REFORMING ICELAND'S FISCAL FRAMEWORK

Gunnar Gunnarsson[*]

After being struck by a financial crisis of unprecedented scale, in October 2008, the Icelandic government was faced with a tripling of gross government debt and large budget deficit. Expectations of sustainable government finances became unanchored. A fiscal consolidation effort amounting to more than 10 per cent of GDP was required to reestablish the sustainability of government finances. The deficit bias of the budget framework was widely recognised in the years before the crisis and to ensure the success of the consolidation effort, the fiscal framework needed reforming. With technical assistance from IMF's Fiscal Affairs Department, a reform schedule was laid out for the budget frameworks at the national and the sub-national level. The reforms on the sub-national level are quite extensive and will take the framework from being among the laxest in Europe to one of the more progressive ones. Two new fiscal rules with statutory base will be applied in a multi-year budgeting framework that is subject to external financial oversight. External enforcement through sanctions following the principle of earned autonomy is to ensure compliance with the rules. The sub-national budget framework will be enshrined into law. The reforms to the national budget framework are also extensive but are not nearly as progressive. Medium-term fiscal and expenditure frameworks are established with three fiscal rules or objectives, with one of them still being only an interim one. The top-down sequencing of budget formulation and approval is improved upon and budget execution, importantly, is improved in several respects. What the national level reform lacks is a statutory base for the reformed framework in what could be regarded as progressive fiscal responsibility laws. Also lacking is an external body like an independent fiscal council that monitors and assesses fiscal policy. The national reforms are thus less progressive than they could be. IMF has served as an external monitoring body with its reviews under the Stand-by Arrangement with the Icelandic government. Whether or not the post-crisis fiscal discipline exerted by the Government is only an IMF imposed discipline will have to be seen. But if so imposed then there is high risk that the national framework will regress back to pre-crisis status as soon as external monitoring ceases.

1 Introduction

In the first week of October 2008, Iceland's three major banks, representing 90 per cent of Iceland's banking system in terms of total assets, collapsed. The banks' large foreign currency balance sheets and their size relative to their home base proved a key vulnerability that contributed to their demise in the conditions that arose in the autumn of 2008. Prior to the banks' collapse, their balance sheets had expanded to almost 11 times GDP, with the foreign currency part amounting to ⅔ of that total, or almost 7 times GDP.

The Icelandic economy was already on its way into recession when the banks collapsed as a consequence of the subsiding of the huge macroeconomic imbalances that had built up in the economy during the upswing. Furthermore, a currency crisis had hit several months before the banks collapsed, with the króna depreciating by 40 per cent since the beginning of the year.

[*] Economist, Economics Department, Central Bank of Iceland. E-mail: gunnar.gunnarsson@sedlabanki.is

The author would like thank the following colleagues at the Central Bank of Iceland for helpful comments: Anna Benassi, Ásgeir Daníelsson, Bjarni G. Einarsson, Gudjón Emilsson, Hördur Gardarsson, Ólafur G. Halldórsson, Markús Möller and Rannveig Sigurdardóttir. Also, thanks to those who commented on the paper at the 13th Banca d'Italia Workshop on Public Finance, Perugia, 31 March-2 April 2011.

The views expressed herein are those of the author and do not necessarily reflect those of the Central Bank of Iceland.

Following the banks' collapse, the depreciation of the króna continued until capital controls were introduced at the end of November. All in all, the króna depreciated by roughly 50 per cent in 2008, both in trade-weighted terms and against the euro.

With the collapse of the three banks, foreign creditors incurred massive losses, as did the Central Bank of Iceland (CBI) and the Treasury. The sustainability of government finances immediately came into question. The budget balance of the central government went from a surplus of 3.9 per cent in 2007 to a deficit of 13 per cent of GDP in 2008, a reversal amounting to 16.9 per cent[1] of GDP.

Currency reserves had to be increased drastically to stabilise the currency and to prevent sovereign default; thus the government was in urgent need of new foreign funding. At the end of October 2008, the Icelandic government reached an agreement with the International Monetary Fund (IMF) on an economic stabilisation programme, under a two-year Stand-by Arrangement supported by a loan of 2.1 billion US dollars. The Stand-by Arrangement also gave the economic programme increased credibility. The agreement was followed by bilateral loan commitments from other European neighbours.

The three newly established state-owned banks took over domestic activities of the three old banks and needed to be re-capitalised, as did the CBI, which had lost financial assets worth nearly 22 per cent of GDP on collateralised lending to the collapsed banks. The re-capitalisation and the financing of the deficit drastically elevated the gross government debt level.

From 2007 to 2011, general government gross debt rose from 28 per cent of GDP to an estimated peak of 100 per cent of GDP, and the CBI's gross debt rose from 4 per cent of GDP to an estimated peak of 25 per cent of GDP. This increase, however, was due not only to losses on financial assets and deficit spending; it is also attributed to acquisition of financial assets in the form of currency reserves and bank equity amounting to 55 per cent of GDP, leaving net debt to increase by 44 per cent of GDP.

The fiscal impact of all this on the government balance sheet was substantial and, with the budget deficit reaching high single digits as a share of GDP, government finances would have been unsustainable if no action had been taken to return the budget to surplus. To ensure the sustainability of government finances, the Stand-by Arrangement with the IMF required the implementation of fiscal consolidation in excess of 10 per cent of GDP from the fiscal year 2010 to the fiscal year 2013.

Weaknesses in the procedures and controls of the budget cycle had become clear in the pre-crisis years and were most evident in lax budget execution. Therefore, a critical component of the Stand-by Arrangement was a reform of the fiscal framework to ensure successful implementation of the consolidation effort. The government has committed itself to implement a majority of the recommendations made by the IMF in Letters of Intent (LOI) to the Fund's Executive Board. As of May 2011, when more than half of the front-loaded programme schedule has passed, both fiscal consolidation and fiscal framework reforms are broadly on track.

In the years prior to the financial crisis,[2] both the IMF and OECD missions to Iceland had pointed out that the fiscal framework needed stronger reform. Here strength encompasses factors such as (1) the statutory base of fiscal rules, procedures and controls (2-3), the nature of the bodies charged with monitoring and enforcing the rules, (4) enforcement mechanisms and (5) media

[1] Reinhart and Rogoff (2009) report the largest fiscal balance reversals following financial crises. The reversals show the change in central government deficit from a year before the crisis to the peak deficit in following years. At the top of the list is Sweden (1991), with a reversal of 15.4 per cent of GDP, and Finland (1991), with 11.8 per cent (p. 231).

[2] See, for example, IMF, Working Paper No. WP/07/235, October 2007; "Strengthening the Fiscal Framework", in OECD Economic Survey: *Iceland*, Chapter 3, Vol. 2008/3, February 2008.

visibility of the rules. But the necessary political constituency required to implement the reforms recommended had not been formed.

