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Balancing the Budget:
Budgetary Practices and Fiscal Policy Issues in Iceland 1/

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1/ This paper was prepared for inclusion in a forthcoming issue of Public Budgeting and Finance, as part of a series of articles on budgetary practices and developments in several countries.

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I. Introduction

Like the normative theories of public economy, a large part of the literature on public budgeting generates the uneasy impression that much effort has been misdirected in the pursuit of unattainable goals. Failure to recognize the essentially political nature of public expenditure determination has led to numerous futile attempts at constructing normative theories of budgeting. Less ambitious efforts to introduce major innovations in budgeting procedures have also been unsuccessful because of their failure to take into account the impact of these innovations on established relationships, rooted interests, and sometimes, basic features of the political system. ^{1/} For these reasons, such attempts have failed to provide an operational rule of budgetary policy. In the present state of the social sciences, a different, if more limited, approach would appear to be more rewarding. It would seek to gain better understanding of the complexities of budgetary processes by describing the economic and political environments that influence budgetary practices and by appraising the factors that motivate certain behavior relevant for determining the final shape of the budget. This approach, which is explanatory rather than prescriptive in character, is followed in this paper.

While all budget systems contain certain common features, they are influenced by political, social, and economic factors that are likely to have evolved differently in individual countries and produced national characteristics or peculiarities in budgetary practices. Therefore, in order to avoid repetition in this series of articles, the more common aspects of budgetary practices will be treated only to the extent that is needed to provide a picture of the general budgetary framework. Greater attention will be paid to particular features of the fiscal environment that may have implications for budgetary attitudes and practices. In the present case a traditional attitude, which is common to all political parties, that the budget must be kept in balance irrespective of the overall economic situation will be given special attention because it appears to constitute a major determinant in matters of budgeting and fiscal policy in Iceland.

The paper is organized as follows: Section II analyzes the size and scope of Iceland's public sector and recent developments in major areas and relates these to experience in the international context. Section III describes the legal framework for budgeting and the practical application of constitutional provisions. The budgetary process is also briefly described. Section IV deals with budgetary practices, relationships

^{1/} For an elaboration of a similar view see for example, Aaron Wildavsky, The Politics of the Budgetary Process, Second Edition (Boston and Toronto, 1974), pp. 127-33 and 143-44.

between the legislature and the executive and related considerations relevant for the determination of the budget. Recent changes in budget administration and presentation are also covered in this section. The notion of annual budget balancing is considered in Section V in the more general discussion of the role of the budget in economic policy. In Section VI, the main approaches applied in efforts to constrain the growth of expenditure are accounted for and appraised, with particular attention to inflation budgeting in this context. The final section summarizes the findings and draws some conclusions.

II. Size and Scope of the Public Sector and Recent Developments

1. The government sector

The government sector in Iceland comprises the Central Government, including social security funds, and local governments. The latter consist of 224 municipalities, of which 14 are classified as towns and 210 as rural counties grouped into 23 districts. There is also a fairly large nonfinancial public enterprise sector. The central government sector accounts for about 77 per cent of total government revenue and expenditure and local governments account for most of the remaining 23 per cent, although this portion also includes certain minor activities engaged in by the districts. In recent years, the size of the government sector, as measured by total government expenditure as a proportion of gross national product (GNP), has been about 37 per cent, of which the Central Government accounts for 29 per cent and local governments account for 8 per cent. The budgets of local governments are balanced as a rule, and the actual outturn ordinarily shows a small surplus. For lack of appropriate data on the classification of local government finances, the remainder of this section will be confined to operations of the dominant central government sector during the period 1968-80 (Tables 2-5). (The year 1968 was chosen as the initial year because a new system of budget presentation was introduced in that year, which makes comparison with data from earlier years difficult.)

2. International comparison

Analysis of fiscal data over a period of time serves the purpose of directing attention to particular developments that may, inter alia, be relevant to a study of budgetary processes. In order to point out the characteristics or peculiarities of a particular country, reference has to be made to developments elsewhere. Global fiscal developments during the past decade have been frequently characterized by a rapid expansion of the relative size of the government sector and by growing fiscal deficits.

The problems involved in international comparisons of fiscal aggregates are well known, but the efforts of the International Monetary Fund to provide conceptually consistent fiscal data in member countries have resulted in substantial improvements in this area. On this basis the expansion of the consolidated central government sector in 20 member countries of the Organization for Economic Cooperation and Development (OECD) between 1972 and 1980 is shown in Table 1. The choice of countries and period was largely dictated by the availability of data. For present purposes the growth in percentage points of gross domestic product (GDP) is of particular interest and probably less controversial as a basis for international comparison than the share figures that reflect, inter alia, different degrees of federalization as state and local governments are not included. In all the countries covered, the government sector has expanded between 1972 and 1980 (or the nearest periods of equal length). Six countries out of a total of 20 have experienced an expansion in excess of 10 percentage points of GDP. Such a rapid growth in a relatively short period of time constitutes a pattern that would conform with the Peacock-Wiseman displacement effect hypothesis, 1/ albeit in the absence of social upheavals. In 7 countries the expansion amounted to 5-10 percentage points of GDP, 5 countries experienced 3-5 per cent expansion, and in only 2 countries did the central government sector grow by less than 3 percentage points of GDP. Iceland was placed lowest in this ranking with only 2 percentage points growth over this eight year period.

