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Foreword

This *Survey* is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Iceland were reviewed by the Committee on 22 May 2023. The draft report was then revised in light of the discussions and given final approval as the agreed report of the whole Committee on 9 December 2022.

The Secretariat's draft report was prepared for the Committee by Hansjoerg Bloechliger, Vassiliki Koutsogeorgopoulou and Natia Mosiashvili, under the supervision of Vincent Koen. Editorial support was provided by Jean-Rémi Bertrand and Michelle Ortiz.

The previous *Survey* of Iceland was issued in July 2021.

Information about the latest as well as previous Surveys and more details about how *Surveys* are prepared is available at www.oecd.org/eco/surveys

Table of contents

FOREWORD 3

Executive Summary 9

1 Key Policy Insights 14
1.1. Introduction 15
1.2. The economy remains strong despite some signs of cooling 16
1.3. Monetary and financial policies are being tightened 27
1.4. Further fiscal tightening is needed 38
1.5. The business climate should improve to raise productivity 45
1.6. Climate action is progressing gradually 52
References 57

2 Immigration in Iceland: addressing challenges and unleashing the benefits 61
2.1. Introduction 61
2.2. Immigration patterns in an international context 64
2.3. Immigration policy is flexible but there is scope to attract more skilled labour 70
2.4. The economic impact of immigration is closely related to integration 73
2.5. Improving the labour market integration of immigrants 83
2.6. Enhancing the educational outcomes of immigrants' children 93
2.7. Meeting the housing needs of immigrants 100
References 107

FIGURES

Figure 1. Inflation is persistent 10
Figure 2. Iceland is ageing, but less than other OECD countries 11
Figure 3. Entry barriers have long been high 12
Figure 4. Immigration has risen fast 12
Figure 1.1. Iceland's performance is strong 15
Figure 1.2. Iceland has become an immigration country 16
Figure 1.3. Growth has peaked 17
Figure 1.4. The labour market has started to ease but remains tight 19
Figure 1.5. Labour market imbalances are considerable 20
Figure 1.6. The gender gap in paid hours worked is the highest in the OECD 21
Figure 1.7. Competitiveness improved, despite wages exceeding productivity growth 22
Figure 1.8. Wages and wage growth are more equally distributed than productivity 24
Figure 1.9. External positions have improved, although foreign capital is shying away 25
Figure 1.10. The structure and destination of exports are evolving 26
Figure 1.11. Tourism has recovered fast but may soon reach its sustainable potential 27

Figure 1.12. Monetary policy has been tightened 28
Figure 1.13. Inflation has been broadening 29
Figure 1.14. Inflation expectations have de-anchored 30
Figure 1.15. Iceland's inflation history 31
Figure 1.16. The financial system looks sound 32
Figure 1.17. Banks are well capitalised 33
Figure 1.18. Pension funds have expanded 35
Figure 1.19. The housing market has started to cool but prices remain high 36
Figure 1.20. Housing supply reacts slowly to rising demand 37
Figure 1.21. Fiscal deficits have begun to shrink 38
Figure 1.22. Spending tends to be procyclical 39
Figure 1.23. Spending quality has declined 41
Figure 1.24. Spending on pensions is small, but ageing costs will rise 42
Figure 1.25. Reform could help contain spending and stabilise debt 43
Figure 1.26. Taxation is around the OECD average and relies heavily on income 44
Figure 1.27. Marginal tax rates are high 45
Figure 1.28. Labour productivity has been rising by around 1% per year 46
Figure 1.29. The business climate is rather unfriendly 47
Figure 1.30. The insolvency framework is ineffective 49
Figure 1.31. Financial support to innovative firms is high 50
Figure 1.32. Corruption is perceived as average in Iceland 51
Figure 1.33. Iceland is addressing climate change 53
Figure 2.1. Immigration has increased rapidly 62
Figure 2.2. Immigration comes with benefits and challenges 63
Figure 2.3. The large influx of foreign citizens changed the migration landscape 64
Figure 2.4. Migration flows appear to be largely influenced by the business cycle 65
Figure 2.5. The geographical diversity of immigrant inflows has increased 66
Figure 2.6. Inflows of refugees and asylum seekers increased sharply 67
Figure 2.7. Immigrants are mainly young, with a balanced gender distribution 68
Figure 2.8. Immigrants tend to live in the capital area and more have been staying longer 69
Figure 2.9. On average, immigrants have lower educational attainment levels than natives 69
Figure 2.10. Immigrants are concentrated in low-skill sectors 70
Figure 2.11. The issuance of temporary work permits has increased in recent years 72
Figure 2.12. Immigration yields large demographic benefits 75
Figure 2.13. The Phillips curve has flattened 76
Figure 2.14. Changes in employment suggest sectoral shifts among native workers 77
Figure 2.15. An increasing share of students has a foreign background 78
Figure 2.16. The average class size remains relatively small 79
Figure 2.17. Immigration can create additional demand for educational resources 79
Figure 2.18. Spending on compulsory education is comparatively high 80
Figure 2.19. The labour market outcomes of immigrants can improve in some respects 83
Figure 2.20. The immigrant-native unemployment gap persists across all age groups 84
Figure 2.21. Immigrants are much more likely to be over-qualified than natives 85
Figure 2.22. Immigrants are under-represented in the public sector 91
Figure 2.23. There is scope to increase immigrant participation in adult training 92
Figure 2.24. Socio-economic background has a small impact on students' outcomes 93
Figure 2.25. PISA scores for reading literacy are weak for immigrant students 94
Figure 2.26. Immigrant students also underperform on other educational indicators 95
Figure 2.27. Vocational education and training could be strengthened 97
Figure 2.28. Teachers need to be better prepared for increasing diversity in classrooms 99
Figure 2.29. Immigrants live mostly in rented dwellings 100
Figure 2.30. Low-income households face high housing costs 101
Figure 2.31. The social housing stock needs to increase further in view of rapidly rising demand 101
Figure 2.32. The foreign-born are more likely to live in overcrowding dwellings 102
Figure 2.33. Support for housing could be better targeted 104

TABLES

Table 1. Growth is gradually slowing 10
Table 1.1. Macroeconomic indicators and projections 18
Table 1.2. Events that could entail major changes to the outlook 18
Table 1.3. Past recommendations and actions taken in monetary, financial, and fiscal policies 43
Table 1.4. Illustrative fiscal impact of recommended reforms 45
Table 1.5. Potential impact of structural reforms on per capita income 46
Table 1.6. Past recommendations and actions taken to foster inclusive growth 52
Table 1.7. Past recommendations and actions taken to address climate change 54
Table 2.1. Recommendations for addressing the challenges and unleashing the benefits of immigration 106

BOXES

Box 1.1. The 2023 “bridge” wage agreements 23
Box 1.2. Inflation, and how to bring it down: lessons from Iceland 30
Box 1.3. The fiscal framework has served Iceland well, but procyclical spending remains an issue 40
Box 1.4. Quantifying fiscal policy recommendations 45
Box 1.5. Quantification of structural reforms 46
Box 1.6. Ownership and market structure in Iceland’s power sector 48
Box 1.7. Supporting investment in research and development in Iceland 50
Box 1.8. Direct air capture and storage – Icelandic technology to reach net zero 54
Box 2.1. The number of applicants for international protection has increased in recent years 66
Box 2.2. Immigration framework: main features 71
Box 2.3. Empirical evidence on the growth effects of immigration 74
Box 2.4. Some international evidence on the fiscal impact of immigration 82
Box 2.5. Fast-track schemes for recognition: some lessons from Norway and Sweden 88
Box 2.6. Recent reforms to strengthen the services provided to jobseekers 90
Box 2.7. Education Policy 2030: main features 97
Box 2.8. Provision of housing support to low-income household 103

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Basic statistics of Iceland, 2022

(Numbers in parentheses refer to the OECD average)[2]

LAND, PEOPLE AND ELECTORAL CYCLE					
Population (million, 2022)	0.4		Population density per km² (2022, OECD 2021)	3.7	(38.7)
Under 15 (%, 2022)	18.6	(17.4)	Life expectancy at birth (years, 2021)	83.1	(78.7)
Over 65 (%, 2022)	15.0	(17.7)	Men (2021)	81.8	(75.9)
International migrant stock (% of population, OECD: 2021)	19.5	(13.2)	Women (2021)	84.5	(81.7)
Latest 5-year average growth (%)	2.1	(0.5)	Latest general election	September 2021	
ECONOMY					
Gross domestic product (GDP)			Value added shares (%, 2021)		
In current prices (billion USD)	27.9		Agriculture, forestry and fishing	5.1	(2.6)
In current prices (billion ISK)	3 766.4		Industry including construction	22.8	(26.6)
Latest 5-year average real growth (%)	1.9	(1.6)	Services	72.2	(70.8)
Per capita (thousand USD PPP, OECD: 2021)	67.3	(50.9)			
GENERAL GOVERNMENT Per cent of GDP					
Expenditure (OECD: 2021)	46.1	(46.3)	Gross financial debt (OECD: 2021)	77.2	(107.5)
Revenue (OECD: 2021)	41.8	(38.8)	Net financial debt (OECD: 2021)	22.2	(68.7)
EXTERNAL ACCOUNTS					
Exchange rate (ISK per USD)	134.99		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	148.66		Manufactured goods	46.1	
In per cent of GDP			Food and live animals	38.0	
Exports of goods and services	46.3	(33.3)	Machinery and transport equipment	3.1	
Imports of goods and services	47.0	(34.9)	Main imports (% of total merchandise imports)		
Current account balance	-1.8	-(1.1)	Machinery and transport equipment	34.6	
Net international investment position	23.0		Mineral fuels, lubricants and related materials	14.5	
			Miscellaneous manufactured articles	12.4	
LABOUR MARKET, SKILLS AND INNOVATION					
Employment rate (aged 15 and over, %)	71.8	(57.5)	Unemployment rate, Labour Force Survey (aged 15 and over, %)	3.8	(5.0)
Men	75.1	(65.4)	Youth (aged 15-24, %)	8.6	(10.9)
Women	68.3	(50.2)	Long-term unemployed (1 year and over, %)	0.5	(1.2)
Participation rate (aged 15 and over, %, 2021)	80.1	(60.9)	Tertiary educational attainment (aged 25-64, %, 2021)	43.1	(39.9)
Average hours worked per year (2021)	1,449	(1,728)	Gross domestic expenditure on R&D (% of GDP, 2020)	2.5	(3.0)
ENVIRONMENT					
Total primary energy supply per capita (toe, 2021)	15.9	(3.8)	CO_2 emissions from fuel combustion per capita (tonnes, 2021)	4.2	(7.9)
Renewables (%, 2021)	88.9	(11.6)	Water abstractions per capita (1 000 m³, 2014)	9.2	
Exposure to air pollution (more than 10 µg/m³ of PM 2.5, % of population, 2019)	3.5	(61.7)	Municipal waste per capita (tonnes, 2020)	0.6	(0.5)
SOCIETY					
Income inequality (Gini coefficient, 2017, OECD: latest available)	0.250	(0.315)	Education outcomes (PISA score, 2018)		
Relative poverty rate (%, 2017, OECD: 2018)	4.9	(11.7)	Reading	474	(485)
Median disposable household income (thousand USD PPP, 2017, OECD: 2018)	34.3	(25.5)	Mathematics	495	(487)
Public and private spending (% of GDP)			Science	475	(487)
Health care (2021, OECD: 2020)	9.7	(9.7)	Share of women in parliament (%)	47.6	(32.5)
Pensions (2019)	7.7	(9.5)	Net official development assistance (% of GNI, 2017)	0.3	(0.4)
Education (% of GNI, 2021)	7.2	(4.4)			

[1] The year is indicated in parenthesis if it deviates from the year in the main title of this table.

[2] Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 80% of member countries.

Source: Calculations based on data extracted from databases of the following organisations: OECD, Statistics Iceland, International Energy Agency, International Labour Organisation, International Monetary Fund, United Nations, World Bank.

Executive Summary

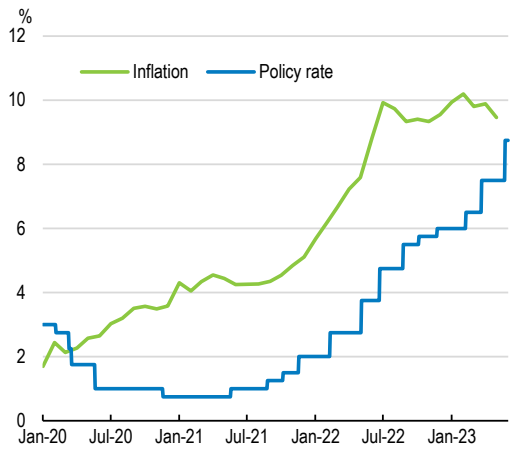
The economy remains strong, but inflation persists

The economy has expanded fast until recently, driven by a rapid recovery of foreign tourism and strong domestic demand. Growth is expected to slow gradually in the course of 2023 amidst tighter financial conditions.

Inflation remains persistent (Figure 1). It peaked in early 2023 at around 10% but has broadened, spreading to domestic services. Energy plays a small role for inflation since Iceland relies largely on domestic sources. Inflation expectations have become unanchored, even though the central bank has strengthened efforts to bring them back to target.

Figure 1. Inflation is persistent

Consumer price inflation and key policy interest rate



Note: Inflation refers to national headline consumer price inflation.
Source: Central Bank of Iceland; and OECD, Consumer Prices database.

StatLink https://stat.link/6aq0o7

Labour markets remain tight. The registered unemployment rate has hovered around 3.5% since mid-2022. Labour force participation is rising again after the pandemic-induced drop. However, imbalances, such as skills mismatch, the shortage of STEM and health care workers, or the simultaneous increase in unemployment and vacancies, are deepening. The decline in real wages may have come to a halt following the wage agreements of end-2022.

Growth is projected to slow (Table 1). Foreign tourism is likely to moderate as capacity limits become more apparent and economic conditions in the origin countries worsen. Tighter financial conditions will weigh on investment. Uncertainty surrounding the projections remains high.

Table 1. Growth is gradually slowing

(Annual growth, unless specified)	2021	2022	2023	2024
GDP at market prices	**4.3**	**6.4**	**4.4**	**2.6**
Private consumption	7.0	8.6	3.7	2.0
Gross fixed capital formation	9.8	6.9	- 5.5	3.1
Exports	14.7	20.6	5.0	3.8
Imports	19.9	19.7	- 1.8	2.4
Unemployment rate	6.0	3.7	3.9	4.3
Consumer price index	4.4	8.3	7.4	3.3
Current account (% of GDP)	- 2.8	- 1.8	- 0.8	- 0.2
Budget balance (% of GDP)	- 8.4	- 4.3	- 2.5	- 1.4
General government gross debt (% of GDP)[1]	77.2	78.4	78.6	78.6

1. Includes unfunded liabilities of government employee pension plans.
Source: OECD Economic Outlook No. 113 database.

Monetary and financial policies are being tightened

The central bank raised the key interest rate and tightened macro-prudential rules for financial institutions and households, notably in the face of higher risks coming from the housing market.

Interest rates are rising. In May 2023, the central bank raised the key policy rate to 8.75%, the 13th hike since tightening started in May 2021. Interest rates are now 8 percentage points higher than two years ago. The central bank had engaged in small-scale quantitative easing in 2020 but has since stopped buying treasury bonds (passive quantitative tightening).

The financial system looks stable overall. Corporate and household credit are expanding but debt levels remain modest. To address emerging risks, the central bank increased the counter-cyclical buffer from 0% to 2% in September 2022 and announced a further increase to 2.5% for March 2024. The capital adequacy ratios of the three systemically important banks are well above requirements. Íslandsbanki, the second-largest bank, has been

partly privatised. Privatisation of the last tranche of 42% has been postponed to 2023-24.

Housing market risks remain elevated. House prices rose fast until mid-2022. The sharp increase in interest rates has cooled markets. Servicing mortgages has become more difficult, but household defaults remain low. To reduce debt service cost in the short term, households are increasingly turning to mortgages indexed to inflation. Housing supply is picking up.

Fiscal policy should be tightened more

Fiscal policy is contractionary, but costs related to ageing pose a risk to long-term debt sustainability.

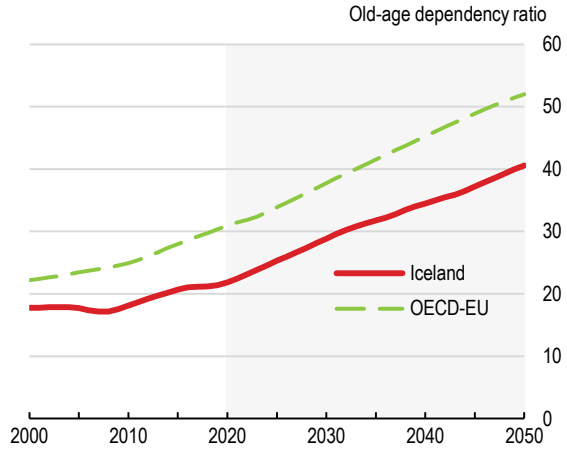
The general government fiscal balance recovered from around -9% in 2020 to around -4.5% in 2022, and the fiscal stance has become contractionary. Public debt as measured by the OECD rose from around 61% of GDP in 2019 to around 78% in 2022, while contingent liabilities continue to decline. The government projects the debt ratio to decline from 2023 and the budget to return to balance in 2027.

Government spending has been pro-cyclical most of the time since the turn of the millennium. However, the fiscal framework adopted in 2015 has improved the budget process. Adding a spending rule could help reduce procyclicality further.

Ageing costs are rising. Iceland's population is getting older and growing more slowly (Figure 2). The government projects health and long-term care spending to rise by more than 3% of GDP by 2050, although from a lower level than in almost any other OECD country. Reforms to the retirement age and others, such as reducing tax expenditures, would slow the build-up of debt.

Marginal tax rates for low-and middle-income earners are high, reducing their incentives to work. High marginal tax rates could also discourage second earners, often women, from taking up work or working longer hours, partly driving the large gap in working hours between men and women.

Figure 2. Iceland is ageing, but less than other OECD countries



Note: The old age dependency ratio is the number of individuals aged 65 and more to the population aged between 15 and 64.
Source: United Nations, Department of Economic and Social Affairs, Population Division, World Population Prospects 2022.
StatLink https://stat.link/i2m4nu

Improving the business climate

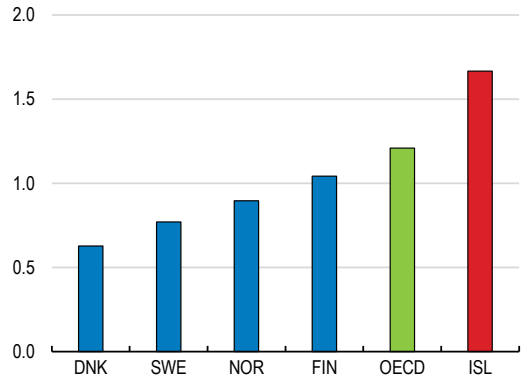
Labour productivity has been trending up by around 1% yearly, close to the OECD average, but has recently slowed. Structural reforms could reinvigorate productivity growth and help with the fight against inflation.

Despite progress, further improvements in the business climate are called for. Over the past two years reforms opened the tourism sector to more competition. Similar measures were implemented in the construction sector, and licensing requirements have been eased or removed for some professions. Even so, barriers to entry for domestic and foreign companies remain high (Figure 3). The licensing and permit system for professional services is extensive, and reform meets with resistance from vested interests. Access for companies domiciled outside the European Economic Area is more restricted than in other OECD countries.

The electricity market could be more open. Productivity increases in the power sector have been close to the OECD average. This mostly state- and municipally-owned sector has been following EU minimum regulatory requirements since 2003 and reforms to create a transparent and fully operational wholesale market are underway.

Figure 3. Entry barriers have long been high

Barriers to domestic and foreign entry, 2018



Note: A higher indicator value means more stringent regulation. Reforms since 2018 have not been taken into account.
Source: OECD, Product Market Regulation database.

StatLink https://stat.link/et9v5f

Iceland's insolvency framework is cumbersome. Firms face more barriers to restructuring or exit than in most other OECD countries. Temporary simplifications introduced during the pandemic should become permanent.

Making the most of immigration

Immigration has increased rapidly since the late 1990s, with the share of foreign citizens soaring to around 18% of the population by mid-2023, transforming the economy and bringing benefits and challenges. A comprehensive approach is needed to make the most of immigration.

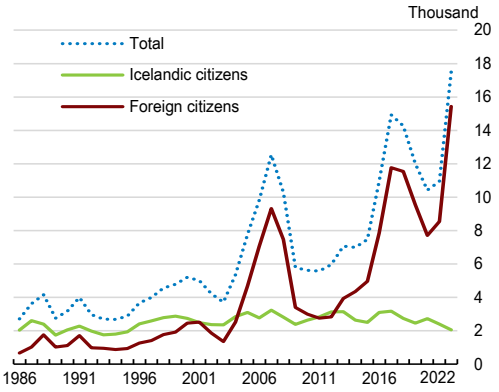
Immigration has visible impacts on the economy. Increasing immigration yields large demographic gains to Iceland, helping to contain the pressures of an ageing population (Figure 4). There are also important labour market benefits arising from increasing migration inflows in the form of enhanced flexibility, knowledge transfer and support to fast-growing sectors.

However, important challenges regarding the integration of immigrants need to be addressed. Effective language training and efficient skills recognition are essential for helping immigrants to meet their potential. At the same time, immigrants' skills should be strengthened, including through more job opportunities in the public sector by developing a specific strategy to this end, as well as through re-skilling.

A better integration of immigrants requires further efforts in the areas of education and housing. Solid foundational and vocational skills are key to stronger education outcomes of immigrant students, with increased teacher preparedness for diverse classrooms a prerequisite. Moreover, the supply of social and affordable housing needs to be expanded, as planned.

Figure 4. Immigration has risen fast

Immigration flows



Note: Immigrating Icelandic and foreign citizens who obtain a residence permit or a work permit for over three months.
Source: Statistics Iceland.

StatLink https://stat.link/smnqax

Decarbonising the economy

Iceland has committed to reduce carbon emissions from their 1990 level by 55% by 2030, by joint agreement with the European Union and Norway. It should do so in a sustainable and cost-efficient manner.

Iceland's per capita carbon emissions exceed the OECD average but are declining. Industry makes up an outsized share because of the oil-powered fishing fleet and three large aluminium smelters. Agriculture is also emitting carbon above the OECD average.

Climate policies need to be strengthened further. Costs and benefits of individual emission reduction measures listed in the climate action plan have been more thoroughly assessed. Reduction targets could be set in partnership with individual sectors. Regulatory procedures for wind energy are being developed. Carbon pricing should be broadened and a path for further rises laid out.

Main findings	Key recommendations
Monetary and fiscal policies	
Inflation has far exceeded the target for more than two years.	Tighten monetary policy further if needed to re-anchor expectations and to bring inflation back to target in due time.
The fiscal stance has turned contractionary.	Continue to tighten fiscal policy and reinstate the fiscal rule by 2026 at the latest.
Iceland's natural capital generates rents for tourism that can be tapped.	Remove tax exemptions in the tourism sector, notably the reduced VAT rate.
Policies to improve the business climate	
Labour market imbalances, in particular skills mismatch, are high.	Invest in education and skills that are high in demand such as STEM and health care, and foster gender balance across professions and economic sectors.
The power wholesale market is not fully operational. Some contracts between power producers and customers are opaque.	Set up a transparent electricity wholesale market coordinated by an independent operator.
Decarbonising the economy	
Albeit falling, carbon emissions remain above the OECD average.	Extend carbon taxation to all greenhouse gases and to all areas not covered by the EU emission trading scheme. Map out a gradual increase in the carbon tax so that tax levels in the non-ETS sectors converge to those in the ETS sectors.
Abatement costs of various climate actions have been thoroughly assessed. They vary strongly across actions.	Based on cost-benefit analysis, prioritise climate actions that carry a low cost per tonne of reduced carbon emissions. End actions with high cost.
Addressing the challenges and unleashing the benefits of immigration	
There is scope to attract more highly skilled immigrants in view of specialist shortages in frontier sectors, notably ICT.	Proceed with the timely implementation of the new provisions for the issuance of work permits for foreign experts. Ensure a swift adoption of the draft bill envisaging an extension of the duration of residence and work permits for foreign experts.
The unemployment rate and overqualification are higher for immigrant workers than for natives, largely reflecting relatively poor command of Icelandic, with room to define more clearly the role and responsibilities of stakeholders in the provision of language training for adult immigrants.	Make language training for adult immigrants part of a comprehensive approach to immigrant integration, combining it with vocational training, and by involving all partners. Increase the accessibility and flexibility of the language training courses. Ensure coherence of teaching quality standards and introduce student evaluation in language training of adult immigrants to help them improve their learning outcomes.
Refugee inflows have increased rapidly in recent years.	Ensure a successful integration of refugees, notably through supporting the rapid acquisition of language skills.
The skills recognition system is complex and information on recognition requirements and processes difficult to access, discouraging third-country immigrants from applying.	Ensure clear eligibility rules and well-coordinated procedures for the recognition of foreign qualifications. Ease access to the skills recognition system by establishing a one-stop shop that offers multiple services to immigrants.
Immigrant students underperform their native counterparts by a wide margin in reading literacy and have higher upper secondary drop-out rates.	Implement the Education Policy 2030 measures for students with a diverse linguistic background within the envisaged timeline.
Immigrants face high housing costs, and the stock of social and affordable housing does not appear to be sufficient to match the needs of an increasing immigrant population.	Better target housing allowances at low-income households and ensure appropriate investment in social and affordable housing based upon a rigorous assessment of pending demand.

1 Key Policy Insights

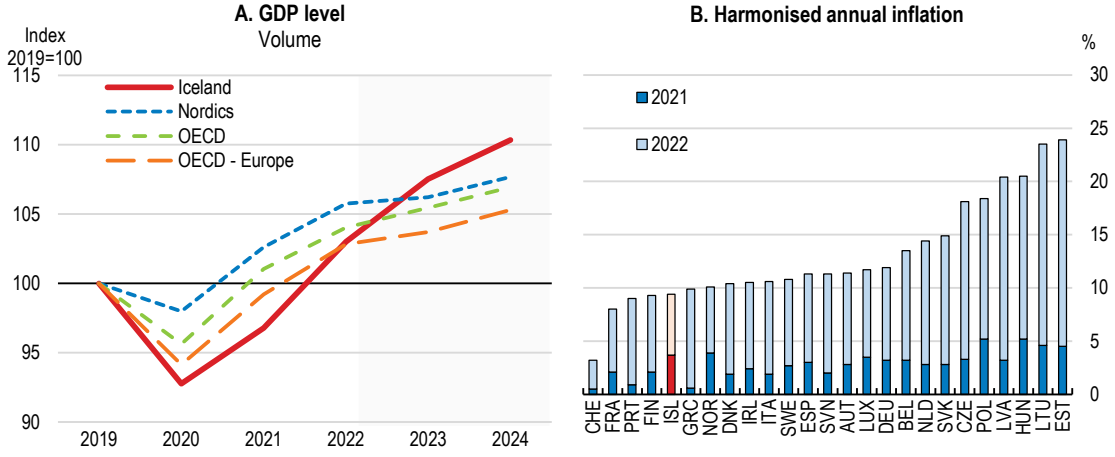
Iceland's economy is one of the fastest-growing of the OECD, driven by foreign tourism and strong domestic demand. The labour market is tight and wage growth robust, while high wage compression helps maintain a highly egalitarian economy. Inflation is persistent and broadening, and inflation expectations have de-anchored. The fiscal stance is tightening but more could be done to dampen inflationary pressures and support monetary policy. Labour market imbalances are rising. While progress has been made to remove barriers to the entry of firms in the tourism and construction sectors, barriers remain high in other sectors. Structural reform could help raise productivity notably in the domestic sector, while also contributing to disinflation. Higher and broader taxation of greenhouse gas emissions, coupled with investment in cost-effective actions, would help to efficiently achieve further emission cuts.

1.1. Introduction

Iceland is the OECD's smallest, among its most remote, and one of its fastest-growing economies (Figure 1.1). Foreign tourism is vigorously rebounding from the collapse during the covid-19 pandemic and exports of goods and services are thriving. Thanks to reliable domestic energy sources, the country has largely been spared the power crisis that has strangled other countries. Innovation activity is picking up, helping to diversify the economy and make it more stable and sustainable. Labour participation of both men and women, which had declined during the pandemic, is again approaching historical highs. A compressed wage distribution and a well-targeted tax-and-social benefit system is helping to maintain one of the most egalitarian economies of the OECD. Finally, trust in institutions, which is a key driver to maintain and reinforce democracy, is high.

However, Iceland is not sheltered from the storm racing through OECD economies. Inflation started to build up earlier than in many other OECD countries; it has reached levels unattained since the financial crisis in 2009, and it is broadening. Although the post-pandemic recovery was much faster than expected, the fiscal stance is not being tightened fast enough, and therefore not contributing sufficiently to the central bank's efforts to return inflation to the target. The wage agreements reached in late 2022 and early 2023, as well as last year's króna depreciation, could also add to inflationary pressures. Labour markets remain tight. The simultaneous rise of both the unemployment and job vacancy rate suggests growing imbalances in the post-pandemic labour market.

Figure 1.1. Iceland's performance is strong



Source: OECD Economic Outlook No. 113 database; and OECD, Consumer Prices database.

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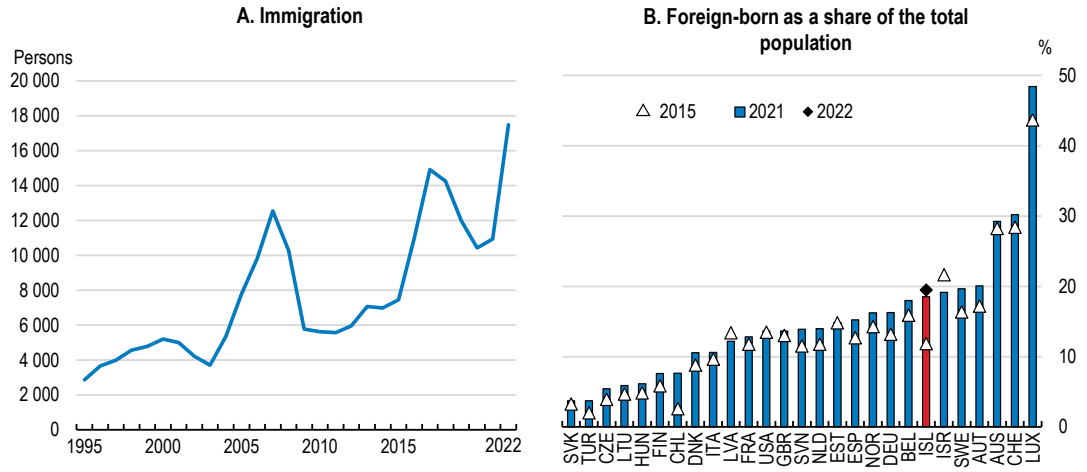
Besides managing the current macroeconomic turbulences, Iceland faces several structural challenges. Productivity growth was close to the OECD average only over the past decade, and it has slowed again after a brief acceleration before the pandemic, jeopardising sustained wage increases in the future. Considerable entry barriers, an extensive licensing and permit system and a cumbersome insolvency framework hamper sound competition and the emergence of new and innovative start-ups. Ageing is a long-term challenge, as the population will grow more slowly and get older, raising the cost for pensions, health care and long-term care. Iceland's net per capita greenhouse gas emissions remain above the OECD average – although they started to decline – and stronger action will be needed to reduce emissions by at least 40% as set in the climate action plan.

Immigration has become a key policy issue, as it has transformed the country more rapidly than most others in the OECD. As the inflow of labour immigrants kept rising, Iceland experienced the largest increase in the share of the foreign-born population among the OECD countries since the mid-2000s (Figure 1.2). Immigration plays an important economic role, including through the demographic gains it yields, helping

to alleviate the adverse effects of population ageing. Immigrant workers contribute significantly to fast growing sectors, and they increase labour market flexibility. At the same time, immigration involves challenges especially for the education system in view of the poor performance and the diverse needs of students with a foreign background. Increased demand for affordable housing in a tight market adds to these challenges. Appropriate policies to better integrate immigrants and help them and their children to meet their potential are key to reap the economic benefits of immigration.

Figure 1.2. Iceland has become an immigration country



Note: In Panel A, data refer to the sum of Icelandic and non-Icelandic citizens. In Panel B, data refer to all persons that were born abroad.
Source: Statistics Iceland; and OECD, International Migration database.

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Against this background, the key policy messages of this Survey are:

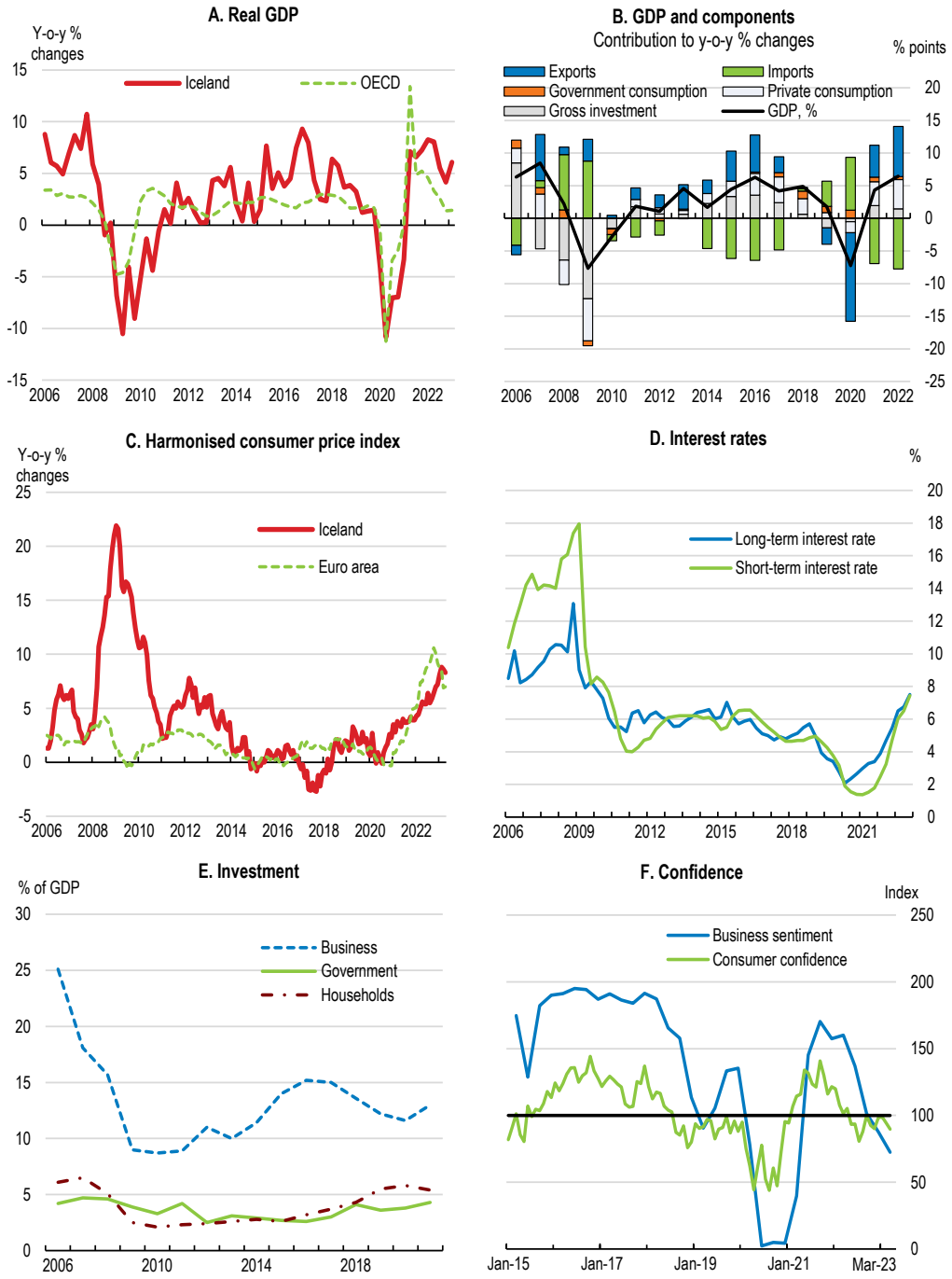
- Better align monetary, fiscal and financial policies to bring inflation back to target, build up fiscal space and maintain financial stability.
- Strengthen productivity growth by improving the business climate, easing the overreaching system of licences and permits, and investing in skills that are relevant for the labour market. Reduce carbon emissions further by mapping out a path towards higher and broader carbon taxation.
- Get the best out of immigration by better integrating immigrants and their children, including through effective language training and efficient skills recognition, as well as by strengthening teachers' professional development and ensuring a sufficient supply of affordable housing.

1.2. The economy remains strong despite some signs of cooling

1.2.1. Growth has peaked

Economic growth remains strong, although some signs of cooling have become apparent in early 2023 (Figure 1.3). Foreign tourism recovered from the pandemic-induced collapse and has regained its pre-pandemic levels. Some sectors such as aquaculture, pharmaceuticals, data storage and processing, and creative sectors like music and film are thriving. Household consumption growth is gradually levelling off on the back of tepid real wage growth and the declining value of assets, however. Business investment has picked up after the pandemic. The fiscal stance is contractionary, while investment in public infrastructure has reached a peak in 2022. Unemployment remains below 4%, close to the estimated structural rate.

Figure 1.3. Growth has peaked



Source: OECD, National Accounts database; OECD, Consumer Price Indices database; Eurostat; Statistics Iceland; and CEIC.

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The central bank's determined reaction to the surge of inflation was necessary, and it is contributing to slowing demand. Real wages have been sliding downwards, with ensuing consequences for household income, although real wage declines could have bottomed out with the wage agreements of late 2022 in the private sector and spring 2023 in the public sector. House prices – a key driver in the ongoing inflation cycle earlier on – are cooling. Both consumer and business confidence have declined.

Economic growth is expected to moderate from 6.4% in 2022 to 4.4% in 2023 and 2.6% in 2024. Household consumption will slow as real wages continue to weaken. Foreign tourism is likely to slow as capacity limits

become more apparent and insofar as economic conditions in some of the origin countries worsen. Tighter financial conditions and considerable uncertainty will weigh on business investment. Housing investment will pick up in 2023 as pent-up demand is realised but will abate in 2024 as higher real interest rates bite. Public investment will no longer grow. The unemployment rate will edge up to around 4.5%. Inflation will decelerate in the wake of continued tightening, although it is projected to stay above target at the end of the projection period.

Table 1.1. Macroeconomic indicators and projections

	2019	2020	2021	2022	2023	2024
	Current prices	Percentage changes, volume (2015 prices)				
GDP at market prices	**3 023.9**	**- 7.2**	**4.3**	**6.4**	**4.4**	**2.6**
Private consumption	1 518.4	- 3.4	7.0	8.6	3.7	2.0
Government consumption	744.0	5.1	2.4	1.6	1.7	1.2
Gross fixed capital formation	631.0	- 7.4	9.8	6.9	- 5.5	3.1
Final domestic demand	2 893.4	- 2.0	6.3	6.4	1.2	2.0
Stockbuilding[1]	- 5.4	1.0	- 0.1	- 0.1	0.0	0.0
Total domestic demand	2 888.0	- 1.1	6.2	6.2	1.2	2.0
Exports of goods and services	1 320.6	- 31.1	14.7	20.6	5.0	3.8
Imports of goods and services	1 184.7	- 20.6	19.9	19.7	- 1.8	2.4
Net exports	135.9	- 5.5	- 2.0	- 0.1	3.2	0.6
Memorandum items						
GDP deflator	_	4.1	6.6	9.0	6.4	3.5
Consumer price index	_	2.8	4.4	8.3	7.4	3.3
Core inflation index[2]	_	2.9	4.4	7.8	7.2	3.4
Unemployment rate (% of labour force)	_	6.4	6.0	3.7	3.9	4.3
Budget balance (% of GDP)	_	- 8.9	- 8.4	- 4.3	- 2.5	- 1.4
Underlying primary fiscal balance (% of potential GDP)	_	- 1.2	- 2.4	- 0.6	0.1	1.1
General government gross debt (% of GDP)[3]	_	70.4	77.2	78.4	78.6	78.6
Current account balance (% of GDP)	_	1.3	-2.8	-1.8	-0.8	-0.2

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food, energy, alcohol and tobacco.
3. Includes unfunded liabilities of government employee pension plans.
Source: OECD Economic Outlook No. 113 database.

The projections continue to be surrounded by considerable risks and uncertainty. The small size of Iceland's economy makes it volatile and vulnerable. Inflation could remain higher than expected, triggering a wage-price spiral or else denting real incomes further. Goods and services exports, in particular tourism, could suffer from a stronger-than-expected slowdown in major origin countries, which could be aggravated by financial sector stress. Domestic shocks, such as a bad fishing season or a decline in viable fishing stocks, could affect exports of marine products. Investment could take an additional hit if financial conditions worsen further. A sharp fall in house prices could spark an economic contraction.

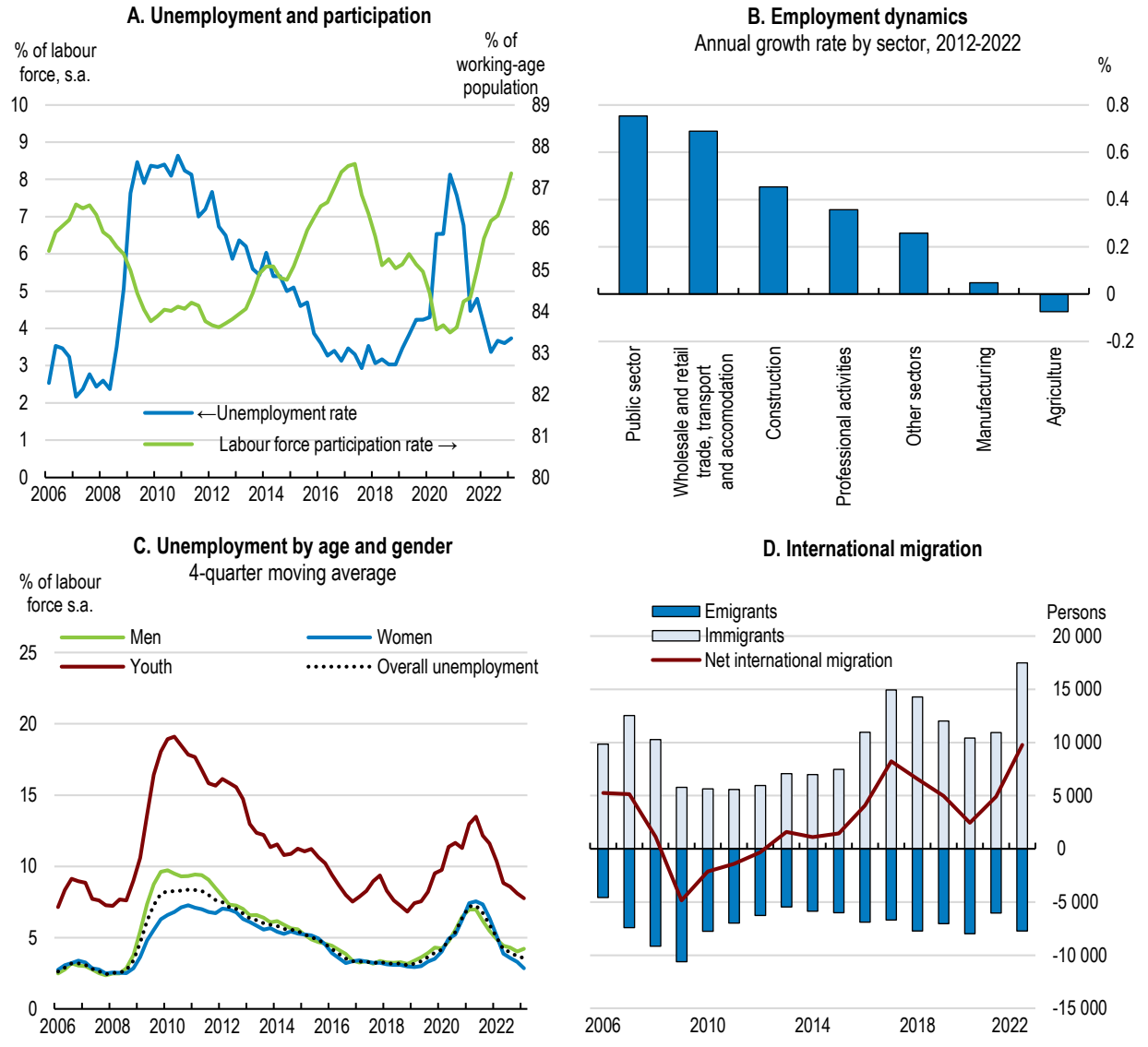
Table 1.2. Events that could entail major changes to the outlook

Shock	Potential economic impact
Inflation remains higher than expected.	Real wages continue to decline, denting household income and consumption.
Foreign tourism declines following a slowdown in the major trading partners, which could be aggravated by financial sector stress.	Export revenues will decline, slowing GDP growth.
Real estate prices plummet, pushing up non-performing loans.	A sharp contraction ensues.

1.2.2. The labour market remains tight, and imbalances deepen

The labour market remains tight (Figure 1.4). Unemployment, which fell rapidly in the wake of the post-pandemic recovery, reached its lowest level in mid-2022 and has hardly changed since. Employment has expanded most in some service sectors, as well as in construction and IT-related activities. Differences in unemployment between men and women are negligible, and the gap between youth and overall unemployment remained largely constant both during and after the pandemic. Labour force participation, traditionally high in international comparison, is rising again, against the backdrop of flexible labour market regulation (notably flexible hire-and-fire and wage-setting rules), a high retirement age and generous support for working families (Olafsdottir, 2022[1]). Labour immigration from Europe, mostly Poland and Lithuania, has picked up after the end of the pandemic, alleviating labour shortages in Iceland's booming economy (see also Chapter 2).

Figure 1.4. The labour market has started to ease but remains tight



Source: Statistics Iceland; and Eurostat.

