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Increasing Simplicity, Neutrality and Sustainability: A Basis for Tax Reform in Iceland

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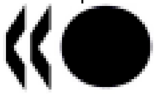

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INCREASING SIMPLICITY, NEUTRALITY AND SUSTAINABILITY: A BASIS FOR TAX REFORM IN ICELAND

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by
Richard Herd and ThorsteinnThorgeirsson

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ABSTRACT/RÉSUMÉ

This paper analyses the possibilities for reforming the Icelandic tax system. It puts the current tax structure in its historic context, showing that there has been a steady movement towards simplification. The personal income tax has a lower than average number of bands and, taxes capital income at an unusually low rate. Such a structure favours saving, especially since consumption taxes are particularly high. Nonetheless, there are a number of additional taxes on capital income that serve to raise the overall tax on assets, notably the tax on net wealth. The paper concludes that, if the current budget surplus persists over the medium-term, priority should be given to further reducing corporate taxes and the net wealth tax. At the same time, a number of discriminatory indirect taxes should be replaced by a uniform tax, and the diesel tax reformed. Consideration should also be given to the gradual introduction of a resource tax or to auctioning fishing quotas to help fund the other tax reductions.

JEL classification: H2
Keywords: Taxation, tax policy, Iceland

*   *   *

Le présent document analyse les possibilités de réformer le système fiscal islandais. Il replace l'actuelle structure fiscale dans son contexte historique et met en évidence l'existence d'une tendance permanente vers la simplification. Le nombre de tranches de l'impôt sur le revenu des personnes physiques y est inférieur à la moyenne et le taux d'imposition sur le revenu du capital est exceptionnellement faible. Une telle structure favorise l'épargne, d'autant plus que les impôts sur la consommation sont particulièrement élevés. Néanmoins, il existe un certain nombre d'impôts additionnels sur le revenu du capital qui contribuent à élever l'imposition globale sur les avoirs, notamment l'impôt sur l'actif net. Le document conclut que, si l'excédent fiscal devait se maintenir dans le moyen terme, de nouvelles réductions de l'impôt sur les entreprises et sur l'actif net devraient devenir prioritaires. Simultanément, plusieurs impôts indirects discriminatoires devraient être remplacés par un impôt uniforme et la taxe sur le diesel réformée. Il pourrait aussi être envisagé l'introduction progressive d'un impôt sur les ressources naturelles ou la mise aux enchères des quotas de pêche afin de financer les autres réductions d'impôts.

Classification JEL : H2
Mots clés : fiscalité, politique fiscale, Islande

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TABLE OF CONTENTS

Introduction 5
Towards a simple tax system 5
The current tax system in Iceland 7
  The tax mix compared to other OECD countries 7
  Individual income taxation 7
  Corporate taxation 16
  Social-security taxation 21
  Expenditure taxation 23
  Non-income taxes on capital 25
  Local government taxation 28
  Overall effective tax rates 28
Scope for action 29
  Conclusion 33

Bibliography 35

Annex

Main features of the tax system in 2001 36

Box

The tax administration in Iceland 11

Tables

1. Tax payments relative to GDP 8
2. Tax investigations: rulings and penalties imposed 11
3. Marginal effective tax wedges on physical investment, R&D and human capital 21
4. Summary of new recommendations for tax reform 34

Annexes

A1. Taxes levied on corporate income: standard regime 36
A2. Taxes levied on household and other income: national and municipal taxes on taxable income 37
A3. Social security contributions 39
A4. Taxes levied on consumption and investment 40
A5. Taxes levied on property 41

Figures

1. Tax-to-GDP ratios: Iceland, European Union and the rest of the OECD 9
2. The share of different taxes over time 9

3. The structure of taxation: an international comparison 10
4. The evolution of marginal tax rates on employment income over time 13
5. The evolution of the personal income tax exemption limit over time 13
6. Average and marginal effective tax rates for a married couple 16
7. The evolution of the average tax rate for two family types over time 17
8. The impact of income taxation on the income distribution 18
9. The progressivity of the income tax system 19
10. Combined corporate and personal income tax wedge on distributed profits 20
11. The tax wedge on labour income 23
12. Excise duties and specific taxes: an international comparison 24
13. Taxation of assets 26
14. The effective tax rate on consumption, labour and capital 29
15. Government spending by purpose: Iceland and other countries 31

INCREASING SIMPLICITY, NEUTRALITY AND SUSTAINABILITY: A BASIS FOR TAX REFORM IN ICELAND

Richard Herd and Thorsteinn Thorgeirsson[1]

Introduction

1. As the principal means by which governments fund their expenditures, taxes are at the foundation of public finances. A properly designed tax system implies readier taxpayer acceptance of that expenditure burden. It should promote the maintenance of a high and sustainable level of output by minimising both distortions to market-set prices and disincentives to work, saving and investment. But optimal tax policy goes beyond mere efficiency and funding considerations to encompass inevitable normative judgements about the amount of redistribution. The Icelandic system incorporates some implicit redistributive goals, but the main thrust of policy recently has been toward simplification. Nonetheless, anomalies remain both in the context of Iceland's integration into the world economy and in terms of the system's simplicity and neutrality.

2. This chapter reviews the current state of taxation in Iceland, how and why the present system has evolved over time and especially over the past 10 or 15 years and what remain its key distinguishing features in terms of mix, rates, bases and progressivity. It will proceed to examine the different categories of taxation, before assessing the scope for a welfare-enhancing, simplifying, affordable reform that could be enacted once the current overheating problem is overcome and the economy has returned to macroeconomic equilibrium.

Towards a simple tax system

3. The underlying thrust of tax policy in Iceland since the end of the 1980s has been to simplify and reduce the extent of discrimination between different economic activities and thereby minimise

1. Richard Herd is a Senior Economist at the OECD. Thorsteinn Thorgeirsson was an Economist at the OECD at the time that this paper was prepared and is now Chief Economist at the Federation of Icelandic Industries. This paper was originally produced for the *OECD Economic Survey of Iceland* released on 11 April 2001 under the authority of the Economic and Development Review Committee. The authors are indebted to Peter Jarrett, Michael Feiner, Jorgen Elmeskov, and Andrew Dean, as well as the Fiscal Affairs Directorate for comments and drafting suggestions, and to the Icelandic authorities for their assistance with obtaining the information and clarifications necessary to prepare the paper. Special thanks go to Françoise Correia for invaluable technical assistance with the graphs and to Mee-Lan Frank and Lillie Kee for expert word processing.

disincentives to work, saving and investment. The preparation for membership in the European Economic Area (EEA), which came in 1994, was also a major driving force for reducing border taxes and shifting to other more commonly used revenue sources. The major 1988 tax overhaul covered expenditure, personal income and corporate taxation, while tariffs eventually were reduced to zero on imports from the EEA.

4. For personal incomes, a large number of exemptions for different purposes were merged into one tax credit. Six income tax rates were merged into one and, given these simplifications, employers, pension funds and the social security system were charged with deducting the income tax at source for their employees or pensioners on a monthly basis, thereby ensuring a marked simplification for employees. Part of this simplification was reversed in 1993 when a surtax of 5 percentage points was introduced. Many anomalies remained, such as whether or not various forms of capital income were taxed. There was also an overhaul of taxes paid by corporations. The deductions for investment and general reserving were progressively reduced. This allowed a marked fall in statutory rates to 33 per cent in 1993, down from the 50 per cent rate that had prevailed in the 1980s. In 1994, the local authorities' corporate turnover tax — levied at each stage of production, irrespective of the profitability of the company — was also abolished. In exchange, they were allowed to increase local income taxes and, at the same time, they received the right to levy a tax on commercial property.

5. In 1990 a value-added tax was introduced. Initially, there was only one rate with the imposition on foodstuffs being compensated by direct payments at the producer level. A second rate was introduced in 1993 and finally in 1994 food was moved from the higher- to the lower-rate category, partly as a concession to the unions to achieve a low pay settlement and direct payments to producers were abolished.

6. The movement to reducing discrimination and enhancing efficiency was renewed in 1997. The payroll tax, which had varied across different forms of activity,[2] was merged with various other taxes into a uniform rate of 5¼ per cent in four annual steps ending in January 2000. The increase in the marginal income tax rate in the 1990s, partially unwinding the 1988 reform, was reversed between 1998 and 2000, thereby lowering the incentives to seek leisure over work. More importantly, the taxation of capital income, previously incomplete, was separated from that of employment income. Any individual can be subject to three statutory income tax rates: *i)* the standard rate on employment income, *ii)* the surtax on higher income, and *iii)* the much lower capital income tax. Finally, the corporate tax rate was lowered and the lower tax rate on profits distributed as dividends was abolished.

7. Another source of some long-standing concern for public policy has been the desire to raise domestic savings. The current account of the balance of payments has been in persistent deficit, averaging 3 per cent of GDP since 1971. Although this level of deficit has not been perceived as a threat to macroeconomic stability as it has not resulted in any significant build-up of interest payments relative to GDP, it has been seen as a symptom of inadequate national savings, especially when cyclical pressures pushed deficits above the long-term average. Private pension funds were established in the late 1960s and have been able to accumulate income without paying taxation. However, until 1994, employees paid contributions out of taxed income but were then taxed on their entire pension income and capital gains. This represented a double taxation in that both the capital and the interest were being taxed, though individuals gained from the exemption from taxation during the build-up period. Starting in 1995, the deduction of pension contributions from income was phased in and was completed in 1997. Subsequently, contributions to supplementary defined-contribution saving schemes for retirement have been allowed with the same tax benefits.

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2. The rate prior to the changes (that is, in 1996) was 6.93 per cent except for agriculture, manufacturing, hotels, restaurants, car rentals, film production and computer software services (where it was 3.63 per cent) and fisheries (4.28 per cent). The average rate was estimated at 5.5 per cent.

8. The simplification of the tax system has been accompanied by a marked increase in the tax burden. By 1999, the overall tax ratio had risen to 36.3 per cent of GDP from 28.9 per cent in 1980 but was still below the OECD average, ranking Iceland sixteenth out of the 28 OECD countries for which disaggregated tax data are available (Table 1). However, the extent to which Iceland is below the average country has fallen from 4 percentage points in 1980 to 1 percentage point in 1999, both years of high cyclical demand in Iceland. The tax ratio remains far lower than in the Nordic members of the EU. The movement towards higher taxation has not been smooth (Figure 1): indeed a large share has occurred since 1997 as the economy moved out of a recession and for reasons that are explored below.

9. The net result of these simplifications has been a substantial change in the mix and a rise in the overall level of taxation. Tariffs have fallen to insignificance as a source of government revenue, but taxes on income have grown markedly: the personal income tax share has risen by nearly 12 percentage points since 1980 (Figure 2). On the other hand, expenditure taxes have remained a relatively stable share, after some decrease following the reform of the sales tax in 1988. Social security and payroll taxes have been used only to a limited extent throughout the post-independence period.

The current tax system in Iceland

The tax mix compared to other OECD countries

10. While the tax system has evolved considerably over the past 20 years, in 1999 it still had a markedly different structure to those seen in the rest of the OECD area (Figure 3). Only for income tax is the share in line with those found in other countries. Corporate taxation accounts for a much lower share of taxation than elsewhere, though in no country is this form of tax a large contributor to overall tax revenues. Social-security taxation is usually a large element of government income, whereas it is almost absent in Iceland. Broadly defined property taxes are somewhat below those found in the United Sates and Japan but above those in the European Union. The lack of corporate and social-security-tax revenues is compensated by a high share of expenditure taxation, especially when compared to the United States and Japan. The rest of section looks in more detail at the features of the system that generate such results and at the consequences for the effective burdens on labour and capital (full details are given in the Annex).

Individual income taxation

11. The income tax system for Iceland's 210 000 taxpayers is extremely simple. Income is divided into two categories: income from capital and income from employment, pensions and transfers. For the former, there has been just one marginal tax rate of only 10 per cent since 1997. For the latter, an individual is faced with only two statutory tax rates compared to the average of 4.8 in OECD countries. Moreover, the highest statutory rate is 3 percentage points below the OECD average. In addition, there are few deductions from taxable income that depend on the individual circumstances of a taxpayer. The tax system is, thus, relatively transparent and equitable between different taxpayers with similar incomes from employment. However, the existence of two means-tested benefits, which are paid through the income tax system, does go against the simplicity of the basic framework (see below). Even so, the administration of the tax system (see Box) is not onerous with the tax authorities staff amounting to one per cent of total government employment.

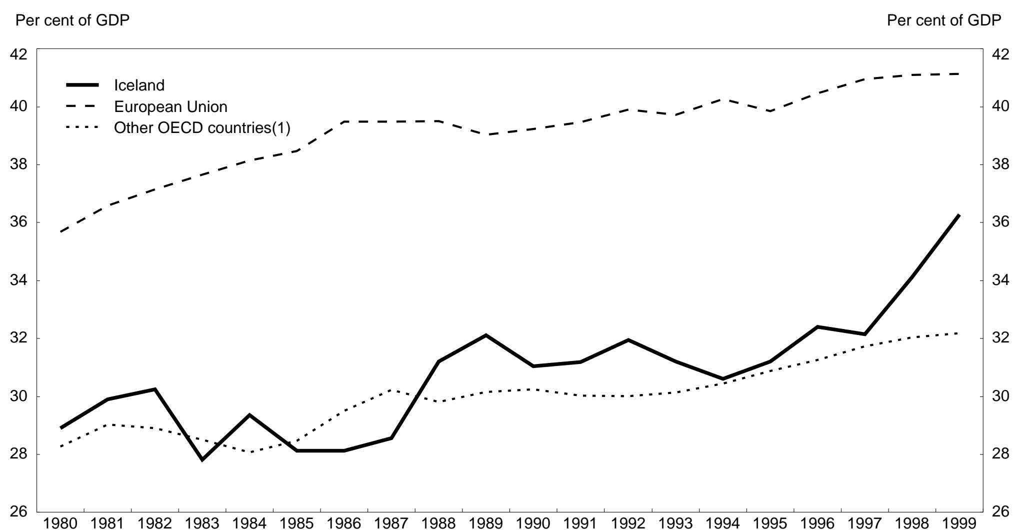
Table 1. **Tax payments relative to GDP**
1999[1], Per cent of GDP

	Corporate Income Taxes	Individual income tax	Social security and payroll taxes	Consumption taxes[1]	Other taxes, including property taxes	Total tax rate
Korea	2.1	3.7	2.5	9.5	4.2	22.0
Japan	3.2	4.7	10.6	5.3	3.0	26.7
United States	2.5	11.4	6.7	4.6	3.0	28.2
Australia	4.7	13.3	0.0	7.8	4.9	30.7
Ireland	3.9	9.7	4.2	11.8	2.1	31.7
Turkey	2.4	7.4	5.4	11.6	5.0	31.8
Greece	2.1	4.4	10.5	13.7	2.6	33.4
Portugal	4.0	5.8	8.8	14.2	1.5	34.3
Spain	2.8	6.9	12.2	10.4	2.6	34.9
Switzerland	2.5	10.3	12.5	6.8	3.0	35.1
New Zealand	4.1	15.0	0.0	12.9	3.8	35.8
Iceland	**1.3**	**12.8**	**2.9**	**16.7**	**2.6**	**36.3**
United Kingdom	3.7	10.5	6.3	11.7	4.3	36.5
Poland	2.8	8.3	12.1	12.9	1.5	37.6
Canada	3.8	14.2	5.2	9.3	5.2	37.7
Germany	1.8	9.4	14.8	10.6	1.1	37.7
Hungary	2.6	6.4	12.9	15.4	1.1	38.4
Netherlands	4.1	5.8	15.8	11.3	2.7	39.8
Czech Republic	3.8	5.2	17.6	13.1	0.6	40.3
Norway	3.2	11.8	10.2	15.6	1.0	41.8
Luxembourg	7.3	7.8	10.9	11.6	4.5	42.1
Italy	3.0	10.7	12.7	10.5	6.1	43.0
Austria	1.8	10.2	15.1	12.6	4.6	44.2
Belgium	3.9	14.1	14.5	11.4	2.0	45.9
France	2.7	8.3	16.6	12.2	6.2	46.0
Finland	4.2	14.7	11.7	14.3	1.3	46.2
Denmark	3.0	25.4	2.1	16.2	3.4	50.0
Sweden	3.0	18.1	13.2	11.2	5.9	51.5
Average OECD[3]	3.2	10.2	9.6	11.6	3.2	37.8
Average EU (15)[3]	3.4	10.8	11.3	12.2	3.4	41.2

1. Provisional data for 1999; 1998 for United States, Canada, Australia, New Zealand, Poland, 1997 for Greece.
2. Unweighted.

