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PARLIAMENT AND THE COUNCIL**

Enlargement Strategy and Main Challenges 2011-2012

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1. INTRODUCTION

1.1. Preface

This is the Commission's second report to the Council and Parliament on progress made by Iceland since the Council's decision to open accession negotiations.

This report:

- briefly describes the relations between Iceland and the Union;
- analyses the situation in Iceland in terms of the political criteria for membership;
- analyses the situation in Iceland on the basis of the economic criteria for membership;
- reviews Iceland's capacity to assume the obligations of membership, that is, the *acquis* expressed in the Treaties, the secondary legislation, and the policies of the Union.

The period covered by this report is from October 2010 to September 2011. Progress is measured on the basis of decisions taken, legislation adopted and measures implemented. As a rule, legislation or measures that are under preparation or are awaiting parliamentary approval have not been taken into account. This approach ensures equal treatment across all reports and enables an objective assessment.

The report is based on information gathered and analysed by the Commission. In addition, many sources have been used, including contributions from the government of Iceland, the EU Member States, European Parliament reports¹ and information from various international and non-governmental organisations.

The Commission draws detailed conclusions regarding Iceland in its separate communication on enlargement², based on the technical analysis contained in this report.

1.2. Context

Further to the Commission's Opinion, the June 2010 European Council decided to open **accession negotiations** with Iceland. Negotiations were officially opened in July 2010 and the screening exercise subsequently started in November 2010.

Iceland has been a party to the **Agreement on the European Economic Area (EEA)** since its entry into force in 1994.

Iceland has been associated with the developments of the Schengen Agreements since 1996 and has applied their provisions since 2001.

¹ The European Parliament's rapporteur for Iceland is Mr Dan Preda.

² Enlargement Strategy and Main Challenges 2011-2012 - COM(2011) 666.

1.3. Relations between the EU and Iceland

As a member of the EEA, Iceland regularly transposes and implements the *acquis* adopted in this framework. It also participates in EEA meetings on a regular basis. The EFTA Surveillance Authority (ESA) continues to monitor Iceland's performance under the EEA. Overall, Iceland's track record in implementing its EEA obligation remains satisfactory. Some shortfalls are still to be noted in areas such as financial services, food safety and free movement of capital. Temporary safeguards adopted on some restrictions of capital flows in the aftermath of the financial crisis remain in place.

Iceland participated in the multilateral economic dialogue between the Commission, EU Member States and Candidate Countries in the context of the pre-accession fiscal surveillance. The exercise included a meeting at Ministerial level in May in Brussels. These meetings focused on the main challenges posed to Iceland by the Copenhagen economic criteria.

Bilateral meetings between Icelandic parliamentarians and Members of the European Parliament continue to take place on a regular basis. The second EU-Iceland Joint Parliamentary Committee met in Reykjavik in April 2011 and the third in Brussels in October 2011.

Iceland's ability to assume the obligations of membership has also been assessed in the light of its participation in the European Economic Area (EEA) and taking into account exemptions granted under the EEA.

The Commission carried out its assessment of Iceland's compliance with the *acquis*, i.e. the **screening exercise**, from November 2010 to June 2011.

This screening exercise represents the first step of the **accession negotiations**. It led to the opening of the first four chapters of negotiation at the Accession Conference of June 2011. Two of these four chapters, namely *science and research* and *education and culture*, have been provisionally closed.

Financial assistance is provided to Iceland under the Instrument for Pre-Accession Assistance (IPA), since Iceland was included as a beneficiary country in July 2010. The strategic priorities for Iceland under IPA were defined in a Multi-Annual Indicative Planning Document (MIPD) for the period 2011 to 2013 with a budget of €28 million. The strategy identifies two objectives: (a) to further enhance Iceland's ability to assume the obligations of membership, by supporting the institutional capacity building for transposition and implementation of the *acquis* and (b) to reinforce Iceland's institutional capacity in its preparations for participation in and implementation of the Structural Funds and other EU funds. The first National IPA Programme for Iceland was adopted in October 2011 with a budget of €12 million.

Iceland continued to benefit from the Technical Assistance and Information Exchange Instrument (TAIEX), targeted on chapters which are not or only partially covered by the EEA and where there are significant divergences with the *acquis*.

2. POLITICAL CRITERIA

This chapter assesses the political criteria, focusing on the progress made by Iceland in addressing the shortcomings identified last year, in particular as regards reinforcing the independence of the judiciary and the anti-corruption policy framework.

As a deeply rooted and well-functioning democracy, Iceland continues to meet the political criteria as stated in the Commission's Opinion of February 2010 and the November 2010 Progress Report on Iceland.

2.1. Democracy and the rule of law

Icelandic institutions are stable and the rule of law is guaranteed. The judicial system is well established and the judiciary is of a high standard. The governance at national and local levels is effective and transparent. The public administration continues to be generally efficient and free of political interference. Human rights and the protection of minorities are legally guaranteed and respected in practice.

The elections for an advisory constitutional assembly held in November 2010 were annulled in January 2011 by the Supreme Court, due to flaws mainly relating to insufficient secrecy of the ballot. The parliament decided to appoint the 25 persons that came first in the elections as members of a **constitutional council**, which held its first formal meeting in April 2011. The constitutional council has an identical role and mandate to that of the constitutional assembly: to review the Constitution and propose changes to parliament on issues that cover, *inter alia*, the division of powers between legislative and executive, the presidential office and the democratic participation of the population, the independence of the judiciary, environmental issues including the ownership of and the right to harness natural resources, the status of the State church and the delegation of powers by the State to international organisations.

Legislative business has been completed or initiated, with a view to strengthening the role and efficiency of **parliament**. A law amending the parliament's rules of procedure was adopted by the Icelandic parliament, the Althingi, in June 2011. Its aims are to strengthen the parliament's oversight role, increase the rights and responsibilities of the opposition and establish a special constitutional and surveillance committee. The law is based on the recommendations of the Special Investigation Committee (SIC)³ and reflects the procedural guidelines of the Council of Europe on the rights and responsibilities of the opposition in parliament. In October 2010 new rules on the parliamentary procedure on EEA matters came into force. They stipulate *inter alia* that the parliament should be involved in the preparation process for the transposition into Icelandic legislation of new EU acts incorporated into the EEA Agreement.

The unity of the coalition **government** was tested on several occasions during the reporting period, most significantly in the vote on the 2011 budget. In the wake of the April 2011 referendum, where 60% of the electorate rejected the Icesave agreement reached in December 2010 (*See also chapter 9 - financial services*), the government faced a no-confidence vote in Parliament.

There continue to be diverging views on the prospect of EU accession among the Icelandic political forces and population, which are reflected in intensive debate. Opinion polls

³ The independent Special Investigation Committee was set up in December 2008 to investigate and analyse the process that led to the collapse of the banking system. It issued its report in April 2010.

continued to show a mixed picture as regards EU membership. Support for continuing the accession negotiations process remained high during the reporting period. As part of the parliament's EU information strategy, a dedicated website was launched in June 2011, to serve as a forum for objective and factual information about Iceland's EU accession process.

As regards internal preparations for accession, the Chief Negotiating Committee and the ten negotiating groups were actively involved in the screening meetings (November 2010 - June 2011). Translation resources, in terms of funding and manpower, have been increased extensively, including through EU financial assistance, in order to make progress on the task of translating the *acquis* by the date of accession.

Good progress can be reported in further implementing the recommendations of the Special Investigation Committee (SIC) and improving the already generally efficient **public administration**. The number of ministries was reduced from 12 to 10 in January 2011, following the merger of four ministries (ministries of health, social affairs, justice and transport) into two, namely the Ministry of Welfare and the Ministry of Interior. Further consolidation of the ministries is planned, with the overall objective of enhancing administrative capacity and coordination.

In September 2011, a bill, amending the legal framework of the central government, was adopted in order to increase flexibility in restructuring the ministries, strengthen the coordinating role of the Prime Minister, clarify the supervisory functions of ministries vis-à-vis agencies, ensure access to the civil service on a non-discriminatory basis and a transparent procedure for higher administrative positions to be filled, and strengthen the policy making capacity of ministries. According to the new law, the restructuring of ministries has to be approved by the parliament through a parliamentary resolution, instead of adopting a new law, as was the case in the past.

Overall, the state of local democracy is in compliance with the European Charter on Local Self-Government. The Additional Protocol to the Charter of Local Self-Government on the right to participate in the affairs of a local authority remains to be ratified.

Legislative work is also ongoing to improve regulatory practice, simplify administrative procedures and improve access to official documents. In February 2011, a working group was set up by the Prime Minister in order to review whether non-discrimination and transparency are sufficiently ensured in the process of partial or full privatisation of state enterprises. The working group issued its proposals in September 2011. A committee has been set up to prepare a report on reducing the number of independent complaints bodies, to be issued by October 2011.

A programme of specialised training for civil servants, the Administrative School, was established in September 2010. The School is carrying out *inter alia* courses on administration law, information law, the role and operation of ministries and project management.

The *independence* of the **judiciary** was strengthened. In May 2011, the process of appointing three judges in the Supreme Court took place according to the rules of the amended Judiciary Act. However, the implementation of the new rules on appointing judges and prosecutors still requires further monitoring. The limited tenure of only five years for prosecutors other than the Public Prosecutor and the Deputy Public Prosecutor needs to be addressed.

In order to strengthen the *efficiency* of the judiciary, the number of judges of district courts was temporarily increased from 38 to 43 and the number of Supreme Court judges from 9 to 12 in order to deal with the additional case-load following the financial crisis. (*See also Chapter 23 — Judiciary and fundamental rights*).

In March 2011, in line with the SIC recommendations, the Court of Impeachment convened to rule on issues relating to the investigation by the Parliament prosecutor in the case against the former Prime Minister at the time of the financial crisis. In May 2011, the parliament's prosecutor issued an indictment against the former Prime Minister.

The **Office of the Special Prosecutor** continued to carry out raids leading to the arrest of several former employees of the old Landsbanki for alleged fraudulent business practices in the bank. Currently, 88 cases relating to the collapse of the Icelandic banks are being dealt with, in which 216 individuals have the legal status of accused persons. A total of three cases concerning the collapse of the banks have been referred to the Courts. Investigations conducted by the Financial Supervisory Authority on possible offences in financial undertakings have been referred to the Special Prosecutor for further investigation in 54 cases. The Office was merged into a single agency with the Economic Crime Department of the National Commissioner of Policy in September 2011.

Good progress can be reported in the further reinforcement of the **anti-corruption** policy framework.

As regards conflict of interests, the law adopted in June 2010 lays down an obligation to establish a series of codes of conduct for ministers, ministerial staff, political advisors and civil servants in general. The first code of conduct applicable to ministers was established in March 2011. Iceland ratified the UN Convention against corruption in February 2011 (*See also Chapter 23 — Judiciary and fundamental rights*).

Iceland's General Penal Code has still to be amended following the December 2010 Interim Compliance Report of the Council of Europe's Group of States against Corruption (GRECO) on incrimination of corruption offences.

The State Auditor monitors the implementation of the September 2010 amended law on the finances of political parties.

2.2. Human rights and the protection of minorities (*see also chapter 23 - Judiciary & fundamental rights*)

As regards **human rights and protection of minorities**, Iceland continued to safeguard fundamental rights, including economic and social rights, and to strengthen their protection. In September 2011, 4 allocated to a decision body applications against Iceland were pending before the European Court of Human Rights (ECtHR).

A new media act, which includes provisions on freedom of expression and sets up a media regulatory authority, was adopted by the Parliament in April 2011. Issues regarding ownership concentration on the Icelandic media market and the role of the Icelandic State Broadcasting in the advertising market remain to be addressed. In order to further develop the legislative framework in these areas, two committees were appointed and started to work in summer 2011.

The amendment to the law on Child Protection was adopted in June 2011. It includes provisions on the division of responsibilities between the state and the municipalities regarding children who are considered best off placed outside their home, in another home or in an institution.

The UN Convention on the Rights of Persons with Disabilities and the Council of Europe Framework Convention for the Protection of National Minorities remain to be ratified.

3. ECONOMIC CRITERIA

In examining economic developments in Iceland, the Commission's approach has been guided by the conclusions of the European Council in Copenhagen in June 1993, which stated that membership of the Union requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

3.1. The existence of a functioning market economy

Economic policy essentials

Economic policy has continued to be oriented towards stabilising the economy from the severe recession that the country experienced following the collapse of the banking sector. Cooperation with the IMF provided an important anchor for economic stabilisation. The authorities managed to deliver key policies laid down in the IMF programme leading to its successful completion in August 2011. The country also managed to re-enter international capital markets with a successful US\$ 1 billion bond issue in mid-2011. Broad political consensus on the key essentials of a market economy and the preservation of the welfare state continues to be strongly embedded in Iceland's society. A three-year collective wage bargaining agreement for the private sector was concluded in the spring, which reduces uncertainty for businesses and consumers, but the ensuing wage increases put additional strain on the economy, in particular the non-tradable sector, and on public finances. The previous political cohesiveness within Iceland remains stretched by the negative effects of the crisis. The country was included in the EU's multilateral pre-accession fiscal surveillance procedure and submitted its first Pre-Accession Economic Programme (PEP) in January 2011. It sets out an ambitious medium-term fiscal framework which, however, is based on a somewhat optimistic macroeconomic scenario and not fully underpinned by comprehensive supporting structural reform measures.

Macroeconomic stability

Following the collapse of its financial sector in October 2008, the Icelandic economy went into a deep and long recession. Real GDP continued to fall in 2010, by 4%, which was larger than expected decline, following a 6.8% drop in 2009. The recession bottomed out in the second half of 2010, when the economy started to recover mildly, based on stronger private consumption and a stronger export performance by non-aluminium and non-maritime products. In the first half of 2011, the recovery continued with a real GDP increase of 2.5% backed by consumption and investment growth, whereas real exports declined. However, the recovery is tentative. Annual growth decelerated in the second quarter compared to the first quarter. Moreover, stronger consumption growth has been largely driven by transitory measures, such as one-off pay increases, pension withdrawals, temporary subsidies and transfers, and debt relief measures provided to households. Balance sheet vulnerabilities

remain in both the corporate and household sectors and continue to impede a stronger resumption of growth. As a result of the crisis, average per capita income (in Purchasing Power Standards) fell to 110% of the EU-27 average in 2010, from 117% a year before. *Overall*, the economy continued to recover, however, at an uneven and moderate pace, and risks and uncertainties persist with respect to the sustainability of growth.

