

Trade Policy Review Body

TRADE POLICY REVIEW

Report by the Secretariat

ICELAND

Revision

This report, prepared for the third Trade Policy Review of Iceland, has been drawn up by the WTO Secretariat on its own responsibility. The Secretariat has, as required by the Agreement establishing the Trade Policy Review Mechanism (Annex 3 of the Marrakesh Agreement Establishing the World Trade Organization), sought clarification from Iceland on its trade policies and practices.

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Document WT/TPR/G/164 contains the policy statement submitted by Iceland.

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

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SUMMARY OBSERVATIONS**(1) INTRODUCTION**

1. Iceland's standard of living is among the world's highest, in part due to the overall openness of its economy facilitating its international specialization and consequent gains from trade. Since its previous Review in 2000, Iceland has continued to exploit its traditional strengths in fisheries and energy, while developing new activities. However, certain agricultural activities remain highly assisted, which both imposes costs on taxpayers and consumers, and reduces overall welfare. Taking further steps to reduce agricultural assistance could bring economic benefits, and help align agricultural policy with the market-based solutions that have helped Iceland to prosper.

2. Iceland undertook numerous reforms during the review period, often driven by its participation in the European Economic Area (EEA) Agreement. A number of policy changes, including liberalization of foreign investment restrictions, have focused mostly on EEA partners and, thus, widened the gap between the treatment Iceland affords such partners and other WTO Members. Closing this gap by applying reforms on an MFN basis, and securing them in the WTO, would help reduce trade and investment distortions, enhance competition in the domestic market, and prevent over-reliance on the EEA market. These are important considerations in view of Iceland's recurrent macroeconomic imbalances, which in early 2006 were again testing the flexibility of its economy.

(2) ECONOMIC ENVIRONMENT

3. Iceland's per capita income is among the world's highest (around US\$33,500 per person). Historically, Iceland's economic performance has been volatile, partly due to its small size and strong dependence on only a handful of production activities and export goods. However, volatility has decreased since the early 1990s, reflecting the increased diversification of the economy, the

implementation of structural reforms, and improved macroeconomic policies. Iceland's public finances are sound but, arguably, a stronger counter-cyclical fiscal policy could help smooth macroeconomic fluctuations. Monetary policy has been conducted within an inflation-targeting framework since 2001.

4. Iceland's average annual economic growth was around 3.6% in the period 2000-05. There was a short and shallow recession in 2002 but growth resumed in 2003 supported by domestic demand, particularly large-scale investment projects in the aluminium and power sectors, and buoyant private consumption. As growth gained momentum in 2004 and continued in 2005, signs of overheating were manifested in rising inflation, rapid credit growth, booming asset prices, a widening current account deficit, and rising external indebtedness. In this context, monetary policy has been tightened, and the fiscal stance has become more restrictive. There is a risk that, against the backdrop of growing imbalances, the sharp depreciation of Iceland's currency in early 2006 could lead to a significant retrenchment in domestic demand particularly in view of Iceland's high levels of external indebtedness.

5. The share of merchandise trade in Iceland's GDP has remained relatively constant since at least 1980, and, at around 50%, is low for a small economy. Membership in the EEA seems to have had a significant effect on Iceland's export pattern, which is increasingly dominated by the European Union. Food, mostly in the form of fish products, remains Iceland's most important export category although the composition of the export basket has changed sharply, reflecting an increase in the share of manufactured products in total exports between 1998 and 2004, notably aluminium and medicaments. Services trade has been very dynamic in recent years, as has direct investment, both inward and outward.

(3) **TRADE AND INVESTMENT POLICY
FRAMEWORK**

6. Given its small size, Iceland sees its participation in international trade as an indispensable element of economic policy and one of the factors contributing to its economic success. Iceland has participated actively in the multilateral trading system, despite its lean public administration, and has submitted several proposals in the context of the Doha Development Agenda. It has made numerous notifications but a few are still outstanding, such as on agricultural export subsidies, preferential rules of origin, government procurement, and SPS measures. Iceland has never been involved in any dispute in the WTO.

7. Iceland conducts trade policy within the framework of its participation in the EEA and, as required by the EEA Agreement, has transposed into domestic law most EU single market legislation. This has led to continued wide-ranging economic reforms since 2000, while also widening the gap between the treatment afforded to EEA and non-EEA partners in various economic sectors. As a member of the EEA, Iceland grants largely unrestricted access to goods, workers, services, and capital from other EEA members.