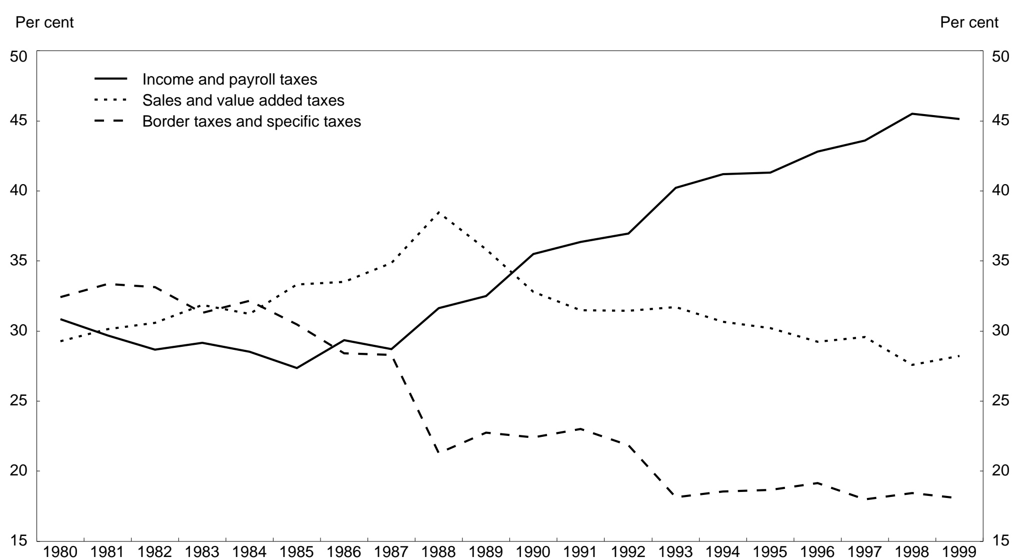
Source: OECD (2000), Revenue Statistics.

Figure 1. Tax-to-GDP ratios: Iceland, European Union and the rest of the OECD
Per cent of GDP



1. Australia, Canada, Japan, Korea, New Zealand, Norway, Switzerland, Turkey, United States.
Source : OECD, Revenue Statistics.

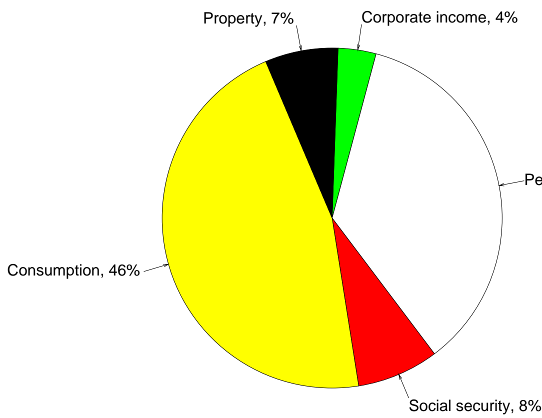
Figure 2. The share of different taxes over time
Per cent of total taxes



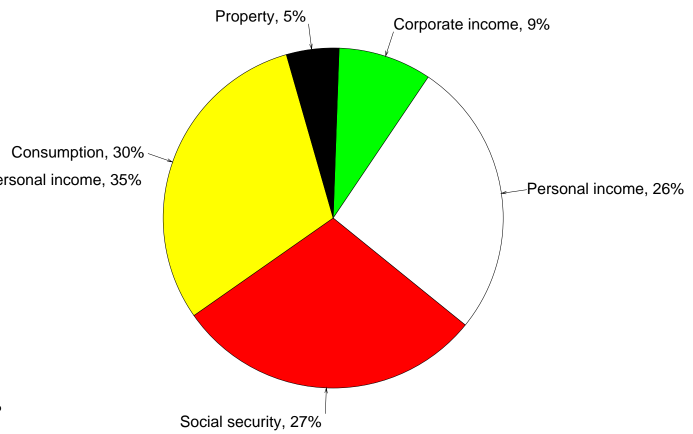
Source: OECD, Revenue Statistics and OECD.

Figure 3. The structure of taxation : an international comparison
Per cent of total, 1999(1)

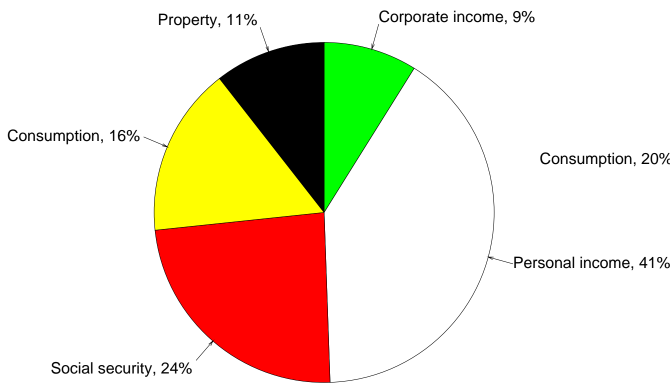
A. Iceland



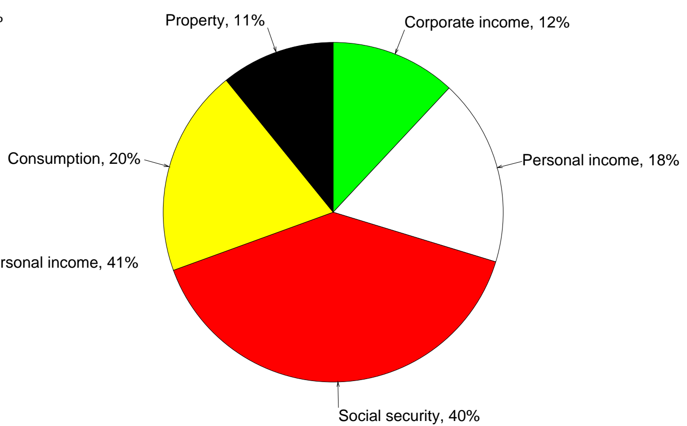
B. European Union (2)



C. United States (1998)



D. Japan



1. Figures for 1999 are provisional.
2. Unweighted average.
Source: OECD, Revenue Statistics.

Box. **The tax administration in Iceland**

Tax enforcement in Iceland is organised in two tiers: a state-wide Internal Revenue Directorate (IRD) and 9 regional tax offices. The first of these units is responsible for the administration of taxes on individuals and corporations, VAT, excise duties, taxes on cars and fuel and all other kind of taxes except customs and other import duties. It also interprets the tax law, directs and co-ordinates the tax enforcement of the 9 regional tax offices and advises the Ministry of Finance regarding the changes and interpretation of tax law and changes made to tax law. The IRD has about 90 employees. The regional tax offices are responsible for the assessment of taxes in the region as well as the collection of VAT and the withholding tax on salaries and other earned income and pensions. The regional tax offices range in size from 4 to around 80 employees, with a total staff of around 196.

Two independent bodies are also part of the tax administration. The State Tax Board hears appeals against the tax decisions of the regional tax offices or the IRD. It consists of 6 members and has a total staff of 16. The second independent body, the State Tax Investigation Department, deals with the investigation of tax fraud and alleged violations of the laws on bookkeeping and accounting. This unit has 23 employees.

Each year the DTI investigates about 100 cases of suspected tax fraud, thought to be most serious in the areas of deductible corporate expenses and unpaid VAT in the construction and restaurant sectors. There has been a noticeable increase in the number of cases going to court from about one or two per year to 20 or more in recent years (Table 2). Likewise the average size of penalties has risen steeply, reaching nearly ISK 2 million ($24 000) in the two most recent years for those imposed by the tax authorities and ISK 4.6 million ($58 000) when brought before the courts. The conviction rate is high.

Table 2. **Tax investigations: rulings and penalties imposed**
ISK millions

	1993	1994	1995	1996	1997	1998	1999	2000	Total
Number of cases where a penalty was imposed by the tax authorities	0	8	10	6	17	23	29	24	117
Size of penalties	0	0.83	2.41	1.34	11.44	6.77	59.59	42.11	124.49
Number of rulings by district court	2	2	5	20	11	23	26	20	109
Size of penalties	1.20	2	25.80	38.75	59.50	42.40	134.65	75.25	379.55
Number of rulings by supreme court	0	1	1	2	2	3	9	5	23
Size of penalties	0	3	20	11	54	2.20	43.53	22.45	156.18

Source: Ministry of Finance.

12. A less onerous treatment of capital income than employment income is a feature of the tax code in almost half of all OECD countries. In those countries with such a schedular system, the average highest rate of tax on interest income is 25 per cent against 29 per cent on dividends. Indeed, only half of the countries that discriminate between capital and employment income have no further discrimination between different types of capital income. For these countries, the highest tax rate on capital income averaged 22 per cent in 1999. In Iceland, not only is there no discrimination between different types of capital income but the tax rate is only 10 per cent. The schedular tax system implies that capital income is not aggregated with other forms of income, though aggregate capital income for a couple is

taxed in the hands of the spouse with the highest employment income rather than being split equally.[3] Realised capital gains are taxed as capital income, except for profits on the sale of owner-occupied houses, which are exempt.

13. Income from sources other than capital is divided into another two categories: *i)* income from employment (including pensions and income from other sources), and *ii)* income from self-employment and own-account business activities. In the latter category, in order to guard against the transfer of personal expenses (cars, telephones, rent, lunches, etc.) into deductible expenses from self-employment income, an income is imputed to each self-employed person that is a fraction of the average earnings of all those in the same occupation in the rest of the economy. This imputed income is taxed as employment income, while any profit remaining after the deduction of normal business expenditures is aggregated with employment income rather than capital income. However, losses on the own-business account cannot be set off against other forms of income. The share of total income tax payments made by the self-employed is low. Moreover, for a country with one of the highest levels of income per capita in the OECD area, the share of self-employment in total employment is particularly high: more than twice that found in other Nordic countries for example and amounts to 20 per cent of the labour force.

14. Any individual only faces two statutory tax rates on employment income, including, since 1993, a "temporary surtax". Local authorities have the right to levy an income tax (see below) within certain limits determined by central government; consequently the two statutory income tax rate vary in different localities. In 2000, on average, the lower statutory rate of taxation on employment income was 38.4 per cent, comprising a central government rate of 26.4 per cent and an average local rate of 12.0 per cent. Despite falls in the former, the overall standard marginal tax rate was quite stable at around this level during the past decade (Figure 4). The surtax on "higher" incomes was raised from 5 to 7 per cent in 1997 though the threshold at which it is paid was raised 14 per cent at the same time, and currently it applies to incomes above about 3.4 million krónur ($40 000) per year for individuals (double that for married couples). Whereas at its inception, the tax applied only to incomes 17 per cent above average compensation, it now applies to incomes only 4 per cent above average compensation. It generated 1.5 billion krónur in 2000 (0.2 per cent of GDP).

15. The principal deduction that is granted to all taxpayers is given in the form of a tax credit. When the taxpayers are married, one credit is given to each spouse, and, if one credit is not used, it can be transferred to the other spouse within certain limits. From the introduction of the PAYE system in 1988, the transferability limit for the allowance was set at 80 per cent. In 2000, 85 per cent of the unused credit could be transferred, but this is being increased in three equal stages so that by 2003 all of it will be transferable. If the credit exceeds the taxes on employment income, it can be set against wealth tax payments and then capital income tax payments, but only 10/38 of the allowance can be set against this form of income tax. However, unused credits are not paid to individuals as cash. The effect of the tax credit is to ensure that, in 2000, no income tax was paid below a threshold equivalent of almost ISK 800 000 per year. This threshold has fallen almost 30 per cent relative to wages since 1988 and somewhat less relative to prices (Figure 5).

