INTERNATIONAL
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Iceland

Toward a New Organic Budget Law

January 2012

**Richard Hughes, Tim Irwin, Iva Petrova, and
Edda Karlsdottir**

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TOWARD A NEW ORGANIC BUDGET LAW

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Contents Page

Tables

Figures

Boxes

Appendixes

ABBREVIATIONS

CBI	Central Bank of Iceland
FAD	Fiscal Affairs Department
FRA	Financial Reporting Act 1997
GAAP	Generally accepted accounting principles/practice
GFSM	Government Finance Statistics Manual
HFF	Housing Financing Fund
INAO	Icelandic National Audit Office
IFRS	International Financial Reporting Standards
IPSAS	International Public Sector Accounting Standards
LG	Local government
LGA	Local Government Act
MoF	Ministry of Finance
MTBF	Medium-Term Budget Framework
MTFS	Medium-Term Fiscal Strategy
OECD	Organization for Economic Cooperation and Development
OBL	Organic Budget Law
PPP	Public-Private Partnership
StatIce	Statistics Iceland
TA	Technical assistance

PREFACE

In response to a request from the Minister of Finance, a technical assistance (TA) mission from the Fiscal Affairs Department (FAD) of the IMF visited Reykjavik during the period October 18–31, 2011 to advise on the structure and content of a new organic budget law (OBL) for Iceland. The mission was led by Richard Hughes and included Tim Irwin, Iva Petrova (all FAD), and Edda Ros Karlsdottir (IMF Resident Representative's Office).

The mission builds upon the findings and recommendations of previous FAD TA missions to Iceland. This mission was organized around a series of discussions with an OBL Reference Group assembled by the Ministry of Finance (MoF) to act as the mission's principal interlocutors. The members of the Reference Group were:

- from the MoF: General Secretary Guðmundur Árnason, Directors General Maríanna Jónasdóttir, Nökkvi Bragason, and Þórhallur Arason, Heads of Division Björn Þór Hermannsson, Elín Guðjónsdóttir, Ingþór Karl Eiríksson, and Ólafur Reynir Guðmundsson;
- from the Ministry of Economic Affairs: Hallgrímur Guðmundsson;
- from Statistics Iceland: Director General Ólafur Hjálmarsson and Head of Unit Jóhann Rúnar Björgvinsson;
- from the Government Financial Management Authority: Director General Gunnar Hall and Head of Division Pétur Jónsson;
- from the National Audit Office: Auditor General Sveinn Arason, Directors Ingi K. Magnússon and Jón Loftur Björnsson;
- from the Central Bank: Gunnar Gunnarsson and Markús Möller; and
- from the Parliament (Althingi): Budget Committee Secretaries Sigurður Rúnar Sigurjónsson and Ólafur Elfar Sigurðsson.

The mission also met with other stakeholders in the budget process including:

- from the Budget Committee of the Althingi: Chairwoman Sigríður Ingibjörg Ingadóttir and other Members of the Committee;
- from ministries: Permanent Secretary Ragnhildur Hjaltadóttir, Directors General Hermann Sæmundsson and Jón Magnússon, Stefanía Traustadóttir, Jóhannes Finnur Halldórsson, and Eiríkur Benónýsson at the Ministry of Interior; General Director Gísli Þór Magnússon, Marta Skúladóttir, and Leifur Eysteinsson from the Ministry of Education; Sigurður Guðmundsson and Hrafn Steinarsson from the MoF;
- from the municipal sector: Gunnlaugur Júlíusson (Chief Economist) and Benedikt Valsson of the Local Government Association; Birgir Björn Sigurjónsson (Director of

Finance) of the City of Reykjavík; and Financial Directors of Capital Area municipalities; and

- from other government agencies: General Director Hreinn Haraldsson, Director of Finance Hannes Sigurðsson, Director Kristín H. Sigurbjörnsdóttir, and Project Leader Eiríkur Bjarnason of the Iceland Road Administration; Managing Director Guðmundur Ragnar Jónsson and Head of Internal Audit Gunnlaugur Jónsson of the University of Iceland; and General Director Björn Zoëga of the University Hospital.

The mission would like to thank all of the above for the frank and open exchanges of views on all matters discussed. In particular, the mission acknowledges the work of Ólafur Reynir Guðmundsson, Ingþór Karl Eiríksson, and Björn Þór Hermannsson in supporting the work of the mission before, during, and after its time in Reykjavik.

EXECUTIVE SUMMARY AND OVERVIEW

Iceland's emergence from the 2008 economic crisis presents a unique opportunity to revisit the laws and procedures that shaped fiscal decision-making over the past decade. In the ten years before the crisis, fiscal policy in Iceland was characterized by pro-cyclicality, weak budget discipline, lack of coordination between levels of government, and inadequate surveillance and management of fiscal risks. Many of these shortcomings can be traced back to weaknesses in the legal framework for budgeting. Over the past few years, the exigencies of the crisis have compensated for some of these legal shortcomings and the government has also developed a number of good budgetary practices. However, with the pressures of the crisis abating, there is a need to develop a new organic budget law to preserve fiscal discipline, restore fiscal sustainability, and prevent a reversion to the more permissive practices of the past.

Iceland's Ministry of Finance (MoF) has seized this opportunity by establishing a Reference Group comprising the main stakeholders in the budget process to develop a new legal framework for budgeting.[1] The Reference Group has been tasked with evaluating the strengths and weakness of the current legal framework and making recommendations on the form and content of a new organic budget law (OBL). The objectives of this new OBL are to:

- address the gaps, loopholes, and inconsistencies in the current legal framework that contributed to fiscal indiscipline before the crisis;
- codify the good budget practices that Iceland has developed since the crisis;
- provide a firm legal foundation for sustainable fiscal policy going forward; and
- put Iceland at the forefront of international budget practice.

During its two week visit from October 18-31, 2011, the mission held a series of discussions with the Reference Group and other participants in the budget process. This report and its recommendations are an initial contribution to the Group's ongoing deliberations.

In designing a new OBL, it is important to preserve the many good features of Iceland's current legal framework for budgeting. Iceland's current organic budget legislation, embodied primarily in the 1997 Financial Reporting Act (FRA):

- is admirably concise and clearly written, with more detailed operational guidance confined to regulations;

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[1] The Reference Group comprised representatives from the Ministry of Finance, Government Financial Management Agency, Ministry of Economic Affairs, Budget Committee of Parliament, Iceland National Audit Office, Statistics Iceland, and the Central Bank of Iceland. A full list of participants is listed in the Preface.

- is relatively comprehensive in that it applies not only to the central government's budget but also to all of the entities and corporations it controls;
- includes a clear categorization of central government institutions for the purposes of financial management and control;
- specifies the required content of key financial documents including the annual budget and final accounts; and
- ensures that both documents are prepared according to the same accounting standards to allow for comparability between plan and outturn.

At the same time, any new OBL should address the key weaknesses in the FRA that prevent it from providing a credible, integrated framework for budgeting. Specifically:

- the **coverage of the FRA** excludes municipalities and their corporations and focuses primarily on *ex post* financial accounting and reporting;
- the law is completely silent on the principles and procedures for **macroeconomic forecasting and fiscal policy-making** and their link to the annual budget;
- the law envisages a relatively unconstrained and fragmented **budget formulation** process in which the country's 260 individual agencies (rather than their parent ministries) are the focus of budget discussions;
- the **budget execution** provisions of the FRA include a number of loopholes that enable the government to overspend its budget with relative impunity; and
- the FRA's **fiscal reporting** provisions were ahead of the standards that existed at the time and are still ahead of most countries' reporting practices today. However, international accounting standards have moved on and the crisis has revealed the need for more comprehensive and timely information to inform fiscal decisions.

To addresses these weaknesses and reflect the lessons from international experience with budget system laws, Iceland's new OBL should incorporate the following reforms:

- **Legal Construction:** the institutional coverage of the OBL should be expanded to encompass the whole public sector and incorporate an integrated timetable for the entire budget process—from fiscal policymaking through to end-of-year accounting;
- **Macro-fiscal Policymaking:** the OBL should incorporate a set of fiscal responsibility provisions that oblige each new government to articulate and adhere to a comprehensive, legally binding, and independently monitored fiscal strategy;
- **Budget Formulation and Approval:** the OBL should promote a more disciplined and policy-oriented approach to budget decision-making by reducing the number of appropriations, adopting a top-down sequence to budget preparation and approval, and increasing ministerial responsibility for budget management;

- **Budget Execution and Treasury Management:** the OBL should ensure the annual budget is respected during implementation by tightening the rules around ministries' rights to retain revenues and carryover past underspends, requiring parliamentary approval of a Supplementary Budget *before* an appropriation can be exceeded, and establishing a more credible array of sanctions for unauthorized overspending; and
- **Fiscal Reporting:** the OBL should ensure the government is held to account for its fiscal performance by requiring the submission of more comprehensive and timely financial reports that are prepared according to international accounting standards.

The mission's specific findings and recommendations in the above areas are summarized in the rest of this section and discussed in detail in the body of this report. A complete list of recommendations is provided in Appendix 1.

Construction of the Organic Budget Law (Chapter I)

In designing the overall architecture of the OBL, the government should aim for a single integrated act that applies to all public institutions and covers all phases of the budget cycle. Iceland has a relatively large municipal and public corporations sector by advanced country standards, and the recent crisis has highlighted the substantial fiscal risks that these sectors can pose to central government. The new law provides an opportunity to improve fiscal coordination between central government, municipalities, and public corporations and bring central government's *de jure* fiscal powers into line with its *de facto* fiscal responsibilities. The OBL should also take a holistic view of the budgeting system and address the gaps in the current legal framework in the areas of macro-fiscal policy and budget formulation. Finally, the law should attempt to integrate the timetables for, and strengthen the interactions between, the four main phases of the budgeting cycle: fiscal policymaking, budget formulation, budget execution, and accounting. This would enable the different elements of the budget cycle to reinforce each other and bolster the integrity and credibility of the public finances as a whole.

Macroeconomic and Fiscal Policymaking (Chapter II)

To provide a more transparent and credible framework for macroeconomic and fiscal policymaking, the OBL should include a comprehensive set of fiscal responsibility provisions. Iceland's previous efforts to introduce a more rules-based approach to fiscal decision-making suffered from a lack of clear grounding in law, weak political commitment from Cabinet and the Althingi, and low visibility with the public. The macro-fiscal section of the OBL should address this by:

- establishing a **procedural fiscal rule** anchored in a set of permanent principles for fiscal policymaking;
- requiring each newly elected government to submit to the Althingi a **Statement of Fiscal Policy** setting out its numerical fiscal objectives for the tenure of the Parliament and demonstrating how they are consistent with the above principles;

- obliging the government to present an annual **Medium-term Fiscal Strategy** to the Althingi for debate in the Spring and to seek its endorsement of the key economic, fiscal, budgetary, and policy parameters for ministries, municipalities, and public corporations to use in preparing their budgets for the coming year; and
- strengthening arrangements for **independent evaluation** of the government's *ex ante* fiscal forecasts and its *ex post* fiscal performance, drawing on existing institutional arrangements.

Budget Formulation and Approval (Chapter III)

To ensure that the government's fiscal objectives shape the formulation of the annual Budget, the new OBL should also institutionalize a more comprehensive, orderly, and policy-oriented approach to budget preparation and approval. In the decade before the crisis, budget formulation was characterized by a steady increase in the expenditure level as the budget passed through the Cabinet and Althingi. Arresting this upward drift in spending during budget preparation will require the OBL to:

- bring forward to early September the **deadline for submission of the Budget Bill** and require it to be accompanied by a **Medium-term Budget Strategy** that demonstrates its consistency with the government's stated fiscal objectives;
- reduce the **number of appropriations** by two-thirds from over 900 to around 300 by elevating the basic unit of appropriation from the agency to the ministry level and grouping agencies into three to five policy-based programs per ministry;
- give ministries greater **flexibility to reallocate resources** within their budgets to meet spending pressures that emerge during budget execution;
- establish a central, unallocated **contingency reserve** in the Budget with clear access criteria and reporting requirements;
- move from a bottom-up to a **top-down sequence to budget approval** in the Althingi and ensure that any legislative **amendments to the Budget Bill** are consistent with the fiscal strategy approved in the Spring; and
- expand the **range of budget approvals** to encompass borrowing by all public sector entities, public-private partnerships, and other multi-year commitments.

Budget Execution and Treasury Management (Chapter IV)

Ensuring the approved budget is respected during execution will require the closing of the loopholes in the current law that enable budget-holders to exceed their appropriations without being sanctioned. Over the past decade, Iceland has overspent its approved budget by around 12 percent on average and has had one of the poorest track records in enforcing budget discipline in the advanced world. Re-establishing the credibility of the annual budget as the principal tool for enforcing fiscal discipline will require the budget execution and treasury management section of the OBL to:

- place an obligation on all public entities to **manage cash efficiently;**
- tighten the rules concerning the **retention and earmarking of revenues**;
- restrict the **carryover** of underspending and abolish the carryover of overspending from one year to the next;
- require the Althingi to approve a **Supplementary Budget** *before* any overspending can take place, with the exception of a small number of mandatory items; and
- treat all other spending not authorized *in advance* by the Althingi as "in excess," and expand the **range of sanctions** for excess expenditure beyond the current "soft" and "nuclear" options.

Fiscal reporting (Chapter V)

Finally, if the government is to be held accountable for its fiscal performance, this will require a more comprehensive and timely set of financial reports. While the reporting provisions of the existing law are already relatively good, the new law presents an opportunity to align reporting with the key fiscal risks that Iceland faces today and once again put the country at the forefront of international reporting practice. The main improvements that should be reflected in the reporting section of a new OBL are to:

- accelerate the **timetable for the production of audited consolidated accounts** so that they are available in time to inform the Medium-term Fiscal Strategy in April;
- improve the **consistency of budget forecasts and end-of-year accounts** by requiring both to be prepared on the same accounting basis;
- expand the **coverage of public institutions** in fiscal statistics and financial statements to provide better information on the consolidated finances of the public sector;
- broaden the **coverage of fiscal flows and assets and liabilities**, so that, for example, the central government recognizes physical assets on its balance sheet, including those related to long-term leases and public-private partnerships; and
- adopt **International Public Sector Accounting Standards** (IPSAS) to ensure that financial reporting continues to follow good practice.

I. CONSTRUCTION OF THE ORGANIC BUDGET LAW

1. **The development of a new organic budget law (OBL) presents an opportunity not only to improve individual elements of the budget process but also to strengthen the integrity of budgeting system as a whole.**[2] The legal framework for public financial management in Iceland, as embodied in the 1997 Government Financial Reporting Act (FRA), the recently amended 2011 Althingi Procedures Act, and related acts[3] is relatively clear, concise, and comprehensive by international standards. However, it does include a number of gaps and inconsistencies that should be addressed as part of any comprehensive reform. In particular, there is a need to revisit:

- the institutional **coverage** of the legal framework, which currently applies to central government ministries, agencies, and corporations but excludes municipalities and their corporations;
- the **scope** of the legal framework, which primarily concerns itself with annual budgeting and accounting but is largely silent on (i) the procedures for *ex ante* fiscal policy-making and medium-term budget planning and (ii) the linkages between *ex post* accounting, audit, and sanctions; and
- the **timetables** for the different phases of the budget cycle, which are characterized by a number of discontinuities that weaken the transparency, discipline, and integrity of the budget process.

A. Coverage of the New Organic Budget Law

2. **Iceland's municipal and public corporations sectors are relatively large by international standards, and both have historically operated with a large degree of fiscal autonomy.** As shown in Figures 1.1 and 5.2, Iceland's 76 municipalities account for around 26 percent of public sector expenditure and 15 percent of public sector liabilities. This compares with an OECD average of around 18 percent of public expenditure taking place at the local government level, and the trend in Iceland is toward further devolution of responsibilities to municipalities. Iceland's public corporations account for around 26 percent of public sector expenditure and 32 percent of public sector liabilities, with the national energy company (Landsvirkjun) and the Housing Financing Fund (HFF) accounting for a large share of the total.

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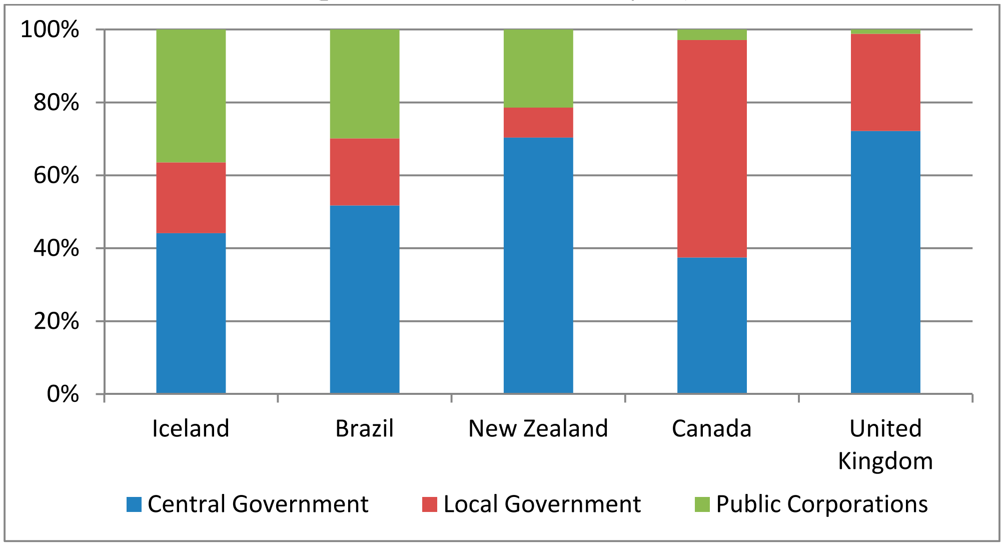
[2] For an overview of the scope and content of organic budget laws, see Lienert and Fainboim (2010), *Reforming Budget System Laws,* IMF Technical Note, Fiscal Affairs Department.

[3] The Constitution, 1997; National Audit Act, 1997; State Guarantee Act; and 2007 Public Procurement Act.

Figure 1.1: Composition of Public Sector Expenditure
(percent, latest available year)



Source: National authorities' public finance statistics

3. **The new OBL provides an opportunity to improve the fiscal coordination between different parts of the public sector and bring central government's *de jure* financial powers into line with its *de facto* fiscal responsibilities.** The impact of the crisis has highlighted the risks that municipalities and public corporations can pose to the central government finances and the need to enhance central oversight of and coordination with these sectors (see Chapter V). At the municipal level, this fact was acknowledged in the recent passage of the 2011 Local Government Act which establishes new fiscal rules for municipalities together with enhanced arrangements for fiscal oversight of municipal finances and new fora for central-local fiscal coordination. In the public corporations sector, the Central Bank of Iceland (CBI), HFF, and other public corporations have, as discussed in Chapter V, become a major drain on the central government finances partly as a result of the impact of household and corporate debt restructuring on their balance sheets.

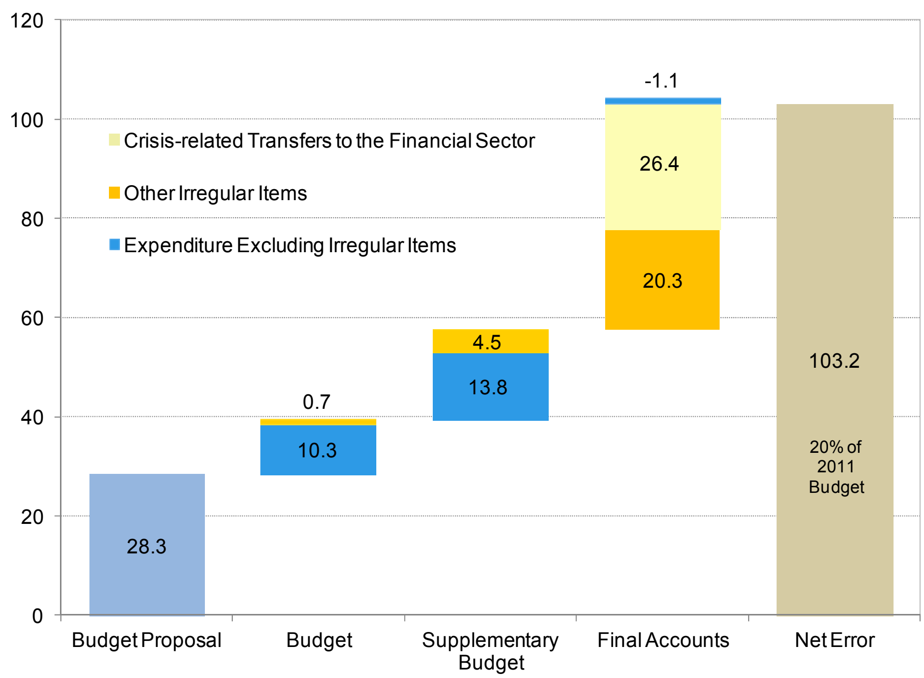
4. ***Recommendation 1.1:* Institutional Coverage**. The provisions of the organic budget law should apply to the whole public sector including central government, municipalities, and financial and nonfinancial public corporations.

B. Scope of the New Organic Budget Law

5. **The new OBL should also look to strengthen public financial management at all phases of the budgeting cycle.** As illustrated in Figure 1.2, the pattern of consistent overspending against medium-term budget plans that has characterized Iceland's financial management over the past decade cannot be attributed to any one stage of the budget process. Rather, over the last 12 years the steady upward drift in expenditure:

- begins during **budget preparation** when the multi-year expenditure frames set in the previous budget are exceeded by around ISK 28 billion;
- continues during **budget approval** when various government- and Athingi-initiated amendments add a further ISK 11 billion;
- carries on during **budget execution** due to Spring wage agreements and other expenditure pressures that add a further ISK 18 billion in the Supplementary Budget; and
- can continue even after the end of the year through various *ex post* adjustments to the **Final Accounts** which add a further ISK 46 billion.

