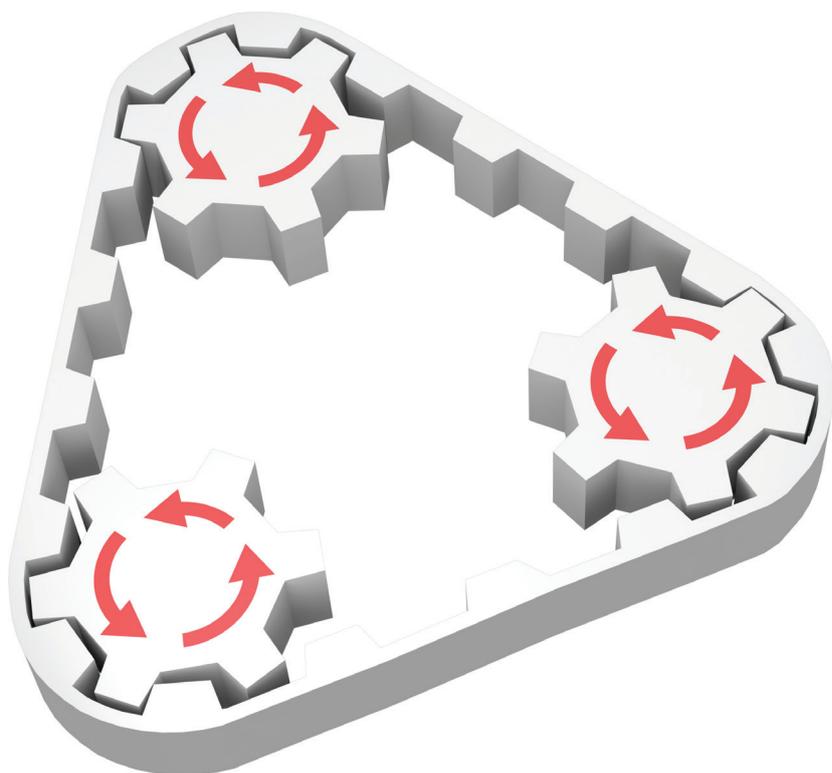


Katrín Ólafsdóttir and Stefán Ólafsson

Economy, Politics and Welfare in Iceland

Booms, busts and challenges



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NordMod 2030. Sub-report 4

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ISBN 978-82-324-0102-4

ISSN 0801-6143

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Preface

The Nordic countries share a number of distinguishing features. With their small economies, well-developed welfare states and organized labour markets, they have given rise to the concept of “the Nordic model”. This social model or models have occasionally been met with criticism: It has been claimed that they are characterized by over-inflated public sectors and excessive tax levels, as well as rigid labour markets caused by strong trade unions, comprehensive collective bargaining and regulations. In recent years the models have attracted positive global attention, since the Nordic countries have demonstrated good results in terms of growth, employment, gender equality, competitiveness, living conditions and egalitarianism when compared to other countries. This ability to combine efficiency and equality has spurred debate in politics as well as in social research.

The Nordic models are facing a host of new challenges, and cannot afford to rest on their laurels. The fallout from the financial crisis has entailed a stress test of Nordic institutions and traditional policy measures. External change in the form of increased global competition, climate problems, migration and European integration, interacting with internal change associated with an increasing, ageing and more diverse population, urbanization and rising expectations with regard to health services, education and welfare in general, will be a test of these models’ resilience. A core issue is whether the social actors will be able to encounter these challenges by renewing the institutions and policies without jeopardizing goals for a fair distribution, balanced growth, full employment and the political support for the models.

NordMod – Erosion or renewal in the Nordic countries 2014–2030?

NordMod2030 is a joint Nordic research project studying the impact that international and national development trends may have on the Nordic social models. The purpose of the project is to identify and discuss the risks and challenges that these countries will need to cope with in the years up to 2030. The project’s goal is thus to produce knowledge that can serve as a basis for designing strategies for reinforcing and renewing the Nordic social models.

The main report from the project will be submitted in November 2014. Until then, a number of sub-reports will be published and open seminars will be arranged in all the Nordic countries. The sub-reports will present specific analyses of selected topics, while the main report will incorporate all the findings and draw the main conclusions. All activities will be posted on the project’s website: www.nordmod2030.org.

- The first sub-reports describe the fundamental pillars of the Nordic models, challenges associated with future demographic change, changes in tax policies and how globalization affects the frameworks of the models. The goal is to analyse external and internal forces of change in the models.
- Country studies are undertaken in each of the five countries to describe development trends from 1990 to 2013. These country reports present analyses of changes in financial, social and political indicators associated with key objectives, institutions, policies and social outcomes in the national context. The country reports also provide input to the analysis of challenges facing the models in each of the countries.

- Finally, a series of thematic reports will be prepared on the basis of Nordic comparisons in the areas of integration, welfare state policies, the future of the collective bargaining model, climate challenges and democracy/participation. The discussion of issues related to gender equality will be integrated into all the reports.

Nordic research group

The research project will be undertaken by a Nordic research group consisting of two representatives from each country and is headed by Fafo. The paired researchers from the different countries will be responsible for the country studies, and will provide input to the design of the other country reports. Several researchers will also contribute to the other sub-reports.

Denmark: Lisbeth Pedersen (Research Director, SFI – The Danish National Centre for Social Research), Søren Kaj Andersen (Head of Centre, FAOS, Copenhagen University) and Christian Lyhne Ibsen (researcher, PhD, FAOS).

Finland: Olli Kangas (Professor, Director, Kela – The Social Insurance Institution of Finland) and Antti Saloniemi (Professor, University of Tampere).

Iceland: Katrín Ólafsdóttir (Assistant Professor, Reykjavik University) and Stefán Ólafsson (Professor, University of Iceland).

Norway: Jon M. Hippe (Managing Director, Fafo), Tone Fløtten (Managing Director, Fafo Institute for Labour and Social Research), Jon Erik Dølvik (Senior Researcher, Fafo), Bård Jordfald (Researcher, Fafo).

Sweden: Ingrid Esser (Assistant Professor, SOFI, Stockholm University) and Thomas Berglund (Associate Professor, University of Gothenburg).

In addition to this core group, other researchers will also contribute to some of the subreports: Richard B. Freeman (NBER, Harvard), Juhana Vartiainen (VATT), Jan Fagerberg (UiO), Line Eldring (Fafo), Anne Britt Djuve (Fafo), Anne Skevik Grødem (Fafo), Anna Hagen Tønder (Fafo), Johan Christensen (EU European University Institute (EUI), Florence), and others.

Project organization

The project has been commissioned by SAMAK – the cooperation forum for the Nordic trade union organizations and the Nordic social democratic parties. For the duration of the project period, SAMAK has also entered into a cooperation agreement with FEPS (Foundation for European Progressive Studies) concerning contributory funding. The commissioning agent (SAMAK) has appointed a reference group consisting of two resource persons from each of the Nordic countries. Although the reference group may provide input, the authors are solely responsible for the project reports. This means that SAMAK as an institution or the members of the reference group have no responsibility for the content of individual reports.

Oslo, April 2013
Jon M. Hippe
Project Director

Preface by the authors

This report is written by Katrín Ólafsdóttir, assistant professor at Reykjavík University and Stefán Ólafsson, professor at University of Iceland. The names of the authors appear in alphabetical order.

We would like to thank all our colleagues in the NordMod Research Group for their helpful comments and fruitful meetings throughout the project period. We also thank Margrét Björnsdóttir, Halldór Grönvold, Gylfi Arnbjörnsson and Árni Páll Árnason for helpful comments on the draft version of this report. The authors however bear full responsibility for the end product.

Abstract

Although firmly connected to the other Nordic nations by history, geography, politics and culture, Iceland exhibits some deviations from the Scandinavian model of work and welfare. Icelandic society has been described as having family resemblances to the other Nordic societies, but at the same time having special characteristics in some areas.

The biggest deviation from the Scandinavian model in the world of politics is the fact that the forces of social democracy have been less influential in Icelandic politics than in the other Nordic countries. This is important since politics is an important shaper of the welfare state and the labour market regime in most Western societies. The left parties have, however, at times gained a key position in coalition governments and thus often managed to bargain for major reforms that they prioritized. Hence, their importance may have been greater than the sole figures on voter support and governmental participation suggest.

On the whole, Iceland and the other Nordic societies have more in common in the labour market than in politics. The main characteristics of the Icelandic labour market are a high level of union density, high labour force participation rate, long work hours, as well as late retirement. The Icelandic labour movement has a high level of organization and also a high level of centralization in confederations, with great capacity for cooperation and coordination. The existence of large umbrella organizations for both workers and employers in the private labour market has made nationwide labour bargains possible, typically with the active participation of the central government. In most cases collective bargaining takes place between the Icelandic Confederation of Labour (ASÍ) and the SA – Business Iceland (SA). Bargaining rights however reside in individual unions. This commonality and the potential strength of the Icelandic labour union movement have been influential in shaping the society in Iceland.

Similar to those of the other Nordic countries and unlike those of many European countries, Icelandic law stipulates few rights concerning the labour market. Iceland's membership of the European Economic Area has, however, paved the way for some regulatory reforms emanating from the EU. But on the whole the protection of employees in the Icelandic labour market is to a great extent regulated through collective bargaining.

While Iceland was a welfare laggard in the Nordic community twenty years ago, it has caught up with the other Nordic nations to some extent. The main explanation for Iceland's increased welfare expenditure rate is increased payments from the occupational pension funds (OPFs) as well as an increased level of health expenditures and family-related expenditures, primarily on subsidies for pre-school and for parental leave. Child benefit expenditures however declined significantly from 1990 to 2008 as did tax credit for interest costs of mortgages. Iceland continued to have low expenditures on unemployment benefits up to the crisis, as the unemployment rate was low.

On the whole, the Icelandic welfare state is quite service intensive, while it has been more modest as regards benefit payments. Despite the trend towards convergence of welfare expenditures approaching the other Nordic nations, this characteristic remained up to the crisis. During the crisis years this changed. Public expenditures on education and health care were significantly cut, due to the difficult state of government finances, at the same time as transfers to households were increased.

The policy of the left-wing government that came to power in early 2009 was to soften the crisis consequences for the lower income groups and balance the budget by a mixture of tax increases and expenditure cuts. Public welfare expenditures were targeted towards the lower and middle-income groups. Hence, expenditures on transfers to households have in fact been raised, mostly on unemployment benefits and household debt relief, but also on minimum pension guarantees and social assistance.

This meant that the real earnings loss of the lower income groups was less extensive than that of the higher income groups. The labour movement also influenced the policy reactions of the government during the crisis and managed to shape favourable developments in the labour market through collective bargaining, such as on issues of unemployment and labour market measures, as well as raising the minimum wages.

The income distribution became more unequal from 1995, with growing speed from 2002 onwards. The inequality trend was closely associated with growing financial income associated with the asset bubble, while taxation and benefits policy also had its share of influence on the inequality development. While income inequality increased more in the Nordic countries than in other OECD countries from 1995 to the late 2000s, Iceland surpassed the other Nordic countries during the bubble economy period.

One of the political challenges facing Iceland concerns the loss of trust in politics, political parties and the parliament, especially after the financial collapse. Polarization was also a part of the developments in party politics, particularly during the reign of the left-wing government from 2009 to 2013. The opposition fought more fiercely against the government than seen in recent decades. Hence, political discourse and deep conflicts have not facilitated any improvement in trust in the main actors and institutions of Icelandic politics. Therefore, it is an important task to regain a collaborative spirit and positive cooperation in politics in Iceland.

The main economic challenges before the crisis were related to improving productivity, innovation and diversification of the economy and improving living standards. These clearly remain, but the financial collapse leaves Iceland with new major challenges that will take years to unwind, the most important of which are debt-related problems.

One of the most consequential effects of the financial crisis is the high level of debt that remains. Government debt is at its highest level since the establishment of the Republic in 1944. Business debt is also at a very high level, as well as household debt. The central government is

now run close to a balance and the public debt level is not expected to rise further, but greater effort is needed in order to lower public debt. A large part of the debt accumulated by business has been written off in recent years, but many organizations are still highly indebted, which will reduce their growth opportunities in the near future. Although many of the government policies implemented in recent years aimed at primarily aiding households having difficulties in servicing their debt, household debt levels are still high. The latest measures announced by the current government are general measures aimed at reducing household debt levels further.

High living standards in Iceland have been achieved in past decades through high volumes of work and before the crisis this was aided by the overvalued currency. As a consequence of the collapse of the Icelandic króna in 2008 and 2009, real disposable earnings of households fell by almost 20%. Lower wages, along with shorter work hours and increased unemployment, as well as the higher debt burden, were the main aspects of the cuts in living standards that the crisis inflicted on households.

Iceland's per capita labour productivity is comparable to that of other Western countries. This, however, is only achieved through a high labour force participation rate and long work hours. If labour force participation rates and the number of work hours were similar to that of the other Nordic countries and the UK, then Iceland's production would be almost a quarter lower than it is currently. It is therefore of utmost importance to improve productivity to ensure better living conditions.

The capital controls that were put in place in late 2008 were initially intended as a temporary measure to reduce the outflow of foreign currency and prevent a further fall in the exchange rate of the króna. However, they are still in place in 2014, and the cost of capital controls tends to go up with time. Thus, one of the most pressing macroeconomic issue facing Iceland today is lifting the controls, while at the same time preserving the delicate recovery of the Icelandic economy.

In order to increase the diversity of the export sector and to enjoy an improved competitive position, Iceland should widen its horizon and look for future growth in areas other than natural resources, especially where there are less limits on quantity in production. Human capital and the knowledge economy should feature more as developmental goals.

In the wake of the recession that began in 2008, the parliament decided to apply for membership of the European Union. The government that came into office in 2013 decided to bring the negotiations to a halt. Thus, the future of Iceland in the European arena is uncertain.

1. The Icelandic political model

1.1 Introduction

The Nordic Model of work and welfare can be generally characterized by a high degree of interest group organization in the labour market, with wide-ranging bargaining and cooperation/consultation, combining flexibility and security and a coordinated wage policy. In the area of welfare there is extensive provision or guarantee of minimum income, welfare services (health and education) and active labour market policies. All are coordinated with the government's macroeconomic and industrial policies. Ideally, the labour market and the welfare provision should be coordinated and work in the same direction. To succeed in that goal there is a need for strong cooperative actors in both the area of politics as well as in the labour market (Dölvik 2013; Esping-Andersen 1990 and 1999).

Having been firmly connected to the other Nordic nations by history, geography, politics and culture, Iceland shares some important features of the Nordic Model of work and welfare. But at the same time it has exhibited some deviations from the common model. Thus Icelandic society has been described as having family resemblances to the other Nordic societies, but at the same time having special characteristics in certain areas (Ólafsson 1999).

It can, of course, be said of any one of the Nordic societies that they share common features of the worlds of politics and work and at the same time have some deviations from the common patterns (Ólafsson 1999; Baldwin 1989; Alestalo et al. 2009), as there are certainly some variations within the Nordic Model. We would, however, argue that this is more pronounced in the case of Iceland. The reason is not least due to long-term differences in the distribution of political power and influence.

The most significant deviation in the world of politics is the fact that the forces of social democracy have not been as influential in Icelandic politics as in the other Nordic countries. This is of importance in so far as politics is an important shaper of the welfare state and the labour market regime in most Western societies. However, it should be underlined that politics is not the sole determinant of structures and outcomes in the worlds of work and welfare.

On the whole there are more commonalities between Iceland and the other Nordic societies in the labour market than there are in the world of politics. That is important since the Nordic nations have probably the most influential labour movements in the world – a characteristic they all share. This raises the question of relative importance of political and labour market shapers of the welfare state, well-being and work. To what extent can Iceland's deviations in areas of work and welfare be traced to political or labour market influences?

Looking first at politics, one can describe Icelandic politics of the post-war period as having to a great extent been shaped by the right-of-centre Independence Party (IP). That party generally has had the greatest voting support and has most often been the leading party in coalition governments during the period. In a way the IP has had the role in Icelandic politics that social democratic parties have had in the Scandinavian countries (that is perhaps less applicable to Finland than to Sweden, Norway and Denmark). The Icelandic left has typically been more divided and the Icelandic equivalent to the predominant Scandinavian social democratic parties has typically been rather small and less predominant as a governing party than its sister parties of Scandinavia (Harðarson 1995; Ólafsson 1999).

While social democratic parties and the labour movement emerged as a joint force early in the modernization transition, in Iceland as well as in the other Nordic countries, the path of history led these forces apart to some extent (Korpi 1983; Christiansen et al. 2006; Ísleifsson 2013). During the post-World War II period they have thus existed as separate organizations for the most part, in fact more so in Iceland than in the other countries.

Thus, while Iceland deviates from the Scandinavian model in its underlying political foundation, there are more commonalities in the labour market, as regards its institutional structure. The Icelandic labour union movement has in recent years had the highest membership level among the Nordic countries, and hence in the world. The organizational features of the Icelandic unions are also in line with that of the other Nordic nations, with an Icelandic equivalent to the LOs (ASÍ) and other main federations amongst private as well as public sector unions. The Icelandic labour movement thus has a high level of organization and also a high level of centralization in confederations, with great capacity for cooperation and coordination. Bargaining rights however reside in individual unions (Ólafsdóttir 2010; Ísleifsson 2013). This commonality and the potential strength of the Icelandic labour union movement have been influential for the shaping of the society in Iceland.

The political exceptionalism in Iceland has had consequences for the society, especially in the fields of welfare and work. Thus Iceland was a laggard when the Scandinavian nations expanded the welfare state rapidly from the 1960s onwards. The Icelandic welfare state has also been described as something of a hybrid model, sharing some commonalities with the Anglo-Saxon model in the area of benefits (rather low welfare benefits and high level of income-testing in the public social security system), while in the area of welfare services there are clearly more commonalities with the other Nordic nations (Ólafsson 1999).

Still, Iceland has not been isolated from the other Nordic societies in any way. In fact the Scandinavian societies have frequently served as models for policy initiatives and benchmarks for comparisons for Icelanders, not least the labour unions, which at times have had the bargaining power to implement Scandinavian-type policies. In recent decades the Icelandic welfare model and the Scandinavian models have converged in terms of welfare expenditures and benefits, i.e. in the areas where previously the deviations were most marked (Eydal and

Ólafsson 2012). Still, the Icelanders have the lowest level of welfare generosity, but only marginally.

As regards welfare outcomes and general levels of living characteristics, there are also commonalities and differences. On the whole, Iceland can be described as sharing a similar level of living standards as the other Nordic nations from the early 1980s (Ólafsson 1990 and 1999; Eydal and Ólafsson 2012). Icelanders have generally enjoyed a less generous public welfare provision, lower pay and thus they have had to rely to a greater extent on their own effort and self-reliance. This has been reflected in higher labour force participation rates and longer weekly working hours, along with lower taxes on labour income. Iceland has been more of a work society with less public welfare provisions. These different characteristics of the well-being environment have remained to some extent to the present, despite a general process of convergence in the last two decades, not least due to the effects of the expanding occupational pension funds.

Another element of difference that should be taken into account is the exceptionally small size of the population in Iceland (about 325.000). The small scale does not free Iceland from having the main institutional architecture that a modern affluent society requires. Hence, resources for common tasks may be small in absolute numbers, even though relative proportions may be similar. The small scale of the society makes for more transparency and better connections between grassroots and top levels of the governance system. This may provide good conditions for voices from below to be heard in higher places, while at the same time increasing the danger of cronyism.

A modest level of class divisions in an egalitarian society has for the most part prevailed in the post-war decades in Iceland, except for the last decade before the financial crisis, when income inequality increased greatly. A high level of social trust and a strong fabric of social relations in an egalitarian society should in fact provide favourable conditions for the workings of democracy. That is a feature that characterizes all the Nordic societies to a great extent, in comparison to other modern societies.

On the whole, Iceland was more regulated or statist in its political economy than the other Nordic societies, in the early part of the post-war period. It was less open to the international market, with tighter controls of international trade and of prices in the domestic economy. This statism began to change gradually from the early 1960s onwards, culminating in a very high level of globalization and liberalization from the 1990s onwards – reaching its zenith during the 2000s.

The industrial structure of the Icelandic economy differs significantly from the other Nordic economies. Iceland has historically relied on fisheries as the main export industry, while energy-intensive industry and tourism have grown in recent decades. During the last decades of the

20th century and in the first decade of the 2000s, financial services expanded greatly, along with software production.

Following a period of strong economic growth in the early 2000s and an extensive financial bubble, the Icelandic economy suffered a severe recession starting late in 2008, as the financial crisis hit countries across the globe. In one week, the bulk of Iceland's financial sector crashed, with a concurring fall in the exchange rate of the Icelandic króna. GDP contracted by almost 10% over two years from 2008-2010, and unemployment rose to levels Iceland has not experienced before. This was primarily a financial shock to the economy that left the infrastructure largely intact, but the cost of the financial collapse and the following recession has been large for the Icelandic society. This leaves many challenges to be dealt with in coming years, such as a high debt level and a loss of trust in politics and key institutions.

In the following section, we look more closely at the political developments in Iceland in context, outlining Iceland's deviation within the Nordic political community. Then we profile Iceland's economic development in the post-war period and through the crisis, before analysing the Icelandic labour market model. After that we focus on various issues of welfare, before identifying the main challenges facing Icelandic society in coming years in the last chapter.

Table 1.1: Iceland

Governance	Presidential democracy
President	Ólafur Ragnar Grímsson
Prime Minister	Sigmundur Davíð Gunnlaugsson (Progressive Party)
Independence	1944 (Self-rule from 1918)
National Anthem	Ó guð vors lands
Population (jan. 2014)	325 671
Employed (jan. 2014)	169 000
Unemployed (jan. 2014)	5.3%
Language	Icelandic
Currency	Icelandic krónur (ISK)
GDP per capita (2013)	5 751 000 ISK
Elections	Last election 2013. Elections every four years.
Parties in parliament (2013)	Government: Progressive Party and Independence Party. Opposition: Social Democratic Alliance, Left-Green Movement, Bright Future and Pirates.
EU-membership	Member of the European Economic Area since 1994. Application country since 2009.
Main union organizations	Alþýðusamband Íslands (ASÍ), Bandalag starfsmanna ríkis og bæja (BSRB), Kennarasamband Íslands (KÍ), Bandalag háskólamanna (BHM).
Main employment organizations	Samtök atvinnulífsins (SA), Félag atvinnurekenda.
Union Organization (2008)	86.4%

1.2 Politics and power constellations

We indicated at the beginning of this chapter that Iceland has had stronger political forces on the right wing, than the other Nordic nations. Thus, the normal leading parties of Icelandic governments have been right or centre parties, while left wing parties, especially the SDPs, have figured more prominently in the other Nordic countries.

In table 1.2 we show the distribution of the vote and parliamentary seats from 1963 to 2013. The table shows the fragmentation of Icelandic politics, especially on the left wing (the top 8 lines in the table). The election of 1999 produced the biggest change on the left, with a fundamental reshuffling of the parties. This involved the emergence of the Social Democratic Alliance (*Samfylkingin*) and the Left-Green Movement (*Vinstri-græn*), two new parties that emerged out of the old Socialist Party (*Alþýðubandalagið*), the old Social Democratic Party (*Alþýðuflokkurinn*), the Women’s List (*Kvennalistinn*) and the People’s Movement (*Þjóðvaki*).

Given the long history of splits amongst politicians on the left, the emergence of the SD Alliance in 1999 was an historical turning point. The electoral support also reached higher levels than seen before. The SD Alliance and Left-Green government that came to power in 2009, after the former government had been driven from power by the “Pots and Pans Revolution” following the financial collapse, was in fact the first two party centre-left government in the history of the Icelandic republic, since 1944. The fact that such governments were the most frequent governments in the Scandinavian countries from the 1930s onwards shows the political exceptionalism of Iceland among the Nordic countries.

Table 1.2: Votes and parliamentary seats by political parties, from 1963 to 2013

Votes (%):	1963	1967	1971	1974	1978	1979	1983	1987	1991	1995	1999	2003	2007	2009	2013
Socialist Party (SP)	16	17.6	17.1	18.3	22.9	19.7	17.3	13.3	14.4	14.3	.	.	.	.	.
Left-Green Movement (LG)	.	.	.	.	.	.	.	.	.	.	9.1	8.8	14.3	21.7	10.9
Social Democrats (old SDP)	14.2	15.7	10.5	9.1	22	17.4	11.7	15.2	15.5	11.4	.	.	.	.	.
Left and Liberal Alliance (LLA)	.	.	8.9	4.6	.	.	.	.	.	.	.	.	.	.	.
Federation of Social Democrats	.	.	.	.	.	.	7.3	0.2	.	.	.	.	.	.	.
Peoples Movement (Þjóðvaki)	.	.	.	.	.	.	.	.	.	7.2	.	.	.	.	.
Womens List	.	.	.	.	.	.	5.5	10.1	8.3	4.9	.	.	.	.	.
Alliance of Social Democrats (new SDP)	.	.	.	.	.	.	.	.	.	.	26.8	31	26.8	29.8	12.9
Progressive Party (old Farmers' P.-PP)	28.2	28.1	25.3	24.9	16.9	24.9	19	18.9	18.9	23.3	18.4	17.7	11.7	14.8	24.4
Independence Party (IP)	41.4	37.5	36.2	42.7	32.7	35.4	38.7	27.2	38.6	37.1	40.7	33.7	36.6	23.7	26.7
Citizens Party (split from IP)	.	.	.	.	.	.	.	10.9	.	.	.	.	.	.	.
Liberal Party (LP)	.	.	.	.	.	.	.	.	.	.	4.2	7.4	7.3	2.2	.
Citizens Movement (CM)	.	.	.	.	.	.	.	.	.	.	.	.	.	7.2	.
Pirates	.	.	.	.	.	.	.	.	.	.	.	.	.	.	5.1
Bright Future	.	.	.	.	.	.	.	.	.	.	.	.	.	.	8.3
Others	0.2	1.1	2	0.4	5.5	2.5	0.5	4.1	4.3	1.9	0.8	1.4	3.3	0.6	11.8
Parliamentary Seats:															
Socialist Party (SP)	9	10	10	11	14	11	10	8	9	9	.	.	.	.	.
Left-Green Movement (LG)	.	.	.	.	.	.	.	.	.	.	6	5	9	14	9
Social Democrats (old SDP)	8	9	6	5	14	10	6	10	10	7	.	.	.	.	.
Left and Liberal Alliance (LLA)	.	.	5	2	.	.	.	.	.	.	.	.	.	.	.
Federation of Social Democrats	.	.	.	.	.	.	4	0	.	.	.	.	.	.	.
Peoples Movement (Þjóðvaki)	.	.	.	.	.	.	.	.	.	4	.	.	.	.	.
Womens List	.	.	.	.	.	.	3	6	5	3	.	.	.	.	.
Alliance of Social Democrats (new SDP)	.	.	.	.	.	.	.	.	.	.	17	20	18	20	9
Progressive Party (old Farmers' P.-PP)	19	18	17	17	12	17	14	13	13	15	12	12	7	9	19
Independence Party (IP)	24	23	22	25	20	21	23	18	26	25	26	22	25	16	19
Citizens Party (split from IP)	.	.	.	.	.	.	.	7	.	.	.	.	.	.	.
Liberal Party (LP)	.	.	.	.	.	.	.	.	.	.	2	4	4	.	.
Citizens Movement (CM)	.	.	.	.	.	.	.	.	.	.	.	.	.	4	.
Others	0	0	0	0	0	1	0	1	0	0	0	0	0	0	9

Source: Statistics Iceland.

On the right wing, the Independence Party (*Sjálfstæðisflokkurinn*) has had the greatest support and splits on the right wing have been fewer with less consequences. The main splits on the right-

wing in recent decades were the foundation of the Citizen's Party (*Borgaraflokkurinn*) in 1987, which was primarily a personal affair within the Independence Party (IP). The Liberal Party (*Friðlýndi flokkurinn*) emerged in 1999 around issues relating to the controversial fisheries quota system that had been implemented in 1984, with fishing quotas becoming tradable on the market around 1990. The quotas were initially distributed without charge, based on the fishing experience in the three years before 1984. This became very controversial. These moves were by many, both on the left and right, seen as symbolic for increasing neoliberal influences in conjunction with crony capitalist proceedings. The Liberal Party struggled against these characteristics of the fishing quota system.

The election of 2009 was another major turning point in Icelandic politics, producing for the first time a Scandinavian-type leftist government, coalition government of the Social Democratic Alliance and the Left-Green Movement. It, however, came to power in an exceptionally difficult situation following the financial collapse, and thus it had a limited chance to stabilize its newfound position. Many voters had a lot to complain about, as the crisis led to a drastic cut in living standards, including a much higher household debt burden and unprecedented levels of unemployment, along with a severe deterioration of the government financial situation, which forced expenditure cuts and tax rate increases. The government was also haunted by internal feuds, with a number of left-wing parliamentarians turning against the government, in a situation where some unpopular decisions had to be taken. Relations with the labour unions became tense at the same time, making the situation even harder for the government. Other issues added to the difficulties, such as the Icesave issue and the establishment of a new political party on the centre-left wing in 2012 (Bright Future), which took sizable support from the Social Democratic Alliance in the election of 2013.

The Icesave issue became one of the largest political issues in the aftermath of the financial crisis. It ignited high emotions inside and outside Iceland, with the result of damaging political relations and in some sense dividing the country.

Late in 2006, Landsbanki started offering the Icesave deposit accounts in England and later in the Netherlands. The Icesave accounts were internet based and thus easy to transfer deposits in and out of the accounts. When Landsbanki was put into administration in the fall of 2008, deposits in Icelandic branches were transferred into the New Landsbanki, while Icesave depositors in the UK and the Netherlands were left outside the ringfence, with only claims to deposit insurance. The Icesave accounts were located in branches of Landsbanki and thus, the Icelandic deposit insurance fund was responsible for covering the deposit insurance. That fund contained only a small fraction of the insured deposits and was unable to pay out the insured amounts to depositors. Authorities in the UK and the Netherlands, however, covered the guaranteed portion of the Icesave deposits, including the amount guaranteed by the Icelandic deposit insurance fund.

Iceland negotiated deals with both the UK and the Netherlands to repay the debt, but twice the deals were rejected in a referendum, where they were sent by the President of Iceland. A case was subsequently brought against Iceland before the EFTA court, which ruled in Iceland's favour in early 2013 (Baldursson and Portes 2013).

The left wing government held office until the end of the term, but lost popularity in the last couple of years. Generous offers of across-the-board cuts in household debt, by the PP and IP in 2013 also proved popular amongst the electorate, which in turn led to a big transfer of voters from the SD Alliance and the Left-Greens. Emergence of unusually many new small parties, both on the left and in the centre, also took their toll in the election of 2013. Following the election, a majority government of the Progressive Party and the Independence Party took office, the same parties that were in government from 1995 to 2007.

1.3 Analysing voter blocks and patterns of possible alliances

These political developments can be better visualized in figure 1.1 through 1.3, which show the development of the major blocks of Icelandic politics: the left, the centre and the right. This presentation facilitates interpretations of voter behaviour in Iceland, as well as laying a better ground for assessing prognoses for future developments.

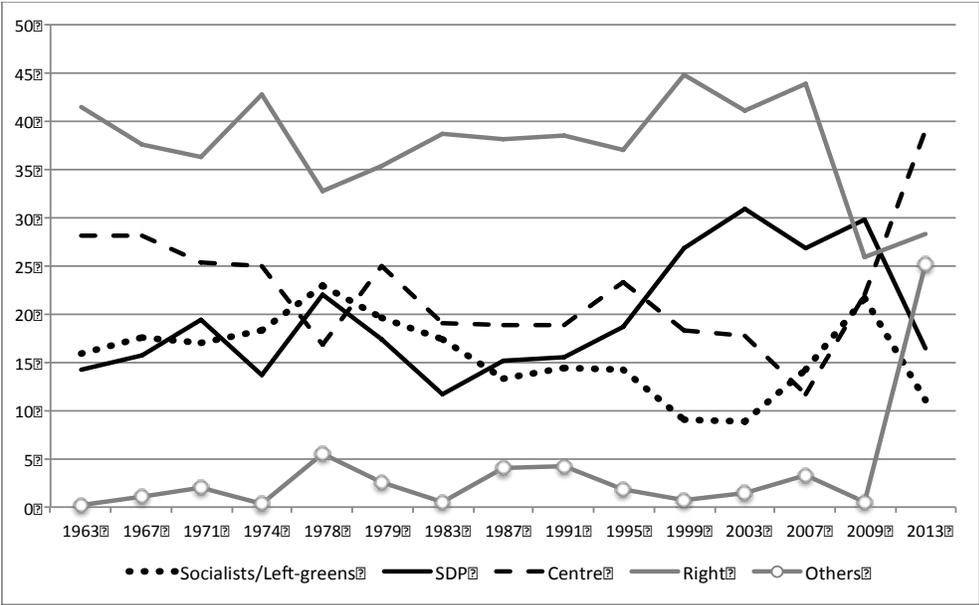


Figure 1.1: Main political divisions in parliament: Left, Centre and Right block votes, 1963-2013. Version I: SDP and L-G separate.

Source: Statistics Iceland (own calculation).

Figure 1.1 shows the dominant position that the right wing has had in Icelandic politics (the line mainly represents the support of the IP, but in 1987 there was a split in the party that brought the support of the IP down by some 11 percentage points. As it remained a right wing support it is included here). In fact it is only the SDPs that have held a similar position in the Scandinavian countries that the IP has had in Iceland.

The primary centre party (the PP) had for decades been the second largest party in Iceland and a frequent participant in coalitions, both towards the right (with the IP) and towards the left (with the SDP and socialists). The party had been on a downward slide from 1993 to a low in 2007. This downward slide was forcefully reversed in the election of 2013, which was a watershed in many ways, following the big shift towards the left in the election of 2009.