8. In the context of its participation in the European Free Trade Association (EFTA), Iceland has a large and growing network of free-trade agreements, which mostly mirror those of the EU. As a result, Iceland offers preferential tariffs on imports from 37 WTO Members under various free-trade agreements. Excluding the EEA and EFTA, free-trade agreements cover a very limited amount of Iceland's trade. Iceland applies the Pan-European Cumulation System for rules of preferential origin.

9. Iceland maintains restrictions on foreign investment in a few but important domestic sectors: fisheries, energy, and airline operations. Some restrictions on investment apply only to non-EEA or non-

OECD nationals and companies. In addition, Iceland's legislation gives the State broad authority to limit foreign investment in the event of serious economic difficulties in particular sectors.

(4) **MARKET ACCESS FOR GOODS**

10. Iceland maintains relatively low MFN applied tariffs, the overall average standing at 5.9%; however, the average on agricultural products is much higher (18.3%, WTO definition) than the average on other products (2.5%). About 70% of Iceland's tariff lines are duty free and 4.7% are non-ad valorem; the latter apply to agricultural products and result in ad valorem equivalents of up to some 500%. Agriculture also receives high tariff protection under preferential agreements. Tariff protection is high at the first stage of processing and for fully processed products, but low for semi-processed products.

11. Tariff quotas apply to 86 tariff lines, with out-of-quota rates ranging up to 306%. Quotas are auctioned when demand exceeds available in-quota volumes for minimum access commitments. This system promotes the efficient allocation of quotas among users and generates additional government revenue but also increases costs to traders. So far quotas have not been assigned to particular countries but from 2007 a reciprocal quota system will enter into operation with the EU.

12. Some 95% of all tariff lines are bound but the average bound rate (31.5%) is much higher than the average applied rate, which reduces the predictability otherwise afforded by Iceland's comprehensive tariff bindings. For a small number of tariff lines, applied rates are higher than bound rates.

13. Iceland has not used anti-dumping, countervailing or safeguards measures.

14. Iceland acceded to the WTO Government Procurement Agreement in 2001, when it also adopted new laws on public procurement and on public projects

procedures. Limitations on the coverage of Iceland's GPA commitments relate to, among others, various services sectors, certain services or utilities contracts, and the procurement of animal products. Iceland is in the process of establishing a system for the collection of the statistical information required under the GPA.

15. In 2000, Iceland notified the WTO of its legislation to implement the TBT Agreement. Iceland is required to transpose EEA legislation on technical regulations, standards, testing and certification, and the majority of Iceland's standards and technical regulations follow EU norms. During the period under review, Iceland made 41 notifications concerning draft technical regulations to the EFTA Surveillance Authority but only one to the WTO.

16. Under the SPS Agreement, Iceland has notified to WTO Members certain emergency import bans; however, it has yet to notify Regulation 509/2004, which banned the import of specified agricultural products unless an exemption is granted by the Minister of Agriculture. Although Iceland has a wide derogation from EEA sanitary legislation, in practice many of its SPS regulations have been harmonized with those of the EU. Animal products from animals that have been given growth promoting agents or hormones are banned in Iceland. The authorities indicate that no restrictions are currently in place on genetically modified organisms.

17. Iceland adopted three new IPR-related laws over the review period: the Design Protection Act, the Act Respecting Collective Marks, and the Act Respecting Employees Inventions. Other IPR legislation has been amended. Iceland is signatory to a number of international IPR treaties, and since 2000 it has acceded to the Geneva Act of the Hague Agreement Concerning the International Registration of Industrial Designs as well as the European Patent Convention.

(5) OTHER MEASURES AFFECTING TRADE

18. There are very few measures directly affecting exports in Iceland, and these are related mostly to agricultural products (see below). Export restrictions or licensing are applied to protect human and animal health or for other non-commercial reasons. There is little by way of official export finance available to Icelandic businesses.

19. Significant amendments have been made since 2000 to Iceland's competition regime to implement institutional changes and EEA legislation, and to strengthen the powers of the competition authority. Iceland's national competition regime runs in parallel with EEA competition rules, which apply where restrictive practices may affect trade between EEA members.

20. Retail distribution of alcoholic beverages and import and wholesale of tobacco and tobacco products are the preserve of the State Alcohol and Tobacco Monopoly, Iceland's only state trading enterprise. Iceland has continued to privatize state enterprises during the period under review, and these have included assets in banking, telecommunications, and the Agricultural Loan Fund. Steps have also been taken to simplify the tax system and reduce tax rates, notably, by reducing corporate income tax from 30% to 18% and abolishing the wealth tax.

21. Excluding agriculture, state aid is low and generally of a horizontal nature, targeting mainly research and development, promotion of small and medium sized enterprises, training and job creation.

