Financial Activities Tax in Iceland

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Background

- Iceland‘s banking system grew to over 10x GDP in the years leading up to the crash.
- The system collapsed in November 2008, leading the government to take over three of the country’s largest banks.
- Complete economic meltdown followed.
- Refunding of the banks has cost the government approx. ISK 200 billion thus far, primarily financed through the issuance of 10-year treasury bonds.

Background, cont.

- A review of the Icelandic tax system necessary to shore up the public finances.

- Technical assistance from IMF - two reports:
    - "Improving the Equity and Revenue Productivity of the Icelandic Tax System" – June 2010.
    - "Advancing Tax Reform and the Taxation of Natural Resources" – May 2011.

- TA proposal:
    - *"Consider abolishing the reverse charge on self-supply by financial institutions and introduce a tax on the profits and remuneration of financial institutions (FAT)."*

“Bank (Debt) Tax “

- FAT is not the only specific tax imposed on financial institutions in Iceland.

- Since 2011, a special tax is levied on financial institutions’ year-end total outstanding debt at a rate of 0.041%.

- A revenue raising measure, but also a politically “symbolic” one. Generated only ISK 1 billion in 2011.

- Primary purpose of the bank tax is to reduce excessive debt accumulation of the financial sector and thus promote stability.

Motivation for the FAT

- Financial institutions should assume a fair share of restructuring costs.
  - In line with ruling government's agenda and public opinion.

- But also:
  - Financial and insurance companies are largely exempt from VAT
  - Need for government revenue to combat deficits.
  - Promote greater stability in the early years of a new financial system.

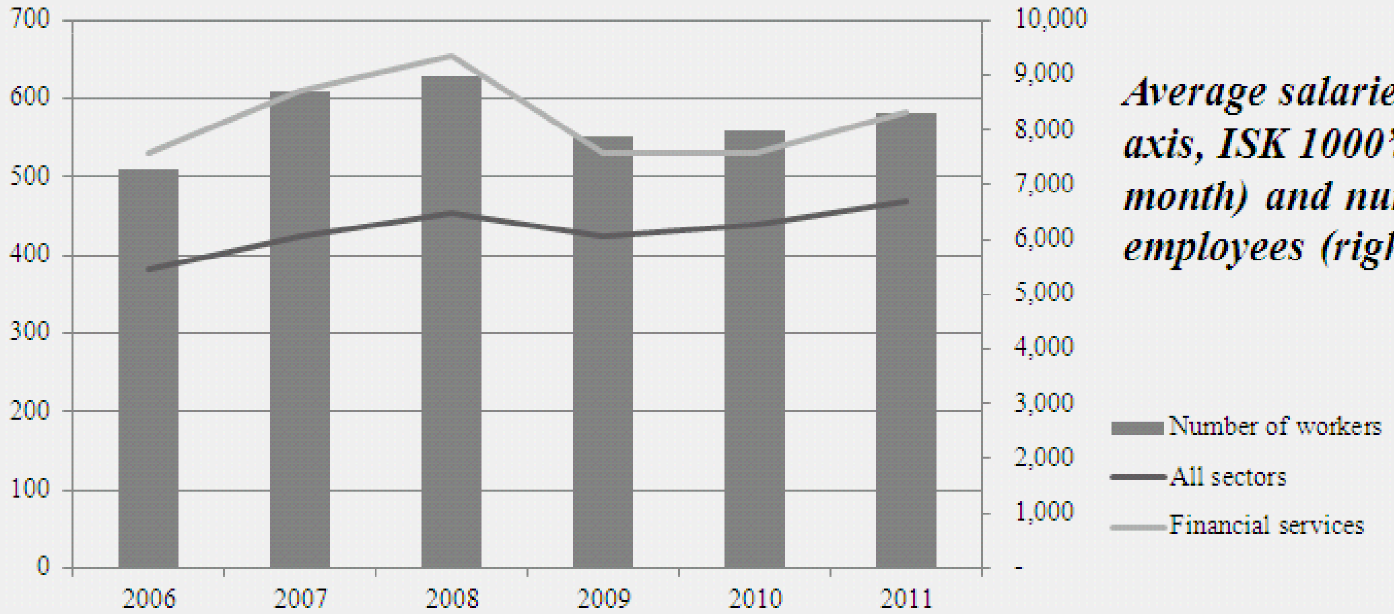
Iceland's FAT

- FAT bill put forward in late 2011:
  - The original proposal was a 10.5% flat tax on all compensation and benefits paid by financial and insurance companies.
  - Estimated to raise ISK 4.5 billion in revenue annually.
  - Partially based on a similar FAT scheme in Denmark.
  - Came under heavy criticism from the financial sector.

- Bill passed with substantial amendments:
  - Two components:
    - (1) a flat tax of 5.45% on all remuneration and benefits paid;
    - (2) special 6% income tax on the corporate income tax base exceeding ISK 1 billion.
  - Each component to raise ISK 2.25 billion annually.

5.45% tax on remuneration

- Tax receipts for H1 2012 total ISK 1,2 billion, in line with the 2.25 billion forecast for the entire year.
- No evidence that jobs and wages in the sector have been adversely affected by the tax.
  - YOY wage growth in Q1 2012 was 14.0% in financial services compared with 11.1% across all sectors.



Average salaries (left axis, ISK 1000's per month) and number of employees (right axis).

6% Income Tax Component

- Collected in assessment year based on companies‘ operations in the previous year.

- To be collected in 2012 as a prepayment, based on financial institutions’ tax base for the calendar year 2011, and later reassessed in the assessment year 2013.

- <u>Problems:</u>
  - Adds a layer of complexity to the original FAT scheme.
  - Difficult to predict revenue.
  - Some technical and administrative problems as regards 2012 prepayment.

Changes to FAT

- In relation to the 2013 budget, a proposal to change the FAT scheme has been put forward.

  (1) Abolish the special income tax component;

  (2) Only impose a tax on total remuneration through a double-rated system, whereby a lower rate applies to wages up to a certain cutoff amount and a higher rate to wages beyond the cutoff.

- In 2013, FAT is to generate ISK 5.5 billion in revenue.

- Given a tax base of approx. ISK 47-50 billion, imposing a rate of 10% on wages up to ISK 550 thous./month and a rate of 20% on wages exceeding 550 thous./month will generate approx. ISK 5.5 billion in annual revenue.

- General VAT rate is currently 25,5%.

Benefits of a Double-Rated FAT

- Shields lower-wage jobs in the sector.
- Reduces wage drift at the top and promotes financial stability.
- Politically easier to implement than a single higher rate.
- Simple from an administrative perspective.

Concluding Remarks

- 2012 is the first year that Iceland imposes a FAT.
  - ... but the bill that was eventually signed into law is very different from the original proposal.

- A proposal to adopt a double-rated FAT is now being considered.

- Long-term consequences will emerge over a long period.
  - However, early signs indicate that the FAT does not adversely affect employment or wage growth in financial services.

Thank you !