Policy Brief

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Economic Survey of Iceland, 2001

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Is there excess demand in the economy?

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Summary

The past five years have seen rapid economic growth, averaging 4½ per cent annually, which has helped push the government's budget into substantial surplus and reduce the unemployment rate to one of the lowest in the OECD area, at close to 1 per cent of the labour force. However, for the past year or so, the economy has been showing worrying signs of overheating, even though policy actions already taken are likely to slow domestic demand. This slowdown in demand will be magnified by the cut in fishing quotas so that GDP growth could slacken to around 1½ per cent in 2001. Nevertheless, significant inflationary pressures remain, although they may be masked in the near term by the fall in oil prices. Also, the current-account deficit is likely to remain uncomfortably large in the next two years. Such developments would pose an increased risk to the stability of the exchange rate and that of the financial system. A concerted policy response is called for. In this regard, the recent adoption of an inflation target, coupled with the grant of operational independence to the Central Bank, and the ending of the exchange-rate band are to be welcomed as giving a stable base for policy. However, the monetary authorities will need to be particularly vigilant to any signs from the labour and product markets that underlying inflation is not on a sustained downward trend. Moreover, financial supervision should be enhanced. Fiscal policy should remain tight, and a stricter control mechanism is needed to ensure that the overspending that has characterised budgets over the past decade does not repeat itself. In the medium-term, growth prospects would be enhanced by reducing and simplifying capital taxation and introducing taxes on resource rents in the fishing and electricity sectors. Shrinking agricultural support provides another important avenue for creating room for

This Policy Brief presents the assessment and recommendations of the 2001 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.

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tax cuts. Elsewhere, the role of the government still needs to be further curtailed, except where justified by externalities, such as in fishing. So long as macroeconomic balance is restored and structural reforms are sustained, the prospects for the economy should again be bright. ■

How strong was activity in 2000?

After four years of rapid growth, averaging almost 5 per cent, the pace of the economic expansion remained robust in 2000. Domestic demand accelerated, led by renewed buoyancy in private-sector investment that boosted imports. Capital formation in the aluminium and fishing industries increased strongly, as did spending on information and communication equipment. More worryingly, public investment continued to soar, and government consumption remained buoyant. Meanwhile, slower real income growth, linked to higher oil prices, and higher debt-service payments hit the purchasing power of households. As a result, the growth of personal consumption was maintained only through even faster borrowing, with household debt estimated to have increased almost 20 per cent. In contrast to domestic demand, exports grew only modestly, as higher investment has not yet been reflected in much of an increase in fish production. Hence, with a negative contribution from net exports, real GDP growth dipped slightly to 3½ per cent, while the current account deficit widened further. ■

Is there excess demand in the economy?

Even that more moderate rise in output was well above the potential growth rate of the economy and thus generated increasing excess demand. The registered unemployment rate fell as low as 1.2 per cent of the labour force by the autumn, even though there was a marked rise in immigration and inexperienced workers were drawn into the labour force. The tightness of the labour market helped push up both wage and price inflation. Over the past year, wages have risen by around 6½ per cent, exceeding the sum of trend productivity growth and expected price inflation. The latter – as measured by the consumer price index – reached 5.1 per cent in 2000, in line with projections made at the time of the last *Survey* at the end of 1999. A further sign of excess demand came from the surge in the deficit on the current external account which may have surpassed 10 per cent of GDP, triple its historical average. ■

How tight has monetary policy been in the past eighteen months?