Assigning numerical values to changes in the budgetary balance on an internationally comparable basis is more difficult and is not attempted here. However, experience is sufficiently clear to warrant the general contention that the fiscal position of most countries deteriorated in this period, and in some cases severely. Here again Iceland's experience is somewhat exceptional in that approximate fiscal balance was maintained during most of the period (Table 2). In 4 out of 13 years there was a fiscal surplus, 2/ and in all years except in 1974 and 1975, the deficit

1/ A.T. Peacock and J. Wiseman, The Growth of Public Expenditure in the United Kingdom (National Bureau of Economic Research, London, 1961), pp. 24-30.

2/ The concept of the fiscal balance as presented in Table 2 differs from the surplus/deficit definition in the Government Finance Statistics Yearbook mainly in the treatment of borrowing and relending by the Central Government to nonfinancial public enterprises. According to this publication relending is entered above the line and borrowing below the line as a financing item, whereas in this presentation these transactions cancel out at the central level and do not affect the fiscal balance as the non-financial public enterprises are supposed to service the debt out of own revenue. The appropriate treatment of these transactions is not a clear-cut case, however, as it involves, in essence, an appraisal of the relative significance of political and market criteria in decision making. This topic is beyond the scope of this paper, however, and in keeping with national accounting practices these operations are considered outside the central government sector.

Table 1. Growth of the Central Government Sector
in Selected OECD Countries, 1972-80 1/

	1972	1980	Growth in Per- centage Points
Australia	20.8	25.8	5.0
Belgium	39.5	51.4	11.9
Canada <u>2/</u>	18.1	20.6	2.5
Denmark	32.7	40.0	7.3
Finland	24.6	28.9	4.3
France <u>3/</u>	32.0	42.0	10.0
Germany, Federal Republic of	24.2	28.6	4.4
Iceland	27.3	29.3	2.0
Ireland <u>2/</u>	34.6	45.3	10.7
Japan	12.7	18.8	6.1
Luxembourg	34.2	49.0	14.8
Netherlands <u>3/</u>	43.2	55.8	12.6
New Zealand	28.3	36.5	8.2
Norway	34.6	38.2	3.6
Spain <u>2/</u>	19.6	26.0	6.4
Sweden	28.8	41.2	12.4
Switzerland	13.8	20.3	6.5
Turkey	22.6	25.8	3.2
United Kingdom	32.7	39.1	6.4
United States	19.7	23.1	3.4

Sources: This table is derived from data on consolidated central government expenditure in Government Finance Statistics Yearbook (Vol. VI, 1982) and on gross domestic product in International Financial Statistics (yearbook issue 1982), both publications of the International Monetary Fund.

1/ For lack of data for an appropriate period, the table does not include Austria, Greece, Italy, Portugal, and Yugoslavia.

2/ 1971-79.

3/ 1973-81.

was less than 1 per cent of GNP. While total revenue and expenditure increased 55 to 60 times, to a large extent this was a reflection of the impact of inflation, which averaged about 31 per cent a year during 1968-80.

3. Revenue and expenditure

As further discussed in Section V an important factor in the maintenance of fiscal balance is a tax system that is responsive to changes in major economic aggregates. Some 85 per cent of total revenue of the Central Government is derived from indirect taxes, of which import duties and a sales tax are the most important (Table 3). Indirect taxes are largely based on ad valorem rates, and the sales tax and the progressive structure of import duties, in particular, yield revenue quickly in response to rapidly rising turnover in nominal terms. Income taxes are paid on income in the previous year, and indexation clauses are applied to reduce fiscal drag. This reduces the elasticity of income taxes. However, although their share in central government revenue has been rising over the past decade, it is still relatively low and does not have any significant impact on the elasticity of central government revenues as a whole. 1/

The composition of central government expenditure by economic category has undergone some changes during the period under review (Table 4). The proportion used for the purchase of current goods and services has increased by almost 10 percentage points to 35 per cent, and the proportion transferred through the social security system has risen by 6 percentage points to 27.5 per cent. Matching relative declines have occurred in the case of capital outlays and other current transfers with the exception of consumer subsidies, which have on the whole remained roughly constant despite year to year fluctuations. A major portion of the relative increase in current outlays on goods and services is accounted for by growing public sector employment and higher real wages and salaries in that sector. 2/ Despite relative growth of transfers for social security purposes, this category has nonetheless grown substantially less than in most neighboring countries, and may be explained in large measure by negligible outlays on unemployment benefits, as virtually full employment has been maintained throughout the period.

1/ Income taxes are a significant source of revenue at the local level, accounting for nearly one half of total local government revenue.

2/ It also involves a change in definition in that certain expenditures previously classified as transfers to the health sector are now classified as wages and salaries.

Table 2. Iceland: Revenue, Expenditure, and the Fiscal Balance, 1968-80

(In millions of Icelandic krónur)

	Revenue	Expenditure and Net Lending	Surplus/ Deficit (-)	Surplus/Deficit as Percentage of GNP
1968	67	69	-2	-0.7
1969	75	78	-3	-0.9
1970	98	94	4	0.9
1971	133	137	-4	-0.7
1972	185	184	1	0.1
1973	249	251	-2	-0.2
1974	377	410	-33	-2.3
1975	510	590	-80	-4.1
1976	713	710	3	0.1
1977	1,003	1,034	-31	-0.8
1978	1,637	1,676	-39	-0.7
1979	2,480	2,502	-22	-0.3
1980	3,929	3,798	131	1.0

Source: Central Bank of Iceland, Annual Report 1981, Appendix Tables 1 and 15.

