

## Economic Survey of Iceland, 2003

### Summary

Iceland's economic performance has improved considerably over the past decade. Major imbalances and tensions that developed when the economy was overheating were corrected in a surprisingly short time span, highlighting the economy's enhanced adjustment capacity. Moreover, this was accomplished without a severe recession, and a gradual recovery seems to be getting underway. This favourable performance is the fruit of the shift in policies towards financial stability and market liberalisation in the 1990s. Nonetheless, important challenges remain. Over the next few years, there will be a substantial boost to demand from expanded aluminium smelting capacity, a new hydropower station and related public investments. This requires an appropriate macroeconomic policy response, lest the economy resumes the overheating and unsustainable external deficits from which it has just escaped. A tight fiscal stance will be required during the peak construction period, especially as regards public investment spending, in order to avoid bottlenecks and excessive labour market pressures. But monetary policy will need to be particularly vigilant in its efforts to maintain macroeconomic balance and preserve price stability. While recent economic outcomes bode well for the economic outlook, some distortions and weaknesses persist that need attention. Although radical fiscal consolidation in the 1990s has put government finances on a much better footing, expenditure creep remains a problem, and there is room for further reforms to improve control over and increase the effectiveness of public spending. The cost of policies aimed at preserving regional balance should be made transparent. Housing policy biases capital allocation away from

- To what extent have reforms improved economic performance?
- What is the short-term outlook and what are the main challenges in the medium term?
- Has the new monetary policy regime been beneficial and what should the authorities do in the period ahead?
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- Following financial-market reforms, what is the outstanding business in this area?
- What are the challenges involved in privatising and deregulating the telecommunication sector?
- In the context of expanding power-intensive industries, how could clearer accounting of social costs and benefits be provided?
- What could be done to make regional policies more transparent?
- Would additional agriculture liberalisation yield sizeable gains for consumers?
- Is there scope for further improving fisheries management and environmental policy?
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*This Policy Brief presents the assessment and recommendations of the 2003 OECD Economic Survey of Iceland. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.*

productivity-enhancing business ventures to an excessive degree. More generally, product-market competition should also be encouraged by further liberalisation. Privatisation in telecommunications should not be delayed further. Electricity deregulation needs to be accelerated, the more so since power-intensive investment projects will increase the importance of the energy sector. Further agricultural liberalisation would lead to a significant improvement in consumer welfare, and prudent catch limits would allow a faster recovery in fish stocks and higher sustainable yields. Action in these areas, combined with skilful macroeconomic management, should safeguard Iceland's current high standard of living relative to the rest of the OECD. ■

### **To what extent have reforms improved economic performance?**

A shift in policies towards achieving financial stability and market liberalisation in the early 1990s contributed to the strong growth of the Icelandic economy seen since the middle of the last decade. As a result, per capita income (at purchasing power parities) exceeds the OECD average by around one-fifth, as compared with one-tenth in 1995. The pronounced improvement in Iceland's relative position suggests that inflation reduction, fiscal consolidation and structural reforms have paid off. Financial-market liberalisation and privatisation appear to have fostered greater entrepreneurship, investment and growth. Some distortions and weaknesses persist, however. The housing, energy and agricultural sectors are still distorted by government policies. The trade-off between regional policy objectives and economic efficiency needs to be addressed. And, although Iceland has made headway in diversifying its exports, it remains exposed to destabilising external shocks. Moreover, following the late-1990s spurt of growth, Iceland's external debt has reached very high levels, with household balance sheets particularly debt-laden.

Even so, the economy has shown a remarkable capacity to adjust, with major imbalances that emerged in the late 1990s when the economy was overheating being rapidly corrected without a severe recession. Indeed, as robust export growth largely offset a contraction in domestic demand, the recent economic downturn has been milder and likely shorter than had been expected. Nonetheless, the slowdown has sufficed to eliminate the large current

account deficit that had reached 10 per cent of GDP in 2000 and to bring consumer price inflation back down from nearly 9½ per cent at the beginning of 2002 to 1½ per cent most recently, as it was in the period 1994-98. Favourable special factors, notably higher fish prices and the resurgence of the krona, have contributed. But the new monetary policy framework, which freed the exchange rate and has anchored inflation expectations, has also helped. Furthermore, the real economy has displayed an impressive adaptability, owing to labour-market flexibility, a propitious business environment and a strong technological base. ■

### **What is the short-term outlook and what are the main challenges in the medium term?**

Improved fundamentals over the past year have allowed substantial monetary easing and set the stage for recovery. The economic upswing is likely to be gradual, with real GDP projected to expand by 1½ to 2 per cent this year and 3½ to 4 per cent in 2004 when there will be a boost to demand from the expansion of power-intensive industry. Inflation should nevertheless remain near the official target (2½ per cent).

