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Iceland: Selected Issues

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ICELAND

Selected Issues

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Approved by European I Department

May 29, 2002

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Iceland: Basic Data

Demographic and other data

Area	103,000 square kilometers
Population (Dec. 2001)	284,600
Natural rate of increase (1992-00)	1.0 percent
Life expectancy at birth (1999)	
Males	77.5 years
Females	81.4 years
Infant mortality (per 1,000 live births)	3
Population per physician (1997)	308
GDP per capita (2001, PPP exchange rate)	US$ 29,196

Composition of GDP in 2001, at current prices	In billions of kronur	Distribution in percent
Private consumption	417.7	55.7
Public consumption	175.2	23.3
Total investment (including stockbuilding)	163.1	21.7
Total domestic demand	756.0	100.7
Exports of goods and services	303.8	40.5
Imports of goods and services	307.3	41.0
GDP at market prices	750.4	100

Selected economic data	**1999**	**2000**	**2001**
	(Annual percentage change)		
Output and unemployment:			
Real GDP at market prices	3.7	5.5	3.0
Average unemployment (in percent)	1.9	1.3	1.7
Earnings and prices:			
Wage Index	6.8	6.6	8.9
Consumer Price Index	3.4	5.0	6.7
Money and interest rates			
M1 (end-period)	19.1	3.8	0.6
M3 (end-period)	17.0	11.0	15.5
3-month Treasury bill yield (eop)	9.8	11.8	10.0
25-year indexed housing bond (real yield)	4.8	6.3	5.9
	(In billions of kronur)		
Fiscal accounts:			
General government receipts	265.4	286.3	308.8
General government expenditures	250.7	270.0	309.9
General government balance	14.7	16.3	-1.1
(In percent of GDP)	2.4	2.4	-0.1
Balance of payments:			
Current account balance	-42.6	-67.5	-33.0
(In percent of GDP)	-6.9	-10.1	-4.4
Trade balance	-22.4	-37.5	-6.1
Exports	144.9	149.3	196.4
Imports	167.3	186.8	202.5
Services and transfers (net)	-6.1	-9.5	2.6
Gross reserves, official basis			
(Millions of SDR, end-period)	360	311	271
Exchange rate (ISK/SDR, end-period)	99.6	110.4	129.4

Sources: National Economic Institute; Central Bank of Iceland; Ministry of Finance; and IFS.

I. Inflation Forecasting and the Monetary Transmission Mechanism[1]

A. Introduction

1. **In an inflation targeting framework the effectiveness of monetary policy is crucially dependent on the central bank's ability to predict inflation accurately, coupled with a well-established understanding of the monetary transmission mechanism.** Both tasks are intertwined: given its role as a feedback variable for monetary policy, deviations of the inflation forecast from the inflation target determine the response of monetary policy. By the same token, the length and magnitude of the transmission of monetary innovations determines the scope of the policy change, which, in turn, has an impact on the central bank's inflation forecast.

2. **The Central Bank of Iceland (CBI) employs a variety of well-established time series models to forecast inflation over a two-year horizon.** Based on these models, the exchange rate pass-through is found to peak six months after the initial shock and gradually levels off over a period of 12–18 months. While these findings are broadly supported by staff's estimates, stylized facts of inflation dynamics suggest that in recent months the pass-through may have increased temporarily, reflecting the prolonged depreciation of the Icelandic króna. As to the transmission mechanism of monetary policy, empirical studies of the CBI indicate that policy lags are shorter in Iceland than in other industrial countries owing to the country's openness and the weight of the exchange rate pass-through. Significant effects of interest rate changes on prices occur after one year and peak after some 18 months, with prices falling by 0.35 percentage points in response to a 1 percentage point increase in the policy interest rate. However, imperfections in Iceland's money market, the relatively short history on the current framework of market determined interest and exchange rates and the very recent adoption of the new monetary policy framework call for a cautious interpretation of the empirical findings regarding the transmission lags.

3. **Given the importance of the link between inflation forecasts and the transmission of monetary innovations, this paper reports on the technical aspects of the model-based inflation forecasts of the CBI and the monetary transmission mechanism in Iceland.**[2] The first part summarizes the structure and results of time series models employed by the CBI to forecast inflation and quantify lags in the transmission of monetary policy changes. The second part briefly discusses recent inflationary trends, including staff's estimate of the exchange rate pass-through. The paper concludes with remarks on potential distortions in the financial market pass-through of monetary policy changes.

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[1] Prepared by Frank Engels.

[2] The IMF Country Report 01/82 provides a comprehensive overview about the inflation-targeting framework in Iceland, and additional discussion of the inflation forecasting methods of the CBI and the transmission mechanism.

B. Inflation Forecast and the Transmission Mechanism—Model-Based Estimates

4. **At present, the CBI infers its inflation forecast from several time series models, namely a single-equation approach (e.g., Guðmundsson (1990, 1998, 2001)), multivariate models allowing for time-varying parameters ((Guðmundsson (2002)), and multivariate vector error correction models (Pétursson (1998, 2002)).** These models are based on the hypothesis that inflation is predominantly determined by variations in wages, import prices, exchange rates, productivity, unemployment, and output gap developments. However, as most of these frameworks only allow for a partial determination of endogenous variables, the CBI aims at developing a full-fledged macroeconometric model to further complement its set of forecasting tools.