Figure 1.2: Timing of Overspending from Medium-term Plan to Final Accounts
(Average 2000-11, in 2011 ISK billion)



Source: Ministry of Finance; Statistics Iceland; and IMF staff calculations.

6. **Arresting this steady upward drift in the expenditure level will require a more complete and integrated legal framework than currently exists.** In particular, the OBL should look to raise the cost to government of deviating from its stated fiscal objectives by:

- strengthening the legal obligations on government to articulate and adhere to a set of principles and objectives for fiscal policy;
- integrating these more formally into the process of preparing, approving, and executing the annual budget;
- ensuring greater consistency of coverage and accounting between the budget, statistics, and accounts to ensure comparability and accountability;

- formalizing the linkage between the government's stated fiscal policy objectives and the Iceland National Audit Office's (INAO) *ex post* audit of its financial performance; and
- specifying the procedures for following up and, where appropriate, sanctioning any overspending or other financial irregularities identified in the INAO audit report.

7. **One means of doing this would be to use the architecture of the new Act to (i) outline the responsibilities of the different actors in the budget process (Section I); (ii) provide those actors with a single, integrated "journey" through the four key phases of the budget cycle (Sections II-V); and (iii) specify the financial provisions which apply to more autonomous public entities (Section VI).** This would imply an OBL organized around six main sections:

- **Section I: Roles and Responsibilities** would clarify the legal powers and obligations of the Althingi, Government, Minister of Finance, Line Ministries, Municipalities, Public Corporations, INAO, and Statistics Iceland with regard to management of the public finances;
- **Section II: Macroeconomic and Fiscal Policy** would specify the principles and procedures for the formulation, approval, and evaluation of the government's medium-term fiscal policy and strategy;
- **Section III: Budget Formulation and Approval** would specify the process for the preparation, adoption, and modification of the annual budget within that strategy;
- **Section IV: Budget Execution and Treasury Management** would specify the arrangements for the (i) planning, deposit, withdrawal, and control of cash; (ii) acquisition, maintenance, and disposal of assets; and (iii) issuance, management, and extinguishment of liabilities to meet the undertakings set out in the budget;
- **Section V: Accounting, Reporting and Audit** would state the standards, coverage, format, and timetable for the production of government financial reports and accounts, and specify the procedures for addressing any authorized deviations from the approved budget identified by the INAO; and
- **Section VI: Oversight of Municipalities and Public Corporations** would specify the specific financial arrangements that apply to these more autonomous public entities.

8. ***Recommendation 1.2:*** **Architecture of the Law**. The OBL should apply to the whole of the budget cycle and the body of the act should be organized around the four key phases: macroeconomic and fiscal policy; budgeting formulation and approval; budget execution and treasury management; and accounting, reporting, and audit. A more detailed indicative outline for the OBL is provided in Box 1.1.

Box 1.1: Indicative Outline for the Organic Budget Law

Section I. Roles and Responsibilities

a. Minister of Finance and Line Ministers
b. Treasury Secretary, Accountant General, and Accounting Officers
c. Althingi, Committees, and Independent Fiscal Commission
d. Auditor General and National Audit Office

Section II. Macroeconomic and Fiscal Policy

a. Principles for Fiscal Policy
b. Statement of Fiscal Policy
c. Medium-term Fiscal Strategy
d. Budget Orientation Debate
e. Evaluation of Fiscal Performance

Section III. Budget Formulation and Approval

a. Budget Documentation
b. Procedures for Budget Formulation and Approval
c. Unit of Expenditure Appropriation
d. Other Budget Approvals
e. Virement Rules
f. Contingency Reserve

Section IV. Budget Execution and Treasury Management

a. Banking and Cash Management
b. Collection, Deposit, and Retention of Revenues
c. Authority to Commit and Spend Public Funds
d. Authority to Issue Loans, Offer Guarantees, and Sell Assets
e. Carryover of Appropriation
f. Supplementary Budgets
g. Treatment of Excess Expenditure

Section V. Accounting, Reporting, and Audit

a. Coverage and Standards of Accounting
b. Timetable for Preparation, Consolidation, and Submission of Accounts
c. External Audit, Follow-up, and Sanctions

Section VI. Oversight of Municipalities, Public Corporations, and Other Bodies

a. Extra-Budgetary Funds
b. Municipalities
c. Public Corporations
d. Other Bodies

C. Budget Calendar

9. **Strengthening the integrity of the budget process depends not only on ensuring that all the legally required elements are in place but that they inform and reinforce each other.** Some of the key weaknesses in Iceland's budgeting system can be traced back to inconsistencies in the budget timetable which are illustrated in Table 1.1. In particular:

- the government's Medium-term Fiscal Strategy (MTFS) is presented to the Althingi alongside the annual budget in early October, meaning that Parliamentarians have no formal role in defining the strategy and framework for budget preparation;
- the annual Budget Bill is based on an outdated macroeconomic forecast from July and often subject to substantial amendment before it is approved in December. This means ministries, agencies and municipalities find it difficult to finalize their annual budget, cash and work plans much in advance of the financial year;
- authorization of carryovers through a retroactive Final Budget Bill means that the total resource envelope for some institutions is not finalized until several months into the year. Supplementary Budgets can also be approved late in the year imposing large windfalls or cuts in appropriation which entities can find difficult to implement; and
- audited outturn data are available only six months after the end of the year which, while three months ahead of the statutory deadline, is still too late to inform the Spring discussion of the government's fiscal strategy for the coming year.

10. **Many of this report's recommendations therefore relate to the need to integrate the timetables for, and strengthen the interactions between the various phases of the budgeting cycle.** Their goal is to reach a situation, represented in Table 1.2, in which:

- the **MTFS** is presented to and approved by the Althingi in a Budget Orientation Debate in the Spring so that ministries, agencies, public corporations, and municipalities have an agreed framework for the preparation of their budgets;
- the broad parameters of the annual **Budget** itself are voted by the Althingi well in advance of the start of the year so managers can finalize their implementation plans;
- **carryovers and retained revenues** are added to or deducted from budgets prior to the start of the year so that ministries' and agencies' **cash and work plans** can be approved and implemented from January 1; and
- **accounts** are closed, consolidated, and audited in time to inform the Medium-term Fiscal Strategy and Budget Orientation Debate for the next budget.

This would enable the four main elements of the budget cycle to reinforce each other and bolster the integrity and credibility of the system as a whole.

11. ***Recommendation 1.3:*** **Budget Calendar.** The OBL should prescribe a new and better integrated timetable for the budget process in line with that proposed in Table 1.2.

Table 1.1: Iceland: Current Budget Timetable

MONTH	FY+1 Macro & Budget	FY Treasury Management	FY-1 Accounting & Audit	Inconsistency
Jan	MoF prepares initial fiscal projections	Cash & Work Plans implemented	Closure of FY-1 accounts	Cash Plans implemented before carryovers are known
Feb	MoF prepares initial MTFS & budget frames		Mins & Agencies submit annual reports to MoF	Budget frames based on outdated Nov StatIce economic forecast
Mar	Mins submit initial proposals StatIce 1st macro forecast		LGs & PC submit annual reports to MoF	Initial Min proposals unconstrained by frames
Apr	MoF submits revised MTFS & budget frames to Cabinet	Stock of carryovers from FY-1 provisionally confirmed		FY-1 outturn too late to inform MTFS & budget frames
May	MoF issues budget circular based on MTFS ceilings	Althingi reviews Q1 execution	MoF submits Consolidated Accounts to INAO	FY-1 audited outturn too late to inform MTFS & budget frames
Jun	Mins submit budget requests to MoF within MTFS ceilings	Stock of carryovers from FY-1 confirmed	INAO submits audited accounts to Althingi	FY resource envelope for Mins & Agency only clear in June
Jul	StatIce 2nd macro forecast			2nd StatIce economic forecast raises doubts about Fiscal Strategy
Aug	MoF prepares Fiscal Strategy & Budget	Althingi reviews Q2 execution	Althingi submits report on FY-2 accounts	No timely Althingi follow-up on FY-1 audit report
Sept	Cabinet approves Fiscal Strategy & Budget			LG & PCs budget submitted to without ex ante framework
Oct	Fiscal Strategy & Budget submitted to Althingi	Govt presents Supplementary Budget	MoF submits Final Budget to Althingi	Althingi only sees fiscal strategy at the end of Budget process
Nov	StatIce 3rd macro forecast 2nd Reading of Budget	Agencies prepare Cash & Work Plans for FY+1		Budget needs to be revised to reflect changes in StatIce forecast
Dec	Budget approved at 3rd Reading	Parliament approves Supplementary Budget	Parliament approved Final Budget	3rd Reading amendments disrupt budget planning

Table 1.2: Iceland: Revised Budget Timetable

MONTH	FY+1	FY	FY-1	Gain from Integration
	Macro & Budget	Treasury Management	Accounting & Audit	
Jan	StatIce 1st Macro Forecast	Cash & Work Plans implemented based on full resource envelope	Closure of FY-1 accounts	Cash & Work Plans based on full resource envelope
Feb	MoF prepares MTFS		Mins, LGs, and PCs submit annual reports to MoF	MTFS prepared informed by LG & PC outturn
Mar	Cabinet approves MTFS		MoF submits Consolidated Accounts to INAO	Draft MTFS based on Consolidated Outturn
Apr	MTFS Submitted to Althingi		INAO submits Audited Accounts to Althingi	Althingi has input into FY+1 fiscal strategy
May	MTFS endorse by Althingi	Althingi reviews Q1 execution	INAO provides assessment of Govt fiscal performance based on MTFS	MTFS debate informed by FY-1 & FY performance
Jun	MoF issues budget circular based on MTFS ceilings	Stock of carryovers from FY-1 confirmed	INAO provide Althingi with report on overspending and irregularities	FY+1 budget circular includes approved carryovers from FY-1
Jul	Mins submit budget requests to MoF within MTFS ceilings	Ministries budget request include plans for use of FY-1 carryovers	Althingi reviews INAO report & recommends approval or sanction	Overspending & sanctions approved in time to reflect in FY-1 Final Budget
Aug	StatIce 2nd Macro Forecast MoF prepares draft Budget	Althingi reviews Q2 execution		FY+1 Budget based on up-to-date economic forecast
Sept	Cabinet approves Budget Budget submitted to Althingi	Govt presents Supplementary Budget	MoF responds to INAO report & presents Final Budget to Althingi	Budget, Supp Budget, & Final Budget submitted together
Oct		Agencies prepare Cash & Work Plans for FY+1		Agencies can prepare Cash & Work Plans earlier
Nov	Parliament approves Ministry budgets at 2nd Reading	Parliament approves Supplementary Budget	Parliament approved Final Budget	Budget, Supp Budget, & Final Budget approved together
Dec	Full Budget approved at 3rd Reading	Mins approve Cash & Work Plans based on full resource envelope	MoF issues Year-end Circular for FY Accounts	Clear legal basis for preparation of FY Accounts

II. Macroeconomic and Fiscal Policymaking

A. Legal Framework for Macro-Fiscal Policymaking

12. **A macro-fiscal framework defines the principles and procedures through which a government sets, implements, and reports on its objectives for the public finances.** A comprehensive OBL should contain all the key elements of a modern macro-fiscal framework. These are: (i) a statement of the permanent principles or rules that guide fiscal policymaking and the conditions under which those principles or rules can be modified or suspended; (ii) a requirement that the government state its medium-term fiscal policy objectives and justify these with reference to long-term macroeconomic and fiscal trends and risks; (iii) an obligation to present a medium-term fiscal strategy covering at least a five-year horizon and a medium-term budget framework setting multi-year expenditure limits by ministry; (iv) arrangements for seeking Parliamentary input into and endorsement of the government's fiscal objectives and expenditure plans at the start of the budget preparation process; and (v) a mechanism for ensuring independent scrutiny of the government's fiscal policy and performance.

13. **Iceland's legal framework is largely silent on the principles and procedures for macro-fiscal policymaking.** Neither the FRA nor other legislation contains specific fiscal objectives or rules. A form of a medium-term budget framework is prescribed by Article 28 of the FRA, which requires a four-year projection of the public finances and an assessment of the economic impact of fiscal policies. However, these projections are presented to the Althingi alongside the annual budget and therefore play little role in shaping the budget preparation process. While recent amendments to the 2001 Althingi Procedures Act will require the government to present its medium-term fiscal and expenditure plans in April, there is no requirement to periodically present longer-term (more than 30-year) fiscal projections which would demonstrate the long-term sustainability of current policies. Other than a requirement that the annual budget provide information about government guarantees, there is no requirement to provide a comprehensive statement of fiscal risks or explore a range of alternative fiscal scenarios. While the government's budget has, since 2010, been based on macroeconomic projections provided by Statistics Iceland, there is no requirement to compare these forecasts with those of other domestic or international forecasters and explain any differences. Finally, there is also no requirement for independent evaluation of the government's performance against its fiscal targets.

B. Macro-Fiscal Policymaking in Practice

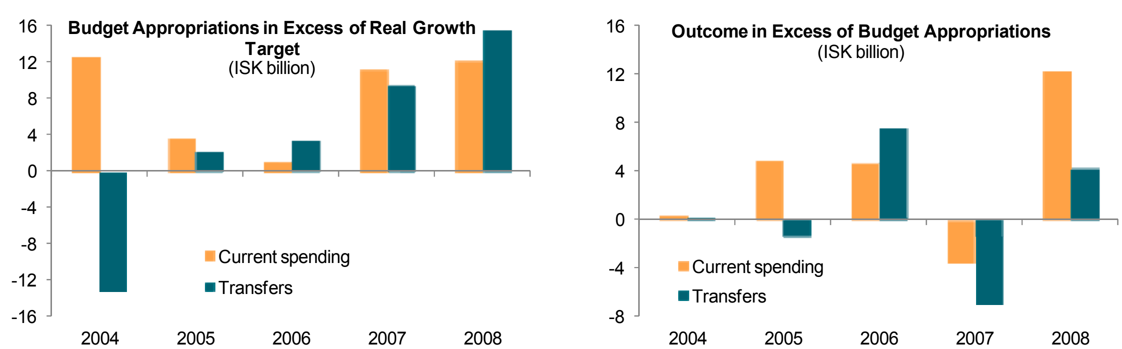
14. **Despite the above gaps in the legal framework, Iceland has developed a number of good fiscal policy practices over the past decade.** Specifically:

- the requirements of Article 28 provided a foundation for the introduction of medium-term "frame budgeting" from the early 2000s, the details of which were elaborated in a 2003 MoF guidance note. A medium-term budget framework (MTBF) has since been prepared in the Spring on the basis of a four-year forecast setting indicative expenditure ceilings by administrative units and project priorities. The framework, which is decided upon by the Government by end-April also guides fiscal policy in the upcoming budget year;

- a 2003 policy declaration of the government—reiterated in subsequent budgets from 2003 to 2008—established a quasi-fiscal rule restraining real growth of central government consumption to 2 percent per year and transfers to 2.5 percent per year. It also committed the government to a policy of maintaining fiscal surpluses for central government; and
- in 2006, the fiscal framework was further enhanced with guidance on frame budget procedures which sought to strengthen the quasi-fiscal rule with a mechanism to correct slippages in expenditure growth. It also clarified the responsibility of ministries to adhere to the medium-term expenditure frames and the role of government in approving amendments to the frames.

15. **In practice, the MoF's attempt to introduce a rules-based fiscal framework without the support of law met with limited success.** Lack of political commitment to the fiscal framework contributed to chronic fiscal indiscipline in the years preceding the crisis. As the rule was not debated, endorsed, or evaluated outside the MoF, budget proposals frequently exceeded the real spending limit. Further upward adjustment during parliamentary approval and lack of discipline during budget implementation meant that actual current spending exceeded the real growth target in each of the five years prior to the crisis by an average of 11 percent over the period, while transfers exceeded the target by an average of 5 percent (Figure 2.1).

Figure 2.1: Overspending Relative to Targets, 2004-08

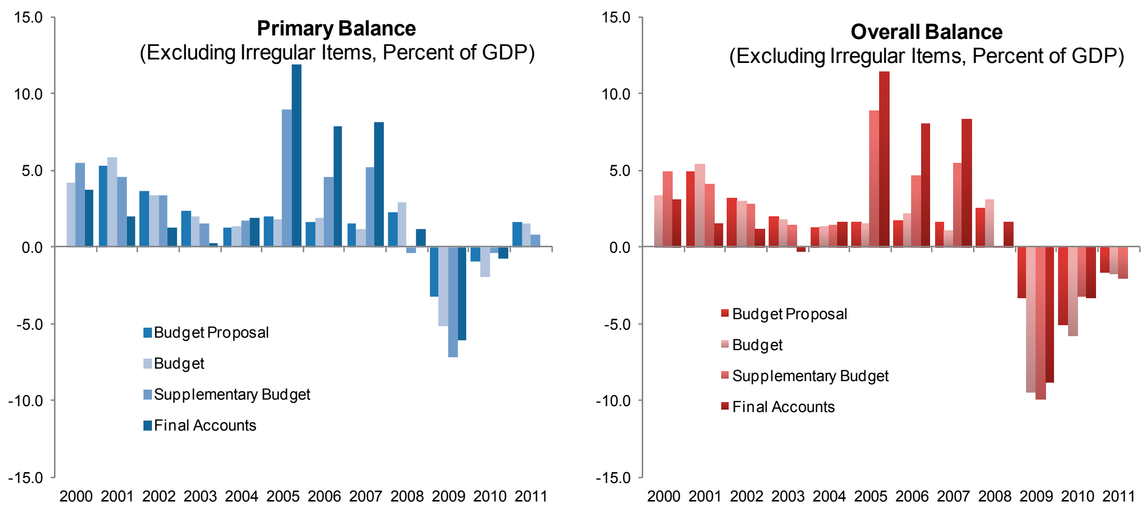


Source: Ministry of Finance; and IMF staff calculations.

16. **The lack of credibility in the fiscal framework was masked by overall good headline fiscal performance in the run up to the crisis.** Fiscal outcomes fared relatively well with respect to the government's objective of maintaining a fiscal surplus for the central government thanks to surging revenues which far exceeded even Supplementary Budget

projections. The weaknesses of the fiscal framework were only exposed with the onset of the crisis, when the fiscal rule was abandoned entirely as revenues collapsed, expenditures spiked, and deficits (excluding bank recapitalization) soared in 2009 (Figure 2.2).

Figure 2.2: Targeted Fiscal Balances, 2000-11



Source: Ministry of Finance; and IMF staff calculations.

17. **The crisis has revealed other underlying weaknesses in these informal procedures for macro-fiscal policy making.** The lack of statutory bases for such procedures has made them easier to overlook and disregard under extreme circumstances. Pressures to introduce, often at short notice, measures required to implement Iceland's adjustment program have also made it difficult to adhere to a well-sequenced fiscal policymaking process. In particular:

- **Fiscal projections:** Frequent substantial revisions to medium-term macroeconomic projections have made the medium-term fiscal targets and nominal expenditure ceilings proposed by the government difficult to adhere to. With high inflation rates—albeit falling below 5 percent more recently—the expenditure ceilings have been considered more as a potential lower limit on spending;

- **Medium-term budget framework**: The abandonment of the Spring discussion between line ministries and the MoF on the overall fiscal strategy and potential revisions to expenditure ceilings has shortened line ministries' planning horizon;

- **Fiscal risks:** There has been limited quantitative analysis of risks to the government's fiscal objectives beyond the potential calling of government guarantees has been limited. A range of macroeconomic and fiscal scenarios has not featured in the preparation of the medium-term fiscal strategy, and contingency buffers have proven inadequate in the face of macroeconomic shocks, negotiation of wage contracts, subsidies to crisis-hit households, and recapitalization of financial institutions.

- **Parliamentary engagement and scrutiny:** While the medium-term fiscal strategy and expenditure framework were discussed in Cabinet in the Spring, they were not presented to the Althingi and the public until its Autumn session. This prevented the Althingi from participating in the definition of the fiscal strategy, formulation of the policies, and planning of the legislation needed to implement it.

- **Intra and inter-governmental fiscal coordination:** Central government has also failed to provide timely information to other government units—such as local governments—on the fiscal effort required to meet its fiscal strategy. The publication of the government's medium-term consolidation plan in July 2009 sought to remedy this, but the practice was not sustained in subsequent years.[4]

Notwithstanding the significant effort and high quality work that goes into preparation of medium-term fiscal forecasts and budget framework, all the above factors mean that they have not lived up to their intended purpose of providing an agreed framework for the preparation, approval, and execution of budgets across the public sector.

C. Implications for the New Organic Budget Law

18. **Introducing a more disciplined, transparent, and consultative approach to fiscal policymaking will require the introduction of a set of fiscal responsibility provisions into the revised OBL**. The provisions should include:

- a procedural fiscal rule anchored in a set of permanent **principles for fiscal policy** set out in the law;

- a requirement that the government submit a **Statement of Fiscal Policy** to the Althingi following each election setting out its **numerical fiscal objectives** which cover at least the length of the Parliament and are consistent with the above principles;

- an annual obligation on the government to present a **Medium-term Fiscal Strategy (MTFS)** to the Althingi setting out (i) its fiscal targets for the central government, general government, and public sector; (ii) nominal expenditure ceilings for each ministry to use in preparing its budget; and (iii) a summary of the specific policy measures required to implement the strategy;

- provision for an annual **Budget Orientation Debate** in the Spring to seek the Althingi's input into and endorsement of the government's fiscal targets, expenditure ceilings, and the legislative changes required to implement them; and

- arrangements for ensuring **independent evaluation** of the government *ex ante* forecast assumptions and *ex post* fiscal performance.