The last *Survey* recommended additional monetary tightening in order to stem these inflationary pressures, but this was late in coming. The Central Bank raised its repurchase rate four times since then, bringing it to 11.4 per cent by November 2000. However, it was not until that point that real short-term interest rates had increased substantially, reaching their highest level in the current upswing. The initial slowness in boosting interest rates came in a period of currency appreciation. But in February 2000, interest rates were raised and the exchange-rate band was simultaneously widened to 9 per cent, a move designed to create room for further monetary tightening. Following downward revision to fishing quotas in the spring, selling pressure on the króna developed, and this was first met by intervention. Monetary policy was then tightened, but without preventing a10 per cent fall in the trade-weighted exchange rate to a level that, by February 2001, was about 3 per cent from the weaker edge of the target band. By then, long-term rates on indexed bonds had risen by100 basis points, the property market had eased, and the stock market had fallen 30 per cent from its level a year earlier. ■

How tight was fiscal policy in 2000?

During 2000, fiscal policy did play a role in restraining demand. However, the public-sector wage bill increased rapidly, primarily reflecting a catch-up in government pay. Plans to curtail medical outlays failed to be implemented. Nevertheless, overall, central-government spending grew markedly less rapidly than nominal GDP. On the revenue side, yields from corporate tax and the relatively new capital income tax were above expectations, while individual income tax yields rose as the basic tax credit was not increased in line with wages. These developments led to a significant increase in the general-government financial surplus, from 2 to 2¾ per cent of GDP. The OECD's estimate of the structural balance, which adjusts for the strength of the business cycle, rose somewhat less, to 2 per cent. ■

Will it help ease demand pressures this year?

The budget for this year does not imply a further tightening of fiscal policy. Overall spending is projected to rise by close to 9 per cent,

and the recent teachers' pay settlement implies a further rise. A part of the explanation is that two expenditure programmes have been modified in a way that will boost spending: a parental-leave scheme has been introduced; and there has been a reduction in the extent of means-testing of child allowances. However, part of the rise reflects temporary increases in agricultural subsidies and interest payments that only affect 2001. In addition, central government is funding a cut in the local real estate tax in rural areas and permitting an increase in municipal income tax rates by lowering its own income tax rate. This last item, however, will not affect the overall position of the public sector, provided that local governments do not spend their additional revenue. ■

Is it likely that economic growth will moderate this year?

The balance of forces is pointing, nonetheless, towards a considerable slackening in the growth of output this year, with real GDP growing by only 1½ per cent. Such a slowdown reflects a likely fall in the fish catch and tighter financial conditions. Both factors are likely to cool personal consumption and business investment. Weaker activity should bring a noticeable rise in unemployment. Yet, with both the quantity and price of fish exports falling, the current-account deficit seems likely to widen further. In these circumstances, the forces acting on inflation are mixed. Substantial excess demand will persist for most of the year, and wage drift may undermine the moderate increases agreed for the second year of the national pay contracts. The drop in the exchange rate that occurred last year is projected to eventually push up the prices of imported goods, but housing costs should decelerate and oil prices may decline slightly further from recent lower levels. Overall, the inflation rate seems likely to ease back this year to around 4 per cent, from 5 per cent previously, and may edge down further in 2002 on the technical assumption of a stable exchange rate from February 2001 onwards. ■

What are the principal risks for the economy?

The risks surrounding this central projection are considerable. First and foremost is the real and financial impacts that any further downward movement in the exchange rate might have on the economy. Sustaining the large current-account deficit has depended on the private-sector capacity and willingness to continue to increase its net foreign-currency debt at a rapid pace. Strains are beginning to emerge in this respect, as shown by the fall in the króna to the lower reaches of the official target range. Pension funds, sensing further weakness in the currency, could further increase their purchase of foreign assets. Fishing companies have taken large losses on their foreign borrowing. Other debtors, without much in the way of foreign-currency income, may become reluctant to increase risks to their balance sheets. Much of this foreign borrowing has been intermediated by banks, which, in addition, have been taking long positions in both the bond and equity markets. Such exposures could lead to further deterioration in the quality of their balance sheets, bringing a possibility that foreigners would reassess their willingness to lend to them, thereby reducing domestic borrowers' access to foreign credit. For any of these reasons, pressure on the exchange rate could continue and even be amplified, given the deterioration in vulnerability indicators, such as the ratio of net foreign reserves to indebtedness, since the last *Survey*. ■

How can these be best avoided?