External deficits have shrunk markedly following the recession. The sharp contraction in domestic demand and depreciation of the exchange rate (around 50% in 2008/09) contributed to a further improvement in the balance of goods and services, which recorded a surplus of 10% of GDP in 2010, after 8.4% in 2009. The current account deficit in 2010 stood at 11.2% of GDP, down from 11.7% in 2009, reflecting mainly the improvements in trade in goods and services. However, the reported current account balance remains heavily influenced by accrued interest of banks in winding-up proceedings which do not reflect any current (or future) outflow of funds. Corrected for these factors, the current account recorded a much lower deficit of 2.4% of GDP in 2010, according to the Central Bank's estimates. In the first half of 2011, the annualised current account⁴ slightly widened to 11.6% as a lower merchandise trade surplus was only partly compensated for by a stronger services and net factor income balance. Merchandise trade data for July and August point to stronger export growth of around 25 and 33% year-on-year, respectively. However, cumulative export growth in 2011 has been weaker than the growth of imports, reversing the trend seen in 2010 which supported a strengthening of the current account. *Overall*, the current account deficit fell in 2010, but developments in 2011 so far point to a smaller trade surplus as compared to the previous year.

Total net capital inflows in 2010 and in the first half of 2011 were larger than the amounts needed to finance the current account deficit. As a result, gross official foreign exchange reserves held at the Central Bank increased by an amount equivalent to 20% of GDP in the twelve months to July, reaching 57% of GDP. The increase in reserves partly reflects official financing provided in the context of the IMF programme and through bilateral loans as well as foreign exchange interventions to bolster non-borrowed reserves. A very high level of external debt continues to pose a key challenge to the Icelandic economy. Official debt statistics report the stock of gross foreign debt at 867% of GDP (end-2010). However, corrected for foreign debt of banks and holding companies in winding up proceedings and of one single international company (the pharmaceutical company Actavis) headquartered in Iceland but with most of its operations abroad, Iceland's total external debt appears to be considerably lower. The Central Bank estimates the 'corrected' external debt stock at around 200% of GDP and Iceland's net international investment position at a negative 23% of GDP. This compares favourably with a pre-crisis external debt of around 570% of GDP. *Overall*, foreign exchange reserves strengthened, partly backed by official external financing, and recent estimates of Iceland's net international investment position suggest a much lower external indebtedness compared to the pre-crisis period.

The labour market remains weak with unemployment close to historically high levels at 7.5% in 2010 and the number of employed significantly lower compared to pre-crisis levels. These crisis-related effects continued to be felt in the first half of 2011 as unemployment reached 8.5% in the second quarter of 2011, only slightly lower than in the same period of 2010. The level of total employment fell by 1% year-on-year in the first quarter and rose marginally in the second quarter (0.3%). Data on registered unemployment point to a fall in the average

⁴ As measured as a four quarter moving average

unemployment rate in the first eight months of 2011, to 7.7% as compared to 8.4% in the same period a year before. Elements of labour market flexibility seem to have provided a degree of cushion, such as a reduction in the number of hours worked (which remain 6.5% below pre-crisis levels), increased part-time work net migration and labour market measures prevented an even larger increase in unemployment. At the same time, weak labour market conditions continued to have a serious effect on long-term unemployment which increased to around 25% of total unemployment in the second quarter of 2011, around 8 percentage points higher than the same period a year ago. Also, the youth unemployment rate as a share of total unemployment remained high at nearly 19%.⁵ Despite high unemployment, the annual average growth of gross wages continued to accelerate in 2011 to 7.1% in June. Thus, average wage growth in the first half of 2011 reached 5%, compared to around 4% in the first half of 2010. The disinflation process has pushed real wage growth into positive territory since the second half of 2010, leading to average real wage increases of around 2% in the first half of 2011, but the recent rise in inflation will lead to a decline in average real wages. *Overall*, the labour market remains seriously affected by the deep post-crisis recession with high unemployment rates, particularly among the youth and long-term unemployed.

The monetary policy easing implemented since March 2009 came to an end in late 2010 when policy rates had reached historically low levels (4% compared to the peak of 18% in March 2009) and the policy focus moved increasingly towards the preparation for a gradual lifting of capital controls. In August 2011, policy rates were raised for the first time since March 2009, by 0.25 percentage points to 4.25%, in reaction to rising inflationary pressures. After annual inflation had fallen below the Central Bank's official 2.5% inflation target in early 2011, inflation accelerated markedly to 5% in July and August as a result of a weaker exchange rate, rising oil-, house- and food prices and strong pass-through effects from unexpectedly high wage increases negotiated in the collective wage agreements of May. These factors have worsened the inflation outlook, and inflation expectations have risen markedly. *Overall*, monetary policy has been tightened slightly as a result of a significantly worsened inflation outlook.

The Central Bank has followed and intends to continue a strategy of exchange rate stabilisation supported for the time being by a system of capital controls. The underlying trade surplus, improved terms of trade, and the declining risk premium have supported a strengthening the Icelandic króna by over 16% vis-à-vis the euro in 2010. However, in early 2011 the króna started to weaken, partly due to large purchases of foreign exchange by the Central Bank at end 2010. In the first half of 2011, the króna lost some 8.3% of its value vis-à-vis the euro, but again slightly appreciated since then. The Central Bank continued to abstain from intervening in the foreign exchange market to support the króna since December 2009 but it purchased foreign exchange through auctions to bolster non-borrowed reserves. Under the current policy framework, while exchange rate risks appear limited over the short term, they could become more prominent in view of the need to gradually liberalise capital movements.

The first step towards lifting capital controls was taken in October 2009 when restrictions on inflows of new capital were abolished. A revised strategy for lifting capital controls was approved by the government in March 2011 following a proposal from the Central Bank. The revised strategy was devised in consultation with the IMF. In a first step, it focuses mainly on

⁵ Prior to the crisis, long term unemployment stood at 3.5% and the youth unemployment rate at 6.5% (first quarter of 2008)

reducing the risk of outflows from large holdings of króna by non-residents. These holdings are estimated at around 30% of GDP. The second step of the strategy foresees a liberalisation of on-shore króna holdings. First steps of the revised strategy were taken in mid-2011, whereby the Central Bank bought foreign króna holdings in two auctions to re-sell them to domestic pension funds. While the first auction was entirely successful, pension funds proved to be reluctant to purchase króna holdings in the second auction, probably as a result of increased risk aversion in international capital markets. The authorities aim to lift the controls gradually as conditions permit; nevertheless, this could still entail potential risks.

Following a marked deterioration of public finances in the wake of the crisis, the authorities took a series of fiscal consolidation measures to reduce the fiscal deficit by around 3 percentage points in 2010, from 10% of GDP in 2009. While the measures were successful in reining in spending and strengthening the revenues, the revised general government deficit in 2010 remained at virtually the same level as in 2009, as measured in % of GDP, as the overall budget spending was affected by called guarantees for the Housing Financing Fund and the Agricultural Fund. The 2011 budget framework adopted in late 2010 initially foresaw new fiscal measures amounting to around 2.7% of GDP with most of the adjustment on the expenditure side (2% of GDP). This was a change to the structure of fiscal adjustment in 2009 and 2010 which was largely based on revenue measures. The first half of the year showed strong revenue performance and spending below projections. Total general government revenues increased by 3.9% and total spending by 0.9% year-on-year. The general government balance recorded a deficit of 2.5% of (annual) GDP, compared to a deficit of 3.1% in the first half of 2010. However, in the context of the three-year collective wage agreement adopted in Spring, the government took additional spending commitments, comprising additional public investment as well as social protection, active labour market policy and education measures. As a result, expenditure measures in 2011 are expected to account for 1% of GDP instead of 2% as initially foreseen. Moreover, the government decided to moderate the medium-term fiscal adjustment path by postponing the achievement of a sizeable fiscal surplus by one year from 2013 to 2014. Fiscal risks remain significant as growth could turn out to be lower than expected. Risks could also arise also from contingent liabilities related to government guarantees for public companies and a possible further need to recapitalise the State Housing Financing Fund, which suffers from uncertain asset quality and low capital ratios. Finally, litigation risks are related to the still unsettled Icesave-dispute and the Supreme Court's ruling on the Emergency Law. A decision overturning the Law would have significant implications for Iceland's public finances. *Overall*, expenditure-based fiscal consolidation remains challenging and possible risks arise from contingent liabilities.

Gross general government debt increased from 88% of GDP in 2009 to 93% at end-2010 and debt levels remain high compared to pre-crisis levels of around 30%. Further progress has been made in establishing a medium-term public debt management framework. A medium-term debt management strategy was published in February 2011 and the positive reception by market participants bodes well for the implementation of the 2011 annual borrowing plan which foresees accessing international markets in the course of the year. In June, Iceland issued international bonds in the amount of US \$1 billion with a 5-year maturity at an interest rate of 4.99%. This was the first international issue after the onset of the crisis two and a half years ago. The transaction was well-received by global investors and the amount was two times oversubscribed. The average maturity profile of the public debt portfolio has been extended to over 4 years, including through debt buy-back operations. Finally, a comprehensive legislation to strengthen local government fiscal frameworks and finances has been submitted to Parliament. It foresees strict limits on municipal borrowing, a rolling three-

year balanced budget and the introduction of a new data-based and more effective monitoring system. The new framework is set to become fully operational in budget year 2012. *Overall*, in view of the high level of public debt, the authorities have taken further measures to reduce refinancing risks and to strengthen local government finances.

The policy mix, with a strong focus on exchange rate stabilisation and fiscal consolidation, has been supportive in re-establishing a higher degree of macroeconomic stability, but the recent fiscal easing and a worsened inflation outlook require a continuation of a tight policy mix. In this respect, the 2012 budget and medium-term fiscal plans will be a test for the government's commitment to continued fiscal adjustment. Finally, macroeconomic stabilisation occurred in a situation of temporary protection through capital account restrictions. Looking forward, their gradual removal will remain a key policy challenge.

Interplay of market forces

Prices of goods and services continued to be determined by supply and demand conditions. As a member of the EEA, Iceland has already removed special government protection in most sectors. In the context of the crisis, the government took over the domestic operations of the three major banks that had collapsed. Following recapitalisation and restructuring, the banks' equity was transferred to their foreign creditors as a compensation for net domestic assets transferred to the new banks. The government at this time still retains majority ownership (81%) of one of the three banks (NBI) and minority stakes in the other two banks. The government has also become a large investor in the remaining savings banks system. The system has, however, been reduced substantially with the exit of the two largest savings banks. The government's stake in the financial firms is held at arm's length from the political process via a special agency.

The private sector accounts for around 75% of GDP. Some sectors remain in government ownership, such as the postal services, broadcasting, and parts of the financial sector (including the state-owned Housing Financing Fund). Moreover, the energy sector remained predominantly publicly owned (by the central and local governments), offering attractive wholesale contracts to industry, mostly aluminium companies. *Overall*, market mechanisms are to a large extent driven by free prices, but public ownership remains significant in some sectors, partly as a result of the crisis.

Market entry and exit

Starting a business is facilitated by a generally low administrative burden and a supportive regulatory framework. The business environment remained characterised by low bureaucratic hurdles and, in general, efficient administration. However, high barriers to entry exist in the fishing, agriculture and energy sectors, which are not covered by the EEA. Icelandic legislation contains prohibitions on foreign ownership in the fisheries, energy, air transport and real estate sectors. Of these, restrictions on investment in fisheries are the only ones that apply to EEA nationals. The recession has significantly affected company start-ups. Despite some pick-up in March, the number of newly registered private limited companies declined by 6.5% year-on-year in the first half of 2011 and remained at around 60% of pre-crisis levels. Bankruptcy proceedings are generally straightforward. However, the financial crisis has put a large part of the corporate sector under severe financial distress. Actions have been taken to address this problem, including expediting out-of court procedures and by increasing the number of judges and their assistants. The number of insolvent companies increased rapidly by some 50% in the first half of 2011, compared to the same period in 2010. *Overall*,

high barriers to market entry for non-residents remain in key strategic sectors and market exit is complicated by large corporate sector indebtedness.

Legal system

The legal system continued to support a business-friendly investment climate. It offers good protection and enforcement of property rights and provides a clear and stable framework for agents to take economic decisions in a situation of legal certainty.

Financial sector development

The restructuring of the banking sector has been largely completed even though further operational and financial restructuring is required to allow for the resumption of bank lending and the required consolidation in the sector. The market remains dominated by the three 'new' banks that emerged from the financial collapse in autumn 2008. They have been recapitalised and are now much smaller in size compared to pre-crisis levels, focusing on domestic operations. Domestic banking sector credit to the private sector is estimated at 90% of GDP at the end of 2010, somewhat lower than the year before and only a fraction of the pre-crisis level. The government retains majority ownership in one of the banks, and minority stakes in the other two banks; with the majority stakes (indirectly) owned by non-residents.

However, the banks are faced with significant vulnerabilities as asset quality is subject to considerable uncertainty and financial imbalances are likely to persist for some time. Assets are largely denominated in or indexed to foreign exchange⁶ whereas liabilities are in domestic currency and at variable interest rates. Balance sheet imbalances pose a significant challenge to financial sector stability, in spite of banks' currently high capital adequacy ratios, reported well above 12% of tier 1 capital. Private households and businesses are faced with significant operational problems and nonperforming loans are exceptionally high (at about 40% of total loans). In reaction, the government has put private sector debt restructuring at the forefront of its economic policy. Various programmes, including debt relief programmes for household's mortgages and a voluntary framework for SMEs have gained pace. In addition, the use of the Financial Supervisory Authorities prudential powers is meant to support this process. The banking sector seems sufficiently strong to bear the burden of debt restructuring, as the difference between loan and book value implies a high level of buffers to offset potential losses after restructuring.

On the funding side, banks are currently relying to a large extent on domestic deposits. The banks' exceptional liquidity experienced in early 2010 has been reduced as investors seek higher returns and the lower policy rate has led to falling deposit rates in the banks. The blanket guarantee on deposits remains in place and the government has put before parliament a draft law establishing a new deposit guarantee scheme fully in line with EU regulations and a €100,000 deposit guarantee. At the same time, foreign direct investment and access to foreign credit still remains limited. The operational restructuring of the savings banks has further progressed, but there remains scope for a further consolidation of the sector. *Overall*, banking sector restructuring has further progressed, but significant vulnerabilities remain with respect to banks' asset quality.

⁶ The share of domestic currency assets has increased following the judgement by the Supreme Court on the illegality of foreign currency indexation of some loans.

Progress has been made in strengthening bank regulatory and supervisory practices, but supervision needs to be strengthened further to bring it in line with international best practice. A Basel Core Principles Assessment of Effective Bank Supervision was concluded in mid-April 2011. On this basis, the FME has developed a 2-year action plan to address remaining supervisory gaps.