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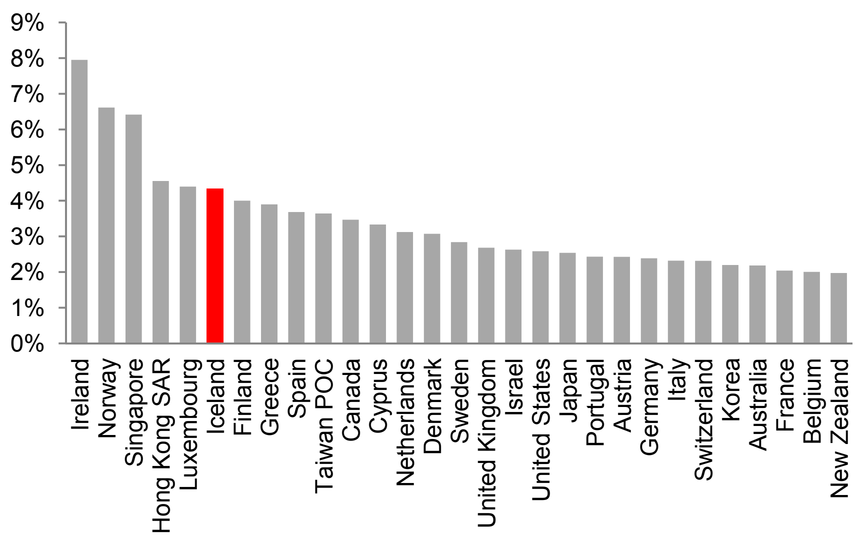
[4] Iceland Ministry of Finance, 2009, *"Measures to Achieve a Balance in Fiscal Finances 2009-2013."*

D. Principles for Fiscal Policymaking

19. **The macro-fiscal section of the law should begin with a statement of the principles and rules that will guide fiscal policy-making in Iceland.** A key decision that needs to be taken at this stage is whether these rules should be:

- **procedural**, in which case the law would include (i) principles for fiscal policy-making, (ii) a requirement for each government to set a numerical objective for one or more fiscal aggregates; (iii) the content of the fiscal strategy statement in which those objectives are set out; (iv) the arrangements for reporting performance against those objectives; or
- **numerical**, in which case the law would set out (i) all of the above plus; (ii) a permanent numerical objective for one or more fiscal aggregates;[5] (iii) the accounting methodology to be used in assessing compliance with the objective; and (iv) an escape clause allowing the government to deviate from its numerical rule under exceptional circumstances.

Figure 2.3: Volatility of Nominal GDP
(2000-2010)



Source: IMF WEO, September 2011

20. **Both Iceland's present fiscal circumstances and the structural features of its economy argue against the adoption of a permanent numerical fiscal rule (Appendix 2).** Iceland's gross general government debt is expected to peak at 100 percent of GDP in 2011,

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[5] For a detailed discussion of numerical fiscal rules, see IMF, 2009, Fiscal Rules—Anchoring Expectations for Sustainable Public Finances.

and the country faces a long period of fiscal consolidation. A numerical rule which is right for this "transitional" period (i.e. one that requires the government to run large fiscal surpluses) is unlikely to strike the right balance between economic stabilization and fiscal sustainability once the government's fiscal consolidation objectives have been achieved. As a very small and open economy, Iceland is exposed to an unusual degree of economic volatility, as illustrated in Figure 2.3. A permanent numerical fiscal rule would either require a complex mechanism to accommodate cyclical and other temporary effects (which would undermine the transparency of the rule) or repeated recourse to an escape clause (which would undermine its credibility).

21. **In view of these considerations, it would be preferable to incorporate a procedural fiscal rule into the OBL supported by strict accountability arrangements.** A procedural rule can cater to both Iceland's current economic circumstances and long-term fiscal challenges, by leaving it to the government of the day to specify its precise fiscal policy objectives. This is also the practice in other Nordic countries, where the fiscal rules are principle-based, and numerical fiscal objectives are not set out in law, but represent high profile political commitments of the governing party or coalition.

22. ***Recommendation 2.1:*** **Fiscal Policy Principles.** The OBL should include a procedural fiscal rule anchored in a set of permanent principles for fiscal policymaking. Examples of the kind of principles that would be appropriate for Iceland would be:

a. **Sustainability:** The government will ensure sustainable levels of public liabilities and net worth.

b. **Prudence:** The government will, on average, maintain a prudent balance between revenue and expenditure which is consistent with achieving *a*.

c. **Economic Stabilization:** Subject to *a* and *b*, the government will contribute to the stabilization of economic activity.

d. **Predictability:** Subject to *a, b,* and *c,* the government will avoid sudden, unexpected changes in revenue and primary expenditure policies.

e. **Transparency:** The government will set clear, measureable, medium-term objectives for fiscal policy which are consistent with *a, b, c,* and *d,* and report regularly on actual and forecast performance against those objectives.

E. Statement of Fiscal Policy

23. **To ensure consistency between the principles set out in the OBL and the actual fiscal policy of the government of the day, there should be a requirement that the government state its fiscal policy objectives at the outset of a Parliamentary term**. The statement should be based on an updated macroeconomic and fiscal forecast and set out how the government will adhere to the fiscal policy principles in the OBL over the course of the Parliament. To ensure that the government's fiscal policy is also consistent with maintaining

sustainability and intergenerational fairness over the long term, the Statement of Fiscal Policy should also present long-term economic and fiscal projections covering 30-50 years and include a range of scenarios based on different assumptions of long-term economic, demographic, and other developments (as recommended in Chapter V).

24. **To enable Parliament and the public to hold the government to account for its fiscal performance, the Statement should set out the numerical fiscal objectives that the government intends to achieve over its tenure**. In most countries these objectives would include a stock aggregate (gross or net debt, or net worth), a balance aggregate (overall balance, primary balance, structural balance, or operating balance), and/or an expenditure aggregate (real or nominal expenditure growth) that define the parameters for fiscal policymaking over the medium-term. To ensure accountability, it is important that the fiscal objectives specify the time period over which the government expects them to be achieved. For illustrative purposes, Appendix 2 looks at the range of possible indicators that the government might consider when preparing such a Statement of Fiscal Policy and highlights the trade-offs involved in specifying objectives that are prudent, flexible, and transparent.

25. **To prevent the government from "shopping" for fiscal indicators at a later stage, the statement should specify *ex ante* the precise indicators and data sources to be used to measure performance against the government's fiscal objectives.** The statement should also contain precise information about which fiscal indicators will be used to set the objectives, how these indicators are measured, and which sources of data will be used should also be contained in the statement. This will prevent the government from changing the indicators or adjusting them at later stages to make fiscal policy implementation appear compliant with its objectives when in fact there have been deviations. It will also aid interpretation and *ex post* evaluation by allowing unambiguous comparison between fiscal objectives and outcomes.

26. **The Althingi should provide an opinion on the Statement of Fiscal Policy and, where appropriate, propose amendments.** The Althingi should be able to draw on independent expertise regarding the consistency of the Statement with the OBL fiscal principles (see Recommendation 2.8). In the event of a crisis or significant changes in the long-term economic outlook for which there is sufficient evidence, the government should be allowed to amend its Statement of Fiscal Policy with the Althingi's approval.

27. **As in other provisions of the OBL, the scope of the government's fiscal policy objectives should be defined as broadly as possible**. The institutional coverage should encompass either the general government or public sector to enhance fiscal coordination between levels of government and improve surveillance of the fiscal risks posed by public enterprises. The annual Medium-term Fiscal Strategy discussed in the next section would then provide a mechanism for setting specific operational targets for different sub-sectors: central government, local government, and public corporations (both financial and non-financial). Monitoring performance against any numerical fiscal objectives set in general

government or public sector terms would require the implementation of the fiscal reporting reforms discussed in Chapter V.

28. ***Recommendation 2.2:*** **Statement of Fiscal Policy.** No later than the first Budget Orientation Debate or Budget following an election, the government should be required to produce a Statement of Fiscal Policy setting out:

a. a post-election economic forecast for the medium term;

b. long-term fiscal projections covering at least 30 years and based on a range of scenarios for important macroeconomic, demographic, and other parameters;

c. numerical fiscal policy objectives for no less than next five years;

d. a small number of indicators that will be used to measure performance against those objectives;

e. the sources of data to be used in measuring performance against those objectives; and

f. a statement of conformity with the government's fiscal principles.

29. ***Recommendation 2.3:*** **Althingi Approval of Fiscal Policy.** The Althingi should approve, amend or reject the fiscal policy objectives in *c.*

30. ***Recommendation 2.4:*** **Revision of the Statement.** The government may submit a revised Statement of Fiscal Policy to the Althingi for approval between elections. The OBL should specify the conditions and procedures under which a revised statement may be presented to the Althingi.

31. ***Recommendation 2.5:*** **Fiscal Objectives:** The Government's fiscal objectives should comprise a combination of (a) a long-term goal for the stock of liabilities or net worth and (b) a medium-term objective for the fiscal balance. Appendix 2 discusses three fiscal objectives that Iceland might consider at this point in time and the pros and cons of each.

F. A Medium-term Fiscal Strategy

32. **The presentation of an annual Medium-term Fiscal Strategy (MTFS) provides the means through which the government operationalizes its Statement of Fiscal Policy.** The MTFS should be submitted to the Althingi in the spring, a development that has been foreshadowed in the recent amendments to the Althingi Procedures Act (Law 84/2011), which calls on the government to submit a three-year budget framework for approval by Parliament no later than April 1each year. The goal of the MTFS should be to translate the numerical fiscal objectives in the Statement of Fiscal Policy into operational targets for different levels of government and multi-year expenditure ceilings for each ministry. These targets and ceilings should be approved by the Althingi and used as the basis for the preparation of individual budgets for the coming year. The MTFS should also include a central unallocated provision to handle contingencies and new policies in later years without

resorting to frequent revision. At least 1 percent of expenditure should continue to be ringfenced for contingencies that arise during the budget year. The provision should be on a rising profile thereafter to reflect the increasing uncertainty and margin for error in later years. For example, in the case of Iceland before the crisis, the one-year expenditure projection error averaged about 1¼ percent of GDP, while the three-year projection error exceeded 2 percent of GDP (see Figure 4.1).[6]

33. **The MTFS should include not only the government's targets for the public finances but also the policies required to ensure they are met.** As such the MTFS should include a summary of the main policy measures that the government proposes to introduce in the annual budget to meet its fiscal targets, along with estimates of the fiscal impact of those measures. To ensure that the government is in a position to implement those policies from the moment the budget is approved, the MTFS should provide a summary of the legislative changes required.

34. **The MTFS also provides a vehicle to enhance fiscal policy coordination within the general government and public sector.** Medium-term fiscal projections should be made available to local governments earlier in the year than they are currently, so local governments can plan for the following year on a consistent basis. The MTFS should identify the policies that affect the operations and mandates of local governments and provide estimates of the impact on local government revenues and expenditures both during the upcoming fiscal year and over the medium term. Box 2.1 provides further discussion of the implications of this report's recommendations for municipalities.

35. **The credibility and durability of a rule-based fiscal framework depends also on the government's ability to contend with a range of macro-fiscal scenarios.** Iceland's adoption of a procedural fiscal rule therefore needs to coincide with more active disclosure and management of fiscal risks. The country faces a wide range of risks to its fiscal outlook in the form of macroeconomic volatility, financial instability, loss-making public enterprises, government guarantees, litigation risks, natural disasters, and increasingly public-private partnerships (PPPs). The 2012 budget proposal already contains a revised and expanded statement of fiscal risks, which is a commendable development. The discussion of fiscal risks in the MTFS should provide a permanent mechanism for demonstrating that fiscal policy is based on prudent macroeconomic and fiscal assumptions. It should also serve as a mechanism for improving the management of fiscal risks by requiring the government to discuss the measures it is taking to mitigate specific risks by, for example, charging risk-based fees for all guarantees, reducing exposure to commercial risks through privatization of

[6] In 2008-11, the one-year projection error increased to 3 percent of GDP, while the three-year projection error increased to 6¾ percent of GDP.

enterprises, improving the regulation of PPPs to ensure proper risk-sharing, and making explicit fiscal provision for unavoidable risks.[7]

36. ***Recommendation 2.6:*** **Medium-term Fiscal Strategy.** By April of every year, the Government should present its Medium-Term Fiscal Strategy setting out:

a. macroeconomic outturn for the last two years and forecast for next five years with comparisons with those provided by independent external and domestic economic forecasters, such as the CBI, commercial banks, IMF, and the OECD;

b. fiscal outturn for the last two years and forecasts for next five years including projections for all of the indicators included in the Statement of Fiscal Policy;

c. targets for at least the next three years for each of the indicators included in the Statement of Fiscal Policy;

d. a list of policies required to meet the fiscal targets and a summary of their fiscal impact relative to a baseline ("policy-off") fiscal scenario;

e. a medium-term budget framework for central government setting out:
   i. an overall expenditure ceiling for the central government budget (Group A) with reconciliation to the budget and ceiling set in the previous budget,
   ii. indicative expenditure ceilings by ministry, and
   iii. an unallocated margin in on a rising profile over the forecast horizon within which at least 1 percent is earmarked for contingencies in budget year;

f. outturn for the last two years and forecast revenues (split into own revenues and transfers), expenditure, and balance for local government for the next five years;

g. a summary of the finances of public corporations for the last two and next five years;

h. a fiscal risk statement showing the impact of alternative economic assumptions and discrete fiscal risks on the government's performance against its fiscal targets; and

i. A statement of compliance with the Government's Statement of Fiscal Policy setting out how fiscal projections are consistent with meeting the government's fiscal policy objectives with confidence.

G. Budget Orientation Debate

37. **Another shortcoming of Iceland's attempts to introduce frame budgeting over the past decade has been the fact that the process takes place entirely within the government.** Neither Parliament nor the public play an active role in the definition of the government's fiscal and budget strategy. This shortcoming should be addressed in the new

[7] For a complete discussion on the management of fiscal risks, see; IMF, 2008, Fiscal Risks—Sources, Disclosure, and Management; and Everaert, G., M. Fouad, E. Martin, and R. Velloso, 2009, Disclosing Fiscal Risks in the Post-Crisis World, Staff Position Note 2009/18.

OBL by requiring the MTFS to be discussed by the Althingi in its Spring session. This will provide an opportunity to engage Parliamentarians in an early discussion of the medium-term fiscal targets and operational ceilings. It will also help to garner greater visibility and engender greater political commitment to achieving those targets and respecting those ceilings. Finally, it will also ensure that Parliament is notified of and committed to adopting the legislation that will be needed to implement the policies laid out in the MTFS.

38. ***Recommendation 2.7:*** **Budget Orientation Debate.** By May, Parliament should

a. review the government's performance against its fiscal objectives and targets based on a report from the National Audit Office; and

b. approve or reject the MTFS through a resolution endorsing:
   i. the fiscal targets for the medium term;
   ii. an overall nominal expenditure ceiling for the central government budget; and
   iii. a program of legislation needed to implement the policy measures.

H. Enhancing External Scrutiny

39. **The failure of the previously established expenditure rule also underlines the need for enhanced external scrutiny of fiscal policy-making and performance.** As the source of the government's authority to tax and spend, the Parliament has the principal responsibility to ensure that those decisions are taken in a manner consistent with the government's stated objectives. However, experience has shown that parliaments often need support from qualified and politically independent bodies to carry out this responsibility. The rise of fiscal councils and legislative budget offices across advanced economies is a testimony to the increasing emphasis being given to the accountability aspects of fiscal policy making.[8] The role of such independent bodies is typically three-fold:

- evaluating the government's **past fiscal performance** based on outturn data;
- validating the **economic assumptions** that underpin the government's forward-looking fiscal strategy; and
- scrutinizing the credibility and sustainability of the **fiscal objectives** that guide the government's fiscal strategy.

40. **Iceland's small size would argue for taking full advantage of the capacity already available in existing independent agencies rather than establishing new institutions.** Currently, Statistics Iceland produces the macroeconomic forecast used by the MoF in its fiscal projections, which already provides an element of external validation to the economic assumptions underpinning the fiscal strategy. A low-cost approach to providing

[8] See Debrun, X. and M. Kumar, 2007, "The Discipline-Enhancing Role of Fiscal Institutions: Theory and Empirical Evidence," IMF Working Paper 07/171 (Washington, DC: International Monetary Fund); Debrun, X., D. Hauner, and M. Kumar, 2009, "Independent Fiscal Agencies," *Journal of Economic Surveys* 23, 44-81.

some additional scrutiny of the government's economic forecasts would be to require the MoF to present independent forecasts currently produced by commercial banks, the CBI, and international agencies alongside its own assumptions and explain any deviations when presenting the government's MTFS, MTBF, and Budget.

41. **However, as a participant in the budget formulation process, Statistics Iceland is not in a position to provide an independent evaluation of either *ex ante* fiscal policy or *ex post* fiscal performance.** Provided that the government has stated clearly measurable fiscal policy objectives and the sources of data to be used in assessing of fiscal performance against those objectives, an annual *ex post* evaluation could be a relatively straightforward task that could be performed in parallel with the auditing of the annual accounts. In this regard, INAO has clear advantage and expertise to undertake such a task.

42. **No existing independent agency is in a position to provide an *ex ante* assessment of the credibility and sustainability of the government's fiscal policy.** However, this could be achieved without establishing a permanent institution, such as a fiscal policy council. One option would be to establish a temporary commission that would be tasked with providing an *ex ante* assessment of the Statement of Fiscal Policy of the incoming government. The commission would focus on assessing consistency between the new government's Statement of Fiscal Policy and the OBL's fiscal principles. This commission could comprise a small number of domestic and external macroeconomic experts who would be appointed three months prior to the election and contracted for a period of six months to complete their analysis and present it to Parliament in time to inform their debate and vote on the new government's Statement of Fiscal Policy. The Althingi would be able to call members of the commission to testify as part of their consideration of the Statement. The commission will be disbanded upon completion of its work and the enactment of the Statement.

43. ***Recommendation 2.8:*** **Independent Scrutiny.** The OBL should provide for independent evaluation of fiscal policy. These requirements could include:

a. specifying who is responsible for producing the government's economic forecast;

b. requiring the government to provide comparisons with independent forecasts in Fiscal Policy Statement, Medium-term Fiscal Strategy, and Budget;

c. giving the Iceland National Audit Office formal responsibility for evaluating the government's performance against its fiscal objectives and targets; and

d. establishing a limited-tenure independent commission to periodically scrutinize an incoming government's Fiscal Policy Statement and evaluate its consistency with the fiscal principles in the OBL.

Box 2.1: Implications of the OBL for Municipalities

A number of recommendations in this report are expected to complement the financial provisions of the 2011 Local Government Act (LGA) in strengthening fiscal coordination between the central and local governments. In particular:

Revised Budget Calendar. The recommended revisions to the budget calendar will provide more timely macroeconomic forecasts to municipalities and support Article 128 of the LGA, which requires cooperation in the preparation of national and local forecasts. Bringing forward the deadline for submission of the central government budget to September and adopting a top-down sequence to its approval will also provide municipalities with the time and information they need to finalize and submit their own budgets by December 15 of each year, as stipulated under LGA Article 62.

Statement of Fiscal Policy. The medium- and long-term projections included in the Statement will provide information about the sustainability of current policies and the impact of economic and demographic trends on key areas of shared responsibility between central and local governments (such as education, health, transport, child and elderly care). This will support the implementation of LGA Articles 129 and 128, which require the costing and allocation of service mandates between the central and local governments to be periodically discussed and agreed by both tiers of government.

Medium-Term Fiscal Strategy. The presentation of the MTFS in April provides the basis for an informed discussion between central and local government about their respective contributions to meeting the government's general government or public sector fiscal targets. This will help to support the implementation of the fiscal rules for local governments stipulated in Article 64 of the LGA. The MTFS will also provide local governments with advance notice of forthcoming national legislative changes that may affect local tax revenues, transfers, or expenditure mandates and enable them to plan the appropriate local policy response. In doing so, it will support the implementation of LGA Article 62, which requires municipalities to adopt a four-year horizon to budget and policy planning.

Supplementary Budgets and Wage Agreements. Eliminating the provision that permits central government to negotiate and implement wage agreements in the middle of the year will limit the sources of unexpected cost pressures for the local governments.

Fiscal Reporting. The production of statistics and accounts for the consolidated general government or public sector will improve understanding of the linkages and interactions between central and local finances.

III. BUDGET FORMULATION AND APPROVAL

A. Legal Framework for Budget Formulation and Approval

44. **The FRA includes some of the basic budgeting provisions one would expect to see in an OBL as well as several examples of more advanced budget practices.** The law includes the standard provisions about the coverage, content, and deadline for submission of the Budget to the Althingi. The more advanced provisions include the requirements that the Budget:

- cover not only the core central government budget (Group A) but also the budgets of all central government controlled enterprises (Group B-E);
- present information and authorize expenditure on an accrual basis;
- include medium-term projections of revenue, expenditure, and financing;
- grant individual agencies flexibility to reallocate resources within three broad line items: operations, maintenance, and capital; and
- seek Parliamentary authorization for a range of public liabilities including not only government expenditure but also borrowing and guarantees.

