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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.

The economic situation and policies of Iceland were reviewed by the Committee on 14 June 2021. The draft report was then revised in light of the discussion and given final approval as the agreed report of the whole Committee on 25 June 2021.

The Secretariat's draft report was prepared for the Committee by Hansjörg Blöchliger and Vassiliki Koutsogeorgopoulou, with inputs from Sigurður Jóhannesson and Marías Halldór Gestsson from the Institute of Economic Studies of the University of Iceland and Eunha Cho, consultant with the OECD Economics Department, under the supervision of Vincent Koen. Research assistance was provided by Natia Mosiashvili, and editorial support by Gemma Martinez and Sisse Nielsen. The previous Survey of Iceland was issued in September 2019.

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BASIC STATISTICS OF ICELAND, 2019*

(Numbers in parentheses refer to the OECD average)**

LAND, PEOPLE AND ELECTORAL CYCLE				
Population (million)	0.4		Population density per km ² (2018)	3.5 (38.1)
Under 15 (%)	19.6	(17.9)	Life expectancy at birth (years, 2018)	82.9 (80.1)
Over 65 (%)	15.2	(17.1)	Men (2018)	81.3 (77.5)
International migrant stock (% of population)	15.5	(13.3)	Women (2018)	84.5 (82.8)
Latest 5-year average growth (%)	2.0	(0.6)	Latest general election	June 2020
ECONOMY				
Gross domestic product (GDP)			Value added shares (%)	
In current prices (billion USD)	24.8		Agriculture, forestry and fishing	4.9 (2.6)
In current prices (billion ISK)	3 045.1		Industry including construction	21.7 (26.8)
Latest 5-year average real growth (%)	4.4	(2.2)	Services	73.4 (70.6)
Per capita (000 USD PPP)	60.0	(48.3)	Central bank policy interest rate (end-year) (%)	3.0
GENERAL GOVERNMENT (Per cent of GDP)				
Expenditure	43.4	(40.6)	Gross financial debt (OECD: 2018)	61.5 (107.6)
Revenue	41.9	(37.5)	Net financial debt (OECD: 2018)	6.5 (67.8)
EXTERNAL ACCOUNTS				
Exchange rate (ISK per USD)	122.61		Main exports (% of total merchandise exports)	
PPP exchange rate (USA = 1)	140.57		Food and live animals	44.7
In per cent of GDP			Manufactured goods	37.3
Exports of goods and services	44.4	(54.2)	Machinery and transport equipment	8.5
Imports of goods and services	39.3	(50.6)	Main imports (% of total merchandise imports)	
Current account balance	6.4	(0.3)	Machinery and transport equipment	33.6
Net international investment position	22.1		Manufactured goods	12.1
			Miscellaneous manufactured articles	12.0
LABOUR MARKET, SKILLS AND INNOVATION				
Employment rate (aged 15 and over, %)	78.4	(57.6)	Unemployment rate, LFS (aged 15 and over, %)	3.5 (5.4)
Men	81.6	(65.6)	Youth (aged 15-24, %)	8.7 (11.7)
Women	75.0	(49.9)	Long-term unemployed (1 year and over, %)	0.2 (1.4)
Participation rate (aged 15 and over, %)	81.0	(61.1)	Tertiary educational attainment (aged 25-64, %)	45.0 (38.0)
Average hours worked per year	1,454	(1,726)	Gross domestic expenditure on R&D (% of GDP, 2018)	2.0 (2.6)
ENVIRONMENT				
Total primary energy supply per capita (toe)	16.8	(3.9)	CO ₂ emissions from fuel combustion per capita (tonnes)	5.2 (8.3)
Renewables (%)	90.1	(10.8)	Water abstractions per capita (1 000 m ³ , 2014)	9.2
Exposure to air pollution (more than 10 µg/m ³ of PM 2.5, % of population)	3.5	(61.7)	Municipal waste per capita (tonnes, 2017, OECD: 2019)	0.7 (0.5)
SOCIETY				
Income inequality (Gini coefficient, 2017, OECD: 2016)	0.250	(0.310)	Education outcomes (PISA score, 2018)	
Relative poverty rate (% , 2017, OECD: 2016)	4.9	(11.4)	Reading	474 (487)
Median disposable household income (000 USD PPP, 2017, OECD: 2016)	34.7	(24.4)	Mathematics	495 (489)
Public and private spending (% of GDP)			Science	475 (489)
Health care	8.8	(8.8)	Share of women in parliament (%)	38.1 (30.7)
Pensions (2017)	7.1	(8.6)	Net official development assistance (% of GNI, 2017)	0.3 (0.4)
Education (% of GNI, 2018)	7.4	(4.5)		

* The year is indicated in parenthesis 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, United Nations, World Bank.

Executive summary

Iceland stands up after a deep fall

After a deep contraction, the economy is recovering from the COVID-19 pandemic on the back of robust export growth.

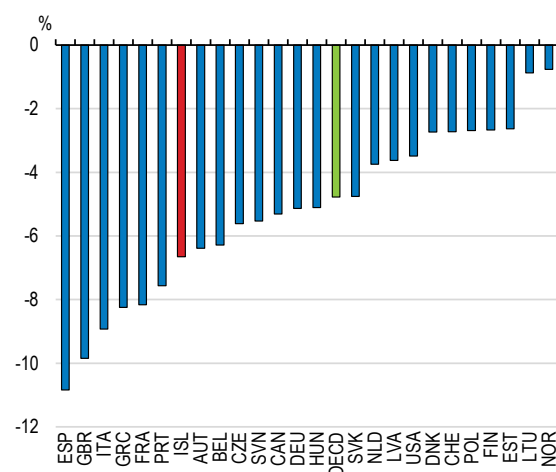
The health situation is under control, and new infections are rare. All domestic restrictions were lifted end of June. Vaccination is progressing rapidly.

The government extended most support programmes until end-2021. It also set up a five-year programme to invest in infrastructure, digitalisation and research and innovation accounting for 0.5% of GDP per year.

Following a 6.6% contraction in 2020, the economy is expected to grow by 2.8% in 2021 and 4.5% in 2022 (Figure 1, Table 1), driven by a rebound of tourism, a successful vaccination programme and the lifting of restrictions. Unemployment will edge down to around 7% in 2022 on the back of accelerating growth.

Figure 1. The economy plunged

GDP decline in 2020



Source: OECD, National Accounts database.

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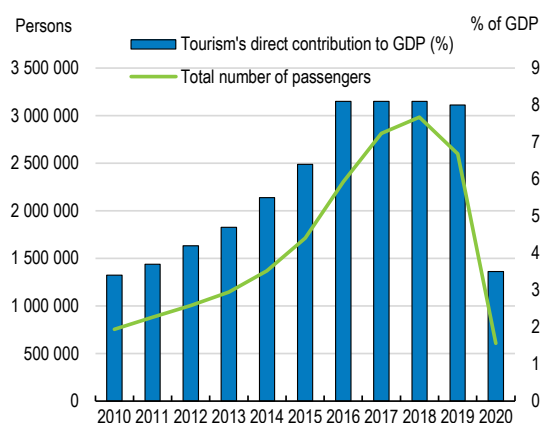
Non-tourism exports are on the rise.

Intellectual property services now account for around 15% of service exports. Data processing and storage are growing rapidly, attracted by low energy prices and a cool and windy climate.

Domestic tourism has only partly replaced foreign travellers.

In 2020, pandemic-related travel restrictions reduced foreign arrivals to around a fourth of the previous year (Figure 2). To a limited extent, this sharp decline was offset by Icelanders travelling in their own country.

Figure 2. Border restrictions hit the tourism sector hard



Note: Passengers who go through security at Keflavik Airport.

Source: Statistics Iceland.

StatLink <https://stat.link/n8bvat>

Table 1. The economy is projected to accelerate

	2019	2020	2021	2022
			Projections	
			Percentage changes, volume (2005 prices)	
GDP at market prices	2.6	- 6.6	2.8	4.7
Private consumption	1.9	- 3.3	2.1	4.9
Gross fixed capital formation	- 3.7	- 6.8	8.0	3.4
Exports	- 4.6	- 30.5	6.5	12.0
Imports	- 9.3	- 22.0	8.2	8.2
Consumer price index	3.0	2.8	4.1	2.5
Unemployment rate	3.9	6.4	8.0	7.6
Budget balance (% of GDP)	- 1.5	- 7.3	- 10.3	- 7.1
Current account (% of GDP)	6.4	1.0	- 1.0	0.0

Source: OECD, Economic Outlook No. 109.

Monetary and fiscal policies are accommodative

Notwithstanding the recent interest rate hike, monetary policy remains accommodative. Fiscal policy continues to support households and firms.

Monetary policy has been eased in response to the crisis and remains appropriately accommodative. Between March and November 2020 the central bank reduced its key interest rate by 2 percentage points to 0.75%. As inflation and short-term inflation expectations have risen above the target, the bank raised the interest rate again to 1% in May.

The easing monetary conditions have helped households more than firms. Mortgage credit rose in 2020, and real estate market activity and house prices rose. Yet corporate lending stagnated, despite measures to ease access to credit, with liquidity constraints a concern especially for the tourism sector.

Fiscal policy is supporting the economy. The budget deficit widened to 7.3% of GDP in 2020. Parliament suspended the fiscal rule and the rolling five-year fiscal plan it approved in late 2020 as well as the one it endorsed in Spring 2021 aim to support the economy in the short term and to reach a positive primary balance by 2025, when gross public debt according to the National Accounts is set to stabilise at 100% of GDP.

Tax reforms help low-income households and the environment. The third and last stage of an income tax reform reduced tax rates by up to 8 percentage points. Environmentally-friendly transport modes receive temporary VAT reliefs.

Regulation should be eased and skills improved

Regulatory barriers are stringent, slowing innovation and the entry of new firms. At the same time, skills gaps need to be addressed.

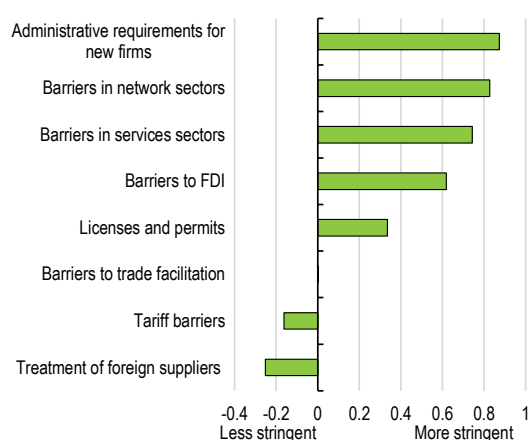
Productivity has recently accelerated but has overall remained sluggish over the past decade. The competitiveness gains built up

shortly after the 2008/09 crisis were exhausted by the late 2010s.


Stringent regulation stifles competition. The state sector is small and well run, but barriers to entry facing domestic and foreign firms are high (Figure 3), hampering competition. Administrative burdens and an extensive licensing and permit system protect incumbents and slow new and innovative start-ups.

Figure 3. Barriers to entry are high

PMR gap with OECD average, 2018



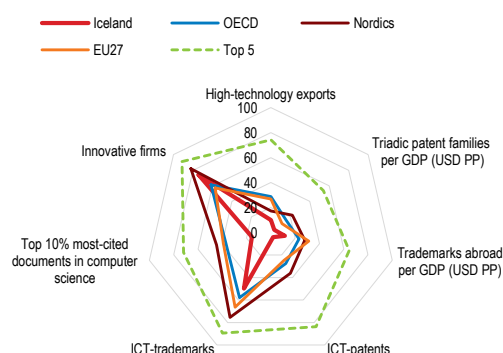
Note: Positive values mean more stringent regulation than the OECD average, negative values less stringent regulation.
Source: OECD, Product Market Regulation database.

StatLink  <https://stat.link/5qjs8n>

Iceland has untapped innovation potential (Figure 4). More effective support for business R&D would unlock private investment and improve the ability of smaller firms to innovate. Encouraging firms to adopt digital technologies would help Iceland to make the most of innovation niches, with productivity gains. The public sector too could become more digitalised with positive societal impact. Skills for the digital era and strong knowledge exchange through closer business-research collaboration on innovation and international cooperation in research are essential for stronger innovation.

Figure 4. Innovation lags behind

Innovation outcomes in international comparison



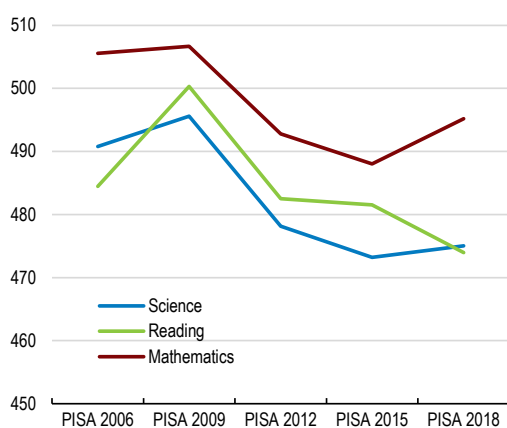
Note: Higher values reflect better outcomes. More information is given in chapter 2.

Source: World Bank, World Development Indicators; OECD, Main Science and Technology Indicators; OECD, Information and Communication Technology; OECD, Education at a Glance database; and Global Innovation Index 2020.

StatLink <https://stat.link/qr11tk>

The quality of primary and secondary education is declining, although the system is remarkably equitable. PISA scores are trending down (Figure 5), as teacher qualifications fail to keep up with requirements, and teacher salaries provide few rewards for experience and excellence.

Figure 5. PISA scores have trended down



Source: OECD, PISA 2018 database.

StatLink <https://stat.link/fsj4b>

Tertiary education induces skills mismatch. Links between universities and the labour market are weak. Funding levers make it attractive for universities to focus on enrolment rather than performance. Collaboration between research institutions and firms is improving, however.

Vocational education and training is underdeveloped. Participation is lower than in any European country and limited to traditional technical and crafts professions. School-based and work-based learning are weakly integrated, and there are only few pathways to higher education.

Addressing climate change

Iceland has committed to reduce carbon emissions substantially over the coming decade. It should do so in a sustainable, cost-efficient and inclusive manner.

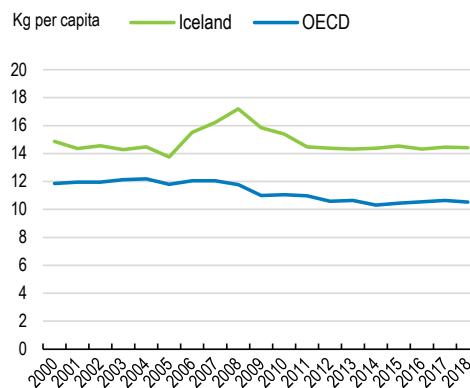
Iceland's per capita carbon emissions exceed the OECD average, partly because of industry's reliance on low energy generation cost (Figure 6). The government committed to reduce emissions from their 2005 level by at least 40% by 2030.

Iceland's climate policy should rely on effective carbon pricing, complemented by investment in low-carbon infrastructure, targeted spending on green research and development, and well-designed environmental regulation. To ease the transition, the country should remove barriers for new and innovative firms and foster the creation of green jobs and skills.

To garner political support and make the low-carbon transition beneficial for all, proceeds from carbon pricing could be redistributed to households and firms, at least partly.

Figure 6. Carbon emissions exceed the OECD average

Total greenhouse gas emissions per capita



Source: OECD Green Growth Indicators.