Single-equation model

5. **The single-equation model forms one of the main components of the inflation forecast**. The model is based on the hypothesis that changes in domestic inflation are a lagged response to variations in wages and import prices. First differences in the logarithmic values of wages (w) and import prices (p_m) are used to estimate the underlying relationship

$$\Delta p_t = c + \sum_{i=1}^{n} a_i \Delta p_{t-i} + \sum_{i=0}^{n} b_i \Delta w_{t-i} + \sum_{i=0}^{n} d_i \Delta p_{m_{t-i}} + \varepsilon_t$$

This model has tracked inflation developments in Iceland fairly well in the past, particularly for the high inflation period of the1970s and 80s. Using quarterly logarithmic data, the CBI finds short-run elasticities of import prices and wages to range between 0.15–0.2, while the long-run elasticity of the exchange rate pass-through is estimated to reach about 0.4. The finding of a relatively swift pass-through of exchange rate and wage shocks on to inflation is most likely a reflection of Iceland's relative long history of fixed and adjustable exchange rate pegs. If the exchange rate peg was perceived as credible and the level of the exchange rate thought not to be misaligned, changes in the exchange value of the króna would have been perceived as permanent and, thus, quickly passed through to domestic prices.

Dynamic wage-price model

6. **A dynamic wage-price framework, based on a vector error correction model (VECM) developed by Pétursson (2002), identifies three main sources of wage and price inflation in Iceland**. First, conflicting claims between employees and employers are found to trigger higher wages and prices. Second, a real depreciation of the króna leads to higher domestic-currency prices of imported goods and shifts demand to domestic goods, thus inducing higher prices, profits, and wages. Finally, excess demand in goods and labor markets result in an upward shift of domestic prices and wages. Estimations of the model's price equation suggest short-run import price and wage elasticities of about 0.2–0.3 and a slightly higher long-run import price elasticity, thus confirming the results of the single-equation approach. As to the response of wages to variations in lagged imported inflation, the

model finds also significant positive short-run effects.[3] The VECM offers reasonably good forecasting capabilities. The fit between actual and estimated values of the model is good, and the model is capable of explaining the volatile wage-price dynamics of the 70s and 80s as well as the stabilization period of lower wage and price growth in the 90s.

7. **Regarding the monetary transmission mechanism, the CBI employs a set of vector autoregressions (VAR).** As to the transmission of interest rate changes throughout the yield curve—the financial market pass-through—the model developed by Pétursson (2001a) finds that monetary innovations have a significant within-the-month effect on money market rates. A change in the CBI's policy rate, i.e., the interest rate on two-weeks repurchase agreements between the CBI and other financial institutions, by 100 basis points (bp) leads to a within-the-month change in the money market rate (proxied by the 3-month nominal T-bill rate) by 71 bp. As to the impact of monetary policy changes on real bond rates, no significant direct effect is found. Instead, the policy change is transmitted through changes in the money market rate inducing contemporaneous changes in the bond rate, which last for about 8 months. Indexed lending rates, proxied by the average indexed bank loan rate, do not rise instantaneously—thus hinting at imperfectly competitive credit markets. Loan rates start rising gradually with a lag of two months following a monetary policy shock, reaching a peak of about 30 bp after four months in response to the higher bond rate.

8. **On the effects of monetary policy changes on economic activity and inflation, preliminary empirical work (Pétursson (2001b)) suggests that price effects of interest rate changes take place more rapidly in Iceland than in other industrialized economies.** An increase in the policy interest rate by 100 bp leads to a 0.35 percent decline in Iceland's headline inflation rate after approximately 15 months compared to a lag of about two years in other industrialized countries. The more rapid transmission in Iceland might be related to the relative openness and size of the economy, thus pointing to the specific importance of the exchange rate pass-through.

C. Stylized Facts of Inflation in Iceland—A Discussion of Recent Trends

9. **Reflecting the marked depreciation of the Icelandic króna since May 2000, and the subsequent appreciation since December 2001, exchange rate changes have been the driving force behind recent price and wage developments in Iceland.** Staff estimates based on the single-equation model and a VAR framework confirm this perception and are generally in line with the CBI's findings that most of the pass-through takes place within the first six months after the exchange rate shock. Based on the authorities' single-equation model, and using the wage and import price index published by Statistics Iceland as proxies

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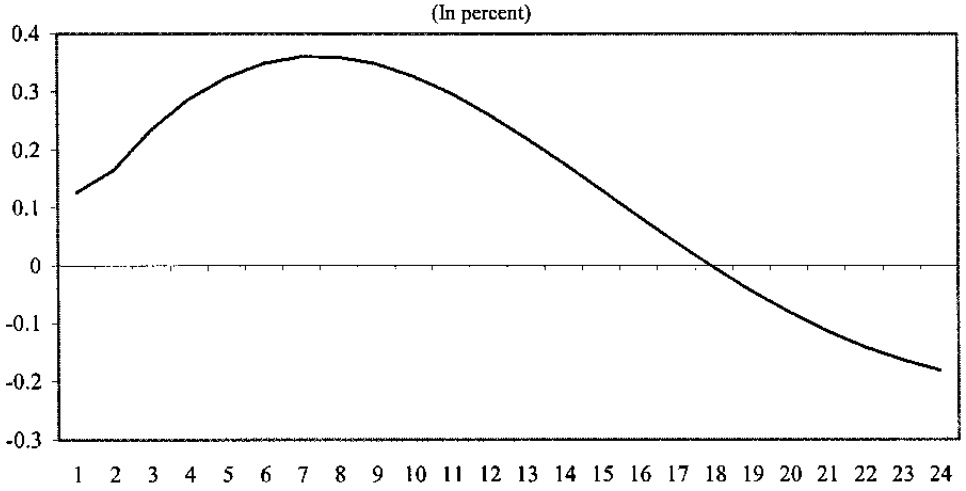
[3] Domestic demand pressures appear to have a relatively benign and delayed inflationary impact, at least if compared with other industrialized countries and emerging market economies (Bårdsen and others (1998); Mihaljek and Klau (2001)). An increase in the output gap by 1 percentage point of GDP is found to lead to a rise in annual inflation of about 0.3 percent after one year.

