

The Icelandic Pension System

Chapter 1. *The Icelandic pension system's characteristics*

1.1 General

The main characteristic of the Icelandic pension system is the operation of mandatory occupational pension funds. In 1969 these funds became general, and then mandatory by law in 1974. This was a result of a general wage settlements after tri-party negotiations between labour unions, the Federation of Icelandic Employers, and the State. Under the agreement, every wage earner working in the private sector is currently obliged by law to contribute a minimum of 12%¹ of his/hers salary to an occupational fund, in most cases a fund predetermined by his trade union. More than half of the burden is, however, carried by the respective employer, who currently contributes a minimum of 8% of the total contribution. A similar arrangement exists in the public sector.

1.2 A pension system of three pillars

The Icelandic pension system is based on three pillars. The first pillar is based on a tax-financed public pension (social security benefits). The second pillar consists of mandatory occupational pension funds which are the dominant feature of the system. The third pillar is based on voluntary individual pension savings with tax incentives.

The second and third pillar were heavily affected by a comprehensive pension reform that took place in 1997 and 1998 and resulted in the current Pension Act, no. 129/1997. Tax incentives for voluntary individual pension savings were established as a part of that reform. At that time the pension system of employees in the public sector was also reformed by establishing a new independent pension fund beside the old fund.

Pillar One - Public pensions. The social security system in Iceland was founded in 1936 with the main purpose of ensuring the livelihood of those unable to work because of old age or disability. The system provides old age pension, disability pension, sickness, maternity and survivors pension. The old age pension is paid from the age of 67.

The public pension is paid as basic pension and supplementary additions to single or low income people. The basic pension is low or roughly 10% of the average earning of unskilled workers and is means-tested by 30% reduction rate after a certain income threshold. The main transfers are, however, paid through the supplementary pension which is also means-tested with 45% reduction rate. The supplementary pension is also tested against half the income of a spouse and pension payments from occupational pensions above a

¹ In 1998, the minimum rate of contribution was 10% of total salaries, 4% for employees and 6% for employers. In 2005, the rate was increased to 11% and again to 12% at the beginning of the year 2007; the minimum share of the employers now being 8% instead of 6%.

certain income threshold. A special supplementary pension is only paid to single persons that also are paid supplementary pension with the same reduction rules. The maximum pension per year for an individual without any kind of income is almost the same as the minimum wage level.

The public pension system in Iceland is fully financed by taxes. The main financing source is the social security tax which is earmarked to the social security system. The social security tax rate is currently 5,79% and the tax base is total salaries. The social security tax is paid by the employers.

Pillar Two – Mandatory occupational pension funds. The current Pension Act requires that all wage earners and self-employed persons belong to a pension fund, which either operates according to a specific law (e.g. pension funds for government employees) or is approved by the Ministry of Finance. The main characteristics of the law are:

- definition of what entities are allowed to call themselves pension funds and receive mandatory contributions for pension rights.
- minimum pension rights and forms of pension are defined.
- general requirements for operating pension funds regarding size, risk, international auditing and funding are defined.
- guidelines and limits for the funds' investment policies based on the risk diversification principle.

To be able legally to call themselves pension funds (a risk sharing entity) and receive mandatory contributions, such entities have to offer retirement pension until the time of death, disability pension and survivors pension. All pension funds that receive mandatory contributions, and thus belong to the second pillar, have some form of risk sharing between members.

The mandatory contribution is currently at minimum 12% of total salaries. Generally, the form and division of the payment is stipulated in wage contracts or specific legislation, now being 4% for employees and 8% for employers.

The contribution can be divided into two parts. The first part goes towards acquiring pension rights which for a 40 years period of contributions, should give a lifelong pension amounting to at least 56% of wages at the end of the contribution period. The second part can go towards acquiring additional pension rights, including defined contribution schemes with individual accounts. According to the Pension Act, banks, pension funds, insurance companies and other financial companies approved by the Ministry of Finance can accept contributions in order to generate rights for both. The Internal Tax Directorate is the supervisor of the mandatory payment of contributions.

The accumulated pension rights in the occupational pension funds are generally indexed to the consumer price index. The main rule is that members can begin to withdraw old-age pensions at the age of 67. It is, however, possible to start withdrawing pension as early as 65, but then with a reduced benefit, or as late as 70 with additional benefits. Until the year 2004 the majority of pension funds offered their members equal rights/fixed level of benefits when there was a sharp turn-around in the direction of age-related benefits.

The Pension Act stipulates that pension fund's membership will in general be defined in general wage contracts or by law. Provided that the regulation of the occupational pension fund in question permits it, employees are free to choose their occupational pension fund. All individuals who are active on the labour market and do not belong to a specific labour union, e.g. self-employed, belong to the General Pension Fund. Employees are, however, free to choose their provider of additional pension rights, i.e. rights in excess of the 56 % minimum stipulated in the Pension Act.

Pillar Three - Voluntary individual pension savings. As part of a general pension reform in 1998, the legislation on tax incentives for voluntary individual pension savings was adopted. The reform made it possible for employees to deduct from their taxable income a contribution to authorised individual pension schemes. Currently, the maximum taxable deduction by the employee is 4%. In addition, employers have agreed in wage settlements to contribute 2% to those voluntary pension savings if the employee matched the amount with at least the same percentage. The total contribution can therefore be 6%. An authorisation has to be acquired by the Ministry of Finance in order to be able to provide such pension schemes. In most cases they are defined contribution individual accounts. The pension saving cannot be distributed until the age of 60 and has to be paid in equal instalments over a period of at least seven years.²

1.3 The interaction between the three pillars

The inter-relation within the pension system between the three pillars can best be described by a simple example. Take a typical Icelandic individual facing a retirement in the near future. From the age of 60 to 67, this individual will enjoy his/hers private savings if relevant while still working, but possibly only part-time while preparing for a full retirement. When 67 years of age, the same individual, still working, enjoys possibly, based on the income earned simultaneously, benefits from the public system, while postponing to withdraw from his/hers occupational pension fund until the age of 70 to increase his/hers pension rights. Then from the age of 70 and onwards, the individual enjoys possibly, both benefits from the public pension system and benefits for his/hers occupational pension funds, dependent on total income earned or accrued (occupational pension benefits included).

