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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.

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1 INTRODUCTION

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

1.2. Iceland's economy has fully recovered after being hard hit by the COVID pandemic. The economic performance is among the highest ranked of the OECD countries, thanks to strong resilience in key export sectors, strong positions of households, and low reliance on fossil fuels. GDP is expected to be on a solid growth path over the next years. The main challenge is high inflation, now at 6.6%, even though inflation has been coming down gradually over the last months and is expected to decline to the target rate of 2.5% in the next two years.

1.3. Iceland's narrow resource base and geographic location make it highly dependent on specialization and international trade. Iceland's trade policy is underpinned by the promotion of an open, fair, and non-discriminatory multilateral trading system with the WTO at its core, participation in the EU internal market through the EEA Agreement and a network of preferential trade agreements with 43 countries and territories outside the EU. Growing protectionism, trade tensions and geopolitical challenges pose a risk to Iceland's future economic prosperity.

1.4. Trade as a share of GDP in the first nine months of 2023 was 90%, with exports accounting for 46% of GDP, and imports 44%.

1.5. The COVID recession hit Iceland particularly hard given the severe impact on tourism, which has become one of the key economic sectors in Iceland. The economy picked up fast after restrictions were lifted and the number of tourists reached pre-COVID levels in 2023.

2 ECONOMIC DEVELOPMENT AND PROSPECTS

2.1. The Icelandic economy has grown at a strong pace in recent years. This despite being disproportionately affected by the COVID pandemic, which led to a 6.9% GDP contraction in 2020. GDP growth was 5.1% in 2021 and 8.9% in 2022. The robust recovery was supported by a sharp bounce back of tourism and robust population growth due to the inflow of foreign workers. Growth slowed down to 4.1% in 2023 in tandem with mildly rising unemployment and the stabilizing of the tourism sector.

2.2. Growth in the years before and after the pandemic were led by strong export growth. The service sector has been growing in a broad range of sectors, in particular tourism. Other industries have also been performing well, such as aluminium production and fisheries. Aquaculture and IP intensive industries have been developing fast and are expected to continue growing.

2.3. Due to geographical factors and the size of the population, Iceland is highly dependent on foreign trade. The export base has been growing and becoming more diverse. Even though tourism suffered through the COVID pandemic period, the economy was resilient overall. Domestic demand was robust and there was growth in exports of manufacturing goods and services other than tourism, e.g. computer services, scientific and technical services, and cultural and entertainment services.

2.4. Inflation was 7.7% in 2023, significantly over the Central Bank of Iceland's target of 2.5%. After a period of price stability before the pandemic, inflation rose sharply due to increased domestic demand and disruptions in the global supply chain and, consequently, unanchored inflation expectations. First, a surge in housing prices following swift interest rate cuts during the early months of the pandemic saw inflation rise rapidly, subsequently spreading to domestic services and retail. Inflation has been persistent, more so than in many advanced economies, constantly remaining above expectations and forecasts. Since late 2023, there were strong signs that economic growth was slowing down and evidence of inflation rates continuing to decrease. However, the path to the 2.5% inflation target may take more time.

2.5. As in many other countries, lowering productivity growth is one of the main challenges facing the Icelandic economy. Various measures have been implemented to mitigate this development, leading to a boost in high skill sectors, e.g. personal tax incentives for foreign specialists and company tax incentives for companies in R&D.

2.6. Private sector balance sheets are strong. Household debt is less than 80% of GDP and corporate indebtedness is similar. The debt level of the private sector has been stable since Iceland's last Trade Policy Review in 2017 and is now at a historical low. The private sector's strong balance sheets act as further macroeconomic buffer.

2.7. Iceland's renewable and reliable energy sources insulated the economy from the turmoil in international energy markets during the pandemic. The Icelandic economy benefited largely from having reliable energy sources while energy prices hit record highs at the beginning of 2022 following the Russian Federation's illegal invasion of Ukraine. Over 90% of the energy consumption in Iceland is renewable, mainly geothermal and hydroelectric.

