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Isabelle Pun Sin '97

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Abstract

Most of the founding members of the European Free Trade Area are now member states of the European Community. What motivated them originally to join the free trade area? What additional advantages did they subsequently hope to derive from membership of the Community?

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Isabelle Pun Sin

Most of the founding members of the European Free Trade Area are now member states of the European Community. What motivated them originally to join the free trade area? What additional advantages did they subsequently hope to derive from membership of the Community?

A free trade area (FTA), such as the European FTA, can be distinguished from a single market, as the European Community (EC), in that the former is mainly concerned with trade cooperation among member states and the latter with more extensive integration of its member economies.

Economic cooperation through the removal of tariff barriers among EFTA states is indeed the first step towards the goal of promoting free trade and achieving economic gains. Designed to promote trade mainly in industrial goods, the EFTA was founded in 1960 at the Stockholm Convention by Austria, Denmark, Iceland, Liechtenstein, Norway, Portugal, Sweden, Switzerland and the UK. The EFTA was not intended as a customs union. There was not a common external tariff; the main purpose of the EFTA was tariff-removal on industrial products: EFTA members thus removed all tariffs among themselves, but they were allowed to fix their own tariff levels against non-member states (Barnes, 1988). Rules of origin clarify where a product has been manufactured and they were introduced to prevent trade deflection, that is, imports from non-member countries entering the free trade area through a low-tariff member and re-exported duty free to a member with a higher external barrier. Moreover, not all commodities and products were included in the free trade agreement; the latter was basically intended for trade of industrial products.

The EFTA was originally set up as a rival organization to the EC, then known as the

EEC (European Economic Community). It was an intergovernmental alternative to the supranational aspirations to the EEC. The countries unwilling to join the EC felt threatened by the greater market power enjoyed by those that did join. Moravcsik (1991), in his essay "Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach," argues that "the formation of an alternative coalition creates an incentive for recalcitrant governments to compromise . . . the threat of exclusion from a coalition is a more powerful incentive to co-operation than a single state's threat of non-agreement." The creation of the EFTA is an example of a response to the threat of exclusion from an alternative coalition. The British government initially sought to undermine European integration by proposing an alternative free trade area, and thus the EFTA was formed. The majority of countries that later founded the EFTA did not want to be members of the EC in the first place because of its all-embracing character: EFTA countries did not want the political aspects of European integration. For the British, they saw the EFTA as a way of minimizing their commitment to Europe in that it was never visualized as anything more than a convenient device to promote trading interests. In the case of Portugal, the latter was not able to join the EC in the first place because it was under an authoritarian regime, but it joined the EFTA as a result of signing the Stockholm Convention (Barnes, 1988). Reluctant to join the EC, EFTA countries

became still better off by joining the free trade association than by remaining on their own. The formation of the EFTA obviously brought numerous benefits to the member countries. The most significant gains derived from membership of the EFTA are through economies of scale and comparative advantage. EFTA members rely heavily on comparative advantage: net trade is a substantial part of their total trade, and there is a high degree of commodity concentration in their exports (Norman, 1991). Openness is one major characteristic of trade of the EFTA, which trades extensively with the EC countries, as well as with other non-European countries throughout the rest of the world. In 1990, EC's imports accounted for 61 percent of EFTA's foreign trade (Hitris, 1994). EFTA countries gain from the fact that there are no tariffs between them. According to the theory of comparative advantage, removal of tariff barriers leads to specialization. Countries will specialize in the production of those goods in which they have a comparative advantage, that is, those goods which they can produce at the cheapest cost. Consumers from those countries within the free trade area thus benefit from low prices due to low cost of production. It can be seen that such specialization and trade within the EFTA lead to economic efficiency. Furthermore, by specializing in the production of the commodity at which they are best, companies will be able to produce and export in large quantities. This might enable them to achieve economies of scale and low costs of production.

