

4. Economic Impact of EU Membership

4 – 1 Key Economic Factors that Change

When estimating the economic benefits of an aspiring EU member, there are two issues that must be considered. Firstly, the direct cost of funds paid to the EU by the aspirant member state, minus direct payments received by the aspiring state from the EU. Secondly, the macroeconomic impact and net welfare change stemming from the benefit (or cost) of a much larger market, zero import and export tariffs for all intra EU trade⁷⁰, customs union, and of a common currency, all of which is more to the benefit of consumers and corporations, rather than the state itself. The first issue, the direct cost/benefit to the state budget, can be estimated with a certain margin of error, but the second part appears to be more an educated guess rather than a clear figure. Although we can't put up an exact figure, we will attempt to quantify it and show if the tendency is positive or negative.

The principal economic factors in the EU not covered by the EFTA-EEA arrangement are:

- (1) The EU Common Budget,
- (2) The EU Customs Union (CU),
- (3) The EU Economic and Monetary Union (EMU),⁷¹
- (4) The EU Common Agricultural Policy (CAP) including a free flow of agricultural goods,⁷²
- (5) The EU Common Fisheries Policy (CFP).⁷³

In this chapter we discuss the government's direct expense of EU membership through participation in EU's common budget (part 4-2), the EU Customs Union, (part 4-3), and other economic issues such as foreign direct investment and economic specialisation (part 4-4). The EMU, CAP and CFP, with all their controversies, are discussed in detail in chapters five, six and seven.

⁷⁰ Recall that industrial goods are fully covered by the EEA, but agriculture and fisheries to a much smaller extent. In comparison, the EU single market covers all goods.

⁷¹ Discussed in chapter 5.

⁷² Discussed in chapter 6.

⁷³ Discussed in chapter 7.

4 – 2 The Government's Direct Cost of EU Membership

4 – 2 – A The EU budget

EU member states contribute to the Union's common budget, but member states also receive money back in various forms. The EU acts in some ways as nation states do; it redistributes parts of its wealth among its subjects in order to promote its common policies. The EU aims to keep its budget below 1.24% of its Gross National Income (GNI), which is a very small budget compared to most member states national budgets.⁷⁴ With a yearly budget of over 100 billion⁷⁵ Euros (approximately 200 Euros per EU citizen), we shall ask where the EU money comes from and what is it spent on? Let us look at the EU revenue and expenses:

The EU revenue is based on:

- Gross National Income payments (GNI). Member states pay a fixed percentage of their GNI to the Union. Currently this amounts to approximately 2/3 of the Union's revenue.
- Value Added Tax (VAT). VAT resources are from a uniform rate applied to a common tax base. This common tax base is a theoretical construct, which compensates for that neither VAT rates nor the list of goods and services covered by VAT are harmonised within the EU.
- Customs duties. Customs duties go to the EU based on the common customs tariff, less member states collection costs. These duties are levied on goods from third countries and it does not matter where the goods enter Union territory.
- Agricultural duties and sugar levies. The Agricultural duties are on agricultural products imported into the EU from third countries and sugar levies are paid by sugar producers to subsidize sugar exports.
- Other (small) revenue, e.g. bank interests, taxes levied by the EU on its personnel, unused financial assistance, balance of previous

⁷⁴ We should emphasize that these direct monetary transfers to and from the Union's common budget are independent of other indirect economic effects of Union membership, such as a larger market, common currency, etc.

⁷⁵ Billion meaning thousand millions (1 000 000 000).

budget and contributions from non-member states to certain EU programmes.

The EU main expenses are:

- Preservation and management of natural resources. This ambiguous subheading is euphemism for agricultural and rural subsidies. It takes approximately 45% of the Union's budget.
- Sustainable growth and structural aid. This includes competitiveness, research, development, transport, energy networks and cohesion expenses to assist less developed areas of the Union. This amounts to approximately 45% of the Union's budget.
- Other (relatively small) expenditure, e.g. aid to third countries, administration, citizenship, security and justice.

4 – 2 – B Previous estimates on costs of EU membership

There have been some attempts to estimate the direct net cost to the Icelandic treasury from EU membership. Asgrimsson (2000), Minister of Foreign Affairs of Iceland at the time, in his report to the Icelandic parliament on the “Position of Iceland in European Cooperation” gave a lengthy overview and discussion on all aspects of Icelandic policy issues versus the EU.⁷⁶ Asgrimsson used empirical evidence and figures on the EU. When he discussed potential consequences in Iceland if Iceland became a EU member, his estimates were in relatively general terms, which reflects well how difficult it is to assess actual impact from membership. Asgrimsson's report has two main chapters, the first one being a general discussion, and the second one with 29 subchapters and analysis of different aspects of European cooperation. Although he made an attempt to mention the changes if Iceland were a EU member compared to the current outsider-EEA position, the discussion on the pros and cons of EU membership is rather inconclusive, except that he estimated that Iceland's direct financial expenses and contributions paid to the EU would be higher than the direct benefits paid back to Iceland out of EU funds. On a yearly basis, Asgrimsson expected Iceland to pay 7-8 billion Icelandic Kronas to the Union, and to get about 5 billion Icelandic Kronas from the EU, resulting

