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FINLAND'S FIRST 10 YEARS IN THE EUROPEAN UNION

ECONOMIC CONSEQUENCES

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Abstract: This paper summarizes the economic performance of Finland in 1995–2004 and compares the actual developments to the projections made prior to the EU membership. The paper also assesses the impacts of the structural changes induced by the membership. The most pronounced impact of EU membership was on Finland's agriculture and food industry. Joining the Common Agriculture meant a total change in the subsidy system and a sharp drop in producer prices. At the same time, agriculture and the food industry became part of the European internal market and the competition that goes with it. In sectors outside of the food chain, the impact of the EU is more difficult to ascertain. It was thought that integration would lead to increased trade in the internal market area. But this has not happened; rather the EU's share of Finland's foreign trade has decreased since membership.

Key words: Finnish economy, EU membership, integration

Tiivistelmä: Tässä raportissa arvioidaan Suomen EU-jäsenyyden ensimmäistä kymmenvuotiskautta. Maatalous ja elintarviketeollisuus kokivat toimialoista suurimman toimintaympäristön muutoksen EU-jäsenyyden seurauksena. Jäsenyyden ansioksi voi katsoa sen, että elintarvikkeiden hinnat laskivat. Raportissa tarkastellaan EU-jäsenyyden vaikutuksia ulkomaankauppaan, tuotantorakenteeseen ja aluekehitykseen. Näissä kaikissa tapahtui suuria muutoksia kymmenvuotiskauden aikana. Suomen ulkomaankauppa kasvoi jopa ennakoitua nopeammin, mutta paradoksaalisesti kävi niin, että kauppa kasvoi eniten muiden kuin EU-maiden kanssa.

Asiasanat: Suomen talous, EU-jäsenyys, integraatio

FOREWORD

The beginning of 2005 marked Finland's tenth anniversary as a Member State of the European Union. Even though 10 years is a short period in terms of changes to economic structures and models of behaviour, it is interesting to assess whether the expectations or fears of the pre-accession period were anywhere near the reality. Ten years is a long enough time in that any transitional periods have elapsed and structural impacts ought to have made themselves felt. This report examines the path of the Finnish economy from various perspectives. The report is based on a larger one published in Finnish in 2005.

Helsinki, December 2005
Reino Hjerppe

Contents

1. Introduction

Finland and the other EFTA countries had a free trade agreement with the EC from the 1970s. In the 1980s they began preparations with the EC for the European Economic Area, which was to define economic relations between the EC's internal market and the EFTA countries. At the same time there was discussion in the EFTA countries about joining the EC. The first country to apply for membership was Austria in 1989. Sweden followed in 1991, and then Finland, Norway and Switzerland in 1992. The path to integration, therefore, was a twin-track process. The EFTA countries were pursuing integration discussions on the basis of the EEA Treaty whilst at the same time directly negotiating EC membership.

Compared to the free trade agreement for industrial goods which had existed between Finland and the EC since 1973, the EEA Treaty and EC membership entailed significantly deeper integration. Then again, EC membership meant immediate changes in the protected status of agriculture and the food industry and in the longer term also participation in monetary union and the attendant limitations on national sovereignty.

This paper summarizes the economic performance of Finland in 1995–2004. We compare the actual developments to the projections made prior to the EU membership. We also try to assess the impacts of the structural changes induced by the membership.

2. Forecasts and outcome

2.1 Preliminary assessments of the effects of EC membership on Finland

A Commission research report entitled ”The Economics of 1992” (European Commission, 1988) gave a detailed sectoral assessment of the benefits of the internal market, in particular resulting from the removal of barriers to trade, better use of economies of scale and greater competition. These benefits at the so-called micro level were thought to amount to as much as five per cent of the area's total production. Factoring in the macro benefits of the removal of border controls, the opening-up of public contracts to competition, the liberalization of financial services, the adjustment of companies to the new competitive environment and the increased leeway for economic policy, the overall benefit was thought to be a couple of percentage points higher still.

A report by the Centre for Economic Policy Research (Baldwin et al., 1992) states that the old EC Member States would benefit from the wealthy EFTA countries being members, in particular through funding of the Community budget. The incremental benefit to the EFTA countries from EC membership compared to the alternative of the European Economic Area (EEA) would be slight and political in nature. For example, being part of the EC's Common Agricultural Policy would be a far worse option than global liberalization of agricultural trade.

In Finland, the Government Institute for Economic Research (VATT, 1992) and the Research Institute of the Finnish Economy (ETLA) (Alho et al., 1992) published their assessments of the impacts of Finnish EC membership in 1992.[1] Both assessments attempted to give an overall picture and to take into account that the EC was likely to develop from a customs union into a monetary union with a common currency and a common monetary policy.

In both assessments the quantitative impacts of membership were compared to the EEA option and illustrated through the following channels.

1. Membership would mean participation in the EC customs union, meaning the removal of barriers to trade between Member States and harmonization of customs tariffs and other trade barriers in trade with other countries. This was assumed to increase trade between Member States (trade creation) and reduce external trade (trade diversion), the net effect however being a growth in trade. This is also one of the net

1 The VATT study was published in early 1992 and that of ETLA at the end of the same year. In the meantime the Finnish markka had been allowed to float and devalued sharply, so that Finland's competitiveness was much better at the end of the year than at the start. This was naturally reflected in economic forecasts and estimates of the effects of EC membership.

benefits of membership, albeit slight compared to the EEA option.

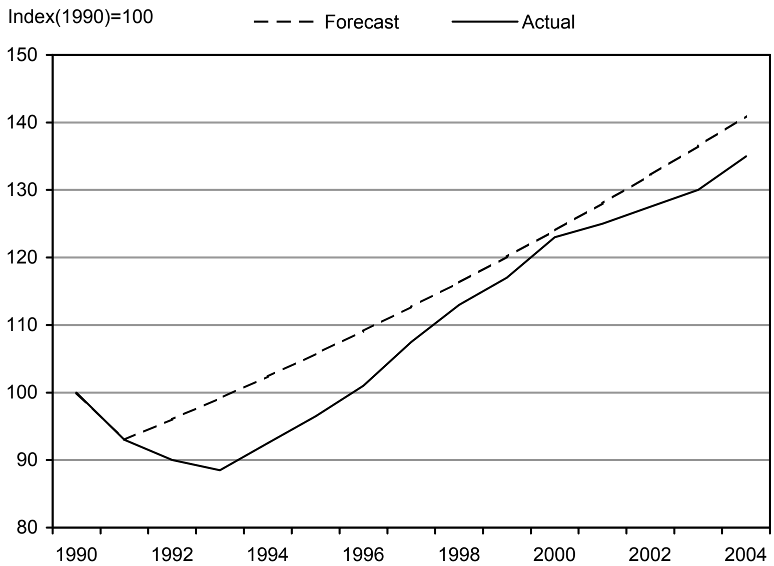
2. EC membership would have major implications for agriculture, with national subsidy policies replaced by the EC's Common Agricultural Policy (CAP). Prices of agricultural products in Finland in the early 1990s were around double those in the EC. It was estimated that lower prices for products and production inputs would create major adaptation pressures in agriculture. Both ETLA and VATT thought that agricultural production and employment would decline. Lower prices for agricultural products and food and reduced national subsidies would be compensated in other parts of the economy in the form of lower costs and increased consumer purchasing power. For producers in other sectors sheltered from competition, EC membership would mean at least a potential increase in competition and a need to become more efficient. For consumers this would mean a slower price trend. Both ETLA and VATT estimated that lower inflation and more efficient use of resources would bring substantial benefits for the overall economy.
3. Both assessments state that EC membership would not substantially affect the mobility of labour since this freedom would be introduced by the EEA Treaty. It is considered that membership would have a greater effect on the mobility of capital. Finland would be a more attractive destination for inward investment as a member of the EC than outside of it.
4. The monetary union to which EC membership would lead is considered to be advantageous to Finland. Removal of exchange rate uncertainty would lead to lower interest rates in Finland. Foreign exchange transaction costs would also be lower.
5. It was assumed that EC membership would require some degree of harmonization of indirect taxation. VATT thought that this would mean considerably lower taxation, slower increases in prices and costs and thus improved competition and a demand stimulus coming into the economy. Over time, economic growth would cancel out the increased public debt brought about by the original decline in tax receipts. ETLA, on the other hand, was of the opinion that Finland might have to compensate the losses in indirect taxation with higher income taxation. The net effect in this case would be negative.
6. The direct price of EC membership is payments to the EC budget. On the other hand, Finland would receive agricultural aid and various forms of structural aid. At the end of the 1990s it was calculated that net payments amounted to approximately half a per cent of gross domestic product.
7. All in all, VATT concludes that after a period of adjustment overall production would benefit to the tune of around 8 per cent and private consumption by around 9 per cent. Spreading this impact over the first 10 years of membership from 1995 to 2005, the effect on annual production and consumption is just under one per cent. ETLA puts the benefit at half that level, even assuming that adjustment to the new environment is successful. If not, the benefit is negligible.

2.2 Finland's economic development in the EU period

Most preliminary estimates of the effects of EC membership on the overall economy were made in the very unstable economic situation of 1991–1992. Finland had just been plunged into the worst recession in its history and there seemed to be no end in sight. Production was shrinking and unemployment was rising sharply. Interest rates were at times in double digits. The markka had first been devalued and was then allowed to float. In those circumstances economic forecasting was difficult.

In the beginning of 1992 the Government Institute for Economic Research (VATT) produced a forecast of the long-term trend of the Finnish economy on the assumption that Finland would join the EC in 1995. Figures 2.1–2.5 show how key economic indicators turned out in the period 1990–2004 compared to forecast.

Figure 2.1 Forecast vs. actual trend in gross domestic product, 1990–2004. Index(1990)=100.



Source: VATT, 1992 and Statistics Finland.