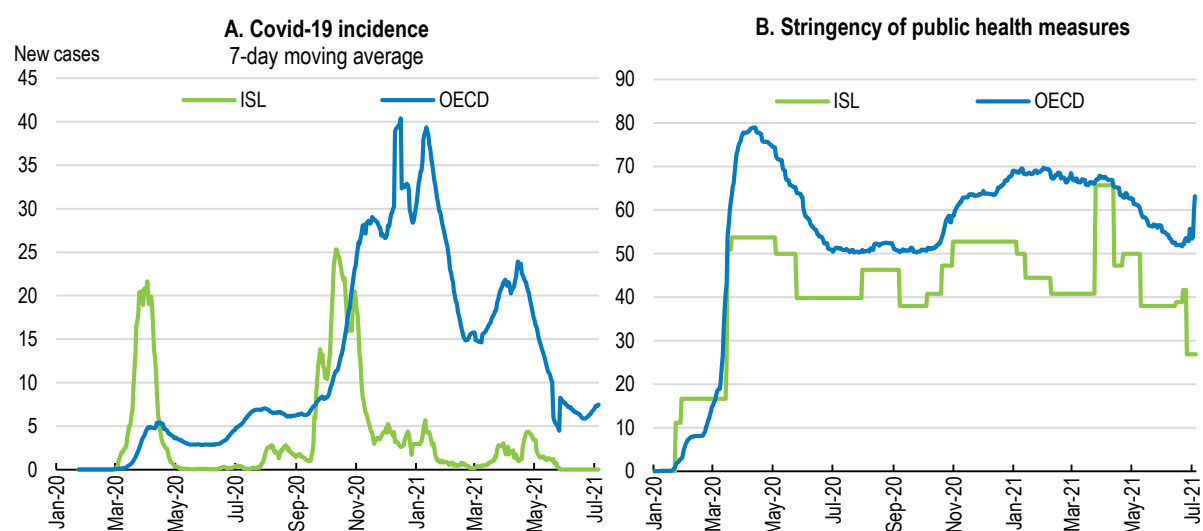
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MAIN FINDINGS	KEY RECOMMENDATIONS
Policies to support the recovery	
Inflation and short-term inflation expectations are above target.	Keep monetary policy accommodative, but stand ready to tighten further if long-term inflation expectations risk becoming unanchored.
The merger of the Central Bank and Financial Supervisory Authority is expected to strengthen the overall surveillance of the financial system.	Remain vigilant to maintain a sound and resilient financial system.
Fiscal policy is supporting the economy.	Continue supporting the economy and start fiscal consolidation as planned once the recovery is firmly established.
Barriers to the entry of new firms are high.	Reduce barriers to sound competition in the tourism and construction sectors. Facilitate access to professions by easing stringent occupational licensing.
Skills mismatch is high. Labour shortages have intensified in some sectors, slowing reallocation.	Continue and extend the training programme for professions in short supply. Strengthen vocational education and training (VET) by extending work-based learning and by facilitating access to tertiary education for VET graduates. Strengthen the link between tertiary education and the labour market, by linking part of university funding to labour market needs.
Promoting innovation	
Business R&D intensity does not match the rapid increase in tax support for R&D in recent years and innovation outcomes of smaller firms, which are the main beneficiaries of such support, are relatively weak.	Ensure that R&D tax-incentives better target smaller innovative firms.
Venture capital, an important source of financing for young and innovative firms without collateral, is not yet well developed.	Ensure that the new publicly-owned venture capital fund invests in privately-owned venture capital funds with large potential to promote start-ups and innovation companies.
The tertiary system does not provide sufficiently broad skills.	Increase the provision of vocational education programmes at the tertiary level and of entrepreneurship programmes.
Collaboration between research institutions and the business sector is weak, limiting knowledge transfer.	Introduce carefully-designed policy initiatives to encourage business-research collaboration on innovation, including specific programmes that connect smaller firms with researchers.
Addressing climate change	
Climate policies lack prioritisation and sequencing and rely mostly on technical measures.	Develop a consistent climate policy framework to guide scope, priorities, and sequencing of actions and measures.
Geothermal energy, waste management and agriculture are not subject to carbon pricing.	Submit all sectors to carbon pricing, taking into account interactions between carbon taxes and emissions trading systems.
There is room for further investment in low-carbon infrastructure.	Step up spending on low-carbon transport infrastructure, energy transition and the digital transformation.

1 Key policy insights

Iceland is recovering from a comparatively mild COVID-19 health crisis. The number of victims and the stress on the health system have remained low. A smart testing and tracking strategy helped the authorities to identify infections early and to implement targeted health measures. Containment was short and less restrictive than in many other countries, and all domestic restrictions were lifted at the end of June 2021 (Figure 1.1). Preschools and primary schools operated almost without interruption, while remote learning became more widespread at secondary and tertiary level. International borders remained open to the Schengen area, with the rules on testing and quarantining gradually being eased since spring 2021. Vaccination is progressing fast, with all people over 16 years old planned to get at least one dose by early summer.

Figure 1.1. The pandemic hit Iceland mildly

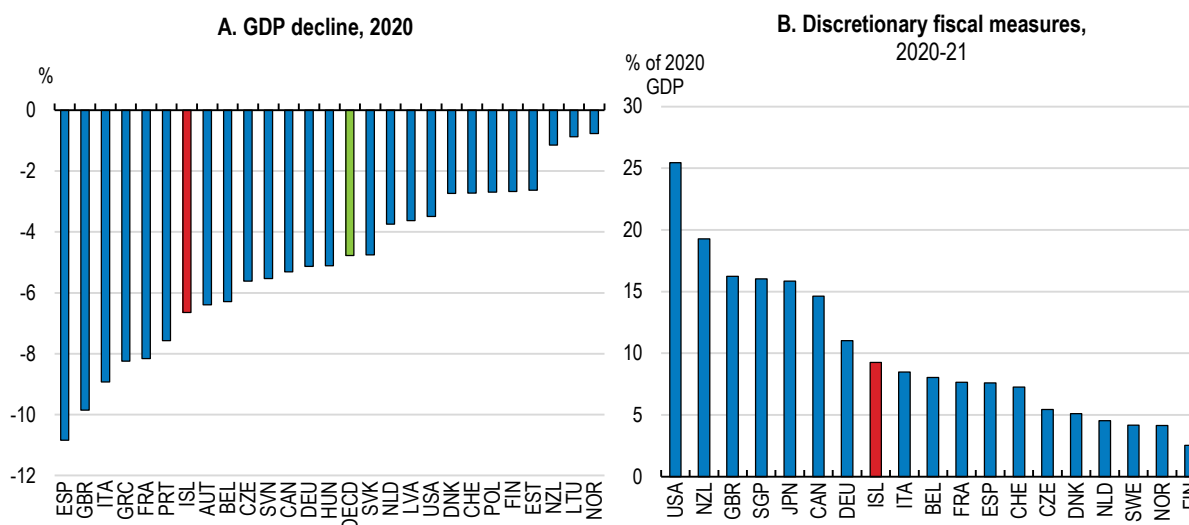


Source: Oxford University; Our World in Data, as of 5 July 2021.


StatLink  <https://stat.link/vq0ao2>

The economic impact of the pandemic was severe but contained by policy action (Figure 1.2). Following widespread lockdowns and travel restrictions worldwide, foreign tourism collapsed, with only around a fourth of foreigners arriving in 2020 compared to the previous year. Icelanders, unable to travel abroad, visited their own country, but this made up only a part of lost revenues. Like in other countries, the government promptly took a range of measures to help the ailing economy, notably with a short-term work scheme to support households and firms (Box 1.1). The central bank's interest rate cuts and liquidity assistance helped to preserve financial stability. Thanks to these measures, total domestic demand declined by 1.3% only. The economy plunged by 6.6% in 2020, still considerable but less than at the time of the global financial crisis.

Figure 1.2. The economy suffered a large contraction, but policy support helped



Source: OECD, National Accounts database; and IMF, Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic.

StatLink  <https://stat.link/ld5e0n>

The dramatic unfolding of the pandemic overshadowed deeper structural shifts in Iceland's economy. Tourism, whose breakneck growth drove the recovery after the 2008/09 financial crisis, peaked already in 2018, and the country's second airline became insolvent in 2019. While tourism might grow less in the medium term, other sectors are taking its place as growth engines. The pharmaceutical industry continues to develop rapidly, and digital service exports such as data processing and storage are booming, benefitting from Iceland's low energy prices and cool and windy climate. Fisheries are climbing up the value chain with fresh seafood and aquaculture rising. Innovative carbon capture technologies help reduce carbon emissions and can provide export income. Yet, structural change is slowed by a lack of relevant skills and overly stringent regulation.

Box 1.1. Government measures have helped households and firms through the pandemic

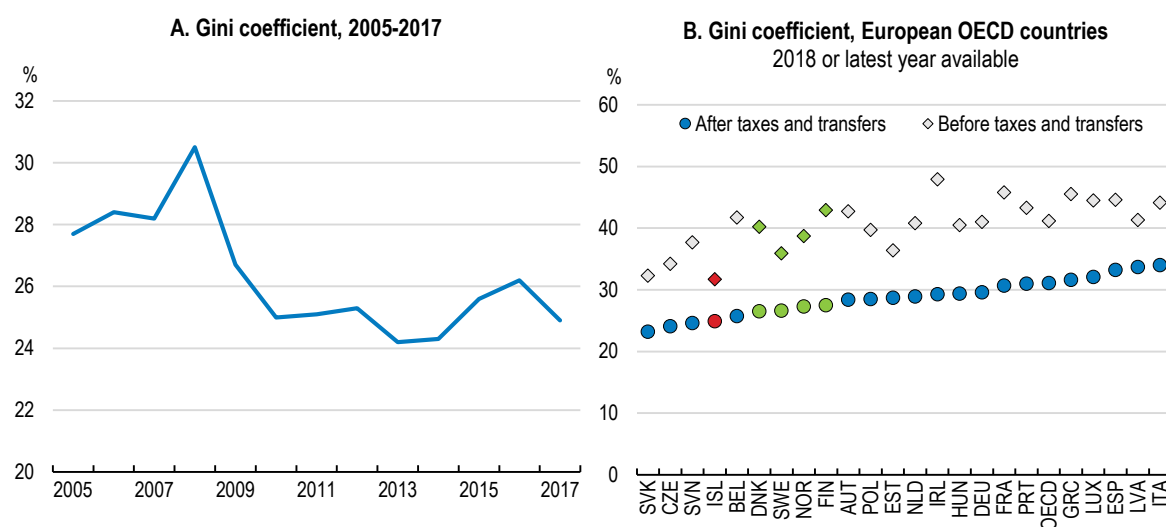
Mid-March 2020, soon after putting in place the first containment measures, the government adopted a support programme to avoid a meltdown of business and household income. The programme was broadened in April and extended in November, with some measures planned to expire mid-2021. It first focused on immediate financial support to households and firms and the health care system and then gradually shifted towards encouraging public and private investment to support the recovery and long-term growth.

The most significant measures included a short-term work scheme; additional child and family benefits; households allowed to draw on third-pillar pension savings; special support for vulnerable groups; and the deferral of income and value-added tax payments of up to a year. Businesses whose revenues fell by more than 40% received financial relief, with the severely hit tourism and aviation industry getting special help. Discretionary fiscal measures amounted to around 9% of 2020 GDP in 2020-21, while the automatic stabilisers (declining tax revenues, unemployment benefits) contributed another 8%. The government also embarked on a five-year investment programme focussing on infrastructure, research and development of around 0.5% of GDP annually. The government issued few guarantees, helping to keep contingent liabilities under control.

Source: OECD COVID-19 policy response tracker database

Iceland remains one of the most egalitarian economies of the OECD thanks to high labour force participation of both men and women and a compressed wage distribution (Figure 1.3). After the global financial crisis, lower incomes grew faster than those at the top, making Iceland even more egalitarian. The social welfare system including pensions is well targeted, reducing inequality further. Access to education and health care is universal, and socio-economic status appears to have a weaker influence on education or health outcomes than in most other OECD countries. An area where Iceland is actually the most *unequal* OECD country is the gap in hours worked between men and women (Figure 1.16). As a result, the gender wage gap is only little below the OECD average.

Figure 1.3. Iceland's economy is highly egalitarian



Note: Gini coefficient after taxes and transfers for the 18-64 year olds. Latest data for Iceland refer to 2017.

Source: OECD, Income Distribution and Poverty database.

StatLink  <https://stat.link/8m1lc3>

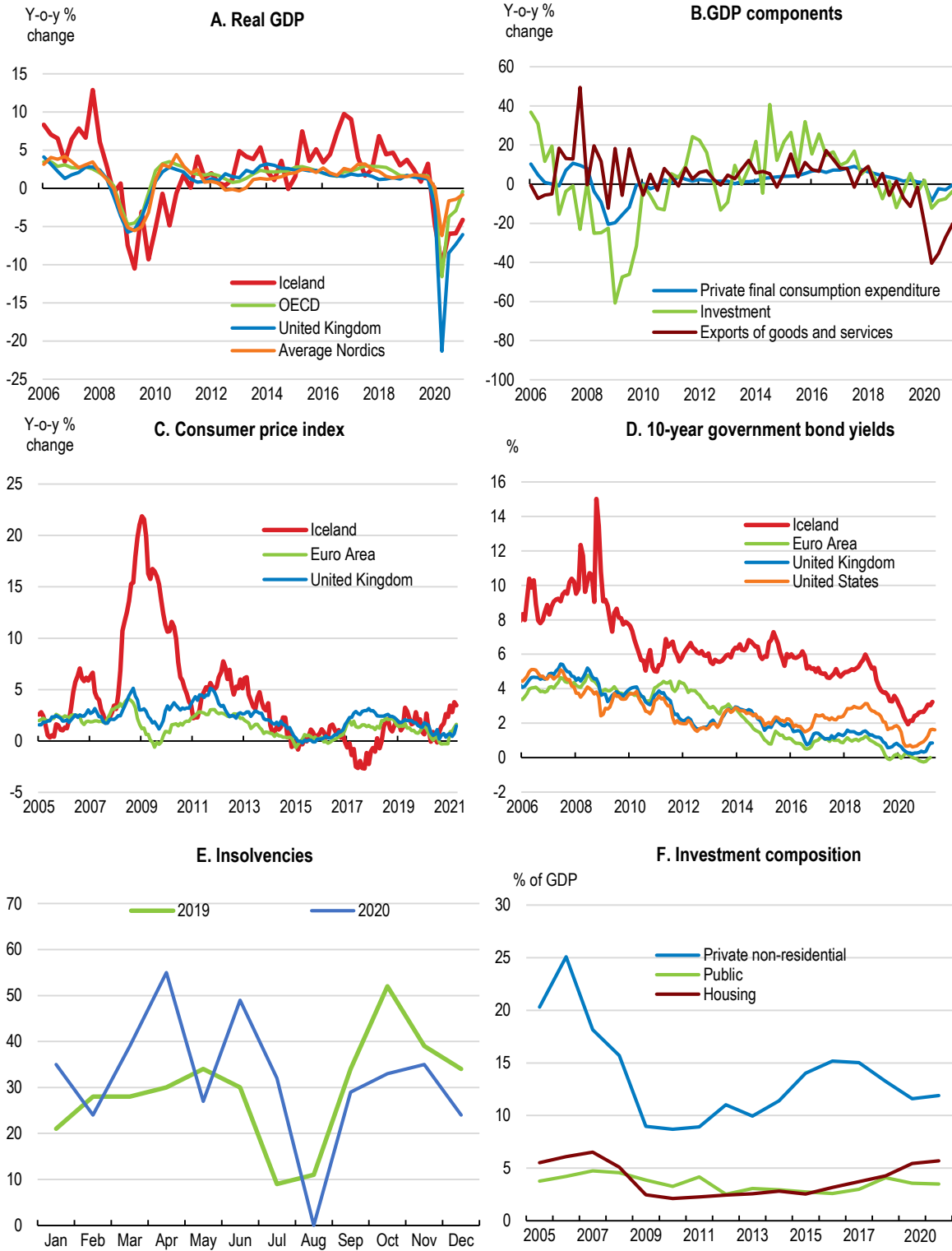
Against this background, the Survey's key messages are:

- Support a resilient, inclusive and sustainable recovery, and start fiscal consolidation as planned once the recovery is firmly established.
- Foster a business-friendly regulatory framework, improve skills and spur innovation by offering well-targeted support for business R&D and promoting e-government.
- Move towards a low-carbon economy, by pricing carbon emissions efficiently, investing in low-carbon infrastructure and fostering research and innovation in green technologies.

