



MINISTRY OF FINANCE
AND ECONOMIC AFFAIRS

Budget Proposal 2015

Medium Term Fiscal Plan 2015-2018

September 22th 2014



1.

FISCAL OBJECTIVES AND PROSPECTS

Budget proposal 2015

GOVERNMENT FINANCIAL REPORTING ACT, NO. 88/1997

- » Stipulates that, with the budget proposal for each year, a medium-term fiscal plan must be presented for a four-year horizon providing an overview of:
 - » the projections and prospects for the government finances based on general economic conditions
 - » the gov't fiscal policy, including it's planned course of action for the evolvement of revenue and expenditure programs
- » The medium-term plan is based on:
 - » current law, regulations and government policies
 - » existing tax system and foreseeable expenditure liabilities
 - » macroeconomic forecast from Statistics Iceland
 - » a range of premises underlying the progression of tax bases and spending programs, e.g. demographics
 - » new gov't policies and initiatives and political priorities for changes in taxes and the development of expenditure categories



MAIN PREMISES OF FISCAL POLICY

- » After the fall of the banking system in 2008, the central objective of the fiscal plan has been to establish a sustainable path for the public finances by arresting the accumulation of debts due to the Treasury's deficits and, thereby, alleviate the associated interest cost burden.
- » At the same time, the provision of essential social and welfare services is to be secured on the basis of financing from a equitable and well designed tax system that promotes rather than hampers economic growth
- » The mounting public debts have left almost no scope for significant fiscal measures to stimulate growth or to moderate the dampening effects of the public finances on the economy.

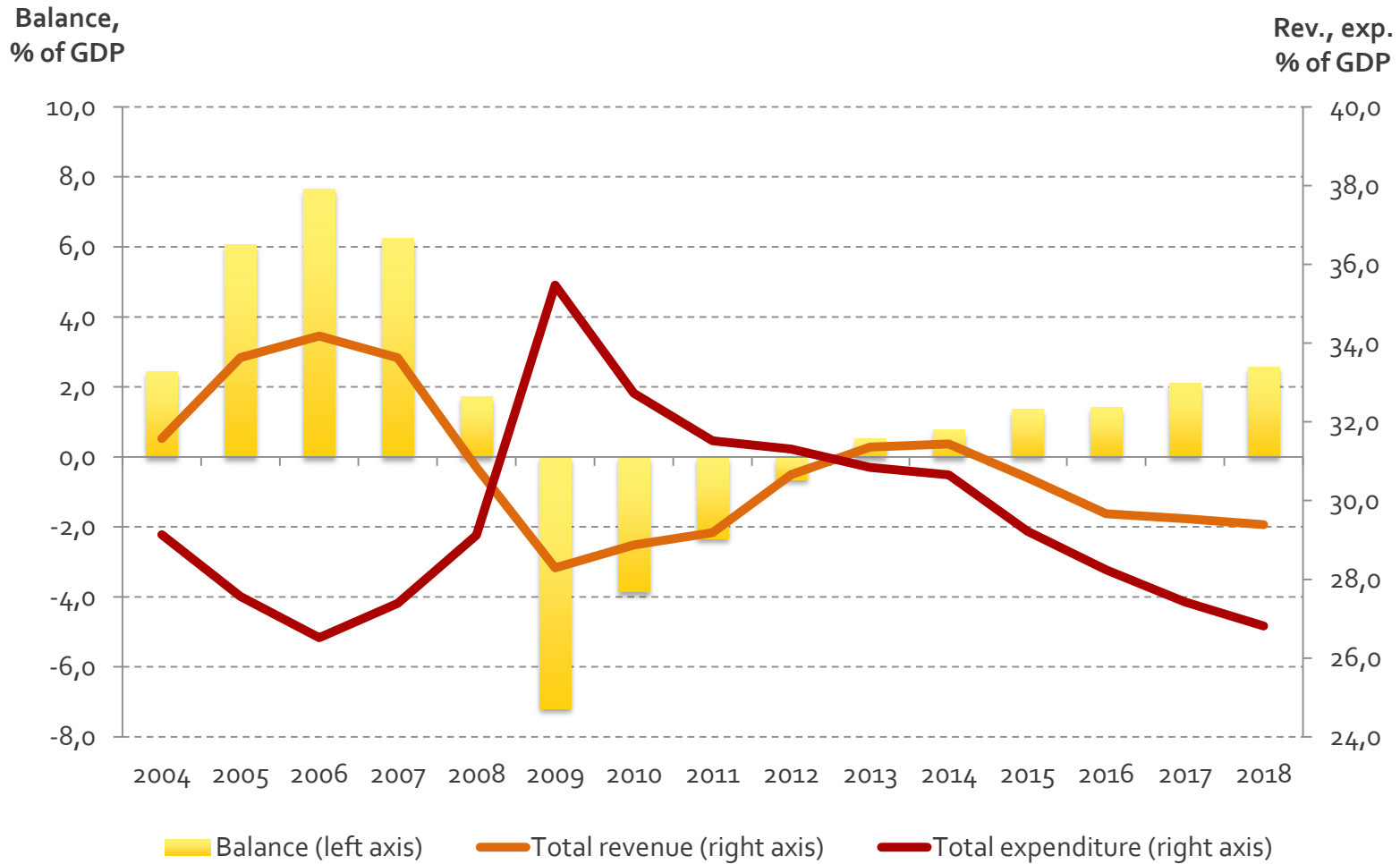


MAIN OBJECTIVES OF FISCAL POLICY

- » The overriding objective of the fiscal plan has been to achieve a substantial surplus in the primary balance to counteract the deficit in the interest balance and produce a surplus in the overall balance of the Treasury.
- » These simple but demanding objectives were the cornerstones of the fiscal consolidation plan formulated in collaboration with the IMF in the winter of 2008-2009.
- » After six years of persistent deficits since 2008, the prospects for this year are that this objective will be reached with a surplus even if favorable one-off irregular revenues are excluded (dividends from banks).



TREASURY BALANCE 2004-2018*



*Excluding irregular items



FISCAL PROSPECTS

- » Economy is recuperating and stabilizing with favorable prospects for the coming years.
 - » Economic outlook: steady GDP growth accompanied by relatively low inflation and less unemployment.
- » Debt accumulation is being brought to a halt and the public finances have been stabilized.
- » This will provide a foothold for a gradually growing surplus that can serve to alleviate some of the debts or other long-term liabilities and fiscal risks in the future.
 - » Debts are still at a precarious level and the interest costs are unabated in nominal terms.
 - » Fiscal scenario calls for continued stringent restraint in expenditures in order to cling to a positive balance in the next two years before yielding a more robust surplus.
 - » The debt level in relation to GDP should drop progressively in the coming years down to around 60% in 2018.



FISCAL CHALLENGES

- » The fiscal challenge ahead is to improve the room for manoeuvre in this stringent 4 year scenario.
 - » Cope with mounting public pension liabilities and aging costs.
 - » Create more fiscal space for investments in public infrastructure and core public services.
- » To that end, revenue collection needs to be strengthened while alleviating the financial drain from the negative interest balance.
 - » Economic policies and the design of the tax system need to provide a favorable setting for business sector investments and economic expansion that generate public revenues.
 - » Measures directed at the balance sheet to diminish the debt and interest cost burden, e.g. sale of shares in banks, refinancing debts on more favorable terms, trim down the foreign currency reserve



PREPARATIONS FOR THE BUDGET PROPOSAL

- » Steps are being taken to strengthen the budget process and adopt a more disciplined approach in the procedures for preparing the budget along the lines of the proposed new organic budget law.
 - » A four-year fiscal framework was formulated in the spring.
 - » Expenditure frames set for ministries comprising both savings targets and new spending space.
 - » In accordance with a recent stipulation in the law for parliamentary proceedings, the budget was presented in the first week of September or three weeks earlier than previously.
- » The new stipulations also require for the first time that all bills concerning legal amendments to secure the premises of the budget have to be submitted simultaneously, including alterations in taxes.



PREPARATION OF THE BUDGET 2015

- » By submitting the budget proposal and all the related legal amendments earlier than before, the Parliament has more scope to discuss the budget and underlying assumptions in the autumn session.
- » The preparation of the legislative bills earlier than before proved to be somewhat problematic in this first run.
- » The numerical basis of the budget needed to be closed with a cabinet decision on the budget proposal at the end of June. However, the elaboration of the legislation for revenue measures and tax reforms continued in August and concluded with a slightly different outcome.

PREPARATION OF THE BUDGET 2015

- » The final version of measures for reforms in the VAT system and the abolishment of the commodity tax was in certain respects different from what was envisaged in the budget.
 - » This entails a small discrepancy between the revenue figures, all other things being equal, but not to the point that the budget surplus would be nullified.
 - » Given the uncertainties in predicting the effects from such far-reaching alterations in the tax system and that the income effect from the repeal of the commodity tax has not been imputed, this discrepancy is considered to be within a reasonable margin of error.
 - » The figures in these slides are in accordance with the ones presented in the budget proposal.
 - » This divergence will be adjusted in the 2nd reading of the budget if the reevaluation of the revenue side on the basis of a new economic forecast will still seem to warrant it.





2.

ECONOMIC PROSPECTS

Budget proposal 2015

ECONOMIC PROSPECTS IN THE MEDIUM TERM

- » Positive and stable Economic outlook according to Statistic's Iceland Economic Forecast in July 2014
 - » Economic growth estimated 3.1% in 2014 and 3.4% in 2015 and to be around 3% in 2016-2018
 - » The growth will be driven by private consumption but fixed capital formation is also expected to grow rapidly until 2016
- » Inflation is historically low and has been below the CBI's inflation target most of the year 2014
 - » 2.5% inflation expected in 2014 and 3.4% in 2015
 - » Inflation expected to gradually decrease over the forecast horizon to 2.6% in 2018
- » Unemployment is expected to gradually decrease over the next few years and is projected 3.4% in 2018



MAIN ECONOMIC ASSUMPTIONS FOR THE 2015 BUDGET PROPOSAL*

- » Economic growth **3.4%**
- » Inflation **3.4%**
- » Unemployment **3.5%**
- » Current account deficit **-0.8%** of GDP
- » Increase in real wages by **2.6%**

* *Statistics Iceland Economic Forecast, July 2014*



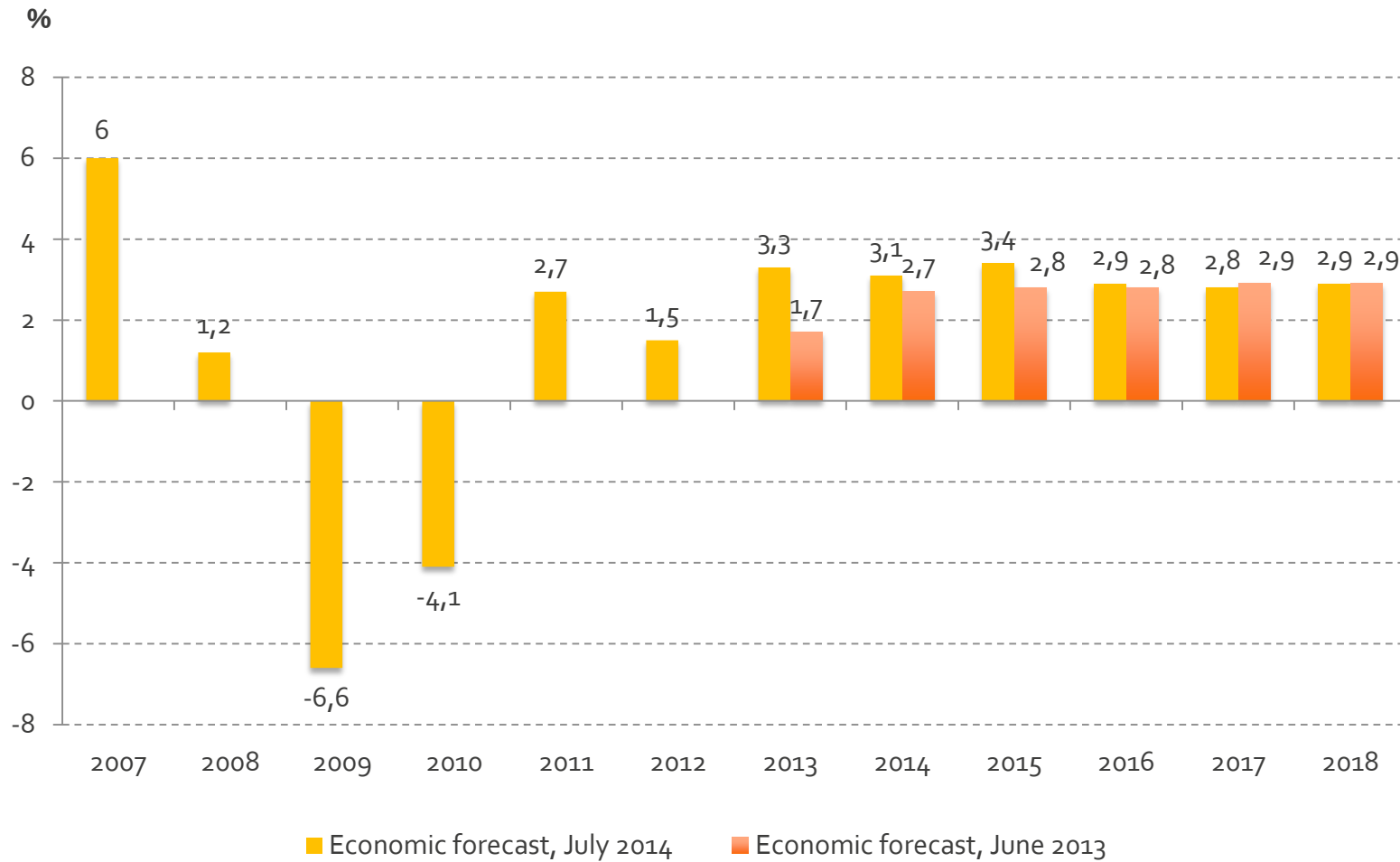
MAIN ECONOMIC ASSUMPTIONS FOR THE BUDGET

	2013	2014	2015	2016	2017	2018
Private consumption	1,2	3,9	3,7	2,8	3	3
Public consumption	1,3	1,2	0,5	1,7	1,9	1,8
Fixed capital	-3,4	16,9	15,7	12,5	0,3	5
Exports of goods and services	5,3	3,5	3,5	2,8	3,2	3,1
Imports of goods and services	-0,1	7,5	6,1	5,2	2,2	3,3
GDP growth	3,3	3,1	3,4	2,9	2,8	2,9
Balance of trade % of GDP	7,4	5,6	4,6	3,4	3,9	3,8
Inflation	3,9	2,5	3,4	3,2	2,8	2,6
Exchange rate index	-1,4	-3,3	1,8	0,6	0	0
Unemployment	4,4	3,8	3,5	3,5	3,4	3,4
Wages	5,7	5,2	6,1	4,8	5	4,7