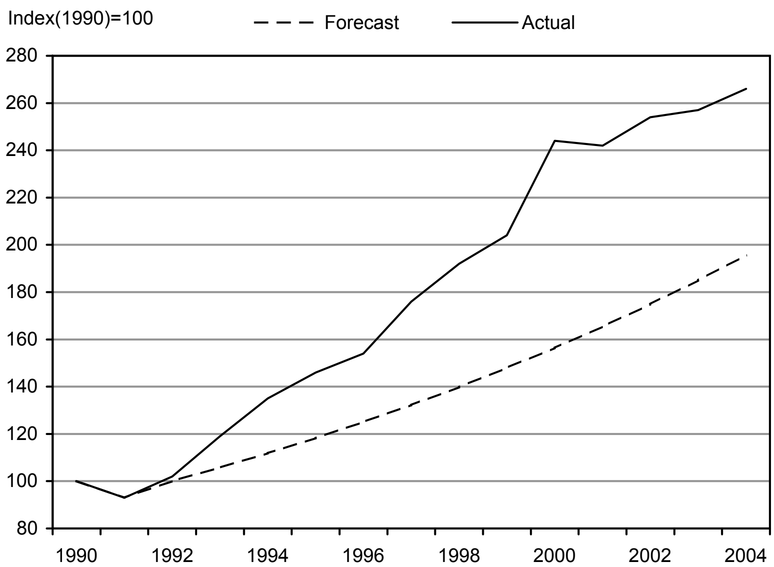
Figure 2.1 shows that the forecasts were made at the height of the recession in the early 1990s. The worst year of the recession was 1991, when overall production shrank by over 6 per cent. Production declined further in 1992–1993, but grew strongly between 1994 and 2000. In 2000 overall production reached its forecast growth path, but between 2001 and 2003 the pace of growth slowed considerably and was somewhat behind the forecast path. Growth picked up again in 2004.

The rapid economic growth at the end of the 1990s cannot be attributed to EU membership. Growth would presumably have been rapid in the EEA environment too, because Finland's external competitiveness was good following the devaluation of the markka and production was starting from a low level after the recession. But the prolonged period of rapid growth can be put down to EU membership because efforts to join Economic and Monetary Union right after accession to the EU have helped to maintain a high level of competitiveness.

The road out of recession came about through exports. This can also be seen by comparing actual growth in exports to the forecast.

Exports have increased almost non-stop since 1992 and the volume of exports in 2004 was over two-and-a-half times that of 1990, whereas the forecast was for an approximate doubling. The rapid growth in exports is largely explained by the devaluations and the competitiveness engendered by rapid productivity increases resulting from breakthroughs in the ICT industry.

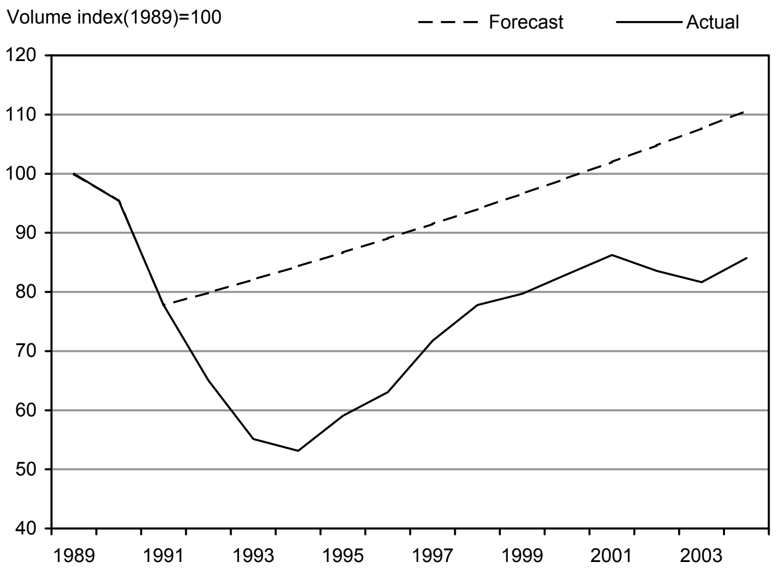
Figure 2.2 Forecast vs. actual exports, 1990–2004. Index (1990)=100.



Source: VATT, 1992 and Statistics Finland.

The rapid growth in exports cannot be attributed to the EU. The destination of Finnish foreign trade during EU membership has been surprising. The proportion bound for the EU area has declined. There are two main factors explaining this. Firstly the EU share grew unusually large in the early 1990s with the collapse of trade with the Soviet Union and Russia. The second factor is the rapid change in the structure of Finnish exports. The electronics industry has increased its share of exports rapidly, and the fastest growing markets in this sector are outside the EU.

Figure 2.3 Forecast vs. actual level of investments, 1989–2004. Index(1989)=100.



Source: VATT, 1992 and Statistics Finland.

Investments are an item of demand that is sensitive to economic fluctuations. The period 1992–2005 contains both a severe recession and a strong upswing. Investments collapsed at the beginning of the period, and although they have increased from the mid-1990s, they are still at a much lower level than the path indicated by the forecast. The level of investments grew significantly in the first four years of EU membership from 1995 to 1998 and slightly more slowly from 1999 to 2001. But after this the volume of investments declined and the trend fell behind the forecast path. In 2004, however, investments again increased markedly.

It was forecast that EU membership would affect Finland's attractiveness as a destination for inward investments. Comparing the first five years in the EU with the five preceding years, the growth in foreign direct investments is remarkable. Cumulative direct investments into Finland grew sixfold and the share of all investments originating in EU countries rose from 67 to 93 per cent. Outward investments by Finnish companies increased more than fourfold and the share going to the EU area rose from 75 to 83 per cent.

Table 2.1 Cumulative direct investments into Finland and from Finland in the periods 1990–1994 and 1995–1999, MEUR and EU share as a percentage.

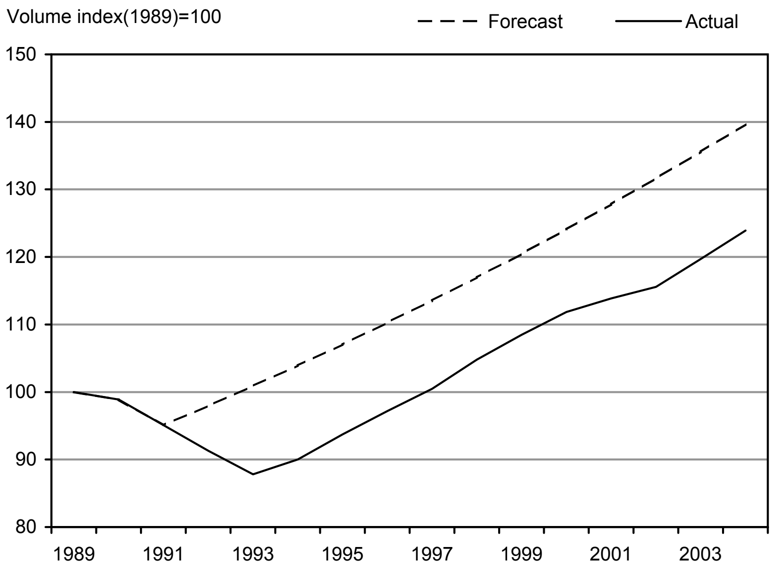
	1990–1994	1995–1999
Investments into Finland, MEUR	3.1	18.7
From EU countries, %	67	93
Investments from Finland, MEUR	7.2	31.5
To EU countries, %	75	83

Source: OECD.

Private consumption contracted by over 10 per cent between 1990 and 1993. The strength and length of the contraction in consumption gives a good indication of the severity of the recession in Finland. Even though consumption has increased since 1994 more or less at the projected rate, the level of consumption is still well below the forecast path.

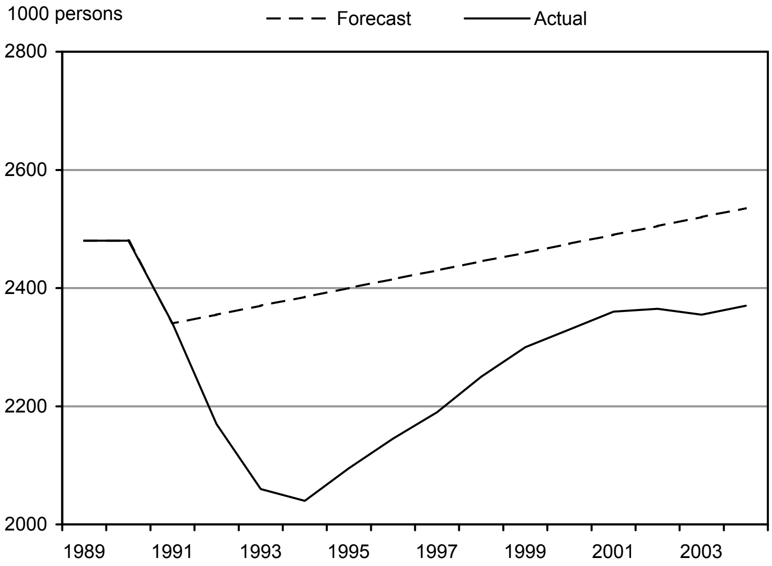
It was not until 1997 that consumption returned to its pre-recession level. Apart from economic growth, the main drivers of consumption have been the pattern of prices and taxation and employment.

Figure 2.4 Forecast vs. actual level of private consumption, 1989–2004. Index(1989)=100.



Source: VATT, 1992 and Statistics Finland.

Figure 2.5 Forecast vs. actual level of employment, 1989–2004, thousands of persons.



Source: Statistics Finland.

With the recession, the number of jobs in Finland fell up to 1994. The actual level of employment in 2005 was approximately the same as in 1991, i.e. the jobs total has not increased at all in the period 1992–2005. But compared with the pre-accession situation of 1994, the number of persons in employment has increased by over 300,000, i.e. by over 30,000 persons a year. A similar phenomenon can be observed for employment as for investments, but from 2000 onwards the pace slowed and again fell short of the forecast path. The number of persons in employment remained unchanged between 2002 and 2004.

