



# OECD Economic Surveys

# Iceland

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OVERVIEW



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*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.*

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**Basic statistics of Iceland, 2018**

(Numbers in parentheses refer to the OECD average)

<b>LAND, PEOPLE AND ELECTORAL CYCLE</b>				
Population (million)	0.4		Population density per km <sup>2</sup>	3.5 (37.8)
Under 15 (%)	20.0	(17.8)	Life expectancy (years, 2017)	82.2 (80.3)
Over 65 (%)	14.8	(17.1)	Men (2017)	80.4 (77.7)
Foreign-born (% , 2017)	13.5		Women (2017)	84.1 (83.0)
Latest 5-year average growth (%)	1.8	(0.6)	Latest general election	October 2017
<b>ECONOMY</b>				
Gross domestic product (GDP)			Value added shares (% , 2016)	
In current prices (billion USD)	26.1		Primary sector	5.2 (2.4)
In current prices (billion ISK)	2810.0		Industry including construction	22.3 (27.5)
Latest 5-year average real growth (%)	4.5	(2.3)	Services	72.5 (70.1)
Per capita (000 USD PPP, 2017)	57.5	(46.4)		
<b>GENERAL GOVERNMENT</b>				
Per cent of GDP				
Expenditure (OECD: 2017)	41.7	(40.3)	Gross financial debt (OECD: 2017)	61.8 (112.4)
Revenue (OECD: 2017)	42.8	(38.1)	Net financial debt (OECD: 2017)	6.5 (69.6)
<b>EXTERNAL ACCOUNTS</b>				
Exchange rate (ISK per USD)	107.79		Main exports (% of merchandise exports)	
PPP exchange rate (USA = 1)	138.33		Manufactured goods	43.7
In per cent of GDP			Food and live animals	41.9
Exports of goods and services	47.1	(56.1)	Machinery and transport equipment	4.5
Imports of goods and services	44.1	(52.0)	Main imports (% of total goods imports)	
Current account balance	2.9	(0.3)	Machinery and transport equipment	34.3
Net international investment position	9.1		Mineral fuels, lubricants and related materials	14.4
			Crude materials, inedible, except fuels	12.4
<b>LABOUR MARKET, SKILLS AND INNOVATION</b>				
Employment rate (aged 15 and over %)	85.1	(68.4)	Unemployment rate, Labour Force Survey (age 15 and over) (%)	2.7 (5.3)
Men	87.5	(76.0)	Youth (age 15-24, %)	6.0 (11.1)
Women	82.5	(60.9)	Long-term unemployed (1 year and over, %, 2017)	0.2 (1.7)
Participation rate for 15-64 year-olds (% 2017)	88.3	(72.1)	Tertiary educ. Attain (aged 25-64 year-olds (% , 2017)	42.4 (36.9)
Average hours worked per year (2017)	1858	(1 746)	Gross domestic expenditure on R&D (% of GDP, 2016)	2.1 (2.5)
<b>ENVIRONMENT</b>				
Total primary energy supply per capita (toe, 2017)	16.8	(4.1)	CO2 emissions from fuel combustion per capita (tonnes, 2016)	6.3 (9.0)
Renewables (% , 2017)	88.5	(10.2)	Water abstractions per capita (1 000 m <sup>3</sup> , 2014)	4.4
Exposure to air pollution (more than 10 µg/m <sup>3</sup> of PM2.5, % of population)	5.7	(58.7)	Municipal waste per capita (tonnes, 2016, OECD; 2017)	0.7 (0.5)
<b>SOCIETY</b>				
Income inequality (Gini coefficient, 2015)c	0.255	(0.315)	Education outcomes (PISA score, 2015)	
Relative poverty rate (% , 2015)	5.40	(11.8)	Reading	482 (492)
Median gross household income (000 USD PPP, 2015)	30.3	(23.3)	Mathematics	488 (490)
Public and private spending (% of GDP)			Science	473 (493)
Health care (2017)	8.5	(8.8)	Share of women in parliament (%)	38.1 (29.7)
Pensions (2015)	9.2	(9.1)	Net official development assistance (% of GNI)	0.3 (0.4)
Education (public, 2017)	7.6	(4.5)		

The year is indicated in brackets if it deviates from the year in the main title of this table.

\*\* Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 80% of member countries.

Source: Calculations based on data extracted from databases of the following organisations: OECD, International Energy Agency, International Labour Organisation, International Monetary Fund, World Bank.

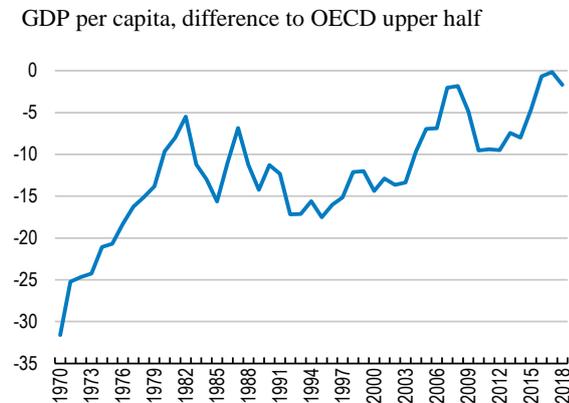
*Executive summary*

### Living standards and well-being are high

Iceland fully recovered from the 2008 financial crisis. The country is rapidly catching up with the richest OECD economies but is now slowing.

**The economy is strong.** Favourable external conditions and good macroeconomic policies helped create high growth, low unemployment, low inflation, sustainable public finances and a positive external balance over the past years. Living standards are among the highest in the OECD.

**Figure A. Iceland is converging rapidly**



Source: OECD National Accounts database

StatLink  <https://doi.org/10.1787/888933996087>

**Slower growth is projected.** Growth is now turning around sharply. Tourism, the most important export sector, is declining because of supply constraints following the insolvency of one of Iceland's airlines. Marine exports also contracted. Consumption growth has eased despite considerable wage increases. The economy is expected to grow by 0.2% only in 2019 and to rebound to 2.2% in 2020, and unemployment will rise.

**Inequality is low.** Iceland is also one of the most egalitarian economies in the OECD thanks to high employment, little wage inequality, and low pay and employment gaps, suggesting that high economic performance and an egalitarian society can co-exist. A well-targeted tax-benefit system supports equality further.

**Growth is green.** Thanks to extensive use of renewable energy, Iceland's environmental impact remains low overall, although greenhouse gas emissions remain elevated. The government plans to make the economy largely carbon-neutral by 2040.

**Table A. The economy is projected to slow**

Growth rates, unless specified	2017	2018	2019	2020
Gross domestic product (GDP)	4.6	4.6	0.2	2.2
Private consumption	8.1	4.8	1.5	1.9
Government consumption	3.6	3.3	2.7	2.3
Gross fixed capital formation	11.6	2.1	0.9	4.3
Exports of goods and services	5.4	1.6	-5.1	0.7
Imports of goods and services	12.5	0.1	-2.6	0.8
Unemployment rate (% of labour force)	2.8	2.7	3.1	3.2
Consumer price index	1.8	2.7	3.7	3.2
Current account balance (% of GDP)	3.6	2.9	0.9	0.3
General government net lending (% of GDP)	0.5	1.1	-0.1	-0.4
General government gross debt (% of GDP)	63.4	61.8	61.6	61.7

**There are risks and vulnerabilities.** A marked downturn in global growth could severely affect revenues from tourism. A hard Brexit could dent exports to the United Kingdom. A bad fishing season would reduce exports further.

### Macroeconomic policy is sound

Monetary policy has eased and fiscal policy remains expansionary. Capital controls have been largely withdrawn.

**Monetary policy has eased.** After several years of undershooting the target, inflation has started to rise again, pushed by the depreciation of the króna in late 2018 coupled with strong domestic wage growth. The central bank increased the interest rate to 4.5% in November 2018 but lowered it to 4% in May, to 3.75% in June and to 3.5% in August 2019 as inflation expectations declined. Rates remain at a historical low, though significantly higher than in most OECD countries.

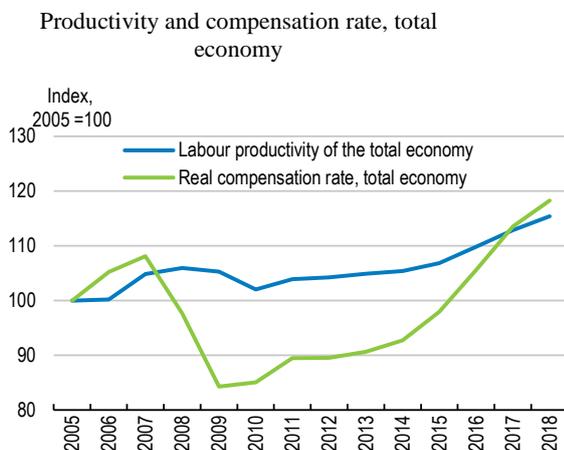
**Capital controls are largely dismantled.** Further capital controls have been lifted and are now virtually non-existent. Capital flow management is now in line with international agreements. Financial market developments have been inconspicuous. House price inflation has slowed, following the recent construction wave, easing immigration and a decline in Airbnb demand. The planned merger of the Central Bank with the Financial Supervisory Authority would strengthen financial sector oversight.

**Fiscal policy is expansionary.** Fiscal policy has been prudent in recent years, helping to achieve a budget surplus and lower debt. The fiscal plan for 2020 is expansionary, reflecting an increase in infrastructure and social spending and tax cuts.

### Boosting competitiveness

Competitiveness is on a long-term decline as wages are rising faster than productivity. Competitiveness gains, achieved after the 2008 crisis thanks to the devaluation of the króna and cuts to real wages, are exhausted by now. A focus on both productivity and wages is needed.

**Figure B. Competitiveness is declining**



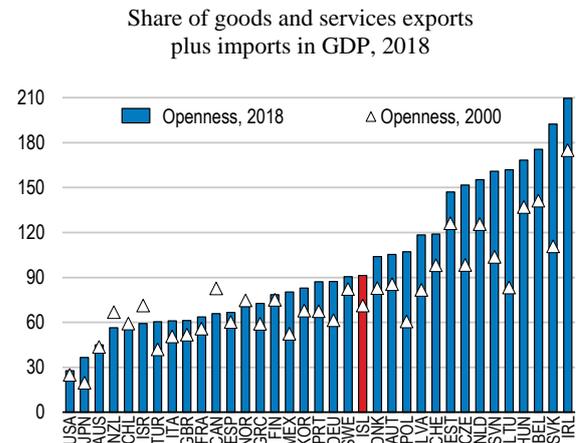
Source: Economic Outlook database

StatLink  <https://doi.org/10.1787/888933996106>

**A more open economy would help raise productivity.** Better integration into the world economy could help raise productivity. Openness remains below its potential. The productivity gap between the export and domestic sectors is wide. Further growth of exports on the back of efficiency gains in the domestic sector could

raise overall productivity and help share them more widely. Stronger integration into the world economy would also raise competition and encourage businesses in the domestic economy to become more innovative.

**Figure C. The country could be more open**



Source: OECD Analytical database.

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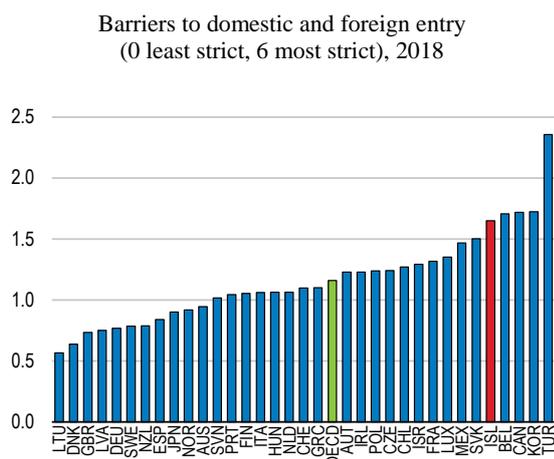
**Regulatory barriers are high.** Regulation should be more commensurate with the needs of a small open economy. Product market regulation is stringent and the administrative burden for start-ups is high, holding back investment and innovation. Restrictions to foreign direct investment are among the highest of the OECD, dampening employment and productivity gains through international knowledge transfer. The government should set up a comprehensive action plan for regulatory reform, prioritising reforms that foster competition, level the playing field between domestic and foreign firms and attract international investment. In early 2019 the government tasked the OECD to carry out competition reviews in two sectors.

**Wages should better reflect productivity developments.** Improved labour relations could also help maintain competitiveness. The wage structure is compressed; contributing to income equality, yet the wage bargaining process often leads to wage drift and creates inflationary pressures. The April 2019 wage agreements provide a welcome novelty by linking future wage developments to growth of GDP per capita.

Further steps should include: link wages more closely to productivity growth; provide reliable and relevant economic information; allow for better wage coordination; and increase power for the state mediator to delay industrial action.

**Stronger skills should respond to labour market needs.** Boosting skills would help Iceland to raise productivity and prepare for rapid technological change. This would require a comprehensive strategy with a high quality education system that builds strong foundation skills and provides the right skill mix. Moreover, effective lifelong learning strategies and well-designed policies should help to make the most of existing skills, including those of immigrants. Developing rigorous skill assessment and anticipation tools is essential to inform policy decisions.

**Figure D. The regulatory burden is high**



Source: OECD 2018 Product market regulation database.

StatLink <https://doi.org/10.1787/888933996144>

### Quality of public spending has declined

The contribution of public spending to inclusive growth has declined. The tax system relies too much on income taxation.

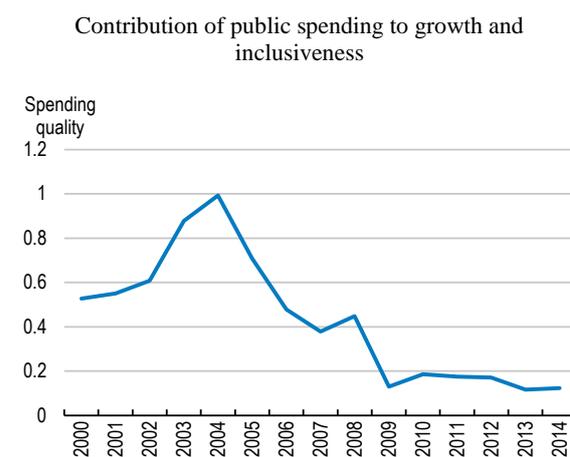
**Spending effectiveness could be better.** The quality of public spending has declined since the 2008 crisis. In particular, public investment is too weak, weighing on productivity, while the

disability benefit system is generous, weighing on employment. Effectiveness of government spending also weakened, especially in education, with declining PISA results despite high and rising spending. Providing a better nexus between spending and performance targets in various policy areas could help increase public sector effectiveness.

**The tax system.** Although below the level of other Nordic countries, taxation is skewed towards income taxation. In 2019 the government reduced income tax rates for low-income earners, and a reform is planned to reduce the tax burden further. The VAT system could be improved, mainly by reducing the gap between the two VAT rates.

**The planned sovereign wealth fund should be built up gradually.** The planned sovereign wealth fund, to be sourced by dividends of the national power company, could help diversify risks, mitigate revenue volatility, and prevent Dutch disease. It can also help avoid fiscal slippage. The pace of asset build up should be gradual and in line with prudent fiscal policy objectives and priorities. An alternative to the fund can be winding down debt more rapidly, investing more in infrastructure or education, or reduce taxes, to boost potential growth.

**Figure E. Spending quality has declined**



Source: Preliminary OECD Public Finance database.

