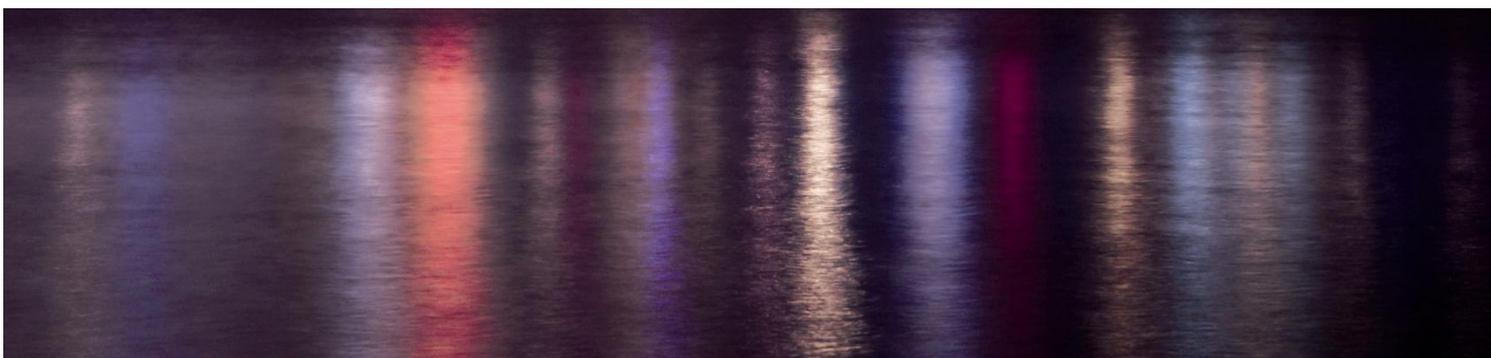




# OECD Economic Surveys Iceland

September 2015

OVERVIEW



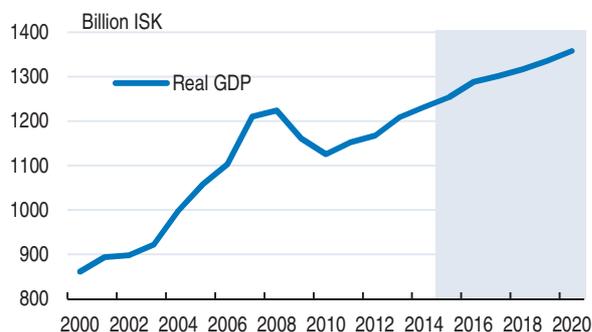
# Executive summary

- *Main findings*
- *Key recommendations*

## Main findings

### Iceland's economic prospects are good, but capital controls and wage increases are key challenges

#### Output has recovered



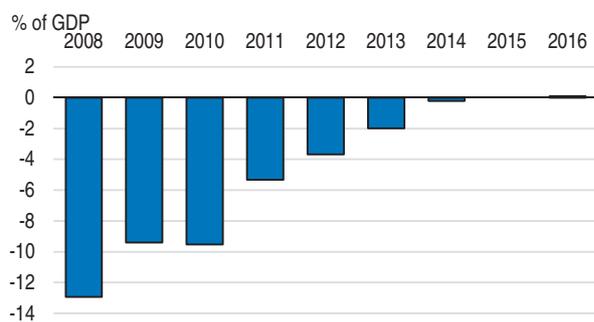
Source: OECD Economic Outlook 97 database and long term baseline.

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Iceland has entered its 5th year of economic recovery and prospects are for continuing growth. Progress has been made on many fronts: inflation has come down, external imbalances have narrowed, public debt is falling, full employment has been restored and fewer families are facing financial distress. Lifting the capital controls introduced in 2008 in an orderly way is a challenge due to the complexity of the problem and the size of potential capital outflows. Large wage increases awarded during the recent collective bargaining round that are well in excess of productivity will require growth-weakening monetary tightening.

### Fiscal policy has become more sustainable, but contingent liabilities remain a risk

#### The budget deficit has been eliminated



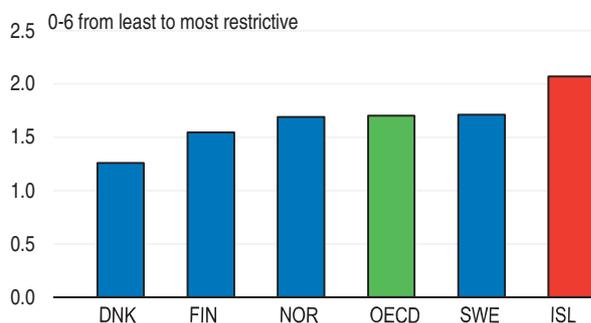
Source: OECD Economic Outlook 97 database.

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Iceland has considerably improved its fiscal position. A budget surplus is about to be achieved and public debt has been lowered. Long-term projections suggest that fiscal policy had been on track to achieve sustainability before subsequent changes were made to secure wage settlements. The simulations also show that it would not take much to derail fiscal policy. In addition, spending pressures, notably future pension entitlements, remain a risk and contingent liabilities, such as the HFF guarantee, could have severe consequences. Staying the fiscal course by bringing down public debt levels further is therefore important to reap the gains of past efforts.

### Barriers to entrepreneurship, lack of competition and weaknesses in education undermine productivity

#### Barriers to entrepreneurship are high



Source: OECD, Product Market Regulation indicators database.

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Despite the recovery, income per capita remains lower than in other Nordic countries and near the OECD average, reflecting weaker productivity. While Iceland has a business-friendly environment, it can be difficult for new firms to enter markets, thus deterring innovation. Due to the small size of the economy, ensuring competition can be a challenge. Also undermining productivity are low skills in some of the labour force due to high drop-out rates from upper-secondary school.

## Key recommendations

### ***Lifting capital controls while preserving stability***

- Progress is needed in lifting Iceland's capital controls and the current plan is a welcome step in this direction. Maintaining a robust macroeconomic stability framework will help avoid a disorderly outcome.
- Monetary policy needs to raise interest rates to ensure that a wage-price spiral does not develop, as already stated by the Monetary Policy Committee. The focus should remain on low and stable inflation over the medium term, while allowing the exchange rate to float apart from limited interventions to smooth erratic fluctuations.
- To protect macroeconomic stability the central bank should remain independent from political interference. The monetary policy committee introduced in 2009 should be retained.
- Strengthen the macro-prudential policy framework, incorporating tools to address large swings in capital flows unrelated to fundamentals, while respecting international commitments.
- To protect the economy from unavoidable shocks and reinforce confidence, buffers should be built up including ample fiscal space, foreign exchange reserves and bank capital and liquidity.
- Reforms to current labour market institutions are needed, including giving the state mediator more resources and power to arbitrate in favour of realistic wage agreements.

### ***Securing fiscal sustainability***

- Pass and implement the Organic Budget Law, including enacting the balanced budget rules and establishing an independent Fiscal Council to assess progress towards sustainability.
- Use windfall gains and one-off revenues to pay down debt, including any proceeds from lifting the capital controls.
- Avoid accumulating further contingent liabilities, including by closing the Housing Financing Fund (HFF).
- Further shift tax revenue from income taxes to VAT, while preserving equity.

### ***Setting the course for productivity growth***

- Adopt an ongoing productivity agenda, including following up on the priorities identified by the recent growth forum.
- Lower barriers to entry including by removing legal barriers to entry in particular sectors.
- Support innovation, including by encouraging links with universities. Ease funding access, notably with public investment funds that can finance firm expansion. Evaluate support measures.
- Toughen competition policy implementation to ensure that abuse of dominant position or cartel/tacit collusion does not stifle competition. Use the OECD's Competition Assessment Toolkit to refine law and enforcement.

## Assessment and recommendations

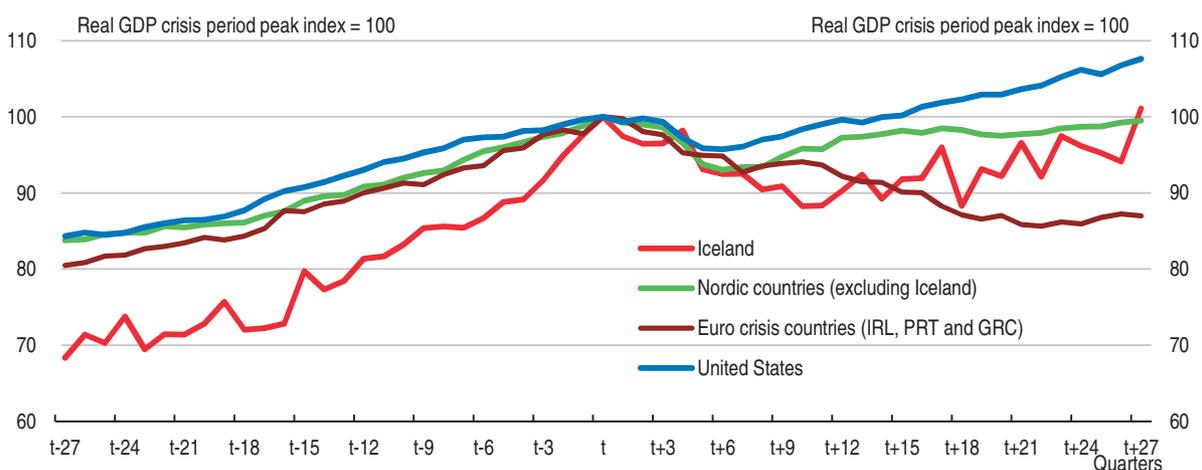
- *The recovery from the crisis is well underway*
- *Lifting capital controls while preserving financial stability*
- *Securing long-term fiscal sustainability*
- *Supporting long-term productivity growth*

Iceland's small and open economy was severely hit by the crisis in October 2008 when its three major banks collapsed and the government lost access to international capital markets. The stabilisation programme conducted with international support was successfully completed in 2011 and economic activity has recovered steadily, returning to its pre-crisis level earlier than in euro-crisis countries (Figure 1). There are other signs of normalisation, such as lower inflation, falling unemployment, improved public finances and stronger household balance sheets.

Nevertheless, critical challenges inherited from the crisis – especially capital controls, and a heavy debt service burden – need to be addressed. A further set of challenges lies in managing wage pressures and in boosting long-term growth. Against this background the present economic survey identifies the following policy priorities:

- Unwinding capital controls
- Reforming the wage bargaining system
- Boosting productivity

Figure 1. **Output is recovering comparatively strongly**



Note: Peak quarter is 2007Q4 for the Nordic countries and Ireland, 2008Q1 for Portugal, 2007Q2 for Greece and 2008Q2 for the United States.  
Source: OECD, Analytical database.

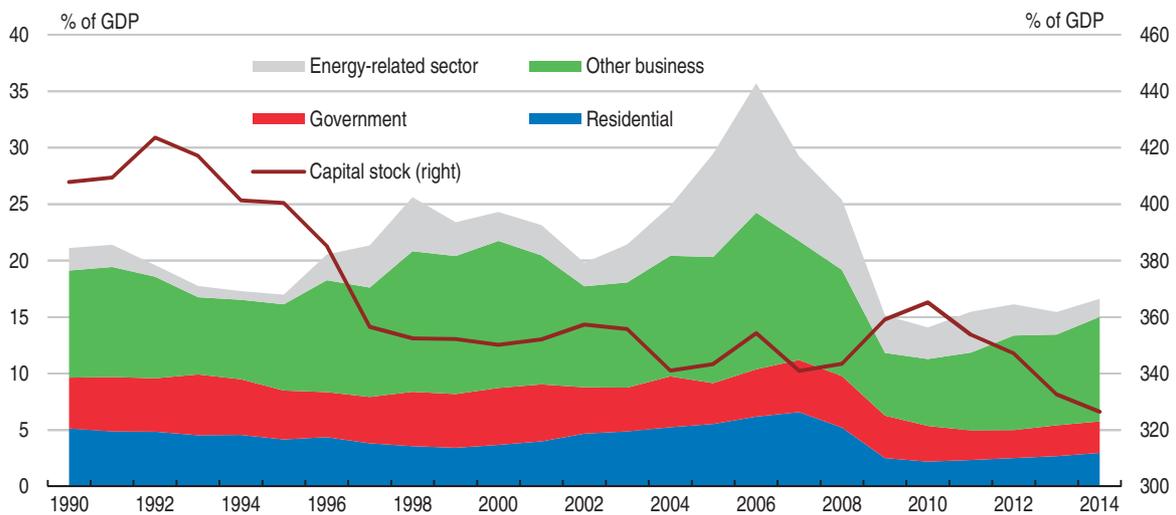
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## The recovery from the crisis is well underway

Iceland has enjoyed a steady economic recovery, with consumer spending rising strongly. Business fixed investment has also recovered, but insufficiently to prevent the capital stock eroding (Figure 2). There is scope for investment to pick up (Lewis et al., 2014) and new projects in the ferrosilicon sector are about to get underway. Public investment has been boosted in the 2015 budget, mainly in transportation projects.