The overall policy challenge is to minimise the substantial risks inherent in the current situation. The economy has to be steered so that aggregate demand slows and wage and price pressures ease. The monetary authorities have a key role to play in ensuring that inflation remains on a clear downward path, thereby helping to restrain the demand for credit. Their job will be easier if fiscal policy-makers keep strictly to budgeted spending levels and have contingency plans ready for possible cuts, if circumstances call for them. The financial supervisors should pay close attention to the risk exposures of the larger banks in order to mitigate the vulnerability of the financial system to external shocks. In addition, consideration should be given to strengthening the supervisory framework for financial institutions through increased required capital-adequacy ratios and stricter loan classification as well as better provisioning. ■

How will the new inflation target work?

Given the risks inherent in the current situation, the government and Central Bank have recently decided that the best way to achieve a smooth movement to domestic bal-

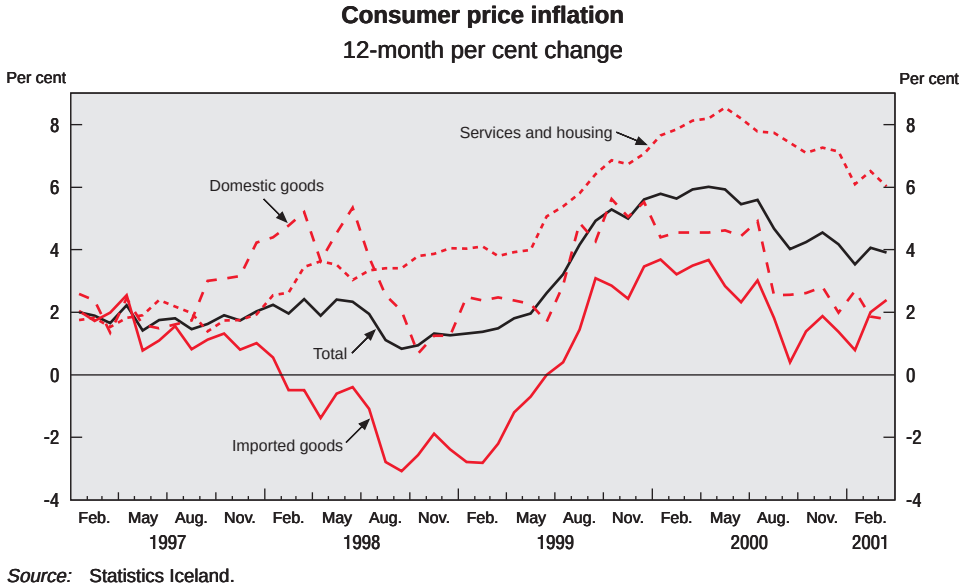
ance is to adopt an inflation target. The aim of the new policy is to reduce inflation to about 2½ per cent by 2003. Special reporting mechanisms have been put in place for the Central Bank to justify its policy if inflation diverges from the target by more than 1½ percentage points by that date, with a somewhat wider band in the interim. Thus, the acceptable range is somewhat higher than for other countries with an inflation target. The Central Bank is being given immediate operational independence, thereby bringing its status into line with that of the monetary authorities in many other countries. At the same time, the fixed exchange-rate band is being abandoned. Such changes in policy are desirable given that the economy is particularly vulnerable to periodic large shocks from the fishing sector. This will give a better focus to monetary policy for the reasons that were outlined in the 1999 *Survey* when this course of action was first advocated. ■

What are the challenges for economic policy in an environment of inflation targeting?