The non-banking financial sector comprises the government-owned Housing Finance Fund, investment banks, leasing companies, payment card companies, investment credit funds and insurance companies. The government injected €206 million into the Housing Financing Fund to raise its capital to about 2% of risk-weighted assets, still far below the 5% pre-crisis level. The government is currently working on a comprehensive review of the Fund's operations and its position within the restored financial system, expected to be completed by end-2011. Leasing companies and payment card companies were fully recapitalised in early 2011 without public support. Total credit provided by the sector fell by 8.5% in the first half of 2011 compared to the same period in 2010 as leasing companies wrote down foreign indexed loans in accordance with the 2010 court rulings and a related law passed in late 2011. The market of both non-life and life insurances expanded through 2010 with total assets increasing by around 6%. Insurance firms also strengthened their equity base. Profits were lower than a year before, partly due asset revaluation needs. *Overall*, a number of steps have been taken to restore the non-banking financial sector but an overhaul of the Housing Financing Fund's operations remains a challenge in view of reducing the government's contingent liabilities.

Domestic equity markets continue to play a much smaller role in financial intermediation than before the crisis in late 2008. Turnover in the equity market in 2010 remained muted at only 2% of the 2008 pre-crisis turnover. Despite an annual increase of 28%, the total market value of all listed shares remains at only 17% of GDP compared with the pre-crisis level of 120% of GDP (end-March 2011). The bond market, on the other hand, continues to be rather strong even though turnover remains at only 50% of the 2008 level and is dominated by government- and government-guaranteed bonds. *Overall*, domestic financial markets have somewhat recovered on the back of a more lively bond market while confidence in equity markets remains weak.

3.2. The capacity to cope with competitive pressure and market forces within the Union

Existence of a functioning market economy

Given the serious impact of the banking crisis, the country's economy is slowly recovering levels of macro-financial stability allowing for an efficient allocation of economic resources. The balance sheets of private households and non-financial firms have been seriously damaged and a large number of firms are in the process of or about to enter into debt restructuring. Under these circumstances and despite some progress in private debt restructuring, consumption and investment activity remain markedly restrained, holding back the recovery process. An efficient allocation of resources remains limited in parts of the economy, also due to financial sector weaknesses and capital restrictions. *Overall*, challenges remain for improving the functioning of markets.

Human and physical capital

The economic crisis severely affected the labour market situation. The labour participation rate has been reduced somewhat to 81.1% in 2010 from the 2007 pre crisis level of 83.3%, but

remains nonetheless high in international comparison. The share of people in part-time work has increased (to 27% from 23% prior to the crisis) and total hours worked have been reduced by around two hours to 39 hours a week in 2010. Outward migration may have prevented the unemployment rate from rising even faster, but net migration could be associated with a loss of needed skills, even though the total number halved in 2010 compared to 2009. The structure of unemployment remains problematic with youth and low-skilled workers representing large shares of the unemployed. The rising share of those youths neither in education nor in the labour force has been pronounced. Under these circumstances, efforts to offer re-training and education are essential to reduce skills mismatches. Active labour market initiatives and life-long learning approaches continued to be carried out aimed at retraining and upgrading skills of the labour force. Moreover, the government introduced measures to grant all persons under the age of 25 years access to free secondary education. Total education spending has remained at around 7.8% of GDP in 2010, but is foreseen to drop in 2011. *Overall*, with unemployment still very high, human capital remains significantly underutilised.

Abundant geothermal sources have attracted substantial foreign investment in the aluminium and hydropower sectors over the past. Even though the financial crisis has slowed down investment, several new projects are now being prepared as access to international capital has been gradually restored – as evidenced by the successful financing by the state power company Landsvirkjun in international financial markets. The share of investment spending in GDP reached only a low 13%, even slightly lower than a year before, and markedly below the 30% pre-crisis share. Investments in all sectors have been affected. At the same time, the fall in real estate activities and construction reflects also some normalisation following the earlier 'boom' years. Public investments have also fallen, from 4% to under 3% of GDP, with the largest declines in transport infrastructure. Net FDI inflows turned again positive in 2010, partly due to new FDI inflows and partly due to residents reducing their outward investments, raising the total stock of inward FDI to around 85% of GDP, up from 72% a year before. With respect to future investment potential, Iceland is implementing a large-scale mapping exercise of its energy resources to categorise them into areas for conservation and those available for exploitation. *Overall*, the country continues to benefit from good basic infrastructure, abundant natural resources, and an overall well-educated population.

Sector and enterprise structure

Although some new segments in manufacturing and services have expanded over the past years, in particular in high-tech areas such as software production, pharmaceuticals and biotechnology, the economy's industrial sector continues to be characterised by a limited degree of diversification. The relatively small industrial sector (excluding construction), mainly aluminium manufacturing, represents roughly 9% of output and one-fifth of employment. The share of construction in GDP has fallen markedly, from 11% in the boom year of 2007 to 4% in 2010, reflecting adjustments in an over-leveraged sector as well as completion of large energy-related projects. The share of the services sector in total output declined somewhat in the context of the crisis, mainly due to reduced economic activity in the real estate, retail trade and financial sectors. However, services still account for two thirds of the economy and almost three quarters of employment. The importance of tourism and transport as a source of foreign exchange income has been increasing, accounting for a quarter of total export earnings in the twelve months to June 2011, also as a result of the 20% yearly increase in foreign tourists in the first half of 2011, which marked a significant turnaround. The importance of small firms in the economy remains high, accounting for 99% of the total

number of firms and 70% of employment and output. *Overall*, the country's industrial sector remains little diversified and the construction sector continues to deleverage.

State influence on competitiveness

The level of state subsidies amounted to 1.8% of GDP in 2010. The relatively small agriculture sector continued to benefit from government subsidies, import protection, and a system of production quotas. Certain industries, such as energy, air transport and fishing, remain protected from foreign competition. The fishing industry, however, does not receive any kind of state support from the budget but its future structure and performance is to a large extent contingent upon the results of the ongoing policy debate as regards the domestic allocation of fishing quotas. Energy production remained largely in government ownership, with large consumers being offered relatively favourable electricity prices. Following its intervention in the banking sector the government retains majority ownership in one of the three new banks. The savings banks sector has also been largely restructured with the largest savings bank being merged with a commercial bank. While the government announced it would give creditors a chance to hold most of the equity, the process will most likely involve some additional state support. The Housing Financing Fund remained state-owned and may require additional public funds to bolster its capital base. Regarding network industries, energy production is predominantly publicly owned, but third-party access to transmission and distribution is granted. Non-nationals are not granted market access to production. The telecommunications sector is liberalised and privately owned while government interventions remain limited to infrastructure investments in remote areas. *Overall*, state interference remains significant in some areas including the banking sector.

Economic integration with the EU

Iceland is an open economy with total trade in goods and services representing around 95% of GDP. The country's export structure remains little diversified. Marine products and aluminium account for two thirds of merchandise exports. The share of services, mainly travel and transport, remained fairly stable in 2010 at around 25% of total exports, and increased slightly in early 2011. The import structure is more diversified, reflecting the country's dependence on a wide range of manufactured goods and some commodities. The EU has continued to be the largest trading partner. Its share in Icelandic merchandise exports increased to nearly 80% in 2010, up from around 75% a year before, and just over half of the country's imports originate in the EU. FDI inflows almost exclusively originate from EU partner countries. *Overall*, integration with the EU in the areas of trade and investment remained very high.

Rough estimates point to a slight deterioration of average labour productivity in 2010. As a result, unit labour costs are estimated to have increased, as real wage adjustments (a fall by 0.6% in 2010) could only partly compensate for lower productivity. In 2010, the exchange rate of the króna against the euro appreciated by around 16% in nominal and by around 13% in real terms (adjusted for different price developments). According to estimates, the real exchange rate remains around 20% below its long-term average. *Overall*, despite an appreciation of the real exchange rate in 2010, Iceland still benefits from strong price competitiveness vis-à-vis its main trading partners as a result of the marked depreciation of the króna during the crisis.

4. ABILITY TO ASSUME THE OBLIGATIONS OF MEMBERSHIP

This section examines Iceland's ability to assume the obligations of membership – that is, the *acquis* as expressed in the Treaties, the secondary legislation and the policies of the Union. It also analyses Iceland's administrative capacity to implement the *acquis*. The analysis is structured in accordance with the list of 33 *acquis* chapters. In each sector, the Commission's assessment covers progress achieved during the reporting period and summarises the country's overall level of preparations.

4.1. Chapter 1: Free movement of goods

Iceland has already reached a high level of alignment and, with a few exceptions, applies the *acquis* in this field due to its EEA membership.

No developments can be reported in the area of **general principles**. The legislation on alcoholic beverages has not been adopted.

On **horizontal measures**, there is no update to report on the legislative framework in the field of conformity assessment. Internal and external coordination of market surveillance still require further improvement. The Icelandic Board for Technical Accreditation has not yet been peer-evaluated.

As regards the '**Old Approach**' **product legislation**, Iceland's alignment with the *acquis* continues to be well advanced. No further developments can be reported in the automotive sector, where alignment still needs to be reinforced.

Iceland continued in general to apply satisfactorily the *acquis* on '**New and Global Approach**' **product legislation** and **procedural measures**.

Conclusion

Overall, Iceland continues to be highly aligned with the *acquis* in the area of free movement of goods. Further improvements are needed on horizontal measures and the old approach product legislation (automotive sector).

4.2. Chapter 2: Freedom of movement for workers

Iceland has already reached a high level of alignment and, with a few exceptions, applies the *acquis* in this field due to its EEA membership.

No additional developments can be reported on **access to the labour market** and on full participation in the **EURES** (European Employment Services) network.

Progress can be reported on **coordination of social security systems**. Preparations for electronic data exchange within the Electronic Exchange of Social Security Information (EESSI) system are advancing under the auspices of the dedicated steering group. Regular meetings took place during the reporting period. Specialists from Icelandic health and social authorities benefited from training. Work on installation of an access point is advancing.

The **European health insurance card** is in use in Iceland.

Conclusion

Overall, Iceland continues to be highly in line with the *acquis* on freedom of movement for workers. The preparations to apply the new regulations on social security coordination are continuing smoothly.

4.3. Chapter 3: Right of establishment and freedom to provide services

Iceland has already reached a high level of alignment and applies a substantial part of the *acquis* in this field due to its EEA membership.

No further developments can be reported on the **right of establishment**.

There has been good progress on the **freedom to provide cross-border services**. Iceland notified the transposition of the Services Directive in July 2011, including various pieces of amending sector-specific legislation and a Point of Single Contact has been launched. However, certain parts of Chapter III, Chapter IV, and Chapter VI of the Services Directive still remain to be transposed.

Some restrictions on the right of establishment and the freedom to provide services in the fisheries sector are still in place (*see also Chapter 13 - Fisheries*).

No progress can be reported in the area of **postal services**. The EEA Joint Committee has not yet taken a decision on the incorporation of the Third Postal Directive into the EEA Agreement, and consequently has not yet ruled on Iceland's request to postpone the implementation deadline of the Third Postal Directive for two years, e.g. until the end of 2012 at the latest.

Some progress can be reported on **mutual recognition of professional qualifications**. Two outstanding national regulations needed to complete implementation of the directive on mutual recognition of professional qualifications, one on the health sector, the other on vocational training, were published in May and June 2011 respectively. However, the main directive is still only partially implemented. Articles on application of the general system to professions benefiting from automatic recognition, automatic recognition on the basis of professional experience and minimum training conditions are still outstanding.

Conclusion

The overall level of alignment with the *acquis* on the right of establishment and freedom to provide services is satisfactory. However, completion of alignment with the Services directive and the transposition of the Third Postal directive remain to be achieved. The administrative capacity for effective implementation and enforcement of EU rules and policies needs to be strengthened.

4.4. Chapter 4: Free movement of capital

Iceland has already reached a high level of alignment and applies a substantial part of the *acquis* in this field due to its EEA membership.

Some developments can be reported on **capital movements and payments**. In March 2011 the Icelandic government approved a revised strategy for liberalisation of capital accounts. The strategy was prepared by the Central Bank in cooperation with key ministries and the

Financial Supervisory Authority and in consultation with the International Monetary Fund. In September 2011, the parliament approved this strategy and extended the capital controls until 31 December 2013. Iceland notified the EEA Joint Committee of this decision. The government may lift the controls at an earlier date if conditions permit this. This timeframe is deemed necessary to allow a phased and conditional liberalisation of the capital controls without threatening the financial stability of the country. The above extension of the capital controls is still not in line with the EU *acquis*.

The liberalisation strategy is divided into two main phases and maintains a gradual, non-discriminatory approach without setting a timetable. Phase I provides for measures to reduce distressed investors' offshore króna holdings and to channel offshore krónur into the Icelandic economy and the Treasury's long-term funding. To this end, two first foreign currency auctions were held, in May and July 2011. Once sufficient progress has been made under Phase I, Phase II, entailing liberalisation of onshore króna holdings, can begin, provided an assessment of the balance of payments outlook indicates that reserves will be adequate and other economic preconditions have been met.

No developments can be reported as regards restrictions on foreign investment in fisheries (*see also Chapter 13 - Fisheries*). These provisions are not in line with the *acquis*. Some progress can be reported in the area of **payment systems**. A bill on implementation of the directive on payment services was adopted in September 2011. However, work is in progress on transposition of the new EU directive on settlement finality in payment and security settlement systems and of the new EU directive on e-money.

Little progress can be reported in the **fight against money laundering**. Iceland has addressed some of the technical deficiencies of its Financial Intelligence Unit. However, in June 2011, the Financial Action Task Force (FATF) placed Iceland into a process of 'enhanced follow-up' on account of its failure (over the last five years) to address a number of shortcomings identified in its evaluation report, including the under-resourcing of its financial intelligence unit. The third Anti-Money Laundering (AML) directive is thus still not fully implemented in Iceland.

Conclusion

Overall, Iceland largely applies the *acquis* on free movement on capital, although alignment with the *acquis* remains incomplete due to extensive capital restrictions still in place. The legislative framework was further reinforced over the reporting period. The administrative capacity of the Financial Intelligence Unit still requires further strengthening.

4.5. Chapter 5: Public procurement

The entire *acquis* in this chapter is covered by the EEA Agreement, with the exception of one technical directive and the defence procurement directive. Iceland is continuing to implement the main body of the *acquis* on public procurement in line with its EEA obligations.

Iceland is fully aligned with the **general principles** of the *acquis*.

Regarding *administrative capacity*, no further developments can be reported.

There has been little progress on **award of public contracts**. The directive on defence procurement remains to be transposed into Icelandic legislation. An e-procurement action

plan was discussed at ministerial level during the reporting period but no such plan has been presented yet. A specific public procurement advisory council has not yet been established.

Transposition of the **remedies** directive and the two related technical directives is still outstanding.

Conclusion

Overall, the level of alignment and implementation in the field of public procurement remains satisfactory, with the exception of the remedies and defence procurement directives.