External market developments would appear to pose the most important near-term downside risk to the outlook. Moreover, the recently completed privatisation of domestic financial institutions and buoyant expectations regarding the power-intensive industrial development projects have been pushing up the exchange rate, thereby endangering Iceland's recently favourable competitive position. On the domestic side, the high level of household debt could make for even slower consumption growth than anticipated, and investment may take longer to recover. Upside risks to the short-term outlook cannot be entirely ruled out, but they would seem to concern mainly the period of peak power-intensive expansion beyond 2004.

It is now apparent that there will be a significant expansion in power-intensive industry, and the associated investments will have a huge economic impact. According to official estimates, economic growth could reach 5 to 7 per cent in 2005-06, and the unemployment rate could drop to below 1 per cent. The current account would deteriorate by 6½ per cent of GDP during the construction period, adding to the foreign debt, and inflation is likely to exceed the 4 per cent tolerance limit associated with the

inflation target in the absence of offsetting measures. A liberal immigration policy would help reduce labour market and hence inflation pressures, but even so maintenance of economic stability will be a major challenge for traditional macroeconomic policies, with the new monetary framework being put to the test. ■

### **Has the new monetary policy regime been beneficial and what should the authorities do in the period ahead?**

The adoption of inflation targeting in March 2001 reflected the recognition of the fact that, in an overheating economy with a surging external deficit, maintenance of a nominal exchange-rate target was both incompatible with internal balance and contributing to the mounting burden of foreign-currency-denominated debt. Under the new regime, the Central Bank's objective is an inflation rate of 2½ per cent with a tolerance band of 1½ percentage points on each side. However, it was expected that earlier pressures in product and labour markets, as well as currency depreciation after the abandonment of the nominal exchange-rate target, would lead to a short-lived but significant pick-up in inflation. Thus, the upper tolerance limit was initially set at 6 per cent for 2001 and 4½ per cent for 2002. It was early 2002 before domestic demand had eased sufficiently and the currency weakened enough to wipe out the current account deficit; that, along with the decision by the labour unions to postpone a re-opening of wage negotiations helped inflation expectations to decline. The Central Bank was then able to reduce interest rates steadily – to 5.3 per cent by February 2003. By now headline inflation is below the target, and medium-term inflation expectations are hovering around 2 per cent. Accordingly, the current policy stance seems appropriate and should underpin the still-fragile recovery.

Although recent indicators suggest that some economic slack has begun to emerge and the economy continues to grow below potential rates, policymakers must start to weigh the likely impact of the major power-intensive investment projects on future capacity conditions and inflation. The boost to demand and attendant tightening in the labour market will increase the risk of a return to excess demand already next year, implying that interest rates will need to be raised. The appropriate timing and size of such increases will depend on a number of factors, including exchange-rate developments and the fiscal stance. The new

inflation-targeting framework provides clear guidance: policy should remain in accommodative mode while two-year-ahead inflation projections remain below 2½ per cent but should reverse course as the expected acceleration in demand boosts those projections above that mark. On that basis, official interest rates will likely need to be significantly higher by end-2004. The targeting framework has already paid dividends, but the Central Bank should consider strengthening it through a move to regular policy meetings so as to improve communications with the financial markets, with decisions announced immediately thereafter as is done by all other inflation-targeters. ■

### **What is the appropriate stance of fiscal policy?**

The substantial general government financial surpluses recorded a few years ago (around 2½ per cent of GDP) have all but disappeared. This reflects the effects of the economic downturn, but also some discretionary easing (for example, new or enhanced social programmes, such as parental leave and child allowances, and tax reductions), as well as other deviations of spending from budgeted levels. Nonetheless, general government finances in 2002 appear to have been in approximate structural balance, which was intended to be maintained this year according to budget plans. However, in February the government announced a substantial bringing forward of public investments (mainly road building) that will be carried out over the rest of 2003 and 2004, rather than in the two subsequent years. This has been followed by similar announcements at the municipal level. The increased spending could be justified by the fragility of the incipient recovery and the unusually healthy long-term condition of the public finances. However, the risk is that some of the resulting construction activity may nonetheless overlap with the gearing up of the power-intensive projects, generating capacity pressures both sectorally and possibly economy-wide. Following these decisions, the room for further fiscal expansion, would seem to have been exhausted, and expenditure overruns must be avoided.