* Economic forecast from Statistics Iceland in July 2014



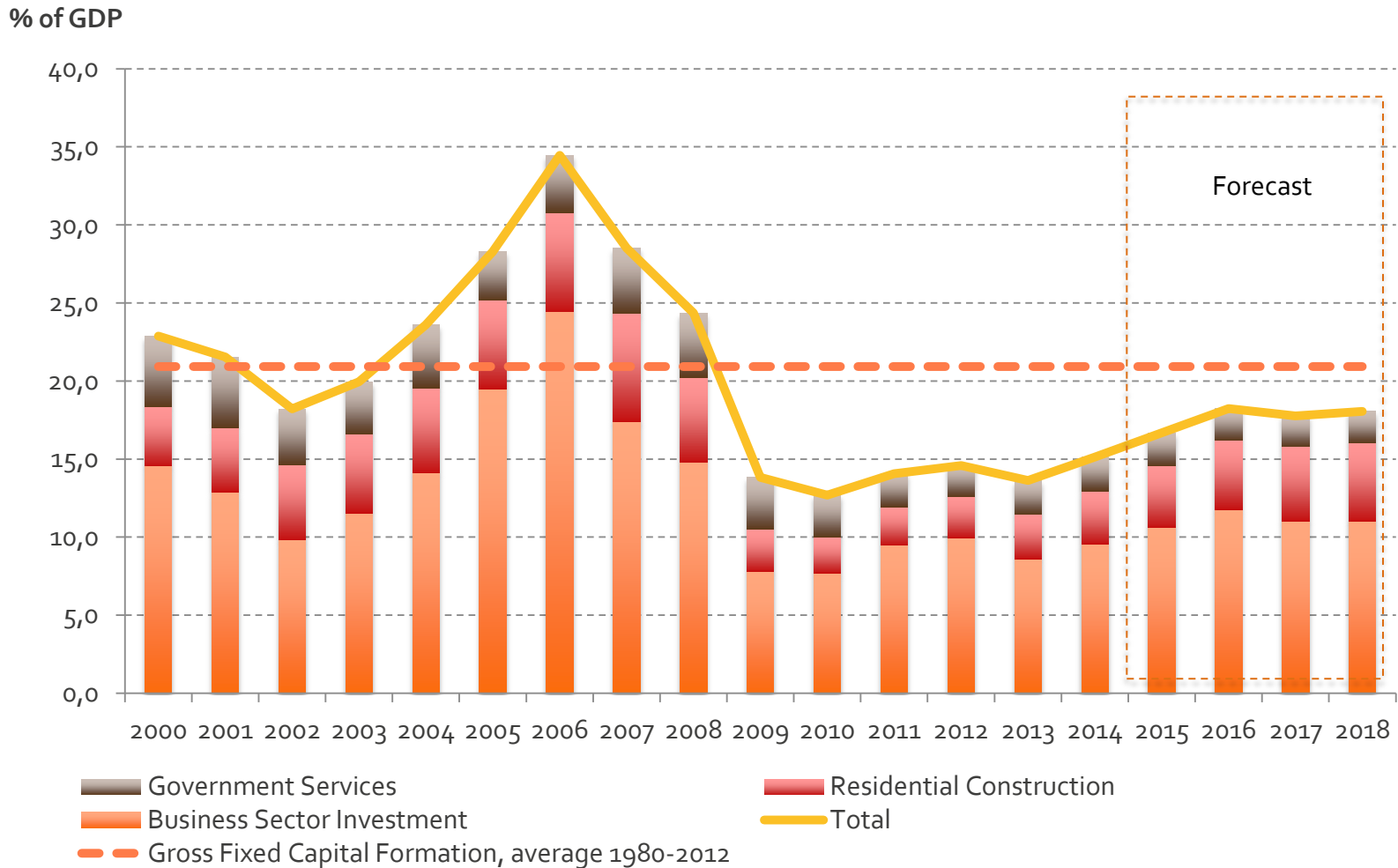
ECONOMIC GROWTH



Source: Statistics Iceland



GROSS FIXED CAPITAL FORMATION

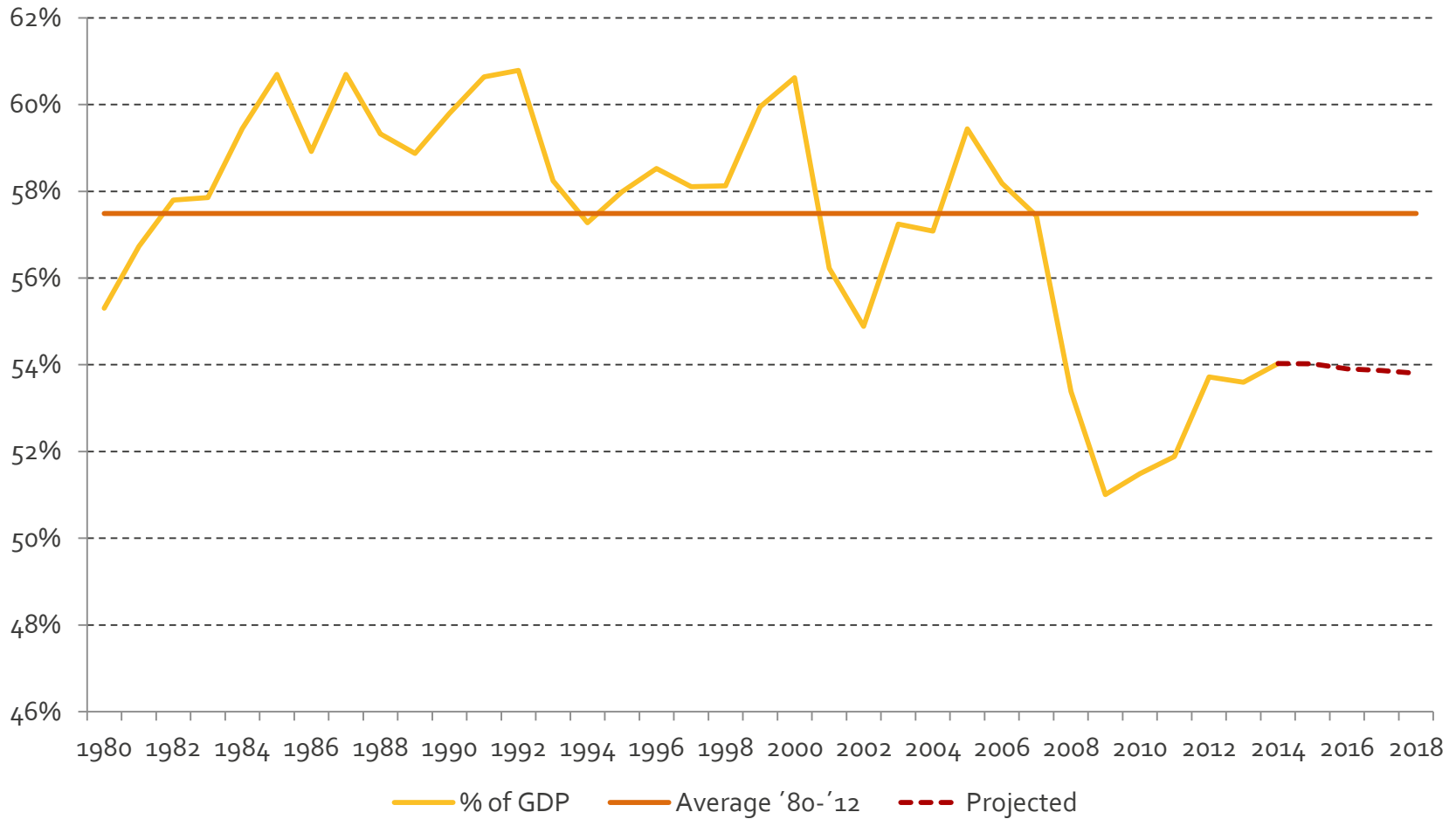


Source: Statistics Iceland



PRIVATE CONSUMPTION

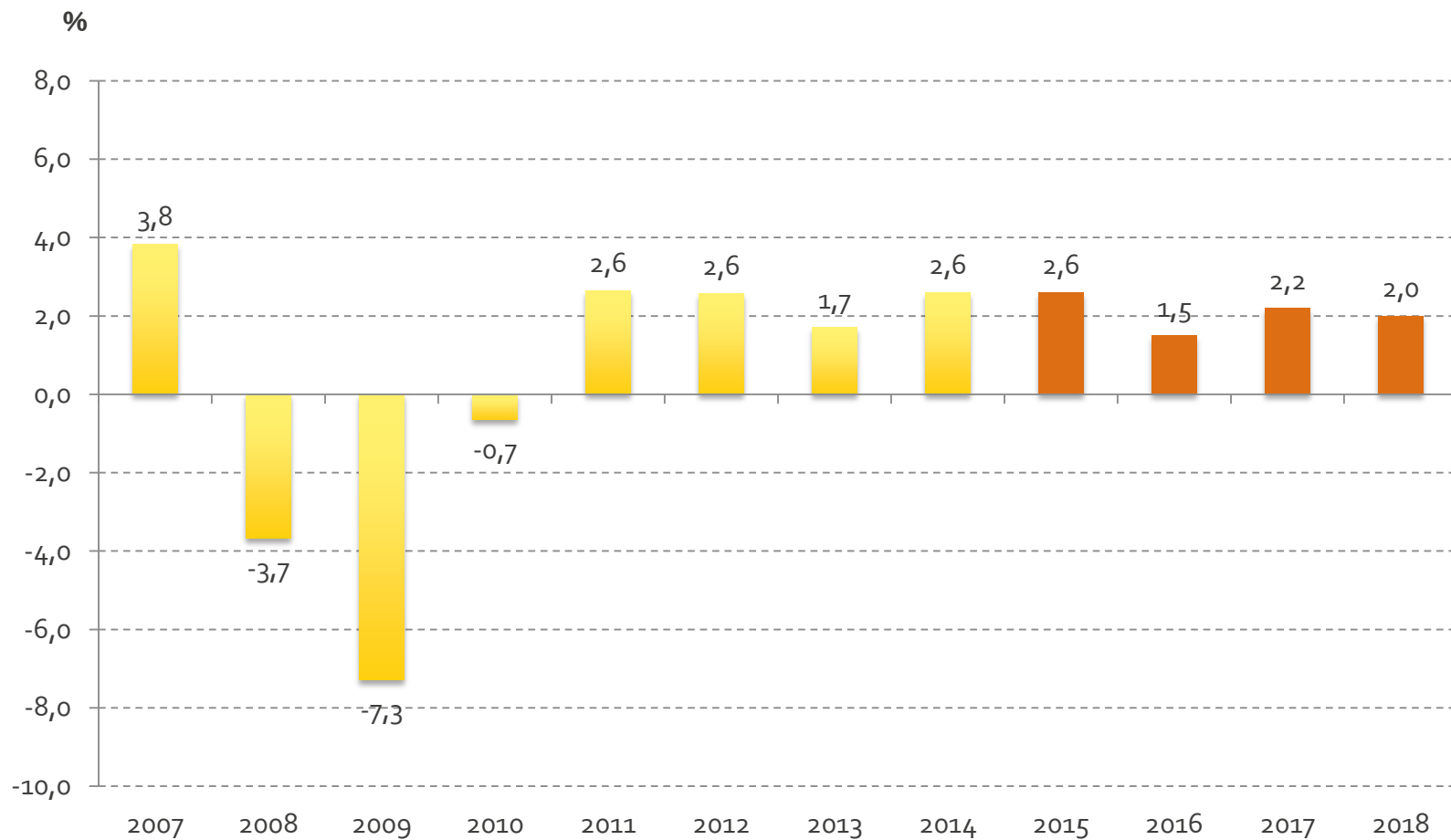
% af VLF



Source: Statistics Iceland



PURCHASING POWER



Source: Statistics Iceland



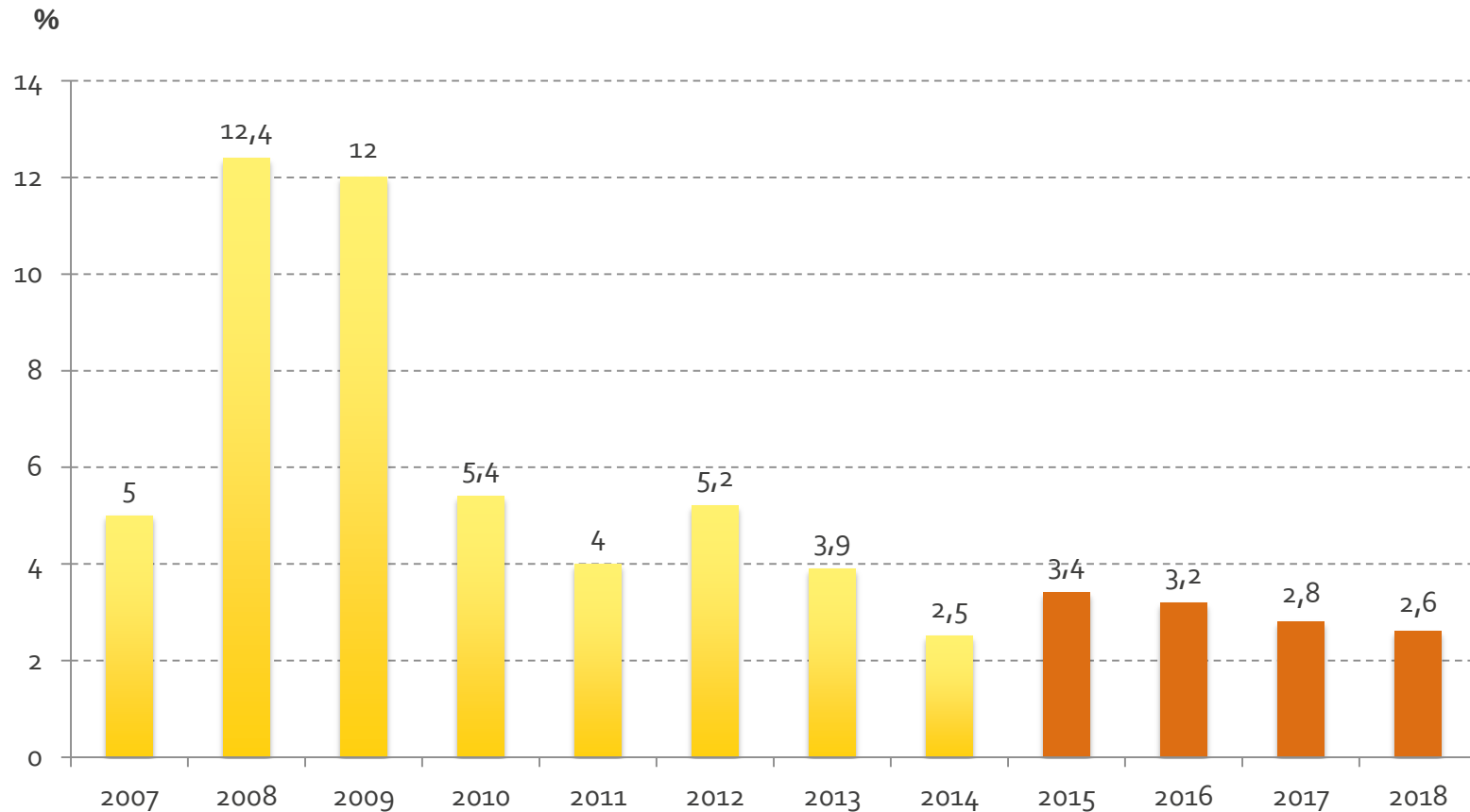
MORTGAGE REDUCTION BY INCOME GROUPS



Source: Directorate of Internal Revenue, MoF



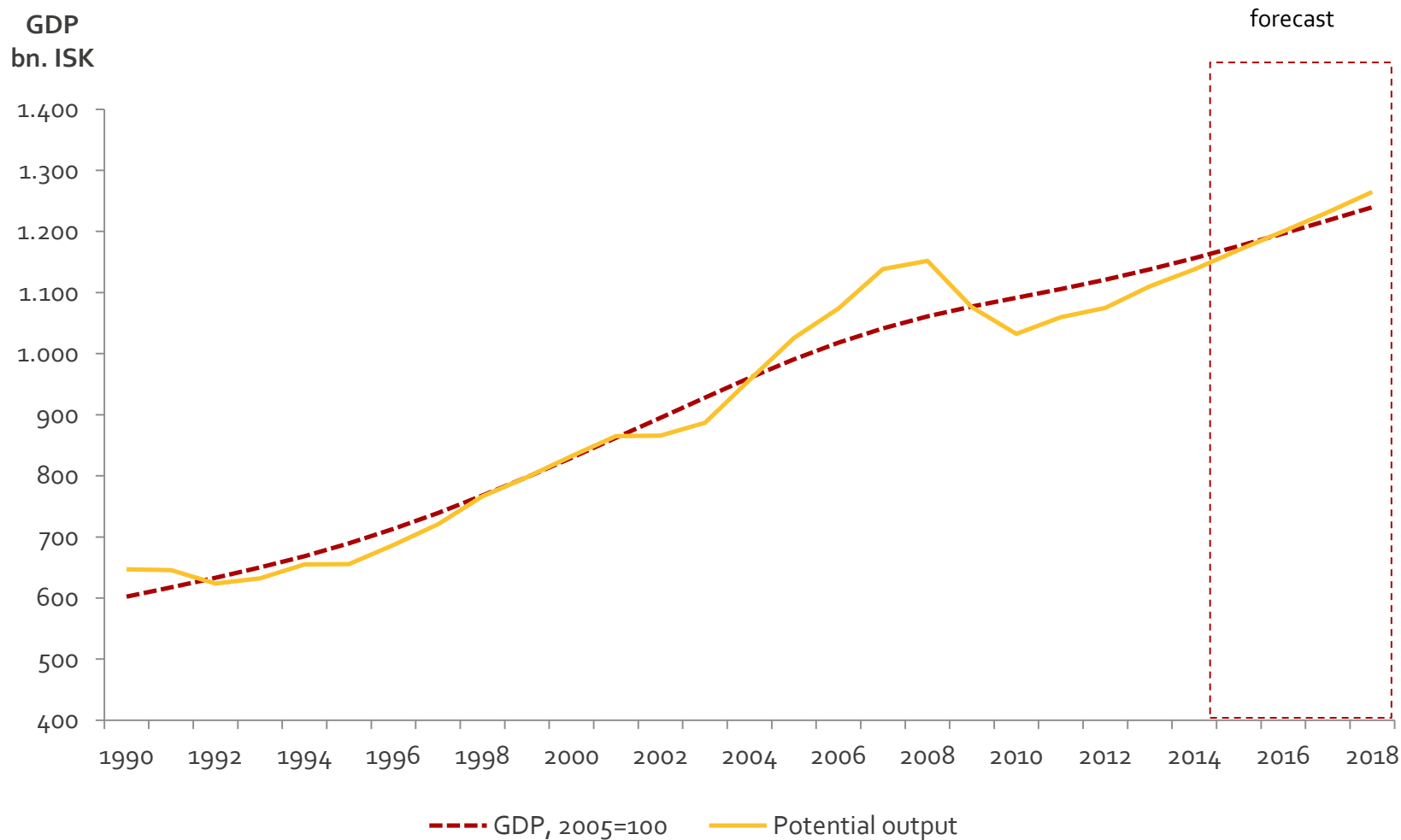
INFLATION RATE



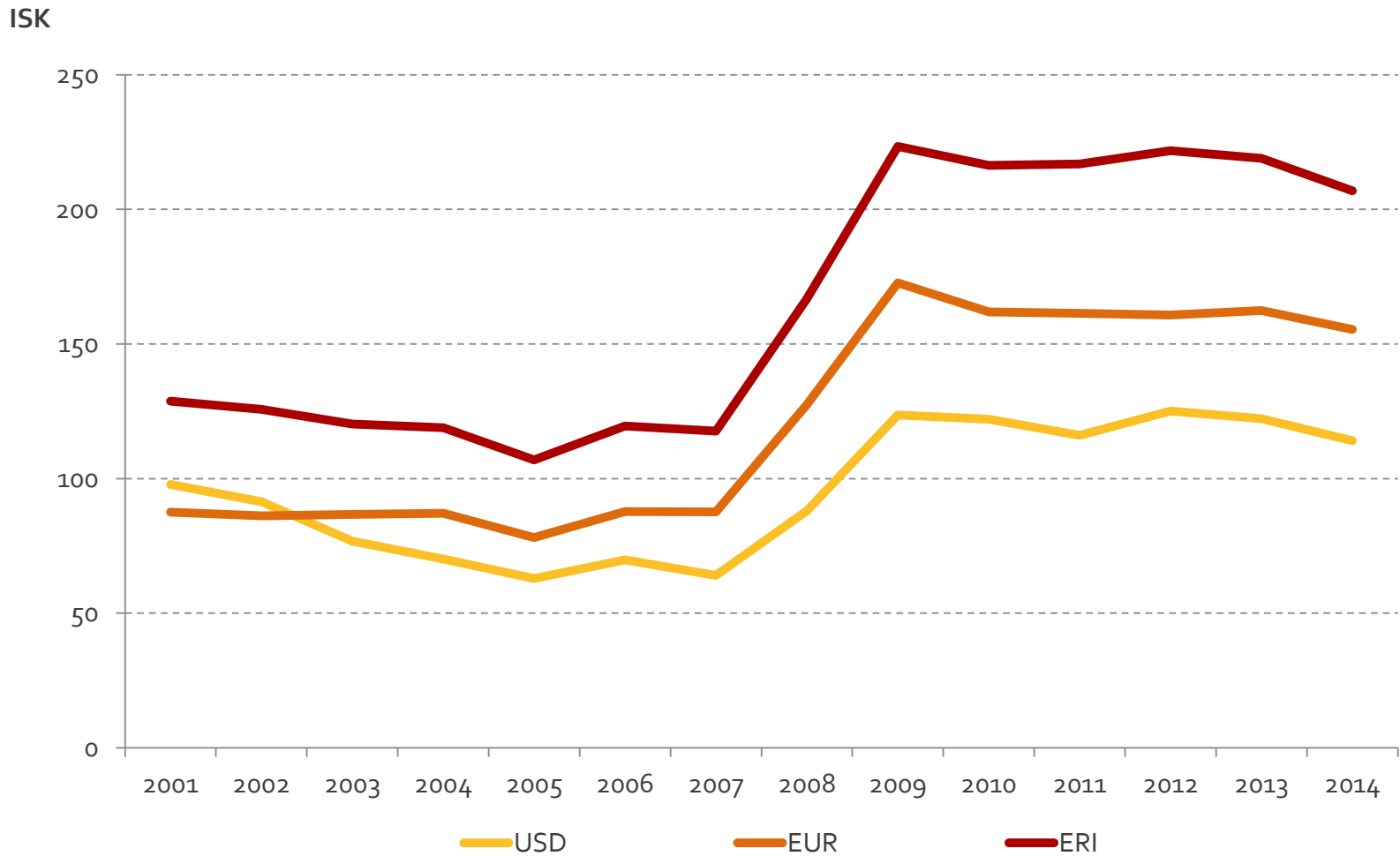
Source: Statistics Iceland



OUTPUT GAP IS CLOSING



EXCHANGE RATE: ERI, EUR OG USD

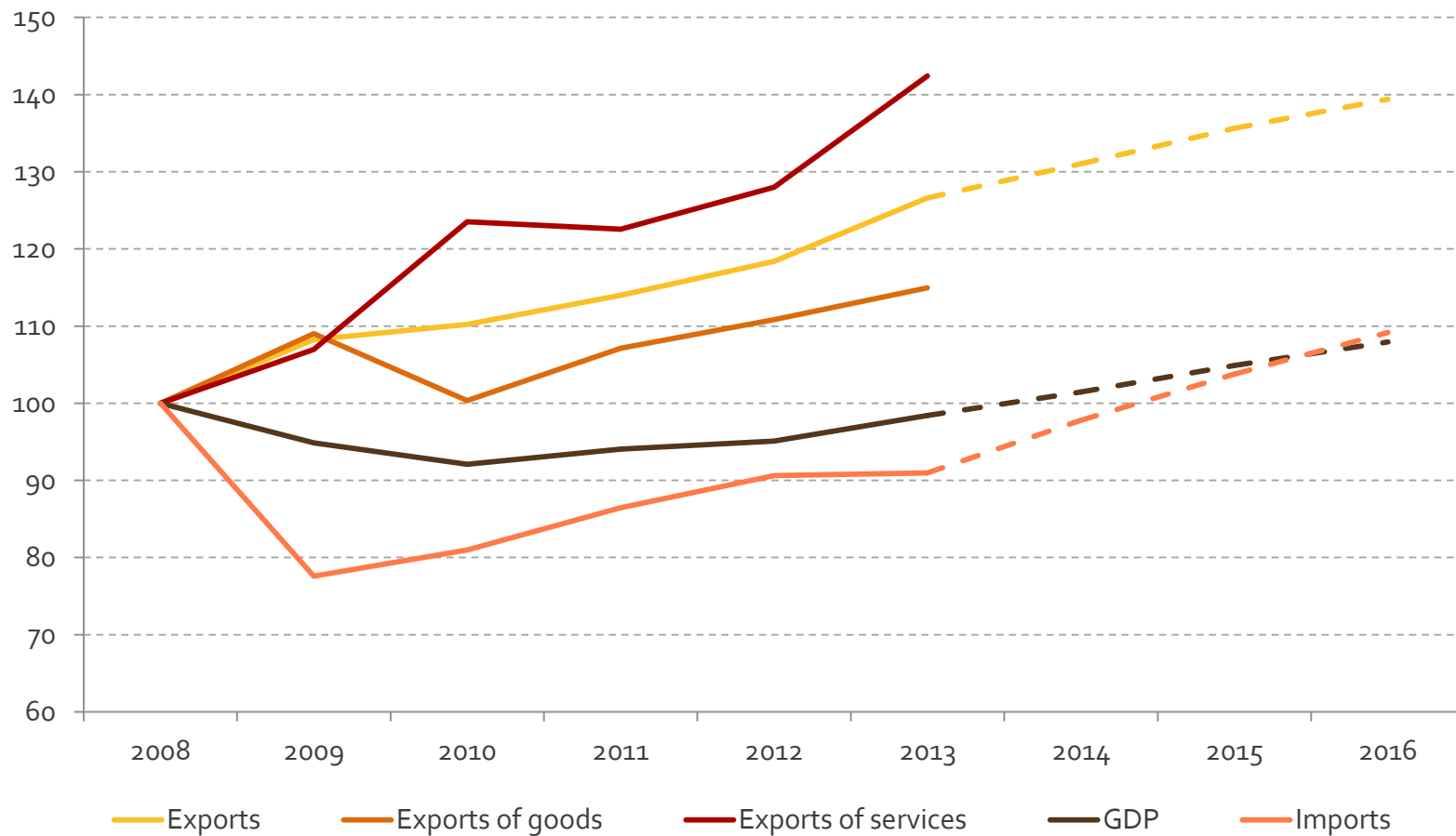


Source: The Central Bank of Iceland



GDP, IMPORTS AND EXPORTS INDEX 2008=100

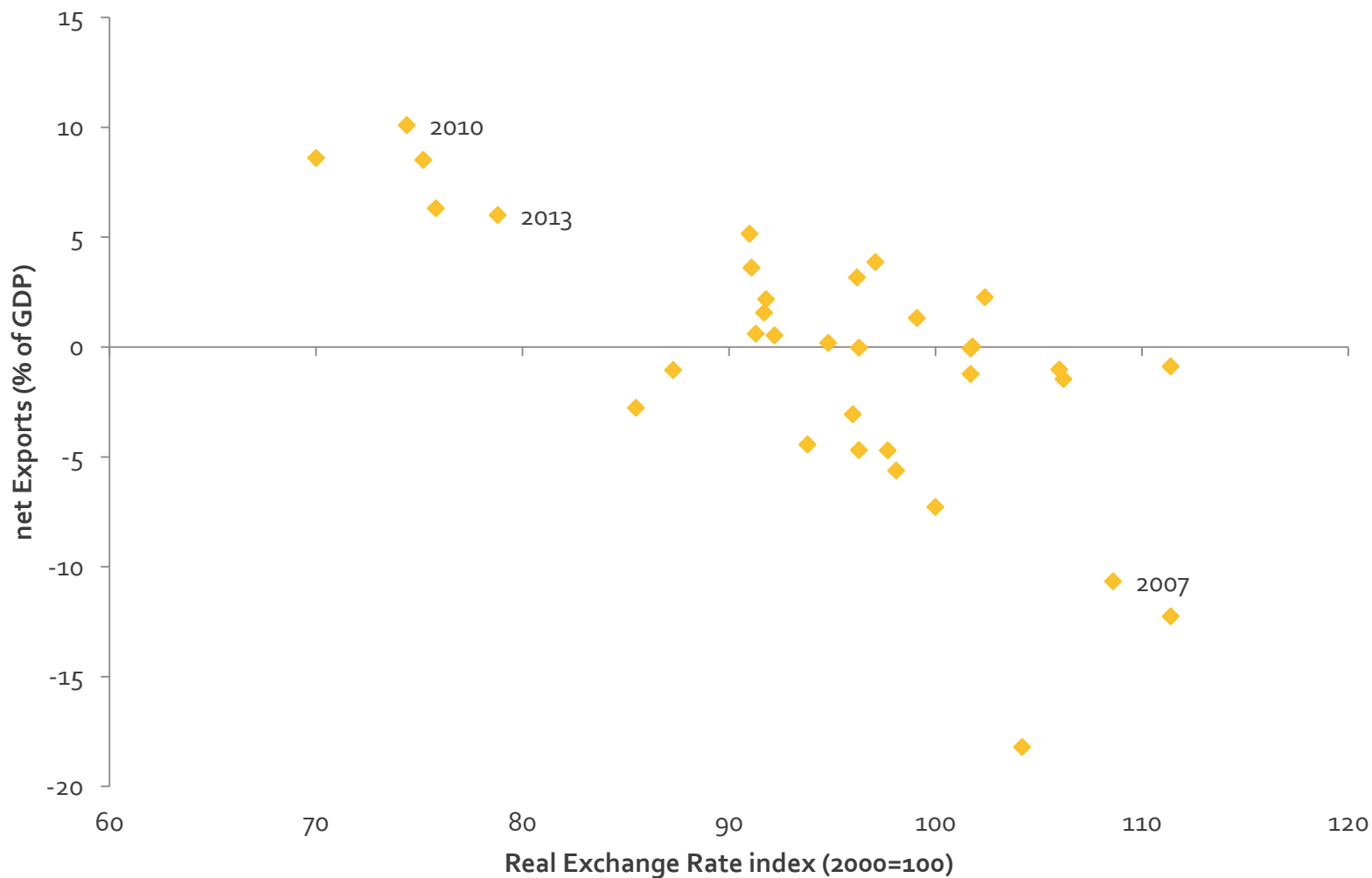
Vísitala
2008=100



Source: Statistics Iceland



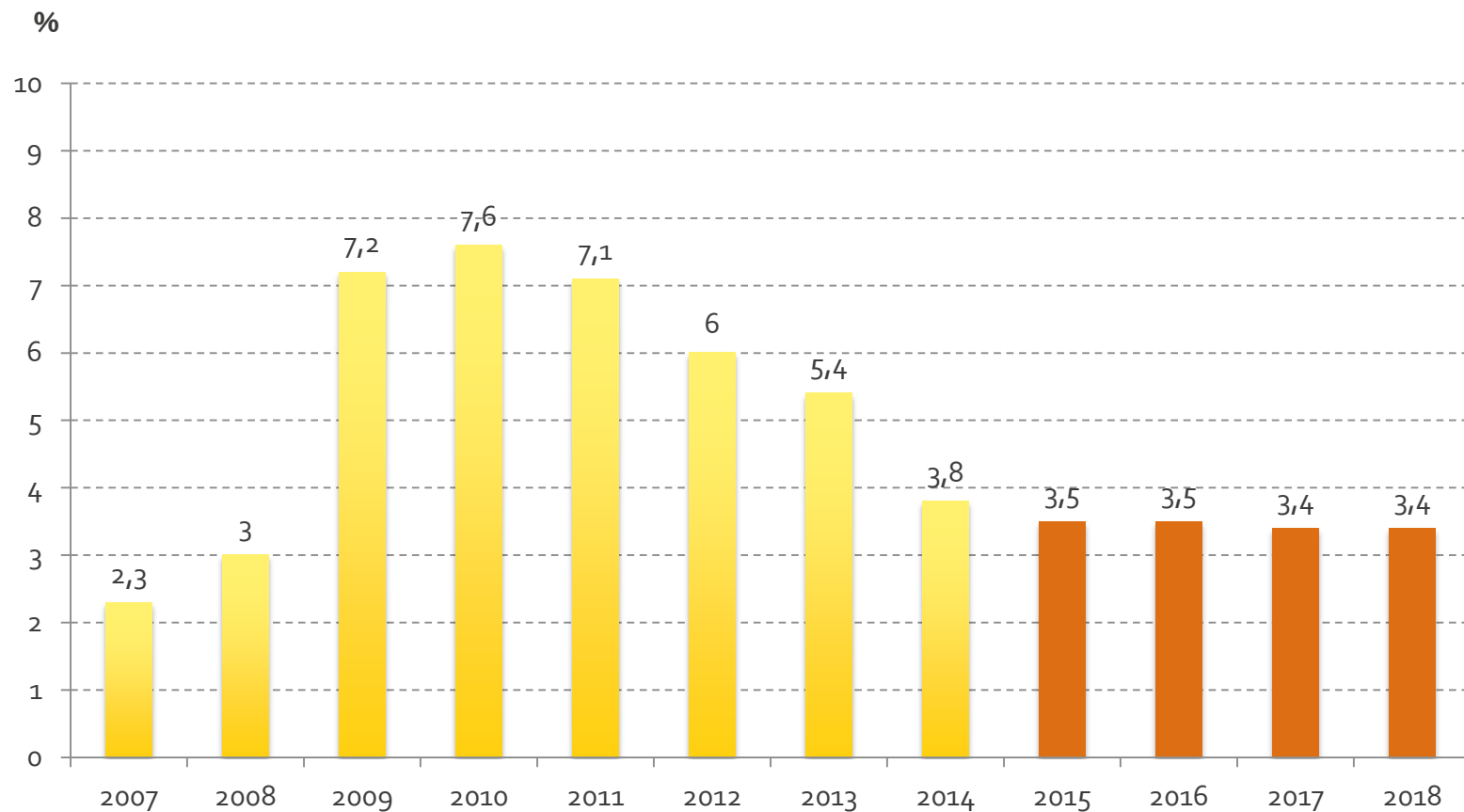
REAL EXCHANGE RATE AND NET EXPORTS



Source: Statistics Iceland



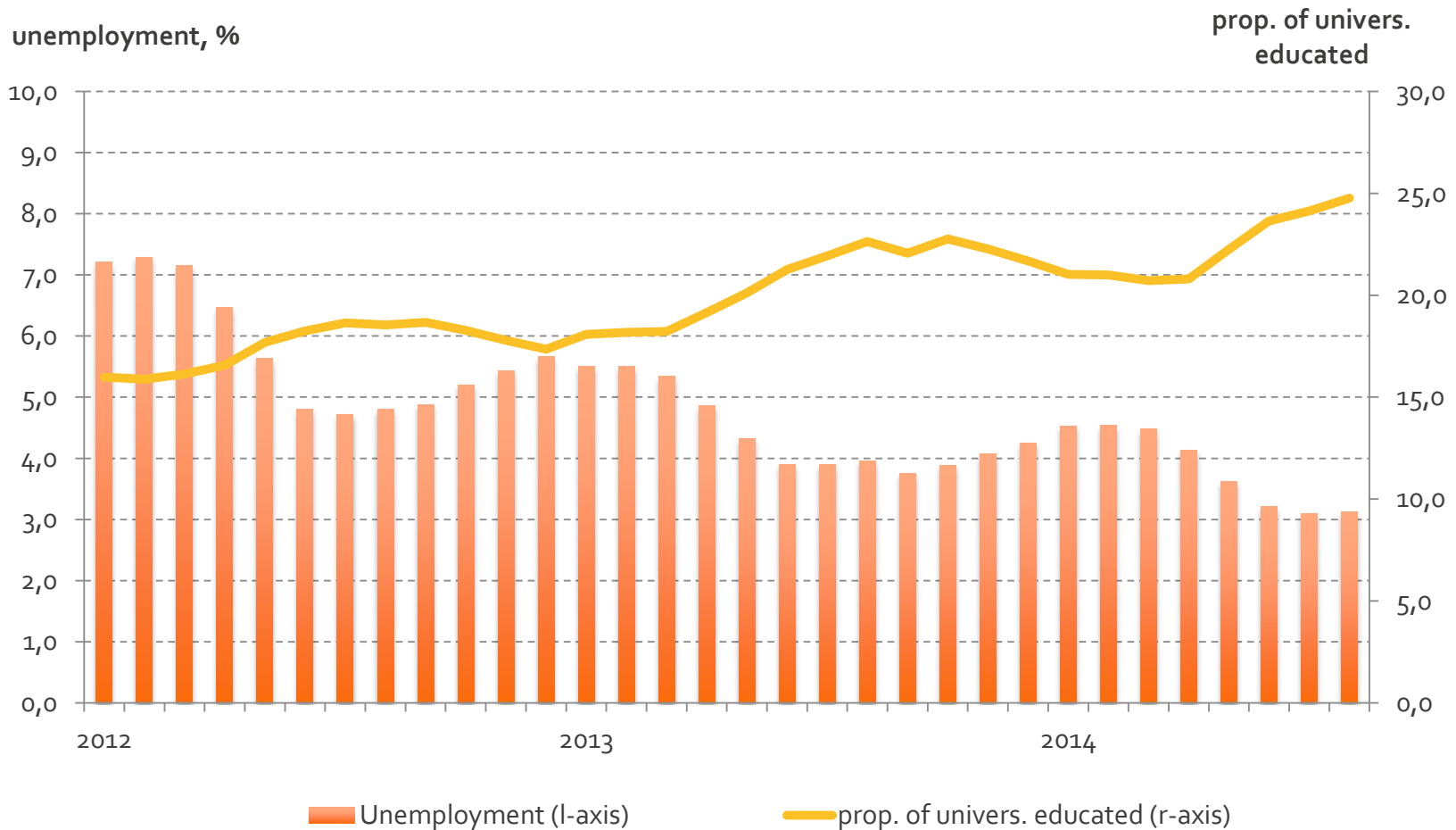
UNEMPLOYMENT



Source: Statistics Iceland



UNEMPLOYMENT AMONG EDUCATED ON THE RISE



Source: Statistics Iceland





3.

