

Weathering The Storm – Icelandic Municipalities’ Handling of an Unprecedented Economic Crisis

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Abstract

Within a few days in October 2008, following serious turmoil on financial markets worldwide, some 85% of the Icelandic banking sector collapsed, together with the Icelandic currency, the *króna*. Almost all the rest followed early in 2009. The Icelandic stock market took a nosedive. The Republic of Iceland had entered the worst economic crisis of its history.

Icelandic municipalities, which had taken on an increasing burden of running the welfare state, were hard hit financially, without the ability of the state to help out. In fact, some of the post-crisis actions of the state, under IMF direction, were difficult for the municipalities. It did not make things easier that the crisis had been precluded by an unprecedented period of growth, encouraging the municipalities to borrow in international markets and invest in infrastructure that turned out to be superfluous in the post-crisis period.

This paper will look at the reactions of the Icelandic municipalities to the crisis, the political implications of it, where they are now and if there are lessons that can be learned from the difficult years in the last decade.

Keywords: Iceland, financial crisis, post-crisis initiative, Icelandic municipalities, reforms

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1. Introduction

Iceland was one of the early casualties of the financial crisis of 2008. Following serious turmoil on financial markets worldwide, some 85% of the Icelandic banking sector collapsed in October that year. Much of the remainder of Icelandic financial institutions followed early in 2009. So did the Icelandic currency, the *króna* (Matthíasson, 2009, p.1). From the beginning of March 2008 to December 2008, the currency index of the króna went from 130 to 250, thus losing half its value (“Gildivísitölunnar,” 2009). The Icelandic stock market lost 98 per cent of its value in less than two years (“Úrvalsvísitalan OMXI15,” 2009). Icelandic society was in total shock. The Republic of Iceland had entered the worst economic crisis of its sixty-year history.

Suddenly the world’s eyes were on Iceland. On 24 October the Icelandic government requested a two-year Stand-By Arrangement from the International Monetary Fund (IMF) for SDR 1.4 billion to prevent a further sharp króna depreciation, ensure medium-term fiscal sustainability and develop a comprehensive bank restructuring strategy (IMF, 21 October 2008).

Iceland’s GDP, which had been growing rapidly in the pre-crisis years contracted by 6.6 percent in 2009 and 4.2 percent in 2010 (Organisation for Economic Co-operation and Development, 2013). In the preceding years many companies and individuals had been tempted by relatively low interest rates abroad, compared with the exceedingly high rates in Iceland, to borrow in foreign currencies. Their debts now more than doubled in less than a year (Daníelsson&Zoëga, 2009, p.14). The consequences of the crisis for the Icelandic people have been severe, and will remain so for years to come.

But no less severe were the consequences for Icelandic municipalities. Many had been investing in infrastructure in the pre-crisis years, trying to attract new companies and inhabitants. This was especially true in the Capital Area, (the capital city Reykjavík and the 6 municipalities around it) and in Suðurnes, a peninsula close to the capital. Many had amassed debt in foreign currency, and when the króna collapsed, their debts multiplied. High inflation was also an important factor in this respect, since most loans in Iceland are indexed to inflation (Íslandsbanki, 2015). This paper will go briefly through what happened, how the municipalities tackled this new reality, where they are

now in this respect, which political implications the crisis had in the largest and hardest hit municipalities and whether there are lessons that can be learned.

2. Icelandic municipalities

As in so many other countries, the 20th century in Iceland was characterized by urbanization. Therefore, by the end of the century, around 70% of the Icelandic population was living in the capital city, Reykjavik, or its neighbouring towns (within a 100 km radius) and 90% of the population increase in Iceland in the last decade occurred there (Nordregio, 2014, p. 17). Iceland has a population of approximately a third of a million with a population density of 3.1 per km². In 2014 there were 74 municipalities in Iceland with a population span of 50 to 118,000 inhabitants (57% of them have fewer than 1,000 inhabitants) (Hagstofa Íslands, 2014). Formally, Iceland has a two-tier administrative system, but local authorities have organized regional associations (*landshlutasamtök*), the importance of which varies from one region to another. (Magnússon & Hlynsdóttir, 2014, p. 2). In the capital area cooperation on important aspects, such as public transport and planning has been growing steadily in recent years (M. Á. Skjöld Magnússon, 2014).

The autonomy of the Icelandic municipalities is constitutionally protected, which has led to the state being reluctant in initiating a mandatory large-scale territorial reform on the local level similar to the territorial reforms that have taken place in the other Nordic countries in past decades. This does not mean that there have been no territorial reforms: in 1990 there were 206 municipalities in Iceland so significant strides have been taken in this respect in the last quarter of a century. Although initiated by functional decentralization by the state, the amalgamation processes have mainly been bottom-up in contrast to top-down incentives in the neighbouring countries (Hlynsdóttir, 2002).

Icelandic local authorities have until recently benefitted from a large degree of fiscal autonomy, especially in their budget and borrowing activities. This became evident after the financial crisis in 2008 when several local authorities experienced serious financial difficulties, partly because of lack of auditing on the part of the central

government. One of the responses was to impose stricter fiscal regulation in the new Local Government Act in 2011 (“Sveitarstjórnarlög, 2011 nr. 138,” 2011).