1.4 Defined-contribution system versus defined-benefit system

The majority of Icelandic pension funds are based on a defined-contribution system. At the end of the year 2005, there were 46 pension funds operating in Iceland, thereof 14 funds with employer guarantee and 32 without employer guarantee. The pension funds based on defined-benefits (guaranteed by the employer) are mainly those that are guaranteed either by the State or the local authorities.

It is, however, somewhat problematic to classify the Icelandic mandatory occupational pension system exactly into either of the two systems. The mandatory occupational pension funds are similar to defined contribution funds in the sense that contribution levels have in most cases been stable for a long time at 10%, now 12%. However, there are no individual accounts and the investment risk is borne collectively by the members of the funds. Also, the funds are not exactly "fair" among its members. Actually, they have a high degree of solidarity and co-insurance since the relation between contributions and rights to benefits is

² The Icelandic Pension System in 2004: Tryggvi Þór Herbertsson (2004). http://www3.kaktus.is/files/bbdcccjhj/ICELAND_Overview_2005.pdf.

in most cases the same for young and old, men and women, those with spouses and children and those without. Furthermore, a lifelong old age pension is guaranteed in all cases. The fund's regulations then define the benefit level in every period.³

Based on rough estimate the balance between defined-contribution pension plans and defined-benefit pension plans are approximately 80% versus 20%. Less than 10% of the occupational pension funds' members belong to a pure defined-benefit pension plan. There has definitely been a trend towards a defined-contribution pension plans in Iceland, but the phase is slow. As an example, the 1998 reform of the pension system of employees in the public sector was a move from defined-benefit pension system towards a defined-contribution system. The tax incentives for voluntary individual pension savings established as a part of the 1998 reform was also a similar move.

Chapter 2. *Demographic trends and retirement behaviour*

2.1 General

Iceland faces smaller problems due to the ageing of the nation than most developed European countries. There are several reasons. Firstly, the Icelandic nation is younger and will remain so during the middle of the twenty-first century, due to a high fertility rate. Secondly, labour participation rates of the elderly are also higher than in most developed countries and the effective retirement age is higher. The main reasons are that public pensions are not paid before the age of 67 and regulations governing the occupational pension funds do not give any incentives for early retirement. Information from tax declaration show that Icelandic pensioners are more active on the labour market than other Nordic pensioners and also compared to pensioners in OECD countries in general. The activity difference between Icelandic pensioners and pensioners from other countries has, however, diminished, but the gap is still considerable. Thirdly, and probably the most important reason for future prospects, a mandatory membership of fully funded occupational pension funds will reduce the public pension burden of future generations.

2.2 Demographics and labour market participation

Tables 2.1 and 2.2. below provide some key figures for Iceland, supposed to give a broad outline of the Icelandic demographics and the Icelandic labour market at present and the development over the past two decades. In Table 2.1, there is also a forecast of the total population and its age division in 2040 done by the Central Statistical Bureau.

The figures in the tables show clearly that Iceland has a population younger than the rest of OECD on the average and also compared to the Nordic countries. This difference will diminish gradually and even disappear altogether in the latter half of the current century. The explanatory factors behind this difference at present is still a rather young population and a relatively high fertility rates, but against it weigh such factors as relatively low mortality rates with increasing life expectancy.

³ The Icelandic Pension System. Már Guðmundsson (2001), <http://www.ll.is/files/baddeafhjb/pension-1.pdf>.

Table 2.1

Demographics of the Icelandic Population

	1985	1990	1995	2000	2005	Forecast 2040
Population, thous.	241,4	254,8	267,4	281,2	295,9	351,2
Changes, 5 years averages, %						
Population	-	2,6	2,6	2,4	2,9	-
Birth	-	4,3	4,6	4,3	4,1	-
Death	-	1,7	1,7	1,8	1,8	-
Natural increase	-	2,6	2,9	2,5	2,3	-
Net migration	-	0,0	-0,3	-0,1	0,6	-
Population - age structure, %						
Under 15 years	26,2	25,0	24,4	23,3	22,1	18,3
From 15 years to 64 years	63,7	64,4	64,3	65,1	66,2	62,0
65 years and over	10,1	10,6	11,3	11,6	11,7	19,8
Dependency ratio, %	15,9	16,5	17,5	17,7	17,7	31,9
Total fertility rate	2,4	2,3	2,2	2,1	2,1	2,0
Life expectancy, average age						
Male	-	-	76,4	-	79,2	-
Female	-	-	81,3	-	82,7	-
Mean retirement age, years						
Male	-	-	-	67,2	-	-
Female	-	-	-	65,2	-	-
Average retirement period, in years						
Male				13,7	14,0	15,5
Female				19,2	19,5	21,5

Improving health and better health services have led to an increasing life expectancy for children born and brought up in Iceland. The average life is getting longer every year. When the social security system was established in the late forties, the pensionable age was set at 67 years. At that time, the life expectancy of 65 year old men was 15 years and that of women 16.5 years. At present this stands at 18 and 21 years respectively.

The average length of employment periods in Iceland is high compared to other industrialized countries, or around 40-45 years on the average. The average retirement period is estimated as 14 years for males and 19.5 years for females at present. Labour participation in the age group 16 – 24 years is also very high or more than 77% in 2005. The average starting age is estimated to be around 20 years.

The official retirement age of the public pension system is 67 years, but the mean retirement age was estimated 67.2 years for males in the year 2000 and a comparable figure for females was 65.2 years.

Table 2.2

The Icelandic Labour Market

	1985	1990	1995	2000	2005
Population, thous	241,4	254,8	267,4	281,2	295,9
Thereof 15-64 years	153,7	164,1	172,0	183,1	195,8
Labour force, thous.	121,9	128,3	149,0	160,1	165,6
Male	-	69,6	79,0	85,1	87,9
Female	-	58,7	70,0	75,0	77,7
Labour force, % of population	50,5	50,4	55,7	56,9	56,0
Labour force, % population from 15-64	79,3	78,2	86,6	87,4	84,6
Labour participation by age groups, %					
16 - 24 years (first year 1991)	-	59,5	61,7	71,6	77,1
25 - 54 years	-	90,1	92,5	92,2	89,7
55 - 64 years	-	87,2	88,7	85,7	86,1
65 and over	-	27,6	25,1	19,7	17,4
Unemployed, thous	1,1	2,3	7,2	3,7	4,3
Unemployment rate, % of labour force	0,9	1,8	4,8	2,3	2,6

Chapter 3. Tax treatment and life cycle period.**3.1 General**

The taxation of pensions is mainly based on EET-principle in Iceland. In broad terms the tax treatment is the following:

- Pension contributions up to a certain maximum are deductible both by the employer and the employee.
- The investment returns of the pension funds are tax exempt until paid out.
- Pension funds are income tax exempt entities.
- Pension income is in most cases taxable as employment income when paid out.

