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Iceland: Improving the Equity and Revenue Productivity of the Icelandic Tax System

This report on "Improving the Equity and Revenue Productivity of the Icelandic Tax System" for the country of Iceland was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in June 2010. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Iceland or the Executive Board of the IMF.

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Iceland

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Fiscal Affairs Department

ICELAND

IMPROVING THE EQUITY AND REVENUE PRODUCTIVITY OF THE ICELANDIC TAX SYSTEM

Julio Escolano, Thornton Matheson, Christopher Heady, and Geerten Michielse

June 2010

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Abbreviations and Acronyms

ACE	Allowance for corporate equity
CIT	Corporate income tax
CPI	Consumer price index
EBIT	Earnings before interest (paid) and taxes
EBITDA	Earnings before interest (paid), taxes, depreciation, and amortization
EEA	European Economic Area
ETS	Emissions Trading System
EU	European Union
EU15	First 15 members of the EU: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom
EUR	Euro (or when plural, euros)
FDI	Foreign direct investment
GDP	Gross domestic product
IFRS	International Financial Reporting Standards
ISK	Icelandic króna (or when plural, Icelandic krónur)
ITA	Income Tax Act (in graphs or tables, ITA stands for Italy)
OECD	Organization for Economic Co-operation and Development
OECD-24	First 24 members of the OECD: Austria, Australia, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States
PAYE	Pay-as-you-go
PIT	Personal income tax
US$	US dollar (or when plural, US dollars)
VAT	Value added tax

Preface

In response to a request from the Icelandic authorities to conduct a review of their system of taxes, a mission from the Fiscal Affairs Department of the International Monetary Fund visited Reykjavik during April 26–May 7, 2010. This report presents the mission's findings and recommendations.

The mission comprised Julio Escolano (head), Thornton Matheson (both FAD), Professor Christopher Heady and Professor Geerten M. M. Michielse (both members of the IMF panel of fiscal experts). Mr. Franek Rozwadowski (IMF Resident Representative) and Ms. Edda Rós Karlsdóttir (IMF Resident Representative's office) participated in the meetings.

The mission held discussions with Mr. Steingrímur J. Sigfússon, Minister of Finance, Mr. Guðmundur Árnason, Permanent Secretary, Mr. Indriði H. Þorláksson, Special Adviser to the Minister, Ms. Maríanna Jónasdóttir, Director-General (Department of Revenue and Taxation), Mr. Sigurður Guðmundsson, Head of Division (Department of Revenue and Taxation) and their staff. The mission also held discussions with officials from the Internal Revenue Directorate, the Tax Investigations Directorate, the Ministry of Industry, and Statistics Iceland. The mission benefited from discussions with representatives of labor and employer unions and social partners, the private sector, tax professionals and academics, and the Icelandic Association of Local Authorities.

The mission would like to express its gratitude to the Icelandic authorities for the assistance and the cooperation it received.

EXECUTIVE SUMMARY

The Icelandic authorities have launched a review of the tax system with a view to improving its income redistribution, growth orientation, and efficiency features, as well as increasing its revenue mobilization potential by 1–2 percentage points of GDP over the medium term. The increased tax collections would shore up the public finances in the wake of the recent crisis and fund medium-term policies to strengthen income redistribution, the social safety net, and public service provision, which are seen as lagging relative to other Nordic countries.

The Icelandic tax system already embodies in many of its features the state of the art in tax policy. It is reasonably simple with relatively low rates, broad tax bases, and few special favorable treatments and opportunities for tax arbitrage or avoidance. As a consequence, it collects a comparatively large amount of revenue while minimizing adverse effects on employment, economic activity, and compliance costs. Indeed, based on the OECD Revenue Statistics, Iceland has had a high revenue ratio in comparison with other OECD countries, and even among other Nordic countries.[1]

The recommendations that follow build on these strengths rather than taking the route of a radical departure from the current tax structure. They aim at minimizing detrimental effects on employment and growth, and at removing inconsistencies with international practices. The suggested tax measures—some with compensating transfers to low-income individuals—would boost the revenue potential in line with the authorities' objectives (Table 1), while substantially increasing income redistribution. The attendant increase in tax yield could support the budget or be used to reduce some of the general tax rates in a net revenue-neutral manner. The impact estimations here are preliminary. Eventual tax measures should be accompanied by an objective technical assessment based on official statistical data regarding their effects on economic activity and income redistribution, as is common practice in many OECD countries. Broad consultation with social partners and civil society should not be seen as a substitute for this analysis.

Fairness. The report analyzes the structure of the Icelandic tax system in the context of other Nordic, European and OECD countries. It emerges that countries that achieve the highest redistribution through their tax and benefit systems do so consistently through the spending side of the budget. In contrast, progressivity of the tax system appears low in all countries and bears little relation with the overall reduction in inequality through public policies. Success in the latter objective appears linked to strong benefit systems funded by tax systems

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[1] When the compulsory pension contributions are included for Iceland, or when social security taxes are excluded for all countries. Most compulsory pension contributions in Iceland are paid into private pension funds and thus do not score as taxes. In contrast, for example, Denmark funds the bulk of pension payments from general taxes, which requires a higher non-social security tax ratio than otherwise.

able to collect significant revenue. Taking tax progressivity beyond a certain point erodes revenue productivity due to associated economic distortions, footloose tax bases, and opportunities for tax avoidance. This, in turn, undermines the government's ability to undertake effective redistributive policies. In conclusion, the key contribution of the Icelandic tax system to the government objectives of income redistribution needs to be raising revenue efficiently in the necessary amounts, rather than achieving the desired reduction in inequality on its own. That said, the recommendations that follow aim at increasing the progressivity of the Icelandic tax system where opportunities exist.

