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# Controlling Public Spending in Iceland

**Hannes Suppanz**

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by  
**Hannes Suppanz**

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## ABSTRACT/RÉSUMÉ

This paper analyses the main features of Iceland's public expenditure and addresses some key policy issues. While overall public spending is not high compared with Iceland's Nordic neighbours, other OECD countries have made more progress in reining it in. Budget consolidation efforts and public-sector reforms temporarily reversed the upward trend in the government expenditure-to-GDP in the 1990s, but since then the ratio has edged up again. This highlights the need for enhancing spending control through further reforms. Indeed, although the expenditure management system has undergone significant changes over the past ten years or so, much remains to be done to increase budgetary discipline and improve the system's ability to contain social-spending pressures, which will intensify as the population ages. In particular, weaknesses that need to be addressed would seem to relate to the budget process and the lack of a medium-term expenditure policy, along with insufficient performance management and poor accountability of public-sector managers.

*JEL classification:* H11, H51, H52, H53, H55, H57, H61, H72.

*Keywords:* Public expenditure, public sector efficiency, public management, budget systems, Iceland.

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Ce document analyse les principales caractéristiques des dépenses publiques en Islande et aborde quelques questions politiques déterminantes. Bien que les dépenses publiques globales ne soient pas élevées comparativement aux pays nordiques voisins de l'Islande, d'autres pays de l'OCDE ont réussi à mieux les maîtriser. Les efforts d'assainissement budgétaire et les réformes du secteur public ont momentanément inversé la tendance ascendante du ratio dépenses publiques/PIB des années 1990, mais depuis lors, ce dernier s'inscrit de nouveau à la hausse. D'où la nécessité de renforcer la maîtrise des dépenses par de nouvelles réformes. Le système de gestion des dépenses a certes été profondément modifié depuis une dizaine d'années, mais il reste encore fort à faire pour renforcer la discipline budgétaire et mieux contenir les pressions exercées par les dépenses sociales, pressions qui vont s'intensifier avec le vieillissement démographique. En particulier, les faiblesses qui appellent des mesures correctives semblent liées au processus budgétaire et à l'absence d'une politique à moyen terme en matière de dépenses, ainsi qu'aux lacunes de l'évaluation des performances et au manque de responsabilisation des gestionnaires du secteur public.

*Classification JEL :* H11, H51, H52, H53, H55, H57, H61, H72.

*Mots clés :* Dépenses publiques, efficacité du service publique, gestion publique, systèmes budgétaires, Islande.

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## CONTROLLING PUBLIC SPENDING IN ICELAND

Hannes Suppanz<sup>1</sup>

### Background

In Iceland, relatively little attention was paid to the size, scope and function of government until the late 1980s, when growth slowed and major fiscal imbalances emerged. Subsequent budget consolidation efforts and public-sector reforms temporarily reversed the upward trend in the public expenditure-to-GDP ratio. But in recent years the ratio has tended to edge up again. And while total public expenditure is not high by international comparison — around the OECD average and below the levels in Iceland's Nordic neighbours — many Member countries have been successful in reducing the size of government over the 1990s. This highlights the need for enhancing spending control through further reforms. Indeed, although the expenditure management system has undergone significant changes over the past ten years or so, much remains to be done to increase budgetary discipline and improve the system's ability to contain social-spending pressures, which will intensify as the population ages. In particular, weaknesses that need to be addressed would seem to relate to the budget process and the lack of a medium-term expenditure policy, along with insufficient performance measurement and poor accountability of public-sector managers, not least at the local-government level.

After setting out past and prospective public expenditure trends in an international context, this paper reviews the success of various reforms that have aimed at improving spending discipline and effectiveness as well as aspects of some of the programmes that absorb a large proportion of government resources. The final section of the paper presents conclusions and policy recommendations.

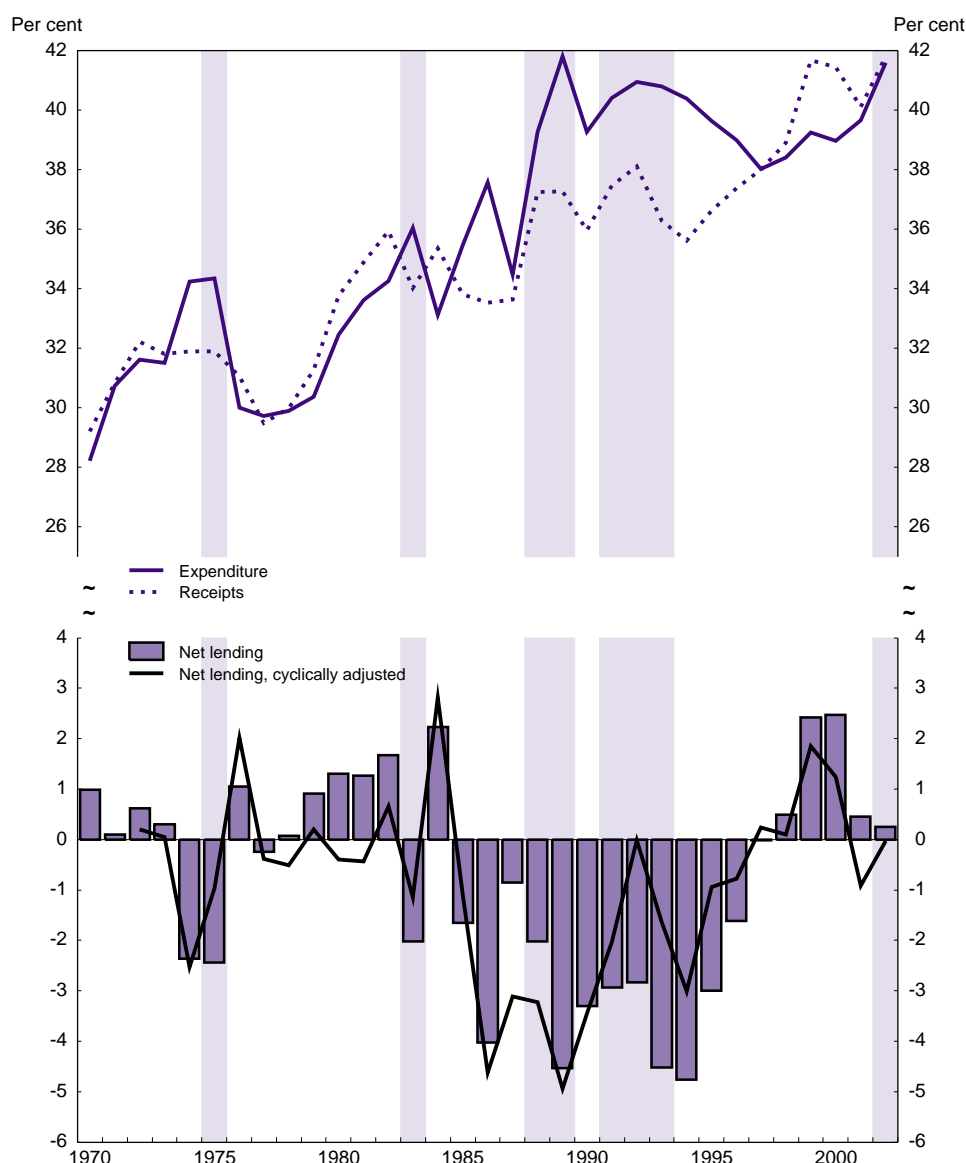
### Public expenditure in perspective

Public expenditure rose gradually from below 30 per cent of GDP at the beginning of the 1970s to around 35 per cent in the mid-1980s (Figure 1). Taking account of cyclical influences, government finances were in broad balance during that period. The situation changed dramatically in the second half of

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1. The author is a member of the OECD Economics Department. This paper was originally produced for the *OECD Economic Survey of Iceland* published in April 2003 under the authority of the Economic and Development Review Committee. The author is indebted to Peter Jarrett, Michael Feiner, Jorgen Elmeskov, Val Koromzay, Andrew Dean and Isabelle Joumard for comments and drafting suggestions, and to the Iceland authorities for their assistance with obtaining the information and clarifications necessary to prepare the paper. Special thanks go to Françoise Correia for invaluable technical assistance with the graphs and to Mee-Lan Frank for expert word processing.

