NSFR Conference in Stockholm, October 30-31, 2008

Non-fiscal Aspects of the Tax System

Icelandic Economic Report

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Introduction
A textbook version of the objectives of budget policy runs as follows:

Three Objectives of Budget Policy
There is no simple set of principles, no uniform rule of normative behavior that may be applied to the conduct of public policy. Rather, we are confronted with a number of separte, though interrelated, functions that require distinct solutions.
....
Let us now think of each of these functions as being performed by a particular branch of our imaginary Fiscal Department. These brances may be referred to respectively as the Allocation, Distribution, and Stabilization Branches. [1]

This is in line with guidelines for the national reports to be prepared for this conference.

Classification of changes in Icelandic tax law 1988 – 2007

It is well known that a clear cut classification of tax changes according to purpose is almost impossible because usually tax changes have multible effects. Looking at tax changes in Iceland for the 20 year period 1988 – 2007, i.e. after the tax reform in 1987, we get the following result:

a) Twenty (i.e. yearly) adjustments of personal allowances, tax credits and tax rates for the purpose of lowering taxes.

b) There were 19 other changes:
6 adjustments of excise taxes
8 administrative matters
1 incomes policy
2 tax competition
1 resource tax
1 environmental tax

It is noteworthy that administrative changes are relatively many. This issue is, however, usually neglected in the theoretic discussion – for better or for worse.

[1] R. Musgrave (1959): *The Theory of Public Finance*.

1960 – 1985 : Incomes policy

Looking back at the sixties and and seventies these decades can be descibed as those of incomes policy and tax progressivity which was used both as an income distribution and an automatic stabilization instrument in the face of inflation or other hardships. Keynesian economics and been dominating since after World War II with emphasis on demand side management. Both marginal and average tax rates were creeping ever higher. This was primarily because of the need to finance the welfare state but also to compensate for tax evasion and increasing tax expenditures of the welfare system. The attempts to fine tune economic measures was at times unsuccessful if not counterproductive like in the case of the "stop-go" policy in the UK which resulted in destabilisation of the economy. This was partly due to the complexity of the tax system and partly due to lack of credibility of financial policy. [2]

1985 – 1990: Tax reforms – vision or necessity?

Tax reductions are a constant theme of discussion in the public debate and various arguments have been put forward in this respect:

a) Fixed tax rates or decreased ones can be used to check or decrease the expansion of government expenditure.
b) Tax reductions will in increase work effort and supply (supply side economics).
c) Increased competition for firms and people in the wake of globalisation demands tax decreases.
d) Tax distortions have become more visible with high tax levels and have to be counteracted (optimal taxation theory).
e) Free capital movements make capital taxes ineffictive.
f) Competition with tax havens call for tax reductions.

Interestingly enough, the countermove to lower taxes started in the US even if the income tax rates were generally lower there than in Europe. This may be because of different welfare functions. One reason may also be, as the US economists I asked, explained to me, that the undergroind economy is closer at hand in the US than in Europe – the Scandinavian countries in particular. We also got supply side economics in the eighties and the Laffer curve. In Reaganonmics – which G:W.Bush, sr., called woodoo economics - tax cuts were supposed to close the budget deficit. The only case I know of where the Laffer curve has been shown to be effective is Sweden. By decreasing the progressivity

[2] Cf., e.g., Persson, T. & Tabellini, G. (1991): *Macroeconomic Policy, Credibility and Politics*. Harwood Academic Publishers. See also the pioneering article by Kydland, F.E. & Prescott, E.C (1977): Rules Rather Than Discretion: The Inconsistency of Optimal Plans. *Journal of Political Economy*, 85, 3.

of the marginal tax rate tax revenue could be increased, i.e. the top of the Laffer curve had been passed.[3]
Tax reforms took place in all the Nordic countries in the eighties. The aim was to simplify the tax system and decrease rates of direct taxation coupled with widening of the tax base and the abolishment of tax exemptions. This was successful in many ways but the simplification was not as much as hoped for. Tax credit systems or negative income taxes were considered but given up.
In Iceland there was also quite some discussion on resource taxation of ocean fishing. The result was a a transferable market quota system for the most valuable speciesA relatively low ITQ catch fee was introduced later in 2002. . It may thus be said that market pricing won over Pigouvian taxation in fishing.[4]

