RESTRICTED

WT/TPR/G/361

30 August 2017

(17-4580)

Trade Policy Review Body

Original: English

TRADE POLICY REVIEW

REPORT BY

ICELAND

Pursuant to the Agreement Establishing the Trade Policy Review Mechanism (Annex 3 of the Marrakesh Agreement Establishing the World Trade Organization), the policy statement by Iceland is attached.

Note: This report is subject to restricted circulation and press embargo until the end of the first session of the meeting of the Trade Policy Review Body on Iceland.

Contents

1 INTRODUCTION

1.1. Iceland submits this statement as part of Iceland's fifth Trade Policy Review.

1.2. Trade, especially external trade, is of vital importance to the economy of Iceland. For a low- and sparsely populated remote island in the far north, faced with difficult topography and climate, there is simply no substitute for free, fair and mutually beneficial trade.

1.3. In 2016, Iceland had a trade to GDP ratio of 91.6%. Imports of goods and services amounted to 42.5% of GDP and the exports of goods and services reached 49.1% of GDP. Accordingly, international trade remains at the core of Iceland´s economic and foreign policy.

1.4. One of Iceland's primary goals in international trade is to promote and strengthen the competitiveness of domestic businesses in world markets and abolish barriers to trade by extending and deepening its multilateral and bilateral trade relations. Iceland is fully committed to furthering trade liberalization under a WTO centred multilateral trading system and actively supports a fair, open and rule-based system.

1.5. Iceland experienced a severe recession in 2008 following the collapse of its banking sector and since then economic policy has been oriented towards stabilising the economy. The report submitted during the last Trade Policy Review in 2012 covers the policy steps taken towards recovery, but throughout the recovery there was a broad political consensus on the key essentials of a market economy and the preservation of the welfare state.

1.6. Today, less than a decade after the collapse, Iceland's economy is performing strongly, with robust growth, low inflation, rising reserves, fiscal and current account surpluses and a decline in the public debt levels, as well as full employment. The capital controls installed due to the crisis have mostly been lifted and Iceland is once again embracing financial openness.

1.7. The economy is considered to be on a firm footing with the high growth numbers, largely due to tourism, private consumption and investment. The risks faced by the economy include the continued appreciation of the currency, overheating and capital flows. Also, Iceland's most important economic partner, the EU, has been experiencing some challenges. Going forward, maintaining a close economic and trade relationship with the UK following Brexit is a primary goal of the Icelandic Government.

2 ECONOMIC DEVELOPMENT AND PROSPECTS

2.1. Iceland has fully recovered the output loss sustained in the wake of the 2008 financial crisis and has enjoyed robust economic growth in recent years, which is assumed to have peaked at 7.2% in 2016. The growth is projected at 6% in 2017 and 3.3% in 2018. Subsequently, growth is expected to slow down and remain stable at around 2.6% through to 2022, according to a May 2017 forecast by Statistics Iceland. The growth has mainly been driven by exports, investment and private consumption.

2.2. Private consumption has been picking up and grew by 6.9% in 2016 and is expected to increase at the same rate in 2017. It stood at 49% of GDP in 2016, well below the pre-2008 average of 55-60%. Households' disposable income has risen sharply and real disposable income has grown by an average of 7.5% per year since 2014. Households have taken advantage of the favourable environment and strengthened their balance sheets and stepped up savings while private consumption has been increasing. Businesses have also reduced their debt and the ratio of private sector debt to GDP has been declining steadily since the aftermath of the crisis in 2008.

2.3. Investment has grown considerably in recent years after being low in historic context between 2009 and 2014. It grew by almost 23% in 2016 after nearly 17% annual growth in 2015. The main driver is residential investment, growing by almost 34% and business investment with 25% growth. The growth in business investment is mainly due to increases in sectors related to transport and tourism. Investment was 21% of GDP in 2016 and was very close to its long-term average. Public consumption was 23% of GDP in 2016 and was also on level with the long-term average.

2.4. The tourist sector has experienced strong growth in recent years. Tourism grew by more than 37% in real terms in 2016 and was around four times higher than in 2010. The tourist sector is now the country's largest export sector, with a larger share of export earnings (39% in 2016) than the fishing industry and aluminium industry combined. This rapid development, which obviously has a huge positive impact, is also accompanied by a number of challenges. Almost 1.8 million tourists visited Iceland in 2016 and forecasts predict a continued increase this year. This increase in tourism has a major impact on the environment, the housing market, the labour market and most infrastructures.