for unit labor costs and import prices for the period 1995:09 to 2002:03, estimation results suggest a short-run import price and wage elasticity of about 0.15 of domestic inflation. Moreover, the pass-through of exchange rate changes on domestic prices appears to peak roughly after six months reaching some 40 percent.[4]

10. **Based on a VAR model using monthly logarithmic and seasonally adjusted values of the trade-weighted exchange rate index of the króna, the domestic consumer price index, the wage index, and the level of the repo rate for the period indicated above, estimation results suggest that the response of domestic prices to an unexpected depreciation of the króna peaks after approximately 6–8 months and levels off subsequently (Figure 1).**[5] The 95 percent confidence interval indicates that the pass-through is statistically significant for at least 12 months, with the pass-through coefficient falling back to zero after some 18 months.

Figure 1. Iceland: Response of CPI to One Percent Exchange Rate Change
(In percent)

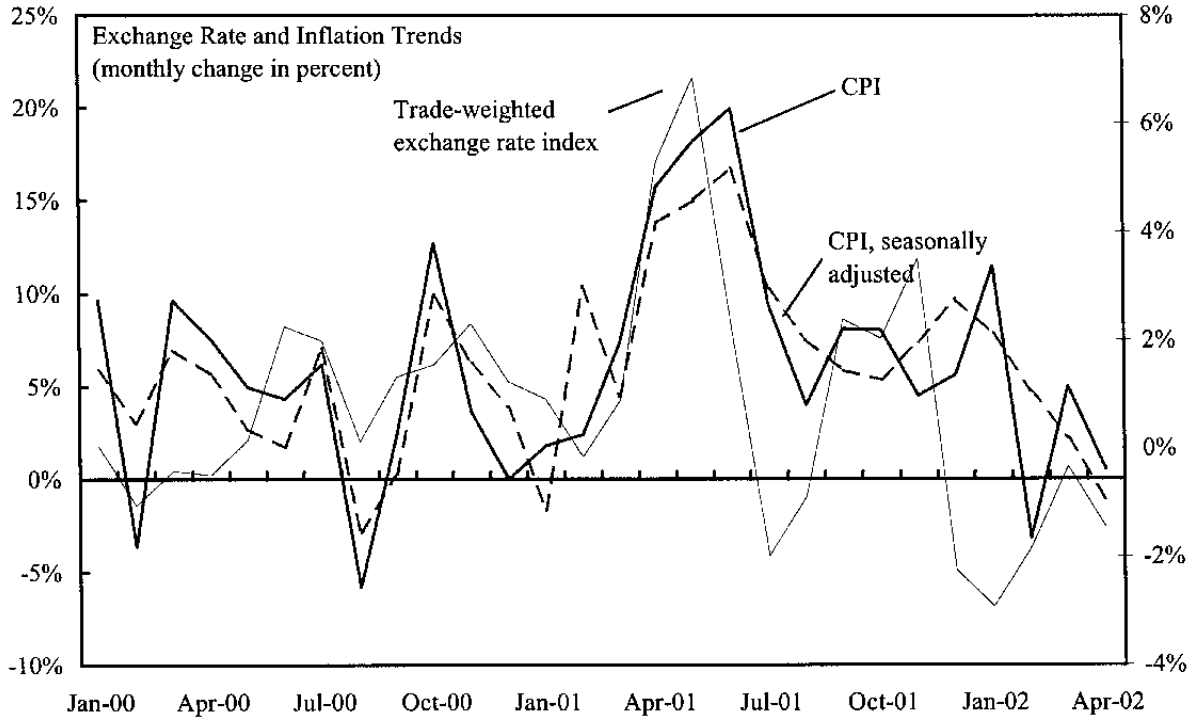


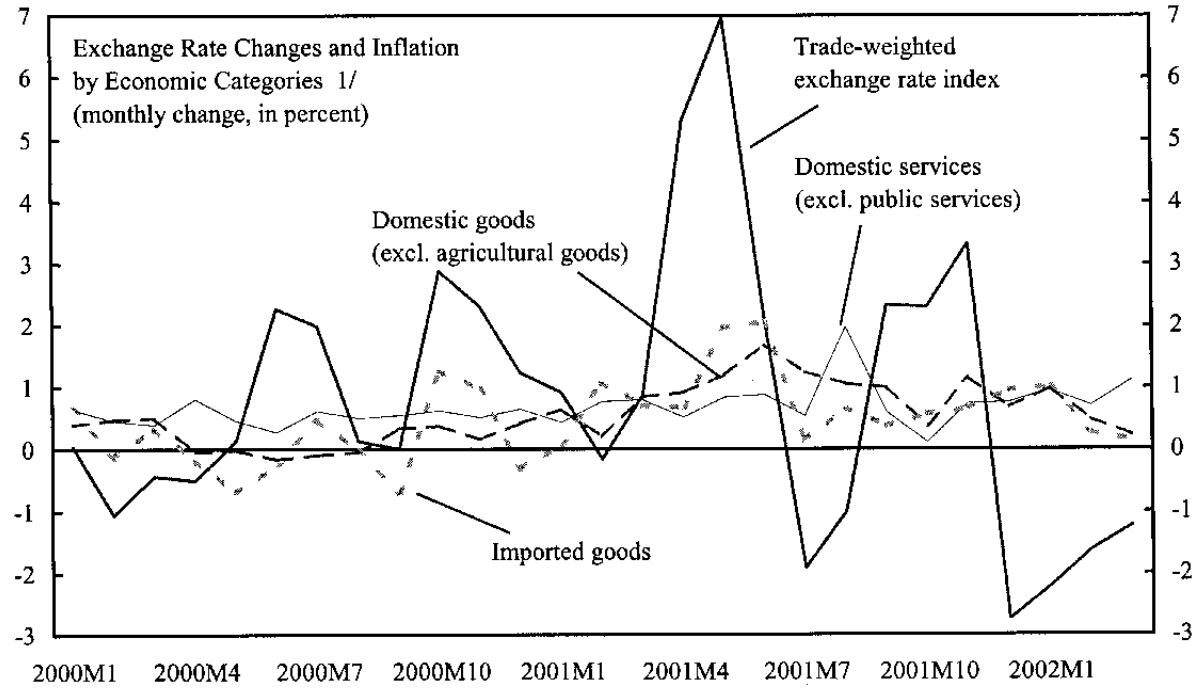
11. **Recent inflation developments are consistent with these findings.** The sharp increase in monthly inflation in Fall 2000 and mid-2001 was triggered by higher import prices in response to the depreciation of the króna (Figure 2). Domestic goods and service