Table 3. Iceland: Composition of Revenue by Type of Tax, 1968-80

(In percentages of total revenue)

	Direct Taxes	Indirect Taxes		Other Revenue
		Sales Tax and Import Duties	Other	
1968	11.9	49.3	37.3	1.5
1969	12.0	50.7	36.0	1.3
1970	11.2	57.1	29.6	2.1
1971	11.3	54.9	32.3	1.5
1972	23.2	47.6	28.1	1.1
1973	22.9	48.2	27.7	1.2
1974	15.6	55.7	27.6	1.1
1975	11.8	54.9	31.8	1.5
1976	12.9	51.6	34.0	1.5
1977	11.0	52.9	34.1	2.0
1978	17.1	48.5	32.6	1.8
1979	18.6	44.6	34.7	2.1
1980	16.5	46.6	34.3	2.6

Source: Central Bank of Iceland, Annual Report 1981 Appendix Table 16.

Table 4. Iceland: Expenditure by Economic Category, 1968-80

(In percentages of total expenditure)

	Current Goods and Services	Current Transfers			Capital Expenditure
		Social Security	Subsidies	Other	
1968	25.7	21.4	8.0	19.0	25.9
1969	28.8	25.7	6.4	13.2	25.9
1970	29.0	27.1	6.1	10.8	27.0
1971	26.7	25.7	12.1	9.2	26.3
1972	27.4	30.9	9.1	9.0	23.6
1973	28.3	32.2	8.5	9.5	21.5
1974	27.2	28.2	9.1	14.3	21.2
1975	24.9	28.2	9.5	12.3	25.1
1976	28.7	28.2	7.3	11.9	23.9
1977	34.6	22.6	5.6	15.2	22.0
1978	34.5	25.9	7.1	14.4	18.1
1979	34.3	26.5	9.0	13.5	16.7
1980	35.1	27.5	7.1	12.6	17.7

Source: Bureau of the Budget.

III. Legal and Institutional Basis for Budgeting

1. Constitutional provisions

Iceland's Constitution contains several provisions relating to budgetary matters. These provisions set forth general conditions for imposing taxes, raising loans, and selling or otherwise disposing of government property, and stipulate that none of these actions may be undertaken except by authority in law. There is also a special provision to the effect that no expenditure must be implemented unless it is based on statute in either the Finance Act (approved budget) or a supplementary budget. The Constitution further stipulates that the budget must be submitted to Parliament at the beginning of each regular session.

The imposition of taxes, public borrowing, the disposition of public property, and, with a few exceptions, the timing of the budget's submission to Parliament have, in practice, been carried out in accordance with constitutional provisions. In matters of expenditure, however, certain procedures have evolved that deviate from these provisions. By a convention of long standing, the executive government has implemented expenditure without prior statutory sanction because certain economic and technical problems have rendered it difficult to adhere to all constitutional provisions. Thus, despite the prohibition to spend funds beyond budgetary limits without prior consent of the legislature, it has become an accepted constitutional practice to seek such consent only ex post. An explanation may be found in the high inflation rates that in recent years have exceeded 50 per cent a year. Beside the difficulties of forecasting the price level one year ahead under these conditions, allowing for inflation in the budget estimates was until recently considered too risky from the point of view of expenditure control, as discussed in Section VI. Moreover, the country's economic conditions are inherently unstable on account of heavy dependence on weather conditions and fluctuations in the volume and prices of fish products, the dominant export industry. Conditions may change abruptly within the fiscal year and upset major assumptions on which budget projections were based. It is generally accepted that short-term upward expenditure adjustments may be needed in these circumstances, and seeking consent ex post in a supplementary budget rarely involves a political risk.

2. The budgetary process

Preparation of the budget is the responsibility of the Bureau of the Budget under the surveillance of the Minister of Finance. The fiscal year is the calendar year. The annual budget preparation is usually launched in early April of the preceding fiscal year, when the Bureau of the Budget sends out an estimate circular to other government ministries inviting them to submit draft estimates on their financial requirements

during the next fiscal year. The circular contains detailed technical instructions regarding major assumptions on which estimates are to be based, including wage and salary rates and the price level to be used. Wages and prices are at this stage based on already existing levels, and subsequent adjustments are left to the Bureau of the Budget. As a rule, a cover letter refers to some general objectives of the Government's economic policy, usually for the purpose of encouraging government ministries and agencies to exercise constraint in their proposals. The estimates are then drafted in the various government agencies, after which they are submitted to the appropriate ministry. Proposals are then submitted to the Bureau of the Budget where they are subject to a careful and detailed scrutiny before they are aggregated and presented to the Finance Minister. By this time revenue forecasts are ready, as well as a forecast of the Government's borrowing requirement and lending operations in the upcoming fiscal year. All these estimates are included in the budget. They are discussed in detail with the Finance Minister, and further adjustments made before he presents a draft budget to the Cabinet. Here, another round of adjustments takes place after ministers have negotiated these issues in a series of Cabinet meetings and other informal meetings between the Finance Minister and individual spending ministers. The main difficulty at this stage of the budget preparation is to keep the budget in balance, because it would be politically unacceptable to present a deficit budget to Parliament (see Section V).