Further ahead, the stimulative effects of the major investment projects should be counteracted by budget surpluses. While monetary policy will bear most of the burden of stabilising the economy, assistance from tighter fiscal policy would be appropriate to moderate the extent of interest-rate increases that would

otherwise be required. This should take the form of restraint in public expenditure, especially on capital projects, during the peak construction period. As to the strategic orientation of fiscal policy, the authorities are aiming at surpluses throughout the business cycle in order to ensure a rapid reduction in the already low public debt. This should be achieved in a process that aims not only at cutting expenditure but also at reducing taxation. While corporate taxation has been reduced substantially, personal tax rates are still higher than in the late 1980s, despite cuts in recent years. Besides having favourable labour supply effects, further cuts in marginal tax rates would maintain downward pressure on the level of government spending. ■

### How could public spending discipline be enhanced?

While overall public spending is not high compared with Iceland's Nordic neighbours, other OECD countries have made more progress in reining it in. Budget consolidation efforts and public-sector reforms temporarily reversed the upward trend in the government expenditure-to-GDP ratio in the mid-1990s, but since then the ratio has edged up again, and budget balance has been maintained only through a rise in the tax-to-GDP ratio. Recurrent overruns of budget spending targets point to the need for further modifying the fiscal framework. Although the introduction of "frame-budgeting" (setting expenditure ceilings) has improved planning and decision-making, its effectiveness has been undermined by a tendency for expenditure targets to be changed in the parliamentary phase of the budget process. Moreover, fiscal slippage has continued, with overspending (typically in civil service pay and health care) systematically sanctioned by supplementary budgets. An early parliamentary vote on the "frames" (ceilings) could ensure that they are not neglected later in the budget process. The execution of the budget needs to be tightened and the use of supplementary budgets restricted. In addition, it would seem necessary to strengthen the medium-term strategic focus of fiscal policy through a process that clearly defines political priorities and the means to achieve them and relies on multi-year spending targets rather than *ad hoc* decisions.

Public finances would also benefit from more efficient public spending, for example from greater use of performance management. So far about half of all government agencies are covered by framework

performance contracts. Implementation clearly needs to be accelerated, setting deadlines and possibly reducing the number of small agencies. Linking the budget process to performance, which was one of the objectives of public-sector reform, remains a challenge. Most ministries have still to adopt performance-based budgeting. This approach should both be extended throughout the government and integrated in the budget formulation from the beginning. Moreover, managerial accountability has lagged the shift of authority to government agencies, contributing to large one-off wage increases as the new decentralised pay system was introduced. But, in addition to enhanced accountability. The wage bargaining process should be strengthened, for example by ensuring that the Ministry of Finance's wage bargainers are given clear instructions in order to limit potential wage overruns. Moving to multi-year budgeting may be helpful in this respect.

The devolution of responsibilities to local authorities has also not been without problems, since they seem to have even greater difficulties than the central government in resisting claims for more public services and pay increases that are out of line with performance. This is compounded by the fact that they have been slower in introducing performance management and other reforms. Part of the problem is that, outside the capital region, local authorities are too small to be effective managers of many categories of expenditure. Thus, incentives should be provided for further local government amalgamation. In contrast to the central government, which has moved to budget surpluses, local authorities have been in persistent deficit over the past decade. To some extent, this reflects the fact that additional revenue provided through more tax room and transfers from the central government, though partly justified by additional responsibilities, has limited incentives to curb spending. A further move to general rather than earmarked grants in the context of equalisation is desirable, since block grants reduce the risk of distorted or excessive spending. In addition, central and local governments should commit to reaching binding annual agreements to ensure the achievement of national public-spending objectives. ■

