

English translation of the Weekly Web Release



MINISTRY OF FINANCE IN ICELAND

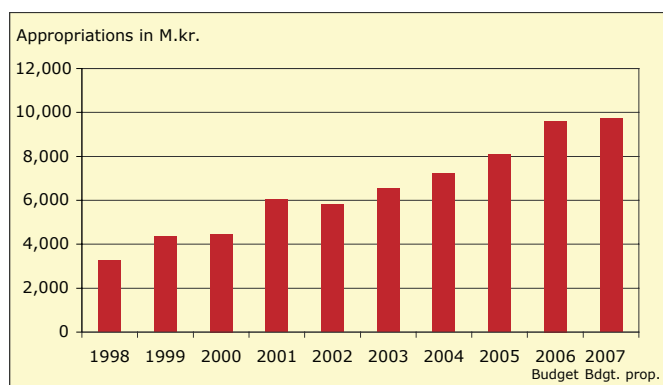
December 14th 2006

Appropriations to Local Authorities' Equalisation Fund

In 1998, the Treasury appropriated 3,247 million krónur to the Local Authorities' Equalisation Fund (LAEF) at the price level prevailing in that year. For 2007, the appropriation amounts to 9,741 million, an increase of about 200 per cent since 1998, equivalent to an annual average increase of 13 per cent. This compares to a 47 per cent increase in the consumer price index over the same period, averaging to an annual 4.4 per cent. The deflator for public consumption, which measures the increase in the cost of public services, rose during the same period by 68 per cent, averaging 6 per cent a year. The following graph shows Treasury appropriations to the LAEF for the years 1998 to 2007. Figures for 2006 are based on the fiscal budget plus the supplementary budget and 2007 figures are also from the budget for that year.

Appropriations to the Fund are on one hand calculated as a share of tax revenue proceeds and the local government income tax base and on the other hand there are temporary appropriations. Since 2001, the Fund has received special appropriations from the Treasury to meet the operating loss of certain local governments in the wake of changes in rules for the levy of real property tax. The initial appropriation was 1,100 million krónur but has since then been increased in line with the proceeds from the Treasury's income tax. The calculation rules for permanent as well as temporary appropriations have been amended over time. The main change took place in 2004 when temporary appropriations began to be calculated as a percentage of the Treasury's tax revenue proceeds. They have amounted to 2.12 per cent since then in addition to 0.264 per cent of the local government income tax base.

Treasury appropriations to the LAEF, 1998-2007



On the measurement of inflation

Inflation is generally defined as an increase in prices over time. The consumer price index (CPI) measures the increase in the price of a selection of goods and services that households regularly purchase and use. The CPI is most frequently used as the basis for the calculation of inflation. Inflation is most often quoted at an annual rate but it may be construed on the basis of different data. The most common method is to quote a twelve-month inflation rate on the basis of monthly data or annual inflation on the basis of annual data. The twelve-month inflation rate measures the monthly CPI figure over a corresponding figure twelve months earlier. The inflation target of the Central Bank is based on this measurement. A longer-term view usually focuses on annual inflation on the basis of the change between annual averages or from the beginning to the end of each year. The Finance Ministry's macroeconomic forecast is based on the former definition.

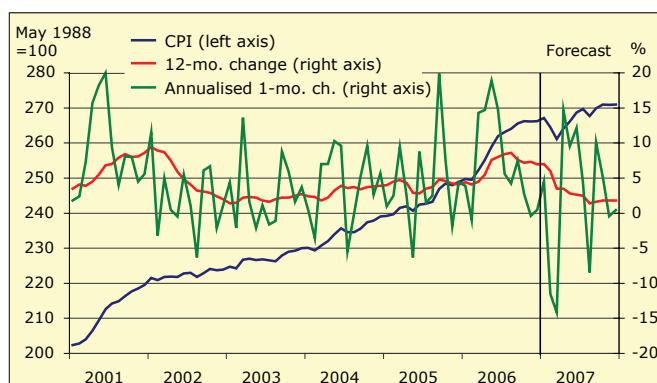
As a rule, it usually takes some time for factors that determine the inflation rate to be reflected in the price level and measured inflation. An example of such factors are taxes and the exchange rate. By the