FISCAL BALANCE

Budget proposal 2015

FISCAL OUTCOME 2013

- » Better outcome in 2013 than previously expected
 - » The deficit on the total balance turned out to be insignificant, **ISK 0.7 bn. (0.04% of GDP)**, instead of ISK 24.3 bn. (1.3% of GDP) deficit according to the MoF prior estimate
 - » Mainly due to a one-off **ISK 24.9 bn.** transaction recorded on the revenue side on the basis of an increased share in Landsbankinn hf. allocated to the state in accordance with a prior contract
 - » The increased revenue was partly offset by **ISK 11.9 bn.** higher irregular tax write-offs on the expenditure side than previously expected



ESTIMATED FISCAL OUTCOME 2014

- » In the **2014 budget**, a small surplus of **ISK 0.9 bn. (0.05% of GDP)** in the overall balance was estimated for the first time in six years
- » Reevaluated fiscal outlook projects a more positive outcome in 2014
 - » **ISK 38 bn. (2% of GDP)** surplus estimated in 2014
 - » Primarily due to one-off revenues in the current year
 - » ISK 26 bn. transaction to lower a bond issued in 2008 to bolster the CBI's equity
 - » ISK 19.5 bn. in extra dividends payments from CBI and financial institutions

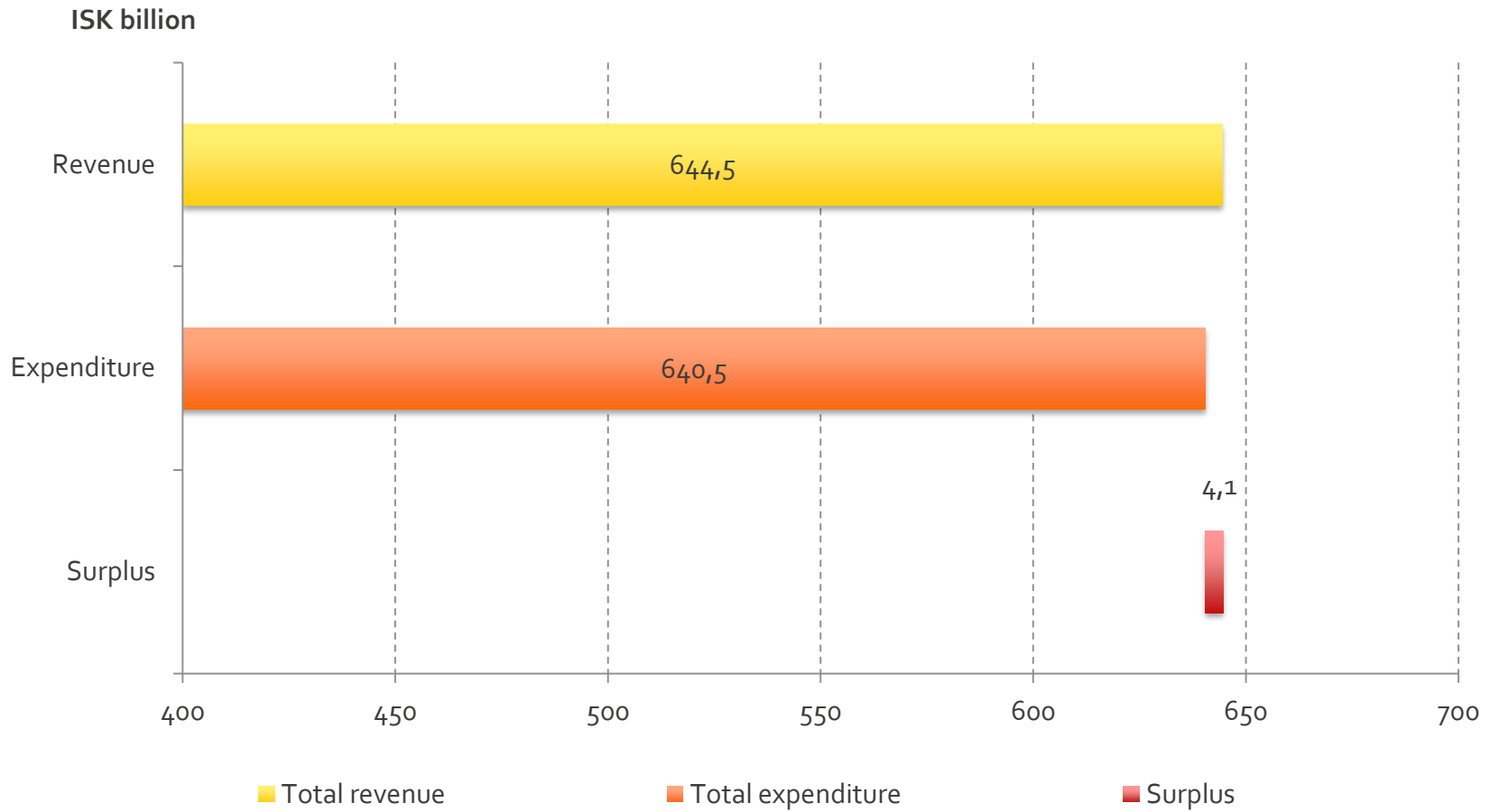


MAIN RESULTS OF THE BUDGET PROPOSAL 2015

- » The budget proposal for 2015 is balanced for the second year in a row
- » **ISK 4.1 bn.** surplus on total balance estimated in 2015, equivalent to **0.2% of GDP**
- » Excluding irregular items* the surplus in the total balance is **ISK 27.5 bn.**, equivalent to **1.4% of GDP**

* E.g. tax write-offs, capital gains tax which the Treasury pays to itself and pension obligations

FISCAL OUTCOME 2015



MAIN RESULTS OF THE BUDGET PROPOSAL 2015

- » It is estimated that the primary balance will be positive by **ISK 70.1 bn.** which is equivalent to **3.5% of GDP**
 - » **ISK 12.6 bn.** increase from the current year's budget or **0.6% of GDP**
- » Cash flow from operations will be negative by **ISK 6.6 bn.** compared to **ISK 11.8 bn.** in the 2014 budget



TOTAL AND PRIMARY BALANCE

ISK billion, nominal prices	Accounts 2013	Budget 2014	Estimate 2014	Proposal 2015
Revenue	591,4	613,1	669,1	644,5
Expenditure	592,2	612,1	631,0	640,5
Total balance	-0,7	0,9	38,1	4,1
Total balance, % of GDP	0,0	0,0	2,0	0,2
Primary revenue	575,0	594,1	651,0	626,3
Primary expenditure	517,8	536,6	552,5	556,3
Primary balance	57,2	57,4	98,5	70,1
Primary balance, % of GDP	3,2	3,1	5,2	3,5

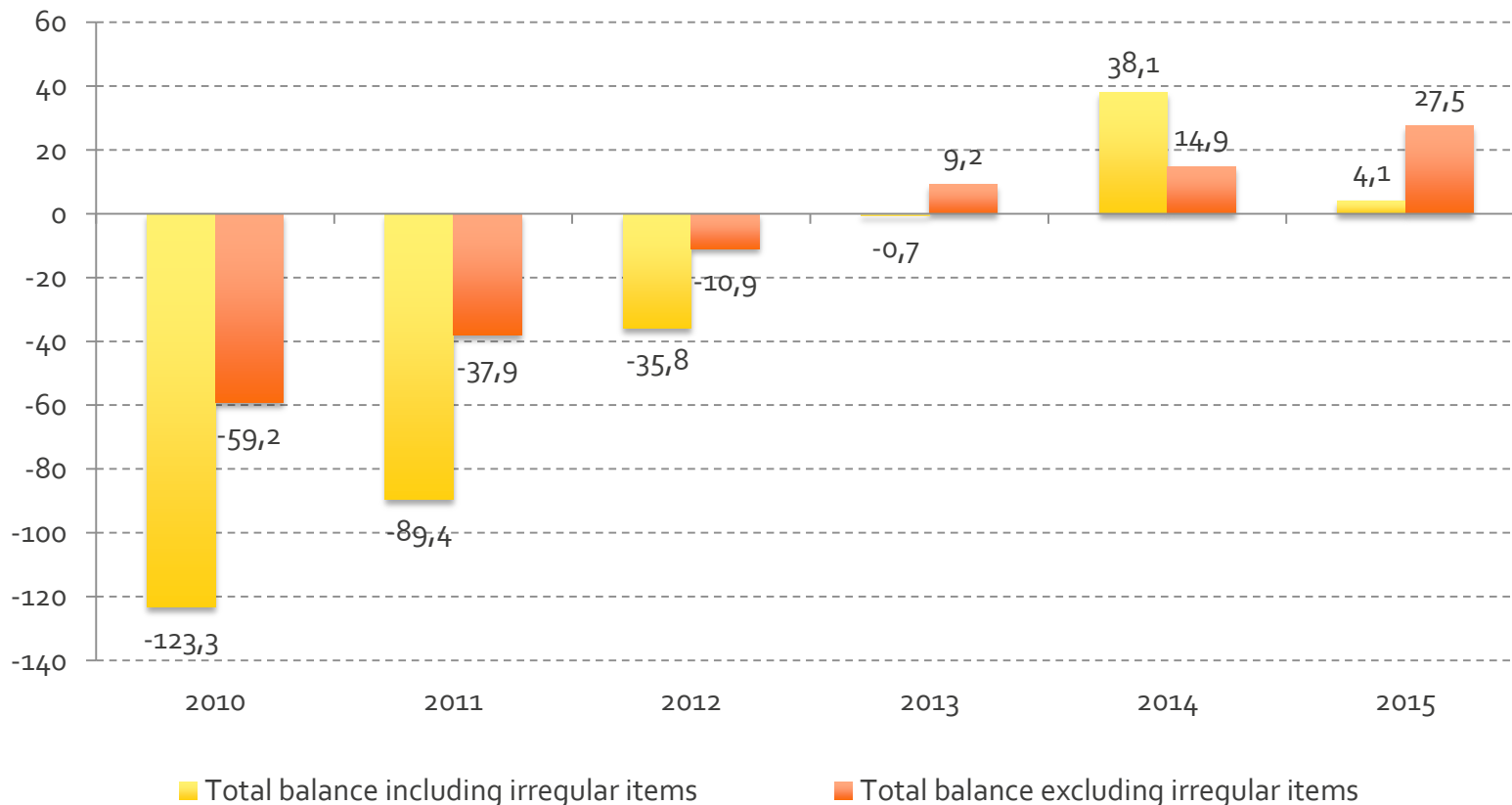
BALANCED BUDGET

- » Fiscal policy for 2015 reflects that targeted measures have achieved a balanced budget.
- » After continuous deficits since 2008, the debt accumulation is being brought to a halt.
- » Fiscal stabilization will provide a foothold for paying down debts and reducing the interest burden.
- » The fiscal plan for the years 2015-2018 estimates a small fiscal surplus in 2015 and 2016 (0.2% and 0.3% of GDP). In 2017 and 2018 a larger surplus is projected (1.1% and 1.5% of GDP).
 - » ISK 4 bn. surplus in 2015 and 7 bn. in 2016.
 - » ISK 24 bn. surplus in 2017 and 36 bn. in 2018.



TOTAL BALANCE INCL. AND EXCL. IRREGULAR ITEMS 2010-2015*

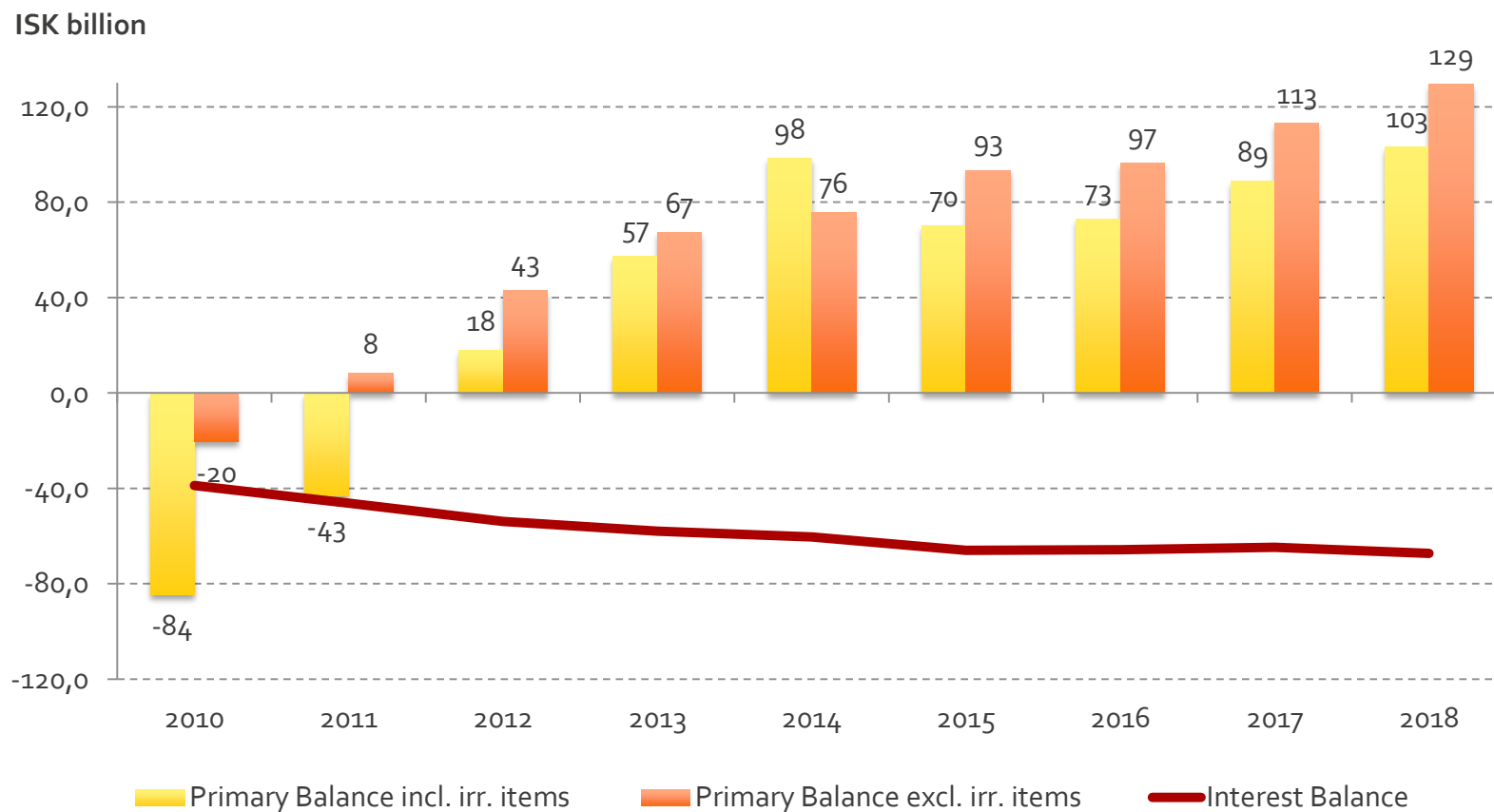
ISK billion



*Adjusted for the transfer of services for disabled people from the state to local governments in 2010



PRIMARY BALANCE AND INTEREST BALANCE INCL. AND EXCL. IRREGULAR ITEMS 2010-2018*

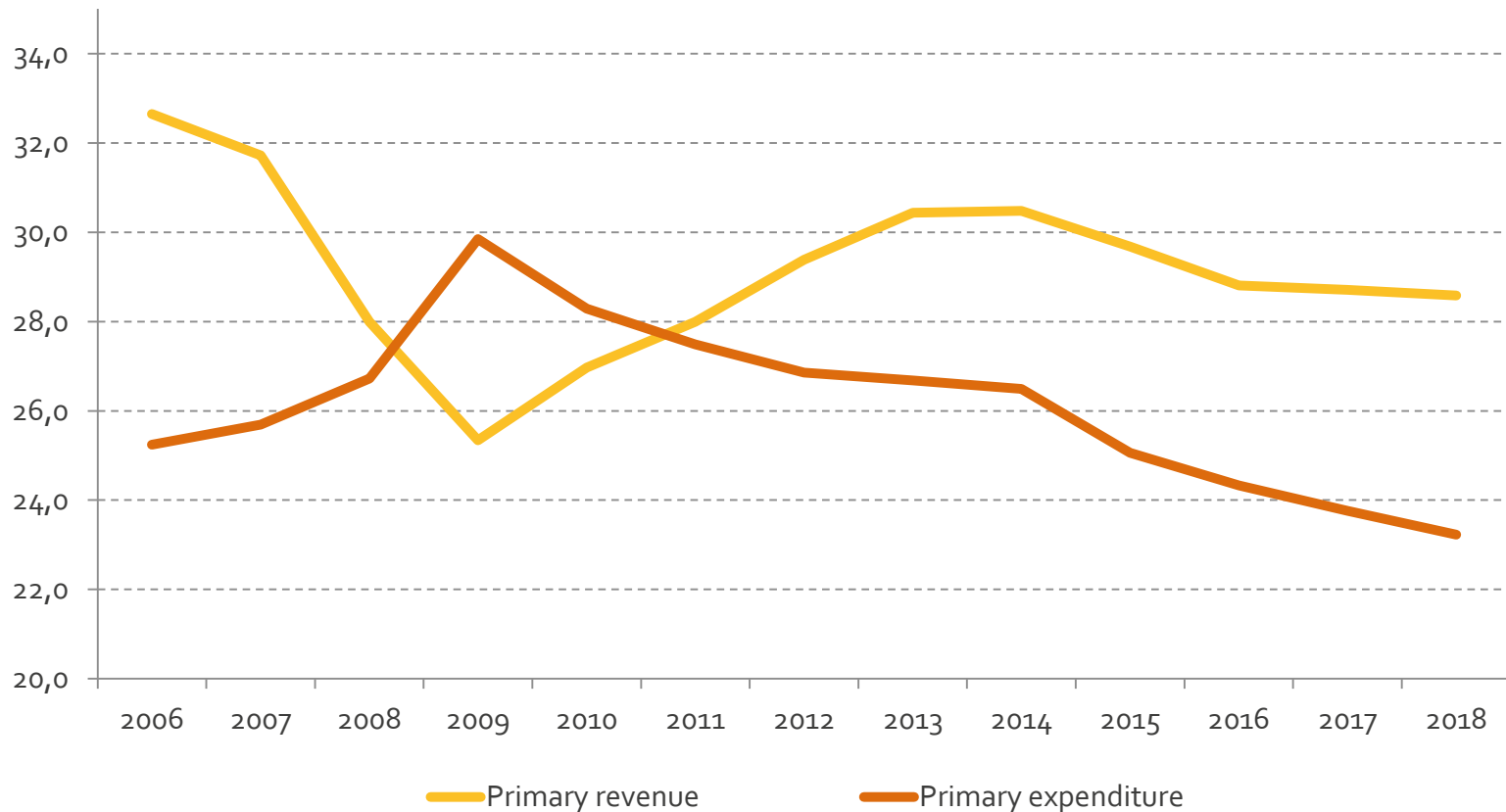


*Adjusted for the transfer of services for disabled people from the state to local governments in 2010



PRIMARY REVENUE AND EXPENDITURE 2006-2015*

% of GDP



* Excluding irregular items

Adjusted for the transfer of services for disabled people from the state to local governments in 2010



FISCAL OUTLOOK 2015-2018

- » The current scenario for the fiscal outlook is based on restraining growth on the expenditure side to allow for a considerable surplus in 2017 and 2018.
 - » Limited real growth allowed for in certain sectors such as demographic growth in old-age and disability pension and real growth in pharmaceutical costs, medical costs, health care and education
 - » ISK 5.5 billion annual restraint measures (around 1% of Treasury's primary expenditure)
 - » Annual ISK 6-7 billion additional contingency budget space included in the fiscal plan in order to meet unforeseen but unavoidable obligations that might occur each year.
 - » e.g. deviations from wage, exchange and price assumptions in the budget
 - » Few new investments, although continued building of a new prison on Hólmsheiði, the Norðfjörðurtunnel and a harbour, tunnel and other facilities at Bakki are included in the outlook

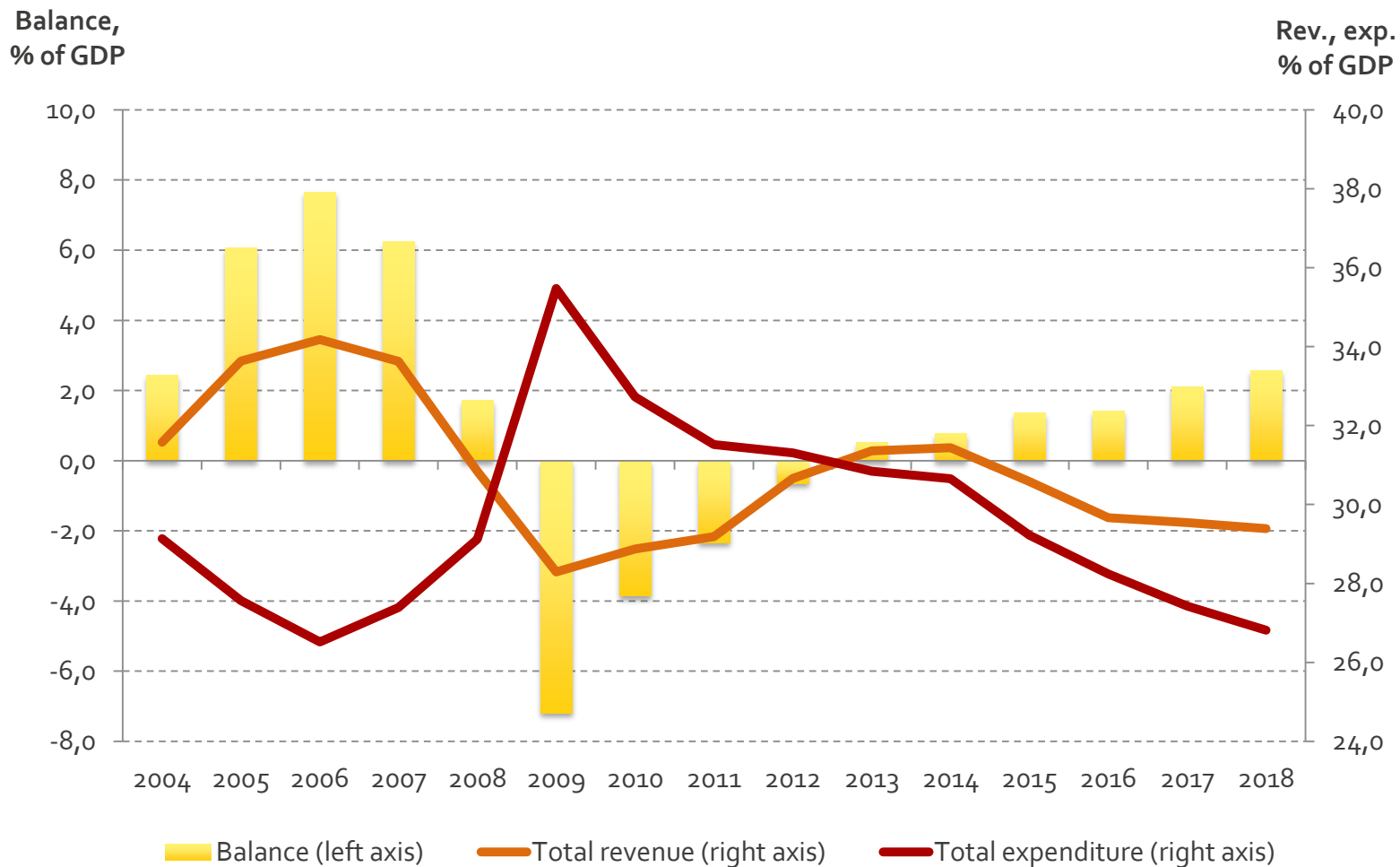


FISCAL OUTLOOK 2015-2018

- » A stable and fairly robust economic growth is forecasted for the coming years, with the implication in this restraint scenario that the ratio of primary expenditure of GDP will decline
 - » Primary expenditure ratio, excluding irregular items, declines from **25.1%** in 2015 to **23.2%** in 2018 or by **1.9%** of GDP
- » Measures in the balance sheet might yield more space for expenditure growth in the future



TREASURY BALANCE 2004-2018*



*Excluding irregular items





4.

EXPENDITURE SIDE

Budget proposal 2015

EXPENDITURES 2015-2018: GENERAL

- » In preparation of the 2015 budget proposal, the budget process was strengthened by employing a more stringent budget framework on the expenditure side
- » Frame budgeting is a means to enhance fiscal discipline and commitment to fiscal goals
- » Responsibility for expenditure frames, prioritization of funds and savings measures as well as budget implementation are increasingly the responsibility of line ministries



EXPENDITURES 2015-2018: PROSPECTS AND WAIVED CONTRIBUTIONS

- » In preparing the budget frameworks, early this year, an analysis of expenditure prospects and commitments was conducted
 - » Various investments
 - » Structural expenditure, e.g. unemployment or parental leave
 - » Various expenditure plans, e.g. purchase of equipment for LSH
- » Also, an annual scrutiny of waived temporary allocations from budgets of previous years was conducted



EXPENDITURES 2015-2018: RESTRAINT TARGETS AND SPENDING SPACE

- » When generating budget frameworks for ministries for 2015, a **ISK 5.5 bn.** restraint target was established with the purpose of improving the Treasury's balance
 - » 0,8% of total expenditures in the 2014 budget
- » At the same time, the ministries were provided with a total of **ISK 5 bn.** new spending space in their frames for new projects or increased operations. Part of that contribution was used to reduce their restraint targets
- » In total, it is estimated that the turnover-linked restraint objectives will yield a **ISK 3.4 bn.** reduction in expenditures in 2015.



