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**COMMUNICATION FROM THE COMMISSION
TO THE EUROPEAN PARLIAMENT AND THE COUNCIL**

Enlargement Strategy and Main Challenges 2012-2013

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1. INTRODUCTION

1.1. Preface

This is the Commission's third report to the Council and Parliament on progress made by Iceland since the opening of 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 take on 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 2011 to September 2012. 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. The first negotiation chapters were opened in June 2011. At present, 18 chapters have been opened, of which 10 have been provisionally closed.

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 relating to the Schengen Agreements since 1996 and has applied their provisions since 2001.

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. The EFTA Surveillance Authority (ESA) continues to monitor Iceland's performance under the EEA. The ESA has initiated proceedings against Iceland at the EFTA Court in a number of cases, investigating possible infringements of EEA provisions and seeking a change in the relevant rules or practices. Overall, Iceland's track record in implementing its EEA obligations remains satisfactory. Some shortfalls are still to be noted in areas such as financial services, food safety and free movement of capital. Temporary restrictions on some capital flows adopted in the aftermath of the 2008 financial crisis remain in place.

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

² Enlargement Strategy and Main Challenges 2012–2013, COM(2012) 600.

In the framework of pre-accession fiscal surveillance, Iceland participated in the multilateral economic dialogue between the Commission, EU Member States and Candidate Countries. The dialogue included an ECOFIN ministerial meeting in Brussels in May. Furthermore, a bilateral economic dialogue between the Commission and Iceland was established to exchange views on economic issues and policies, with a first annual meeting held at senior official level in November 2011. The discussions are guided by the Copenhagen economic criteria and thus touch on both macroeconomic and structural issues.

Bilateral meetings between Icelandic parliamentarians and Members of the European Parliament continue to take place on a regular basis. The fourth EU-Iceland Joint Parliamentary Committee met in Reykjavik in April 2012.

The first meeting of the EU-Iceland Joint Consultative Committee with representatives of the European Economic and Social Committee (EESC) and Icelandic social partners took place in July 2012. Preparations are under way for the establishment of a Joint Committee between the Committee of the Regions and the Association of Icelandic municipalities.

Iceland's ability to take on 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 **accession negotiations** have progressed further. During the reporting period, 14 chapters were opened, of which eight were provisionally closed. Negotiations continued in a number of areas such as *competition, energy, social policy and employment and financial control*. In the chapters on *company law, intellectual property law, freedom of movement of workers, consumer and health protection, judiciary and fundamental rights and foreign security and defence policy* negotiations were provisionally closed. Overall, more than half of all negotiating chapters (i.e. 18) have now been opened, of which 10 have been provisionally closed.

The EU accession process continued to attract attention in the political sphere and more generally in the public debate. Interparty and intraparty divisions on EU accession remained over the reporting period. A motion for a resolution for a national referendum on whether or not to continue the EU accession process was voted down by the parliament in May 2012. Opinion polls indicated that a majority of Icelanders continued to support the accession negotiations although a majority also remained opposed to membership. In January 2012, the EU Information Centre opened officially in Reykjavik, its primary role being to provide information on EU policies and institutions. A Consultative Group for Iceland's EU accession negotiations was set up by the Minister of Foreign Affairs at the end of 2011, with the purpose of sharing information on progress in the negotiations with the public and facilitating discussions on the process in the Icelandic mainstream discourse. Its 24 members are from different backgrounds and represent different views on European affairs.

Financial assistance is provided to Iceland under the Instrument for Pre-Accession Assistance (IPA). The strategic priorities for Iceland under IPA were set in a Multiannual Indicative Planning Document (MIPD) for the period 2011 to 2013 with a budget of €30 million. They address institutional capacity building for transposing and implementing the *acquis* and for preparing for and utilising the EU's Structural and other funds. The second National IPA Programme for Iceland was adopted in July 2012 with a budget of €12 million. The IPA Framework Agreement was approved by the Icelandic parliament in June 2012.

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 divergences with the *acquis*.

As an EEA member, Iceland continued to benefit from participation in **EU programmes**, e.g. the 7th Framework Programme for research and technological development, the Lifelong Learning programme, the EU Culture programme and the EU Progress programme.

2. POLITICAL CRITERIA

This section assesses the situation in Iceland in terms of the political criteria for membership, concentrating on the progress made by the country in addressing the shortcomings identified last year.

As a well-established and functioning democracy, Iceland continues to meet the political criteria as stated in the Commission's Opinion of February 2010, and the two previous Progress Reports on Iceland (November 2010 and October 2011).

2.1. Democracy and the rule of law

Stable institutions guarantee Iceland's well-functioning democracy and sound governance, at both national and local levels. The public administration is overall effective, transparent and independent. Respect for the rule of law is ensured in particular by an efficient judicial system and the high quality of the judiciary and the law enforcement forces. Human rights and the rights of persons belonging to minorities enjoy a high level of legal protection and respect in practice.

The advisory **constitutional council** completed a comprehensive review of the Constitution and, in August 2011, presented its proposals to the parliament, which has since been reviewing them. The amendments proposed are aimed at increasing democratic safeguards, strengthening checks and balances, improving the functioning of the state institutions and better defining their respective roles and powers. The parliament would see its powers broadened while direct democracy through referenda would also be strengthened. Several proposals also address conflicts of interest issues and aim to further strengthen the independence of the judiciary and respect for human rights. The parliament has agreed to put the constitutional amendments to an advisory referendum, to be held on 20 October 2012. The referendum will contain six questions on a range of proposals.

At the presidential election of June 2012, the incumbent **President** of Iceland was re-elected for a fifth term in office.

The law amending the **parliament's** rules of procedure is being implemented after its entry into force in September 2011. It has strengthened the parliament's power of political supervision, creating a standing committee on constitutional matters and government control, providing for the Prime Minister to present an annual report on follow-up given to parliamentary resolutions, setting out the obligation of ministers to provide information to the parliament on important matters and enhancing the possibilities for the minority to request information.

The **government** was reshuffled in December 2011: the Minister of Economic Affairs and the Minister of Fisheries and Agriculture left the Cabinet. The two ministries were taken over by the Minister of Finance, who was in turn replaced by the leader of the major coalition partner's parliamentary group. The revised law on central government entered into force in September 2011. It clarifies further *inter alia* the relationship between ministries and government agencies, defines the role of civil servants in providing objective advice to ministers, in particular on the lawfulness of their decision, and provides a clearer framework for the cabinet and ministerial committees.

Overall, the state of local democracy is in line with the European Charter on Local Self-Government. A law was adopted in January 2012, further clarifying the legal status,

responsibilities and activities of municipalities. A law was adopted in June 2012 with guidelines on monitoring the local government finances. Ratification of the Additional Protocol to the Charter of Local Self-Government on the right to participate in the affairs of a local authority is pending.

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 restructuring of ministries was decided by the government and a relevant resolution was adopted by the parliament in May 2012. The number of ministries was reduced from 10 to 8 in September 2012. The new ministries are the Ministry of Finance and Economic Affairs, the Ministry of Industries and Innovation and the Ministry for the Environment and Natural Resources. The government's working methods have been streamlined. The cabinet has overhauled its working methods to increase efficiency. Rules on transparent recruitment procedures for the central government were adopted in April 2012, whereas rules for mobility within the civil service are under preparation.

The working group set up by the Prime Minister on non-discrimination and transparency in the process of partial or full privatisation of state enterprises delivered its recommendations in February 2012. Work on following up these recommendations has commenced in the form of legislative proposals. The Administrative School continued to run training courses focusing on topics such as human resources and project management.

The Icelandic **judicial system** continues to meet high standards. In September 2012, 186 civil and criminal cases were pending before the Supreme Court. The new cases registered by the district courts during the first half of 2012 amount to 8,393, an important part of them being bankruptcy and debt cases. The numbers of district court judges and Supreme Court judges, which temporarily increased in order to deal with the additional case-load following the financial crisis, will decline gradually (*see also Chapter 23 — Judiciary and fundamental rights*). The budget for the judiciary (excluding the salaries of replacement judges by the Supreme Court) was approximately €8.5 million in 2011, representing 0.08% of the country's GDP. It has increased in 2012 by around 14%.

In April 2012, the Court of Impeachment found the former Prime Minister at the time of the financial crisis guilty of one of four charges against him, namely that he had failed to hold dedicated Cabinet meetings ahead of the 2008 financial crisis. No sentence was passed.

The Financial Supervisory Authority, investigating possible offences in financial undertakings, has been strengthened. According to its November 2011 annual report, the Authority has forwarded 77 cases to the Special Prosecutor's office for further investigation, whereas it has dealt with 44 cases without taking any further action. A new Director has been appointed to the Authority. The previous one was dismissed by the Board of the Authority and criminal charges were laid against him.

The Office of the Special Prosecutor continued working efficiently. Currently, 76 cases relating to the 2008 banking crisis are being dealt with by the Office of the Special Prosecutor, in which 130 individuals have the legal status of accused persons. A total of seven cases have been referred to the Courts, where 12 individuals have been prosecuted.

As regards conflicts of interest, in the context of **anti-corruption policy**, in accordance with the relevant law of 2010 a code of conduct for central government staff was established in spring 2012. Codes of conduct for civil servants in general and political advisors remain to be established.

A bill amending Iceland's General Penal Code has been adopted by the government, aimed at achieving full implementation of all the recommendations in the December 2010 Interim

Compliance Report of the Council of Europe's Group of States against Corruption (GRECO) on incrimination of corruption offences. The bill's objective is also to implement recommendations of the OECD Working Group on Bribery and to allow ratification of the additional protocol to the Council of Europe Criminal Law Convention on Corruption. The bill has yet to be adopted by the parliament.

2.2. Human rights and the protection of minorities (*see also Chapter 23 — Judiciary and fundamental rights*)

As regards human rights and the protection of minorities, Iceland has continued to guarantee fundamental rights, including economic and social rights, and the protection of minorities through legal and normative instruments and their actual implementation. During the reporting period, the European Court of Human Rights (ECtHR) delivered judgments on two applications finding that Iceland had violated rights guaranteed by the European Convention on Human Rights (ECHR). A total of eight new applications have been submitted to the ECtHR since September 2011, bringing the total of pending applications to 12.

During the reporting period, Iceland ratified the Aarhus Convention and the Council of Europe Convention on Action against Trafficking in Human Beings. The Council of Europe Convention on the Protection of Children against Sexual Exploitation and Sexual Abuse was ratified in spring 2012. In March 2012, the outcome of the Universal Periodic Review on Iceland was adopted by the UN Human Rights Council. It confirmed that overall the status of human rights was good in the country and made a number of recommendations, also regarding the better treatment of immigrants. The new media law stipulates a ban on hate speech and incitement to criminal behaviour by the media on the basis, inter alia, of race, religious belief or nationality.

The UN Convention on the Rights of Persons with Disabilities, the Council of Europe Convention on preventing and combating violence against women and domestic violence and the Council of Europe Framework Convention for the Protection of National Minorities have been signed and remain to be ratified.

Work to prepare a National Action Plan for the Respect of Human Rights to be presented to the parliament commenced during the reporting period and two groups were appointed — a group of representatives of ministries and a consultative group of representatives of civil society and academia.

A media regulatory authority has been established under the new *media* law. Two new bills adopted by the government and yet to be adopted by the parliament, address ownership concentration in the Icelandic media market and the role of the State Broadcaster (RUV), narrowing its scope in the advertising market.

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

Broad political consensus on the key essentials of a market economy and the preservation of a welfare state continues to be strongly embedded in Iceland's society. The authorities proceeded with domestic debt restructuring, financial sector stabilisation and fiscal consolidation. Following the first post-crisis international bond issue in mid-2011, the country

was able to sell a USD 1 billion bond to foreign investors in May 2012 at a yield of 6%. Early repayments of IMF and Nordic loans started in March 2012 and continued in June. Furthermore, Iceland was restored to investment grade status by major rating agencies. The country submitted its second Pre-Accession Economic Programme (PEP) in January 2012. It presents a broadly plausible medium-term macroeconomic scenario and a relatively ambitious fiscal framework. Both are subject to considerable downside risks and are not fully underpinned by supporting structural reform measures. *Overall*, economic policy has been geared towards further stabilisation.

Macroeconomic stability

Following a deep and long recession, the Icelandic economy eventually turned to growth in 2011. Real GDP increased by 2.6%, after economic activity had declined by 4% a year before. The recovery was driven by a 2.7% growth in private consumption, which benefited from temporary income-boosting measures provided to households, such as early third-pillar pension withdrawals, temporary increases in subsidies and transfers and debt relief schemes. Investment activity recorded growth of 12.8%, driven by a close to 26% increase in business investment. At the same time, the contribution of net exports to growth remained negative, as strong domestic demand led to an acceleration of imports. In the first half of 2012, the economy continued to grow, at 2.4%, somewhat weaker than earlier expected and based on robust private consumption and investment demand. Net exports continued to be a drag on growth as import growth outpaced export growth. High frequency and leading indicators point towards a continued growth in the third quarter, including a pick-up in the construction sector. While the recent growth pattern has become more broad-based, remaining balance sheet vulnerabilities in both the corporate and household sectors as well as the challenging global outlook and the euro area debt crisis could threaten the recovery process. Average per capita income (in Purchasing Power Standards) remained at 110% of the EU average in 2011. *Overall*, the economy continued to recover at a reasonably robust pace, but uncertainties persist regarding the sustainability of growth.

External trade developments point to a narrowing surplus in trade in goods and services, primarily due to stronger merchandise imports. The surplus fell from around 10.1% of GDP in 2010 to 8.5% in 2011 and further to 6.6% in the four quarters to June 2012. Thanks to a significantly lower deficit in the net factor income balance, the current account deficit declined from 8% of GDP in 2010 to 7% in 2011, however, it increased again to 8% in the four quarters to June 2012. Reported current account balances remain highly 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 'underlying' current account recorded a much lower deficit of 1.1% of GDP in 2011, down from 2.1% in 2010, according to the Central Bank estimates. *Overall*, while external imbalances improved compared to pre-crisis levels, the surplus in trade with goods and services narrowed.