When compared to the other Nordic countries, where municipal and regional authorities account for roughly two-thirds of official spending, in Iceland, even though it has grown somewhat in the last decades, the proportion is closer to one third (Kristinsson, 2007, p. 248-9).

3. The Hardest Hit

Although the financial crisis in 2008 undoubtedly touched all municipalities in one way or another, it did so differently. This of course reflected what had been going on in the municipalities before the financial crisis. During the boom years the population of the Capital Area and Reykjanes peninsula (Suðurnes) grew up to roughly 5 per cent on average per year. The greatest population growth was in Reykjanesbær, the largest municipality on the Reykjanes peninsula, the site of Iceland’s main international airport and just 30 minutes’ drive away from Reykjavík, 5.2 per cent between 2005 and 2010. It must be taken into consideration that the years 2009-2010 are included in this figure but during that period the population in Reykjanesbær actually contracted around 1 percentage point (Hagstofan, 2010, p. 14. Total population growth in Reykjanesbær between 2005 and 2014 was 32.6 per cent, compared with 10.9 per cent in Iceland as a whole (Haraldsson, 2014, p. 10).

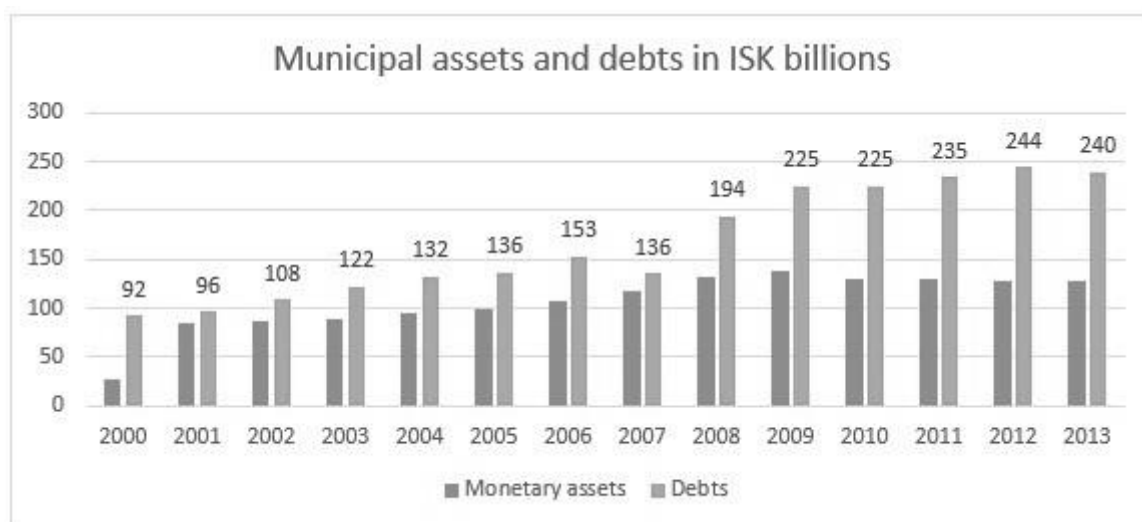
The slowest relative growth in this area was in Reykjavík proper, which only grew by 0.8 per cent per year between 2005 and 2010 and a meagre 6.5 per cent between 2005 and 2014. The bulk of the growth took place in the townships surrounding Reykjavík, in Kópavogur, Garðabær and Hafnarfjörður, which all grew 3.3 per cent per year during the period 2005 to 2010 and by around and just over 25 per cent up to 2014, and Mosfellsbær which grew 4.6 per cent in the boom years and by 33.1 per cent up to 2014, the biggest population increase in a relatively large town in Iceland (Haraldsson, 2014, p. 11).

This quick population growth strained the infrastructure of the area and it is safe to say that the construction industry was overstretched during the period. New neighbourhoods were planned, prepared and built, much of which was financed by

borrowing abroad in an international capital market flooded with cheap capital. Iceland’s credit rating was during these years amongst the best in the world and this was reflected in the ratings of Icelandic municipalities that had a relatively easy access to capital in international markets(Moody’s Investors Service, 2008).

Borrowing in foreign currency meant that when the Icelandic currency took a nosedive, the debts of these municipalities almost doubled without their incomes being affected in a similar manner. Figure 1 shows how the financial crisis affected the debts of Icelandic municipalities, where it shoots up from ISK 136 billion in 2007 to ISK 225 billion in 2009 and monetary assets staying approximately the same(“Helstu hagstærðir sveitarfélaga 1980-2014,” 2015). The hardest hit were the municipalities that had previously grown fastest with a few municipalities in the Capital Area and Reykjanesbærin the lead. One small municipality, Álftanes, (population ca. 2,500) the site of the residence of the President of Iceland squarely within the Capital Area, became a casualty of the crisis. Due to the extravaganza of a swimming pool it built during the boom years, the debts it had amassed were so impressive, that it had no option other than,in the year 2013,to merge into a significantly larger neighbouring municipality, the financially strong Garðabær (population ca. 11,000), mainly inhabited by citizens with higher than average incomes(“Alþingi, þingskjal 611 — 104. mál.,” 2014).