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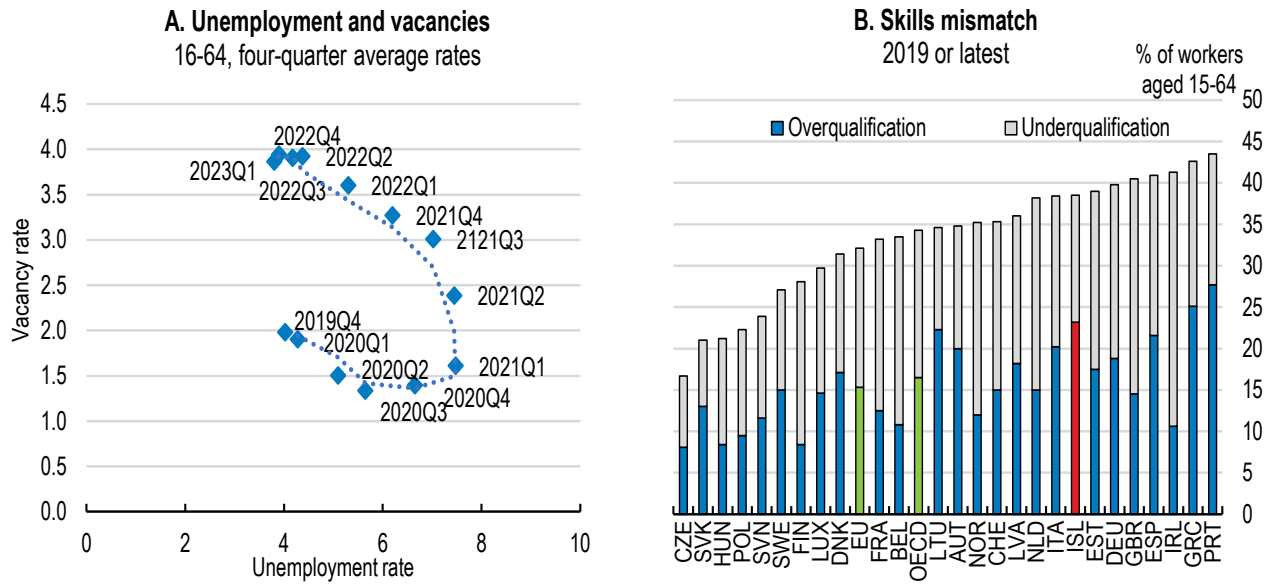
Both the pandemic and the recovery have exacerbated labour market imbalances (Figure 1.5). The relationship between unemployment and job vacancies has worsened over the past three years, as both the numbers of vacant jobs and unemployed workers have increased (the "Beveridge curve" has shifted outwards, although results should not be overinterpreted given the short period for which data are available). Rising unemployment is going hand in hand with rising labour market shortages, especially in the technical areas and in the health care sector, and overqualification in certain occupations sits along insufficient qualifications. In a 2022 survey, 56% of Icelandic firms said that they were short- or understaffed. Also, indicators of labour market qualification such as skills mismatch or field-of-study mismatch remain considerably above the OECD average. Around 75% of surveyed firms see lacking skills as a limiting factor for future growth. Business organisations point at increasing labour market polarisation and consider that the number of middle-skilled jobs is gradually declining.

The transition towards a more digitalised and greener economy is transforming Iceland, as in other countries. The transition requires strong and relevant skills, as pointed out in the previous *Survey* (OECD, 2021[2]). Against this background, the government should further develop skills and labour market policies to facilitate the labour market transition and provide sufficient qualifications for both existing and emerging job categories. It should notably expand skills in the STEM areas (science, technical, engineering and mathematics) which are in short supply, for instance by investing in dedicated upper-secondary and tertiary education. The fiscal plan 2023-28 foresees additional spending to expand education in STEM areas and in health care, which is welcome.

Figure 1.5. Labour market imbalances are considerable



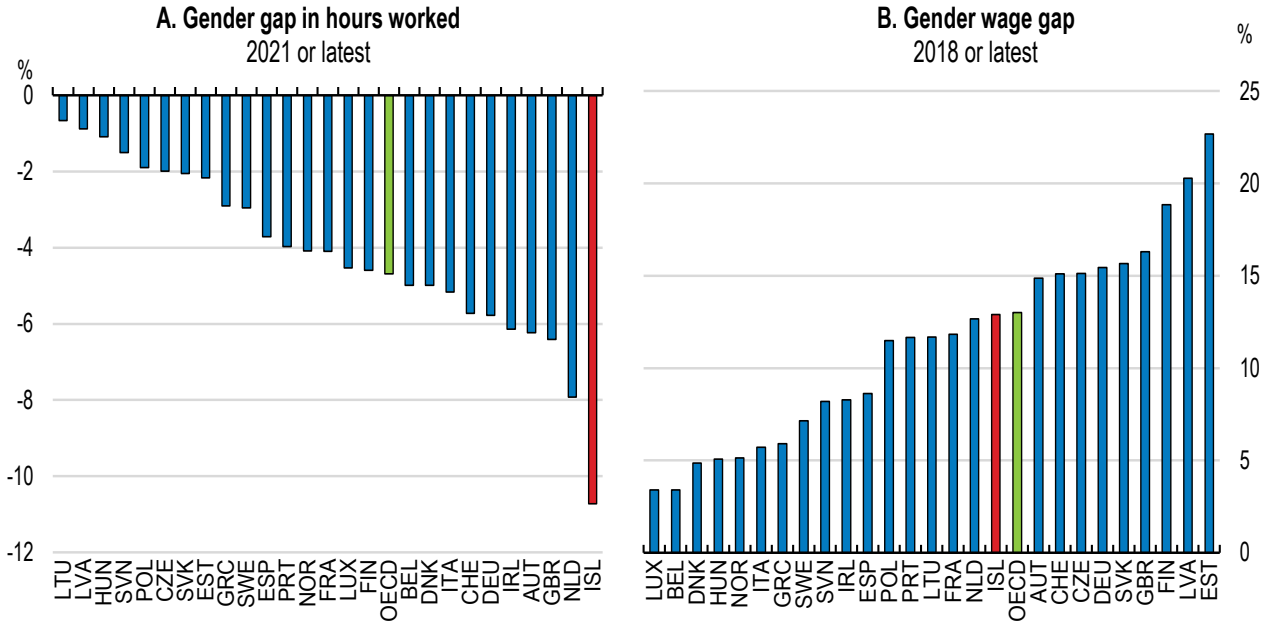
Source: OECD, Skills for Jobs database; and Statistics Iceland.

StatLink https://stat.link/gs8ray

The gap in paid hours worked between men and women remains the widest in the OECD, despite a gradual decline over the past two decades and high female labour participation (Figure 1.6). During Iceland's decades-long catch-up with the OECD's wealthier countries, households followed a traditional work division whose shadows persist. Men often had several jobs and worked long hours to compensate for low hourly earnings, while women focused on child and family care (Olafsdottir, 2022[1]). Women are much more likely to work part-time than men (36% against 13%), and work more often in the public sector or in social services. Moreover, women are less often in higher management positions and in positions requiring STEM qualifications than men. The tax and benefit system provides few incentives for second earners - mostly women - to move from part-time to full time work as marginal tax rates are high (see fiscal section).

As a result, and despite identical employment rates and a compressed wage structure, the wage gap between men and women is close to the OECD average. Against this background, an education system that fosters gender balance across professions and economic sectors, and reforms to the tax-benefit system could help reduce the gender wage gap.

Figure 1.6. The gender gap in paid hours worked is the highest in the OECD



Note: Panel A, percentage point difference in hours worked between men and women in full-time dependent employment. Panel B, data refer to gross monthly earnings of full-time employees, excluding apprentices, working in enterprises with 10 or more employees.
Source: OECD, Labour Force Statistics database.

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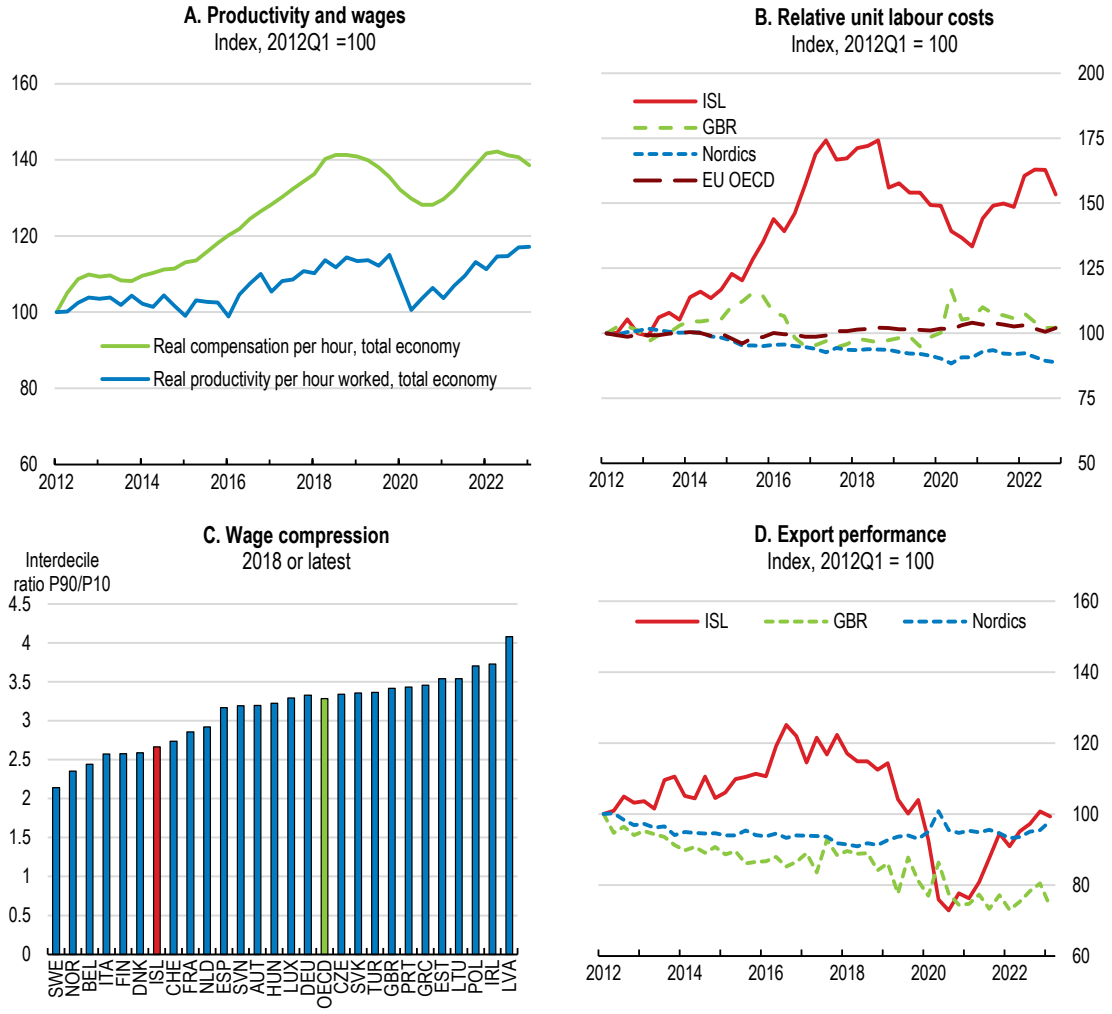
1.2.3. Competitiveness could decline again

Real wages are moderating after the rebound from the trough associated with the pandemic-related collapse of foreign tourism and after having outpaced productivity growth for almost a decade since 2010. Productivity growth has become sluggish after it had accelerated a bit before the pandemic. Competitiveness as measured by relative unit labour costs has improved since the late 2010s and more so than in the other Nordic countries and the European Union, notwithstanding some erosion in 2021 (Figure 1.7). In 2022, relative unit labour costs fell by over 5 percentage points. However, they are unlikely to decline further in 2023 following the considerable wage increases agreed in late 2022 and expected weaker labour productivity growth, with firms retaining workers despite slowing output. Export performance follows a similar pattern as competitiveness, having recovered strongly after the deep fall during the pandemic.

Figure 1.7. Competitiveness improved, despite wages exceeding productivity growth



Note: Panels B and D: Nordics exclude Iceland. Panel B: relative unit labour costs (ULC) are measured economy-wide and trade-weighted, and show the evolution of competitiveness over time, with a rise in ULC reflecting declining competitiveness. Panel C: data refer to gross monthly earnings of full-time employees, excluding apprentices, working in enterprises with 10 or more employees. Panel D: export performance reflects the growth of a country's export volumes compared to that of its export market.
Source: OECD, National Accounts database; OECD, Economic Outlook No. 113 database; and OECD, Labour Force Survey – decile ratios of gross earnings.

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Iceland's collective wage bargaining system tends to foster inclusiveness and countervail firms' labour market power, but it could undermine flexibility, weaken the link with productivity and stifle workers' incentives to move to more productive firms and jobs (OECD, 2018[3]). Iceland is the OECD's most unionised country, with collective agreements covering around 90% of labour contracts. Negotiated minimum wages are binding and cannot be opted out by individual firms. The wage bargaining process is quite fragmented, with leapfrogging (or "dolphins' race" in Icelandic) of wage demands potentially undermining competitiveness, although the merger of smaller unions over the past few years could have strengthened social partners' consideration of the macroeconomic impact of wage settlements. Negotiations usually start in the private, export-oriented industrial sectors, and then move on to the domestic sectors and finally to the public sector. The "Living Standard Agreement" 2019-22 was the first to build on an explicit link between future GDP and wage growth but stopped short of using productivity as an anchor for wage developments. In late 2022, a connecting short-term "bridge" agreement was settled, valid until February 2024 (Box 1.1).

Box 1.1. The 2023 "bridge" wage agreements

The wage negotiations to follow up on the "Living Standard Agreement" – that had governed labour relations from 2019 to 2022 - took place in a context of high economic uncertainty. Therefore, the prospects to reach a long-term agreement covering several years, as did the former agreement, were dim. Also, negotiations took place under the impression that the "Living Standard Agreement" had not been flexible enough to react to the productivity slowdown during the pandemic and the surge of inflation thereafter.

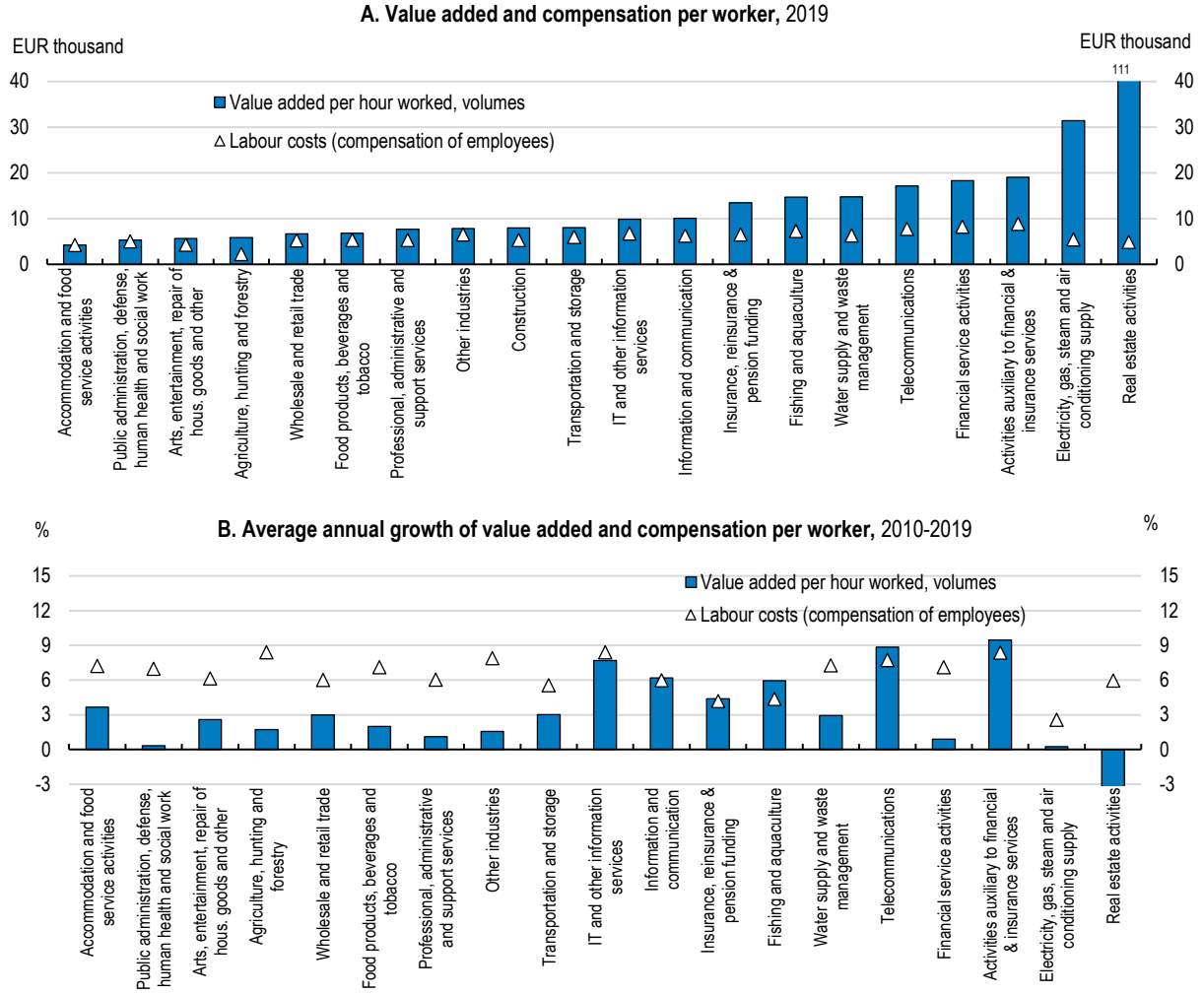
In this context, employer organisations and unions reached a "bridge" agreement that took effect in November 2022 and will last until February 2024. The new collective agreements initially covered around 80% of all private sector employees, with wages set to increase by an average of 7.4%. In March 2023 the agreements were extended to an additional 20% or so of private sector employees, mainly in the accommodation and oil distribution sectors, following industrial action, walkout of employees and some disruptions in hotels and at airports. A small share of the labour force remains uncovered by new agreements. In the public sector, an agreement was reached in April 2023 for the vast majority of central and local government employees.

Source: https://www.ruv.is/frettir/innlent/2023-02-13-efling-bodar-til-verkfalls-1650-starfsmanna.

The wage bargaining framework focuses strongly on maintaining and even strengthening a compressed wage distribution - although the latter is less equal than in the other Nordic countries - with wage and other benefit increases often being the same in absolute terms across all wage groups (Figure 1.8). The compressed wage distribution partly explains Iceland's egalitarian income distribution. Yet a wage structure that is compressed horizontally (across sectors) and vertically (across a firms' hierarchy) might discourage workers to move to new, more productive jobs or to invest in stronger and more relevant skills, since respective monetary gains are small (OECD, 2019[4]). As a result, skills and study field mismatch remain high.

Against this background, the government and the social partners should rely more strongly on the link between productivity and wages when negotiating future agreements. While the government has no direct influence on private sector wage settlements, it could encourage negotiations to focus more on sectoral or firm-level productivity developments, as is the case in Denmark, Norway, or Sweden (OECD, 2016[5]). Under a multi-annual agreement, yearly wage adjustments could be handled more flexibly, to remain in line with actual developments in the economy. Some bargaining could be devolved to the firm level taking on the form of "organised decentralisation", allowing firms to opt out from a collective agreement under certain conditions. Opting-out rules could promote productivity as firms could be allowed to use incentive schemes such as performance pay more frequently (OECD, 2018[3]). Finally, better productivity and wage data could help support more evidence-based negotiations. A first step has been made with the government now collecting more representative wage data.

Figure 1.8. Wages and wage growth are more equally distributed than productivity



Source: OECD, Structural Analysis (STAN) database.

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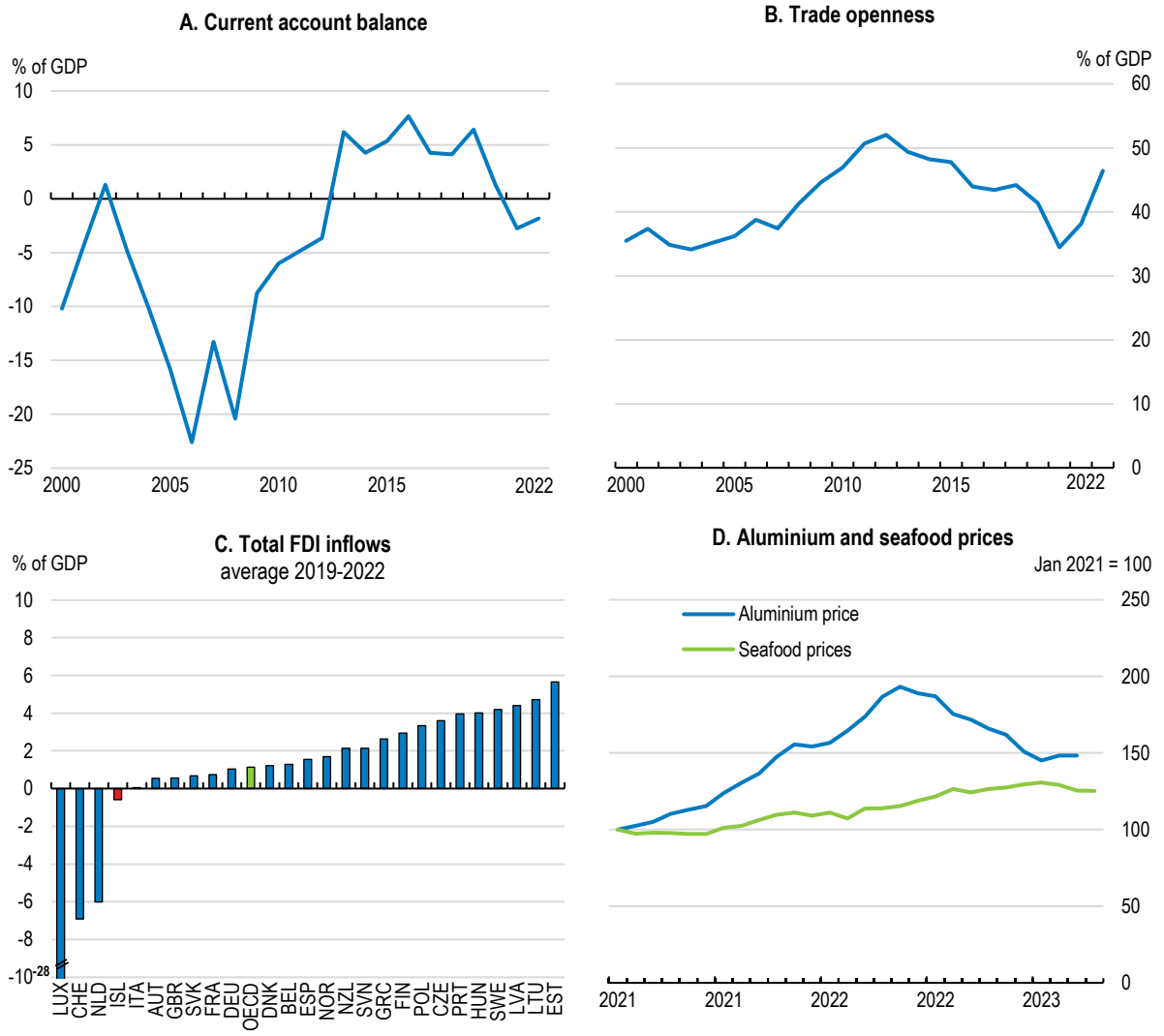
1.2.4. The external sector has improved overall

External positions have improved following the strong recovery of foreign tourism and thriving exports of energy-intensive goods and services (Figure 1.9). The current account balance, which became negative during the pandemic, is heading towards positive territory again, although rising exports are partly compensated by expanding imports, notably Icelanders travelling abroad again, and rising imports of capital goods. The terms of trade improved during the pandemic but are expected to worsen following the decrease of aluminium prices, the levelling off in seafood prices, and the increase in import prices. Net financial assets (or the net international investment position, i.e., the difference between Icelanders' investments abroad and foreigners' investments in Iceland), amounted to 39% of GDP in 2021, more than in most other OECD countries. Yet foreign direct investment (FDI) flows turned negative over the past few years, as opposed to most other OECD countries. Openness is deepening again as both exports and imports are expanding but it remains low in view of the country's small size. Against this background, Iceland should continue to ease restrictions on foreign capital, to help fund investments in new sectors and in climate action.

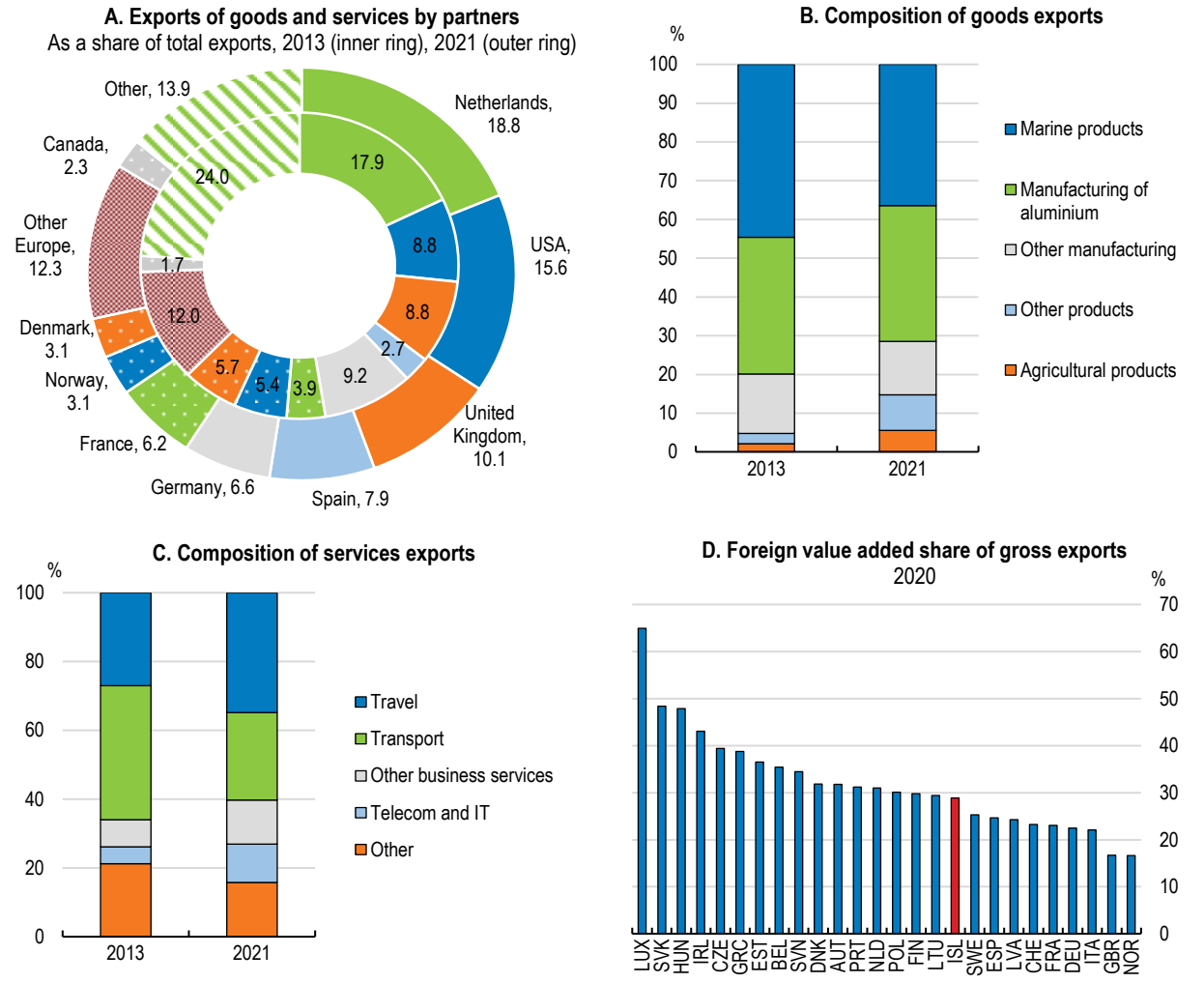
Figure 1.9. External positions have improved, although foreign capital is shying away



Note: Panel B, Trade openness is measured as the average of goods and services imports and exports divided by GDP.
Source: OECD, Balance of Payments statistics; OECD, National Accounts database; OECD, FDI Statistics; and Statistics Iceland.
StatLink https://stat.link/rd1quh

Exports and their destination countries are evolving gradually (Figure 1.10). The share of fisheries in total exports is declining but fresh and sustainably produced seafood is in ever higher demand. Aluminium exports remain key with the three smelters currently working at full capacity, benefitting from reliable domestic energy and stable energy prices. Tourism remains by far the most important service export. Non-traditional exports such as data processing, film production, software programming, and intellectual property revenue (e.g. pharmaceutical licences) are growing fast, helping to diversify the economy. However, the share of R&D-intensive exports remains low, as the fisheries, aluminium and tourism still dominate exports. The share of goods and services exported to Europe and the United States is increasing. Trade with Russia, Belarus and Ukraine was very limited before the war at around 2% of exports and 1% of imports.

Figure 1.10. The structure and destination of exports are evolving



Source: Statistics Iceland; and OECD, Trade in Value Added database.

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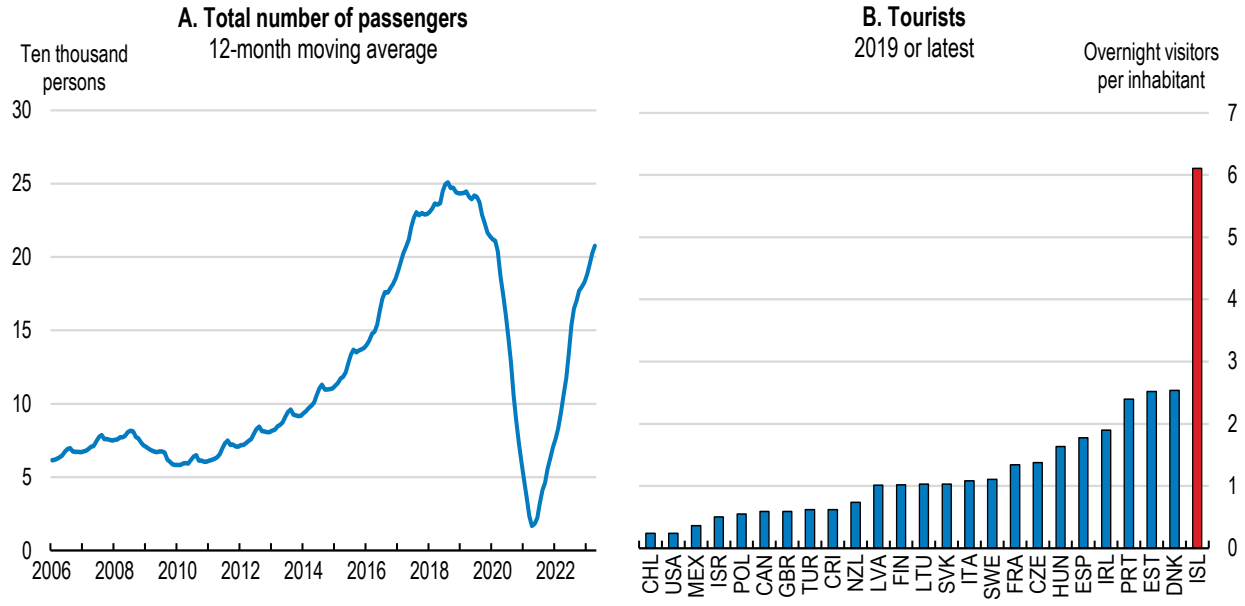
Tourism has largely recovered from the pandemic-inflicted collapse and might reach its sustainable potential soon (Figure 1.11). Value-added per tourist is rising as tourists tend to stay longer and spend more per stay, although tourism's share in GDP remains below the 8% reached between 2016 and 2019. Iceland hosts more tourists per inhabitant than any other OECD country, exerting pressure on infrastructure and the environment. Climate change is altering a part of Iceland's natural capital such as oceans and glaciers, jeopardising the supply of several tourism services (OECD, 2019[4]). Tourism remains concentrated in the Southwest region and along the South coast, where accommodation facilities are springing up even more rapidly than in other areas. Against this background, Iceland should continue to build on its 2019 policy framework for productive and sustainable tourism. A balanced tourism strategy – whose implementation was interrupted during the pandemic - should help improve productivity of tourism services; capitalise on the natural assets that form the basis of Iceland's tourism sector; limit pressures on infrastructure and the environment; and aim for a geographically more even development across the country (OECD, 2022[6]). Iceland may take inspiration from New Zealand's tourism policy framework to tap the rents generated by a fixed supply of natural capital (see also fiscal section) (Ministry of Business, Innovation and Employment of New Zealand, 2022[7]).

Figure 1.11. Tourism has recovered fast but may soon reach its sustainable potential



Note: Panel A, monthly number of passengers (12-month moving average) who go through security at Keflavík Airport, including foreigners residing in Iceland, foreign labour leaving the country and transit passengers. Panel B, data for 2019 except Finland (2018) and Sweden (2014).
Source: Statistics Iceland; and OECD, Tourism database.

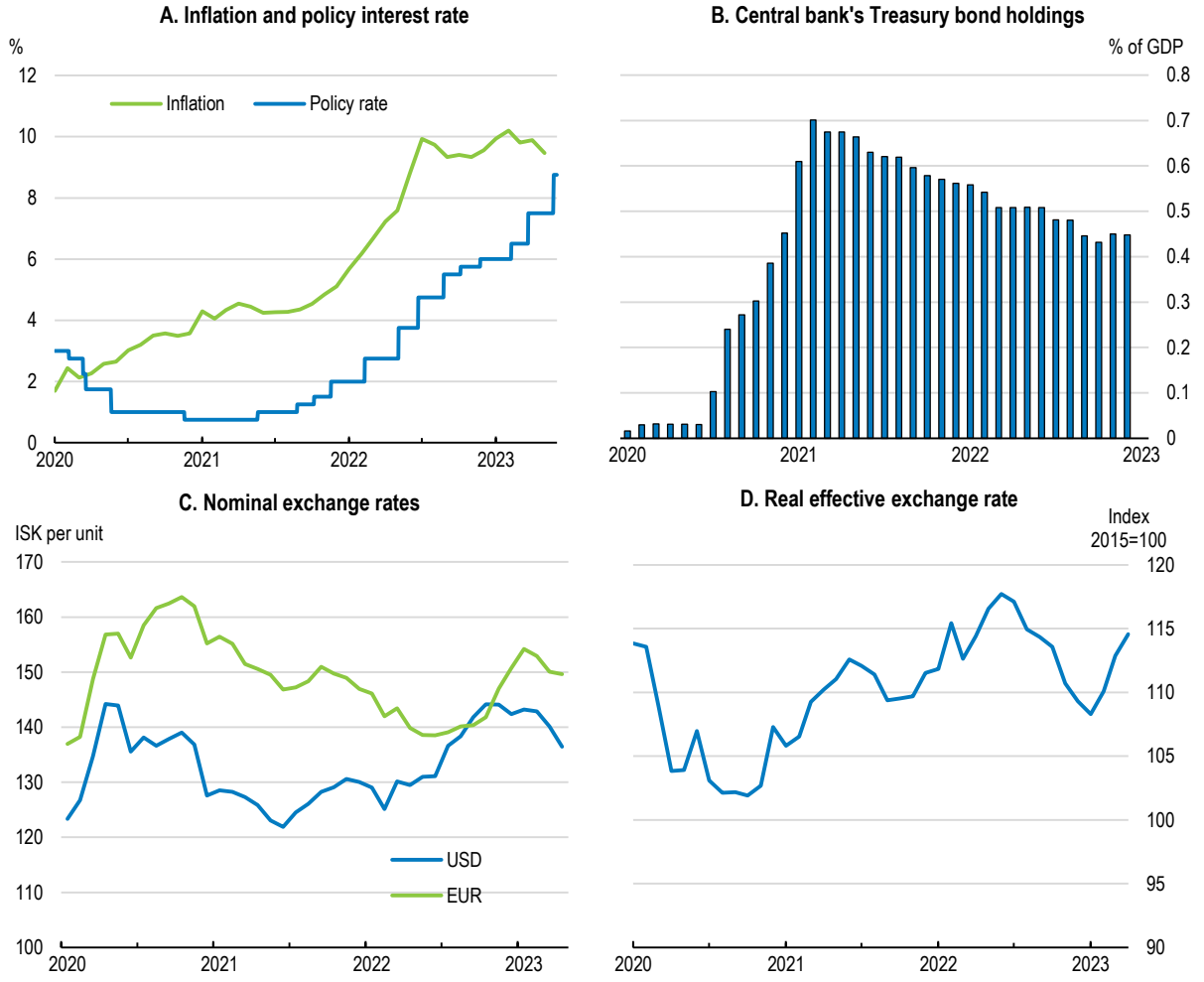
StatLink https://stat.link/gnowbk

1.3. Monetary and financial policies are being tightened

1.3.1. The central bank has reacted resolutely to the inflation spike

The monetary stance continues to be tightened (Figure 1.12). In May 2023, the central bank raised the key policy rate to 8.75%, the 13th increase since the cycle started in May 2021. Interest rates are 8 percentage points higher by now than two years ago, when they bottomed after the onset of the covid-19 pandemic. The central bank is also unwinding the balance sheet by divesting the proceeds of maturing treasury bonds (passive quantitative tightening). As such, treasury bond holdings have been declining from below 0.7% of GDP in mid-2021 to 0.4% of GDP by spring 2023. By international comparison, balance sheet expansion (quantitative easing) had played a minor role in the central bank's pandemic-related toolbox, as treasury bond acquisitions amounted to 15% only of what had been planned initially (OECD, 2022[8]). Real interest rates as calculated from various measures of inflation and one-year inflation expectations have been rising by around 4 percentage points since mid-2022, currently standing at around 0.2%. The central bank considers that monetary transmission – i.e. the effect of interest rate changes on economic activity – still works through the usual household wealth, disposable income and labour market channels (Central Bank of Iceland, 2023[9]).

Figure 1.12. Monetary policy has been tightened

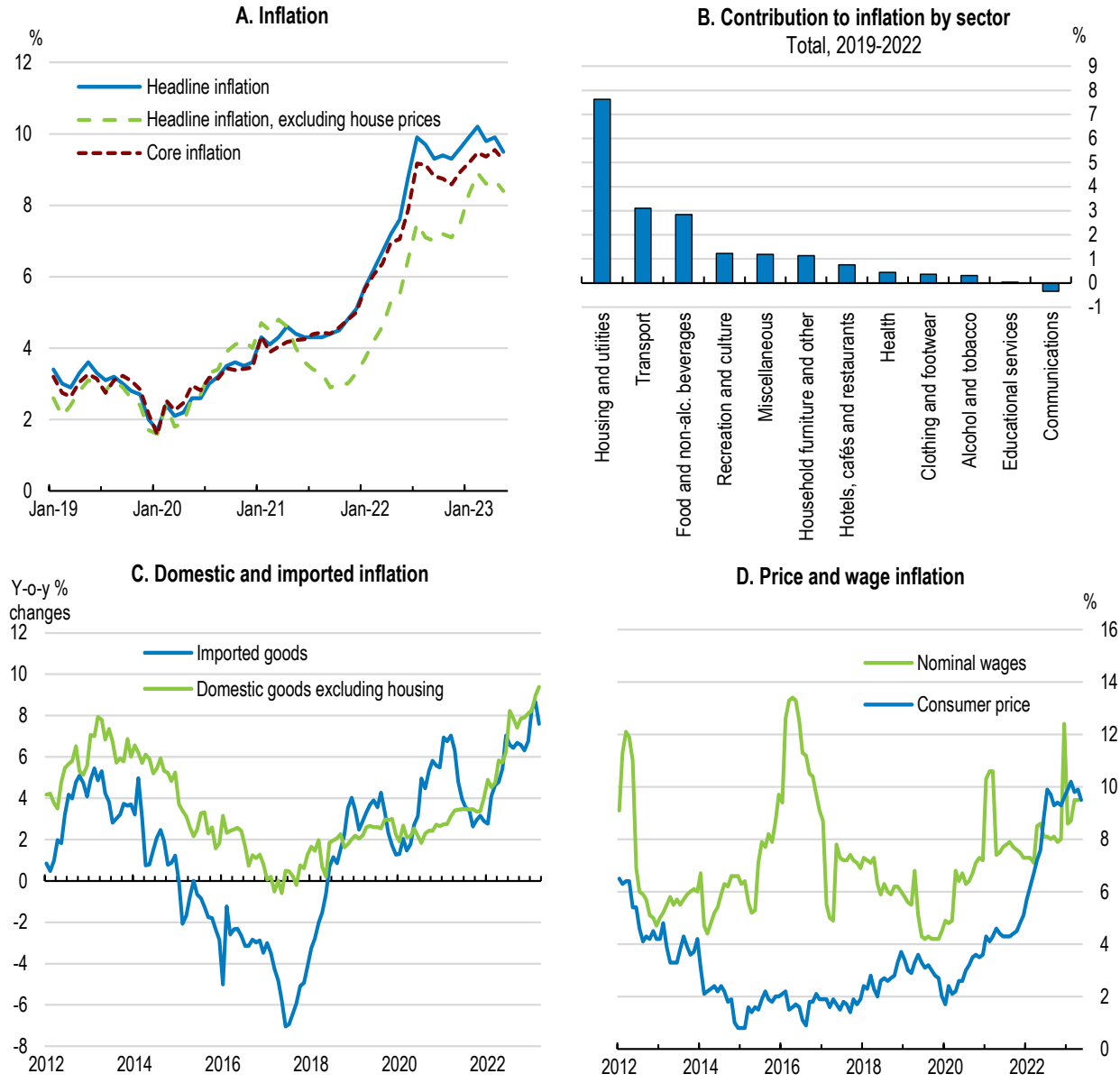


Note: Panel A, inflation refers to national headline CPI. Panel B, monthly holdings of central bank treasury bond holdings are divided by annualized and seasonally adjusted quarterly nominal GDP. Panel D, the real effective exchange rate is a CPI deflated measure of competitiveness. Rising values reflect declining price competitiveness.
Source: Central bank of Iceland; OECD, Consumer Prices database; and OECD, Competitiveness Indicators.

StatLink https://stat.link/wjhe5l

Inflationary pressures have been broadening (Figure 1.13). Headline inflation peaked at around 10% in early 2023 and has flattened since, remaining much above the central bank's 2.5% target. Unlike in continental European countries, Iceland's inflation surge was initially propelled by house prices, which shot up by around 50% between mid-2020 and mid-2022, largely driven by the strong post-pandemic recovery and labour immigration. Energy price inflation plays a small role as the country relies mostly on domestic energy sources. Inflation was then transmitted to the wider economy, notably the service sector. Core inflation, which excludes food and energy prices, is rising with a lag and becoming more broad-based. As such, the share of products in the consumer basket that have a year-on-year inflation rate above 6% has been gradually rising (Central Bank of Iceland, 2022[10]). The króna depreciated by around 10% against the euro and the dollar in the course of 2022, but strengthened somewhat during the early months of 2023. The exchange rate transmission channel – long a key driver of inflation in Iceland - has weakened significantly with rising credibility of monetary policy over the past decade (Edwards and Cabezas, 2022[11]).

Figure 1.13. Inflation has been broadening



Note: In Panels A and B, inflation refers to the national CPI. Panel B shows the weighted contribution of each spending item to overall inflation.
Source: Statistics Iceland; OECD, Prices database; and Bank of Iceland.

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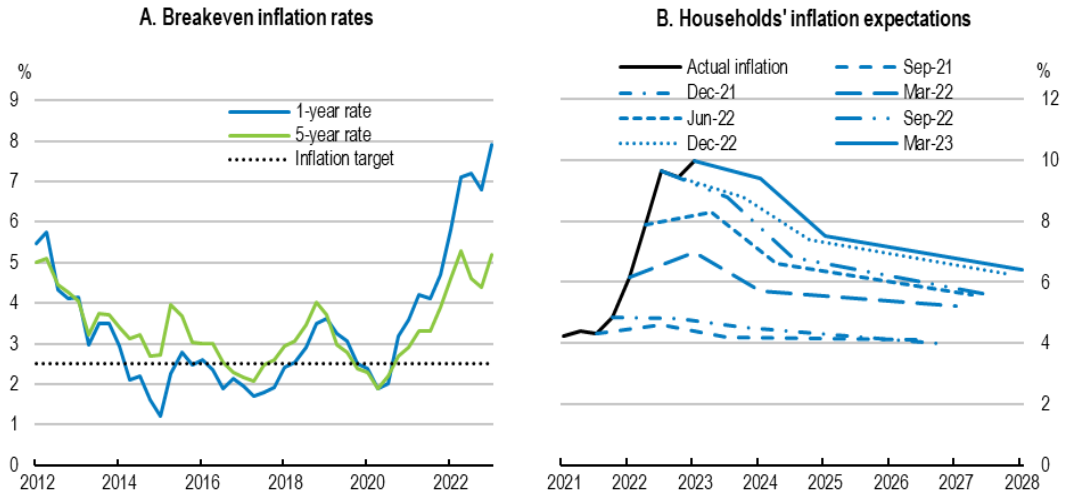
Long-term inflation expectations have ratcheted up (Box 1.2). Since the start of the inflation spike, expectations have regularly surprised on the upside. The share of households and businesses expecting an inflation rate higher than 5% has risen sharply between late 2021 and late 2022, suggesting that expectations have detached from the 2.5% target. By the same token, the impact of inflation shocks on inflation expectations has risen, keeping long-term inflation expectations above the target (Pétursson, 2022[12]). Domestic inflation pressures are persistent as the labour market remains tight and the wage agreements of late 2022 and early 2023 are yielding annual wage hikes above productivity growth. Uncertainty is compounded by the fact that global factors and common shocks play a much larger role than in Iceland's earlier cycles, making domestic inflation ever more wayward (Box 1.2).