4.6. Chapter 6: Company law

Iceland has already reached a high level of alignment and applies a substantial part of the *acquis* in the field of company law due to its EEA membership.

Little progress was made in the area of **company law**. Legislation on reporting and documentation requirements in the case of mergers and divisions was submitted to parliament in March 2011 and has yet to be adopted. It aims at completing alignment with the Second, Third and Sixth Company Law Directives and with the directive on cross-border mergers of limited liability companies. Alignment with the directive on shareholders' rights remains to be completed.

Little progress was made on **corporate accounting**. Draft legislation implementing parts of the directive amending certain provisions on annual and consolidated accounts along with the regulation on equivalence of accounting standards was adopted in September 2011. The infringement case initiated following the reasoned opinion issued by the EFTA Surveillance Authority in November 2010 was subsequently closed.

Iceland continued to apply the *acquis* on **auditing**. A new regulation on quality control of auditors' work was adopted in October 2010. Two new regulations were adopted in 2011, one covering the continuous education of auditors, the other the listing of auditors and audit firms. Alignment with the international standards on audits remains to be achieved.

Conclusion

Overall, Iceland has already reached a high level of alignment and applies a substantial part of the *acquis* in the field of company law. However, full alignment with accounting standards and international standards in audit remains to be achieved.

4.7. Chapter 7: Intellectual property law

Iceland has already reached a high level of alignment and applies a substantial part of the *acquis* in the field of intellectual property law due to its EEA membership.

Progress has been made in the area of **copyright and neighbouring rights**. Following the incorporation into Icelandic legislation of the bulk of the Copyright Act last year, five new collecting societies obtained legal status during the reporting period. Iceland continued to cooperate with the European Observatory on Counterfeiting and Piracy on soft-law issues.

No development can be reported on **industrial property rights**.

Some progress can be reported on **enforcement**. The working group, made up of representatives from two ministries and three agencies, continued to discuss enforcement policy regularly, to raise awareness of IPR issues amongst consumers in Iceland. The group is also working on establishing a website providing with information and possibly details of administrative and judicial proceedings against IPR infringements and on establishing a warning system based on agreements between right-holders and telecommunications operators. The enforcement directive remains to be fully transposed.

Conclusion

Overall, Iceland has already reached a high level of alignment with the *acquis* on intellectual property law and has the administrative capacity necessary to implement it. Steps have been taken to improve Iceland's enforcement policy.

4.8. Chapter 8: Competition policy

Iceland has already reached a high level of alignment and applies a substantial part of the *acquis* in the field of competition due to its EEA membership.

The institutional framework was further reinforced with the adoption, in February 2011, of the Act amending the Competition Law with a view to strengthening the powers of the Competition Authority. The Authority can take action against any situation or conduct in the market that prevents, restricts or distorts competition, even in the absence of a breach of the Competition Law.

Iceland continues to maintain a high level of alignment in the field of **antitrust and mergers** and no developments can be reported.

As regards **State aid** measures taken in response to the financial crisis, in December 2010 the EFTA Surveillance Authority (ESA) opened a formal investigation procedure on the aid measures in favour of the Glitnir, Kaupthing and Landsbanki banks and their successors. In March 2011 the ESA provisionally approved rescue aid of ISK 33 billion (approximately €123.8 million) for the Icelandic Housing Financing Fund, subject to abolition of the mortgage loan scheme and recovery, by the end of October 2011 at the latest, of any incompatible and unlawful aid granted. The ESA also approved an Icelandic scheme for innovation companies with the aim of improving and fostering research and development.

In February 2011, under the existing aid procedure, the ESA asked Iceland to bring the financing arrangements for the State radio station into line with the rules on State aid to public service broadcasting. Iceland agreed in May to take the necessary steps to eliminate any incompatible aid resulting from the financing scheme and has until the end of December 2011 to do so.

Conclusion

Overall, Iceland has already reached a high level of alignment and applies a substantial part of the *acquis* in the field of competition.

4.9. Chapter 9: Financial Services

Iceland has reached a high level of alignment and applies a substantial part of the *acquis* in this field due to its EEA membership.

There has been limited progress in the cases of **banks and financial conglomerates**. Legislation on a new deposit guarantee scheme, based on the new EU *acquis*, including minimum coverage of €100,000, was presented to parliament in November 2010. The parliamentary approval procedures are continuing. In the area of banking supervision, the Central Bank of Iceland and the Financial Supervisory Authority signed a new cooperation agreement in January 2011 to enhance financial stability by means of better integration of micro and macro supervision. The two institutions are currently working on designing a registry to improve monitoring of large exposures. The directive on the prudential assessment of acquisitions in the financial sector was implemented in 2010. The amended Act on Financial Undertakings was adopted in September 2011. It brings the national legislation further in line with the directive on banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management.

The Capital Requirements Directive (CRD II) has not yet been fully transposed. Work is advancing on formulating and implementing rules concerning: good business practices; loans secured by mortgages on shares or guarantee capital certificates issued by undertakings; remuneration policies; calculation of the amount of exposure; what constitutes secure collateral; evaluation of connections between parties for the purposes of the rules on large exposures; exceptions from internal auditing units for financial undertakings; and qualifying holdings outside the financial sector.

In December 2010 a new agreement on Icesave was reached between the governments of Iceland, the United Kingdom and the Netherlands and was eventually adopted in February 2011 by the parliament. The Icelandic President declined to sign the Icesave bill into law, thereby creating the conditions for a referendum in April, in which almost 60% of Icelandic voters rejected the bill.

The government confirmed that the outcome of the referendum would not affect the commencement of the payments to the UK and the Netherlands from winding up the estate of Landsbanki, due to start later in 2011. Repayments are expected to start before the end of 2011, subject to a final ruling of the Supreme Court on priority creditor status of deposit holders. In May 2011 the government sent its reply to the letter of formal notice of May 2010 from the EFTA Surveillance Authority (ESA). In June 2011 the ESA decided to proceed with the second step of the infringement procedure, i.e. to issue its reasoned opinion, which reiterates the findings set out in the letter of formal notice. This legal analysis is shared by the European Commission. Iceland's government provided the answer to the EFTA Surveillance Authority's reasoned opinion at the end of September. The Authority is now examining the response in detail before deciding on further action in this case. At this stage, the Icesave dispute remains unresolved.

Good progress can be reported in the fields of **insurance and occupational pensions**: the outstanding issues regarding implementation of the reinsurance directive, the life insurance directive, the insurance groups directive and the financial conglomerates directive were fully addressed over the reporting period.

In March 2011 the Ministry of Economic Affairs published a new Regulation regarding assets covering technical provisions of insurance companies.

In January 2011 the Financial Supervisory Authority published new guidance on risk management for insurance undertakings. This guidance is partly based on future solvency II requirements. A committee is working on a bill on implementation of the solvency II

Directive. The Financial Supervisory Authority started work on new rules regarding calculation of the adjusted solvency of insurance groups in order to align them with the calculation of the solvency of financial conglomerates. These new rules will change the method for implementing the insurance groups directive. Work also continued on other rules such as on financial independence, assessment of qualifications and remuneration of board members and chief executive officers.

No developments can be reported in the areas of **financial market infrastructure, securities markets and investment services**.

Some progress can be reported on the administrative capacity. The staff of the Financial Supervisory Authority had been increased to nearly 100 by the end of 2010. The number of full-time equivalent posts is expected to increase to 117 by the end of 2011, of which 17 will be temporary jobs to respond to the large scale of the investigative tasks entailed by the banking collapse.

Conclusion

Overall, alignment in the area of financial services is good, although the reforms introduced remain partial. Implementation is not complete in some key areas, notably insurance and securities, and the supervisory capacity needs further improvement. The Icesave dispute remains unresolved.

4.10. Chapter 10: Information society and media

Iceland has already reached a high level of alignment and applies a substantial part of the *acquis* in the field of on the information society and media due to its EEA membership.

No progress can be reported in the areas of **electronic communications and information technologies**. The 2009 EU electronic communications reform package (revised regulatory framework) has not been incorporated into the EEA Agreement and, therefore, has not been transposed into national law. The EU directive on data retention and the regulation on the .eu top-level domain have not been transposed. No developments can be reported on strengthening the independence of the national regulatory authorities.

No further progress can be reported in **information society services**, where legal protection for conditional access devices needs to be extended to decoders for purposes other than broadcasting services. Furthermore, the e-commerce directive remains to be fully transposed. Iceland continued to participate in the Information and Communication Technologies (ICT) Policy Support component of the EU Competitiveness and Innovation Programme.

Good progress was achieved regarding **audiovisual policy**, where Iceland passed a new law on media and broadcasting in April 2011 with the aim of transposing the EU's Audiovisual Media Services (AVMS) directive. However, the new legislation fails fully to transpose the AVMS directive and several gaps still remain. Apart from not fully transposing a number of articles of the AVMS directive, the Icelandic Media Act also introduced provisions that could create an unjustified restriction of the rules on freedom of expression. Other provisions are contrary to the principle of freedom of reception and retransmission laid down in the AVMS directive.

The digital switchover is planned for the end of 2012, but the method remains to be decided.

Iceland continued to participate in the MEDIA 2007 Programme.

Conclusion

Overall, Iceland has already reached a high level of alignment and applies a substantial part of the *acquis* in the field of the information society and media. However, the revised communications regulatory framework remains to be transposed and several gaps in transposition in the field of audiovisual policy and information society services need to be closed.

4.11. Chapter 11: Agriculture and rural development

As regards **horizontal issues**, no new legislative developments can be reported. The administration continued to study the *acquis* and the structures necessary to implement it in order to prepare for future membership. The limited administrative capacity remains to be addressed.

The Farmers' Association and the Minister of Fisheries and Agriculture signed an agreement in October 2010. It covers, in particular, the rural development measures for 2011 and 2012 and includes significant budget cuts in this sector. Due to the economic situation, the agreement is valid for two years, instead of the usual four-year period.

Working groups were set up in March 2011 to analyse and prepare for institutional issues within the EU framework and on the market and support system. They include both civil servants and stakeholders. Iceland continued analysing the current land registration system. It also started a pilot project in connection with the Land Parcel Identification System (LPIS) with the aim of providing maps and technical support.

No progress can be reported with the single **common market organisation**.

A working group on **rural development** was set up in March 2011 to analyse and prepare a plan to set out how Iceland could coordinate its rural development strategies within the EU framework.

No developments can be reported in **quality policy** and **organic farming**, although the latter is covered by the EEA Agreement and is largely in line with the *acquis*.

Conclusion

Overall, Iceland's agricultural policy is not in line with the *acquis* and no new legislative alignment has been undertaken. The appropriate administrative structures in this area will need to be set up.

4.12. Chapter 12: Food safety, veterinary and phytosanitary policy

Iceland partially applies the *acquis* on food safety, veterinary and phytosanitary policy due to its EEA membership.

No progress can be reported on **general** food safety since adoption of the Food Law aiming at harmonisation with the EU hygiene package. Full implementation of these provisions is expected to start in November 2011. Official controls related to production and placing on the market of fishery products are not carried out in line with the legislation in force within the

European Economic Area (EEA). Some developments can be reported towards clarifying the distribution of control tasks between central and public health authorities with the finalisation, over the reporting period, of a number of cooperation agreements at municipal level. The central food and veterinary authority still has to sign inspection contracts with all reference laboratories.

In March 2011, Iceland supplemented its legislation in the **veterinary sector** with the adoption of a Law on exports of horses. Iceland continued to benefit, under the EEA Agreement, from an exemption from EU rules on trade in live animals and germ plasm enabling it to prohibit all imports of live animals except fish and fish germ plasm. No developments can be reported in this area. Iceland's legislation on imports of live animals and animal health is not in line with the *acquis*.

Limited progress can be reported as regards the **placing on the market of food and feed** with the start, over the reporting period, of work on a national upgrading plan to bring food establishments into line with the hygiene rules. However, the hygiene package is expected to be fully implemented in November 2011. On animal by-products, no developments can be reported on setting up collection systems and incineration facilities for carcasses potentially infected with transmissible spongiform encephalopathy (TSE).

As regards **food safety rules**, some developments can be reported on *genetically modified foods* with the adoption, in December 2010, of legislation on the labelling and traceability of genetically modified food and feed. The part of the legislation dealing with feed entered into force in September 2011. However, Iceland's legislation on novel foods and *specific rules for feed* are not in line with the *acquis*. A new regulation on release into the environment of genetically modified organisms was adopted in July 2011.

Some progress can be reported on **phytosanitary policy**, as Iceland started preparing legislation on plant protection products. However, Icelandic legislation does not comply with EU rules on plant protection products and plant health. The capacity of accredited laboratories remains to be enhanced.

Conclusion

Overall, Iceland is partially in line with the *acquis* on food safety, veterinary and phytosanitary policy. Iceland's legislation on live animals is not in line with the *acquis* and no new development can be reported in this area. The hygiene package remains to be fully implemented in November 2011. Further developments are needed in the legislation on plant protection products and novel food and overall administrative and laboratory capacity requires further strengthening.

4.13. Chapter 13: Fisheries

No new developments can be reported in a number of areas such as **structural action, market policy** and **State aid**.

As regards **resource and fleet management**, no development can be reported. The restrictions on the internal market *acquis* regarding the right of establishment and the freedom to provide services and on the free movement of capital in fisheries production and processing remain in place.

In the areas of **inspections and control**, no new developments can be reported. However, preparations for ratification of the 2009 FAO Agreement on port State measures to prevent, deter and eliminate illegal, unreported and unregulated fisheries continued.

When it comes to **international agreements**, Iceland continued its preparations to ratify the 1993 FAO Agreement to promote compliance with international conservation and management measures by fishing vessels on the high seas.

It was not possible, over the reporting period, to reach an agreement on the management of the mackerel stocks for 2011 between the coastal States of the North-East Atlantic. Iceland's continued expansion of mackerel fisheries, through the unilateral setting of total allowable catches, continues to cause widespread concern within the EU, also with regard to the principles of sustainable resource management.

Conclusion

Overall, Iceland continues to apply a fisheries policy which has similar objectives to those pursued in the EU, but some rules differ substantially. No developments can be reported. The Icelandic legislation is not in line with the *acquis*. Mechanisms to implement and monitor EU support measures remains to be set up. The existing restrictions on foreign investment in fisheries and services are not in line with the *acquis*.

4.14. Chapter 14: Transport policy

Iceland partly applies the *acquis* on transport policy due to its EEA membership.

In January 2011 the Ministry of Justice and Human Rights was merged with the Ministry of Transport, Communications and Local Government to form the Ministry of the Interior.

