

# English translation of the Weekly Web Release



MINISTRY OF FINANCE IN ICELAND

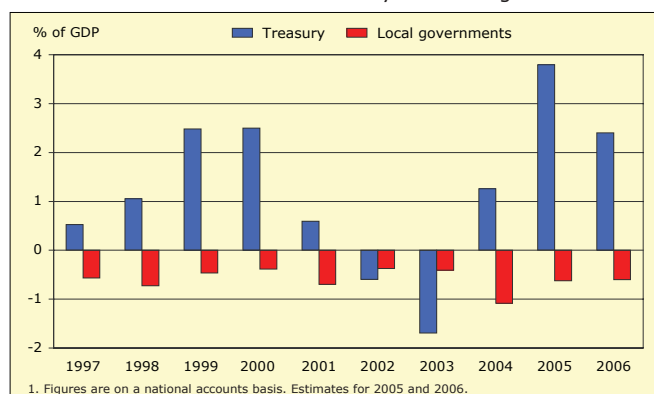
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## The role of local governments in economic policy

There has been considerable discussion lately of the need for increased restraint in economic policy, especially since latest economic data indicate that the imbalance in the economy is greater than earlier data indicated. In light of these developments, the Central Bank has recently raised its policy rate in larger steps than before. The need for increasing fiscal restraint has also been frequently discussed.

In this respect, it must be pointed out that public finances cover the Treasury as well as local governments. As can be seen in the chart below, the Treasury has been operating with an impressive surplus for most of the past ten years, peaking last year with a surplus of nearly 4 per cent of GDP. By comparison, local governments have been running deficits for the past ten years, reaching a peak of 1.1 per cent of GDP in 2004, or about 10 billion krónur. Last year, the deficit is thought to have declined slightly, to about 0.6 per cent of GDP, and a similar deficit is expected this year. This means that local governments are gradually accumulating debt. Total local government debt is expected to reach 150 billion krónur this year, exceeding their annual revenue.

Revenue balance of the Treasury and local governments<sup>1</sup>



Investment by local governments is crucial for their financial balance. Their investment amounted for example to 20 billion krónur or more than 17 per cent of their total revenue in 2004 and is estimated at 11 per cent this year which in part explains the reduced deficit. Since the share of local government in the public sector is close to 30 per cent, it is important that they act in concert with the Treasury in their fiscal finances by slowing down the growth of expenditure when revenue increases rapidly. By these means they can reduce debt and strengthen their financial position, thus contributing to economic stability.

## World economic growth is accelerating

World economic growth has been increasing in recent years and is expected to approach 5 per cent this year and next. The pace of globalisation has increased the participation of populous developing countries in Asia, Latin America and Africa where economic growth has been high, in some cases reaching 10 per cent a year. Growth in OECD countries, that include Iceland's major trading partners, is expected to be considerably less, averaging 3 per cent this year and next. World trade has increased at an 8 per cent rate in recent years, a development that is expected to continue.

Growth differs considerably amongst OECD countries, since conditions vary. Growth has been scant in the euro area. The growth of employment and demand has been negligible in Germany, France and Italy, in part due to structural problems in the labour market. A low policy rate and growing demand from the rest of the world are however expected to stimulate euro area growth, bringing it to some 2 per cent this year and next. Growth in the US has reached 3.5 per cent in recent years. A low policy rate has stimulated demand but also led to an imbalance on the external account.

Annual GDP growth, per cent	2005	2006	2007
Euro area	1.4	2.1	2.2
United States	3.5	3.5	3.0
United Kingdom	1.8	2.4	2.9
Nordic countries	2.7	3.3	2.8
Japan	2.7	3.0	3.3

Source: OECD, April 2006.

Treasury finances have been run at a deficit. Due to a rising policy rate and measures designed to reduce the Treasury deficit, it is estimated that US growth will be about 3 per cent in 2007. Growth in the UK and the Nordic countries is increasing to nearly 3 per cent next year. Growth in Japan is now up to 3 per cent and is forecast to increase next year. The Japanese policy rate has been unusually low for several years.