Figure 1.14. Inflation expectations have de-anchored



Note: Panel B, inflation refers to national headline CPI.
Source: Central Bank of Iceland; and OECD, Consumer Prices database.

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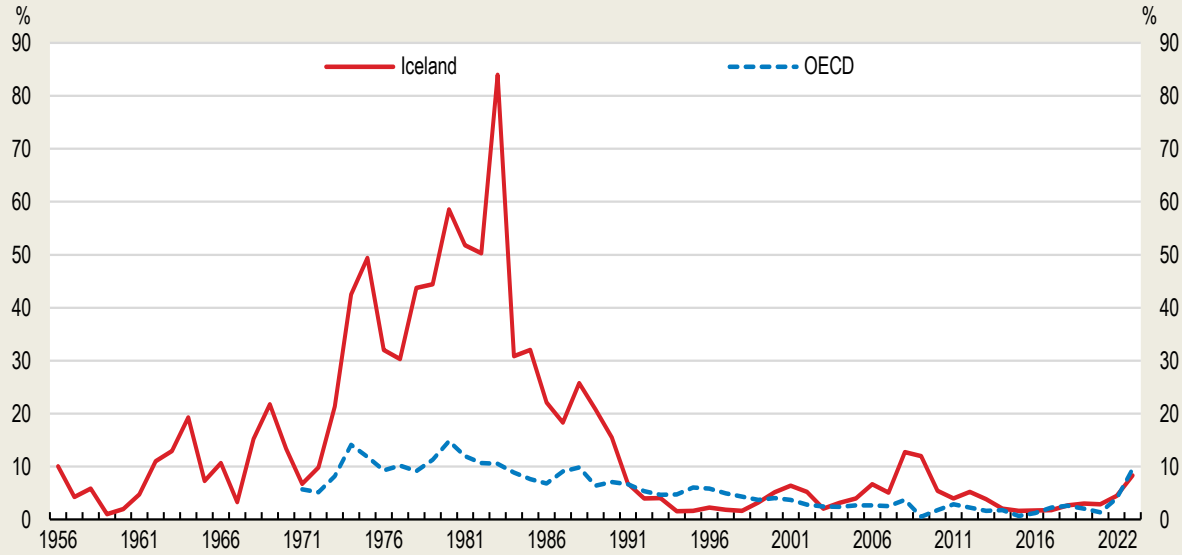
Against this background, the central bank should tighten further as needed to re-anchor expectations and to bring inflation back to the target. Tightening should take the impact of policy changes into account, as well as potential spillovers from policy in other countries given their impact on domestic inflation (Obstfeld, 2022[13]). Fiscal policy should work in the same direction as monetary policy while limiting support to vulnerable households. Finally, structural reform such as fostering a more friendly business climate and easing the conditions for foreign direct investment could help tame inflation and improve monetary policy transmission (see the section on the business climate).

Box 1.2. Inflation, and how to bring it down: lessons from Iceland

Iceland has a history of entrenched inflation and episodes of sudden inflation bursts that used to stand out among European OECD member countries. The factors most often cited to explain persistent inflationary pressures include Iceland being a small and volatile economy prone to shocks; sudden depreciations of the currency; poor coordination between monetary and fiscal policies; excessive wage increases; lacking competition between firms; flaws in financial market supervision; and low credibility of the central bank. Over the past three decades, policy reform has helped address many of these factors and bring inflation down.

Figure 1.15. Iceland's inflation history

Annual headline inflation, 1956-2022, Iceland and OECD



Source: OECD, Consumer Price Indices database.

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Inflation hovered between 10% and 15% in the two decades following World War II and started to ratchet up afterwards. It spiked for the first time in the late 1960s when the collapse of herring stocks in the North Atlantic caused by overfishing triggered a financial and currency crisis. A vicious cycle of terms-of-trade shocks, devaluations and inflationary surges followed the fall of the Bretton Woods system and the oil crisis in the 1970s. Exchange rate management often transmitted rather than absorbed shocks. Indexation became entrenched in goods and labour markets as well as in the financial sector, fuelling a wage-price spiral. In the early 1980s, when inflation spun out of control, the talks at many family tables centred anxiously on how to cope with the price increases of the coming week. In the 1990s inflation fell to single-digit rates. The 2009 financial crisis and ensuing supply shock led to the penultimate inflation burst.

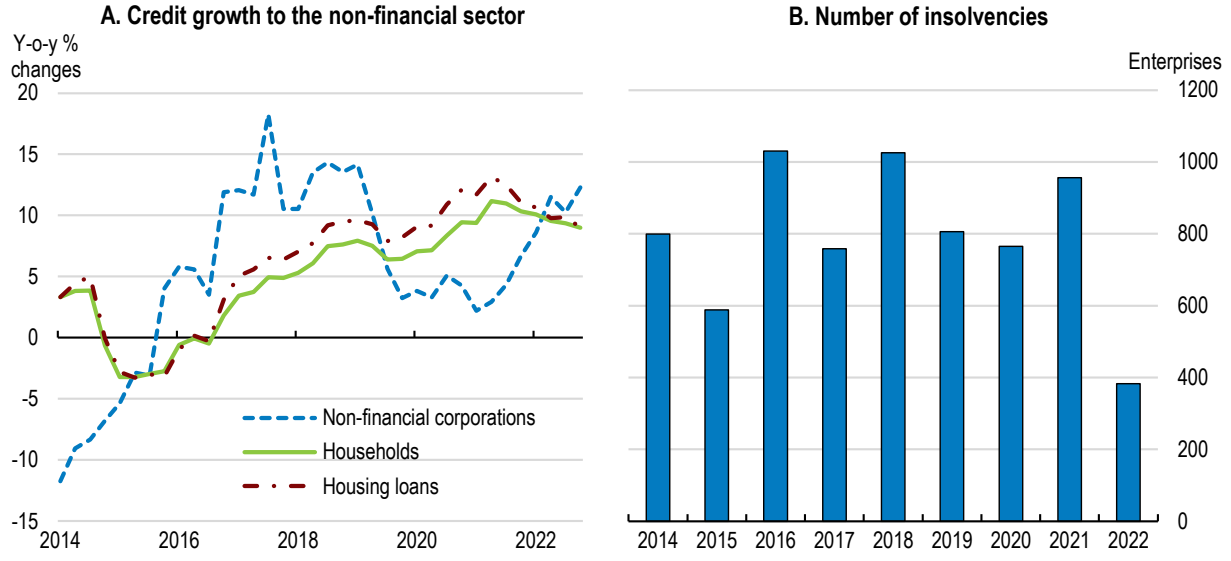
Multi-faceted policy reform helped tame inflation. In the 1980s and 1990s tighter and better aligned monetary and fiscal policies started to contain price pressures. The National Reconciliation Agreements of 1990 brought about a first concerted effort to restrain wage developments. Pro-competition regulatory reforms narrowed firms' scope to pass cost increases onto consumers, and rising immigration eased pressure from the labour market, helping to flatten the Philips curve (see also Chapter 2). The 2001 reform of the monetary framework contributed to anchor inflation expectations by establishing a numerical inflation target. The new framework also forbade the central bank explicitly to finance government spending (monetisation). The creation of the Monetary Policy Committee in 2009 helped increase the central bank's credibility. The fiscal framework adopted in 2015 helped reduce pressure from fiscal policy by setting numerical limits on government deficits and debt. Finally, cognisant of the close links between monetary and financial policies, a new macro-prudential framework was adopted, and the central bank and the financial supervisory authority were merged in 2019.

Source: (OECD, 1984[14]); (Andersen and Guðmundsson, 1998[15]; Central Bank of Iceland, 2017[16]; Olafsdottir, 2022[1]; Pétursson, 2018[17]; Þórarinsson, 2022[18].

1.3.2. The financial system looks resilient

The financial system held up well in the face of the pandemic and remained largely unaffected by Russia's invasion of Ukraine and the global energy crisis (Figure 1.16). Global financial risks have recently ratcheted up, however, with high-profile bank failures in the United States and Switzerland, increasing risks to Iceland's domestic financial sector. Against this backdrop, corporate credit has been recovering vigorously from the pandemic, and household credit has continued to expand, albeit at a slowing pace. The number of insolvencies has been declining. The housing market shows signs of overheating, although house prices have started to decline in 2023. To address emerging risks, the central bank tightened macroprudential policy starting in 2022, increasing the counter-cyclical buffer in two steps from 0% to 2.5% by 2024 and lowering maximum loan-to-value and debt-service-to-income ratios on household mortgages, which is welcome. Corporate and household debt remain modest, providing ample buffers for shocks. The central bank should remain vigilant, considering potential repercussions of monetary policy – such as hikes of the key interest rate - on the financial system's stability.

Figure 1.16. The financial system looks sound



Source: Central Bank of Iceland; and Statistics Iceland.

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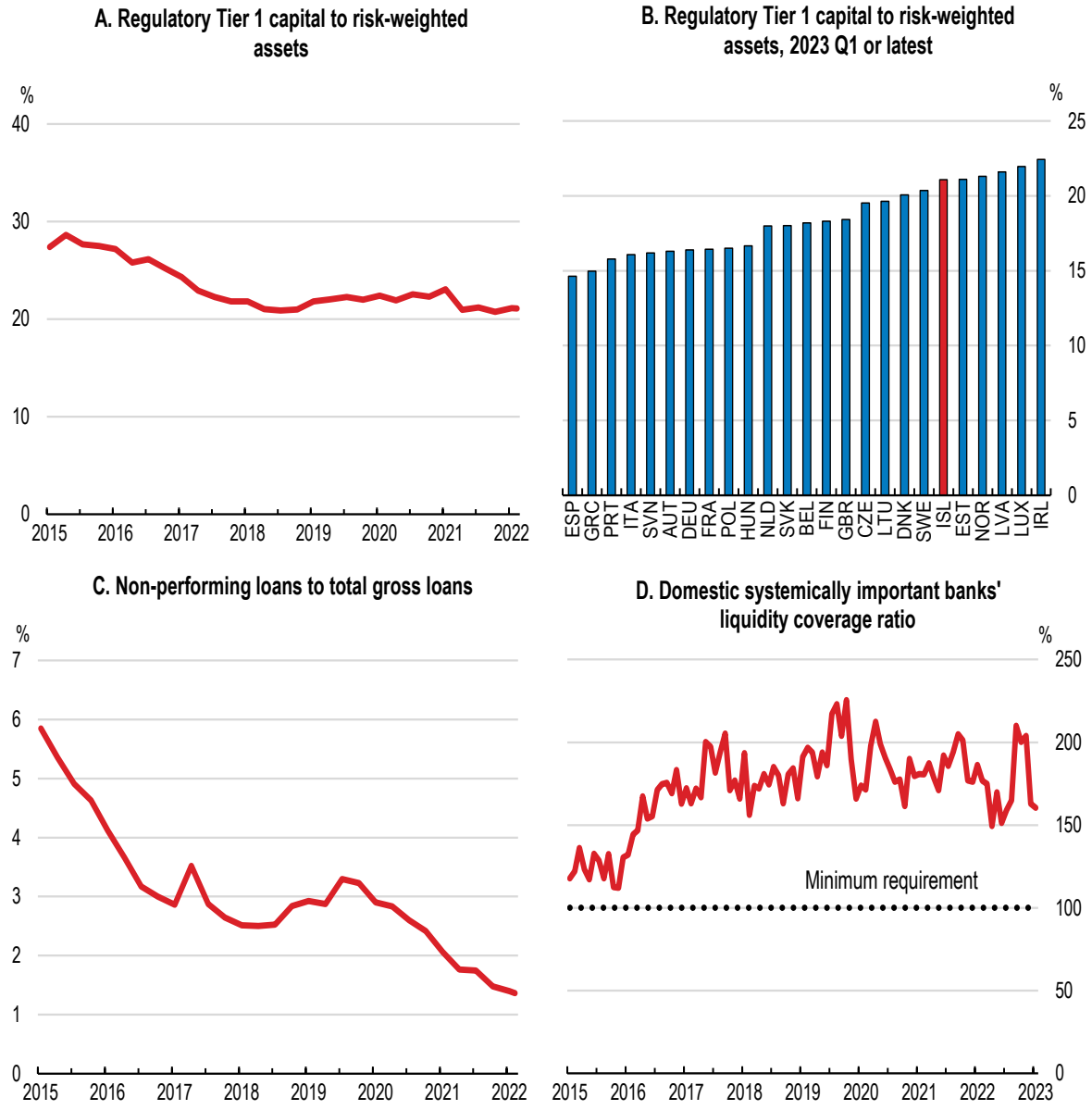
The banks seem well-capitalised and liquid, and bank profitability has increased. The regulatory capital to risk-weighted assets ratio has fallen but remains above most other OECD countries (Figure 1.17). Liquidity ratios have declined as both households and firms have been taking up more credit after the pandemic (not shown). The non-performing loans ratio continues to decline. The banking system is dominated by three domestic banks, which are considered systemically important. They are subject to additional macroprudential regulation and capital buffer requirements, to protect them better against shocks and improve the system's resilience in case of a crisis. The capital adequacy ratios of these banks are well above regulatory requirements (Figure 1.17 D). Foreign banks' presence in Iceland remains negligible.

Figure 1.17. Banks are well capitalised



Source: IMF, Financial Soundness Indicators database; and Central Bank of Iceland.

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Íslandsbanki, the second-largest bank, has been partly privatised. A first tranche of 35% was sold in an initial public offering in summer 2021 and a second tranche of 23% was sold in spring 2022, leaving the government in a minority position, as recommended in the previous *OECD Economic Survey* (OECD, 2021[2]). Shares are mostly held by domestic investors, and among them a large part is held by pension funds (IMF, 2022[19]). Questions surrounding the reputation of a few small investors prompted the state auditor and the central bank to start investigations, and the sale of the third and final tranche, planned for early 2023, was postponed. However, the authorities still aim to conclude the privatisation of Íslandsbanki during the current parliamentary term. Landsbankinn, which is one of the two other systemically important banks, remains in public hands. In April 2022 the government proposed to dissolve the state holding managing the public banks and to set up a new framework for state holdings of financial companies. The incident along the privatisation of Íslandsbanki highlights the importance of vigilance in the process of selling public companies.

The role of the domestic financial technology sector (or fintech, including digital payment systems, crowdfunding and investment platforms, peer-to-peer lending platform operators, digital currencies, and fast data analysis) is gradually increasing but remains modest. Expanding fintech's significance could foster competition in the financial sector (Central Bank of Iceland, 2022[20]). One concern for the authorities is that more than 90% of digital payments are routed via international payment card infrastructure, compromising its ability to maintain retail payment transactions in the case of disruptions, and first steps towards an independent domestic solution have been taken (Central Bank of Iceland, 2023[21]).

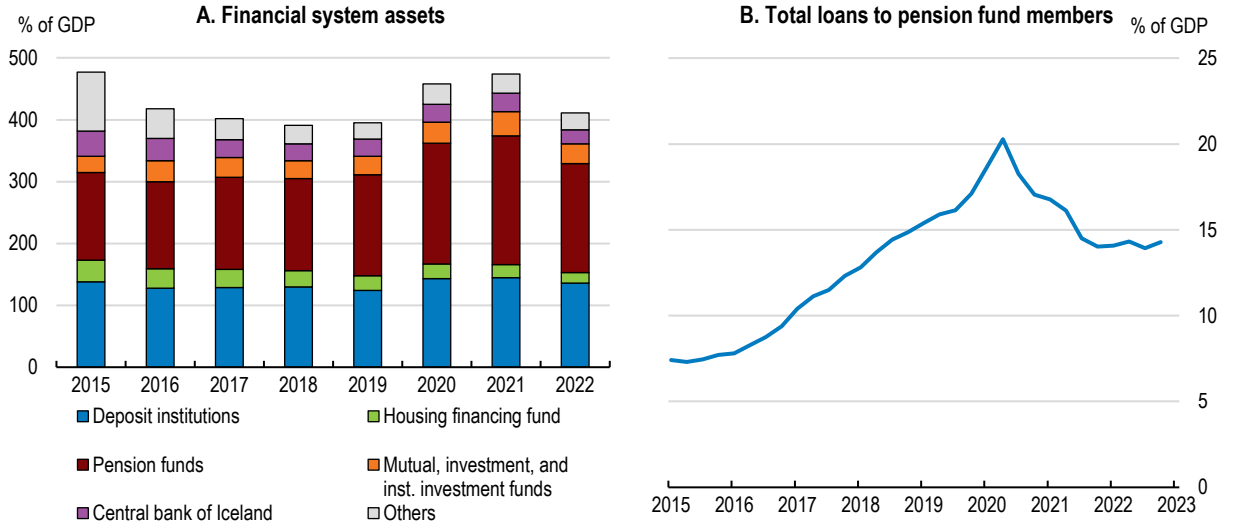
The government recently stepped up efforts to help the financial system underpin the transition towards a low-carbon economy. Climate change could have a considerable impact on the financial positions of Icelandic households and firms, including glacier retreat, shifts and reductions of fishing stocks, ocean acidification above the global average, and a rising risk of hazards such as landslides and floods. In 2021 the government set up a sustainable financing framework to support sustainable spending and investment (Government of Iceland, 2021[22]). In 2023 an annex on gender balance was added. While these efforts are welcome, the government should regularly monitor the efficiency of the sustainable financing framework.

1.3.3. Pensions funds are systemically important

Pension funds have become systemically important within Iceland's financial system. Pension funds' assets reached almost 200% of GDP by end-2022, up from around 150% in 2018 (Figure 1.18). The pension funds are a major source of household mortgage lending. They are also the largest investors in the domestic equity market and are among the largest owners of two of Iceland's three systemically important banks (Central Bank of Iceland, 2022[23]). A 2022 reform allows the pension funds to gradually increase asset holdings denominated in foreign currency from below 50% to up to 65% of total assets, which is welcome as it reduces the funds' exposure to developments in Iceland's small and volatile economy. With Iceland's pension funds having acquired a large part of the private shares of Íslandsbanki, linkages with other financial institutions have deepened. Borrower-based macro-prudential tools have been uniform across pension funds and other financial institutions since these rules were introduced in 2017, limiting the scope for leakages and regulatory arbitrage.

Pension funds may act as a macroeconomic buffer but could also be the source of macroeconomic risks. To cover future pension benefits in a sustainable manner, pension funds are expected to reach a minimum yield - the "real reference rate" - of at least 3.5% on their assets, which is above Iceland's potential growth rate of around 2.5%. In a low-yield environment, this obligation may lead pension funds to enter ever riskier asset classes (IMF, 2022[19]), although rising interest rates and the concomitant reduction of the net present value of long-term nominal liabilities could provide some relief (OECD, 2022[8]). Against this background, the authorities should closely monitor pension funds' risk-taking, including through stress-tests. The intention to include pension funds in the CBI's recently launched lending survey of financial institutions is welcome. Reducing the minimum real reference rate could be another, yet politically contested, option (see also fiscal section).

Figure 1.18. Pension funds have expanded



Note: Panel A includes parent companies only.
Source: Central Bank of Iceland.

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1.3.4. Cybersecurity and anti-money-laundering efforts are being stepped up

Cybersecurity issues have become more prominent, with several cyberattacks at financial institutions and payment services having caused disruptions (Central Bank of Iceland, 2022[20]). The number of severe attacks rose from two in 2019 to 14 in 2021, with risks growing further and spreading to non-financial and government institutions. Repeated or large-scale attacks could jeopardise financial stability, particularly if systemically important financial infrastructure is affected. The data cables linking Iceland and Europe could also become potential targets of a cyberattack. Against this background, the central bank considers cybersecurity as one of its top priorities. In 2021 the bank set up a cooperation forum on operational security of financial infrastructure and included cyber- and IT security as a priority in the central bank supervisory authority strategy for 2022-2024. Also, several business and consumer associations set up a campaign to raise public awareness of cyber-risks in daily digital payments. These efforts should continue and intensify.

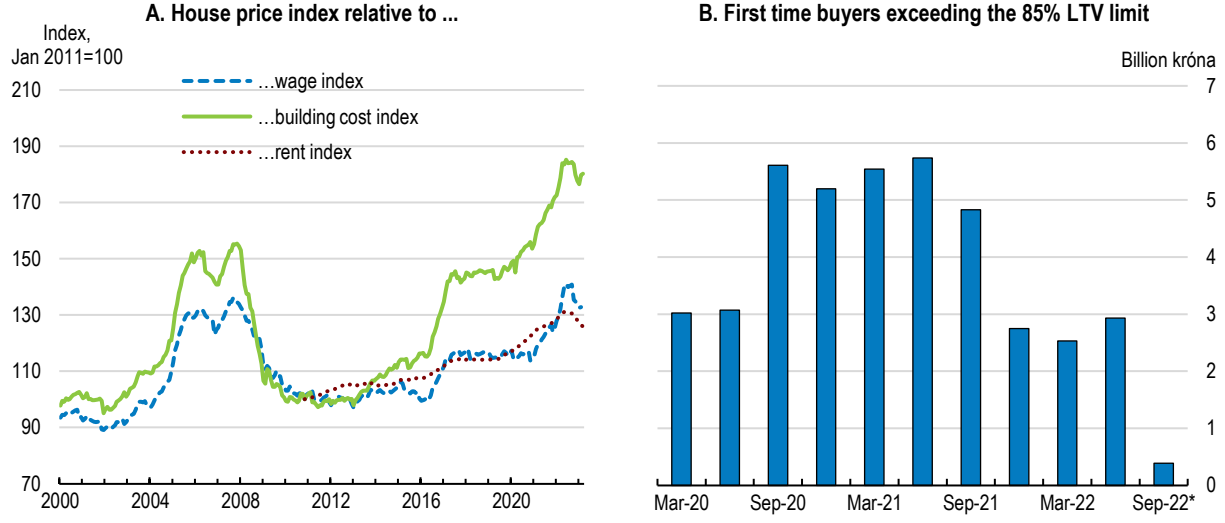
Further progress has been made in strengthening anti-money-laundering and combating terrorist financing (AML/CFT) effectiveness. Iceland has addressed deficiencies identified in the 2018 Financial Action Task Force (FATF) report, is considered compliant or largely compliant with 38 out of 40 FATF recommendations and has been removed from the FATF's "grey list" in 2021. Legal amendments in 2022 address money-laundering and terrorist financing risks related to virtual assets and asset providers and authorize the business registry to liquidate unregistered companies. The authorities conducted regular risk-based supervision and on-site inspections of obliged entities' compliance with the AML/CFT Act - focusing on their IT systems - and implemented the guidelines on money-laundering and terrorist financing risk factors. Central bank data of foreign exchange transactions and cross-border flows is now available for other government entities to fulfil their AML/CFT roles. The risk-based control and monitoring of designated nonfinancial businesses and professions has been strengthened.

1.3.5. The housing market is cooling, but risks remain

House prices and associated financial risks rose fast from around mid-2020 to mid-2022. Despite having remained stable since, house prices still diverge from fundamentals (Figure 1.19, Panel A). Favourable financial conditions during the pandemic, rapidly rising household income and credit, growing immigration and changing preferences – such as working from home - are among the reasons for the rise in housing demand and increasing mortgage debt, and more so than in many other OECD countries (Housing and Construction Agency, 2022[24]). The phenomenon is broad-based, with prices rising across Iceland and for all types of housing. The gap between house prices on the one hand and rents, wages and building costs on the other has widened considerably over the past few years.

The sharp increase in interest rates for new mortgages has cooled the housing market to some extent, but it also increased risks to the financial system. Debt service cost is rising, and the rollover of existing mortgages has become more difficult (Central Bank of Iceland, 2023[21]). The share of non-performing household mortgage loans is low and declining further, though. The central bank estimates that a tighter monetary stance prompts households to shift mortgage financing from non-indexed to indexed loans, but that such a shift does not compromise monetary policy's capacity to affect household demand (Central Bank of Iceland, 2023[9]). Housing supply in the form of new construction and sales has started to rise, thereby cooling markets further, although it seems to remain below long-term needs, and housing affordability remains an issue.

Figure 1.19. The housing market has started to cool but prices remain high



Note: Panel B includes all new mortgage loans issued by systemically important banks and the Housing and Construction Authority. The nine largest pension funds are included from August 2020 onwards. Latest data is preliminary.
Source: Statistics Iceland; and Central Bank of Iceland.

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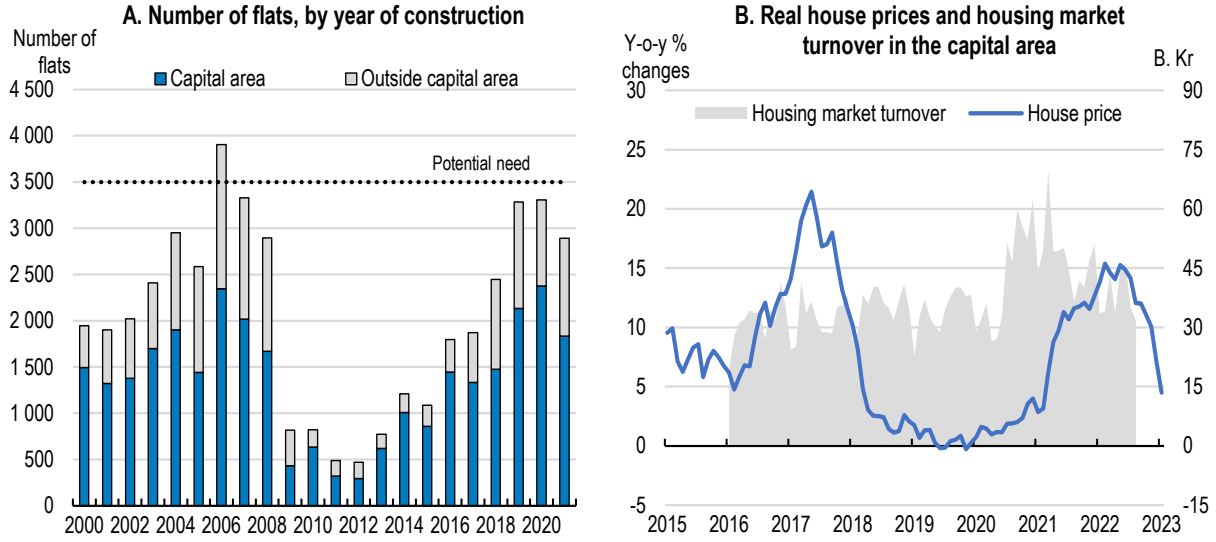
In reaction to the overheating housing market, the central bank tightened several sector-specific macroprudential rules, to contain systemic risk and safeguard financial resilience. In June 2021, it lowered the maximum loan-to-value ratio for all but first-time buyers from 85% to 80% and in September 2022 for first-time buyers from 90% to 85%. The central bank also amended the maximum debt service-to-income ratios on consumer mortgages introduced in December 2021. Finally, in June 2022 accounting was refined by requiring a minimum interest rate, and the maximum maturities of indexed mortgages were tightened. Following these measures, the share of mortgages exceeding the LTV limits declined rapidly (Figure 1.19, Panel B). The central bank should assess the measures regularly and amend them if needed. Limiting or abolishing households' entitlement to withdraw third-pillar pension savings on a tax-free basis could further help reduce pressures in the housing market.

A key factor driving house prices is sluggish supply (Figure 1.20). Annual construction of new houses has been consistently below what is regarded as long-term demand of around 3 000-4 000 dwellings per year (Housing and Construction Agency, 2022[24]) (University of Iceland, 2022[25]). The construction sector took more than a decade to reach activity levels before the 2008/09 financial crisis, despite the strong recovery afterwards. As such, the number of dwellings per 1 000 inhabitants has fallen to one of the lowest levels of the OECD (OECD, 2020[26]). While building new houses takes time under any circumstances, a part of low supply responsiveness seems to be brought about by policy. Insufficient availability of land ready for construction, complex planning regulations, and a high administrative burden to obtain building permits could slow the provision of new housing. Insufficient construction could also be responsible for the rising share of households with difficulties to find affordable housing (see Chapter 2).

Figure 1.20. Housing supply reacts slowly to rising demand



Note: Panel A, number of flats listed in the Iceland Property Registry that have been allocated a construction year. Panel B, housing market turnover is expressed at constant December 2021 prices.
Source: Central Bank of Iceland.

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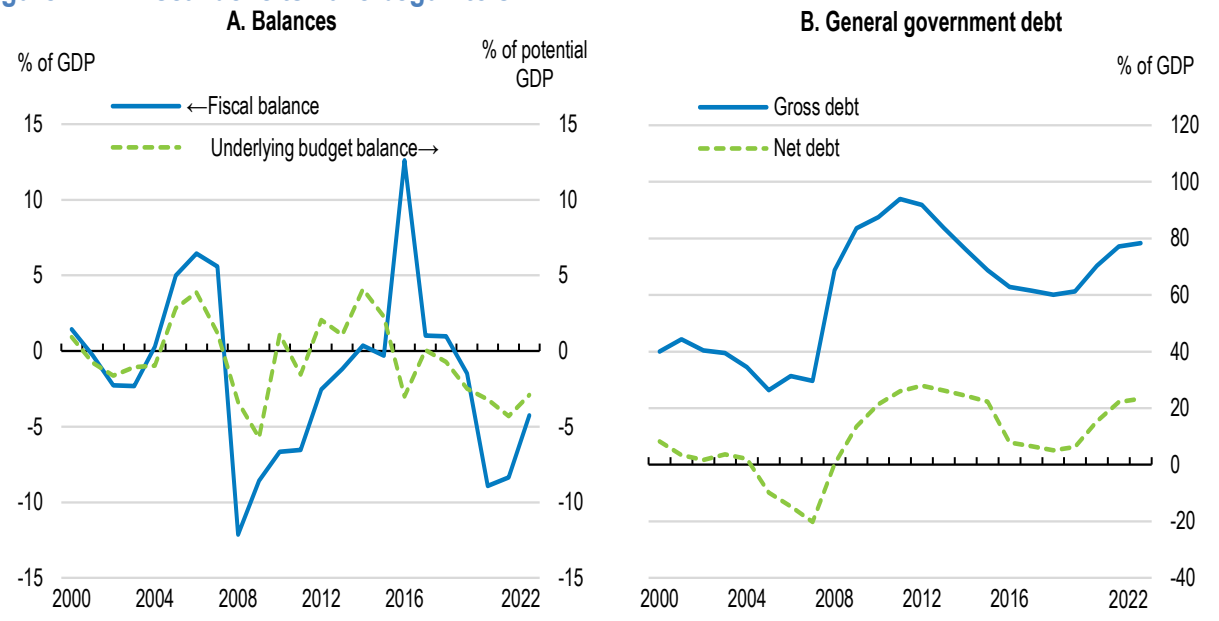
Recent policy initiatives are paving the way for more reactive housing supply. In April 2023 the government published a green paper on a long-term housing strategy, ahead of a parliamentary resolution (Government of Iceland, 2023[27]). In July 2022 the government and the municipalities sealed a framework agreement on housing, which is a welcome starting point for further policy action (Government of Iceland, 2022[28]). Also, in 2022 the municipalities of the capital area agreed to improve coordination of land-use and infrastructure policy, and planning at the regional level has been strengthened, which is welcome given the importance of land-use governance for housing purposes (Cournède, Ziemann and De Pace, 2020[29]). The government could take further steps to address imbalances originating in the housing market. It could consider removing or further limiting households' option to withdraw third-pillar pension savings on a tax-free basis, to reduce excessive housing demand. Housing support should be well-targeted at vulnerable households, to avoid that it just ends up in higher house prices and rents. The government, both at the central and local levels, should help step up housing supply, including sufficient affordable housing, by simplifying and clarifying planning regulations, easing the administrative burden of obtaining building permits, and by improving long-term planning and housing need forecasts.

1.4. Further fiscal tightening is needed

1.4.1. The budget balance is improving

After the deep fall to -9% of GDP in 2020 following the outbreak of the pandemic, the general government fiscal balance recovered to -8% in 2021 and to around -4.5% in 2022 (Figure 1.21). A rapid exit from the pandemic has allowed to scale back fiscal support to households and firms, although interest expenditures are increasing slightly, partly because of rising indexation cost on inflation-indexed government bonds. Rapid growth after the pandemic-led contraction has buoyed tax revenues, lifting the fiscal balance in 2022 more rapidly than projected. The fiscal stance has become contractionary, after the strong pandemic-related expansion in 2021 and 2022. Gross public debt following National Accounts rules rose from around 61% of GDP in 2019 to around 78% in 2022. Net debt is low at around 23% and there is hence a considerable difference between gross and net debt, like in some other OECD countries such as Canada (OECD, 2023[30]). In Iceland's case, it is due to large and liquid government financial assets held at the central bank, suggesting that net debt can be an appropriate metric to measure fiscal sustainability. Contingent liabilities, largely owing to debt of the Housing Financing Fund – a government-owned mortgage lender - continue to decline, reaching 24% of GDP at the end of 2022.

Figure 1.21. Fiscal deficits have begun to shrink



Note: Reflecting differences in the treatment of public entities, contingent liabilities and pension funds, the National Accounts and Statistics Iceland measures of public debt differ.
Source: OECD Economic Outlook No. 113 database.

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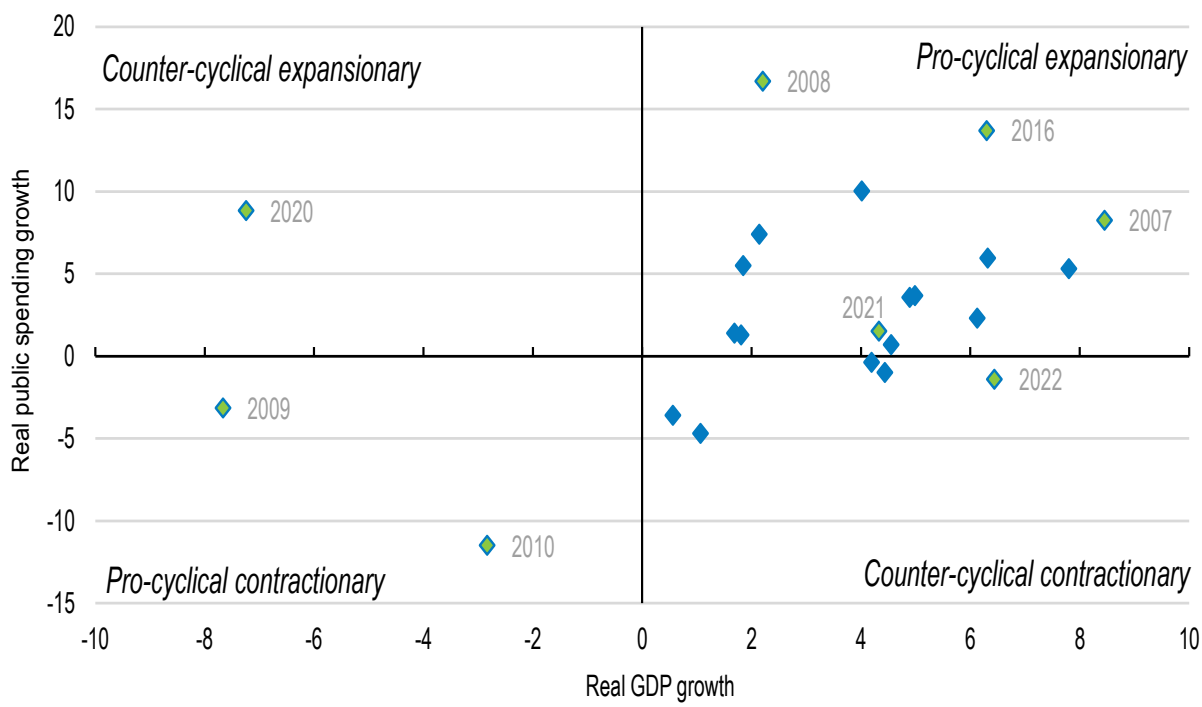
Going forward, the fiscal plan 2024-28 projects to reinstate the fiscal rules in 2026. The fiscal deficit is planned to decline gradually until it is close to zero by 2027, and the debt-to-GDP ratio is planned to decline slightly in 2026. To reach that target, the government plans to limit real spending growth at around 1% per year. The government also plans to unwind the Housing Fund with a view to eliminate the risk that guarantees for the fund's debt will be called upon in the future (Ministry of Finance and Economic Affairs, 2022[31]). Public consumption and transfers as a share of GDP are planned to decline to pre-pandemic levels by 2027. Several tax measures – notably an automatic adjustment of income tax progression thresholds to inflation and productivity growth – will slow tax revenue increases and keep the tax-to-GDP share roughly constant (see tax section). These plans are broadly welcome, although a more rapid return

to a balanced budget would be preferable to rebuild fiscal buffers faster. Also, in view of the current account deficit and with inflation running high, fiscal policy should avoid any stimulus, thereby ensuring consistency with monetary policy.

Government spending tends to be procyclical, i.e., it is expanding and contracting at times that are inappropriate from a stabilisation perspective, as in several other OECD countries (Egert, 2010[32]). On average, annual spending expands more the faster the economy grows (Figure 1.22). Spending was highly expansionary in the run-up to the financial crisis of 2008/09, while being contractionary afterwards. Overall, spending policy has been pro-cyclical more than two-thirds of the time since the turn of the millennium. Spending became more neutral in the years around 2015, when the new fiscal framework was adopted (Box 1.3), and in the face of the pandemic, but it has become pro-cyclical again during the post-covid-19 recovery. Against this background, the government should consider complementing the fiscal framework with a spending rule. While spending rules tend to add complexity to the fiscal framework and reduce budget flexibility, they can help making fiscal policy both more sustainable and stable. Around half of all OECD countries have implemented spending rules in addition to a deficit and debt rule (Rawdanowicz et al., 2021[33]). After pro-cyclical spending drift in the late 2000s, particularly at the local level, Denmark introduced a rolling four-year general government expenditure rule. A recent evaluation suggests that the spending rule helped contain spending pressure, while allowing the automatic stabilisers to work fully (Danish Ministry of Finance, 2022[34]). More recently, Ireland introduced a spending rule in 2021, requiring spending to remain below trend growth.

Figure 1.22. Spending tends to be procyclical



Note: Public spending refers to real general government total disbursements, using the GDP deflator.
Source: OECD, National Accounts database.

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Box 1.3. The fiscal framework has served Iceland well, but procyclical spending remains an issue

The 2015 reform of the public finance law aimed at addressing the twin problems of excessive fiscal deficits and procyclicality which had plagued Iceland for long. The government adopted numerical fiscal rules, established an independent fiscal council, and reorganised the budgeting process. The two numerical fiscal rules consist of *first*, two budget balance rules, requiring the annual deficit to remain below 2.5% of GDP, and the budget to be balanced over a five-year period; and *second*, a debt rule requiring net debt (national definition) exceeding 30% of GDP to be reduced by 5% on average over three years. The rules are quite straightforward, facilitating budgeting in a volatile economy when potential output is difficult to gauge.

The fiscal framework has helped Iceland to improve budgeting. The framework provides guidance about the medium-term trajectory of the public finances and hence mitigates concerns about debt sustainability. It could however be strengthened further, especially as some scenarios point to a rising debt burden, notably because of the long-term rising cost of ageing, notably spending on health and long-term care (Figure 1.24). Moreover, government spending remains pro-cyclical, as described in the main text. Against this background, complementing the budget framework with an expenditure rule could help increase both the sustainability and stabilisation properties of fiscal policy in Iceland.

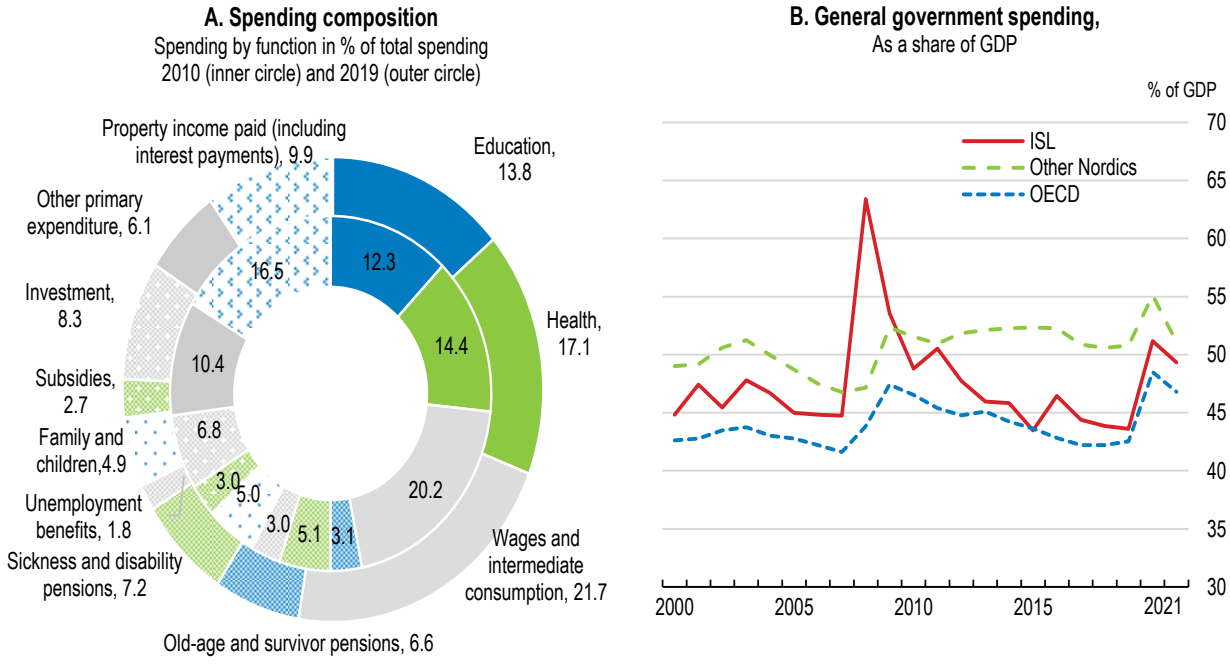
Source: Fjármálaráð, 2022[35], von Trapp and Nicol, 2018[36].

1.4.2. Public spending quality has room to improve

Spending as a share of GDP has changed little over the past decade or so, except for the rapid increase in 2020 following the drop in GDP and the government's pandemic-related fiscal support programmes (Figure 1.23). Yet, the composition of spending has evolved, mainly because of the rising share of spending on pensions. Child and family benefits – which tend to boost growth – only grew slightly. Public investment has been expanding. Finally, pro-cyclical cuts in growth-enhancing public spending during downturns could have been detrimental to growth (Fournier and Johansson, 2016[37]).

Following the covid-19 pandemic, whether some of the recent shifts in spending are structural or permanent is an open question. Some developments will have reversed in 2021 or 2022. Unemployment-related benefits and health spending, which jumped during the pandemic, contracted, and spending on subsidies that helped firms to survive lockdowns and other restrictions were cut back. Under these circumstances, the government should continue to aim for public spending that underpins growth, using more spending reviews and building on the experience gained. Again, fiscal policy should turn more counter-cyclical, to support the move towards higher spending quality.

Figure 1.23. Spending quality has declined



Source: OECD, Public Finance database; and OECD, National Accounts database.

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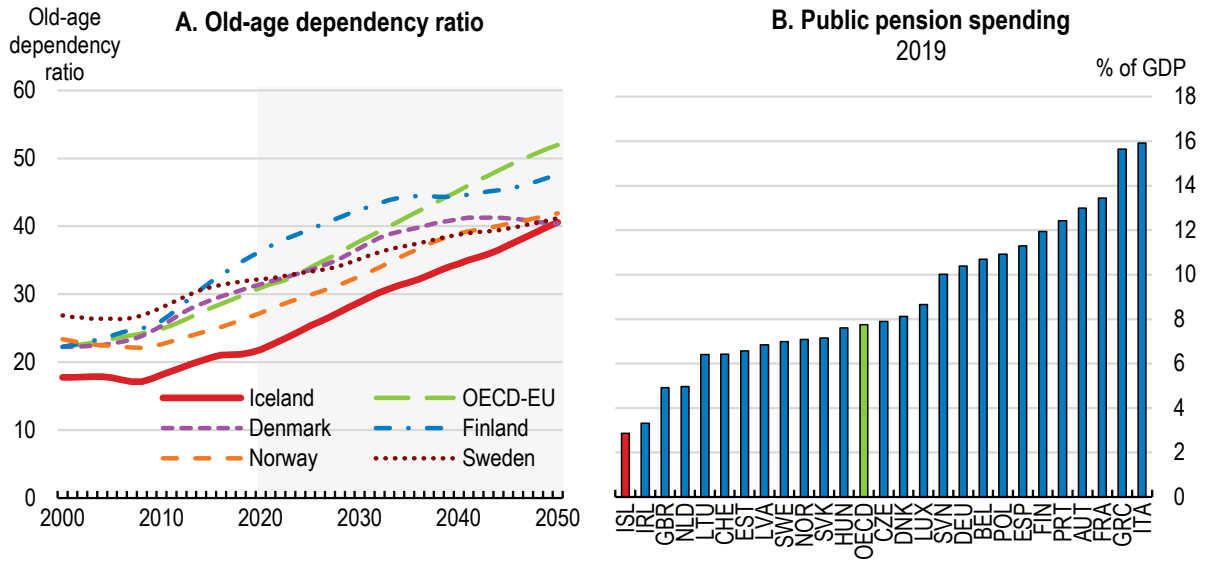
1.4.3. Ageing costs will increasingly weigh on the budget

Iceland's population is young and growing fast, owing not least to considerable labour immigration. Healthy life expectancy is one of the highest in the OECD, both for men and women. The work life is long with the statutory retirement age at 67 years, and older workers are well-integrated into the labour force. The pension system is sustainable, well-funded and diversified, comprising means-tested pay-as-you go state pensions (first pillar), statutory private funded pensions (second pillar) and individual tax-favoured savings (third pillar). Public spending on pensions as a share of GDP is the lowest in the OECD (Figure 1.24 B). Incentives for early retirement are weak, keeping participation high and pension spending under control. In this context, ageing is currently less of an issue than in almost any other OECD country.