Total net capital inflows in 2011 were larger than needed to finance the current account deficit. As a result, gross official foreign exchange reserves held at the Central Bank increased to close to 65% of GDP at year-end. In March and June 2012, Iceland repaid early around 55% of the €3.5 billion loans received from the IMF and Nordic countries with a view to reducing short-term debt and costs of holding borrowed reserves. These transactions contributed to a moderate fall in the stock of gross reserves which stood at 45% of projected GDP in August 2012. At the same time, the high stock of external debt continues to represent a key challenge to the Icelandic economy. Official debt statistics report the stock of gross foreign debt at around 840% of GDP at end-March 2012. However, corrected for foreign debt of banks and holding companies in winding-up proceedings, the Central Bank estimates the external debt stock at around 220% of GDP and Iceland's net international investment

position at a negative 52% of GDP. This compares favourably with a pre-crisis external debt of around 570% of GDP. However, Iceland's balance of payments situation remained sheltered by capital controls and external financing could become tighter once capital restrictions start to be lifted. *Overall*, recent estimates of Iceland's net international investment position suggest a much lower external indebtedness when compared to the pre-crisis period, but risks and vulnerabilities remain high with respect to Iceland's external financial position.

Unemployment remained close to historically high levels for the country, at 7.1% in 2011, though somewhat lower than the 7.5% recorded a year before. The drop was mainly due to labour market exits rather than job creation. Employment levels remained unchanged from 2010, but the share of full-time employment increased. During the first half of 2012, labour market conditions gradually improved. The unemployment rate was recorded at 7.2%, a significant improvement compared to the rate of 8.2% in the same period of 2011. The level of total employment rose by about 1% year-on-year. Data on registered unemployment confirm positive trends in early 2012. The registered rate fell to 4.4% in July, the lowest rate since December 2008, and the average unemployment rate in the first seven months was 6.2%, compared to 7.8% a year before. At the same time, the high and increasing rate of long-term unemployment (27% of total unemployed in 2011) remains a particular concern. Also, the youth unemployment rate remained high at 16% in 2011 and 17.1% in the first quarter of 2012. Despite high unemployment, the annual average gross wage growth increased by 2 percentage points to 6.8% in 2011, and further accelerated to close to 10% in the first seven months of 2012. Average real wage growth increased from 2.8% in 2011 to 4.0% in the first seven months of 2012. *Overall*, amid some recent stabilisation, the labour market remains affected by the post-crisis recession with high unemployment rates for the country, particularly among youth and long-term unemployed.

The Central Bank of Iceland continued to officially operate under an inflation targeting regime to keep consumer price inflation under 2.5% with a tolerance band of 1.5% in both directions. After annual inflation had fallen below the Central Bank's inflation target in early 2011, a weaker exchange rate, rising oil, house and food prices and higher wages pushed inflation to 5.3% by end-2011, exceeding the upper band of the inflation target. Inflation accelerated further in the first four months of 2012, but since then the rate has gradually fallen to 4.1% in August. In reaction to rising inflation in 2011 and early 2012, monetary policy has been gradually tightened since August 2011. The key policy rate (7 day collateralised lending rate) has been increased in five successive steps to 5.75% in June. Since the crisis, exchange rate stabilisation remained an intermediate objective of monetary policy, supported by a regime of capital controls. Seasonal effects have remained relatively strong on the Icelandic króna due to the capital controls and the importance of the fishing and tourism sectors for currency flows. The Icelandic króna depreciated in the first months of 2012 in line with the usual seasonal patterns and driven by the decision of some large domestic firms to pay down foreign-denominated debt. In reaction to unusually strong foreign exchange outflows, the Central Bank intervened in the foreign exchange market for the first time since 2009, selling €12 million in March. Since May, the króna gradually recovered and appreciated relatively strongly by some 11% by mid-August, mainly due to inflows from tourism, a strengthening of capital controls, and a lower accumulation of reserves for debt service payments by market participants. The strong appreciation let the Central Bank to announce at end-July to double its weekly purchases of foreign exchange to €1 million from each market maker. 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. *Overall*, a recently tighter monetary policy stance has supported a gradual lowering of

inflation and exchange rate stability has been broadly preserved under the cushion of capital controls.

The authorities continued to implement the first steps of the capital liberalisation strategy which essentially aims to transform the large stock of non-resident króna holdings, mostly short-term deposits and government-guaranteed bonds into long-term domestic investments. These holdings are estimated at 25% of GDP, but may increase substantially as the old failed banks are being wound up. In a first phase, under way since May 2011, the Central Bank organised auctions to purchase króna from non-residents and auction them to investors willing to buy long-term government bonds or other domestic assets and hold them for a minimum of five years. It conducted a number of auctions resulting in a minor decrease of off-shore holdings, which fell by less than 10% of the initial estimated stock. A second phase started in November 2011, enabling investors to purchase half of the króna required to perform their investment through auctions, and to finance the remainder on the Icelandic financial market (50/50 option). Once the off-shore holdings are significantly reduced, liberalisation of capital controls on residents is envisaged. Following an extension of the capital controls until the end of 2013, rules were tightened in early 2012 to eliminate loopholes, remove exemptions on some bond payments and regulate payments made by the estates of the old banks. The Ad Hoc Group on the Removal of Iceland's Capital Controls set up by the Icelandic government and the European Commission met in September 2012 to assess the state of play, prospects and challenges associated with lifting the existing controls. *Overall*, implementation of Iceland's strategy for lifting of capital controls has progressed slowly and with limited success.

Fiscal consolidation continued in 2011, with significant cuts in current and capital spending and increase revenues through higher capital income, net wealth and inheritance taxes and a new bank levy. These measures helped reduce the general government deficit from 10% of GDP in 2010 to 5.4% in 2011. The deficit target of 3.4% of GDP was missed, largely due to the activation of government guarantees. Moreover, some fiscal slippage occurred as a result of the government's decision to contribute to the collective wage agreement by raising current spending. The 2012 budget targets a reduction of the general government deficit to 1.4% of GDP. It includes new consolidation measures of around 1.7% of GDP with most of the adjustment on the revenue side (1.2% of GDP). Expenditure restraint measures are projected at 0.5% of GDP, encompassing cuts in current expenditure and transfers and in investment. Fiscal performance during the first half of 2012 saw a solid 11% year-on-year rise in general government revenues, the strongest increase since 2007. This resulted mainly from higher receipts from income taxes and —to a lesser extent— taxes on goods and services. Compared to initial plans, some fiscal loosening continued on the expenditure side, estimated at 0.5-1% of GDP. Total spending rose by around 6.6%, encompassing all main components of current spending and a particularly strong increase in wages and debt service costs. Public investment spending continued to decline, by around 9% year-on-year. The deficit in the first half fell to 2.5% of GDP (or 1.2% of projected annual GDP), compared to 4.1% in the first half of the previous year. *Overall*, amid a successful process of fiscal consolidation, the adjustment of government finances has recently slowed.

Fiscal risks remain significant. Implementing expenditure restraint has become more challenging following years of fiscal adjustment and new expenditure pressures appear to be mounting. Weaknesses in Iceland's budgetary framework still hinder effective control of spending by government agencies. The authorities have prepared and launched consultations on a draft organic budget law which aims to improve budget preparation and execution, broaden the coverage of fiscal reporting, and increase the government's accountability to the Parliament. Risks remain linked to contingent liabilities in the form of government guarantees

for public companies. The government's expressed commitment to further strengthen the capital base of the State Housing Financing Fund implies a considerable fiscal effort, estimated at around 1% of GDP. In view of the high level of public debt, fiscal space remains very limited. Moreover, capital controls have provided public finances with the benefit of artificially lower interest rates than could otherwise be expected in view of the level of indebtedness. *Overall*, fiscal risks remain high and expenditure-based fiscal consolidation a particular challenge.

Gross general government debt increased from 88.1% of GDP in 2009 to 98.7% at end-2011 and debt levels remain high compared to pre-crisis levels of around 30%. Further progress has been made in professionalising medium-term public debt management. The average maturity profile of the public debt portfolio was extended to over 4 years, reducing rollover risks. The new Medium-Term Debt Management Strategy (2012-2015) published in March 2012 confirms the authorities' commitment to reduce central government debt to below 75% of GDP by 2015 and to below 60% in the long term. Comprehensive legislation to strengthen local government finances was adopted, stipulating strict limits on municipal borrowing. *Overall*, in view of the high level of public debt, the authorities have taken further welcome measures to reduce refinancing risks and to strengthen local government finances.

The policy mix with a strong focus on exchange rate stabilisation, fiscal consolidation, and domestic debt restructuring has been supportive in re-establishing a higher degree of macroeconomic stability, but risks and vulnerabilities remain. Annual Inflation remains still above target and inflation expectations have apparently not come down. Fiscal risks are elevated and preserving exchange rate stability remains challenging, all in all requiring a rather tight policy mix. Implementation of the 2012 budget and medium-term fiscal plans will remain a key test for the government's commitment to continued fiscal adjustment. Macroeconomic stabilisation occurred in a situation of protection through capital account restrictions. Their gradual removal remains a key policy challenge.

Interplay of market forces

Prices of goods and services continued to be mostly determined by supply and demand conditions except in agriculture where the level of import protection remained high. The private sector accounts for nearly 80% of GDP. Some sectors remain in government ownership, such as energy, postal services and broadcasting. The state owns the Housing Financing Fund and retained majority ownership (81%) of one of the three commercial banks (Landsbankinn) and minority stakes in the other two banks. It has also kept its position as a large investor in the savings banks system, although the importance of the system has declined significantly with the exit from the market of the two largest savings banks. There are currently no plans to transfer public ownership in those sectors to private investors. *Overall*, market mechanisms are to a large extent driven by free prices. Public ownership remains significant in some sectors and there are no plans for privatisation.

Market entry and exit

The business environment remained characterised by low bureaucratic hurdles and a generally efficient administration. Starting a business is facilitated by a supportive regulatory framework. High barriers to entry continue to exist in fishing, agriculture and energy, which are not covered by the EEA Agreement. The economic recovery has recently led to the revival of company start-ups. The number of newly registered private limited companies increased by 8.8% in the 12 months to July 2012, following a 23% drop in the preceding 12 months when potential businesses were still harshly affected by the strong recession. However, total registrations remained at around two thirds of pre-crisis levels. Bankruptcy proceedings are generally straightforward. The crisis put a large part of the corporate sector under severe

financial distress and insolvency levels in 2011 were still twice as high as pre-crisis levels. In the twelve months to July 2012, the number of insolvent companies dropped for the first time after the crisis, by close to 5%, but was still one third higher compared to pre-crisis levels, suggesting on-going adjustments and deleveraging. *Overall*, high barriers to market entry for non-residents remain in key strategic sectors. Market exit has been functioning well, supporting economic adjustment.

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 and recapitalisation of the core banking sector has been largely completed even though further operational and financial restructuring is required to allow bank lending to resume. The number of banks decreased from 22 prior to the crisis to 14, and banks are solely operating domestically. The three largest commercial banks together with the Housing Financing Fund represent a market share of 94%. Private sector deleveraging and bank balance sheet repair continued through 2011 and the first half of 2012, and the private sector credit to GDP ratio dropped further to an estimated 88% of GDP, from 90% at the end of 2010, reflecting continuing adjustment to deal with past excessive imbalances. The government retains majority ownership of one of the banks, and minority stakes in the other two banks, with the majority stakes (indirectly) owned by non-residents. The total capital adequacy ratio of the three banks increased to 23% in the first half of 2012 from 22.1% a year before, well above the minimum requirement of 16%. All banks remained profitable with returns on equity at 11.5% in the first half of 2012, down from 16% a year before, but banks carry relatively high cost-to-income and cost-to-asset ratios. Also, the Supreme Court's February 2012 judgement on the settlement of illegal exchange rate-linked loans could significantly impact on the quality of banks' balance sheets and reduce future profits. However, the Financial Supervisory Agency expects a limited impact, not least due to relatively high capital buffers. Finally, interest rates on deposits remain distorted by capital controls, providing a competitive advantage to domestic banks that will disappear once restrictions start to be lifted.

Banks are faced with significant vulnerabilities as asset quality is subject to considerable uncertainty and financial imbalances are likely to persist for some time. Debt restructuring continued and led to more manageable domestic debt positions. Household debt fell further to 110% of GDP by March 2012, down from a peak of 130% in 2009. Corporate debt declined to 194% of GDP, after peaking at 380% at end-2008. However, private debt levels still remain among the highest for industrial countries and private households and businesses are still operating under significant financial constraints. The share of non-performing loans continued to decrease significantly from 40% at end-2010, but remains high at 23% (end-2011) and above 20% (mid-2012)³, and defaults continue to be widespread. Open foreign exchange positions of banks decreased following the earlier Supreme Court judgment on the illegality of foreign currency indexation of some loans and the subsequent transformation of the relevant loans into domestic currency loans. But legal uncertainty for some loan classes persists, adversely affecting their value. On the funding side, banks continued to rely mainly on domestic deposits, since foreign direct investment and access to foreign credit remained limited, except for the sovereign. Prescribed liquidity requirements remained over-fulfilled

³ Measured when using the cross-default rate. When measured without the cross-default rate, the NPL ratio stood at 11.8% at end-2011.

through 2011 by a large margin. Savings remained locked by capital controls, facilitating banks' domestic funding. *Overall*, banking sector and debt restructuring continue to progress, but significant uncertainties remain with respect to banks' asset quality.