The last decade's robust economic growth gave rise to unexpectedly strong tax revenues. Additionally, revenues from the privatisation programme carried out from 1998 to 2005 amounted to 15 per cent of GDP. Repeated surpluses despite expenditure overruns and a strengthening balance sheet masked the deficit bias of the budget framework. The government was under little pressure to consolidate. The weaknesses with regard to expenditures were clear to most, but there were also latent weaknesses on the revenue side. At the time, the Icelandic sovereign was highly rated by rating agencies and by credit markets, as many believed that the strong fiscal position rested on strong fundamentals. Many internal and external observers alike regarded Iceland as a model of economic reform characterised by tax cuts, privatisation and free markets.

The revenue buoyancy, however, was predominantly the product of positive balance sheet effects generated by a credit-driven asset bubble. The result was a consumption boom that greatly amplified the pro-cyclicality of tax revenue elasticity. Underestimation of that elasticity resulted in an overestimation of the structural balance, as the cyclical component of revenues was underestimated. Real-time estimation of elasticity is always difficult, especially in the presence of strong balance sheet effects, but with the benefit of hindsight, the extent of the increase in elasticity became clear. As balance sheet effects have now turned negative, expenditure overruns are now a "luxury" that Iceland can no longer afford.

The fiscal framework was reformed in 1992 with the adoption of top-down "frame budgeting" to enhance the policy-making role of the government and to increase fiscal discipline. The frame budgeting was initially only set for the next fiscal year. Although that was a great improvement, it failed to curb the tendency towards expenditure drift. In 2003, the frame budgeting framework was extended to include medium-term plans, setting four-year revenue and expenditure projections and frames for expenditure growth in real terms. Regrettably, it turned out to be more of a forecasting exercise that served only an illustrative purpose. Also adopted in 2003 was a numerical fiscal rule that stipulated that central government public consumption may not grow by more than 2 per cent per year in real terms and that real transfers may not grow by more than 2.5 per cent. This real expenditure growth rule failed miserably, perhaps not surprisingly, as the framework around it was weak. On the five-parameter strength list enumerated above, the framework of the rule scores almost no points.

Political economy factors in Iceland are not markedly different from other countries. The political economy's bias towards expenditure growth and pro-cyclicality of that growth can be explained to a large extent by the common pool problem. A majority of ministers saw revenue windfalls as common property that feed through to higher spending and tax cuts. These increased appropriations and tax cuts always prove difficult to reverse when the economic cycle turns. The main goal of strong fiscal frameworks is to improve the processes and controls of the budget framework so that the common pool externality can be internalised. Iceland is a commitment-type country,[3] and reforms made to the fiscal framework in EU countries of this type over the past two decades have focused on making fiscal rules more stringent and on establishing fiscal councils or committees that are used, for example, to supply independent forecasts and assess fiscal policy (Hallerberg *et al.*, 2004; Annett, 2007).

Having a strong budget framework with regard to formulation, approval and execution of the budget and reporting of budget positions is at the heart of the fiscal framework and is a prerequisite for the success of national and sub-national fiscal rules. Both the OECD and the IMF have

[3] A country is of the commitment type when different political parties forming a coalition negotiate on a fiscal contract by setting budget targets. The threat of breaking up the government serves as the main enforcement mechanism.

provided instructive reform recommendations to the government. After the crisis and in the context of the Stand-by Arrangement, the IMF has been instrumental in conveying both what the literature says on fiscal framework design and what the experience has been. Budget frameworks that have proven successful in introducing fiscal discipline of the central government most often include three elements that all work in combination. The elements are (1) a medium-term fiscal framework, (2) a medium-term expenditure framework and (3) a top-down approach to budgeting. This should call for a revision of the legal framework as regards the statutory basis for rule-based processes and controls.

Local governments and the central government have reached an agreement about the adoption of sub-national fiscal rules. There is also an agreement on formal procedures in the coordination of general government fiscal policy. The sub-national fiscal rules are two: (1) a three-year rolling balanced budget requirement and (2) a debt ceiling. There are penalties for violating the rules, which are enforced by the Municipal Fiscal Oversight Committee (MFOC). The fiscal rules, the penalties, and their enforcement are to be enshrined in law by June 2011.

At the national level, there is now an interim general government budget balance rule or objective, as well as a debt level ceiling. But in addition to those two rules, central government now has a fixed two-year nominal expenditure ceiling rule that replaces the pre-crisis real expenditure growth rule. Inflation and output volatility are greater in Iceland than in most other countries, so an important factor to consider is the counter-cyclicality of fiscal policy. Nominal ceilings on expenditures add to the counter-cyclicality of fiscal policy because real expenditures decline in periods of unexpectedly high inflation.

Iceland is currently engaged in accession negotiations with the European Union (EU), with the aim of first joining the EU and ultimately joining the European Monetary Union (EMU). The aim is to put the contract to a referendum. If the *yes* vote wins, Iceland hopes to be fast-tracked into the EU, as it is already a member European Economic Area (EEA). This would require that Iceland adopt the supranational numerical fiscal rules stipulated in the Stability Growth Pact (SGP) and the Maastricht treaty. When the consolidation phase is completed in 2013, Iceland will be in a good position to adopt the supranational fiscal rules.

While no formal governmental policy statement regarding the adoption of fiscal responsibility laws (FRLs) enshrining the entire fiscal framework has been issued, the government has made a formal statement declaring that the Ministry of Finance (MoF) is to dramatically increase its reporting and accountability to the Parliament. This is at the centre of FRL objectives, in addition to elevating rules, procedures and controls to a statutory base. But progressive FRLs are very unlikely to result, and this may prove to be a major weakness.

Iceland's ministers and members of Parliament are still at the early stages in debating the merits of creating an independent fiscal council. The topic has not been put on the government's agenda.

This paper is structured as follows. Section 2 reviews the conduct of fiscal policy in the years leading up to the crisis. Section 3 identifies the major weaknesses that became evident in the pre-crisis period. Section 4 lists the recommended reforms and describes how they have been adopted. Section 5 discusses what is missing from the reform agenda and describes the merits of fiscal councils. Section 6 contains the conclusion.

2 The pre-crisis fiscal policy experience in Iceland

In the months before the financial crisis, the Icelandic sovereign was still highly rated by rating agencies, as it had been for many years. Owing to a strong fiscal position compared to other European countries, fiscal policy was – despite some criticism – regarded as broadly prudent.

Iceland's fiscal position owed its strength primarily to two factors. First, as a result of its privatisation programme, assets worth approximately 15 per cent of 2009 GDP were sold. The proceeds of privatisation were allocated towards reducing government debt and government-funded pension liabilities and building up a cushion of deposits in the CBI amounting to over 10 per cent of GDP. Second, during the boom years, the central government was run with a substantial surplus, as revenues repeatedly exceeded both the MoF's and external observers' projections. As a result, central government net debt declined from roughly ⅓ of GDP in the mid-nineties to zero in the years before the crisis.