Figure 1.24. Spending on pensions is small, but ageing costs will rise



Note: Panel A, the old age dependency ratio is the number of individuals aged 65 and more to the population aged between 15 and 64. Panel B, public pension spending refers to total public cash benefits spent on old age and survivors.
Source: United Nations, Department of Economic and Social Affairs, Population Division (2022), World Population Prospects 2022, Online Edition; and OECD, Social expenditure database.

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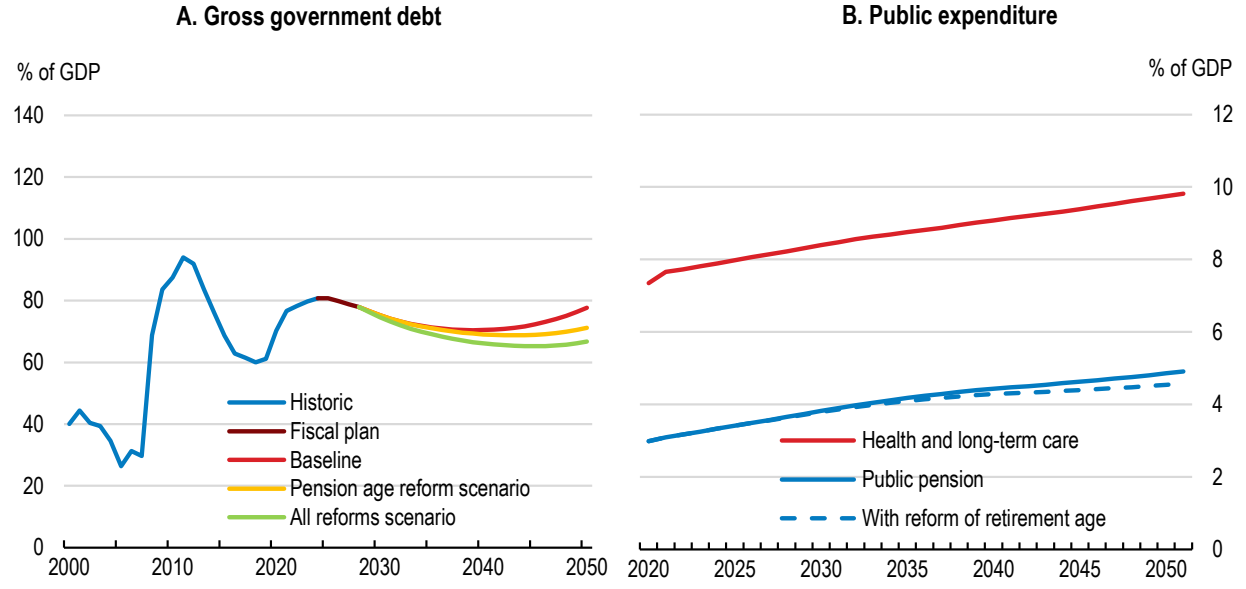
The country will not escape the economic and fiscal impact of ageing, however. The old-age dependency ratio is expected to rise as population growth slows and the share of active cohorts contracts (Figure 1.24 A). The government projects the fiscal cost of ageing to rise by more than 3% points of GDP until 2050, mainly because of higher spending on health and long-term care, although the lower cost of educating the young is expected to partly compensate the rising cost of ageing (Ministry of Finance and Economic Affairs, 2021[38]). The government assumes that the system of funded pensions will not require additional public funding since an in-built sustainability mechanism will adjust benefits for each age cohort, keeping the system overall sustainable. It also expects that the spending share of the state pension system will remain stable – and even decline from around 2035 – even though that share has almost doubled from 1.5% to 2.9% of GDP since 2010, partly because of a revision in 2017 that increased replacement rates. Health spending is expected to expand with life expectancy, jointly with growing incomes and technological progress. Against this background, the government should address the fiscal cost of ageing now to avoid imbalances later. One option could be to link the retirement age to life expectancy to keep the share of life spent in work and retirement roughly constant and hence allow for small incremental increases every year, as in Finland or, recently, the Netherlands (OECD, 2021[39]).

The need for and the cost of long-term care (LTC) is expected to grow as the number of people above 80 years will expand along with the prevalence of dementia over the coming decades. The cost of LTC as a share of median household income is below the Nordic average but unlike for most other OECD countries institutional care is more expensive than individual home care (Hashiguchi and Llena-Nozal, 2020[40]). As such, the government should address rising LTC cost by adequate reforms, notably by strengthening individual home and family care. While helping to contain cost, LTC reforms could also help people stay more independent into old age.

Overall, Iceland's long-term debt profile depends on the implementation of structural reform, including linking the retirement age to life expectancy (Figure 1.25). In a baseline scenario with no reforms to address rising ageing costs, gross government debt would reach around 78% of GDP by 2050, similar to where it stands now. Age-related costs comprising health, long-term care and first-pillar state pensions will rise by 5% of GDP (from 10% to 15%). In a scenario where ageing costs are addressed by introducing an

automatic link between the retirement age and life expectancy, debt will decline as labour participation will be higher and growth stronger. In the full-reform scenario, with implementation of all structural reforms recommended in Table 1.5, debt would stabilise below 70% of GDP. Reform progress in the financial and fiscal domain is shown in Table 1.3.

Figure 1.25. Reform could help contain spending and stabilise debt



Note: Debt projections until 2028 follow the fiscal plan as published in March 2023. The baseline reflects rising state pension (first pillar), public health and long-term care spending obligations, assuming an unchanged replacement rate for state pensions. The "pension age reform scenario" reflects the positive effect of linking retirement age to life expectancy by a factor of two-thirds, while the "all reforms scenario" shows the effects of reforms shown in Box 1.5, subtracted from the baseline. Based on Guillemette et al. (2017).
Source: OECD Economic Outlook No. 112 database; and OECD calculations.

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Table 1.3. Past recommendations and actions taken in monetary, financial, and fiscal policies

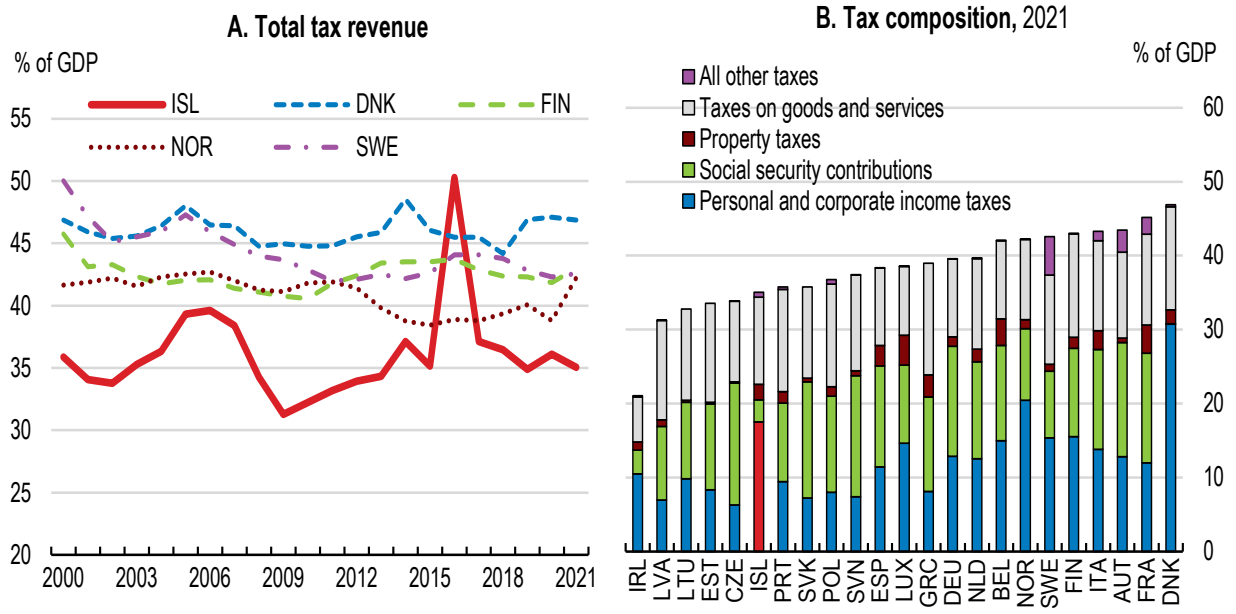
Recommendations	Actions
Monetary and financial policies	
Keep monetary policy accommodative, but stand ready to tighten if long-term inflation expectations are rising	After the burst of inflation, monetary policy has been tightened substantially since mid-2021.
Fiscal policy and public finance	
Continue supporting the recovery, including by providing liquidity support for distressed, yet viable firms.	All support measures have been withdrawn.
Ensure that the planned investment in infrastructure, education, innovation and digitalisation is properly implemented.	Investment in these areas continues as planned, although more could be done in education.

1.4.4. Tax levels are average but marginal tax rates are high for working families

The government thoroughly overhauled the income tax system in 2019-22 as described in the past *Survey*. A notable measure is an automatic annual adjustment of the income tax brackets for inflation plus 1% for productivity growth, akin to a fiscal rule. The productivity adjustment keeps the share of taxpayers per tax bracket roughly constant by curtailing unwarranted tax hikes as real wages grow economy-wide, thereby avoiding real progression. The measure aligns with practices in Denmark, Norway, and Sweden (OECD, 2023[41]). Several tax reliefs for innovation (see also innovation section), green investment, inheritance and charity were introduced or widened. The VAT relief for electric cars is set to expire at the end of 2023, to be replaced by a direct subsidy (OECD, 2021[2]). Yet, at 46%, the overall VAT revenue ratio (the ratio of actual collection to what is theoretically possible) remains below the 56% OECD average. Most covid-

related tax reliefs have been withdrawn except the hotel tax which is planned to be reinstated in 2024. The overall tax burden is below the OECD and tilted towards personal income (Figure 1.26). The government should further reduce tax expenditures, notably reinstate the standard VAT rate in the tourism sector. It should also introduce a tourism levy to fund local sustainable development, as in New Zealand (Ministry of Business, Innovation and Employment of New Zealand, 2022[42]).

Figure 1.26. Taxation is around the OECD average and relies heavily on income



Note: Panel B, the spike in 2016 reflects revenues from the "exit tax" levied on creditors reclaiming assets from banks that had defaulted in the 2008/09 crisis.
Source: OECD, Global Revenue Statistics database.

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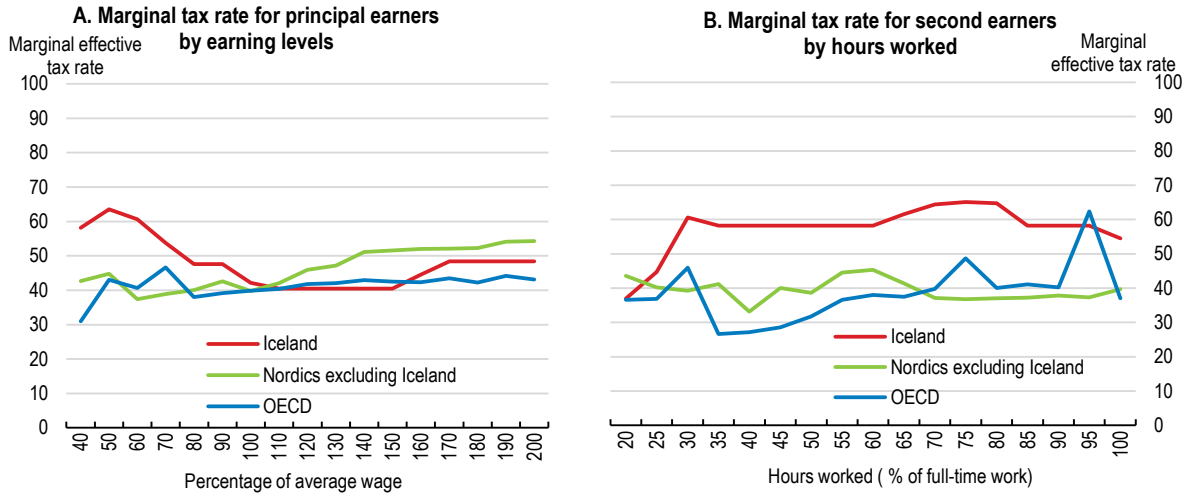
Marginal tax rates are relatively high, which is the combined result of a progressive tax system and strong means-testing of social benefits, notably for child and family benefits (Figure 1.27). While strong means-testing makes fiscal support to households well-targeted, the resulting high marginal tax rates could discourage low-income earners from seeking to earn more. Unlike in other Nordic countries, the disincentives extend far into the group of middle-income households (OECD, 2019[4]). The system of "tax bracket sharing" (a specific Icelandic form of taxing family rather than individual income) implies that Iceland has the highest marginal income tax rates for second earners in the OECD (OECD, 2022[43]). Also, strong tapering of benefits could be one factor driving the large gap in working hours between men and women, or having slowed its decline over the past decade (see Figure 1.6). A recent reform of the child and family benefit system extends benefits to middle-income earners and reduces marginal tax rates (Government of Iceland, 2022[44]). Against this background, the government should abolish "tax bracket sharing". It could also continue to taper child and family benefits less and gradually move towards a universal child and family benefit, as in all other Nordic countries and as Lithuania did in 2018, complementing an extant means-tested instrument.

Figure 1.27. Marginal tax rates are high



Note: The marginal effective tax rate (METR) is computed according to the formula $METR = 1 - \frac{\Delta y\ net\ earnings}{\Delta y\ gross\ earnings}$ for a two-earner couple with 2 children, claiming social assistance and housing benefits, whenever eligible. Annual housing costs are set at 20% of average wage of Iceland. In both panels, the second earner earns 67% of the average wage of the first earner.
Source: Own calculations based on output from the OECD tax-benefit model, version 2.5.0.

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Altogether, the fiscal recommendations would improve the budget balance by 0.5% of GDP (Box 1.4).

Box 1.4. Quantifying fiscal policy recommendations

The following estimates roughly quantify the fiscal impact of selected recommendations within a 5 to 10-year horizon, using simple and illustrative policy changes. The reported effects do not include behavioural responses and growth effects.

Table 1.4. Illustrative fiscal impact of recommended reforms

Policy measure		Impact on the fiscal balance, % of GDP
Recommendations		
Child and family benefits	Move from means-tested towards universal child and family benefits	-0.4
Carbon pricing	Increase carbon taxes to levels consistent with reaching climate targets, and redistribute proceeds to households and firms or use them to support green investment	0.0
Retirement age	Establish an automatic link between the retirement age and life expectancy by a factor of two-thirds	+0.3
Value-added tax	Terminate the lower VAT rate for tourism, which would increase the VAT revenue ratio from 0.46 to 0.49	+0.5
Total fiscal impact		**+0.4**

Note: The following recommendations are included in the structural quantification, but their fiscal impact cannot be quantified: regulatory reform in tourism, construction, and professional licensing; power sector; control of corruption.
Source: OECD own calculations.

1.5. The business climate should improve to raise productivity

Labour productivity has grown by around 1% each year on average, close to OECD-wide growth, maintaining productivity at roughly 20% above the OECD level (Figure 1.27). Productivity growth accelerated in the late 2010s but slowed again after 2019 in the wake of several supply shocks and the pandemic (OECD, 2021[2]). It remains lacklustre in the domestic goods and services sector (Figure 1.7).

Reforms to improve the business climate have been limited despite some action in the tourism and construction sectors. Stepping up regulatory reform efforts could help attract new and innovative firms, diversify the economy, and raise productivity to sustain high wages. Structural reform could raise GDP per capita by up to 5% (Box 1.5).

Box 1.5. Quantification of structural reforms

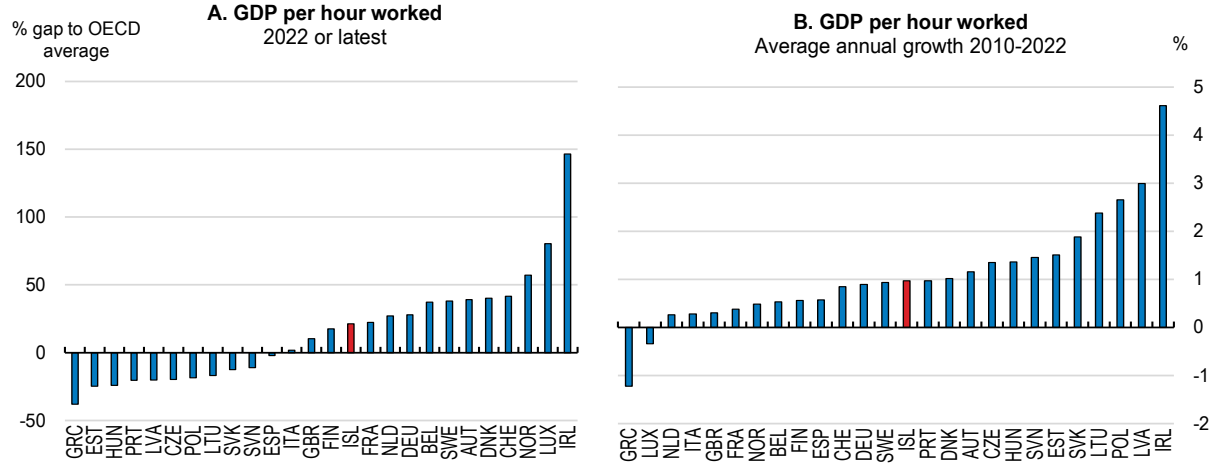
Selected reforms proposed in the Survey are quantified in the table below, using simple and illustrative policy changes and based on both cross-country and single-country regression analysis. Some reforms are not quantifiable under available information or given the complexity of the policy design. Most estimates rely on empirical relationships between past structural reforms and productivity, employment and investment, assuming swift and full implementation. They do not reflect idiosyncratic settings in Iceland. Hence, the estimates are merely illustrative, and results should be interpreted with care.

Table 1.5. Potential impact of structural reforms on per capita income

Policy	Measure	10 year effect, %
Retirement age	Link retirement age to life expectancy by a factor of two-thirds	1.1
Regulatory reform in tourism and construction, and in professional licencing	Strengthen competition in the domestic sector further, notably in tourism and construction, and ease stringent licensing in the professions	1.0
Power sector	Set up a transparent electricity wholesale market coordinated by an independent operator	0.8
Taxes and social benefits	Reduce marginal tax rates for second earners	1.1
Control of corruption	Increase control of corruption by 0.1 indicator points to reach average scores of 2010-16	0 to 0.7
Carbon taxation	Increase carbon taxation to a level commensurate with achieving climate objectives	-0.3 to -0.6

Note: Lower marginal tax rates for second earners are achieved by introducing a universal (rather than a means-tested) child and family benefit, as reflected in the fiscal quantification (Box 1.4). The following recommendation is included in the fiscal quantification, but the impact on per capita income cannot be quantified: terminate the reduced VAT rate in tourism.
Source: OECD calculations based on Égert and Gal, 2017[45], Cournède, Fournier and Hoeller, 2018[46], OECD, 2020[47] and Blöchliger, Johannesson and Gestsson, 2022[48].

Figure 1.28. Labour productivity has been rising by around 1% per year



Source: OECD, Productivity database.

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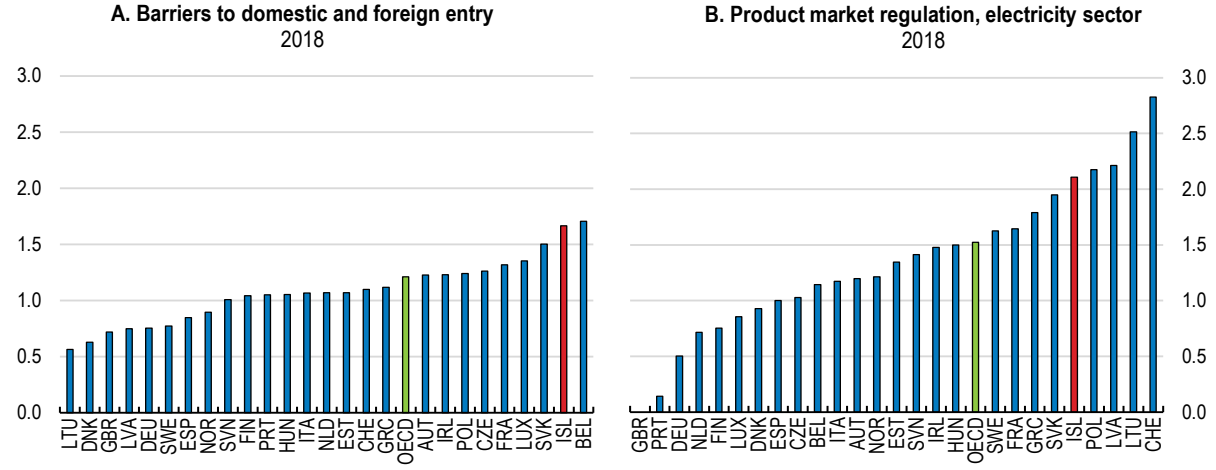
1.5.1. Barriers to entry are considerable

Notwithstanding improvements, Iceland's business climate as measured by the OECD's product market regulation indicators remains rather unfriendly. While distortions induced by direct state involvement in business activities are small, barriers to entry, notably for start-ups, are high. Foreign access to the computer service and construction sectors is more restricted than in any other OECD country, according to the OECD Services Trade Restrictiveness Index (STRI), partly because of restrictions on non-EEA companies (OECD, 2022[49]). Over the past few years reforms opened the tourism and construction sectors to more competition, as recommended in the past *Survey* (OECD, 2021[2]) and the report commissioned by Iceland's government (OECD, 2020[47]). Moreover, a simplification of building regulations is planned. However, professional licencing requirements were hardly eased as attempts met with resistance from vested interests. In this context, the government should continue its efforts to improve the business climate. A new attempt to reform professional licencing is planned for 2023.

Figure 1.29. The business climate is rather unfriendly



Note: A higher indicator value means more stringent regulation.
Source: OECD, Product Market Regulation database.

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The electricity sector is unique given Iceland's peculiar geography and geology. Domestic power generation relies on hydro and geothermal. The power grid is physically separated from the networks in Europe and the United States, restricting the pass-through of foreign energy market imbalances. The sector is mostly state- and municipally-owned and in part vertically integrated, even though it follows EU minimum regulatory requirements since 2003 (Box 1.6). Productivity increases in the sector over the past ten years have been close to the OECD average. The Competition Authority expressed concerns that a reform standstill could slow innovation in the sector, notably wind farm technology which could help meet rising electricity demand in an efficient and environmentally sustainable manner. Against this backdrop, regulatory reform, notably a transparent wholesale market coordinated by an independent operator, should form the core of a productive and competitive power sector (OECD, 2022[50]). The network operator *Landsnet* plans to set up a wholesale market by the end of 2024.

Box 1.6. Ownership and market structure in Iceland's power sector

Iceland's electricity sector is mostly owned and operated by publicly owned companies and in part vertically integrated, unlike many other countries where transmission grids are operated by independent transmission system or network operators (ownership unbundling). *Landsvirkjun* is the largest production company, generating around 71% of electricity, followed by *Reykjavik Energy* (19%) and a few smaller power companies. *Landsnet*, the network operator, is in the main part owned by the government (93%) after *Landsvirkjun* sold its 65% share at the end of 2022. Five distribution companies and municipally owned retailers are responsible for getting electricity to households and firms. The energy regulator *Orkustofnun* is responsible for monitoring and regulating power companies and for issuing licences for new power plants.

The market is dominated by a few large producers and consumers, with the latter mostly firms producing energy-intensive commodities like aluminium and other metals. Long-term bilateral agreements – often confidential - govern the relationship between market participants, allegedly on the grounds of heightened long-term planning security and the high capital cost of hydro and geothermal energy generation. Some large industrial electricity consumers enter direct contractual relations with producers or the network operator instead of with distributors. Overall electricity costs for industrial consumers are akin to those in several comparison countries. A subsidiary (ELMA) of the network operator *Landsnet* plans to set up a wholesale power exchange involving clear and transparent trading rules and a functioning price-setting mechanism by the end of 2024.

Source: (Zheng and Breitschopf, 2020[51]) and updates provided by the administration.

Regulatory reform could also help reduce inflationary pressures (see Box 1.2 on Iceland's inflation history), thereby supporting policy in the current macroeconomic context. Companies with a dominant position in the market or less exposed to new and innovative entrants are more likely to pass cost increases to consumers (Andrews, Gal and Witheridge, 2018[52]). Stronger competition can also help keep a potential wage-price spiral under control, as containing price hikes may help reduce wage pressure. A report on the Icelandic labour market published ahead of the 2022 wage negotiations observes that competition-fostering measures in sectors such as retail sale, oil distribution, banks and insurance companies could help increase real incomes without the need for wage increases (Olafsdottir, 2022[1]). As such, the government should strongly resist the demands from certain industries that seek exemptions from the existing competition framework.

1.5.2. Temporary changes to the insolvency framework should become permanent

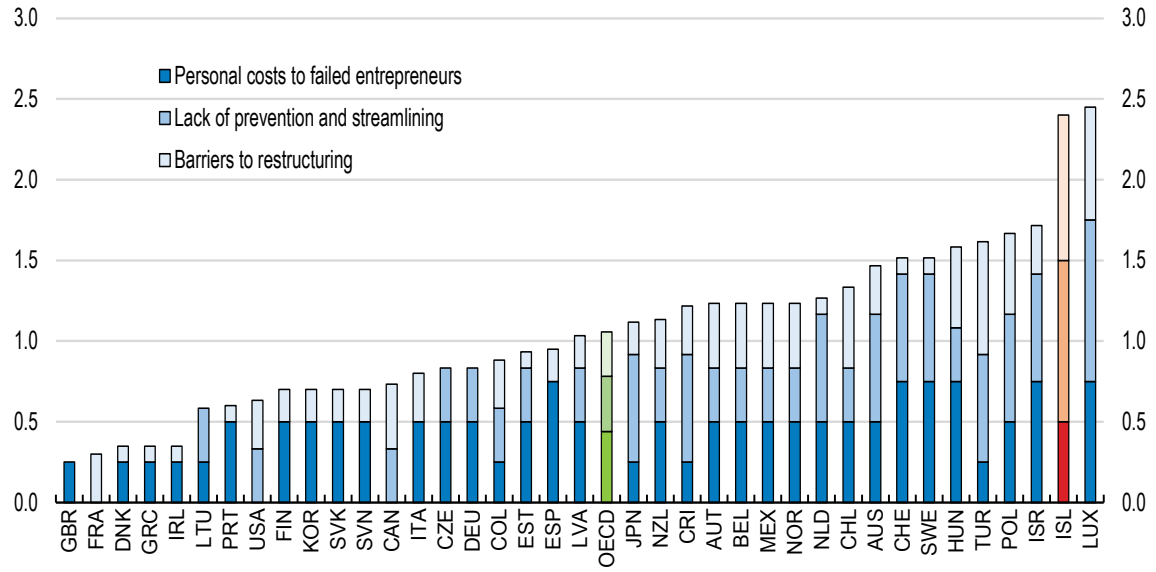
Efficient insolvency procedures have become more pressing as the withdrawal of covid-19-related policy support, the rise in interest rates, and growing restructuring needs induced by the green and digital transition raise pressure on businesses (André and Demmou, 2022[53]). Systems that help restructure viable firms and facilitate the exit of unviable ones can facilitate the reallocation of resources towards more productive uses and entrepreneurial risk-taking. Sound insolvency regimes can help foster technological diffusion and move the economy closer to the technological frontier. Effective insolvency frameworks encourage the parties to look for dialogue and out-of-court solutions; provide business with more options for restructuring rather than exit; speed up court procedures; improve accountability of insolvency administrators; and establish supervision rules implying more self-regulation.

Iceland's insolvency framework is relatively cumbersome (Figure 1.30). There is room for improvement in the treatment of failed entrepreneurs, and Iceland compares particularly unfavourably on prevention and streamlining as well as on the restructuring tools. Firms face several barriers to restructuring, and more so than in most other countries. Creditors are usually not allowed to initiate a restructuring; management has an indefinite stay on assets which may delay restructuring; and new funding sources have priority over

both secured and unsecured creditors, which could adversely affect legal certainty and the long-term availability of credit (Adalet McGowan and Andrews, 2018[54]). Temporary amendments in the wake of the covid-19 pandemic have facilitated the initiation of bankruptcy procedures, the change of payment plans without the consent of all creditors, and protection from enforcement procedures. These amendments should become permanent, and further reform should be pursued.

Figure 1.30. The insolvency framework is ineffective

Indicator, from 0 (most effective) to 3 (least effective), 2022



Note: A lower score indicates a more effective (less stringent) insolvency framework.

Source: André, C and Demmou, L. (2022), "Enhancing insolvency frameworks to support economic renewal", OECD Economics Department Working Paper.

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1.5.3. Support for innovation is generous

Iceland's innovative potential is evident in the energy and fishing sectors, including cutting-edge technology for carbon storage and sustainable fish farming, with strides in health technology and towards high-tech solutions in the food industry. Iceland outranks many European countries in terms of overall innovation performance. Firms perform well overall in the adoption and use of digital technologies, although smaller firms tend to lag as in other countries. Key areas where policy could foster the innovative potential include a more business-friendly competition and regulatory framework (see above); more effective support for business research and development (R&D); and faster and more effective technology adoption especially by small firms, as underlined in the previous *OECD Economic Survey* (OECD, 2021[2]). As pointed out earlier, the education system should provide more relevant skills, especially in the areas that are important for a creative and innovative economy. At the same time, business and universities need to collaborate more to turn innovation into productivity growth.

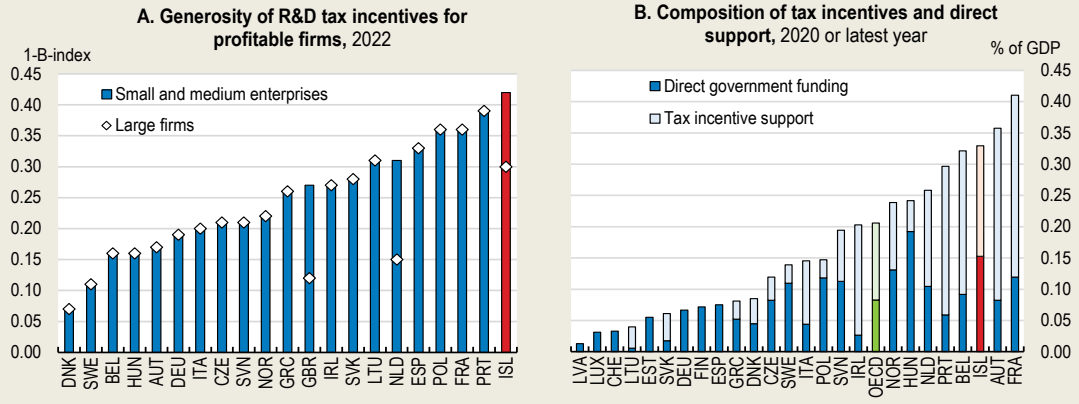
Government support to business R&D is generous by international comparison, as tax incentives have considerably expanded over the past few years. A reform in 2020, as part of a broader package to counter the impact of the covid-19 pandemic, raised the annual ceiling on qualifying R&D expenditure and introduced different tax credit rates for SMEs and large firms, at 35% and 25%, respectively, from a common rate of 20% previously. Support to SMEs has hence become particularly generous. The share of firms that perform R&D and use the tax credit has more than doubled over the past few years, most of them being small firms. The OECD's recent assessment of Iceland's tax incentive scheme suggests that

it is relatively effective in fostering business R&D, although it seems to have little effect on corporate productivity (Box 1.7).

Box 1.7. Supporting investment in research and development in Iceland

Iceland's business tax framework provides several tax incentives to promote investment, research and development, and innovation, in line with a trend across OECD countries, where tax incentives have become increasingly important in supporting investment in research and development (R&D). Compared to direct government funding, tax incentives have lower administrative costs and facilitate compliance with international competition regulation and state aid rules. In Iceland, the tax incentive, introduced in 2010, has been instrumental in boosting government support for business R&D, increasing from 0.07% of GDP in 2006 to 0.32% in 2020. Today Iceland has the most generous R&D tax support scheme and one of the most generous tax plus direct support schemes of the OECD (Figure 1.31).

Figure 1.31. Financial support to innovative firms is high



Note: Panel A: the B-index specifies the pre-tax income needed for a representative firm with sufficiently large profits to be able to make use of earned tax credits to break even on a marginal, monetary unit of R&D outlay (OECD, 2020). The indicator is shown as an implied subsidy rate, or "one minus the B index". Panel B refers to Business Enterprise Research and Development expenditure (BERD).
Source: OECD R&D Tax Incentives database.

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The Government of Iceland is evaluating the R&D tax incentive scheme in collaboration with the OECD. Preliminary results suggest that the R&D tax credit had a positive sizeable impact on R&D investment, with a stronger effect on micro-firms and firms with lower initial R&D investments. Preliminary results also suggest that by boosting R&D investments the tax credit has a positive impact on firms' sales, employment, and average wages. Going forward it will be important to continue monitoring the effects of the most recent reforms of the tax credit on R&D investment but also on broader innovation output, such as patents, as well as firms' performance, including productivity and gender-related indicators.

Source: OECD (forthcoming): Evaluating the effects of the R&D tax credit in Iceland.

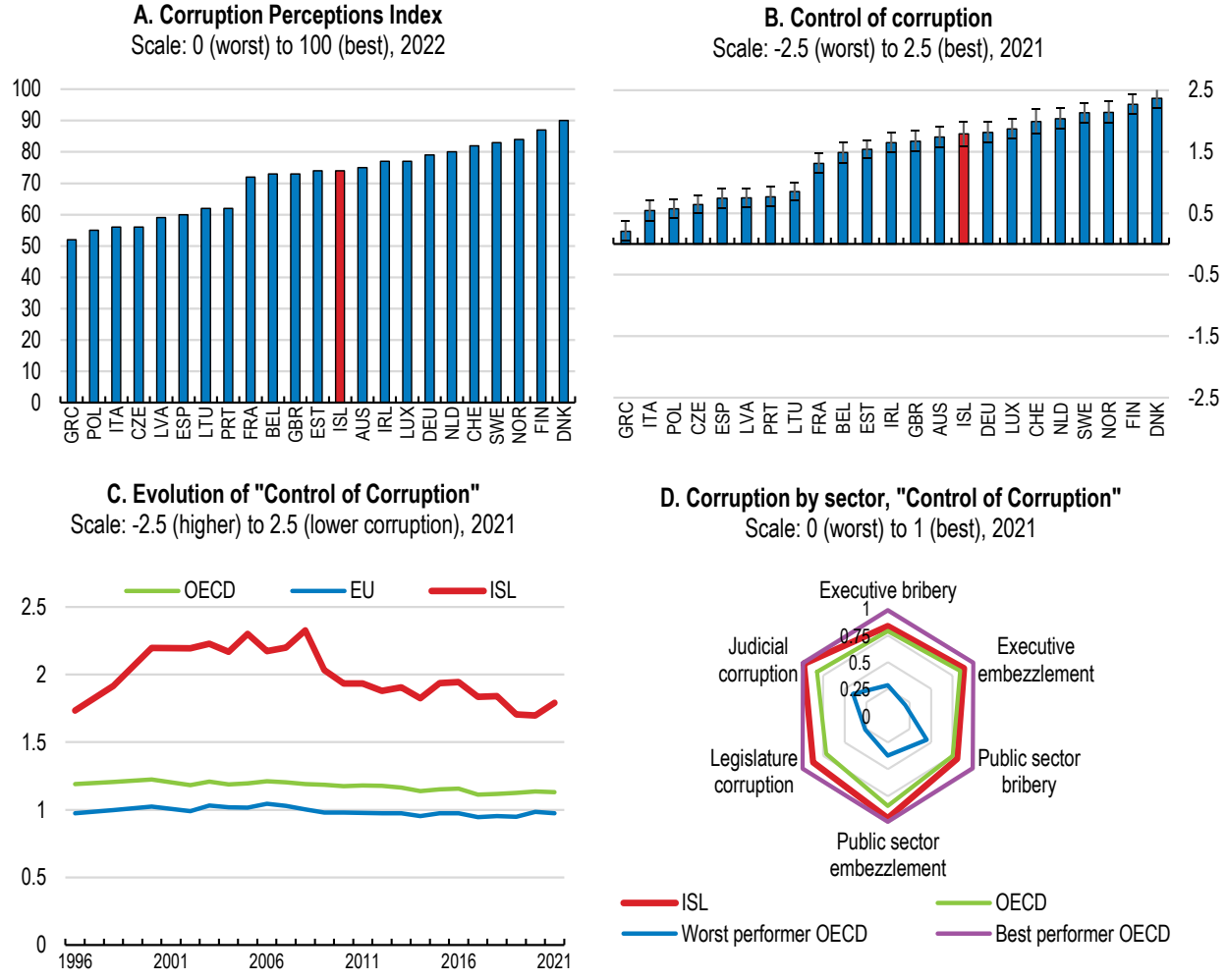
Digitalisation of the public sector is a key policy issue for innovation as it can act as a model for the economy, encouraging households and firms to become more innovative. While a large share of the population uses the Internet to interact with the government and e-government services are well developed, Iceland lags in evaluating the government's own performance, as documented in the previous *OECD Economic Survey* (OECD, 2021[2]). Moreover, there is room to coordinate government services better digitally. Against this background, the Digital Iceland taskforce, under the Ministry of Finance's purview, coordinates digital matters in the public sector, manages the implementation of digital projects and provides support to public entities on digital matters. Over the past two years, a digital platform ("X-Road") has been set up to facilitate communication between information systems, enabling agencies to

provide digital services and sharing data, with over 80 government services now being connected. The government is also working on a national strategy on open data, which is welcome.

1.5.4. Iceland is addressing corruption vigorously

Indicators of public integrity and control of corruption suggest that Iceland performs above the OECD average but below its Nordic peers. After a gradual deterioration in the wake of the financial crisis of 2008/09, perceived corruption has receded in the past few years, and control of corruption has strengthened (Figure 1.31). Closeness of public and private actors seems to be a problem, as is sometimes the case in small communities. Iceland's institutional framework, in particular the rule of law, is strong. Trust in government slid below the OECD average after the global financial crisis, but it has recovered over the past few years.

Figure 1.32. Corruption is perceived as average in Iceland



Note: Panel B shows the point estimate and the margin of error. Panel D shows sector-based subcomponents of the "Control of Corruption" indicator by the Varieties of Democracy Project.
Source: Transparency International; World Bank, Worldwide Governance Indicators; Varieties of Democracy Project, V-Dem Dataset v12.
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Iceland has been reactive to demands to improve anti-corruption measures. Several amendments to the penal code strengthened and clarified issues of bribery by foreign public officials, as recommended by the OECD's working group on bribery (OECD Working Group on Bribery, 2020[55]). Also, a comprehensive

whistleblower protection act came into force in 2021 to help better detect foreign bribery. Guidelines and awareness-raising of the act's content and impact have been published. Finally, a beneficial ownership registry is managed by the Iceland Revenue and Customs. One suspected case of foreign bribery from 2019 is still under investigation. Public integrity should remain a guiding principle in the government's anti-corruption policies, given the role of such efforts in improving the business climate and in raising productivity.

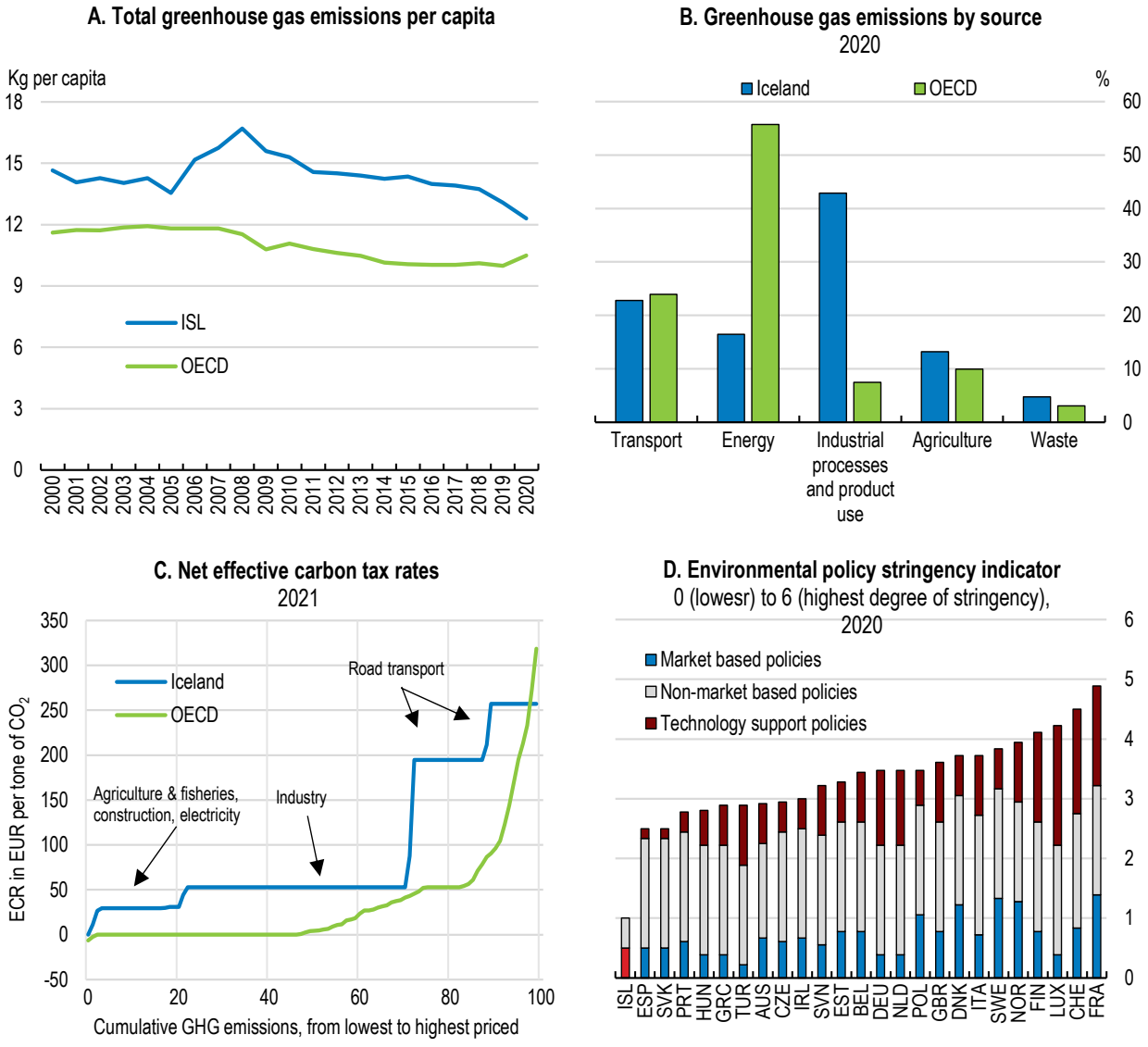
Table 1.6. Past recommendations and actions taken to foster inclusive growth

Recommendations	Actions taken
Implement the OECD competition review recommendations for the tourism and construction sectors, especially competition-friendly regulation of airport services.	Some regulation in the construction sector has been eased.
Facilitate access to professions by removing restrictive occupational licensing.	Limits on the number of taxi licenses have been abolished.
Increase openness by easing restrictions on foreign-owned companies, public procurement and auditing.	No action taken.
Strengthen competition in the electricity sector by separating generation, transmission and distribution of electricity more clearly, and enforce existing competition legislation better.	The largest electricity generator has sold its share in the transmission operator (vertical unbundling).
Improve compensation to attract high quality teachers and reward them for excellence. Adapt the curriculum to pupils' capacity and needs.	Steps have been taken to attract more students with paid work placements in the last academic year.
Continue and extend the training programme for professions in short supply set up jointly by the education and labour ministries. Strengthen vocational education and training (VET), by extending firm-based learning and by facilitating access to tertiary education for VET graduates. Strengthen the link between tertiary education and the labour market, by linking a part of university funding to labour market outcomes.	In 2021 the government established an agency to facilitate access to and increase the number of apprentices in industry. The Ministry of Education and Children has announced an action plan to increase the number of VET students during the period 2022-2027 by at least 1 000 students. Legislative changes grant VET master-apprentices access to university programmes based on qualifications.
Reduce high marginal tax rates in the tax-benefit system, for instance by moving from means-tested towards universal child and family benefits.	Marginal tax rates have been reduced by extending child and family benefits to higher income deciles.
Reduce distorting and damaging subsidies in agriculture.	No action taken.
Tighten rules on public-private relations, notably with respect to cooling periods. Ensure proper implementation and effectiveness of the new whistle-blower legislation.	Guidelines and awareness-rising measures for the whistleblower protection act from 2021 have been published.

1.6. Climate action is progressing gradually

Iceland's per capita carbon (or greenhouse gas) emissions remain above the OECD average, but their decline has accelerated over the past few years (Figure 1.33). Industry accounts for the highest share of emissions given the activities of three large aluminium smelters and the fossil fuel-based fishing fleet, while emissions from energy production – mainly carbon leakage from geothermal harnessing - are small. Agricultural emissions, mostly methane and nitrous oxides, are above OECD averages, reflecting the importance of subsidised sheep and cattle raising. Iceland is directly affected by climate change through melting glaciers which provide storage for hydropower and the acidification of the ocean, affecting fishing stocks. The government committed to reduce emissions from their 1990 level by 55% by 2030 and regularly updates its climate action plan, thereby focussing on cross-sectional measures and land transport.

Figure 1.33. Iceland is addressing climate change



Note: Panel D, environmental Policy Stringency is defined as the degree to which environmental policies put an explicit or implicit price on polluting or environmentally harmful behaviour through various policy tools (Kruse and al., 2022[1]).
Source: OECD, Environment Statistics database; OECD, Effective Carbon Rates; and OECD, Environmental Policy Stringency Index.