The framework of the taxation are mainly stipulated in two Acts, i.e. the Income Tax Act, no. 90/2003 and the Pension Act, no. 129/1997.

A typical “life cycle” for an individual/employee is to pay the mandatory 4% income tax deductible contribution of his/hers total salaries to an occupational linked pension fund during their employment period which in most cases corresponds to the contribution period. His/hers employer is required to top up the employee’s contribution with minimum 8% of total salaries and to pay it into the same pension fund.

During the contribution period, the pension portfolio grows within a collective scheme in the custody of the pension fund in question, both due to continuing contributions and accruing interest, dividend or other capital income. When retired, usually at the age of 70, the individual receives the benefits in form of a pension income based on his/hers acquired pension rights without any distinction between actual contributions and capital income. These benefits are then taxed as ordinary income, like salaries without

any exemption. (“life-cycle” of Pillar two). At the age of 67, the individual has also the possibility to withdraw public pension (“life-cycle” of Pillar one).

The majority of employees in Iceland have taken the voluntary decision also to contribute to an individual pension scheme, usually the 4% income tax deductible amount from total salaries. In most cases his/hers employer adds to it a maximum of 2%. The individual can choose where to invest those contributions but it has to be with a bank, pension fund or any other financial institution with a license from the Ministry of Finance if the contributions are to be treated as pension savings and therefore tax deductible.

During the contribution period, the pension portfolio grows in the same way as in the mandatory system but on an individual account. At the age of 60, the individual can begin to withdraw his benefits in equal instalments over the period of seven years. He/she can, however, also postpone the withdrawal while carrying on contributing into the scheme, which makes the withdrawal period shorter with a higher payment of benefits per year. The tax treatment of those pension benefits are the same as of the mandatory system, i.e. taxed as ordinary income without any distinction between actual contributions and capital income. (“life-cycle of Pillar three).

Other typical forms of pension savings which fall outside the definition of the Pension Act are mainly owner occupied housing and all kinds of financial assets, such as ordinary bank accounts and securities. Only the first mentioned one, personal homes, has an important share in individuals’ overall accumulation of pension assets in Iceland where the saving ratio is relatively low if the assets of the pension funds are excluded.

3.2 Public Pensions- Pillar one

The public pension system in Iceland is fully financed by taxes, partly with a social security tax levied on all employers and partly by general taxation. The main financing source is the social security tax which is earmarked to the social security system and covers about 85% of the total expenditures of the system.

The social security tax rate is currently 5,73% and the tax base is total salaries. There is a minimum social security tax base for a self-employed person, amounting to approximately 9 thousand euros per year in the year 2006. Exemptions from the social security tax base include retirement income and pension benefits but the employer contribution to a pension fund is considered as a part of the tax base. No social security tax is levied on employees. The social security tax is regarded as regulatory operating expense and therefore deductible from the income tax base of employers.

Public pensions are taxed in the hands of recipients as ordinary income without any exemptions.

3.3 Mandatory occupational pension funds – Pillar two

As discussed earlier, every wage earner working in the private sector is obliged by law to contribute a minimum of 12% of his salaries paid or remuneration for any type of work, task, or service to a mandatory occupational pension fund, in most cases a fund predetermined by his trade union. More than half of the burden is, however, carried by the respective employer, who currently contributes a minimum of 8% of the total contribution. A similar arrangement exists in the public sector. Self-employed persons have also

to contribute a minimum of 12% of a minimum estimated salary according to specific rules published by the Minister of Finance.

The pension contributions, both the share of employers and employees, are deductible from the income tax base⁴. When paid out as pensions at the time of retirement the benefits are taxed as salaries. The amount of pensions paid is based on the rights that the pension fund member has accrued through contributions paid by himself/herself and the employer, plus the return of the fund. For tax purposes the payment from a pension fund is viewed, in its entirety, as a pension and taxed accordingly⁵.

Pension funds are fully exempt from taxation of their entire revenues pursuant to Article 4, Item 6 of Act no. 90/2003, cf. Article 2 of Act no. 77/2006.

3.4 Voluntary individual pension schemes – Pillar three

The third pillar is based on voluntary pension savings with tax incentives. As already discussed in chapter one the legislation on tax incentives for voluntary private pension savings was adopted as a part of the general pension reform in 1998. Its main aim was to encourage employees to increase their total pension savings individually, by allowing them to deduct from their taxable income a contribution to authorised individual pension schemes. An authorisation has to be acquired by the Ministry of Finance in order to be able to provide such pension schemes. In most cases they are defined contribution individual accounts.

Currently, the maximum taxable deduction by the employee is 4%. In addition, employers have agreed in wage settlements to contribute 2% to those voluntary pension savings if the employee matches the amount with at least the same percentage. The total contribution can therefore be 6%. The employer's contribution is treated as an operating expense and is therefore deductible for the employer's income tax base.

Any individual 16 years of age can contribute up to 4% of his/her salaries to private pension schemes, topped up by maximum 2% from the employer. The accrued tax exempt contributions together with the investment return are taxed as ordinary income when paid out. The minimum pension age is 60 years and the maximum 67 years. The pension is paid out in equal instalments over the withdrawal period.

3.5 Pension schemes without tax benefits

Contributions paid by an individual into life insurances or other similar voluntary pension saving schemes run by companies without specific pension funds licence approved by the Ministry of Finance are not

⁴ Legally or contractually required employer contributions for the purpose of acquiring pension rights for employees in a pension fund can be considered a deductible operating expense, cf. Article 31 of Act no. 90/2003, cf. Article 7 of Act no. 86/2000, provided that the pension funds receiving the contributions operate in accordance with the provisions of the Pension Act.