[4] Given the small sample, the information content of the data set is fairly limited and the number of estimated parameters is large. Moreover, with R^2 ranging at about 0.3–0.4, a very cautious interpretation of the results is warranted.

[5] The results are subject to considerable uncertainty, due in part to the small underlying data sample. Figure 3 reports the final estimate of the impulse response function for a one percent exchange rate change. In accordance with Icelandic conventions, an increase in the exchange rate index of the króna denotes a depreciation of the domestic currency.

Figure 2. Iceland: Stylized Facts of Exchange Rate Changes and Inflation





Sources: Statistics Iceland and Central Bank of Iceland.
1/ Seasonally adjusted.

prices increased swiftly reaching a peak after some 3–5 months. Conversely, the most recent decline in inflation was almost contemporaneous with the appreciation of the króna, which started in December 2001. Domestic currency prices of imported goods began to decline with a lag of about 2–3 months, mitigated in part by a lagged response of domestic goods and services prices to the exchange rate shocks. Against this background, it seems likely that, while a large part of the price pressures related to the prolonged depreciation of the króna might have been passed through to domestic prices, remaining inflationary pressures related to last year's depreciation will remain for some time. Some of the latter effects, however, are likely to be offset by the recent appreciation of the króna.

12. **Stylized facts of recent trends in the exchange value of the króna and domestic inflation appear to suggest temporary changes in the strength of the exchange-rate pass-through**. For the period from early 1999 to mid-2000, the short-run impact of exchange rate changes on domestic prices seems to have been temporarily weaker (Figure 2). While exchange rate volatility increased markedly during this period, the pass-through on domestic prices of domestic goods and services remained fairly negligible. This probably reflects the decision of intermediaries to absorb exchange-rate-induced variations in input prices through adjustments in their margins either to maintain market share or because the exchange rate shock was thought to be short-lived.[6]

13. **Since Spring 2001, however, the pass-through to domestic prices and services seems to have risen**. In view of the prolonged and accelerating depreciation of the króna, producers were probably forced to pass through exchange rate changes more quickly to domestic goods prices so as to safeguard margins and profitability.[7] Prima facie this seems to counter the hypothesis that more frequent changes in the exchange rate yield a weaker pass-through as exchange shocks are perceived as temporary. However, given the size of Iceland's external and internal imbalances at that time, it appears plausible that agents anticipated that a marked depreciation was required to restore macroeconomic balances and, thus, changed their price setting behavior accordingly.

14. **The notion of a temporarily weaker and subsequently slightly enhanced pass-through was confirmed by observations of Central Bank staff regarding the accuracy of their inflation forecasts**. If the forecasts are adjusted ex-post for exchange rate movements that occurred during the forecast period, the results suggest that the CBI would have constantly overpredicted inflation in 1999 and 2000.[8] Since the second half of 2001,

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[6] This is in line with recent studies suggesting that rising exchange rate volatility, increased international competition and sustained integration of financial markets might have led to a decline in the short-run coefficient of the exchange rate pass-through (Adolfson (2001)).

[7] Domestic services prices, however, continue to respond with a lag of roughly 3 months to exchange rate shocks.

[8] See IMF Country Report No. 01/82. The inflation forecast of the CBI is based on the assumption of a constant exchange rate over the forecast horizon.

however, the CBI inflation forecast would have underpredicted inflation developments, which in turn hints at a recent increase in the short-run pass-through coefficient.