2.5. Inflation was 1.9% in 2016. It has measured below the Central Bank's inflation target for more than three years now, and is not expected to change until 2018. The reasons for low inflation in recent years are particularly favourable external conditions, low international inflation and exchange rate appreciation. The housing component of the consumer price index is really the only factor that has driven inflation. Strong demand on the housing market has reflected in rising housing prices and in March 2017 the year-on-year increase measured 21% in the capital.

2.6. Since 2011, wages have risen quite sharply. The accumulated increase in the wage index over the years 2015 and 2016 is over 19%. Despite the large wage increase, inflation has remained low in the current upswing and therefore the increase in purchasing power has become more substantial. The increase in purchasing power last year was 9.5% compared to the previous year. At the same time, unemployment has been falling. It measured at 3% in 2016 and is expected to be lower this year, or 2.8%. Long-term unemployment, i.e. the proportion of those unemployed for more than a year has almost disappeared, and was only 7% of the total number of unemployed in the last quarter of 2016. Labour market participation was 83.6% in 2016 and remains high in an international context.

2.7. The ongoing growth period is rather unique in Iceland's economic history as it has lasted over six years and yet the internal and external balance of the economy remains preserved. There is a substantial surplus on the current account (8% of GDP in 2016) and the net international investment position has improved substantially. Iceland is now a net lender rather than a net borrower for the first time since measurements began. This environment led to substantial exchange rate appreciation in 2016, especially in the last six months of the year, as growth in tourism increased and the GBP depreciated following the Brexit referendum. The króna has continued to appreciate in 2017, albeit more gradually.

2.8. The current short-term goals of economic policy include maintaining stability, as the collective bargaining agreements concluded in 2016 go counter to the goal of price stability. However, the agreements have not yet transmitted into inflation as external factors, such as low oil prices and low international inflation, along with an appreciating exchange rate, contribute to low domestic inflation. International economic developments and geopolitical factors can also influence the forecast, especially low inflation and low policy rates in main trading countries, which affect domestic inflation and capital flows to and from the country.

2.1 Lifting of Capital Controls

2.9. The capital controls imposed after the financial crisis have now essentially been lifted. The three- stage plan to remove capital controls has been a success and capital controls were lifted on individuals, businesses and pension funds in March 2017. The only remaining restrictions on capital outflows regard offshore króna assets and transactions that may give rise to carry trading.

2.10. Credit rating agencies responded positively to the capital account liberalization. Standard & Poor's (S&P) raised the long-term ratings on Iceland from A- to A on 17 March 2017. Fitch and Moody's have assessed the prospects of an upgraded credit rating as positive.

2.2 New Act on Public Finance

2.11. On 1 January 2016, a new act on public finance (the Organic Budget Law, OBL) entered into force in Iceland. The act proceeds the Financial Reporting Act (FRA) of 1997. The FRA had many good features, such as being relatively comprehensive. It was applicable not only to the central Government's budget but also to all of the entities and corporations under Government control, included a clear categorization of central Government institutions for the purpose of financial

management and control, and specified the required content of key financial documents, including the annual budget and final accounts. However, it had some key weaknesses that prevented it from providing a credible, integrated framework for budgeting. Iceland's emergence from the economic crisis provided a unique opportunity to revisit the laws and procedures that shaped fiscal decision-making over past decades. The objectives of the OBL are to address the aforementioned gaps, loopholes and inconsistencies in the FRA that contributed to the fiscal indiscipline before the crisis. This includes ensuring a comprehensive scope of fiscal policymaking in the long-term and the short-term, improving fiscal coordination between different parts of the public sector and providing a firm legal foundation for sustainable fiscal policy going forward.

2.12. The act preserves fiscal discipline, restores fiscal sustainability and prevents a reversion to the more permissive practices of the past. The OBL covers the public sector as a whole and promotes a disciplined and policy-oriented approach to budget decision-making by reducing the number of appropriations, adopting a top-down sequence to budget preparation and approval, and increasing ministerial responsibility for budget management.

2.13. Since the OBL entered into force, two Fiscal Policy Statements and two Fiscal Strategy Plans have been introduced on the basis of the new law. The implementation of the OBL is currently a key priority in the Ministry of Finance and it will continue to be so. Line ministries, agencies, the PMO and Parliament also play a key role in the OBL.