2.8. Record population growth has been a key contributor to economic growth in Iceland since the pandemic. Immigration has increased rapidly, with the share of foreign citizens soaring to around 19% of Iceland's total population by the end of 2023. For perspective, the foreign population was only 2% in the mid-1990s. Most immigrants come from the EEA, Ukraine and Bolivarian Republic of Venezuela. Immigrants are mainly of working age and have led recent employment growth, helping to ease pressure on the country's welfare system due to an ageing population. Through a greater variety of skills and abilities, and enhanced demographic diversity, the economy has been reshaped by the steady influx of immigrants. Foreign labour constitutes 23% of all those employed in 2023, and over a half of those unemployed at the end of that same year. The inflationary environment after the pandemic has been reflected in a strong labour market, with a high employment. The registered unemployment rate was 3.8% in January 2024.

2.9. Immigration has had a significant impact on the economy through a variety of channels. Not only does immigration significantly boost the workforce and relieve some of the constraints associated with the native workforce's decline, as mentioned above, but it additionally boosts labour market flexibility and fills critical gaps in the labour market by substantially contributing to rapidly growing industries like construction and tourism. An expanding workforce is increasingly contributing to other sectors as well. However, the population growth has put strain on the housing market.

2.10. With the increased influx of foreigners, their integration has become more of a focus than before. Teaching Icelandic is a prerequisite for successful integration, and the emphasis has grown on increasing and facilitating access to that education with employers.

2.1 Public finance and monetary policy

2.11. The legal framework for public finance, monetary policy and financial stability has proven its worth in recent years. Responsible fiscal policy has led to a positive primary balance in 2022 after the fiscal shock during the COVID pandemic.

2.12. The fiscal plan for 2024–2028 assumes continually improving primary and overall balances. As such, the debt ratio as defined by the Public Finance Act of 2015, which is currently around 38% of GDP, is expected to decline.

2.13. There has been strong growth in R&D in recent years. Policy efforts to support knowledge and technology sectors with large growth potential is paying off with employment in knowledge-intensive sectors rapidly growing since 2017. Employment in R&D grew by 31% to 2022. Investment in research and development is approaching the European frontier.

2.2 Tax and customs reforms

2.14. During the time that has passed from the last report, the Government aimed to bolster the competitive position of Icelandic production, in particular *vis-à-vis* foreign competitors in export markets, and reform the tax system into what it considered to be a more equitable one, by e.g. modifying the taxation on wages and capital income to improve the living standards of the most disadvantaged. During that period, the Government made many further changes to the tax system. This included incentivizing the use of modes of travel emitting less carbon dioxide, as well as working to countervail tax avoidance and tax evasion. In the coming years, Iceland will take an active role in international cooperation against tax evasion and tax havens and supports OECD plans for an international minimum tax.

2.15. Changes to personal taxation since 2017 have been relatively moderate, although the number of income tax brackets were increased from two to three in the year 2020. This was the result of a comprehensive review of the income tax system aimed to reduce the tax burden, especially for low - and middle-income groups, with a new and lower base level.

2.16. The tax rate for capital income and capital gains increased from 20% to 22% in 2018, but concurrently the capital income tax exemption was increased for savings accounts, leaving most households unaffected. Moreover, in 2021 the income threshold was doubled, and amendments were made so that the threshold covered both dividends and capital gains on shares in listed companies.

2.17. Corporate income tax has stayed at 20% during the review period, whereas social security contributions paid by employers have continued to decrease during the period and now stand at 6.35% in 2023. The tax rate for entities with limited tax liability and certain legal entities, such as partnerships and limited partnerships, which considers both corporate income tax and personal capital gains tax, increased from 36% to 37.6% in 2018.

