Iceland: Starting the reform engine to maintain high living standards

Category: Iceland
written by oecdecoscope | June 26, 2025



By Hansjörg Blöchliger

Rather small, rather remote, and prone to volcanic shocks – Iceland might not seem predestined for economic success. Yet it has become one of the wealthiest countries in the OECD. The economy is bolstered by a sound macroeconomic framework, a highly skilled workforce, and a culture of innovation. And it is among the most egalitarian in the OECD, thanks to high labour force participation, compressed wages, and well-targeted social benefits.

Growth has slowed, reforms are needed

Yet growth has considerably declined over the past two years. The economy shrank by 0.7% in 2024, down from 5½% growth in 2023, as monetary policy tightened and exports slowed. While momentum is picking up again, risks loom – from global tensions to domestic imbalances.

The latest ***OECD Economic Survey of Iceland*** calls for bold reforms. Some are indeed envisaged by the new government and should be taken forward, to keep growth strong and living standards high. Better fiscal policy should be on top of the

list. It is often procyclical, amplifying fluctuations in an already volatile economy. Iceland’s budget rules have been on hold since 2019, and deficits are shrinking only slowly. A new spending rule could help smooth economic cycles and put public finances on firmer ground. Restarting spending reviews, notably for education or health care, could also do a lot to underpin prudent fiscal policy.

Inflation has cooled from a high 10% in early 2023 to around 4% in spring 2025 but is still well above the 2.5% target. Housing costs are the main culprit, driving over half of consumer price inflation. Until inflation and inflation expectations have settled around the target, monetary policy needs to stay tight.

Education: a wake-up call

Iceland’s PISA scores have been sliding for two decades, which could jeopardize long-term economic growth and well-being. The gap between native and immigrant students is among the widest in the OECD. The government should reboot the education system with:

- National assessments of students and schools
- A sharper curriculum
- Better teacher training and an improved competency framework
- More language support for immigrant students.

Powering up the electricity sector

Iceland’s energy security is under pressure. Demand is surging, but the power grid is ageing and at capacity limits. Electricity is no longer so cheap or abundant. Land-use disputes and a tedious licensing process are holding back new generation and transmission projects. A fast-track approval

process for key energy projects could restore Iceland’s energy advantage and support its green ambitions.

Unleashing business dynamism

Iceland’s business climate is generally good, but not perfect. Product market regulations are still tighter than in most OECD countries. To boost productivity and innovation, Iceland should:

- Cut red tape for business licenses
- Ease restrictions in the professional services
- Open up to more foreign investment
- Streamline insolvency rules

Iceland has the capacity to thrive, but it is time to modernize the policy framework. With the right reforms, it can turn the challenges into opportunities.

For more information, please visit the **Iceland Economic Snapshot page**, where you’ll find more information about the 2025 Economic survey of Iceland.

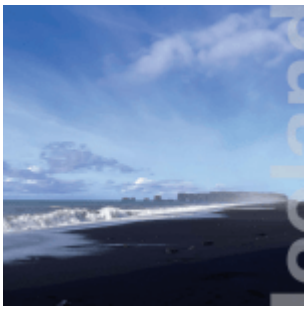
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Iceland: taming the inflation

