Board of the Fund that is composed of 24 members. In the autumn of 1999, it was agreed to strengthen this co-operation by establishing two working groups of senior officials for this purpose. The economic and finance ministries of the countries now play a greater and more decisive role in this co-operation than before. One group, the Finance Working Group, has the task of co-ordinating and directing the co-operation within the constituency, whereas the other group, the Senior Officials Working Group, deals with various matters of joint concern to the member countries. Emphasis has been placed on reviewing the role of the Nordic-Baltic office in Washington in order to strengthen its ties with member country governments. The future role of the Fund and possible changes in the voting weight of individual constituencies within the Fund has also been under discussion in view of the growing dissatisfaction of the United States, Canada, Japan and several other Asian countries over the relatively heavy influence of European countries in decision-making, partially at the expense of developing countries.

As of the beginning of 2002, Iceland will assume the office of the Executive Director for the Nordic-Baltic constituency, thus heading the Nordic-Baltic office at the Fund. Iceland's Minister of Finance will join the International Monetary and Finance Committee of the Fund. Iceland will assume the chairmanship in the Nordic-Baltic Finance Committee and also assume the task of co-ordinating the work of the constituency for the next two years as regards individual issues regarding the Fund.

The slowdown in the US and in other industrialised countries has a substantial influences on other economies, especially on transition economies. The decline in demand in the industrialised countries – especially in demand for IT and high tech products - has an especially negative effect. The growth forecasts for most of these

The downturn in industrialised countries has a negative effect in other countries

countries have thus been adjusted downwards. Exports from many developing countries in Asia have declined because of this and GDP growth is now forecast to decline from 7 per cent last year to 5.3 per cent this year, but increase slightly next year to 6 per cent. Growth in China is least affected and is expected to be 7 per cent this year and in 2002. Economic growth in Latin America is expected to decline to 2.1 per cent this year but increase again next year to 3.7 per cent. The downturn in the US has had a substantial impact on growth prospects in Latin America, but economic difficulties in Argentina and a decline in energy supply in Brazil are also contributing factors. Economic growth has slowed in EU-applicant countries especially due to declining demand in Europe. Apart from Turkey, which has experienced serious economic difficulties, the slowdown in Central and Eastern Europe has not been grave and growth is forecast to remain similar to last year's or about 3.5 per cent this year and 4.2 per cent next year. The IMF forecasts 4 per cent growth in Russia this year and next. This is considerably lower than last year when GDP growth reached 8.3 per cent, especially due to rising oil prices and a sharply depreciated exchange rate. These factors have now been reversed and external demand has declined. As before, prospects for economic growth in Russia depend to a great extent on the success of various needed structural adjustments in the economy.

3.2 The Icelandic economy

The indications are that the Icelandic economy has now reached a turning point. Demand is slowing down and some sectors are contracting. These rapid changes followed some turbulence in financial markets in the spring when the krona exchange rate declined, following the abolishment of exchange rate bands. The economy reacted as could have been expected under the circumstances. Import prices increased significantly and led to a considerable rise in inflation. Import demand began to decline and the current account improved gradually. The decline in the krona exchange rate encouraged exports as their competitiveness improved.

**A turning point
for the
Icelandic
economy....**

The adjustment of the economy to changed circumstances is in many respects different from previous occasions, although there are some reminders of the experience of earlier years. In those days, the krona exchange rate acted as a kind of a safety valve in cases of excessive demand expansion. The inevitable question is whether the demand expansion in the first half of the year had reached the point where the exchange rate was bound to yield or whether a more balanced situation could have been attained by other means. The development of main economic indicators provides useful clues.

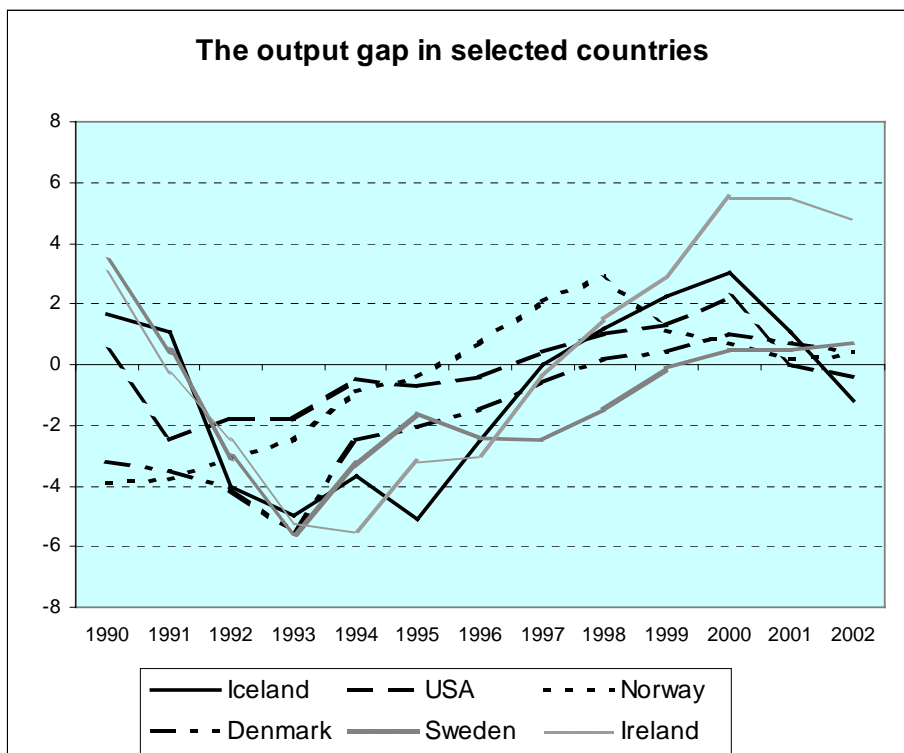
**...and an
adjustment
process is
underway...**

The state of the economy can be gauged by various means, such as inflation, the

**...following a
long period of
expansion**

current account balance, the development of credit and the output gap. The last-mentioned indicator shows actual output in relation to the economy's potential output. If actual output exceeds potential output the markets for goods, services and labour tend to overheat which sooner or later leads to price pressures and inflation.