Record surpluses generated by revenue buoyancy caused politicians to turn a blind eye to the need to rectify the deficit bias of the budget framework. The Icelandic National Audit Office (INAO) repeatedly reported on spending overruns relative to budgeted values.[4] Despite existing regulations, ministries and agencies frequently overspent their budgets with few repercussions. The counter-cyclicality of fiscal policy, however, was dependent on firm execution of the budget while allowing automatic stabilisers to play their role. The full effect of automatic stabilisation was never realised, as tax rates were discretionarily lowered. However, despite tax cuts and spending overruns, budget surpluses were larger than ever, complicating the debate on the overall fiscal policy stance.

But what was the source of the revenue buoyancy? The pro-cyclical response of tax revenues to the change in real activity was greater than could be expected unless revenue elasticity changed in a pro-cyclical manner at the same time. Estimating the cyclical component of revenues at fixed elasticity would lead to an overestimation of the structural balance. Estimating elasticity in real time is difficult, especially when the source of the pro-cyclicality is, to a large extent, positive balance sheet effects. Morris and Schuknecht (2007) found strong asset price effects on revenue elasticity in Europe; more specifically, they found that a 10 per cent increase in asset prices added half a per cent of GDP to revenues. Earlier, Jaeger and Schuknecht (2004) had found that, in a European context, the cyclical responsiveness of the budget balance doubles in asset price-driven economic cycles. These effects are quite substantial and were undoubtedly prominent in Iceland as well in the pre-crisis boom years.

The appreciation of asset prices in Iceland was sizable. House prices rose by 75 per cent from 2004 to 2008, and stock prices rose by 150 per cent. The asset price-driven real growth, which was fuelled by massive credit expansion, led to a consumption boom. Consumption as a percentage of potential output rose from 53 per cent in Q1/2002 to 66 per cent in Q4/2005. In addition to value-added tax revenues, a large share of consumption consisted of imports subject to excises, as the real exchange rate had risen substantially. Because the ratio of indirect taxes relative to direct taxes was among the highest in Europe, this consumption boom helped produce record tax revenues. But there was also a credit-driven boom in income, which caused direct taxes to jump to record levels as well.

Research shows that there was a much stronger relationship between the private consumption ratio of potential output and total tax revenues than between the output gap and total tax revenues.[5] So, with the change in consumption ratio of potential output being greater than the change in output

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4 A number of INAO reports touch on this subject: most recently, for example, Implementation of the 2007 Government Budget and Annual Plan for 2008, INAO May 2008. See also Suppanz, H. (2003), "Controlling Public spending in Iceland", OECD, Economics Department, Working Paper, No. 360, June, and "Strengthening the Fiscal Framework", in OECD Economic Survey: *Iceland*, Chapter 3, Vol. 2008/3, February 2008.

5 A regression model of differenced total tax revenue (Δtax) on a constant plus the differenced consumption ratio of potential output (Δc_ratio) and the output gap (*gap*) shows that the *c_ratio* is highly significant, while the gap is not, at the 5 per cent significance level.

$$\Delta tax = 0.022 + 0.558\,\Delta c\_ratio - 0.194\,gap;\ R\text{-squared is } 0.53$$

$$\begin{array}{llll} t\text{-stat:} & (5.80) & (9.36) & (-1.84) \\ \text{Prob.:} & (0.000) & (0.000) & (0.0689) \end{array}$$

gap, tax revenue elasticity turned highly pro-cyclical with respect to the output gap. The elasticity of tax revenues relative to the output gap thus jumped in a highly pro-cyclical fashion.

During the boom years, many argued that the source of revenue buoyancy rested on strong fundamentals of positive supply-side effects of tax cuts in preceding years and the structural reform of the economy. But even though this may have played a part, the main source of revenue buoyancy was the positive balance sheet effects from a credit-driven asset price boom. The cyclical component of the tax base caused by these effects was underestimated, leading to an overestimation of the structural balance and to the belief that the fundamentals of the budget balance were stronger than they actually were.

In the boom years, there was a pro-cyclical stance on the expenditure side that was mostly driven by fundamentals explained by political economy factors. An upward drift in expenditure was caused by a combination of spending overruns, in-year discretionary initiatives, and excessive reliance on supplementary budgets. Insufficient spending discipline can also be found, in that frame budgeting was not extended to cover binding multi-year budgeting, which would, for example, help address the problem of expenditure base drift. Medium-term plans existed, but they were not discussed in Parliament and were often taken as a projection exercise by the MoF that served an illustrative purpose rather than existing as a firm budget. The budget framework did not hold.

Annett (2007) examined the cyclical properties of the expenditure side in Iceland during the period 1980-2005. Following Lane (2003), the log differenced government expenditure items were regressed on a constant plus a log differenced real GDP on a country-by-country basis. The expenditure variables are translated into constant prices using the GDP deflator. The results are reported in Table 1, where a positive value signals pro-cyclicality. The results show that Iceland's expenditure side is more pro-cyclical than the EU average, except with regard to non-wage consumption. Government wage consumption and transfers have the greatest effect on the policy stance.

Government transfers are highly pro-cyclical in Iceland, while they are intuitively counter-cyclical on average in the EU; the same applies to the government wage bill, which is much more pro-cyclical than in the EU. This indicates that the budget cycle – the execution in particular – is subject to politically motivated expenditure pressures. Government employees and transfer recipients have well-represented constituencies, while non-wage government consumption, the only counter-cyclical expenditure item, has a weak constituency. Thus the common pool problem has been unchecked to some extent in Iceland. Annett (2007) finds, in data from the World Bank, three proxy measures of the intensity of common pool pressures. First, the data show that Iceland's government fractionalisation,[6] a measure of divisions within the government, is high or 0.52 compared to the EU average of 0.30. Second, Iceland's legislative fractionalisation,[7] a measure of divisions within the legislature, is somewhat higher or 0.76 compared to the EU average of 0.69. Most often there is a strong government majority in Iceland, which boosts the value of becoming part of the governing coalition, increasing the potential for politically motivated distortions in fiscal policy. Iceland's coefficient for government majority[8] is 0.64, while the EU average is 0.55. Thus the need to internalise the externalities of the common pool problem is greater in Iceland than in most EU countries. Tying politicians to the mast by reforming the fiscal framework is vital in order to anchor expectations of the sustainability of government finances.

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[6] The probability that two members of Parliament drawn at random from governing coalition members will be from the same political party.

[7] The probability that two members of Parliament drawn at random from the legislature will be from the same political party.

[8] The fraction of seats held in Parliament by the government.