In comparison with the past, considerable progress was made in 2014 and early 2015 in bringing down inflation (Figure 3, Panel B). Annual consumer price inflation has dipped

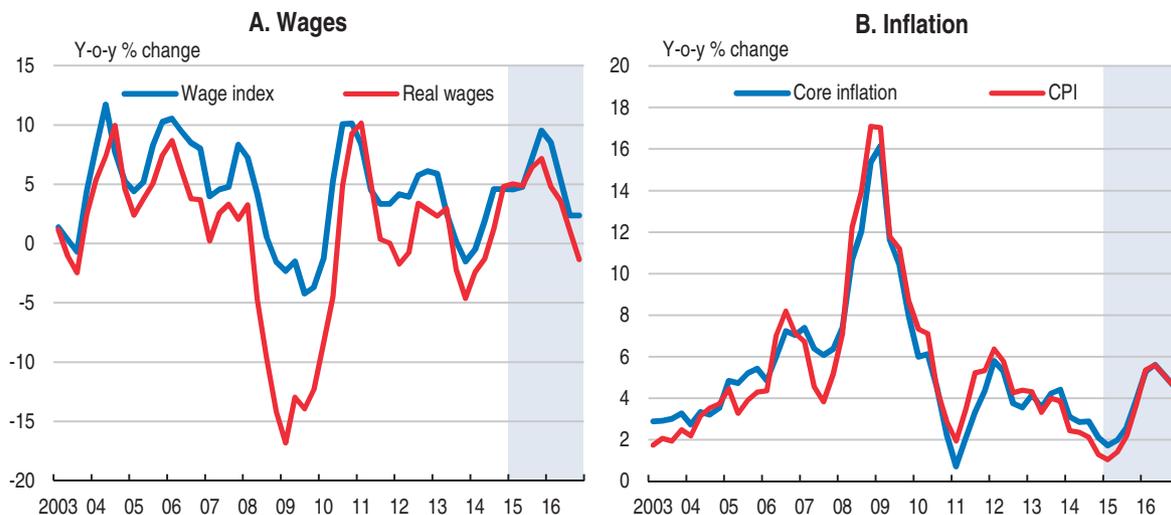
**Figure 2. Investment slumped after the crisis**  
Residential, government, business investment and capital stock  
Investment as % of GDP; Capital stock as % GDP



Source: OECD, Analytical database.

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**Figure 3. Wage and price inflation**



Note: The projections assume interest rates hikes and monetary policy credibility facilitating inflation moving back to target.

Source: OECD, Analytical database, Central Bank of Iceland and Statistics Iceland.

StatLink  <http://dx.doi.org/10.1787/888933258432>

below the Central Bank's inflation target. The cost of housing has recently been the most dynamic component of the consumer price index, reflecting higher imputed rents in the greater Reykjavik area. However, recent wage settlements will push up inflation in the short term and high inflation may become entrenched without an adequate policy response.

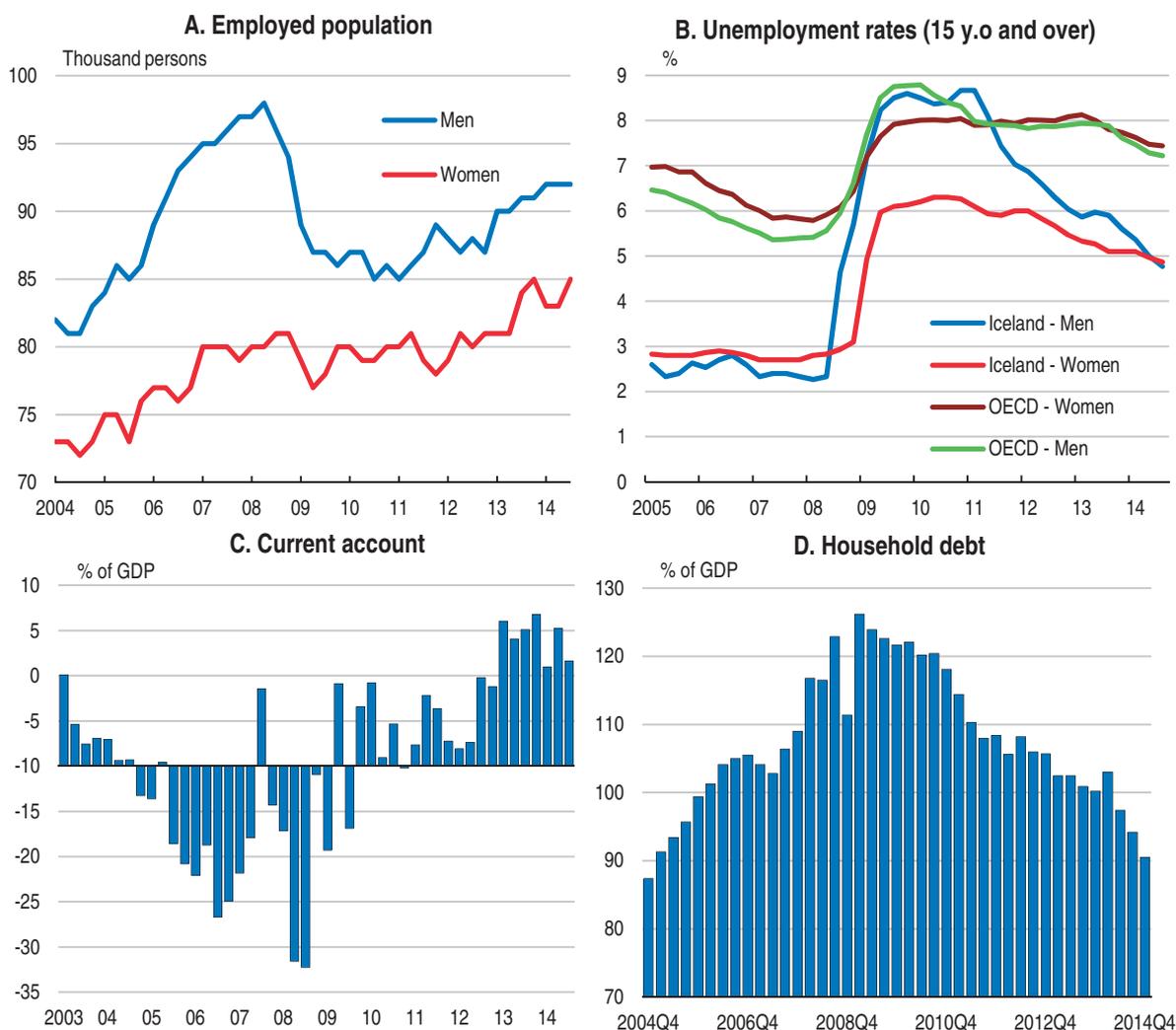
The substantial depreciation of the króna from its pre-crisis level went a long way towards rebalancing the economy and helping the recovery, and more recently the large fall in oil prices and rise of marine product prices have improved the terms of trade and

helped to reduce external imbalances (Figure 4, panel C). Exports of goods have also changed, with less reliance on the traditional exports of fish and aluminium and more on services, notably related to the tourism boom.

The labour market has improved considerably. Job gains have been large, especially in the tourism sector, and the unemployment rate dropped sharply (Figure 4, Panel A and B). Long-term unemployment remains somewhat higher than before the crisis, but has been steadily declining. With labour demand remaining strong, tensions in the labour market have intensified, notwithstanding a pickup in the immigration of workers, pushing real wages back towards their pre-crisis level (Figure 3, Panel A). Furthermore, large settlements in the recent collective bargaining round will raise nominal wages substantially.

The recovery of the labour market has helped households to pay down their debt (Figure 4, panel D). Additional support to household finance has come from the recovery in asset prices, rulings by the Supreme Court that certain loans indexed to foreign currency were illegal, and from a number of government programmes to reduce mortgage debt.

Figure 4. **The economy is normalising**



Source: OECD, Labour Force Statistics and Analytical databases, Central Bank of Iceland, Statistics Iceland.

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These include the current government's programme to reduce mortgage debt by around 8% of household financial liabilities (relative to the end of 2013), which will be largely implemented in 2015 (Central Bank of Iceland, 2014). Healthier household balance sheets will further boost consumer spending.

Near-term economic prospects are good (Table 1). Lower energy prices, improved household balance sheets, higher business investment, less fiscal drag, monetary support and healthier export markets are all projected to sustain real GDP growth of over 4% a year in 2015 and around 3% in 2016. Resolving the uncertainty surrounding capital controls would further improve the investment climate, which would temper inflationary pressures and support stronger growth in the medium term. Sustained current account surpluses would create favourable conditions for lifting capital controls. However, the large overhang of króna debt, which may flood out of the country when capital controls are eased, remains a vulnerability (Box 1).

**Table 1. Iceland: Macroeconomic indicators and projections**

Percentage changes, volume (2005 prices)

	2011	2012	2013	2014	2015	2016
	Current prices billion ISK					
<b>GDP</b>	<b>1 703.2</b>	<b>1.3</b>	<b>3.6</b>	<b>1.9</b>	<b>4.3</b>	<b>2.7</b>
Private consumption	879.0	2.0	0.5	3.7	4.1	2.7
Government consumption	419.4	-1.7	0.7	1.8	2.0	2.5
Gross fixed capital formation	263.7	5.6	-1.0	13.7	17.9	6.7
Final domestic demand	1 562.0	1.6	0.4	4.9	5.9	3.4
Stockbuilding <sup>1</sup>	3.4	0.0	0.0	0.0	-0.3	0.0
Total domestic demand	1 565.4	1.5	0.4	4.7	5.8	3.4
Exports of goods and services	959.9	3.7	6.9	3.1	4.7	4.5
Imports of goods and services	822.1	4.7	0.3	9.9	9.7	6.3
Net exports <sup>1</sup>	137.8	-0.2	3.7	-3.0	-2.0	-0.5
<b>Other items</b>						
Potential GDP		1.4	1.4	1.6	2.0	2.2
Output gap <sup>2</sup>		-4.3	-2.2	-1.9	0.3	0.8
Employment		1.0	3.4	1.6	4.1	1.3
Unemployment rate		6.0	5.4	4.9	3.9	4.1
GDP deflator		3.2	2.0	4.0	6.2	4.0
Consumer price index		5.2	3.9	2.0	2.1	5.1
Core consumer prices		4.6	4.1	2.7	2.6	5.1
Trade balance <sup>3</sup>		6.1	8.2	6.4	7.8	7.7
Current account balance <sup>3</sup>		-4.4	5.8	3.6	2.6	2.8
General government financial balance <sup>3</sup>		-3.7	-2.0	-0.2	0.0	0.1
General government underlying primary balance <sup>3</sup>		2.1	2.4	3.1	3.0	2.9
General government gross debt <sup>4</sup>		95.2	87.7	85.4	81.9	79.3
General government net debt <sup>4</sup>		28.9	27.4	26.1	23.6	22.0
Short-term interest rates		5.5	6.2	6.1	6.0	7.4
Long-term interest rates		6.2	5.8	6.4	6.7	6.5

1. Contributions to changes in real GDP, actual amount in the first column. The sum of contributions can deviate from GDP growth due to chain linking.

2. As a percentage of potential GDP.

3. As a percentage of GDP.

4. As a percentage of GDP. Includes unfunded liabilities of government employee pension plans, which amounted to about 20% of GDP in 2014.

Source: OECD Economic Outlook database (June 2015) updated with incoming information.

### Box 1. Vulnerabilities for the outlook

There are a number of vulnerabilities for the outlook. The vulnerabilities are low probability events that would create challenges for the economy, but are not included in the baseline.

Vulnerability	Possible outcome
Disorderly exit from capital controls	The process of lifting the capital controls has many possible pitfalls that could prove to be disorderly to the outlook. Failure to reach agreement with creditors may lead to legal challenges if policies are deemed discriminatory. Capital outflows may increase as barriers are progressively relaxed. Domestic financial institutions may also be exposed to shocks during this process, which may result in increased nonperforming loans or strain on liquidity. However, capital adequacy ratios are relatively high in the banking sector.
Wage bargaining complicates macroeconomic policy	Large wage settlements being made during collective bargaining rounds can be destabilising. Substantial pay rises are likely to trigger a significant tightening to bring inflation and inflation expectations under control. High public sector settlements and fiscal measures to secure settlements can undermine the fiscal position.
Rising financial losses of the state-owned Housing Finance Fund (HFF)	The weakness of the Housing Finance Fund could undermine the financial position of the Treasury budget, especially if more losses crystallise quickly. The Housing Finance Fund has already required substantial recapitalisation and the entire stock of HFF debt is guaranteed by the government (Kr. 881 billion, equivalent to 44% of GDP).
Large rises in oil prices	The substantial drop in the price of oil has boosted Iceland's terms-of-trade. A large rebound would undermine some of the improvement in the current account balance.
Euro area weakness	A further intensification of euro area difficulties could further weaken the demand for Icelandic products. A resolution to the current problems and stronger euro area growth represent upside risks for Icelandic exports.
Financial market turbulence	International financial markets may become more volatile and risk premia could jump. These could translate to important shocks for Iceland, undermine some of the progress made in fiscal policy, and affect its external position due to being a net debtor.
Political stalemate	Iceland faces a number of complex challenges, not least with respect to capital controls. Forging political consensus to take the next steps may prove elusive leading to delays in needed reforms.
Natural disaster	Iceland has been periodically affected by volcanic eruptions. Severe eruptions can have damaging impacts on economic activity. However, Iceland has a system of disaster insurance which would mitigate the economic impacts

The outcome of the recent wage bargaining round threatens the recovery. On average, private-sector wages will rise by over 20% between mid-2015 and mid-2018 and even more rapidly for low-income workers. The wage agreements were facilitated by fiscal measures, including tax cuts, at an estimated net cost of 0.5% of GDP. The central bank has raised interest rates in response to these developments and has signalled further increases.