The economy is recovering

The economy is recovering (Figure 1.4). Tourism is rebounding, following the easing of the rules on testing and quarantining. Fisheries' exports remain strong, especially of higher-value fresh seafood and aquaculture. Some sectors such as pharmaceuticals and data storage and processing, continue growing fast. Business investment is benefitting from pent-up demand and a five-year government investment programme. Monetary and fiscal policy provide support to businesses. Household consumption remains robust based on growing wages, regained confidence and the drawing down of savings accumulated during the pandemic. Headline inflation is creeping up as wages and oil prices are rising, and policy remains accommodative.

Figure 1.4. The economy is recovering



Source: OECD, National Accounts database; OECD, Main Economic Indicators; and Statistics Iceland.

StatLink  <https://stat.link/ebuhvc>

After the contraction in 2020, momentum is gradually returning. While the health situation seems under control and confidence has rebounded, tourism continues to suffer from the impact of the pandemic. The short-term work scheme was terminated in mid-2021, while most other policy support measures introduced at the onset of the crisis have been extended until end-2021. The government's investment programme is expected to continue to support business investment and long-term growth beyond that date. GDP is set to grow by around 3% in 2021 and 4% in 2022 (Table 1.1).

Projections are subject to substantial uncertainty and risks. The recovery of the tourism sector relies strongly on foreign arrivals and hence on economic and health conditions overseas. The economy may further face unforeseen events, including supply shocks such as the disappearance of a specific fish stock or a disruption to international travel links due to a volcanic eruption (Table 1.2). Brexit may negatively affect Iceland's economy notwithstanding the recently announced trade agreement with the United Kingdom. There are also upside risks, however: a faster than planned vaccination overseas could give a stronger boost to travel and tourism.

Table 1.1. Macroeconomic indicators and projections

	2017	2018	2019	2020	2021	2022
	Current prices (ISK billion)	Percentage changes, volume (2015 prices)			Projections	
GDP at market prices	2 642.0	4.7	2.6	- 6.6	2.8	4.7
Private consumption	1 323.5	4.8	1.9	- 3.3	2.1	4.9
Government consumption	625.5	4.7	3.9	3.1	2.2	0.9
Gross fixed capital formation	575.2	1.2	- 3.7	- 6.8	8.0	3.4
Final domestic demand	2 524.3	3.9	1.1	- 2.5	3.4	3.5
Stockbuilding ¹	- 0.8	0.2	- 0.5	1.2	0.0	0.0
Total domestic demand	2 523.5	4.2	0.3	- 1.3	3.4	3.5
Exports of goods and services	1 208.2	1.7	- 4.6	- 30.5	6.5	12.0
Imports of goods and services	1 089.7	0.5	- 9.3	- 22.0	8.2	8.2
Net exports ¹	118.5	0.6	1.9	- 4.9	- 0.6	1.2
Memorandum items						
GDP deflator	–	2.7	4.5	3.4	2.3	2.7
Consumer price index	–	2.7	3.0	2.8	4.1	2.5
Core inflation index ²	–	2.5	2.9	2.9	3.7	2.4
Unemployment rate (% of labour force)	–	3.1	3.9	6.4	8.0	7.6
General government financial balance (% of GDP)	–	0.9	- 1.5	- 7.3	- 10.3	- 7.1
General government gross debt (% of GDP) ³	–	60.4	61.5	69.1	78.7	84.0
Current account balance (% of GDP)	–	3.8	6.4	1.0	- 1.0	0.0

1. Contributions to changes in real GDP, actual amount in the first column.

2. Consumer price index excluding food and energy.

3. Unlike in some other OECD countries, this includes unfunded liabilities of government employee pension plans.

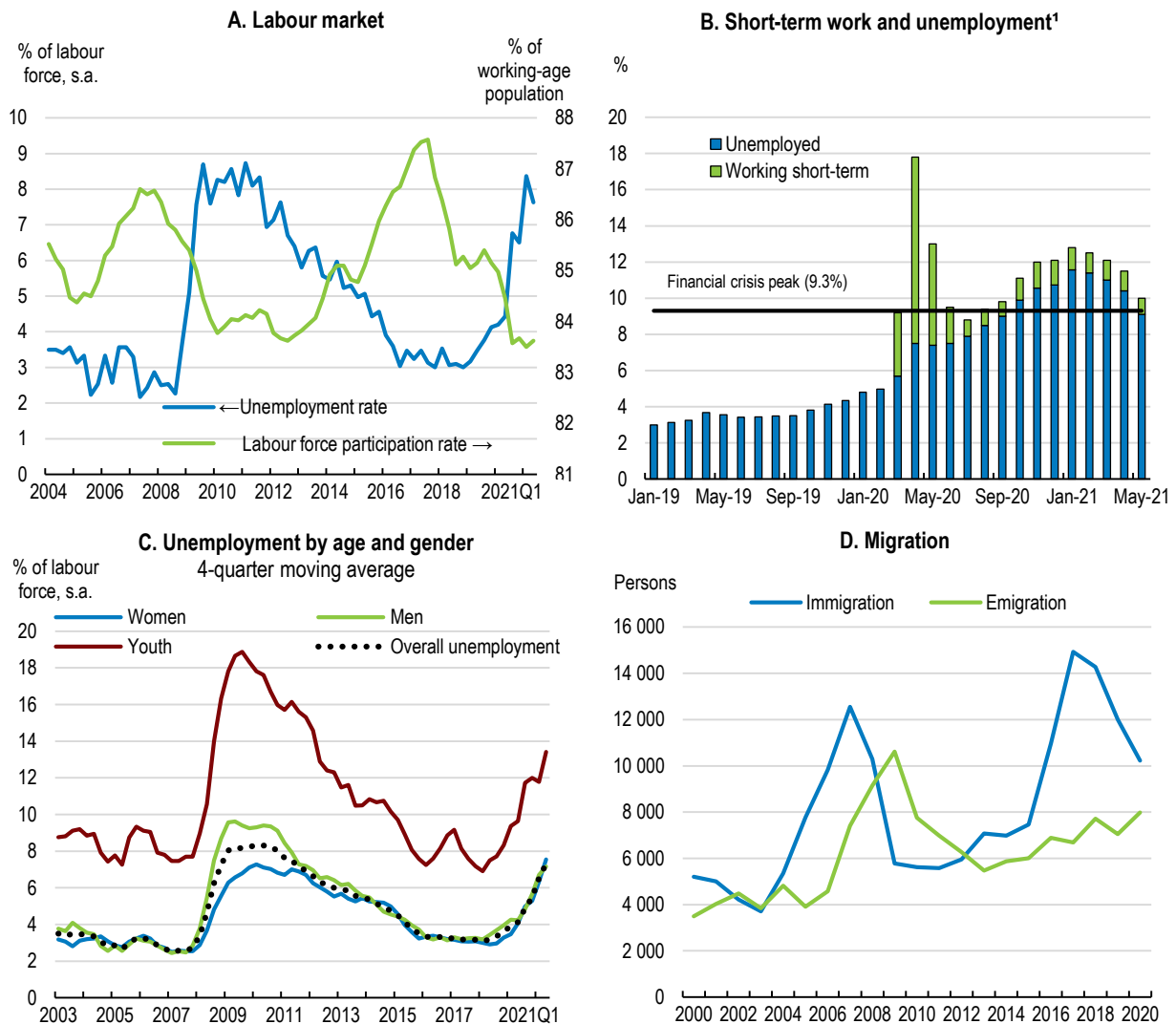
Source: OECD Economic Outlook database No. 109.

Table 1.2. Events that could entail major changes to the outlook

Shock	Potential impact
New or extended travel restrictions for foreign tourists related to renewed COVID-19 outbreaks	Economic growth and the recovery of employment would suffer.
Disappearance of fishing stock	Export revenues would fall.
Large-scale volcanic eruption	International and domestic transport links could be disrupted, hampering some economic activities.

The labour market is stabilising (Figure 1.5). Unemployment, which peaked at over 8% of the labour force in late 2020, is receding fast. Labour participation is rebounding after falling to a historical low. The short-term work scheme helped avoid an unemployment surge during the first wave in spring 2020. Unemployment rates for both men and women have remained almost identical throughout the crisis. Notwithstanding the uptick in early 2021, youth unemployment is evolving in line with general unemployment, suggesting that labour market developments have not disproportionately hit the young. Rising student numbers suggest that part of the rise in youth unemployment is being absorbed by the education system. Immigration has declined sharply, while emigration also slowed as the employment outlook is hardly better abroad.

Figure 1.5. The labour market is stabilising



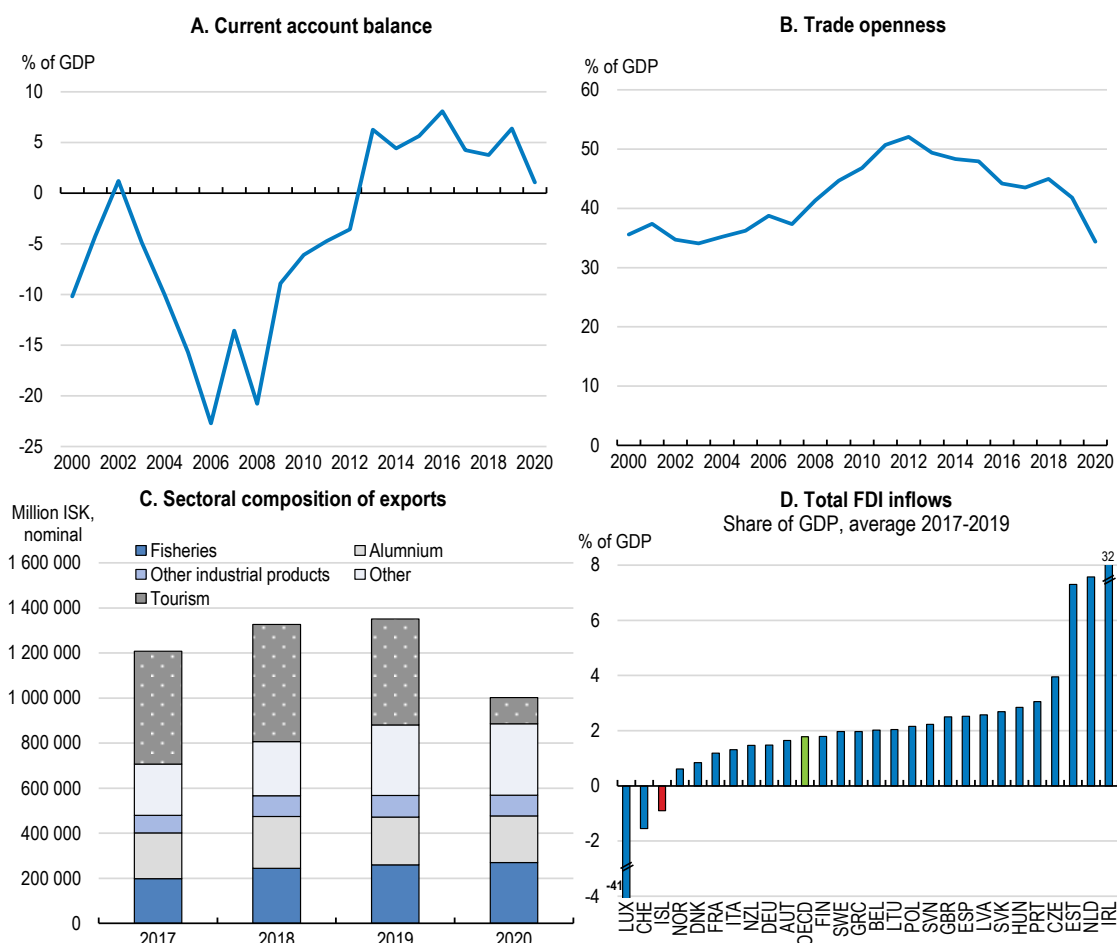
Note: 1. Data refer to unemployment as registered by Directorate of Labour, as opposed to the Labour Force Survey data show in Panels A and C.

Source: Ministry of Finance; and Statistics Iceland.

The pandemic is exacerbating labour market imbalances. Iceland's labour market is open and flexible, facilitating reallocation. Even so, unemployment remains high in the tourism and associated service sectors, while qualified labour has become scarcer in some technical and digital sectors. To underpin reallocation, the government set up a vocational training programme for professions in short supply, especially technicians, crafts and trade, and health care workers. The government also plans to ease access to work permits for high-skilled workers from outside the European Economic Area, to ease labour shortages. The training programmes should be extended, to prepare workers for jobs in areas with high demand.

The external position has been affected by the collapse of foreign tourism, Iceland's largest pre-COVID-19 export sector (Figure 1.6). The current account surplus shrank but remained positive, especially as lower imports – notably Icelanders travelling abroad – partly compensated for the loss of foreign tourism revenue. As one of only few OECD countries, foreign direct investment (FDI) flows turned negative over the past few years, and this trend might have accelerated following the pandemic. The net investment position improved, however, reflecting valuation gains on assets held overseas. Overall, openness continues to decline and remains low in view of the country's small size. Against this background, Iceland should ease restrictions for foreign capital, to fund investments in new and growing sectors and in climate action.

Figure 1.6. External positions have weakened



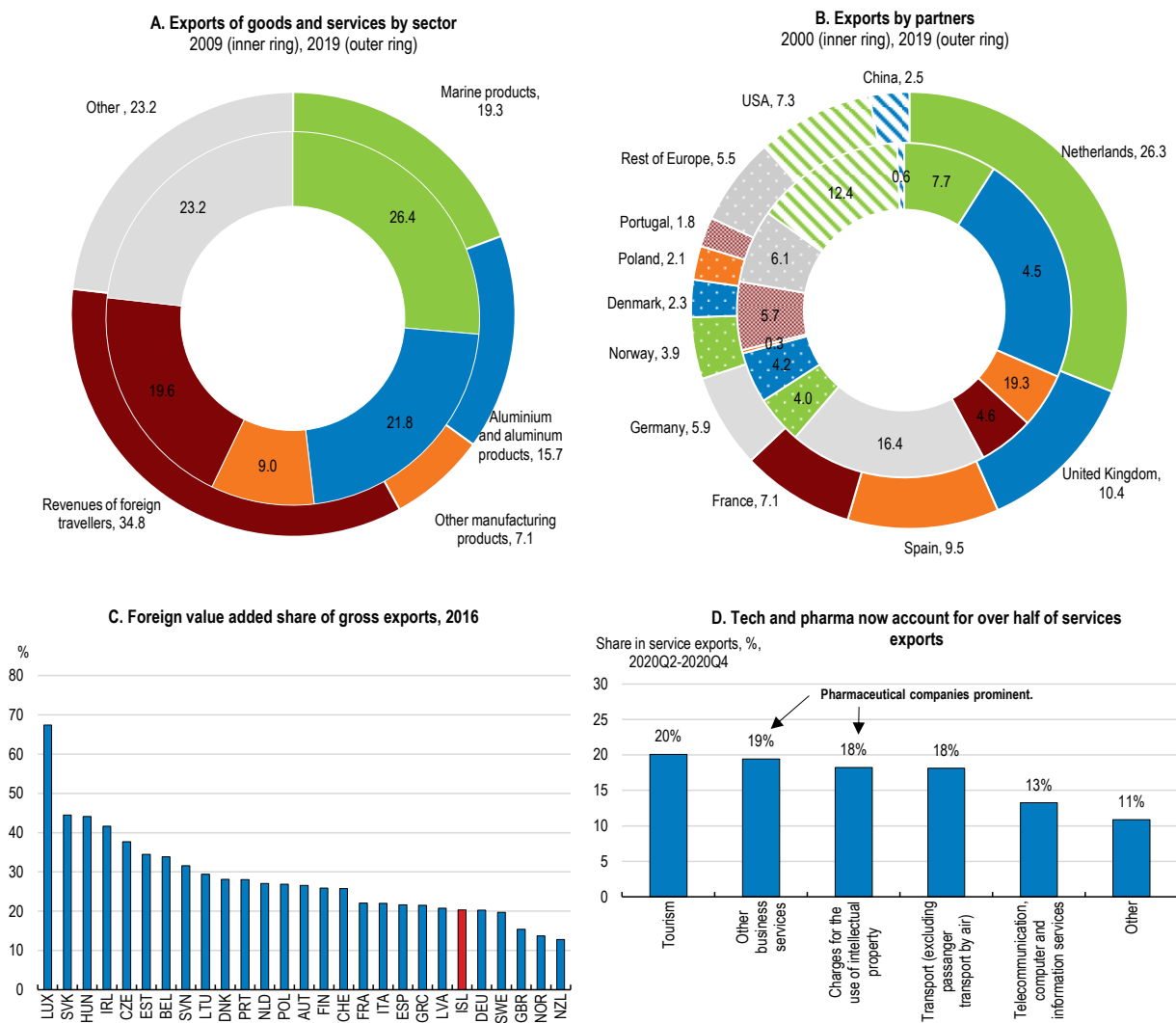
Note: Panel B: Trade openness is measured as the average of goods and services imports and exports divided by GDP.