2.18. In 2017, a new support system came into force for first time homebuyers. It makes it permissible to withdraw and use a tax-free contribution for individual pension savings for up to 10 years for the purchase of a first apartment. In 2021 the tax exemption threshold for inheritance tax increased substantially, from ISK 1.5 million to ISK 5 million. Henceforth, it has been adjusted annually based on the development of the consumer price index. The tax rate remains unchanged at 10%. In 2020, one of the government's pandemic measures was to waive the accommodation tax of ISK 300 per overnight stay, which remained in force until the end of 2023. This year, the accommodation tax will be implemented again but at a higher rate and with a broadened tax base, with the levy extended to cruise ship operators with vessels staying within Iceland's customs territory.

2.19. During the years 2020–2023, tax subsidies, primarily regarding the VAT for electronic vehicles, were provided with the purpose of encouraging the use of environmentally friendly modes of transport, benefitting both households and businesses. A waiver on the purchases of bicycles was extended throughout 2024. From 2024 onwards, a direct subsidy will likewise be awarded from the Energy Fund, managed by the National Energy Authority, for the purchase of zero-emission vehicles. As regards taxes levied, two changes are noteworthy; one being the imposition of a green tax on fluorinated greenhouse gases, and the other being changes made to the taxation of road and fuel use, to counter the decrease in tax revenue stemming from those two factors. This amendment entailed the imposition of (i) a special 5% excise duty levied on new motor vehicles with registered carbon dioxide emissions, and (ii) another excise duty of equal rate levied on all new passenger cars powered by hydrogen or an electric motor altogether, including electric cars.

2.20. Additionally, a new distance-based charge per kilometre was introduced at the beginning of 2024 for electric, hydrogen and plug-in hybrid vehicles. This change was the first step in introducing a new vehicle and fuel revenue collection scheme that is intended to respond to a decrease in tax revenue from sales of fossil fuels and reflect actual use of the road network. The fee will be ISK 6/km for electric and hydrogen vehicles and ISK 2/km for plug-in hybrid vehicles. The second step is envisaged in 2025, extending the fee to the use of all vehicles using the road system, including diesel and petrol cars.

2.21. The objective of Act No. 152/2009, regarding support for innovation enterprises, is to strengthen research and development activity and to improve the competitive condition of innovation enterprises by providing them with the right to tax credits in respect of costs of innovation projects. With an amendment to the transitional provisions of the Act., first from 2020 and later in 2022, a special deduction from levied income tax was extended until the income year 2025 by 35% of the expenses incurred for these projects in the case of SMEs and 25% in the case of large enterprises, provided that these are deductible operating expenses according to the Income Tax Act. OECD's 2022 report, 'Evaluating the effects of the R&D tax credit in Iceland,' assessed the impact of tax credits for companies for research and development in Iceland. In general, the OECD report on the regulatory framework in support of innovative enterprises is positive and calls for the continued application of the segregated tax credits between SMEs and larger enterprises in R&D made with the amendment of the law in 2020 and the extension of 2022. The assumption is that tax credits for R&D will have greater impacts for SMEs than for larger enterprises.

2.22. In the year 2023, a working group was set up by the Minister of Finance and Economic Affairs tasked with examining the fiscal environment of energy production in a larger context. In January 2024, the group submitted a report to the Minister presenting, among other things, the possibility of a new tax framework and ways to ensure that benefits from energy resources are more widely passed on to local communities. One of the proposals was aimed at removing exemptions from property assessment value obligations for electric utility. The group furthermore suggested looking at future resource taxation.

2.3 Volcanic activity in the Reykjanes peninsula and Grindavik

2.23. Volcanic activity in the Reykjanes Peninsula has caused significant damages in the town of Grindavik, which has close to 4,000 inhabitants. The damages are, as of this writing, still under assessment and it is uncertain if and when Grindavik will be habitable again. Although this is a significant local shock for the economy in Grindavik, the macroeconomic consequences of the volcanic activity are minimal.

2.24. The Government has submitted a bill to Parliament proposing to offer eligible residents of Grindavik to sell their houses to a Government sponsored Special Purpose Vehicle (SPV). The cost of the measure is estimated to range between 0.5-1% of GDP and could turn out to be even lower, depending on volcanic activity near Grindavik and the town's habitability going forward.