Figure 1.1 also shows clearly the broad swings in 2009 and 2013. The 2009 swing was a forceful swing towards the left, while the swing of 2013 was from the left to the centre. The Independence Party saw an all-time low in support in 2009, as many blamed the party for the emergence of the bubble economy and the collapse. The party only gained a little in 2013, remaining at its second weakest support level in its history.

From its founding in 1999, the SD Alliance seemed to have gained a new high ground for social democracy in Iceland, thus changing the basic structure of party politics in the country. However, this newfound strength proved to be volatile, as the outcome of the election of 2013 shows, when it lost more than a half of its support. But the crisis situation of these last five years is an unusual situation and political currents may be more modest and resistant to change once the effects of the crisis wear off. The loss of trust in politics and politicians may however work against that, as well as the effects of globalization.

Although the Left-Green support fell by about a half in 2013, its longer-term level is expected to be in the region of 10-15%, which is large for a formerly socialist party. That outcome reflects the more pragmatic approach of the Left-Greens and perhaps some weakness of the SDPs, as they should be able to draw more support away from L-G. Currently, the biggest challenge for the SD Alliance is the competition with the PP and now with Bright Future (BF), which to some extent address the same electorate as the SD Alliance, the centre-left. One of the lessons of the crisis is that responsiveness to the demands of the voters, even though they may seem unrealistic, is of major importance for support, especially when the public feel that their living standards are threatened or in an inadequate state.

The last finding in figure 1.1 is the fact that many new parties emerged in the election of 2013, reflecting the continued disillusion of voters. Altogether new parties received about 25% of the vote, with the centrist Bright Future getting 8.3% and Pirates 5.1%. The rest was split between nine micro parties.

In figure 1.2 we have grouped the voters of 2013 further into three blocks, by allocating all the parties in the “Others” category to the Left-Centre-Right blocks, except Pirates who remain

separate as “Others”. This figure gives a better picture of the real strength of the left in Icelandic politics, by putting together the SD Alliance and the Left-Greens and their predecessors, in the longer-term context.

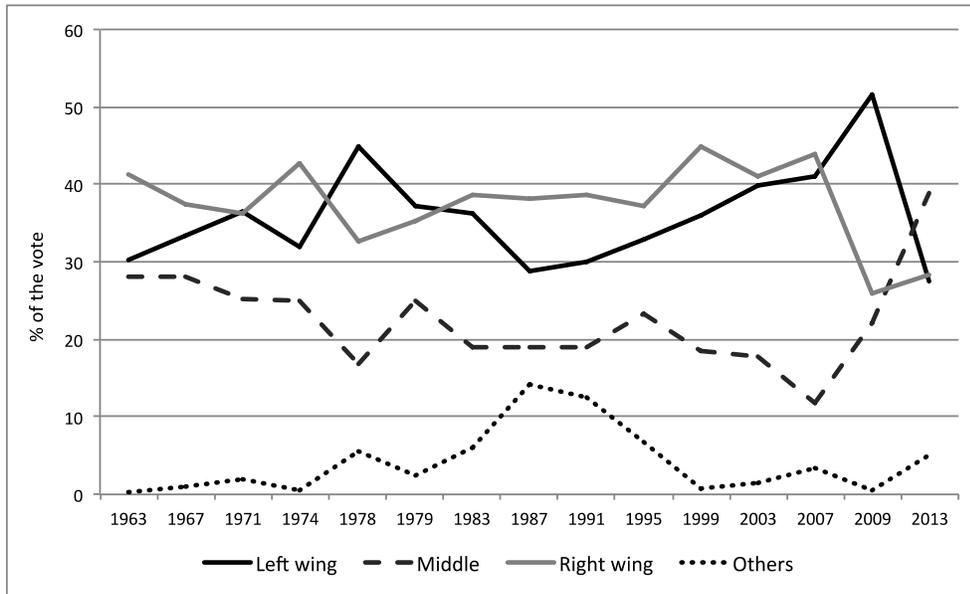


Figure 1.2: Main political divisions in parliament: Left, Centre and Right block votes, 1963-2013
Version II: SDP and L-G together as Left-wing.

NB: Most of minor parties (previously categorized as “Others” in 2013) are here allocated to L-C-R categories, except Pirates who received 5.1%. Source: Statistics Iceland (own calculation).

The bulge in the “Others” category between 1983 and 1995 mainly represents the Women’s List, which joined the Social Democratic Alliance in 1999. Looked at in this way, the indication is that on the whole the left and centre would have been the dominant political force in Iceland if the left wing parties had been able to join forces. The right wing consists mainly of the IP and its short-term splinter parties. Had the Women’s List sooner joined forces with the centre-left, the left with that addition would have been larger than the IP.

Much has always depended on whether the centrist PP favoured cooperation towards the right or the left. More often they have favoured working with the IP. These two parties remained together in government consecutively from 1995 to 2007, pursuing considerable neoliberal policies, associated with the bubble economy that eventually burst in the autumn of 2008. If the PP had favoured working with the SDP and related parties more often, such a Centre-Left coalition could have been in majority a number of times in the last decades.

With the PP preferring IP as coalition partner, the two have regularly formed a government in the last decades. However, figure 1.3 shows that their overall electoral support has fallen since the early 1960s. That coincides with a gradual gain of the left block (represented by the SD Alliance and the L-G). These long-term trends could perhaps indicate the possibility of further fundamental changes in Icelandic politics, with the left wing gaining somewhat at the cost of the

centre-right wing. But the high propensity for splits on the left may stand in the way. Alternatively these trends could also indicate more room for new parties.

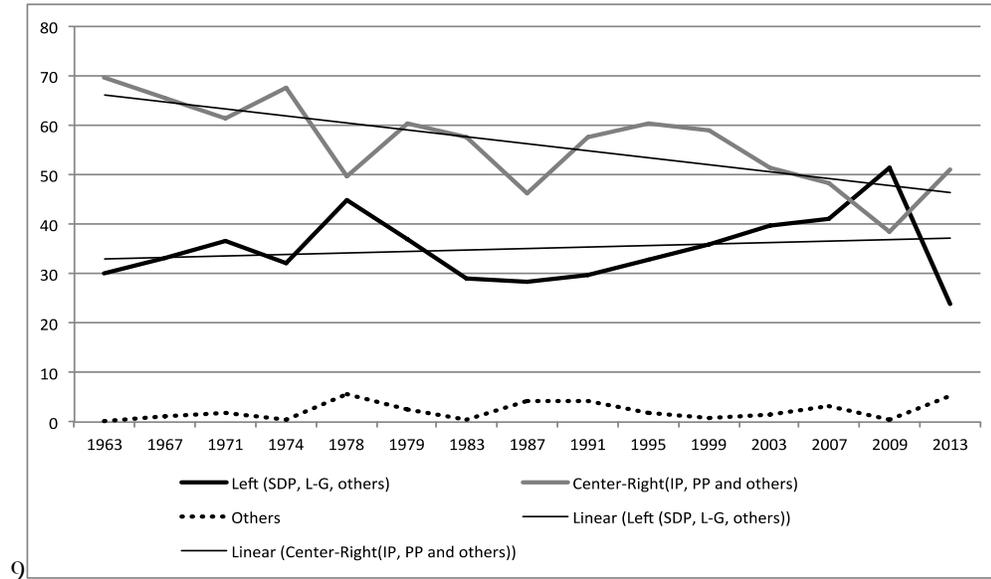


Figure 1.3: Main power divisions in parliament: Left and Centre-Right block votes, 1963-2013
Version III: IP and PP together as Centre-Right; SDP and L-G together as Left.

Source: Statistics Iceland (own calculation).

Thus, the position of the left in Icelandic politics improved until 2009, not least due to the emergence of the SD Alliance, which also attracted considerable support from centrist voters, and a more pragmatic welfare orientation of the Left-Green Movement. However, the negative outcome of the election of 2013 is a major blow to that position, both the loss of support for the two major left parties, as well as the emergence of many new minor parties. The prospect for the left parties, as well as indeed for all parties, remains vulnerable and undecided at present. Loss of trust in politics following the financial crash may play itself out over a long-term period, with unforeseen consequences.

The stronghold of the left in Scandinavian and Finnish politics has on the other hand weakened in the last decades and recently with some blue-collar support flowing from the SDPs to nationalistic populist parties, emphasising resistance to further immigration, but also generally supporting welfare and redistributive policies of the traditional SDP genre (see for example Kangas and Saloniemi 2013). This development is perhaps not as pronounced in Iceland as in the other countries, but such factors may have been of importance for strengthening the position of the PP in the last election. They seemed to have gained a significant blue-collar vote and they also strongly oppose Iceland’s membership of the EU.

1.4 Analysing power blocks in Icelandic politics

Voter support is only one aspect that can explain strength and influence of political parties. Therefore, one must also look to other means of power and resources, which both can explain differential support of individual parties as well as explain policy and interest orientations of the main parties. In figure 1.4 we profile the power resources of the main political parties and relate them to spheres of influence in the society. This provides a more comprehensive assessment of power distribution and the build-up of power constellations in the Icelandic political-economy environment.

From independence in 1944 to the present day, the right-of-centre Independence Party (IP) has been closely associated with the employers' federations in the private sector, as well as with the most influential private newspapers and other media. In that sense the IP was primarily a party of employers and private business, while at the same time claiming to be a party of all classes, aiming for worker support as well. This emphasis was exemplified in the slogan "class with class", which the IP used effectively in earlier decades. The party gradually shifted its policy emphasis more towards neoliberalism from the early 1980s and more forcefully from the late 1990s.

The PP was in previous decades associated with the cooperative movement in Iceland and regional interests (figure 1.4). As the cooperative movement was quite powerful in the business sector until the early 1980s, the PP was also to a considerable extent a "business party" like the IP, but for a different section of business. In earlier decades of the 20th century there was considerable competition between these two parties and their respective business interest groups. Both the IP and the PP managed to gain considerable support from the centrist voters and in that sense also competed with the democratic left, primarily the SDP. For decades the PP also owned the second largest daily newspaper in Iceland (*Tíminn*), which was an important asset.

Historically, the PP has been in governments both on the right and on the left. The PP led all the centre-left wing governments that were formed before 2009. From 1995 until 2007, the IP and PP were joined in government consecutively and grew increasingly neoliberal in orientation. The shift was more important for the PP, which with the collapse of the cooperative movement during the 1980s and diminishing population in the provincial areas, had to a significant extent lost contact with its classical social roots and thus became more business oriented. Still, the PP has throughout emphasised its social policy emphasis and played that card strongly in the election of 2013, with great success.

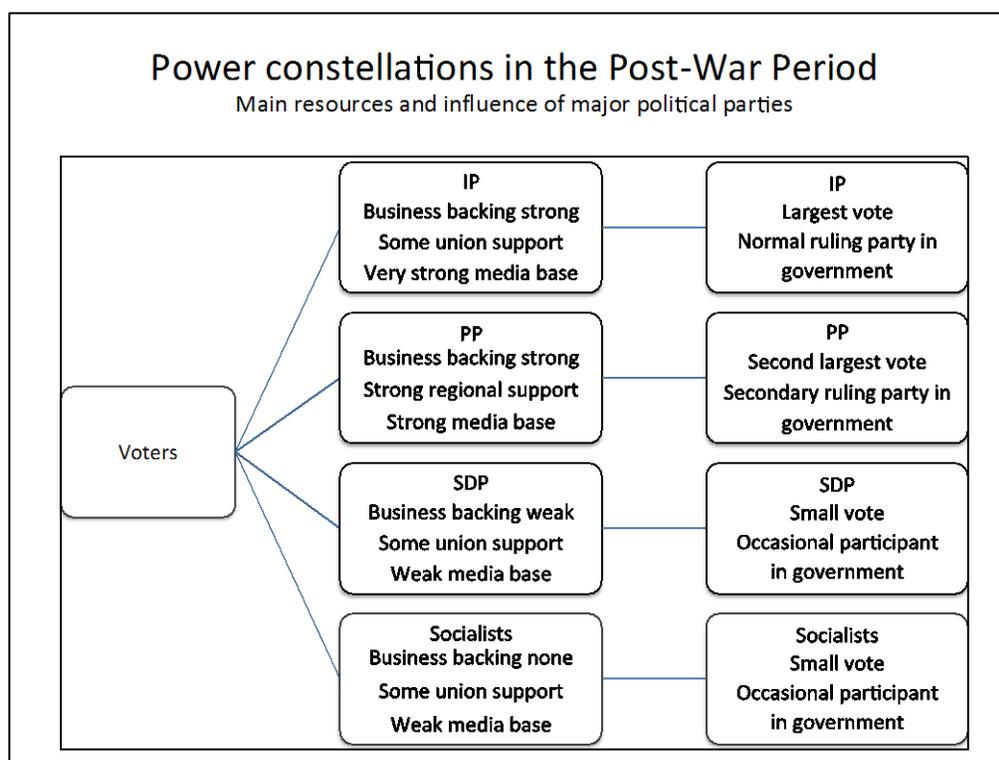


Figure 1.4: Main features of the power sources and influence of Icelandic political parties from 1945 to 1999.

Source: Ólafsson (2011).

The left wing in Icelandic politics generally suffered lack of voter support, due to frequent splits and internal feuds and weaker resources in terms of media and organizational support than the business parties. Hence the SDP never gained a comparable position to its sister parties in the other Nordic nations. It had minor support amongst business interests, it had lost the direct support of the labour union movement by the beginning of the post-war period and it never had any significant media power to combat that of the IP and PP. It did, however, gain a bargaining position in a few cases of government coalition participation, such as at the beginning of the post-war period, when it could press for the legislation of a social security system, “comparable to the most advanced of the time” (Johannessen 1981). The SDP’s longest governmental participation was from 1960 to 1971 with the IP. That government took major steps in liberalizing the economy, while it also favoured some welfare reform and increased corporatist consultations with the unions. The SDP and L-G government of 2009-2013 was the major achievement of the SDP in the history of the left in Icelandic politics, producing the first SDP-led government in Iceland. That government was considered by many as a successful government in an unusually difficult situation, but voters were not satisfied with its performance. Other factors were also of importance for producing the dismal outcome of the elections of 2013, but perhaps the experience that the SDP-LG government acquired for centre-left politicians may still be a valuable asset for these parties in the near future.

Unlike the other Nordic countries, the SDP in Iceland has not enjoyed the support of the labour unions. When the ASÍ (Iceland's equivalent to the LOs) was established in 1916, the hope was that it would provide backing for the left of Icelandic politics. The labour movement started with organizational features similar to that of the Scandinavian model, with the SDPs and unions forming generally a cohesive labour movement. This organizational link between the SDP party and the labour movement formally lasted until 1940-42, but had begun to dissolve before. First, there were splits on the left, between socialists and social democrats over influence within unions, and then later the IP made inroads into the unions. The IP has had important support, most notably from the union of shop and office employees in Reykjavík (VR), which is the largest single union in terms of membership. Thus, from the beginning of the post-war period, the union movement has been formally independent of political parties (Kristjánsson 1993; Harðarson 1995).

The socialists (consecutively named Communist Party, Socialist Party and Peoples' Alliance) were probably larger in terms of voting support in Iceland than similar parties in the other Nordic nations (particularly the Peoples' Alliance), but their influence in Icelandic politics was rather limited, as indeed was that of the old SDP. While these left parties have had sectional influences within the unions and have been vocal in national debates at times, their influence in Icelandic society was generally rather limited.

Hence, the left of Icelandic politics was significantly weaker than the right and centre, taking into account the voting support and other important power resources, such as business, union and media links. While this has changed somewhat after 1999, with the establishment of the Social Democratic Alliance, the weaker resources of the left wing parties remain, since business interests continue their overwhelming support for the IP and to some extent for the PP. While the media situation has opened up to some extent, with the development of new media, the right still has a better position on that front. Improved coordination and cooperation between the labour movement and the centre-left parties could change the power structure. Alternatively, the right-wing of Icelandic politics may continue its predominance in coming decades, given its strong backing from the most important business interests of the society, in conjunction with a strong media position.

2. Economic development

In this chapter we survey the longer-term economic development and industrial structure, from the beginning of the post-war period. We outline the major political-economy periods, representing the most important changes in the development of the Icelandic economic environment up to the present. In the latter part of the chapter we focus on more recent economic developments, including the financial crisis starting in 2008, which was a major setback for Iceland.

2.1 Political-economy developments since 1945

Iceland profited greatly during the Second World War, firstly by exports of marine products to the UK and secondly by the increased economic activity associated with the presence of, first UK and later US troops in Iceland. The employment level rose greatly as did wage levels between 1942 and 1946. Iceland, thus, entered the post-war period with full independence from Denmark (1944) and in a rather favourable economic condition. The funds accumulated during the war years were quickly spent on a new fishing fleet and infrastructure investments, further supplemented by Marshall Fund grants (Ingimundarson 2011; Jónsson 2004).

Table 2.1: Iceland's major political economy periods, from 1945 to 2010

Periods:	1945-1960: Modernization based on fishing exports	1960-1989: Extension of fishing zone and energy intensive industry added	1989-1995: Social pact against inflation. Tourism growing	1995-2008: Rapidly growing neoliberalism and extreme bubble economy. Finance becomes dominant	2008+: Financial collapse and recession
General political-economic orientation	Nation-building after independence; Statist regulation of economy; fishing and agriculture prioritized	Increased marketization and free trade; still significant statist regulation, but some easing during 1980s	National effort to contain inflation; difficulties due to overfishing of cod stocks, hence stagnation	Iceland joins the EEA in 1994. Free flow of capital allowed. Privatization and laissez-faire gain ground. Iceland promoted as an international financial centre	In the wake of an extreme bubble economy Iceland's financial system collapses. Currency also. Recession sets in.

Source: Ólafsson, 2011.

On the whole, one can characterize the Icelandic political-economy environment from the beginning of the post-war period as being statist to a great extent, i.e. with a high level of direct governmental influence in the economy and society (Jónsson 2002; Ólafsson 2011). The government played a large role in shaping conditions for industry and the economy in general, giving priority to fishing and agriculture. Hence, government regulation of the economy,

especially international trade was a major characteristic, in the shadow of which there developed a close cooperation between political forces and trade interests, which to some extent have survived to the present. Table 2.1 profiles the major political-economy periods from 1945 to the present, mapping the transitions towards a more liberal environment.

The period from 1945 to 1960 is characterized by general modernization in a statist political-economy environment. Economic growth was generally high but greatly fluctuating. The beginning of the period also saw the introduction of a modern social security system (1946) along the lines of William Beveridge’s system, with state hospitals and a public school system as well. Iceland joined the UN and NATO early in the period, but was rather late in joining GATT (1968).

It was during this period that inflation became the economic problem it remained until 1990. The inflation problem arose as a consequence of the main method of macro-economic adjustments by means of devaluating the exchange rate of the Icelandic króna. The official policy was a fixed exchange rate. However, when the economy suffered worsening terms of trade in foreign markets and/or when the size of fish catches contracted, the government would step in and devalue the Icelandic króna. The devaluations were an effective means of adjusting the competitive position of the export sector.

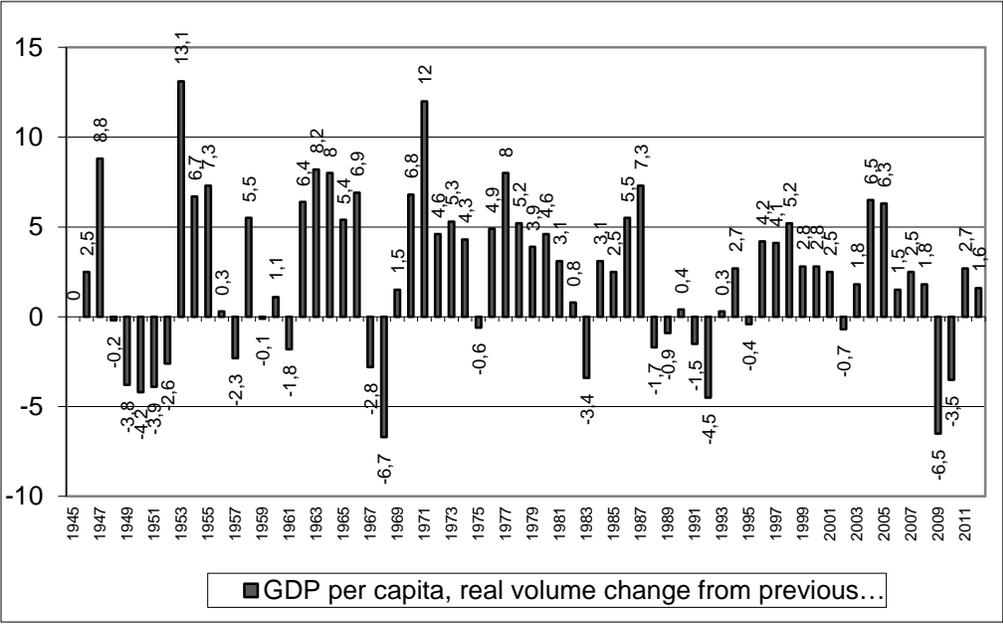


Figure 2.1: Economic growth in Iceland, 1945 to 2012. Yearly change in real GDP per capita (in %)

Source: Statistics Iceland and National Economic Institute.

The period from 1960 and until about 1989 was marked by a significant step towards liberalization of trade, but still within a rather extensive statist environment. Investment was relatively high until the early 1980s, credit and exchange rates were controlled. Devaluations

continued as a major policy tool for economic adjustment to changing external conditions. Iceland joined EFTA (the European Free Trade Agreement) in 1970 and labour market corporatism increased in scope during the 1960s and onwards. Social security was expanded and the occupational pension funds were extended greatly by means of a collective agreement in 1969, gradually becoming compulsory for all employed individuals.

Figure 2.1 shows real economic growth rates from the foundation of the independent republic in 1944. The figure shows clearly the great fluctuations in the economy, with deep but short-lived recessions alternating with periods of very high growth rates, especially between the years of 1960 and 1987. There was a deep recession between 1967 and 1969, in 1983 and between 1988 and 1994. Most of these recessions, except the one between 1988 and 1994, were short-lived. Up until the 1980s, economic fluctuations could often be linked to fluctuations in fish catch as well as fish prices in the international market. However, after the introduction of the fishing quota system in 1984, fluctuations in the Icelandic economy have less to do with fishing and more to do with domestic economic policy, the exchange rate and the international economy.

Figure 2.2 shows one of the defining characteristics of the Icelandic political-economy environment from 1960 to 1989, i.e. the inflation experience. Iceland more or less lost control of the inflation rate between the early 1960s and the 1980s, reaching a height of 80% annual change in 1983 (exceeding 100% for a part of the year). From 1971 to 1990, the inflation rate measured on average 35% per year. The high and growing inflation rate was associated with the recurring use of devaluations of the exchange rate of the Icelandic króna which led to a vicious wage-price spiral

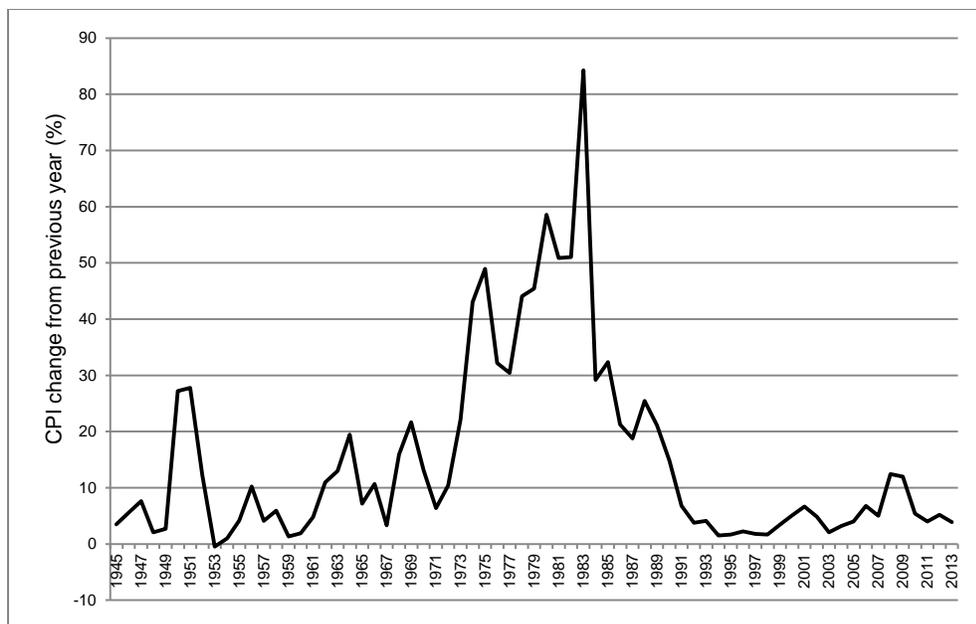


Figure 2.2: Inflation in Iceland, 1945 to 2013 (Consumer Price Index change from previous year, in %)

Source: Statistics Iceland.

The wage-price spiral came about as a consequence of the distributional effects of the devaluations. Devaluing the exchange rate of the króna led to higher import prices, which contributed to a higher inflation rate. A higher inflation rate led to a reduction in real disposable earnings of households. The unions, being a strong organizational party in the society, typically had much to regain in real wage levels after each devaluation period. Hence, the wage pressure added to the inflationary effect of the devaluations, which typically was countered with another devaluation – hence, the vicious devaluation-wage-price spiral continued.

In spite of the high inflation rate, growth rates remained high. This was prominent between 1953 and 1955 and then from the early 1960s through 1987. The latter period is the most prosperous period in the last six decades. This is the period that lifted Iceland on to a high level of affluence by international standards, generally on level with the other Nordic nations. From the late 1970s and 1980s, Iceland was firmly a member of the 10 to 15 most affluent countries in the world, albeit with more fluctuations than most other advanced countries.

By 1985-1990 Iceland had reached a standard of living that in many respects was comparable to that of the other Nordic nations (Ólafsson 1990 and 1999; Eydal and Ólafsson 2012). The Icelandic welfare state was smaller at the time, providing less generous pensions and benefits and wages were lower. The Icelanders made up for that with lower tax rates on labour income and a greater work volume, which made the net real earnings more comparable to those of the other Nordic nations. That situation remains to a significant extent to date, even though there has been a trend towards convergence in welfare expenditures in the last two decades (Eydal and Ólafsson 2012; ASÍ 2013).

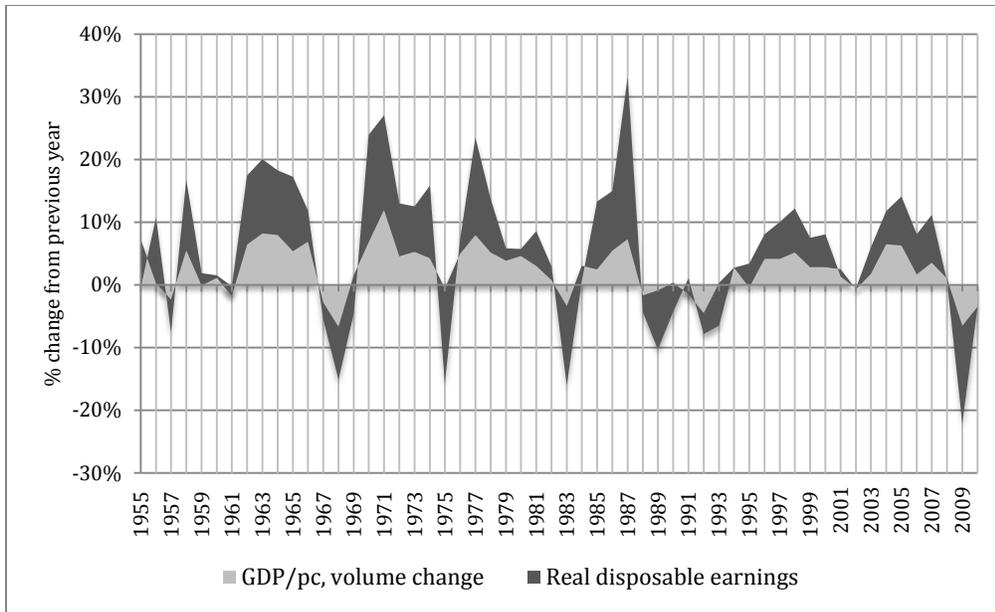


Figure 2.3: Change in real GDP per capita and real disposable earnings from 1955 to 2010
 Source: Statistics Iceland and National Economic Institute.

Figure 2.3 shows how periods of recessions (usually involving reduced fish catch or lower market prices of marine products) typically involved larger contractions of real earnings than the contraction of GDP per capita (the black troughs in the figure).

During periods of contraction, real disposable earnings generally declined significantly more than the proportional contraction of GDP per capita. Thus the reductions in living standards were particularly great in 1968-70, 1975 (when there was a minor contraction in GDP), in 1983 and between 1988 and 1994.

While the troughs in real earnings of households were clearly more drastic than the reduction in GDP per capita, the deviation was significantly more marked in the upswing, when employees typically gained greater increases in real earnings than the relatively large increases in GDP per capita. It should however be added that a part of the large gains in real earnings were also affected by increased work volumes, particularly involving increased female labour force participation.

Figure 2.4 shows the level and development of real GDP per capita in Iceland in comparison to the other Nordic countries (in euros with PPP adjustments), from 1990 to 2011. Iceland did not suffer as serious a setback in the early 1990s as Finland and Sweden. It, in fact, had a high level of GDP per capita from the 1980s onwards, closely following Norway until 1999, when Norway galloped ahead of all the other Nordic nations.

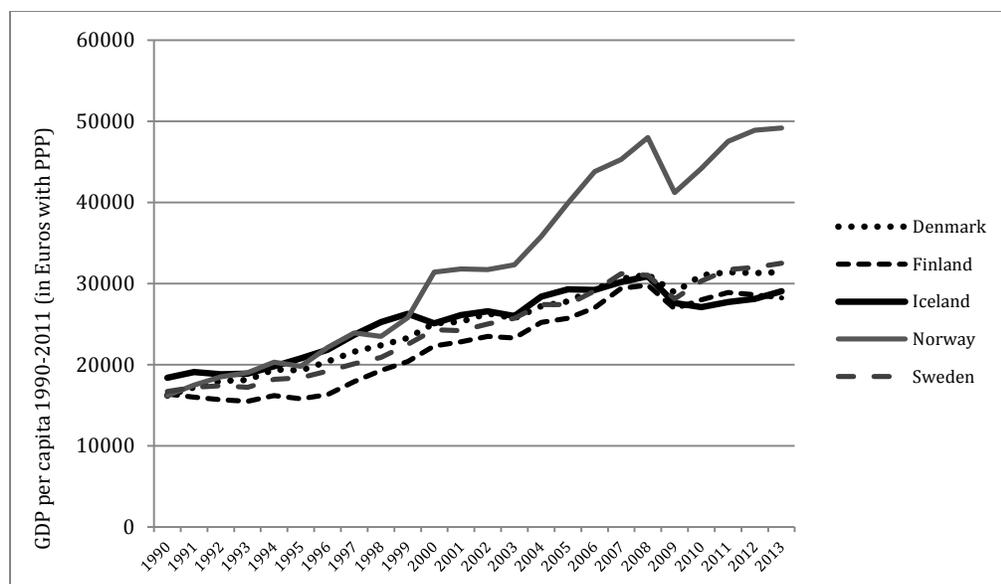


Figure 2.4: Development of GDP per capita in Iceland and the other Nordic countries, 1990 to 2011

Source: Eurostat.

The period from 1960 up to 1987 was the period of the largest gains in living standards of Icelandic households (see figure 2.5). Setbacks due to economic recessions were typically short-lived (except during the 1989-1994 period) and the gains during the upswing were strong indeed, more than making up for the losses inflicted during the recessions. While Icelanders typically lament the large peaks in inflation associated with the gains in real wages and earnings, it is clear that this period, in spite of the high inflation, was a favourable period both for economic growth and for improvements in living standards (Ólafsson 1990 and 2011; Ólafsson and Kristjánsson 2012).

The period between 1989 and 1995 (see table 2.1 above) was a period characterized by the National Pact, a social pact against inflation implemented in 1990, between the organizations of labour and employers, in cooperation with the government. The social partners agreed that the previous policy of devaluations of the exchange rate was destabilizing, bringing high inflation rates, high fluctuations in economic growth and even greater fluctuations in real household income. Thus, the social partners agreed to lower nominal wage increases, while the government promised to ensure lowering of the inflation rate. As can be seen in figure 2.3 above this produced a major turning point on the inflation front, making containment of inflation tendencies a reality for the first time since the early 1960s.

In 1994, Iceland joined the European Economic Area (EEA). This introduced the four freedoms of the European Union fully into the Icelandic political-economic environment, which was a big shift from the previously rather strong statist environment. One of the most consequential impacts was from the freedom of movement of capital to and from the country. This set the ground for a new policy regime in a more neoliberal political environment. Iceland's

entry into the EEA provided many favourable influences for the economy, especially in terms of a more competitive environment, while also expanding opportunities for expansion and innovations, but it also involved new risks to the economy.