spectre

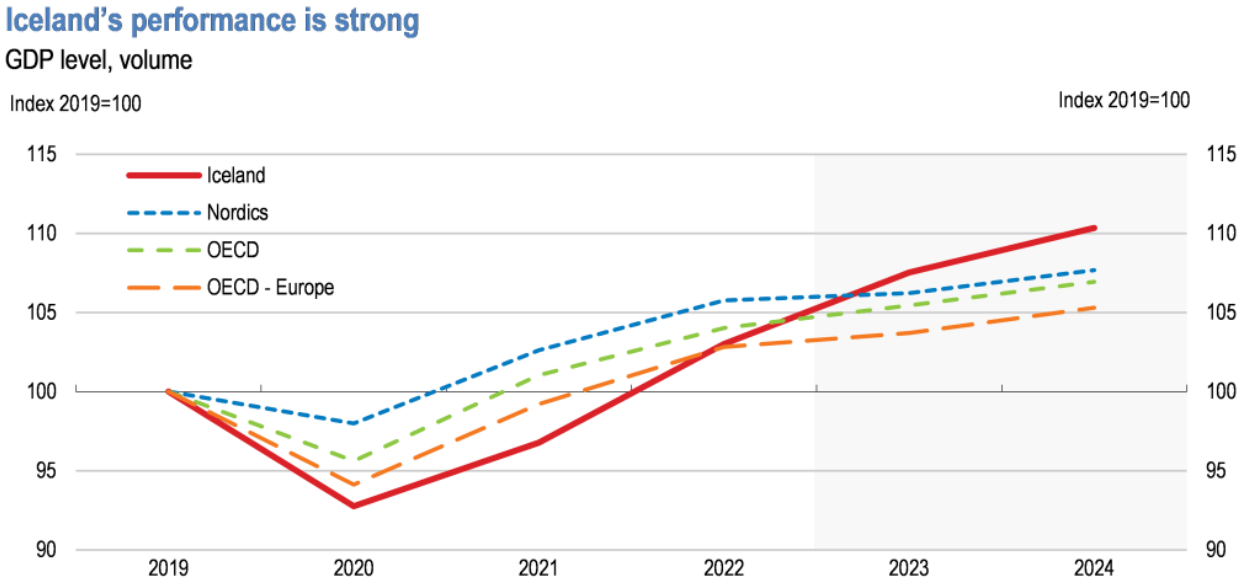
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by Hansjoerg Bloechliger

Iceland’s economy is riding high. Since the pandemic, the country’s growth has been one of the fastest of the OECD, driven by exports of energy-intensive goods and services and a strong rebound of foreign tourism. Relying on domestic energy sources, the country has largely been spared the power crisis that has strangled other countries, as shown in the Economic Survey of Iceland.



Source: OECD Economic Outlook No. 113 database.

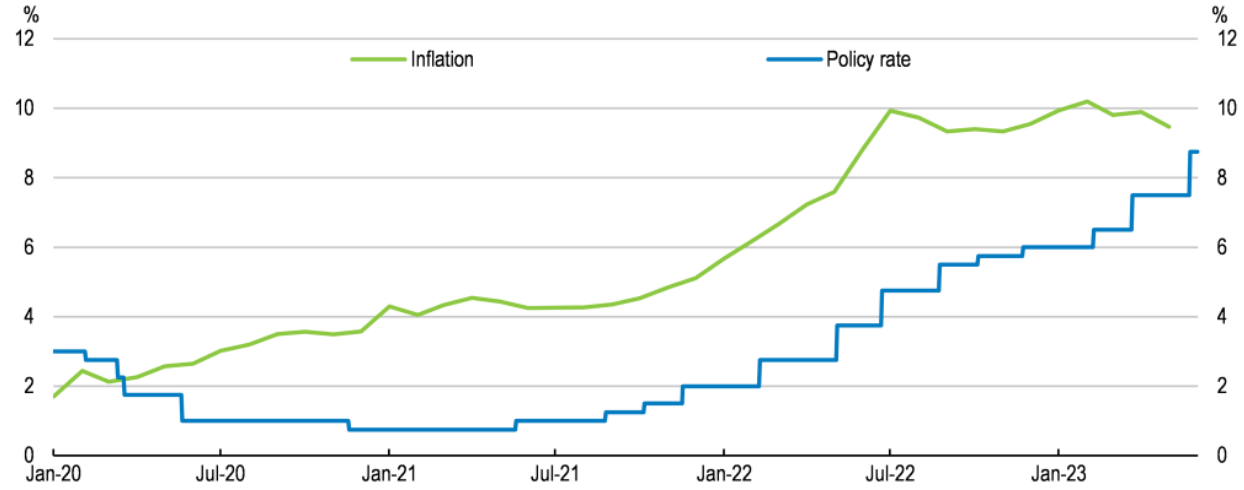
Unemployment is low and stable at around 3.5%, and labour participation of both men and women is again reaching historical highs. Economic growth is expected to moderate from 6.4% in 2022 to 4.4% in 2023 and 2.6% in 2024, still well above the OECD average.

