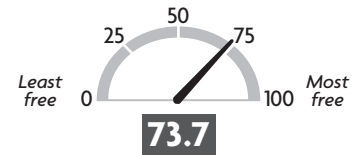


ICELAND

Economic Freedom Score



World Rank: **18**

Regional Rank: **9**

Iceland's economic freedom score is 73.7, making its economy the 18th freest in the 2010 *Index*. Its overall score has declined by 2.2 points from last year, reflecting drops in seven of the 10 economic freedoms. Iceland is ranked 9th out of 43 countries in the Europe region, and its overall score is higher than the world and regional averages.

Iceland's economy has contracted significantly, with its financial sector severely affected by the global financial turmoil. Aggressive overseas expansion of bank lending, unchecked by the domestic regulatory environment, caused the buildup of considerable systemic risk for such a small economy. The resulting collapse of the banking sector has increased government debt, triggering a sharp surge in the fiscal deficit.

Nevertheless, Iceland's overall levels of economic freedom are still relatively high. Such institutional strengths as the strong rule of law, low levels of corruption, efficient business regulations, and competitive tax rates are good foundations on which to build recovery, curb long-term high unemployment, and restore economic stability, but they need to be supported by further reforms in financial management and the labor market.

BACKGROUND: Iceland is a centuries-old democracy that traditionally has enjoyed low unemployment and a growing economy. However, in October 2008, the banking sector collapsed, sparking a currency crisis. Prime Minister Geir Haarde of the Independence Party and his cabinet were forced to resign, and the Social Democrats took over on February 2, 2009, with Johanna Sigurðardóttir as prime minister. A deep recession has taken hold, and unemployment is high. Reversing its long-held opposition to joining the European Union, Iceland's parliament voted in July 2009 to apply for EU membership. Iceland is already a member of the European Free Trade Association and the European Economic Area, which allows for free cross-border movement of capital, labor, goods, and services with the EU.

Country's Score Over Time



Quick Facts

Population: 0.3 million

GDP (PPP): \$11.7 billion

0.3% growth in 2007

4.4% 5-year compound annual growth

\$36,775 per capita

Unemployment: 7.1% (1st quarter of 2009)

Inflation (CPI): 12.4%

FDI Inflow: -\$2.6 billion

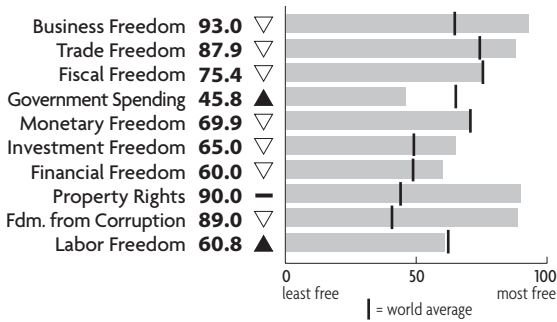
2008 data unless otherwise noted

Data compiled as of September 2009

How Do We Measure Economic Freedom?

See page 457 for an explanation of the methodology or visit the *Index* Web site at heritage.org/index.

ICELAND'S TEN ECONOMIC FREEDOMS



BUSINESS FREEDOM — 93

The overall freedom to start, operate, and close a business is strongly protected under Iceland's regulatory environment. Starting a business takes an average of five days, compared to the world average of 35 days. Obtaining a business license requires much less than the world average of 18 procedures and 218 days. Bankruptcy proceedings are straightforward.

TRADE FREEDOM — 87.9

Iceland's weighted average tariff rate was 1.1 percent in 2008. High agriculture tariffs, import bans and restrictions, import taxes, strict sanitary and phytosanitary regulations, and government support programs for the agricultural sector add to the cost of trade. Ten points were deducted from Iceland's trade freedom score to account for non-tariff barriers.

FISCAL FREEDOM — 75.4

Iceland has a competitive flat-tax system. The main income tax rate is 22.75 percent (which, combined with the local government rate, can rise to 35.72 percent). Investment income is subject to a flat 10 percent rate. The corporate tax rate is a flat 15 percent. Other taxes include a value-added tax (VAT) and an estate tax. Excise taxes on tobacco, alcohol and fuel were raised in 2009. In the most recent year, overall tax revenue as a percentage of GDP was 41.4 percent.

GOVERNMENT SPENDING — 45.8

Total government expenditures, including consumption and transfer payments, are high. In the most recent year, government spending equaled 42.5 percent of GDP. Privatization of state-owned enterprises has progressed over the past 10 years. A mounting fiscal deficit was projected to reach 13 percent of GDP in 2009.

MONETARY FREEDOM — 69.9

Inflation has been high, averaging 10.1 percent between 2006 and 2008. Inflation fell from nearly 19 percent in January 2009 to 11.3 percent in July and would have fallen further were it not for the depreciation of the krona since March, which has boosted import prices. The government subsidizes agricultural production; milk is subject to production-linked direct payments, production quotas, and administered prices; and sheep farmers receive direct payments based on support targets and quality-dependent

payments. Ten points were deducted from Iceland's monetary freedom score to account for policies that distort domestic prices.

INVESTMENT FREEDOM — 65

The 1996 Act on Investment by Non-Residents in Business Enterprises grants national treatment to non-residents of the European Economic Area (EEA). Under the law, foreign ownership of businesses is generally unrestricted, but there are limitations in fishing, energy, and aviation. Investment regulations are transparent, although bureaucratic delays can occur. Until recently, Icelandic law provided for full convertibility and transferability of dividends, profits, interest on loans, debentures, mortgages, lease payments, and invested capital. However, following the financial turmoil in 2008, movements of capital to and from Iceland have faced new restrictions. Foreign investors from outside the EEA may purchase land or real estate in Iceland upon government approval.

FINANCIAL FREEDOM — 60

Iceland's financial sector, which remains dominated by banking, has been under considerable strain. While undergoing rapid transformation and restructuring over the past decade, the banking sector grew to about eight times GDP by 2007, mostly through aggressive expansion of overseas lending. Regulatory oversight proved insufficient to deal with such an anomalous situation. Macroeconomic imbalances and private-sector borrowers' high indebtedness added to the instability, rendering banks highly vulnerable to any external shock. The three main banks, which accounted for over 80 percent of the banking system, collapsed in late 2008 and have been brought under the government's control since then. Efforts to shore up stability and confidence have been made, but vulnerabilities linger.

PROPERTY RIGHTS — 90

Private property is well protected. The constitution provides for an independent judiciary, and the government respects this in practice. Trials are generally public and conducted fairly. Iceland is one of the few countries with efficient, property rights-based fisheries management.

FREEDOM FROM CORRUPTION — 89

Corruption is perceived as minimal. Iceland ranks 7th out of 179 countries in Transparency International's Corruption Perceptions Index for 2008. Isolated cases of corruption are not an obstacle to foreign investment. Iceland's 1,000-year history of parliamentary government has encouraged the institutionalization of accountability and transparency.

LABOR FREEDOM — 60.8

Labor regulations are relatively rigid. The non-salary cost of employing a worker is moderate, but dismissing an employee can be costly. The labor market remains highly centralized, with broad wage settlements and over 80 percent unionization.