



**MS ritgerð**  
**Hagfræði**

**Moulding the Icelandic Tax System**

Primary-Industry-Based Special Interest Groups, Taxation,  
Tax Expenditure, Direct and Indirect State Support, and the  
Shaping of Tax Rules

Jóhannes Hraunfjörð Karlsson

Leiðbeinandi Þórólfur Geir Matthíasson

Hagfræðideild

Október 2014



**HÁSKÓLI ÍSLANDS**

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Prentun: Háskólaprent

Reykjavík 2014

*In memory of my parents*

*Ólöf P. Hraunfjörð 10<sup>th</sup> July 1932–6<sup>th</sup> December 2011*

*and*

*Karl Árnason 2<sup>nd</sup> May 1932–28<sup>th</sup> December 2012*

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## **Abstract**

This paper outlines the main developmental aspects of the taxation system (the definition of tax-base, tax rate, and the tax structure) and its administration according to primary-industry-based special interest groups in Iceland, from the time financial independence was obtained in 1874 to the present, the chief characteristics of Icelandic tax policy, and its contribution to developing the economic base. Special consideration is given to how corruption related to the tax system affects tax evasion, tax avoidance and inequality.

Evading taxes is illegal, and that introduces a fundamental difficulty into the measurement of tax evasion. The term “Non-Observed Economy” (NOE) refers to all economic activities for which unreported payments are made. Unreported payments can leave a trace: The three different methods to measure the gross domestic product, GDP, (the production approach; the expenditure approach; and the income approach) can be used as a tool to measure the NOE. The outcome of all these three methods should be the same. However, we can’t distinguish between tax evasion and other undeclared activities.

Corruption is principally a governance issue. A weak administration and pervasive corruption are related, and extractive institutions thrive on this. We point out how Icelandic institutions’ failure to manage society by means of social, judicial, political and economic balances lies in the taxation system.

There is no link between taxation policies or tax rates with Iceland’s economic growth, as taxes were fixed in response to the economic situation rather than according to proactive government planning. In the 1940s, the rate of tax evasion is estimated to have been between 35 and 45 percent, but in the events leading up to the crisis 2008, between 15 and 25 percent of the tax revenue.

The Icelandic tax system is such that the taxes are highly regressive and proportionally decreasing as the income is higher. Other causes of inequality are low replacement incomes and transfer payments between income groups in Iceland, as compared with other countries.

## Útdráttur

Skoðaðir verða helstu þróunarþættir skattkerfisins (skilgreining tekjuhugtaks, skatthlutfalls og uppbygging) og stjórnun þess með hliðsjón af hagsmunahópum á Íslandi, allt frá því efnahagslegt sjálfstæði fékkst árið 1874 og til dagsins í dag, ennfremur verða skoðaðir helstu einkenni skattastefnunnar og þáttur hennar í þróun efnahagslífins. Í því samhengi verður litið til þess, hvernig skattatengd spilling hefur áhrif á skattsvik, skattasniðgöngu og tekjudreifingu.

Skattsvik eru ólögleg, og eðli málsins samkvæmt er torvelt að mæla umfang þeirra. Hugtakið svart hagkerfi vísar til allrar starfsemi, sem greitt er fyrir. Þrjár mismunandi aðferðir eru notaðar til þess að mæla verga landsframleiðslu (VLF): framleiðsluaðferðin, ráðstöfunaraðferðin og tekjuskiptingaraðferðin. Útkoman ætti að vera sú sama, hver sem aðferðin er. Ekki er hægt að greina milli skattsvika, skattasniðgöngu, spillingar og annarrar ótilkynntrar starfsemi.

Spilling er stjórnunarvandamál sem öll ríki þurfa að takast á við, hvert sem þróunarstigið er. Rætur hennar liggja djúpt í stjórnsýslu- og stjórnmalastofnunum. Veik stjórnsýsla og djúpstæð spilling fara saman, og á því þrífast útdráttarstofnanir. Bent er á að á Íslandi hefur ekki tekist að stýra samfélaginu innan ramma jafnræðis að því er varðar félagsmál, dómsmál, stjórnsmál og efnahagsmál, og er skýringar að leita í skattkerfinu.

Engin tengsl eru milli skattstefnu eða skatthlufalls annars vegar og hagvaxtar hins vegar, þar sem hið fyrra er fremur viðbragð við efnahagsstöðunni fremur en áætlun ríkisstjórnar. Á fimmta áratugnum eru skattsvik áætluð milli 35 og 45 af hundraði, en í aðdraganda hrunsins 2008 eru skattsvikin áætluð milli 15 og 25 af hundraði skatttekna.

Skattkerfið byggist á háum en stiglækkandi sköttum, þ.e. skattgreiðslur fara hlutfallslega lækkandi með hærri tekum. Aðrar orsakir misréttis eru lítil tekjujöfnun og lág tilfærslugjöld milli tekjuhópa á Íslandi, miðað við það sem tíðkast annars staðar.

## Contents

Acknowledgements .....	1
Abstract .....	2
Útdráttur .....	3
Contents .....	4
Figures .....	8
Tables .....	9
1 The Research Area .....	11
1.1 Introduction .....	11
1.2 Research Problem Statement .....	12
1.3 Scope and objectives .....	13
1.4 Organization.....	14
2 The Conceptual Framework .....	16
2.1 Introduction .....	16
2.2 The Behavioral Response to Taxation .....	16
2.2.1 Tax Incidence.....	17
2.2.2 Taxation and Welfare Losses.....	19
2.2.3 Optimal Taxation .....	20
2.3 Governance Failure in Tax Collection.....	21
2.3.1 Tax Evasion.....	22
2.3.2 Tax Avoidance .....	23
2.3.2.1 Postponement of Taxes .....	23
2.3.2.2 Income Shifting .....	24
2.3.3 The Collection Process: the Role of Firms .....	24
2.3.4 Corruption, Clientelism and Economic Institutions.....	26
2.4 The Taxation Process and the Special Interest Groups.....	29



2.4.1	Taxation Process.....	30
2.4.2	Special Interest Groups .....	32
2.4.3	Model of change .....	34
2.5	Summary.....	35
3	Methods .....	36
3.1	Introduction .....	36
3.2	Research Questions .....	36
3.3	Sources of Information .....	37
3.4	Methodology .....	37
3.5	Summary.....	40
4	Iceland and the Scandinavian heritage.....	42
4.1	Introduction .....	42
4.2	The Nordic countries.....	42
4.3	The shift of power between the Danish King and the Icelandic people .....	45
4.4	The Political effects on the Budgeting Proposals.....	49
4.5	Summary.....	52
5	The SIGs' Infiltration of the Political Parties in Iceland.....	53
5.1	Introduction .....	53
5.2	Corporatist Framework for Small States.....	53
5.3	The Icelandic Sectorial Corporatism .....	54
5.4	Special Interest Groups versus Political Parties .....	58
5.5	Summary.....	62
6	The Effect of the Taxation Policy on the Economy since 1874 .....	63
6.1	Introduction .....	63
6.2	Local Government.....	63
6.3	The Income Tax System .....	65

6.3.1	The DIT-system 1877–1921.....	65
6.3.2	The CIT-system 1921–1996 .....	66
6.3.3	The DIT-system from 1997 to the present day.....	66
6.4	Indirect Taxation .....	68
6.5	The Influence of the Taxation Policy on the Economy.....	70
6.5.1	The Structure of Inequality .....	70
6.5.2	Economic Growth by Tax Periods.....	77
6.6	Summary.....	78
7	Agriculture: Market Failures and the Role of Subsidies.....	79
7.1	Introduction .....	79
7.2	Effects of Alternative Trade Policies .....	79
7.3	Agriculture, Fishing and Taxation in the Ancien Régime.....	82
7.4	The Influence of SIGs on Agricultural Policy .....	84
7.5	Summary.....	91
8	The Fishing Industry and Rent-Seeking.....	92
8.1	Introduction .....	92
8.2	Sovereignty, Rent Distribution, and Inflation .....	92
8.3	The Constitution and the Debate on a Fishing Fee .....	100
8.4	Saving the Furniture.....	103
8.5	Summary.....	105
9	The Influence of Special Interest Groups on the Taxation System .....	106
9.1	Introduction .....	106
9.2	Tax Evasion .....	106
9.3	Evaders are not Penalized.....	117
9.4	Shape the Tax System to fit your Interests .....	125
9.5	Summary.....	131

10 Summary of findings.....	132
10.1 Introduction .....	132
10.2 What is a Taxation System? .....	132
10.3 Factors Affecting the System of Taxation .....	132
10.4 The Icelandic taxation system.....	134
References.....	135
Appendix A: The Budgeting system in Iceland 1874–2014.....	144
The Formal Budgeting Process in Iceland .....	144
The Legal Framework for the Budgeting since 1874.....	147
The Budgetary System since 1874 .....	149
Formulation.....	149
Approval .....	152
Execution.....	154
Control and Auditing .....	156
Appendix B: The Right to Vote.....	159
Appendix C: Tax Administration in Iceland since 1877.....	163
The Structure of Icelandic Tax Administration.....	163
The Development of Tax Administration .....	165
Appendix D: The Marginal Tax Rates for Central Government and Local Government in Iceland 1931–2009 .....	169
Appendix E: Assessment in Reykjavík 1920–1961 .....	170
Appendix F: Taxation, Public Services, Transfers and Revenue as Percentage of GDP 1945–2009 .....	171
Appendix G: Taxes to Local and Central Government in 1927, ISK .....	172
Appendix H: Individuals Properties and Debts in 2014, in millions ISK .....	173

## Figures

Figure 1. Taxes and domestic and foreign transactions .....	17
Figure 2. The basic model of change .....	35
Figure 3. The Hierarchy of the Bureaucratic system in Iceland 1684–1873 .....	46
Figure 4. Finance Ministers by Political Parties, Total Taxation as % of GDP and CPI 1931–2009 .....	56
Figure 5. The Taxation Decision-Making Process .....	62
Figure 6. Local income tax in Reykjavík as a Percentage of Taxes to Central Government 1920–1961 .....	64
Figure 7. Direct and Indirect Taxes as Percentage of Total Income of the Central Government 1880–2009 .....	68
Figure 8. Income Taxes as Percentage of Couples' Total, Expressed as Proportional Layers 1993, 1998, 2003 and 2007 .....	73
Figure 9. Percentage of Marginal Tax, Average Tax and Income Tax for Couple with Two Children and a 5 million ISK Mortgage in 1996 .....	74
Figure 10. Taxation, Public Services, Transfers and Revenue as Percentage of GDP 1945–2009 .....	75
Figure 11. GDP to Disposable Income in ISK 1927, 2007 and 2009.....	76
Figure 12. Effects of Subsidies on Trade .....	80
Figure 13. Agricultural Export Subsidies in a Small Home Country .....	81
Figure 14. Subsidies as Percent of GDP 1877–1926 .....	85
Figure 15. Subsidies as Percent of GDP and Agricultural Ministers by Political Parties 1927–2010 .....	86
Figure 16. Evolution of %PSE, producer NAC and producer NPC for Iceland 1986– 2012 .....	88
Figure 17. Producer %SCTs by commodity .....	90

Figure 18. The difference between the expenditure approach and the income approach, and the CPI 1943–1976, % .....	98
Figure 19. The difference between the expenditure approach and the income approach, and the CPI 1921–1960, % .....	107
Figure 20. Collected sales tax and growth of GDP per person 1960–1989, 1960=100 .....	110
Figure 21. The difference between the expenditure approach and the production approach 1973–1990, % .....	112
Figure 22. Exchange Rate and CPI 1939–1959, 1939=100 .....	129
Figure 23. Taxation System .....	133
Figure 24. A simple presentation of the Budgeting Process in Iceland .....	144
Figure 25. The organizational structure of tax administration in Iceland since 1972 .....	163

## Tables

Table 1. Revenues by Social Classes in Iceland 1927 .....	70
Table 2. Revenues by Social Classes in Iceland 2007 .....	72
Table 3. Revenues by Social Classes in Iceland 2009 .....	72
Table 4. Yearly Population Growth, Economic Growth and CPI by Taxation Periods 1876–2009 .....	77
Table 5. Summary of Effects of Alternative Trade Policies on Prices .....	82
Table 6. Subsidies on Agricultural Produce 1877–1945, 1877=100 .....	86
Table 7. Subsidies on agricultural produce 1945–1986 .....	87
Table 8. The Expenditure Approach, the Income Approach, CPI and the exchange rate 1921–1976 .....	99
Table 9. Collected sales tax on each percent 1960–1989, at 1989 prices in million ISK. ....	111

Table 10. The Expenditure Approach, the Production Approach, and CPI 1973– 1990 .....	113
Table 11. Financing of households' final consumption 1997-2005 .....	114
Table 12. Total Tax Penalties ruled by Courts, the State Internal Revenue Board and the Directorate of Tax Investigations 2000–2013 .....	115
Table 13. Rulings of the Supreme Court of Iceland 2000–2009 .....	115
Table 14. Rulings by the District Courts of Iceland 2000–2009 .....	116
Table 15. Verdicts of The State Internal Revenue Board 2000–2009 .....	116
Table 16. Comparing tax controls and tax investigation per employee 2003–2009 .....	117
Table 17. The Evaluation of Tax Evasion as the percentage of the tax revenue 1875–2008 .....	117
Table 18. Taxes and Revenues of Companies in Reykjavík 1957 in ISK 000 .....	130

*There is no part of the administration of government that requires extensive information and a thorough knowledge of the principles of political economy, so much as the business of taxation. The man who understands those principles best will be least likely to resort to oppressive expedients, or sacrifice any particular class of citizens to the procurement of revenue. It might be demonstrated that the most productive system of finance will always be the least burdensome.*

*Alexander Hamilton, Federalist No 35 1788.*

## **1 The Research Area**

### **1.1 Introduction**

Economic growth and economic development in a country are affected by institutions in various ways. Such institutions are used to establish society, to provide public goods, to mitigate the effects of externalities. There are institutions for solving conflicts related to the distribution of rents, and institutions for solving problems related to filling gaps in insurance markets. Gaps in the insurance market can be filled by formal insurance schemes (e.g unemployment insurance and deposit insurance schemes, to name two widely different institutions), or informal schemes (paying hospital costs and other health related costs by tax money) where government is the risk manager (Moss, 2002).

The provision of public goods can be self-financing, in the sense that an economy with an optimal (or close to optimal) provision of the said goods may be considerably bigger than an otherwise comparable economy with an under-provision of public goods. Funding the public sector has proven a hard nut to crack, however, even if it can be shown that gains exceed costs. One source of the funding problem is the fact that gains may be considered to be unevenly distributed and costs may also be incurred by disproportionately by some part of the population.

It is the purpose of the taxing regime to facilitate the funding of useful projects, to redistribute rents, and to fund social insurance schemes. The majority of voters must accept the principles used for funding and redistribution embedded in the tax-code. Securing that acceptance is no easy task, and it can be firmly stated that the devil is in the details. In this thesis we analyze different patterns of taxation to understand variations in economic and political development in Iceland since 1874.

Our approach is in line with the famous pamphlet, *The Crisis of the Tax State* (Schumpeter, 1991 [1918]), where the taxation is the skeleton of the state stripped of all misleading ideologies, and the thesis of (Acemoglu & Robinson, 2013) presented in their book, *Why Nations Fail* (2013), where the difference between the states that fail and those that do not fail, lies in the difference between extractive and inclusive institutions. When institutions are centralized and pluralistic, they are inclusive, else they are extractive. The roots of these differences can be identified in the history of each nation.

Hence, there are several patterns and puzzles relevant to that, but this study seeks to explain this in the light of major reforms in the taxation policy in Iceland since 1874 by using tax-system analysis, as developed by Slemrod and Gillitzer in their book, *Tax Systems* (2014).

The core question of this research is: **To what extent is the legislation ruling taxation in Iceland influenced by Special Interest Groups?**

In tackling this question, tax policies are viewed as the equilibrium outcome of a collective choice process that is constrained by political as well as economic forces where the focus is on the willingness to pay, as Knut Wicksell recommended in his model on just taxation in 1896, and not on the ability to pay, which has been the mainstream approach since John Stuart Mill's sacrifice theory in 1861 (Blankart & Fasten, 2011).

## **1.2 Research Problem Statement**

We examine the main developmental aspects of the taxation system (the definition of tax-base, tax rate, and the tax structure) and its administration according to primary-industry-based special Interest groups in Iceland from the time financial independence was obtained in 1874 to the present, the chief characteristics of the tax policy, and its contribution to developing the economic base. The project is approached by the methods of public finance and collective choice in democratic states, where tax policies are viewed as the equilibrium outcome of a collective choice process that is constrained by political as well as economic forces (Drazen, 2002; Hettich & Winer, 1999). The idea that the political process may bias the result away from a socially preferred solution has



at least two aspects to it: the society may have preferences over efficient outcomes, or the political process may absorb resources in one way or another.

The main actors in the decision-making process of taxation policies in Iceland are: a) the Finance Ministry; b) Political Parties; c) Special Interest Groups; d) Government Ministers; and e) the Finance Minister. Until 1966 the preparation of the budget followed a rather consistent pattern, involving very few actors. During the Governors period (1874–1903), the Governor himself was the main actor, between 1904 and 1966 the budget was prepared by the Minister himself and the Permanent Secretary, in 1930 the budget procedure was reformed, and in 1966 the Bureau of the budget was established. In addition, it is important to observe how these policies are implemented, because the adopted policies are often further modified in the process of implementation. The central and local government offices that implement the fiscal policies in Iceland are: Ministry of Finance (which is responsible for drafting the Budgeting and Acts of Law relating to the tax-code, as well as doing the necessary research connected to proposed changes); The Icelandic National Audit Office (which is responsible for the audit); The Accounting Office (which is responsible for the accounting system); The Directorate of Internal Revenue (which is responsible for supervision of tax administration and ensuring the harmonization of the application of tax law to direct and indirect taxes); The Directorate of Tax Investigations (which is responsible for investigation of tax crimes, particularly major tax crimes); The State Internal Revenue Board (which decides in cases of disagreement between taxpayers and the relevant district tax office or the Directorate of Internal Revenue); and The Directorate of Customs (which is responsible for the collection of duties and other taxes and charges payable at customs clearance)

### **1.3 Scope and objectives**

How to finance government and how funding is distributed between the citizens are two fundamental, but difficult, political issues faced by every modern government (Stiglitz, 2012). This is, however, a little-researched topic, and the gap in the Icelandic literature is all the more surprising when one considers that taxation is at the core of the redistributive mechanisms of the modern welfare state and has been a central instrument of state economic policy since World War II.

By examining the role and impact of tax policy on social and economic development in Iceland since 1874, we will try to fill this gap. We will frame the effects of taxation (tax system and administration) by the methods of political economy within the context of economic and politics of Iceland. Furthermore, the traditional concerns of public finance (the incentive and incidence effects of taxation for efficiency in the allocation of resources and for interpersonal equity) all play an important role. In addition, this project broadens the study of taxes to countries like Iceland, where crises and political clientelism have been a recent phenomenon. Until now, research on taxation has mainly been focused on taxes in the United States of America. The result of the study will provide some insights and information on government actions. The work will also contribute to the study of the history of Iceland and to political science.

#### **1.4 Organization**

The plan of the present paper is as follows: In chapter 2, we describe the general theoretical framework, which is divided into three sections. The first section introduces the behavioral response to taxation. The second section reviews governance failure in tax collection. The third section narrows the study from the broad area of optimal taxation to the influence of special interest groups (SIGs) on taxation policy. In chapter 3, we describe the methods and the material to obtain and analyze the information collected by the research. The chapter is divided into three sections. The first section states the research questions of this research. The second section lists and explains the sources of information used in the research. The third section explains the strategy used to analyze the taxation policy in Iceland. In chapter 4, we discuss taxation and the Scandinavian heritage. In chapter 5, we deal with political parties and special interest groups. In chapter 6, we present and analyse the taxation policy since 1874. In chapter 7, we analyse subsidies to agriculture. In chapter 8, we analyse the relation between the taxation system and the main natural resource, fisheries. In chapter 9, we describe how the ruling elite shapes the tax system to fit their own interests and attempt to evaluate tax evasion as a proportion of the total tax revenue in Iceland since the end of the 19<sup>th</sup> century, and, finally, chapter 10 summarizes the findings.

There are 8 appendixes, where we discuss some relative materials in more details. In appendix A, we describe the budgeting system in Iceland 1874–2014; Appendix B: the

right to vote according to taxation; Appendix C: the tax administration in Iceland since 1877; Appendix D: The marginal tax rates for central government and local government in Iceland 1931–2009; Appendix E: assessment in Reykjavík 1920–1961; Appendix F: taxation, public services, transfers and revenue as percentage of GDP 1945–2009; Appendix G: taxes to local and central government in 1927; Appendix H: individuals properties and debts in 2014.

## **2 The Conceptual Framework**

### **2.1 Introduction**

This chapter presents a summary of the literature considered in this study. The chapter is divided into three sections. The first section presents general ideas about tax incidence and optimal taxation.

The second section raises the problem that originated this research, i.e. the problem of governance in tax collection.

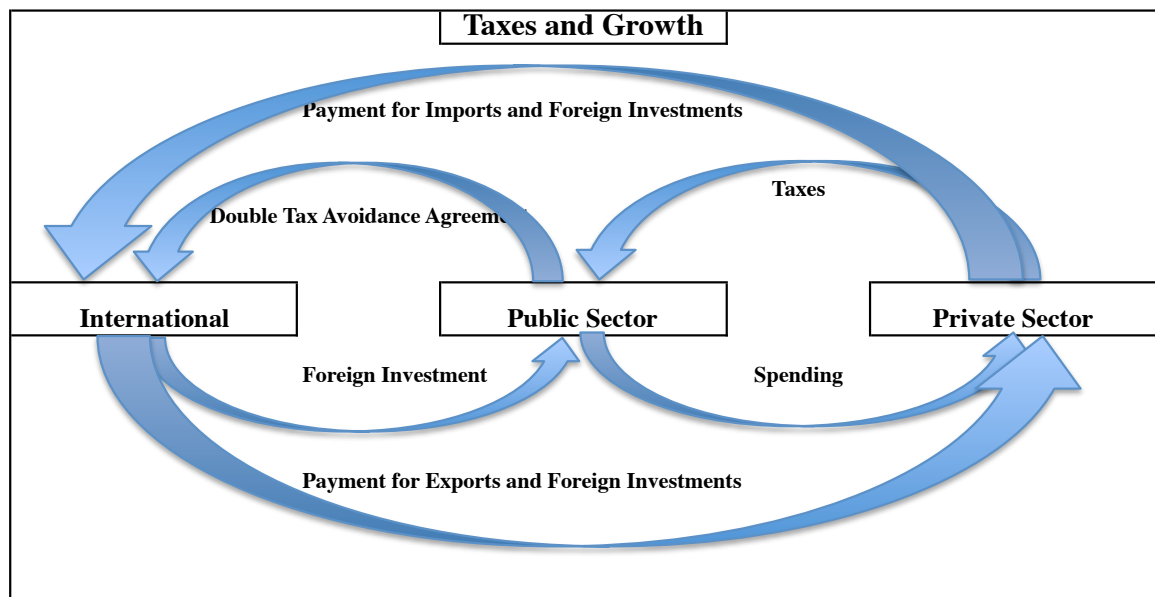
The last section narrows the study from the broad area of optimal taxation to the influence of the special interest groups on taxation policy.

### **2.2 The Behavioral Response to Taxation**

This part of the literature review is dedicated to the study of the economic effects of taxation.

The provision of public goods and the correction of market failure are the core functions of a modern state. Additionally, some states force their subjects to save for old age and/or engage in some form of additional insurance schemes. Taxation plays a role both as a forced insurance payment and as a tool to finance public goods and other goods provided by the state.

However, taxation is almost never a simple transfer of wealth. Economic theories of taxation focus upon the question of how to maximize economic welfare through taxation. A Pareto-efficient tax structure is such, that there exists no alternative tax structure that can make some individuals better off without making other individuals in the same social situation worse off. If such an alternative tax system exists, the current tax system is inefficient in the Pareto sense and is therefore not an optimal tax structure.



**Figure 1. Taxes and domestic and foreign transactions**

Figure 1 shows the effects of domestic and foreign transaction on economic growth. The key factor for such transaction is a double tax avoidance treaty, and such a treaty is also an efficient tool against tax frauds. This is a convention between two countries that aims to eliminate the double taxation of income or gains arising in one territory and paid to residents of another territory. It works by dividing the tax rights that each country claims, by its domestic laws, over the same income and gains. The history of such treaties is long.<sup>1</sup> The League of Nations started by its model in 1928, but now most conventions are done according to the OECD Model Convention.

We start by identifying tax incidence, then we will describe the effects of taxation on welfare and finally we will describe optimal taxation.

### 2.2.1 Tax Incidence

Who pays taxes? A first answer consists in accepting that it is the person who signs the check, like the government does. However, the economic reality does not always suit the government. Therefore, economists distinguish between those who bear the tax burden and those on whom a tax is imposed. The tax burden is the true economic weight of a tax. It is the difference between the individual's real income before and

---

<sup>1</sup> The first Icelandic double treaty was with Norway in 1022, i.e. Icelanders who went to Norway had to pay a special tax. This tax was discontinued with the Old Treaty in 1262.

after taxes have been imposed, taking full account of how wages and prices may have adjusted. In other words, the incidence of a tax describes who actually bears the burden of the tax. It does not depend simply upon who writes the check to the government.

However, although transparency is an important characteristic of good government, it sometimes seems as if the government deliberately misrepresents the true costs of the services it provides or who bears the costs. For instance, in most countries, social security (pension, unemployment and health benefits) is financed in large part from payroll taxes based on wages. Some of these taxes are “paid” by employers and some by workers. This legal distinction is artificial: the only wages that matter are those paid by the employee (the net wages). Whether the employer “pays” 70 percent or 30 percent of payroll taxes is immaterial to the equilibrium gross and net wages to the determination of employment, but makes workers believe that the employer actually bears some part of the tax.

Anyway, although the incidence of a tax does not depend simply upon who writes the check to the government, there are a few factors that affect the tax incidence. For example the wholesale merchant may pass on some or all of the tax in form of higher prices to the consumer. Whether or not a tax is wholly shifted forward will depend upon the price elasticity of supply and demand for the product. If the consumer does not reduce her purchases following an increase in price, the wholesale merchant will also be worse off and will be bearing part of the tax, although supply and demand curves are likely to be more elastic in the long run than in the short run. There are two general rules of incidence. In general, a company tax is paid by its shareholders, its employees or its customers. The company itself does not pay tax. And secondly, in the very long term, tax ends up being borne by people in proportion to their ability to transfer the inputs they provide to an economy, or their consumption, from one jurisdiction to another. Therefore, supply is more elastic in an open economy than in a closed one. If capital can move anywhere, governments will find themselves unable to capture revenue from providers of capital. On this account, a jurisdiction with high taxes on capital will simply have less capital, and capital will thus earn high pre-tax returns, which can increase tax frauds (Harberger, 1962, 2008).

### **2.2.2 Taxation and Welfare Losses**

Taxes affect economic behavior and reduce the efficiency of the economy. They transfer resources from individuals to the governments. As a result, individuals must alter their behavior in some way. If they do not adjust the amount of work they do, they must reduce their consumption. They may enjoy less leisure by working more, or they need to reduce their consumption.

This, of course, ignores the benefits that may accrue from the increased government expenditures that result from the increased taxes, but how can this impact be measured? At a Pareto optimum, and in the absence of externalities and public goods in an economy, the marginal rates of substitution of all consumers are equal to the technical marginal rates of substitution of all firms. Under the market conditions and without taxation, the competitive equilibrium is Pareto optimal since every consumer equates her marginal rates of substitution to the relative prices, while every firm equates its technical marginal rates of substitution to the relative prices. Once taxes are introduced in such an economy, the relative prices perceived by various agents differ, i.e. consumers perceive after-tax prices, while producers perceive before-tax prices. In these conditions equilibrium does not lead to the equality of marginal rates of substitution and it cannot be Pareto optimal. The price system sends different signals to different agents. For sake of completeness it should be added that taxation in presence of externalities and/or public goods may or may not “correct” a market failure that results from the presence of externalities and/or public goods.

Taxation has various effects on the economy (labor supply, savings and risk taking); some of these disturbances will be mitigated by the market through price changes while others cause welfare losses, such as underproduction and/or underconsumption, although the substitution effect may be masked by an income effect (Giffen good). The deadweight losses (welfare losses caused by the total tax burden) of a tax that is not a lump-sum tax increase with the magnitude of the substitution effect and increases with the square of the tax rate. This is often used as an argument for broadening the tax base: to collect a given revenue, it is better to have several low-rate taxes than one big tax or to have a broad-based low-rate tax rather than narrowly-based high-rate tax. An interest income tax, as viewed by a saver, would typically lead to an increase in savings,

while the substitution effect would lead to a decrease in savings (the net effect is ambiguous). For workers, the income and substitution effects of an increase in wages have opposite effects, i.e. higher wages may lead to either increase or a decrease in labor supply.

### 2.2.3 Optimal Taxation

The optimal design of a tax system is a topic that has long fascinated economic theorists. In his famous work, *Wealth of Nations*, Adam Smith listed four maxims for good taxes (Smith, 1998 [1776], pp. 451-454):

I. The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. (...)

II. The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. (...)

III. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. (...)

IV. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state. (...)

In the notes to his maxims, Adam Smith states that those who have a high income should pay proportionally high taxes:

It is not very unreasonable that the rich should contribute to the public expence, not only in proportion to their revenue, but something more than in that proportion.

The optimal tax structure, given a particular social welfare function, is the Pareto efficient tax structure that maximizes that social welfare function. Clearly, different social welfare function will generate different optimal tax structures. For instance a social welfare function in the spirit of Adam Smith and John Rawls (Rawls, 1971), which reflects a greater concern for equality may imply that optimal tax structure is more progressive, i.e. the rich bearing larger fraction of the burden for paying for public



goods, than that welfare function which is based on the work of Robert Nozick (Nozick, 1974).

In a perfectly competitive economy, the second welfare theorem tells us that any Pareto optimum can be attained through the right lump-sum redistribution. From this point of view, the lump-sum tax is the optimal form of taxation since it achieves any redistribution objectives at zero social cost. However, in the real world, things are more complicated. Individuals differ and governments wish to redistribute income.

Economists focus on trade-offs between equity and efficiency, points I and IV in Adam Smith's maxims, though equity is only studied in its vertical meaning, and the inefficiencies do not include the administrative costs, only distortions induced in the economy. However, since 1971 we do have a model that allows us to discuss the trade off between equity and efficiency in direct taxation (Diamond & Mirrlees, 1971a, 1971b). Anyway, the more progressive the tax, the larger the deadweight loss, the inefficiencies from the tax, but the less the degree of inequality.

Much of the political debate concerns how the tax structure should be, i.e. how much deadweight loss one is willing to accept for a given decrease in inequality. The optimal tax structure balances the gains from additional redistribution with the cost in terms of loss in efficiency. According to this, the government could collect the same or higher taxes where there is a large number of individuals with low marginal tax rates as where there is a low number of individuals with high marginal tax rates. On the other hand, high marginal rates in such ranges enable the government to collect the same or greater revenue with a lower marginal tax rate from the upper income individuals.

### **2.3 Governance Failure in Tax Collection**

This part of the literature review is dedicated to the study of governance failure in the collection of taxes.

Optimal taxation generates equity and efficiency cost of the tax system according to the utility maximization of each individual. Tax payers are heterogeneous, and some taxpayers are not too keen to pay their tributes, and this calls for "good governance" (OECD, 2012).

Governance is based on bureaucracy, which is a system of rule or a governmental system dominated by officials. The three main things that affect the bureaucracy's efficiency in collecting taxes are: tax evasion, tax avoidance and corruption. Tax evasion is the failure to declare taxable activity, while tax avoidance is a strategy for lowering tax payments. Tax avoidance is legal whereas tax evasion is not. Corruption is a complex phenomenon and is usually described as the illegitimate use of public power to benefit a private interest.

We start by identifying tax evasion, then we will describe the tax avoidance and how tax remittance is linked to that, and finally we will describe corruption and how it is linked to political and economic institutions.

### **2.3.1 Tax Evasion**

Since tax evasion is illegal, those engaging in it have every reason to seek to conceal what they are doing. First, this introduces a fundamental difficulty into the measurement of tax evasion. Second, the term Non-Observed Economy (NOE) refer to all economic activities for which payments are made but are not officially declared. These include (OECD, 2002):

Underground production, defined as those activities that are productive and legal but are deliberately concealed from the public authorities to avoid payment of taxes or complying with regulations;

Illegal production, defined as those productive activities that generate goods and services forbidden by law or that unlawful when carried out by unauthorized producers;

Informal sector production, defined as those productive activities conducted by unincorporated enterprises in the household sector that are unregistered and/or are less than a specified size in terms of employment, ant that have some market productions;

Production of household goods for own final use, defined as those productive activities that result in goods or services consumed or capitalized by the households that produced them.

Thus, there are several issues concerning the way economic activity is divided between the regular economy and the NOE. For instance, most national accounts do not include proceeds from criminal activity, but that is changing as many countries have started work on including proceeds from smuggling, prostitution, gambling and other activities

that are not legal into the national accounts. In principal, the UN System of National Accounts (SNA) includes both legal and illegal activities.

This implies that the extent of tax evasion cannot be measured directly, but must be inferred from economic variables that can be observed. The three different methods to measure gross domestic product, GDP, (the production approach; the expenditure approach and the income approach) can be used as a rod to see whether something fishy is going on in the economy. The outcome of all these three methods should be the same in principle; but in reality many things can cause differences, e.g., misunderstandings between buyers and sellers, reporting of the activity of one agent in year  $t$  while reporting of the same transaction by a counter-party in year  $t+1$ . Also, if income is concealed from the tax authority a transaction may be reported by one counterpart but not by the other counterpart. Hence, it is not uncommon to look at the difference of GDP as measured by different methods and use that difference as a measure of the degree of tax evasion.

### **2.3.2 Tax Avoidance**

Tax avoidance is legal, but the distinction between tax avoidance and tax evasion is not as clear-cut as it seems, since tax avoidance schemes frequently need to be tested in court or the State Internal Revenue Board in order to clarify their legal status. Basically, there are two principles involved when it comes to income-tax avoidance: the postponement of taxes and shifting the income from a high-tax category to a lower-tax category.

#### **2.3.2.1 *Postponement of Taxes***

There are several methods to postpone taxes by accounting tricks. For instance, one can postpone the capital gains tax on the sale of a summerhouse by postponing the date at which the transfer of the summerhouse finally occurs. When an individual buys a business, a car or a summerhouse, she often gets a loan from the seller, which is repaid over several years. When must the seller pay capital gain tax? Must you pay the tax when the control of the asset is transferred, or when the buyer pays off the loan? That depends on how the sale is designed. If the title is not transferred until all funds are received, the later payments may be deemed payments as a part of the purchase price, rather than debt repayments, and the seller will be able to postpone the capital gains

tax. A sale can be presented as a loan rather than the payment of the product (kaupleiga)—if the individual is registered as a company. This allows the recipient to defer payment of income taxes until the project is complete and the debt is paid off.

#### **2.3.2.2      *Income Shifting***

The second major strategy for avoiding taxes is to shift the income from one person to another, simply because the marginal tax rates increase with income. With a flat-rate tax structure, there is no incentive for income shifting, and thereby the government misses opportunities to balance the tax burden between the rich ones and the poor. Another way is simply to change the tax base. In Iceland, for instance, the capital gains tax is 20 percent, while the inheritance tax is 10 percent. If one buys a summerhouse and its value goes up, one can, of course, postpone paying the tax simply by not selling the summerhouse, but one can also shift the asset to one's children and thereby pay the inheritance tax only.

Corporations have more possibilities than individuals to shift their income between tax bases, and they also have tax credits for investment. Indeed, the corporations' tax planning is one of the biggest industries in the world and depends on the tax law in each country. Indeed, tax planning is often seen as interacting with corruption on a national and international scale.

#### **2.3.3    The Collection Process: the Role of Firms**

Taxes do not collect themselves. No government can expect taxpayers to comply with a tax code without devoting resources to administration and enforcement. Therefore, procedure for ensuring compliance, audit rates, penalties, and reporting requirements all represent important taxation system instruments.

In the *ancien régime*, the kings used to keep tax farms around their realm to collect taxes. It was much easier and cheaper for them to let one person, usually a merchant or the sheriff, collect all the taxes, rather than dealing with a smaller number of larger remitters with relatively sophisticated recordkeeping and accounting systems. Today the governments use business firms as a tax farms, but instead the word "tax farm" we speak of "withholding" or a "withholding system".

Withholding refers to a situation where someone other than the statutory bearer of the tax liability must remit it and, as in the old days, it allows the tax authority to take advantage of economies of scale and acts as a revenue safeguard. Withholding for income tax is widespread around the OECD countries and also for other taxes as well. However, there are differences in responsibility for remittances. For example, a retail sales tax is a consumption tax under which all tax liability is remitted by retail businesses, while a value-added tax, VAT, is a consumption tax under which the tax liability is remitted by firms all along the importing, producing, and distributing chain. In other words, the VAT has a so-called self-policing control system, which is main reason why the VAT rates are much higher than the sales tax (i.e. the sales tax rate is usually under 10 percent while the VAT rate is usually around 20 percent).<sup>2</sup>

Let's consider a standard partial equilibrium tax incidence analysis. When suppliers have the legal liability to remit taxes, equilibrium requires that the price for goods paid by consumers to suppliers,  $P_c$ , clears the market in the presence of a specific tax at rate  $t$ :

$$S(P_c - t) = D(p_c);$$

and conversely, when consumers are legally required to remit the tax:

$$S(p_s) = D(p_s + t);$$

where  $p_s$  is the price received by the supplier. Recognizing that  $p_s = p_c - t$ , both parties are in an identical economic position regardless of who remits the tax.

But when consumers and suppliers have different evasion and or avoidance technologies, the demand function when the consumer remits the tax is:

$$D = D(p, \tau, \omega_c),$$

and the supply function when the supplier remits the tax is:

$$S = S(p, t, \omega_s),$$

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<sup>2</sup> It was Maurice Lauré, a Frenchman born in Marrakesh 1917, who invented the VAT, and it was first legalized in France in April 1954.

where  $\tau$  and  $t$  are the tax rates remitted by consumers and suppliers when they bear the legal incidence, respectively, and  $\omega_c$  and  $\omega_s$  are parameters describing their respective avoidance/evasion technologies. Only in the special case when:

$$(\delta D/\delta p) - (\delta D/\delta \tau) = (\delta S/\delta p + (\delta S/\delta t)$$

are the economic incidence and other consequences independent of the party remitting the taxes. In general, the avoidance and evasion opportunities will differ between sellers and buyers, due to different reporting requirements, observability, ease of auditing transactions, and corruption (Slemrod & Gillitzer, 2014).

### **2.3.4 Corruption, Clientelism and Economic Institutions**

Corruption is a complex phenomenon that all governments, at any level of development, have to deal with. Its roots lie deep in bureaucratic and political institutions. The problem of corruption lies at the intersection of the public and the private sectors and is one of the world's largest obstacles to economic development and growth. Research shows that corruption affects economic growth, inequality and poverty, and the allocation of public spending and infrastructure.

In developing countries, where the distinction between the private and public sphere is often unclear, corruption is defined as: "abuse of entrusted authority for illicit gain" (NORAD, 2009). For a developed country, such as Iceland, this definition is too broad. Therefore, we will use the definition of (World Bank, 2006) and (UNDP, 2004) for corruption: "the abuse of public office for private gain". These forms of corruption can come in various forms of behavior, such as bribery, fraud, nepotism, falsification of records, and illicit campaign contributions, but all this damages economic growth and development. Corruption and governance failures can also be extended to other behaviors that may not always be considered illicit, but are driven by the narrow and self-serving interests of powerful elites consisting of policy-makers (bureaucrats and politicians) and Special Interest Groups, SIGs. Sources of revenue are central in shaping the elite incentives and strategies. In particular, it makes a difference whether or not the elite consists of employees, i.e. bureaucrats, or whether their revenues are 'unearned', particularly in the case of rents arising from high-value natural resources, as in the case of the owners of fishery quotas in Iceland. The incentives for both groups are

to increase their income and power by increasing spending and the control of resources, or else rely on specific institutional details of budget, taxing and legislative process.

Corruption is principally a governance issue and there is a strong positive causal effect running from better governance to higher per capita income (Kaufmann & Kraay, 2002). Corruption is a failure of institutions and a lack of capacity to manage society by means of a framework of social, judicial, political and economic checks and balances. When these formal and informal systems break down, it becomes harder to implement and enforce laws and policies that should ensure accountability and transparency. Robert Klitgaard, a leading expert in this field, devised a simple equation, which identifies the causes of corruption: monopoly control of public officials wielding discretionary powers in the absence of accountability systems (Klitgaard, 1998).

The UNDP, modified his formula by adding other dimensions: integrity and transparency. This creates the formula:

$$C=(M+D)-(A+I+T)$$

where C is corruption, M is monopoly, D is discretion, A is accountability, I is integrity and T is transparency. This suggests that the absence of AIT (primarily as a consequence of weak governance) in addition to monopoly and discretion, results in corruption. This formula strengthens the theory that corruption is primarily a failure in governance (UNDP, 2004).

In a democracy, taxation policy is an equilibrium outcome of a collective choice process (Hettich & Winer, 1999). It is the role of the political institutions to shape the taxation policy, as well as the relationships between those institutions and the political norms and rules that govern their functions including such concepts as the right to vote, political parties, trade unions, employers, responsible government, transparency and accountability. Politics is the process by which a society chooses the rules the will govern it, and according to (Acemoglu & Robinson, 2013, pp. 79-83) political institutions of a society are a key determinant of the outcome of the economic game. Following Acemoglu and Robinson, there are two kinds of political institutions or behavior: Extractive or exclusive institutions and inclusive institutions. When institutions are centralized and pluralistic, they are inclusive, else they are exclusive. There is a strong economic link between political and economics institutions. While political inclusive

institutions tend to support inclusive economic institutions, which lead to a more equal distribution of income, empowering a broad segment of society and tending to level the political playing field, extractive political institutions do the opposite. They concentrate power in the hands of a narrow elite and place few constraints on the exercise of this power. This elite, then, will often structure the economic institutions by tailoring the tax-code to the SIGs so as to be able to extract resources from the rest of society. Therefore, societies, where extractive political behavior is the norm, are more corrupted than those where the political behavior is inclusive.