⁵ Retirement income and pension benefits are considered taxable income at the time they are paid pursuant to Article 7 of Act no. 90/2003 and are taxed at the general tax rate no matter how they have been invested, cf. Article 66 of the cited Act, no matter whether they are paid to the pensioner himself or to his heirs pursuant to Act no. 129/1997. The same applies to individual pension savings. Article 8 of the Act no. 86/2000, on Taxable Interest, Discounts, and Capital Gains states the following: "Interest, indexation, and other returns on pension savings pursuant to the Pension Act shall be considered as pension income according to Article 7, Item A, at the time such payments are remitted."

deductible from the income tax base. Returns from such schemes, i.e. interests, dividends, and other returns, are considered as investment income and taxed accordingly by 10% at the time of payment, while the withdrawal of the accrued contributions at the time of retirement is tax exempt.

If an employer is paying into such a scheme for his/hers employee, the contribution would be treated as a payment of wages in the hands of the latter and taxed accordingly. Simultaneously, the employer is supposed to treat it as wages in the company's accounts and as such the amount is deductible from the employer's income tax base. The tax treatment of the employee is the same as if he/she had paid the contribution directly into such a scheme as an individual.

No value added tax are paid on sales/brokerage of life insurance or similar pension insurance contracts.

3.6 Tax asymmetry

The general rule of the pension taxation in Iceland is reciprocity. Both mandatory and voluntary pension contributions are tax deductible for the employee and the employer and the benefits are taxed in the same way in the hands of the retiree. However, tax asymmetry could occur in exceptional cases.

The precondition for tax deductibility and hence the same tax treatment is mainly twofold. One is that the pension scheme provider or the custodian of the pension contributions has to operate according to the legislative rules of the Pension Act on a basis of a licence from the Ministry of Finance. If that condition is not fulfilled the benefits from the so-called pension scheme will be treated as withdrawal from a bank account or life insurance scheme, i.e. only the investment return accruing from the contributions will be taxed as capital income. If the individual has by mistake or wrongly deducted his/hers contributions from the income base, the tax authorities reassess his/hers tax return accordingly by levying and claiming additional income tax from the contributions. The same would happen as regards possible contribution from an employer into such a scheme. The employer can still claim such a contribution as a deductible cost from the company's tax base, but not as a contribution to a licensed pension fund for the employee but as an ordinary salary in his/hers hands.

Second, it could happen that the total mandatory and voluntary pension contributions of an individual/employee exceed the 8% maximum tax deductible amount of total salaries from his/hers income, usually in such manner that the voluntary contribution exceeds 4%. In such cases, his/hers tax returns are reassessed as regards the excess deduction but when paid out in a form of a pension benefit a double economic taxation will occur. The same would happen if the employer would pay more than 2% to voluntary individual pension schemes for an employee. Needless to say, these cases are very rare.

3.7 Tax rates

For the year 2006 the personal income tax for individuals 16 years and older was 36.72%, where 23.75% are levied by the central government and the 12.97% by the municipalities. The tax base are total income except capital income and the tax is levied on an individual basis. As regards the tax base, no distinction is made between pension benefits of any kind and other kind of income.

The personal tax credit amounted to about 350 thousand Isk for the year 2006 or approximately 4 thousand euros. It means that the income tax free threshold per individual was almost 1 million Isk or around 11 thousand euros in the year 2006. The tax credit is fully transferable between spouses. Children under the age of 16 pay 6% personal income tax in excess of total income of 100 thousand Isk or around 1.150 euros per year but they do not enjoy a personal tax credit. The personal income tax is withheld by the employer/pension fund at the time of the payment of wages/pension to the recipient.

The tax rate levied on investment income of an individual, such as interest, dividend, capital gains and rent, are 10%, usually withheld at the time of payment. The tax base is the gross investment income without any deduction of cost or investment losses.

3.8 Ceilings on deductibility of contributions

For the mandatory pension plans, the contributions are in general fully deductible by the employer but the maximum for the employee based on the income tax legislation is 4% of total salaries. The minimum contribution of total salaries must be 12% but in many cases the contributions are considerably higher dependent on the trade union contract in question or the financial situation of the pension fund. For example the State's contributions to the new pension fund of the public employees, amount to 11.5% of total salaries on top of the 4% paid by the employees themselves, or total contributions of 15.5%.

As regards contributions to a voluntary individual pension plan on the basis of the Pension Act, the ceiling for tax deductibility of the employee is 4% of total salaries while being 2% for the employer.

3.9 Retirement age, length of contribution and benefit periods

Pursuant to Article 1 of the current Pension Act, no. 129/1997, all employees and employers or self-employed persons are obliged to ensure their pension rights through membership in a pension fund from 16 years of age until 70 years of age. Contributions towards pension benefits shall be determined in special legislation, in collective bargaining agreements, in an employment contract, or by other comparable means. The main rule is that members can begin to withdraw old-age pensions at the age of 67. It is, however, possible to start withdrawing pension as early as 65, but then with a reduced benefit, or as late as 70 with additional benefits.

Article 4 of the Pension Act contains stipulations concerning minimum insurance benefits. It is assumed that contributions will be paid for 40 years and that the pensioner will begin drawing benefits at age 70, so that the minimum contribution should guarantee the pension fund member monthly pension benefits of at least 56% of the monthly salary upon which contributions are based, for the rest of his life. The obligation to acquire pension rights generally concludes at age 70, and the pensioner must begin drawing (old-age) pension benefits no later than at that age. In general, however, it is assumed that the drawing of individual pension savings is permissible from age 60 and concludes at age 67, at which time pension benefits from the social security scheme begin.

Pursuant to Article 14 of the Pension Act, a pension fund may authorise members to expedite or delay the drawing of general pension benefits by up to five years during the period between ages 65 and 70. With regard to individual pension rights, it is permissible to begin drawing pension benefits at age 60, provided

that two years have passed since contribution payments began. The disbursement of benefits may not take place over a period of less than 7 years, but only until age of 67 if that time limit is reached earlier.

3.10 Inheritance of pension rights

Pension rights earned and provided by the mandatory pension system are not inherited by the spouse of the deceased or his/hers children. However, the spouse can in most cases claim pension benefits from the pension fund in question based on the pension rights of the deceased for some years after his/hers death and the same rule applies generally for the children of the deceased until the age of 18.

Voluntary individual pension savings, on the other hand, are inherited by spouses, children or other relatives. Payments to children shall be divided into equal amounts and are payable until age of 18. These benefits, both the mandatory and voluntary individual pension savings, are taxed as ordinary income.