EXPENDITURES 2015-2018: WAGE AND PRICE LEVEL ASSUMPTIONS

- » Relies on an inflation forecast from Statistics Iceland from July 2014
- » Inflation is expected to be 3.4% in 2015
 - » Declines later in the forecast and will be at 2.6% at the forecast horizon in 2018
- » It is assumed that the wage component of the budget will increase by 3.5% in 2015 and by 3.6%-4.4% in the years 2016-2018 or about 1 percentage point above inflation
 - » Same assumption was applied for social security benefits



EXPENDITURES 2015-2018: ASSUMPTIONS ABOUT REAL GROWTH

- » Limited real growth has been assumed in main policy areas since the fall of the banks in 2008
 - » Demographic growth in old-age and disability pensions and real growth in pharmaceuticals and medical costs
 - » In the new fiscal outlook, real growth in health and higher education is increased slightly
- » The outlook, generally, does not assume a significant volume increase in expenditure over the forecast period, e.g. more jobs in public services
 - » If such increases would unfold in some policy areas, they would have to be met with streamlining or decreased spending for other projects



EXPENDITURES 2015-2018: RESTRAINT MEASURES

- » The fiscal plan assumes that yearly restraint measures, during the years 2016-2018, will amount to ISK 5.5 bn.
 - » About 1% of central government's primary expenditure
 - » Same premise as in previous fiscal outlooks
 - » The measures are not pre-determined but ministries implement the relevant measures in the budget each year
- » Nearly every year since 1998, restraint measures were implemented in the annual budget even though the Treasury's position was far better than now
 - » Generally been in the range 0.5%-2% of the budget turnover



EXPENDITURES 2015-2018: CONTINGENCY APPROPRIATION

- » In accordance with the strategy of the fiscal plan, a new contingency budget appropriation is generated yearly in order to accommodate spending deviations, especially in wages, exchange rate of the krona, inflation or other unforeseen but unavoidable obligations that may accrue
- » The contingency appropriation amounts to **ISK 6 bn.** in the 2015 budget and increases by ISK 1 bn. from 2014
- » ISK 6 bn. also in the 2016 budget but grows to 6.5 bn. in the year 2017 and **7 bn.** in 2018
 - » Prudent precaution in a plan of this nature as uncertainty increases as projections are made further into the future



EXPENDITURES 2015-2018: FRAMES AND IRREGULAR ITEMS

- » In determining the total expenditure frames, irregular items are deducted, i.e. items that can fluctuate greatly from year to another because of economic developments or on the basis of an accounting settlement after the end of the fiscal year that the government can not have an impact on, at least not in the short-run
 - » Written-off tax claims
 - » Liabilities of public employee's pension funds
 - » Capital gain tax that the Treasury is not exempt from
 - » Loan guarantees
 - » Written-off claims or shares or equity
 - » Accrued interest costs



EXPENDITURES 2015-2018: FRAMES AND IRREGULAR ITEMS

- » In addition, the following items are not included in the expenditure frames:
 - » The Equalization Fund for local governments
 - » Unemployment benefits
 - » Equity contributions to the Housing Financing Fund
 - » Debt relief for households

- » When these items have been excluded, the result constitutes the total expenditure frame for each year that the budget will be based on



MAIN EXPENDITURE CHANGES FROM 2014 BUDGET

- » Primary expenditure is estimated **ISK 556.3 bn.** in 2015 and increases by **ISK 19.6 bn.** from the 2014 budget in nominal prices (**1.0% of GDP**)
- » Total expenditure is expected to be **ISK 640.5 bn.** and increases by **ISK 28.4 bn.** from 2014 budget (**1.4% of GDP**)
- » Excluding projected wage and price changes in 2015, the primary expenditure will increase by **ISK 4.3 bn. (0.2% of GDP)** and the total expenditures will increase by **ISK 13.1 bn. (0.6% of GDP)**



MAIN EXPENDITURE CHANGES FROM 2014 ESTIMATE

- » Primary expenditures are estimated **ISK 556.3 bn.** and increase by **ISK 3.8 bn.** from the estimate for 2014 in nominal prices (**0.2% of GDP**)
- » Total expenditure are expected to be **ISK 640.5 bn.** and increase by **ISK 9.5 bn.** from 2014 estimate (**0.5% of GDP**)
- » Excluding projected wage and price changes in 2015 the primary expenditure will decrease by **ISK 11.5 bn. (0.6% of GDP)** and the total expenditures will decrease by **ISK 5.8 bn (0.3% of GDP)**

CHANGES IN EXPENDITURE 2015*

	ISK billion
Net increase in expenditure obligations	7.8
Restraint measures	-3.4
Increase in price levels 2015	15.3
Interest expenditure	8.7
Total	28.4

*Changes from the 2014 budget



NET INCREASE IN EXPENDITURE OBLIGATIONS*

	ISK billion
Old age and disability insurance and welfare support payments	2.4
Increase in government employee's pension fund liabilities	2.3
Tax write-offs	2.0
New and increased contribution to various health care items	1.8
Contingency fund - increase due to nominal increase in turnover	1.0
Increased contribution to transportation projects	0.9
Increased funding to strengthen universities and upper secondary school operations	0.9
Increased contribution to Iceland Research Fund and Technology Development Fund	0.8
Other expenditure obligations	-1.1
Total net increase in expenditure obligations	11.0

* Changes from 2014 budget



RESTRAINT MEASURES 2015

- » One of the largest restraint measures is the shortening of the period during which unemployment benefits are paid out, from 36 months to 30 months
 - » The measure is expected to yield **ISK 1.1 bn.** reduction in spending in 2015, a third of the restraint measures in the budget proposal for 2015
- » The budget proposal also assumes that the contribution to private pension funds to equalize disability pensions will be reduced by 20% annually for five years
 - » Assumptions made in a statement from the government in November 2005, in connection with an agreement with the business sector about measures to respond to growing disability pensions, have changed considerably

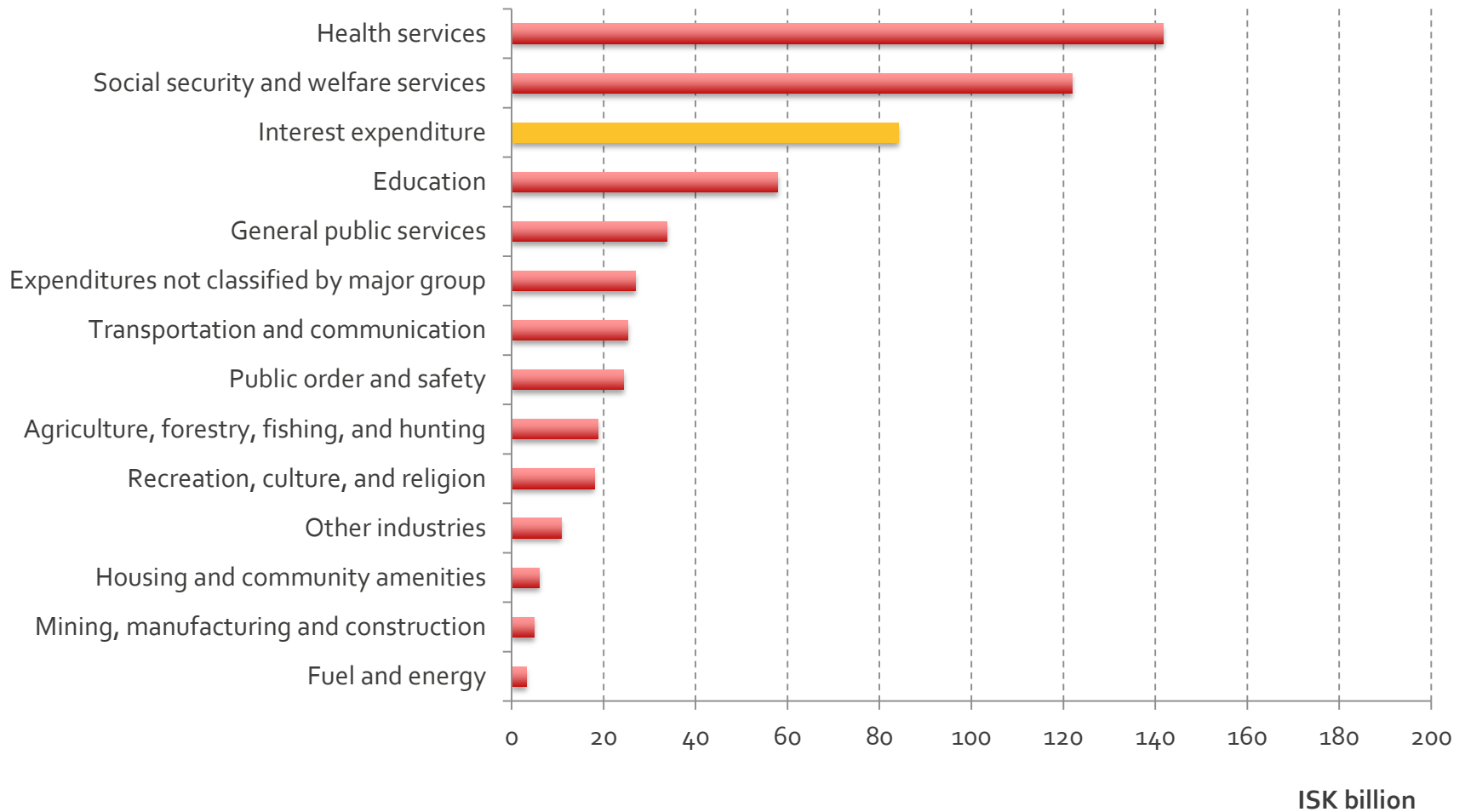


RESTRAINT MEASURES BY ECONOMIC CATEGORY*

ISK million	Change ISK million	Turnover 2014	Change in percentage
Current expenditure	-1.585	224.434	-0,7
Transfers	-1.818	188.004	-1,0
Maintenance and investment	-45	9.599	-0,5
Total	-3.449	422.037	-0,8

* Changes from 2014 budget turnover excluding interest expenditure, irregular items and various other expenditure items that are exempt from the turnover based restraint target.

EXPENDITURES BY ECONOMIC FUNCTION*



*Irregular items other than interest expenditure are excluded

Economic function according to COFOG (Classification of the Functions of Government)

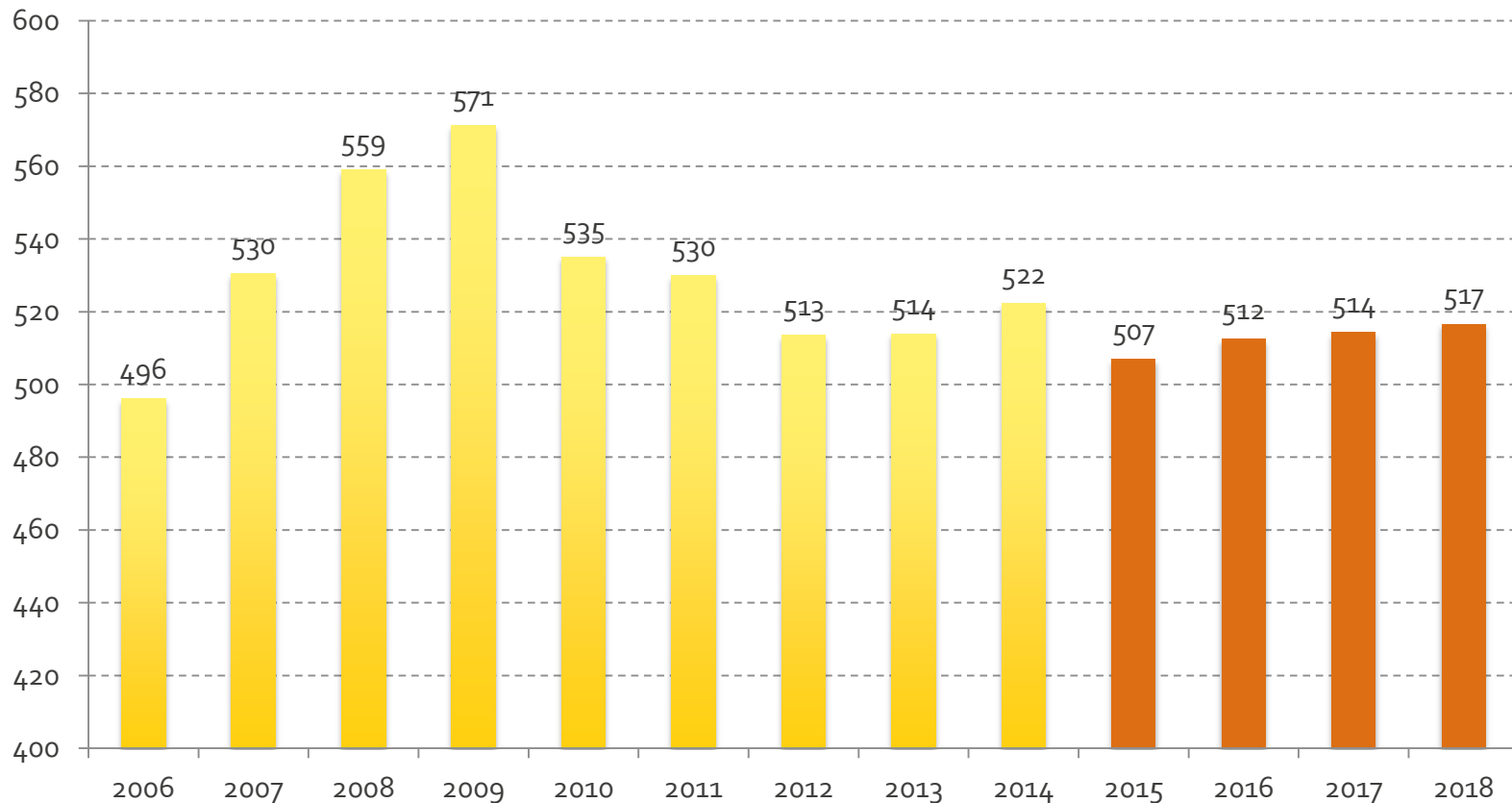


BUDGET FRAMEWORK 2015-2018

Total expenditures	640,5	658,0	677,0	679,4
Irregular items				
Pension obligations	10,0	11,5	11,9	12,4
Capital gains tax	5,3	5,3	5,6	5,9
Written-off tax claims	12,0	12,4	13,2	13,4
Unemployment	14,0	13,2	13,4	13,6
The Local Authorities' Equalization]	17,5	17,6	18,7	19,3
State guarantees	0,0	0,0	0,0	0,0
Written-off liabilities and benefits	0,1	0,1	0,1	0,1
Interest expenditures	84,2	84,3	83,8	86,7
Contributions to the HFF	3,3	2,3	2,3	1,3
Amortization of indexed mortgages	18,4	18,4	18,4	0,0
Total irregular items	164,8	165,0	167,3	152,8
Expenditure frame	475,7	493,1	509,7	526,7

PRIMARY EXPENDITURES IN CONSTANT PRICES*

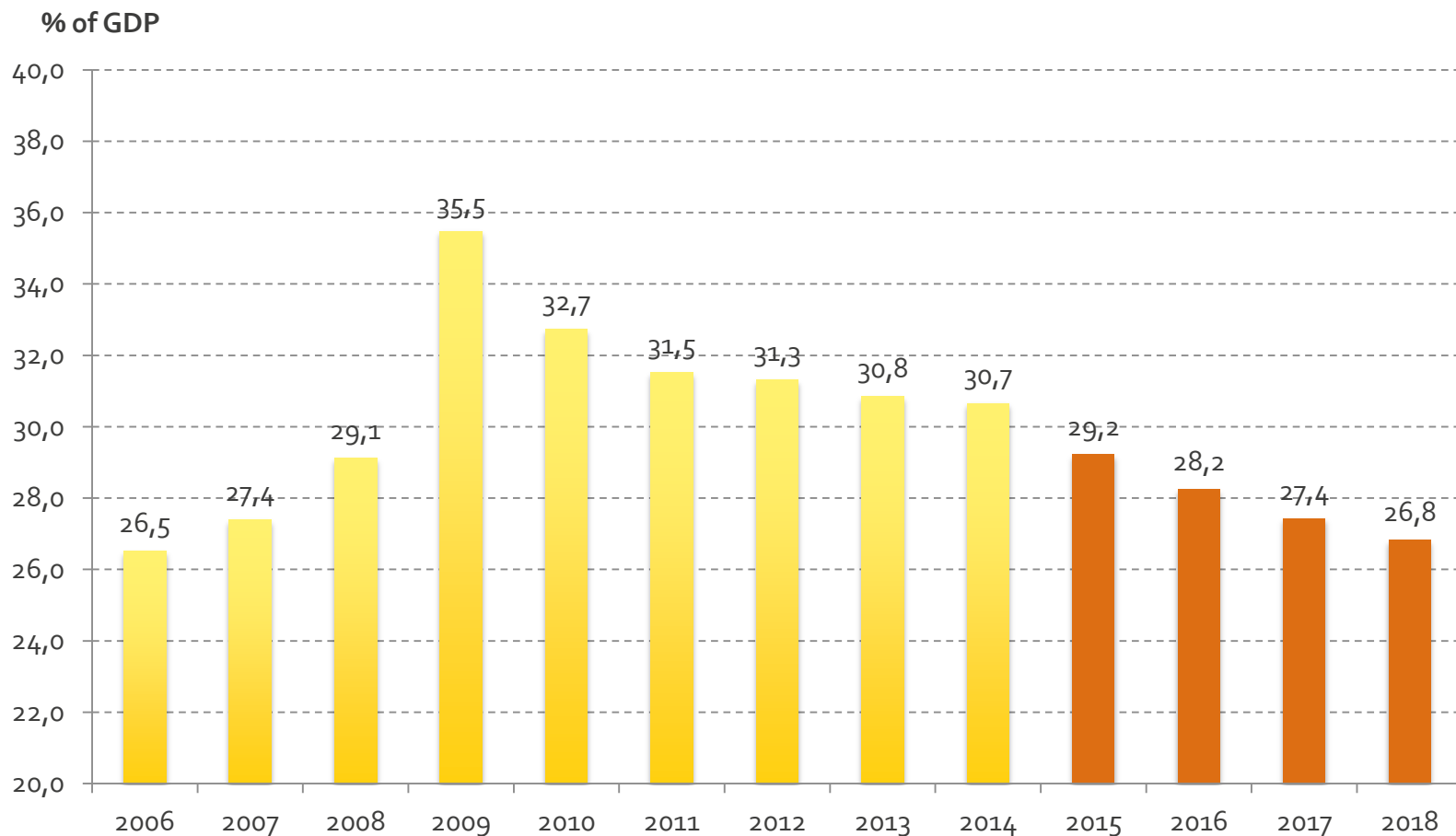
ISK billion



** In 2015 budget proposal prices, excluding interest expenditure and irregular items
Adjusted for the transfer of services for disabled people from the state to local governments*



DECREASE IN TOTAL EXPENDITURE*



* Excluding irregular items

Adjusted for the transfer of services for disabled people from the state to local governments



GENDER BUDGETING AND BUDGET PREPARATION

- » Three-year implementation plan: 2012-2014
 - » 10 projects: completed over a three-year period
 - » Gender effects analyzed for about ISK 200 bn. of budget turnover
 - » 30% of revenues
 - » 5% of expenditures
- » Analysis shows that the revenue raising and allocation of public funds has different effects on the status of women and men
 - » Systemic barriers exist
- » Interim reports presented in National Budget proposals for 2013 and 2014
- » Final reports presented in National Budget proposal for 2015
 - » Accessible on Ministry of Finance and Economic Affairs website
- » New implementation plan for 2015-2019 in preparation





5.

REVENUE SIDE

Budget proposal 2015

REVENUE FORECAST ASSUMPTIONS 2015-2018

- » Basis of projection: Tax revenue 2013, estimated revenue 2014
- » Macroeconomic assumptions: Statistics Iceland, July 2014
- » Previous structural changes: legal provision new/expired
- » New structural changes 2015: VAT and excise duties with countermeasure
- » Quantity-based excises not raised, which implies 2.5% reduction in real terms (alcohol, tobacco, petrol, diesel, carbon, recurrent car tax)
- » Revenue from interest and dividends: general / specific assumptions
- » Fisheries Levy: Unchanged system 2015/2016
- » Authorization to sell shares in Landsbanki has no effect



MACROECONOMIC ASSUMPTIONS 2015-2018

- » Economic growth on average 3.0% over the next four years
- » Strong growth in domestic demand to begin with
- » ... then the driving force moves to foreign trade
- » Inflation on average 3.0% in 2015-2018
- » Prices in 2017 is 1.7% higher than in autumn 2013 forecast
- » PIT is sensitive to wage agreements and the automatic increase in personal allowance
- » Labour demand grows rather slowly, especially 2017-2018
- » Real wages grows by an average of 2.1% from 2015 to 2018
- » Wage base shrinks relative to GDP
- » Tax revenues fail to increase in proportion to GDP



TAX REDUCTIONS 2015-2018 (A)

» Impact of measures continues 2015-2018

» 2015

- » VAT and excise duties
- » Capital income tax ()
- » Radio fee
- » Social security contributions (SSCs)
- » Fisheries Levy
- » Net wealth tax (expired)
- » Side effects of the Housing debt relief program

» 2016

- » Social security contributions (SSCs)
- » Energy tax on electricity

» 2018

- » Bank tax



TAX REDUCTIONS 2015-2018 (B)

- » Net wealth tax expires in 2015
- » Energy tax on electricity is repealed in 2016
- » Social security contributions (SSCs) decreases in 2015 and 2016
 - » 7.59% → 7.49% → 7.35%
- » Radio fee decreases in 2015 and 2016
 - » 19.400 kr. → 17.800 kr. → 16.400 kr.
- » Tax exemption limit for individuals' interest income raised to 125,000 kr. (effect in 2015)
- » Side effects from the debt relief program: PIT decreases but SSC increases
- » Fisheries Levy: full income effect from 2015
- » Quantity-based excises not raised: full income effect from 2015

BANK TAX 2014-2018

- » Legislative changes in December 2013
 - » Tax base: exemption for entities in winding-up proceedings or receivership abolished
 - » tax free limit (50 billion kr.)
 - » tax rate increased from 0.041% to 0.145% ...
 - » ... and finally increased to 0.376%
- » Estimated tax base 2013
 - » operating companies 24%
 - » company in winding-up proceedings or receivership 76%
- » Uncertainty about the tax base
 - » 2014–2015: based on the financial information
 - » 2016–2017: based on income generation target
 - » 2018: Only operating companies
- » 2018
 - » Expected tax rate 0.145%



REVENUE IMPACT OF TAX REFORM 2014–2018

Billion ISK	2015	2016	2017	2018
Tax reform since autumn 2013				
Changes in autumn session 2013	29,5	15,3	15,2	-7,9
thereof bank tax reform	38,0	25,9	26,1	3,3
thereof various tax reductions	-8,6	-10,6	-10,9	-11,1
Changes in spring session	-5,5	-5,6	-4,6	-2,1
Changes in budget proposal 2015	-0,5	0,7	0,2	-0,3
Tax changes from autumn 2013, total	23,5	10,4	10,8	-10,2
thereof bank tax reform	38,0	25,9	26,1	3,3
thereof other	-14,6	-15,5	-15,3	-13,5
Impact from previous tax reform				
Expiration of wealth tax and electricity tax	-10,5	-12,7	-12,8	-12,9
Expirations and reform, total	13,0	-2,4	-2,0	-23,1
thereof other than bank tax	-25,1	-28,2	-28,0	-26,4
The values shown indicate total revenue impact in each year.				



REVENUE ESTIMATE 2014-2018 (A)*

Accrual basis b.kr.	2014	2015	2016	2017	2018
Total revenue	669,1	644,5	665,1	701,1	715,5
Tax revenue	573,8	591,1	612,1	647,4	660,2
Primary revenue	651	626,3	646,6	682,1	696
Interest revenue	18,1	18,2	18,5	19	19,4
% of GDP					
Total revenue	35,5	31,9	30,9	30,7	29,6
Tax revenue	30,5	29,2	28,4	28,4	27,3
Primary revenue	34,6	31	30	29,9	28,8
Interest revenue	1	0,9	0,9	0,8	0,8

* Including irregular items



REVENUE ESTIMATE 2014-2018 (B)*

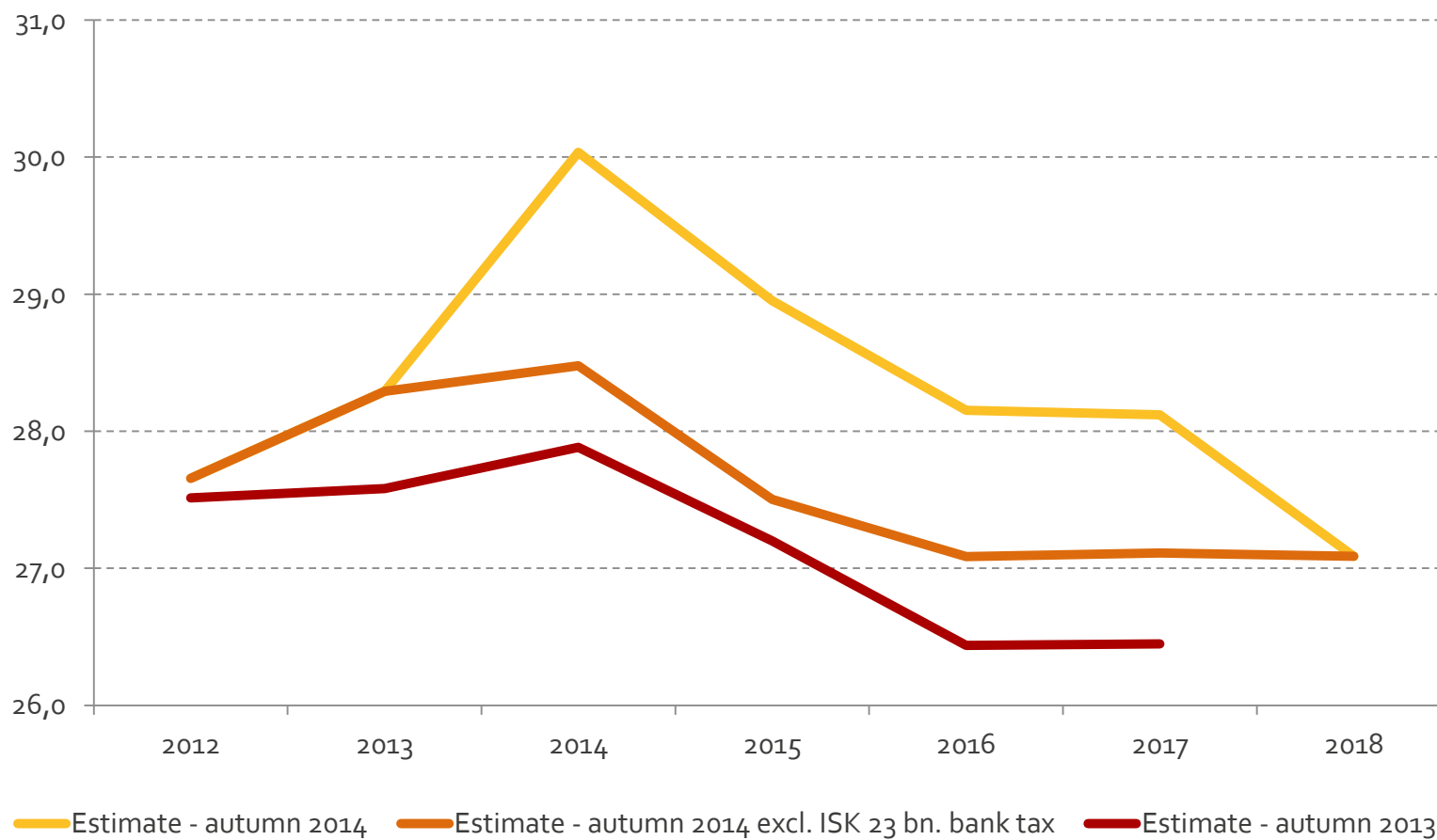
Accrual basis b.kr.	2014	2015	2016	2017	2018
Total revenue	634	638,5	659	694,7	708,8
Tax revenue	565,9	585,8	606,8	641,8	654,3
Primary revenue	615,9	620,3	640,5	675,7	689,4
% of GDP					
Total revenue	33,6	31,6	30,6	30,4	29,3
Tax revenue	30	29	28,2	28,1	27,1
Primary revenue	32,7	30,7	29,7	29,6	28,5