Without deep reform to the collective bargaining system such wage pressures could reoccur (Box 1). While Iceland has many of the same labour market institutions as other Nordic countries (Box 2), these countries have tended to avoid such sharp disputes. Pinpointing the features that support a well-functioning collective bargaining system is difficult (OECD, 2004), but some dimensions may be important and elements of other systems may provide useful examples of alternative approaches for Iceland:

- In Iceland, the wage demands do not appear to take into account macroeconomic externalities. Other systems set reference points for negotiations to limit adverse consequences. For example, in Norway, the sequencing of agreements starts with the internationally-exposed sector, basing the settlement on competitiveness concerns, with that award then influencing subsequent agreements. The natural-resource based

### Box 2. **Collective bargaining in Iceland**

The collective bargaining system in Iceland, whilst similar to other Nordic models, has its own peculiarities.

Collective bargaining rounds typically occur every three years with the structure of the pay settlements tending to offer large increases in the first year and smaller increases in subsequent years. Wage demands are often expressed as the cumulative increase over the three years.

The degree of co-ordination amongst the social partners can vary. On the employers' side, the vast majority of firms negotiate under the aegis of the Confederation of Icelandic Employers. On the union side, the right to bargain lies with each union, though this may be transferred to national federations. On occasion, the largest unions form a collective negotiating committee. In the recent bargaining round, on the other hand, the unions did not work together and the employers then negotiated with the larger unions to find a settlement that could serve as a template for other settlements.

The private sector unions' arguments for wage increases can vary, but in the past decade they have tended to concentrate on the lowest wages. The size of the demands tend not to be based on an evaluation of what is consistent with macroeconomic stability, but on wages for other groups. If settlements for some workers have already been made, those awards tend to set a floor for wage demands. In the recent bargaining round, three-year awards of around 25-30% for doctors and teachers led to demands by other unions for 50% pay increases over three years, whereas employers were offering annual increases of 3%.

In the private sector, the centralised contracts typically negotiate a minimum increase for everyone's wages. On top of this increase, sectoral and firm-level negotiations take into account specific local conditions offering top ups. Finally, private firms may grant additional pay rises that contribute to wage drift over the settlement period. In the public sector, negotiations usually follow the private sector, with the award typically based on the minimal wage increase. Top ups to the base are less common in the public sector, partly due to the "flat" nature of public sector occupations, such as teaching, and more recently, to the fiscal consolidation. When relative wages vis-à-vis the private sector get out of line, parity in public sector wages is often restored through industrial action.

When disputes erupt, the social partners can turn to the state mediator. The mediator then leads the negotiations and can submit proposals to the social partners. When these talks break down, industrial action can be initiated if advanced notification is given. The mediator submits a proposal to the social partners if the difference between them is not too large. If the mediator's proposal is rejected, parliament may be required to rule on whether strikes are harmful and thus banned, as was the case in the recent wage bargaining round.

The government has been typically involved in the collective bargaining process. The social partners expect the government to offer tax concessions and social transfers in an effort to encourage moderate settlements. The Government's contribution in the last two negotiation rounds (2011 and 2015) has been unusually large, not least in light of the size of the negotiated wage increases.

export industries in Iceland may provide a poor signal of what the rest of the economy can bear. In Belgium, legislation limits pay awards to forecasts of labour costs in neighbouring countries. The Icelandic government has proposed the establishment of a macroeconomic council to provide information on the state of the economy before the collective bargaining round, which goes some way in this direction.

- With many different agreements needing to be reached (around 400 in Iceland), the potential for co-ordination failures can arise with different agreements trying to get their members the largest award. The degree of co-ordination in other Nordic systems appears to be relatively high, which helps reduce this type of problem.
- Public sector wage growth tends to lag behind the private sector and relative wage levels are reset during the wage bargaining rounds. This leads to periodic large wage adjustments. Such catch-up awards helped trigger the large wage demands in the recent collective bargaining round. In other countries, such as Denmark, partial indexation of public sector wages to the private sector limits how far relative wages get out of line.
- When impasse is reached a state mediator can intervene in both Iceland and other Nordic countries. However, in other countries the powers of the mediator appear stronger. In Denmark, the state mediator can propose an agreement - generally costly to both sides - that can be made into law if ultimately necessary. In other cases, such as Luxembourg, the wage bargaining system requires considerable negotiation and the use of mediation and arbitration before industrial action can commence. Iceland's state mediator could be given greater authority to arbitrate in favour of realistic wage settlements, in line with practices in these countries.

### **Lifting capital controls while preserving financial stability**

Iceland imposed capital controls in the wake of the banking collapse in 2008. Although lifting these controls is desirable for long-term prospects, doing so risks disorderly capital outflows in the short run. These outflows would include foreign claims on domestic assets locked in the insolvent estates of the failed banks (which could unleash capital amounting to between 25% and 45% of GDP), carry trade funds trapped in Iceland (sometimes called offshore króna holdings, which now amount to around 15% of GDP), and the potential for an abrupt rebalancing of pension funds and other domestic investment portfolios toward foreign assets (which could amount to roughly 35% of GDP).

In consultation with the IMF, the central bank initially issued a two-step plan in 2011 that aimed gradually to:

- channel unstable offshore króna holdings to longer-term investors until the stock was manageable relative to official reserve holdings, and then
- ease the controls, possibly using exit taxes or incentives to slow outflows and redirect funds toward domestic assets.

The central bank implemented the first part of the plan by holding foreign exchange auctions that have gradually trimmed offshore króna holdings from about 40% of GDP in 2008 to 15% of GDP in late 2014. Despite this success, the plan had a shortcoming because it failed to address the threat from the insolvent bank estates, which only later became apparent. The realisation of this threat compelled the authorities to broaden the capital controls to cover the estates in 2012, and rendered the previous plan insufficient.

Despite the absence of a concrete plan, significant steps have been taken to pave the way for liberalising controls. Steps have been taken to fortify the financial system, including regular meetings of a newly created Financial Stability Council since the fall of 2014 and the Central Bank's introduction of rules on bank foreign currency funding ratios and liquidity.

In June 2015, the authorities announced a plan to unwind both the failed banks' estates and the remaining offshore króna. The plan was formed in consultation with a task force of outside experts (including economists and legal experts on international taxation)

appointed by the government in July 2014. The plan to resolve the insolvent estates uses a combination of incentives to motivate the boards charged with winding up the failed banks to reach voluntary agreements with their claim holders to allocate remaining assets in a way that does not compromise financial stability. Specifically, the authorities will only accept composition plans that satisfy specified stability conditions, including:

- measures to neutralise the threat from distributing króna-denominated assets, such as making an offsetting “stability contribution” to the Icelandic treasury;
- extending the maturity of foreign-currency denominated domestic assets (such as foreign exchange bank deposits) to terms of 7 to 10 years; and
- refinancing or otherwise ensuring the repayment of foreign-exchange denominated loans granted by the authorities to the new banks following the crisis.

Estates that fail to reach a suitable composition agreement by end of 2015 will be subject to a one-time “stability tax” on their total assets holdings of 39% – roughly in the line with the total proportion of all domestic assets in all three estates (Króna denominated or otherwise). Estates can reduce their tax liability to some extent by converting liquid foreign-currency holdings to longer-term assets. To unwind the offshore króna, the authorities plan to employ a one-time auction that will allow foreign investors to either convert short-term króna assets into Icelandic government bonds or to foreign exchange at a cost. Unconverted funds will be locked in non-interest bearing accounts, thereby discouraging holdouts.

Although this plan is subject to litigation risks, the winding-up boards of the three estates, in consultation with their largest stakeholders, have proposed composition agreements to the authorities that satisfy the stability conditions. Each proposal would require approval from estate stakeholders representing at least 70% of the claimants and 60% of the total value of claims. The government estimates that the stability tax would generate a one-time boost in treasury revenues ranging between about 34% and 42% of 2014 GDP, compared to revenues between 18% and 32% of 2014 GDP for composition agreements.

The authorities recently announced measures that begin to address the threat of capital outflows from private portfolio rebalancing. Pension funds will be allowed to apply to the central bank for exemptions to purchase foreign assets over the remainder of 2015 amounting to as much as ½ percent of GDP overall, allocated amongst applicants based upon a weighting of their size and net inflows. To facilitate further portfolio rebalancing, it would be sensible to continue to place temporary restrictions on private foreign asset purchases that can be adjusted in light of balance payments conditions.

The Icelandic authorities are also working with the OECD’s Investment Committee and its Advisory Task Force on the Codes of Liberalisation of Capital Movements and Current Invisible Operations. When Iceland imposed capital controls it received a derogation from the obligations of the Codes under Article 7.

### ***Low inflation is threatened by high wage settlements***

Monetary policy has successfully reduced inflation, and low inflation has allowed the central bank to reduce its policy rates from their peak after the crisis. Combined with capital controls, this contributed to exchange rate stability. Amendments to central bank legislation in 2001 and 2009 created a framework that has contributed to these successes, including setting up a monetary policy committee with a clear mandate for monetary policy and measures to promote accountability. The government is currently considering

changes to the Central Bank Act. Any changes should not undermine the actual or perceived independence of monetary policy, especially in the light of political pressures on the central bank that have undermined its credibility in the past. For example, ensuring that appointments to the monetary policy committee continue to be made on the basis of expertise rather than political orientation would help safeguard perceived independence.

Monetary policy is particularly challenging in Iceland, given the tiny size of the economy and challenges posed by international capital mobility. Iceland's withdrawal from consideration for EU accession has for the moment removed the option of joining the euro area, a possibility raised in the previous *Economic Survey*. Past attempts at pegging the króna have been unsuccessful, suggesting that foreign exchange interventions can at most only smooth erratic and transitory fluctuations.

Once capital controls are lifted, monetary policy should focus on inflation stability in the medium term and allow the exchange rate to float. To this extent, bolstering credibility and reputation can help anchor expectations and reduce the degree of exchange-rate pass-through, hence limiting output losses linked to fighting inflation.

Monetary policy is poorly equipped to offset the effects of supply shocks, which are especially destabilising in Iceland given its small size and limited production base. As such, monetary policy needs to be complemented by enhanced flexibility in the economy and by the maintenance of fiscal and financial buffers that help mitigate effects from economic and financial shocks.

The implementation of monetary policy could be made easier if the inflation targeting framework were refined to reflect national circumstances. In particular, policy implementation is particularly challenging because of high exchange-rate pass through; exchange rate movements can cause pronounced short-term swings in inflation that largely play out within two years. Attempts to smooth through pass-through effects likely compound instability due to policy lags, the bluntness of monetary policy instruments, and any tendency to react asymmetrically to inflationary and disinflationary shocks. Hence, it may be desirable to lengthen the horizon for achieving the inflation target and craft policy communication to focus attention away from transitory inflationary disturbances. Such measures would help to anchor longer-term inflationary expectations and thereby enhance credibility.

### ***Bolstering macro-prudential policy and prudential regulation***

To deal with systemic threats, a Financial Stability Council has been created. It brings together the Ministry of Finance, the Governor of the Central Bank and the Director General of the Financial Supervision Authority and is supported by a systemic risk committee. Macro-prudential policy to ensure financial stability will be based on a number of operational concerns, such as credit growth and leverage, but will also examine ways to reduce moral hazard and address the effects of excessive capital flows. One important consideration will be embedding actions to address excessive capital flows in Iceland's international obligations on capital flows, including the OECD Codes of Liberalisation of Capital Movements. An agreed set of capital flow management instruments as part of the macroprudential policy framework would reduce the vulnerability of the economy to abrupt swings in capital flows unrelated to fundamentals. Finally, the central bank could further enhance credibility by maintaining large foreign exchange reserves as an additional safeguard.

Actions to tighten prudential regulation have already been substantial and go a long way to building up buffers in the financial sector. The main initiatives in bank regulation has been to phase in, between the end of 2014 and 2017, increases in the liquidity coverage ratio, particularly for foreign currency, and raising funding rules to reduce the risks of term and currency mismatches. With its membership of the European Economic Area, Iceland is committed to adopting European Union financial regulation, which concerns capital requirements, bank resolution and deposit insurance, areas where reforms were recommended in the 2013 *Economic Survey*. As a result, considerable progress has been made in building up buffers in the financial sector, particularly the banks. The Icelandic authorities are already at - or close to - the international frontier in prudential regulation through the timely implementation of Basel III. Remaining at the frontier by keeping up with international norms and using stress tests to evaluate the robustness of the financial sector will help maintain the health of the financial sector.