Chapter 4. *Balance between mandatory and voluntary pension arrangement, level of public pensions and degree of freedom*

4.1 The Government funded pension system.

The public pension system or the co-ordinated social security scheme was first implemented with the passing of Act no. 26/1936 on Public Insurance and is intended to guarantee pensioners minimum pension rights. Pursuant to the current Act no. 117/1993 on Social Security, pension insurance now includes old-age pensions, disability pensions, age-linked disability allowances, income guarantees, supplemental income guarantees, disability subsidies, and children's pension benefits. The cost of pension insurance within the social security scheme is now paid in full by the State, *inter alia* mainly with revenues generated by the social security tax. The old age pension is paid from the age of 67.

As described in more detail in chapter 1 the public pension consists of means-tested benefits. The core benefit is a basic payment which amounts roughly to 10 % of the average earning of unskilled workers and is means-tested by 30% reduction rate after a certain income threshold. The main transfers are, however, paid through the supplementary pension which is also means-tested with 45% reduction rate. The maximum pension per year for an individual without any kind of income is roughly the same as the minimum wage level. In short, the role of the public pension system is to be a safety net or a poverty relief for individuals without low or no other income or pension savings of any kind.

The public pension is paid on a monthly basis, but the means-testing is based on the yearly income of the recipient as declared on his/hers latest tax return. The State Social Security Institute, being a part of the Ministry of Health Care and Social Security, is responsible for the administration of the public pension system in Iceland.

4.2 The mandatory occupational pension system

The backbone of the Icelandic pension system is the mandatory occupational pension funds. Over the past few years their pension payments have increased very rapidly. In the year 2005 the total payments of

occupational pension benefits exceeded for the first time the total amount paid out as public pensions in form of social security benefits.

Pension payments from the occupational pension system are expected to increase still further in the years to come while the expenditures of the social security system in form of pension payments due to the means-testing will diminish. Voluntary individual pension savings have also increased very rapidly over the last decade in the wake of the 1997 pension reform. This also helps to accelerate the foreseeable development that pension payments under pillar two and three will gradually replace to a great extent pension payments under pillar one.

Chapter 5. *Issues of fiscal sustainability*

5.1 General

Retirement pensions have become a serious fiscal concern in most industrialised countries. Pensions are largely paid for from tax revenues and it is foreseen that contributions will need to be raised substantially during the coming decades. The reasons are that large age groups are now nearing retirement age, and that the populations of these countries live longer and have fewer children than in the past. The ratio of pensioners to people of working age will therefore rise substantially in the twenty-first century.

As described in earlier chapters the aging problem is not going to hit the Icelandic economy as hard as most other developed European countries in the near future. Hence, the fiscal concern of the central government which is responsible for the public pension system is not as grave as elsewhere even though the social security expenditures in Iceland have been increasing as everywhere else over the past decades.

5.2 The fiscal situation of the central government

The development of the central government finances has been positive in most respect over the past decade where the Treasury has been run with a surplus of 1% on the average as a percentage of GDP. The Government finances improved significantly in 2004 after a deficit in 2003 and then reached a record height in 2005, when the surplus amounted to 5,6.8% of GDP. The preliminary outcome for the year 2006 points to a surplus for the third consecutive year amounting to 4% of GDP.

The net debt of the central government, excluding pension fund commitments, has greatly improved during the past decade. For the year 2006, net debt is estimated at the equivalent of 4,5% of GDP compared with 35 percent in 1995.

Table 5.1

Central Government Finances 1995 – 2006

As % of GDP	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Financial balance	-2,5	-1,5	0,5	1,1	2,5	2,5	0,6	-0,6	-1,7	1,3	5,6	4,0
Net debt	35,0	35,3	32,8	25,9	19,2	19,1	22,6	18,6	19,3	17,4	6,2	4,5

The medium-term prospects are that the financial balance of the Central Government will be positive in the year 2007 and near balance in the period 2008-2010. Hence, the net debt of central government are supposed to decrease still further in the years to come.

5.3 Expenditures on different types of public pension

Several types of pension benefits are paid by the social security system as discussed in more detail in chapter 1. Following are some statistical information on the development of the social security outlays to elderly and disabled persons over the last decade.

Table 5.2

Expenditures of the Public Pension System 1995 – 2005

	Social security expenditure million lsk	Treasury expenditure total billion lsk	Social security as % of total expenditure of GDP		Beneficiaries as % of population	Numbers of beneficiaries Old age Disability	
1995	12.030	152,9	7,9	2,7	-	-	-
1996	12.657	163,0	7,8	2,6	11,4	23.063	7.577
1997	13.501	159,6	8,5	2,6	11,7	23.901	7.776
1998	14.629	177,8	8,2	2,5	11,8	24.382	7.980
1999	16.056	198,2	8,1	2,6	12,0	24.635	8.673
2000	18.452	211,7	8,7	2,7	12,3	25.175	9.329
2001	19.456	240,9	8,1	2,5	12,4	25.669	9.780
2002	22.190	262,0	8,5	2,8	12,7	26.054	10.443
2003	26.121	288,4	9,1	3,2	13,1	26.644	11.199
2004	29.249	302,9	9,7	3,2	13,1	26.427	12.011
2005	30.899	324,2	9,5	3,1	13,3	26.692	12.755

Over the past ten years the expenditures of the public pension system have slowly risen, from being around 8% of total expenditure of the central government up to 9.5%. This increase stems mainly from steadily increase of claims for disability pensions over the past few years, as can be seen from the table above, which has created some worries for the future of the public pension system. This development is also seen in the outlays of the occupational pension funds. This situation is currently under serious discussion between the Government and the pension funds with the aim to find a sustainable solution for the pension system as a whole.

5.4 The fiscal sustainability of pension system

In the year 2005 the return on the occupational pension funds' investments was positive for the third consecutive year. All mutual insurance divisions and personal pension schemes showed positive returns in 2005. Preliminary figures for the year 2006 indicate continuing positive returns. Pension fund returns must, however, be viewed in a longer –term perspective, as the returns of the past years are very high in a historical context. Thus, the pension funds' average real return during the past 10 years, i.e from 1995-2005, was 6.5%. At year-end 2005, the funds' net assets were ISK 1.220 billion, or the equivalent of 122% of GDP.

At year-end 2005 there were 46 occupational pension funds in operation in Iceland. Of these, 36 are still fully operational, while 10 no longer receive contributions. The obligations of 12 of the 46 pension funds are guaranteed by another party, i.e. the state, a local authority or a bank.

