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Treasury finances, January-August 2005

The cash surplus from operations amounted to 16.3 billion krónur in the first eight months of this year, 33.5 billion more than had been projected and 23.1 billion more than at the same time a year ago. Revenue increased by 38.3 billion from last year and expenditure by 14.4 billion. The net financial surplus amounted to 27.6 billion, compared to 1.1 billion last year.

Total revenue amounted to 219.3 billion krónur, an increase of 38.3 billion, or 21 per cent. Tax revenue amounted to 200.6 billion, increasing by 18.5 per cent, substantially more than had been projected. Taking 3.8 per cent inflation into account, the real increase came to 14.2 per cent.

Taxes on income and profit amounted to 61.6 billion, increasing by 15.5 per cent. The personal income tax increased by 10.4 per cent, the corporate income tax by 10.9 per cent and the capital income tax by 45 per cent, equivalent to about a 40 per cent increase in real terms. The social security tax amounted to 21.1 billion, an increase of 16.6 per cent, compared to a 6.6 per cent increase in the wage index. Taxes on assets and net wealth rose by 45 per cent in real terms, mostly on account of the stamp tax levied on real property transactions that have been quite lively this year. Other revenue amounted to 18.1 billion and rose by 6.6 billion between years, mostly due to dividends from Iceland Telecom and fines levied on oil companies.

The development of indirect taxes, especially of the value added tax, reflects the development of demand in the economy. Indirect taxes rose by 18.4 per cent in nominal terms and 14.1 per cent in real terms. The value added tax increased by 21.1 per cent. Excise taxes on vehicle imports rose by 71.6 per cent, reflecting a 62.6 per cent increase in vehicle imports.

Total expenditure amounted to 203.8 billion krónur, increasing by 14.4 billion of which 5.4 billion is due to an interest payment on a large savings bond issue that matured this year, along with accumulated interest. Excluding interest, expenditure rose by 9 billion or 5 per cent between years. About 65 per cent of total expenditure or 131.6 billion goes to social services, health and education. Together, expenditure in these categories rose by 8.2 billion or 6.7 per cent. Of this amount, 3.9 billion went towards health and 2.8 billion to education. Expenditure on social security rose considerably less, by 1.1 billion. Expenditure in other categories rose less, and outlays for roads and other communications declined.

The scope for using fiscal policy in the business cycle

The most recent Economic forecast of the Ministry, published at the beginning of this month, contains a special section with a discussion on the scope for using fiscal policy in the business cycle. Due to the substantial power project investments, demand pressures in the economy have temporarily increased. In order to prevent overheating, the Government has presented tight fiscal budgets for 2004-2006. The Central Bank has also significantly increased its policy rate in order to prevent an increase in inflation. The fiscal surplus has increased sharply and will peak this year. In spite of this achievement, there are some demanding more fiscal restrictiveness. This section discusses what reasonably can be expected from fiscal restraint.

Due to the substantial power project construction, which has the aim of increasing the potential growth rate, a temporary demand pressure has emerged in the economy. The goal of economic policy is to prevent inflation pressures from emerging. The Central Bank has increased its policy rate from 5.3 per cent in May 2004 to 10.25 per cent in October 2005 and announced at the same time that further increases could not be excluded. The Government has pursued a tight fiscal policy, and the 2005 fiscal surplus is estimated at 2.8 per cent of GDP on a national accounts basis. The budget improvement is expected be close to 5 per cent of GDP from 2003 to 2005, which is one of the best results among the OECD countries in this period. The 2006 budget is estimated to deliver a surplus of 1 per cent of GDP. The sales proceeds from the privatisation of Iceland Telecom are not included in these figures, but the use of the proceeds to repay public debt abroad and invest in Central Bank bonds is also having an effect to improve the budget position and reduce demand pressures further in the economy.

In addition to a tight fiscal policy in 2004-2006, the Government has outlined a Medium-Term Programme that postpones public investments in 2004-2006 and then to increase them again in 2007 and 2008 when power project construction has tapered off. Growth in public consumption is to be held below 2 per cent a year and transfer payments below 2.5 per cent a year. At the same time, personal income tax rate is being cut in 2005-2007 to allow taxpayers to share in the improvement in public finances.

A recent research report of the OECD discusses to what extent fiscal policy can be used in countering overheating in small, open economies in the Euro-area. The main conclusions of the report are as follows:

i) Automatic fiscal stabilisers only help to a limited extent to mitigate demand shocks.

ii) The fiscal multiplier is not large in small, open economies. Large swings in fiscal finances are needed to dampen business cycles.

iii) Large swings in government expenditures and revenue undermine the stability and credibility of public finances in the medium term.

The above-mentioned report examined on one hand the market conditions that tend to prevent overheating of the economy and automatic fiscal stabilisation on the other. The reasoning is that market forces in small, open economies will more easily react to changing circumstances, once the proper market conditions are at hand. Strong competition, business integration between countries, a flexible labours market and wage comparisons between larger areas all serve to temper economic imbalances. An active short-term fiscal policy with large swings in taxation and government expenditure would only distort the market mechanism, create uncertainty and undermine the credibility of fiscal policy in the longer term. Aside from automatic fiscal stabilisers, it is probably better to adhere to a long-term fiscal goal and let market forces deal with short-term cyclical correction.

Imports in September

Merchandise imports amounted to 27 billion krónur in September, excluding ships and aircraft. These figures indicate that September is one of the strongest import months this year exceeding June imports of 26.2 billion. The main increase from the previous month is due to fuels, 3 billion. On a three-month moving average basis, imports increased by nearly 40 per cent from the previous year.

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 - September	3.4	4.8
Core inflation -September	2.8	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
Unemploym.in % August	2.9	1.8

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