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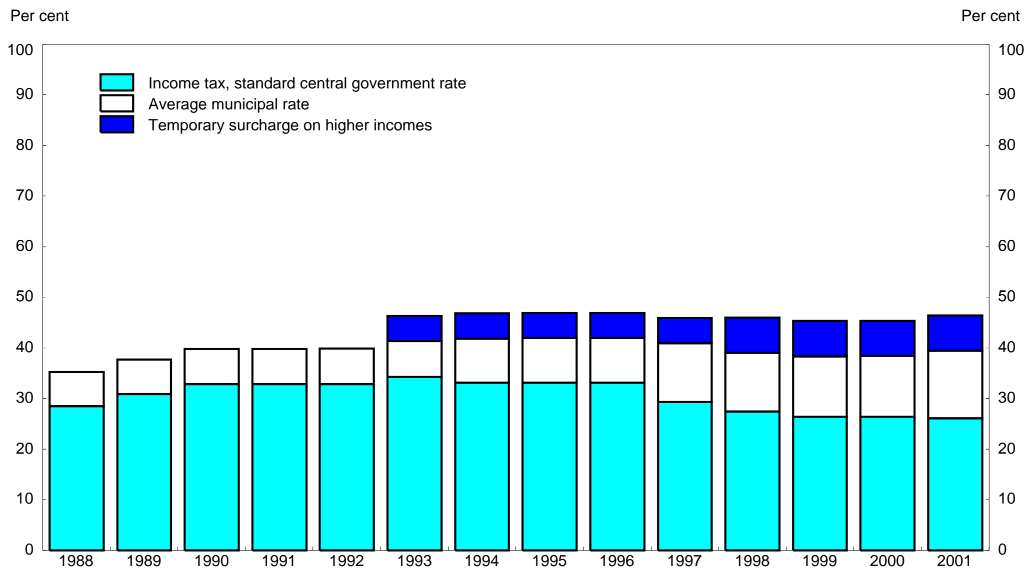
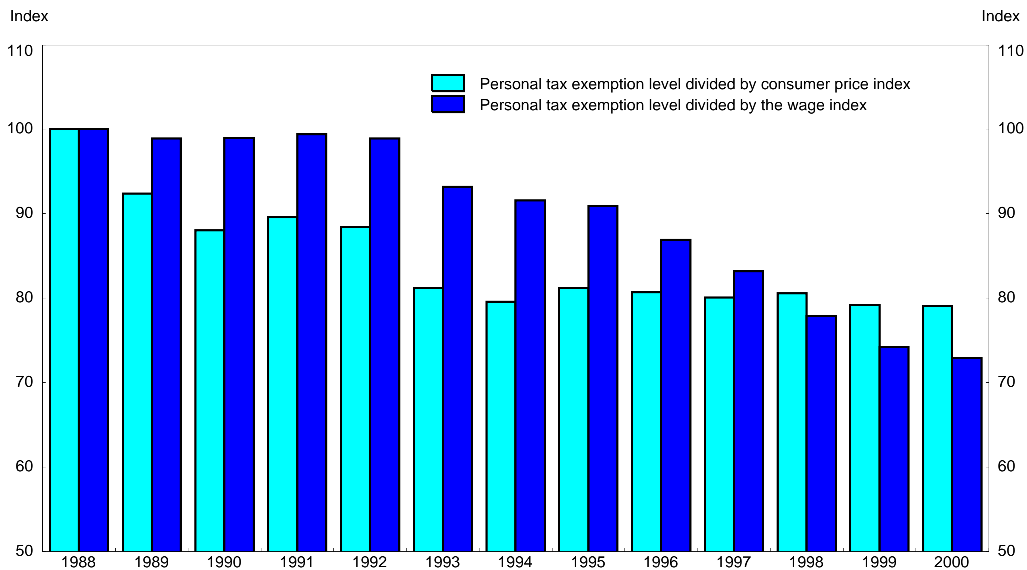
3. This ensures that unused tax credits of one spouse cannot be used to reduce capital income tax payments of the other spouse.

Figure 4. The evolution of marginal tax rates on employment income over time



Source: National Economic Institute.

Figure 5. The evolution of the personal income tax exemption limit over time
Index, 1988 = 100



Source : Ministry of Finance.

16. The other major deduction is for pension contributions, though such an offset represents only a deferral of tax payment. All employees must join a pension scheme, and nearly all private-sector plans are completely funded. For the employer, contributions amount to 6 per cent of the employees' income and are a normal business expense. For the employee, the contribution rate is set at 4 per cent, and this contribution has been fully deductible from gross income since 1997. The investment income of the pension fund is tax-free. The resulting pension is taxed in its entirety as employment income. Thus, from the point of view of the government, the initial revenue loss is largely recuperated in present-value terms when the pension is paid relative to the situation in which the individuals immediately consume what would otherwise be their pension-fund contributions — provided that the return paid by the fund to the pensioner is equivalent to the government's own borrowing rate.[4] From the point of view of the employee who chooses to save, the opportunity to invest in a fund whose income is not taxed represents a gain and a loss for the government. However, the extent of the gain is limited, as the so-called "double taxation of saving" is reduced in Iceland by the very low rate of tax on capital income (10 per cent). Employees can also invest up to a limit of 4 per cent of income in a supplementary defined-contribution pension scheme that is subject to the same tax treatment as ordinary defined-benefit pensions. These have had rather modest take-up rates of 20 or 25 per cent due to low employer-matching provisions, but with improved matching as from 2000 (see Chapter IV of OECD 2001, *Economic Survey of Iceland*), that share is expected to rise.

17. There is only one other deduction allowable against employment and capital income. Purchases of equities of companies registered in the European Economic Area are deductible from income up to an amount of 133 333 krónur ($1 590) per year representing a significant, if small, subsidy to the purchase of shares.[5] This amount is clawed back if the shares are sold within five years. Any gain is taxed as capital income (at 10 per cent). The tax can be deferred if new qualifying shares are purchased within 30 days of a sale. Certain other assets also have the right to this deduction, such as savings accounts that are blocked for five years and which are invested in the creation of a small business when the account is closed. In addition, the annual ceiling for the grant of stock options is 600 000 krónur (about $7 000).[6] Beyond this limit, gains in employee options are taxed as employment income.[7] When this allowance was first introduced, its objective was to help establish a culture of share-ownership. The stock market still had only a small capitalisation a decade ago, a situation that has changed markedly.

18. One category of workers, seamen, has a higher rate of tax exemption. Their additional tax credit is set at ISK 671 per day spent at sea, thereby adding about 50 per cent to the standard credit. This higher allowance was originally introduce to help attract people to work in fisheries in the 1960s. Labour needs of

4. A tax loss could occur in the following cases. The pensioner has no other income on retirement in which case part of the pension would be set against the tax credit. However, all Icelanders receive a basic state pension on retirement, the tax on which exceeds the tax credit. A further possible loss could occur through pension contributions being offset against the higher marginal tax rate than the rate at which pensions are taxed. This loss will be limited in Iceland since the difference between the higher and lower tax rate is only 7 percentage points. Against these losses, if the return on pension-fund assets exceeds the government borrowing rate, the government gains tax revenue. This has generally been the case in the past.

5. In effect, people who invest in shares have an overall tax credit that is about 17 per cent higher than those who do not invest in equities, for those who pay the standard rate. The gain amounts to $610 per year.

6. The 600 000 krónur limit is set with respect to the exercise price, even if the market price and exercise price are the same when the option is issued. Profits from the exercise of such options are treated as capital income provided that the options are available to all employees, that there is at least a 12-month gap between the grant and the exercise of the option and that the shares are held for two years after the exercise date. Prior to the 2000 budget, gains from the exercise of options were treated as employment income.

7. A more logical method would be to price the option when granted using a standard options-pricing model and to tax this value as employment income at that point in time. Any gain would then be taxed as capital income when it was realised.

the industry have subsequently fallen. Currently the allowance costs ISK 1.5 billion per year (0.2 per cent of GDP).

19. The simplicity of this system is slightly offset by the existence of two benefits (one depends on the number of children under 15 and the marital status of the mother,[8] the other on the amount of interest paid on housing loans) that are paid through the income tax system. These benefits are paid in full to those with no other income, but the amount of the allowances is reduced by 4.5 (if there are two children[9]) and 6 per cent of gross income, respectively, until their value is eliminated, thereby adding to the effective marginal tax rate of the individual. Thereafter, the effective marginal tax rate reverts to the standard tax rate.

20. For mortgages, the government pays all of the interest on a housing loan up to a maximum interest payment of 244 822 krónur (just below $3 000) per year for a married couple where the borrower has no other income. As well as there being a ceiling on the interest payments, there is also an upper limit on the interest rate that can be paid on the loan (7 per cent). The effect of these ceilings is that, at current interest rates, the government pays all interest on a mortgage equivalent to almost 1.2 times annual average earnings when the borrower has no income or wealth. The amount of the benefit is reduced both as income increases and as net worth increases. For a couple with zero net worth, the government ceases to subsidise mortgage interest when total household income is 25 per cent higher than average compensation per employee (*i.e.* at about $4 000 per month). This benefit is paid through an adjustment of income tax payments. If the allowance exceeds tax payments, the balance is refunded directly. The allowance is counted as government expenditure.

21. The impact of the phasing-out of these two benefits paid through the tax system is to create a hump-shaped schedule for marginal tax rates (Figure 6). In the 2001 budget, the shape of the curve was changed somewhat, as the phase-out rate for the child benefit was lowered.[10] This increased the number of households who receive at least part of the benefit. The linkage to net wealth was dropped and the dependence of part of the child allowance on income was removed (Chapter II of OECD, 2001). Moreover, for children under 7, all means-testing was withdrawn. The combination of these cash allowances and the tax credit means that, for a couple, average tax rates reach 30 per cent quite quickly (when total household earnings are at 110 per cent of average compensation).[11] Thereafter rates increase quite slowly towards the average standard marginal rate of 38.4 per cent.

22. The combination of a uniform annual basic tax credit (of around ISK 290 000 or $3 480 for single taxpayers), which has fallen in real value over time, and a high standard income tax rate has been to raise average tax rates for employment income over the past decade (Figure 7). This increase has been most marked for lower-income families that have been gradually brought into the tax net. Indeed, between 1996 and 1999, the income tax yield rose from 10.2 to 12.8 per cent of GDP, pushing Iceland's take 2.6 percentage points above the OECD average (Table 1). Furthermore, according to the latest estimates, the share jumped another percentage point in 2000.

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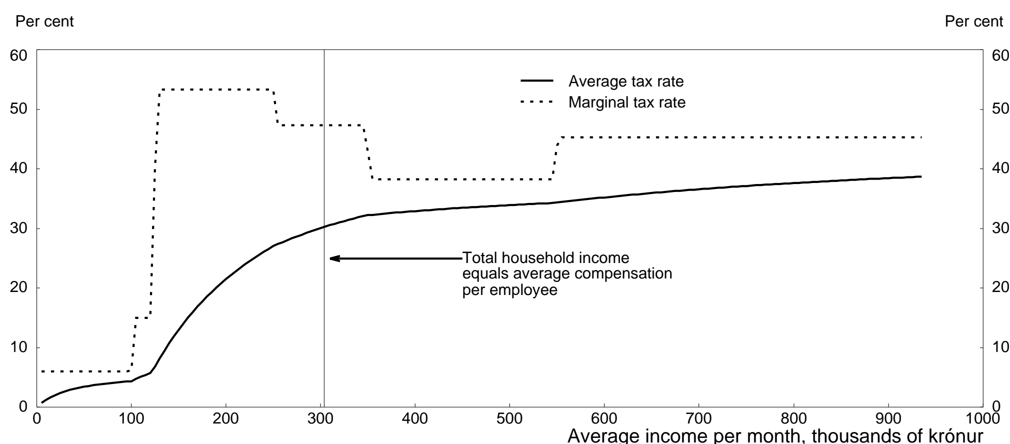
8. A cohabiting couple would receive the same allowance as a married couple. A woman who is neither cohabiting or married receives the higher allowance.

9. The phase-out rate for a child allowance was 5 per cent when there is one child in the family, 4.5 per cent with two children and 3.67 per cent for three children.

10. In 2000, the allowance for a family with two children was eliminated at a similar household income level.

11. The average tax rate is defined as the complement of the ratio of actual allowances plus post-tax income to the maximum allowances plus pre-tax income. All income is assumed to come from employment. The calculation is based on a couple with two children and an interest allowance, before means testing, of 180 000 krónur.

Figure 6. Average and marginal effective tax rates for a married couple (1)
with two children and a mortgage, 2000



1. The average tax rate is calculated as the sum of income tax payments and means-tested reductions in the child and interest-rate allowances to the sum of pre-tax income and the value of the child and interest-rate allowances before means-testing. The calculations assume that income is equally split between the spouses and that the interest-rate rebate amounted to 15000 krónur per month. It is assumed that the household has no capital income and zero net wealth.
Source : National Economic Institute and OECD.

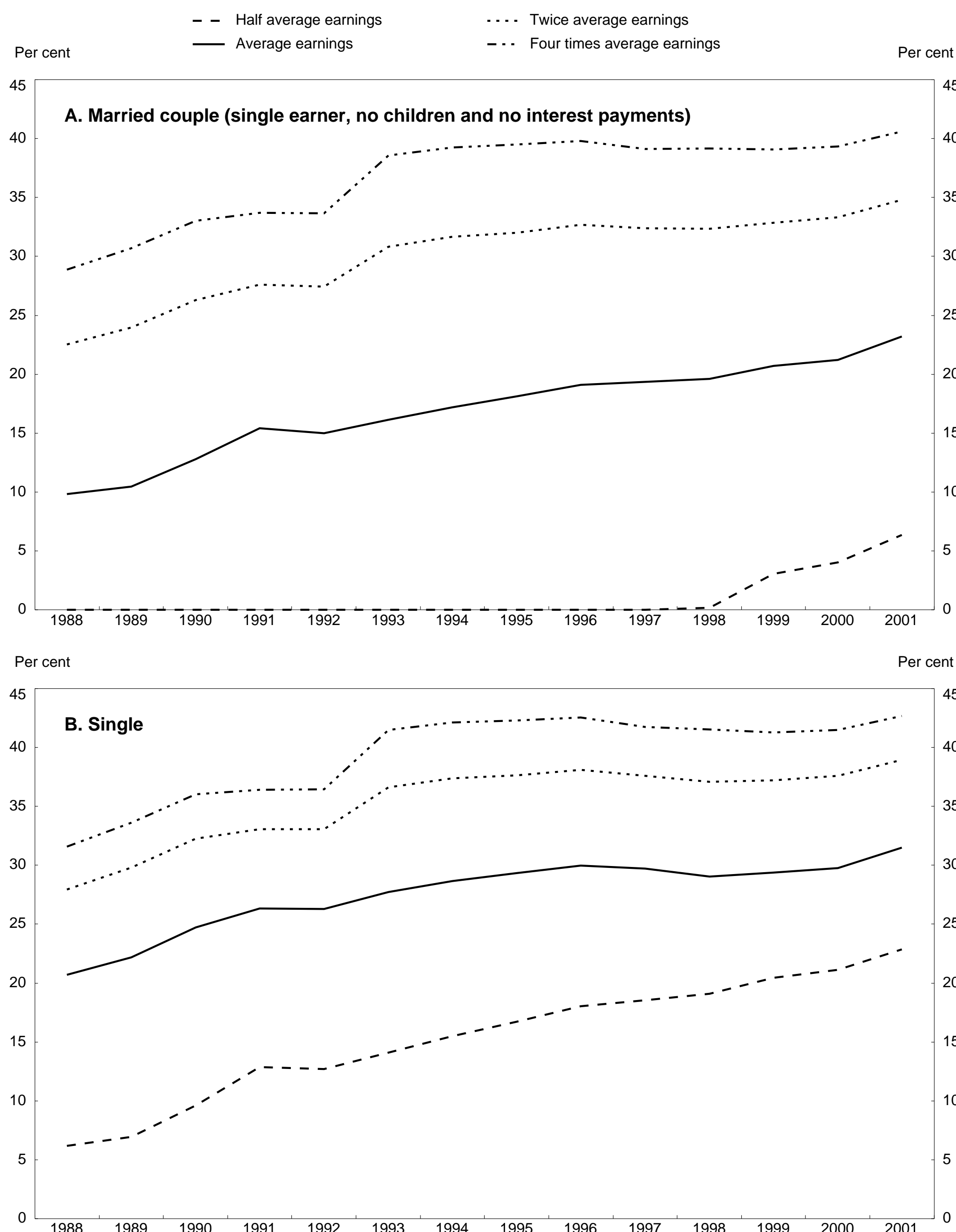
23. The consequence of the fall in the value of tax-free income, the means-tested allowance and the relatively high level of the initial marginal rate is that the system has become steadily less redistributive: the pre- and post-tax distributions of income are very similar (Figure 8, Panel A). In 1999, the average tax rate of half of all married couples (those in the fifth to ninth pre-tax income deciles) was within ±5 percentage points of the average tax rate for all couples (Figure 8, Panel B), based on an NEI survey of income and tax payments. The impact of the redistribution of the tax burden is felt to a major extent only in the lowest two income deciles and among single parents. At the other end of the income scale, the excess tax rate for the average couple in the highest income decile was limited to 9.3 percentage points. The concentration of redistribution at the lower end of the income scale appears to be greater than in many other countries, where the rise of the average tax rate at low income levels is less marked than in Iceland (Figure 9).