Inflation remains stubbornly high

Yet everything is not cool in Iceland. Since mid-2022, headline inflation has been hovering at around 10%, much above the central bank's target of 2.5%. Unlike in continental European countries, Iceland's inflation surge was initially propelled by house prices. Those shot up by around 50% between mid-2020 and mid-2022, driven by the strong post-pandemic recovery and labour immigration. Inflation is now increasingly transmitted to the wider economy, notably the domestic service sector. Inflation expectations have de-anchored.

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; OECD, Consumer Prices database.

Three decades ago, Iceland succeeded in putting an end to entrenched inflation and repeated inflation bursts. It should do so again, tightening monetary policy further as needed to bring inflation back to the target and avoid a wage-price spiral. Fiscal policy should work in the same direction as monetary policy and avoid any stimulus, while limiting support to vulnerable households.

Structural reform could help raise productivity and tame inflation

Over the past few years reforms opened the tourism sectors to more competition. Despite these improvements, 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. Professional licencing requirements were hardly eased as attempts met with resistance from vested interests.

The government should continue its efforts to improve the business climate. Strengthening competitive forces will not only help raise productivity growth – currently at 1%, which is around the OECD average – but also contribute to bring inflation down.

Building on Iceland’s natural capital and reducing carbon emissions

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 several tourism services. Iceland should continue to develop a balanced strategy for productive and sustainable tourism. It should remove the current tax privileges in the tourism sector, notably the reduced VAT rate, and it should introduce a tourism levy to fund local sustainable tourism infrastructure.

The government has strengthened climate policies over the past two years and carried out thorough cost-benefit analysis of abatement measures. Carbon emissions are declining gradually. Yet per capita emissions remain above the OECD average. The government should strengthen climate action further in a sustainable and efficient manner. It should notably strengthen carbon taxation and prioritise climate actions with low abatement cost per tonne of carbon.

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Fostering a resilient recovery and sustainable

growth in Iceland

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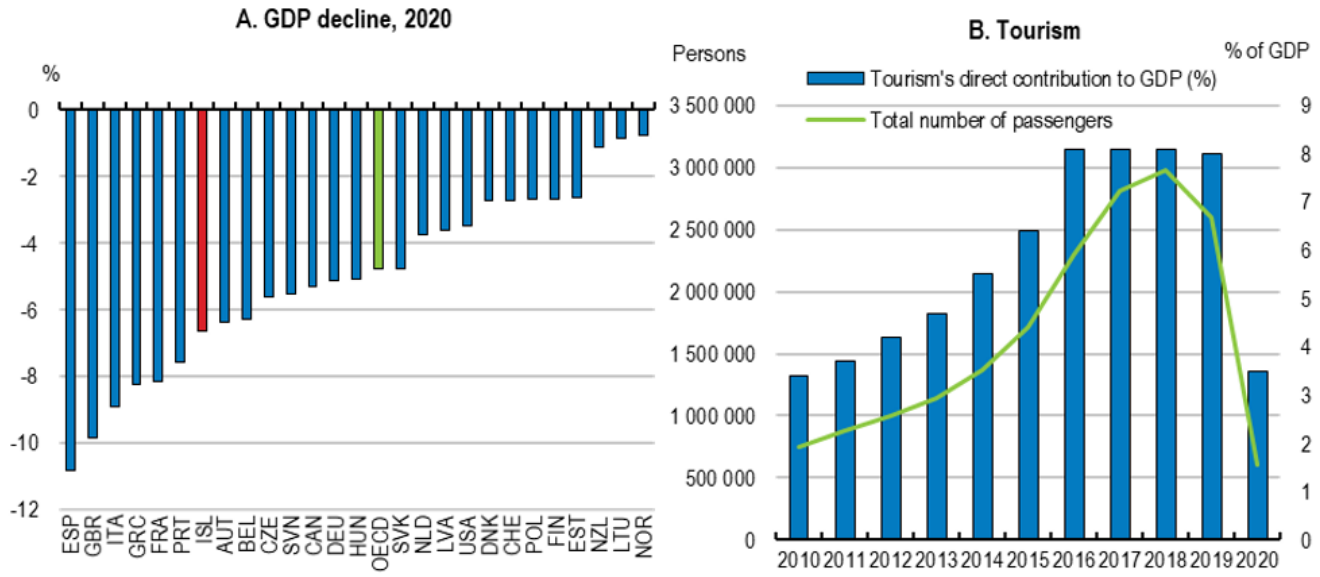