It became almost inevitable that the EFTA and the EC would start working together due to their proximity and historical ties. The EFTA countries signed a free-trade-area agreement with the EC (Lipsey, 1989). This EC-EFTA mutual trade agreement, concluded in the early 1970s, led to Western Europe becoming a free trade area for industrial products (Hitris, 1994). In 1973, Denmark and the UK left the EFTA to join the EC, but this did not diminish the importance of the free

trade area. In fact, the EC made bilateral agreements with each of the remaining member countries of the EFTA. In July 1977, tariff removal on mutual trade between the EC and the EFTA was completed (Hitris, 1994). In 1992, the European Economic Area (EEA) was officially set up. It was designed to provide even closer links with the Community by "encouraging economic harmonization and integration between the Twelve and the EEA countries" (Holland, 1993). (Switzerland eventually did not sign the agreement.) According to Hitris (1994), the objective of the EEA is "to strengthen trade and economic relations between the EC and the EFTA countries by setting up 'a dynamic and homogeneous integrated structure based on common rules and equal conditions of competition and equipped with the means, including the judicial means, necessary for its implementation.' "

As Antola (1991) observed, "all the EFTA countries are in a similar position and that therefore they have a common interest in acting together in order to improve their negotiating position" (Holland, 1993). By joining the EEA, EFTA states agreed to abide by EC laws that rule the four basic freedoms--the freedom of movement of persons, goods, capital and services--as well as the EC competition rules of restrictive practices, abuse of monopoly power, mergers, and take-overs (Hitris, 1994). However, they could not have decision-making power nor voting or veto rights, but they were guaranteed consulting (Siebelink, 1995). The EEA agreement is widely viewed as "a bridging mechanism" that will eventually lead to enlargement of the EC (Hitris, 1994).

Of the EFTA countries, the latest countries to join the European Community are Finland and Sweden. The UK and Denmark left the EFTA to become EC members in 1973, and Portugal followed in 1986 (Hitris, 1994). The only remaining members of the EFTA today (after the last EC enlargement of 1995) are Iceland, Norway, Liechtenstein and

Switzerland (Siebelink, 1995). The present EFTA-EC agreement covers industrial goods, but there are no EFTA-EC free trade agreements covering agricultural products, services, labor mobility, or capital mobility. The EC program covers a much broader range of issues than does the present EFTA Charter. There are consequently much more potential gains and benefits to be achieved with membership in the EC which, over the years and especially more recently in the 1990s, has increased in size (with a number of European countries joining) and gained in significance.

The wider scope of the single market as encompassed in the EC offers a much greater perspective and potential for further development and progress for its members. The EC, being a common market, incorporates the idea of a free trade area as well as a customs union. It represents a more advanced degree of economic cooperation. A free trade area is only the first step in economic cooperation, then comes the customs union. The table below summarizes the possibilities offered by the three types of organization to achieve varying degrees of economic cooperation.

As can be seen from Table 1, a free trade area such as the EFTA only includes trade with no tariffs between the member states. A customs union would include the free trade area's characteristic of tariff-free trade as well as a common-trade tariff with non-members. Finally, the EC common market would also include the features of the customs union in addition to the free movement of capital and labor with no exchange and immigration control restrictions. It is useful to know the fundamental characteristics and goals of the EC before analyzing the additional advantages that future or potential membership to the EC would provide to EFTA states.

The main objective of the EC is the enlargement of the market and changes in production structures leading to improvement in efficiency through specialization and economies of scale (Hitris, 1994). Article 102a of the TEU (Treaty on European Union)² states: "The Member States and the Community shall act in accordance with the principles of an open market economy with free competition, favoring an efficient allocation of resources."