D. The Financial Market Pass-Through—Some Remarks

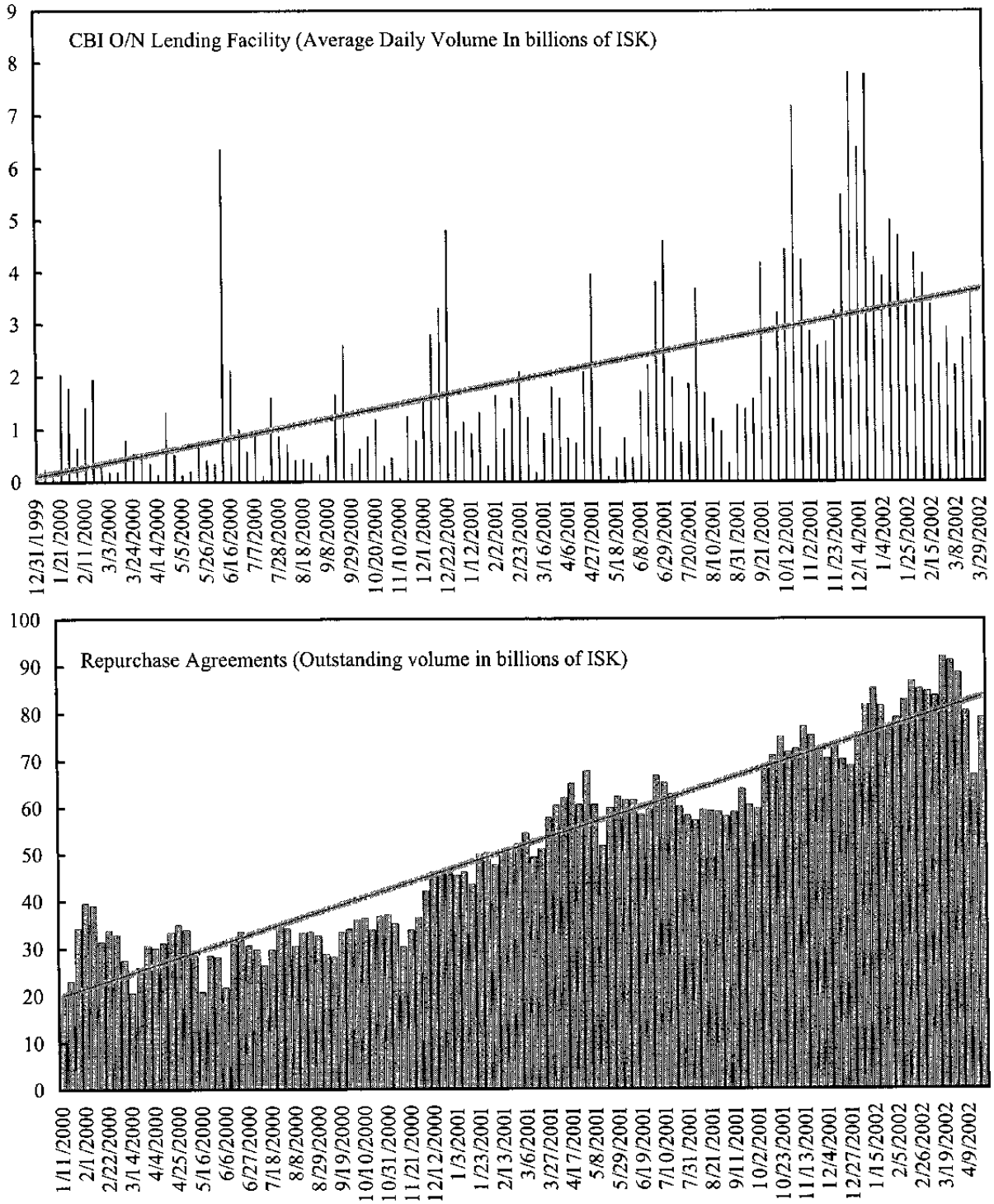
15. **The empirical finding of a relatively swift propagation of monetary policy changes through the very short end of the yield curve needs to be qualified by the following remarks**:

- This finding is most likely a reflection of the structure of Iceland's financial markets, given that (i) approximately half of the borrowing in Iceland carries flexible interest rates; (ii) the dominance of central bank financing (Figure 3) for banks which allows the CBI to determine de facto the yield curve up to 12 months; and (iii) potential market pricing power of banks. In fact, empirical results (Pétursson (2001a)) appear to confirm the latter two hypotheses: the repo rate has a stronger effect on the marginal cost of loan funding than the money market rate, which in fact is a sign of either insufficient competition among banks or of underdeveloped money markets (or a combination of both). Moreover, the bond rate is found to be the main determinant of banks' marginal lending costs, probably reflecting the shallowness of Iceland's interbank market.

- The dominant role of longer-term bond yields in the determination of the loan rate, which is probably related to the fact that most loans in Iceland are inflation-indexed with banks' deposits competing with investments in inflation-indexed bonds, impairs the financial market pass-through at the longer end of the yield curve and, thus, the effectiveness of monetary policy. In this context, it is important to note that Iceland's pension funds are active lender in their own right and dominate the long end of the yield curve reflecting the largely privately funded pension fund system in Iceland. Consequently, if bond yields can be strongly influenced by pension funds' investment decisions, and with bond yields as the key determinant of the marginal cost of credit, the transmission of monetary policy changes throughout the longer end of the yield curve could be watered down by yield variations stemming from pension funds' investment decisions.