In recent years, an annual investment and credit budget containing estimates of total public investment and its financing in the next financial year has been considered by the Cabinet along with the central government budget. The investment and credit budget is presented to Parliament and discussed there, but it is not passed as such. Authorization for borrowing and implementing investment expenditures is obtained by specific legislation or in the Finance Act (approved budget). As mentioned earlier, both the central government budget and the investment and credit budget cover one fiscal year, and no multiyear projections have so far been undertaken.

The budget is presented to Parliament when it assembles in early October. It is given three readings in a joint session of both houses and passed before the end of the year on the basis of a simple majority vote. Between readings the expenditure side is examined by the Appropriations Committee whose members are elected on a proportional voting basis. Responsibility for the spending of funds appropriated by Parliament lies with the minister or ministry responsible for the particular service. The Ministry of Finance is in charge of the disbursement of appropriated funds to government ministries and agencies. All budget appropriations for current expenditure lapse at the end of the year, but in the case of capital expenditure, the Bureau of the Budget can authorize a carry-over of unspent appropriations for four years. The system of audit is in two parts. One is performed by the Government Audit Department, whose head

is appointed by the Finance Minister. This is a continuous audit, whereas the other part, undertaken by examiners of public accounts, is carried out when the Government Account has been completed. The examiners are appointed annually by Parliament.

IV. Budgetary Practices

1. Budgetary techniques and strategies

The smallness of the economy does not imply simplification of budgetary issues, but it puts limits on administrative capacity. The nature of fiscal issues is not markedly different from that faced by the large industrial nations, and to some extent the problems are further exacerbated by the limited administrative capacity that results from the country's small population size.

Historically, budgeting was a somewhat peripheral activity in the Ministry of Finance, and estimates, especially on the revenue side, tended to be unrealistically low. In part this was the result of inadequate budgeting techniques and perfunctory expenditure control. But it also reflected a deliberate strategy on the part of the government to acquire extra powers in fiscal matters. It was the practice to make conservative revenue estimates that resulted in high excess revenue in the first place, and this created scope for implementing excess expenditure without upsetting the budget balance. 1/ Generally short-term political considerations induced governments to spend the whole of the excess revenue, with the result that expenditure frequently exceeded budget estimates by 20-40 per cent. 2/

Budgeting techniques are essentially incremental in that the current year's budget is constructed on the basis of the previous year's budget. The scope for influencing the size and composition of expenditure has been increasingly restricted in recent years by previous spending commitments stipulated in specific legislation. These legislative provisions, together with widespread indexation arrangements, have made projections from a given basis and price adjustments a major preoccupation in budget preparation.

1/ This practice reflects a fairly general tendency of budgeteers to deliberately underestimate revenues in the hope that the margin available in the form of higher-than-estimated revenues could be used for financing needed additional expenditures without unduly upsetting the original fiscal strategy.

2/ G. Blöndal, "The Growth of Public Expenditure in Iceland," The Scandinavian Economic History Review (Vol. XVII, No. 1, 1969), pp. 1-22.

Limited manpower in spending ministries restricts their capacity to scrutinize budget proposals from the various agencies in any detail, and they tend to be simply passed on to the Bureau of the Budget. To some extent because of the long-standing convention in the Finance Ministry to make unrealistic expenditure estimates, agencies have tended to inflate requests on the assumption that they will in any case be cut indiscriminately. This reflects the misconception that proposals rather than incrementalism form the basis of budgeting. The consequence is a loss of confidence in these proposals and concentration of expenditure powers in the Bureau of the Budget. The detailed scrutiny of budget proposals undertaken in the Bureau of the Budget, along with the price adjustments already mentioned, preoccupies its staff and has contributed to the fact that the Bureau, and the Ministry of Finance for that matter, has not acquired authority for economic management to an extent that has occurred with similar central agencies in countries such as the United Kingdom, France, and Japan. 1/

2. Role of the legislature

Historically, Parliament used to possess considerable budgetary powers. In part this was a heritage from the period of foreign rule when the King of Denmark was responsible for the presentation of the budget and Parliament was partly endowed with the legislative power. The idea of a powerful Parliament vis-à-vis the executive government was the core of the struggle for independence. Also, securing grants to constituencies by parliamentary representatives was perceived as greatly enhancing their chances of being re-elected. These external and internal political motivations contributed to expenditure increases in the parliamentary process almost every year during the period 1876-1960, fluctuating from year to year in a range of 0.5 per cent to 45 per cent of the original expenditure proposals of the Government. 2/

Along with independence and enlarged constituencies these special features have gradually eroded. However, as shown in Table 5, Column 1, expenditure increases in the parliamentary process have continued, although for a different reason. As conditions for budgeting have improved, estimates have become more realistic, and the major cause for these increases is now a changed budget strategy. Inflation budgeting, which is further considered in Section VI, implies in this case that price adjustments, often substantial, are made to the original budget before it is passed, and in this sense the budget preparation is extended to the parliamentary stage. Most other important amendment proposals come from

1/ See Aaron Wildavsky, Budgeting: A Comparative Theory of Budgetary Processes (Boston and Toronto, 1975), Chapters 4 and 5.