Some progress can be reported in the area of **road transport**. Iceland acceded to the European Agreement on the international carriage of dangerous goods by road (ADR) in February 2011. However, the *acquis* regarding driving licences, roadworthiness tests for motor vehicles, road side check lists for inspections in the transport of dangerous goods, and road infrastructure safety management remains to be fully implemented. Over the reporting period the EFTA Surveillance Authority (ESA) sent Iceland letters of formal notice regarding the outstanding transposition of the *acquis* on driving licences.

There is no **rail transport** sector or **inland waterways transport** sector in Iceland.

No further developments can be reported in the area of **combined transport**. In the absence of railway systems and inland waterways, combined transport in Iceland consists mainly of road transport.

In the field of **air transport** there has been good progress. The National Supervisory Authority within the Icelandic Civil Aviation Administration, as the independent body ensuring the application and monitoring of the *acquis* in this field, is improving its security surveillance capacity and a new aviation security plan is being finalised. In June 2011, the second phase of the Open Skies Agreement with the USA was signed, putting Icelandic operators on equal footing with other operators in the EU with regard to flights to the USA. Several other areas of the *acquis* remain to be transposed, including public services obligations, computerised reservation system, single European Sky II, safety and airworthiness of aircraft and aeronautical products.

Progress can be reported in the area of **maritime transport**, particularly in the area of security, where the Maritime Administration actively participated in the corresponding committees. The outstanding *acquis* on marine equipment, training and safety rules has been transposed. However, the *acquis* on rights of passengers travelling by sea, port reception facilities for ship-generated waste and port State control remains to be transposed.

No developments can be reported in the area of **satellite navigation**.

Conclusion

Overall, Iceland has a good level of alignment with the *acquis* on transport policy. However, the country still needs to transpose the relevant EU legislation on road and air transport.

4.15. Chapter 15: Energy

Iceland partly applies the *acquis* on energy due to its EEA membership.

There has been some progress in the area of **security of supply**. The steering group in charge of developing a comprehensive energy policy for Iceland delivered a final draft report in January 2011. The draft report, which was open to public consultation until April 2011, focuses on an energy strategy for the future. Work has begun on how to implement legislation on oil stocks, in particular with regard to the alternatives that may exist, administrative aspects and the obligations of the parties. Meetings with EU national experts in this field took place in April 2011.

Limited progress can be reported in the area of the **internal energy market**. With regard to the procedure to improve the transparency of gas and electricity prices, a law has not been adopted yet. In December 2010 a law amending the Electricity Act was adopted, postponing the separation of competition and franchise operations. Incorporation of the third energy package directive into the EEA Agreement has not been finalised. The relations between and independence of the Competition Authority and the National Energy Authority have not been clarified yet.

Little progress can be reported in the field of **renewable energy**, where the National Renewable Energy Action Plan is still in the process of being drafted under the leadership of the National Energy Authority. Icelandic legislation is still not in line with the 2009 renewable energy directive, although it has a share of 67% of renewable energy in its final energy consumption. Further measures are envisaged for increasing the use of renewable energy in the transport sector. This sector remains the most challenging from the renewable energy perspective. Some progress can be reported in the area of **energy efficiency**. Iceland aligned in 2010 with the directive on the promotion of cogeneration, based on useful heat demand in the internal energy market. Under the EEA Agreement, Iceland has been exempted from transposing the directive on energy performance in buildings. Substantial parts of the energy efficiency *acquis* remain to be transposed, including the energy services directive and the new legislation on eco-design and labelling of end-user products. The National Energy Authority has initiated a project to raise awareness of the importance of energy efficiency and energy saving, both for companies and households. However, Iceland has no national energy-saving targets and implementation of the *acquis* on energy end-use efficiency is still at an early stage.

There have been no further developments in the areas of **nuclear energy, nuclear safety and radiation protection**.

Conclusion

Overall, Iceland continues to be highly aligned with the *acquis* in the field of energy. However, alignment in the areas of oil stocks, the independence of the regulatory authority and energy efficiency remains moderately advanced.

4.16. Chapter 16: Taxation

The working group on taxation to evaluate the overall impact of *acquis* legislation and provide a gap analysis on national legislation with relevant *acquis* completed its work in March 2011. In the area of **indirect taxation**, few developments can be noted over the reporting period. Tax legislation remains only partly in line with the *acquis*, in particular on VAT - especially regarding definitions, exemptions, special VAT schemes or reimbursement - and excise duties, with special reference to rates and product category definitions, including for alcohol and tobacco, petrol and diesel fuel, travellers' allowances, warehousing, duty suspension and duty-free goods.

As regards **direct taxation**, no further developments can be reported on aligning the legislative framework with the *acquis*. An amendment to the Law on income tax, covered by the EEA, was adopted in December 2010 concerning the income of persons with limited tax liability and who earn no less than 75% of their income in Iceland. Laws on, *inter alia*, inheritance tax and wealth tax were also adopted in December 2010.

Regarding **administrative cooperation and mutual assistance, operational capacity and computerisation**, initial steps have been taken to measure the operational capacity and best practices of Iceland's tax system against the EU fiscal blueprints and best practices. This included study trips and training seminars for the working group on taxation with experts on the EU fiscal self assessment exercise and as part of the regional blueprints exercise on customs and taxation. The final report was submitted in September 2011. The process of aligning with the *acquis* provisions relating to mutual assistance in indirect and direct taxation matters, including the establishment of a Central Liaison Office and an Excise Liaison Office, has yet to start. Iceland needs to decide as soon as possible on a strategy to achieve interconnectivity and interoperability of its IT systems for taxation with those of the EU.

Conclusion

Overall, some progress can be reported. Iceland's tax legislation remains partially aligned with the *acquis*. Iceland continues to have a good level of administrative capacity in the field of taxation. Nevertheless, a strategy for achieving IT interconnectivity and interoperability with EU IT systems for taxation needs to be defined.

4.17. Chapter 17: Economic and Monetary policy

No progress can be reported on **monetary policy**, including in the functional, institutional, personal and financial independence of the Central Bank, where alignment with the *acquis* remains incomplete. National legislation on Central Bank financing of credit institutions other than in connection with the support of insolvent credit and/or other financial institutions remains incompatible with the prohibition on monetary financing, unless it is established that the Central Bank acts only as a fiscal agent of the State.

With respect to **economic policy**, coordination between the Ministry of Economic Affairs and the Central Bank has improved, albeit insufficiently, particularly after a new Ministry of Economic Affairs was established in October 2010 to enhance coordination of economic policy and between macroeconomic and financial sector policies. As before, regular and frequent meetings are held between the Ministry of Economic Affairs and Central Bank staff.

In December 2010 the Central Bank published a report on monetary policy in Iceland, discussing possible frameworks for monetary policy, including changes to the present inflation-targeting framework. Iceland is included in the pre-accession fiscal surveillance and submitted its first Pre-Accession Economic Programme in January 2011.

Conclusion

There has been some progress in the area of economic policy, but further efforts on improving policy coordination remain necessary. No further developments can be reported in the field of monetary policy and, overall, alignment with the *acquis* in this area remains incomplete, notably on the independence of the Central Bank and the prohibition of monetary financing of the public sector.

4.18. Chapter 18: Statistics

Iceland partly applies the *acquis* on statistics due to its EEA membership.

Some progress has been made in the **statistical infrastructure**. Cooperation between Statistics Iceland and the Central Bank of Iceland is good and has been strengthened. Statistics Iceland has started working on cooperation agreements with the Customs Department, the Environment Institute and the Energy Authority. Its operational budget has been cut further. As a result, some measures had to be postponed. Progress in other areas of capacity-building continued with the aid of study visits, working groups and training. However, apart from statistics Iceland, the country has a number of other producers of official statistics and the oversight and coordination of the entire national system needs to be strengthened.

Some progress can be reported on **classifications and registers**. The main statistical classifications are in place and follow the *acquis*. Work on upgrading the classification on occupations has started. The statistical business register is not yet operational. Concerning **sector statistics**, Iceland continued to follow its Strategy for Agricultural Statistics, presented in September 2010. This included Statistics Iceland hiring an additional three persons to work on Agricultural Statistics. Statistics Iceland also prepared plans and budget proposals on the production of Agricultural statistics beyond 2012, but so far no formal decisions on the budget proposals have been taken. The Farm Structure Survey was launched in January 2011, data collection from farmers ended in May and processing is due to start in September 2011. In June 2011 a law was adopted abolishing the Agricultural Statistics Service as of the beginning of 2012. The responsibility for agricultural statistics and the Farm Structure Survey has been moved to Statistics Iceland. The housing and population census started in April 2011 and is partly financed by unused appropriations from previous years and partly through EU support. Iceland has started to prepare for Intrastat. Gaps in national accounts, such as supply and use tables, input-output tables and sector accounts, need to be filled. Short-term statistics and structural business statistics need further development. Production of statistics following the new regulation on job vacancies has not yet begun, at least partly due to budgetary issues. The adult education survey and the continuing vocational training survey remain to be carried out.

Transmission of available statistical data to Eurostat remains to be improved. Iceland will need to ensure that resources are available in these areas. National Accounts are compiled according to European System of Accounts (ESA 95) but neither do they comprise the required supply and use and input-output tables, nor a set of full sector accounts. Financial accounts need to be comprehensively developed. The area of structural business and short-term statistics needs considerable development which is linked to the necessary establishment of a business register. As concerns other sector statistics, preparations in the area of sector statistics are advanced but incomplete.

Conclusion

Progress can be reported in the area of statistics. Production and provision of statistical data in line with EU methods, in particular on national accounts, businesses, the labour market and agriculture, remain to be improved. The implementation capacity of the statistical office is stretched to its limits. Allocation of sufficient resources remains a concern.

4.19. Chapter 19: Social policy and employment

Iceland has reached a high level of alignment and applies a substantial part of the *acquis* in this field due to its EEA membership.

In January 2011 the administration dealing with social policy and employment was reorganised, with the creation of the Ministry of Welfare.

As a member of the EEA, Iceland has continued to implement a substantial part of the *acquis* in the field of **labour law**. In the reporting period, the Icelandic legislation transposing the posting of workers directive was found to be in breach of EU law by the EFTA Court. The EFTA Surveillance Authority launched in November 2010 an infringement procedure against Iceland regarding the working time directive. Subsequently, in April 2011, a bill was introduced in the parliament set to make changes in order for Iceland to comply with the directive.

In the area of **health and safety at work**, a new legal act was adopted in February 2011 with the aim of transposing the EU directive on optical radiation.

The **social dialogue** continued to function well during the reporting period. In May 2011, after five months of negotiations, a three-year collective wage agreement for the private sector was ratified. For most of the public sector, agreements have been concluded as well. The agreements are expected to ensure stability in the labour market.

Progress continued as regards Iceland's **employment policy**. The new *Iceland 2020 Policy Statement*, adopted by the government in January 2011, sets a number of social policy objectives such as the reducing of long term unemployment to under 3%. These were formulated in consultation with representatives from trade unions and the Confederation of Icelandic Employers and place particular emphasis on the groups at risk of long-term unemployment in the wake of the financial crisis. The government has continued to implement active labour market policies focusing on young people. While these policies have been successful, an overall employment strategy still remains to be established. Overall, the labour market situation continues to be seriously affected by the economic crisis with young workers and the low skilled being hit the hardest.

Preparations for participation in the **European Social Fund** are still at an early stage.

Iceland has continued taking appropriate measures for **social inclusion** of the vulnerable groups in society. Stakeholder consultations take place regularly under the umbrella of a steering committee, led by the Ministry of Welfare, to monitor the welfare system. Financial assistance for poor households remains available from the municipal authorities, which decide themselves on the amounts to be paid. Debt mitigation measures and financial advice to indebted households, adopted in the aftermath of the financial crisis, are still in place. A new law concerning people with disabilities was adopted in December 2010. Under this law, services for people with disabilities are now under the responsibility of the municipal authorities. Iceland is well advanced in terms of social inclusion and social protection of persons with disabilities.

Iceland continues to guarantee the quality of **social protection** services, despite a lower share of expenditure than in the EU overall and the difficult economic background. As regards healthcare, pocket payments cover about 10% of primary healthcare and 30% of specialist consultations. The relatively high effective retirement age helps to maintain the sustainability of the pension system. Some of the pension funds affected by the crisis continued to cut pension rights and payments.

The two **anti-discrimination** directives remain to be transposed in Icelandic law. The Ministry of Welfare submitted a proposal for a new law to implement these directives to parliament in May 2011.

Iceland's standards in the field of **equal opportunities** remain high and Iceland continues to be the world leader in gender equality. However, two equal opportunities directives remain to be transposed, one on gender equality in social security, the other on access to goods and services.

Conclusion

Overall, Iceland has reached a high level of alignment and continued to apply a substantial part of the *acquis* in this chapter due to its EEA membership. Iceland issued the *Iceland 2020 Policy Statement* which sets a number of objectives in the areas of social policy and employment. Social dialogue mechanisms continue to function well, and a three-year collective wage agreement for the private sector has been signed. However, a comprehensive employment strategy has yet to be drafted.

4.20. Chapter 20: Enterprise and industrial policy

Iceland partially applies the *acquis* in this field due to its EEA membership.

In the area of **enterprise and industrial policy**, the *Iceland 2020 Policy Statement* sets goals and targets related to enterprise and industrial policy. In particular, it includes specific quantitative goals on welfare, knowledge, R&D, sustainability and economic development by increasing the share of GDP accounted for by exports of high-tech industrial and eco-innovation products. *Iceland 2020* is an outcome of the Moving Iceland Forward initiative which was prepared in consultation with a wide range of stakeholders. Iceland is already familiar with the Small Business Act and participates in the SME performance review.

In the area of **enterprise and industrial policy instruments**, Iceland is continuing to participate in the Enterprise and Innovation Programme and is a member of the Enterprise Europe Network. The performance of the Icelandic members of the network improved

steadily over the reporting period and has now reached satisfactory levels. At the same time, there is still room for further improvement, notably to stimulate enterprises to make fuller use of the services offered with a view to internationalisation of small and medium-sized enterprises (SMEs). Various financial support programmes for SMEs are in place. However, access to finance for SMEs is still affected by the financial crisis.

Concerning **sectoral policies**, a new policy on creative industries was presented in August 2011.

Conclusion

Overall, alignment in the area of enterprise and industrial policy remains at a high level. Measures have been taken on in industrial and SME policy to address the challenges posed by the post-crisis environment.

4.21. Chapter 21: Trans European Networks

Iceland has already reached a good level of alignment and applies a substantial part of the *acquis* in this field due to its EEA membership.

In the area of **transport networks**, Iceland participated in the TEN-T guidelines committee. TEN-T maps are currently being prepared in line with the revision of the TEN-T guidelines.

No progress can be reported in the area of **energy networks**. A TEN-E-related policy remains to be established.