By Hansjörg Blöchliger and Vassiliki Koutsogeorgopoulou, OECD Economics Department

Iceland went through a comparatively mild COVID-19 health crisis. Containment measures were less severe than elsewhere, and all domestic restrictions were lifted at the end of June 2021. Yet the economy suffered a lot. Following lockdowns and travel restrictions worldwide, tourism, Iceland's most important export sector, collapsed with only around a fourth of foreigners arriving in 2020 compared to the previous year. GDP declined by 6.6% in 2020, and unemployment rose to 8%.

Even before the pandemic, other sectors had started to draw level with tourism as growth engines. The pharmaceutical industry continues to develop rapidly, and digital services such as data processing and storage benefit from Iceland's low energy prices and cool and windy climate. Fisheries are climbing up the value chain with fresh seafood and aquaculture rising fast. Innovative carbon capture technologies help reduce carbon emissions and provide export income.

Figure 1. The economy was hard hit as foreign tourism collapsed



Note: Passengers who go through security at Keflavík Airport.
Source: OECD, National Accounts database; and Statistics Iceland.

Macro policy supported households and firms

Like overseas, monetary and fiscal policy cushioned the blow for households and firms. In addition, the government plans to increase spending on infrastructure, digital and green transition, and research and development by around 0.5% points of annual GDP over the next few years, to ensure a healthy and sustainable recovery.

Yet public debt could continue to rise since Iceland, as a small open economy, is highly vulnerable to external shocks. To maintain fiscal space, the government should start consolidating once the recovery is firmly underway. Although Iceland’s population is young and active, the government should start addressing disability, pension and long-term care spending.

Structural reform could help boost productivity

Regulation is restrictive, hampering sound competition. Administrative burdens and an extensive licensing and permit system slow the entry of new and innovative firms. Skills gaps are considerable. To boost productivity and diversify the economy, regulation particularly in the tourism and

construction sectors should be eased. The quality of education, from primary to tertiary, should be better aligned with the needs of economy and society.

Fostering innovation is crucial for strong economic performance in the digital era

Innovation outcomes remain weak in some critical areas, notably ICT. Despite generous R&D tax incentives, many smaller firms have not been inclined to innovate. Icelandic firms should also be encouraged to step up the adoption of digital technologies, which would help the country make the most of innovation niches. Improving framework conditions and easier access to finance for young innovative firms are important. At the same time, the provision of digital skills needs to be strengthened and knowledge exchange enhanced, through closer business-university collaboration on innovation.

Making climate action more cost-efficient and inclusive

Iceland’s per capita greenhouse gas emissions exceed the OECD average, partly because of emission-intensive aluminium smeltering. The government committed to reduce emissions from their 2005 level by at least 40% by 2030. Iceland’s climate policy should rely on effective carbon pricing, complemented by investment in low-carbon technology and participation in international projects to finance emission reduction in transition and emerging market economies. Revenues from carbon pricing could be redistributed to households and firms.