45. **At the same time, a number of gaps and weaknesses in the budget provisions of the FRA undermine the credibility of the annual budget:**

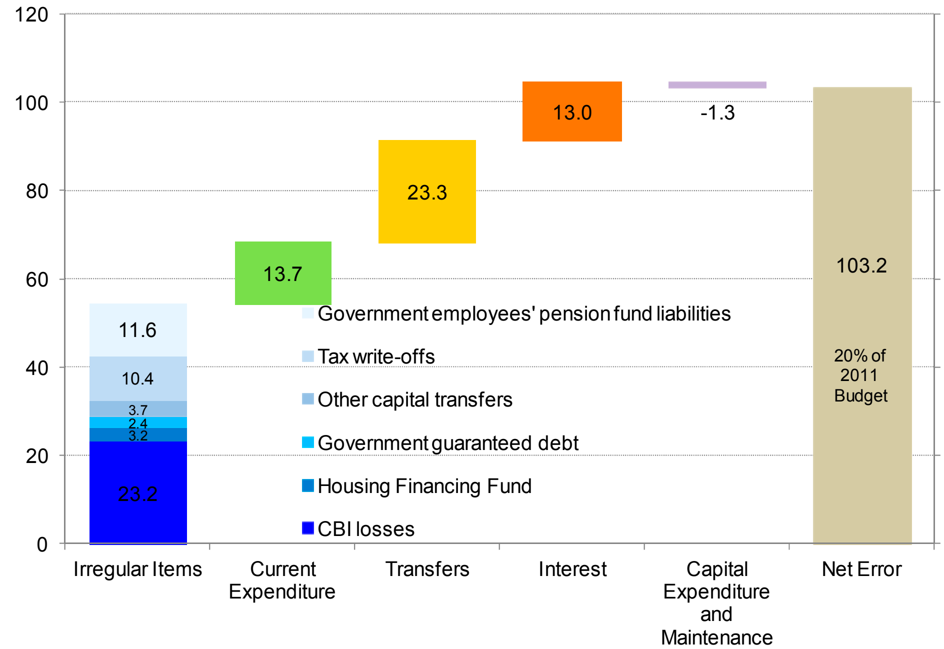
- owing to the general lack of macro-fiscal content in the Act, no provisions require the government to ensure **consistency between its medium-term fiscal strategy and the annual budget** presented to and approved by the Althingi;
- the basic unit of budget **appropriation is an individual agency**, many of which are too small to be viable units of budget management;
- there is no discussion of the **sequencing of Parliamentary budget debates and votes,** which means that the overall size and shape of the budget is not fully known until the final reading in December; and
- there is no requirement on the MoF to maintain an **unallocated central contingency reserve**, though this practice has developed and proved useful during the crisis.

B. Budget Formulation and Approval in Practice

46. **While Iceland has taken some important steps toward the adoption of a more disciplined, top-down approach to budget preparation, this effort has thus far been confined to the process within the executive and therefore met with limited success.** As discussed in the previous chapter, since the early 1990s, the MoF has presented a set of ministerial expenditure “frames” for Cabinet to endorse in the Spring as the basis for budget preparation at ministry level. However, owing to a combination of weaknesses in the legal

framework, surging revenues prior to the crisis, and the pressures and uncertainties prevailing since the crisis, it has proven difficult to get ministries, Cabinet, and Parliamentarians to adhere to these limits during budget preparation and approval. The result has been a consistent upward drift in all categories of expenditure between the medium-budget framework presented in the previous year's budget and final budget execution. (Figure 3.1).

Figure 3.1: Sources of Expenditure Increases from Y-1 MTBF to Y Final Accounts
(2000-11, in 2011 ISK bn)



Source: Ministry of Finance; Statistics Iceland; and IMF staff calculations.

C. Implications for the New Organic Budget Law

47. **Arresting the persistent upward drift in the expenditure during budget formulation necessitates a more comprehensive, orderly, and policy-oriented approach to budget preparation and approval.** This will require the budget formulation provisions of the new OBL to:

- bring forward the **deadline for submission of the Budget Bill** and autumn economic forecast to September;
- oblige the government to present a comprehensive **Medium-term Budget Strategy,** which demonstrates how the annual State budget is consistent with its Medium-term Fiscal Strategy for the general government or public sector;
- reduce the total **number of appropriations** by around two-thirds from over 900 to around 300 by elevating the basic unit of legal appropriation from the agency to ministry level and grouping agencies into three to five programs per ministry;

- provide ministries with greater **flexibility to reallocate resources** between appropriations within their budgets to meet spending pressures that emerge during budget execution;
- establish a central, unallocated **contingency reserve** in the Budget with clear access criteria and reporting requirements;
- adopt a **top-down sequence to Budget approval** and restrict the **Althingi's powers to amend the Budget Bill** to those consistent with the agreed MTFS targets; and
- expand the **range of budget approvals** to encompass total borrowing by all public sector entities, public private partnerships, and other multi-year commitments.

D. Deadline for Budget Submission

48. **The date at which the annual Budget Bill is submitted to the Althingi is somewhat late by the standards of other Nordic countries.** The FRA requires the government to submit the annual Budget Bill to the Althingi "as soon as it convenes in the autumn." In practice this means the Budget is typically submitted in early October which is about a month later than most other Nordic countries (Table 3.1). This compresses the time that Parliamentarians have to consider the Budget and the time that ministries and agencies have to prepare their work, operating, and cash plans for the coming year. The recent amendments to the Althingi Procedures Act, which bring forward the commencement of the Athingi's Autumn session to September, present an opportunity to bring forward the deadline for submission of the Budget Bill to Parliament as well.

Table 3.1: Deadlines for Submission and Approval of Budgets to Parliament
(months before the start of the financial year)

Country	Deadlines	
	Submission to Parliament	Approval by Parliament
Denmark	4	0
Finland	4	0
Norway	4	½
Sweden	3⅓	0
Iceland	3	0

Source: OECD Budget Practices Database 2007 and national legislation

49. ***Recommendation 3.1:*** **Date of Budget Submission.** The deadline for the government to submit the Budget Bill to the Althingi should be brought forward to the first week of September to provide four months for budget consideration in Parliament and implementation planning at the ministry, agency, and municipal level.

50. **The decision to contract out the economic forecast to Statistics Iceland has created some discontinuity between the economic forecasting and budget preparation cycles.** Specifically, Statistics Iceland produces three economic forecasts in April, July, and

November. This means that the Budget Bill presented in October is based on outdated macroeconomic assumptions and typically includes a proviso that budget totals may need to be revised in November to reflect the updated economic outlook. This undermines the credibility of the government's initial Budget proposal (especially where there have already been significant changes to the outlook since July) and encourages all budget actors to "wait and see" what comes out of the November forecast before taking any definitive decisions.

51. ***Recommendation 3.2:*** **Synchronizing the Economic Forecasting and Budget Cycles.** Statistics Iceland should bring forward the production of its Autumn macroeconomic forecast to September and not produce another forecast until January of the following year.

E. Medium-term Budget Strategy

52. **While the FRA requires the presentation of three-year budget projections alongside the annual Budget, these projections are not sufficiently comprehensive and detailed to demonstrate consistency with the government's fiscal targets and shape future budgets.** Article 28 of the FRA calls for the submission of three-year projections of the government finances including figures for the composition of revenue, expenditure, investment, borrowing, and debt. In the past, this provision has been interpreted as a requirement to present projections (i) for the central government budget only and (ii) by economic category rather than by administrative category (by ministry). Between 2004 and 2009, the three-year budget plan included expenditure "frames" by ministry but the coverage has remained limited to the central government budget and there is no reconciliation between this year's set of expenditure frames and those set in previous years' budget plans.

53. ***Recommendation 3.3:*** **Medium-term Budget Strategy.** The government should be required to present, alongside the annual Budget Bill, a comprehensive Medium-term Budget Strategy with the contents set in out in Box 3.1. The aim of the Medium-term Budget Strategy would be to demonstrate the annual Budget Bill's consistency with the general government or public sector fiscal targets and ministerial expenditure ceilings set in the Medium-term Fiscal Strategy in April. Where the annual Budget Bill deviates from those targets, the government should be obliged to provide an explanation for those deviations, separately identifying the impact of changes in (i) baseline assumptions (e.g., overspending in the current year); (ii) macroeconomic assumptions (e.g., GDP growth); (iii) microeconomic parameters (e.g., increase in pensioners numbers); (iv) accounting changes (e.g., reclassifications of entities or transactions); and (v) policy changes (e.g., new legislation introduced since April). Where these deviations are substantial enough to breach the fiscal objectives set out in the government's Statement of Fiscal Policy, the government should be required to submit a new Statement of Fiscal Policy for consideration and endorsement by the Althingi before it discusses the annual Budget.

Box 3.1: Contents of the Medium-term Budget Strategy

The Medium-term Budget Strategy should cover the previous year, current year, budget year, and subsequent three years and include:

a. A **medium-term macroeconomic forecast** which presents:
   i. the evolution of the macroeconomic variables that are relevant for fiscal policymaking;
   ii. a reconciliation of the main forecast changes since the April MTFS; and
   iii. comparisons with other independent domestic and economic forecasters.

b. A **medium-term fiscal forecast** which presents:
   i. the evolution of the main fiscal aggregates for the consolidated general government/public sector and its subsectors broken down by economic category;
   ii. alternative macro-economic and fiscal scenarios showing the impact of more pessimistic and optimistic assumptions on the public finances;
   iii. how the government's fiscal forecasts are consistent with meeting the fiscal objectives set out in the Statement of Fiscal Policy; and
   iv. a restatement of the government's fiscal targets for the medium-term and a detailed reconciliation of any changes since the April MTFS.

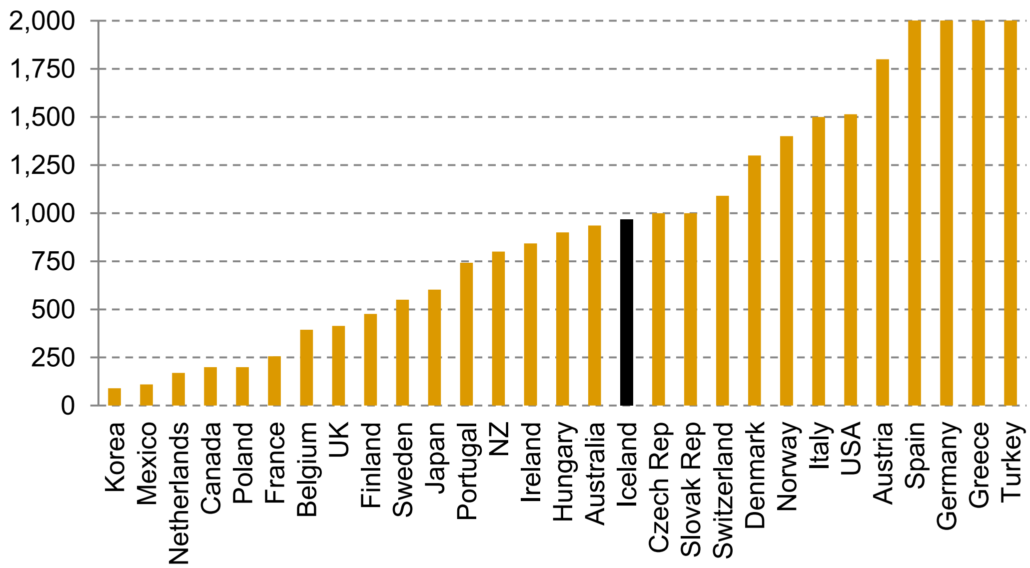
c. A **medium-term budget plan** which presents:
   i. the evolution of the main budgetary aggregates for central government, local government, and public corporations;
   ii. a breakdown of the central government budget by ministry and by main economic category (e.g., wages, other operating costs, transfers, maintenance, and capital);
   iii. in addition to the 1 percent contingency margin in every year of the forecast, an unallocated planning margin beyond the budget year of at least 1 percent of expenditure in Y+2, 2 percent of expenditure in Y+3, and 3 percent of expenditure in Y+4; and
   iv. a detailed reconciliation of changes to ministerial budget ceilings since the April MTFS.

d. A **medium-term debt management strategy** which presents:
   i. the evolution of the government's borrowing and debt;
   ii. the evolution of the government's financial assets;
   iii. a summary of the stock and evolution of guarantees, PPPs, and other contingent liabilities; and
   iv. alternative scenarios for the profile of government borrowing based on a range of assumptions for the fiscal aggregates, interest rates, exchange rates, inflation, calling of government guarantees, and crystallization of other contingent liabilities.

F. Unit of Appropriation

54. **Iceland has a relatively large number of appropriations for an advanced country.** This high degree of fragmentation is attributable to the fact that the basic unit of institutional appropriation in Iceland is not the 10 central government ministries (e.g., Ministry of Education, Science, and Culture) as in most advanced countries but the 260 individual agencies that fall under each ministry (e.g., University of Iceland). This, coupled with the fact the each agency (i) has separate legally binding appropriations for operations, maintenance, and capital expenditure and (ii) can have one or more line items earmarked by statute to a particular revenue source, means that there are over 900 separate legally binding appropriations in the Budget. This is more than three times the number of appropriations one finds in other countries that have recently reformed their organic budget laws (Figure 3.2 and Table 3.2).

Figure 3.2: Number of Legally Binding Appropriations*



***Off the scale:** Spain: 4,593; Germany: 6,000; Greece: 14,000; Turkey: 34,583

Source: OECD Budget Practices Database (2007) and IMF staff estimates.

Table 3.2: Iceland's Appropriation Structure in Context

COUNTRY	NUMBER OF LEGAL APPROPRIATIONS			
	Number of Ministries	**Programs / Agencies per Ministry**	**Line Items per Program / Agency**	**TOTAL**
Netherlands	11	15	1	**170**
France	32	4	2	**256**
UK	25	3	6	**414**
Sweden	27	20	1	**550**
Australia	18	13	4	**936**
Iceland	12	35	2.3	**966**
Greece	19	100	7	**14,000**
Turkey	182	15	2,300	**34,583**

Source: OECD Budget Practices Database (2007) and IMF staff estimates.

55. **The relatively high degree of budget fragmentation in Iceland is the source of many of the budget management problems discussed elsewhere in the report.** In particular, the fact that individual agencies are the basic unit of legal appropriation:

- **discourages ministerial accountability for expenditure** as “parent” ministries have no power to move resources between the individual agencies under their purview, and agency heads often have a direct relationship with the MoF and the Athingi;
- **lowers the standard of Parliamentary discussions** of the Budget and encourages MPs to focus on the financial implications for the agencies and institutions operating in their constituencies, rather than the wider policy agenda to which they contribute;
- **encourages earmarking of revenues** as a means of protecting the funding of specific “pet” projects, which appear as separate line items in the Budget;
- **complicates the production and consolidation of the accounts** by the State Accounting Office who need to wait for and scrutinize 430 different accounts before it can submit the consolidated State Accounts to the INAO for audit; and
- **undermines the comprehensiveness and integrity of auditing** as the INAO is unable to audit 430 different accounts every year and is forced to take a selective approach.

56. ***Recommendation 3.4:*** **Unit of Appropriation.** The basic unit of legal appropriation of expenditure should be elevated from the agency to the ministry level, and the total number of legally binding appropriations should be reduced by around two-thirds from over 900 to around 300. This could be achieved by revising the appropriation structure so that the Althingi votes the annual budget by:

- each of the **ten ministries** (e.g., Ministry of Education, Science, and Culture);
- no more than **five programs/policy areas per ministry** (e.g., Primary Education, Secondary Education, Tertiary Education, Culture, and Administration);
- **two broad economic categories** per program/policy area (e.g., operations and capital). This would imply allowing the Government to move resources for maintenance into other operating expenditure without Parliamentary approval; and
- **three sources of funding** (e.g., new appropriation, carried over appropriation, and retained revenue).

G. Virement Rules

57. **Partly owing to the fragmentation of the appropriation structure, the FRA provides ministries and agencies with relatively little flexibility to reallocate resources within their budgets.** In practice the Government relies upon (i) unallocated provisions with agency and ministry budgets of between 0.2 and 0.6 percent of their budgets and (ii) the relatively liberal rules around carryover of under/overspends between years to cope with expenditure pressures that arise during budget execution. This results in insincere budgeting and non-transparent accounting. It also complicates budget management for ministries and agencies who would prefer to have some limited flexibility to reallocate resources within the

year rather than rely on a complex set of credits and debits accumulated on particular line items, which are reconciled *ex post* in the final Budget Bill or future Budgets (See Recommendations 4.5 and 4.6 on Carryovers). Further discussion of the implications of the Organic Budget Law for budget management at the ministry level is provided in Box 3.2.

58. ***Recommendation 3.5:*** **Virement Rules.** The OBL should specify the scope of the government's authority to reallocate resources between legal appropriations during budget execution. Specifically:

- to reinforce ministerial accountability for expenditure, **reallocation of expenditure between ministries should be prohibited** without prior Parliamentary approval through a Supplementary Budget;
- to provide ministers with some managerial flexibility and incentives for efficient budget management, the law should permit the government to **reallocate resources between programs/policies areas up to 3 or 5 percent** of the total approved budget of the ministry; and
- to protect investment and maintain the link between flow statements and balance sheets, ministers should *either* (i) be **prohibited from reallocating resources between operating and capital** expenditure *or* (ii) be allowed to transfer resources from **operations into capital but not from capital into operations**.

Box 3.2: Implications of the OBL for Ministries

A number of recommendations in this report are designed to improve the degree of ministerial responsibility, control, and accountability for their budgets by providing line ministers and their ministries with greater:

- **Predictability**: Line ministers and their ministries would have a clearer picture of their likely level of resources much earlier in the budget process than is the case now. The government would publish a more credible Medium-Term Fiscal Strategy, including indicative spending ceilings for each ministry, in April, present the Budget proposal itself to the Althingi in September, and approve the Final Budget (including carryovers) by November.
- **Flexibility**: Line ministers and ministries would also have more authority and flexibility to manage their budgets during execution. There would be fewer appropriations than now, fewer earmarked revenues, and only two line items (operations and capital). This would mean that ministries would have more authority to allocate spending within their portfolios and could make use of the new virement rules to meet new priorities while keeping their expenditure within budget limits. Individual institutions such as schools and hospitals would no longer have their own appropriations, and ministries would be able to allocate expenditure between institutions based on demonstrated performance and need.
- **Accountability**: Line ministers and ministries would be more accountable for keeping spending within budgets. It would be harder to have additional spending authorized in Supplementary or Final Budget, and sanctions for overspending would be more credible than at present. When overspending occurs, ministers and their permanent secretaries would, among other things, be expected to appear before a committee of the Althingi to explain the reason for the overspending and how they will prevent a recurrence in future.

H. Contingency Reserve

59. **Before the crisis, the government frequently exceeded its Budget partly owing to a lack of adequate provision for contingencies in the annual Budget.** The FRA places no requirement on the Government to set aside an unallocated central contingency reserve to deal with unforeseen expenditure pressures that cannot be accommodated through the exercise of the other financial flexibilities at their disposal. Since the crisis, the MoF has included an unallocated reserve of around 1 percent of the Budget. However this is often considered to be "earmarked" to deal with discretionary increases or other pressures which were foreseen when the Budget was approved.

60. ***Recommendation 3.6:*** **Contingency Reserve.** The appropriation for the MoF should include an unallocated contingency reserve of at least 1 percent of total budgeted expenditure. The reserve should be used only to fund expenditures which are:

a. temporary;

b. unforeseeable;

c. unavoidable; and

d. unabsorbable.

61. ***Recommendation 3.7:*** **Auditing the Contingency Reserve.** Transfers from the contingency reserve to ministerial appropriations should be notified to the Althingi in monthly budget execution reports and the INAO should be asked to audit whether access is consistent with criteria *a, b, c* and *d*. If it is determined that access is not consistent with these criteria, the government should be required to introduce a Supplementary Budget to authorize that additional expenditure.

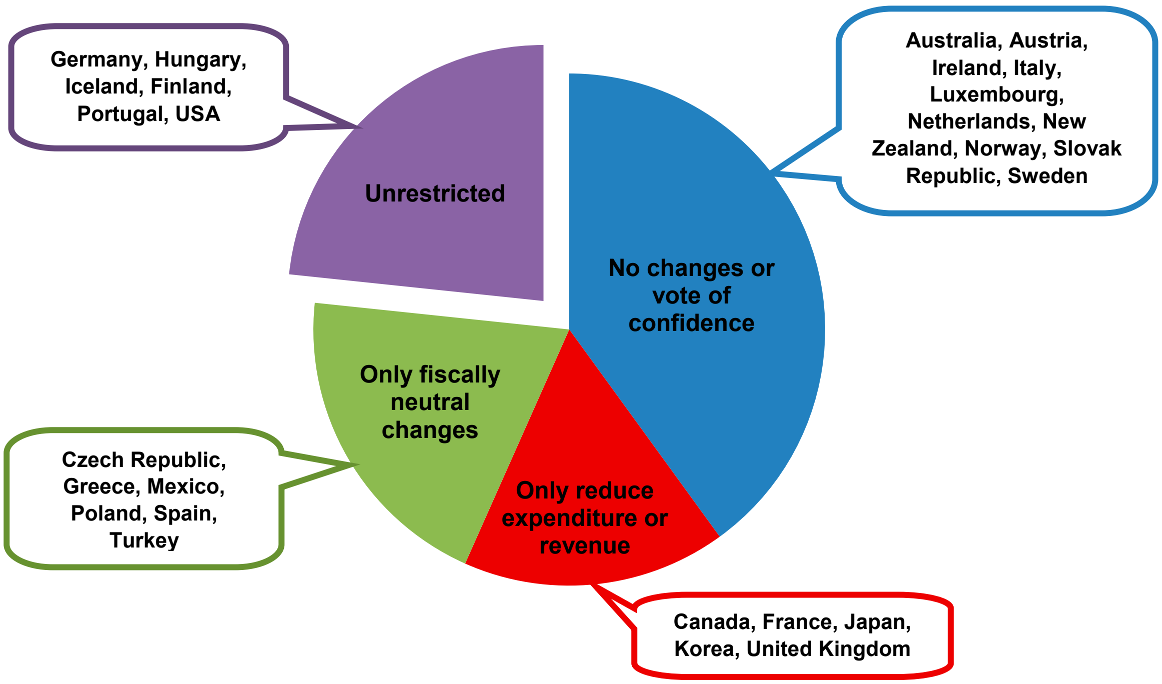
62. ***Recommendation 3.8:*** **Deducting Reserve Claims from Carryovers.** Claims on the contingency reserve should be deducted from the stock of underspends that a ministry can carry over to the next year. This is important to provide some penalty for "abuse" of the contingency reserve by ministries who "cry wolf" about lacking resources during the year and then underspend their budgets at the end of the year.