Further progress has been made in strengthening bank regulatory and supervisory practices, including the creation of a framework for effective coordination between the Central Bank and the supervisory authority (FME). A Basel Core Principles Assessment of Effective Bank Supervision was concluded in mid-April 2012. On this basis, the FME has developed a two-year action plan to address remaining supervisory gaps. New risk management tools are being introduced. Supervision needs to be further strengthened to bring it in line with international best practice and to close supervisory gaps.

The non-banking financial system comprises the government-owned Housing Financing Fund, pension funds, insurance companies and mutual, investment and institutional funds. The government injected €206 million into the Housing Financing Fund in 2011 to raise its capital to just above 2% of risk-weighted assets, still far below the 5% long-term target. However, the capital adequacy ratio dropped again in the first half of 2012, to 1.4% as a result of continued losses from operations. The government expressed its commitment to strengthen the Fund's capital base to the regulatory target as soon as clearer evidence exists on the losses resulting from the private sector debt restructuring process. The authorities also started work on a comprehensive review of the Fund's operations and its position in the restored Icelandic financial system, expected to be finalised by end-2012. *Overall*, a number of steps have been taken to restore the non-banking financial sector; 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. Turnover in the equity market in the first four months of 2012 remained broadly unchanged from the same period a year before while the stock market index increased by 19%. The total market value of all listed shares remains at only around 20% of GDP (mid-2012) compared with a pre-crisis level of around 120% of GDP. The bond market, on the other hand, recovered its trading volume and reached pre-crisis levels. The market continues to be dominated by government and government-guaranteed bonds. *Overall*, domestic financial markets have somewhat recovered on the back of a more lively bond market while equity markets remain shallow.

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

Existence of a functioning market economy

The country's economy continued to recover from the long and severe post-crisis recession. Private sector debt restructuring made further progress, generally improving the financial positions of household and firm, conducive to macro-financial stability. The authorities expect the debt restructuring process to be completed by end-2012, although a large number of private sector balance sheets remain vulnerable. Efficient allocation of resources is still impeded in parts of the economy, due to financial sector vulnerabilities, extensive capital restrictions, and high barriers to market entry in some sectors. *Overall*, improving the functioning of financial markets and reducing barriers to market entry in some sectors remains a particular challenge.

Human and physical capital

The economic crisis severely affected the labour market. The labour participation rate fell further in 2011, to a historical low of 80.4% (compared to a pre-crisis level of 83.3%), but

remains nonetheless high in international comparison. The share of employment in part-time work dropped to 24% (from 27% a year before) and total average working hours per week rose to 40 (from 39 in 2010). Outward migration may have prevented the unemployment rate from rising even faster, but net migration could entail a loss of skills. Net migration however has declined substantially since 2009. The structure of unemployment remains problematic with youth and low-skilled workers representing large shares of the unemployed.

The share of youth neither in education nor in the labour force has risen significantly. Under these circumstances, efforts to offer retraining and education, active labour market initiatives and lifelong learning approaches continued, aimed at retraining and upgrading skills of the labour force. The government also introduced measures to grant all persons under the age of 25 access to free secondary education. Total education spending remained at around 7.8% of GDP in 2011, with private households bearing around 10% of total costs. *Overall*, with unemployment still very high for the country, human capital remains significantly underutilised. Newly introduced measures on education and vocational training are addressing some of these problems.

Abundant sources of hydro- and geothermal power attracted substantial foreign investment in the aluminium sector in the past. Although the financial crisis slowed down investment, several new projects are under preparation, but continued risk aversion in international capital markets seems to have delayed planned projects. The share of investment in GDP reached a historic low at 12.9% in 2010 and increased somewhat to 14.1% in 2011, but still remained markedly below the long-term pre-crisis average of 22%. At the same time, the fall in real-estate activities and construction reflects some normalisation following earlier 'boom' year excesses. Public investment also fell, from a 3.7% of GDP long-term average to 2.2% in 2011. Net FDI inflows declined in 2011 but still remained rather strong at 7.4% of GDP, raising the total stock of inward FDI to around 95% of GDP, up from 85% a year before. Regarding future investment potential, Iceland is implementing a large-scale mapping exercise of energy resources, categorising them in areas for conservation and for exploitation. The results of this exercise were presented to the parliament in early 2012. *Overall*, the country continues to benefit from good basic infrastructure and abundant natural resources, suggesting significant potential for investment.

Sector and enterprise structure

Although new segments in manufacturing and services have expanded over the past years, in particular in some high-tech areas such as software, 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 2007 to approximately 4% of GDP in 2010 and 2011, reflecting adjustments in an over-leveraged sector and completion of large energy-related projects. The share of the service 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 steadily increasing, accounting for a quarter of total export earnings in 2011, a result of the 20% increase in foreign tourism income in 2011. The share of marine products and primary aluminium products increased to 80% of merchandise exports. The share of services, mainly travel and transport, remained fairly stable in 2011 at around 35% of total exports. The importance of small firms in the economy remains high, accounting for 70% of employment and output.

Overall, post-crisis adjustment continued to impact the sector structure of the economy; in particular tourism and transport have gained in importance.

State influence on competitiveness

The level of state subsidies amounted to 1.7% of GDP in 2011, decreasing by 0.1 percentage points compared to 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 and fishing remain protected from foreign ownership. The fishing industry does not receive any State support. The telecommunication 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 108% of GDP. The country's export structure continues to show a low level of diversification. The import structure is more diversified, reflecting the country's dependence on a wide range of manufactured goods and some commodities. The EU continues to be the largest trading partner, although its share in Icelandic merchandise exports dropped somewhat to 75% in the first four months of 2012, compared to 81% a year before. Just over 40% of imports originate in the EU. FDI inflows originate almost exclusively originate from EU partner countries. *Overall*, integration with the EU in the areas of trade and investment remained high.

Rough estimates point to average labour productivity remaining unchanged in 2011 as compared to 2010. Thus, unit labour costs rose in line with total labour costs, increasing on average by around 6% in the manufacturing sector. In 2011, the exchange rate of the króna depreciated by 3.5% vis-à-vis the euro. It remained rather constant in nominal effective terms and recorded a slight appreciation in real effective terms, continuing the trend of the previous year. According to estimates, the real exchange rate remains around 20% below its long-term average. *Overall*, 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 TAKE ON THE OBLIGATIONS OF MEMBERSHIP

This section examines Iceland's ability to take on 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**, Iceland continued to apply the *acquis* on *standardisation*. No progress has been made in the field of *conformity assessment*, where Iceland is not yet fully aligned with the *acquis* covering the establishment of a common framework for the marketing of products. No progress has been made on *accreditation*, as the Icelandic Board for Technical Accreditation has not yet been peer-evaluated. Progress has been made on *metrology*, with Iceland aligning with the Directive on units of measurement. Some progress

has been made in the area of *market surveillance*, with Iceland publishing its first National Market Surveillance Programme in January 2012. Administrative capacity as well as internal and external coordination of market surveillance need further improvement.

As regards the **‘Old Approach’ product legislation**, Iceland’s alignment with the *acquis* continues to be well advanced. No further progress can be reported in the automotive sector, where Iceland does not apply the *acquis* for importing vehicles. Alignment with the latest *acquis* in the areas of REACH and pharmaceuticals needs to be completed. (*See also Chapter 27 — Environment*)

Progress has been made in the area of **‘New and Global Approach’ product legislation and procedural measures**. Regarding legal metrology, Iceland aligned with the Directive on measuring instruments in respect of the exploitation of maximum permissible errors. In the field of medical devices, alignment has been achieved with the Directive on in vitro diagnostic medical devices. The Iceland Construction Authority was established and took over responsibility for market surveillance of electrical equipment intended to be permanently fixed to buildings. Legislative alignment needs to continue in particular on pressure equipment, low voltage equipment, toys and construction products.

Conclusion

Overall, Iceland continues to be highly aligned with the *acquis* in the area of free movement of goods. Progress was made in the area of metrology and market surveillance. Legislative alignment of horizontal measures, ‘Old Approach’ product legislation (automotive sector, REACH and pharmaceuticals) and ‘New and Global Approach’ product legislation needs to be completed. Administrative capacity, including in the area of market surveillance, needs to be improved.

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.

As regards **access to the labour market**, Iceland continues to apply the *acquis*. As of January 2012 the restrictions on the free movement of workers from Romania and Bulgaria have been lifted.

No further developments can be reported on the **EURES** (European Employment Services) network, in which Iceland is already fully participating.

Good progress can be reported on **coordination of social security systems**. Iceland adopted in June 2012 the modernised coordination rules in this area. Iceland will need to extend these rules also to legally resident third-country nationals and apply the respective EU Regulation by accession. Further staff training is necessary on the new EU coordination rules. Preparations for electronic data exchange within the Electronic Exchange of Social Security Information (EESSI) system are advancing via participation in the dedicated EU-level steering group. 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. Good progress can be reported on coordination of social security systems, where the modernised rules on social security coordination have been adopted. Iceland will need to extend these rules also to legally resident third-country nationals and continue preparations for setting up an electronic data exchange system.

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.

Progress can be reported on the **right of establishment and freedom to provide cross-border services**. Administrative requirements imposed on cross-border temporary employment agencies have been aligned with the *acquis*. Although the Services Directive is being implemented, some restrictions on the right of establishment and the freedom to provide services in the fisheries sector continue to be in place. (*See also Chapter 13 — Fisheries*)

No progress can be reported in the area of **postal services**. The EEA EFTA countries, including Iceland, have so far opposed a decision on the incorporation of the Third Postal Directive into the EEA Agreement. A working group has been established in January 2012 by the Ministry of the Interior to work on the revision of the Icelandic postal legislation.

Good progress can be reported on **mutual recognition of professional qualifications**. Iceland has aligned with the outstanding elements of the Directive on the mutual recognition of professional qualifications. However, the Icelandic legislation on the recognition of professional qualifications of health care professionals from other EEA Member States contains requirements in which are not in line with the Directive.

Conclusion

Overall, there is a high level of alignment with the *acquis* on the right of establishment and freedom to provide services. Iceland is now almost fully aligned with the *acquis* in the field of mutual recognition of professional qualifications. Alignment with the Third Postal Directive is yet to be achieved and existing restrictions in the fisheries sector need to be lifted. The administrative capacity for effective implementation and enforcement of EU rules and policies needs to be ensured.

4.4. Chapter 4: Free movement of capital

Iceland applies parts of the *acquis* in this field due to its EEA membership. Significant exceptions remain, notably in connection with Iceland's extensive capital controls and restrictions on the free movement of capital between Iceland and third countries.

No progress can be reported on **capital movements and payments**. Legislation allowing the extension of the temporary capital controls from 2011 until 2013 was enacted. The first phase of the capital controls liberalisation strategy continued, with incentives for the medium- and long-term investment of offshore krónur in Iceland, in the form of currency auctions and the sale of foreign exchange-denominated Treasury bonds. The Foreign Exchange Act was amended in March 2012 to prevent the circumvention of capital controls through the bond market and to tighten control on capital flows related to the winding-up of the failed Icelandic banks. In line with the special rules in the EEA Agreement, the EFTA Court ruled in December 2011 that the critical situation in Iceland after the financial crash justified a number of temporary protective measures that were necessary to safeguard macroeconomic and financial stability. Iceland's overall policy of capital controls is still not in line with the requirements of the *acquis*.

In May 2012, the Icelandic government and the European Commission agreed to establish an Ad Hoc Group on the Removal of Iceland's Capital Controls, with the purpose of assessing the state of play, prospects and challenges associated with lifting the existing controls. The group held its first meeting in September 2012 (*See also Economic Criteria*).

No progress can be reported as regards the lifting of existing restrictions on foreign investment in fisheries, which are not in line with the *acquis*. (*See also Chapter 13 —*

Fisheries) There has been no progress in lifting the investment restrictions applied to third-country (non-EEA) nationals in the sectors of energy, real estate and air transport.

No progress can be reported in the area of **payment systems**. Work continues on aligning with the new EU Directive on e-money.

Some progress can be reported in the **fight against money laundering**. In June 2012 the parliament amended the existing legislation on measures against money laundering and financing of terrorism with the aim to implement recommendations made by the Financial Action Task Force. However, several shortcomings are still to be addressed, including the under-resourcing of the Financial Intelligence Unit. Full implementation of the third Anti-Money Laundering (AML) Directive is yet to be completed.

Conclusion

Overall, Iceland applies parts of the *acquis* on free movement on capital. Exceptions remain, notably in connection with investment restrictions including in the fisheries sector and extensive capital controls. The administrative capacity of the Financial Intelligence Unit still requires further strengthening.

4.5. Chapter 5: Public procurement

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.

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

There has been some progress on **award of public contracts**. Iceland has decided not to establish a formal Public Procurement Advisory Council as regular consultation meetings with stakeholders have proven to be sufficient. A website publishing Icelandic authorities' tender notices is under preparation and is expected to facilitate the collection of statistics on public procurement. The Directive on defence procurement remains to be transposed into Icelandic legislation.

The *administrative capacity* of the Ministry of Finance has been strengthened by allocating a full-time staff member to deal with public procurement issues. The State Trading Centre has also recruited three additional staff and currently employs 25 persons.

Some progress has been made on **remedies**. The two technical directives are implemented as of June 2012. Iceland has yet to align with the Remedies Directive.

Conclusion

Overall, Iceland is well advanced in the area of public procurement. The level of alignment and implementation in this field 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.

Progress has been made in the area of **company law**. Legislation on reporting and documentation requirements in the case of mergers and divisions was adopted in February 2012, in order to align 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 is yet to be completed.

There has been no further progress in the area of **corporate accounting**. Alignment with the Directive on certain disclosure requirements for medium-sized companies and the obligation to draw up consolidated accounts still has to be achieved.

There has been no further progress in the area of **auditing**. Iceland continued to apply the existing *acquis* in this area. Alignment with the international aspects of the Directive on statutory audits of annual and consolidated accounts still has to be completed.

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. Full alignment with company law *acquis* and with accounting and auditing standards is yet to be completed.

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.

