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TECHNICAL ASSISTANCE REPORT—MODERNIZING THE ICELANDIC VAT

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Modernizing the Icelandic VAT

April 2014

Thornton Matheson and Artur Swistak

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ABBREVIATIONS AND ACRONYMS

CIT	Corporate income tax
CO_2	Carbon dioxide
CPI	Consumer Price Index
EU	European Union
EUR	Euro (currency)
EEA	European Economic Area
FAD	Fiscal Affairs Department
GDP	Gross domestic product
HCS	Household Consumption Survey
IMF	International Monetary Fund
ISK	Icelandic krona
kg	kilogram
MFN	Most favored nation
mns	millions
MOF	Ministry of Finance and Economic Affairs
OECD	Organization for Economic Cooperation and Development
PIT	Personal income tax
RSK	Icelandic Revenue Administration
TA	Technical assistance
UK	United Kingdom
US	United States
USD	US dollar
VAT	Value-added tax
WTO	World Trade Organization

PREFACE

In response to a request from the Icelandic authorities at the 2013 IMF Annual Meetings for a technical assistance (TA) mission to advise on value-added tax (VAT) reform, a mission comprising Ms. Thornton Matheson (head) and Mr. Artur Świstak (both Fiscal Affairs Department, FAD) visited Reykjavik February 26–March 4, 2014.

At the Ministry of Finance and Economic Affairs (MOF), the mission met with Bjarni Benediktsson, Minister of Finance and Economic Affairs; Marianna Jonasdottir, Director General—Department of Taxation; Tomas Brynjolfsson, Director General—Department of Economic Affairs and Financial Services; and Deputy Directors Gudrun Thorleifsdottir and Sigurdur Gudmundsson. At the Ministry of Industry and Innovation, the mission met with Ingvi Mar Palsson, Director General—Department of Resource Management and Valgerdur Run Benediktsdottir, Director General—Department of Business Practices. At the Icelandic Revenue Administration (RSK), the mission met with Jon Gudmundsson, Head of Office, and staff; the mission also met with staff at the Directorate of Customs. At Statistics Iceland, the mission met with Rosmundur Gudnason, Director.

The team also met with representatives of the Icelandic Association of Local Authorities, private business and industry, employers and labor unions.

The mission wishes to thank Elin Gudjonsdottir, Head of Division, Department of Taxation, MOF for her excellent support in organizing and informing the mission.

EXECUTIVE SUMMARY

Iceland's government, elected in 2013, is conducting a general review of its tax policy with a view toward making it more efficient and less distortionary.[1] To this end, it has targeted VAT reform as a priority to become more reliant on consumption rather than income taxation. The narrow base and wide gap between the very high 25.5 percent main VAT rate and lower rate of 7 percent distort economic behavior and encourage tax arbitrage, evasion and lobbying. The efficiency of the Icelandic VAT is thus currently well below the European and OECD averages.

To address this situation, the government plans in the near term to broaden the base by eliminating exemptions, raising the lower rate, and reducing the top rate. In the medium term, the government targets a single-rate system. To offset the potentially inflationary effects of VAT reform and reduce price distortions, the government is considering repealing the commodity tax and reviewing the trade regime for agriculture. It may also seek to increase social benefits for low-income households most affected by the VAT increases.

These measures are all in accord with recommendations made by two previous IMF missions in 2010 and 2011. This mission reiterates its previous recommendations that Iceland should in the near term: (1) eliminate exemptions at least for tourism, transport, sports and culture; (2) limit VAT refunds to local government to services that could be outsourced; (3) double the lower rate to 14 percent; (4) reduce the top rate as revenue permits, depending on base broadening; and (5) in the longer term, move to a single VAT rate of about 21 percent. In addition, this report makes the following major recommendations:

- **Consider at least doubling the VAT threshold to ISK 2,000,000 (about USD 17,850 or EUR 12,900).** A higher threshold will ease administration, allowing limited RSK resources to be focused on the large taxpayers who generate most VAT revenue.

- **Fully tax all sales and leasing of commercial buildings, as well as first sales of new residential buildings**. While materials and construction activities are subject to VAT, sale of buildings has been exempt. This has created pressure for special refund schemes for builders to recoup their input VAT. Taxing commercial buildings and rent will remove this necessity and prevent cascading, while taxing first residential sales will broaden the VAT base to include housing consumption.

- **Eliminate special VAT refund schemes for buses, and domestic boats and aircraft, as well as CO_2 tax refunds for rental car imports.** These schemes have been

[1] "Iceland: Economic Program 2014", report by Ministry of Finance and Economic Affairs, Reykjavik, February 2014.

encouraged by the exemption of passenger transport, and by the anomalous taxation of car rental services at the top rate. Taxing transportation will remove the need for these accommodations and level the playing field for car rental companies.

- **Repeal the commodity tax on building products, appliances and electronics.** This will help offset the one-off inflationary effects of VAT reform and remove price distortions on these goods, which having neither inelastic demand nor negative externalities do not meet the criteria for special excise taxation.

- **If the sugar tax portion of the commodity tax is retained,** conduct a study to ensure that the price increase it imposes on sweetened products is sufficient to discourage their consumption. Alternatively, repeal the sugar tax and move sweetened products to the top VAT rate.

I. INTRODUCTION

1. **To increase the efficiency of its tax system, Iceland's new government plans to reverse the trend toward heavier income taxation since the 2008 financial crisis in favor of greater reliance on consumption taxation.** The crisis necessitated a sharp increase in tax rates to reduce the groundswell of public debt that resulted from the bank rescue. In response, the previous government raised all types of taxes, but direct taxes were raised more in the interest of progressivity (Table 1). The share of income and property taxes in total tax revenue rose from 49.2 percent in 2007 to 51.6 percent in 2012. The share of the personal income tax (PIT) rose almost 5 points as two upper brackets were introduced and the capital income tax rate doubled from 10 to 20 percent. The share of property taxes, which include the wealth tax introduced in 2010, also gained about one point. The share of corporate income tax (CIT) revenue remained more or less constant at around 6.5 percent due to the drop in profits over the period, but the CIT rate was raised from 15 to 20 percent.

Table 1. Pre- and Post-Crisis Revenue Structures

Tax	Percent of GDP		Percent of Tax Revenue	
	2007	2012	2007	2012
Tax Revenue	37.5	33.0	100.0	100.0
Income Taxes	18.4	17.0	49.2	51.6
PIT	13.8	14.2	36.7	42.9
CIT	2.5	2.1	6.6	6.4
Property Taxes	2.5	2.5	6.6	7.5
Taxes on goods and services	16.4	12.9	43.8	39.2
VAT	10.5	8.3	28.0	25.1
Excises	3.5	3.2	9.4	9.7
Trade	0.4	0.5	1.1	1.4
Other	2.0	1.0	5.3	3.1

Source: OECD Revenue Database.

2. **Early in the crisis, the government also raised the top VAT rate from 24.5 percent to 25.5 percent—at that point the highest rate in the OECD.**[2] This rate is well above the European and OECD averages, and even above that of other Scandinavian countries (Table 2). Despite this increase, however, the VAT's share of revenues fell about 3 points from 2007 to 2012, and its share of GDP fell about 2 points as its efficiency declined (Table 3). "C-efficiency", the ratio of actual VAT revenues to the product of the main VAT rate and total consumption (the ideal VAT base), measures the comprehensiveness of the rate regime, as well

[2] Hungary has since introduced a higher rate of 27 percent.

as the quality of compliance and enforcement.[3] OECD countries on average experienced a decline in VAT efficiency following the crisis of about 3 percentage points, while Iceland, along with several other countries including Ireland, the Netherlands and the U.K., experienced a much sharper drop of about 6 points. This is likely due in large part to shifting consumption patterns resulting from the sudden decline in incomes and expectations. Since most European governments levy reduced VAT rates on necessities such as food, any increase in the consumption share of basic necessities will reduce VAT productivity. Recessions have also been shown to negatively impact tax compliance, which may also account for part of the decline.[4]

Table 2. Selected OECD VAT Indicators

Country	Main VAT Rate	Reduced VAT Rates	VAT Threshold (EUR)
	2013		
Denmark	25.0	0.0	6,700
Finland	24.0	0.0/10.0/14.0	8,500
Iceland	25.5	0.0/7.0	6,450
Ireland	23.0	0.0/4.8/9.0/13.5	37,500 (goods) 75,000 (services)
Norway	25.0	0.0/8.0/15.0	6,000
Sweden	25.0	0.0/6.0/12.0	0
United Kingdom	20.0	0.0/5.0	95,900
OECD Average	19.0	NA	NA
EU-15 Average	21.4	NA	NA

Source: OECD Database.