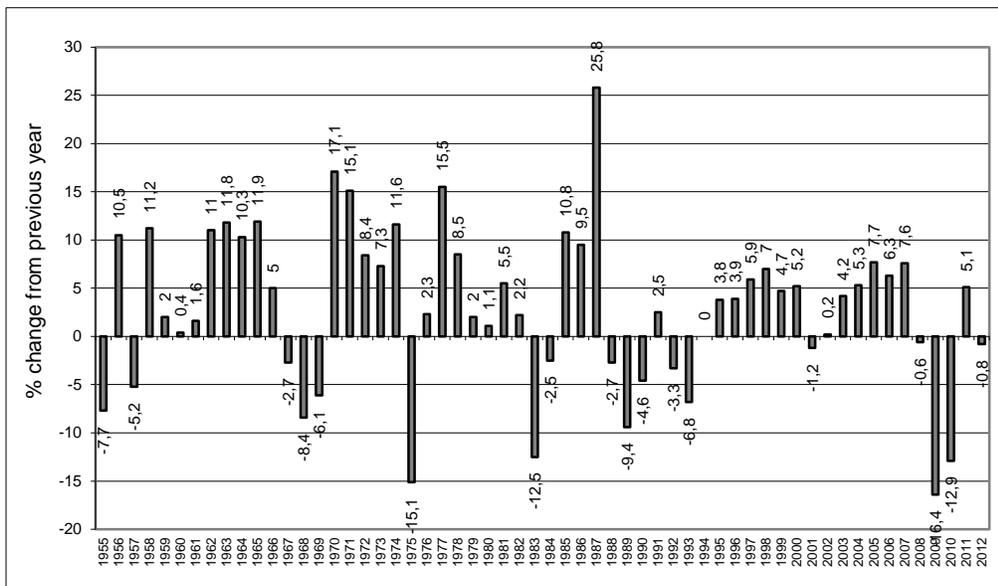


Figure 2.5: Development of real disposable earnings of households (% change from previous year)

Source: Statistics Iceland and Þjóðhagsstofnun.

The second last period in table 2.1, from 1995–2008, was primarily politically driven, involving a considerable turn towards neoliberal policy emphasis. Such a policy shift had been brewing from the 1980s within the Independence Party (IP), carried forth by a new generation of ideologists (the “Locomotive group” – *Eimreiðin*). The government coalition of the IP and the Progressive Party made a strong dose of neoliberal policies possible in an environment that was changing considerably from the statist environment to a more liberal base. The period was characterized by liberalization in the financial sector as well as other sectors, growing laissez-faire attitude in government, lowering of tax rates on businesses and financiers, debt accumulation by business, growing income inequality as well as higher debt levels of households. While such an increased liberalization initially benefitted the economy, this policy unfortunately went off track, with failed privatizations of banks and an excessive financialization and debt accumulation during the 2000s.

The government started its privatization program in 1991, initially privatizing a travel bureau, a shipping company, a printing press, and a herring smelter, to name a few. The program culminated in the privatization of the state banks between 1998 and the beginning of 2003, as well as the state telephone company. The banks were sold to business speculators, closely associated with the two governing parties (IP and PP). These new owners quickly turned the banks into investment banks. These banks aggressively borrowed in the foreign financial market and directed the flow of money into Icelandic businesses. With the abundance of funds available

in the international market, the banks lent money for speculation purposes within the Icelandic economy, while also aggressively making inroads into the neighbouring markets, most markedly in Denmark and England (PIC 2010; Aliber and Zöega 2011).

The period after 2003 is characterized by increased imbalance in the economy, driven by low interest rates and growing private consumption, which led to household debt accumulation. Foreign debt escalated, as shown in figure 2.6, with Iceland already by the end of 2004 having become the world's most heavily indebted economy. The debt continued to increase at an unprecedented pace until it had increased further by a factor of four on the eve of the banking collapse of late 2008 (Reinhart and Rogoff 2009 and 2011; Aliber and Zöega 2011; Ólafsson 2011).

The labour movement managed, however, to gain important reforms during this period. A new clause on human rights in the constitution strengthened the position of unions in 1995. In 2000-2004, the unions negotiated the establishment of funds to promote occupational skill developments for employees and measures to enhance life-long learning. This became organized within the Labour Market's Education and Training Service Centre (*Fræðslumiðstöð atvinnulífsins*). Between 2004 and 2006, the rights of foreign labour were strengthened and unions became more active in securing them and combatting social dumping. In 2006, a new legislation on unemployment benefits was implemented, raising the basic benefit level and for the first time in Iceland introducing a right to 70% of former pay for the first three months of unemployment. In 2008, the labour market partners established a Rehabilitation Fund (VIRK), for promoting rehabilitation and activation of individuals who had become temporarily inactive due to accident or sickness. This was an important addition to the activation architecture of the labour market and the welfare system, which was operated in cooperation with the sickness funds of the unions. This development was also expected to restrain the growth of disability pensioners, thus reducing the burden of disability in the occupational pension funds as well as in the public social protection system.

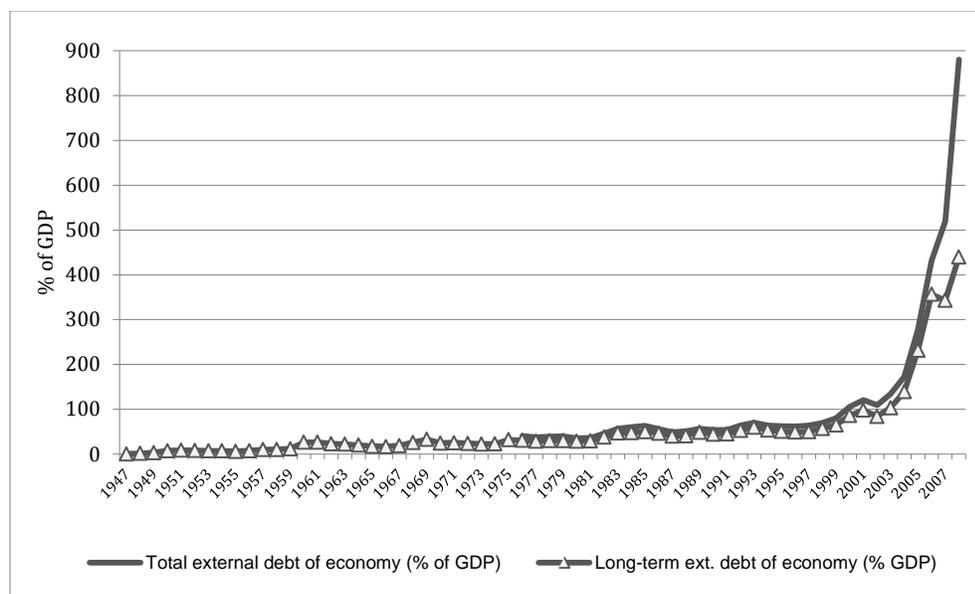


Figure 2.6: External debt of the Icelandic economy 1947-2008, % of GDP
 Source: Central Bank of Iceland and National Economic Institute.

When the Social Democratic Alliance formed a government with the Independence Party in 2007, a program of reforms in the public social protection system was started, with modifications of the pension system, aiming to provide more incentives for work and savings. A number of important reforms were implemented during late 2007 and 2008, culminating in the introduction of a new minimum pension guarantee in September 2008. The financial collapse came in October, halting further progress on that front. Still the new minimum pension guarantee was raised by 20% at the beginning of 2009 and that helped to keep many of the lowest earning pensioners above the poverty line through the crisis. The value of the minimum guarantee was preserved through the crisis and in fact raised somewhat from 2011 onwards.

2.2 Industrial structure and productivity

Iceland industrialized rather late compared to the other Nordic nations, with the exception of Finland. The development in Iceland was more sporadic and in the post-war period it was generally quite rapid, especially from 1960 onwards (Ólafsson and Stefánsson, 2005; Ólafsson 2008a). In figure 2.7 we show the industrial transition, by the main industrial sectors (primary, secondary and tertiary).

The rise of modern fishing from the 1890s onwards was Iceland's equivalent to the industrial revolution. Fishing remains one of the most important export sectors of the economy, even though its share has declined in recent decades. Fishermen are now only about 2.5% of the

labour force and fish processing workers compose another 2.5-3%. Thus, the fishing sector is no longer an important employer in the Icelandic labour market.

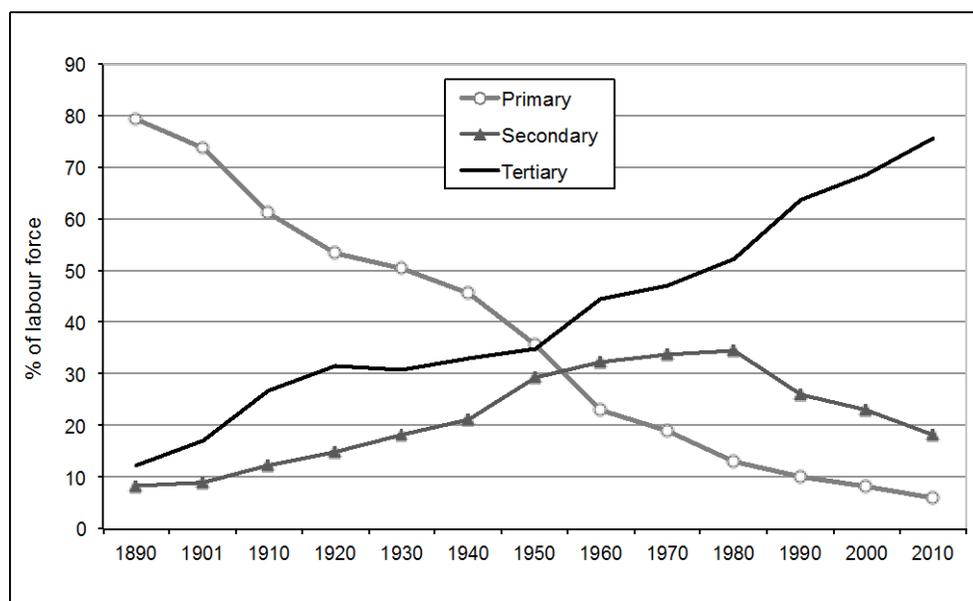


Figure 2.7: The industrial transition in Iceland. Sectoral distribution of employment from 1890 to 2010

Source: Ólafsson and Stefánsson 2005, with an update from Statistics Iceland.

On the whole, one can describe the Icelandic industrial structure as in some ways unique, given the historical reliance on fisheries and fish processing in export earnings. While fishing is, of course, an important food producer in many regions of the world, Iceland is probably the only country in the world to have modernized and based a very high level of affluence on exports of marine products, without relying on government subsidies. The foundation for that has been the rich fishing grounds around the country and long-term favourable prices for fish products in foreign markets. The high level of technology used in the fishing fleet, experienced fishermen, as well as profitable management of the sector, including by means of the quota system in 1984, have contributed to this favourable outcome. Nowadays the fishing sector contributes some 11-12% of GDP (Statistics Iceland 2012), while the share of marine products in export earnings is in the region of 26% of exports of goods and services (Íslandsbanki 2012).

Manufacturing was always rather weak in Iceland, with the main components being construction and maintenance. Figure 2.7 shows the proportional decline of the manufacturing sector since the 1980s. Agriculture has been in a steady decline as an employer for all of the 20th century. In recent decades it has become more integrated with the growing tourism sector in the provincial regions. Tourism continues to date to expand greatly and is now a major platform for growth and export earnings.

Iceland is rich in natural resources, among them hydroelectric and geothermal energy. Geothermal energy is primarily used for residential heating, while hydroelectric energy is used as

residential electricity and in energy intensive industry. The growth of energy intensive industries has been significant in recent decades, both in aluminium and ferrosilicon. In 1999, 12% of export revenues stemmed from production of aluminium and ferrosilicon, while the share had grown to 27% in 2011, a share similar to that of marine products.

The share of the labour force working in services has risen from 64% in 1991 to about 76% in 2010, this includes an increase in the share of labour force working in the public sector (Ólafsson and Stefánsson 2005).

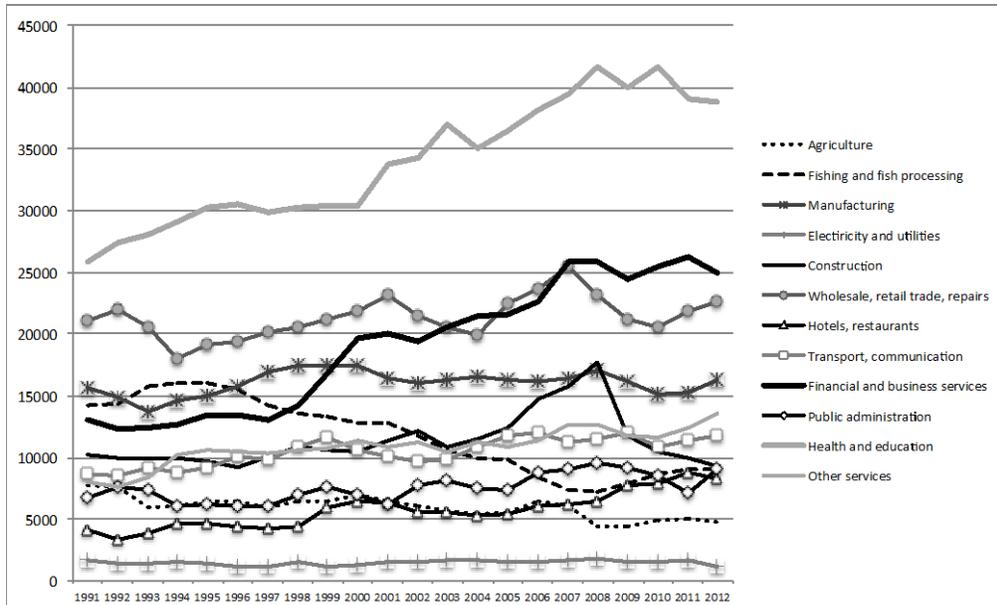


Figure 2.8: Industrial development from 1991 to 2012. Number of employees in main industries
 Source: Statistics Iceland.

In figure 2.8 we show the more detailed development of the main industries from 1991 to 2012. Health and education employ the greatest numbers in this industrial classification and this employment sector grew very fast up to the crisis. Since then there has been a slight contraction. Other decisive growth industries are finance and business services that had become the second largest job provider in the advent of the crisis. Construction had been booming during the 2000s until the crisis, when employment there fell drastically. On more modest scales, hotels and restaurants along with transport and communication, have had a persistent growth in job numbers, also through the crisis years. The number of public administration jobs also rose up to the crisis when they took a dive.

Other significant developments are increases in wholesale, retail and repairs, with considerable fluctuations though, including a sizable contraction during the crisis when private consumption contracted. Manufacturing contracted slowly but steadily since the early 2000s and agriculture has continued on its long-term contraction as an employer, albeit at a slow pace in the last decade. It is gaining some support from expansion of tourist services in the provincial regions.

Lastly, jobs in fisheries and fish processing contracted considerably from the late 1990s to the crisis, when there was some increase, particularly in fish processing.

With Iceland's high affluence level, which was reached during the 1960s, the transition towards a modern occupational structure have continued up to the present. This is reflected in figure 2.9, which shows occupational class transitions from 1991 to 2011.

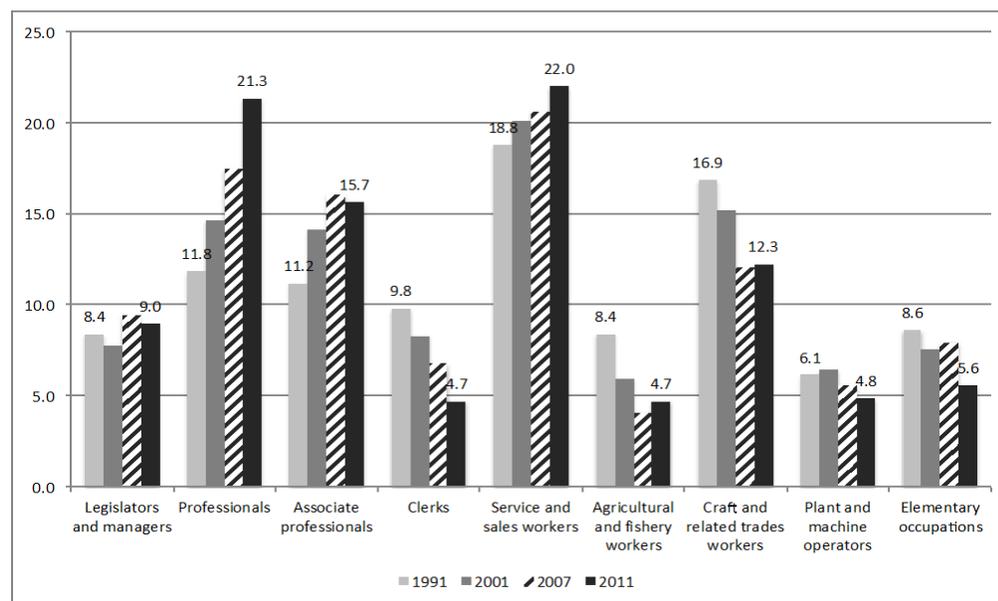


Figure 2.9: Occupational structure 1991 to 2011 (% of total employed)

Source: Statistics Iceland.

The main feature of occupational developments during the last two decades is growth in non-manual higher professional jobs as well as in lower-skilled service jobs. At the same time, there has been a decline in the proportion of manual lower-skilled jobs and clerical jobs. There has also been a decline in the share of elementary and low-skilled manual jobs, but slower than in clerical jobs.

The category of professionals has the steepest growth profile, along with associate professionals. The decline was steepest amongst clerical workers and in craft and related jobs. Elementary jobs have also declined significantly as have agricultural and fisheries jobs. The top ranked category of managerial and administrative jobs has retained its share of the labour force during this period. On the whole, we can say that the Icelandic occupational structure has most of the basic features of a modern service economy (Crouch 2000; Ólafsson and Stefánsson 2005).

Iceland's per capita labour productivity is comparable to the productivity of other countries and Iceland's labour productivity, defined as GDP per hour worked, grew by 2.4% on average from 1993-2008, the second highest among the Nordic countries (IMF 2013). This, however, is only achieved through a high labour force participation rate and long work hours. If labour force participation rates and the number of work hours were similar to that of the other Nordic

countries and the UK, then Iceland's production would be almost a quarter lower than it is currently and GDP per capita would be on par with Greece and Slovenia (McKinsey 2012).

Labour productivity is low in the agricultural sector and in arts and entertainment. On the other hand, labour productivity is high in metal manufacturing and electricity and water. The fishing industry and financial services also show relatively high labour productivity.

Table 2.2: Productivity characteristics in 2010

	Labor productivity	Labor productivity	Capital productivity
	Gross value added per worker, ISK millions per year, 2010	Compared to other Nordic countries, %	Gross value added per unit of capital, percent 2010
Agriculture	4	11	16
Arts & Entertainment	4	-46	115
Construction	6	-20	43
Electricity and Water	30	21	8
Financial services	13	-46	167
Fishing industry	15	104	69
Food production	7	4	63
Info & Communications	7	-38	193
Metal manufacturing	28	160	21
Other manufacturing	7	-32	38
Other services	6	-8	51
Public services	6	-8	46
Real estate activities	180	-	45
Tourism & Logistics	6	-8	40
Wholesale & Retail	6	-8	174

Source: McKinsey (2012).

A different picture emerges when we look at capital productivity. Agriculture still shows low productivity, and financial services and the fishing industry still show fairly high productivity of capital. However, electricity and water show very low capital productivity, while arts and entertainment show high productivity. The sectors with the highest capital productivity are information and communications, wholesale and retail, along with financial services and arts and entertainment. At the low end, along with electricity and water and agriculture, is metal manufacturing with the lowest capital productivity.

On the whole, Iceland lags behind the other Nordic countries in terms of total factor productivity (TFP) and capital intensity. Relative to the other Nordic countries, labour productivity is over 15% higher in Iceland in metal manufacturing, the fishing industry and electricity and water, and less than that in agriculture and food production. In other sectors, the labour productivity in Iceland is lower than in the other Nordic countries and in sectors like construction, other manufacturing, information and communications, arts and entertainment

and financial services, the labour productivity in Iceland is more than 15% below that in the other Nordic countries. Hence, improving productivity continues to be a major challenge for Iceland in the coming years.

2.3 Economic aspects of the financial crisis

Following a period of high economic growth, Iceland went into a deep recession that hit in 1987 and a long period of stagnation followed. Average growth from 1987-1995 was 0.4% per year on average. Three things weighed heavily in this development. The cod stock was low and thus, catch was low. The economic situation in the neighbouring countries was poor and economic policy was contractionary.

In the beginning of 1990 the so-called National Pact agreement was signed between the social partners and the government, aiming to combat inflation. Instead of negotiating high nominal wages in collective bargaining agreements as was previously the norm, the agreement was based on incomes policy and included low nominal wage increases, with a promise from the central government to aid in lowering inflation, i.a. by keeping the exchange rate of the króna fixed. Thus, the agreements in effect aimed at real wage improvements. The effort was successful in that the level of inflation fell down to levels comparable to that of Iceland’s neighbouring countries. However, at the same time unemployment rose to 5% by 1995, a previously unprecedented level.

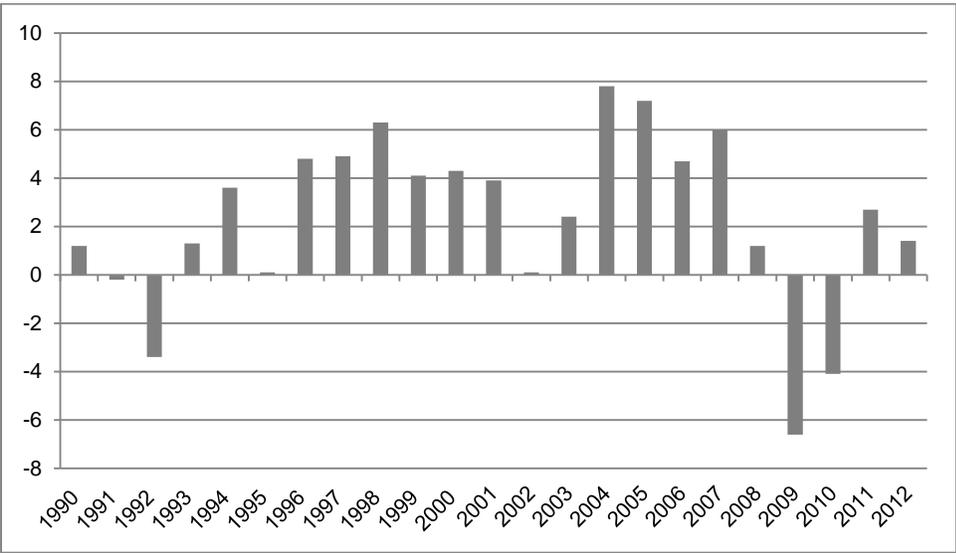


Figure 2.10: Changes in gross domestic product 1990-2012

Source: Statistics Iceland.

The early 1990s were characterized by changes in the structure of the political economy. In early 1991, a new coalition government took office. The coalition consisted of the right wing Independence Party (*Sjálfstæðisflokkurinn*) and the old Social Democratic Party (*Alþýðuflokkurinn*). The conduct of macroeconomic policy was revised with less emphasis on direct intervention and more reliance on market oriented approach to economic policy and increased promotion of competition. Iceland joined the European Economic Area (EEA) in 1994, extending the four freedoms of the European Union to Iceland (see section 2.1). The financial sector was liberalized in steps during the first half of the decade. The government established a privatization program and started to sell off some government corporations and incorporating others. Markets were liberalized through deregulation and an active stock market was created.

A period of strong economic growth started in 1995 and from 1995 to 2007, the economy grew by 4.3% per year on average (figure 2.10). Unlike earlier business cycles in the Icelandic economy, the upswing was not led by the fisheries sector. The long period of stagnation and restructuring had left a big slack in the economy. What triggered the upswing were decisions for construction in the energy-intensive industry sector. Thus, a boom period in the construction sector led to an upswing in other sectors. Labour contracts made in 1997 led to considerable wage increases and with low inflation, purchasing power rose fast. This led to a growth in private consumption, which ended up being far greater than the growth in income, leading to a considerable increase in private debt. This was no doubt aided by the liberalization of the financial market.

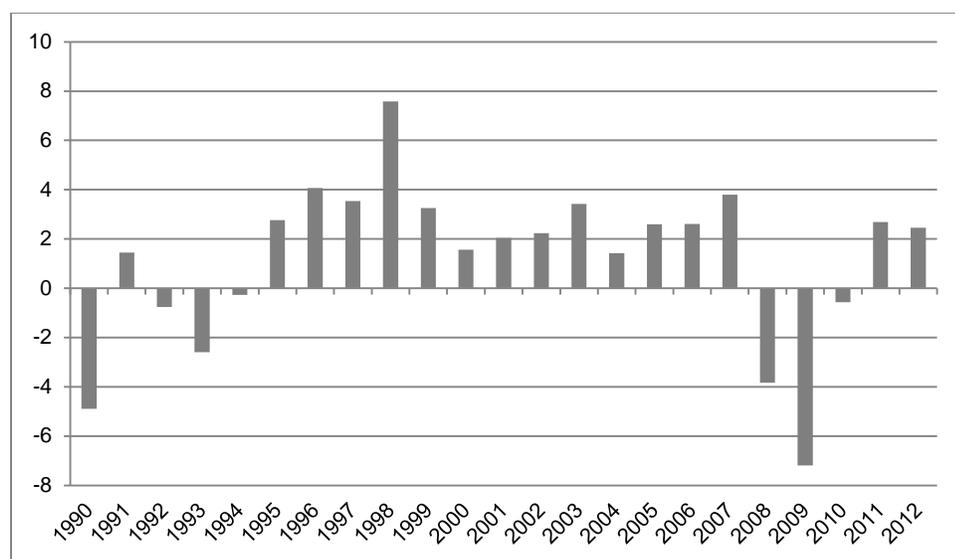


Figure 2.11: Changes in real wages, %
Source: Statistics Iceland.

The National Pact agreements, along with the slack in the economy, helped to lower inflation from over 20% in 1989 down to around 2% in 1994-1998 as shown in figure 2.2. The slack in the economy is further evidenced by the negative growth of real wages until 1995 (figure 2.11).

From 1995 to 2007, real wages, however, rose by 45%, or by 3.2% per year on average, both due to the lowering of inflation and high nominal wage increases. By 1998 the slack in the economy had disappeared and inflationary pressures rose. The inflation rate went above 6% in 2001, mainly due to a fall in the exchange rate, but came down again only to rise above 6% again in 2006.

Investment grew very fast from 1995 to 2001, as total fixed investment grew by 11.1% per year on average. This growth was led by business sector investment, mostly in energy-intensive industry and accompanying investment in power plants. At the end of the construction period for the energy intensive industry, other sectors picked up the slack and the growth in investment continued.

Although Iceland’s economy has diversified significantly in recent years, it still depends heavily on fisheries. In 1999 fisheries generated 46% of export revenues, compared to 26% in 2013. Like other industrialized countries, Iceland’s economy has become ever more service-oriented. In particular, tourism services have grown steadily in the last decade and accounted for 13% of export revenues (excluding transport) in 2013. In 2013, 807 thousand tourists visited Iceland, up from 303 thousand in 2000, and 142 thousand in 1990. In comparison, the population of Iceland is 325 thousand.

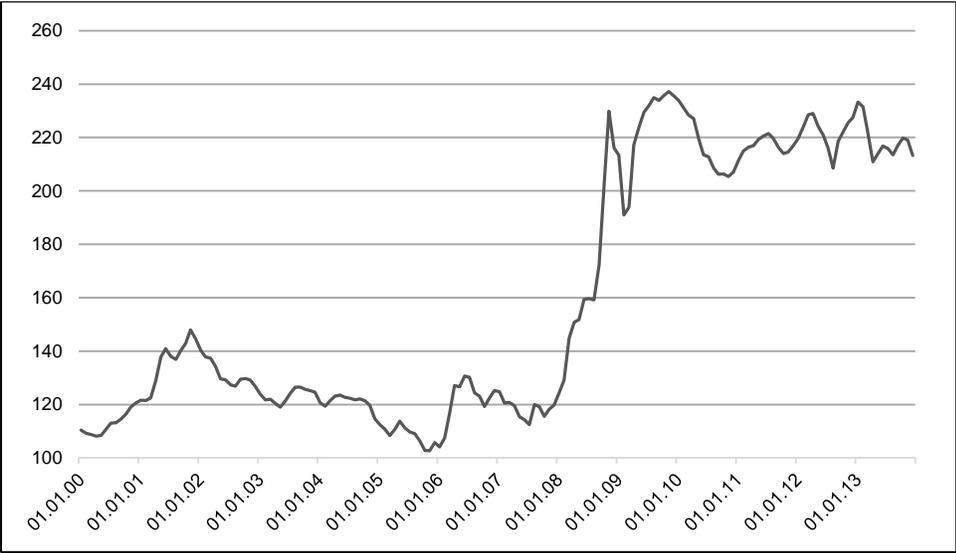


Figure 2.12: The exchange rate of the Icelandic króna, index, weighted average of main trading partners

Source: Central Bank of Iceland.

The exchange rate of the króna vis-à-vis the exchange rate of our main trading partners was fixed in 1990. From 1990 to 1994 the exchange rate weakened by 16%, mainly due to two devaluations of the króna. From 1995 to 2000, the exchange rate remained relatively stable. In 2001 the fixed exchange rate regime was abandoned and replaced with an inflation rate target. With the rising imbalance on the current account, which in 2000 had a deficit of 10% of GDP,

coupled with lower expectations following the bursting of the dotcom bubble, the exchange rate fell in 2001 by 20% (figure 2.12). In the following years, the exchange rate strengthened again, albeit not without fluctuations.

The growth in consumption and investment coupled with a strong króna led to an increasing deficit on the current account. With financial markets fully open and rising rates of interest domestically, investors moved to invest increasingly abroad. The current account had reached balance following the turmoil of the year 2000. It moved into deficit again, culminating in a record deficit of almost 25% of GDP in 2007.

Iceland had been watching the events unfolding in the financial markets in 2008 and knew that the Icelandic banks were having difficulties with financing their activities. However, their balance sheets in the middle of 2008 looked good and therefore no threat seemed imminent. With the bankruptcy of Lehman brothers in mid-September 2008, the situation got very serious very suddenly. In the week starting on October 6, 2008, all three major commercial banks in Iceland went under as the government could not provide them with liquidity in foreign currency. The government acted swiftly and enacted what became known as the Emergency Legislation, moving the domestic operations of the banks into new banks and sending the foreign operations into receivership. Coupled with the fall of the banking sector was a large depreciation of the króna (which had however started by the beginning of 2008). The depreciation amounted to about 50% from August 2007 to November 2009.

In a way the Icelandic financial crisis is a typical financial crisis following on a bubble economy that burst (Reinhart and Rogoff 2009; Kindleberger and Aliber 2005; Minsky 2008). In a sense it was comparable to the Scandinavian crises of the early 1990s, only more extreme. The IMF and the OECD have described the Icelandic experience as the largest bubble and the largest financial collapse in history, in relation to the size of the national economy. Ireland is the closest competitor for that dubious status (Reinhart and Rogoff 2010).

The construction sector, which had been expanding rapidly during the period of growth up to 2007, experienced serious cutbacks after the recession hit in 2008. The sector grew by 120% from 1997 to 2007, while the economy as a whole grew by 68% as shown in figure 2.13. However, from 2007 to 2011, the construction sector contracted by 57% while all sectors combined contracted by 7%. The construction industry was the hardest hit sector of the economy, contributing greatly towards the increased unemployment level, which we examine further in the next chapter.



Figure 2.13: Gross domestic product for the country as a whole and in construction, index 2005=100

Source: Statistics Iceland.

In early 2009, Icelandic authorities sought help from the international community and entered a program with the International Monetary Fund (IMF), in order to get policy advice and secure the finances needed to get Iceland back on track. The IMF lent Iceland 2.1 million USD and facilitated further loans from the other Nordic countries, Russia, Poland and the Faroe Islands. In return, Iceland declared that it would recapitalize the three new banks, strengthen the regulatory framework and supervisory practice in the financial sector. On the fiscal side, the automatic stabilizers would operate in full in 2009, while the government would embark on an ambitious medium-term fiscal consolidation program starting in 2010. The plan for fiscal consolidation laid forth in connection with the Stability Pact (2009) aimed to improve the general government balance in steps until a surplus would be reached in 2013. This would include both increases in taxation as well as expenditure cuts (Prime Minister's Office 2009).

As a part of monetary policy, interest rates were raised and restrictions on capital account transactions were put in place. These capital controls were put in place to prevent a further fall in the exchange rate of the króna, with the aim of lifting them within a few months' time. However, the capital controls are still in place in late 2014 (Prime Minister's Office 2008).

In the following two years, GDP fell by a total of 10%. There was a contraction in GDP every quarter from the third quarter of 2008 until the fourth quarter of 2010. With the depreciation of the króna, inflation rose significantly and quarter-on-quarter inflation went up to 17% in the last quarter of 2008 and the first quarter of 2009. The inflation currently lies close to the inflation rate target of 2.5%. Real disposable income of households fell dramatically and the unemployment rate rose to levels never seen before in Iceland as will be discussed later in this report.

2.4 Wage developments during the crisis

Households were hit particularly swiftly in the fall of 2008, as unemployment rose while working hours fell, and wage increases were limited. Coupled with this, the generally unstable Icelandic króna fell significantly in the beginning of the crisis, from early 2008 to 2009. This produced a rising rate of inflation and hence, the purchasing power of wages fell. The inflation also raised the debt burden of households. Later tax rates were also raised, particularly on higher incomes. Put together this led to a significant fall in disposable income. Here we look closer at wage developments.

Between 2008 and 2009 the mean of basic pay for full-time workers rose by 3.1% in nominal terms as shown in table 2.3. Total earnings, on the other hand, fell by 6.8%. The mean basic pay for managers and professionals fell in nominal terms between 2008 and 2009, although the cut is rather small or 1.5% and 0.5%, respectively. When it comes to total earnings, the cut is much larger for these groups, or 17.0% and 11.7% respectively. Other groups also experienced nominal cuts in total earnings, especially workers in construction (Craft and related trades workers)(Statistics Iceland n.d.). In real terms, the cuts are larger as the CPI rose significantly between 2008 and 2010, as also shown in the bottom line of table 2.3.

Table 2.3. Nominal changes in basic pay and total earnings, %.

