

## **1. Introduction**

The subject of this study is to look at the changes that would likely take place in the Icelandic political economy<sup>1</sup> if Iceland became a member of the European Union (EU). Iceland did not apply for EU membership until mid-2009 and accession negotiations will start in 2010 at the earliest.<sup>2</sup> Hesitating to join the EU is unusual amongst European nations. It is only recently that EU membership has been seriously debated in Icelandic politics. The European Union is steadily growing and currently encompasses 27 European states, which all see an advantage of EU membership. For those very few European states that are not EU members, it can be explained by various reasons. There is an economic case, such as when Greenland left the EU by its own choice because of the European Common Fisheries Policy (CFP). There is the political case, such as Switzerland, which turned down EU membership, as it would compromise its sovereignty and independence. There is the social case when former communist and non-democratic countries, such as Croatia and Macedonia, or islamic countries such as Turkey, are not yet deemed ready for EU membership by the Union itself.

What are the Icelandic reasons for not being a EU member? Iceland has been a member of the European Free Trade Association (EFTA) since 1970 and the European Economic Area (EEA) since 1994. The EEA includes the EU and EFTA, except Switzerland. Under the EEA agreement Iceland participates in the EU Common Market with a (almost) free flow of capital, goods, services and people. However, the EEA does not provide for participation in the Economic and Monetary Union (EMU), Customs Union, Agricultural Policy or Fisheries Policy. If Iceland became a EU member, it is expected that Iceland would adopt these EU policies, which would indeed have some significant economic consequences for the country.

Our methodology is to look at the differences between the EFTA-EEA arrangement and full EU membership. The central question we look at is what influence will the EU policies that are not covered by the EEA agreement have in Iceland? Will there be a positive or negative macroeconomic effect? We survey the literature on the EU, monetary unions, agriculture and fisheries. The main question is broken into sub-

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<sup>1</sup> “Political Economy” is explained in the Preface.

<sup>2</sup> For most European states, accession negotiations were a one to five year process (see e.g. Arnorsson 2009).

themes, which are then added up in our overall estimate of the effects of EU membership. In chapter two we give a historical overview of the EU, EFTA, EEA, and Iceland. Chapter three reviews the policy and the political, social, and economic debate on EU affairs. Chapter four discusses the influence of EU membership on the Icelandic government finances, effects of the Customs Union, and eventual other economic effects. Chapters five, six, and seven, break the central question into the sub-questions and discuss respectively the Economic and Monetary Union (EMU and the Euro), Agricultural Policy, and Fisheries Policy. The Economic and Monetary Union analysed in chapter five, studies the literature arguing for and against monetary unions and ideal currency areas. In that part we study the criteria to join the European Economic and Monetary Union and finally look at to what extent Iceland fulfils those criteria and what benefits or costs it might bring. Chapter six on agricultural policies recalls principles in agricultural economics and protection of the food production industry. It gives a detailed overview of agricultural policies in Iceland and the EU, compares them and assesses what change the EU Common Agricultural Policy (CAP) might have on Icelandic economics. Chapter seven on fisheries management explains the fundamentals of sustainable fisheries in the high seas. It compares the Icelandic fisheries policy to the EU fisheries policy, which indeed differs substantially and could be an obstacle in Icelandic EU accession negotiations. Chapter eight adds up and summarizes the advantages and disadvantages of EU membership, including the macroeconomic effect on Icelandic society. This includes the effects of the EMU, EU's Common Agricultural and Fisheries Policies, the EU Customs Union, and direct expenses for the state treasury linked to EU membership.

EU membership is a political, economic, social and cultural issue. Our focus is primarily on the political-economic part and this study focuses on policy comparison between EU and Iceland, and cost-benefit estimates. Nevertheless, the decision on joining the EU is more than just a cost-benefit analysis, although a knowledge of the costs and benefits are helpful in the decision making process.<sup>3</sup> In the case of new entrants to the EU, it is a question of accepting the whole package (Acquis

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<sup>3</sup> Essentials of a cost-benefit analysis are to identify the factors, evaluate and estimate their influence, compare the options, and select the "best". Although most literature on cost-benefit analysis uses monetary units as a measurement of welfare, some factors are very subjective and cannot be measured in monetary terms, e.g. what constitutes an ugly or beautiful object or landscape. In EU context, the psychological issue of being "European" or being from an "independent nation" has no measurable value.

Communautaire) with its advantages and obligations. We therefore identify, discuss and compare the relevant EU and Icelandic policies, but Iceland would most likely not be in a position to select just those policies it would find suitable, as was the case with the EEA agreement.

The numerical data used in this study is mainly from the European Commission, EFTA, Statistics Iceland, National Economic Institute of Iceland (recently closed and divided between Statistics Iceland and the Icelandic Central Bank), Organisation for Economic Cooperation and Development (OECD), and various government agencies and ministries. The policy and political discussion draws on a wide array of sources, most from the academic world, but also from politicians and bureaucrats. This includes articles in professional journals, classical books on options in policy development, e.g. agriculture, and contemporary political and policy overviews (detailed in the bibliography). The theoretical background has its roots in mainstream economics. This includes that trade increases net welfare, and vice versa that trade barriers reduce net welfare, and that competition contributes to lower prices and reduces redundancy in production. Nevertheless, the part on agriculture refers to many arguments for government interventionism and protectionism, which is widely practised in the modern world, but often criticized by modern economists because of the economic waste it generates.

There is a tremendous amount of literature available on the EU and its affairs. However, there exists rather limited academic literature on the EEA per se, perhaps because for most EFTA members, the EEA was only a stepping-stone on the way to EU membership. Many EFTA states appear to have looked at the EEA as an adaptation period or as a test of some of the advantages (or possible disadvantages) from EU membership, without jumping straight into full membership, which could have met opposition from politicians and citizens. Consequently, for most former EFTA states, the EEA is more related to political-economic history than actual new EU association or new membership. Nevertheless, there is a reasonable number of facts and figures available on the EFTA states and on Iceland, along with some academic discussion on EU association agreements, EFTA as an organisation in general, customs unions, free trade areas and monetary unions. This limited academic interest in the future of the EEA is possibly also because the EU is not willing to elaborate further on the idea of an EEA. The EU prefers either membership applications and/or association agreements with individual states. For the remaining four EFTA members that have not yet left EFTA and joined the EU, Norway has had its eyes on the EU with a

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history of two EU applications, both narrowly rejected in national referendums, Switzerland opted out of both the EU and the EEA, and Liechtenstein has never applied for Union membership. Iceland intends to bring its still un-negotiated accession treaty up for a national referendum. At this stage it is not possible to forecast the results.

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