3. **The government wants the current VAT reform to greatly improve the efficiency of Iceland's VAT, which is well below the OECD and European averages.** To this end, the Finance Minister wants to narrow the wide differential between the top and reduced rate (now 25.5 percent and 7 percent) and reduce the large number of exemptions. These features distort economic activity, create incentives for arbitrage and evasion, and complicate compliance and enforcement. Over the longer term, the government favors adopting a single-rate VAT, although it does not regard this goal as feasible in the short term and would thus have to approach it in steps.

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[3] M. Keen ("The Anatomy of the VAT", IMF Working Paper 13/111, 2013) finds that for OECD countries, most VAT efficiency loss is due to the "policy gap"— reduced rates and exemptions defined in the VAT law--rather than the "compliance gap"—evasion and/or lack of enforcement.

[4] J. Brondolo, "Collecting Taxes during an Economic Crisis: Challenges and Policy Options," IMF Staff Position Note 09/17, July 2009.

Table 3. VAT C-Efficiencies in Selected OECD Countries

Country	C-Efficiency				
	2008	2009	2010	2011	2012
Iceland	0.47	0.41	0.40	0.41	0.41
Denmark	0.54	0.51	0.51	0.51	0.51
Finland	0.51	0.49	0.46	0.49	0.47
Ireland	0.49	0.43	0.43	0.39	NA
Norway	0.50	0.48	0.49	0.49	0.50
Sweden	0.51	0.50	0.51	0.51	0.49
United Kingdom	0.42	0.37	0.37	0.42	0.41
OECD Average	0.53	0.50	0.52	0.48	0.46
EU-15 Average	0.50	0.47	0.47	0.47	0.45

Source: OECD Database.

4. **Concerns regarding VAT reform include the impact of increasing the lower rate and broadening the base on inflation, as well as raising the cost of living for lower-income households**. Iceland's economy, which has a history of periodic high inflation (Figure 1)—most recently following the 40 percent krona depreciation that accompanied the crisis—is extremely vulnerable to its effects. Household mortgages are usually indexed to inflation, so any increase in the monthly CPI is added immediately to their outstanding principal. Given the current high levels of household debt stemming from the recent property market boom and collapse,[5] any policy that accelerates inflation will meet stiff resistance. Typically for a Scandinavian country, Iceland also has strong labor unions, so any increase in inflationary expectations is likely to feed quickly through into higher wages. The government is currently engaged in long-term wage negotiations with unions, so inflationary policies are particularly unwelcome at this time.

5. The Finance Minister suggested several indirect tax measures that could help mitigate the effects of increasing the lower rate and broadening the VAT base. Increased revenues from those reforms could permit a reduction of the top VAT rate. The commodity tax, which imposes both specific and ad valorem excises of 15–25 percent on a variety of products including sweets, soft drinks, building materials, appliances and electronic goods, could be repealed. Additionally, trade rules could be reformed to allow greater competition and downward pricing pressure on various sectors, notably agriculture.

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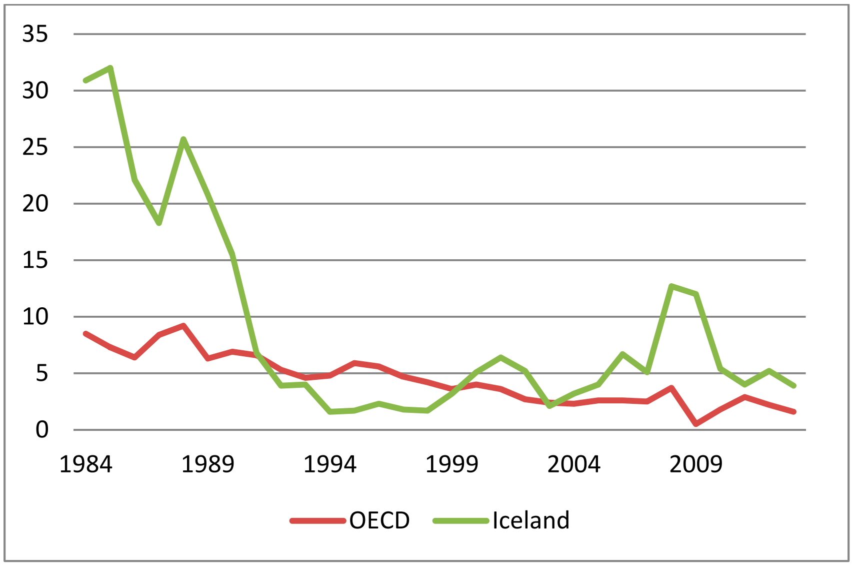
[5] As of mid-2013, household debt totaled 108 percent of GDP, and more than 80 percent of it was indexed to inflation. Central Bank of Iceland Financial Stability Report, 2013:2.

Figure 1. Iceland's History of Inflation



6. **As noted in the 2010 and 2011 IMF tax policy TA reports[6], taxing basic necessities at a reduced rate in an effort to support lower-income households is an inefficient subsidy.** Wealthier households also buy basic necessities, and because they consume more overall they usually receive most of the subsidy. Iceland's Household Consumption Survey (HCS) indeed shows that the consumption share of food expenditure by the lowest quartile of households, 16 percent, does not differ much from the 14 percent share of the entire population. It is therefore more efficient to tax all goods at the same rate and to spend some of the increased revenue on subsidies targeted directly at lower-income households. Labor representatives noted their concern, however, that targeted expenditures may be more politically vulnerable than broad-based tax expenditures. While some countries find targeted subsidies difficult to administer, Iceland has a well developed social welfare infrastructure and could handle this through existing programs, such as child benefits or PIT expenditures. This report will focus on reform of indirect taxes, while PIT and benefit adaptations will be deferred for follow-up TA.

7. **The government's roadmap for VAT reform is highly consistent with the recommendations of the 2010 and 2011 TA reports.** The reports from these missions recommended: (1) that the lower VAT rate be increased back to its 2007 level of 14 percent; (2) that exemptions for at least transportation, travel agencies and sports and culture be eliminated by taxing these items at the lower rate; (3) that the top rate could then be lowered in a revenue neutral manner to help offset the inflationary impact of those measures; and 4) that the

[6] J. Escolano, T. Matheson, C. Heady and G. Michielse, "Improving the Equity and Revenue Productivity of the Icelandic Tax System," International Monetary Fund, June 2010. P. Daniel, R. de Mooij, T. Matheson and G. Michielse, "Advancing Tax Reform and the Taxation of Natural Resources," International Monetary Fund, May 2011.

government aim in the medium term at returning to a single VAT rate. The IMF cautions, however, that any reform of the tax regime should be at least revenue-neutral, since sticking to Iceland’s path of medium-term fiscal consolidation is critical to krona stability and capital account liberalization, which are in turn necessary for price stability and growth.

II. VAT Reform

A. Overview

Issues

8. **Though it has several positive features, Iceland's VAT has a relatively narrow base, a high top rate and a low reduced rate, numerous special refund schemes, and a fairly low registration threshold.** These features distort competition, encourage arbitrage, evasion and lobbying, and complicate administration.

Discussion

9. **The Icelandic VAT's narrow tax base and numerous exemptions distort competition and produce pressure for special VAT refund schemes.** For example, exempt transport services compete with car rental services, which are taxed at the top rate. Exemption of real estate necessitates a special VAT refund scheme for building contractors. And local governments receive VAT refunds when providing exempt services, giving them an edge over private providers. Broadening the VAT base to eliminate unnecessary exemptions would not only raise revenue, but alleviate economic distortions, simplify administration, and remove the need for special refund schemes.

10. **The large gap between the top rate of 25.5 percent and the reduced rate of 7 percent creates a strong incentive for businesses to lobby for reclassification of their products.** Recently, diapers were moved from the top to the lower rate—first just cloth diapers, and then disposable diapers as well, despite their negative environmental impact. Now, retailers are pushing for a similar reclassification for clothing, citing the prevalence of cross-border shopping (especially in the UK, which exempts children's clothing from VAT). Narrowing the gap between the rates in the short term and moving to a single, lower rate in the medium term will alleviate this problem. Eliminating exemptions and raising the lower VAT rate will allow the top rate to be reduced slightly in the near term, but VAT revenue should not be reduced on net.