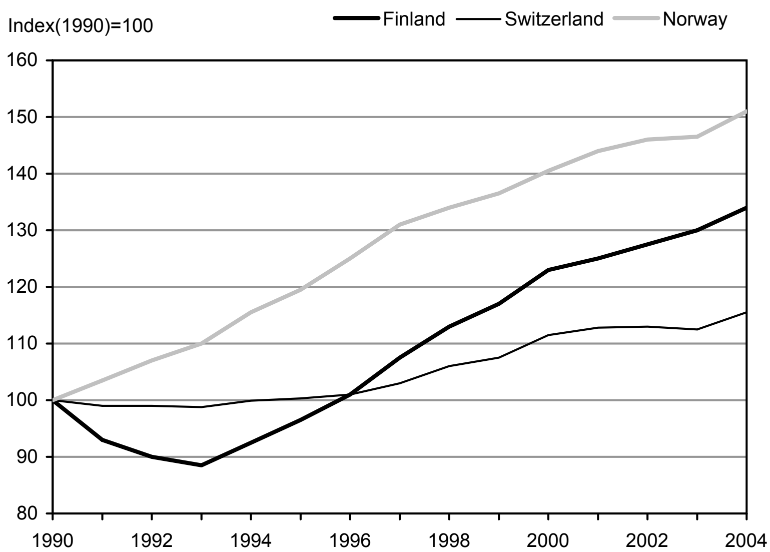
The disappearance of jobs caused a steep increase in unemployment. The unemployed total increased fivefold between 1990 and 1994, when unemployment was at its worst. Then the unemployment rate stood at 16.6 per cent. Since then unemployment has fallen fairly steadily, albeit only slowly after 2000. In 2004 the unemployment rate stood at almost 9 per cent, so that since joining the EU Finland's unemployment rate has fallen by about 8 percentage points.

Forecasts for the Finnish economy up to 2005 made before the application for EC membership seem to have been fairly accurate. Considering that the forecasts were made at a time when the recession was still getting worse, the differences between the actual and the forecast outcome for the overall economy are small. On a number of indicators, the actual outcome since 1995 has in fact been better than forecast. But because of the setback of the recession, the economy was still behind forecast in 2005 in all respects apart from exports, which have outstripped all the forecasts.

By comparison Finland's overall economic performance in the EU period has been pretty much in line with prior forecasts. But the outcome might have been similar under the EEA option. The actual outcome has been very much due to the post-recession catch-up and vastly improved competitiveness prior to EU membership.

It cannot be claimed that EU membership has given Finland a significant boost compared to Norway or Switzerland, which stayed outside the EU. Although the Finnish economy has grown faster than its peers since the mid-1990s this is at least partly attributable to the recession in the early 1990s, which afflicted Finland particularly severely. Following the recession there was plenty of spare production capacity and other resources and price competitiveness was excellent following the devaluation of the markka. The conditions for growth were exceptionally good. EU membership possibly made it easier to exploit them.

Figure 2.6 Gross domestic product 1990–2004 in Finland, Norway and Switzerland. Index(1990)=100.



Nor is it possible to deduce from the performance of Switzerland and Norway how Finland would have performed outside the EU. Within the EEA Treaty (Norway) or based on separate treaties (Switzerland) and more especially owing to their particular strengths, these countries have managed to perform favourably in many respects.

In two ways, however, the effects of the Finnish EU membership can be seen. The first is the rapid decline in Finnish interest rates in the EU period. Compared to Norway, for instance, both nominal and particularly real interest rates have been low in recent years. Interest rates came down even before Finland formally joined the euro zone. EU membership may also be linked to the increase in direct investments into and out of Finland. From the late 1990s in particular, substantial investments have been made into and by Finland, most of them into and from the EU area. No similar EU concentration can be seen for foreign investments in Norway and Switzerland. Relative to the size of the economy, Finland has received more foreign investments in the EU period than Norway or Switzerland, whereas in the early 1990s it was the other way round.

3. Finnish agriculture and CAP

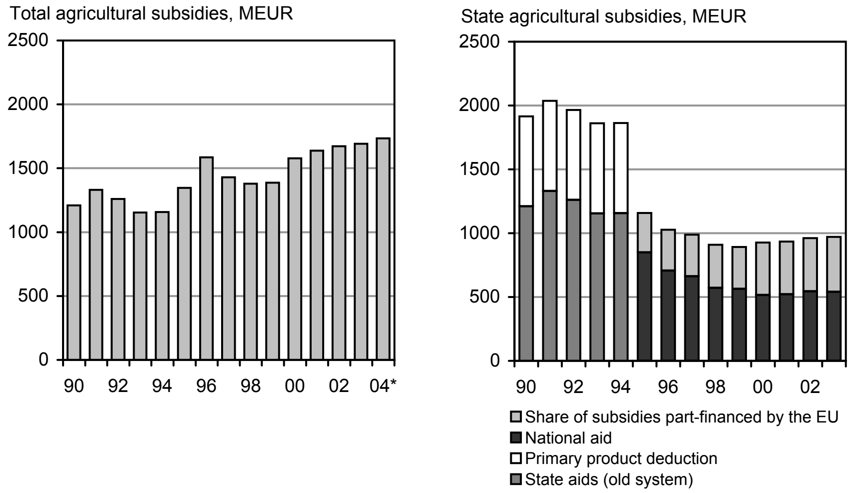
Prior to EU membership, Finnish agricultural production and the entire food sector were sheltered from foreign competition. It was known that membership would mean big changes in the operating environment and conditions of these sectors. Even though agricultural production was and still is supported in the EU through import barriers and export subsidies, i.e. applying the same principles that Finland did, there were big differences in the level of import barriers and producer prices and in the structure of the agricultural subsidy system. In prior estimates it was feared that EU membership would seriously weaken the productive capacity of agriculture and that production of certain products would cease altogether.

The food industry used Finnish ingredients. Because of the primary product deduction, the prices paid for agricultural products by the processing industry were in practice close to world market prices. Import barriers also ensured that Finnish food products were produced and processed in Finland. Import barriers were in the form of licences, import duties and excise duties. Indeed, Finland's import barriers were among the highest in Europe. Any production in excess of domestic demand was exported with state export subsidies.

Nowadays agricultural subsidies in Finland consist of CAP aid, which is common to all Member States, LFA (less favoured area) aid, environmental aid and national aid agreed with the EU and paid from Finland's own funds. The EU finances CAP aid in full, whereas around one third of LFA aid and over half of environmental aid are financed by the EU. The remainder is paid from national funds.

Finland is allowed to pay aid from national funds to farms which, even after all other forms of subsidy, suffer serious accession-related difficulties. In the EU's interpretation this is not permanent aid and negotiations were last held on the subject in 2003. The outcome of the negotiations was that Finland may grant both national, direct aid and increased investment aid to livestock holdings and horticultural producers in southern Finland up to the end of 2007. The precondition is that subsidies are reduced in stages by 2007. On the other hand Finland has been allowed to pay higher LFA subsidies to farmers in southern Finland as from 2005. Thus there is still no definitive interpretation as to how permanent the aid is.

Figure 3.1 Total aid received by agriculture between 1990 and 2004 and aid paid by the Finnish government between 1990 and 2003, MEUR.*



Source: Farm statistics year book, various years, Maatilatilastollinen vuosikirja, various years, Suomen maatalous ja maaseutuelinkeinot 2005, Törmä et al., 1995.

Before accession it was thought that Finland's national agricultural support in the EU might be in the region of EUR 500–700 million, i.e. membership would mean a reduction in agricultural expenditure in the state budget of approximately EUR 700–800 million (VATT, 1992). Figure 3.1 shows that the reduction in expenditure has been rather small.

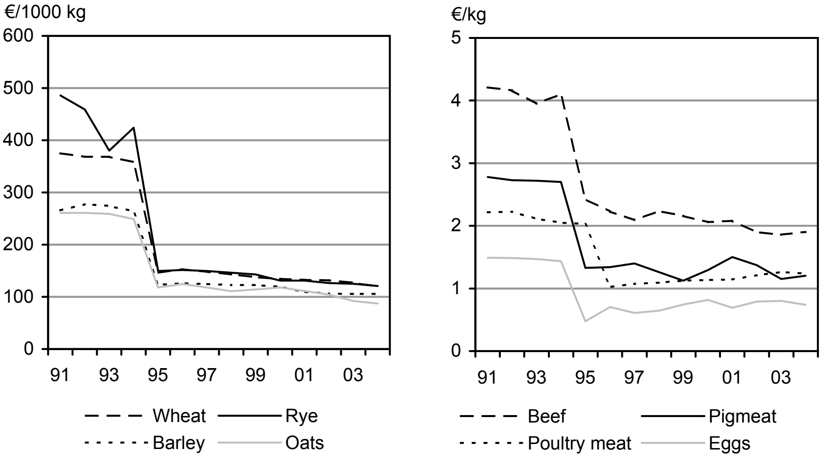
The EUR 700–800 million reduction in state agricultural expenditure that was forecast has more or less been achieved owing to the phasing-out of primary product deductions. Joining the Common Agricultural Policy appears to have resulted in considerable savings for the state. Total agricultural aid has grown significantly over the same period, so agriculture has not had to foot the bill for the savings.

3.1 Agricultural prices, production and investments

In the early 1990s prices for agricultural products were considerably higher in Finland than in the main producer countries of the EU. Figure 3.2 shows that producer prices for cereals and meat fell dramatically in the first year of membership. Following the 1995 price crash, however, the trend in producer prices for cereals has been stable.

Prices for meat and eggs also fell steeply following accession. Prices fell to about half the 1994 level, as was predicted. Since 1995 producer prices for meat and eggs have remained stable or increased slightly.

Figure 3.2 Producer prices for cereals, meat and eggs, 1991–2004.



Source: Farm statistics year book, various years, Suomen maatalous ja maaseutuelinkeinot 2005.