Table 1: Comparison of Possibilities

	Tariff-Free Trade between member states?	Common tariffs on trade with non-members?	Movement of capital and labor unrestricted by exchange and immigration controls?
Free Trade Area	YES	NO	NO
Customs Union	YES	YES	NO
Common Market	YES	YES	YES

Tariff and non-tariff barriers (NTBs) were removed in the process of liberalizing EC commodity trade in the late 1950s / early 1960s. (NTBs could also be referred to as “qualitative” barriers. Examples are: health and safety regulations, technical standards and environmental requirements.) Moreover, a Common External Tariff (CET), also referred to as the Common Customs Tariff (CCT), was adopted by EC members. On July 1, 1987, the Single European Act (SEA) came into force and introduced numerous changes in the Community’s integration strategy (Hitris, 1994). It brought about the principles of harmonization and mutual recognition. The harmonization principle requires EC members to adjust their policy targets and instruments in recognition of international economic interdependence. Harmonization is a negotiated solution to the problems that arise due to the different systems of national standards and policies. On the other hand, mutual recognition refers to member states recognizing other members’ norms and regulations with a view to eliminate the obstacles to market integration caused by different inter-state standards. The principles of harmonization and mutual recognition might bring about substantial cost savings to the EFTA countries which become EC members. For example, conflicting tax regulations hindering transborder business activity may be removed.

EFTA countries already benefit from the “non-existence” of tariff barriers in their free trade organization, but the lack of NTBs and other technical and fiscal barriers in the EC can confer additional advantages to those EFTA members that decide to join the EC. The economic gains arising from the internal market can be classified into two categories: static effects and dynamic effects. The static welfare effects are the reduction in costs brought about by the reduction in tariff barriers and NTBs, and hence the creation and expansion of trade. The dynamic effects refer

to increased technical efficiency, reduced oligopoly profits, and greater choice of products for consumers.

Membership in the EC rather than the EFTA would help those latter countries save on costs that generally arise with tariffs and NTBs. Examples are red tape and delays due to customs formalities and border controls. A study made by the European Commission in 1988 estimated that throughout the EC, firms pay around ECU 8 billion in administrative costs and delays due to customs procedures in intra-EC trade, or an equivalent of 2 percent of these transborder sales (Cecchini, 1988).

EFTA markets are small: joining the EC which has no NTBs gives the possibility of EFTA to achieve more economies of scale. While economies of scale might have already been achieved for industrial goods (which are the main type of goods that are part of the EFTA agreement), EFTA countries might still be able to tap scale economies in other areas and thus benefit from integration with the EC. Service industries in EFTA markets are mostly closed to international competition. In particular, the Nordic EFTA countries are strictly protected and regulated by the government. The smallness of their domestic markets gives much scope for economies of scale as well as gains arising from competition through integration. One example is the transportation industry in the Nordic EFTA states, which is under very heavy regulation--in some cases through public monopolies and in others through a concession system with monopoly rights for private carriers (Norman, 1990). Presently, the Scandinavian Airlines (SAS) is granted the national carrier rights for international air transportation for Denmark, Norway, and Sweden, and has a virtual monopoly on inter-Scandinavian routes, and the right to 50 percent of all routes out of Scandinavia. A study by Norman in 1990 (in which he used a simulation model of monopoly versus competition) has found that breaking the monopoly situation that exists with the

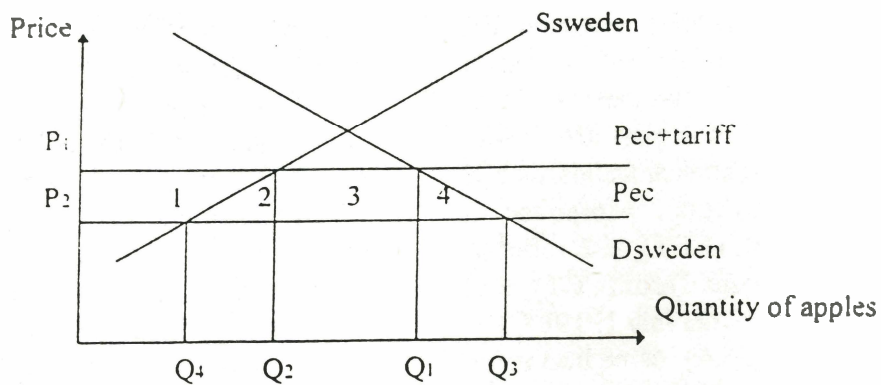


Figure 1: Trade Creation

SAS by introducing a duopoly on the Oslo-Stockholm route would give a consumer gain of more than 45 percent of initial consumer expenditures and a welfare gain to the world of approximately 36 percent. This tremendous potential gain from deregulation through integration represents only a fraction of the gains that could be achieved. It should be noted that EFTA countries will not only benefit with regards to the airline industry, but in the transportation industry overall. Indeed, EFTA states that become EC members can enjoy the advantage of cabotage, whereby they will be able to share transportation services across national frontiers in the EC.