Change in basic pay				
	2007	2008	2009	2010
Managers	11,7	7,5	-1,5	5,5
Professionals	12,9	10,2	-0,5	4,3
Technicians and associate professionals	8,5	6,8	1,5	3,4
Clerks	13,4	10,0	4,0	5,5
Service workers and shop and market sales workers	8,2	2,5	3,2	7,5
Craft and related trades workers	9,3	5,5	0,3	2,6
Plant and machine operators and assemblers	10,4	7,4	6,1	6,8
Elementary occupations	7,8	9,3	5,2	7,2
All groups	11,1	7,6	3,1	4,1
Change in total earnings				
	2007	2008	2009	2010
Managers	14,7	9,2	-17,0	3,1
Professionals	12,4	9,4	-11,7	2,5
Technicians and associate professionals	9,2	5,1	-7,2	3,2
Clerks	10,3	8,4	-1,4	4,7
Service workers and shop and market sales workers	7,4	1,9	2,8	7,2
Craft and related trades workers	7,5	5,1	-9,7	4,9
Plant and machine operators and assemblers	10,1	8,1	-5,7	6,6
Elementary occupations	9,0	7,2	-6,7	5,1
All groups	10,4	7,3	-6,8	3,5
Inflation rate	5,0	12,4	12,0	5,5

Source: Statistics Iceland and author calculations.

While average wages lost significant real value (some 18% from 2008 to 2010), the minimum real wage was a focus of the labour movement in bargaining during the crisis years. As seen in figure 2.14 the labour movement managed to maintain and even increase the purchasing power of the minimum wage through the crisis, by maintaining the continuous rate of rise from the early 2000s. This was a strategy similar to the one the government applied to pensioners within the social security system. There, the minimum pension guarantee was raised to keep the lowest income-earning pensioners above the poverty line, while pensioners with higher income suffered significant cuts in their real pension level. These strategies of sheltering the most vulnerable were quite successful during the crisis in Iceland, and most likely facilitated a successful return to economic growth from 2011 onwards.

Wages are only one indicator of changing earnings conditions during the crisis. Looking at real disposable earnings gives a more complete picture of the overall effects of the crisis on households. It includes the effects of wages, financial income, pensions and benefits and direct taxes. This is also more relevant for assessing the policy reactions of government. Real disposable income fell by 27% from 2008 to 2010. Since then it has recovered by 9% and is now at a level comparable with real disposable income in 2004-5 (Central Bank 2014).

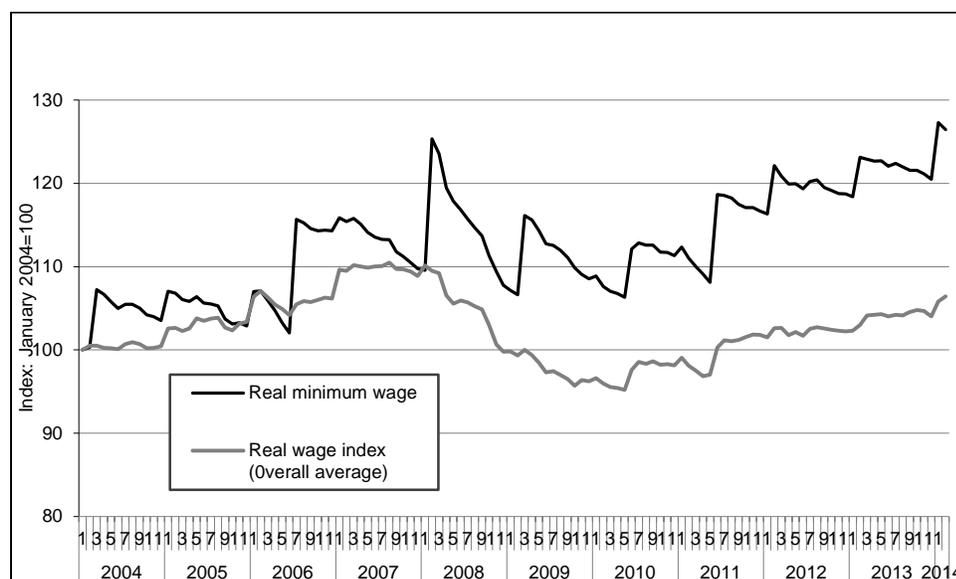


Figure 2.14: Development of averages real wages and real minimum wages through the crisis.

Index: January 2004=100

Source: ASÍ.

Following the onset of the recession in 2008, Iceland's policy emphasis changed fundamentally, from the Anglo-Saxon inspired neoliberalism of the 2000s in the direction of equalization and a Nordic welfare policy, emphasizing the use of the social protection system to alleviate the worst consequences of the crisis, particularly for the lower and middle income households (Ólafsson and Kristjánsson 2012b). Hence the income distribution became more equal following a period of increasing inequality up to 2007, both for reasons of declining financial income and growing

redistribution effects of public policy. Figure 2.15 shows the change in real disposable earnings by income groups (Ólafsson 2012c).

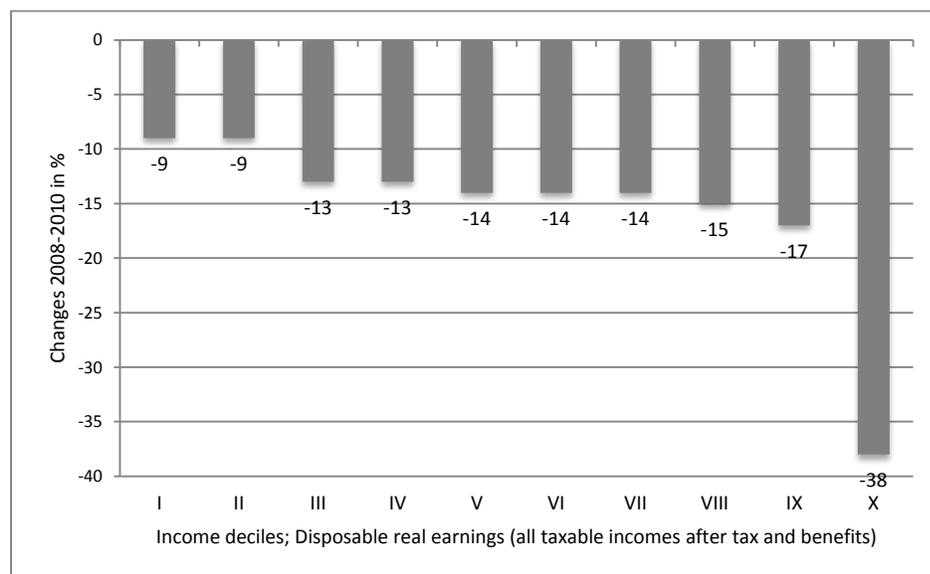


Figure 2.15: Change in real disposable income by income deciles, 2008-2010

Source: Icelandic tax data, Ólafsson and Kristjánsson 2012b.

As figure 4.8 shows, there was a fall in real disposable income for all 10 income groups. Looking first at the lowest two income groups, they each lost about 9% of real disposable income while the median groups lost 14%. The real disposable income of the highest income group fell the most, or by 38%. Hence, the burden of the crisis was disproportionately born by the higher income groups in Iceland. In many other crisis countries in Europe the sharing of the burden was in the opposite direction, for example in Ireland, Hungary and UK, as well as in the USA, where income disparities widened with the burden born disproportionately by the lower income groups. This reflects the turn towards more equal distribution of incomes in Iceland after the onset of the crisis and is the result of changing government policy on taxes and benefits, by the unions' emphasis on protecting the real minimum wages and by declining financial incomes after the bubble burst (Ólafsson and Kristjánsson 2012b).

3. The Icelandic labour market model

3.1 Introduction

With a population of 325,000 people, it follows that Iceland's labour market is quite small, at around 185,000 people in 2013 (Statistics Iceland n.d.). Iceland's gross national income per capita (measured in USD, PPP adjusted) in 2007 was 6% above the OECD average, while in 2009 after being hit by a severe recession, the per capita income was 10% below the OECD average (OECD 2013c).

The main characteristics of the Icelandic labour market are a high level of union density, high labour force participation rate, long work hours and low incidence of part-time employment, as well as late retirement. The labour force participation rate is 80% (OECD 2013c), while average work hours are 40 per week (Statistics Iceland n.d.). Participants in the Icelandic labour market also retire at a later date than those in most other OECD countries. Trade union density is exceptionally high in Iceland and wage bargaining is generally centralized (OECD 2012b). In most cases wage bargaining takes place between the Icelandic Confederation of Labour (ASÍ) and SA – Business Iceland (SA).

Table 3.1. Overview of the Icelandic labour market, age 16-74 unless otherwise stated

	1995	2000	2005	2008	2009	2010	2011	2012	2013
Labour force, thousand	149	160	166	185	181	181	180	180	185
Labour force participation rate, %	82,9	83,5	82,1	82,8	81,1	81,1	80,5	80,5	81,4
Men	87,7	87,9	86,1	87,1	84,7	84,4	83,7	83,1	84,2
Women	77,9	79,0	78,0	78,2	77,3	77,8	77,1	77,7	78,5
Unemployment rate, %	4,9	2,3	2,6	3,0	7,2	7,6	7,1	6,0	5,4
Men	4,8	1,8	2,6	3,3	8,6	8,3	7,8	6,4	5,7
Women	4,9	2,9	2,6	2,6	5,7	6,7	6,2	5,7	5,1
Youth unemployment rate (16-24)	11,0	4,7	7,2	8,2	16,0	16,2	14,6	13,6	10,7
Working hours	42,9	43,8	42,4	41,6	39,7	39,6	40,0	39,8	39,8
Men	50,0	50,9	48,0	46,2	43,8	43,7	44,1	43,9	44,0
Women	34,5	35,5	35,7	35,9	35,0	34,9	35,4	35,2	35,1

Source: Statistics Iceland.

Similar to those of the other Nordic countries and unlike those of many European countries, Icelandic law stipulates relatively few rights concerning the labour market. Iceland's membership of the European Economic Area has however produced more regulation of the labour market, especially as regards health and safety and cross-boarder work. But to a large extent the protection of employees in the labour market is stipulated through labour contracts. With the high level of union density and high level of coordination in the labour market, coupled with

long-term low unemployment level and a relatively high growth rate of the economy, the Icelandic labour market can be classified as a flexible labour market (Ólafsdóttir 2010). We look at these issues in more detail in what follows.

3.2 The Icelandic corporatism and labour market institutions

The institutional structure of the Icelandic labour market has many similarities to those of the other Nordic societies (SA-ASÍ 2013; Bamber et al. 2011). The legal environment is in many ways similar to that of the Danish labour market (Madsen, Due and Andersen 2011). There is a framework legislation for the operations of the labour market partners and for mediation and conciliation, but on the whole regulation is mainly up to the partners and usually undertaken by means of collective bargaining. Icelandic law gives collective bargaining agreements the legal status of law (Act No. 55/1980)¹.

The organizational level of both unions and employers is very high, among the highest in the world and the capacity for centralization by means of federations for industries or sectors and overall confederations is high. On the employer side is SA-Business Iceland, which represents about 2000 businesses in Iceland, accounting for 70% of all salaried employees in the Icelandic labour market (SA n.d.)

Figure 3.1 shows the union density levels in Iceland, in comparison to that of the other Nordic countries, based on OECD figures.

¹ «Wages, and other working terms agreed between the social partners shall be considered minimum terms, independent of sex, nationality or term of appointment, for all wage earners in the relevant occupation within the area covered by the collective agreement. Contracts made between individual wage earners and employers on poorer working terms than those specified in the general collective agreement shall be void».

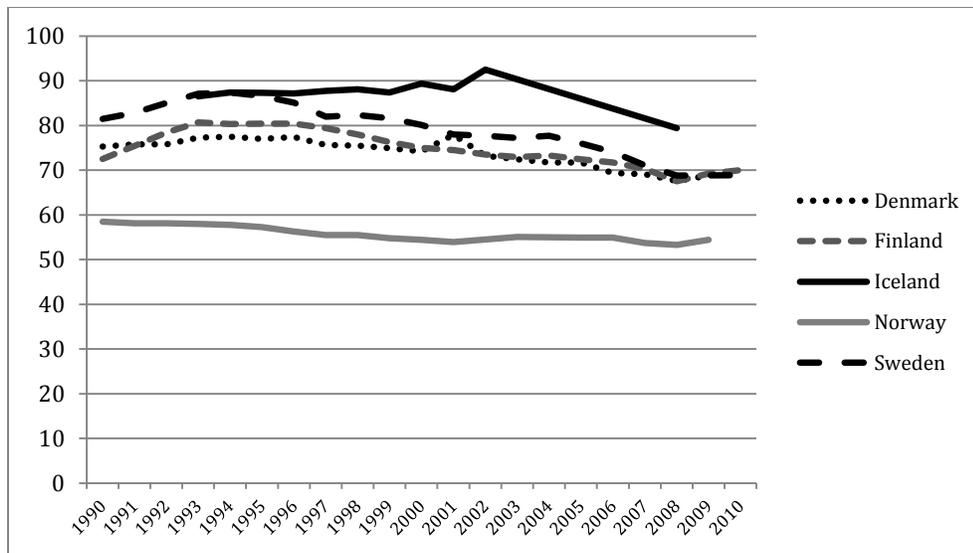


Figure 3.1: Trade union densities in Iceland and the other Nordic countries, 1990 to 2010
Source: OECD.

On the employee side, the largest federation is the Confederation of Labour (ASÍ), which is a comparable organization to the LOs in the other Nordic nations. Other main federations are the BSRB, a general federation for public employees and BHM, which is a federation of university-educated individuals, employed both in the public and private sectors (a great majority of the members work in the public sector). However, bargaining rights remain with individual local unions.

While declining union membership is a troubling development for union leadership, it must be noted that the Nordic labour movements have been the strongest in the world, in terms of both membership and organisational capacities for collective bargaining and other interest representation. The decline of membership density ratios has also been slower in the Nordic countries than in most other Western nations (OECD 2013a; Schnabel 2012; Visser 2003).

Even if union density is declining, it does not necessarily mean declining absolute numbers of membership. Even with growing membership, the total number of employed may be increasing faster, thus lowering the proportion that are members of unions. However, that does not necessarily mean that bargaining coverage has to be declining.

The main reasons for declining union densities in Western countries, according to Schnabel (2012) and Visser (2003), are the following.

- Young employees do not join unions to the same extent as older ones did.
- Industries with large proportions of manual jobs who used to be stronghold industries for classical unions have many been declining. Many firms in these formerly stronghold unionized industries have been moved to lower wage countries as well.

- Many workers in services, particularly the more educated and those working in smaller firms, join unions to a lesser degree than others.
- While public services are in many countries a stronghold of unionizations, contemporary trends of privatization and contraction of welfare states reduces union densities in some countries.
- Globalization and increased low-wage competition reduces union membership in some countries.
- Weakening of the Ghent system of unemployment benefits has been associated with declining union membership in some European countries.
- Unions may have image problems, being identified with blue-collar organizations from earlier and less prosperous eras. They need to find better ways of attracting members from middle class and upper specialist occupations.

While the causes of declining union densities vary from one country to another, or from one regime to another, this applies less to the Nordic nations, and least to Iceland. In the Nordic countries, unions in the public sector are strong. Hence, women tend to be highly unionized in those countries. Similarly, globalization is at a high level in the Nordic countries and goes together with the highest levels of unionization. The same applies to various post-industrial characteristics of the Nordic labour markets, including common forms of atypical employment.

Even though there are important structural trends in contemporary societies that work against union memberships these are not inevitable. Much seems to depend on union strategies in bargaining (for example presence at work places) and service provisions to members. Success in promoting the unions and their images are also important, as well as participation in corporatist bargaining.

The main explanation of the unusually high membership rates in Iceland is the fact that some of the collective bargaining agreements include a priority clause that states that union members have a priority to jobs in each area. The first priority clause (Icelandic: *forgangsréttur*) was established between the union Dagsbrún and the company Landsverslun during World War I, and was intended to prevent “free riders” from underbidding in times of unemployment, as they did not pay union fees or have to endure strikes (Snævarr 1993). In practise, employers automatically enlist their new employees into the relevant local union and collect the dues for the unions along with the pension fund contribution.

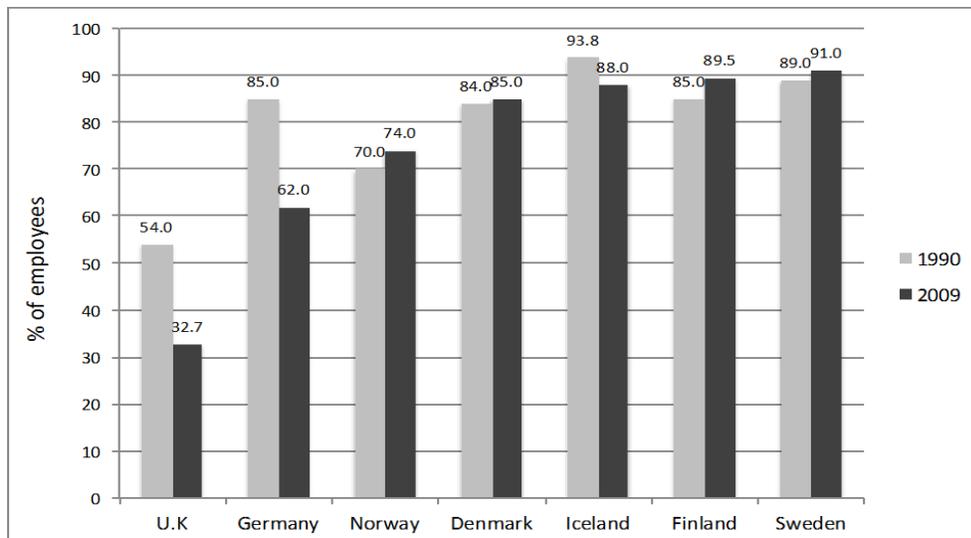


Figure 3.2: Collective bargaining coverage in selected countries, 1990 and 2009

Source: ALAS database and ICTWSS database.

The industrial action on behalf of the unions was intense in earlier decades, typically involving wide participation, approaching general strikes at times. During the 1960s and 1970s it seemed as if there was a general strike in Iceland almost every other year. Consequently, Iceland had one of the highest rates of working-days lost due to strikes between 1960 and 1980, along with Italy and the UK (Ólafsson 1984; Crouch and Pizzorno 1978; Boeri et al. 2001).

The Nordic countries have generally succeeded in maintaining their bargaining coverage from 1990 to 2009 as evident from figure 3.2. Germany and the UK have faced a significant decline in coverage but some of the continental European countries have managed to maintain significantly higher bargaining coverage than membership rates (OECD 2012b). The Icelandic Confederation of Labour is of the opinion that bargaining coverage is even higher in Iceland than these figures indicate, close to 95%, with only the very top managerial positions in public and private sectors excluded.

Social pacts became a part of the collective agreements at times, such as in 1965 when extensive housing construction for workers was negotiated between the labour market partners and the government. In 1969 the partners negotiated for the establishment of an occupational pension fund system, which involved compulsory membership for workers from 1975 and for all employed individuals from 1980. Various improvements of social welfare rights continued to be a part of the trade-off at the bargaining table, in order to restrain direct wage increases, which were often perceived as feeding directly into the inflation spiral.

From the 1980s onwards, there was a growing unrest amongst influential actors in the labour market about what was increasingly perceived as a dead-end inflation situation (Magnússon 2004). This eventually led to the general social pact against inflation, the National Pact of 1990, aiming to contain inflation and based on a formula for increasing real wages modestly while

growing over time, instead of the large rises of earlier inflation bargains. This involved a strong emphasis on price containment, with wide participation of interest groups in the society, as well as central and local governments. That effort was generally successful (cf. chapter 2).

Social pacts became somewhat less extensive in scope during the late 1990s, while generally present, but increased greatly during the present financial crisis. There was not much to bargain over in terms of wage rises in the midst of the crisis so the emphasis by unions and employers on various policy measures to combat the crisis became more extensive. This produced the Stability Pact (2009) which was made between the government, the Icelandic Association of Local Authorities and SA (the largest employer federation) and the main union confederations (ASÍ, BHM, BSRB, KÍ and SSF). In the Stability Pact the collective bargaining agreements were extended in time and wage increases were delayed.

On the whole, we can thus say that the degree of corporatism and policy cooperation has been quite extensive in Iceland in recent decades and still remains so.

The labour market partners have worked closer together since the early 1980s than before and particularly after the social pact of 1990. Their joint custodianship of the occupational pension system (OPFs) has cemented their relationship, leading to a growing emphasis on service-provision or build-up of what the union leaders are prone to call the “welfare system of the labour market”. In addition to the occupational pension funds this refers to sickness funds, the unemployment benefit fund (until 1997), rehabilitation funds for long-term ill or injured workers (since 2008/legalized in 2012), and funds for continuous education of lower skilled workers and life-long learning.

In recent bargaining sessions the social partners have aired their goals of transferring the custodianship of the unemployment insurance fund and the labour market activation institutions from the public Directorate of Labour to the labour market partners. In effect, this would be a return in the direction of the Ghent system of unemployment insurance that was in effect up to 1997. The ultimate goal of the labour market partners regarding the welfare system of the labour market at times resembles an attempt at having a significant part of the public welfare system transferred to the custodianship of the labour market partners. This would involve an extension of the important welfare function that the labour market partners already have. The pros and cons of such a change have not been much discussed in Icelandic politics, but such a development would involve significant changes for politicians, in the sense that they would lose a large part of the function of providing welfare rights and services to the public. While a poor performance on the side of governments in some areas of welfare provisions in past decades may be a strong argument for transferring larger parts of welfare provisions to the labour market partners, it can be seen as a movement away from the Nordic welfare state model towards a more labour market based welfare model.

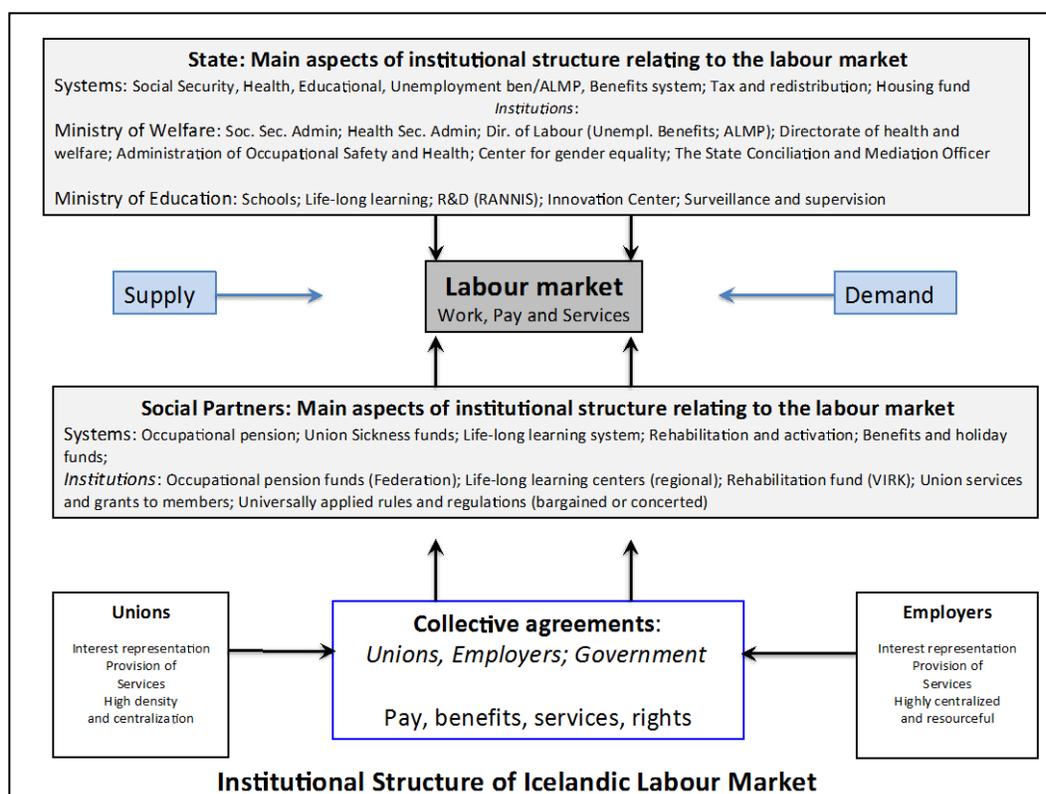


Figure 3.3: Institutional structure of the labour market: public and private features
 Source: Andersen et al. 2011.

One important characteristic of the regime of rights bargained for in the labour market dates from 1980 (originally from 1974). This is a legislation which extends the rights bargained for in the labour market into universal rights for all citizens. Hence, bargained minimum wages automatically become “legal” minimum wages in the country, for all to comply with, including immigrants (Act no. 55/1980). The legislation stipulates the following: “Agreements made between the organisations of the social partners regarding the handling of disputes as to whether the wages and terms of service of workers on the Icelandic labour market conform with the provisions of legislation and collective agreements shall have the same general validity as their agreements on wages and other terms of service under Article 1, with the limitations stated in the agreements.” Hence, this applies to all rights provided in collective agreements. (Halldór Grönvold, personal communication). Thus, unions have made sure that the rights of foreign labour are the same as for locals, giving the unions an active role in combatting social dumping.

Rights and obligations concerning the occupational pension system are of the same kind, universal in application through legislation. While this feature is known in the other Nordic countries (for example in particular sectors, most extensively in Finland), it seems to be more extensive in Iceland. This might have important consequences for retaining some universalist features of the welfare regime system even though public provisions were increasingly transferred to the labour market partners.

In figure 3.3 we show the contours of the welfare-related institutional structure of the labour market in Iceland, along with the features of the public welfare system.

Reading the figure from the bottom up, we see how bargaining between employers and unions has clear goals of not just pay and occupationally-related benefits, but also provision of services and rights. Government is also a “resident member” of the tripartite bargaining process. In many ways the bargaining achievements as regards basic pay levels and working hours are relatively meagre in Iceland, compared to the other Nordic countries, given the low level of wages (ASÍ 2006 and 2013). Icelanders make up for the relatively low wages with longer working hours and relatively low taxes and they thus manage to end up with comparable disposable earnings, and a relatively high level of private consumption (Ólafsson 1990; Eydal and Ólafsson 2012). As regards rights and service provisions, the unions have been quite successful indeed.

The welfare system of the labour market is a significant institutional hallmark, with the occupational pension funds (OPFs) as the jewel in the crown. The sickness funds, occupational, educational and retraining system, the life-long learning system, the new rehabilitation and activation fund (VIRK), other benefits, as well as holiday funds, are mainly operated out of the union offices or with labour market partners’ direct coordination. The OPFs are operated from separate offices but governed by coalitions of representatives of the unions’ and employers’ federations.

The main institutional features of the public welfare system are outlined at the top of the figure. Given that OPFs are already paying a majority of the pensions that old-age pensioners are receiving nowadays, and that this will continue to grow in the future, it seems clear that the private sector part of the pension system will be the main feature of the pension system in the future. At the same time, the public social security system will continue as the securer of minimum pensions and provider for those who never accumulate occupational pension rights through a working career, or who accumulate insufficient rights (see further the section on the social security system below). With the occupational pension funds and the public social protection system as the two main pillars of the Icelandic pension system, along with the third pillar in the form of voluntary individual pension savings accounts, Iceland has a strong foundation for providing pension payments in the future. The division of labour between government and the labour market partners’ occupational pension funds will reduce the future burden on government, making the aging problem less of a problem in Iceland than in most countries in Europe.

Given the importance of pension payments this means that the labour market partners will be taking over growing aspects of what the state now provides through the welfare state. If the goal of transferring the unemployment benefits and activation functions to the labour market partners becomes successful, their role in welfare provision will be larger still. At the same time, the role of the state in the field of welfare would be transformed more in the direction of surveillance and regulation as the state’s role of direct welfare provision would contract (Castles

2010). Such a development would fundamentally change the role of politics. The pros and cons of such a system shift should be carefully examined and discussed.

3.3 Unions

The union movement is dominated by a few labour confederations. The Icelandic Confederation of Labour (ASÍ) was founded in 1916 and is by far the largest, with about 95,000 active members in 2012, while the estimated total number of active union members was around 150,000. The union members belong to one of 51 unions that are affiliated with ASÍ, most of them through industrial or occupational federations. Private-sector employers are also represented by a bargaining organization, SA – Business Iceland (SA). The organization was founded in 1999 with the merger of two confederations, the older of which dates from 1934.

In 2012 there were 9,600 registered companies with two or more employees with 119,000 individuals on their payroll. Companies affiliated to SA are 2,100 (22% of all registered companies). They had 84,000 employees on payroll in 2012, which means that 71% of all employees in the private labour market were employed in companies within SA.

There are two other employer federations which make collective agreements, The Icelandic Federation of Trade (*Félag atvinnurekenda-FA*) and The Federation of the Automobile-related industry (*Bílgreinasambandið-BGS*). FA has 180 affiliated companies and BGS 155, together they have 345 in total. According to the best possible information these two federations make collective agreements which cover about 2,000 employees.

Thus, these three employer organisations cover collective agreements of 26% of all registered companies (with two or more employees) and 72% of all employees in the private sector (cf. personal communication with Halldór Grönvold).

Employees in the public sector are represented by public-sector unions organized into three main confederations, BSRB, KÍ, and BHM – and a sizable number of low skilled public employees and craftsmen are within the ASÍ. The largest of these confederations is the Federation of State and Municipal Employees (BSRB), established in 1942. In 2014 BSRB had 25 unions and almost 22,000 members. University graduates working for the public sector belong to a separate federation of unions, the Association of Academics (BHM), formed in 1958. In 2014 there were 27 member-unions in BHM, consisting of over 10,000 employees with an academic degree of 3 years or more. Furthermore, teachers and school administrators at the preschool, primary school, and secondary school levels are members of the Icelandic Teachers' Union (KÍ), whose members numbered around 10,000 in 8 unions in 2014. A few public-sector unions operate outside these three federations. These include the Icelandic Air Traffic

Controllers' Association, the Icelandic Medical Association, and the Society of Chartered Engineers. In addition, public-sector workers also belong to unions that are a part of the Icelandic Confederation of Labour (ASÍ). The group consists mainly of employees doing blue-collar work, such as maintenance and custodial work, but also includes the Union of Icelandic Electrical Workers.

On the employer side, the public sector is represented by the central government, which is by far the largest single employer in the country, and by the municipal governments. About 20-24% of employees in Iceland work in the public sector (Mósesdóttir et al. 2006; OECD n.d.). In the negotiating round in 1997, the central government changed to a more decentralized system, where there are central negotiations with each public sector union and then there are institutional agreements that are made with each union in each institution.

The existence of large umbrella organizations for both workers and employers in the general labour market has made nationwide labour bargains possible, typically with the active participation of the central government. Underlying this centralization of wage agreements, however, is a fragmented system of labour unions, as individual unions have the right to negotiate independently of the confederations. The confederations and industrially or occupationally based federations officially act only on behalf of the unions, since agreements must be voted on within each union. Although the labour confederations and sectional federations are large, individual labour unions are quite small, as their membership is often determined by both type of work and geographical location. As a result, there are around 150 separate unions operating in Iceland.

When it comes to bargaining, ASÍ, sectional federations, or some member unions of ASÍ bargain directly with SA and usually lead the negotiations and set the stage on which other agreements are based (both in the private sector and the public sector). In times of slow economic growth and increased unemployment, when expectations for higher purchasing power through wage negotiations are low, unions generally delegate the negotiation to the federation to which they belong. On the other hand, when economic growth is on the rise and expectations are running high, unions may decide to negotiate on their own behalf, without the cooperation of other unions. Even though such negotiations sometimes become more fragmented, they remain synchronized, that is, the wage agreements in Iceland mostly cover the same period and expire at approximately the same time.

The structure of the Icelandic collective bargaining system ranks high in terms of both centralization and coordination, more so during recessions than in boom periods. Bargaining occurs most often at the national or sometimes at the industry level, and there is generally a large degree of coordination among the collective bargaining partners.

Negotiated wages and wage increases have the status of a legal minimum wage. There is no upper limit to the wage or wage increase that union members can receive. Thus, actual wage

increases can easily deviate from the negotiated minimum. The extension of contracts, however, is generally not practised in Iceland.

Tripartite agreements, in which the government steps in to facilitate the signing of new agreements between labour unions and employers, have been the norm in recent decades. Furthermore, the attitude of the unions has changed from demanding ever-larger nominal wage increases to focusing on real wage increases. The lengths of the contracts vary from 1 year or less to around 3 years. Also, specific emphasis has been laid on increasing the wages of the lowest paid groups to a greater extent than union members in general since 1997.

Historically, strike activity in Iceland has been high, and Iceland is still close to the top of the list, having the highest strike rate among the OECD countries. This is the case even though strikes are illegal while a contract is valid. The average number of working days lost to strikes and lockouts per year from 1990 to 2006 was 48,000 days. Half of those days, or 25,000 per year, are due to strikes among fishermen and other seamen. Furthermore, teachers in Iceland have gone on few, but long, strikes throughout the years. Excluding these two groups, fishermen and teachers, the average number of working days lost to strikes falls from 48,000 days per year to 5,200 a year, thus significantly lowering the average (Ólafsdóttir 2010).

3.4 Flexibility of the labour market

The Icelandic labour market is classified as a flexible labour market (Ólafsdóttir 2010). There is not a single definition of a flexible labour market, however, economists largely agree on a set of criteria that define the flexibility of a labour market (OECD 2004; Solow 1998; Flanagan 1999; Nickell 2003). These include the strictness of a country's labour market institutions, specifically, the system of laws that regulate the labour market and the ease of hiring and firing; as well as taxes on labour, social security, and unemployment insurance; the system of education and training; and barriers to mobility. Unions and bargaining structures also fall under this heading.

Compared with other countries, the strictness of Iceland's employment protection is very low. Unlike those of many European countries and the United States, Icelandic law stipulates few rights concerning the labour market. Instead, the protection of employees in the labour market is stipulated through collective agreements. Thus, there are no laws on minimum wages, but because each collective agreement stipulates the minimum wages under that contract, it is the equivalent of having minimum wages as stated in Act No. 55/1980.