Source: OECD, Balance of Payments database; OECD, National Accounts database; Ministry of Finance; and OECD, FDI Statistics.

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The composition of exports has changed in recent years, even before the pandemic, which abruptly reduced the share of tourism (Figure 1.7). The share of intellectual property services, especially those related to licenses of the pharmaceutical industry, has risen. The energy-intensive data processing and storage industry is assumed to make up around 2% of GDP and seems to have grown rapidly as well, attracted by low energy prices and a cool and windy climate (Adalbjornsson, 2019^[1]). Further expansion is hampered by Iceland's remote position and capacity constraints, with only three submarine data cables linking the island to Europe and North America. Increasing transmission capacity of the existing cables or investing in new cables as planned could strengthen competition and raise export revenues.

Figure 1.7. Services other than tourism are getting more important



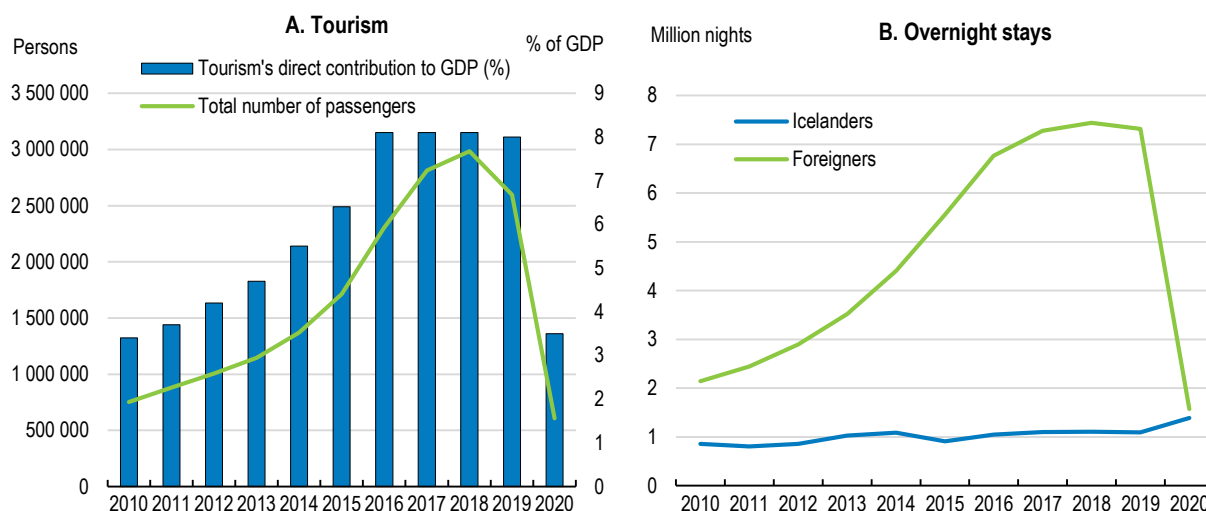
Source: Statistics Iceland; UN Comtrade, International Trade Statistics database; OECD, Trade in Value Added database; and Ministry of Finance.

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Growing domestic tourism helped offset the collapse of foreign tourism a bit. Foreign tourism started to cool in 2019 following slowing demand overseas and the insolvency of WOW Air. In 2020, the pandemic reduced foreign arrivals to around a fourth of the previous year. In turn, Icelanders almost doubled domestic trips, cushioning the blow to other services such as accommodation, restaurants and cultural activities

(Figure 1.8). In addition, since travelling abroad makes up a higher share of imports than in most other OECD countries, its sharp fall made up for some of the losses stemming from the lack of foreign tourists.

Figure 1.8. Foreign tourism collapsed, while domestic travel compensated a bit



Note: Passengers who go through security at Keflavík Airport, including foreigners residing in Iceland, foreign labour leaving the country and transit passengers who go through security.

Source: Statistics Iceland.

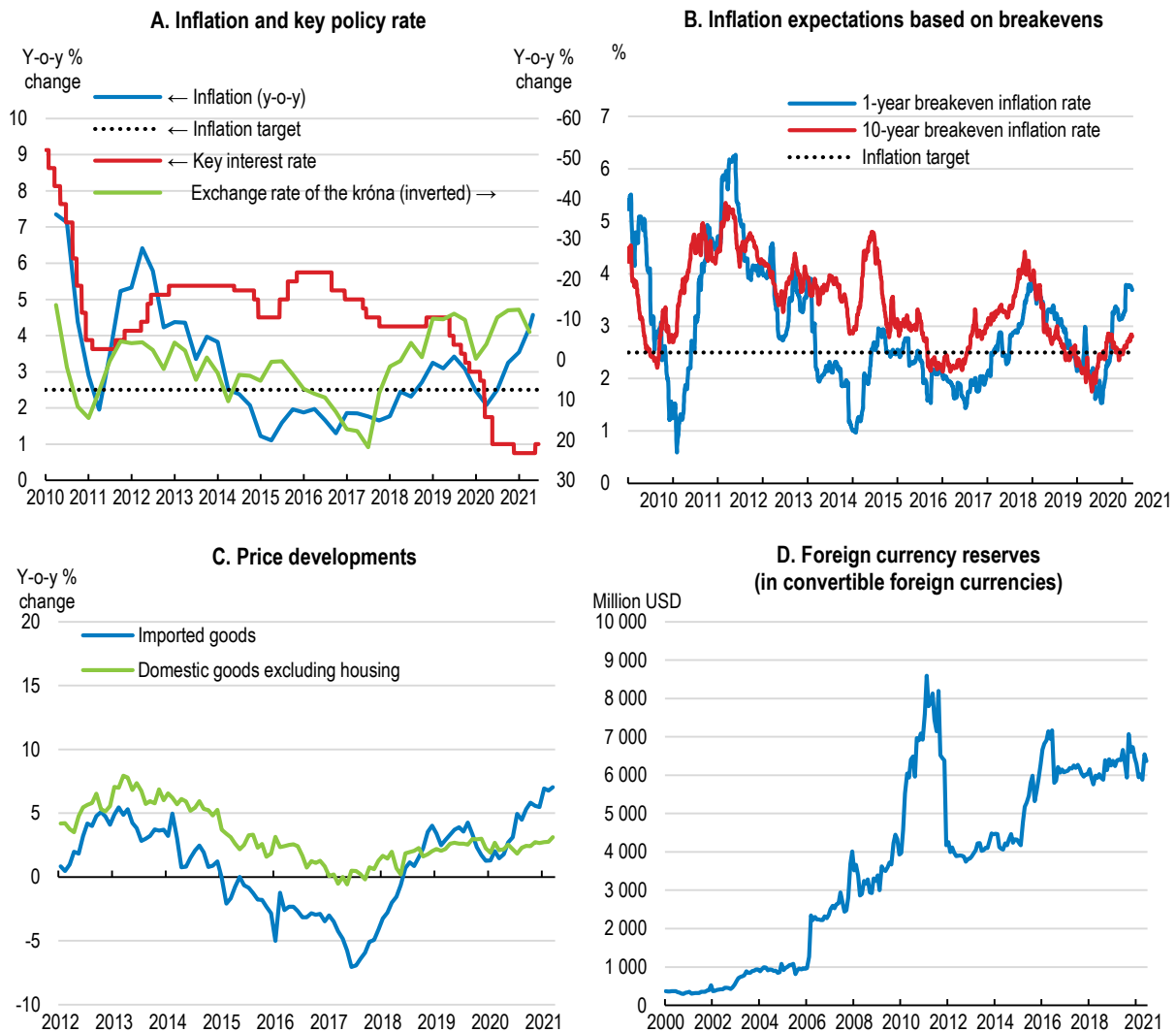
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Monetary policy has been eased in response to the Covid-19 crisis

Monetary policy has been relaxed since the onset of the pandemic and remains accommodative. Mid-May the Central Bank raised the key interest rate by 0.25 percentage points to 1%, but rates remain at historically low levels following the 2 percentage point reduction from March 2020 (Figure 1.9) and are lower than in the euro area in real terms. As part of a broader monetary and financial response package, monetary easing helped to counter the adverse effects of the pandemic and related containment measures on economic activity, in a context of heightened uncertainty (Box 1.2).

Inflation was around the 2½ per cent target before the onset of the pandemic but has risen since, largely because of exchange rate depreciation, but also more recently due to rising wages and house prices, soaring global commodity prices, supply bottlenecks in certain sectors and base effects. It hovered around 4¼ per cent in the first quarter of 2021 on a year-on-year basis. The króna has appreciated somewhat in recent months, and the Central Bank expects that headline inflation will ease in the near term, once the effects of the exchange rate depreciation have abated, and against a backdrop of slack in the economy. Long-term readings remain close to target, but short-term inflation expectations have risen above the target. Moreover, real wage growth has been strong, at around 6% in early 2021 year-on-year, despite the crisis-related rise in unemployment, following the 2019 collective agreements. Moving forward, monetary policy should remain accommodative, given the uncertain outlook, but the authorities are advised to monitor developments closely and stand ready to act to ensure inflation expectations remain well anchored.

Figure 1.9. Monetary policy remains accommodative



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, Main Economic Indicators; Statistics Iceland; and Central Bank of Iceland.

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Box 1.2. Monetary and financial measures to deal with the Covid-19 crisis

In response to the COVID-19 pandemic, the Central Bank has taken a wide range of actions to ease the monetary stance and boost liquidity in order to shore up demand, support access to credit and preserve financial stability.

- From March to November 2020, it cut the policy interest rate in steps by 2 percentage points to 0.75%.
- Measures were taken to inject liquidity in the financial system. In March 2020 the average reserve requirement for deposit institutions was lowered from 1% to 0%. Changes were also made to the treatment of the fixed reserve requirement (1%) in liquidity rules, so that the Central Bank could allow the reserves to be used in cases of liquidity outflows. Fixed reserves now

count as liquidity buffer. The countercyclical capital buffer was also reduced in March from 2% to 0%. Moreover, the Bank reduced and subsequently eliminated its offerings of one-month term deposits. These deposits had been one of financial institutions' main avenues for investing in króna-denominated liquid assets and complying with liquidity requirements, as Treasury bonds had been in short supply. The commercial banks held a large share of their liquid assets in these accounts, and interest rates on them had been somewhat above the Bank's key rate. Furthermore, a special temporary collateralised credit facility was established in April 2020 with an expanded list of eligible collateral.

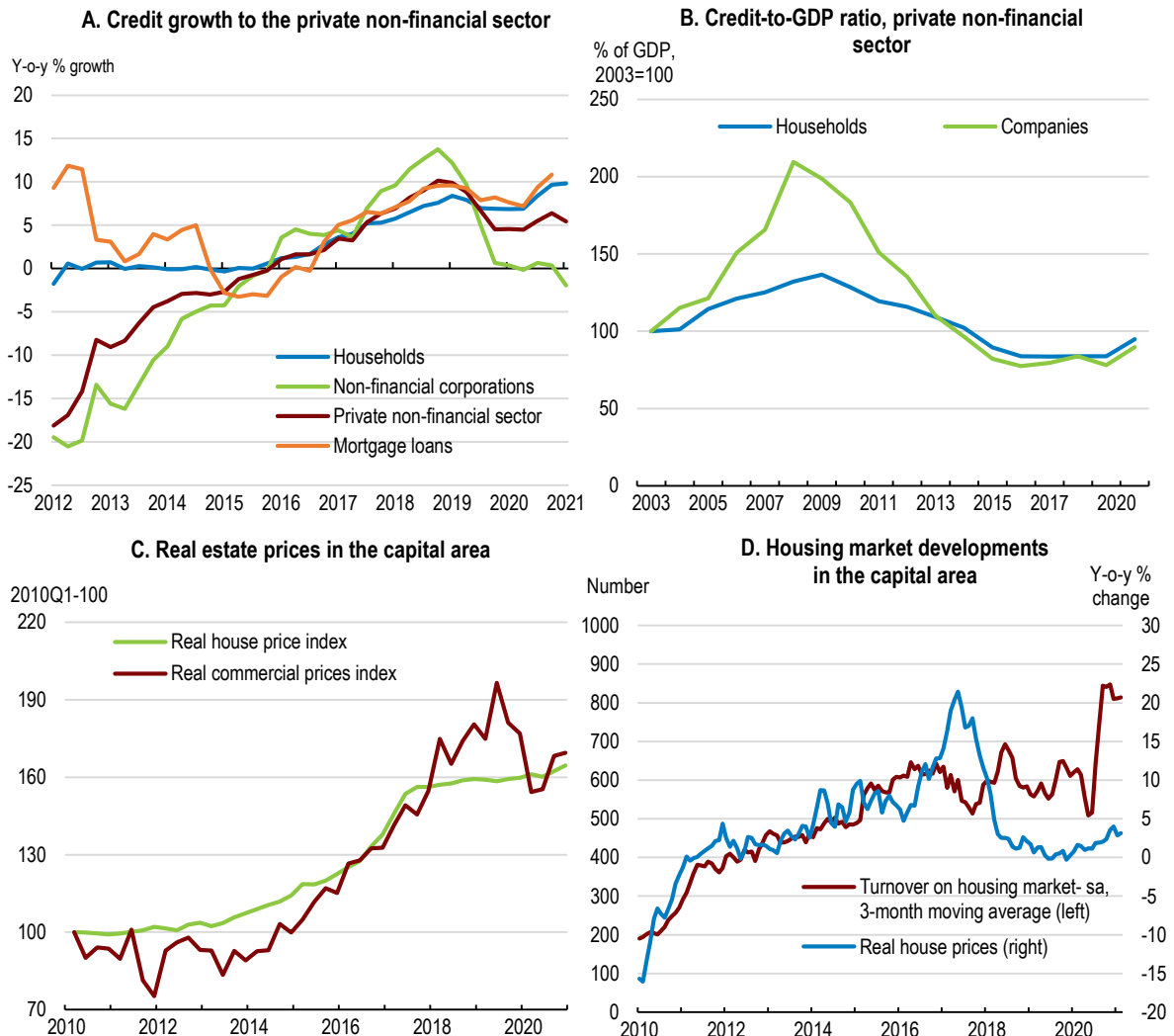
- The Central Bank initiated purchases of Treasury bonds on the secondary market to meet the increase in Treasury bond issuance and ensure the transmission of monetary easing to households and businesses. These purchases have nevertheless been small.
- Since the onset of the crisis, the Bank has intervened in the spot foreign exchange market to mitigate exchange rate volatility. In 2020, the Bank's net foreign currency sales totalled Euro 825 million or 37% of total market turnover. In addition, in September 2020 the Bank launched a regular programme to sell foreign exchange in the domestic market, arguing that it should be deepened and price formation improved. The programme was discontinued in May 2021 as the króna has appreciated and the Bank assessed that equilibrium in the foreign exchange market has improved.
- Other measures included a voluntary temporary suspension of foreign exchange purchases by pension funds and the payment of dividends or equity buy-backs by financial institutions and insurance companies.