StatLink <https://doi.org/10.1787/888933996163>

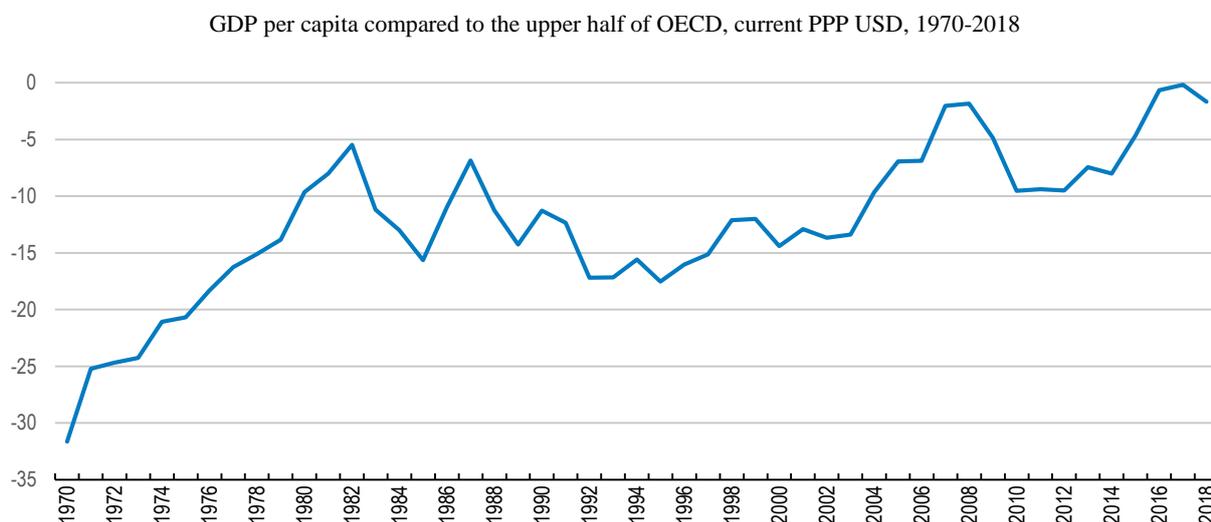
MAIN FINDINGS	KEY RECOMMENDATIONS
<b>Monetary, financial and fiscal policies</b>	
Inflation and inflation expectations are above target	Adjust interest rates in line with inflation developments
The banking sector is state-owned to a significant degree	Proceed with privatisation plans
The reform of financial sector oversight is under way	Complete the reform of the financial sector, while ensuring that regulatory and operational functions remain separated
Risks for expansionary fiscal policy remain. Debt reduction has slowed down	Follow the deficit rules of the fiscal framework Reduce debt further
<b>Productivity and competitiveness</b>	
Regulatory barriers are high. Openness remains below its potential. Productivity is weak and differs widely between the external and the domestic sector	Reduce the regulatory burden, especially in the service sector and the network industries Reduce barriers to foreign investment
Wage growth is above productivity, reducing competitiveness. Wage differences are small, which helps sharing productivity gains widely but discourages labour mobility and investment in education	Follow productivity growth when settling wages and rely on "wage guidelines" established by an expert group
<b>Green growth</b>	
CO2 emissions per capita are below OECD average thanks to abundant use of renewable energy. However, CO2 taxation is below OECD average and below social cost	Increase CO2 tax rates Broaden the environmental tax base by covering industry and agriculture
Agricultural subsidies contribute to environmental degradation, in particular soil erosion.	Decouple subsidies from production and disburse them conditional on sustainable land management and the production of environmental amenities
<b>Promoting skills</b>	
Educational performance remains weak, with many students lacking strong core skills at the end of compulsory education. The score is lower among immigrant children	Improve teaching quality by extending the period of practical training in initial education programmes and by providing more custom-made opportunities for teachers' professional development Offer effective language training programmes
The analysis and forecasting of skills needs has not been conducted on a systematic basis to inform policy decision Skills shortages and qualification mismatch weigh on productivity growth	Develop methods and tools for monitoring skills needs that rely on several information sources, preferably both quantitative and qualitative Strengthen vocational skills by better integrating work- and school-based training Link university funding partially to the success of tertiary courses in providing skills corresponding to labour market needs
<b>Improving public spending</b>	
Performance budgeting is not well established despite being required by the new organic budget law	Extend spending reviews to core policy areas like education or health care, relying on international experience. Strengthen the role of the fiscal council and possibly merge it with the national accounting office
Transport infrastructure is at capacity limits, weighing on productivity. Investment needs are rising for energy and digital infrastructure	Apply more comprehensive cost-benefit analysis to infrastructure projects. Raise investment in transport, energy and digital infrastructure. Introduce road pricing for demand management and funding of transport infrastructure
The share of disability benefit recipients has doubled over the past 20 years.	Reform the disability system by shifting the focus from paying benefits towards return to work. Tighten eligibility criteria while offering more support for staying in work

## Key policy insights

Small, remote and subject to eruptive geology, Iceland has nonetheless converged towards the wealthiest economies of the OECD since independence 100 years ago (Figure 1). Rapidly rising productivity and export orientation of the fishing industry were the core drivers of economic growth for decades, supported by a comprehensive quota management that helped maintain the sustainability of the fishing grounds (Haraldsson and Carey, 2011<sup>[11]</sup>). In the 1960s Iceland started to exploit its abundant renewable energy sources and attracted energy-intensive industries such as aluminium production, which boosted productivity further and improved the external balance. Regulatory reform, exchange rate liberalisation and tighter monetary and fiscal policy in the 1990s unleashed productive potential including the rise of the financial sector.

Still the road to prosperity was not smooth. A deep financial crisis due to excessive risk-taking shook the economy in 2008. GDP declined by 13%, unemployment reached 8% and public debt rose from around 30 to 95% of GDP within two years. The strong depreciation of the króna and a swift and solid policy response, including the introduction of capital controls and the rebuilding of the banking system, helped restore trust of financial markets and brought back employment and growth. A tourism boom with annual growth rates of 25%, making tourism Iceland's most important export sector, also boosted activity. Knowledge-intensive industries such as data processing or pharmaceuticals are developing rapidly. Today the economy is strong, unemployment low, the public finances sustainable and the external balance positive.

**Figure 1. Iceland: an impressive catch-up**



*Note:* Values before 1980 are estimated for some countries.

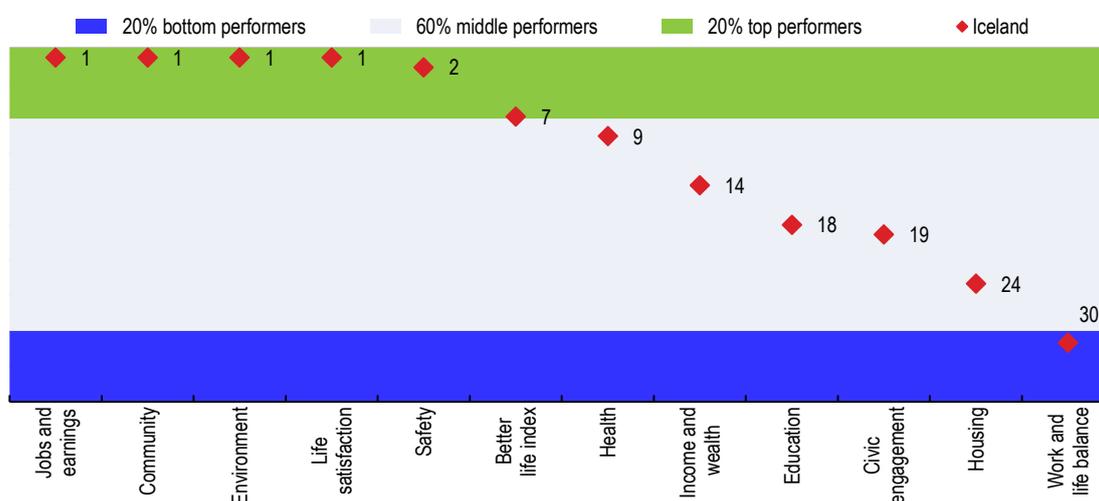
*Source:* OECD National Accounts.

StatLink  <https://doi.org/10.1787/888933996087>

Iceland is also one of the most egalitarian economies of the OECD thanks to high labour force participation, a compressed wage distribution, and small pay and employment differences between men and women. Over the past years inequality declined further as incomes of poorer households grew more than those at the top. The tax and welfare system including pensions is well targeted, making the country even more egalitarian. Access to education and health care is universal, and intergenerational equity is strong as socio-economic status has a weaker influence on education or health outcomes than in most other countries.

Wellbeing indicators point at a country that fares well overall, with most indicators above the average of the upper half of OECD countries (Figure 2). Performance is lower in education - resulting from declining PISA results – and in housing, owing to steep rises in house prices and a dearth of affordable housing for low-income earners. Iceland also scores poorly when it comes to the work-life balance, partly because of long working hours.

**Figure 2. Wellbeing is overall high**



Source: OECD Wellbeing database.

StatLink  <https://doi.org/10.1787/888933996182>

A number of structural weaknesses overshadow the strong economic performance. Productivity is held back by stringent product market regulations, below-average openness, weak business and public investment, and few resources dedicated to innovation. Competitiveness is declining as wages have outpaced productivity for several years, and the competitive edge gained after the crisis has vanished. Quality and efficiency of the public sector has declined, and government effectiveness was already deteriorating before the crisis. Most disquietingly, outcomes of the education system, as measured by the international PISA tests, are on a long-term decline. Finally, the targeted social welfare system makes for high marginal tax rates for low- and low-to medium earners, which could discourage work or investment in human capital.

Iceland has successfully left post-crisis management. It should now forcefully turn its attention to structural reform, which will help boost productivity and inclusive growth. Against this background, the key challenges for the economy are:

- To improve the regulatory framework to support competition and openness of the economy, as well as to boost productivity and innovation;
- To raise skills of the labour force through high quality education to meet present and future labour market demands;
- To make public spending more effective, underpinning productivity growth while maintaining Iceland's egalitarian society.

### **Growth is slowing**

The economy is slowing rapidly, partly due to several presumed temporary supply shocks (Figure 3). Tourist arrivals are declining after the insolvency of the low-cost Icelandic airline WOW. A contraction in marine exports adds to the shock. The global economic slowdown further weakens demand for Icelandic goods and services, although products from aquaculture and data processing are holding up well. As a result, the krona has weakened and the current account surplus narrowed. Business investment and business confidence has weakened because of easing external demand and the above-mentioned supply shocks. Household demand, including for imports, is easing on the back of deteriorating consumer confidence and a weaker employment outlook. Inflation is on the rise again driven by the weaker króna. Growth is projected to slow sharply to around 0.2% in 2019 and to recover to 2.2% in 2020 (Table 1).

**Table 1. Macroeconomic indicators and projections**

Annual percentage change, volume (2010 prices)

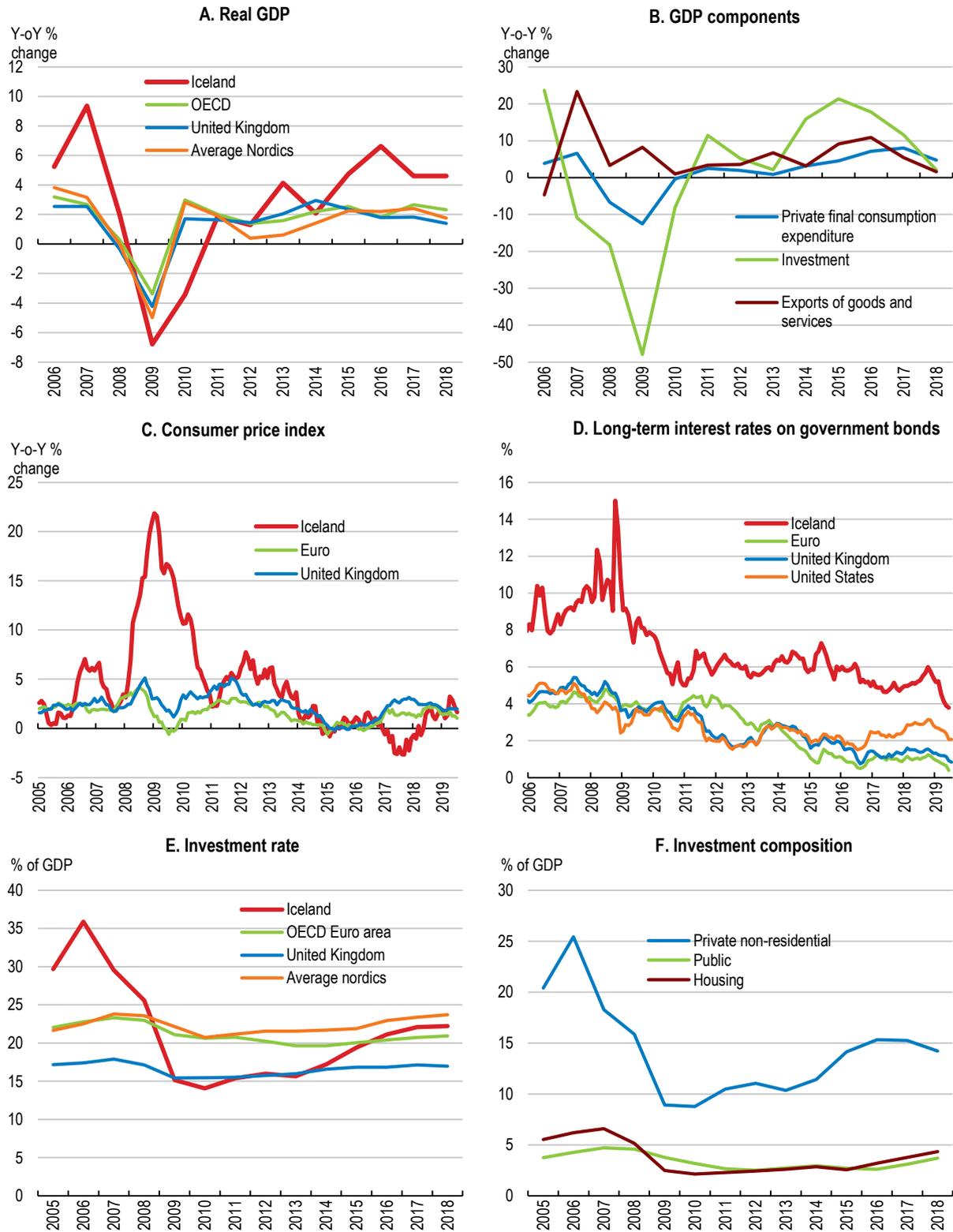
	2015	2016	2017	2018	Projections	
	Current prices (billion ISK)				2019	2020
<b>Gross domestic product (GDP)</b>	2,293.9	6.6	4.6	4.6	0.2	2.2
Private consumption	1,146.6	7.2	8.1	4.8	1.5	1.9
Government consumption	535.3	1.9	3.6	3.3	2.7	2.3
Gross fixed capital formation	445.0	17.8	11.6	2.1	0.9	4.3
Housing	58.6	26.4	20.7	16.7	5.6	4.3
Business	324.2	19.4	7.5	-5.2	-6.1	4.5
Government	62.2	-0.1	23.3	21.2	23.9	3.8
Final domestic demand	2,126.8	8.0	7.7	3.7	1.6	2.6
Stockbuilding <sup>1</sup>	3.5	-0.6	-0.5	0.4	0.3	0.0
Total domestic demand	2,130.3	7.4	7.4	4.3	1.9	2.6
Exports of goods and services	1,188.4	10.9	5.4	1.6	-5.1	0.7
Imports of goods and services	1,024.7	14.5	12.5	0.1	-2.6	0.8
Net exports <sup>1</sup>	163.6	-0.8	-2.6	0.7	-1.3	-0.1
<b>Other indicators</b> (growth rates, unless specified)						
Potential GDP	..	3.0	3.3	3.2	3.0	2.9
Output gap <sup>2</sup>	..	0.4	1.7	3.1	1.8	0.9
Employment	..	3.7	1.8	2.3	1.3	0.4
Unemployment rate (% of labour force)	..	3.0	2.8	2.7	3.1	3.2
GDP deflator	..	1.8	0.4	2.4	2.1	3.2
Consumer price index	..	1.7	1.8	2.7	3.7	3.2
Core consumer price index	..	2.2	2.4	2.5	3.5	3.2
Current account balance (% of GDP)	..	7.5	3.6	2.9	0.9	0.3
General government financial balance (% of GDP)	..	12.4	0.5	1.1	-0.1	-0.4
Underlying general government financial balance <sup>2</sup>	..	-3.0	-0.5	-0.7	-1.2	-1.0
Underlying government primary financial balance <sup>2</sup>	..	0.0	2.7	1.8	1.1	1.3
General government gross debt (% of GDP)	..	64.4	63.4	61.8	61.6	61.7
General government net debt (% of GDP)	..	9.1	8.1	6.5	6.3	6.4
Three-month money market rate, average	..	6.3	5.1	4.7	5.1	5.5
Ten-year government bond yield, average	..	5.6	4.9	5.3	6.0	6.4

1. Contribution to changes in real GDP.

2. As a percentage of potential GDP.

Source: OECD Economic Outlook database (preliminary).