**Figure 1. General government expenditure, receipts and balance<sup>1</sup>**  
Per cent of GDP



1. Shaded areas are recessions.  
Source: OECD and OECD estimates.

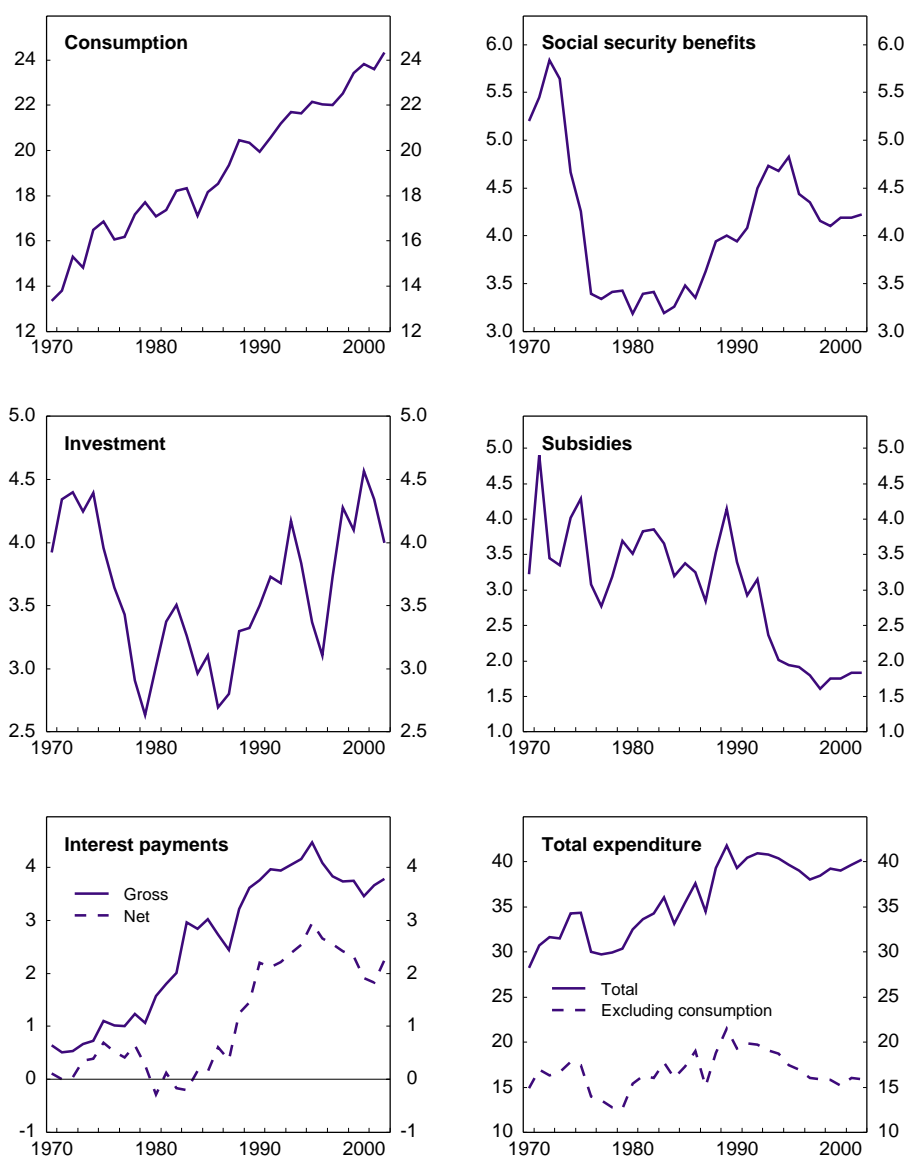
the 1980s, when the expenditure ratio jumped to as high as 42 per cent and the budget moved into substantial deficit. To some extent, this reflected weak economic activity — Iceland has comparatively powerful automatic stabilisers<sup>2</sup> — but discretionary government intervention to arrest the rise in unemployment accounted for the bulk of the deterioration in the fiscal position. Despite continued economic slack, policy makers changed course in the early 1990s, implementing expenditure cutbacks worth nearly 3 per cent of GDP. The public spending ratio reached a low of 38 per cent of GDP in 1997 when the budget deficit was eliminated. Since then, it has moved back to 42 per cent, mostly due to

2. Nordic Council of Ministers (1997), “Fiscal Consolidation in the Nordic Countries”, Copenhagen.

discretionary action. The budget has nevertheless remained in surplus given a substantial increase in the revenue ratio, a trend which has only been arrested recently.

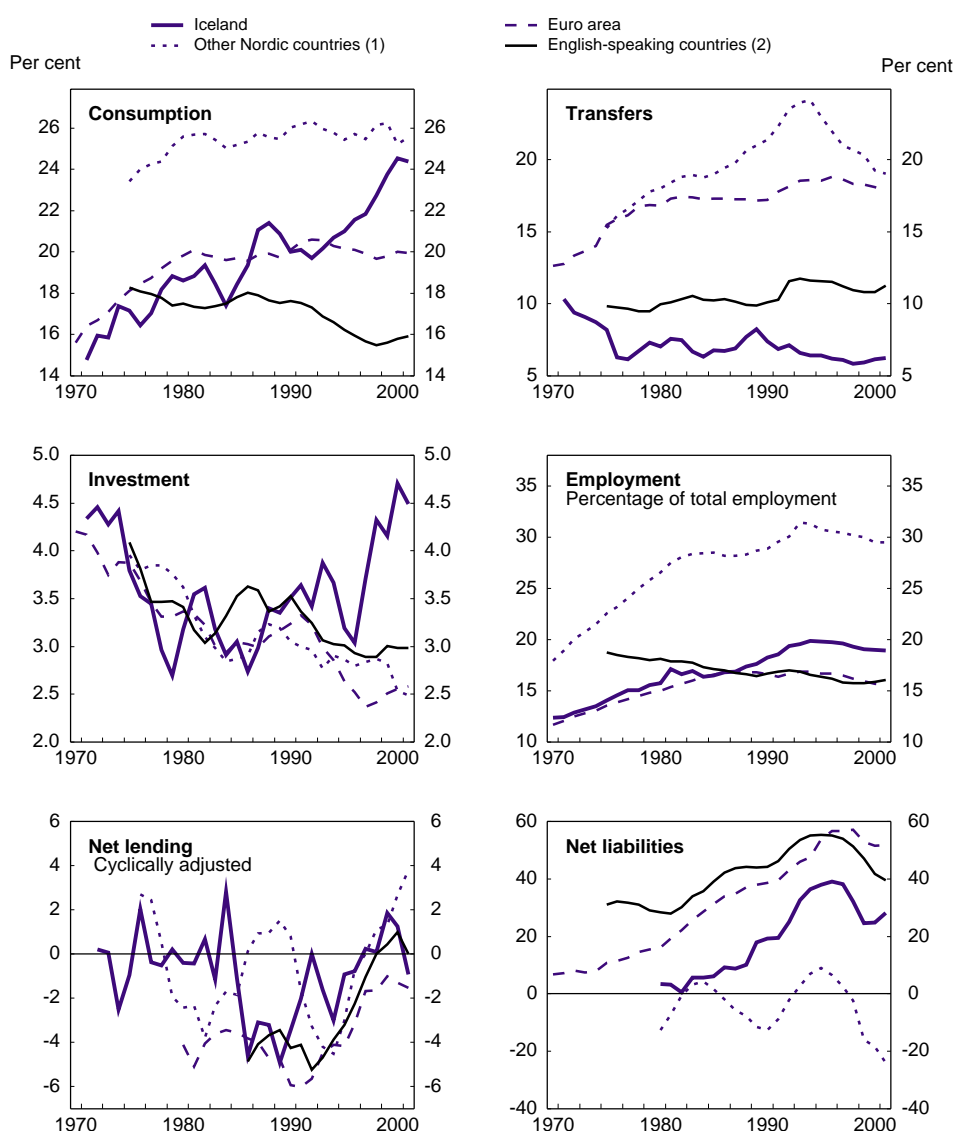
Budget consolidation efforts in the 1990s concentrated on social security benefits and subsidies, while government spending on goods and services was less affected (Figure 2). Public consumption, in particular, continued to rise relative to GDP due to a persistently growing wage bill, largely accounting for the increase in the overall expenditure ratio over the past 30 years. As a result, consumption has approached the high levels recorded in other Nordic countries, although public employment in Iceland (as a proportion of total employment) is not especially high by international comparison (Figure 3 and Box 1). In this regard, it is worth noting that Iceland, despite being a NATO member, has no army and,

**Figure 2. Trends in public expenditure, 1970-2001**  
Per cent of GDP



Source: OECD.

**Figure 3. General government spending by international comparison**  
As a per cent of potential GDP



1. Weighted average (1995 GDP and PPPs) of Denmark, Finland, Norway and Sweden.
2. Weighted average (1995 GDP and PPPs) of Australia, Canada, New Zealand, United Kingdom and United States.

Source: OECD and OECD estimates.

therefore, no defence outlays, which absorb substantial resources elsewhere. On the other hand, the large size of the country relative to its population and cost of preserving a decentralised settlement pattern must not be overlooked. The public investment ratio has been very volatile but exceeded the international average throughout the 1990s, when capital outlays abroad tended to decline relative to GDP. High spending on goods and services is offset, however, by low transfer payments compared with other OECD countries. This, in turn, is attributable to relatively low expenditures on old-age and survivors pensions and sickness and unemployment benefits as a share of GDP (Table 1), reflecting favourable demographics and labour-market conditions but also the move to a funded occupational pension system. In contrast to income transfers, public spending on merit goods (education, health care and services for elderly, disabled and families) is above the OECD average and close to the peak levels recorded in Nordic countries.