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The government has strengthened climate policies since the publication of the previous *OECD Economic Survey* and its thematic chapter on climate action (Table 1.7). Two policy measures were added to the action plan, and emission reduction targets might be set in partnership with each individual sector, like in Denmark or Sweden (OECD, 2021[57]). Electricity generation is being considered, not least to produce more hydrogen replacing fossil fuels, although this will be only for domestic use rather than exports. A regulatory framework for wind energy generation is being developed. The government carried out thorough cost-benefit analysis of several measures (University of Iceland, 2022[58]). Carbon sequestration achieved from land use change and reforestation (LULUCF), carbon capture from geothermal power production and broadening greenhouse taxes are estimated to be the cheapest way of reducing Iceland's carbon imprint. In contrast, supporting the purchase of electric cars is considered to be one of the most expensive ways. Icelandic firms have developed cutting-edge technology to store carbon underground (Box 1.8). Carbon taxes are above the OECD average.

Table 1.7. Past recommendations and actions taken to address climate change

Recommendations	Actions taken
Develop a consistent climate policy framework to guide scope, priorities, and sequencing of actions and measures.	The 2020 climate action plan with defined actions and measures to reduce GHG emissions is under revision, to be updated in autumn 2023.
Carry out comprehensive cost-benefit analysis of planned climate actions, using a common carbon shadow price.	A comprehensive cost-benefit analysis of various climate actions has been carried out by the University of Iceland.
Participate in international carbon abatement, to reduce emission reduction costs and to foster technology transfer.	No action taken.
Submit all sectors to carbon pricing, taking into account interactions between carbon taxes and emissions trading systems	Under consideration.
Commit to a gradual phase-in of higher carbon prices for sectors not covered by the EU emissions trading scheme, consistent with reaching climate targets.	No action taken.
Include methane and nitrous oxides in the carbon tax base.	No action taken.
Cut agricultural subsidies and couple the remaining ones to sustainable land management and less carbon-intensive production.	No action taken.
Step up spending on low-carbon transport infrastructure, energy transition and digital transformation.	In 2021 new tax incentives for green investments were introduced, with a 5% discount of the purchase price of sustainable and environmentally friendly movable assets.
Increase research and development in the area of carbon capture technologies, clean vessel propulsion and soil conservation, including by stepping up international cooperation in these areas.	Under consideration.
Strengthen collaboration between universities and firms and participate in international research consortia for green innovation.	Collaboration with Nordic research institutions has been strengthened.
Remove barriers to foreign direct investment to the extent possible.	The act on foreign direct investment 34/1991 was amended in 2022 to remove barriers to investment in airline companies.
Invest in tertiary education, especially in STEM areas. Ease occupational licensing in the construction sector.	The fiscal plan 2023-2028 foresees additional spending in STEM areas, notably in vocational education and training.
Assess the need for regulatory requirements.	No action taken.

Box 1.8. Direct air capture and storage – Icelandic technology to reach net zero

Direct air capture is a technology whereby gaseous carbon dioxide (CO_2) is filtered from the air and stored in rock formations or used as a climate-neutral stock for a range of products, from beverages to chemicals and synthetic aviation fuels. The technology offers a solution for legacy emissions, and the captured CO_2 can be integrated into an emission trading system. The approach has a relatively small land and water footprint and a high degree of certainty in the amount of CO_2 removed, yet it is quite energy-intensive.

Iceland currently hosts the world's largest operating direct air capture plant. "Orca", since September 2021 run by the Icelandic-Swiss Climeworks-Carbfix joint venture, captures around 4 000 tonnes of CO_2 per year to store it underground in basalt formations. Within few years carbon dioxide is turned into rock through mineralisation. The plant is located close to a geothermal power station to benefit from cheap and reliable energy and to inject the captured CO_2 into the ground. The cost of CO_2 abatement through direct air capture is currently estimated at between 200 and 700 USD/tonne.

The future of direct air capture hinges on the capacity to scale it up and reduce the cost per tonne of captured carbon dioxide. Currently capturing 0.01 million tonnes of CO_2 per year, the technology is planned to remove 980 million tonnes in 2050, or around 3% of current worldwide emissions. The cost of direct air capture is projected to fall to around 125-335 USD/tonne in large capture plants removing above 1 million tonnes per year. If so, direct carbon capture could become a competitive factor in the pathway towards net zero in Iceland and elsewhere.

Source: https://www.thinkgeoenergy.com/worlds-largest-direct-air-capture-and-co2-storage-plant-on-in-iceland/, (International Energy Agency, 2022[59]).

The government should strengthen climate action further to achieve the stated emission targets in a sustainable and efficient manner. As such it should focus on a three-pronged strategy: *first*, it should strengthen carbon taxation by including more sectors and extending it towards other damaging carbon gases such as methane and nitrous oxides in all areas not covered by the EU emission trading scheme. *Second*, it should prioritise climate actions with low abatement cost per tonne of carbon. *Third*, it should strengthen investment in R&D in carbon capture technologies, clean vessel propulsion and soil conservation, including by stepping up international cooperation in these areas.

Table 1.8. Findings and recommendations to foster a strong and resilient economy

Monetary, financial, and fiscal policies	
Inflation has far exceeded the target for more than two years.	**Tighten monetary policy further needed to re-anchor expectations and to bring inflation back to target.**
Financial risks emanating from the housing market have risen.	Carefully monitor financial risks associated with house price developments and tighten macro-prudential rules if needed. Limit or abolish household options to withdraw third-pillar savings on a tax-free basis. Ease administrative procedures and planning regulations to foster the supply of housing. Closely monitor pension funds' risk-taking, including through stress-tests.
The fiscal stance has turned contractionary.	**Continue to tighten fiscal policy and reinstate the fiscal rule by 2026 at the latest.** Consider adopting an expenditure rule to complement the fiscal framework.
The fiscal cost of ageing, notably health and long-term care, is rising.	Introduce an automatic link between life expectancy and the retirement age and strengthen individual home and family care.
Public spending has tended to contribute less to growth over the past decade.	Carry out more spending reviews, building on the experience gained over the past few years.
Marginal tax rates for second earners are high.	Abolish the family-based "tax-bracket-sharing" system.
Iceland's natural capital generates rents for tourism that can be tapped.	**Remove tax expenditures in the tourism sector, notably the reduced VAT rate.** Introduce a tourism levy to fund local sustainable development
Policies to improve skills and the business climate	
Labour market imbalances, in particular skills mismatches, are high.	**Invest in education and skills that are high in demand such as STEM and health care, and foster gender balance across professions and economic sectors.**
Wage developments are only partly linked to productivity growth.	Adapt the wage bargaining system so that wages reflect sector- or firm-level productivity better. Improve the collection of productivity and wage data.
Productivity growth in the domestic sector is low. Barriers to entry remain high, slowing innovation.	Strengthen competition in the tourism, construction, and aviation sectors further, and ease professional licensing to the extent possible. Conduct analyses for other sectors.
The power wholesale market is not fully operational. Some contracts between power producers and customers are opaque.	**Set up a transparent electricity wholesale market coordinated by an independent operator.**
Iceland's insolvency framework is rather ineffective and cumbersome.	Make the temporary amendments implemented during the pandemic permanent, and streamline procedures further, to help accelerate the restructuring of viable firms and the exit of non-viable ones.
Digitalisation of the public sector is advanced, but coordination across agencies could be improved.	Invest further in digital government and a data-driven public sector, e.g., by implementing a digital platform to which all government services are connected.
Perception of corruption is low and decreasing.	Continue the implementation of legislation to promote public integrity.
Decarbonising the economy	
Albeit falling, carbon emissions remain above the OECD average.	**Extend carbon taxation to all greenhouse gases and to all areas not covered by the EU emission trading scheme.** **Map out a gradual increase in the carbon tax with tax levels in the non-ETS sectors converging to those in the ETS sectors over time.**
Abatement costs of various climate actions have been thoroughly assessed. They vary strongly across actions.	**Based on cost-benefit analysis, prioritise climate actions that carry a low cost per tonne of reduced carbon emissions. End actions with high cost.**
Some technical measures to reduce emissions are potentially promising.	Support investment in carbon storage technologies, clean vessel propulsion and soil conservation, and strengthen international cooperation in these areas further.

Note: Key recommendations are in bold and feature in the executive summary.

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2 Immigration in Iceland: addressing challenges and unleashing the benefits

Vassiliki Koutsogeorgopoulou, OECD

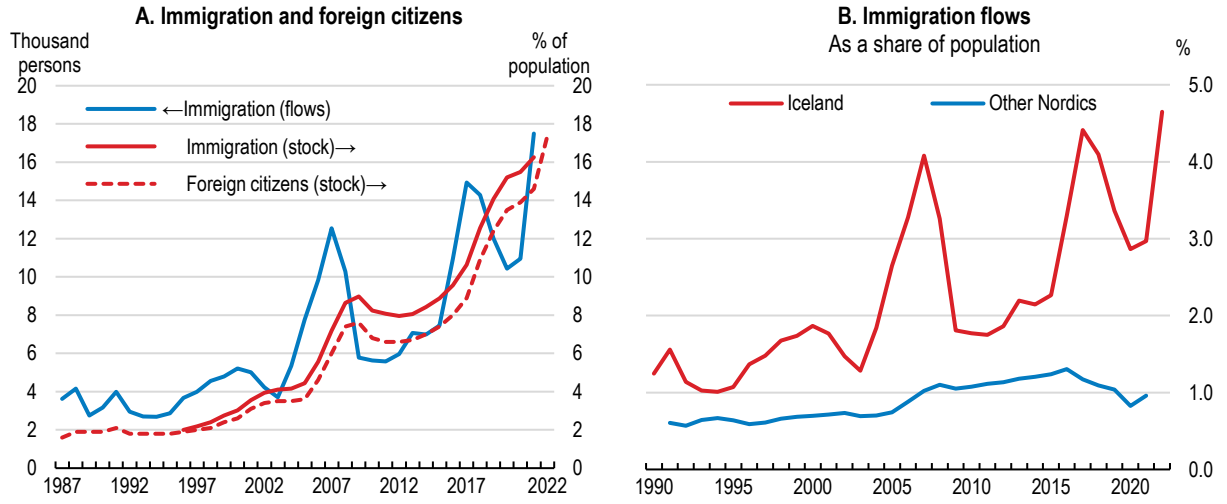
Immigration has increased rapidly since the late 1990s, driven largely by strong economic growth and high standards of living. By mid-2023, foreign citizens made up around 18% of the population. This has brought important economic benefits to Iceland, including by boosting the working age population and helping the country to meet labour demands in fast-growing sectors. However, there are important challenges regarding the integration of immigrants and their children that need to be addressed through a comprehensive approach, helping to make the most of immigration. Successful labour market integration of immigrants requires more effective language training for adults and an improvement in skills recognition procedures. At the same time, immigrants need more opportunities to work in the public sector and the adult learning system should be adjusted to better encompass their training needs. Strengthening language skills is key to improving the weak educational outcomes of immigrant students. Enhancing teachers' preparedness to accommodate students' diverse educational needs is another pre-requisite. Strengthening integration further hinges upon meeting the housing needs of the immigrant population, including through an increase in the supply of social and affordable housing.

2.1. Introduction

Immigration is not a new phenomenon in Iceland but has become increasingly prominent since the late 1990s, more so than in the other Nordic countries on average (Figure 2.1). Strong economic growth and

high standards of living are important attractors, facilitated by the opening of Iceland's labour market to European Economic Area (EEA) countries since the mid-1990s. The most recent waves raised the proportion of foreign citizens close to 15% of the population in 2022, compared to merely 2% in the mid-1990s, with a further increase to around 18% by mid-2023. The rapidly rising influx of immigrants and its changing geographical origins have transformed the economy through a wider variety of skills and competencies and increased population diversity. Overall, the Icelandic public has a positive view of immigration, according to a recent opinion survey covering areas such as the labour market, education, and the political and social engagement of immigrants (Ćirić, 2021[1]).

Figure 2.1. Immigration has increased rapidly

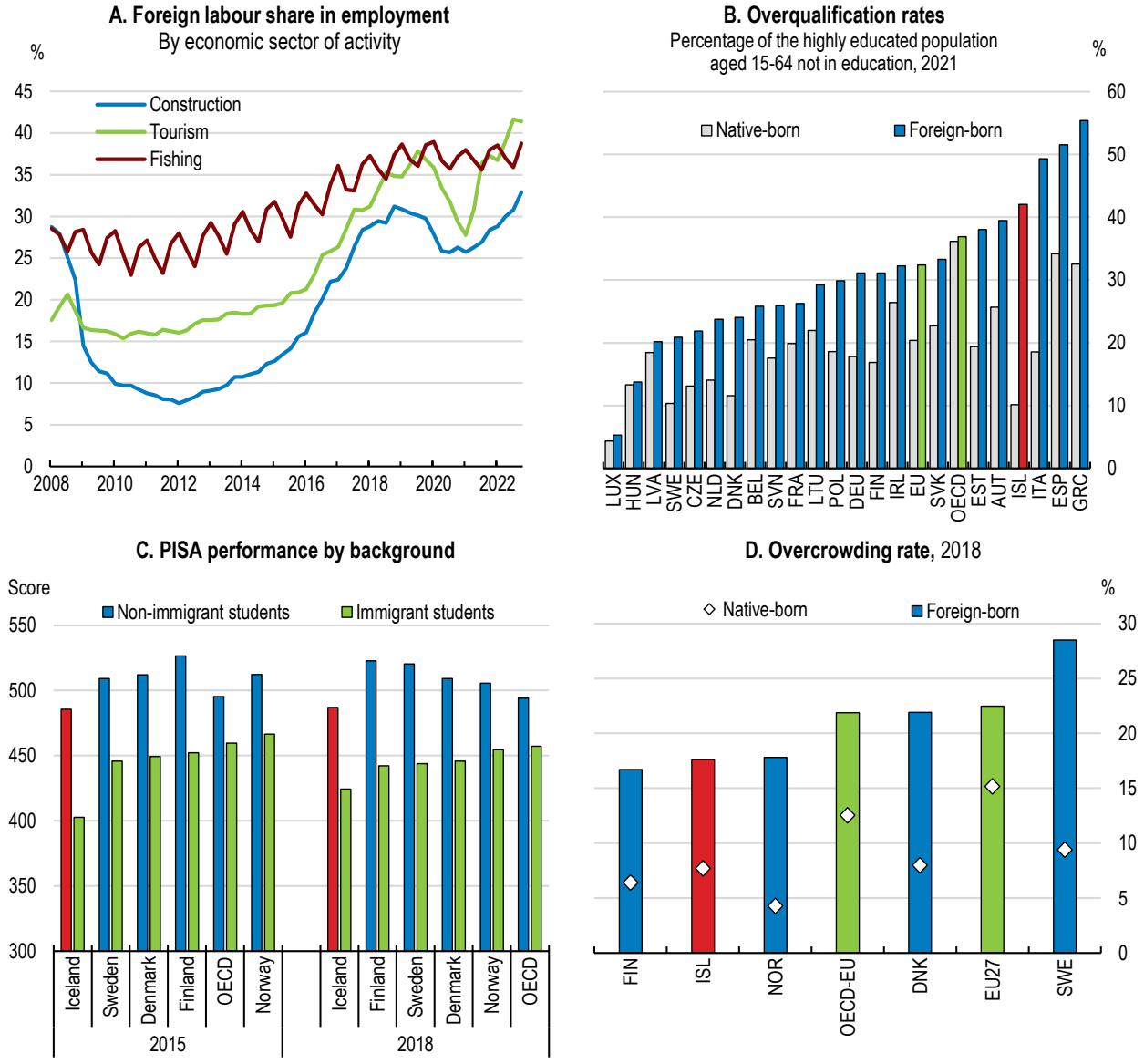


Note: In Panel A, data on immigration refer to immigration flows in Iceland, including both Icelandic and foreign citizens who obtain a residence permit or a work permit for a period exceeding three months. Foreign citizens refer to overall number of individuals that live in Iceland and do not hold Icelandic passports. Latest data point for foreign citizens correspond to 2023 first quarter. In Panel B, the other Nordics include Denmark, Finland, Norway, and Sweden. It is computed as simple average of immigration flows as a share of population in the countries depicted in the panel.
Source: Statistics Iceland; and Nordic Statistics database.

StatLink https://stat.link/jh7bf9

Immigration plays an important economic role, affecting performance through multiple channels. It yields visible demographic benefits not only by contributing largely to growth in the workforce, helping to alleviate pressures from shrinking native workforce, but also by changing the age structure of the population, since immigrants are in general younger than natives. Moreover, immigrant workers fill important niches in the labour market, contributing significantly to fast-growing sectors such as tourism and construction, and they increase labour market flexibility (Figure 2.2). By supplementing the human capital of the native workforce, immigrants also help to augment Iceland's productive capacity. Indeed, empirical estimates point to a positive productivity impact from an increase in net migration, especially in the long run, which exceeds the OECD average (Boubtane, Dumont and Rault, 2016[2]). Simple scenario analysis by OECD (described below) also suggests significant output gains from net migration in the long run.

Figure 2.2. Immigration comes with benefits and challenges



Note: In Panel A, data come from the Labour Force Register. The over-qualification rate is the share of the highly educated (ISCED Levels 5-8), who work in a job that is ISCO-classified as low- or medium-skilled (levels 4-9). In Panel C, immigrant students include both first- and second-generation. In Panel D, the overcrowding rate is the share of the population living in a household that does not have an appropriate number of rooms at its disposal.

Source: Statistics Iceland; OECD, "Settling In 2023: Indicators of Immigrant Integration"; OECD, PISA 2018 database; and Eurostat – Living Conditions Survey.

StatLink https://stat.link/qlv9ys

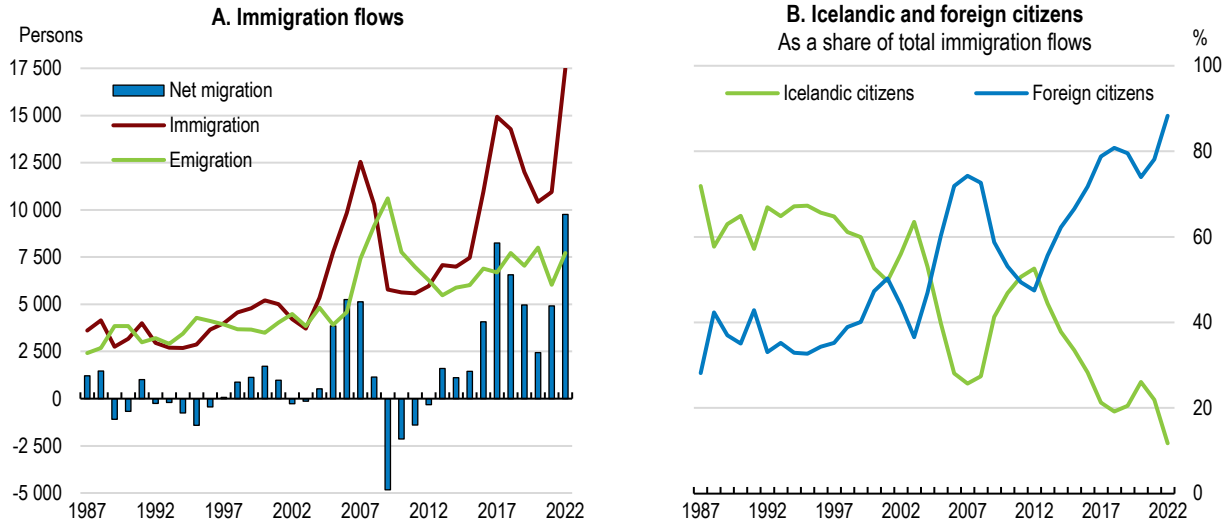
However, immigration also poses policy challenges related to the integration of immigrants and their children. A much larger proportion of immigrants are over-qualified compared to natives, implying that many workers with a foreign background do not manage to translate their educational qualifications into good labour market outcomes (Figure 2.2). There are also important challenges for the education system in view of the poor educational performance and the diverse needs of students with a foreign background. Increased demand for affordable housing in a tight market adds to these challenges. Immigrants face high housing costs and tend to live in overcrowded dwellings.

This chapter discusses the economic role of immigration in Iceland focusing on the labour market, education and housing, as well as relevant integration issues in these areas, and identifies reform options to make the most of immigration. The chapter first discusses immigration patterns, putting them in an international context. This is followed by a discussion of immigration policy with an emphasis on labour markets. The subsequent sections focus on policies to better integrate immigrants and help them and their children to meet their potential. These include measures to enhance the labour market integration of immigrants by enabling them to better use the qualifications they obtained abroad and to strengthen their skills through work experience and lifelong learning, as well as measures that improve the outcomes of immigrant students, including potential reforms to better prepare school and teachers to meet diverse needs. The last section focuses on reforms to address burdensome housing costs and the poorer housing conditions immigrants tend to face. The main findings and recommendations are summarised in Table 2.1 at the end of the chapter.

2.2. Immigration patterns in an international context

Migration inflows and outflows were roughly balanced until the late 1990s, when immigration started increasing faster than emigration (Figure 2.3). Iceland's economic boom opened up new opportunities for foreigners in tandem with its joining the EEA in the mid-1990s, and especially the EEA enlargement to Eastern Europe in the 2000s. Foreign citizens (from EEA and third countries) accounted for around 90% of total migration flows in 2022 compared to a third in the early 1990s, with a fall in the corresponding share of returning Icelanders. The flows of migrants since the turn of the century appear to be closely related to the business cycle, a link that was much less evident in previous decades (Elíasson, 2017[3]). Inflows were particularly strong in the run-up to the global financial crisis and during the post-crisis recovery, despite a slowdown during the pandemic (Figure 2.4). The estimated inflows of immigrants as a percentage of the population in 2021 were among the highest in OECD (OECD, 2022[4]).

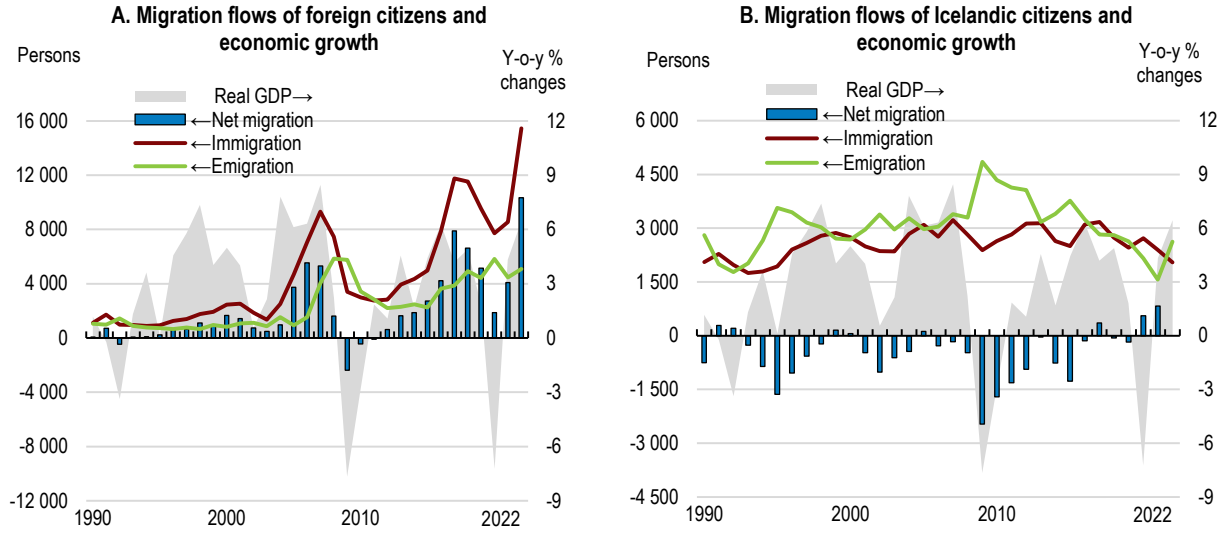
Figure 2.3. The large influx of foreign citizens changed the migration landscape



Note: In Panel A, data refer to immigration flows to Iceland, including both Icelandic and foreign citizens who obtain a residence permit or a work permit for a period exceeding three months.
Source: Statistics Iceland.

StatLink https://stat.link/shm6qt

Figure 2.4. Migration flows appear to be largely influenced by the business cycle



Note: In Panels A and B, data refer to immigration flows in Iceland, including both Icelandic and foreign citizens who obtain a residence permit or a work permit for a period exceeding three months.
Source: Statistics Iceland; and OECD, National Accounts database.

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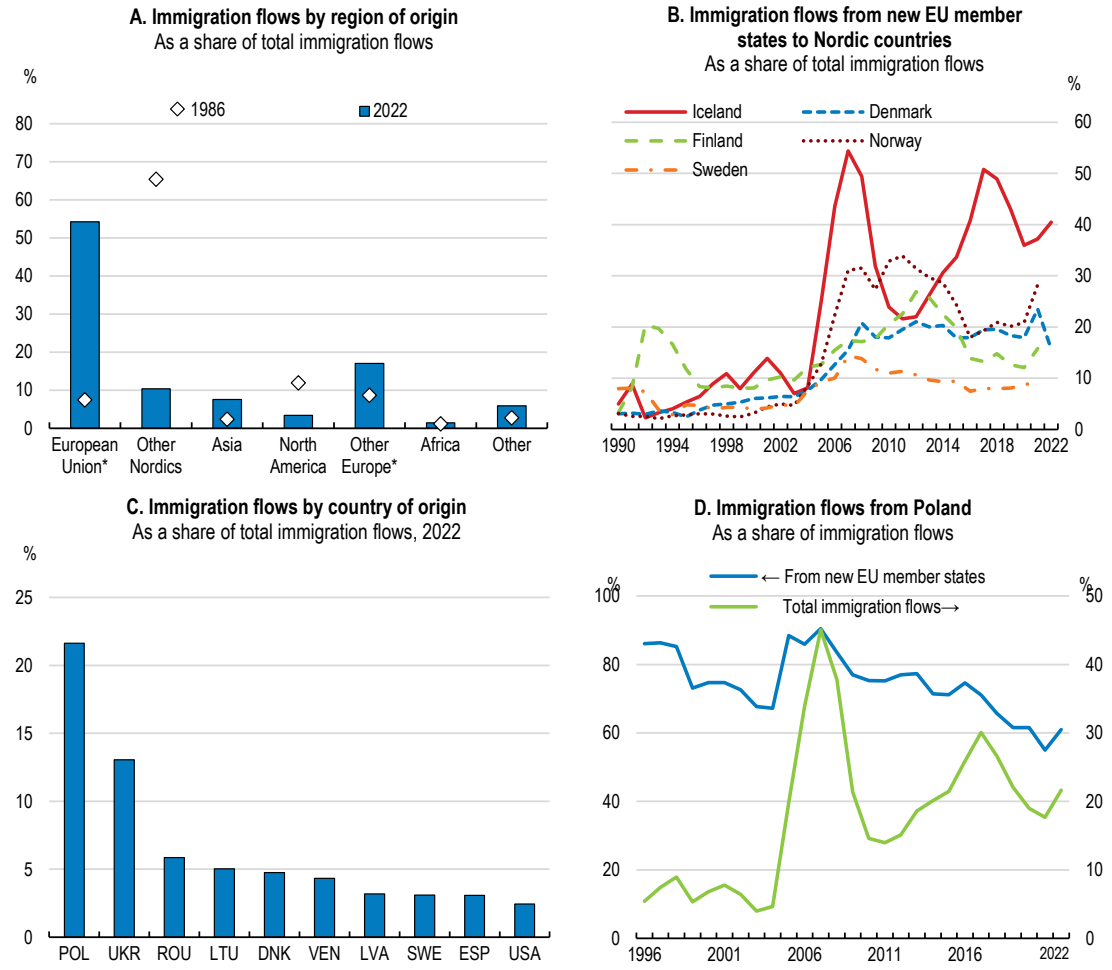
The composition of migration inflows by region/country of origin has changed over time, with the rest of Europe overtaking the other Nordic countries (Figure 2.5). In the mid-1980s, over 65% of immigrants came from the other Nordic countries and around 15% originated from elsewhere in Europe (EU and other Europe), with the pattern reversing by 2022. EU enlargements in 2004 and 2007 triggered a surge of immigration from the new member states to Iceland**,** above the increases experienced by the other Nordic countries. Poland is the main country of origin among the new EU member countries, followed by Romania and Lithuania. Outside the European Union, Ukraine and Venezuela account for the largest share of immigrants. An increasing number of foreigners from third countries entered Iceland over the past decade or so with refugee or other forms of protection status (Box 2.1).

Figure 2.5. The geographical diversity of immigrant inflows has increased



Note: Immigrant flows include both foreign citizens and returning citizens from the former host country. Panel A: data referring to the other Nordic countries (Denmark, Finland, Norway, Sweden) are not included in the EU and "other Europe" groups. Panel B: data refer to individuals from new EU member states registered in the country as immigrants during the year. New EU member states refer to 12 new EU entrants since 2004.
Source: Statistics Iceland; and Nordic Statistics database.

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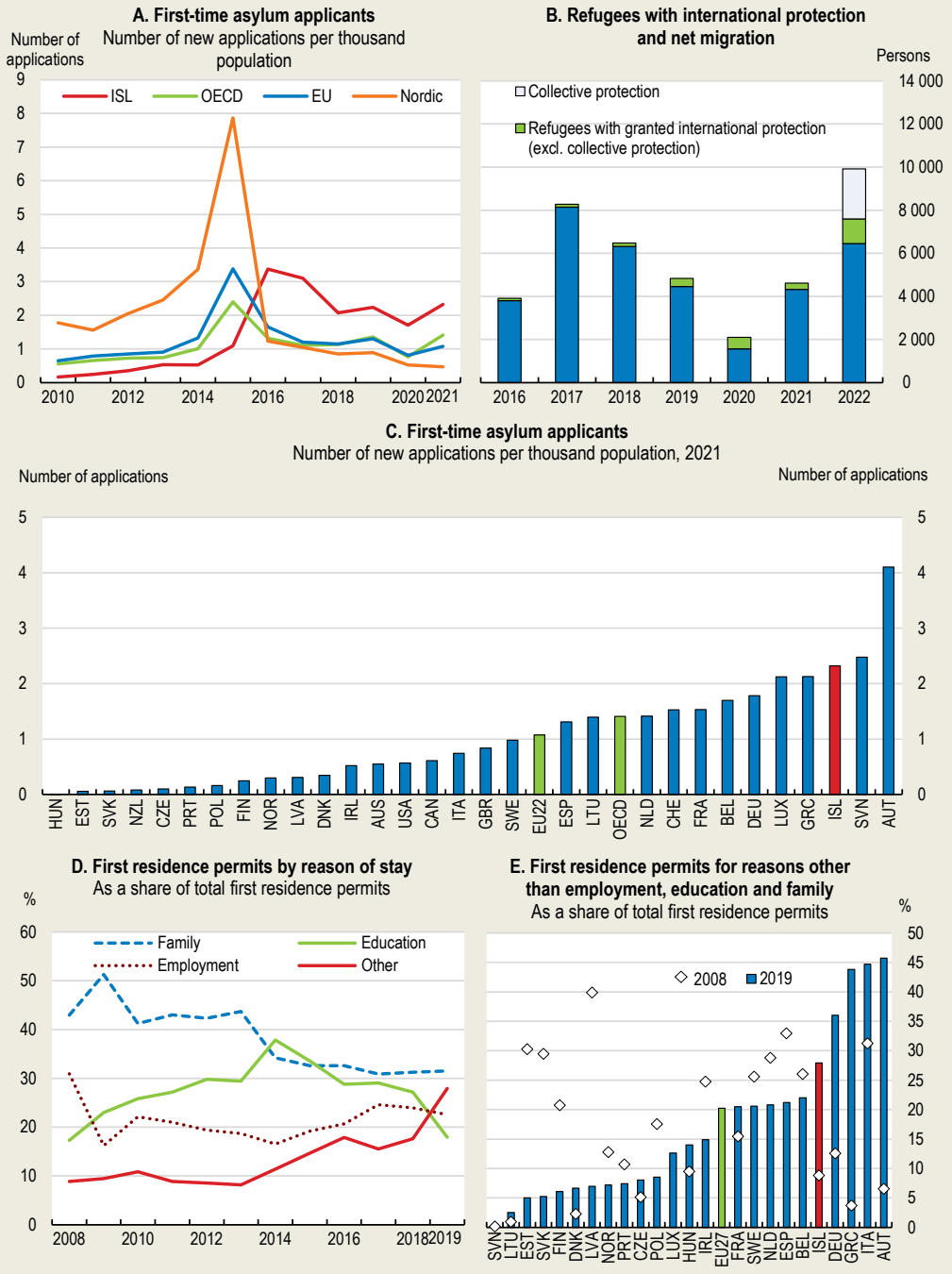
Box 2.1. The number of applicants for international protection has increased in recent years

The number of new asylum applications (per thousand of population) has risen fast since the mid-2000s (Figure 2.6). In 2021, Iceland received more new asylum seekers than most OECD countries, including the Nordic peers, and the number rose five-fold in 2022. Refugees with international protection, including those with a temporary protection status, comprised around 35% of total net immigration in 2022, with the majority coming from Ukraine and Venezuela.

The share of immigration related to reasons including international protection has increased rapidly in recent years on the basis of first residence permits issued for non-EU immigrants (Figure 2.6). On the other hand, the number of first permits for education-related reasons has almost halved as a share of total issuances between 2014 and 2019, while permits issued for employment-related reasons increased mildly without however reaching their 2008 level. Family-related reasons remain the largest category of first resident permits, accounting for around a third of the total in 2019, but the share has declined compared to its 2009 peak.

Figure 2.6. Inflows of refugees and asylum seekers increased sharply



Note: In Panel B, collective protection corresponds to temporary protection status as defined by Foreign National Act (80/2016) article 44. In Panels D and E, first residence permits for over three months are included, the category "other" refers to the first residence permits issued to asylum claimants, unaccompanied minors, to victims of trafficking and for other humanitarian reasons.
Source: OECD, International Migration database; Directorate of Immigration; Statistics Iceland; Ministry of Finance; and Eurostat.
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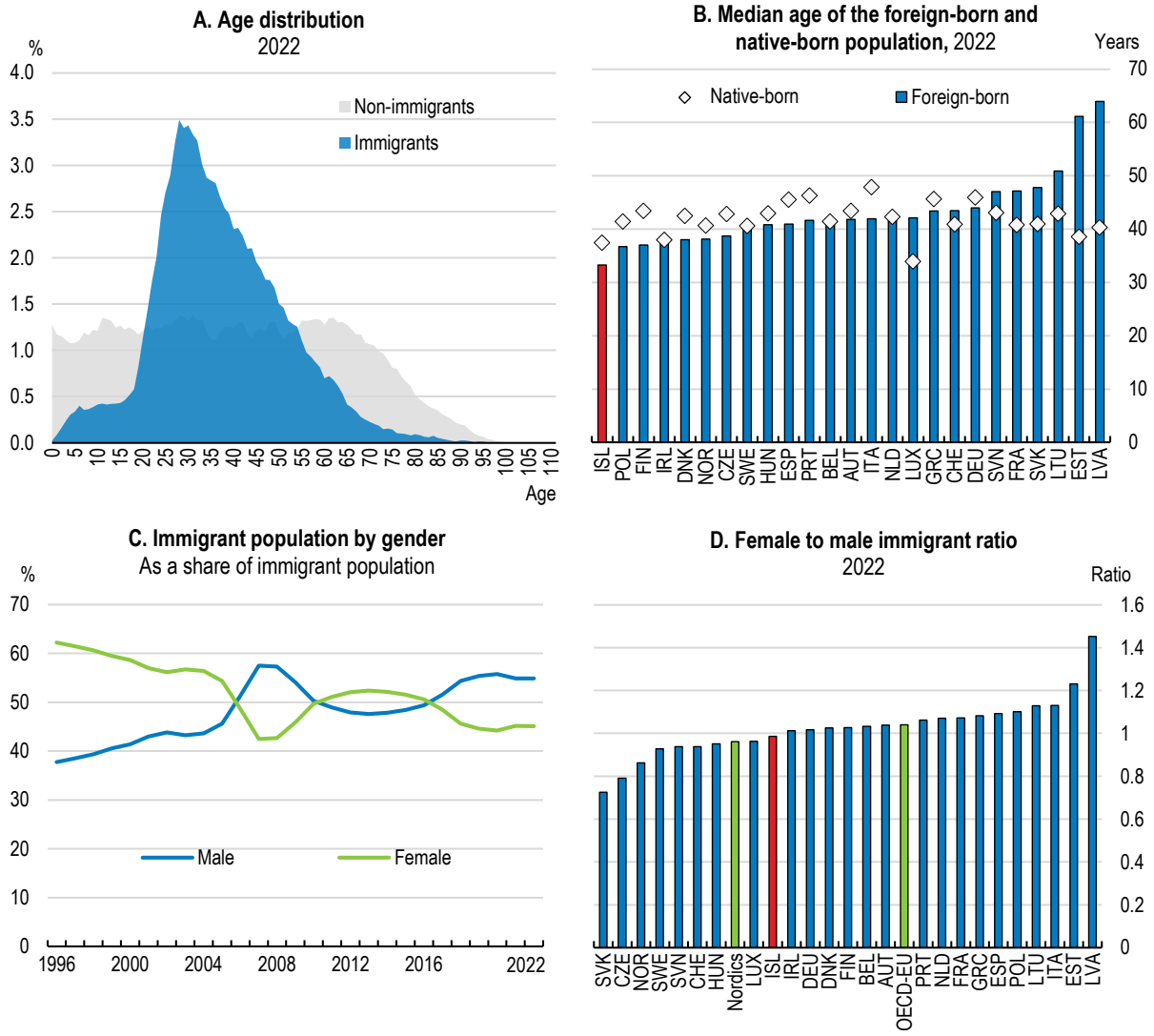
Immigrants are predominately young, with almost equal shares of men and women. The age distribution of the immigrant population is centred around younger groups within the working age population compared to a relatively flat distribution in the case of natives. The median age of the foreign-born population is the lowest in the EU area (Figure 2.7). Immigrants of prime age (25-54 years), with large work potential,

accounted for over 70% of their population in 2022, against around 40% for natives. There were more women than men in the immigrant population until 2005, but the pattern has become more balanced since, probably reflecting an increase in jobs that are traditionally occupied by men (Statistics Norway, 2022[5]). In 2022, the female-to-male immigrant ratio was on par with the average of the other Nordic countries.

Figure 2.7. Immigrants are mainly young, with a balanced gender distribution



Note: In Panel A, population data are as of 1 January 2022. According to Statistics Iceland, an immigrant is defined as an individual who was born abroad, with both parents and both grandparents born abroad. Otherwise, a person is referred as native. In Panel B, data refer to population as of 1 January 2022 for all countries. Median values were imputed based on Eurostat age-distribution interval data. In Panel C, Statistics Iceland's definition of an immigrant is used, and data are reported as of 1 January 2022. In Panel D, an immigrant is defined as an individual who was born abroad. Data are reported as of 1 January 2022. Nordic average refers to the simple average for Denmark, Finland, Norway, and Sweden. OECD-EU refers to the simple average of OECD member countries that are EU members.
Source: Statistics Iceland; and Eurostat.

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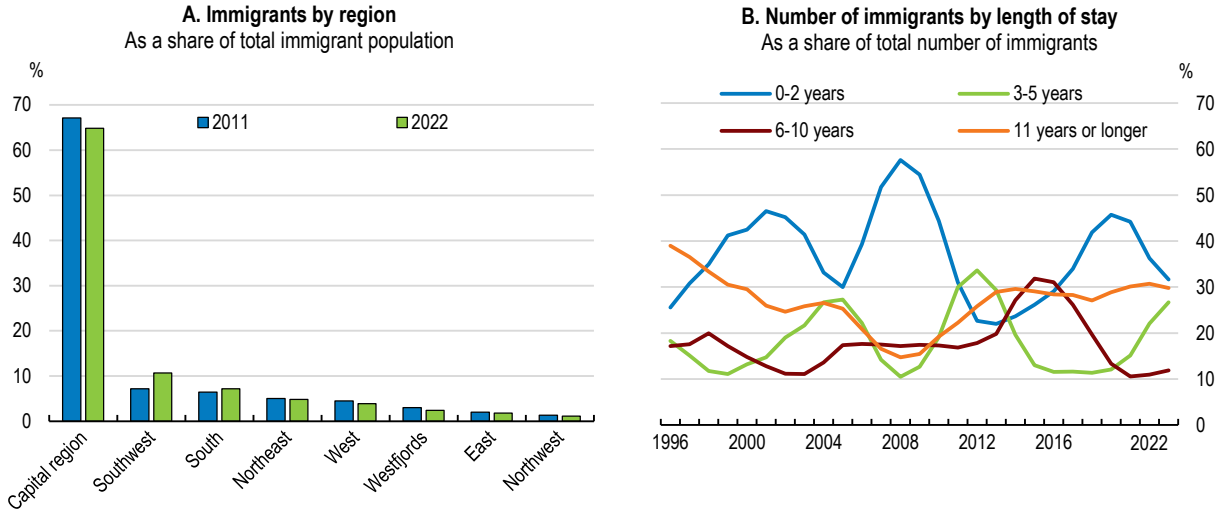
Immigrants are not distributed equally among regions. In 2022, around 65% of the immigrant population were living and worked in the capital area, a pattern that has remained broadly unchanged over time and is in line with that of the total population (Figure 2.8). Immigrants tend to concentrate in areas where tourism and construction jobs are available. An increasing share of immigrants has been staying for over five years.

Figure 2.8. Immigrants tend to live in the capital area and more have been staying longer



Note: In Panel A, immigrants include both first and second-generation immigrants. In Panel B, an immigrant is defined as an individual who was born abroad, with both parents and both grandparents born abroad. Data are reported as of 1 January 2022.
Source: Statistics Iceland; and Nordic Statistics database.

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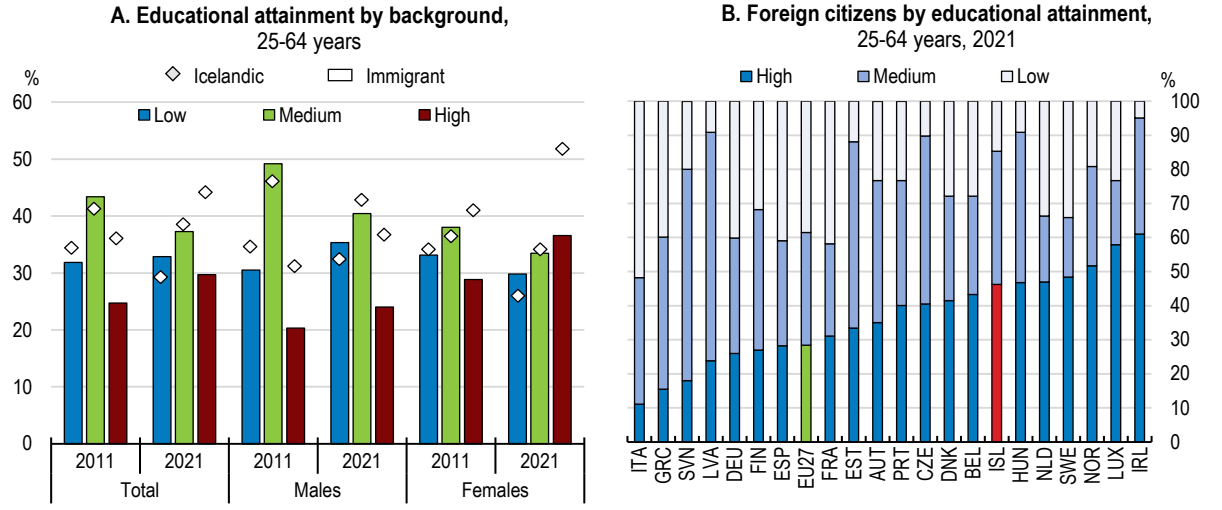
Moreover, immigrants are on average less educated than natives. The share of immigrants with tertiary education has increased over time but remains lower than that of natives, with the difference between the two groups having increased (Figure 2.9). At the same time, the share of immigrants with a basic level of education remained broadly the same between 2011 and 2021, while it declined by over 6 percentage points in the case of natives. Within the immigrant population, women tend to be better educated than men, an attainment gap that has increased over time. This may reflect the higher concentration of immigrant men in sectors requiring lower skills (see below). By international comparison, Iceland tends to host better educated immigrants than the EU countries on average, although it lags Sweden and Norway.

Figure 2.9. On average, immigrants have lower educational attainment levels than natives



Note: Low educational attainment refers to less than primary, and lower secondary education (ISCED levels 0-2), medium educational attainment refers to upper secondary and post-secondary non-tertiary education (ISCED levels 3 and 4), and high educational attainment refers to tertiary education (ISCED levels 5 and 8). In Panel A, low, medium, and high educational attainment shares may not add up to 100% due to rounding errors and omission of a "not specified" category.

Source: Statistics Iceland; and Eurostat.

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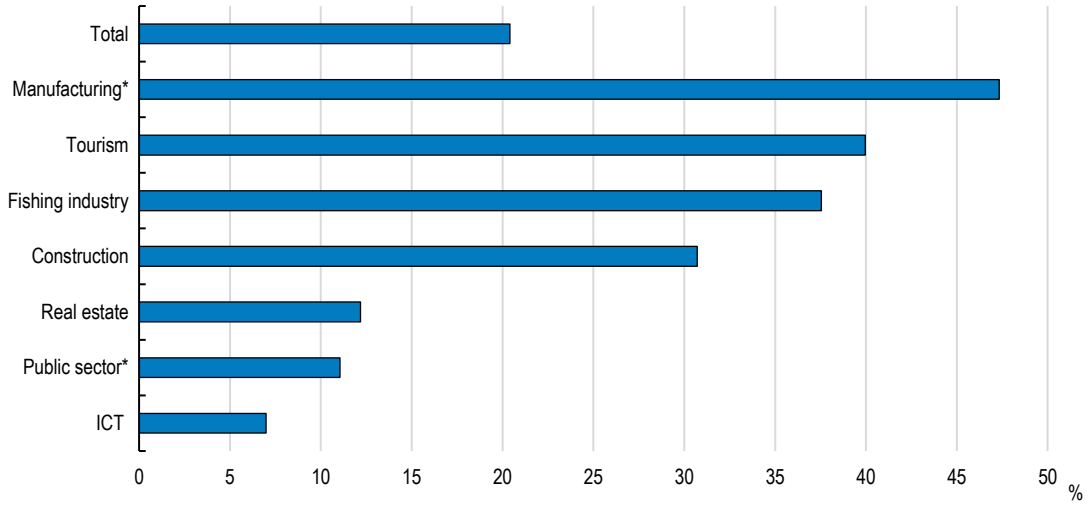
Immigrant workers are over-represented in low-skill, labour-intensive sectors. In 2022, immigrants accounted for over 20% of total employment with important contributions to fast-growing sectors such as tourism, fishing and construction, where they filled between 30% and 40% of the available jobs (Figure 2.10). These sectors are highly volatile. The tourism industry, for instance, was adversely affected by the lockdowns and travel restrictions during the pandemic, fueling large increases in unemployment among immigrants (Government of Iceland, 2022[6]). On the other hand, the share of foreign workers in higher tech activities is low. In the ICT sector, in particular, immigrants accounted for less than 10% of total employment in 2022, but recently-adopted legislation should facilitate the recruitment of foreign experts (see below).

