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Tax Expenditure in Iceland

Second draft, to be presented at the Spring meeting of the Nordic Tax Research Council in Helsinki, in May 2012

Introduction

An estimate of tax expenditures has been published in the annual statement of Tresury Finances since 1998, see (Ministry of Finance, Government of Iceland, 2011). The estimate is not an integral part of the state budget, but the Bureau of the Budget and the State Accounting Office are required to provide an overview of tax expenditures, as stipulated by the State Accounting Act (Act 88/1987).

Definition

As discussed in Iceland's budget for 2012, tax expenditures are conventionally divided into five subcategories:

a) tax exemptions,
b) tax rates below the general rate,
c) delayed payments,
d) special tax deductions, and
e) reduced tax base.

Total tax expenditures in Iceland

.The Budget for 2012 states that total tax expenditures were ISK 15.3 billion in 2010, Expenditures related to the general income tax amounted to ISK 2.1 billion in 2010, with the largest single expenditure being the so-called seamens' exemption, which qualifies seamen for extra tax deductions beyond other occupational groups. . However, Althingi has passed a bill to gradually eliminate the seamen's' deduction over a period of four years. VAT exemptions, which comprise the largest share of tax epxenditures amounted to ISK 10.9 billion in 2010. The two major VAT-related

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expenditures are the fact that municipalities are exempted from paying VAT and a temporary exemption of services related to building and maintenance of residential properties. Tax expenditures related to imports were ISK 1.6 billion in 2010, much of which is related to import of rescue equipment by voluntary rescue organizations (Red Cross etc).

The composition of tax expenditures has changed in Iceland over the past several years with the proportion of income-tax related expenditures falling considerably and VAT-related expenditures rising substantially. However, tax expenditures have been relatively constant as a percentage of GDP throughout the previous decade or so, with total expenditures amounting to around 1% of GDP.

Total tax expenditures in Iceland, divided into the major sources, are summarized in the table below.

Tax expenditures in	1998		2009		2010	
Iceland (ISK, billions)	Bn	%	Bn	%	Bn	%
Income tax	2.3	36.5	2.0	13.7	2.1	14.4
Value-added tax	2.4	38.1	10.9	74.7	10.9	74.7
Trade tariffs	1.1	17.5	1.2	8.2	1.6	11.0
Other excises	0.5	7.9	0.5	3.4	0.7	4.8
Total	**6.3**	**100**	**14.6**	**100**	**15.3**	**104.8**
% of total tax revenue	3.9		3.8		3.7	
% of GDP	1.1		1		1	

Not included in the official figures

Iceland's VAT is not uniform. The highest rate is 25.5%, whereas lower rates are 14% or 7% and some services are entirely exempted from VAT. The politically stated objective is to reduce cost-of-living for low income families. A broader definition of tax expenditures would be to assume that all services and all goods that are not taxed at the highest VAT-rate rate should be considered a tax expenditure. That is not the interpretation of the Icelandic State Accounting office. Estimates of the size of tax expenditures due to lower VAT rates for food and food-related goods are not easily obtained. In a 2006 report (Snorrason, 2006) it is estimated that a reform of the VAT rates for food and food-related goods so that all such goods would be subject to a 14% VAT rate and not partly 24,5% and 14% would cost ISK 950 million. Now the income accruing to the public purse from goods subject to the higher rate is a third of the income accruing from goods subject to the lower rate. Assuming inelastic consumption, the income accruing to the government would have increased by 4 billion 2006-ISK if the VAT rate had been increased to 24,5% for all food and food-related items. As the VAT rate for many food groups was lowered from 24,5% to 14% and some further from 14% to 7%, it seems fair to assume that the range of tax-exemption related to multiple VAT rates on food-items is 4-5 billion 2006 kronur. That is 3-4% of total VAT-income that year. It must be emphasized, however, that the report cited is a bit outdated as the construction of the VAT-system has been changed.

Several services are exempted from VAT due to their nature. The services are listed in paragraph 2 of Act 50/1988. Four categories of exemptions can be identified. Firstly, categories where the value added concept does not apply. This applies to health-related services (largely tax-financed damage-reduction) and funeral-services. Secondly, activities where there is a long delay from input consumption until the final output is on the market. This goes for education services, sports, real-estate services and services of artists. A third category includes banking, finance and insurance. It may be hard to identify which part of a payment maid to such institutions is service and which is not. Starting in 2012, financial services will be subject to a financial activities tax (FAT), which is arguably to compensate for the VAT-exemption. A forth category of exemptions is such that it is hard to justify why they should be included as exemptions. Renting out salmon rivers to consumers is one such exemption that is present in the Icelandic tax-code, see (Matthiasson, 2011). The size of this exemption is considerable, one estimate is that it costs ISK 300 to 400 million per year.

Estimate by non-official sources using non-standard definition

Former head of the Internal Tax Revenue Office Mr. Indriði H. Þorláksson has adopted a much broader view of what constitutes tax expenditures. (Þorláksson, 2007) It is important to note that this broader definition is not consistent with the conventional view of what constitutes tax expenditure, and that it is not based on an international standard. Þorláksson gives the following break-down of his estimate of the size of tax expenditure in Iceland in 2005:

Estimated tax-expenditure in Iceland in 2005, billions of current ISK	
Due to delayed taxation of pension contribution (taxed when disbursed not when contributed)	7,5
Due to employers contribution to the pension funds (same reason as above)	7,5
Child support not taxed	6
Deduction interest, loans to owner occupied housing	5
Various deduction due to bad health, death, illness, handicap	0,4
Seamans-deduction	1,2
Lower tax-rate on capital-income	11,0
Total	38

Þorláksson bases his estimate partly on back-of-the-envelope calculations and partly on information from the tax-authorities and the Ministry of Finance. He further assumes that a considerable part of other tax-exemptions itemized in the table are below the threshold for income-taxation.

Tax expenditure in Iceland compared to tax expenditure in other Nordic countries

Tax expenditure in Iceland amounts to about 1% of GDP according to the definition employed, as discussed in a previous section. That is 1/5 to 1/8 of what it is in the other Scandinavian countries. The estimate by Þorláksson would increase the tax expenditure by a factor of two or so, bringing the total expenditure up to being about a half of what it is in the other countries. Different observers will have different view on if this low estimate is in the ballpark or not. Whatever ones view is in this respect it is fair to state that further research is needed.

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