11. **More general reform of indirect taxes, notably the commodity tax, will alleviate inflationary pressures from increased VAT coverage, and rationalize consumption taxation**. At present, consumption taxes often pursue conflicting goals: For example, the commodity tax penalizes sugary foods, but they are then taxed at the lower VAT rate. Similarly, building materials are subject to a special 15 percent commodity tax, but constructions are not subject to the VAT. It would be more efficient to repeal the commodity tax and broaden the base of the standard VAT rate.

12. **To further facilitate VAT administration, which currently consists of only 30 staff nationwide, the VAT threshold could be at least doubled to ISK 2,000,000.** Although low VAT thresholds are fairly common in Europe, some countries including the UK and Ireland

have set much higher thresholds (Table 2) to help ease administration.[7] Best practices prescribe a high threshold in order to focus administrative resources on larger taxpayers, who provide most of the revenue (Table 4). Indeed, many small registrants (particularly voluntary registrants below the threshold) have negative liabilities or remit minimal VAT at best.

Table 4. VAT Remittances by Taxpayer Turnover

Turnover (ISK mns.)	No. of taxpayers	Net VAT payable (ISK mns.)	Percent of Total VAT Revenue
< 1	10,176	-3,864	-34
1 to 5	8,439	2,183	19
5 to 10	4,978	4,160	36
10 to 100	8,960	21,494	188
100 to 500	1,808	21,956	192
500 to 1,000	258	4,251	37
1,000 to 5,000	281	9,562	84
5,000 to 10,000	46	1,234	11
> 10,000	53	-49,561	-434
Total	34,999	11,416	100

Source: Ministry of Finance.

Recommendations

- Eliminate exemptions for construction, tourism services, transportation, sports and culture, and postal services.
- Increase the lower VAT rate to 14 percent in the near term, and reduce the top rate to the extent allowed by revenue pressures.
- Eliminate zero-rating of goods and services other than imports by repealing special refund schemes.
- In the longer term, move to a single-rate VAT.
- Consider at least doubling the VAT threshold to ISK 2,000,000 to ease administration.

[7] The UK and Ireland's low efficiencies should not be attributed to their high thresholds, but rather to extensive application of reduced VAT rates.

B. Food and Agriculture

Issues

13. **All sales of food products and other goods for human consumption are subject to reduced VAT rate at 7 percent**. There are no explicit limitations to this category except for alcoholic beverages. Food and other goods for human consumption are defined by reference to customs codes. In addition to VAT, a commodity tax is levied on sugar and sugary products (Chapter III).

14. **Agriculture is subject to the standard VAT rules, with two notable exceptions:** In contrast to filing regular monthly VAT returns, farmers submit returns and settle their tax payments on a six month basis; however, they may request an immediate VAT refund if they have significant claims due to the purchase of investment or operational goods. A reverse charge mechanism is available for agricultural producers.

15. **Also, contractual payments to milk producers and sheep farmers are zero-rated**. These subsidies are paid by the government to the milk processors and slaughterhouses to which farmers deliver their products, and the processors then pass them on to farmers as part of the payment for their deliveries. Processors generally reverse-charge VAT on their payments to farmers, but not on the contractual payments. Only production that has been contracted with the Ministry of Agriculture according to its quota system receives these subsidies, which are geared towards lowering consumer prices of milk and lamb.

Discussion

16. **There is a large gap between the standard VAT rate and the reduced VAT rate applied to food products.** While the majority of consumption is taxed at the high rate of 25.5 percent, the reduced rate applied to food products in Iceland is one of the lowest in both the OECD and the EU. Thirteen members of the EU apply a rate lower than 7 percent to foodstuffs, but rarely to all food products. Only Luxembourg, Malta and the Netherlands apply a rate lower than Iceland's to all food products. In terms of the absolute difference between the standard and reduced rates, the gap in Iceland—18.5 percentage points—is the largest when compared to the EU and OECD members. As stated in previous IMF TA reports, this gap creates distortions and inefficiency and calls for a reduction.

17. **Taxation of food products at a reduced rate is very costly and does not significantly improve the progressivity of the tax system.** In percentage terms, all households benefit almost equally from the rate reduction, but in absolute terms wealthier households benefit more.[8] Even though reduced VAT rates or exemption of food products is not an efficient

[8] For further discussion on revenue implications and distributional concerns see Chapter IV. Also see discussion in previous IMF TA reports, 2010 and 2011

subsidy, it is not unusual for governments to use such a policy approach. Nevertheless, not many of them apply exemption or a reduced rate to all foodstuffs; usually they limit this policy to basic food categories. Highly processed food, delicacies or unhealthy products are very often excluded from preferential treatment. There are, however, merits in treating all food products equally, as it adds to simplicity of tax compliance and administration and does not distort product choice. Therefore, closing the gap between the standard and reduced rate on food products should be a priority for Iceland.

18. **The best approach would be to tax all food at a standard rate.** Revenue gains from this increase could be used to lower the very high standard rate and also to fund compensation to those mostly affected—households in the lowest income quartile. As recommended by the previous missions, a single rate may be approached in two steps—first increase the reduced rate to 14 percent and broaden the tax base, then implement a unified VAT rate for all goods and services at a much lower, approximately 21 percent rate. If this is not possible or revenue pressures are high, then taxing at least non-staple food at a standard rate should be considered.

19. **Treatment of agriculture on a par with other business activity is laudable.** This is a best practice not always followed by other countries, even developed nations with efficient tax administrations. Farmers do not differ from other businesses. In this context special rules for registration and filing by farmers are not needed. Both the tax administration and farmers themselves would benefit from standard treatment, especially filing on a two-month rather than a six-month basis. The six-month filing policy may have been justified 25 years ago when tax administration was not computerized, farmers lacked the capacity to cope with frequent filing, and the seasonality of farming was more pronounced, but now it calls for revision.

20. **Zero-rating of contractual payments to dairy and lamb farmers likely increases administrative costs without improving VAT productivity**. The proper treatment of these payments hinges on their classification as subsidies or payments for supplies. Income subsidies, like other transfers made by government, are typically not subject to VAT, as they do not meet the criterion of a taxable supply. Because the contractual payments are passed through the processors, however, they become part of the price received by farmers for their supplies and thus should arguably be subject to VAT. Since these transactions are concluded between two taxable entities, there is no net impact on the VAT base or revenues from zero-rating them: farmers' VAT liabilities are reduced, but processors' liabilities increase by the same amount. However, the administrative cost of zero-rating is likely to be higher, since farmers are more likely to be in a refund position. Taxing the contractual payments would thus reduce the need to make refunds to many small farmers.

Recommendations

- Increase the VAT reduced rate on food products to at least 14 percent.

- If a general increase of the VAT rate on all food is not feasible, consider imposing VAT at a standard rate on non-staple food, including sugary products.

- Treat agriculture on a par with other business activity: Do not request special registration and allow for filing on regular basis.

- Repeal zero-rating of farmers' subsidies paid through intermediaries (meat and milk processors).

C. Real Property and Construction

Issues

21. **Real property does not fall within the scope of the Icelandic VAT**. Accordingly, supply of real property is not a taxable transaction and does not attract VAT. Rental of real property, including parking spaces, is exempt regardless of its residential or commercial character. However, in the latter case a special VAT registration is available for those choosing to be in the VAT net. Rental of hotel accommodation, guestrooms and camping lots is taxable if its duration does not exceed one month. Building materials and construction services are taxed at the standard VAT rate. In addition, many building materials are subject to commodity tax at 15 percent.

22. **Input VAT paid on commercial property construction is refunded.** Upon receiving special registration, developers may seek refund of VAT paid on all inputs used in construction of real property if such a property is sold to a VAT registered taxpayer. This VAT refund amortizes over the following 20 years on a straight-line method. Any subsequent sales of commercial property to VAT registered taxpayers do not attract VAT and do not give rise to a credit or refund. However, in cases where a property is further sold to a non-registered person within 20 years from the initial sale, the amortized balance of the refunded VAT is chargeable upon sale (5 percent of the amount refunded for every year short of the 20 years time limit).