Corrupted behavior is defined by (OECD, 2012) as:

**Predations** defined as the theft or confiscation of privately owned or publicly held goods for private gain;

**Corruptions** defined as the abuse of public office for private gain. This definition captures three elements of corruption. One, corruption occurs in both the public and private sectors, media and civil society actors are not exempt. Two, it involves abusing power held in a state institution or a private organization. Three, the bribe-taker, for example, a political party as well as the bribe-giver benefit, whether it be in terms of money, legislation or an undue advantage. According to this, grand corruption typically takes place at the top levels of the public sphere where policies and rules are formulated and executive decisions are made. On the other hand, petty corruption is the everyday corruption that takes place at the implementation end of politics, where public officials meet the public.

**Rent-seeking behavior.** Rents are the excess earnings above normal profits —i.e. the proportion of the sales value of a product that can be captured by a tax authority, a criminal or a protection racket, while leaving the producer with enough profit to be motivated to continue to produce. Rents can be created by policy distortions, trade and sales restrictions and market power, and can also arise in the extraction of natural resources whose world market price greatly exceeds production costs, as in the case of Iceland;

**Political patronage.** The allocation of resources (arising either from rents or targeted public expenditure) to narrow interest groups in a way that is intended to buy political loyalty and keep political patrons in power.

Clientelism is another form of corruption. Historian Richard Graham characterized clientelism as an action-set built upon the principle of "take there, give here," enabling clients and patrons to benefit from mutual support as they play parallel to each other at different levels of political, social, and administrative articulation. Clientelism is therefore, associated with the particularistic use of public resources and with the



electoral arena. It entails votes and support given in exchange for jobs and other benefits. It can also become a useful strategy for winning elections and building political support through the selective release of public funds to supporting politicians and associates or the acceptance of political nominees as personnel in state related agencies. It can also comprise a useful strategy for winning elections and building political support through the selective release of public funds to supporting politicians and associates or the acceptance of political nominees as personnel in state related agencies (Roniger, 2004).

## **2.4 The Taxation Process and the Special Interest Groups**

This part of the literature review focuses on the behavior of the special interest groups (SIGs) with respect to taxation.

Provisions of the tax code that allow people to reduce tax obligations or escape paying taxes are called “loopholes”. Hence, there are often disagreements about what constitutes these loopholes. Some of these loopholes are put inadvertently into the tax acts, as a result of errors when drafting legislation, and those may be corrected a year or so later. The fact that such errors occur with such regularity is a testimony to the complexity of the tax system, and the difficulty of making precise legal definitions in a complex economy. Other loopholes seem to be planted in the texts on purpose. Suppose, for instance, that the legislative authority intends to claim a fish resource fee. Those who view the act as unwarranted, and a result of the influence of SIGs, will label the relevant provision as a loophole, because it limits the taxes paid by the fish quota owners, while those who are not adverse to the act will see it as a tax expenditure, reducing other income taxes, value-added taxes and so forth, without lowering the degree of services to the tax payers. Thus it can be taken as a deliberate government decision to enable the public to enjoy some profits from a natural resource.

We start by identifying taxation process, then we will describe the special interest groups, and how they lobby in order to influence the taxation process and influence regulators, and finally we will describe the model of change that lead to our research questions.

### **2.4.1 Taxation Process**

The budget of the state is the most important decision of the government of every state wherein taxation is derived from expenditure. The budget process, including the rules and institutions by which the budget is made, is also one of the main political explanations of the size of the government. By limiting the size of the government, one limits the power of the politicians (Meltzer & Richard, 1981). The legislative branch and the executive branch are the two most important players in the budgeting process. Their respective roles and power differ between countries and are influenced by many factors, including the wider historical, constitutional and political contexts, as well as internal legislative structures and processes. The division of power between executive and legislative branches ranges from presidential systems with a separation of powers, such as in the United States, where the legislature has a strong role, to Westminster Parliamentary systems, where the executive generally dominates. In between, there are modified forms, such as those of the Nordic countries. However, the formal legal framework guiding the budgeting process is rather slight in Iceland in comparison to Denmark and Sweden, where special acts of law or regulations have been established to give instruction on the manner in which budgets are to be prepared. Hence, a new act is under consideration in the Ministry of Finance (as of early 2014).

There are two general classes of fiscal rules: quantitative rules and procedural rules. A balanced budget restriction is probably the most widely discussed quantitative fiscal rule, at least in Iceland, but this rule includes a variety of constraints: restrictions on deficit financing, including balanced budget laws; expenditure ceilings; numerical targets for fiscal variables; borrowing rules; and restrictions on issuance of debt. Much of the discussion on fiscal rules concerns such restrictions. The best-known regulations for quantitative fiscal rules are the Maastricht Criteria in Europe for the transition to EMU since 1992 and the Gramm-Rudman rules in the United States since 1985. Second, there are rules on the procedure by which fiscal decisions are made and how they are implemented. Procedural rules may concern the general procedures by which fiscal policy is formulated, as well as procedures to help ensure that policy rules are actually executed (Drazen, 2004). However, budgetary decision-making is political, rather than based on economic conditions (Wildavsky, 1986).

Nonetheless, the budgetary decision-making process is a system of rules and regulations, formal and informal, which determine how the fiscal decisions are made and, as mentioned above, it depends on the political structure in each country. The process can be hierarchical, where the higher have relatively more power in the preparation of the budget than the lower, or collegial, where individual ministers have significant power. In a coalition government, the power is also divided between the political parties. There are also two kinds of budgeting systems: a top-down system, or frame budgeting, and a bottom-up system.

The bottom-up budgeting process is much more expenditure-driven than the top-down system (IMF, 2009). Iceland started to use the top down system, or the frame budgeting, in 1992, where the frames are equal to the number of ministries.

The budgeting decision-making process may be divided into four major steps: formulation, approval, and execution or implementation, and finally, the auditing.

1. The budgeting process starts with negotiation within the executive branch itself, where the next year's estimation is usually based on the previous year.
2. The second stage is the Parliamentary process, where the legislature debates, alters (if it has the power to do so), and approves the budget plan. Procedural rules in the legislature concern several dimensions of the nature of voting on the budget, such as rules of agenda and rules of amendment. For example, in Iceland every bill is given three readings before it is legislated.
3. The third stage is the execution process (implementation, monitoring, and control), where the government implements the policies in the budget, and where there are also a number of conceptual issues concerning procedural rules and trade-off between actors. This stage is also the most turbulent one in the budgeting process, especially after the financial crisis in the Western World in 1980s when the level of public spending was much higher than it had ever been. The relationships between the participants are so highly interconnected that it is hard to change anything. It is not just that taxes are high, and therefore there is pressure to lower them, but all the welfare system is based on negotiations between government, unions and the employers (Webber & Wildavsky, 1986, pp. 490-493).
4. At last, we come to the revision stage (auditing and legislative assessment)—when the national audit institution and the legislature account for and assess the expenditures made under the budget.

Typical features of a corrupted policy-makers system are (NORAD, 2009):

Concentration of powers in the executive and weak or non-existent checks and balances;

Poor transparency surrounding executive decisions, combined with restricted access to information;

Elaborate regulatory systems allowing for discretionary decision making;

Weak systems of oversight and enforcement;

Soft social control systems/high tolerance for corrupt activities.

The best way to address popular disillusion towards politicians is to reduce the number of promises they can make, and the best way to constrain the power of SIGs is to limit the number of favors that the state can hand out. However, the need for reform is often acknowledged by political elites, but those gaining from corrupt conduct may delay or stop the reform process using legitimate arguments.

#### **2.4.2 Special Interest Groups**

Needless to say, special interest groups are not necessarily big business groups only. They can be consumers' co-operatives, associations of small and medium sized enterprises, groups of artists, writers' unions, small fishing vessel owners, labor unions, farmers co-operatives, universities, chambers of commerce, etc., and in fact, it is desirable to have such groups in every democratic country. However, in the case we are studying in the present paper, SIGs are policy maximizers, existing to transmit the policy preferences of its constituents to our elected officials. These groups are interested in passing legislation favorable to their preferred policy outcomes. Although SIGs are policy maximizers, they may be interested in partisanship, or their interests may be completely non-partisan. Where these groups find their ideological 'friends' is, in part, a function of the distribution of ideology among the members of the Parliament. SIGs want to maximize the number of representatives who share their partisanship. According to (Brunell, 2005), there are three reasons why SIGs have a shifting party preference: First, SIGs will naturally have an ideological affinity for one party or the other (i.e., no interest group is perfectly indifferent to the two parties). Second, political parties pressure those groups that lean in their direction to make more donations to their preferred party and less to the other party. Third, SIGs understand the importance of majority party status in the Parliament. Sincere donations are given to maximize the electoral benefit to the group's preferred candidates. Strategic donations are more oriented toward access to the opposite party; however, the donations are made to

ensure access, but minimize the electoral impact. The cornerstone of Brunell's argument is that the campaign contributions are fundamentally about affecting election outcomes. Donations are, for the most part, not made to buy votes or to buy access, but used by many groups to try to bring the distribution of ideological positions in the Parliament closer to the ideal point of the interest group.

The ethics and morality of lobbying are double-edged, and therefore, in most countries, lobbying in the form of campaign contributions etc., is only done within the framework of the law with rigid surveillance, but in Iceland for instance, such legislation did not exist until after the crisis of 2008 and, according to (GRECO, 2013), both the legislation and the monitoring system in Iceland are unduly poor and should be improved.

Following Brunell, there are two kinds of interest groups: Labor groups and corporate groups. Labor groups are interested in electing Democrats and corporate groups are primarily interested in electing Republicans. We have the same model in Iceland. Yet our main interest lies not in the campaign contributions to the political parties but on the contrary, in how the political parties have changed the tax legislation and the taxation system serving the interests of these groups.

Lobbying is often spoken of with contempt, when the implication is that people with inordinate socio-economic power are corrupting the law—twisting it away from fairness—in order to serve their own interests. The main reason for that is scarcity, which can corrupt incentives and notice that reduction in government spending or increased regulations can produce scarcity (Rose-Ackerman, 1999, pp. 39-42). The incentives for policy-makers (bureaucrats, politicians) and SIGs are to increase their income and power by increasing spending and the control of resources or through specific institutional details of budget, taxing and legislative process. Yet we must note that as long as the SIGs do not interfere with the optimal choice of the economic policies made by the government, from the viewpoint of long-term economic growth, it does not do any harm. With a view to taxation, the pressure becomes undesirable when the following effects result from the demands of SIGs and we can start to talk about clientelism or even corruption:

- Reducing investment and hence economic growth, by increasing costs and uncertainty (direct foreign investment and the productivity of public investment and infrastructure because corruption acts as a indirect tax);
- Lack of trust in society, i.e. politicians, institutions, instances;
- Entry prevention;
- Reducing tax revenues due to corrupt tax bureaucracy (deregulation, dysfunctional or corrupted bureaucracy, retarded efficiency, etc.).

There is also the other side of the coin, i.e. how the SIGs influence the regulators—in our case the bureaucrats of ministries and tax offices. The economic literature on regulatory capture relies on two premises: the regulators can be influenced and not all groups have equal opportunities to influence them. There are plenty of illegal ways to capture regulators, bribes, threats, etc. However, they are easy to fight, but it is more difficult to fight the legal ones: career concerns, control of information, and social pressure (Zingales, 2013):

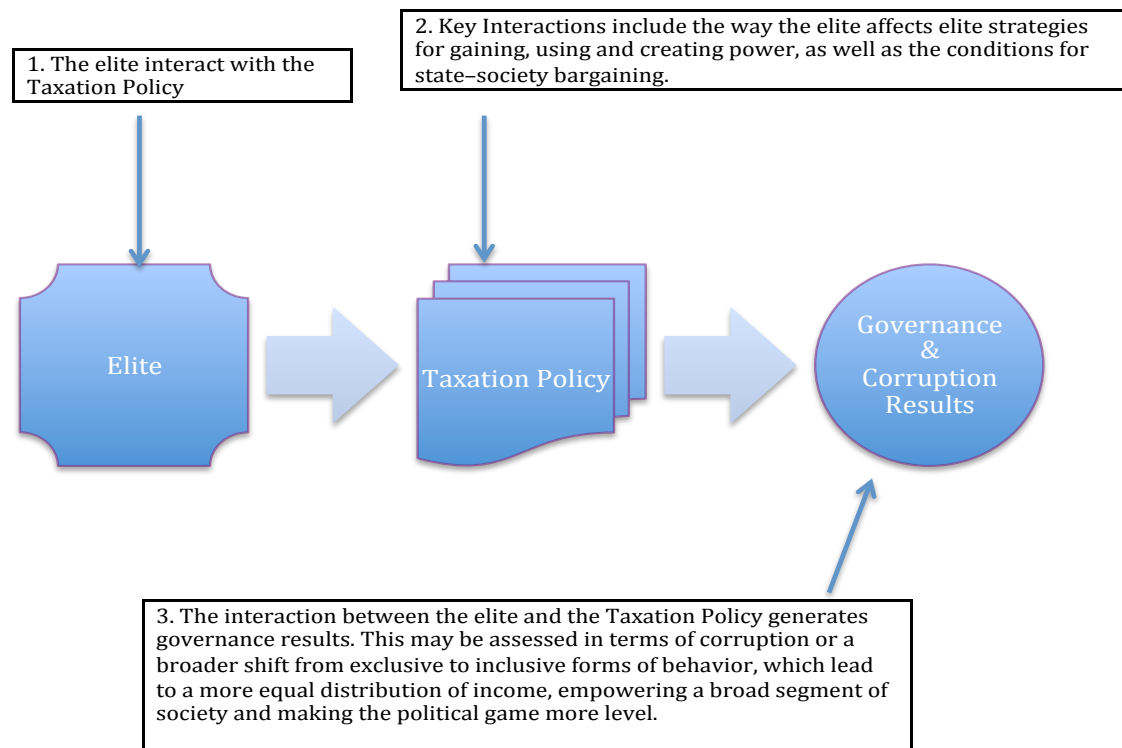
- The regulator can be offered a better-paid job outside the regulatory arena, i.e. SIGs may hire a former regulator because of the valuable skills he has accumulated on the job. Outside interests will prefer regulators who seem to understand their interest and are more sympathetic to them. Hence, if the regulator is not interested in getting a job outside of the regulatory arena, the SIGs can affect this person's career inside the regulatory world.
- Regulators need a lot of industry-specific information so they can do their job properly. Therefore, the regulator tries to establish a cooperative environment with the regulated.
- The regulated do not operate in a vacuum. They generally possess an industry-specific human capital, which has been accumulated through years of formal training. Part of the problem is, of course, the fact that the regulators rely on their network of trusted friends to gather information from the outside. If everyone in that network is drawn from the same milieu, the ideas that flow to the policymakers will be severely limited.

### **2.4.3 Model of change**

In order to streamline our ideas, we will use a well-known model where society is seen as consisting of two groups, the elites and the citizens, in which the latter are more numerous, see for example (Acemoglu & Robinson, 2006). Usually the word “elite” refers to a minority group with power or influences over others, recognized as being in some way superior, i.e. the rulers and the ruled. In our model, the elite consists of

policy-makers (bureaucrats and politicians) and SIGs, which all have the same incentives to increase their income and power by using the legislative process, bureaucratic systems, and the economic institutions. The model is illustrated in figure 2.

#### The basic model of change



**Figure 2. The basic model of change**

## 2.5 Summary

This chapter has emphasized that taxation policy is influenced by special interest groups. Taxation policies are also equilibrium outcomes of a collective-choice process that is constrained by political as well as economic forces. Our study question is the following: how do special interest groups influence the tax policy in Iceland.

The review of existing studies in this area drew attention to important aspects of the behavioral response to taxes and economic effects of taxation. Then we moved to failures of governance in the collection of taxes, and finally we focused on the behavior of special interest groups in connection with the taxation process and the models of change that lead to our research questions.

## 3 Methods

### 3.1 Introduction

This chapter presents information on the documentation supporting the research, the collection of the data, and preliminary considerations for data analysis.

The chapter is divided into three sections. The first section presents the questions that guide the study. The second section enumerates and describes the sources of information used to select and document the research. An explanation of the strategy of analysis used for the study concludes the chapter.

### 3.2 Research Questions

The core question of this research is: **To what extent is the legislation ruling taxation in Iceland influenced by special interest groups?** In order to narrow the scope of this interrogation to the research, the following main and secondary questions were raised.

Looking at the process of taxation in Iceland this study asks:

- What are the primary industries in Iceland?
- Which are the main SIGs?
- What is the relation between the SIGs and the political parties?
- What effects has tax policy had on inequality?
- What makes the political landscape in Iceland different from other Nordic countries?
- What effects does the tax legislation process have on actual taxation?
- How has the governance of the tax administration been influenced by the SIGs?

In order to identify behavioral responses to the process of taxation the following question was included:

- What behavioral patterns have influenced the process of tax evasion and tax avoidance in Iceland?



Finally, in order to determine how the tax burden has been transferred from the fishing industry to other groups by shifting assets towards the SIGs, we may ask:

- How are the inflation and the exchange rate connected to the fishing fee?

### **3.3 Sources of Information**

The study is based on primary and secondary data. The author of this thesis has acquired hands-on experience of taxes, first as a statistician at Statistics Iceland, and then as the Head of the Tax Surveillance Department at the Internal Revenue Directorate; he is thus well acquainted with the tax acts. The secondary data consist of national accounts and public finance statistics, etc. from Statistics Iceland, reports from the Directorate of Internal Revenue, the State Internal Revenue Board, OECD, IMF, the Ministry of Finance in Iceland, and, for the Tax Acts of Iceland, the Proceedings of the Parliament (*Alþingistiðindi* and *Stjórnartíðindi*). I will also refer to my MA-thesis in economic history from the University of Iceland (1996), dealing with the history of taxation in Iceland since the 10<sup>th</sup> century, and to my own unpublished history of Icelandic taxation and the tax system (Jóhannes Hraunfjörð Karlsson, 1996).

### **3.4 Methodology**

The research here examines the impact of tax policy on social and economic development in Iceland since 1874. Our main interest is determining how the policy-makers have changed the tax legislation and the taxation system serving the interests of SIGs and how this has affected taxation.

We will use methods of History, Political Science and Economics.

Social scientists have been questioning for a long time how the game-theory framework approaches the subject of tax evasion decision-making, and they have been asking questions about its central assumptions, including that nothing matters *per se* about its illegality and everyone acts as a free rider, so that there is no issue of intrinsic willingness to pay or tax morale. Some social scientists have even gone further and suggested that it is necessary to abandon the standard expected utility maximization model and incorporate behavioral considerations. One approach stresses that some people may fully comply with their obligation because of a sense of civic duty regardless of, or in addition to, possible pecuniary gains and argues that the tendency to perform

one's duty is susceptible to aspects of the enforcement process. Another approach suggests that, rather than behaving as free riders, the behavior of individuals depends on the process by which the taxation system is formulated and its features, as an instance they may be more willing to comply with a system whose formulation they took part in through voting. Taxpayer attitudes toward authority may also influence compliance behavior. Citizens are more likely to be law-abiding if they view legal authorities as legitimate. When both the explicit enforcement and the control system are weak, legitimacy may erode and thus undermine the intrinsic willingness of taxpayers to comply with the law. In other words the taxpayers behavior and motivations depends on the government itself. When citizens believe that the government will act in their interest, that its procedures are fair, and their trust of the state is reciprocated, people are more likely to pay their taxes (Slemrod & Gillitzer, 2014).

The three different methods to measure the gross domestic product (GDP)—the production approach; the expenditure approach and the income approach—can be used as a rod to measure the Non-Observed Economy (NOE). The outcome of all these three methods should be the same. When it is not, we have an indication that tax collection is in some way being circumvented, but, using data, we cannot easily distinguish between tax evasion, tax avoidance and corruption. Here, we argue that some of the points we want to make about tax evasion can be made about tax avoidance and corruption. To illustrate this interrelationship, recall from section 2.4 how the SIGs may plant loopholes in the tax laws.

Using the production approach to the measurement of GDP, the starting point is to measure output and intermediate consumption of goods and services, obtain added value as the difference between output and intermediate consumption, and sum the values added by different productions. In the expenditure approach, GDP is measured as the sum of expenditure components, i.e. final consumption expenditure, gross capital formation and net exports. The income approach directly measures the income arising from production, wages paid to employees and the operating surplus/mixed income coming from productive activities. The distinction between these three approaches is somewhat artificial because they are seldom used completely independently of one

another as they often share the same basic data. In practice, the compilation of national accounts is often a patchwork, with some elements estimated from the production approach, others from the expenditure approach, and still other from the income approach.

In Iceland, variations of all these methods have been used to measure the GDP. National accounts made in accordance with the value added approach have existed since 1870. Guðmundur Jónsson, professor at the University of Iceland, collected and calculated and constructed the national accounts from 1870 to 1945, but the government has been responsible for their construction since 1945. From 1945 to 1957, the government used the income approach, but from 1957 to 1960 the expenditure approach was also used. However, the GDP measurements by the income approach also existed from 1921 to 1976. The government has also made the national accounts employing the production approach 1973–1997 (the base was changed 1990, so we will only use it to 1990) (Guðmundur Jónsson, 1999, pp. 19-22, 43-52, 145-146; Þjóðhagsstofnun, 1992b, pp. 151-153, 215-228; 1994, pp. 15-30).

The Value Added Approach from 1870 will be the base against which the other two national accounting methods will be compared. We will use a method developed by Þröstur Ólafsson, Chairman of the Supervisory Board of Central Bank of Iceland, and Þórólfur Matthíasson (then an employee of the Ministry of Finance, now professor at the University of Iceland), together with Eyjolfur Sverrisson, employee of the National Economic Institute and Olafur Davidsson, CEO of the Federation of Icelandic Industries. This method was used to measure NOE in a committee report on tax evasion to the Parliament in 1986 (Fjármálaráðuneyti, 1986). Furthermore, in Iceland the Inflation has always been one of the main facilitator of equilibrium between macroeconomic supply and macroeconomic demand in the economy. Briefly, the reason for inflation is the failure of tax revenue to meet government expenditures. In Iceland, the tax base from income and consumption has been inadequate, and in the absence of large-scale borrowing from abroad, the Government has been forced to use seigniorage taxation. In other words, the Government does not use optimal taxation rules but has simply printed money to pay for expenditures. Therefore, inflation is principally a governance issue and generally, there is a strong cause and effect interaction between inflation, an

important economic parameter, and corruption (Akça, Ata, & Karaca, 2012). Therefore, we will view the Consumer Price Index (CPI), the collection of sales tax 1960–1989, the households' financing of their final consumption 1997–2005, the available rulings and verdicts 2000–2009 and the tax penalties 2000–2013 in order to measure the performance of the tax administration, and last but not least, the decision-making structure of the budgeting and the tax administration.

For describing the relationship between the ruling elite and the business elite we will use the research of Baldur Þórhallsson, professor at the University of Iceland, (Thorhallsson, 2010; Thorhallsson & Kattel, 2012) and to measure how the tax burden has been transferred from the fish industry to other groups we will use tools first described by Bjarni Bragi Jónsson, Deputy Governor of Central Bank of Iceland (Bjarni Bragi Jónsson, 1975), and principles for the distribution of rent from a 'commons' elucidated by Thórólfur Matthíasson (Matthíasson, 1992). When discussing subsidies in Icelandic agriculture, we will use the national accounts for the period 1870–1945, the Icelandic Agriculture 1945–1989, by the National Economic Institute (Þjóðhagsstofnun, 1992a) and OECD Producer Support Estimate, PSE DATABASE FOR ICELAND, since 1986 (OECD, 2014). The data are not classified by the same method in these various sources. The national accounts are based on the value added method, i.e. the subsidies are not divided between consumers and producers and often registered not as agricultural subsidies but as industrial subsidies. The National Economic Institute distinguishes between price subsidies and export subsidies, and the OECD has made a common base for policy dialogue by using a consistent and comparable method to evaluate the nature and incidence of agricultural policies between countries. The difference between the data is not an issue in this research. Our goal here is primarily to see the big picture according to the influence of the SIGs, and the data mentioned will be examined along with other sources.

### **3.5 Summary**

This chapter has presented main and secondary research questions focusing the process of the taxing policy, the primary industry of Iceland (fisheries) and the SIGs. The sources of information have been listed and described. Finally, a the methodology for

processing the data collected for the analysis has been briefly described. Emphasis has been placed on the relation between SIGs, political parties and taxation.

## **4 Iceland and the Scandinavian heritage**

### **4.1 Introduction**

This chapter focuses on the political process that led to the political landscape that contemporary Icelanders have partly inherited and partly chosen. The most important act of law in every country is its constitution, and it is also the constitution that sets the fundamental principles of taxation (Buchanan, 1986). How were the rules of law chosen? Were they forced upon society or approved by the nation? The roots of such differences can be identified in the history of each state (Acemoglu & Robinson, 2013).

The chapter is divided into three sections. The first section gives a brief overview on how the decision procedure took place in the Nordic countries.

In the second section we describe the situation in Iceland that led to the shifting of power from the Danish King to the Icelandic people in 1904.

In the last section we describe the effects of the Icelandic political institutions on budgeting proposals.

### **4.2 The Nordic countries**

The Nordic model refers to the economic and social models of the Nordic countries (Denmark, Finland, Iceland, Norway and Sweden). They all made their own constitutions as independent sovereign states, except Iceland. There are significant differences between these countries, but they also have some common traits. These include support to the welfare state in which the state plays a key role and accepts responsibility for the protection and promotion of the economic and social well being of its citizens. The Nordic model is distinguished from other types of welfare states by its emphasis on maximizing labor force participation, promoting gender equality, egalitarian and extensive benefit levels, the large magnitude of wealth redistribution, and liberal use of expansionary fiscal policy. The fundamental rule on which the Nordic Model is based is the cooperation between the Nordic countries where the Nordic Council, since 1952, and the Nordic Tax Convention Model, since 1989 (originally since

1972), play central roles, and were indeed the model for the free movement in the EU and the OECD Tax Convention Model (originally since 1963).

However, we must bear in mind the fact that the Nordic countries share a common heritage and history, extending more than 1000 years back. *Gylfaginning* (The fooling of Gylfi) by Snorri Sturluson (1179–1241) starts by telling how Gefjun, a woman of asa-race, fooled the King Gylfi of Sweden by using her knowledge of taxation. Gylfi rewarded her by promising her she would own the land she could plow in one day and one night. This bears witness to an ancient tradition that prevailed for centuries. Gefjun was a supernatural being, and her plow shaped the land, so it became what we know as Seeland. The Malar Lake formed where the where Seeland was cut out of Sweden. The oxen pulling the plow were indeed a powerful means of taxation, and they laid the foundation for the Nordic taxation system. Indeed, until the 20th century, arable land was the basis for all taxation in this part of Europe. The Kalmar Union (1397–1523) joined the three kingdoms of Denmark, Sweden (then including Finland), and Norway (then including Iceland, Greenland, the Faroe Islands, and the Shetland and Orkney Islands) under the single monarchy of Margaret I of Denmark. Legally, the countries remained separate sovereign states, but with their domestic and foreign policies dictated by the same common monarch. Diverging interests gave rise to a conflict that would hamper the Union in several intervals from the 1430s until its definite breakup in 1523, when Gustav Vasa became king of Sweden.

The 18<sup>th</sup> century marked the end of absolutism in Sweden. The first constitutional Instrument of Government was enacted in 1719, and between 1739 and 1772, Sweden enjoyed a constitutional monarchy, with two parties contesting for political power, the Hats, representing large business and industry supported by France, and the Caps, who were favored by Russia and stood for small merchants and manufacturing. The Hats, who might be today regarded as Keynesian types, held power from 1738, but because of the seven years war their policy collapsed, and by 1772 Gustav III had achieved a *coup d'état*. He was assassinated in 1792, and his son Gustav IV Adolf was not talented enough to steer his kingdom through the dangerous era of the French Revolution and Napoleonic wars. After the Treaty of Tilsit 1807, between Napoleon and Alexander of Russia, Alexander started to pay serious attention to this unpopular Swedish King.

Gustav IV Adolf, allied with Britain against Napoleon in order to prepare a joint attack against Denmark, whose Norwegian possessions he coveted. Russia defeated Sweden in 1809 (Finnish war 1808–1809)—Finland had been a part of Sweden since the 13<sup>th</sup> century—and the Grand Duchy of Finland was created as an autonomous part of the Russian Empire. It remained in force until Finland's independence in 1917. The loss of virtually half the realm to Russia led to a new royal dynasty in Sweden and a new constitution in 1809. The Riksdag elected Jean-Baptiste Bernadotte as a Crown Prince (Karl Jóhann) who joined the allies against Napoleon. He defeated the Danes in 1813 and the King of Denmark, Frederick VI, ceded Norway to the King of Sweden in the Treaty of Kiel 1814 (Kindleberger, 2007).

Based on the constitution of 1809, Sweden was a constitutional monarchy ruled by the House of Bernadotte, who became hereditary kings in 1810 (The Swedish Constitution Day is June 6). Power was shared between the king and the Riksdag of the Estates consisting of the nobility, the clergy, the bourgeoisie and the peasantry. In 1865, this system was abandoned in favor of a two-chamber system. The members were selected by one quarter of the male population. Those whose total wealth was above 80,000 crowns or who received a personal income of above 4,000 crowns a year elected the first chamber indirectly. It consisted of 150 members of the upper class. The second chamber was elected directly and less restrictively by citizens with an income of above 800 crowns or with an estate valued more than 1,000 crowns; this second chamber consisted of 230 members. Acts of legislation had to pass both chambers to become valid. According to this system, the distribution of representatives was markedly skewed towards the rich and very rich. They decided on the taxes, which had to be paid by both the rich and the poor. The Swedish economist, Knut Wicksell, based his model of just taxation in 1896 on this parliamentary system (Blankart & Fasten, 2011).

We will come back to Wicksell's model later. Now let us look at the situation in Norway. Following the end of the Gunboat War between Denmark and England 1807–1814, during the Napoleonic Wars (1799–1815), the Crown Prince of Denmark-Norway, Christian Frederik, was sent to Norway as a governor to promote the loyalty of the Norwegians to the royal house of Denmark. The Danish royal house was in danger from those who supported Sweden, because the Treaty of Kiel had forced Denmark to cede



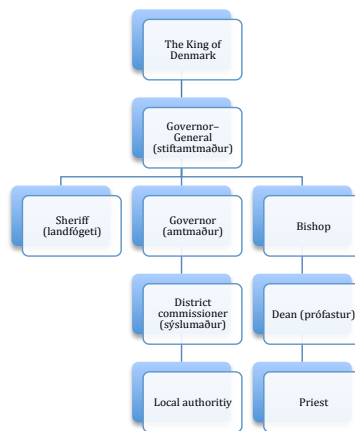
Norway to Sweden. In Norway, Christian Frederik founded a Norwegian independence movement to reunite Norway and Denmark. His initiative was successful, and at the national assembly at Eidsvoll during the spring of 1814, a constitution was written, inspired by the United States Declaration of Independence of 1776 and the French Revolution of 1789. The constitution was ratified by the assembly on May 16, and signed the following day, the latter date now celebrated as the Norwegian Constitution Day. By the end of the year, the Norwegian Parliament had agreed to rally with Sweden in a personal union with the Swedish king. Although nationalist aspirations were not to be fully realized until the events of 1905, the year 1814 saw the crisis and turning point in the events that eventually led to a fully independent Norway.

The Danish liberal and national movements began with the rise of nationalism in Europe in the 19th century, especially after the July Revolution of 1830 in France. In 1834, the King's power was gradually reduced with the creation of 4 assemblies called "diets" for Iceland, Jutland, Schlesvig and Holstein. Only men who owned a certain amount of property could vote, and the diets only had the power to advise the King. Furthermore, during the period between 1837 and 1841, local self-governments were created in Denmark. Yet, liberals demanded more reforms. The growing bourgeoisie had demanded a share in the government, and in an attempt to avert the sort of bloody revolution occurring elsewhere in Europe—Frederick VI died 1839 and Christian Frederik, the former governor in Norway, became King as Christian VIII—the King gave in to the demands of the citizens. Denmark became a constitutional monarchy on June 5, 1849 (the Danish Constitution Day). A new constitution emerged, separating the powers and granting the franchise to all adult males, as well as providing for freedom of the press, religion, and association. The King became head of the executive branch. The legislative branch consisted of two Parliamentary chambers as in Sweden: the Folketing, comprising members elected by the general population, and the Landsting, elected by landowners.

### **4.3 The shift of power between the Danish King and the Icelandic people**

In 1262, Iceland became a province of Norway and followed it as a province to Denmark in 1383, but remained with Denmark after 1814.

### The Hierarchy of the Bureaucratic system in Iceland 1684–1873



#### Notes:

##### Population by Households and Administrative Divisions (average) in Iceland 1850

	Governor– General (Stiftamtmaður)	Governor (Amtmaður)	Province (Sýsla)	Rural county (Hreppur)
Number of administrative divisions	1	3	18	211
Population by administrative division	59,157	19,719	3,287	280
Households by administrative division	8,750	2,917	486	41

The Governor-General was the head of the executive power in Iceland. He was directly linked to the King, resided in Copenhagen and rarely visited Iceland. Each Governor also acted as district commissioner, overseeing more than one province. The Sheriff's main job was to control and collect taxes. The Governor-General, or the Governor, also acted as Sheriff. The church was part of the bureaucracy system.

In 1850, Count Jørgen D Trampe was both the Governor-General and Governor of the South Amt, Páll Melsteð was Governor of the West Amt, District Commissioner, and the King's representative at the Althingi. Pétur Havsteen was Governor for the Nord- and East Amt. He was also District Commissioner in Norður-Múlasýsla and the King's representative at the Althingi. Pétur Havsteen was also the father of the first Minister of Iceland in 1904, Hannes Þ. Hafstein. Kristján Kristjánsson was the Sheriff, he was also the King's representative at the Althingi, Governor, Judge and District Commissioner, and the Bishop was Helgi G. Thordersen. He was also the King's representative at the Althingi.

In 1850, there were three local representatives on average in each local government (around 600 men) and each household had on average 6.8 men. The peasants were serfs and bound to each farm and could neither move nor marry without permission. Revenues from direct taxation were low. In the 1830s, only 7,928 paid the tithe, thereof 4,690 had farms and 3,238 had no farm, and 2,687 paid the King's tax (thingfararkaup), but these two taxes were the main direct taxes in Iceland for centuries. The King and the Icelandic elite got their main revenues from land rental and fishery.

The number of rural counties was taken in 1930, but then the numbers had not changed for centuries. The population of different districts varies from as few as 30 to more than 1,100 in Reykjavík.

Sources: Einar Laxness (1995), Hagskinna (1997) and Jóhannes Hraunfjörð Karlsson (1996)

**Figure 3. The Hierarchy of the Bureaucratic system in Iceland 1684–1873**

In 1660, the Danish assembly, the Rigsdag, had granted the King autocratic powers. From then on until 1874—when the king “gave” Icelanders their own constitution—the Danish King was an absolute monarch and the whole bureaucratic system in Iceland was

based on that. Figure 3 illustrates the hierarchy of the bureaucratic system in Iceland 1684–1873. The nation was divided into officials (the elite or rulers) and peasants (the serfs or ruled), and a cause to the huge bureaucratic system, where there was one official for each two households, making it easy to monitor and control the people.

The Danish national movement influenced the Icelandic students in Denmark, and they began their struggle for the restoration of legislative authority and financial control in Iceland, but unlike other Nordic countries, the Icelandic national movement operated only in Denmark. Their main leader was Jón Sigurðsson (1811–1879), the founding father of Icelandic sovereignty and belief in the islanders' capability of self-governance (his birthday, June 17, has been the National day in Iceland since 1944). He spent most of his lifetime in Denmark, and his way of communicating with Iceland was to publish an annual magazine, in Icelandic, called *Ný félagsrit* (New Association Writings) 1841–1873, which had a wide audience in Iceland.

In July 1851, a national assembly that had been chosen and elected earlier, convened in Reykjavík, with 40 representatives, two from each constituency, thereof 6 as the King's representatives. Only men, who were 25 years or older and paid the King's tax or owned an equivalent property to the King's tax, could vote, i.e. 5 percent of the nation. Icelanders demanded a constitution, but the King rejected their claim. Count Jørgen D. Trampe, the Governor-General, came to the assembly with naval forces (a novel show of force in the history of Danish governance of Iceland), and the national assembly adjourned without reaching a conclusion. The situation remained unchanged for the following 20 years, mainly because the elites were against any changes in the relation between Denmark and Iceland. They wanted to maintain the privileges they had acquired through their relationships with the King.

In 1871, the King issued an Act (*Stöðulögin*) defining the status of Iceland within the Danish realm, defining Iceland as a province of Denmark but the Icelanders refused to recognize its validity. Following that, the King reorganized the bureaucratic system, and in 1874 handed down a constitution for Iceland.

The constitution was not *the* critical turning point for Iceland as had been the case in the other Nordic countries, for many reasons. First, the Icelandic constitution was handed down as a gift from the King, not a declaration drafted by the people for the

people. Second, the Icelanders themselves did not write the constitution. Third, the voting population did not approve it by any means. All these factors are immensely important, especially for the identity of a nation. Therefore, the struggle for independence kept on until the Home Rule period started in 1904, and it is worth mentioning that the revision of the constitution started in the 1880s, but the most of the amendments and changes that have been made have been the consequences of ratification of international treaties like the UN Charter in 1995. Full independence in 1944 brought in a President as a substitute for the King in the older constitution). Nothing has happened since, mainly because of conflict of the sovereignty over the country's natural resources (land and fisheries). The elites hold these from the sovereign, but every chain of title goes back to a grantor who originally seized the land or the fisheries, see chapter 8. The Act of 1871 (Stöðulögin), was, in contrast to the constitution, certainly the most important turning point for Iceland. The main reason is that the Icelanders never recognized its validity, which led to a conflict of identity; but the second, and not the smallest, reason is that during the Governor's period, especially in the years 1886–1904, when Magnús Stephensen was Governor, the foundations were laid for clientelism, which has been the backbone of Icelandic politics ever since. Magnús is an example of how the Danish selected their caciques or their local cooperating rulers from the native population. He was born into an ancient Icelandic elite family and was a successful bureaucrat. He was judge during the period 1870–1886, municipal representative in Reykjavík in the years 1874–1886, governor of the South-West Amt from 1883 to 1886, and the King's representative at the Althingi from 1877 to 1886, where he was the head of the control of the state accounts, and the head of the tax committee, i.e. the committee that made the first Icelandic income tax law, in 1877. Therefore, as a governor, he had an overview of all aspects of the government, and made all law proposals on behalf of the government, especially budget proposals. No one was employed by the government without his approval (Indriði Einarsson, 1972), and he also used his bureaucratic powers against his political opponents (e.g. the Skúli Thoroddsen affair, which was a political scandal in Iceland in the 1890s similar to the Dreyfus affair in France at the same time).

#### 4.4 The Political effects on the Budgeting Proposals

The politicians have always had a great influence on the administration in Iceland and *de facto*, the political system and the administration system have been one and the same (Gunnar Helgi Kristinsson, Halldór Jónsson, & Hulda Þóra Sveinsdóttir, 1992). Hannes Hafstein, who worked as his Permanent Secretary (landshöfðingjaritari) during the years 1889–1895 used the tactics of Magnús Stephensen as the first Minister of Iceland, and employed only members of his party or his friends as bureaucrats. Eggert Briem, the first Permanent Secretary in the Finance Office, and Indriði Einarsson, who controlled the state accounts 1877–1909, his successor, were the only ones that were not members of his party, but they were all friends. (Agnar Kl. Jónsson, 2004).

The Parliament's structure (how it is divided between chambers and how law proposals are debated) and, as Wicksell has pointed out, the collective choice process, reflect these interactions:

- With the constitution, in 1874, the Althingi obtained legislative power, domestic autonomy and control of the national finances. The King had the right to veto any parliamentary act presented to him, but that right was transferred to the president in 1944. Those MPs nominated by the King (1874–1915), who all were in the upper chamber, also had the right to veto if they all agreed to say no. The veto power can be hidden implicitly in the debate structure. From 1874 to 1991, the Althingi had two chambers: the lower chamber (2/3 of the MPs) and the upper chamber (1/3 of the MPs); Acts of legislation had to pass both chambers in order to become valid. Each law proposal—except the Finance Bill which was debated three times in general assembly from 1934—, had to be debated three times in each chamber, and if one of the chambers amended the law proposal, it had to be sent back to the other one, and if the chambers could not agree on the proposal, it was debated in the united Althingi where it would be adopted on the basis of two thirds of the votes.
- “Government by the people” has never been a recognized political principle in Iceland, just as the rule “one person, one vote” has never been in force (see Appendix B. The right to vote). Women did not have rights equal to those of men until 1920. The same applied to farm hands. However, according to the tax law,

married women were not independent taxpayers until 1979, and the head of the family, or the farmer, paid the taxes for the farm hands until 1934, and in practice even longer. Until 1934, the right to vote was restricted to those eligible to pay taxes. Voters in urban areas have always had fewer representatives per 1000 voters than voters in rural areas. This is one of the main reasons for the governmental crisis between 1930 and 1960. Those parties that have profited from the election systems are the Progressive Party and the Independence Party (Gunnar Helgi Kristinsson, 1993; Svanur Kristjánsson, 1993), and these two parties have taken turns in managing the tax system in Iceland.