The graph below shows the output gap in selected countries over the past decade and forecasts for the coming year. The forecast for Iceland is based on the calculations of the Ministry of Finance of the productive capacity of the Icelandic economy, whereas figures for other countries are based on the latest OECD forecast. By this measurement, only Ireland amongst the countries shown has experienced a greater output gap over the past two years than has been the case in Iceland. On the other hand, the output gap is rapidly falling and may even disappear next year.



The sharp economic expansion of the past several years was in part fuelled by increased purchasing power of households, the liberalisation of financial markets and the considerable growth in new economy sectors. Inflation was low at first and expectations of future prosperity ran high. This undoubtedly helped fuel the investment and consumption intentions of businesses and households, even if such intentions were not altogether well founded and in many instances credit-financed. This inevitably contributed to a growing current account deficit. Nonetheless, it was clear that this

Is the current account deficit a problem for Iceland?

state of affairs could only be temporary and that sooner or later, this would come to an end. Furthermore, it should be pointed out that the deficit was wholly generated by businesses, households and municipalities. The central government, however, yielded a substantial surplus throughout this period.

There were no economic grounds for such a large fall in the exchange rate as took place last summer. This applies regardless of whether one views the real exchange rate in an historical context or the economic situation in general. Similar views have also been voiced by the Central Bank as well as the financial sector. It has been pointed out that the domestic financial market went through a period of disquiet and uncertainty which probably contributed to a larger devaluation than warranted by economic circumstances.

No grounds for such a sharp fall in the exchange rate

With the new Central Bank Act that was passed last spring, a new monetary policy framework was introduced which marks a watershed in Icelandic economic management. Iceland has now joined the group of nations that have formally charged their central banks with the task of pursuing an inflationary target. The joint policy declaration of the Central Bank and the Government stated that the Central Bank was to pursue a target of 2½ per cent annual inflation with a tolerance band of 1½ per cent in each direction. In view of the fact that it would take time to sharpen the effectiveness of monetary policy instruments and also with regard to the inflationary situation at the present time, it was decided to define a wider band width in the beginning. The Central Bank's upper tolerance band was set at 6 per cent for 2001 and 4½ per cent for 2002. These changes in the goals of monetary policy and the increased independence of the Central Bank mean that Iceland is following the example of most of those countries to which Iceland is compared.

A changed role for the Central Bank

The Central Bank is entrusted with the role of ensuring price stability through the application of the traditional instruments of monetary policy. It is thus charged with the task of being the principal manager of short-term economic policy. In a world of freely floating capital movements, this means that the role of fiscal policy is altered. It can no longer be applied to implement rapid, major changes in the economy. The emphasis of fiscal policy will have to be on economic stability in the longer term. This will best be achieved by yielding an adequate Treasury surplus and creating an efficient tax environment, both for business and households.

The role of fiscal policy changes

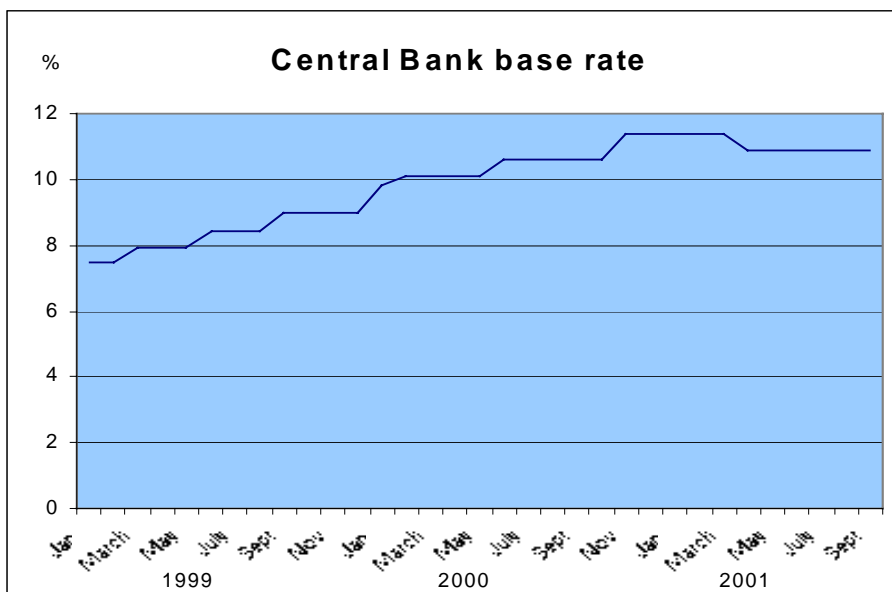
Fiscal policy is not only a matter of longer-term considerations. It plays an important role in supporting monetary policy. The economic expansion of recent years along with the rise in Treasury revenue clearly shows the importance of distinguishing between

Fiscal policy has supported monetary policy

the effects attributable to general economic developments on one hand and the more underlying or structural trends of fiscal finances at each point in time. The Treasury has yielded an impressive surplus in recent years, both on a cyclical and structural basis. Thus, the structural (i.e. cyclically adjusted) surplus amounted to nearly 3½ per cent of GDP in 1999-2000. It is estimated to amount to 1 per cent of GDP in 2001 and to 2½ per cent as projected in the 2002 budget.