Corporate taxation

24. The method of determining profits in Iceland is markedly different from that used in most countries. As a result of the tradition of high inflation, profits are determined after a series of adjustments for movements in the general price level. Assets are revalued by an overall price index, thereby boosting depreciation charges relative to a system of historic-cost accounting. The depreciation rates themselves are similar to those in other countries and are uniform over the life of the asset, which is assumed to be between 5 and 10 years for most machinery and longer for structures. Once the depreciated value of an asset has fallen to 10 per cent of its book value, no further depreciation can be charged until the asset is scrapped. At the same time, to the extent that debts are not indexed, interest payments are reduced by the erosion in value of debt caused by inflation. Capital gains (after revaluation by the change in the general price level) made by a company are taxed as ordinary corporate profit. However, if the company holds physical assets, the depreciation on these can be accelerated to offset the capital gains. In the event that the company does not have such assets available, taxation on capital gains can be deferred for two years. In

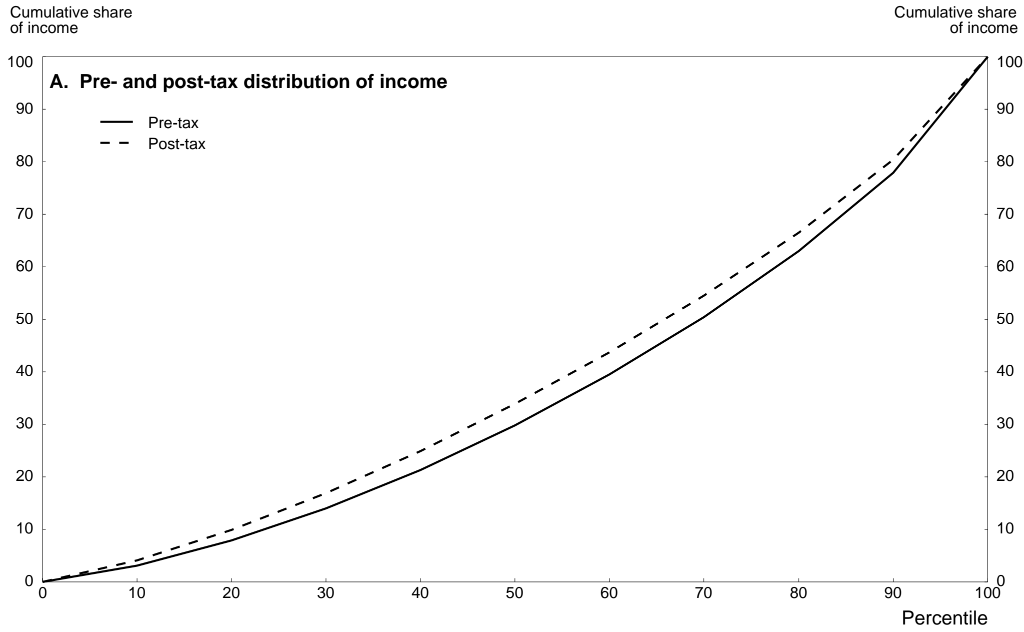
any case, whatever the capital gain, it is never considered to exceed 50 per cent of the sale price. Losses can be carried forward for eight years and are indexed over the carry-forward period.

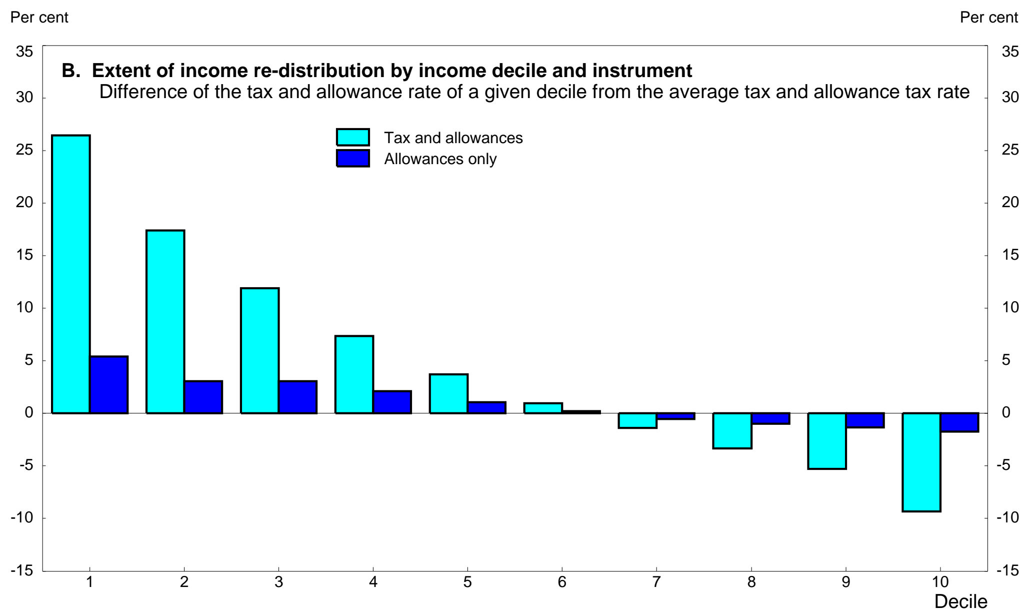
Figure 7. The evolution of the average tax rate for two family types over time



Source : National Economic Institute and OECD.

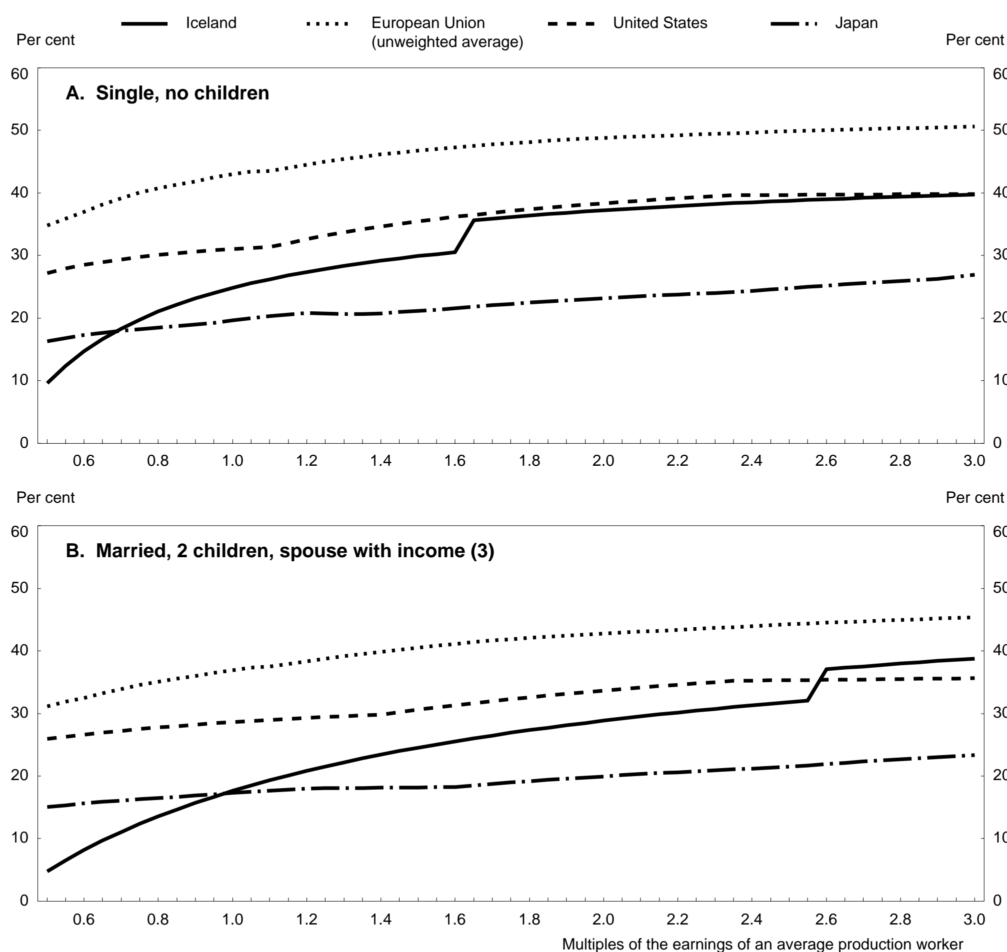
Figure 8. The impact of income taxation on the income distribution





Source: National Economic Institute.

Figure 9. The progressivity of the income tax system (1)
Net average tax wedges by multiples of average income(2)
1998



1. The statutory progressivity presented here is based on OECD's tax equations. These equations do not include specific tax allowances and credits such as those related to housing investment or child care expenses.
2. Income tax plus employers' and employees' social security contributions, less cash benefits.
3. Assumes that one spouse earns 67 per cent of the income of the average production worker, while the pay of the other spouse is varied.

Source: OECD, Taxing wages.

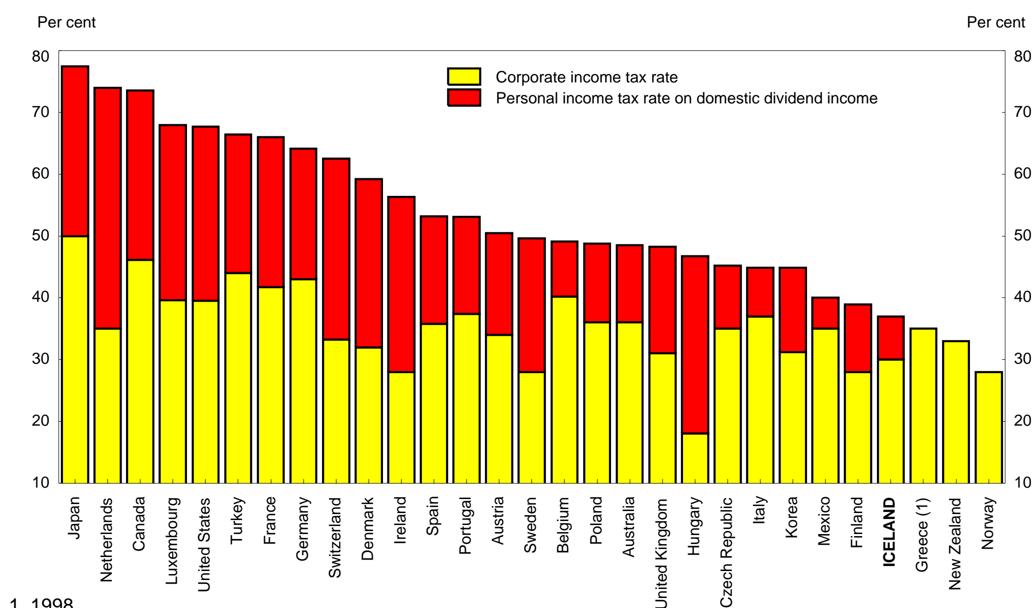
25. Corporate taxation is one of the two areas where the tax yields are low relative to the OECD area. The statutory corporate income tax rate, at 30 per cent, is slightly lower than the average rate in the rest of the OECD area. In 1999, the yield of this tax was only 3.7 per cent of total taxes, against an average of 8.8 per cent in the rest of the OECD area. Relative to GDP, the difference was even slightly greater at 1.3 per cent and 3.2 per cent. There are a number of possible explanations for the paucity of corporate tax revenues, relative to GDP. *First*, profits may be a small share of national income, as self-employment is relatively high in Iceland. Moreover, real interest rates have been higher in Iceland than elsewhere. *Second*, until recently, a significant part of the economy was controlled by state-owned enterprises that were not incorporated and so were not subject to taxation. Rather, they remitted part of their profits directly to the government. This position is now changing, and, in the past two years, corporate taxes have been rising rapidly, also helped by the gradual exhaustion of the carry-forward from cumulated losses from the early

1990s stagnation in the private sector. *Finally*, fishing companies were until this budget able to depreciate the cost of quota rights that they purchased from other fishing enterprises.[12]

26. In an attempt to increase the extent to which Iceland could act as a base for offshore activities, a new class of enterprises called "international trading companies" was allowed as from June 2000. Such firms can either be holding companies for financial, physical and intangible assets located outside Iceland, or can be engaged in international trading activities in the area of marine or agricultural products. They are also allowed to act as intermediaries in trade in services between companies located outside Iceland, to own aircraft and vessels and tranship goods in Iceland. They are not allowed to engage in business within Iceland. They are subject to a profits tax of 5 per cent and are exempt from the wealth tax and stamp duties. As yet, there have been only two such companies established. Moreover, the regime is inscribed in the OECD list of potentially harmful tax practices.

27. The corporate tax regime is not integrated with the personal tax regime, so that shareholders do not receive any credit for tax paid by the corporation, in contrast to two-thirds of OECD countries whose systems are integrated to a varying extent. Nonetheless, with the tax rate on capital income being the lowest in the OECD area, the overall rate of taxation on distributed profits — at 37 per cent — was still the fourth lowest in the OECD area in 1999 (Figure 10) and was indeed slightly less than the lowest marginal tax on employment income in Iceland.

Figure 10. Combined corporate and personal income tax wedge on distributed profits
1999, for a resident paying the highest marginal tax rate



1. 1998.
Source: OECD, Revenue Statistics.

28. With modest taxation of capital income, there is an incentive for companies to pay high dividends and finance their growth externally. According to OECD estimates, the tax wedge on financing by either

12. Depreciation is generally only allowed against a wasting asset. Provided that the government continues to restricted fishing to sustainable levels, the quotas should not fall in value over time. Thus, a fishing quota is more akin to a non-depreciable bond than to an investment good. The purchase price of quotas cannot be set against tax, though rental costs can.

new issues of equity or debt is markedly lower than in the rest of the OECD area (Table 3). However, the extent of divergence between the different types of financing is not appreciably different from that seen in other OECD countries due to the non-integration of corporate taxation that pushes up the tax wedge on financing from retained earnings. As to the difference between the tax wedges on machinery and structures, this is almost equal to that found elsewhere. These figures do not, though, incorporate the payments of the wealth tax by the corporate sector, payments of property tax or the impact of inheritance taxes on the cost of capital. These aspects of the tax burden will be dealt with below.