Tax reform in Iceland in1987

The Icelandic personal income tax system was simpified, modified and modernised in 1987. There were in effect six tax brackets in then existing system and a myriad of exemptions. The taxpayer was at a loss to grasp the combined effect of high inflation, widespread indexation of wages and the gap between the time income was earned and tax paid. Budget planning was also very difficult.
At this time a pay-as-you-earn (PAYE) system was introduced as of January 1st 1987. It had been discussed for 40 years and was finally adopted by the Althing thanks to an intitative taken by the labour union. It was adopted as a tripartite agreement by the labour union, the employer´s union and the Government. Accordingly, 1986 became an income tax free year. The progressively increasing marginal tax rates were abolished and a two bracket system was adopted. Income below a certain level was tax free but income exceeding that level was subject to a 35,2% tax, which included both central government and municipality taxes. The flat rate did not hold for very long and a surcharge was added to the higher bracket. But as of now in 2008 the surcharge has been abolished and the highest marginal tax rate is now almost down to the 1987 level again, or to 35,72%, whereof 22,75% is state tax and 12,97% is municipal tax.

[3] Feige, E.L. & McGee, R.T., Sweden´s Laffer Curve (1983): Taxation and the Unobserved Economy. *Scandinavian Journal of Economics*.
[4] Þórólfur Matthíasson (2008): Rent Collection, Rent Distribution, and Cost Recovery: An Analysis of Iceland´s ITQ Catch Fee Experiment. *Marine Resource Economics*, Vol. 23, pp. 103 – 115.

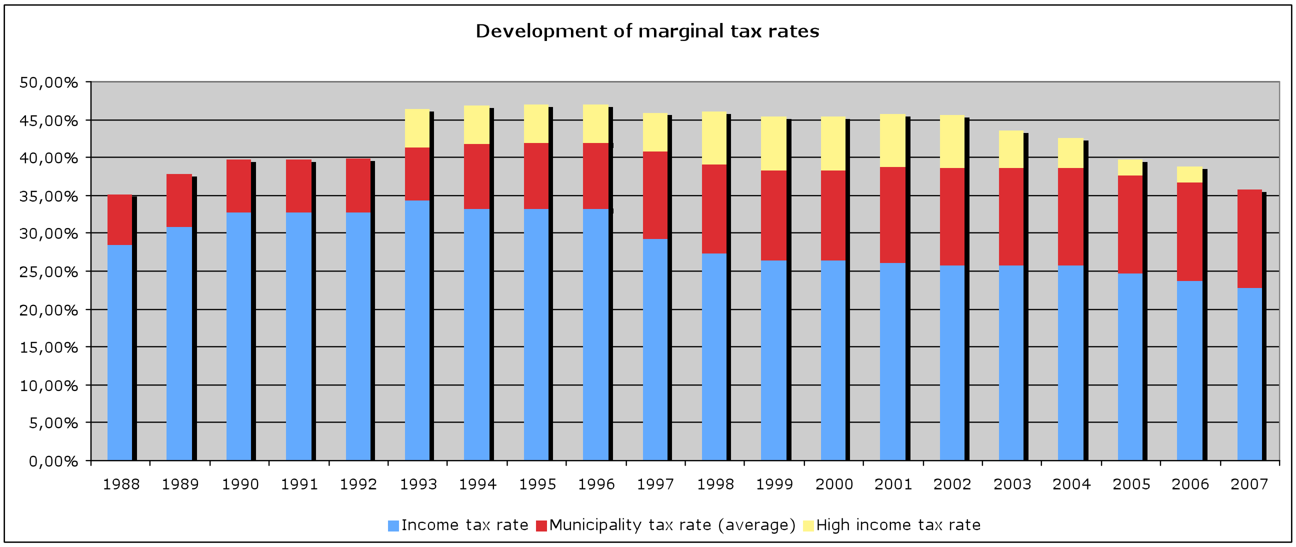

Fig. 1. Marginal tax rates 1988 – 2007.

Source: Þórólfur Matthíasson (2006): *Icelandic Economic National Report*, NSFR.