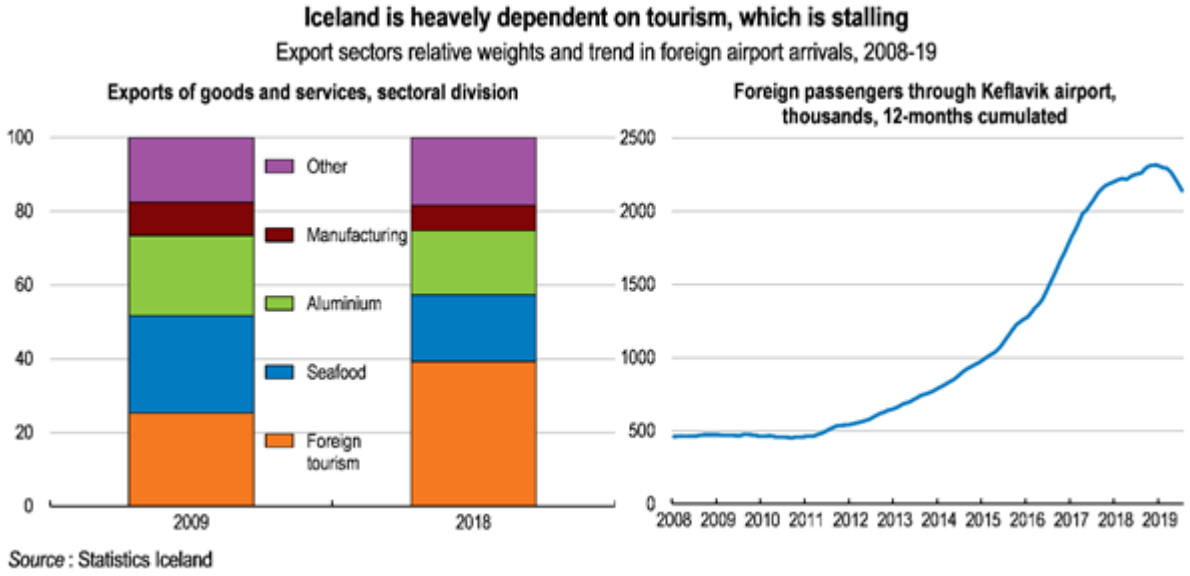
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A rapid downturn is exposing Iceland’s structural weaknesses

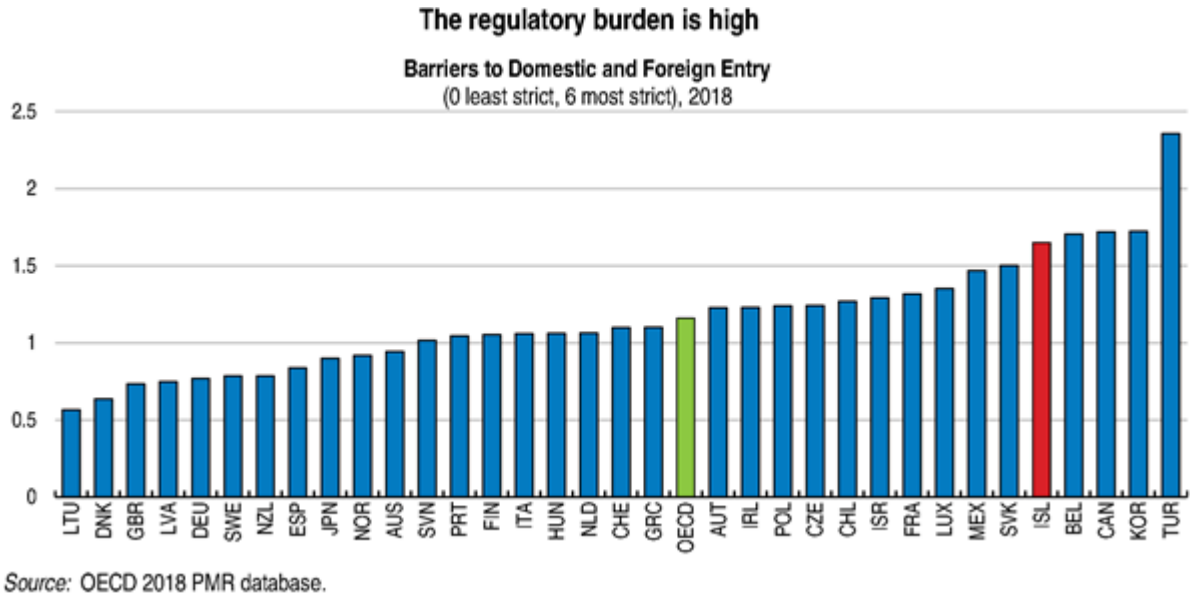
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by Hansjörg Blöchliger, Vassiliki Koutsogeorgopoulou , Iceland Desk, OECD Economics Department

Over the years Iceland caught up rapidly with the richest OECD economies. Favourable external conditions and good macroeconomic policies helped foster strong growth, low unemployment, low inflation, and sustainable public finances. Iceland is also one of the most inclusive economies in the OECD thanks to high employment, little wage inequality, and a well-targeted social benefit system, suggesting that a performing economy and an egalitarian society can go together.