2/ G. Blöndal, The Development of Public Expenditure in Relation to National Income in Iceland (unpublished Ph.D. dissertation, London School of Economics and Political Science, 1965), Chapter III.

the Government itself through the Appropriations Committee, whose majority invariably supports the Government. The Committee, often referred to as the most influential parliamentary committee, is largely preoccupied with detailed scrutiny of special requests submitted to it by individuals or local governments. True to Parkinson's law of triviality major items, such as social security appropriations, tend to receive negligible attention. Expenditure increases in the parliamentary process are thus no longer an indication of the relative strength of Parliament. On the contrary, there are strong indications that the executive government holds a dominant position in matters of expenditure.

When the Bureau of the Budget was set up in 1966 it was decided that for the purpose of improving cooperation between the legislature and the executive, the Budget Director, or his representative, should attend all meetings of the Appropriations Committee when the budget was being considered. Conversely, the Chairman of the Appropriations Committee, and sometimes other members of the Committee, frequently follow the preparation of the budget. Experience with these arrangements has been encouraging, and they have substantially facilitated the budgetary process.

3. Recent innovations

In 1966, two major steps were taken to put budgeting on a firmer footing. The first was the setting up of a separate Bureau of the Budget, with the status of a government ministry. The Bureau took over the preparation of the budget and related matters from the Ministry of Finance, a change that created conditions for devoting work to budgetary matters on a continuous and systematic basis. The other step was the enactment of a new law on the Government Account and the budget. This law, which was first implemented with the 1968 budget, pertains primarily to budget coverage and the classification of budget items and represents a vast improvement over previous budgeting and accounting procedures. The coverage was extended to include practically all central government transactions, a considerable amount of which had been outside the budget. The budget was divided into two parts. Part A covers all current and capital expenditures of the Central Government, while Part B includes all nonfinancial public enterprises. The budget also sets forth financial transactions of the Central Government. A uniform classification of revenue and expenditure by type, and of expenditure by function and economic category, was introduced at the same time. In addition to better conforming with administrative requirements, the new presentation enabled the application of computer processing that has facilitated budget preparation and expenditure control as well as decision making in various spheres of fiscal policy.

V. Role of the Budget in Economic Policy

1. The framework

The extent to which the budget is used as an instrument of economic policy is influenced by a variety of factors. The size of the budget in relation to total economic activity and the relative size of the central government sector, where decisions are made at the national level, form an important part of the framework for economic management. The prevailing attitudes toward the role and responsibility of the Government and the scope for implementing changes in existing policies as reflected in the size and composition of the budget, in turn, play a significant role in determining the degree of management of the national economy through fiscal policy. The relative size of the budget was analyzed in Section II, and aspects relating to the degree of management will be discussed in this section.

In Iceland, the preparation of each year's budget is an integral part of the Government's economic policy formulation for that year. In many respects the budget estimates form the basis of the annual national economic forecasts that are developed simultaneously by a separate government agency. In recent years the national economic forecasts have been presented to Parliament along with the budget, but as a separate document in which the Government's economic policy is stated and subsequently debated. While generally the budget serves to promote the broad aims of fiscal policy with respect to resource allocation and growth, income redistribution, and stabilization of the economy, there is a distinct feature of prevailing attitudes toward the budget balance that has far-reaching implications for the budgetary process.

2. Balancing the budget

Traditional fiscal policy attitudes are characterized by a strong urge to balance the budget. This is a legacy of the farming community of the nineteenth century when the government finances were looked upon by analogy with the finances of the individual farm whose soundness required balance and preferably surpluses in favorable years to build up reserves to meet contingencies. Fiscal deficits, which would mean indebtedness abroad, were seen as a real threat to financial and political independence in a predominantly subsistence economy where fiscal surpluses were the sole source of national savings. The desire to play safe was reinforced during the country's struggle for independence, which extended well into the twentieth century. 1/

1/ G. Blöndal, op cit., pp. 134-43.

The traditional balanced budget attitude has persevered to the present. While concern about national independence is no longer a motivating force, new concerns about the overall impact of the budget on the economy have lent support to the traditional view as the persistent inflationary developments have called for a strict stance of fiscal policy. This stance has been largely defensive, however, in seeking to prevent fiscal deficits rather than pursuing restrictive fiscal policy in terms of substantial surpluses. Other aspects of the overall impact on the economy have received more attention. ^{1/} These cautious attitudes are an important determinant of the particular budgetary practice that both original budgets as presented by the Government and in recent years budgets as approved by Parliament invariably show some positive balance. The annual budget balancing notion appears to be so firmly embedded in the minds of policymakers that a deficit budget would be viewed as politically unacceptable. However, the intended balance often turns into deficit in the course of the fiscal year, and while deficits usually attract a great deal of criticism, this is somewhat blunted by the fact that they have proved to be relatively small (Table 2). Moreover, realized deficits are probably easier to live with politically than would be planned deficits because the budget is subject to much more rigorous political debate at the time of its presentation, and also because realized deficits often may be explained, rightly or wrongly, by reference to unforeseeable events in an unstable economy.