FIGURE 1: ASSETS AND DEBTS OF ICELANDIC MUNICIPALITIES



Source: Hagstofa Íslands 2015

On 1 January 2012 a new Local Government Act came into force with stricter fiscal regulations for municipalities. Thus now the debt ratio of municipalities could not be higher than 150 per cent of its revenues (“Sveitarstjórnarlög, 2011 nr. 138,” 2011). Although this is a worthy goal for the future, it does not reflect the reality of many Icelandic municipalities today in the wake of the financial crisis. Thus in 2013, Reykjanesbær’s ratio was the highest, 271.4 per cent of income. The average for all Icelandic municipalities was at that time 184 per cent and a year earlier they were on average 213 per cent (Haraldsson, 2014, p. 12). The municipalities above the 150 per cent target were given ten years from 1 January 2013 to reach the benchmark and debts have been going down significantly (Íslandsbanki, 2015).

It must be noted that not all the debts are a result of foreign borrowing to pay for infrastructure, some of it reflects the obligations of these municipalities in pension funds, the debts of municipal companies, such as utility services and geothermal plants and rent contracts into the future, but some municipalities, such as Reykjanesbær, “outsourced” housing for schools and municipal services, by having private companies building, owning and running the houses and the municipality renting it from these private actors long term. Such contracts accounted for 34 per cent of the total debt of Reykjanesbær in 2013. Previously such rent contracts were excluded from municipal annual accounts, but since 2010 the municipalities have been obliged to factor them in (Haraldsson, 2014 p. 14).

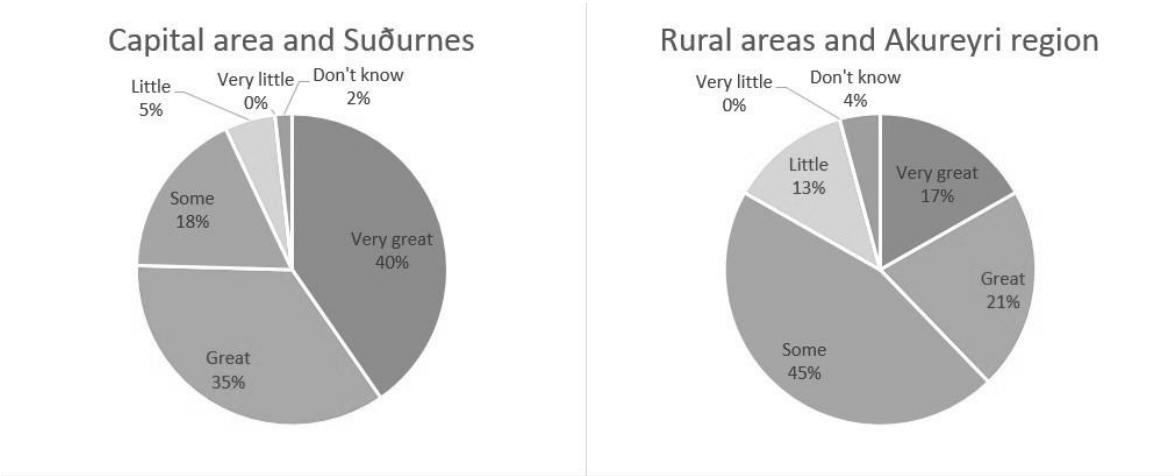
4. Municipalities’ Reactions To The Crisis

In 2011 the Association of Icelandic Municipalities (*Sambandíslenskrasveitarfélaga*) published a report on the fiscal reactions of Icelandic municipalities to the crisis in which it was shown that most of them were in the process of undertaking significant measures to cut budgets and restructure the ways things were done to meet the contraction in revenues caused by the crisis. Many of them did so without consulting the citizens, but those that did reported better results. Much of the municipal expenses are salaries so it came as no surprise that around a half of the municipalities foresaw downsizing staff. Also, many municipalities in Iceland are small and the tasks they are obliged to perform are formidable and sensitive, such as social

services, general administration, education, childcare, culture, sports and youth activities, so increased cooperation was also high on the agenda. (Samband íslenskra sveitarfélaga, 2011, p. 5).

In a poll² conducted for this paper amongst municipal council members in Iceland and Icelandic mayors in the fall 2014, 49% of the respondents who replied said that the financial crisis in 2008 had had a great (26%) or a very great (23%) impact on their municipality's finances (M. Á. S. Magnússon, 2014b). Thirty-eight per cent said the crisis had had some impact, 11% said little impact and only 2% that it had had very little impact. This should come as no surprise since there is a wide variety in size and function of Icelandic municipalities. There is as mentioned above a marked difference between the Capital Area and Suðurnes (which is the area closest and – since it is almost exclusively urban – most comparable to the capital area) and the rural regions plus the Akureyri region (Iceland's second city outside the capital area) on the other. Thus, 78% of those polled in the capital area and Suðurnes said the crisis had had a great or very great impact on their municipality's finances, but only 38% of those in the rural regions. "Some impact" was, however, visible in the rural regions, where 43% used that phrase to describe the effects of the crisis, compared to 18% of those in the capital area and Suðurnes (see figure 2).