23. **Partial refunds of input VAT paid on development, improvements and maintenance of residential property are also available.** Persons engaged in building of residential housing, building for themselves or for sale, are entitled to a refund of 60 percent of the VAT paid on construction labor purchased by them. Similar reimbursement is available to owners of residential housing for services purchased in connection with maintenance and improvements to their housing. In March 2009, the scope of services eligible for VAT refunds was broadened to include also services provided by licensed architects and inspectors, and the amount of the refund was increased to 100 percent. The purpose of these measures was to stimulate the building trades, which collapsed in the financial crisis, and to combat informality in the construction industry. This broadening is now bound to expire at the end of 2014 unless extended as in previous years.

Discussion

24. **In VAT terms, real property is akin to other durable goods and services**. Under a pure VAT all transactions regarding real property by VAT-registered taxpayers attract output tax, while purchasers or users of real property are entitled to a corresponding input tax credit when the property will be used to make taxable supplies. Net VAT revenue is then only collected if the purchaser or user of the property is not a business or uses the property for making exempt supplies. In practice, however, all VATs distinguish between residential property and commercial property, mainly to ensure that VAT does not "stick" on the latter.

25. **Modern VAT systems exempt residential property only**. Many countries, including Australia, Canada, New Zealand, and most of the EU member states tax the sale, lease, alteration and maintenance of all real property. However, residential rents and the sale of previously occupied residential property (unless sold by a property developer who is a registered VAT taxpayer) are exempt. Hotels and other places of lodging are taxed unless they provide long-term accommodation. On balance, all construction, repair and maintenance services, related professional services, and the supply of all building material, including those used in construction of residential buildings, are taxable supplies.

26. **The VAT treatment of real property in Iceland deviates from international standards and appears to be fairly opaque and unnecessarily complex.** Rather than taxing sales and leasing of commercial buildings in a standard way, surrogate measures were adopted to prevent VAT sticking on business inputs and thus VAT cascading: i.e., special reimbursement of VAT paid on construction of an initially sold building and special registration of lessors renting out commercial buildings (Table 5). These measures are complex, costly in terms of compliance and tax administration, and no more efficient than standard taxation.

Table 5. VAT Treatment of Real Property and Construction

	Type of transaction	Standard treatment	Treatment in Iceland
Sale	Commercial buildings	Taxed	Zero-rated (refund of input VAT) - if supplied to taxable person; Otherwise exempt
	Residential buildings - initial sale	Taxed	Exempt
	Residential buildings - subsequent sale	Exempt	Exempt
	Construction services	Taxed	Zero-rated (refund of input VAT) if related to residential housing; Otherwise taxed
	Construction materials	Taxed	Taxed
Lease	Commercial buildings	Taxed	Taxed if a lessor chooses to apply fo a special registration (special conditions apply); Otherwise exempt
	Residential buildings	Exempt	Exempt

Source: VAT Act

27. **Taxation of new residential property should be considered**. Housing is part of any household consumption, not much different from other expenditures satisfying basic needs, e.g., food, water or heating, and under a broad-based VAT should be taxed. This is justified also on equity grounds, in particular to the extent that some low-income households tend to self-build and thus bear only input tax on the building materials and a few construction services that they purchase. Taxation of the initial sale of residential building represents taxation of all future housing services rendered by a given property; therefore, subsequent sales of pre-occupied residential property should be exempt. In terms of efficiency, taxation of newly constructed housing allows developers to credit input VAT and thus creates an incentive for formalizing their activity. No refunds have to be paid on inputs purchased by developers of residential property for sale. It also reduces distortions typical to exempt activities, e.g., self-supply bias, and helps further to develop the construction sector. Taxation of new residential property may lead to some price increase, but not by the full amount of the output VAT. Only the developer's margin will be added to the final tax base, since under exemption all input VAT is shifted to home or apartment buyers anyway. One way to reduce the price increase from subjecting residential properties to VAT would be to abolish the commodity tax paid on building materials (Chapter III).

28. **Zero-rating of construction services constitutes a poorly targeted subsidy.** Even though it may help stimulate demand for construction services and tackle tax evasion in that sector, these factors must be weighed against revenue loss and compromised fairness of the tax system. First, the refund policy is likely regressive, since better-off households tend to spend more on housing, including maintenance and improvements. Further, not all contractors evade taxation, and in those cases where VAT would have been collected anyway, zero-rating constitutes a deadweight revenue loss for the state. By taxing construction services, the

government could collect enough revenue to improve tax administration and enforcement in the sector. VAT is traditionally perceived as tax on those who are difficult to tax, because even evaders must buy taxed inputs for their business. When their services are zero-rated, the state may give up all VAT beyond what could be collected even if all contractors chose to evade. Although the VAT refund on construction is supposed to apply only to labor services, the refund policy raises the risk that contractors may try to shift the VAT on some of their inputs into that amount. Policing whether a contractor included VATable materials in the price of his service is no easier or cheaper than detecting informal and underreporting businesses.

29. **It is also unusual to use the VAT system to stimulate demand for particular goods and services.** The EU experience with reduced VAT rates on labor intensive services (e.g., bicycle repairs, hairdressers, etc.), where the intention was to stimulate demand for services usually performed by taxpayers themselves and boost employment in this sector, did not prove to be successful.[9] Moreover, any effectiveness of such incentives is likely to decline over time. Now that Iceland's economy is recovering, the demand for construction services is likely driven by other factors than VAT refunds, presenting an opportunity to repeal this preference. Reducing tax expenditures on construction will also help remove the bias towards homeownership rather than renting, as renters are not entitled to any refunds of VAT paid on their maintenance or improvements expenditures.

Recommendations

- Bring all commercial properties into the VAT system:
    - Tax sale and lease of commercial property.
    - Abolish reimbursement of input VAT on newly constructed commercial property along with the special registration scheme for lessors.
- Tax newly constructed residential property, but exempt sales of pre-occupied residential property and lease of all residential property.
- Abolish refunds of input VAT paid on construction services for home builders and home owners, and use part of increased revenue to fund improvements in tackling tax evasion in construction sector.

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[9] See discussion in *Study on reduced VAT applied to goods and services in the Member States of the European Union*, Copenhagen Economics, 2007

D. Tourism Sector

Issues

30. **Services typically associated with tourism receive differential treatment under the VAT (Table 6)**. Hotel accommodation, including rental of rooms in guesthouses and of camping lots, as well as dining in restaurants are taxed at the reduced rate of 7 percent. In addition hotels charge a flat tax (ISK 100 per room per night). Other guest services, usually provided by hotels, e.g., personal care and wellness, telecommunication or laundry services, as well as alcoholic beverages are taxed at a standard rate of 25.5 percent. Passenger transportation, including taxi services and domestic flights, is exempt. Guided tours, including sightseeing, whale watching and horse hiring are treated as passenger transportation and thus also exempt. Travel agent services are also exempted.

31. **Rental of cars is taxable at a standard rate**. This extends also to other motor vehicles, e.g., jet skis and snow-mobiles, and even horse rental. Excise tax paid on passenger cars is partially refunded to car rental owners. The amount of the refund depends on the CO_2 classification of cars—the higher the emission level (and thus excise tax paid) the higher the refund. A company benefiting from the refund may not sell the car for 15 months and has to pay an exemption fee of ISK 1.75–6.75 million, depending on the number of cars imported.

Table 6. Summary of VAT Treatment of Tourism Sector

Type of supply/import	VAT rate
Hotel accomodation	7 percent
Other guest services 1/	25.5 percent
Restaurants	7 percent
Restaurants (alcoholic beverages)	25.5 percent
Travel agents	exempt
Guided tour services 2/	exempt
Car hire 3/, 4/	25.5 percent
New coaches and buses 5/	partial refund
Old coaches sold abroad	Refund of 20.32 percent ofsale price 6/
Domestic flights	exempt
Maintenance of aircrafts and boats	zero-rated

1/ E.g., personal care and wellness, telecommunication, loundry
2/ Treated as passenger transportation; include sightseeing, whale watching, horse riding, etc.
3/ Including hire of jet skis, horse hiring, etc.;
4/ Excise tax paid on cars is partially refunded (from 20 to 46 percent - depending on CO2 emission level)
5/ Two thirds (2/3) of VAT paid on imports is refunded (effectively taxed at 8.5 percent)
6/ This corresponds to depreciated input VAT paid upon purchase of a coach

Source: Icelandic VAT Act, MoF and Icelandic Travel Industry Association

32. **Since 2011, refunds of two-thirds of input VAT are available to operators of motor coaches and buses**. These apply to purchase or lease of new coaches or buses meeting at least the standards of EURO 5 emission limits. Operators of motor coaches are also entitled to reimbursement of 20.32 percent of the sales price if they sell them abroad. This corresponds to a depreciated refund of VAT paid upon importation.