Most of the officers who had been in charge of the budget proposals after 1904 (the National Secretary and the Permanent Secretary) were hired on the basis of political party affiliation or the kinship structure. For those who were considered to be “independent”, working conditions became more and more unfavorable until they resigned (see Appendix A: The budgeting process in Iceland 1874–2014).

However, the key issues on budget execution are always whether deficit targets are likely to be met, and whether the implementation of budget adjustments (both on the revenue and expenditure sides) agreed at the preparation stage has proceeded as planned. On the expenditure side of the budget, the key issues are whether the outcome is likely to be within the budget figure; whether any changes in expenditure priorities (as against past patterns) are being implemented in specific areas as planned; and whether any problems are being encountered in budget execution. The State Audit Office, “Ríkisendurskoðun” was removed administratively from the Ministry of Finance and made a part of the control apparatus of the legislative arm in 1986. Shortly afterwards they started performance audits, which led to the Financial Reporting Act No. 88 of 1997. Since the beginning of its own budgeting in 1874, Iceland has had a poor track record of enforcing discipline during budget execution. Supplementary budgets are now submitted during the budget year, whereas earlier they were submitted a year or two or three after the fact. The supplementary budget as a percentage of the total expenditure has been very high most of the time. This is partly due to unpredicted

inflation but is also a symptom of clientelism<sup>3</sup>. Until WWI, Iceland overspent its annual budget by an average of 15.8 percent, (1917–1921, its annual overspending was 71,1 percent). From WWI to the end of WWII, Iceland overspent its annual budget by an average of 33.2 percent, and from WWII to 1959, Iceland overspent its annual budget by an average of 13.3 percent. Although there were some ‘good’ years in the beginning of the 1960s, overspending soon reverted to previous levels. In the 1970s, Iceland overspent its annual budget by an average of 18.3 percent, and during the decade leading up to the 2008 crisis, Iceland overspent its annual budget by an average of 12 per cent (G. Blöndal, 1983; Gísli Blöndal, 1965a; IMF, 2012).

This overspending is mainly the consequence of political negligence, clientelism and disorganization, and although some of the loopholes that enable the Government to exceed the annual Financial Act have been closed, there have existed at least five different ways in which spending agencies could overspend relative to their annual appropriations without being sanctioned:

- According to articles 12 and 23 of the Financial Reporting Act No 88 of 1997, the spending agency can increase or anticipate the collection of a range of own revenues, which are netted off against their appropriation in the current year.
- According to article 37 of the Financial Reporting Act No 88 of 1997, the spending agency can overspend from its accumulated stock of underspends carried forward from previous years.
- According to articles 33 and 34 of the Financial Reporting Act No 88 of 1997, the spending agency can seek retrospective of Parliamentary authorization for the overspend before the end of the year through a supplementary budget.
- According to article 44 of the Financial Reporting Act No 88 of 1997, the spending agency can seek retroactive Parliamentary authorization of the overspending after the end of the year through the Finance Act.
- According to article 45 of the Financial Reporting Act No 88 of 1997, the spending agency can deduct the overspend from their appropriation for the following year.

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<sup>3</sup> Inflation inflated both revenue and expenditure. Hence, if inflation is in excess of what is projected in the budget, and if legislative control is lax, the Ministry of Finance and the Minister of Finance are defacto given budgetting power that is only limited by the excess income generated by the “unexpected inflation” on revenue.

These channels are supposed to close when the new Act takes effect in 2015 (IMF, 2012).

#### **4.5 Summary**

The chapter presented the political landscape in Iceland and other Nordic countries since the early middle ages, the development of political institutions in Iceland in 1880s and finally the effect of the politics on the budgeting process in Iceland.



## **5 The SIGs' Infiltration of the Political Parties in Iceland**

### **5.1 Introduction**

This chapter focuses on how Special Interest Groups in Iceland encourage their supporters to join political parties in an attempt to expand influence and expand their ideas and program. The incentives for SIGs are to increase their income and power by increasing spending and the control of resources or to exploit specific institutional details of the budget, taxation and legislative processes. When the economic institutions are extractive, the tax legislation and the taxation system are twisted away from fairness and equality and the outcome is undesirable.

The chapter is divided into three sections. The first section gives a brief account of why the political elites in small states have come to the conclusion that inclusive decision-making based on consensus is best suited to minimizing conflicts and maximizing economic gains.

In the second section, we will describe influence of the sectorial corporatism on taxation in Iceland.

In the last section, we will describe the relationship between the ruling elites and the business elites, how the ruling elites make it to the top of the power pyramid, and how they use and maintain power.

### **5.2 Corporatist Framework for Small States**

Two reasons have been presented to explain why small European states seem better equipped than large states to deal politically with economic crisis. According to the first one, the political parties on the right in these states are divided, which has led to a distinctive party system and encouraged a system of coalition, or minority, governments. This has created a system of consensual decision-making and given opposition political parties significant influence over policy formation. In essence, these are compound policies. However, the main argument has been the democratic corporatism enhanced by an extensive domestic consensus. The historical origin of democratic corporatism has been dated back to the economic and political crisis of the

1930s and 1940s, when labor-market organizations become crucial actors in the government's decision-making concerning public finances and the national economy. Its aim is to limit conflict in the society (Thorhallsson & Kattel, 2012).

The author of the thesis, Katzenstein, argues that size of the states facilitates particular political outcomes and should be dealt with as a variable rather than a constant. He identifies three characteristics of strong corporatism that can be contrasted with the weak corporatism found among large states. Firstly, an ideology of social partnership prevails in the small states. This emphasizes consensual decision-making between all key actors in the society. Accordingly, labor-market organizations and the government come to joint decisions regarding economic policy and finances. Secondly, the smallness of the society means there are fewer important economic sectors, fewer important organizations, and fewer policy-making sub-units as compared to larger states. Hence, decision-making in small states is characterized by centralization and concentrated interest groups, and it is easier to reach a compromise and consensus than in larger states. Thirdly, a formal political bargaining framework is set up in which all-important interest groups participate in policy formation and implementation of the government's policy (Katzenstein, 1985).

In other words, democratic corporatism may be the result of historical choices and the smallness of a society. The political elites have determined that inclusive decision-making based on consensus is best suited to minimizing conflicts and maximizing economic gains. This decision-making framework is vital in order for small states to deal with economic and political vulnerability due to increased economic openness.

### **5.3 The Icelandic Sectorial Corporatism**

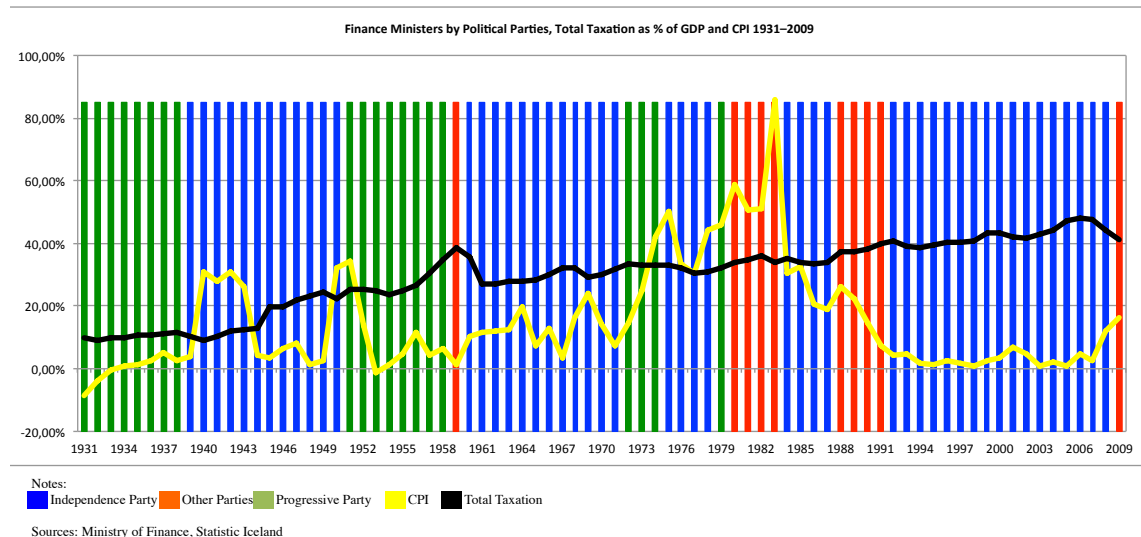
According to Baldur Thórhallsson, Katzenstein's corporatist framework does not fit Iceland. Instead he uses the term, sectorial corporatism where more note is taken of the interests of certain specific lobby groups than of others in governmental decisions. That differs fundamentally from the social corporatism in Nordic countries. The origin of European sectoral corporatism is when agrarian interest groups gained privileged access to governments. Countries characterized by sectoral corporatism are more likely to adopt a societal corporatist decision-making structure. Under this model, the government and the primary economic organizations engage in joint decision-making.

However, Baldur states that Katzenstein's historical approach sheds light on the nature of Icelandic sectoral corporatism. The Right in Iceland has not been weak and divided. It is also a fact that the substantial over-representation of the rural coastal areas in the national parliament created conditions for the dominance of agrarian interests. From the late 1920s, the Progressive Party has been the main influence on the agricultural policy, except in 1960–1971 when the Independence Party was in charge of the agricultural policy, see chapter 7.4 figure 15, (at the cost of representatives from the Greater Reykjavík area, see Appendix B) (Thorhallsson, 2010).

The Independence Party, the largest political party in the country since 1930, has always had a broad appeal for voters of all classes. The leadership presented itself not as representatives of particular interests, but of the whole nation and secured support from all classes by its ideology, manifested in the slogan: 'solitary of classes' (stétt með stétt), referring to the importance of having workers, farmers and employers unite (Thorhallsson, 2008). However, the entire political elite (officials, employers etc.) supported the party and therefore formed its backbone (Svanur Kristjánsson, 1979).

The fisheries sector has always been the main supporter of the Independence Party while the co-operative movement (agrarian interests group) (Samband íslenskra samvinnufélaga, SÍS) was from the beginning the main supporter of the Progressive Party. Other parties (Social Democratic Party and Communist party) have more or less been related to the Workers Union (ASÍ). Also, the agrarian sector benefited from its historical ties to the Independence Party and the Progressive Party, the second-largest political party in the country until the end of the twentieth century; see also chapters 7 and 8. Accordingly, the powerful fisheries and farmers' lobbies have been in such close contact with the government that it has been difficult to observe where their influence ends and the role of the government begins. Policy-making in Iceland has been characterized by centralization, and its substantial emphasis has been on political favoritism rather than general policy-making. The fisheries sector has obviously benefitted from its economic importance, and the over-representation of the rural regions in the Parliament has given the farmers' lobby a strong political voice. These sectors are also the core players in the policy-making process and, often, are responsible for implementing the policies (which they themselves have largely

designed). The most important in this context is the taxation policy (see chapters 6 and 9). The management of the Ministry of Finance has been split between the Independence Party and the Progressive Party since the 1930s (see figure 4) (Thorhallsson, 2008, 2010; Thorhallsson & Kattel, 2012).



**Figure 4. Finance Ministers by Political Parties, Total Taxation as % of GDP and CPI 1931–2009**

However, by the end of 1930s, these two parties, the Independence Party and the Progressive Party, made a coalition deal in response to the tax policy of the first leftist government in Iceland, formed by the Social Democratic Party and the Progressive Party in 1934, where the main taxation specialists of the nation were appointed. The Prime Minister in this leftist government, Hermann Jónasson, was the General Director of the police in Reykjavík and the head of the State Internal Board; The Finance Minister, Eysteinn Jónsson, was the Director of Internal Revenue in Reykjavík, both gentlemen were members of the left wing of the Progressive Party; and from the Social Democratic Party, there was Haraldur Guðmundsson, who had been appointed by the Parliament to a committee to make a recommendation about the taxation system in 1928, which formed the basis for the taxation policy of the government (Valdimar Unnar Valdimarsson, 1984).

The abovementioned coalition was formed by party leaders, who at the time were both members of the Board of Directors of the Landsbanki Íslands: Ólafur Thors, for the Independence Party, and Jónas Jónsson, for the Progressive Party. These two gentlemen

were both MPs and Ministers over a long period and were also in charge of the two largest Special Interest Groups in Iceland ever: Ólafur for the fishing vessel owners, and Jónas for the co-operative movement. At the beginning of the 1930s, these two SIGs joined forces in The Federation of Icelandic Fishing Vessel Owners (Landsambands íslenskra útvegsmanna, LÍÚ) under the leadership of Sigurður Kristinsson, Minister for the Progressive Party in 1931 and the General Director of the co-operative movement (SÍS), and Jóhann Þ. Jósefsson, an MP who was one of the founders of the Independence Party in 1929, a member of the Board of Directors of the Landsbanki Íslands 1938–1944, a long-time spokesman for the fishing vessel owners, and Minister of Fisheries, Industries and Finance for the Independence Party 1947–1950 (Kristján Ragnarsson, 1999).

The fishing industry was dissatisfied with the tax system and did everything it could to encourage hostility within society.<sup>4</sup> The government transformed the labor law (gerðardómur 1938) in order to comply with the demands of LÍÚ, and furthermore, to save the companies from bankruptcy, it granted loans to the workers so that they could buy shares in the trawler companies. Tax exemptions and deductions for the fishing industry were increased, and this Potemkin-type taxation of the fishing industry laid the ground for the decreasing GDP during the next twenty years, see chapter 8 (Atvinnumálaráðuneytið, 1936, pp. 446-505; Benjamín H. J. Eiríksson, 1990, pp. 490-572; Jón Gunnar Grjetarsson, 1993; Valdimar Unnar Valdimarsson, 1984). History repeated itself in the 2008 crisis. Following a period of coalition government by the Independence Party and the Progressive Party after 1995, a leftist government was elected in 2009. This government changed the tax system, but the fishing industry did everything it could to encourage hostility within society. In 2013, the Independence

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<sup>4</sup> It should not come as a surprise that the whole society went topsy-turvy. During that time, the fishing industry paid no taxes at all to the State and only very low taxes to the municipalities (1934–1938 the average tax each year for the ten biggest trawler companies in Reykjavík was: 44.70 kr. to the State and 6,500 kr. to the City), but instead of using the profits to update the fishing fleet, or the trawlers, the owners used the profit for personal consumption, which was one of the main reasons for the turbulence in society (the ships were old, and when they broke down, no one got paid) During the 1930s, there were 40 strikes in Reykjavík alone.

Party and the Progressive Party formed a government. Tax exemptions and deductions for the fish industry were increased while other taxpayers were “allowed” to use their own pension-assets to pay their debts.

#### **5.4 Special Interest Groups versus Political Parties**

Special Interest Groups, SIGs, may not seem much different from political parties. Both are organizations of individuals sharing some common attitudes and opinions, and they both seek to influence elections, government officials and public policy choices. Nevertheless, there are some crucial differences between the two types of organizations. Initially, we can think of SIGs as policy maximizers who tend to be much more narrowly focused on a specific area of public policy or social concern than political parties. SIGs form around specific concerns like the environment, free speech, tax reform, agricultural subsidies, free trade, school funding, and labor standards, to name a few topics. On the other hand, political parties seek to bring together many of these issues under one single umbrella.

However, voters may associate specific interest groups with particular parties in a more general way, especially when the industrial activity is undiversified and the patron of “the one and only” company in town is the local politician (Gunnar Helgi Kristinsson et al., 1992). Also, political parties sometimes act as SIGs because SIG spokesmen gain a central position in the party, or because they fund the party, in full or partially.

Politics are a power game whose rules determine the ways in which politicians can use the legislative process, the bureaucracy system and economic institutions to increase their income and power. The justification for taxes lies in a government’s need for resources to carry out its essential functions. In a democracy, taxation policy is an equilibrium outcome of a collective choice process. It is the role of the political institutions to shape the taxation policy, as well as the relationships between those institutions and the political norms and rules that govern their functions including such parameters as the right to vote, political parties, trade unions, employers, responsible government, transparency and accountability. The main point of the taxation policy is to enrich both the people and the sovereign. The decision-making process depends upon both the political and the economic structure, where the political institutions of the society are the key determinants of this game. They are also the rules that govern

incentives in politics and determine who has the power in society and to what ends that power can be used (Acemoglu & Robinson, 2013, pp. 79-80). These allocations of work between politicians and institutions are the cornerstone of democracy. Taxes are accepted when the citizens feel that they result from a public consensus, the rules apply to all, and the system is fair. On the other hand, when the political process may bias the taxation policy away from a socially preferred solution, the political process by which the taxation policy is chosen will generally absorb resources in one way or another, leading to a economically inefficient outcome and social instability.

In the 1920s, the transition from the independence struggle to class politics began. At that time, the emerging parties of workers and farmers coexisted with the old elitist groupings. This was based on the growing strength of the trade unions, the co-operative movement, and the agricultural societies. By the end of the 1930s, the fundamental characteristics of the Icelandic system of power still remained intact. The co-operative movement was the main financial contributor to the Progressive Party for many years, and the fishing industry to the Independence Party, while other parties only got membership fees (Svanur Kristjánsson, 1979).

Hence, the structure of the Independence Party reminds one much more of a powerful interest group than of a political party. The party was founded in 1929 with the merger of the Conservative Party and the small Liberal Party. The background of these parties is to be found in the independence movements. The title of the Independence Party's first manifesto, 'Iceland for Icelanders' (Ísland fyrir Íslendinga), reveals the roots of nationalism in its ideology, but the party kept the independence struggle alive during the extension of the Icelandic fishing zone from 4 miles in 1952 to 200 miles in 1975, and this brand of nationalism has been the backbone of the movement against Iceland's EU application. The party is closely linked to the fishing industry. Eimskipafélag Íslands, the leading commercial shipping company in Iceland, and LÍÚ were both established on the 17<sup>th</sup> of January, Eimskip in 1914 and LÍÚ in 1939, by the same elite. Prominent party leaders, such as Ólafur Thors, were also among those who controlled the fishing industry. Ólafur Thors' family owned a trawler company (Kveldúlfur) of which he was a director 1914–1939. He was the leader of the trawler owners' association 1918–1935 (Félag íslenskra botnvörpuskipaeigenda) and

later became the leader of the Independence Party 1934–1961 (Thorhallsson, 2008; Thorhallsson & Kattel, 2012). Thus, the elites used nationalism to glorify the work of the seamen for the benefit of their businesses. In 1938, Ólafur Thors was the representative of LÍÚ when the authorities of Iceland created "The Unknown Seaman", a heroic figure, in a country with no army, in order to strengthen the patriotism of Icelanders and referred to it when the government justified special tax deductions both for Eimskip and the fishing industry, see chapter 9 (Sjómannadagsráð, 1962).

However, it is the magnificent 'Dark-Money-Moving-Machine' (Kosningamaskína) that laid the groundwork for the success of the Party, especially in Reykjavík. In 1934 Gunnar Thoroddsen, one of main leaders of the Independence Party, studied the organization of elections, e.g. by reading *Mein Kampf* by Adolf Hitler (Guðni Th. Jóhannesson, 2010, pp. 69, 79). Gunnar, who was the founder of the Party's Political School and its first director 1938–1940, admired the way the Nazis used propaganda to recruit followers and members. In Hitler's *Mein Kampf*, it was the task of the propagandist to recruit the followers, and it was the task of the organizer to select members. The follower only needed passive recognition of a party's ideas, while a member had to represent and fight for them. From ten followers, two members could be expected. Nonetheless, in this context we would like to point out that, just as bureaucracy is the base for an effective tax system<sup>5</sup>, the structure of a political party, and the preparation of elections, determines the elections' results. Democracy is lost

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<sup>5</sup> The most effective tax system in history is the Prussian tax system 1640–1806, especially under Frederick II (the Great), King of Prussia (1740–1772). He was able to avoid the fiscal crises faced by most early modern monarchs. The system was highly bureaucratized and organized, and cited by Weber to explain the term bureaucracy. According to that definition, the word "bureaucracy" has at least four meanings: First, bureaucracy is a system of rule or a governmental system in which officials dominate. Second, bureaucracy is defined as an administrative discretion, i.e. those who are responsible for social welfare benefits or receive complaints of tax payments should have some discretion or procedure to ensure that there is 'just' treatment of the needy, and this can be contrasted with the bureaucratic approach which argues that justice can only result from the impersonal application of general formulae and that greater justice is achieved by improving the general formulae. Third, and related to this, is the concept of bureaucracy in terms of efficiency and inefficiency. Fourth, bureaucracy can refer to a social group, or those who work in bureaus, i.e. the civil servants at the tax offices.

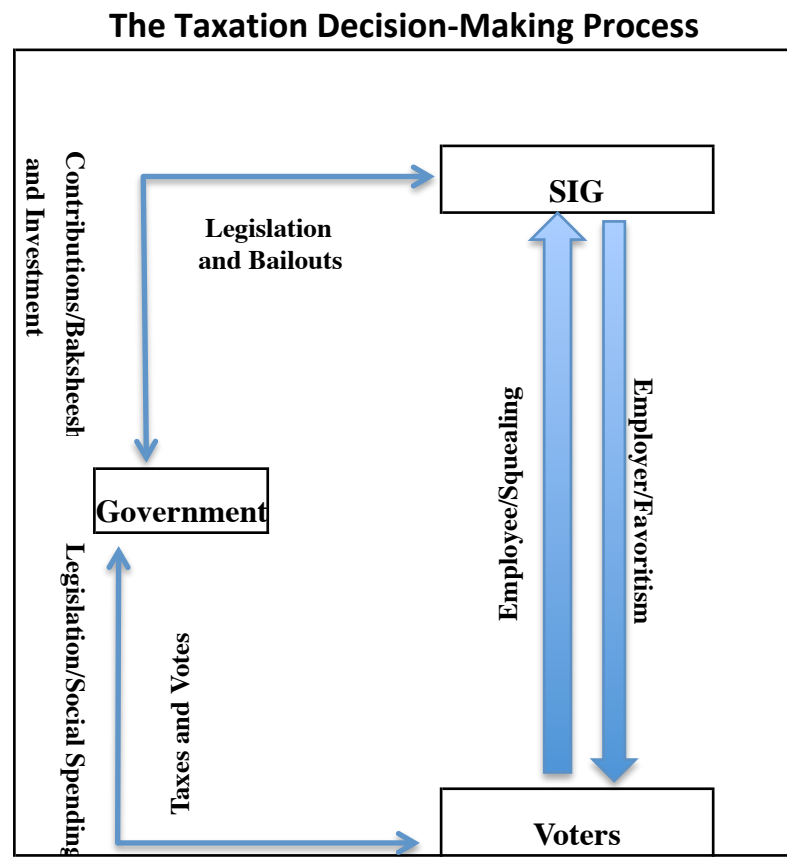


when “preparation work” determines the election results by force or falsification (Page, 1992; Schneider, 1994). Yet, the ‘Dark-Money-Moving-Machine’ operates on two or three levels, see also figure 5 and chapter 9 (Einar Kárasón, 2005; Guðni Th. Jóhannesson, 2010; Gunnar Helgi Kristinsson, 2006a; Gunnar M. Magnúss, 1967; Hitler, 2014; Svanur Kristjánsson, 1979; Thorhallsson, 2008; Wikipedia, 2013b):

- First, Reykjavík was divided into zones and in each zone there was a group of men whose main job was to spy on their neighbors, write down their political views and report to the headquarters of the Independence Party, Valhalla, where the information was registered. In 1957, there were 120 zones in Reykjavík with 5-10 men in each zone. In all, there were 654 men who each had 25 families to collect information about (or more bluntly to spy on).
- Second, almost all employers in Reykjavík were members of the Independence Party and used their power to hire members of the Party and to fire non-members. For this selection, the Party had special agents in most workplaces in Reykjavík. In 1957, there were 392 such agents in Reykjavík, and the goal was to have at least one agent on every workplace with 10 people or more. The Party also governed the city of Reykjavík for decades and used the same technique: those who were not in the Party did not get a job, nor did they get plots for home-building. This state of affairs lasted for many decades.
- Third, the companies pay to the Party (campaign contribution or *baksheesh*) a certain amount, usually as a percentage of turnover—sometimes a very large amount as in 2006, when Landsbanki Íslands paid the Independence Party the 30 million kr. That year, contributions to the Party totaled 250 million kr. In the early days, the Party could use the money to pay workers for their votes, although such payments were usually in kind (alcohol, land, jobs etc.).
- The fall of the Soviet Union in 1991 had a great impact on business worldwide. In Iceland, deregulation of the finance system started in the late 1990s to prepare for the privatization of the banks, and a new type of businessmen entered the stage. Jón Ólafsson, a press magnate, and Jón Ásgeir Jóhannesson, CEO of Baugur Group, refused to pay the annual *baksheesh* to the Independence Party; instead, they supported those who suited them. In 1994, Jón Ólafsson paid all the debts of the Social Democratic Alliance in Reykjavík and in 2006, Jón Ásgeir paid the Social Democratic Alliance 25 million kr. Yet the total contribution to the Social Democratic Alliance was almost four times less than the Independence Party or 73 million kr. These figures do not include grants to individual MPs, nor the bullet loans that were made to MPs, and that led to billions of kr. being written off following the 2008 financial collapse.

Figure 5 shows the impact of the ‘Dark-Money-Moving-Machine’ on elections and taxation decision-making process. Taxation policies are viewed as the equilibrium outcome of a collective choice process that is constrained by political as well as economic forces. The SIGs pay campaign contributions and get favorable legislation and

bailouts in return. Only the members of the party or those who will vote for the party get government-controlled jobs. "The members" spy on their neighbors or their fellow workers. The Government spends taxpayers' money in favorable regions (construction) and those who are favorable may get a job and/or special tax treatment from the authorities.



The SIGs pay campaign contributions and get favorable legislation and bailouts instead.  
 "The members" get the jobs.  
 "The members" spy on their neighbors or their fellow workers.  
 Those who are favorable get a job and/or a special tax treatment from the authorities.

**Figure 5. The Taxation Decision-Making Process**

## 5.5 Summary

The chapter has presented an overview of corporatism, the influence of sectorial corporatism on taxation in Iceland, and the relationship between the SIGs and the political parties through which the SIGs use and maintain power.

## **6 The Effect of the Taxation Policy on the Economy since 1874**

### **6.1 Introduction**

Our aim in this chapter is to look at how the public revenue system has developed since the 19<sup>th</sup> century, and to analyze the taxation policy. The history of Icelandic public finance dates back to 1874, when Iceland received a constitution and the Icelanders obtained control over their own finances, which had been under Danish control for many centuries. Until 1960 the structure of the tax administration (see Appendix C) was based on the 19<sup>th</sup> century system, which had an effect on the tax collection, due to the fact that the population is very small and the individuals closely interlinked by blood ties and/or common interests (cognitive regulatory capture).

The chapter is divided into four sections. The first section gives a brief overview of the local tax system.

In the second section, we will describe the income tax system since 1877.

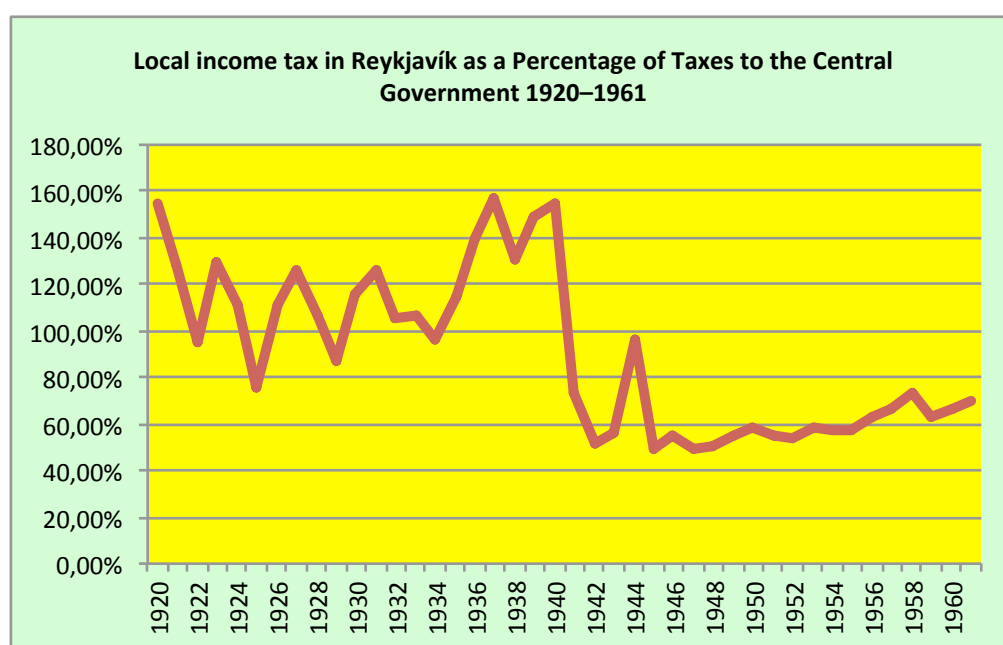
In the third section, we will discuss indirect taxation since 1874.

The final section deals with the effect of the implementation of taxation policy on the economy.

### **6.2 Local Government**

The structure of the local tax system was almost unchanged from 1809 to 1960. Taxation was not based on rules but on the needs of local government for money, and it has been almost unchanged since 1972. Until the beginning of 19<sup>th</sup> century, one fourth of the Tithe (introduced in 1097) was the only income the local governments could count on. During that time, their responsibility was to take care of the poor (a function carried out by the church in many other European countries), and although the Tithe had never been enough for the local governments, the income system was not changed formally until 1809—with the Act named *Hreppstjórainstrúxið*—when the so-called rates receipts (*aukaútsvar*) were added to the Tithe. By that time taxes were not imposed according to the value of farmland, or the revenue of each person, but rather according to the needs of the poor in each community. Thus, in locations where there

were few poor people, the tax burden was low, and if there were many, the tax burden was high. This system remained almost unchanged until 1960, with small adjustments in 1872, 1926, 1942, and in 1945, a special turnover tax on companies. The tax ladder was fixed in Reykjavík in 1929 and in other communities during the following years. However, the tax rates in the communities were not harmonized until 1962, although it was not until 1980 that local tax commissioners assessed the local tax. Until then, each community assessed the local tax without any relation to other communities. In 1972, Act No 8, the local income tax was changed from a progressive tax on net income (maximum marginal rate of 30 per cent) to a flat rate tax on gross income, and in 1988 the tax base for the local income tax and the central income tax was harmonized, see also chapter 9.4 and Appendixes C, D, E and G.



**Figure 6. Local income tax in Reykjavík as a Percentage of Taxes to Central Government 1920–1961**

The finances of the central and local governments are inter-related in many ways. Thus, many local projects are financed in common by these bodies, for example in the fields of education and communication, where central and local governments contribute to the costs in fixed proportions. Local governments also share certain taxes with the central government, such as the war profit tax 1941–1958 (*stríðsgróðaskattur*), from 1960, the sales tax, from 1990, the VAT, and the income tax on “big” companies in Reykjavík (*landsútsvar*), import duties and national rates. These are distributed among

the municipalities through the Municipal Equalization Fund, which was established in 1937.

Of the taxes just mentioned, the war profit tax was the most important (Act No 10 of 1941, for persons until 1954 and for companies until 1958). It increased the power of the central government, while local governments found themselves weakened accordingly, see figure 6. A tax of 90 percent was paid on revenue of 200,000 kr. and over, and the proceeds were divided among the provinces that did not get any windfall tax at all. 45 percent went to the municipalities and 50 percent to the State.

The personal income tax is currently the major source of local government revenue. However, the rate has changed over the years. In the middle of the 20<sup>th</sup> century, around 90 per cent of the revenue came from the income tax, but this has decreased, while other taxes have increased, and the rate was around 50 per cent 2009. Taxes on property are another important source of revenue for local government, but from 1877 until 1953, they were a source of revenue for the central government.

### **6.3 The Income Tax System**

The first Budget was presented to the Parliament in 1875 and related to the period 1876–1877 (each budget period was two years until 1921, see Appendix A). Since 1877, there have been two kinds of income taxation system, but with some variations: Dual Income Taxation—the DIT-system—and Comprehensive Income Taxation—the CIT-system. The DIT-system is a system where wages and income from capital are separated and are taxed at different rates. The CIT-system is when the taxpayer faces the same marginal tax rate on all types of net income, which means that wages and capital are taxed at the same rate, usually progressively.

#### **6.3.1 The DIT-system 1877–1921**

1877–1921, a DIT-system based on Adam Smith's school of thought. The direct tax system was based on three kinds of taxes, two property taxes—one for those who lived in the countryside, the other for those who lived in towns (Skattur á jarðir og lausafé og húsaskattur)—and a progressive income tax. Wages were taxed progressively, after ISK 1,000, with rates ranging from 1 to 4 per cent, whereas capital income was taxed by flat tax, 4 per cent after the first ISK 50. The capital tax was changed by Act No 20 1918,

putting an end to the taxing of capital income by flat tax and instead, taxing the capital income progressively with rates ranging from 4 to 15 per cent after the first ISK 50. Until 1919, the fishing industry and agriculture did not pay income tax like other sectors.

### **6.3.2 The CIT-system 1921–1996**

This taxation system was originally based on the Danish taxation system from 1903 (*Tillögur um skattamál Íslands*, 1908) and is the basis of the current Act No 90 from 2003. But many changes were made during this period (especially by Acts No 40 of 1978), mostly because of the absence of harmonization between the revenues and the expenditures of the Parliament. Act No 66 from 1921 combined the two property taxes from 1877 into one, which later went to the local governments. All personal income was taxed progressively with rates ranging from 1 to 25 per cent of taxable income. Corporate income tax, on the other hand, was based both upon capital and upon taxable income, and was also progressive, but based on other principles than personal income taxes, with rates ranging from 5 to 30 per cent. In 1923, Act No 2, the tax system was changed to net income tax system, i.e. the income taxes to the local and the central governments were deducted from the revenue before assessment, which meant tax reduction for higher-income earners. Following the Great Depression in the thirties—with Act No 6 1935—the tax rates were made the same for both persons and companies, which increased the problems for the companies. The income tax was changed from a progressive tax on net income to a progressive on gross income by Act No 20 1942. At the same time, the tax rates were indexed by a special tax index, which remained in force until 1960, and was adopted again in 1965. A new tax system was designed for companies in the sixties, which remained basically unchanged until 1971, except for the conditions for deductions.

### **6.3.3 The DIT-system from 1997 to the present day**

The Icelandic tax system was not in line with that of other countries. The lack of economic balance that followed the years of World War II had serious effects upon the economy, especially upon the rates of growth and the inflation. Savings were scarce, because no one gained any interest, (*Viðskiptaráðuneytið*, 1955) although the underlying reason for the scarce savings might have been the property survey from 1948. Confidence had declined because the government allowed the tax fraudsters to

slip away, see chapter 9.4. The government exempted interest on bank accounts from tax, and excluded such interest from tax reporting in 1954. These measures hampered the development of the tax system for years. Inflation went skyrocketed in the eighties and nineties, bank accounts were indexed, and the Parliament was loath to tax bank savings for fear of facing further savings scarcity. During the nineties, many OECD countries began to reform their personal income tax systems, and although tax policies varied greatly among these countries, the reforms can be characterized as rate-reducing and base-broadening. Simultaneously, fairness and simplicity became the keywords for reformers. The Nordic countries have been involved in these reforms, and in the course of the last two or three decades, the tax system in all the Nordic countries has been changed from a comprehensive tax system to the dual tax, where wages and capital income are separated, wages being taxed at a progressive rate and capital income at a flat rate. However, the tax rates for capital income taxes are not the same in all the countries. In Finland and Norway, the rate is 28 per cent; in Sweden it is 30 per cent, while the Danish system for capital tax is quite different from that of other Nordic countries. The capital is taxed with several different rates depending on both the type and the size of the capital income—not unlike our former DIT-system, i.e. 1877–1921 (Kukkonen, 2008). The Icelandic DIT-system came into force first of January 1997 with Acts No 94 of 1996 and Act No 96 of 1996. It was not based on the same principles as in other Nordic countries. The wage income tax was fixed with high personal tax credit and the capital tax rate was low compared to rates levied in other countries—until 2009 it was 10 per cent, but it has since increased to 20 per cent. However, inflation reduces the relative value of previous borrowing, and at the same time, it increases the amount of revenue from taxes; and because the tax base is indexed, the real tax rates can in some case exceed 100 per cent. The main results were that taxes on individuals increased, while they decreased on companies and the government improved its debt-to-revenue ratio. The burden of inflation borne by the poor is, of course, higher than for the rich, and this policy also has large effects on social benefits, because when the government increases inflation, capital income increases (the tax base is indexed) and therefore the social benefits, which are also indexed, decrease accordingly.

## 6.4 Indirect Taxation

During most of the period we are studying, the Icelandic tax structure has been characterized by a heavy dependence on import duties, and until the 1980s, no less than 60 to 85 per cent of the total revenue was collected in this form. In other words, the tax system is extremely regressive, while the municipalities had a more progressive system of direct taxation. Therefore, the income tax system alone has been useless for equalization but during the 1990s reliance on import duties decreased, and after the general sales tax was adopted in 1960, approximately 30 per cent of Treasury revenue was derived from this source. Thus, after 2000, only 10 per cent of total revenue has come from import duties, see figure 7.

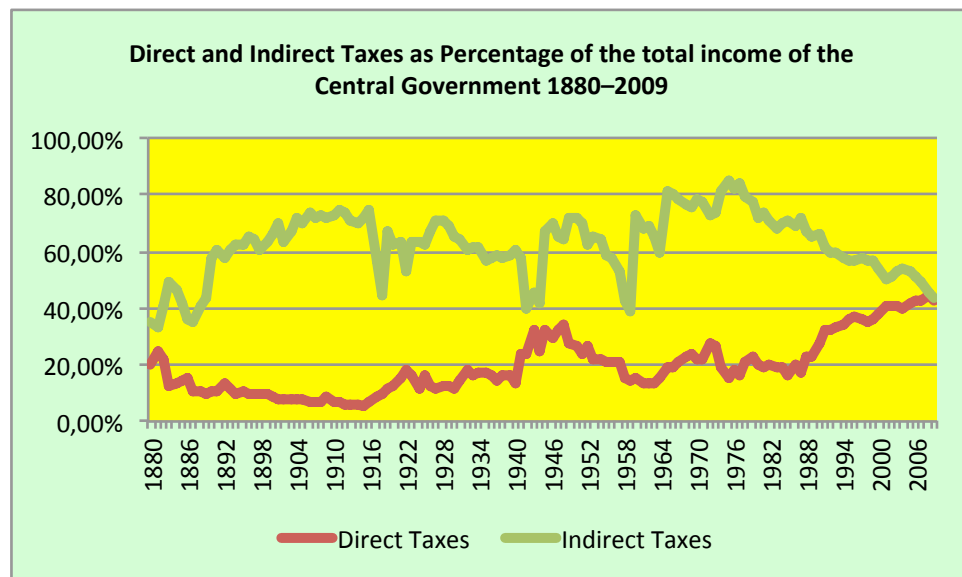


Figure 7. Direct and Indirect Taxes as Percentage of Total Income of the Central Government 1880–2009

The main role of international agreements<sup>6</sup> is to increase cross-border trade between member states by reducing tariffs. Iceland became a member of GATT in the Kennedy round in 1968 and of EFTA in 1970. No single factor has had as much impact on the tax system of Iceland as membership in EFTA.

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<sup>6</sup> The General Agreement on Tariffs and Trade, GATT, 1947–1994, and since 1995, the World Trade Organization, WTO, the European Union, EU, since 1957, and the European Free Trade Association, EFTA, since 1960.



At the beginning of the period we are studying, i.e. 1874, import duties served the sole purpose of providing the State with income; there were duties on alcohol from 1872, on tobacco from 1876, and on sugar and coffee from 1889; but there was no coherent structure in the legislation, and the relevant Acts were almost randomly adopted. In 1901, all these Acts were united into one Act, the Customs Act for Iceland. By the end of laissez-faire, the government started to use tariff barriers in order to encourage specific economic sectors (Act No 38 1921), and from the crisis in the early forties until 1970, this was the main policy in Iceland. The governance of customs was not very efficient. There was no harmonized customs tariff until Act No 62 1939 was adopted, and until then, import duties were based on FOB-value (Free on Board) rather than CIF-value (Cost, insurance and freight). Introducing the CIF-based tariff had more drastic effects on government revenue than anticipated. By 1960, the government adopted the Brussels tariffs from the 1950s, but it was not until the end of the sixties that the government reviewed its policy and started to strengthen the country's position through trade agreements with other countries (GATT 1968 and EFTA 1970) and basically, this is still the main principle of the tariff policy of Iceland today.

The structural changes in the tax system may always be traced to political changes (1877, 1920, 1942, 1960s, 1978, 1990s, 2009) but the power over them was a key factor for the political parties to bring its policy into practice.

These are the main changes in indirect taxation:

- in 1920, when Iceland started to use tariff barriers,
- in 1970, when Iceland joined EFTA
- in 1960, when a general sales tax was initiated
- in 1990, when the VAT, which is currently the main income source for the State, was initiated

Other sources of revenue were mostly in form of transfers from the Danish Treasury 1875–1918 and profits and transfers from publicly owned and operated enterprises. The transfers from the Danish Treasury accounted for over one third of the total revenue in 1876, but they showed a steady decline until this contractual type of revenue was terminated in 1918, when Iceland became a Sovereign State. Revenue from public enterprises come mostly from the state monopolies on tobacco and

alcoholic drinks, rents from land and buildings, and interest receipts (Gísli Blöndal, 1965a).

## 6.5 The Influence of the Taxation Policy on the Economy

We start this examination by looking at the structure of inequality, revenue distribution and social transfers from the beginning of the 20<sup>th</sup> century. We then examine economic growth by tax periods since 1880.