Rules for hiring and firing are lenient. Most collective bargaining contracts stipulate 1–6 months' notice, depending on tenure, and usually 3 months. Firing is generally done without awarding severance pay. To dismiss an employee, one must present him or her with a written notice

before the end of the month prior to the notice taking effect (Júliusdóttir 1993). Shop stewards, pregnant women, and employees on parental leave enjoy greater protection from dismissal. Employers in the private labour market did not need to demonstrate reason for dismissal up to 2008; however, the rules for dismissal in the public sector have generally been more stringent. Severance-pay agreements are rare, except for top-ranking personnel, in both the private and the public sector and are bound in individual contracts. There are also no restrictions on part-time work.

Iceland is not a member of the EU. It is, however, a member of the European Economic Area (EEA), which extends the four freedoms of the EU to Iceland, Norway, and Lichtenstein. Since the EEA was formed in 1994, Icelandic labour legislation and collective agreements have been altered in accordance with EU regulations and directives. The most notable changes relate to the protection of children and adolescents in employment and restrictions on maximum working hours (on average, 48 hours per week). Thus, the number of rules governing the Icelandic labour market has increased in recent years, either through legislation or through collective agreements (Ólafsdóttir 2010).

On the whole, we can say that the Icelandic labour market model has many similarities to the labour market arrangements in the other Nordic countries. The Icelandic labour movement has the highest union density rates in the democratic world and the organizational structure of the movement facilitates a high degree of centralization through federations and confederations, hence, it can rather easily coordinate collective action. The labour movement in Iceland has been quite successful in many respects and continues to play a key role in the political economy of the country. The generally weak political parties on the left in Iceland, in comparison to the other Nordic countries, means that the role of the labour movement has perhaps been more important for welfare and well-being developments than the labour movement in the other Nordic nations.

3.5 Labour market trends

3.5.1 Employment activity

One of the main objectives of economic policy in Iceland after World War II and up to 1990 was to ensure peace in the labour market as well as ample employment. Iceland has in fact been very successful in securing high rates of employment participation for most of the post-war period. This has though been interrupted by recessions, but typically they were short-term fluctuations that affected more the real wage level than the employment rate.

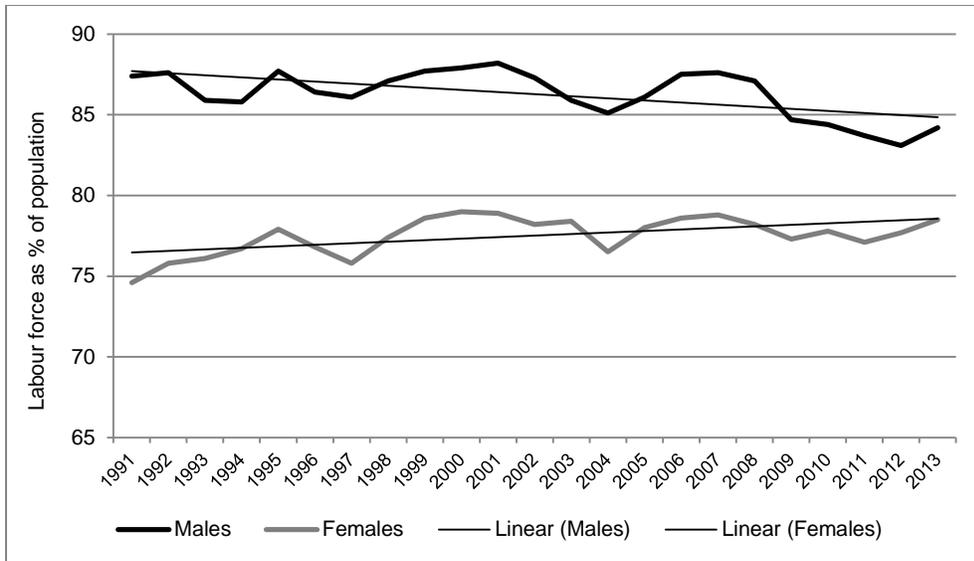


Figure 3.4: Labour force participation rate in Iceland, 1991-2013, as % of population 16-74 years of age

Source: Statistics Iceland.

As figure 3.4 shows, the trend for the labour force participation of men has been downwards since the early 1990s – and most decisively so with the onset of the financial crisis of 2008. This is admittedly a decline from a very high level of labour force participation. For women the opposite trend has prevailed, i.e. a gradually increasing participation in the labour force. The biggest steps in rising female labour force participation came between 1960 and 1990, so the trend since the early 1990s is modest compared to the previous decades. However, the rate of female labour force participation is very high. The crisis after 2008 lowered the female rate from about 79 to about 77, but by 2013 it was already at top level again.

Labour force participation rates in Iceland rank indeed amongst the highest in the OECD-countries for both men and women, as shown in figure 3.5. The rate amongst people aged 15-64 was 86.6% in 2000 and 85.5% in 2012, compared to the OECD average of 69.9% and 70.9% respectively (OECD 2013d).

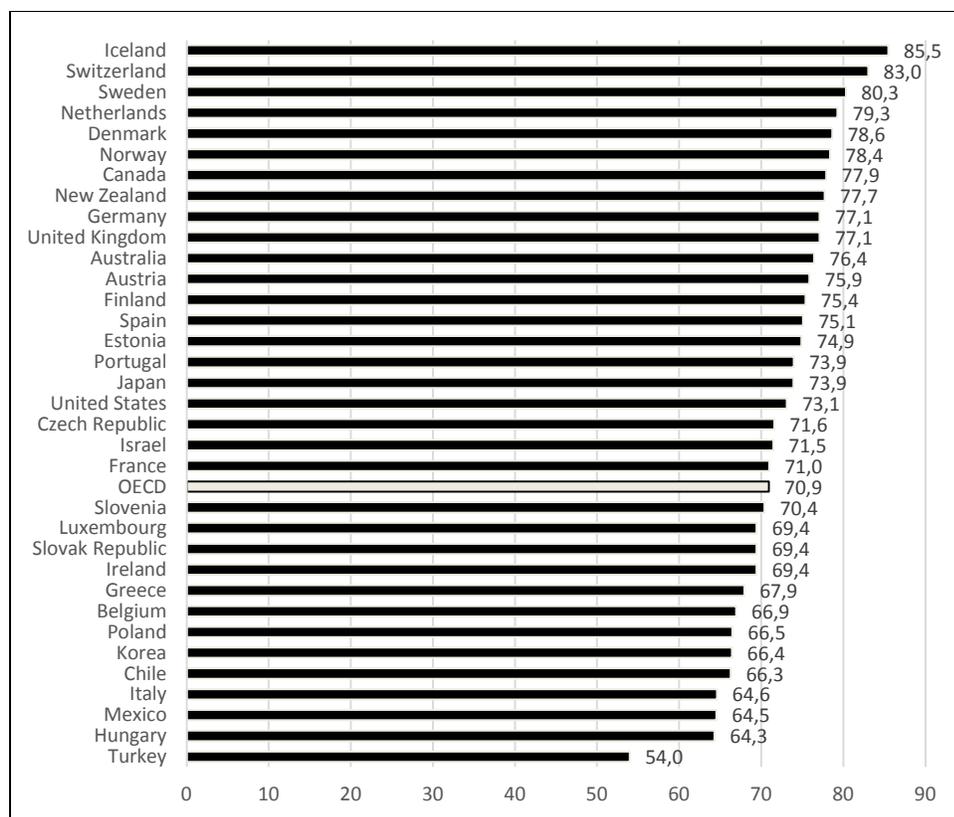


Figure 3.5: Labour force participation rates in OECD-countries in 2012

Source: OECD.

As evident from figure 3.5 Iceland had by far the highest labour force participation rate within the OECD, easily surpassing Switzerland that came second, and has maintained that status, although the labour force participation rate fell slightly during the crisis. The Nordic nations have the highest labour force participation rates (along with Switzerland, the Netherlands and Canada), while the USA and the UK are lower on this scale, and many of the continental European countries are further down towards the middle of the ranking order.

Icelanders also work long hours. In 2012, the average work-week was 39.8 hours. For men the work-week was 44 hours, compared to 35.1 hours for women. As figure 3.6 shows, working hours for men have been on a gradual downward track during the 2000s and they took a significant dive in 2009. After that dive, the hours remained at a similar level through the crisis, up to 2013. The average working hours for women also contracted a little during the crisis, after having increased somewhat from the early 1990s to the boom years before the crisis.

Icelanders also retire late. The labour force participation among the elderly is particularly high in Iceland. In 2012, 64.2% of people aged 55-74 were active in the labour market, compared to 70.4% in 2000 (Statistics Iceland n.d.).

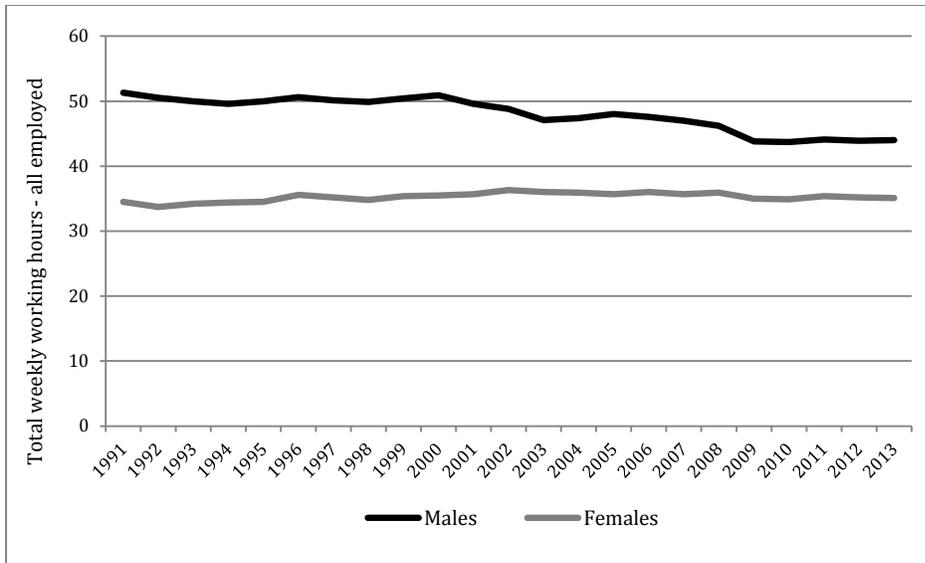


Figure 3.6: Average overall weekly working hours (both in main and second jobs), men and women in Iceland, 1991-2013

Source: Statistics Iceland.

As already indicated, Iceland has had both a high labour force participation rate and relatively long weekly working hours. That makes for a high volume of work per capita in the society, indeed the highest in the OECD (Stefánsson 2012). This high volume of work worked to offset the low level of productivity, as discussed in chapter 2 above.

3.5.2 Unemployment

Up to 1990 the unemployment was generally low or between 0-1 per cent of the labour force. Figure 3.7 shows the unemployment development among men and women from 1991 to 2013.

During the recession of 1991-5, the unemployment rate rose up to 5%, then one of the highest experienced during the post-war period. However, it rose almost equally for men and women. The unemployment rate then came down quite quickly, to 1.3% by 2000. There was a slight rise in unemployment after 2001, before coming down again during the height of the bubble economy. By end of 2008, the unemployment had shot up quickly and it topped at 8.6% for men in 2009 but the top for women came in 2010 at 6.7%. Since then the rates for both have come down again. It is interesting to compare unemployment in crisis ridden Iceland and Ireland as shown in figure 3.8.

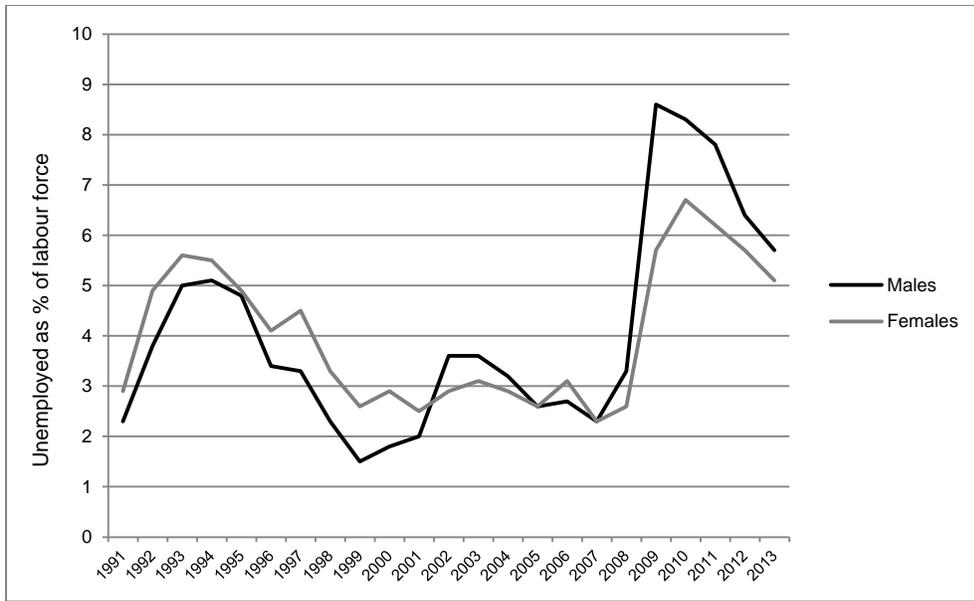


Figure 3.7: Unemployment as a % of the labour force: men and women 1991 to 2013
 Source: Statistics Iceland.

The contraction in GDP was similar in both countries, after the financial bubbles burst, but the unemployment consequence was significantly greater in Ireland. In fact Iceland's employment development through the crisis was better than in all the other deep crisis countries in Europe (Ólafsson, Kristjánsson and Stefánsson 2012) as would be predicted by the flexibility of the labour market (Einarsdóttir, Ólafsdóttir and Arnardóttir 2011).

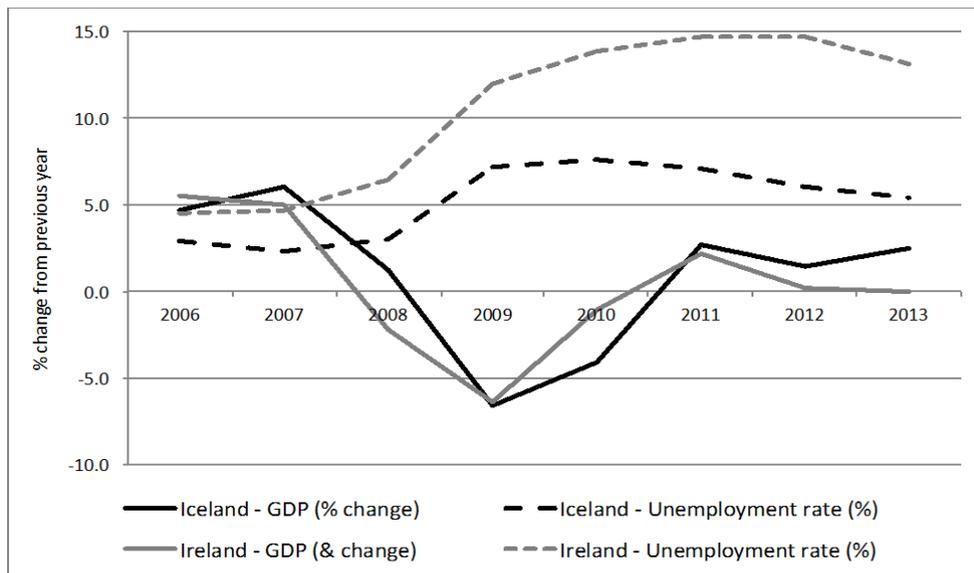


Figure 3.8: Unemployment and GDP in Iceland and Ireland, through the crisis
 Source: Eurostat.

Active labour market policies have been used in many countries to facilitate the move from unemployment to employment. With the historically low unemployment rate in Iceland, there

was little demand for active labour market policies. However, public employment agencies, which list local jobs as well as those in other EEA countries, operate in each part of the country. They also offer assistance to job-seekers in the form of various kinds of instruction, such as computer courses, self-enhancement courses, and courses in operating heavy machinery, to name a few. From the fall of 2008, active labour market policies were used extensively to help job seekers to reenter the labour market as discussed in Chapter 4.4. The period of unemployment compensation was three years prior to the recent recession. The period was temporarily extended to four years in the beginning of the recession. It is also possible to receive unemployment compensation while working part time.

After the recession hit in the fall of 2008, the number of group-layoffs rose sharply. A group layoff is defined as layoff of 10% or more of employees within a calendar month and has to be reported to the union(s) in question as well as to the Directorate of Labour (Act no. 63/2000). In September of 2008, 113 people were laid off in four organizations, but in the following month a total of 2.960 people were laid off in 65 organizations. From October 2008 to May 2009 a total of 4.461 people were laid off through group-layoffs in 107 organizations, or about 2.6% of the labour force. During the period June 2009 to April 2010, a total of 1.098 people were laid off in group-layoffs in 38 organizations, accounting for about 0.6% of the labour force. In comparison, a total of 2.520 people received unemployment benefits when the economy went into the downturn (Directorate of Labour, n.d.).

In 2007, there were on average 4,000 people unemployed throughout the year, but in 2009 this number had more than tripled up to 13,000 people and went down to 7,300 people in 2013. The number of young people aged 16-24 that were unemployed in 2006 was 2,500 on average, but counted 5,000 in 2009 and went down to 1,300 in 2013.

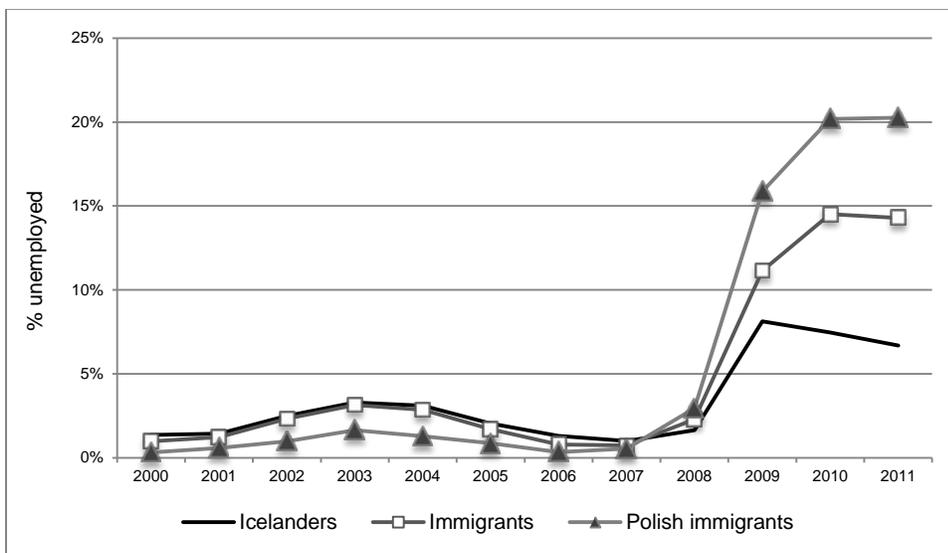


Figure 3.9: Registered unemployment 2000-2011: Icelanders and immigrants compared
Source: Directorate of Labour, direct contact (Karl Sigurdsson).

The unemployment rate was 2.6% in October 2008 and rose to 4.8% by year's end. The unemployment peaked at over 11.9% in May 2010, averaging 7.6% for the year. Since then, unemployment has gone down and measured 5.4% in 2013 (Statistics Iceland). Long-term unemployment, measured as the percentage of those unemployed that have been out of work for 12 months or longer, was 8.1% in Iceland in 2007. At that time the European average measured 44%. During the recession, long-term unemployment has risen and has stayed over 20% from 2010 to 2013.

While unemployment among Icelandic nationals reached a top of 8.1% in 2009, the unemployment rate among the immigrant population topped at 14.5% in 2010 and Polish immigrants specifically topped at just over 20% also in 2010, as shown in figure 3.9. The reason for higher unemployment rate amongst Polish immigrants is probably due to the fact that they have been very prominent as workers in the construction industry, which was particularly badly hit.

However, the progress towards lower registered unemployment seems to be the sole prerogative of Icelandic nationals, at least to the end of 2011. This is in line with the higher rate for risk of poverty or social exclusion amongst foreigners in Iceland (Andersen, Hougaard and Ólafsson 2011). This raises the question of whether the measures implemented for reducing unemployment were sufficiently reaching the immigrant population. The pattern of unemployment before the crisis does not indicate a direct discrimination at that time, since the Polish immigrants had the lowest unemployment rate from 2000 through 2007. If the higher unemployment rate amongst this group during the crisis is due to construction industry effects then the indication is that labour market measures are not reaching them sufficiently. Education options may also be a special hindrance for them. Hence, this issue seems in need of great consideration in order to avoid the creation of a longer-term problem and a divide between Icelandic nationals and the immigrant population.

3.5.3 Immigration and emigration

Immigration has risen significantly in recent years in Iceland. As a member of the European Economic Area, there is free flow of people between member states. With the enlargement of the European Union in 2004, some limitations were initially put on the flow of people from the 10 new entrant countries as they had to apply for work permits. People from countries outside the EEA must apply for residency and for a work permit in order to be able to live and work in Iceland.

Immigration became an issue of major change during the 2000s, when the rate of foreigners residing in the country went from about 2-3% of the population up to about 8%, during the height of the bubble economy. The immigrants come from all over the world; however, the largest group of immigrants comes from Poland, as one in five foreign nationals is from there (Statistics Iceland). In 1998 there were more women than men among foreign nationals living in

Iceland, and this was the case until 2005, when the ratio was reversed and since then more men than women are among foreign nationals living in the country. Figure 3.10 shows the net external migration flow of Icelandic nationals and foreigners from 1990 to 2012.

The general pattern has been that Icelandic nationals emigrate primarily to the other Nordic countries. This is particularly pronounced in recession periods. On the other hand, foreigners flow into the country, largely affected by the business cycle. Thus, there was a large flow of foreign immigrants to Iceland during the late 1990s and early 2000s and again during the height of the bubble economy period. As the figure shows there was considerable outflow of Icelanders during the crisis years after 2008, but the outflow of foreigners was less pronounced after 2009 (Ólafsson, Kristjánsson and Stefánsson 2012). However, the outflow of Icelanders was no more that could be expected considering the depth of the recession.

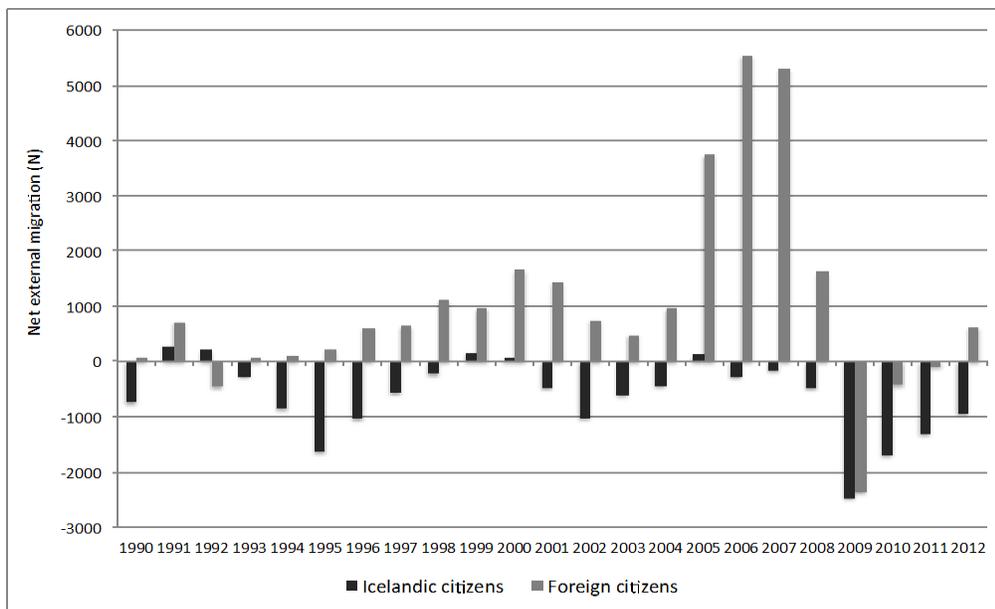


Figure 3.10: Net external migration flows: Icelandic nationals and foreigner citizens, 1990-2012
 Source: Statistics Iceland.

Less than a fifth of those who came in the five years before the crisis have left again, but the rest seem set to remain. Thus the labour force grew very rapidly in these years and remains larger than trendlines would have predicted, despite the crisis and increased emigration of Icelandic nationals, especially to Norway (Skaptadóttir, Eydal and Sigurðardóttir 2012; Ólafsson, Kristjánsson and Stefánsson 2012). Asylum seekers have generally been rather few in Iceland, but their numbers have grown in the last two decades.

4. Social protection

4.1 Introduction

A new study of welfare developments in Iceland during the last two decades leading up to the crisis of 2008 indicates that while Iceland was a welfare laggard in the Nordic community at the beginning of the period, it has caught up with the other Nordic nations (Eydal and Ólafsson 2012). In terms of welfare expenditures this has been influenced not just by increased public welfare service expenditures but also by the increased payments from the occupational pension funds (OPFs). Figure 4.1 shows the development of overall expenditures on social protection and health during the period, as a proportion of GDP.

Given the deep crises in Finland and Sweden at the beginning of the 1990s it is not surprising that the welfare expenditures, as a proportion of GDP, have come down from that time. However, such a development is also evident in Norway (partly due to a steep rise in GDP). But Iceland's catch-up is clear and by the end of the period it is quite close to Norway's proportion. Still Norway's welfare expenditures per capita in euros (PPP adjusted) are significantly higher than Iceland's, as GDP per capita is higher in Norway and the Norwegian currency is also higher valued. The Icelandic figures cover all public expenditures on welfare and health, as well as the expenditures from the mandatory occupational pension funds.

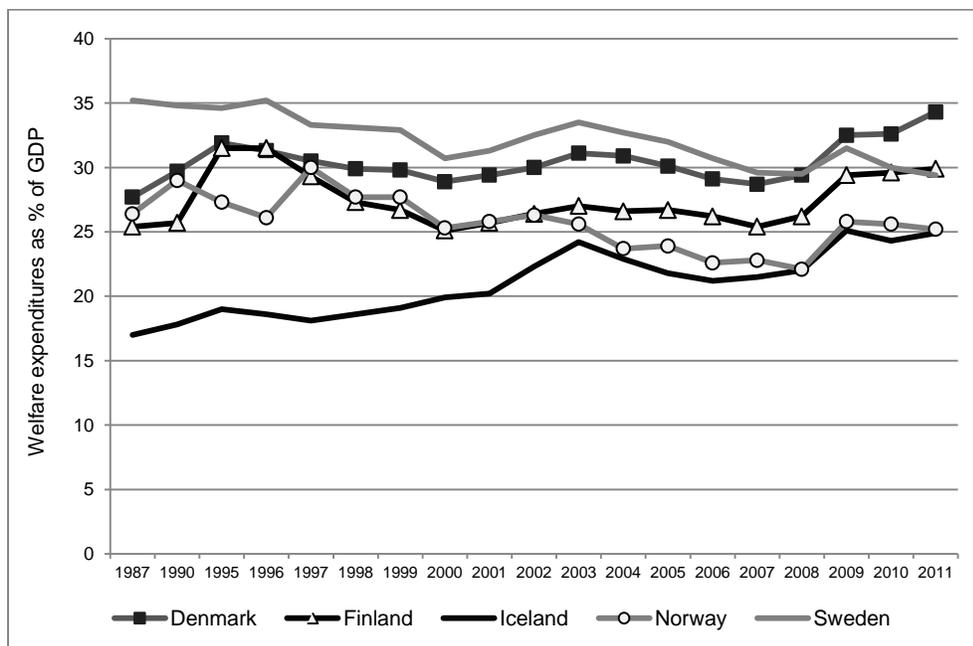


Figure 4.1: Development of welfare expenditures (social security and health) in the Nordic countries, % of GDP from 1987 to 2011

Source: Ólafsson 2012 and Nososko (various years).

After the onset of the financial crisis, the welfare expenditures increased in all the countries, not least due to increased unemployment. In Iceland the transfers to households became more targeted at lower income households, with the aim of alleviating poverty hardships. On the whole, transfers were increased significantly but expenditures on services were cut considerably. Denmark has increased its welfare expenditures to the greatest extent and is now surpassing Sweden at the top. After 2009, welfare expenditures have come down slightly in Sweden and Norway, stayed on a similar level in Iceland and increased in Denmark and Finland. So Iceland still ranks at the bottom with the lowest welfare expenditure share, despite a significant convergence during the last two decades.

4.2 Developments since the 1990s

The main explanation for Iceland's increased welfare expenditure rate is increased payments from the occupational pension funds (OPFs), as well as an increased level of health expenditures and family-related expenditures, primarily for parental leave. Child benefit expenditures, however, declined significantly during the period from 1987 to 2008 as did the interest tax credit, which subsidizes interest costs of mortgages, at the same time that debt levels of households increased steeply, as we show later in this report.

In table 4.1 we analyse further Iceland's situation compared to the other Nordic nations in terms of welfare expenditures per capita (in euros, with PPP adjustments), by individual categories of the welfare provisions, between 1995 and 2007, thus highlighting the convergence of expenditures.

	Family policy	Unemployment	Health care	Old age and disability	Housing	Other social issues	Total
Denmark 1995	768	915	1109	2997	152	273	6214
Denmark 2007	1100	474	1934	4463	208	221	8400
<i>Change in %</i>	43.2	-48.2	74.4	48.9	36.8	-19.0	35.2
Finland 1995	651	701	1040	2330	73	102	4897
Finland 2007	825	551	1869	3623	69	158	7094
<i>Change in %</i>	26.7	-21.4	79.7	55.5	-5.5	54.9	44.9
Iceland 1995	432	145	1267	1378	22	95	3339
Iceland 2007	867	72	2666	2458	184	177	6422
<i>Change in %</i>	100.7	-50.3	110.4	78.4	736.4	86.3	92.3
Norway 1995	746	356	1394	2564	39	199	5297
Norway 2007	1246	128	3233	4981	63	265	9916
<i>Change in %</i>	67.0	-64.0	131.9	94.3	61.5	33.2	87.2
Sweden 1995	677	664	1293	2951	204	183	5972
Sweden 2007	901	332	2306	4973	146	184	8842
<i>Change in %</i>	33.1	-50.0	78.3	68.5	-28.4	0.5	48.1
<i>Iceland and Scandinavia compared:</i>							
Scandinavia 1995	711	659	1209	2711	117	189	5595
Iceland 1995	432	145	1267	1378	22	95	3339
<i>Difference (% of Iceland)</i>	61	22	105	51	19	50	60
Scandinavia 2007	1018	371	2336	4510	122	207	8563
Iceland 2007	867	72	2666	2458	184	177	6422
<i>Difference (% of Iceland)</i>	85	19	114	55	151	86	75

Table 4.1: Development of welfare expenditures (per capita; euros in PPP values), by policy areas, from 1995 to 2007

Source: Ólafsson 2012 and Nososko (various years).

Table 4.1 shows that Iceland caught up with the other Nordic nations in the area of housing benefits (mainly due to the introduction of rental subsidies), where Iceland went from the lowest position to the second highest after Denmark. In health care, Iceland was above the Scandinavian mean at the beginning and increased its level, from 105% of the Scandinavian mean to 114%. The increase was primarily up to about 2003; from then on the expenditures on health care declined slightly again or remained at level.

The family expenditures is the third most important area of catch-up for Iceland, due to increased subsidies for day care or pre-school and the new and expanded parental leave (with a particularly expensive father's leave). Iceland's current system of parental leave dates from 2000. In the event of the birth of a child the mother receives 3 months' leave; the father receives another 3 months' leave, and further 3 months can be used by either parent (Act no. 95/2000). During the parental-leave period, the parent receives 80% of his or her former wages, up to a certain limit. That produced an increased expenditure level despite significant cuts in real expenditures on child benefits.

Iceland continued to have low expenditures on unemployment benefits up to the crisis (due to particularly low unemployment rates) and expenditures on old-age and disability issues had the second largest increase in the Nordic community, after Norway. The growth of OPF's expenditures counted for most of the the growth in old-age and disability benefits, since public

social security expenditures on those benefits were contained during the period, due to the effect of income-testing (Ólafsson 2012b).

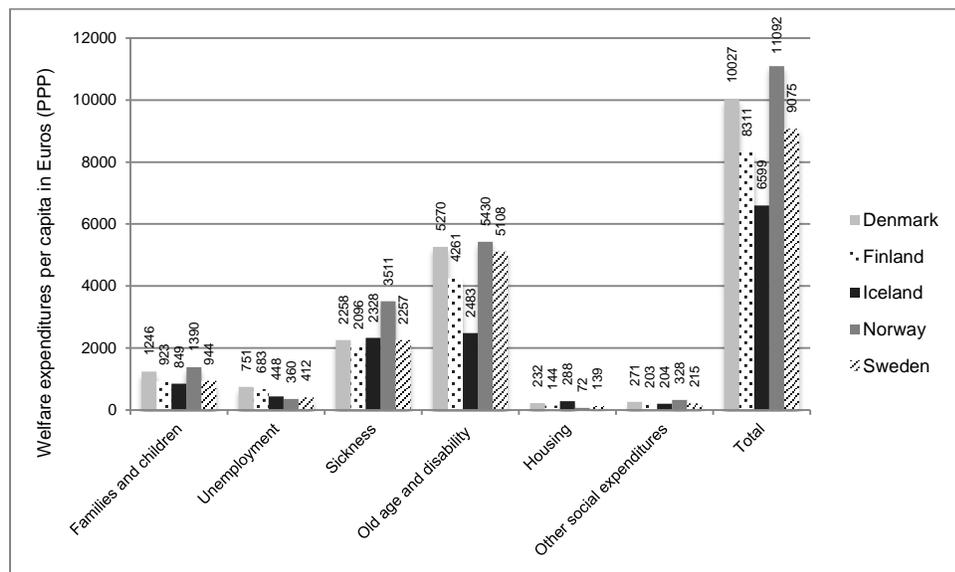


Figure 4.2: Welfare expenditures per capita in 2010 (in euros with PPPs)

Source: Nososko 2012.