Source: Central Bank of Iceland.

The financial system is considered to be sound but vigilance is warranted

The easing of monetary conditions has benefitted households more than firms. Lending to households rose robustly in 2020, along with a surge in real estate market activity (Figure 1.10). The number of first-time buyers increased rapidly, accounting for one-third of homebuyers in the first quarter 2021, a record high (Central Bank of Iceland, 2021^[2]). House price increases, however, are broadly in line with macroeconomic fundamentals, according to the assessment by the Central Bank. Housing supply increased as construction initiated by the earlier tourism boom came on stream. Better borrowing terms encouraged mortgage refinancing: demand for non-indexed mortgage loans, and the share of variable-rate loans in total lending, have increased (Central Bank of Iceland, 2021^[3]). In contrast, corporate lending stagnated, possibly reflecting tighter access to credit as a result of increased risk, and/or a fall in demand for credit as the pandemic-related crisis reduced firms' risk appetite (Central Bank of Iceland, 2020^[4]). Liquidity constraints are mainly a concern for companies in the tourism and personal services sector, but related sectors, such as commercial property leasing, have also been affected. Household and non-financial corporate debt ratios to GDP have increased, in part due to the GDP contraction, but remain low by historical standards (Figure 1.10).

Figure 1.10. Households benefitted more than firms from the easing of monetary conditions



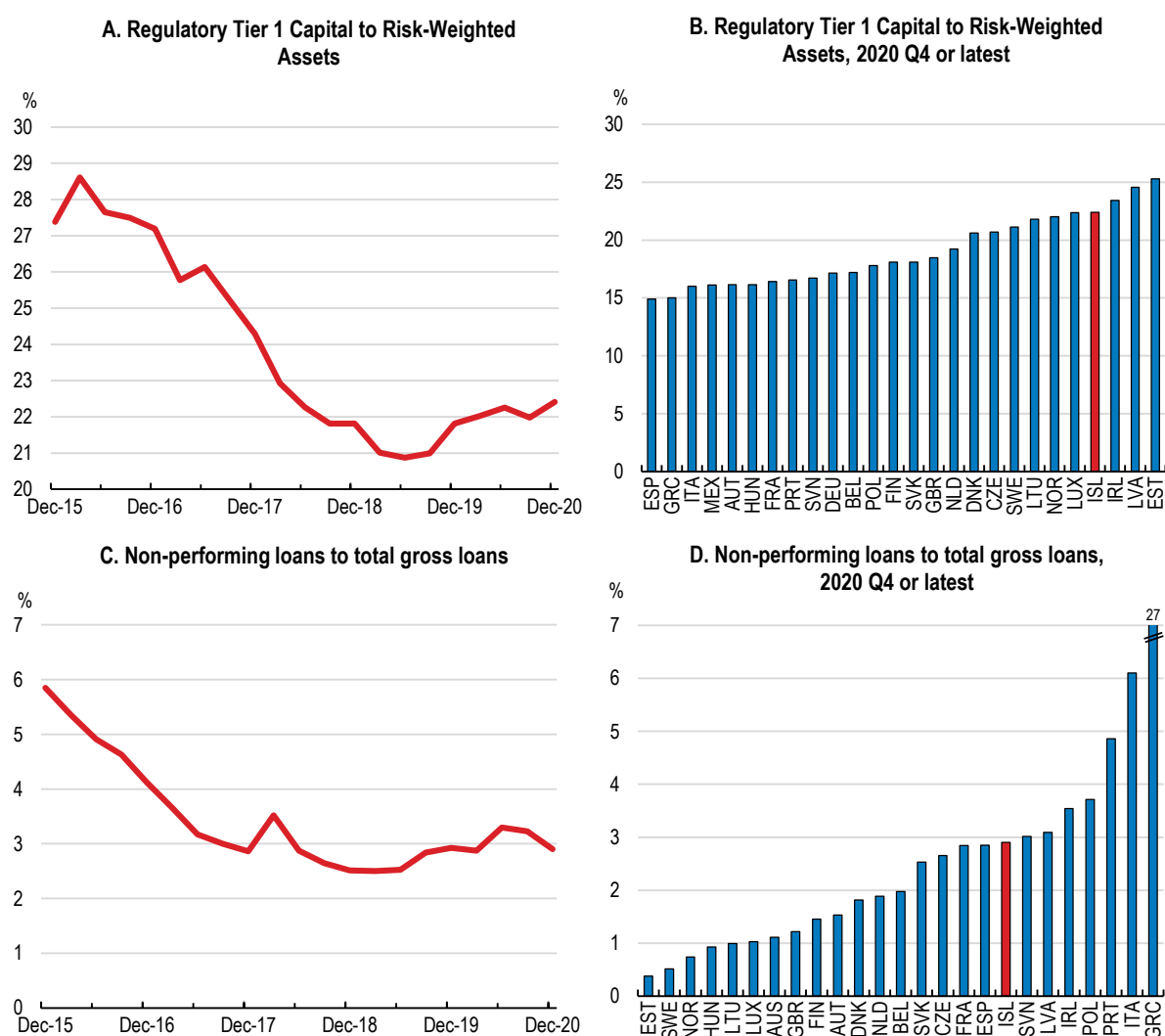
Note: Credit stock adjusted for reclassification and effects of government debt relief measures.

Source: Central Bank of Iceland; Statistics Iceland; and Registers Iceland.

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The financial system has held up well in the face of pandemic-related stress and helped to cushion the economy from the severity of the health shock through moratoria on payments and increased credit to private sector (Figure 1.10, Panel A). The overhaul of the banking sector after the 2008 crisis and increased use of macro-prudential tools have put the banking sector on a more solid footing to withstand the adverse effects of the pandemic (Figure 1.11). The recent merger of the Central Bank and Financial Supervisory Authority (see previous Survey) is expected to strengthen the overall surveillance of the financial system. The authorities consider that bank capital and liquidity buffers are strong, since adequacy ratios of systematically important banks are well above requirements and banks have ample liquidity to support the economy. Loan-to-value ratios and debt service ratios on new bank loans have fallen, despite an increase in banks' share in the household mortgage market at the expense of other lenders (Central Bank of Iceland, 2021^[5]). Indicators of credit quality are generally positive. Despite renewed buoyancy, the real estate market is not expected to pose risks for financial stability in the near term, though close monitoring needs to continue (Figure 1.10). The crisis may pose longer-term challenges to real estate market related to changes in habits and work practices associated with the increase in teleworking, which may shift demand durably, affecting especially commercial property.

Figure 1.11. The banking sector appears sound



Source: IMF, Financial Soundness Indicators database.

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Several measures have been taken to support access to credit and preserve financial stability. Reserve requirements have been relaxed, along with countercyclical capital buffers, and quantitative easing coupled with interventions in foreign exchange markets have helped to ease monetary conditions (Box 1.2). In particular, the easing of the countercyclical capital buffer from 2% to 0% in March 2020 provided commercial banks room to lend even as they restructured loan portfolios.

The COVID-19 crisis still poses challenges, warranting vigilance. The impact of the pandemic on financial institutions' balance sheets requires close attention, even if the banking system appears to have entered the crisis in a strong position. The average non-performing loan ratio, for example, rose slightly from 2.6% at end-2019 to 2.9% at end-2020. Nonetheless, some early indications of increased credit risk can already be observed. For instance, the share of "non-performing" corporate loans, based on a very prudent methodology (i.e. loans past due by over 90 days, frozen or deemed unlikely to be paid) jumped from around 5% at end-2019 to 18½ per cent in early 2021, with the tourism sector recording the highest share (Central Bank of Iceland, 2021^[6]). This mainly reflects the fact that many loans previously protected by special pandemic-related payment deferrals are now considered non-performing, according to this methodology (Central Bank of Iceland, 2021^[3]). If the recovery is weak, or the pandemic-related shock

persists, some vulnerable firms may become insolvent and non-performing corporate loans may increase further. Going forward, it is advisable to maintain liquidity support for distressed firms that are deemed viable, until the recovery is well-established. The share of non-performing household loans rose marginally between end-2019 and early 2021 but remains low at around 3%. However, with variable-rate instruments now comprising a relatively high share of housing loans, household budgets have become sensitive to interest rate rises, thereby increasing risks (Central Bank of Iceland, 2020^[4]).

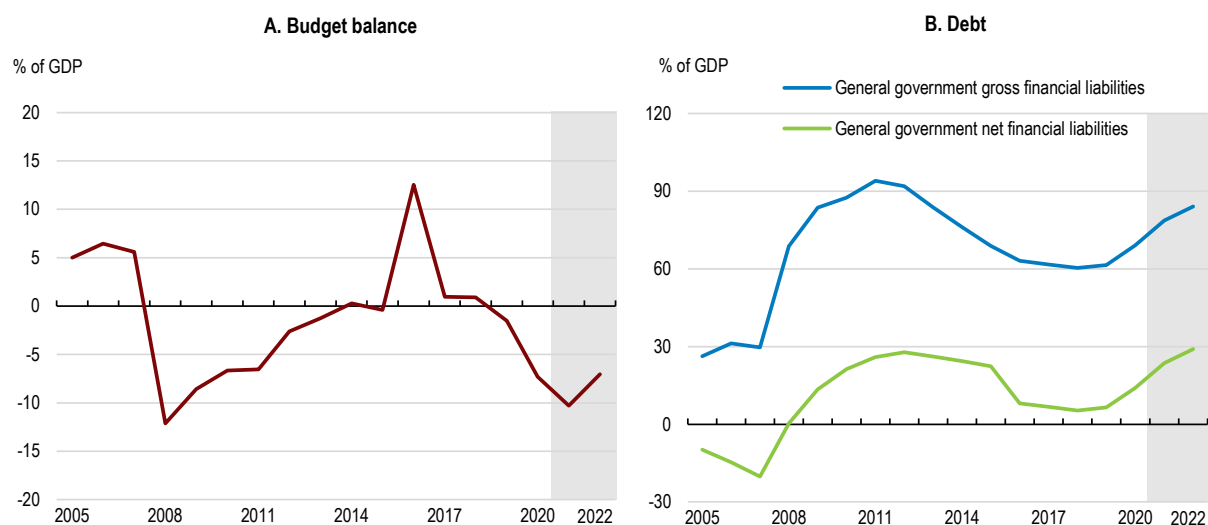
The previous OECD Economic Survey recommended to go ahead with privatisation plans in the banking sector. Two of the three commercial banks that represent approximately 97% of the deposit money market, and which are considered systematically important institutions, are state-owned. Privatisation has started to be implemented, with the sale of 35% of Íslandsbanki in June 2021. Appropriate post-privatisation ownership and management are essential to minimising risks in the future.

Iceland made considerable progress over the past few years towards strengthening its anti-money laundering and counter-terrorist financing (AML/CTF) regime, following the publication of the 2018 Financial Action Task Force (FATF) Mutual Evaluation Report (FATF, 2018^[7]). To that effect, actions have been taken to enhance supervision related to both financial institutions (supervised by the Central Bank) and designated non-financial businesses or professions (supervised by the Directorate of Internal Revenue). The Central Bank currently conducts systematic risk assessment on approximately 80 entities under its supervision (“obliged” entities) to ensure implementation of targeted financial sanction obligations through extensive supervisory engagement. Resources allocated to combatting AML/CFT have been considerably increased over the past two to three years. Cooperation and co-ordination between relevant competent authorities in the AML/CFT field has also been enhanced and a Steering Committee was appointed as the national co-operation and co-ordination mechanism. A National Risk Assessment on money laundering and terrorist financing is now published every two years, followed by an action plan responding to the threats and weaknesses. Furthermore, the Central Bank has increased its focus on guidance to raise awareness among the obliged entities of AML/CFT risks. The November 2020 follow-up report of the Financial Action Task Force (FATF) has rated Iceland as “compliant” or “largely compliant” in 37 out of 40 priorities areas, and “partially compliant” in the remaining three, including those related to virtual assets and virtual asset service providers (FATF, 2020^[8]). Iceland is committed to continuing to work with the FATF to improve its AML/CTF regime further.

Fiscal policy is supporting the economy

Like in most countries, the fiscal position deteriorated because of the pandemic-related support programmes and the working of automatic stabilisers (Figure 1.12. A). The 2020 general government budget deficit amounted to 7.3% of GDP, with automatic stabilisers and discretionary COVID-19 measures each accounting for around half of the deficit increase. Gross public debt rose to 69% of GDP, still below the peak reached after the 2008/09 financial crisis, while net public debt, accounting for government assets, remains below 30% of GDP. The short-term work scheme was the largest programme in financial terms, supporting employment especially during spring 2020 (Figure 1.5B). Specific support was directed at firms that had lost more than 40% of their turnover, mainly in the tourism and aviation industry. Contingent liabilities, mostly related to state guarantees for the Housing Fund, continued to decline from 75% of GDP in 2014 to 32% at the end of 2020. The recent revision of national government financial statistics for the years 1998-2019 has reclassified most contingent liabilities as general government debt.

Figure 1.12. Fiscal policy is supporting the economy



Note: Reflecting differences in the treatment of public entities, contingent liabilities and pension funds, government debt may differ between National Accounts and Statistics Iceland.

Source: OECD, National Accounts database; OECD Economic Outlook database No. 109; and Statistics Iceland.

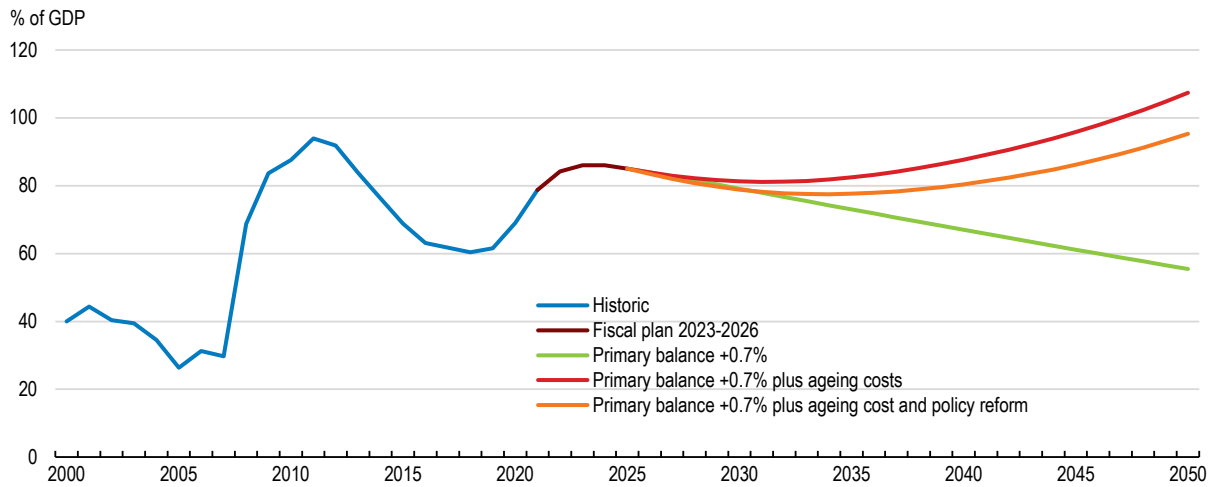
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The authorities reacted boldly and flexibly to mitigate the crisis, but have also set out a trajectory to bring public finances back on a sustainable path once the recovery is under way. In Autumn 2020, the parliament suspended the numerical fiscal rule first until 2022 and then until 2025, and approved a new five-year fiscal plan through 2025. In May 2021, it endorsed an updated fiscal plan running through 2026. According to the fiscal plan, the general government budget deficit is expected to reach 11.4% of GDP in 2021 and then to decline by around 2.5% annually until 2025, when it is expected to reach 1.6% of GDP. Gross public debt according to the National Accounts definition should stabilise in 2025 at 100% of GDP, while net debt is expected to remain considerably below, in view of large government assets (Figure 1.12. B).