### What is the scope for getting better value for money in social expenditures?

Health care, education and social support are the main tasks of government, with spending on these

activities accounting for more than three-fifths of both the state's and local authorities' total outlays. This highlights the importance of expenditure management in these sectors, the more so since they are also facing the strongest spending pressures. Iceland's expenditure on health care, which is largely publicly funded, was lower than the OECD average until the 1980s, but is now among the highest in per-capita terms. This has been reflected in an above-average level of care and better health outcomes. However, even adjusting for changes in life style, the returns to the rapid expansion of expenditure in recent years can be questioned; it has not been matched by much further improvement in health outcomes. Although government initiatives have yielded some cost savings, thought has to be given to developing a more substantial reform package, while recognising the complexity of improving efficiency without sacrificing equity. The turnaround has been even more striking in education expenditure, where Iceland has moved from well below average in the 1980s to the highest level among OECD countries. This largely reflects a deliberate government effort, which seems to be leading to an improvement in educational outcomes. The focus should now be on getting better value for money. The recent conclusion of performance-related contracts with all higher-education institutions should be helpful. Other useful measures would be an increase in class sizes where they are low and the introduction of tuition fees (flanked by a student loans scheme) in tertiary education where returns are largely private; this would also provide an incentive to students to reduce the duration of studies. ■

### **Following financial-market reforms, what is the outstanding business in this area?**

As noted, the financial system has weathered the recent economic slowdown, despite increased defaults and bankruptcy rates. This partially reflects fortunate exchange-rate developments: repayment difficulties on foreign-currency-denominated debt for those sectors with little foreign-currency income, such as households and retailers, undoubtedly would have become more widespread, had the krona failed to appreciate from late-2001 levels. In addition, earlier concern about the adequacy of banks' capital positions and financial supervision received prompt attention. Staffing levels at the Financial Supervisory Authority were increased markedly. Commercial banks have also raised their capital reserves. Looking forward, regulators should maintain pressure on

banks to maintain generous amounts of capital because of the volatility of the economy and the generally high level of indebtedness.

Two areas remain in need of some structural policy changes, though. *First*, efforts to spur consolidation among savings banks should be increased. They have significantly lower quality portfolios, and, while this does not present a systemic risk, capital would be allocated more efficiently if the discipline in loan decisions apparent at larger commercial banks was also applied at these small institutions. The current incentives for savings banks to incorporate have so far been insufficient, in part because a portion of the own capital would not accrue to the current members at incorporation. *Second*, and more importantly, housing receives large direct and indirect support – on the order of 1¼ per cent of GDP – through government debt guarantees, substantial amounts of mortgage interest payments (subject to limits on beneficiaries' incomes and assets), partial rebates on the value-added tax on construction wage costs and (means-tested) rental assistance. Consequently, homeownership is high (at over 80 per cent), as are household debt levels. Moreover, these support measures bias investment decisions away from productivity-enhancing capital spending. This set of policies is excessively generous and should be reconsidered; the distributional objectives implicit in means-testing should be pursued in a manner that does not affect housing decisions. ■

### **What are the challenges involved in privatising and deregulating the telecommunication sector?**

The authorities' decade-long privatisation programme has been a great success. Almost all of the government's remaining stakes in two large commercial banks were sold in 2002; these sales, in conjunction with the entry of a new player, should heighten competitive pressures in the sector. On the other hand, the planned sale of Iceland Telecom did not proceed, in part because of the plunge in market valuations of telecommunication firms world wide. Now that its privately owned competitors have all merged, its privatisation is no longer a simple decision: a regulatory environment appropriate to such a duopoly will have to be a concomitant reform. But even if the stock market were to remain weak for an extended period, this should not be taken as a permanent argument against privatisation. In the

meantime sectoral regulators and competition authorities will need to be vigilant to prevent it from abusing its dominant position. ■

### **In the context of expanding power-intensive industries, how could clearer accounting of social costs and benefits be provided?**

The other major sector still subject to government ownership is electricity. Currently, the predominantly state-owned National Power Company (NPC) dominates generation, and distribution is performed by a number of local-government-controlled utilities. This structure does not distinguish between natural monopoly areas (such as transmission and system operation) and competitive elements (such as generation and distribution). Reform is also needed to comply with EU directives under the European Economic Area agreement. Proposals before Parliament would separate the natural monopoly and competitive areas and eventually privatise government-owned enterprises. However, some aspects could be improved. The inter-regional distortion resulting from the uniform tariff schedule (as distribution is less expensive in Reykjavik, for instance) should be removed to encourage efficient use. Moreover, the government guarantees NPC's debt, and its tax-exempt status further distorts the playing field relative to potential competing energy suppliers. Removal of these measures would make the social returns to power-generation projects more transparent and also provide a clearer market basis for the development of energy-intensive industries.