CIT. While already consistent with OECD country practices, the Icelandic CIT would benefit from adopting financial accounting (IFRS in Iceland) as the basis to determine taxable income, except when explicitly otherwise indicated in the Income Tax Act. In particular, capital gains and losses should be treated as regular income. This would address many of the current difficulties in dealing with derivatives and other complex operations, and with debt forgiveness. Legacy cases in the latter area associated with the recent crisis could be dealt through a one-time transition policy. The current general arm's length criterion appears insufficient to forestall excessive interest expensing and could be complemented by a thin capitalization test, and treaty-based withholding relief on interest payments abroad expedited. Changes to the treatment of intercompany dividends would improve consistency with EU practices. Investment incentives under consideration could severely threaten the tax base—it is essential to avoid tax concessions or, at a minimum, radically restrict eligibility.

PIT. The current Icelandic taxation of individual capital income at a uniform rate separately from labor income and other earnings (the "dual income tax") allows capturing a broad base by offering little opportunity for tax arbitrage and very few exemptions—thus maximizing the effective revenue potential of this highly mobile base. The dual income tax is a feature of all Nordic tax systems (except Denmark) and lower taxes on capital income are applied in most OECD countries. Switching to comprehensive taxation with the progressive rate schedule applied to capital income is not advisable as it would severely harm savings, investment and job creation. In practice, it would likely result in complex exemptions, deductions, and special treatments, and ultimately erode revenue. The relatively favorable treatment of capital income, however, appears to have prompted a multiplication of closely held corporations to shelter income from the progressive taxation of labor income. It is recommended that closely held corporation and partnership income be split by determining capital income by a normal return on assets (e.g., the rate on medium-term government bonds) after deducting interest paid; the rest would be treated as labor income.

The PIT rate schedule has a comparatively large tax credit and consequently a steep jump at the first non-zero rate, while the first and last non-zero tax brackets are very narrow. To increase progressivity and revenue, and given the difficulties in reducing the tax credit, it is recommended that the non-zero brackets be reduced to two with the threshold between them at ISK 4.5 million and rates of 37.2 percent (the current first rate) and 47.2 percent. This

would yield about 0.25 percentage point of GDP in additional revenue. An alternative is also suggested, which would raise more revenue (0.4 percent of GDP) and keep three brackets, but it would entail a lower increase in progressivity. Raising the current 18 percent rates on corporate and individual capital income (which are lower than in other Nordic countries) to 20 percent would raise over 0.3 percent of GDP in additional revenue. It would also bring the consolidated tax rate on distributed profits very close to the lowest non-zero marginal rate on labor income, reducing tax arbitrage possibilities. In order to better integrate the corporate and individual taxation of capital income, and drastically reduce incentives for thin capitalization, it is recommended that the authorities consider for the medium term the introduction of a modified Allowance for Corporate Equity (ACE) in the CIT. This would allow the deduction of a normal return on assets and tax only profits and interest paid in excess of the normal return. However, the cross-border implications of a modified ACE warrants further study, and it is not recommended until budgetary pressures subside, owing to a likely revenue loss.

VAT. Compared to other OECD countries, the Icelandic VAT levies a large amount of revenue with low adverse effects on employment and growth. Non-standard exemptions and a lower second rate, however, undermine its neutrality and revenue potential without achieving any redistributive goals given Icelandic household expenditure patterns. It is recommended that, as circumstances permit, these features be removed in conjunction with the allocation of about one third of the revenue gain to fully compensate poorer households through means-tested programs. This would increase revenue by 1½ percentage points of GDP net of compensation costs and greatly increase overall progressivity. A more modest reform is also proposed as an intermediate step: eliminating non-standard exemptions and bringing the lower 7 percent rate back to 14 percent while restricting it to food, with full compensation to low-income households. This would yield slightly more than 1 percent of GDP net of compensation costs and would also increase the progressivity of the overall system, albeit to a lesser extent. In addition, better targeting of the local government refund for unrelieved VAT credit would increase efficiency.

Other taxes. The report welcomes the introduction of resource and environmental taxes, while pointing to potential base broadening and rate increases toward EU Emission Trading System (ETS) prices. Raising fuel tax rates (with compensating public transportation subsidies) would yield 0.3 percent of GDP. Food excises should be better targeted or otherwise phased out over time. Stamp duties should also be phased out due to their distortive and unfair features. The neutrality of motor vehicle taxes and associated incentives to fuel efficiency could be enhanced. Finally, property taxes offer significant revenue-raising potential with little negative implication for economic activity—which could be considered as incomes and housing markets recover.