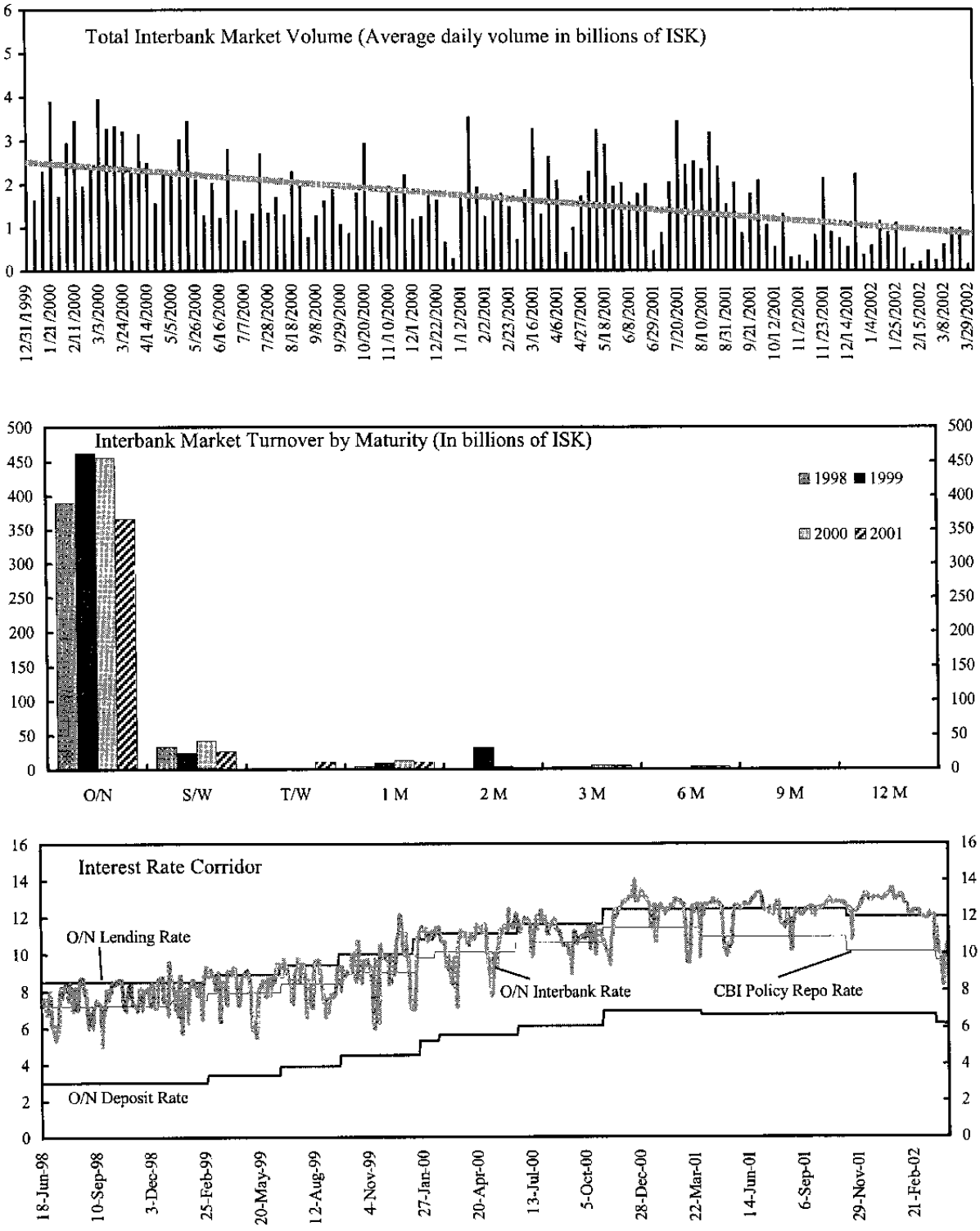
- Market imperfections in the interbank money market appear to hinder the effectiveness of the transmission mechanism. First, overnight market rates have repeatedly fluctuated above the CBI's interest rate for overnight lending funds, providing incentives to banks to fund their activity through the overnight window of the CBI rather than the interbank market. This appears to have hampered the development of the interbank market in recent times (Figure 4). Interbank money market transactions are not collateralized as opposed to overnight and repo transactions with the CBI. This may well have contributed to money market rates repeatedly exceeding CBI overnight lending rates. Second, the rapid increase in the stock of outstanding repos (Figure 3) seems to have also adversely affected interbank money market turnover, with banks dealing predominantly with the CBI rather than among themselves through the interbank market.

Figure 3. Iceland: Central Bank Liquidity Provision



Source: Central Bank of Iceland.

Figure 4. Iceland: Interbank Market Turnover and Central Bank Interest Rate Corridor



Source: Central Bank of Iceland.

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II. Recent Tax Reform [9]

A. Introduction and Overview

16. **The goal of the 2001 tax reform in Iceland is threefold: to simplify the system, encourage saving, and improve the overall growth outlook by reducing the level of discrimination among different forms of activity**. The current round of tax reform is part of a longer-term structural reform agenda of the government. While Iceland's tax burden was once below the average for OECD countries, recent initiatives to lower business taxation throughout member countries placed Iceland at the average of OECD countries (Figure 5). Furthermore, the tax base was substantially broadened in comparison with other countries through previous reforms that eliminated various credits and deductions. The first round of tax reform began in the late 1980s in preparation for membership in the European Economic Area (EEA) and consisted of shifting revenue generation away from export and import taxes to a system based on consumption, personal income, and corporate taxes. The second round of tax reform was enacted in the mid 1990s to further enhance efficiency and promote saving by consolidating payroll taxes, modifying capital income taxation, and classifying pension contributions as tax-exempt.

17. **The recently enacted tax reform has brought the corporate income tax system more in concert with that prevalent in other European countries.** The current round of tax reform includes the elimination of inflation adjusted corporate accounting, a reduction in the corporate tax rate, and the elimination or reduction of various additional taxes (corporate wealth tax, net wealth tax, and special wealth tax), all of which should enhance productive efficiency and potentially increase saving. After substantial reform, the current tax system in Iceland differs from that found in other EU countries in that Iceland is more reliant on consumption based taxes and less so on corporate and social security taxes (Box 1). The following sections discuss the main elements of the current reform in corporate and personal taxation.

B. Changes in Corporate Taxation

18. **Corporate tax reform has created a more favorable business climate and the corporate income tax system is generally in line with systems of other European countries.** The Icelandic enterprise environment is limited by its distance from markets, relatively high transport costs, and small domestic markets which make economies of scale difficult to achieve. The current tax reform includes a substantial reduction in the corporate tax rate to partially offset some of these shortcomings, the elimination of inflation adjusted corporate accounting, and provisions for firms to keep their accounts in foreign currency.

19. **The reduction in the corporate income tax from 30 percent to 18 percent is designed to stimulate business activity and compensate for any locational disadvantage.**

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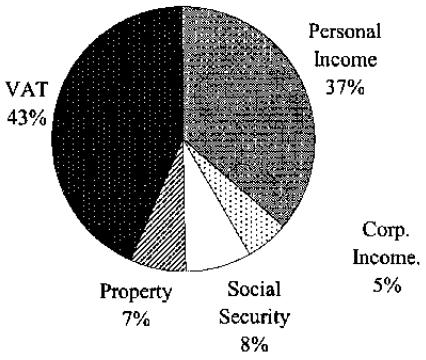
[9] Prepared by Michael Gapen.