No further progress can be reported in the area of **copyright and neighbouring rights**. Iceland attended as an observer the plenary meeting of the Observatory on Counterfeiting Intellectual Property Rights (IPR) Infringements in September 2012.

Some development can be reported in the area of **industrial property rights**. In June 2012 the parliament adopted legislation on patents to incorporate the Singapore Agreement, a World Intellectual Property Organization (WIPO) Trademark Law treaty. It also amended legislation on brands, adding services to the definition of brand, and on fees and trademark application procedures and adopted legislation on patent fees, trademarks, designs, and on trademark registration.

There has been little progress in the field of **enforcement**. The Icelandic website with information on IPR infringements has been established and is operational. Iceland is not yet fully aligned with the Enforcement Directive.

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. Full alignment with the Enforcement Directive has yet to be achieved.

4.8. Chapter 8: Competition policy

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

No progress can be reported in the field of **anti-trust and mergers**. In the area of **State aid** control, progress was made regarding the review by the EFTA Surveillance Authority (ESA) of the main State aid measures granted by Iceland to its financial sector. In July 2012 the ESA approved the State aid granted for the restructuring of two Icelandic banks. These final ESA decisions close the main cases that it has dealt with following the collapse of the financial system in Iceland in 2008. In assessing the impact of the aid on competition, the ESA has cooperated closely with the Icelandic Competition Authority. It is also analysing the restructuring plan for the Sjóvá Insurance Company, after it was submitted by Iceland in September 2011. In March 2012, ESA decided to open a formal investigation regarding the transfer of mortgage loans secured against collateral in residential property from financial undertakings, to the Icelandic Housing Financing Fund (HFF). Following this ESA decision, Iceland adopted legislation in June 2012 on appropriate measures to be adopted by the State, including revision mechanisms.

Regarding State aid measures to the state radio broadcaster, proposals have been submitted to the parliament to change its financing regime in order to bring it into line with State aid guidelines as required by the ESA.

Conclusion

Overall, Iceland has already reached a high level of alignment and applies a substantial part of the *acquis* in the field of competition. Iceland's State aid measures taken in response to the financial crisis have been in line with the relevant *acquis*.

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 some progress in the areas of **banks and financial conglomerates**. Amendments were made to the winding-up procedures, ensuring equality of creditors of financial undertakings undergoing liquidation proceedings by extending the time limit for cancellation, as well as ensuring the equal treatment of Icelandic and foreign parties. A National Credit Registry became operational in the autumn of 2011, allowing the Financial Supervisory Authority (FME) to collect information regarding exposures above ca €1.85 million. The credit registry is only accessible to the FME, but the information is being shared with the Central Bank of Iceland (CBI) without specific data regarding particular obligors and financial undertakings.

The FME has devised a detailed plan to address the shortcomings outlined in an assessment report carried out in August 2011, regarding non-compliance with the Basel Core Principles for Effective Banking Supervision, particularly the lack of a Risk Model to supervise and assess banks.

Legislation on a new deposit guarantee scheme, based on the new *acquis*, including minimum coverage of €100,000, remains to be adopted. Work on implementing the new Financial Conglomerates Directive and the Omnibus I Directive has not yet started.

Alignment with the Capital Requirements Directive (CRD II) has not yet been fully achieved, despite some limited progress. Legislative work is advancing on drafting new rules concerning: good business practices and customs; loans secured by mortgages on shares or guarantee capital certificates issued by the undertaking; calculation of the amount of exposure, hybrid capital investment, and what constitutes secure collateral; the evaluation of connections between parties within the meaning of rules on large exposures; the exemption from rules on internal auditing units for financial undertakings, and qualifying holdings outside the financial sector.

In December 2011 the EFTA Surveillance Authority (ESA) filed a case against Iceland with the EFTA Court, seeking a declaration that Iceland had failed to comply with the Directive on deposit guarantee schemes and with Article 4 of the EEA Agreement regarding non-discrimination. Iceland rejected these claims and contended that they should be dismissed. A number of EU and EFTA Member States sent written observations to the Court. The European Commission has intervened before the EFTA Court in support of the EFTA Surveillance Authority. Meanwhile, the first two partial payments to priority creditors in the commercial winding-up of Landsbanki Íslands hf were made in December 2011 and May 2012. At this stage, the Icesave dispute remains unresolved.

Progress has been made on **insurances and occupational pensions** with the implementation of the two Directives on motor insurance. Preparations for alignment with Solvency II are

under way. New rules have been adopted to address issues of 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**. The amending Directives on settlement finality and financial collateral arrangements need to be transposed.

Progress has been made on **securities markets and investment services** by aligning with the Directive on undertakings for collective investment in transferable securities (UCITS) regarding the clarification of certain definitions. The FME also published rules implementing the Directives on risk management. Alignment needs to continue in areas such as markets in financial instruments, prospectuses, market abuse and UCITS.

Some progress can be reported on administrative capacity. In January 2012 the FME completed an institutional reorganisation from a sector-oriented approach to on-site, off-site and oversight departments. The fees paid to the FME by regulated entities have also been amended. The reinforcement of the FME's staff numbers needs to be matched by an increase in the quality of technical expertise, supervisory systems and practices and IT systems so as to ensure effective and reliable prudential supervision.

Conclusion

Overall, alignment in the area of financial services is good. Despite progress being made, work on alignment with and implementation of the new *acquis* needs to continue in all the areas covered by this chapter. The supervisory capacity requires further improvement in view of the FME's increasing responsibilities and future obligations deriving from the application of the evolving *acquis*. The Icesave dispute remains unresolved. The ESA case against Iceland is pending before the EFTA Court.

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 information society and media due to its EEA membership.

Some progress can be reported in the areas of **electronic communications and information and communications technologies (ICT)**. The independence of the national regulatory authority has to be strengthened further with the amendment of the Media Law. Furthermore, the authority's financial viability needs to be safeguarded, in order to perform its role independently. The 2009 EU electronic communications reform package (revised regulatory framework) has not been transposed into national law. The EU Directive on data retention and the Regulation on the .eu top-level domain also remain to be transposed.

Good progress can be reported in **information society services**. Legal protection for conditional access devices was extended in June 2012 to decoders for purposes other than broadcasting services. 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.

No progress was achieved in the area of **audiovisual policy**. Digital switchover is planned for the end of 2014, 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 information society and media. Good progress was achieved in

information society services, where legal protection of conditional access devices was established. The independence of the national regulatory authority has to be further strengthened. The revised communications regulatory framework has yet to be transposed and several gaps in transposition in the field of audiovisual policy and information society services, in particular the e-Commerce Directive, need to be addressed.

4.11. Chapter 11: Agriculture and rural development

Iceland's agricultural policy is not in line with the *acquis*.

Little progress can be reported as regards **horizontal issues**. In July 2012, Iceland presented to the Commission a strategy paper for meeting the EU agriculture and rural development policy requirements. The paper describes the necessary preparations in all areas included in this chapter and provides a timetable for their implementation. As part of this strategy, a feasibility study will be carried out on domestic implementation of the Land Parcel Implementation System.

Current administrative capacity in the field of agriculture and rural development is limited and will need to be further addressed in order to administer the CAP, including the management of agricultural and rural development funds. As part of the general restructuring and streamlining of the public sector, the Agricultural Economics Institute was closed down on 1 January 2012. Its tasks were transferred to the Agricultural University and Statistics Iceland. Statistics Iceland will now be responsible for gathering and processing statistical information on agriculture. Overall, preparations in the area of horizontal issues are at an early stage.

Little progress can be reported in the areas of **common market organisation** and **rural development**. The strategy paper on meeting the agriculture and rural development policy requirements includes a description of steps to be undertaken in order to comply with the *acquis* in both areas. The preparations in these areas still need to be launched.

No progress can be reported in **quality policy** and **organic farming**. The latter is covered by the EEA Agreement and Iceland is largely in line with the relevant *acquis*. Alignment with the *acquis* on organic products and on imports of organic products from third countries has yet to be achieved. Preparations in the area of quality policy still need to be launched.

Conclusion

Overall, Iceland's agricultural policy is not aligned with the *acquis*. Preparations in this chapter are at an early stage and progress has been limited. A strategy and planning schedule of measures to be taken to ensure compliance with the EU agriculture and rural development requirements has been adopted. The appropriate administrative structures to implement all aspects of the common agricultural policy including the management of agricultural and rural development funds needs to be set up. Preparations in the areas of the common market organisation and quality policy need to be launched and alignment in the field of organic farming needs to be completed.

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.

Progress can be reported on **general food safety**. In November 2011 Iceland started implementing the EU hygiene package. However, Iceland continues to prohibit the import of fresh meat, meat products and other products of animal origin from the EU, which is not in line with the *acquis*. The EFTA Surveillance Authority (ESA) has started legal proceedings against Iceland concerning these bans on imports. Preparations in the area of general food safety are advanced.

There has been no progress as regards **veterinary policy**, where Iceland is partially aligned with the *acquis*. Iceland still needs to align with the EU legislation on animal health as well as remove present restrictions on imports of live animals, which are not in line with the *acquis*. On both these issues, Iceland currently has an exemption under the EEA Agreement.

There has been some progress in the field of **placing on the market of food, feed and animal by-products**. A national upgrading plan is under preparation for evaluating all slaughterhouses, dairies and other food establishments and bringing them into conformity with EU standards. No progress was made on closing existing gaps in Iceland's legislation, which concern in particular the alignment with *acquis* on novel foods, transmissible spongiform encephalopathies (TSEs) and animal by-products that are not intended for human consumption. In this area, Iceland's preparations are moderately advanced.

Progress can be reported with regard to **food safety rules**. The relevant legislation was amended in spring 2012 to allow the small-scale direct sale of products under certain conditions. No progress was made as regards **specific rules for feed**. Alignment with the *acquis* in these areas is advanced.

In the area of **phytosanitary policy**, no progress can be reported. Iceland still needs to align with the *acquis* on both plant health and plant protection. Regarding pesticide residues Iceland's legislation is partly aligned with the *acquis*, except for import restrictions on certain plants and plant material. The capacity of accredited laboratories to conduct residue analyses still has to be enhanced. Preparations in the area of phytosanitary policy are at an early stage.

There has been no progress in further aligning with legislation regarding **genetically modified organisms**.

Conclusion

Overall, Iceland is partially aligned with the *acquis* on food safety, veterinary and phytosanitary policy due to its participation in the EEA Agreement. Some progress was made in the areas of general food safety and food safety rules. The import restrictions on fresh meat and live animals are not in line with the *acquis*. Gaps in legislation in the areas of animal and plant health, genetically modified organisms, novel foods and animal products that are not intended for human consumption are yet to be addressed. Administrative and laboratory capacity also need further strengthening.

4.13. Chapter 13: Fisheries

Iceland's fisheries policy is generally not in line with the *acquis*.

There have been no developments as regards **resource and fleet management**. No major changes have taken place in the fisheries management system in Iceland. Iceland adopted part of the reform of its *fisheries* management system by significantly raising the fees paid by quota holders. Restrictions on 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.

Little progress has been made in the area of **inspection and control**. Iceland signed in 2011 an agreement on an Electronic Reporting System (ERS) with Norway which is to be implemented in 2012 and 2013. Preparations are still ongoing for the ratification of the 2009 Food and Agriculture Organisation (FAO) Agreement on port state measures to prevent, deter and eliminate illegal, unreported and unregulated fisheries.

No new developments can be reported in the areas of **structural action, market policy and State aid**.

Progress has been limited concerning **international agreements**. Preparations to ratify the 1993 FAO Agreement, to promote compliance with international conservation and management measures by fishing vessels on the high seas, continued.

It was not possible, over the reporting period, to reach an agreement on the management of the mackerel stocks for 2012 between the coastal states of the North-East Atlantic. Iceland's mackerel fisheries continue to cause widespread concern within the EU with regard to the principles of sustainable resource management of this stock.

Conclusion

Iceland continues to apply a fisheries management system which has similar objectives to those pursued in the EU, but some rules differ substantially. Overall, Iceland's fisheries policy is not in line with the *acquis*. Existing restrictions in the fisheries sector on freedom of establishment, services and capital movements are not in line with the *acquis*.

4.14. Chapter 14: Transport policy

Iceland applies a substantial part of the *acquis* on transport policy due to its EEA membership.

A new Transport Strategy 2011-2022 and a Transport Action Plan 2011-2014 were adopted in June 2012. They formulate the policy and objectives for air, maritime and road transport in Iceland. The transport strategy is set for 12 years, to be revised every four years. Within the new strategy, the Action Plan is adopted for four years with the aim of revising it every two years. The objectives of the new strategy are to improve accessibility and mobility in the transport of passengers and goods within and between regions, ensure cost-efficient, safe and environmentally sustainable transport and take into account the needs and specific conditions of regions and thus promote regional development.

Progress can be reported in the area of **road transport**. The *acquis* regarding driving licences, road infrastructure safety management and roadside check lists for inspections was transposed. The *acquis* regarding the adaptations to technical progress of requirements on vehicle roadworthiness and dangerous goods transport, including a uniform roadside check list for dangerous goods transport, has yet to be fully implemented.

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

No progress can be reported in the area of **combined transport** due to the absence of railway systems or short sea shipping modes of transport.

Good progress can be reported in the field of **air transport**. A regulation transposing the aviation security *acquis* was adopted in January 2012. The EU Regulation on common rules for civil aviation security for domestic air services has yet to be implemented. New legislation was adopted with the aim of transposing the *acquis* on the continuing airworthiness of aircraft and aeronautical products, parts and appliances, and on the approval of organisations and personnel involved in the relevant tasks. The *acquis* concerning common rules for the operation of air services in the EU was transposed during the reporting period. The maximum length of the time limitation for public services obligations is yet to be established. The *acquis* regarding the list of air carriers which are subject to an operating ban within the EU based on the flag state criteria and on company performance (following inspection of airfleets) has been transposed into Icelandic law, as well as the *acquis* on insurance requirements for air carriers. The *acquis* concerning the computerised reservation system and the single European Sky II package remains to be transposed. During the reporting period eight new agreements on air services were signed between Iceland and Ghana, Jordan, Laos, Paraguay, Ruanda, Saudi

Arabia, Zambia and South Africa. A Memorandum of Understanding on air traffic and a future agreement was signed with Australia.