same token, such influences can last long after the initial changes have taken place. As a result, calculations are often used that apply to periods less than twelve months, but which are then converted to an annualised rate of inflation. An annual inflation rate that is based on the changes in the CPI from one month to the next gives a clearer picture of the more recent inflation development if the factors governing the recent inflation are seen as likely to continue. In other words, it is then implied that the latest monthly change will continue to the same extent over the coming twelve months. Since monthly changes tend to fluctuate, they should be interpreted with care. Lesser volatility is associated with price developments covering three to six months. Here, the same method is applied; the quarterly or the half-yearly change is annualised. This approach gives a clearer picture of how the inflation rate within the year is evolving.

The twelve-month measurement of inflation has the advantage of eliminating seasonal volatility in the price level, such as the beginning and end of retail store sales and the school year. On the other hand other irregular or underlying changes are reflected in that measure.

The following graph shows the twelve-month inflation rate as well as the month-to-month rate, on an annualised basis. The graph shows that the monthly rate fluctuates sharply between months. For comparison, the consumer price index is also shown, which, with few exceptions, has increased in recent years. The possible path of inflation for next year is also shown in order to highlight the impact of the Government's recently announced measures to reduce food prices and overall consumer prices thereby. Such measures do not arrest underlying inflation trend, and inflation is therefore expected to continue next year, although at a lower rate than in the recent past. Such calculations must however be viewed with caution since the factors affecting inflation may turn out to be different from those assumed in forecasts.

Inflation developments 2001-2007



Extension of the temporary reduction in the diesel oil tax

The Althingi passed legislation on December 9th that extended the temporary reduction in the diesel oil tax from 45 to 41 krónur until December 2007. When Act no. 87/2004 on the diesel oil tax and the distance weight tax et. al was passed, the diesel oil tax was set at 45 krónur per litre on taxable diesel oil. The intention at that time was to keep the retail price of diesel oil slightly below the petrol price in order to encourage the choice of diesel-powered private automobiles. In view of the relative increase in the price of diesel oil as against the world price for petrol, the diesel oil tax was temporarily reduced from 45 to 41 krónur with Act no. 70/2005. This temporary provision was originally set for six months but has since then been extended three times. Since the inception of the diesel oil tax, the world price of diesel fuel has more often than not been higher than the price of petrol. Forecasts indicate that this price difference may still last for some time, although such forecasts are quite unreliable.

Treasury revenue January-October		
12 month changes (%)	2005	2006
Total tax revenue	20.8	11.8
Taxes on income & profit	27.3	19.9
Taxes on property	7.2	-37.0
Taxes on goods & services	19.8	10.3
Social contributions	15.7	16.6
Total revenue	47.2	-8.4

Treasury expenditure January-October		
12 month changes (%)	2005	2006
General public services	35.8	-23.0
Health	6.7	7.5
Social security & welfare	5.0	4.2
Economic affairs	-3.7	2.3
Education	16.3	12.2
Total expenditure	10.0	0.9

Treasury finances January-October		
Million krónur	2005	2006
Cash from operations	20,294	48,791
Net financial balance	68,671	46,785
Debt redemption	-61,557	-41,565
Gross borr. requirement	3,814	1,921
Net borrowing	9,048	25,961
Overall cash balance	12,862	27,882

Economic indicators		
12 month changes (%)	2005	2006
Inflation (December)	4.1	7.0
Core inflation (December)	4.6	7.0
Wage index (October)	6.9	11.0
Total turnover (Jan. - August)	8.5	12.6
Retail turnover (Jan. - August)	5.3	4.1
Unemployment rate, sa (Nov.)	1.6	1.1