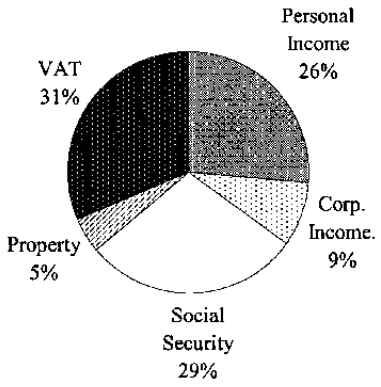
Box 1. The Current Tax System in Iceland

The Icelandic tax system has evolved considerably and the revenue composition has a somewhat different structure than seen in European Union and other OECD countries. While personal income tax receipts as a percent of total tax revenues are roughly similar across these countries, the distribution across corporate income taxes, property taxes, consumption taxes, and social security/payroll taxes differ greatly. Corporate taxation and social security revenues account for a relatively small share of taxation in Iceland and are compensated for by a higher share of consumption based taxation. The following describes the basic features of the current tax system in Iceland.

Iceland
(Percent of total tax revenue)



OECD Europe
(Percent of total tax revenue)



Personal Income Taxation
The personal income tax is a combination of the central government rate and the municipal rate and is levied on gross income other than from capital. The main exemption arises from the deductibility of pension contributions.
Rates: 38.5 percent for individual incomes above ISK 809,616 (US $8800) and 45.5 for individual incomes above ISK 3,865,000 (US $42,011).

Corporate Taxation
The corporate income tax is 18 percent and the rate on partnerships is 26 percent.
International trading companies are subject to a 5 percent income tax.
Net losses can be carried forward for eight years.
Depreciation rates on machinery are in the range of 5%-15% (straight line method).

Taxes on Capital Income and Net Wealth
A consolidated tax on capital income of 10 percent is withheld at source for both individuals and corporations. Corporations can offset this withholding against their corporate income tax liability.
The corporate net wealth tax is 0.6 percent.
The personal net walth tax is 0.6 percent applied to net assets over ISK 4,720,000 (US $51,304).

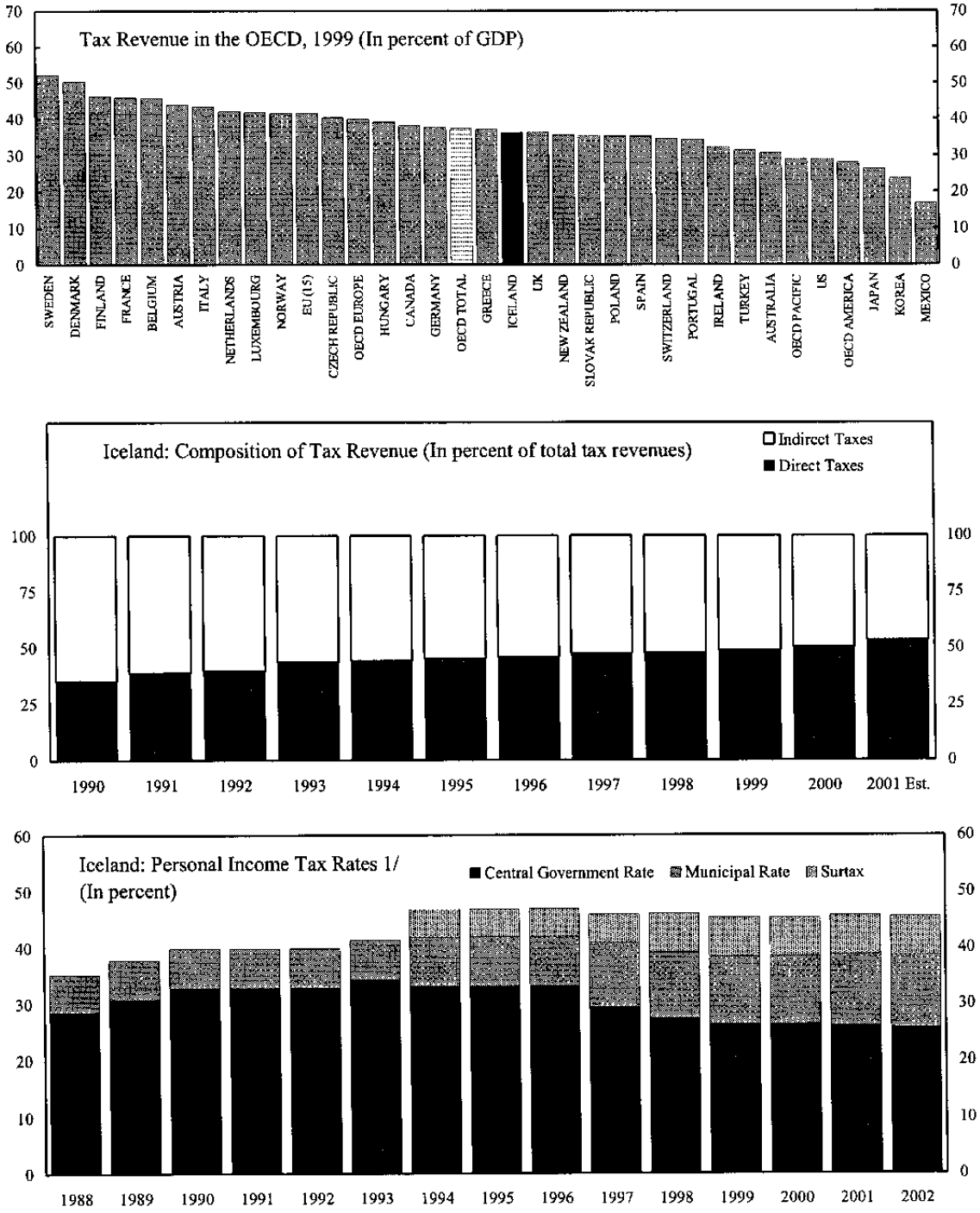
Consumption/Expenditure Taxation
The general value added tax of 24.5 percent is applied to goods and services.
A lower rate of 14 percent is applied to most food items, electric, heating oil, hotels, and other items.