The development of marginal tax rates 1988 – 2007 in depicted in Fig.1.
The high income surcharge on marginal tax shown in the figure was as decreased stepwise from 7% in 2002 to zero in 2006.

Other tax reductions

Inheritance taxes have been decreased and net wealth taxes that were previously levied on individuals were abolished as of January 1st 2006. The 24,5 % VAT has also been decreased for some consumer goods to 7% and some goods and services are exempt from the tax.. The objevtive has been to counteract price increases and to lower the consumer price index to avert wage increases.

Taxation of savings, shares and dividends

Financial savings were extremely low in Iceland in the early seventies. Nominal interest rates were determined by the Central Bank and inflation was high. Real interest rates were more often than not negative. Interest earnings of individuals were in principle tax free
At the same time share earnings and dividends were taxed . With the emergence of a stock market it became clear that savings in shares were discriminated against. In order to compensate for this and to enhance the development of the equity market, a tax deduction at the buying of shares up to a certain amonut was introduced. In fact this tax exemption applied only to shares in “big” companies (with more than 50 shareholders if I remember correctly) which discrimnated against the smaller ones. When capital income and dividends became taxed at the same rate (10%) this tax allowance continued for some years until it was phased out.

In 1979 indexed deposit bank accounts were allowed and indexation of financial instruments made more liberal. The indexation of savings gradually led to increased financial savings. When capital income became taxed at 10% this did not have a negative effect on savings, probalby because it was a low tax anyway and lower than the tax on wages and salaries. This may also be partly be due to *Richardian equivalence* according to which we get the result that savings will icrease when taxes are decreased and borrowing increased to fincance a given amount of governent expenditure savings.

Tax expenditures – deductions and exemptions in the tax system

There is no comprehensive survey available of tax expenditures in the Icelandic tax system but is being preparing at the time of writing.

Table 1. Tax expenditures 2005 – 2008

(Million IKR)	2005	2006	2007	2008
Children allowance	5.035	5.993	7.438	8.383
Interest allowance	5.174	4.490	5.290	6.653
Days at sea allowance	1.256	1.185	1.102	1.109
Pension supplement	-	-	-	421
Total	11.465	11.668	13 .820	16 .566
Per cent of income tax	7,9	7,1	7,4	7,8

Source: Páll Kolbeins. Álagning 2008. *Tíund* (Tenth), ágúst 2008.

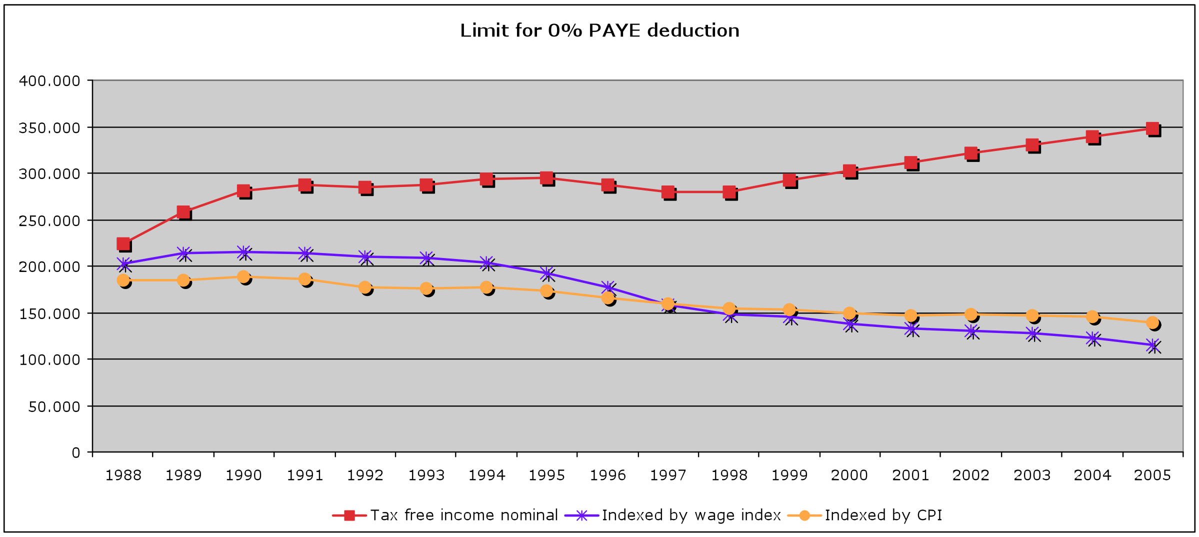

Fig. 2. Limit for zero bracket income deduction.