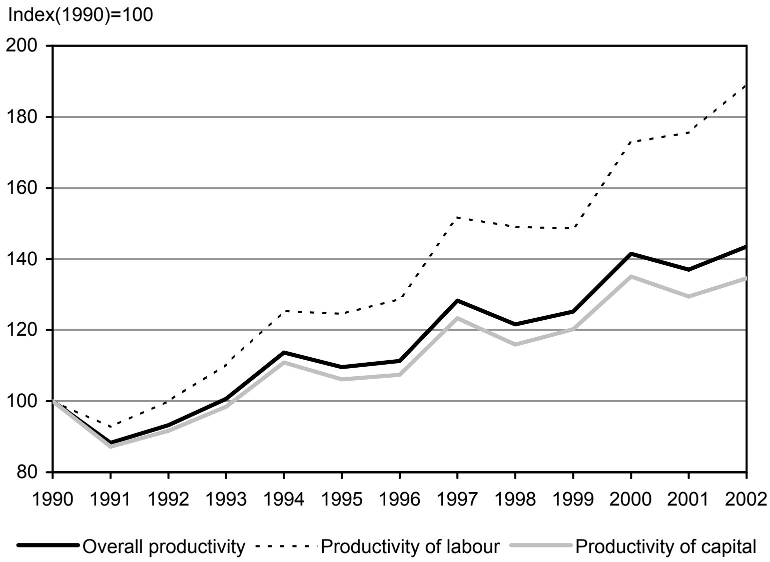
It was estimated that the producer price of Finland's principal agricultural product, milk, would fall by around a quarter, i.e. less than the price of cereals or meat (VATT, 1994). The price of milk stabilized at the forecast level at the beginning of 1995. The eventual price level was also close to the EU average.

The trend in agricultural producer prices after the mid-1990s shows that the drop in prices has been permanent. The index fell by almost 40 percentage points between 1994 and 1996 and since then has remained pretty much at the same level. The purchasing price index for the means of production fell by considerably less. It has even risen slightly since 1995, but has not regained the level that prevailed before EU membership.

It was forecast that the drop in prices of agricultural products and the changes in the subsidy system would lead to cuts in production. Even the best case foresaw production declining by a third. This scenario assumed that EU prices were on average half of Finland's pre-membership producer price level. Self-sufficiency would be around 80–90 per cent of the pre-membership level (VATT, 1992).

There is no evidence of the predicted drop in the production of the most important agricultural products. Production volumes have remained at the pre-membership or have increased. Only egg production has decreased significantly during membership. There is also evidence of a slight downturn in beef production. Agricultural investments have increased strongly during the EU period.

Figure 3.3 Productivity trend in agriculture and forestry, 1990–2002. Index(1990)=100.



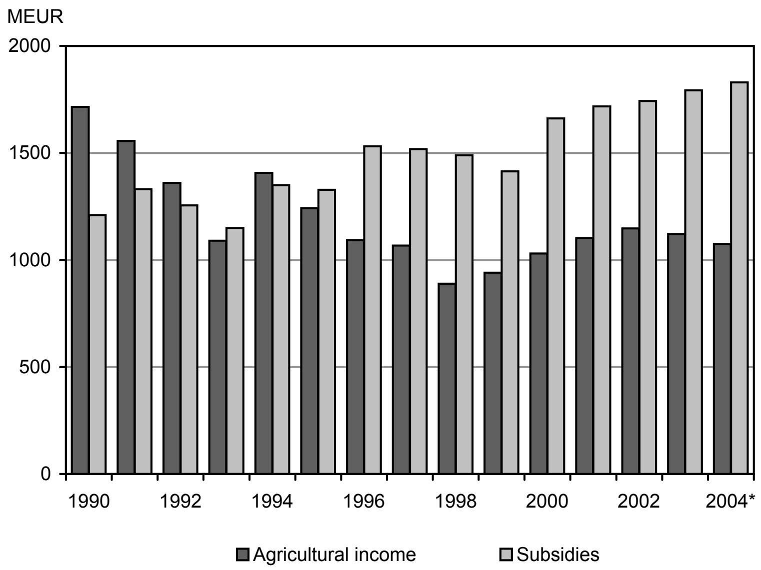
Source: Statistics Finland.

Productivity in agriculture and forestry has increased significantly. The productivity of labour almost doubled from the early 1990s up to 2002. The productivity of capital and overall productivity have developed at a fairly similar rate and are also considerably higher at the start of the 21st century than 10 years before. There is no discernable shift in the trend as between the pre-and post accession years.

3.2 Farmers' incomes

It was predicted that joining the EU's Common Agricultural Policy would mean changes in farmers' income levels and especially in the structure of incomes. As it turned out, the feared collapse in incomes did not materialize. Post accession, entrepreneurial income in agriculture has continued to fluctuate as before. In the new millennium total agricultural income has been fairly stable. The number of holdings has decreased, so the total is spread between fewer farms. Entrepreneurial income by holding almost doubled between 1994 and 2002.

Figure 3.4 Agricultural income and subsidies, 1990–2004.*



Source: Farm statistics year book, various years, Suomen maatalous ja maaseutuelinkeinot 2005.

4. Opening-up and adjustment of sheltered sectors

It was predicted that EC membership would fundamentally alter the operating environment of the so-called closed sector, which had previously also been sheltered from external competition. Liberalization of the food sector and trade in services, the abolition of public monopolies, the opening-up of public construction and other projects to competition and unlimited personal imports in the internal market would be reflected in increasing competition in retailing, service sectors and construction.

In recent years Finland has implemented a large number of reforms aimed at liberalizing markets and stimulating competition. The interesting issue from the point of view of the impacts of EU membership is whether Finland would have instituted similar reforms even if it had not been an EU member. Experience from other OECD countries suggests that Finland would have dismantled market regulation even, and perhaps especially, outside the EU.

Finland had embarked on reforms designed to increase competition before applying for membership of the EU. Some of the reforms, such as the liberalization of foreign ownership, were related to the EEA Treaty. Reforms would quite clearly have continued outside the EU, partly because of the EEA Treaty. However, the changes in the agricultural and food sector are largely on account of EU membership.

Finland's EU membership was more significant for the food industry than for other sectors of industry since the 1973 free trade agreement between Finland and the EC did not apply to agriculture or the food industry. Thus membership of the Community meant bigger changes for the sector than for the rest of industry.

For the food industry, the EU period has been marked by extensive structural change and investments in modern technology. Structural change has taken place through mergers and acquisitions. Marketing and product development have been increased and brands have been built systematically. There is increased openness (exports and imports) in the sector and companies have embarked on a rapid internationalization phase that is advancing apace, especially in the Baltic Sea region. Exports are increasing at the same time as a foreign presence is being established.

Table 4.1 Food industry and agriculture in 1990, 1995 and 2003.

	Food industry			Agriculture		
	1990	1995	2003	1990	1995	2003
Production volume, index(1990)=100	100	107	120	100	84	94
Number of employees, 1000s	58	46	41	181	139	100
Production per employee	100	135	170	100	109	170

Source: Statistics Finland, economic accounts.

Production in the food industry has increased at about the same rate as the Finns' food consumption. The use of imported inputs, the share of production that is exported and the share of consumption that is imported have all increased. The EU accounts for a larger share of both exports and imports.

Employment in the food industry has decreased and the productivity of labour and overall productivity have increased rapidly. Labour productivity increased particularly rapidly in the early 1990s when the recession forced companies to become more efficient. Even after the recession, productivity in the sector has increased more rapidly than the economy average. The growth in overall productivity has increasingly been a factor in the rise in the productivity of labour in the food industry.

Table 4.2 Factors contributing to the change in labour productivity in agriculture, the food industry and the overall economy, 1975–2002.

	Average increase in labour productivity, % p.a.			Contribution of capital intensity, % points			Contribution of overall productivity, % points		
	75-90	90-95	95-02	75-90	90-95	95-02	75-90	90-95	95-02
Agriculture	3.7	3.8	5.3	3.5	3.3	2.3	0.1	0.4	3.0
Food industry	3.4	6.3	3.3	1.6	2.5	0.3	1.9	3.7	3.0
National economy	2.9	2.7	2.1	1.5	2.4	-0.1	1.4	0.3	2.2

Source: Jalava, 2004.

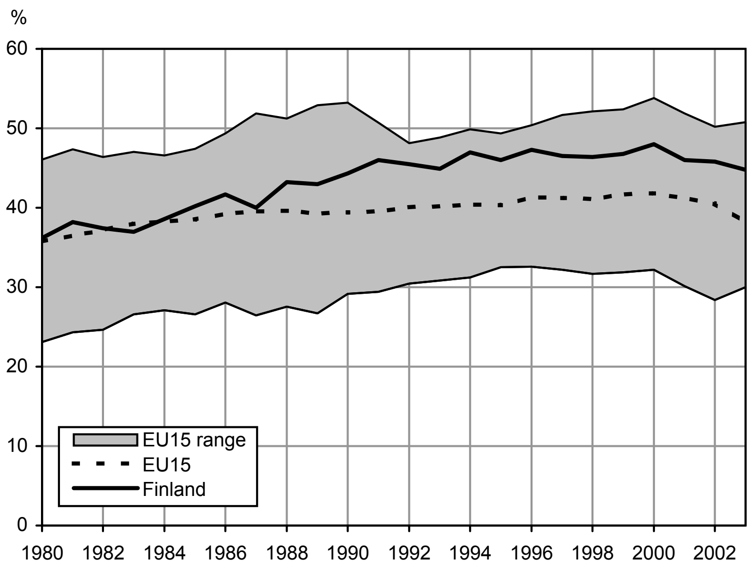
5. Changes in taxation

5.1 EU jurisdiction in taxation

In assessments of the economic impacts of EC membership performed in Finland in 1992 (VATT, 1992 and Alho et al., 1992), tax harmonization was a key part of the future scenario. VATT estimated that the loss of taxation income resulting from membership would entail cuts in public expenditure.