Monetary policy will have to remain vigilant to the possibility that exchange-rate depreciation might feed into second-round effects on wages and prices and stand ready to counter any such eventuality with a sufficiently tight monetary policy. The recent introduction of an inflation target may help lessen the prospect of such a wage-price spiral by improving the credibility of monetary policy. However, the Central Bank will have to ensure that the economy continues to slow down after the recent half-point cut in official interest rates. Should growth remain too strong, the Bank would need to take further action in order that a better balance emerges in the labour and product markets. Indeed, developments in the labour market in the coming months will give a crucial indication as to whether the desired moderation in activity is actually occurring, more so than the overall inflation rate, which may be held down in the very short-term by the fall in oil prices. ■

Are forceful constraints on public spending needed?

In the context of an economy that needs a better balance between demand and supply, the top priority for fiscal policy should be to remain within the spending levels set in the budget for 2001. The historical record for expenditure control has not been good. It is to be hoped that the new sanctions put in place with respect to public agencies that exceed their budget limits will be of some help in this area, but more forceful general constraints on spending may be needed. ■



Source: Statistics Iceland.

Can the government meet its aim of having no net debt by 2004?

Additionally, a new instrument needs to be put in place to define the nominal sums available to Ministries over the medium term. In particular, a mechanism should be implemented to ensure that spending increases next year and thereafter will be reined back to under 5 per cent, the medium-term nominal growth rate of the economy consistent with a modest inflation rate. Unless any of the risks outlined above were to occur, the government should be able to achieve its aim of having no net debt by 2004. In this regard, it is noteworthy that central government net debt has been reduced to18 per cent of GDP at end-2000 from 35 per cent five years previously. A resumption of privatisation sales, which are planned to reach 2.5 per cent of GDP this year, will sustain, or indeed accelerate, this trend. Such a rapid improvement in public finances is clearly warranted, even if it will present some challenges for debt management. In particular, since it is unlikely that the entire consolidation could be undertaken by repurchases of domestic debt in this time period, some domestic financial assets might have to be acquired and net foreign indebtedness (which amounted to 61 per cent of central-government debt at end-2000) reduced, even if such action might put downward pressure on the exchange rate for a time. ■

Can the tax system be improved?

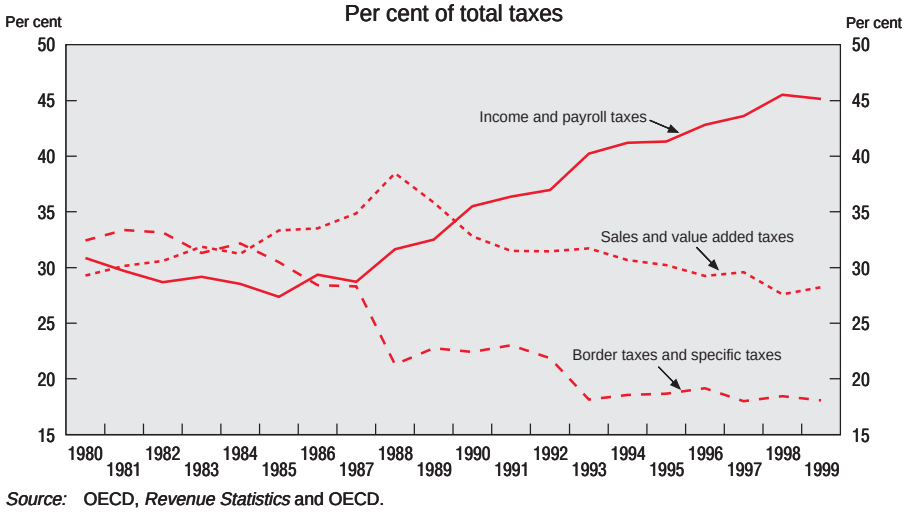
The longer-term accumulation of domestic financial assets would not be appropriate. Such a policy would raise questions concerning the extent of government control over the private sector. Moreover, running a surplus would unduly favour future generations at the expense of current ones, given that, as outlined in the previous *Survey*, ageing poses only a small problem to public finances. Rather, macroeconomic stability permitting, longer-term fiscal policy should be oriented towards reducing taxes and enhancing their efficiency. While the tax system functions quite well overall, with a number of features (such as a low number of rates and broad bases) that are exemplary, it could be improved in a way that would boost incentives to work, save and invest. ■

What has been the aim of past tax reforms?