Table 1

Regression-based Cyclicality Coefficients: International Comparison

	Total Expenditure	Primary Current Expenditure	Wage Government Consumption	Non-wage Government Consumption	Government Transfers	Government Investment
Iceland	**0.40**	**0.58**	**1.38**	**–0.31**	**0.60**	**1.51**
Austria	0.16	0.17	0.59	–0.02	–1.18	0.48
Belgium	–0.37	–0.13	0.37	–0.06	–0.22	1.28
Denmark	–0.60	–0.44	–0.36	–0.50	–0.53	1.04
Finland	–0.67	–0.55	–0.05	0.26	–1.39	1.06
France	–0.33	–0.63	–0.30	–0.72	–0.05	1.75
Germany	0.69	0.79	0.39	0.50	–0.52	2.00
Greece	–0.17	0.18	0.86	–0.90	0.16	1.47
Ireland	0.17	0.05	0.24	0.98	–2.53	2.41
Italy	0.32	0.25	0.65	0.41	–0.18	1.04
Netherlands	–0.20	–0.13	0.04	0.05	–0.21	0.75
Portugal	0.83	0.77	1.53	0.83	0.61	2.22
Spain	–0.48	0.08	0.40	0.08	–0.27	0.65
Sweden	–0.54	–0.08	0.29	–0.31	–0.59	1.37
UK	–0.70	–0.66	–0.23	0.06	–2.73	1.58
EU mean	**–0.14**	**–0.02**	**0.32**	**0.05**	**–0.69**	**1.36**
EU standard dev.	0.50	0.46	0.51	0.54	0.96	0.58

Source: Table 3 in Annett (2007).

3 Weaknesses in the pre-crisis fiscal framework

3.1 The consumption rule failed

Perhaps the best evidence of the weakness of the pre-crisis fiscal budget framework is the way in which the numerical fiscal expenditure rule adopted in 2003 was honoured. The rule stated that real growth of public consumption should not exceed 2 per cent per year. It came close in 2004, the first year the rule was in effect, when it grew by 2.1 per cent, but after that the growth rate kept increasing each year (see Table 2) until, in 2008, it was completely off the mark, growing at 3.7 per cent.

There were two factors contributing to the failure of the rule. First, the budget framework from formulation to execution was too lax. There were many weaknesses that had been identified by both internal and external observers such as the INAO, OECD and IMF mission teams. Second, the framework of the rule itself was extremely weak. The rule had no statutory foundation; no one outside of the MoF was in charge of monitoring and enforcing it. Those in charge of budget formulation and execution within the MoF were also responsible for monitoring and enforcing the rule. There was no formal reporting requirement to Parliament if the rule was violated, and no extra enforcement or control mechanism was available. Last but not least, media visibility of the rule was

Table 2

Real Growth of Public Consumption and Transfer Payments

	2003	2004	2005	2006	2007	2008	2009
Treasury and social security	2.7	2.1	2.7	2.7	3.2	3.7	–0.7
Local governments	1.2	0.1	5.1	6.4	5.7	6.2	–3.7
General government	1.8	2.2	3.5	4.0	4.1	4.6	–1.7
Transfer payments	5.9	–7.3	1.6	–3.2	7.0	517.4	–79.4

Source: Statistics Iceland.

virtually non-existent. Educating the public and the media about the merits and purpose of the rule was not a priority when the rule was adopted, and consequently, it actually functioned more like an internal rule of the MoF. As a result, violations of this firm numerical fiscal rule received little or no media attention, and not even the political opposition in Parliament made an attempt to enforce the rule by, for example, "naming and shaming". They had no appetite for playing the role of enforcer of the rule. Instead, they even proposed stepping up spending of windfall revenues, as most opposition politicians do.

3.2 Transfer growth held

But the public consumption overshooting is not the whole story as the expenditure fiscal rule also stated that the real growth of transfer payments should not exceed 2.5 per cent each year. This part of the rule did hold on average between 2004 and 2007 (see Table 2). To what extent that can be credited to the fact that transfers payments generally go down during economic booms is not explored here but this rule should ideally be applied to cyclically-adjusted transfer payments or be averaged over a long period of time to see if it holds. Year-by-year growth can fluctuate too much. This can be seen in that transfers skyrocket in 2008 because of the financial crisis as massive transfers to for example the CBI were realised.

3.3 The beginning of the framework: 1992 – frame budgeting

Returning to the weaknesses of the budget framework, it would be best to begin by providing some background information so as to foster a fuller understanding of how the budget framework has progressed in the last two decades while needed reforms are identified. With the aim of enhancing the control and effectiveness of public spending, the fiscal framework has undergone substantial changes since the beginning of the 1990s.

In 1992, in line with fiscal framework reforms in other Nordic countries, a frame-budgeting approach was introduced. A top-down orientation to fiscal policy was adopted which served the purpose of emphasising the policy-making role of the government and increasing overall fiscal discipline. Each year, early on in the budget formulation phase, expenditure frames or ceilings for the following year were to be set for each ministry by a special cabinet committee, led by the prime minister. Each minister was then held responsible for appropriating the allocated funds to the ministry's agencies and projects. Each October, the budget is presented to Parliament for amendment and approval.

In 1997 the Government Financial Reporting and State Guarantee Acts were passed into law with the aim of improving the quality of information by shifting from traditional cash to modified accrual budgeting, accounting, and reporting.

In 2003 the frame-budgeting arrangement was amended by introducing frames for expenditure growth in real terms. At the same time, the numerical expenditure rule discussed above was adopted. The MoF also began presenting a medium-term plan by publishing four-year revenue and expenditure projections. These projections were not binding cabinet-approved four-year expenditure frames.

3.4 *Auto-acceptance of spending overruns*

The INAO and the technical assistance missions from the OECD and IMF have identified and reported on the main weaknesses in the budget framework. At the heart of it, many find that the national budget lacks credibility because its legitimacy is undermined by extensive use of supplementary budgets. Operational spending overruns and discretionary spending decisions are routinely legitimised *ex post* by supplementary budgets. Furthermore, agencies can borrow from future appropriations, creating an upward drift bias. Budget transparency and discipline are further jeopardised by earmarking of revenue and allowances for carryovers of unspent appropriations to the next year.

The decentralised public finance management (PFM) system adopted in 1992 did not have proper checks and balances, nor did it provide for sanctions for non-compliance with rules on budget execution and control. This has contributed to spending overruns.

Overspending against published medium-term expenditure projections had consistently been very high since the projections were introduced in 2003. Upward expenditure base slippage results when each annual budget presents an update of the previous medium-term plan starting from a higher level. The fact that the medium-term plan is the MoF's projection rather than a commitment and that it is not the result of bottom-up aggregation of spending agencies' long-term budget plans matched by top-down political engagement makes it ill-suited to ensure multi-year expenditure discipline and fiscal sustainability. The medium-term fiscal framework must be integrated with the budget cycle itself rather than being an extension of it.

Better definitions of the relative roles and responsibilities of key actors in the budgeting cycle are needed. Budget formulation lacks discipline, and the legal framework needs revision. Importantly, the INAO's reports should be taken more seriously, and recommendations should be acted upon more aggressively by Parliament and the MoF.

3.5 *Weaknesses at the local government level*

There are two levels of government in Iceland. Local government expenditure amounts to 14 per cent of GDP in 2009, while central government expenditure amounts to 38 per cent of GDP in the same year. There are 78 municipalities, 30 of which have fewer than 500 inhabitants. They have a high degree of autonomy regarding their spending, which often translates into weak fiscal policy coordination between the two levels of government. In the boom years leading to the crisis, local governments let their spending rise in tandem with buoyant revenues to a great extent. Over the 2004-2008 period, local government public consumption increased by an average of 4.7 per cent per year in real terms, or at a rate of growth 60 per cent higher than that of the central government. With local government expenditure constituting nearly one-third of general government expenditure, this had a noticeable effect on the overall general government fiscal stance.

