In & Out – A Country Comparison Reflecting on the Enlargement Round of 1995

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This paper provides an overview of the economic effects EU membership has had on the countries Austria, Finland and Sweden since their accession in 1995, primarily focusing on implications for price stability and GDP growth. EU accession has led to an intensification of competition or opened up industries to competition in the first place. This, in turn, has dampened prices, in particular in previously sheltered sectors like the agricultural sector. Economic integration has also had a positive effect on GDP growth, increasing annual growth by approximately 0.5 percentage point. As a non-EU member, Switzerland did not experience these benefits.

1 Introduction

In the late 1980s, European states like Austria, Finland, Sweden and Switzerland were confronted with the introduction of the Single Market, which was to intensify economic integration among participating states. Between 1989 and 1992 these four states, all of them EFTA members at the time, applied for EU membership, not least because of the prospective disadvantages outsiders would be facing in the course of growing integration.

The European Economic Area (EEA) had already made limited participation in the Single Market possible without full EU membership. Nevertheless, the Swiss population voted against EEA participation in December 1992,[2] while Austria, Finland and Sweden signed the EEA Agreement, which entered into force in 1994. The EEA is based on the four freedoms (free movement of goods, persons, services and capital) and on large parts of the body of EU law. It aims at closer cooperation in the fields of research and development, environmental protection, education and social policy. As far as agriculture and fishing products are concerned, the movement of goods is still restricted, however. EEA and EU membership are also very different when it comes to political decision-making. EEA members' right to be heard is limited, and they are also excluded from further integration steps such as Economic and Monetary Union (EMU).

Already in the run-up to EU accession, economic analysts in Austria, Finland and Sweden had tried to quantify the consequences of EU membership for their countries; in all three countries, the overall assessment had been positive.[3] In the following, this paper will investigate the accuracy of these assessments and, in particular, the effects of integration on price stability and GDP growth, as well as the institutional changes brought about by EU membership. The findings for Austria, Finland and Sweden will be contrasted with developments which occurred in Switzerland during the same period (i.e. after 1995). It goes without saying that the different dynamics in the three Member States and in Switzerland cannot be attributed to EU (non-)membership alone. Thus, differences which arise from a lower level of integration are explicitly pointed out.

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[2] *In a referendum on the opening of accession negotiations with the EU held in March 2001 the majority of the Swiss population also voted against.*

[3] *In this context see Felderer et al. (1994) and WIFO (1994) for Austrian analyses.*

2 Open Markets Lead to Lower Inflation[4]

From the point of view of a central bank whose primary aim is price stability the effects EU accession has had on inflation are of particular interest. Expectations regarding the potential impact of EU membership on prices were primarily based on the following rationale: If remaining trade barriers like e.g. border crossing formalities were to be eliminated, the prices for imported goods should fall; this intensification of competition and the opening-up of previously sheltered sectors should, in turn, prevent businesses from setting prices in a monopolistic or oligopolistic manner and force them to develop more efficient and thus cheaper production methods.

In the case of Austria, Finland and Sweden, customs tariffs did not change much upon EU accession, as trade in industrial goods between EFTA and EU members had already been exempt from customs duties. Imports from nonmember countries became subject to EU tariffs, which meant that these tariffs had to be reduced by 5% in Austria, while those in Sweden had to be raised by approximately 1%. The Finnish tariffs already corresponded to EU norms. Border controls and other formalities tied up with bilateral trade were eliminated, which led to cost savings in the amount of 2.5% to 5% of trade volume according to an estimate by Breuss (2003). A long-term comparison of import prices before and after 1995 shows the following: In Austria, the average annual growth rate of import prices came to 0.7% between 1985 and 1994 as well as between 1995 and 2004. In Finland and Sweden, import prices grew much more slowly in the ten years following EU accession than in the ten years before. It has to be mentioned, however, that Finland and Sweden experienced severe depreciation in the early 1990s, which considerably drove up import prices.[5]