Table 3. **Marginal effective tax wedges on physical investment, R&D and human capital**[1]

		Manufacturing, 1999						1996			
		Sources of financing[2]			Physical assets[3]			R&D[4]		Human capital	
	Standard deviation[5]	Retained Earnings	New equity	Debt	Machinery	Building	Inventories	Short lived	Long lived	Training	Tertiary Studies
Mexico	0.3	0.8	1.0	1.0	0.7	0.7	1.4	-0.3	-0.3	..	..
New Zealand	0.3	1.5	1.5	1.5	1.5	1.1	2.0	0.7	0.3	0.0	..
Norway	**0.3**	1.1	1.1	1.1	0.8	1.0	1.7	0.1	0.1	0.0	..
Italy	0.4	1.3	1.3	0.4	0.7	1.2	1.2	0.3	0.3	0.0	-0.1
Australia	0.4	2.0	2.1	2.1	1.7	2.2	2.8	-6.0	-0.9	0.9	-0.6
Korea	0.4	0.6	1.6	1.6	0.8	1.5	1.1				
Denmark	0.5	1.9	2.4	2.5	1.9	1.8	3.2	-1.7	0.6	1.6	..
Spain	0.5	3.2	2.2	1.6	2.4	2.7	2.8	-7.1	-0.8	2.0	-0.1
Germany	0.6	0.9	2.5	1.3	1.1	1.5	1.1	0.0	0.0	-0.2	-0.4
United Kingdom	0.6	2.9	2.4	1.6	2.0	2.3	3.3	0.8	0.8	0.8	..
Greece	0.6	0.9	0.9	-0.6	0.1	0.3	1.0	-0.6	-0.6	-0.6	..
Sweden	0.7	2.1	2.8	0.8	1.5	1.8	2.1	1.1	1.1	1.0	-1.8
Finland	0.7	2.2	0.9	0.9	1.2	1.6	2.5	0.7	0.7	0.7	-0.7
Iceland	**0.9**	**1.8**	**2.3**	**-0.1**	**0.8**	**1.3**	**2.0**	**1.3**	**1.3**	**1.0**	**..**
Luxembourg	0.9	3.6	2.4	1.6	2.2	2.7	4.1	1.7	1.7	1.6	..
Portugal	0.9	1.4	2.8	-0.1	1.0	0.9	1.3	-0.2	-0.2	-0.3	-0.7
Switzerland	1.1	0.4	3.5	1.8	1.1	1.3	1.3	0.5	0.5	0.4	-0.3
Austria	1.1	0.7	2.7	0.1	-0.1	0.9	2.2	-2.4	-0.8	-0.1	-0.8
United States	1.3	1.7	4.8	1.4	1.5	2.5	2.0	-3.8	-0.2	1.0	0.0
Belgium	1.3	1.4	2.5	-0.6	0.1	0.6	2.7	-0.5	-0.5	-0.5	..
Canada	1.4	4.5	5.6	2.0	2.7	4.2	5.3	-4.0	-0.4	1.1	-0.7
Ireland	1.4	1.5	4.7	0.7	1.2	1.5	2.4	0.8	0.8	0.8	-0.8
Netherlands	1.7	0.5	5.3	2.5	1.5	1.9	1.6	-3.6	-0.1	1.0	-0.5
Japan	1.9	3.3	5.5	-0.1	1.4	3.7	2.6	0.2	0.6	0.5	0.7
France	2.3	3.6	7.7	0.7	2.2	3.5	4.0	-1.1	0.1	0.5	0.0
OECD	0.9	1.8	2.9	1.0	1.3	1.8	2.3	-1.0	0.2	0.7	-0.5
EU	0.9	1.9	2.9	0.9	1.3	1.7	2.4	-0.8	0.2	0.6	-0.6

1. These indicators show the degree to which the personal and corporate tax systems scale up (or down) the real pre-tax rate of return that must be earned on an investment, given that the household can earn a 4 per cent real rate of return on a demand deposit. Wealth taxes are excluded. See OECD (1991), *Taxing Profits in a Global Economy: Domestic and International Issues,* for discussion of this methodology. Calculations are based on top marginal tax rates for the personal income tax and a 2 per cent inflation rate. Data are ranked in ascending order according to the overall standard deviation. Cross-country data are simple averages.
2. The weighted average uses the following weights: retained earnings 55 per cent, new equity 10 per cent, debt 35 per cent.
3. The weighted average uses the following weights: machinery 50 per cent, buildings 28 per cent, inventories 22 per cent.
4. The weighted average uses the following weights: machinery 5 per cent, building 5 per cent, current expenditure across assets 90 per cent, and weights in footnote 3 for financing.
5. Calculated across sources of financing in manufacturing.

Source: OECD.

Social-security taxation

29. Another area where taxation is much lower than in most OECD countries is social security. In Iceland, this form of taxation has more of the characteristics of an employer-paid payroll tax than in most other OECD countries in that there is no linkage to employee benefits. Indeed, employees do not pay any social-security taxes, nor are any public social benefits linked to a contribution record. Only employers pay

the 5¼ per cent tax that is earmarked mostly for funds responsible for social insurance programmes, such as those covering unemployment, workplace accidents, guarantees for the payment of pension contributions by bankrupt companies and all other insurance programmes.[13] There is, however, no linkage between the aggregate expenditure of these funds and their income from this form of taxation: central-government revenues cover the remainder of their programme costs.

30. The consequence of this different approach to the financing of social insurance is that social-security taxation raises only a small proportion of total tax revenue.[14] Only four countries (Australia, Denmark, Korea and New Zealand) have a lower dependence on this revenue source than Iceland. Indeed in 1999, its share of total revenue was only 7.9 per cent against an average of 25.2 per cent in the OECD area, with the difference in yields representing 6.8 percentage points of GDP.

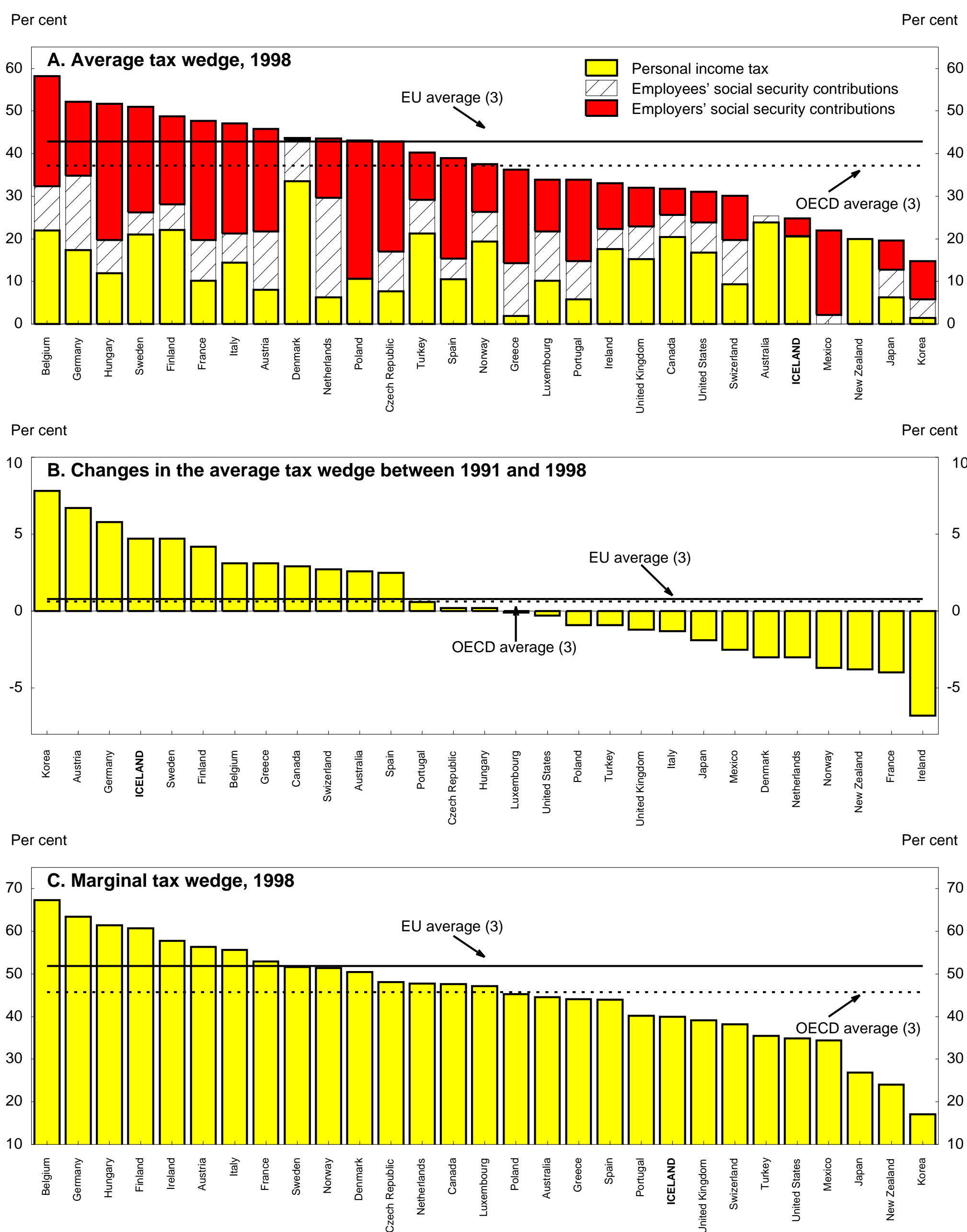
31. While the social-security tax is paid by employers, most of its ultimate incidence is on employees.[15] Consequently the sum of the yields and rates on social-security and income taxation is a more realistic indicator of the tax burden on labour, especially as the latter tax is paid primarily on employment income. In 1999, the sum of income tax and social-security taxation in Iceland represented 43.2 per cent of the total tax yield against an average of 52.2 per cent in the OECD area. The gap of the combined yield was only 9.0 percentage points against 17.3 percentage points for social-security taxation alone. This still, however, resulted in Iceland having one of the lowest average tax rates on labour income in the OECD area: only Korea, Japan, New Zealand and Mexico taxed labour income to a lesser extent (Figure 11). However, it should be noted that this form of taxation provides a direct return to individuals in countries other than Iceland, through eventual pensions. In the case of Iceland, the major part of employees' eventual pension is paid through a mandatory private-sector contribution to capitalised pension schemes. Total employee and employer contributions to the schemes amounted to 5.3 per cent of GDP in 1999 and these cannot be regarded as a tax. The overall tax rate on labour income also depends on the tax on consumption. This is high in Iceland (see below). The *marginal* tax rate for a person at the pay level of an average production worker at 47.3 per cent in 1999 (and 42.4 per cent in 2001) was somewhat closer to the OECD average than the *average* tax rate. The highest marginal tax rate on labour income was even closer to the average, as many OECD countries cap the upper payment of social-security taxes. Nonetheless, the failure in the real value of the various thresholds and allowances has resulted in some increase in the average tax rate on labour income.

13. The breakdown is as follows: unemployment insurance 1.15 per cent; workplace accidents, 0.08 per cent; pension contribution guarantees 0.04 per cent; childbirth leave 0.8 per cent; other social insurance programmes, 3.11 per cent; Export Council, 0.05 per cent.

14. Indeed, it could be argued that social security taxation in Iceland should be allocated to the category of payroll taxation, though this is not current OECD or Icelandic practice.

15. To the extent that labour supply is elastic, both the payroll tax and the tax on employment income will lower pre-tax wage rates and the overall participation rate.

Figure 11. The tax wedge on labour income(1)
As a percentage of labour costs (2)



1. For a single individual at the income level of the average production worker.
2. Gross wage plus employers' social-security contributions.
3. Unweighted average.
Source: OECD, Taxing wages,1999.

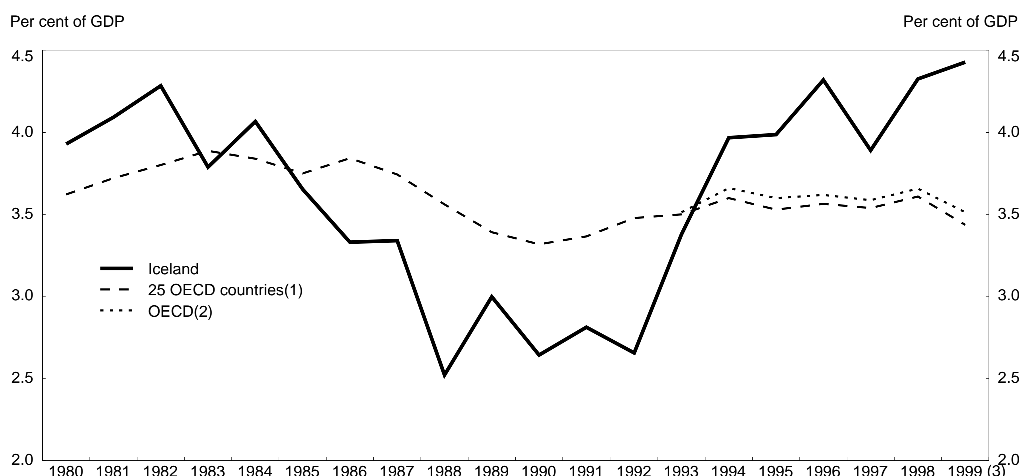
Expenditure taxation

32. A high share of taxation derived from consumption taxes (46 per cent — almost one and a half times the figure in the average OECD country) is the obverse side of the low share taken from taxes on

various forms of income. A major reform of expenditure taxation was introduced in 1990. The sales tax and a number of commodity-specific taxes were replaced by a value-added tax. The standard rate was set at 24.5 per cent for most products and, not having changed, is now the second highest in the OECD area. A certain number of goods and services are exempted from taxation, and there is a lower rate of 14 per cent that covers foodstuffs, magazines, newspapers, books in Icelandic, heating and hotels. The principal remaining exempted items are financial services, international transportation, house rentals, postal services and publicly-provided healthcare and education services. In an attempt to diminish the extent of cash payments in the building industry, and to subsidise housing, 60 per cent of the VAT payable on the wage cost of building a new house or renovating an old house is refunded. The overall scale of exemptions and lower-rate provision would appear to be similar to those in other OECD countries having such a tax in 1998. The actual yield of VAT was 59.5 per cent of the theoretical yield using the standard rate on total consumption, against a figure of 61.8 per cent in the average OECD country.

33. As well as the relatively neutral value-added tax, there remain a number of taxes on specific items. As in many countries there are quantity-based excise taxes on petrol, alcohol and tobacco. The taxes on alcohol are particularly high, exceeded only in Norway; however, low-alcohol drinks with an alcohol content of less than 2¼ per cent are exempt from such taxes. Taxes on petrol were close to the average for other European countries in 1999. There are also a number of *ad valorem* taxes on items such as cars, various electrical products and building materials. These taxes varied from 15 per cent on building materials and 25 per cent on electrical goods to 40 per cent on larger cars. The purchase of these goods generates few externalities. Nonetheless, in 1999 this form of excise taxation yielded revenues of 1.4 per cent of GDP, while those on alcohol, tobacco and petrol yielded a further 3.0 per cent of GDP. Toxic waste and plastic bags are taxed on a joint specific and *ad valorem* basis, but the yield was only 0.07 per cent of GDP. Overall, the yield of excise and specific taxes is somewhat higher than in the average OECD countries, at 4.4 per cent against 3.5 per cent (Figure 12).