Many municipalities were running deficits even in the boom years, as they were not subject to a firm deficit rule or to a limit on their borrowing. However, the Local Government Act from 1998 contains a weakly phrased balanced budget requirement stipulating that municipalities' revenues should match expenditure *as far as possible*. Phrasing the restriction so loosely renders it ineffective, as was evidenced by lax budget formulation and execution on the part of many municipalities. Furthermore, many municipalities do not view the required three-year budget plan as binding, which weakens the medium-term fiscal framework. When fiscal discipline was found lacking, few sanctions for non-compliance were available short of a takeover by the central government in the case of a municipality's imminent default on debt. Municipal finances need to be subject to closer scrutiny from an independent external body.

4 Reforms to the fiscal framework

The fiscal impact of the financial crisis and the size of the necessary fiscal consolidation that followed helped to build the political constituency required to implement the reforms recommended, in the context of the Stand-by Arrangement, by the IMF's Fiscal Affairs Department (FAD) in January 2009.[9] Recommended reforms emphasised the need to reform the budget framework. The budget framework must strike a balance between achieving broad political representation and maintaining fiscal discipline. Importantly, the aim is not to depoliticise fiscal appropriations but rather to subject politicians to fiscal discipline when they are prioritising appropriations according to their political agenda.

In IMF's Stand-by Arrangement with the Icelandic authorities, a proposed reform schedule was laid out. The reforms were to be front-loaded. The reforms are broadly on track but have not yet been fully adopted as only two budget cycles out of four under the Stand-by Arrangement have passed. The reform recommendations can be divided into six categories. The full adoption of three of them has already been agreed upon and one of them is in the process of being passed into law with minimal political opposition. In the other three categories some progress has been made. Some reform recommendations will not be fully adopted but there are still some reforms scheduled for adoption or are being considered for adoption in the 2012 budget cycle.

The six categories are listed below. The first three concern reforms at the national level, and the next two concern reforms at the sub-national level and the coordination between the two levels of government. The last category concerns the legal framework regarding the statutory foundation of the rule-based processes and controls of the fiscal framework.

A) A medium-term budget framework (adopted)

It integrates and quantifies fiscal objectives and rules into a binding multi-year budget that sets out the medium-term fiscal path. Three fiscal rules are adopted:

- a budget balance rule or objective (still interim),
- a debt level ceiling rule, and
- fixed two-year nominal expenditure ceilings.

The medium-term budget framework is to provide a medium- to long-term anchor or an objective for government finances.

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9 A technical assistance mission from the IMF's Fiscal Affairs Department visited Iceland in January 2009 in the context of the IMF-supported Stand-by Arrangement. The mission comprised Messrs. Cangiano (head), Hughes (both FAD), and Balassone and Molander (both experts from the FAD panel).

B) *Top-down formulation and approval of budget (partly adopted)*

Budget formulation and approval should strictly follow a top-down approach. The budget cycle begins with macro-level discussion that decides on the budget balance in accordance with fiscal rules and objectives. This translates into a decision on how total revenues and total expenditures should evolve. After the ceilings on expenditures have been established, the formulation of the budget on individual appropriations basis can begin. Appropriations must be prioritised, with individual appropriations subject to change or cancellation.

C) *Budget execution and controls (mostly adopted)*

More stringent supervision of budget execution through various means with an emphasis on restricting the practice of legitimising spending overruns after the fact.

D) *Local governments restricted to a rule-based fiscal policy (adopted)*

Municipalities are prohibited from running operating deficits over a rolling three-year-period.

A debt-to-revenue ceiling of 150 per cent is to be introduced.

Sanctions ranging from mild to severe can be applied to a non-compliant municipality.

E) *Coordination between central and local governments (adopted)*

A high-level committee comprising at least three ministers (including the Minister of Finance and Minister of Local Governments) and three representatives of local government (including the mayor of Reykjavík, the capital) is to be formed. It will meet at least three times a year. A lower-level sub-committee will meet more frequently throughout the year and report on fiscal matters to the high-level committee.

F) *The legal framework (partly adopted)*

Procedures on how Parliament discusses and approves the budget in a top-down manner should be established in a standing order for Parliament. Amendments to the 1997 Budget Act with provisions describing the top-down sequence of formulating the budget are needed. There should also be a formalised procedure of processing audit reports to Parliament. The statutory foundation for the three fiscal rules should be established. Regrettably, at present it seems that the government is going to contend with governmental statements rather than adding to the current FRLs when it comes to the national budget framework. The Local Government Act of 1998 will be amended to provide a legal framework for the sub-national budget framework.

Below is a more detailed discussion of the reforms adopted in these six categories.

A) *Medium-term budget framework*

Firm formulation, approval, and execution of the budget are a prerequisite for successful rule-based fiscal policy. A medium-term perspective is of the essence. A large part of the IMF economic programme has been to budget for the recovery of government finances. In preparing the multi-year budgets, the budget process has been a combination of the following:

1) *a medium-term fiscal framework (MTFF)* that serves the purpose of anchoring long-term objectives by providing a medium-term rule for fiscal policy that lays out the fiscal path that lines up with the long-term rule;
2) *a medium-term expenditure framework (MTEF)* that, through multi-year expenditure ceilings/frames, quantifies the path towards the fiscal objectives of the government; and
3) *a top-down approach* to budgeting that integrates the MTEF ceilings into the formulation and approval of the annual budget. The top-down approach is the topic of the next section, but is listed here because of how closely these three factors work together in combination.

Iceland's fiscal framework proved not to be a binding restraint on fiscal policy decisions in the pre-crisis period, and it would have been a poor guide out of the fiscal crisis, given the fiscal consolidation needed. Comparison with fiscal frameworks in other countries that have been successful in meeting their goals revealed several important flaws in the Icelandic framework. The main reforms needed regarding the medium-term budget framework are:

- first, a stable fiscal sustainability-type long-term anchor for fiscal policy, such as a ceiling for government debt as a percentage of GDP;
- second, a medium-term rule to ensure that the fiscal policy stance is counter-cyclical and the budget balance is such that the long-term anchor of fiscal policy holds. A medium-term rule like this should provide the necessary fiscal discipline but should be as simple and clear as possible and provide the flexibility to deal with economic cyclicality;
- third, the annual budget should include a multi-year binding cabinet commitment integrated into both budget cycle formulation and approval. Medium-term fiscal policy expectations should be based on a binding multi-year budget. Committing to next year's budget only is not sufficient;
- fourth, there is a need for a transparent agreement on how much headroom to build into the budget so as to ensure that the medium-term rule is met even in the case of adverse fiscal shocks;
- fifth, it should be clear how the medium-term rule translates into a medium-term path of total expenditures according to the fixed nominal expenditure ceilings of the MTEF.