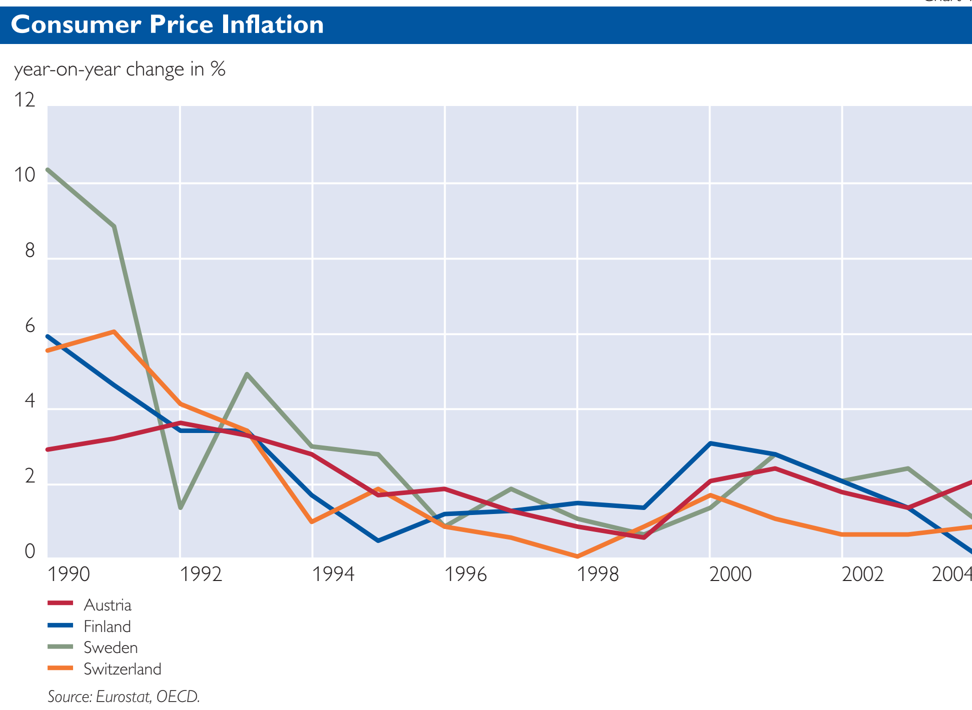
EU accession was also expected to have a significant impact on food prices, as the agricultural sector, which had been particularly sheltered from competition in the past, would henceforth be subject to the common agricultural policy. Indeed, food prices in Austria fell by 1.7% in the year of its accession; in Finland price reductions even amounted to 4.6% owing to numerous government monopolies (e.g. sugar). Finland had been granted an exception for alcoholic beverages, which remained upright until 2004 and which reduced the HICP (Harmonised Index of Consumer Prices) inflation rate by a further 0.8 percentage point when it expired. Switzerland did not experience these effects; at 0.6%, food price growth in 1995 corresponded to the average level of the 1990s. In Sweden, EU accession did not have the same dampening effect on food prices as in Austria and Finland. According to Dahl (1999), this was mainly attributable to the high degree of concentration and the related lack of competition in the Swedish retail trade sector and to Swedish consumers' strong preference for domestic food products. Moreover, the liberalization of Sweden's agricultural sector was already more advanced prior to EU accession than in Austria and Finland. In 1995, when the three countries joined the EU, food imports from the EU rose by 67% in Austria, by 44% in Finland and by 34% in Sweden;

[4] *See also Fluch et al. on inflation in Austria since EU accession in this issue of Monetary Policy & the Economy.*

[5] *The Finnish markka depreciated by around 14% in 1992 and 1993, and the Swedish krona by 17% in 1993. Import prices in Sweden increased by 14% in 1993.*

Chart 1

Consumer Price Inflation



Source: Eurostat, OECD.

in Switzerland they increased by a mere 7%.

EU accession also caused downward price effects in other areas, especially in the industrial goods sector, in which producers are exposed to more international competition than in the services sector. Breuss (2003) cites the example of the energy market, on which consumer prices and production costs were positively influenced by the complete liberalization of the electricity and gas markets (with effects being stronger for businesses than for households). Annual price growth in the nonenergy industrial goods sector has also slowed down since 1995: From 1990 to 1994 it had averaged 2.5% in Austria, 4.2% in Finland and 3.4% in Sweden; in the period from 1995 to 2004 average annual price growth amounted to 0.3% (Austria), 0.5% (Finland) and 0.2% (Sweden), respectively. The reduction in inflation rates seems to be mainly attributable to an increase in production efficiency and the related cost savings. Neither Sauner-Leroy (2003) nor Badinger (2004) find corporate profit margins to have dropped significantly after EU accession.