* *Excluding irregular items*



TAX REVENUE 2012-2018*

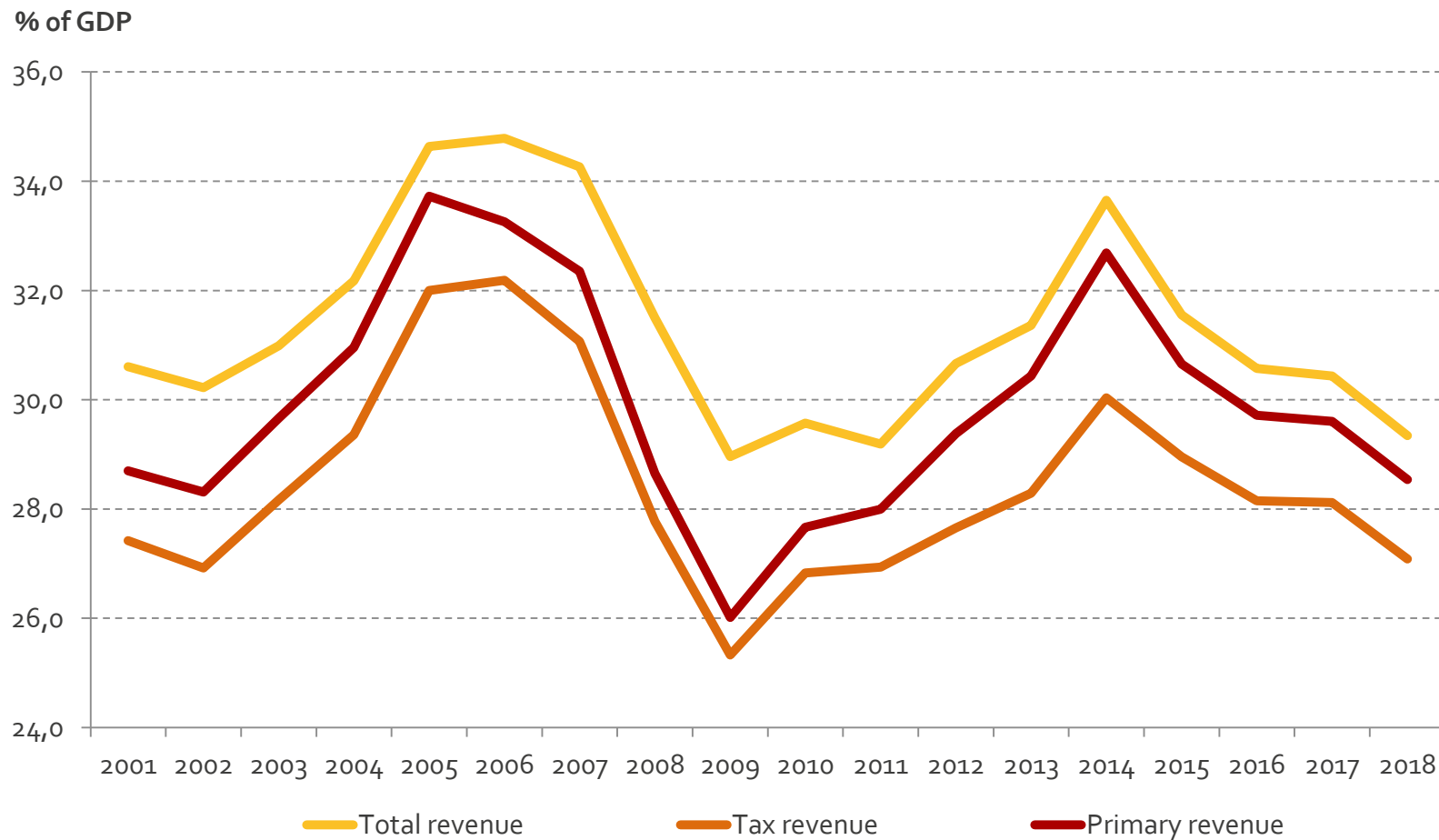
% of GDP



* Excluding capital income tax paid by the Treasury



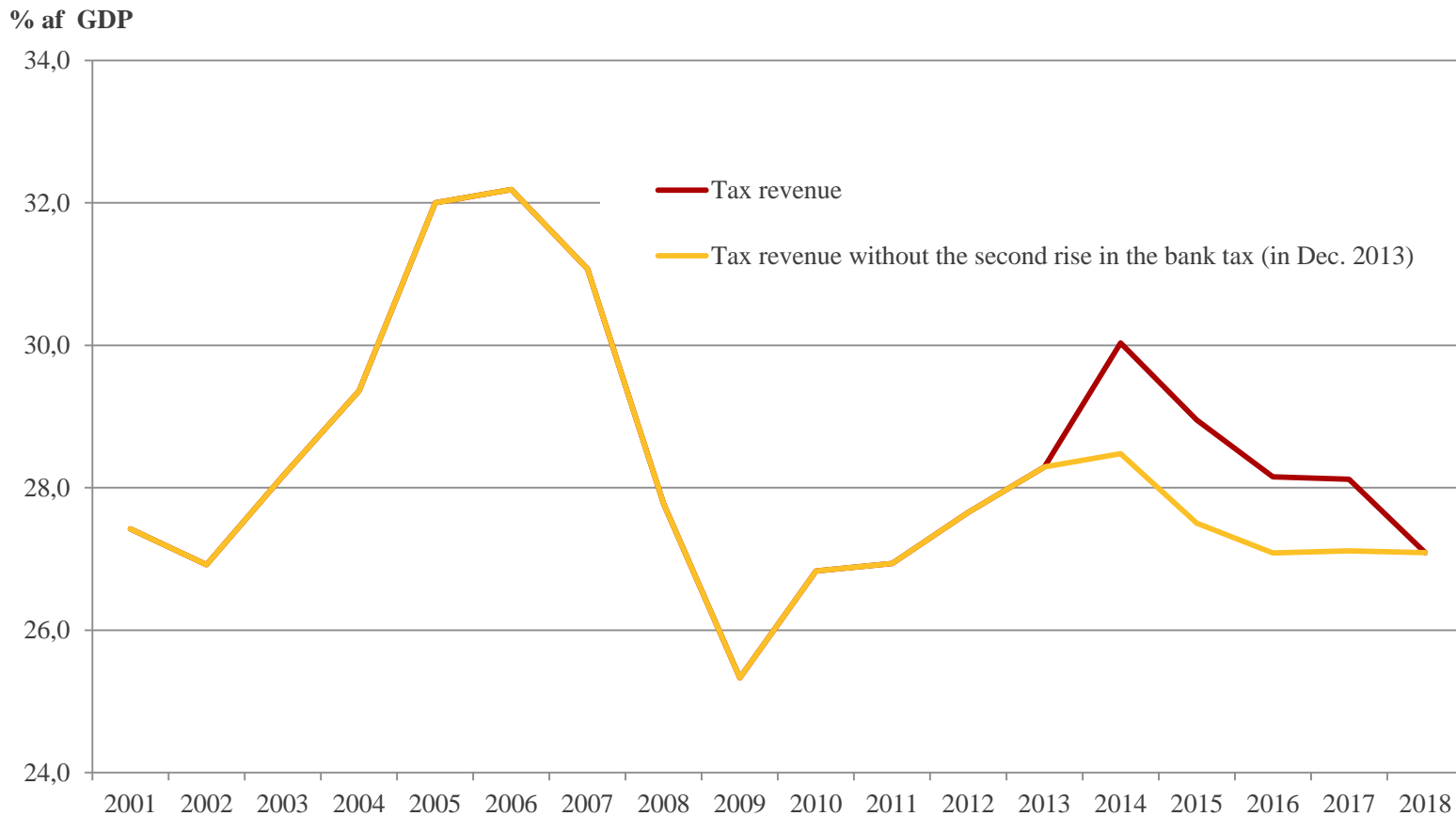
REVENUES 2001-2018*



* Excluding irregular items



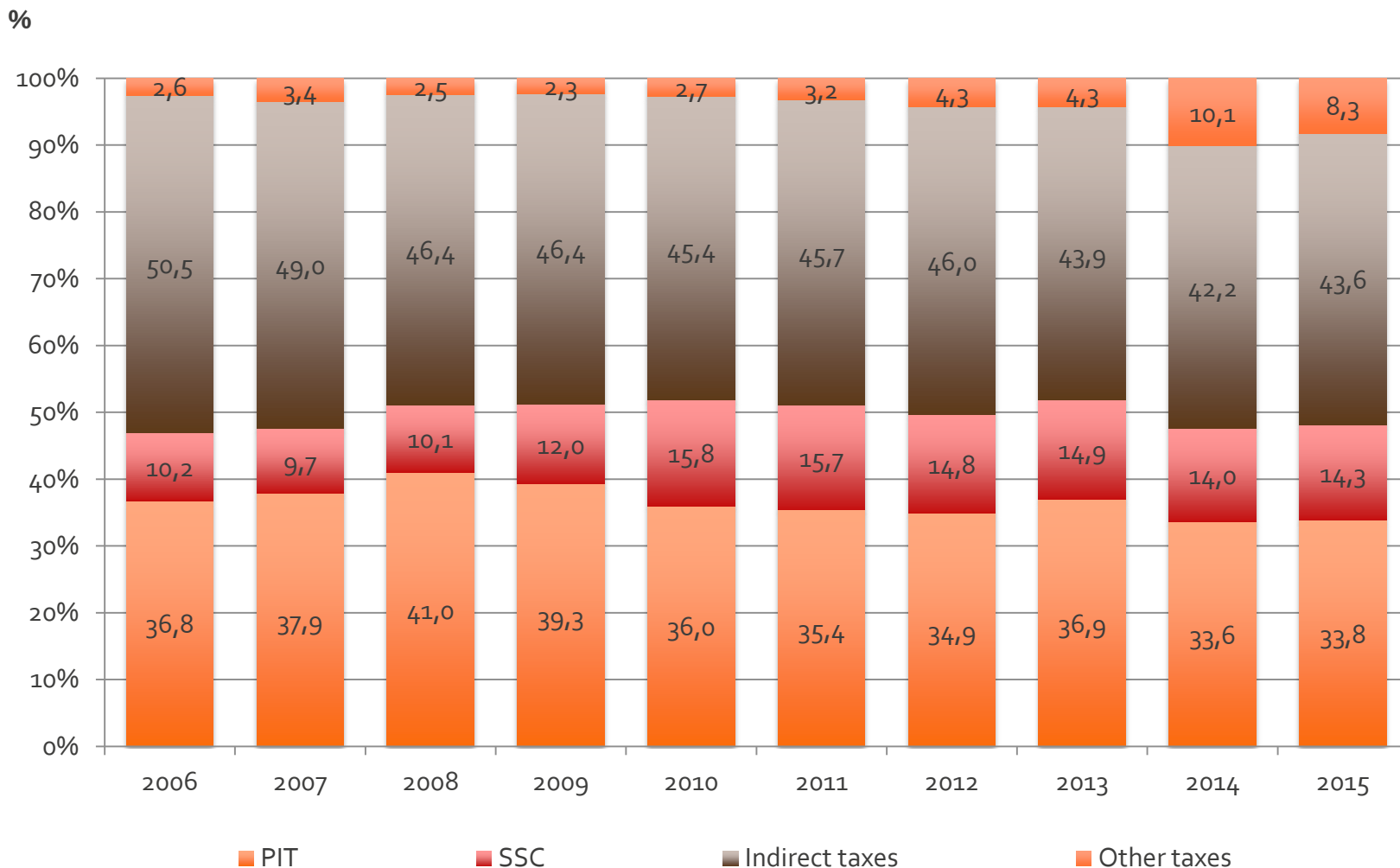
TAX REVENUE 2001-2018*



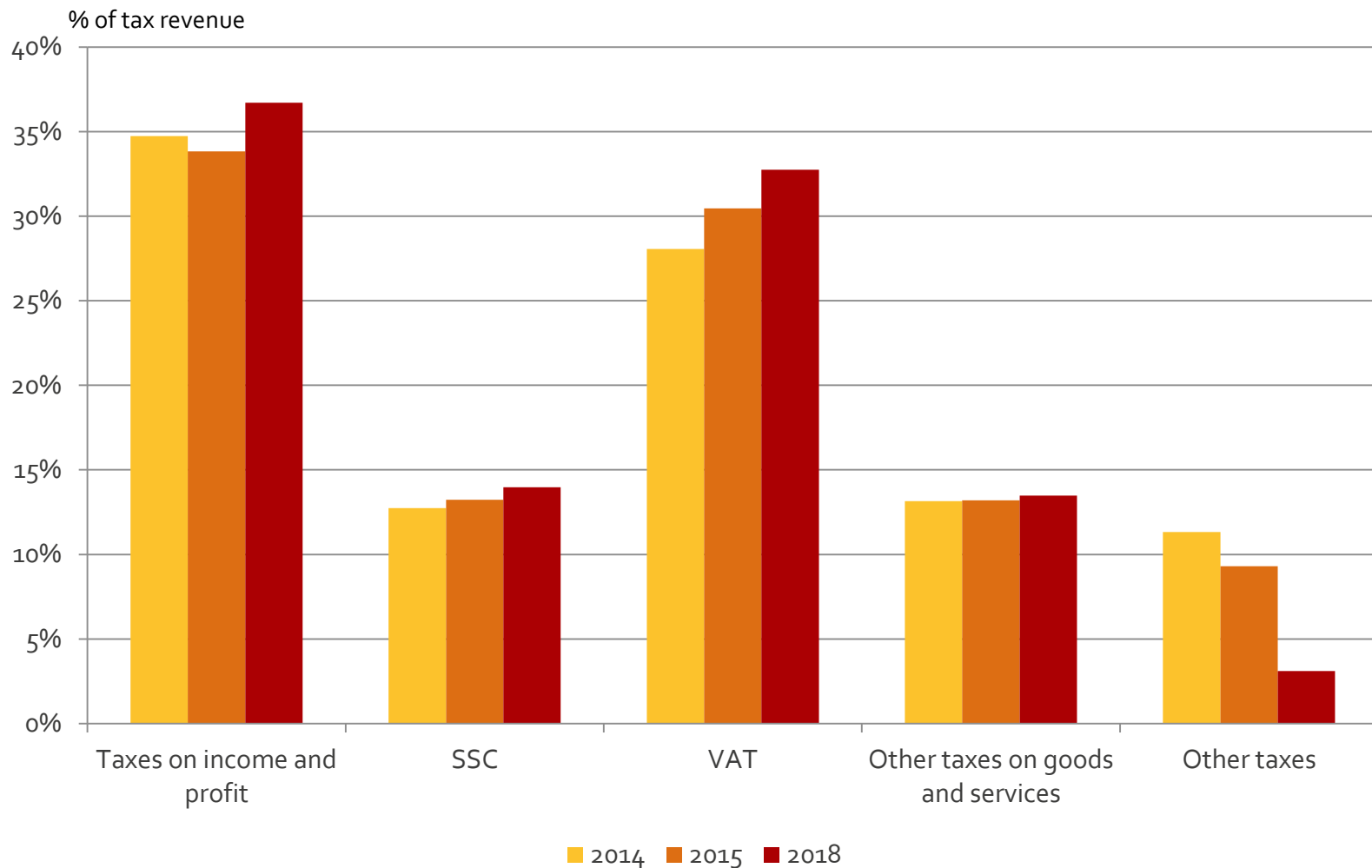
* Excluding irregular items



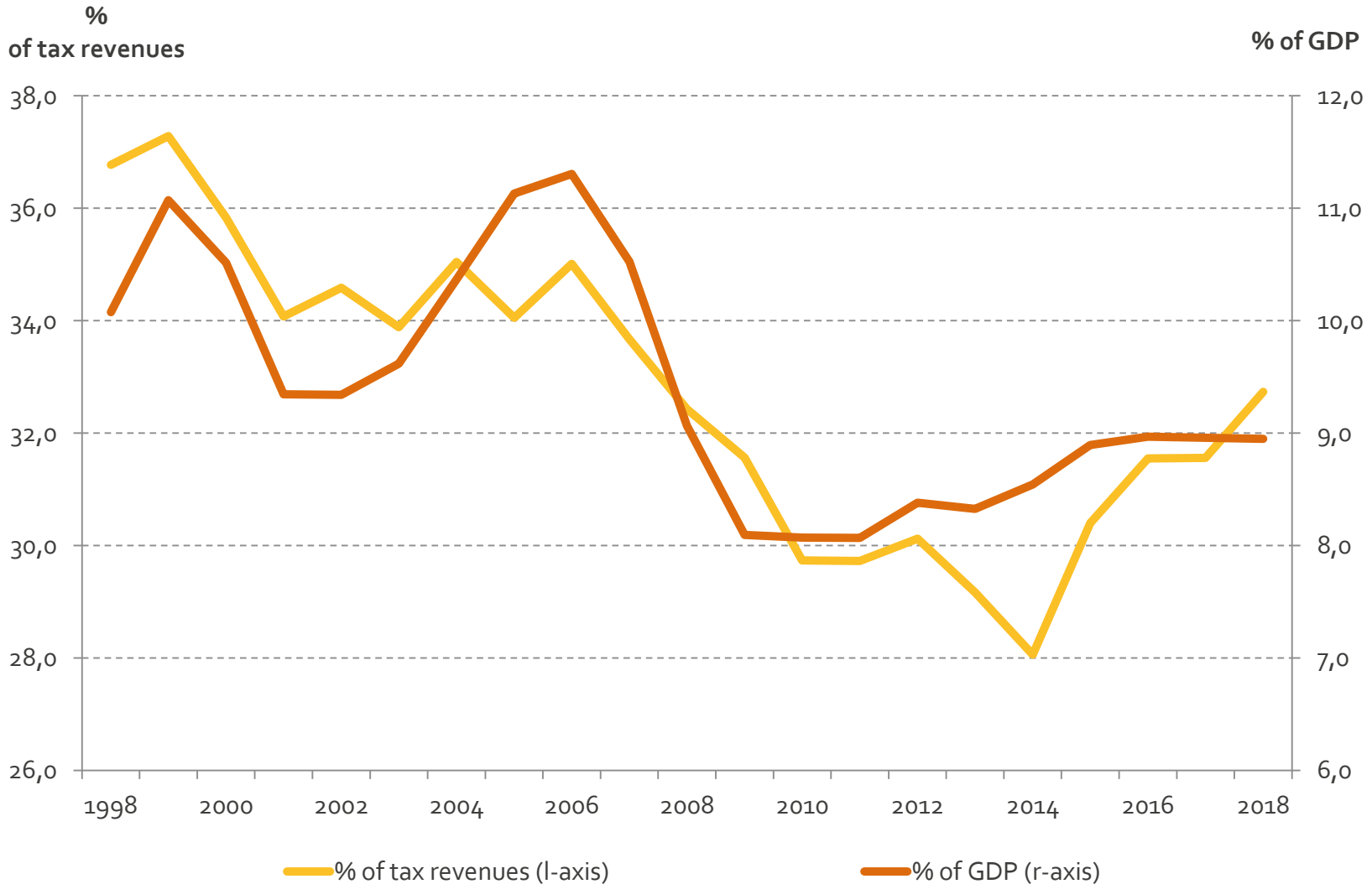
TAX REVENUE COMPOSITION



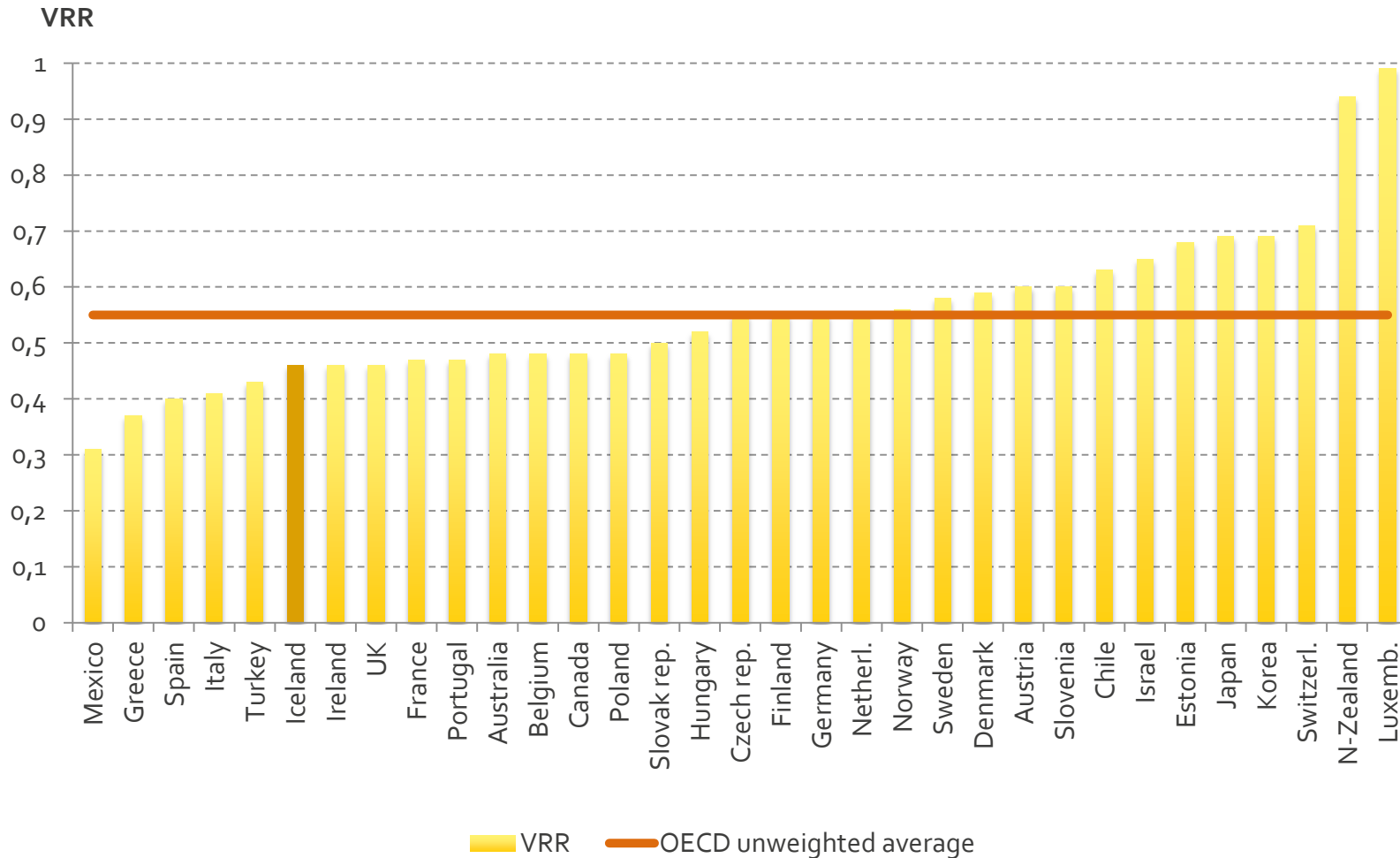
COMPOSITION OF TAX REVENUE 2014-2018



REVENUES FROM VAT 1998-2018



VAT REVENUE RATIO 2011

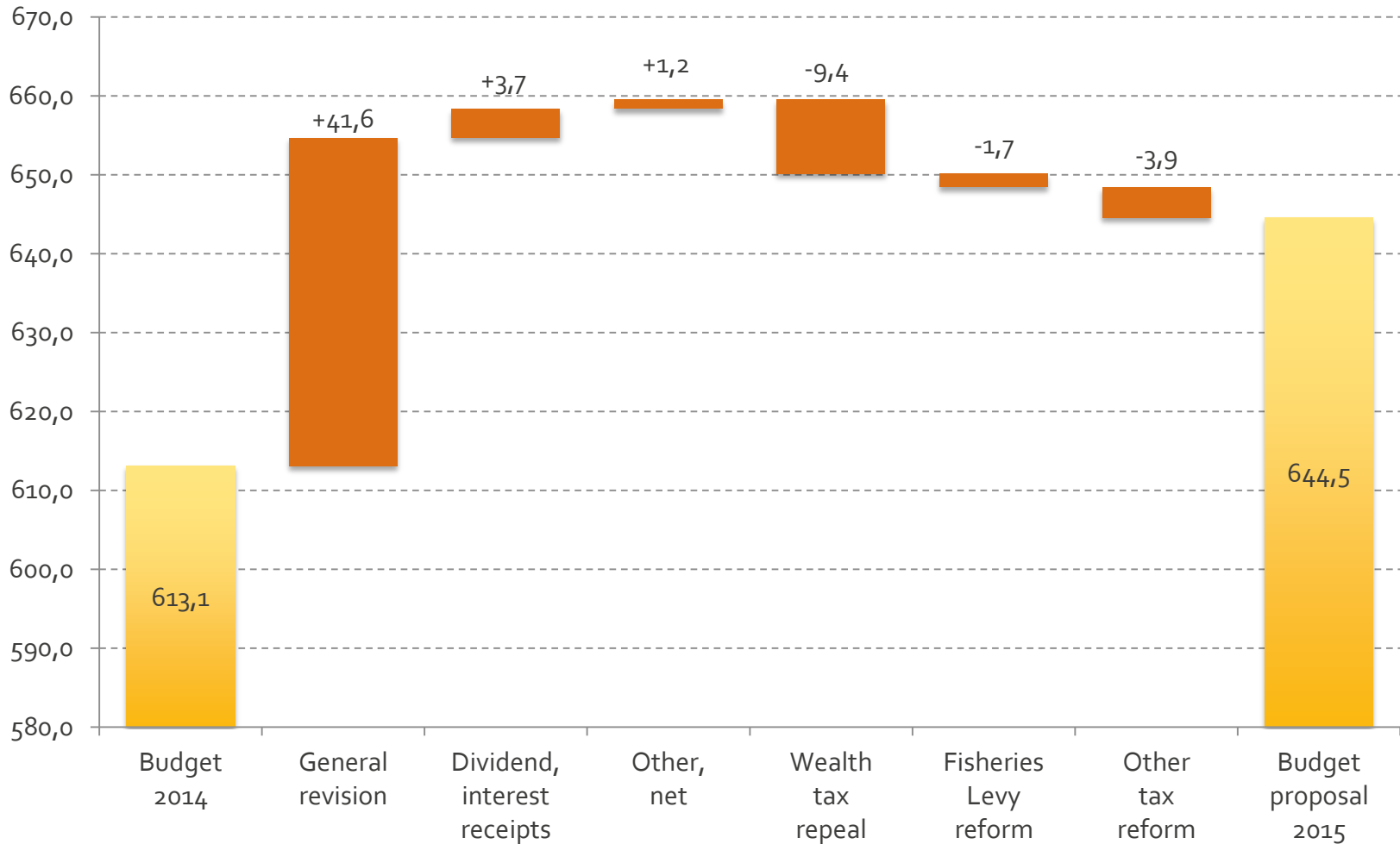


Source: OECD Consumption Tax Trends 2014, forthcoming in November 2014.



REVENUE ESTIMATE 2015: CHANGES FROM BUDGET 2014

ISK billion



Budget proposal 2015



TAX CHANGES AND COUNTERMEASURE

- » VAT standard rate 25.5% → 24.0%
- » VAT reduced rate 7% → 12.0%
- » Passenger transport with entertainment purpose such as whale watching, river rafting etc. subject to reduced rate 1 May 2015
- » Commodity tax repealed 1 January 2015
- » Child benefits raised, amounts by 13% plus 2.5% prices update; means-testing rates by 1 ppt.
- » Quantity-based excises not raised



OTHER MEASURES TO INCREASE DISPOSABLE INCOME

- » Increasing child benefits
- » Increased contributions to disability and pensioners
- » Raising the children tax-free allowance
- » Increasing the maximum parental leave payment
- » Government's debt relief program



6.