Figure 3. The economy is slowing

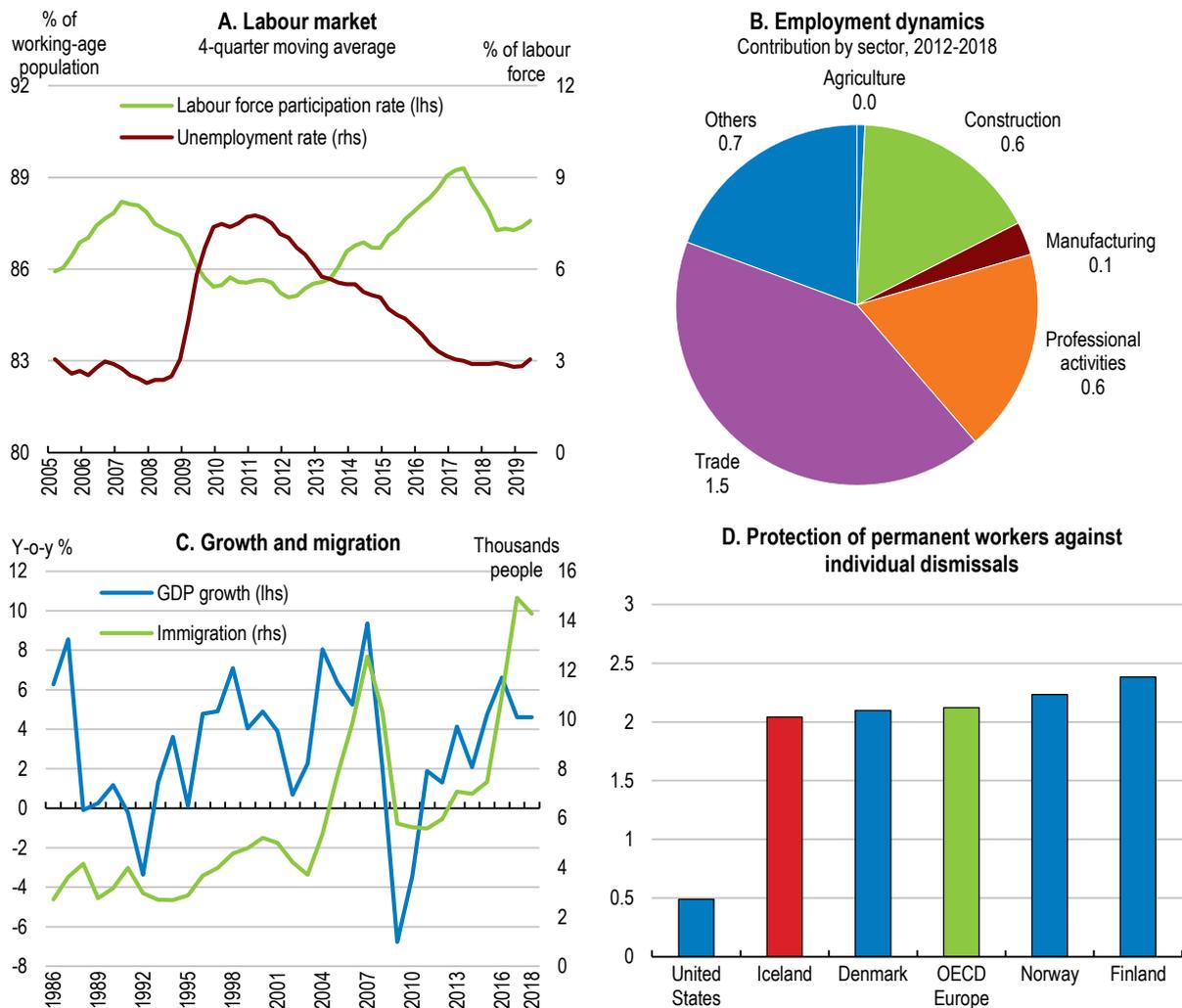


Source: OECD Economic Outlook database.

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The tight labour market is easing, mostly because around 1000 workers or 0.5% of the labour force lost their jobs upon WOW's collapse (Figure 4). Labour participation is also declining, but remains widely above OECD average for both men and especially women, mainly because of the high retirement age, few incentives for early retirement, a high share of the young working, and relatively generous support for working families with children. Wage growth is easing but remains solid in the wake of the April 2019 wage agreements. The Icelandic labour market remains quite flexible; companies can easily adjust their labour force, with labour immigration mostly from Eastern European countries acting as an automatic stabiliser. Indicators of the quality and inclusiveness of the labour market such as job security, small gender pay and employment gaps, or job strain, put Iceland often at the top ranking, although the incidence of low-pay work is little above the OECD average and well above other Nordic countries (OECD, 2018<sub>[2]</sub>).

**Figure 4. The labour market is easing**

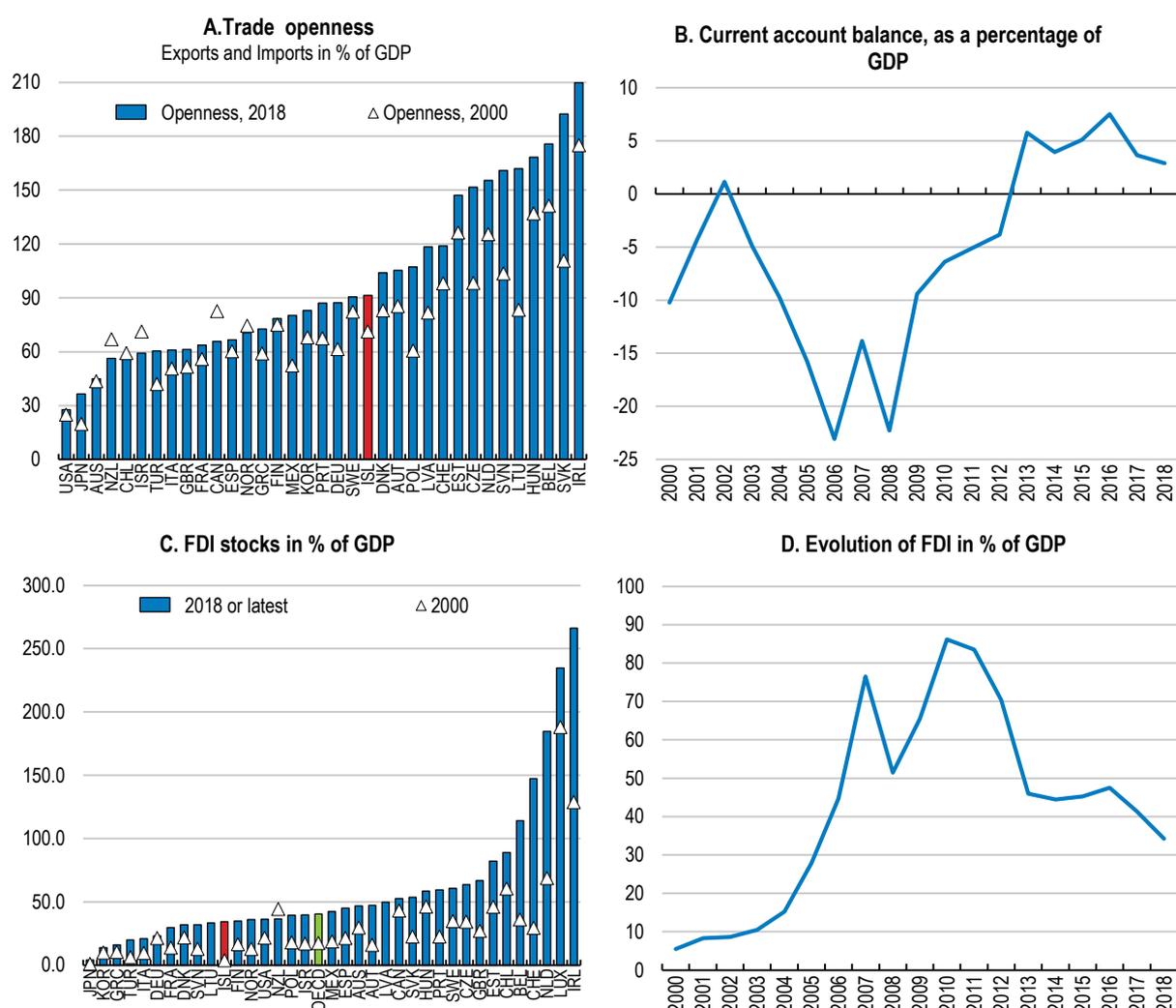


Source: OECD Analytical database, Statistics Iceland

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External positions are sound but the economy could be better integrated in the world economy (Figure 5). The current account has been positive for the past few years, although it is now narrowing due to worsening terms of trade and less foreign tourist income. Openness increased over the past 20 years, but remains relatively low considering the small size of the economy, partly because exports still rely more on commodities and fewer products altogether than other countries (Einarsson et al., 2013<sup>[3]</sup>). Although foreign direct investment (FDI) has risen from almost nothing 20 years ago to around 40% of GDP, it remains relatively low compared to other small countries. More FDI would not only improve the external balance, but could also foster knowledge transfer and boost productivity. Against this background, improving the climate for foreign investment could help compensate for slowing income from tourism, underpin Iceland's attractiveness and help sustain growth in the future.

**Figure 5. External positions are sound but the economy could be more open**

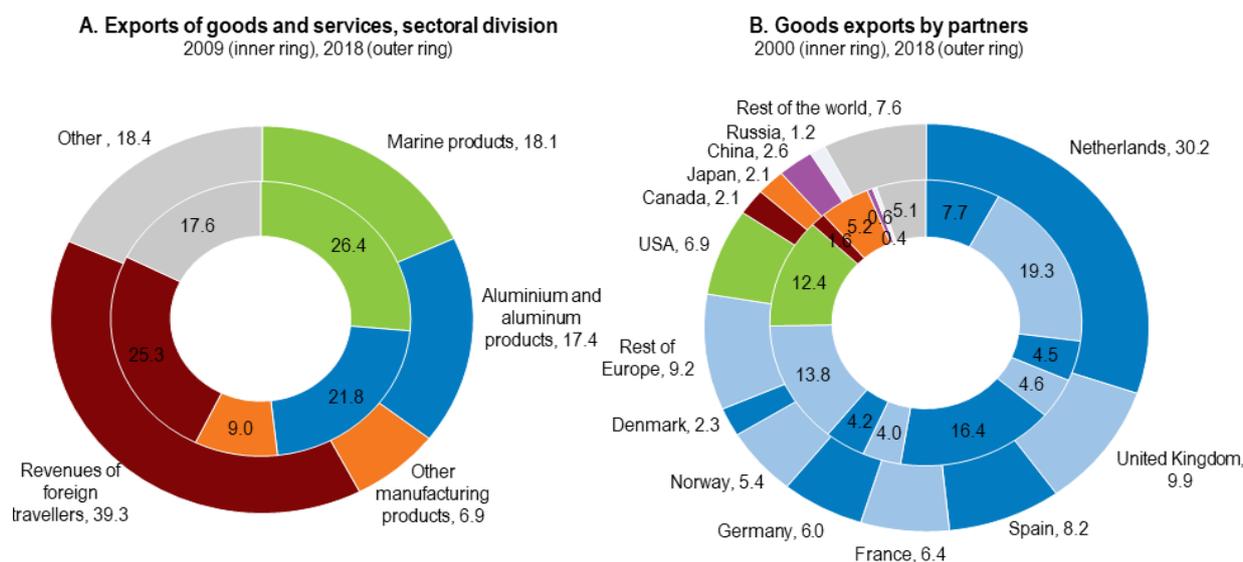


Source: OECD Economic Outlook database; OECD FDI database.

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Service exports are growing faster than goods exports, mainly reflecting the growth of tourism now accounting for around two fifths of total export income and making the export structure less diversified than 10 years ago (Figure 6). The country's goods export destinations also changed, with the European Union becoming more important, while the share of exports going to the US declined. Tariff wars and looming overcapacity in the aluminium industry have had no discernible impact on Iceland's exports so far, yet depreciation of the British Pound and uncertainty surrounding Brexit slows exports to the United Kingdom. While a "resource curse" – i.e. being trapped in the low-productivity commodity export sector – does not seem an imminent problem, Iceland has to ensure a diversified export portfolio and a move towards knowledge-intensive export industries to boost productivity and sustain growth. Recent developments in the pharmaceutical sector and, in particular, the emergence of a data storing and processing industry, which benefits from low energy prices, are promising. However, these industries require adequate policy support such as targeted investment in education and/or infrastructure.

**Figure 6. Tourism drives Iceland's export growth**



Source: Statistics Iceland; Comtrade database. Exports through Dutch ports partly explain the large share of the Netherlands (Gudjonsson, 2015<sup>[4]</sup>).

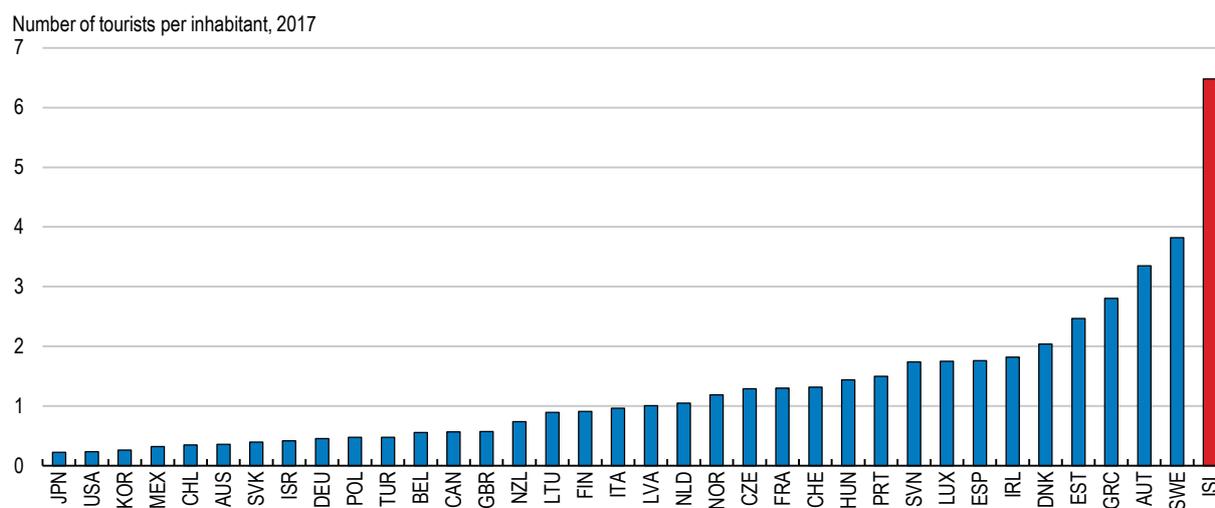
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Tourism growth may have reached its sustainable potential (Figure 7). With around six tourists annually per resident, the country could already have passed the point where the negative economic, social and environmental impacts might exceed the positive impulse for the economy (McKinsey&Company, 2017<sup>[5]</sup>). Continuing to welcome foreign tourists while addressing Iceland's vulnerability, the government should develop a comprehensive tourism strategy, which involves all stakeholders and vies for high-value-added and environmentally sustainable tourism, as suggested by the 2017 *OECD Economic Survey* (Table 2. Policies should include the removal of tax privileges for tourism services, a better geographical distribution of tourists across the country, limiting and/or pricing access to environmentally fragile sites and areas, and cost-benefit analysis, including social and environmental impacts, for infrastructure projects.