Figure 12. Excise duties and specific taxes: an international comparison
Per cent of GDP



1. The series refer to the 25 OECD countries for which continuous data are available between 1980 and 1998.
2. As from 1993, data are available for the Czech Republic, Hungary and Poland. No data are available for Slovakia and Greece.
3. Data for Australia, Belgium, Canada, Poland, Portugal and United States have been estimated in 1999.
Source: OECD, Revenue Statistics and OECD.

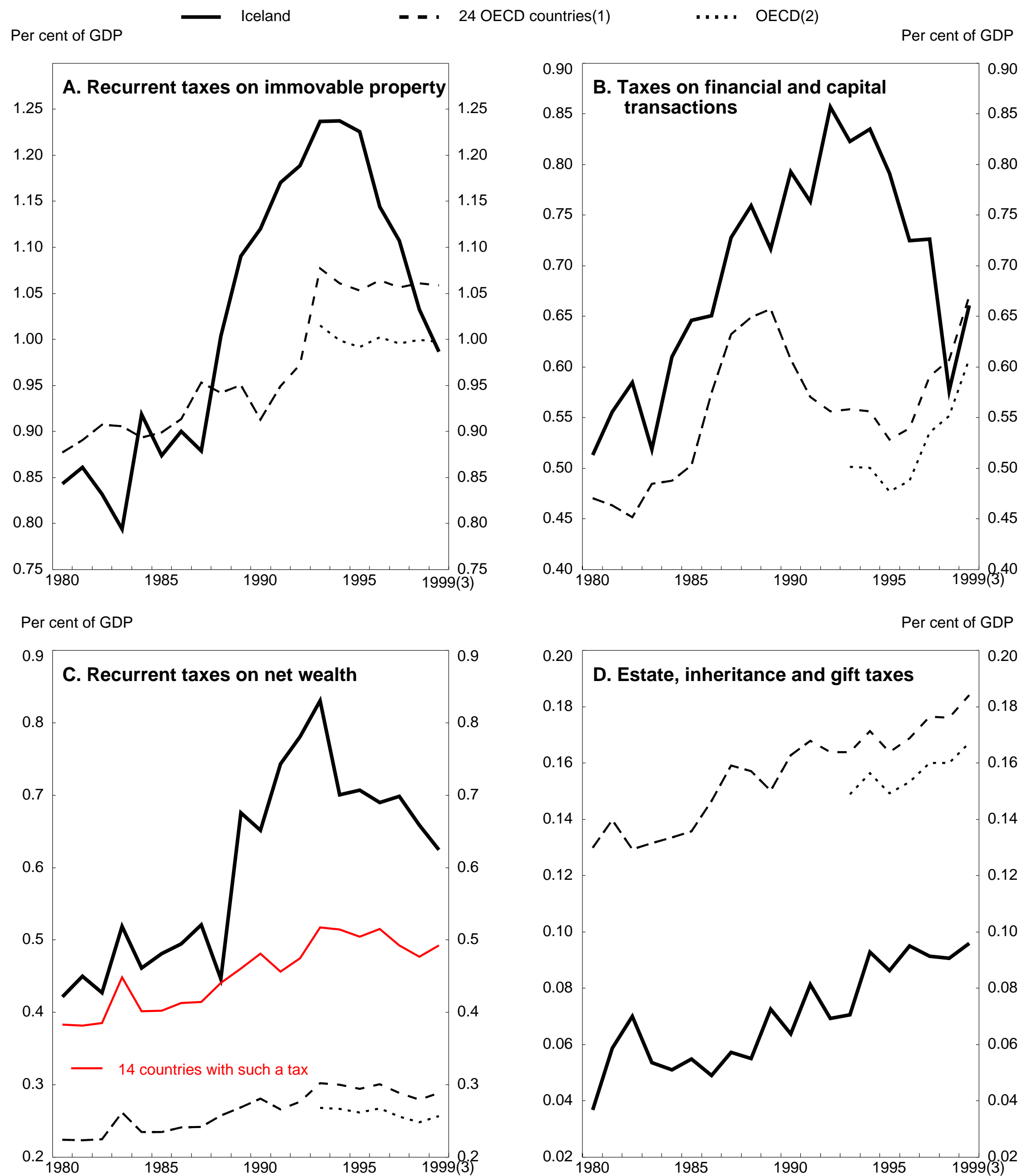
34. There is no excise tax on diesel fuel; rather, there is a usage tax. Each diesel-powered vehicle weighing over 2 tonnes is fitted with a distance meter that is read annually by the authorities. A tax is then charged based on the distance travelled and the weight of the vehicle. The tax increases with weight, with that for vehicles over 11 tonnes being nearly 50 per cent more than the charge for a 4-tonne vehicle. However, the rate of increase of the tax with weight does not appear to match the rate at which the damage to the road surface inflicted by a vehicle rises with weight. For smaller vehicles, the usage tax was until recently based just on weight; as a result, if average mileage was low, it was not economic to purchase diesel cars weighing less than 2 tonnes. The 2001 budget changed this basis, giving owners of this type of vehicle the option of installing usage meters. In the past, diesel vehicles were primarily used for the transport of goods. A usage tax could then be thought of as a contribution to infrastructure costs. These vary with the weight per axle of a vehicle, though the Icelandic tax varies only with weight. With the change in basis of the usage taxation for cars, diesel and petrol will become competing fuels in the personal transport market. The incentives facing users in each market will be different. In order to avoid fuel-switching, which could have adverse environmental effects, an excise tax on diesel should be introduced at a level that generates the same tax on carbon as that on petrol. The usage tax should then be set at a level that varies with the axle weight of the vehicle. If congestion costs still generate substantial externalities (unlikely in Iceland), then road pricing should be considered when technically feasible. The scope for other taxes on other forms of carbon emissions is limited. It would be difficult to tax marine fuel, in the absence of an international agreement. Apart from marine uses, little other carbon is used as fuel in Iceland. Both the diesel usage tax and the special excise tax on petrol are earmarked for the construction and maintenance of roads.

Non-income taxes on capital

35. The most important form of this type of capital taxation is the municipal real estate tax. It generated revenues of almost one per cent of GDP in 1999 and, since 1987, has been a much larger source of revenue than in other OECD countries (Figure 13, Panel A). Assessments for the tax are based on the market value of the property. For residential property, the tax rate can vary within a range of 0.35 to 0.5 per cent of the value of the property, depending on the decision of the local authority. The tax is paid to the local authority where the property is situated, but the permissible range of the rate is set nationally by central government. For non-residential properties (and secondary homes) there is a uniform national tax rate of 1.5 per cent. The overall yield of this tax fell relative to GDP in the 1990s, as property prices were depressed for most of the decade. Once the recent increase in prices feeds through to assessed market values however, the yield should start to pick up once again. This form of taxation can be seen as an alternative to the taxation of imputed rent in the hands of households that own houses.[16] Indeed, property tax can be offset against actual rental income. It can, thus be seen as a substitute, albeit imperfect, for the absence of a capital income tax on the imputed rent of owner-occupiers. For businesses, though, there appears little reason to tax the value of structures. There is, however, a good justification for taxing the value of the land occupied by the structures. This land value represents a capitalised rent and can be taxed without adversely affecting incentives.

16. If the yield on rental housing is 5 per cent, the property tax equates to a tax on imputed capital income of between 7 and 10 per cent — similar to, but no more than the statutory rate on other forms of such income.

Figure 13. Taxation of assets
Per cent of GDP



1. The series refer to the 24 OECD countries for which continuous data are available between 1980 and 1998.
2. As from 1993, data are available for the Czech Republic, Hungary and Poland. No data are available for Slovakia, Greece and Mexico.
3. Data for Australia, Belgium, Canada, Poland, Portugal and United States have been estimated in 1999.
Source: OECD, Revenue Statistics and OECD.

36. The stamp duties levied on capital transactions are the second most important additional tax on capital. The tax is levied on all transactions in bonds, mortgages, leases and bills of exchange. Transactions in equities are taxed only once, when they are first issued. The rates generally vary between 0.4 and 1.5 per

cent, with an exceptionally low rate on bills of exchange.[17] For housing transactions the rate is 0.4 per cent, lower than the European average. In the mid-1990s, depressed house prices pushed down the yield of this tax relative to GDP (Figure 13, Panel B). In 1999, it started to pick up once again as the residential property market became more buoyant. Such taxes serve to raise start-up costs, discourage business refinancing and reduce market liquidity and have been accordingly losing favour elsewhere in the OECD.[18] Moreover, with the Icelandic equity market now becoming part of the Nordic Stock Exchange, there is always a risk that financial transactions will move to a lower tax environment.

37. In common with almost half of all OECD countries, a wealth tax is levied on net assets over a certain ceiling. This tax is paid by both individuals and companies at an initial rate of 1.2 per cent per year. For individuals, the threshold is relatively low (3 836 619 krónur in 2001 — about $45 000 per person) and the rate increases to 1.45 per cent for net assets in excess of 5 277 058 krónur or about $62 000 per person), though people over 67 are exempt from the surcharge.[19] The tax is discriminatory between different assets. Bank deposits are exempt to the extent that they do not exceed the indebtedness of an individual. Equities are included in the tax base but, when held by individuals, enter only to the extent of the par value of the shares. As a result, it is attractive to transfer such holdings to a foreign (holding) company domiciled in a low-tax country and whose shares are issued at an extremely low par value. The individual escapes wealth tax and the foreign company is not liable for any Icelandic tax. Companies are liable to pay the wealth tax on the extent to which the book value of their equity exceeds the par value of their shares. No wealth tax is paid on the component of the market value of the company that exceeds its net worth (par value of shares plus equity reserves), and this component is substantial for most Icelandic companies. Moreover, the corporate part of the tax cannot be levied if the company holding the assets is resident abroad. Over the 1990s, companies' payments of wealth tax were equivalent to one-third of their corporate tax bill, making the tax especially burdensome for unprofitable firms. As to houses their value is re-assessed each year, as for property taxes. Government bonds were exempt from the tax until 1999. In 2000, a transition measure limited the extent to which government bonds were excluded from the base. But as from 2001, they are finally fully included. The yield of the net wealth tax has not kept up with the growth of GDP in the second half of the 1990s (Figure 13, Panel C), as house prices were depressed until 1999 and soaring equity prices do not increase the assessed tax base. The yield, though, remains greater than that in other countries with such a tax and considerably higher than the OECD average.

38. For a number of reasons, inheritance taxes are a relatively small source of revenue in Iceland (Figure 13, Panel D). *First*, the tax rate on legacies to spouses and to children of the deceased is low, the former being exempt and the rate for the latter being between 5 and 10 per cent.[20] *Second*, the tax rate depends not on the overall size of the estate but on the size of each individual bequest. *Finally*, equities and bonds are valued at their par and not their market values. This provision may have reflected the absence of a stock market when the law was last changed in 1984. Now, with a significant proportion of wealth held in equities, it represents a significant reduction in the tax burden. For people who intend to leave bequests, inheritance tax can be seen as a further tax on capital. In any case, there is a strong incentive in Iceland's case for people to sell all their assets prior to death and use the proceeds to buy shares or bonds with low par values relative to market value.

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17. The key rates are: leases, 2.0 per cent; bonds, 1.5 per cent; new equity issues and zero coupon bonds, 0.5 per cent; house purchases, 0.4 per cent; and bills of exchange, 0.25 per cent.

18. For example, Denmark abolished its new issue tax in October 1999.

19. The surcharge of 0.25 per cent for people between 16 and 67 is paid to the National Library.

20. For bequests to parents, or their descendants, the tax rate varies between 15 and 25 per cent. For other recipients the rate varies between 30 and 45 per cent.

Local government taxation

39. Local authorities have the freedom to raise both income and real estate taxes within very tight limits specified by central government. The use of local income taxes has meant that, aside from governments with a federal structure, Icelandic local authorities receive a substantially higher share of total tax revenues than in the rest of the OECD area — they account for 23 per cent of total tax revenues against an average of close to 14 per cent in non-federal OECD countries. Iceland's share is exceeded only in Denmark, Sweden, Belgium and Japan. This apparently high level of financial autonomy is, however, strictly circumscribed.

40. The principal source of revenue for local authorities is the municipal income tax, but the rate for this tax can vary only within limits that are set by Parliament. In 2000, the range was 11.24 to 12.04 per cent. While there is some variation, the average rate, at 11.96 per cent in 2000, was quite close to the upper limit. The tax is included in the overall standard rate of income tax that was 38.4 per cent in 2000 and is collected centrally and then transferred to the appropriate local authority. The cost of the basic tax credit and the deduction allowed for the purchase of equities is deducted solely from the central government tax receipts, while local governments share in the cost of pension contribution deductions. Thus, the local authorities' share of total personal income tax, at almost 54 per cent in 1998, was higher than the ratio of their tax rate to the total tax rate, which was only 30 per cent in the same year.

41. The share of real estate taxation in total municipal revenues has been falling over time and is also constrained by the central government (see above). It now accounts for only 13 per cent of total revenues against 16 per cent in 1990. The main reason for this has been the progressive transfer of competencies and income tax revenue from central to local government. In 1997, when primary education became a local responsibility, the municipal income tax rate was raised 2¾ percentage points. In 2001, the maximum local authority tax rate is being raised, in two stages, by 0.99 percentage point, partially compensated by a 0.66 percentage point drop in the central government rate. This change will take the top municipal rate to 13.03 per cent and the average standard marginal tax rate to 39 per cent in 2002, if all authorities were to raise tax rates by the maximum permissible extent.

Overall effective tax rates

42. The structure of taxation in Iceland, therefore, remains weighted towards consumption, but in the past decade the effective tax rate on capital has been rising markedly from 15 per cent in 1990 to almost 28 per cent in 2000 (Figure 14). The effective tax rate on consumption is estimated to have averaged 42 per cent during the past decade.[21] It rose in the period 1997-99, reflecting the rapid recovery in the demand for consumer durable goods that carry high rates of specific duties. Even so, it only returned to its level when the value-added tax was first introduced in 1990. The effective tax rate for labour has been moving steadily upwards at a fairly constant rate. However, the increase in the effective tax rate on capital is estimated to have been more significant than the increase in the effective rate on labour. Some part of this may relate to a mis-measurement of the tax base for capital income (notably profits of the self-employed are included in labour taxes, while some of the yield of the income tax attributed to employment income came from dividends, prior to the introduction of the capital income tax). Nonetheless, despite the low taxation of capital income in the hands of individuals, the weight of other taxes on capital is such that the effective tax rate on capital income is much higher than suggested by the capital income tax.

21. This figure is measured in relation to the ex-tax value of private consumption.

Figure 14. The effective tax rate on consumption, labour and capital

Source: OECD.