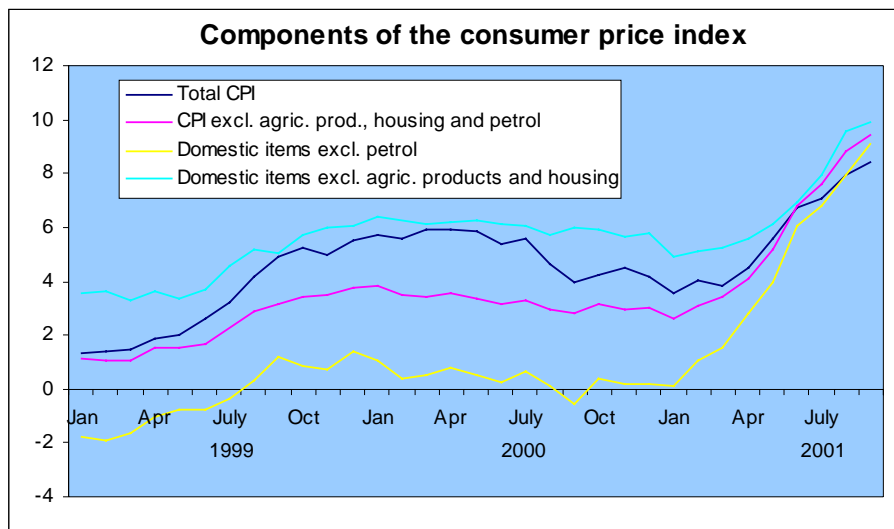
The sudden surge in inflation in the wake of the sharply falling exchange rate in the first half of 2001 has prompted the Central Bank to pursue an unusually tight monetary policy by keeping its base interest rate high in spite of the fact that there are by now some clear signs of contraction in the economy. The Bank has argued that these signs do not unequivocally signal that the economic expansion is abating so as to justify a reduction in the base rate. The Bank reduced its base rate by 50 basis points last March, to 10.9 per cent, but a few months earlier the rate was raised by 80 basis points, from 10.6 per cent to 11.4 per cent. The Central Bank's concern about inflation is understandable in the light of the inflationary surge in recent months, which is reflected both in the rise in prices for domestic goods and services as well as in import prices following the decline in the exchange rate.

Interest rates and inflation



The graph below shows clearly that domestic inflation, as measured by the domestic components of the index, was already rising sharply in the second half of 1999 and has since been around a 6 per cent annual rate. Following the decline in the exchange rate, the price increase of the domestic components has accelerated to a 10 per cent annual rate. The import-related components rose less prior to the exchange rate

decline being close to zero until the beginning of 2001 but rising sharply thereafter in concert with the declining exchange rate. At present, it appears the inflation will rise by about 6½ per cent on average between 2000 and 2001 and just over 8 per cent from the beginning to the end of 2001. In 2002, the prospects are for a rapidly diminishing inflation as the effects of the declining exchange rate dissipate and economic growth slows down. The assumption behind the fiscal budget regarding inflation in 2002 is largely in concert with the Central Bank's forecast and the latest information on price developments in 2001. It is assumed that prices will rise by about 5 per cent on average between 2001 and 2002 and by about 3 per cent from the beginning to the end of the year. Inflation is expected to decline still further in 2003.



The labour market situation is somewhat uncertain at present. Despite clear signs of economic contraction, unemployment is low and the demand for labour still appears to be considerable. There have been reports of firms laying off workers because of economic difficulties but it appears that these workers have been able to find new jobs without difficulty. The question is whether the labour market is still so tight that some time may pass until reduced demand will lead to increased unemployment.

The labour market situation is uncertain....

Experience shows, however, that the relation between labour market developments and changes in output is not always clear-cut. A part of the explanation is that firms normally do not react to reduced demand by laying off workers immediately. There are a number of reasons for this. Workers as a rule hold job contracts with a few months' notice which makes it difficult for employers to shed staff at short notice. The first reactions of managers are usually to reduce overtime or by resorting to reorganisation. Most firms see their workers as part of their base capital. They have often invested in their education and training and try to keep their staff as long as they can. Therefore, it

...but the contractionary impact emerges with a lag...

can take some time for a slowdown in the economy to show up in unemployment figures.

A second important factor in the labour market situation is a likely change in the participation rate. Experience shows that the labour market in Iceland has a strong tendency to fluctuate with the business cycle. During an upswing the supply of labour increases and contracts in times of downswing. One can thus expect that the participation rate will temporarily decline in the present downswing, as workers may return to school or move abroad. Furthermore, the number of workers moving from abroad may decline. Unemployment is expected to be around 1½ per cent of the labour force in 2001, slightly above the 1.3 per cent rate in 2000. The assumption behind the budget proposal is that unemployment will reach 2 per cent next year.

...and labour market participation is likely to decline

The turnaround in the economy has called for a rapid adjustment of the economy to declining demand, the tighter financial market and the uncertain international situation. Not surprisingly, firms are not all well prepared for such a rapid adjustment. The contraction has been most keenly felt in the ITC sectors. No one disputes the importance of the new economy sectors and that the increase in productivity in recent years is to a large extent attributable to them. The downturn has, however, hurt these sectors most, both in this country and other industrial countries. This is to be expected, since the growth of the new economy companies has been phenomenal and the downturn was therefore more likely to hurt those firms than others. This development has given rise to the opinion that the new economy optimism was illusory and ill-founded.

The business sector is adjusting rapidly

Is the New Economy dead?