**Table 2. Past OECD recommendations on tourism**

Establish an inter-ministerial tourism strategy focused on making tourism environmentally, socially and economically sustainable. This should include non-government stakeholders.	Inter-ministerial work on a policy framework is underway.
Limit the number of visitors to fragile sites. Introduce user fees to manage congestion and pressure on the environment.	Access to fragile sites and national parks can be temporarily suspended. A working group is reviewing a user fee strategy. Parking fees were introduced in a few rural areas
Subject infrastructure investment to cost-benefit analysis, including consideration of social and environmental impacts.	No action taken
Remove current tax subsidies for tourism-related activities, by taxing them at the standard VAT rate and broadening the base to excluded services.	In 2015 VAT-rates were increased to 11% for most tourism-related service and in 2016 the tax base was broadened.s
Improve the economic analysis of tourism activity, with better data and research.	A special research and analysis department has been established at the Icelandic Tourist Board

Important downside risks to the outlook mainly derive from a worse-than expected decline in external conditions, resulting in a larger downturn of tourism or falling export prices. A hard Brexit could dent trade relations with the United Kingdom (Central Bank of Iceland, 2019<sup>[6]</sup>). Rising inflation following a weaker krona and rapidly growing wages would also slow down growth. Some low-probability extreme shocks could derail the economy (Table 3).

**Figure 7. Has Iceland hit peak tourism?**

Source: OECD tourism database.

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**Table 3. Possible low-probability extreme shocks to the Icelandic economy**

Shock	Possible impact
Weak tourism demand following a strong economic decline and/or changing preferences in origin countries	Strong decline in revenues from tourism export, rising unemployment in various sectors linked to tourism
Large drop in fisheries or in aluminium prices	A strong decline would worsen the current account balance
Breakdown of multilateralism	A breakdown of the liberal world order and new trade barriers would hit Iceland's exports

### The monetary policy framework is well established

Iceland significantly reformed its monetary policy framework after the financial crisis with the inflation target complemented by foreign exchange interventions, macroprudential tools, stronger regulation of foreign exchange liquidity risks of banks, and capital flow management. The reformed framework, known as “inflation targeting plus”, has served Iceland well. In particular:

- *Exchange rate interventions*: Limited central bank interventions in the foreign exchange markets have helped smooth excessive short term króna volatility. From 2013 until mid-2017, policy was more interventionist, to build reserves and mitigate the risk of an overshooting of the exchange rate in the run-up to capital account liberalisation (IMF, 2018<sup>[7]</sup>).
- *Macro-prudential tools*: Macro-prudential tools help Iceland guard against financial shocks, strengthening financial stability by preventing undue risk-taking by lenders and borrowers alike. Banks are subject to rules on foreign exchange balance and various capital and liquidity buffers, and the housing sector is subject to loan-to-value caps and constraints on foreign exchange lending (Table 4). Recent OECD analysis suggests that such instruments are associated with fewer cyclical downturns (Cournède, Sakha and Ziemann, 2019<sup>[8]</sup>).
- *Capital flow management*: Introduced in the aftermath of the 2008 crisis to curb destabilising capital movements, nearly all capital controls have now been phased out. A special reserve ratio (SRR), introduced in 2016 in the form of withholding requirement on specific capital inflows, has been reduced to 0% in March 2019 (Box 1).

Preconditions for a successful “inflation targeting plus” framework are well in place, including a strong financial oversight with prudential limits on banks’ international activities, well-capitalised and liquid banks, and an adequately funded pension system. This is important to address vulnerabilities and guard against risks associated with disorderly capital flow movements.

**Table 4. Prudential regulations: A summary**

Caps on LTV-ratios	85-90%
Capital flow management measure (CFM)	Lowered to 0% in March 2019
Restrictions on FX lending to unhedged borrowers	High restriction on lending to unhedged households
Net stable funding ratio	For 1 year in foreign currency
Liquidity coverage ratio	100% over the next 30 days
Leverage ratio	3% of Tier 1 capital
Rules on foreign exchange balance	10-15% of capital base
Systemic risk buffer	3%
Buffer due to systemic importance	2%
Countercyclical buffer	1.25% (1.75% from mid-May 2019 and 2% from February 2020)
Capital conservation buffer	2.5%
<b>Combined capital buffer required</b>	<b>8.75%</b>

Source: Central Bank of Iceland.

### Box 1. Turning the page on capital controls

Iceland is an example for successful policy normalisation after a deep crisis. The capital controls introduced in the aftermath of the 2008 crisis were gradually removed. Controls on capital flows were removed in October 2016 and January 2017, and an agreement was reached with several of the largest offshore króna holders in March 2017 (IMF, 2017<sup>[9]</sup>; OECD, 2017<sup>[10]</sup>). Offshore króna were carry trade inflows trapped in Iceland when capital controls were introduced. The removal did not cause any undue financial turbulence, according to the central bank's assessment, but only short-lived and moderate foreign exchange rate volatility.

Plans to release the last offshore króna assets locked in by capital controls were announced in December 2018 and legislated in March 2019. These policy actions put Iceland on the path of terminating the derogation it invoked post-crisis. The offshore króna initially accounted for 40% of GDP in 2008, but were brought down to around 4% of GDP in March 2017, transferred to special accounts with restrictions, thereby neutralising risks of disorderly currency outflows arising from these assets.

The special reserve ratio (SRR) on capital inflows for investments in the domestic bond market, introduced in 2016 to discourage investment in high-yielding fixed-income assets arising from carry trade, was gradually reduced. The SRR initially entailed a 40% unremunerated withholding requirement for investment in certain types of securities during one year. The requirement was lowered to 20% in November 2018 and then to 0% in March 2019, as the interest rates differential narrowed and inflows motivated by carry trade fell. The SSR appears to have affected the composition of capital inflows and possibly total volume controls (Forbes, 2018<sup>[11]</sup>). It is advisable that the SSR rate be kept at zero whenever possible and treated as a third line of defence, after conventional policy, including foreign exchange market interventions, and macro-prudential tools. The SRR is a capital flow management tool rather than an outright capital control and is in line with Iceland's commitments under the OECD Capital Movements Code.

Remaining capital controls, including restrictions on derivatives trading for non-hedging purposes, will be examined in due course as part of a comprehensive review of the Foreign Exchange Act (Central Bank of Iceland, 2019<sup>[12]</sup>).

### *Further reforms to the monetary policy framework are underway*

In October 2018, the government launched a wide-ranging review of the statutory framework for monetary and macroprudential policy, and financial market supervision based on the proposals of expert committees (Government of Iceland, 2018<sup>[13]</sup>). Guiding the review is the merging of the Central Bank and the Financial Supervisory Authority (FSA) into a single institution, called the Central Bank of Iceland. The legislation bill on the merger was submitted to Parliament in March 2019 and approved in June 2019 and is to take effect on 1 January 2020. The bill is not intended to change the tasks entrusted currently to the two institutions. It proposes, however, a new decision making-structure comprising three committees that lead, respectively, activities in the areas of monetary policy, financial stability and financial supervision (Central Bank of Iceland, 2019<sup>[14]</sup>). According to the bill, all decisions currently entrusted to the FSA will be taken by the Financial Supervisory Board, while decisions on financial stability, at present taken by the Central Bank and the Financial Supervisory Authority on the basis of recommendations from the Financial Stability Council, will be transferred to a single body, the Financial Stability Committee. The key objectives of the Central Bank after the merger will be to promote price stability, financial stability, and sound and secure financial operations.

The integrated approach to financial sector oversight is welcome since it avoids institutional fragmentation and has the potential of enhancing synergies between regulatory and oversight functions. Nevertheless, it is important to ensure that regulatory and operational functions remain separated to facilitate effective supervision. The three committees to be responsible for decision-taking under the new structure need to be well-co-ordinated.

While financial stability is in some cases part of the mandate of inflation-targeting central banks, a clear mandate to pursue price stability is an essential feature of the monetary policy regime. It is therefore welcome that the authorities are working towards the creation of an operational framework that allows interactions between the committees deciding on monetary and financial policy and ensures that price stability and inflation targeting remain the guiding principles of monetary policy.

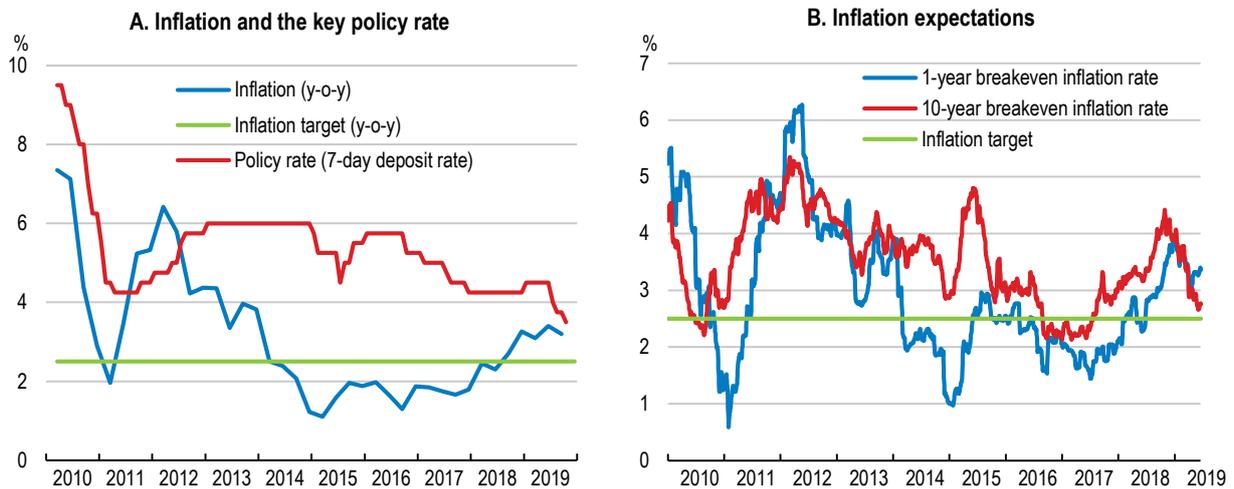
The inclusion of housing costs in the inflation target has been recently an issue of debate. A government-commissioned task force on the monetary policy framework suggested that such costs, accounting for over a fifth of the consumption basket in Iceland, are excluded to avoid potential conflict between price stability and financial stability objectives (Government of Iceland, 2018<sup>[13]</sup>). The measure of inflation should remain comprehensive, in line with the practice of the Central Bank. While trimmed measures of inflation excluding volatile items could inform policy, as is conventional practice among inflation-targeting central banks, the target should reflect all households' spending items to enhance transparency, accountability and trust in the target. It is also easier to communicate developments and monetary policy decisions based on the headline measure. At the same time, issues of house inflation need to be examined carefully.

### *Monetary policy has eased but vigilance is needed*

Iceland's balance between domestic inflationary pressure and external disinflationary relief has become more fragile. The depreciation of the króna in the autumn of 2018 coupled with buoyant domestic demand on the back of increasing wages and a positive, albeit declining, output gap pushed inflation above the target of 2.5%, after four years of undershooting (Figure 8). The central bank appropriately increased the policy rate by 0.25 basis points to 4.5% in November 2018, the first hike since rates were lowered late 2017. With growth

slowing rapidly and inflation expectations declining, the bank lowered the rate to 4% in May 2019, 3.75% in June and 3.5% in late August. Real interest rates are historically low (Central Bank of Iceland, 2019<sub>[15]</sub>).

**Figure 8. Monetary policy is easing**



*Note:* Breakeven inflation rate is calculated from yield spreads between nominal and index-linked Government and Government-backed bonds (5-day moving averages). Daily data.

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

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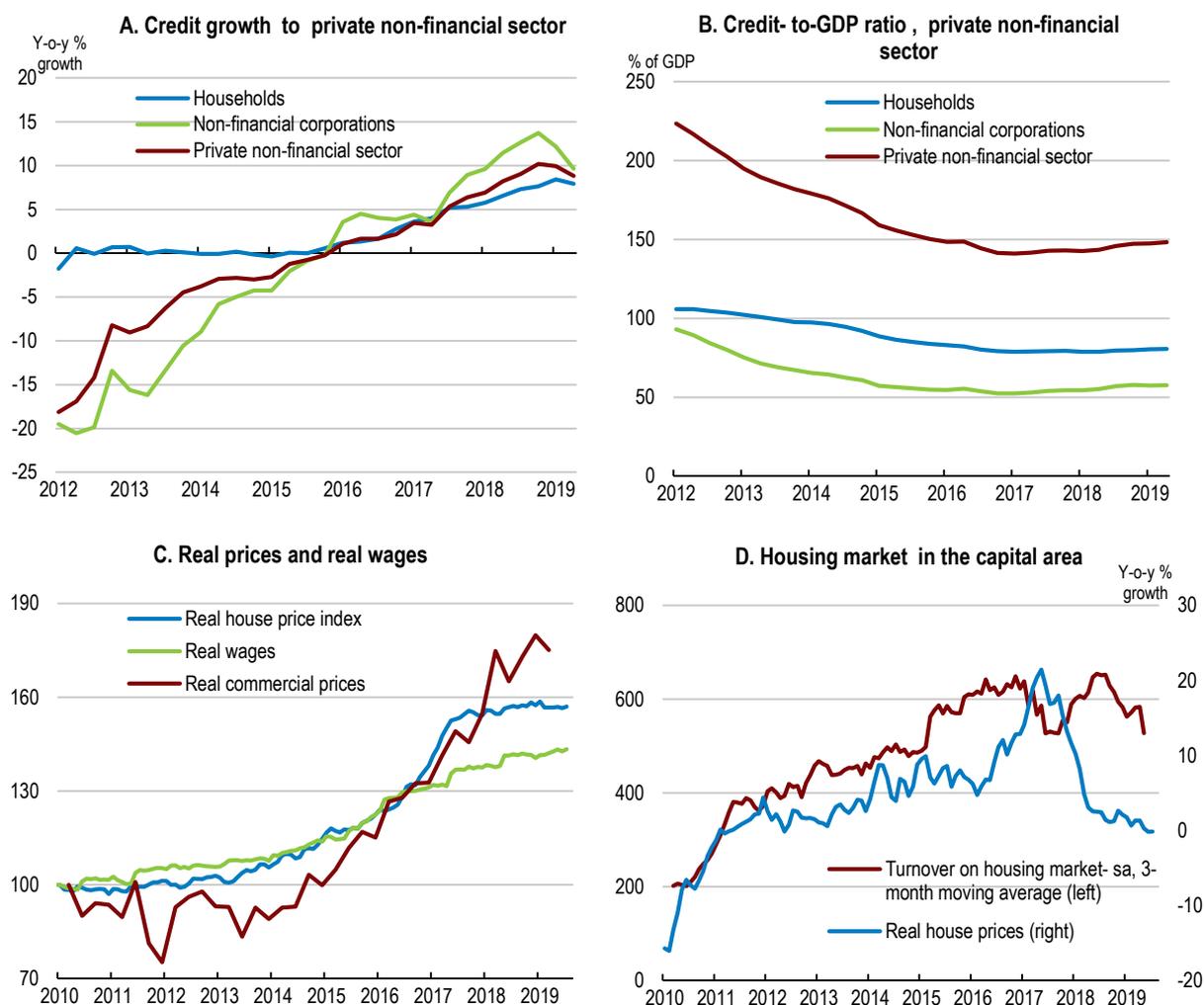
Several uncertainties surround the inflation outlook. These include pay rises in excess of productivity growth following the April 2019 wage agreement, and persistence of the exchange rate pass-through following depreciation of the króna. Monetary policy will need to follow developments closely, to ensure that inflation expectations remain well anchored and in line with the target. If inflation pressures materialise, the authorities should stand ready to tighten the monetary stance again.