Building a new aluminium smelter in eastern Iceland requires the construction of a large new hydropower plant. Apart from the macroeconomic impact during the construction phase, this project – as well as proposals to expand capacity at the two existing smelters – raises a number of long-term issues. It implies a near-doubling in the debt of the NPC and in the importance of aluminium in exports. The resulting increase in diversification is desirable, given that marine products currently represent about two-thirds of merchandise exports. But the increased debt level of the NPC could complicate its privatisation. While it is now too late to pursue a private-market scheme with substantial foreign investor participation, this would have been desirable both to diversify the risk being assumed by the NPC and to allow for a market-based test of the project's financial return. ■

### **What could be done to make regional policies more transparent?**

Regional concerns have been a factor in many areas: regional cross-subsidisation of electricity, support to farming to boost the economy in some locations and infrastructure projects. As this list illustrates, the mix of policies designed to maintain some regional balance in population has often been indirect and has yielded distorted relative prices and hence inefficient resource allocation. Moreover, the patchwork approach has resulted in a set of policies whose cost is indeterminate and that to date has proven unable to prevent a continued drift toward the capital region. While public opinion may demand continued efforts to preserve regional balance, this objective could be achieved in a less distortionary manner if policies did not impinge on market signals across such a wide range of activities. Clearer accounting of the costs of these policies would also facilitate public decision-making, ensuring that efforts to maintain regional populations reflect the national will, rather than more narrow interests. ■

### **Would additional agriculture liberalisation yield sizeable gains for consumers?**

Progress in agriculture liberalisation has occurred over the past decade, especially with regard to the elimination of quotas for sheep meat and price regulation in most areas, excluding dairy. Nonetheless, support to Iceland's farmers remains among the highest in the OECD, resulting in consumer prices for agricultural commodities that are typically close to double world market levels. Protection takes the form of minimum access quotas, most of which have been filled, and high tariff levels, usually over 100 per cent. The priority changes that should be pursued – which would lead to a significant improvement in consumer welfare – are increases in minimum access quotas, lower tariff rates and dismantling of administered prices for dairy products. ■

### **Is there scope for further improving fisheries management and environmental policy?**

Iceland introduced a science-based, market-driven limit on fishing in time to place the industry on a sustainable basis. With the rapid emergence of quota trading, the fleet is in the process of being rationalised

without the need for government subsidies. A resource tax in the form of a fishing fee has now been agreed. This will serve, initially in 2004, to ensure that the industry pays the cost of the fisheries management system and research. As the tax rises, reaching 9.5 per cent of net revenues by 2009, it will start to capture part of the rent that arises from access to low-cost fishing grounds. This tax could be raised further, provided that it does not cause the catch to drop excessively. After an unexpected fall in cod stock estimates in 2000, the generally applied method for determining the allowable catch was temporarily suspended, and a limit on the inter-annual changes in the quota was introduced. This has delayed the recovery of stocks to their optimal level, and so there is a case for a more conservative catch limit in the immediate future to allow a faster recovery in stocks. Finally, the special treatment of small boats in the form of inefficient effort-related limits on fishing should be phased-out.

Greenhouse gas emissions are much lower, relative to GDP, than in other OECD countries but have been rising relatively rapidly due to Iceland's industrial specialisation. Nonetheless, it is unlikely that this increase has raised global emissions. In effect, domestic policies have promoted renewable energy and so allowed energy supplies to new aluminium

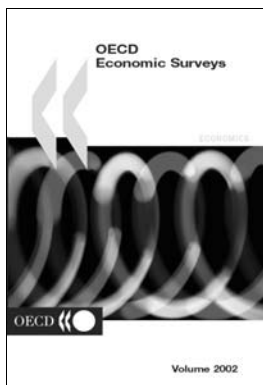
plants to be less emissions-intensive than in the rest of the world. Expansion of these industries has broad implications for the natural environment, air pollution and regional policy. While the current practice is to consider such factors in the planning stage of major projects, explicit use of cost-benefit analysis would provide greater information to decision-makers and the public with respect to the trade-offs between purely economic and other goals. This would also allow for some estimates of the social, *versus* the private, return to power-intensive investments, thereby making any implicit government subsidy transparent. Finally, a shift to taxing diesel vehicles on the basis of fuel consumption rather than distance travelled should be considered in order to encourage fuel efficiency and reduce associated emissions. ■

### For further information

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