#### **Recommendations for lifting capital controls while preserving financial stability**

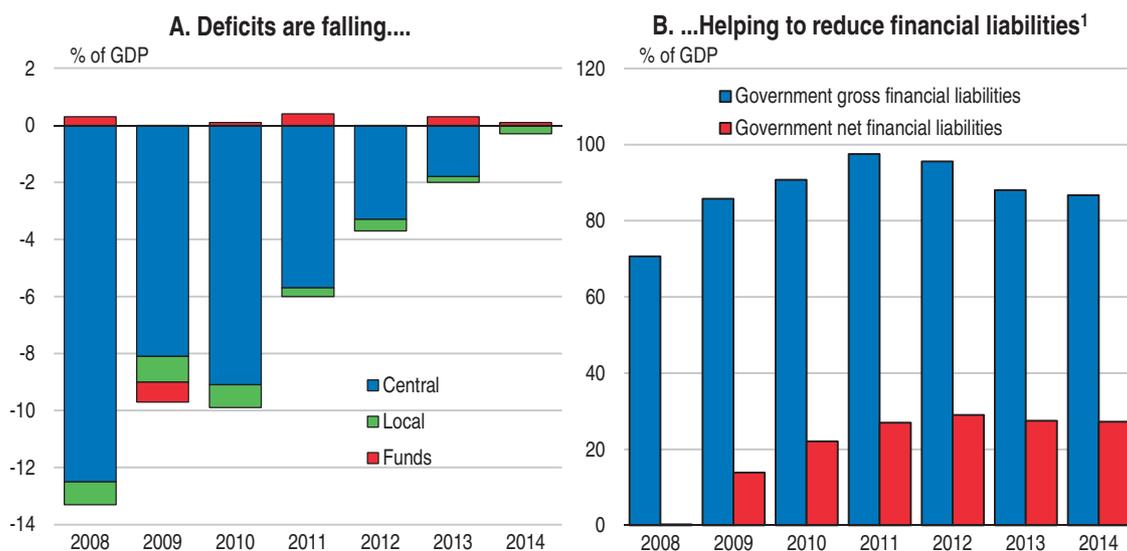
- Progress is needed in lifting Iceland's capital controls and the current plan is a welcome step in this direction. Maintaining a robust macroeconomic stability framework will help avoid a disorderly outcome.
- Monetary policy needs to raise interest rates to ensure that a wage-price spiral does not develop, as already stated by the Monetary Policy Committee. The focus should remain on low and stable inflation over the medium term, while allowing the exchange rate to float apart from limited interventions to smooth erratic fluctuations.
- To protect macroeconomic stability the central bank should remain independent from political interference. The monetary policy committee introduced in 2009 should be retained.
- Strengthen the macro-prudential policy framework, incorporating tools to address large swings in capital flows unrelated to fundamentals, while respecting international commitments.
- To protect the economy from unavoidable shocks and reinforce confidence, buffers should be built up including ample fiscal space, foreign exchange reserves and bank capital and liquidity.
- Reforms to current labour market institutions are needed, including giving the state mediator more resources and power to arbitrate in favour of realistic wage agreements.

#### **Additional recommendations**

- To safeguard the perceived independence of monetary policy appointments to the committee should be for staggered fixed terms and should continue to be made on the basis of professional experience.

## **Securing long-term fiscal sustainability**

Fiscal policy has succeeded in eliminating the budget deficit and lowering public debt (Figure 5). Public debt has started to decline, which, combined with a little change in financial assets, brought down net government financial liabilities by around 2% of GDP in 2014. While some of the progress has been helped by one offs (such as dividends from the banks; also the planned partial privatisation of the state-owned bank Landsbankinn

Figure 5. **Public finances have improved**

1. The figures on Panel B exclude unfunded public pensions liabilities.

Source: OECD, Analytical database and Statistics Iceland.

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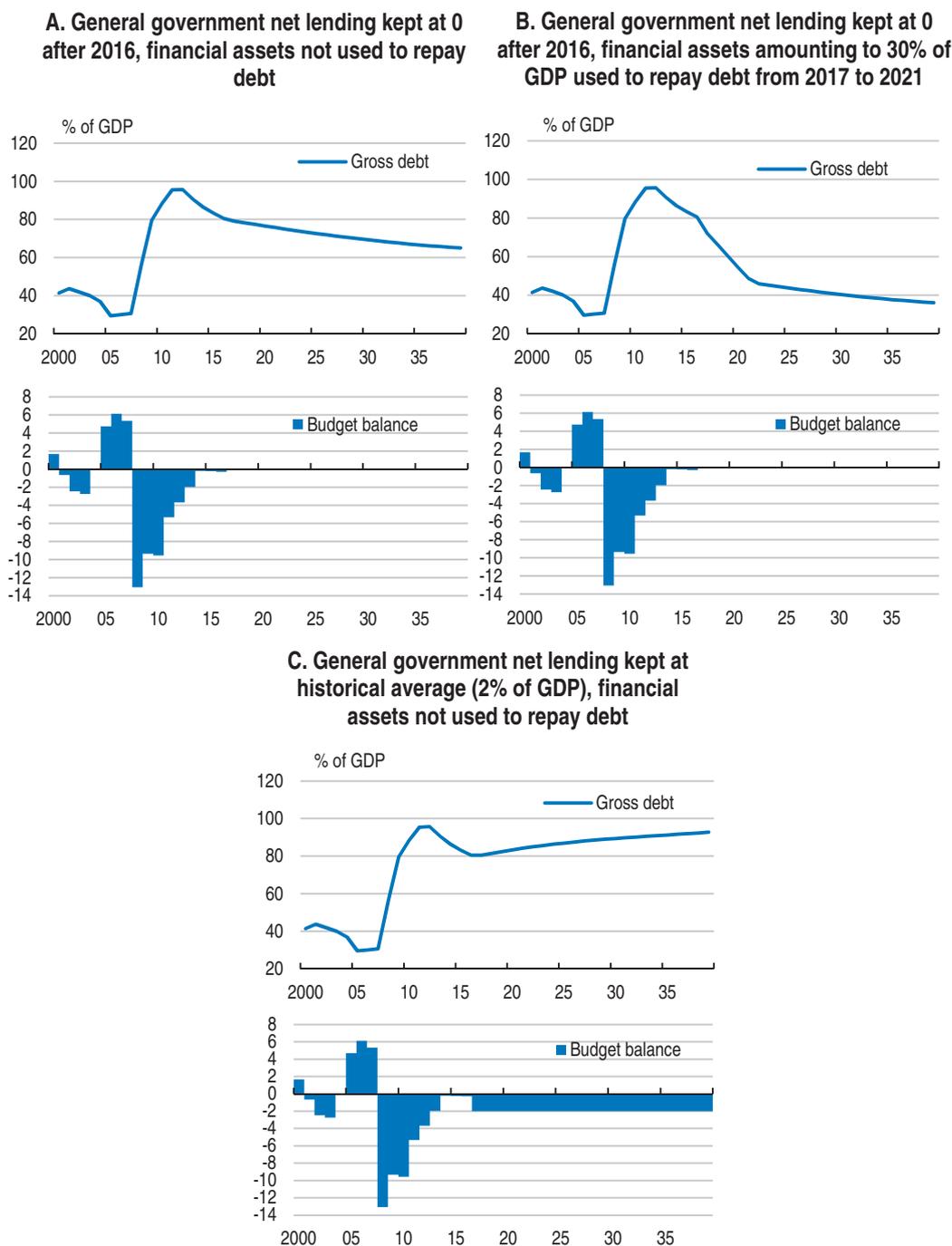
should be used to reduce debt), the underlying improvement in the primary balance is sufficient to put gross debt on a downward trajectory.

Iceland's fiscal policy is currently on track to achieve sustainability and lower debt, but relaxing fiscal policy risks derailing this process and reverting to unsustainable trends. Projections can shed light on the consequences of different deficits and use of windfall resources on debt sustainability (Figure 6). The projections are based on macroeconomic assumptions for growth and interest rates, and evaluate the path of gross debt (the government uses a slightly different debt measure, but the implications hold for either measure). Keeping the budget balanced in line with current plans would reduce gross debt to about 60% of GDP in 2040 (assuming that government financial assets remain constant relative to GDP at the level of 2013) and virtually eliminate the net debt position (when not considering contingent liabilities and unfunded public pension schemes). If the proceeds from the sale of Landsbankinn and the stability contributions are used to retire debt, gross debt declines more rapidly and would drop below 40% of GDP by the end of the projections. However, the apparent favourableness of the current fiscal position should not give grounds for complacency as relaxing fiscal discipline could easily undermine sustainability. If fiscal policy reverts to past performance by running a 2% deficit on average, and the one-off and windfall revenues are not used to pay down debt, gross debt begins to mount again and approaches 100% of GDP in 2040.

### **Sizeable pressures on fiscal policy remain**

With risks that fiscal policy could be thrown off track, policymakers need to remain focused on debt reduction. Reducing gross debt would lower very high borrowing costs (effective interest rate of about 5½ per cent) that exceed the return on government financial assets (about 2%). Another reason to reduce financial liabilities is the shortfall in funding for state pensions (the implicit debt is currently estimated to be around 20-25% of

Figure 6. Simulations of public debt paths



Note: Simulations follow the OECD projection through 2016. Thereafter, real GDP growth averages 2.4% and inflation averages 2.5%. In simulations shown in panels A and C, financial assets are kept constant at their latest projected level (57.3%).

Source: OECD, Economic Outlook database and OECD calculations.

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GDP). Finally, creating larger fiscal buffers would allow the government to react to future destabilising economic or financial shocks, including a disorderly lifting of capital controls.

The government has financial assets of around 60% of GDP, but not all of them can be counted on if government finances were to come under short-term pressure. At the end of

2013, government financial assets included currency and deposits worth 22% of GDP, shares and other equity worth 21% of GDP, as well as loans and other accounts receivable amounting to 16% of GDP. Around 25% of GDP of government assets are foreign exchange reserves for use by the central bank. Other financial assets may be hard to draw upon in an emergency. For example government holdings of Landsbankinn require parliament's approval to sell additional shares and, in a crisis, fire-sale prices may prevail.

Large contingent liabilities in the form of state guarantees suggest that the measured net debt position may be somewhat flattering. A large financial risk is the Housing Finance Fund (HFF), which has facilitated access to mortgage loans with a state guarantee. The HFF has struggled recently as commercial banks offer lower interest rates, drawing away new mortgage growth, while existing customers have prepaid in large numbers. Coupled with a default rate of around 8%, the HFF has made losses, requiring the state to recapitalise it periodically (around 50 billion króna so far, 2.5% of 2014 GDP). The total state guarantee to the HFF is worth around 881 billion króna (44% of 2014 GDP). The current plan of winding down the HFF is therefore appropriate. Instead of using the HFF to provide universal support to homeownership, Iceland should target its financial aid to low-income families who wish to rent – a more effective and less expensive approach.

A second large source of contingent liabilities arises from world aluminium prices. State guarantees are in place for the largest energy company, Landsvirkjun. As around one-half of electricity sales are linked to the aluminium price, the company (and indirectly the government) is therefore exposed to commodity price risks. The state guarantee to Landsvirkjun is estimated at around 300 billion króna or 15% of GDP in 2014. No further state guarantee to such industrial development should be undertaken as has been the case more recently with Landsvirkjun.

### ***Adopting a new fiscal framework***

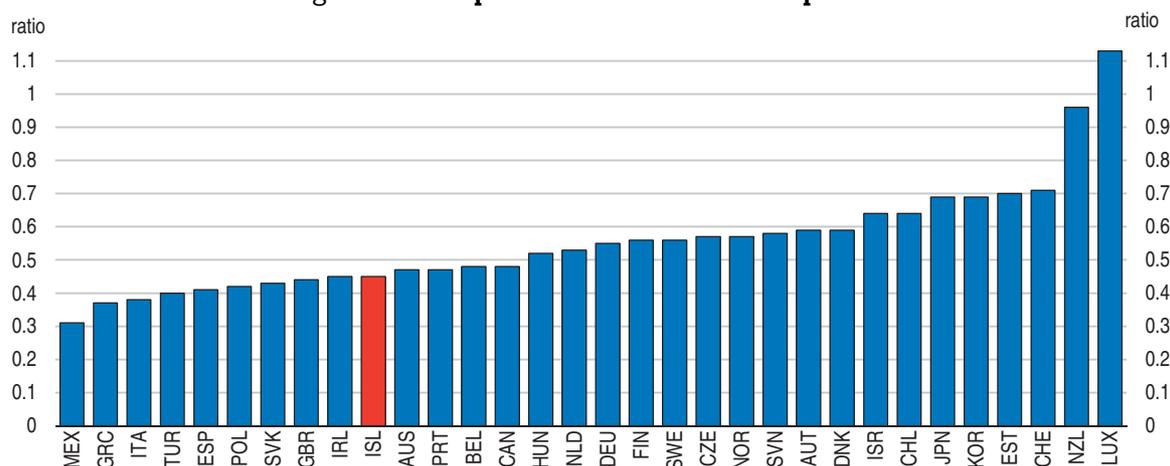
The government has prepared a fiscal framework for long-term sustainability and to secure space for counter-cyclical stabilisation. The fiscal rules built into the proposed Organic Budget law limit the deficit to 2.5% of GDP in any given year and require the cumulative balance over a 5 year period to be positive. They also target public debt of 30% of GDP (public debt is defined as gross financial liabilities less unfunded pension liabilities and other accounts payable, as well as the value of currency and deposit assets; in 2014 debt by this measure was about 55% of GDP). When debt is above the target, the government must reduce it by 1/20 of the difference annually. While this should see government debt brought down, any slippage could see debt loads rising again.