FIGURE 2: IMPACT OF FINANCIAL CRISIS ON MUNICIPALITY'S FINANCES



Source: Magnússon, M.Á.S. (2014b)

²A poll conducted by the author amongst almost all current council members and mayors in Iceland in the period 25 August 2014 – 8 September 2014. Four hundred and thirty-seven questionnaires were sent out; 222 were completed and returned, a response rate of just over 50%.

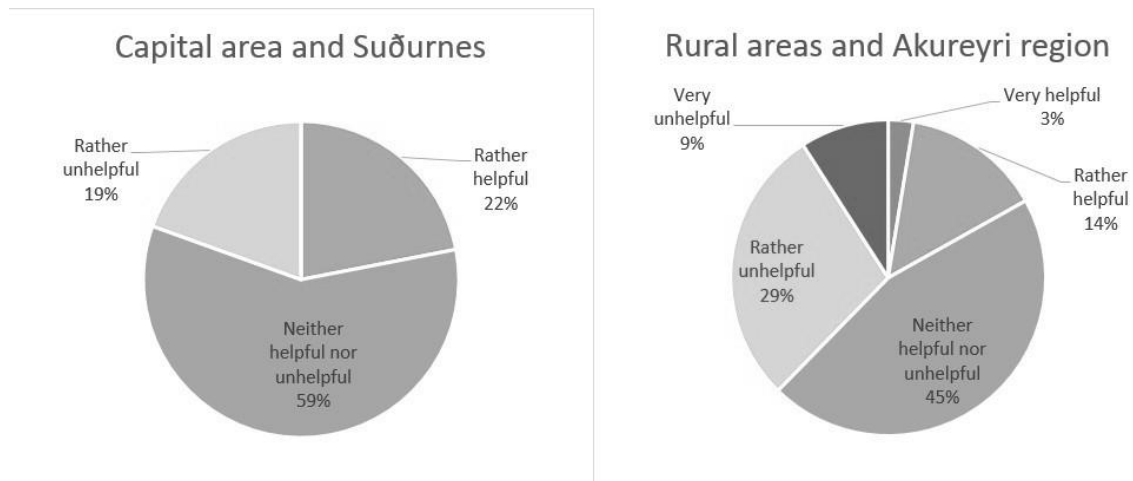
Thus, the crisis and the responses to it are obviously very salient issues amongst Icelandic municipalities. Seventy-two per cent of those who responded acknowledged that their municipalities took specific measures to tackle the consequences of the crisis, 16% said that their municipalities did not take any specific measures and 12% were not aware whether or not anything in particular was done. None of the municipalities where the respondents claimed no measures had been taken were in the capital area. Of those polled, most mentioned “cuts in municipal budget” as the main measure (121), “new priorities in spending” (90), “adjustments of salaries” (86), “changes in prices of municipal services” (80), “projects postponed” (78), “organisational changes within local government” (68), “renegotiations with lenders” (51), “sale of properties” (50) and “specific reactions in social services” (48). Other measures were mentioned less often.

Most (92%) were in agreement that the measures undertaken had produced at least some results. Sixteen per cent said they had produced very significant results, 39% significant results and 37% some results. Only 4% said they had produced little or very little results, and 4% did not know one way or the other. It is perhaps no surprise that none of those who claimed some responsibility for the measures thought that they were in vain. Cuts in budgets were also most frequently mentioned as the one measure that had produced most results (29 of the respondents ranked this on top, compared with only 12 mentioning the three other measures that came collectively second: postponement of projects, changes in salaries and new priorities in spending).

The Icelandic left-wing government of 2009-2013 found itself in the position of having to tackle the fallout of the financial crisis of 2008. Many of the measures taken by the government impacted the municipalities, and when polled the majority of mayors and council members were of the view that the government’s responses to the crisis had been less than helpful if viewed in terms of the impact they had had on their municipalities’ means to tackle the crisis. Only 2% of the respondents found the government’s measures very helpful; 15% found them somewhat helpful, 44% neither helpful nor unhelpful, 23% rather unhelpful and 5% very unhelpful; 11% claimed not to know one way or the other. There is also a slight difference here between the capital area and Suðurnes, on the one hand, and the rural areas on the other, as can be seen in figure 3. Those in the rural areas are slightly more negative, with 38% saying the government’s measures were rather, or very, unhelpful, while 19% of those in the

capital area and Suðurnes said they were rather unhelpful and no one said they were very unhelpful.

FIGURE 3: IMPACT OF THE MANOEUVRES OF THE STATE ON THE MUNICIPALITIES' EFFORTS TO TACKLE THE CONSEQUENCES OF THE CRISIS



Source: Magnússon, M.Á.S. (2014b)

As to the measures taken by the government which the respondents found most helpful/unhelpful, most mentioned changing the regulatory framework regarding municipal finances without consulting the municipalities as the most adverse measure. This was the case both in the capital area and in the rest of the country. In the rural areas, downsizing of infrastructure projects, cut-backs in public positions and the government's perceived hostility towards the fishing industry were mentioned as having had an unhelpful effect on the municipalities' means to tackle the effects of the financial crisis.