Some progress can be reported in the area of **maritime transport**. The *acquis* regarding port state control was transposed in April 2012. A new regulation concerning the rescue and safety equipment of Icelandic vessels was issued in June 2012, which covers the *acquis* on passenger ships and safety of fishing vessels. The *acquis* concerning the rights of passengers travelling by sea and port reception facilities for ship-generated waste has yet 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. Progress can be reported as regards road safety rules. Transposition of the relevant EU legislation on air and road transport needs to be completed.

4.15. Chapter 15: Energy

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

There has been little progress in the area of **security of supply**. In February 2012, the Minister for Industry presented a report to the parliament containing recommendations on a comprehensive energy policy for Iceland. The report is based on the work of the steering committee set up by the Ministry in 2009. No progress can be reported on aligning with the *acquis* on oil stocks.

No progress can be reported in the area of the **internal energy market**. With regard to the procedure for improving the transparency of gas and electricity prices, legislation has not been adopted. The Third Energy Package has not been fully incorporated into the EEA Agreement and, as such, is not yet implemented in Iceland. Separation of the regulatory authority from the Ministry of Industry, Energy and Tourism and further measures to guarantee the independence of the regulator's budget and board still have to be implemented. Ownership unbundling of the Transmission System Operator from the energy companies also remains to be achieved. The independence of the National Energy Authority needs to be achieved and its working arrangements with the Competition Authority established.

There has been little progress in the field of **renewable energy**. The National Renewable Energy Action Plan to meet the 2020 targets is still in the process of being drafted under the leadership of the Ministry of Industry. A new bill was adopted in June 2012 partially aligning with the 2009 Renewable Energy Directive. Full alignment is yet to be achieved. Approximately 67% of Iceland's consumed energy already comes from renewable sources. Initial steps were taken to increase the use of renewable energy in the transport sector, such as the VAT exemption on importing electric cars.

In the area of **energy efficiency** no progress can be reported. Full alignment with the energy efficiency *acquis* is yet to be achieved, including rules on the energy performance of buildings, the Directive on energy end-use efficiency and energy services and the new legislation on eco-design and labelling of energy consumption. Iceland does not have national energy-saving targets yet and the implementation of the *acquis* on energy end-use efficiency is still at an early stage. The administrative capacity to implement the energy efficiency *acquis* is limited.

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

Conclusion

Overall, Iceland is partly aligned with the *acquis* in the field of energy. Alignment in the areas of oil stocks, the internal market, renewable energy, energy efficiency and nuclear safety and radiation protection needs to continue. The independence of the regulatory authority and the administrative capacity to implement the new *acquis* need to be addressed.

4.16. Chapter 16: Taxation

Iceland partly applies the *acquis* in the area of taxation.

Tax legislation in the area of **indirect taxation** is partly in line with the *acquis*. Little progress can be reported on aligning the legislative framework with the *acquis*. Iceland adopted various laws on VAT during the reporting period, including an amending law reducing VAT on e-books, CDs with books and electronically supplied music from 25.5% to 7%, and introducing new obligations whereby foreign sellers of e-books and electronic music have to register with the Icelandic authorities for VAT purposes. These new provisions partially diverge from the *acquis*, since the EU VAT Directive stipulates that reduced rates must not apply to electronically supplied services (such as e-books) or music. The provisions concerning temporary reimbursement of two thirds of the VAT paid when purchasing or renting coaches were extended to 31 December 2013. Provisions on the reimbursement system applicable to fire equipment and vehicles for municipalities were adopted in June 2012. Neither of the above is in line with the *acquis*.

In June 2012, an amending law was adopted on VAT exemptions and repayments for electric and hydrogen powered vehicles. The legislation aims at making ‘green’ vehicles less expensive by deducting an amount from the customs value or the VAT transaction price. This provision is not in line with the EU customs and VAT legislation.

Divergences with the *acquis* on indirect taxation concern mainly VAT - 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, traveller’s allowances, warehousing, duty suspension and duty-free goods.

With regard to **direct taxation**, there has been little progress. A Financial Activity Tax (FAT) was introduced on the activities of companies providing financial and/or insurance services. The FAT was set at 5.45% or 6% of the taxable base established for income tax, depending on whether the income tax base is below, or above €6.1 million, respectively. New implementing provisions were introduced concerning income tax for persons with limited tax liability and earning not less than 75% of their income in Iceland. In the area of direct taxation, the tax legislation remains partially aligned with the *acquis*.

Some progress can be reported in the area of **administrative cooperation and mutual assistance**. Iceland ratified the Protocol amending the OECD Convention on Mutual Administrative Assistance in Tax Matters which became applicable in February 2012. Iceland does not have legislation reflecting the *acquis* on mutual assistance and administration.

Little progress took place in the field of **operational capacity and computerisation**. Work has continued to assess the operational capacity and best practices of Iceland’s tax system against the EU tax blueprints and best practices. Iceland is working on a strategy to achieve interconnectivity and interoperability of its VAT and other IT systems for taxation with those of the EU. The process of establishing a Central Liaison Office and an Excise Liaison Office has yet to start. In the area of operational capacity and computerisation, Iceland remains partially aligned with the *acquis*.

Conclusion

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

4.17. Chapter 17: Economic and monetary policy

Iceland is largely aligned with the *acquis* in the area of economic and monetary policy.

No progress can be reported on **monetary policy**, including as regards the functional, institutional, personal and financial independence of the Central Bank, and the prohibition of monetary financing, all areas where alignment with the *acquis* remains incomplete. In March 2012 the Ministry of Economic Affairs released a report on the future structure of the financial system, including the role of the Central Bank. Proposals for a comprehensive legal and regulatory framework are under preparation.

Some developments can be reported on **economic policy**. In November 2011 the Minister for Economic Affairs introduced an Economic Programme for Iceland, drawn up after completion of the recovery programme under Iceland's stand-by arrangement with the International Monetary Fund (IMF). It analyses competitiveness, fiscal consolidation, the labour market, restructuring of household and corporate debt, rebuilding of the financial system and monetary policy.

In March 2012 the Ministry of Finance released the Treasury's Medium Term Debt Management Strategy for 2012-2015. The Strategy sets out the government's plans for medium-term debt financing of government debt. The Local Government Act, which includes sections on controlling local government finances, was approved in September 2011.

Iceland is included in the pre-accession fiscal surveillance procedure and submitted its second Pre-Accession Economic Programme (PEP) in February 2012. (*See also Economic criteria*)

The capacity for economic policy formulation and coordination needs to be further improved at local and central level also because a significant part of government spending is linked to local governments, which requires stronger coordination and planning for fiscal policy consolidation.

Conclusion

Overall, Iceland has a good level of alignment with the *acquis* on economic and monetary policy. There has been some progress in the area of economic policy. Gaps in alignment with the *acquis* in the field of monetary policy remain to be addressed, including strengthening 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.

With regard to **statistical infrastructure**, some progress has been made. In addition to the cooperation between Statistics Iceland and the National Land Survey of Iceland, work on a cooperation agreement with the Directorate of Immigration has started. Work continues on cooperation agreements between Statistics Iceland and the Customs Department, the Environment Institute and the National Energy Authority. In June 2012, Iceland adopted a law on imposing fines on private firms and public institutions, if they do not respond to requests for information for statistical purposes. Also in June 2012, the new business statistics directorate was set up and a new director recruited. Since September 2011 there has been a net

increase of five staff members at Statistics Iceland while the operational budget has been cut by a further 3%.

Some progress can be reported in the area of **classifications and registers**. A paper on the classification of statistical regions and a paper on national classification of completed education is under preparation. Work to set up the statistical business register has not yet started.

Concerning **sectoral statistics**, good progress has been made despite the scarce resources. With a response rate of 75%, the data from the Farm Structure Survey carried out during the reporting period are considered reliable. The majority of the administrative registers related to the housing and population census has already been collected. The development of the database for the census data is under way.

Statistics Iceland has started to compile agricultural statistics. These include milk production statistics, livestock statistics, statistics on slaughtering and meat production, statistics on activity of hatcheries and trade of chicks, annual crop statistics and land use statistics. Work has also started on economic accounts for agriculture (EAA) and agricultural price statistics (APS).

Statistics Iceland has continued preparatory work on Intrastat, including carrying out a feasibility study and exploring data collection procedures. With financial support from the Modernisation of European Enterprise and Trade Statistics (MEETS) programme, work has started on exploring how to estimate the minimum data quality needed for Intrastat. Preparations for delivery of comprehensive data on national accounts need to be stepped up in order to comply with the requirements of the data transmission programme. The adult education survey and the continuing vocational training survey are yet to be carried out.

Conclusion

Overall, Iceland is partly aligned with the *acquis* on statistics. Progress can be reported. A large part of the register-based population and housing census was carried out. Allocation of sufficient resources remains a concern and additional human and financial resources will have to be made available to the Statistical Office in order to fulfil the obligations of the *acquis* in this chapter.

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.

There have been some developments in the area of **labour law**, where Iceland has already implemented a substantial part of the *acquis* as a member of the EEA. Following the EFTA Court Decision of June 2011 regarding the Posting of Workers Directive, Iceland amended parts of its legislation in March 2012. Further amendments are under preparation. Legal alignment has yet to be achieved as regards temporary agency work and the establishment of a European Works Council. The EFTA Surveillance Authority (ESA) has started proceedings in a number of cases due to incorrect implementation of labour law Directives.

Few developments can be reported in the area of **health and safety at work**, where Iceland has already implemented substantial parts of the *acquis* as a member of the EEA. The first yearly Campaign Against Bullying Day took place in November 2011. It was organised by the Ministry of Welfare in cooperation with social partners and other stakeholders. Alignment with the *acquis* on asbestos has yet to be achieved. Full alignment with the health and safety *acquis* needs to be ensured in all three sub-sets of national legislation regarding land, air and sea.

Social dialogue has continued to function well. The wage agreements concluded in 2011 are still valid and they contribute to substantial net wage increases for both public and private sectors. Social partners continue to be proactive in labour market policies, and participate in their implementation.

There has been progress with regard to **employment policy**. The consultative committee that was appointed in 2011 and includes representatives from the Ministry of Welfare, the Directorate of Labour and social partners is working on developing a comprehensive employment strategy for Iceland. However, overall, the labour market situation continues to be adversely affected by the 2008-2010 economic crisis, with young workers and the low-skilled being hardest hit. The government has continued to implement active labour market policies according to the *Iceland 2020 Policy Statement* and focusing on efforts to reduce unemployment among young people, in particular for the long-term unemployed. In February 2012, the Directorate of Labour and the Ministry of Welfare introduced a new initiative, 'Working Way', targeting long-term unemployed with the aim of bringing 1,500 unemployed back into the labour market. The government has also stepped up cooperation with civil society and social partners in order to reduce unemployment. A special campaign to reduce undeclared work in the small-scale maintenance and reconstruction sector through means of VAT deductions for house owners has continued in 2012.

Progress has been made regarding the **European Social Fund (ESF)**, where preparations for participation in the ESF have started. The Ministry of Welfare has been identified as the institution responsible for drafting the ESF operational programme. The Minister for Welfare charged a working group in March 2012 with drafting an operational programme for the preparations necessary to participate in the ESF. Iceland has also drawn up an action plan on how to meet the objectives of the EU cohesion policy. Adequate training is necessary in this field.

In the area of **social inclusion** progress has continued. The impact of the financial crisis continued to be visible, with most households reporting that they make ends meet 'with difficulty' or 'with great difficulty'. Whilst disposable earnings of households fell across the board due to the financial crisis, government policies helped to cushion the effects for the lowest income groups. Targeted debt relief measures were effective. Overall, the percentage of households at risk of poverty remains substantially lower than the EU average. Close monitoring and evaluation of the social situation of single-parent families, low-income elderly, children and social assistance recipients is needed.

An 'Action Plan for *People with Disabilities*' was approved by the parliament in June 2012. The UN Convention on the Rights of Persons with Disabilities remains to be ratified.

Social protection expenditures increased to 8% of GDP, the highest level ever in Iceland, although still lower than the EU average. Cuts in the health care system were significant, but high-quality services were maintained. Unemployment expenditures have increased more than sixfold since 2007. In June the parliament adopted legislation on the establishment of an Employment Rehabilitation Fund. The objective of the Fund is to make sure that everyone who is forced to leave the labour market can receive assistance to return.

Some developments can be reported in the field of **anti-discrimination**. In June, the parliament adopted legislation improving the legal status of transgender persons. Work is ongoing to align with the two Anti-Discrimination Directives. An Equality body responsible for combating discrimination on grounds of racial or ethnic origin has yet to be established. Iceland needs to ensure that the future Equality body is independent and able to carry out independent surveys, produce reports and provide assistance to victims of discrimination.

No further development can be reported in the field of **equal opportunities**, where Iceland's standards continue to be high. The Plan of Action on Gender Equality for the period 2011-2014 continues to be implemented with gender mainstreaming and gender budgeting playing a central role. Full alignment with the *acquis* has yet to be achieved, namely as regards alignment with the *acquis* on equal treatment of men and women in matters of employment and occupation.

Conclusion

Overall, Iceland has reached a high level of alignment and continues to apply a substantial part of the *acquis* in this chapter due to its EEA membership. Preparations for participation in the European Social Fund have commenced and a comprehensive employment strategy is being drafted. Legal alignment remains to be completed in the areas of anti-discrimination and equal opportunities. The impact of the 2008-2010 financial crisis remains visible; challenges in social inclusion and employment thus persist.