33. **In addition, sale, leasing and maintenance services related to aircrafts and boats are zero-rated.** This does not include private aircrafts and small boats, but is applicable to most of the crafts used for tourism purposes.

Discussion

34. **The tourism sector in Iceland is lightly taxed under the VAT**. Reduced rates, exemptions and refunds not only deprive the government of needed revenue, but also complicate compliance and tax administration and lead to efficiency loss. This calls for a thorough review of and changes to the VAT treatment of services and goods supplied in the tourism sector.

35. **The 7 percent rate on hotel accommodation and restaurant services is low compared to elsewhere in the EU (Table 7)**. Although reduced rates for hotel accommodation and restaurants are quite common in Europe, the unweighted average VAT rate for hotel accommodation in the EU exceeds 11 percent, which is roughly half of the unweighted average standard VAT rate. Not all countries, however, resort to using reduced rates for hotel accommodation and/or restaurants. Four countries, notably Denmark, Lithuania, Slovakia, and the UK, tax hotel accommodation at standard rates, and a few countries reduced their hotel VAT rates only in response to the recent financial crisis.

Table 7. VAT Reduced Rates for Hotels, Restaurants and Transport in the EU

Country	Rate			
	Standard	Hotels	Restaurants	Transport 1/
Austria	20	10	10	10
Belgium	21	6	12	6
Bulgaria	20	9	20	20
Croatia	25	13	13	25
Cyprus	19	9	9	9/19
Czech Republic	21	15	21	15/21
Denmark	25	25	25	25/ex
Estonia	20	9	20	20
Finland	24	10	14	10
France	20	10	10	10
Germany	19	7	19	19
Greece	23	6.5	13	13
Hunagry	27	18	27	27
Ireland	23	9	9	ex
Italy	22	10	10	10/ex
Latvia	21	12	21	12
Lithuania	21	21	21	21
Luxembourg	15	3	3	3
Malta	18	7	18	0/18
Netherlands	21	6	6	6
Poland	23	8	8	8
Portugal	23	6	23	6
Romania	24	9	24	24
Slovakia	20	20	20	20
Slovenia	22	9.5	22	9.5
Spain	21	10	10	10
Sweden	25	12	12	6
United Kingdom	20	20	20	0
Unweighted average	21.6	10.7	15.6	x

1/ Domestic passenger transport by air, see, inland waterway, rail or road

Source: European Commission (January, 2014)

36. **In the case of restaurants, the average VAT rate in the EU is higher, at 15.7 percent, or 73 percent of the standard rate.** Fourteen countries, i.e., half of the EU members, do not use reduced rates for restaurants, and three of those who do (Belgium, Greece, and Finland) apply a higher rate than they apply to hotel accommodation: 5 percentage points on average. The same is true for Norway, the closest competitor to Iceland in tourism sector, where hotel accommodation is subject to a 9 percent rate but restaurants are taxed at

15 percent. Even if the price of hotel accommodation plays a role in choice of destination by foreign tourists, restaurant prices are not necessarily taken into account. This argument is willingly used by many countries, not only in the EU but other popular tourism destinations, e.g., the Caribbean countries. Revenue forgone due to the reduced rate on accommodation may be thus partially recouped by higher than present taxation of meals.

37. **There is, however, no compelling evidence that reduced rates on hotel accommodation help attract foreign tourists in Iceland.** A survey of foreign visitors conducted by Icelandic Tourism Board (2013) confirms that a suite of other factors tends to weigh more heavily on the destination choice: Natural wonders and unique attractions are probably the most important ones. The representatives of the tourism industry in Iceland do not see many countries as direct competitors to Iceland, with Norway being the only notable exception. Unlike in the Caribbean, where every country offers virtually the same product (sun and sand), Iceland with its aurora borealis, whale watching, thermal baths, glaciers and geysers as well as historical attractions is fairly unique. Even in the Caribbean, however, hotel accommodations are usually subject to about a 10 percent VAT rate.

38. **The tourism sector in Iceland is rapidly growing.** The number of foreign visitors has been increasing since 2000 on an average by 7.3 percent annually. In 2012, almost 700,000 tourists visited Iceland—19 percent more than in 2011. It is forecast that by 2020 Iceland may expect 1 million tourists.[10] In tandem with the number of foreign visitors, tourist spending in Iceland is steadily increasing: in 2012 it was ISK 106 billion, 15 percent more than in 2011. The hotel room occupancy rate is also up from 69 percent in 2012 to 75 percent in 2013. With a shortage of rooms (3,700 in 2013), Iceland is a more supply- than demand-constrained market where hotel accommodation prices are of less significance. In the coming years, a number of rooms in upscale hotels will be added to cater to more demanding and less price-sensitive tourists. The condition and prospects of the tourism sector thus warrant increases in the VAT rate on hotel accommodation. The timing to implement this change is now perhaps better than any time before.

39. **There is also room for change in VAT taxation of passenger transportation.** Only in a handful of European countries is transportation exempt, and if so it is only public transportation. Taxi and tours are taxable either at standard or reduced rate. Such treatment is warranted on equity and efficiency grounds. If a person chooses to use a taxi, they do it for convenience rather than necessity if public transportation is available. Tours are used exclusively for leisure, and mostly by foreigners. Since this is a significant market in Iceland, it could be an important revenue source for the government without any loss in welfare. Taxation of private passenger transportation services will also help reduce distortions between renting a car, using a taxi or tour services. These are substitutes but receive different treatment under the

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[10] *Tourism in Iceland in Figures, April 2013*, Icelandic Tourism Board, page 3

Icelandic VAT. Even if Iceland chooses not to tax genuine passenger transportation services, including taxi and domestic flights, it is important to better define what passenger transportation is. Guided tours, including sightseeing, whale watching and horseback riding, are forms of entertainment rather than movement from one location to another. An alternative to those tours is not a different mode of transport or telecommunication but choice of other leisure activities. They should therefore be taxed at the standard VAT rate.

40. **Taxation of passenger transportation services would ease compliance and administration in the tourist sector and eliminate distorting incentives.** Under standard taxation, tour operators would be able to credit the VAT paid on their inputs and zero-rate their exports without the need to apply for special refunds. Standard taxation of passenger transportation services would also eliminate the need to distinguish between transportation (exempt) and rental (fully taxed). At present, the two are often distinguished by the presence or absence of a guide, but one could easily be represented as the other (e.g., rental of a snowmobile as a snowmobile tour). Taxation of transportation would also remove the distortion between using new coaches and older ones. Although the authorities' desire to replace the old fleet of coaches is commendable for environmental reasons, it may be better achieved by excise or motor vehicle taxes. Any potential bias to import new coaches would be eliminated, as would be any inefficiency in domestic trade in coaches.

41. **Zero-rating of sales and lease of aircrafts and boats, as well as their maintenance constitutes a generous subsidy to tour operators.** This relief, perhaps designed for those engaged in international transportation, may be easily used by domestic transport services providers, including tour operators. Unlike VAT exemption, where the government agrees to give up only a portion of VAT on a given good or service, with zero-rating the loss of revenue extends to VAT paid on inputs. Providers of tour services by boat or aircraft, unlike those using used coaches or smaller passenger vehicles, enjoy not only exemption from their value added but also exemption of tax on their inputs. Standard taxation of passenger transportation would eliminate this distortion (or "close the loophole", as noted by one industry expert).