Figure 2.10. Immigrants are concentrated in low-skill sectors

Share of immigrants in employment by economic sector of activity, 2022



Note: In Panel A, an immigrant is defined as an individual born abroad, with both parents and both grandparents born abroad. Manufacturing here refers to manufacturing of food, beverage and tobacco and include NACE classes C10-12; fishing industries include NACE classes A03 and C102; tourism industries include NACE classes: H491, H4932, H4939, H501, H503, H511, H5223, I551, I552, I553, I561, I563, N771, N7721, N79 and division S9604; and public sector here refers to NACE classes O-Q public administration, education, health, and social activities. Data are sourced from Labour Force Register.
Source: Statistics Iceland.

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2.3. Immigration policy is flexible but there is scope to attract more skilled labour

Immigration policy has been amended in recent years in response to increasing immigration. A new migration law (Act on Foreign Nationals No 80/2016) entered into force in early 2017. The law simplified, among others, the application and approval processes for the issuance of residence permits, required for non-EEA citizens (Greve Harbo, Heleniak and Ström Hildestrand, 2017[7]). It also provided for a wider range of residence permits, with a particular focus on the humanitarian aspects of immigration (Government of Iceland, 2022[8]). However, the governance of immigration and integration issues remained distinct, in legal terms and administrative terms (Box 2.2), which can result in overlapping responsibilities. Planned reforms aim to amend the system of working permits for non-EEA citizens, making it simpler and more efficient (Box 2.2).

Box 2.2. Immigration framework: main features

Responsible government agencies

Immigration and integration issues in Iceland are mainly under the responsibility of two separate ministries. More specifically, issues related to foreign nationals and citizenship affairs (border control, residence permits, international protection and visa) are under the responsibility of the Ministry of Justice, while integration, inclusion and refugee resettlement (once they have been granted international protection or been invited through the UNHCR Resettlement Scheme) are under the responsibility of the Ministry of Social Affairs and Labour.

The Multicultural and Information Centre has played a key role in recent years, along with the municipalities, in providing assistance and counselling to immigrants. A March 2023 law has merged this Centre with the Directorate of Labour with the objective to enhance coordination, efficiency and synergies with regard to issues related to immigration, integration, social inclusion and refugee resettlement.

The Immigration Council is an intergovernmental body that advises the Minister of Social Policy and Labour on policy, implementation and monitoring of the Immigration Policy and promotes collaboration and coordination between the ministries, local authorities and other relevant stakeholders

Framework for labour immigration: issuance of temporary work permits for non-EEA nationals

While nationals from a European Economic Area (EEA) country do not need a permit to work in Iceland, non-EEA nationals are required under existing legislation (Foreign Nationals' Right to Work Act No. 97/2002) to have a work permit prior to arrival in Iceland, which is usually a pre-condition to be granted a residence permit. Employers must submit an application for a work permit to the Directorate of Immigration. The Directorate of Labour decides whether to approve or reject the application.

There are seven categories of temporary work permits. These can be grouped into permits granted to individuals on the grounds of labour market needs and permits that accompany the individual's residence permit. The first group includes permits that are obtained for jobs that require specific expertise (Article 8), due to labour market shortage (Article 9), service provision from a foreign provider (Article 15), and permits granted to foreign athletes and coaches (Article 10). The second group consists of work permits for students (Article 13), on the grounds of family reunification (Article 12), and due to special circumstances (Article 11), such as residence permits on humanitarian grounds.

There are several conditions for the granting of temporary work permits. These include the fulfilment of a labour market test in the case of permits granted on the grounds of labour market shortages, when this is deemed necessary by the Directorate of Labour on the basis of labour market evaluation. In cases where a labour market test is deemed to be necessary, the employer is requested to advertise the job via the EURES job search portal, which enables the Directorate to gather information on the supply of labour domestically and within the EEA.

For all categories of temporary work permits (apart from the ones for service contracts) applicants must obtain the opinion of the relevant labour union. The union provides guidance when the employment contract does not meet the minimum requirements of the relevant collective bargaining agreements and relevant labour legislation. In addition, the employment contract must be signed between the foreign national and employer

A recent draft bill proposes changes in the system of working permits for non-EEA citizens to make it simpler and more efficient. The envisaged amendments include an extension of the duration of temporary permits for foreign experts from two years under current legislation to four years. In addition, spouses of experts will no longer need a work permit to enter the labour market. The daft bill further

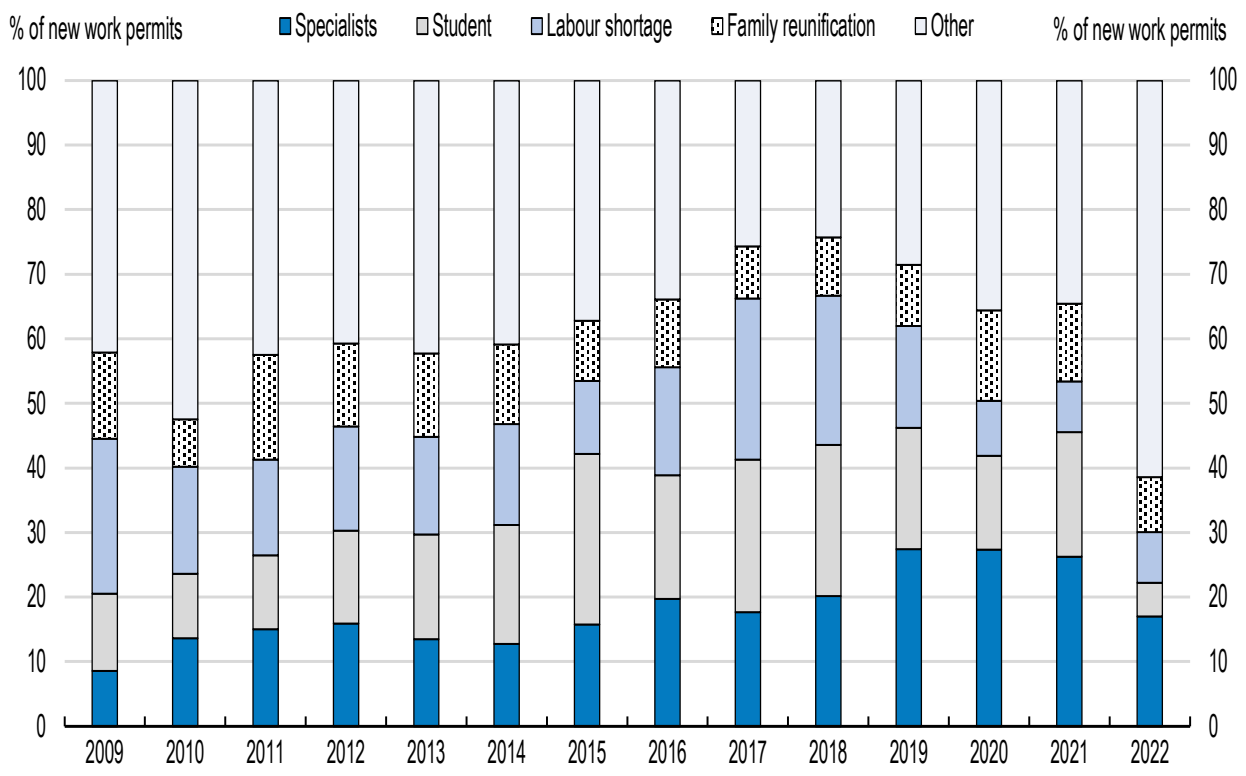
proposes to allow foreign students to stay in the country after their graduation from Icelandic universities for up to three years, as against six months currently. They will be able to work part time (up to 60%) and bring their families while studying.

Source: Directorate of Labour; (Government of Iceland, 2022[8]); (Greve Harbo, Heleniak and Ström Hildestrand, 2017[7]).

Increased immigration flows since the turn of the century appear to have been handled flexibly, providing Iceland ample scope for meeting seasonal and cyclical variations in labour demand. There are no restrictions for citizens from EEA countries, who account for the vast majority of immigrants, to enter the Icelandic labour market, but the law requires a temporary work permit for third-country nationals. There are several conditions for the granting of such temporary work permits for non-EEA nationals, including a labour market test (Box 2.2). However, tight labour markets might have effectively reduced the impact of labour market tests and other legislative requirements for non-EEA workers. Official estimates indicate high approval rates for all types of temporary work permits for third country workers, with the average approval rate exceeding 90% over the past ten years. The share of temporary work permits for foreign specialists in issuances has increased considerably since 2009 (Figure 2.11)

Figure 2.11. The issuance of temporary work permits has increased in recent years

Types of new work permits, as a share of total new work permits



Source: Directorate of Labour.

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Flexibility is important in view of skills shortages, so that workers from third countries can help meet demand and supplement the labour resources provided by EU/EEA immigrants. However, the skill mix can be strengthened by attracting more foreign specialists in view of shortages in frontier sectors, notably ICT. The government provides tax incentives on a case by case basis to foreign and Icelandic immigrated specialists in the form of a 25% income tax reduction for the first three years of employment of such workers, subject to certain conditions, but the system lacks transparency. Preferential tax schemes for foreign workers have become increasingly common in OECD countries, although their design differs (OECD, 2011[9]; Timm, Giuliodori and Mulle, 2022[10]; OECD, 2023[11]). However, research on the effectiveness of such schemes in terms of migration response and their economic impact is limited, making it difficult to derive clear conclusions. Focusing on the tax incentives for highly skilled migrants in the Netherlands, a recent study infers that the preferential tax scheme was effective in attracting more skilled immigrants (Timm, Giuliodori and Mulle, 2022[10]). Increased transparency and predictability of the application process and eligibility rules in the context of a major reform of the scheme in 2012 appear to have played a crucial role in this respect.

A new law facilitates the issuance of work permits for foreign specialists. An important change, in this regard, is that the proposed provisions do not condition the issuance of work permits on specific educational qualifications but rather on specialised knowledge that is in short supply in the country. It is also proposed that the government publishes a shortage occupation list for jobs requiring specialised knowledge, which would be updated regularly. The reform goes in the right direction. Implementation will help Iceland to reduce labour shortages in frontier sectors, notably ICT. A swift adoption of the draft bill proposing an extension of the duration of residence and work permits for foreign experts from two to four years (Box 2.2) is also of high importance in attracting foreign experts. At the same time, the effectiveness of the tax incentive scheme needs to be regularly monitored and assessed. Fast-track procedures for skill certification would accelerate the entry of skilled immigrants into shortage occupations (see below).

Proposed legislative changes aim to further increase the attractiveness of studying in Iceland including by allowing foreign students to stay in the country for up to three years after graduation, as against six months currently (Box 2.2). This is an important step towards facilitating the labour market integration of non-EEA students and promoting knowledge transfer. Over 15% of all students at Icelandic universities are of a foreign origin with the majority coming from third countries. The government should consider, in this context, introducing university fees for students from outside the EEA, as all the other Nordic countries have done.

2.4. The economic impact of immigration is closely related to integration

2.4.1. The impact of immigration on GDP per capita

Immigration plays an important economic role. It impacts GDP per capita by affecting demographic trends and changing the age structure of the population as, on average, immigrants are younger than natives, and through its impact on labour productivity when there are complementarities between the skills of immigrant and native workers. Immigrants arrive with skills and abilities that can supplement the human capital of the host country, contributing to innovation and productivity growth. Indeed, empirical research shows that immigration can affect human capital in the host country directly, if foreign nationals have high educational attainment, or indirectly by incentivising natives to invest in education (Portes, 2018[12]). Cross-country evidence suggests that immigration is likely to have a positive impact on GDP per capita, including in the case of Iceland, especially in the longer term, although the findings do not capture the changes in the composition of Iceland's immigrant population observed in recent years (Box 2.3).

Box 2.3. Empirical evidence on the growth effects of immigration

Empirical research on the impact of immigration on the economy focuses on productivity and GDP per capita. The main findings of some comparative studies are as follows:

(Boubtane, Dumont and Rault, 2016[2]) estimate the impact of migration on economic growth for 22 OECD countries over the period 1986 to 2006, taking into account the skill composition of foreign immigrants. They report a positive relationship between migrants' human capital and GDP per capita, with the estimated magnitude varying widely across countries. For Iceland, in the short run, an increase of 50% in the net migration rate of foreign-born migrants boosts economy-wide productivity by six-tenths of a percentage-point per year, with a long-run effect at 4.4% per year. In both cases, the estimated impact is over twice the average of the OECD countries considered by the analysis.

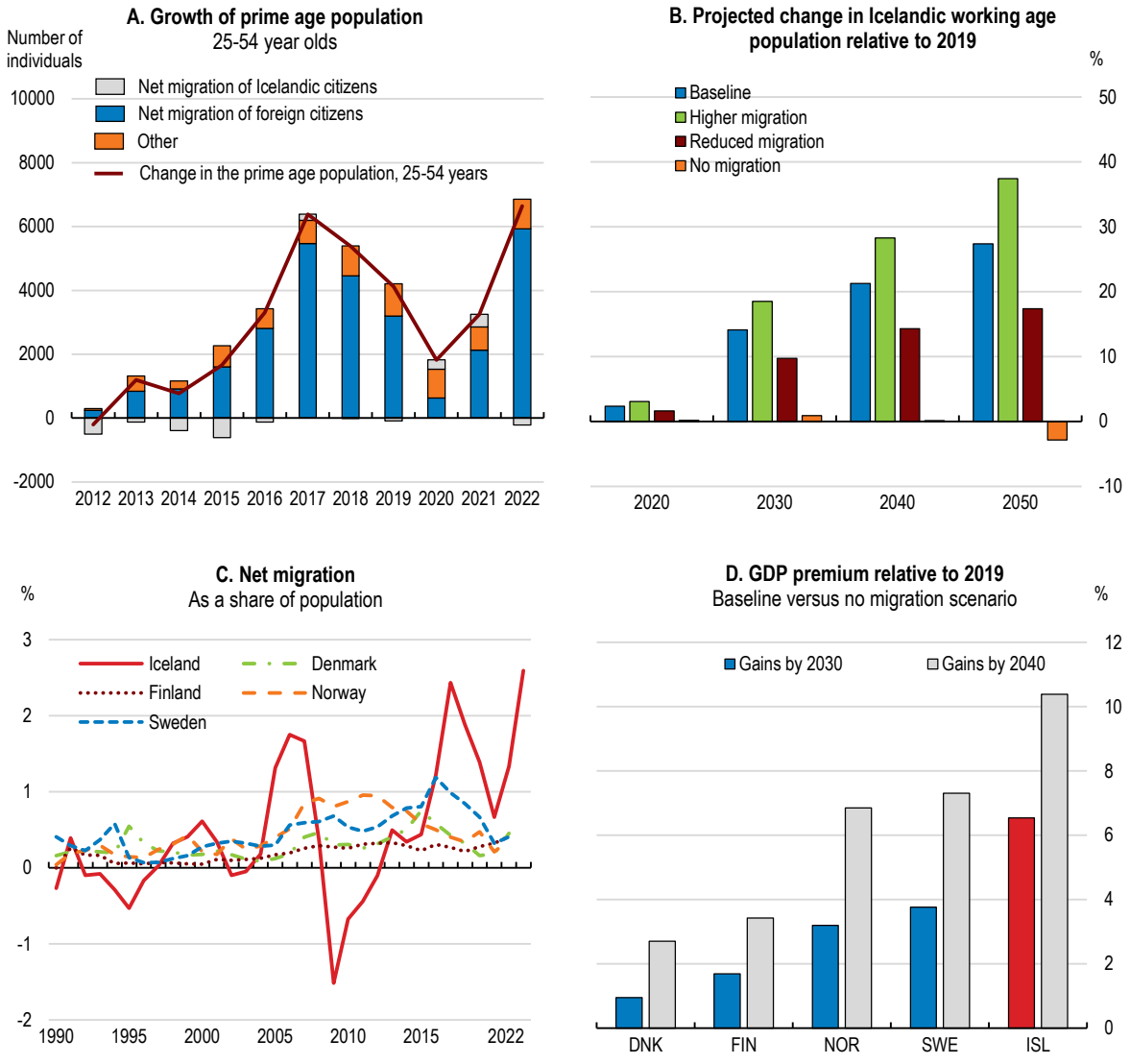
Other studies also show that immigration has a beneficial effect on economic growth in the longer term. Research by (Brunow, Nijkamp and Poot, 2015[13]), for instance, covering 36 rich countries with high immigration rates, concludes that net migration has a positive effect on GDP per capita with a lag of two decades. Exploring the longer-term impact of migration for 18 advanced countries, (Jaumotte, Koloskova and Saxena, 2016[14]) find that immigration boosts GDP per capita in host countries, operating mainly through labour productivity, with a 1% increase in the migrant share of the adult population raising GDP per capita by approximately 2% in the long run. When looking at the impact of migrants by skill level, the study concludes that both high- and low-skilled immigrants contribute to productivity, in part due to complementarity effect. The dividends from immigration appear to be broadly shared, according to the authors.

A recent study by (d'Albis, Boubtane and Coulibaly, 2019[15]) assesses the dynamic effects of an exogenous migration shock on the economy and the public finances. The results of a panel analysis of 19 OECD countries over the period 1980-2015 show that a migration shock that increases the net flow of migrants by one incoming individual per thousand inhabitants raises GDP per capita by boosting both labour supply and employment. According to these estimates, the impact on GDP per capita is 0.25% in the year of the shock and peaks at 0.31% the year after.

2.4.2. Labour market impacts

Increased inflows of immigrants has yielded important demographic benefits to Iceland, with foreign citizens contributing largely to growth in prime age population (Figure 2.12, Panel A), while helping to address the adverse impact of population ageing. This is particularly important in the fast-growing sectors of the economy. Without continued net migration, Iceland's working age population would shrink by a cumulative 5% by 2050 (Figure 2.12, Panel B), according to OECD calculations, with clear benefits, on the other hand, from higher immigration in the years to come. Simple scenario analysis suggests significant output gains from net migration in the long run: real GDP for Iceland would be about 6.5% higher by 2030 and 10.4% by 2040 compared to a scenario with no further net immigration (Figure 2.12, Panel D). The effect is higher for Iceland than for the Nordic peers, given the current high net immigration relative to its population.

Figure 2.12. Immigration yields large demographic benefits



Note: In Panel A, net migration of foreign and Icelandic citizens refers to the age group 25-54, corresponding to the change in prime age population. The 'other' category refers to citizens not covered by the definition in Panel A, such as individuals that became adults in reference year. In Panel B, population projections illustrate hypothetical developments of the population size and its structure at a national level based on assumptions explained below. 'Baseline' scenario corresponds to keeping current demographic trends and net migration at 2019 levels. 'Higher' ('reduced') migration scenario corresponds to 33% higher (lower) than in the baseline net migration assumptions per each year. In the 'no migration scenario' net migration is set to zero. In Panel C, migration flows include both citizens and non-citizens of respective countries that obtain a residence permit or a work permit for a period exceeding three months and are settling in the destination country. In Panel D, calculations estimate the effect of expanded labour supply on GDP based on 'baseline' and 'no migration' scenarios presented in Panel B.
Source: Statistics Iceland; Eurostat, Population Projections; Nordic Statistics Database; and OECD, National Accounts database.

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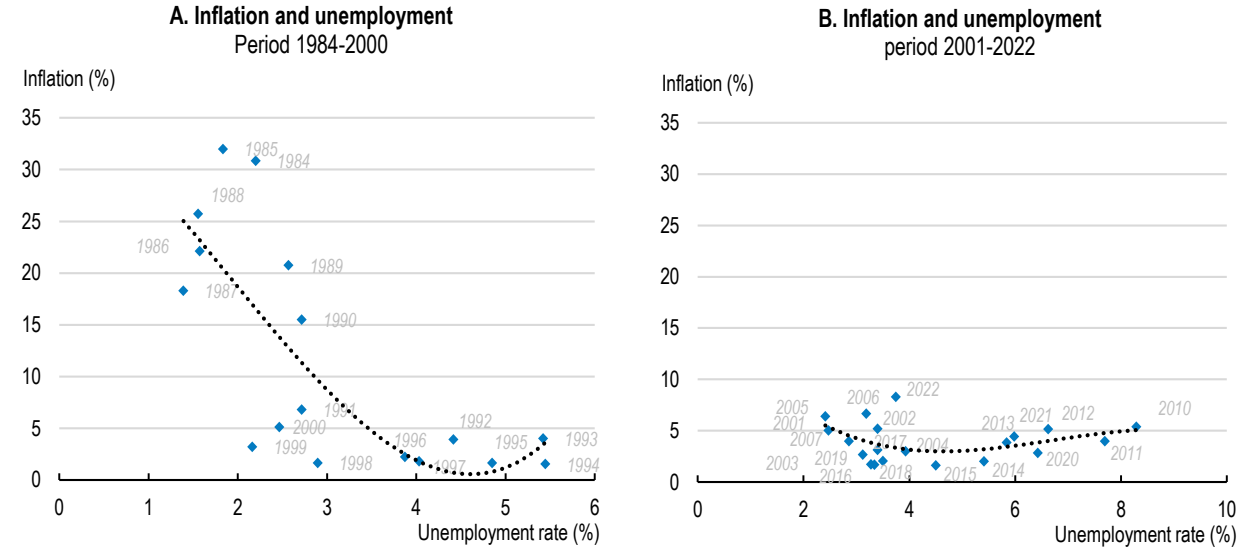
Immigration has also added to the flexibility of the Icelandic labour market in view of the close relation between migration inflows and the business cycle since the turn of the century (Figure 2.4). The adjustment of the labour market during the years of the financial crisis provides some supportive evidence in this regard. Many of the foreign workers that entered Iceland in the early 2000s left the country in the wake of the crisis, contributing to proportionally greater net emigration than in previous contractions. This likely caused the unemployment rate to rise less than would have been the case without labour migration (Central Bank of Iceland, 2011[16]; Jauer et al., 2014[17]).

There is also evidence that, in some countries, immigration has contributed to weakening the response of inflation to economic activity. For instance, empirical evidence for Spain (Bentolila, Dolado and Jimeno, 2007[18]) and Sweden (IMF, 2015[19]) provides support in this regard. In Iceland too, the Phillips curve appears to have flattened since the late 1990s, maybe in part due to the increase in migrant inflows (Figure 2.13). Immigration may weaken the unemployment-inflation trade-off in the host country by increasing the elasticity of labour supply, which in turn has a dampening effect on wage growth (Razin and Binyamini, 2007[20]), or other channels, such as reducing the natural rate of unemployment through lower labour market mismatches (IMF, 2015[19]). Studies employing a microfounded Phillips curve further stress other labour-market channels through which immigration can affect inflation dynamics. According to the findings, increases in immigration can lower the expected marginal costs of production, leading to lower inflation for a given unemployment rate than in the absence of foreign workers (Dolado, Jimeno and Bentolila, 2008[21]). Unlike conventional models that treat labour as a homogeneous input, these studies assume some differences between immigrants and natives in terms of the determination of their wages and marginal rate of substitution between consumption and leisure (Bentolila, Dolado and Jimeno, 2007[18]).

Figure 2.13. The Phillips curve has flattened



Note: Due to being outliers, years 2008 and 2009 were excluded.
Source: OECD, Analytical database.

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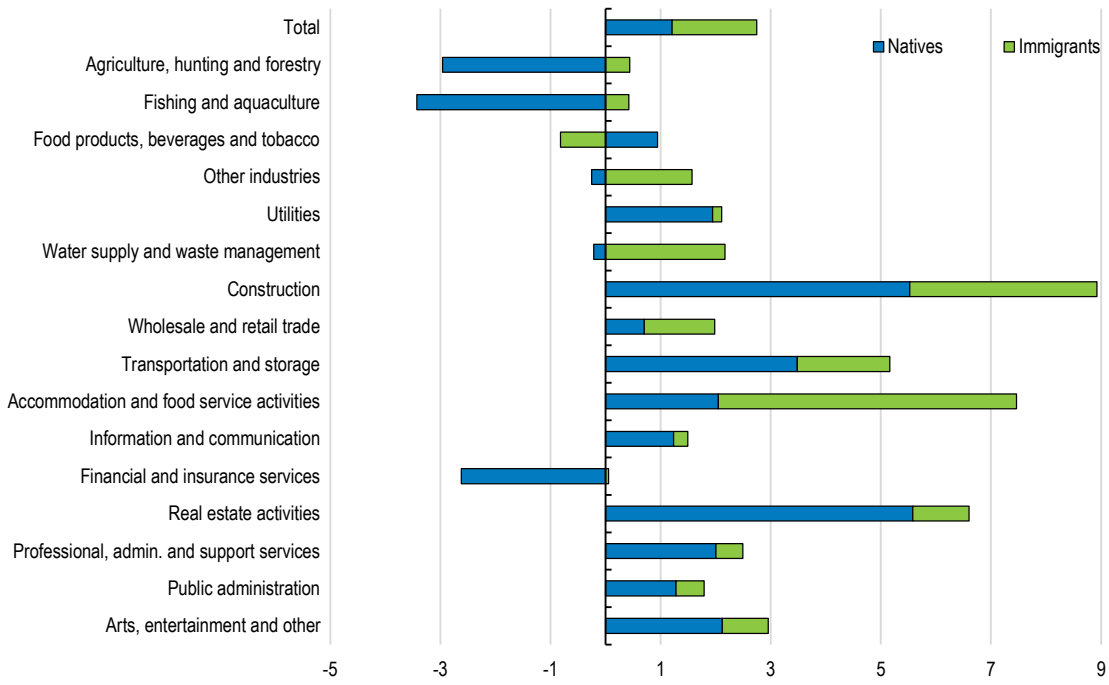
The impact of immigration on wages and employment in the native population is prominent in the public debate. Most studies nevertheless point to a very small impact, reflecting to a large extent skill complementarities between native and immigrant workers (Edo et al., 2020[22]; IMF, 2020[23]). However, the impact is not evenly distributed. A review of 12 studies (conducted between 2003 and 2008) for the United Kingdom, suggests that immigration has a negative impact among certain groups, notably those with lower levels of education (Ruhs and Vargas-Silva, 2020[24]). IMF research covering 22 OECD countries over the period 1995-2012 further infers that the adverse impact is felt most strongly in the young and low-skilled segments of the labour market (IMF, 2015[19]). Overall, a rise in migration results in a larger increase in unemployment for foreign-born than native workers, according to the study. Also, research on the wage effects of immigration provides little evidence that this lowers the wages of less educated native workers (Peri, 2014[25]). Nevertheless, new immigrants tend to compete more with earlier immigrants than native workers, thereby exerting a negative and slighter larger adverse impact on the wages of the former group.

There are no specific studies analysing the impact of immigration on average wages and employment of native workers in Iceland. However, tight labour market conditions could be expected to alleviate potentially negative impacts of immigration on the employment of native workers. Moreover, as immigrant workers tend to be concentrated in low-skilled jobs, it is likely that natives move to higher-skilled jobs requiring linguistic proficiency that immigrants often lack. There are some indications, in this context, of a decline in employment of native workers over the period 2012-19 in agriculture and fishing, whereas in sectors such as real estate, transportation, ICT, as well as construction, probably at higher-skilled jobs, their employment has increased (Figure 2.14). At the same time, Iceland's high degree of unionisation could be expected to limit the potential adverse effects on wages from increased labour supply, while the concentration of immigrants in specific sectors keep wages in such sectors stable, containing distributional consequences.

Figure 2.14. Changes in employment suggest sectoral shifts among native workers

Average annual growth in employment by sector of activity and background between 2012 and 2019



Note: According to Statistics Iceland, an immigrant refers to a person born abroad, with both parents and both grandparents born abroad. Otherwise, a person is referred to as a native. Labour data are sourced from Labour Registry.
Source: Statistics Iceland.

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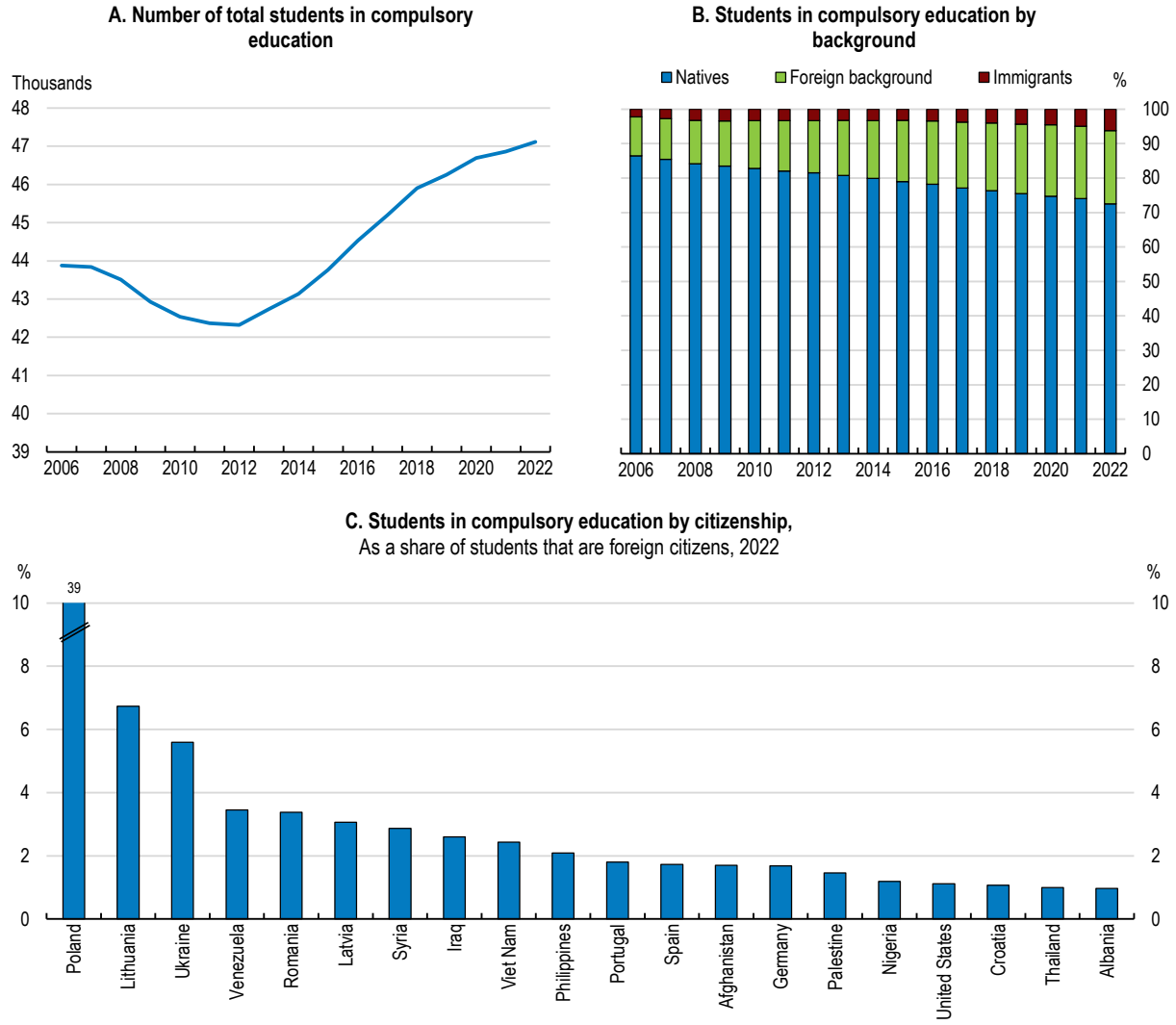
2.4.3. The impact of immigration on education

The population in compulsory education has increased steadily over the past decade driven by a rise in the share of foreign students (Figure 2.15). Immigrant students, in particular, accounted for a bit over 6% of student population in compulsory schools in 2022, three times the corresponding share in 2006. Students from Poland accounted for the largest share of foreign students, mirroring the composition of immigration.

Figure 2.15. An increasing share of students has a foreign background



Note: In Panel B, natives refer to persons with no foreign background, immigrants refer to persons born abroad, with both parents and all grandparents born abroad. Foreign background refers to individuals who are not classified as natives or immigrants.
Source: Statistics Iceland.

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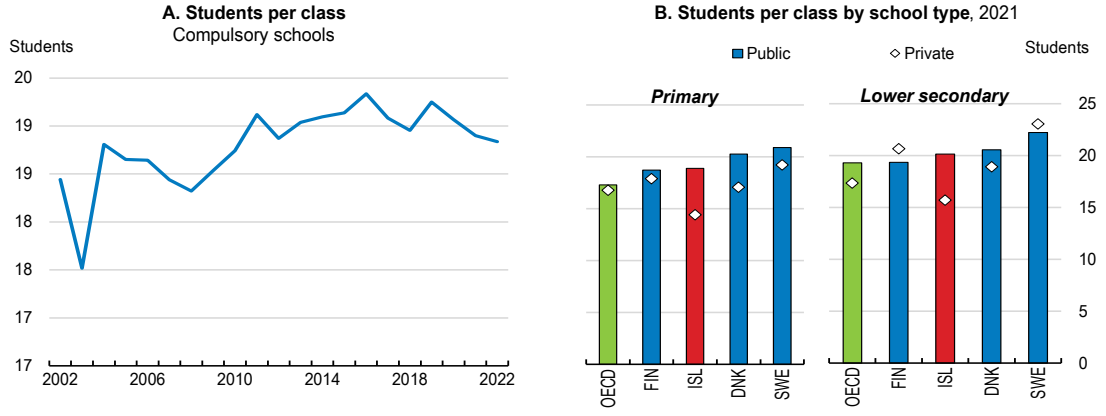
Increasing immigration can impact the education system in various ways, including by creating additional demand for places, posing a risk of overcrowded classes, and also through additional demand for resources in view of the diverse educational needs of students. The poor educational performance of immigrant students (discussed below) also raises qualitative challenges for schools.

School overcrowding does not appear to be a source of concern. While the student population in compulsory education increased steadily over the past decade, the number of students per class remained, on average, broadly unchanged (Figure 2.16). International comparisons further suggest that Iceland ranks close to the OECD in this indicator both in primary and lower secondary education, with a small difference between the two levels. The average figures, however, mask variations among regions, as the problem may arise more in the areas receiving higher proportions of immigrants. In addition, Iceland exceeds the OECD average in terms of the gap in average class size between public and private institutions. The large majority of students in the country attend public schools.

Figure 2.16. The average class size remains relatively small



Note: In Panel A, students in special education schools and special education classes are excluded. Students in multi-grade classes are included. For 2004-06, students in Kárahnjúkaskóli are excluded.
Source: Statistics Iceland; and OECD, Education at a Glance.

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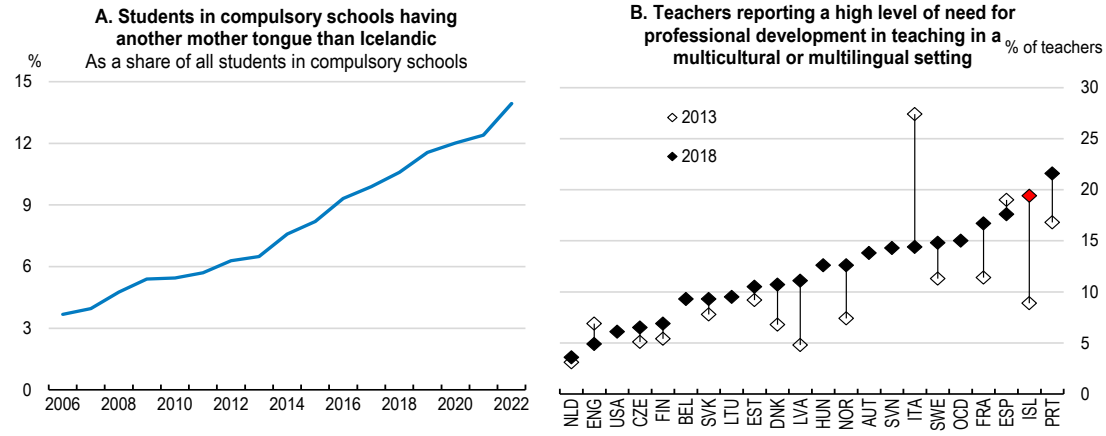
Immigrant students often require higher per-capita educational expenditure, especially upon arrival in the host country, placing additional demands for resources on schools (OECD, 2016[26]). An important component of such costs regards the additional language needs of foreign students. The share of students in compulsory education with a foreign mother tongue has increased steadily since 2006 (Figure 2.17, Panel A). Around 7% of students in compulsory education were receiving support for learning Icelandic in 2020-21, according to national data, compared to merely 3.5% a decade before, and increasing immigration will most likely raise budgetary cost further. The government provides financial assistance to municipalities to meet expenses for special needs and Icelandic lessons for immigrant children. A larger population of students with diverse needs also requires additional resources for in-service training and support for teachers to work effectively with immigrant students. The share of teachers working in multicultural or multilingual settings (including with refugee children) and reporting high needs for professional development has increased in recent years. In 2018, it was among the highest in OECD, according to the latest findings from TALIS (Teaching and Learning International Survey) (Figure 2.17, Panel B). The challenges can be larger in small rural communities where access to qualified teaching staff is more limited.

Figure 2.17. Immigration can create additional demand for educational resources



Note: In Panel A, mother tongue is defined as the language the child learns first, uses most fluently and is spoken at home, sometimes only by one parent.
Source: Statistics Iceland; and OECD, Teaching and Learning International Survey (TALIS) database.

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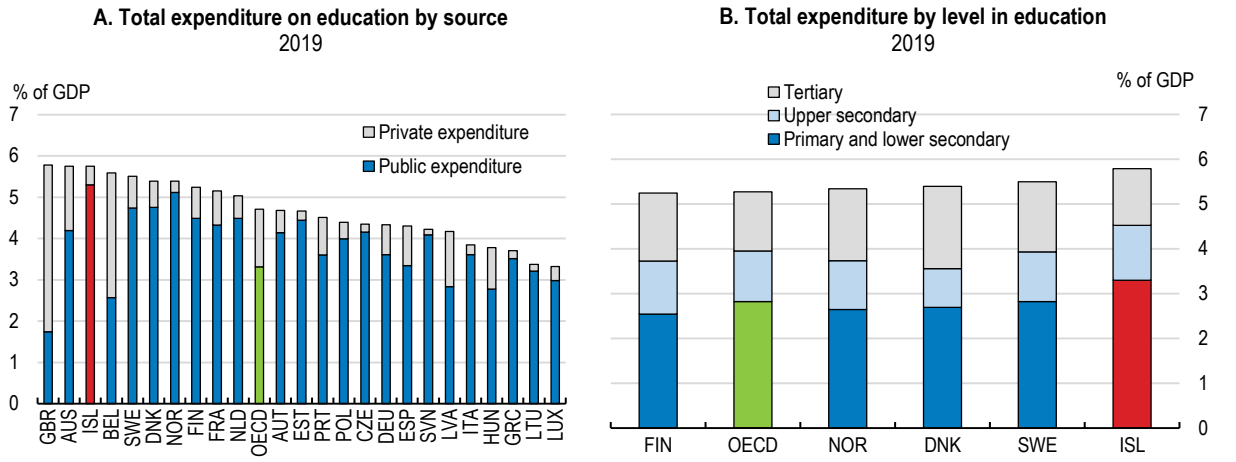
There are no available estimates of the overall school expenditure allocated to immigrant students in Iceland. International comparison of total education expenditure reveals, however, that Iceland spends 0.8% of GDP more on education than the average OECD country, with the difference mainly reflecting high expenditure on compulsory education (primary and lower secondary education), which is almost fully publicly funded (Figure 2.18). This reflects, to a large extent, the "inclusive school" policy, stipulating that all students, irrespective of their special education needs, should have access to regular schooling, an objective that is reinforced by the current education multi-year government strategy (OECD, 2016[27]). The first pillar of the "Education Policy 2030" strategy focuses, in particular, on measures to accommodate multi-cultural school populations and differentiate teaching and support (OECD, 2021[28]) (see below). For the implementation of the strategy, additional government funding will be required to ensure that schools and teaching staff can meet the needs of migrant students.

Figure 2.18. Spending on compulsory education is comparatively high



Source: OECD, Education at a Glance; and OECD, National Accounts database.

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Empirical evidence on educational peer effects is mixed. Several studies have looked at the impact of the presence of immigrant students on the school performance of native-born students, or all students. There are concerns, for instance, that teachers in classrooms with a high concentration of immigrant students may be overburdened or need to spend considerably more time on such students, which may lead to negative peer effects (OECD, 2016[26]). Empirical evidence on the topic is mixed (Mezzanotte, 2022[29]). For instance, cross-country analysis by (Seah, 2016[30]) shows a differential impact of immigrant peers across the three countries considered (Austria, Canada and the United States). In particular, exposure to immigrant students has a positive impact on Australian natives, while the impact is negative in the case of Canadian natives. Exposure has no effect on native students in the United States. Institutional factors, such as the organisation of educational systems, play a crucial role in how immigrant students affect their peers. For Iceland, empirical evidence based on immigrant background and the language spoken at home shows a smaller peer effect across primary school classes than the average of the six European countries (France, Germany, Iceland, Netherlands, Norway, and Sweden) considered (Ammermueller and Pischke, 2009[31]), but this evidence dates back to a time when the share of immigrants in the total population was much smaller.

2.4.4. The impact of immigration on the housing market

Immigration affects housing markets by adding not only to demand but also to supply, given the important contribution of immigrants to the construction sector (Figure 2.10). A priori, the increased demand for housing resulting from the arrival of immigrants would be expected to affect the dynamics of house prices and rents, but the magnitude of the impact depends on the elasticity of housing supply, and thereby on the

housing/rent and construction regulations. The less elastic the supply the larger the impact of immigration, at least in the short run. Other parameters also affect house prices. Immigration, for instance, may influence the composition of housing demand, given that immigrants usually opt for inexpensive housing due to their relatively low incomes (Kalantaryan, 2013[32]). Moreover, rising immigration may lead to lower building costs, which increases incentives for the construction of new dwellings, affecting house price developments.

Other factors that go beyond population growth, such as credit conditions and expectations, should also be considered when assessing the impact of immigration on house prices, while at the local level such impact also depends on the mobility response by previous residents to increased immigration, which can attenuate the house price effect (Kalantaryan, 2013[32]; OECD, 2016[26]). At the same time, establishing causality is difficult as newly arrived immigrants tend to locate in regions with good economic prospects and thus likely rising house prices (OECD, 2016[26]). Estimating and predicting the impact of immigration on the dynamics of housing markets is therefore difficult.

Empirical evidence on the impact of immigration on house prices is also mixed. On the one hand, examining the drivers of the housing market boom between 2004 and 2007, (Elíasson, 2017[3]) shows that net immigration of 1% of the population results into a house price rise of between 4% to 6% in Iceland, a stronger impact, according to the author, than the estimated effect derived by studies for other countries, such as Spain. Empirical analysis by (Gonzalez and Ortega, 2013[33]) concluded that immigration in Spain is responsible for an increase in housing prices of about 2% annually. On the other hand, some studies have found that immigration has actually reduced house prices in areas where immigrants settled because of the mobility response of the native population (Cochrane and Poot, 2019[34]; Sá, 2015[35]). For instance, estimates by (Sá, 2015[35]) for the United Kingdom show that previous inhabitants at the top of the wage distribution leave high immigration areas and move to other regions.

2.4.5. The fiscal impact of immigration

Immigration has both costs and benefits for the budget. Most studies, however, suggest a limited net fiscal impact (Box 2.4). In the case of Iceland, available estimates suggest that immigration may well have a positive net fiscal impact, to the extent that immigrants contribute more in taxes and social contributions than they receive in benefits (Nyman and Ahlskog, 2018[36]; OECD, 2013[37]). The composition of the immigrant population matters (OECD, 2021[38]; OECD, 2013[37]). In countries where recent labour migrants account for a large part of the immigrant population, such as Iceland, immigrants tend to have a more favourable fiscal impact than in countries with longstanding immigrant populations, as in the former case immigrants are relatively young, and thereby do not burden pension expenditure. With the increased number of people seeking international protection and refugees, the direct fiscal costs have increased in recent years.

Another key determinant is the employment status of immigrants. While in most countries, governments tend to spend less on immigrants on a per capita basis than on natives, immigrants tend to make lower per capita contributions to public revenues than natives (OECD, 2021[38]). The less favourable contribution reflects the fact that immigrants often have lower employment rates and wages than natives. Reducing the gap in employment rates between immigrants and natives would therefore yield significant fiscal gains. These are estimated for instance at around 0.5% of GDP for Sweden and Denmark, with the yield rising with the level of education (OECD, 2021[38]). There are no specific estimates for Iceland, but overall immigrants already have higher activity rates than in Sweden and Denmark. Even so, improving labour market conditions for highly educated immigrants, including by addressing overqualification (see below), could yield important fiscal gains, especially in view of the favourable demographics of immigrants in the country, with most immigrants being of working age.

Box 2.4. Some international evidence on the fiscal impact of immigration

A number of studies have attempted to estimate the fiscal impact of immigration, using different approaches. Most found a small net fiscal impact.