(6) SECTORAL POLICIES

22. Iceland's small agricultural sector is among the world's most highly assisted, with the producer support estimate at about 70%. Assistance targets mainly the sheep and dairy sectors. Milk is subject to production-linked direct payments, production quotas and

administered prices. Sheep farmers receive direct payments based on support targets and quality-dependent payments. Producers of lamb meat must export a percentage of their production. Over the period under review, changes to agricultural policy included the establishment of a price equalization mechanism to support agricultural exports, whereby exports of goods made from agricultural raw materials benefit from a refund equal to the difference between the cost of raw materials in the international and domestic markets; the introduction of direct payments to farmers producing vegetables and plants in greenhouses; and the creation of new rules regarding the production of milk. In its most recent notification to the WTO, Iceland indicated that it had not provided export subsidies in agriculture for the years 2000-02.

23. Fishing and fish processing continues to be a mainstay of the Icelandic economy, accounting for 60% of total merchandise export revenue. To protect the resource base, fisheries are managed through a system of individual transferable quotas; in 2004, a fishing fee levied on owners of vessels holding harvesting rights was introduced. The EEA Agreement does not cover fisheries. Ownership of fishing operations and primary fish processing is limited to Icelandic nationals or residents, although non-residents can own up to 25% of the shares in Icelandic companies involved in these activities.

24. Iceland is richly endowed with energy resources, and energy costs are low by international standards. Driven by Iceland's EEA commitments, there have been a number of important legislative changes over the review period to promote greater efficiency and competition. However, the electricity industry remains entirely owned by the State or local governments. Only Icelandic, EEA or EFTA residents and legal entities may own energy exploitation rights or enterprises involved in producing or distributing energy, although agreements may be reached to extend these benefits to other parties.

25. Manufacturing activities in Iceland are concentrated mainly in energy-intensive industries, notably aluminium production, although other industries have gained in importance. The sector is export-orientated due to the small size of the domestic market. Manufactured exports have expanded significantly over the review period and the development of new aluminium smelting capacity has generated significant inflows of foreign direct investment. A feature of the review period has been the growth in turnover and export of medicinal and medical products.

26. The services sector is of increasing importance to Iceland, accounting for some 80% of GDP in 2004. This expansion has been driven largely by financial services, and real estate, renting and business activities. Under the GATS, Iceland undertook sector-specific commitments in 9 of the 12 sectors included in the services classification. It also signed the Fourth Protocol on Basic Telecommunications and the Fifth Protocol on Financial Services. Iceland has submitted initial and revised GATS conditional offers in the context of the Doha Development Agenda.

27. There have been major changes in the telecommunications sector during the period under review. Legislative developments driven by Iceland's EEA commitments have been aimed at creating a more liberal and competitive environment. In addition, stemming from Iceland's WTO commitments, a regulation was issued confirming the right of companies established in WTO Members to offer telecommunication services in Iceland. Other changes include the separation of postal from telephone services and the privatization of Iceland Telecom, which was sold to a consortium of predominantly Icelandic investors.

28. The current structure of the financial services sector is the result of a process of privatization and intense consolidation between 1998 and 2003. A state-owned firm (the Housing Financing Fund) remains the largest institution in the financial system. There is one branch of a foreign bank

operating in Iceland, but no subsidiaries or representative offices of foreign banks. In contrast, Icelandic banks have made significant international acquisitions. Iceland's insurance market is characterized by a relatively high degree of concentration. Financial services legislation has been extensively revised since Iceland's last Review. Iceland's banking and insurance markets are largely open to foreign participation, although treatment of foreign firms differs markedly between firms licensed in EEA States and other firms.

29. *Due to Iceland's geographical location and its reliance on international trade, maritime and air transport play a major role in its economy. Iceland's civil aviation industry is subject to EEA competition laws, and one case was referred to the EFTA Court during the review period. Foreign ownership in Icelandic companies involved in airline operations may not exceed 49%, although this limitation does not apply to EEA nationals,*

who are granted national treatment. In addition, no undertaking may be granted an operating licence unless it is effectively controlled by EEA nationals. Iceland has signed and is in the process of completing a number of bilateral air transport agreements, most of which are open skies agreements.

30. *Practically all movement of goods to and from Iceland is by maritime transport. Costs are high because of the distances involved, low competition, and small volumes transported. There are no restrictions on private or foreign ownership of ports, however, all ports are currently the property of the community in which they are located. Iceland is one of the few WTO Members to have requested that its offer made in the suspended extended WTO Negotiations on Maritime Transport Services be made part of its GATS Schedule of Specific Commitments. In addition Iceland is the only WTO Member to have scheduled a specific commitment on cabotage.*