Most industrial countries have gone through great turbulence in stock markets in recent months. Share prices have fallen rapidly during the past year, particularly high-tech stocks in the information and communications sectors. This has prompted a debate full of doubt on the state of the so-called New Economy. Many have declared it dead and others have maintained that it never existed as such in the first place. This is an important debate since many have explained the expansion in the American economy and elsewhere to a large extent with the sharp growth of these sectors. Conversely, the recent slowdown is blamed on the overreach and consequent difficulties of these sectors. But, is the New Economy dead? In order to answer that question one must first identify the New Economy, what it included and what not. The misconception is widespread that the New Economy is confined to firms operating in the hi-tech sector, i.e. in information, communications and other hi-tech areas, such as biotechnology. The steep dive in the share prices of these companies indicates to many that the New Economy was but a passing bubble.

True enough, the growth of hi-tech has been rapid and contributed heavily to economic growth. What is more important however is that the developing technology has spread far and wide, to business, schools and households. The impact on productivity could well be sustainable in the long run.

Iceland is in the forefront in the use of hi-tech applications. It nearly leads the world in cell-phone use and the spread of the Internet. The computerisation of databases, paperless transactions and electronic tax returns is widespread, more so than in most other countries. Most important, however, is that the economy is maintained on a sound footing and that economic policy contributes to stability as a prerequisite to sustained growth and an improved standard of living. The New Economy will neither replace the more traditional industries nor solve the old economic problems. Emphasis must therefore be placed upon guarding inflation, the external balance, the level of employment and other principal economic aggregates.

The export sector has improved its position significantly in wake of the fall in the krona exchange rate. Although it has a temporary adverse effect on the profits of export companies due to the increase in their external debt in domestic currency terms, the impact is nonetheless going to be beneficial in the long run. A lower krona exchange rate has therefore a beneficial impact for the supply side of the economy, both as regards the export sector as well as the import-competing sector. The positive impact on the supply side must be seen along with the negative impact on the demand side due to a reduced purchasing power. Under certain circumstances, a devaluation can cause undesirable expansionary influences rather than act as a brake on demand. There is little prospect for that in the Icelandic economy at the moment. Icelandic export companies are generally not prepared to increase their production in the short run. Companies in the fisheries sector are subject to constraints of fishing quotas and the large-scale manufacturing companies are operated at full capacity. It is therefore unlikely that the improved revenue of these companies will lead to wage drift.

No danger of overheating ...

Although fishing quotas have been shrunk, the fisheries sector on the whole appears in good health. Prices for marine products have been rising, particularly for capelin and herring. Fisheries production is expected to remain constant in 2001. Although the fishing quotas for the 2002 fisheries year (which runs from September 2001) have been reduced, experience shows that the fisheries companies are well prepared to mitigate the reduction with other measures. The large-scale manufacturing companies, especially in aluminium, have also done quite well. Prices for aluminium have been declining so far this year, following a period of price stability which did much to strengthen aluminium production in this country as well as elsewhere. Ferro-silicon production has, on the other hand, been in difficulties due to depressed prices.

...although profits of export companies have improved

The rise in inflation following the devaluation has led to a reduction in household purchasing power. Not only have prices increased but the rise in nominal interest rates as well as the indexation of debt has put a dent in household budgets. Indicators of

Domestic demand is contracting...

domestic demand clearly point to a decline. This applies both to consumer demand for durable and non-durable goods as well as to business activity. Consumers have reined in their purchases of automobiles, they travel less abroad and a contraction is in evidence in other areas. Only 6,500 new automobiles were registered in the first seven months of 2001, compared with more than 12,000 during the corresponding period in 2000. Travel to abroad also appears to have declined, although no confirmed data exist for this area.

The most reliable data on the decline in domestic demand is to be found in data on Treasury revenue from indirect taxes. Collection of value added tax declined by 5.7 per cent in real terms in the first eight months of 2001 and revenue from imports by one-fifth. Information on the real property market also indicates that demand is abating in that area. It should be noted, however, that mortgage credit terms changed in the wake of the comprehensive reassessment of real property and fire insurance valuations that took effect on 15 September 2001. Nevertheless, there is common agreement that demand in the real property market is no longer the same as before.

...as is clearly shown by the development in Treasury revenue

These changed circumstances have done much to adjust the external balance. The contraction in consumption and investment has led to reduced imports, and improving terms of trade and a declining real exchange rate lead to rising export revenue. The trade deficit has therefore declined sharply. It amounted to 11.5 billion krónur in the first seven months of 2001 compared with 24.3 billion in 2000, calculated at constant exchange rates. This represents an improvement of 12.8 billion krónur. Figures on the current account tell a similar story. Provisional balance of payments results for the first half of 2001 show a decline in the current account deficit of 8 billion krónur, also calculated at constant exchange rates.

The current account deficit is thus in rapid decline...

The adjustment process is likely to dominate the economy in 2002. There is thus little scope for an improvement in economic growth and both consumers and businesses must adapt to different circumstances from recent years. Economic growth amounted to 5 per cent in 2000 whereas in 2001 it is expected to be about 1-1½ per cent which means that in real per capita terms it is close to zero. For the 2002 fiscal budget it is assumed that economic growth will be slightly less, whereas growth is expected to revive to 2-3 per cent a year over the medium term. Should plans for hydro-energy investments be realised, growth will be even higher.

...but economic growth is likely to be slow in 2002

The decline in domestic demand is clearly reflected in private consumption. Revised revenue estimates assume that private consumption will decline by 2 per cent in real terms in 2001. This is mostly explained by factors discussed above, such as declining

Private consumption is expected to decline in 2001...

purchases of vehicles and other consumer durables as well as less travel abroad. The impact of higher interest rates and the increasing cost of indexed loans is also influential. For 2002 the assumption is that private consumption will remain constant in real terms, reflecting a 1 per cent fall per capita.