### 6.5.1 The Structure of Inequality

At the end of the 19<sup>th</sup> century and the beginning of the 20<sup>th</sup> century, the inequality in Iceland was overwhelming. According to a parliamentary report (see Appendix G and table 1), there were about 25,100 income tax payers in the country as an average in 1924, 1925 and 1927, whereof 170 were associations, and the average total of taxable income during this same period amounted to ISK 45–35 million. This sum does not include the costs of levying the taxes, the personal allowances of individuals (ISK 500 each) all interest on debts, insurance fees, and taxes such as income tax to municipalities, income and property taxes (ISK 6 million per year), a third of the contributions for reserve fund.

**Table 1. Revenues by Social Classes in Iceland 1927**

<b>Revenues by Social Classes in Iceland 1927, ISK.</b>				
<b>Class</b>	<b>Tax Payers</b>	<b>Annual Income</b>	<b>Monthly Income</b>	<b>%</b>
<b>Total</b>	<b>24.822</b>	<b>7.429</b>	<b>619</b>	<b>100%</b>
<b>Lower Class:</b> The poorest 43%	<b>10.709</b>	1.000	0	<b>3%</b>
<b>Middle Class:</b> The 42% of the middle	<b>10.273</b>	3.000	300	<b>16%</b>
<b>Upper Class:</b> The top 15%	<b>3.840</b>	61.000	5.100	<b>81%</b>
<i>Thereof 14%</i>	<i>3.670</i>	<i>38.000</i>	<i>3.200</i>	<i>46%</i>
<i>Thereof the top 1%</i>	<i>170</i>	<i>257.000</i>	<i>21.500</i>	<i>35%</i>

Notes: GDP 1927 and revenue distribution 1927: 43% taxpayers have 83 ISK per Month or less, but they have 3% of the total revenue etc.

Sources: Statistic Iceland and Appendix G

Table 1 shows revenues by social classes in Iceland 1927. There were 24,822 tax payers; thereof 10,709 belonging to the lower class, 10,273 to the middle class, and 3,670 to

the upper class, of which 170 counted among the richest 1 percent. The revenue of the lower class amounted to 3 percent of the total revenue, the revenue of the middle class earned 16 percent, and the upper class got the rest, or 81 percent of the total revenue. Thereof, the richest 1 percent got 35 percent of the total revenue.

During these years, around 70% of those who did pay taxes had a taxable income of less than ISK 1,000, and that had not changed for years. The total amount of the taxable income for all those taxpayers was below ISK 8 million, i.e. around 23% of the total taxable income. Around 30% of the taxpayers received 77% of the income. An average of about 190 individuals submitted a revenue return yearly during that period, totaling around ISK 3.5 million of taxable income. Even if the total of taxes on individuals and associations had been levied solely on those 190 persons, they would still have withheld around ISK 2.2 millions in all for each of these years. It must be borne in mind that the estimated income of these individuals is based on their own tax returns, whereas the income of taxpayers in general is known from reports submitted by those who paid their wages. During the 1930s, inequality increased, although we do not have as good income distribution statistics as is reported in table 1 for those years (Atvinnumálaráðuneytið, 1936, pp. 58-74).

Taxable property, according to the income tax return, amounted to nearly ISK 100 million. A mere 4600 individuals, about 18% of the taxpayers, had such property amounting to ISK 5,000, and taxable for that reason. Of those, around 80%, owned about one third of the property, while about 20%, around 900 persons, were the owners of around 70% of the property. A hundred individuals or so declared a total of ISK 25 million taxable property. According to these figures, they owned a full quarter of all property, although all properties were reported according to the assessment value, which is usually lower than the market value. This situation has not changed over the years, and the gap between social classes has even increased because of corruption, as we will discuss in chapter 9. In 2014, the top 1%—770 families—owned 56% of the total net wealth in the whole country, see Appendix H.

Table 2 shows revenue by social classes in Iceland 2007. There were 240,818 taxpayers; thereof, 120,450 belonged to the lower class; 96,308 to the middle class, and 24,060 to the upper class; 2,406 members of the upper class comprised the richest 1

percent. The revenue of the lower class amounted to 23 percent of the total revenue, while the revenue of the middle class amounted to 39 percent, and the upper class got the rest, or 38 percent of the total revenue. Thereof, the richest 1 percent got 18 percent of the total revenue.

**Table 2. Revenues by Social Classes in Iceland 2007**

<b>Revenues by Social Classes in Iceland 2007</b>				
<b>Class</b>	<b>Tax Payers</b>	<b>Annual Income</b>	<b>Monthly Income</b>	<b>%</b>
<b>Total</b>	<b>240.818</b>	<b>5.433.639</b>	<b>452.803</b>	<b>100%</b>
<b>Lower Class:</b> The poorest 50%	<b>120.450</b>	2.463.000	205.200	<b>23%</b>
<b>Middle Class:</b> The 40% of the middle	<b>96.308</b>	5.297.000	441.500	<b>39%</b>
<b>Upper Class:</b> The top 10%	<b>24.060</b>	20.839.000	1.736.600	<b>38%</b>
<i>Thereof 9%</i>	<i>21.654</i>	<i>11.996.000</i>	<i>999.700</i>	<i>20%</i>
<i>Thereof the top 1%</i>	<i>2.406</i>	<i>100.359.000</i>	<i>8.363.300</i>	<i>18%</i>

Notes: GDP 2007 and revenue distribution 2008: 50% taxpayers have 205.200 ISK per Month or less, but they have 23% of the total revenue etc.  
Sources: Statistic Iceland and The Directorate of Internal Revenue

**Table 3. Revenues by Social Classes in Iceland 2009**

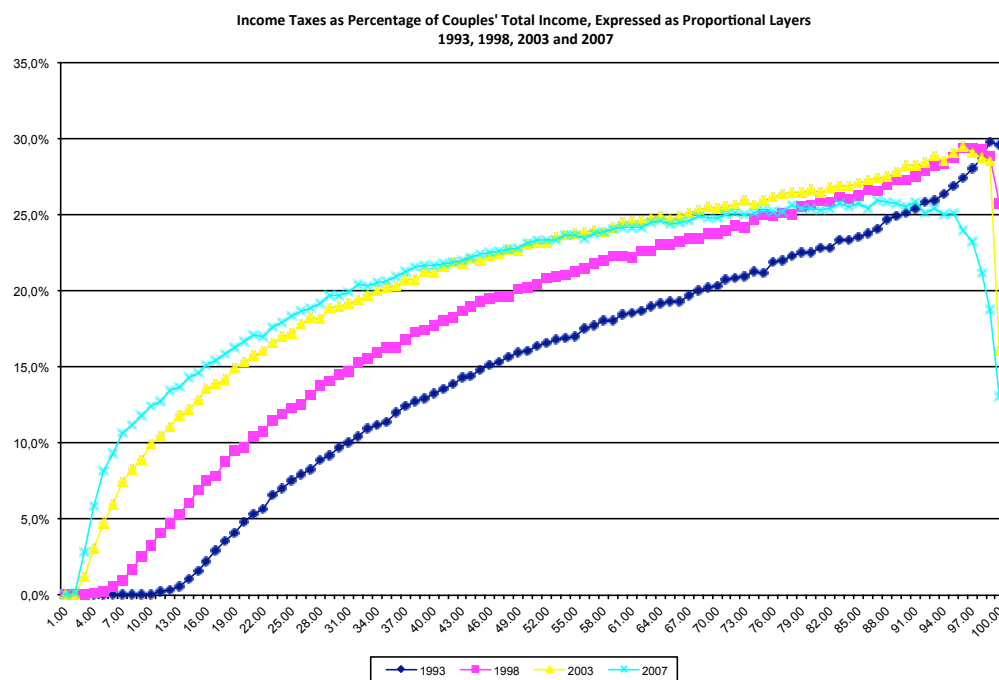
<b>Revenues by Social Classes in Iceland 2009</b>				
<b>Class</b>	<b>Tax Payers</b>	<b>Annual Income</b>	<b>Monthly Income</b>	<b>%</b>
<b>Total</b>	<b>243.522</b>	<b>3.055.069</b>	<b>254.589</b>	<b>100%</b>
<b>Lower Class:</b> The poorest 50%	<b>121.790</b>	1.632.000	136.000	<b>27%</b>
<b>Middle Class:</b> The 40% of the middle	<b>97.392</b>	3.468.000	289.100	<b>45%</b>
<b>Upper Class:</b> The top 10%	<b>24.340</b>	8.524.000	710.400	<b>28%</b>
<i>Thereof 9%</i>	<i>21.906</i>	<i>6.697.000</i>	<i>558.100</i>	<i>20%</i>
<i>Thereof the top 1%</i>	<i>2.434</i>	<i>24.959.000</i>	<i>2.080.000</i>	<i>8%</i>

Notes: GDP 2009 and revenue distribution 2010: 50% taxpayers have 136.000 ISK per Month or less, but they have 27% of the total revenue etc.  
Sources: Statistic Iceland and The Directorate of Internal Revenue

Table 3 shows revenue by social classes in Iceland 2009, the year after the crisis. There were 243,522 taxpayers; thereof 121,790 belonged to the lower class; 97,392 to the middle class, and 21,906 to the upper class, and thereof 2,434 to the richest 1 percent—in other words, the crisis did not affect those who were very rich. The revenue of the

lower class amounted to 27 percent of the total revenue, while the revenue of the middle class totaled 45 percent and the upper class got the rest, or 28 percent of the total revenue. Thereof, the richest 1 percent got 8 percent of the total revenues.

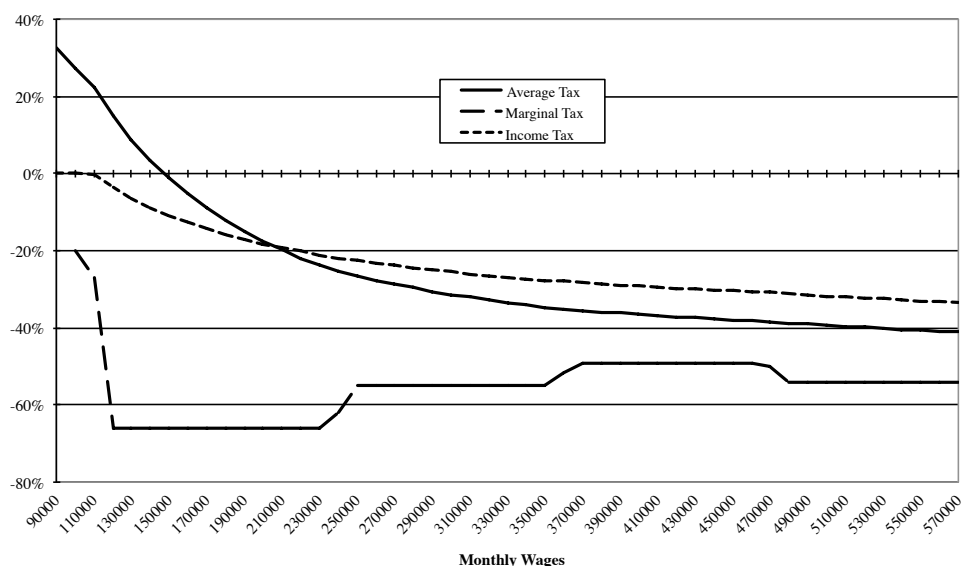
However, since the 1920s, the middle class has become pre-eminent, while both the lower and upper classes have been greatly reduced in numbers, see tables 2 and 3. One of the reasons is, of course, the influence of the tax system, but also the fact that the burden of the income tax has been heavier on those with lower wages than on those with higher wages, and the marginal tax rates have been higher for those with less income, becoming a counter-incentive for work, see figures 8 and 9.



**Figure 8. Income Taxes as Percentage of Couples' Total, Expressed as Proportional Layers 1993, 1998, 2003 and 2007**

Figure 8 shows income taxes as percentage of couples' total revenue, expressed as proportional layers (1.00–100.00, or lowest to highest) 1993, 1998, 2003 and 2007. The tax burden is much heavier in 2007 on those with lower wages than it is on those with higher wages than in 2003, 1998 and especially 1993, and similarly, the tax burden is much lighter on those with the highest income in 2007 than in 2003, in 1998 and in 1993, or 13 percent in 2007 compared to 16 percent 2003, 26 percent 1998, and 29 percent 1993.

Percentage of Marginal Tax, Average Tax and Income Tax for a Couple with Two Children and a 5 million ISK Mortgage in 1996



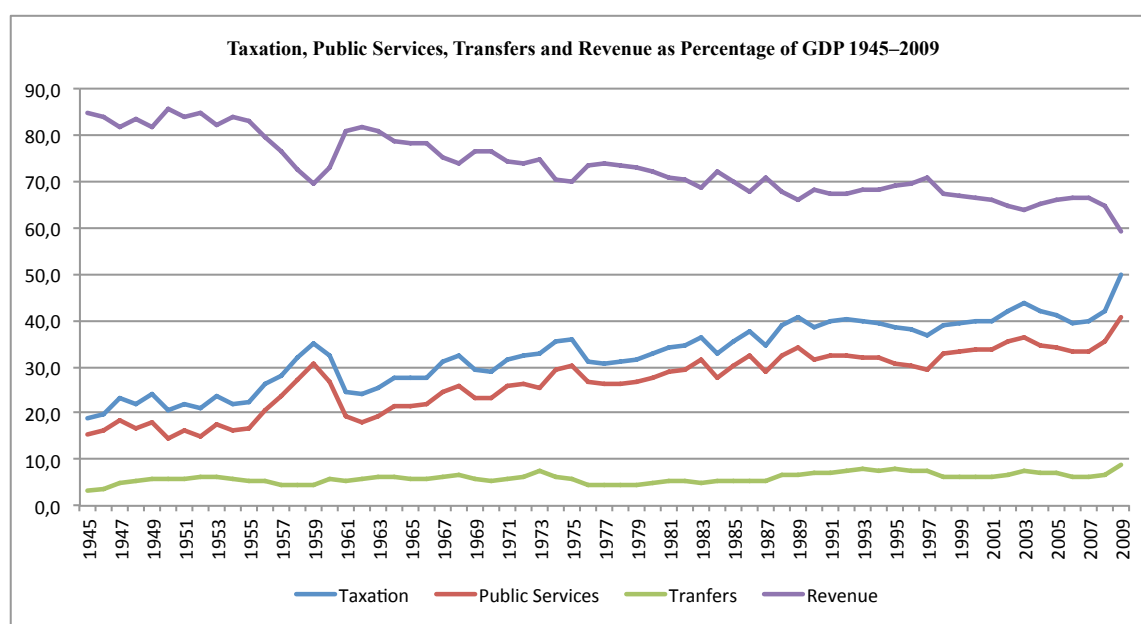
**Figure 9. Percentage of Marginal Tax, Average Tax and Income Tax for a Couple with Two Children and a 5 million ISK Mortgage in 1996**

Figure 9 shows the average tax, the income tax and the marginal tax for a couple with 2 children in 1996. Both the average tax and the income tax increase with increased revenue, while the marginal tax rates are higher for those with less income, and thus become a counter-incentive for work.

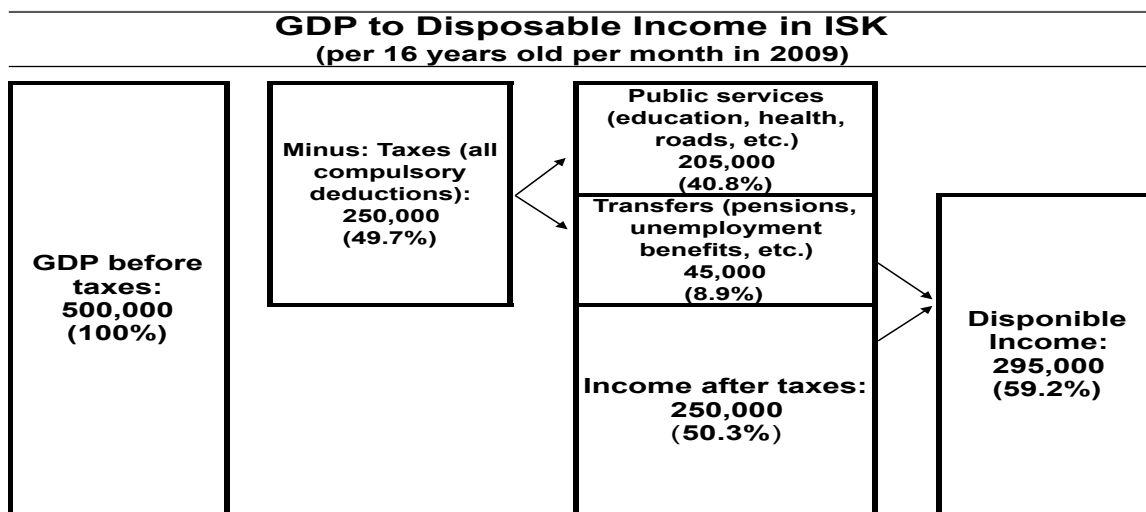
Other reasons are that replacement incomes and transfer payments between income groups are very low in Iceland compared to other countries. In most of the rich countries today, these income replacements generally consume 10–15 percent of the GDP, or even more, 20%, e.g. in France, the transfers amounted to 23% in 2010. Unlike public spending on education and health, which may be regarded as a transfer in kind, replacement income and transfer payments form part of a household disposable income: the government takes in large sums in taxes and social insurance contributions, and then pays them out to other households in the form of replacement income (pensions and unemployment compensation) and transfer payments (family allowances, guaranteed income, etc.) so that the total disposable income of all households in the aggregate remains unchanged (Landais, Piketty, & Saez, 2011; Piketty, 2014). In Iceland,

such transfers amounted to 1,6% in 1927, 6,3% in 2007 and 8,9% in 2009, see figures 10, 11 and Appendix F.

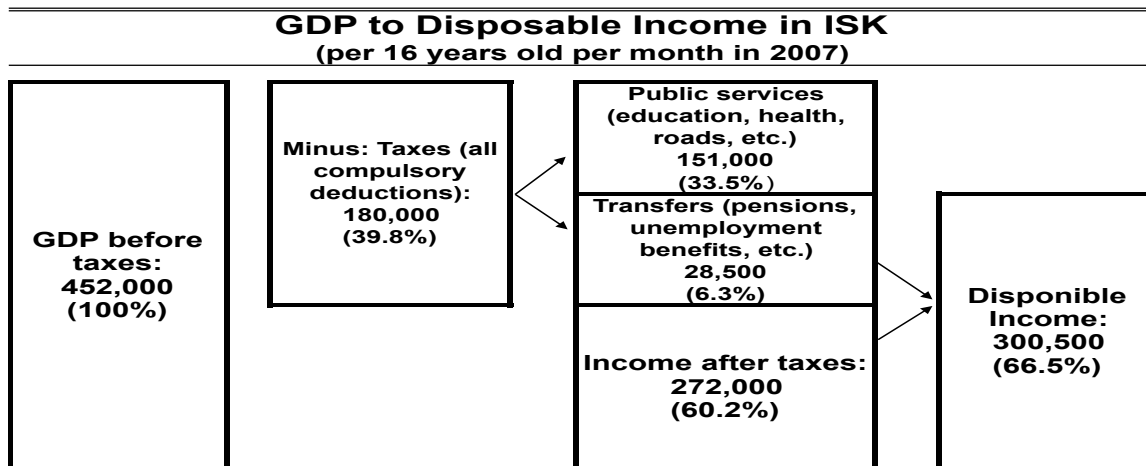
Figures 10 and 11 show the importance of transfer on disposable income, especially for those in the lower class since 1927 to 2009. In 1927, there were almost no transfers between income groups, but after 1936, with the establishment of the Social Insurance System (Almannatryggingar) and the renewal of the social insurance Acts in 1945, the transfers increased. However, the transfers have always been very low in Iceland compared to other European countries and did not increase until the crisis of 2009, when the Government used the transfer system to decrease the effect of the crisis on the lower class. Yet, since 1960 both the taxes and public services have doubled but transfers have remained stable.



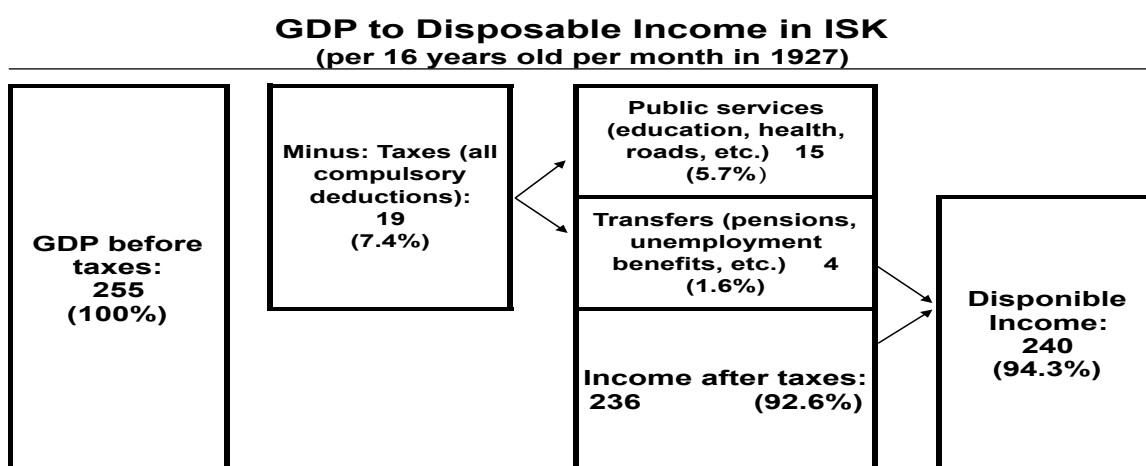
**Figure 10. Taxation, Public Services, Transfers and Revenue as Percentage of GDP 1945–2009**



Source: Appendix F



Source: Appendix F



Sources: See Notes to Appendixes E and G, transfers are estimated 20% of the central government income 1945–1946 27% of the local government income 1945–1950.

Figure 11. GDP to Disposable Income in ISK 1927, 2007 and 2009



## 6.5.2 Economic Growth by Tax Periods

The period 1880–2009 can be divided into 12 periods referenced to changes in marginal tax rates and the tax base, see table 4. The second period (1914–1922) can then be divided into two sub-periods according to the marginal tax rate: 1877–1918, when it was 4% and 1919–1922, when it was 25%. The third period (1922–1931) can also be divided into two sub-periods: 1923–1928, when it was 26%, and 1929–1930, when it was 32%. We shall also keep in mind that the crisis period between 1914–1920 was very similar to the period 2007–2009: the yearly growth rate per capita was -4.04 and the yearly inflation was 26.24%, but both these crises had the same root—corruption—and the same impact—the bankruptcy of Iceland—and the government was, in both cases, forced to change its taxation and monetary policies (Johnsen, 2014; Jóhannes Nordal, 1997; Sigurður Stefánsson, 2009, pp. 169-202).

**Table 4. Yearly Population Growth, Economic Growth and CPI by Taxation Periods 1876–2009**

	Population	Growth rate	Growth rate per capita	CPI	Taxation Periods
1876–1880	0,65	4,06	4,40	-1,16	0
1880–1914	0,55	2,27	1,35	0,63	1
1914–1922	1,12	2,23	-0,50	13,49	2
1922–1931	1,47	3,78	3,89	-4,13	3
1931–1941	1,11	5,01	3,36	6,49	4
1941–1954	1,84	3,85	3,79	11,97	5
1954–1960	2,17	4,25	1,90	6,47	6
1960–1971	1,45	5,35	3,86	12,69	7
1971–1980	1,14	5,83	4,43	37,65	8
1980–1990	1,11	2,74	1,61	33,94	9
1990–1997	0,88	1,55	0,67	3,34	10
1997–2007	1,40	4,43	3,22	2,94	11
2007–2009	0,30	-1,74	-4,04	14,13	12
1876–1922	0,66	2,42	1,29	2,60	...
1914–1920	1,12	0,02	-4,04	26,24	...
1922–1997	1,40	4,12	3,09	13,41	...
1997–2009	1,22	3,38	1,98	4,73	...
1876–2009	1,12	3,46	2,36	8,76	...

Notes: The taxation periods are based on fundamental changes in the marginal tax rates and tax base of the income tax to the central government.

Sources: Statistic Iceland, Guðmundur Jónsson, 1999, and Appendix D.

From 1922 to 1980, the growth rate per capita per year was both steady and high (except for the period 1954–1960), or between 3.36 percent each year during the period 1931–1941 to 4.43 percent each year during the period 1971–1980. This had nothing to do with taxation policy or tax rates, which were responses to the economic situation rather than reflecting any sort of planning the government had done for the economy or the people. The growth during the period 1971–1980 was the consequence of the overfishing or the overexploitation of fish stocks which we will describe in chapter 8.

## **6.6 Summary**

This chapter explained how the public revenue system has developed from the 19<sup>th</sup> century to the present. We started by looking at taxation by local governments; then we presented the income taxation system (Dual Income Taxation—DIT-system and Comprehensive Income Taxation—CIT-system), indirect taxation, and finally we described the influence of the taxation policy on the economy.

## **7 Agriculture: Market Failures and the Role of Subsidies**

### **7.1 Introduction**

This chapter focuses on the agricultural policy in Iceland since 1877 and the effect of Special Interest Groups, SIGs, on such policy.

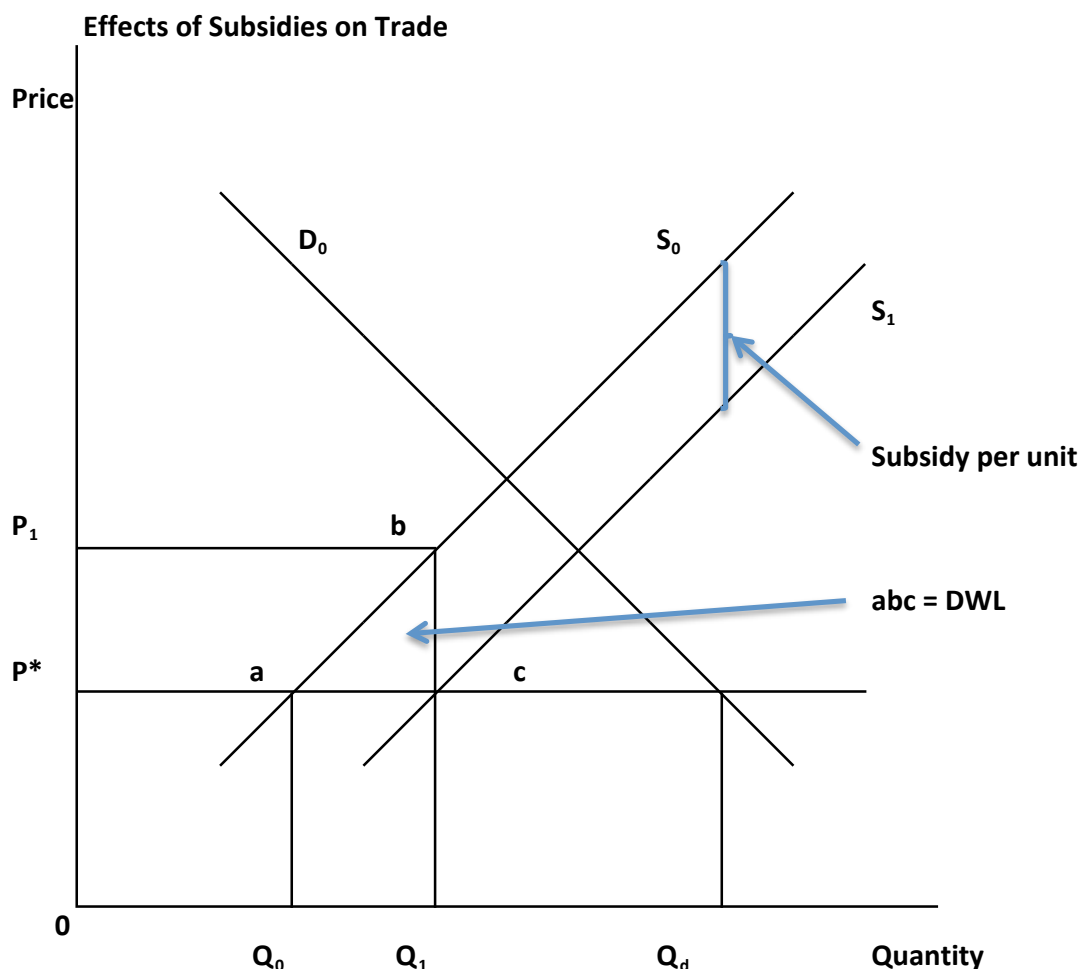
The chapter is divided into three sections. The first section gives a brief overview of the effects of subsidies in a perfect market setting.

In the second section, we will describe the ties between fisheries, agriculture and taxation in the *ancien régime*.

In the third section, we will discuss price support programs for farmers and their effect on the agricultural production.

### **7.2 Effects of Alternative Trade Policies**

If a market is assumed to be perfect and closed to international trade, production subsidies to firms have the effect of expanding output, reducing the prices paid by consumers and creating an overall welfare loss, since resources will be allocated inefficiently. Introducing international trade into this scenario complicates matters, i.e. an important distinction is whether the subsidy is granted to an export-competing or import-competing industry. If it is the latter, and assuming world prices are unaffected, the end result will be an expansion in domestic output at the expense of imports, see figure 12. Since subsidies create a wedge between the world price of a good or service and the actual price paid to domestic producers, a welfare loss arises from the subsidy.



$S_0$  is domestic supply, domestic demand is  $D_0$  and the world price is  $P^*$   
 If the government decides that the level of domestic production should be  $OQ_1$  instead of  $OQ_0$  domestic supply will shift from  $S_0$  to  $S_1$  causing domestic production to expand to the desired level and imports to fall by  $Q_0Q_1$  and the additional cost to the economy is represented by the area  $abc$  (DWL).

Source: WTO

Figure 12. Effects of Subsidies on Trade

Now consider the case of export subsidies to agricultural exports. Both production and export subsidies may have the effect of expanding domestic output and exports. They differ in their effects on domestic prices. Domestic prices are unaffected by producer subsidies, but rise in the case of export subsidies if re-imports are prevented. Costs to the taxpayers in the export subsidy will also be lower than in the production subsidy scenario, since the volume of subsidized domestic consumption will be lower, i.e. domestic prices rise with the export subsidy and the demand will fall, see figure 13. The

**Export subsidy** is a payment by the government to a firm or individual shipping goods abroad. When the government offers an export subsidy, shippers will export the goods up to the point where the domestic price exceeds the foreign price by the amount of the subsidy.

An export subsidy unambiguously leads to costs that exceed its benefits. Exports rise as a result of the subsidy, from  $X_1$  to  $X_2$  in panel II.

The Home Export Supply curve shifts down by exactly the amount of the subsidy, since the marginal cost of a unit of exports decreases by exactly  $s$ .

As in the case of a tariff, the deadweight loss as a result of the subsidy is the triangle  $(b + d)$ , the sum of consumer loss  $b$  and producer loss  $d$ .

**Loss from subsidy**

Fall in Consumer Surplus:	$-(a + b)$
Rise in Producer Surplus:	$+(a + b + c)$
Payment by Government for subsidy	$-(b + c + d)$
Net effect on Home Welfare:	$-(b + d)$

The same happens when the government uses tariffs or quotas. Since tariffs are simply a tax on imports they discourage imports. Hence, producers often prefer quotas. With limitations on the quantity imported, the domestic price increases above the world price, but producers know exactly the magnitude of the foreign supply and in that sense, quotas provide domestic producers with greater certainty than do tariffs: insulating them from the worst threats of competition. Following international agreements (GATT, WTO and the Uruguay Round in 1986–1994, etc.) the level of tariffs has been reduced and the use of quotas restricted. Accordingly, countries have sought to protect themselves from the world market by other means, i.e. voluntary export

restraints, which is preferable to quotas by the export countries, because their producers will get the quota rents.

**Table 5. Summary of Effects of Alternative Trade Policies on Prices**

<b>Effects of Alternative Trade Policies on Prices</b>				
	Export subsidy	Tariff	Import quota	Voluntary export restraint
Consumer surplus	Decrease	Decrease	Decrease	Decrease
Producer surplus	Increase	Increase	Increase	Increase
Government revenue	Decrease	Increase	No change	No change
National welfare	Decrease	Ambiguous	Ambiguous	Decrease

### 7.3 Agriculture, Fishing and Taxation in the Ancien Régime

At the dawn of the 18th century, Icelandic society had deteriorated since its “golden age” in the 13th century. Bishop Brynjólfur Sveinsson had sent the *Codex Regius* (Konungsbók) , a manuscript from 1260, to King Frederick III of Denmark in 1662. This included the *Snorra-Edda* cited in chapter 4.2. All knowledge about assessment in the country had been forgotten and the tax administration was in ruins—the elites’ main source of income was rent revenue, but one quarter of the Tithe, which was the main tax, was used for income replacement 1097–1914, see chapter 6.2. The Icelandic Tithe was not based on the same principle as the Biblical Tithe, but on the arable land—the minimum size of farms were 5 hundred or five cows and the Tithe was 6 half-yards or 1 percent. However, when Árni Magnússon and Páll Vídalín came to make the census in 1703, Daði Halldórsson forged the writ known as the “Statute of Bergthór” to explain how the assessment was executed<sup>7</sup>: instead of using arable land as a the base for all

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<sup>7</sup> The *Codex Regius* was Brynjólfur’s favorite manuscript, and it is possible that when Árni Magnússon and Páll Vídalín came to make the census in 1703, Daði Halldórsson wanted to besmirch Bishop Brynjólfur’s memory. The bishop had stated that Daði was the father of his daughter’s baby and she denied by oath, e.g. Ragnheiður oath.

taxation, as Snorri did in his *Gylfaginning*, i.e. a unit of work, Daði used the size of the field needed to feed one cow, which is, of course, contrary to the law of rents enunciated by Ricardo 1809. Árni and Páll rejected this writ, but the effect of this forgery has muddled all the ideas concerning the relationship between taxes, property valuation and agriculture in the *ancien régime*. However, this muddle served elite interests and encouraged favoritism. There was a barter system wherein prices were based on cattle, i.e. 1 hundred = 1 cow = 6 quarters of fish = 6 ewes = 120 half-yards = 240 fish = 5 dollar specie = 5.6 in dollar courant.<sup>8</sup> Two fish were therefore equivalent to one half-yard, and 20 half-yards were equivalent to one quarter of fish or 40 fish (each fish or stock fish = 1 kg). Because this system was only valid in Iceland, not in Denmark or in trade between the countries, the price for the fish was three or four times higher in Denmark or in Hamburg than in Iceland, so the export of the fish paid all the cost the Danish merchant in Iceland had of the import of all other products, i.e. corn, rye etc., and the other agricultural export from Iceland. The household formed the basic unit of feudal society and the serfs were bound to their landlord legally, economically, and socially, see chapter 4.3, figure 3. It was the landlord who sent the serfs fishing, but where the serfs were allowed to fish, they were bound to pay their rent in fish. Therefore, fisheries, agriculture and taxation were linked together and it was in the interest of the elites to keep the assessment unclear (see footnote 8) and to keep the fisheries primitive to be in better shape to keep their serfs at their manor (vistarband) (Gísli Gunnarsson, 1987; Guðmundur Jónsson, 1993; Jóhannes Hraunfjörð Karlsson, 1996).

With the advent of autonomy in the early 20<sup>th</sup> century, it became advantageous for the elite to take over all fisheries, and a page was turned, see chapter 5.3, 5.4 and 8.

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<sup>8</sup> The barter system was based on cattle. The basic unit was 1 cow aged 3-8 years as this was considered the valuable assets for the society. 1 half-yard was a unit of woven fabric 1 yard wide. 2 fish had a value of 1 half-yard and quarter was equal to 40 fish, therefore 80 shillings were equal to 40 fish. However, the value of the fish depends on which taxes were being paid because taxes were based on custom and tradition, rather than legislation. The dollar specie and dollar courant were equivalent while there were fewer shillings in dollar specie. The cattle was also the base for the valuation of the land: 1 ox or 1 horse pulling a plow counted as 1 hundred.

## 7.4 The Influence of SIGs on Agricultural Policy

The first fundamental theorem of welfare economics asserts that the economy is Pareto efficient only under certain circumstances or conditions. There are six important conditions or market failures under which markets are not Pareto efficient and they provide a rationale for government activity:

- 1) Imperfect competition (monopoly, oligopoly, etc.);
- 2) Public goods (non-excludability and non-rivalry);
- 3) Externalities (negative and positive);
- 4) Incomplete markets;
- 5) Imperfect information (such as addressed by the EU Directive on the Protection of Consumers of Financial Services);
- 6) Unemployment and other macroeconomic disturbances.

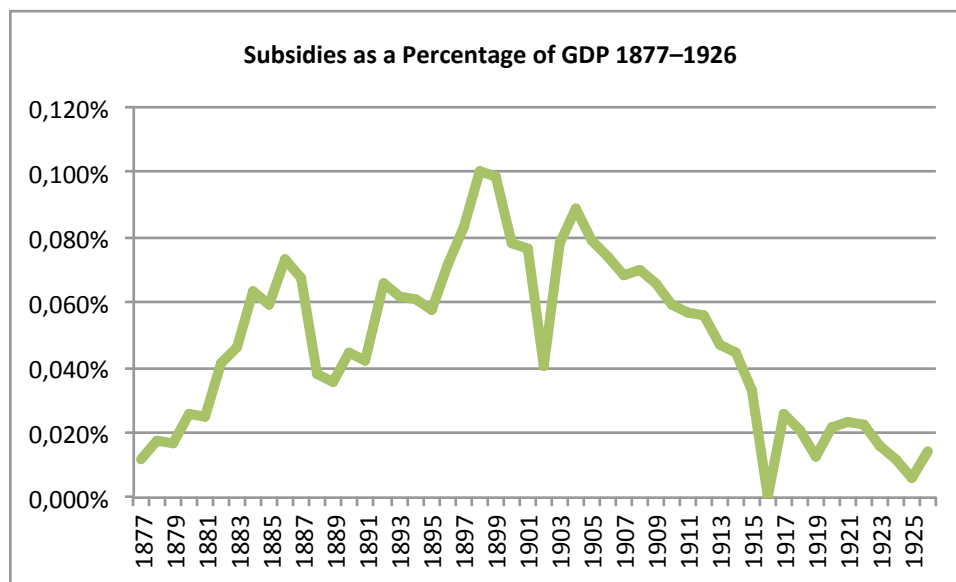
However, even if the economy were Pareto efficient, there are two further arguments for government intervention. The first argument involves income distribution and the second argument arises from concern that individuals may not act in their own best interest.

Over the past century the growth of the public sector has been enormous. In developed countries, government expenditure was only a small proportion of GDP at the start of the 20<sup>th</sup> century, but is now usually between 40 and 50 percent of GDP. This growth cannot be entirely explained by benevolent governments maximizing social welfare. The agricultural price support program provides an illustration of an instance where the appeal to market failures is more of an excuse for a program than a rationale. Support for agriculture dates back to the 19<sup>th</sup> century. It was developed extensively in the EU and USA across the two World Wars and the Great Depression to protect domestic food production, but remains important across the world today. Yet there are important market failures in agriculture, as we discussed in chapter 7.2. Price and output are highly variable. Farmers typically cannot buy insurance to protect themselves against either price or output fluctuations. Though they could reduce their exposure to price risk somewhat by trading in futures and forward markets, these markets are highly speculative and farmers worry that they are at a marked disadvantage in trading in them.



What farmers really care about is not price variability, but income variability. Programs to stabilize prices do not fully stabilize income, since income depends both on the price received and the quantity produced. Normally, prices rise when, on average, quantities fall. If prices rise proportionately, then income may vary very little, with price increase just offsetting quantity decreases. In such a situation, stabilizing prices will increase income variability.

In Iceland, price support programs for farmers started in 1920s with import restrictions. However, agriculture was, of course, supported in many ways before that. From 1874 until WWI the subsidies increased tenfold, see figure 14, and table 6, but the value added increased only by 25 percent. Hence, in order to reduce the effects of the Great Depression, unemployment and other macroeconomic disturbances and, of course, income distribution inequality (see chapter 6.5.1 table 1), price support programs started in 1934, see table 6. Since that time, there have been some drastic developments, as the program that was intended as a relief for workers in the wake of the Great Depression, has now become its opposite, mostly because of the influence of the Progressive Party, see figure 15.



**Figure 14. Subsidies as Percent of GDP 1877–1926**

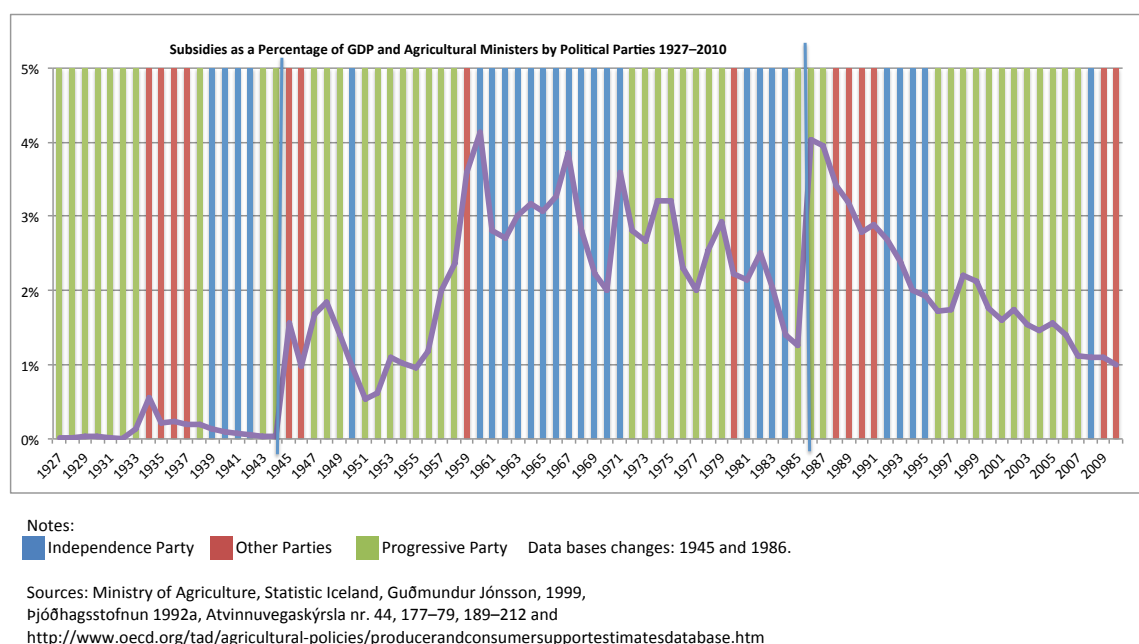
**Table 6. Subsidies on Agricultural Produce 1877–1945, 1877=100**

**Subsidies on Agricultural Produce 1877–1945, 1877=100**

Year	Subsidies	Value added	Year	Subsidies	Value added
1877–1880	171,6	108,6	1911–1915	1000,2	125,5
1881–1885	447,4	100,2	1916–1920	250,1	94,6
1886–1890	453,7	88,4	1921–1925	317,5	83,8
1891–1895	669,2	112,5	1926–1930	625,1	103,7
1896–1900	1078,2	108,6	1931–1935	6766,8	97,7
1901–1905	1114,3	105,1	1936–1940	6707,1	128,6
1906–1910	1214,3	111,2	1941–1945	2713,5	196,4

Notes: Five-years averages, except 1877–1880.