Conclusion

Overall, Iceland maintains a good level of alignment with the *acquis* in this chapter. However, a TEN-E-related policy needs to be developed.

4.22. Chapter 22: Regional policy and coordination of structural instruments

In relation to the **legislative framework**, as a member of the EEA, Iceland is at an advanced stage with alignment with Union legislation and policies in areas that are a prerequisite for proper implementation of the EU Cohesion Policy, such as public procurement, competition, non-discrimination and equality between men and women. Further efforts are needed in the area of the environment. Iceland's current budget planning system does not provide sufficient guarantees with a view to multiannual programme budgeting.

No decision has been taken concerning setting up the **institutional framework** for management of the Structural Funds. However, preparatory work is under way.

As regards **administrative capacity**, a comprehensive training action plan has been put in place. It addresses most of the institutions likely to be involved in implementing Cohesion Policy and covers areas relating to programme and project preparation and management. Iceland needs to develop and implement a targeted capacity-building programme for all future stakeholders involved in EU Cohesion Policy once programme and institutional choices are made.

Progress was made on **programming**, in the form of adoption of the *Iceland 2020 Policy Statement* in January 2011, a long-term planning document for social and economic

development. It contains a number of policy targets relevant to regional policy. The statement provides for action plans for each district. Based on the objectives of the policy statement, long-term regional action and investment plans for the whole country are to be made. These will serve as a basis for preparing the strategy and programming documents required by Cohesion Policy.

No particular developments can be reported on **monitoring and evaluation**. Iceland continued to use monitoring systems in relation to the EU co-funded programmes in which the country is involved due to its EEA membership. Iceland needs to mobilise adequate resources for proper establishment of a monitoring and evaluation system for Cohesion Policy programmes.

No particular development can be reported on **financial management and control**. Iceland needs to put in place its financial management and control system (including internal and external audits) for the Structural Funds and to pay due attention to separation of functions and the independence of key bodies such as the certifying authority and the audit authority.

Conclusion

Overall, some limited progress has been made in the area of regional policy and coordination of structural instruments. A comprehensive action plan is being prepared with the aim of enhancing the administrative capacity in the area of Cohesion Policy. However, Iceland needs to identify the institutions responsible for implementation of the Cohesion Policy and to develop appropriate management mechanisms, including financial control, monitoring and evaluation.

4.23. Chapter 23: Judiciary and fundamental rights (*see also Political criteria*)

Progress can be reported in the **judiciary**. Iceland's judiciary continues to be of a high standard and the judicial system is well established. In January 2011, the Ministry of Justice and Human Rights was merged with the Ministry of Transport, Communications and local Government into the Ministry of Interior. A law extending the mandate of the president of the Supreme Court board from two to five years was adopted in February 2011.

Independence has been strengthened. As regards appointments and dismissals of prosecutors, the State Prosecutor and his Deputy are appointed by the Minister of Interior for an indefinite period of time, whereas other prosecutors are appointed by the Minister of Interior for five years. The limited term of office of prosecutors needs to be addressed. Prosecutors, the State Prosecutor and his Deputy cannot be dismissed unless a case against them is brought before the Courts. These are the same conditions that are applied to Supreme and district court judges. Discussions on merging all eight District courts into one court and on the possible establishment of a Court of Appeal are ongoing. The working group set up in December 2010 to look into the establishment of an Appeal Court for civil and criminal cases delivered its recommendations in June 2011. Its recommendations are ongoing public consultations.

The implementation of the new rules on appointing judges and prosecutors requires further monitoring.

As regards *accountability*, disciplinary procedures for judges are in place. The Committee on Judicial Functions acts on an advisory basis and any decision by the Minister of Interior to

remove a judge from the bench has temporary effect. It can only become permanent if confirmed by a court.

Measures were taken to improve the *efficiency* of the judicial system. A temporary increase in the number of district court judges (38 to 43) and Supreme Court judges (9 to 12) was decided by the parliament in February 2011 to deal with the increased case-load following the financial crisis. This number will be reduced further as of January 2013. Three Supreme Court and five district court judges were appointed during the reporting period according to the rules of the revised Act of Judiciary.

The Office of the *Special Prosecutor* was reinforced in order to continue conducting a number of criminal investigations in the wake of the financial crisis. The Office was merged with the Economic Crime Department of the National Commissioner of Police in September 2011. With this merge, the Office of the Special Prosecutor will also be in a position to investigate and prosecute serious financial and economic cases in addition to the criminal actions connected with the operations of financial undertakings. In June 2011, a law amending the law of the Special Prosecutor was amended to take into account the merge of the Office with the Economic Crime Department.

Progress can be reported on **anti-corruption policy** with the ratification in February 2011 of the UN Convention against Corruption. In March 2011, a code of conduct for ministers was adopted in application of the June 2010 law. Codes are being prepared for Central government staff and for the civil service in general. A special implementation plan for ethical standards within the administration was launched in November 2010 under the auspices of the Coordination Committee on Ethical Standards for the Administration. The plan aims to ensure extensive consultations before codes of conduct are adopted and makes provision for training activities. Training activities on investigations of corruption cases also took place during the reporting period. The General Penal Code remains to be amended following the December 2010 interim compliance report of the Council of Europe's Group of States against Corruption (GRECO) on incrimination of corruption offences.

According to the law on the financing of political parties amended in September 2010, political parties have to provide their financial report by the beginning of October 2011, as a precondition for them to receive State funding. The State Auditor monitored the implementation of the amended law on financing of political parties. During the reporting period, 7 out of 8 political parties have delivered their obligatory financial report for the year 2009. No payments are executed if the information provided to the National Audit Office by the political party is not submitted or is not in line with the legal provisions. The impact and effects of the new legislation need to be monitored. The GRECO recommendation on party funding regarding the independence of auditors who check the political parties' and candidates' accounts remains to be addressed.

Some measures were taken during the reporting period to further strengthen the already high level of protection of **fundamental rights**. These concern in particular *women's rights* and the fight against domestic violence: in March 2011, the Ministry of Welfare presented to the Parliament a report with recommendations on various actions related to both preventive measures and response to domestic violence. A new law to improve the functioning of restraining orders and the removal from home of perpetrators of domestic violence was adopted in June 2011.

No progress can be reported on the *protection of personal data*. The Law on data protection is not yet fully in line with the *acquis*, in particular as regards the transfer of data to third countries. The independence of the Data Protection Authority needs further strengthening. The Authority is administratively subject to the Ministry of Interior, which allocates and supervises the Authority's yearly budget. The rules on the appointment of the members of the board of directors by the Minister of Interior need to be reviewed. The Additional Protocol to the Council of Europe Convention 108 for the Protection of Individuals with regard to Automatic Processing of Personal Data has not yet been ratified.

There are no developments to report on **EU citizen's rights**.

Conclusion

Overall, Iceland's judiciary and anti-corruption policy continue to be of a high standard. The limited tenure of prosecutors other than the Public Prosecutor and the Deputy Public Prosecutor needs to be addressed. Iceland ensures continuous strengthening of its already high level of protection on fundamental rights. Progress was made in further reinforcing the independence of the judiciary and the anti-corruption policy framework. Further monitoring of the implementation of these measures is needed. The legislation on citizen's rights and data protection is not yet fully in line with the *acquis*.

4.24. Chapter 24: Justice, freedom and security

As an associated member of the **Schengen Agreement**, Iceland continued to implement a large part of the *acquis* in the area of justice, freedom and security, in particular as regards **external borders** and **visas**. Iceland has continued to be actively involved in the activities of Frontex. Iceland is also participating in the Visa Information System (VIS).

In January 2011, the amended Law on the restructuring of the government and its ministries came into force. The Ministry of Justice and Human Rights merged with the Ministry of Transport, Communications and Local Government to form the Ministry of the Interior.

Iceland is advanced in the area of **migration**, but its legislation on long-term residents, special provisions for researchers and implementation of the EU Blue Card Directive still needs to be aligned. The same applies to family reunification.

As regards **asylum**, the amendments to the Act on foreigners which entered into force in October 2010 broadened the definition of refugee to include those eligible for subsidiary protection. It also included provisions to tighten up the procedures and consolidate the rights of asylum-seekers. Work has started with a view to joining the European Asylum Support Office (EASO).

Progress can be reported in the area of **judicial cooperation in civil and criminal matters**. Iceland ratified the Lugano Convention on jurisdiction and the enforcement of judgments in civil and commercial matters in January 2011 and the Convention entered into force as regards Iceland in May 2011. No new developments can be reported with regard to joining the 1996 Child Protection Convention and the 2007 Child Support Convention and its protocol on applicable law, nor with cooperation in criminal matters. The good cooperation between Iceland and Eurojust has continued.

As regards **police cooperation and the fight against organised crime**, the protocols to the UN Convention against transnational crime (Palermo Convention) on smuggling of migrants

and on illicit manufacturing and trafficking in firearms remain to be ratified. The specialist coordination team dealing with human trafficking continued to provide training for professionals and civil servants. It also provided safe refuges, protection, legal aid, emergency health services and psychological assistance for victims of human trafficking and organised activities to build up their social abilities. Information and guidelines on human trafficking for police officers are available. They include information on the difference between human trafficking and smuggling of people, misconceptions and identification of victims. A law was adopted in June increasing the punishment for trafficking in human beings to 12 years. Iceland has not ratified the Council of Europe Convention on trafficking in human beings. Iceland is continuing its good cooperation with Europol, in particular on investigations in the wake of the financial crisis. Iceland continues to be advanced in the fight against money laundering. No new development can be reported.

Iceland remains well advanced in the **fight against terrorism, cooperation in the field of drugs and customs cooperation**, where no further developments can be reported.

As regards **counterfeiting of the euro**, see Chapter 32 - *Financial control*.

Conclusion

Overall, Iceland continues to apply the Schengen Agreement and is well advanced in aligning with the *acquis* in the area of justice, freedom and security. Further efforts are still needed to ratify and implement international instruments in the field of child protection, the fight against organised crime and currency counterfeiting.

4.25. Chapter 25: Science and research

Iceland has already achieved a high level of alignment and applies a substantial part of the *acquis* in this field due to its association with the EU Framework Programmes and its participation in the European Research Area governance structures under the EEA Agreement.

Iceland's framework for **research and innovation policy** is in line with and comparable to those of EU Member States.

Iceland continued to participate in the 7th EU **Framework Programme** for research and technological development (FP7) as associated country. Participation remained successful and was spread over all the thematic areas and specific programmes covered by FP7.

Regarding the **European Research Area** (ERA), over the reporting period Iceland took a number of actions which further facilitate its integration into the ERA and strengthens the research and innovation capacity at national level. The *Iceland 2020 Policy Statement* of January 2011 takes due account of the objectives of the ERA.

Regarding research funding, the Policy Statement contains actions to increase the level of expenditure in R&D currently at 2.7% of GDP to reach 4% of GDP by 2020, with 70% coming from companies and 30% from public funds. To attain this objective, the government is expected to offer tax incentives to private companies for R&D spending.

Conclusion

Overall, Iceland has achieved a high level of alignment in the field of science and research and continued to participate actively in EU FP7. Furthermore, as a result of its involvement in European Research Area activities, Iceland is well advanced to meet the targets and objectives of the ERA and the Innovation Union.

4.26. Chapter 26: Education and culture

Iceland has already implemented a substantial part of the *acquis* on education and culture, due to its EEA membership.

No further developments can be reported in the fields of **education, training, youth**, culture and sport.

As regards *cooperation on policies*, Iceland continued to participate actively in the open method of coordination on education. Iceland's share of 30-34 year olds with tertiary education remains above the EU average and is already above the target set by the EU Education & Training 2020 framework. The rate of early school-leavers remains above the EU average. To improve this situation, the government put forward proposals in April 2011 to reduce the drop-out rate from upper secondary school and decrease youth unemployment. In the field of lifelong learning, Iceland remained above the EU average targets for 2020.

Regarding *access to education of EU citizens*, the Ministry of Education is working on amending its legislation on access for EEA citizens to loans from the Icelandic Student Loan Fund. This amendment is expected to enter into force in autumn 2011 and will introduce a residence requirement for all beneficiaries.

Iceland continued to participate in several *EU programmes*, including Life-long Learning, Youth in Action and Erasmus Mundus. It also continued to participate in the European Centre for the Development of Vocational Training and nominated representatives to take part as observers in the Advisory Committee on Vocational Training. The Ministry of Education, Science and Culture is working on streamlining procedures and on achieving full compliance with the programme management requirements for the Lifelong Learning and Youth in Action Programmes. So far, Iceland is not participating in the Europe for Citizens Programme.

A comprehensive national qualifications framework based on learning outcomes is being developed.

Iceland continued to participate in the EU **Culture** Programme for 2007-2013 and has reiterated its interest in participating in the open method of coordination on culture.

Conclusion

Overall, Iceland has achieved a high level of alignment in the field of education and culture.

4.27. Chapter 27: Environment

As regards **environment**, Iceland's policy is to a large extent in line with the EU *acquis* due to its EEA membership.

An integrated national strategy on environmental issues was introduced with the new *Iceland 2020 Policy Statement*. It contains several firm environmental targets with a focus on

sustainable development, especially in the context of exploitation of natural resources and energy. Objectives include to become a pioneer in testing, producing and using eco-friendly fuels. Some progress has been achieved in the *horizontal legislation*. A law set to transpose the environmental liability directive was presented to the parliament in March 2011. It includes provisions on damage to protected species and nature conservation areas. However, these are not yet in line with the EU nature *acquis*. Legislation set to implement the third pillar of the Aarhus Convention was adopted by parliament in September. The Aarhus Convention still has to be ratified. Transposition of the environmental crime directive is still pending. Legislation transposing the INSPIRE directive was adopted in May 2011.

The Ministry of the Environment is preparing amendments to the environmental impact assessment legislation which are expected to be presented to parliament in 2011. The main changes concern the criteria on which projects will be subject to screening in order to decide whether an environmental impact assessment is required. No developments can be reported regarding ratification of the Espoo Convention on environmental impact assessment in a transboundary context.

Iceland's *air quality* legislation is largely in line with the EU *acquis*. However, a law transposing the National Emissions Ceilings Directive remains to be adopted.

Good progress was achieved in the field of *waste management*. New waste management legislation was adopted by parliament in May 2011 with the aim of transposing a whole range of provisions of the EU waste framework directive, batteries directive and mining and waste directive and packaging waste directive.

In the field of *water quality*, a significant step was taken in the form of new framework legislation, adopted in April 2011, transposing the water framework directive. New staff were recruited in the Environment Agency over the reporting period to work on water framework issues. Iceland still needs to take specific steps to transpose the remaining *acquis*, notably the marine strategy framework directive, bathing water directive and floods directive.