⁷⁶ It is understood that the report is the work of the Ministry with several anonymous contributing authors, although it is published in Asgrimsson's name.

in a net expense of 2-3 billion Kronas.⁷⁷ After the EU enlargements in 2004 and 2007, he believed that Iceland would pay even more and receive even less in return, at least until the economy of the new member states would get better. Asgrimsson was very vague on macroeconomic gains or losses stemming from membership. In 2003 the Ministry for Foreign Affairs of Iceland, still headed by Mr. Asgrimsson, requested the international advisory firm Deloitte & Touche to estimate again the direct cost of EU membership. This time the net expenses were estimated to be between 2.5 and 4 billion Icelandic Kronas.

Herbertsson and Sturluson (2002) also estimated the financial gains and expenses of the Icelandic state treasury if Iceland joined the EU. Their estimation was done at request of the then Prime Minister of Iceland, David Oddson, and only assessed the state finances but not the overall macroeconomic gain or loss on the Icelandic society. In line with Asgrimsson (2000), Herbertsson and Sturluson (2002) found that the state would have to contribute more to the EU than it would get back in form of direct payments from the Union. This also confirmed the reservations the then Icelandic Prime Minister, Mr. Oddson, had about the EU. Herbertsson and Sturluson (2002) estimated a net payment to the EU of between 3.7 billion and 5.6 billion Icelandic Kronas before the 2004 and 2007 enlargements, and 8.3 billion and 10.1 billion after the enlargements. However, Sturluson has informed us (2009, verbal discussion) that he believes that the estimation of the direct costs of Icelandic EU membership after the enlargements was overestimated in 2002, mainly because the Union's expenses to agriculture in the new member states were lower than anticipated at the time.

4 – 2 – C Iceland's payments to and from the EU

There are some inherent difficulties in estimating Iceland's direct expenses of EU membership. Iceland will pay a certain amount to the Union and receive some payments back as agricultural subsidies (discussed and estimated in chapter 6) and as structural aid (referred to as competitiveness and cohesion expenditure in the EU budget). The amount of agricultural and rural subsidies Iceland would receive depends on accession negotiations, such as the possibility of extra support granted to Europe's harsher regions. The structural aid, discussed in part 4-2-D,

⁷⁷ The exchange rate of Euro vs. Icelandic Krona is shown in Figure 9 on page 99. Although the value fluctuates considerably, for quick comparison purposes one Icelandic Krona is close to having the value of one Eurocent.

would most likely be in line with the other Nordic countries. The theoretical VAT base would have to be clarified, and the amount of imports to Iceland that would go into the EU Customs Union through other ports of duty than Icelandic ports may influence estimates. In this study we intend to find what net percentage of the Icelandic GNI (or GDP) would go to the Union. The only way to get a realistic idea is to look at empirical evidence: how much do other member states pay and receive back.

Table 6 on next page shows member states contributions to the Union's budget in 2007. It details the VAT part, the GNI part, the UK correction⁷⁸, and EU's "Traditional Own Resources", which includes the customs and agricultural duties. The reader will notice that the Nordic countries, Denmark, Finland and Sweden, contribute to the EU 0.96%, 0.91% and 0.86% of their GNI respectively, the EU average being at 0.90% (the rest being surplus from previous year and other revenue). It is fairly straightforward to anticipate that Iceland, as a Nordic country, would be comparable to the average of the other Nordic countries that are already EU members, notably with a gross contribution of approximately 0.91% of GNI.⁷⁹

⁷⁸ Based on former UK Prime Minister Margaret Thatcher's (Minister 1979-1990) request in EU budget negotiations: "I want my money back", where the other EU members caved in. This legacy is still in the Union's budget.

⁷⁹ In this context it is important to bear in mind that leaving the EFTA-EEA arrangement will not lead to savings of the associated expenses. Iceland's contribution to the EFTA Secretariat is approximately 1 million Euros per year. If Iceland joined the EU, increased expenses of having more personnel working in Brussels on EU affairs rather than on EFTA matters will certainly offset this amount. New personnel will include not only government bureaucrats, but also interest organisations' representatives such as farmers and fishermen. Iceland currently participates in many EU programmes in culture and science. Iceland's current contribution to these programmes is in the vicinity of 6 million Euros per year. Although this is currently an expense for the government, most of this money comes back to Icelanders through the various cooperation projects. (See e.g. EFTA Bulletin: Guide to EU Programmes 2007-2013, (which also provides guidelines on how to apply)).