Source: Þórólfur Matthíasson (2006): *Icelandic Economic National Report*, NSFR.

Fig. 2 shows the erosion of the limit for real income applicable to the zero bracket rate over time.

Table 2. Individual capital income declared 2005-2008

	2005	2006	2007	2008	Ch. ´07-´08	
(Billion IKR)						%
Shares						
Income from domestic shares	14	25	34	41	21,8	
Income from foreign shares	1	1	3	2	- 31,6	
Interest income from						
Bank deposits	9	11	18	25	36,6	
Domestic and foreign bonds	11	13	17	20	16,4	
Outstanding debts/bonds	6	-	-	-		
Taxfree bonds	4	-	-	-		
Rents	3	3	4	4		
Capital gains						
Shares	35	63	77	142	85,9	
Other	2	4	7	9	28,6	
Total captial income	75	120	160	244	53,0	

Source: Páll Kolbeins: *Tíund* (Tenth), ágúst 2008.

In 2008 capital taxes increased by 54,6% from the previous year and it is now 22,6% of total state income taxes. At the same time general income tax increased by 5,5% in 2008. This reflects the increasing share of the financial sector in the Icelandic economic which last year had become as big relatively to GDP as that of Switzerland.

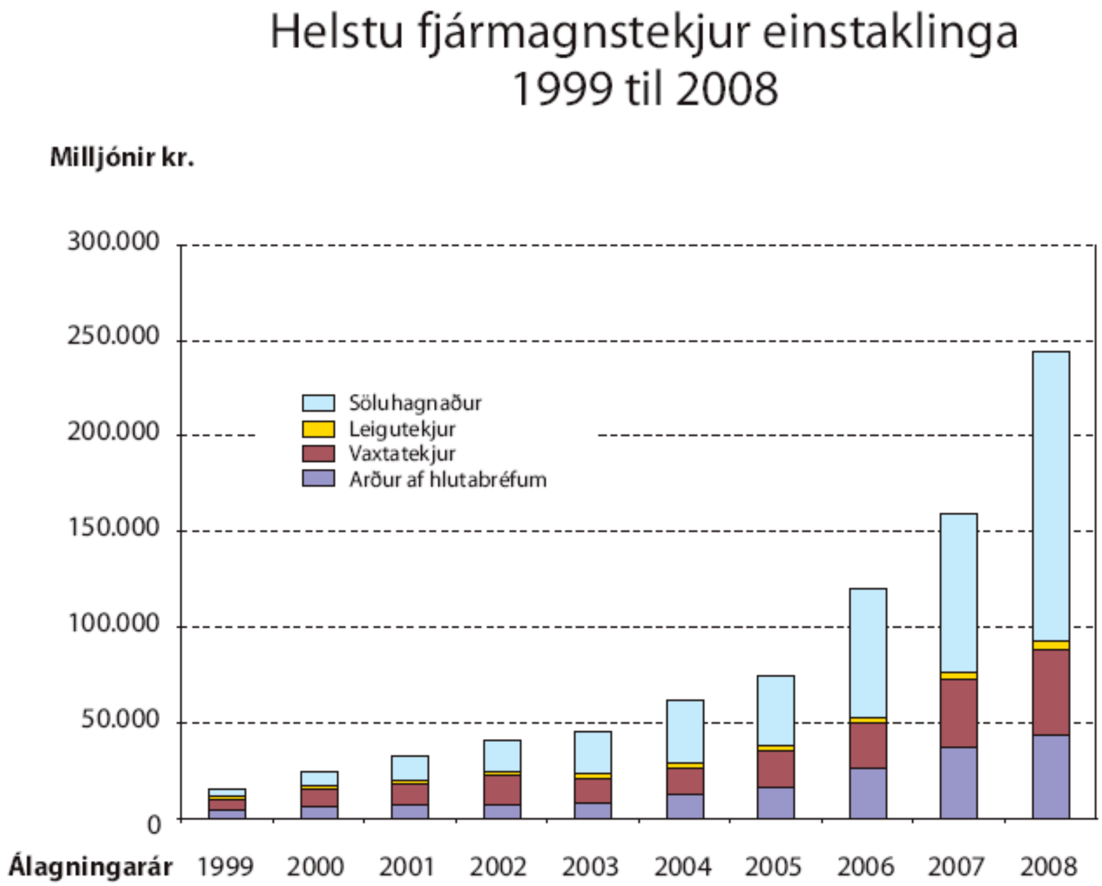

Fig. 3. Individual capital income according to assessment 1999 – 2008 (data from Table 2).

Source: Páll Kolbeins: Álagning 2008. *Tíund* (tenth), ágúst 2008.

Taxation and income distribution

Most studies find that the distribution of income after tax (disposible income) in Iceland has become more uneven during the last decade. In a study by S. Ólafsson (2006) it is shown that measured by the Gini coeffcient for married couples and cohabitants it increased from 0,21 in 1993 to 0,34 in 2005. The corresponding cefficients for singles was 0,34 and 0,40, cf. Fig. 4. The increase in inequality is found to be unusually rapid when compared to otheother Western countries during the last decades.