2.4 State ownership

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

2.26. The entire holdings of Islandsbanki hf. (bank) were transferred to the state in 2016, as part of Glitnir Bank's stability contribution to the state in connection with the comprehensive capital account liberalization strategy. In the past few years, the Government has reduced its holdings in two phases, initially through a public offering in 2021 and then through an ABB process in March 2022. The aim is to sell the remaining 42.5% share in 2024 and 2025 in a fully marketed offering.

2.27. The Treasury also sold its 13% stake in Arion bank hf in 2018.

2.28. Approximately 98.2% of shares in the bank Landsbankinn hf. remain in the Treasury's ownership.

2.29. The Treasury bought 71% in Farice, the operator of the FARIC-1 submarine cable between Iceland and Scotland, in 2019 and now holds 100% of the shares.

2.30. The Treasury bought Auðkenni, security solutions in electronic communications, in 2021 and holds now 100% of the shares.

2.31. In late 2022, the Treasury bough 93% of the shares in Landsnet, operator of the electricity grid.

2.5 Gender equality in Iceland

2.32. Iceland continues to rank first in the World Economic Forum's Global Gender Gap Report from 2023. 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.

2.33. The present Government reiterates the importance of gender equality and equal rights in its platform from November 2021. The Parliament agreed on a new action plan in December 2019 for the period of 2019-23. The action plan introduces 24 projects to be implemented within the timeframe. A new action plan for 2024-2027 is being formulated. The Government has highlighted gender mainstreaming as a key method within the Governmental sector in accordance with the Gender Equality Act No 150/2020, which is overseen by the Prime Minister's Office. Gender budgeting has been practiced in Iceland since 2009 and been mandatory at state level since 2016 as

laid out in the Public Finance Act No 123/2015. To increase understanding of the current situation, gender analysis of government expenditure areas is conducted and updated annually.

2.34. 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 Prime Minister's Office in cooperation with various labour market stakeholders and Icelandic Standards, the national standards body. 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. In 2010, a law was passed that obligates companies with over 50 employees to have a minimum of 40% women or men on their boards. The unadjusted gender pay gap in Iceland has slowly been decreasing from 15% at the time of Iceland's last Trade Policy Review in 2017 to 9.1 % in 2022. Studies have shown that the gender pay gap varied greatly between occupational groups, with the biggest gap amongst technicians and associated professionals and lower among clerks. Gender segregated labour market is one of the main explanatory factors of unadjusted gender pay gap in Iceland.

2.6 Island.is

2.35. The Icelandic government operates Island.is, a central public information and service hub for government agencies in Iceland. It is a portal where Icelandic agencies provide information relevant for individuals and legal entities, both general information on an open website and data and information directed to individual natural and legal persons through their personal digital mailbox. The introduction of Island.is and the establishment of Digital Iceland, a unit within the Ministry of Finance and Economic Affairs which develops the portal, stems back to November 2017, when the Government announced the introduction of a single digital portal, where residents of Iceland should be able to access all public services in a single place. The Government furthermore agreed in May 2018 that by 2020, digital service should be the main channel for communication between the authorities (at both the national and the local level) and the general public and enterprises.

2.36. Island.is was launched in its current form in the autumn of 2020. A legal basis for this arrangement was established by Act No 105/2021, on a Digital Mailbox, which stipulates the operation of a digital mailbox in a centralized services portal of the government under the responsibility of the Minister of Finance and Economic Affairs. It states that individuals and legal entities shall have their own mailbox which they can access by electronic identification. The Act states that by no later than 1 January 2025, any kind of documentation from the national and local authorities to individuals and legal entities (for example announcements and decisions) shall be submitted via their mailbox.

