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STATE OF THE UNION**Miracle on Iceland**

By HANNES H. GISSURARSON

REYKJAVIK -- Iceland was the first tax haven. Or so claimed the Norse Vikings who settled the island in the 9th and 10th centuries. According to their Chronicles, the Norwegian kings drove out countrymen who opposed the rule, and the heavy taxes, of a newly established central government. In the 10th and 11th centuries, the Icelanders explored the North Atlantic in their little ships, founding settlements in Greenland and even, briefly, in North America. As Oscar Wilde once quipped, the Icelanders had discovered America, but that they had had the good sense to lose it again.

Over the past century, Icelanders have discovered not America but the free market. A hundred years ago this Sunday, when Iceland gained home rule from Denmark, the island was the poorest country in Western Europe. Now, after a radical and comprehensive course of liberalization that mirrors similar reforms in Thatcher's Britain, New Zealand and Chile, Iceland has emerged as one of the world's most prosperous countries.

Much of the credit goes to Prime Minister David Oddsson. The leader of Iceland's conservative party is now the longest serving leader in the Western world, having formed his first government in 1991. At that point, Iceland resembled more a dysfunctional socialist economy. Inflation was high, hitting 100% as recently as 1983. Mr. Oddsson also inherited a huge government deficit.

In the early years, inflation was brought under control, down to 2-3% today. The government deficit was gradually reduced and, by 1996, turned into a surplus that has been used to reduce the public debt. Mr. Oddsson's government cut extensive direct and indirect government subsidies early on, mainly by dissolving some public investment funds and privatizing others. Mr. Oddsson himself jokes that he managed to empty the waiting room at his office. There were no more favors to be handed out.

Having stabilized the economy with monetary and fiscal restraint, the Oddsson government started privatizing. It began with small companies, later turning to large fish-processing plants, factories and financial companies. All the commercial banks are now in private hands. Altogether, the sales brought in \$1 billion, not a bad haul for a country of 280,000. Only one large company remains, Icelandic Telephone, but it will soon be put on the sales block.

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The deregulation of the economy targeted the special privileges of groups such as pharmacists, and, more importantly, allowed the free transfer of capital in and out of the country and competition in the telecommunications sector. Moreover, the government is also creating conditions for competition in Iceland's hydro-electrical system by bringing in foreign investors.

The government continued to fine-tune Iceland's innovative fisheries-management system. In the 1970s and 1980s, the Icelanders suffered from overinvestment in the fisheries and depletion of fish stocks. In came a system of individual transferable quotas. Each fishing firm received, on the basis of its catch history, a right to harvest a given proportion of the total allowable catch in a given fish stock. These rights were transferable between individual firms. In essence, this is a system of informal property rights in fish stocks. Those who hold the fishing rights or quotas thus gain an interest in the long-term profitability of the resource. They become custodians of the fish stocks.

The system works relatively well. While fishing firms in most other countries usually make huge losses and are heavily subsidized, in Iceland they are mostly quite profitable, and the fishing rights fetch high prices in the market. The country had no choice but to come up with an innovative market-based answer: it relies on fish for 60-70% of its exports.

Last but not least, tax cuts propelled an economic boom. In 1991, during a recession and with unemployment on the rise, the government reduced the corporate income tax to 30% from 50% and abolished a special tax on company turnover. In 2001, the government decided to go further in cutting the corporate income tax to 18%. The net-wealth tax is being phased out and the estate tax greatly reduced. Interestingly, revenue from the corporate tax in fact has gone up over the past decade -- which proves that a smaller slice of a bigger pie is preferable to a big slice of a small one. Since 1995, unemployment has been negligible, and economic growth strong, averaging 3-4% annually.

Why did Iceland turn this way? The international trend toward economic liberalization played a role. Free-market economists like Friedrich von Hayek, Milton Friedman and James M. Buchanan all visited the country in the 1980s, influencing not only Mr. Oddsson but many of his generation. In the battle of ideas here, the right won. There was also a common recognition that the old methods did not work. Inflation was proving too disruptive, government companies too inefficient, the subsidies too costly. Ideas conspired with circumstances to bring about successful economic reforms.

But much remains to be done. The health and education systems are publicly operated, and so are the utilities, some broadcasting stations, and the hydro-electric power system. People close to Mr. Oddsson believe that two priorities are cutting the individual income tax and clarifying and strengthening private property rights, both to capital and natural resources. For example, many companies in Iceland, especially in agriculture, have no clearly defined owners, having initially been established as cooperatives. Also, while the pension funds were successfully restructured to ensure their financial health, the public has neither much say in their operations nor a choice about them.

Yet some Icelandic intellectuals still believe the country's future lies with membership in the European Union. Why? Iceland enjoys a bilateral defense deal with the U.S. and full access to the European market through the European Economic Area. What's more, EU membership is no key to prosperity. As Mr. Oddsson notes, the richest countries in terms of GDP per capita are Luxembourg, Switzerland, the U.S., Norway and Iceland, in that order. Of these countries, only Luxembourg belongs to the EU. All are small, except the U.S., which is a federation of fifty smallish states.

Small states tend to be more affluent than big ones when they maintain open and flexible economies. Smallness is not only a challenge; it is also an opportunity. Iceland has seized this opportunity and is becoming an attractive place for international corporations and capital.

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