Table 6. National contribution of EU member states and traditional own resources collected by member states on behalf of the Union, year 2007, in millions of Euros

	VAT based own resource	GNI based own resource	UK correction	Total national contribution			Traditional own resources (TOR net 75%)	Total own resources		
	(1)	(2)	(3)	(4) = (1)+(2)+(3)	%	% GNI	(5)	(6) = (4)+(5)	%	% GNI
BE	468.5	1 985.8	232.5	2 686.8	2.9%	0.80%	1 685.1	4 371.9	4.0%	1.31%
BG	46.3	163.0	20.8	230.0	0.2%	0.80%	60.8	290.8	0.3%	1.02%
CZ	199.9	703.8	84.4	988.2	1.1%	0.83%	178.8	1 167.0	1.1%	0.98%
DK	332.8	1 393.5	162.9	1 889.2	2.0%	0.81%	329.8	2 219.0	2.0%	0.96%
DE	3 635.2	14 653.8	294.2	18 583.2	19.9%	0.76%	3 126.8	21 710.0	19.7%	0.89%
EE	26.8	95.8	11.2	133.8	0.1%	0.91%	42.8	176.7	0.2%	1.21%
IE	276.4	972.2	119.6	1 368.3	1.5%	0.86%	218.0	1 586.4	1.4%	1.00%
EL	697.9	1 946.6	145.8	2 790.3	3.0%	1.25%	229.6	3 019.9	2.7%	1.35%
ES	1 722.8	6 073.4	751.7	8 548.0	9.2%	0.84%	1 290.1	9 838.2	8.9%	0.96%
FR	3 113.8	11 215.7	1 326.9	15 656.4	16.8%	0.83%	1 332.5	16 988.9	15.4%	0.90%
IT	2 030.1	9 143.7	1 163.2	12 336.9	13.2%	0.81%	1 687.2	14 024.2	12.8%	0.92%
CY	25.0	88.2	10.7	123.9	0.1%	0.82%	46.4	170.3	0.2%	1.13%
LV	35.2	118.0	14.9	168.1	0.2%	0.88%	30.9	199.0	0.2%	1.04%
LT	47.1	158.3	20.1	225.5	0.2%	0.84%	45.4	271.0	0.2%	1.01%
LU	53.2	202.2	21.2	276.6	0.3%	0.95%	19.2	295.8	0.3%	1.02%
HU	137.8	546.7	74.9	759.4	0.8%	0.81%	110.9	870.2	0.8%	0.93%
MT	9.1	32.5	3.6	45.2	0.0%	0.86%	11.8	57.0	0.1%	1.09%
NL	936.3	3 400.6	92.4	4 429.3	4.7%	0.78%	1 873.5	6 302.8	5.7%	1.10%
AT	409.0	1 564.9	43.0	2 017.0	2.2%	0.75%	201.1	2 218.1	2.0%	0.82%
PL	508.7	1 745.6	215.8	2 470.1	2.6%	0.84%	338.4	2 808.6	2.6%	0.96%
PT	269.4	940.1	113.9	1 323.3	1.4%	0.85%	137.1	1 460.4	1.3%	0.93%
RO	162.1	681.7	86.4	930.3	1.0%	0.80%	159.2	1 089.4	1.0%	0.93%
SI	55.9	198.3	22.6	276.8	0.3%	0.84%	82.5	359.4	0.3%	1.09%
SK	84.6	302.5	41.6	428.7	0.5%	0.81%	90.5	519.2	0.5%	0.98%
FI	260.7	1 087.7	132.0	1 480.5	1.6%	0.82%	148.9	1 629.4	1.5%	0.91%
SE	486.6	1 948.9	41.3	2 476.7	2.7%	0.73%	438.4	2 915.2	2.7%	0.86%
UK	3 409.6	12 551.2	-5 188.9	10 771.9	11.5%	0.53%	2 657.0	13 429.0	12.2%	0.66%
EU 27	19 440.8	73 914.8	58.9	93 414.5	100%	0.76%	16 573.0	109 987.5	100%	0.90%
Surplus from previous year								1 847.6		
Surplus from EAGGF Guarantee								0.0		
Surplus external aid guarantee fund								260.9		
Other revenue								5 467.0		
Total revenue								117 563.0		

Source: EU Budget and Financial Report 2007.