### Safeguarding a resilient financial sector

Developments in the financial sector have improved (Figure 9). Financial conditions are supportive, with a robust increase in credit especially for businesses despite some recent easing (Central Bank of Iceland, 2019<sub>[15]</sub>). Low private sector indebtedness and easing house price inflation mitigate the near term risk to financial stability. In particular, a robust supply response – *i.e.* construction –, less immigration, and a slowing tourism sector affecting demand for Airbnb, contribute to an easing housing market. However, real house prices remain high in historical perspective, and they are rising fast outside the capital area. Housing affordability has been a contentious issue, and in the wake of the spring 2019 wage settlements, the government agreed on a set of social housing measures. Moreover, household debt, while still low, is picking up; and commercial real estate prices are expanding briskly and much faster than real wages. To enhance the banks' resilience against potential credit losses, the counter-cyclical buffer was raised by 0.5 percentage points effective from mid-May 2019, to be raised further by 0.25 percentage points from

February 2020. The authorities should remain vigilant and stand ready to tighten prudential measures if signs of systemic risks emerge.

**Figure 9. Conditions in the financial sector have improved**



Source: Central Bank of Iceland; OECD Economic Outlook database.

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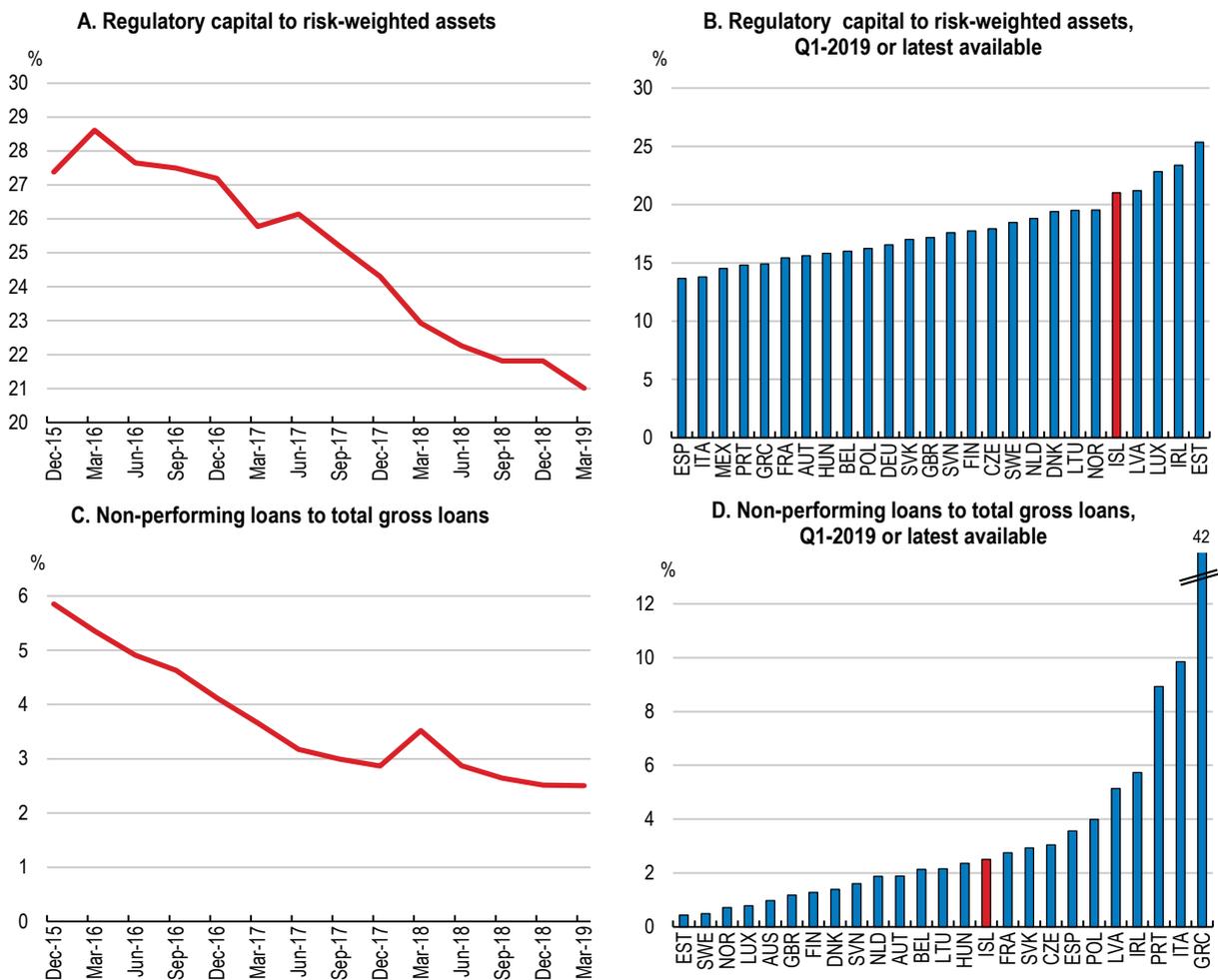
The banking system is considered sound, following its complete overhaul in the aftermath of the crisis (IMF, 2018<sup>[7]</sup>). The authorities consider that banks are well capitalised and that banks' liquidity is above the required level. The non-performing loans are on a downward trend (Figure 11). Based on its stress tests, the central bank concludes that the banking sector can weather a significant slowdown in tourism as capital buffers have been increased during the upswing (Central Bank of Iceland, 2018<sup>[16]</sup>). Lending to the tourism sector accounted for approximately 10% of total bank lending in 2018.

Iceland's banking sector is state-owned to a significant degree. Despite recent disinvestment, the government still owns two of the three main banks, with a 98% share in Landsbankinn and a 100% share in Islandsbanki. The authorities should proceed with

privatisation plans of the state-owned banks, while ensuring sound post-privatisation ownership and management, thereby minimising risks in the future.

Recently anti-money laundering efforts have been stepped up. According to the June 2019 follow up to the 2018 Financial Action Task Force (FATF) mutual evaluation report (an intergovernmental organization monitoring money-laundering), Iceland is currently rated as “compliant” in 14 out of 40 priority areas identified by the report, compared to 5 areas in 2018, while it has almost halved the number of “partially compliant” and “non-compliant” ratings. Staff working on financial crime-related issues was also tripled (IMF, 2018<sup>[7]</sup>). Efforts towards addressing remaining weaknesses in the existing anti-money laundering/counter-terrorist financing framework are important to minimise risks to financial stability, especially after the lifting of most capital controls in 2017. Going forward the 2018 FATF report recommends enhancing internal co-operation and co-ordination to effectively continue combat financial crime (FATF, 2018<sup>[17]</sup>).

**Figure 10. The banking sector appears sound**



Source: IMF, Financial Soundness Indicators

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**Table 5. Past OECD recommendations on monetary and financial policies**

Monetary policy should be ready to tighten, should inflation expectations rise again	The Central Bank raised the policy rate by 0.25% in autumn 2018 but it lowered it gradually to 3.5% by August 2019
Smooth excess short-term exchange rate volatility. Use macro-prudential tools in accordance with international agreements to manage potentially destabilising short-term capital flow	Capital controls have been lifted further and are virtually dismantled by now. Macro-prudential tools are largely in line with international agreements
Tightening macro-prudential policies should be considered to ensure that asset price inflation does not gather additional steam	Macro-prudential buffers have been increased. House price inflation has eased

## Fiscal policy for inclusive growth

Ten years after the crisis, fiscal positions are sound (Table 6). The budget balance has been in surplus for several years, while gross public debt according to the National Accounts definition stands at around 60% of GDP and continues to decline further. The fiscal stance has become more prudent. This stands in stark contrast to the situation ten years ago when the country had to spend around 70% of GDP for recapitalising and restructuring the banking sector and to protect the most vulnerable from the fallout of the crisis (Figure 11). Prudent consolidation brought both deficits and debt gradually down, aided by a one-off stability contribution from the failed banks, accounting for 16% of GDP in 2016. Taking advantage of these fiscal revenues, the government injected around 5% of GDP into the first-pillar public pension fund, switching it from unfunded to funded-based. Contingent liabilities remain sizeable but continue to decline.

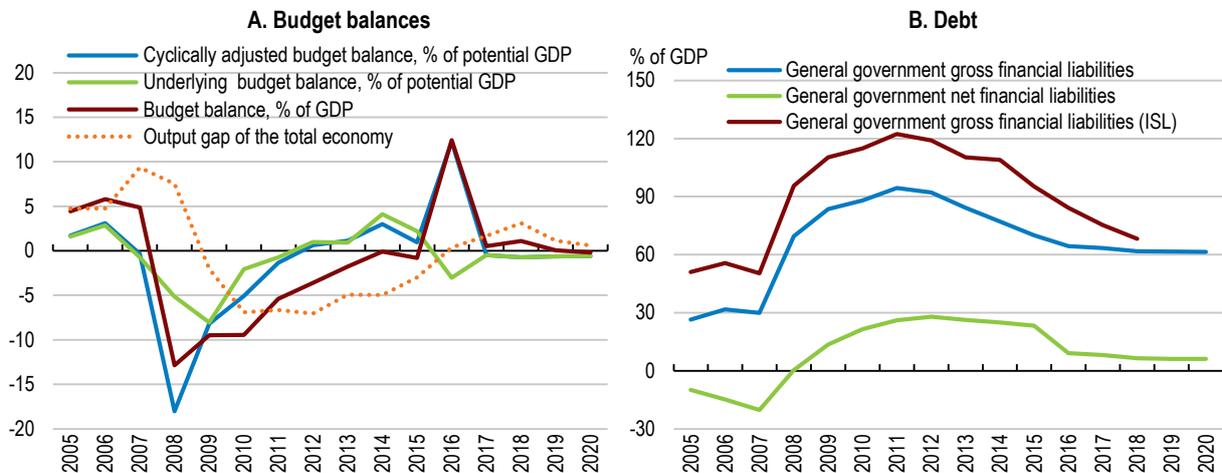
**Table 6. Fiscal overview**

Main fiscal aggregates 2005 and 2017, percent of GDP

	2005	2017
Gross financial liabilities	26.4	63.4
Net financial liabilities	-9.8	8.1
Budget balance	4.4	0.5
Total revenue	45.8	43.8
Tax on individual income	13.7	14.3
Tax on corporate income	1.9	3.1
Taxes on property	2.6	2.1
Taxes on sales and services	16.2	12.5
Other Taxes	1.9	2.2
Social contributions	3.1	3.4
Other revenue	6.3	6.3
Total expenditure	41.3	43.3
Social protection	8.8	9.7
General public services	5.1	8.1
Health	7.9	7.6
Education	8.2	7.5
Economic affairs	5.7	4.7
Other expenditure	5.7	5.7

Source: OECD National Accounts, Statistics Iceland.

Figure 11. Debt is declining more slowly



Note: The difference in gross financial liabilities between the OECD and Iceland essentially reflects different accounting of pension funds.

Source: OECD Economic Outlook 105 database; Statistics Iceland.

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### *The fiscal framework can be strengthened further*

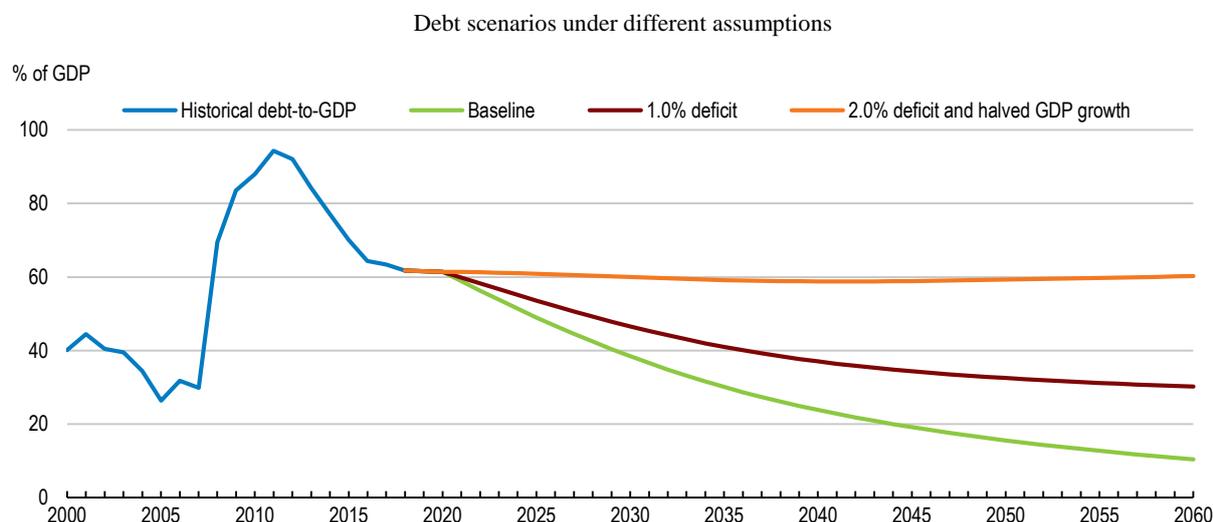
After the crisis, the fiscal framework underwent considerable reform with the adoption of a new public finance law in 2016. In particular, the new law introduced numerical fiscal rules and established an independent fiscal council. The law has now gone through more than two years of operation under three different governments.

- The two numerical fiscal rules consist of 1) a budget balance rule, requiring the annual deficit to remain below 2.5% of GDP, and the budget to be balanced over a five-year period; and 2) a debt rule requiring net debt (national definition) exceeding 30% of GDP to be reduced by 5% on average over three-years. The rules are relatively simple – in particular, they do not rely on potential output – and, despite being rather stringent, have been followed so far.
- The fiscal council has so far been cautious, focussing on procedural aspects and budget transparency rather than on a substantive assessment of fiscal policy. Its position is relatively weak in comparative perspective, mainly because of a limited remit and a lack of resources (von Trapp and Nicol, 2018<sup>[18]</sup>). Providing the council with more resources and improving collaboration with other independent bodies like the national audit office could strengthen its role.

While the fiscal framework has served Iceland well so far, it can be strengthened further, especially as some scenarios point to a dogged debt burden (Figure 12). Although the size of fiscal buffers needed in a severe downturn is difficult to estimate, one should bear in mind that public debt rose by more than 60 percent points during the 2008-09 crisis. Moreover, contingent liabilities arising from state guarantees for the Housing Fund and the national power company *Landsvirkjun* are still sizeable at around 35% of GDP. Finally, Iceland is not immune to the costs of ageing, although a low old-age dependency ratio, birth rates slightly above the OECD average and the high and rising retirement age help keep them under control (see also chapter 2). As such, it could be useful to build additional

buffers by reducing debt more rapidly. Establishing an expenditure rule could be another option, to help reduce pro-cyclical spending.

**Figure 12. Debt will decline further but only if fiscal policy remains disciplined**



*Note:* The projections are based on the OECD Economic Outlook No. 105 until 2020. From then on, long-term GDP growth is assumed to stand at 2.5% and inflation at the target (2.5%). The implicit interest rate on public debt is assumed to be 5%. The baseline scenario assumes a long-run balanced budget. The second scenario assumes a 1% long-run deficit. The third scenario assumes a 2% deficit and a long-run growth rate of 1.25%. All scenarios reflect the gradual rise of the pension age to reach 70 years by 2042.

*Source:* OECD Analytical database.