In the longer term, however, it was thought that the loss of taxation income would be compensated by increased purchasing power and a positive demand shock engendered by the reduction in taxation. In VATT's calculations the majority of the growth impacts brought about by membership were attributable to a substantial drop in excise duties and an associated slowing in price and wage development.

Figure 5.1 Tax rate in Finland and the EU15, 1980–2003, as a percentage of GDP.*



Source: OECD and Statistics Finland.

After the first 10 years of membership the impact of EU taxation rules on Finland's tax receipts and more on the economy generally has been much less pronounced than expected. The principal national reason for this is the deferral of cuts in alcohol taxation to 2004, when the transition period for personal imports of alcoholic beverages agreed in the membership negotiations expired.

Finland’s tax rate rose in the early 1990s, both because of tax hikes and a drop in gross domestic product. Structural changes in taxation were also made that increased the tax rate, extending the tax base of personal taxation by replacing deductions with transfer payments. At the start of EU membership the tax rate was 45.1 per cent and has hardly changed in 10 years – nor has Finland’s position compared to other EU countries. In 2003 Finland’s tax rate was 44.8 per cent, making it the fourth highest in the EU after Sweden, Denmark and Belgium and well above the average for the EU15.

A second factor that has restrained changes in taxation is that since the early 1990s very few actual harmonization steps have been concluded at the EU level. Rather than harmonization the talk has been of co-ordinating taxation. As elsewhere, the taxation reforms implemented in Finland have mainly been the result of increased international tax competition. In recent years the rulings of the EC’s Court of Justice have also had an impact on national tax legislation.

5.2 Changes in indirect taxation

Major VAT, corporate and capital taxation reforms had been implemented in Finland before membership. Research institutes – especially VATT – calculated ahead of Finland’s EC membership that a big drop in indirect taxation was on the way. However, there was no compulsion to cut indirect taxation before 2004, when alcohol taxation was reduced after the expiry of the transition periods agreed in the membership negotiations.

VATT (1992) made only a rough assessment of the impact of changes in excise duties. The assumption underlying the calculations was that EC membership would mean that taxes on tobacco, beer, alcoholic beverages and fuel would be harmonized to the EC level and other excise duties would be phased out. In this scenario the government stood to lose EUR 2.1 billion of tax revenue at 1992 levels. This represented 10.5 per cent of government tax revenues.

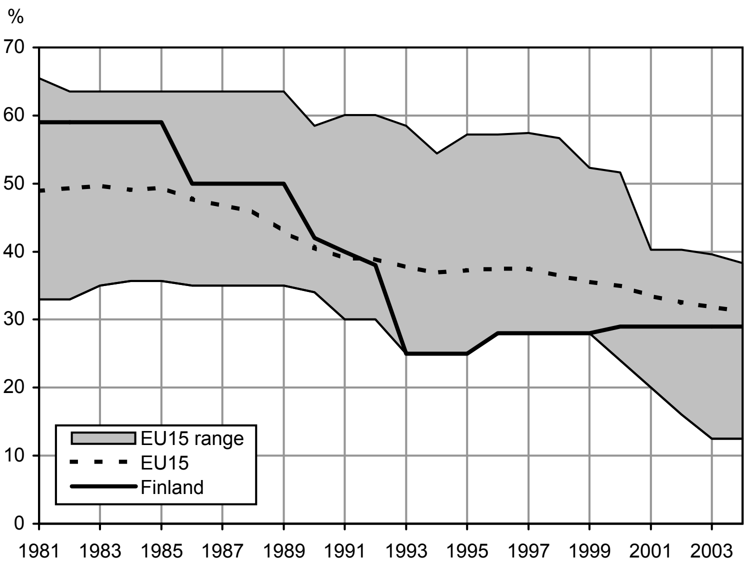
Contrary to what was forecast, the levels of excise duties on alcoholic beverages at the time of accession remained in force for a long time. The quotas on personal imports of alcohol from the EU and third countries also remained in force and were smaller than forecast. In the membership negotiations the transition period for personal imports was restricted to the end of 1996, but subsequently an extension was granted to the beginning of 2004. Right at the end of the transition period (3 December 2003) the Finnish parliament passed legislation to reduce taxation on alcohol. Urgency was added by the fact that the border between Finland and Estonia was to become an internal market border from the beginning of May 2004. The decision also abolished the quantity limits on alcohol imports from

EU countries. The limits on tobacco imports were also abolished for EU countries other than those that acceded in 2004.

The tax cuts made meant that retail prices of alcohol fell by an average of 22 per cent. In 2004 retail sales of alcoholic beverages calculated as 100 per cent alcohol increased by 10.3 per cent.

EU membership barely affected Finland's national corporate taxation legislation for the first decade of membership. The Union has no direct jurisdiction to harmonize direct taxation. However, EU countries have been faced with tax competition pressures from other parts of the world. The result has been a continual reduction in corporation tax rates in the Member States.

Figure 5.2 Tax rates on undistributed corporate profits in the EU15, 1981–2004, per cent.



Source: KPMG.

Following the example of many other Member States, Finland introduced an avoir fiscal system in 1990. The basic idea was to remove double taxation on the profits of a limited company distributed as dividends by crediting the tax paid by the company on its profit against the tax paid by the recipient of the dividend. This also ensured that distributed profits were taxed once via the company's taxation.

When it came to cross-border distribution of profits, it was the intention with the avoir fiscal system to set up a network of tax agreements. Indeed this was tried with the United Kingdom, but it did not work in practice. The general attitude towards the avoir fiscal system became more critical and the Supreme Administrative Court asked the EC Court of Justice for a preliminary ruling on whether the system is in contravention of the Treaties by discriminating against foreign owners.

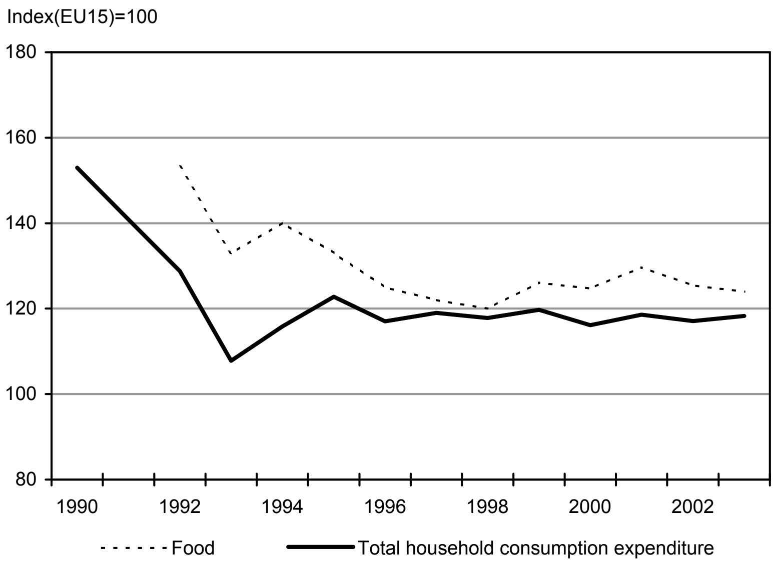
Anticipating the ruling of the Court of Justice, dividend taxation was reformed. The avoir fiscal system was abolished and dividends were partly subjected to double taxation. At the same time the corporate tax rate was reduced from 29 to 26 per cent and the capital income tax rate from 29 to 28 per cent. The legislation for the reforms was passed on 30 July 2004.

In the beginning of September 2004 the EC Court of Justice delivered its ruling, which confirmed the government's interpretation. In the light of that it indeed appears that tax levied on dividends received from the EU area has been in contravention of European law.

6. Prices and consumer purchasing power

In August 1991 the prices of consumer goods in Finland were the highest of the OECD countries. VATT (1992) forecast that EC membership would mean that producer prices in agriculture would halve, and that product prices in the food industry would fall by 30 per cent. It was forecast that agricultural policy changes, lower excise duties and tougher competition would narrow the gap between Finnish and EU prices at the rate of one per cent annually. That would have meant that by 2005 Finland's price level would have been approximately 127 per cent of the EU average.

Figure 6.1 Finnish domestic consumer price level, index(EU15)=100.



1990–1993: Index(EU12)=100.

Source: Eurostat, Statistics Finland.

Largely as a result of devaluations, the relative price level for private consumption declined by almost 30 per cent in three years, and by 1993 was just 8 per cent above the EU average. From there, however, prices rose over the next couple of years to a level around 20 per cent above the EU average (figure 6.1).

The rise in prices is partly due to the exchange rate, which strengthened from the post-devaluation level. Another reason for the rise in prices is higher pricing margins (Sauramo, 2004). For example, during the recession retailers' operating surplus plummeted to an unsustainably low level. Since the depths of the recession, retailers' operating surplus has recovered by EUR 3 billion, adding 4–5 per cent to consumer prices.

When Finland joined the European Union, food imports from other EU countries were liberalized and agricultural producer prices fell to the level of other Member States. This meant an average 11 per cent decrease in food prices. Even though Finland was not flooded with foreign foodstuffs, a slight increase in imports and above all the possibility of imports keep prices in check. Producers, Finnish industry and retailers were forced to adapt to the new situation (Lehtinen, 2004).

With changes in taxation, prices in the category 'alcoholic beverages and tobacco' fell by 12 per cent at the start of 2004. This had the effect of bringing down overall consumer prices by around 0.7 per cent.

Still some catching-up to do

Between the early 1990s and 2002, the Finnish price level declined by 20 per cent compared to the average for the EU 15. Relative prices for actual foodstuffs (excluding drinks and tobacco) fell by over 40 per cent to stand around 10 per cent above the EU average. Cuts in taxes and prices for alcoholic beverages were a significant brake on overall price increases in 2004.

Forecasts of the impact of European Union membership on prices in Finland were in the right direction. However, the devaluations of the early 1990s played a considerable part in the drop in the relative price level. When the forecasts were made it was not yet possible to take this into account. A quarter of the decline in the relative price level is due to EU membership.