Past tax reforms have aimed at simplification and a reduction in the extent of discrimination. A flat income tax of 35 per cent with a uniform tax credit was introduced. The corporate tax rate was lowered to 30 per cent by widening the tax base. A value-added tax replaced the sales tax, and the municipal turnover tax was abolished. Although some of these changes were partly reversed with the introduction of a higher rate of income tax, the government renewed its reform of income taxation in 1997. Marginal tax rates were reduced, and the taxation of all capital income was unified, with only one low rate of 10 per cent. A uniform payroll tax for all sectors of the economy was introduced. Consumption taxes and the taxation of employment and pension income now account for the bulk of government revenues, with an overall tax

The share of different taxes over time

Per cent of total taxes



Source: OECD, *Revenue Statistics* and OECD.

yield slightly lower than in the average OECD country but up from a decade ago. ■

Is the tax system neutral today?

Despite the introduction of the uniform capital income tax, the principal area of non-neutrality remains the taxation of different forms of capital. If saving is made either through pension schemes or through the purchase of bonds, the extent of the double taxation of saving is low. When an investment is made in equities, it is higher – though amongst the lowest in the OECD area. In addition, there are a number of further charges on capital income, notably the wealth tax and stamp duties (transfer taxes). The former is also discriminatory between different forms of wealth but, in this case, favours investment in equities, as in that case taxation is based on the par value of shares rather than their market value. Finally, there are inheritance and property taxes. The former is set at different rates according to the closeness of the family linkages between the donee and donor. Overall, the impact of these additional taxes has been to raise the effective rate of taxation on capital to above that on labour. This is undesirable in Iceland's case because it is faced with a chronic inadequacy of domestic savings while it enjoys low structural unemployment. ■

Could a more coherent taxation of capital taxation improve growth prospects?

The basis of future tax reform should be to further increase simplicity and neutrality, while improving the sustainability of the recent increase in living standards. Simplicity would best be served by reducing the number of different taxes on capital: a goal that would also help improve the neutrality of the tax system as between consumption and saving – a particularly desirable result insofar as the combination of large current-account deficits and budget surpluses suggests inadequate incentives to save. The first stage in this process would be to lower the difference between the taxation of corporate profits and that of interest payments. Two routes would be possible. The corporate tax could be progressively reduced or shareholders could be given a credit for the payment of corporate taxation. The wealth tax might be a candidate for elimination, the more so since it discriminates between different assets. For example, with current rules, individuals can markedly reduced wealth tax payments by holding assets abroad in specially created companies whose shares have artificially low par values. Its revenue yield is low relative to collection costs and incentives for avoidance. It is also likely that the growing globalisation of domestic financial markets will make it difficult to continue with stamp duties on financial transactions, which are increasingly mobile internationally. Finally, inheritance taxes should be eased – they represent an extra burden on those who are not related to donors and provide important "tax planning" incentives. They may also encourage dis-saving among the elderly, since they cut into long-run rates of return. ■

How could taxation of expenditure and income be changed?

The reform package should not neglect expenditure and individual income taxes. In the first area, it would be appropriate to raise the overall value-added tax and reduce the use of additional excise taxes on specific items, other than on those with clear negative externalities (on users' health or the environment more generally). In the area of income taxation, the priority over the longer term should be to gradually lower the marginal tax rate. At the same time, the child benefit and the mortgage interest allowance should be reformed. The first of these benefits discriminates in an unjustifiable way between children of different ages. As to the allowance for mortgage interest payments, even if it is less distortionary than corresponding treatment in many other OECD countries, it favours purchase rather than rental of accommodation and has little justification in the absence of capital income taxation on the imputed rent from owner-occupied housing. It would be best replaced by a one-off lump-sum housing benefit. ■

Could resource rents be tapped as a tax base?