Sources: Guðmundur Jónsson, 1999, table 5.11



**Figure 15. Subsidies as Percent of GDP and Agricultural Ministers by Political Parties 1927–2010**

Imports of agricultural products were banned in 1927, while price subsidies on agricultural products started in 1943. In the beginning, the percentage of the total value of production was between 4 and 9 percent, except for the years 1947 and 1948 when extra support came in. Yet the subsidies increased rapidly. By 1959, they were 24 percent of the total value of the production and by 1971 had risen to 30 percent, when

the government decided to decrease the supports again due to overproduction, see figure 15 and table 7.

**Table 7. Subsidies on agricultural produce 1945–1986**

Subsidies on agricultural produce 1945–1986							
Mill. new ISK	Price subsidies					Export subsidies	
	Total	Dairy products	Mutton and lamb	Other	Percent of total value of productions	Subsidies	Percent of total value of exports
1945	0,2	17,7%	81,3%	1,0%	9,4%	...	...
1946	0,2	29,6%	70,4%	—	7,4%	...	...
1947	0,3	16,5%	83,2%	0,3%	12,6%	...	...
1948	0,4	26,1%	73,9%	—	12,9%	...	...
1949	0,3	40,1%	59,9%	—	9,6%	...	...
1950	0,2	46,1%	52,1%	1,8%	6,4%	...	...
1951	0,2	73,3%	22,0%	4,7%	3,9%	...	...
1952	0,2	80,4%	15,3%	4,2%	4,6%	...	...
1953	0,4	80,7%	8,5%	10,7%	8,3%	...	...
1954	0,4	87,1%	6,1%	6,8%	7,8%	...	...
1955	0,5	86,7%	7,2%	6,1%	7,6%	...	...
1956	0,6	82,4%	10,2%	7,4%	8,4%	0,1	14,3%
1957	0,9	74,0%	17,0%	9,0%	11,2%	0,3	50,0%
1958	1,0	60,5%	23,5%	16,0%	12,1%	0,6	85,7%
1959	2,2	59,4%	30,1%	10,6%	24,1%	0,6	75,0%
1960	2,8	56,9%	30,3%	12,8%	26,9%	0,8	66,7%
1961	2,6	56,7%	24,9%	18,5%	20,9%	0,2	10,5%
1962	2,9	55,8%	27,6%	16,6%	20,8%	0,3	12,0%
1963	3,4	52,9%	23,5%	23,5%	19,8%	0,9	39,1%
1964	3,6	58,3%	27,8%	13,9%	17,5%	2,2	88,0%
1965	5,1	64,7%	25,5%	9,8%	20,0%	1,7	73,9%
1966	6,1	55,7%	26,2%	18,0%	22,8%	2,6	92,9%
1967	7,6	69,7%	30,3%	0,0%	25,6%	2,8	96,6%
1968	5,5	72,7%	23,6%	3,6%	17,3%	2,6	53,1%
1969	4,9	75,5%	24,5%	0,0%	12,7%	3,1	50,8%
1970	5,7	71,9%	28,1%	0,0%	12,6%	3,3	76,7%
1971	16,4	56,7%	27,4%	15,9%	30,1%	4,1	95,4%
1972	16,8	63,1%	29,8%	7,1%	25,1%	3,3	58,9%
1973	21,4	57,0%	34,6%	8,4%	22,9%	5,5	67,9%
1974	37,4	56,1%	36,6%	7,2%	26,2%	9,7	97,0%
1975	55,9	48,1%	36,3%	15,6%	28,5%	11,4	77,0%
1976	51,8	51,2%	35,9%	12,9%	20,2%	15,8	77,1%
1977	57,7	43,7%	41,6%	14,7%	15,8%	27,4	107,9%
1978	117,9	38,4%	46,1%	15,5%	19,5%	49,4	113,3%
1979	224,9	40,6%	44,9%	14,5%	26,6%	59,4	78,8%
1980	270,5	43,6%	41,5%	14,9%	22,0%	84,4	99,4%
1981	388,5	36,4%	43,8%	19,9%	19,6%	145,4	158,5%
1982	805,1	39,0%	45,8%	15,2%	26,0%	172,3	152,2%
1983	1095,6	37,1%	46,4%	16,5%	21,0%	282,8	124,7%
1984	817,6	35,1%	44,2%	20,8%	12,9%	444,2	100,6%
1985	986,9	23,7%	53,5%	22,8%	11,0%	558,7	102,9%
1986	1350,4	35,0%	48,1%	16,9%	12,6%	834,0	120,0%

Notes:

*Totals are according to the Government Accounts, whereas disaggregated data is partly estimated. The only subsidized products other than dairy products, mutton and lamb until 1957 were potatoes. Subsidies on wool and sheepskin began in 1957, on agricultural inputs in 1959, on beef in 1975 and on horse meat, pork, eggs and poultry in 1988. At wholesale prices. The total value is partly estimated. Sources: Þjóðhagsstofnun 1992a, Atvinnuvegaskýrsla nr. 44, 177–79, 189–212.*

Export subsidies were first used in 1941, but that practice came to a halt in 1956, because of a lack of meat. Since the 1960s and until 1992, when the government put an end to export subsidies—in the wake of EFTA, GATT and WTO—the subsidies were often more than 100 percent of the total value of the exported product, see table 7.

Since 1986, the OECD has published a Producer Support Estimate, PSE, the annual monetary value of gross transfers from consumers and taxpayers to agricultural producers, measured at the farm-gate level, arising from policy measures that support agriculture, regardless of their nature, objectives or impacts on farm production or income, which is a much better measure than that we have been using. The most important units the OECD uses are the following:

- Percentage PSE (%PSE): PSE as a share of gross farm receipts (including support).
- Producer Nominal Assistance Coefficient (producer NAC): the ratio between the value of gross farm receipts (including support) and gross farm receipts valued at border prices (measured at farm gate). The reference (border) price is the import (c.i.f.) or export (f.o.b.) price of a commodity used for calculating the market price support price gap, measured at the farm gate level. An implicit border price may be calculated as, for example, the unit value of imports or exports.
- Producer Nominal Protection Coefficient (producer NPC): the ratio between the average price received by producers at farm gate (including payments per ton of current output), and the border price (measured at farm gate). A basic price with the “farm gate” as the pricing point, that is, the price of the product available at the farm, excluding any separately billed transport or delivery charge.

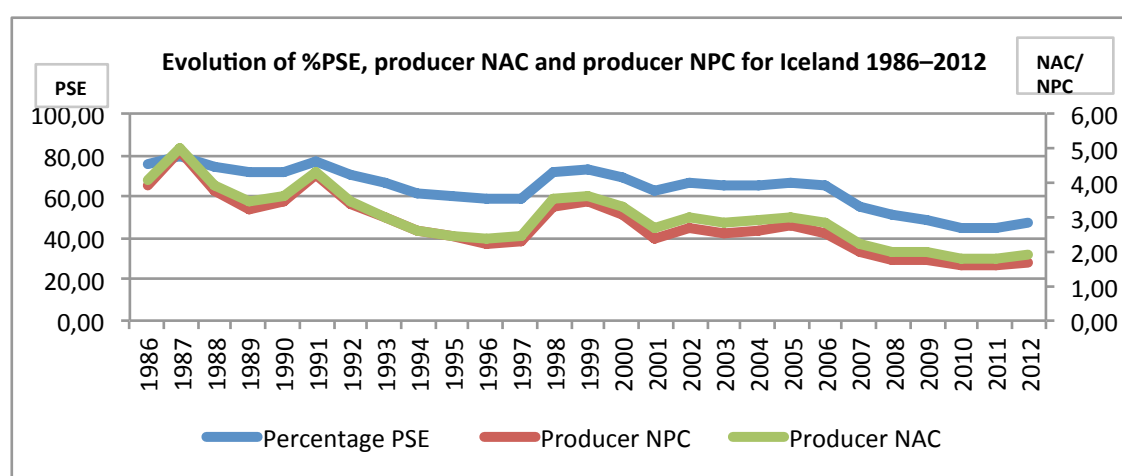
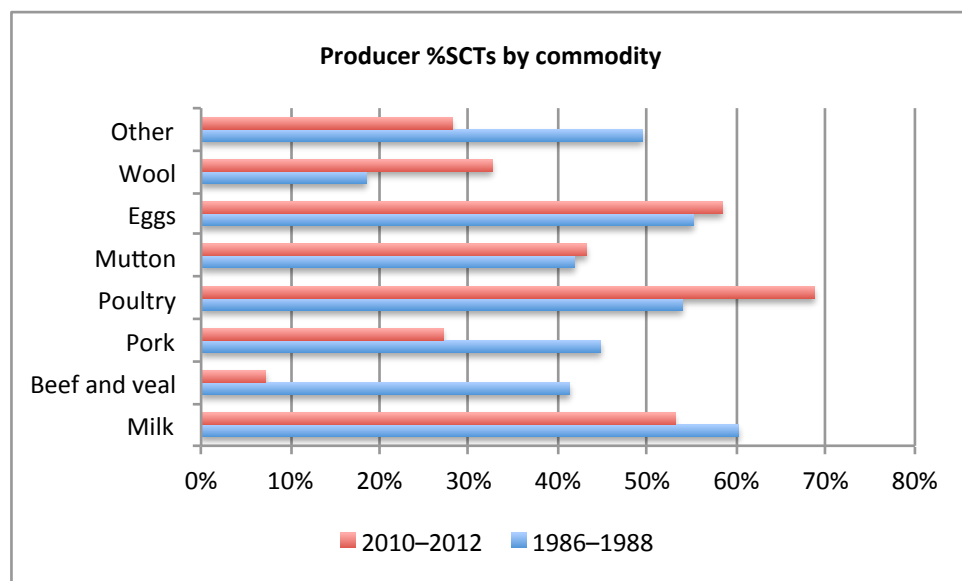


Figure 16. Evolution of %PSE, producer NAC and producer NPC for Iceland 1986–2012

A %PSE of 80% means that the estimated total value of policy transfers to individual producers from consumers and taxpayers represents 80% of total gross farm receipts, or, alternatively, that 80% of gross farm receipts come from transfers due to policy measures supporting producers, see figure 16. A %PSE of 0% indicates that the estimated aggregate value of transfers to individual producers from consumers and taxpayers is zero. A %PSE cannot be higher than 100%, at which level all farm receipts come from policy measures, with no returns from the market.

According to figure 16, the level of producer support, as a share of gross farm receipts (%PSE), has fallen from 75% in 1986 to 47% in 2012—a decline of 63%. In 1986, transfers arising from support policies increased farm receipts by 295% above what they would have been if production had been valued at border prices. By 2012, farm receipts were only 68% higher due to support policies. The producer NPC indicates that prices received by producers were on average 310% higher than border prices in 1986. By 2012, the gap had fallen by 46%, so that prices received by producers are now on average only 90% higher than border prices.

We can also use the OECD indicator to calculate the level of support at the individual commodity level. The %SCT measures the extent to which production of an individual commodity is required to receive support. Comparing %SCT values across a range of commodities provides an indication of the degree to which support is directly linked to production of these specific commodities. Figure 17 shows changes in the %SCT from a base period. It is obvious that in the long term, the reduction in transfers to a single commodity has not been uniform across commodities. A three-year average reduces some of the year-to-year variability in support levels that arise due to fluctuations in world prices, exchange rates, etc. The reference period is 1986-88; a period of relatively high support and the WTO Uruguay Round base period for domestic support reduction commitments for developed countries; this predates most of the substantial agricultural reforms that have taken place.



**Figure 17. Producer %SCTs by commodity**

As a result of import duties, import levies; export premiums and consumer subsidies, the price system of Iceland has been distorted more than the price system of any other neighboring country. To this have been added the effects of price controls, which have been maintained, at least on agricultural products, for more than 80 years. In the beginning, such measures were adopted to obtain immediate and specific results. Import duties were raised during the depression in order to promote domestic production and improve government finances. Import levies and exchange premiums were introduced in order to maintain the operation of the export industries in spite of the incorrect rate of exchange. Consumer subsidies originated in the desire to keep down the prices of prime necessities and prevent the increase of the cost of living index and of wages. Price controls were introduced for similar reasons. Prices carry messages from the surrounding world to individuals and enterprises. In accordance with these messages, economic decisions are taken and these decisions in turn affect the surroundings. A description was offered above of the effects of alternative trade policies on the prices of agricultural products. However, if this system of communication is distorted, economic decisions will be made on the basis of incorrect assumptions and their effects will be correspondingly disadvantageous. In Iceland, the distortions that originated during the depression and WWII, were corrected later and to a lesser extent than in other Western European countries, and some of them have not been corrected

yet. The main reason why the price system in Iceland has not been corrected is, of course, a manipulated rate of exchange that has been tailored to the needs of fishing industry through the years. As a result, the economy has been directed into channels that have not in all cases been the most appropriate; investment priorities have not always been the most beneficial, and the interest of employers and employees in improvements in operations has been diminished.

## **7.5 Summary**

In this chapter, we explained the agricultural policy in Iceland since 1877 and the effect of Special Interest Groups, SIGs, on the policy. It started with the effects of subsidies on the perfect market, then we presented the bound between fisheries, agriculture and taxation in the *ancien régime*, and finally we described the implementation of the price support programs for farmers and its effect on the agricultural production.

## **8 The Fishing Industry and Rent-Seeking**

### **8.1 Introduction**

This chapter focuses on the fisheries in Iceland and the collection and distribution of economic rents created in the fisheries. The chapter is divided into three sections.

The first section describes how the fisheries have been taxed through the years and how the taxation system has diverted some of the rent away from the initial benefactors.

In the second section, we describe the constitution, the debate in Iceland on the subject of a fishing fee during the last decades, and we argue that a quota system with a fishing fee is better, more equitable, and more flexible than a quota system without such a fee.

In the third section, we will discuss attempts of the Government of Iceland to introduce a fishing fee after the financial crisis 2008.

### **8.2 Sovereignty, Rent Distribution, and Inflation**

In a democratic country, a country's natural resources should belong to its people, and the “rent” that they generate provides a source of revenue that could be used to reduce inequality or finance public goods that would otherwise either be undersupplied or financed by distortionary taxation. Taxing the rents of natural resources at high rates—i.e. the nation takes fees from those that use its natural resources—does not cause the adverse consequences that arise when taxing savings or work (reserves of fisheries and geothermal energy cannot move to another country to avoid taxation as can workers or capital).

History teaches us that the land and its natural resources are the main causes of conflict in the world, both between governments and between groups inside each territory. The rent seekers try to grab the land or the natural resources. Then they select their cacique (their local cooperating rulers), who is usually picked out among the local landholding oligarchy that is quite stable, often thanks to our support. When the Norwegian King “conquered” Iceland with the Old Treaty in 1262, each taxpayer



(around 4000) had to pay him 20 hundreds each year, 10 hundreds for the King and 10 for his cacique or collector (*sýslumaður*, see appendix C). During that time, if we can take the accounts of the ancient law books literally, 30 percent of the elite revenue came from land rent, but in the beginning of the 18th century, the rental income was 94 percent of the elite total revenue. The rents were based on the *King's Law Book* from 1281 (*Jónsbók*), 10 percent each year. Therefore, all changes of the administration or the tax system would threaten the status of the caciques and the elites. It was simple, gross, and basic, and much more consequential than the trivial rent-seeking we are used to today. The bulk of the people may have been affected only marginally: they just paid Prince B instead of Prince A. Yet it made all the difference to Prince B and Prince A, the ones who made basic decisions about global conflict and cooperation. Just as the volcanic eruption of Mount Laki in Iceland 1783–1785 has been said to be one of the main causes for the French Revolution in 1789, it had a drastic effect on the Icelandic economy. To save the economy, the state sold large parts of its land to the serfs (after the Reformation, when the King confiscated most church property, the state owned around 50% of all land) and halted the practice of renting out trade with Iceland to the merchants of Copenhagen (usually termed the “trade monopoly” in Iceland), which had been the King's main source of income in Iceland since 1602, especially the fisheries. The rent rate was lowered to 5 percent, thereby laying the basis for the administration changes in Iceland during the 19<sup>th</sup> century, unfortunately not as radical as in France.

However, before we go any further, it is useful to acknowledge the difference between profit seeking and rent seeking:

- Profit seeking is the expenditure of resources to create a profitable position that is ultimately beneficial to society. Therefore, profit seeking is what drives progress in the economy and is the motivating force behind competition.
- Rent seeking is the expenditure of resources to gain control of rents of any sort. The process of rent seeking is the process of spending money to redistribute what has already been created. Hence rent-seeking is ultimately damaging to society.

Iceland has sufficient natural resources to sustain both a growing population and an increasing standard of living. The most important factor in this context is the fact that—among other important factors such as its unique scenery and history, favoring a tourist industry, and abundant hydroelectric power, natural steam, and hot water)—it is one of

the world's greatest fisheries. However, its people have never received any "rent" from that resource. In order to strengthen the nation, a wider sharing of rent is indicated. This is a simple matter of readjusting tax systems. Many oil-rich jurisdictions already provide models, albeit modest in degree (like Alaska's social dividend from oil royalties, Norway with its fast-growing sovereign wealth fund, and Canada has developed system of interprovincial equalization of resource revenues).

Ricardian rent is a fundamental concept in the taxing literature for transfer pricing and evaluating benefits for taxing purposes: evaluating rent when the employer provides housing, assessing the costs of natural resources, or setting the price for goods and services sold between controlled (or related) legal entities within an enterprise. The Ricardian doctrine states that the rent of a land site is equal to the economic advantage obtained by using the site in its most productive use, relative to the advantage obtained by using marginal (i.e., the best rent-free) land for the same purpose, given the same input of labor and capital (Ricardo, 1996, pp. 45-60). According to the Income Tax Act (No 90/2003), Article 118, it is the Minister of Finance who evaluates benefits for taxing purposes:

At the beginning of each year the Minister of Finance, after receiving the recommendations of the Director of the Internal Revenue, is to publish rules of how to evaluate benefits, as noted in Article 7, and other income and deductions that have to be given a monetary value according to this Act.

The rent (Earnings Before Taxes, EBT) is published by Statistics Iceland each year, i.e. how much the whole fishing industry earns after the cost of goods sold, interest and selling, and general and administrative expenses have been subtracted from gross sales. The EBT of the fishing industry has been between 2 and 4 percent of the GDP each year during recent decades, which is much more than the whole income of the Icelandic state from the VAT for the same period. However, taxing a renewable resource such as the fish in the seas around Iceland involves a twofold problem, which must be taken into account by the government in order to get the most out of the resource. The first aspect is biological: how to avoid overfishing to avoid destroying the resource. The second is how to allocate rights to exploit the fisheries. According to Thorolfur Matthíasson, professor at the University of Iceland, these rights can be classified as follows (Matthíasson, 1992):

- I. the right either to devote effort or to bring a given catch ashore;
- II. ownership of the resource delegated to a public enterprise, or the fishing contracted out to contractors, or rights to fish auctioned, sold rented or handed out to individuals or firms;
- III. rights allocated to persons, vessels, communities or firms;
- IV. rights as transferable or non-transferable;
- V. rights allocated for a limited, unlimited or undefined period of time.

(I) addresses the question of whether it is input or output that is regulated, (II) how rights are allocated, (III) to whom rights are allocated, (IV) whether those rights may be resold and (V) how certain the rights are and how long they can be enjoyed. Every management system represents a choice along one of the dimensions given in I to V. Following professor Thorolfur, all these dimensions have both pros and cons, but in the end, it is the main Special Interest Group in Iceland, LÍÚ, who has the last word about how to tax the fisheries and how to allocate rights to exploit them.

In practice, instead of taxing the rents of natural resources at high rates, taxation is mainly based upon inflation and the distortion of exchange rates. In other words, the devaluation of the currency is reflected by inflation. The question is, who bears the tax burden? For example, a company itself does not pay tax, a company tax is paid by its shareholders, its employees or its customers, and in the very long term, all tax ends up being borne by people in proportion to their ability to transfer the inputs they provide to an economy, or their consumption, from one jurisdiction to another. According to Arnold Harberger, the after-tax return on capital should be the same in the corporate and the unincorporated sectors, i.e. the cost of the capital should be borne equally by all sectors of the economy. How the burden is shared by consumers, owners of capital, and workers depend upon the price elasticity of supply and demand for the product (Harberger, 1962). Therefore, the question is how the burden is shared among these groups. The effects of inflation upon economic growth are well known. Inflation reduces free savings and makes it more difficult to obtain financing for the investment of private enterprises and public authorities. The redistributive role of inflation through its effect on wages has been widely recognized in the literature. When inflation is taking place, price rises tend to run ahead of increases in money wages. Therefore, inflation leads to a shift of income away from wage earners, and toward profits. On this ground, inflation

is claimed to increase income inequality because it affects the poor relatively more than the rich. There is a strong cause and effect interaction between inflation, an important economic parameter, and corruption (Akça et al., 2012) and, there is, of course, a correlation between the difference between GDP as measured by the production approach and GDP as calculated through the income approach and the devaluation of the currency; and therefore, there is a strong correlation between inflation and the exchange rate, i.e. when the Government devalues the krona, the inflation increases (see table 8). One of the features of an inflationary situation is that over-all demand is in excess of over-all supply, which means that there is an excess demand for services, and that there is dishoarding at the same time. Let us examine the composition of the demand for foreign currency in Iceland, and how such currency is earned through import and export. In Iceland, imports amount to about half of the GDP, and obviously external trade is crucial. For instance, almost all construction projects in the country require foreign currency in one form or another. This currency is earned with labor and capital in all economic sectors, which then form the product that is exported, seafood products being the most important. When the import exceeds the export, there is a balance of payments deficit, and the over-all demand is in excess of the over-all supply. However, like for any other subject to trade, the value of money is determined by demand and supply, yet in Iceland, the Government has always distorted the exchange rate in one way or in another, usually by rating the krona too high. In other words, the Government has moved the profit from the export sector to other economic sectors through the exchange rate. Thus, the fishing industry is made to pay the fishing fee through a fictitious exchange rate. Nonetheless, a rise in the krona reduces the prices that consumers in Iceland have to pay for imported goods, and on that account they are better off. This policy has led to a lack of economic balance, appearing internally as inflation and devaluation of the currency, and externally, as a balance of payments deficit (Benjamín H. J. Eiríksson, 2012 [1954]; Matthíasson, 1999). Hence, the seigniorage taxation is random. Furthermore, when the debts are not indexed, (as was the case before the adoption of Act No 13 in 1979), those in debt will draw a profit, while those who own money will lose, and the indexation of all financial instruments is tantamount to shooting oneself in the foot. All business will be rendered difficult, for example corporate financial statements, which were indexed from 1981 to 2002 (Acts

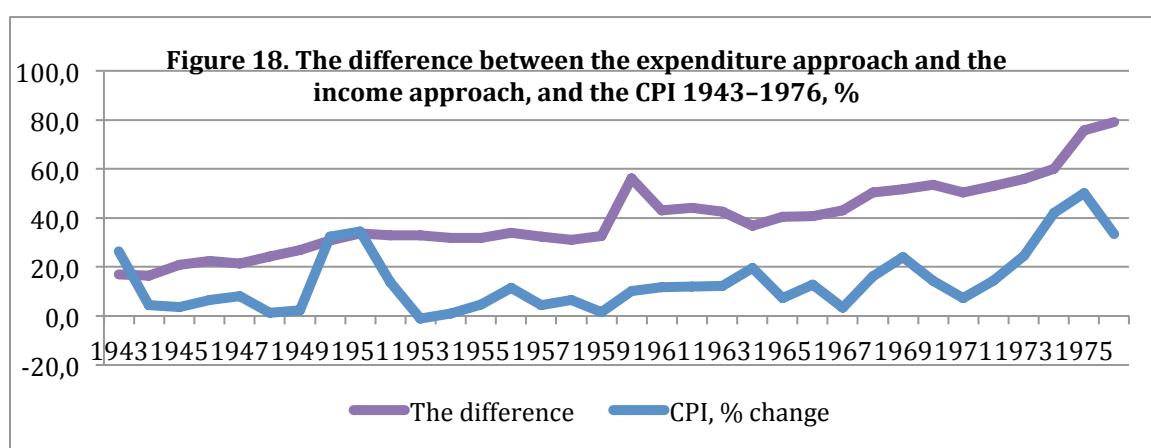
No 7 in 1981 and No 133 in 2001), and this inhibited FDI—for those who are not used to index base and indexation clauses, such businesses were not worth the risk—and led to corporate financial statements in foreign currency. Yet, to this day, the krona remains the main barrier against FDI.

The course of a redistributive policy for national resources can be described by reference to the aggregate demand and aggregate supply (AD-AS), which is the total demand and supply for final goods and services in the economy at a given time and price level, the demand-pull inflation, which is asserted to arise when aggregate demand in an economy outpaces aggregate supply, and the law of diminishing returns, which states that in all productive processes, adding more of one factor of production, while holding all others constant ("ceteris paribus"), will at some point yield lower per-unit returns. There are five main steps:

- I. Initially, the economy is in equilibrium, with price stability and adequate employment (market clear).
- II. The balance is broken with higher income for the fish industry (increased catch or increased price).
- III. Higher income in the fish industry increases the demand for products and services in other economic sectors and their costs increase.
- IV. This leads to no change in aggregate output, after all, the economy is already at full capacity, but there is large upward pressure in prices and demand-pull inflation starts, then economy finds new equilibrium.
- V. The fish industries revenues are paid in a foreign currency. Transfer takes place in accordance with an exchange rate, which is forceably kept constant or distorted. Since the exchange rate is fixed, the revenues of the fishing industry are not in accordance with the expenses (wages and domestic costs), but increase domestic costs in line with inflation, until the fishing industry cannot be sustained and the currency is devalued—and so on (see table 8 and figure 18).

Such a system of high internal exchange rate and import duties was used to transfer income from the fishing sector in Iceland to the public at large before 1984, but because of international agreements, import duties and import levies are now not as important as before—the EFTA-effect. Nevertheless, during these years, the Icelandic Government collected a resource tax which the people of Iceland have enjoyed in the form of lower taxes and/or higher supply of public services than would have been the case if no transfer had been made. Thorolfur Matthíasson argues that, consequently, the general

public has established a right to appropriate some of the resource rent (Matthíasson, 1999). Furthermore, Markús Möller of the Central Bank of Iceland, (quoted in (Matthíasson, 1999), investigated how the real wage rate would be influenced by the existence of a renewable resource in the economy and whether the access would be restricted. According to the advocates of allocating quotas free of charge, it does not matter to whom the quotas are initially allocated, as the resource rent will trickle down the economy and end up with the public. According to Möller, the real wage rate is unaffected by a change in the institutional setting in the fishing industry. The introduction of ITQs does not change the unit cost function of the traded-good industry and the workers will not automatically receive any resource rent created by an ITQ-system. Therefore, the proposition that ITQ-created rent influences real wages is false, although ITQ-system determines how the resource rent is distributed. If quotas are handed out free of charge to the owners of the fishing sector, then they will grab all the resource rent. Alternatively, the Government can auction off the quotas to the highest bidders, and in that case, the resource rent would accrue to Government, which could redistribute it to the public.



**Figure 18. The difference between the expenditure approach and the income approach, and the CPI 1943-1976, %**

**Table 8. The Expenditure Approach, the Income Approach, CPI and the exchange rate 1921–1976**

	<b>1</b> Expenditure Approach	<b>2</b> Income Approach	<b>3</b> The difference between 1 and 2	<b>4</b> CPI, % change from prev. year	<b>5</b> 1 US dollar in ISK
1921	131,1	102,4	28,1	-15,3	6,4503
1922	131,9	97,1	35,8	-19,7	5,8506
1923	125,0	97,2	28,6	-6,2	6,6149
1924	167,4	122,4	36,8	10,5	7,1813
1925	171,7	122,0	40,7	-4,0	5,26
1926	144,2	106,8	35,0	-12,4	4,57
1927	156,6	112,5	39,2	-9,2	4,5625
1928	175,7	130,2	34,9	-2,8	4,555
1929	184,7	137,8	34,0	0,2	4,565
1930	187,8	140,5	33,7	-2,8	4,56
1931	155,8	127,4	22,3	-8,7	4,9575
1932	144,0	125,4	14,8	-3,8	6,35
1933	162,9	134,9	20,7	-0,5	5,40
1934	172,5	139,4	23,8	0,9	4,4075
1935	176,7	137,4	28,6	1,1	4,5325
1936	183,4	140,1	30,9	2,5	4,4675
1937	199,0	152,5	30,5	5,0	4,4925
1938	205,0	155,0	32,2	2,4	4,5425
1939	235,4	167,3	40,7	3,9	5,76
1940	354,0	276,4	28,1	31,1	6,5165
1941	570,8	452,3	26,2	27,9	6,508
1942	866,7	705,0	22,9	31,1	6,505
1943	1077,2	920,2	17,1	26,4	6,505
1944	1198,4	1029,4	16,4	4,4	6,505
1945	1341,0	1109,0	20,9	3,6	6,505
1946	1615,0	1318,0	22,5	6,5	6,505
1947	1875,0	1545,0	21,4	8,1	6,505
1948	1900,0	1530,0	24,2	1,3	6,505
1949	1933,0	1523,0	26,9	2,5	7,4583
1950	2237,0	1711,0	30,7	32,4	15,16
1951	2770,0	2072,0	33,7	34,5	16,32
1952	3101,0	2334,0	32,9	13,8	16,32
1953	3737,0	2809,0	33,0	-1,1	16,32
1954	4173,0	3167,0	31,8	1,1	16,32
1955	4805,0	3646,0	31,8	4,6	16,32
1956	5712,0	4264,0	34,0	11,6	16,32
1957	6009,0	4536,0	32,5	4,5	16,32
1958	6952,0	5304,0	31,1	6,6	16,32
1959	7842,0	5914,0	32,6	1,5	16,32
1960	8790,0	5626,0	56,2	10,3	35,06
1961	9987,0	6972,0	43,2	11,71	40,17
1962	11985,0	8315,0	44,1	11,95	43,06
1963	14318,0	10032,0	42,7	12,39	43,06
1964	18288,0	13360,0	36,9	19,60	43,06
1965	22097,0	15715,0	40,6	7,43	43,06
1966	26541,0	18845,0	40,8	12,82	43,06
1967	26931,0	18820,0	43,1	3,30	44,23
1968	28942,0	19238,0	50,4	16,16	61,31
1969	35818,0	23596,0	51,8	24,09	88,10
1970	44816,0	29171,0	53,6	14,29	88,10
1971	57030,0	37906,0	50,5	7,34	87,86
1972	71655,0	46807,0	53,1	14,44	87,67
1973	100606,0	64538,0	55,9	24,69	90,02
1974	146431,0	91523,0	60,0	42,16	100,24
1975	209080,0	119008,0	75,7	50,23	154,03
1976	294065,0	164196,0	79,1	33,55	182,31

Sources: Statistic Iceland and Guðmundur Jónsson, 1999.

### **8.3 The Constitution and the Debate on a Fishing Fee**

After WWII, the countries of Western Europe followed a determined policy of maintaining economic balance, while reducing protections and controls, and correcting the price system. The backbone was international co-operation within such organizations as the OEEC, the IMF and GATT, where each country could apply the new policy in the knowledge that other countries would do the same and they would all benefit from this. Simultaneously, monetary and fiscal policies were directed towards maintaining full employment, which was the main explanation for the rapid economic growth achieved in Western Europe.

Iceland had followed a different economic policy in many important respects. Employment had been maintained at an even higher level than that of the neighboring countries, which was one of the main reasons for the GDP being so much higher than it had been before the war. On the other hand, economic balance had not been achieved. At the same time, the policy of protections and controls had largely been maintained, and the great price distortions created during the war were not corrected until at a later stage, and then only to a limited extent. The main cause of the policy was, of course, the lobbying of LÍÚ, especially after the re-organization of the group in 1944. Until 1960, the business of the fishing industry was not based on the profit from fishing, but on distorted exchange rates, as the fishing companies received compensation from funds that were obtained by applying different charges to the currency. The charges varied according to the currency denominator used (Kristján Ragnarsson, 1999). This economic policy had important effects upon investment and the operation of enterprises and also affected the attitudes of employers, employees and their associations. On the whole, these effects tended to obstruct rather than promote economic growth. From 1948 to 1952, the national production per capita declined by almost 15 percent and the national income by more than 25 per cent. Improvement did not begin until the year 1953, when catches increased and prices of exports rose, a sizable labor force was employed at the Defense Force Base (the increase in employment at the Base played a substantial role in the great increase of GDP 1953–1955), and investment activities based upon the Marshall Plan were started. However, the growth was uneven, and in the following years, national production increased little more than corresponded to the increase in population, i.e. 2–3 percent a year.



This transfer system of multiple exchange rates etc. was abandoned in 1960. However, at the same time the discussion of taxing the natural resources was started by Bjarni Bragi Jónsson, Deputy Governor of Central Bank of Iceland, followed by many economists. During that time, Europe was changing with the establishment of the European Economic Community, EEC and the European Free Trade Association, EFTA, and many people were hoping for a general improvement of economic policy. Bjarni's main idea was to use the tax on the fisheries to develop economic industries other than fishing, especially outside the Reykjavík Area, for the benefit of the nation. The fisheries are a limited natural resource, and therefore the economic growth based only upon fishing has its limits. Hence, that would have meant the share of the fish industry in the economy would have decreased followed by decreasing impact of LÍÚ on the government (Bjarni Bragi Jónsson, 1975).

In 1975, there were two reports published on the situation of the fisheries on the Icelandic waters. The Icelandic Marine Research Institute (MRI) published the "Black Report" and the Icelandic Research Council (IRC) published the "Blue Report". These two reports, and the discussion that followed their publication, made the general public in Icelandic conscious of the fact that uncontrolled fishing of stocks in Icelandic sea was not a viable option for the future. In other words, the progress of fisheries in Iceland would be brought to an end within a relatively short time unless changes were made in fisheries management. Yet, it was not until December 1983, when the complete collapse of the cod stock appeared imminent, that the parliament adopted the quota system and at the same time proclaimed that the fishing stocks of the country's sea were the common property of the Icelandic nation (Matthíasson, 2001).

The system we currently have in Iceland of individual, transferable quotas (ITQs) is intended to alleviate some of the flaws that had arisen in the era of limited access, but just like all other systems, it could be contended. Fishing fees have an impact of distribution of permits, although a fixed tax enhances efficiency compared to the case of no fees, while retraction and reallocation by auction reduces efficiency compared to both alternative treatments (Baldursson & Sturluson, 2009). However, a quota system with a fishing fee is potentially a better, more equitable and more flexible arrangement

than a quota system without such a fee. Thorolfur lists six reasons in favor of a quota system with a fishing fee (Matthíasson, 2001):

- 1) Flexibility with a view of introducing other forms of management in the future.
- 2) Equity and fairness, contending that having a fishing fee makes it easier to ensure that the entire nation enjoy the benefit of the resource.
- 3) Spreading risk, maintaining that having a fishing fee makes it possible to offer vessel operation an indirect insurance policy which otherwise would not be available to them.
- 4) Equalization of fluctuations and the problem of co-habitation, which refer to the possibility of wage earners and/or taxpayers being forced to apply general policy instruments to acquire a portion of the fishery rent.
- 5) Neutrality, based on the idea that the so-called resource rent taxes should not affect the use of the factors of production.
- 6) Economic growth arguments, which are linked to the theories of rent-seeking and Dutch disease<sup>9</sup>.

Further, optimal management strategies differ for different stakeholders. Fishery managers may find themselves in the line of fire between groups, and the final outcome will be decided by the political weight of each group (Matthíasson, 2005).

However, although a small fee is collected, the full potential of taxing the fishing rent has not been utilized, mainly because of the conflict of the sovereignty over the country's natural resources (land and fisheries) and the quota owners. In the end of the last century, the government wanted to write a new article about natural resources into the constitution so it could release a fishing fee. Still nothing happened. A new draft constitution was approved by two thirds of the voters in a referendum held in October, 2012. It contains a new article about natural resources, which has a long history in the nation, and when asked about that article, three out of four voters approved it; but still

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<sup>9</sup> The Dutch disease is the apparent relationship between the increase in the economic development of natural resources and a decline in the manufacturing sector. An increase in revenues from natural resources will make a given nation's currency stronger compared to that of other nations, resulting in the nation's other exports becoming more expensive for other countries to buy, and imports becoming cheaper, making the manufacturing sector less competitive.

nothing happened. Article No 34 states (Auðlindanefnd, 2000; Samtök um nýja stjórnarskrá, 2014):

Iceland's natural resources that are not private property shall be the joint and perpetual property of the nation. No one can acquire the natural resources, or rights connected thereto, as property or for permanent use and they may not be sold or pledged.

Publicly owned natural resources include resources such as marine stocks, other resources of the ocean and its bottom within Iceland's economic zone and the sources of water and water-harnessing rights, the rights to geothermal energy and mining. The public ownership of resources below a certain depth under the earth's surface may be determined by law.

In the use of natural resources, sustainable development and public interest shall be used for guidance.

The public authorities, along with those using the natural resources, shall be responsible for their protection. The public authorities may, on the basis of law, issue permits for the use of natural resources or other limited public goods, against full payment and for a modest period of time in each instance. Such permits shall be issued on an equal-opportunity basis and it shall never lead to a right of ownership or irrevocable control of the natural resources.

#### **8.4 Saving the Furniture**

Until now, our main theme has been the relationship between the Special Interest Groups, SIGs, and the two main political parties in Iceland: the Independence Party and the Progressive Party. Nonetheless, SIGs are not interested in parties or partisanship. They are policy maximizers existing to transmit the policy preferences of their constituents to our elected officials. SIGs are only interested in passing legislation which favorable to their preferred policy outcomes. Where these groups find their ideological 'friends' is, in part, a function of the distribution of ideology among the members of the Parliament. SIGs want to maximize the number of representatives who share their partisanship. According to (Brunell, 2005) there are three reasons why an SIG has a weak party preference: Firstly, an SIG will naturally have an ideological affinity for one party or the other (i.e., no interest group is perfectly indifferent to the two parties). Secondly, political parties pressure those groups that lean in their direction to make more donations to their preferred party, and fewer to the other party. Thirdly, SIGs understand the importance of majority party status in the Parliament. Sincere donations

are given to maximize the electoral benefit to the group's preferred candidates. Strategic donations are oriented toward access to the opposite party; however, the donations are made to ensure access, while minimizing the electoral impact. The cornerstone of the argument is that campaign contributions are fundamentally about affecting election outcomes. Donations are, for the most part, not made to buy votes or to buy access, but rather used by many groups to try to bring the distribution of ideological positions in the Parliament closer to the ideal point of the interest group.

In February 2009, after the 2008 financial crisis, the Social Democratic Alliance (SDA) and the Left-Green Movement (LG) formed a government. According to the Policy Declaration of the government, it was formed in order to assure the country an effective administration to carry out urgent and important measures, particularly for the benefit of households and business, for rebuilding the banking system, for administrative reform, and to increase democracy and an open and honest society. The economic policy of the Government was based on the program then already established by the authorities and the International Monetary Fund, IMF. Yet, in this context, the most important points were that (Government, 2009):

Amendments will be made in regard to the following issues in the Icelandic Constitution:

Reference will be made to natural resources owned by the nation.

Provision will be made for national referendums.

The process for amending the Constitution by special referendum [SIC]. Legislation will be enacted on the composition and tasks of a constitutional council.

The electoral legislation will be amended to allow for the possibility of voting for individual candidates in elections to the Althingi.

During that time, the whole society went topsy-turvy. Jón Bjarnason (LG) was the Minister of Fisheries, and it was his job to make a proposal for a fishing fee. However, nothing happened, and in the end of 2011, the Left-Green Movement had to replace him by Steingrímur J. Sigfússon, the leader of the party. The fishing industry did everything it could to encourage hostility within society by using all their forces through the Parliament by blocking all legislation and using the media and social networking sites; and on June 7, 2012, the fishing oligarchs even sailed the whole fleet to Reykjavík,

in order to protest in front of the Parliament building, at Austurvöllur. Of course, this had effects, and as mentioned above, only a small fishing fee was collected through the Act No 74, 5 July 2012. On top of all this, the first thing the new Government of the Independence Party and the Progressive Party did was to reduce the fishing fees by half (Act No 84, 9 July 2013). Thus, the full potential of taxing the fishing rent has not been utilized, mainly because the MPs are financially dependent on the fishing oligarchs.

## **8.5 Summary**

In this chapter, we explained why the state should tax its natural resources. We began with the Ricardian rent idea and examined how the Icelandic fisheries have been taxed through the years; and finally, we described the effects of the taxation schemes on the economy, examining the arguments for fishing fees and why the full potential of taxing the fishing rent has not been utilized so far.