Yet the country was hit by several export shocks during the first half of 2019, and the economy turned sharply. Revenues from tourism have almost stalled, especially after the Icelandic low-cost airline WOW went bankrupt. Seafood exports also declined as a specific specimen disappeared from the country’s fishing grounds. Over the summer, the Central Bank gradually lowered interest rates by 1% percent point to 3.5%. Growth is projected to reach 0.2% in 2019, rebounding to 2.2% in 2020.



The rapid slowdown has exposed Iceland's structural weaknesses. The economy relies heavily on tourism and seafood, which together make up almost 60% of total exports. The gains in competitiveness, achieved after the 2008 financial crisis, have been exhausted by now. Product market regulation is stringent and the administrative burden for start-ups is high, holding back creative young firms. Restrictions to foreign direct investment are among the highest in the OECD, dampening potential productivity gains through more intensive knowledge transfer.



The government should set up a comprehensive action plan to open up the economy more, prioritising reforms that foster competition, level the playing field between domestic and foreign firms and attract investment from abroad. In addition,

wages should be linked closely to productivity developments, to maintain competitiveness.

Productivity would also benefit from addressing a decline in student performance and better matching adult skills to the labour market. Iceland has a highly equitable education system and a large share of its workforce is well-educated. Yet it could make education more responsive to labour market needs, to avoid people having the wrong skills or being overqualified. The business sector hardly supports tertiary education. A reform of university funding could help attract more private R&D activities and increase the quality and performance of higher education.

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A balancing act: Why inequality increased in the Nordics

Category: Denmark,Finland,Iceland,Inequality,Sweden,Uncategorized
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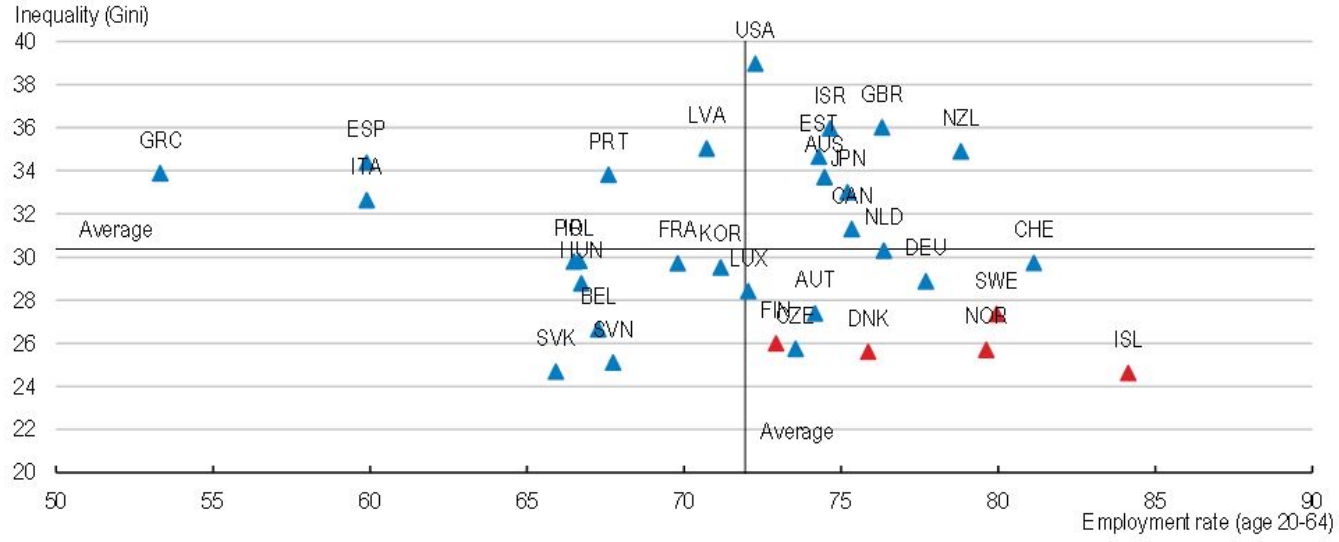
The Nordics are rightly renowned for being inclusive societies with low inequality compared to other OECD countries. However, some of the largest inequality increases over the past few decades took place in Sweden, Finland and Denmark. A newly

released article building on previous OECD work discusses how market forces, demographic trends and redistribution together shaped the income distribution of the Nordics.