While the general thrust of the tax reform package would be one of rate reduction and tax elimination, there is at least one area where taxation should be introduced. Resource rents are an appropriate tax base because their taxation is non-distortionary. Since the introduction of fishing quotas, considerable rents have been generated for the owners of these rights. Secretariat estimates put the size of the rent at over one per cent of GDP for cod alone. The production of hydro-electricity is another area where sizeable rents could emerge for the owners of the rights. The taxation of these rights, or – even better, in the case of fishing and radio frequencies – their auction, has the possibility of raising substantial revenue and so

helping finance the recommended package of tax reform. ■

Should any expenditure policies be changed to lower taxes?

Such a tax reform would go beyond the likely availability of funds from the budget surplus and would require extra financing from expenditure reductions. A prime candidate for such cutbacks would be moving toward a more market-related agricultural policy. Public farm spending amounted to 1.8 per cent of GDP in 1999, and outlays were the second highest (on a per capita basis) amongst OECD countries. Moreover, consumers are subjected to hidden, implicit taxes that keep the price of domestically produced foodstuffs 2¼ times above world market levels and disrupt the efficient allocation of resources domestically. Indeed, agricultural policy reform would also allow the abolition of the lower rate of value-added tax that is designed to partially offset the impact of agricultural policy in raising food prices. Policy is presently constrained by contracts between the government and farmers in certain sectors, but over the medium-term horizon, agriculture should be opened to the benefits of globalisation. ■

Will growth benefit from a reduced government role in capital markets?

Tax reform is not the only approach to enhancing trend growth of the economy. A reduction in the level of government ownership and regulation is also necessary. Progress has been made in opening financial markets to competition since the last *Survey*. Several of the investment credit funds were merged into an investment bank that was subsequently fully privatised and which later merged with the only completely private commercial bank. The two state commercial banks now have private shareholders, but the pace of change in this sector slowed in 2000. Nevertheless, the government took steps to ensure that bank deposits of the state banks are not fully guaranteed by introducing a deposit insurance scheme that put a ceiling on compensation in the event of bank failure. A concerted effort needs to be made this year to implement current plans to completely sell the state holdings in the commercial banks and to further review the possibility of privatising the government housing funds, as recommended in the last *Survey*. Equally, it will be important to implement the restructuring of the savings-bank sector in order to give them clearer commercial priorities. ■

What is the role, in improving economic prospects, of liberalisation initiatives taken in other sectors?

Significant new initiatives were taken to increase competition elsewhere in the economy. The new regulatory authority for telecommunications has already taken steps to increase competition. New licences have been granted both for mobile telephones and terrestrial services. These new operators should help drive prices even lower and further extend market penetration, already the highest in the OECD area. The monopoly power of the historic telephone operator has been further eroded by obliging it to unbundle the services offered through its local loop. This year, the government needs to finalise its plan for the privatisation of the national telephone company in a way that maximises competition, even if this reduces the price it will receive for its stake. In the area of electricity, an objective should be to separate generation and distribution of electricity before privatising this company too. Consumers will need to have the freedom to purchase supplies from new producers. Market forces in the economy are also likely to be improved by the new competition legislation, which increases the powers of the competition authorities to vet mergers, thereby addressing the concerns expressed in previous *Surveys*. Overall, structural policy has been a success in recent years and has helped in the development of new activities, even if fisheries remain the principal source of export earnings. In that area, the increase in fishing quotas will need to be held back in the next few years below that allowed in the legislation, in order to rebuild stock levels that are now not thought to be as high as before. ■

For further information

Further information on the *Survey* can be obtained from Richard Herd (e-mail: richard.herd@oecd.org, tel.: 33-1-45.24.87.00).

For further reading

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- **Economic Outlook No. 69, June 2001.** A preliminary edition is published on the OECD Web site approximately one month prior to the publication of the book: *www.oecd.org/eco/out/Eo.htm*.

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