4.20. Chapter 20: Enterprise and industrial policy

Iceland has already reached a high level of alignment in the area of enterprise and industrial policy.

In the area of **enterprise and industrial policy principles**, Iceland has an industrial policy that is in line with EU principles and is associated with the EU Small Business Act.

No new developments can be reported on **enterprise and industrial policy instruments**. Iceland has a wide array of enterprise and industrial policy instruments. It continues to participate in the Enterprise and Innovation Programme and is a member of the Enterprise Europe Network. In addition to EU resources, Iceland also uses own resources to provide direct support to SMEs through the appropriate instruments. But access to finance for SMEs can still be problematic due to the macroeconomic situation.

Regarding **sectoral policies**, Iceland continues to implement policies according to its sectoral strategies, which are in line with EU principles.

Conclusion

Overall, alignment in the area of enterprise and industrial policy remains at a high level. Little progress can be reported in the field of enterprise and industrial policy. Access to SME finance is still affected by the financial crisis.

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.

There has been good progress in the field of **transport networks**. Iceland has finalised the TEN-T maps according to the new TEN-T Guidelines, one on airports and one on roads, ports and airports.

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. A TEN-E-related policy needs to be developed.

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

Regarding the **legislative framework**, alignment of legislation with the *acquis* relevant for EU cohesion policy is at an advanced stage. Iceland's current budget planning system does not include sufficient rules on multiannual programme budgeting. Planned preparations in this area include an assessment of municipal co-financing capacities, review of the public budgeting process, drafting legislation -where necessary- for cohesion policy implementation, and preparations for mechanisms for complying with EU policies.

In January, a new law on the municipalities entered into force which overhauled the pre-existing laws on the municipalities. The main changes relate to the municipalities' finances and their monitoring. Municipalities are now expected to prepare multiannual programming. The law also stipulates increased consultation between the government and the municipalities.

Some progress can be reported as regards the **institutional framework** for managing the Structural Funds. In March 2012, Iceland presented to the Commission a plan for meeting the EU cohesion policy requirements. The plan describes the preparations in all areas included in this chapter and provides a timetable for their implementation. The Ministry of Industry, Energy and Tourism is leading the preparatory work for setting up the Managing Authority in close cooperation with other relevant ministries. Other stakeholders such as the Association of Local Authorities were also associated in the preparations for the implementation framework. The Icelandic National Audit Office (INAO) has been identified as the future Audit Authority and the Ministry of Finance as the future Certifying Authority.

Progress was made in the area of **administrative capacity**, where a comprehensive training action plan was put in place and started being implemented. It addresses most of the institutions likely to be involved in implementing the cohesion policy and covers areas relating to programme and project preparation and management.

Some limited progress was made in relation to **programming**. Iceland has identified the Ministry of Industry, Energy and Tourism as the body responsible for supervising preparations for programming for the European Regional Development Fund. The Ministry of Welfare has been identified as the institution responsible for supervising preparations for programming for the European Social Fund. Programming preparations are overseen by the Negotiation Group on Regional Policy. The Ministry of Education and the Ministry of the Interior will also be fully associated with the programming work and the involvement of further stakeholders, in particular local authorities, will be emphasised.

Some modest progress can be reported on **monitoring and evaluation**. Iceland has started preparatory work for the establishment of a monitoring and information system for cohesion policy programmes. Experts are working on analysing needs and processes.

As regards **financial management, control and audit**, Iceland is already advanced due to its participation in EU programmes in the framework of the EEA Agreement and no further progress can be reported. Financial management and control systems in Iceland are largely in line with EU best practices and international standards, but progress is required in the field of internal audit. Independent external audit of the public sector is under the responsibility of INAO. INAO does not audit the municipalities. However, it is authorised to examine the accounting of municipalities in relation to joint operations of central and local governments. *(See also Chapter 32 — Financial control)*

Conclusion

Overall, Iceland has started preparations and adopted a timetable and action plan for meeting the EU cohesion policy requirements. Certain institutions (future Audit Authority and Certifying Authority) have been identified, preparations for setting up the Managing

Authority have started and a comprehensive training action plan has started to be implemented. The Managing Authority and other bodies still need to be identified. The establishment of implementation systems, including the monitoring and information system, is at an early stage.

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

Iceland's **judiciary** continues to be of a high standard. As regards its *independence and impartiality*, there have been no major developments with regard to the recommendations delivered last year by the working group set up in December 2010 to look into the establishment of an Appeal Court for civil and criminal cases, although the issue is under examination by the Ministry of the Interior.

As regards the *efficiency* of the judicial system, the numbers of district court judges and Supreme Court judges, which were temporarily increased in order to deal with the additional case-load following the 2008 financial crisis, are planned to be gradually reduced after January 2013. Of the 43 district court judges currently in office, two were appointed during the reporting period. The number of Supreme Court judges remained the same. A law was adopted in June 2012 to further improve the efficiency of the assistants to courts, giving them more legal power in civil cases. An expert group on the future organisation of the investigation and prosecution of economic crime cases was appointed in January 2012.

In the first major case relating to the banking collapse brought by the Office of the *Special Prosecutor* in December 2011, criminal charges were filed against the former CEO of the old Glitnir Bank, the first of the Icelandic banks that collapsed in 2008, and one of his senior staff. The Supreme Court confirmed in February 2012 that the former Permanent Secretary of the Ministry of Finance, already convicted by the District Court of Reykjavik in 2011, was guilty of insider trading and upheld his sentence to two years' imprisonment.

In March 2012, the CEO of the Financial Supervisory Authority was dismissed by the Board of the Authority and criminal charges were laid against him.

A law amending the Code of Criminal Procedure was adopted in December 2011, delaying the setting-up of regional prosecutors' offices until 2014, due to lack of funding. The time until 2014 will be used to evaluate whether this new administrative level of prosecution should be established at all. A group of specialists will be set up to assess the structures.

Progress can be reported on **anti-corruption policy**. A code of conduct for central government staff and civil servants in ministries was adopted in May 2012. Codes of conduct for civil servants in general and political advisors are yet to be established and work is under way. The Prime Minister presented to the parliament the first report of the Coordination Committee on ethical standards within the administration in spring 2012. A bill amending the General Penal Code following the December 2010 Interim Compliance Report of the Council of Europe's Group of States against Corruption (GRECO) on incrimination of corruption offences was adopted by the government. It also aims to implement recommendations of the OECD Working Group on Bribery and to introduce the necessary changes to the Code in order to ratify the additional protocol to the Council of Europe Criminal Law Convention on Corruption. The bill has yet to be adopted by the parliament.

The State Auditor continued to monitor implementation of the law on the financing of political parties, which requires parties to provide a financial report as a precondition for receiving state funding. During the reporting period, six out of seven political parties delivered their obligatory financial report for the year 2010. GRECO adopted its second Third Round Compliance Report on Iceland in May 2012. It concluded that its previous

recommendation on party funding regarding the independence of auditors who check political parties' and candidates' accounts has been dealt with in a satisfactory manner.

Some measures were taken during the reporting period to further strengthen the already high level of protection of **fundamental rights**.

Work to prepare a National Action Plan for Human Rights to be presented to the parliament started during the reporting period and two groups were appointed — a group of representatives of ministries and a consultative group of representatives of civil society and academia. The Plan is intended to further enhance the protection and promotion of human rights in Iceland, determine the role and coordinate the work of different ministries and organisations in human rights matters, decide on ratification of human rights agreements and evaluate whether a national institution for human rights should be set up. Monthly seminars on human rights issues in connection with the ongoing work have been held since December 2011.

As regards civil and political rights, several meetings and seminars were organised in cooperation with stakeholders, the academic community and the public on freedom of expression and democracy, freedom of religion, and democracy and municipalities.

A draft law on religion is being discussed in the parliament. It includes provisions that would make all religions and philosophical organisations equal before the law, and give greater freedom to those who choose not to register with any religion at all. It would also mean that philosophical organisations, secular humanist groups and the like would be able to receive the 'tithe tax' which normally goes to whichever religious group a person is registered with. The draft law would also discontinue automatic registration with the national church of a child born to a mother registered with that church.

As regards economic and social rights, an awareness-raising campaign on sexual violence against children started during the reporting period. The Icelandic Centre for Gender Equality published an overview on gender equality in Iceland aimed at offering insight into successes, best practices and lessons learned.

A law on compensating victims of sexual offences was adopted in June 2012. A conference was organised on the same subject to discuss how to further improve the judicial system. Issues discussed included various aspects of procedures, legislative reform and the role of prosecution in the area of sexual offences, and the protection of children against sexual exploitation.

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 rules on the appointment of the members of the board of directors by the Minister of the Interior still 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 citizens' rights**. The differential treatment between citizens of Nordic countries and other EU countries, as regards voting rights in municipal elections, is not in line with the EU *acquis* and Iceland will need to align in due course.

Conclusion

Iceland continues to have high standards in the area of the judiciary and fundamental rights. Progress was made in further reinforcing the anti-corruption policy framework. Iceland also

continues to strengthen its high level of protection of fundamental rights. Data protection legislation in Iceland is yet to be aligned with the *acquis*, in particular as regards the independence of the national Data Protection Authority.

4.24. Chapter 24: Justice, freedom and security

Iceland has already achieved a high level of alignment and applies a large part of the *acquis* in the area of justice, freedom and security as an associated member of the **Schengen Agreement**, in particular as regards **external borders** and **visas**. Iceland has continued to be actively involved in the activities of Frontex. Iceland has also continued to participate in the Visa Information System (VIS).

No progress can be reported in the field of **migration**. Legislation on long-term residents, special provisions for researchers and implementation of the EU Blue Card Directive still need to be aligned with the *acquis*. The same applies to family reunification and minimum standards on sanctions and measures against employers of illegally staying third-country nationals. Overall, Iceland is advanced in this area.

There has been no progress in the area of **asylum**. Iceland still needs to ensure full alignment with the relevant *acquis*, including amending the definition of refugees and persons eligible for subsidiary protection. Iceland has not yet joined the European Asylum Support Office (EASO). Iceland is well on track to meet the requirements in this area.

No progress can be reported in the area of **judicial cooperation in civil and criminal matters**. The 1996 Child Protection Convention and the 2007 Child Support Convention and its protocol on applicable law have yet to be signed and ratified. The good cooperation between Iceland and Eurojust has continued. Preparations need to be made for the exchange of criminal records with Member States through the European Criminal Records Information System (ECRIS). Iceland is well on track to meet the requirements of the *acquis* in these areas.

Progress has been made in the area of **police cooperation and the fight against organised crime**. Iceland has ratified the Council of Europe Convention on trafficking in human beings and work on reviewing the five-year Action Plan against human trafficking has started. The Council of Europe Convention on the protection of children against sexual exploitation and sexual abuse is signed but remains to be ratified. Iceland amended the General Penal Code concerning child pornography in order to align with the Council of Europe Convention on cybercrime. The Optional Protocol to the Cybercrime Convention still needs to be ratified. The Economic Crime Department of the National Commissioner of Police merged with the Office of the Special Prosecutor. The protocols to the UN Convention against transnational organised crime (Palermo Convention) on the smuggling of migrants and on the illicit manufacturing of and trafficking in firearms have been signed but remain to be ratified. Iceland has continued its good cooperation with Europol. Practical rules and procedures regarding exchange of data as well as IT infrastructure need to be adapted to meet the requirements in the areas of police and customs cooperation. Iceland is well advanced in this area. 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. Iceland needs to continue its alignment with the *acquis* in areas including migration, asylum and judicial cooperation.

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 an associated country. Participation is successful and spreads over all the thematic areas and specific programmes covered by FP7.

Progress was made regarding the **European Research Area (ERA)**, where Iceland took a number of steps to further facilitate its integration into the ERA and strengthen its research and innovation capacity. The *Iceland 2020 Policy Statement* takes due account of the objectives of the ERA.

Regarding research funding, the aim remains to raise the level of expenditure on R&D from currently 2.7% of GDP to 4% of GDP by 2020 as stated in the *Iceland 2020 Policy Statement*. To attain this objective, the government continues 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 the EU's FP7. As a result of its involvement in European Research Area activities, Iceland is also well advanced in meeting the targets and objectives of the ERA and the Innovation Union.

4.26. Chapter 26: Education and culture

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

Some developments can be reported in the fields of **education, training, youth** and sport. A new curriculum for all school levels was published in May 2011 and implementation commenced with the academic year 2011-2012. In June 2012 amendments to the Law on Universities were adopted regarding the autonomy of the universities, democracy and participation of students and staff in the management of the universities, and the rights of disabled students.

As regards cooperation on policies, Iceland continued to participate in the open method of coordination on education. Iceland's share of 30-34 year-olds with tertiary education remains above the EU average, as does, however, the rate of early school leavers. Over the reporting period the government formally signed an agreement for a programme to encourage early school leavers between the ages of 18 and 25 to enter secondary school. In the field of lifelong learning, Iceland remained above the EU average targets for 2020.

Some progress can be reported in the area of access to education for EU citizens. Legislation was adopted in September 2011 clarifying access for EEA citizens to loans from the Icelandic Student Loan Fund and introducing a general residence requirement for beneficiaries.

Iceland continued to take part in several EU programmes, including Lifelong Learning, Youth in Action and Erasmus Mundus. It also continued to participate in the European Centre for the Development of Vocational Training and appointed representatives to take part as observers in the Advisory Committee on Vocational Training. The Ministry of Education, Science and

Culture continued to work on streamlining procedures and achieving full compliance with the programme management requirements for the Lifelong Learning and Youth in Action Programmes. Iceland has shown interest in participating in the Europe for Citizens Programme.

A comprehensive national qualifications framework, based on learning outcomes, has been developed at university level. This framework is based on the European Qualification Framework (EQF).

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 and continued to participate in several EU programmes on education and culture.

4.27. Chapter 27: Environment and climate change

Iceland's policy in this field is to a large extent in line with the *acquis* due to its EEA membership.