To strengthen the medium-term fiscal framework, a binding commitment in four-year budgeting has been adopted, starting with the 2009 budget cycle, that quantifies a medium-term fiscal path honouring the two main objectives or rules of the MTFF. The two main objectives are first of all that government debt should not exceed 60 per cent of GDP by 2020[10] which calls for a declining debt path. Secondly, the general government primary balance is to show a surplus of close to five per cent of GDP in 2013, leaving the overall balance to also be in surplus with a comfortable margin.[11] The fiscal rules are very specific rather than general because they must be both ambitious and stringent enough to support the consolidation effort. The second rule or objective is still only an interim rule that stipulates the primary surplus needed to get the debt level on a sufficiently steep declining path to be consistent with the long-term rule. After the successful completion of fiscal consolidation, Iceland will be in a position to adopt a permanent, more general and perhaps less stringent budget balance rule. No statement has been given about the continuation of the budget balance rule but current fiscal projections predict that the five per cent surplus will hold from 2013 to 2016. For the same reason that the 60 per cent debt ceiling was no accident, the most likely budget balance rule in the future is an EU-type maximum deficit rule of 3 per cent. Preferably complemented with a numerical structural primary surplus rule that accommodates the economic cycle by allowing the automatic fiscal stabilisers to play their role. Both are less stringent than the interim rule currently used.

According to the current cabinet-approved multi-year budget, the interim budget balance objective is to be upheld as stipulated. This means that the general government's primary budget will have gone from a 5.6 per cent surplus in 2007 to a deficit of 6.6 per cent in 2009 and then back into a 5.3 per cent surplus in 2013. This requires quite an effort if implemented successfully and should qualify for fiscal discipline. General government gross debt is expected to peak at

[10] The debt ceiling rule was declared in a governmental policy statement in Febuary 2011. See: http://eng.forsaetisraduneyti.is/media/2020/iceland2020.pdf and http://eng.forsaetisraduneyti.is/iceland2020/

[11] The medium-term rule or objective was set up at the beginning of the consolidation effort in the first LOI (in the Memorandum of Economic and Financial Policies by the authorities of Iceland), see: http://www.imf.org/external/pubs/ft/scr/2009/cr09306.pdf. At the time the debt level was still uncertain but as time passed it turned out more favourably than expected raising demands to lower the primary surplus requirement since the declining debt path would still be steep enough compared to the initial one. So this objective may come under pressure.

100 per cent in 2011, but as early as 2015, gross general government debt is forecast to total 72 per cent of GDP, compared with the 2020 goal of 60 per cent. Successfully restoring the health of the budget and putting the gross debt level on a declining path.

To further ensure the success of the MTFF, it must be complemented by a credible MTEF. Expenditure rules have proven to be great complement to a budget balance rule. This decreases the risk that expenditures will rise, for example, in tandem with unexpectedly buoyant revenues. By setting expenditure ceilings in nominal terms in a medium-term perspective, line ministries and agencies know better what to expect with regard to budgeting. It encourages longer-term ministerial budgeting that translates into agencies' adopting longer-term budgeting as well. This, coupled with stringent execution of the budget, enforces medium-term expenditure discipline. To minimise uncertainties regarding the nominal budget, expenditure ceilings are to be set in nominal rather than real terms, so that changes in inflation do not lead to revisions of targets. This keeps the MTEF transparent and relieves monitoring of the rules from the problem of having to estimate the deflator. Also, nominal rules are beneficial if economic stabilisation is a goal because unexpectedly high inflation leads directly to lower real expenditure in a counter-cyclical fashion. The expenditure rule should cover as much expenditure as possible, and the list of irregular items excluded from the expenditure ceiling should be limited to highly irregular and non-discretionary items only. Still, it will always be necessary to set escape clauses.

Therefore in addition to the two fiscal rules of the MTFF, a medium-term expenditure rule that fixes expenditures below a two-year nominal ceiling has been adopted. The expenditure ceiling covers ¾ of total expenditure. Items excluded are debt interest, pension liabilities, tax write-offs, capital income taxes, unemployment compensation, and the Municipal Equalization Fund (MEF).[12] Like the budget balance rule of the MTFF, the expenditure rule is not set as a general numerical expenditure growth rule while consolidation is ongoing. It is set as a specific rule that stipulates how much nominal expenditure must be cut to ensure the success of the consolidation effort. As the four-year budget rolls on, the nominal ceilings that are not fixed are updated on a rolling basis from one budget year to the next, so as to eliminate planning surprises. In this way, line ministries are given an early indication of the savings required, if any, to stay within the aggregate expenditure ceiling.

B) Top-down formulation and approval of the budget

Top-down sequencing of budget discussions is of paramount importance in achieving fiscal discipline. Medium-term fiscal policy is set at the macro level using aggregated fiscal data. The success of the medium-term framework requires that bottom-up ministerial input into the budget process is matched by structured top-down political engagement in the frame budgeting process.

The common pool problem is well known when it comes to appropriations. The budget cycle often has more to do with political than economic factors. So can the autonomy of ministers and members of Parliament be restricted? Won't self-interested politicians always find a way to nullify the effectiveness of budget procedures if left to their own devices? International evidence[13] shows that, to a large extent, strong fiscal frameworks are effective in controlling the common pool problem and introducing fiscal discipline.

The budget cycle must start with the cabinet deciding on the medium-term fiscal policy path with respect to the long-term debt ceiling rule, budget balance rule, and two-year nominal expenditure rule. After the cabinet has decided to honour the rules of the medium-term framework

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[12] The purpose of the Municipal Equalization Fund is to equalise differences in economies of scale with regard to size.

[13] See, for example, Alesina and Perotti (1999).

and a multi-year budget plan has been decided on, the IMF FAD recommended that Parliament be given a chance to vote on that plan in order to endorse it. The voting should take place early in the budget cycle; for example, in May. After that, it is up to a strong MoF to enforce the ceilings implied by the agreed four-year fiscal path. The ceilings would then be integrated into the remaining formulation phase by quantifying the cabinet and Parliament's policy discussion. Ministers would prioritise individual appropriations within ministerial frames.

Previously, the multi-year budget frames were generated internally by the MoF, with limited input from the line ministries they were intended to constrain. The lack of bottom-up technical assistance from line ministries was compounded by a lack of top-down political engagement from both cabinet and Parliament in determining binding ministerial medium-term expenditure frames.

In the budget discussion of the 2011 budget cycle, the cabinet followed a top-down sequence. Introduction of a spring budget orientation debate in Parliament, where the cabinet's medium-term fiscal strategy is subject to parliamentary scrutiny and endorsement, is under consideration for the 2012 budget cycle. It is very likely to happen, but the procedure would be that the cabinet reports to Parliament on a medium-term fiscal path to be debated but not voted on. Also under consideration is the adoption of a top-down sequence to budget debating and voting on the annual budget in Parliament.