**Table 1. Major current government outlays: an international comparison**  
1999,<sup>1</sup> per cent of GDP

	Merit goods					Income transfers							
	Total	Education	Health	Services for elderly and disabled	Family services	Total	Old-age pension	Survivors pension	Disability	Sickness	Family cash benefits	Unemployment	Housing and other benefits
<b>Iceland</b>	<b>16.8</b>	<b>6.5</b>	<b>7.0</b>	<b>2.1</b>	<b>1.1</b>	<b>8.2</b>	<b>3.8</b>	<b>0.5</b>	<b>1.5</b>	<b>0.1</b>	<b>1.2</b>	<b>0.5</b>	<b>0.5</b>
Denmark	18.8	6.8	6.8	3.0	2.2	17.8	6.8	0.0	2.0	0.7	1.5	5.0	1.8
Finland	14.0	5.7	5.3	1.5	1.4	18.3	7.0	1.0	3.1	0.4	1.9	3.9	1.0
Norway	18.6	6.8	7.1	3.4	1.4	15.2	6.0	0.4	2.8	1.5	2.2	1.4	0.9
Sweden	18.6	6.6	6.6	3.7	1.7	18.9	7.5	0.7	2.4	1.1	1.6	3.9	1.7
Belgium	11.4	5.0	6.1	0.1	0.2	18.1	7.3	2.5	1.7	0.4	2.0	3.8	0.3
France	15.0	5.9	7.3	0.7	1.2	19.7	10.6	1.6	1.1	0.5	1.5	3.1	1.3
Germany	13.7	4.4	7.8	0.7	0.8	18.0	10.5	0.5	1.4	0.3	1.9	2.6	0.8
Italy	10.8	4.8	5.5	0.2	0.3	19.1	12.8	2.6	1.0	0.7	0.6	1.4	0.0
Netherlands	12.1	4.5	5.9	1.3	0.4	16.1	6.2	0.8	2.4	1.0	0.8	3.9	1.0
Spain	10.2	4.4	5.3	0.3	0.1	13.9	8.1	0.8	1.3	0.9	0.3	2.2	0.2
United Kingdom	11.6	4.6	5.6	0.8	0.5	17.8	9.8	1.0	2.7	0.1	1.7	0.6	1.8
Canada	12.1	5.5	6.6	..	..	11.2	5.0	0.5	0.9	0.1	0.8	1.4	2.6
Japan	9.8	3.6	5.6	0.3	0.3	8.4	5.7	1.1	0.5	0.1	0.2	0.7	0.2
United States	11.0	4.8	5.8	0.0	0.3	8.2	5.1	0.9	0.9	0.2	0.2	0.4	0.5
EU average <sup>2</sup>	12.8	4.9	6.4	0.7	0.7	17.9	9.9	1.3	1.6	0.5	1.4	2.3	0.9
Mean	12.7	5.1	5.9	1.0	0.8	16.8	8.2	1.3	1.8	0.6	1.4	2.5	0.9
OECD average <sup>2</sup>	11.5	4.7	6.0	0.4	0.4	12.3	7.0	1.1	1.2	0.3	0.8	1.2	0.7
Mean	11.9	5.1	5.8	0.8	0.6	14.4	6.9	1.0	1.7	0.6	1.3	1.8	0.9

1. Or 1998 when not available. Education data always concern 1998.

2. Weighted average based on 1995 GDP and purchasing power parities (PPPs), excluding Korea, Luxembourg, Mexico and the Slovak Republic.

Source: OECD, Social Expenditure Database and OECD, Education at a Glance - OECD indicators, 2001.

### Box 1. The trend increase in Iceland's share of public consumption in GDP

Even among Nordic countries, Iceland stands out as the only country to have experienced a trend rise in the ratio of public consumption to GDP over the past two decades. In 1980, government consumption spending was less than 18 per cent of GDP, similar to Finnish and Norwegian outcomes, but some 10 percentage points below those in Denmark and Sweden. However, by 2001 the situation had shifted: Iceland's ratio had jumped to over 23½ per cent, precisely the average in the other four nations (Figure 4). Indeed, Iceland has become the OECD country with the third highest level of public consumption relative to GDP, up from 11<sup>th</sup> place in 1990 and 16<sup>th</sup> position in 1980.

Looking beyond the aggregate level of such spending, it can be seen that the upward trend is attributable mainly to wage payments to civil servants, although non-wage outlays were also on a rising trajectory until 1995. Elsewhere among the Nordics, the government's wage bill was either falling in relation to GDP (Denmark, Sweden and Finland) or stable (Norway), while the non-wage component was flat, except in the case of Finland.

The ratio of the government wage bill to GDP can be seen as the product of three separate terms: the share of government employment in the total; compensation per employee relative to the economy-wide average; and the share of economy-wide compensation in overall GDP. Growing wage payments reflect a rising government employment share until 1994, rising relative compensation since 1992 (especially in 1997-98)\* and, to a lesser extent, an upward shift in labour's overall income share since 1988. In the other Nordic countries, any tendency for the government's employment share to rise up to 1993-94 (as in Finland and Norway) was partly offset by a fall in relative compensation, a trend that has continued everywhere in stark contrast to Iceland.

By the end of the period the low civil service employment share in Iceland was entirely offset by higher relative compensation. Norway enjoyed low relative compensation and a low aggregate wage share, as well as modest non-wage government consumption, while Finland benefited from a low aggregate wage share and a relative compensation outcome well below Iceland's. It should be noted, however, that high relative compensation does not necessarily imply that public-sector wages are out of line with performance.

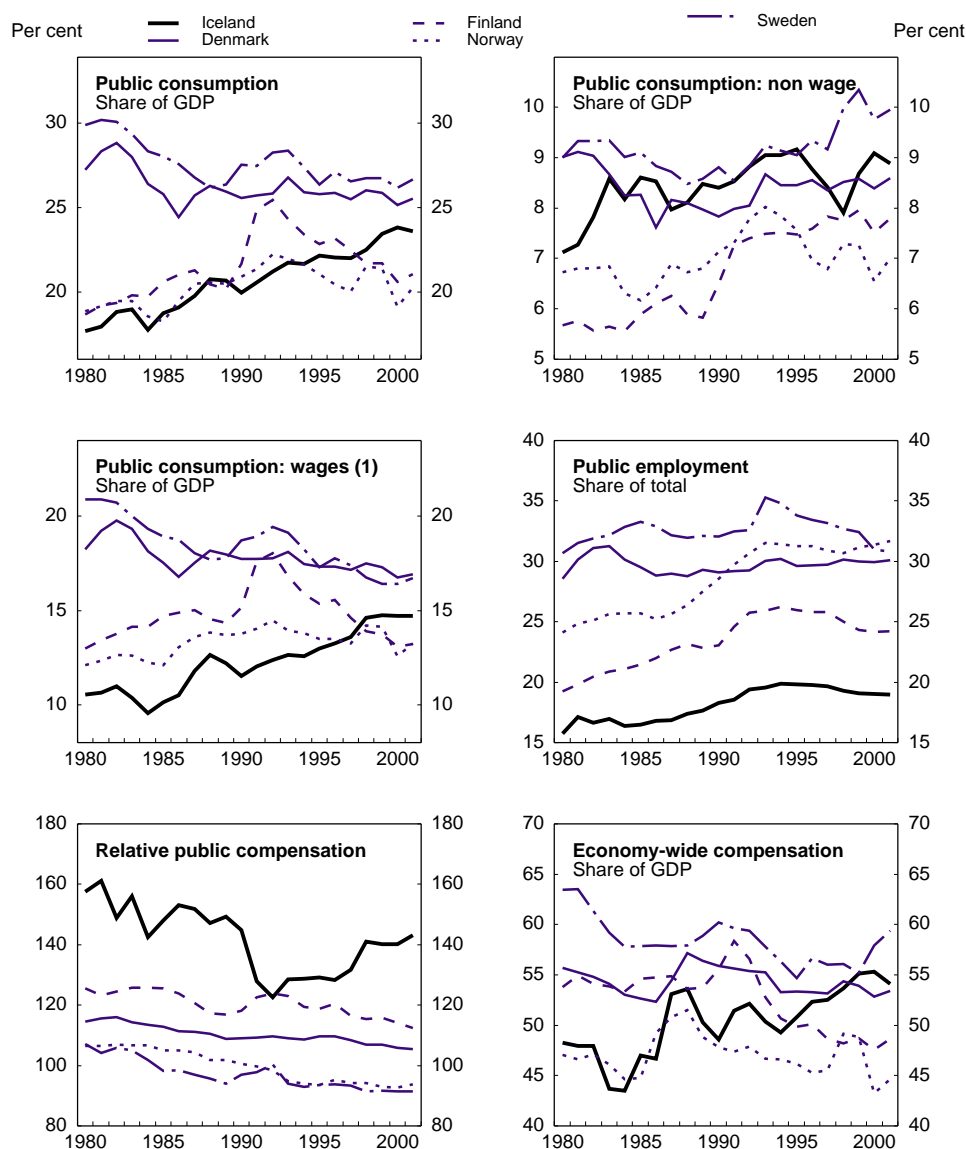
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\* Iceland does not provide total government employment other than on a full-time equivalent basis. Thus, in order to make the cross-country comparisons, this time series was adjusted by the ratio of economy-wide employment on a headcount basis to the same figure in full-time equivalents. This assumes that average hours per person are the same in the two sectors. This will generate misleading results when higher compensation is offered to public employees explicitly to offset longer working hours, as, for example, occurred with teachers in the late 1990s.

Pressures on public spending are likely to intensify in the period ahead. In the near term, major investment projects in power-intensive industries and regional development policies will involve expenditure on infrastructure. New social policy initiatives (such as compensation for paternal leave without an income limit) have proved to be very costly, burdening future budgets. Changes in public-sector management (such as the move to activity-based financing, see below) should promote cost efficiency, but they may also raise the supply of public goods and services above the social optimum, if price signals are not effective. In the long run, upward pressures on social transfers are likely to gain further momentum due to population ageing. Though starting from a rather favourable position, the expected increase in the old-age dependency ratio during the first half of the century is broadly similar to the OECD average. Current arrangements for income support for the elderly (in particular, the increase in the funded occupational pensions) suggest that public pension spending could rise by only half a percentage point of GDP during that period, although it may exceed this level temporarily. This is much less than the projected OECD average of 3 to 4 percentage points. However, the age-related rise in spending on health- and long-term care is likely to be much closer to the OECD benchmark (also 3 to 4 percentage points of GDP; see *e.g.* the *OECD Economic Outlook 72*). Given the fact that privatisation receipts will cease to be a major source of financing and the desirability of arresting the long-term rise in the tax-to-GDP ratio, there is a

clear need to address the longstanding problem of expenditure creep and to strengthen public spending management further.

**Figure 4. Public consumption share in a Nordic context**



1. The wage component of public consumption as a share of GDP can be expressed as the product of three terms: public employment in relation to total employment; relative public compensation per employed person; and economy-wide compensation as a share of GDP. These terms are given in the following charts.  
Source: OECD and OECD estimates.