In the area of **environment**, regarding *horizontal legislation*, a law designed to transpose the Environmental Liability Directive was adopted in June 2012. The Law includes provisions on damage to protected species and nature conservation areas as defined by Icelandic law.

The Aarhus Convention was ratified in October 2011. Amendments were made to existing legislation on the duty of the government to provide information on the environment. The government is from now on always responsible for informing, on its own initiative, the public of imminent danger caused by pollution or significant changes in the environment. Transposition of the Environmental Crime Directive is still pending.

Amendments to the environmental impact assessment legislation are under preparation. The proposed 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 *acquis*. Work is ongoing to align with the National Emissions Ceilings Directive.

Waste management legislation is to a large extent in line with the *acquis*. No new developments can be reported in this area.

No progress can be reported in the field of *water quality*. A regulation on bathing water exists but it is not completely in line with the Directive. Alignment with the Marine Strategy Framework Directive and the Floods Directive has yet to be achieved.

As regards *nature protection*, Iceland continued the work on mapping habitat types in the 60% of the territory that remains to be mapped, and on other tasks needed for the selection of preliminary sites for the Natura 2000 network. No legislative or implementing measures can be reported to align with the *acquis* on protection of whales, wild birds and conservation of natural habitats and wild fauna and flora or with the trade ban on imports of seal products into the EU.

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

As regards *chemicals*, the Regulation on the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH) is being implemented and work is on track. No developments can be reported as regards ratification of the Rotterdam Convention.

Iceland lost an EFTA court case brought by the EFTA Surveillance Authority for failing to address the problem of road *noise*, as required by the Environmental Noise Directive, and has handed in noise maps for major roads in June 2012 as required by the court.

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.

Regarding **climate change**, Iceland continued to make steady progress. The EU and Iceland strengthened cooperation in the international context. Iceland submitted in May its provisional quantified emission limitation and reduction objective (QELRO) for the second commitment period under the Kyoto Protocol, which is based on the understanding that it will be fulfilled jointly with the EU and its Member States, in accordance with Article 4 of the Kyoto Protocol. Furthermore, Iceland regularly associated itself with EU positions and also continues to fulfil its reporting obligations under the United Nations Framework Convention on Climate Change and the Kyoto Protocol.

Legislation on climate was adopted in June 2012 to align with the revised EU Emissions Trading System (EU ETS), as well as provide the legal basis to adopt a National Climate Action Plan and set up a Climate Fund. Alignment with EU ETS related *acquis* regarding auctioning, registries, monitoring and reporting has yet to be achieved.

In so far as the EU Monitoring Mechanism is concerned, Iceland made good progress towards compliance, although some adjustments are still needed, especially with regard to the compilation and reporting of data for the greenhouse gas (GHG) inventory.

As regards fuel quality, Iceland still needs to align with the Directive on specifications for fuels. Regarding emissions from road transport, preparations for the implementation of the EU Regulation on emission standards for new cars and vans are under way.

Steps were taken to align with EU legislation on fluorinated gases and ozone depleting substances. Iceland still needs to align with the Directive on the geological storage of carbon dioxide.

Regarding **administrative capacity**, the Ministry of the Environment has increased its staff by three during the reporting period. The Icelandic Institute of Natural History has hired an extra four staff for three years. However, in the field of climate change no developments to strengthen the administrative capacity took place during the reporting period.

Conclusion

Overall, Iceland's policy is to a large extent in line with the *acquis* in this chapter, due to its EEA membership, and there has been further progress. Institutional structures are mostly in place. Compliance with the *acquis* on nature protection has not been achieved, in particular with regard to the protection of whales, seals and wild birds and the conservation of natural habitats and of wild fauna and flora. The same applies to the water sector, with special reference to alignment with the Marine Strategy Framework Directive and the Floods Directive. Further steps are also needed as regards climate change, in particular in the areas of the EU ETS (registries, auctioning, monitoring and reporting), fuel quality as well as geological storage of carbon dioxide. Iceland also needs to ratify the Espoo and Rotterdam Conventions.

4.28. Chapter 28: Consumer and health protection

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

There has been some progress in the area of **consumer protection**. A committee within the Ministry of the Interior is reviewing consumer protection issues with a view to simplifying procedures for consumers and establishing a one-stop shop.

Concerning *product safety related issues*, alignment with the Commission Decision on banning products containing biocide dimethylfumarate has been completed. Alignment with the *acquis* on general product safety, on dangerous imitations and on liability for defective products has yet to be achieved. The RAPEX early notification system has become more efficient, with an improved notification procedure. Furthermore, the rules regarding the access of national surveillance authorities to the RAPEX system were amended in February 2012 giving all relevant Icelandic supervisory authorities access to RAPEX. Proactive market surveillance needs to be strengthened.

As regards *non-safety related issues*, the parliament has yet to adopt legislation aligning with the Directive on credit agreements for consumers and the Directive on timeshares. Legislative initiatives are also needed in areas such as unfair contract terms, injunctions, distance selling, doorstep selling, misleading and comparative advertising and unfair commercial practices.

Some progress can be reported in the field of **public health**. Preparations have started for the National Health Plan 2015, which will replace the Health Plan 2010.

On *tobacco control*, a national policy on tobacco prevention is under preparation. The National Hospital and the Directorate of Health have signed a cooperation agreement which includes the roll-out of a tobacco control strategy at the hospital.

In the area of *communicable diseases* a list of diseases covered by the EU surveillance system has been published.

In the field of *blood, tissues, cells and organs*, alignment with the Directive regarding the maximum pH values for platelets concentrates at the end of shelf life has been achieved. Alignment with the *acquis* on organs, on guidelines concerning the conditions of inspections and control measures, and on the training and qualification of officials still has to be achieved.

Alignment with the *acquis* on *patients' rights in cross-border healthcare* is yet to be completed.

Promotion of community-based *mental health* services is similar to that of EU Member States.

Preparations have started to develop a National Cancer Plan. The colorectal *cancer screening* programme remains to be implemented.

Conclusion

Iceland has already achieved a high level of alignment and applies a substantial part of the *acquis* on consumer and health protection. Further progress can be reported in the field of public health. Additional efforts to align with the *acquis* are necessary, especially in the area of consumer protection, where certain transposition gaps remain.

4.29. Chapter 29: Customs union

Iceland applies to a large extent the *acquis* in the area of customs union.

There have been no further developments in the area of **customs legislation**. The gaps in transposition of the EU Customs Union *acquis*, which include the customs tariff, general

customs rules, rules of origin, procedures with economic impact, security rules and the abolition of customs fees, have still to be addressed. Preparations in this area are ongoing.

Progress can be reported regarding **administrative and operational capacity**. Following recommendations resulting from the Blueprints exercise, a Business Strategy is currently being drafted. Work on an IT Strategy started in spring 2012 and initial steps have been taken with regard to developing the IT systems. This included further study trips, workshops and training. A budget has been set aside for the preparation of the transit and tariff customs systems project and a number of specialists have been recruited. Training in the areas of the structure, decision-making processes and functions of the Customs Union and customs legislation is ongoing.

A law amending the rules related to the customs school was issued in January 2012. The required minimum education for being hired to certain positions in the customs area has been raised. Preparations in this area are moderately advanced.

Conclusion

Iceland applies to a large extent the *acquis* in the area of customs union. Some progress has been made in the area of customs union. Discrepancies, in particular in the fields of customs rules, rules of origin, procedures with economic impact, security rules and the abolition of customs fees, have still to be addressed. Preparations for effective implementation of the *acquis* upon accession have been initiated, in particular regarding customs procedures and the development of interconnectivity with the EU-related IT systems. Nevertheless, efforts to address the existing gaps as regards customs legislation and administrative capacity, including IT, need to be stepped up.

4.30. Chapter 30: External relations

Iceland is already highly aligned in the area of external relations.

With regard to the **common commercial policy**, Iceland continued to assess the adjustments required in order to align with the *acquis*. With regard to the World Trade Organisation (WTO), Iceland and the EU have agreed to hold regular trade policy consultations.

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 still being processed. No new developments can be reported with regard to joining the Kimberley process.

As regards **bilateral agreements with third countries**, negotiations continued on a bilateral free-trade agreement (FTA) on goods and services with China. In the context of EFTA, Iceland ratified FTAs with Montenegro, Hong Kong and the Cooperation Council for the Arab States. FTA negotiations are ongoing with Bosnia and Herzegovina, central American countries (Guatemala, Honduras, Costa Rica and Panama), India, Indonesia, Algeria and Vietnam, along with negotiations for a joint agreement with Russia, Belarus and Kazakhstan. Negotiations on bilateral investment treaties are ongoing with Turkey.

As regards **development policy**, development aid in 2011 amounted to 0.21% of GNI. Iceland is pursuing the strategy for development cooperation for the years 2011-2014 that it adopted last year. An agreement was signed between the United Nations University (UNU) and the Icelandic National Energy Authority extending cooperation with regard to the UNU Geothermal Training Programme (UNU-GTP). Iceland started a cooperation partnership with the World Bank and six east African countries in the field of geothermal energy. Iceland also funded a new hospital in Malawi.

With regard to **humanitarian aid** Iceland spent in 2011 8.4% of its official development assistance on humanitarian and emergency assistance, compared to 9% in 2010.

Conclusion

Iceland is already highly aligned with the *acquis* in this area and some further progress can be reported as regards external relations. Some progress can be reported with regard to the WTO, as Iceland and the EU have agreed to hold regular trade policy consultations.

4.31. Chapter 31: Foreign, security and defence policy

Iceland has already reached a high level of alignment in this policy area.

The regular **political dialogue** between the EU and Iceland continued to cover foreign policy issues. Iceland has been showing particular interest in an active dialogue focusing on the Arab Spring, with the situation and developments unfolding in Syria and Iran. Given its geographical position, Iceland continued playing an active role in Arctic affairs.

As regards the **common foreign and security policy (CFSP)**, during the reporting period Iceland aligned itself, when invited, with 64 out of 70 relevant EU declarations and Council decisions (91% alignment). Non-alignment is largely due to technical reasons, as in several of the cases implementing regulations are already in place.

In September 2011, the parliament adopted a resolution calling on the Minister for Foreign Affairs to set up a cross-party committee of parliamentarians tasked with drafting a national security policy for Iceland. The policy needs to be based on the fact that Iceland has no armed forces, while taking into account the Risk Assessment Report for Iceland of 2009, the United Nations Charter and other international commitments entered into by Iceland. The committee was appointed in January 2012 and convened its first meeting in February. The committee is expected to present its proposals to the Minister for Foreign Affairs by November 2012.

There has been no progress in establishing and filling the post of European Correspondent. The Director-General for International and Security Affairs in the Ministry of Foreign Affairs continues to act as the Political Director.

With regard to *restrictive measures*, Iceland adopted the relevant decisions to implement most restrictive measures introduced by the Council Decisions. There has been no progress concerning implementation of 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* and *non-proliferation* and the strategy on weapons of mass destruction/small arms and light weapons.

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, the Barents Euro-Arctic Council, the Northern Dimension, the Nordic Council of Ministers and the West Nordic Council. Iceland actively supported the call on the governments of the Nordic countries to draw up a strategy for cooperation on the Arctic under the auspices of the Nordic Council. It supports the EU's application for permanent observer status in the Arctic Council. Iceland has also launched an initiative to define the common interests of Iceland, Greenland and the Faroe Islands in the area of climate change and global warming.

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 is currently not

participating in any EU civilian or crisis management missions. Responsibility for defence, security and NATO matters remains with the Ministry of Foreign Affairs, whereas responsibility for managing the tasks of the former Defence Agency now falls under the Ministry of the Interior.

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. It further advanced the agenda on Arctic affairs given its clear objective to play an active part in regional organisations in northern Europe and the Arctic region.

4.32. Chapter 32: Financial control

Iceland is partly in line with international standards and EU best practices in the field of financial control.

There has been some progress in the area of **public internal financial control (PIFC)**. A detailed PIFC gap assessment was finalised in January 2012. A comprehensive law revising budgetary procedures, including PIFC is under preparation. A PIFC policy paper, including deliverables and timeframes for actions, still needs to be prepared. Internal audit in the public sector remains to be systematically introduced. Preparations in this area are ongoing.

Good progress can be reported in the area of **external audit**. External audit has been separated from internal audit, as the Icelandic National Audit Office (INAO) ceased all internal audit-related activities at the end of 2011. A strategic development plan for external audit is currently being drafted. Full alignment with the standards of the International Organization of Supreme Audit Institutions (INTOSAI) is yet to be achieved, including immunity from prosecution for the Auditor General and INAO staff. Preparations in this area are well on track.

No progress can be reported in the area of **protection of the EU's financial interests**. Iceland's legislation needs to be further aligned 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 the protection of the EU's financial interests. Preparations in this area are ongoing.

There has been little progress in the area of **protection of the euro against counterfeiting**. The Geneva Convention for the suppression of counterfeiting currency is being translated into Icelandic with a view to being ratified. Overall preparations in this field are on track.

Conclusion

Overall, Iceland's financial control system is partly in line with international standards and EU best practices and preparations in this chapter are ongoing. Work needs to continue on preparing the PIFC policy paper, establishing internal audit, ensuring compliance with INTOSAI standards in the area of external audit and protecting the EU's financial interests.

4.33. Chapter 33: Financial and budgetary provisions

Iceland is partially aligned with the *acquis* in the field of financial and budgetary provisions.

There has been no progress as regards **traditional own resources (TOR)**. Appropriate procedures and systems for accounting for TOR and making them available still have to be put in place, in particular as regards the 'A' and 'B' accounts. The system for writing off irrecoverable debts remains to be amended and post-clearance auditing on traders' premises further developed.

There is no development to be reported regarding the preparations for the application of the own resources system (OWNRES). The basic principles and institutions for the policy areas indirectly affecting the OWNRES continue to function well. The information requirements of the OWNRES need to be reviewed and procedures set up to communicate cases of fraud and irregularity to the Commission.