It may seem like a paradox that the Nordics, which are very open economies, heavily integrated in global value chains and front-runners in the use of new technologies, have not seen even more widening distributions of market incomes. However, the extent to which skill-biased technological change and other forces widening the earnings distribution of workers will actually drive up inequality depends on a number of factors, and key policies and institutions in the Nordics play a dampening role. First, institutions such as unions and collective bargaining, employment protection legislation and minimum wages dampen the direct effect of market trends on earnings. Second, higher demand for skills are met by publicly-funded higher education, increasing the supply of skilled workers and thus holding back skills premiums. Third, a widening earnings distribution among workers coincided with increasing employment, limiting the overall effect on inequality.

Low income inequality in the Nordics is only sustainable if employment is high

Gini index for household disposable income and employment rates, 2014 or latest available year



Note: All OECD countries included except Chile, Mexico and Turkey. Data refer to 2012 for Japan; 2015 for Finland, Israel, Korea, the Netherlands, the United Kingdom and the United States; and 2014 for the rest.
Source: OECD Income Distribution Database; OECD Labour Force Statistics.

With a relatively modest overall impact from market forces, explanations for increasing inequality must be sought elsewhere:

- Demographic trends have been relatively strong drivers of inequality in the Nordics. Household structure, with more single-headed households has widened income dispersion in Denmark, Finland, Norway and Sweden. Ageing has increased inequality significantly in Finland, and immigration has increased inequality in Norway, Denmark and Sweden.
- Redistribution through taxes and transfers has weakened significantly in Denmark, Finland and Sweden, notably due to less insurance transfers (i.e. unemployment, sickness, disability insurance) and only partially offset by more assistance (i.e. means-tested) transfers. Income taxes have played a less important and more heroegneous role, as progressivity increased in Sweden while it decreased in Denmark and Iceland.

Technological and demographic pressures are set to continue going forward, and these challenges need to be embraced. Continued flexibility and constructiveness of the social dialogue and improvements to education are essential to seize opportunities from technological change and avoid a widening wage distribution. Making social insurance and welfare transfers more flexible and agile would improve workers' protection in a rapidly changing world of work. Improving benefit system design so that work always pays, notably in Denmark and Finland, and linking benefits to real-time income registries are important steps to this end.

The Nordics demonstrate that equity and efficiency can be compatible if incentives are right. Low inequality and strong safety nets can even be an advantage in today's globalised world, which requires constant adaptation. Reaping the full benefits from globalisation and technological progress requires broad support, which is easier to muster when the

social dialogue is constructive and representative, when everyone is given opportunities to fulfil their potential, risks are shared and losers compensated.

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Collective bargaining in Iceland: sharing the spoils without spoiling the shares

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written by oecdecoscope | June 26, 2025
by Urban Sila, Iceland Desk, OECD Economics Department