### Assessing public expenditure policies

Iceland has only two administrative levels of government, the municipalities and the central government. At the central government level, the Prime Minister's Office co-ordinates a few high-priority activities (such as privatisation, regulatory reform and policies related to the information society), but the

Ministry of Finance has in practical terms been most involved in policy co-ordination, and public-sector reforms have tended to reinforce this role. As in Sweden, each ministry has jurisdiction over a number of agencies. There are currently around 230 executive agencies (nearly one agency per 1 000 inhabitants), and almost half of them have less than 20 employees. The central government, including agencies, accounts for about half of government employment and around three-quarters of general government spending (reflecting an above-average share of transfers).

For about a decade, it has been the government's policy to make the public sector a purchaser of services on behalf of the taxpayers rather than a provider of goods and services and of employment. This has been reflected in a privatisation programme, which is now largely completed. At the same time, various initiatives have been taken to reform the public sector, which have aimed at decentralising decision-making, improving the performance of government agencies and increasing the accountability of public servants. As to expenditure policies proper, they include the introduction of "frame-budgeting" (see below), new rules on budget execution and monitoring, improved financial reporting and increased emphasis on performance management and measurement.

A comprehensive assessment of how well existing frameworks and policies have performed in ensuring or encouraging good spending outcomes is difficult both because of the scarcity of relevant indicators and the recent or ongoing nature of the implementation of some reforms, which partly explains the lack of national evaluation. The following section attempts, nonetheless, to identify areas where apparent weaknesses would seem to deserve further attention and possibly policy measures. To this end, it reviews, in turn: the budget process; performance and human-resource management; the use of market mechanisms; problems specific to local government; and social spending, which accounts for the bulk of overall expenditure and is rising rapidly.

### ***Budgeting***

Over the past ten years or so, the budget process has undergone substantial changes, with a view to enhancing the control and effectiveness of public spending. "Frame-budgeting" has been applied since 1992. This system entails a "top-down" approach in preparing the budget and is meant to enhance the policy-making role of the government and increase overall fiscal discipline. Its main feature is that expenditure frames (ceilings) are set for each ministry early on in the budget formulation phase (that is, in April of the preceding year). Each minister is then responsible for allocating available funds to agencies and projects under his/her auspices, in accordance with the limits set by the frame. The so-called "frame-decision" is made by a special committee, which consists of the Prime Minister, the Minister of Finance and two other ministers (usually the leaders and vice-chairmen of the coalition partners). It is preceded by a decision on the overall fiscal target (in recent years, a budget surplus), which determines the aggregate level of expenditure on the basis of economic and budget projections prepared, and policies proposed, by the Minister of Finance. The latter also makes recommendations about the allocation of funds to new projects or increased levels of operations in the light of prioritised proposals submitted by the line ministries. After a re-evaluation of economic prospects and government revenue estimates in August, a draft budget is presented to Parliament at the beginning of October, and, following amendments, the final vote on the budget for the coming year takes place in December.

"Frame-budgeting" has been supplemented by other changes aimed at promoting the efficient use of government appropriations and containing the rise in spending. As of 1992, some flexibility was introduced regarding the treatment of year-end surpluses and deficits by defining how, and to what extent, they may be carried over into the next fiscal year. Agencies are thus in a better position to plan on a longer-term basis, instead of being compelled to spend available funds under an end-of-year deadline. Conversely, overspending can be transferred as debt to the following fiscal year with the consequent

reduction in disposable funds. A new regulation issued by the Ministry of Finance in 2000 aims to tighten spending control further by making it obligatory for agencies to report to the relevant ministry whenever expenditure has exceeded the target by 4 per cent in a given period. It also clarifies under what circumstances budget overruns could be considered unavoidable.

Recognising that a longer-term orientation of fiscal policy could strengthen budget discipline, the Ministry of Finance began to produce four-year fiscal projections in the mid-1990s. These are submitted to the above-mentioned special ministerial committee before the frame-decision and published together with the budget bill in order to draw the attention of the legislature and the public to medium-term fiscal dynamics and the implication of demographic developments. As part of this exercise, a report on generational accounts was issued in 1997 to illustrate the impact of the prospective decline in the share of the working-age population on government finances, given the health- and welfare system in place. However, although the Ministry of Finance prepares such projections, budget decisions continue to be made over a one-year horizon.

Changes to financial reporting have also given a more forward-looking orientation to fiscal policy — notably the increased use of accrual accounting, which illustrates the longer-term consequences of expenditure decisions. However, efforts to enhance fiscal transparency have to be seen as a part of the broader programme of improving public-sector management. The 1997 Government Financial Reporting Act reorganised the budget, regrouping individual agencies and functions of the central government according to international accounting standards and calling for a budget presentation both on a cash and a modified accrual basis. All financial obligations entered into over the course of the year, whether or not they are paid, are registered as outlays in that year. Substantial differences between cash and accrual accounting arise, in particular, from public employee pension rights and the timing of interest payments on outstanding debt (much of which is indexed). In addition, items previously subtracted on either the revenue or expenditure side of the budget have been moved to the other side, grossing up both revenue and expenditure. Moreover, the accounts of government agencies have to be prepared in accordance with private-sector principles, with the important exception that assets are in most cases written off in the first year. This does not apply to state enterprises, however, which depreciate their capital assets in line with private-sector accounting standards.

There is no doubt that the changes to the budget process have had positive effects, contributing to the improvement in the fiscal situation over the past decade. However, as noted, after a period of austerity in the mid-1990s that eliminated the budget deficit, expenditure creep has resurfaced. This suggests that several weaknesses in the fiscal framework persist. These appear to concern both the preparation and execution of the budget, as well as the absence of a sufficiently binding medium-term orientation of the policy framework.

Although the “frame method” has improved budget planning and decision-making, its effectiveness has been undermined by the fact that expenditure targets have tended to be modified during the parliamentary phase of the budget process. Fiscal discipline has clearly tightened insofar as adjustments made to the frames during the budget formulation phase — that is, between the “frame-decision” and the presentation of the draft budget in Parliament — have become much smaller over the past decade. However, subsequently, control over expenditure targets is eroded. It might be argued that this is legitimate because Parliament is free to make final decisions. But, in fact, the bulk of proposed changes at that stage, calling for spending increases, can be traced to the government itself *via* the budget committee’s majority. In other words, the government does not stand by its frame decisions once the budget formulation process is over. In a recent report on the budget process, the National Audit Office has drawn attention to the Swedish system of having a spring fiscal bill, whereby the Swedish government submits its “frame-decision” to the Riksdag, noting that in Iceland this decision is neither made public nor discussed by Parliament. The Office recommends that the budget discussion should be initiated by a parliamentary

vote on the frames, which would determine the spending ceilings for ministries, thereby limiting the scope for *ad hoc* initiatives that jeopardise spending control under the “frame-method”.

Table 2. **Proposed, voted and realised government spending**

	ISK billion					Per cent	
	Budget bill	Voted budget	Outcome	Difference		Difference	
	(A)	(B)	(C)	B-A	C-B	B-A	C-B
1998	162.7	165.7	189.6	2.7	23.9	1.7	14.4
1999	179.2	182.4	199.0	3.2	16.6	1.8	9.1
2000	190.0	193.2	229.0	3.2	35.8	1.7	18.5
2001	210.0	219.2	228.7	9.2	9.5	4.4	4.3
2002	239.3	239.4	251.4 <sup>1</sup>	0.1	12.0	0.0	5.0
2003	253.3	260.1	-	6.8	-	2.7	-

1. Estimate.

Source: Ministry of Finance.

Moreover, despite efforts to improve the execution of the budget, fiscal slippage has diminished but persisted, with central government expenditures exceeding budgeted levels by about 10 per cent (nearly 3 per cent of GDP) on average during the past five years (Table 2). These figures are on an accruals basis, reflecting factors such as the re-evaluation of pension liabilities or tax claims, and it could be argued that they are not a good gauge of spending management. On a cash basis, spending overruns have been less than half of those reported on an accrual basis over the last five years, but they have shown no clear signs of abating. According to the Icelandic constitution, no payment from the exchequer can take place without prior approval of Parliament. An exception to this rule has been the permission for the Minister of Finance to allow certain additional spending when budgetary appropriations have proved to be insufficient. In these circumstances, it might be preferable to provide for a budget reserve like it exists in other countries with a view to enhancing fiscal transparency and accountability. Such spending has nevertheless to be sanctioned at the end of the year by a so-called “supplementary budget”. In recent years, rules have been tightened to reduce the leeway of the Minister to permit spending outside the regular budget. In the 1997 Government Reporting Act, the role of the “supplementary budget” was restricted to “unforeseeable” events. However, additional expenditure on wages and health care, which has accounted for the bulk of budget overruns in recent years, has been such a regular feature that it can hardly be considered as such. In its report, the National Audit Office also noted that, despite tougher rules, managers have not been held responsible when agency spending exceeded appropriations. It is to be hoped that the recent directive concerning the execution of the budget will lead to better enforcement of spending ceilings. While additional expenditures have tended to be accommodated, the amount carried over to the following fiscal year has gradually increased since the mid-1990s. It seems that some agencies have been building up a financial buffer in order to deal with future uncertainties. This has some advantages but could be a problem to the extent it risks reducing the scope for transferring allocations between agencies or ministries. In any case, the sanctioning of extra spending through supplementary budgets should be curtailed, since it introduces a *de facto* asymmetry in the treatment of deficits and surpluses when it comes to carrying them over to the next fiscal year.