Before the crisis, the Icelandic welfare state had a rather low level of transfers to households, but on Scandinavian levels as regards service intensity (Ólafsson 2012b). The generosity of the Icelandic welfare system increased significantly during the period and is close to the Nordic one (i.e. in terms of relative expenditures as proportions of GDP, but less so when looking at real expenditures in euros, PPP adjusted).

Figure 4.2 shows the profile of welfare expenditures in the main areas of social protection. The figures are in euros with purchasing power parities and refer to 2010, when Iceland reached the bottom of the crisis (more recent figures are not available). Iceland's expenditures on housing benefits is high at that time, and were raised further as a part of the crisis management strategy of the government. Regarding sickness expenditures, Iceland is on level with the other countries, except Norway which ranks the highest. Expenditures on unemployment insurance were unusually high for Iceland in 2010, which puts Iceland close to the average for the Nordics on that front. But when it comes to old-age and disability benefits, Iceland ranks the lowest. This is mainly due to extensive incomes-testing of benefits and a significantly later take-up of retirement pensions in Iceland than in the other countries. Iceland has a relatively high level of expenditures on disability pensions and services.

An issue of great concern amongst the operators of the occupational pension funds (OPFs) and in government, was the growing number of disability pensioners from the early 1990s to the late 2000s (Herbertsson 2005; Ólafsson 2005). This came as a surprise to many and was by critics of the welfare state seen as reflecting too favourable incentives for leaving employment and taking

up disability pension, for example for single mothers (Herbertsson 2005). This was questioned when data showed that disability benefits had lagged behind wages in the labour market (Ólafsson 2005). Hence, the presence of an increased incentive for transitions to the disability pensions could not be established (Ólafsson 2005). Much of the increase was due to more leniencies towards opening up the pension system to awarding disability benefits to individuals with psychiatric diseases. Still, the concern of the OPFs and government remained, due to the cost effects of the growing number of disability pensioners. Later research has shown that when unemployment rises, the incidence of disability pensioners rises as well, without a proportional fall when the unemployment rate falls again (Thorlacius and Ólafsson 2010).

A more recent study found that the growth of disability pensioners slowed during the late 2000s and despite worries that it might grow rapidly again during the present crisis that has not been born out (Ólafsson 2012a and 2012c). Still, these concerns lead to growing emphasis on activation and vocational rehabilitation, which triggered changes in the disability pension system and led also to the establishment of the Rehabilitation Fund of the labour market partners (VIRK). See further discussion later in this chapter.

4.3 The Icelandic pension system

Iceland has a three-pillar pension system which has many characteristics commonly associated with the Scandinavian pension systems, while also retaining some of its own characteristics. The public social security pension system is universal in coverage, with rights based on period of residence in the country. It is primarily tax funded, while the occupational pensions are contribution-based. The system is redistributive on the whole and succeeds well in alleviating poverty amongst the elderly and other pensioners, in comparison to other European societies (Eydal and Ólafsson 2012; OECD 2008a, 2009; Kangas and Palme 2005).

The main deviation from the Scandinavian model is that the occupational pension pillar is in the private sector, unlike in Sweden and Norway. The Icelandic system is most similar in structure to the Danish one, and partly to the Finnish one. In the Icelandic Social Security System the use of flat rate benefits with a high degree of incomes-testing is a deviation, more in the direction of the Anglo-Saxon models, while the services part of the Icelandic welfare state is more in line with the Scandinavian systems (Ólafsson 1999 and 2012b).

Iceland has a three-pillar pension system, with the following characteristics and workings:

- I. A public tax funded pay-as-you-go universal Social Security System (Soc. Sec.) with a defined benefit which secures a minimum pension for everyone. The legal basis dates from 1946, originally modelled on Beveridge's plan, but also incorporating

significant use of incomes-testing, in line with New Zealand's legislation from 1938. It has a universal coverage, unlike the other two pillars. The Social Security pension has three components: Basic pension; Pension supplement and Household supplement. The benefits had a tradition of being rather low in early decades. Hence, the growing need for "additional pension", which eventually led to the institutionalization of the second pillar in 1969.

- II. A funded Occupational Pension System (OPS) with defined contributions (DC), introduced as a result of collective bargaining between unions and employers' federations in 1969. Public employees and a few occupational groups in the private sector had, however, gained occupational pensions before. Participation in the OPS is compulsory. From the beginning employees contributed 4% of pay and employers another 6%. Nowadays the overall contribution is 12% of total earnings (4% from employees and 8% from employers in the private market, the central government pays 11.5%). The occupational pension became mandatory for employees in 1974, and for all employed persons from 1980. Even though the system is a DC-system, it promises 56% of average career earnings (stipulated in framework legislation from 1997, Act no. 129/1997) as a minimum. Contributions are exempt from taxation when paid in, but fully taxed when taken out as earnings. The OPS funds are managed by the labour market partners, the unions and employers' organisations and are supervised by the Financial Supervisory Authority (*Fjármálaeftirlitið* -FME). The public sector pension funds are different in that they are based on defined benefits as opposed to defined contributions. They are partially funded, but with a state guarantee.
- III. Individual Pension Accounts (IPA). The framework legislation is from 1997. These are voluntary accounts with a defined contribution. Individuals can pay contributions up to 4% exempt from income tax (when paid in) and have the right to 2% additional contribution from employers with the first 2%. So altogether 6% are exempt from direct taxation when paid in (this was temporarily lowered to 4% during the crisis, but went up to 6% again in 2014). These are managed by occupational funds, banks or private investment funds and supervised by the Financial Supervisory Authority, as the OPS funds.

The different pillars have different roles in society and differing effects on the distribution of living standards. The Social Security equalizes the income distribution with its minimum guarantee and universal incomes-tested benefits. It is, thus, of great importance for alleviating poverty and quite successful in that respect, since Iceland has, along with the Scandinavian countries, one of the lowest poverty rates in Europe (Eurostat: EU-SILC data and OECD 2008a). The high labour force participation rate also contributes greatly to that outcome. The universal benefits are also of great importance for elderly women, especially widows who have

little accumulation of rights in the occupational pension funds, or other means of earning income.

A great majority of old age pensioners receive some pension from Social Security, while only a small minority have to rely solely on the minimum guarantee (less than 5%). For many of those who have little income from the occupational pension funds, the minimum guarantee provides a supplement and at present about 20-25% of old age and disability pensioners get some supplement from the minimum guarantee, many, however, only a small sum (Cf. a personal communication from the Social Security Institute). This proportion was previously higher (from September 2008 through June 2009), but was reduced somewhat with an introduction of a greater degree of incomes-testing in 2009, as a part of austerity measures. The function of the minimum guarantee is primarily that of improving the level of living for those pensioners that have low other income, whether from the OPS funds or other means (employment or financial income).

The second pillar aims at replacing the income distribution in the labour market proportionally, without any roof and has been gradually increasing in importance for raising the living standard of pensioners by adding to the modest income provided by Social Security. The yearly accrual rate for rights in the OPS is 1.4% of pay and the system works on notional accounts. Rights are proportional to pay and indexed during periods of accumulation by a fixed rule. After pensioners start receiving their pension, the amount they get is indexed to the cost of living from then on (Ísleifsson 2007; Ólafsson 1999).

The individual pension accounts (IPAs), being voluntary, have an incomplete coverage, with about 60% of wage earners contributing (which incidentally is high by international standards). The 40% who do not contribute are disproportionately low income earners and single parents (mainly single mothers). This pillar, thus, makes the income distribution amongst pensioners more unequal on the whole.

The first two pillars are the main building blocks of the Icelandic pension system. The second pillar pays out to pensioners a slightly higher proportion of GDP than the public Social Security System at present. The importance of the third pillar has declined in the last year, both due to losses of assets in the financial crash, and also due to the fact that as one of the crisis measurements, the government opened up the pillar for subscribers under the age of 60, who were allowed to liquidate their contribution up to a prescribed sum. This policy was extended through 2014.

Since the Social Security pillar uses incomes testing to a high degree, also fully against occupational pension earnings from 2009 to 2014, the amounts paid to pensioners from Social Security decrease as occupational pensions increase, with growing maturity of individuals' rights in the occupational pension funds (cf. SSI - Staðtölur almannatrygginga 2007 and 2009). Of old age pensions, the OPFs pay out about 65% of all pensions and the Social Security System 35%.

When the OPS becomes fully mature in 2025-2030, the proportion paid by the OPFs will approach 90%. For invalidity pensions the OPFs pay one-third, while the Social Security System pays two-thirds.

Looking at the three components of the Social Security pension (Basic Pension; Income Supplement; Household Supplement), we see that prior to 2009 94-95% of old-age pensioners received the Basic Pension without any cuts. At this time this component was only cut due to employment and financial earnings. From 1st July 2009 to January 1st 2014, occupational pension benefits were also subtracted from the Basic Pension. Thus in 2009 the share had fallen to 81.5% of pensioners receiving full Basic Pension without any cuts. The new government abolished the cut due to pension benefits again at the beginning of 2014.

As regards the Pension Supplement, the second component of Social Security, which is incomes-tested against all other income, about 20% of pensioners received the supplement without any cuts (leaving 80% of pensioners who either receive a part of the supplement or not at all), and the third component (Household Supplement, also incomes-tested against all other income, while payable only to single pensioners) is received in full by only 6-7% of pensioners.

Due to incomes testing, and increased pension receipts from the occupational pension funds, the overall public expenditure on Social Security pensions has remained stagnant, or lowered as a share of GDP in recent years. It went from 2.5% of GDP in 2002 to 3.1% in 2003; then it lowered to 2.8% in 2006 and increased again to 2.9% in 2007 and 2008. All of these years were years of positive economic growth, the lowest, however, being the growth of 1.2% in 2008, the year of the financial collapse (in October). This proportion increased in 2009, with the GDP declining by 6.6% during the year, at the same time expenditures of Social Security were increased on the whole, not least with 9.6% general rise of the pension amounts and a 20% rise of the minimum pension guarantee on the 1st of January 2009. The OPFs are paying a somewhat higher proportion of GDP to pensioners (3.4% of GDP for old age pensions and 0.7% of GDP for invalidity pensions) than the public Social Security (SSI – Staðtölur almannatrygginga 2007 and 2012).

Iceland has had a long-term high rate of employment and low unemployment. This has been coupled with a high average age of exit from the labour market. Both ample job opportunities and incentives for delaying take-up of pensions have contributed to the late exit from the labour market and into the pension system. But barriers to early exit have also been an influence in that respect. Figure 4.3 shows the main exit routes for the elderly or disabled in the Icelandic pension system.

One of the features of the Icelandic pension system has been the absence of a special early retirement scheme. Hence, those that have wanted or needed to retire early have had to rely on special provisions in their own pension funds (such as fishermen who can retire at age 60 or public employees) or simply to enter the disability pension scheme. Given that disability

pensioners have to qualify in the disability test this has in effect been something of a barrier. It has probably been more difficult to retire early in Iceland than in the other Nordic countries, and much more so than in the European continental countries.

Late retirement and frequent delaying of pension take-up has, thus, maintained a high activity rate amongst Icelanders above the age of 60. One in three people aged 65-74 are still in the labour market. This has been important to avert poverty problems in this age group. Poverty among people aged 65 and over, measured as individuals with income below half of the median in each country, is about 5% in Iceland, compared to 13% as the average for the OECD countries. It has also meant that public pension expenditures have been a relatively low burden on the public budget, or 2-3% of GDP, compared to 7.2% as the OECD average (OECD 2009). The mandatory OPFs add another 3-4% of GDP in pension expenditures in Iceland. The age structure in Iceland is expected to approach the OECD average in the middle of this century, when the baby boom generation that was born in 1955-1960 retires in 2025-2030, the burden is expected to exceed 10% of GDP.

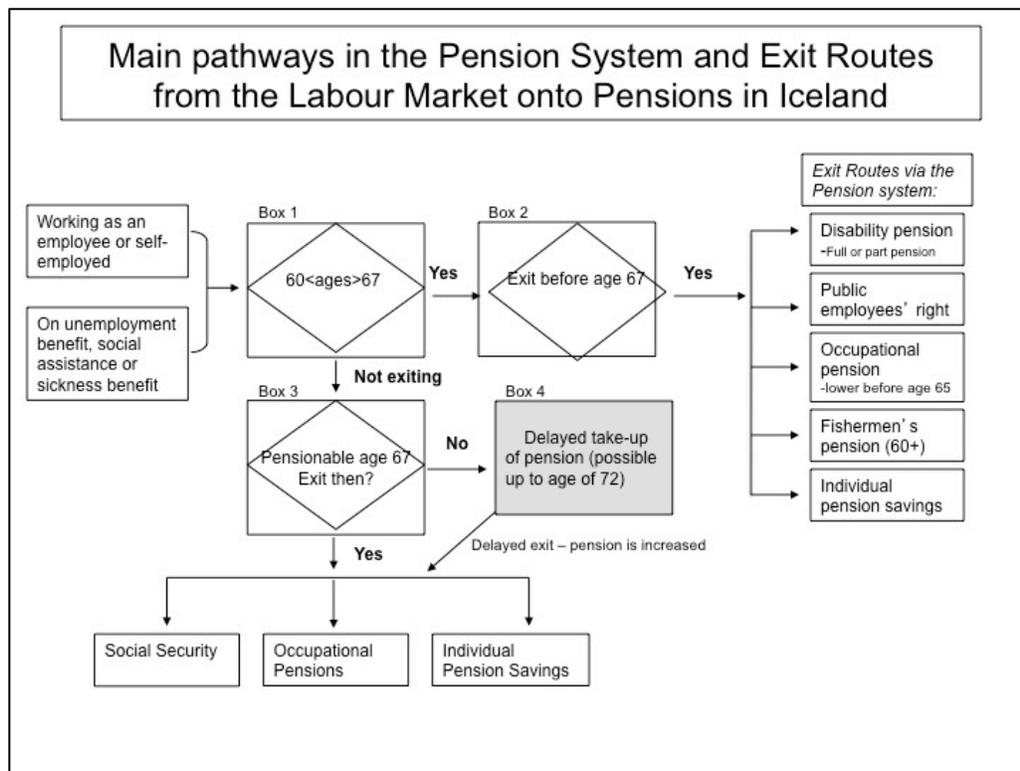


Figure 4.3: Exit routes from the Icelandic labour market into the pension system, as of 2010
 Source: Ólafsson and Karlsson 2009.

The most common retirement age for men in Iceland is close to 70 years, while most men in the OECD countries retire between the age of 61 and 67. Icelandic women generally retire around the age of 65, while women in the OECD countries usually retire between 59 and 65 years of age. While Icelandic people retire late, they also live longer. It is expected that Icelandic men

receive retirement income for 16.8 years, while women are expected to receive retirement income for 19.2 years. The average for the OECD countries is 18.5 and 22.2 years, respectively (Ólafsdóttir 2012).

On the whole, one can say that the Icelandic pension system is in a rather good position for the future. This is because the Icelandic population retires very late indeed. In addition, Iceland has still a relatively high birth rate and the OPFs have accumulated funds with which to pay the majority of pensions of the future. The size of the assets of the occupational pension funds is amongst the largest within the OECD, or approaching 150% of GDP.

The Icelandic pension fund system experienced a significant setback when the crisis struck, along with pension systems around the world. The OECD estimated that the loss among pension funds in OECD countries averaged 23% (OECD 2009). The estimated loss of Icelandic pension funds was close to the average, or about 22%, while Ireland, Australia and the US exceeded the average.

The pension funds that operate in the private sector are fully funded. If they show a serious negative financial standing, they need to either increase contributions or cut pension payments. With the onset of the financial crisis, all the pension funds suffered a setback, but some more than others. In 2006 and 2007, none of the pension funds showed a deficit in terms of their actuarial position of over 10%. In 2008, 41% of pension funds showed a deficit in excess of 10%, with the number rising to 57% in 2009. In 2012 and 2013 all the pension funds either showed a surplus or a deficit less than 10% (Fjármálaeftirlitið).

The OECD estimated that the group most vulnerable to the loss of the pension funds is older people, still in the labour market, but planning to retire soon. Their pension payments are likely to be lower than expected. Those that have already retired are less likely to be affected as pension payments are index-linked and there are limits to how much pension payments can be changed after retirement. The youngest cohort is least likely to be affected as they have time to make up for the loss resulting from the financial crisis during their lifetime (OECD 2009).

4.4 Social inclusion measures during the crisis

The crisis hit the central government hard. After running the general government with a surplus during the bubble years, the balance quickly turned into a deficit in the second half of 2008. The surplus amounted to 4.9 of GDP in 2007, turning into a deficit of 13.1% of GDP in 2008. The deficit measured around 10% of GDP in 2009 and 2010, while coming down to 5% in 2011. In cooperation with the International Monetary Fund (IMF), the central government set up a medium term plan to bring the deficit under control, with the support of the social partners.

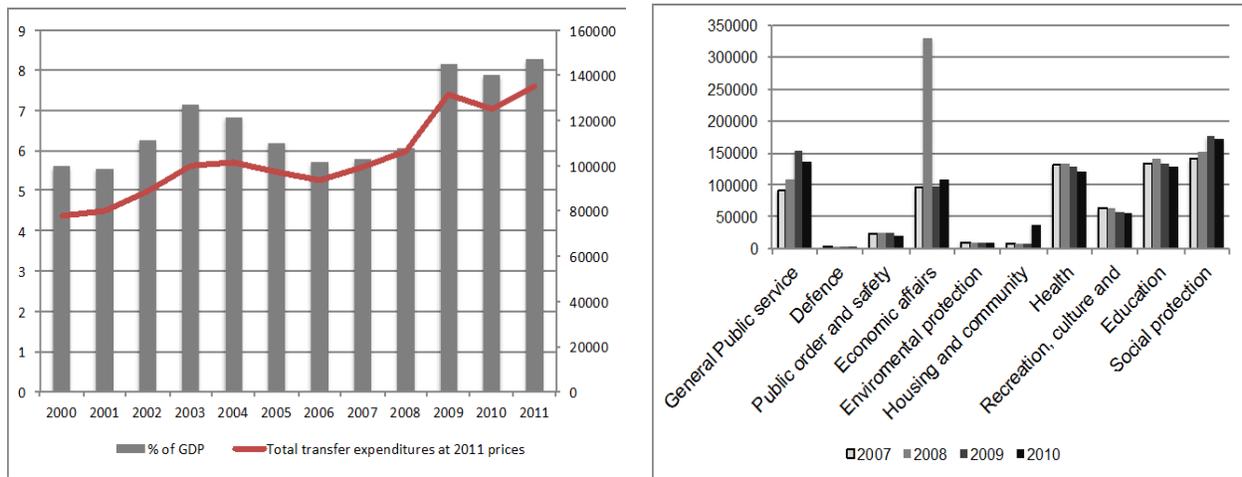


Figure 4.4: Development of total public and social transfer expenditures through the crisis
 Source: Statistics Iceland.

The plan included using the automatic stabilisers to the fullest in 2009, thus delaying fiscal adjustments until 2010. The plan included both tax hikes and expenditure cuts. Most tax rates have been raised, the VAT was raised by 1 percentage point to 25.5%, the corporate income tax was raised to 20% and the tax on financial income was raised to 20% from 10%. The personal income tax system was changed, by introducing three tax brackets instead of one, the lowest tax bracket similar to the old bracket and the two new tax brackets higher, thus increasing the progressivity of the income tax. Furthermore, a tax on net wealth was reintroduced, but with much higher wealth limits than the earlier version of the tax. In spite of the tax increases and cut in expenditures, the government had a strategy of sheltering welfare from cuts and aimed to use welfare transfers to shelter the most vulnerable groups against the consequences of the crisis (Ólafsson and Kristjánsson 2012a; Ólafsson, Kristjánsson and Stefánsson 2012). This strategy involved a large increase in the level of the minimum social security pension, lower tax burden on lower income groups and a large increase in the tax credit of interest cost of mortgages.

As seen in figure 4.4 above, the welfare transfers to households increased significantly during the crisis, both as a proportion of GDP and in real króna values. This was largely due to an increase in unemployment benefit payments. It is important to note that a large share of transfer payments are based on collective agreements and hence, not a part of the state budget. These include payments such as sick leave payments and old age pensions. Therefore, the austerity measures during the crisis were less extensive than in many European countries. Public expenditure cuts were more common in public administration, health care and education, i.e. in the service field, which previously had quite high expenditures levels as shown on the right hand side of figure 4.4.

4.4.1 Activation measures

While it would be too much to say that a comprehensive and integrated policy on social inclusion in Iceland has been formed, the policy environment still has many characteristics of a comprehensive nature. This is due to the fact that even though progress on individual fronts concerning issues of social inclusion (adequate income, inclusive labour market and quality services for all) has generally been done in a piecemeal fashion over time, the policy environment is neither ignorant nor aversive to the importance of coordination in policy-making. This is particularly important since the policy environment in Iceland is characterized by a very high degree of consultations and corporatism (Andersen et al. 2011; Ólafsdóttir 2010).

The policy package formed to combat the crisis in Iceland was defined by the government of the Social Democratic Alliance and the Left-Greens, which got a majority in the election of April 2009. The government defined itself as a Nordic Welfare Government, aiming to shelter in particular the lower and middle income groups against the worst vagaries of the crisis as well as resurrecting the financial system and getting the society up and running again. The government also pledged to change course from the pre-crisis emphasis on unrestrained financial capitalism to a more marked emphasis on equality and social justice, sustainability, feminist goals, reaffirming good morality and democracy. Many of the policies were implemented in cooperation with the labour market partners.

The policy issues of major relevance for the task were the following (Ólafsson 2012d):

- Sheltering the lower income households against the reduced level of living, by redirecting welfare expenditures and making them more effective.
- Changing the tax burden, lowering the burden on lower groups while increasing the burden of the higher income groups.
- Relieving the debt burden of households as far as public finances allowed (freezing of repayments; rescheduling; strategically cutting debt levels relating to modest homes for families unable to service their debts; increasing debt relief by use of tax rebates on mortgage interest costs).
- Securing the housing position of the general public, thus avoiding foreclosures.
- Strengthening activation of the unemployed, which reached an unprecedented level in Iceland (even though remaining below the EU average for most of the crisis).
- Providing foundations for increased job creation, including by use of the occupational pension funds, which had capital amounting to about 125% of GDP.

Specifically, the government stated that all changes in the area of social security and health would be directed by the goals of equality, accessibility, quality, security and efficiency. The government also placed great emphasis on maintaining the educational system. The aim was also to extensively cooperate and consult with stakeholders in central government, municipalities, the social partners of the labour market and independent interest groups.

The already started work on simplifying and restructuring the social security pension system continued. Similarly various goals of increasing rehabilitation and activation of previously excluded pensioners and sick persons dropping out from the labour market, were continued.

New more varied options in family housing were also to be promoted, such as relating to options of rented housing, some of which are prominent in the other Nordic countries.

On issues of employment, the government stated the aim of greatly strengthening activation and educational measures, as well as for increasing availability of jobs. This was also related to the goal of formulating a comprehensive employment policy for Iceland in cooperation with the labour market partners and the academic community.

In addition, the government announced a program of job creation and a number of other employment-promoting initiatives, in cooperation with the labour market partners and local municipalities. These included:

- Facility to hire individuals from the unemployment registry with partial temporary support from the unemployment benefit fund (part-benefit with work).
- Strengthening innovation and start-ups.
- Emphasis on labour-intensive operations with allocations of public funds to job creation.
- Tax credit for investment in innovation and for R&D.
- Government emphasis on maintenance work on public buildings, with the aim of creating or maintaining more jobs.
- Public services jobs maintained, especially in welfare services and education.
- Increased cooperation with local governments, interest groups and the Directorate of Labour in creating summer jobs for young people, including green jobs and tourism-related jobs.
- Facilitate provision of study loans to individuals entering school or university from the labour market or from the unemployment registry.
- Place a particularly great emphasis on combatting long-term unemployment.

The government also pledged to formulate a strategic national developmental plan, which then emerged as the „Iceland 2020“ plan by the end of 2010, after extensive consultations with stakeholders in all regions of the country.

On the whole there has been an increase in public expenditures on labour market activation and inclusion measures by about 60% from 2008 through 2011. Prior to the crisis, Iceland did not have a large array of measures to activate individuals, since the employment rate was generally very high and unemployment levels were generally low and primarily short-term. After the crisis, this was widely seen as a field for a major increase in efforts, and was done through the collaboration of the government and the labour market partners, often at the initiative of the labour movement. The following are some of the main public measures put in place from 2009 onwards, both in the form of special strategic efforts (*Átaksverkefni*) and more varied ongoing measures offered by the Directorate of Labour and the Public Employment services.

Special strategic programs (see further on www.vinnumalastofnun.is):

- **Ungt fólk til athafna (Youth to Action).** This program is aimed at young people aged 16-29. The program guarantees an offer to all individuals of that age registered as unemployed, either a job, educational opportunity, training for specific skills or any other accepted measure on offer by the Directorate within a period of three months. The program started in February 2010 and is still running in 2014. In relation to this, access to various educational options were extended, both in the labour market program for life-long learning (*Starfsmenntastöðvar atvinnulífsins*) and in the formal public educational system.
- **ÞOR – Þekking og reynsla (Dare – Knowledge and experience).** This is a program that is aimed at long-term unemployed individuals, defining long-term unemployment as 3 months or more. It started on August 1st 2010 and participation was made compulsory for all concerned registered unemployed individuals. When the call comes, the respective individual is required to meet an advisor at the Directorate and register for some of the about 70 specific measures on offer (ranging from jobs to education or skill training). Failure to comply can lead to loss of benefits. This is also tied to continuing efforts to seek jobs.
- **Nám er vinnandi vegur (Education is a Working Option).** This is a special effort to channel registered individuals into education, started in the autumn of 2011 and continued in 2012. Specific educational offers were made available and individuals transferring from the unemployment registry to education continue to receive unemployment benefits to the end of the respective year. At that time, they qualify for student loans (from the publically financed Icelandic Student Loan Fund– LÍN). Those who do not qualify are eligible for a study grant from the unemployment benefit fund. The study options ranged from access to university, to formal study in the secondary educational system, as well as in shorter-term courses.
- **Vinnandi vegur (Working option).** This program of 2012 aimed at offering individuals that had been unemployed longer than 12 months job opportunities.
- **Liðsstyrkur (Added workers).** This program of 2013 provided job opportunities for long-term unemployed individuals.

Routine labour market measure were also on offer (see further on www.vinnumalastofnun.is):

- Educational opportunities of various kinds.
- Charity work, in connection with formal charity organizations (such as the Red Cross, church related, etc.).
- Employment-related rehabilitation.
- Start-up initiatives, for example in cooperation with incubation centres.
- Special support for entrepreneurial activities.
- Training programs for specific skills.

- Subsidized employment – retention of unemployment benefit, plus pension insurance contribution, while employed and paid by union contracts.

All of these measures were formal and usually involve contracts and monitoring of progress.

In late 2013, the Ministry of Social and Housing Affairs delivered an evaluation report to parliament on the labour market measures undertaken during the crisis, with a special focus on young unemployed individuals.² The conclusion of the report was that the labour market activities had been very important for containing and reducing the unemployment consequences of the financial crisis. Young unemployed individuals had a high rate of participation in the various measures and their unemployment rate came down faster than that of older unemployed individuals (aged 50-70). By mid-2012 the unemployment rate for 16-29 year olds was no longer above the overall rate, for the first time since the start of the crisis (Félags- og húsnæðismálaráðherra 2013).

4.4.2 Debt relief

During the crisis, debt problems became quite extensive, both for households, firms and eventually for the government. That is a common feature of financial bubbles and the crises when they burst. In order to reduce the impact, the government implemented specific measures, in cooperation with the newly resurrected banks. The main measures directed at households were the following:

- **General debt relief:** Debtors with negative equity value could get their debt reduced to 110% of the value of their assets, up to the value of a modest home.
- **Special debt relief:** This is a more restricted measure, open to people in very serious financial difficulties, offering more write-offs than the general debt relief.
- **Increased interest tax credit:** The special targeted tax credit on interest payments for housing loans was raised significantly at the start of the crisis, giving all those with housing debt some credit.
- **New temporary general subsidy on interest cost:** This is a new temporary feature, introduced in 2011 (effective for income year 2010), directing more aid in the form of direct subsidy payment to homeowners in financial hardships. This is universal in the sense of not being income-tested, but it is instead asset-tested, i.e. once net value of the family asset goes beyond a fixed sum it is reduced and eventually phased out. This can give an indebted family up to 1800 euros in subsidy of their interest burden in a year. The government bargained with financial institutions and pension funds to finance this measure.
- **Special effort to aid families in arrears:** A special effort is made to reach all families who are in arrears with their mortgages before 1st of June 2011.

² This report was requested in Parliament by a former Minister of Social Affairs (Árni Páll Árnason) and other parliamentarians.

- **New social measures in housing provisions:** The government organizes a special effort, in cooperation with financial institutions, local authorities and NGOs, to establish more varied options in family housing, including new renting options. **Rent rebates** were increased at the beginning of the crisis and they are to be kept at a higher rate than they were at before the crisis.

To put the debt problem into context we show the development of housing and consumer debts of households in figure 4.5.

As figure 4.5 shows, the debt level of households was increasing continually through the period before the collapse, but with increased speed after 2003, i.e. as the bubble economy gained momentum (Aliber and Zoega 2011; Ólafsson 2011a). The household debt reached its height in early 2009 of 130% of GDP, but have come down since then. At the end of 2013, household debt amounted to 105% of GDP (Central Bank 2014). The Central Bank estimates that in 2011 the overall debt levels of households were reduced by 8% and by 2013 they had come down by more than 20% (Central Bank 2012 and 2014; see also Ólafsson and Vignisdóttir 2012).

Most loans to households in Iceland are indexed to the price level using CPI and thus, the principal increases with inflation. Inflation had started to increase from late 2007 and onwards in early 2008, thus adding to the debt level. In the fall of 2008, the exchange rate of the Icelandic króna fell by 50%, which produced a spike in inflation. Inflation rose above 10% in April 2008 and stayed above 10% until October of 2009. The fact that real housing debts came down in 2009, despite the inflation effect is important, and reflects writedown effects. Then in 2010, the effect of the government's debt relief measures came to be significantly felt and more so in 2011. By the end of 2011, the debt level of households seems clearly to have been lowered significantly, in fact approaching the level of 2007. However, at the same time household debt rose due to inflation, real disposable income fell for the same reason.

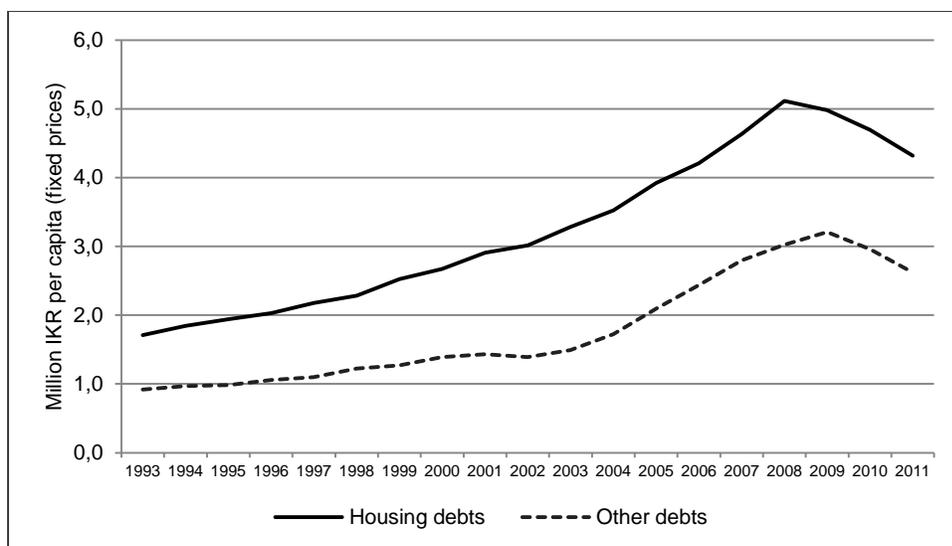


Figure 4.5: Debts of households, 1993 through 2011; housing debts and other debts. Debts in real IKR per capita (prices of 2010)

Source: Social Research Centre: Tax data analysis and Central Bank estimate for 2011.

Another aspect of interest in figure 4.5 is the growth of other debt (consumer debts, mainly due to purchases of cars, other consumer loans and credit card debts), which also rose significantly after 2003, not least due to easier access to credit after the privatization of the banks. Loans for car purchases were often index-linked to the value of foreign currency and hence, outstanding debt skyrocketed with the fall in the Icelandic króna in 2008. There were less extensive write-downs efforts on those loans until in 2010 and 2011, when they had been ruled illegal by the Supreme Court (Hæstiréttur).

Figure 4.6 shows the development of the tax credit on interest expenditure of housing loans from 1995 to the height of the crisis.

In 1995 the government was, in effect, subsidizing 27.3% of the interest expenditure of housing loans of households on average. From 1995 to 2005, the real and relative value of the subsidy fell significantly, down to just over 12%. Then it increased up to 19% in 2008 and in 2010 it rose considerably, in fact to a level much higher than before, or up to 30.9%.

This means that on average the government was paying about 31% of the interest expenditure of housing loans in 2010. This is the average, but when we look at this support by income groups, we see that the subsidy is higher for lower income groups than higher income groups. Thus, for the lowest income decile (the lowest 10% of households) the subsidy was up to 45% of the interest expenditures while the top 10% received a 5-7% subsidy on their interest expenditures on mortgages from the government (Ólafsson, Kristjánsson and Stefánsson 2012).