The practical implementation of the notion of annual budget balancing has been greatly facilitated by a responsive revenue system, as the major part of total revenues is based on ad valorem rates. This has lessened the need for discretionary revenue action, although the growth of expenditure has also necessitated a recourse to such measures from time to time. The high rates of inflation experienced in the period under review and short collection lags have tended to cause revenue to respond quickly to rising nominal imports and turnover and, until recently, this automatic impact was considerably stronger on the revenue than on the expenditure side of the budget. These automatic stabilizers rarely produced fiscal surpluses of any significance, however, as the balanced budget notion appears to work in both directions: public spending beyond budgetary limits was not seriously challenged as long as deficits were avoided. This implies a de facto rejection of Keynesian doctrine and is also manifest in traditional reluctance on the part of governments to present the budget with any significant surplus despite the persistent

^{1/} A special manifestation of the macroeconomic approach, apart from the national economic forecasts mentioned above, consists in the annual investment and credit budgets initiated in the early 1960s. These cover total public investment and its financing, as well as forecasts of available public funds for certain private investments such as housing, and represent an attempt to coordinate investment and credit policies in the framework of given price and balance of payments objectives.

inflationary situation. A surplus, it is feared, would quickly be eliminated by further expenditure appropriations in the parliamentary process. The practice has developed in recent years, however, to include repayments of debt to the Central Bank among outgoings on financial transactions before arriving at the overall balance, thus creating hidden surpluses. This is consistent with the annual budget balancing notion, because of its concern with the public debt, irrespective of the monetary impact of government operations.

The Icelandic version of the balanced budget philosophy has its peculiar motivations as considered above, and it appears to have been effective in avoiding fiscal deficits and in restraining expansion of the government sector. However, these achievements are to a certain extent and somewhat paradoxically a reflection of less satisfactory performance in other spheres of economic policy. Thus the contribution to fiscal balance through the responsive tax system has at times been caused by rising imports and weakening of the external position. Also, while a high level of public and private investment has kept up employment and thereby increased revenue and relieved the budget of unemployment benefits, it has, along with excessive wage increases and accommodating monetary policy, contributed to higher rates of inflation than experienced in most, if not all, OECD countries over the past decade.

3. Erosion of fiscal stabilizers

The degree of economic management has been affected in recent years by the introduction of arrangements that have restricted the scope for maneuver on the expenditure side of the budget and at the same time blunted the built-in fiscal stabilizers. Indexation, which for a long time had been restricted to wages and salaries, has been extended to social security benefits, and semiautomatic price adjustments have been adopted for public health outlays. Similarly, contracts regarding public projects generally incorporate price adjustment clauses, and indexation of financial obligations has become widespread. In a survey undertaken by the Bureau of the Budget, it was found that over 40 per cent of expenditure in the 1976 budget moved automatically and pari passu with prices. There has also been a growing tendency to enact legislation that provides for expenditures in prescribed amounts in the budget, often with price adjustment clauses. The survey also revealed that approximately 70 per cent of total expenditures was "uncontrollable" in the sense that this portion of expenditures cannot be affected except by amending laws or contracts.

VI. Efforts to Constrain the Growth of Public Expenditure

The notion of annual budget balancing has required continuous efforts to constrain the growth of expenditures as pressures on increased spending have far outstripped the balancing effects of the responsive revenue system and governments' willingness to take discretionary revenue actions. High rates of inflation tend to blur the perception of real values and have constituted a particular environment in which these efforts have been exercised with far-reaching repercussions on budgetary practices. In general, these efforts have assumed a defensive stance rather than special measures to cut expenditures, although these have also been tried. Other arrangements to check expenditure growth have been adopted and certain provisions have been legislated, although the practical relevance of the latter is yet to materialize.

1. Inflation budgeting

The persistence of high inflation rates greatly complicates budgeting and economic forecasting. Even if next year's price level could be forecast reasonably accurately, disclosing such a forecast in instructions to spending agencies is likely to embarrass the Government whose political platform invariably places the fight against inflation as top priority. Bold intentions expressly stated in the budget documents involve a political risk in that failure to accomplish the price objective would constitute a source of criticism that governments like to avoid. Also, concern about labor union reactions discourages such practice. Moreover, reluctance to reveal forecasts of next year's price level reflects concern about the implications for expenditure control, especially if inflation turned out lower than anticipated. These considerations have induced the Bureau of the Budget to adopt certain strategies in inflation budgeting.

Budget estimates used to be based on wage and price levels some nine months prior to the beginning of the fiscal year. To avoid undue discrepancies between the budget and the actual outturn, however, the wage and price assumptions were gradually moved to levels as close as possible to the fiscal year, but not beyond that. Although it was realized that the price assumptions would entail excess expenditures in the relevant fiscal year, this was accepted, since expenditure increases could be expected to be exceeded, or at least matched, by automatic revenue increases, and hence the budget balance would be preserved. This budgeting strategy was motivated by the consideration that basing expenditure estimates on forecast price increases in the forthcoming fiscal year would induce spending agencies to regard voted appropriations as minimum amounts at their disposal on which they could base further requests for upward adjustments in the course of the fiscal year, a practice that had become customary in the inflationary environment.