7. Liberalization of capital movements

In the early 1990s Finland still applied a law (219/1939) enacted in 1939 that limited the right of foreigners to own and control real property and equities in Finland. The law was repealed as of 1 January 1993, when the EEA Treaty was due to come into force.[2]

Although EC membership did not change the legal situation regarding the regulation of capital movements, both the proponents and opponents of membership campaigned on the issue in the run-up to the membership decision. Supporters anticipated that Finland would receive substantial capital investments from abroad to boost the economy. The opponents, on the other hand, conjured up the spectre of Finland being sold out to foreigners. Both sides, therefore, foresaw the flow of capital into the country growing, but interpreted the consequences of capital inflow differently.

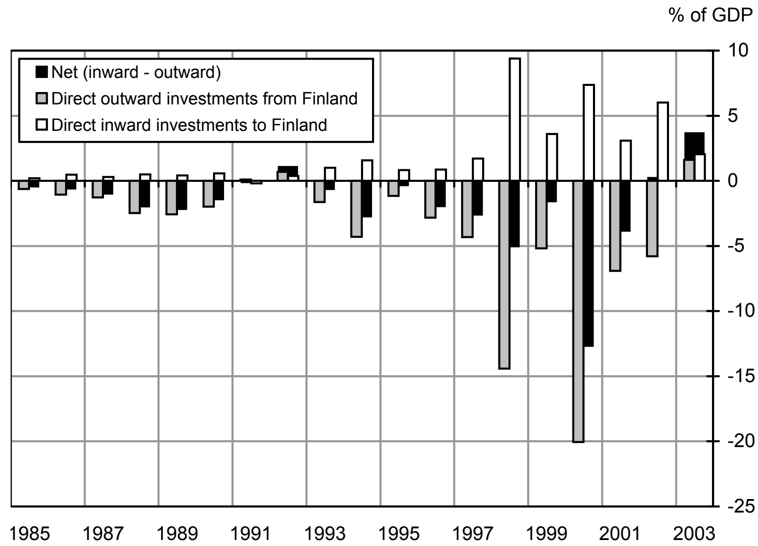
Forecasts of a sharp increase in inward investment to Finland were largely based on the image effects of EC membership; as an EC member Finland would be a more attractive proposition for foreign investors than if it remained outside.

However, the growth in direct inward investment into Finland resulting from EC membership was not forecast to be all that high. The membership dividend in terms of direct investment was put at 0.3 per cent of gross domestic product (Alho et al., 1992).

Finnish companies have as a rule invested more abroad than foreign companies have invested in Finland (figure 7.1). That was the case both before and after the law restricting ownership was repealed in 1993. Not even EU membership altered this state of affairs, even though inward investments to Finland since 1993 have increased more rapidly than outward investments from Finland. Only in 1992, 2002 and 2003 did inward investments exceed outward investments. In 1992 and 2003 the outward investment flow was negative because the capital returned to Finland by subsidiaries exceeded the new capital invested abroad. In 2002 there was more direct inward than outward investment, but the difference was relatively small.

2 The EEA Treaty was signed in May 1992 and was due to come into force in the beginning of 1993. But when the treaty was rejected in the referendum in Switzerland, its entry into force was postponed by a year.

Figure 7.1 Direct outward investments from Finland (-) and inward investments to Finland (+) and the difference between the two, 1985–2003, % of gross domestic product.



Source: Bank of Finland (a).

Sweden the main destination and source of investments

Direct outward investments from Finland in the period 1985–1992 averaged EUR 862 million annually (at nominal prices). In the period following the liberalization of capital movements from 1993 to 2003 direct outward investments averaged EUR 7076 million annually, an eightfold increase over the period of the law restricting ownership (table 7.1).

Of individual countries, Sweden has been the principal destination of Finnish corporate investment projects abroad. This applies equally to the period before and after the liberalization of capital movements. Sweden's popularity has even increased following the liberalization of capital movements. The rest of the EU has more or less maintained its position, but the USA has lost its attraction as a destination for Finnish corporate investments. Some major M&A activity explains the unusually large investment flows (Stora Enso, Nordea, Telia Sonera).

Table 7.1 Direct outward investments from Finland by country.

Country/ Group of countries	Annual average, MEUR		Percentage distribution, %	
	1985–1992	1993–2003	1985–1992	1993–2003
Sweden	234	2632	27.1	37.2
EU15 excluding Sweden	332	2560	38.5	36.2
Other Europe	94	1084	10.9	15.3
USA	202	556	23.4	7.9
Rest of world	1	243	0.2	3.4
All	862	7076	100.0	100.0

Source: Bank of Finland (a).

Direct inward investments to Finland in the period 1985–1992 averaged EUR 246 million annually. In the period following the liberalization of capital movements from 1993 to 2003, direct inward investments averaged EUR 4185 million annually, i.e. the flow of investments to Finland swelled 17-fold compared to the period under the law restricting ownership.

Sweden has been by far the largest source of foreign direct investments. During the period of EU membership Sweden's relative position as a source of inward investment capital to Finland has strengthened still further. In the period 1985–1992 around 40 per cent of inward investments to Finland came from Sweden. In the subsequent period Sweden's share rose close to around 70 per cent.

At the same time the shares of all other country groups decreased substantially. In the period 1993–2003 more investment came from Sweden to Finland than from Finland to Sweden. For other regions the situation is the opposite.

Finns invest abroad in industry, foreigners invest in Finland in services

Much of the outward investment from Finland has been in the forest and metal industries. In the entire period under review each sector accounted for approximately 25 per cent of all direct investments.

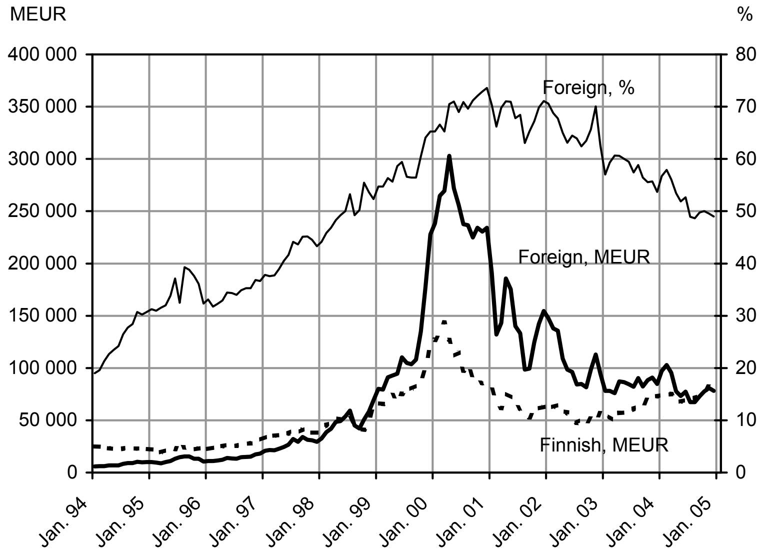
In 1996 the foreign subsidiaries of Finnish companies[3] had 137,000 employees. In 1999 there were 257,000 employees and by 2003 over

3 Here foreign subsidiaries are recipients of direct investments where the investor's ownership stake exceeds 50%. The personnel figures do not take account of the share of ownership. The figures are the total number of employees for the companies irrespective of the degree of Finnish ownership.

330,000. Around half of the employees are in companies in EU countries, although the proportion in the EU area has decreased whilst that of the rest of Europe in particular has increased. The proportion of employees in Europe and in areas outside the USA has increased sharply.

Following the liberalization of capital movements there was a particular increase in inward and outward portfolio investments.

Figure 7.2 Market value of shares listed in Helsinki and foreign ownership, 1994–2004, MEUR and per cent.



Source: Bank of Finland (c).

When the law restricting ownership by foreigners was still in force, both outward and inward portfolio investments were naturally negligible. When the law was repealed in 1993 inward portfolio investments began to increase immediately. Outward portfolio investments, on the other hand, only began to grow significantly in 1996.

Investment flows can be seen clearly in the ownership distribution of shares listed in Helsinki. Foreign ownership of equities began to increase immediately when the law restricting ownership was repealed in 1993. At its peak, foreign ownership reached 74 per cent at the end of 2000. Subsequently foreign ownership has decreased and was approximately 50 per cent at the end of 2004 (figure 7.2). These large swings in the share of ownership are largely due to big changes in the value of the most valuable company, Nokia.

8. On the impacts of Finnish EU membership on foreign trade and the production and regional structure

Even though the EEA Treaty admitted Finland to the EC's internal market programme, it was predicted that EC membership would further impact the Finnish economy through changes to the structure of foreign trade and the related economy.

8.1 Impacts of integration on the production structure and foreign trade

The benefits of deeper European integration have been propounded on the basis of the new theory of international trade, where imperfect competition and economies of scale in production play a central role. In conditions of imperfect competition, the benefits of integration and the expansion of trade are based on changes in the availability of the factors of production and relative productivity and also changed market structures. As trade barriers come down, the natural market area of individual companies increases.

Table 8.1 presents key figures giving the dispersion of Finnish foreign trade and production for 1995 and 2001. The index, which represents the share of intra-industry trade, is calculated for all trade and for trade with EU countries and non-EU countries. The figures in the table are calculated on the basis of a detailed (6-figure) classification of goods. The material comprises almost 1000 names of goods or products. The concentration of production is represented by both a Gini ratio and a Herfindahl index. The values of the Gini ratio vary between 0 and 1, and an increase in the index indicates an increase in concentration. The Herfindahl index is the sum of the squares of the output shares of the goods. The export specialization index is a modification of the Herfindahl index, where the squares of the output shares of exports are added together.

The figures in table 8.1 indicate that the concentration of both production and exports have increased, whether concentration is measured by export specialization, the Herfindahl index of production or the Gini ratio. An interesting feature is that although intra-industry trade as a whole has increased, its importance in trade with the EU has decreased – albeit very slightly. In this respect the anticipated internal market impacts would not appear to have materialized.

Table 8.1 Concentration of foreign trade, key figures.