Fiscal policy should continue to support vulnerable firms and households until the recovery is well underway, while avoiding that public debt climbs to unsustainable levels. With the health situation improving, restrictions gradually easing and many households waiting to draw down savings, demand growth is expected to resume. Going forward, ageing costs could push up debt to unsustainable levels, while policy reform to contain spending, in particular in the disability benefit system, could help contain further debt increases (Figure 1.13). Support for firms should be phased out when the recovery has been sustained (OECD, 2021^[9]). Structural reforms should accompany fiscal support measures to speed up the recovery.

Figure 1.13. Adjustments will be required to stabilised the debt ratio over the longer run

Debt evolution under different scenarios



Note: Debt projections until 2026 follow the fiscal plan as published in March 2021. Ageing costs include public health, long-term care and pension expenditures, adding spending obligations on top of a permanent primary balance of +0.7% of GDP. The “ageing cost plus policy reform” scenario reflects a reduction of disability benefits as assessed in Box 1.4 and Box 1.5. The primary balance is defined as the budget balance minus net interest payments, accounting for around 2% of GDP. Calculations are based on Guillemette et al. (2017) and recalibrated in accordance with planned policy reforms and recommendations in this Survey (Table 1.4). Debt is defined according to OECD National Accounts. Source: OECD Economic Outlook database No. 109; and OECD calculations.

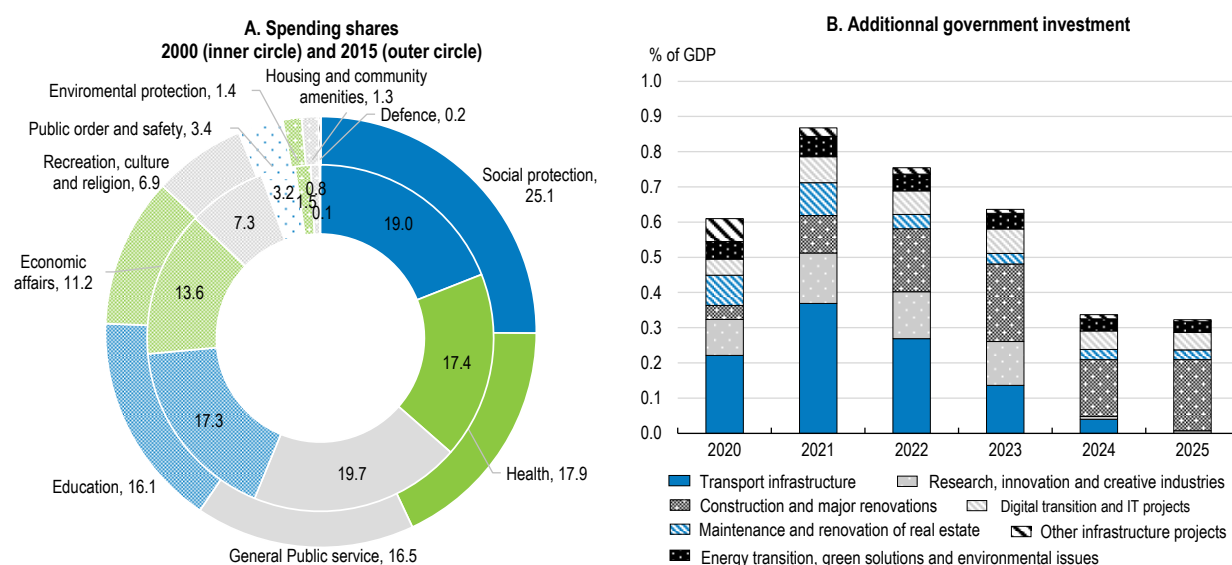
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Spending reforms should address long-standing weaknesses of public finance

The quality of spending has gradually declined over the past 15 years, exerting a drag on growth as described in the previous OECD *Economic Survey* (OECD, 2019_[10]). In particular, the disability benefit system has grown from 4.8% to 7.4% of public spending between 2000 and 2015, driven by a rising incidence of mental health disorders among young claimants (Figure 1.14). The system reaches almost 9% of the working-age population. Also subsidies remain high, covering around 3.5% of public spending, with agriculture absorbing around half of all subsidies. On the other hand, ageing costs are still low thanks to a young population, a high retirement age and a well-funded pension system. Against this background, the government should reform the disability benefit system, putting more emphasis on returning to and remaining in work. Also, the government should cut subsidies, especially in agriculture. The government’s plan to increase spending on infrastructure, digital transition, green transition, and research and development by around 0.5% points of GDP per year is welcome.

Spending reviews can both help keep expenditure in check and foster the effectiveness of public service delivery. The government made progress by carrying out spending reviews in the areas of education, elderly care and disability, building on earlier exercises in the Ministries of Justice and of Industry and Innovation, which is welcome. The Ministry of Finance and Economic Affairs is in the process of establishing a specific unit to carry out such reviews, and assists those who participate. Against this background, spending reviews should become a routine part of the budget process, as planned by the government. Regular and thorough spending reviews as in the Netherlands or the United Kingdom would help address issues raised in the thematic chapter of the previous OECD *Economic Survey* (OECD, 2019_[10]).

Figure 1.14. Spending quality will improve as public investment is stepped up



Source: Statistics Iceland; and Ministry of Finance.


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Table 1.3. Past recommendations and actions taken in monetary, financial and fiscal policies

Monetary and financial policies	
Key recommendation	Actions taken
Adjust interest rates in line with inflation developments.	The central bank gradually cut the policy interest rate from 4.5% in mid-2019 to 0.75% in November 2020. It increased the rate again to 1% in May 2021.
Proceed with privatisation plans.	The Government has sold 35% of its share in Íslandsbanki in June 2021.
Complete the reform of the financial sector, while ensuring that regulatory and operational functions remain separated.	The reform was completed.
Fiscal policy and public finance	
Follow the deficit rules of the fiscal framework. Reduce debt further.	The measures to address the economic impact of the COVID-19 pandemic caused deficits and debt to rise. The fiscal rules have been temporarily suspended. The government plans to halt the rise in the debt-to-GDP ratio by 2025.
Apply more stringent cost-benefit analysis.	New legislation on public investments is being drafted. A working group is preparing a new framework for cost-benefit analysis for public investment projects.
Raise investment in transport, energy and digital infrastructure.	The government will increase investment by around 0.5% points of GDP.
Introduce road pricing for demand management and funding of transport infrastructure.	A working group is preparing proposals for use-related car taxation.
Reform the disability system by shifting the focus from paying benefits towards return to work.	In light of the pandemic, steps have been taken to foster return to and remaining in work.
Tighten eligibility criteria while offering more support for remaining employed.	Some steps were taken to support employment during the pandemic.
Extend spending reviews to core policy areas like education or health care, relying on international experience.	Three spending reviews are being carried out in adult education, elderly care and social welfare. The spending review methodology is being developed in line with international experience and spending reviews are to become annual.
Strengthen the role of the fiscal council and possibly merge it with the national accounting office.	No action taken.

Tax reforms benefit low-income earners, innovative firms and the environment

Iceland's tax burden is above the OECD average, and close to the average of the Nordic countries if the compulsory contribution of 15.5% of wage income to the private second-pillar pension funds is accounted for (Figure 1.15 A). As in the other Nordics, Iceland's tax system is geared toward income taxation. Following the gradual decline and then abrupt fall of the economy since 2019, tax revenues dwindled both in absolute terms and as a share of GDP (Figure 1.15 B). Recent reforms to income taxation made the system more innovation-friendly and reduced tax pressure, especially for low-income households (Box 1.3).

Box 1.3. Overview on recent tax reforms

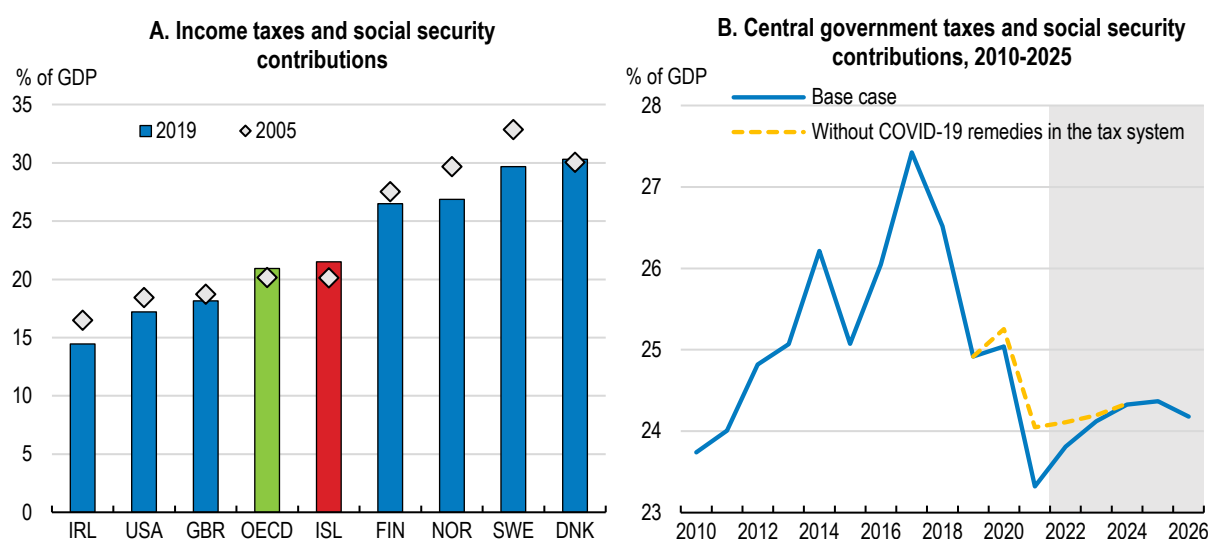
The government has been active in the area of taxation and passed several reforms over the past two years, mainly to reduce tax pressure on low-income households:

- **Personal income taxes.** The government implemented the third and last stage of a tax reform started in 2019. Tax rates on low and medium incomes were reduced by up to 5.5 percentage points, and a third tax bracket was created. Thresholds and brackets will be adjusted in line with productivity and inflation developments. Social security contributions were reduced further. The government is taxing pension savings that households were allowed to withdraw during the pandemic.
- **Corporate income taxes.** Temporary legislation allows companies to apply a higher depreciation rate to "green" assets for the years 2021-2025. Environmentally-friendly company cars can be fully depreciated in the year of acquisition. The annual ceiling on qualifying R&D expenditure was raised and different tax credit rates for SMEs and large firms introduced, at 35% and 25% respectively. **Value-added tax.** In 2020 the government introduced a number of VAT reliefs for environmentally-friendly transport modes, to be phased out in 2023. The VAT revenue ratio, i.e. the ratio of VAT collection to what could be collected if a uniform VAT rate were applied to all consumption, is at 55%, the lowest among the Nordic countries and slightly below the OECD average.
- **Environmental taxes.** In 2020, the government introduced a tax on fluorinated carbons, thereby broadening carbon taxation. There are no plans yet to increase carbon tax rates further. A tax on landfills has been postponed.

Source: OECD Tax Policy Questionnaire 2021.

COVID-19-related temporary tax relief will further reduce tax revenues in 2021, in particular extended VAT reimbursements for construction projects and a deferral of the hotel accommodation tax. VAT tax expenditures, especially in the tourism sector, contribute to the below-average VAT revenue ratio and should be cut.

Figure 1.15. Tax revenues declined



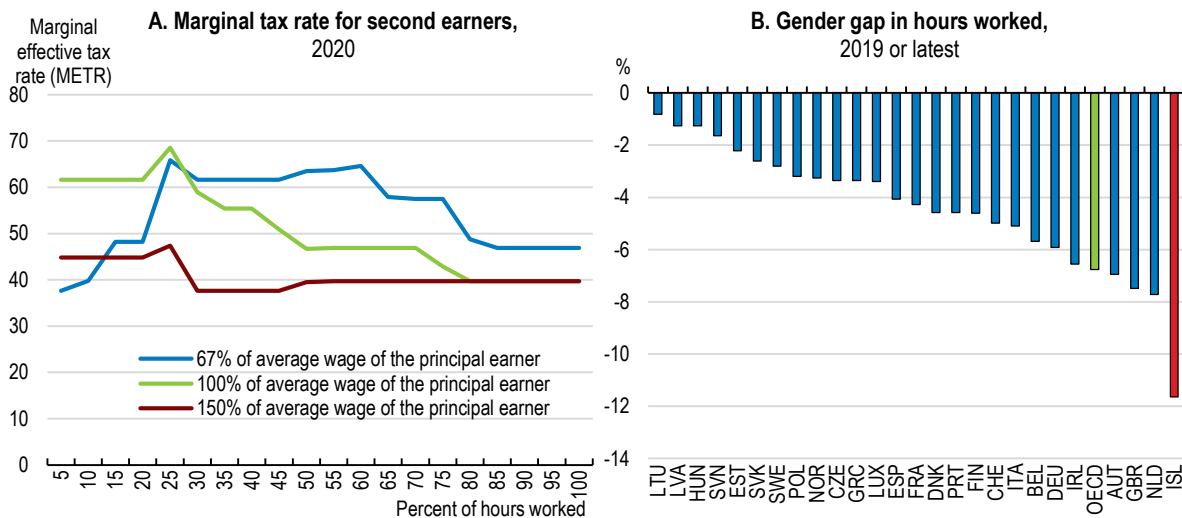
Note: Income taxes and social security contributions do not include contributions to private pension funds.
Source: OECD Revenue Statistics database; Statistics Iceland; and Ministry of Finance.

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Social benefits are well targeted but tend to penalize second earners, often women

Iceland's tax-and-benefit system is well-targeted (OECD, 2020^[11]). Most social benefits, including family and pay-as-you go pensions, are means-tested, and income taxation is progressive, supporting low-income households. The flipside of such a targeted system is that it results in high marginal tax rates, discouraging second earners, often women, from working longer hours (Figure 1.16 A). Although the gap in hours of (paid) work between men and women has been falling over the past two decades from a high level (Olafsdottir, 2020^[12]), it remains the widest in the OECD (Figure 1.16 B). High marginal tax rates could have slowed the path towards reducing the gender gap in hours worked. Despite the recent income tax reforms, low-income earners still face high marginal tax rates if working more than around 20% of full time. The 2021 reform of parental leave, extending benefits and encouraging a more equal division of childcare, is welcome as it will reduce the gender gap further (Work in Iceland, 2021^[13]). Against this background, the government should continue to reduce work disincentives for second earners, for example by tapering child and family benefits less.

Figure 1.16. High marginal tax rates discourage second earners, often women



Note: Panel A: Marginal effective tax rate (METR) is computed according to the following formula $= 1 - \frac{\Delta y \text{ net earnings}}{\Delta y \text{ gross earnings}}$. Panel B: Percentage point difference in hours worked between men and women in full-time dependent employment. Data for Australia refer to 2018. Source: OECD, Tax-Benefit model; and OECD, Labour Force Statistics database.