Instead, by keeping budget estimates at price levels close to the beginning of the fiscal year it was felt that expenditure control would be more effective. This enabled the Ministry of Finance to control the disbursement of excess payments to spending departments in line with actual price developments during the fiscal year. Moreover, within reasonable limits extra discipline could be imposed on spending agencies by keeping nonindexed disbursements below the rate of inflation.

This strategy prevailed until the 1970s when special appropriations to meet wage and price compensations came to be included in the budget estimate. By that time accelerating inflation rates and extension of indexation mechanisms had resulted in untenable divergencies between approved budgets and actual outcomes. Expenditures in excess of budget estimates were, with a few exceptions, roughly in line with the rate of inflation. Concern over these divergencies and the need to apply uniform price assumptions in all aspects of economic forecasting outweighed the political and other risks involved in presenting price forecasts explicitly. Allowing for inflation in budget estimates has therefore been progressively adopted lately as far as aggregate revenue and expenditure are concerned. The average rate of inflation is forecast for the upcoming fiscal year and incorporated in revenue and expenditure estimates with the result that excess expenditure has, in percentage terms, been about half the rate of inflation since 1975 and substantially less in the last year under review (Table 5). However, the practice of recording appropriations for individual spending agencies at prefiscal year price levels has been largely retained and appropriations for price compensations are kept in a lump sum under a separate item in the budget for disbursement by the Ministry of Finance. While this method greatly reduces the discrepancy between budgeted and actual total expenditures, it retains the control qualities of the previous approach and may even open up an avenue for incorporating hidden reserves in the expenditure estimates to reinforce the efforts to keep the budget in balance.

As previously indicated, the purpose of this inflation budgeting strategy is essentially to constrain the growth of expenditure. While it is inherently difficult to evaluate the influence this method has had on the growth of real expenditure, it can be plausibly argued that apportioning funds by a central agency in line with price developments in the course of the fiscal year is a more effective control mechanism than placing the price compensation appropriations at the disposal of spending agencies at the beginning of the fiscal year. This procedure has a drawback, however, in that expenditure is bound to exceed budgetary limits as far as individual spending agencies are concerned, and when experienced over a number of years, it tends to be regarded as a normal state of affairs with negative consequences for financial discipline. In the long run, therefore, the overall impact is somewhat indeterminate.

Table 5. Iceland: Expenditure Increases in the Budgetary Process,
1968-80

	Percentage Increase From		Memorandum Item: Rate of Inflation 1/
	Original to Approved Budget	Approved Budget to Actual Outturns	
1968	0.3	13.1	13.8
1969	8.2	8.6	24.0
1970	5.0	14.6	14.3
1971	9.8	22.7	7.4
1972	18.5	11.5	14.4
1973	8.0	16.7	24.7
1974	9.3	39.5	42.2
1975	5.5	24.2	50.2
1976	2.6	19.7	33.5
1977	7.2	15.2	30.5
1978	12.4	19.4	44.3
1979	1.9	23.2	45.7
1980	2.6	10.7	59.0

Sources: Bureau of the Budget and the Central Bank of Iceland.

1/ Consumer prices.

2. General versus specific expenditure cuts

Attempts to restrain public spending are exercised primarily at the budget preparation stage. In the course of the fiscal year, however, general economic developments have occasionally necessitated expenditure cuts to supplement other measures designed to contain aggregate demand. Parliamentary authorization is considered necessary to implement expenditure cuts in this manner, and this is sought either by submitting bills providing for amendments in the approved budget or, when Parliament is not in session, by provisional law. The authorizations, which usually are limited to the fiscal year in question, may be in the form of specific expenditure cuts or general across-the-board measures. Legislating expenditure reductions does not ensure implementation of the intended adjustments, however, and the success or failure may depend on the particular approach chosen. In Iceland, the empirical evidence suggests that specific expenditure cuts stand a much better chance of being implemented than general across-the-board reductions. While it is easier to secure approval of the latter type of cuts at cabinet level because ministers feel that the sacrifice is equally shared, such decisions tend to be made without sufficient consideration of certain actions that may constitute a precondition for a successful implementation of expenditure reductions. These actions may involve the laying off of personnel and related sensitive measures that prove to be insurmountable obstacles when they have to be squarely faced. Specific cuts listed item by item in a parliamentary bill normally require thorough preparation by the Bureau of the Budget to minimize these obstacles. Reduction proposals presented to the Cabinet in this form by the Minister of Finance are liable to meet substantially stronger resistance than proposals for general cuts and involve lengthy negotiating processes at cabinet level. However, once politically uncomfortable commitments have been hammered out, the subsequent execution of expenditure cuts is relatively easy.

3. Other endeavors to restrain spending

Salary payments and associated costs have been increasing during the period under review and account for almost 30 per cent of total expenditure of the Central Government. This proportion was less than 20 per cent in 1968. Efforts to curb expenditure growth have taken account of this development, although direct action is especially difficult in this area because of human factors involved that tend to be particularly sensitive in a small society, and also because of protective labor legislation and intense labor union involvement. While new positions in government employment are normally determined in each year's budget, a supplementary arrangement has been instituted whereby requests for permanent staff are subject to approval by a committee of high-ranking officials. Such approval is needed to give new positions legal status, and the committee's decisions can only be changed by the Cabinet

upon appeal, which rarely occurs. This procedure, which is intended to curb pressures for additional staff, ensures reasonably well that such requests are not granted unless they are well substantiated, and that they are treated uniformly. Such a highly centralized arrangement can function without undue delays in a small community. However, the system suffers from the drawback that certain government sectors, such as in the rapidly expanding health sector, are not subject to this process, and the same applies when positions are determined by law, a device sometimes applied as an escape mechanism.