All in all, consumer prices in all three Member States did not rise as strongly after 1995 as in the years prior to EU accession, the average increase in the HICP coming to around 1.5% in Austria and Finland, and to approximately 1.6% in Sweden. Austria and Finland[6], which participate in Stage Three of EMU, have contributed to meeting the euro area's monetary policy objective of keeping inflation rates below but close to 2% over the medium term. The inflation differentials between Austria, Finland and Swe-

[6] *In Finland, prices were already very stable at the time of its EU accession owing to the fact that the country had introduced an explicit inflation target in 1993 (price stability being defined as an increase in core inflation, i.e. consumer price inflation without rises in indirect taxes and housing costs of 2%, (OECD, 1995).*

den have narrowed since they joined the EU.

Switzerland also experienced a marked slowdown in consumer price inflation after 1995. This, however, was not so much related to increased competition but to a widening of the output gap caused by the rather weak economic growth in the years following 1995.[7] Weak GDP growth was also reflected by unit labor cost developments: Although, since 1995, Switzerland has recorded the lowest wage growth of all four countries under review, its unit labor costs have risen more strongly than those in Austria, as annual productivity growth in Switzerland only averaged 0.7% after 1995. In Austria (as in Finland and Sweden) yearly productivity growth after 1995 amounted to around 2%, which resulted in average annual unit labor cost growth of 0.7% given the moderate rises in actual wages in Austria.

The low competitive pressure in Switzerland has been criticized by the OECD (2002), as it leads to relatively high prices. While the scope of Swiss competition law was expanded in the 1990s, the competent authorities do not have sufficient powers to sanction noncompliance. In 2001, for instance, the European Commission imposed the then highest fine ever on a Swiss cartel in the pharmaceutical sector. Under Swiss law the involved businesses had only been issued a warning, as the national competition authorities can only punish breach of competition law upon evidence of repeated offense. The OECD also blames the lack of competition in Switzerland for the relatively high public procurement prices.

3 Growth Effects of Integration

Economic integration opens up new possibilities for the international division of labor, and via specialization it leads to more trade and higher growth. This, in short, was how traditional economic theory assessed the prospective impacts of European integration on trade and GDP growth. While traditional economic theory explains the positive effects of closer international cooperation primarily through comparative advantages, newer theories emphasize other aspects, e.g. market size and the associated potential benefits arising from economies of scale, technology and human capital spillovers resulting from trade and foreign direct investment, and the proximity of production sites to customers.[8] A model-based analysis of trade effects caused by EU accession is provided by Fidrmuc in this issue of Monetary Policy & the Economy.

Manufacturing enterprises were in a position to expect an acceleration of growth from participation in the Single Market, as, in general, they produce tradeable goods. And indeed, in all three Member States under review the manufacturing sector has recorded higher growth rates since 1995 – the highest of all economic sectors in fact –, while industrial growth in Switzerland has remained constantly below the levels achieved in Austria, Finland and Sweden.

Growing specialization entails structural change in the industrial production sector. Finland and Sweden's economic sectors have undergone particularly strong structural shifts since

[7] *See OECD (1999).*
[8] *For an overview of the theoretical literature on economic integration see Wolfmayr-Schnitzer (1999).*

