Box 5

Fiscal budget proposal 2018

The fiscal budget proposal for 2018 was presented by the outgoing Government last September. Deviations from the strategy laid down in the Government fiscal plan presented this past spring lie mainly in changed assumptions concerning macroeconomic developments. Table 1 shows the Statistics Iceland forecast used as a basis for the budget proposal, together with revisions from the previous Statistics Iceland forecast, which was used as a basis for the fiscal plan. For comparison, the forecast in *Monetary Bulletin* 2017/3, published at around the same time as the forecast used for the budget proposal, is shown as well. As can be seen, macroeconomic assumptions changed between the fiscal plan and the budget proposal. This warranted an upward revision of revenues from tax bases and, in total, a reduction in changes in wages, prices, and exchange rate in the 2018 fiscal budget proposal.

Table 1 Macroeconomic assumptions in the 2018 fiscal budget proposal

	2018 (%)	*Change since February (percentage points)*	*MB 2017/3 (%)*
Private consumption	5.2	1.3	6.0
Public consumption	1.3	-0.2	1.6
Gross capital formation	4.0	3.0	-0.7
Exports	4.1	-0.1	4.3
Imports	5.8	2.3	3.8
Gross domestic product	3.3	0.3	3.3
Consumer price index (CPI)	2.7	-0.5	2.6
Trade-weighted exchange rate index (TWI)	-3.1	-3.1	-3.3
Wage index	6.5	0.2	5.3

Source: Central Bank of Iceland.

Changes have also been made to various items relating to fiscal policy. The fiscal plan provided for an increase in value-added tax (VAT) on tourism-related activities as of 1 July 2018 and a reduction in the general VAT bracket from 24% to 22.5% as of 1 January 2019. The budget proposal, on the other hand, postpones the VAT hike on tourism until 1 January 2019, thereby reducing estimated 2018 revenues by nearly 9 b.kr. This special measure entails an easing of the fiscal stance. In spite of this change, revenues decline

Table 2 Impact of tax changes on Treasury revenues in 2018

Changes enshrined in law	*B.kr.*	*Effective date*
Support for first-time homebuyers	-0.7	1 Jul 17
Tax bracket sharing for jointly taxed individuals	-0.8	.
Cancellation of discount on excise tax for rental motor vehicles	2.0	1 Jan 18
Trebling of bed-night tax	1.0	1 Sep 17
Total	1.5	
Planned statutory amendments, autumn 2017 legislative session		
Doubling of carbon tax	3.2	1 Jan 18
VAT exemption for importation of new electric motor vehicles	-2.0	1 Jan 18
Equalisation of oil and petrol tax	1.4	1 Jan 18
Equalisation of alcohol tax on table wine and beer	0.4	1 Jan 18
Total	3.0	
Statutory amendments planned but set aside		
Increase in VAT on tourism to the general tax bracket	-8.9	
Total	-3.9	

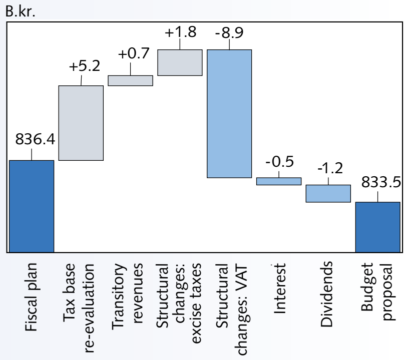
Source: Central Bank of Iceland.

overall by only 3 b.kr., according to the budget proposal (Chart 1). The difference lies in a 5.2 b.kr. revision of revenues from tax bases, although the estimate of other revenues has also been revised upwards, by 0.7 b.kr. Changes in excise taxes, another special measure, are expected to deliver an additional 1.8 b.kr. in revenues. Finally, interest and dividend income will decline by 1.7 b.kr. The effect of other changes in the tax system on 2018 revenues can be seen in Table 2, which shows that special tax system changes will lower net revenues by a total of 3.9 b.kr during the year.

The revision of estimated revenues for 2017 also affects the 2018 revenue estimate in the budget proposal. The revenue estimate in the 2017 National Budget, 776 b.kr., has been increased by nearly 25 .b.kr., or 3.2% (Chart 2). Of that total, revenues from tax bases rise by 2.5 b.kr., owing mainly to increased revenues from indirect taxes. Interest income is now estimated to be 400 m.kr. higher than in the 2017 Budget, but dividends paid by State-owned commercial banks account for 80% of the increase. Because the estimates in the fiscal budget proposal indicate that dividends and other revenues in 2017 will be higher than was assumed in the National Budget, the targeted outcome specified in the Budget will be achieved even though expenditures will exceed budgetary allocations.

Chart 1

Change in expected revenues between fiscal plan and 2018 budget proposal



Source: 2018 fiscal budget proposal.

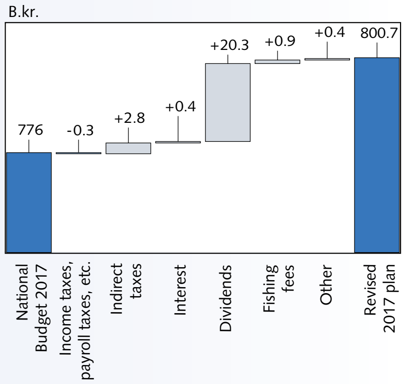
Various assumptions in the 2018 fiscal budget proposal

Wage assumptions: The 2017 National Budget assumed a 3.3% weighted average wage increase this year, accounting for the fact that contractual public sector pay rises would not take effect until June. The actual increase turned out to be 5.1%, and this affects wage assumptions for 2018. Wage settlements involving a third of Government employees are up for review this year, and projected wage developments in 2018 are based on the projected results of those settlements. The fiscal budget proposal assumes that a 3% increase as a result of the wage settlements will take effect on 1 June 2018. This accords with provisions in private sector union contracts, which expire at the end of 2018. The weighted average wage increase for 2018 is estimated at 2.1%.