DEBT MANAGEMENT

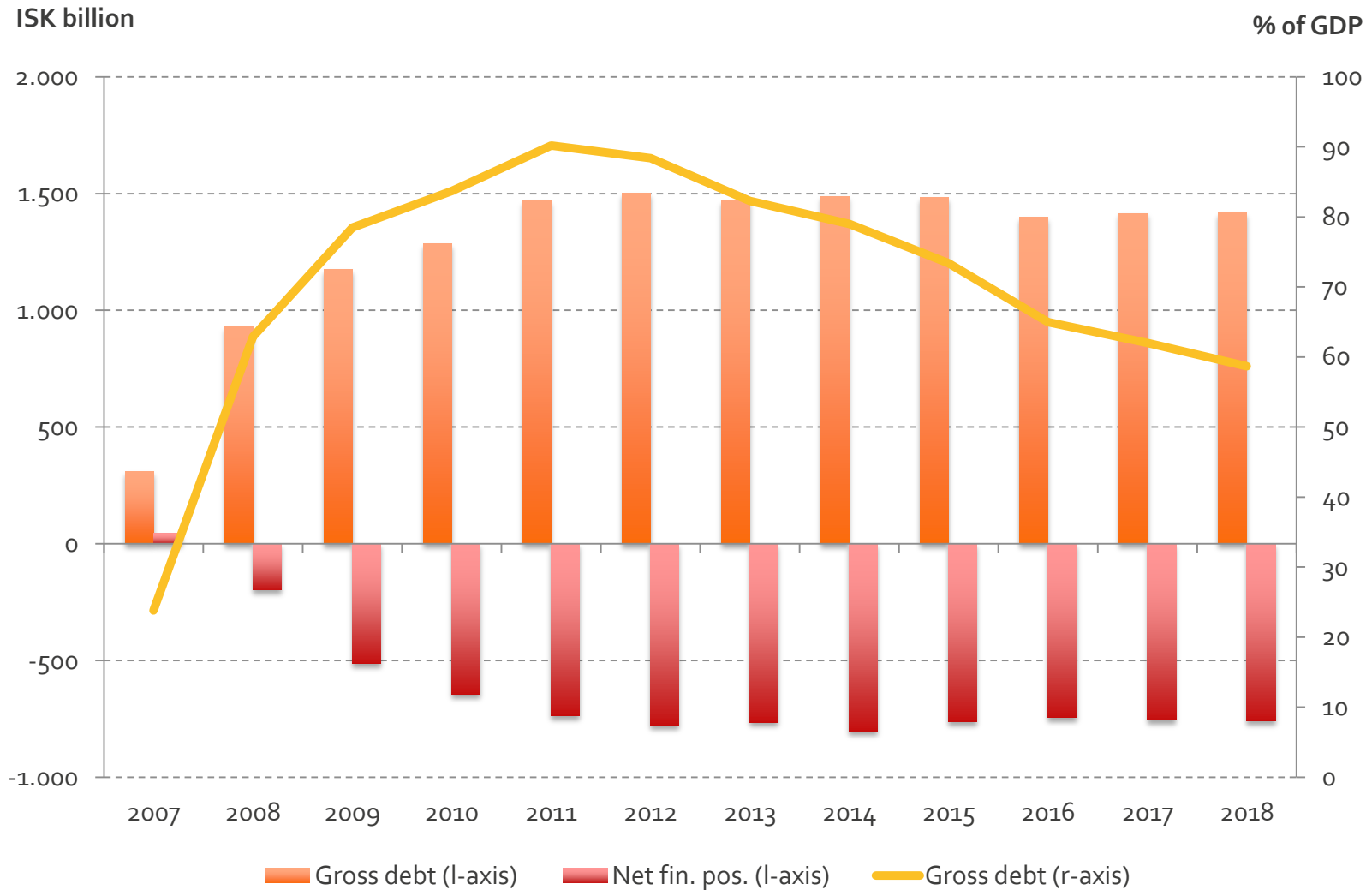
Budget proposal 2015

DEBT MANAGEMENT AND FINANCING

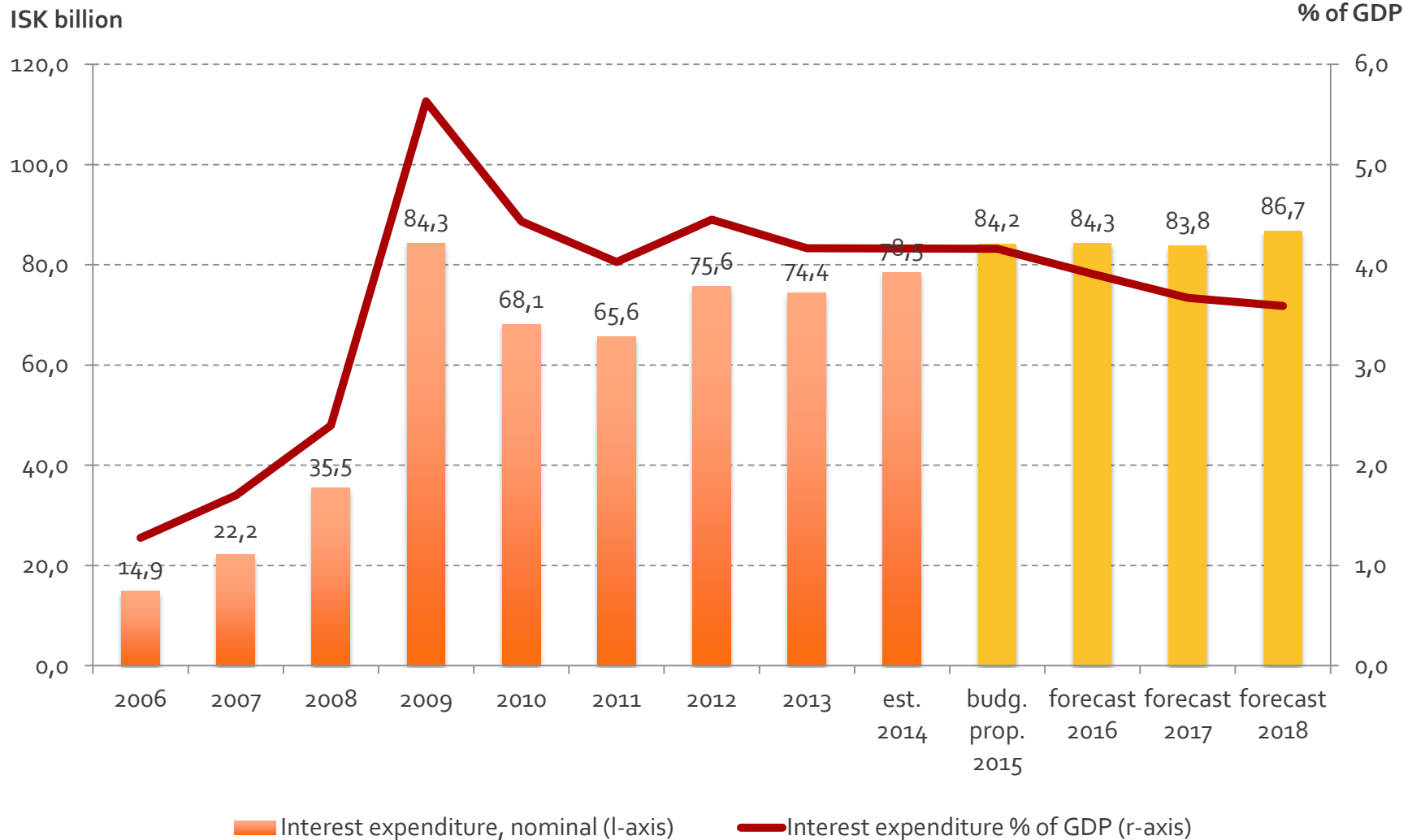
- » Important milestone in 2014 when the debt-to-GDP ratio of the central government falls to 78%
- » The government's aim is to push the ratio below 60%
- » The largest domestic maturity date is in 2018 – ISK 213 bn.
- » The largest foreign maturity is in 2016 – ISK 117 bn.
- » CBI's bond will be restructured into a nominal bond with amortization profile
- » Interest expenditure is a significant burden for the Treasury
- » Rising interest rates and inflation cause interest expenditure to increase in the coming years



GROSS DEBT AND NET FINANCIAL POSITION



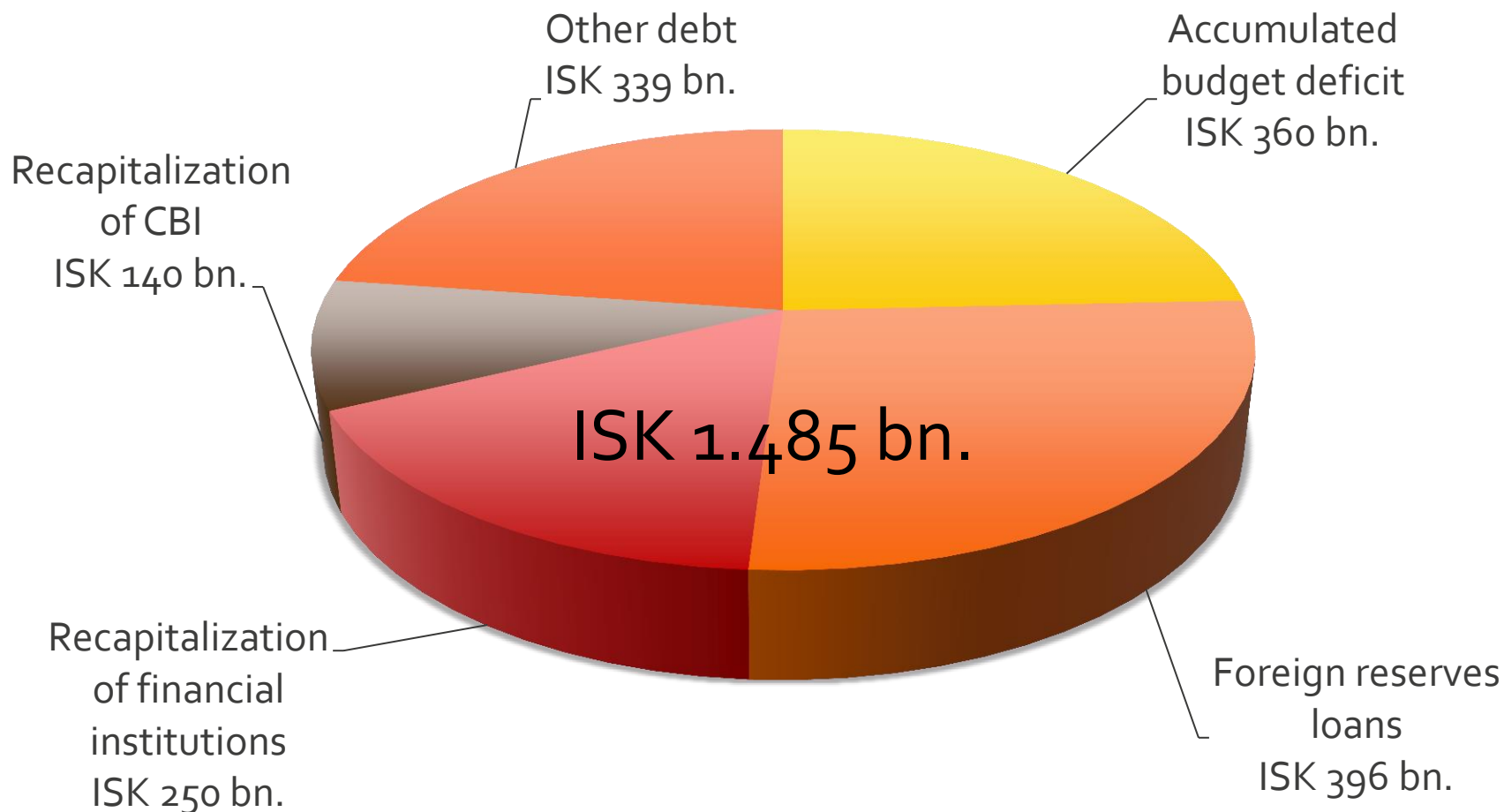
INTEREST EXPENDITURE 2006-2018



Budget proposal 2015



DEBT COMPOSITION



DEBT MANAGEMENT 2015-2018

- » It is assumed that significant steps will be taken towards liberalization of the capital account in the coming months
- » IMF loans to the CBI mature in 2015 and 2016
- » It is expected that the CBI will use its foreign currency reserves for the payments
- » USD bond, which matures in 2016, will be refinanced by half and the rest paid with the CBI's FCR
- » Proceeds from sale of shares in Landsbankinn will be used to pay down debt
- » Positive net financial balance reduces the need for domestic issuance and will be used to pay down debt



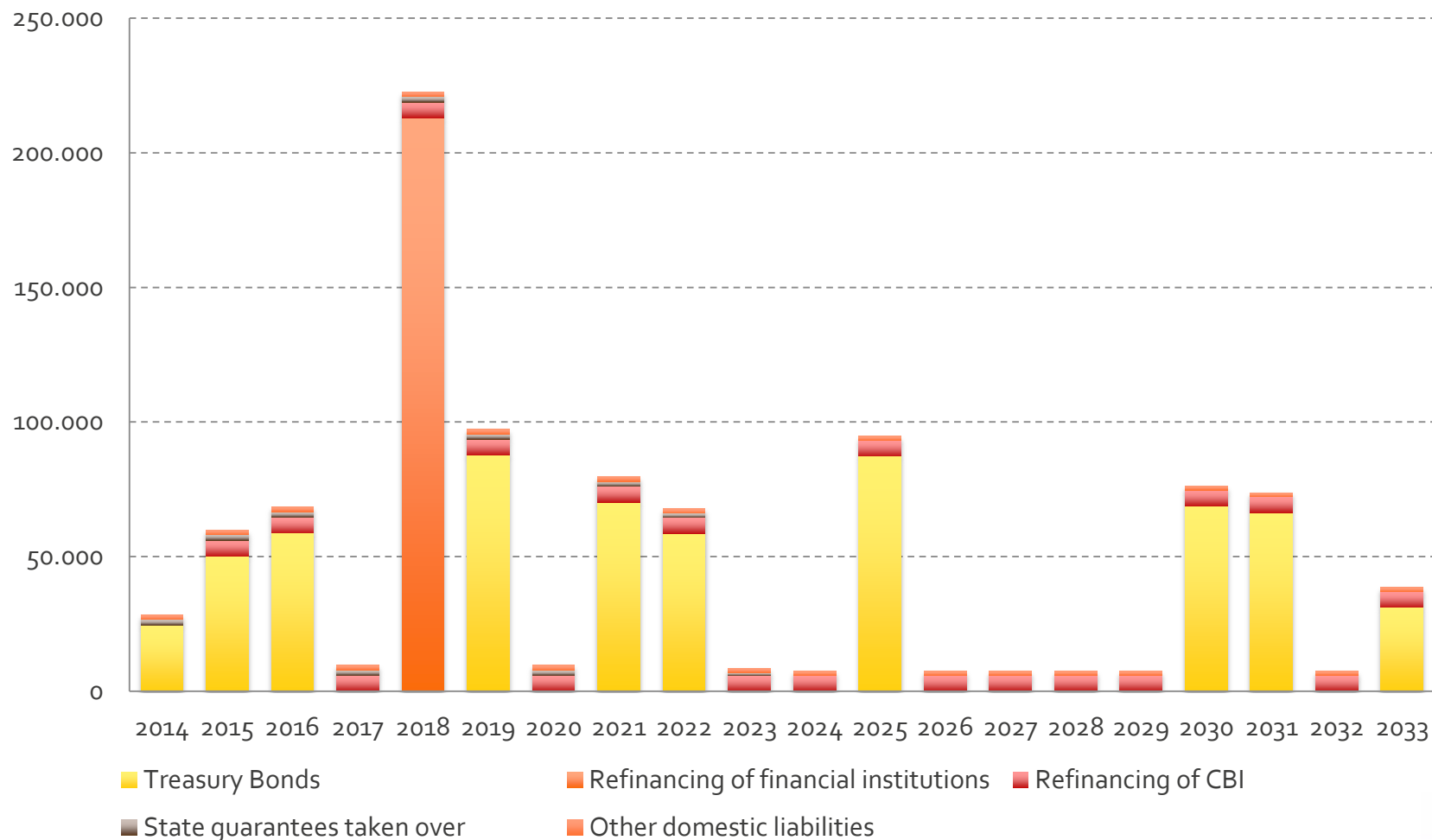
DOMESTIC DEBT MANAGEMENT STRATEGY

- » Medium Term Debt Management strategy describes the objectives of DM and guidelines followed and is reviewed and updated annually
- » The main objective is to ensure that financial needs and obligations are met with lowest possible cost that is consistent with a prudent risk policy
- » Efforts are made to have the maturity profile of securities issued as even as possible
- » The strategy is intended to encourage further development of efficient primary and secondary markets for domestic bonds
- » Principal guidelines relates to the maturity profile, benchmark series, degree of refinancing and maturity



REPAYMENT PROFILE - DOMESTIC DEBT

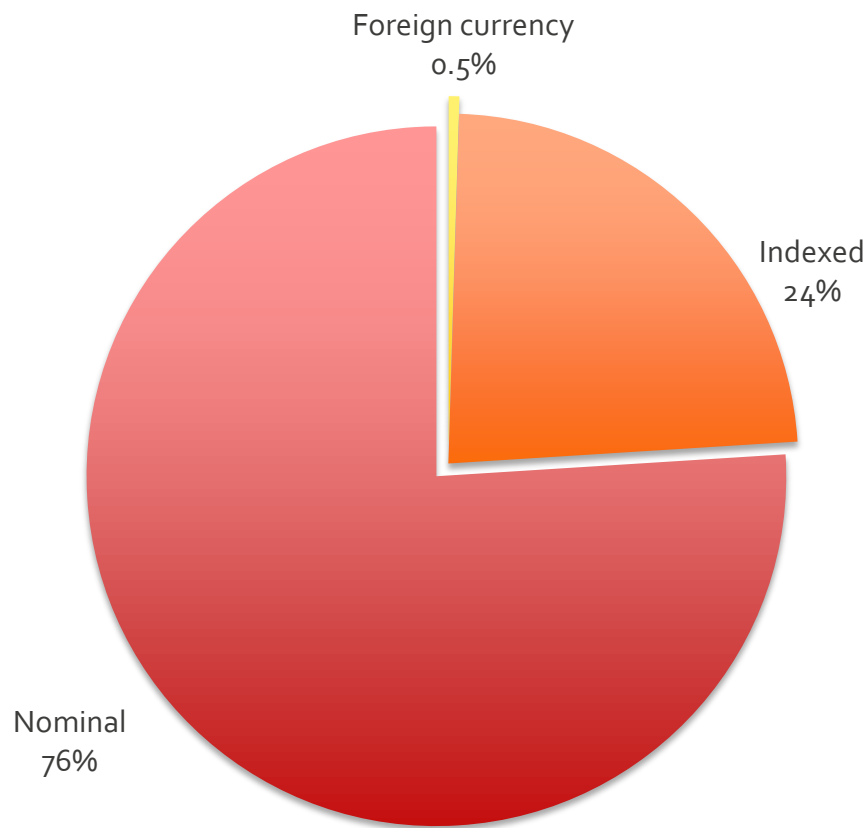
ISK million



Budget proposal 2015



DEBT COMPOSITION*



*excluding foreign reserve loans



OWNERS OF DOMESTIC GOVERNMENT BONDS

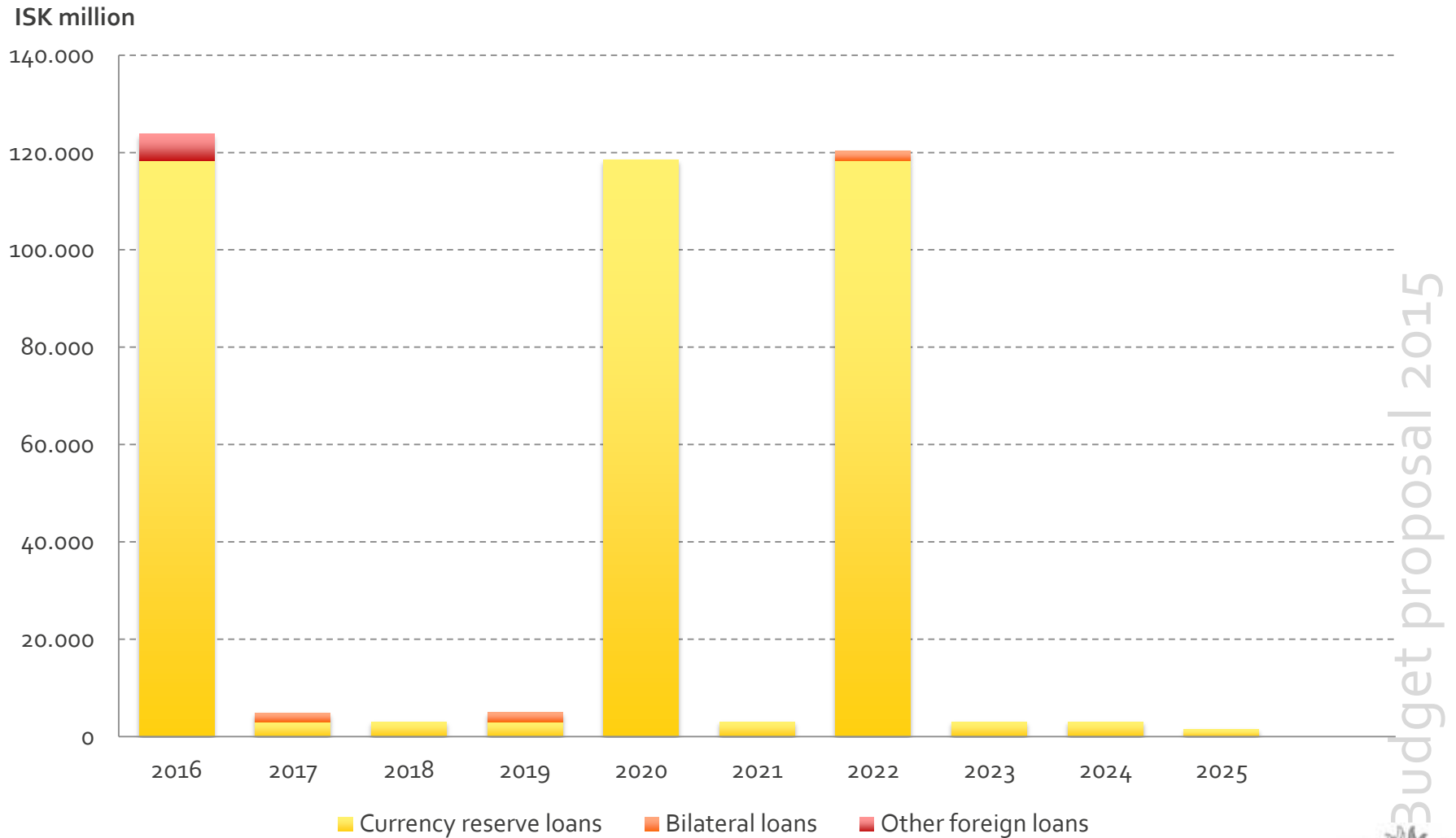
- » The purpose of an issuance of Treasury securities with different maturities is to appeal to a broad base of investors and minimize the cost of capital
- » At the end of 2013, 26% of Treasury securities were held by financial institutions, 29% were owned by pension funds, 22% by foreign entities and investment funds and others held 17%

FOREIGN DEBT MANAGEMENT STRATEGY

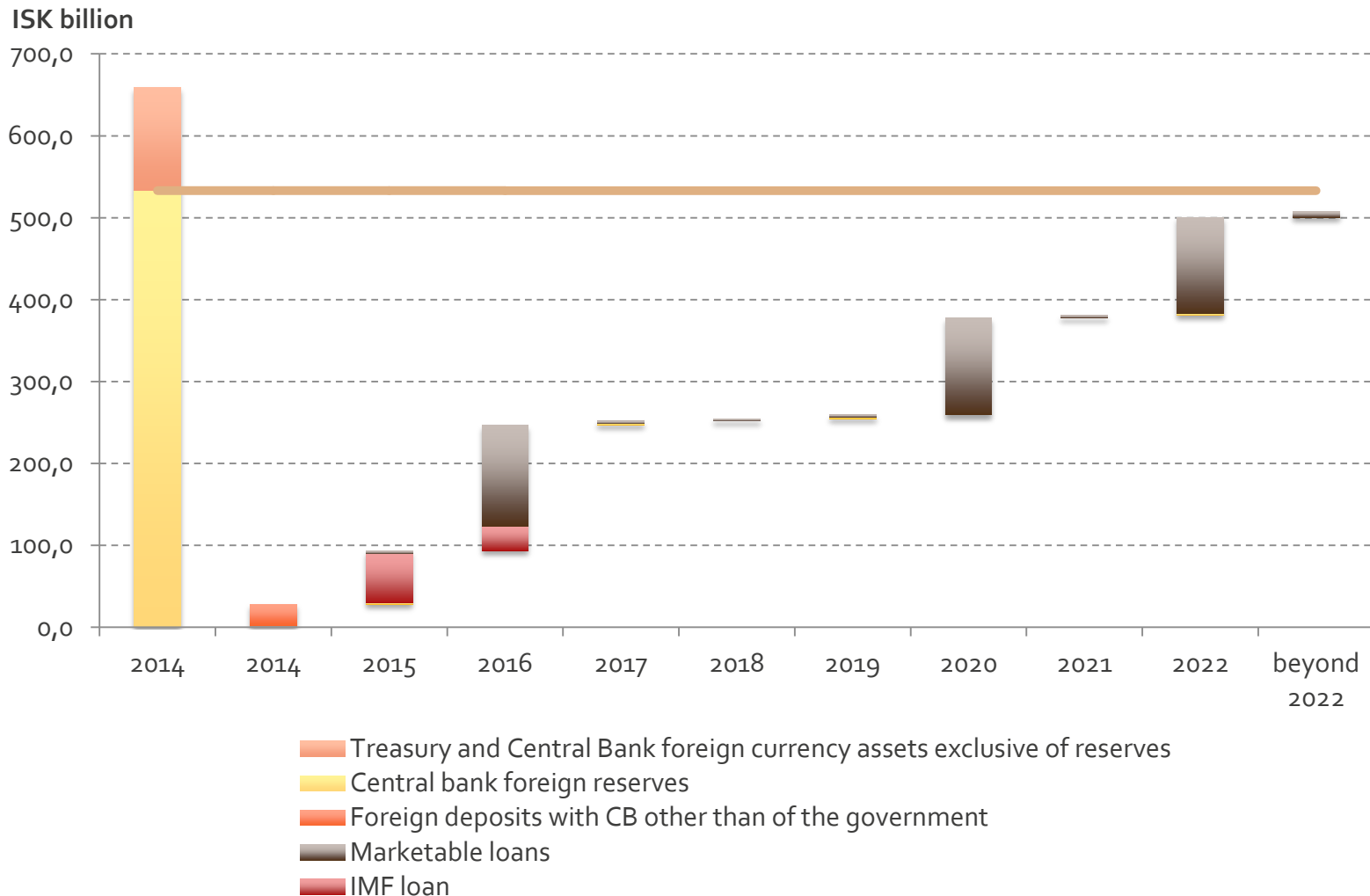
- » Treasury borrows in foreign currencies primarily to strengthen the CB's foreign reserves
- » The strategy aims at maintaining access to international capital markets
- » Enhance the name recognition of the Republic as an issuer and appeal to a diverse group of investors
- » Regular issuance of securities in foreign markets is intended
- » Issuance of the Treasury lays the foundation for the access of domestic banks and firms to international capital markets
- » The necessity for international issuance is always carefully evaluated



REDEMPTION PROFILE - FOREIGN DEBT



FX RESERVES EXCEEDS FX REPAYMENTS BEYOND 2022



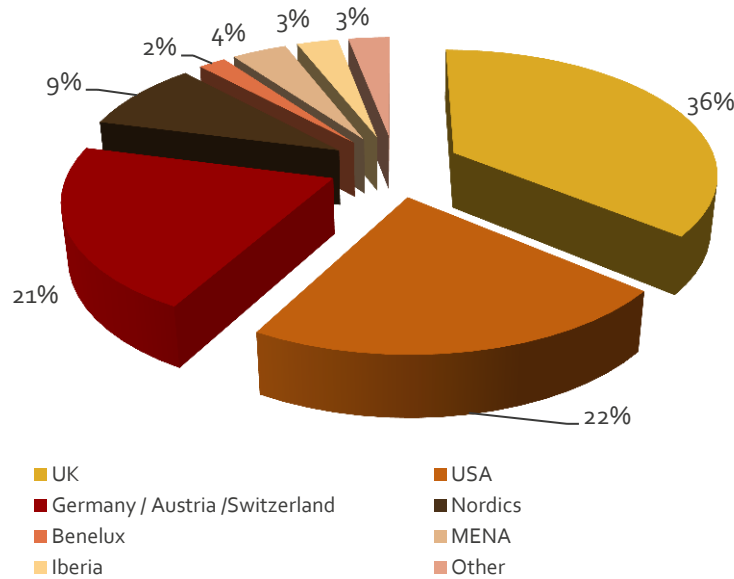
EURO BOND ISSUANCE 2014

- » In July, the Treasury issued a euro denominated bond of 750 million – ISK 116 billion
 - » First Treasury issuance in euros since 2006
 - » Fixed 2,5% interests and maturity in 2020
- » Investors showed great interest and total demand was around 2 billion euros
- » Group of investors was well diversified, majority went to fund managers in UK, USA, Germany, Austria and Switzerland
- » Proceeds were used to prepay the rest of the Nordic programme related loans
 - » Loans taken by the Treasury and the CBI