## Treasury finances, January-April 2006

Data for [Treasury finances](#) for the first one-third of the year are now available. The surplus of cash from operations amounted to 24.1 billion krónur, 13 billion more than at the same time a year ago and 22.3 billion more than has been forecast in the Treasury's cash projections. Revenue increased last year's figure by 10.3 billion, whereas expenditure declined by 2.7 billion. The net financial surplus amounted to 21.9 billion, 2.5 billion more than last year.

Total Treasury revenue amounted to 124.6 billion, 10.3 billion or 9 per cent more than last year. When account is taken of a shift between months of the collection of corporate income tax, the increase amount to 6.2 per cent. Tax revenue, including social security taxes, amounted to 114 billion krónur, an increase of close to 12 per cent, whereas inflation was 4.6 per cent at the same time, leaving a real increase of 7 per cent.

Taxes on income and profit amounted to 47.7 billion, increasing by 12.1 billion or 34 per cent. The increase is mostly due to rising revenue from capital income tax that amounted to 13.9 billion, an increase of 44 per cent. Five billion krónur of the increase in revenue from corporate income tax is explained by the aforementioned shift between months. Proceeds from social security tax also rose from last year, or by 14.3 per cent, when the wage index rose by 8.5 per cent. Taxes on net wealth and assets amounted to 3.6 billion and declined by 29 per cent. Of this amount, the stamp tax amounted to 2.8 billion, having declined by 15.3 per cent.

Indirect taxes amounted to 53 billion, increasing by 6.5 per cent or by 1.8 per cent in excess of the rise in the CPI. Revenue from value added tax rose by 4.2 per cent, equivalent to an 0.4 per cent decline in real terms. This is due to a change in legislation that provides for a longer payment period for the value added tax and customs duties.

The excise tax revenue at the point of import on motor vehicles rose by 42 per cent, a considerable increase. New vehicle registrations rose by 16.8 per cent in the first four months of this year, but the rate of increase has declined in recent months.

Total expenditure amounted to 100.5 billion, declining by 2.7 billion or 2.7 per cent. The decline is wholly due to a 7.6 billion decline in interest payments, since a large savings bonds issue matured in April last year, together with accumulated interest. Excluding interest payments, expenditure rose by 4.8 billion or 5.3 per cent. Expenditure on health rose by 1.8 billion and by 1.5 billion for social security and welfare. For education, the increase was 1.1 billion. These three expenditure categories account for about two-thirds of total expenditure. Spending on law enforcement rose by 0.4 billion and expenditure on culture by the same amount. This is offset by an 0.8 per cent decline in expenditure on economic affairs, mostly due to lower outlays for roads and harbours.

Treasury revenue January-April	2004- 2005	2005- 2006
12 month changes (%)		
Total tax revenue	21.0	15.0
Taxes on income & profit	18.0	34.0
Taxes on property	64.4	-29.1
Taxes on goods & services	19.7	6.5
Social contributions	23.1	14.3
Total revenue	25.4	9.0

Treasury expenditure January-April	2004- 2005	2005- 2006
12 month changes (%)		
General public services	122.5	-30.7
Health	52.4	6.9
Social security & welfare	47.8	6.6
Economic affairs	46.0	-6.7
Education	41.0	10.4
Total expenditure	58.7	-2.7

Treasury finances January-April	2005	2006
12 month changes (%)		
Cash from operations	13.092	24.347
Net financial balance	19.356	21.869
Debt redemption	-29.826	-31.685
Gross borr. requirement	-11.670	-11.136
Net borrowing	13.949	6.456
Overall cash balance	2.279	-4.680

Economic indicators	2004- 2005	2005- 2006
12 month changes (%)		
Inflation (May)	2.9	7.6
Core inflation (May)	3.4	6.4
Wage index (April)	6.7	8.4
Total turnover (Jan. - Feb.)	5.9	9.2
Retail turnover (Jan. - Feb.)	1.8	6.5
Unemployment rate (April)	2.1	1.1