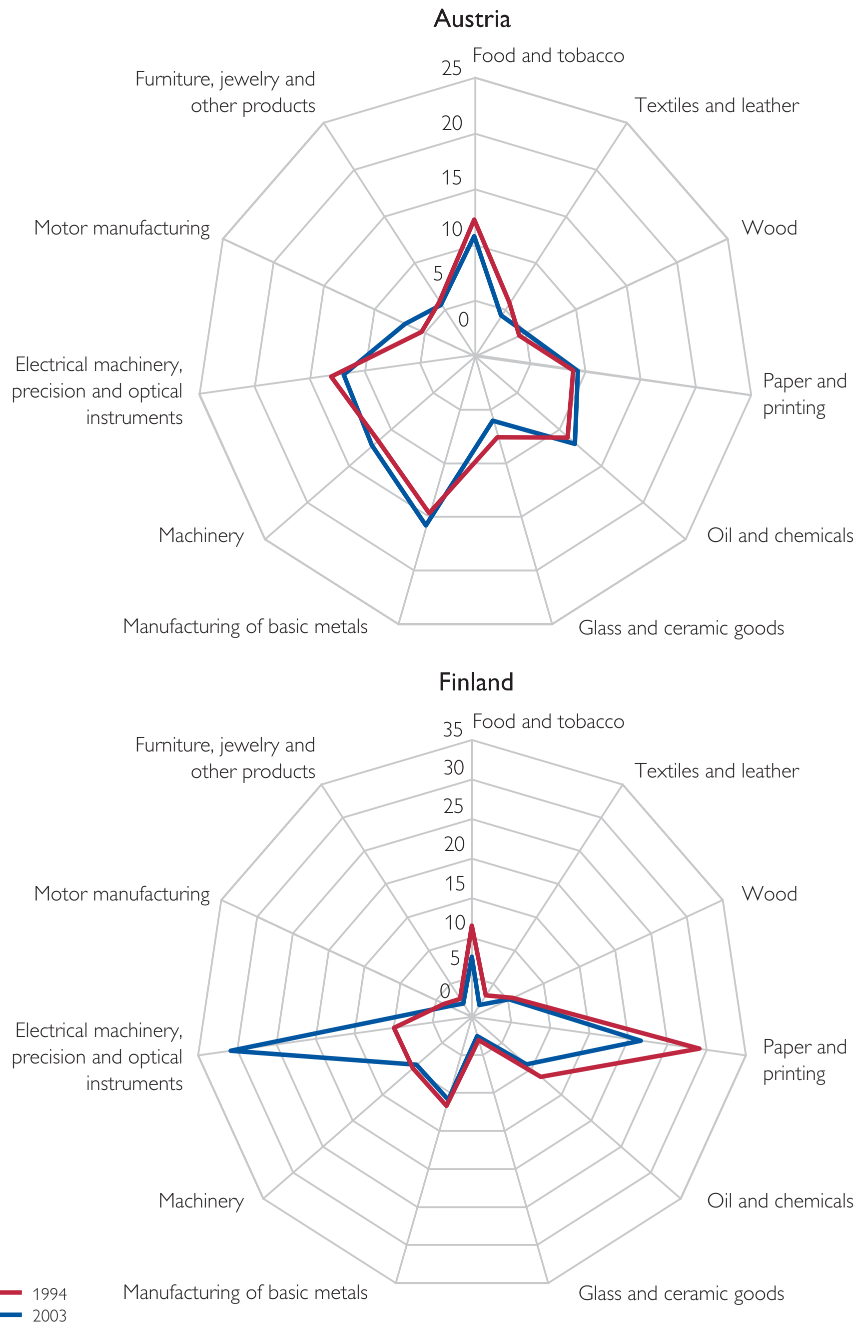
1995. In both countries the paper industry had made the most significant contribution to value added in the manufacturing sector in 1994. Since then, the significance of this industry has diminished. The electronics industry, by contrast, has strongly gained in importance, in particular the production of telecommunications goods. Since 1995, the entire electronics industry has grown by 400% in Finland and by even 500% in Sweden, while it has expanded by 20% in Austria.

In general, changes in Austria have not been as drastic. Traditionally important sectors like metal manufacturing have further increased their share in the overall manufacturing sector. The most significant gains have been recorded by the motor industry, with an average annual growth rate of 7% since 1995 (total manufacturing sector: 3%). As the largest industrial sector in Austria, metal manufacturing accounted for just under 16% of total manufacturing in 2003; the share of the electronics industry in both Finland and Sweden exceeded 30%. Such a high degree of specialization is, however, accompanied by certain risks. Growth potential in both Finland and Sweden is highly dependent on demand for a narrowly defined group of goods. When enterprises in a small open economy take advantage of increasing economies of scale, risky national specialization patterns are likely to emerge quickly. As in Austria, industrial structures in Switzerland remained relatively constant in comparison with the two Scandinavian states.

Chart 2a

Structural Change since EU-Accession[1])