Scope for action

43. The objective of previous tax reforms in Iceland has been three-fold: *i)* to simplify; *ii)* to increase savings, and *iii)* to reduce discrimination between different types of economic activity. The second objective has been pursued through a series of changes designed to encourage saving through pension plans. A recent government report advocates further expansion of such retirement saving programmes, and increasing national saving also remains a government priority, given that the current-account deficit has now reached 9 per cent of GDP. At the same, the introduction of the capital income tax in 1997, as well as being at a low rate, removed discrimination between most types of income,[22] while further changes introduced in the 2001 budget have ensured that capital gains are taxed more completely.[23]

44. The exact extent of the scope for further action in reforming the current tax system depends on whether it is expected to provide sufficient revenue for the future spending needs of the government. As noted above and in Chapter II, its medium- and longer-term fiscal position is good, provided that recent apparently structural gains in tax revenue are maintained when the economy slows. The government should become a net creditor by 2004, while still running a structural budget balance of around 2 per cent of potential GDP. There is a risk, though, that the current macroeconomic disequilibrium will be resolved through a fall in domestic activity and incomes. In this case, it is not clear how robust the estimates of the

22. Income that accumulates in pension schemes is not subject to capital income tax, but this is not necessarily discriminatory, given the tax treatment of pension payments.

23. Prior to the 2001 budget, realised capital gains were not taxed if they were reinvested within 60 days. Realised gains that were not reinvested were taxed as employment income if they were over 3.18 million krónur per year (around $38 000). Gains of under 348 000 krónur are exempt from taxation, if the asset was acquired between 1990 and 1996 and has been held for four years.

structural budget balance would prove to be, and, in any case, a temporary downward adjustment in tax revenues cannot be ruled out.

45. Although there are some risks to the maintenance of a budget surplus in the medium term, public finances are well placed to meet the longer-term challenge of ageing, given the emphasis on private provision of retirement income. Already the government spends little on age-related pensions; indeed only two of 22 other OECD countries spent less in 1997 (Figure 15). Moreover, other forms of social-insurance spending were also considerably lower than in the rest of the OECD area at that point. Over time, the emphasis on private funding should further reduce the average cost of social security pension payments, though this may be offset by growing numbers of pensioners. Payments of pension for public sector employees do pose a problem, but the government has recognised the size of the unfunded liability in this area and has started to take steps to reduce it. Tax receipts should also be boosted as the private sector pensions increase rapidly. The absence of long-term pressure on the surplus is supported by a generational accounting approach to long-run fiscal policy. Such calculations suggest that with current tax rates, future generations will experience lower tax rates than those levied on present generations (Chapter II of OECD, 2001).

46. At the moment, though, the macroeconomic situation calls for the maintenance of a structural budget surplus, in order to ensure a marked slowing in the economy. Nonetheless, there is scope for a revenue-neutral tax reform in the short-term that could be achieved through the introduction of new taxes and the reduction of existing taxes. It should be possible to introduce resource taxes, as is pointed out in Chapter IV of OECD (2001). The scope for introducing such taxes follows from the fact that a large part of national wealth represents abundant stocks of fish and renewable sources of electricity that are often to be found in the public domain.[24] A resource rent could be drawn from each of these activities without threatening their competitive position or disturbing incentives in the economy. In the case of fishing, the size of the resource is difficult to estimate, (though under certain assumptions it could be as much as one per cent of GDP, see Chapter IV of OECD, 2001).[25] There is, however, a problem of how to extract these rents. The existing quotas were granted free of charge to the trawler owners at that time. Since then, the quotas have been freely traded. Taxation of the capital values of these fishing quotas has been suggested. Normally, a resource tax suffers from the drawback that the government is unlikely to be able to determine the exact extent of the rent and, thus, may set the tax rates at levels that disturb incentives to participate in the industry. However, the existence of a market for the permanent resale of the original quota rights reduces this risk in the case of the fisheries. If their price fell to zero, the tax would be too high. An alternative to a tax on the capital values of quotas would be to phase out the current ownership of quotas and for the government to eventually auction them. In many ways, this approach is to be preferred, as it leaves the market to determine the amount of the rent. As to electricity, the extent to which rents are available is less certain, but, given that less than 10 per cent of the electricity that is viable at current prices capacity has actually been constructed, the existence of intra-marginal rents is highly probable.

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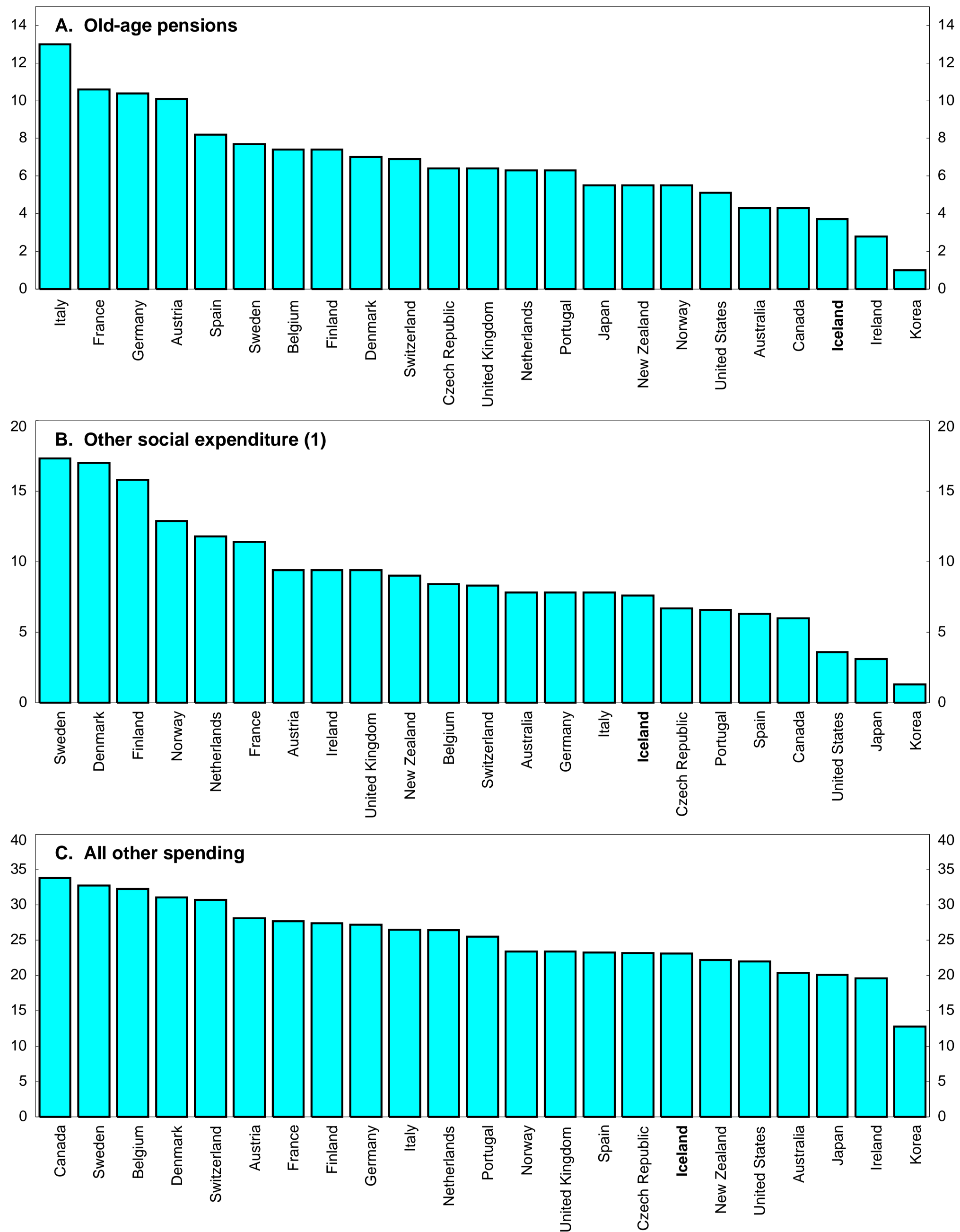
24. A similar situation exists with respect to the electromagnetic spectrum, which is of substantial value to telecommunications services providers, a value that should optimally be appropriated by the state through an auction procedure.

25. In the autumn of 2000 a committee of experts and politicians recommended the adoption of resource taxation, but limited their proposal to charge a fee to cover certain costs incurred by the government for the industry.

Figure 15. Government spending by purpose: Iceland and other countries
Per cent of GDP, 1997



1. Social transfers and services such as unemployment and housing benefits, family services, etc.
Source: OECD Social expenditure database and OECD, Education at a Glance.

47. Additional funds for a revenue-neutral tax reform could be found by reductions in interest relief for housing, the tax break for the purchase of equities and in the hidden taxes on food. At present the interest-relief favours those people with low incomes that are purchasing rather than renting at a cost of 4.2 billion krónur in 2000. A further tax relief to housing is given through the rebate of 60 per cent of the normal value-added tax on the wage cost of new housing construction.[26] Secretariat estimates put the cost of this second subsidy at 1.5 billion krónur.[27] In total, these two tax expenditures cost an amount equivalent to 0.9 per cent of GDP. The allowance for the purchase of shares is an anomaly that discriminates in favour of one asset. It has long ago met its objective of helping to establish a stock market and should now be abolished. As to agriculture, subsidy programmes are still large, and total public spending on agriculture amounts to 2 per cent of GDP, with the hidden taxes on agriculture doubling the cost of the average farm product to the consumer (see Chapter IV of OECD, 2001).

48. The priority for tax reform, whether undertaken through revenue-neutral changes or a medium-term reduction in taxation, should continue to be changes that will probably reduce discrimination between different forms of activity and potentially increase saving. There are still some examples of discrimination in the tax system that need to be removed. In a few cases, international competition may force change (for instance, transfer taxes on financial assets). Moreover, the objective of increasing savings fits poorly with the large number of taxes on capital that would normally be paid out of income, in addition to the standard capital income tax. These additional taxes (corporation tax, wealth tax, inheritance tax and transfer taxes) yield six times the revenue generated by that tax. While empirical international evidence suggests that taxation has only limited effects on the overall level of saving, reform of the taxation of capital could lower discrimination between different forms of economic activity and increase welfare, even if enhancing the returns to saving prove insufficient to boost its level.

49. In the area of corporate taxation, the first priority should be to end the discrimination between the taxation of equity profits (both dividends and retained earnings) and interest payments. Such a measure (especially if coupled with the payment of a withholding tax, equal to the capital income tax, on payments of interest to foreigners) ought also help to reduce the growth of borrowing by Icelandic companies. This could be achieved by progressively reducing the domestic corporate tax rate towards that on capital income, since it would be inappropriate to reverse the move to a classical corporate tax system, which was only introduced recently. Such a reduction would have to be accompanied by strict rules concerning the use of thinly-capitalised closely-held companies. If not, there would be a danger that employment income would be transformed into capital income. Such a move might also help attract the foreign direct investment that will be necessary to exploit untapped electricity resources, for example.

50. A further element of discrimination is introduced by the net wealth tax, transfer taxes and inheritance taxes. The accumulation of net wealth through pension schemes is not taxed, nor are bank deposits. Wealth held as equities is taxed but to a varying extent, depending on the form in which it is held and the extent to which the market value of company assets is reflected in their balance sheet. The yield of the wealth tax is close to that of the capital income tax. It offsets the benefits of the low capital income tax and should be a target for abolition. International competition is likely to push down transfer taxes on financial instruments over time. Their elimination would help create a more liquid capital market and would cost substantially less than the overall yield of 4 billion krónur from stamp duties, if the tax on housing transactions was retained. Finally, the merging of all inheritance taxes into one low rate and the abolition of various anomalies in valuation methods would end discrimination both between different

26. It is anomalous that at the same time as part of the VAT on building labour is rebated, building materials are subject to a specific tax of 14 per cent in addition to VAT.

27. Housing investment amounted to 20.5 billion krónur in 2000. If labour costs amounted to 50 per cent of the total and the VAT rebate was 60 per cent of the standard rate of 24.5 per cent, then the subsidy is 0.6 times 0.245 times 10.25 billion krónur.

groups of relatives and different assets. With most inheritances are either exempt or taxed at only 5 per cent, the incentives for wealthy individuals to take avoidance actions would be minimised.

51. There is also some case for a reform of expenditure taxation to remove the remaining unjustified discrimination between different products. The reliance on value-added taxation is a good feature of the current system, though there are a number of items that are taxed only at a low rate. Some of the extra excise taxes may be justified by externalities, such as health effects and pollution (for alcohol, tobacco and petrol). The current treatment of petrol and diesel is anomalous. The former is subject to an excise, while the latter is not; rather the usage of diesel vehicles is taxed. The taxation burden on the two fuels should be unified in a way that equalises the implied tax on carbon emissions, while retaining part of the usage tax to compensate for infrastructure costs. The other specific taxes on building materials, electrical equipment and cars do not correspond to any externality and should be abolished and the revenue replaced by a somewhat higher VAT rate. The lower VAT rate on food could also be abandoned, if a reduction in agricultural protection were introduced concurrently.

52. While past reforms have concentrated on the tax on employment and pension income, this tax would also benefit from some reform. The basic tax allowance (that ensures no low-income households pay tax).has not kept pace with the growth in average earning since 1995, nor has the threshold for the payment of surtax. Over the medium term, the government should guard against a fall in the value of these allowances that produces an increase in the average tax rate, while at the same time aiming to reduce marginal tax rates.

Conclusion

53. The Icelandic tax system has evolved considerably in recent years in a favourable, simplifying direction. Special exemptions from the corporate tax base have been eliminated, allowing a reduction in the corporate tax rate. A high tax rate on consumption has been maintained, while reducing the extent of differential taxation through the introduction of a value-added tax. At the same time, the double taxation of saving has been markedly reduced by the introduction of a separate low rate on capital income. As to employment income, individuals now face only two statutory tax rates. To be sure the economy faces a number of imbalances, but these do not appear to be caused by the structure of taxation. Overall, judged against other OECD countries, the tax system appears to be in good shape. But some further changes could be envisaged (Table 4). Some possible tax bases have been ignored in the resource area and the introduction of taxes here would help increase the scope for a revenue-neutral tax reform. Beyond that, reduction in taxation may have to wait for an economy that is more in balance. Priority areas would include reducing the extent of the taxation on capital, especially through reductions in wealth taxation, transfer taxes, inheritance taxation and corporate taxation, thereby bringing the system closer to one based on consumption. Reform of the existing taxation of consumption and employment income should not be neglected, especially the former where a number of specific excises exist that cannot be justified by externalities. All of these changes would help in continuing the objective of past reforms, namely building a simple and neutral tax system.

Table 4. **Summary of new recommendations for tax reform**

Taxation of employment income

- Reduce allowance for housing loan interest payments with a general, means-tested housing benefit.
- Eliminate the tax break for the purchase of equities.
- Index the basic tax credit to average earnings.
- Consider ending the temporary high-income surtax or raising threshold for its payment.
- Standardise treatment of child benefits across age groups.