Finally, an important weakness of the budget process is that there is no medium-term expenditure policy. As noted, the Ministry of Finance has introduced a forward-looking aspect to fiscal policy, adding four-year spending projections, both in the aggregate and for each ministry, to the draft budget. These

projections are based on existing policies, expected demographic developments and the general economic outlook. They are, however, illustrative and not agreed targets. They are not discussed or voted on in Parliament and hence not considered binding in any way. And, although they are submitted to the special ministerial committee responsible for the frame-decision, they are not used as a starting point for the subsequent annual budgetary exercise. Thus, while being present to some extent in the budget formulation process, they are not an integral part of the fiscal framework. To enhance spending discipline, it would be preferable if the government prepared rolling multi-year budget plans with explicit expenditure limits and presented them for discussion and vote in Parliament. Experience in other countries (notably Sweden and Finland) with departmental or aggregate expenditure ceilings suggests that they can be successful in tackling spending pressures, at least for a time.

### *Performance management*

Development towards performance management began in 1992 when a project was launched to benchmark outputs, unit costs and service levels across several groups of homogenous government agencies. This was followed by the conclusion of several experimental service contracts with agencies aimed at giving them clearly defined targets and responsibilities in exchange for increased managerial freedom. Since 1995 the Ministry of Finance has systematically collected and published activity indicators for most agencies with a view to developing standards by which one can measure what the government is getting for its money. In the light of experience, a more comprehensive approach to performance management was introduced in 1997. It is gradually being implemented throughout the entire central-government sector. Three-to-five-year framework agreements (called performance contracts) specify the main tasks of an agency and provide a communications framework between the agency and its supervising ministry. The role of the agency is derived from a definition of the services the state is to fund and render, as set out by law and regulations. On the basis of the contract, the agency has to develop a strategic plan for three to five years, which sets the stage for a dialogue with the ministry. This is an important part of expenditure planning and supports the “frame-budgeting” process. The strategic plan is then made operational through annual plans and target-setting, with agencies expected to report annually on results to the ministry. In this context, the Ministry of Finance has taken steps to strengthen performance measurement and reporting in the public sector (see below). Along with the decentralisation of decision-making authority to agencies, management processes within ministries have been reformed, with line managers being given more responsibility, including control over their staff.

Despite some progress, much remains to be done in the area of performance management. So far, about one-half of all government agencies are covered by framework performance contracts, and most smaller agencies are still without one. The Ministry of Education, for instance, has completed performance contracts with all its upper secondary schools, and the Ministry of Justice has done the same with all magistrates (in particular, the Commissioner of Police and Customs). But each ministry has had some scope to implement performance management with its agencies at its own pace. The strategy to date has been to do this gradually, and ministries and agencies have not been pressured to act. The first government directive with direct reference to performance management was issued only in 2001. Stating clearly that agencies are to adopt this approach and conduct their work in conformity with the guidelines put forth in 1996 should serve to speed up the implementation of the performance management approach. However, given that small agencies have not been willing or able to move in this direction, merging some of them would seem to be necessary to ensure a generalised application of performance management. In any case, consolidation should be pursued with a view to enhancing efficiency in the public sector.

A formal appraisal of the performance management initiative has not yet been carried out, although the National Audit Office has begun an evaluation of its design and implementation, which is expected to be finalised imminently. The partial evidence that has been gathered seems to indicate mixed

experiences and results. There is considerable variation in how far performance management has been actually implemented. Some agencies have not done much more than concluding a framework agreement, while others have made more progress with long-term strategic planning, annual performance targets and reviews. Many agencies have improved their management, and more of them have improved overall planning. The results vary, however, considerably between agencies and depend largely on the commitment of the ministry involved. A survey conducted by the Ministry of Finance in December 2001 found that almost 70 per cent of managers felt that the introduction of performance management in their agency had either very positive or rather positive effects. But less than half thought that the ministries had done their share to honour the government resolution that initiated performance management in the public sector, and less than one-third considered that management procedures had changed significantly following the adoption of the new approach. Among the agencies without a contract (about half), only around one-half indicated that they were interested in having one. Pending the National Audit Office's evaluation results, these findings would seem to point to the need for both improving the design and enforcing the adoption — by both ministries and agencies — of the government's performance management initiative. In this context, it also appears desirable to devote more resources to policy evaluation, both within government and at the National Audit Office.

The increased flexibility regarding inputs given to departments and agencies requires more information on the outputs they produce. But activity indicators have still not asserted themselves as an actively used tool of public-sector management. As noted, the Ministry of Finance has collected and published such indicators since the mid-1990s. The initiative was designed as a three-step programme. *First*, departments and agencies were to identify and define their activities. *Second*, the cost of each activity should be determined. And, *third*, quantitative descriptions of each activity were to be developed in a uniform manner. One problem with these indicators has been that they have often been seen as another piece of unnecessary paperwork. A number of public entities, mostly hospitals, now include performance indicators in their annual reports. However, there is no general requirement for agencies to do this, and many disclose only basic financial information. The National Audit Office has found that, although the majority of government agencies now collect performance indicators on a regular basis, they have in general not been used for comparison with planned outputs or with other agencies. Few agencies take action to ensure that actual outputs match planned ones. Furthermore, as in other countries, to the extent they are produced, indicators have focused on outputs rather than outcomes. Ministries and agencies have been encouraged to review indicators and co-ordinate them with the performance goals put forth in their plans and information in the annual reports. The Ministry of Finance is working on improving performance measurement, and a pilot project has been launched to introduce the "Balanced Scorecard" method in the public sector. One agency, the Directorate of Customs, has started to implement it (see Box 2).

Linking the budget process to performance, which was one of the objectives of public-sector reform, remains a challenge. Performance-based budgeting has been implemented in upper secondary education (and recently also colleges and universities). Allocation rules for funds have been at times intensively debated by the interested parties in this area and seen several modifications since they were first adopted in 1998. Even if there is some dissatisfaction with this funding system, the general feeling both at the Ministry of Education and among school managers appears to be positive. But new funding systems still have to be implemented in most other areas (feasibility studies are being carried out for the police and health care). In its report on the budget process, the National Audit Office came to the conclusion that, overall, the presentation of activity indicators with the draft budget has not yet had the desired effect of influencing the way in which funds are allocated. It opined that linking their allocation to results might provide stronger incentives to managers to consider performance indicators. But it also underlined that current indicators need to be developed further to become meaningful performance measures and be accepted as useful tools for public-sector management. Indeed, to strengthen the latter, improving the quality of reporting is a major challenge, together with linking performance with budgeting and enhancing evaluation capacities.



### Box 2. Performance management in the Directorate of Customs

The Directorate of Customs (DOC) has approximately 200 full-time employees and an annual budget of US\$ 8.3 million. The DOC's approach to performance management can be described as top-down. Its mission, strategic plan, overall goals and guiding principles are all set at the top. Individual divisions within the DOC are responsible for developing annual plans, including functions, budgets, performance targets and indicators. They are also supposed to provide information on performance evaluation strategies and trends in past performance results. If the agency stays within its budget, surpluses are moved to the next year, and if deficits occur, next year's budget is reduced accordingly. With the DOC's new Balanced Scorecard system, rewards for divisional and individual performance, which do not exist so far, will be considered.

The implementation of performance management was triggered both by organisational changes and an initiative from the Ministry of Finance. In 1998, management was changed, and the DOC started the collection of municipal income taxes for the city of Reykjavik. In addition, the Ministry of Finance signed an agreement with the DOC to supervise tax collections in all of the country's customs districts. In 1999, the DOC signed a performance management contract with the Ministry of Finance, defining the working relationship between the Ministry and the Directorate, and the latter's mission, service functions/tasks and objectives. The contract also specifies the plans and reports the DOC is required to prepare. These include a five-year plan, which is to be reviewed every year. An annual plan is to be submitted to the Ministry for approval at the beginning of every year. The agency also has to present an annual performance report, including both financial and non-financial measures according to targets and actual results. In addition, activity indicators are to be collected and submitted to the Ministry annually.

The Ministry of Finance intended to use the DOC's performance management implementation as a pilot project. The focus was on changing the way public agencies see the relationship between inputs, processes and outputs and identifying the best performance indicators for the evaluation of outputs and outcomes. The DOC received a special grant from the Ministry to develop and implement the Balanced Scorecard system, which is to be used as a benchmark for other agencies. It is hoped that the adoption of this methodology will make agencies' mission, strategy and goals more transparent and strengthen both organisational communication and managerial accountability.

### *Human resource management*

Human resource management in the public sector has undergone far-reaching changes over the past decade. The first steps were taken in the early 1990s, involving reduced *ex ante* controls and partial decentralisation of pay determination. A comprehensive new policy approach was adopted in the mid-1990s, emphasising devolution of authority to agencies and a more flexible and transparent pay system, and formalised by the 1996 Civil Service Act and the introduction of a new decentralised pay structure in 1997. The Act aims at aligning the management of human resources with that of other resources, and at bringing the rights and responsibilities of public employees more into line with conditions prevailing in the private sector. For example, it abolished lifetime appointments and introduced fixed-term contracts for senior civil servants. The revised pay system seeks to increase transparency by incorporating extra payments into basic wages. At the same time, it places more emphasis on staff performance, allowing managers some leeway in determining salary grades for, and providing premiums to, individual government employees. Pay scales and general wage increases are still negotiated, however, between the Ministry of Finance and the trade unions (except for higher-ranking civil servants).