Table 7, (below and on next page), shows allocation of EU expenditure to member states as a percentage of their GNI. It is less straightforward to estimate how much the EU would pay back to Iceland, than what Iceland would pay to the EU. The variation between member states (2007 data) is larger than with the contributions to the EU. Using the other Nordic countries as reference, Denmark receives 0.63% of GNI, Finland receives 0.79% of GNI, and Sweden receives 0.49% of GNI, the Nordic average being at 0.64%. Denmark's net contributions to the EU are therefore 0.33% of GNI (0.96% minus 0.63%), Finland's net contributions to the EU are 0.12% of GNI (0.91% minus 0.79%) and Sweden's net contributions to the EU are 0.37% of GNI (0.86% minus 0.49%). Using the average, we arrive at 0.27% of GNI. We can therefore conclude with a reasonable accuracy that Iceland's net contributions to the EU might be close to 0.27% of GNI (or GDP), with an estimation error of 0.15% percentage points up or down.⁸⁰

Table 7. Allocation of EU expenditure to member states as a percentage of their GNI, year 2007, in millions of Euros

Austria	0.59 %
Belgium	1.70 % (including 1.10 % on EU administration)
Bulgaria	2.07 %
Cyprus	0.84 %
Czech Republic	1.44 %
Denmark	0.63 %
Estonia	2.57 %
Finland	0.79 %
France	0.74 %
Germany	0.51 %
Greece	3.77 %
Hungary	2.60 %
Ireland	1.37 %
Table continued on next page	

⁸⁰ The EU uses GNI in its Financial Report. The difference between Icelandic GNI and GDP is unsubstantial. ¼ % of GNI corresponds to approximately 3 billion Icelandic Kronas. As shown in chapter 8, an estimation error in the order of 0.15% of GNI (or GDP) is trivial in the overall estimates of the effects of EU membership.

Table continued from previous page	
Italy	0.74 %
Latvia	3.52 %
Lithuania	3.88 %
Luxembourg	4.42 % (including 3.80 % on EU administration)
Malta	1.71 %
The Netherlands	0.34 %
Poland	2.65 %
Portugal	2.49 %
Romania	1.37 %
Slovakia	2.04 %
Slovenia	1.19 %
Spain	1.25 %
Sweden	0.49 %
United Kingdom	0.37 %
Non-EU	0.04 %
Other	0.02 %
Earmarked	0.01%
EU-27	0.86%

Source: EU Budget and Financial Report 2007.

4 – 2 – D **Structural aid to Iceland**

Some of the money Iceland would pay to the EU comes back as structural aid, (support for cohesion and competitiveness, including research and technological development). Structural aid is channelled through the Cohesion Fund, the European Regional Development Fund (ERDF) and the European Social Fund (ESF).⁸¹ A EU member country producing less than 90% of the Union's average can receive structural aid, but Iceland does not fulfil this criterion, having a GDP per capita higher than the EU average. A region in the EU, which produces less than 75% of the EU average GDP per capita, is eligible, but we are not aware of any Icelandic regions fulfilling this criterion either. Structural aid based on

⁸¹ Besides structural aid, the other main EU spending is through the Common Agricultural Policy, where the main instrument is the European Agricultural Guidance and Guarantee Fund (EAGGF), which in 2007 was split into the European Agricultural Guarantee Fund (EAGF) and the European Agricultural Fund for Rural Development (EAFRD). Agriculture is discussed in chapter 6.

the rule of less than 8 inhabitants per square kilometre applies to large parts of the Icelandic countryside and to the country as a whole (roughly 300 000 inhabitants on 103 000 square kilometres, with about half of the population in the capital city). Iceland is therefore likely to be considered a sparsely populated region, remote region, and with harsh climate, but not as a poor country or poor region.

The EU Budget and Financial Report for 2007 shows recipients of EU funds:

- Of Denmark's total EU allocations, 81% is for agriculture⁸² and 16% for structural aid (cohesion and competitiveness, including research), the rest being minor items;
- Of Finland's total EU allocations, 68% is for agriculture and 29% for structural aid (cohesion and competitiveness, including research), the rest being minor items;
- Of Sweden's total EU allocations, 67% is for agriculture and 29% for structural aid (cohesion and competitiveness, including research), the rest being minor items.

Structural aid is generally intended for poorer members of the Union. It is therefore not surprising that the Nordic countries receive less in structural aid than in agricultural subsidies, considering that they are well developed and with relatively high income per capita. With large sparsely populated areas, Iceland resembles Finland and Sweden much more than Denmark. In per capita terms Finland's structural aid (cohesion and competitiveness) is 79 Euros per citizen (416.6 million Euros / 5.3 million citizens) and Sweden's structural aid (cohesion and competitiveness) is 53 Euros per citizen (486.2 million Euros / 9.2 million citizens). In EU accession negotiations, based on economic and geographic comparison, Iceland would undoubtedly be considered on similar terms as Finland and Sweden, just like the Baltic states, East European states, and the Mediterranean states are often considered like groups. Assuming that Iceland would receive similar structural aid as Finland and Sweden, it would amount to between 15.9 million Euros (53 Euros x 0.3 million citizens) and 23.7 million Euros (79 Euros x 0.3 million citizens) per year.