The budget law would also hold the government accountable for its fiscal policy, including through the creation of an independent fiscal council. Newly-elected governments must present a statement of objectives for fiscal policy and the annual budget must be linked to medium-term fiscal policy objectives. Anchoring the annual budget on medium-term objectives should mitigate the risk of relaxing spending control towards the top of the cycle. The law also aims to make fiscal policy more predictable and less susceptible to the tendency for adjustments to be introduced during the budget year. Assessing progress of fiscal policy against the fiscal rules and evaluating longer-term sustainability are areas where the fiscal council could develop its role.

### Better targeting fiscal policy

The 2015 budget introduces several initiatives to support growth and inclusiveness: higher spending on health and education; further investment on transportation infrastructure; more generous child benefits; and a switch towards indirect taxation. On the eve of the reform, the VAT revenue ratio, which gives an indication of the efficiency relative to a benchmark of uniform rates and full VAT compliance, was below that of many other countries (Figure 7). The reform should improve overall efficiency by raising the reduced rate (from 7 to 11%), while reducing the standard rate, which was amongst the highest in the OECD (from 25.5 to 24%). The reform also abolishes a commodity tax levied on consumption goods. The distributional impact of the tax reform will be modest. A further reduction in VAT exemptions and narrowing the gap between the reduced and standard rates would make the system more neutral and easier to administer. Greater VAT revenue could facilitate a reduced reliance on direct taxes, which account for a significantly higher share of revenue than the OECD average (45% and 34%, respectively).

Figure 7. VAT performance could be improved



Note: The VAT revenue ratio (VRR) measures the ratio of the VAT revenue actually collected to what would theoretically be raised if VAT was applied at the standard rate to the entire potential tax base in a “pure” VAT regime and all revenue was collected.

Source: OECD, Consumption Tax Trends (2014).

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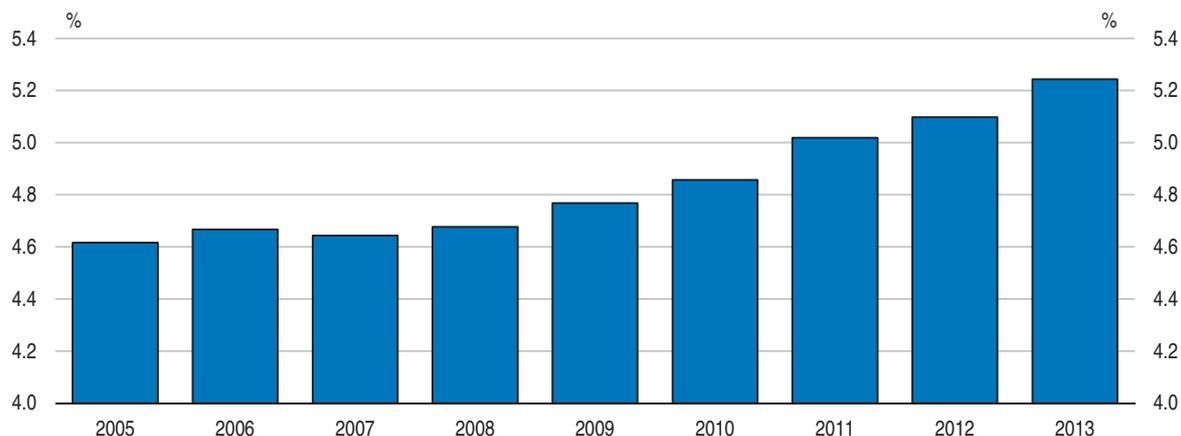
### Disability is rising

Disability benefits account for a large and rising share of public social spending. Life expectancy is high in Iceland (particularly for women) and the share of people who report that they are in good or very good health is substantially higher than the average for the OECD (OECD, 2013c). However, enrolment in disability programmes has been rising (Figure 8). Disability and sickness programmes are amongst the most costly in the OECD, accounting for over one fifth of all social spending (OECD, 2010). A large proportion of those receiving benefits are women and persons with low education outcomes.

### Young people can be reliant on benefits

Since 2007, the percentage of young people not in employment, education or training (NEET) has risen more than on average for the OECD (Carcillo *et al*, 2015). This increase reflects the impact of the crisis on the young, which has seen their unemployment rate rise to over 10% in 2013, and growing disability rolls, which accounted for around 3% of those aged between 20

**Figure 8. Disability rolls are rising**  
Percentage of the population receiving a disability pension or allowance.



Source: Tryggingastofnun.

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and 25. Survey evidence indicates that over 13% of the youth in Iceland received either unemployment or disability benefits at some point during 2012, while the OECD average was around 9% (Carcillo *et al.*, 2015). The large number receiving unemployment benefits is partly an outcome of a high labour force participation rate amongst the young (almost 79% in Iceland for those aged between 15 and 24 compared to the OECD average of just over 47% in 2013). Iceland is unusual in having the longest duration of unemployment benefits (recently reduced from 36 to 30 months) with the shortest contribution period for eligibility (3 months). The young can also qualify for disability benefits and means tested benefits (including when living with their parents). This system reduces poverty. However, reducing the incentives to drop out of the labour force provided by current support mechanisms and working to reintegrate those with weak labour market attachment would also reduce poverty and absorb fewer fiscal resources. Helping people back to work and avoiding scarring (which amongst the young can be damaging for career prospects) may require training and retraining, which underlines the importance of improving outcomes in education.

#### **Recommendations for fiscal policy sustainability**

- Pass and implement the Organic Budget Law, including enacting the balanced budget rules and establishing an independent Fiscal Council to assess progress towards sustainability.
- Use windfall gains and one-off revenues to pay down debt, including any proceeds from lifting the capital controls.
- Avoid accumulating further contingent liabilities, including by closing the Housing Financing Fund (HFF).
- Further shift tax revenue from income taxes to VAT, while preserving equity.

#### **Additional recommendations**

- To preserve labour force attachment and reduce fiscal costs, help people get back to work, tighten access to welfare benefits and further reduce the duration of unemployment benefits.

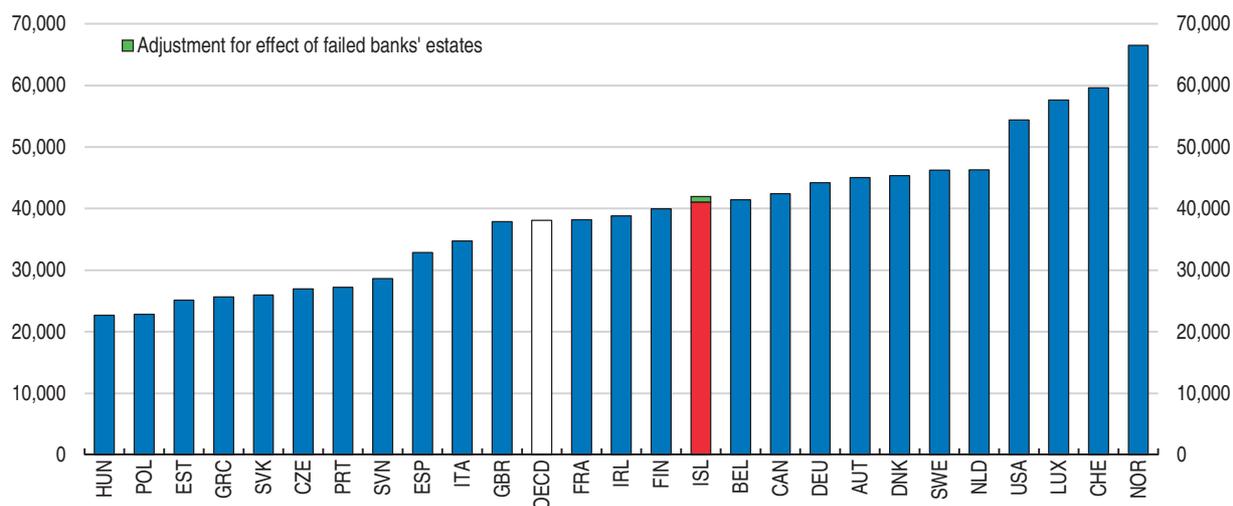
## Supporting long-term productivity growth

Despite economic recovery, Iceland's GNI per capita remains below the average of other Nordic economies and near the OECD average (Figure 9). This largely reflects weak labour productivity, which slumped after the crisis, although multifactor productivity has held up (Figure 11). Compared with other Nordic countries, productivity shortfalls are apparent across all sectors apart from fishing and energy-intensive metallurgy (particularly aluminium). With labour force participation already high, stronger growth will require more business investment and higher multifactor productivity growth (Figure 11, Panel D). Addressing the relative mediocrity of income would help boost an aspect of well-being where Iceland performs quite poorly (Box 6).

Iceland's business sector has four main components (McKinsey, 2012). The capital intensive resource-based sector - fisheries and metallurgy - combined with tourism account for the majority of exports. A smaller international sector consists of other firms exposed to international competition, including business and ICT services, as well as some manufacturing. The remaining two sectors are the public sector and private domestic services, which together account for 70% of employment. Outside the metallurgy sector, foreign ownership is low, partly as a result of restrictions but also due to the strong presence of state-ownership in the energy sector.

Figure 9. **GNI per capita is slightly above average**

2013 estimates in US dollars, current prices, current PPPs



Note: OECD average excludes Mexico and Turkey. The GNI per capita figure for Iceland is somewhat higher when a correction is made for estimates of service payments sent abroad by the estates of the failed banks.

Source: OECD, National Accounts database, Central Bank of Iceland (adjustments)

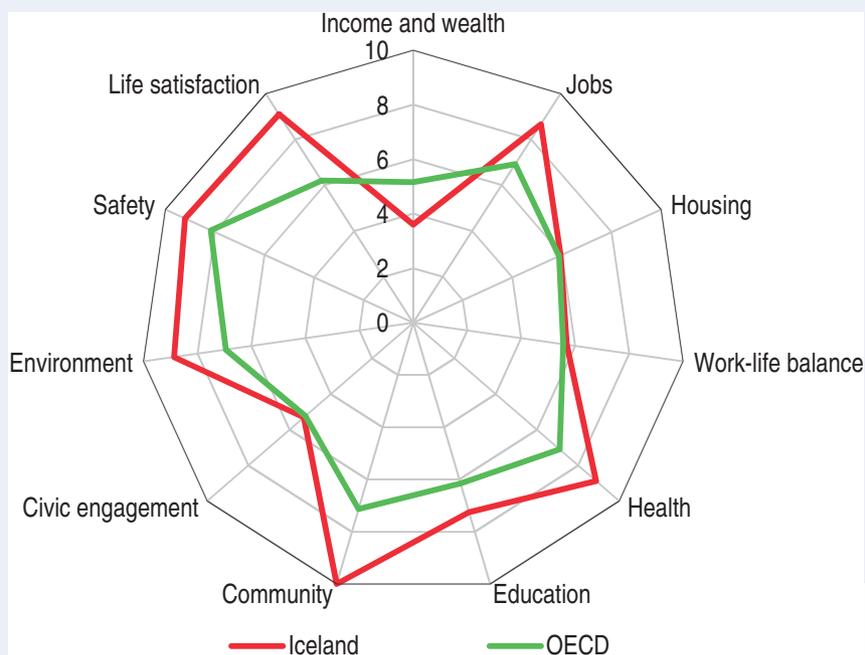
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Recent developments are somewhat disquieting from the perspective of the longer term. Booms in specific sectors, such as fishing, energy, aluminium and finance, all contributed to rapid expansions but were also followed by slowdowns or crashes. Unfortunately, positive spillovers from these sectors to other sectors have been limited due to sector-specificity of skills or a high degree of capital intensity. Furthermore, the deals made to attract energy-intensive investments, with large multinationals that can credibly threaten to invest elsewhere, have led to Iceland capturing a relatively small share of the

### Box 3. Well-being in Iceland

Well-being in Iceland is high in comparison with the rest of the OECD. According to the OECD's Better Life Index, residents enjoy high levels of employment, community engagement, environmental services, health and life satisfaction. On the other hand, Iceland's rankings for housing, civic engagement, work-life balance and particularly income and wealth are only average at best (Figure 10). Per capita income in comparison with the rest of the OECD has dropped over time and was hit by the crisis.

Figure 10. Well-being is high in Iceland



Note: Each well-being dimension is measured by one to three indicators from the OECD Better Life indicator set. Normalized indicators are averaged with equal weights. Indicators are normalized to range between 10 (best) and 0 according to the following formula:  $(\text{indicator value} - \text{minimum value}) / (\text{maximum value} - \text{minimum value})$ .