Public consumption is expected to rise by 2½ per cent in 2002, slightly less than in recent years. This is in part due to the fact that pension fund liabilities by the public sector are expected to increase far less than in recent years when they have been a prime source of growth in public expenditure. It is important to distinguish between different forces behind private and public consumption when considering total demand. The largest part of public consumption, about two-thirds, represents public sector wages. Decisions on changing public consumption are therefore quite different from those applying to private consumption. Private consumption is governed by purchasing power and expectations for the future, whereas public consumption is largely dictated by the organisation of public services and the division of tasks between the private and public sectors. The size of the public sector has been smaller in Iceland than in most neighbouring countries, although the relative growth of the public sector has been faster than in the private sector. This is explained by the fact that health services and education are growing fast due to the emphasis on these sectors in addition to the fact that service sectors in general are growing relatively faster than traditional goods-producing sectors.

...whereas public consumption is expected to grow

Investment plans point to a decline both in 2001 and 2002. The contraction is expected to be most significantly felt in the business sector, especially in those sectors that have grown most rapidly in recent years. Several large investment projects have recently been, or are about to be, completed, such as the extension of the Keflavik Airport Terminal, the Smaralind shopping centre and hydro-power projects by Landsvirkjun. Investment is therefore expected to continue its decline in 2002, by about 10 per cent in real terms. It is important to note that this estimate is rudimentary, largely based on the general trend of the economy rather than sector-specific estimates.

Business investment may decline...

The tax reductions presently being discussed could, however, mitigate the contraction in investment already in 2002, since they would tend to strengthen the business sector and therefore the economy as a whole, especially in the long run. They would also tend to have a positive influence on economic developments and thus contribute to improved growth and a better standard of living.

...but tax reductions could change these prospects

Public investment is forecast to remain unchanged in 2002, following several years of increase. Investment expenditures of the Treasury are expected to increase by close

Public investment is mostly unchanged

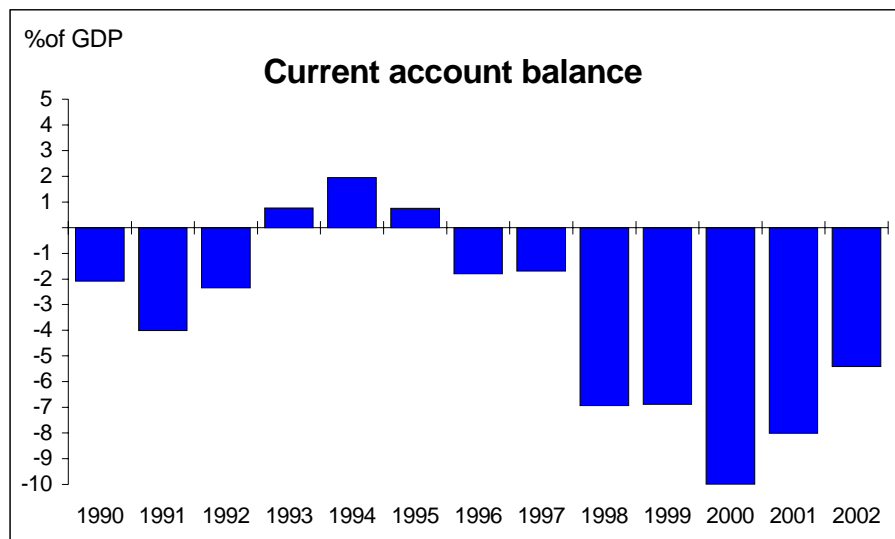
to 3 per cent in nominal terms, which is equivalent to a 2 per cent decline in real terms. Investment in roads and harbours as well as health facilities will increase whereas expenditure on airport facilities will decline, following a sharp increase in recent years.

The contraction in private consumption and investment will mean that domestic demand is expected to decline in spite of the growth in public consumption. The assumptions behind the budget proposal project a 2-3 per cent real decline in domestic demand in 2001 and a slightly smaller decline in 2002. In nominal terms, however, domestic demand is expected to increase by close to 6 per cent in 2001 and close to 4 per cent in 2002.

Domestic demand is expected to decline...

There are clear prospects for a sharp improvement in the current account balance in 2001 and 2002. Last June, the National Economic Institute forecast a 73 billion krónur deficit for 2001. Present prospects are that it will be much lower. The budget proposal assumes a current account deficit of 58 billion krónur this year and just over 40 billion krónur in 2002. This projection is based on the expectation that the economy will continue to contract as it adjusts to a lower real exchange rate.

...and the current account deficit falls sharply



All told, economic prospects for 2001 and 2002 imply a marked slowdown of economic growth from recent years. The 2002 budget proposal assumes an average annual GDP growth of 1-1½ per cent this year and next. This is a considerable decline from the past five years when growth has averaged 4½ per cent.

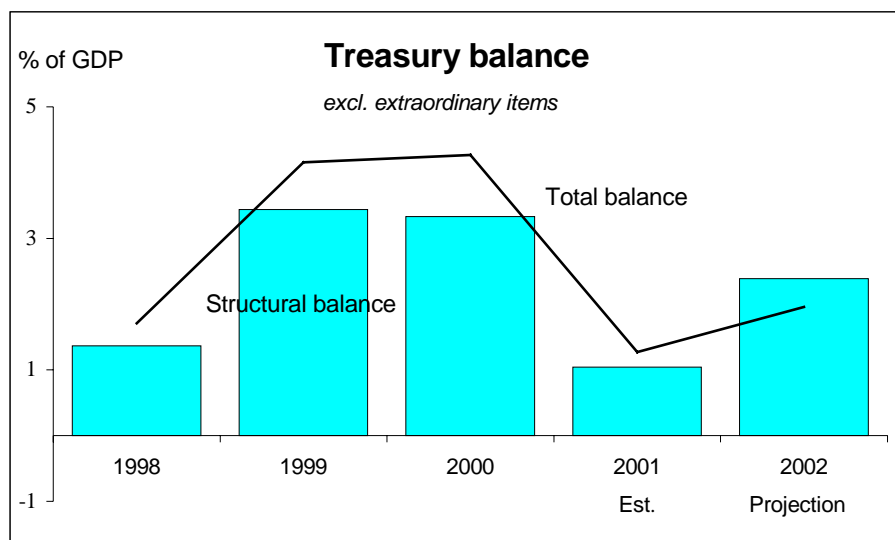
Growth will be lower than in recent years

Nonetheless, it is important to emphasise that the output of the economy is at an historical high. The change in economic growth primarily reflects an adjustment to

changed circumstances following a period of particularly rapid expansion rather than the onset of a recession. The recent terrorist attacks in the United States will probably have some negative influence on Icelandic economic developments, although it is uncertain how extensive they will be and when they will materialise.