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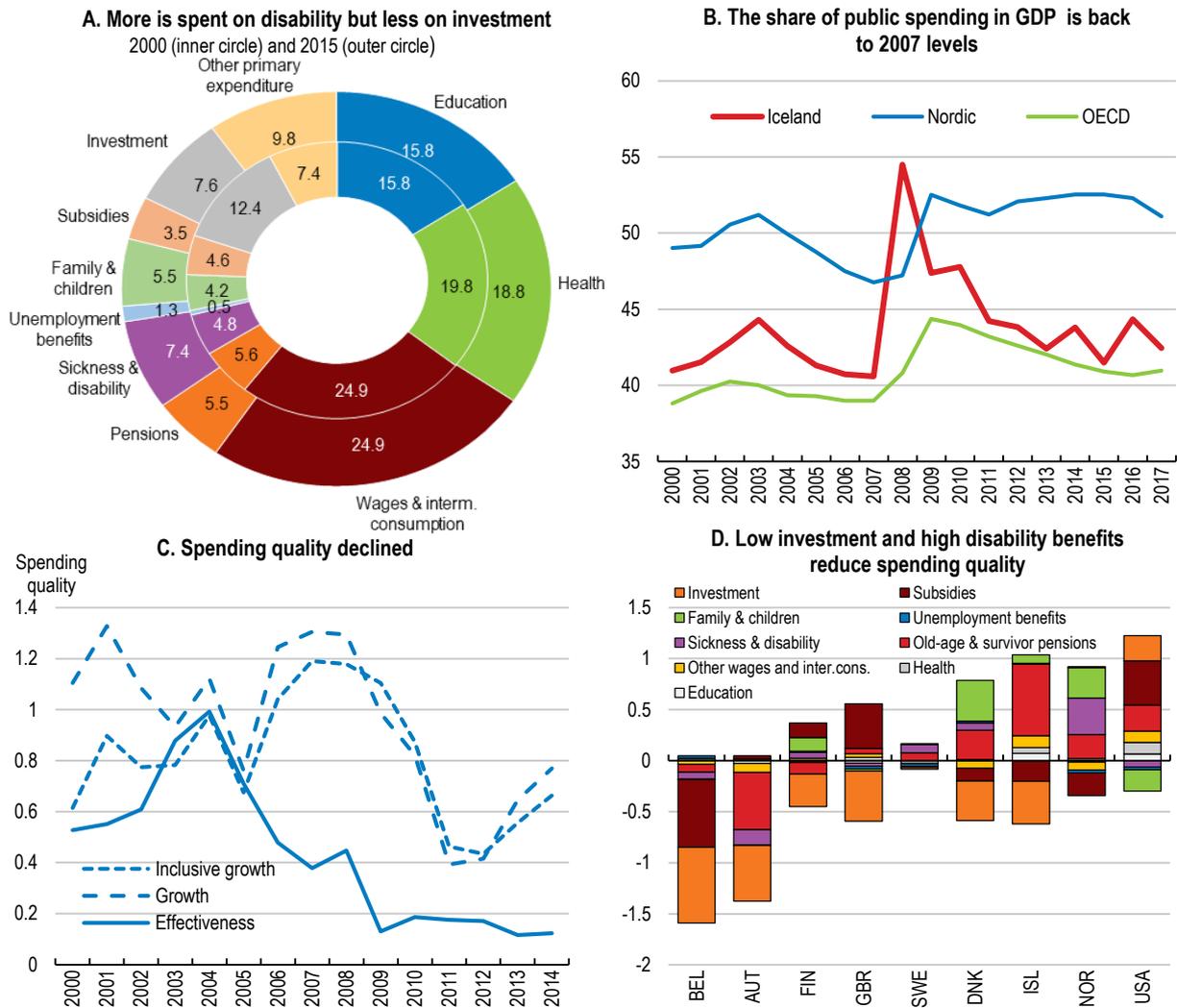
Local governments, accounting for around one-third of general government, also improved fiscal positions, but pro-cyclical policy remains an issue. In 2011, the government tightened local government finances by introducing a budget balance and a debt rule. The three-year horizon of the budget balance rule makes counter-cyclical budgeting difficult for the municipalities. After painful consolidation, virtually all municipalities now remain within the limits of the local rules. Yet fiscal equalisation is still highly pro-cyclical since it relies on general government tax revenues, exacerbating pro-cyclical of local budgets. Against this background, a reform of the municipal equalisation fund to better smooth municipal revenue volatility would be useful.

### *Improving the quality of spending*

The quality of public spending – i.e. the contribution of spending to growth and a more equal income distribution – has declined until recently (Figure 13). While the government increased social spending to protect the most vulnerable from the fallouts of the crisis, the share of spending on education and on infrastructure so far failed to reach pre-crisis levels. Today spending quality is around OECD average. Pension spending in GDP is below average because of a high retirement age, which is conducive to employment and growth, while extensive disability benefits and low public investment put a drag on growth (Bloch and Fournier, 2018<sup>[19]</sup>). The medium-term spending plan of the government foresees considerable spending rises in tertiary education and infrastructure in transport

infrastructure and in the new central national hospital, while spending on disability is planned to rise below average, which is welcome.

**Figure 13. Spending quality declined**



*Note:* The three spending quality indicators measure the contribution of the public spending mix to growth (“growth”); to growth and equality (“inclusive growth”); and to growth taken government size and effectiveness into account (“effectiveness”). Indicators are derived from a set of regressions linking public spending and other determinants to long-term growth of around 30 OECD economies. All indicators measure spending quality relative to the OECD average.

*Source:* Preliminary OECD Public finance database.

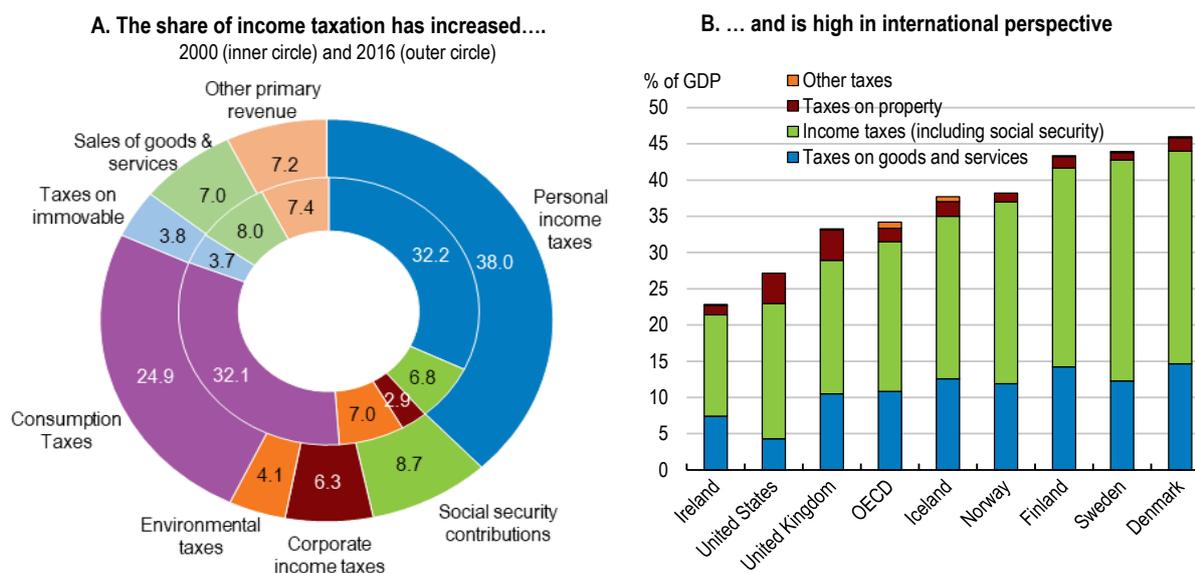
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Improving spending effectiveness, could both help improve performance in the public sector and free up scarce resources. Effectiveness has been on the decline for long (see chapter 2). Despite above-average education spending, educational outcomes are relatively poor. Problems also loom in other sectors where outcomes are often not commensurate with what is being spent. Against this background and as pointed out in earlier *OECD Economic Surveys*, spending reviews, linking spending with performance targets, could help identify opportunities to increase public sector performance. The government recently started spending reviews in the ministry of justice and the ministry of industries and innovation. Since spending review is challenging technically and politically, the authorities might rely on international experience, e.g. spending reviews carried out in the United Kingdom or the Netherlands (see also chapter 2).

### Rebalancing taxation

The tax burden in terms of GDP is lower in Iceland than in other Nordic countries, even accounting for compulsory contributions of 4% of wage income to the private second-pillar pension funds, yet it is above the United Kingdom and the United States. The quality of taxation as measured by its contribution to inclusive growth declined since the crisis. The share of the personal income tax (PIT) in total taxation is high, while social security contributions, which are more distorting than PIT, are small (Figure 14).

Figure 14. Taxation relies strongly on income



Source: OECD Revenue Statistics.

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By type of tax, key features of the current tax system and planned reforms are as follows (OECD, 2018<sub>[20]</sub>):

- **Income taxation:** Like in other Nordic countries, personal income is taxed at a progressive rate at the national and a flat rate at the local level. In 2019 average tax rates for low-income earners were slightly reduced. Corporate income tax is rather low at 20%, and R&D tax credits were broadened in 2018. The capital gains tax rate was raised to 22% in 2018, thereby narrowing the gap in the tax burden

between labour and capital income. The government plans a comprehensive income tax reform for 2020 involving: 1) lower tax rates for minimum-wage earners; 2) a new indexation mechanism to strengthen stabilization properties of income taxes; and 3) improved neutrality of the tax system with respect to gender and civil status.

- *Consumption taxes:* Value-added tax (VAT) rates are above the OECD average but the VAT tax gap is high at around 45%. Several items are not taxed or at a lower rate, especially in services catering to tourists (OECD, 2018<sub>[21]</sub>). Since 2015 the government lowered the statutory VAT rate from 25.5% to 24% and increased the lower rate from 7% to 11%. Broadening the tax base and abandoning special rates, especially on tourist services, should go further, as it would allow reducing the statutory rate. Moreover, the turnover threshold for businesses to pay VAT remains low at around 14 000 US-Dollars, burdening the administration and inviting avoidance, and it should be increased.
- *Environment-related taxes:* Cars are currently taxed through a variety of ownership and fossil fuel taxes. Revenues from fuel taxes will decline in the long run following the planned energy transition and the rise of electric cars, requiring appropriate policy responses. In 2018 a working group published a set of proposals to simplify the car tax system, to promote domestic energy use and to reduce pollution. There is also a CO<sub>2</sub> tax embedded in fuel taxation, but it is low (see below), while agriculture and industry remain untaxed (OECD, 2018<sub>[20]</sub>). CO<sub>2</sub> tax rates are planned to rise in three steps by around 80% until 2020, which is welcome. To address distributional concerns, to avoid an unwarranted increase in the tax burden and to overcome political economy obstacles, CO<sub>2</sub>-tax proceeds could partially or fully be reimbursed to businesses and citizens, as done in Switzerland (OECD, 2013<sub>[22]</sub>).

Implementing tax reform and other recommendations from this Survey would improve the budget balance in the medium term (Box 2).

### Box 2. Quantifying fiscal policy recommendations

The following estimates roughly quantify the fiscal impact of selected recommendations within a 5-10 year horizon, using simple and illustrative policy changes. The reported tax effects include behavioural responses, while most spending effects do not.

Table 7. Illustrative fiscal impact of recommended reforms

Policy Measure		Impact on the fiscal balance, % of GDP
<b>Deficit-increasing recommendations</b>		
Lower personal income taxation	Reduce marginal tax rates by 1% point for all income groups	-0.3
Less tapering of child and family benefits	Reduce implicit marginal tax rates on benefits by half	-0.2
Increase public investment	Increase by 0.5% point to 2.0% of GDP	-0.5
<b>Deficit-reducing recommendations</b>		

Reduce disability benefits	Reduce spending on benefits by one-half of the increase since 2000 (from 3.1% to 2.6% of GDP)	+0.5
Increase environmental taxes	Increase CO2-taxes and reimburse the proceeds to businesses and citizens	0
Increase VAT revenues	Raise the VAT revenue ratio from 0.55 to 0.58	+0.5
Reduce subsidies	Reduce subsidies by one fifth (from 1.5% of GDP)	+0.3
<b>Total fiscal impact</b>		<b>+0.3</b>

### *Establishing a sovereign wealth fund*

The government intends to establish a sovereign wealth fund and submitted a draft bill to parliament. The primary role of the fund will be to mitigate adverse fiscal effects stemming from natural disasters or economic shocks such as the realization of contingent liabilities. The fund will build up primarily on dividends from *Landsvirkjun*, the national power company, and assets will be invested abroad. Disbursements will be contingent on a prescribed set of conditions and the approval of Parliament. Besides supporting stabilization and sustainability, a sovereign wealth fund could help overcome political economy obstacles to sound fiscal policy and efficient public spending. It would also help diversify risks and act as counterweight to capital inflows.

The pace of asset build up should be gradual, and in line with prudent fiscal policy objectives and priorities. An alternative to build up a fund can be winding down debt more rapidly, investing more in infrastructure or education, or reduce taxes, to boost potential growth (Box 3). The role of the fund should be clearly defined and its corporate governance framework should ensure that assets are professionally managed, the board is independent from political interference, and that the fund remains accountable to the public.

#### **Box 3. Sovereign wealth fund – a case for Iceland?**

Many commodity-exporting economies, including OECD member countries like Australia, Canada, Chile, Mexico or Norway, have set up so-called sovereign wealth funds. These funds are usually sourced with the revenues arising from natural resource exploitation and drawn down subject to economic and fiscal shocks. Assets are generally invested abroad. Sovereign wealth funds may help diversify risks, mitigate revenue volatility, help prevent Dutch disease, and underpin commitment to sound fiscal policy. They provide liquidity when in a crisis financial markets are closing to new debt. In some cases, funds can also help reduce exchange rate fluctuations or maintain a fixed exchange rate regime. Given the multitude of objectives, countries often set up more than one fund, usually separating funds with a long-term sustainability objective from those with a focus on short-term stabilisation.

Some features of its economy tend to make Iceland a less typical country to establish a sovereign wealth fund. While most funds are set up by natural resource exporters to address the macroeconomic implications of high price fluctuations, Iceland's export structure is more diversified, and terms of trade volatility is less pronounced than in many other commodity exporters. Moreover, Iceland's financial and economic crises were barely the consequence of volatile commodity exports. Finally, Iceland's natural resource depletion rate is close to zero as its resources are mostly renewable, which obviates the need to

accumulate reserves to balance a shrinking resource stock. Against this background, the macroeconomic role of an Icelandic fund might differ from most other funds. While commodity exporter's obvious strategy is to safeguard against price volatility and resource exhaustion, Iceland would have to hedge against volatility from fish, tourists and geothermal heat.

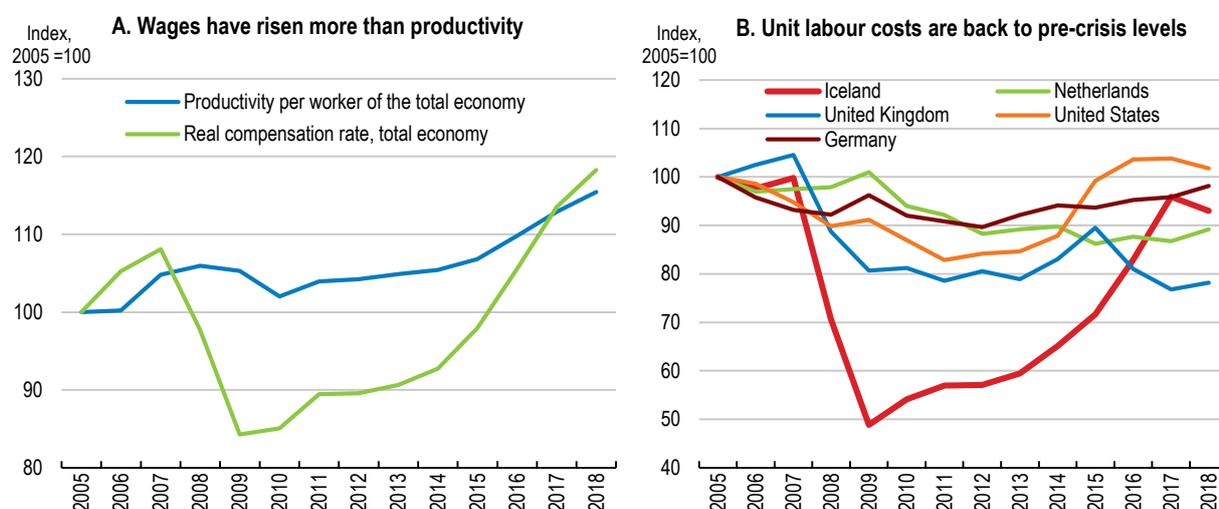
The merits of a sovereign wealth fund have to be set against the opportunity costs of competing investments. Winding down government debt more rapidly and saving on interest payments could be more beneficial than setting up a wealth fund bearing recurrent management cost and volatile returns. For example, Norway's global pension fund generated an average annual performance of around 6% over the past 20 years, while long-term interest rates in Iceland averaged around 7.5%. Moreover, investment into the fund must be set against public spending for productivity-enhancing policies such as education or infrastructure, or tax reductions, and their long-term impact on growth. Still a sovereign wealth fund may support the established budget framework further, help avoid long-term fiscal slippage and build up fiscal space. Moreover, the pace of asset build up could be adjusted to prevailing economic needs and policy objectives.