42. **Excise tax relief provided to car rentals is not necessary and violates the environmental policy objective.** Although car hire services are fully taxable under VAT, the cost of their input is reduced by refunds of excise tax. This is another example of the authorities' adjusting the cost of inputs for a particular sector regardless of whether it is justified on policy grounds. If the authorities desire to lower the cost of cars, they may easily do it by adjusting the schedule of excise taxes. It should, however, be done to the benefit of everyone, not only car hire customers. This is not only because such an approach creates bias towards the use of rented cars, but also because the excise tax on cars is imposed to correct negative externalities, i.e., the pollution they cause. For this reason all that should matter is the level of pollution and not the form of possession at the time of driving—own vs. rented car. This argument is aggravated by the structure of the relief: the higher the level of CO_2 emissions of a given car, the greater the relief. The requirement to use the car by rental agencies for only 15 month also raises important concerns. The economic usefulness of cars usually exceeds five

years. Under the Icelandic CIT, cars are depreciated over 10 years. The wear and tear of rented cars may be somehow higher than a regular company car, but its life is far longer than 15 months. In such a setting, rental agencies may well be engaged in car dealing rather than renting business. If abolishing excise tax relief is not possible, the authorities should at least extend the time requirement for resale of subsidized cars.

43. **Overall, VAT taxation of the tourism sector requires the authorities' attention and reform.** The Association of Icelandic Tourism is aware of the complexities of VAT taxation of their sector and advocates its simplification by subjecting all the services to a uniform reduced VAT rate (7 percent or perhaps slightly higher). There are merits in such an approach, but careful assessment should be undertaken. Unquestionably broadening the VAT base by applying a uniform VAT rate to all activities of the tourism sector would improve efficiency and simplifies taxation, bringing savings to businesses and revenue to the government. Consideration of the nature of many tourism services, the taxable supplies with which they compete, and the fact that they are usually consumed by foreigners, suggests that the standard VAT rate would be appropriate for most of them. If a reduced rate is to be applicable, for equity and revenue generation reasons, it should not extend at least to tour operators and restaurants.

Recommendations

- Increase the VAT rate on hotel accommodation to at least 14 percent when raising the reduced rate.
- Tax restaurant services at standard VAT rate.
- Remove the VAT exemption on passenger transportation and tourism services; tax them at standard VAT rate.
- Abolish VAT refunds for the import and sale of coaches and domestic boats and airplanes.
- Abolish excise tax relief for cars imported by car rental businesses.

E. Government Services

Issue

44. **Under Article 2 of the VAT Act, Iceland exempts from VAT a broad array of goods and services that are frequently provided by government entities**. These include health, education, child care centers, postal services, transportation, sports and cultural activities. VAT charged on inputs into these services is generally therefore not refunded and becomes part of the cost of provision. However, Article 42 of the VAT Act permits states, municipalities and their agents to claim refunds for their VAT paid on certain services, including: waste and snow removal; cleaning services; rescue, emergency and security activities and various professional

services (engineers, lawyers, architects, etc.). The purpose of Article 42 is to alleviate the incentive that VAT exemption creates for "vertical integration" vs. outsourcing. Article 3 of the VAT requires government services provided in competition with taxable private parties to be subjected to VAT.

Discussion

45. **The provisions in Articles 2 and 42 of the VAT Act have the potential to distort on two margins:** the selection of inputs used in producing exempt services, and competition between public and private entities to provide those services. The IMF's 2010 TA report discussed the former issue in some depth, and recommended that, given the prevailing fiscal constraints, local governments be reimbursed only for VAT on services that could be outsourced. Local authority representatives estimate that, at present, local authorities pay approximately ISK 8–10 billion in input VAT, of which about ISK 1.3 billion is refunded.

46. **As noted in the 2010 report, the most comprehensive solution to this problem, as practiced in New Zealand, is for government services to be fully taxed**, whether on the basis of consideration paid, grants received, or the local tax bill. This eliminates the problem of trapped input VAT and puts government and private entities on an equal footing. However, it would necessitate a general rebalancing of central and local government revenues and could result in redistribution of tax liabilities across households. Taxing government services also does not conform with European practice (including the EU VAT directive). This mission therefore affirms the current system of limited reimbursements targeted solely at areas that affect procurement. Representatives of both government and private entities complain, however, that efficient procurement practices are constantly changing, while the reimbursement rules often fail to keep pace. Information technology and eldercare services were cited as examples of current problem areas. Periodic review of VAT reimbursement rules to ensure that they reflect current best practices in procurement thus appears advisable.

47. **While VAT reimbursement helps alleviate government procurement distortions, it slants the competition between government and non-governmental provision of exempt services.** Although VAT exemptions apply to both public and private providers, the VAT reimbursements in Article 42 apply only to government entities. Public providers will therefore have a cost advantage in providing exempt goods and services over private or non-profit entities, which are not eligible for reimbursements.[11]

[11] Article 3 of the VAT Act provides that, where government entities provide taxable goods or services in competition with taxable providers, they must also charge VAT. For example, governments renting vehicles from a municipal car pool pay 25.5 percent VAT on the rental, the same as if renting from a private agency.

48. **While subjecting all government services to VAT may be infeasible, greatly narrowing the scope of exempt activities would correspondingly reduce the scope of distortions.** Exemptions should be limited to core public goods, such as health and education, while services in which private and non-profit entities could compete, such as postage, sports and culture, should be taxed. A broader approach would be to tax all consideration paid for public services, but not the taxes or grants with which those services are also financed. Taxing a wider array of services will automatically permit government entities to recoup more of their input VAT without seeking higher reimbursements from the central government, and will allow non-governmental entities to compete for provision of these services on a level playing field.

Recommendations

- Reduce the scope of VAT exemption to core public goods, such as health and education.
- Tax other services including postage, sports and culture, and public transport at least at the reduced VAT rate.
- Restrict VAT reimbursements to local governments to services that can be outsourced, and conduct periodic reviews of best practices in service procurement.

III. OTHER INDIRECT TAXES

A. The Commodity Tax

Issues

49. **Iceland's Commodity Tax Law 97/1987 imposes specific and ad valorem excises on various goods other than tobacco, alcohol and petroleum products.**[12] The government is considering repealing the commodity tax to reduce economic distortions and relieve the inflationary pressures that may result from VAT reform.

50. **Sections A and B of the Commodity Tax Law, which were extensively revised in 2013, constitute the "sugar tax".** They impose a specific tax of ISK 210 per kilogram (kg) of sugar or ISK 42 per gram of artificial sweetener on food and drinks, based on the average sweetening content of items in each customs classification code.[13] This tax was more than tripled from ISK 60 per kg in 2013. The 2013 reform also sought to improve the incentive to reduce sugar content by allowing producers and importers of foods with below-average sugar content for their customs category to opt for taxation based on their product's actual sugar content. For example, if the average product in a category contains 50 percent sugar, then the tax will be ISK 105 per kg, but a product in that category containing only 25 percent sugar could opt to be taxed at a rate of ISK 52.5 per kg instead.

51. The European Economic Area (EEA) has lodged a complaint against the sugar tax because it discriminates between the taxation of imports and domestically produced goods. Importers of sweet goods pay a final tax at the border, whereas domestic producers receive a credit for sugar imports and are finally taxed only on products sold. Importers thus pay the sugar tax on all imports, including on goods that spoil and are not sold.

52. **The ad valorem duties imposed by the commodity tax are:** a 15 percent duty on various building materials and automotive spare parts (Section C); a 20 percent duty on various large household appliances (Section D); and a 25 percent duty on various electronic goods (Section E).

Discussion

53. **Generally speaking, excise taxes should be limited to goods that have inelastic demand and/or negative externalities**. To the extent that demand for these goods is inelastic, they will raise revenue in an efficient manner (i.e., without distorting economic behavior); and

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[12] Excises on these products, specified in Law No. 29/1993, Law No. 96/1995 and Law No. 87/2004, were addressed in the 2010 and 2011 TA reports.

[13] Section A imposes a tax per kg on sweetened foodstuffs, and Section B a tax per liter on sweetened drinks.

to the extent that the excises do change behavior by decreasing consumption, they will correct the externality. This group of goods typically includes tobacco, alcohol, and petroleum products.

54. **Concern about the rising rate of obesity, which imposes substantial health care costs, has prompted numerous countries to introduce taxes on sugar and/or fats in recent years.** Denmark, for example, increased its excises on chocolate, ice cream, sugary drinks and confectionery by 25 percent in 2010. In 2011, it also introduced a tax on foods containing more than 2.3 percent saturated fats, but repealed it in November 2012 due to a surge in cross-border shopping to Germany and Sweden. Hungary introduced a tax on selected manufactured foods with high sugar, salt or caffeine content in 2011. The same year, Finland introduced a tax of 0.75 per kg on confectionery products and raised its excise tax on soft drinks from 4.5 cents to 7.5 cents per liter. France introduced a tax of EUR 0.072 per liter on both sugary and artificially sweetened soft drinks in 2012. Numerous other countries including the United States, some of whose localities have already enacted sugar or soft drink taxes, are considering introducing such taxes.