I. Parliamentary Approval of the Budget

63. **Both the Constitution and the FRA are silent on the scope of the Althingi's power to amend the annual Budget Bill presented by the Government.** In principle, therefore, the Althingi has unlimited powers to amend the draft Budget even if this implies a higher level of total expenditure, lower level of total revenue, or increase in the deficit. This makes Iceland exceptional among advanced countries in terms of the discretion given to the legislature to amend the draft budget (Figure 3.3). In practice, the executive and legislature in Iceland have come to a procedural compromise regarding the Athingi's power to initiate amendments in which the Government sets aside unallocated provisions within the budgets

of individual agencies which are given to the Athingi to allocate during the approval process. The complicated "horse trading" involved in allocating these small amounts to different Parliamentarians' priorities that takes place in late November and December is colloquially known as the "Christmas Tree Process."

Figure 3.3: Scope of Parliament's Powers to Amend the Draft Budget



Source: OECD Budget Practices Database (2007) and IMF staff estimates

64. **The MoF, ministries, agencies, and the Budget Committee of the Althingi all consider the "Christmas Tree Process" unsatisfactory.** As illustrated in Table 3.3, the reallocation of expenditure resulting from the amendments made by the Althingi amounted to 0.19 percent of the total budget over the past three years. This compares with the 3.31 percent increases resulting from amendments made by the Government over this period, largely to adjust interest payments and transfers for the effects of higher inflation (Figure 3.4).[9] Despite the relatively minor impact of the Althingi's own amendments, the soliciting of proposals from MPs, prioritizing between competing requests, negotiating with the MoF, and revising the Budget Bill between readings consumes an inordinate amount of MoF, Budget Committee, and Parliamentary time. Ministries and agencies complain that between the Government's own last minute amendments and those introduced by the

[9] It is important to note that these figures reflect the relative scale of amendments introduced by the Government and Althingi. They do not, necessarily, reflect the original source of those amendments. There will have been, for example, amendments that originated with the Government but were introduced by the Althingi and amendments suggested by the Althingi that were introduced by the Government.

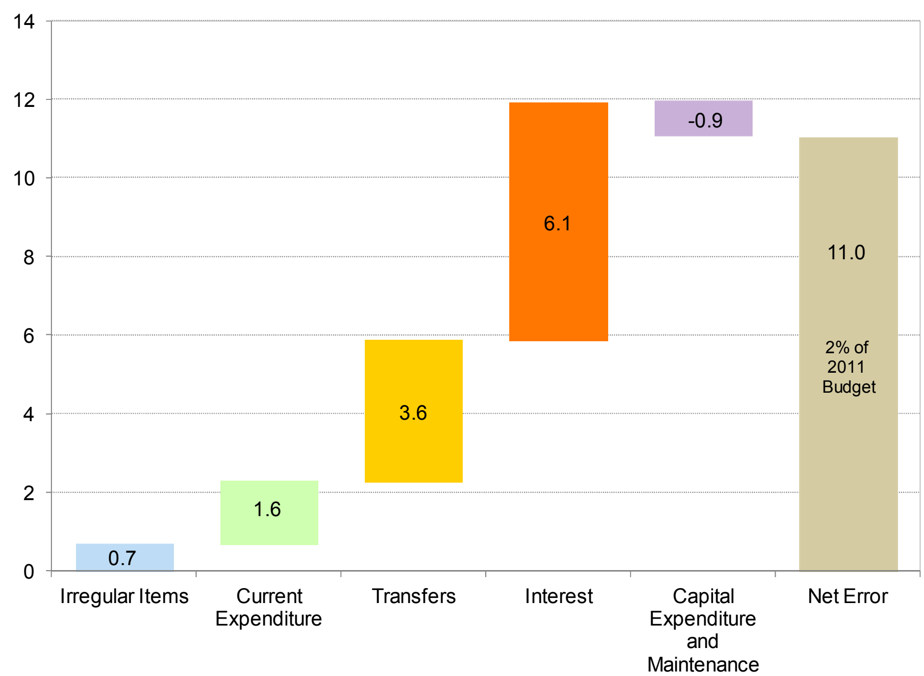
Althingi, it is difficult to plan for the execution of the budgets much before the Budget is finally approved in late December. In a recent report, the INAO noted that for 2009 only 10 of 223 agencies had submitted their annual operating plans to their parent ministry for approval before the statutory 31 December 2008 deadline. The lack of an approved operating plan proved an important predictor of whether that agency would overspend its budget during 2009.

Table 3.3: Size of Amendments to the Budget Bill

	Budget (ISK m)	**Government**		**Althingi**	
		ISK m	Percent of Budget	ISK m	Percent of Budget
2008	434,232	2,256	0.52	1,621	0.37
2009	555,641	47,815	8.61	411	0.07
2010	560,724	4,470	0.80	651	0.12

Source: Iceland MoF and staff estimates

Figure 3.4: Sources of Expenditure Increases during Budget Approval
(2000-11, in 2011 ISK bn)



Source: Ministry of Finance; Statistics Iceland; and IMF staff estimates.

65. **All stakeholders would like to see a more substantive, orderly, and policy-oriented set of budget discussions and decisions in the Althingi**. For the 2012 Budget, the MoF has made some attempts consolidate the unallocated provisions into "funds" for each ministry. The Budget Committee has also taken steps to devolve the discussion of the

allocation of these funds to the individual sectoral committees of the Althingi. However, further procedural reforms are required to ensure that:

- any amendments are consistent with the Medium-term Fiscal Strategy endorsed by both the Government and Althingi in the Spring;
- the budget debate focuses on the allocation of resources between broad policy priorities rather than individual agencies or projects; and
- ministries and agencies have greater certainty about their likely budgets before the final reading and vote on the Budget Bill.

66. ***Recommendation 3.9:*** **Parliamentary Amendment Powers.** To ensure consistency with the fiscal targets and expenditure limits previously endorsed by the Althingi in the Spring MTFS, the Althingi's powers to amend the Autumn Budget Bill should be limited to those changes that **do not**, in either the budget year or over the medium term:

- increase total central government expenditure;
- reduce total central government revenue; or
- increase net public sector liabilities.

67. ***Recommendation 3.10:*** **Sequence of Parliamentary Voting.** To provide a more orderly discussion of the Budget Bill and greater predictability to budget-holders about their allocations before year-end, Althingi debates and votes on the Budget Bill should follow a top-down sequence so that:

- on the **first reading**, the Althingi considers the **economic assumptions and fiscal targets** set out in the government's Medium-term Budget Strategy and votes on the **total level of expenditure, revenue, and liabilities** in the budget year and the medium-term;
- on the **second reading**, the Althingi considers the **allocation of expenditure between broad policy priorities** and votes on the annual budget limit for **each ministry and program/policy area**; and
- on the **third reading**, Althingi **finalizes and "tidies up"** the allocation of expenditure within programs and votes the **division of expenditure between economic categories and sources of funding** for each program.

J. Range of Budget Approvals

68. **Under the FRA, the approvals granted through the Budget cover a broad range of government transactions but do not currently cover the liabilities created by public-private partnership (PPP) contracts.** According to Article 26 of the FRA, the government must seek, through the annual Budget, the Althingi's approval for not only expenditure but also other claims on taxpayers including borrowing and guarantees. Annual cash limits on

the total value of the new liabilities are voted in Article 6 of the Budget Bill. However, the same does not apply to PPP contracts where only flow of payments for the budget year and next three years needs to be reflected in the Budget. The cost of PPP contracts can often be quite modest in the first few years but increase sharply after five to seven years when the construction phase is completed and service charges begin. While information about the total liabilities associated with PPP projects is included in the explanatory notes to the Budget, these are not formally considered or approved by Parliament.

69. ***Recommendations 3.11:*** **Other Budget Limits.** The range of non-expenditure approvals granted by Parliament in the annual Budget resolution under Article 26 of the FRA should be expanded to include an annual ceiling on the total value of new public private partnership contracts that can be signed by the government that year. In seeking approval to sign those contract, the Budget Bill should demonstrate how the flow of liabilities is consistent with meeting the government's Medium-term Budget Strategy.

70. **The FRA also does not require the government to seek the Althingi's approval for multi-year contracts or other commitments, though it does require them to be disclosed in the notes to the Budget.** Article 30 of the FRA empowers ministers and heads of agencies under Group A to conclude multi-year contacts so long as their projected costs over the subsequent three years are disclosed in the notes to the Budget Bill. Under Article 41, those entities that fall into Groups B and C (public corporations) are permitted to enter into multi-year commitments "necessary to ensure the normal operations of the enterprise." As with PPPs, three years is seldom a sufficient horizon to judge the affordability of a major contract such as the procurement of a multi-year transport project or signing of a long-term lease. Furthermore, public corporations should not be given blanket authority to conclude major contracts with third parties without first seeking authorization from the government, their major shareholder.

71. ***Recommendations 3.12:*** **Multi-year Financial Commitments.** Articles 30 and 41 should be expanded to require all public entities to ensure that any multi-year financial commitments are affordable within their medium-term budget plans and consistent with the government's medium-term fiscal objectives.

a. For ministries, Althingi approval should be required for all multi-year commitments exceeding a percentage of the ministry's budget to be determined in regulations. When seeking Althingi approval, the MoF should present:
    i. the total costs of the commitment;
    ii. the flow of revenue, expenditure, and financing over the life of the commitment; and
    iii. a demonstration of how the commitment is to be accommodated with the government's medium-term budget plans and fiscal targets.

b. For public corporations, MoF approval should be sought through their annual financial plans.

IV. BUDGET EXECUTION AND TREASURY MANAGEMENT

A. Legal Framework for Budget Execution and Treasury Management

72. **The FRA contains some significant loopholes that enable the government to exceed the annual Budget voted by the Althingi with effective impunity.** While recent governments have not taken advantage of some of these loopholes, in principle the FRA provides five different ways in which a ministry or agency can overspend its annual appropriation without being sanctioned:

a. it can increase or anticipate collection of a range of **own revenues** which are netted off against their appropriation in the current year (Articles 12 and 23);

b. it can fund the overspend from their **accumulated stock of underspends** carried forward from previous years (Article 37);

c. it can deduct the overspend from their **appropriation for the following year** (Article 45)**;**

d. it can seek **retrospective Parliamentary authorization** for the overspend before the end of the year through a **Supplementary Budget** (Articles 33 and 34); and

e. it can seek **retroactive Parliamentary authorization** of the overspending after the end of the year through the **Final Budget Bill** (Article 44).[10]

In the rare cases where ministries or agencies are identified as having engaged in unauthorized overspending, the Act and associated regulations provide relatively few credible or effective sanctions.

73. **The MoF has attempted to tighten some of these loopholes in the supporting regulations and the annual Budget Act itself.** For example, Regulation 1061/2004 on the implementation of the Budget requires ministries to take corrective action if the expenditure of one of their agencies exceeds planned levels by more than 4 percent. More recently, the MoF has used the annual Budget Bill to put more stringent conditions on Supplementary Budgets, limit the accumulation of carryovers, and restrict the classes of revenue that agencies can retain. However, without the full support of the basic law, there is a limit to what can be achieved though these kinds of stop-gap measures.

B. Budget Execution and Treasury Management in Practice

74. **Owing in part to the relative laxity of the legal regime, Iceland has historically had a poor track record of enforcing expenditure discipline during budget execution.** In

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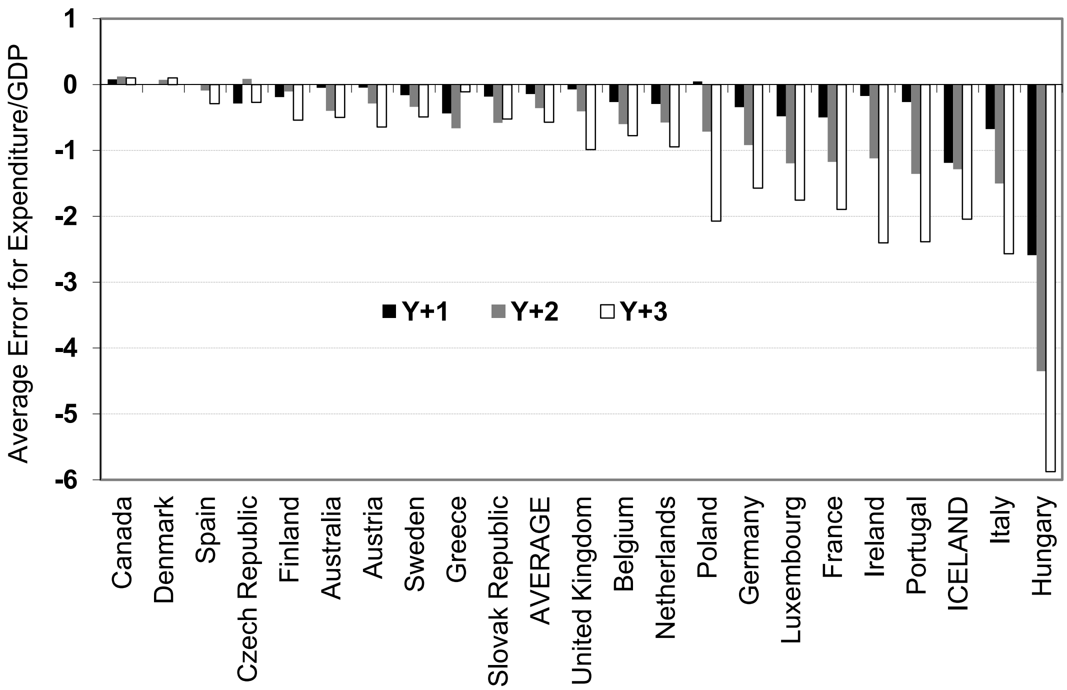
[10] Strictly speaking, the Supplementary and Final Budget Bills are meant to be reserved for overspending that is due to "unforeseen circumstances, wage agreements, or new legislation" but these conditions are so broad as to mean that most overspending could be justified in these terms.

the decade leading up to the crisis, Iceland overspent its annual budget by an average of 12 percent. Among 22 EU and OECD countries surveyed, only Hungary had a worse track record in sticking to its approved budget (Figure 4.1). Previous FAD TA missions noted that only a small share of this overspending could be attributed to unexpected inflation or exchange rate developments. Rather, the bulk of the overspending was due to large, discretionary increases in expenditures—partly in response to surging revenues.

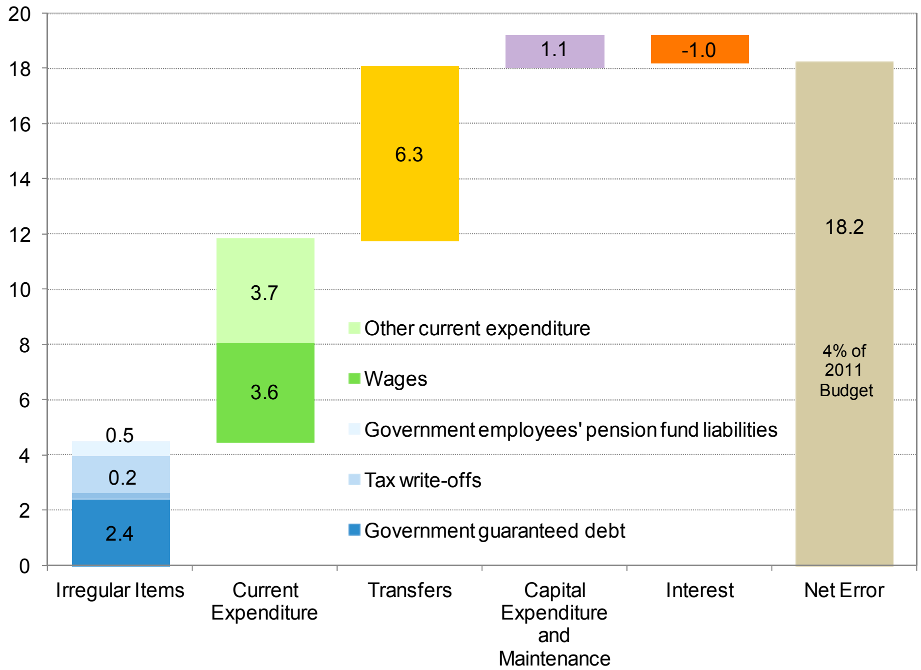
Figure 4.1: Ave. Forecast Error for Expenditure: One, Two, and Three Years Ahead
(Percent of GDP, 1998-2007)



Source: European Commission and IMF staff calculations

75. **While budget discipline has improved since the crisis, the average annual overspend against the budget has remained high by advanced country standards.** Between 2005 and 2011, the government overspent its approved budget by around 4 percent on average, as shown in Figure 4.2. Some of this overspending can be attributed to one-off expenditure related to the crisis (such as the recapitalization of the banking sector). However, much of the overspending is the result of above-budget increases in civil service salaries and household transfers as part of wage agreements negotiated with social partners in the middle of the budget year.

Figure 4.2: Sources of Expenditure Increases during Budget Execution
(2000-11, in 2011 ISK bn)



Source: Ministry of Finance; Statistics Iceland; and IMF staff estimates.

C. Implications for the New Organic Budget Law

76. **Introducing a more efficient, transparent, and disciplined approach to budget implementation will require the budget execution and treasury management section of the new OBL to:**

- place an obligation on all public entities to **manage cash efficiently;**
- clarify the budgeting treatment of different types of **retained and earmarked revenues**;
- restrict the **carryover of underspends and overspends** from one year to the next;
- require any overspending against budget totals to be approved by a **Supplementary Budget** *before* it can take place, with the exception of a small number of mandatory items; and
- treat all other spending not authorized *in advance* by the Althingi as "in excess," and expand the **range of sanctions** for excess expenditure beyond the "soft" and "nuclear" options that currently exist in regulations.

D. Cash Management

77. **Like most OBLs, Iceland's FRA says relatively little about the rules and procedures for the management of government cash holdings.** This is understandable

given that cash management takes place within the executive and can therefore be governed by regulations and guidance without the involvement of Parliament. However, the inefficient planning and management of cash by the government can impose costs on the taxpayer in the form of (i) lower interest on government cash deposits; (ii) higher borrowing costs created by liquidity shortfalls; and (iii) opportunity costs created by delays in payment of invoices. For this reason, most countries place some legal obligation on governments to manage cash efficiently. In the case of Iceland where ministries and agencies have considerable fiscal autonomy, there is also an argument for elevating some of the cash management provisions currently in regulations into the law to ensure that agencies comply with obligations to submit their cash plans to their parent ministry and the MoF for approval before the start of the financial year.

78. ***Recommendation 4.1:*** **Cash Management:** The law should include an obligation on government to manage cash efficiently, ensuring that (a) payments are not made in advance of need; (b) borrowing costs are minimized; and (c) invoices are paid on time.

79. ***Recommendation 4.2:*** **Cash Planning.** The OBL should require ministries and agencies to have approved operating and cash plans for the coming financial year by December 31. These plans should be consistent with budgeted limits and in the format prescribed by the MoF.

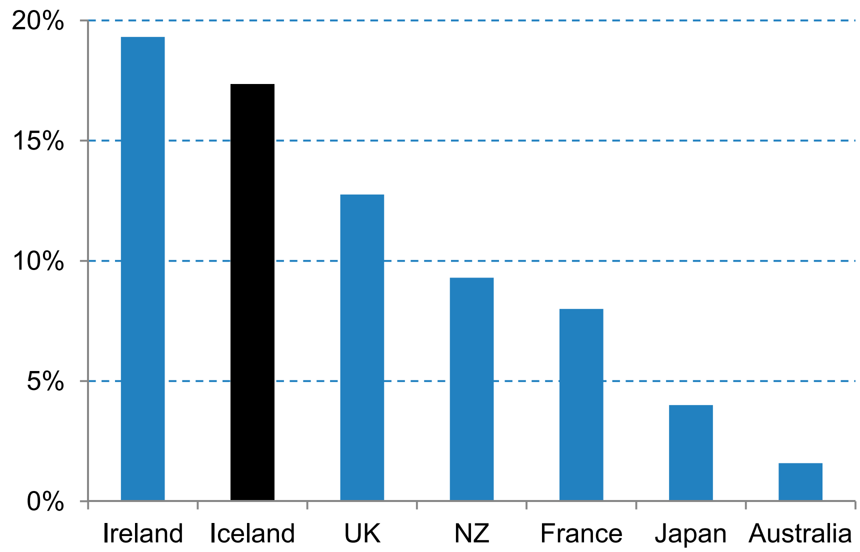
E. Retained and Earmarked Revenues

80. **The proliferation of retained and earmarked revenue poses a serious problem for budgetary planning, expenditure control, and accounting in Iceland.** Around 17 percent of gross expenditure is funded out of retained or earmarked revenues in Iceland, the second highest percentage among advanced countries informally surveyed (Figure 4.3). The widespread retention and earmarking of revenues in Iceland:

- **reduces the discretion that the government has** to prioritize expenditure between ministries, agencies, and projects during budget preparation;
- **reduces the flexibility budget managers have** to stay within their overall budget limits during budget execution and increases the likelihood that they will need a Supplementary Budget to deal with unforeseen expenditure pressures; and
- **complicates the production of accounts** by requiring the MoF to spend considerable time after the end of the year matching specific revenues to specific expenditures.