## **9 The Influence of Special Interest Groups on the Taxation System**

### **9.1 Introduction**

This chapter focuses on how Special Interest Groups shape the taxation system to serve their own ends. According to a report on suggestions regarding the prosecution of economic crimes, published by the Minister of Justice after the financial crisis of 2008, the scale of economic crimes and tax frauds is much greater in Iceland than in other Nordic countries, which confirms what we have stated before. The social control system in Iceland is much softer than in other Nordic countries, and therefore the tolerance for corrupt activities is greater (Innanríkisráðuneytið, 2013). This attitude has been traced back to the behavior of the Icelandic elite towards common people, the rulers vs. the ruled, in the late Middle Ages (Gísli Gunnarsson, 1987). A weak administration and pervasive corruption are closely related, and extractive institutions thrive on this.

This chapter is divided into three sections. In the first section, we seek to evaluate tax evasion as the rate of tax revenue in Iceland since the end of the 19<sup>th</sup> century.

In the second section, we describe the influence of clientelism on the structure of the taxation administration in Iceland.

In the last section, we will describe how the ruling elites shape the tax system to fit their own interests.

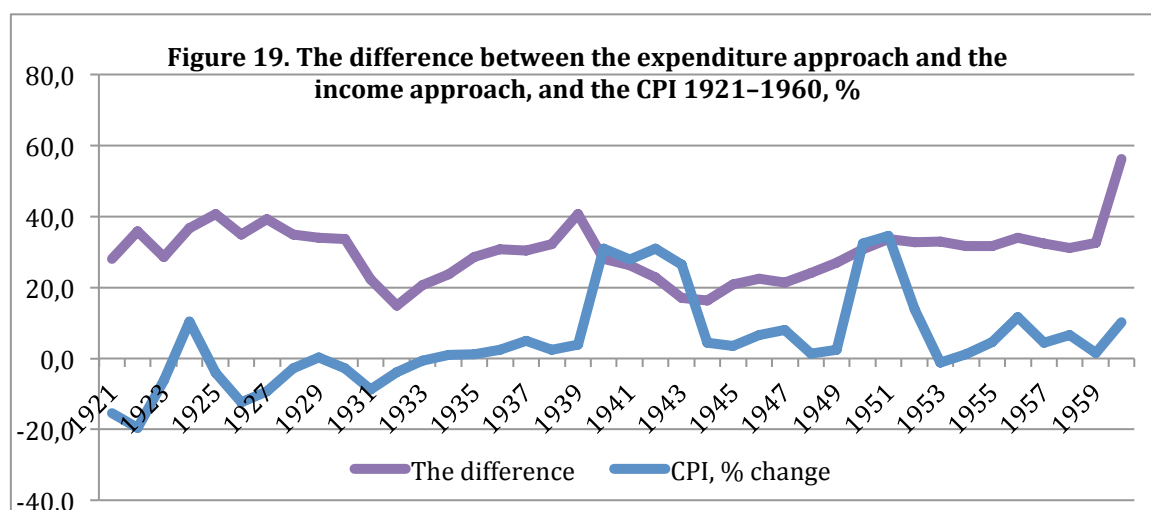
### **9.2 Tax Evasion**

Tax evasion is illegal, and those engaging in it have every reason to try to conceal what they are doing. This introduces a fundamental difficulty into the measurement of tax evasion. The term Non-Observed Economy (NOE) refers to all economic activities for which payments are made but are not officially declared. These include: underground production, illegal production, informal sector production and production of household goods for one's own final use.

The three different methods to measure the gross domestic product, GDP, (the production approach; the expenditure approach; and the income approach) can be used

as a tool to measure the NOE. The outcome of all these three methods should be the same. However, using these data, we cannot distinguish between tax evasion, tax avoidance, corruption, and other economic activities that are not officially declared.

There is a huge difference between the GDP as measured by the production approach, and the GDP as calculated through the income approach (See figure 19 and table 8).



**Figure 19. The difference between the expenditure approach and the income approach, and the CPI 1921–1960, %**

From 1921 on to WWII, there is a clear correlation between that difference and the various stages of the economic cycle (See table 4). However, even though the income approach might be underestimated, since the local income tax was much higher than the central income tax, but was not added to the income approach 1923–1942 (see figure 6 and chapter 3), the companies did not return separate income statements until 1934, and the taxable income might have been underestimated up to 1938 because of missing tax returns. Yet the difference between the two methods is so considerable that it undeniably points to corruption anchored deep in the folds of society. Although corrupt societies produce corrupt data (inflation etc.), the government shows no respect for taxpayers' money, and in spite of the correlation with the economic cycle, there is no clear proportion involved. This in turn points to significant tax evasion involving the oil companies, the fish industry, and the importers, as these parties used false invoices to show that the purchase prices were up to 10 times higher than they actually were, and this affected the whole community (Þórarinn Þórarinsson, 1986). We

must bear in mind that counterfeit invoices, price fixing and transfer pricing methods have been the major tool for corporate tax avoidance through history.<sup>10</sup> Transfer pricing adjustments have been a feature of many tax systems since the 1930s, but not in Iceland (Fjármálaráðuneyti, 2013). In this connection, the property investigation in 1948 is the most significant:

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<sup>10</sup> According to the Parliament, the tax evasion of craftsmen was about 10 percent in the 1930s (Atvinnumálaráðuneytið, 1936, p. 308). In 1936, the Oil Distribution Companies in Iceland, British Petroleum in Iceland (BP) and the Shell Company in Iceland, were caught red-handed in counterfeiting invoices and price-fixing in order to increase their profits by millions of krónur. The General director of BP was Héðinn Valdimarsson, an MP for the Social Democrats and the Chairman of the State Internal Revenue Board; and the Chairman of the Shell Company was Magnús Guðmundsson, former Finance and Justice Minister for the Independence Party. Nothing was done about it. However, the Oil Companies kept up their collusion in one way or another for many years. Interestingly, in the 1990s, the three main oil companies in Iceland were charged for price-fixing after a very thorough investigation by the Competition Authority. Everything was done to delay the case. The Oil Companies had direct access to all political parties. For example, Sólveig Pétursdóttir, the Minister of Justice for the Independence Party, was the wife of Kristinn Björnsson, the General Director of the Shell Company in Iceland. After the case attracted the attention of the newspapers, Sólveig became the Speaker of the Parliament, while the director of the institution that started the case, Georg Ólafsson, lost his job (Verkalyðsblaðið, 1936; Wikipedia, 2013a). In Iceland, the fishing industry is the basis for elite power. Therefore, it is not a surprise that bribes, counterfeit invoices, price-fixing and transfer-pricing behavior are frequent in that area. The main elite family in Iceland during the early 20<sup>th</sup> century was the Thors family, and, as mentioned before, the head of the family was Ólafur Thors, leader of the Independence Party 1934–1961. The family based its power on two fishing-industry organizations: Kveldúlfur and Icelandic Seafood (SÍF). In 1949, Icelandic Seafood was caught red-handed committing all of the above-mentioned reprehensible acts (bribery, counterfeiting invoices, price-fixing and transfer-pricing) in Italy and Greece. Geir H. Zoega an employee of the Federation of Icelandic Fishing Vessel Owners, LÍÚ, in London, was the one who unveiled these activities. Geir examined the case and, according to him, the company had defrauded millions of krónur, starting in 1932 with the establishment of Icelandic Seafood. The General Director of Icelandic Seafood was Richard Thors, brother of Ólafur, who had, as the Minister of Fisheries, granted the company a monopoly to export bacalao from Iceland. However, that monopoly license was revoked when the coalition of the Independence Party and the Progressive Party was defeated in the late 1950s, and the cleanup process was started (Nýi-tíminn, 1949, 1957).



- Right after WWII, the Allies started to “de-nazify” Germany. This was done through a series of directives. In 1948, they changed the currency, and the citizens had to declare all properties, including bank accounts, shares, paintings, houses, books, cars, etc., to determine how they had come by it, and who was the rightful owner. The same was done in Denmark and Norway, as the Nazis had occupied both these countries. In Norway, it was called: *Love om engangsskatt på formuestigning*, or a special windfall tax. The Nazis did not occupy Iceland. However, the tax frauds were so enormous by the end of WWII that the Parliament in Iceland decided to do the same thing. According to the special Tax Act No 67 in 1947, the tax evasion was defined by the following procedure:

Net assets according to the property investigation 31 December 1947.

**minus:**

Net asset prices per 31 December 1939 and the increase in real-estate appraisals from 31 December 1939 to 31 December 1947. Estimated savings from 1940 to 1946. Tax-free capital gains.

**Plus:**

Loss on sale of equivalent assets during the same period.

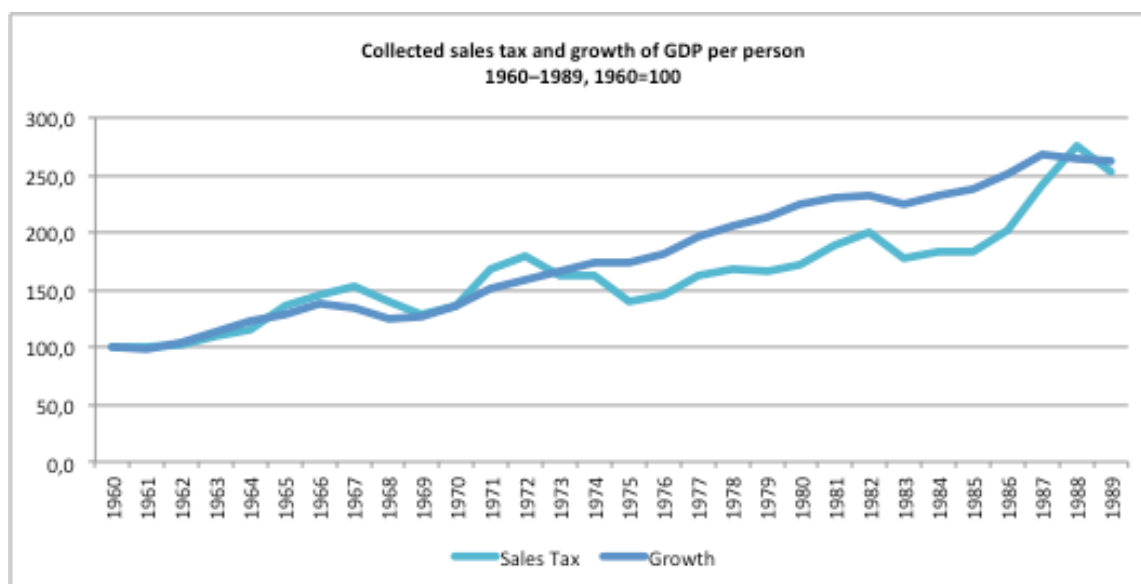
**Equal:**

The outcome: assets unaccounted for. According to the investigation committee, these were traced to tax evasion.

The local tax officer in Reykjavík, Halldór Sigfússon and his staff, published special tax returns for this purpose, and people stood in queues in front of the currency-exchange stations all around the country to change their old currency for the new; but nothing came out of this, and no one was charged. The main reason was, of course, the conflict between the Finance Minister, Jóhann Þ. Jósefsson, from the Independence Party, and the Parliament. The Minister took all the edge out of the law and the administration was weak. The Minister declared that there was no need

to punish tax evaders, they were only defending themselves (Jóhannes Hraunfjörð Karlsson, 1999).

In the 1950s, tax evasion was estimated to amount to around 25 percent of the total revenue of the State (OEEC, 1958), but after economic reforms in 1960, especially after the introduction of the sales tax, Act No 10, tax evasion increased enormously, as shown in table 8, figure 19, table 9, and figure 20, where the difference between methods goes from 32.6 in 1959 to 56.2 in 1960 and to 36.2 in 1964, when the government started to index the tax scale again, then the difference followed the CPI, and furthermore, the collection of sales taxes increased, and tax monitoring became more effective.



**Figure 20. Collected sales tax and growth of GDP per person 1960–1989, 1960=100**

**Table 9. Collected sales tax on each percent 1960–1989, at 1989 prices in million ISK.**

	<b>Sales tax, percent</b>	<b>Million ISK</b>	<b>On each percent</b>	<b>Sales Tax 1960 = 100</b>	<b>Growth 1960 = 100</b>
1960	3,0	1.637,2	545,73	100,0	100,0
1961	3,0	1.625,4	541,82	99,3	98,2
1962	3,0	1.658,1	552,69	101,3	104,6
1963	3,0	1.782,6	594,21	108,9	113,2
1964	5,5	3.465,7	630,12	115,5	122,2
1965	7,5	5.554,5	740,60	135,7	128,7
1966	7,5	5.972,8	796,37	145,9	137,6
1967	7,5	6.259,8	834,65	152,9	133,8
1968	7,5	5.699,6	759,95	139,3	124,8
1969	7,5	5.291,1	705,48	129,3	126,7
1970	11,0	8.185,8	744,16	136,4	135,4
1971	11,0	10.106,0	918,73	168,3	151,6
1972	11,0	10.799,8	981,80	179,9	158,5
1973	13,0	11.510,4	885,42	162,2	166,9
1974	19,0	16.804,0	884,42	162,1	174,0
1975	22,0	16.863,5	766,52	140,5	172,9
1976	22,0	17.544,7	797,49	146,1	181,5
1977	22,0	19.563,3	889,24	162,9	196,0
1978	22,0	20.098,5	913,57	167,4	206,1
1979	22,0	19.928,6	905,84	166,0	214,1
1980	23,5	22.137,3	942,01	172,6	224,0
1981	23,5	24.169,2	1028,47	188,5	230,8
1982	23,5	25.649,5	1091,47	200,0	232,6
1983	23,5	22.806,5	970,49	177,8	224,7
1984	24,0	24.083,8	1003,49	183,9	231,5
1985	25,0	24.979,4	999,18	183,1	237,3
1986	25,0	27.662,8	1106,51	202,8	250,3
1987	25,0	33.056,6	1322,26	242,3	268,7
1988	25,0	37.549,3	1501,97	275,2	264,2
1989	25,0	34.570,0	1382,80	253,4	261,9

Sources: Act No.: 10/1960; 1/1964; 61/1965; 3/1970; 4/1973; 10/1974; 85/1974; 5/1975; 6/1975; 76/1975; 12/1980; 23/1984; 48/1985.

Búskapur hins opinbera 1980–1989. Þjóðhagreiðningaskýrsla no. 2 and no. 8.

Notes: Sales tax is levied on the sale of a good to its final end user, and is charged every time that item is sold retail. In accordance with Act No. 50/1988, the collection of Value Added Tax started in 1990.

By Regulation No. 169/1970, the control system of the sales tax was changed significantly.

The collection of the sales tax has a strong relation to the economic cycle and obviously, tax evasion increased sharply following the construction work following the volcanic eruptions in the Vestman Islands in 1973, the oil crisis 1974 and the corruption that it entailed.

In the 1970s, the IMF also confirmed that tax fraud was a big problem for economic growth in Iceland (IMF, 1972). The tax legislation for companies was not aligned to that of other countries until Iceland joined EFTA in 1970, with the Act No 68 of 1971. According to the IMF, most of the big companies had by then stopped fraudulent behavior (see figure 21 and table 10), but sales tax evasion had increased (see figure 20), and the legislation applicable to individuals was still a mess, although some MPs from the Labor Union Association had started inquiring about grants and campaign contributions to the Independence Party (Alþingistiðindi, 1975).

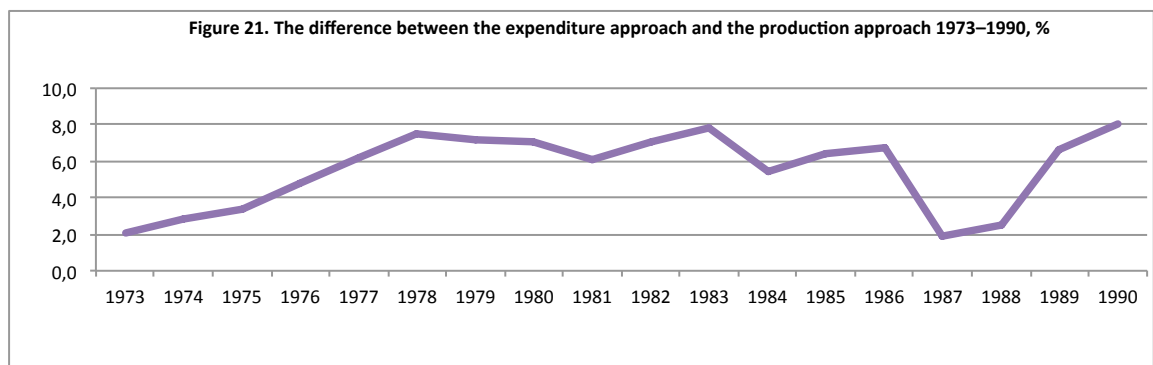


Figure 21. The difference between the expenditure approach and the production approach 1973–1990, %

**Table 10. The Expenditure Approach, the Production Approach, and CPI 1973–1990**

	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
	Production Approach	Expenditure Approach	The difference between 1 and 2	CPI
1973	985,4	1.006,1	2,1	24,7
1974	1.422,2	1.464,3	2,9	42,2
1975	2.020,8	2.090,8	3,3	50,2
1976	2.800,8	2.940,7	4,8	33,6
1977	3.981,5	4.246,7	6,2	30,5
1978	6.091,7	6.584,4	7,5	44,3
1979	9.033,1	9.728,2	7,1	45,7
1980	14.851,1	15.982,0	7,1	59,0
1981	23.335,0	24.860,0	6,1	50,6
1982	36.279,4	39.020,0	7,0	51,1
1983	62.370,9	67.696,0	7,9	85,7
1984	84.553,1	89.440,0	5,5	30,3
1985	114.250,6	122.026,0	6,4	32,7
1986	150.636,5	161.561,0	6,8	20,6
1987	206.360,6	210.348,0	1,9	18,9
1988	252.193,0	258.780,0	2,5	26,4
1989	297.584,5	318.780,0	6,6	22,3
1990	341.424,4	371.437,0	8,1	14,7

Sources: Statistic Iceland

Notes:

The year 1987 was tax free. Therefore, we can state that there was no tax evasion that year.

The 5 percent difference in GDP corresponds approximately to 15 percent of General Total Revenue.

In 1976, there were strong protests against tax frauds around the country, especially in Bolungarvík and Hveragerði. The government could not let the matter wait much longer (Árni Kolbeinsson, 1978), and a number of improvements on the tax system and tax administration were made by the adoption of Act No 40 of 1978 and Act No 7 of 1980, including inflation accounting and the merging of the Tax Penalty Committee with the State Internal Revenue Board.

According to the three special tax investigation committees (1984, 1994 and 2004), tax evasion seemed to be under better control in terms of estimated percentages during these years, or around 10 percent of the tax revenue. However, during that time, the Independence Party and the Progressive Party wanted to change Iceland into a tax haven, especially designed for Icelandic expatriates living in the UK and Luxembourg.

This led to drastic tax evasion in the events leading up to the crisis 2008. Furthermore, in 2003, there was excessive unexplained financing of the Icelandic economy, amounting to 127 billion ISK (as adjusted by Statistics Iceland), roughly the equivalent of 10 per cent of the GDP. According to the Central Bank of Iceland, this was mainly due to changes in methodology, but according to Statistics Iceland, this hypothesis does not hold water. The greatest difference appears in items 8.1.1, and 8.2.1. To put it bluntly, this reeks of money laundering, tax evasion or both, but it has not been researched, see table 11 (Jóhannes Hraunfjörð Karlsson, 2010).

**Table 11. Financing of households' final consumption 1997-2005**

	1997	1998	1999	2000	2001	2002	2003*	2004	2005
1. Disposable income of the household sector	255.330	281.840	307.738	349.478	365.340	402.034	422.481	467.750	529.720
2. Households' final consumption	295.516	330.262	365.912	400.154	418.190	430.988	463.308	511.556	588.633
3. Net savings	-40.186	-48.422	-58.174	-50.675	-52.850	-28.954	-40.827	-43.806	-58.913
4. Depreciation of dwellings and individual business activities	17.435	19.386	22.639	25.563	27.512	28.377	31.409	36.745	46.929
5. Gross savings (5.= 3.+ 4.)	-22.751	-29.036	-35.535	-25.112	-25.338	-577	-9.418	-7.061	-11.984
6. Residential construction	20.678	21.573	22.217	25.886	31.714	39.354	42.483	50.626	58.466
7. Gross fixed capital formation in unincorporated enterprises	6.565	7.417	10.956	9.317	9.028	6.226	6.641	7.752	12.650
8. Net lending (+) / Net borrowing (-) (8.= 5.- 6.- 7.)	-49.993	-58.026	-68.708	-60.315	-66.080	-46.157	-58.542	-65.439	-83.099
8.1. Incurrence of liabilities	43.716	65.312	78.147	104.170	76.553	98.263	48.607	114.889	244.556
8.1.1. Net lending to households	34.845	58.265	62.172	92.633	64.645	91.147	39.698	95.675	197.628
8.1.2. The share of unincorp. enterpr. in lending to ind.	8.871	7.047	15.974	11.537	11.908	7.116	8.908	19.214	46.928
8.2. Acquisition of financial assets	24.653	39.270	41.863	34.958	27.561	35.620	117.304	74.883	85.625
8.2.1. Increase in households deposits	6.832	13.818	16.823	18.123	19.246	35.853	57.183	28.826	53.725
8.2.2. The share of unincorp. enterpr. in deposits of ind.	569	617	1.254	751	1.055	1.042	1.246	1.120	1.529
8.2.3. Increase in securities	9.273	20.718	20.582	10.903	8.032	87	59.430	48.422	22.504
8.2.4. Increase in shares	7.978	4.116	3.204	5.181	-772	-1.362	-555	-3.486	7.868
9. Discrepancy in financial balance (9.= 8.- 8.2.)	-30.930	-31.984	-32.425	8.898	-17.088	16.486	-127.239	-25.433	75.831

Source: Statistic Iceland, Hagtíðindi 2007:5. CBI, MONETARY BULLETIN 2004:1. Gunnar Tómasson, 2013, and Gudrun Johnsen, 2014.

**Notes:**

In 2003, there was excessive unexplained financing of the Icelandic economy, amounting to 127 billion ISK (after the adjustments of the Statistic Iceland), roughly the equivalent of 10 per cent of the GDP. According to the CBI, this is mainly due to changes in methodology, but according to Statistic Iceland, this hypothesis does not hold. The greatest difference appears in items 8.1.1, and 8.2.1. To put it bluntly, this reeks of money laundering, tax evasion or both, yet it has not been researched.

In 2003, the coalition government of the Independence Party and the Progressive Party privatized the banks, delivering them into the hands of their friends, although they never paid for them, and therein lies the root of the financial crisis of 2008. The Icelandic businessmen who bought Landsbanki, (Björgólfur Guðmundsson, his son, Björgólfur Thor and Magnús Þorsteinsson) had had several breweries in Saint Petersburg, Russia. These ventures in Russia did raise suspicion at the time, and many serious newspapers wondered where these people got their funds.

In 2004, the above-mentioned banks started to finance the brand-new private branch of housing loans market in Iceland. It is remarkable that in early 2009, Boris Berezovsky (23 January 1946–23 March 2013) a Russian business oligarch, had this to say in Sky News, <http://www.youtube.com/watch?v=Jl3NqnjzUFw>:

„And you remember three months ago, Russian government decreed that they would help Iceland. And Russia is so strong that they are able to help even a member of NATO.

And the trick is very simple because Russian top-level bureaucrats like Putin, like others – and the oligarchs together they create a system how to operate in the West, how to use this fantastic money to buy assets and so on. And they find a very clever solution. They took a country and bought the country, which is a member of NATO and not a member of EU, because regulations are different. They put a lot of money, dirty money into it...”

Gunnar Tómasson, a respected Icelandic economist, also pointed out in his blog in 2013, that the increase of interest rates paid by the Icelandic state, from 1/25 of the GDP in 2004 to 1/3 in 2008, amounts to a drastic draining of society.

Gunnar remarks: “It is not yet clear what exactly caused this—but it is not possible to exclude that Icelandic financial enterprises and black foreign money were involved.”

Gunnar continues and raises some questions about that year's developments, at home and abroad:

Why did the U.S. Federal Reserve Board not want to assist the Central Bank of Iceland?

Why were Icelandic authorities reluctant to seek out the IMF?

Why did the United Kingdom apply terrorist law against the National Bank of Iceland?

Why has Geir Haarde, former Prime Minister of Iceland, not spoken with Gordon Brown, former Prime Minister of UK, since then?

Why won't Davíð Oddsson, former Prime Minister of Iceland and former Governor of CBI, express his view on this point?

Why are Icelandic authorities reluctant to submit their dispute with the United Kingdom to a court of law?

Why did the Russian ambassador mention a \$4 billion dollar loan to Iceland?

Why did Icelandic authorities take this point seriously?

However, at the same time, the government ensured that results from tax investigations were kept to a strict minimum (see table 12 and 13, 14 and 15). The first thing the new government did in 2009, after the 2008 crisis, was to strengthen tax controls (see table 16).

**Table 12. Total Tax Penalties ruled by Courts, the State Internal Revenue Board and the Directorate of Tax Investigations 2000–2013**

	% of Govern.	Total	Courts	SIRB	DTI
<b>Total</b>		<b>12.169.633.718</b>	<b>4.374.603.718</b>	<b>1.569.895.000</b>	<b>324.150.000</b>
2013	0,22	1.748.710.000	1.416.620.000	298.630.000	33.460.000
2012	0,16	1.179.631.000	856.391.000	264.800.000	58.440.000
2011	0,15	991.660.000	718.395.000	239.055.000	34.210.000
2010	0,31	1.980.984.000	1.386.544.000	548.840.000	45.600.000
2009	0,19	1.167.413.000	794.673.000	319.910.000	52.830.000
2008	0,16	1.060.991.000	851.811.000	126.560.000	82.620.000
2007	0,10	601.701.387	314.501.387	193.830.000	93.370.000
2006	0,16	872.709.323	542.954.323	234.425.000	95.330.000
2005	0,16	749.720.000	575.150.000	174.570.000	
2004	0,11	446.762.000	364.552.000	82.210.000	
2003	0,16	590.416.000	493.836.000	96.580.000	
2002	0,09	291.583.000	118.958.000	172.625.000	
2001	0,11	360.543.008	233.468.008	127.075.000	
2000	0,04	126.810.000	84.700.000	42.110.000	

Source: The Ministry of Finance, Statistics Iceland

Notes:

SIRB= The State Internal Revenue Board

DTI=The Directorate of Tax Investigations

% of Govern. = Percent of General Total Revenue

However, according to the Statement of General Government Operations tax penalties 2000-2012 were in ISK:

2000	2002	2004	2005	2006	2007
50.000.000	210.000.000	110.000.000	190.000.000	270.000.000	250.000.000
2008	2009	2010	2011	2012	
180.000.000	350.000.000	550.000.000	230.000.000	310.000.000	

(Figures are not available for 2001 and 2003)

According to figure 12, the total tax penalties were highest in 2010, in the aftermath of the 2008 bank crash, or 0.31 percent of all taxes.

**Table 13. Rulings of the Supreme Court of Iceland 2000–2009**

	Total	Evasion	Defaults
<b>Total</b>	62	11	51
2009	2	0	2
2008	2	1	1
2007	19	0	19
2006	11	2	9
2005	1	0	1
2004	0	0	0
2003	7	3	4
2002	3	1	2
2001	5	2	3
2000	12	2	10

Source: The Ministry of Finance

**Table 14. Rulings by the District Courts of Iceland 2000–2009**

	<b>Total</b>	<b>Evasion</b>	<b>Defaults</b>
<b>Total</b>	<b>304</b>	<b>134</b>	<b>170</b>
2009	36	23	13
2008	45	24	21
2007	22	9	13
2006	39	10	29
2005	44	14	30
2004	23	3	20
2003	21	10	11
2002	18	6	12
2001	30	17	13
2000	26	18	8

Source: The Ministry of Finance

The total rulings by the District Courts and the verdicts by the State Internal Revenue Board increase after the financial crisis 2008.

**Table 15. Verdicts of The State Internal Revenue Board 2000–2009**

	<b>Total</b>	<b>Evasion</b>	<b>Defaults</b>
<b>Total</b>	<b>578</b>	<b>207</b>	<b>371</b>
2009	76	42	34
2008	49	26	23
2007	52	19	33
2006	83	18	65
2005	58	21	37
2004	39	19	20
2003	43	10	33
2002	79	9	70
2001	74	34	40
2000	25	9	16

Source: The Ministry of Finance



**Table 16. Comparing tax controls and tax investigation per employee 2003–2009**

	Control		Investigation		Control/Investigation	
	Overall changes	Loss Carryforward	Overall changes	Loss Carryforward	Overall changes	Loss Carryforward
	125.653.719	252.009.818	11.756.919	9.067.907	1068,76	2779,14
2009	89.271.332	39.413.222	9.405.056	3.092.214	949,18	1274,60
2008	82.849.319	267.072.646	17.232.463	9.462.105	480,77	2822,55
2007	48.543.103	31.046.553	23.219.713	4.791.112	209,06	648,00
2006	74.322.103	15.670.339	15.901.167	75.234.864	467,40	20,83
2005	33.018.741	15.636.802	21.699.455	8.343.967	152,16	187,40
2004	19.562.344	1.888.315	71.180.181	6.236.449	27,48	30,28
2003	11.474.745	2.760.373	17.275.136	28.954.268	66,42	9,53

Source: The Ministry of Finance, Jóhannes Hraunfjörð Karlsson, 2010.

Notes:

Investigation = 100

Tax controls are obviously much more effective than tax investigation per employee.

This is especially true from 2009, when a special firm control unit was founded, in spite of the government's fierce opposition (Independence Party).

According to these and the following sections, (see also chapter 6 and appendixes A, B and C), our evaluation of tax evasion is as follows (table 17):

**Table 17. The Evaluation of Tax Evasion as the percentage of the tax revenue 1875–2008**

1875–1914	7–10
1914–1930	9–12
1930–1940	9–17
1940–1950	35–45
1950–1960	20–25
1960–1970	20–30
1970–1980	20–25
1980–2000	10–15
2000–2008	15–25

### 9.3 Evaders are not Penalized

According to Adam Smith's third maxim, the administrative costs of a taxation system should never be more than the tax that is collected. Administration costs are costs incurred directly by the tax authority in establishing and operating the taxation system. Compliance costs are borne by taxpayers and by third parties (employers who are required to remit tax on behalf of their employees and to provide information to the tax authority) in following the rules and procedures set out by the taxation authority and in

planning to reduce tax liabilities. It is often in an effort to reduce administrative and compliance costs that a taxation system imposes excess burdens due to real behavioral responses, avoidance and evasion. Governments that are inappropriately focused on the explicit costs of administration may be tempted to reduce these costs, even if other costs increase by more than the administrative cost savings.

Scholars of historical evolution of taxation structures have stressed the importance of administrative issues and the identification of ‘tax handles’, that is, tax bases for which administrative costs are low, compared to the revenue collected. They note that the modern tax structure development has generally been characterized by a shift from excise, customs, and property taxes to corporate income and progressive individual income taxes, made possible by the expansion of the market sector and the relative decline of the rural sector, the concentration of employment in larger establishments, and the growing literacy of the population (Slemrod & Yitzhaki, 2002).

However, there is more to be considered than the total administrative costs. Important features include the degree of self-assessment, the extent to which income withholding at sources is used, and the amount of arm’s-length information reported to the tax authority. Information is a central element in all tax administration, and the cost of gathering information depends on how accessible the information is. Hence, basing tax liability on market transactions raises several questions. Market transactions involve two parties, the seller and the buyer. The transaction information can potentially be obtained from either party, which provides a natural check on its accuracy, and the more the transaction is documented, the lower the costs of gathering information on it. The ability of the tax authority to access bank records, the number of tax treaties (OECD Model), the size of fines that can be levied, and the powers available to enforce compliance with audit findings, have similar effects.

For any given objective, there are more and less effective ways for a taxation administration to operate. For example, the following questions may be asked:

- I. What is the optimal use of computers and information technology?
- II. How is the taxation administration organized—by tax levy (e.g. corporate tax/VAT) or by taxpayer segment (e.g. corporation/high-income individuals)?

### III. How should the tax administration be organized to minimize evasion and/or corruption?

As we described in the last section, tax frauds in Iceland have been enormous over a long period, especially in the 1940s. Nonetheless, we had to wait until 1970 for the first tax fraud case to be decided in the Supreme Court of Iceland, (*Hrdr 115*, 1970), and since the year 2000 there have only been, on average, 1,1 rulings on tax fraud each year (see table 13). The main reason for this lies in the integration of the tax administration with the political sector:

- There was no clear separation or distinction made between executive and administration functions on the one hand, and general policy-making and legislation functions on the other. The Minister of Finance himself had the sole power to penalize tax fraud from 1877 to 1965 (see appendix C). Whenever the bureaucracy caught someone for fraud, the Minister would release him.
- The local representatives assessed the income tax on each household 'according to their means' until 1960, i.e. first, the total expenditures were determined and then the representatives added ten percent to that and assessed the total amount on each household 'according to their means'. In other words, the assessment was not based on a tax scale or explicit norms. Rather, the representatives had to know the conditions of each person in their district. The representatives were selected on a political basis, and the risk of abuse was therefore enormous. The system was widely criticized, but the Parliament did not agree on a new tax system for the municipalities until 1960.
- The governance of the municipal tax system was linked directly to the political system during the period 1872–1962—and even longer because current tax system for the municipalities was not legalized until 1972, Act No 8—except in Reykjavík, where the General Director of the Internal Revenue had taken charge of it since 1922. However, in 1942, there was a change. Stefán J. Björnsson, head of the Reykjavík tax directorate, took charge of that function. In practice, this meant there were two General Directors of the Internal Revenue in Reykjavík during that time, one for the Progressive Party, and the other for the Independence Party (Acts No 8 and 17 of 1942). Thus, both parties had access to all tax data and could compare those with contributions paid to the parties' funds, see chapter 5.3.

The second reason lies in the organization and the operation system of the government. The government provides direct services on a large scale, such as building and maintaining roads and schools and conducting social security programs; it operates governmental enterprises either directly or indirectly along with subsidy programs involving millions of kronur; and its regulation of the general economy of the country has a direct impact on every home in Iceland. To do all of these things efficiently

requires sound organization, competent personnel, workable procedures, farsighted and inspired planning, and effective direction.

There are three major factors every government needs to keep in order: the personnel administration, the financial administration and the organization of the government. According to the budget process, described in Appendix A, the government did not have procedures and controls to carry out a budgetary policy until 1966, and there was no law governing the executive branch of the government until 1969. Yet, much of the organizational confusion that existed in the government, much of the delay in adopting modern methods of budgeting and accounting, and much of the failure to perceive the need for long-term program planning, might be attributed, at least in part, to the fact that there was practically nobody available who had been trained specifically for government service. So let us look at the personnel administering the taxation system.

No competitive tests are used to ensure that a vacant position was being filled with the most competent person available. In the 1950s, there were approximately 800 persons working in the taxation system, i.e. 1/4 of the total government employees, see Appendix C, compared to approximately 400 in 2014. Their salaries were determined by a general law on salaries, and each position was assigned to one of sixteen salary ranges established by that law. Salaries increased automatically within the salary range, and it normally required four to six years to go from the minimum to the maximum salary within each range. No attendance or leave records were maintained, and salary payments were made monthly. No law or regulation was in force on recruitment or working conditions until the adoption of the Act of civil servants No 38 of 1954. However, during these years, the people who worked for the taxation system were generally better trained than those working at other government offices, although they were not trained specifically in public administration or government management. Nevertheless, the taxation administration was not organized by tax levy but by municipalities and counties. In other words, in every one of the 200 municipalities and in every one of the 24 counties in the country, the staff had to do the same work. Because of that, it was almost impossible to know whether and where each person had

to pay taxes until the National Register was established in 1952, and in 1965, the taxes to the central government were assessed via the computer system.

With the changes of the tax administration in 1962 and the introduction of the Tax Penalty Committee in 1965, it was hoped that these times would be over. However, the changes of the tax administration in 1962 were based on a 30-year old idea, as the General Director of the Internal Revenue Directorate was in charge of tax assessments and also of verdicts in case of complaints from taxpayers, as he was also the chairman of the State Internal Revenue Board until 1972, and thereby, taxpayer rights were obviously limited. But in a democracy, the trust between the authority and the citizen are the most important factors. In 1992, everything went back to the cold-war spirit of the 1950s, when the State Internal Revenue Board rendered two fateful verdicts. One concerned the power block, i.e. the coalition of the Independence and Progressive parties, and how to divide up the war profits (Jóhannes Hraunfjörð Karlsson, 2010), and the other verdict concerned the taxation of the fishery quota benefits (Ásmundur G. Vilhjálmsson, 2000). Following these verdicts, the State Internal Revenue Board (ríkis-skattane-fnd) was immediately shut down and dismantled, whereupon a new institution, bearing a slightly different name (yfírs-kattane-fnd) was founded and staffed with fresh personnel.

We must also consider here the influence of the SIGs influence on the regulators. There are many illegal ways to capture regulators, bribes, threats, etc. However, these are easy to fight. But there are often legal means, which are more difficult to deal with: career concerns, control of information and environmental pressure (Zingales, 2013). Hence, the SIGs cannot only affect the regulators' careers inside and outside the regulatory world, but also the careers of politicians if they do not play along.

In 1964, Gunnar Thoroddsen, the Finance Minister, introduced a new Tax Investigation Office and appointed Guðmundur Skaptason, a hard-working lawyer from Akureyri, as the director. In parallel with that decision, Gunnar decided to establish a Tax Penalty Committee and proposed a bill to the Parliament in 1965. However, Gunnar's decision to create a Tax Investigation Office, or a Tax Police, as it was usually named, caused a great controversy within the Independence Party. Gunnar, who had been one of the main leaders of the Party—an MP since 1934, the Mayor of Reykjavík

1947–1959, vice president of the Party 1961–1965 and Finance Minister since 1959—was sent to Denmark as an Ambassador in the middle of the electoral term to calm the Party down. The Independence Party appointed Magnús Jónsson as a Finance Minister (Frjáls þjóð, 1965). Magnús was an MP for the Party, and the General Director of one of the State Banks, Búnaðarbanki. He had also been the director of the Independence Party 1953–1960 and had therefore an insider’s knowledge of the ‘Dark-Money-Moving-Machine’ (see chapter 5.3). Magnús was appointed as a Finance Minister on the 8<sup>th</sup> of May 1965. In the midst of the second debate of the bill about the Tax Penalty Committee, May 11<sup>th</sup>, the last working day of the Parliament before summer vacation, he changed the bill and decided to grant a total indulgence to all tax fraudsters, both those who had committed a fraud on the income tax and those who had committed a fraud on the sales tax. Needless to say, all merchants collecting sales taxes in Reykjavík were unflinchingly supporting the Independence Party. Magnús not only granted them indulgence, but further, these tax fraudsters did not have to pay any taxes at all on the extra money they had obtained illegally by these means. Many MPs considered this an affront to the taxpayers’ sense of justice (1964-B Alþingistíðindi, pp. 1901-1940). However, this indulgence was accepted as Act No 70 of 1965. This attitude to taxpayers’ money was in line with the attitude of the Independence Party in the property investigation 1948 and *Morgunblaðið*, the newspaper that supported the Independence Party, was pleased (*Morgunblaðið*, 1966).

The reorganization of the tax administration was not consistent with the adoption of the sales tax in 1960. The collection of the sales tax was in the hands of merchants who did not fill in the forms nor make the reports demanded by the law. The local tax officer in Reykjavík had no means to control the tax collection—there were no cash registers at that time. However, Guðmundur Skaptason, as the director of the Tax Investigation Office, started to compare reports from the wholesalers with the figures from traders and was very successful in his work (see table 9 and figure 20, year 1965–1967), but the Minister of Finance thought that he was ‘too good’ at his job (Frjáls þjóð, 1967), and according to Guðmundur, he and his family were also threatened by some of the ‘big fish’, so he decided to quit the job after only two years. However, he had initiated some cases, which the judicial system delayed as much as possible. We had therefore, as we

mentioned before, to wait until 1970 before the first tax fraud case was decided in the Supreme Court of Iceland (*Hrdr 115*, 1970).

It is evident that the system itself slowed down the procedure in every possible way. The tax investigation started in 1965 and ended in 1967, when the Public Prosecutor issued an indictment for income tax fraud, sales tax fraud and falsified bookkeeping. Still, in 1968, the accused asked the Supreme Court for re-examination because the judge had not had special experts to examine the case with him. The case was sent back to the District Courts, and they appointed two accountants as judges. Yet one of them had so much to do in his work that he had no time to deal with the case, so the case had to wait for a while. The other judge began to review the whole case. Finally, in 1970, the District Court in Reykjavík found the accused guilty of income tax fraud, sales tax fraud and falsified bookkeeping, and the Supreme Court confirmed the verdict a few months later. The fine amounted to ISK 1,200,000 (but was ISK 650,000 in the District Courts) and the accused lost his trade license.