Pension funds have been steadily decreasing in number in recent years. At year-end 1999, for example, 66 pension funds were in operation in Iceland. There have been several large mergers of occupational pension funds over the past few years and the outlook is for further mergers in the coming years. Since larger funds can diversify their risk better and operate more efficiently, the reduction in the number of pension funds is a positive trend. At year-end 2005 the ten-largest pension funds owned 75% of the net assets of all pension funds.

The actuarial position of pension funds without employer guarantees have improved a lot over the past few years due to an exceptionally good rate of return from their investments. At the end of 2005, the position of 22 active non-guaranteed mutual pension funds out of a total of 34 was positive and the majority of those in red showed a deficit ranging from 0% to 5%. The pension funds guaranteed by employers are on the other hand run with a considerable deficit. The largest one is the old pension fund of the public employees. Hence, every year since 2000 the central government has paid additional contributions into the old fund with the aim to rectify its actuarial position against future commitments.

Pension funds, commercial banks, savings banks, securities firms and life insurance companies are authorised to accept premiums for private pension savings in addition to the mandatory minimum coverage, in accordance with the provisions of the Pension Act. At year-end 2005, there were 48 parties offering pension savings schemes and supplementary insurance cover, thereof 18 pension funds.

By the end of the year 2005 Icelandic pension funds held assets of almost 1.220 billion Isk while the GDP the same year amounted to little less than 1.000 bn. kr. Contributions to pension funds are still far in excess of payments to retirees and disabled persons. Pensioners are still few in proportion to working fund members, and most have only paid contributions from their total income for part of their working life and are therefore entitled to relatively small benefits. Furthermore, funds receive income on their investments. Their assets therefore look set to increase substantially over the coming years.

However, the number of old-age pensioners is expected to rise relative to the working-age population in the years to come and their benefit levels will be considerably higher.

According to the Financial Supervisory Authority's yearly report for the year 2005 the funds' assets and expected contributions from current members do not entirely cover their future commitments based on their accounts at the year-end 2005. The main shortfall is faced by funds with employer guarantees, namely in the public sector, although these also have sizeable assets. On the whole, however, Icelandic pension funds face only a minor challenge compared with the problems looming over the systems of most advanced countries. Interestingly, notwithstanding all the monetary savings made through the pension fund system, the level of national saving in Iceland is low compared to other countries.

Table 5.3

Assets of mandatory and voluntary pension schemes 1999 – 2005

	<i>Voluntary pension schemes</i>			<i>All pension funds</i>	
	Assets, net b. kr.	GDP b. kr.	Assets % of GDP	Total assets, net b. kr.	Supplementary assets as % of total assets
1999	31	628,5	4,9	518	5,9
2000	35	678,3	5,2	566	6,2
2001	43	764,9	5,6	645	6,6
2002	59	799,6	7,4	679	8,7
2003	83	827,9	10,0	824	10,1
2004	111	916,8	12,1	987	11,2
2005	146	996,0	14,7	1.220	12,0

Future prospects for the pension funds are heavily dependent on the development of demographic factors such as the age distribution of members and their life expectancy. Also on interest rates development, the inflation and currency fluctuations which are the driving factors behind the pension funds' returns on their assets. The pension rights are price-indexed and indexed bonds have hitherto accounted for a large share of the funds' asset portfolios. Wage changes, especially those of real wages which are dependent of changes in productivity, are also an important factor. In a system where contributions are a fixed percentage of lifetime earnings, pensions will be a small percentage of the wages of the employed if productivity increases strongly. The arrangement of the pension rights also plays an important role.

It has even been suggested that the means-testing of the social security benefits will wipe out the supplementary public pension for most people who have paid into occupational pension funds during their working life. Based on the recent trends, the retirement income in the future will be based on three different pillars than it is now, which are relatively small public pension, dominant mandatory funded pension schemes and voluntary private pension saving with tax incentives. The role of the tax-financed public pension system will therefore diminish as the following table shows.⁶

⁶ A report published by the Confederation of Employers in the year 2006.
http://www.sa.is/files/SA%20lifeyrisskýrsla_545063612.pdf.

Table 5.4

Pension Payments 2005 – 2040				
<i>Estimates</i>				
Year	Billions, ISK		Relative share, %	
	Pension funds	Social Security	Pension funds	Social Security
2005	21,9	21,4	51	49
2010	24,7	22,2	53	47
2015	32,2	24,6	57	43
2020	44,5	26,8	62	38
2025	59,6	29,4	67	33
2030	75,5	31,7	70	30
2035	89,9	33,1	73	27
2040	99,2	32,9	75	25

Chapter 6: *International mobility of labour and capital*

6.1 General

Free movement of labour and capital has had a large impact in Iceland during the upswing of the economy over the past few years. A mass of immigrant workers, both from countries within the EEA area and other countries, has flooded the Icelandic labour market, with strong impact on the tax and the pension system.

Every wage earner working in Iceland is obliged by law to contribute a minimum of 12% of his salaries to a mandatory occupational pension fund, whereof his/hers respective employer contributes a minimum of 8% of the total contribution. This rule applies both to resident and non-resident wage earners without any exception. The social security tax must also be paid of wages paid to non-resident workers, except in cases where the worker in question has an E-101 certificate.

Non-residents have the same right to tax privileges on contributions to pension schemes as residents.

6.2 The establishment and operation of pension funds

All pension funds that receive mandatory contributions from employed persons in Iceland must have a license from the Ministry of Finance and fulfil obligations that are stated in the Pension Act. Those funds which are monitored by the Financial Supervisory Authority in Iceland, must be located in Iceland and operate according to Icelandic law.

But if a pension fund operates a voluntary pension scheme, it is not required to be situated in Iceland if it fulfils requirements stipulated in the Pension Act. The requirements are that these pension funds are established and licensed in another state of the European Economic Area or member state of the European Free Trade Association treaty. This also applies to commercial banks, saving banks, and securities undertakings and life insurance companies.

Both the mandatory pension funds and the institutions offering individual pension schemes are obliged to provide the Internal Revenue Directorate with relevant information on tax deductible contributions in connection with the yearly filing of individuals' tax returns. No non-resident pension fund or a branch offering individual pension schemes with tax incentives has yet been established in Iceland; several foreign insurance companies have, however, put up a branch, offering insurance schemes without tax incentives.