⁸² Natural resources in EU jargon. In the EU natural resource budget, approximately 99% is agricultural and rural support, the remaining 1% is spent on fisheries and environmental issues.

4 – 2 – E Concluding remarks on government expenses

It is clear that richer member states tend to pay more to the EU budget than they get back in direct payments, and vice versa, the poorer states tend to receive more than they contribute. From a socialist's viewpoint this is fair, but not everybody shares that idea and many will say that people (and states) should work for their own money but not live on subsidies. This is open to discussion, but the EU aid is not intended to foster laziness and dependency, but to promote the coherent functioning of the Union by reducing disparities. EU policies are not likely to change drastically in the near future and Iceland would clearly have a net contribution to the EU close to $\frac{1}{4}$ % of GNI (or GDP).

State expenses stemming from EU membership are not necessarily correlated to macro economic welfare gains or losses for society as a whole, as we will show in the following chapters. We shall therefore look at the question if abandoning the EEA for EU membership would cause other net welfare changes that would outweigh the direct costs. The first question to ask is if the Icelandic state budget will not benefit from EU membership, who will benefit from EU membership? The answer could be citizens and businesses (corporations). In the rest of this study we shall therefore elaborate on the changes EU membership would bring to Iceland, beyond the participation in the Union budget.

4 – 3 The EU Customs Union

In principle the EU Customs Union, which is not covered by the EEA agreement, should be discussed in a chapter on its own, just as we treat the Economic and Monetary Union in chapter 5, Agricultural Policy in chapter 6 and Fisheries Policy in chapter 7. However, the Customs Union is delegated to this sub-chapter because we find it less important than the other common policies that are not included in the EEA. According to Statistics Iceland, Icelandic customs duties during the last 10 years have been between 0.30% and 0.42% of Iceland's GDP, and in the same period they have on no occasion reached 1% of government revenue.⁸³ Furthermore, approximately $\frac{3}{4}$ of Iceland's foreign trade is with other members of the EEA and therefore already free from customs duty. The exception is agricultural products, which are subject to several restrictions and discussed in detail in chapter 6.

Balassa (1961) notes that economic integration can take several forms that represent varying degrees of integration. These are (1) free-trade area, (2) customs union, (3) common market, (4) economic union, and (5) complete economic integration. In a (1) free trade area, tariffs (and quantitative restrictions) between the participating countries are abolished, but each country retains its own tariffs against non-members. Establishing a (2) customs union involves, besides the suppression of discrimination in the field of commodity movements within the union, the equalisation of tariffs in trade with non-member countries. A higher form of economic integration is attained in a (3) common market, where not only trade restrictions but also restrictions on factor movements⁸⁴ are abolished. An (4) economic union, as distinct from a common market, combines the suppression of restrictions on commodity and factor movements with some degree of harmonisation of national economic

⁸³ Excise duty ("vörugjald" in Icelandic) is a different issue from customs duties. Iceland has excise duty on several products, e.g. cars, sugar and sweets, some electric appliances, some construction materials, etc. This duty is levied on both Icelandic and imported goods, as long as they fall into the taxable categories. However, the Icelandic excise duty has traditionally been aimed at goods that are not produced domestically and we believe that the excise system would have to be reconsidered if Iceland joins the EU Customs Union. Some goods that are easily controlled can continue under the current system, e.g. cars upon registration, but e.g. DVD players cannot, as consumers are free to import from other EU member states goods for own consumption, without duties or formalities, subject to a reasonable maximum.

⁸⁴ Factors such as labour, services and capital.

policies, in order to remove discrimination that was due to disparities in these policies. Finally, (5) total economic integration presupposes the unification of monetary, fiscal, social, and counter cyclical policies and requires the setting up of a supranational authority whose decisions are binding for the member states.

The EEA is a mixture of the variations of economic integration mentioned by Balassa (1961). The EU part of the EEA can be defined as being somewhere between “economic union” and “total economic integration”, but the EFTA part of the EEA is not in a customs union and only allows free trade in industrial goods and services. There is no common external customs tariff for the whole of the EEA, only within the EU. The EEA allows movement of factors such as labour, services and capital, but it does not have a monetary (or fiscal) union. The EFTA-EEA states apply EU trade rules and directives. As such, the EFTA-EEA states are for the largest part participating in the EU Common Market, with the exception of agriculture and fisheries, which are only partially within the scope of the EEA. Under the assumption that the current Icelandic excise system would be unchanged, this means that if Iceland joined the EU, consumers in Iceland would in principle have industrial goods and services from the EU at the same price as today, but industrial goods from outside the EU would be subject to EU customs duties, which sometimes vary from Icelandic duties. To complicate matters, a free trade area can be used to import goods into a common market by choosing the country with the lowest tariff and then sell the goods onwards. To avoid such circumvention of customs duties, there are rules concerning the origin of products and minimum requirement for goods to be changed or worked on by the “intermediary country”, in order to avoid the EU or the EFTA-EEA countries being used as a cheaper gateway to the Common Market. Administratively this is more burdensome than a customs union with a common external tariff.