2.3 Tax and Customs Reforms

2.14. The report submitted by Iceland in connection with the 2012 Trade Policy Review highlights the most relevant measures introduced by the Government from mid-2009 to end-2011, in the wake of the collapse of the Icelandic banking system and the severe crisis of 2008. These measures, driven by the need for fiscal adjustment, were successful in bringing Government debt back down to a sustainable level.

2.15. From 2013–2017, the Government adhered to the general policy of stimulating production in society as a means to improve economic conditions for the general public and industries. This policy included a plan to simplify the tax system and introduce such incentives as the reduction of taxes on income and trade in goods and services. The plan was to be administered in close connection with other important economic measures, such as the lifting of capital controls and the collective bargaining of wages and other terms of employment. The Government also aimed at making changes to the tax system more predictable and to make the system as a whole more stable.

2.16. Changes to personal taxation since 2012 have been moderate, although the number of income tax brackets was reduced from three to two in 2017. The net wealth tax expired in 2015. The tax rate for capital income and capital gains has stayed at 20% since 2011, as has the corporate income tax rate. Social security contributions paid by employers have been gradually reduced back towards pre-crisis level and stand at 6.85% in 2017. New tax incentives include numerous measures supportive of R&D activities and innovation. From 2017, tax relief is granted to foreign specialist employees. In 2016, a tax allowance was introduced for individuals' investment in innovation companies and the ceiling for refundable R&D tax credit for businesses was raised threefold.

2.17. With a new act on stamp duty in 2014, the tax was simplified and is currently only levied upon the official registration of documents conferring title in connection with ownership of real property and ships. The fiscal adjustment process after the crisis prompted the introduction of new taxes on the financial sector: a Bank Levy in 2011 and in 2012 a Financial Activity Tax (FAT) on salaries paid by financial companies and insurance companies, currently 5.5%, together with a 6% special income tax on high profits of the same companies. The Bank Levy, initially 0.041% of total debt with no tax-free threshold, was in 2014 raised to 0.376% above a ISK 50 billion threshold.

2.18. In relation to indirect taxation, reform has aimed at improved revenue efficiency of VAT and elimination of outdated, distortive taxes. Along these lines, in 2015 the commodity tax on numerous goods and sugary foods was abolished and the VAT rate gap was decreased by lowering the standard rate from 25.5% to 24%, and raising the reduced rate from 7% to 11%. In 2016, the VAT base was broadened to include passenger transport and other tourist services previously

exempt, now subject to the 11% reduced rate. In September 2017, the occupancy tax of 2012 will be raised from ISK 100 to 300 per unit. A carbon tax on all liquid fuels and LPG, and a resource tax on hot water were adopted in 2010. The temporary resource tax on electricity expired in 2016.

2.19. In 2016, custom duties levied on import of clothing and shoes were abolished. In 2017, custom duties on import of all industrial products in chapters 25–97 of the Icelandic Tariff Schedule were abolished leaving only the following goods subject to customs duties upon import to Iceland: meat products, some fish, dairy products, birds' eggs, live plants, edible vegetables and certain roots and tubers, animal fodder and animal feeding ingredients and cereals, potato flour, meal, etc., preparations of meat, of fish or of crustaceans, molluscs or other aquatic invertebrates, some sweets, some cocoa and cocoa preparations, some preparations of vegetables, fruit, nuts or other parts of plants, some miscellaneous edible preparations, some waters, beers, wines and sodas, and some residues and waste from the food industries.

2.20. The present Government has set its policy goal on stability and foresight. Its course of direction is towards desirable living conditions, equality, human rights, diversity, freedom and responsibility. The Government views the tax system as a mechanism for income generation and its role is to finance public expenditure. As such, the Government plans to strengthen the system as a whole with emphasis on measures to prevent and eradicate tax evasion and prevent the deterioration of the tax base. Special attention will be paid to tax havens. A fair and simple tax system reduces the need for concessions and exemptions and increases competitiveness of Icelandic companies at the international level. In its review, the Government intends to guarantee fair taxation of self-employed persons and SME's and improve coordination of environmental taxes.

2.4 State Ownership

2.21. A number of developments have taken place since Iceland's last Trade Policy Review in relation to state ownership.

2.22. The Government has merged the five small regional savings banks, in which the state held a majority share, with Landsbanki hf., in which the state holds just over 98% of the shares.

2.23. In addition, the entire holding of Glitnir hf. in Íslandsbanki hf. was transferred to the state effective as of 2016, as part of Glitnir's stability contribution to the state in connection with the comprehensive capital account liberalization strategy devised by the authorities. As a result, as of 2016 Íslandsbanki is 100% state-owned. The shares of Arion banki hf. are, however, 13% state-owned.