Now that growth is reduced and the economy is adjusting to new circumstances, it is evident that Treasury revenue will be proportionately reduced. This is easy to explain and in fact but a reversal of the expansion of revenue in recent years in concert with rising output and income. In the 2002 budget proposal it is assumed that Treasury revenue will amount to 28½ per cent of GDP, half a per cent less than in 2001 and close to 2 per cent below the 1999-level when the proportion stood at a high. As noted above, this development is attributable to the fact that the Treasury tax base grows sharply in times of expansion, both direct and indirect taxes. The proportion of indirect taxes is relatively high in this country and changes in spending have a large impact on Treasury revenue. Furthermore, the spending items most subject to change are also those bearing the highest taxes. This is clearly reflected in the development of revenue in the course of 2001 when revenue from imports and the value added tax are declining in line with a contraction in imports and private consumption. Direct taxes have not followed this trend so far, since the impact on the tax base only shows up with a lag.

The Treasury balance is sensitive to the business cycle...



In order to discern the underlying state, or the structural balance, of fiscal finances, one must separate the structural and cyclical impact on Treasury finances. The Ministry of Finance assesses this balance on a national accounts basis. According to this calculation, there has been a structural surplus on Treasury finances since 1997,

...and the structural balance declines initially but rises thereafter

following deficits in earlier years. Another method is to estimate the structural balance, excluding extraordinary items that are not related to the year's bottom line, although included in the accounts. This applies to such items as profits from sales of government assets and accounting reassessments of public enterprises' book value on the revenue side and future pension liabilities and tax claims write-offs on the expenditure side. By this measurement, it is estimated that the Treasury structural surplus will amount to some 1 per cent of GDP in 2001. Actually, this is considerably less than in 1999 and 2000 when it amounted to close to 3½ per cent of GDP. The lower structural surplus in 2001 is primarily attributable to increased salary costs and social security and welfare expenditures. For the 2002 budget it is assumed that the structural surplus increases to 2½ per cent of GDP. Hence, nearly the entire 2002 surplus will be structural, since the cyclical component is expected to be close to none for that year, given the condition of the economy in 2002.

Appendix

Table 1

Treasury revenue and expenditure

Accruals basis, millions of krónur	1999	2000	Budget 2001	Estimate ¹ 2001	Budget Proposal 2002
Tax revenue	187.796	200.651	217.126	212.121	222.245
Personal income tax	37.987	44.125	51.250	53.760	58.980
Corporate income tax	9.126	9.679	9.700	8.000	6.000
Social security taxes	17.787	19.680	20.204	21.099	22.565
Net wealth taxes	8.450	9.872	10.686	11.824	12.883
Value added tax	70.020	71.903	82.220	75.400	79.220
Other taxes on goods and services	38.013	39.064	40.244	38.195	39.233
Other taxes	6.413	6.328	2.822	3.843	3.364
Other current revenue	17.464	19.031	19.612	18.486	19.513
Dividends income	2.733	2.477	1.978	923	1.479
Interest income	9.269	10.698	12.445	13.167	12.910
Other	5.462	5.856	5.189	4.396	5.125
Revenue from sales of assets	11.140	635	15.516	21.516	15.520
Revenue and cost sharing transfers	1.294	1.231	809	825	621
Revaluation of state enterprise assets	4.938	3.167			
Total revenue	222.632	224.715	253.063	252.948	257.900
Expenditure					
The Presidency, Althingi and Supreme Court	1.876	2.149	2.058	2.085	2.604
Office of the Prime Minister	1.689	1.459	1.058	1.408	1.100
Ministry of Education, Science and Culture	21.368	22.459	23.850	25.187	27.814
Ministry for Foreign Affairs	3.635	4.807	4.084	4.272	5.012
Ministry of Agriculture	9.346	9.502	10.526	10.738	10.749
Ministry of Fisheries	2.505	2.508	2.581	2.664	2.617
Ministry of Justice and Church	10.797	11.574	11.944	12.452	13.629

Ministry of Social Affairs	11.483	11.266	15.965	16.333	18.035
Ministry of Health and Social Security	72.621	78.479	79.873	83.526	89.205
Ministry of Finance	30.431	48.981	28.193	33.389	28.355
Ministry of Communications	11.908	13.315	15.301	15.340	15.961
Ministry of Industry	1.853	2.631	2.751	2.995	2.906
Ministry of Commerce	1.278	1.404	1.338	1.353	1.454
Statistics Iceland	330	378	370	373	382
Ministry for the Environment	2.550	2.842	3.074	3.097	3.170
Interest expenditure	15.332	15.245	16.200	16.790	16.300
Total expenditure	199.002	229.001	219.164	232.000	239.293
Revenue balance	23.630	-4.286	33.899	20.948	18.607

¹ Budget plus supplementary budget.