The Cecchini Report “The Costs of Non-Europe” (Cecchini et al. 1988) lists and tries to estimate the benefits of a single European market. Cecchini et al. (1988) discuss Europe’s diverse markets (as they were in 1988), border controls, government protectionism in procurement, diverging technical standards, blocks to trans-border business activity, the costs for the service sector and costs in the manufacturing sector. This work was important at the time, but it was forward looking, where today there are some lessons already learned on the effects and results of the Single Market. Cecchini et al. (1988) note that customs related costs can result in an extra expense for many companies of up to a 25% of their profits. Needless to say, such extra costs are often passed on to the

consumers. The Cecchini Report estimated that the EU Single Market (of 1992) would increase EU output by between 2.5% and 6.5%. Baldwin (1989) finds that since Cecchini only estimated one-time effects on productivity and output, by adding medium-term growth effects caused by higher productivity, increased savings, and a better investment climate in Europe, these figures could be doubled. Matthews (1999 lecture) repeats some of Cecchini's figures. He estimates that removing barriers would increase the EU GDP by:

Table 8. Effects of trade barriers on EU GDP

Barrier removed:	% increase in EU GDP:
1. Trade barriers (frontier controls, quota restrictions, cost incr. barriers):	0.2-0.3%
2. Barriers affecting production (market entry barriers):	2.0-2.4%
3. Barriers preventing reaping the benefits of economics of scale:	2.0-2.1%
4. Barriers that allow inefficiency and monopolies to exist:	1.6%
Total effect:	5.8-6.4%
Total amount:	171-187 billion (ECU) ⁸⁵ .

Source: Matthews (1999).

Although the figures mentioned in Table 8 above may appear impressive, corporations, entrepreneurs, and other businesses within the EFTA-EEA already face competition from the EU since the EEA agreement provides for a free flow of capital, services, persons and industrial goods. As such, to a large extent, these benefits are already there for the EFTA-EEA states. Considering this, the felt effects in Iceland from joining the Customs Union are likely to be considerably less than Table 8 indicates, simply because the EEA already extends most parts of the EU single market to the EFTA-EEA states. It is also worth noting that non-tariff barriers have been removed on intra EEA trade, except on agricultural products, where Icelandic food, plant and veterinary rules sometimes obstruct imports to Iceland.

Kristjansdottir (2005) studied exports from Iceland using a gravity model of trade. In the case of Iceland, size and distance are important factors. Developing this idea further is not an easy task. Iceland is not a total outsider trying to join the EU, and the EFTA-EEA states and the EU are not two trade blocks, but one giant free trade area (less agricultural and fisheries products for the EFTA part). Theoretically it should be possible to make a model showing duty on Icelandic imports from outside

⁸⁵ Year 1999 figure. 1 ECU (European Currency Unit) = 1 Euro.

the EEA and compare the tariffs on these imports to the EU tariffs. The nomenclatures and customs coding system of both the EU and Iceland are based on the World Customs Organisation (WCO) model. However, our research showed that of the many thousands of entries in the Harmonized Commodity Description and Coding Systems of the WCO, some sub-sub-categories did not match completely between the EU and Iceland. A human expert assessment would be required to decide on a case-by-case basis which sub-sub-category a product should go into. Faced with this dilemma, we informally discussed this with both with the Icelandic Ministry of Finance and the Icelandic Directorate of Customs. Our conclusion is that this could be a process that may take several man-years of work. Even if Iceland joins the EU, a case-by-case comparison will most likely not be done. Rather, the EU customs tariff coding and duty level will just replace the Icelandic system. Despite the above mentioned difficulties in estimations, we will try to quantify the change through some examples. Some random checks on several customs tariffs and product categories in the EU and in Iceland are shown in Table 9 below and on next page.

Table 9. Customs duty on selected products in EU and in Iceland

Category ⁸⁶	EU ⁸⁷	Iceland ⁸⁸
Coal (including several subcategories)	0 %	0 %
Aluminium powder and flakes	0 % - 5 % depending on origin	0 %
Silver powder	0 %	0 %
Vacuum cleaners (various sub categories according to type, power, etc.)	0 % - 2.2 % depending on origin	0 %
Video and DVD players (including sub categories)	0 % - 13.9 % depending on origin	7.5 %
Ladies leather shoes (selected types)	0 % - 8 % ⁸⁹ depending on origin	15 %
Table continued on next page		

⁸⁶ Because of the numerous sub categories within each product group, we are not in a position to guarantee that nothing has been omitted. Importers should check an up-to-date customs code before importing.