In rural areas, creating stability was mentioned as the government's main positive achievement; in the capital area, mention was made of infrastructure projects and job creation measures to tackle increasing unemployment.

Given the difficult relations between the two tiers of government in recent years, the attitudes toward the state come as no surprise. Two major shifts in competences have taken place between the two tiers in the last two decades. Responsibility for primary education was transferred to the local authorities in 1996, and the financial burden, and not least administrative complexity of providing educational services,

proved to be too much for many small local authorities (Hlynsdóttir, 2002). The provision of services to disabled people was transferred to the municipalities on 1 January 2011 under a contract signed in 2010 (“Samkomulagríkisogsveitarfélaga um tilfærsluþjónustuviðfatlaða,” 2010, Sambandi Íslenskrasveitarfélaga, 2014, p. 4). It is the opinion of the municipalities that sufficient funds have not followed in the wake of these transfers, and the Association of Icelandic Municipalities has recently put together a “grey book” listing 24 points in which it believes the state is in direct breach of contract on the allocation of funds to the municipalities (“Grábóksveitarfélagaoghvítbókríkisins,” 2014).

5. Political Implications

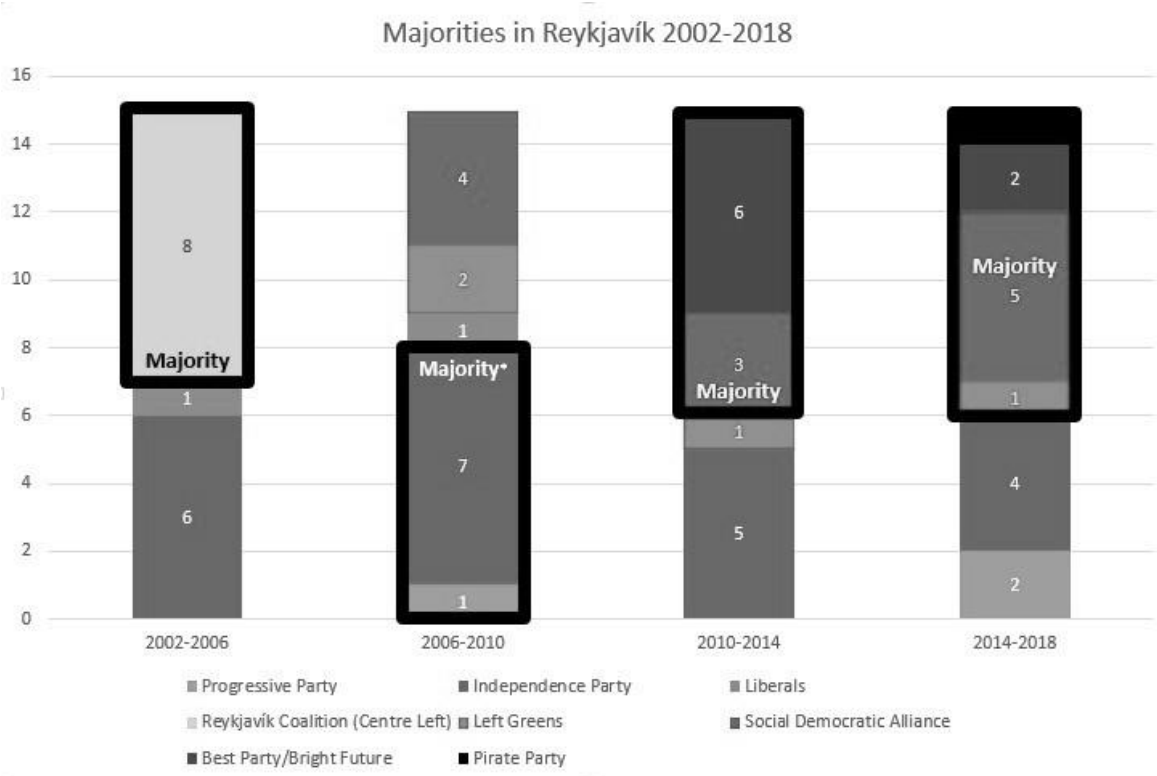
Municipal elections take place in Iceland every fourth year, the last one being in 2014. When looking at the results of the four elections that have taken place in the 21st century, it is possible to see democratic reactions to the crisis. However they are twofold. In the first wave in the municipal elections in 2010, when the severity of the crisis had not materialised into serious actions on behalf of the municipalities, there was a reaction towards voting “anti-establishment”.

This was especially visible in Reykjavík, where a new party, jokingly named “The Best Party” and headed by the comedian Jón Gnarr, took the elections by storm and got 34.7 per cent of the votes and 6 city council members, out of fifteen (“Sveitarstjórnarkosningar,” 2015). It went on and formed a majority with the Social Democratic Alliance (SDA) with Gnarr as the mayor. In Akureyri – Iceland’s “second city” outside the capital area, the so-called “List of the People” (*Listifólksins*) got a pure majority of 6 council members out of eleven. It was not an entirely new party, it had council members in the two previous elective terms, and was perhaps not as “anti-establishment” as The Best Party, but the result was considered an enormous blow to the traditional parties, especially the centre-right Independence Party (IP) that lost 3 out of its previous four council members and was relegated into minority.