Taxation of capital and capital income

- Lower the discrimination between the treatment of interest and dividends for corporate taxation by reducing corporate tax rates or giving domestic shareholders a credit for corporate tax paid.
- Consider the introduction of a withholding tax on all foreign interest payments.
- Eliminate transfer taxes on financial instruments.
- Merge all inheritance taxes into one low rate, with all assets valued at market prices.
- Abolish the net wealth tax.
- Change valuation base for equities to market prices for inheritance tax and wealth tax, if it is not abolished.
- Exempt structures from the tax base of property taxation for companies.

Taxation of goods and services

- End lower rate of VAT on food in the context of a liberalised agricultural policy.
- Replace the tax on usage of diesel vehicles with an excise tax and a reduced usage tax based on axle weight.
- Replace excise taxes, except for tobacco, alcohol and petrol, with a revenue-neutral increase in VAT.

Introduce resource taxation

- Introduce a tax on the capital value of fishing quotas or withdraw existing rights and auction new rights.
- Introduce a resource tax on the rent created by ownership of water and sub-surface rights used for generating electricity.

Source: OECD.

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ANNEX

MAIN FEATURES OF THE TAX SYSTEM IN 2001

Table A1. **Taxes levied on corporate income: standard regime**

Nature of tax

- Resident companies are liable for both national income tax and net wealth tax. Municipal taxes are not levied on corporate profits.
- In practice, a company is resident if it is registered with the Company Registrar of Iceland (*Fyrirtækjaskrá*). Funds are resident if their place of effective management is in Iceland.
- Since 1999, Iceland has had a "classical system" of corporate taxation, where corporate profits are fully taxed and distributions from the taxed profits to shareholders are taxed at 10 per cent.
- The taxable base is net income, *i.e.* income after deduction of business expenses and certain allowances provided by law. To counteract the effects of inflation on the income tax base, a price adjustment factor (PAF) is applied to the various items of income and expenses for the determination of net taxable income from business operations.
- Resident companies are subject to income tax on their worldwide income.
- Capital gains derived by a company from the disposal of assets used in a business operation or held as an investment, whether depreciable or not, constitute taxable income, regardless of the holding period. In certain cases, taxation of capital gains can be deferred or spread over a period of successive years.
- The taxable gains are calculated as the sales price of the asset less its depreciated book value, adjusted for inflation. For non-depreciable immovable property the gains are the difference between the sales price of the property and its cost of acquisition, adjusted for inflation. Taxpayers also have the option to declare an amount equal to 50 per cent of the sales price as taxable capital gains.
- The tax year is the calendar year.

Exemptions, credits and allowances

- Resident companies (joint-stock companies and limited liability companies) which meet certain requirements can receive a licence to operate as an international trading company (ITC) in Iceland.
- Dividend payments between domestic companies are exempted from the withholding tax. There is, however, a 20 per cent withholding tax on dividends payments and capital gains paid from domestic companies to foreign companies, except in case of a double tax treaty, where it can be lower or even zero.
- There is no withholding tax on royalties paid to resident companies.
- The net operating loss of a company, as adjusted annually for inflation, may be carried forward for eight years. Carry-back is not allowed.
- A straight-line depreciation method is employed for calculating depreciation for income tax purposes.
- The residual value of movable or immovable property amounting to 10 per cent of the depreciation base, as adjusted, is not depreciable; *i.e.* 10 per cent of the original value of the asset remains on account until it is scrapped or sold.
- Assets subject to ordinary depreciation are classified in various categories, with different yearly depreciation rates:

Category	Rate (%)
Ships, aircraft and cars carrying fewer than 9 persons (except taxis)	5-10
Automobiles and other transport vehicles	10-20
Industrial machinery and equipment	5-15
Office equipment	10-20
Machinery and equipment for building and construction	10-20
Other movable property	10-20
Buildings and other structures, *e.g.* office buildings, industrial plants and storage tanks	1-3
Quays	6-8
Drilling holes and electric transmission lines	7.5-10
Patents, copyrights and other similar rights	15-20
Goodwill	10-20

- Depletion of mines, quarries and other natural resources must be deducted from income as depreciation, by the unit-of-production method.
- Companies and their subsidiaries may be jointly taxed, provided the subsidiary is at least 90 per cent owned by the present company.

Rates

- For the income year 2000, the national corporate income tax rate is 30 per cent on net profits. The rate is 38 per cent for unincorporated enterprises (or partnerships) registered as distinct legal entities. ITCs are subject to corporate income tax of 5 per cent, dependent on certain conditions.

Source: Ministry of Finance.

Table A2. **Taxes levied on household and other business income: national and municipal taxes on taxable income**

Nature of tax

- Resident individuals are subject unlimited tax liability on all their incomes, wherever earned, in terms of national and municipal taxes. Any individual staying in Iceland for six months or longer is considered a resident. Former residents remain subject to unlimited tax liability for three years after leaving the country, unless they prove they have become subject to taxation in another country.
- The concept of taxable income is wide and includes all payments in money and other property whose monetary value can be ascertained. Taxable income is divided into three main categories.
  - A: wages and salaries, including presumptive employment income of the self-employed, employment related benefits, grants, payments to copyright holders, royalties, etc.
  - B: income from business and independent economic activities.
  - C: investment income of any description, including dividends, interest and capital gains.
- The taxable base for individuals not engaged in business is income in categories A and B. For individuals engaged in business, it is the aggregate income of all three categories. Individuals engaged in business are subject to the same rules and taxes as companies.
- For individuals not engaged in business, the tax on income from category C is levied by way of assessment. Withholding tax on dividends collected in the preceding tax year is credited against the tax levied by assessment. The withholding tax on interest is, however, final.
- Investment income of married couples, and of cohabiting persons who are treated as married couples for tax purposes, is taxed in the hands of the spouse whose total employment income is the higher. Other types of income are taxed separately.
- In principle, all "benefits in kind" are included in taxable income. In some cases, *e.g.* company cars, special rules apply.
- Pension benefits (including supplementary benefits) are taxable income.

Exemptions, credits and deductions

- All individual taxpayers are entitled to a personal *tax credit* against the computed income tax from all income categories. This credit amounts to ISK 747 828 for the assessment year 2001 (tax year 2000). If the credit is higher than the tax, the difference will be applied by the State Treasury to settle the municipal and net wealth taxes payable. In the case of a married couple, 85 per cent of the unused credit is added to the credit of the other spouse.
- A seaman's *tax credit* (*sjómanna afsláttur*) is a fixed amount for each week registered spent on sea.
- Different *exemptions* apply to the categories of taxable income. Only exemptions expressly provided for by law may be *deducted* from incomes in categories A, while operating losses may be *deducted* from category B income.
- Net operating loss, adjusted annually for inflation, may be *carried forward* for eight years. Carry-back is not allowed.
- A *deduction*, up to a given maximum, is permitted from an individual's total income for increased investment in a business, including co-operatives and savings banks. Qualifying investments include the purchase of shares in companies fulfilling certain requirements.
- There is an annual limit for individuals on the amount of *capital gains* subject to the standard withholding tax (From the beginning of the year 2001, that limit has been abolished, and capital gains are now subject to 10 per cent capital tax as other capital income).
- *Capital gains* on the sale of a private residence are exempt if the residence has been owned by the taxpayer for at least two years and its size is within certain limits. If the residence has been owned for less than two years, the gains may be rolled over through a reduction in the acquisition cost of another residence. Taxation of such gains may be deferred for two years.
- A *tax deduction* is in effect for purchases by individuals of domestic or foreign stocks, with 60 per cent of the purchase price deductible from income tax, up to a limit of ISK 133 333 for individuals and double that for couples. The purchaser must, however, hold the shares for five years to be eligible for the deduction. Should the shares be sold, he must reinvest within 30 days in other shares, or otherwise be liable for tax on the capital gains.
- Stock options are eligible for this *tax deduction*, provided *a)* they are available to all employees, *b)* that a minimum of 12 months passes between the stock option contract and its exercise date, and *c)* the employee holds the stock for at least two years after the purchase.
- The State Treasury pays individuals a benefit which is means-tested both with respect to income and net wealth, for the interest incurred on the financing of a residence for personal use. The benefit is paid through the income tax system.
- The State Treasury pays individuals a benefit that is means-tested with respect to income and varies with the number of children and whether the both the family has one or two parents. The benefit is paid through the income tax system.
- Employee contributions to pension funds of which 4 per cent is compulsory and which can be increased voluntarily up to 8 per cent of total employment income are *deductible* Otherwise, no significant deductions are allowed from employment income.

Table A2. **Taxes levied on household and other business income: national and municipal taxes on taxable income** (*cont'd*)

Rates	
• For the assessment year of 2000 (tax year 1999), the rate of national income tax on aggregate income (*tekjuskattur til ríkisins*) is 26.41 per cent. • The municipal income tax (*útsvar*) rate varies between 11.24 per cent and 12.04 per cent, with an average of 11.93 per cent. • The total tax rate — the sum of the national and municipal income taxes — is 38.37 per cent. • An additional tax (*sérstakur tekjuskattur til ríkisins*) of 7 per cent is levied on aggregate income in excess of ISK 3 277 950 (ISK 6 555 900 for couples).	• Capital income (category C income) derived by individuals not engaged in business is taxed separately at a flat rate of 10 per cent. • For individuals engaged in business, capital income is taxed in the same manner as other income. • Losses on the sale of property are generally not deductible; however, they may be deducted from *gains* made on the sale of a similar property in the same year.

Source: Ministry of Finance.

Table A3. **Social security contributions**

Employers' social security contributions	Individual social security contributions
Nature of the tax	
• Social security contributions (*tryggingagjald*) are imposed on all renumeration paid for dependent personal services. The contributions are partly used to finance the social security system. Social security contributions are payable only by employers. • The same social security and bankruptcy contributions are imposed on the presumptive employment income of self-employed individuals.	• Individuals do not pay a specific social security charge. • All individuals aged between 16 and 69 pay a fixed contribution to the Construction Fund for the Elderly.
Exemptions, credits and allowances	
• Employer contributions to employee social security plans are deductible as an operating expense. The norm is 6 per cent. For supplementary payment of the employees contributions up to 4 per cent, the additional employer contribution up to maximum 0.4 per cent is deductible from the social security tax.	• People with an income under ISK 718 401 are exempt.
Rates	
• For the assessment year 2001 (tax year 2000), the general rate for all activities not explicitly exempt is 5.23 per cent. • A special rate of 5.88 per cent applies to seamen. • A contribution to the bankruptcy fund (*ábyrgðarsjóðsgjald*) is imposed on the same base, at a rate of 0.04 per cent. This fund covers unpaid employee wages due to bankruptcy.	• The contribution is ISK 4 162.

Source: Ministry of Finance.

Table A4. **Taxes levied on consumption and investment**

Value-added tax	**Excise duties**
Nature of the tax	
• Value added tax is levied on the supply of goods and services. • All taxable persons selling goods and services are required to register for value added tax *(virðisaukaskattur)* in Iceland. These include: ° entrepreneurs (companies, partnerships and individuals) carrying on a business or trade involving the supply of taxable goods or services; ° co-operatives and other societies, even if they are tax exempt organisations in competition with other enterprises; ° public utility enterprises; ° the government, county and municipal organisations and public enterprises in competition with commercial undertakings; ° auctioneers; ° agents and other representatives of foreign-owned enterprises. Non-residents without an office or fixed place of business in Iceland must appoint a local representative for VAT purposes.	• The excise duty on motor vehicles is assessed on the basis of engine displacement (cubic centilitres). • The excise duty on petrol is at a fixed rate. • Tobacco and alcohol are assessed on the basis of product type and volume respectively. • An excise tax is levied on certain electrical goods and building materials. • A VAT is applied on top of excise taxes.
Exemptions, credits and allowances	
• A zero tax rate applies to international transport, fuel and equipment used in ships and aircraft engaged in international traffic, and shipbuilding. • A reduced VAT rate applies to the supply of the following goods and services: ° Hotel rooms, rooms in guest houses and other accommodations, as well as campground facilities; ° newspapers, magazines, periodicals (local or national) and books in Icelandic, whether written by Icelandic authors or translated; ° licence fees to use radio and television broadcasting services; ° warm water, electricity and fuel oil used for heating of houses and swimming pools; ° all foodstuffs, except sweets and soft drinks.	• Alcohol under 2.25 per cent volume is not subject to an excise tax. • Cars purchased for use as taxis or hire-cars pay a lower tax rate.
Rates	
The standard VAT rate is 24.5 per cent and the reduced VAT rate is 14 per cent.	• ISK 5 870 per each per cent of alcohol by volume exceeding 2.25 per cent. • 45.45 per cent is applied to cigarettes, and between 38.4 per cent and 38.9 per cent applies to other types of tobacco products. • The fixed rate excise tax on unleaded petrol is ISK 39.10 per litre and ISK 40.93 per litre for all other petrol. • Other excise rates: Per cent Building materials, auto parts 15 Household appliances 20 Electronic appliances 25 Vehicles with an engine size 0-2000 ccs 30 Vehicles with engine size larger that 2000 ccs 45

Source: Ministry of Finance.

Table A5. **Taxes levied on property**

Real estate	**Net wealth**	**Inheritance and gifts**
	Nature of the tax	
• Municipalities levy a real estate tax (*fasteignagjöld*) on the estimated value of immovable property, based on size, etc. • Immovable property is assessed at the real estate assessment value effective at the end of the year.	• Individuals aged 16 years and older are liable for the net wealth tax (*eignarskattur til ríkisins*). Individuals between 16 and 67 years are also subject to the extraordinary net wealth tax (*sérstakur eignarskattur til ríkisins*). • The taxable base for net wealth tax purposes is the aggregate value of an individual's assets at the end of the tax year, less his liabilities. The taxable base of married couples, or cohabiting couples taxed as if married, is divided equally between them, and each individual is taxed separately. Shares are assessed at their par value. • Companies pay wealth tax on the value of their share reserves. • Net worth of individuals exceeding ISK 3 836 619 is subject to net wealth tax, while a net worth exceeding ISK 5 277 058 is subject to the extraordinary net worth tax. The starting amount is doubled for couples.	• Inheritance tax is imposed by the state on property acquired by inheritance. The tax is not imposed on the estate of the deceased, but separately on each beneficiary in respect of his share in the estate. • There is no gift tax in Iceland, but gifts are taxable as income in accordance with the general principles. However, gifts given on particular occasions may be exempt if their value is not greater than what is the normal practice.
	Exemptions, credits and allowances	
	• An individual may deduct certain assets from his taxable assets. These assets include deposits in resident banks and depository institutions, certain debt instruments and shares up to a certain maximum. • The assets so deducted may not exceed the total liabilities, and provided the assets are not related to a business or an independent economic activity. • Holdings of government savings bonds, up to ISK 2 million for individuals (double that for couples) may be deducted from assets. This exception ends in 2001.	• Exemptions apply to inheritances to a spouse or a cohabitant and charitable organisations.
	Rates	
• The amount of real estate tax varies, depending on the municipality.	• The rate of the net worth tax is 1.25 per cent and that of extraordinary net worth tax 0.25 per cent	• The rate of tax depends on the amount of inheritance and the relation between the deceased and the beneficiary. The lowest rate being 5 per cent (for children) and the highest 45 per cent.

Source: Ministry of Finance.

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