StatLink  <https://stat.link/zljbbq>

Implementing the fiscal recommendations from this Survey would slightly deteriorate the budget balance in the medium term (Box 1.4).

Box 1.4. 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 effects do not include behavioural responses.

Policy measure		Impact on the fiscal balance, % of GDP
Deficit-increasing recommendations		
Lower tax rates for second earners	Reduce marginal tax rates for second earners by 5 percentage points	-0.4
Spending on infrastructure, digital transition, green energy and innovation	Implement the government investment programme as planned	-0.5
Deficit-reducing recommendations		
Less spending on disability benefits	Reduce spending on benefits by one-half of the increase since 2000 (from 3.1% to 2.6% of GDP)	+0.5
Fewer agricultural subsidies	Reduce agricultural subsidies by 0.3% points of GDP (one fifth of current level)	+0.3
Total fiscal impact		-0.1

Policies to increase productivity and employment

Competitiveness has improved but is at risk

Competitiveness improved in the late 2010s, with productivity accelerating and wages slowing. Even so, productivity growth has been sluggish over the past decade. The competitiveness gains achieved after the 2008/09 crisis, owing to the devaluation of the króna and deep cuts in real wages, are exhausted by now (Figure 1.17 A). Productivity growth was rather weak in the network industries such as electricity generation, and average in employment-rich but productivity-poor services such as tourism (Figure 1.17). Against this backdrop, structural reforms in these and other sectors recommended in this *Economic Survey* could help raise productivity and employment (Box 1.5).

Box 1.5. Quantification of structural reforms

Selected reforms proposed in the Survey are quantified in the table below, using simple and illustrative policy changes and based on cross-country regression analysis. Other reforms, including in the areas of education or environmental policy, are not quantifiable under available information or given the complexity of the policy design. Most 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. Hence, the estimates are merely illustrative, and results should be taken with caution.

Table 1.4. Potential impact of structural reforms on per capita income

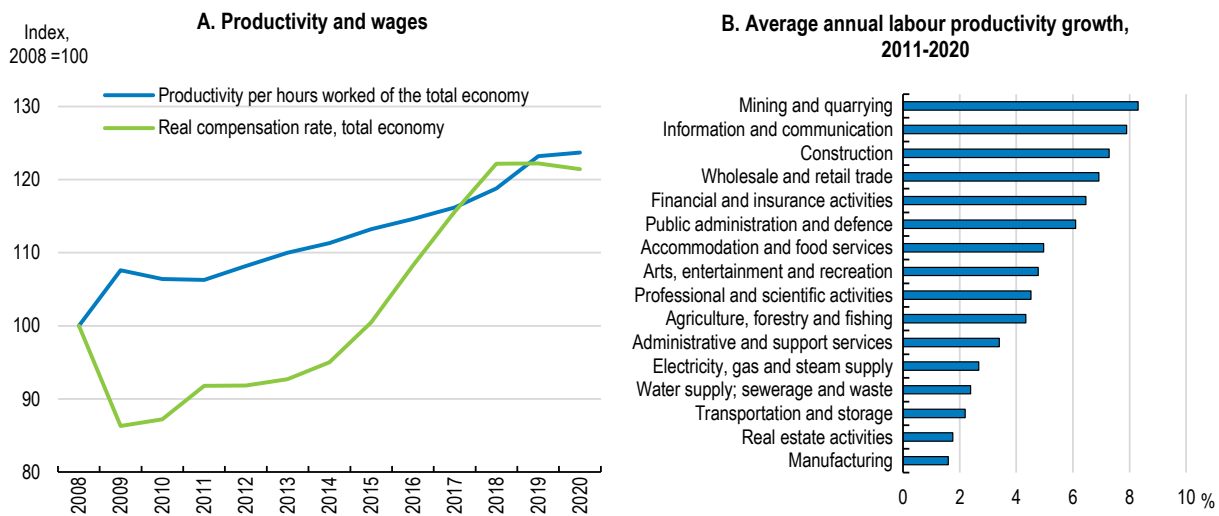
Policy	Measure	10-year effect, %
Higher trade openness	Lift trade openness by 5% points of GDP	1.6
Competition reform	Implement the OECD competition review recommendations for the tourism and construction sectors	1.0
Reform the electricity market	Separate ownership of generation, transmission and distribution of electricity completely, and fully open the wholesale market	0.8
Lower tax rates for second earners	Reduce marginal tax rates for second earners by 5% points	1.1
Better control of corruption	Increase control of corruption to Iceland's average level reached over 2010-16	0.0 - 1.4
More public investment on infrastructure, digital and green transition, and innovation	Increase public investment by 0.5% points of GDP as planned	1.5
Less spending on disability	Reduce spending on benefits by half the increase since 2000 (from 3.1% to 2.6% of GDP)	0.4
Fewer agricultural subsidies	Lower agricultural subsidies by one fifth or 0.3% of GDP	0.6

Note: The recommendation to increase carbon taxes is included in the fiscal quantification (Box 1.3), but its impact on GDP cannot be quantified.

Source: OECD calculations based on (Égert and Gal, 2017^[14]) (Cournède et al., 2018^[15]) and (OECD, 2020^[16]).

Trend wage growth has been slowing notwithstanding an acceleration of real wages in 2020 (3.4% against 1.8% in 2019), partly thanks to the 2019 wage agreements that coupled future wage increases to GDP per capita developments. The agreements contributed to weather the economic consequences of the pandemic, helping to support purchasing power of low-income earners. Even so, productivity would be a better anchor for maintaining competitiveness and macroeconomic stability while ensuring that growth continues to benefit all. Against this background, the 2016 wage bargaining reforms in Finland, which link wages more tightly to productivity developments, could serve as a model for the social partners in Iceland once the recovery is firmly on its way (OECD, 2018^[17]).

Figure 1.17. Competitiveness has improved but productivity growth is low in some sectors



Note: In panel B, labour productivity is defined as gross value added per hour worked and expressed in ISK.

Source: OECD, Economic Outlook No.109 database; and Statistics Iceland.

StatLink  <https://stat.link/clryhj>

Stringent regulation stifles competition

The stringency of Iceland's product market regulation is close to the OECD average, but with wide differences between areas (Figure 1.18). While the state sector is small and well run, barriers to entry are high for both domestic and foreign firms, hampering sound competition. Considerable administrative burdens for new companies, and an extensive licensing and permit system, protect incumbents and slow new and innovative start-ups. Finally, close and potentially unchecked ties between the political sector and interest groups, raise the risk of distortive lobbying activities. Iceland should foster an open and competition-friendly environment and ensure a strict separation between public and private interests. The recent introduction of cooling periods between the civil service and interest groups is welcome.

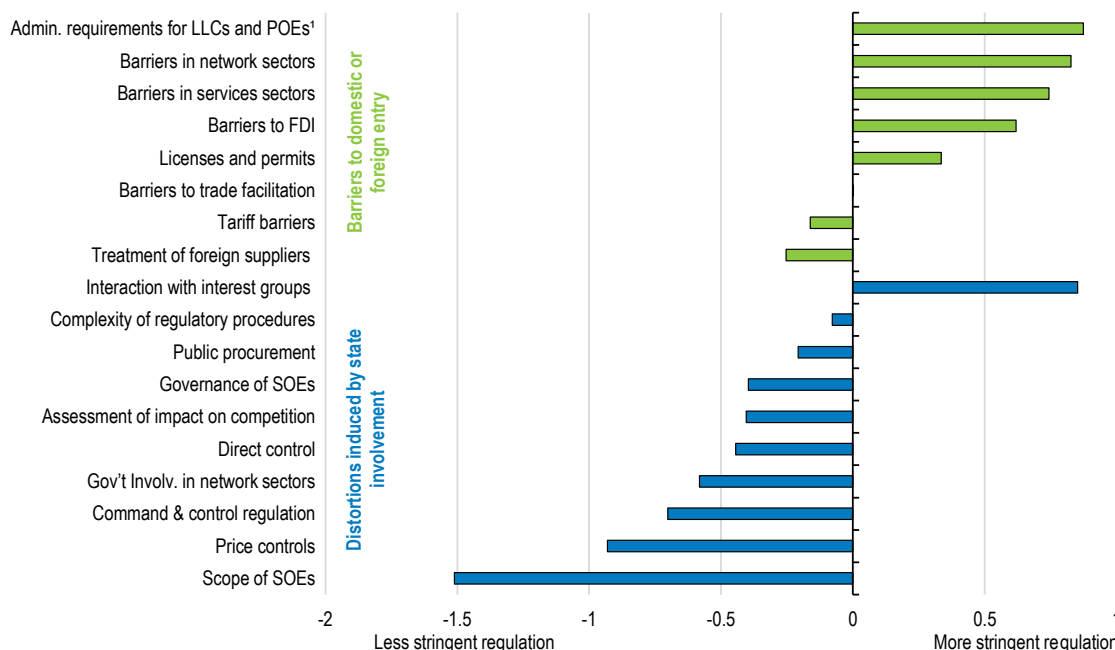
A recent OECD Competition Review assessed regulation in two sectors, namely tourism and construction, to prepare policy reforms for a more pro-competitive regulatory framework (OECD, 2020^[16]). These two sectors are key pillars of the Icelandic economy, together representing around 17% of GDP and 23% of employment.

- The main recommendation for the tourism sector is to overhaul the inefficient and costly airport ownership and operation scheme. Since competition between airports is hardly possible in Iceland, airport operation should be subjected to tendering, and airport tariffs should be regulated properly. The report also proposes revising the concessions of commercial activities to improve productivity in ancillary services, including bus transport, at Keflavik International Airport. Finally, the report suggests easing the regulation for tour operators and taxis.
- Recommendations for the construction sector include a targeted easing of planning and building regulations, especially to address a burdensome permit process and ease some building materials regulations that raise costs without improving building quality. Moreover, the broad and restrictive

occupational licensing framework in the two sectors should be eased, to allow new jobs to be created (see below).


Figure 1.18. Barriers are high for firms to enter the market

Product market regulation, gap with OECD average, 2018



Note: Negative bar values reflect less stringent regulation; positive bar values reflect regulation that is more stringent. Green bars belong to the high-level indicator “Barriers to domestic and foreign entry”, while blue bars belong to the high-level indicator “Distortions induced by state involvement”.

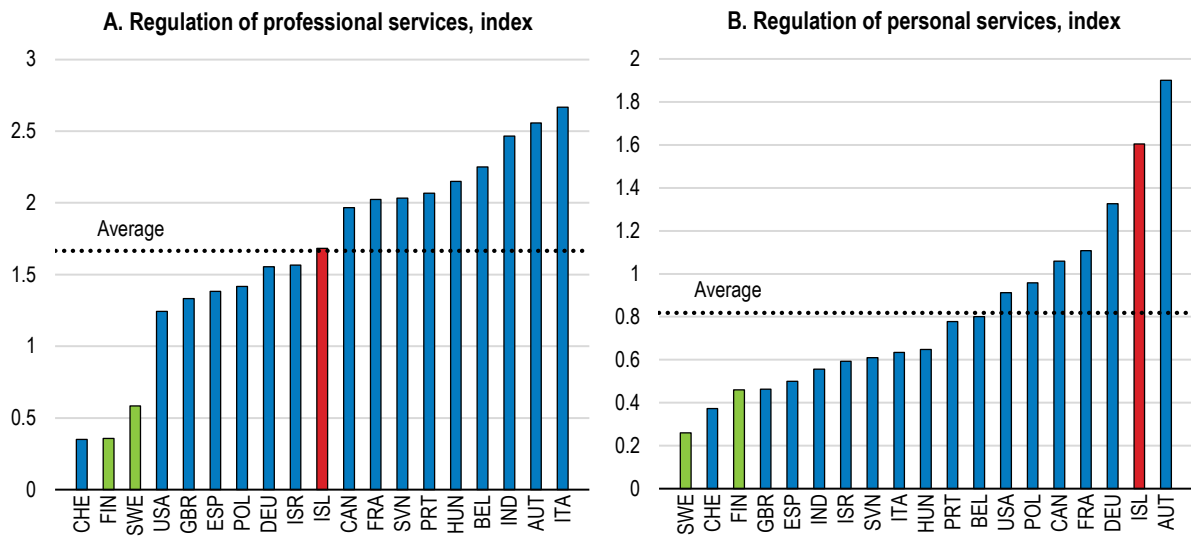
Source: OECD, Product Market Regulation database.

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The report identifies more than 670 individual regulations slowing competition, and finds that removing or amending them could raise Iceland’s GDP level by around 1%. In spring 2021, the government presented parliament with a bill to cut the administrative burden in the restaurant and car rental sectors. Against this background, the government should assess the impact of regulation in other sectors, especially agriculture and energy, and abolish harmful regulation.

Regulation of professional and personal services is tighter than in most OECD countries (Figure 1.19). Professionals are not allowed to operate any manual trade without a licence. Many activities require multiple professional designations, compounding the burden on professional entrants especially in the construction sector (OECD, 2020_[16]). Foreign professionals, even from the European Economic Area, need to pass additional exams in Icelandic. While occupational licensing may respond to policy objectives such as health and safety, restrictive access to professions may slow employment and productivity and stifle the transition towards a more innovative economy. The government should remove the regulation of services if no compelling reasons to maintain restrictions exist, while addressing concerns such as consumer protection through relevant legislation.

Figure 1.19. Regulation of professions is stringent



Note: A higher index value reflects more stringent regulation. A value of 0 indicates the absence of regulations, 6 reflects a fully regulated market. Dotted lines show the OECD average. Regulations for Canada and the United States represent the unweighted average of province/state level regulations.

Source: (von Rueden and Bambalaite, 2020^[18]) Measuring occupational entry regulations: a new OECD approach.

StatLink  <https://stat.link/29zvwj>

Foreign direct investment is restricted, partly explaining its low share in GDP (see chapters 2 and 3). Legislation, going back to the 1990s, limits investment of foreign companies domiciled outside of the European Economic Area in the fishing as well as in the energy and aviation industry. More generally, foreign investment may be “blocked” if it is deemed to reduce competition or to have a detrimental effect on the domestic economy, although this provision has never been used. Half of the board and the CEO of corporations need to be resident in Iceland or European Economic Area (EEA) member countries. Access for foreign companies to public procurement is open, yet onerous regulation on auditing favours locally licensed auditors. Finally, investment in real estate for non-nationals is restricted. The telecom market, in contrast, is very open. Against this background, the government should further ease restrictions on foreign direct investment in sectors where there are no compelling reasons to maintain them.

Regulation in the network sectors, especially in electricity provision, is restrictive, limiting the potential of the sector’s ability to deliver on the sector’s innate comparative advantages. Iceland’s electricity generation is physically separated from European or North American transmission networks, giving considerable market power to domestic electricity providers (and creating almost insurmountably high barriers for foreign providers). Projects to build an energy transmission cable to the United Kingdom have been aborted. Since 2003 Iceland follows the minimum regulatory requirement of the European Union to unbundle generation, transmission and distribution of electricity, yet the market remains dominated by a few mostly public players. Against this background, the government should improve the regulatory framework in the power market, particularly by separating ownership of generation, transmission and distribution companies and by fully opening the wholesale market.