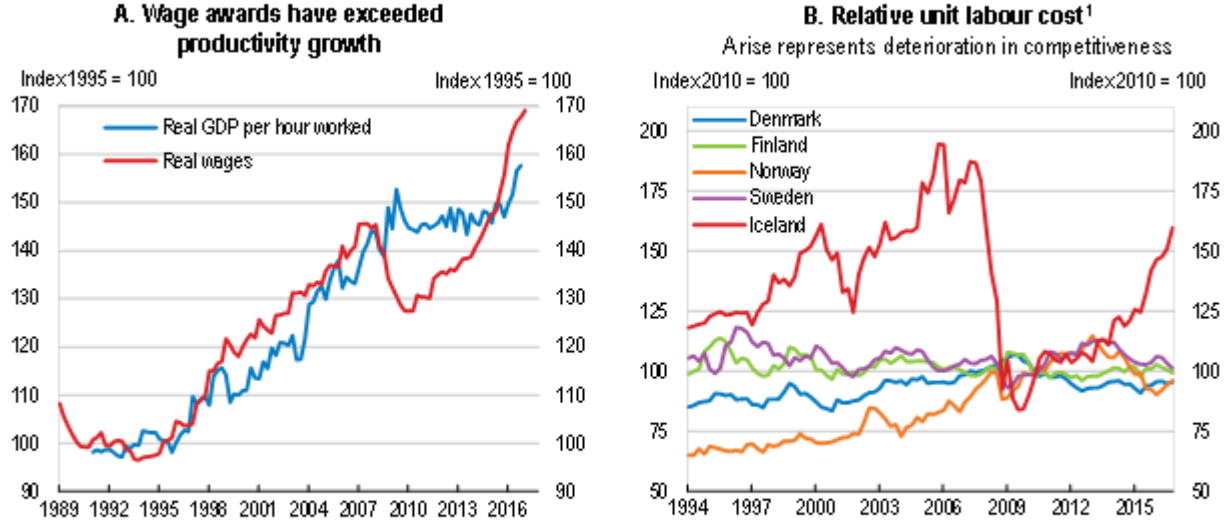
Icelandic labour market is flexible with high labour market participation, low unemployment, and labour supply dynamically responds to the economic cycle. Iceland is the most highly unionised country in the OECD and wage bargaining is a cornerstone of the economy. Strong unions have contributed to very low inequality, high inclusiveness and gender balance. Successful social pacts have protected the lowest paid workers during crises, and on occasion helped fight inflation.

Paradoxically, however, the Icelandic bargaining model has been less successful in times of economic boom, and Iceland suffers from recurrent bursts of social tensions and labour unrest. During such periods trade unions approach collective

rounds fragmented and with little regard for wider consequences of their demands. Wage demands by one union trigger topping-up demands by others, resulting in excessive awards. Recently, Iceland has again experienced a period of elevated tensions. In the 2015 bargaining round, doctors and teachers obtained three-year wage awards of around 25-30%, which led to demands by other unions for 50% pay increases. A bitter dispute erupted resulting in negotiated three-year nominal wage awards – that set the minimum over the settlement period – of more than 20% on average. Wages have been rising steeply ever since and together with króna appreciation, this has caused external competitiveness to plummet (Figure 1).

Iceland is a very small open economy prone to boom and bust cycles, and the pro-cyclical wage pressures add fuel to these harmful dynamics. The recently released OECD Economic Survey of Iceland 2017 argues for changes to the structure of collective bargaining to help sustain the benefits of the system for future generations.

Figure 1. Wage growth has eroded competitiveness



1. Labour costs adjusted for productivity and exchange rates in comparison with the country's trading partners.

Source: Statistics Iceland; OECD Analytical Database; and Central Bank of Iceland: Quarterly Macroeconomic Model database (seasonally adjusted).

Labour negotiations often break down because parties differ in their view of the economy. They frequently disagree even on what exactly has been agreed in the past. Iceland has been

through a challenging decade during which trust in politicians and among the social partners has been undermined. Trust and mutual respect can however be rebuilt by active and regular participation of the social partners in a tripartite macroeconomic council – to discuss issues of collective bargaining, welfare policy and social reform. Greater trust can also be fostered by setting up a "technical committee" that can provide impartial and accurate statistics on wages, economy, productivity and competitiveness to be used as a reference point in negotiations.

Wage coordination in Iceland is low. Labour unions tend to be very small and a large number of agreements need to be reached, creating the potential for co-ordination failure. Other countries ensure wage coordination for example by letting the sector that is exposed to foreign competition negotiate first, while other sectors follow (Nordic countries), or by linking wage increases to developments in neighbouring countries, to maintain competitiveness (Belgium). Recognising the Iceland specific context, the OECD Survey proposes that at the beginning of each negotiation round peak worker and employer organisations together issue "wage guidelines", taking into account the information provided by the technical committee.

A strong role of the state mediator is needed, however, to underpin such a system. The Icelandic state mediator is relatively weak compared to other Nordic systems. The state mediator should be seen as a promotor and protector of the wage guidelines and when issuing conciliation proposals, they should be in line with the wage guidelines.

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