Table 2

Treasury cash flow and capital transactions

In billions of krónur	1999	2000	Budget 2001	Estimate ¹ 2001	Budget Proposal 2002
Cash flow from operating activities.....	17,0	17,5	9,2	-2,4	0,9
Capital transactions					
Credit transactions, net.....	2,5	3,3	11,4	3,0	3,6
Revenue from sales of assets and other capital transactions.....	11,0	-	18,2	-6,6	36,7
Capital transactions, total.....	13,5	3,3	29,6	-3,6	40,3
Discounts on borrowings.....	3,7	2,5	-	-	-
Net financial balance (before contribution to GEPP).....	26,8	18,2	38,7	-6,0	41,2
Contrib. to Gov. Employees Pension Fund (GEPP).....	-7,8	-8,8	-15,0	-12,5	-9,0
Net financial balance (after contribution to GEPP).....	19,0	9,5	23,7	-18,5	32,2
Changes in credit transactions.....	-16,6	-8,2	-9,2	38,8	-25,2
Cash balance.....	2,4	1,3	14,5	20,3	7,0
Per cent of GDP					
Cash flow from operating activities.....	2,7	2,4	1,2	-0,3	0,1
Net financial balance.....	4,3	2,5	5,0	-0,8	5,3
Cash balance.....	0,4	0,2	1,9	2,8	0,9

¹ Budget plus supplementary budget.

Table 3

Treasury revenue

Accruals basis, millions of krónur	Budget					
	1998	1999	2000	2001	Estimate ¹ 2001	Budget Proposal 2002
I Tax revenue.....	161.219	187.796	200.651	217.126	212.121	222.246
Taxes on income and profits.....	42.744	53.030	59.595	63.207	64.547	67.167
Individuals.....	34.410	42.102	49.331	51.250	53.760	58.980
Personal income tax.....	31.687	36.855	42.853	45.500	47.840	53.740
Personal income surtax.....	615	1.132	1.272	1.700	1.620	1.240
Other taxes on income and profits.....	2.108	4.115	5.206	4.050	4.300	4.000
Corporations.....	7.155	9.126	9.679	9.700	8.000	6.000
Other.....	1.179	1.802	585	2.257	2.787	2.187
Tax on central gov't capital gains.....	644	1.232	12	1.570	2.100	1.500
Tax for the Nursing Home Constr. F'd.....	535	570	573	687	687	687
Social security taxes.....	16.088	17.768	19.681	20.204	21.099	22.565
Net wealth taxes.....	7.788	8.450	9.872	10.686	11.824	12.884
Taxes on goods and services.....	94.263	108.033	110.966	122.464	113.596	118.453
Value added taxes.....	59.282	70.020	71.903	82.220	75.400	79.220
General excise taxes.....	10.080	10.900	11.067	12.003	11.598	12.122
Excise tax on motor vehicles.....	4.970	5.896	4.960	5.150	2.900	3.300
General excise tax on petrol.....	1.603	1.760	2.127	2.180	2.160	2.190
Special excise tax on petrol.....	5.089	5.398	5.430	6.026	6.026	5.434
Other turnover taxes.....	6.683	6.850	7.357	6.816	7.361	7.517
Motor vehicle tax.....	2.261	2.341	2.550	2.650	2.610	2.680
Diesel weight tax.....	3.515	4.050	4.639	4.342	4.780	4.964
Misc. charges.....	780	818	932	1.077	761	1.026
Other taxes.....	336	515	538	565	1.056	1.177
II Other current revenue.....	15.581	17.464	19.030	19.612	18.486	19.513

Dividends and rental income.....	2.406	2.733	2.477	1.978	923	1.479
Interest income and other property income...	8.381	9.269	10.698	12.472	13.167	12.952
Charges and licences.....	4.277	4.845	5.208	4.438	3.814	4.384
Other.....	517	617	647	724	582	699
III Revenue from sales of assets.....	2.471	11.140	634	15.516	21.516	15.520
IV Capital transactions.....	340	-	-	-	-	-
V Cost sharing transfers.....	1.235	1.294	1.231	809	825	621
Revaluation of government assets.....	-	4.938	3.167	-	-	-
Total revenue, accruals basis.....	180.846	222.632	224.713	253.063	252.949	257.900
Total revenue, cash basis.....	167.631	202.041	217.978	235.735	225.576	246.600

¹ Budget plus supplementary budget.

Table 4

Treasury expenditure by economic activity

Accruals basis, millions of krónur	1998	1999	2000	Budget 2001	Estimate ¹ 2001	Budget 2002
Current expenditure						
Wage costs.....	49.790	51.050	53.958	63.380	66.006	71.651
Pension fund contributions.....	20.811	12.873	24.877	6.535	9.535	6.205
Other current expenditure	24.882	37.033	48.310	33.499	36.242	40.145
Service charges	-11.226	-12.337	-13.763	-11.243	-11.623	-16.583
Total current expenditure	84.257	88.619	113.382	92.172	100.160	101.419
Interest	15.964	15.332	15.245	16.200	16.790	16.300
Transfer payments						
Old age and disability insurance	16.063	17.534	20.090	19.220	20.370	22.709
Health insurance	8.537	9.865	10.873	11.301	12.201	12.043
Agricultural support payments	5.833	6.138	6.200	6.990	6.990	6.935
Welfare support payments	4.551	4.910	5.435	5.855	5.989	6.453
Municipal Equalisation Fund	2.982	4.074	4.200	5.800	5.800	5.142
Child benefits	4.167	3.942	3.702	4.430	4.430	4.930
Per-diem-based nursing homes	3.389	3.432	4.047	4.055	4.355	4.592
Interest cost rebates	3.822	3.950	4.309	3.885	3.885	3.885
Parishes and churchyards	1.779	2.031	2.246	2.410	2.410	2.554
Parental Leave Fund	-	-	-	2.369	2.619	4.611
Unemployment Insurance Fund	2.438	1.860	1.444	2.284	1.924	2.302
Student Loan Fund	1.727	1.780	1.910	2.150	2.420	2.550
National Broadcasting Service	1.568	1.730	1.777	1.625	1.625	1.905
Other transfer payments	14.892	12.109	13.990	16.175	17.498	17.901
Total transfer payments	71.748	73.356	80.223	88.548	92.515	98.512
Maintenance						
Public Roads Administration	3.277	3.754	4.151	4.228	4.228	4.234