Those who are regulated do not operate in a vacuum, and regulators need a lot of industry-specific information so they can do their job properly. Therefore, the regulator tries to establish a cooperative relationship with the regulated. This also applies to the SIGs who infiltrate the administration system with ‘their’ men (Gunnar Helgi Kristinsson, 2006a). The Independence Party has almost single-handedly directed the Ministry of Finance since 1959 (see figure 4 and chapter 5). However, as discussed above, the Party has in practice always been against tax investigation, tax monitoring and penalties for tax fraudsters. In 1992, all tax investigations were taken from the Internal Revenue Directorate and became the main task of a brand new institution, the Directorate of Tax Investigations. Its General Director, Skúli Eggert Thórðarson, a member of the Independence Party, who remained in office until 2007; the results from tax investigations during that period lived up to the Party’s expectations (see tables 12, 16 and 17). Nevertheless, it was the Directorate of Tax Investigations that initiated the Baugur case in 2003. The case started a few years earlier with the so-called Jón Ólafsson case, centering upon a media magnate, and that case became the case of Baugur, at least in the press, when Jón Ásgeir Jóhannesson, CEO of Baugur Group, bought Norðurljós, the biggest media company in Iceland, in 2003. Both of these cases were

originated by the tax administration, and both are related to grants paid to the Social Democratic Alliance (see chapter 5.3), such grants being frowned upon by the Independence Party (Einar Kárasón, 2005, pp. 473-485). The Directorate of Tax Investigations had found 273 million krónur on which no taxes had been paid. Based on that investigation, the case was sent to the Internal Revenue Directorate for further assessment. Most of that money had gone to three persons: Hreggviður Jónsson, Óskar Magnússon and Jón Ásgeir Jóhannesson, and according to previous judgments, each of them could get a suspended sentence for at least one year and ISK 150 million in penalty or fines, which meant that none of them could become member of a company's board. Each of these gentlemen was granted a different procedure—one was fined by the General Director himself, another was referred to Internal Revenue Directorate, and the third had to be judged by a court of law. The Supreme Court of Iceland provided the Public Prosecutor with a search warrant to get documents from the Directorate of Tax Investigations in order to investigate the reasons for this disparity of treatment. (*Hrdr.* 21, 2008; Jóhann Hauksson, 2011).

The willingness of politicians to provide or allow control will depend on the costs and benefits of doing so. All use of controllers involves the problem of who should control the controllers in order to prevent and detect corruption. According to the model of Karl Ove Moene and Jens Andvig, quoted in (Matthíasson, 1999), it is assumed that expected punishment for corruption when detected declines with an increase in the number of corrupt officials. This model generates two stable Nash equilibria of the level of corruption: one where the level of corruption is high and another where the level of corruption is low. A temporary change in conditions can induce a permanent change in corruption level. Applying this to the authorities of the Icelandic tax system; the level of corruption in Iceland is high. The division of power between authorities is one of the means intended to prevent infiltration and corruption. The repartition of the authority between offices in the tax system is as follows: the Internal Revenue Directorate imposes taxes, the Directorate of Tax Investigations investigates tax frauds, and the State Internal Revenue Board determines tax fines in those cases where fines have been imposed by the Directorate of Tax Investigations. In other words, when the Directorate of Tax Investigations finds frauds, it always sends the Internal Revenue Directorate the case for review, but it depends upon the details of the cases which way they go from



there: the lesser ones go to the State Internal Revenue Board, while the substantial ones are referred to the State Public Prosecutor, see Appendix C.

However, even after the financial crisis of 2008 this does not seem to work in practice. By the end of 2008, the Directorate of Tax Investigations started an investigation of Stoðir h.f. (previously known as FL Group or Icelandair) that ended in 2010. One of the main factors in the investigation was deferred taxes for 2006 amounting to ISK 50 billions of trading in equities, which was unauthorized according to the investigation and the general verdict (bindandi álit) of the Internal Revenue Directorate from 2000. Thus the company should have paid ISK 13 billion (1 percent of the GDP of Iceland) in taxes in 2007, but did not. In 2011, the Directorate of Tax Investigations sent the case to the Internal Revenue Directorate for reassessment. The General Director of the Internal Revenue Directorate, Skúli Eggert Thórðarson, did not follow the lawful procedure and usurped the authority of another institution in order to render unlawful and unsubstantiated verdicts, as he did not provide the reassessment that was required of him by law. The person who had investigated the case for the Directorate of Tax Investigations drew attention to this by a letter to the Minister of Finance, yet nothing happened, except that the investigator lost his job. This dismissal was judged illegal, and the State had to pay him damages, in accordance with the ruling rendered by the District Court of Reykjavík (Héraðsdómur Reykjavíkur í máli nr. E-1783/2013, 2013; Jón Steinar Gunnlaugsson, 2013)

#### **9.4 Shape the Tax System to fit your Interests**

Historically, the formation of accountable and effective states has been closely linked to the emergence of taxation systems. In Western Europe, and later in North America, bargaining between rulers and taxpayers helped to provide governments with an incentive to promote broad economic prosperity and improve public policies in ways that meet citizens' demands. The concept of a "fiscal social contract" is central to explanations on how a representative government and democracy emerged in Western Europe and the United States (Moore, 2007).

A Special Interest Group, SIG, is a policy maximizer existing to transmit the policy preferences of its constituents to our elected officials. These groups are interested in passing legislation favorable to their preferred policy outcomes, and often, these groups

use lobbying to twist society away from fairness, in order to serve their own interests. The main reason is scarcity of wealth, which can corrupt incentives and prevent reduction in government spending. Increased regulations can also produce scarcity. The incentives for policy-makers and SIGs are to increase of their income and power by increasing spending, controlling resources, and manipulating specific institutional details of budget, taxation and legislative processes.

As we described above (chapters 5.3, 7 and 8), the main economic pillars in Iceland used to be fishing and agriculture. Other economic pillars were industry and banking. There were double taxation agreements for the Aluminum sector in Straumsvík (1966) and the Silicon Plant at Mývatn (1964), and the banks were state-owned and free of taxes until their privatization in 2003. The main SIGs in Iceland are the Federation of Icelandic Fishing Vessel Owners (LÍÚ), and the co-operative movement (agrarian interests group - Samband íslenskra samvinnufélaga, SÍS). LÍÚ has always been the main supporter of the Independence Party, while SÍS was from the onset the main supporter of the Progressive Party. Through the privatization of the banks in 2003, these two groups, and thereby the two parties, split the banking system between them. Agriculture was untaxed as before (see chapter 5.3, 7 and Appendix B), while the fishing industry was granted very special treatment, reflected in the tax legislation by the tax on corporations and the tax on cooperatives, and by special acts that worked in the SIGs' favor.

No Special Interest Groups in Iceland have had as much influence on the tax legislation as these two groups: LÍÚ and SÍS. Of course, there are many exceptions in the tax law. Eimskipafélag Íslands, the leading merchant vessel company in Iceland, was tax-free from 1924, Act No 43, to 1955, Act No 48, but it is related to LÍÚ. Mjólkursamsala Reykjavíkur, the biggest dairy producer in Iceland, and the Icelandic Seafood (SÍF) were both tax-free for decades, per Act No 96 of 1936, and as we described in chapter 7, all agricultural production, and agricultural imports and exports in Iceland, have been thoroughly regulated since the late 1920s. As for the fisheries, they are the main natural resource in Iceland, and according to the OECD, tax crimes in the fishing sector have a great impact on the ability of the country to raise government revenue to fund public expenditure and development (OECD, 2013). The case of LÍÚ as a special interest group

is remarkable. Therefore, our focus will be on the influence of LÍÚ on the tax legislation 1938–1958, when the taxation became more general (Act No 36 of 1958). During that time, the tax legislation was changed many times. The situation can be summed up as follows:

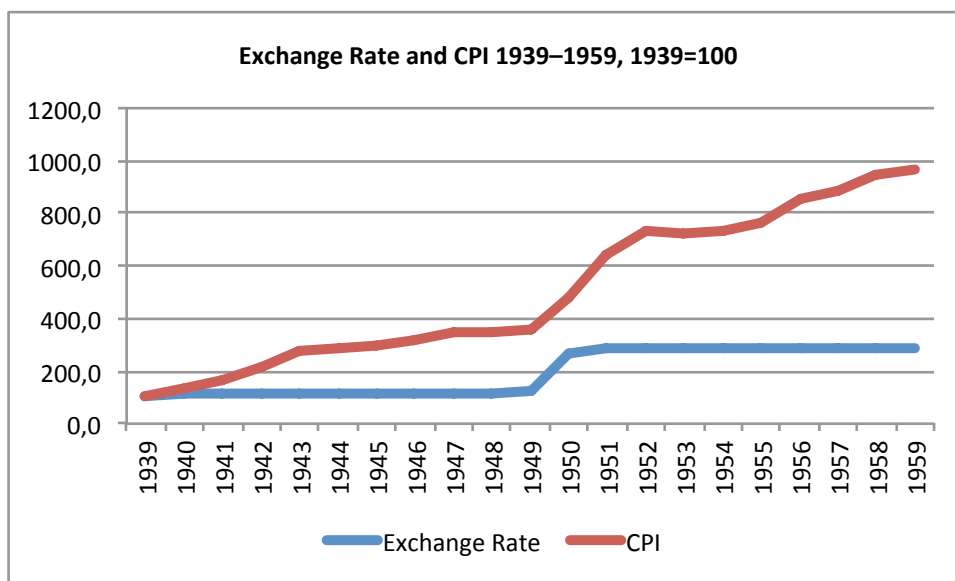
- In 1938–1940, all operational losses of the fleet, from January 1, 1931, to December 31, 1939, could be deducted from 1940 taxable income, but as we mentioned above, these losses occurred because the owners had taken money out of the businesses and used it for personal purposes.
- In 1939 and 1940, companies in LÍÚ were allowed to put 90 percent of their profits into a booked reserve to update the fishing fleet, which they used to buy all kinds of assets at the highest price, as they were investing the war profits (Acts No: 93 of 1938; 39 of 1939; 49 of 1940). This 90 percent allowance was reduced to 50 percent and then to 35 percent. Additionally, these business got loans and various privileges from the state (Acts No: 22 and 109 of 1938, 120 of 1950, 74, 76, 95 and 96 of 1951, 21 of 1952, 80 and 114 of 1954)
- In 1941 (Acts No 9 and 98), companies in LÍÚ were allowed to put 50 percent of their profits into a booked reserve to update their fleets. They were also allowed to subtract from taxable income 5 percent of the paid-in capital, i.e. if the corporation had 20 thousand kr. in profit before tax, which it put into a booked reserve, then it should have to pay a tax amounting to 10 thousand kr., but because of this 5 percent rule, (if the paid-in capital was 100,000 kr.) they could also subtract 5 thousand kr. from Pay-Before-Taxes, PBT, which meant they only had to pay tax on 5 thousand kr., or 285.60 kr., to the State. At the time, an unmarried individual with a 20 thousand kr. annual income, or 19,200 kr. in taxable income, paid 5,407.36 kr. in taxes to the State, or 19-fold the amount paid by the LÍÚ corporations. In addition, he paid 3,800 kr. of his salary to the City, but the corporations paid nothing to the City. Those companies that did not belong to LÍÚ were only allowed to put 40 percent of their profit into a book reserve and, of course, the 5 percent rule did not apply to them.
- At the same time (Act No 10 of 1941), the companies in LÍÚ were supposed to pay a special windfall tax on the war profits (stríðsgróðaskattur), 90 percent of

PBT 200,000 kr. and over, which was divided among the provinces that did not get any windfall profits at all. 45 percent of the tax went to the municipalities and 50 percent to the State. Because of the deduction rules, the collected tax was never significant, and the revenue of some municipalities, especially Reykjavík, was actually reduced because of this.

These Tax Acts were complicated; in addition, the tax rates were indexed because of the galloping inflation, and these corporations could also reduce all operating loss from the taxable income. There was no interest in compliance with these legislative Acts, nor for the authorities to enforce them, and therefore tax evasion increased immensely during the following years (see the section above). Since other companies could not compete with the corporations in LÍÚ, and there was no way to monitor such funds, the LÍÚ corporations could invest the war profits to buy all kinds of assets at the highest price in order to increase their economic influence further. Thus, the dominance of these firms became even greater because of this tax legislation.

Short-term solutions often cause long-term problems, and by 1949, this tax policy had drawn the state into a dilemma causing the Government to ask the IMF to step in. The main advice of the IMF was that the tax legislation and those, who had profited from the war (the inflation etc.), should pay a special windfall tax, 10 to 12 percent of all properties that were of more value than a normal price for residential assets. Those who would have paid were, of course, the corporations in LÍÚ, mostly from their other investments. Therefore, the Government of the Progressive Party and the Independence Party would not accept this advice, and the Potemkin taxation system continued unchecked until 1958. A special windfall tax was imposed, but it was 20 percent and had to be paid by almost everybody except the fishing industry (Benjamín H. J. Eiríksson, 1949; 1990, pp. 573-625). This game was repeated in 1957 to finance the General Mortgage System of Dwellings.

However, as we described in chapter 8.2 the taxes on the fisheries are mainly based upon inflation and distorted exchange rates (see figure 22). Inflation tripled from 1939 to 1945, but increased tenfold from 1939 to 1959. At the same time, the exchange rate only tripled. In other words, the costs of the fisheries became tenfold while the revenue tripled (at least half of the total costs were indexed).



**Figure 22. Exchange Rate and CPI 1939–1959, 1939=100**

One of the pieces of advice given with the Marshall Plan in 1950 was to get an outside expert to study the fiscal system of Iceland. The Icelandic fiscal system was unusual compared to other countries (see chapter 6), inasmuch as the national system of taxation was highly regressive, while the municipalities had a more progressive system of direct taxation. In 1950, sales taxes and customs duties were around 56 percent of the national government's revenue, the wine and tobacco monopolies accounted for a further 23 percent, while direct income taxes were only around 13 percent (Clark, 1951). Nothing was done, and various industrial players, wholesalers, shop owners, the Union of the Icelandic Employers (VSÍ) and the Chamber of Commerce of Iceland, not trusting the Government (the alliance of the Progressive Party and the Independence Party) to change the taxation system, sought independent analysts to undertake research on corporate taxation in 1956. In 1958, dr. Nils Wästhagen, a Swedish specialist from the Organization for European Economic Cooperation, OEEC, suggested changes to the taxation system, and most of them were adopted (OEEC, 1958). According to Wästhagen, the tax system was a mess. Its administration was very complicated, and the national system of taxation was highly regressive. The taxes from the companies in LÍÚ were between 2 or 3 percent of the State income, and this has not changed much over the years. Neither the State nor the companies had any records of the annual reports of the companies, and the accounting system was a fiasco, so, for

example, in 1957 the trawler companies supposedly paid 140 percent of their profits in total taxation and the fish plants supposedly paid 335 percent of their income in total taxation (see table 18).

The tax legislation for companies was not aligned to that of other countries until Iceland joined EFTA in 1970, with the Act No 68 of 1971, and the tax legislation for individuals was only harmonized with international practices with Act No 40 of 1978; but the legislation for companies was incomplete until 1995, with Acts No 138 (respecting Private Limited Companies) and 145 of 1994 (Accounting—the first Acts about double-entry accounting were No 62 of 1938 and then No 51 of 1968) and No 2 of 1995 (respecting Limited Companies).

**Table 18. Taxes and Revenues of Companies in Reykjavík 1957 in ISK 000**

	No	Earning Before Taxes	Income Taxes Gov.	Municipal		Total taxes	
				Income Taxes	Turnover tax	ISK	%
<b>Total</b>	<b>382</b>	<b>39.506</b>	<b>15.382</b>	<b>23.221</b>	<b>16.240</b>	<b>38.603</b>	<b>98%</b>
Cars' and accessories' salespoints	21	1.750	640	1.031	777	1.671	95%
Newspaper and book publishing	17	810	238	229	160	467	58%
Breweries	3	1.244	642	568	444	1.210	97%
Construction companies	27	8.300	3.996	1.507	882	5.503	66%
Construction products stores	15	2.354	898	1.242	898	2.140	91%
Textile shops	36	2.054	571	1.374	1.000	1.945	95%
Fish plants	11	892	281	1.311	854	1.592	178%
Airlines	4	162	36	587	549	623	385%
Wholesales companies	137	14.100	5.502	6.333	4.439	11.835	84%
Engine workshops	25	2.273	883	1.207	917	2.090	92%
Hardware stores	5	709	187	266	132	453	64%
Food trades	22	424	65	233	165	298	70%
Oil companies	6	1.143	674	3.817	3.437	4.491	393%
Printing companies	18	958	155	471	329	626	65%
Ship companies	4	91	61	1.546	192	1.607	1766%
Small fishing vessel companies	9	193	16	104	74	120	62%
Trawlers' companies	6	414	46	534	382	580	140%
Sugar confectionery	16	1.635	491	861	609	1.352	83%

Source: OEEC 1958

Taxation and monetary policy has had enormous effects on society. The monetary policy in Iceland has for years been caught in a squeeze between a low supply of transferable savings, on the one hand, and a high demand for credit on behalf of business enterprises and the Government on the other. During the years of rapidly increasing prosperity and relative economic stability of 1953–1954 (the Marshall plan), savings deposits in the banks increased greatly. In a country where a bond market had

never developed, savings deposits represented the principal source of transferable savings. This increase in savings deposits proved to be of a temporary nature only. From 1955 onwards, an increasing proportion of individual savings was diverted directly to residential construction (from 1954 to 1959, the investment in dwellings of the total asset formation was 35 percent each year, or around three times more than in the fisheries) as a building frenzy caught on in the 1960s. As a result, savings deposits declined proportionally, although they remained considerably higher than during the years prior to 1953. Behind this development of transferable savings was the lack of trust in the value of the currency, characteristic of a country that has experienced prolonged inflation. At the same time as the increase in savings deposits was slowing, the banks were faced with greater demands for credit than ever before and had to meet commitments made during previous years. The banks have been enabled to meet these requirements through automatic rediscounts in the Central Bank of bills secured by export goods, and so on, as explained in chapter 8.

## **9.5 Summary**

In this chapter, we evaluated tax evasion as a proportion of the total tax revenue in Iceland from the end of the 19<sup>th</sup> century to 2008. We then described the influence of SIG infiltration on the structure of the taxation administration in Iceland; and finally we described the influence of SIGs on the taxation system.

## **10 Summary of findings**

### **10.1 Introduction**

This chapter briefly summarizes, in three sections, our general findings on the processes shaping taxation in Iceland. In the first section, we summarize the main aspects of a taxation system; the second section identifies the main factors affecting a taxation system and the tax policy of the government, and the last section briefly describes the general aspects of the Icelandic taxation system.

### **10.2 What is a Taxation System?**

A taxation system is a reflection of a nation's values. In a democratic country, taxation and taxation policy are an equilibrium resulting from a collective choice process, and therefore, by examining it, we may discover the values of the nation. In countries where the public does not have a significant amount of influence over the taxation system, that system may rather reflect the values of those in power.

A taxation system is a set of rules, regulations and procedures, where the main actors, in a democratic society, are: the voters (taxpayers); the legislature and its oversight system system, elected by the taxpayers; the executive authorities, typically a Minister of Finance as the head of the taxation administration, producers or employers who withhold taxes, and special interest groups, SIGs, see figure 23.

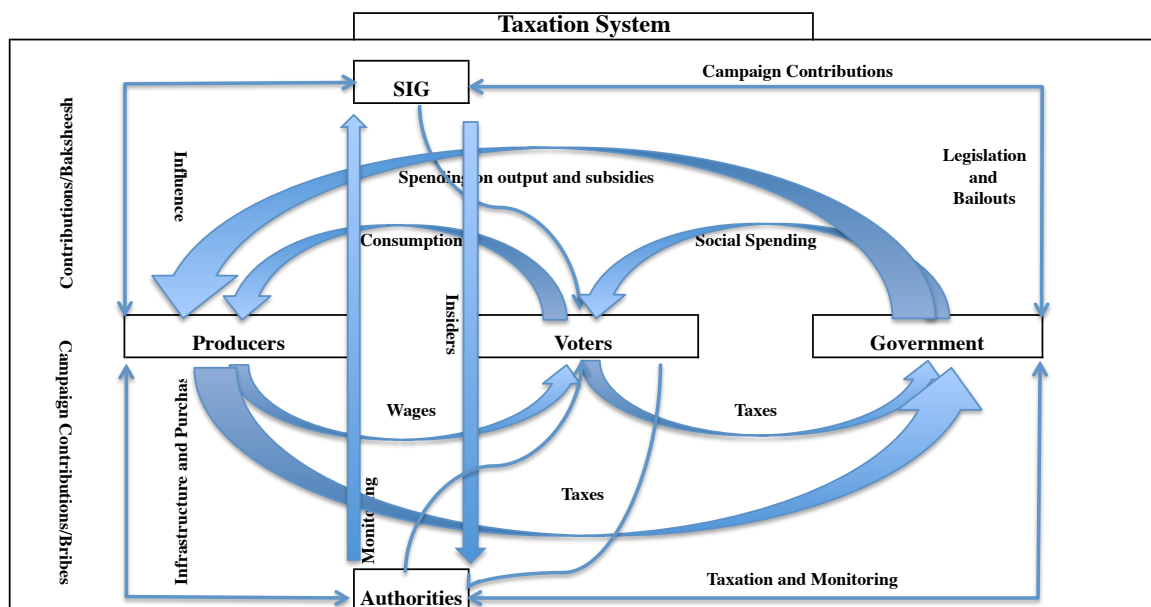
The most important law for every government is the Budgeting Bill, how it is debated, and how the system of oversight can follow it through. We also have the Income Tax Law that defines which events trigger tax liability (tax base and tax rates), specifies who must remit taxes and when (remittance rules), and details procedures for ensuring compliance, including information-reporting requirements and the consequences, (including penalties) of not remitting taxes in a timely fashion (enforcement rules).

### **10.3 Factors Affecting the System of Taxation**

The justification for taxes lies in a government's need for resources to carry out its essential functions. It is the role of political institutions to shape taxation policy, as well



as the relationships between those institutions and the political norms and rules that govern their functions. Important to these institutions are such elements as the right to vote, the existence and roles of political parties, the existence and roles of trade unions, the status of employers, the responsibilities of governments, transparency, and accountability. In principle, the main point of taxation policies is to enrich both the people and the sovereign. Decision-making processes depend upon both political and economic structures, where the political institutions of the society are the key determinants in the way in which the game is played. The political institutions are also the rules that govern incentives in politics and determine who has the power in society and to what ends that power can be used.



**Figure 23. Taxation System**

There are always some individuals who will not remit their taxes dutifully and who resort to tax avoidance, tax evasion and income shifting. Controlling such actions is costly, and tax authorities have limited administrative resources. In corrupt countries, the politicians use the legislative process, the bureaucracy system and economy institutions to increase their income and power and SIGs use both legal and illegal tools to achieve their ends, see figure 23:

- The SIGs pays campaign contribution and gets, in return, favorable legislation and bailouts.
- Producers pay contribution or baksheesh to the SIGs to influence them.
- Producers bribe the authorities in order to get contracts for projects.
- Producers get favorable tax treatment and subsidies from the Government.

Those who have earned the favors of the elites (producers and voters) get a special tax treatment from the authorities.

#### **10.4 The Icelandic taxation system**

Among the weakest points of the Icelandic taxation system, we may mention the lack of the following:

- rules and processes;
- a responsible Government;
- transparency;
- accountability.

The result is a highly regressive taxation system, with the burden of the income tax heavier on those with lower wages than on those with higher wages, and higher marginal tax rates for those with less income. Replacement incomes and transfer payments between income groups are also very low in Iceland, compared to other countries.

The main reason is, of course, that the political system, the special interest groups and the administrative system in Iceland have, in fact, been parts of one and the same system. Hence, the structure of the Independence Party looks much more like that of a powerful interest group than of a political party. Since the founding of the Independence Party in 1929, it has been in charge of the tax system most of the time.

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## Appendix A: The Budgeting system in Iceland 1874–2014

### The Formal Budgeting Process in Iceland

The budget process in Iceland consists of four stages that involve several activities, negotiations and actors. The first stage is the formulation of the Government's budget proposal, the second is the Parliament's discussion of the proposal and approval of the budget law, the third its implementation and the fourth its execution and auditing. In this section, we present a brief description of these stages, focusing on the formal aspects of the process. The dimensions to be considered are the different components, the actors and the negotiations involved and the important dates of the process. In figure 24 we show a simple outline of the different stages mentioned above.

#### Simplified presentation of the Budgeting Process in Iceland



Figure 24. A simple presentation of the Budgeting Process in Iceland

The main actors contemplated by the rules that guide the formal budget process are the Executive branch, especially the Prime Minister and the Minister of Finance, and the Parliament, Althingi. Let us now analyze their role in the different stages of the process.

In a nutshell, the Executive, at the formulation stage, determines the aggregate budgetary policy and distributes the expenditure ceilings among the agencies. In October, it submits the budget proposal to Althingi. The ministries allocate the resources they receive among programs and formulate the preliminary budget proposals. At the approval stage, the Minister of Finance submits the budget proposal, replies to enquiries (oral and written) formulated both by the Appropriations Committee and the MPs in the Parliament, where the budget is given three readings and enacted before the end of the year on the basis of simple majority vote. Between the readings, the Appropriations Committee examines expenditures. At the implementation stage, the Executive distributes the expenditure authorizations among agencies, and introduces modifications to the project. It cannot introduce modifications that alter the total expenditure and the debt level. The ministries and agencies' heads distribute the quotas among the programs and they are responsible for keeping records of the physical execution. The Chairman of the Appropriations Committee is responsible for providing Althingi with information regarding the budget execution. At the control stage, the Icelandic National Audit Office coordinates the internal auditing activities and procedures.

The Government plays a key role in the frame budgeting at all stages. It makes all the major decisions relating to the budgeting process and the budget, i.e. regarding timetables, revenue and expenditures policies, expenditures frames and the final detailed elaborated version of the budget. Its principal role is to address the order of priority of the categories of the Governmental activities and to establish the expenditures frames that other administrative levels must adhere to in their work.

At the formulation stage, the Ministerial Committee on Public Finances is in charge. It consists of four ministers, the prime minister, the minister of finance and two other ministers. Usually, the committee includes the Chairman and the Vice-Chairman of each of the coalition parties. The committee can be viewed as a type of executive committee for the Government in this area, as it addresses, for the most part, the same aspects of

the public finances and from a similar viewpoint but does so in a more detailed fashion. The Committee, furthermore, decides which proposals will be submitted to the Government for discussion.

At the formulation stage, the Ministry of Finance sets the budget priorities and defines the investment programs, prepares macroeconomic forecasts, and provides support in the definition of expenditure ceiling setting. The role of the Ministry of Finance consists primarily in presenting the prospects for the public finances at each juncture, preparing the decisions of the Ministerial Committee and the Government, and leading the work from one stage to another in accordance with the established timetable. At the same time, the Ministry of Finance is responsible for co-operation with the other ministries and the Althingi and co-ordinates dissemination of information between all parties.

The Ministry of Finance is responsible for financial management and all control systems. The main role of the Ministry is to monitor various tasks pertaining to the implementation of the budget and other selected tasks in government financial management. The Ministry monitors the execution of the budget by individual ministries and a monthly report on fiscal finances is prepared. The development of expenditure is reported on a quarterly basis to the Cabinet and the Budget Committee of Althingi. The report also covers changes in the government's accounting system and other issues pertaining to the development of projections and accounting by government agencies. Individual ministries are responsible for the execution of the budget within their field and managers of individual agencies are fully responsible for the agencies' finances. Agencies are responsible for their own affairs, and answer to the line ministries. The line ministries then answer to the Ministry of Finance. These tasks are the responsibility of the Budget Department of the Ministry of Finance, while the Ministry's Economic Department is responsible for the evaluation of economic premises and projections for the revenue side of the budget.

At the implementation stage, Althingi is the only institution that can modify total expenditure, the debt level and the purpose and objective of expenditures. The Treasury's position shall be stated monthly and at least once within the accounting year the Ministry of Finance shall disclose special commitments and claims incurred by the

Treasury that have not fallen due for payment. The Minister of Finance shall at least once during the accounting year report on the prospects for Government finances and credit finances and the main deviations from the fiscal budget as regards entities under Group A.

### **The Legal Framework for the Budgeting since 1874**

The legal framework for budgeting process is primarily in the constitution. Hence, the provisions contained in the constitution with respect to the preparation of the budget are short. The Icelandic constitution has not changed much since 1874. In the current version of the constitution, Article 41 states: “No disbursement may be made unless authorized in the budget or the supplementary budget.” Article 42 states: “A budget proposal for the coming fiscal year, containing a report on the revenue and expenditure of the State, shall be submitted to each regular session of Althingi upon it being convened.” And Article 44 states: “No bill may be passed until it has received three readings in Althingi.”

These provisions mean that the Parliament holds the taxing power. Therefore, all expenditure authorizations for operations of the Government should be included in a specific fiscal budget and supplementary budget. Formerly it was the duty of the King to present the budget to every regular session of the Althing.

The auditing is stated in the Article 43 of the constitution: “The financial accounts of the State, its institutions and administrative bodies, shall be subject to an audit by, or under the supervision of Althingi, as provided by law.” Until 1995 it was stated in the constitution that the parliament should choose three MPs to audit (Act No 100 of 1995). The Acts ruling auditing are No 61 of 1931, 52 of 1966, 12 of 1986 and 86 and 88 of 1997 and before that, there were three Regulations: No 6 of 1915, No 4 of 1919 and No 82 of 1929.

The Constitution also states that ministers are responsible for all executive acts:

- 1874–1903, it was the Governor who had the executive power
- 1904–1917, there was only one Minister
- 1917, there were three ministries: The Ministry of Justice, the Ministry of Industry, and the Ministry of Finance.

The revenue side was the responsibility of the Finance Ministry, although the Finance Minister did not have the responsibility of the administration of taxation alone until 1922 (cabinet collective responsibility), while the Government, as a whole was responsible for taxation. At the same time, there was a new order for the Government office. The King changed the name of the Government office, from Government Departments to Government Ministry; the Finance Department was changed to Finance Ministry and so on, which was legalized by a directive of the 5 of January 1922, and the financial period was shortened from two years to one (Agnar Kl. Jónsson, 2004). As regards the accountability of Ministers, Act No 4 of 1963 applies, as do provisions contained in Acts No 73 of 1969 and No 115 of 2011 on the Government Offices of Iceland. The first specific Act on financial reporting and control was adopted after the financial crisis of 1920 when the double entry bookkeeping system was legalized with the Act No 61 of 1931—Act No 29 of 1905 of Housing Fund and Act No 78 of 1947 of Limitation Fund. These Acts were renewed by Act No 52 of 1966 and by Act No 103 of 1974 on Borrowing by the Treasury and Government Enterprises, and finally the actual Act on Financial Reporting is No 88 of 1997 and the regulation No 1061 of 2004.

Act No 52 of 1966 was first implemented with the 1968 budget, relating primarily to budget coverage and the classification of budget items, and represented 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. Because of a new computer processing system, a uniform classification of revenue and expenditure by type, and of expenditure by function and economic category, was introduced at the same time. The budget was divided into two groups, A and B, where the former covers all current and capital expenditure of the central Government, while the second includes all non-financial public enterprises.

The Government Financial Reporting Act No 88 of 1997 focuses principally on the accounting standards, structure and presentation of both the Treasury accounting statement and the budget, but contains few provisions that provide direct instructions on the preparation of the budget. Article 21 of the Act simply states: The budget proposals of entities in Groups A, B and C shall be turned in with each ministry



concerned. Entities in Groups D and E are not included in the budget; the Government's holdings of assets in these entities are reported in the accounts. Each ministry shall turn in its budget proposals to the Ministry of Finance according to rules set by the Icelandic National Audit Office.

The audit used to be performed by the Minister of Finance, but from 1986, with Act no 12, the Icelandic National Audit Office is responsible for the audit. The State Accounting Office —Fjársýslan—was changed on the same occasion as the structure of the Ministry of Finance in 1988.

### **The Budgetary System since 1874**

This section analyses the budgeting process in Iceland since 1874 according to the decision-making process and the check and balance mechanism. We start our discussion by the formulation procedure, then the approval procedure, and the execution, and finally the auditing system.

#### **Formulation**

The budget proposal is prepared in the Ministry of Finance under the surveillance of the Finance Minister. During the Governors period (1874–1903), the budget proposal was done by the Governor himself then by the National Secretary (landritari), and from 1917 it was the responsibility of the Permanent Secretary (ráðuneytisstjóri); with Act No 52 of 1966, the preparation of the budget proposal was the responsibility of the director of the Bureau of the budget (hagsýslurstjóri), who had the same status as the Permanent Secretary. Since 1988, the budget proposal has been the responsibility of the Budget Department of the Ministry of Finance, while the Ministry's Economic Department is responsible for the evaluation of economic premises and projections for the revenue side of the budget.

Until 1966 the preparation of the budget was almost unchanged. The annual budget preparation started in March or early in April when the Ministry sent out an estimate circular to other ministries invited them to submit draft estimates on their financial requirements during the next fiscal year with guidelines and a cover letter, encouraging the ministries to exercise constraint in their proposals. When submitted to the Ministry, they were examined thoroughly and then presented to the finance minister. By that

time revenue forecasts were ready, as well as a forecast of the Government's borrowing requirement and lending operation in the upcoming fiscal year. After the budget had been discussed in detail, the finance minister presented a draft budget to the cabinet, and then the Ministry had to take another round.

Following the Economic Program of the 1960s, the conditions for budgeting were improved by the establishment of the Bureau of the budget in 1966, and estimations became more realistic with a changed budget strategy. The Bureau started to budget by volume, i.e. by indexing against inflation as was done by the tax rates from 1964. The budget estimate was formerly based on wage and price levels some nine months prior to the beginning of the fiscal year. However, to avoid undue discrepancies between the budget and the actual outcome, the wage and price assumption were gradually moved to levels as close to the fiscal year, but not beyond that. Moreover, extra discipline could be imposed on spending agencies by keeping non-indexed disbursements below the rate of inflation (G. Blöndal, 1983). This causes budgeters to lose control of money because they have to supply whatever is needed. Inflation causes a loss of price awareness, the budgeters are no exception, and because the public sector is protected against inflation it is the private sector who pays the price (Wildavsky, 2003).

In the 1980s, the economic situation in Iceland was even worse than in 1950s (the CPI was at average 70 percent in the 1980s), and in the 1990s Iceland followed other OECD States and undertook a number of initiatives aimed at establishing the key elements of a modern public financial management system, especially by Acts No 86 and 88 of 1997 (J. R. Blöndal, 2003). However, the lack of discipline in budgeting was one of the main causes for the crisis of 2008. Iceland did not follow the OECD rules for budgeting. Among the key initiatives that were taken in the 1990s were frame-budgeting; a top-down approach to budget preparation, which in fact was not quite followed by the Ministry; the progressive shift toward a medium-term orientation to fiscal policy; the adoption of an accrual basis in both financial reporting and the annual budget; the development of a delegated approach to financial management based on accountability and responsibility; the introduction of performance management in a number of spending agencies; and a clear legislative framework. Similar initiatives were introduced at the municipal level, but the municipalities were not in the budgeting

proposal until after the adjustment of the budget proposal in 2013.

However, although the formulation process for the budgeting proposal has changed a lot since 1874, there are few things we want to highlight.

- **First**, the power in the executive branch is extremely concentrated and there are weak or non-existent checks and balances. Since 1904, most of the officers who were in charge of budget proposals (the National Secretary and the Permanent Secretary) were hired on the basis of political parties or the kinship structure. The first three, i.e. 1904–1920: Klemens Jónsson, Indriði Einarsson and Magnús Guðmundsson, were all politicians. Magnús Gíslason, 1939–1952 and Sigtryggur Klemensson, 1952–1966 were both hired on a political basis, Magnús on behalf of the Independence Party (Magnús was also an MP for the Party) and Sigtryggur on behalf of the Progressive Party. Recently, the budget proposals have been composed by Baldur Guðlaugsson, who was the Permanent Secretary 2000–2009 on behalf of the Independence Party. It may be a coincidence but those who were considered to be independent, Gísli Blöndal, 1967–1978, and Gunnar H. Hall, in 1988, found their working conditions more and more unfavorable until they resigned. Then the lack of rules, or of willingness to follow the rules, led to poor transparency of executive decisions.
- **Second**, no legislation, not even the Financial Reporting Act No 88 of 1997, contains specific fiscal objectives or rules. A form of a medium-term budget framework is prescribed there by Article 28, which requires a four-year projection of the public finances and an assessment of the economic impact of fiscal policies. However, these projections are presented to the Parliament alongside the annual budget and therefore have little impact in shaping the budget preparation process. While recent amendments to the 2001 Parliamentary Procedures Act will require the Government to present its medium-term fiscal and expenditure plans in April, there is no requirement to periodically present longer-term (more than 30-year) fiscal projections, which would demonstrate the long-term sustainability of current policies.
- **Third**, since the National Economic Institute, that existed from 1974 to 2002, was shut down, there exists no independent agency in a position to provide an ex

*ante* assessment of the credibility and sustainability of the Government's fiscal policy.

- **Fourth**, the budget proposal is first introduced to the Parliament in October each year. Therefore, neither the Parliament nor the public, play an active role in the shaping of the Government's fiscal and budget strategy.

### **Approval**

The risk of corruption is highest in this phase of the budget proposal and there is often little time for scrutiny of the budget proposal by the MPs. The constitution stipulates that the budget proposal must be submitted to the Parliament at the beginning of each regular session, where the budget is given three readings and enacted before the end of the year. However, when delays occur in the earlier phases, the great urgency to have the budget adopted in a timely manner will often lead to a shortened time for legislative scrutiny. The legislative debate is often about geographical allocations where the MPs are fighting for a piece of road or a school for their constituency rather than focusing on possible cases of corruption. This is also the place where the Special Interest Groups may secure the votes of the MPs through more or less subtle forms of compensation to overturn the proposal or to safeguard an allocation that is in danger of being reversed in the parliamentary debate. Therefore, the structure of the parliamentary debates i.e. how the budget proposal is debated, is the most important feature for the bill.

With the amendment of 1915, the right to vote was extended and the Parliament established several committees, whose members are elected on a proportional voting basis; every committee had five members, except the Appropriations Committee — *fjárveitinganefnd* or *fjárlaganefnd*—with seven members. From 1922, each financial period was shortened from two years to one, and until 1934, the budget proposal was debated in both chambers of the Parliament, although the lower chamber had much greater power in matters of expenditure. The budget proposal was first debated in the lower chamber, and the time left for the upper chamber to deal with the budget proposal was usually so scarce that the debate was in many cases just a formality. If the chambers could not agree on the budget proposal, it was debated in a joint session of both chambers of the Parliament where proposals that had been passed by the lower

chamber usually received majority support. At the same time, the number of members of the Appropriations Committee was increased to nine. From 1959, in order to improve cooperation between the legislature and the executive, the chairman of the Appropriations Committee frequently attended meetings at the Ministry of Finance when it was preparing the budget, and in 1966 when the Bureau of the Budget was established, it was decided that the budget director or his representative should attend all meetings of the Appropriations Committee when the budget was being considered. However, the actual political power rests mostly with the Appropriations Committee. From 1974, there were ten members in the Appropriations Committee, from 1978, there were nine again, ten in 1983, nine in 1985, from 1991 to 2011 (Act No 55 of 1991), there were 11 members in the Appropriations Committee, but nine members in all other Committees, and with Act No 84 of 2011 there are nine members in all Committees.

Between 1934 and 1991, the budget was given three readings in a joint session of both chambers of the Parliament, but from 1991, the Parliament has been unicameral, where the budget is given three readings and enacted before the end of the year on the basis of simple majority vote. Between the readings, the Appropriations Committee examines expenditures. During all this time, the expenditure and revenue procedure have been separated, although the cooperation between the Committees (fjárlaganefnd and efnahags- og viðskiptanefnd) is much closer now than it used to be in the beginning of the 20<sup>th</sup> century.

Both the constitution and the Financial Reporting Act No 88 of 1997 are silent on the scope of the Parliament's power to amend the annual budget proposal presented by the Government. Historically, Althingi possessed considerable budgetary power. The idea of a powerful Parliament against the executive Government was the core struggle for independence. Also, MPs secured their chances of being re-elected by securing grants to their constituencies. 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 proposal of the Government, although an

increase of more than 10 per cent was less frequent, and the highest percentages can be associated with the changes in society during WWII (Gísli Blöndal, 1965a).

With the changing of the constituencies in 1959, it was hoped that these special features of the budget would disappear. Nevertheless, this parliamentary process continued, but for different reasons than formerly. Conditions for budgeting were improved by the establishment in 1966 of the Bureau of the budget, and, as mentioned above, estimates became more realistic when the Bureau of the budget started to budget by volume and use built-in fiscal stabilizers etc., and in that sense, the budget proposal was extended to parliamentary control. Most other important amendment proposals came from the Government itself through the Appropriations Committee, whose majority supports the Government. Expenditure increases in the parliamentary process were therefore no longer an indication of the relative strength of Parliament (G. Blöndal, 1983), but on the contrary, pressure from the SIGs on the executive Government, which has increased since the closure of the Bureau of the budget in the beginning of the 1990s. However, although the difference between the original expenditure proposal of the Government and the bill has been decreasing the last decades, the situation in Iceland is far worse than in other OECD countries (Gunnar Helgi Kristinsson, 1999; IMF, 2012), which pointing to corruption.

### **Execution**

When Government expenditures exceed the Finance Act, as passed by the Parliament, the expenditure can be divided into two categories. The first consists of those expenditure items which can be placed under particular clauses of the Finance Act, but with respect to which no estimates have been done. The second category is ordinary excess payments on individual items already estimated in the Finance Act. In the first category we can find three kinds of Acts: supplementary budgets, specific authorizations (Heimildarlög) and parliamentary resolutions (Sérstök lög). The supplementary budget contains provisions for appropriations to meet various irregular and unforeseen expenditures within the year. It has been presented each year as a rule since 1879, and takes the same form as the original budget and it undergoes the same parliamentary procedure. The form of supplementary budgets has evolved. This can be divided into three categories:

1. The supplementary budget contains a reserve fund which is managed by the Ministry of Finance and is intended to meet expenditures resulting from collective wage agreements and price-level changes which exceed the premises of the budget.
2. The Government as a whole, and individual ministers; are provided with certain discretionary funds to resolve the financial requirements of various projects that may arise within the budget year.
3. Many spending categories within the ministries are allocated special collective appropriation items that are used to meet minor operating difficulties and unforeseen expenditures.

In cases where these measures are not sufficient due to changes to economic premises or the external operating conditions of Government activities, a supplementary budget proposal must be submitted to the Parliament to obtain further appropriations. Decisions on other expenditure items, such as new projects and various kinds of operating difficulties are usually referred to the preparation of the next annual budget. The other two categories: specific authorization and parliamentary resolution are used when laws of this kind are passed after the budget proposal has gone through the parliamentary process.