A guarantee system for customs duties incurred on release of goods for free circulation with deferred payment facilities needs to be introduced to protect the EU's financial interests. The customs clearance declaration processing system (CDPS) will have to be further developed to make it compatible with EU systems.

There have been no developments in the area of the **VAT resource**, where Iceland will need to develop the capacity to accurately calculate the weighted average rate and the positive and negative corrections to the intermediate VAT base.

There has been some progress as regards the **Gross National Income (GNI) resource**, where Iceland is already well aligned with the *acquis* and widely applies the ESA 95 standards. Remaining shortcomings in the application of ESA 95 are being addressed by means of an action plan with related timetable.

Little progress can be reported in the area of **administrative infrastructure**. Iceland needs to set up the operational management of the own resources system (OWNRES) at national level and apply the EU own resources rules. Coordination and cross-institutional cooperation still has to be initiated to prepare for the application of the EU funding rules. An action plan to develop an adequate level of administrative capacity needs to be established by the Icelandic Ministry of Finance.

Conclusion

Overall, Iceland has a good level of alignment in the policy areas underlying and affecting financial and budgetary provisions. There has been no further progress on this chapter during the reporting period. A coordination unit needs to be formally set up to steer and streamline pre-accession preparations and working procedures need to be established. The various institutions to be involved in the OWNRES need to be designated and their tasks and responsibilities defined.

Statistical Annex

STATISTICAL DATA

Iceland

Basic data							
	Note	2001	2007	2008	2009	2010	2011
Population (thousand)		283	308	315	319	318	318
Total area of the country (km ²)		103 000	103 000	103 000	103 000	103 000	103 000
National accounts							
	Note	2001	2007	2008	2009	2010	2011
Gross domestic product (GDP) (million national currency)		771 894	1 308 530	1480 346	1497 639	1536 512	1 626 335
GDP (million euro)		8 823	14 938	11 614	8 673	9 491	10 075
GDP (euro per capita)		31 136	48 550	36 817	27 158	29 881	31 637
GDP (in Purchasing Power Standards (PPS) per capita)		26 293	30 533	31 245	27 664	27 210	27 672
GDP per capita in PPS (EU-27 = 100)		132	121	123	118	111	110
Real GDP growth rate (growth rate of GDP volume, national currency, % change on previous year)		3.9	6.0	1.2	-6.6	-4.0	2.6
Employment growth (national accounts, % change on previous year)		:	:	:	:	:	:
Labour productivity growth: GDP growth per person employed (% change on previous year)		2.2	1.4f	0.5f	-0.8f	-3.7f	3.0f
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)		104.0	96.5f	100.9f	100.1f	93.6f	:
Gross value added by main sectors (%)							
Agriculture and fisheries	1) 2)	8.8	5.3	6.0	7.1	7.8	:
Industry	1)	19.0	14.5	17.7	18.1	19.0	:
Construction	1)	8.4	11.6	9.0	4.9	4.5	:
Services	1)	63.9	68.6	67.3	69.9	68.7	:
Final consumption expenditure, as a share of GDP (%)		79.8	81.7	78.2	77.5	77.4	77.2
Gross fixed capital formation, as a share of GDP (%)		21.5	28.5	24.4	13.8	12.8	14.0
Changes in inventories, as a share of GDP (%)		-0.3	0.5	0.2	0	-0.2	0.3
Exports of goods and services, relative to GDP (%)		38.8	34.6	44.4	52.8	56.3	59.3
Imports of goods and services, relative to GDP (%)		39.9	45.3	47.2	44.2	46.2	50.8
Industry							
	Note	2001	2007	2008	2009	2010	2011
Industrial production volume index (2005=100)		95.5	107.9	124.5	121.3	119.0	126.5
Inflation rate							
	Note	2001	2007	2008	2009	2010	2011
Annual average inflation rate (CPI, % change on previous year)		6.7	5.0	12.4	12.0	5.4	4.0
Balance of payments							
	Note	2001	2007	2008	2009	2010	2011
Balance of payments: current account total (million euro)		-381	-2 351	-2 853	-1 013	-758	-719
Balance of payments current account: trade balance (million euro)		-68	-1 004	-52	523	743	600
Balance of payments current account: net services (million euro)		-18	-502	-219	209	210	223
Balance of payments current account: net income (million euro)		-285	-800	-2 554	-1 693	-1 658	-1 490
Balance of payments current account: net current transfers (million euro)		-11	-44	-27	-51	-53	-53
of which government transfers (million euro)		-13	-41	-31	-32	-34	-31
Net foreign direct investment (FDI) (million euro)		-192	-2 458	3 537	-1 580	1 966	819
Foreign direct investment (FDI) abroad (million euro)		386	7 448	-2 904	1 641	-1 780	-91
of which FDI of the reporting economy in EU-27 countries (million euro)		-224	-4 018	1 885	-1 740	1 446	-
Foreign direct investment (FDI) in the reporting economy (million euro)		194	4 990	633	61	186	728
of which FDI of EU-27 countries in the reporting economy (million euro)		41	6 003	423	607	176	-
Public finance							
	Note	2001	2007	2008	2009	2010	2011
General government deficit/surplus, relative to GDP (%)		-0.7	5.4	-13.5	-10.0	-10.1	-4.4
General government debt relative to GDP (%)		42.0	27.2	52.8	84.4	97.8	102.7e
Financial indicators							
	Note	2001	2007	2008	2009	2010	2011
Gross foreign debt of the whole economy, relative to GDP (%)	7)	112.7	245.8	168.1	220.4	218.5	232.5
Gross foreign debt of the whole economy, relative to total exports (%)		-0.7	5.4	-13.5	-10.0	-10.1	-4.4
Money supply: M1 (banknotes, coins, overnight deposits, million euro)		811	4 688	4 257	2 976	3 074p	3 099p
Money supply: M2 (M1 plus deposits with maturity up to two years, million euro)		1 672	7 399	8 494	5 859	5 717p	6 192p
Money supply: M3 (M2 plus marketable instruments, million euro)		3 922	14 053	12 758	9 316	8 950p	9 622p

Total credit by monetary financial institutions to residents (consolidated) (million euro)	3)	:	36 359	15 410	9 724	10 527	10 999p
Interest rates: day-to-day money rate, per annum (%)	4)	13.1	14.0	18.3	9.0	4.6	4.3
Lending interest rate (one year), per annum (%)	4)	12.0	15.3	22.0	11.5	5.5	5.8
Deposit interest rate (one year), per annum (%)	4)	6.7	13.3	15.0	8.5	3.5	3.8
euro exchange rates: average of period - 1 euro = ... national currency	5)	87.490	87.600	127.460	172.670	161.890	161.424
Effective exchange rate index (2005=100)		135.0	120.2	216.4	232.8	208.0	217.3
Value of reserve assets (including gold) (million euro)		400	1 771	2 533	2 696	4 322	6 606

External trade	Note	2001	2007	2008	2009	2010	2011
Value of imports: all goods, all partners (million euro)		2 536.0	4 881.0	4 167.0	2 583.0	2959.0	3477.0
Value of exports: all goods, all partners (million euro)		2 247.0	3 479.0	3 650.0	2 908.0	3478.0	3839.0
Trade balance: all goods, all partners (million euro)		-289.0	-1 403.0	-517.0	324.0	519.0	362.0
Terms of trade (export price index / import price index)		102.5	101.0	94.8	84.3	92.4	90.7
Share of exports to EU-27 countries in value of total exports (%)		70.0	74.6	75.9	77.6	77.4	78.3
Share of imports from EU-27 countries in value of total imports (%)		58.9	60.1	54.0	51.9	52.0	46.0

Demography	Note	2001	2007	2008	2009	2010	2011
Natural growth rate: natural change (births minus deaths) (per 1000 inhabitants)		8.3	8.4	9.0	9.5	9.1	7.9
Infant mortality rate: deaths of children under one year of age per 1000 live births		2.7	2.0	2.5	1.8	2.2	0.9
Life expectancy at birth: male (years)		78.3	79.6	80.0	79.8	79.8	79.9
Life expectancy at birth: female (years)		83.2	83.4	83.3	83.8	84.1	83.6

Labour market	Note	2001	2007	2008	2009	2010	2011
Economic activity rate (20-64): share of population aged 20-64 that is economically active (%)		89.9	88.1	87.3	86.2	86.2	86.1
* Employment rate (20-64): share of population aged 20-64 in employment (%)		88.6	86.7	85.3	80.6	80.3	80.6
Employment rate male (20-64) (%)		93.1	91.5	89.9	83.2	83.1	83.3
Employment rate female (20-64) (%)		83.8	81.4	80.4	77.8	77.6	77.9
Employment rate of older workers (55-64): share of population aged 55-64 in employment (%)		86.1	84.7	82.9	80.2	79.8	79.2
Employment by main sectors (%)							
Agriculture		7.3	5.8	4.6	4.8	5.5	5.3
Industry		16.0	11.9	12.4	12.0	11.7	12.3
Construction		7.2	9.1	9.9	7.1	6.3	6.0
Services		69.6	73.3	73.1	76.1	76.5	76.3
Unemployment rate: share of labour force that is unemployed (%)		1.9	2.3	2.9	7.2	7.6	7.0
Share of male labour force that is unemployed (%)		1.6	2.2	3.2	8.6	8.3	7.8
Share of female labour force that is unemployed (%)		2.2	2.3	2.6	5.7	6.7	6.2
Unemployment rate of persons < 25 years: share of labour force aged <25 that is unemployed (%)		5.1	7.0	8.2	15.9	16.2	14.4
Long-term unemployment rate: share of labour force that is unemployed for 12 months and more (%)		:	0.2	0.1	0.4	1.3	1.7

Social cohesion	Note	2001	2007	2008	2009	2010	2011
Average nominal monthly wages and salaries (national currency)		249 000.0	414 000.0	446 000.0	433 000.0	446 000.0	474 000.0
Index of real wages and salaries (index of nominal wages and salaries divided by the CPI/HICP) (2000=100)		103.7	133.9	128.3	111.2	108.7	111.1
* Early school leavers - Share of population aged 18-24 with at most lower secondary education and not in further education or training (%)		30.9	26.3	27.6	23.4	25.9	23.1

Standard of living	Note	2001	2007	2008	2009	2010	2011
Number of passenger cars per 1000 population		:	:	:	:	:	:
Number of subscriptions to cellular mobile telephone services per 1000 population		875.2	1 059.6	1 068.3	1 095.9	1 180.6	1 212.1

Infrastructure	Note	2001	2007	2008	2009	2010	2011
Density of railway network (lines in operation, per 1000 km ²)		-	-	-	-	-	-
Length of motorways (km)		:	:	:	:	:	:

Innovation and research	Note	2001	2007	2008	2009	2010	2011
Spending on human resources (public expenditure on education in % of GDP)		7.0	7.4	7.6	7.8	7.6	7.2
* Gross domestic expenditure on R&D in % of GDP		3.0	2.7	2.3	3.1	:	:
Percentage of households who have Internet access at home (%)		:	84.0	88.0	90.0	92.0	93.0

Environment	Note	2001	2007	2008	2009	2010	2011
* Greenhouse gas emissions, CO2 equivalent (tons, 1990=100)		108.8	130.6	141.6	134.2	129.7	:
Energy intensity of the economy (kg of oil equivalent per 1000 euro GDP)		342.6	:	:	:	:	:
Electricity generated from renewable sources in % of gross electricity consumption		100.0	100.0	100.0	100.0	100.0	100.0
Road share of inland freight transport (% of tonne-km)		:	:	:	:	:	:

Energy	Note	2001	2007	2008	2009	2010	2011
Primary production of all energy products (thousand TOE)		2 451	3 946	4 397	4 819	:	:
Primary production of crude oil (thousand TOE)		0	0	0	0	0	0
Primary production of hard coal and lignite (thousand TOE)		-	-	-	-	-	-
Primary production of natural gas (thousand TOE)		-	-	-	-	-	-
Net imports of all energy products (thousand TOE)		947	:	:	:	:	:
Gross inland energy consumption (thousand TOE)		3 397	4 912	5 235	5 645	5 588	5 624
Electricity generation (thousand GWh)		8.0	12.0	16.5	16.8	17.1	17.2

Agriculture	Note	2001	2007	2008	2009	2010	2011
Agricultural production volume index of goods and services (producer prices, previous year=100)		:	:	:	:	:	:
Total utilised agricultural area (thousand hectare)	6)	1326e	1332e	1334e	1335e	1336p	1336p
Livestock: cattle (thousand heads, end of period)		70	71	72	73	74	74
Livestock: pigs (thousand heads, end of period)		5	4	4	4	4	4
Livestock: sheep and goats (thousand heads, end of period)		474	455	458	470	480	476
Production and utilisation of milk on the farm (total whole milk, thousand tonnes)		c	c	c	c	c	c
Crop production: cereals (including rice) (thousand tonnes, harvested production)		4	11	15	17	13	10p
Crop production: sugar beet (thousand tonnes, harvested production)		-	-	-	-	-	-
Crop production: vegetables (thousand tonnes, harvested production)		:	5	5	5	5	6

: = not available

- = not applicable

p = provisional

f = forecast

e = estimated value

b = break in series

c = confidential value

* = 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) 2000 - 2009, data according to Nace Rev. 1.1.

2) 2000 - 2009, fishing (predominantly marine fishing) represents 77% (in 2008) of this share.

3) 2007 - 2011, lending of DMBs to residents and loans of Central bank to Non-bank institutions.

4) Year average.

5) 2001 - 2010, average annual exchange rate and end of period exchange rate as published by the Central Bank of Iceland (midrate).

6) Based on preliminary results from the Farm structure survey (FSS).

7) Figures from 2011 data collection corrected as they were given in thousand EUR instead of million EUR.