55. Preliminary studies of sugar taxes suggest that large pricing changes may help discourage consumption of unhealthy goods. Bahl, Bird and Walker (2003)[14] found that the elasticity of demand for soft drinks in Ireland was slightly larger than one—much larger than for food items in general. This result suggests that sugar taxes could help reduce sugar consumption, but that their role should be limited to correcting for behavioral externalities rather than raising revenue. Powell and Chaloupka's (2009)[15] study of the U.S. finds that small taxes are unlikely to produce significant changes in behavior, but nontrivial price increases may have some measurable effects, particularly for children and adolescents, low-socio-economic status populations, and those most at risk for being overweight.

56. **If Iceland faces a compelling need to reduce obesity rates, it may wish to persist with heavier taxation of sugary products.** The longevity of its effort to tax sugary products, which prior to the introduction of the commodity tax in 1987 were taxed at the higher VAT rate, suggests that this has been a persistent goal. The 2010 TA report recommended that Iceland either redesign its sugar tax to more effectively discourage sugar consumption or repeal it, and in 2013, the previous government chose the former option. The structure of the tax now provides producers and importers to use less sugar, but it is likely that the excise is too low to

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[14] Bahl, R., Richard Bird, R and Walker, M.B. (2003). "The Uneasy Case Against Discriminatory Excise Taxation: Soft Drink Taxes in Ireland," *Public Finance Review*, 31, 510-533.

[15] Powell, L.M. and Chaloupka, F.J. (2009) "Food Prices and Obesity: Evidence and Policy Implications for Taxes and Subsidies," *The Milbank Quarterly*, 87(1), 229–257.

effectively discourage sugar consumption. A 2012 MOF study[16] estimates that the 210/kg excise will increase the price of sweetened food and drinks by 2–3 percent; and that with an estimated price elasticity of -0.65, this will reduce consumption by 1.3–2 percent. If Iceland truly wants to discourage sugar consumption, the sugar tax would likely have to be significantly increased. As recommended by the 2010 TA mission, the objections of the EEA could be addressed (and administration simplified) by taxing all sugar imports finally at the border.

57. **A simpler alternative to imposing an additional tax on sugar is returning to the policy of taxing them at the standard VAT rate.** It is contradictory to subject sugary products to an excise tax and then tax them at the lower VAT rate (although it may somewhat ease VAT administration). Taxing sugary products at the standard rate, even if the gap between the lower and upper rates were substantially narrowed, would raise the price of most sweet goods significantly more than the current sugar tax. This approach would also not raise issues with the EEA. The behavioral effect of this measure would, however, vanish if Iceland moves to a single-rate VAT.

58. **If the goal of taxing sweet foods is to deter obesity, then taxing foods containing artificial sweeteners appears to make little sense, since these goods offer low-calorie substitutes for the foods whose consumption is being discouraged**. This provision of the commodity tax should therefore be repealed. Denmark's experience with cross-border shopping also provides a caution: Iceland may be too geographically isolated for cross-border shopping for comestibles to make sense[17], but smuggling of heavily taxed products becomes more likely as the gap between domestic and foreign prices increases.

59. **Excises on business inputs distort production as well as consumption decisions, since in contrast to the VAT businesses do not receive credit for excises paid on their inputs.**[18] The excises on building materials likely have this effect in the construction industry and should be repealed; inclusion of new constructions in the VAT base should compensate for the revenue they generate (Table 8). Electronics, appliances and foodstuffs may also serve as inputs in certain sectors, so the same argument applies in favor of repealing sections D and E of the commodity tax.

60. **Countries often try to tax luxury goods in an effort to make the tax system more progressive, which appears to be the rationale for Sections D and E.** However, these taxes are seldom very successful in meeting this goal for several reasons. The domestic demand for

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[16] Ministry of Finance, "A Review of the Commodity Tax on Food," Reykjavik, November 2012.

[17] Cross-border shopping for consumer durables, however, is clearly an issue, as discussed later in this section.

[18] P. Diamond and J. Mirrlees, ""Optimal Taxation and Public Production I: Production Efficiency," *American Economic Review*, 1971.

items like jewelry, clothing and smaller electronics tends to be highly elastic, since if they are heavily taxed at home wealthier individuals can often acquire them in a lower-priced foreign jurisdiction. Icelandic authorities confirm that Icelanders travel frequently abroad to shop, especially for consumer electronics; the application of commodity tax to iPods was accordingly repealed in 2011. The incidence of luxury taxes thus tends to fall on domestic producers and retailers rather than on wealthy consumers. Further, the definition of "luxury" items tends to shift over time, as goods prices decline with technological advances and items once considered luxuries become middle-class staples. The appliances in Section D appear to fall under this heading. The income tax is thus a far better instrument than luxury excises for promoting progressivity.

Table 8. Commodity Tax Revenues

ISK mns	2008	2009	2010	2011	2012	2013
Domestic Production	102	118	1,026	1,018	1,012	1,100
Imported goods	3,202	2,468	3,671	3,536	3,705	4,474
Refunds on Imports	164	297	937	779	689	1,195
Net collections	3,140	2,289	3,760	3,775	4,028	4,379
Percent of GDP	0.21	0.15	0.24	0.23	0.24	0.24*

Source: Iceland Customs Authority.
*IMF Staff estimate.

61. **Repealing the commodity tax would cost approximately 0.25 percent of GDP in revenues.** In 2013, the sugar tax in Section A-B accounted for about 40 percent of this amount, so repealing sections C-E would reduce revenues by 0.15 percent of GDP. The mission estimates the inflationary impact of repealing the entire commodity tax at 0.6 percent. (See Chapter IV.)

Recommendations

- Repeal at least sections C, D and E of the Commodity Tax and replace the revenues with VAT base broadening and an increased lower rate.

- If the "sugar tax" (Sections A and B) are retained, repeal the tax on low-calorie sweeteners and increase the excise to a level that will effectively deter excessive sugar consumption.

- Alternatively, consider taxing high-sugar foods at the standard VAT rate.

B. Trade Taxes

Issue

62. **Iceland's trade regime for foodstuffs is restrictive.** This appears to be widely recognized, with authorities in various disciplines pointing to the market power that trade barriers confer on some domestic producers and distributors, notably in dairy products.

Discussion

63. **A comprehensive review of Iceland's trade regime is beyond the scope of this report.** However, a cursory examination of basic trade descriptors (Table 9) suggests that trade liberalization could help put downward pressure on food prices in particular. First, Iceland's tariff revenues, at 0.5 percent of GDP, are five times larger than the OECD average of 0.1 percent. Iceland's simple average applied agricultural tariffs are well above those in the EU, the US, and Canada, although lower than those applied by Norway. On a trade-weighted basis, its average agricultural tariffs are higher than the EU and US, but about the same level as those in Canada. Under the World Trade Organization (WTO) Doha accord, more than a third of Iceland's agricultural tariff lines are subject to "tariff quotas" (multiple-rate tariffs designed to replicate quotas as part of the agricultural quota phase-out of), and 40 percent are subject to "special safeguards" (temporary trade restrictions imposed when certain market conditions are breached). A critical assessment of the impact of Iceland's trade restrictions, particularly in agriculture, thus appears timely, particularly in light of the government's desire to offset the higher food costs that may arise from VAT reform.