	1995	2001
Grubel-Lloyd for all trade	0.4242	0.4333
Grubel-Lloyd EU trade	0.4086	0.3942
Grubel-Lloyd non-EU trade	0.3279	0.3435
Gini ratio – production	0.8145	0.8305
Gini ratio – exports	0.8726	0.8806
Gini ratio – imports	0.7758	0.7968
Herfindahl index for the concentration of production	0.0136	0.0146
Export specialization index	0.0008	0.0012

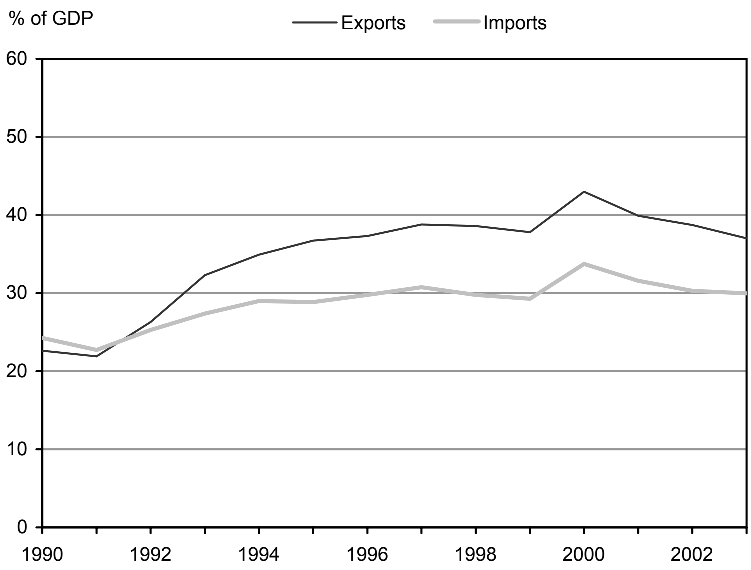
Intra-industry trade has increased with non-EU countries, but is less widespread than in EU trade. Countries that engage in a lot of intra-industry trade are generally relatively similar in their income level and availability of the factors of production. In non-EU trade the countries differ more from Finland in respect of these factors. The growth in intra-industry trade with non-EU countries is largely explained by increased intra-industry trade in the electronics industry.

Trend in exports during EU membership

Exports and imports grew strongly in the early 1990s before Finland became a member of the EU. With the improved competitiveness from the devaluation of the markka, export-led growth got going in 1992.

Both prior to and since membership, exports to the EU area grew more slowly than overall exports. This was partly because, with the collapse of exports to the Soviet Union, the share of exports to the EU was exceptionally high at the start of the 1990s. Exports to Asian countries and to the former socialist countries of central and eastern Europe – the new EU countries – grew strongly in the early 1990s.

Figure 8.1 Relative share of exports and imports of gross domestic product.



Impacts of EU membership on foreign trade slight

Even though the Finnish economy opened up rapidly in the 1990s, in the light of the structural indicators described above foreign trade has changed only little. The share of intra-industry trade has been fairly stable for a prolonged period. The OECD (2002) has analysed the development of intra-industry trade in its member countries in the periods 1988–1991, 1992–1995 and 1996–2000. The OECD's index for Finnish intra-industry trade over the period as a whole has remained more or less unchanged.

An assessment of the impacts of increased export specialization and intra-industry trade on the productivity of labour in manufacturing industry reveals that changes in the structure of trade appear to have contributed just 0.1 per cent annually to the growth in labour productivity, whereas the increase in labour productivity in the late 1990s was 4.1 per cent annually.

Finland's EU membership came at a time of exceptionally rapid changes in technological development. EU trade has played a marginal role in this development. Technological change – whatever the factors driving it forward – has altered foreign trade so much that the impacts of EU membership pale in comparison.

8.2 Regional development in the 1990s[4]

Regional differences in production and income levels in Finland had been narrowing right up to the recession of the early 1990s. (Kangasharju 1998,

4 This subject is described in more detail in the study by Kangasharju and Pekkala, 2004.

Loikkanen et al. 1998, Pekkala 1999). The same phenomenon has been observed in other countries and between countries. Economic theory explains this so-called convergence phenomenon as the decreasing (marginal) return on capital and the spread of innovation and knowledge.

However, Finland's regional development no longer followed this theoretical and empirical rule in the 1990s, rather differences in production and income levels began to grow concurrently with an economic crisis, EU membership and a general opening-up of the economy.

Internal migration led to a greater concentration of the population in wealthy areas. International migration also played a slightly greater role. This is probably due to the boost given by EU membership to migration between Finland and other EU countries and more generally the advance of globalization.

It is difficult to isolate the impacts of EU membership on regional development from other concurrent impacts, including big swings in the economy, the spread of globalization and the so-called new economy. A rapid decline in jobs in agriculture was already underway earlier.

EU membership and globalization as a whole brought down barriers to trade, increasing competition and emphasizing the role of so-called agglomeration benefits. The recession freed up a lot of resources, allowing a further consolidation of centralization. Thus the economic crisis, together with the general integration trend, accelerated regional centralization in the 1990s.

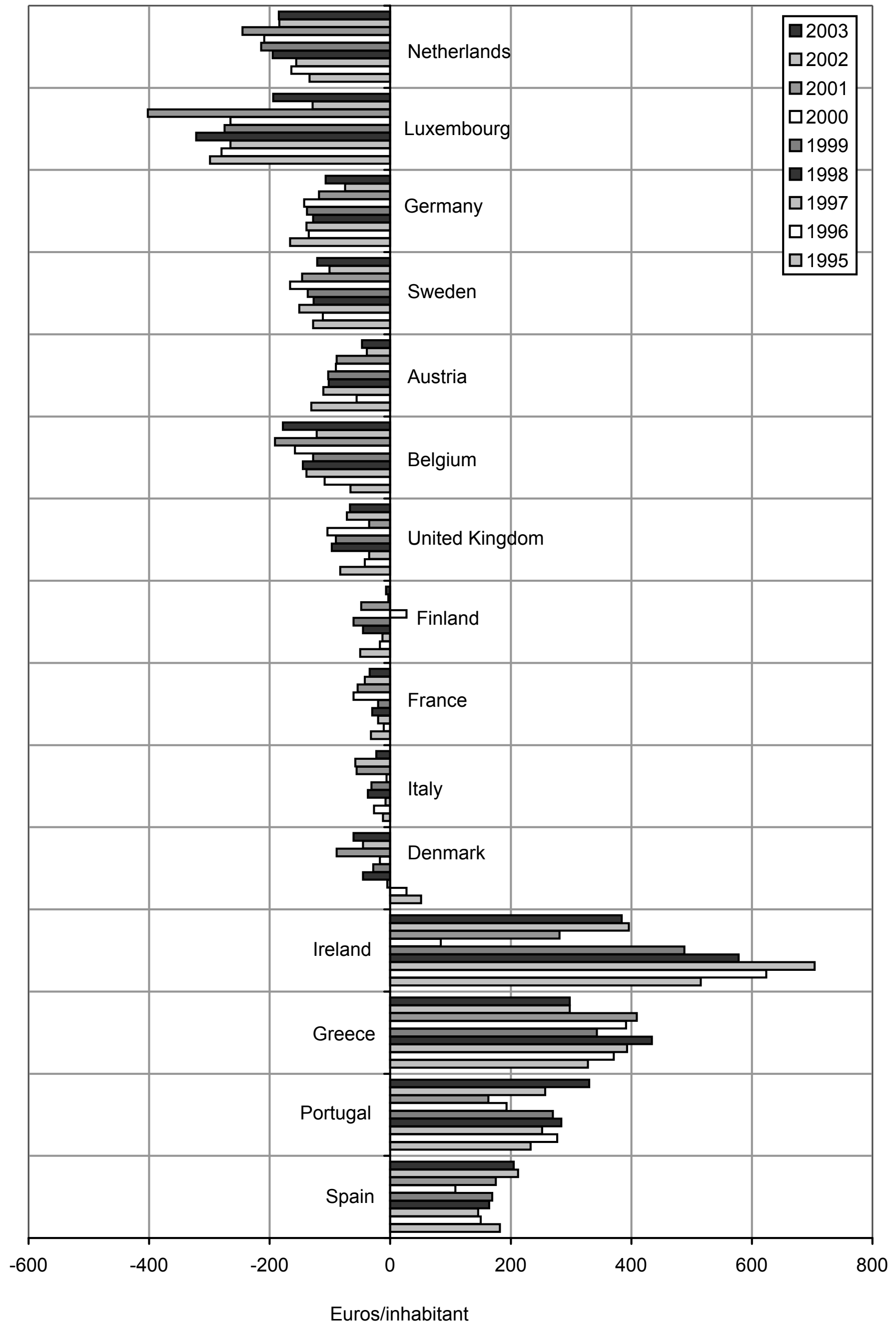
9. Finland's net payments to the EU budget

It was difficult to put forward very precise estimates of the scale of Finland's net payment before membership negotiations were concluded. Alho et al. (1992) based their calculations on the Commission's opinion of Finland's membership application and certain assumptions regarding the development of the Finnish economy in the 1990s. They concluded that Finland's net payment would be in the region of EUR 400 million (0.5% of gross domestic product) at the end of the 1990s. The study by VATT (1992) did not present any calculations as such, but it was estimated that the net payment would be roughly of the same magnitude.

In the 10-year period from 1995 to 2004, Finland's annual payments have increased steadily from around EUR 1 billion to around EUR 1.5 billion a year. This increase has been slightly higher than the increase in Finland's gross domestic product. From 1996 payments and Finland's overall production have increased at the same rate. Finland's receipts from the EU have fluctuated strongly. For this reason there have been similarly large variations in Finland's net payment between years.

Over the entire 10-year period Finland has paid a total of EUR 12.3 billion to the EU and received EUR 10.8 billion. Thus the total net payment has been EUR 1.5 billion or an average of EUR 152 million annually. Relative to gross domestic product the net payment has averaged 0.15 per cent.

Figure 9.1 Net payments or net receipts by Member State, 1995–2003, euros per inhabitant.