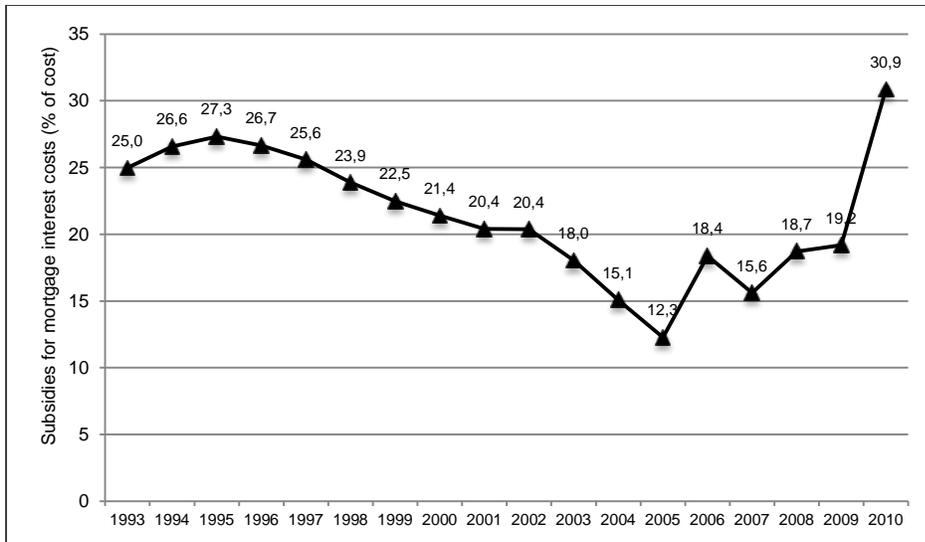


Figure 4.6: Tax credit on interest expenditures of housing loans (tax credit as % of interest expenditures), 1993 through 2010. Average for all income groups

Source: Icelandic tax data, analyzed by Social Research Centre, University of Iceland.

In its 2012 report on the finance and economy of Iceland, the International Monetary Fund (IMF) hailed Iceland's debt relief program as particularly strategic and well carried out. The Fund ranks it as outstanding along with Franklin D. Roosevelt's program from 1933, branding the two as both extensive and well structured. The Fund estimated that by early 2012 about 20% of household debts had been written down on average in Iceland or were in the process of being written down (see IMF, April 2012, chapter 3).

On the whole, the debt relief program was particularly directed at relieving the burdens of the households in greatest difficulties, particularly amongst lower income households. This was quite successful, as the IMF emphasized, not least in the context of the great difficulties in governmental finances, with a large deficit that needed to be balanced. But debt burdens were more widespread than solely amongst the lower income groups, not least due to the great cut in real earnings induced by the fall in the exchange rate of the króna and the accompanying spike in inflation. Hence, many had a lot to complain about and thus the government was quite heavily criticised for not doing enough, despite its pledge of sheltering households.

When the political opposition offered generous tax cuts and a further flat 20% cut in housing debt principals before the election of 2013, many turned away from the governing parties, who lost badly in the election. In 2014, the new government implemented a mixed program of write-offs and tax benefits, aimed at reducing the level of household debts further. The methodology this time seems, however, to be more regressive than before, benefitting middle income groups to a greater extent.

5. Service provisions of the welfare state

5.1 Introduction

On the whole, the Icelandic welfare state is quite service-intensive while it has been more modest as regards benefit payments (Ólafsson 1999; Eydal and Ólafsson 2012). Despite the trend towards convergence of welfare expenditures towards the other Nordic nations, this characteristic remained up to the crisis. During the crisis years this did, however, change. Public expenditures on education and health care were significantly cut, while transfers to households were increased.

The policy of the government that came to power in early 2009 was to soften the crisis consequences for the lower income groups, and balance the budget by a mixture of tax rises and expenditure cuts. Public welfare expenditures were targeted towards the lower and middle-income groups. Hence, expenditures on transfers to households were raised, mostly on unemployment benefits and household debt relief, but also on minimum pensions and social assistance. Although cuts were generally lower on welfare provisions than on administration, investment and maintenance, significant cuts were implemented in the areas of welfare services, especially on health care and education, as seen in figure 5.1.

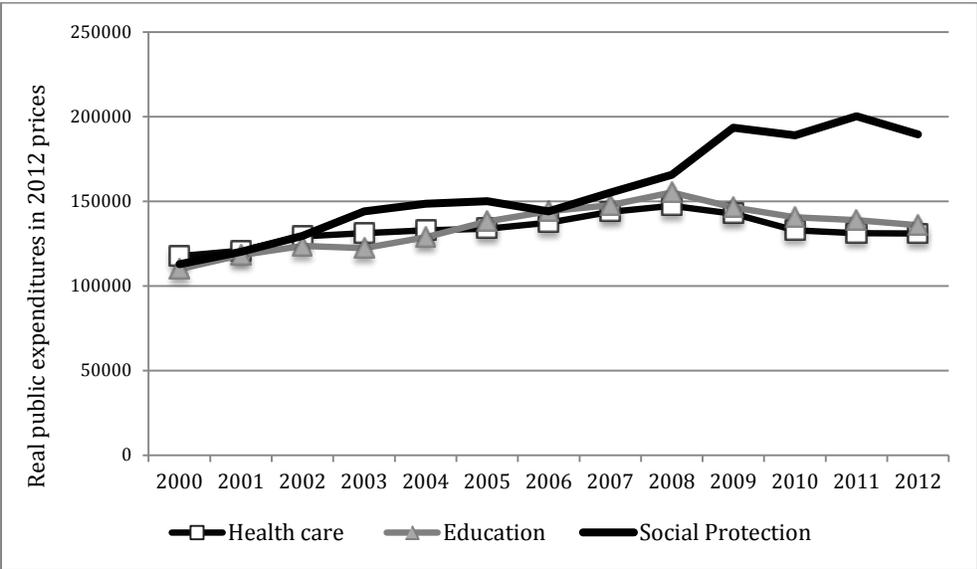


Figure 5.1: Real public expenditures (2012 prices) on welfare, health and education, 2000 to 2012
Source: Statistics Iceland.

Even though the overall welfare expenditures in Iceland increased in the wake of the financial crisis, both in real terms and as share of GDP, the pain of cuts was significantly felt, especially in health care and education (Ólafsson, Kristjánsson and Stefánsson 2012). Real expenditures on transfers to households were raised to the highest level ever, while health and education suffered a setback. That was generally met with cuts in the volume of operation and rationalization,

including layoffs. By 2013 there were decisive strains felt in both sectors, especially in hospital services. Such strain continues to be felt at the date of writing and loss of human capital amongst health care personnel and doctors have continued, especially through emigration to the other Nordic nations.

5.2 Health care

Legislation on health care in Iceland from 2007 states the following as its objective: “...all people of Iceland shall have access to the optimum health service which it is possible to provide at any time in order to safeguard mental, physical and social health” (Act no. 40/2007). This goal is to be attained irrespective of people’s financial situation or residence.

The Icelandic health care system is primarily publicly funded, administered and supervised. Hospitals are mainly state operated and the majority of the health care personnel is employed by the state. The Ministry of Health, since 2011 the Ministry of Welfare (after a merger of the ministries of social affairs and health), has the administrative responsibility for the overall system, and the Directorate of Health has the main supervisory role, according to Act no. 40/2007. The latter now has overall responsibility for supervision of health care institutions, health care personnel, prescriptions of pharmaceutical products, measures for combating substance abuse and quality promotion of all public health services. There is also a special supervisory authority for medicine control and a supervisory commission dealing with prices of medicine (Ministry of Health³, NOMOSKO, 2009).

Despite the large public role in the health care sector in Iceland, there is a significant private sector operated alongside the public sector, while this sector is to a great extent publicly financed. The main aspects of the private practice are specialist services, some health care centres, physiotherapists, occupational therapists, psychologists, all dentists and some nursing homes and old peoples’ homes (those are most often run by not-for-profit voluntary or social organisations). User fees are generally applicable in the private parts of the service provisions. Thus nursing homes and old peoples’ homes are partly financed by users and partly by public authorities.

The Icelandic health care system can, thus, be classified as a Scandinavian health care system, with a large role of the government and mainly financed by taxes. The Icelandic system does, however, have some unique characteristics (Magnussen, Vrangbaek and Saltman 2009), which include more centralization in its governance structure, management, regulation, implementation

³ Ministry of Health www.heilbrigdisraduneyti.is, www.velferdarraduneyti.is

and financing (Ásgeirsdóttir 2009). The roles of local authorities are very small indeed. In that sense, one can say that Iceland as a whole is to some extent comparable to a single local health area in the other Nordic countries, that have a large role in governing and delivering health care services. Due to its relatively small population, Iceland thus lacks the intermediate local administrative structure in the health care system (Ólafsson 2012a).

Health care centres are responsible for primary health services, preventive services (including child health care, maternity care, school health care, immunisation and family planning). Physicians and specialists working in the private sector generally operate according to a contract, previously with the state Social Security Institute (SSI), but since 2009 with a new institution - the Sickness Insurance of Iceland (SÍ), which subsidises the costs. Hospitals also provide out-patient services. In general, no referral is needed for use of specialists' services so GPs are not effective as gate-keepers in the operation of the services. Still, the prevailing law assumes that the primary health care service should be the first stop in the system for patients. However, there are no general penalties or significantly higher fees for patients who directly seek services of a self-employed specialist. Health care centres also provide home nursing services, but home help services (for the elderly and long-term patients) are provided by local municipalities' social services. There are measures now being undertaken to merge administrations of home nursing and home help at the municipalities' level (Sigurðardóttir 2008).

One major high-tech university hospital operates in Iceland serving the country (Landsspítali – Háskólasjúkrahús), a teaching hospital in Akureyri (the biggest municipality in the Northern part of the country) and a few smaller local hospitals, some operating partly as nursing homes for the elderly. In some cases these local hospitals have facilities for some minor operations and facilities for birth and maternity care.

Pharmacies are privately run and are less publicly controlled than seems to be the case in Denmark, Norway and Sweden (NOMOSKO 2009, Ólafsson 2008b).

The outlays for the Icelandic health care system has for a number of years ranked among the highest in Europe, in proportion to GDP. In 2006 it consumed about 9.6% of GDP when the OECD average was 9.0%. In 2007 the expenditures were 9.3% against 8.9% average for the OECD countries (OECD 2009), putting Iceland in 12th place on the list of relative health care expenditures among the OECD countries. In recent decades it has typically come second to the Norwegian one in regard to costs in the Nordic community.

The high cost of health care is somewhat surprising given that the Icelandic population is relatively young compared to the other Nordic and European societies. The main reasons for the relatively high cost of the Icelandic health care system have been a high level of services, high price of medicine and extensive use of specialist physicians (due to little use of general doctors providing gate-keeping services). Maintaining a high level of health care services in the more sparsely populated areas of the country is also relatively expensive. Icelandic physicians are

also said to be prone to subscribe new and more expensive medications to a greater extent than what is typical in the neighbouring countries (Ólafsson 2012a and 2008b; OECD 2009; NOMOSKO 2009). Before the crisis, OECD had voiced the opinion that while the Icelandic health care system delivers very high quality service levels by international standards, it in some cases does so at too high cost, thus lacking efficiency and incentives for using less costly available means (OECD 2008b; Suppanz 2008).

Table 5.1: Public expenditures on health care, from 2003 through 2012 (% of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
07 Health	8.86	8.44	8.09	7.92	7.89	7.92	8.34	7.88	7.62	7.71
0711 Pharmaceutical products	0.71	0.69	0.59	0.57	0.54	0.63	0.72	0.62	0.57	0.52
0713 Other medical products	0.17	0.16	0.15	0.15	0.16	0.16	0.19	0.2	0.19	0.2
0721 General medical services	0.9	0.88	0.84	0.86	0.86	0.86	0.87	0.87	0.88	0.87
0722 Specialized medical services	0.37	0.35	0.34	0.32	0.32	0.35	0.4	0.38	0.38	0.38
0723 Dental services	0.13	0.13	0.12	0.11	0.1	0.09	0.09	0.08	0.08	0.08
0724 Paramedical services	0.27	0.3	0.28	0.28	0.28	0.28	0.27	0.25	0.25	0.24
0731 General hospital services	4.57	4.19	4.02	3.93	3.92	3.89	4.04	3.73	3.55	3.7
0732 Specialized hospital services	0.08	0.09	0.08	0.08	0.08	0.1	0.13	0.11	0.11	0.1

Source: Statistics Iceland.

The cost of Icelandic health care has however significantly decreased during the crisis, as shown in table 5.1. Public expenditures on health care amounted to 8.9% of GDP in 2003 (in addition to that some 1% of GDP was added with private out-of-pocket expenditures in that year). By 2012 the public expenditure level was down to 7.7% of GDP. Out-of-pocket health care expenditures rose by 26% between 1998 and 2006 and they have increased further during the crisis years, both as regards cost of medication and health care services (Vilhjálmsón 2009; Ólafsson 2012a).

The most drastic cuts were on pharmaceutical products, from 0.7% of GDP to about 0.5%; on general hospital services from 4.6% in 2003 to 3.6-3.7% in 2011-2012; and on dental services from 0.13% to 0.08%. Expenditures on general medical services (health care centres) and on specialized medical services (primarily in the private sector) remained more or less stable, in relation to GDP, throughout the period.

The state-run university hospital in Reykjavík (*Landsspítalinn*) was significantly hit by the cuts resulting in mergers and closures of various regional hospitals and operations. On the whole, the reforms of health care services of the last five years have thus primarily been of the austerity kind.

5.3 Care services

The legislation that shaped the structure of the present long-term care system in Iceland dates back to 1983. Services in nursing homes, old-age homes or hospitals are based on Act no.

125/1999 on elderly care. This was previously the responsibility of the Ministry of Health but with the transfer of the responsibility for the issues relating to the elderly and disabled from the Ministry of Health to the Ministry of Social Affairs, effective from 1st January 2008, a new basis for reorganisation was laid, as well as a policy shift from medical consideration to more social emphasis in shaping policies for these groups (Sigurðardóttir 2008; Guðmundsson and Sigurðardóttir 2009). From then on, all services to the elderly should be defined and operated as local services under the supervision of local authorities. The main goal would be to make it possible for the elderly to reside in their own accommodation for as long as possible. The state would continue to define policies and supervise the operations to ensure they are in accordance with the law and stated aims. This responsibility has now been transferred to the new Ministry of Welfare as of 1st January 2011 (see Ólafsson 2012a for an account of the new ministry).

In Iceland, the care services for the frail elderly and disabled or long-term patients are collectively the responsibility of the government, local authorities and third sector voluntary organisations (mainly not-for-profit). Governments primarily finance the services (both at central and local level), but also for the third sector organisations, which frequently negotiate contracts with the government paying the operational costs, (i.e. charges on a per-bed/person-per-day basis). Voluntary organisations of individuals belonging to a particular disease groups and the organisations of the disabled are particularly active in providing services to their members⁴. Many service homes for the elderly are also of this type, reflecting a very active relationship between the government, local authorities and the civil society voluntary sector in the provision of welfare services⁵. This form has the added benefit of often producing employment opportunities for people with disabilities. In addition to these formal services, significant informal services are also provided by relatives and neighbours, which make a difference in a tightly knit small-scale society, such as the Icelandic one (Egilsdóttir and Sigurðardóttir 2009; Sigurðardóttir 2010; NOMOSKO 2011).

In the Nordic community, Iceland has for some years had a relatively large number of long-term care beds in institutions, as well as providing more home help. During the crisis years some new nursing homes were built, both in the Reykjavik area and in some provincial areas, with the aim of reducing sharing of rooms and improving conditions. This was also justified as an economic stimulus measure, facilitating job creation in the badly hit construction industry.

The large number of care beds in institutions may seem somewhat surprising, given that the demographic composition of the Icelandic nation is such that it has a lower proportion of people aged above 65, and the number of disabled people under 65 is not significantly larger in Iceland either. In some cases this ample supply of places in institutions can be related to the operations of local hospitals in the provincial areas. These and residential and service homes for

⁴ See for example www.obi.is; www.saa.is; www.sjalfsbjorg.is

⁵ See for example www.hrafnista.is; www.eir.is; www.grund.is; <http://www.island.is/cfriarin/busetumal/-hjukrunarheimili-umsokn>

the elderly were possibly built beyond a well defined need in earlier decades, partly for regional policy reasons, particularly at the time when the central government carried a larger share of the cost.

However, it is particularly interesting that Iceland has by now the highest proportion of elderly people receiving home help, equally amongst the Nordic and EU countries (Fujisawa and Colombo 2009; Ólafsson 2012a). It has been the major policy goal in recent years to reduce the number of people living in institutions and increase the possibilities for people to stay as long as possible in private homes (the ratio of home ownership amongst elderly Icelanders is very high; cf. Ólafsson and Jóhannesson 2007). Norway has a similar rate of elderly individuals living in institutions or service housing, but a lower rate for home help, whereas Denmark comes second to Iceland in that category.

5.4 Education

Illiteracy is rarely found in Iceland. However, the average number of years of formal education for those aged 25 to 64 is below the OECD average of 11.9 years, or only 10.5 years. The OECD average does not show a difference in educational attainment between men and women, while in Iceland, the average number of years in formal education is higher for women than for men, or 11.4 years for women compared with 9.7 for men (OECD 2012a).

Iceland ranks amongst the highest within the Nordic community as regards enrolment of children into pre-schools (Eydal 2012; NOSOSKO 2011). Before 1995 Iceland was a laggard in this respect but from 1995 onwards this was gradually lifted towards the highest Scandinavian levels. Enrolment in education is high up to the level of secondary education.

The share of the population that has attained at least an upper secondary education is relatively low, or 71% of people aged 25 to 64, compared with an OECD or European average of 75% (OECD 2013b). The main reason for the low percentage is not low enrolment rates in secondary schooling; it is due instead to high dropout rates. In 2003, the dropout rate from upper secondary schools in Iceland was just under 20% (OECD 2007). They have contracted somewhat in recent years but still remain above the EU 2020 goal. Iceland has set itself the goal of improving educational attainment of the drop-out population in its program for Iceland 2020 (Ólafsson and Arnardóttir 2008; Prime Minister's Office 2010). Currently the graduation rate from upper secondary school designed to prepare for tertiary-type education is 59%, same as in Denmark and Norway, but lower than in Finland (85%) and Sweden (75%) (OECD 2013b).

Although a relatively low percentage of the population finishes upper secondary education, the share of the population that has attained tertiary education is close to the average of the OECD

countries. Thus, a high proportion of those who finish secondary education continue on to receive tertiary education. Furthermore, tertiary education has increased dramatically in recent years; thus, this share is expected to rise in the coming years. In Iceland, as in most other OECD countries, relatively more women than men finish tertiary education. On average 33% of women aged 25-64 in the OECD countries have attained tertiary education, compared to 29% of men. In Iceland the difference is even larger, as 39% of women aged 25-64 have attained tertiary education, compared to 27% of men in the same age group (OECD 2013b).

Public expenditures on education in Iceland per full-time equivalent student from primary through tertiary education is 3% below the OECD average. The expenditure level in the other Nordic countries is 15-59% above the OECD average (OECD 2013b). However, the expenditures vary between levels of education. At the level of primary education, Iceland's outlays per full-time equivalent student is 19% above the OECD average. The expenditures in the other Nordic countries are from 4% below the OECD average (Finland), to 53% above (Norway) (OECD 2013b).

When it comes to secondary and tertiary education, outlays in Iceland are below the OECD average. Iceland's outlays to secondary education are 13% below the OECD average, while the outlays in the other Nordic countries are from 2% above the OECD average (Finland) to 54% above the average (Norway). The difference is, however, most striking when it comes to tertiary education. Outlays to tertiary education in Iceland are 35% below the average in the OECD countries per full-time equivalent. The outlays among the other Nordic countries are all above the OECD average from 24% (Finland) to 44% (Sweden) (OECD 2013b).

In recent years, increased emphasis has been laid on continuous education and to open channels for people in the labour market to improve their education. Funding for this activity has increased mainly through collective bargaining agreements and currently employers pay 0.2% of wage costs into continuous education funds, with additional funding from the government.

6. Income distribution, poverty and well-being

6.1 Introduction

The income distribution became more unequal from 1995, with growing speed from 2002 onwards. The inequality trend was closely associated with growing financial income associated with the asset bubble, while taxation and benefits policy also had its share of influence, particularly in the early part of the 1995-2007 period (Ólafsson and Kristjánsson 2012a and 2012b). While income inequality increased more in the Nordic countries than in other OECD countries from 1995 to the late 2000s, Iceland surpassed the other Nordic countries significantly during the bubble economy period, especially when account is fully taken of capital earnings (Fritzell et al. 2012).

6.2 Distribution of income

Indications of long-term developments of income distribution in Iceland seem to tell a story of relatively minor changes in the income distribution in the high growth period of 1960s through the 1980s⁶. During the 1980s and early 1990s, the income distribution in Iceland seemed to be on level with that of the other Nordic nations. Iceland was indeed a very egalitarian society from 1960 through 1980 (Ólafsson 1999; Jónsson et al. 2001).

During the 1980s, the inequality of employment earnings seemed to increase somewhat, but from 1988 to 1993, the distribution of disposable income became slightly more equal. This was due to increased equalizing effect of taxation and benefits, associated with a new system of taxation established in 1988, where the tax system was simplified and the tax base broadened.⁷ Tax data shows a major change in the income distribution from 1995 onwards, towards a much more unequal distribution (Ólafsson 2006a and 2006b; Baldursson et al. 2008; Jónsson et al., 2001; Kristjánsson and Ólafsson 2009). The rise in income inequality is associated with the policy change from 1995 onwards and the bubble economy of the 2000s.

The period from 1993 to 2012 is characterized by an increase in inequality until 2007 (the boom period), and then a decrease from 2008 to 2010 (the bursting of the bubble). We show the Gini

⁶ Figures from Geirsson (1977), Snævarr (1988) and the National Economic Institute (1994-2001) indicate that the Gini coefficient was quite stable in the period from 1960 to 1985. However, figures are not comparable to the more recent data we are using. See also Jónsson et al. (2001).

⁷ The Gini coefficient for market income (employment and pension incomes) increased marginally from 1988 to 1994, while disposable income decreased significantly (Jónsson et al. 2001).

coefficient for disposable income for families from 1993 to 2012 in figure 6.1. The inequality of income rose decisively from 1995 and with growing speed after 2002 as the bubble grew (Ólafsson and Kristjánsson 2012b and 2013).

In 1995 when inequality started to increase from the egalitarian position of 0.21 it rose roughly by one Gini point per year up to 2002. The rise accelerated from 2005 to 2007 at the height of the bubble.

The inequality reduction in 2008 to 2010 is also remarkable, with the Gini coefficient decreasing by 19 Gini-points in three years, a massive shift indeed (Ólafsson and Kristjánsson 2012a). In 2009 the Gini was at a similar level as in 2002-3 and by 2010 it was down to a similar level as in 1998, as can be seen in figure 6.1.

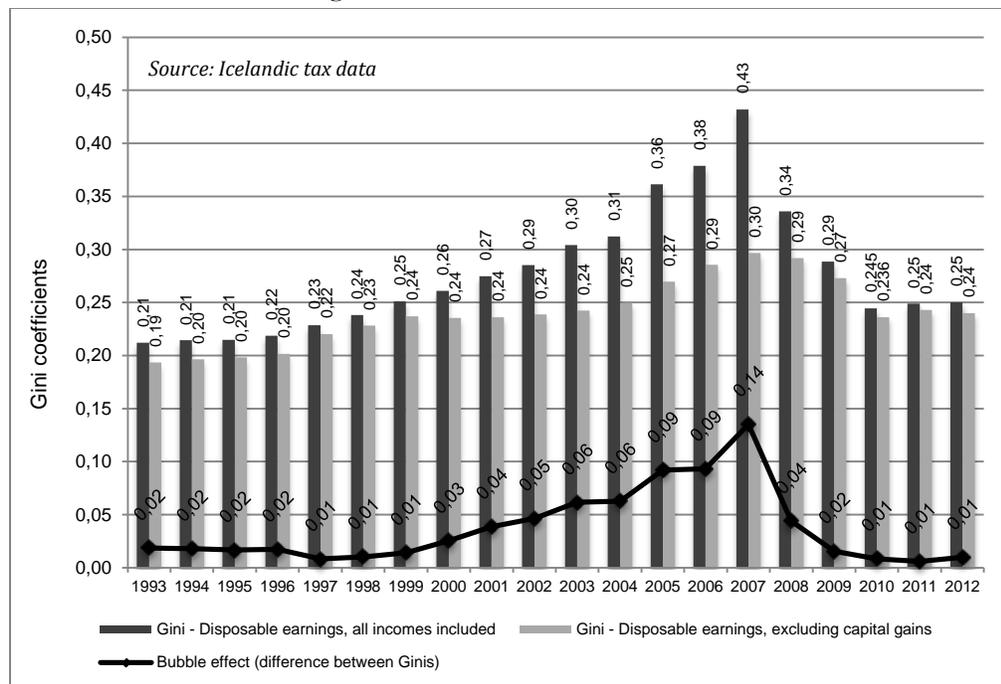


Figure 6.1: Income inequality development in Iceland 1993 to 2012. Ginis for total taxable earnings (black columns, including capital gains), and excluding capital gains (light grey columns)

The line is the difference between the two Gini series and gives an indication of the effect of the speculation bubble on income inequality. The tax data refers to all couples and cohabiting individuals.

Source: Ólafsson and Kristjánsson 2013.

Since capital earnings accrue disproportionately to the highest income groups, the speculation bubble contributed decisively to inequality after 1998. It should be noted that in 1998 a new low tax on interest income was introduced. Asset earnings were liable to income tax prior to the introduction and reporting of financial income may have improved after the tax change. The contribution of financial income to income inequality rose significantly from 2003 to 2007, as evident from the graph.

On the whole, the growing income inequality was due to increased financial earnings as well as reduced redistribution of government income tax and benefits policies. In the earlier part of the period, the reduced redistribution led to lower incomes lagging behind middle and higher income groups, but the effect of financial earnings was more important in the latter part of the period. The financial earnings effect accounted for about two thirds of the increased inequality in the period as a whole, and the tax and benefit policy accounted for most of the remaining third of the effect (Ólafsson and Kristjánsson 2012b).

In figure 6.2 we show the income share of the top 1% of income earners in Iceland in comparison to the USA. In both cases all taxable income is counted, including capital gains. The Icelandic figures are for 1993 to 2011, but the US data covers the period from 1960 to 2012. The growing inequality from around 1980 in the USA is evident, and when compared to the development in Iceland, we see that the increase in inequality in Iceland was significantly more rapid, especially during the 2000s. The income share of the top 1% in Iceland went from around 4% in the mid-1990s to almost 20% in 2007, at the height of the bubble, when the comparable income share in the USA was 23.5%.

The return towards equality after the financial crisis is also interesting. The reversal of the trend is much larger in Iceland than in the USA and while the top income share started to increase again in the USA from 2010 onwards it has remained in the region of 7% in Iceland until 2011. Contraction of financial earnings explains the largest share of that change, while increasing the policy of redistribution of tax and benefits also had an impact, since the government raised the marginal income tax rate on higher incomes and on net wealth at the same time that benefit levels to the lower income groups were raised. The controls imposed on capital movements in and out of the country can also be expected to contribute to the limited growth in financial income after 2008 as investment opportunities have been limited.

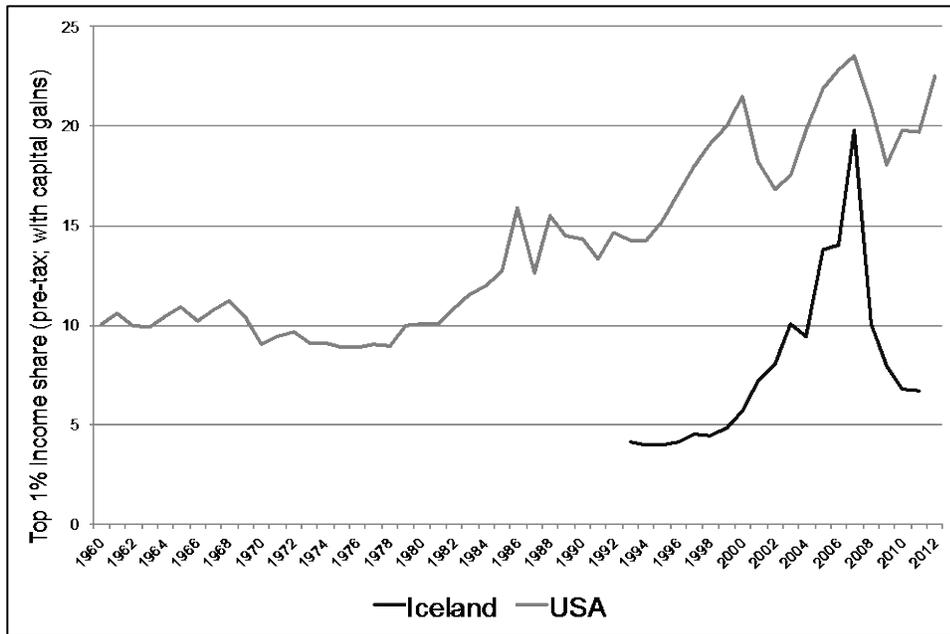


Figure 6.2: The income share of the top 1% of income receivers in Iceland and the USA
 Source: Ólafsson and Kristjánsson 2013 and Saez 2013.

Although the income distribution in Iceland has not fully returned to the egalitarian position of the early 1990s, as shown in figures 6.1 and 6.2, the reduction of inequality after 2008 is large indeed. The income distribution may, in the future, become more unequal than in previous egalitarian decades since considerable assets remain in the hands of members of the higher income groups. When the economy and the stock market revive further and financial controls have been lifted, these may produce increased financial earnings that will no doubt increase inequality again. However, policy on taxation and general welfare is an important contributor to income inequality and thus, the development is partly in the hands of governments of the future.

6.3 Poverty and financial hardships

Even though the income inequality increased greatly during the decade prior to the financial collapse, the relative poverty risk for families with children in Iceland did not increase. Neither did it during the first years of the financial crisis and in fact it declined in 2010 to 2012 (Statistics Iceland n.d.). The main reason is the policy emphasis of the government to shelter lower income groups directly and thus soften the consequences of the crisis for their earnings. This meant that the real earnings loss of the lower income groups was less extensive than that of the higher income groups (cf. chapter 4.4). The 60% poverty risk ratio for the whole population fell from 10.2% in 2008 to 9.2% in 2010 and has come down even further in 2011. However the rate for

parents was similar in 2004 as it was at the height of the crisis. The fact that it was not worse reflects the fact that the most vulnerable groups in Iceland were partly protected against the crisis consequences after 2009.

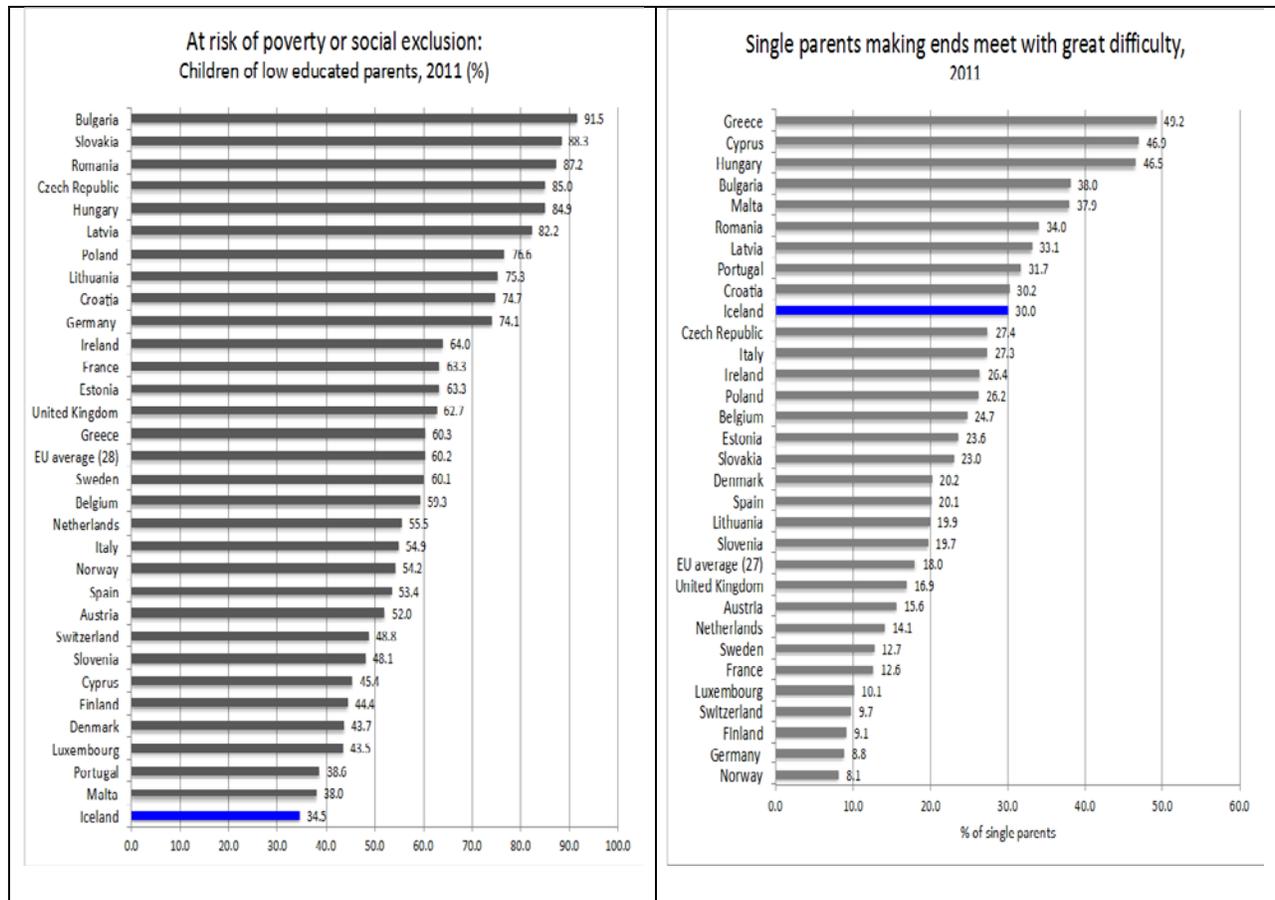


Figure 6.3: Relative and realist perspectives on monetary poverty in Iceland: Risk of poverty or social exclusion in a vulnerable group: Low educated parents (left diagram) and single parents making ends meet with great difficulty (right diagram), both 2011 (%).
 Source: Eurostat.