Addressing skills gaps is key

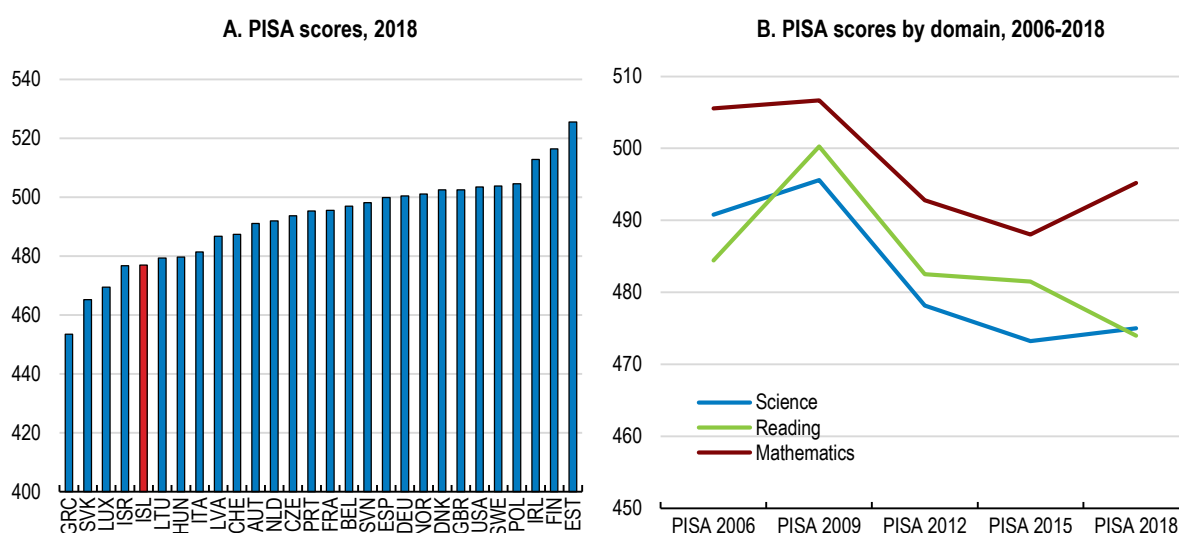
The pandemic highlighted the need to reallocate labour more rapidly and to strengthen skills in line with labour market needs. The transition towards a more digital and low-carbon economy, and the demographic pressure also require skills to be transferable to new activities. The government started to address these

new challenges. Universities and schools, under joint guidance of the education and labour ministries, have developed re-skilling courses in sectors with labour shortages, especially for technicians, craft, and health care workers. The government also strengthened programmes to improve language skills of immigrants. Research funds allocated to innovation were increased, with a larger number of students working on projects undertaken jointly by universities and firms, likely fostering relevance. Finally, the government has started to compile skills forecasts.

Still, deep-reaching education and skills reforms are needed to prepare Iceland for the longer-term economic transition challenges:

- Primary and secondary education, as reflected in PISA scores), remains weak (Figure 1.20). Boys' reading skills are weaker than girls', and the gap is wider than in other Nordic countries. The gap between native and immigrant students is also larger than in most Nordic peers (OECD, 2019^[19]). The 2015 national literacy strategy and a new teacher competency framework developed in 2017 have yet to deliver tangible results. While Iceland's education system is remarkably equitable, social recognition for teachers is lower than in many other OECD countries, teacher qualifications have been declining, and the salary and compensation system provides few rewards for experience and performance in the classroom. Against this background and as recommended in the previous OECD *Economic Survey*, the government should improve the compensation system to attract high-quality teachers, reward them better for excellence, and adapt the curriculum to pupils' capacity and needs.
- Tertiary education is little oriented towards labour market needs, inducing skills mismatch. Participation in science, technical, engineering and mathematical (STEM) courses, especially in digitalisation where labour market demand is highest, remains below potential needs. The funding system makes it attractive for universities to focus on enrolment rather than performance, prompting a bias towards inexpensive courses and popular studies. Public funding predominates, although collaboration between universities and the private sector is improving. Against this background, university funding should be more tightly linked to performance and labour market outcomes as in Denmark (Box 1.6).

Figure 1.20. Basic skills are relatively weak



Note: In panel A, bars reflect the simple average of science, reading and mathematics scores.

Source: OECD, PISA 2018 database.

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Box 1.6. The Danish university funding reform

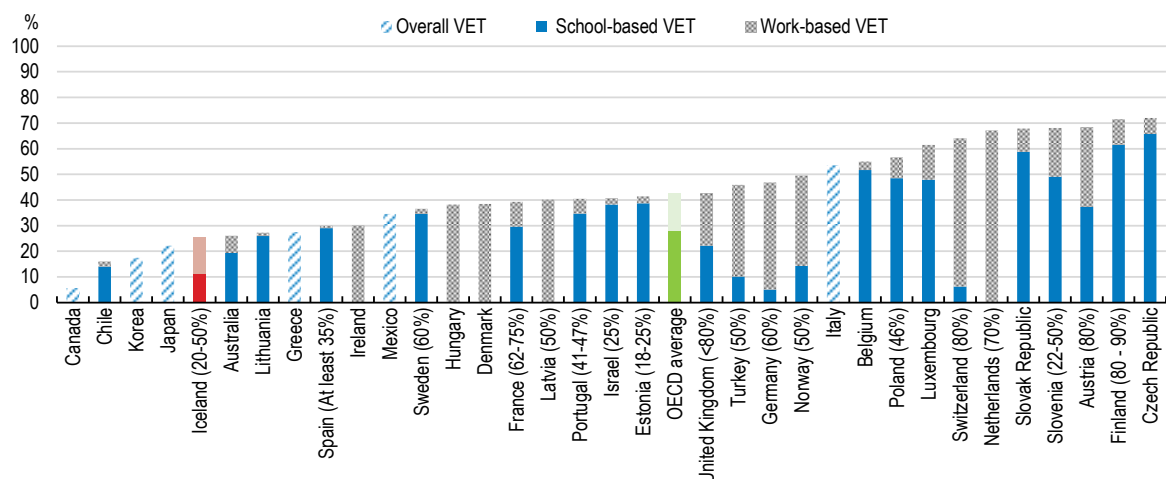
Like Iceland, Denmark is facing difficulties to meet labour demand for certain skills. Skills shortages appear in various knowledge areas such as education and training, mathematics and computer and electronics. While the share of the adult population with tertiary education is slightly above the OECD average, fewer students are choosing STEM as their field of education than in other OECD countries. The share of firms facing difficulties in filling vacant positions of ICT specialists is among the highest among OECD countries.

Against this background, the government launched an initiative to encourage students to choose study fields that are in line with their abilities, to complete education in a reasonable time, and to focus on occupations in high demand. An agreement was passed in December 2017 to reform university funding based on quality and outcomes of students. Funding will be based for 25% on the present budget level, for 67.5% on activity (number of courses offered) and for 7.5% on a labour-market outcome-oriented allocation. The Government also launched a Technology Pact, aiming to raise the number of STEM graduates in collaboration with companies, educational and research institutions.

Source: (OECD, 2019^[20]).

Vocational education and training (VET) needs to be strengthened. After compulsory education, only 25% of secondary students embark on vocational education, less than in any other European OECD country (Figure 1.21). While the VET system has a strong firm-based or apprenticeship component, especially in the traditional technical and crafts professions, school-based and work-based learning are still weakly integrated. Against this background, extending work-based learning to service sectors such as digital technology or tourism could help strengthen labour market relevance. Offering more work-based learning opportunities could also help address the dropout challenge, given that Iceland has one of the highest shares of 25 to 34 year olds without an upper-secondary education degree (OECD, 2020^[21]). The government has started to offer VET students more pathways towards tertiary education, for example by facilitating access to universities and by creating specific tertiary vocational branches, which is welcome.

Figure 1.21. Vocational education and training needs strengthening



Note: Figures in parentheses refer to the most typical duration of the actual work-based component as a percentage of the total firm-based programme duration. For example, in Germany, time spent at work accounts for about 60% of the total firm-based programme duration, while the remainder is spent at school.

Source: OECD, Education at a Glance database. For the Czech Republic and Lithuania, data rely on European Center for the Development of Vocational Training (CEDEFOP).

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Table 1.5. Past recommendations and actions taken to raise competitiveness and skills

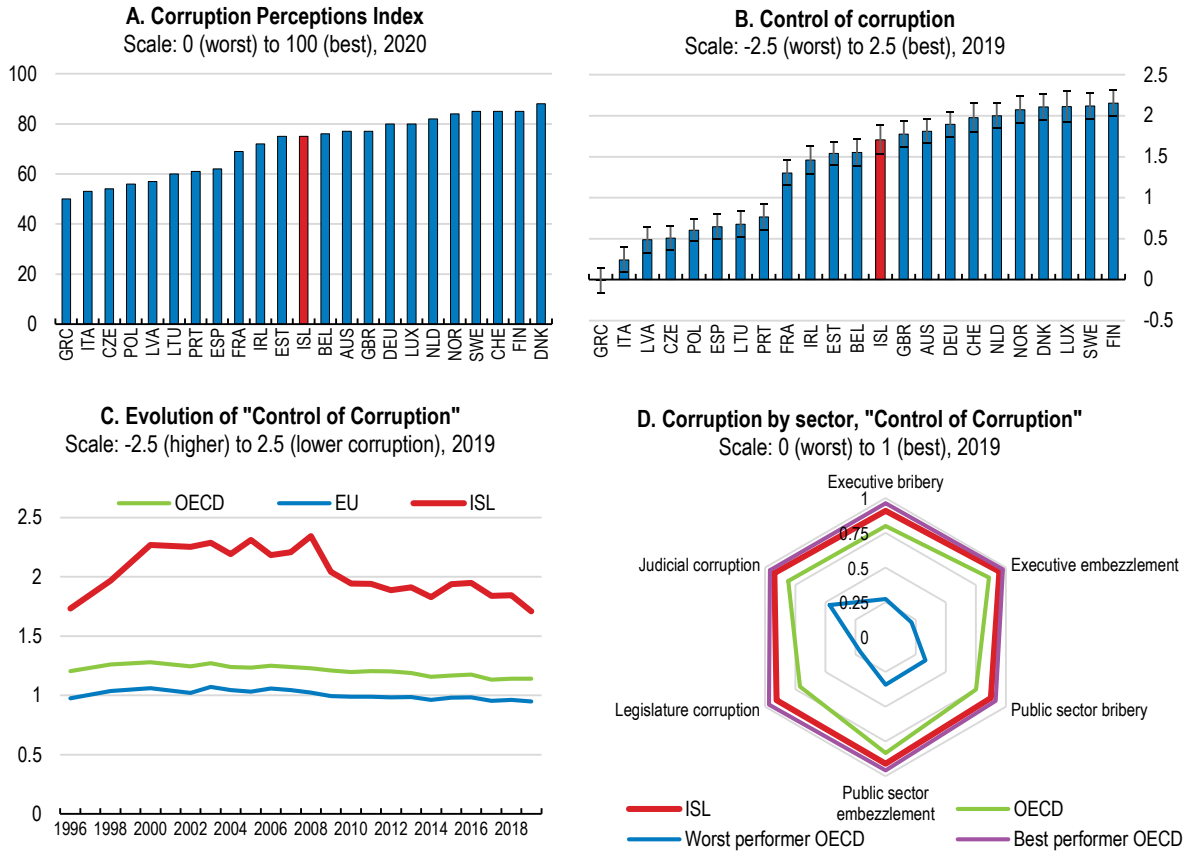
Key recommendation	Actions taken
Reduce the regulatory burden, especially in the service sector and the network industries.	The government has set up an action plan to implement the recommendations of the OECD competition review published in 2020. A bill to ease regulation in the restaurant and car rental sectors is before parliament.
Reduce barriers to foreign investment.	In 2019 the requirement for board members to reside in Iceland has been removed.
Follow productivity growth when settling wages and rely on “wage guidelines” established by an expert group.	A Committee on Labour Market Statistics, established in 2019, helps prepare and follow-up collective wage agreements.
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.	Students can follow paid internships in their final year of initial teacher education. Continued professional development of teachers has been extended.
Offer effective language training programmes.	The number of language courses offered to immigrants increased.
Develop methods and tools for monitoring skills needs that rely on several information sources, preferably both quantitative and qualitative.	The government has started to compile skills forecasts.
Strengthen vocational skills by better integrating work- and school-based training.	Schools have become more active in integrating apprenticeships into the curriculum.
Link university funding partially to the success of tertiary courses in providing skills corresponding to labour market needs.	No action taken.

Improving public governance and integrity

Indicators of public integrity and control of corruption suggest that Iceland performs above the OECD average but that its lead is declining (Figure 1.22). Low transparency in government decision-making and frequent conflicts of interest seem to be the drivers according to some observers. Closeness of public and private actors seem to be a problem as noted above. Iceland’s institutional framework, in particular the rule of law, is strong, yet is deemed weaker than in other Nordic countries. Trust in government sharply slid below the OECD average after the global financial crisis, but has been rising again over the past few years.

Iceland has taken a number of steps to improve anti-corruption measures. In spring 2020, it adopted legislation to strengthen the protection of whistle-blowers in the public and private sector and improve access to information. The country should undertake efforts to ensure proper implementation and effectiveness of the new legislation (OECD, 2020^[22]). Iceland has not yet concluded a foreign bribery case and, where credible allegations of foreign bribery have been reported, the allegations were not assessed. A first foreign bribery case is currently under investigation. Public integrity should remain a guiding principle in the government’s anti-corruption policies, given the role of such efforts in raising productivity and inclusiveness (OECD, 2020^[23])

Figure 1.22. Corruption is perceived as low



Note: Panel B shows the point estimate and the margin of error. Panel D shows sector-based subcomponents of the "Control of Corruption" indicator by the Varieties of Democracy Project.

Source: Panel A: Transparency International; Panels B & C: World Bank, Worldwide Governance Indicators; Panel D: Varieties of Democracy Institute; University of Gothenburg; and University of Notre Dame.

StatLink <https://stat.link/lbka57>

Table 1.6. Findings and recommendations to foster a strong, resilient and inclusive recovery

Monetary and fiscal policies for a strong, resilient and inclusive recovery	
Inflation and short term inflation expectations are above target.	Keep monetary policy accommodative, but stand ready to tighten further if long-term inflation expectations risk becoming unanchored.
Fiscal policy is supporting the economy.	Continue supporting the economy and start consolidating as planned once the recovery is firmly established..
More public investment is needed to support reallocation.	Ensure that the investments in infrastructure, education, innovation and digitalisation are carried out as planned.
Subsidies and VAT expenditures are high.	Reduce subsidies, especially in agriculture, and reduce VAT expenditures.
Spending reviews can help increase the quality of public spending.	Ensure that spending reviews become a routine part of the budget process, as planned by the government.
Structural policies to foster inclusive growth	
Barriers to the entry of new firms are high.	Reduce barriers to sound competition in the tourism and construction sectors. Facilitate access to professions by removing stringent occupational licensing.
Foreign direct investment is low and declining.	Increase openness by easing restrictions on foreign-owned companies, public procurement and auditing.
Competition is weak in the electricity sector.	Separate ownership of power generation, transmission and distribution companies, and fully open the wholesale market.
PISA scores are weak and trending down.	Improve the compensation structure to attract high quality teachers and reward them for excellence.
Skills mismatch is high. Labour shortages have intensified in some sectors, slowing reallocation.	Continue and extend the training programme for professions in short supply Strengthen vocational education and training (VET) by extending firm-based learning and by facilitating access to tertiary education for VET graduates. Strengthen the link between tertiary education and the labour market, by linking a part of university funding to labour market needs.
The gap in working hours between men and women is large, bringing about a considerable gender wage gap.	Reduce high marginal tax rates on second earners, e.g. by tapering child and family benefits less.
Spending on disability benefits is high.	Continue the reform of the disability benefit system, putting emphasis on returning to and remaining in work.
Perception of corruption is low but increasing.	Tighten rules on public-private relations, notably with respect to cooling periods. Ensure proper implementation and effectiveness of the new whistle-blower legislation.

Note: Key recommendations are in bold and feature in the executive summary.

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