⁸⁷ Some countries enjoy a reduced tariff into the EU for certain goods. When a range is shown, zero generally refers to a free trade agreement and the higher number to a third country tariff. Reduced preferential tariffs may be somewhere between, depending on the type of goods and their origin.

⁸⁸ The numbers in this column apply to goods from countries where Iceland does not have a free trade agreement.

⁸⁹ Definitive anti dumping duty of up to 16.5 % (China).

Chapter 4. Economic Impact of EU Membership

Table continued from previous page		
Self propelled artillery weapons	0 %	7.5 % ⁹⁰
Particle wood for floors, made of bamboo	0 % - 10 % depending on origin	0 %
Sawed, coniferous, planed wood	0 %	0 %
Vaccines for humans	0 %	0 %
Inflatable vessels for pleasure and/or safety	0 % - 2.7 % depending on origin and size	0 % - 10 % depending on intended use
Polyethylene plastics with weight volume ratio of less than 0.94	0 % - 6.5 %	0 %

Sources: EU TARIC (2010) and Icelandic Directorate of Customs (2010).

The selected examples in Table 9 (above and on the previous page) show that customs tariffs on goods from third countries can vary between Iceland and the EU by a few percentage points (only a small part of the tariffs reviewed are reproduced in Table 9). It is common to see EU and Icelandic tariffs ranging from zero and up to 15% on goods from third countries, however, as the examples in Table 9 show, there is not necessarily a correlation between EU and Iceland. If Iceland adopts the EU customs tariffs, some goods from third countries will consequently become proportionately cheaper or more expensive, depending on if the EU tariff is lower or higher than the Icelandic tariff. We have not found any cases in the EU TARIC or in the Icelandic Customs Directory where the differences are more than a few percentage points, although we cannot exclude that on some of the thousands of goods listed, this could be the case. The relative similarity in keeping tariffs low is in fact not surprising, considering the GATT and WTO. If we develop this knowledge further and take into consideration that Iceland already enjoys a free trade agreement (FTA) with the EU, which indeed covers approximately 75% of Iceland's total foreign trade, the overall macroeconomic effects of joining the EU Customs Union will be considerably smaller than the tariff change on individual goods originating from countries not having an FTA. Based on these facts, we assume that by joining the Customs Union, administration of trade will be simpler, but it is not likely to bring major changes in trade of industrial goods or services on the whole, although some individual goods may move up or down in price by a few percentage points. Nevertheless, the only way to fully test this assumption is to compare the EU and Icelandic

⁹⁰ This item does not physically exist in Iceland since the country has no army, but it shows the details (and perhaps absurdity) of the customs code. Only governments can buy this item.

customs tariffs, - product by product, - something that cannot easily be done without a small specialised task force. On the other hand, agricultural products, which are not covered by the EEA, are a different story from industrial products, as we show in chapter 6.

It should be pointed out that tourists and private citizens can import for their own consumption whatever they want between EU member states without any formalities, either in their personal luggage or via mail order (subject to a reasonable maximum value and special guidelines on alcohol and tobacco). This may in itself not be a decisive economic factor, but it puts pressure on importers to have more competitive prices and at the same time makes travellers feel at ease when returning home with full suitcases of newly purchased goods from Europe.⁹¹ Last but not least, although excise duty is not related to imports only, we think that the current Icelandic excise system would have to be simplified as a result of abolishing customs and border controls on EU goods. If this is done, some goods currently sold in Iceland, - domestic products, EU products, or from beyond, - could show noticeable price changes up or down⁹².

⁹¹ There is no automatic customs control or duty on intra-EU borders, but that does not prevent police enforcement of banned goods, such as drugs or weapons.

⁹² Down for those goods where the current excise duty would be removed, and up on those goods used to compensate government revenue lost by lowering or exempting other goods.