2.37. Island.is serves as an excellent tool for the authorities to make public services more efficient and transparent and secure ways to communicate data to individuals and legal entities. Its content is constantly growing and improving as more and more government agencies move their content to the portal, which is constantly being developed. The agencies and service providers themselves are responsible for adding and maintaining content with support from Digital Iceland. The objective is to create a single portal where individuals and legal entities can seek data and services from all national and local authorities. The number of page views on the portal increased from 7 million in 2021 to 10.6 million in 2022 and 17.5 million in 2023.

2.38. Information provided on the portal includes for example the following:

- All regulations issued by the different ministries.
- Information for the general public (information on issues such as on tax-related matters, on rights and obligations vis-a vis the authorities, on how to establish companies, on immigration etc.).
- Information from public agencies (such as schools, organizations and institutions) regarding their services, including application and registration forms, where relevant.

- A personal digital mailbox for all individuals and legal entities, in which they receive documents from the authorities (such as notifications on tax- and other payments).

3 TRADE POLICY

3.1. Iceland's trade policy has consistently focused on creating the best possible conditions for Icelandic enterprises in foreign markets. It 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 prosperity largely to a well-functioning rules-based international trading system. Iceland advocates for rules designed to address modern day trade issues and increased liberalization of trade through global, regional and bilateral agreements. In recent years, Iceland has taken unilateral steps towards more free trade, i.e. by eliminating 90% of tariff lines for all but the most sensitive agricultural products.

3.1 WTO

3.2. The WTO remains at the core of Iceland's trade policy. Nearly all trade between countries is based on rules governed by the WTO. Iceland works actively with like-minded WTO members to support 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 is concerned with the lack of progress in the WTO's negotiation pillar since the launch of the Doha Round. Nevertheless, Iceland continues to actively engage in the WTO Agenda, including taking on leadership roles on mainstreaming gender and trade and Chairing the Phase II negotiations on disciplining harmful fisheries subsidies. Iceland is also engaged in a number of plurilateral efforts, including Joint Statement Initiatives on Domestic Regulation, E-Commerce, Investment Facilitation and MSMEs. Iceland has stepped up its efforts in fulfilling its WTO notification obligations in recent months. Further, Iceland has since the last TPR been active in advocating for gender mainstreaming in the work of the WTO and actively participated in establishing the Informal Working Group on Trade and Gender in 2021.

3.2 EFTA

3.4. Iceland negotiates, concludes and administers its free trade agreements mostly in association with its EFTA partners, Liechtenstein, Norway and Switzerland. Through Iceland's membership of EFTA, it has concluded 30 FTAs with 41 countries and territories outside the EU. Since 2017, new EFTA free trade agreements have entered into force with Georgia (2017), Ecuador (2020) and Indonesia (2021). Negotiations were also concluded with India (2024) and Republic of Moldova (2023). The EFTA States also modernized their FTA with Türkiye (2021) and recently concluded an update with Chile (2024).

3.5. The EFTA States are currently conducting free trade negotiations with Kosovo, Malaysia, Mercosur (Argentina, Brazil, Paraguay, and Uruguay), Thailand and Viet Nam. Furthermore, the EFTA States are currently conducting negotiations with Ukraine on the modernization of its existing free trade agreements and with Singapore on a Digital Trade Agreement.

3.3 EEA

3.6. Iceland is a party to the Agreement on the European Economic Area which entered into force in 1994. The Agreement brings together the 27 EU member states and the three EEA EFTA states (Iceland, Liechtenstein, and Norway) in a single market. It 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 30 EEA States. In addition, the Agreement covers cooperation in areas such as research and development, education, social policy, the environment, consumer protection, tourism and culture. It guarantees equal rights and obligations within the internal market for citizens and economic operators in the EEA.

3.7. The scope of the EEA Agreement does not include the EU Common Agricultural Policy or the EU Common Fisheries Policy but contains provisions on various aspects of trade in agricultural and

fish products. Furthermore, the EEA Agreement does not entail a customs union or a common trade policy towards third countries.