C) Budget execution and controls

The key objective of any budget execution and control system is to ensure compliance with the budget as approved by Parliament. Apparently, this has not been a priority in Iceland over the last decade, as expenditures exceeded original appropriations by an average of 6 per cent a year from 1998 to 2008. The INAO has repeatedly reported on this, but managers exceeding their appropriations have not been held accountable. This has undermined budget discipline.

In the execution phase of the budget cycle, the dominant role is played by the MoF. At the heart of it, the MoF needs to take a firm stand on how to react to non-compliance and also how to deal with proposals for budget supplements by members of Parliament, and even ministers. Numerous recommendations aimed at improving execution came from the INAO, OECD and IMF FAD mission teams.

On top of the list was the need to restrict the use of supplementary budgets to exceptional situations, so as to halt the legitimisation of spending overruns after the fact. The authorities have acted on this. Since the 2010 budget cycle, supplementary budgets have not been used to address spending overruns or to fund new policies; thus they have remained expenditure-neutral. This is quite a change, as deviations between the budget and outturns in the past reflect entrenched use of supplementary appropriations (Suppanz, 2003; OECD 2006).

This change in supplementation of the budget called for the introduction of a contingency reserve of at least 1 per cent of total expenditure to cope with unforeseen, unavoidable, and non-absorbable pressures arising during budget execution. So far, access to this reserve has been limited to genuine contingencies.

The abolition of borrowing from future appropriations was also essential, as was the need for a quantitative limit on the carry-forward of unspent appropriations from one year to the next. Borrowing from future appropriations was abolished in the 2010 budget cycle, and the carry-forward was limited to 4 per cent of turnover per year, with the maximum total carry-forward set at 10 per cent. Reduction of earmarking of revenue to specific expenditures is under consideration for the 2012 budget cycle.

Real-time monitoring of budget execution is now carried out on a monthly basis instead of a quarterly basis. It is also no longer restricted to MoF staff, as the cabinet and the Parliamentary Budget Committee have been receiving monthly reports on budget execution. This began with the 2010 budget cycle.

D) Local governments restricted to rule-based fiscal policy

Reforms at the sub-national level are quite extensive. First, two numerical fiscal rules are adopted which provide a long-term anchor and a medium-term fiscal path that is quantified in a required multi-year budget. Second, municipalities will be subjected to a three-tiered approach to financial monitoring based on the principle of earned autonomy. Third, there are sanctions, ranging from mild to severe, for violating the fiscal rules. Fourth, there is an independent external body, the MFOC, which has the authority to penalise municipalities that are in breach of the rules.

Thus, in one step, the budget framework of local governments goes from being one of the laxest in Europe to one of the more progressive ones. These reforms are the product of joint work done by representatives from central and local governments, with technical assistance from the IMF FAD. The reforms are not forced upon local governments, as they have come to recognise that the old framework was not sufficiently stringent.

The two fiscal rules are clear and simple, a balanced budget rule and a debt ceiling rule that extend to both A and B sections[14] of the budget. The first rule is that municipalities are prohibited from running operating deficits within a rolling period of three years. This means that the next year's budget balance is a function of both the current and the previous year's budget outcomes. The second rule is that municipalities are subject to a maximum debt-to-revenue ratio of 150 per cent. Municipalities whose debt-to-revenue ratio already exceeds 150 per cent are only allowed to borrow in local currency from the Municipal Credit Iceland (MCI) loan fund. Municipalities whose debt-to-revenue ratio exceeds 250 per cent are only allowed to refinance. A complementary general expenditure growth rule was considered, but differences in the municipalities' growth rates made it impractical; therefore, it was not adopted.

Municipalities will be subjected to a three-tier monitoring where municipalities are classified into one of three categories based on whether, and by how much, they are in breach of the rules. Both the autonomy and the degree of external monitoring to which a municipality is subjected vary depending on its category. A municipality that is not in breach of either rule is in category 1; it has full autonomy within the limits of the rules and is subject to minimum monitoring. A municipality that is in breach of either of the rules is in category 2. It loses autonomy in that a five- to ten-year fiscal adjustment path must be quantified in a MFOC-approved multi-year budget that maps out the return to compliance. A municipality with a debt-to-revenue ratio in excess of 250 per cent is placed in category 3. The same restrictions apply to category 3 municipalities as to those in category 2, but additionally, all major revenue and expenditure decisions including investments must be approved by the MFOC. The municipality has *de facto* lost its autonomy and is only responsible for daily operations.

Further sanctions, ranging from mild to severe, are available to the MFOC in order to enforce compliance. They can "name and shame" violators in public reports, or they can go as far as withholding payments from the MEF.

[14] In the A section are activities operated directly through the the Treasury or Municipal account while in the B section are the operations of government owned companies.

E) Coordination between central and local governments

The coordination between central and local governments in deciding on general government fiscal policy was insufficient in the past. To put these communications in a formal setting that is mutually favourable to both levels of government, a contract has been agreed upon that is soon to be signed. This contract draws from what has been done in other Nordic countries.

A high-level committee that is in charge of the coordination of fiscal policy will be set up. That committee comprises three ministers and three local government representatives. The three ministers are the Minister of Finance, the Minister of Local Governments and the Minister of Economic Affairs; the representatives of local government are the mayor of Reykjavík, the Chairman and the Director of the National Association of Local Authorities (NALA). The committee will meet at least three times a year.

A lower level sub-committee meets much more frequently and reports to the higher-level committee on matters such as the fiscal policy stance, macroeconomic forecasts, and MFOC rulings. Also, various research projects are directed to this committee. This sub-committee, for example, came up with the recommendations that were used in reforming the budget framework of local governments.

F) The legal framework

What will be the statutory base of the reformed rules, procedures and controls, and increased reporting? The numerical expenditure rule introduced in 2003 had no statutory foundation and utterly failed. That should be a lesson learned. Also, the laws must not be weakly phrased and open to interpretation, such as the current *as far as possible* phrasing of the balanced budget requirement in the Local Governments Act.

At present, it is not clear what changes will be made to the legal framework of the national budget. At this point in time, the changes are not likely to be extensive. The revisions will probably be limited to top-down sequencing of budget formulation with amendments to the 1997 Budget Act. A standing order on how Parliament discusses and approves the budget in a top-down manner must also be established when the exact procedures have been decided.

It is not likely, however, that fiscal rules and reporting requirements will be elevated to have a firm statutory base. So instead of adding to the current FRLs, formal governmental statements will probably be the instrument of choice. The existing legal framework is said to be adequate. That, however, does not mean that there is not a case for a progressive FRL-type legislation with laws to regulate fiscal transparency, accountability, and a rule-based fiscal policy aimed at macroeconomic stabilisation. The main argument used against increased legislation is that without cabinet commitment to fiscal discipline, the FRLs may not be sufficient to enforce compliance with fiscal objectives and rules. But although laws alone are not sufficient, they provide agreed main parameters of fiscal policy against which every cabinet can be measured.

