

# English translation of the Weekly Web Release



MINISTRY OF FINANCE IN ICELAND

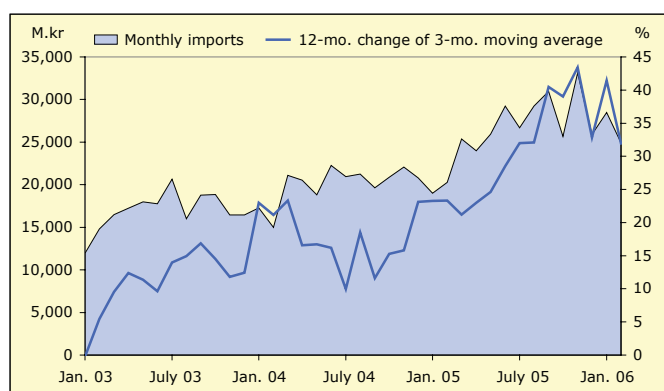
March 9<sup>th</sup> 2006

## Imports in February 2006

February merchandise imports amounted to 22 billion krónur, 3.5 billion less than last month, according to provisional figures derived from value added tax receipts. On the basis of constant prices and exchange rates, February imports are 23 per cent higher than in February a year ago and 32 per cent higher in the last three months than in the corresponding period a year earlier.

The import decline since January is mainly attributable to lower fuel imports which in any case fluctuate from month to month. Imports of investment and intermediate goods also declined. Imports of consumer goods rose, a seasonal fluctuation following January retail sales. Auto imports showed a significant renewed increase, following substantial but stable imports in recent months. In light of the decline in the exchange rate in recent weeks, one may expect that auto imports will slow down in coming months.

Merchandise imports (in real terms)



## Consultation on financial stability and contingency measures

For the past two years, three ministries, along with the Financial Supervisory Authority and the Central Bank have consulted informally on the stability of the financial system. These consultations have now been made formal. A similar consultation arrangement exists in many neighbouring countries.

The consulting group will meet at least twice a year, providing a forum for the exchange of information and opinions. The group will discuss the state and prospects of the financial market, major changes in legislation, regulations and operating procedures concerning the financial market, as well as current issues in international cooperation, particularly within the EEA. The agreement between the parties to the consulting group stipulates that in the case of danger to the financial system, the authorities will react as the circumstances dictate in each instance. The basic premise is that managers of financial firms and market participants will seek to deal with their own difficulties.

## Reimbursement of value added tax to public entities

In discussing the reimbursement of value added tax to public entities, one must bear in mind the regulations for the value added taxation of internal services of tax-exempt entities, since these regulations are intertwined.

Paragraph 2 of Article 3 of the Value added Tax Act, no. 50/1988, states that those entities that engage in operations that are exempt from VAT are nevertheless subject to VAT on production and services

for own use in competition with other parties that are obligated to pay value added tax. On the basis of this provision, two regulations have been issued, no. 562/1989, regarding value added tax on internal services and purchased goods of entities exempt from VAT, and regulation 248/1990, regarding the value added tax on the taxable operations of public entities. These regulations are derived from the same origins and their aim is neutralise the choice of VAT-exempt entities between purchased services and internal services. The provisions of the VAT Act and regulations are designed to ensure that the value added tax will not lead to market distortion.

When the value added tax was adopted, it was assumed that the same rules would apply regarding the VAT obligation of entities engaged in tax-exempt operations as well as public entities, i.e. that these entities would be subject to VAT on the production of goods and services for own use in competition with entities subject to VAT. The municipalities were quite opposed to this legislation and predicted that it would significantly increase their costs. The result was that, instead of obligating public entities to impose VAT on their internal services, they were reimbursed for the VAT on the outside purchases of certain specified services. This means that if a public entity purchases such a service from an entity subject to VAT, e.g. computer software, it will be reimbursed for the VAT. The VAT will thus not enter into the decision of the public entity as to whether to make an outside purchase or provide the service internally.

The reimbursement to public entities amounted to more than 3.1 billion krónur in 2004 of which more than 1.5 billion were reimbursed to municipal entities. Such reimbursements have increased sharply in recent years. By comparison, they amounted to about 900 million krónur in 1993.

Regulation no. 562/1989 regarding firms et. al. that engage in tax-exempt activity, specifies which activity is subject to VAT inasmuch as the activity in question is in competition with commercial enterprises, such as services of professionals, cf. the following:

- .....
- The services of engineers, technicians, architects, attorneys, chartered accountants, computer professionals and other professionals engaged in service to the business sector who have completed a university degree or a comparable higher education or prove to be engaged in the activity of the above entities or provide a comparable service.

An identical provision is to be found in Regulation no. 248/1990 regarding the taxation of public entities and the reimbursement of VAT to public entities for purchases of certain work or services. Accordingly, tax-exempt entities must pay value added tax on professional services rendered inside the entity for own purposes, whereas public entities will get a refund on VAT paid on account of services of those same professionals. As noted earlier, the above provisions have the aim of neutralising the choice of VAT-exempt entities as to whether they buy services from outsiders or provide them internally, even if done by two different approaches.

The Office of Internal Revenue has interpreted the regulations on professional services in such a manner that the entry of data into computer systems, computer processing as part of the normal procedures of the entity concerned, as well as user support performed as part of the general service of the entity, should be VAT-exempt and therefore not reimbursable. The same applies to the running and installation of computer hardware as well as entries into the entity's own accounting records. The lodging of computer systems is also viewed as a part of normal daily operations.

Treasury revenue in January		
12 month changes (%)	2004-2005	2005-2006
Total tax revenue	28.8	37.6
Income taxes	35.2	54.3
Social security taxes	60.7	11.2
Asset taxes	15.6	14.2
Indirect taxes	34.4	15.0
Total revenue	27.0	37.6

Treasury expenditure in January		
12 month changes (%)	2004-2005	2005-2006
Administration	8.9	6.5
Social affairs	-1.6	10.1
Economic affairs	-19.8	-2.5
Interest	141.0	-76.6
Other	1.7	4.3
Total expenditure	2.4	0.7

Treasury finances in January		
Million krónur	2005	2006
Cash from operations	2,655	13,926
Net financial balance	5,874	12,849
Debt redemption	-11,135	-4,049
Gross borr. requirement	-5,261	8,470
Net borrowing	5,563	1,532
Overall cash balance	302	10,002

Economic indicators		
12 month changes (%)	2004-2005	2005-2006
Inflation (Feb. '06)	4.5	4.1
Core inflation (Feb. '06)	4.5	3.8
Wage index (Jan. '06)	6.6	8.3
Total turnover (Jan. - Oct. '05)	10.0	9.5
Retail turnover (Jan. - Oct. '05)	4.5	5.2
Unemployment rate (Jan. '06)	2.6	1.2