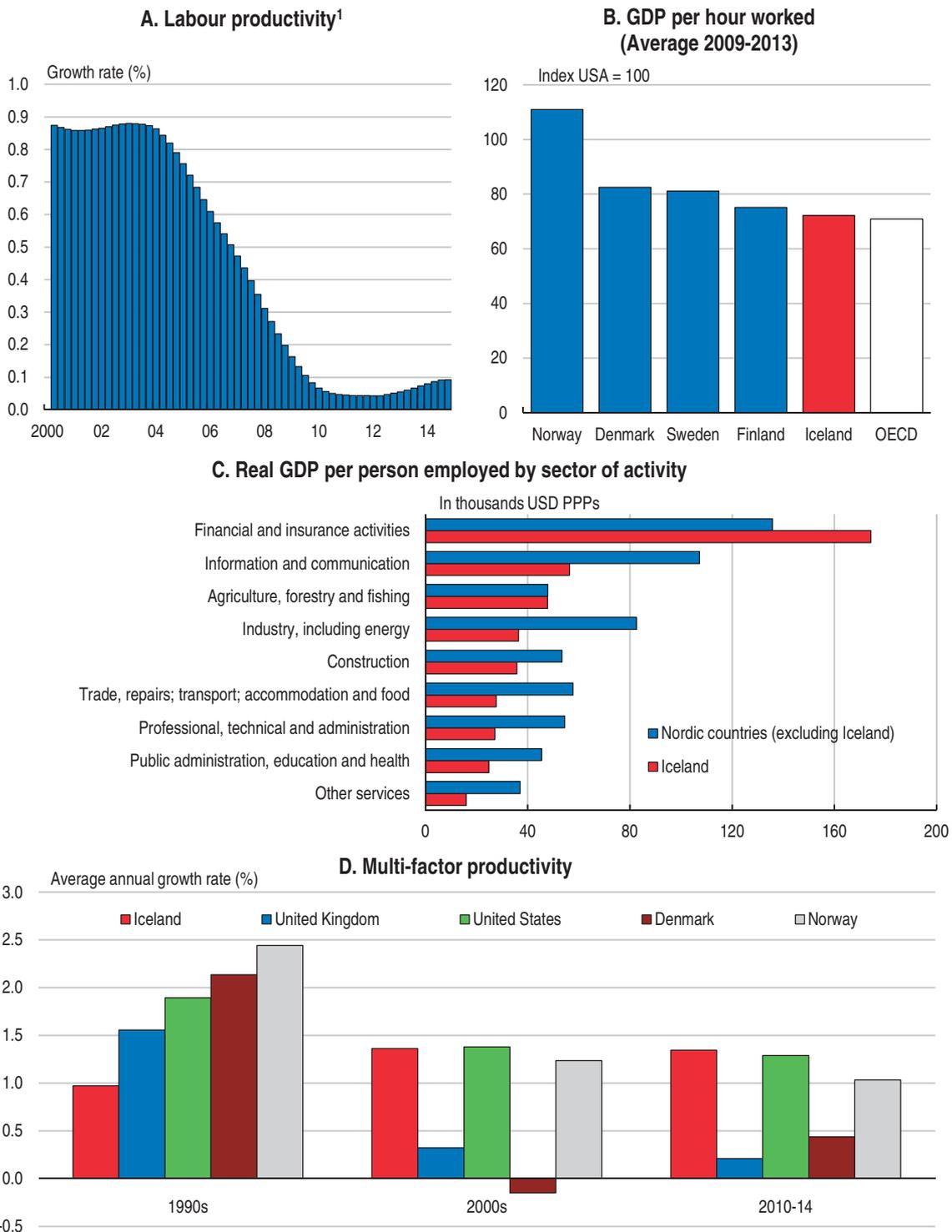
Source: OECD, Better Life Index indicators 2014.

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resource rent. A proposal to capture more of the resource rent by laying an electricity transmission cable to Scotland has not been fully fleshed out and how the resource rent would be shared is unresolved.

The current boom is based to some extent on the rapid development of the tourism sector. With one million visitors in 2014, this is welcome, but it tends to create relatively low-skilled low-wage jobs and comes with limited opportunities for productivity growth. Against the draw of migrants to the booming low-skill jobs, the Icelandic economy is experiencing outmigration of high-skilled people. Furthermore, unemployment amongst university graduates is rising, suggesting mismatch. As such, and despite the economic recovery, Iceland remains in transition away from a largely resource-dependent development model, but a new growth model that also draws on the strong human capital stock in Iceland has yet to emerge.

Figure 11. Productivity developments in Iceland



1. Time series smoothed using a Hodrick-Prescott filter.

Source: OECD, Analytical and Economic Outlook databases; Labour Force Statistics and Productivity databases.

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Against this backdrop, there have been calls for reorienting Iceland's growth strategy towards more balanced development. A forum was established in 2013 to discuss a growth strategy, with the members including political and business leaders as well as academics and representatives of the labour unions. However, progress thus far has been modest. In this context, supporting the work of the growth forum with a dedicated body, such as a productivity or growth commission, would help identify and prioritise the policies which are the most conducive to improving the business environment overall. Such a body would play an important role in undertaking or commissioning the necessary research and analysis to identify the most promising growth-enhancing policies for Iceland. The productivity commission would also help move the debate forward by championing productivity-enhancing reforms and thereby help overcome resistance from particular interest groups. Furthermore, the advocacy role would help build constituencies supporting these reforms, particularly where entrenched interests may be resistant, raising the likelihood of better policies being introduced. Improving product market regulation will play an important role in this agenda.

### **Improving product market regulation**

Iceland's regulatory framework for product markets is close to the OECD average when measured by the OECD's overall product market regulation indicator (Figure 12). This is in line with indicators for Norway and Sweden, but more restrictive than the case for Denmark and Finland. But performance in Iceland is poorer for regulations creating barriers to entrepreneurship, with the complexity of regulatory procedures noticeably more restrictive.

The number of newly registered firms in Iceland has dropped significantly from the peaks just before the financial crisis, although those rates were likely unsustainable (Figure 13). Reducing barriers to entrepreneurship is important for both boosting employment and productivity. Recent empirical evidence suggests that new firms contribute importantly to employment growth (Criscuolo *et al.*, 2014) and that a growing share of start-ups in a sector is associated with higher productivity growth (Adelet McGowan *et al.*, 2015).

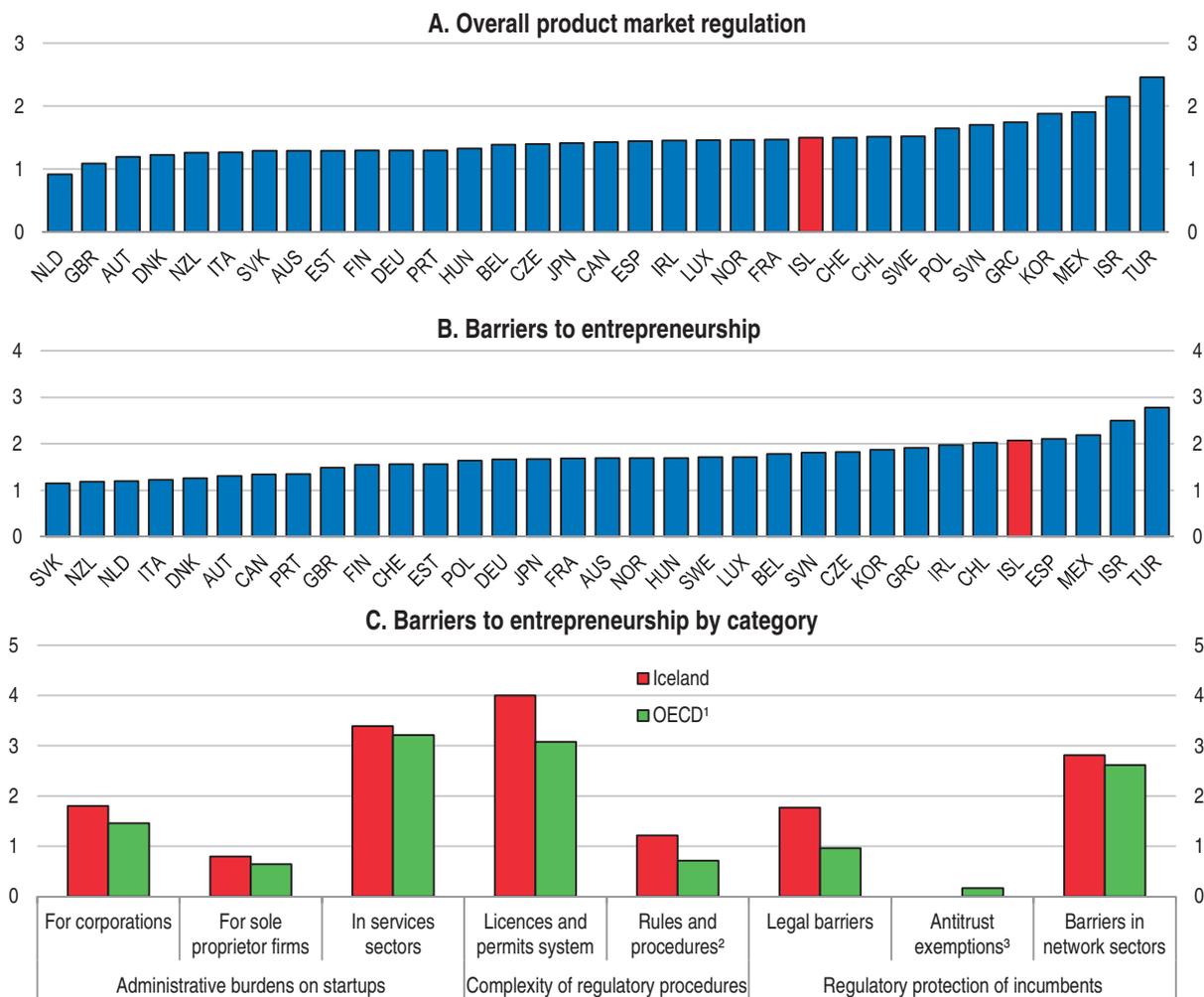
While there are few administrative barriers to establishing a company and progress has been made recently to facilitate doing so online, other barriers to entry are somewhat more pronounced in Iceland. The complexity of regulatory procedures in the licensing and permitting systems and regulatory protection of incumbent (particularly due to legal barriers) are high in comparison with other OECD countries. In this light, the government should review the number of licences and permits required and simplify regulations. Additional progress should be made in reviewing the legal barriers to entry in the electricity, air transport and airport, and seaport sectors.

The government has supported the creation of small firms through innovation incubators, which are often clustered by sector to promote knowledge spillovers. Experience so far has been positive with the existing eight incubators attracting a lot of promising entrepreneurs and links with universities being established. As this is still a relatively new initiative, the government should evaluate the effectiveness of these programmes with the aim to adjust them as needed to achieve the maximum impact.

For Iceland, one of the important constraints on entrepreneurship is the lack of venture capital. Partly, the lack of funds reflects the uncertainty surrounding capital

Figure 12. **Barriers to entrepreneurship is relatively restrictive in areas**

Indicator scale of 0-6 from least to most restrictive



1. The OECD aggregate is an average of data available (25-30 countries depending on the year covered).

2. Communication and simplification of rules and procedures.

3. Zero for Iceland.

Source: OECD (2013), Product Market Regulation Database, [www.oecd.org/economy/pmr](http://www.oecd.org/economy/pmr).

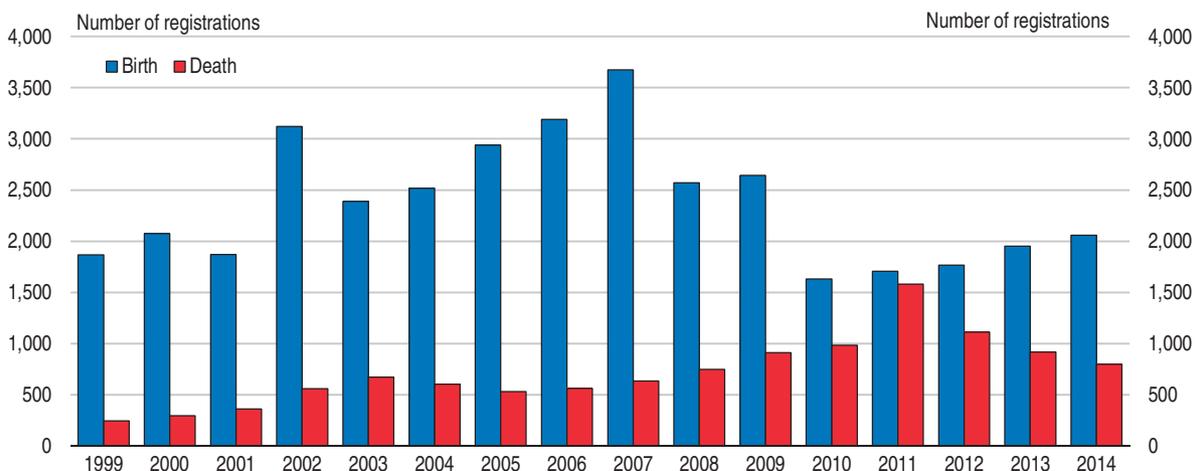
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controls, which will dissipate when they are relaxed. High risk premia associated with macroeconomic volatility also play a role, reinforcing the need for strong macroeconomic policy. Pooling risks in a country as small as Iceland is difficult. One way around this is to have the government pool risks, and it has stepped into this arena by establishing funds, one with the involvement of domestic financial institutions, to promote start-ups that can compete internationally. However, overall funding remains modest.

Another approach to pooling is to involve foreign investors. According to the OECD FDI Restrictiveness Index, however, Iceland has one of the most restrictive regimes for foreign investors. In particular, entry is severely constrained in fishing, electricity and to a lesser extent some parts of transportation, often through limitations on equity participation. The government is working on simplifying the legal framework for investment by non-residents in business enterprises.