Changes to the legal framework for local government finances, on the other hand, are clear and are expected to be passed into law by Parliament late in the spring session. There is little or no political opposition, and the NALA has already agreed to it. The new law will stipulate (1) the fiscal rules to be applied to budgets, (2) the restrictions on municipal borrowing, (3) surveillance modalities, (4) sanctions for non-compliance to the rules, (5) the mechanisms for dealing with revenue volatility, (6) multi-year budgeting, and (7) coordination mechanisms. Thus the law is quite progressive and promises to provide a firm framework around the budget cycle.

5 Fiscal council?

The creation of an independent fiscal council reporting to Parliament is not part of the IMF-supported fiscal framework reform. In the MoF's July 2009 report[15] to Parliament, an invitation was given to widen the scope of the INAO's audits by having it report on the achievement of fiscal policy targets at the end of each budget year. Sadly, such procedures and controls, which are at the centre of progressive FRLs, have still not been adopted.

The establishment of an independent fiscal council would have many benefits, which can be summed up in terms of two factors: depoliticising assumptions made in the budget, and providing external monitoring of fiscal policy. A factor of critical importance is that a fiscal council could help strengthen the top-down approach further by keeping the focus on the medium-term fiscal path, through reporting on whether the budget accords with the fiscal rules and objectives of the medium-term fiscal framework. Optimally, the fiscal framework setup is transparent enough to reward politicians for achieving fiscal objectives and to impose political costs for failing to achieve them. But an independent fiscal council would be of great benefit to the political opposition, the media, and the public – and even the cabinet – by enabling a more effective gauge of the fiscal policy stance and by providing an objective opinion on compliance with the rule-based fiscal framework. Furthermore, it could also serve as an objective body that assesses proposals from members of Parliament and ministers on fiscal matters; for example, by estimating revenue effects of changes to the tax code.

Regarding the source of budget assumptions made then both OECD and IMF missions to Iceland have repeatedly suggested that an independent non-political body should prepare the macroeconomic and tax revenue forecasts on which the budget is based. Depoliticising these forecasts is critical.

Such independent body that would greatly add to Iceland's institutional strength. Regrettably, although under discussion, it is not on the Government's agenda. The fiscal framework reforms are not as progressive as they could be. In the literature, such independent bodies have been shown to contribute to fiscal discipline by acting as arbiters of fiscal policy, especially when they are well respected, credible, and visible in the public debate (European Commission, 2006a; Fabrizio and Mody, 2006). For example, there is evidence within the EU that independent forecasts can eliminate systemic forecast biases that could otherwise feed through to deficit biases (Jonung and Larch, 2004).

Although fiscal consolidation has proven successful so far, partly because of reforms to the budget framework, to some extent it also has been accomplished because of the IMF's role acting as an "independent fiscal body" – an enforcer, as it were. IMF missions prepared reviews under the Stand-by Arrangement where the fiscal policy path was assessed in comparison to fiscal objectives, and if divergence was detected, compliance was enforced through effectively reducing the autonomy of the MoF by threatening to withhold lending. The MoF has thus been subjected to external monitoring of fiscal policy. How the new national budget framework will fare without an external fiscal body such as a fiscal council remains to be seen.

There is considerable risk that the national budget framework will regress back to pre-crisis status because the reformed rules, procedures and controls lack statutory status. The reformed fiscal discipline can be here today and gone tomorrow if commitment to fiscal discipline evaporates. Especially if no external agency has been set up to monitor and gauge fiscal policy as the political opposition cannot be counted on to be an enforcer of fiscal discipline.

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[15] In June 2009 the Minister of Finance submitted a report to Parliament regarding measures to achieve a balance in government finances. The purpose was to report on the goals and measures in government finances that were decided in accordance with the plans under the Stand-by Arrangement with the IMF.

6 Conclusions

Years of revenue buoyancy masked the deficit bias of the pre-crisis budget framework. After the sustainability of government finances came into question, fiscal framework reform was needed to ensure successful completion of the fiscal consolidation effort. The sustainability of government finances will be re-established. The reform agenda called for a rule-based medium-term fiscal framework at both national and sub-national levels.

At both levels of government, budget balance rules and debt level ceilings will be adopted as a part of an MTFF, albeit interim at the national level. Finalising the reforms to the budget framework in general terms in the middle of a consolidation effort is not necessarily the most opportune time (Cottarelli, 2009). Additionally, at the national level a fixed two-year nominal expenditure rule was adopted as a part of an MTEF. The nominal expenditure rule will probably be instrumental to fiscal policy in establishing the medium-term fiscal path. It will serve to curb politically motivated expenditure pressures and increase the counter-cyclicality of fiscal policy where automatic fiscal stabilisers play the leading role. The rules adopted will serve as guides quantifying the medium-term fiscal path in binding multi-year budgets. Multi-year budget formulation has been elevated to a cabinet-approved budget with input from line ministries. In formulating these multi-year budgets, a strict top-down approach has been adopted.

A Parliamentary endorsement procedure where, in a report, the cabinet gives the main parameters of medium-term fiscal policy in a spring session will very likely be adopted in the 2012 budget cycle. This enforces top-down sequencing in setting out the fiscal path. There is a Nordic precedence for such a parliamentary process of endorsing the main parameters of medium-term fiscal policy. Norway's Cabinet Budget Conference (CBC) serves such a purpose successfully.

Budget execution has progressed greatly, as can be seen in increased compliance with the budget. Most of the recommendations given have been adopted while others are still being considered.

The sub-national budget framework is changed in a progressive manner. Fiscal discipline is controlled through an independent MFOC with the authority to enforce the rules by penalising municipalities in breach of the rules by reducing their autonomy and increasing financial monitoring.

The reforms are a big step forward that will likely serve their purpose well in the future. Reforms at the sub-national level are quite extensive, but those at the national level are not nearly as progressive as they could be. Progressive FRLs and the creation of a fiscal council are not on the Government's agenda. The literature has shown that commitment countries like Iceland benefit from rule-based frameworks with external agencies that aid in the entire budget cycle (European Commission, 2006a; Annett, 2006). Belgium and the Netherlands are commitment countries like Iceland, and missions from both the IMF and the OECD have suggested that Iceland emulate their external fiscal agencies.

Thus the fiscal impact of the financial crisis has evidently served us in building the necessary political constituency to implement a somewhat extensive reform of the fiscal framework, but not enough to place Iceland on an equal footing with the most progressive countries in this respect. The conduct of successful fiscal policy always begins and ends with commitment to fiscal discipline. This does not mean, however, that strong progressive fiscal frameworks are not necessary, as international evidence[16] shows that, to a large extent, strong frameworks are effective in controlling the common pool problem and introducing fiscal discipline.

[16] See, for example, Alesina and Perotti (1999).

In the introduction to this paper, five parameters of the strength of a fiscal framework were given as (1) the statutory base of fiscal rules, procedures and controls, (2-3) the nature of the bodies charged with monitoring and enforcing the rules, (4) enforcement mechanism, and (5) media visibility of the rules. The sub-national framework scores high on each parameter. The national framework does not because it lacks progressive FRLs and external monitoring. One had hoped that the 2003 budget framework reforms were a lesson learned, but at present it is not at all clear.

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