Social security benefits in various forms constitute the other expenditure category that has grown most rapidly in recent years, even though, as already noted, unemployment benefits are negligible. While the political appeal associated with improved social security arrangements has placed this objective high on the priority list of successive governments, there is less evidence that the cost consequences of the relevant legislative action have been appropriately perceived. The legislation of social entitlement programs may not entail immediate cost at the time of enactment, whereas subsequently, under different economic and demographic conditions, they may constitute a severe drain on the budget. To some extent the generosity of these programs is thus unintentional rather than the result of conscious policy action. Motivated by considerations of this kind, an arrangement was legislated in 1979 whereby all bills submitted to Parliament that involved cost components were to be accompanied by an estimate of these costs. The purpose was to ensure that the cost implications of legislation would be properly evaluated, and that both the Government and the Parliament would become more cost conscious. The problem with these provisions, which formed part of a broader legislation on restrictive economic measures, was that insufficient consideration was given to their implementation. Therefore, these provisions have not so far been effective.

Other control mechanisms developed in recent years include monthly spending limits for individual agencies based on a projection of monthly financial requirements within the budgetary framework. Similar projections are made on a monthly basis for revenue and financial transactions. The resulting outcome yields an estimate of the seasonal pattern of the overall budget balance that is presented to and agreed with the Central Bank where the Treasury keeps its main account. During the course of the fiscal year these projections are compared with expenditure and revenue reports that become available each month through a computerized information system. This control system is highly centralized and enables the Ministry of Finance to closely monitor virtually all spending agencies included in Part A of the budget. However, the high degree of centralization may have its drawbacks. Thus spending agencies have complained that the system unduly restricts their freedom for maneuver and transfers responsibility to the Ministry of Finance to the extent that the agencies lose interest in prudent financial management. Despite these risks, the

new control mechanism certainly represents a substantial improvement over previous practices as far as the overall monitoring of fiscal developments throughout the year is concerned. In particular, it serves as an early warning signal when major deviations from projections occur.

VII. Summary and Conclusion

The framework of Iceland's budgetary system is set by the Constitution and has many basic features that are commonly found in other countries. However, certain characteristics of the country, especially the small size of the population and the inherent instability of the economy, as well as the evolution of the country's political history have engendered particular budgetary attitudes. The subsistence economy of the nineteenth century and the struggle for independence created a budget philosophy that was characterized by a strong desire to play safe. Initially, this budgetary feature was reflected in efforts to build up reserves to meet contingencies in an unstable economy, but later a firm notion of annual budget balancing developed and, along with other national characteristics, has been a significant determinant of budgetary practices.

Changed economic and political conditions have been associated with a weakening of parliamentary power over expenditures and the smallness of the economy has resulted in administrative stringencies that have led to the adoption of highly centralized budgeting procedures, which are otherwise largely on an incremental basis. These procedures have, in turn, entailed preoccupation with detail in the central budgeting agency rather than with overall economic management. As a political necessity, budgets are invariably submitted to Parliament in approximate balance, irrespective of the overall state of the economy.

The strong annual budget balancing notion has been a motivating force in the development of certain budgetary strategies and control procedures designed to restrain spending. These have been exercised in an environment of high inflation rates and widespread indexation mechanisms. In essence, the inflation budgeting strategy aims at establishing a basis from which the disbursement of price compensation payments can be controlled by a central agency in line with price increases as they occur in the course of the fiscal year, or within reasonable limits, at a rate below that of inflation. The small population size has again influenced control procedures as it has facilitated the application of a highly centralized control system through which detailed information on fiscal developments becomes available on a monthly basis. While the high degree of centralization in budgeting and expenditure control may involve certain risks with respect to undue preoccupation with detail

in central agencies and loss of financial discipline in spending agencies, these recently adopted procedures are nonetheless a vast improvement on previous practices.

While it is inherently difficult to attribute fiscal developments to particular attitudes or budgeting and control techniques, it is of interest, against this background, to view Iceland's performance in two areas that have been distinct features of international fiscal developments over the past decade--rapid expansion of the government sector and growing fiscal deficits. In 1972-80, among 20 OECD countries, Iceland experienced the smallest expansion of the central government sector, and in contrast to the global experience, deficits in central government finances were not significant.

In a narrow budgetary sense, performance in these areas has been somewhat remarkable, but certain qualifications have to be made when viewed in the broader context of overall economic policy. This achievement has thus been facilitated by a responsive tax system that has reduced the need for discretionary revenue actions and thereby perhaps caused certain complacency in matters of taxation. Strengthening of the fiscal position is frequently a reflection of weaknesses in other areas of economic policy, such as accelerating rates of inflation and deteriorating external position through rising imports. Moreover, the built-in stabilizing qualities of the fiscal system have been reduced in recent years by legislative actions providing for future spending commitments and by proliferation of indexation mechanisms. And finally, while the annual budget balancing notion generates a healthy atmosphere of constraint in budgeting, it also implies inflexibility in fiscal policy.