6.3 Tax deductibility of pension contributions paid to foreign institutions

As regards individual voluntary pension schemes an amendment was adopted in 2004 in order to address concerns raised by the EFTA Surveillance Authority on the compatibility of the previous provision in the Icelandic Pension Act with the freedom to provide services. Hence, a person resident in Iceland enjoys equal possibilities of tax-privileged pension contributions to domestic or foreign pension institutions if the latter one is situated in a EEA or EFTA member state. However, preferential tax treatment of contributions paid to mandatory occupational pension schemes is still conditional on the institution being established in Iceland. The right to deductions is based on the provisions of the Act on Income Tax, no. 90/2003. Tax treaties between Iceland and other countries do not include any special provisions governing the treatment of contributions paid to foreign pension institutions.

6.4 Tax treatment of pension payments from a abroad to an Icelandic resident

The tax treatment of pension payments paid from abroad to an Icelandic resident is the same as of one paid domestically; they are taxed as ordinary earned income. If the person concerned is from a Nordic country, the pension benefits are taxed in the country paying the retirement income, but indirectly according to the exemption method in Iceland. However, tax treaties between Iceland and other countries stipulate in most cases the use of the credit method.

6.5 Tax treatment of pension payments to a resident abroad

In case of an individual who is entitled to a pension in Iceland but resides abroad the tax treatment is the following. The recipient of the payment is taxed as a resident in Iceland and is granted a personal tax deduction that can only be used to offset levied income tax and municipal tax on retirement income or pension benefits, cf. Article 70, Item 2, Paragraph 3 of Act no. 90/2003. However, tax treaties between Iceland and other countries stipulate in most cases a use of a residence taxation.

6.6 The tax treatment of pension portfolio return (yield taxation)

Iceland does not subject tax-privileged pension schemes to yield taxation. Licensed pension funds are tax exempt entities.

6.7 Tax incentives – persons moving from one state to another

Iceland has special rules of domestic law ensuring the right of persons moving within the EEA area (those countries) to privileged tax treatment if they continue to pay contributions to a pension scheme in the state of origin irrespective of whether this scheme meet the same conditions as national pension schemes. Iceland has not included provision in that respect in any of their double-tax treaties.

6.8 EU/EEA law on the forming of the taxation of pensions

EU/EEA law has had various effects on the taxation of pensions in Iceland despite the fact that when the Agreement on the European Economic Area was signed in Oporto on 2 May 1992, it was acknowledged that the scope of the EEA Agreement was not meant to cover matters of taxation. In this regard, the EEA Agreement deviates from the EC Treaty.⁷ This has been further stipulated in various judgments from the EFTA Court.⁸ In addition to amendments to the Act on Income Tax, no. 90/2003 two amendments have been made to the Pension Act, no. 129/1997, which derive from EU/EEA law. The first amendment came about with Act no. 65/2002, concerning the investment provisions of the Pension Act (Article 36). The second amendment is Act no. 70/2004, concerning the implementation of Council Directive 98/49/EC, on safeguarding supplementary pension rights. In addition to the implementation of Council Directive 98/49/EC, the amending Act no. 70/2004 also took into account comments received from the EFTA Surveillance Authority regarding the establishment of branches. All these three amendments to the Pension Act, Articles 8(4-5), 19(a) and 36, were adopted in order to fulfil Iceland's obligations under the EEA Agreement.

According to the EEA Agreement, and the EFTA Court and Surveillance Agreement, it is the purpose of the EFTA Surveillance Authority to ensure that the contracting parties fulfil the obligations they undertook when signing the EEA Agreement. The Authority has, in three cases, made comments to the Icelandic authorities on the Pension Act no. 129/1997, and these three cases have all been dealt with as is explained above.⁹

Chapter 7. *Implications for capital markets and financial stability*

7.1 The development of the pension funds

The growth of the Icelandic occupational pension funds has been enormous over the last decade. Before 1979, at the time of financial repression, the assets of the pension funds were dissipated. But assets growth took off during 1979-1986 when financial indexation and market-determined interest rates were introduced. Assets now amount to more than 120% of the country's GDP. Prior to the liberalization of the financial system in the 1990s, the pension funds had very few choices for properly investing their funds. However, the almost simultaneous emergence of the new pension system (after 1997) and the liberalization of financial markets had powerful interactive effects¹⁰. Presently, Iceland has the highest ratio of assets as percentage of GDP compared to the OECD member states.

7.2 Pension funds as a domestic investor.

The Icelandic pension funds are the largest domestic investors on the Icelandic capital market today. Hence, they are playing a very important role in its development at present. But pension funds also played an important part on the domestic market in the past, being the largest buyer of bonds on the Icelandic

⁷ Reference is made to Articles 93, 94 and 308 of the EC Treaty.

⁸ Reference can be made to judgments of the EFTA Court E-6/98, E-1/01 and E-1/03. Paragraph 17 of judgment E-1/01 states: "The Court notes that, as a general rule, the tax system of an EEA State is not covered by the EEA Agreement."

⁹ With the amending Acts no. 65/2002 and 70/2004.

¹⁰ Mishkin, Frederic S., and Herbertsson, Tryggvi Thor (2006). *Financial Stability in Iceland*, a report to the Iceland Chambers of Commerce. Iceland Chamber of Commerce, Reykjavik.

capital market for years. Today, the pension funds are both significant buyers of domestic equities and securities and also an important supplier of mortgages to households. The pension funds' strong demand for financial instruments, combined with new opportunities for supplying securities and bonds, was the catalyst that in the 1990s rapidly triggered a vibrant market for financial securities in Iceland.

According to Mishkin and Herbertsson the pension fund system has also served an indirect educational function by training investment managers and providing challenging opportunities for a new generation of financial managers, who were also helped by a stable and favourable climate during the 1990s. The outcome has been a dynamic financial system that has outgrown the Icelandic market.