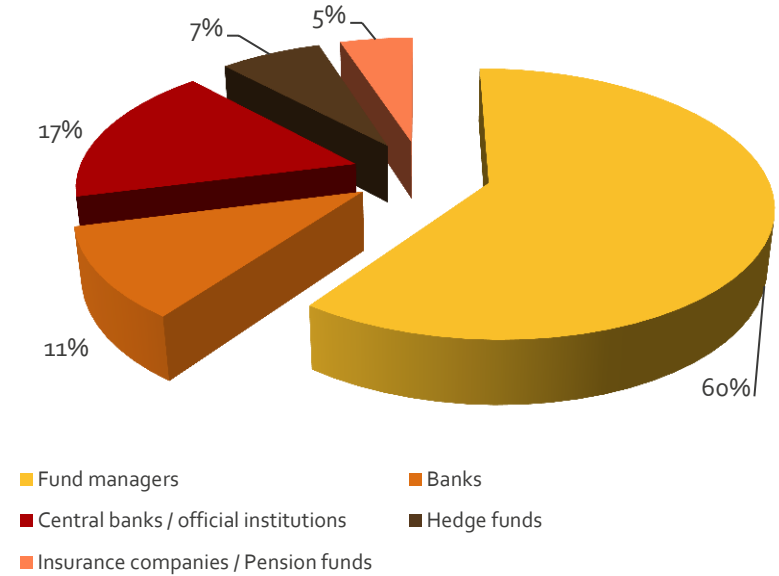


EURO BOND ISSUANCE 2014: INVESTORS COMPOSITION

Geographical composition



By type of investors



Budget proposal 2015

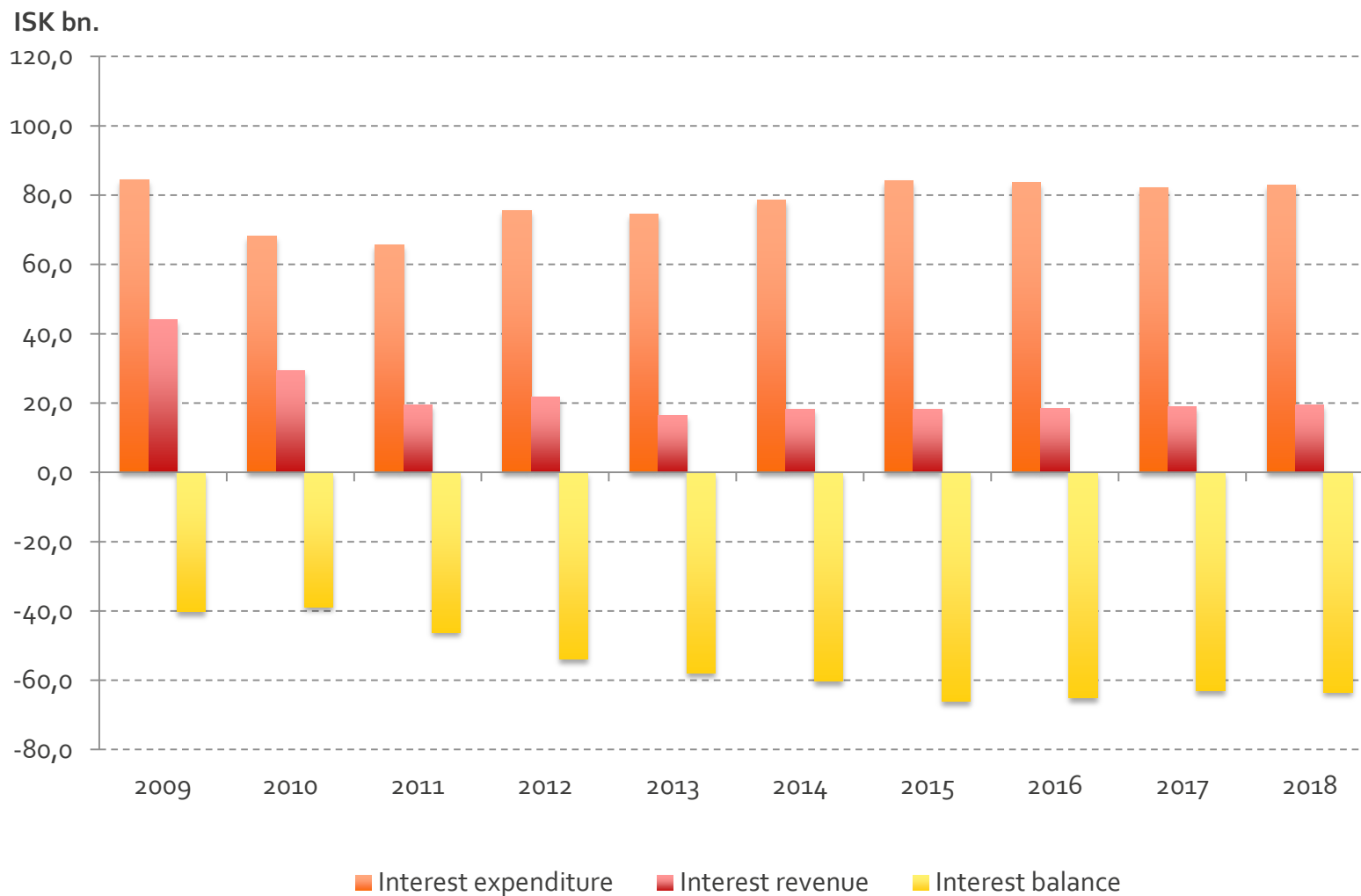


A POSITIVE AND IMPORTANT STEP

- » Yet another positive step in the economic progress
- » Treasury shows it's ability to fund it's debt in the European market
- » The issuance further opens up opportunities for domestic entities that are seeking foreign funding
- » The issuance made it possible to pre-pay the Nordic loans (interest margin of 1,75% instead of 2,75% on the Nordics)
- » Average maturity unchanged – 6 years



INTEREST BALANCE



CHALLENGES AHEAD

- » Reduce total debt in the coming years
- » Reduce burdensome interest costs as much as possible
- » Consider a restructure of the Treasury's balance sheet
- » Carefull monitoring of developments in international markets to spot favorable opportunities to refinance
- » Possible effects of capital account liberalization on debt management



DEBT LEVELS ARE TOO HIGH

- » The main fiscal issue is significant Treasury debt and substantial interest burden
- » There are also large contingent liabilities that may have negative impact on the fiscal outlook in the future:
 - » Liabilities of the Pension Fund for State Employees
 - » State guarantees – HFF etc.
 - » Increased expenditures due to an aging population
- » Debt as a % of GDP is set to decline in coming years
 - » Treasury debt was close to 90% of GDP in 2011
 - » Estimated to be 78% of GDP in year-end of 2014 and 74% in the year-end of 2015
 - » Forecasted to decline below 60% of GDP in 2018



ASSETS NEEDS TO BE SOLD AND DEBT REDUCED

- » Other things being equal, it would take decades to pay down the Treasury's debt and at the same time the interest burden is crowding out resources for other important expenditure categories
- » It is therefore necessary to restructure the Treasury balance sheet through asset sales and debt reduction
- » The Government aims to sell a 30% stake in Landsbankinn hf. in 2015 and 2016 and use the proceeds to pay down loans taken to recapitalize domestic financial institutions following the collapse of the banks in 2008





7.

ICELAND IN AN INTERNATIONAL COMPARISON

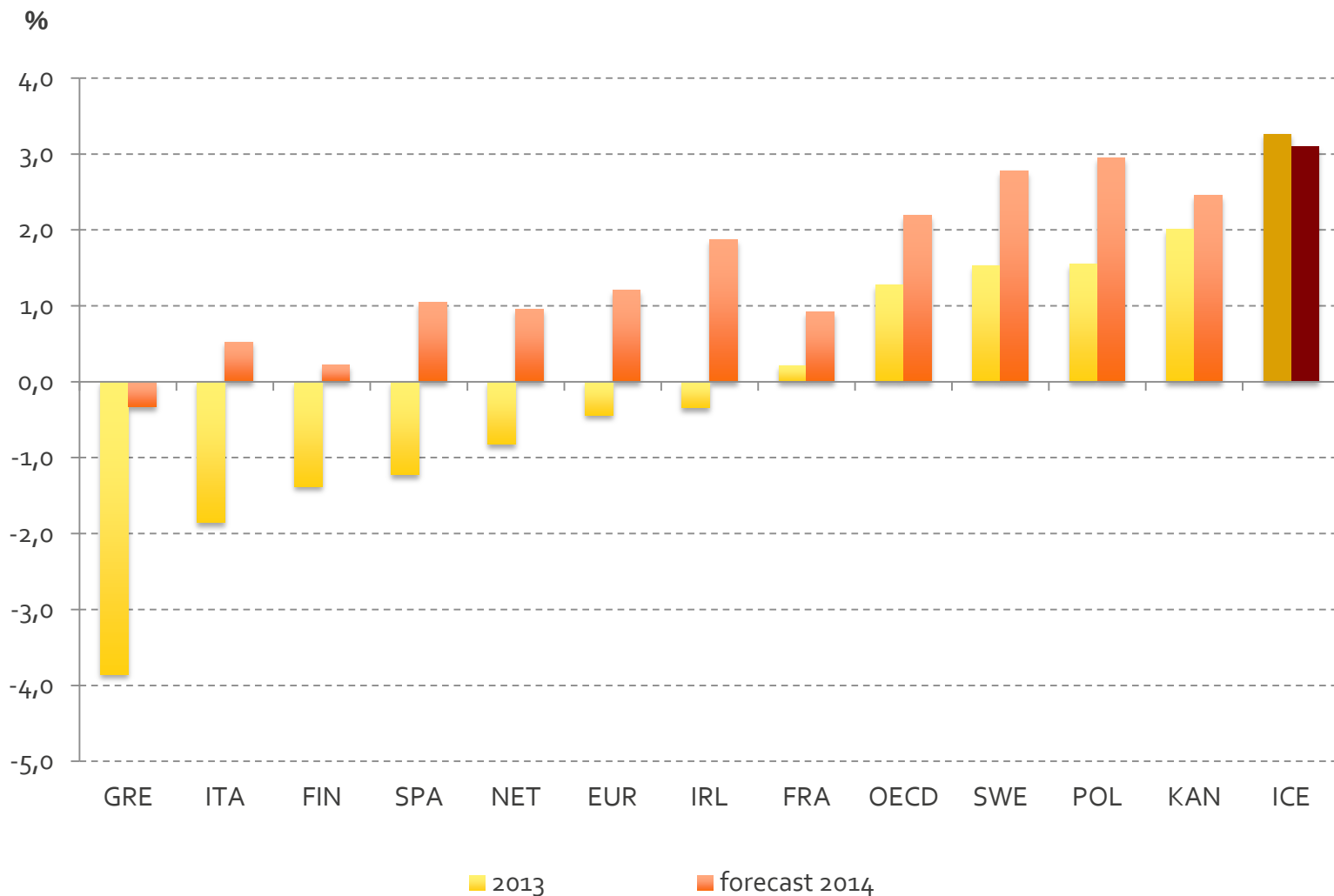
Budget proposal 2015

ICELAND IN INTERNATIONAL COMPARISON

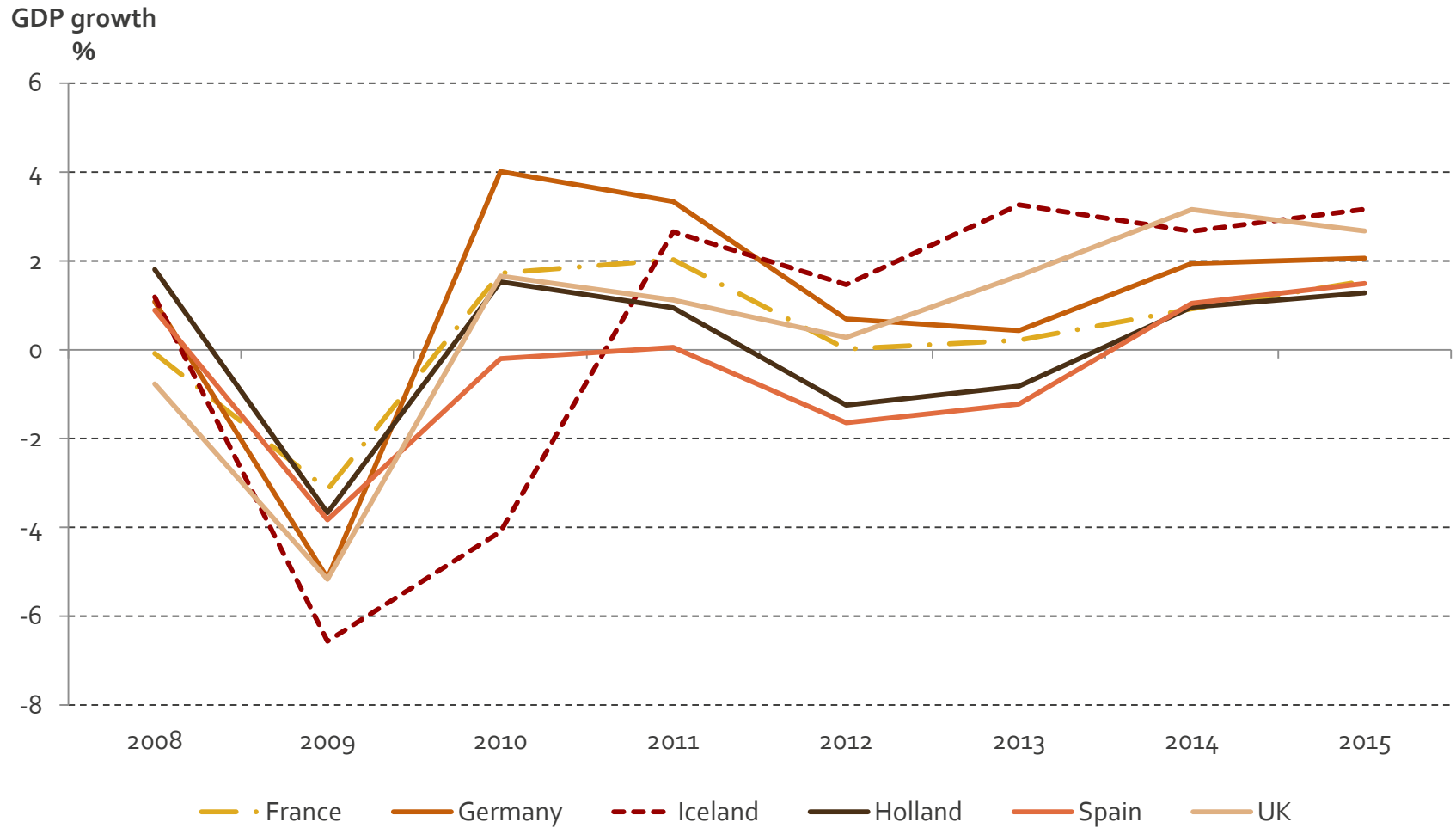
- » High GDP growth
- » Low unemployment rate, including the long term unemployment rate
- » Despite being low by Icelandic standard the inflation is high in international comparison
- » Private debt levels high
- » High debt level of the Treasury



GDP GROWTH IN 2013 AND FORECAST FOR 2014



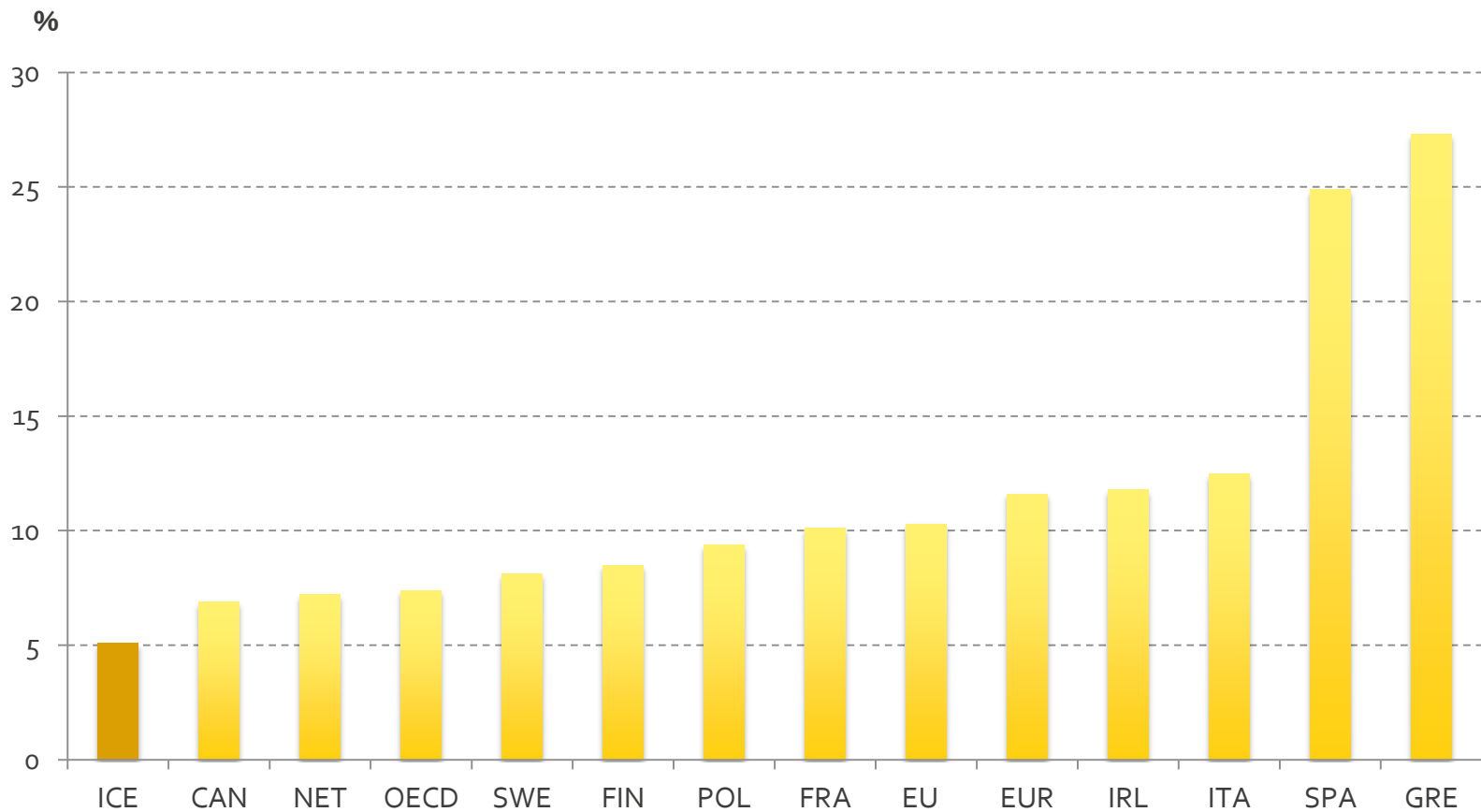
GDP GROWTH 2008 - 2015



Source: OECD



UNEMPLOYMENT IN SELECTED OECD COUNTRIES

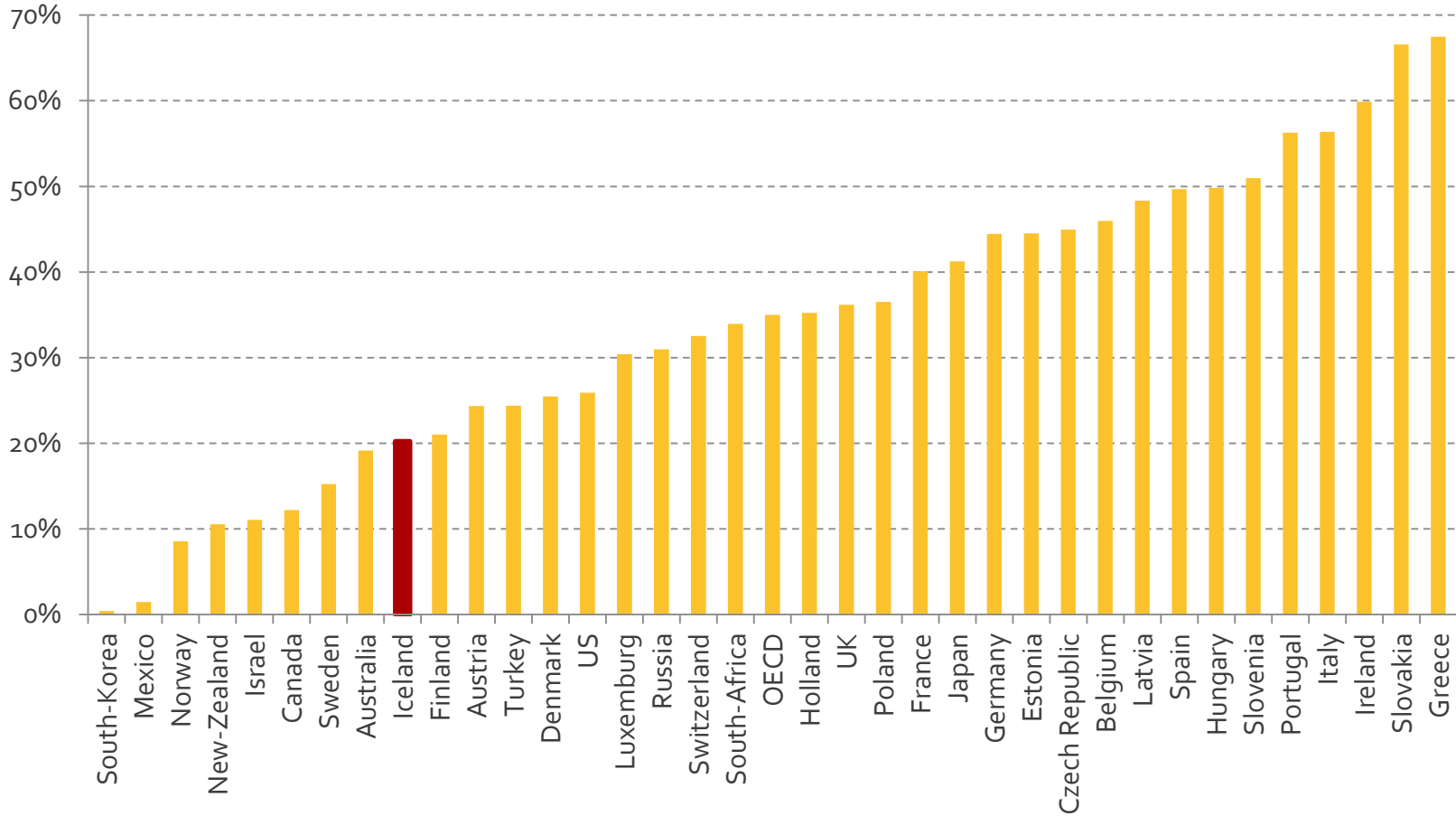


Source: OECD April 2014



LONG-TERM UNEMPLOYMENT

Long-term unempl., %
of total unempl.

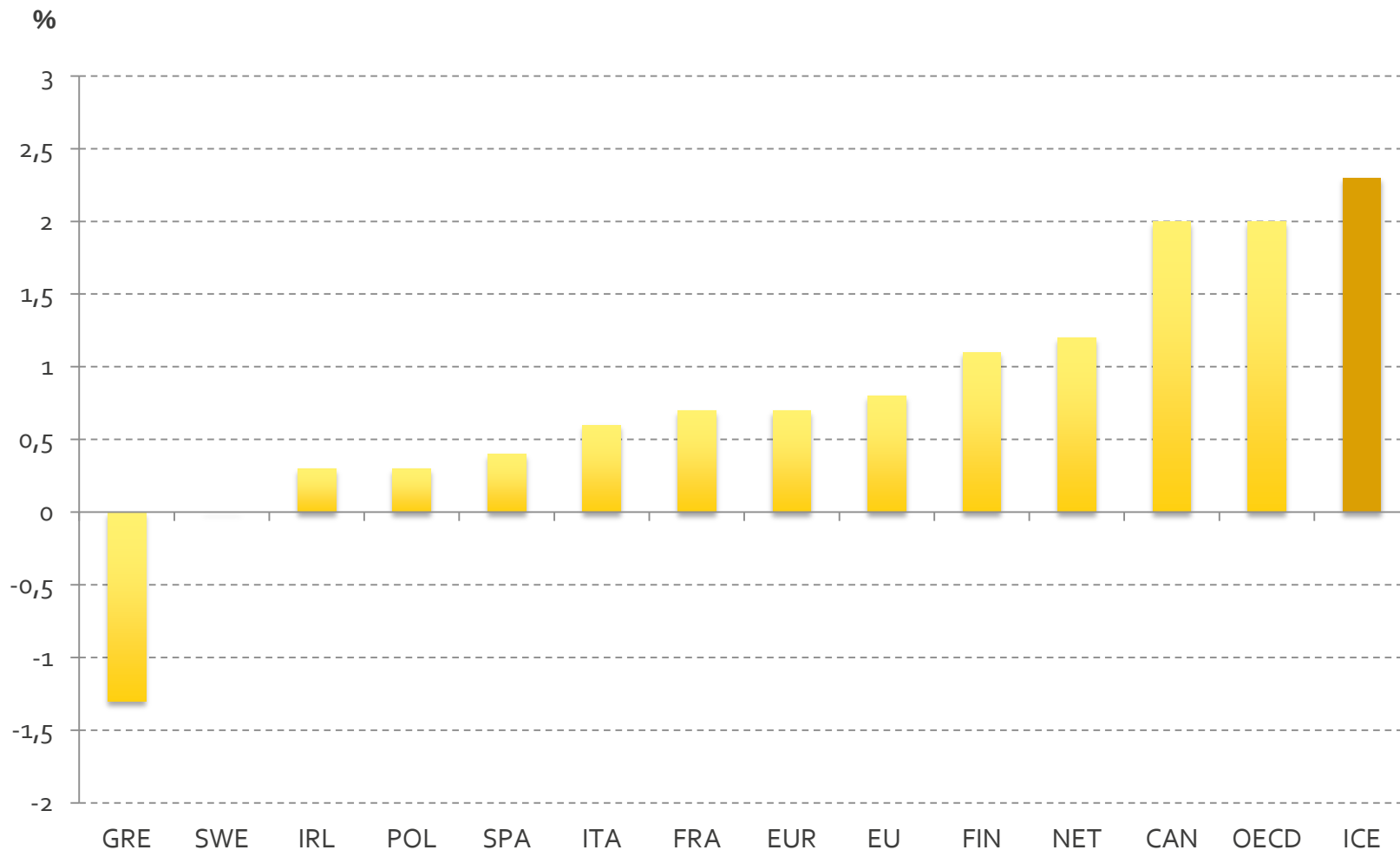


Source: OECD

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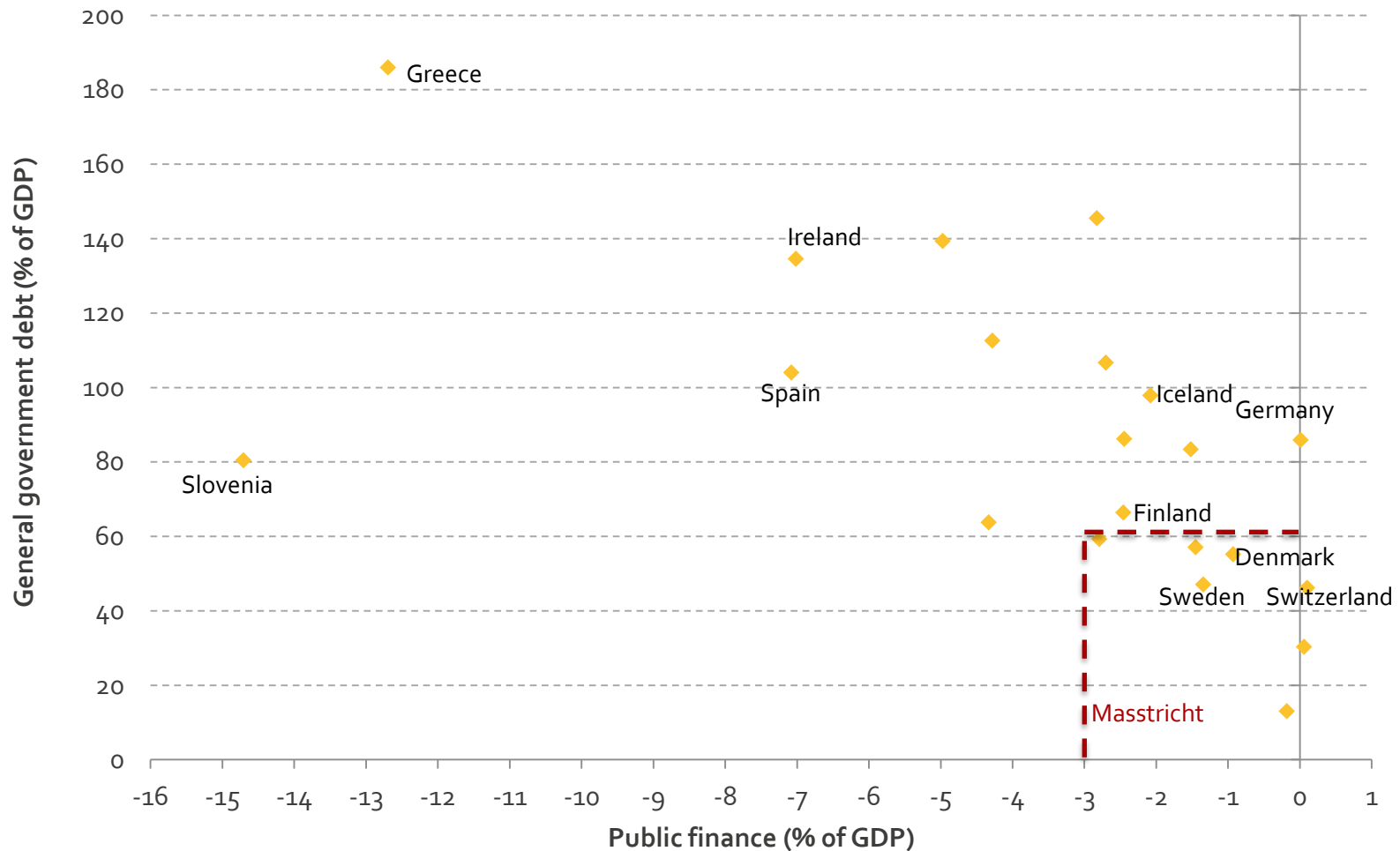
INFLATION IN SELECTED OECD COUNTRIES