Cross-country analysis (OECD, 2013[37]), also covering Iceland, for the period before the global financial crisis, estimates that the net fiscal contribution of immigrants is close to zero, on average, rarely deviating in one or the other direction by more than 0.5% of GDP. For Iceland, the study finds a high positive net fiscal contribution of around 1% of GDP, above the OECD average. A more recent OECD study (not covering Iceland) for the period 2006-18, also finds a persistently small total net fiscal contribution over the period, ranging between minus and plus 1% of GDP for most countries considered (OECD, 2021[38]). The study concludes that government expenditure on the foreign-born is 12% lower than on native-born on average across countries, whereas immigrants contribute, on average, 11% per capita less than the native-born.

A study by (Nyman and Ahlskog, 2018[36]), also covering Iceland, focuses on the fiscal effects of intra-EEA migration. It infers that most EEA countries (21 out of 29) saw a positive fiscal impact from intra-European migration. The net fiscal impact in almost all countries was relatively small, between plus and minus 0.4% of GDP. The study concluded that the total net impact for Iceland was not significantly different from zero.

Assessing the dynamic effects of an exogenous migration shock on a panel of 19 OECD countries for the period 1980-2015 (d'Albis, Boubtane and Coulibaly, 2019[15]) find that increased migration improves the fiscal balance, through its positive effect on GDP per capita (see above) and through a decrease in per capita net transfers from the government and per capita old-age public spending.

Using the tax-benefit microsimulation model of the European Union (EUROMOD), (Christl et al., 2021[39]) find that immigrants had a more positive net fiscal contribution in 2015 than the native-born. However, estimates for the net fiscal impact over the life cycle indicate a larger net fiscal impact for natives than migrants, especially in the case of extra-EU migrants, even though the results vary considerably across EU member states.

An OECD review of recent country studies for EU members shows that the overall fiscal impact is small, with the findings further revealing a lower fiscal contribution for the non-EU immigrants compared to their counterparts from the EU group probably due to lower employment rates for the former group (OECD, 2021[38]). In France, evidence for the period 1979-2011 suggests that the net contribution of EU immigrants declined over the period, as a result of the ageing of immigrant population.

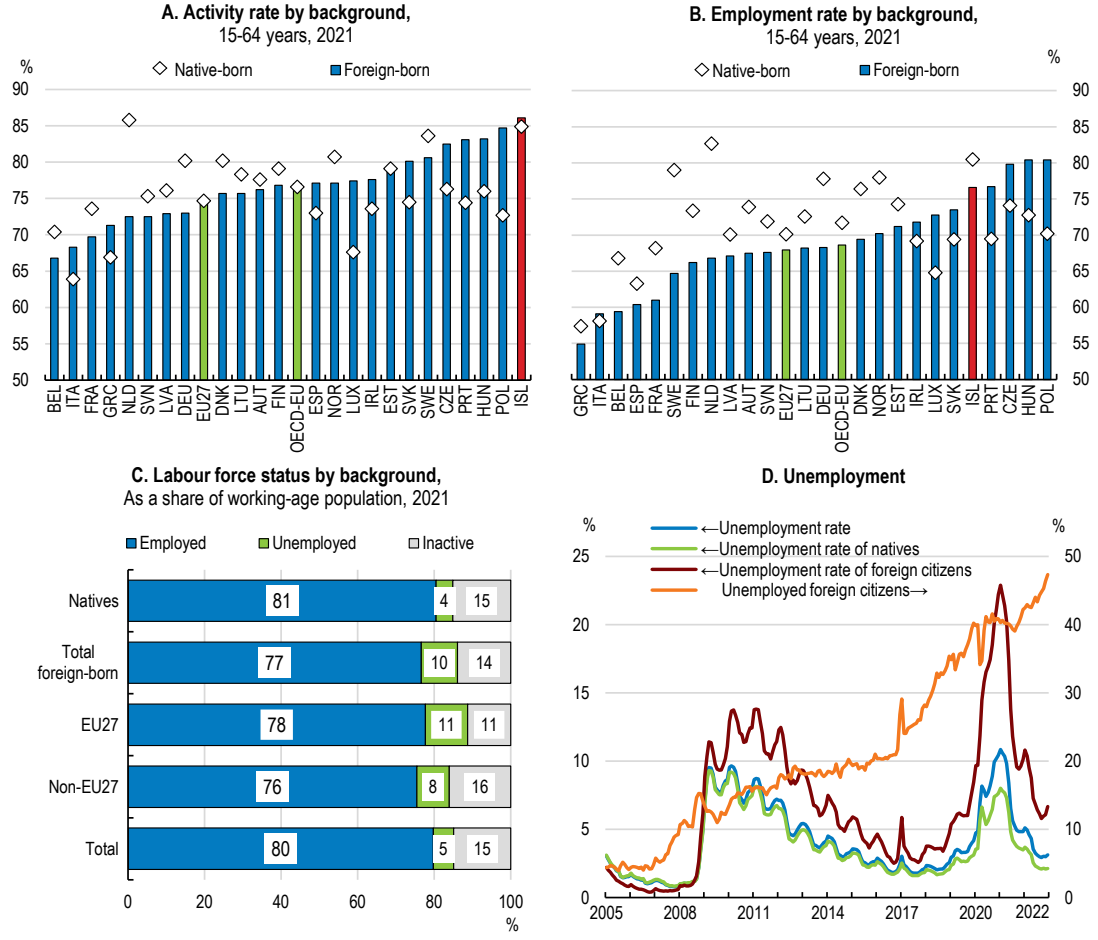
The broader economic consequences of immigration and its fiscal impact depend critically on the integration of immigrants. Appropriate policies that facilitate labour market integration of immigrants and improve the educational outcomes of their children, as well as the provision of adequate social and affordable housing, are of key importance as they largely condition other aspects of integration, shaping the economic role of immigration and helping to harness the potential benefits. Such areas also receive particular attention in the government's four-year Action Policy Plan on Immigration Issues, covering the period 2022-25, with an overall objective to ensure equal opportunities and promote active participation in the labour market and society regardless of origin (Government of Iceland, 2022[6]). Ensuring successful integration, inclusion and social cohesion requires coordinated efforts by all stakeholders namely the government, municipalities and employers.

2.5. Improving the labour market integration of immigrants

2.5.1. On average, immigrants have worse labour market outcomes than natives

The participation rate of the foreign-born population is the highest among OECD countries and somewhat above the corresponding rate for the native-born (Figure 2.19). Moreover, Iceland has the narrowest employment gap between natives and foreign-born nationals among the Nordic countries, with relatively small differences in employment status between EU and non-EU nationals. Nonetheless, foreign-born workers face much higher unemployment than natives. The share of foreign-born nationals in registered unemployment has increased steadily since the mid-2000s, reaching 50% in 2022. Disaggregated data suggest that the unemployment gap between foreign-born and native-born persists across different age groups, although the foreign-born in Iceland, especially in the case of youth, have lower unemployment rates than their EU counterparts on average (Figure 2.20).

Figure 2.19. The labour market outcomes of immigrants can improve in some respects



Note: In Panel A, activity rate is calculated as economically active (employed and unemployed) working age (15-64) population divided by the total working-age population. In Panel B, employment rate is calculated as working age (15-64) employed population divided by the total working-age population. In Panel C, the rates are defined as the ratio of number of persons aged 15 to 64 under each status to the total population of the same age group. In Panel D, the data are sourced from the Labour Force Register and the unemployment rate corresponds to the share of unemployed in the active population. Unemployed foreign citizens refer to the share of unemployed foreign citizens in total registered unemployment.

Source: Eurostat, Labour Force Survey; and Statistics Iceland, Labour Force Register.

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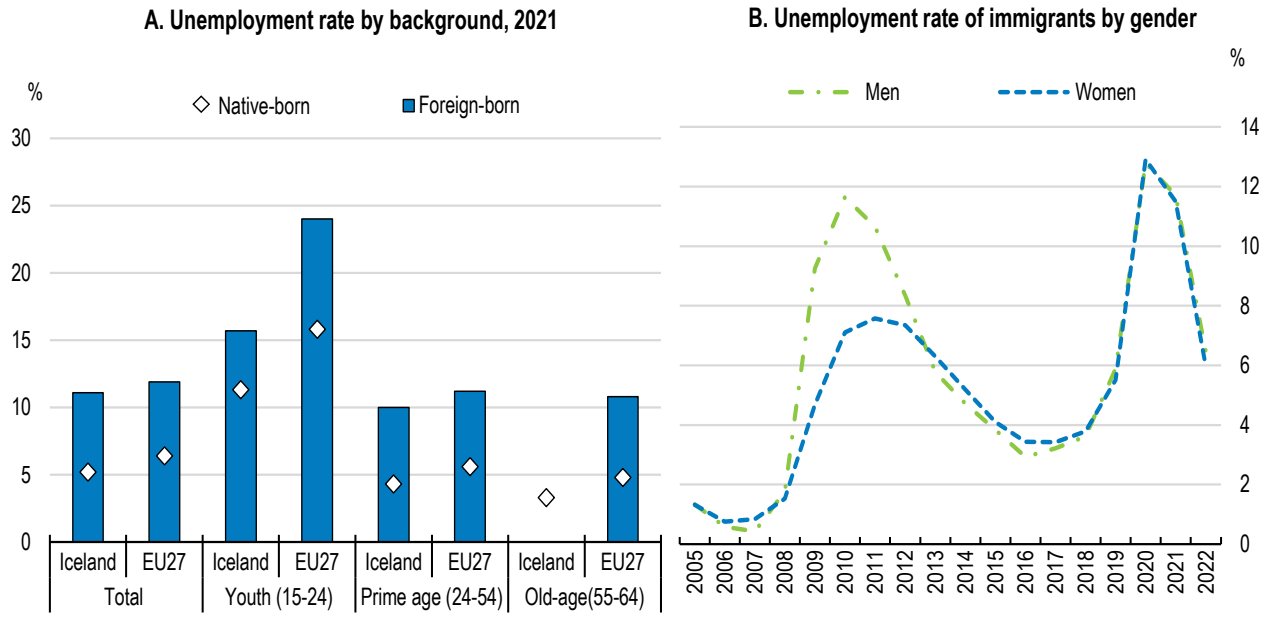
Gender differences in the labour market performance of immigrants, as reflected in the registered unemployment data, are very small, despite the fact that foreign-born women tend to be better educated than foreign-born men (Figure 2.20 and Figure 2.9). This may reflect the fact that women with an immigrant background are less likely to work in low-skilled occupations where is usually an excess demand for labour as they have on average a higher education level than their male counterparts (OECD, 2020[40]). At the same time, it is welcome that immigrants in Iceland have the same access to childcare facilities as the natives, especially as it is likely that women with a foreign background lack support of family networks in the host country.

Figure 2.20. The immigrant-native unemployment gap persists across all age groups



Note: In Panel A, data are sourced from the Labour Force Survey and the unemployment rate is defined as the share of unemployed in economically active (employed and unemployed) working age (15-64) population, unless specified otherwise. In Panel B, unemployment rate is defined as the ratio of registered unemployed immigrants to the working age (15-64) population.
Source : Eurostat, Labour Force Survey; and Labour Force Register.

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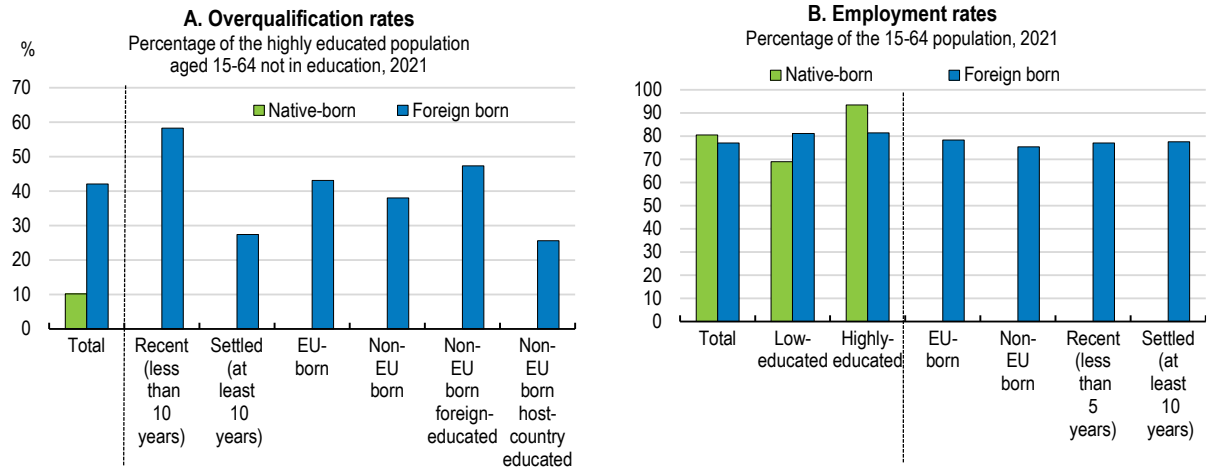
A much larger proportion of immigrants are over-qualified compared to natives, implying that many of these workers do not meet their potential (Figure 2.21, Panel A). In 2021, more than 40% of the highly educated immigrants worked in a job below their formal qualification level, over 30 percentage points above the rate of natives. Over-qualification is particularly widespread among the foreign-born who have more recently settled in the country and non-EU immigrants who are foreign-educated. In addition, while overall employment rates for immigrants and natives do not differ much, the former group underperforms when looking at the highly-educated workers (Figure 2.21, Panel B).

Figure 2.21. Immigrants are much more likely to be over-qualified than natives



Note: The over-qualification rate refers to the share of highly educated (ISCED 2011 Levels 5-8) who work in a job that is ISCO-classified as low- or medium-skilled (ISCO Levels 4-9).
Source: OECD, "Settling In 2023: Indicators of Immigrant Integration.

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The less favourable labour market outcomes of immigrant workers compared to natives may be due to several inter-related factors. For instance, as discussed above, immigrants tend to be concentrated in sectors with high volatility, such as construction and tourism, thereby being disproportionally affected by economic shocks. Moreover, immigrants often work on temporary projects and become unemployed at their completion (Government of Iceland, 2022[6]). At the same time, skills differences between immigrant workers and natives, and especially the poor linguistic skills of immigrants, make it difficult for them to move between jobs or to another field with higher linguistic requirements. The pandemic highlighted the more vulnerable position of immigrants in the labour market. According to a recent study, immigrants fared worse than their native counterparts in 2020 in terms of job opportunities, and especially job-security (Karlsson, 2022[41]). The findings for other labour market indicators included in the study, namely choice of employment, opportunities for self-employment and real incomes, also indicated that immigrants were affected disproportionally by the pandemic, with lower perceived happiness levels among immigrants than natives.

Immigrants tend to have some wage disadvantage compared to natives. A study by Statistics Iceland finds a wage differential of around 8%, on average, over the period 2008-17 after controlling for individual characteristics and various employment-related factors (Statistics Iceland, 2019[42]; Statistics Iceland, 2019[43]). The pay differential varies by occupation, with the higher earning gaps found in low-skilled occupations such as cafeteria assistants and cleaning staff, by country of origin, as well as by length of stay in Iceland, with the gap declining over the years following the arrival. The gap in earnings between immigrant and native workers remains, irrespective of the educational level, according to the findings. Nonetheless, a large part of the wage differential remains unexplained. Cross-country analyses also suggests that, by international comparison, Iceland has a relatively large share of the native-to-immigrant wage gap that cannot be explained on the basis of productivity differentials (Cupak, Ciaian. and d'Artis, 2021[44]). Natives seem to still earn around 13% more than immigrants after controlling for productivity differentials, according to the results. The study attributes the unexplained wage gap and its variation across the examined countries to several factors, including labour market discrimination, penalties associated with non-standard forms of employment (e.g. part-time, temporary employment), imperfect transferability of skills (education and experience) and language proficiency.

2.5.2. Providing effective language training to adult immigrants

Early intervention yields important benefits in terms of integration. Evidence for EU countries suggests that language courses for recently arrived non-native speakers can increase by 8 percentage points the likelihood of proficiency in the host language, with concomitant employment benefits (OECD, 2021[45]). Supporting the rapid acquisition of language skills is also essential for the successful integration of refugees who intend to stay.

Participation in language training is not mandatory, but a variety of language learning courses are available for adult immigrants in Iceland, with applicants for international protection also being eligible for such training. Language learning courses are offered by a number of providers including by Landnemaskólinn (The Settlers School), where the courses are organised by the trade unions, as well as by various education institutions and in the context of the certified programmes of further education (Government of Iceland, 2022[6]). Language schools are funded privately and through government grants (Hoffmann et al., 2021[46]). More specifically, accredited education providers offering Icelandic language courses which are not part of a general curriculum in the public school system can apply for grants from the Icelandic Centre for Research (Rannís). Government support is granted only for courses recognised by the Directorate of Labour.

There is scope to make adult language training more effective. Around 60% of immigrants covered by a survey in 2018 reported dissatisfaction with the language courses received, generally expressing a preference for courses that are better aligned to their daily needs (Hoffmann et al., 2021[46]). Other frequently cited shortcomings included a lack of in-class evaluations for the levels of language proficiency and of an official language certificate that could be used in job applications. There are also regional disparities in the provision of Icelandic language training, with fewer courses in rural areas. A comprehensive approach to language training for adult immigrants is required. In other Nordic countries, language training is a part of the introduction programmes for immigrants (Nordic Council of Ministers, 2019[47]). In Norway, for instance, around 60% of refugees leaving the Introduction Programme in a specific year were employed or engaged in education one year after the programme, according to Statistics Norway. A study from the Institute for Social Research further concluded that refugees who participated in the Introduction Programme do better in terms of employment, welfare dependency and the level of income compared to their counterparts who did not participate in such programmes (Røed et al., 2019[48]).

A clearly defined framework for language training of adult immigrants, defining accessibility and quality standards, as well as the role and responsibilities of stakeholders, is essential for achieving involvement of all partners and ensuring effective integration. It is important that publicly-supported language training programmes are flexible in terms of structure in order to be compatible with participants' work and family obligations. As noted above, a lack of flexibility was identified as one of the main shortcomings of the language training for adult immigrants in Iceland. Australia, Canada and New Zealand offer a range of language training options including part-time, evening and distance learning, while combining them with free childcare (OECD, 2021[45]).

Making language training for adult immigrants a part of a comprehensive approach to immigrant integration, rather than as an isolated skill to develop, is key. A new OECD report highlights that combining language instruction and vocational training has proven to be more effective in terms of future integration than providing trainings in parallel (OECD, 2023[49]). Several countries provide vocation-specific courses, including Denmark and Sweden. Iceland has been offering work-related language courses during working hours since 2003, largely funded by the government in cooperation with unions and employers. More systematic provision of language courses by Icelandic employers would further enhance the labour market relevance of training, in addition to improving the linguistic skills of employees with an immigrant background. Including language training in activation programmes is an additional way to help immigrants' labour market integration (OECD, 2021[45]). The right of all jobseekers under the Public Employment

Service (PES) to attend two Icelandic courses per year for free is a welcome initiative that needs to continue.

To reach a greater number of immigrants, regional disparities in the provision of language training and/or obstacles related to its financial cost for immigrants need to be addressed. Increasing the provision of online language training would be important in this regard, helping to deal with under-provision in the rural areas (see above). It is crucial to ensure that cost is not an obstacle to participation in language training. Iceland does not provide free accredited language courses for immigrants but union members can get a large part (around 75%) of the fee reimbursed. There is no clear-cut answer according to a recent OECD report (OECD, 2021[45]) as to whether or not language courses for adult immigrants should be free of charge, with varying cross-country experience in this area. Language courses are provided free of charge in Finland and Sweden, and reimbursement options are available in Denmark. The OECD report highlights, however, the need for the financing models to guarantee the affordability of courses for eligible learners, while also including incentives for performance by providers, as is the case for the results-based financing system used in Denmark (OECD, 2021[45]). Under this system, providers are paid half the tuition fee prior to the course and half after the individual migrant has passed the course exam, with the potential to contribute to more efficient course outcomes. Financing models should also ensure incentives for students to participate in the courses.

There is scope to increase the quality of language training for adult immigrants. There were some positive moves in recent years towards improving teacher training, including through the introduction in 2016 of the Master's degree in Second Language Teaching, and the adoption of curricular guidelines in 2008 and 2012 to standardise language teaching (Hoffmann et al., 2021[46]). Nonetheless, there are still no formal requirements for teachers of Icelandic as a second language. Such teachers, in particular, are not required to have a degree or training in teaching Icelandic to adults as a second language and as a result, their education background and professional experience can vary considerably. In addition, some studies conclude that that the government curricula guidelines have not been implemented rigorously so far, which may inhibit the standardisation of courses (Hoffmann et al., 2021[46]; Innes, 2020[50]).

Increasing quality also requires that language courses are developed further and reformed to better meet the different skills and learning speeds of the immigrants, while introducing student evaluation in language training to help immigrants improve their learning outcomes. The recent OECD report (OECD, 2021[45]) refers in this context to the modular system operated by Sweden and Denmark as an example of high-quality, personalised language courses to a diverse group of learners. Such a system organises learning in consecutive modules with increasingly advanced learning goals, enabling migrants aiming to continue beyond the integration targets to reach their personal or professional objectives. A modular system also better takes into account the linguistic diversity and training needs of refugees (OECD, 2016[51]). A better co-ordination of language training providers is also crucial for improving quality. There is also a need to review the curricula for Icelandic as a second language and for their implementation to be reinforced (see above), while defining competency levels in line with the European language framework, as done in the other Nordic countries (Nordic Council of Ministers, 2023[52]). It is important, in this context, that the government go ahead with the preparation of quality standards for Icelandic teaching, improving coherence (Government of Iceland, 2022[6]), while also defining formal requirements for language teachers. Ensuring adequate funding for Icelandic language teaching, including for teacher preparation, is essential, in tandem with developing rigorous evaluation mechanisms to regularly assess the outcomes in terms of language proficiency and labour market integration of immigrants. The announced increase of government funding to support language training for immigrants is welcome, especially in view of rising immigration.

2.5.3. Ensuring efficient and timely assessment procedures for skills recognition

Greater transferability of skills obtained abroad can help reduce skills mismatch and overqualification. The recognition of immigrants' education credentials in Iceland is complex as the underlying procedures are

often not sufficiently transparent and also due to the large number of actors involved, with over 10 different bodies in charge of assessing different types of credentials (Réttur Aðalsteinsson & Partners, 2019[53]). Under current arrangements, the ENIC/NARIC network (operated by the University of Iceland) is responsible for the recognition of academic qualifications, while the recognition of qualifications in regulated professions is granted by the appropriate competent authority in charge for the licenses in this field (Government of Iceland, 2023[54]). Immigrants need to navigate a complex system to find the right body responsible for recognising their qualifications, and the finalisation of assessment procedures takes longer than in other Nordic countries – three months on average in 2016 – although such data do not capture more recent improvements (OECD, 2017[55]).

Immigrants from non-EEA countries face relatively demanding recognition conditions for their qualifications and additional procedural hurdles. They need to ascertain equivalence with corresponding education provided in Iceland, which is not the case for their peers from EEA countries (Réttur Aðalsteinsson & Partners, 2019[53]). Navigating the system to obtain information on assessment and recognition of foreign qualifications is difficult for such groups due to language barriers. At the same time, the current system does not seem to provide sufficient guidance to applicants, even though Iceland maintains an information portal online explaining recognition requirements and procedures. Immigrants from the non-EEA countries frequently express concerns about a lack of information on the conditions to be met when applying for foreign credential recognition and a work permit (Réttur Aðalsteinsson & Partners, 2019[53]). Complexity may discourage immigrants from seeking to have their qualifications assessed and recognised, increasing the likelihood of over-qualification.

Ensuring timely recognition and assessment procedures is essential for enhancing effectiveness. This would avoid having immigrants unemployed or in jobs that do not match their qualifications for long periods. Norway and Sweden have developed novel approaches to speed up recognition procedures (OECD, 2017[55]) (Box 2.5). Norway's scheme provides a pre-arrival fast-track assessment of foreign higher education credentials, which combines speed with high evaluation standards. Sweden's scheme aims to accelerate the entry of skilled immigrants into shortage occupations. International experience can provide valuable guidance for speeding up the process for hiring foreign experts to meet the labour needs of the ICT sector as envisaged by the legislative proposal under way (see above). Other countries have also taken steps to accelerate the recognition procedures. Australia, for instance, has introduced a pre-arrival assessment of foreign qualification since 1999, while Canada is providing relevant information and exam preparation material to international trained individuals prior to arrival (OECD, 2017[55]). In addition, in Canada's case, many occupations have offshore exams capacity to speed up the provision of licences.

Box 2.5. Fast-track schemes for recognition: some lessons from Norway and Sweden

Norway developed a "turbo-evaluation" for employers in 2014, which entails a fast-track assessment of the candidate's foreign higher education credentials (OECD, 2017[55]). This makes it easier for employers to assess job applicants with foreign education. Interested employers fill in an online application form containing the applicant's education credentials, his or her CV and written authorisation. Evaluation is carried out by NOKUT (the Norwegian Agency for Quality Assurance in Education) within five working days and is free of charge. This is a non-binding evaluation and only for the job at hand.

Sweden has introduced a fast-track programme to speed up the entry of skilled immigrants into shortage occupations including engineering, teaching, technical occupations and the medical profession (OECD, 2017[55]). The objective of the programme is to combine recognition of foreign credentials and prior learning with workplace training and language lessons to provide an occupational certificate. The aim of the training process is to lead to a job that fits the participant's skills and qualifications. Tripartite fast-track discussions are under way in a number of sectors.

The skills recognition system needs to become more user-friendly and transparent. Clear rules regarding eligibility requirements for the recognition of foreign qualifications and well-coordinated assessment processes among the bodies involved, along with easily accessible information and guidance for immigrants on how to obtain recognition are essential to reduce complexity and improve effectiveness. The establishment of a one-stop shop offering multiple services would very helpful. Several countries have established such contact points. Based on international experience, in addition to informing applicants on how to obtain skills recognition, one-stop shops accept their initial applications and pass them directly to the bodies in charge of the process (OECD, 2017[55]). They also assemble information and provide advice to the applicants and stakeholders, strengthening the system and enhancing transparency. All holders of foreign qualifications in Denmark are entitled under the Assessment of Foreign Qualification Act to an assessment through the central recognition agency (OECD, 2023[49]). In Sweden, a coordinating body, established in 2013, serves as a one-stop shop for all types of qualifications, while the online portal in Germany refers the applicants to competent authorities and provides information in various languages (OECD, 2017[55]).

2.5.4. Helping immigrants gain job experience

Gaining job experience is a pathway to successful integration, and active labour market programmes (ALMPs) that combine work experience and on-the job training have proven to be effective instruments (OECD, 2014[56]). Based on available evaluations, private-sector incentive schemes appear to be a successful measure for immigrants. A meta-analysis of 33 empirical studies for the European countries concluded that wage subsidies work better than other active labour market programmes targeted to immigrants and that they also have positive employment effects on immigrants in the short run (Butschek and Walter, 2014[57]). A recent review, focusing on the larger Nordic countries, also confirms that subsidised private-sector employment is the most effective activation programme for promoting the employment of immigrants, at least in the short run (Calmfors and Sánchez Gassen, 2019[58]). The impact of labour market training on employment outcomes appears to be lager in the medium to longer term, according to the review. In Iceland, jobseekers who have been unemployed for over three months are generally entitled to a recruitment grant (wage subsidy) for up to six months. In 2022, 43% of the beneficiaries were foreign citizens, including immigrants and refugees.

A careful design is required for wage subsidies. While such schemes can be an effective tool for improving the employability of low-skilled workers, they may involve the risk of crowding out unsubsidised hires, when employers choose to rely on subsidised labour rather than regular contracts and are reluctant to offer a permanent job to programme participants when subsidies expire. This problem could be addressed, however, by targeting the subsidies at the jobseekers most in need, using the subsidy schemes on a temporary basis and making them conditional on not substituting existing workers with those receiving a subsidy (OECD, 2014[56]). Moreover, providing information about the subsidy schemes in different languages is important.

The Directorate of Labour (VMST) plays a role in the labour market integration of immigrants by providing job-search support, connecting jobseekers with a foreign background with employers, and enhancing their employability through active labour market policies (ALMPs). Efforts towards VMST modernisation need to continue, along with the development of a solid set of performance indicators to evaluate and monitor the effectiveness of the provided activation programmes, as was recommended in an earlier *OECD Economic Survey* (OECD, 2019[59]).

As a step forward, the counselling services provided to jobseekers have been re-organised recently, with a view to limit long-term joblessness (Box 2.6). Such reform is particularly important for jobseekers with an immigrant background who have a greater need for support than their Icelandic-speaking counterparts. In addition, a variety of courses are provided to help jobseekers develop their skills and abilities, which can further facilitate the labour market integration of immigrants. Moreover, an immigration counselling office

was established in 2021. The increased focus on the labour market support for immigrants is welcome. Some countries, such as Austria and the United Kingdom, have targeted immigrants and their children for ALMPs, enabling Public Employment Services (corresponding to VMST in Iceland) to allocate more resources to jobseekers with an immigrant background in the form of training and/or increased provision of individualised services (OECD, 2014[56]). In Norway, immigrants are given priority to participate in labour market programmes, with several studies inferring that participation in different programmes increases the transition into employment among immigrants (Directorate of Labour and Welfare, 2023[60]). Providing more training courses in languages other than Icelandic would be advisable as it would help the job search activity of immigrants and promote their participation in activation measures, facilitating labour-market integration. Empirical analysis for the larger Nordic countries concludes that while spending on ALMPs helps reducing unemployment among natives, it has a much higher impact on foreign-born unemployment, thereby narrowing the gap between the two groups (IMF, 2015[19]).

Box 2.6. Recent reforms to strengthen the services provided to jobseekers

The counselling services have recently been reformed, and they are now organised according to the length of unemployment, with a view to limit long-term joblessness. All jobseekers need to answer a screening list when they have been unemployed for two months. Frontline interviews are set up for those who are deemed to need little support. If more support is needed, jobseekers are interviewed by a career counsellor. Every jobseeker who has been continuously unemployed for 12 months will get an assessment interview, a job search plan, and individualised support with more help to find a job, reskilling or rehabilitation. The counselling services provided are the same for all jobseekers in Iceland, regardless of the area they live.

A variety of courses are also provided to help jobseekers develop their skills and abilities. These include self-empowerment courses, career development, Icelandic courses, certified study paths in collaboration with lifelong learning centres and special projects for young job seekers.

To help immigrants in a more effective way, an immigration counselling office was set up in February 2021. The ultimate purpose is to reach out to more immigrants and provide them with a contact point on integration, including acquiring information regarding labour market opportunities. As a further welcome step, a 2023 law has merged the Multicultural and Information Centre, offering assistance and counselling, with the Directorate of Labour (see Box 2.2).

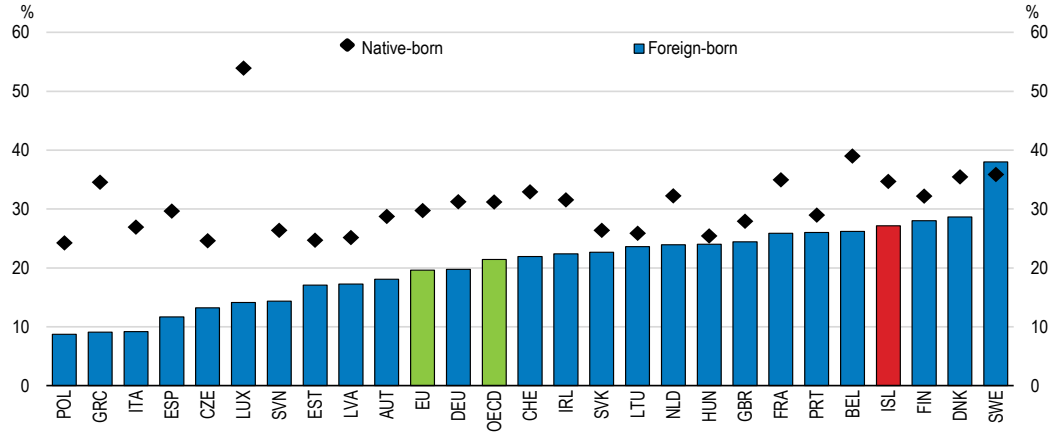
Source: (Government of Iceland, 2022[6]).

2.5.5. Fostering employment of immigrants in the public sector

More and better-quality jobs for immigrants in the public sector are an important lever to support their integration in the labour market, as well as society. While above the OECD average, the share of immigrants in public service employment is lower than that of natives and than in the other Nordic countries (Figure 2.22). The native-immigrant employment gap stood at around 7½ percentage points in 2020, indicating that the presence of immigrants in public employment can be strengthened. Survey results suggest, for instance, a relatively high rejection rate (at around 40%) for immigrants' applications for public sector jobs (Réttur Aðalsteinsson & Partners, 2019[53]). The results also reveal differences between the public and private sectors in terms of qualification mismatches. Around 28% of the survey participants who were employed in the private sector worked in their field of expertise, compared to 18.5% in the case of their counterparts employed in the public sector.

Figure 2.22. Immigrants are under-represented in the public sector

Share of employment in the public services sector, aged 15- 64, 2020



Source: OECD, "Settling In 2023: Indicators of Immigrant Integration.

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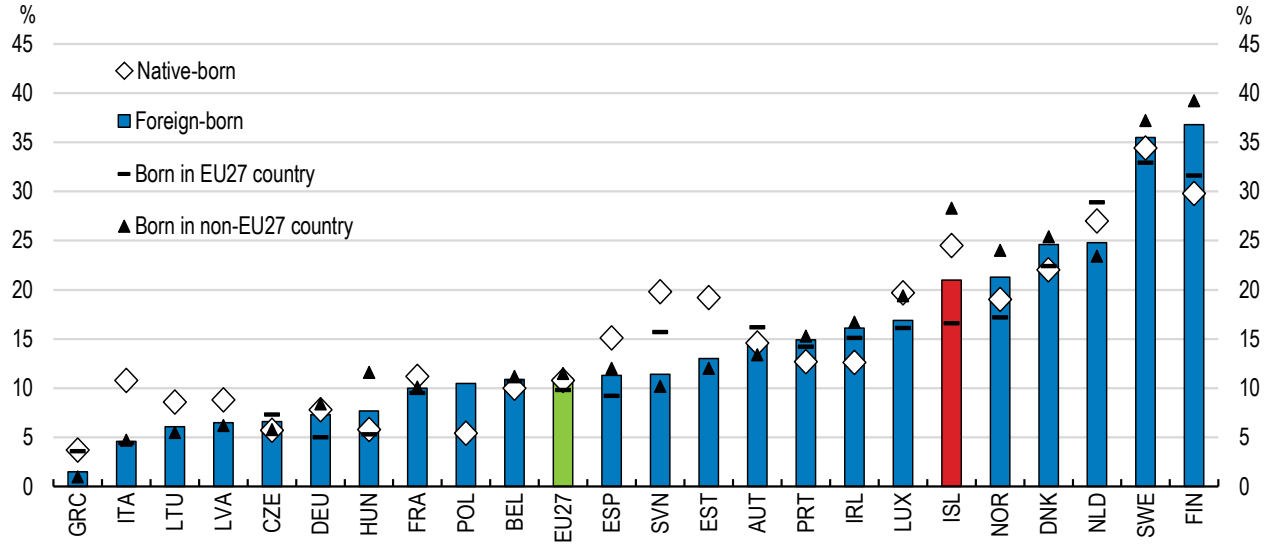
There are various barriers to the employment of educated immigrants in the Icelandic public sector. Poor linguistic skills are a significant obstacle, but other factors, such as unfavourable practices, for instance discrimination, also limit the employment opportunities of immigrants (Réttur Aðalsteinsson & Partners, 2019[53]). As a welcome step, Iceland has removed legal restrictions to foreign nationals working in the public sector, following changes in anti-discriminatory legislation in 2018**.** Nonetheless, awareness about the law among immigrants seems to be low, suggesting a need to further strengthen the implementation and monitoring of the new anti-discrimination legislation and enhancing transparency in the recruitment process of immigrants in the public sector (Réttur Aðalsteinsson & Partners, 2019[53]). Improvements in the recognition procedures of the qualifications obtained abroad is also essential (see above).

Several countries have promoted the employment of immigrants in the public sector. These include, for example, the introduction of a benchmark, usually as part of broader equal employment policies, for the equitable representation of immigrants and their children at all levels of the public sector (OECD, 2014[56]). In Norway, for instance, public sector institutions are required to set targets for the recruitment of candidates with a foreign background and develop recruitment plans towards achieving these targets (OECD, 2014[56]). In addition, the country has introduced legal obligations for the public sector to interview immigrants. These initiatives have helped to improve the representation of immigrants in the public sector, according to a recent OECD report (OECD, 2022[61]). Denmark's 2003 diversity agenda also set up an equity benchmark, requiring all state and municipal governments to have a roughly proportional representation of people with a migrant background (i.e. immigrants and second generation), with specific targets (Liebig, 2007[62]; OECD, 2014[56]). Moreover, a regular employment statistics watch has been put in place. Based on international practice, there is room for Iceland to develop a specific strategy that fosters the employment of immigrants in the public sector. Setting indicative targets for the share of immigrants in public employment or new hirings would be advisable, while developing mechanisms to monitor the outcomes of such policies.

2.5.6. Strengthening immigrants' skills through adult learning and bridging courses

The participation of immigrants in adult learning compares well internationally (Figure 2.23). Overall, non-EU immigrants participate more in adult learning than their EU peers, also exceeding somewhat the share of natives. This is welcome in view of the important role of such learning for re-skilling and enhancing the productivity of low-skilled workers. At the same time, there is scope to close the gap with the Nordic peers by encouraging further participation, especially among immigrants from EU countries.

Figure 2.23. There is scope to increase immigrant participation in adult training
Participation in adult learning, 25-64 year olds by place of birth, 2021



Source: Eurostat.

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Iceland should continue to pursue a more comprehensive approach to adult learning that better takes into account the training needs of immigrants (OECD, 2021[63]). It is important, in this context, to strengthen the system of Validation of Prior Learning (VPL) and ensure an effective access of immigrants. This would facilitate re-entry into the formal school system for workers with a foreign background who lack a formal educational degree. A recent report recommends to make the VPL system more accessible to immigrants by translating existing validation tools into other languages, based on the analysis of needs, while also developing a guidance and assistance system at a national level to help them through the validation process (Guðmundsdóttir et al., 2020[64]). It is also very important to develop pathways between the VPL and formal education for individuals with a foreign background who wish to complete their formal educational qualification after the validation process. At present, the system does not offer specific educational opportunities for such individuals. Provision of language support during the period of studies following the validation of competences could help bridge this gap and strengthening such pathways (Guðmundsdóttir et al., 2020[64]).

For the adult learning programmes to be effective in improving labour market outcomes, especially among immigrants, they should lead to certification and be accompanied by clearly defined career paths (OECD, 2014[56]). Such programmes should also be flexible enough to correspond to the needs of immigrant workers and be well advertised and explained to enhance incentives for re-skilling. Carefully designed financial incentives could be provided to encourage participation in adult learning among immigrants (OECD, 2021[63]). Individual Learning Accounts (ILAs), for instance, have received growing attention in recent years as they facilitate career transitions. France and the Netherlands, for example, have introduced financial incentives in the form of ILAs that allow for portability of the training rights between jobs and also employment statuses (OECD, 2019[65]).

Moving towards the formal provision of bridging courses would be advisable. Such courses give foreign-educated immigrants the opportunity to train, helping them to quickly close skills gaps and secure a host-country qualification in their field (OECD, 2014[56]; OECD, 2017[55]). As such, bridging courses would benefit non-EEA immigrants whose qualifications are usually not fully equivalent to a domestic degree. In Iceland, at present, bridging is dealt with on a case-by-case base rather than through formal programmes (OECD, 2017[55]). Moving towards a formal provision, would help to speed up the labour market integration of

immigrants. Bridging programmes are also cost effective if they enable immigrants to quicky re-qualify. For instance, evidence from a bridging programme for foreign-trained nurses in Australia suggests that it cost only 10% of the alternative training that would be provided through higher education (Konno, 2006[66]). Bridging courses can be particularly effective when they combine tailored professional training with language instruction and mentoring and when all relevant stakeholders are engaged (OECD, 2014[56]).

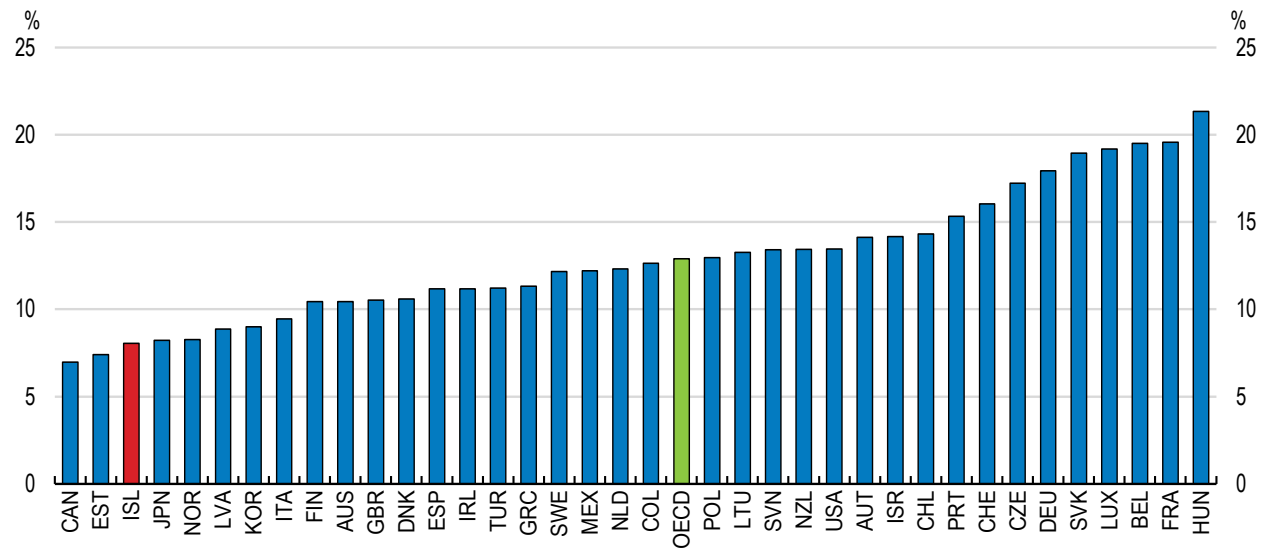
2.6. Enhancing the educational outcomes of immigrants' children

2.6.1. A large gap remains between the school performance of immigrant and native students

Immigrant students in compulsory education underperform their native counterparts by a wide margin, according to 2018 PISA (Performance for International Student Assessment) results, despite some improvement and Iceland's very equitable education system (Figure 2.2 and Figure 2.24). Underperformance persists, even after accounting for socio-economic backgrounds. The 2018 PISA findings for reading literacy show a score difference of 55 points, which is equivalent to around a year of schooling, more than twice the corresponding OECD average and above Denmark and Norway (Figure 2.25). The outcomes are weaker for first- than second-generation immigrants. Only 7% of immigrant students in Iceland attained the top-quarter of performance in reading, and can thus be considered "academically resilient", compared to the 17% OECD average. Although, as in other countries, there are important differences in academic resilience across different groups of students with an immigrant background (Cerna, Brussino and Mezzanotte, 2021[67]), the overall share remains low in international comparison.

Figure 2.24. Socio-economic background has a small impact on students' outcomes

Percentage of variance in student performance in PISA explained by ESCS (strength of the socio-economic gradient), 2018



Source: OECD, PISA 2018 database.

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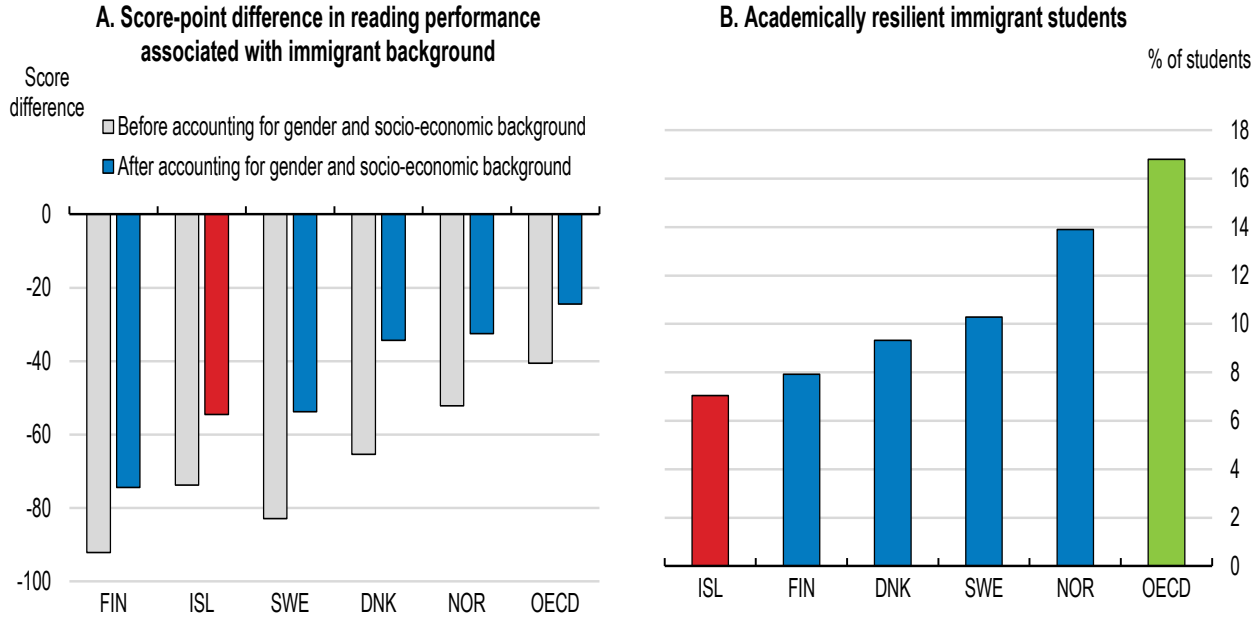
Figure 2.25. PISA scores for reading literacy are weak for immigrant students



Note: In Panel A, socio-economic background refers to students' and schools' socio-economic profile. In Panel B, immigrant students are considered as academically resilient if they have scored in the top quarter of reading performance amongst students in their own country.
Source: OECD, PISA 2018 database.