*Source:* (Einarsson et al., 2015<sup>[23]</sup>) (IMF, 2010<sup>[24]</sup>), (Kakanov, Blöchliger and Demmou, 2018<sup>[25]</sup>), (Norges Bank, 2018<sup>[26]</sup>), (OECD, 2012<sup>[27]</sup>), (World Bank, 2016<sup>[28]</sup>)

### **Structural reform to improve competitiveness is needed**

Iceland's competitiveness is declining. It rose sharply after the 2008 crisis following the devaluation of the króna and cuts in real wages, triggering the rapid recovery of the economy as the export sector expanded. Since then competitiveness deteriorated almost inextricably and is now where it was at the start of the crisis (Figure 15). While wages grew rapidly, productivity growth came almost to a halt and has only recently started to rise again, suggesting that the recovery was mostly driven by employment-rich service sectors such as tourism. Since wages are comparatively low in these sectors, this also affects inclusiveness. Finally, relatively low business investment may explain lacking productivity growth. Structural reforms recommended below or in the thematic chapter would boost productivity and growth considerably (Box 4).

Figure 15. Competitiveness is declining



Note: Higher values for unit labour cost mean lower competitiveness.

Source: OECD Analytical database

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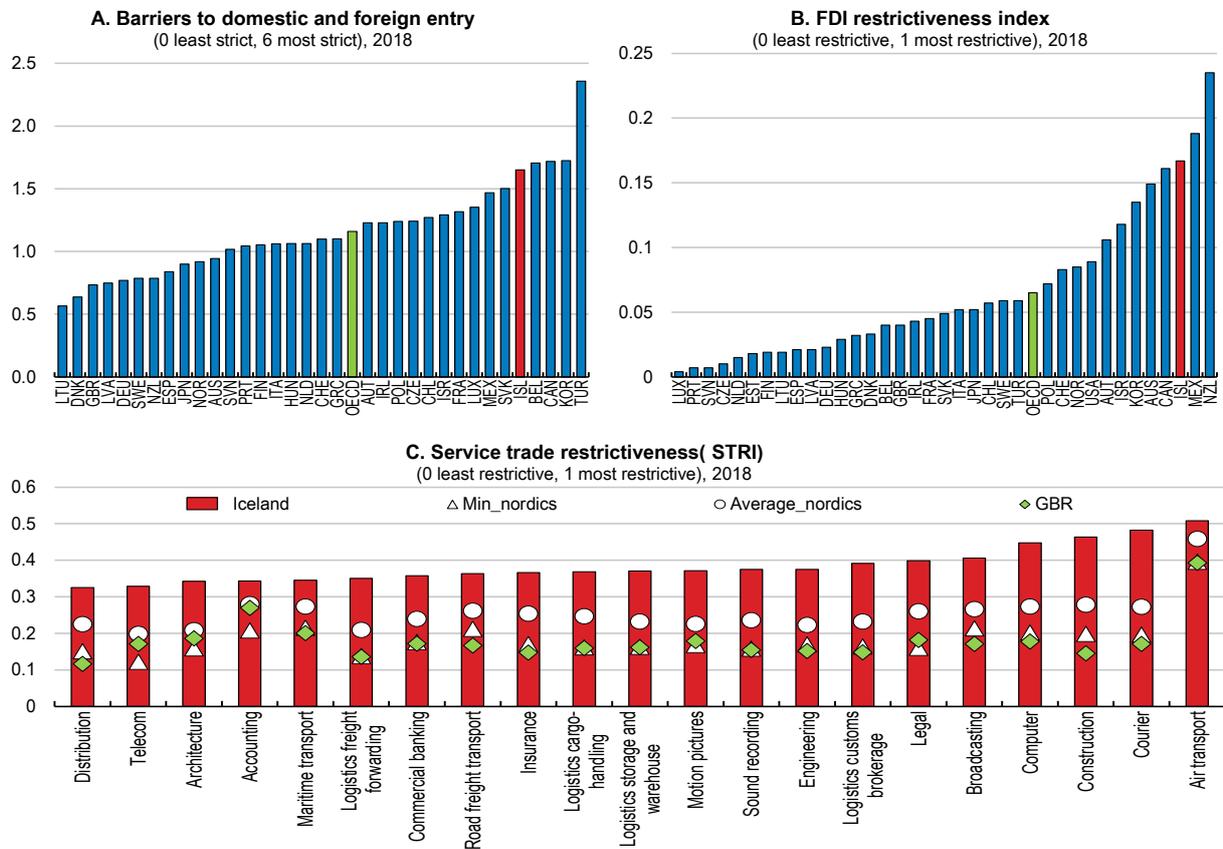
### Lowering the regulatory burden

The regulatory burden on Iceland's businesses is not commensurate with the needs of a small open economy. Regulation is widespread and stringent (Figure 16):

- Extensive product market regulation covers large swathes of the economy, with barriers to entry in the network industries and the service sector being particularly high. Administrative burdens for start-ups are high, holding back investment and innovation.
- Restrictiveness is high for all services and consistently higher than in the other Nordic countries, particularly affecting productivity in the domestic service sector.
- Restrictions to foreign direct investment are among the highest of the OECD, dampening employment and productivity gains through international capital and knowledge transfer.

Since regulation is restrictive across the board, the government should set up a comprehensive action plan for regulatory reform, prioritising reforms that foster competition, level the playing field between domestic and foreign firms and attract international investment. The OECD is currently carrying out a competition policy review for the construction and tourism service sectors, and the government should rapidly implement recommendations to reduce the regulatory burden.

Figure 16. The regulatory burden is high



Source: OECD 2018 Product Market Regulation database; OECD FDI Regulatory Restrictiveness Index database; OECD Services Trade Restrictiveness Index database.

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The size of Iceland's public corporate sector accounts for around 2.5% of total employment, close to the OECD average, with state-owned enterprises (SOEs) active mainly in the network industries and banking (OECD, 2017<sub>[29]</sub>). Public ownership is particularly important in the electricity generating and distributing sector, with major companies owned by either the central government or groupings of municipalities. Companies investing in the energy industry require a license to operate and firms outside the European Economic Area are barred from direct investment. Moreover, the government still owns two of the three main banks; their privatisation is planned but no timeline has been set yet. SOEs might benefit from lower capital cost and other implicit advantages due to their public status, potentially distorting competition.

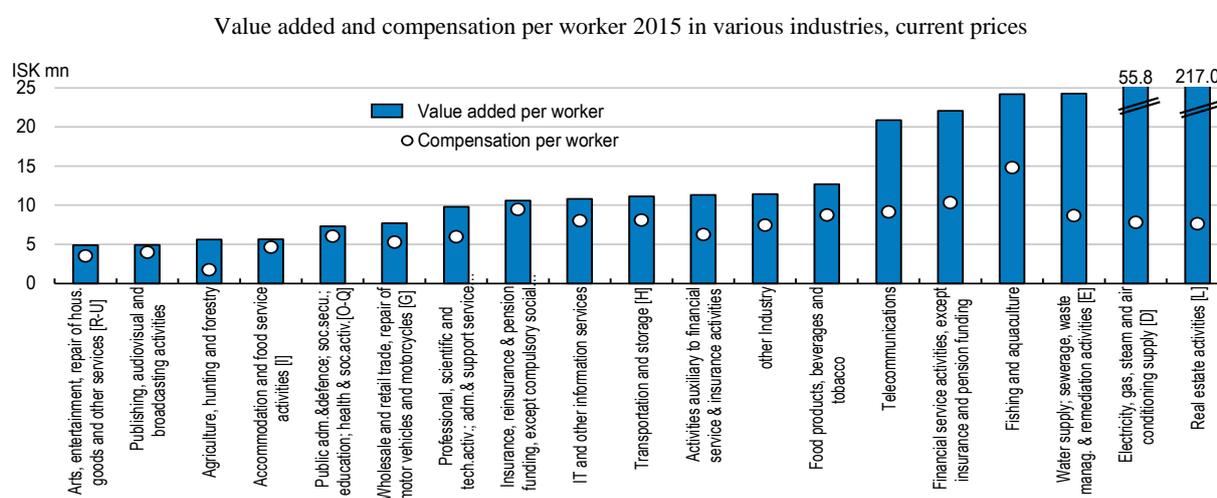
Iceland follows the OECD Principles of Corporate Governance and the OECD Guidelines on Corporate Governance of State-Owned Enterprises and in 2012 established a general state ownership strategy, which remains relatively generic however, making it difficult to assess objectives and performance of SOEs (Ministry of Finance, 2012<sub>[30]</sub>). As such, the government should define more clearly the policy objectives it wants to achieve by nurturing SOEs. In parallel, the government should ensure that SOEs – especially those operating in competitive markets – are subject to the same rules as private companies, to safeguard competition and productivity.

### *Productivity differs more than wages*

Productivity differs significantly across economic sectors. Iceland's export sectors such as fisheries or aluminium, competing on an international scale, traditionally produce high value added per worker. Productivity is more modest in the domestic sector, including services related to tourism, as markets are small and competitive pressures low, weakened further by tight regulation. Since the export sector generally depends on domestic inputs, developments in the domestic sector affect international competitiveness. Against this background, reducing the obstacles holding back domestic productivity, in particular a high regulatory burden, could strengthen the links between the domestic and external sector and help increase overall productivity and competitiveness.

The wide differences in productivity are in contrast to the relatively narrow differences in wages across sectors (Figure 17). A compressed wage structure is commendable, fostering inclusiveness and reducing pressure for costly redistribution (OECD, 2019<sup>[31]</sup>). However, the disconnect between productivity and wages across sectors might imply potential drags on long-term growth. *First*, in small open economies like Iceland, with wages largely determined by the export sector and then spilling over to the rest of the economy and the public sector, wage growth above domestic productivity increases inflationary pressures. *Second*, the small wage differences provide few incentives for workers to move from low to high productivity sectors. Over the past 15 years the size of the domestic sector remained largely unchanged at around 70% of the workforce (Federation of Icelandic Industrialists, 2018<sup>[32]</sup>). *Third*, a flat wage curve might discourage higher education, as investing in human capital and knowledge-intensive activities and sectors hardly pays off.

**Figure 17. Productivity differs more than wages across sectors**



Source OECD calculation on STAN database.

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Improved labour relations could help manage wage developments, as pointed out in earlier *OECD Economic Surveys* (Table 8). Iceland is the most unionised country in the OECD, contributing to the relatively compressed wage structure. However, the Icelandic wage bargaining process is quite fragmented, with leap-frogging of wage demands potentially undermining competitiveness and creating inflationary pressures (SALEK, 2016<sup>[33]</sup>). The Icelandic social partners should build on the successful spring 2019 wage agreements, by

linking wage developments and productivity growth more closely (Box 4). The recent wage bargaining reforms in Finland as part of the 2016 “competitiveness pact”, which links wages more tightly to productivity developments, could serve as a model (OECD, 2018<sup>[34]</sup>). Moreover, the government should avoid offering social benefits during the negotiations, as this could lead the social partners to conclude agreements at the cost of the public purse.

**Table 8. Past OECD recommendations on improving labour relations**

To nurture trust all parties need to participate actively in the Macroeconomic Council.	As part of the spring 2019 wage settlement, social partners agreed to participate in the Macroeconomic Council
Establish a tripartite technical committee to provide reliable and impartial information to wage negotiators.	Work is ongoing, with participation of social partners and Statistics Iceland
Wage negotiations should begin with an agreement on “wage guidelines” for the negotiation round. State mediator (and arbitration bodies) should also base their proposals on these guidelines.	The spring 2019 wage agreements contain a link from GDP per capita growth to future wage growth
Increase the powers of state mediator, including the power to delay industrial action for a limited period in agreement with the social partners, in an effort to achieve a negotiated agreement	No action taken

#### **Box 4. The spring 2019 wage agreements**

In April 2019, employers and trade unions settled on a new collective wage agreement. The agreement covers the years 2019 to 2022, which is unusually long in view of the country’s negotiation history, reflecting growing trust in the stability and resilience of the economy. The agreement, while focussing on purchasing power of low-income earners, stressed macroeconomic constraints such as the need to keep inflation at bay and to avoid interest rate hikes. Negotiation outcomes were partly shaped by the insolvency of the WOW airline, directly affecting around 0.5% of the labour force.

Wages of low-income earners will go up by around 6% in 2019 and around 34% by 2022. The wage settlement also includes a set of government concessions such as tax reductions for low-income earners; more generous family benefits; and extensive support for affordable housing, which together will help raise disposable household income by more than 50% until 2022. Wages not subject to collective agreements will be negotiated in the course of 2019, with experience suggesting that individual wage settlements could considerably rise the overall wage bill, contributing to wage drift.

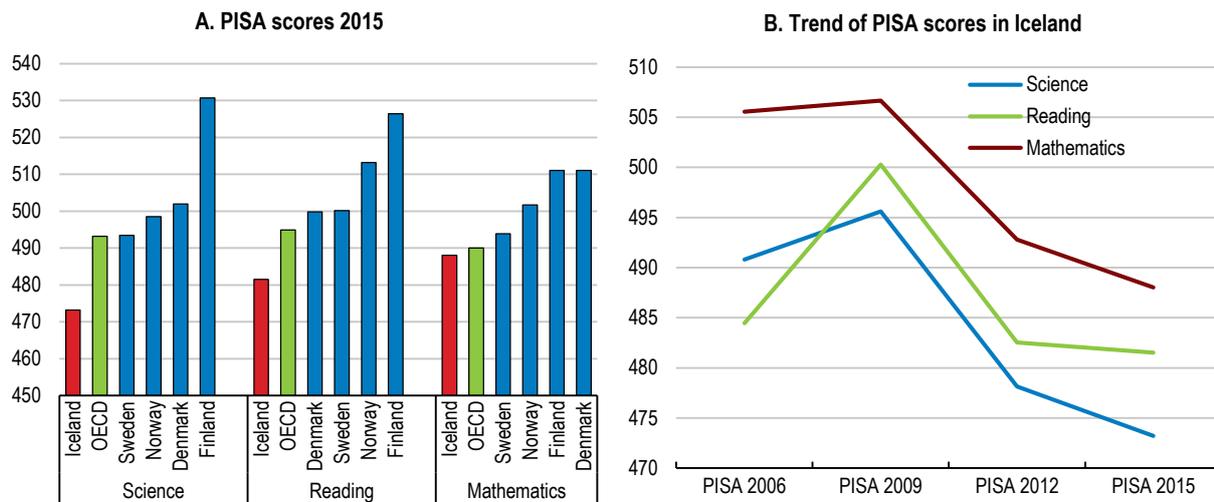
A welcome novelty in the wage agreement is the link between future wage developments and growth of GDP per capita. A numerical scale defines the additional wage increases if GDP rises more than projected in the wage settlements, providing a robust instrument to safeguard competitiveness. Still productivity would be a better anchor for maintaining competitiveness and macroeconomic stability while ensuring that growth continues to benefit all. A technical wage statistics committee has been created which could inform future wage guidelines based on reliable productivity measures.