Price assumptions: The 2017 National Budget assumed that inflation would measure 2.4% during the year. Statistics Iceland has revised its forecast and now projects it at 1.9%. There is no precedent for lowering budgetary authorisations because of an overestimation of inflation in the Budget itself; instead, the overage is deducted from the next year's price level update. Statistics Iceland forecasts 2018 inflation at 2.7%, and the price level revision for other operating expenditures therefore amounts to 2.2%, after adjusting for the deduction. Operating expenditures generally total about 20-30% of institutions' operating turnover.

Chart 2

Revision of revenue plan from 2017 National Budget



Source: 2018 fiscal budget proposal.

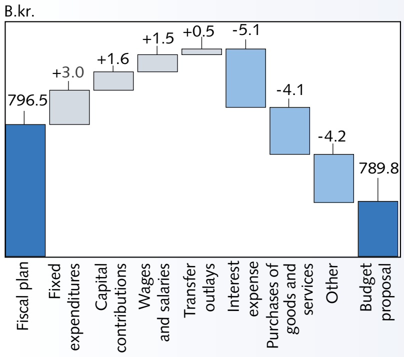
Exchange rate assumptions: In the 2018 fiscal budget proposal, foreign-denominated expenditures are calculated based on the average exchange rate in July 2017, which is 7.7% below the exchange rate on which the 2017 National Budget is based. This causes a 1.5% reduction in institutions' budgetary authorisations.

Unemployment and social security benefits: The budget proposal assumes that benefits will increase by 4.7% on 1 January 2018. Benefits paid to disability and old-age pensioners who live alone will rise by an additional 2.4%, to 300,000 kr., as of the same date. The total cost of these increases is 6.7 b.kr.

In all, the above-specified changes to budgetary authorisations in the 2018 budget proposal – changes in wages, prices, and exchange rates and increased unemployment and social security benefits – total nearly 18 b.kr. (see Table 3).

Chart 3

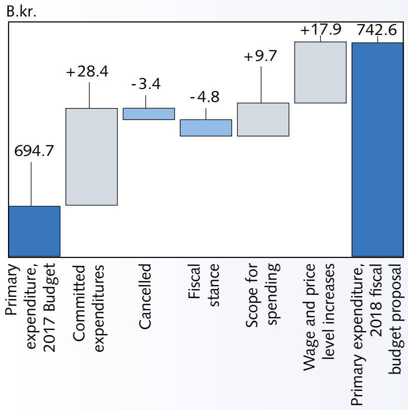
Change in expenditures between fiscal plan and 2018 budget proposal



Source: 2018 fiscal budget proposal.

Chart 4

Change in primary expenditure from 2017 National Budget



Source: 2018 fiscal budget proposal.

Table 3 Changes in wages, prices, and exchange rate in 2018

Accrual basis	*Expenditures in b.kr.*
Wage assumptions	
Revision of wage assumptions in 2017 National Budget	3.2
Projected wage increases in 2018	6.7
Special resolutions included in 2015 and 2016 wage settlements	0.1
Total wage increases	10.0
Unemployment and social security benefits	6.7
General price level assumptions	2.7
Exchange rate assumptions	-1.5
Total wage, price, and exchange rate changes in the 2018 fiscal budget proposal	17.9

Source: Central Bank of Iceland.

The reduction in total expenditures between the fiscal plan and the 2018 budget proposal amounts to 6.7 b.kr., and the outcome is therefore 3.3 b.kr. better than was assumed in the fiscal plan (Chart 3). Spending is reduced because of lower interest and transfer expense and less spending on goods and services purchases, although spending on fixed assets, grants and wages has been increased.

The increase in primary expenditure (i.e., total expenditure excluding interest expense) between the 2017 National Budget and the 2018 budget proposal totals 48 b.kr., or 7% in nominal terms and 4.3% in real terms. According to the 2018 proposal, primary expenditure totals 2.2 b.kr., about 0.3% more than was assumed in the fiscal plan. Interest expense falls by 11 b.kr. between years, and total expenditures are therefore less than previously estimated, or 36 b.kr., which corresponds to a 4.7% nominal increase and a 2.4% real increase. Chart 4 shows changes in primary expenditure between the 2017 Budget and the 2018 proposal, by major category.

How is the fiscal stance evaluated?

When the fiscal stance is evaluated, it is necessary to adjust for the effects of the business cycle on government revenues and expenditure. Taxes rise in line with income, thus boosting government revenues in an economic upswing. At the same time, there is reduced spending on various social welfare programmes such as unemployment benefits and subsidies; therefore, the fiscal outcome improves during an economic upswing and deteriorates during a downswing. Over the cycle, the primary balance adjusted for the effects of these automatic stabilisers should remain unchanged. If there are changes in the cyclically adjusted primary balance, this reflects changes in the fiscal stance.

Cyclical adjustment of the primary balance entails estimating what the outcome would be if the economy were in balance. This means that the cyclically adjusted primary balance is poorer than the unadjusted balance during a cyclical upswing and better during a downswing. A relaxation of cost restraint that leads to increased primary expenditure eases the fiscal stance even though the overall outcome may be held unchanged – for example, with extraordinary dividend payments from the commercial banks, which are not considered regular primary income. Increased primary expenditure boosts demand and demand pressures, which is justifiable during a recession but less so during an economic boom. An alternative scenario describing the effects of fiscal easing on demand, inflation, and interest rates can be found in Chapter I.