Other	791	1.219	1.112	1.204	1.204	1.582
Total maintenance	4.068	4.973	5.263	5.432	5.432	5.816
Capital expenditure						
Road construction	3.805	4.469	4.631	5.955	5.655	6.386
Universities and higher education	1.032	1.023	854	1.475	1.475	1.594
Hospitals and health centres	860	2.760	1.010	1.384	1.384	1.389
Harbour construction	554	827	486	1.293	1.293	1.415
Airfields	296	457	882	613	861	557
Fisheries Development Fund	675	620	630	560	560	545
Other capital expenditure	6.375	6.567	6.396	5.533	5.876	5.361
Total capital expenditure	13.597	16.723	14.889	16.813	17.104	17.247
Total expenditure	189.634	199.003	229.002	219.164	232.000	239.293

¹ Budget plus supplementary budget.

Table 5 Central government debt and claims¹

Stock figures									Estimate	Budget
Millions of krónur, year-end values	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Gross debt	195 569	213 924	232 585	239 246	241 566	237 764	225 968	228 530	291 195	265 930
Central Bank.....	6	-	-	-	-	-	-	-	-	-
Treasury bonds.....	60 796	69 008	74 140	73 889	84 424	82 865	82 618	68 898	-	-
Treasury notes.....	6 012	5 563	5 768	8 366	11 258	15 846	11 018	11 430	-	-
Treasury bills.....	13 742	14 630	16 406	15 811	12 296	15 209	9 899	5 970	-	-
Other domestic liabilities.....	12 709	11 090	9 010	8 962	6 960	6 526	4 297	2 907	-	-
Foreign debt.....	102 304	113 633	127 261	132 218	126 628	117 318	118 136	139 325	-	-
Total claims	64 968	69 066	77 266	71 023	69 309	86 496	107 152	101 172	145 655	133 377
Long term credit.....	46 875	55 469	64 134	63 663	65 278	64 739	69 347	70 919	70 535	69 375
Indexed to domestic prices.....	26 405	36 965	45 176	50 565	52 885	53 215	57 699	59 262	-	-
In foreign currency.....	20 470	18 504	18 958	13 098	12 393	11 524	11 648	11 657	-	-
Taxes outstanding and other short-term claims	18 093	13 597	13 132	7 360	4 031	21 757	37 805	30 253	75 120	64 002
Net debt	130 601	144 858	155 319	168 223	172 257	151 268	118 816	127 358	145 540	132 553
Claims as a percentage of debt.....	33,2	32,3	33,2	29,7	28,7	36,4	47,4	44,3	50,0	50,2
Percentage of GDP										
Gross debt	47,5	48,7	51,5	49,4	46,1	41,1	36,2	33,9	39,2	33,9
Of which: foreign debt.....	24,8	25,9	28,2	27,3	24,2	20,3	18,9	20,7	-	-
Total claims	15,8	15,7	17,1	14,7	13,2	14,9	17,2	15,0	19,6	17,0
Of which: In foreign currency.....	4,4	3,1	2,9	1,5	0,8	3,8	6,1	4,5	-	-
Short term credit, net.....	4,4	3,1	2,9	1,5	0,8	3,8	6,1	4,5	10,1	8,2
Net debt	31,7	33,0	34,4	34,8	32,9	26,1	19,1	18,9	19,6	16,9

1) Including accrued interest liabilities.

Table 6

General government debt and claims ¹

Millions of krónur, nominal values	1993	1994	1995	1996	1997	1998	1999	2000	Estimate 2001	Budget 2002
General government gross debt.....	220 084	245 071	267 611	274 447	279 351	280 460	271 455	277 469	343 644	321 925
Domestic debt ²	113 296	126 467	135 881	138 088	145 149	153 144	141 472	126 644	-	-
Foreign debt.....	106 788	118 604	131 730	136 359	134 202	127 316	129 983	150 825	-	-
General government total claims.....	76 905	79 577	88 313	82 925	82 820	99 746	124 477	116 407	161 589	150 026
Long-term claims.....	54 091	61 559	70 760	71 249	74 449	74 482	80 429	81 654	81 969	78 421
Taxes outstanding and other short-term claims..	22 814	18 018	17 553	11 676	8 371	25 264	44 048	34 753	79 620	68 502
General government net debt.....	143 180	165 494	179 298	191 522	196 531	180 713	146 984	161 062	182 055	171 899
Central government.....	130 602	144 858	155 390	168 224	172 256	151 297	118 815	127 358	145 540	132 553
Local governments.....	14 552	22 185	25 130	24 190	25 038	30 089	28 663	34 173	36 961	39 770
Social security system.....	-1 974	-1 549	-1 222	- 892	- 763	- 672	- 494	- 469	- 446	- 424
Percentage of GDP										
General government gross debt.....	53,4	55,8	59,3	56,7	53,3	48,4	43,5	41,2	46,3	41,1
Domestic debt.....	27,5	28,8	30,1	28,5	27,7	26,4	22,7	18,8	-	-
Foreign debt.....	25,9	27,0	29,2	28,2	25,6	22,0	20,8	22,4	-	-
General government total claims.....	18,7	18,1	19,6	17,1	15,8	17,3	20,0	17,3	19,1	15,3
General government net debt.....	34,7	37,7	39,7	39,6	37,5	31,2	23,6	23,9	24,5	21,9

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