As is well known increased inequality does not mean that the lowest incomes have not increased but rather that the increase in income has been uneven. This is brought out by Fig. 3 which demonstrates the increase of income by income brackets.

The rapidly increasing inequality can be explained by the increased importance of capital income and by the fact that both capital income and capital gains are taxed at a lower rate than wages and salaries. This in itself may also cause some tax evasion. It thus matters quite a lot whether the income distribution is calculated with or without capital gains. In a study by the Bureau of Statistics where half of capital income and gians are included lower Gini coefficients are obtained than in the study by Stefán Ólafsson (2206).

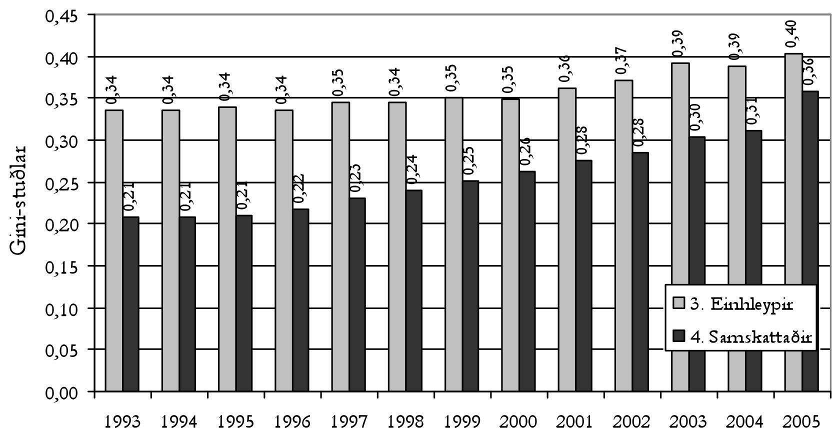

Fig. 4. Inequality of Income Distribution in Iceland 1993 – 2005. Singles and cotaxed.

Source: Stefán Ólafsson (2006): Breytt tekjuskipting Íslandinga. Greining á þróun fjölskyldutekna 1996 til 2004. *Rannsóknir í félagsvísindum VII.*

In a study by The Economic Institute af the University of Iceland in 2001 it is found that the income distribution had been becoming more equal from 1988 until 1994 but it had become more unequal from then on. It is also found that the incomes are most even in the region that has the lowest average income. At the same time all income had been increasing although at different rates, cf. Fig. 5.