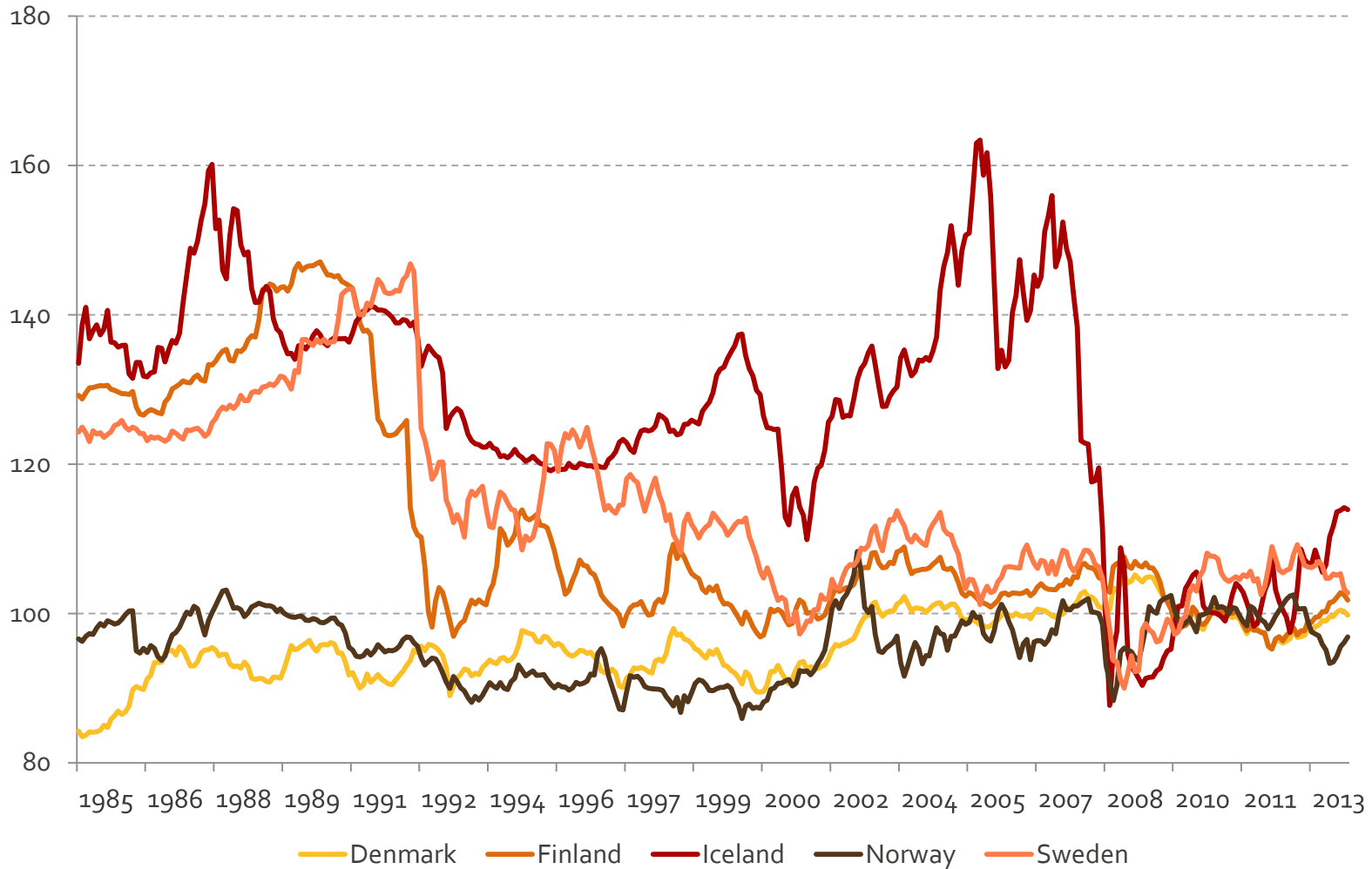
Source: OECD April 2014



GEN. GOV. DEBT AND FINANCES OF SEVERAL EUROPEAN COUNTRIES IN 2013, % OF GDP



REAL EXCHANGE RATE – NORDIC COMPARISON



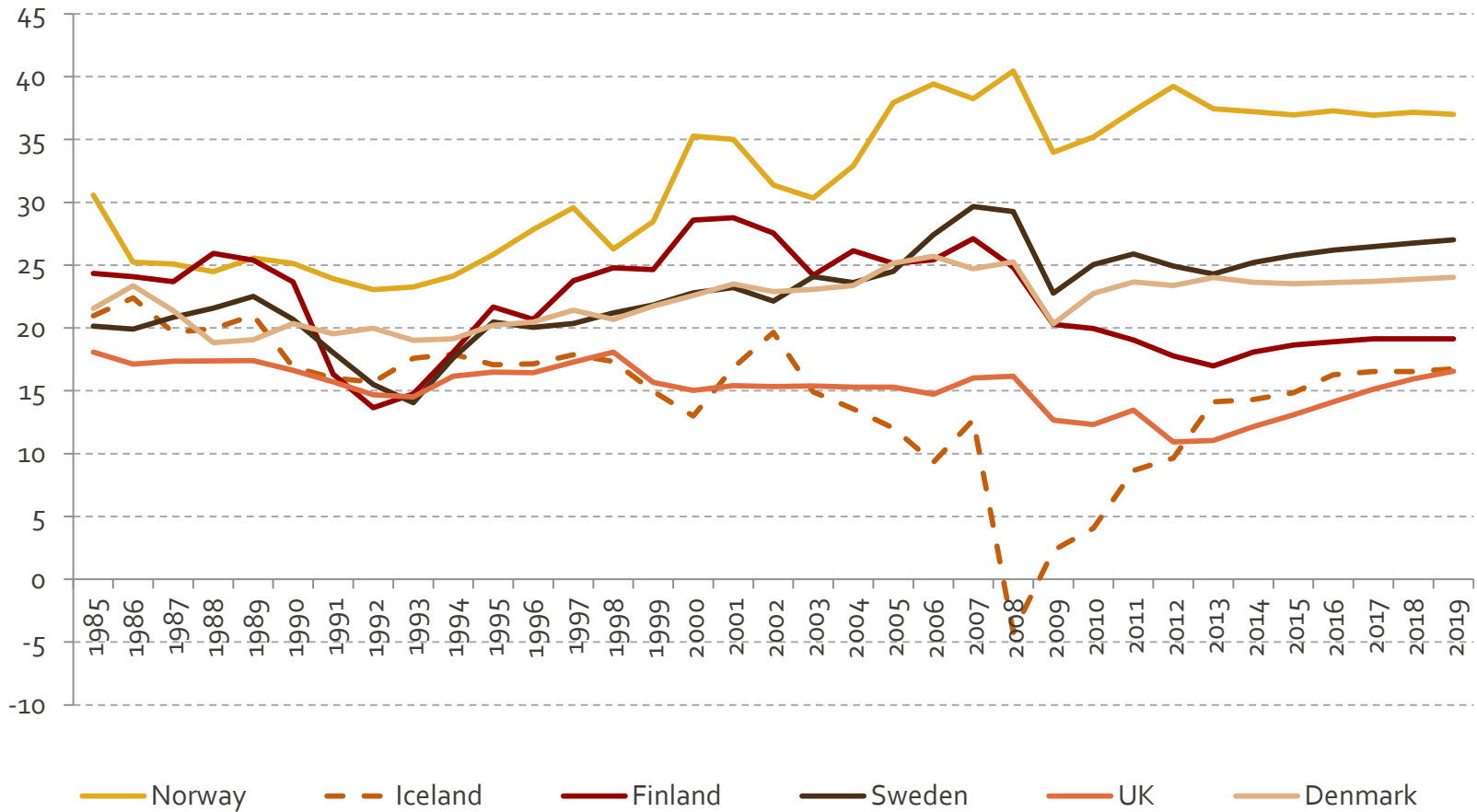
Source: OECD April 2014

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NATIONAL SAVINGS

% of GDP





8.

GENERAL GOVERNMENT AND MUNICIPALITIES

Budget proposal 2015

REVENUES OF MUNICIPALITIES 2014-2018

ISK bn.	Div. 2014	Proj. 2014	Proj. 2015	Proj. 2016	Proj. 2017	Proj. 2018
Total revenue	100,0	258,7	275,7	290,0	306,3	322,0
Tax revenue	73,9	191,2	205,5	217,2	230,2	243,0
Tax on revenue and profits	60,8	157,4	169,1	179,0	190,1	201,1
Tax on assets	12,5	32,4	34,9	36,6	38,4	40,1
Tax on goods and services	0,5	1,4	1,5	1,6	1,7	1,8
Contributions	11,4	29,5	30,6	31,6	33,0	33,8
Other revenue	14,7	38,1	39,6	41,2	43,2	45,2
Revenue from assets	4,2	10,8	11,3	11,4	12,0	12,7
Sale of goods and services	10,2	26,3	27,3	28,7	30,0	31,4
Other revenue	0,3	0,9	1,0	1,0	1,1	1,2
Total revenue, % of GDP		13,7	13,6	13,5	13,4	13,3

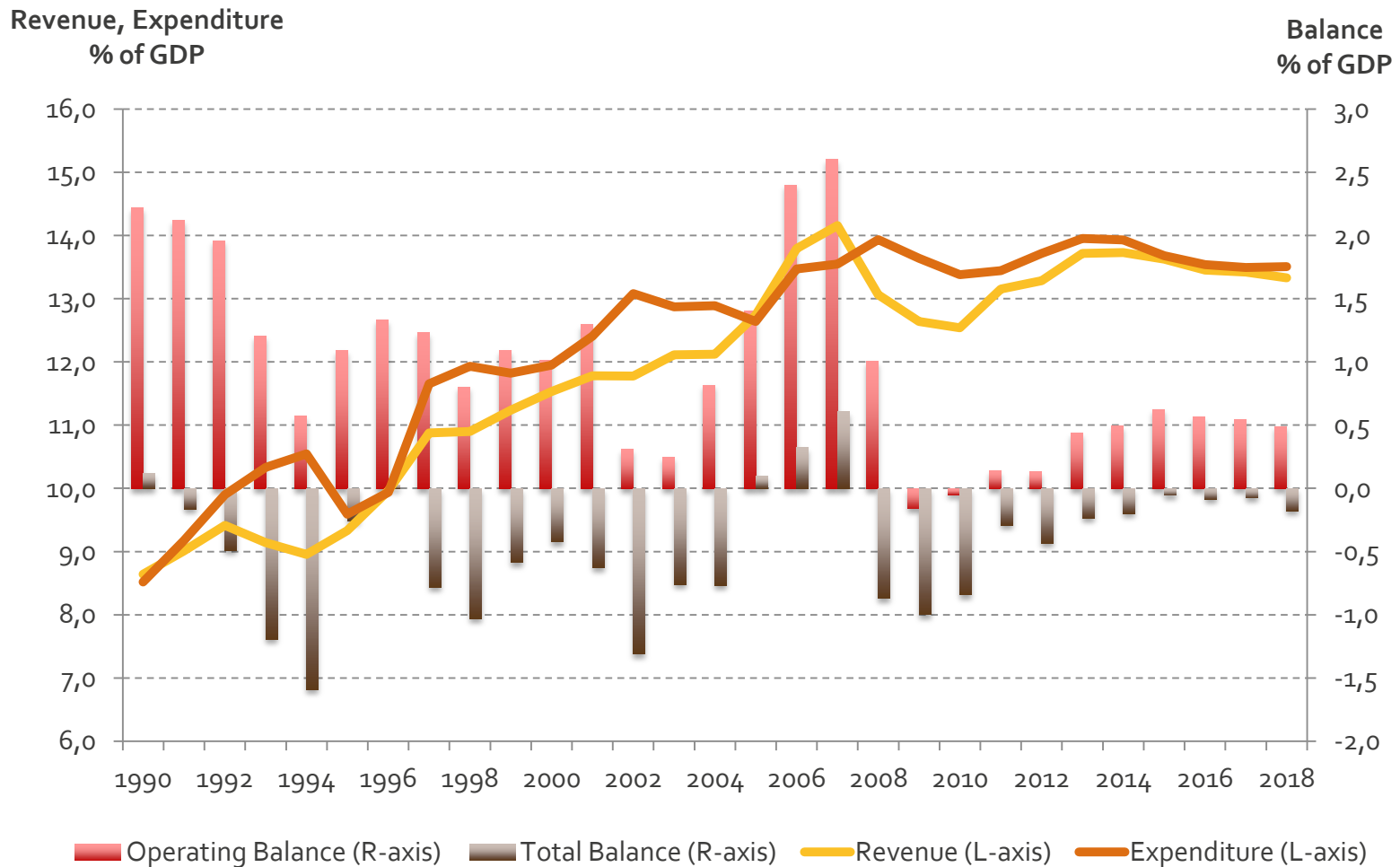
- » Forecast of municipal taxes are based on forecasts for wages, unemployment, employment, population growth and municipal tax percentage
- » According to forecasts, municipal tax revenue will increase by 7.4% in 2015 and by 6% annually in the years after
- » Forecast for property taxes is based largely on a forecast for property value and developments in investment in real estate
- » 7.5% increase in property taxes is assumed in 2015 and 4.5% in the years after over the forecast horizon
- » Contributions from the Treasury to the municipalities is in accordance to laws and regulations
- » Property income is mainly interest revenue and dividends

EXPENDITURES OF MUNICIPALITIES 2014-2018

ISK bn.	Div. 2014	Proj. 2014	Proj. 2015	Proj. 2016	Proj. 2017	Proj. 2018
Total expenditure	100,0	262,4	276,8	291,8	308,0	326,3
Wages	44,4	116,5	124,3	132,4	141,7	151,0
Goods and services	31,7	83,1	86,4	90,7	95,0	99,2
Interest expenditure	2,9	7,7	8,0	8,1	8,3	8,5
Subsidy on production	2,1	5,4	5,7	6,1	6,4	6,8
Social transfers to homes	4,9	12,9	13,7	14,3	15,0	15,7
Other tranfers	5,0	13,1	13,8	14,7	15,5	16,3
Investment	9,0	23,7	24,9	25,5	26,1	28,8
Total expenditure, % of GDP		13,7	13,6	13,5	13,4	13,3

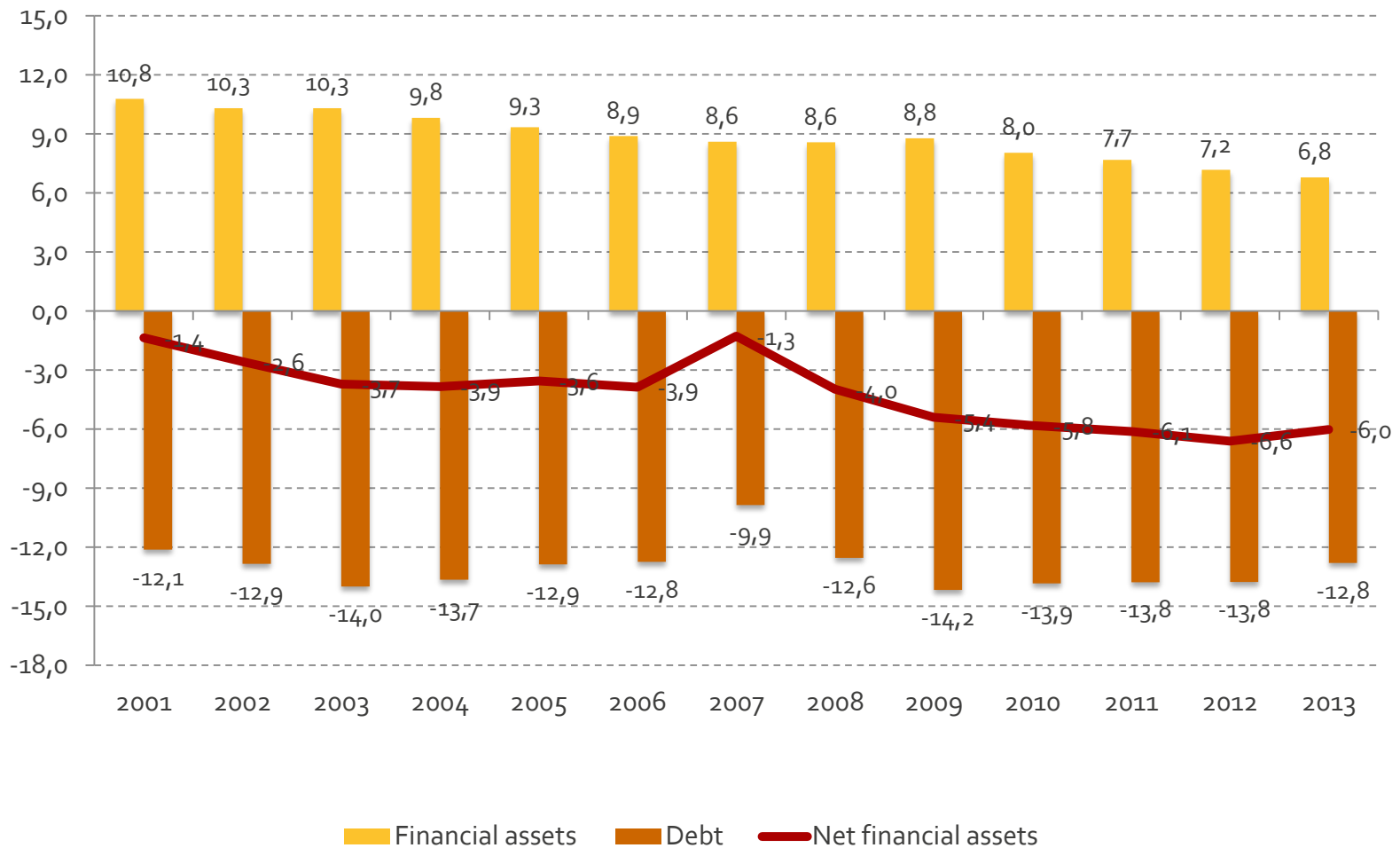
- » More than ¾ of municipal spending is collective consumption, i.e. wages and buying of goods and services
- » Developments of wages and inflation is the largest determinant in the expenditures of collective spending. Also, volume changes in macroeconomic forecasts and demographic items such as number of students etc.
- » Transfers are based on inflation and municipalities's plans
- » Investment reached a historical low in 2011, 1% of GDP. In the forecast period it is assumed that that investment will be 1.2% of GDP. In the years before the banking collapse it was close to 2%
- » The investment forecast is based on an macroeconomic forecast but not financial plans of the municipalities where investment is deteriorating.

FINANCIAL BALANCE OF MUNICIPALITIES 1990-2018



NET FINANCIAL ASSETS OF A-PART OF MUNICIPALITIES

% of GDP



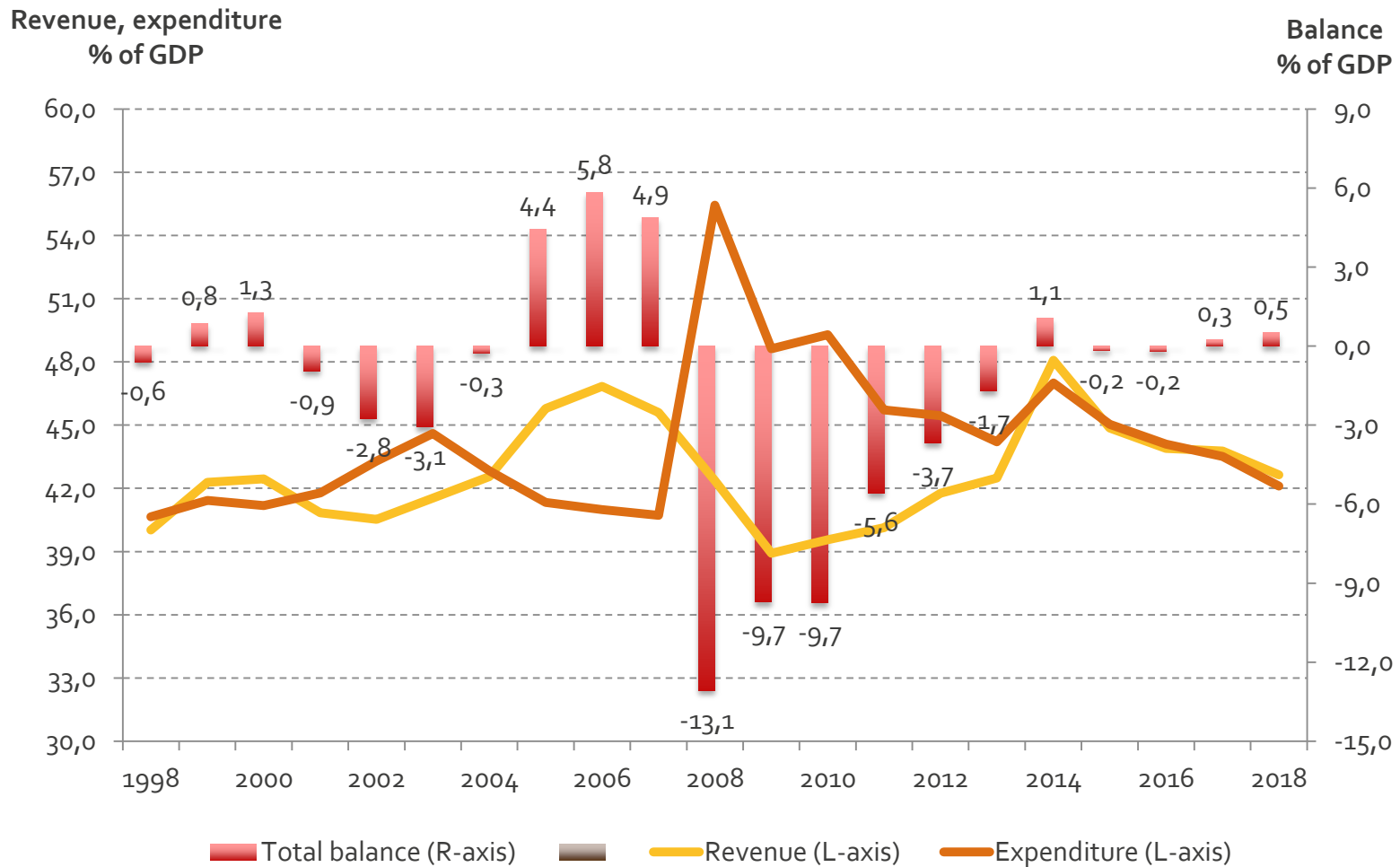
GENERAL GOVERNMENT FINANCES 2013-2018*

Ratio of GDP	2013	Proj.. 2014	Proj.. 2015	Proj.. 2016	Proj.. 2017	Proj.. 2018
Total revenue	44,5	48,1	44,9	43,9	43,8	42,6
Tax revenue	34,0	36,0	34,8	34,2	34,2	33,2
Social security charge	3,9	3,9	3,9	3,8	3,8	3,8
Contributions	0,1	0,1	0,1	0,1	0,1	0,1
Other revenue	6,5	8,1	6,1	5,8	5,7	5,6
Total expenditure	47,0	47,0	45,0	44,1	43,5	42,1
Operating expenditure	46,9	46,7	44,7	43,9	43,4	42,0
Investment expenditure	0,2	0,3	0,3	0,2	0,1	0,1
Investment	2,3	2,4	2,3	2,1	2,0	2,0
Write-offs	-2,1	-2,1	-2,0	-1,9	-1,9	-1,8
Total balance	-2,5	1,1	-0,2	-0,2	0,3	0,5

Although national accounts are settled on an accrual basis, as is the budget, there is a difference in how some items under both revenues and expenditures are treated

- » Special revenues are settled on the revenue side
- » Pension obligations are related to worked hours during the year
- » Tax revenue and tax claims (write-offs) are supposed to reflect real value
- » Internal transfers, i.e. capital gains tax of the Treasury and Treasury's real estate
- » Profits from sales/losses which does not appear in national accounts but are settled on market value

GENERAL GOVERNMENT BALANCE 1998-2018





9.

FISCAL OUTLOOK
– OTHER ASPECTS

Budget proposal 2015

MAIN WEAKNESSES

- » Risks associated with the liberalization of capital controls
- » Indebted Treasury and significant interest balance deficit
- » Opposition to tax changes may affect the fiscal target in the 2015 budget proposal
- » Expenditures as % of GDP are historically low and are projected to be restrained for the coming years



MAIN STRENGTHS

- » Favorable demographics
- » Stable and positive economic prospects in the medium-term
- » Considerable assets that partly offset the debts of the Treasury
- » Fully funded private pension system
- » Renewable natural resources

