

Erindi Finns Oddssonar, framkvæmdastjóra Viðskiptaráðs, á ráðstefnu AGS, Seðlabankans og íslenskra stjórnvalda um lærdóma sem draga má af efnahagskreppunni og þau verkefni sem framundan eru. Ráðstefnan fór fram undir yfirskriftinni „Iceland´s Recovery - Lessons and Challenges“.



Ministers, ladies and gentlemen.

Selecting topics under the heading “Challenges ahead” is a challenge in and of itself. It would be quite obvious to direct attention to issues having to do with the

- resurrection of the financial system,
- getting rid of capital controls,
- policy towards investment or the
- lack of future monetary and economic policy.

All of these are important, but I would like to take a different view, essentially a behavioral view of how the mood in the economy currently is and will be, given how incentives and disincentives for important activities are set up.

To start you off, I would like to quote a ten year old interview with one of Iceland´s best handball players, and some would say philosophers, Ólafur Stefánsson – where he discussed his experience as a player in the best handball league in the world, having won the championship with his team. He offered the following observation on his arrival in Magdeburg:

“The players where afraid to take any chances; a long pass to a wide open player on a fastbreak did not happen even if it was only minimally risky. It was better not to stand out if something went wrong. The atmosphere was inhibited and despite the fact that the team had many world class players, none played up to their abilities at Magdeburgh and they had slumped since they arrived.”

This, however, did not last long. The team went on to change their coaching approach, players started flourishing and championships followed.

In a way, we are facing a similar challenge with the Icelandic economy. The potential is there - in people, nature and good infrastructure - but the challenges ahead have to do with capitalizing on this potential.

Looking back, for a brief moment, the road of the last few years has not been an easy one to travel. Some would say good progress has been made while others would say things have not progressed well at all.

Taking the former perspective, one can point out that it is an important milestone in and of itself, that the IMF has completed the final review of the economic program with the Icelandic government. It also looks like we will see modest growth this year, fiscal consolidation is progressing in the right direction, the financial system has stabilized and so have exchange rates.

But taking the latter perspective, it can be appropriately pointed out that the means for achieving the above objectives, fiscal consolidation in particular, are questionable when it comes to long term sustainability, which needs to be our focus. It is also worth mentioning that the growth prospects now forecasted for Iceland are very bleak compared to other countries - not that there are any guarantees there either - and finally, many would find it strange, at best, to talk of exchange rate stability under strict capital controls.

Be that as it may. It should be clear from today's proceedings that the last few years have been challenging, some things have gone well and others have not. More important, however, is the road ahead, which I would like to turn to now.

My approach today is not so much predicated on economic theory, but more so reflects a systemic or behavioral approach to evaluating the current situation and the strength of economic recovery to be expected in the near future. What I would like to look at, almost in nitty gritty behavioral terms, is what behavior is expected of people running households or businesses, and how do the current systems support those activities?

In discussing challenges ahead, I believe it is appropriate to attempt to define where we are going. During the last few years, this has seemed rather difficult in Iceland, where at times we don't seem to be able to agree on many things.

I do believe, however, that there is a general consensus on one thing, which is the importance of maintaining living standards and attempting to improve them as time passes. Putting this in an economic context, one can say that living standards are linked to purchasing power, which again has a high correlation with economic growth. So, in some sense and perhaps oversimplifying a bit, the common, agreed upon objective of our endeavours is economic growth.

So, before leaving economics, it is helpful to further identify what this entails, i.e., private consumption, investment, government spending and exports in excess of imports.

But now the question becomes, what does this mean in a more mundane, understandable language. If we are interested in growth, what do we expect people to do, people in charge of running households, employed by Icelandic companies, running those companies, of investors, both Icelandic and foreign?

At the risk of oversimplifying, let me try to paint that picture:

We want people to work more rather than less, work hard and show initiative. We would like people in general, people running our households, to continue moderate consumption, buy goods and services, and to continue securing a roof over their heads, by investing in housing. We want Icelanders to take conservative risk by starting businesses to create something of value to others and in the meantime, creating jobs for themselves and others. And we want people to keep consumption and revenue in the real economy, not in the underground one, and choose to continue living and working in Iceland.

As for businesses, we would like for them to continue existing and planning for the future making of goods and services for investments, sales and export. We want them to keep people on staff and hire others for new jobs. They should continue investing and choose Iceland as a jurisdiction for

future operations and tax payments. And as for people, we definitely want them to operate in the real economy as opposed to the grey one. This applies to any company, Icelandic or foreign.

But taking this simple behavioral approach, defining behaviors that are important for economic recovery, begs the question of „how well do the current systems support these behavior, through various incentives and disincentives that people are generally pretty well tuned into“

Do they support critical activities, leading to a better performing economy and future viability? And do the changes that have been made to our systems push us in the right direction or the wrong direction?“

There are no conclusive answers, but we can try, e.g., by looking at different aspects of the economy that are relevant for affecting behavior. Now, there are quite a few worth mentioning, but the most notable ones have to do with taxation, economic policy in general, regulation and supervision.