The Independence Party, long the dominating force in Reykjavík politics and holding a majority in the capital city from the 1930s until the mid-1990s (with a four year interval in 1978-1982), had been struggling in the city ever since losing its majority

to the opposition parties, unified in the Reykjavík-list (*Reykjavíkurlistinn*). The parties split up again before the elections in 2006 and this provided an opportunity for the return of the IP. It did not regain its majority, however, it managed to form a majority with its long-standing government partner, the Progressive Party (PP), previously part of the Reykjavík-list. The majority split up because of disputes over Reykjavík's geothermal company, and the opposition parties managed to form a majority again with the support of the Progressives. It was destined to be short-lived, since the Liberal Party defected after around 100 days and formed a majority with the IP. The Liberal Party proved to be an unreliable partner for the IP which managed to form a new majority with the Progressive Party. At this time voters were starting to view Reykjavík city politics as rather chaotic, and adding to it the commotion around the financial crisis and the subsequent "Pots-and-Pans Revolution" that saw the ousting of a government led by the Independence Party, the time was ripe for something different in Reykjavík. The Best Party was the answer many voters were looking for. So its electoral success was a reflection of the zeitgeist at the time, rather than a reaction to financial hardships due to the financial crisis. Reykjavík City was however one of the municipalities in Iceland that had the highest debts per capita in the country, its debt ratio in 2012 being 268.4 per cent (Haraldsson, 2014, p. 13).

FIGURE 4: COUNCIL MEMBERS AND MAJORITIES IN REYKJAVÍK CITY COUNCIL 2002-2018



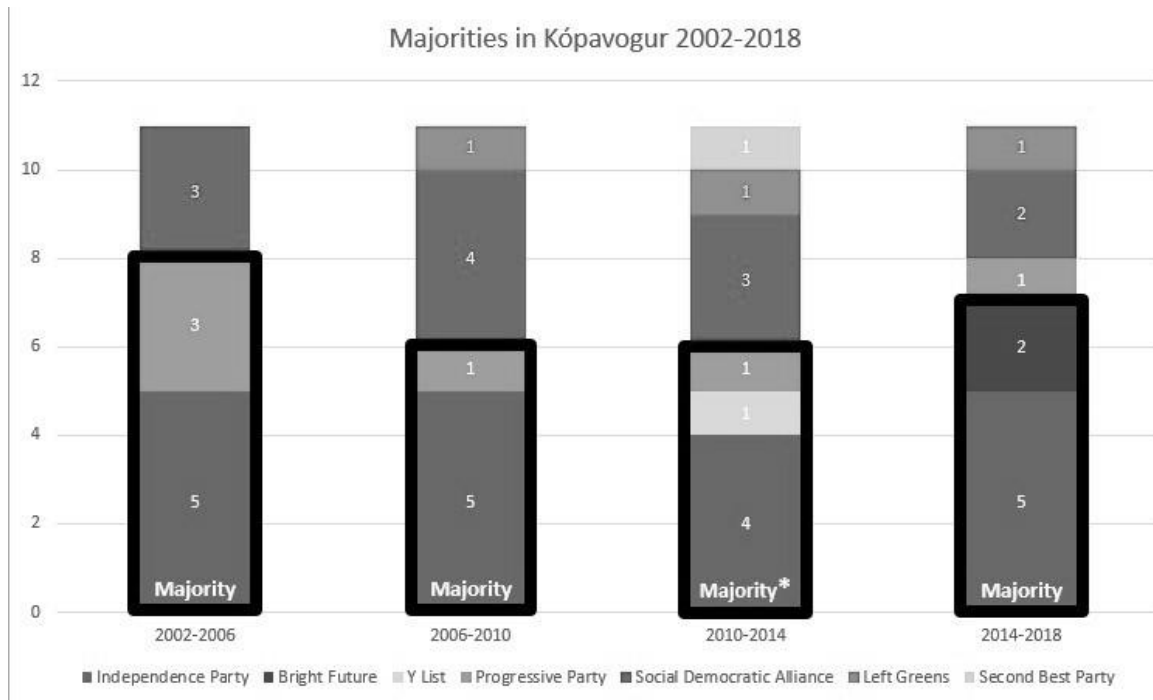
Source : “Sveitarstjórnarkosningar,” (2015)

The mayor Jón Gnarr decided to leave politics at the end of the 2010-2014 term and the Best Party – now rebranded as Bright Future, a new party making inroads in national politics in the general elections the previous year – did not manage to hold on to its 2010 gains. The majority had to join hands with the Left Greens and the newcomers in the Pirate Party to retain power. A flirt with anti-immigration rhetoric saw the Progressive Party making serious gains in the city and getting two city council members, up from none in the previous term. It however did not suffice since the Independence Party lost again and has now only four council members in the Reykjavík City council, its lowest proportion ever (“Kosningasaga,” 2015).