The transition to the new decentralised public-sector pay system in recent years has not been without difficulties. If anything, wage pressures in the public sector intensified in the late 1990s, with the share of employee compensation in total government expenditure rising from 34 per cent in 1996 to 37 per cent in 2001 (13 and 15 per cent of GDP, respectively). The fundamental problem seems to be that managerial accountability has lagged behind the devolution of management authority. The National Audit Office has found that many agencies have exceeded their authority to pay salary premiums. Also, instead

of being purely a matter of agreement between managers and individual staff members, the introduction of merit-based pay and flexible grade levels has been seen by unions as an opportunity to increase the salary levels of all employees. The Audit Office has found some evidence that the decentralisation of pay determination has been “exploited” by unions to re-bargain deals for their members by pointing to strong increases in other sectors, a case in point being the settlements in the hospital sector. Not able or willing to resist pressure from employees and unions, many managers have yielded to demands that jeopardised their budgets (admittedly, sometimes after consulting with their ministries). In the end, additional funds have usually been provided to cover the resulting deficits. The question of how to strengthen managerial accountability has been addressed recently by the government directive aimed at tightening the budget execution, but it is too early to tell whether the situation will change significantly, and additional efforts might well be necessary.

It is worth noting, however, that wage negotiations that fix salary scales are carried out centrally (by the Ministry of Finance), with agreements at the local government level often on similar terms as their central counterparts, and that public-sector settlements have systematically exceeded budget targets. Moreover, recent developments have to be seen against the backdrop of strong demand for labour during most of the transition period to the new system; in these circumstances, wage pressures associated with skill shortages in some areas have tended to spill over to other sectors. They also illustrate the difficulty of permanently reducing civil servants’ relative pay. As discussed in the previous *Survey*, recent trends represent to some degree a reversal of the cuts that occurred during the budget consolidation programme in the early 1990s. But there has been a strong rise in the relative compensation of civil servants over the past decade as a whole. As a result, public-employee compensation now exceeds that in the private sector by a large margin. While this partially reflects skill differentials, the gap exceeds that existing on average in the OECD and in other Nordic countries (see Figure 4). The conclusion of multi-year pay agreements and easing of labour-market conditions should facilitate containing wage pressures in the near term. Nonetheless, it would be advisable to introduce measures to limit future potential wage bill overruns. The wage bargaining process should be strengthened, for example, by ensuring that the Ministry of Finance’s wage bargainers are given clearer instructions. Moving to multi-year budgeting may be helpful in this respect. In this context, further performance management initiatives under consideration, in particular a rewards system, need to be implemented in a way that avoids increases in total spending.

### *Use of market mechanisms*

In parallel with reducing its presence in the enterprise sector, the government has gradually increased its use of contracted services from the private sector. Early efforts had been concentrated in outsourcing ancillary services such as catering and maintenance. In recent years, increased emphasis has been placed on service contracts with private companies and non-profit organisations to run specific government activities (health centres, nursing homes, high schools, medical research). At the local government level, too, a few authorities have contracted out services in addition to privatising municipally owned enterprises. At the same time, some municipalities have signed service contracts with the central government (see below). Experience with outsourcing has been mixed. While there is some evidence that cost savings have been realised, evaluations have also revealed significant shortcomings. For instance, a National Audit Office report on the purchase of consultancy services by government agencies has found that the latter lacked clear rules and guidelines and that the tasks of consultants were poorly defined. It was also common that offers were not obtained from competing consultancy firms, and only half the agencies studied had written contracts with the consultants working for them. Price competition and competency evaluations were almost never employed, in spite of legal provisions and other instructions for purchases of goods and services by the government. While international experience shows that it is very difficult to achieve cost-effective contracting out (see, for example, the 2002 *Economic Survey of Denmark*), it is

worth making the effort, and in Iceland more could and should be done to reap the potential benefits of outsourcing.

The government has also initiated a policy to increase private participation in public services through public/private partnerships (PPPs). Since 1997, three major PPPs of different size and structure have been finalised. These projects are: a tunnel — a typical concession project that is financed with user tolls; the building and operation of a municipal technical school, financed by the state; and the design, building and operation of a nursing home for elderly people. In general, these projects have been successfully executed and proved to be a cost-effective method of delivering public services. The authorities therefore intend to encourage increased use of PPP projects in the future. In doing so, they should consider international experience suggesting that this approach is no panacea (for a discussion of both potential drawbacks and advantages, see the 2002 *Economic Survey of the United Kingdom*).

The government reformed its procurement methods in the mid-1990s, expanding the use of tendering for legal, accounting, engineering and architectural services in line with practices existing in the construction area. A private finance initiative was launched in 1999, extending tenders for construction to include also design, funding and operations. The 2001 Public Procurement Act, which is based on the principles set forth in various EU directives, called for the purchase of goods and services above a certain threshold to be tendered out under competitive bidding. The same applies to building projects above a certain size. Under European Economic Area (EEA) rules, these tenders are now open to foreign companies. The Ministry of Finance estimates that in some cases tendered offers have generated 15 to 20 per cent cost reductions. A National Audit Office study of the effectiveness of the system of framework agreements introduced by the State Procurement Agency showed that it offers advantages, both in terms of time saved and favourable prices. However, the Audit Office also found that many vendors did not supply the Agency with the required information. Considering that the dissemination of information on purchasing activity and follow-up measures were inadequate, the Audit Office recommended that governmental agencies should be encouraged to formulate a procurement policy and be better informed as to their obligations concerning purchases.

Local governments levy various user charges, e.g. for water, sewerage, electricity, geothermal energy, harbours, public transport services, some school activities and home help. In some instances, the user fees cover only part of the service cost borne by the local authority, notably in public transport and in the case of kindergartens where charges cover about one-third of costs. By contrast, geothermal district heating systems, which are in most cases organised as municipal corporations, levy charges that cover both capital and operational costs. The same applies to a few electricity works owned by local authorities. A comparison with other Nordic countries shows that in Iceland fees are a much less important source of local government revenue. User charges are even less widespread at the central government level (see below). While there are arguments that full cost recovery should not be aimed at in all cases, the absence of user charges is a lost opportunity to restrain demand and, hence, public expenditure, but also for those benefiting to contribute to paying for what they get.

### ***Local government***

The specific structure and increasing responsibilities of local authorities both have effects on public spending outcomes. Local government is in the midst of an amalgamation process that is expected to continue over the next few years. There are now 105 municipalities as compared to 229 in 1950 and 196 in 1994, when the pace of mergers accelerated. Nonetheless, their size remains heavily disparate: about 40 per cent of the municipalities still have fewer than 200 inhabitants, while, on the other hand, Reykjavik, the capital, accounts for two-fifths of Iceland's population. Local government consolidation has facilitated to some extent the transfer of responsibilities from the central to the municipal level, the major example of

which was primary and lower-secondary education (in August 1996). Until the early 1990s, the trend had been to shift tasks to the central government to ease the service burden of financially strapped municipalities. In addition to education (up to the age of sixteen), local government is now responsible for social services (including those for the elderly and housing for low-income earners, but excluding employment services) and some infrastructure (including harbours and environmental matters).

Within their areas of responsibility, local authorities have the right to decide on expenditure priorities and the execution of projects. With the transfer of compulsory schooling to the municipalities, education is now the largest component of local government spending, accounting for over one-third of total outlays, followed by social services (one-fifth). To finance their activities, municipalities have limited (independent) taxation powers but considerable discretion to charge fees for services they provide, and they do not require the authorisation of the central government to raise loans. Nonetheless, taxes represent the bulk of their revenue. Equalisation payments contribute on average less than one-tenth, although this share can reach one-half for very small municipalities. When municipalities became responsible for compulsory education, local tax rates and payments from the Local Government Equalisation Fund were raised accordingly. However, more generally, there has been a trend away from earmarked transfers towards general grants within the equalisation system (Table 3). This is desirable, since earmarked grants often result in distorted or excessive spending, although they may be justified to the extent that there are positive externalities of local spending. Central government involvement in the finances of municipalities is minor, although the Ministry of Social Affairs exercises general supervision over local authorities. If a municipality is unable to pay its debts, it can be put under the direct administration of the Ministry. In order to improve policy co-ordination, the Association of Local Authorities and the central government have signed a co-operation agreement that calls for regular consultative meetings.

Table 3. **Local Government Equalisation Fund**

	1998		2001	
	ISK million	Per cent	ISK million	Per cent
<b>Earmarked grants:</b>				
General primary school grants	1 847	38.7	2 402	27.7
Grants to specific teaching	540	11.3	887	10.2
Specific investment grants	641	13.4	608	7.0
Other school subsidies	377	7.9	505	5.8
Sub-total	3 405	71.4	4 402	50.8
<b>Block grants:</b>				
General service equalisation	566	11.8	1 497	17.2
Real estate contribution	-	-	1 325	15.3
Tax revenue equalisation	413	8.7	660	7.6
Grants to compensate for population reduction	108	2.3	394	4.5
Rent rebate contribution	280	5.9	390	4.5
Sub-total	1 367	28.6	4 266	49.2
Total	4 772	100.0	8 668	100.0

Source: Association of Local Authorities in Iceland.

Municipalities as a whole have been less successful in consolidating their finances than the central government, and the renewed rise in public expenditure relative to GDP in recent years partly reflects developments at the local government level. The transfer of government functions to municipalities has played a role. It can also be argued that spending pressures are strong in areas of local government responsibility and that their acquired competence for compulsory education (and thus teachers' salaries) has added to these pressures. However, while there is evidence that some functions are better run at the local level, it appears that municipalities have even greater difficulties in containing costs than central government, as it is harder for them to resist claims for more public services and higher pay for employees. In addition, increased revenues through taxes or transfers from the central government may have reduced incentives for local authorities to curb spending. Moreover, reforms have been more limited at the local government level. For instance, although some municipalities have begun to implement performance management, most of them have not gone as far as the ministries and their agencies (where progress has also been uneven and slow).