The expenditure rigidities and accounting complexities engendered by earmarked revenues are magnified by the relatively high degree of budget fragmentation that enables Parliamentarians to hypothecate revenues not only to particular ministries or agencies but even to specific line items within those agencies' budgets.

Figure 4.3: Retained Revenues in Selected Countries
(share of gross expenditure)



Source: National budget documents (latest year)

81. **Rather than discouraging the practice (or banning it as some OBLs do), Iceland's FRA creates something of an "enabling framework" for the hypothecation of revenues.** Three of the FRA's articles are devoted to the budget and accounting treatment of earmarked and retained revenues. There are no clear criteria for determining what classes of revenues can be retained or how overcollections are to be treated for budgeting purposes. Accounting for use of retained revenues is further complicated by the fact that Article 12 allows commercial revenues to be netted off expenditure in budgets but requires them to be reported in gross terms in accounts.

82. ***Recommendation 4.3:*** **Reporting of Own Revenues.** The law should require all sources of revenue to be reporting on a gross basis in budgets, statistics, and accounts.

83. ***Recommendation 4.4:*** **Retention of Revenues.** The law should specify a set of principles regarding the retention of revenues by individual ministries or agencies which distinguish between:

a. operating revenues from the **sale of goods and services**. These revenues should count as negative expenditure in all budgets to encourage ministries to maximize commercial collections. This means that ministries and agencies can retain and spend any overcollection during the year without exceeding their gross appropriation;

b. capital receipts from the **sale of assets**. All capital receipts should be returned to the MoF and allocated through the budget process. Individual ministries should not be making isolated decisions about the structure of the government balance sheet;

c. **fees and charges** collected from the direct beneficiaries of government services. Fees and charges should be set at the level required to recover the costs of providing the corresponding service as reflected in the ministry's budget allocation. Any collections above budgeted amounts should be returned to the MoF to prevent ministries from becoming "tax farms." The MoF may, subject to Recommendation 4.6, credit some or all of the overcollection to a ministry's stock of carryovers for expenditure in future years to incentivize collection.

d. **social security contributions**. Social security contributions may be earmarked to particular appropriations or funds that benefit the contributors (i) with the approval of the MoF; (ii) by an Act of Parliament; and (iii) where the annual expenditure is approved in the budget as a mandatory expenditure. This procedure is in line with the contributory principle that underpins some social welfare programs.

e. **taxes**. Tax revenues should be deposited with the MoF in line with the principle of gross budgeting. There are two possible options for responding to pressures to earmark tax revenues to particular expenditures:

   i. **Option 1:** The earmarking of tax revenues to specific expenditures should be prohibited. Where the government wishes to demonstrate that particular taxes are being spent in particular areas, this should be done presentationally through budgets and accounts.

   ii. **Option 2:** Earmarking of tax revenues to specific appropriations should be allowed only (i) in exceptional circumstances; (ii) by an Act of Parliament which must be renewed at least every five years; and (iii) to the ministerial (rather than agency or program) level of appropriation.

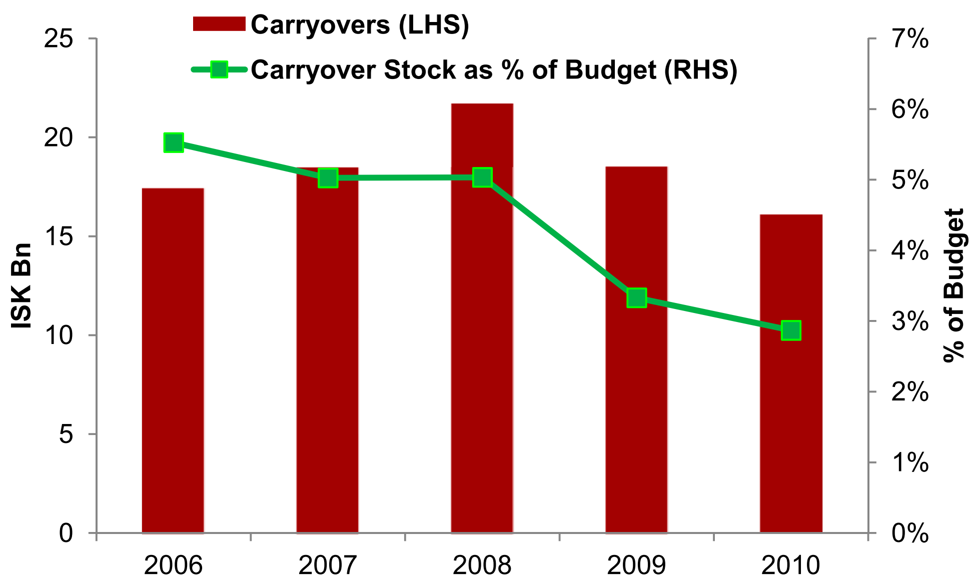
F. Carryovers of Under/Overspending

84. **Iceland has a relatively liberal regime for carryover of appropriations by advanced country standards.** Article 37 of the FRA grants the Minister of Finance unlimited authority to carryover an unused appropriation from one year to the next, with the consent of the line minister concerned. Most advanced countries that allow carryover of appropriations limit it to certain types of appropriation, place a limit on the on-flow, stock, or drawdown of carryovers, and require Parliament to "revote" the appropriation carried over to the subsequent year. Article 45 of the FRA is also unusual in that it permits agencies to carryover *overspends* from one year to the next by allowing them to be deducted from future appropriations. Few other advanced countries permit the government to "borrow" against future appropriations in this manner.

85. **While the stock of carryovers has diminished in recent years, their size as a share of some entities' budgets remains a concern from a budget management point of view.** Since 2007, the total stock of carryovers has fallen from over 5 percent of the total central government budget to around 3 percent in 2010 (Chart 4.4). However, at the end of 2010, about 130 of budgetary entities had positive carryovers of more than 10 percent of their

total budget while 20 appropriations had positive carryovers exceeding 100 percent of their annual budget (though most of the latter were earmarked funds or investment projects). At the same time, around 50 appropriations were still classed as having negative carryovers of anywhere between 1 and 78 percent of their annual appropriation.

Figure 4.4: Iceland: Stock of Carryovers
(2006-10)



Source: Iceland Ministry of Finance

86. **The administrative restrictions on carryovers introduced by the MoF during the crisis remain at the permissive end of where most countries strike the balance between discouraging year-end splurges and preserving the annuality of the budget process.** In 2010, the MoF eliminated the carryover of overspends and restricted the underspend that a ministry or agency can carryover in a given year to 4 percent of its budget and the total stock of carryover that can be accumulated over time to 10 percent. Most advanced countries with experience of operating a carryover regime also prohibit carryover of overspending. However, these countries also tend to limit the types of expenditures that can be carried over and cap the total stock of accumulated carryovers at around 3 percent.[11]

87. **Even with this lower stock of and tighter limits on carryovers, the process of crediting underspends to each ministry and agency complicates the accounting process and also weakens annual budget discipline at the (all important) margin.** This arises because the final stock of underspends from the previous year is not known until individual

[11] For further detail see Lienert and Ljungman (2009), *Carryover of Budget Authority,* IMF Technical Guidance Note, Fiscal Affairs Department.

agencies and ministries submit their accounts two or three months after year-end. This means that individual ministries and agencies do not know their full resource envelope until after the budget is approved. While it would require budgetholders to accept some "delayed gratification" it may be preferable to base the amount carried over on the previous year's accounts in order to end post Budget "haggling" over the precise resources available to spend in the budget year. The complications of budgeting for carryovers would also be greatly reduced if the number of appropriations is reduced and carryovers are credited to ministries rather than individual agencies.

88. ***Recommendation 4.5:*** **Carryover of Overspending.** The provision in Articles 37 and 45 of the FRA permitting carryover of overspending in the current year and "deducting" it from future appropriations should be repealed.

89. ***Recommendation 4.6:*** **Carryover of Underspending.** The possibility to carry forward underspends with the approval of the MoF should be retained but be applied at the ministry (rather than agency) level in line with Recommendation 3.4. However, the law should limit the MoF's authority to approve the carryover of unspent appropriation to:

a. a maximum of 3 percent of the ministry's total budget for the previous year;

b. non-wage, non-transfer operating expenditure and capital expenditure;

c. underspending that can be attributed to either more efficient utilization of resources or justifiable delays in the execution of expenditure;

d. underspends reported in the audited accounts from the *previous year*, rather than unaudited estimates for the current year; and

e. the level of drawdown approved by Parliament in the annual budget appropriation for the following year.

G. Supplementary Budgets

90. **Several other provisions of the FRA permit the government to overspend its approved budget and retrospectively legitimize those overspends during or even after the end of the financial year.** Specifically, in addition to carry forward of overspending permitted under Article 45:

- Article 33 permits the MoF to make payments that have not been authorized in the annual Budget so long as they (i) are due to "unforeseen circumstances;" (ii) "cannot wait;" (iii) are notified to the Budget Committee; and (iv) are subsequently authorized through a Supplementary Budget;
- Article 34 empowers the government to negotiate above-budget and often retroactive wage agreements with social partners and seek the approval of the Althingi through a Supplementary Budget after they have already been implemented; and

- Article 44 gives the government the authority to use the Final Budget Bill, presented months or even years after the end of the financial year, to retrospectively authorize overspending associated with the "unforeseen circumstances, wage agreements, or new legislation."

These provisions undermine not only the credibility and integrity of the annual Budget but also the fundamental principle that all expenditure of taxpayer money must be authorized by Parliament before it can take place. It also greatly weakens the effectiveness of the relative limited sanctions provisions included in the legislation by allowing the government to normalize any overspending against the budget *ex post*.

91. **While some countries do allow the retrospective authorization of some expenditure through a Supplementary Budget, this authorization is typically limited to a handful of mandatory items.** For example, Finland's 1988 State Budget Act distinguishes between "fixed" and "estimated" appropriations while France's 2005 Organic Budget Law distinguishes between "cash-limited" and "mandatory" appropriations. In both cases, the latter can be exceeded without prior authorization by Parliament but must be authorized in a final supplementary or "rectifying" budget. Expenditures included in this category typically include debt service, some social security, expenditure earmarked to specific revenues, and international subscriptions.

92. ***Recommendation 4.7:*** **Supplementary Budgets.** The new OBL should require any unbudgeted expenditure that cannot be accommodated through the utilization of the virement rules or funded from the contingency reserve to be authorized by the Althingi through a Supplementary Budget. The law should require that the Supplementary Budget be approved by the Althingi *before* the expenditure can take place, with the exception of a small number of non-discretionary expenditures such as (i) interest payments on debt; (ii) demand-led social security payments; and (iii) subscriptions to international organizations.

93. ***Recommendation 4.8:*** **Final Budget Bill.** In the new law, the Final Budget Bill should be **either**:

a. abolished and all unauthorized overspending identified in accounts treated as "in excess" or

b. retained but forbidden from retrospectively increasing either total expenditure or any legal appropriation, except for a small number of non-discretionary items.

94. ***Recommendations: 4.9:*** **Wage Agreements:** Article 34 of the FRA which grants the government the power to retrospectively authorize above-budget wage agreements via a Supplementary Budget should be repealed. Instead, wage agreements should be negotiated (a) within MTFS parameters, (b) take effect in the following year; and (c) be fully reflected in the annual budget for that year. This would mean that wage negotiations and budget discussions move in sync and within the affordability framework established by the Medium-term Fiscal Strategy.

H. Sanctioning of Overspending

95. **In addition to offering a range of opportunities for retrospective authorization of overspending, Iceland's legal framework offers relatively few options for sanctioning any unauthorized overspending.** Article 49 of the FRA includes a general statement that "The Heads and Board of Directors of government entities are responsible that their financial measures are in accordance with spending limits," but this could be taken as a statement of fact rather that an obligation to prevent overspending. Chapter V of Regulation 1061/2004 requires financial managers of agencies to report overspending to their parent ministries only after it exceeds 4 percent of the budget. However, the range of sanctions on those whose budgets are "repeatedly or considerably in excess of budget limits" is limited to an internal written reprimand from their parent ministry on the one hand or temporary or permanent relief of duty on the other.

96. **The discipline engendered by any OBL ultimately depends upon the credibility of the sanctions at the disposal of governments and parliaments to deal with overspending and other infractions.** The most effective OBLs place the judgment as to whether overspending has taken place in the hands of the National Audit Office (NAO) through its examination of the government accounts. Where the NAO determines that overspending or some other financial infractions has occurred, it refers the matter to either the Budget or Public Accounts Committee of Parliament for adjudication. The Committee may call the responsible Minister, Permanent Secretary, and Finance Director to a public hearing to account for the overspending or infraction before deciding whether the expenditure should be (i) authorized through a "vote of excess" or (ii) referred for administrative, financial, or criminal sanction. In most cases, the reputational sanction of the hearing itself and the administrative sanctions that often follow (such as more intrusive MoF controls, more regular reporting, or a requirement to repay the overspend in future) are sufficient to discourage overspending. These "intermediate" sanctions between the "soft sanction" of a private reprimand and the "nuclear sanction" of dismissal are largely missing from Iceland's legal framework.

97. ***Recommendation 4.10:* Investigating Overspending.** The new OBL should place an obligation on the INAO to report any overspending or other financial irregularities and require the Althingi to investigate the matter and determine whether the overspending or irregularity should be authorized or sanctioned.

98. ***Recommendation 4.11*: Sanctioning Overspending.** The new OBL should provide the Athingi and Government with a broader range of administrative, financial, and criminal sanctions to deal with overspending or other financial irregularities. The range of possible sanctions should include the following intermediate options:

a. a requirement to give evidence in a public hearing;

b. the formulation of a financial management improvement plan;

c. additional reporting requirements;

d. freezing or withholding of appropriation or cash disbursement;

e. suspension of powers to carryover, vire, retain, or borrow resources;

f. tighter controls on the authorization of major expenditure commitments;

g. suspension of performance-related bonuses;

h. appointment of a financial overseer or administrator; and

i. a requirement to merge with another agency or entity.

V. Fiscal Reporting

99. **Requirements for fiscal reporting—that is, for the publication of information on the public finances—are an important part of a comprehensive OBL**. In a well-functioning system, fiscal reporting shows whether the government has complied with the budget law, whether it is meeting its fiscal objectives, and whether its policies are sustainable or will eventually require taxes to be raised or spending cut. By doing so, it encourages governments to manage the public finances well.

A. Fiscal Reporting in Law and Practice

100. **The reporting required under Iceland's FRA, or provided by the government in practice, is mostly in line with international standards, and many features of the existing system should be preserved.** The following are just a few of those features:

- the government prepares an accrual-based operating statement, a cash-flow statement, and a balance sheet;
- the government's financial report is audited by the INAO and currently receives an unqualified audit opinion;
- budgets are prepared on the same accounting basis as end-of-year financial statements, making it easier to compare plans with outcomes and to hold the government accountable; and
- Statistics Iceland produces good statistics for general government and some data for the entire public sector.

These things may be taken for granted in Iceland, but there are many advanced countries where they are lacking.

B. Developments in Fiscal Reporting

101. **Much has changed in the years since the 1997 FRA was developed, however, and there are now many opportunities for improvements in fiscal reporting**. For example, when the FRA was being prepared,[12] International Public Sector Accounting Standards (IPSAS) and the IMF's *Government Finance Statistics Manual (GFSM) 2001* were still to be written. Both documents recommend approaches that differ in some respects from Iceland's practice, such as the recognition of nonfinancial assets. Fiscal reporting in other advanced economies has also moved on and in some areas now surpasses Iceland's in quality, for example in the discussion of fiscal risks and the long-term sustainability of public finances.

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[12] See Ministry of Finance, *Financial Reporting Reform: The Report of the Financial Reporting Commission,* February 1995.

C. Implications for the New Organic Budget Law

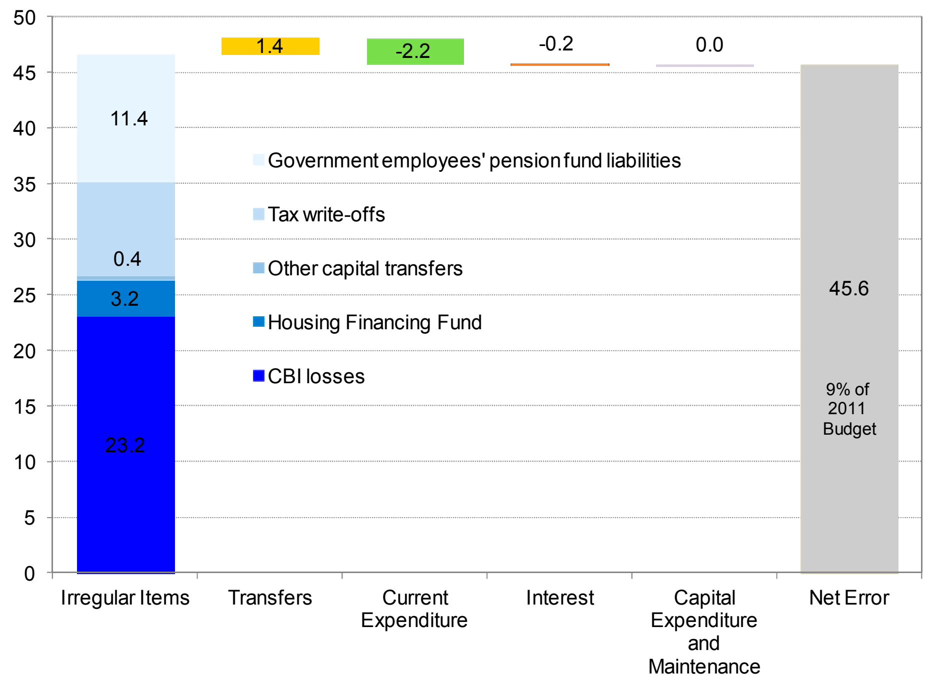
102. **The new OBL presents an opportunity to align fiscal reporting with the key fiscal risks that Iceland faces today and once again put the country at the forefront of international reporting practice**. The main improvements that should be reflected in the reporting provisions of a new OBL can be grouped under the following headings:

- further improving the **consistency of budgets and *ex post* reporting** by requiring forecast financial statements to be prepared on the same accounting basis as the *ex post* reports;
- extending the **scope of fiscal reporting** to provide high-quality information on the public sector as well as the central and general government;
- improving the reporting of certain **fiscal flows and stocks**, to provide fuller information on the government's financial performance and financial position;
- adopting **International Public Sector Accounting Standards** to ensure that financial reporting continues to follow good practice; and
- improving the **timeliness of audited financial statements** as an input into fiscal policy evaluation and planning.

D. Improving Consistency of Forecasts and Financial Statements

103. **Although budgets are generally prepared on the same accounting basis as accounts, budget forecasts are not reliable estimates of all parts of the final accounts.** Final outcomes will always differ from forecasts, because of myriad sources of fiscal uncertainty. But forecasts should be unbiased. Figure 5.1 suggests that although the Supplementary Budget includes reasonably reliable estimates of most categories of spending, its estimate of the costs of pensions, tax write-offs, and transfers to entities outside central government (Group A) are consistently underestimated.

Figure 5.1: Sources of Expenditure Increases: Supplementary Budget to Final Accounts
(Average 2000–10, in 2011 billion ISK)



Source: Ministry of Finance; Statistics Iceland; and IMF staff estimates.

104. **To help address this problem, forecasts in budget documents should be prepared on the same accounting basis as end-of-year accounts.** Requiring all forecast financial statements to be prepared on the same basis as the accounts should help ensure that forecasts of tax write-offs, pension costs, and other items are unbiased estimates of end-of-year actual figures. In addition, preparing forecast statements for the *consolidated* government, as proposed below, should help ensure that costs associated with entities such as the CBI and the HFF are included in forecasts. Box 5.1 includes excerpts from the New Zealand government's most recent forecasts that reflect attempts there to improve forecasting by requiring the government to affirm that forecasts incorporate all available information and are prepared according to the same standards of integrity as final accounts.

105. ***Recommendation 5.1*: Accounting Basis of Forecasts.** The government's budgets, fiscal forecasts, and other prospective reports should be prepared on the same accounting basis as its retrospective reports.

Box 5.1: Excerpts from Recent Pre-Election Forecast Updates in New Zealand

Statement of Responsibility

On the basis of the economic and fiscal information available to it, the Treasury has used its best professional judgment in supplying the Minister of Finance with this Economic and Fiscal Update. The Update incorporates the fiscal and economic implications both of Government decisions and circumstances as at 11 October 2011 that were communicated to me, and of other economic and fiscal information available to the Treasury … [signed Secretary of the Treasury, 18 October 2011]

… I accept overall responsibility for the integrity of the disclosures contained in this Update… To enable the Treasury to prepare this Update, I have ensured that the Secretary to the Treasury has been advised of all Government decisions and other circumstances as at 11 October 2011 of which I was aware and that had material economic or fiscal implications [signed Minister of Finance, 18 October 2011]

Accounting Policies

These forecast financial statements have been prepared in accordance with … New Zealand Generally Accepted Accounting Practice ... The accounting policies applied in the statements are the same as those applied in the audited, actual financial statements of the Government for the year ended 30 June 2011….

Source: http://www.treasury.govt.nz/budget/forecasts/prefu2011.

E. Coverage of Institutions

106. **Fiscal reporting should offer a panoramic view of the public sector, as well as close-ups of meaningful subsectors like central government, local government, and public corporations.** Otherwise, potential fiscal problems such as growing liabilities in public enterprises like the HFF and Reykjavik Energy may not be noticed and dealt with until they become severe. A panoramic view also reduces the temptation to meet debt and deficit targets by pushing spending onto local governments or public enterprises. This risk has been underlined by the global financial crisis, where the liabilities of entities defined as outside the government have either helped to precipitate crisis (e.g., in Greece) or made the fiscal effects of the crisis worse (e.g., in Portugal). There are two features of Iceland's reporting that limit the panoramic view.