Social Security Taxation
One unified rate of 5.23 percent applies to all industries. Employers can reduce this by 0.4 percent in order to match employee contributions to optional supplementary pensions.

Resource Taxation
A bill presently before Parliament will introduce a resource fee on economic rents in the fishing industry.

Sources: Ministry of Finance; OECD, *Revenue Statistics*.

Figure 5. Iceland: The Structure of Taxation



Source: OECD, *Revenue Statistics*; National Economic Institute, Ministry of Finance.
1/ The financing of primary schooling was transferred from the central government to the local municipalities beginning in 1997 and largely accounts for the increasing share of municipal taxes in personal taxation.

The new 18 percent rate plus the 10 percent tax on capital income (see below) amounts to a consolidated tax rate of approximately 26 percent and will place Iceland at the lower end with respect to other OECD members. Concurrent with the reduction in the corporate income tax, the rate applied to partnerships with unlimited liability was reduced from 38 percent to 26 percent. International trading companies—companies that exclusively trade in goods and services outside Iceland—are taxed at the rate of 5 percent.

20. **The elimination of inflation-adjusted accounting will simplify the tax system and bring it in line with international practice.** Inflation accounting was introduced in 1981 due to the historical high rates of inflation in Iceland and provided for a revaluation of monetary assets and liabilities, depreciation bases, and depreciation charges in line with inflation. Furthermore, profits on sales of assets were inflation-adjusted. Given the improvement in inflation outturns and with the inter-country comparison of company financial accounts becoming more prevalent, the decision was made to eliminate the practice of inflation accounting. While the revenue loss to the Treasury is not estimated to be substantial, the impact on companies across sectors varies widely, with the expectation that the financial sector will receive the largest increase in tax burden and the fishery sector will receive the largest decrease. In addition to the elimination of inflation accounting, firms will be allowed to keep their accounts in foreign currency. Corporations must apply to the Annual Accounts Registry of the Directorate of Internal Revenue for permission; the currency chosen must be the principal transaction currency and must be used to record accounts for at least five years.

C. Taxes on Capital Income and Net Wealth

21. **The personal and corporate net wealth tax rate will be cut in half and the surtax on net wealth of individuals and corporations will be eliminated after 2002.** The previous personal and corporate net wealth tax rate was 1.2 percent and the net wealth surtax was 0.6 percent. The net wealth surtax on individuals and corporations was originally imposed to finance the construction of the National Library and had remained in place temporarily to finance the construction of several other cultural buildings. Net wealth taxation on individuals would have increased substantially in 2002 due to the countrywide reassessment of property values during 2001, reflecting the widespread increase in property values in recent years. To offset this additional burden, the threshold level of net assets was increased by 20 percent to ISK 4,720,000 (US $51,304) for assets at year-end 2001 and the rate will be reduced to 0.6 percent for assets valued at year-end 2002.

22. **In 1997, a uniform 10 percent tax on interest income, dividend income, and capital gains of individuals replaced the previous system.** The previous system of capital income taxation discriminated among different forms of economic activity, particularly forms of saving. For example, interest income was tax-exempt, but other capital income such as dividends and capital gains was taxed at the individual income tax rate, which was as high as 47 percent in 1996. Starting in 1997, the uniform rate of 10 percent applies to all forms of capital income of individuals and is withheld at source. Individuals pay no additional capital

income tax, while capital income realized by business, including capital gains, is taxed as ordinary corporate profits.

D. Changes in Personal Taxation

23. **The bottom personal income tax rate was reduced slightly beginning in the mid 1990s and the income threshold for the upper tax rate was increased by 15 percent in 2001.** Personal income taxation in Iceland is accomplished through a two-tiered rate system. Above the individual tax-free income allowance of ISK 809,616 (US $8,800), the personal income tax rate of 38.5 percent is applied. A special central government surtax of 7 percent is then applied to individual income above ISK 3,865,000 (US $42,011), creating the second-tier rate. The personal income tax rate was 35 percent in 1988 and had risen to a high of 42 percent in 1996 before being reduced over time to its current level. The increase in the income threshold for the upper tax rate was due to widespread bracket creep as a result of strong nominal (and real) income growth during the past decade; income brackets are not statutorily indexed to inflation.

24. **To promote private saving, a deduction of pension plan contributions from gross taxable income was phased in beginning in 1995 and completed in 1997.** Employees contribute about 4 percent of gross pay and employer-matching constitutes an average of 6 percent[10]. Employer-matching constitutes a deductible operating expense and employee contributions are deductible from taxable income. Furthermore, beginning in 1999, employees had the option of contributing an additional 2 percent, matched by a 0.2 percent contribution from employers, into a supplemental pension plan. Due to relatively low enrollment rates, the contribution and matching rates were doubled in May 2000 to 4 percent and 0.4 percent, respectively. In addition, the central government chose to increase their matching contribution to 1 percent in 2001 and 2 percent in 2002. All payments into the supplemental pension scheme are tax-free for both employee and employer.

[10] The matching contribution for government employees is 11 percent and differs across industries.