An acceleration of the amalgamation process could help, as the small size of many municipalities prevents the adoption of innovations in public management. Indeed, Reykjavik has implemented many initiatives along the lines of the central government reforms described above. The small size of municipalities also limits the capacity of local government to take over tasks devolved from the centre. Many local authorities outside the capital region are even unable to perform all their current responsibilities in a satisfactory way, as they are too small to be effective managers of many categories of expenditure. Local government reorganisation has been a recurring theme in Iceland for a long time. Ten years ago, a government committee made wide-ranging recommendations for reform, including the reduction in the number of municipalities to at most 43, the transfer of functions between government levels and improvements in central-local relations. Although the proposal was rejected by referendum, amalgamation gathered momentum; but the number of municipalities is still considerably above the targeted level. Mergers can be imposed when the population of a municipality falls below 50 inhabitants, and this threshold could be raised. But in the absence of forced unification, which is excluded by the government, the only option to speed up the process would seem to be the use of financial incentives through the Equalisation Fund.

Despite the negative result of the 1993 referendum, devolution has also made some progress through legislated transfers of responsibilities (in particular, compulsory education) along with tax resources and service contracts with the central government. Under a Local Government Pilot Programme, local authorities may opt to run certain functions of central government during a trial period. This applies chiefly to the provision of health services, where one or more municipalities undertake to run such services within their area. Selected municipalities have been allowed to carry out various experiments in administration, with increased freedom from some regulations (such as building control). A study on pilot contracts done by a private consultancy firm on behalf of the government and concerned municipalities has concluded that outcomes have in general been favourable. The National Audit Office has been more critical. It found no evidence that costs had decreased but noted that deficient monitoring and information made it difficult to evaluate whether the aims of the contracts to produce savings and improve service had been attained. These experiments have not led to further devolution initiatives. Indeed, the transfer of compulsory schools to the municipalities has been more complicated than anticipated, and so local authorities seem to be careful in not taking on other new responsibilities at the same time.

It is clear that mechanisms for steering public finances need to be developed as the local government's share of total spending grows (it has risen from less than one-fifth to more than one-fourth over the past decade). As noted, there is an agreement between the central government and the Association of Local Authorities that aims at co-ordinating policies in order to better attain national economic objectives. But this provides for consultations rather than binding targets. Furthermore, the link between macroeconomic policies and budget discussions would be strengthened by expanding the coverage of fiscal

projections to both levels of government, including local authorities. Finally, there seems to be scope for reinforcing the government's supervision of local finances. As noted, municipalities can be put under direct administration, but this has rarely happened. Moreover, except for the city of Reykjavik, auditing for local authorities is carried out by private consultancies. Although municipalities are content with this arrangement, the National Audit Office has found it to be not always satisfactory.

### *Social spending*

Health care and education are among the main tasks of government. Together with social support, spending on these activities accounts for more than three-fifths of the state's fiscal budget, and a similar proportion of local government outlays is devoted to them. This highlights the importance of expenditure management in these sectors, the more so since they also are those facing the strongest spending pressures.

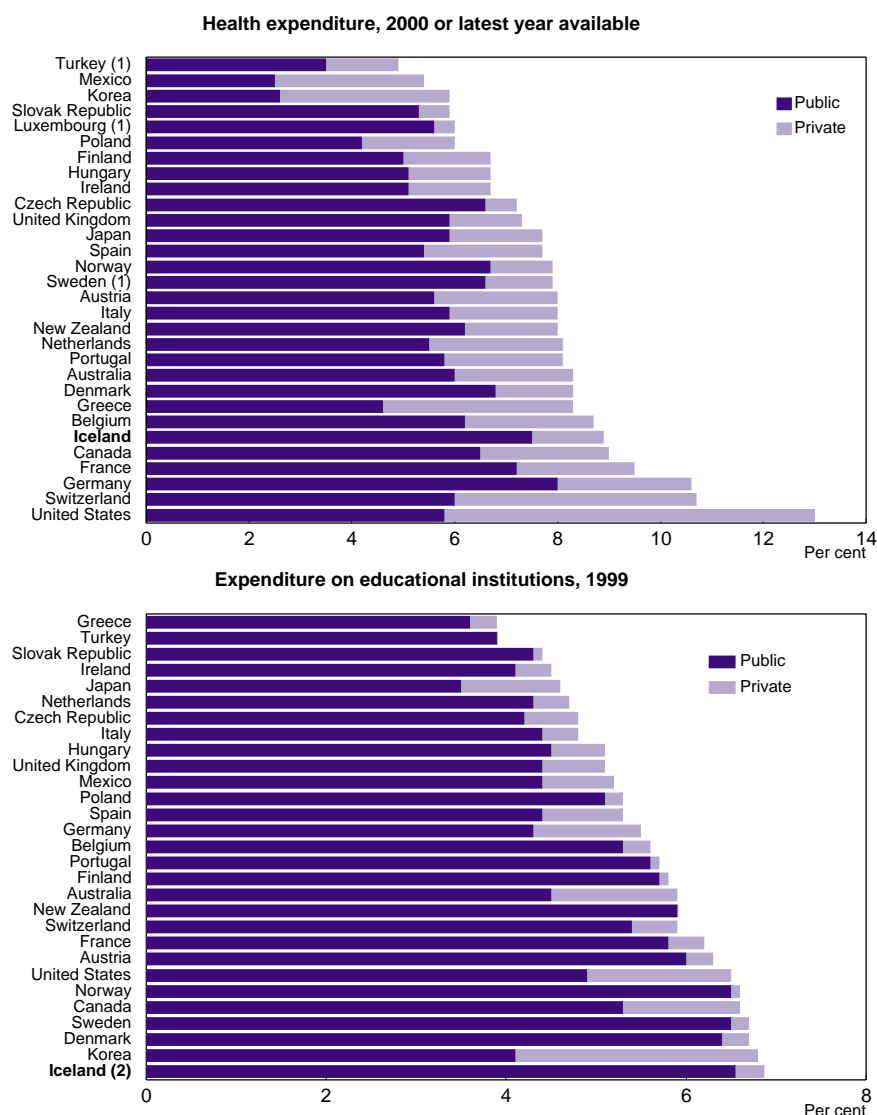
### *Health care*

Iceland's spending on health care reached 9 per cent of GDP in 2000 as compared with an unweighted OECD average of 8 per cent (Figure 5). Up to the 1980s, it was lower than abroad, but it has increasingly exceeded the OECD benchmark since then. Over the past 30 years, it has increased by 4 percentage points of GDP, while the rise in the OECD area has been just over 2½ points. In terms of per-capita expenditures on health care (measured in GDP purchasing power parities), Iceland ranked fourth in 2000, after the United States, Switzerland and Germany. The average annual increase in per capita spending on health care has exceeded the OECD mark by 1½ percentage points over the past 30 years, despite a sharp temporary slowdown during the budget consolidation period in the first half of the 1990s.

Heavy expenditure has probably contributed to an above-average level of care and better health outcomes than generally elsewhere (Table 4). Coverage and quality of clinical care is high, as indicated, for example by the very low rates of maternal and perinatal mortality. Life expectancy, both at birth and at age 65, is among the longest in OECD area. However, health status in Iceland has become less exceptional over time, as other countries are catching up. This is mainly attributable to slower progress or even deterioration in the health status of women and older people in general. To some extent, this can be traced to the effect of increased tobacco consumption among women on mortality rates. But, even adjusting for life-style effects, the rapid expansion of expenditure can be questioned, as it has not been matched by much of an improvement in health outcomes.

The health system is characterised by the dominance of the public sector. At 84½ per cent, the public share of total health expenditure is among the highest in the OECD area. All residents are covered by public insurance. All hospitals are publicly owned, and primary care is mainly provided by a network of public health centres. The private sector consists of dentists, specialists and a few general practitioners and nurses. The state thus employs most medical personnel. The number of health care professionals per capita is high, with Iceland ranking second (after Finland) for both nurses and practising pharmacists, for example, among OECD countries. Financing of health care is based on taxes, and services have no significant user charges except for specialist care, day surgery, some pharmaceuticals and dentistry. User charges are reimbursed, however, when they exceed a certain amount by calendar year (somewhat over \$200 for people aged 18 to 70, \$70 for children, and around \$50 for the elderly, disabled and long-term unemployed). Nursing homes and old-age homes, which are run by municipalities or voluntary organisations, are partly financed by user charges, but the major part of funding is provided by the government (through health insurance or the public pension scheme).

**Figure 5. Health and education expenditures in OECD countries**  
As per cent of GDP



1. 1998 for Sweden and Turkey; 1999 for Luxembourg.

2. 1998.

Source: OECD *Health Data*, 2002 and OECD, *Education at a Glance*, 2001 and 2002.

Given the persistent spending pressures and the apparent declining returns in terms of marginal population health, the government has initiated some reform measures. The last few years have seen both cutbacks and attempts to increase the cost-effectiveness of the health care system. This has mainly concerned the hospital sector. The most important development has been the administrative merger of the three Reykjavik hospitals into one. In rural areas, health centres have been merged with local hospitals. One recent change was the merger of all health centres and hospitals in eastern Iceland under one board and director. In addition, the small rural hospitals have increased their collaboration with larger ones. At the same time, there are also attempts to decentralise health care, such as the above-mentioned experiments to transfer the responsibility for health services to municipalities.

Table 4. **Selected health indicators**  
1998 or latest available

	<b>Iceland</b>	EU	Minimum among EU countries	Maximum among EU countries
Life expectancy (years)	<b>79.2</b>	77.8	75.4	79.3
Men	<b>77.0</b>	74.4	71.7	76.7
Women	<b>81.5</b>	81.0	78.6	82.8
Maternal mortality	<b>0.0</b>	7.1	0.7	10.8
SDR for cardiovascular diseases per 100 000 population	<b>284</b>	280	176	385
SDR for cancer per 100 000 population	<b>185</b>	191	160	226
SDR for external causes per 100 000 population	<b>59</b>	42	28	73
New cases of tuberculosis per 100 000 population	<b>6.2</b>	13.7	5.3	51.4
New cases of AIDS per 100 000 population	<b>0.7</b>	3.5	0.3	10.6
Regular daily smokers, ≥ 15 years (per cent)	<b>25</b>	29	18	37
Registered alcohol consumption in litres per person	<b>4.3</b>	9.4	4.9	11.8

*Note:* SDR: standardised death rate; AIDS: acquired immuno deficiency syndrome.