As regards *nature protection*, the Nature Conservation Act is being reviewed to take into consideration the birds and habitats directives. Meanwhile, no legislative or implementing measures can be reported to align with the *acquis* on protection of whales or with the trade ban on imports of seal products into the EU. Work has continued on developing management plans for the national parks. A management plan for Vatnajökull national park was adopted by the Minister of the Environment in February 2011.

Iceland is well advanced on aligning with the EU *acquis* on *industrial pollution, control and risk management*. No further developments can be reported in this area.

Some progress was achieved in the area of *chemicals*. Legislation aiming at transposing the EU regulation on classification, labelling and packaging of chemical was adopted by parliament in May 2011. The amendments to the Registration, Evaluation, Authorisation and Restrictions of Chemicals (REACH) remain to be fully transposed and the administrative capacity for its implementation needs to be strengthened. No developments can be reported as regards ratification of the Rotterdam Convention.

As regards *noise*, in March 2011 the EFTA Surveillance Authority decided to take Iceland to court for failing to address the problem of road noise, as required by the Environmental Noise Directive.

As regards civil protection Iceland continued to participate in the EU Civil Protection Mechanism and contributed to the work of the EU Civil Protection Committee.

As regards **climate change** Iceland's pledge for the post-2012 climate regime is at the level of -30% in comparison to 1990 with Iceland stating that this pledge requires them being able to use the provisions of Article 4 of Kyoto Protocol or similar arrangement and agreement with the European Union. Iceland regularly associated itself with the EU positions on climate change during the reporting period.

As regards the EU Monitoring Mechanism, Iceland continued to take steps towards compliance. However, some adjustments are still needed, especially in the timing of data compilation for both the greenhouse gas (GHG) inventory and GHG projections.

Regarding emissions trading, Iceland in June adopted legislation to complete transposition of the current EU emissions trading (EU ETS) and aviation directives. However, further steps are needed to complete transposition and prepare to implement the revised EU ETS directive, in particular in so far as aviation, registries and auctioning are concerned.

Iceland adopted an implementation plan for mitigation of greenhouse gas emissions in November 2010 to achieve closer alignment with the EU effort-sharing decision. Further efforts and capacity-building are, however, needed.

Regarding fuel quality, Iceland still needs to transpose the directive on specifications for fuels. As regards emissions from road transport, Iceland still needs to implement the EU regulation on emission standards for new cars and vans, primarily through setting up a scheme for monitoring and reporting of CO₂ emissions.

Iceland continued to prepare for transposition of the directive on the geological storage of carbon dioxide. Iceland needs to take steps to align with some remaining pieces of EU legislation on ozone-depleting substances and fluorinated gases. It has not yet associated itself with the Declaration adopted at the 22nd meeting of the Parties to the Montreal Protocol on the global transition away from HCFCs and CFCs.

As far as **administrative capacity** is concerned, the Environment Agency recruited two new members of staff to deal with the ETS aviation issues. The inter-ministerial committee was reinforced by adding, amongst others, a representative of municipalities and by holding consultations with business and civil society.

Conclusion

Overall, Iceland has reached a high level of alignment and applies a substantial part of the *acquis* in this chapter due to its EEA membership and there has been further progress. Institutional structures are mostly in place and in operation. Full compliance with the *acquis* on nature protection remains to be achieved, in particular in the cases of protection of whales, seals and wild birds and conservation of natural habitats and of wild fauna and flora. The same applies to the water sector, in particular as regards alignment with the Marine Strategy Framework Directive. Further steps are also needed as regards climate change, in particular in the areas of aviation, registries and auctioning. There are issues on which Iceland needs gradually to align with the EU positions in the international environmental fora. Iceland also needs to ratify outstanding important multilateral environmental agreements.

4.28. Chapter 28: Consumer and health protection

Iceland partly applies the *acquis* on consumer and health protection due to its EEA membership. Limited progress can be reported in the field of **consumer protection**.

Regarding *product safety-related issues*, Iceland is broadly in line with the General Product Safety Directive (GPSD) and related measures. However, some amendments are necessary to the Act on product safety and official market control which transposes the GPSD. The Commission decision on dimethylfumarate remains to be transposed. Some further progress can be reported on the processing of RAPEX notifications in the reporting period.

On *non-safety-related issues*, the consumer credit directive remains to be transposed as well as the *acquis* on timeshare contracts and injunctions.

Some progress can be reported in the area of **public health**.

Legislation on new pictorial health warnings on *tobacco* products entered into force in August 2011.

In the area of *communicable diseases*, a regulation was adopted in March 2011 to start new routine vaccinations of babies against pneumococcal ear infections. Alignment with the list of communicable diseases to be covered by the EU surveillance system remains to be completed. The colorectal *cancer* screening programme is yet to be implemented.

No further progress can be reported in the field of *mental health*, where Iceland's measures and activities are similar to those of the EU Member States.

Conclusion

Iceland has already achieved a good level of alignment and applies a substantial part of the *acquis* in the fields of consumer protection and health. Further efforts to align with the *acquis* are necessary, especially regarding consumer protection, where intensified participation in the RAPEX system is needed.

4.29. Chapter 29: Customs Union

The customs legislation of Iceland is partially in line with the *acquis*. The working group set up to analyse the overall impact of aligning with the *acquis* in this area and provide a gap analysis on national legislation with relevant *acquis* completed its work in March 2011.

Concerning **customs legislation**, the December 2010 amendments to the Customs Act changed provisions on temporary imports of rental cars. No developments can be reported on addressing the gaps in transposition of the Combined Nomenclature and on the value of certain customs fees.

There has been little progress on **administrative and operational capacity**. Initial steps have been taken to measure the operational capacity and practices of Iceland's Customs Directorate against the customs blueprints. This included study trips and training seminars with experts on the EU fiscal self assessment exercise and as part of the regional blueprints exercise on customs and taxation. The final report was submitted in September 2011. Additional efforts are necessary to ensure effective implementation of the *acquis* by the Customs Administration upon accession. The interface to connect the national IT system to EU customs systems

(CCN/CSI) is not yet in place. Iceland needs to decide as soon as possible on a strategy to be followed in achieving the interoperability and interconnectivity of its IT systems for customs with those of the EU.

Conclusion

The customs legislation is largely in line with the *acquis*. Discrepancies in the legislation, in particular in the fields of customs rules, procedures with economic impact, duty free and security aspects still have to be addressed. Iceland's administrative capacity in the customs field remains adequate. Nevertheless, preparations for effective implementation of the EU *acquis* upon accession still have to be initiated, in particular to develop interconnectivity with the EU-related IT systems.

4.30. Chapter 30: External relations

With regard to the **common commercial policy**, Iceland continued to assess the adaptations required in order to align with the *acquis*.

In connection with the World Trade Organisation (**WTO**), work continued on collecting information with a view to further alignment of horizontal limitations and sector-specific commitments under the General Agreement on Trade in Services (GATS). Iceland has decided to participate as a third party in cases WTO DS400 and DS401 (EU seal cases). In this context, it took a position opposing the EU. As part of its preparations for membership, Iceland is expected to coordinate its positions in the WTO with the EU at an early stage.

No new major developments can be reported on **export credits** and **dual-use goods**. Legislation in this field is already largely in line with the *acquis*. As regards dual use, Iceland's application to join the Wassenaar Arrangement on export controls for conventional arms and dual-use goods and technologies is being processed. The implementing regulation for the control of services and items of strategic significance of July 2011 is in line with the *acquis*. No new developments can be reported with regard to the Kimberley process: Iceland is not associated with this process and its legislation on exports and imports of rough diamonds is therefore not in line with the *acquis*.

Work is continuing on a database of all **international agreements** in the area of external relations that are relevant to relations with the EU. Bilateral negotiations between China and Iceland on a free-trade agreement continued at a technical level. In the context of EFTA, Iceland is engaged in negotiations with Bosnia and Herzegovina, Montenegro, Hong Kong, China, India, Indonesia, Russia, Belarus, Kazakhstan, Algeria and Thailand.

Iceland is already a member of the WTO and has most GATS commitments in line with those of the EU. However, by accession to the EU, Iceland should bring its WTO commitments in line with the commitments undertaken by the EU.

As regards **development policy**, a resolution on a strategy for Iceland's development cooperation for the years 2011-2014 was adopted by parliament in June 2011. This is the first time that parliament has adopted a comprehensive strategy and action plan for development cooperation. Part of the strategy is to increase the government contribution to development aid from 0.21% of GNI in 2011 to 0.7% in 2019.

Humanitarian aid is part of the strategy for Iceland's development cooperation. Iceland spent 11% of its official development assistance on humanitarian and emergency assistance.

Revised guidelines for cooperation and applications have been issued, including the humanitarian aid sector.

Conclusion

Iceland is already highly aligned with the *acquis* in this area and some further progress can be reported in external relations. Further progress has been made on the work on the need to amend or revoke Iceland's international agreements. However, Iceland has made no progress on aligning its positions with the EU in the WTO. Progress has been made in the fields of development cooperation and humanitarian aid, where the new strategy aims at increasing Iceland's official development assistance in the medium term.

4.31. Chapter 31: Foreign, Security and Defence Policy

The regular **political dialogue** between the EU and Iceland continued to cover foreign policy issues.

As regards the **common foreign and security policy (CFSP)**, during the reporting period Iceland aligned itself, when invited, with 58 out of 67 relevant EU declarations and Council decisions (86 % alignment). Non alignment is largely due to technical reasons as in several of the cases implementing regulations are already in place.

Iceland closed its Defence Agency in January 2011. Responsibility for defence, security and NATO matters remains with the Ministry for Foreign Affairs, whereas responsibility for managing the tasks of the former Defence Agency now falls under the Ministry of the Interior.

The Director-General for International and Security Affairs acts as the Political Director; the post of European Correspondent still has to be established.

A parliamentary resolution on establishing a new security policy, based on civilian values, civilian institutions and the fact that Iceland has no military force, was adopted in September 2011. According to the resolution, the Minister of Foreign Affairs should appoint a parliamentary committee to work on a proposal for a national security policy by June 2012.

With regard to *sanctions and restrictive measures*, Iceland adopted the relevant decisions to implement most restrictive measures introduced by the Council Decisions. Iceland needs to implement the Common Position on specific measures to combat terrorism or the Joint Action concerning measures protecting against the effects of the extra-territorial application of legislation adopted by a third country and action based thereon.

No further developments can be reported with regard to *conflict prevention or non-proliferation and the strategy on weapons of mass destruction/small arms and light weapons (WMD/SALW)*, as Iceland is already highly compliant in these areas.

Iceland continued its good *cooperation with international organisations*, such as the UN, NATO, the OECD, the OSCE and the Council of Europe. It participated actively and played a key role in the Arctic Council, the Conference of Parliamentarians of the Arctic Region (CPAR), the Barents Euro-Arctic Council (BEAC), the Northern Dimension, the Nordic Council of Ministers and the West Nordic Council. In March 2011, a Resolution on an Icelandic "High North Policy" was adopted by parliament.

There have been no developments with regard to *security measures (classified information)*.

As regards the **common security and defence policy (CSDP)** and contributing capacity, no developments can be reported in the field of *civil crisis management*. Iceland continued to support EU civilian missions.

Conclusion

Overall, Iceland has reached a high level of alignment in this area. It has aligned with most EU declarations and Council Decisions when invited to do so. The adoption of a resolution on an Arctic policy underlines Iceland's continuous objective to play an active part in regional organisations in Northern Europe and the Arctic region.

4.32. Chapter 32: Financial control

Limited progress can be reported on **public internal financial control (PIFC)**. The working group set up in January 2010 in the Ministry of Finance performed an initial assessment of the possible gaps and weaknesses in Iceland's PIFC system during the second half of 2010. A detailed PIFC gap assessment still needs to be carried out and a policy paper to be prepared.

No developments can be reported in the area of **external audit**. No measures have been taken to further strengthen the constitutional independence of the Icelandic National Audit Office (INAO). Completion of the separation of internal and external audits by the end of 2011 needs to be monitored. No progress can be reported on further aligning Iceland's legislation with the Convention on the **protection of the EU's financial interests** and its protocols. Iceland also needs to designate the entity responsible for coordination and cooperation with the European Commission in the fight against fraud and on protection of the EU's financial interests.

With regard to **protection of the euro against counterfeiting**, the Geneva Convention for the suppression of counterfeiting currency is currently being translated into Icelandic in view of being ratified (*see also Chapter 24 - Justice, freedom and security*).

Conclusion

Overall, Iceland's financial control system is largely in line with international standards and EU best practice. Limited legislative progress can be reported. Targeted action is required, including preparing a policy paper on public internal financial control and ensuring separation between internal and external audits. Preparations for protection of the EU's financial interests still have to be made.

4.33. Chapter 33: Financial and budgetary provisions

The basic principles and institutions for the policy areas affecting **traditional own resources (TOR)** continued to function well, with a significant level of alignment. Appropriate procedures and systems for accounting for TOR and making them available will have to be put in place, in particular as regards the so-called 'A' and 'B' accounts. The system for writing off irrecoverable debts also needs to be amended and post-clearance auditing on traders' premises further developed.

No particular developments can be reported on **VAT resources**. Iceland will need to develop the capacity to calculate accurately the weighted average rate.

As regards **GNI resources**, Iceland already widely applies the ESA 95 standards. Alignment should continue.

Regarding the **administrative infrastructure** and operational management of the own resources system, a working group continued to analyse the overall impact of aligning with the *acquis*. The Ministry of Finance continued to manage and coordinate the preparations in the pre-accession period. This coordination structure will need to be strengthened and formally established. Besides steering and coordinating pre-accession preparations, the coordinating department will have to establish the organisational and procedural links between the various institutions involved in own resources.

Conclusion

Overall, Iceland has reached a good level of alignment in the policy areas underlying and affecting this chapter. It has continued to identify the required alignment with the *acquis*. Administrative preparations and concepts for setting up the own resources system are needed. A coordination structure remains to be formally established.