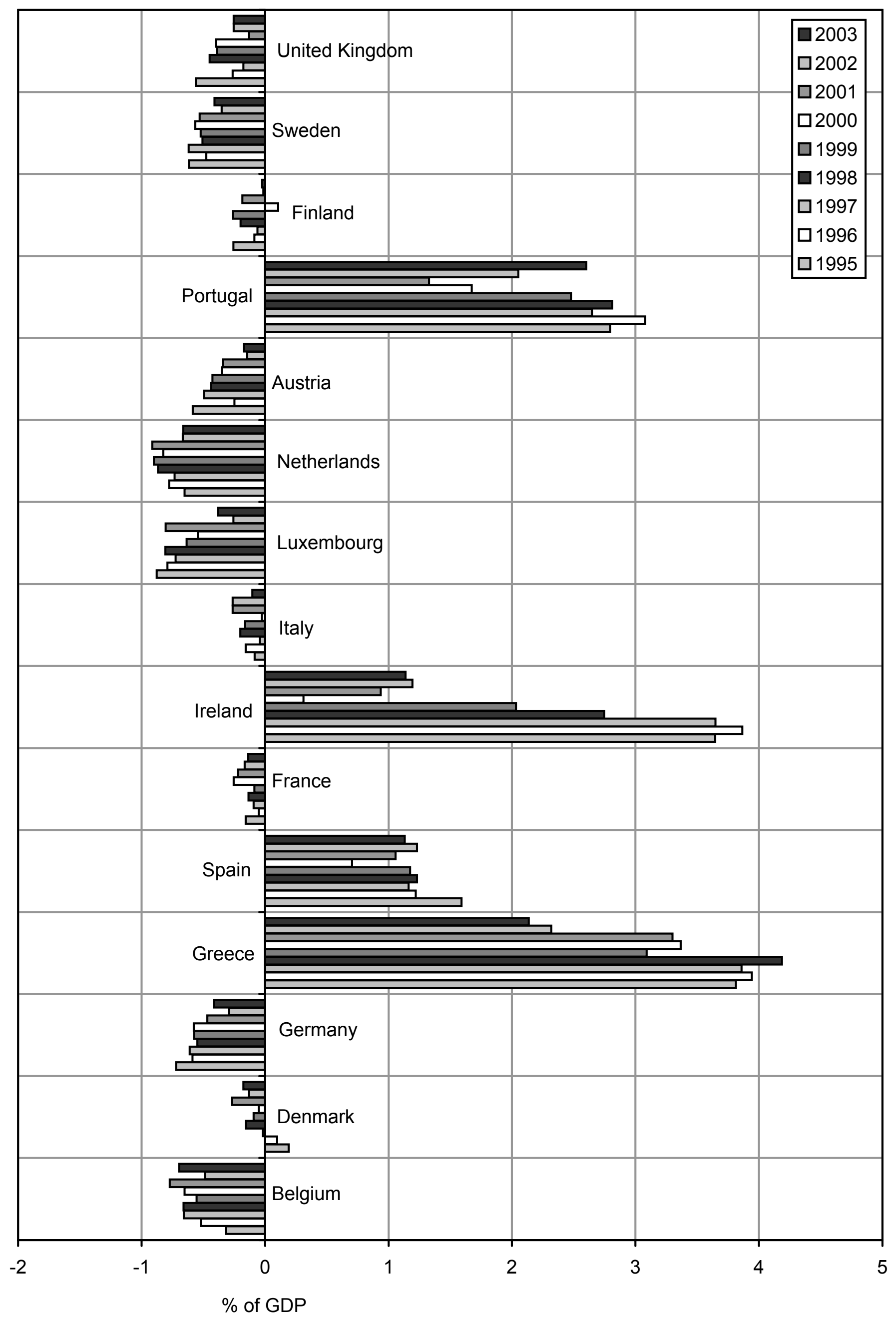
Supplementary table 9.1
Net payments or net receipts by Member State, 1995–2003, MEUR.

Country	1995	1996	1997	1998	1999	2000	2001	2002	2003
Belgium	-669	-1103	-1420	-1478	-1307	-1617	-1957	-1261	-1848
Denmark	264	142	-26	-237	-150	-89	-475	-240	-331
Germany	-13544	-11017	-11379	-10492	-11388	-11721	-9701	-6153	-8838
Greece	3428	3863	4133	4564	3640	4144	4322	3277	3266
Spain	7112	5867	5758	6468	6645	4303	6905	8566	8379
France	-1874	-614	-1151	-1736	-1181	-3610	-3233	-2503	-2120
Ireland	1852	2227	2579	2134	1821	320	1075	1543	1517
Italy	-708	-1526	-450	-2141	-1782	-317	-3213	-3304	-1350
Luxembourg	-121	-113	-112	-136	-119	-116	-177	-57	-88
Netherlands	-2066	-2521	-2439	-3052	-3365	-3310	-3916	-2965	-3003
Austria	-1054	-451	-898	-826	-839	-723	-726	-316	-383
Portugal	2307	2718	2486	2823	2677	1934	1635	2652	3451
Finland	-254	-87	-66	-230	-313	137	-249	-18	-35
Sweden	-1131	-982	-1350	-1124	-1228	-1471	-1299	-896	-1087
United Kingdom	-4862	-2453	-2066	-5706	-5323	-6209	-2088	-4219	-3990

Supplementary table 9.2
Net payments or net receipts by Member State, 1995–2003, euros per inhabitant.

Country	1995	1996	1997	1998	1999	2000	2001	2002	2003
Belgium	-66	-109	-139	-145	-128	-158	-191	-122	-178
Denmark	51	27	-5	-45	-28	-17	-89	-45	-61
Germany	-166	-135	-139	-128	-138	-143	-118	-75	-107
Greece	328	371	393	434	343	391	409	298	298
Spain	182	150	146	164	169	108	175	212	205
France	-32	-11	-20	-30	-20	-61	-54	-42	-34
Ireland	515	624	704	578	488	84	281	396	384
Italy	-12	-27	-8	-37	-31	-6	-56	-58	-23
Luxembourg	-299	-280	-265	-322	-275	-265	-402	-129	-194
Netherlands	-134	-164	-156	-195	-214	-209	-245	-184	-185
Austria	-131	-56	-111	-102	-103	-90	-89	-39	-47
Portugal	233	277	252	284	270	193	163	257	330
Finland	-50	-17	-13	-45	-61	27	-48	-3	-7
Sweden	-128	-112	-151	-127	-137	-166	-146	-101	-121
United Kingdom	-83	-42	-35	-97	-90	-104	-35	-72	-67

Supplementary figure 9.1
Net payments or net receipts by Member State, 1995–2003, % of gross domestic product.



10. Conclusions

Comparing Finland's economic performance since EU membership to the preceding period shows membership in a positive light. This is natural since the years preceding membership were a period of recession. By any standards, Finland's economy has performed well in the EU period. In terms of employment and unemployment, the performance has been at best satisfactory, but here too Finland is close to the average for the EU15. The figures for growth in overall production and especially exports and industrial production have been excellent. It is impossible to say to what extent these figures are the result of EU membership.

Whether the outturn would have been similar or better in the EEA environment than as an EU member will remain conjecture. Even a comparison with former EFTA countries that have gone through their own integration processes does not provide a clear answer to this. Of the largest EFTA countries, Austria, Sweden and Finland joined the European Union in the beginning of 1995. Austria and Finland also joined the euro zone in 1999. Sweden has so far retained its own currency. Norway has the EEA agreement with the EU, but Switzerland rejected this too. Compared with the performance of these countries from the mid-1990s, Finland comes off very favourably in many respects. Economic growth has been rapid, inflation has been low, interest rates have come down and public finances have been in balance. The only area where Finland clearly lags behind is unemployment. Finland's unemployment rate is still high, even though it has almost halved since the record reached in 1994.

Evaluations of the impacts of membership conducted prior to accession stressed changes in taxation, because in the early 1990s the EU was making a concerted push to harmonize indirect taxation. This might have entailed a significant lowering of value added tax and other indirect taxes in Finland. It is only in the last couple of years that the EU has begun to have an effect on taxation, with cuts in taxes on alcohol and motor vehicles and the abolition of the avoir fiscal system. Despite these changes in taxation, the overriding outcome is that EU membership has not led to a meltdown scenario of a collapse in tax revenues or a dismantling of the welfare state. On the contrary, all the Nordic countries have retained their high overall levels of taxation.

The most pronounced impact of EU membership was on Finland's agriculture and food industry. Joining the Common Agriculture meant a total change in the subsidy system and a sharp drop in producer prices. At the same time, agriculture and the food industry became part of the European internal market and the competition that goes with it. Since there was no guarantee that production costs would come down, it was feared that domestic production would come to a halt and that rural areas would be deserted.

On the whole agriculture appears to have adjusted to the changed environment better than expected. The number of employees and farms has decreased, but more slowly than was forecast. Producer prices have come down more rapidly than production costs, but then again production volumes and incomes have turned out more favourably than forecast. Agricultural subsidies have increased and productivity is up.

The decrease in producer prices in agriculture has also been reflected in lower consumer prices. Finland's food industry has been forced to rationalize and internationalize, but has held on to its market share relatively well.

Finland has been thorough in implementing the internal market directives and has deregulated, even in areas where other EU countries have advanced more slowly. Admittedly these steps, such as communications liberalization, had been initiated before EU membership and would probably have gone ahead even outside the EU.

In sectors outside of the food chain, the impact of the EU is more difficult to ascertain. It was thought that integration would lead to increased trade in the internal market area. But this has not happened; rather the EU's share of Finland's foreign trade has decreased since membership. The resurgence of Russia and the strong growth in the Asian economies have directed trade outside of Europe. There are no signs of the structural changes resulting from consolidation of production and/or increased intra-sectoral trade that were forecast. Rather the principal change has been the structural change resulting from the technological revolution whereby the electronics industry has become a new cornerstone of Finnish exports.

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