By joining the EC and its CET, EFTA can also benefit from trade creation. Trade creation is where consumption shifts from a high-cost producer to a low-cost producer. This is tied in with the theory of comparative advantage. Because of removal of trade barriers, the theory of comparative advantage states that this will lead to specialization. For instance, instead of Swedish consumers paying high prices for domestic goods, say apples, in which the country has a comparative disadvantage (supposing some Swedish producers grow apples), then they can buy the same goods more cheaply from other members of the EC--France, for example. In return, Sweden can export goods, such as seafood, to other EC members when it has a comparative advantage. There is thus a gain to all

consumers. Figure 1 above demonstrates an example of trade creation.

Assuming EC price is given, then before joining the EC, Sweden had to pay EC price, plus the tariff. At P_1 , Sweden produced Q_2 , consuming Q_1 and importing Q_1-Q_2 . When Sweden joins the EC, tariffs are removed and price falls to P_2 . Consumption then increases to Q_3 and production falls to Q_4 . Therefore, imports have increased from Q_3 to Q_4 . Hence it is said that trade has been created. The fall in price from P_1 to P_2 means that there has been an increase in consumer surplus, shown by areas 1+2+3+4. On the other hand, there is a loss in profit to domestic producers of apples, of area 1. There is also a loss in tariff revenue to the French government of area 3. However, there is still a net gain of areas 2 and 4.

By becoming members of the EC, the EC public procurement directives for works, supplies and utilities are extended to those EFTA states. EFTA members that become EC members have rights to the EC regional policies. Finland's and Sweden's accessions to the EC should lead to an improvement of rail and road links with Denmark and Germany on the one hand, and Central and Eastern Europe on the other (European Commission, 1994). The liberalization of public procurement in the EC will provide substantial savings for EFTA public enterprises, such as significant reductions in purchasing and investment costs,

as capital goods in particular become cheaper under the competitive pressure of foreign suppliers (Cecchini, 1988). Competitive tendering provisions will apply and since many Nordic EFTA countries, especially Sweden, have a comparative advantage in capital goods, this can be a major consideration for EFTA countries to join the EC. According to the Cecchini Report (1988), "Opening public procurement should . . . mean an increase in [EC] GDP of 0.5%, and in the process, provide nearly 400,000 new jobs in the medium-term."

EFTA countries will benefit from internal as well as external economies of scale: they will gain from the dynamic effects of greater competition on innovation, investment and growth. Overall, joining the EC might lead to greater economic growth for the EFTA states in the long run. From a political point of view, EFTA members that join the EC can enjoy further advantages. Mostly, they are able to have voting or veto rights and most probably have wider access in respect to fishing rights. They have increased political power being EC members as well as EFTA members.

There are many advantages and incentives for EFTA countries to join the EC. However, EFTA states that do become EC members should bear in mind that gains from membership are not likely to be automatic. Also, there are states that will gain more than others, that is, the benefits derived from EC membership are likely to be unevenly spread. But still, there is no doubt that there are numerous gains and incentives for EFTA states to become EC members, for there are much more potential gains to be achieved with the EC, which is now part of the European Union.

FOOTNOTES

1. Austria, Finland, Iceland, Liechtenstein, Norway, Sweden, and Switzerland
2. The Treaty on European Union is more

widely known as the Maastricht Treaty, which was formally signed in February 1992 but only came into force in November 1993 following ratification of member states' national parliaments (Hitris, 1994).

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Isabelle Pun Sin ('97) wrote this paper while studying at the University of Westminster in London, England. She is a major in Risk Management and Insurance, and has minors in Economics as well as Business Administration. She hopes to find a job in the insurance and risk management field.