Statistical Annex

STATISTICAL DATA (as of 30.09.2011)

Iceland

Basic data

Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Population (thousand)	279	283	287	288	291	294	300	308	315	319	318
Total area of the country (km ²)	103 000	103 000	103 000	103 000	103 000	103 000	103 000	103 000	103 000	103 000	103 000

National accounts

Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	
Gross domestic product (GDP) (million national currency)	683 747	771 894	816 450	841 490	930 141	1 025 740	1 168 602	1 308 530	1 481 986	1 497 672	1 537 106	
GDP (million euro)	9 421	8 830	9 474	9 711	10 674	13 112	13 316	14 932	10 304	8 674	9 495	
GDP (euro per capita)	33 500	31 000	32 900	33 600	36 500	44 300	43 800	48 000	32 299	27 200	29 900	
GDP (in Purchasing Power Standards (PPS) per capita)	25 100	26 100	26 600	26 000	28 400	29 300	29 200	30 200	30 500	27 700	26 900	
GDP per capita in PPS (EU-27 = 100)	132	132	130	126	131	130b	123	121	122	118	110	
Real GDP growth rate (growth rate of GDP volume, national currency, % change on previous year)	4.3	3.9	0.1	2.4	7.8	7.2	4.7	6	1.3	-6.7	-4.0	
Employment growth (national accounts, % change on previous year)	:	:	:	:	:	:	:	:	:	:	:	
Labour productivity growth: GDP growth per person employed (% change on previous year)	2.3	2.2	1.6	2.3	8.3	3.8	-0.4	1.4	0.5	-0.7	-3.7	
Real unit labour cost growth (national accounts, % change on previous year)	:	:	:	:	:	:	:	:	:	:	:	
Labour productivity per person employed (GDP in PPS per person employed, EU-27 = 100)	:	:	:	:	:	:	:	:	:	:	:	
Gross value added by main sectors (%)												
Agriculture and fisheries	1)	9.0	9.2	9.3	7.9	6.8	6.3	6.3	5.7	6.2	7.1	:
Industry	1)	17.3	19.2	16.8	15.7	15.2	13.7	15.3	14.1	17.8	20.3	:
Construction	1)	8.6	7.8	7.5	7.5	8.8	10.4	11.0	11.5	9.2	5.0	:
Services	1)	65.1	63.8	66.4	68.9	69.1	69.8	67.4	68.8	67.0	67.8	:
Final consumption expenditure, as a share of GDP (%)		84.0	79.8	80.2	83.3	82.2	84.0	82.6	81.7	78.0	77.2	76.7
Gross fixed capital formation, as a share of GDP (%)		22.9	21.5	18.2	20.0	23.5	28.4	34.0	28.5	24.5	14.1	12.9
Changes in inventories, as a share of GDP (%)		0.4	-0.3	0.0	-0.2	-0.1	-0.1	1.2	0.5	0.2	0.0	-0.2
Exports of goods and services, relative to GDP (%)		33.6	38.8	37.4	34.3	34.1	31.7	32.2	34.6	44.3	52.9	56.5
Imports of goods and services, relative to GDP (%)		40.9	39.9	35.9	37.4	39.7	44.0	50.0	45.3	47.1	44.3	45.9

Industry

Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Industrial production volume index (2000=100)	:	:	:	:	:	:	:	:	:	:	:

Inflation rate

Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Annual average inflation rate (CPI, % change on previous year)	:	:	:	:	:	:	:	:	:	:	:

Balance of payments

Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Balance of payments: current account total (million euro)	-926	-372	149	-460	-1050	-2151	-3172	-2347	-2848	-923	-778
Balance of payments current account: trade balance (million euro)	-518	-83	162	-179	-420	-1202	-1781	-1012	-257	525	743
Balance of payments current account: net services (million euro)	-131	15	-7	-109	-170	-418	-551	-501	-213	219	282
Balance of payments current account: net income (million euro)	-266	-292	-21	-158	-448	-507	-813	-791	-2351	-1617	-1749

Balance of payments current account: net current transfers (million euro)		-11	-10	15	-13	-14	-23	-28	-44	-25	-52	-52
of which government transfers (million euro)		-11	-14	-10	-7	-16	-20	-24	-40	-29	-33	-33
Net foreign direct investment (FDI) (million euro)		-237	-190	-251	-39	-1 481	-3 225	-1 304	-2 402	-2 298	-1 619	-773
Foreign direct investment (FDI) abroad (million euro)		-422	-383	-344	-333	-2 066	-5 700	-4 379	-7 392	-2 932	1 675	-1 041
of which FDI of the reporting economy in EU-27 countries (million euro)		-240	-229	-356	-301	-1 930	-4 480	-3 670	-4 729	-2 050	-1 698	:
Foreign direct investment (FDI) in the reporting economy (million euro)		185	193	93	294	585	2 475	3 075	4 990	634	56	268
of which FDI of EU-27 countries in the reporting economy (million euro)		136	10	113	215	385	2 274	2 930	6 042	305	607	:

Public finance	Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
General government deficit/surplus, relative to GDP (%)		:	:	:	:	:	4.9	6.3	5.4	-13.5	-10.0	-10.1
General government debt relative to GDP (%)		:	:	:	:	:	26.0	27.9	28.5	70.3	87.9	92.9

Financial indicators	Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Gross foreign debt of the whole economy, relative to GDP (%)		107.0	123.3	110.6	139.6	179.1	285.7	444.4	567.9	997.5	1 014.0	891.5
Gross foreign debt of the whole economy, relative to total exports (%)		318.8	318.0	295.6	407.6	525.9	908.1	1 386.0	1 647.4	2 266.2	1 916.1	1 579.0
Money supply: M1 (banknotes, coins, overnight deposits, million euro)		920	776	1 036	1 199	1 676	2 313	2 236	4 504	3 192	2 857	3 242
Money supply: M2 (M1 plus deposits with maturity up to two years, million euro)		1 670	1 601	1 886	2 107	2 899	4 070	3 827	7 109	6 370	5 625	6 024
Money supply: M3 (M2 plus marketable instruments, million euro)		3 787	3 755	4 666	5 173	6 392	8 802	8 299	13 490	9 558	8 931	9 415
Total credit by monetary financial institutions to residents (consolidated) (million euro)		7 779	7 650	8 296	9 019	13 561	22 941	25 745	35 486	11 652	9 351	11 151
Interest rates: day-to-day money rate, per annum (%)		11.0	12.3	9.3	5.1	6.1	8.9	12.0	13.8	15.6	11.4	6.9
Lending interest rate (one year), per annum (%)		16.7	18.0	15.4	12.0	12.2	14.8	17.8	19.3	20.5	16.4	10.4
Deposit interest rate (one year), per annum (%)		1.4	1.7	0.7	0.2	0.3	1.3	3.4	4.6	6.0	3.5	0.5
euro exchange rates: average of period - 1 euro = ... national currency		72.58	87.42	86.18	86.65	87.14	78.23	87.76	87.63	143.83	172.67	161.89
Effective exchange rate index (2000=100)		:	:	:	:	:	:	:	:	:	:	:
Value of reserve assets (including gold) (million euro)		438	403	441	647	785	901	1 774	1 785	2 526	2 696	4 323

External trade	Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Value of imports: all goods, all partners (million euro)		2525.8	2225.3	2409.8	2498.0	2988.5	4024.5	4788.2	4881.3	4167.1	2583.1	2944.9
Value of exports: all goods, all partners (million euro)		2013.4	2025.9	2369.04	2110.9	2322.1	2487.2	2758.0	3478.6	3650.2	2907.5	3474.8
Trade balance: all goods, all partners (million euro)		-512.3	-199.4	-40.8	-387.2	-666.4	-1537.3	-2030.2	-1402.8	-516.9	324.4	529.9
Terms of trade (export price index / import price index)		100.0	102.5	103.7	97.2	95.1	94.7	101.2	101.0	94.8	84.3	92.4
Share of exports to EU-27 countries in value of total exports (%)		68.2	69.6	72.3	73.8	75.3	74.7	71.0	74.6	76.1	77.6	77.4
Share of imports from EU-27 countries in value of total imports (%)		60.0	58.8	58.3	64.0	61.1	62.1	58.3	60.1	53.6	51.9	52.3

Demography	Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Natural growth rate: natural change (births minus deaths) (per 1000 inhabitants)		8.8	8.3	7.7	8.0	8.3	8.2	8.3	8.4	9.0	9.5	9.1
Infant mortality rate: deaths of children under one year of age per 1000 live births		3.0	2.7	2.2	2.4	2.8	2.3	1.4	2.0	2.5	1.8	2.2
Life expectancy at birth: male (years)		:	78.1	78.4	79.0	79.2	79.2	79.4	79.4	79.6	79.7	79.5
Life expectancy at birth: female (years)		:	82.2	82.6	82.4	82.7	83.1	83.0	82.9	83.0	83.3	83.5

Labour market	Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Economic activity rate (15-64): share of population aged 15-64 that is economically active (%)		88.6	88.5	87.5	86.9	85.4	86.7	87.8	87.8	86.9	85.3	84.7
Employment rate (15-64): share of population aged 15-64 in employment (%)*		86.6	86.5	84.7	83.3	82.3	83.8	84.6	85.1	83.6	78.3	78.2
Employment rate male (15-64) (%)		90.2	89.9	87.7	86.3	85.8	86.9	88.1	89.1	87.3	80.0	80.1

Employment rate female (15-64) (%)		82.8	82.9	81.6	80.1	78.8	80.5	80.8	80.8	79.6	76.5	76.2
Employment rate of older workers (55-64): share of population aged 55-64 in employment (%)		84.2	85.6	87.2	83.0	81.8	84.3	84.3	84.7	82.9	80.2	79.8
Employment by main sectors (%)												
Agriculture	2)	:	:	7.2	6.7	6.0	6.3	6.3	5.8	4.3b	4.7	5.4
Industry	2)	:	:	15.1	14.7	15.6	14.0	12.7	11.9	11.9b	12.5	12.1
Construction	2)	:	:	7.4	7.0	8.3	7.8	8.8	9.0	10.0b	7.0	6.2
Services	2)	:	:	70.3	71.6	70.0	71.9	72.2	73.2	73.7b	75.8	76.3
Unemployment rate: share of labour force that is unemployed (%)		1.9	1.9	3.0	4.0	4.0	2.5	2.8	2.3	2.9b	7.2	7.6
Share of male labour force that is unemployed (%)		1.3	1.6	3.3	4.0	5.1	2.6	2.6	2.2	3.2b	8.6	8.3
Share of female labour force that is unemployed (%)		2.6	2.2	2.6	4.0	2.8	2.5	3.1	2.3	2.6b	5.7	6.7
Unemployment rate of persons < 25 years: share of labour force aged <25 that is unemployed (%)		4.4	5.1	6.4	12.5	12.1	7.4	8.3	7.0	8.2	15.9	16.2
Long-term unemployment rate: share of labour force that is unemployed for 12 months and more (%)		:	:	:	:	:	:	:	:	:	:	0.7

Social cohesion

	Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Average nominal monthly wages and salaries (national currency)		:	:	:	:	:	:	:	:	:	:	:
Index of real wages and salaries (index of nominal wages and salaries divided by the CPI/HICP) (2000=100)		:	:	:	:	:	:	:	:	:	:	:
Early school leavers - Share of population aged 18-24 with at most lower secondary education and not in further education or training (%)*		29.8	30.9	28.8	20.3b	24.9	24.9	25.6	23.2	24.4	21.3	22.6

Standard of living

	Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Number of passenger cars per 1000 population		569.8	564.7	565.3	578.9	602.3e	637.0e	:	:	:	:	:
Number of subscriptions to cellular mobile telephone services per 1000 population		770.5	875.2	907.3	967.2	998.0	899.3	947.0	1059.6	1068.3	1064.6	:

Infrastructure

	Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Density of railway network (lines in operation, per 1000 km ²)		:	:	:	:	:	:	:	:	:	:	:
Length of motorways (thousand km)		-	-	-	-	-	0.011	0.011	0.011	0.011	:	:

Innovation and research

	Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Spending on human resources (public expenditure on education in % of GDP)		5.8	6.2	6.8	7.7	7.5	7.6	7.6	7.4	7.6	:	:
Gross domestic expenditure on R&D in % of GDP*		2.7e	3.0	3.0e	2.8	:	2.8	3.0	2.7	2.7p	3.1	:
Percentage of households who have Internet access at home (%)		:	:	:	:	81.0	84.0	83.0	84.0	88.0	90.0	92.0

Environment

	Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Greenhouse gas emissions, CO2 equivalent (tons, 1990=100)*		110.3	109.4	110.1	109.2	110.6	109.1	124.9	132.0	142.9	135.2	:
Energy intensity of the economy (kg of oil equivalent per 1000 euro GDP)		343.4	342.6	345.6	336.5	322.6	311.1	357.7	:	:	:	:
Electricity generated from renewable sources in % of gross electricity consumption		:	:	:	:	:	:	:	:	:	:	:
Road share of inland freight transport (% of tonne-km)		100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Energy

	Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Primary production of all energy products (thousand TOE)		2 306	2 451	2 462	2 457	2 519	2 636	3 259	3 946	4 397	4 819	:
Primary production of crude oil (thousand TOE)		0	0	0	0	0	0	0	0	0	0	:

Primary production of hard coal and lignite (thousand TOE)		0	0	0	0	0	0	0	0	0	0	:
Primary production of natural gas (thousand TOE)		:	:	:	:	:	:	:	:	:	:	:
Net imports of all energy products (thousand TOE)		1 036	947	969	937	1 072	1 063	1 099	1 070	976	877	:
Gross inland energy consumption (thousand TOE)		3 235	3 354	3 388	3 379	3 489	3 616	4 349	5 016	5 374	5 696	:
Electricity generation (thousand GWh)		7 684	8 033	8 416	8 500	8 623	8 686	9 930	11 976	16 468	16 835	:

Agriculture	Note	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Agricultural production volume index of goods and services (producer prices, previous year=100)		:	:	:	:	:	:	:	:	:	:	:
Total utilised agricultural area (thousand hectare)		120e	120e	120e	120e	120e	120e	120e	120e	120e	120e	120
Livestock: cattle (thousand heads, end of period)		72	70	67	66	65	66	69	71	72	73	:
Livestock: pigs (thousand heads, end of period)		4	4	4	5	4	4	4	4	4	4	:
Livestock: sheep and goats (thousand heads, end of period)		466	474	470	463	456	455	456	455	458	470	:
Production and utilisation of milk on the farm (total whole milk, thousand tonnes)		:	:	:	:	:	:	:	:	:	:	:
Crop production: cereals (including rice) (thousand tonnes, harvested production)		3	4	5	7	10	10	11	11	15	16	18
Crop production: sugar beet (thousand tonnes, harvested production)		:	:	:	:	:	:	:	:	:	:	:
Crop production: vegetables (thousand tonnes, harvested production)		14	16	14	12	12	12	20	19	19	20	21

: = not available

p = provisional

e = estimated value

b = break in series

* = Europe 2020 indicator

The balance of payments sign conventions are used for FDI. For FDI abroad a minus sign means investment abroad by the reporting economy exceeded its disinvestment in the period, while an entry without sign means disinvestment exceeded investment. For FDI in the reporting economy an entry without sign means that investment into the reporting economy exceeded disinvestment, while a minus sign indicates that disinvestment exceeded investment.

Footnotes:

1) According to NACE, Rev. 1.1

2) Data for 2000-2007 based on NACE Rev.1.1, data for 2008-2010 based on NACE Rev.2.