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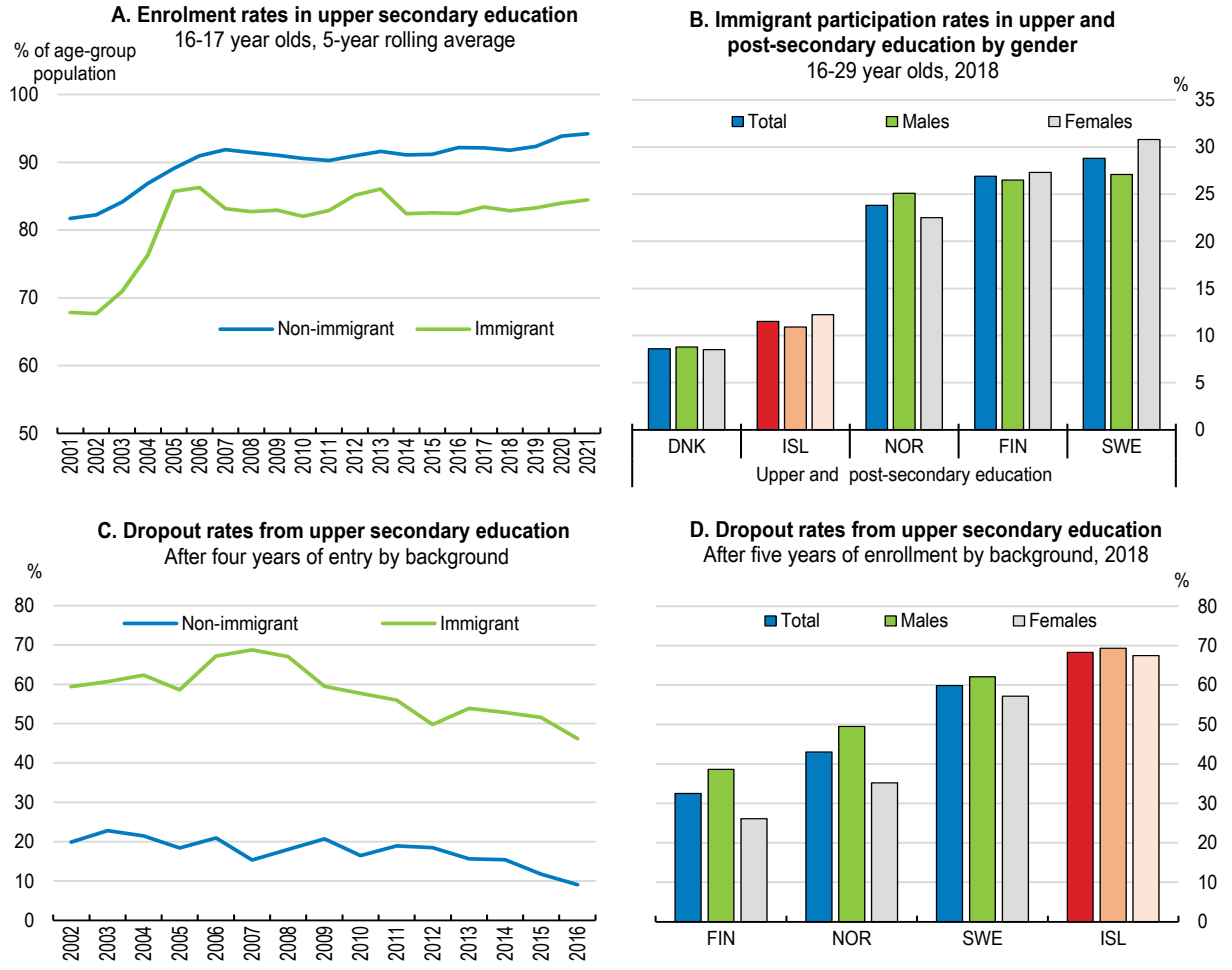
The weak educational performance of immigrant students is also evidenced by other indicators, including relatively low enrolments in upper-secondary education compared to native peers, and higher upper-secondary dropout rates, although the gaps have narrowed somewhat in recent years (Figure 2.26). Around half of those immigrant students who entered upper-secondary education for the first time in 2016 had not graduated after four years, compared to less than 10% among students with no foreign background. This gap may be overestimated, however, as some of the foreign students might have been exchange students or immigrants returning to their countries, rather than dropping out from school. Upper-secondary dropouts among immigrants are also high, however, in comparison to the Nordic peers, and this is the case for both men and women. OECD cross-country evidence suggests that students with poor academic achievements in school do not generally catch up later in life, highlighting the need to strengthen the learning outcomes for immigrant students.

Figure 2.26. Immigrant students also underperform on other educational indicators



Note: In Panels A and C, an immigrant refers to a person born abroad whose both parents and all grandparents are foreign born, while non-immigrant refers to all rest. In Panel B, the data refer to the foreign-born with two foreign-born parents with more than two years of stay since the first date of residency. Upper and post-secondary education corresponds to ISCED 2011 levels 3 and 4. In Panel C, data include new entrants in day courses at the upper secondary level of education (ISCED level 3) according to the Statistics Iceland Student Register. The data from Statistics Iceland for immigrant students in upper secondary schools include foreign exchange students which results in an overestimation of dropout rates ranging between 5 and 15 percentage points.
Source: Statistics Iceland; and Nordic Statistics database.

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Further improving the participation rates of immigrant students in upper-secondary education, which lag those in Nordic peers except Denmark (Figure 2.26), would also help to reduce the share of young people with an immigration background who are not in employment, education or training (NEET). Approximately 13% of youth (16-24 years old) with a foreign background (including individuals born abroad with both parents Icelandic) belonged to the NEET group in 2020 compared to around 9% among natives over the period 2014-20 (Varða, 2021[68]). Youths with a foreign background tend be more vulnerable to external factors, such as the economic situation in the communities, and other risk factors compared to their native counterparts, that can reflect the weaker integration of immigrant students.

A comprehensive reform approach is required to improve student outcomes that calls for specific initiatives focusing on areas of particular concern, notably weak reading skills, as well as measures to strengthen the vocational skills of immigrant students and ensure teachers' preparedness to accommodate students' diverse needs, with teaching quality at the core. These are discussed below along with the government's initiatives under its longer-term education strategy.

2.6.2. Improving the language skills of students with an immigrant background

A draft policy proposal recommends the provision of appropriate Icelandic lessons for students with diverse linguistic backgrounds, along with well-targeted support from the start of kindergarten, or upon arrival in the country (Ministry of Education and Culture, 2020[69]). Assessing the level of language skills before the provision of formal learning is also considered important to meet the linguistic needs of children with a foreign background. Continuity of learning and a well-coordinated policy on multicultural school work, as well as effective training of teachers to adapt to new work methods and practice (see below) were seen by the draft policy proposal as additional prerequisites of success

The new long-term educational strategy, Education Policy 2030 (Box 2.7), pays particular attention to students with a diverse linguistic background. The first action plan, covering 2021-24, envisages an increase in the publication of diverse study material for students with Icelandic as a second language and increased access to specialised pedagogical support, notably expert advice, at all school levels throughout the country and for all age groups. Such measures are accompanied by actions promoting teacher training (see below). The government also plans to develop standardised tests to monitor students' progress in Icelandic and other foreign languages.

The reforms go in the right direction and should be implemented within the envisaged timelines. Regular assessments of linguistic skills provide useful information on students' achievement at different school stages, enhancing the capacity for diagnosing reading difficulties. Diverse study material can better meet the needs of immigrant students. Such material should be readily accessible electronically. Appropriate Icelandic lessons and well-targeted support for students with a foreign background at an early stage, as was also recommended by the draft policy proposal (see above), is essential for building up solid educational foundations. A recent study concludes, for instance, that while immigrant status and other socioeconomic factors, notably the education level of parents, play an important role in explaining the relatively high dropouts from upper-secondary education of immigrant students, addressing the problem hinges upon strengthening academic performance at the compulsory school level (Stefánsson and Eyjólfsson, 2022[70]).

Revisions under way to the National Curriculum Guide for Compulsory School, with increased emphasis on Icelandic as a second language, are also welcome and should continue. The new curricula should take into account the different standards and learning experiences of students, helping those with diverse linguistic and cultural backgrounds to develop their potential. A recent OECD report (OECD, 2023[71]) on equity and inclusion in education calls for curricula flexibility to enable schools to develop solutions for local problems responding better to students' needs, while highlighting the need to combine such flexibility with adaptive instruction and enhanced activities, in order to avoid its potential adverse impacts on students' performance. It is also important to ensure that information about the school programme and activities is easily accessible and available in more languages than Icelandic to help parents respond better to the educational needs of their children (Ministry of Education and Culture, 2020[69]).

Box 2.7. Education Policy 2030: main features

A ten-year education strategy, Education Policy 2030, was approved in March 2021 with an overarching objective to ensure a dynamic and flexible education system that can drive economic and social change. The policy will be implemented in three stages over the envisaged 10-year period. The first phase, currently under implementation, is set to be completed in 2024. The strategy covers all levels of education, including teacher education. It includes five pillars, under which further objectives are described. In particular:

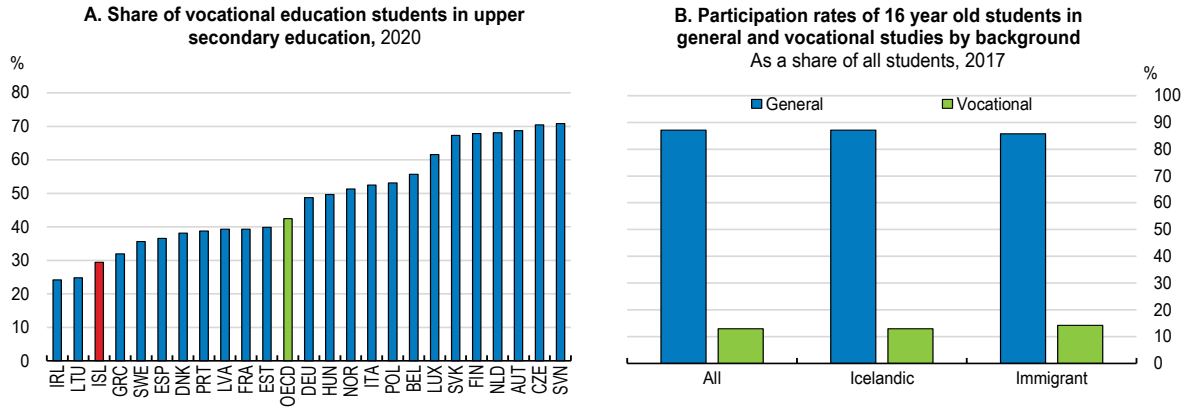
- Equal opportunities for all: the first pillar focuses on equity, including areas related to catering to the needs of all students, the geographical distribution of education provision, diversity, and early learning opportunities.
- Superior teaching: the second pillar focuses on areas related to the teaching profession, teachers' competence development, innovation, as well as teachers' working conditions.
- Skills for the future: this pillar includes focus on areas related to development of a range of skills that are considered to be of key importance for the future of Iceland, including Icelandic proficiency, science, technical education, creativity, digitalisation and lifelong learning.
- Putting well-being first: the fourth pillar focuses on well-being, including areas to enhance student mental health.
- Quality at the forefront: the fifth pillar focuses on strengthening quality assurance across the education system, including focus areas related to reinforcing student assessments and accountability and the efficient use of resources.

Source: (OECD, 2021[28]).

2.6.3. Equipping immigrant students with solid vocational skills

Higher participation in vocational education and training (VET) would help immigrant students to develop their skills. By providing an alternative school partway, VET can contribute to reducing high dropout rates among immigrant students, re-engaging early school leavers in education (OECD, 2019[59]; OECD, 2023[71]). The VET system in Iceland has relatively low participation rates (Figure 2.27). The scope for strengthening engagement remains large, especially for immigrant students where the benefits of VET appear to be stronger (Jeon, 2019[72]). The government has announced its intention to prioritise funding for the VET system in its Medium-Term Fiscal Plan.

Figure 2.27. Vocational education and training could be strengthened



Note: In Panel A, upper secondary education refers to ISCED 2011 level 3 classification.
Source: OECD, Education at a Glance database; and Ministry of Finance.

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Increasing the uptake of VET by immigrant students hinges upon effective preparation courses and making VET a more attractive education pathway. Many students with an immigrant background complete elementary school with low grades and have weak foundational skills, making entry to upper-secondary VET difficult. It is important, in this context, to monitor regularly the effectiveness of preparatory courses available to students with an inadequate preparation for either the vocational or general tracks. Outcomes should be assessed not only in terms of entry rates of immigrant students into upper-secondary education, and in particular the vocational stream, but as well on the basis of completion rates. The government could also consider the introduction of pre-apprenticeship programmes to support VET students at risk of dropping out, in line with international experience (OECD, 2023[71]). France, for instance, has recently introduced a pre-apprenticeship programme (*prépa-apprentissage*) that aims to identify and address basic and employability skill gaps before starting an apprenticeship. The two-year 'EBA' apprenticeships (*Grundbildung mit Eidgenössischem Berufsattest*) programme in Switzerland focusses on youth who face difficulties in school, struggle to find a three or four-year apprenticeship, or who are at risk of dropping out. Such programmes provide additional support and coaching (OECD, 2023[71]).

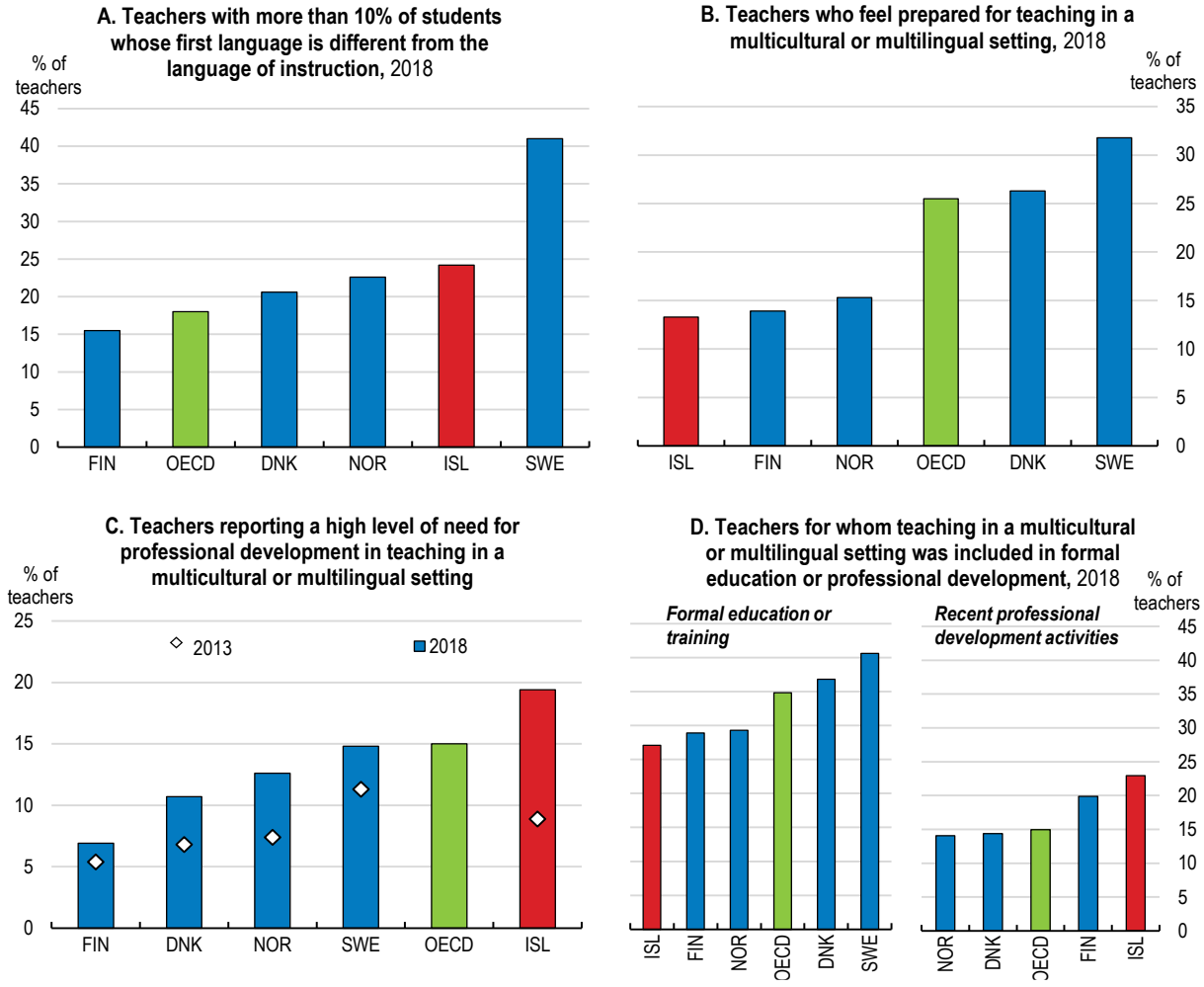
At the same time, the VET system needs to be strengthened by extending work-based learning and ensuring availability of apprenticeships, especially for immigrant students. This would help to increase the labour market relevance of VET, equipping students with solid practical skills. Previous Surveys called, in this context, for a better integration between the school- and work-components of VET, and against this background, for extending work-based learning to service sectors, such as digital technology or tourism, given the importance of these sectors in the economy. In tandem, firms must be encouraged to offer apprenticeship contracts. As a welcome step, the Icelandic Student Centre (a student agency for industry) was established in 2022 with the aim to increase the number of companies offering apprenticeships (Government of Iceland, 2022[73]). The agency is a collaborative effort of the industry associations. Ensuring placements of students with an immigrant background needs to be among its priorities in view of the high upper secondary dropout rates of such students.

As an additional positive initiative towards strengthening the VET system, a recent reform has increased the pathways of VET students towards tertiary education, including by facilitating access to universities (OECD, 2021[63]).

2.6.4. Preparing teachers to address the educational needs of immigrant students

There is a need to better prepare teachers to accommodate the diverse educational needs in classrooms and help immigrant students. Teaching plays a key role for the quality of educational outcomes. Around a quarter of lower-secondary teachers in Iceland teach in schools with linguistically diverse students, according to the results of the 2018 OECD Teaching and Learning International Survey (TALIS) – above the OECD average (OECD, 2019[74]) (Figure 2.28). However, most teachers reported that they did not feel equipped to teach in a multicultural or multilingual setting upon finishing their initial teacher education or training, with 20% of them reporting a high need for professional development, exceeding the OECD average and corresponding share in 2013.

Figure 2.28. Teachers need to be better prepared for increasing diversity in classrooms



Note: In Panel B, the data refer to teachers who felt 'well prepared' or 'very well prepared' for teaching in a multicultural or multilingual setting.
Source: OECD, Teaching and Learning International Survey (TALIS) database.

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Initial teacher education (ITE) programmes should have stronger diversity-related content, helping to prepare novice teachers for the realities of the classroom. The share of teachers who reported that teaching in multicultural and multilingual settings was included in their ITE is below the OECD average (Figure 2.28). In line with practice in other European countries, ITE curricula in some Icelandic universities contain standalone courses regarding diversity issues. However, a recent OECD report highlights that such an approach is less effective in preparing new teachers for diverse classrooms than when equity and inclusion are embedded in the ITE curriculum as central and cross-cutting themes (OECD, 2023[71]). Making teaching for students with a foreign background a part of the initial ITE in Iceland would be advisable. The government could further consider incorporating knowledge and skills related to diversity and inclusion into the required competences and standards for the graduation of new teachers (OECD, 2023[71]). In Australia, for instance, in order to obtain their ITE qualification, student teachers are required to demonstrate a solid understanding of diversity and inclusion in the classroom and show preparedness for the adoption of differentiated teaching to meet diverse educational needs (OECD, 2023[71]).

Strengthening professional development is also essential to ensure effective teaching for multicultural classrooms. Most teachers in Iceland participated in some kind of in-service training, according to 2018 TALIS findings, but less than a quarter had undertaken training in multicultural or multilingual education in the year preceding the survey, despite the reported high and rising training needs, although this share

compares well internationally (Figure 2.28). A better matching of professional development opportunities to teachers' needs is important. Encouragingly, the government recently introduced short-term courses for teachers to enhance their ability to accommodate diverse educational needs. Requiring teachers' feedback on the training programmes offered, along with a close monitoring of teachers' participation in such programmes, would help to ensure effective in-service training and teaching practices in a context of increasing diversity in classrooms (OECD, 2023[71]). Indeed, research suggests that participation in continuous learning is more likely when teachers are given the opportunity to influence the substance and process of professional development (Forghani-Arani, Cerna and Bannon, 2019[75]).

Ongoing reforms to improve the quality of teaching are welcome. The qualification framework introduced in 2020 sets the criteria for general and specialised qualifications and provides guidance for professional development and teacher re-training (Government of Iceland, 2022[6]). Going forward, developing a systematic evaluation of teachers is essential to ensure that the diverse educational needs of students are accommodated. At the same time, it is important to meet demands for qualified teaching staff in rural communities with a rapidly growing immigrant population (see above).

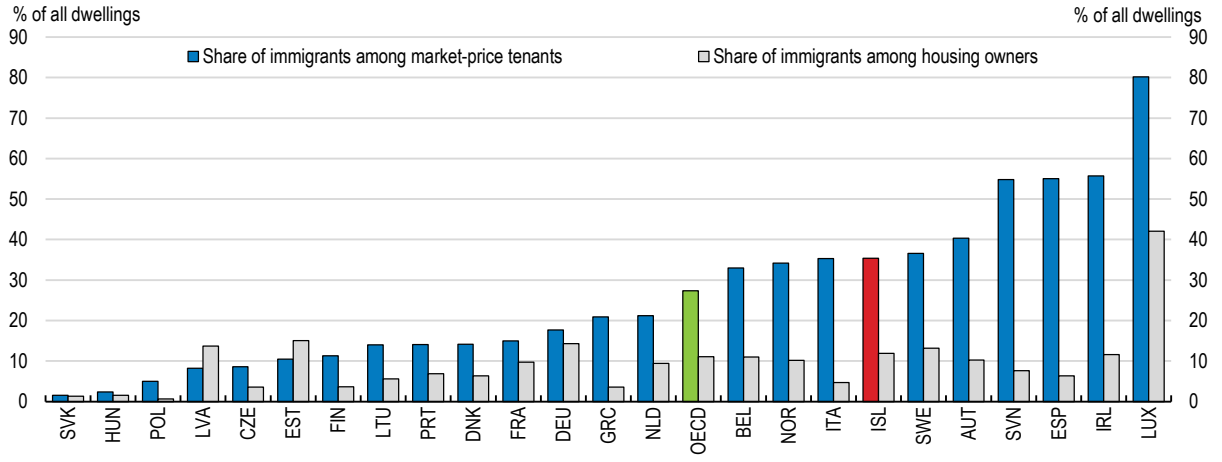
2.7. Meeting the housing needs of immigrants

2.7.1. Immigrants incur burdensome housing costs and face poorer housing conditions

Housing affordability has become an issue in Iceland, including for immigrants. Rising prices of owner-occupied houses have pushed up rents as well, thereby increasingly burdening immigrants' budgets, who live mostly in rented dwellings (Figure 2.29). The burden of rent payments in Iceland is well above the OECD average**,** like in the other Nordic countries (Figure 2.30). The share of low-income tenants in the private market who are overburdened, that is spending over 40% of their disposable income on housing, is also standing out in international comparison. Recent IMF analysis for Iceland concludes that, overall, housing affordability pressures are higher for tenants than homeowners (IMF, 2022[76]). In addition, research by Statistics Iceland shows that relatively more immigrants than natives experience burdensome housing costs (Statistics Iceland, 2019[77]).

Figure 2.29. Immigrants live mostly in rented dwellings

Share of immigrants among owners and market-price tenants, 2020



Note: The tenure of the household is attributed to all members of the household.
Source: OECD, "Settling in 2023: Indicators of Immigrant Integration.

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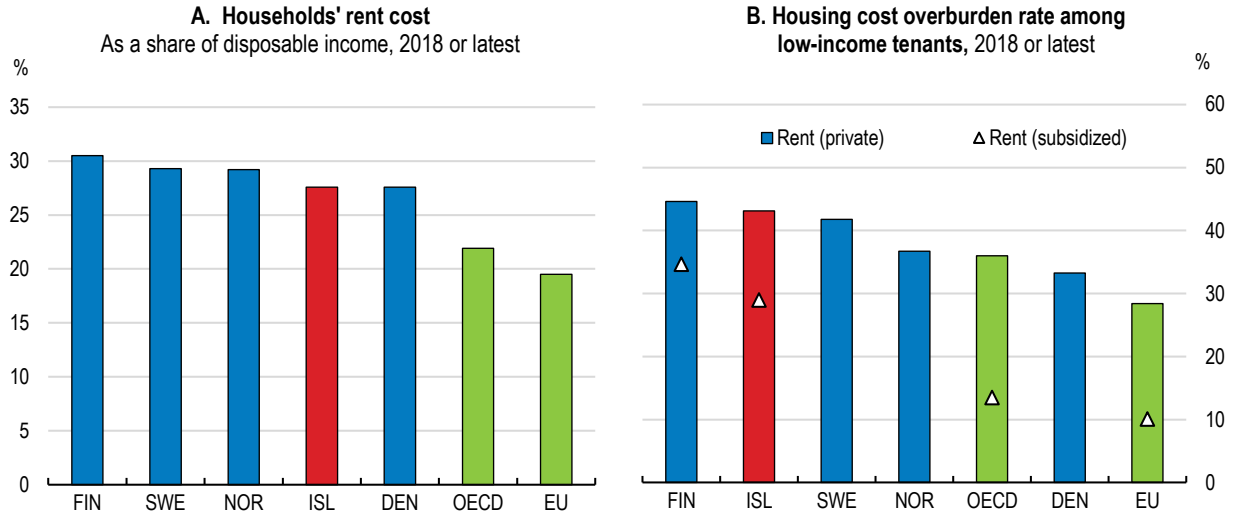
Figure 2.30. Low-income households face high housing costs



Note: In Panel A, households' housing cost represents the median of the rent (private market and subsidized rent). In panel B, data refers to the share of population in the bottom quintile of the income distribution spending more than 40% of disposable income on rent.
Source: OECD, Affordable Housing database.

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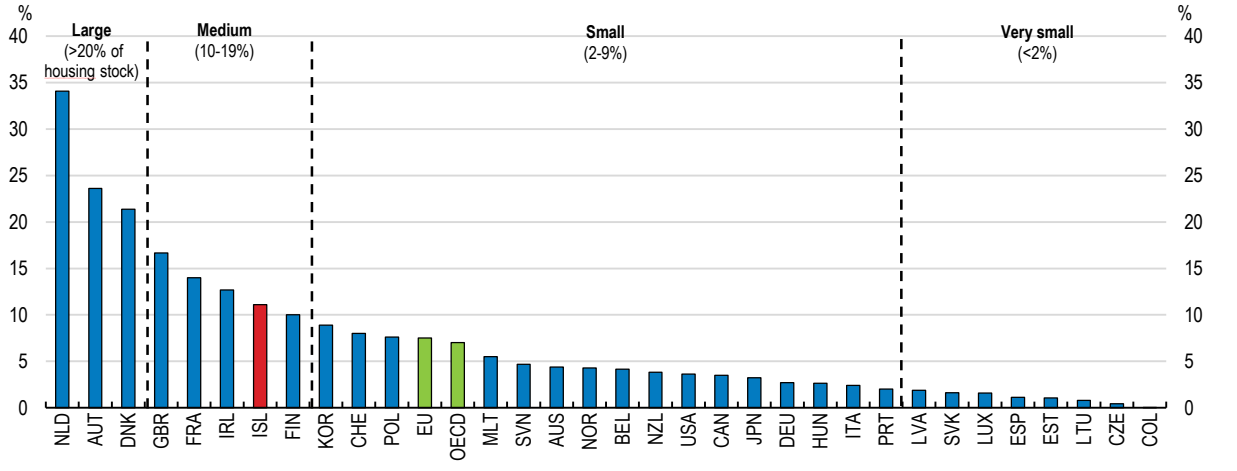
The supply of affordable housing appears to lag rising demand (Chapter 1). This includes social housing, an important dimension of affordable housing provision. In particular, Iceland is among the countries with a "moderately-sized social housing stock", according to the OECD definition, which may not be sufficient to match the needs of an increasing immigrant population (Figure 2.31). The provision of social housing in Iceland is under the responsibility of municipalities, which by law have to provide such housing to people in need registered in their jurisdiction. Eligibility criteria seem to differ across municipalities. Some municipalities require, for instance, a minimum amount of time of residence before an immigrant is eligible to apply for social housing. The share of immigrants on waiting lists for social housing in the capital was around 9% in 2018 (Government of Iceland, 2022[6]), although the situation may differ across regions.

Figure 2.31. The social housing stock needs to increase further in view of rapidly rising demand

Number of social rental dwellings as a % of total dwellings, 2020 or latest year available



Source: OECD, Affordable Housing database.

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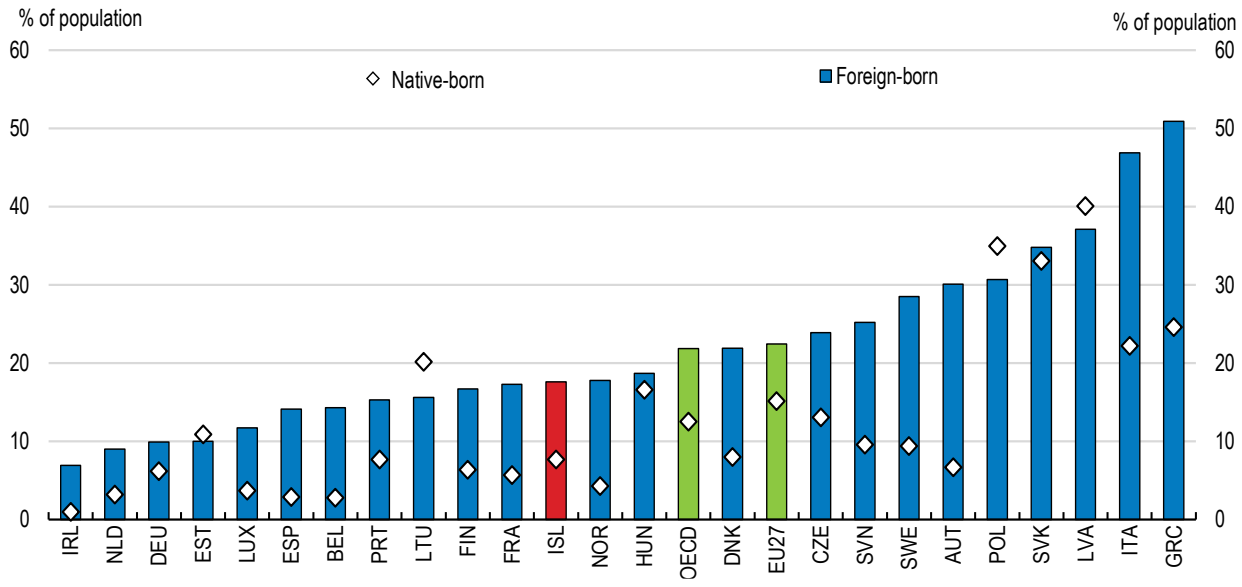
At the same time, the rental market is tight (Government of Iceland, 2023[78]), which especially affects immigrants, who tend to be renters (Figure 2.29). This is particularly the case in smaller municipalities since most dwellings there are privately owned and not available for rent. In some cases, immigrants rent accommodation provided by their employers. According to the latest government Action Policy Plan on Immigration Issues (see above), studies focusing on the situation of immigrants in the housing market indicate scope to reduce vulnerability in this area, including in terms of housing insecurity (Government of Iceland, 2022[6]).

Poor quality housing conditions for immigrant adds to challenges. It is more common for immigrants than for natives to live in overcrowded dwellings. Statistics Iceland estimated, for instance, that the share of immigrants living in overcrowded dwelling ranged between 15% and 33% over the period 2008 to 2016, compared to 6% to 7% in the case of natives. Eurostat estimates point in the same direction (Figure 2.32). At the same time the overcrowding rate among immigrants in Iceland is below the EU average.

Figure 2.32. The foreign-born are more likely to live in overcrowding dwellings

Overcrowding rate by country of birth, aged 18 or older, 2018



Note: The overcrowding rate is the share of the population living in a household that does not have enough rooms at its disposal as defined by Eurostat in its Living Conditions Survey.
Source: Eurostat, Living Conditions Survey.

StatLink https://stat.link/a790kr

2.7.2. Policies to better accommodate immigrants' housing needs and help integration

Under current arrangements, low-income households in Iceland are entitled to means-tested housing support, with the same eligibility conditions applying to both immigrants and natives (Box 2.8). Official estimates suggest that around a quarter of the recipients of the housing benefit from the central government in 2022 had a foreign background. A recent working group on housing support schemes commissioned by the government found that housing benefits from the state had reduced the number of housing cost overburdened tenants receiving such benefits by 38% in 2022 (Government of Iceland, 2022[79]).

Box 2.8. Provision of housing support to low-income household

Iceland provides housing support to low-income households through means-tested benefits from the central government and/or municipalities, with the same eligibility conditions applying to both immigrants and natives. Specifically, a means-tested housing benefit (*Húsnæðisbætur*) is available for low-income tenants that is financed and administered by the central government. The amount of housing benefit increases with the number of dwellers, up to pre-defined income thresholds, and can cover up to 75% of the actual rent. The benefit amounts and annual income threshold were raised in June 2022 as part of the government's response to contain higher living costs associated with increased inflation, with a further rise in January 2023 in line with the proposals of the working group on housing support scheme (see below). In addition to means-testing, there is also a net wealth test. Save some exceptions, a household is not eligible for housing benefits if it is renting housing that is registered for commercial use. There is also a housing benefit scheme available for homeowners in the form of interest rebates to offset mortgage payments.

As of 2017 all municipalities are required by law to provide special housing support, although the amounts and eligibility conditions differ across municipalities. Such support is provided to those in difficult financial and/or social circumstances, although some municipalities target low-income households (by applying the same income thresholds as the central government´s housing benefit scheme) rather than households in difficult financial circumstances. In 2020, 60 out of 72 municipalities had established rules for the provision of special housing support, with 28 municipalities conditioning such support on applicants' social situation.

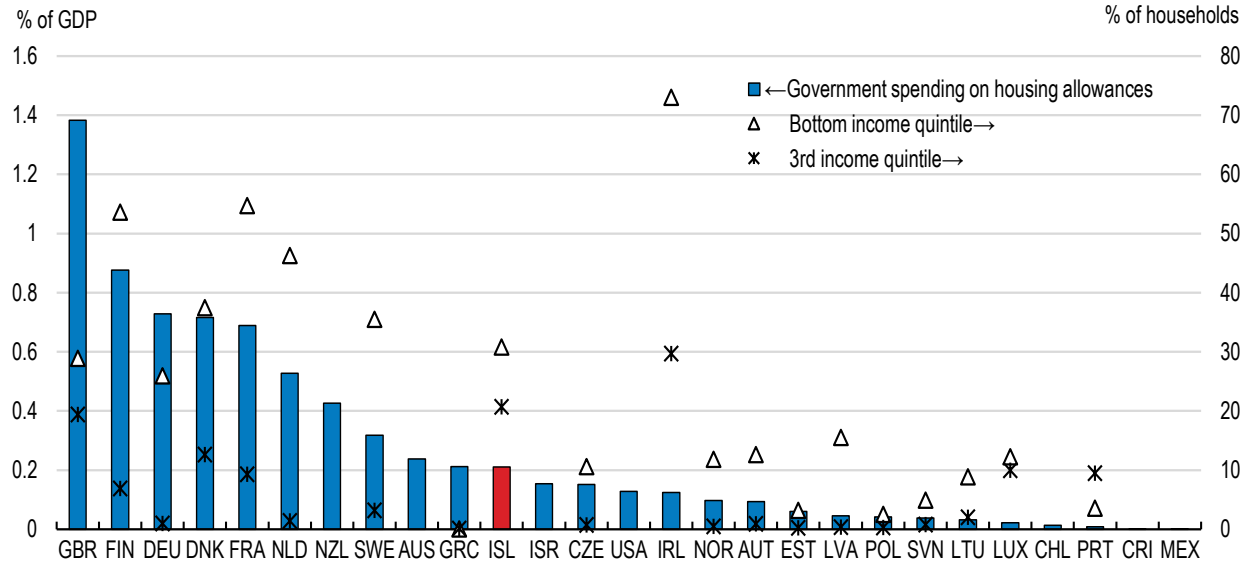
Local governments further provide municipal financial assistance (*Fjárhagsaðstoð sveitarfélaga*) for those without other resources. The benefit is means-tested, with benefit amounts differing across regions and household types. Financial assistance is granted on the basis of monthly decisions and for certain applicants it may be granted for six months at a time. No general absolute duration limit applies, however.

Source: (OECD, 2022[80]); (Government of Iceland, 2022[79]).

There is scope to improve the effectiveness of housing support for low-income households. Public spending on housing allowances as a share of GDP is still relatively low compared to Nordic peers (Figure 2.33). Over 30% of households in the bottom income quantile receive housing allowances in Iceland, above the OECD average, but more than 20% of the housing allowances are allocated to households in the third quantile (Figure 2.33). The share of higher-income households (third quantile) receiving housing support is the largest among the Nordic countries. There is scope to better target housing support on low-income households. The recent working group on housing support schemes (see above) has further proposed to reform housing assistance for tenants by merging the housing benefits provided by the state and special housing support from the municipalities into one support scheme that will be provided by the state and be conditioned solely on the financial situation of the applicants, with no additional requirements related to their social situation (Government of Iceland, 2022[79]). As a follow-up, a new working group has recently been created to make further proposals on such merged housing support scheme for tenants.

Figure 2.33. Support for housing could be better targeted

Government spending on housing allowances and households receiving housing allowances, 2018 or latest



Note: The housing allowance for Iceland refers to housing benefit (*Húsnæðisbætur)*. Detailed methodological note can be found at Housing Affordability indicators - OECD.
Source: OECD, Affordable Housing database.

StatLink https://stat.link/gekiru

Strengthening social and affordable housing is essential. Investment to improve the quality of existing social housing and develop new dwellings can be an effective tool to address the housing needs of the low-income groups, notably immigrants, who usually struggle to afford housing in the private market. As a step forward, the central government and the municipal authorities have signed a framework agreement under which 35 000 new units are to be built over the next ten years. Of these, 30% should be affordable housing and 5% social housing, according to official estimates. This initiative can help to reduce unmet needs for social and affordable housing. Appropriate investment levels need to be ensured following a rigorous assessment of the pending demand for such housing.

There are several options to finance social housing. Funding could come directly from the general government budget or through other channels that could limit budgetary pressures. Iceland's Housing Fund provides loans to municipalities, companies and associations for the construction and/or purchase of residential housing. In addition, since 2016, the government has granted state capital foundation contributions for the building of affordable rental dwellings (*Almennar Ibudir*). In recent years, up to 20% of new residential housing units have been built with capital contributions. The latter are repaid into a revolving fund, like in some other countries. Austria and Denmark, for instance, have developed revolving funds as part of a long-term funding strategy for housing which finance the development and maintenance of the social housing stock through a mix of state-guaranteed and market loans (OECD, 2021[81]). It is important that the impact of the government's capital contributions for the construction and purchase of public rental dwellings be evaluated regularly in terms of sustainable development of social and affordable housing and as well achievement of environmental objectives. Reducing complex planning regulations and administrative barriers to construction is also essential to expand supply of social housing, and more broadly, affordable housing supply (Chapter 1). Empirical OECD analysis highlights the importance of land-use reforms for making housing markets more affordable (Cournède, De Pace and Ziemann, 2020[82]). Recent policy initiatives under the Framework Agreement on Housing between the government and municipalities to reform statutory processes for planning and housing construction are welcome, paving the path for a more responsive housing supply (Government of Iceland, 2022[83]) (Chapter 1).

At the same time, eligibility conditions for social and affordable housing should be harmonized across municipalities to increase transparency and effectiveness. Setting an upper limit for the period on the waiting list for access to social housing could also be considered. In Lithuania, for instance, a municipality will by law have to reimburse the actual rental costs in case it cannot meet its obligation to grant access to social housing by the end of this period (OECD, 2022[84]). It is important, however, to avoid the risk that, when being allocated, a social housing dwelling becomes an obstacle for low-income workers to follow jobs, hindering resource reallocation. Allowing eligibility for social housing to be portable across cities and regions would facilitate residential and hence labour mobility (OECD, 2021[81]).

It is also important to improve immigrants' access to information regarding eligibility to housing allowances and/or social housing. The provision of free legal advice to tenants under the service agreement between the government and National Consumers Association and translation of information (funded by the government) on tenants´ rights and obligations into English and Polish are welcome (Government of Iceland, 2022[6]). Information on the eligibility to housing allowances and/or social housing in a language other than Icelandic is also essential and efforts in this regard should continue as part of a comprehensive strategy towards improving immigrant integration and making the best of immigration.

Table 2.1. Recommendations for addressing the challenges and unleashing the benefits of immigration

Attracting more high-skilled immigrants	
There is scope to attract more highly skilled immigrants in view of specialist shortages in frontier sectors, notably ICT.	**Proceed with the timely implementation of the new provisions for the issuance of work permits for foreign experts.** **Ensure a swift adoption of the draft bill envisaging an extension of the duration of residence and work permits for foreign experts**.
The government provides tax incentives to foreign specialists but outcomes are not assessed systematically.	Regularly evaluate the effectiveness of the tax incentive scheme for the foreign specialists.
Public universities provide free education for all students. The other Nordic countries charge non-EEA students school fees.	Introduce tuition fees for non-EEA public university students.
Improving the labour market integration of immigrants and refugees who intend to stay	
The unemployment rate and overqualification are higher for immigrant workers than for natives, largely reflecting relatively poor command of Icelandic, with room to define more clearly the role and responsibilities of stakeholders in the provision of language training for adult immigrants.	**Make language training for adult immigrants part of a comprehensive approach to immigrant integration, combining it with vocational training, and by involving all partners.** **Increase the accessibility and flexibility of the language training courses.** **Ensure coherence of teaching quality standards and introduce student evaluation in language training of adult immigrants to help them improve their learning outcomes**.
Refugee inflows have increased rapidly in recent years.	**Ensure a successful integration of refugees, notably through supporting the rapid acquisition of language skills.**
The skills recognition system is complex and information on recognition requirements and processes difficult to access, discouraging third-country immigrants from applying.	**Ensure clear eligibility rules and well-coordinated procedures for the recognition of foreign qualifications.** **Ease access to the skills recognition system by establishing a one-stop shop that offers multiple services to immigrants.**
The public sector can serve as an important lever to support immigrants' integration in the labour market but employs few of them.	Set indicative targets for the share of immigrants in public employment or new hirings, while developing mechanisms to monitor the outcomes of such policies**.**
Participation of immigrants in adult learning remains below that of the natives, with the gap driven by EU immigrants.	Develop pathways between the validation process of prior learning and education options for immigrants who wish to complete their formal qualification.
Bridging courses provide the opportunity to immigrants whose qualifications are not equivalent to a domestic degree to train and secure a host-country qualification, but are offered on a case-by-case base rather than through formal programmes.	Move towards a formal provision of bridging courses for immigrants.
Enhancing the educational outcomes of immigrants' children	
Immigrant students underperform their native counterparts by a wide margin in reading literacy and have higher upper secondary drop-out rates.	**Implement the Education Policy 2030 measures for students with a diverse linguistic background within the envisaged timeline**. Proceed with the implementation of the National Curriculum Guide for Compulsory Schools.
Participation of immigrant students in vocational education and training (VET) remains low, reflecting weak foundational skills and the low attractiveness of the system.	Strengthen preparatory programmes through the introduction of pre-apprenticeship schemes to support VET students at risk of dropping out. Make VET more market-relevant by extending work-based learning.
A comparatively high share of teachers reports a high need for professional development in teaching in a multicultural or multilingual setting.	Strengthen the diversity-related content of initial teacher education, while better aligning professional development opportunities to teachers' training needs.
Meeting the housing needs of immigrants	
Immigrants face high housing costs, and the stock of social and affordable housing does not appear to be sufficient to match the needs of an increasing immigrant population.	**Better target housing allowances at low-income households and ensure appropriate investment in social and affordable housing based upon a rigorous assessment of pending demand.**

Note: Key recommendations, featuring in the Executive Summary, are in bold.

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Iceland's economy is one of the fastest-growing in the OECD, driven by foreign tourism and strong domestic demand. The labour market is tight and wage growth robust, while high wage compression helps maintain a highly egalitarian economy. Inflation is persistent and broadening, and inflation expectations have de-anchored. The fiscal stance is tightening but consolidation could be faster to support monetary policy. Despite progress, barriers to entry remain in many sectors. Structural reform could raise productivity while also contributing to disinflation. Higher and broader taxation of greenhouse gas emissions, and investing in lower-cost actions to cut emissions, would help achieve further reductions efficiently. Immigration has increased rapidly since the late 1990s, driven largely by strong economic growth and high standards of living. This has brought important economic benefits, including by boosting the working age population and helping Iceland to meet labour demands in fast-growing sectors. However, challenges regarding the integration of immigrants and their children need to be addressed. More effective language training for immigrants and improved skill recognition procedures are called for. So is enhancing teachers' preparedness to accommodate students' diverse educational needs. Better integration also requires meeting the housing needs of the immigrant population, including through expanding the supply of social and affordable housing.

THEMATIC CHAPTER: ADDRESSING THE CHALLENGES AND UNLEASHING THE BENEFITS OF IMMIGRATION

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