These policies, systems if you will, set the tone for what is in some sense allowed and what is not allowed. They set the mood or create a culture, and determine broadly what behavior takes place in the economy and what not.

Before exploring this further, it is worth noting that a universal tendency of people is to maximize output relative to input. In other words, most of the time, most people will behave in a way that makes sense from their perspective.

The problem becomes when the sensible thing to do, for an individual, no longer aligns with the interest of the system as a whole. This, in fact, is the characteristic of a poorly designed behavioral system. When you put good people to work in such systems, they will predictably behave in a way that is the most beneficial to them as individuals, but at the detriment of the system as a whole because of design flaws.

So, in the words of Rummel and Brace, the system always wins because it always controls behavior with remarkable efficiency, but it just may be the wrong behavior for the survival of the system.

Now, there are many policy decisions at the disposal of governments that one can regard as tools for behavior management. Taxation is the most salient one and here you see the changes that have been made to our tax system in the last few years. For those of you looking at this for the first time, you may be perplexed. If it is any consolation, so are those who have looked at this every day for too long now.

For our purposes, it is worthwhile to understand how our current tax system, and the changes of the last few years, is supporting or hindering the very behaviors required for sustained economic recovery.

As a note of qualification, it is worth mentioning that Iceland's fiscal position in the past few years did require budget cuts and revenue generation through tax system modification. Not many dispute that. It is also worth noting that by their very nature, tax systems are generally inhibitory and distorting for economic activity, i.e., they usually counter the very behaviors that we are interested in for economic recovery. The question is, how much and could we get away with less?

A brief look at the changes that have been made to our tax system reveals an alarming trend. To simplify, here are the highlight:

1. More than 100 changes have been made in a span of 3 years, all of which entail new or higher taxes
2. We have one of the highest tax to GDP ratios in OECD (this is accounting for difference in social security contributions)*
3. We have doubled capital gains tax
4. Individual income tax has been raised and made considerably more progressive, with three salary brackets
5. A new wealth tax (net equity) has been imposed
6. Employers payroll tax has been upped by half
7. And corporate tax has been increased and so has tax on dividend payments.

To make a long story short, all these changes clearly tip the scale in the wrong directions for behavior required for economic recovery. The incentives for work, consumption, investment and business activity in general have been reduced and incentives for undesirable behavior of not reporting income or leaving Iceland have been increased.

To some extent, this is reflected in economic statistics.

1. We have more Icelandic citizens emigrating than ever before.
2. Consumption and investment are at a historic low - investment levels particularly alarming - and recovery of domestic demand not yet apparent in the statistics.
3. Fewer new businesses are being started each year and
4. Working hours have stayed low since fourth quarter of 2008.

Now, it is very clear that these trends are obviously affected by the crash of 2008. But that was three years ago and it is impossible to disregard the impact of policy decisions since that time. It is in fact very likely, that some of these trends simply reflect sensible behavior of sensible people.

- It may make sense for someone trying to make a living for a family, to move to another country where there is work and more left over after taxes.
- Or someone with high net worth to have it taxed elsewhere.
- And why bother starting a business in the difficult current environment when the economic incentives have never been smaller.
- And it may make sense, because of high marginal tax rate, to not take the extra job ... or not report it if one does.

And for those wondering about an answer to the impossible question - What is the relative impact of economic downturn and policy incentives in these trends? - In the last few years we have seen a number of examples of very strong reactions of changes in the tax system.

One example of that is when inheritance tax that was raised from 5 to 10%. In one month, December of 2010, after the this change was introduced and passed into law, there were made more advance payments of inheritance than in all of 2009. Seems like the sensible thing to do.

So, we cannot afford to attribute the previous trends - investment, consumption, immigration numbers, only to the economic recession - because doing so equals surrendering to the problem. It amounts to saying „our policies are fine, we´re not doing anything differently to counter those trends“.

We know, that the recession plays a role, but we also know that policy that changes peoples incentives plays a huge role. Our penchant for prepaid inheritance last December demonstrates this pretty well. But the lesson applies much more broadly.

It also should be noted that the policy modifications of the last few years are probably well intended, but it nevertheless seems painfully obvious that systemic changes that interfere with economic recovery have become all too prevalent. This applies across the board, to taxation, regulation, surveillance and general economic policy.

For everyday Icelanders trying to decide what to do next, actions of policy makers speak much louder than their words. As a consequence, it is important to take a broader perspective on policy modifications and ensure that it is in line with what we really want people and businesses to do.

Evaluating the behavioral impact of various policy actions can be a daunting effort, but it is one that needs to be made. And it should be based on the important premise of how people actually behave – sensibly – rather than how we think they should behave. The litmus test for policy making in times of economic distress then needs to be whether it encourages work, initiative, investment and value creation.

With this as a guiding principle, Iceland's future is pretty bright - all things being equal. To borrow the words of our handball player, we have many world-class players on our team, in natural resources, good infrastructure, enterprising people and excellent businesses. Currently, many are not playing up to standard.

But with some more consideration of coaching styles, providing the right conditions - or incentives - they will play up to standard, giving rise to a more robust economic recovery, which I think everybody agrees is needed.

Thank you.