Fiscal Statistics for the Public Sector

107. **First, Statistics Iceland presents a detailed picture of the finances of general government, but only a rough sketch of those of the broader public sector.** For example, its report on government finance statistics for 2010 contains 12 tables on the general government and only one on the public sector. This single table helpfully shows estimates of the net operating balance and net lending of the public sector, as well as its net financial liabilities. But Statistics Iceland should aim to present at least a statement of operations, a statement of economic flows, and a balance sheet for the public sector. Transactions within the public sector should be eliminated in consolidated accounts, but the priority should be to produce fuller information even if the elimination is imperfect.

108. ***Recommendation 5.2:*** **Public Sector Statistics.** The OBL should require Statistics Iceland to prepare a comprehensive set of fiscal statistics for the public sector, including a statement of operations, a statement of other economic flows, and a balance sheet.

Consolidated Audited Financial Statements

109. **The second feature of reporting that limits the panoramic view is that the government's financial statements cover only central government (Group A[13]).** Notes to the statements show information on the finances of each of the other groups (B to E), and the individual entities in Groups B to E publish high-quality financial reports. But the government's income statement, cash-flow statement, and balance sheet consolidate only the operations, cash flows, and assets and liabilities of Group A.

110. **The decision in the mid-1990s not to consolidate state-owned enterprises was not without justification**. In particular, the activities of government are typically quite different from those of state-owned enterprises, which are often more like private firms than government agencies. As a result, fiscal policy usually pays particular attention to government excluding state-owned enterprises. Iceland's choice also finds support in the practice of some other countries with advanced financial reporting, including France and Sweden and to a lesser extent Canada and the United States (Table 5.1).

[13] Group A is central government (ministries and budget-funded institutions). Group B is nonfinancial public enterprises that are not joint-stock companies or unincorporated enterprises. Group C is lending agencies other than banks and includes the Housing Financing Fund. Group D is financial institutions and includes the central bank and the Icelandic Catastrophe Fund. Group E is unincorporated enterprises and joint-stock companies in which the government has a majority share and includes Landsbanki and Landsvirkjun.

Table 5.1: Scope of Financial Reports of Seven Governments

Country	Reporting Entity and Consolidation	State-Owned Enterprises	Central Bank	Local Govt	Selected Other Exclusions
Iceland	Central government	No	No	No	
Australia	Central government and entities it controls	Yes	Yes	No	
Canada	Central government and financially dependent entities it controls	Some	No	No	
France	Central government	No	No	No	
New Zealand	Central government and entities it controls	Yes	Yes	No	
Sweden	Central government	No	No	No	
United Kingdom	Public sector bodies that exercise public functions or are substantially funded from public money	Yes	Not yet	Yes	Rescued banks
United States	Central government	Some	No	No	Rescued financial institutions

Source: Financial statements of relevant governments.

Note: The United Kingdom plans to consolidate the central bank in 2012.

111. **There are the three main options regarding the coverage of audited financial statements in the new OBL:**

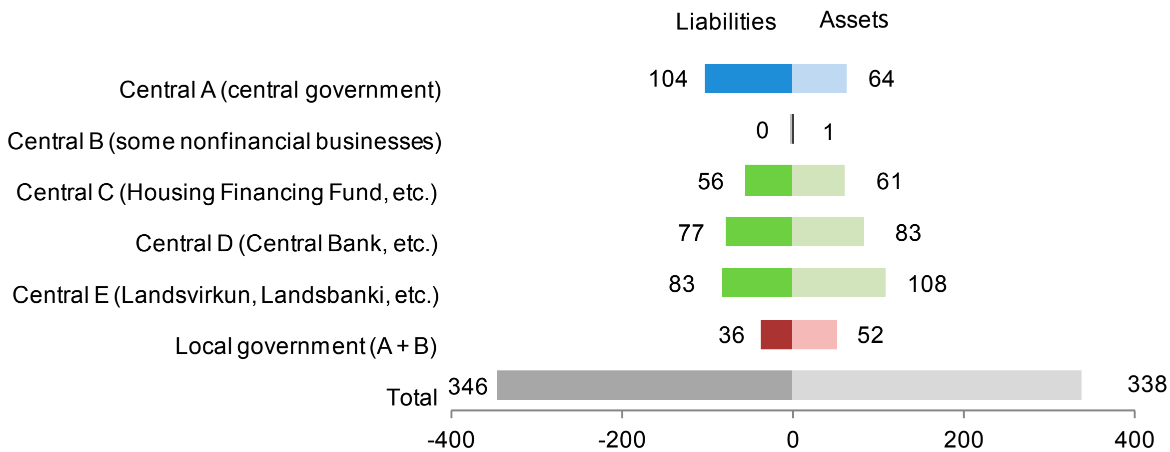
- **Option 1:** Maintain the existing approach of producing consolidated accounts for **central government only**;
- **Option 2:** Expand the scope of audited accounts to consolidate **central government plus all commercial entities it controls** (all entities in Groups B to E); and
- **Option 3:** Further extend the scope of audited accounts to consolidate the **entire public sector**, so that they include not only central government and the commercial entities it controls but also local governments and the commercial entities they control.

112. **The first option is unsatisfactory, and government should produce consolidated financial statements for at least the entities it controls.** Not consolidating these entities creates a misleading picture of the government's financial performance, its assets and liabilities, and the risks it faces. The government's finances depend heavily on the performance of state-owned enterprises such as Landsvirkjun and the HFF, which may pay the government large dividends if they perform well or, otherwise, may require bailouts. Reporting only the government's small equity investment in these highly leveraged enterprises does not reveal the size of the associated risks and opportunities (Figure 5.2). By

comparison with the central governments of Australia and New Zealand, for example, Iceland's central government controls very large assets with correspondingly large liabilities (Figure 5.3). Moreover, the Althingi and voters can reasonably hold the government accountable for the performance of state-owned enterprises, since the government appoints their boards and directs aspects of their operations. For these reasons, IPSAS 6 requires that a government's accounts consolidate all entities that it controls, except where control is expected to last for less than a year.[14] Finally, although fiscal statistics can provide information on public finances not provided by audited financial statements, statistical standards do not provide for consolidated information on central government and the entities it controls.

Figure 5.2: Assets and Liabilities of Entities in Iceland's Public Sector by Group

(Percent of GDP, December 31, 2010)

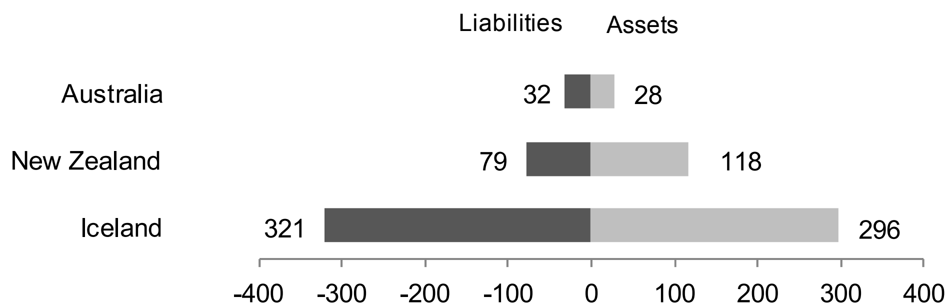


Source: Ministry of Finance, Ministry of the Interior, IMF *World Economic Outlook* (September 2011).

Note: "Central A" means Group A of the central government. The total eliminates central government's holding of equity in Parts B to E and its deposits and loans to the central bank, but is otherwise a simple sum. The assets of Group A of central government exclude physical assets. See footnote for definitions of the groups of central government.

[14] Control is considered to have two elements: the "power element" (the power to govern the financial and operating policies of another entity) and the "benefit element" (which represents the ability of the controlling entity to benefit from the activities of the other entity). See IPSAS 6, paragraph 28.

Figure 5.3: Assets and Liabilities of Consolidated Central Governments
(Percent of GDP, 2010)



Source: MoF; Australian and New Zealand central government financial statements.

Note: See note to Figure 5.2 for information on data for Iceland.

113. **The move to greater fiscal cooperation between central and local government raises the question of whether the scope of the government's audited financial statements should be further extended to also cover local governments.** In the recently adopted Local Government Act 2011, the Althingi has imposed fiscal rules on local governments and called for greater coordination between central and local government in the setting the fiscal policy. Under the IMF program the national government made commitments relating to the finances of general government, and because of the importance of local governments for overall fiscal policy the government may continue to set targets for general government now that the program has ended. If Iceland joins the EU, the government will be held accountable for meeting the Stability and Growth Pact limits on the deficit and debt of the general government. Arguments for making general government the basis of fiscal targets suggest that the public sector should at least be closely monitored and included in reporting. Although it is possible for this monitoring to rely on national statistical reports, using audited financial statements for all fiscal targets would be simpler and more reliable. If the government is prepared to be held accountable for the financial performance of local governments—and local governments accept the idea of consolidation—it may be sensible to produce consolidated accounts for the entire public sector.

114. ***Recommendation 5.3:*** **Consolidation.** The government's financial statements should cover **either**:

a. the central government and all the commercial entities that it controls; **or**

b. the public sector, that is central government, local governments, and all the commercial entities that they control.

Audited Financial Statements for Subsectors

115. **For the reasons mentioned in paragraph 110, the Government should also produce statements for subsectors of the public sector**. The subsectors could be defined as groups A to E (plus parts A and B of local government if local governments are

consolidated). That would create six or eight subsectors, however, which may be too many. A simpler option, which also has the advantage of integrating concepts from government finance statistics into audited financial statements, is to define the subsectors as central government, local government, nonfinancial public corporations, monetary financial public corporations (i.e., the central bank), and nonmonetary nonfinancial public corporations (five subsectors). The financial reports of the Australian central and state governments provide illustrations of subsector reporting using concepts from government finance statistics.[15]

116. ***Recommendation 5.4*: Reporting on Government Subsectors.** As well as requiring consolidated reporting, the OBL should require disaggregated reporting on subsectors of government, where the segments are defined as central government, local government, nonfinancial public corporations, monetary financial public corporations, and nonmonetary financial corporations.

F. Coverage of Fiscal Flows and Stocks

117. **Fiscal reporting should also provide information on a broad range of fiscal stocks and fiscal flows.** Iceland's accounting and statistics are better than many countries' in this respect, but they could be improved by recognizing certain additional assets and liabilities on the balance sheet and by providing information on long-term future cash flows associated with tax revenue and social spending.

Physical Assets of Central Government in Accounts and Statistics

118. **The 1997 FRA requires the government to follow business accounting, with certain exceptions, including notably the non-recognition of physical assets by ministries and institutions (Group A).** That is, the central government treats spending to acquire land, buildings, and other durables as an expense, instead of recognizing an asset on the balance sheet and its depreciation in the operating statement. This divergence from business accounting was considered appropriate at the time because of the difficulty of valuing certain kinds of government assets and the desirability of having a measure of spending that showed the cost of purchasing assets.[16]

119. **Although this exception had some justifications, it should now be removed**. IPSAS and *GFSM 2001* subsequently required governments to recognize physical assets on their balance sheets, and other countries with advanced financial reporting do so. Table 5.2

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[15] See the Commonwealth of Australia's consolidated financial statements available at http://www.finance.gov.au/publications/commonwealth-consolidated-financial-statements/index.html and State of Victoria's financial reports, available at http://www.dtf.vic.gov.au/CA25713E0002EF43/pages/publications-annual-financial-reports.

[16] *Financial Reporting Reform*, pp. 21–22.

gives an indication of the significance of physical assets on the balance sheets of those countries. Although these governments have found the valuation of some assets difficult on conceptual or practical grounds (and a few assets are recognized at a nominal value, such as $1), there is now much experience, as well as standards, to draw on.

Table 5.2: Physical Assets in Balance Sheets of Seven Other Governments

Country	Percent of Total Government Assets	Percent of GDP
Australia	32	8
Canada	15	3
France	50	23
New Zealand	21	15
Sweden	36	13
United Kingdom	59	49
United States	29	6

Source: Financial statements of relevant central governments.
Note: The coverage of the balance sheets of the governments varies as set out in Table 5.1, except for Australia and New Zealand, where the table presents information for subsectors similar to Group A in Iceland. Differences among governments reflect these and other accounting differences, as well as differences in the governments' responsibilities.

120. **Recognizing physical assets will have implications for budgeting.** The current principle—to limit both cash and accrual costs—can be preserved, but its implications will be somewhat different. If the cost of physical assets is not expensed in the year in which the assets are acquired, the cost will not show up that year in accrual-based appropriation numbers. It will show up in cash numbers for that year and in the depreciation component of subsequent years' accrual numbers. Large projects that increase a ministry's assets will still need a separate appropriation, but small projects that simply replace depreciated assets may not. In considering exactly how to proceed in this area, the government can draw on the experience of the other countries listed in Table 5.2, (some of which do not budget on the same basis as they prepare accounts), as well as that of Icelandic municipalities (which do).

121. **The government's financial statements can still report spending on the purchase of physical assets even when physical assets are recognized**. First, the cash-flow statement should show cash disbursed for the acquisition of physical assets. In addition, the operating statement can show the government's net lending, a measure of the surplus defined in government finance statistics, which treats the purchase of nonfinancial assets as a cost. Table 5.3 reproduces the surplus measures shown in the Australian central government's most recent annual financial statements, which include net lending. The Australian government's operating statement also shows the government's net operating balance and its change in net worth, and, more generally shows how it is possible to include measures from government finance statistics in audited financial statements.

Table 5.3: Surplus Measures in Australian Government's Operating Statement
(Year ending June 30, 2011, $A billion)

Revenue from transactions	298.897
– expenses from transactions	349.871
of which depreciation	6.099
= Net operating balance	**-50.974**
+ other economic flows [recognized in accounting income statement]	-8.081
= Operating result	**-59.055**
+ certain other economic flows [recognized in comprehensive income]	-1.654
= comprehensive result (change in net worth)	**-60.709**
Net operating balance (as above)	-50.974
+ depreciation (as above)	6.099
– purchase of nonfinancial assets	13.267
+ sales of nonfinancial assets	0.312
– change in inventories and other	0.729
= net lending/net borrowing ("fiscal balance")	**-58.559**

Source: Consolidated financial statements of Australian government for year ending June 30, 2010.
Note: the rows in boldface type are measures of the surplus.

122. ***Recommendation 5.5:*** **Nonfinancial Assets.** The accounting required by the OBL should ensure that ministries, institutions, and the government itself recognize nonfinancial assets on their balance sheets.

123. ***Recommendation 5.6:*** **Surplus Measures in Accounts.** The operating statement required of the government by the OBL should show the government's net lending, as well as standard accounting measures of the surplus.

124. ***Recommendation 5.7*****: Public Sector Balance Sheet**. Statistics Iceland should produce a full balance sheet and a full statement of other economic flows for central, local, and general government and the public sector.

Leases and Public-Private Partnerships

125. **Recognizing physical assets will make it easier to recognize the assets and liabilities associated with certain leases and public-private partnerships.** The Icelandic central government is unique among the seven countries discussed in this section in that it appears not to treat long-term leases or PPPs as creating liabilities. One reason for its approach is perhaps that the current accounting system does not allow the government also to recognize the assets created by those contracts. Although it is possible simply to disclose commitments related to leases and PPPs, disclosure may do little to prevent commitments from becoming unaffordable. Portugal, for example, clearly disclosed its commitments in PPPs before the crisis, but—following Eurostat standards—it did not recognize any liability related to PPPs in its estimates of government debt. It took on large PPP commitments,

which are now adding to its fiscal problems. The approach of countries such as Australia and the United Kingdom that recognize liabilities related to PPPs on their balance sheets is likely to be more effective in ensuring that PPP commitments are affordable and represent value for money.

126. ***Recommendation 5.8*: Leases and Public-Private Partnerships.** The government should recognize assets and liabilities associated with leases and public-private partnerships when that would be required by modern standards such as IPSAS.

Interest Costs

127. **At present, the estimates of interest expense in the government's accounts and statistics exclude inflation-linked increases in the value of the outstanding principal of inflation-indexed debt, a practice that should change**. The origin of the practice was a kind of inflation-adjusted accounting that could have been useful when inflation was high. But the rest of the government's existing accounts and statistics are presented in nominal terms, and current practice makes inflation-indexed debt seem cheaper than nominal debt even if it is not. The practice is inconsistent with IPSAS and *GFSM 2001* and with practice in the seven other countries with advanced financial reporting discussed in this section.

128. ***Recommendation 5.9*: Interest Cost**. The accounting required by the OBL should calculate interest cost by multiplying outstanding principal by the "effective interest rate," which is the projected internal rate of return on the debt, considering all future cash flows (e.g., according to IPSAS 29, Financial Instruments: Recognition and Measurement).

Future Taxes and Spending

129. **Even if the balance sheet of the public sector included all the assets and liabilities that would be recognized by IPSAS or *GFSM 2001*, it would still provide a partial picture of public finances.** The reason is that the right to tax will not be recognized as an asset and the obligations associated with future spending on education, healthcare, and other services and transfers will not be recognized as liabilities. As a result, a government with negative accounting or statistical net worth may still be in a comfortable financial position if projected future taxes are high enough relative to projected spending—and, in the opposite case, one with positive accounting or statistical net worth may still be in financial trouble. Although accounting and statistical balance sheets are important tools for fiscal monitoring, they need to be supplemented by projections of future spending and revenue.

130. **Almost all countries in the OECD other than Iceland regularly produce long-term fiscal projections.** All members of the European Union, for example, must analyze long-term public finances as part of their annual Stability or Convergence Programs. In the United Kingdom, the new Office for Budget Responsibility has recently issued an impressive

report on the subject.[17] Also impressive is the reporting in the annual financial statements of the US government. Those statements now include not only long-term projections but also a kind of balance sheet showing the present values of various categories of projected spending and revenue (Table 5.4). As long-term projections are usually conditioned on the unrealistic assumption that current policy will be maintained, their purpose is not to predict the future but to offer an informed guess at the sustainability of current policy. By doing so, they help ensure that the expected future costs of current policy decisions are taken into account even when those costs are not reflected in a liability or asset on the accounting or statistical balance sheets.

Table 5.4: US Federal Government's Summary of Long-Term Fiscal Projections
(September 30, 2010)

	Trillion dollars	Percent of 75-year GDP
Total Receipts	**175**	**20.2**
Social-security payroll taxes	38	4.4
Medicare payroll taxes	12	1.4
Individual income taxes	91	10.5
Other	34	4.0
Primary spending	**192**	**22.1**
Defense discretionary	31	3.6
Nondefense discretionary	31	3.6
Social security	49	5.7
Medicare A	17	2.0
Medicare B and D	20	2.4
Medicaid	24	2.8
Other mandatory	19	2.2
Receipts less primary spending	**−16.3**	**−1.9**

Source: Financial Report of the US government, for year ending September 30, 2010.

131. ***Recommendation 5.10*: Long-Term Fiscal Projections.** The OBL should require the government to publish long-term fiscal projections based on a range of macroeconomic, demographic, and other assumptions, along with an estimate of the present values of the main lines of the projections.

G. Use of Accounting Standards

132. **Another crucial question is the set of standards for financial reporting to which the OBL refers.** The FRA currently states that the government will follow local generally accepted accounting principles (GAAP), except where the Act provides otherwise. The main exception provided by the Act is the nonrecognition of the physical assets of Group A. The current treatment of interest costs, leases, and PPPs raises the question, however, whether the

[17] The Fiscal Sustainability Report, July 2011, available at http://budgetresponsibility.independent.gov.uk/fiscal-sustainability-report-july-2011.

government's accounting has actually diverged from local GAAP in ways not envisaged by the FRA.

133. **There are three main options for referring to international accounting standards in the OBL:**

a. **Option 1:** Continue to refer to Icelandic generally accepted accounting principles (**GAAP**), modify them for the public sector where necessary, but ensure that there are fewer unnecessary and undesirable exceptions (such as for finance leases);

b. **Option 2:** Refer to International Financial Reporting Standards (**IFRS**), and again modify them for the public sector where necessary.

c. **Option 3:** Refer to International Public Sector Accounting Standards (**IPSAS)**, which are based on IFRS but are already modified for governments.

134. **Adopting IPSAS is now an attractive option, especially for a small country**. Governments that, like Iceland's, adopted modern accrual-based accounting in the 1990s or 2000s generally chose to follow a modified version of local GAAP, although France refers to IPSAS and IFRS as well as local GAAP (Table 5.5). The mission is not aware of any national government that prepares audited financial statements that fully comply with accrual IPSAS. But some governments that have more recently decided to adopt modern accrual-based accounting, including those of Austria, South Africa, and Switzerland, have chosen to base their new standards on IPSAS. And international organizations such as the OECD, the Council of Europe, and NATO (the North American Treaty Organization) already follow IPSAS. The advantage of IPSAS over IFRS and local GAAP is that IPSAS do not need to be modified to apply to governments.[18] Adopting them would therefore reduce the workload on the Government Financial Reporting Committee and help ensure that reporting continues to follow good practice. Adopting international standards without modification would also help make the setting of numerical fiscal targets more credible. If standards are modified by the Government Financial Reporting Committee, people may believe that the modifications have been made to help the government meet the targets.

[18]On this subject, see "The Auditor-General's Views on Setting Financial Reporting Standards for the Public Sector," 2009, available at www.oag.govt.nz.