Table 7.1

<u>Some Key Figures</u>						
Year	Population yearly average Thous	Pension assets billions kr.	GDP billions kr.	Assets % of GDP	Assets per capita thous kr.	USD
1995	267	263	453,7	57,9	982	14.710
1996	269	307	487,3	62,9	1.140	17.247
1997	271	353	525,9	67,1	1.302	18.789
1998	274	407	584,1	69,7	1.488	21.059
1999	277	518	628,5	82,4	1.867	26.349
2000	281	566	678,3	83,5	2.013	25.682
2001	285	645	764,9	84,3	2.262	24.018
2002	288	679	799,6	84,9	2.361	25.434
2003	289	824	827,9	99,5	2.849	37.066
2004	293	987	916,8	107,6	3.372	50.534
2005	296	1.220	996,0	122,5	4.124	65.797

7.3 The Investment Rules

As discussed earlier, Icelandic pension funds and entities of similar kind operate today on the basis of the Pension Act which contains detailed rules on required investment policy of the pensions. Before 1997, no such rules were in place for the funds. According to those rules the board of a pension fund shall formulate its investment policy and invest the assets of the fund according to the best terms at each time, as regards return and risk on the basis of the stipulated investment rules. Pension funds are then obliged to send information regarding their investment policy for the upcoming year to the Financial Supervisory Authority, no later than December 1 each year.

The main investment rules are as follows:¹¹

1. *In Treasury bills, bonds and other securities guaranteed by the Treasury.*
2. *In bonds guaranteed by the municipalities.*
3. *In mortgage debentures amounting to a maximum of 80% of the evaluated market price of a residential property. Also in mortgage debentures for commercial buildings, but there the maximum shall be 35%.*
4. *With deposits in commercial banks, savings banks and credit institutions.*

¹¹ More detailed information on the pension funds' investment rules can be found on the website of the Ministry of Finance; <http://www.stjr.fjr.is>.

5. *In bonds issues by commercial banks, savings banks or other credit institutions that are subject to the supervision of FME.*
6. *In equities.*
7. *In units in collective investment undertakings (UCITS) with certain limitations*
8. *In other securities.*

7.4 The Role of FME

The Financial Supervisory Authority (FME) is a state authority with its own board of directors. Its role is to ensure that the activities of parties subject to supervision are in accordance with laws and regulations and that they are in every respect consistent with sound and proper business practices. Pension funds are one of the parties under the FME's supervision.

The FME has formulated a role of providing parties subject to supervision with a constructive and systematic restraint, while at same time supporting the development of efficient and sound financial activities with an emphasis on the professional internal organisation of financial firms. The FME fulfills its role by ensuring that the activities of parties subject to supervision are in compliance with current laws, regulations, rules and by-laws applicable to their operations and in all other respects consistent with sound and proper business practices.

According to FME's annual report for the year 2005, all Icelandic pension funds are expected to have undergone overall inspection or more specific examinations of their investments by the year-end 2005. No serious problems seem to have emerged from FME inspection and the general operation of the Icelandic pension funds seem to be in good compliance with laws, regulations and guidelines put forward by the FME and other parties.

7.5 Financial stability/robustness of the Icelandic occupational pension funds

The Pension Act stipulates very clearly the financial stability rules that the pension funds have to meet each year under the supervision of FME. The evaluation does not take accounts of taxes as the returns from pension portfolios are tax exempt.

Net assets of a fund for payment of pensions, along with the current discounted value of future contributions, shall be equal to the current discounted value of expected pensions arising from already paid contributions and future contributions. A schedule of future contributions and expected pensions shall be based on real fund members at the time of reference used by an actuarial assessment. Net assets for payment of pensions shall at all times be evaluated in accordance with the Pension Act's provisions.

If an actuarial study reveals that there is more than 10% difference between asset items and pension commitments the respective pension fund is obligated to make necessary changes to the statutes of the fund. The same applies if, according to actuarial studies, the difference between asset items and pension commitments has been more than 5% for a continuous period of five years.

7.3 The main assets of the pension funds

The asset composition of the pension funds has changed substantially since the Pension Act came into force at the beginning of the year 1998. A larger portion of the funds' assets is now variable-yield securities, with a corresponding drop in fixed-income securities which were previously the mainstay of the funds' assets. At present, pension funds' securities portfolios are divided roughly equally between fixed-income securities and variable-income equities and mutual fund units.

The proportion of equities in limited companies and in closed-end mutual funds, as well as in unit share certificates in UCITS, has increased greatly since 1997. At year-end 2005 these asset classes amounted to almost half of the total assets of the pension funds, rising by almost 10% over half a decade. Another striking feature is the increasing share of foreign assets, from almost non-existence in 1995 to about one fourth of the pension funds' total assets a decade later.

Table 7.2

Assets of occupational pension funds						
	<u>Billion kr.</u>			<u>Types of assets, % of total</u>		
	1995	2000	2005	1995	2000	2005
Cash and deposits	6	9	24	2,1	1,6	2,0
Fixed-income securities	230	335	589	87,4	59,1	49,1
Treasury	21	18	26	7,8	3,2	2,2
Municipalities	13	17	35	4,8	3,0	2,9
Housing bonds	54	98	57	20,6	17,3	4,8
Household mortgages	38	56	95	14,3	9,9	7,9
Other securities	105	146	376	39,8	25,8	31,3
Variable-income securities	12	218	578	4,5	38,5	48,2
Equities	7	103	231	2,8	18,1	19,3
Mutual funds	5	58	158	1,7	10,2	13,1
Equity funds	0	58	189	0,0	10,2	15,8
Other assets	16	4	10	6,0	0,8	0,8
Assets, net	263	566	1.200	100,0	100,0	100,0
Thereof foreign securities	5	128	297	1,9	22,6	24,7
% of GDP				57.9	83.5	122.5

7.4 The future development¹²

Over the next ten years the Icelandic pension funds will need to invest around 1,000 b.kr. at present price level, or close to the value of one year's GDP, over and above their current assets. In what areas are the pension funds going to invest ?

¹² Gudmundsson, Gudmundur and Baldursdottir Kristiana. *Pension funds– Future prospects and uncertainties*, <http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=3581>.

Pension funds are already very active in the domestic market and its relatively large size makes them a major force in domestic financial markets, both at present and in the future. They own around 12-13% of all equities listed on the Icelandic Stock Exchange. Then, the pension funds are a major stakeholder of market bonds where they hold around 47%. Mortgage lending by pension funds has been quite stable over the past decade and little prospect for further increase in that area. Hence, available domestic investment opportunities to pension funds for domestic investment of the large sums they will have at their disposal over the coming decades seem to be very limited. The most likely implication of those scarce domestic opportunities is that pension funds will gear up their investment abroad. Thus, returns on foreign securities could be crucial for the future of the occupational pension funds in Iceland.

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