Sectoral shares in total industry in %



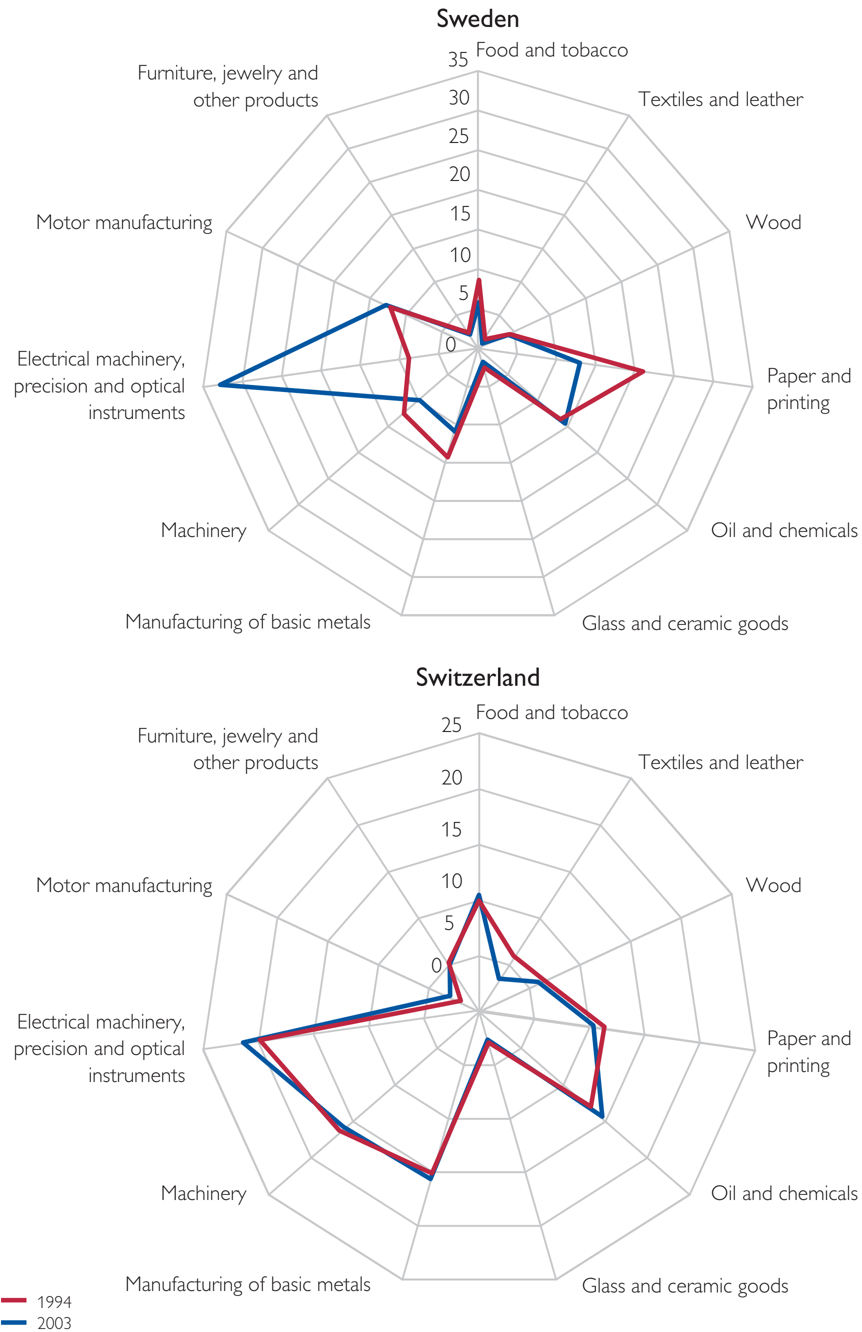
Source: Eurostat, Swiss Federal Statistical Office.

[1]) These charts show the contributions of individual industries in Austria, Finland, Sweden and Switzerland to the total value added in the manufacturing sector before EU accession and compare them with recent data. In the case of Switzerland, the percentages refer to employment figures.

Chart 2b

Structural Change since EU-Accession[1])

Sectoral shares in total industry in %



Source: Eurostat, Swiss Federal Statistical Office.

[1]) These charts show the contributions of individual industries in Austria, Finland, Sweden and Switzerland to the total value added in the manufacturing sector before EU accession and compare them with recent data. In the case of Switzerland, the percentages refer to employment figures.

The cumulated growth effects of EU accession are investigated by Crespo-Cuaresma et al. (2003). In a panel estimation, they regress GDP growth on a number of variables, inter alia the length of EU membership. The latter turns out to be significantly positive. As the intensity of trade is also included as an explanatory variable, the effects of EU membership are explained through the improved diffusion of technological knowledge in line with endogenous growth theory. Breuss (2005) also provides an econometric estimate of the effects EU membership has had in the three Member States under review. According to his estimate, EU accession triggered the strongest growth impulses in Finland. The integration effects caused by the creation of the Single Market and by EEA membership have brought Finland additional annual growth of 0.7 percentage point, primarily owing to the massive FDI inflows and the marked increase in Finnish research activities. At 0.4 and 0.3 percentage point per year, respectively, growth effects in Austria and Sweden were somewhat less pronounced. These growth effects have to be viewed as temporary results of integration which subside after five to six years, upon which growth rates return to their previous levels. As Switzerland is geographically located at the very center of the EU, which naturally favors close trade relations, it is safe to assume that, in the case of Switzerland's accession, growth effects would have surpassed those experienced by Sweden.