In Kópavogur, Iceland’s second most populous municipality, centrally situated in the Capital Area, the elections 2010 delivered two new parties into the town council, thus leading to the fall of the majority of the Independence Party and the Progressive Party that had at that point lasted for two decades. However, internal squabbles in the new majority led to one of the new parties joining hands with the IP and the PP in reinstating a centre-right majority. The new parties in 2010 rode on the same wave as the Best

Party in Reykjavík, a cynical reaction to the situation in the country. One of them was even (somewhat rightly) named the Second Best Party, since it only got one council member. The other new party – the one that joined hands with the IP and the PP – was more traditional “citizen movement” oriented, somewhat in line with the “List of the People” in Akureyri, mentioned above.

FIGURE 5: COUNCIL MEMBERS AND MAJORITIES IN KÓPAVOGUR TOWN COUNCIL 2002-2018



Source: “Sveitarstjórnarkosningar,” (2015)

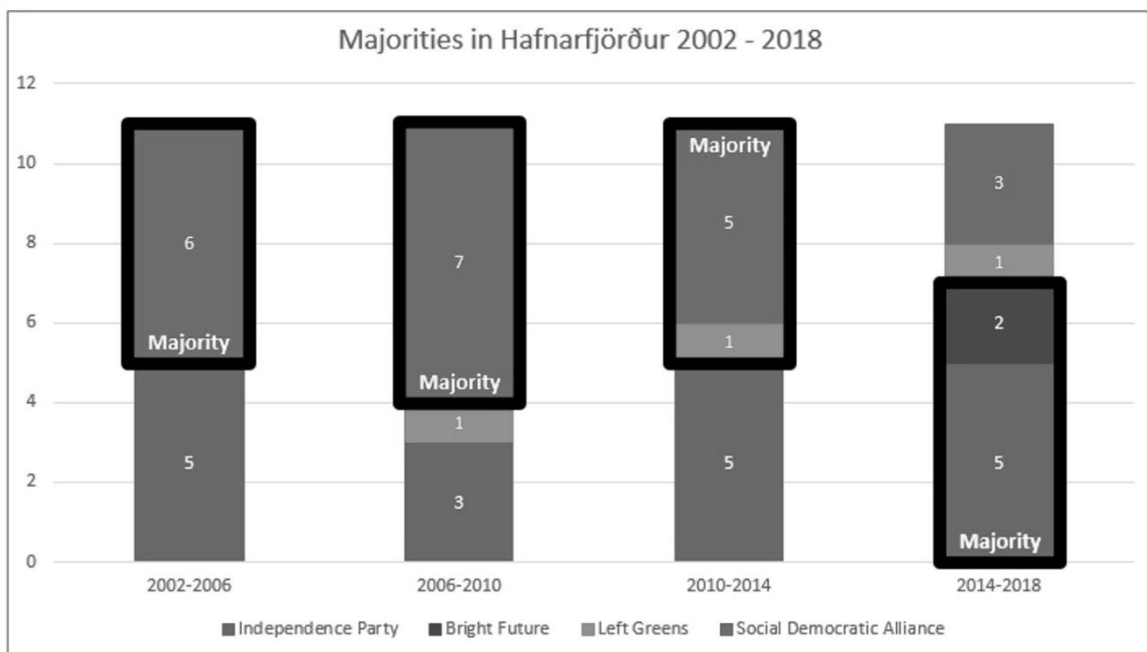
Although Kópavogur is one of the municipalities in Iceland that was hardest hit by the financial crisis, with a debt ratio of 195.1 per cent in 2013 (Haraldsson, 2014, p. 13), the ruling Independence Party was not punished for its pre-crisis role, regaining its traditional five council members in 2014. It somewhat surprisingly chose to form a majority with Bright Future instead of with its long-standing partner, the Progressive Party, even though the Progressives held their ground in the elections with one council member (see figure 5).

In Hafnarfjörður and Reykjanesbær – arguably the two townships hardest hit by the crisis – the backlash against the ruling parties The Social Democratic Alliance and the Independence Party respectively, did not materialize in the elections in 2010. In Hafnarfjörður no cynical reaction was possible in 2010, since, as in Reykjanesbær, only

the “traditional” parties were on the ballot. The town however saw its lowest voter turnout ever, only 64 per cent, which is very low in the Icelandic context. The Social Democratic majority in Hafnarfjörður lost two of its seven council members in these elections, but managed to join hands with the Left Greens to stay in power. In Reykjanesbær the Independence Party, under the leadership of a popular and energetic mayor, managed to hold its ground of seven council members out of eleven.