4 – 4 Foreign Direct Investment and Economic Specialisation

Some thought should be given to if leaving the EFTA-EEA arrangement for EU membership might influence foreign direct investment (FDI) in Iceland. Within the EEA there is a free flow of capital and this has greatly simplified Icelandic investments in Europe and vice versa. When considering if EU investments in Iceland would increase, or if Icelandic investments in Europe would increase by joining the EU, the principle of free flow of capital will not change.⁹³ Under the EEA agreement, Iceland participates in EU's principles of free investments, both on direct ownership of firms and on financial portfolios (with an exception concerning fisheries firms). Lizondo (1991) discusses several determinants of FDI: different rates of return, diversification, tax policy, government regulations, political stability, currency area, market imperfections, product cycles and other issues. None of this will change by leaving the EFTA-EEA arrangement for EU membership, - unless Iceland joins the European Economic and Monetary Union (EMU). As noted by Einarsson and Sturluson (2008), if Iceland were a member of the EMU, - which is not automatic for EU members (see chapter 5), - exchange rate risk will disappear and would possibly increase cross border investments. Einarsson and Sturluson think that if Iceland were a part of the EMU, FDI could in fact increase substantially. This is indeed likely, but Icelandic investments in other EMU countries could also increase. It is impossible to tell if net FDI would be zero, in, or out of Iceland by adopting the Euro as a currency, but investment speculation against the Icelandic currency's real value and pure exchange rate speculation would disappear, promoting only true capital investments. If Iceland enters the EMU at the right exchange rate, there should be no capital imbalances or net flows. Cross border investments would likely be more within the Euro-zone for those interested in pure production related long-term investments, and the speculators would most likely continue to use their portfolios in betting against non-EMU currencies, in a similar manner as Iceland was a source of speculative capital for FDI while the Icelandic Krona was strong up until 2007. It is interesting to note how unrestrained Icelandic investments abroad in the first decade of this century turned sour

⁹³ Free flow of capital in and out of Iceland was temporarily suspended in the wake of the 2008 banking collapse and the following economic crisis. Originally envisaged as a short-term measure, no fixed timetable for relaxation or abolition has yet been set.

in 2008, which led to a major domestic crisis for the economy, currency, banks and the government. Needless to say, this outward Icelandic FDI speculation came to an automatic end with the rapid depreciation (or correction) of the value of the Icelandic Krona in 2008 (figure 9 on page 99 shows the abrupt change in value of the Icelandic Krona vs. the Euro). Indeed, as discussed by Lizondo (1991), the strength or weakness of a currency can influence FDI flows substantially.

Attracting FDI sounds appealing. Ireland made an effort during the latter part of the last century to attract FDI through the use of grants as well as tax and financial incentives. However, this policy has lately come under scrutiny (see e.g. OECD 1994: OECD reviews of FDI; Ireland) because of the distortions the grants and other government incentives produced at the expense of developing local enterprises. A somewhat controversial Icelandic case has arisen in connection with a few foreign companies that have invested in aluminium plants in Iceland. These companies are indeed a source of FDI, but some Icelanders complain that the profits belong to the shareholders, regardless of their nationality, and as such large parts of the profits leave the country. Balanced FDI is an excellent source of know-how and foreign money, but having a country where foreigners own large parts of the infrastructure can also be considered neo-colonialism⁹⁴. When considering investments from outside the EEA in order to gain access to the EU Common Market, this seems, at least so far, not to have materialized in any significant manner for any of the newest EU entrants, and for the period Iceland has been a part of the EEA this has not been a major factor.

It is clear that EMU membership would remove exchange rate risk on foreign investments (for better or worse), but future economic specialisation in Iceland remains rather uncertain. Despite the speculative nature of the subject, there are two issues that stick out that currently give Iceland some production advantages, and one where Iceland is at a disadvantage. The first advantage is that Iceland has relatively cheap hydroelectricity, which is currently being sold to electricity intensive industry such as the above mentioned aluminium production (the raw materials are imported and the products exported again). These firms are mostly funded through FDI. Investment from other EU and EEA countries in electricity demanding industry is free under the EEA agreement and might therefore not change much by joining the EU.

⁹⁴ Instead of states being the colonial powers, neo-colonialism refers to multinational corporations (economic force) and international organisations (political force) as being the colonial powers in the new world order.

Another advantage is Iceland's rich fishing grounds. Fisheries are discussed in chapter 7, but we should point out already that lifting restrictions on non-Icelandic investments in Icelandic fisheries companies is not likely to increase investments in the fisheries sector as such because the sector remains overcapitalised, given the current restrictions on catch quotas. Nevertheless, the possibility of foreign ownership of some of the fisheries companies could push their share price upwards and increase their market value (but not intrinsic value).⁹⁵ Lastly, a particular Icelandic disadvantage is that some parts of Icelandic agriculture are not suited to the country's semi-arctic location and as suggested in chapter 6, other European countries with warmer climate have an advantage in some sectors of the food production. This would change by joining the EU Common Agricultural Policy, which is presently excluded from the EEA provisions on free flow of goods. Leaving the EFTA-EEA arrangement and joining the EU would therefore somewhat increase specialisation in Icelandic agriculture (or perhaps reduce the domestically produced diversity through more competitive imports) and accordingly increase general welfare, but we find it highly speculative to predict other industries' future.

⁹⁵ Icelandic law on foreign commercial investments (law no. 34 of 1991) currently restricts non-Icelandic ownership of fisheries firms. The same law also limits some strategic investments in the energy sector to EEA citizens and entities.