Austria and Finland already participate in State Three of EMU, i.e. have introduced the euro. The ensuing deepening of financial and product market integration suggests further growth impulses in the future according to findings produced by Rose (2000) and Persson (2001). Some of these impulses can be attributed to a reduction in exchange rate volatility, which has fallen significantly in Finland and Sweden since their accession. In Austria and Switzerland, it remained more or less the same after 1995 as in the ten years before. It should be mentioned, however, that exchange rate volatility has traditionally been very low in Austria owing to its successful hard currency policy.[9]

4 Changes in the Legal and Institutional Framework and in Relations to the EU

Participation in the Single Market made it necessary to adapt legal framework conditions in Austria, Finland and Sweden. This first of all meant translating directives adopted at the European level into national law, as, in many areas, uniform legal standards are an essential prerequisite for the smooth functioning of the Single Market. The European Commission monitors the implementation of EU directives in the individual Member States and publishes progress reports on its Internal Market Scoreboard. Austria, for instance, had only implemented 90% of the regulatory framework of the Single Market by 1997, Finland

[9] *Gnan et al. show that Austria's effective exchange rates have clearly stabilized since Austria joined EMU (see this issue of Monetary Policy & the Economy).*

96% and Sweden 94%. By 2004, however, the three countries had already implemented around 98%.[10]

EU Member States are obliged to contribute to the EU budget. These contributions minus EU funds invested in the individual Member States yield their respective budgetary balances, which are published in the European Commission's annual report on the allocation of EU operating expenditure. Austria and Sweden are among the net contributors within the EU; Sweden's contribution remained relatively constant between 1995 and 2003 at around 0.4% of its GDP, while Austria's net contribution gradually decreased from 0.5% of GDP in 1995 to 0.15% in 2003. Finland's contributions to and receipts from the EU budget remained roughly balanced in most years.[11] In Austria, 72% of the receipts from the EU budget flow into agriculture in the form of direct aid, export refunds or support for rural development. In Finland and Sweden, 66% and 60%, respectively, are allocated to agriculture. These two countries receive a higher share from the structural funds than Austria.

To be able to participate in European integration despite the negative outcome of the referendum, Switzerland concluded a number of bilateral agreements with the EU, which entered into force in June 2002. These complemented the free trade agreement of 1972 in the following areas: free movement of persons, technical barriers to trade, public procurement, air and land transport, as well as agriculture and research. The objective of these agreements was to ensure that Swiss citizens and businesses were put on a broadly similar legal footing as EU members in the areas listed above. For example, Swiss citizens were granted full access to the EU labor market, agricultural tariffs were reduced and new regulations for alpine transit were introduced. When these agreements came into force, Switzerland entered a new negotiation round with the EU ("Bilateral Negotiations II"), which focused on issues like taxation of savings income, anti-fraud activities, security and asylum policies and statistics. As these negotiations were concluded in 2004, the resulting new agreements can be expected to be ratified in the course of 2005. Hauser and Roitinger (2001), however, point out that these bilateral agreements do not accommodate continuous developments, which means that changes in the legal framework of the participating states cannot be reacted to adequately. Whether the bilateral agreements can be adapted to such changes will always depend on the EU's willingness to renegotiate.

5 Conclusions

The effects the three Member States under review expected from joining the EU have largely materialized in the areas analyzed in this paper. Inflation in these three countries has fallen since their accession, owing, on the one hand, to the opening-up of previously sheltered sectors (e.g. agriculture) and, on the other hand, to the intensification of competition. Austria did not experience a reduction of

[10] *Only Hungary, Lithuania, the Netherlands and Spain have already translated more of the regulatory framework of the Single Market into national law than the countries under review. For information on implementation progress in all EU Member States see European Commission (2005).*

[11] *In half of the years since its EU accession, Finland's net balance of contributions to and receipts from the EU budget was less than 0.1%. Moreover, Finland was net recipient for as many years as it was net contributor.*

import prices; in Finland and Sweden, import prices did decrease, but most likely as a result of exchange rate fluctuations in the early 1990s. Although productivity growth has been more or less the same in all three countries, unit labor costs in Austria rose much less than in the other two countries, which can be attributed to lower increases in actual wages.

There is also empirical evidence which substantiates that EU accession has had positive effects on GDP growth. Finland and Sweden have more readily embraced the opportunities for sectoral specialization arising from economic integration than Austria has. Because of its nonmembership Switzerland has clearly missed out on all these positive effects. The existing bilateral agreements and the general rapprochement observed in recent years may have triggered integration effects in Switzerland, but these cannot compare to EEA or EU membership.

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