However, the key issues on budget execution are always whether deficit targets are likely to be met, and whether any budget adjustments (both on the revenue and expenditure sides) agreed at the preparation stage are being implemented as planned. On the expenditure side of the budget, the key issues are whether the outturn is likely to be within the budget figure; whether any changes in expenditure priorities (as against past patterns) are being implemented in specific areas as planned; and whether any problems are being encountered in budget execution. Since the beginning of its own budgeting in 1874, Iceland has had a poor track record of enforcing discipline during budget execution. Until WWI, Iceland overspent its annual budget by an average of 15.8 percent, (1917–1921, its annual overspending was 71.1 percent) from WWI to the end of WWII, Iceland overspent its annual budget by an average of 33.2 percent, and from WWII to 1959, Iceland overspent its annual budget by an average of 13.3 percent, and although there came some ‘good’ years in the beginning of the 1960s, it

soon returned to previous levels. In the 1970s Iceland overspent its annual budget by an average of 18.3 percent, and in the last decade leading up to crisis 2008, Iceland overspent its annual budget by an average of 12 per cent (G. Blöndal, 1983; Gísli Blöndal, 1965a; IMF, 2012).

This overspending is mainly the consequence of political negligence, clientelism and disorganization, and although some of the loopholes that enable the Government to exceed the annual Financial Act have been closed, there still exist at least five different ways in which a spending agency can overspend its annual appropriations without being sanctioned (IMF, 2012):

1. According to articles 12 and 23 of the Financial Reporting Act No 88 of 1997, the spending agency can increase or anticipate the collection of a range of own revenues, which are netted off against their appropriation in the current year.
2. According to article 37 of the Financial Reporting Act No 88 of 1997, the spending agency can overspend from its accumulated stock of underspending carried forward from previous years.
3. According to articles 33 and 34 of the Financial Reporting Act No 88 of 1997, the spending agency can seek retrospective parliamentary authorization for the overspending before the end of the year through a supplementary budget.
4. According to article 44 of the Financial Reporting Act No 88 of 1997, the spending agency can seek retroactive parliamentary authorization of the overspending after the end of the year through the Finance Act.
5. According to article 45 of the Financial Reporting Act No 88 of 1997, the spending agency can deduct the overspending from their appropriation for the following year.

### **Control and Auditing**

Public internal financial control in Iceland covers the control and audit of income; expenditure, assets, liabilities and all parts of the national budgets. The control and audit of taxes is done through the tax authorities. The control and audit of customs is done through the customs authorities.



The public internal financial control system in Iceland consists of three parts: the Finance Minister, the State Accounting Office and the Icelandic National Audit Office, which is an independent body operating under the auspices of the Parliament.

- The Ministry of Finance is responsible for the financial management and all control systems, but as we mentioned above, the Bureau of Budget was in charge of this function 1966–1988. The main role of the Ministry is to monitor various tasks pertaining to the implementation of the budget and other selected tasks in government financial management.
- Until 1931, there were no special laws or regulations ruling the National Accounts, and the records depended rather on the whims of the Finance Minister than on any accounting system. Certain tax collectors—the District commissioners—used the treasury as if it were their own money (*Atvinnumálaráðuneytið*, 1931). In addition, the Government did not present the accounts to the Parliament until two to four years after the close of the respective financial year, when the interest in that particular year's accounts was naturally somewhat lessened; and by that time any disapproval that there might be concerning excess expenditures would not be to much avail anyway (*Gísli Blöndal*, 1965a). In 1950, the Public Administration Service of the United States in Washington D.C. advised the Government to change its personnel administration, financial administration and the organization of the government (PAS, 1950). The National Reports of Iceland (*SKÝRR*) was established in 1952 and the Act of civil servants No 38 of 1954 was passed, but no law or regulation was in force on recruitment or working conditions for the civil servants. The accounting system was deficient in several respects. It was impossible to exercise real and effective budgetary control. Insufficient information was available for use in preparing the budget estimates. No information regarding proposed work programs or unit costs was available, and the budget document itself contained no information regarding the actual revenues and expenditure of previous completed fiscal years. The classification of accounts used in the budget was not designed to permit the maximum analysis or control and made it difficult to ascertain readily the total expenditures for principal government

activities, or for objects of expenditure, such as total payments for salaries. The main reason was of course that the executive, or administrative, functions and the general policy-making, or legislative, functions were in the same hands. However, most of the counseling of the Public Administration Service of the United States in Washington D.C. was postponed until the 1960s when the whole administration and budgeting system was amended by a number of Acts. Thus, the accounting system was reformed in 1968, but the separation between the executive power and the legislative functions has not yet been implemented. The presently applicable law is the Financial Reporting Act No 88 of 1997.

- The same applies to the Audit as to the National Accounts: until 1931 there were no special laws or regulations pertaining to it. The Government did not seem to have laid much stress on exercising whatever power they may have been endowed with in this connection. Thus the auditors have always been preoccupied with formal accountancy considerations, while other objectives, such as ensuring value for money or selecting among projects on the basis of cost-benefit analysis, were unknown in the budget process until 1966. This was again in a large degree explicable by the traditional stress laid on formalities, which in turn, derived from the special kind of labor in governmental services (Gísli Blöndal, 1965b). Until 1986, the Minister of Finance performed the audit, but since then the National Audit Office has been an independent body operating under the auspices of the Parliament. The Office is a part of the legislative branch that monitors the executive branch. Its main role is to audit the state accounts and the financial statements of state bodies, monitor and promote improvements in the financial management of the State and in the use of public funds. The present law for the Icelandic National Audit Office is the National Audit Act No 86/1997.

## **Appendix B: The Right to Vote**

The right to vote is one of the most important human rights in democratic countries. That right has changed a lot since the early 1800s when most states gradually dropped property requirements for voting. Other reforms make the process fairer and easier. Yet the principle of “Government by the people” has never been recognized in Iceland, as the rule “one person, one vote” has never been in force. The proportion of votes, expressed as a percentage of the total population of voters, was as follows: 8.8 in 1874; 15.4 in 1914; 31.7 in 1916; 45.2 in 1923; 56.4 in 1934; 62.6 in 1979; and since the 1990s, it has been around 70. Participation in the elections has always been high in Iceland compared to other nations. It was around 20 percent in 1874, 75 percent in 1908, and since the 1930s it, has been around 90 percent. However, it is important to understand who MPs’ voters are. Did the voters reflect the nation, or was it only the elite who could vote, as Wicksell pointed out in his model? Let’s look at the evolution of the right to vote in Iceland since 1845, the number of the constituencies, the number of MPs in each constituency, and how these figures are relevant to the taxation:

- 1845: 20 constituencies: Reykjavík and 19 provinces: 1 Member of Parliament for each province + 6 nominated by the King, i.e. 2 from the church and 4 officials, or totaling 26. Those who could vote were men over 25 years of age, autonomous, of untarnished reputation and ancestry 10 hundreds, a house of stone or wood worth a thousand rd (riksdalers), or a life-long lease on a farm owned by the nation or the church, 20 hundreds, i.e. the tax to the King. Each term was 6 years until 1920, since then each term has been 4 years (see footnote 8).
- 1857: No Member of Parliament representing the Westman Islands for the period 1845–1857, therefore, there were only 25 representatives for this period. At the same time, the right to vote was expanded. All farmers paying some direct taxes acquired the right to vote, as did merchants and tradesmen residing in an authorized place of trade, paying 4 rd., and workers on the seaside paying 6 rd. to the county—and not enjoying subsidies from the county; also officials

and those who had completed a degree from a university or a priests' school. They had to have been legal residents in the constituency for a year prior to the elections.

- 1874: The same provisions applied to the right to vote, but there were now 19 constituencies, i.e. 8 with a single representative and 11 with two representatives, + 6 nominated by the King, totaling 36. Reykjavík had a single representative => farmers and seamen had the strongest impact.
- 1877: The provinces Thingeyjar- and Skaftafellssýsla split up, ergo there were 21 constituencies, i.e. 12 with a single representative and 9 with two representatives, + 6 nominated by the King, totaling 36. In 1880 an average votes per MP were 219, 48 voters per MP at least, up to 342 at most.
- 1902: The province of Ísafjarðarsýsla split in two, ergo there were 37 constituencies.
- 1903: Reykjavík gets two representatives and Ísafjörður, Akureyri and Seyðisfjörður one each, ergo there were 25 constituencies, of which 16 with one representative each, and 9 with two representatives each,  $16 + 18 + 6 = 40$ . All those living in places of trade were now eligible, also workers on the seaside and journeymen, provided they paid 4 kr. (króna) as an extra tax, were independent, ergo farm hands were not eligible and the same rule applied to the Parliament and the county.
- 1915: The conditions ruling the extra tax are revoked, and women and farm hands obtained the right to vote if they were 40 years old or more, the provision concerning the university degree and the officials was revoked, but a county subsidy that had not been repaid was still a hindrance. Representatives elected by the country's inhabitants replaced those nominated by the King. They had to be 35 years of age, or older, and each term was 12 years. In 1916, an average number of votes per MP were 839, 400 voters per MP at least, up to 2,291 at most (Reykjavík).
- 1920: There were four Reykjavík representatives, elected proportionally. Age restriction for women and farms hands were revoked. Therefore, men and women had the same right to vote. The term for the Representatives elected by the country's inhabitants was shortened from 12 years to 8 years. There were 25

constituencies, of which 16 had one representative each, while 8 of them had two each: ergo there were  $16 + 16 + 4 = 36 + 6 = 42$  constituencies.

- 1922: The province Húnavatnssýsla split up (this took effect 1923) => 26 constituencies, i.e. 18 with a single representative and 7 with two representatives: ergo there were  $18 + 14 + 4 = 36 + 6 = 42$  constituencies.
- 1928: Hafnarfjörður and Gullbringu- og Kjósarsýsla got one representative each (took effect 1931): ergo there were 27 constituencies, i.e. 20 with a single representative and 6 with two representatives: ergo there were  $20 + 12 + 4 = 36 + 6 = 42$  constituencies.
- 1934: There were six Reykjavík representatives, elected proportionally. Representatives elected by the country's inhabitants were revoked but instead, there were 11 compensatory representatives, divided between the parties according to their respective number of votes. The age restriction for the right to vote was changed to 21 years instead of 25 years, and those who enjoyed subsidies from the county did not lose their right to vote: ergo there were  $20 + 12 + 6 + 11 = 38 + 11 = 49$  constituencies. In 1934 an average number of votes per MP was 1,313, at least 476 voters per MP and up to 2,635 at most (Reykjavík area).
- 1942: There were eight Reykjavík representatives, elected proportionally, also in other constituencies with two representatives. Siglufjörður gets one representative: ergo there were 28 constituencies, i.e. 21 with a single representative and 6 with two representatives + Reykjavík: ergo there were  $21 + 12 + 8 + 11 = 52$  constituencies.
- 1959: The whole country was divided into eight constituencies where representatives were elected proportionally: Reykjavík had 12 representatives, all others had 5, except for two that had 6, and there were still those 11 compensatory representatives, which were divided between the parties according to their respective number of votes. In 1959, before the changes, an average number of votes per MP was 1,828, i.e. 435 voters per MP at least, and up to 3,968 at most (Reykjavík). After the changes, an average number of votes per MP was 1,594, i.e. 828 voters per MP at least, and up to 2,669 at most (Reykjavík).

- 1967: The age restriction for the right to vote was changed to 20 years instead of 21 years (this took effect for the election to the Parliament in 1971, but in 1970 for the municipal elections).
- 1984: The number of MPs in the constituencies is variable—"the Joker". Representatives were 50 + 12 compensatory representatives + "the Joker," totaling 63.
- 1995: "The Joker" became fixed in Reykjavík.
- 2003: The whole country was divided into six constituencies, while Reykjavík was divided into two. Representatives were elected proportionally, but the numbers of voters per MP were still unequal. In the general election of 2013, there around 2,170 voters per MP at least, up to 3,910 at most.
- 2010: A new constitution is drafted, "one person, one vote", but despite the fact that it has been approved in a referendum, the Althingi would not adopt it.

As stated above, the right to vote varies greatly between groups. Women did not have rights equal to those of men until 1920. Neither did farm hands. However, according to the tax law, married women were not independent taxpayers until 1979, and the head of the family, or the farmer, paid the taxes for the farm hands until 1934, and in practice even longer. Until 1934, the right to vote depended on taxation. There has always been a deficiency of equal representation between urban areas and rural areas, to the urban areas' disadvantage. This is one of the main reasons for the governmental crisis between 1930 and 1950. Those parties that have profited from these election systems are the Progressive Party and the Independence Party (Gunnar Helgi Kristinsson, 1993; Svanur Kristjánsson, 1993), but they have taken turns in managing the tax system in Iceland. Furthermore, the amendments to the Constitution made in 1934 aimed at increasing the power of the parties, not that of the people, and this has characterized Icelandic politics ever since. As a result of all these factors, the fishing vessel owners, who have been the main campaign contributors for these two parties, have always enjoyed certain tax exemptions.

## Appendix C: Tax Administration in Iceland since 1877

### The Structure of Icelandic Tax Administration

The Ministry of Finance is the highest tax authority in Iceland and there are four independent agencies affiliated to the Ministry of Finance, which all have special fields of responsibility: the Directorate of Internal Revenue, the State Internal Revenue Board, the Directorate of Tax Investigations, and the Directorate of Customs. Additionally, there were nine district tax offices located around the country 1962–2009.

The organizational structure of tax administration in Iceland since 1972

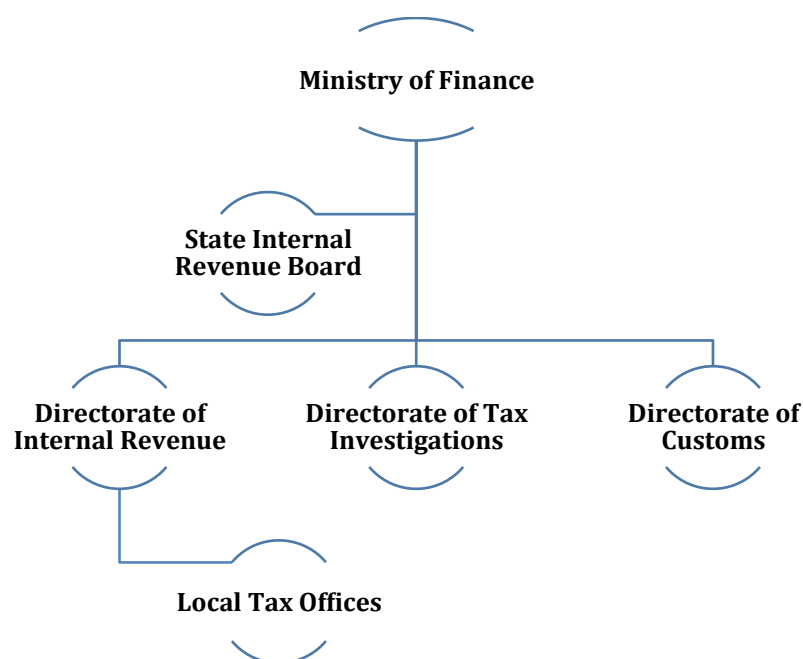


Figure 25. The organizational structure of tax administration in Iceland since 1972

The Directorate of Internal Revenue was established in 1962. It is the central tax authority in Iceland and also the head of tax control and audit in Iceland. Its main tasks can be described as follows:

- Supervision of tax administration and ensuring the harmonization of the application of tax law on direct and indirect taxes
- Supervision of withholding taxes and social security contributions
- Technical development for all software used for tax assessment, data gathering, etc.
- Supervision and maintenance of all computer hardware used by the tax authorities
- Distribution and printing of various tax forms
- Central tax assessment on certain excise duties
- Coordination and monitoring of tax audits
- Acts as competent authority regarding exchange of information in tax matters
- Business and company registry
- Annual report registry
- Supervision of premiums paid to pension funds

The State Internal Revenue Board decides in cases of disagreement between taxpayers and the relevant district tax office or the Directorate of Internal Revenue. The State Internal Revenue Board also decides tax fines through closed administrative procedures in those cases where fines have been imposed by the Directorate of Tax Investigations.

The Directorate of Tax Investigations is a specialized independent organization that investigates alleged tax crimes, particularly major tax crimes, and decides upon penalty procedures for such violations since 1992. The main tasks can be described as follows:

- Investigation of cases where there is suspicion of tax fraud
- Representation on behalf of the tax authorities in cases where a penalty procedure takes place through a closed administrative action by the State Internal Revenue Board
- Preparation of major cases for criminal proceedings, i.e. preparing cases for further investigation by The National Commissioner of the Icelandic Police and for the Directorate of Public Prosecutions



Local tax offices: Nine regional tax offices assessed personal income tax and company income tax as well as VAT from 1962–2009. The district tax offices were located in Hafnarfjörður, Reykjavík, Akranes, Ísafjörður, Siglufjörður, Akureyri, Egilsstaðir, Hella and Vestmannaeyjar.

The operations of the Directorate of Customs are divided into two core divisions, the Customs Division and the Collection Division. The Directorate of Customs also has an office of Internal Audit, which works in cooperation with the Icelandic National Audit Office and the Division of Internal Audit within the Police. Since 2009, the Directorate serves the whole of Iceland in one customs district.

The Role of the Directorate of Customs:

- Customs enforcement on a national scale
- The levy and collection of duties and other taxes and charges payable at customs clearance
- Control of importation, transit and exportation of goods to and from the country and of journeys and transport of vessels and people to and from the country
- Assistance to the Minister of Finance in customs matters
- Analysis in respect of risk management for customs control

### **The Development of Tax Administration**

The old Icelandic tax system, which grew out of the establishment of the Church in the 11<sup>th</sup> century, ceased to provide the revenue necessary to run the state in the 18<sup>th</sup> century. The changing of the tax system was therefore bound to be a central issue in creating a modern society during the 19<sup>th</sup> and early 20<sup>th</sup> century. Taxes were based on the value of land. The Parliament of Iceland, Althingi, is the nation's oldest and highest institution. It was founded at Þingvellir (Parliament Plains) in 930 AD and restored as an elected representative body in 1845. An Officers Committee made a report in 1845 (Þórður Sveinbjörnsson, Páll Melsteð, Jón Johnsen, Eggert Briem, & Pétur Havstein, 1846), but Iceland and Denmark did not reach an agreement about new tax system. The main claim against Denmark was to get the taxing power from the King, but the power to levy taxes is among the prerogatives of a sovereign state (Jón Sigurðsson, 1867). The King renounced his absolutism in Denmark in 1849, and as mentioned above, no

agreement was reached on an Icelandic settlement, although this report made the base for the New Tax Code in 1877 (Act No 21 of 1877 and Regulation No 49 of 1878).

During that time, there existed almost no administration in Iceland, except for the church and the local governments. Iceland was divided into two types of administrative districts: rural districts (hreppar) and townships (bæjarfélög). There were also administrative units known as counties or districts (sýslur), which were in fact a kind of legalized association of rural districts, though superior to them in some respects and otherwise comparable to townships. From the middle of 19<sup>th</sup> there were three local representatives on average in each local government, assessing the income tax on each home 'according to their means', i.e. these representatives had to know the situation of each person in their districts. In 1872, the number of representatives was changed according to the number of their residents: 3 in rural districts, 5 in towns, and 7 in Reykjavík. In rural districts and towns, the rural or the town council assessed the tax, but in Reykjavík the citizens voted on a special tax committee. The members of the committee were divided into the majority and the minority. Every person who had the right to vote could vote for the majority (four persons) but only the taxpayers could vote the minority (three persons). The majority was elected for six years, but the minority was elected for three years. In 1921, the number of the representatives in Reykjavík was reduced to five, the town council appointed the committee and the local tax commissioner in Reykjavík, who had the status of Director of the Internal Revenue until 1962, was the head of the committee (changed in 1942 as mentioned above). In towns, the chairman of the council was also the chairman of the tax committee, except if there exists a local tax commissioner in the town (Act No 6 of 1935), but in rural districts it was the mayor. Until 1960, there was no law on the tax scales, which were first presented as guidelines in Reykjavík in 1929. Therefore the tax assessment in the locals were based on political power until 1960 when the Government legalized special tax scales for the municipalities and even to 1980, Act No 13, when the local tax commissioner replaced the local governments in the tax assessment.

The form of the local tax administration made the base for the State tax administration. In each rural district were three men in a special tax committee (skattanefnd) who assessed the income tax, and in each town or districts there were so

called general tax committee (yfírséðingur), with other three men, and when a taxed entity believed its taxes or tax base, including operating losses, wrongly assessed, it could file a reasoned appeal to that one. If the taxed entity still believed its taxes were wrongly assessed, it could file a reasoned appeal to the Governor. The tax return was not written until 1922 (Act No 74 of 1921) and tax-free threshold was very high, therefore, the only ones who paid the income tax at that time were the officials.

From 1922 there was a local tax commissioner in Reykjavík. Einar Arnórsson, former Finance Minister and later member of the Independence Party was the first one in office, and in the 1940s and especially in the 1950s, for political reasons, the number of towns that had a local tax commissioner increased significantly. If there was no local tax commissioner in the town, the mayor was the chairman of the tax committee, but the chairmanship of the general tax committee was in the hands of the director of the police or the district commissioner who were also responsible for the tax collection.

As mentioned above the financial crisis of 1920 led to significant changes in the Government administration. The revenue side was the responsibility of the Finance Ministry, but the Finance Minister did not have the responsibility of the administration of taxation alone until 1922. According to the Income Tax Acts No 23 of 14 December 1877 and No 74 of 27 June 1921, the Government office as a whole was responsible for the administration of taxation (cabinet collective responsibility), but by the Regulation of the Income Tax No 90 of 14 November 1921, which came into force the first of January 1922, the Finance Minister alone was responsible for the tax administration, i.e. a system of unity of command. At the same time, the name of the Government office was changed from Government Departments to Government Ministry, i.e. the Finance Department was changed to Finance Ministry etc., by a directive dated December 9, 1921.

The State Internal Revenue Board with three members (ríkisfiskattaneingur) was established in accordance with Act No 20 of 1932. (Hermann Jónasson, from the Progressive Party, who was then the director of the police in Reykjavík was the first chairman of the Internal Revenue Board.) Thus there were four tax administration levels: the tax committee/local tax commissioner, the general tax committee, the State Internal Revenue Board and the Finance Minister.

In accordance with Act No 20 of 1942, a special Tax Investigations Office (skattadómari) was established. This office was under the Minister of Justice, not the Minister of Finance, and was abolished in 1950.

Tax administration was very complex and inefficient with almost 800 employees. From 1928 to 1960, the Parliament had appointed ten committees to fix the system, but nothing happened, and the recommendations from the Public Administration Service in the Washington D.C. since 1950 was not followed until 1962, Act No 70 of 1962, when the Directorate of Internal Revenue was established with nine district tax offices located around the country. The PAS had recommended one tax office for the whole country. However, at the same time, the general tax committee was abolished, and the director of the Internal Revenue was also the chairman of the State Internal Revenue Board, although that was changed with Act No 7 of 1972.

Thus, from 1962 to 1972, there were three tax administration levels: the Local Tax Commissioner, the Directorate of Internal Revenue/the State Internal Revenue Board and the Finance Minister.

From 1972–2009, there were four tax administration levels: the Local Tax Commissioner, the Directorate of Internal Revenue, the State Internal Revenue Board and the Finance Minister.

From 2010, there were three tax administration levels: the Directorate of Internal Revenue, the State Internal Revenue Board and the Finance Minister.

In 1964 a new Tax Investigation Office was established, and in 1965 a special Tax Penalty Committee (sektarnefnd) with three members was also established. In 1980, the Tax Penalty Committee was merged with the State Internal Revenue Board. With the establishment of the Tax Penalty Committee, the Finance Minister lost his power to penalize those who evaded taxes, a power he had had since 1877. The tax investigations process changed significantly in 1978 and also in 1992 with the establishment of the Directorate of Tax Investigations and a brand new State Internal Revenue Board (yfyrskattanefnd).

## Appendix D: The Marginal Tax Rates for Central Government and Local Government in Iceland 1931–2009

	Total	Central Gov.	Local Gov.
1931	56,00	26,00	30,00
1932	67,50	32,50	35,00
1933	82,40	36,40	46,00
1934	80,40	36,40	44,00
1935	88,00	44,00	44,00
1936	99,00	45,00	54,00
1937	99,00	45,00	54,00
1938	104,28	50,28	54,00
1939	109,68	50,28	59,40
1940	112,38	50,28	62,10
1941	116,00	80,00	36,00
1942	91,00	69,00	22,00
1943	91,00	69,00	22,00
1944	91,00	69,00	22,00
1945	91,00	69,00	22,00
1946	90,00	68,00	22,00
1947	90,00	68,00	22,00
1948	90,00	68,00	22,00
1949	90,00	68,00	22,00
1950	90,00	68,00	22,00
1951	90,00	68,00	22,00
1952	90,00	68,00	22,00
1953	90,00	68,00	22,00
1954	65,00	40,00	25,00
1955	66,25	40,00	26,25
1956	70,00	40,00	30,00
1957	70,40	40,40	30,00
1958	70,40	40,40	30,00
1959	68,51	40,40	28,11
1960	57,99	30,30	27,69
1961	57,00	30,30	26,70
1962	55,65	30,30	25,35
1963	55,20	30,30	24,90
1964	57,60	30,30	27,30
1965	56,07	27,27	28,80
1966	55,77	27,27	28,50
1967	55,47	27,27	28,20
1968	55,47	27,27	28,20
1969	55,47	27,27	28,20
1970	55,47	27,27	28,20
1971	55,20	27,00	28,20
1972	54,00	44,00	10,00
1973	54,00	44,00	10,00
1974	50,00	40,00	10,00
1975	50,00	40,00	10,00
1976	50,00	40,00	10,00
1977	50,00	40,00	10,00
1978	60,00	50,00	10,00
1979	60,00	50,00	10,00
1980	61,00	50,00	11,00
1981	61,00	50,00	11,00
1982	61,00	50,00	11,00
1983	61,00	50,00	11,00
1984	56,00	45,00	11,00
1985	55,00	44,00	11,00
1986	55,00	44,00	11,00
1987	49,50	38,50	11,00
1988	35,20	28,50	6,70
1989	37,74	30,80	6,94
1990	39,79	32,80	6,99
1991	39,79	32,80	6,99
1992	39,85	32,80	7,05
1993	46,34	39,30	7,04
1994	46,84	38,15	8,69
1995	46,93	38,15	8,78
1996	46,94	38,15	8,79
1997	45,88	34,31	11,57
1998	46,02	34,41	11,61
1999	45,34	33,41	11,93
2000	45,37	33,41	11,96
2001	45,76	33,08	12,68
2002	45,54	32,75	12,79
2003	43,55	30,75	12,80
2004	42,58	29,75	12,83
2005	39,73	26,75	12,98
2006	36,72	23,75	12,97
2007	35,72	22,75	12,97
2008	35,72	22,75	12,97
2009	45,20	32,10	13,10

Sources: Jóhannes Hraunfjörð Karlsson, Saga skatta  
og skattlagningar á Íslandi frá öndverðu til vorra daga.

## Appendix E: Assessment in Reykjavík 1920–1961

	Assess- ment	1961 Prices	Central Government	Local Gov. % of Central Gov.	Local Gov. % of GDP
1920	1.766.441	286.497	1.139.000	155,09%	1,28%
1921	1.511.490	207.531	1.174.000	128,75%	1,15%
1922	1.453.284	160.309	1.536.000	94,61%	1,10%
1923	1.427.702	147.793	1.104.000	129,32%	1,14%
1924	1.298.135	148.448	1.169.000	111,05%	0,78%
1925	1.846.391	202.697	2.448.000	75,42%	1,08%
1926	1.634.203	157.123	1.462.000	111,78%	1,13%
1927	1.406.657	122.778	1.111.000	126,61%	0,90%
1928	1.613.310	136.855	1.507.000	107,05%	0,92%
1929	1.629.303	138.525	1.862.000	87,50%	0,88%
1930	2.033.295	168.070	1.752.000	116,06%	1,08%
1931	2.455.685	185.241	1.951.000	125,87%	1,58%
1932	2.114.128	153.366	2.014.000	104,97%	1,47%
1933	2.428.064	175.204	2.266.000	107,15%	1,49%
1934	2.453.884	178.722	2.552.000	96,16%	1,42%
1935	3.221.699	237.288	2.814.000	114,49%	1,82%
1936	3.731.569	281.672	2.672.000	139,65%	2,04%
1937	4.068.786	322.602	2.596.000	156,73%	2,04%
1938	4.347.387	353.068	3.327.000	130,67%	2,12%
1939	4.825.097	407.205	3.233.000	149,25%	2,05%
1940	5.757.212	636.732	3.722.000	154,68%	1,63%
1941	9.055.023	1.280.614	12.264.000	73,83%	1,59%
1942	11.504.761	2.132.482	22.297.000	51,60%	1,33%
1943	20.612.308	4.829.396	36.746.000	56,09%	1,91%
1944	29.688.200	7.264.743	31.005.000	95,75%	2,48%
1945	31.695.447	8.036.842	63.700.000	49,76%	2,36%
1946	38.477.265	10.394.051	69.400.000	55,44%	2,38%
1947	49.918.280	14.581.139	101.900.000	48,99%	2,66%
1948	56.758.876	16.798.003	113.300.000	50,10%	2,99%
1949	54.996.658	16.679.141	99.900.000	55,05%	2,85%
1950	60.011.286	24.097.017	102.800.000	58,38%	2,68%
1951	72.869.961	39.369.436	133.500.000	54,58%	2,63%
1952	87.601.508	53.843.701	162.600.000	53,88%	2,82%
1953	94.336.055	57.328.693	160.300.000	58,85%	2,52%
1954	97.446.861	59.895.084	171.200.000	56,92%	2,34%
1955	118.174.970	76.005.405	205.500.000	57,51%	2,46%
1956	161.592.940	116.010.654	255.900.000	63,15%	2,83%
1957	196.436.431	147.308.399	297.800.000	65,96%	3,27%
1958	220.317.590	176.169.171	301.300.000	73,12%	3,17%
1959	231.598.313	187.956.088	368.100.000	62,92%	2,95%
1960	202.363.499	181.152.373	304.400.000	66,48%	2,30%
1961	234.049.179	234.049.179	336.500.000	69,55%	2,34%

### Notes:

The assessment of income 200.000 kr. and higher was done by the Municipal Equalization Fund, which distributed them among all municipalities 1941–1958.

Sources: Jóhannes Hraunfjörð Karlsson, Saga skatta og skattlagningar á Íslandi frá öndverðu til vorra daga.

## Appendix F: Taxation, Public Services, Transfers and Revenue as Percentage of GDP 1945–2009

	Tax Payers	GDP millions kr.	Taxation	Public Services	Tranfers	Revenue	Tax systems Average
1945	88.516	13,41	18,7	15,4	3,3	84,6	1945-1954
1946	90.267	16,15	19,6	16,2	3,5	83,8	Taxation
1947	92.231	18,75	23,3	18,5	4,9	81,5	22,1
1948	93.974	19,00	21,9	16,7	5,2	83,3	Transfers
1949	95.268	19,33	24,1	18,1	5,9	81,9	5,4
1950	96.682	22,37	20,5	14,5	6,0	85,5	Revenue
1951	97.877	27,70	21,9	16,2	5,8	83,8	83,4
1952	98.779	31,01	21,3	15,1	6,2	84,9	
1953	100.136	37,37	23,8	17,7	6,1	82,3	
1954	101.631	41,73	21,9	16,1	5,8	83,9	1954-1960
1955	103.033	48,05	22,4	16,9	5,5	83,1	Taxation
1956	104.220	57,12	26,1	20,6	5,5	79,4	28,3
1957	105.834	60,09	28,3	23,7	4,6	76,3	Transfers
1958	107.642	69,52	31,8	27,4	4,4	72,6	5,2
1959	109.472	78,42	35,2	30,7	4,5	69,3	
1960	111.311	87,90	32,6	26,9	5,7	73,1	
1961	113.070	99,87	24,5	19,2	5,3	80,8	1960-1971
1962	115.043	119,85	24,1	18,1	6,0	81,9	Taxation
1963	117.224	143,18	25,4	19,4	6,0	80,6	28,2
1964	119.571	182,88	27,5	21,4	6,1	78,6	Transfers
1965	122.120	220,97	27,5	21,7	5,8	78,3	5,9
1966	124.689	265,41	27,5	21,9	5,6	78,1	
1967	127.166	269,31	31,1	24,7	6,4	75,3	
1968	129.500	289,42	32,6	26,1	6,5	73,9	
1969	131.509	358,18	29,3	23,4	6,0	76,6	
1970	133.287	448,16	28,9	23,4	5,5	76,6	
1971	135.607	570,30	31,7	25,7	6,0	74,3	
1972	138.683	716,55	32,4	26,3	6,1	73,7	1972-1980
1973	141.679	1.006,06	32,7	25,2	7,5	74,8	Taxation
1974	144.759	1.464,31	35,6	29,5	6,1	70,5	32,6
1975	147.850	2.090,80	35,7	30,1	5,6	69,9	Transfers
1976	150.638	2.940,65	31,1	26,6	4,5	73,4	5,4
1977	153.104	4.246,70	30,7	26,3	4,4	73,7	
1978	155.565	6.584,43	30,9	26,4	4,5	73,6	
1979	158.191	9.728,22	31,4	26,9	4,5	73,1	
1980	160.846	15.982,00	32,9	27,8	5,1	72,2	
1981	163.632	24.860,00	34,2	29,0	5,2	71,0	Taxation
1982	166.804	39.020,00	34,8	29,6	5,2	70,4	36,4
1983	169.706	67.696,00	36,4	31,4	4,9	68,6	Transfers
1984	172.072	89.440,00	33,0	27,8	5,2	72,2	5,7
1985	174.191	122.026,00	35,3	30,0	5,3	70,0	
1986	176.224	161.561,00	37,7	32,4	5,2	67,6	
1987	178.821	210.348,00	34,5	29,0	5,5	71,0	
1988	182.401	258.780,00	39,2	32,4	6,8	67,6	
1989	185.181	318.780,00	40,6	34,0	6,6	66,0	
1990	187.088	371.437,00	38,5	31,6	6,9	68,4	
1991	189.754	401.610,00	39,7	32,5	7,2	67,5	1990-1997
1992	192.292	401.445,00	40,2	32,5	7,6	67,5	Taxation
1993	194.259	414.168,00	40,0	32,0	8,0	68,0	39
1994	196.022	440.286,00	39,5	31,8	7,7	68,2	Transfers
1995	197.600	454.013,00	38,7	30,7	8,0	69,3	7,6
1996	199.599	487.509,00	38,1	30,4	7,6	69,6	
1997	201.924	526.322,00	36,8	29,4	7,4	70,6	
1998	205.020	588.367,00	38,9	32,6	6,3	67,4	1998-2007
1999	208.273	632.399,00	39,4	33,3	6,1	66,7	Taxation
2000	211.695	683.748,00	39,8	33,7	6,1	66,3	40,6
2001	215.148	771.894,00	40,0	33,9	6,1	66,1	Transfers
2002	217.338	816.450,00	42,2	35,3	6,8	64,7	6,6
2003	219.009	841.322,00	43,9	36,2	7,7	63,8	
2004	222.438	928.889,00	42,0	34,7	7,3	65,3	
2005	225.763	1.026.718,00	40,9	33,9	7,0	66,1	
2006	234.196	1.168.577,00	39,5	33,4	6,1	66,6	
2007	241.321	1.308.518,00	39,8	33,5	6,3	66,5	
2008	248.395	1.483.134,00	42,0	35,3	6,7	64,7	
2009	248.008	1.495.294,00	49,7	40,8	8,9	59,2	

Source: Statistic Iceland

Notes:

Based on the population average, 16 years and above. Statistic Iceland changed its base in 1998, and figures prior to that date are not fit to be compared to figures 1998-2009.

The Central Bank of Iceland went bankrupt: ISK 192.2 billions are not included.

Income: income after taxes + income transfers

Public service: all expenses except income transfers, such as fees on interests and investment.

## Appendix G: Taxes to Local and Central Government in 1927, ISK

	Total			Reykjavik			Other		
	Tax Payers	Revenue	Taxes	Tax Payers	Revenue	Taxes	Tax Payers	Revenue	Taxes
<b>Total</b>	<b>24.969</b>	<b>30.254.250</b>	<b>4.851.867</b>	<b>7.639</b>	<b>16.772.950</b>	<b>1.873.962</b>	<b>17.330</b>	<b>13.481.300</b>	<b>2.977.905</b>
Companies	147	1.006.800	704.430	71	686.100	128.204	76	320.700	576.227
Persons	24.822	29.247.450	4.147.436	7.568	16.086.850	1.745.758	17.254	13.160.600	2.401.678
100–500	10.709	3.121.050	139.169	1.072	351.800	31.615	9.637	2.769.250	107.554
500–1000	6.302	4.718.250	233.680	2.070	1.603.500	145.235	4.232	3.114.750	88.445
1–2000	3.971	5.815.700	412.216	1.727	2.642.250	247.409	2.244	3.173.450	164.807
2–3000	1.806	4.487.450	425.394	1.172	2.923.300	282.531	634	1.564.150	142.863
3–4000	884	3.088.500	373.239	645	2.261.700	226.568	239	826.800	146.671
4–5000	425	1.919.900	292.777	311	1.401.400	146.216	114	518.500	146.561
5–6000	235	1.301.600	242.647	180	1.000.150	109.045	55	301.450	133.601
6–7000	136	885.800	194.857	107	699.450	79.440	29	186.350	115.417
7–8000	114	859.500	220.073	86	649.700	76.918	28	209.800	143.155
8–9000	70	597.350	174.108	56	478.200	58.872	14	119.150	115.236
9–10000	42	400.800	131.365	37	352.950	45.160	5	47.850	86.205
10–12000	50	551.700	211.081	41	449.400	60.661	9	102.300	150.420
12–15000	35	472.450	223.707	28	378.700	55.943	7	93.750	167.765
15–20000	19	329.400	203.553	15	263.100	44.162	4	66.300	159.391
20–30000	19	448.000	356.817	16	381.250	72.934	3	66.750	283.883
30–50000	3	115.650	127.571	3	115.650	26.865	—	—	100.707
50–100000	2	134.350	185.182	2	134.350	36.185	—	—	148.996

Notes: It is only income taxes, property taxes were 154,509 ISK, i.e. in Reykjavik 73.501 ISK, in 1927.

Average income for the Local government 1924–1927 were in ISK: 4,595,000 and 10,115,000 for the Central Government.

There were about 25 100 income tax payers in the country 1924–1927, whereof 170 associations, and the average total of taxable income during this same period amounted to ISK 45 -35 million.

This sum does not include the costs of levying the taxes, the personal allowance of individuals (ISK 500 each) all interests of debts, insurance fees, taxes such as: taxes on property, income tax to municipalities, income and property tax (ISK 6 million per year), a third of the contributions for reserve fund, etc.

During this period, around 70% of those who did pay taxes had a taxable income of less than ISK 1,000. The total amount of the taxable income for all those tax payers was below ISK 8 million, i.e. around 23% of the total taxable income. Around 30% of the tax payers received 77% of the income. An average of about 190 individuals submitted a revenue return yearly during that period, totaling around ISK 3.5 million of taxable income. Even if the total of taxes on individuals and association had been levied solely on those 190 persons, they would still have withheld around ISK 2.2 millions in all for each of these years as a compensation. It must be borne in mind that the estimated income of these individuals is based on their own return, whereas the income of tax payers in general is known from reports submitted by those who pay their wages.

Taxable property, according to income tax return, amounted to nearly ISK 100 million. A mere 4600 individuals, about 18% of tax payers, had such property, amounting to ISK 5,000, as to be taxable in that respect. Of those, around 80%, owned about one third of the property, while about 20%, around 900 persons, were the owners of around 70% of the property. A hundred individuals or so, declared a total of ISK 25 million taxable property. They owned a full quarter of all property, and yet, all properties were reported according to the assessment value, which is much lower than their actual value.

Sources: Jóhannes Hraunfjörð Karlsson, Saga skatta og skattlagningar á Íslandi frá öndverðu til vorra daga.



## Appendix H: Individuals Properties and Debts in 2014, in millions ISK

Net Properties in millions ISK	Families	Real Properties	Remaining debt	Capital Assets	Properties in the end of the year	Total debts	Net wealth	Net wealth Per family
<b>Total</b>	<b>64.512</b>	<b>1.855.734</b>	<b>1.094.520</b>	<b>202.297</b>	<b>1.980.225</b>	<b>1.412.243</b>	<b>770.276</b>	<b>898</b>
<0	18.520	400.935	434.237	17.559	421.437	589.676	-150.681	-8,14
0–10	18.530	414.002	314.132	24.302	438.907	378.328	84.881	4,58
10–20	10.911	301.248	152.211	25.971	321.129	187.269	159.831	14,65
20–30	6.748	231.342	85.530	25.680	248.123	108.006	165.797	24,57
30–40	3.763	155.551	45.029	20.473	167.755	58.148	130.080	34,57
40–50	2.395	117.359	27.363	17.657	126.641	37.525	106.772	44,58
50–60	1.420	77.126	13.959	13.543	83.487	19.590	77.440	54,54
60–70	792	48.701	7.905	9.692	52.847	11.551	50.987	64,38
70–80	480	32.034	4.916	7.951	34.987	7.083	35.854	74,70
80–90	285	21.112	2.665	5.848	22.622	4.283	24.187	84,87
90–100	222	16.846	2.160	5.831	18.480	3.279	21.032	94,74
100–110	87	10.419	1.394	4.334	11.451	2.140	13.645	156,84
110–120	130	7.256	805	3.432	7.946	1.391	9.987	76,82
>120	229	21.803	2.214	20.024	24.413	3.974	40.464	176,70

Sources: The Directorate of Internal Revenue