*Source:* Ministry of Health and Social Security.

An important source of cost pressures has been pharmaceutical expenditure, with Iceland showing the highest growth in per capita spending over the past 30 years among the OECD countries for which data are available. Nevertheless, the deregulation of the pharmacy sector in 1996 has led to increased competition, as manifest in lower prices for medicines through discounts granted from the maximum permissible price. Additional cost savings for the government have resulted from a reduction in subsidies on, and wholesale and retail margins for, medicines. The authorities have also moved to tighten drug approval rules. As to health-care procurement more generally, a recent report by the National Audit Office recommended that the authorities should adopt a more strategic approach to the purchase of medical services from doctors with private practices and obtain better information on the various costs involved. The government has taken steps in this direction. However, thought has to be given to developing a more substantial reform package in the health-care area, while recognising the complexity of improving efficiency without sacrificing equity. In this respect, Iceland could learn from the lessons of attempts at health reform in other OECD countries (as summarised in the context of the OECD Health Project).

### *Education*

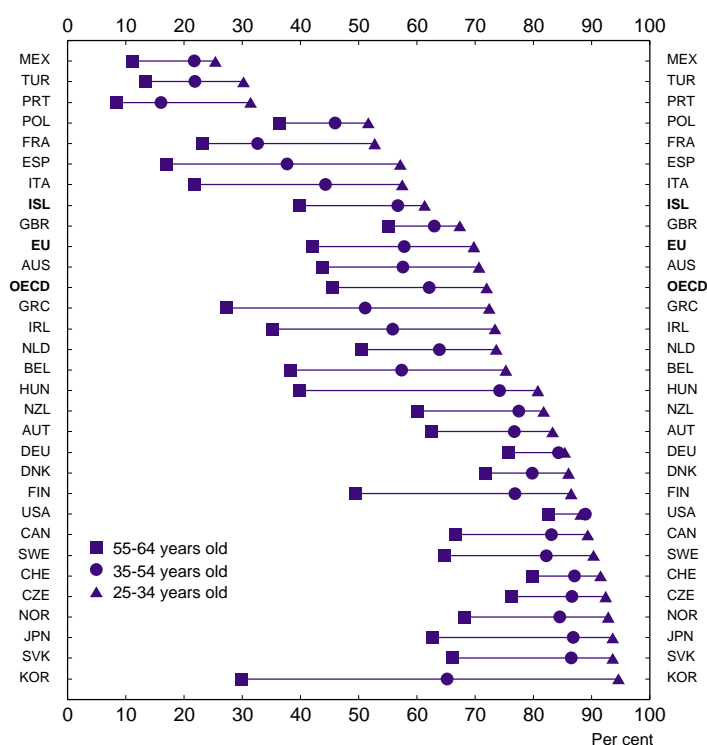
Expenditure on educational institutions approached 7 per cent of GDP in 1998 (the most recent data available), the highest ratio among OECD countries (Figure 5).<sup>3</sup> This is a marked change from 1990, when it still was below the OECD average. Over that period, it increased by two percentage points, more than double the corresponding rise in the OECD area. Education in Iceland has traditionally been organised within the public sector, and there are very few private institutions, which almost all receive public funding. Public spending accounts for about 95 per cent of total educational expenditure, little changed from 1990. Hence, the recent boost to education spending largely reflects a government effort. It is probably too early to expect it to be reflected in better performance. According to the most recent available

3. The OECD has not published these data for Iceland since 1998, because Iceland does not meet the tighter standards of comparability introduced since then. That being said, the figures for 1998 do not seem to be too far off reality and Iceland certainly belongs to the Member countries with the highest spending levels.



statistics, around 40 per cent of the working-age population has still not more than lower secondary education (Figure 6). Even among young people educational attainment is well below the OECD average and considerably below the levels recorded in other Nordic countries. The PISA study reveals, however, some improvement in educational outcomes by international comparison. At the same time as Icelandic students have continued to score above average in reading literacy, they now seem to be moving up toward average performance in mathematical and scientific literacy, areas where their achievements used to be rather poor.

**Figure 6. Educational attainment of the working-age population**  
Population with at least an upper-secondary qualification, 2001<sup>1</sup>



1. Per cent of each age group; 2000 for Austria, Belgium, Denmark, Hungary, the Netherlands and Norway.  
Source: OECD, *Labour Market Statistics database*.

Following the spurt in education expenditure, which has catapulted Iceland from the group of low-spenders to that of high-spenders in this area, it would appear that the focus should now be on getting better value for money. The recent conclusion of performance-related contracts with all higher-education institutions should be helpful in this respect, although care must be taken that activity-based financing does not lead to the provision of public services beyond the social optimum. But there would seem to be scope for enhancing cost-efficiency in other areas. For instance, the ratio of students to teaching staff, which is a key determinant of compensation spending, continues to be very low, except at the upper secondary level. It should be possible to achieve better balance between students and teachers, and thus cost savings, without jeopardising the quality of education. In any case, it may be better policy to devote the limited resources available for education to employing more capable teachers rather than keeping class sizes low.<sup>4</sup>

4. Woessmann, L. and M.R. West (2002), "Class-Size Effects in School Systems Around the World", Institute for the Study of Labour (IZA), Bonn, Discussion Paper No. 485, April.

Moreover, public education is free of charge, even at higher levels (except for modest enrolment fees). University students have also in most cases access to loans from the Icelandic Student Loan Fund. Given the largely private nature of returns to post-compulsory education, increased student fees would be justified, the more so since access could be ensured by expanding the Loan Fund as well as making reimbursement contingent on income. Tuition fees would encourage students to finish their studies in good time. Indeed, the high subsidy element in public tertiary education by international comparison seems to be the major factor behind the relatively long duration of university studies.

## Conclusions and policy recommendations

In summary, although overall public spending is not high compared with Iceland's Nordic neighbours, other OECD countries have made more progress in reining it in. As well, there seems to be room for enhancing its efficiency. As noted, budget consolidation efforts and public-sector reforms temporarily reversed the upward trend in the public expenditure-to-GDP ratio in the mid-1990s, but since then the ratio has tended to edge up again, and budget balance has been maintained only through a rise in the tax-to-GDP ratio. Recurrent overruns of budget spending point to the need for further modifying the fiscal framework. In particular, it would seem to be desirable to strengthen the strategic focus of fiscal policy. The government's objective to achieve budget surpluses is easily understandable to the public but not necessarily justifiable in terms of achieving intergenerational balance. Fiscal policy should rather aim at reducing marginal tax rates, both for supply-side considerations and because extra revenues due to conservative budget estimates and fiscal drag have encouraged overspending. A stronger medium-term orientation of policies is required, with a process that clearly defines political priorities and the means to achieve them, and relies on multi-year spending targets rather than *ad hoc* decisions. There is also room for enhancing near-term spending discipline. Although the introduction of "frame-budgeting" has improved planning and decision-making, its effectiveness has been undermined by the fact that expenditure targets have tended to be modified in the parliamentary phase of the budget process. Moreover, fiscal slippage has continued, with overspending (typically in the areas of compensation and health care) systematically sanctioned by supplementary budgets.

With respect to the efficiency of public spending, much remains to be done in the area of performance management. Most ministries have still to adopt performance-based budgeting. Moreover, managerial accountability has lagged the devolution of management authority to government agencies. This has contributed to large wage increases following the introduction of a new decentralised public-sector pay system. The devolution of responsibilities to local authorities has also not been without problems, since they seem to have had greater difficulties in containing costs than the central government, as it is harder for them to resist claims for more public services and higher pay. And they have been even slower than the central government in introducing performance management and other reforms. This is in part due to their often microscopic size, highlighting the need for further amalgamation. Finally, there is scope for greater reliance on market mechanisms and signals, such as outsourcing, user charges and client choice, in order to improve allocative efficiency. Box 3 sets out some recommendations as to what could be the most promising avenues of further reform in the area of public-spending management.

**Box 3. Recommendations concerning public-spending management**

- Strengthen “frame-budgeting” by making sure that it is not neglected in the late phase of the budget process (*e.g.* through an early parliamentary vote on the frames).
- Tighten budget execution and limit the use of supplementary budgets in order to reduce persistent — even if diminishing — fiscal slippage.
- Reinforce the medium-term orientation of expenditure policy by introducing rolling multi-year budget plans with explicit spending limits.
- Accelerate the implementation of performance management, setting deadlines and eventually reducing the number of small agencies.
- Improve the quality and encourage the use of performance indicators.
- Move further toward performance-based budgeting, making it both more widespread and integrating it in budget formulation from the very beginning.
- Strengthen human resource management by enhancing accountability and taking measures to limit wage overruns.
- Make greater use of market mechanisms and price signals, such as outsourcing and user fees (in particular in the area of tertiary education).
- Provide incentives for further local government consolidation to allow both the transfer of more responsibilities and better control and effectiveness of spending (through more widespread adoption of reforms).
- Make the co-operation between central and local government more effective through binding annual agreements to ensure the achievement of national spending objectives.
- On the basis of lessons learned abroad, develop a more substantial reform package for the health care sector, recognising the complexity of improving efficiency while maintaining equity.
- Following the significant expansion of education spending, focus on quality and cost efficiency, by increasing class size somewhat and introducing tuition fees in tertiary education, where returns are mostly private, both to reduce the duration of studies and as a source of financing.

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