On the whole, families with children suffered more increases of financial hardship with the onset of the financial crisis in Iceland than families without children. Hence, we should expect increased poverty problems for children and their families. Families without children went from 28% saying it is difficult to make ends meet in 2006-7 up to 46% in 2011, while families with children went from 29% in 2007 up to 60% in 2011. The ratio for both groups came down a little in 2012, reflecting a slight improvement of household financial position in that year.

Hence, financial hardships increased significantly in the wake of the banking collapse of 2008. Still Iceland is amongst the countries that in general have lower levels of relative child poverty amongst Western nations, as reflected in figure 6.3.

On the left hand side of the figure, it emerges that Iceland indeed has the lowest relative risk of poverty or social exclusion for one of the more vulnerable groups in society (low educated parents) in 2011, i.e. after the worst of the crisis was over and a gradual progress had set in. Still single parents were relatively high on the rank of financial hardship, i.e. making ends meet with great difficulty (right hand side of the figure). In that respect, Iceland was not among the countries it prefers to compare itself with, i.e. the other Nordic nations and the more prosperous nations on the European continent. While single parents emerge as a group with great financial difficulties, adult couples with two children are closer to the EU average in complaints about making ends meet with great difficulty.

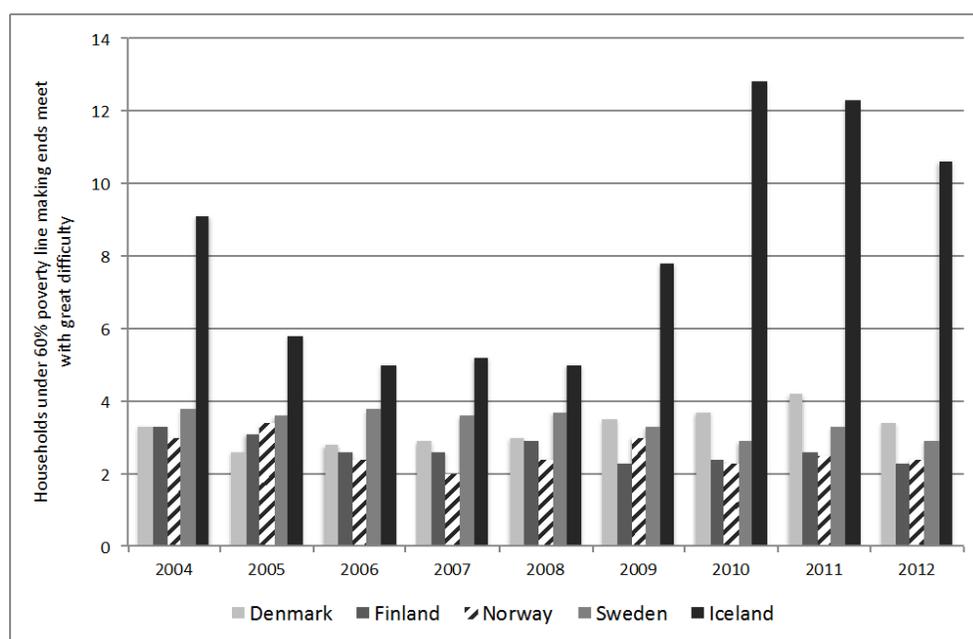


Figure 6.4: Financial hardship (“Making ends meet with great difficulty”) amongst households that are under the 60% poverty line

Source: Eurostat (income data refer to incomes the year before, hence data for 2012 are for 2011).

While Iceland in general has a low level of risk of poverty, it has significant financial difficulties among some groups of families with children, especially single parents and adult couples with many children (3 or more). Hence child poverty deserves a special focus in the Icelandic policy environment.

While Iceland now has lower proportions of households under the 60% poverty line than the other Nordic nations, the financial hardships of low-income people in Iceland seem generally to be greater than in the other Nordic countries, as emerges from figure 6.4.

Some 9% of Icelandic households that were under the 60% poverty line said in 2004 that they make ends meet with great difficulty, while the proportion for the other Nordic nations was

below 4%. The proportion came down in Iceland during the bubble economy period, but increased rapidly in 2009 and 2010. By 2010 the size of this group in Iceland had tripled, while there was no significant change in the other Nordic countries. Part of the reason for this difference can be traced to the high proportion of home-owners in Iceland, as a part of this group is facing difficulty due to a rise in outstanding housing loans. The rise in financial hardship is an indicator of the strain on household finances that came in the wake of the financial collapse. While the size of this problem group has declined again in 2011 and 2012, it still remains much higher than in the pre-crisis period.

This data can also be used to reflect on the question of whether there are greater poverty problems in Iceland, than in the other Nordic countries. As mentioned above, Iceland has had a lower relative poverty rate than the other Nordic countries in the last years and previously these countries were on a similar level. However, Iceland has since 2004 had a significantly higher proportion of overall households that complain about difficulty in making ends meet (Ólafsson and Kristjánsson 2012a). The low income groups appear to have been in greater financial hardships in Iceland before the crisis and this difference increased greatly after the onset of the financial crisis.

6.4 Well-being: An international comparison

Stefán Ólafsson (2013) did a comparative study of well-being in 29 modern nations, with a particular focus on the Nordic nations. This study asks how well they have managed in a new social environment of globalization, increasing competition and new challenges to the Nordic welfare model? The focus is on well-being outcomes, rather than on welfare inputs (expenditure generosity or rights and institutional features).

Iceland was included in the study, which was based on 69 measures of various aspects of well-being, primarily covering the period from 2005 to 2008. The methodology of the study is comparable to that used in the United Nations Human Development Index, except that Ólafsson's study uses 9 dimensions of well-being and 69 variables, while the HDI index is generally based on three dimensions and four variables. Hence the data in the Ólafsson study is much broader. The following dimensions form the overall well-being index (WBI):

- Economic strength and competitiveness (average of 5 variables)
- Health condition (11 variables)
- Employment level (9 variables)
- Educational level (6 variables)
- Income equality (3 variables)
- Poverty reduction (7 variables)
- Family conditions (9 variables)

- Social cohesion and participation (7 variables)
- Subjective well-being (12 variables)
- Total Well-Being Index (average of the 9 sub-indexes)

The z-scores for the variables in each dimension are averaged to constitute a sub-index and these are then averaged to create the total WBI.

Figure 6.5 shows the comparison of overall well-being scores for the 29 nations included.

The outcome ranks the Nordic nations and Netherlands the highest, closely followed by Switzerland, Luxembourg and Austria. This is in line with many outcomes in various recent comparative studies of welfare or well-being. This favourable outcome for the Nordic nations is also in line with the findings of Castles and Obinger (2008) about commonalities of public policy patterns. The Nordic countries indeed share many similarities in their patterns of public policies, as well as in structural features of their societies, such as a strong and influential labour union movement, significant long-term influences of social democratic politics and egalitarian and participative cultures.

Iceland ranks fifth, after the other Nordic nations, and slightly below the Netherlands. As mentioned above, Iceland had reached a comparable level of living as the other Nordic nations by the 1980s, even though the Icelanders have to date had to build their level of living on more volume of work than the other nations (see Figure A.2 in the appendix). Iceland maintained its overall standing through the 1990s and 2000s compared to the other Nordic nations, despite growing inequality during the bubble economy period.

Iceland had, before the crisis, a high level of economic affluence, a good health condition, a very high level of employment, a comparable level of education in some respects (although lagging behind Finland), a low level of poverty and material deprivation, a favourable environment for families and gender equality, a high level of social cohesion and participation and a very high level of subjective well-being (as measured by 12 subjective variables covering various aspects of life satisfaction and assessments of their societal environment).

The outcome of the Netherlands, Switzerland and Luxembourg is also favourable. It is no surprise that the Netherlands ranks on level with the Scandinavian nations in comparisons of well-being and levels of living, since there are many commonalities in the welfare systems of these countries. Switzerland and Luxembourg combine a very high level of affluence with significant welfare provisions and redistribution measures.

Iceland suffered a major setback in its level of well-being as the financial crisis struck. Real earnings contracted greatly, the unemployment rate rose and the debt burden increased. Still, overall well-being did not decline to the same extent as real earnings and employment in the short-term. This is due to the fact that many well-being factors have more long-term accumulated characteristics. For example, the health status of the nation remains much the same

despite reduced health care expenditures in the short-run, as well as education. Increased activation measures during the crisis may in fact have improved the overall educational attainment of the nation. The subjective satisfaction with life has increased in 2011, and by 2012 it was almost up to the level prevailing before the crisis (Ólafsson, Kristjánsson and Stefánsson 2012).

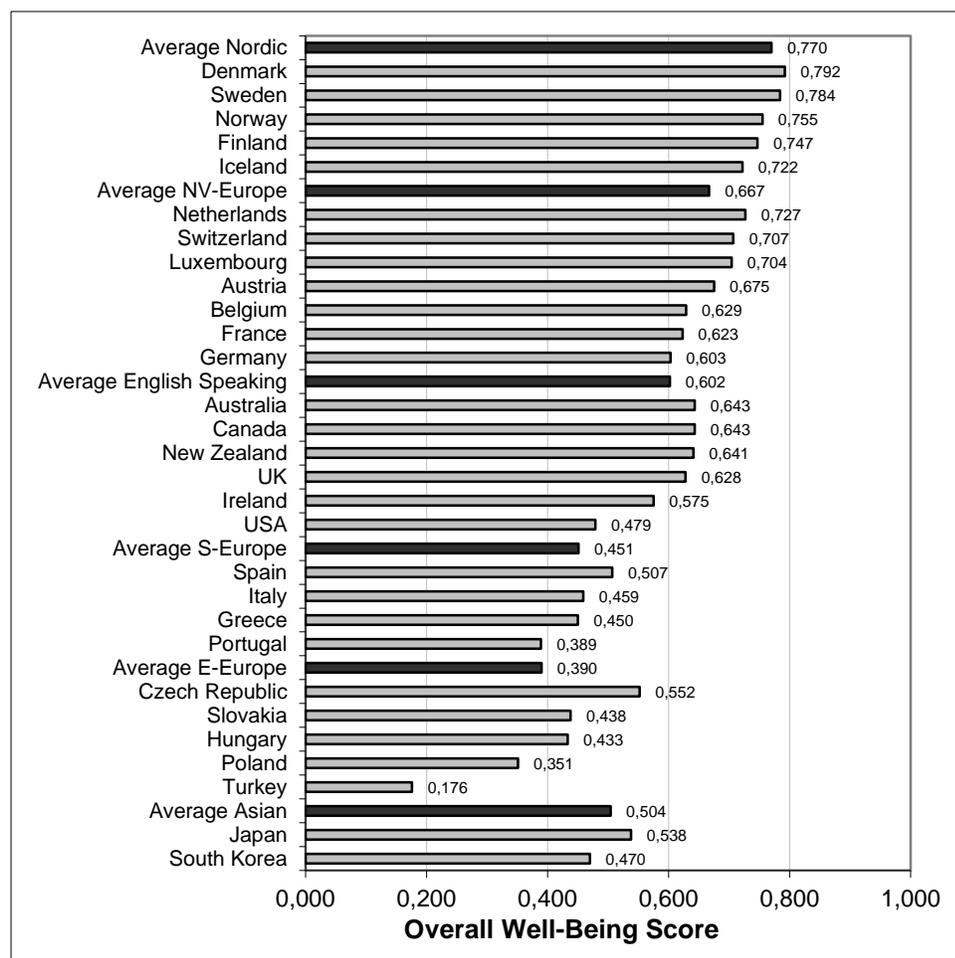


Figure 6.5: Comparison of overall well-being of 29 modern nations. WB Index based on 69 variables

Source: Ólafsson (2013)

Five years after the financial crisis hit, the unemployment rate has come down and is already one of the lowest in Europe. Real earnings have improved and are almost at pre-crisis levels. The debt level of households has come down by some 20 percentage points as a share of GDP from 2009, but still remain a burden. Health care expenditures are on the rise again. Despite a real setback in well-being, significant improvements have already been achieved. More will be needed to regain fully a level of well-being comparable to the high Scandinavian levels. That thus remains an important challenge for Iceland.

Returning to Ólafsson’s study of 29 modern nations, he finds that when correlating the overall well-being outcomes of these nations with various societal background factors, a high degree of association is found with welfare state generosity, affluence level and strength of unions. But a stronger and perhaps more interesting association emerges between well-being of nations and the degree of social capital in the community, as well as with the strength of democracy. The latter association is very strong indeed as shown in figure 6.6. The Nordic nations do well on both dimensions, the well-being and strength of democracy. An interesting feature in the figure is the fact that relatively small advanced nations do particularly well on these measures. In addition to the Nordic nations, that applies to the Netherlands, Luxembourg, and Switzerland. Most of these are also nations with relatively high level of corporatism.

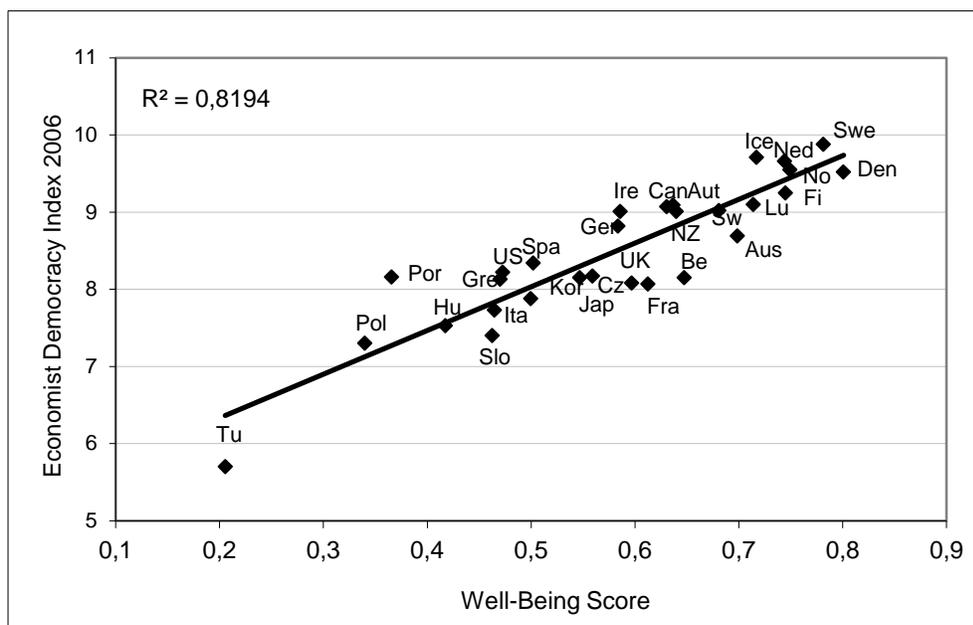


Figure 6.6: Association between well-being and strength of democracy (the Economists’ Democracy Index for 2007) in 29 modern nations

Source: Ólafsson (2013).

However, the strongest correlation with the overall well-being index was found to be the real disposable earnings level of the lowest income decile in these nations. Ólafsson (2013) concludes this study with the following lesson:

“The strongest association we find to well-being outcomes of modern nations is the real disposable earnings level of the lowest income group in these societies (the lowest income decile). That supports a narrative emphasizing the importance of lifting the bottom, or the lower half, of the households up the level of living ladder. Such a strategy of equality succeeds best in improving the overall well-being level of modern nations.

There are however many ways of lifting the absolute living standards of the worse off. The Nordic welfare model is one of them, but the welfare system has to accommodate to

other important factors, such as an efficient economy, educational system and an inclusive, innovative and democratic social environment.”

7. Challenges for the future

The main challenges before the crisis were related to improving productivity, innovation and diversification of the economy and improving living standards. These clearly remain but the financial crisis leaves Iceland with new challenges that will take years to unwind. We deal with these under the subtitles of political challenges, debt problems, overall living standards, productivity, and other challenges.

7.1 Political challenges

Iceland has for all of the post-war period deviated from the rest of the Nordic countries in the area of politics. This is due to the relative weakness of social democracy and persistent divisions on the left wing, while the right-wing Independence Party (IP) has been the dominant and most influential political party and normal leading party of government for the most part of the post-war period. This has meant that the left-wing parties have primarily been junior members of governments, either with the IP or under the leadership of the centrist Progressive Party (PP). As a consequence, the left or social democratic parties have had less marked long-term influences on policy-making in Iceland than has been typical in the other Nordic countries.

Still the junior participants in coalition governments have at times managed to gain a strong bargaining position and thereby achieved important policy innovations. Many Scandinavian welfare policy innovations have entered Icelandic legislation through such arrangements, as well as through the influence of the labour movement. Parties on the centre-right have also been known to implement Nordic types of welfare provisions.

Another factor of importance has been the strong position of the Icelandic union movement, with very high membership rates and organizational centralization. Thus, the labour market partners, employers and unions together, have proved to be a formidable force in Icelandic society, often with great impact on government policy. One can say that Icelanders have, to some extent, made up for the weakness on the left of the political spectrum with potential strength on the union front.

Splits on the centre-left wing of politics have been common in Icelandic politics. The election of 2013 was no exception, when the SD Alliance and the Left-Greens lost heavily after having been in government through the difficult crisis years. Many new parties on the left and centre were formed before the election, thus the split seems to be more extensive than before. Hence, the progress in unification on the centre-left wing that was achieved with the formation of the SD Alliance in 1999 has suffered a major setback, as the emergence of the SD Alliance produced a

fundamental shift in Icelandic politics, making the social democratic party the second largest party for the first time. Part of that success was more support of centrist voters than previously.

While fluctuations in party votes are generally great during and shortly after a major crisis has hit, the future for the centre-left in Icelandic politics is more uncertain now than before the crisis. The competition between the PP and the SD Alliance is more difficult than it seemed before the crisis. The emergence of Bright Future (BF) took significant votes from the SD Alliance. The PP deviates primarily from the SD Alliance as regards its view towards EU membership. The PP is firmly against and the SD Alliance firmly a supporter of joining the EU. On this platform, the PP was capable of attracting a significant share of the working-class vote in the 2013 election that otherwise would have been in favour of the other centre-left parties (SDA, LG and BF). The Icesave issue magnified the political divide and eroded support for EU membership. Hence the firm support of the SD Alliance in Iceland for EU membership may come at a cost of lower working class voting support, as has been the case in other Nordic countries and the UK. How strongly this will affect the SD Alliance in the near future remains to be seen.

Another challenge is the loss of trust in politics, political parties and the parliament, among the general public. This is at an all-time low after the financial collapse. Polarization was also a part of the developments in party politics, particularly during the reign of the left-wing government from 2009 to 2013. The opposition fought more fiercely against the government than previously seen. Hence, political discourse has not facilitated the regaining of trust in the main actors and institutions of Icelandic politics. Thus it remains an important task to regain a collaborative spirit and positive cooperation in politics in Iceland.

7.2 Debt problems

One of the most consequential effects of the financial crisis is the high level of debt that remains. Government debt is higher than ever before from the establishment of the Republic in 1944 and business debt is also at a very high level, as is household debt.

Gross public debt amounted to only 30% of GDP in 2006 and 2007 as the surplus on the central government balance in the previous years had been used to lower debt levels. As the financial crisis hit, public debt shot up as the balance on the central government went into a large deficit. The government also had to refinance the three commercial banks, as well as refinancing the central bank. In 2011 gross public debt amounted to 99% of GDP, but has since come down to 93% in 2013. Servicing this debt is a big strain on the central government and according to the budget proposal for 2015, interest payments are expected to amount to 13% of total government expenditures. In addition to the high level of government debt, the

government guarantees the obligations of the public sector pension funds which are only partially funded, an obligation that will become payable in the coming decades.

Business debt has been rather extensively written down by the banks, but it still remains high by international standards. It topped at 340% of GDP in the middle of 2009, but has come down to 150% of GDP by the middle of 2013 (Central Bank 2013).

Household debt was an issue of major concern for the previous government. Its measures aimed at targeted write-offs and measures of debt relief, specifically aimed at households in greatest need, i.e. those with lower incomes and lower equity ratios in their housing. This was deemed to be a great success by the IMF, but the general public felt that more should have been done to relieve the debt burden.

This became a major issue in the election of 2013, when the Progressive Party promised a further 20% across-the-board cut in mortgage principals. The voters showed their support in the elections and the PP now leads a government of the PP and the IP, the two business parties in Icelandic politics (i.e. these are the parties with the greatest support amongst businessmen). Measures for scaling down household debt have already been announced, but they seem not to be as extensive as promised during the election campaign. This seems set to be an issue of considerable concern in the near future.

7.3 Capital controls as a response to the crisis

From the beginning of 2008 and through the collapse of the banks and onwards into 2009, the exchange rate of the króna fell by over 50% against other currencies. The fall in the exchange rate led to a hike in inflation, which rose to nearly 20% by the end of 2008. The main goal of the programme drafted between the Icelandic government and the International Monetary Fund was to halt further depreciation of the króna to prevent a greater deterioration in the financial situation of households and businesses. As a result, it was deemed necessary to impose temporary restrictions on capital flows in and out of the country. The capital controls would provide the shelter necessary for households and businesses to restructure their finances while the government would gain control over public finances.

The capital controls played an important part in stabilizing the exchange rate and thereby lay the ground for getting the Icelandic economy back on its feet. Still, the capital controls are controversial. There is a cost to capital controls in that some options formerly open to businesses are no longer available, as is the case with any barriers to trade. Furthermore, many use their resources to find ways to circumvent the controls, leading to economic waste and a

distorted competitive position between those who circumvent the controls versus those who abide by the rules (Central Bank 2010).

The capital controls were initially intended as a temporary measure, but in 2014 they are still in place and in general the cost of controls such as these tends to go up with time. Thus, one of the most pressing macroeconomic issue facing Iceland today is lifting the controls while at the same time preserving the delicate recovery of the Icelandic economy and avoiding further cuts in real earnings.

7.4 The European Economic Area and EU membership

Iceland is a member of the European Economic Area (EEA) which extends the four freedoms of the European Union to Iceland. That includes the free movement of capital. The EEA Agreement allows temporary restrictions of movement of capital in the case of currency and balance of payments crisis. Iceland is, therefore, not violating the EEA Agreement. However, the question remains as to how temporary is a 6-year long restriction of capital movements.

The left-wing government that was in power from 2009 to 2013 started a formal application process to the European Union during its term in office. The main union confederations, including ASÍ firmly support joining the EU and adopting the euro. The negotiations were still in progress when the centre-right government took office in the spring of 2013. The incoming government suspended the application process and has no plans to continue the negotiations.

Thus, the future of Iceland in the European arena is unknown at this point in time. In the future, Iceland might have to leave the EEA if it is not able to lift the financial controls. Iceland could though possibly maintain its membership of the EEA, or Iceland could at some point reconvene the negotiations with the EU to eventually have a referendum on membership.

7.5 Productivity

Iceland's per capita labour productivity is comparable to the productivity of other countries. This, however, is only achieved through a high labour force participation rate and long work hours. If labour force participation rates and the number of work hours were similar to that of the other Nordic countries and the UK, then Iceland's production would be almost a quarter lower than it is currently (McKinsey 2012).

Thus, it is of fundamental importance for improved living conditions in Iceland that there will be an improvement in productivity. This can be achieved through varied means. First, it can be achieved through increased business-sector investment as capital intensity is relatively low and business-sector investment has been historically low in recent years. Second, productivity can be improved through improved competition. There is an oligopoly in many sectors of the Icelandic economy and Icelandic business is quite sheltered from foreign competition. Thus, any increase in competition either from within or from outside Iceland would aid in improving productivity. Furthermore, increased education, especially by reducing drop-out rates from secondary schools and raising the skill level of the labour force, would improve the human capital of the nation and hence its productive capacity.

7.6 Challenges in the labour market and welfare system

While many European nations face serious challenges for their pension systems and labour markets, Iceland can be said to enjoy a more favourable situation than many nations.

In regard to the pension system, Icelanders retire late compared to other Western nations, hence greatly saving expenditures on pensions. People with disabilities also have a high employment participation rate and so do single parents. Hence, the pressure on the Icelandic pension system is relatively small compared to many Western systems. In addition, the occupational pension system is fully funded and will be taking on a continually growing share of pension payments, as it gradually relieves pressure on expenditures in the public social security system, due to income testing of the social security benefits.

In the labour market, Iceland has for many decades enjoyed a very high employment participation rate. Most households have two income earners and demand for pre-school places for children is nearly fully met.

A problem that is high on the Iceland 2020 target plan is to reduce drop-out from secondary schools. On that front Iceland lags behind many of its neighbouring countries. This will remain a challenge for some time yet, but political action has now been taken to reduce drop-outs.

After the crisis it remains to catch up on the previous high levels of welfare provisions. For example, cuts in expenditures on health-care services and hospitals were quite large, as well as on education. Currently, there is great pressure to increase expenditure in those sectors, while regaining acceptable levels will most likely take a few years. Iceland might have to accept somewhat lower expenditure levels in those sectors than prevailed before the crisis. But some increase will be necessary, not least due to declining standards in health-care, reduced human capital in the health-care sector and increased user cost in the welfare services.

The level of unemployment for immigrant workers and youth remains too high and that problem needs to be addressed. Apart from these issues there are of course important goals of continuously improving well-being that remain, just as they did before the crisis.

7.7 Regaining Scandinavian living standards

As a consequence of the collapse of the Icelandic króna throughout the year 2008 and into 2009, real disposable earnings of households came down by about 20% on average. That, along with increased unemployment and the increased debt burden, were the main aspects of the cuts in living standards that the crisis inflicted on households. The cuts in earnings were however lower amongst the lower income groups, due to redistributive policy reactions and bargained increases of minimum wages by the labour movement. The unemployment rate has fallen significantly and is by now amongst the lowest in Europe. The debt burden has been eased somewhat, while some of the reduction in real disposable earnings has been regained.

It is a major challenge for Icelandic politics and unions to regain more comparable living standards to those of the other Nordic nations, including higher pay and shorter working hours. Wage levels, especially of skilled workers, are not comparable to those in our neighbouring countries, while the work day is much longer. Unless successful in addressing these issues, Iceland may be susceptible to significant emigration of Icelandic nationals. The net loss of health care personnel, engineers and technicians, and skilled workers is already at an all-time height from 2009 to 2013. While the net overall immigration flow to Iceland was positive in 2013, for the first time since the onset of the crisis, there was still a net loss of Icelandic nationals, but the main gain was of foreign immigrants. Hence, the threat of losing valuable Icelandic skills and young people through emigration remains.

Regaining living standards that are more comparable to Scandinavian levels is thus a major challenge for Iceland, if it is to retain its competitiveness as a home country for the younger generations. Depreciation of the unstable Icelandic króna has been a major source of periodic cuts in living standards in Iceland and they need to be seriously addressed if more sustainable higher levels of living are to be gained.

7.8 Innovation and new bases of growth

Iceland's economy is undiversified and its exports are largely based on its natural resources. With the depreciation of the króna the country's competitive position improved. However, this

was not reflected in greatly expanded export revenues. The two main export industries in Iceland are fisheries and energy intensive industry, like aluminium smelters. The fisheries are under a quota system and the aluminium smelters are run at full capacity. Hence, they were not capable of enjoying the improved competitive position due to quantity restraints. Tourism services, however, have grown fast in recent years, taking full advantage of the improved competitive position, without restraints on their production capacity.

By encouraging diversification of the economy and developing new areas of growth, other resources, such as human capital, can be used more efficiently. Iceland has made some progress, such as in designing artificial limbs, in making computer games that are played world-wide and many world-class musicians and other artists reside in Iceland. The knowledge sector needs to be cultivated further. It already constitutes an important source of export revenues that could indeed be significantly expanded.

In order to increase the diversity of the export sector and to enjoy an improved competitive position, Iceland should widen its horizon and look for future growth in areas other than natural resources, especially where there are less limits on quantity in production. Tourism, knowledge industry and sustainable energy provide extensive opportunities for further expansion and innovation.

Appendix – further data

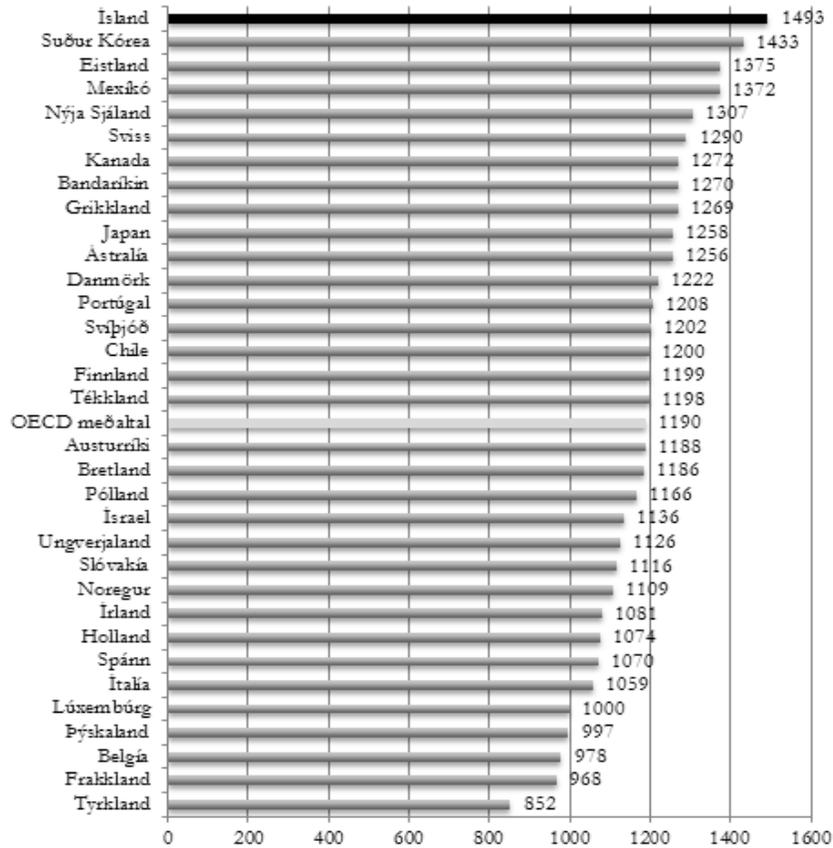


Figure A.1: Overall volume of work in OECD countries in 2008 (average number of yearly working hours multiplied by proportion employed in ages 16-64)

Source: Stefánsson 2012

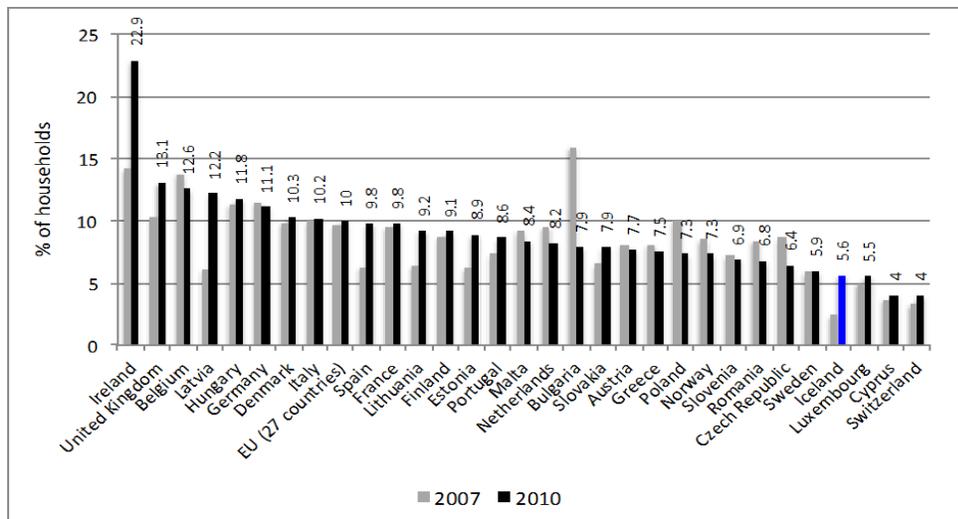


Figure A.2: Proportion of persons living in households with very low work activity, 2007 and 2010.

Source: Eurostat

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- Sub-paper 1: Nordic tax policy
- Sub-paper 2: A sleeping giant? German trade unions in the European crisis
- Sub-paper 3: Climate in the Nordic Model
- Sub-report 1: The Nordic models' pillars
- Sub-report 2: Nordic population changes
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- Sub-report 8: Country Study of Sweden
- Sub-report 9: Decent work – the future of the collective agreement
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- Sub-report 11: Inclusion and integration challenges
- Sub-report 12: To create and share – the remarkable success and contested future of the Nordic Social-Democratic Model
- Sub-report 13: Innovation and innovation policy in the Nordic region
- Sub-report 14: Democracy and participation
- Main report

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Economy, Politics and Welfare in Iceland

The Nordic countries share many common traits. Their small, open economies, generous welfare states, and highly organized labour markets have given rise to the notion of a distinct Nordic model. NordMod 2030 is a Nordic research project, assigned to identify and discuss the main challenges these countries will have to cope with towards 2030. The purpose is to contribute to the knowledge basis for further development and renewal of the Nordic models.



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Borggata 2B/P.O.Box 2947 Tøyen
N-0608 Oslo
www.fafo.no/english/

Fafo-report 2014:13
ISBN 978-82-324-0102-4
ISSN 0801-6143