2.5 Gender Equality in Iceland

2.24. In the *World Economic Forum's Global Gender Gap Report* from 2016, Iceland is ranked number one as in previous years. Participation in the labour market by both men and women has always been at a high level in Iceland and the participation of women in the labour market in Iceland is the highest among OECD countries.

2.25. The present Government states in its platform from August 2016, that it will emphasize equal rights. The Parliament agreed on a new action plan in September 2016 for the period of 2016-2020. The action plan introduces 21 projects to be implemented within the timeframe. The Government has highlighted gender mainstreaming as a key method within the Governmental sector in accordance with the Act on Gender Equality (No. 10/2008, Art. 17).[1]

2.26. Bridging the gender pay gap is a priority in the Government's programme on gender equality. In 1961, Iceland adopted an Act on Equal Pay for Equal Work. Challenges identified for the gender pay gap include: gender segregated workforce, additional wage payments for men, low participation of women in managing corporations and institutions, different valuation of the work of women and men and women seem to have the tendency to value their own work less. One of the important challenges ahead is increasing the number of women on boards and as directors of corporations and institutions. Research has shown that there is a need to identify gender equality

[1] The Centre for Gender Equality in Iceland. *Gender Equality in Iceland: Information on Gender Equality Issues in Iceland.* March, 2017.

principles in wage policies of corporations and institutions and job evaluation needs to be standardised. In 2010, a law was passed that obligates companies to have a minimum of 40% women or men on their boards.

2.27. The Government continues to develop policies and promote initiatives that focus on decreasing the gender pay gap and its causes. This includes increased research on both the gender pay gap and its causes and the development of an equal-pay standard, led by the Ministry of Welfare in cooperation with various labour market stakeholders and Icelandic Standards, the national standards body.[2] The equal-pay standard is, like other management standards, a requirement standard. The aim is that companies and institutions can establish management systems which will ensure and certify that their handling of cases and decision-making on wage issues will not be based on gender-specific discrimination.

3 TRADE POLICY

3.1. Iceland's trade policy remains firmly rooted in its membership of the WTO, the OECD, EFTA and the EEA, as well as other free trade agreements. Iceland is a small open economy that owes its success to a large extent to a well-functioning global free trade environment. Moving towards more free trade and increased market access accordingly underpins Iceland's trade policy. In recent years, Iceland has taken unilateral steps towards more free trade, i.e. by eliminating tariffs of 90% of the tariff lines on all but the most sensitive agricultural products. A newly concluded bilateral agreement on agricultural products with the EU marks a further step towards liberalization in the trade of these sensitive products through sizeable quota openings as is described partially in the Chapter on Tax and Customs Reforms.

3.1 WTO

3.2. The WTO remains at the core of Iceland's trade policy. Iceland is fully committed to a strong multilateral rules-based trading system, including the implementation of existing disciplines and commitments. The WTO system provides legitimacy, transparency and a level playing field in international trade for all the actors in the global economy. It is necessary to strengthen the global trade system in order to move towards sustainable development and shared prosperity.

3.3. Iceland continues to actively engage in the WTO Agenda. Iceland submitted its ratification document for the Trade Facilitation Agreement on 31 October 2016. Furthermore, Iceland is making the necessary arrangements to remove the last legal provision that formally allows export subsidies to become fully in line with the MC10 Nairobi outcome. Iceland has over recent months stepped up its efforts in fulfilling different WTO obligations regarding notifications leaving only few left to be complied with. Iceland remains committed to the objectives of the Doha Mandate and in the context of the review of its development policy it is engaged in internal consideration on how the new policy can best support international trade.

3.4. Although Iceland strongly supports multilateral solutions, it notes that plurilateral agreements can be a powerful tool for trade opening and more liberalization. In many instances, they can provide immediate benefits for trade and growth. Iceland has accordingly engaged in various plurilateral initiatives conducted in the margins of the WTO, including the Information Technology Agreement and the negotiations for an Environmental Goods Agreement. Iceland has also participated in the negotiations on a plurilateral Trade in Services Agreement (TISA) and remains committed to the conclusion of the negotiations. Furthermore, Iceland actively partakes in the plurilateral initiative to prohibit harmful fisheries subsidies. It foresees, as other participants in these initiatives, that they can, once concluded, be integrated into the WTO framework at a later stage.