Table 5.5: Accounting Standards of Central Governments in Selected Countries

Country	Standards
Iceland	Local GAAP with exceptions set out in FRA 1997
Australia	Local GAAP, which includes “Australian equivalents to” IFRS, which adapt IFRS so that they are applicable to governments
Canada	Canadian GAAP for public sector
France	Standards specific to French government, developed with “privileged reference” to local GAAP, IPSAS, and IFRS
New Zealand	Public Finance Act specifies local GAAP, which includes “New Zealand equivalents to” IFRS, which adapt IFRS so that they are applicable to governments
Sweden	Standards specific to government, based on local GAAP
United Kingdom	Government Financial Reporting Manual, which applies “EU-adopted International Financial Reporting Standards (IFRS) as adapted or interpreted for the public sector context; “statutory override” for reporting entity
United States	Federal Accounting Standards Advisory Board issues Statements of Federal Financial Accounting Standards

Source: Websites of relevant governments

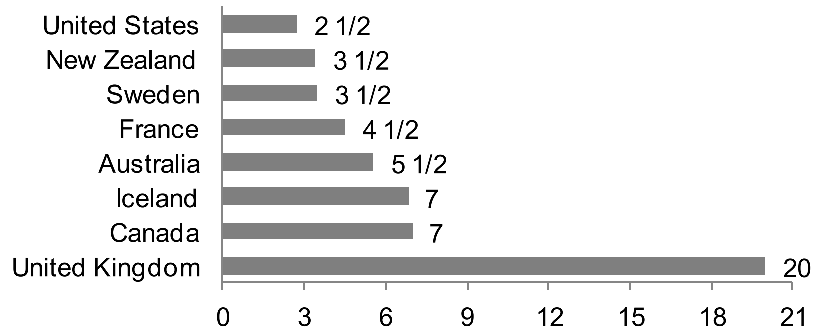
135. ***Recommendation 5.11*: Accounting Standards.** The OBL should require ministries, institutions, and the government itself to prepare financial reports that comply with International Public Sector Accounting Standards.

H. Timeliness of Reporting

136. **Improving the timeliness of fiscal reporting helps strengthen transparency and the integrity of budgeting.** At present, reporting is quicker than in some countries, but by no means at the frontier of countries with advanced financial reporting (Figure 5.4). Accelerating the production, consolidation, and audit of the governments accounts would have three distinct advantages from the point of view of budget management:

- it would give the government, Althingi, and the public reliable data on the government’s fiscal performance by the time of the Budget Orientation debate;
- it would provide a firmer basis for the preparation of the Government’s Medium-term Fiscal Strategy; and
- it would give ministries a clear picture of the final stock of retained revenues and carryovers available for use in the preparing their budgets for the following year.

Figure 5.4: Lags in Publication of Audited Annual Financial Reports
(In months)



Source: Websites of relevant governments.
Note: The lag for the United Kingdom is for its first whole-of-government report.

137. ***Recommendation 5.12:*** **Timeliness of Reporting.** The new organic budget law should require the government to publish audited annual financial statements no more than four months after the end of the financial year.

Appendix 1: Summary of Recommendations

#	SUBJECT	RECOMMENDATION	PAGE
I. Construction of the Organic Budget Law			
1.1	Institutional Coverage	OBL should apply to the whole public sector	14
1.2	Architecture of the Law	OBL should be organized around the four main phases of the budget cycle	16
1.3	Budget Calendar	OBL should prescribe a new, better integrated timetable for the budget process	18
II. Macroeconomic and Fiscal Policy			
2.1	Fiscal Policy Principles	Adopt a procedural fiscal rule anchored in a set of fiscal policy principles	26
2.2	Statement of Fiscal Policy	Each new government should state its numerical fiscal objectives for the Parliament	28
2.3	Althingi Approval of Fiscal Policy	Althingi should approve, amend, or reject Statement of Fiscal Policy	28
2.4	Revision of the Statement	Government may revise the statement with Althingi approval	28
2.5	Fiscal Objectives	Statement should include objectives for the stock of liabilities and fiscal balance	28
2.6	Medium-term Fiscal Strategy	By April of each year, the government should present its fiscal strategy for the medium-term	30
2.7	Budget Orientation Debate	Parliament should review past fiscal performance and approve MTFS targets, ceilings & legislation	31
2.8	Independent Scrutiny	OBL should require independent scrutiny of fiscal objectives forecasts, and performance	32
III. Budget Formulation and Approval			
3.1	Date of Budget Submission	Deadline for Budget submission to Althingi should be brought forward from October to September	36
3.2	Align Econ Forecast & Budget Cycles	Statistics Iceland should produce two official macroeconomic forecasts in January and August	37
3.3	Medium-term Budget Strategy	Require Budget to be accompanied by a Medium-term Budget Strategy	37
3.4	Unit of Appropriation	Reduce number of appropriations from to 300 and make ministries the focus of budget discussions	40
3.5	Virement Rules	Allow ministries to reallocate operating/capital expenditure between programs up to 3-5 %	41
3.6	Contingency Reserve	Require reserve of at least 1% for temporary, unforeseeable, unavoidable, unabsorbable pressures	42
3.7	Auditing Contingency Reserve	Transfers from the contingency reserve should be notified to Althingi and audited by INAO	42
3.8	Deduct Reserve Claims from Carryovers	Claims granted to ministries from the reserve should be deducted from the final stock of carryovers	42
3.9	Parliamentary Amendment Powers	Althingi Budget amendments should not increase expenditure, reduce revenue, or increase liabilities	45
3.10	Sequence of Parliamentary Voting	Althingi debates and votes on the Budget should follow a top-down sequence	45
3.11	Other Budget Limits	Scope of Budget authorizations should be expanded to include public-private partnerships	46
3.12	Multi-year Financial Commitments	Althingi approval should be required for commitments that exceed a percent of a ministry's budget	46

IV. Budget Execution and Treasury Management			
4.1	Cash Management	OBL should place an obligation on government to manage cash efficiently	50
4.2	Cash Planning	Ministries and agencies should be required to have cash and work plans approved by 31 December	50
4.3	Reporting of Own Revenues	All revenues should be reported on a gross basis in budgets, statistics, and accounts	51
4.4	Retention of Revenues	OBL should specify principles for the retention of revenues by individual ministries and agencies	51
4.5	Carryover of Overspending	Carryover of overspends to future years should be abolished	54
4.6	Carryover of Underspending	Carryover of underspends should be applied at the ministry level and limited to 3% of appropriation	54
4.7	Supplementary Budgets	Overspending should be authorized by a Supplementary Budget before it can take place	55
4.8	Final Budget Bill	Final Budget Bill should be abolished or be expenditure neutral	55
4.9	Wage Agreements	Wage agreements should be negotiated alongside budget and contained within budget limits	55
4.10	Investigating Overspending	INAO should be required to report any overspending for Althingi to the authorize or sanction	56
4.11	Sanctioning Overspending	OBL should provide a broader range of credible sanctions to deal with overspending or irregularities	56
V. Fiscal Reporting			
5.1	Accounting Basis of Forecasts	Government budgets, forecasts, and accounts should be prepared on same accounting basis	60
5.2	Public Sector Statistics	Statistics Iceland should produce comprehensive statistics for the consolidated public sector	62
5.3	Consolidation	Financial statements should cover all central government controlled entities or whole public sector	65
5.4	Reporting on Government Subsectors	Financial statement should also be produced for 5 sub-sectors of the public sector	66
5.5	Nonfinancial Assets	Non-financial assets should be recognized in government balance sheets	68
5.6	Surplus Measure in Accounts	Government operating statements should show net lending as well as other surplus measures	68
5.7	Public Sector Balance Sheet	Statistics Iceland should produce a full balance sheet and statement of other economic flows	68
5.8	Leases & Public-Private Partnerships	Assets and liabilities associated with leases and PPPs should be recognized in budgets and accounts	69
5.9	Interest Costs	Accounts and statistics should recognize inflation-linked increase in principal of indexed debt	69
5.10	Long-term Fiscal Projections	Government should public long-term fiscal projections based on a range of assumptions	70
5.11	Accounting Standards	Government accounts should comply with International Public Sector Accounts Standards	72
5.12	Timeliness of Reporting	Audit financial statements should be published no more than four months after the end of the year	73

APPENDIX 2: SELECTING FISCAL OBJECTIVES AND INDICATORS FOR ICELAND

Fiscal Rules and the State of Iceland's Economy

138. **While Iceland's recovery from the economic crisis has commenced, fiscal consolidation will continue to be a prominent feature of Iceland's fiscal policy making for years to come.** The government is committed to reducing general government debt to about 80 percent of GDP by 2016, which will require a sustained improvement in the primary balance of more than 5 percentage points of GDP. Further fiscal effort will be needed to bring gross public debt to the government's goal of 60 percent of GDP in the long run.

139. **Under these circumstances, introducing a numerical fiscal rule in the OBL would tend to be either excessively stringent in the long run or provide insufficient adjustment in the short-to-medium-term.** For example, given Iceland's high level of debt, a numerical rule seeking to reduce gross general government debt to 60 percent of GDP in a 7-10 year horizon would entail maintaining fiscal balances that would be considered excessively high once the consolidation process is complete. However, setting a looser objective for the overall fiscal balance would imply a much longer horizon to reduce public debt and allow the public finances to drift away from a sustainable path should a new large negative shock happen in the interim. In view of these considerations, it appears that a procedural fiscal rule, which would require the government to set binding medium-term objectives for fiscal policy but leave their precise numerical specification to the government of the day, is more appropriate for Iceland at this juncture. This is also consistent with experience in other Nordic countries, in which the law requires governments to state numerical objectives for the fiscal balance and/or expenditure when the governing party or coalition present their policy programs at the start of each parliament.

Table A.1: Statutory Basis of Fiscal Rules

	ALL COUNTRIES				NORDIC COUNTRIES		
	Spending	**Revenue**	**Balance**	**Debt**	**Denmark**	**Finland**	**Sweden**
Political Commitment	6	1	2	1	X	X	X
Coalition Agreement	4	1	0	0			
Statutory	6	2	2	3			
International Treaty	0	0	24	26	X	X	X
Constitutional	1	1	4	1			
Total	**17**	**5**	**32**	**31**			

Note: Includes EU and other advanced countries

Source: IMF Fiscal Rules Database;.

Setting Fiscal Objectives

140. **Under a procedural fiscal rule, the OBL would require each new government to specify its numerical fiscal objectives in a Statement of Fiscal Policy together with the relevant indicators to measure performance and ensure compliance.** Experience with fiscal frameworks suggests that the most effective and durable fiscal indicators:

- ensure fairness between generations (**sustainability**).
- provide an unambiguous guide for setting the annual fiscal stance (**operability**);
- allow fiscal policy to stabilize macroeconomic fluctuations (**counter-cyclicality**);
- facilitate multi-year expenditure planning and minimize sudden and disruptive changes in the levels of taxation or expenditure (**medium-term**); and
- can be clearly explained to policy-makers and assessed by the public (**simplicity**).

141. **In choosing the right fiscal indicator to target, countries face trade-offs among the above criteria**. Indicators that secure sustainability (debt ratio and overall balance) tend to be acyclical or even procyclical, and may require abrupt changes in revenues and/or expenditure in order to stay on a sustainable debt path. Indicators that serve the objective of economic stabilization (balance over the cycle or expenditure rules) may lead to deviations from a sustainable path and be derailed under extreme shocks. Efforts to incorporate some countercyclical features into the above fiscal indicators would typically require one to estimate the output gap, which in Iceland has proven to be a major technical challenge given the structural changes of the economy and asset price distortions prior to the crisis and the severe contraction of potential output during the crisis.[19] Therefore, complex indicators that serve multiple objectives (structural balance with debt brakes) tend to be non-transparent and can struggle to garner political commitment and public credibility.

142. **Some examples of fiscal objectives that would be appropriate for Iceland's current circumstances and balance sustainability, simplicity, and flexibility are**:

- ***Balance over the cycle or over a specified time horizon***. Indicators defined over the cycle allow flexibility to output shocks, by allowing for the operation of automatic stabilizers and for discretionary fiscal stimulus. However, greater flexibility may come at the expense of less credibility, as these indicators could lead to excessively loose fiscal policy at times during the cycle. In addition, monitoring the performance in relation to the fiscal objective requires precise dating of the cycle, which hinges on the methodology used and the consistency of national accounts data over time. Dating

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[19] See Central Bank of Iceland, 2011, Monetary Bulletin, 2011/4, for details on the factors affecting potential output in the wake of the financial crisis.

economic cycles also requires judgment, which can be controversial. Since the length and level of peaks and troughs of any cycle are unknown until the cycle is complete, the performance of the rule is only fully tested ex-post. An alternative to using an over-the-cycle concept is to specify a period of time over which the balance rule must be satisfied. The length of the period could be selected to coincide with the average length of the business cycle (for example 7 years, as in Sweden).

- ***Augmented growth-based balance:*** The augmented growth-based balance responds to deviations of actual output growth from trend growth. It requires a nominal balance below its medium-term target when real GDP growth exceeds trend (long-term) GDP growth. The deficit increases automatically when output growth is below its long-term trend. The indicator is relatively simple as it does not rely on any specific measure of the output gap. It could also be supplemented with a requirement to correct past year's slippages in fiscal performance by specifying an adjustment coefficient as a proportion of the size of the slippage. The adjustment coefficient represents, in effect, a measure of the trade-off between sustainability and countercyclicality: the higher the adjustment coefficient, the less countercyclical the rule would be.
- ***Expenditure growth limit with a debt or deficit brake:*** In general, an expenditure growth ceiling set at or just below the level of long-term real growth includes an element of countercyclicality and accommodates inflation shocks. The reason is that the expenditure ratio will decrease when actual growth is above trend and increase when it is below trend. Revenues are also allowed to vary freely according to the cycle. However, simple expenditure ceilings are not anchored in a target for the deficit or debt, which could lead to significant increase in deficits and debt without triggering a policy response. By including a debt brake mechanism together with the ceiling, the countercyclical benefits of an expenditure-based framework are preserved. The rate of expenditure growth can be adjusted according to the fiscal consolidation needs, the need to reduce the size of the public sector, and take into account of rigidities in the budgetary items.

Simulating Fiscal Indicators for Iceland

143. **This final section provides a simulation of how the three different indicators would perform in Iceland if adopted by the government as fiscal objectives in its first Statement of Fiscal Policy after the passage of the OBL.** The simulation is based on the following baseline assumptions: (i) the new fiscal policy objectives will be introduced in 2013 and commence in 2014, when output is expected to be at its potential level; (ii) the targeted debt ratio of 60 percent of GDP will be achieved in 7 years; (iii) the 2014 projected general government debt ratio of 96 percent of GDP combined with a consolidation horizon of 7 years implies that the authorities should set as a fiscal objective an average surplus of at least 1.5 percent of GDP over the consolidation period.

144. **In addition, the indicators simulated for Iceland have the following common features**: (i) flexibility: allowing automatic stabilizers to be accommodated by fiscal policy; (ii) simplicity and transparency—use of a concept of long-term growth (2.3 percent of GDP for 2000-2010) rather than potential growth, which is difficult to estimate, especially during a crisis period; (iii) institutional coverage of the general government sector; and (iii) an automatic adjustment mechanism, which ensures that the fiscal stance always returns to the required sustainability level (Table A.2).

Table A.2: Description of Fiscal Indicators

Fiscal Objective	Fiscal Indicator	Institutional Coverage	GDP Indicator	Adjustment Mechanism	Expenditure Adjustment
7-year rolling surplus	Overall Balance	GG	Average 7-yr growth	Automatic: 7-yr horizon	No
Augmented growth-based balance	Overall Balance	GG	Long-term growth	Automatic: 50% of slippage	No
Limit on real spending growth with deficit brake	Primary Expenditure	CG/GG	Long-term growth	Automatic: 50 % of slippage	Yes

145. **The shocks applied to the fiscal objectives replicate the shocks in standard debt sustainability analysis**.[20] These include a growth shock, an interest shock, a combined shock scenario, and a contingent liability shock of 30 percent of GDP. In addition a boom-bust scenario is also considered.[21]

146. **The results show that a rolling surplus or an augmented growth-based objective is more likely to provide a reliable anchor for debt sustainability than a real expenditure limit**. While under the baseline, debt declines faster under an expenditure limit—since the expenditure ratio declines as the economy recovers—most shock scenarios would derail spending and undermine the fiscal balance, thereby eventually slowing down debt reduction. The expenditure limit helps reduce debt rapidly under a boom-bust scenario, but needs to be supplemented with a stringent correction mechanism (deficit brake) in order to avoid reversal during a bust. The rolling surplus and the augmented growth-based objective behave similarly, both succeeding in bringing down the debt ratio to 60 percent of GDP in 7 years under all scenarios except a contingent liability shock. However, unlike the expenditure limit, they require abrupt spending adjustment under all shocks, which undermines medium-term planning.

[20] IMF, 2011, "Iceland—Sixth Review Under the Stand-By Arrangement and Proposal for Post Program Monitoring," IMF Country Report.

[21] The mission team presented the full results of the simulations to the OBL Reference Group.

147. **The three fiscal indicators are assessed against the three desirable qualities (each measured by two criteria) listed in Table A.3:**

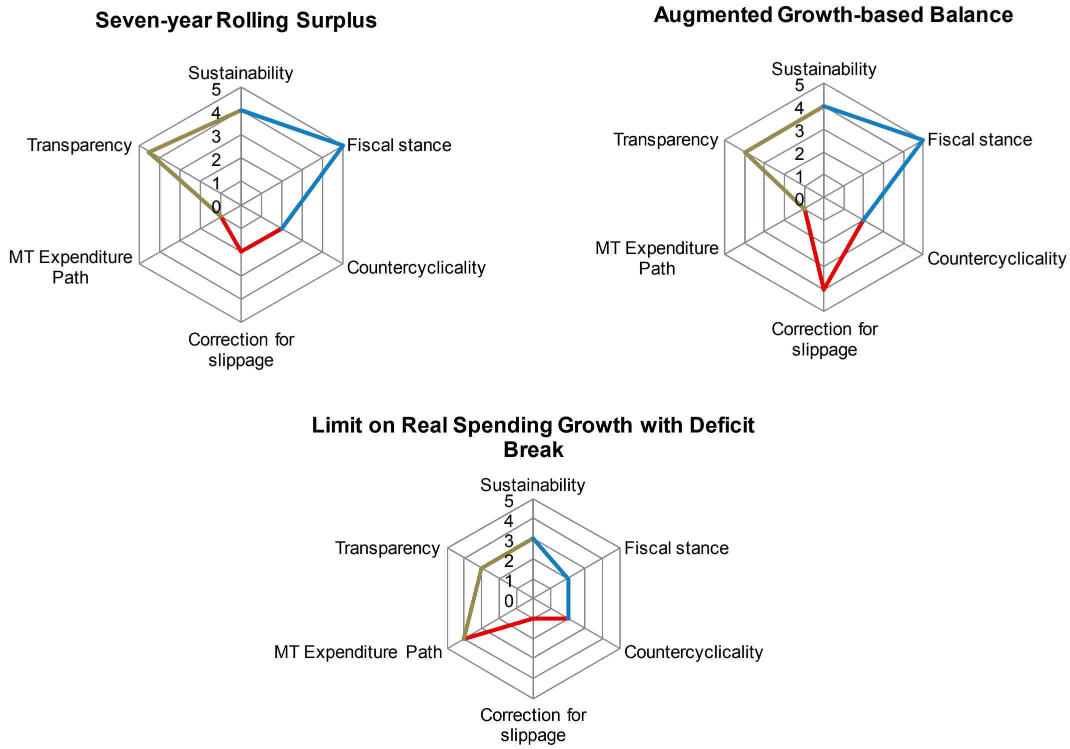
- their ability to maintain **fiscal discipline** by keeping the overall deficit less than 0.5 percent of GDP and succeeding to reduce general government debt to 60 percent of GDP in less than 10 years even under shocks;
- their ability to **adjust to shocks** by allowing the automatic stabilizers to operate during above/below-trend phases of the economic cycle and correcting for any fiscal slippage against the consolidation path within a reasonable period (three years);
- their **operability** as demonstrated by the ease with which one can measure performance against the objective (without complex cyclical adjustment calculations or judgments about output gap,) and their ability to promote multi-year expenditure planning by preventing sudden, large (1.5 percent of GDP per year) adjustment in primary expenditure.

Table A.3: Assessment Criteria for Fiscal Indicators

Qualities	Criteria	Measurement	Example
Fiscal Discipline	Long-term debt sustainability	General government debt below 60% of GDP by 2024	60% of GDP Debt Limit (EU)
	Prudent fiscal stance	1.5% overall surplus and deficit not exceeding 0.5%	1% Primary surplus Target (Sweden)
Adjustment to Shocks	Counter-cyclical fiscal policy	Positive correlation between output gap and cyclically adjusted balance.	Balance over the cycle (UK)
	Corrects for slippage	Targeted surplus restored within 3 years of slippage	Debt brake rule (Switzerland)
Operability	Simple to calculate	Compliance does not require great forecasting precision or use of output gap or structural balance measure.	Rolling average surplus (Iceland LG)
	Facilitates multi-year budget planning	Primary expenditure do not have to be reduced by more than 1.5% of GDP in any given year under shock	Nominal expenditure ceiling (Finland)

148. **This assessment demonstrates the trade-offs that exists between the desirable qualities for a fiscal objective.** Rolling 7-year surplus and augmented growth-based balance objectives provide relatively good policy guidance by maintaining a prudent fiscal stance (a fiscal surplus). However, the augmented growth-based balance objective is more likely to preserve sustainability due to its quick reaction to potential slippage in the previous year. However, this rapid adjustment comes at the expense of economic stability, which is better preserved under a rolling 7-year surplus. A ceiling on real expenditure growth with a deficit brake provides a smooth expenditure path but could deviate from sustainability, especially if growth is below the long-term trend for a long time. These trade-offs need to be considered carefully before selecting a specific numerical fiscal objective in Iceland's first Statement of Fiscal Policy following the adoption of the OBL.

Figure A.1: Scoring of Fiscal Indicators



Source: Ministry of Finance; Statistics Iceland; and IMF staff calculations.