#### ***Fostering strong and relevant skills***

Strong and relevant skills are important to help Iceland prepare for rapid technological change and for boosting inclusive growth. The PISA results reveal internationally weak and sliding proficiency levels among students at the end of compulsory schools, despite high expenditure on education (Figure 18). A large divide remains between immigrant

(making up 7% of 15-year-old students) and native students, especially in literacy, even if Iceland's education system is very equitable. Building solid core skills is vital for further skills development and success in a knowledge- and innovation-driven environment. Reforms underway to improve students' performance are in the right direction and need to continue. These include, in particular, a literacy initiative to strengthen the reading skills of compulsory education students and a new teacher competency framework that establishes standards to guide teacher appraisal and professional development.

**Figure 18. The PISA scores have weakened**

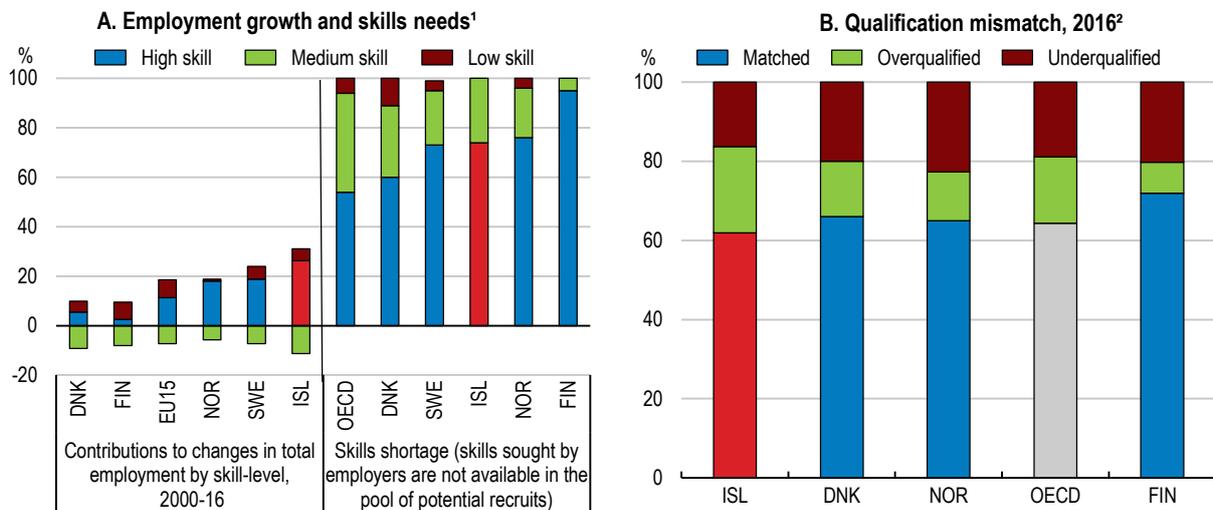


Source: OECD PISA 2015.

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The education system should also be more responsive to evolving skills needs. Iceland seems to face skills imbalances, although data to assess their actual size is not yet available (Figure 19). Strengthening the vocational pillar is essential to reduce skills-mismatch and meet future skills demands, even if the employment rates among young people are high at the current conjuncture. Work- and school-based training should be better integrated and vocational education made more attractive to students. Moreover, complementary measures that encourage employer-based training may be necessary. In addition, linking university funding partially to the success of courses in providing skills corresponding to labour market demands, through for instance differentiated awards to institutions for such courses, would contribute to the development of the right skills-mix. A rigorous assessment of labour market needs and solid data on graduates' employment outcomes are essential in this regard. Finally, encouraging less educated workers to participate in lifelong learning programmes and integrating immigrants better in the labour market are crucial for responding successfully to shifting skill demands.

Figure 19. There is scope for better skills match



1. High-skilled workers refer to ISCO occupational groups 1-3, medium-skilled to group 4-8 and low-skilled to group 9. Data refers to latest year available.

2. Qualification mismatch describes a situation for which a worker has qualifications that exceed (overqualified) or do not meet (under-qualified) the ones generally required for the job.

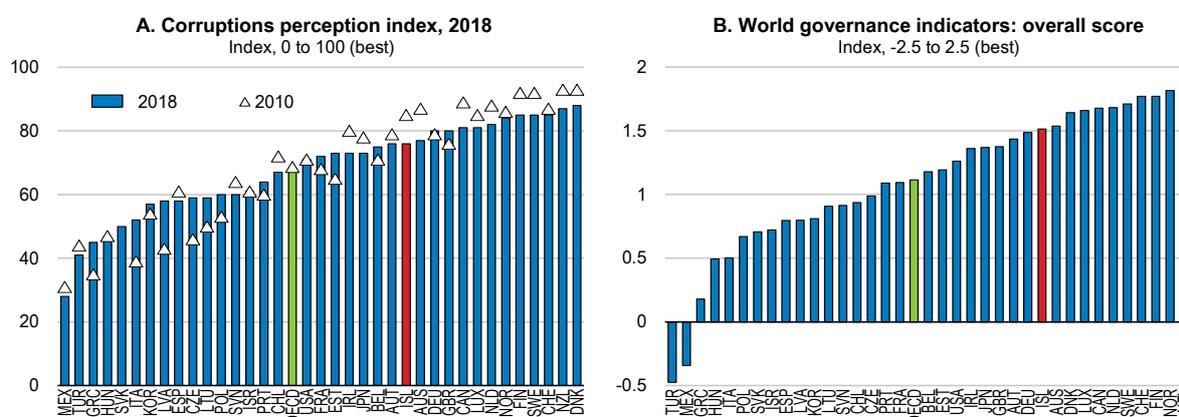
Source: OECD Skills for Jobs; Eurostat.

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### *Institutions and governance could be strengthened further*

Productivity developments are partly affected by governance and institutions. They comprise elements such as the rule of law, regulatory quality, government effectiveness, and control of corruption. Iceland's institutional framework, in particular the rule of law, is strong, which helps to exploit the productive potential of the economy, but it remains below the other Nordic countries (Guillemette et al., 2017<sup>[35]</sup>). Trust in government sharply slid below OECD average after the crisis, but rose again over the past few years (WorldBank, 2019<sup>[36]</sup>).

Perception of corruption is low in Iceland, but it has crept up since 2012 (Figure 20). The small size of the country can exacerbate susceptibility to corruption. Low transparency in government decision-making and frequent conflicts of interest indeed seem to be a problem (Council of Europe, 2015<sup>[37]</sup>). In 2018, in response to the OECD's Working Group on Bribery, parliament amended legislation specifically to cover bribery of officials employed by state-owned and state-controlled companies (OECD Working Group on Bribery in International Business Transactions, 2018<sup>[38]</sup>). In 2018, the government sent a bill to parliament to strengthen the protection of whistle-blowers in the public and private sectors and to improve access to information.

**Figure 20. Corruption is low but creeping up**

Source: Transparency International and World Bank (2018).

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### Box 5. Quantification of structural reforms

Selected reforms proposed in the Survey are quantified in the table below, using simple and illustrative policy changes. Other reforms, including in the area of skills or public spending, are not quantifiable under available information or the complexity of the policy design. Some estimates rely on empirical relationships between past structural reforms and productivity, employment and investment, assuming swift and full implementation, and they do not reflect particular institutional settings in Iceland. The estimates are hence illustrative, and results should be taken with caution.

**Table 9. Potential impact of structural reforms on per capita GDP**

Policy	Measure	10 year effect, %	Long-run effect, %
Reduce product market regulation	Reduce product market regulation in the network industries, the service sector and for foreign investment from 1.8 to 1.4 index points (one standard deviation)	3.2	8.3
Reduce marginal income tax rates	Reduce marginal tax rates by 2% points for all income groups	0.75	1.25
Increase public investment	Increase public investment by 0.5% points to 2.0% of GDP	1.5	3.0
Increase VAT revenues	Increase the VAT revenue ratio from 0.55 to 0.58	-0.0	-0.0
Reduce spending on disability	Reduce spending on benefits by half of the increase since 2000 (from 3.1% to 2.6% of GDP)	0.4	1.2
Reduce agricultural subsidies	Reduce subsidies by one third from the current level (1.5% of GDP)	1.0	2.5

Note: The following recommendations are included in the fiscal quantification (Box 2), but their impact on GDP cannot be quantified: reduce tapering of child and family benefits, increase environmental taxes. The high multipliers for investment assume that each of the public investment projects are well identified and highly profitable.

Source: OECD calculations based on (Égert and Gal, 2017<sup>[39]</sup>) and (Cournède et al., 2018<sup>[40]</sup>)

## Green growth

Iceland boasts pristine wilderness, spectacular landscapes, and abundant hydro and geothermal energy resources and generally enjoys excellent water and air quality. Relative to GDP, energy-related CO<sub>2</sub> emissions are lower than elsewhere in the OECD since renewables cover most energy needs, helping to keep small particle emissions low (Figure 21, panels A to D). Still the country is one of the highest per capita greenhouse gas (GHG) emitter in the OECD, excluding emissions from land use and land-use change, and emissions have risen by more than 10% since 2010 (OECD, 2014<sub>[41]</sub>).

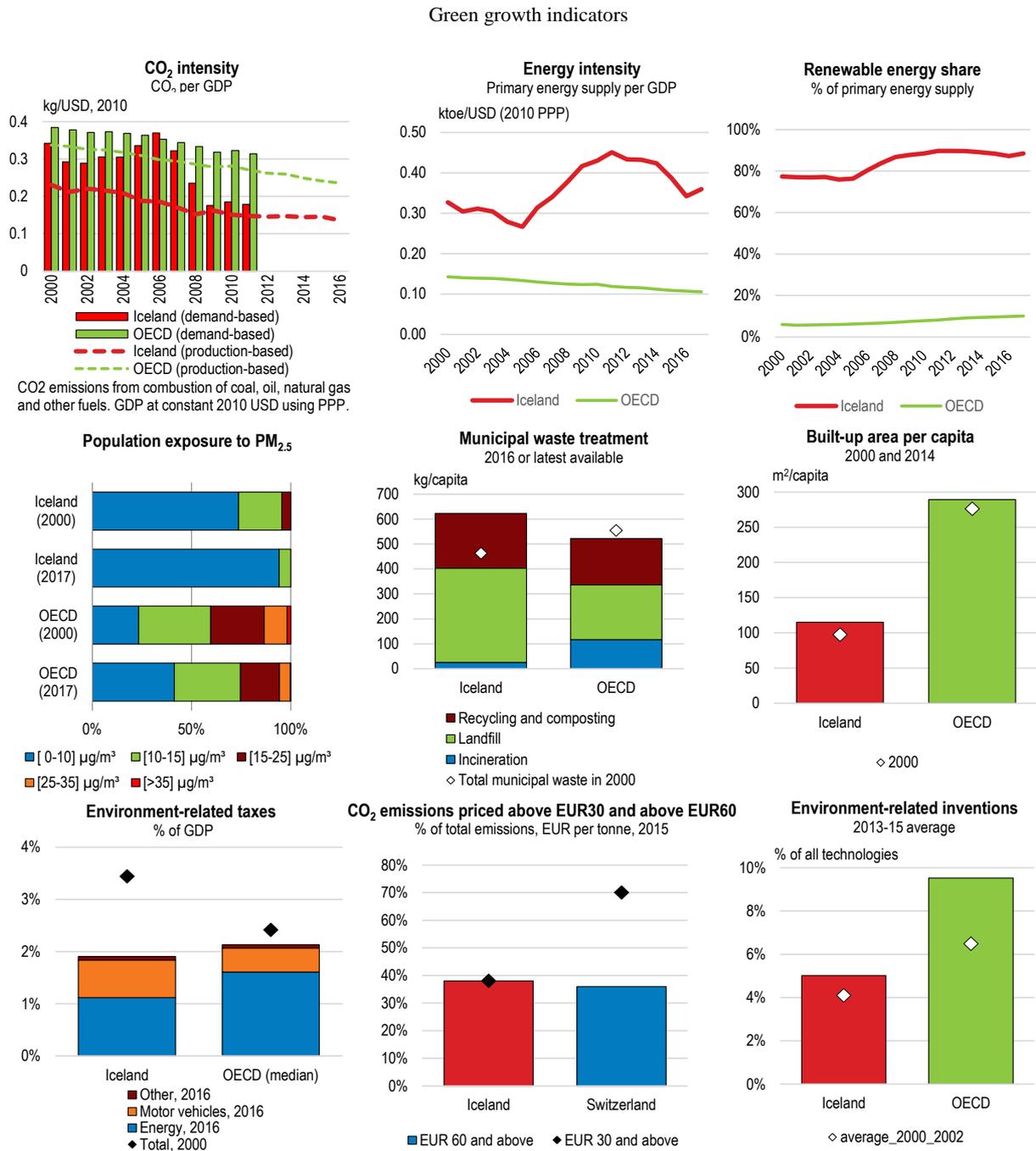
Abundant cheap energy has given Iceland a comparative advantage in energy-intensive aluminium smelting, which contributes substantially to GHG emissions. These emissions are included in the EU's emission trading scheme (ETS), in which Iceland participates even though it is not an EU member. Emissions from agriculture are also high, reflecting sheep raising. Overgrazing also contributes to soil erosion on half of the country's surface, damaging biodiversity and weakening flood control. Chapter 2 discusses reforms of agricultural subsidies to reduce these adverse environmental impacts. Hydropower and geothermal exploitation, urban sprawl and tourism also weigh on biodiversity (OECD, 2014<sub>[41]</sub>).

Iceland has joined the EU and Norway in their aggregate targeted GHG emission reduction of 40% by 2030 compared to 1990 (Ministry for the Environment and Natural Resources, 2018<sub>[42]</sub>). The government's emission reduction plan includes phasing out fossil fuels in transport, as well as restoring woodlands and wetlands. The government has committed more funding for charging stations and low-emission infrastructure as well as for tax incentives for electrical cars. It has announced a ban on new gasoline and diesel cars by 2030, 10 years earlier than several European countries.

Iceland has even more scope to reduce its energy-related CO<sub>2</sub> emissions (panel H). Iceland has a carbon tax, but its rate (about EUR 15 per ton CO<sub>2</sub>) is well below international benchmarks for the climate related external cost of carbon, projected to be at least EUR 60 by 2030. Tax exemptions for certain industrial sectors and the free allocation of emission permits to industry reduce the efficiency of emission mitigation and are a major reason why CO<sub>2</sub> pricing is not inclusive. The government's announcement that it will gradually increase carbon taxes is welcome. There is also a case for introducing taxes on hydroelectric and geothermal energy exploitation in view of their environmental impacts (OECD, 2018<sub>[43]</sub>). Finally, a more consistent approach to emissions pricing could also boost environment-related innovation, which is weak (panel I) (Calel and Dechezleprêtre, 2016<sub>[44]</sub>). Still high administrative barriers in the implementation of environmental regulation may unnecessarily hurt economic activity (Kozłuk, 2014<sub>[45]</sub>).

Iceland generates significant municipal waste, and much more than in 2000 (panel E). A large share is landfilled. Reducing and recycling waste reduces natural resource and energy consumption and GHG emissions substantially, including in sectors that are relatively difficult to decarbonise. The small size of municipalities, some with weak administrative capacity, result in inconsistencies in how environmental measures are designed and enforced, which could affect waste management. An option to reduce waste and recycle more could be to extend the Recycling Act to more products. By charging a fee proportional to waste volumes on all manufacturers and importers, the Act generates incentives to avoid and recycle waste (OECD, 2014<sub>[41]</sub>). The government announced a new landfill tax in summer 2019.

**Figure 21. Despite abundant renewables, environmental impact remains considerable**



Source: OECD Green Growth Indicators database.

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