Figure 13. **Firm creation has slowly recovered and bankruptcies increased**

New registrations of limited liability companies and number of bankruptcies



Source: Statistics Iceland

StatLink  <http://dx.doi.org/10.1787/888933258539>

### ***Harnessing competitive pressures***

Achieving effective competition can also be a challenge in a small economy when even modest economies to scale imply that the market can support only a single or just a few firms. Indeed, in a number of markets (financial, transport, telecoms, food) only a handful of companies exist or a single firm occupies a dominant position. Where a natural monopoly element is important in a market, separating the competitive segment and setting access rules for the monopoly element can encourage competition. The competition authority repeatedly clashed with the incumbent telecom operator until 2012, when both sides reached agreement to restructure the group into separate companies for retail and wholesale operations, thereby allowing more competition to emerge in the retail segment.

Despite the constraints imposed by the small size of the economy, over the past decade the Icelandic Competition Authority has concluded more than 17 major enforcement cases on abuse of dominant position and 14 major cases on cartels or tacit collusion. Smaller cases are not concluded. In this context, applying the OECD's "Competition Assessment Toolkit" may be particularly helpful. The toolkit provides a means to identify pro-competitive reforms, including removing unnecessary restraints and proposing alternative less restrictive policies to achieve government objectives.

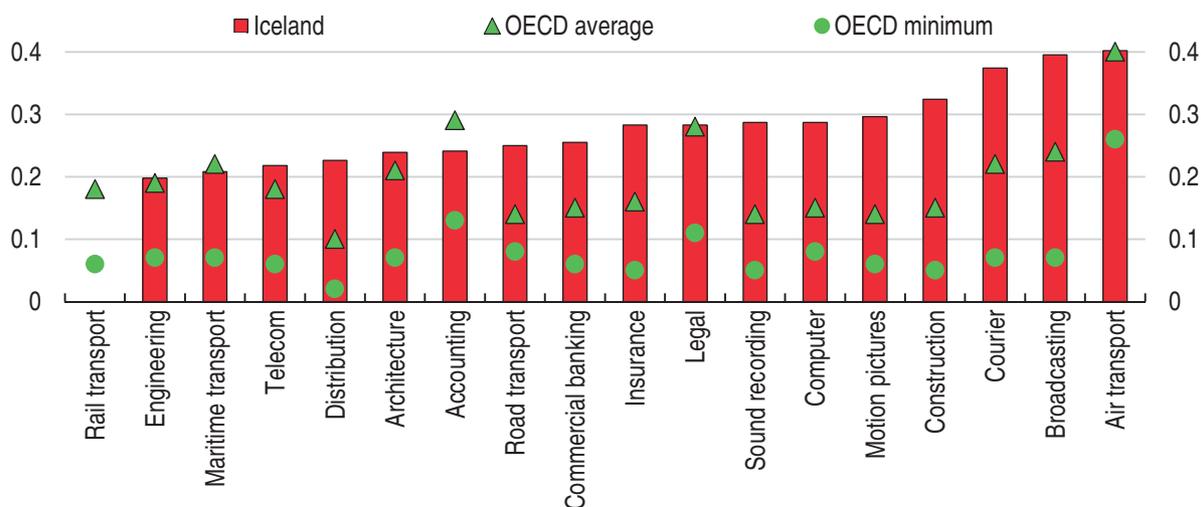
Another potential factor could undermine effective competition. After the crisis, the high indebtedness of many domestic firms made the banks important stakeholders in firms' decisions. This degree of concentration and possible conflict of interest requires careful monitoring. The slow process of restructuring, which is reflected in the delayed rise in bankruptcy following the crisis (Figure 13), created uncertainty about firm ownership. The competition authorities have acted by setting limits on when the company had to be sold and imposing conditions to ensure fair competition between companies owned by banks and other companies (such as requiring a normal rate of return and preserving the independence of the firm).

In some cases, the authorities may need to be more aggressive in pursuing competitive outcomes. For example, complaints that the low-cost carrier Wow Air could not obtain slots at Keflavik airport to allow it to take advantage of international transfers (and thus compete with Icelandair) have not been resolved despite the efforts of the competition authority and the fact that the slot allocation mechanism was recognised as detrimental to competition as early as 2008 (OECD Competition Committee, 2014).

The OECD's Services Trade Restrictiveness Index shows that in a number of sectors restrictions are more binding than the average in the OECD (Figure 14). Restrictions on foreign entry and movements on people were the most important factors, which are related to the barriers to entrepreneurship noted in domestic product market regulation. In part the restrictions were higher due to the imposition of capital controls. Competition could therefore be sharpened through trade more generally. The introduction during 2014 of a bilateral trade agreement with China is a step in this direction. The recent step back from European Union accession need not reduce competitive pressures because the European Economic Area agreement opens borders, even if it does not cover all sectors of the economy.

Figure 14. **Iceland's service trade restrictiveness index across sectors**

The indices take values between zero and one (the most restrictive)<sup>1</sup>



1. The index includes regulatory transparency, barriers to competition, other discriminatory measures, restrictions on movement of people and restrictions on foreign entry. The STRI methodology takes into account different market and trade cost structures across sectors to ensure that they reflect the relative restrictiveness of each sector. Nevertheless, the indices may not be perfectly comparable across sectors. The indicators are for 2013 or the most recent year available.

Source: OECD Services Trade Restrictiveness Index (STRI)

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### **Strengthening corporate governance**

Strengthening corporate governance could reinforce efficiency, even in sectors where competitive pressures are weak. Robust corporate governance raises firm performance, in part by mitigating conflicts of interest between managers and stakeholders. State-owned and private enterprises can be held to the same high standards of transparency, governance and efficiency, even if they pursue different objectives. However, in some cases economic efficiency appears to have been sacrificed. For example, the return on equity, when taking into account state guarantees, has been negative for the main state-owned electricity company. In part, this outcome reflects past weaknesses in decision-making

within the company. Basing appointments in state-owned enterprises on professional and managerial experience should be the norm, and indeed management is increasingly drawn from people with relevant experience. Another potential benefit from improving the governance of state-owned enterprise arises from levelling the playing field for the private sector.

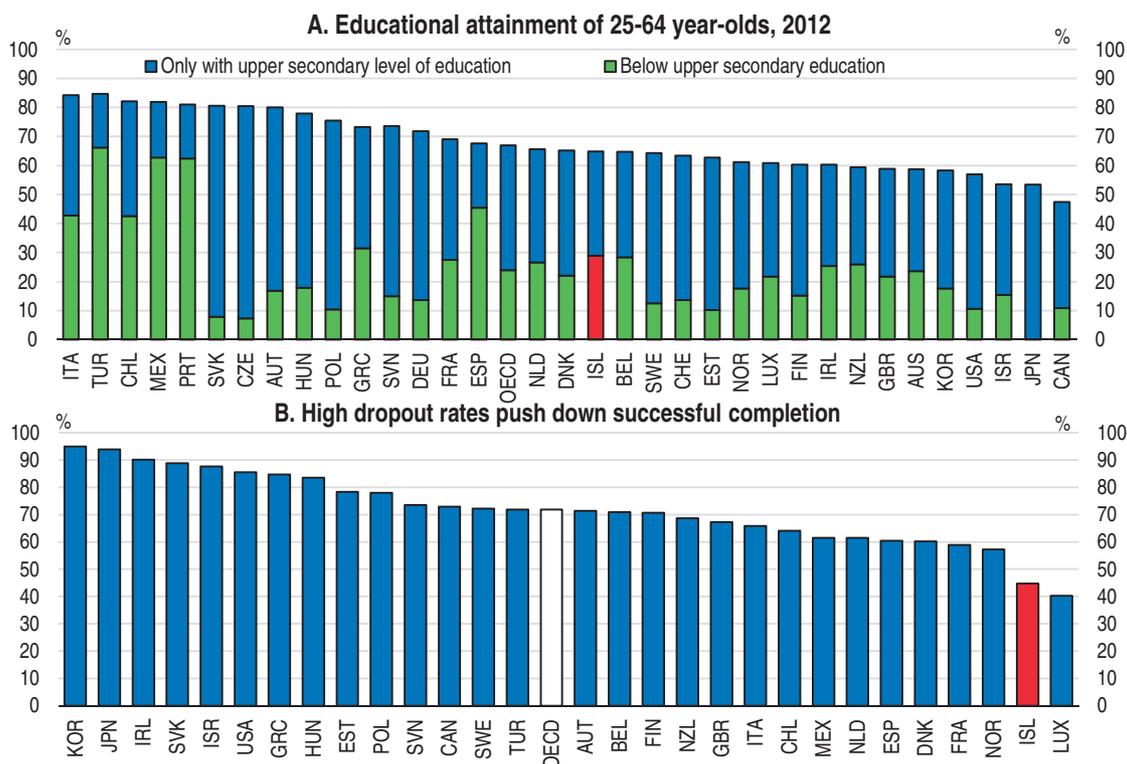
Iceland is still implementing the OECD Anti-Bribery Convention, but progress has been slow and patchy. Making progress in its implementation and enforcement would help emphasise the government's commitment to fight corruption.

### Strengthening skills on the labour market

Education, training and retraining, play an important role in ensuring that businesses can find people with the needed skills. Unfortunately, the push of lengthy school duration and the pull of demand for low-skilled workers have contributed to high dropout rates. Addressing these factors to improve high-school completion rates would strengthen the skills on the labour market.

The quality of compulsory education as measured by PISA scores is somewhat below average in Iceland, with average student performance ranking around 20th in the OECD (OECD, 2014b). The share of the population with tertiary education is also around the OECD average. However, many students drop out before finishing upper secondary education (Figure 15). Only 44% of students successfully complete upper secondary education within 4 years, against the OECD average of 68% (OECD, 2012). The consequences of a high drop-

Figure 15. Education: Room for improvement



Note: Countries are ranked in descending order of the successful completion of upper secondary programmes.

Source: OECD (2014), Education at a Glance ([www.oecd.org/edu/eag.htm](http://www.oecd.org/edu/eag.htm)).

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out rate are reflected in labour market performance. While around one-third of the working-age population have only completed primary or lower secondary education, they account for the majority of those out of the labour force and nearly 45% of those unemployed. Disincentives to completing upper secondary education include the prolonged length of schooling and the late graduation age, which the 2013 *OECD Economic Survey* recommended to lower. Weaknesses in vocational education and training and the pull of the labour market, particularly when pay differentials provide limited incentive to invest in skill acquisition, also act as disincentives to completing secondary education. Other factors influencing drop-out include student characteristics, such as whether the children are from immigrant families.

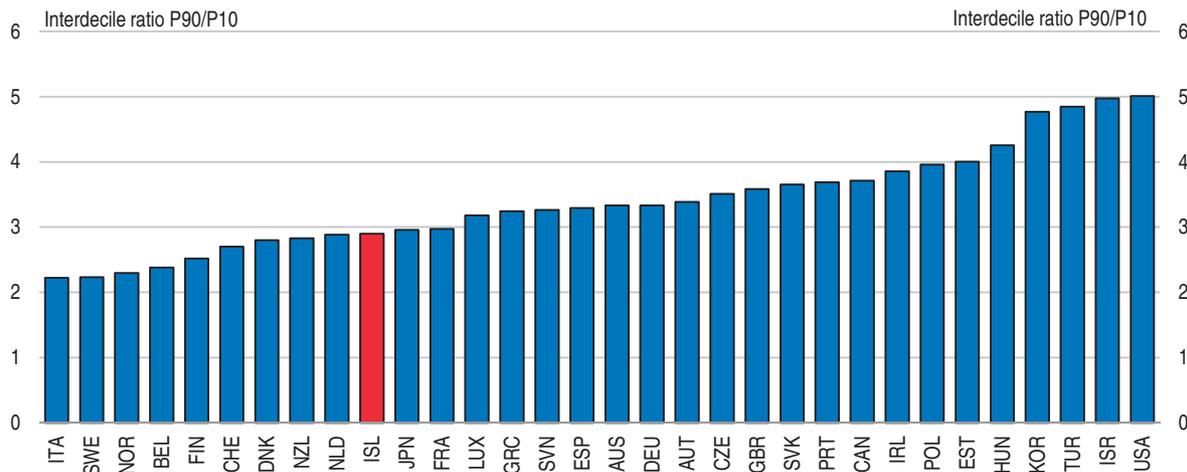
Against this background, the authorities reduced the length of upper-secondary schooling, allowing students to graduate a year early. Schools offering credit-based programmes have already seen markedly more pupils graduating early. Strengthening vocational education and training and supporting links with employers will increase the attractiveness of remaining in education. In addition, ensuring that all students entering secondary education are suitably prepared would help reduce drop-out rates of vulnerable groups. The recent white paper on education reform establishes two goals for 2018: increasing the graduation rate from its current rate of 44% to 60% and boosting reading literacy from 79% in 90%, which should also reduce the high school drop-out rate. The different actors involved in education (national and local authorities and teachers) need to ensure that pupils are acquiring the requisite skills as they progress through the education system (OECD, 2012).

Iceland spends more per student annually for compulsory education than the OECD average, but performs relatively poorly in attainment, as measured by PISA. The previous *Economic Survey* advocated better resource management to ensure that costs are minimised and quality increased, and efforts should continue to target higher spending efficiency in compulsory education. For example, greater guidance of attainment in the national curricula guides would allow schools and local authorities to identify where problems are emerging and make timely interventions in underperforming schools. Accompanying measures could include extending the school year, which is currently comparatively short.