3.8. A key feature of the EEA Agreement is its dynamic character. Its common rules are continuously updated by incorporating new EU legislation. A number of EU legislative acts are thus incorporated into the Agreement by decisions of the EEA Joint Committee on a regular basis, and thereafter transposed into the EEA EFTA States' national legislation. The EEA EFTA States may seek adaptations to EU legislation in its application to the EFTA States when special circumstances call for it.

3.4 Bilateral agreements

3.9. Apart from EFTA free trade agreements, Iceland has also concluded bilateral free trade agreements. A comprehensive free trade agreement was signed between Iceland, Liechtenstein and Norway with the United Kingdom in 2021 following the UK's withdrawal from the EU and the EEA Agreement. 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 2018. In late 2023, Iceland and the EU concluded a new agreement on temporary tariff rate quotas for certain seafood products into the Union. Furthermore, Iceland has free trade agreements with China (2014), Greenland (1985) and the Faroe Islands (2006).

3.5 Gender and trade

3.10. Gender equality and women's empowerment has long been one a key element in Iceland's foreign and domestic policy. There is a strong evidence-based data that demonstrates how gender equality and women's economic empowerment can support and contribute to economic growth and this has been the experience in Iceland.

3.11. Iceland continues to advocate for gender equality and the economic empowerment of women within trade. Since Iceland's last TPR significant steps have been taken to advance this issue in Geneva.

3.12. As a member of the International Gender Champions initiative, Iceland played a leading role, along with Sierra Leone and the International Trade Centre in mobilizing support for the Buenos Aires Declaration on women's empowerment that was launched on the margins of MC11 in 2017. This Ministerial Declaration paved the way for the establishment of an Informal Working Group on Trade and Gender at the WTO in 2021, which Iceland co-chaired with Botswana and El Salvador until the summer of 2023.

3.13. WTO members' acknowledgement of the importance of advancing women's economic empowerment for the first time in the MC12 and MC13 outcome documents is a further step towards this goal.

3.14. Iceland will continue to advocate for gender-responsive trade policies and rulemaking to support women's economic empowerment and work with WTO Members in advancing gender and trade issues at the WTO, including encouraging the use of the Trade Policy Review mechanism to report on efforts on promoting gender sensitive trade policies at home.

3.15. As many other WTO Members, Iceland has within the scope of the EFTA Free Trade negotiations emphasized the importance of including gender provisions in FTAs.

3.6 Trade and environment

3.16. Environmental sustainability is an important component of Iceland's international trade policy. On the multilateral front, Iceland actively participates in the negotiations on fisheries subsidies at the WTO. Iceland does not provide any subsidies within the meaning of the SCM Agreement to its fisheries sector and imposes resource utilization levies on the fishing industry (USD 74 million in 2023). Iceland is the only country in the OECD database on Fisheries Support Estimates with a fishing industry that is a net-contributor to the state budget. Iceland has ratified the Agreement on Fisheries Subsidies and Iceland's Permanent Representative in Geneva has acted as Chair of the negotiations on the outstanding elements that need to be agreed on to conclude a comprehensive Fisheries Subsidies Agreement.

3.17. Iceland participates in all environmental related plurilateral initiatives at the WTO; the Trade and Environmental Sustainability Structured Discussions (TESSD), the Joint Ministerial Statements on Fossil Fuel Subsidy Reform (FFSR) and the Dialogue on Plastics Pollution and Environmentally Sustainable Plastics Trade (DPP).

3.18. Iceland is an active participant in the negotiations on an Agreement on Climate Change, Trade and Sustainability (ACCTS) which seeks to liberalize trade in environmental goods and services, develop binding disciplines to eliminate harmful fossil fuel subsidies, and develop best-practice guidance for voluntary eco-labelling schemes.

3.19. Iceland works with trade partners to develop comprehensive chapters on trade and sustainable development through its EFTA Free Trade Agreements. Iceland's approach to such chapters includes commitments to effectively implement multilateral environmental agreements (including the UNFCCC and the Paris Agreement), sustainable fisheries management, sustainable forest management, promotion of biological diversity and sustainable agriculture and food systems in addition to a consultation mechanism and a provision on a panel of experts.