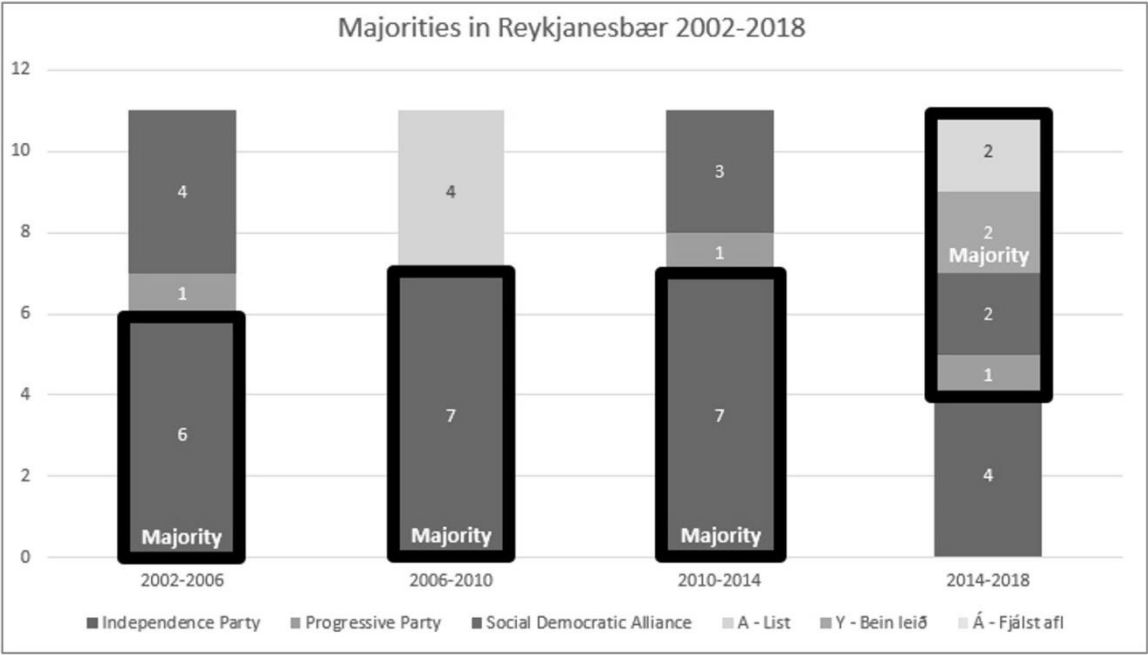
The period 2010 to 2014 was characterised by highly unpopular reactions to the crisis, and in both Hafnarfjörður and Reykjanesbær the ruling majorities could also be held accountable for the situations these municipalities were in, since they had ruled there during the boom years as well. Thus, probably predictably, they both lost their majorities in 2014. The Independence Party in Reykjanesbær losing three of its seven council members and the Social Democrats two of its five in Hafnarfjörður. In both these towns the losing parties were not invited to join the majority (see figures 6 and 7).

FIGURE 6: COUNCIL MEMBERS AND MAJORITIES IN HAFNARFJÖRÐUR TOWN COUNCIL 2002-2018



Source: “Sveitarstjórnarkosningar,” (2015)

FIGURE 7: COUNCIL MEMBERS AND MAJORITIES IN REYKJANESBÆR TOWN COUNCIL 2002-2018



Source: “Sveitarstjórnarkosningar,” (2015)

6. Conclusion

In this short paper it is not possible to go through detailed reactions to the financial crisis in Iceland. On one hand municipalities are an operation that provide rather generic services to their citizens and a large proportion of their budgets are allocated to tasks that they are legally obliged to undertake and do not have much leeway to venture out of. Elementary education is the costliest task of Icelandic municipalities and other social services – to disabled people, unemployed and partly the elderly – straining the budgets as well, especially during hard times in the job market. The poll conducted for this paper showed that cuts in the municipal budget, new priorities in spending, adjustments of salaries and changes in prices of municipal services were the most common measures, together with the postponing of already started projects, organisational changes within the government, sale of properties and renegotiations with lenders. This is a similar result as from an earlier poll conducted by the Association of Icelandic Municipalities, where downsizing of staff and increased municipal cooperation were high on the agenda.

The political implications of the financial crisis can be viewed as two waves. During the first wave in the elections 2010 we see an anti-establishment movement gaining ground, characterized by the inroads of the Best Party in Reykjavík and similar movements where they were on offer. Also in the success of citizen movement lists, such as the List of the People in Akureyri and a similar one in Kópavogur.

The second wave is the backlash against the ruling parties in the hardest hit municipalities, especially Hafnarfjörður and Reykjanesbær. The effects of the financial crisis took some time to sink in and the measures these parties had to take, downsizing, freezing projects, cutting budgets, took even longer. Thus it is not until the elections 2014 that this effect starts materialising, with the fall of the majorities in these two indebted townships.

It would be preferable to pursue this effect further with polls and interviews so as to demonstrate whether lessons can be learned from how the ruling majorities handled the recovery process. There are examples of towns where old majorities regained their ground in 2014, such as in Kópavogur. Arguably the “first wave” in 2010 might have had a mitigating effect there, since voters in Kópavogur had their shot at electing “anti-establishment” parties, while the voters in Hafnarfjörður and Reykjanesbær had not, since in 2010 only the “traditional” parties were on the ballot in these two towns.

The position of Icelandic municipalities has been gradually improving. They have been adjusting their finances and paying down debts. Their investments in new infrastructure has been low, although a few of them have built homes for the elderly in the period since 2009. The finances of almost 90 per cent of Icelandic municipalities are entirely sustainable, i.e. their incomes can handle debt payments and current expenses (Íslandsbanki, 2015). Others are currently weathering the storm.

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