An innovation in compulsory schooling that should help boost efficiency and reduce the overall length of studies is experiments with flexible transitions from compulsory schooling to upper secondary schools. These flexible transitions allow some pupils to advance to upper-secondary education early, either by taking upper-secondary school courses or enrolling in these schools. If the current evaluations of flexible transitions are favourable, these opportunities should be rolled out further.

### **Remuneration and the business environment**

An additional channel through which productivity can be lifted is through resource reallocation towards higher productivity sectors. However, a strong degree of wage compression – often a feature in countries where union membership and bargaining coverage is high – weakens the incentives to invest in education and potentially mutes price signals that might lead to smoother resource reallocation (Figure 16). In the past, the internal rate of return on attaining upper-secondary or tertiary education has been significantly below the average in the OECD. For example, estimates reported in OECD (2006) suggest that Icelandic males enjoy less than half of the returns experienced

Figure 16. **Wages are compressed**

Source: OECD Labour Force Statistics – Decile ratios of gross earnings.

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elsewhere. For women, returns are comparable only when they have completed tertiary education. For geographically mobile workers wage compression can also induce outmigration. With these effects there is a risk that the skills of the labour market can erode.

The distribution of wages is highly compressed by international comparison, particularly when taking into account returns to education (Statistics Iceland, 2015). In this context, a better balance needs to be struck between providing incentives for skill acquisition and resource reallocation against the possible impacts on increasing income inequality.

### **Using natural resources while respecting the environment**

Iceland's environmental quality is generally good (OECD, 2014c). Environmental stewardship in Iceland is well developed. Indeed, in the realm of fisheries management Iceland has taken a leading role in implementing a policy framework that targets sustainability. As a member of the European Economic Area, Iceland aligns its environmental policies and legislation with that of the European Union. Nevertheless, policies have not fully addressed a number of pressures on the environment. For example, due to the fragility of the environment, over-grazing contributing to soil erosion is a major concern and has already seen a number of measures introduced. Newer challenges include ensuring that the boom in tourism is managed in a way to mitigate adverse environmental impacts, which would ultimately reduce the attractiveness of Iceland as a green tourist destination.

In recent years, the Ministry of Fisheries (now the Ministry of Industry and Innovation) has adopted the proposed total allowable catches from the scientific advisors - the Marine Research Institute – based on an assessment of catches that are consistent with fish stock sustainability. The individual transferable quota (ITQ) system, by giving participants a long-term stake in healthy fish stocks, has thereby created incentives to respect quotas and helped fish stocks recover. The flexibility in the ITQ system has also reduced overcapacity in the industry, boosting productivity. Thus while total landings of cod were

almost 30% more than the total allowable catches in the initial years of the system, they have dropped to just 12% more recently and the number of fishing vessels has dropped substantially. Measures of total factor productivity in the sector have been strong and substantially higher than the fishing sectors in other Nordic countries (Eggert and Tveteras, 2013). The fisheries sector has become an important innovation cluster.

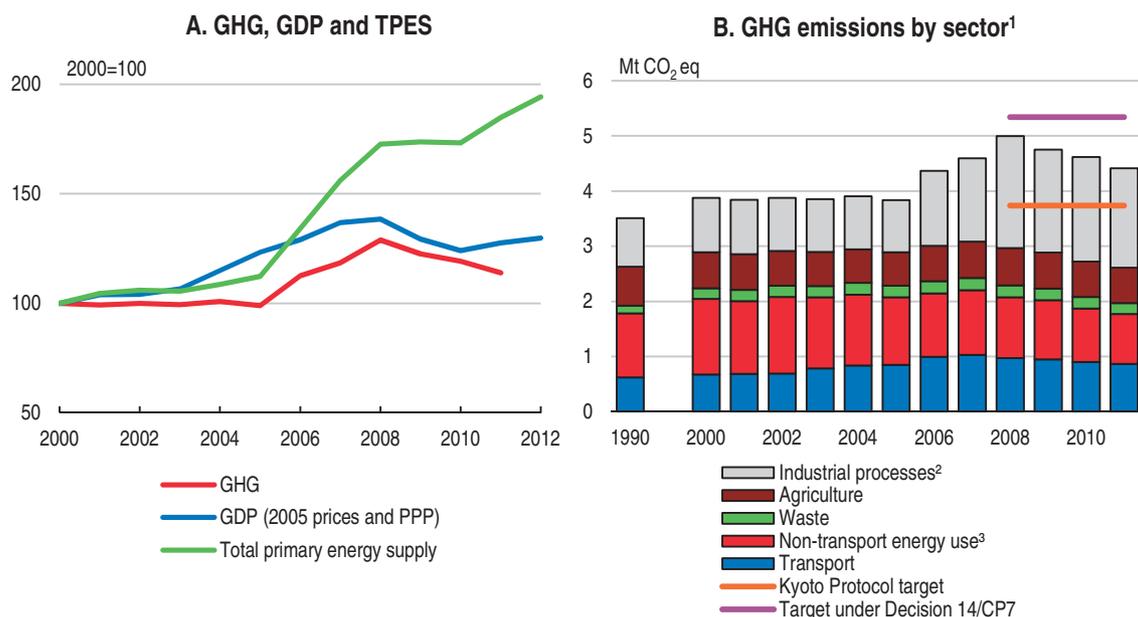
While these are positive steps, uncertainty arises in other aspects of fisheries management. Despite the system having proven very effective in managing fish resources, recent proposals could radically change the fishing regime. As the initial individual transferable quotas were allocated without charge, the owners of the fishing rights have captured resource rents as the fish stocks have recovered, fishing capacity has decreased and fish prices have risen. Levying a tax on the resource rent has allowed the government to claw back some of the rent for the broader public. Since the natural resource belongs to the Icelandic people, the resource rent should also accrue at least in part to them. Finally, a resource tax may also limit some of the pressures for Dutch disease.

Different ideas on reforms to the system have been discussed, including amending the individual transferable quotas system by introducing long-term leases to replace indefinite quotas. While details of this regime are yet to emerge, any proposal will need to ensure that sufficient incentives remain to preserve stocks and ensure economic efficiency as effectively as the current regime. For example, as fishing companies approach the termination of their lease they may be less concerned about preserving fish stocks and may stop investing, leading to losses in economic efficiency and more pronounced lumpiness in capital spending.

Reforms to the individual transferable quotas system could reconsider the carve out from the overall total allowable catch to sustain coastal communities. Over time, the ITQ share of hook and line fisheries with smaller boats has increased, but have also been captured by fewer companies and the size of the fishing vessels has grown considerably. Therefore, the original regional policy aims of this part of the carve out are not being met as effectively as before. Other parts of the carve-out include coastal fisheries with a common pool quota for small vessels and quotas allocated to vulnerable coastal communities. The rapid development of tourism as part of a broader development strategy may help sustain coastal villages without distorting the fisheries management system.

Iceland has made progress in reducing producer support for agriculture, but supports remain high by comparison with the rest of the OECD. Support continues to be applied to market prices, maintained by border measures and through direct payments, which are based on payment entitlements, directly or indirectly linked to production. From an environmental perspective, agriculture, particularly livestock grazing, can put additional burdens on the land and contribute to soil erosion and desertification. Programmes, such as the quality control programme for sheep farming, including land utilisation criteria, and Farmers Heal the Land, supporting land improvement projects, can contribute to sustainable management. Over 90% of sheep farmers participate in the quality control programme but Farmers Heal the Land has been taken up by only around one-third of sheep farmers and monitoring of the impacts on soil erosion is limited (OECD, 2014c).

Despite the abundance of hydroelectric and geothermal energy, per capita and per unit GDP emissions of greenhouse gases in Iceland are larger than the OECD average (Figure 17), though they have declined significantly. A large share of greenhouse gas emissions originate in energy-intensive industry, not from electricity generation but during

Figure 17. **GHG emissions are beginning to fall**

1. Excluding emissions/removals from land use, land-use change and forestry.
2. Includes solvents.
3. Includes emissions from energy use in the following sectors: manufacturing and construction; agriculture, forestry and fisheries; and residential, commercial and institutional.

Source: OECD (2013), OECD Economic Outlook No. 93 (database); UNFCCC (2013), Greenhouse Gas Inventory Data (database).

StatLink  <http://dx.doi.org/10.1787/888933258576>

processing stages in aluminium and ferrosilicon production. Transport is the second most important source of greenhouse gas emissions. Emissions from industry have more than doubled since 1990, reflecting an allowance granted to small countries to increase emissions from some new projects if renewable energy and best available technology is used. Taking the allowance into account, greenhouse gas emissions have declined relative to the 1990 Kyoto Protocol benchmark (as emissions from a new aluminium plant are excluded) by around 4% and Iceland will have met its Kyoto-related target in the first commitment period to 2012. In a joint effort with the European Union, Iceland has communicated a target of reducing emissions by 30% by 2020 in comparison with 1990 levels, conditional on other countries setting themselves consistent targets.

The Icelandic government has already taken steps to increase abatement (Government of Iceland, 2015). For example, in 2010, a tax based on the carbon content of fuel was introduced, which unusually also covered the fishing fleet. The effective tax rate from energy use was around €76 per tonne of carbon dioxide in 2012, which was above that of the average OECD country (€50 per tonne). However, the effective tax rate varies substantially, being lower for aviation and marine fuels than for road transport fuels. As transport is the second major sources of emission, recent efforts have targeted this sector, including by changing vehicle taxation to reflect fuel efficiency and promoting renewable fuels. The impact of altering excise duties may help introduce more fuel efficient vehicles, though vehicle numbers and use may increase. In this light, taxation should adjust to price carbon emission more effectively, principally through equating marginal abatement costs across different fuels. Initiatives to use renewables or waste products as fuel for the fishing fleet and other vehicles should be expanded if current trials are successful.

### Recommendations for strengthening long-term productivity growth

#### Main recommendations

- Adopt an ongoing productivity agenda, including following up on the priorities identified by the recent growth forum.
- Lower barriers to entry including by removing legal barriers to entry in particular sectors.
- Support innovation, including by encouraging links with universities. Ease funding access, notably with public investment funds that can finance firm expansion. Evaluate support measures.
- Toughen competition policy implementation to ensure that abuse of dominant position or cartel/tacit collusion does not stifle competition. Use the OECD's Competition Assessment Toolkit to refine law and enforcement.

#### Additional recommendations

- Evaluate possible ways to reduce further the length of secondary education and to lower drop-out rates.
- Harmonise marginal abatement costs in climate change policy.
- Improve monitoring of land erosion and if necessary take further action to reduce damage from sheep farming.
- Levy a resource tax on the fishing fleet and be very careful about reforming the individual transferrable quota system.
- Fully implement the OECD's Anti-Bribery convention.

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# Summary of Chapters from 2015 Economic Survey of Iceland

## Chapter 1

# A policy framework to promote stability and resilience

*Iceland's openness to global capital and goods markets has contributed to fast-rising living standards over the past decades. Nonetheless, its unusual status as a very small open economy with an independent currency has left the country susceptible to macroeconomic instability. The banking sector's collapse of 2008 and 2009 was the latest example, when financial turbulence from abroad was amplified by serious shortcomings in domestic policy. Countries can promote stability without resorting to capital controls or exchange-rate pegs by implementing well-designed frameworks for monetary policy, fiscal policy and financial regulation. In addition, resilience to destabilising capital flows can be bolstered by maintaining precautionary buffers, notably substantial holdings of foreign exchange reserves, as well as ample bank capital buffers and fiscal space.*

## Chapter 2

# Supporting long-term growth by improving the business environment

*Iceland has a high standard of living in international comparison, but amongst OECD countries its relative ranking has been sliding. In the wake of the financial crisis, investment slumped and while the economic recovery has progressed, growth is appreciably slower than during the previous expansion. In particular, labour productivity growth has remained very weak. Against this background, policies that improve the business environment will help lift productivity growth through encouraging innovation and competition. A wide range of policies can have an impact. The regulatory environment for product markets is generally among the least restrictive economies in the OECD, but the regulatory stance is uneven. Regulations governing barriers to entrepreneurship are notably more restrictive. Strengthening competitive pressure is another means of encouraging greater efficiency and innovation, but achieving this is complicated in a small economy. Raising human capital levels amongst certain groups will also boost growth and facilitating resource reallocation can play a role in reacting to economic shocks while supporting productivity growth. Finally, public policy fostering innovation and firm creation can underpin a dynamic part of the economy, which would otherwise experience financing difficulties.*

*This Overview is extracted from the 2015 Economic survey of Iceland.*

*This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries. The Economic situation and policies of Iceland were reviewed by the Committee on 23 June 2015. The draft was revised in the light of the discussion and given final approval as the agreed report of the whole Committee on 15 July 2015.*

*The Secretariat's draft report was prepared for the Committee by Douglas Sutherland and Jonathan Millar under the supervision of Patrick Lenain. Damien Azzopardi and Valery Dugain provided the statistical research assistance, and Brigitte Beyeler provided the administrative support. The Survey also benefited from contributions by Gunnar Haraldsson.*

*The previous Survey of Iceland was issued in June 2013*

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