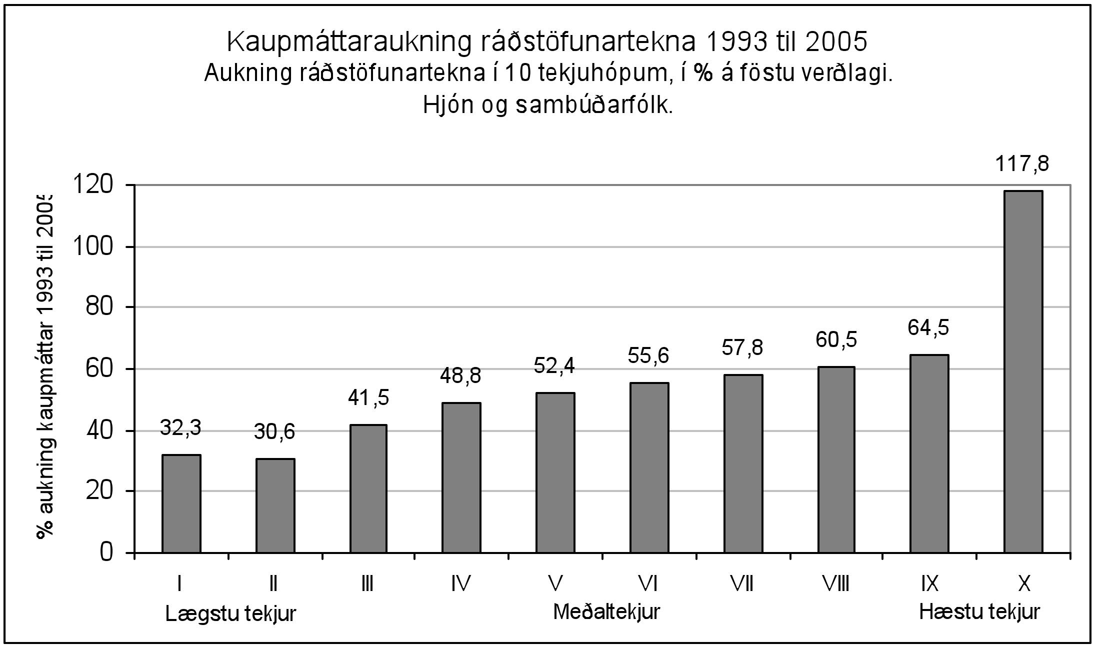

Fig. 5. Increase in real disposable income of cotaxed individuals in per cent 1993 – 2005.

Source: Stefán Ólafsson (2007): Ójöfn kaupmáttaraukning, *Morgunblaðið*, 26. feb.

Purchasing power of families in the two lowest groups (lowest 20% of families) increased by 31-32% during the period as a whole, or by 2,6% annually on the average. The purchasing power increased gradually the higher the families were in the income scale. Families with average income got an increase of 52-56% in their purchasing power, or about 4,6% per year. Finally the purchasing power of those in the highest decile increased considerably more, or by some 118% which means about 10% annually.

1990 – 2005: Credibility issues, globalization and the environment

Company taxation

The company tax reductions came later than thoseof personal income taxes. The company tax was successively reduced from 51% in 1986 to 30% in 1998 but the big step was taken in 2002 when it was lowered to 18%. In the 1980ies a special turnover tax had been abolished and in the nineties a special tax on offices and industrial buildings was dropped.

Between then and now – 1983 to 2008

In 1983 NSFR had a conference on “the conflict between the fiscal and non-fiscal objectives of taxation.” At the end of the general economic report it is written:

Allmänt sett synes skattesystemen i de nordiska länderna kunna uppfylla det fiskala målet om begränsning av den totala efterfrågan. De icke-fiskala målen avseende framför allt fördelningseffekter och begränsade störningar av resurallokeringen i ekonomin synes dock lägga starka restriktioner för vilka skattehöjningar som kan anses vara acceptabla. En fortsatt ökning av den skattefinansierade offentliga sektorns utgifter som andel av BNP kan därför försvåras och kanske till och med förhindras av de gränser för beskattningens fiskala funktion som uppkommer genom olika icke-fiskala mål.[5]

This seems to give a fairly optimistic view of using taxes as a stabilisation instrument. It also seems to convey the message that taxation may reach an upper limit rather than that taxes will decrease. The themes that are discussed to-day are rather *optimal taxation*, *credibility issues*, *tax competition* and *environmental taxes*, cf. , e.g. , green taxes and double dividends. I think it is fair to say that the believe in using taxes as a stabilisation instument is fairly impaired and that taxes have been reduced in many countries to enhance economic growth. That certainly applies to Iceland.

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