Table 9. Selected Trade Regime Indicators

Indicator		Iceland	Norway	EU	Canada	US
Tariff revenue as a percentage of GDP		0.5	0.1	0.0	0.2	0.2
Simple average final bound tariffs 1/	Total	23.5	20.2	5.2	6.9	3.5
	Agriculture	109.4	132.0	13.7	17.5	4.7
	Non-agriculture	9.6	3.2	3.9	5.3	3.3
Simple average MFN applied tariffs 2/	Total	5.5	8.0	5.5	4.3	3.4
	Agriculture	24.4	53.2	13.2	16.2	4.7
	Non-agriculture	2.3	0.5	4.2	2.4	3.2
Trade weighted average tariffs 3/	Total	2.5	2.8	2.7	2.9	2.1
	Agriculture	12.7	32.6	8.6	13.6	3.9
	Non-agriculture	1.6	0.4	2.3	2.1	2
Agricultural Tariff quotas (in %) 4/		35.4	30.6	11.3	9.2	4.5
Agricultural Special safeguards (in %) 5/		40.1	46.4	23.9	5.8	2.9

Source: OECD revenue database; WTO: *World Tariff Profiles 2013*
1/Simple average of final bound duties (tariff ceilings agreed to under WTO), excluding unbound tariff lines.
2/ Most-favored nation tariff rates actually applied to trade with other WTO member countries.
3/ MFN tariff averages weighted by 6-digit import flows.
4/ Percentage of 6-digit subheadings in the schedule of agricultural concession covered by tariff quotas.
5/ Percentage of 6-digit subheadings in the schedule of agricultural concessions with at least one tariff line subject to Special Safeguards.

Recommendation

- Conduct a comprehensive review of the trade regime, particularly regarding agriculture, with a view toward increasing product competition and lowering consumer prices.

IV. Summary of Revenue and Inflation Estimates

64. **In line with the IMF's 2011 TA Report, the mission recommends that government take a two-step approach to implementing a uniform VAT rate (Figure 2).** Two alternative approaches to taking the first step are analyzed:

- Increasing lower rate to 14 percent; removing non-standard exemptions and taxing them at the 14 percent rate; and reducing slightly the top rate to 25 percent.

- Taking all the measures in the first scenario, but also taxing restaurants, tourism services, taxis and entertainment (sports and culture) at the top rate at 23 percent.

Figure 2. VAT Reform Phases and Policy Scenarios

<table>
<tr><th colspan="2"></th><th>Scenario 1</th><th>Scenario 2</th></tr>
<tr><td rowspan="6">Phase I</td><td rowspan="2">1)</td><td rowspan="2">Increase reduced rate to 14 percent</td><td>Increase reduced rate to 14 percent</td></tr>
<tr><td>Move restaurants to top rate</td></tr>
<tr><td rowspan="2">2)</td><td rowspan="2">Tax transport, tourism, sports, culture, radio and postal services at reduced rate</td><td>Tax public transport, radio and postal services at reduced rate</td></tr>
<tr><td>Tax private transport, tourism, sport and culture at top rate</td></tr>
<tr><td>3)</td><td>Lower top rate to 25 percent</td><td>Lower top rate to 23 percent</td></tr>
<tr><td>4)</td><td colspan="2">Compensate households in lowest income quartile</td></tr>
<tr><td rowspan="2">Phase II</td><td>1)</td><td colspan="2">Unify top and lower rate at 21 percent</td></tr>
<tr><td>2)</td><td colspan="2">Compensate households in lowest income quartile</td></tr>
</table>

65. **The second step of the reform is limited to merging the dual rates into a single rate of 21 percent.** Compensating measures are adopted to compensate those mostly affected by one-off price increases resulting from VAT reform, most of which fall in the first phase. Such an approach is likely to maximize support for the reform among different stakeholders.

66. **Raising taxation is of course a politically sensitive issue, even more so when it affects vulnerable lower income households**. On the one hand, higher taxes provide government with the revenue to finance public goods and services; but on the other hand, higher VAT rates depress the purchasing power of households and lead to inflation. This report therefore estimates both revenue and inflationary effects of all measures and calculates the cost of fully compensating households in the lowest quartile of disposable income for higher living costs due to VAT increases. Households in the top three quartiles receive no compensation.

67. **The mission updated and extended revenue and inflation estimates provided by the 2011 mission.** The impact of VAT reform on government revenue, inflation and compensating measures was assessed using data from the HCS of 2012. Spending by foreign tourists, as recorded in national accounts, was also included in the analysis. Calculations for commodity tax repeal were performed using data from customs. All calculations were performed under the assumption of full forward shifting of taxes to consumer prices: The analysis is static and does not assume any behavioral response to changes in tax rates or the inflation they produce, such as shifts in demand due to changes in relative prices. Since consumption is held constant, our inflation estimates are on the high side. In reality, consumers are likely to shift consumption away from higher-taxed goods, and households (even if compensated) may reduce their consumption in response to higher price levels. These behaviors would reduce the price impact of the VAT rate changes, but the mission did not impose such assumptions. Foreign tourists' spending, as an important part of domestic consumption (ISK 106 billion, or 15 percent of expenditures made by Icelandic households in 2012), is factored into the revenue assessment. However, it is not included in the inflation estimates, since services bought by tourists (tours, hotel accommodations, etc.) weigh little in the CPI basket, or disproportionally less than their share in total domestic consumption. The analysis also does not assume any changes in other factors influencing revenue performance, such as tax administration and or compliance.

68. **Although it is the mission's understanding that the government wishes to lower the overall burden of taxation, the two scenarios estimated were not calibrated to be revenue neutral**: Each raises on net about 1.5 percent of GDP over the two stages. This was done due the authorities' expressed desire to shift taxation from income to consumption, in the anticipation that income taxes might be lowered in the near future, and to help cover for potential costs of other policy priorities, such as household debt relief.[19]

69. **In Scenario 1 (Table 10), the base broadening reform may have a very moderate impact on inflation and also bring some revenue to the government.** This will of course depend not only on the scope of the VAT reform itself, including the choice of rates, but also on the related reform of commodity taxes as well as compensating measures for VAT increases provided to lower-income households. Scenario 1 would bring the government approximately ISK 10 billion or 0.6 percent of GDP in revenue, and produce a 1 percent of one-off increase in the CPI in the first phase. In the second phase of the reform, where a uniform VAT rate is introduced at 21 percent, additional revenue would amount to ISK 7.5 billion or 0.4 percent of GDP and a 0.4 percent increase in inflation.

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[19] "Iceland: Economic Program 2014", report by Ministry of Finance and Economic Affairs, Reykjavik, February 2014

Table 10. VAT reform—Scenario 1

	VAT Policy Option	Revenue ISK (million)	Revenue GDP (percent)	Inflation (percent)
Phase I	Increase lower rate to 14%	12,730	0.75	1.49
	Tax non-standard exempt items at 14%	4,049	0.24	0.24
	Lower top rate to 25%	-1,337	-0.08	-0.18
	Compensate LIHs	-1,529	-0.09	-
	Repeal Commodity Tax	-4,028	-0.24	-0.55
	Total Effect	9,885	0.58	1.00
Phase II	Increase lower rate to 21%	19,521	1.15	1.86
	Lower top rate to 21%	-10,693	-0.63	-1.46
	Compensate LIHs	-1,297	-0.08	-
	Total effect	7,531	0.44	0.40

Source: Statistics Iceland data and IMF staff calculations

70. **In the second scenario, taxing more items at the top rate in the first phase permits a sharper reduction of the top rate to 23 percent (Table 11)**. Inflation would be 1 percent, and the revenue increase would be about ISK 18 billion or 1 percent of GDP. The introduction of a uniform rate at 21 percent in the second phase would bring an additional ISK 3.2 billion or 0.2 percent of GDP and result in 0.6 percent inflation.

Table 11. VAT reform—Scenario 2

	VAT Policy Option	Revenue ISK (million)	Revenue GDP (percent)	Inflation (percent)
Phase I	Increase lower rate to 14%	8,639	0.51	1.20
	Tax non-standard exempt items at 14%	688	0.04	0.10
	Increase lower rate to top rate 23% *	9,350	0.55	0.67
	Tax non-standard exempt items at 23% *	11,383	0.67	0.48
	Lower top rate to 23%	-6,673	-0.39	-0.92
	Compensate LIHs	-1,529	-0.09	-
	Repeal Commodity Tax	-4,028	-0.24	-0.55
	Total Effect	17,830	1.05	0.98
Phase II	Increase lower rate to 21%	9,794	0.58	1.36
	Lower top rate to 21%	-5,339	-0.31	-0.73
	Compensate LIHs	-1,297	-0.08	-
	Total effect	3,158	0.19	0.63

* Immediate adoption of the top rate is assumed (as outlined in Figure 4.1). All values should be read as a net result of moving from the 7 percent reduced rate (restaurants) and exemption (tourism and recreational services) to the top 23 percent rate.

Source: Statistics Iceland data and IMF staff calculations