3.2 EFTA

3.5. Iceland negotiates, concludes and administers its free trade agreements mostly in association with its EFTA partners. Through Iceland's membership of EFTA, it has concluded 27 FTAs with 38 countries. Since 2012, new EFTA free trade agreements were concluded with the Central American

[2] The Centre for Gender Equality in Iceland. *Gender Equality in Iceland: Information on Gender Equality Issues in Iceland.* March, 2017.

states of Costa Rica, Panama (2013) and Guatemala (2015), Bosnia & Herzegovina (2013), Georgia (2016) and the Philippines (2016).

3.6. The EFTA States are currently conducting free trade negotiations with Ecuador, India, Indonesia, Malaysia, Mercosur (Argentina, Brazil, Paraguay, and Uruguay) and Viet Nam. Negotiations with Algeria, Thailand, and the Customs Union of the Russian Federation, Belarus and Kazakhstan are currently on hold. Furthermore, the EFTA States are currently conducting negotiations on the development of existing free trade agreements with Mexico and Turkey.

3.3 EEA

3.7. Iceland is a party to the Agreement on the European Economic Area. The EEA Agreement, which entered into force on 1 January 1994, brings together the 28 EU member States and the three EEA EFTA states (Iceland, Liechtenstein, and Norway) in a single market.

3.8. The EEA Agreement covers the four freedoms; the free movement of goods, services, persons and capital, and provides that the same rules shall apply throughout the internal market of the EEA States. In addition, the Agreement covers cooperation in other important areas, such as research and development, education, social policy, the environment, consumer protection, tourism and culture. The Agreement guarantees equal rights and obligations within the internal market for citizens and economic operators in the EEA.

3.9. The scope of the EEA Agreement does not include the EU Common Agricultural Policy or the EU Common Fisheries Policy, but it contains provisions on various aspects of trade in agricultural and fish products. Moreover, the EEA Agreement does not entail a customs union or a common trade policy towards third countries.

3.10. A key feature of the EEA Agreement is its dynamic character. Its common rules are continuously updated by incorporating new EU legislation. Regularly, a number of EEA-relevant EU legislative acts are incorporated into the Agreement by decisions of the EEA Joint Committee. The EEA EFTA states may ask for consultations on matters of concern and may also seek adaptations to Community legislation in its application to the EFTA states when special circumstances call for it.

3.4 Bilateral Agreements

3.11. Apart from EFTA free trade agreements, Iceland has also concluded bilateral free trade agreements. Free trade negotiations with China were concluded in 2013 and the Agreement entered into force in 2014. Two bilateral agreements with the EU are in force in parallel with the EEA Agreement; a bilateral free trade agreement from 1972 and an agreement on trade in basic agricultural products from 2007. Earlier this year, Iceland and the EU signed a new agreement on trade in basic agricultural products, which will replace the agreement from 2007, and agreed on an improved market access for processed agricultural products under the EEA Agreement, as well as an agreement for the protection of geographical indications for agricultural products and foodstuffs. Furthermore, Iceland has free trade agreements with both Greenland and the Faroe Islands.

3.5 Gender and Trade

3.12. Advancing gender equality and women's empowerment is integrated horizontally into all areas of Icelandic foreign and domestic policy, including trade policy. Iceland has itself seen the economic benefits that increased gender equality brings. Inclusive trade policies can contribute to advancing gender equality and the economic empowerment of women, which in turn are a fundamental driver of economic growth and prosperity, and play an important role in eliminating poverty and ensuring sustainable development. Iceland, therefore, advocates for the gender perspective being central when it comes to trade policies, both in the international fora, including through its development cooperation, as well as at home.

3.13. Iceland is involved in initiatives in Geneva that support these objectives. This includes being among proponents presenting proposals to take binding commitments in the area of domestic regulation in services on removing explicit and implicit discrimination based on gender elements.

Iceland supported a similar initiative in the TISA negotiations and will continue to do so when they resume.

3.14. Furthermore, in the implementation of some trade agreements specific attention should be placed on the impact on women. Also, countries could use the Trade Policy Review mechanism to voluntarily report on their efforts to promote a more gender sensitive approach to trade policy issues at the domestic level.

3.15. Iceland would moreover welcome provisions of this nature to be included into FTAs.

3.16. As a member of the International Gender Champions initiative, Iceland is leading, along with Sierra Leone and the International Trade Centre (ITC), an impact group on Gender & Trade which has the role of looking into ways to support gender equality and empowerment of women in the field of trade.